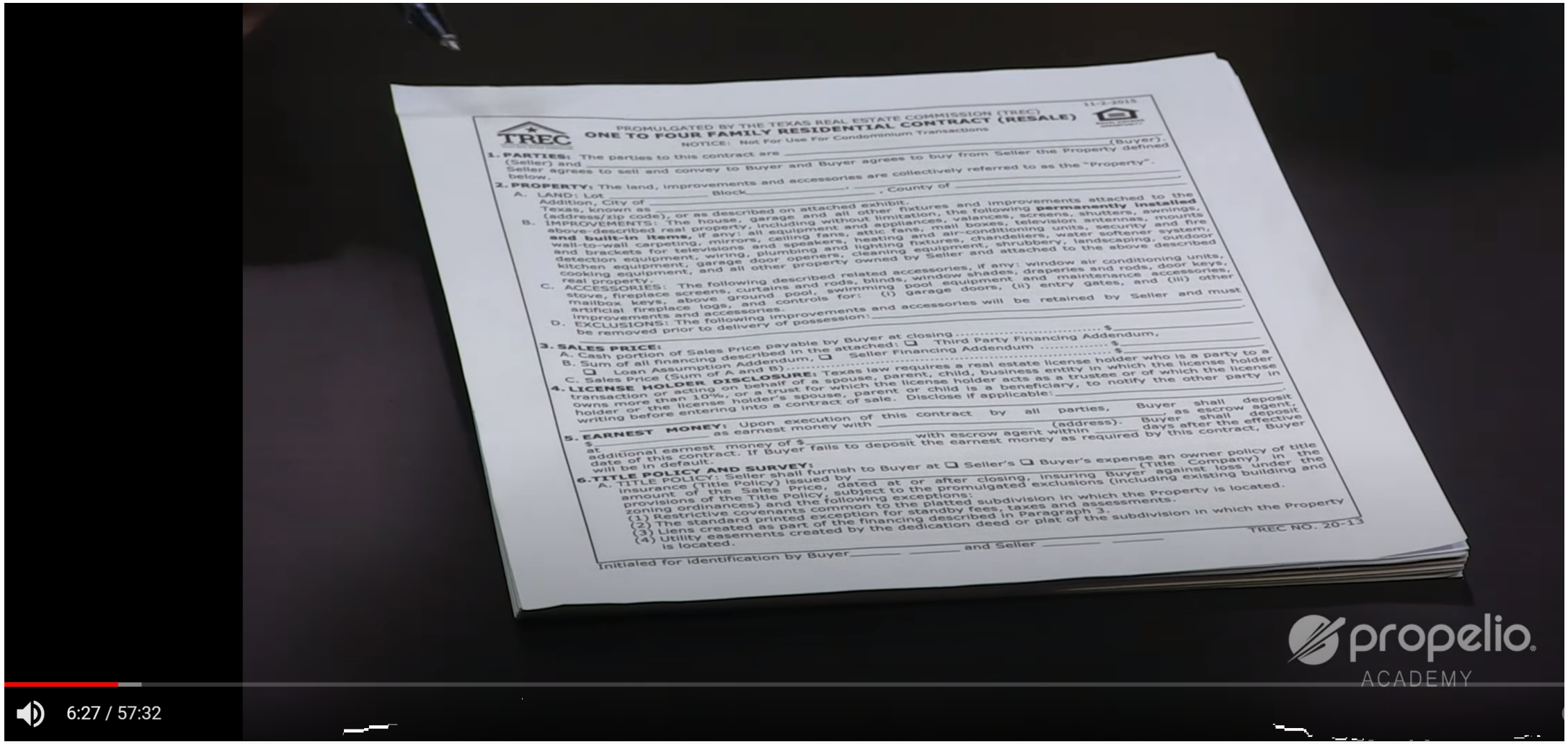

How to contract a Seller - Subject to Contracts

All Sales Related

PROMULGATED BY THE TEXAS REAL ESTATE COMMISSION (TREC)

ONE TO FOUR FAMILY RESIDENTIAL CONTRACT (RESALE)

NOTICE: Not For Use For Condominium Transactions

1. PARTIES: The parties to this contract are _____ (Buyer). (Seller) and _____ Seller agrees to sell and convey to Buyer and Buyer agrees to buy from Seller the Property defined below.

2. PROPERTY: The land, improvements and accessories are collectively referred to as the "Property".

A. LAND: Lot _____ Block _____, _____, County of _____, Addition, City of _____ Texas, known as _____ (address/zip code), or as described on attached exhibit.

B. IMPROVEMENTS: The house, garage and all other fixtures and improvements attached to the above-described real property, including without limitation, the following **permanently installed and built-in items,** if any: all equipment and appliances, valances, screens, shutters, awnings, wall-to-wall carpeting, mirrors, ceiling fans, attic fans, mail boxes, television antennas, mounts and brackets for televisions and speakers, heating and air-conditioning units, security and fire detection equipment, wiring, plumbing and lighting fixtures, chandeliers, water softener system, kitchen equipment, garage door openers, cleaning equipment, shrubbery, landscaping, outdoor cooking equipment, and all other property owned by Seller and attached to the above described real property.

C. ACCESSORIES: The following described related accessories, if any: window air conditioning units, stove, fireplace screens, curtains and rods, blinds, window shades, draperies and rods, door keys, mailbox keys, above ground pool, swimming pool equipment and maintenance accessories, artificial fireplace logs, and controls for: (i) garage doors, (ii) entry gates, and (iii) other improvements and accessories.

D. EXCLUSIONS: The following improvements and accessories will be retained by Seller and must be removed prior to delivery of possession: _____.

3. SALES PRICE:

A. Cash portion of Sales Price payable by Buyer at closing ..... $ _____

B. Sum of all financing described in the attached: ☐ Third Party Financing Addendum, ☐ Loan Assumption Addendum, ☐ Seller Financing Addendum ..... $ _____

C. Sales Price (Sum of A and B) ..... $ _____

4. LICENSE HOLDER DISCLOSURE: Texas law requires a real estate license holder who is a party to a transaction or acting on behalf of a spouse, parent, child, business entity in which the license holder owns more than 10%, or a trust for which the license holder acts as a trustee or of which the license holder or the license holder's spouse, parent or child is a beneficiary, to notify the other party in writing before entering into a contract of sale. Disclose if applicable: _____.

5. EARNEST MONEY: Upon execution of this contract by all parties, Buyer shall deposit $ _____ as earnest money with _____, as escrow agent, at _____ (address). Buyer shall deposit additional earnest money of $ _____ with escrow agent within _____ days after the effective date of this contract. If Buyer fails to deposit the earnest money as required by this contract, Buyer will be in default.

6. TITLE POLICY AND SURVEY:

A. TITLE POLICY: Seller shall furnish to Buyer at ☐ Seller's ☐ Buyer's expense an owner policy of title insurance (Title Policy) issued by _____ (Title Company) in the amount of the Sales Price, dated at or after closing, insuring Buyer against loss under the provisions of the Title Policy, subject to the promulgated exclusions (including existing building and zoning ordinances) and the following exceptions:

(1) Restrictive covenants common to the platted subdivision in which the Property is located.

(2) The standard printed exception for standby fees, taxes and assessments.

(3) Liens created as part of the financing described in Paragraph 3.

(4) Utility easements created by the dedication deed or plat of the subdivision in which the Property is located.

How to contract a Seller - Subject to Contracts

PROPERTY: The land, improvements and accessories are collectively referred to as the "Property".

A. LAND: Lot _____ Block _____, _____ Addition, City of _____, County of _____, Texas, known as _____ (address/zip code), or as described on attached exhibit.

B. IMPROVEMENTS: The house, garage and all other fixtures and improvements attached to the above-described real property, including without limitation, the following **permanently installed and built-in items,** if any: all equipment and appliances, valances, screens, shutters, awnings, wall-to-wall carpeting, mirrors, ceiling fans, attic fans, mail boxes, television antennas, mounts and brackets for televisions and speakers, heating and air-conditioning units, security and fire detection equipment, wiring, plumbing and lighting fixtures, chandeliers, water softener system, kitchen equipment, garage door openers, cleaning equipment, shrubbery, landscaping, outdoor cooking equipment, and all other property owned by Seller and attached to the above described real property.

C. ACCESSORIES: The following described related accessories, if any: window air conditioning units, stove, fireplace screens, curtains and rods, blinds, window shades, draperies and rods, door keys, mailbox keys, above ground pool, swimming pool equipment and maintenance accessories, artificial fireplace logs, and controls for: (i) garage doors, (ii) entry gates, and (iii) other improvements and accessories.

D. EXCLUSIONS: The following improvements and accessories will be retained by Seller and must be removed prior to delivery of possession: _____.

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A. Cash portion of Sales Price payable by Buyer at closing ..... $_____

B. Sum of all financing described in the attached: ☐ Third Party Financing Addendum, ☐ Loan Assumption Addendum, ☐ Seller Financing Addendum ..... $_____

C. Sales Price (Sum of A and B) ..... $_____

4. LICENSE HOLDER DISCLOSURE: Texas law requires a real estate license holder who is a party to a transaction or acting on behalf of a spouse, parent, child, business entity in which the license holder owns more than 10%, or a trust for which the license holder acts as a trustee or of which the license holder or the license holder's spouse, parent or child is a beneficiary, to notify the other party in writing before entering into a contract of sale. Disclose if applicable: _____.

5. EARNEST MONEY: Upon execution of this contract by all parties, Buyer shall deposit $_____ as earnest money with _____, as escrow agent, at _____ (address). Buyer shall deposit additional earnest money of $_____ with escrow agent within _____ days after the effective date of this contract. If Buyer fails to deposit the earnest money as required by this contract, Buyer will be in default.

6. TITLE POLICY AND SURVEY:

A. TITLE POLICY: Seller shall furnish to Buyer at ☐ Seller's ☐ Buyer's expense an owner policy of title insurance (Title Policy) issued by _____ (Title Company) in the amount of the Sales Price, dated at or after closing, insuring Buyer against loss under the provisions of the Title Policy, subject to the promulgated exclusions (including existing building and zoning ordinances) and the following exceptions:

(1) Restrictive covenants common to the platted subdivision in which the Property is located.

(2) The standard printed exception for standby fees, taxes and assessments.

(3) Liens created as part of the financing described in Paragraph 3.

(4) Utility easements created by the dedication deed or plat of the subdivision in which the Property is located.

(5) Reservations or exceptions otherwise permitted by this contract or as may be approved by Buyer in writing.
(6) The standard printed exception as to marital rights.
(7) The standard printed exception as to waters, tidelands, beaches, streams, and related matters.
(8) The standard printed exception as to discrepancies, conflicts, shortages in area or boundary lines, encroachments or protrusions, or overlapping improvements: ☐(i) will not be amended or deleted from the title policy; or ☐(ii) will be amended to read, "shortages in area" at the expense of ☐Buyer ☐Seller.

B. COMMITMENT: Within 20 days after the Title Company receives a copy of this contract, Seller shall furnish to Buyer a commitment for title insurance (Commitment) and, at Buyer's expense, legible copies of restrictive covenants and documents evidencing exceptions in the Commitment (Exception Documents) other than the standard printed exceptions. Seller authorizes the Title Company to deliver the Commitment and Exception Documents to Buyer at Buyer's address shown in Paragraph 21. If the Commitment and Exception Documents are not delivered to Buyer within the specified time, the time for delivery will be automatically extended up to 15 days or 3 days before the Closing Date, whichever is earlier. If, due to factors beyond Seller's control, the Commitment and Exception Documents are not delivered within the time required, Buyer may terminate this contract and the earnest money will be refunded to Buyer.

C. SURVEY: The survey must be made by a registered professional land surveyor acceptable to the Title Company and Buyer's lender(s). (Check one box only)

☐(1) Within _____ days after the effective date of this contract, Seller shall furnish to Buyer and Title Company Seller's existing survey of the Property and a Residential Real Property Affidavit promulgated by the Texas Department of Insurance (T-47 Affidavit). **If Seller fails to furnish the existing survey or affidavit within the time prescribed, Buyer shall obtain a new survey at Seller's expense no later than 3 days prior to Closing Date.** If the existing survey or affidavit is not acceptable to Title Company or Buyer's lender(s), Buyer shall obtain a new survey at ☐Seller's ☐Buyer's expense no later than 3 days prior to Closing Date.

☐(2) Within _____ days after the effective date of this contract, Buyer shall obtain a new survey at Buyer's expense. Buyer is deemed to receive the survey on the date of actual receipt or the date specified in this paragraph, whichever is earlier.

☐(3) Within _____ days after the effective date of this contract, Seller, at Seller's expense shall furnish a new survey to Buyer.

D. OBJECTIONS: Buyer may object in writing to defects, exceptions, or encumbrances to title: disclosed on the survey other than items 6A(1) through (7) above; disclosed in the Commitment other than items 6A(1) through (8) above; or which prohibit the following use or activity: _____.

Buyer must object the earlier of (i) the Closing Date or (ii) _____ days after Buyer receives the Commitment, Exception Documents, and the survey. Buyer's failure to object within the time allowed will constitute a waiver of Buyer's right to object; except that the requirements in Schedule C of the Commitment are not waived by Buyer. Provided Seller is not obligated to incur any expense, Seller shall cure the timely objections of Buyer or any third party lender within 15 days after Seller receives the objections and the Closing Date will be extended as necessary. If objections are not cured within such 15 day period, this contract will terminate and the earnest money will be refunded to Buyer unless Buyer waives the objections.

E. TITLE NOTICES:

(1) ABSTRACT OR TITLE POLICY: Broker advises Buyer to have an abstract of title covering the Property examined by an attorney of Buyer's selection, or Buyer should be furnished with or obtain a Title Policy. If a Title Policy is furnished, the Commitment should be promptly reviewed by an attorney of Buyer's choice due to the underlying matters or Buyer's right to object.

(2) MEMBERSHIP IN PROPERTY OWNERS ASSOCIATION(S): The Property ☐is ☐is not subject to mandatory membership in a property owners association(s). If the Property is subject to mandatory membership in a property owners association(s), Seller notifies Buyer under §5.012, Texas Property Code, that, as a purchaser of property in the residential community identified in Paragraph 2A in which the Property is located, you are

9:17 / 57:32

to contract a Seller - Subject to Contracts

(Address of Property)

(5) Reservations or exceptions otherwise permitted by this contract or as may be approved by Buyer in writing.
(6) The standard printed exception as to marital rights.
(7) The standard printed exception as to waters, tidelands, beaches, streams, and related matters.
(8) The standard printed exception as to discrepancies, conflicts, shortages in area or boundary lines, encroachments or protrusions, or overlapping improvements: ☐(i) will not be amended or deleted from the title policy; or ☐(ii) will be amended to read, "shortages in area" at the expense of ☐Buyer ☐Seller.

B. COMMITMENT: Within 20 days after the Title Company receives a copy of this contract, Seller shall furnish to Buyer a commitment for title insurance (Commitment) and, at Buyer's expense, legible copies of restrictive covenants and documents evidencing exceptions in the Commitment (Exception Documents) other than the standard printed exceptions. Seller authorizes the Title Company to deliver the Commitment and Exception Documents to Buyer at Buyer's address shown in Paragraph 21. If the Commitment and Exception Documents are not delivered to Buyer within the specified time, the time for delivery will be automatically extended up to 15 days or 3 days before the Closing Date, whichever is earlier. If, due to factors beyond Seller's control, the Commitment and Exception Documents are not delivered within the time required, Buyer may terminate this contract and the earnest money will be refunded to Buyer.

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☐(1) Within _____ days after the effective date of this contract, Seller shall furnish to Buyer and Title Company Seller's existing survey of the Property and a Residential Real Property Affidavit promulgated by the Texas Department of Insurance (T-47 Affidavit). **If Seller fails to furnish the existing survey or affidavit within the time prescribed, Buyer shall obtain a new survey at Seller's expense no later than 3 days prior to Closing Date.** If the existing survey or affidavit is not acceptable to Title Company or Buyer's lender(s), Buyer shall obtain a new survey at ☐Seller's ☐Buyer's expense no later than 3 days prior to Closing Date.
☐(2) Within _____ days after the effective date of this contract, Buyer shall obtain a new survey at Buyer's expense. Buyer is deemed to receive the survey on the date of actual receipt or the date specified in this paragraph, whichever is earlier.
☐(3) Within _____ days after the effective date of this contract, Seller, at Seller's expense shall furnish a new survey to Buyer.

D. OBJECTIONS: Buyer may object in writing to defects, exceptions, or encumbrances to title: disclosed on the survey other than items 6A(1) through (7) above; disclosed in the Commitment other than items 6A(1) through (8) above; or which prohibit the following use or activity: _____.
Buyer must object the earlier of (i) the Closing Date or (ii) _____ days after Buyer receives the Commitment, Exception Documents, and the survey. Buyer's failure to object within the time allowed will constitute a waiver of Buyer's right to object; except that the requirements in Schedule C of the Commitment are not waived by Buyer. Provided Seller is not obligated to incur any expense, Seller shall cure the timely objections of Buyer or any third party lender within 15 days after Seller receives the objections and the Closing Date will be extended as necessary. If objections are not cured within such 15 day period, this contract will terminate and the earnest money will be refunded to Buyer unless Buyer waives the objections.

E. TITLE NOTICES:
(1) ABSTRACT OR TITLE POLICY: Broker advises Buyer to have an abstract of title covering the Property examined by an attorney of Buyer's selection, or Buyer should be furnished with or obtain a Title Policy. If a Title Policy is furnished, the Commitment should be promptly reviewed by an attorney of Buyer's choice due to the time limitations on Buyer's right to object.
(2) MEMBERSHIP IN PROPERTY OWNERS ASSOCIATION(S): The Property ☐is ☐is not subject to mandatory membership in a property owners association(s). If the Property is subject to mandatory membership in a property owners association(s), Seller notifies Buyer under §5.012, Texas Property Code, that, as a purchaser of property in the residential community identified in which the Property is located, you are obligated to be a member of the property owners association(s). Restrictive covenants governing the use and occupancy of the Property and all dedicatory instruments governing the establishment, maintenance, or operation of this residential community have been or will be recorded in the Deed Records of the county in which the Property is located. Copies of the restrictive covenants and dedicatory instruments may be obtained from the county clerk. You are **obligated to pay assessments to the property owners association. The amount of the assessments is subject to**

Initialed for identification by Buyer_____ Buyer _____ _____

TREC NO. 20-

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(5) Reservations or exceptions otherwise permitted by this contract or as may be approved by Buyer in writing.
(6) The standard printed exception as to marital rights.
(7) The standard printed exception as to waters, tidelands, beaches, streams, and related matters.
(8) The standard printed exception as to discrepancies, conflicts, shortages in area or boundary lines, encroachments or protrusions, or overlapping improvements: ❑(i) will not be amended or deleted from the title policy; or ❑(ii) will be amended to read, "shortages in area" at the expense of ❑Buyer ❑Seller.

B. COMMITMENT: Within 20 days after the Title Company receives a copy of this contract, Seller shall furnish to Buyer a commitment for title insurance (Commitment) and, at Buyer's expense, legible copies of restrictive covenants and documents evidencing exceptions in the Commitment (Exception Documents) other than the standard printed exceptions. Seller authorizes the Title Company to deliver the Commitment and Exception Documents to Buyer at Buyer's address shown in paragraph 21. If the Commitment and Exception Documents are not delivered to Buyer within the specified time, the time for delivery will be automatically extended up to 15 days or 3 days before the Closing Date, whichever is earlier. If, due to factors beyond Seller's control, the Commitment and Exception Documents are not delivered within the time required, Buyer may terminate this contract and the earnest money will be refunded to Buyer.

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Buyer must object the earlier of (i) the Closing Date or (ii) _____ days after Buyer receives the Commitment, Exception Documents, and the survey. Buyer's failure to object within the time allowed will constitute a waiver of Buyer's right to object; except that the requirements in Schedule C of the Commitment are not waived by Buyer. Provided Seller is not obligated to incur any expense, Seller shall cure the timely objections of Buyer or any third party lender within 15 days after Seller receives the objections and the Closing Date will be extended as necessary. If objections are not cured within such 15 day period, this contract will terminate and the earnest money will be refunded to Buyer unless Buyer waives the objections.

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(1) ABSTRACT OR TITLE POLICY: Broker advises Buyer to have an abstract of title covering the Property examined by an attorney of Buyer's selection, or Buyer should be furnished with or obtain a Title Policy. If a Title Policy is furnished, the Commitment should be promptly reviewed by an attorney of Buyer's choice due to the time limitations on Buyer's right to object.
(2) MEMBERSHIP IN PROPERTY OWNERS ASSOCIATION(S): The Property ❑is ❑is not subject to mandatory membership in a property owners association(s). If the Property is subject to mandatory membership in a property owners association(s), Seller notifies Buyer under §5.012, Texas Property Code, that, as a purchaser of property in the residential community identified in Paragraph 2A in which the Property is located, you are obligated to be a member of the property owners association(s). Restrictive covenants governing the use and occupancy of the Property and all dedicatory instruments governing the establishment, maintenance, or operation of this residential community have been or will be recorded in the Real Property Records of the county in which the Property is located. Copies of the restrictive covenants and dedicatory instruments may be obtained from the county clerk. **You are obligated to pay assessments to the property owners association(s). The amount of the assessments is subject to**

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Contract Concerning _____ (Address of Property)

change. Your failure to pay the assessments could result in enforcement of the association's lien on and the foreclosure of the Property.

Section 207.003, Property Code, entitles an owner to receive copies of any document that governs the establishment, maintenance, or operation of a subdivision, including, but not limited to, restrictions, bylaws, rules and regulations, and a resale certificate from a property owners' association. A resale certificate contains information including, but not limited to, statements specifying the amount and frequency of regular assessments and the style and cause number of lawsuits to which the property owners' association is a party, other than lawsuits relating to unpaid ad valorem taxes of an individual member of the association. These documents must be made available to you by the property owners' association or the association's agent on your request.

If Buyer is concerned about these matters, the TREC promulgated Addendum for Property Subject to Mandatory Membership in a Property Owners Association(s) should be used.

(3) STATUTORY TAX DISTRICTS: If the Property is situated in a utility or other statutorily created district providing water, sewer, drainage, or flood control facilities and services, Chapter 49, Texas Water Code, requires Seller to deliver and Buyer to sign the statutory notice relating to the tax rate, bonded indebtedness, or standby fee of the district prior to final execution of this contract.

(4) TIDE WATERS: If the Property abuts the tidally influenced waters of the state, §33.135, Texas Natural Resources Code, requires a notice regarding coastal area property to be included in the contract. An addendum containing the notice promulgated by TREC or required by the parties must be used.

(5) ANNEXATION: If the Property is located outside the limits of a municipality, Seller notifies Buyer under §5.011, Texas Property Code, that the Property may now or later be included in the extraterritorial jurisdiction of a municipality and may now or later be subject to annexation by the municipality. Each municipality maintains a map that depicts its boundaries and extraterritorial jurisdiction. To determine if the Property is located within a municipality's extraterritorial jurisdiction, contact all municipalities located in the general proximity of the Property for further information.

(6) PROPERTY LOCATED IN A CERTIFICATED SERVICE AREA OF A UTILITY SERVICE PROVIDER: Notice required by §13.257, Water Code: The real property, described in Paragraph 2, that you are about to purchase may be located in a certificated water or sewer service area, which is authorized by law to provide water or sewer service to the properties in the certificated area. If your property is located in a certificated area there may be special costs or charges that you will be required to pay before you can receive water or sewer service. There may be a period required to construct lines or other facilities necessary to provide water or sewer service to your property. You are advised to determine if the property is in a certificated area and contact the utility service provider to determine the cost that you will be required to pay and the period, if any, that is required to provide water or sewer service to your property. The undersigned Buyer hereby acknowledges receipt of the foregoing notice at or before the execution of a binding contract for the purchase of the real property described in Paragraph 2 or at closing of purchase of the real property.

(7) PUBLIC IMPROVEMENT DISTRICTS: If the Property is in a public improvement district, §5.014, Property Code, requires Seller to notify Buyer as follows: As a purchaser of this parcel of real property you are obligated to pay an assessment to a municipality or county for an improvement project undertaken by a public improvement district under Chapter 372, Local Government Code. The assessment may be due annually or in periodic installments. More information concerning the amount of the assessment and the due dates of that assessment may be obtained from the municipality or county levying the assessment. The amount of the assessments is subject to change. Your failure to pay the assessments could result in a lien on and the foreclosure of your property.

(8) TRANSFER FEES: If the Property is subject to a private transfer fee obligation, §5.205, Property Code, requires Seller to notify Buyer as follows: The private transfer fee obligation may be governed by Chapter 5, Subchapter G of the Texas Property Code.

(9) PROPANE GAS SYSTEM SERVICE AREA: If the Property is located in a propane gas system service area owned by a distribution system retailer, Seller must give Buyer written notice as required by §141.010, Texas Utilities Code. An addendum containing the notice approved by TREC or required by the parties should be used.

(10) NOTICE OF WATER LEVEL FLUCTUATIONS: If the Property adjoins an impoundment of water, including a reservoir or lake, constructed and maintained under Chapter 11, Water Code, that has a storage capacity of at least 5,000 acre-feet at the impoundment's normal operating level, Seller hereby notifies Buyer: "The water level of the impoundment of water adjoining the Property fluctuates for various reasons, including as

Initialed for identification by Buyer _____ _____ and Seller _____ _____

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a result of: (1) an entity lawfully exercising its right to use the water stored in the impoundment; or (2) drought or flood conditions."

7. PROPERTY CONDITION:

A. ACCESS, INSPECTIONS AND UTILITIES: Seller shall permit Buyer and Buyer's agents access to the Property at reasonable times. Buyer may have the Property inspected by inspectors selected by Buyer and licensed by TREC or otherwise permitted by law to make inspections. Any hydrostatic testing must be separately authorized by Seller in writing. Seller at Seller's expense shall immediately cause existing utilities to be turned on and shall keep the utilities on during the time this contract is in effect.

B. SELLER'S DISCLOSURE NOTICE PURSUANT TO §5.008, TEXAS PROPERTY CODE (Notice):

(Check one box only)

☐ (1) Buyer has received the Notice.

☐ (2) Buyer has not received the Notice. Within _____ days after the effective date of this contract, Seller shall deliver the Notice to Buyer. If Buyer does not receive the Notice, Buyer may terminate this contract at any time prior to the closing and the earnest money will be refunded to Buyer. If Seller delivers the Notice, Buyer may terminate this contract for any reason within 7 days after Buyer receives the Notice or prior to the closing, whichever first occurs, and the earnest money will be refunded to Buyer.

☐ (3) The Seller is not required to furnish the notice under the Texas Property Code.

C. SELLER'S DISCLOSURE OF LEAD-BASED PAINT AND LEAD-BASED PAINT HAZARDS is required by Federal law for a residential dwelling constructed prior to 1978.

D. ACCEPTANCE OF PROPERTY CONDITION: "As Is" means the present condition of the Property with any and all defects and without warranty except for the warranties of title and the warranties in this contract. Buyer's agreement to accept the Property As Is under Paragraph 7D(1) or (2) does not preclude Buyer from inspecting the Property under Paragraph 7A, from negotiating repairs or treatments in a subsequent amendment, or from terminating this contract during the Option Period, if any.

(Check one box only)

☐ (1) Buyer accepts the Property As Is.

☐ (2) Buyer accepts the Property As Is provided Seller, at Seller's expense, shall complete the following specific repairs and treatments: _____

_____

(Do not insert general phrases, such as "subject to inspections" that do not identify specific repairs and treatments.)

E. LENDER REQUIRED REPAIRS AND TREATMENTS: Unless otherwise agreed in writing, neither party is obligated to pay for lender required repairs, which includes treatment for wood destroying insects. If the parties do not agree to pay for the lender required repairs or treatments, this contract will terminate and the earnest money will be refunded to Buyer. If the cost of lender required repairs and treatments exceeds 5% of the Sales Price, Buyer may terminate this contract and the earnest money will be refunded to Buyer.

F. COMPLETION OF REPAIRS AND TREATMENTS: Unless otherwise agreed in writing: (i) Seller shall complete all agreed repairs and treatments prior to the Closing Date; and (ii) all required permits must be obtained, and repairs and treatments must be performed by persons who are licensed to provide such repairs or treatments or, if no license is required by law, are commercially engaged in the trade of providing such repairs or treatments. At Buyer's election, any transferable warranties received by Seller with respect to the repairs and treatments will be transferred to Buyer at Buyer's expense. If Seller fails to complete any agreed repairs and treatments prior to the Closing Date, Buyer may exercise remedies under Paragraph 15 or extend the Closing Date up to 5 days if necessary for Seller to complete the repairs and treatments.

G. ENVIRONMENTAL MATTERS: Buyer is advised that the presence of wetlands, toxic substances, including asbestos and wastes or other environmental hazards, or the presence of a threatened or endangered species or its habitat may affect Buyer's intended use of the Property. If Buyer is concerned about these matters, an addendum promulgated by TREC or required by the parties should be used.

H. RESIDENTIAL SERVICE CONTRACTS: Buyer may purchase a residential service contract from a residential service company licensed by TREC. If Buyer purchases a residential service contract, Seller shall reimburse Buyer at closing for the cost of the residential service contract in an amount not exceeding $_____. Buyer should review any residential service contract for the scope of coverage, exclusions and limitations. **The purchase of a residential service contract is optional. Similar coverage may be purchased from various companies authorized to do business in Texas.**

8. BROKERS' FEES: All obligations of the parties for payment of brokers' fees are contained in separate written agreements.

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9.CLOSING:

A. The closing of the sale will be on or before _____, 20____, or within 7 days after objections made under Paragraph 6D have been cured or waived, whichever date is later (Closing Date). If either party fails to close the sale by the Closing Date, the non-defaulting party may exercise the remedies contained in Paragraph 15.

B. At closing:

(1) Seller shall execute and deliver a general warranty deed conveying title to the Property to Buyer and showing no additional exceptions to those permitted in Paragraph 6 and furnish tax statements or certificates showing no delinquent taxes on the Property.

(2) Buyer shall pay the Sales Price in good funds acceptable to the escrow agent.

(3) Seller and Buyer shall execute and deliver any notices, statements, certificates, affidavits, releases, loan documents and other documents reasonably required for the closing of the sale and the issuance of the Title policy.

(4) There will be no liens, assessments, or security interests against the Property which will not be satisfied out of the sales proceeds unless securing the payment of any loans assumed by Buyer and assumed loans will not be in default.

(5)If the Property is subject to a residential lease, Seller shall transfer security deposits (as defined under §92.102, Property Code), if any, to Buyer. In such an event, Buyer shall deliver to the tenant a signed statement acknowledging that the Buyer has acquired the Property and is responsible for the return of the security deposit, and specifying the exact dollar amount of the security deposit.

10.POSSESSION:

A. Buyer's Possession: Seller shall deliver to Buyer possession of the Property in its present or required condition, ordinary wear and tear excepted: ☐upon closing and funding ☐according to a temporary residential lease form promulgated by TREC or other written lease required by the parties. Any possession by Buyer prior to closing or by Seller after closing which is not authorized by a written lease will establish a tenancy at sufferance relationship between the parties. **Consult your insurance agent prior to change of ownership and possession because insurance coverage may be limited or terminated. The absence of a written lease or appropriate insurance coverage may expose the parties to economic loss.**

B. Leases:

(1)After the Effective Date, Seller may not execute any lease (including but not limited to mineral leases) or convey any interest in the Property without Buyer's written consent.

(2) If the Property is subject to any lease to which Seller is a party, Seller shall deliver to Buyer copies of the lease(s) and any move-in condition form signed by the tenant within 7 days after the Effective Date of the contract.

11.SPECIAL PROVISIONS: (Insert only factual statements and business details applicable to the sale. TREC rules prohibit license holders from adding factual statements or business details for which a contract addendum, lease or other form has been promulgated by TREC for mandatory use.)

12. SETTLEMENT AND OTHER EXPENSES:

A. The following expenses must be paid at or prior to closing:

(1) Expenses payable by Seller (Seller's Expenses):

(a) Releases of existing liens, including prepayment penalties and recording fees; release of Seller's loan liability; tax statements or certificates; preparation of deed; one-half of escrow fee; and other expenses payable by Seller under this contract.

(b) Seller shall also pay an amount not to exceed $_____ to be applied in the following order: Buyer's Expenses which Buyer is prohibited from paying by FHA, VA, Texas Veterans Land Board or other governmental loan programs, and then to other Buyer's Expenses as allowed by the lender.

(2) Expenses payable by Buyer (Buyer's Expenses): Appraisal fees; loan application fees; origination charges; credit reports; preparation of loan documents; interest on the notes from date of disbursement to one month prior to dates of first monthly payments; recording fees; copies of easements and restrictions; loan title policy with endorsements required by lender; loan-related inspection fees; photos; amortization schedules; one-half of escrow fee; all prepaid items, including required premiums for flood and hazard insurance, reserve deposits for insurance, ad valorem taxes and special governmental assessments; final compliance inspection; courier fee; repair inspection; underwriting fee; wire transfer fee; expenses incident to any loan; Private

Initialed for identification by Buyer _____ _____ and Seller _____ _____

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Mortgage Insurance Premium (PMI), VA Loan Funding Fee, or FHA Mortgage Insurance Premium (MIP) as required by the lender; and other expenses payable by Buyer under this contract.

B. If any expense exceeds an amount expressly stated in this contract for such expense to be paid by a party, that party may terminate this contract unless the other party agrees to pay such excess. Buyer may not pay charges and fees expressly prohibited by FHA, VA, Texas Veterans Land Board or other governmental loan program regulations.

13. PRORATIONS: Taxes for the current year, interest, maintenance fees, assessments, dues and rents will be prorated through the Closing Date. The tax proration may be calculated taking into consideration any change in exemptions that will affect the current year's taxes. If taxes for the current year vary from the amount prorated at closing, the parties shall adjust the prorations when tax statements for the current year are available. If taxes are not paid at or prior to closing, Buyer shall pay taxes for the current year.

14. CASUALTY LOSS: If any part of the Property is damaged or destroyed by fire or other casualty after the effective date of this contract, Seller shall restore the Property to its previous condition as soon as reasonably possible, but in any event by the Closing Date. If Seller fails to do so due to factors beyond Seller's control, Buyer may (a) terminate this contract and the earnest money will be refunded to Buyer (b) extend the time for performance up to 15 days and the Closing Date will be extended as necessary or (c) accept the Property in its damaged condition with an assignment of insurance proceeds, if permitted by Seller's insurance carrier, and receive credit from Seller at closing in the amount of the deductible under the insurance policy. Seller's obligations under this paragraph are independent of any other obligations of Seller under this contract.

15. DEFAULT: If Buyer fails to comply with this contract, Buyer will be in default, and Seller may (a) enforce specific performance, seek such other relief as may be provided by law, or both, or (b) terminate this contract and receive the earnest money as liquidated damages, thereby releasing both parties from this contract. If Seller fails to comply with this contract, Seller will be in default and Buyer may (a) enforce specific performance, seek such other relief as may be provided by law, or both, or (b) terminate this contract and receive the earnest money, thereby releasing both parties from this contract.

16. MEDIATION: It is the policy of the State of Texas to encourage resolution of disputes through alternative dispute resolution procedures such as mediation. Any dispute between Seller and Buyer related to this contract which is not resolved through informal discussion will be submitted to a mutually acceptable mediation service or provider. The parties to the mediation shall bear the mediation costs equally. This paragraph does not preclude a party from seeking equitable relief from a court of competent jurisdiction.

17. ATTORNEY'S FEES: A Buyer, Seller, Listing Broker, Other Broker, or escrow agent who prevails in any legal proceeding related to this contract is entitled to recover reasonable attorney's fees and all costs of such proceeding.

18. ESCROW:

A. ESCROW: The escrow agent is not (i) a party to this contract and does not have liability for the performance or nonperformance of any party to this contract, (ii) liable for interest on the earnest money and (iii) liable for the loss of any earnest money caused by the failure of any financial institution in which the earnest money has been deposited unless the financial institution is acting as escrow agent.

B. EXPENSES: At closing, the earnest money must be applied first to any cash down payment, then to Buyer's Expenses and any excess refunded to Buyer. If no closing occurs, escrow agent may: (i) require a written release of liability of the escrow agent from all parties, (ii) require payment of unpaid expenses incurred on behalf of a party, and (iii) only deduct from the earnest money the amount of unpaid expenses incurred on behalf of the party receiving the earnest money.

C. DEMAND: Upon termination of this contract, either party or the escrow agent may send a release of earnest money to each party and the parties shall execute counterparts of the release and deliver same to the escrow agent. If either party fails to execute the release, either party may make a written demand to the escrow agent for the earnest money. If only one party makes written demand for the earnest money, escrow agent shall promptly provide a copy of the demand to the other party. If escrow agent does not receive written objection to the demand from the other party within 15 days, escrow agent may disburse the earnest money to the party making demand reduced by the amount of unpaid expenses incurred on behalf of the party receiving the earnest money and escrow agent may pay the same to the creditors. If escrow agent complies with the provisions of this paragraph, each party hereby releases escrow agent from all adverse claims related to the disbursal of the earnest money.

14:50 / 57:32
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D. DAMAGES: Any party who wrongfully fails or refuses to sign a release acceptable to the escrow agent within 7 days of receipt of the request will be liable to the other party for (i) damages; (ii) the earnest money; (iii) reasonable attorney's fees; and (iv) all costs of suit.

E. NOTICES: Escrow agent's notices will be effective when sent in compliance with Paragraph 21. Notice of objection to the demand will be deemed effective upon receipt by escrow agent.

19. REPRESENTATIONS: All covenants, representations and warranties in this contract survive closing. If any representation of Seller in this contract is untrue on the Closing Date, Seller will be in default. Unless expressly prohibited by written agreement, Seller may continue to show the Property and receive, negotiate and accept back up offers.

20. FEDERAL TAX REQUIREMENTS: If Seller is a "foreign person," as defined by applicable law, or if Seller fails to deliver an affidavit to Buyer that Seller is not a "foreign person," then Buyer shall withhold from the sales proceeds an amount sufficient to comply with applicable tax law and deliver the same to the Internal Revenue Service together with appropriate tax forms. Internal Revenue Service regulations require filing written reports if currency in excess of specified amounts is received in the transaction.

21. NOTICES: All notices from one party to the other must be in writing and are effective when mailed to, hand-delivered at, or transmitted by fax or electronic transmission as follows:

To Buyer at: _____

Phone: ( ) _____

Fax: ( ) _____

E-mail: _____

To Seller at: _____

Phone: ( ) _____

Fax: ( ) _____

E-mail: _____

22. AGREEMENT OF PARTIES: This contract contains the entire agreement of the parties and cannot be changed except by their written agreement. Addenda which are a part of this contract are (Check all applicable boxes):

- ☐ Third Party Financing Addendum
- ☐ Seller Financing Addendum
- ☐ Addendum for Property Subject to Mandatory Membership in a Property Owners Association
- ☐ Buyer's Temporary Residential Lease
- ☐ Loan Assumption Addendum
- ☐ Addendum for Sale of Other Property by Buyer
- ☐ Addendum for Reservation of Oil, Gas and Other Minerals
- ☐ Addendum for "Back-Up" Contract
- ☐ Addendum for Coastal Area Property
- ☐ Environmental Assessment, Threatened or Endangered Species and Wetlands Addendum
- ☐ Seller's Temporary Residential Lease
- ☐ Short Sale Addendum
- ☐ Addendum for Property Located Seaward of the Gulf Intracoastal Waterway
- ☐ Addendum for Seller's Disclosure of Information on Lead-based Paint and Lead-based Paint Hazards as Required by Federal Law
- ☐ Addendum for Property in a Propane Gas System Service Area
- ☐ Other (list): _____

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Phone: ( ) _____ Fax: ( ) _____

Fax: ( ) _____ E-mail: _____

E-mail: _____

22. AGREEMENT OF PARTIES: This contract contains the entire agreement of the parties and cannot be changed except by their written agreement. Addenda which are a part of this contract are (Check all applicable boxes):

- ☐ Third Party Financing Addendum
- ☐ Seller Financing Addendum
- ☐ Addendum for Property Subject to Mandatory Membership in a Property Owners Association
- ☐ Buyer's Temporary Residential Lease
- ☐ Loan Assumption Addendum
- ☐ Addendum for Sale of Other Property by Buyer
- ☐ Addendum for Reservation of Oil, Gas and Other Minerals
- ☐ Addendum for "Back-Up" Contract
- ☐ Addendum for Coastal Area Property
- ☐ Environmental Assessment, Threatened or Endangered Species and Wetlands Addendum
- ☐ Seller's Temporary Residential Lease
- ☐ Short Sale Addendum
- ☐ Addendum for Property Located Seaward of the Gulf Intracoastal Waterway
- ☐ Addendum for Seller's Disclosure of Information on Lead-based Paint and Lead-based Paint Hazards as Required by Federal Law
- ☐ Addendum for Property in a Propane Gas System Service Area
- ☐ Other (list): _____

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Contract Concerning _____ (Address of Property)

23. TERMINATION OPTION: For nominal consideration, the receipt of which is hereby acknowledged by Seller, and Buyer's agreement to pay Seller $_____ (Option Fee) within 3 days after the effective date of this contract, Seller grants Buyer the unrestricted right to terminate this contract by giving notice of termination to Seller within _____ days after the effective date of this contract (Option Period). Notices under this paragraph must be given by 5:00 p.m. (local time where the Property is located) by the date specified. If no dollar amount is stated as the Option Fee or if Buyer fails to pay the Option Fee to Seller within the time prescribed, this paragraph will not be a part of this contract and Buyer shall not have the unrestricted right to terminate this contract. If Buyer gives notice of termination within the time prescribed, the Option Fee will not be refunded; however, any earnest money will be refunded to Buyer. The Option Fee ☐ will ☐ will not be credited to the Sales Price at closing. **Time is of the essence for this paragraph and strict compliance with the time for performance is required.**

24. CONSULT AN ATTORNEY BEFORE SIGNING: TREC rules prohibit real estate license holders from giving legal advice. READ THIS CONTRACT CAREFULLY.

Buyer's Attorney is: _____

Phone: ( ) _____

Fax: ( ) _____

E-mail: _____

Seller's Attorney is: _____

Phone: ( ) _____

Fax: ( ) _____

E-mail: _____

EXECUTED the _____ day of _____, 20____ (EFFECTIVE DATE).
(BROKER: FILL IN THE DATE OF FINAL ACCEPTANCE.)

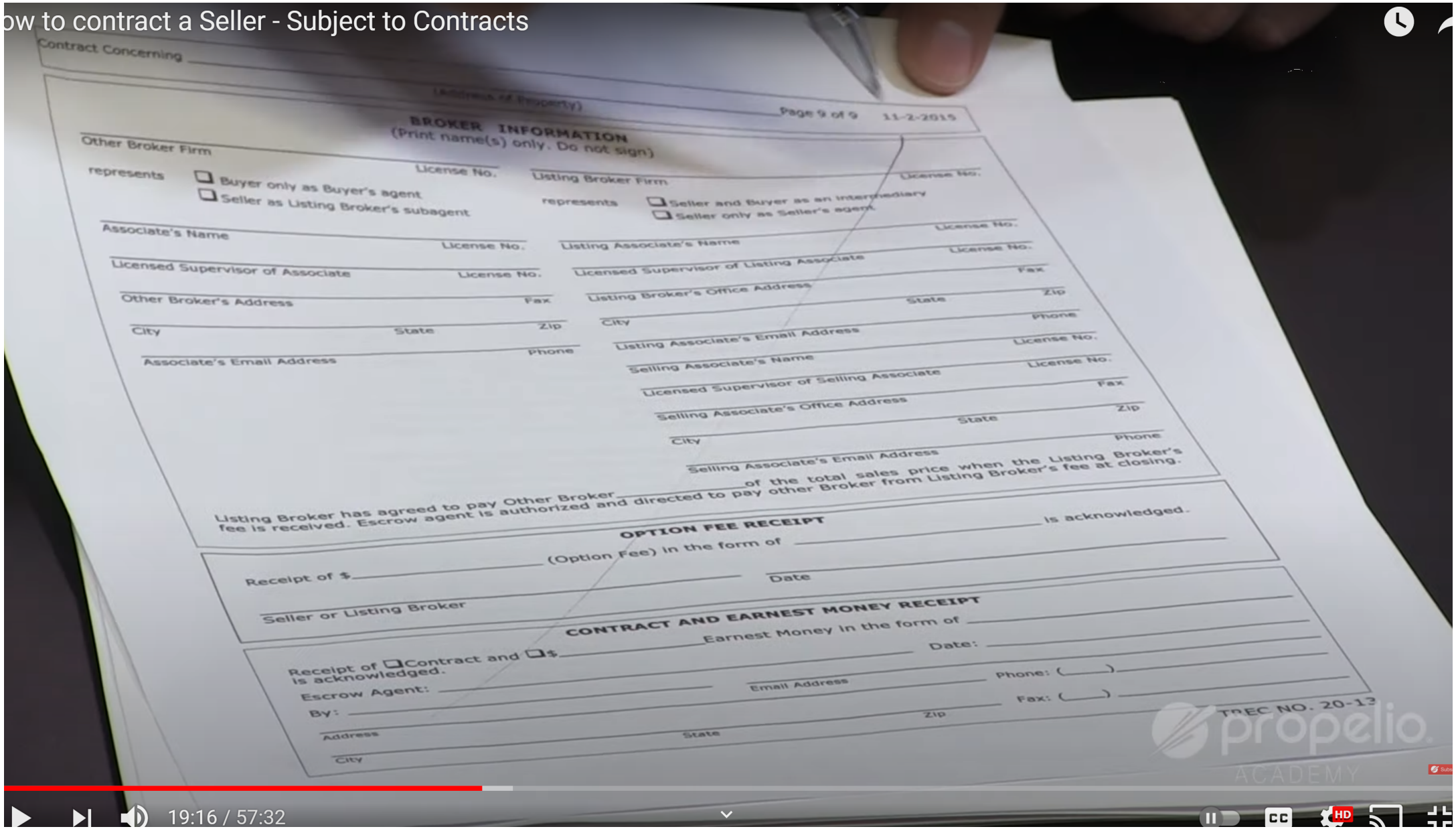
_____ Buyer

_____ Seller

_____ Buyer

_____ Seller

17:18 / 57:32


ow to contract a Seller - Subject to Contracts
Contract Concerning
Page 9 of 9
11-2-2015
BROKER INFORMATION
(Print name(s) only. Do not sign)
Other Broker Firm
License No.
represents
Buyer only as Buyer's agent
Seller as Listing Broker's subagent
Listing Broker Firm
License No.
represents
Seller and Buyer as an intermediary
Seller only as Seller's agent
Associate's Name
License No.
Listing Associate's Name
License No.
Licensed Supervisor of Associate
License No.
Licensed Supervisor of Listing Associate
License No.
Other Broker's Address
Fax
Listing Broker's Office Address
Fax
City
State
Zip
City
State
Zip
Associate's Email Address
Phone
Listing Associate's Email Address
Phone
Selling Associate's Name
License No.
Licensed Supervisor of Selling Associate
License No.
Selling Associate's Office Address
Fax
City
State
Zip
Selling Associate's Email Address
Phone
Listing Broker has agreed to pay Other Broker _____ of the total sales price when the Listing Broker's fee is received. Escrow agent is authorized and directed to pay other Broker from Listing Broker's fee at closing.
OPTION FEE RECEIPT
Receipt of $ _____ (Option Fee) in the form of _____ is acknowledged.
Seller or Listing Broker
Date
CONTRACT AND EARNEST MONEY RECEIPT
Receipt of ☐ Contract and ☐ $ _____ Earnest Money in the form of _____ is acknowledged.
Date:
Escrow Agent:
Email Address
Phone: (____)
By:
Fax: (____)
Address
State
Zip
City
TREC NO. 20-13
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19:16 / 57:32

ADDENDUM A
(To Contract for Sale)

Name of Seller(s): (Replace Seller's Name)
Name of Buyer(s): (Replace Buyer's Name)
Property: (Replace Property Address)

Notwithstanding anything herein to the contrary the following provisions shall govern.

1. **Seller hereby grants to Buyer the irrevocable right to assign this Contract for Sale to a third party of Buyer's choosing, without the consent of Seller. That upon such assignment, Seller agrees to release Buyer from any and all liability under the Contract for Sale and agrees to look solely towards the substituted Buyer. Seller agrees to honor the terms and conditions of the contract as drafted to the substituted Buyer.**

2. **Buyer shall have an option to purchase this property for a period of 60 days with an option to extend said option period for an additional term of 30 days. Upon Buyer's election to close said contract, Buyer agrees to notify Seller of their intent to close in writing whereupon the property shall be closed within 30 days thereof. In the event this contract is not consummated by Buyer with in specified option period, and is not renewed or extended in writing, this contract shall terminate and Buyer and Seller shall have no further obligations, one to the other. It is specifically acknowledged that the Buyer has no obligation to close under this contract.**

3. Consideration under this contract shall be $10.00 and other good and valuable consideration, including but not limited to Buyers,
   a. Evaluation of the property;
   b. Agreement to purchase the property subject to the underlying lien;
   c. Expenditures in marketing and advertising the property;

4. Buyer is contracting and or purchasing the property for investment intent;

5. Buyer and Seller acknowledge the following:
   a. That this transaction will be closed "subject to" the Seller's underlying Mortgage.
   b. Once Buyer purchases the property Seller acknowledges that the Buyer, as the owner of the property, may lease or resell the property in any fashion, at Buyer's sole option;
   c. That Seller's underlying lien is not assumable without full qualification and that Buyer is not qualifying to assume said loan; that Buyer has no obligation to assume said loan or to make payments under said loan;
   d. That the "subject to" transaction will be without the underlying lenders consent and will be a violation under the due on sale clause in the mortgage;
   e. Seller and Buyer acknowledge that the Deed of Trust securing said loan may contain a due on sale clause. If so the underlying lender has the right to call said loan due in the event of a sale. In the event the underlying lender calls the loan due, Seller and or Buyer may be obligated to payoff said underlying lien;
   f. Seller acknowledges that the liability on the underlying lien is not terminated until such time as the loan is paid off;

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19:20 / 57:32

g. Seller acknowledges that there are risks of damage to the Property from any prospective future occupant thereof, whether an owner occupant or tenant;

h. Seller and Buyer accept and acknowledge these risk factors;

6. It is the Buyer's primary intent upon purchase to treat this property as an investment property. Buyer may lease or sell the property under any mechanism they so choose, as the owner after closing. It is specifically acknowledged that it is not the intent of the Buyer to pay off the underlying loan regardless of the mechanism of purchase or sale; In any event, Seller acknowledges same and recognizes Buyers right to resell or lease the property without further authorization from Seller

7. Seller acknowledges that the Buyer or any shareholder, officer, director or member / manager of Buyer may hold a valid Texas Real Estate Broker or Sales / Agent License, a mortgage broker's license or a law license and is buying the Property for either investment intent or to assign the Contract; that the contract price may not represent market value. Seller acknowledges that Buyer does not represent Seller in any capacity. Seller accepts and acknowledges same;

8. Seller, hereby grants to Buyer the right to perform the following on or with the property prior to sale:

   a. List the property for sale in the Multiple Listing Service (MLS) utilizing a licensed real estate agent;

   b. To place a lock box on the door for showing purposes pursuant to the MLS or otherwise;

   c. That the Seller shall agree, with reasonable notice, to allow Buyer to show the property to third party buyers as necessary;

   d. To place signs in the yard in order to market the property;

9. Seller has the right to cancel this Contract at any time by providing written notice to the Buyer, subject to the following provisions:

   a. In the event Seller elects to cancel said Contract prior to the expiration hereof, Seller will pay Buyer a $3,500 cancellation fee in money order or cashier's check.

   b. Without payment of said cancellation fee, Seller's cancellation will not be effective.

   c. Should Seller fail to pay said cancellation fee, besides any remedy set forth in the Contract, Seller hereby acknowledges and authorizes Buyer to file this Contract any corresponding affidavit in the Deed Records of the County where the property is located.

   d. Should Seller, at any time prior to the termination of this Contract, receive a bona fide offer to sell the property, where it can be verified that the new purchaser Buyer has the ability to purchase and obtain financing for the property, that upon written notification and verification of new Purchaser's financial ability to purchase the property, Buyer will agree to terminate this Contract for Sale whereupon Buyer and Seller shall have no further obligation, one to another, and there shall be no cancellation penalty.

   e. Whether Buyer purchases the property direct or assigns the contract, Buyer will notify seller in writing or by email of Buyer's intent to close. Upon receipt of same, this contract may no longer be terminated by the Seller. Upon receipt of same, closing shall occur within 30 days from the date thereof.

10. The terms and conditions of the contract and mortgage being assumed are as follows: **Chose either Subject to Terms or Wrap Around terms**

Subject to terms

Contract Price: $_____

Down Payment or Fee (if any): $_____

1st Lien:

Current Loan Balance: $_____

Current interest rate: _____

Remaining Term: _____

Original Amortization term: _____

Principal and Interest pmt: $_____

2nd: (if any)

Current Loan Balance: $_____

Current interest rate: _____

Remaining Term: _____

Original Amortization term: _____

Principal and Interest pmt: $_____

Taxes and Insurance Pmt: $_____

Other mortgage pmts.: $_____

Total Monthly payment: $_____

Contract Price Adjustment: In the event the contract price should differ from the loan being assumed:

_____ If the Contract price is less than the loan amount, the loan amount shall Govern;

___X___ If the Contract price is greater than the loan amount, the loan amount shall govern;

_____ If the Contract price is greater than the loan amount, the Contract shall govern;

Pro-rata / Next month payment Option:

_____ Seller agrees to pay the pro-rata portion of the next monthly payment due after the closing date subject to the date of closing;

_____ Seller agrees to pay the entire next monthly payment due after closing regardless of the date of closing;

_____ Seller shall make no payments regarding the next monthly payment due after closing;

Wrap Around Terms:

Contract Price: $_____

Down Payment or Fee (if any): $_____

1st Lien: $_____

Loan amount: _____

Interest Rate: _____

Term: _____

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Amortization term: _____
Principal and Interest pmt: $_____

2nd Lien (if any) $_____%
Loan amount: _____
Interest Rate: _____
Term: _____
Amortized: $_____
PI: $_____

Taxes Pmt: $_____
Insurance Pmt: $_____
Total Monthly payment: $_____

Closing costs:
Seller and Buyer agree to pay the following toward the closing costs associated with this transaction.
Seller $_____ or _____%; Buyer $_____ or _____%

11. Buyer and Seller acknowledge that unless otherwise specified in writing **Seller will not provide Buyer with an Owner's Title Policy** on the Property. Buyer accepts a simple title run or an Abstract of Title in lieu thereof.

12. Buyer and Seller acknowledge that there has been no independent investigation, representation, or assurance whatsoever regarding ad valorem taxes, or at what value said Property may be assessed. The taxes will be pro-rated, if applicable, pursuant to the contract for sale. If taxes are escrowed with any underlying lender, taxes will not be prorated other than within the scope of said escrow.

13. Buyer shall provide, Seller, upon Seller's written request, at closing with a 1 year **prepaid insurance** policy of Buyer's choice insuring the property in an amount not less than the loan balance or Buyer and Seller may agree to have Buyer added as an additional insured under Seller's insurance policy, provided Seller's insurance company allows same.

14. It is agreed and understood that even though Buyer may execute an Assignment of Contract with a third party assignee, there is no guarantee that said transaction will be consummated and close. Seller hereby acknowledges same and agrees to indemnify and hold Buyer harmless from any such actions.

15. Seller acknowledges that Buyer does not represent Seller in any capacity, including but not limited to, real estate sales agent, property manager or investment, financial or legal advisor.

16. **Consent of Noteholder**: If the noteholder fails to consent to the assumption of the loan or owner financed sale, either Seller or Buyer may terminate this contract by notice to the other party in writing and the earnest money will be refunded to the Buyer.

17. **Seller's Liens:** Unless Seller is released from Liability on any assumed or underlying note, a Vendor's Lien and Deed of Trust to Secure Assumption (performance) or Wrap Around Real Estate Lien Note and Deed of Trust will be required. The Vendor's Lien on any

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Amortization term: _____
Principal and Interest pmt: $_____

2nd Lien (if any) $_____%
Loan amount: _____
Interest Rate: _____
Term: _____
Amortized: $_____
PI: $_____

Taxes Pmt: $_____
Insurance Pmt: $_____
Total Monthly payment: $_____

Closing costs:
Seller and Buyer agree to pay the following toward the closing costs associated with this transaction.
Seller $_____ or _____%; Buyer $_____ or _____%

11. Buyer and Seller acknowledge that unless otherwise specified in writing **Seller will not provide Buyer with an Owner's Title Policy** on the Property. Buyer accepts a simple title run or an Abstract of Title in lieu thereof.

12. Buyer and Seller acknowledge that there has been no independent investigation, representation, or assurance whatsoever regarding ad valorem taxes, or at what value said Property may be assessed. The taxes will be pro-rated, if applicable, pursuant to the contract for sale. If taxes are escrowed with any underlying lender, taxes will not be prorated other than within the scope of said escrow.

13. Buyer shall provide, Seller, upon Seller's written request, at closing with **a 1 year prepaid insurance** policy of Buyer's choice insuring the property in an amount not [illegible] the loan balance or Buyer and Seller may agree to have Buyer added as an [illegible] Seller's insurance policy, provided Seller's insurance

underlying lien will automatically be released on delivery of an executed release by Noteholder.

18. **Tax and Insurance Escrow**: If this is an Assumption Transaction, and if Noteholder maintains an escrow account for ad valorem taxes, casualty insurance premiums or mortgage insurance premiums, Seller shall transfer or assign the escrow account to the Buyer without any deficiency.

Buyer ____ will, ____ will not reimburse Seller for the amount in the transferred accounts.

19. **Financial Information:** Buyer agrees that within 7 days from the date of execution hereof to provide Seller with their requested financial information, which may include, but not be limited to the following, application, 2 years tax returns, pay stubs, Verification of Employment / Rent / Mortgage, and bank statement. Upon receipt Seller shall have 7 days to review and either approve, deny or counter the offer based upon information provided. If Seller fails to respond within said 7 days, the Buyer's application and contract shall be deemed accepted and approved.
If Buyer should fail to provide Seller the requested financial information, Seller may, at Seller's sole election, accept the contract and or information provided or terminate this contract and retain Buyer's earnest money.

Acknowledged _____ Buyer _____ Buyer

THIS CONTRACT IS A VALID, BINDING LEGAL DOCUMENT. IF YOU DO NOT UNDERSTAND THE EFFECT OF THIS CONTRACT OR ANY PROVISION HEREOF, SEEK COMPETENT LEGAL ADVISE FROM AN ATTORNEY OF YOUR CHOICE.

BUYER

_____ Date Executed: _____

_____ Date Executed: _____

SELLER

_____ Date Executed: _____

_____ Date Executed: _____

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o contract a Seller - Subject to Contracts

ACKNOWL

Name of Seller(s): (Replace S name)
Name of Buyer(s): (Replace Buyer's Name)
Property: (Replace Property Address)

This Acknowledgement of Transaction is executed by and between the above noted Seller and Buyer on the below executed date concerning the above referenced Property.

WHEREAS, Seller has entered into a Contract for Sale with Buyer to sell the Property;

NOW THEREFORE, for good and valuable consideration, the receipt and sufficiency which are hereby acknowledged, the execution of the Assignment of Contract it is hereby agreed and understood by and among the parties hereto that:

I.
ACKNOWLEDGEMENT OF FORM OF SALE

Seller understands that any underlying mortgage, which may be taken "subject to" may contain an acceleration (due-on-sale) clause, which entitles the mortgagee to accelerate the note upon title transfer. Seller hereby acknowledges that this will be either a Wrap Around Mortgage or an Assumption Mortgage in order to sell the Property. That said Wrap Around or Assumption Mortgage is without the underlying lien holder's permission and that the underlying lien holder has the right but not the obligation to call the lien due and payable. Buyer acknowledges and recognizes that the assumption or wrap around mortgage is valid only between Seller and Buyer. No assurances or promises have been made to me that the mortgage(s) will be paid off or of the buyer's ability to refinance, even in the event said mortgage company may elect to call said loan due.
Seller acknowledges that due to the nature of this transaction that Seller's mortgage may not be paid off and Seller may have continuing financial liability and obligations under my existing mortgage. I may be required to provide future tax information to any prospective Buyer as well.

II.
ACKNOWLEDGEMENT OF SELLER

Seller acknowledges that due to the nature of this transaction Seller may obtain any financial information on the Buyer, it is Seller's obligation to obtain any assurances of Buyer's ability to pay or of Buyer's creditworthiness. Seller acknowledges that due to the nature of this transaction that in the event of a default by the Buyer, Seller will have the option to foreclose on the lien created at closing, pay any arrearages under my mortgage and regain possession of the property.

III.
ACKNOWLEDGEMENT OF PAYMENT OPTIONS

Seller acknowledges that if they collect the monthly payment from the Buyer, that they have a direct obligation to pay the mortgage company in a timely manner. Seller and Buyer may agree to utilize a 3rd party servicing company in order to ensure payments made are allocated properly.

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35:39 / 57:32

IV.
ACKNOWLEDGEMENT OF NO TITLE INSURANCE

Seller acknowledges that Title Insurance is available to be purchased at Seller's option. Should the Seller wish to obtain title insurance Seller may contact a closing agent or title company of their choice to discuss and arrange for purchase of same.

V.
ACKNOWLEDGEMENT OF MEDIATION

It is the policy of the State of Texas to encourage resolution of disputes through alternative dispute resolution procedures such as mediation. Any dispute between Seller and Buyer or Seller and Buyer related to this contract, which is not resolved through informal discussion, will be submitted to a mutually acceptable mediation service or provider. The parties to the mediation shall bear the mediation cost equally.

VI.
BEST INTERESTS

Seller acknowledges that due to various market conditions that this transaction is for good and valuable consideration and in my best interest. That Seller has been fully informed of all risk factors involved and acknowledges same.

VII.
NO ORAL AGREEMENTS AND SURVIVABILITY

All agreements between Buyer and Seller are and shall be in writing. There are no verbal agreements between Buyer and Seller. This Acknowledgement of Transaction shall survive the assignment of contract, if any, and subsequent closing and not merge therein.

THE REFERENCED CONTRACT IS A VALID, BINDING LEGAL DOCUMENT. IF YOU DO NOT UNDERSTAND THE EFFECT OF THE CONTRACT OR ANY PROVISION OR ADDENDUM THEREOF, OR ANY PROVISION IN THIS ACKNOWLEDGMENT SEEK COMPETENT LEGAL ADVISE FROM AN ATTORNEY OF YOUR CHOICE.

AGREED AND EXECUTED on this the _____day of _____, 20____.

Seller _____ Date Executed: _____

_____ Date Executed: _____

Buyer _____ Date Executed: _____

_____ Date Executed: _____

SELLER'S ACKNOWLEDGEMENTS

(At time of Contract)

Name of Seller(s): (Replace Seller's Name)
Name of Buyer(s): (Replace Buyer's Name)
Property: (Replace Property Address)

This Seller's Acknowledgment is executed by and between the above noted Seller and Buyer on the below executed date concerning the above referenced Property.

I further state as follows:

_____1. OWNERSHIP OF THE PROPERTY: I am the owner of The Property and am able to contract for its sale without any additional joinder by others.

_____2. ACCEPTANCE: I have reviewed the terms and conditions contained in The Agreement and have accepted Buyer's offer to purchase The Property.

_____3. GOOD AND VALUABLE CONSIDERATION: I have received good and valuable consideration in signing The Agreement, and I acknowledge both the receipt and the sufficiency of the consideration.

_____4. IN MY BEST INTEREST: I am satisfied with The Agreement and have agreed to sell The Property because it is in my best interest to do so.

_____5. FULLY INFORMED AND NOT CONFUSED: I have signed The Agreement being fully informed and with sufficient understanding of all terms and conditions contained therein. I am not confused about any aspect of The Agreement.

_____6. SATISFIED WITH THE SALES PRICE: I understand I may be selling The Property for less than market value but have chosen to do so because circumstances dictate that an immediate sale, even at a discounted price, is in my best interest. I am satisfied with the sales price I have negotiated.

_____7. SALE IS FINAL: I understand by signing The Agreement, I have agreed to sell The Property to Buyer and am now bound by the terms and conditions described in The Agreement. I further understand that I cannot "change my mind" or cancel the contract at some later date, nor can I continue to market The Property to any other buyer.

_____8. CONTINGENCIES MAY EXIST: I understand the sale may be contingent upon Buyer's inspection and approval of certain items described in The Agreement. I further understand that if Buyer does not approve of these items, Buyer may cancel The Agreement and if cancelled, I must return Buyer's earnest money in full.

_____9. NOT A LOAN: I understand The Agreement I have signed is for the outright sale of The Property and is "subject to" my underlying mortgage which will not be paid off.

_____10. AGREEMENT MAY BE ASSIGNED: I understand Buyer may assign The Agreement to another party and I may be closing the sale with someone other than Buyer. I have granted my permission for the Buyer to assign the contract and in the event of such an

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assignment, have agreed to release the Buyer from liability under the Contract and have agreed to look solely to the Assignee as the new buyer.

_____11. CLOSING: I understand this transaction will close at the office of an escrow agent or at a law office, however, I acknowledge that they do not represent me.

_____12. CLOSING DOCUMENTS: I understand there will be additional closing documents to sign and upon receipt, agree to sign and deliver the closing documents either into Escrow or directly to Buyer, as Buyer may direct, in a timely manner.

_____13. COPIES OF THE PAPERWORK: I understand that copies of the paperwork I've signed will be provided to me in a timely manner and I acknowledge that circumstances dictate that copies may not be immediately made available to me.

_____14. BUYER ENTITLED TO MAKE A PROFIT: I understand Buyer may resell the Property and may realize a profit in doing so. I agree Buyer is entitled to any profit that may ultimately result from the subsequent resale of The Property.

_____15. LEGAL COUNSEL ADVISED: I acknowledge Buyer has advised me to seek independent representation or legal counsel to review The Agreement.

_____16. FINANCIAL REVIEW ADVISED: I acknowledge Buyer has advised me to seek an independent financial advisor to review The Agreement.

_____17. CONTINUING LIABILITY AND FINANCIAL OBLIGATION: I acknowledge that due to the nature of this transaction that my mortgage may not be paid off and I may have continuing financial liability and obligations under my existing mortgage. I may be required to provide future tax information to any prospective Buyer as well.

_____18. OPTION TO FORECLOSE: I acknowledge that due to the nature of this transaction that in the event of a default by the Buyer, I will have the option to foreclose on my lien, pay any arrearages under my mortgage and regain possession of the property.

_____19. CREDITWORTHINESS OF BUYER/ASSIGNEE: I acknowledge that due to the nature of this transaction that there is no guarantee of the creditworthiness of the Buyer or any final Buyer, or of their ability to pay or pay timely.

_____20. FINANCIAL INFORMATION OF BUYER/ASSIGNEE: I acknowledge that due to the nature of this transaction I may not obtain any financial information on the Buyer or final Buyer. I further acknowledge that the Buyer has no obligation to provide me with financial information on any future Assignee and that Buyer is in no way providing me any assurances of Assignee's ability to pay.

_____20. FAIRLY NEGOTIATED: I understand Buyer has negotiated on his own behalf and likewise, I have negotiated on mine. I acknowledge The Agreement has been negotiated fairly and Buyer has not taken advantage of me or my current situation.

_____21. NO PRECLUDING AILMENTS: I have no physical, mental or emotional ailments that preclude me from signing The Agreement.

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_____22. NOT UNDER THE INFLUENCE: I am not now under the influence of alcohol or any other mind-altering substance, nor am I taking medication that would cloud my judgment or make me unable to think clearly.

_____23. NO OTHER PROMISES: I have not been promised anything other than what is described in The Agreement. There are no unresolved issues, no outside agreements, nor are there other terms not disclosed in The Agreement.

_____24. NOT UNDER DURESS: I am not under duress and have signed The Agreement of my own free will, without any undue financial pressure. Buyer has in no way pressured me into signing The Agreement.

_____25. FULLY SATISFIED WITH AGREEMENT: I am fully satisfied with all terms and conditions contained in The Agreement.

THE REFERENCED CONTRACT IS A VALID, BINDING LEGAL DOCUMENT. IF YOU DO NOT UNDERSTAND THE EFFECT OF THE CONTRACT OR ANY PROVISION OR ADDENDUM THEREOF, OR ANY PROVISION IN THIS ACKNOWLEDGMENT SEEK COMPETENT LEGAL ADVISE FROM AN ATTORNEY OF YOUR CHOICE.

AGREED AND EXECUTED on this the _____day of _____, 20____.

Seller

_____ Date Executed: _____

_____ Date Executed: _____

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ACKNOWLEDGEMENT OF MORTGAGE PROCESSING

(At time of Contract-Seller)

Name of Seller(s): (Replace Seller's Name)
Name of Buyer(s): (Replace Buyer's Name)
Property: (Replace Property Address)

This Acknowledgement of Mortgage Processing is executed pursuant to the Contract for Sale between Buyer and Seller for the above referenced property

1. Seller acknowledges that they have the option to perform a full mortgage process on the buyer by an independent Registered Mortgage Loan Originator;.
2. In the event Seller should elect to perform mortgage processing on the Buyer the Seller should inquire of their real estate professional or closing agent for recommendations.

THE REFERENCED CONTRACT IS A VALID, BINDING LEGAL DOCUMENT. IF YOU DO NOT UNDERSTAND THE EFFECT OF THE CONTRACT OR ANY PROVISION OR ADDENDUM THEREOF, OR ANY PROVISION IN THIS ACKNOWLEDGMENT SEEK COMPETENT LEGAL ADVISE FROM AN ATTORNEY OF YOUR CHOICE.

AGREED AND EXECUTED on this the _____ day of _____, 20____.

Seller

_____ Date Executed: _____

_____ Date Executed: _____

AUTHORIZATION TO RELEASE INFORMATION

I/We hereby and fully authorize the below listed entities / parties to release any and all information concerning my mortgage loan and / or hazard insurance which may be requested by:

_____

Mortgage Information:
Including, but not limited to, any discussion of my/our loan, the loan balance(s) or payoff(s), reinstatement, modification, transfer or inquiry, and any credit or tax return information.

Lender: _____
Loan Number: _____
Borrower: _____ SSN: xxx-xx-_____
Borrower: _____ SSN: xxx-xx-_____
Property Address: (Replace Property Address)

Hazard Insurance Information:
Including, but not limited to, any discussion of my/our hazard insurance policy, insured's / mortgagee's, premiums and coverage's under the policy, amounts due if any, or any associated property information.

Thank you for your cooperation.

_____ Date Executed: _____

_____ Date Executed: _____

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to contract a Seller - Subject to Contracts

ACKNOWLEDGEMENT OF EVIDENCE OF ELECTION OF TYPE OF TITLE ASSURANCE

(At time of Contract)

Name of Seller(s): (Replace Seller's Name)
Name of Buyer(s): (Replace Buyer's Name)
Property: (Replace Property Address)

This Acknowledgement of Evidence of Election of Type of Title Assurance is e
Seller on the below executed date concerning the above referenced Property.

WHEREAS, Seller has executed a Contract for Sale for the sale of the above Property and will be acting as the lender in the transaction;

WHEREAS, Seller has the option to elect to purchase mortgagee title insurance insuring their mortgage;

NOW THEREFORE, for good and valuable consideration, the receipt and sufficiency which are hereby acknowledged, the execution of the Assignment of Contract it is hereby agreed and understood Seller that:

I.
ACKNOWLEDGEMENT of AVAILABLE TITLE SEARCHES or TITLE INSURANCE

Buyer acknowledges that they may obtain one of the following types of Title searches or Title Insurance. A brief description and estimated pricing has been provided for each type of search or insurance provided. Buyer, if Buyer is unsure of which form to select, Buyer should contact their real estate professional or legal counsel for proper determination.

Title Run-Name search: Cost: $100-200	Quick look at what has been recorded on the property after the original loan being assumed was recorded. May not disclose all recorded liens May not pick up bankruptcy filings No Property tax search included (available for a fee) No insurance offered
Abstract of Title: Cost: $250-350	More thorough title examination after the original loan being May not disclose all recorded liens Includes bankruptcy search No Property tax search included (available for a fee) No insurance offered
Title Insurance:	Full title examination by the title company with associated insurance insuring the title on the property.
Cost:	Title insurance is based upon the dollar amount of the loan and will include property tax searches, tax lien and other judgment searches. Other fees will be associated with the

Seller - Subject to Contracts

ACKNOWLEDGEMENT OF EVIDENCE
ELECTION OF TYPE OF TITLE ASSURANCE
(At time of Contract)

(Replace Seller's Name)
(Replace Buyer's Name)
(Replace Property Address)

This Acknowledgement of Evidence of Election of Type of Title Assurance is executed Seller on the below executed date concerning the above referenced Property.

WHEREAS, Seller has executed a Contract for Sale for the sale of the above Property and will be acting as the lender in the transaction;

WHEREAS, Seller has the option to elect to purchase mortgagee title insurance insuring their mortgage;

NOW THEREFORE, for good and valuable consideration, the receipt and sufficiency which are hereby acknowledged, the execution of the Assignment of Contract it is hereby agreed and understood Seller that:

I.
ACKNOWLEDGEMENT of AVAILABLE TITLE SEARCHES or TITLE INSURANCE

Buyer acknowledges that they may obtain one of the following types of Title searches or Title Insurance. A brief description and estimated pricing has been provided for each type of search or insurance provided. Buyer, if Buyer is unsure of which form to select, Buyer should contact their real estate professional or legal counsel for proper determination.

Title Run-Name search: Cost: $100-200	Quick look at what has been recorded on the property after the original loan being assumed was recorded. May not disclose all recorded liens May not pick up bankruptcy filings No Property tax search included (available for a fee) No insurance offered
Abstract of Title: Cost: $250-350	More thorough title examination after the original loan being May not disclose all recorded liens Includes bankruptcy search No Property tax search included (available for a fee) No insurance offered
Title Insurance:	Full title examination by the title company with associated insurance insuring the title on the property.
Cost:	Title insurance is based upon the dollar amount of the loan and will include property tax searches, tax lien and other judgment searches. Other fees will be associated with the

closing. Example: $100k Loan- approx closing costs will be $1500

II.
ELECTION of TITLE SEARCHES or TITLE INSURANCE

I hereby acknowledge that I am fully informed of my title search or insurance options. As such I have initialed next to my preferred election.

Initial only one (1)

_____ Title Run

_____ Abstract of Title

_____ Title Insurance

THE REFERENCED CONTRACT IS A VALID, BINDING LEGAL DOCUMENT. IF YOU DO NOT UNDERSTAND THE EFFECT OF THE CONTRACT OR ANY PROVISION OR ADDENDUM THEREOF, OR ANY PROVISION IN THIS ACKNOWLEDGMENT SEEK COMPETENT LEGAL ADVISE FROM AN ATTORNEY OF YOUR CHOICE.

AGREED AND EXECUTED on this the _____day of _____, 20____.

Buyer

_____ Date Executed: _____

_____ Date Executed: _____

Seller - Subject to Contracts

POWER OF ATTORNEY

NOTICE: THE POWERS GRANTED BY THIS DOCUMENT ARE BROAD AND SWEEPING. THEY ARE EXPLAINED IN THE DURABLE POWER OF ATTORNEY ACT, SUBTITLE P, TITLE 2 ESTATES CODE. IF YOU HAVE ANY QUESTIONS ABOUT THESE POWERS, OBTAIN COMPETENT LEGAL ADVICE. THIS DOCUMENT DOES NOT AUTHORIZE ANYONE TO MAKE MEDICAL AND OTHER HEALTH-CARE DECISIONS FOR YOU. YOU MAY REVOKE THIS POWER OF ATTORNEY IF YOU LATER WISH TO DO SO.

You should select someone you trust to serve as your agent (attorney in fact). Unless you specify otherwise, generally the agent's (attorney in fact's) authority will continue until:

(1) you die or revoke the power of attorney;

(2) your agent (attorney in fact) resigns or is unable to act for you; or

(3) a guardian is appointed for your estate.

STATE OF TEXAS
COUNTY OF DALLAS:

I, _____, my social security number being _____ appoint Fabiola Ramirez as my agent (attorney-in-fact) to act for me in any lawful way with respect to the following initialed subjects:

[TO GRANT ALL OF THE FOLLOWING POWERS, INITIAL THE LINE IN FRONT OF (N) AND IGNORE THE LINES IN FRONT OF THE OTHER POWERS LISTED IN (A) THROUGH (M)]

[TO GRANT A POWER, YOU MUST INITIAL THE LINE IN FRONT OF EACH POWER YOU ARE GRANTING]

[TO WITHHOLD A POWER, DO NOT INITIALIZE IN FRONT OF IT. YOU MAY, BUT NEED NOT, CROSS OUT EACH POWER WITHHELD]

INITIAL

X_____ (A) real property transactions;

X_____ (B) tangible personal property transactions;

_____ (C) stock and bond transactions;

_____ (D) commodity and option transactions;

X_____ (E) banking and other financial institutions transactions;

_____ (F) business operating transactions;

X_____ (G) insurance and annuity transactions;

_____ (H) estate, trust and other beneficiary transactions;

_____ (I) claims and litigation;

_____ (J) personal and family maintenance;

_____ (K) benefits form social security, Medicare, Medicaid, or other governmental programs or civil or military service;

_____ (L) retirement plan transactions;

_____ (M) tax matters;

_____ (N) ALL OF THE POWERS LISTED IN (A) THROUGH (M). YOU NEED NOT INITIAL ANY OTHER LINES IF YOU INITIAL LINE (N).

SPECIAL INSTRUCTIONS

Special instructions applicable to gifts (initial in front of the following sentence to have it apply):

X_____ I grant my agent (attorney in fact) the power to apply my property to make gifts outright to or for the benefit of a person, including by the exercise of a presently exercisable general power of appointment held by me, except that the amount of a gift to an individual may not exceed the amount of annual exclusions allowed from the federal gift tax for the calendar year of the gift.

ON THE FOLLOWING LINES YOU MAY GIVE SPECIAL INSTRUCTIONS LIMITING OR EXTENDING THE POWERS GRANTED TO YOUR AGENT.

This power of attorney is specifically limited to communications and the execution of documents concerning the real property located at (Replace Property Address)

UNLESS YOU DIRECT OTHERWISE ABOVE, THIS POWER OF ATTORNEY IS EFFECTIVE IMMEDIATELY AND WILL CONTINUE UNTIL IT IS REVOKED.

CHOOSE ONE OF THE FOLLOWING ALTERNATIVES BY CROSSING OUT THE ALTERNATIVES NOT CHOSEN:

(A) This power of attorney is not affected by my subsequent disability or incapacity.
(B) This power of attorney becomes effective upon my disability or incapacity.

bject to Contracts

YOU SHOULD CHOOSE ALTERNATIVE (A) IF THIS POWER OF ATTORNE
TO BECOME EFFECTIVE UPON THE DATE IT IS EXECUTED.

IF NEITHER (A) NOR (B) IS CROSSED OUT, IT WILL BE ASSUMED THAT YOU
CHOSE ALTERNATIVE (A).

If Alternative (B) is chosen and a definition of my disability or incapacity is not contained in this power of attorney, I shall be considered disabled or incapacitated for purposes of this power of attorney if a physician certifies in writing at a date later than the date this power of attorney is executed that, based on the physician's medical examination of me, I am mentally incapable of managing my financial affairs. I authorize the physician who examines me for this purpose to disclose my physical or mental condition to another person for purposes of this power of attorney. A third party who accepts this power of attorney is fully protected from any action taken under this power of attorney that is based on the determination made by a physician of my disability or incapacity.

I agree that any third party who receives a copy of this document must act under it. Revocation of the durable power of attorney is not effective as to a third party until the third party receives actual notice of the revocation. I agree to indemnify the third party for any claims that arise against the third party because of reliance on this power of attorney.

If any agent named by me dies, becomes legally disabled, resigns, or refuses to act, I name the following (each to act alone and successively, in the order named) as successor(s) to that agent: None

SIGNED this _____ day of _____, 20____.

_____

STATE OF TEXAS
COUNTY OF DALLAS

This document was acknowledged before me on _____, 20____, by _____
_____.

_____

NOTARY PUBLIC IN AND FOR
THE STATE OF TEXAS

My commission expires: _____

PURCHASE AND SALE AGREEMENT

This PURCHASE AND SALE AGREEMENT (the "Agreement") is entered into by and between _____ and/or assignee ("Buyer"), with an address of _____ and _____ ("Seller") with an address of _____ .

1. OPENING. The "Opening" will occur upon the date this Agreement is mutually executed and acknowledged by Title, Escrow or Closing Agent/Attorney ("Escrow Agent").

2. PROPERTY. Seller hereby agrees to sell and Buyer hereby agrees to buy the real property in its "as-is" condition with all improvements, fixtures and appurtenances thereon or incidental thereto described below as_____ (the "Property").

3. PURCHASE PRICE. The purchase price to be paid at Close of Escrow (COE) defined below by Buyer for the Property is_____($_____).

The Purchase Price shall be paid to Seller as follows:

An Earnest Money Deposit (EMD) of $ _____.

The balance of $ _____ to be paid at COE.

3. PURCHASE PRICE. The purchase price to be paid at Close of Escrow (COE) defined below by Buyer for the Property is_____($_____).

The Purchase Price shall be paid to Seller as follows:

An Earnest Money Deposit (EMD) of $ _____.

The balance of _____ to be paid at COE.

4. EARNEST MONEY DEPOSIT (EMD). to be held in an insured escrow account and held by Escrow Agent and if escrow closes, the earnest money deposit in escrow shall be credited against the Purchase Price. If this Agreement is cancelled by Buyer pursuant to the terms of this Agreement, Buyer becomes entitled to a return of the EMD and Escrow Agent shall immediately refund to Buyer all EMD then in escrow.

5. FINANCING: Funds to purchase property shall be:

_____ CASH. "Cash" is defined as capital from Buyer's personal funds and/or Buyer's investors, partners and/or other unconventional lending sources. This agreement is NOT contingent on Buyer securing funds to close.

_____Subject to Buyer taking over Seller's existing loan of $_____.

_____Seller Financing with the following terms: _____.

_____Traditional Financing contingent on Buyer obtaining the following terms:_____
_____.

_____Seller Financing with the following terms: _____.

_____Traditional Financing contingent on Buyer obtaining the following terms:_____
_____.

6. INSPECTION PERIOD. Buyer's obligations to close this transaction are subject to the satisfaction of Buyer's investigations and inspections of the Property. Buyer shall have until the business day before COE (the "Inspection Period"), during which time Buyer will have the absolute right to cancel this Agreement for any reason whatsoever at Buyer's sole and absolute discretion. Upon such cancellation, Buyer shall be entitled to a return of all EMD held in escrow. Unless Buyer gives written notice of cancellation before the expiration of the Inspection Period, then Buyer will be deemed to have elected not to cancel this Agreement.

BUYER INITIAL(S) _____ _____ **SELLER INITIAL(S) _____ ____**

7. ACCESS TO PROPERTY. Between date of Opening herein and COE, Seller grants Buyer and/or Buyer's employees, inspectors, partners, investors, contractors and/or agent(s) access to Property as follows:

7. ACCESS TO PROPERTY. Between date of Opening herein and COE, Seller grants Buyer and/or Buyer's employees, inspectors, partners, investors, contractors and/or agent(s) access to Property as follows:

_____ **VACANT.** If the Property is vacant as of the Opening, Buyer reserves the right to install a lockbox on the Property, which will contain a key to the Property. Seller acknowledges and agrees that the lockbox will permit access to the Property. Seller acknowledges and agrees that there is a risk in having a lockbox on the Property, and that it is possible an unauthorized person may go into the Property. Buyer is not insuring Seller against theft, loss or vandalism resulting from any unauthorized access.

_____ **OCCUPIED.** If the Property is occupied by seller, tenant or otherwise as of the Opening, Seller shall permit Buyer access with 24-hour notice.

8. TENANT OCCUPIED. If Property is currently in use as a rental property, Tenant shall:

_____Vacate Property on or before COE.

_____Continue occupying property according to applicable and current lease agreement. Seller shall deliver the following to Buyer within five days after Opening: (a) current leases of the Property; (b) a certified rent roll (which Seller shall update at least five days before COE); (c) evidence of security deposits on hand, if any.

9. ESCROW AGENT. Seller and Buyer hereby employ _____, Phone _____ (the "Escrow Agent"); to act as escrow agent for this transaction. This Agreement

_____Continue occupying property according to applicable and current lease agreement. Seller shall deliver the following to Buyer within five days after Opening: (a) current leases of the Property; (b) a certified rent roll (which Seller shall update at least five days before COE); (c) evidence of security deposits on hand, if any.

9. ESCROW AGENT. Seller and Buyer hereby employ _____, Phone _____ (the "Escrow Agent"); to act as escrow agent for this transaction. This Agreement constitutes the escrow instructions to Escrow Agent. If required by real estate governance in state of _____, Escrow Agent, is hereby authorized and instructed to prepare and execute on behalf of Buyer and Seller an Affidavit of Property Value, using the Purchase Price for the established value of the Property.

10. CLOSE OF ESCROW. The closing date shall occur on or about _____, (the "COE"). COE shall occur when exclusive physical possession is given to Buyer and the deed is recorded at the appropriate county recorder's office. Buyer and Seller shall comply with all terms and conditions of this Agreement, execute and deliver to Escrow Agent all closing documents and perform all other acts necessary for COE to occur. Buyer shall have the right to approve the property's title status before COE. Title to the Property shall be conveyed to Buyer at COE by a General Warranty Deed or equivalent warranty deed used in the local jurisdiction with standard owner's title insurance policy. Buyer shall take title as determined by Buyer before COE.

11. ESCROW AND CLOSING FEES. Closing Fees due at COE with the exception of delinquent property taxes, mortgage liens, mechanics liens, IRS liens, judgements and/or any liens, to be paid as follows:

____ Buyer and Seller shall each pay their respective Escrow and Closing Fees according to the usual and

necessary for COE to occur. Buyer shall have the right to approve the property's title status before COE. Title to the Property shall be conveyed to Buyer at COE by a General Warranty Deed or equivalent warranty deed used in the local jurisdiction with standard owner's title insurance policy. Buyer shall take title as determined by Buyer before COE.

11. ESCROW AND CLOSING FEES. Closing Fees due at COE with the exception of delinquent property taxes, mortgage liens, mechanics liens, IRS liens, judgements and/or any liens, to be paid as follows:

____ Buyer and Seller shall each pay their respective Escrow and Closing Fees according to the usual and customary practice in state of _____ .

____ Buyer and Seller agree to split evenly all Escrow and Closing Fees.

____ Buyer shall pay all Escrow and Closing Fees.

____ Seller shall pay all Escrow and Closing Fees.

BUYER INITIAL(S) _____ _____ **SELLER INITIAL(S) _____ _____**

12. PRORATIONS. Real property taxes payable by Seller will be prorated to COE based upon the latest tax information available. The amount of any assessment, other than homeowner's association assessments, that is a lien as of COE shall be paid in full by Seller.

13. PROPERTY TURNOVER. Seller will provide Buyer with the keys to the Property on day of COE.

14. DEBRIS/PERSONAL BELONGINGS. At COE, Seller shall deliver the Property to Buyer:

____ WITH debris and/or personal belongings that are currently present in the property and Buyer assumes all responsibility for trash-out, removal and clean-up of said debris/belongings.

____WITHOUT debris and/or personal belongings. All debris and/or personal belongs to be removed from the interior/exterior of the Property. In the event the Property is not left in a neat and clean condition, Buyer will have clean-up completed at Seller's expense which costs, at Buyer's option, may be deducted from the Purchase Price. Seller's obligation to pay Buyer shall survive the cancellation of this Agreement or COE. Any items remaining in the Property as of COE will be considered trash and removed by the Buyer.

15. APPLIANCES. At COE, all working appliances currently present in the property shall:

___ NOT be included in the sale, herein.

___INCLUDED in the sale, herein with the exception of _____
_____.

16. ADDITIONAL PERSONAL PROPERTY. The following personal property to be included in the

by the Buyer.

15. APPLIANCES. At COE, all working appliances currently present in the property shall:

___ NOT be included in the sale, herein.

___INCLUDED in the sale, herein with the exception of _____
_____.

16. ADDITIONAL PERSONAL PROPERTY. The following personal property to be included in the sale herein: if any: _____.

17. MARKETING. If permissible by real estate governance in the state of _____, Seller authorizes Buyer to advertise the Property for sale or rent (as a principal to this contract, not the Seller's broker, agent or representative), and place signs on or advertise online the Property.

18. SELLER'S DELIVERIES. Seller shall deliver the following to Buyer within five days after Opening: (a) a written five-year insurance claims history regarding the Property (or a claims history for the length of time Seller has owned the Property if less than five years) from Seller's Insurance company; (b) any other disclosures to be made by Seller pursuant to applicable law;

19. INVESTOR DISCLOSURE. Seller acknowledges that Buyer is an investor and purchases properties with the intent to lease, "flip," resell, or otherwise make a profit. Seller acknowledges that the Purchase Price may be less than market value, and is willingly selling it as such for convenience, to save time, lack of funds to renovate, and/or other personal reasons. Seller waives any claims against any existing equity

19. INVESTOR DISCLOSURE. Seller acknowledges that Buyer is an investor and purchases properties with the intent to lease, "flip," resell, or otherwise make a profit. Seller acknowledges that the Purchase Price may be less than market value, and is willingly selling it as such for convenience, to save time, lack of funds to renovate, and/or other personal reasons. Seller waives any claims against any existing equity or added value arising from the Property. Buyer has not made Seller any representations or promises as to the value of the Property in its "as is" condition.

20. REMEDIES. If Seller fails to comply with any provision of this Agreement, Buyer shall deliver a notice to Seller specifying the non-compliance and if the non-compliance is not cured within three days after delivery of Buyer's notice to Seller, such failure shall be a breach of Agreement, entitling Buyer to pursue any and all remedies available to Buyer under this Agreement or at law or in equity, including, without limitation, an action for specific performance. In the event Buyer is forced to institute legal action to enforce this Agreement, Seller will be held responsible for and hereby agrees to pay all legal fees and

BUYER INITIAL(S) _____ _____ **SELLER INITIAL(S)** _____ _____

pay out of such unpaid Purchase Price funds for any/all of Buyer's attorney's fees and costs as they are incurred.

21. STATEMENT REGARDING LEAD BASED PAINT: The parties acknowledge that dwelling units constructed prior to 1978 are likely to contain lead-based paint which could create a health hazard. In the event that the real property which is the subject of this Agreement consists of or contains a residential unit built prior to 1978, the parties agree that each party has received, reviewed, signed and annexed hereto a completed Disclosure and acknowledgment Form regarding Lead-Based Paint as required by federal HUD/EPA disclosure regulations.

22. REPRESENTATIONS BY SELLER. Seller represents and warrants to Buyer as follows:
A. This Agreement and each of the documents and agreements to be delivered by Seller at COE constitute legal, valid and binding obligations of Seller, enforceable against Seller in accordance with their respective terms.

B. Neither the execution of this Agreement nor the performance by Seller of its obligations under this Agreement will result in any breach or violation of (1) to Seller's actual knowledge, the terms of any law, rule, ordinance, or regulation; or (2) any decree, judgment or order to which Seller is a party now in effect from any court or governmental body; and (3) there are no consents, waivers, authorizations or approvals from any third party necessary to be obtained by Seller In order to carry out the transactions contemplated by this Agreement.

C. The execution and delivery of this Agreement and performance by Seller of its obligations under this Agreement will not result in the creation of any new, or the acceleration of any existing, lien, charge, or

C. The execution and delivery of this Agreement and performance by Seller of its obligations under this Agreement will not result in the creation of any new, or the acceleration of any existing, lien, charge, or encumbrance upon the Property.

D. Seller has no actual knowledge and has received no notice that the Property is not in compliance with all applicable laws governing the use and operation thereof, nor, to Seller's actual knowledge, does there exist any facts or circumstances of the Property which with notice or the passage of time would constitute such a violation.

E. As of Opening, Seller has not entered into any other Agreement or contract to sell the Property.

F. Seller has disclosed to Buyer all material latent defects and any information concerning the Premises known to Seller.

Each of the representations and warranties of Seller contained in this Section constitutes a material part of the consideration to Buyer and Buyer is relying on the correctness and completeness of these representations and warranties in entering into this transaction. Each of the representations and warranties is true and accurate as of the date of execution of this Agreement by Seller, will be true and accurate as of COE and will survive COE.

23. OTHER AGREEMENTS. Seller shall not enter into an Agreement or Contract to purchase with anyone else concerning the Property from and after Opening. Should seller participate in another agreement which will interfere with COE, Seller will be responsible for any and all costs and losses to

known to Seller.

Each of the representations and warranties of Seller contained in this Section constitutes a material part of the consideration to Buyer and Buyer is relying on the correctness and completeness of these representations and warranties in entering into this transaction. Each of the representations and warranties is true and accurate as of the date of execution of this Agreement by Seller, will be true and accurate as of COE and will survive COE.

23. OTHER AGREEMENTS. Seller shall not enter into an Agreement or Contract to purchase with anyone else concerning the Property from and after Opening. Should seller participate in another agreement which will interfere with COE, Seller will be responsible for any and all costs and losses to Buyer.

BUYER INITIAL(S) _____ _____ **SELLER INITIAL(S)** _____ _____

24. INDEMNITY AND RELEASE OF CLAIMS. Seller will indemnify Buyer in connection with defending any claim or action against Seller or Buyer. Seller shall defend, indemnify, save and hold Buyer harmless for and against any and all Claims: (a) directly or indirectly relating in any way to the Property and accruing prior to COE; and (b) arising as a result of the breach by Seller of any of Seller's obligation under this Agreement or under any other agreement or document delivered by Seller in accordance with this Agreement, or as a result of the inaccuracy of any representation or warranty made by Seller in this Agreement or in any other agreement or document delivered by Seller pursuant to this Agreement or in connection with the transactions contemplated by this Agreement. "Claims" means any and all obligations, debts, covenants, conditions, representations, costs, and liabilities and any and all demands, causes of action, and claims, of every type, kind, nature or character, direct or indirect, known or unknown, absolute or contingent, determined or speculative, at law, in equity or otherwise, including attorneys' fees and litigation and court costs.

25. AGENCY. Seller acknowledges that seller has NOT been represented by Buyer or by any representative of Buyer with respect to the Purchase and Sale of the Property. Seller agrees and understands that the Buyer that the Buyer's Representatives are NOT acting as Seller's Broker or Agent in the transaction and have been acting solely for Buyer's own benefit as a principal to this Agreement. Seller agrees to hold Buyer free from any/all liability regarding the property and transaction arising from any claim of agency.

26. ASSIGNMENT AND RELEASE. Seller agrees and acknowledges that Buyer may assign its rights

defending any claim or action against Seller or Buyer. Seller shall defend, indemnify, save and hold Buyer harmless for and against any and all Claims: (a) directly or indirectly relating in any way to the Property and accruing prior to COE; and (b) arising as a result of the breach by Seller of any of Seller's obligation under this Agreement or under any other agreement or document delivered by Seller in accordance with this Agreement, or as a result of the inaccuracy of any representation or warranty made by Seller in this Agreement or in any other agreement or document delivered by Seller pursuant to this Agreement or in connection with the transactions contemplated by this Agreement. "Claims" means any and all obligations, debts, covenants, conditions, representations, costs, and liabilities and any and all demands, causes of action, and claims, of every type, kind, nature or character, direct or indirect, known or unknown, absolute or contingent, determined or speculative, at law, in equity or otherwise, including attorneys' fees and litigation and court costs.

25. AGENCY. Seller acknowledges that seller has NOT been represented by Buyer or by any representative of Buyer with respect to the Purchase and Sale of the Property. Seller agrees and understands that the Buyer that the Buyer's Representatives are NOT acting as Seller's Broker or Agent in the transaction and have been acting solely for Buyer's own benefit as a principal to this Agreement. Seller agrees to hold Buyer free from any/all liability regarding the property and transaction arising from any claim of agency.

26. ASSIGNMENT AND RELEASE. Seller agrees and acknowledges that Buyer may assign its rights under this Agreement to a wholly or partially owned entity of the Buyer or a third party that will close directly with Seller. If such an assignment should happen, Seller agrees to release Buyer from any liability or duties under this Agreement.

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27. MISCELLANEOUS.

A. Time. Time is of the essence of this Agreement. The time for performance of any obligation or taking any action under this Agreement shall be deemed to expire at 5:00 p.m. _____(state) time on the last day of the applicable time period provided for in this Agreement. If the time for the performance of any obligation or taking any action under this Agreement expires on a Saturday, Sunday or legal holiday, the time for performance or taking such action shall be extended to the next succeeding day which is not a Saturday, Sunday or legal holiday.

B. Notices. All notices and requests must be in writing. They may be delivered either (a) personally; (b) by certified mail; (c) by fax; or (d) electronically. Notices or requests will be deemed received: 0) when accepted or rejected, if delivered personally, (ii) two days after being mailed, if mailed by certified mail; (c) when a fax confirmation is received, if faxed; or (d) when the receiving party has responded by email confirming receipt (email auto responses do not count).

C. Necessary Documents and Acts. Seller and Buyer each agree to sign such other documents and perform such acts as may be reasonably necessary or appropriate to consummate this transaction in accordance with the terms of this Agreement.

27:57 / 30:13

this Agreement shall be stricken from and construed for all purposes not to constitute a part of this Agreement, and the remaining portion of this Agreement shall remain in full force and effect and shall, for all purposes, constitute the entire Agreement.

H. Counterparts. This Agreement may be signed electronically and in counterparts, each together making it a binding agreement.

I. Survival. The following obligations of the parties will survive COE or cancellation of this Agreement, whether contained in this Agreement or in any agreement. instrument, or other document given by a party in connection with the transactions contemplated by this Agreement: (a) any and all obligations of the parties that are to be performed following COE; (b) all Indemnity obligations of the parties; (c) any and all warranties or representations of the parties; and (d) any other obligation with respect to which it is expressly provided that it will survive COE or cancellation of this Agreement.

J. Waivers. No waiver or any provisions of this Agreement shall constitute a waiver of any other provision, whether or not similar, nor shall any waiver be a continuing waiver. Except as expressly provided in this Agreement, no waiver shall be binding unless executed in writing by the party making the waiver.

K. Attorneys' Fees. If either party should prevail in any litigation, arbitration or other legal proceeding instituted by or against the other related to this Agreement, the prevailing party shall receive from the non-prevailing party all costs and reasonable attorneys' fees incurred in such proceeding, including costs on appeal.

the parties and their respective heirs, personal representatives, successors and assigns.

N. Right to Counsel. Seller represents and agrees that Seller fully understands Seller's right to discuss all aspects of this Agreement with an attorney, that Seller has carefully read and fully understands all of the provisions of this Agreement that Seller freely and voluntarily entered into this Agreement and that Seller has read this document in its entirety and fully understands the meaning. intent and consequences of this Agreement. This representation will survive this Agreement's termination.

BUYER INITIAL(S) _____ _____ **SELLER INITIAL(S) _____ ____**

O. Governing Law/Jurisdiction. This Agreement shall be governed by and construed and enforced under the laws of the state of ____ whose courts shall have jurisdiction over any legal proceedings or actions arising out of this Agreement. _____ County, in the state of _____ shall be the place of

O. Governing Law/Jurisdiction. This Agreement shall be governed by and construed and enforced under the laws of the state of ____ whose courts shall have jurisdiction over any legal proceedings or actions arising out of this Agreement. _____ County, in the state of ____ shall be the place of venue of any such proceeding or action.

P. Acceptance. This agreement shall remain in full force and effect until _____o'clock local time on _____(date). If at this time the Seller has not executed and delivered a fully executed original agreement, the contract shall become of no force and effect.

28. ANY OTHER TERMS AND CONDITIONS (If None Write None):

_____

_____

_____

_____

SELLER(S): _____ _____

Signature Date Signature Date

28:50 / 30:13

O. Governing Law/Jurisdiction. This Agreement shall be governed by and construed and enforced under the laws of the state of ____ whose courts shall have jurisdiction over any legal proceedings or actions arising out of this Agreement. _____ County, in the state of ____ shall be the place of venue of any legal proceeding or action.

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28. ANY OTHER TERMS AND CONDITIONS (If None Write None):

_____

_____

_____

_____

SELLER(S): _____ _____

Signature Date Signature Date

28:30 / 30:13

Venture Atlas

STANDARD REAL ESTATE PURCHASE AND SALE AGREEMENT

Parties VENTURE ATLAS, LLC
MARK HULL, hereinafter referred to as Buyer, and
and include the heirs, successors, personal representatives and assigns of Seller and Buyer, hereby agree that Seller will sell and Buyer
will buy the following property, with such improvements as are located thereon, and is described as follows: All that tract of land lying
and being in Land Lot _____ of the _____ District, _____ Section of _____ County, and being known as Address:
135 ROBBINS ROAD City: WINSTON SALEM State: NC Zip: 27107 according to the present
system of numbering in and around this area, and being more particularly described as Lot ___, Block ___, Unit _____, Phase/Section
_____ of _____ Subdivision, as recorded in Plat Book 18, Page 50, FORSYTH
County, _____ records together with all light fixtures, all electrical, mechanical, plumbing, air-conditioning, and any other
systems or fixtures as are attached thereto; all plants, trees, and shrubbery now a part thereof, together with all the improvements thereon;
and all appurtenances thereto, all being hereinafter collectively referred to as the "Property." The full legal description of said Property
is the same as is recorded with the Clerk of the Superior Court of the County in which the Property is located and is made a part of this
Agreement by reference.

Seller will sell and Buyer will buy upon the following terms and conditions, if completed or marked. On any conflict of terms or conditions, that which is added will supersede that which is printed or marked. It is understood that the Property will be conveyed by General Warranty Deed (unless otherwise specified in Paragraph 21), with covenants, restrictions, and easements of record.

1. **Total Purchase Price** to be paid by Buyer is payable as follows:

   A. Earnest money deposit check ☒; or promissory note ☐, which will remain as a binder until closing, and be held for Seller by closing agent (chosen by Buyer) for Seller until closing, unless sooner forfeited or returned, according to the provisions of this Agreement. $ 100.00

   B. Due Diligence Fee made payable and delivered to seller by the effective date $ [illegible]

   C. Balance due at closing (not including [illegible]

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#26531

Max Maxwell Live | EXACTLY HOW TO DO SUB TO DEALS | Wholesaling Real Estate

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B. Due Diligence Fee made payable and delivered to seller by the effective date $ 100.00

C. Balance due at closing (not including Buyers closing costs, prepaid items or prorations) in U.S. cash or locally drawn certified or cashier's check.
approximately ☒: exactly ☐ $ 11,800.00

D. Proceeds of a new loan to be executed by Buyer to any lender other than Seller; Name of Lender: _____ $ _____

E. Seller financing as herein set forth in paragraph 17 A-3.
approximately ☐: exactly ☐ $ _____

F. "Subject to" existing loan balance encumbering the Property $ 55,000.00 (Approx
Lender SUNTRUST Loan # _____
Interest Rate _____% Fixed Rate ☐; Adjustable Rate ☐; $_____ /month
Includes Principal ☐; Interest ☐; Escrow: Taxes ☐; Insurance ☐; HOA ☐

G. "Subject to" existing second loan balance encumbering the Property $ 20,000.00 (Approx
Lender TRULIANT Loan # _____
Interest Rate _____% Fixed Rate ☐; Adjustable Rate ☐; P&I $_____ per month

H. Existing mortgage balance encumbering the Property to be assumed by Buyer $ _____
Approximate balance: _____

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6:04 / 13:23

(Escrow by Buyer) for Seller until closing, unless sooner forfeited or returned, according to the provisions of this Agreement. $ 100.00

B. Due Diligence Fee made payable and delivered to seller by the effective date $ 100.00

C. Balance due at closing (not including Buyers closing costs, prepaid items or prorations) in U.S. cash or locally drawn certified or cashier's check.
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Lender TRULIANT Loan # _____
Interest Rate _____% Fixed Rate ☐; Adjustable Rate ☐; P&I $_____ per month

H. Existing mortgage balance encumbering the Property to be assumed by Buyer $ _____
Approximate balance: _____

I. Other Encumbrances or record.....$ _____
List other encumbrances: _____

J. **Total Purchase Price:** approximately ☒; exactly ☐ $ 87,000.00

Buyer Initials MM Buyer Initials _____ Seller Initials MH Seller Initials _____

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6:34 / 13:23

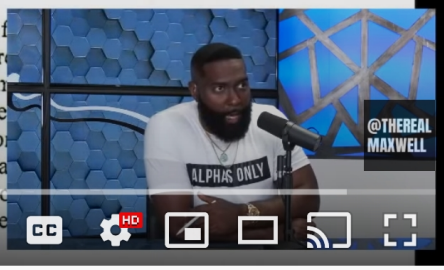
2. Seller Will Pay: (Unless otherwise specified in Paragraph 21) **Seller** will pay all closing costs to include: Recording Fees, Intangibles Tax, Credit Reports, Funding Fee, Loan Origination Fee, Document Preparation Fee, Loan Insurance Premium, Loan Discount, Title Insurance Policy, Attorney's Fees, Courier Fees, Overnight Fee, Appraisal Fee, Survey, Transfer Tax, Satisfaction and Recording Fees, Wood Destroying Organism Report and any other costs associated with the funding or closing of this Agreement, Buyer will pay all additional monies.

3. Payment of Expenses: If Buyer fails to perform, all loan and sale processing and closing costs incurred, whether the same were to be paid by Seller or Buyer will be the responsibility of the Buyer, with costs deducted from binder deposit. If Seller fails to perform, all loan, fee obligations, appraisal, survey, credit report, application, sales processing and closing costs incurred whether the same were to be paid by Seller or Buyer will be the responsibility of Seller; and Buyer will be entitled to the return of the binder deposit. This will include, but not be limited to the transaction not being closed because Seller is unwilling to complete the transaction, or because Seller elects not to pay for the excess amount in paragraph 11 (with respect to repairs) or because Seller cannot deliver marketable title.

4. Prorations: Any accrued loan interest shall be prorated to the date of closing. Seller will assign to Buyer, at no cost to Buyer, Seller's escrow account and property hazard insurance policy, and/or any refunds which may issue, in lieu of proration of all taxes, association fees, monthly hazard insurance premiums, and monthly mortgage insurance premiums as of the date of closing. Seller will bring any escrow shortage current at closing. In the absence of an escrow account, taxes shall be prorated as the date of closing. If this is rental property, rents are to be prorated as of the date of closing and any deposits of any kind or nature are to be transferred to Buyer at closing.

5. Wood Destroying Organism Report: "Wood Destroying Organism" means any arthropod or plant lif
Seller will have property inspected by a State Certified Pest Control Firm, within seven (7) days of this Agr
there is any visible active wood destroying organism infestation or visible existing structural damage fron
to the improvements. Buyer will be informed of either or both of the foregoing and Seller will have se
written notice thereof within which to have all such wood destroying organism damages whether visible o
by a licensed building or general contractor. Seller will pay costs of treatment and repair of all structural da
of the purchase price. If such costs exceed the amount agreed to be paid by Seller and Seller declines t
have the option of (a) terminating this Agreement, (b) proceeding with the transaction, in which event Selle
percent (1%) of the purchase price.

6. Title Examination, Place and Time for Closing:



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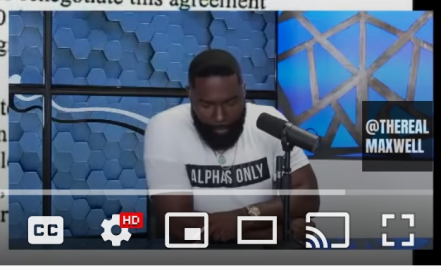
at closing. ... and any deposits of any kind or nature are to be transferred to Buyer

5. Wood Destroying Organism Report: "Wood Destroying Organism" means any arthropod or plant life, which damages a structure. Seller will have property inspected by a State Certified Pest Control Firm, within seven (7) days of this Agreement, to determine whether there is any visible active wood destroying organism infestation or visible existing structural damage from wood destroying organisms to the improvements. Buyer will be informed of either or both of the foregoing and Seller will have seven (7) days from receipt of written notice thereof within which to have all such wood destroying organism damages whether visible or not inspected and estimated by a licensed building or general contractor. Seller will pay costs of treatment and repair of all structural damage up to one percent (1%) of the purchase price. If such costs exceed the amount agreed to be paid by Seller and Seller declines to treat and repair, Buyer will have the option of (a) terminating this Agreement, (b) proceeding with the transaction, in which event Seller will bear costs equal to one percent (1%) of the purchase price.

6. Title Examination, Place and Time for Closing: A. If title evidence and survey show Seller is vested with a good, clear and marketable title, subject to permitted title exceptions contained in a national title insurance company commitment at its standard rates (permitted exceptions are for restrictive covenants, leases, survey, current taxes, zoning ordinances and easements of record), the transaction will be closed and the deed and other closing papers delivered on or before March 24, 20 20, plus any extensions necessary in order to complete paperwork, unless extended by other conditions of this Agreement or this Agreement is canceled by the Buyer. Buyer shall select closing attorney or title company. **B.** If title evidence or survey reveal any defects which render the title unclear, Buyer will have 7 days from receipt of title commitment and survey to notify Seller of such title defects and Seller agrees to use reasonable diligence (including payment of money) to cure such defects at Seller's expense and will have 30 days to do so, in which event this transaction will be closed within 10 days after delivery to Buyer of evidence that such defects have been cured. Seller agrees to pay for and discharge all due or delinquent taxes, liens and other encumbrances, unless otherwise agreed. If Seller is unable to convey to Buyer a good, clear and marketable title, Buyer will have the right to terminate this Agreement, at the same time returning to Seller all title evidence and surveys received from Seller, OR Buyer shall have the right to renegotiate this agreement with Seller and accept such title as Seller may be able to convey, which election will be exercised within 10 ... inability to cure. Closing attorney or title company will then close upon the modified agreement. Seller ag... Purchase and Sale Agreement" so that the Buyer may protect their interest in the contract herein.

7. Loss or Damage: If the property is damaged by fire or other casualty prior to closing, and cost of rest... of the insurance cost of replacement tables for the improvements located on the Property, cost of restoration ... Seller and closing will proceed pursuant to the terms of this Agreement with cost thereof escrowing at cl... restoration exceeds 3% of the stated valuation of the improvements and Seller declines to repair or restore, ... of either taking the Property as is, together with either the said 3% or any insurance proceeds payable by vir... with Seller paying Buyer in cash any insurance deductible, OR of canceling this Agreement.

8. Due Diligence Period: The period beginning on the Effective Date and ...



7:33 / 13:23

of general contractor. Seller will pay costs of treatment and repair of all structural damage up to one percent (1%) of the purchase price. If such costs exceed the amount agreed to be paid by Seller and Seller declines to treat and repair, Buyer will have the option of (a) terminating this Agreement, (b) proceeding with the transaction, in which event Seller will bear costs equal to one percent (1%) of the purchase price.

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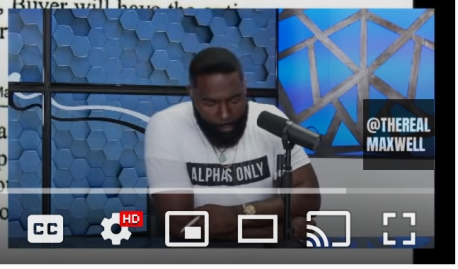
7. Loss or Damage: If the property is damaged by fire or other casualty prior to closing, and cost of restoration does not exceed 3% of the insurance cost of replacement tables for the improvements located on the Property, cost of restoration will be an obligation of the Seller and closing will proceed pursuant to the terms of this Agreement with cost thereof escrowing at closing. In the event cost of restoration exceeds 3% of the stated valuation of the improvements and Seller declines to repair or restore, Buyer will have the opti
of either taking the Property as is, together with either the said 3% or any insurance proceeds payable by vir
with Seller paying Buyer in cash any insurance deductible, OR of canceling this Agreement.

8. Due Diligence Period: The period beginning on the Effective Date and extending through 5:00 p.m. on Ma

9. Buyer's Right to Terminate: Buyer shall have the right to terminate this Contract for any reason or no rea
written notice of termination (the "Termination Notice") during the Due Diligence Period (or any agreed-up
Due Diligence Period), TIME BEING OF THE ESSENCE. If Buyer timely delivers the Termination No
terminated, and the Earnest Money Deposit shall be refunded to Buyer. If buyer delivers the Termination No
period but prior to closing, the earnest money deposit shall be delivered to seller.

10. Foreclosure Notice: If the subject property is in a foreclosure or default status the seller



7:39 / 13:23

render the title unclear, Buyer will have 7 days from receipt of title commitment and survey to notify Seller of such title defects and Seller agrees to use reasonable diligence (including payment of money) to cure such defects at Seller's expense and will have 30 days to do so, in which event this transaction will be closed within 10 days after delivery to Buyer of evidence that such defects have been cured. Seller agrees to pay for and discharge all due or delinquent taxes, liens and other encumbrances, unless otherwise agreed. If Seller is unable to convey to Buyer a good, clear and marketable title, Buyer will have the right to terminate this Agreement, at the same time returning to Seller all title evidence and surveys received from Seller, OR Buyer shall have the right to renegotiate this agreement with Seller and accept such title as Seller may be able to convey, which election will be exercised within 10 days from notice of Seller's inability to cure. Closing attorney or title company will then close upon the modified agreement. Seller agrees to execute a "Notice of Purchase and Sale Agreement" so that the Buyer may protect their interest in the contract herein.

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8. Due Diligence Period: The period beginning on the Effective Date and extending through 5:00 p.m. on March 12, 2020.

9. Buyer's Right to Terminate: Buyer shall have the right to terminate this Contract for any reason or no reason, by delivering to Seller written notice of termination (the "Termination Notice") during the Due Diligence Period (or any agreed-upon written extension of the Due Diligence Period), TIME BEING OF THE ESSENCE. If Buyer timely delivers the Termination Notice, this Contract shall be terminated, and the Earnest Money Deposit shall be refunded to Buyer. If buyer delivers the Termination Notice after the due diligence period but prior to closing, the earnest money deposit shall be delivered to seller.

10. Foreclosure Notice: If the subject property is in a foreclosure or default status the seller hereby acknowledges that buyer has made

Buyer Initials MM Buyer Initials_____ Seller Initials MH Seller Initials_____

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8:24 / 13:23

no guarantees to stop or postpone the pending foreclosure auction or sheriff's sale. Should the buyer remit any funds on the seller's behalf to Lenders, trustees, banks, or any other parties in order to stop or postpone the seller's default or foreclosure status, seller agrees that any funds remitted from the buyer will be credited to the buyer towards the purchase price at closing. Seller agrees that buyer has made no guarantees or representations regarding any amounts of proceeds that seller may or may not receive resulting from the sale of the subject property.

11. Property Condition and Inspection: Seller shall deliver the Property in the same condition as they were on the date of this Agreement, normal wear and tear excepted, and they shall be in a clean and ready to occupy condition, except as otherwise specified herein. Seller further certifies and represents that Seller knows of no latent defects to the Property and knows of no facts materially affecting the value of the Property except the following: _____

_____

_____

_____

This Agreement is subject to an inspection of the Property and approval by Buyer and/or his associates and assigns after acceptance of this Agreement by Seller. If not already on, Seller shall have all utilities on for inspection and shall notify Buyer when they are on. In the event any system, appliance, roof, foundation or structural member, etc., shall be found defective during this inspection, Buyer shall have the right to choose to have the Seller remedy the defect, take the Property "As-Is" or to terminate the Agreement. If Buyer elects to terminate this Agreement, Buyer shall be entitled to receive a full refund of all earnest monies hereunder. Seller guarantees that the appliances remaining with the dwelling and the heating, air conditioning, plumbing and electrical systems, where applicable, will be in operating condition at the time of closing.

12. Occupancy: Seller represents that there are no parties in occupancy other than Seller and Buyer will be given occupancy on _____ at closing. Seller will pay a fee of $50.00 per day for each day beyond occupancy date that Seller remains on the premises. Any belongings, furniture or fixtures on property after closing shall be considered as abandoned and Buyer shall have the right of disposal of same. Any tenant, if appropriate, shall be terminated and shall have vacated the Property prior to the closing of this Agreement, unless otherwise agreed to by Buyer in writing.

13. Personal Property: Included in the purchase price are all fixed

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8:28 / 13:23

wear and tear excepted, and they shall be in a clean and ready to occupy condition, except as otherwise specified herein. Seller further certifies and represents that Seller knows of no latent defects to the Property and knows of no facts materially affecting the value of the Property except the following: _____

_____

_____

_____

This Agreement is subject to an inspection of the Property and approval by Buyer and/or his associates and assigns after acceptance of this Agreement by Seller. If not already on, Seller shall have all utilities on for inspection and shall notify Buyer when they are on. In the event any system, appliance, roof, foundation or structural member, etc., shall be found defective during this inspection, Buyer shall have the right to choose to have the Seller remedy the defect, take the Property "As-Is" or to terminate the Agreement. If Buyer elects to terminate this Agreement, Buyer shall be entitled to receive a full refund of all earnest monies hereunder. Seller guarantees that the appliances remaining with the dwelling and the heating, air conditioning, plumbing and electrical systems, where applicable, will be in operating condition at the time of closing.

12. Occupancy: Seller represents that there are no parties in occupancy other than Seller and Buyer will be given occupancy on _____ at closing. Seller will pay a fee of $50.00 per day for each day beyond occupancy date that Seller remains on the premises. Any belongings, furniture or fixtures on property after closing shall be considered as abandoned and Buyer shall have the right of disposal of same. Any tenant, if appropriate, shall be terminated and shall have vacated the Property prior to the closing of this Agreement, unless otherwise agreed to by Buyer in writing.

13. Personal Property: Included in the purchase price are all fixed equipment including all window treatments, built-in appliances, refrigerator, floor coverings, stove, air conditioner(s), ceiling fans, attached lighting fixtures, mailbox, fence, storage building, plants, yard ornaments and shrubbery as now installed on the property, and these additional items which will be conveyed by Bill of Sale at the closing: _____

_____

Items specifically excluded from this Agreement: _____

_____

14. Default and Attorney's Fees: If Buyer defaults on this Agreement, all deposits will be retained by the Seller as full settlement of any claim, whereupon Buyer and Seller will be relieved of all obligations under this Agreement. If Seller defaults under this Agreement, the Buyer may seek specific performance or elect to receive the return of the Buyer's binding earnest money without thereby waiving any action for

Buyer Initials

8:34 / 13:23

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14. Default and Attorney's Fees: If Buyer defaults on this Agreement, all deposits will be retained by the Seller as full settlement of any claim, whereupon Buyer and Seller will be relieved of all obligations under this Agreement. If Seller defaults under this Agreement, the Buyer may seek specific performance or elect to receive the return of the Buyer's binder deposit(s) without thereby waiving any action for damages resulting from Seller's breach. If Seller refuses to sell for any reason other than those outlined herein, Seller and Buyer herewith agree that this Agreement, and all transactions contemplated hereby, shall be governed by, construed and enforced in accordance with applicable state law. Any and all claims, controversies or disputes arising out of or relating to this Agreement, or the breach thereof, which remain unresolved after direct negotiations between the Parties, shall first be submitted to confidential mediation in accordance with the rules, procedures, and protocols for mediation of disputes under applicable state law then in effect upon ten (10) days notice via both certified and regular mail, one party unto the other. If any issues, claims or disputes remain unresolved after mediation concludes, the Parties hereto agree to immediately submit any such issues to binding arbitration before one/three arbitrator(s) in accordance with the rules, procedures, and protocols for arbitration of disputes under applicable state law then in effect. The parties further agree that the award of the arbitrator(s) is binding upon the Parties and that all expenses of such mediation and/or arbitration shall be borne by the losing Party and that any judgment upon the award rendered may be entered, after ten (10) days, into any court of competent jurisdiction.

Buyer Initials MH

Seller Initials MM

15. Zoning and Restrictions: Seller warrants Property is zoned residential. Should Buyer discover any proposed zoning change unacceptable to Buyer, Buyer may void this Agreement and maintain all rights to compensatory and consequential damages.

16. Maintenance and Access: Until title is delivered, Seller agrees to completely maintain all elements of the Property, including, but not limited to, the heating and air conditioning systems, the entire grounds, the roof, sewer, plumbing and electrical systems and any appliances remaining with the Property, and all other equipment, in normal and correct working order. Buyer has the right to make repairs, show the Property to prospects, lenders, contractors or partners, and to post signs for sale, rental or rent to own before closing. If Seller fails to maintain the Property, Buyer shall have the right, without further notice, to maintain the Property and make all needed repairs. The cost of such repairs may be deducted from the sales price at closing. If the property does not close, Buyer may file a lien

Buyer Initials MM Buyer Initials_____ Seller Initials MH Seller Initials_____

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8:36 / 13:23

on the Property with the County Recorder's office and keep it in place until such time that the amount of the maintenance and repairs have been paid by Seller to Buyer and Buyer shall have all legal and equitable rights to collect for such maintenance and repair.

17. Financing and Contingencies: If Buyer does not obtain the required financing, or if the additional conditions set forth in this Agreement are not satisfied to Buyer's satisfaction or waived in writing by Buyer, the earnest money deposit will be immediately returned to the Buyer and this Agreement shall thereafter terminate and be of no further force or effect.

A. Financing.

A-1. Application: the application for the mortgage described in paragraph 1. D. above will be made with any lender satisfactory to Buyer. Unless such mortgage loan is approved without continued contingencies other than those elsewhere covered in this agreement within _____ days of the date of acceptance of this agreement, Buyer will have the right to terminate this agreement, and Seller shall immediately return the earnest money deposit to Buyer.

A-2. Loan Assumption: paragraph 1H. above: Buyer understands that interest will will not, escalate and is a variable fixed rate. Buyer will within _____ days make application and timely make a good faith effort to provide qualifying information as reasonably required by lender. Buyer's obligation to close is contingent on lender's approval of the assumption within _____ days of the date of acceptance of this agreement. If such assumption is not approved by the lender, then Seller shall immediately return the earnest money deposit to Buyer.

A-3. Purchase Money Note: Seller agrees to take back a Purchase Money Note, as contained in paragraph 1E, for the amount of $_____ with _____ (___) _____ payments of $_____ each, which include principal and interest, and shall start on _____, 20____. In the event of default, Seller must notify Buyer, in writing by certified mail, of default, and give Buyer 30 days to cure default. This property shall stand as sole security for the Purchase Money Note. Buyer may at any time, without penalty, pay in part or in full the principal balance of the Purchase Money Note owing to Seller. Buyer has the right to substitute like collateral of equal or greater value. Should Seller decide to sell Purchase Money Note, the Buyer shall have the first right of refusal to buy Seller's interest. Any mortgage created by this transaction must include agreed provisions above and be acceptable to Buyer. Seller agrees not to further encumber the Property in any way.

18. Existing Financing: Buyer will be taking the property subject to deed(s) of trust existing on the property and the underlying existing loans and is not expressly assuming responsibility through a formal assumption of said debts. Commencing on _____, _____, the Buyer shall pay all monthly obligations on the underlying loans and property taxes, assessments, homeowner's association dues (if applicable) and any other

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8:38 / 13:23

$_____ with _____ (___) _____ payments of $_____ each, which include principal and interest, and shall start on _____, 20____. In the event of default, Seller must notify Buyer, in writing by certified mail, of default, and give Buyer 30 days to cure default. This property shall stand as sole security for the Purchase Money Note. Buyer may at any time, without penalty, pay in part or in full the principal balance of the Purchase Money Note owing to Seller. Buyer has the right to substitute like collateral of equal or greater value. Should Seller decide to sell Purchase Money Note, the Buyer shall have the first right of refusal to buy Seller's interest. Any mortgage created by this transaction must include agreed provisions above and be acceptable to Buyer. Seller agrees not to further encumber the Property in any way.

18. Existing Financing: Buyer will be taking the property subject to deed(s) of trust existing on the property and the underlying existing loans and is not expressly assuming responsibility through a formal assumption of said loans. Commencing on _____, _____, the Buyer shall pay all monthly obligations on the underlying loans and property taxes, assessments, homeowner's association dues (if applicable) and any other expenses related to the property. **Seller is aware that this loan will not be satisfied in full at closing and may continue to appear on Sellers credit file.** Seller will provide Buyer with loan payment booklets and written permission to contact the holders of any debt securing a deed of trust on the property. Seller will execute a Limited Power of Attorney pertaining to the subject property. **Both Seller and Buyer acknowledge that the deed(s) of trust securing the property stated above may contain a "due on sale" provision giving the lender an option to call the loan immediately due and payable if all or any part of the Property is sold or transferred without satisfying the said loans.**

19. Survival of Agreement: This Agreement shall survive the closing, execution and delivery of the Warranty Deed, as agreed herein by the undersigned. Buyer intends to buy, sell, rent or trade for a profit. Seller hereby gives their consent that buyer may file with the County Recorder an AFFIDAVIT AND MEMORANDUM OF PURCHASE AND SALE AGREEMENT to protect its interest in this contract. Seller agrees to execute such acknowledgement with the execution of this agreement.

20. Assignment: Parties hereto agree that Buyer shall have the right to assign this Agreement and the terms and provisions hereof shall be binding upon and inure to the benefit of the parties hereto, their successors, representatives, heirs and assigns.

21. Additional Terms, Conditions or Exhibits (lettered A, B, C, D, etc.): In any conflict of terms or conditions, that which is added will supersede that which is printed or marked

A. SUBJECT TO CORPORATE / PARTNER'S APPROVAL.

B. IF FINAL BALANCE SHOWN BY LENDER'S STATEMENT OF ACCOUNT SHOWS A LOWER PRINCIPAL BALANCE, THEN THE PURCHASE PRICE SHALL BE REDUCED BY THIS AMOUNT. IF THE STATEMENT SHOWS A HIGHER BALANCE, THEN THE CASH DUE FROM BUYER AT CLOSING SHALL BE REDUCED. IF NO CASH IS DUE, THEN THE SELLER AGREES TO PAY ANY SHORTAGE AT CLOSING.

C. Buyer reserves the right to assume or originate new hazard insurance and to be refunded any unearned premiums.

D. Buyer may take possession of the Property upon acceptance of this offer

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8:43 / 13:23

existing loans and is not expressly assuming responsibility through a formal assumption of said loans. Commencing on _____, _____, the Buyer shall pay all monthly obligations on the underlying loans and property taxes, assessments, homeowner's association dues (if applicable) and any other expenses related to the property. **Seller is aware that this loan will not be satisfied in full at closing and may continue to appear on Sellers credit file.** Seller will provide Buyer with loan payment booklets and written permission to contact the holders of any debt securing a deed of trust on the property. Seller will execute a Limited Power of Attorney pertaining to the subject property. **Both Seller and Buyer acknowledge that the deed(s) of trust securing the property stated above may contain a "due on sale" provision giving the lender an option to call the loan immediately due and payable if all or any part of the Property is sold or transferred without satisfying the said loans.**

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C. **Buyer reserves the right to assume or originate new hazard insurance and to be refunded any unearned premiums.**

D. **Buyer may take possession of the Property upon acceptance of this offer for the sole purpose of (1) improving the Property; and (2) showing it to prospective tenants or buyers.**

E. Proceeds at closing shall be disbursed as follow: Seller to receive $5,000.00 at closing and remaining balance of $6,800.00 upon surrender of keys to Venture Atlas, as agreed between Seller and Buyer.

F. Buyer to pay ALL Closing Costs

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8:46 / 13:23

Property stated above may contain a "due on sale" provision giving the lender an option to call the loan immediately due and payable if all or any part of the Property is sold or transferred without satisfying the said loans.

19. Survival of Agreement: This Agreement shall survive the closing, execution and delivery of the Warranty Deed, as agreed herein by the undersigned. Buyer intends to buy, sell, rent or trade for a profit. Seller hereby gives their consent that buyer may file with the County Recorder an AFFIDAVIT AND MEMORANDUM OF PURCHASE AND SALE AGREEMENT to protect its interest in this contract. Seller agrees to execute such acknowledgement with the execution of this agreement.

20. Assignment: Parties hereto agree that Buyer shall have the right to assign this Agreement and the terms and provisions hereof shall be binding upon and inure to the benefit of the parties hereto, their successors, representatives, heirs and assigns.

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A. **SUBJECT TO CORPORATE / PARTNER'S APPROVAL.**

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F. Buyer to pay ALL Closing Costs.

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8:54 / 13:23

G. _____

22. Full Understanding: There are no other agreements, promises or understandings between these parties except as specifically set forth herein. This legal and binding Agreement will be construed under ~~North Carolina~~ Law. The parties warrant that they have consulted an attorney if they have had any questions regarding this agreement. The parties, by signing below, acknowledge that they understand the agreement and assent to all the terms and conditions herein. The parties further agree that this agreement is a negotiated effort and that any ambiguity herein shall not be construed against either party but shall be enforceable to the extent of the letter and spirit of this agreement. If any signature is faxed or digitally produced it shall have the same legal force and effect as an original ink signature.

23. TIME IS OF ESSENCE IN THIS AGREEMENT. Unless this offer is signed by Seller and personally received by Buyer, by ~~March 3, 2020~~ 4, at ~~5:00~~ AM/PM, the offer shall be deemed revoked and the deposit shall be returned.

Signed, sealed on the date herein stated. **Show Seller's name(s) as it appear(s) on existing deed, if available.**

VENTURE ATLAS, LLC
Buyer: _____

Buyer: _____

03/02/2020
Date of Offer

MARK HULL Mark Hull
Seller: _____

Seller: _____

3-4-20
Date of Acceptance

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9:35 / 13:23

OMB Approval No. 2502-0265

A. Settlement Statement (HUD-1)

B. Type of Loan

1. ☐ FHA 2. ☐ RHS 3. ☐ Conv. Unins. 4. ☐ VA 5. ☐ Conv. Ins.	6. File Number: VENTUREATLAS.135ROBB	7. Loan Number:	8. Mortgage Insurance Case Number:

C. **Note:** *This form is furnished to give you a statement of actual settlement costs. Amounts paid to and by the settlement agent are shown. Items marked "(p.o.c.)" were paid outside the closing; they are shown here for informational purposes and are not included in the totals.*

D. Name and Address of Buyer:	E. Name and Address of Seller:	F. Name and Address of Lender:
Venture Atlas, LLC 4030 Wake Forest Road, Ste 349 Raleigh, NC 27609	Mark Hull	CASH

G. Property Location:	H. Settlement Agent:	I. Settlement Date:
135 Robbins Road Winston-Salem, NC 27107 Forsyth County, North Carolina	Law Offices of Thomas G. Jacobs 1590 Westbrook Plaza Dr., Suite 103 Winston-Salem, NC 27103 Ph. (336)893-7465 Place of Settlement: 1590 Westbrook Plaza Dr., Suite 103 Winston-Salem, NC 27103	March 27, 2020

J. Summary of Buyer's transaction		K. Summary of Seller's transaction	
100. Gross Amount Due from Buyer:		400. Gross Amount Due to Seller:	
101. Contract sales price	87,000.00	401. Contract sales price	87,000.00
102. Personal property		402. Personal property	
103. Settlement Charges to Buyer (line 1400)	1,265.98	403.	
104.		404.	

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Winston-Salem, NC 27103

J. Summary of Buyer's transaction		
100. Gross Amount Due from Buyer:		
101. Contract sales price		87,000.00
102. Personal property		
103. Settlement Charges to Buyer (Line 1400)		1,265.98
104.		
105.		
Adjustments for items paid by Seller in advance		
106. City/Town Taxes	to	
107. County Taxes	to	
108. Assessments	to	
109.		
110.		
111.		
112.		
120. Gross Amount Due from Buyer		88,265.98
200. Amounts Paid by or in Behalf of Buyer		
201. Deposit or earnest money		100.00
202. Principal amount of new loan(s)		
203. Existing loan(s) taken subject to		
204.		
205.		
206.		
207.		
208.		
209. Due Diligence		100.00
Adjustments for items unpaid by Seller		
210. City/Town Taxes	to	
211. County Taxes	to	
212. Assessments	to	
213. Existing SunTrust		55,000.00
214. Existing Truliant		20,000.00
215.		
216.		
217.		
218.		
219.		

K. Summary of Seller's transaction		
400. Gross Amount Due to Seller:		
401. Contract sales price		87,000.00
402. Personal property		
403.		
404.		
405.		
Adjustments for items paid by Seller in advance		
406. City/Town Taxes	to	
407. County Taxes	to	
408. Assessments	to	
409.		
410.		
411.		
412.		
420. Gross Amount Due to Seller		87,000.00
500. Reductions in Amount Due Seller:		
501. Excess deposit (see instructions)		
502. Settlement charges to Seller (Line 1400)		6,800.00
503. Existing loan(s) taken subject to		
504. Payoff First Mortgage		
505. Payoff Second Mortgage		
506. Deposit retained by seller		100.00
507.		
508.		
509. Due Diligence		100.00
Adjustments for items unpaid by Seller		
510. City/Town Taxes	to	
511. County Taxes	to	
512. Assessments	to	
513. Existing SunTrust		55,000.00
514. Existing Truliant		20,000.00
515.		
516.		
517.		
518.		
519.		

11:12 / 13:23
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106. City/Town Taxes	to		406. City/Town Taxes	to	
107. County Taxes	to		407. County Taxes	to	
108. Assessments	to		408. Assessments	to	
109.			409.		
110.			410.		
111.			411.		
112.			412.		
120. Gross Amount Due from Buyer		88,265.98	**420. Gross Amount Due to Seller**		87,000.00
200. Amounts Paid by or in Behalf of Buyer			**500. Reductions in Amount Due Seller:**		
201. Deposit or earnest money		100.00	501. Excess deposit (see instructions)		
202. Principal amount of new loan(s)			502. Settlement charges to Seller (Line 1400)		6,800.00
203. Existing loan(s) taken subject to			503. Existing loan(s) taken subject to		
204.			504. Payoff First Mortgage		
205.			505. Payoff Second Mortgage		
206.			506. Deposit retained by seller		100.00
207.			507.		
208.			508.		
209. Due Diligence		100.00	509. Due Diligence		100.00
Adjustments for items unpaid by Seller			**Adjustments for items unpaid by Seller**		
210. City/Town Taxes	to		510. City/Town Taxes	to	
211. County Taxes	to		511. County Taxes	to	
212. Assessments	to		512. Assessments	to	
213. Existing SunTrust		55,000.00	513. Existing SunTrust		55,000.00
214. Existing Truliant		20,000.00	514. Existing Truliant		20,000.00
215.			515.		
216.			516.		
217.			517.		
218.			518.		
219.			519.		
220. Total Paid by/for Buyer		75,200.00	**520. Total Reduction Amount Due Seller**		82,000.00
300. Cash at Settlement from/to Buyer			**600. Cash at settlement to/from Seller**		
301. Gross amount due from Buyer (line 120)		88,265.98	601. Gross amount due to Seller (line 420)		87,000.00
302. Less amount paid by/for Buyer (line 220)		(75,200.00)	602. Less reductions due Seller (line 520)		(82,000.00)
303. Cash [X] **From** [ ] **To Buyer**		13,065.98	**603. Cash** [X] **To** [ ] **From Seller**		5,000.00

* Paid outside of closing by borrower(B), seller(S), lender(L), or third-party(T)

Buyer acknowledges receipt of a completed copy of this statement & any attachments referred to herein

Buyer Seller

11:26 / 13:23

L. Settlement Charges

700. Total Real Estate Broker Fees			Paid From Buyer's Funds at Settlement	Paid From Seller's Funds at Settlement
Division of commission (line 700) as follows:				
701. $ to				
702. $ to				
703. Commission paid at settlement				
704.				
705.				
800. Items Payable in Connection with Loan				
801. Our origination charge	$	(from GFE #1)		
802. Your credit or charge (points) for the specific interest rate chosen	$	(from GFE #2)		
803. Your adjusted origination charges to CASH		(from GFE #A)	0.00	
804. Appraisal fee to		(from GFE #3)		
805. Credit Report to		(from GFE #3)		
806. Tax service to		(from GFE #3)		
807. Flood certification to		(from GFE #3)		
808.		(from GFE #3)		
809.		(from GFE #3)		
810.		(from GFE #3)		
811.		(from GFE #3)		
900. Items Required by Lender to Be Paid in Advance				
901. Daily interest charges from to	@ $/day	(from GFE #10)		
902. Mortgage insurance premium for months to		(from GFE #3)		
903. Homeowner's insurance for years to		(from GFE #11)		
904.		(from GFE #11)		
905.		(from GFE #11)		
1000. Reserves Deposited with Lender				
1001. Initial deposit for your escrow account		(from GFE #9)		
1002. Homeowner's insurance @ $	per	$		
1003. Mortgage insurance @ $	per	$		
1004. Property taxes		$		
1005.		$		
1006. @ $	per	$		

11:55 / 13:23

810.			(from GFE #3)		
811.			(from GFE #3)		
900. Items Required by Lender to Be Paid in Advance					
901. Daily interest charges from	to	@ $/day	(from GFE #10)		
902. Mortgage insurance premium for	months to		(from GFE #3)		
903. Homeowner's insurance for	years to		(from GFE #11)		
904.			(from GFE #11)		
905.			(from GFE #11)		
1000. Reserves Deposited with Lender					
1001. Initial deposit for your escrow account			(from GFE #9)		
1002. Homeowner's insurance	@ $	per	$		
1003. Mortgage insurance	@ $	per	$		
1004. Property taxes			$		
1005.			$		
1006.	@ $	per	$		
1007.	@ $	per	$		
1008.			$		
1009. Aggregate Adjustment			$		
1100. Title Charges					
1101. Title services and lender's title insurance			(from GFE #4)		
1102. Settlement or closing fee			$		
1103. Owner's title insurance to			(from GFE #5)		
1104. Lender's title insurance to			$		
1105. Lender's title policy limit	$				
1106. Owner's title policy limit	$				
1107. Agent's portion of the total title insurance premium			$		
1108. Underwriter's portion of the total title insurance premium			$		
1109. Deed Preparation	to	Law Offices of Thomas G. Jacobs	$	150.00	
1110. Attorney Fee	to	Law Offices of Thomas G. Jacobs	$	650.00	
1111. Title Insurance	to	SouthEastern Title	$	235.98	
1112. Wire Fee - Proceeds	to	Law Offices of Thomas G. Jacobs	$	25.00	
1113.			$		
1200. Government Recording and Transfer Charges					
120[illegible] Gove[illegible] charges	to	Forsyth County Register of Deeds	(from GFE #7)	[illegible]6.0[illegible]	
1202. Deed $ 26.00	Mortgage $	Releases $	Other $		

12:00 / 13:23
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1104. Lender's title insurance to			$		
1105. Lender's title policy limit	$				
1106. Owner's title policy limit	$				
1107. Agent's portion of the total title insurance premium			$		
1108. Underwriter's portion of the total title insurance premium			$		
1109. Deed Preparation	to	Law Offices of Thomas G. Jacobs	$	150.00	
1110. Attorney Fee	to	Law Offices of Thomas G. Jacobs	$	650.00	
1111. Title Insurance	to	SouthEastern Title	$	235.98	
1112. Wire Fee - Proceeds	to	Law Offices of Thomas G. Jacobs	$	25.00	
1113.			$		
1200. Government Recording and Transfer Charges					
1201. Government recording charges	to	Forsyth County Register of Deeds	(from GFE #7)	26.00	
1202. Deed $ 26.00	Mortgage $	Releases $	Other $		
1203. Transfer taxes	to	Forsyth County Register of Deeds	(from GFE #8)	174.00	
1204. City/County tax/stamps	Deed $	Mortgage $			
1205. State tax/stamps	Deed $ 174.00	Mortgage $			
1206. E-Recording Fee	to	Forsyth County Register of Deeds		5.00	
1207.					
1300. Additional Settlement Charges					
1301. Required services that you can shop for			(from GFE #6)		
1302. Balance of Proceeds	to	Mark Hull	$		6,800.00
1303.			$		
1304.			$		
1305.			$		
1400. Total Settlement Charges (enter on lines 103, Section J and 502, Section K)				1,265.98	6,800.00

* Paid outside of closing by borrower(B), seller(S), lender(L), or third-party(T)

By signing page 1 of this statement, the signatories acknowledge receipt of a completed copy of page 2 & 3 of this three page statement.

Thomas G. Jacobs, Settlement Agent

Certified to be a true copy.

12:17 / 13:23

se a Subject To Real Estate Contract And Guide To Filling Out This Contract

OFFER TO PURCHASE AND CONTRACT

NOTICE: This is a legal and binding Agreement for the purchase and sale of property. The parties hereto are urged to discuss the purchase or sale with an attorney BEFORE YOU SIGN.

1. The following agreement (hereinafter to as the "Agreement") to buy and sell real property is made between:

SELLER: Billy Bob
hereinafter referred to as "Seller"

ADDRESS OF SELLER: 123 Main St Houston, TX
Town/City State ZIP

BUYER: Koach Joe and/or assigns
hereinafter referred to as "Buyer"

ADDRESS OF BUYER: List Company Address Not Personnel
Town/City State ZIP

Seller agrees to sell and Buyer agrees to buy for the purchase price and upon the terms and conditions stated herein the real property with all buildings and other improvements thereon and all appurtenances thereto, in the same condition as they were on the date of Buyer's signature, reasonable wear and tear excepted.

2. REAL PROPERTY TO BE PURCHASED:

a) Street Address: 231 Paul Ave

b) City/Town: Houston STATE TX ZIP

3. INCLUDED IN SALE PRICE: The Real Property shall include all items permanently attached to the property on the date Buyer signed this Agreement and: all screens, storm windows, TV antenna, awnings, security, fire and smoke alarms, garage door openers with controls, venetian blinds, curtain/drapery rods, wall to wall carpet, plumbing and heating fixtures (except portable heaters or rented water heaters), light fixtures, shrubbery and plants. Unless mentioned below, all personal property is excluded.

ADDITIONAL PERSONAL PROPERTY, if any, to be included:

There is no leased personal property except:

4. PURCHASE PRICE $ Mortgage Payoff payable as follows:

a) By initial Deposit submitted herewith receipt of which is hereby acknowledged $ 10.00

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the real property with all buildings and other improvements thereon and all appurtenances thereto, in the same condition as they were on the date of Buyers signature on this Agreement and that the total

2. REAL PROPERTY TO BE PURCHASED:

a) Street Address: **231 Paul Ave**

b) City/Town: **Houston** STATE **TX** ZIP _____

3. INCLUDED IN SALE PRICE: The Real Property shall include all items permanently attached to the property on the date Buyer signed this Agreement and: all screens, storm windows, TV antenna, awnings, security, fire and smoke alarms, garage door openers with controls, venetian blinds, curtain/drapery rods, wall to wall carpet, plumbing and heating fixtures (except portable heaters or rented water heaters), light fixtures, shrubbery and plants. Unless mentioned below, all personal property is excluded.

ADDITIONAL PERSONAL PROPERTY, if any, to be included: _____

There is no leased personal property except: _____

4. PURCHASE PRICE $ Mortgage Payoff payable as follows:

a) By initial Deposit submitted herewith receipt of which is hereby acknowledged $ **10.00**

b) By additional Deposit due upon Sellers Acceptance $ _____

c) Balance due at Closing $ **Mortgage Payoff**

d) Subject to 1st deed of trust balance: Lender _____ Loan No. _____ $ _____

Interest Rate _____% fixed rate(__); adjustable rate(__); _____ / month including principal (__) and interest (__) and escrow (__): including taxes (__) and insurance (__)

d) Subject to 2nd deed of trust balance: Lender _____ Loan No. _____ $ _____

Interest Rate _____% fixed rate(__); adjustable rate(__); _____ / month including principal (__) and interest (__) and escrow (__): including taxes (__) and insurance (__)

TOTAL PRICE TO BE PAID (Must equal "Purchase Price") $ **Mortgage Payoff**

****NOTE: The purchase price may be adjusted by Buyer, in Buyer's discretion, if the actual loan balances for the first mortgage and second mortgage (if applicable) are different from the amount disclosed by Seller.****

Buyer Initials _____
Seller Initials _____

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5. DEPOSITS: The initial Earnest Money Deposit and additional deposits, if any, (collectively "Earnest Money Deposit") shall be made at the stated times. The Earnest Money Deposit shall be held in escrow and made payable to the Listing Broker or the escrow agent: **$10.00**. All checks are subject to collection and failure of collection shall constitute a default. In the event any deposit funds payable pursuant to this Agreement are not paid by Buyer, Seller may give written notice of such failure to Buyer. If such notice is given and a period of three (3) days pass without Buyer paying the deposit owed, Seller may declare Buyer in default and shall have the remedies set forth in Paragraph 14.

6. ESCROW ACCOUNT: Seller shall assign to Buyer, at no cost to Buyer, Seller's escrow account and property hazard insurance policy, and/or any refunds which lender may issue, in line of all taxes, association fees, monthly hazard insurance premiums, and monthly mortgage insurance premiums as of the date of closing. Seller shall bring any escrow shortage current at closing.

7. CONDITION OF PREMISES: Buyer represents that Buyer has examined the Property and is satisfied with the physical condition subject to the Inspection Contingency if applicable. Neither Seller nor any representative of the Seller has made any representation or promise other than those expressly stated herein which Buyer has relied upon in making this Agreement.

8. INSPECTION CONTINGENCY:
a) Inspections shall be completed and results reported to Seller on or before 5:00 P.M. on _____ (Inspection Period).
b)Seller agrees to permit Buyer's designees to inspect the Property during the Inspection Period. If Buyer is not satisfied with the physical condition of the Property, and so notifies Seller in writing prior to the expiration of the Inspection Period, then Buyer may, at Buyer's option, (1) terminate this Agreement or (2) give Seller the option to correct the conditions that are unsatisfactory to the Buyer. Should Buyer elect to terminate this Agreement or Seller is unwilling to correct any unsatisfactory conditions, this Agreement shall be null and void and the Earnest Money Deposit shall be returned immediately to Buyer and neither Buyer nor Seller shall have any claims against each other under the terms of this Agreement. If Buyer fails to notify Seller as provided herein, this Inspection Contingency shall be deemed satisfied and this Agreement shall continue in full force and effect.
c) If initiated, Buyer does NOT choose to have any inspections performed and WAIVES any rights to object to any defects in the Property that would have been disclosed by a full and complete inspections except as provided under Paragraph 12 hereinbelow. _____ **BUYER'S INITIALS**

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9. STATEMENT REGARDING LEAD BASED PAINT: The parties acknowledge that dwelling units constructed prior to 1978 are likely to contain lead-based paint which could create a health hazard. In the event that the real property which is the subject of this Agreement consists of or contains a residential unit built prior to 1978, the parties agree that each party has received, reviewed, signed and annexed hereto a completed Disclosure and acknowledgment Form re: Lead-Based Paint as required by federal HUD/EPA disclosure regulations.

10. OCCUPANCY, POSSESSION, CLOSING DATE: _____
Unless otherwise stated herein, Buyer shall receive exclusive possession and occupancy with keys on Closing Date. The Property shall be maintained by Seller until time of Closing and shall be transferred in broom clean condition, free of debris. Buyer shall have the right to a walk-through inspection of the Property within forty-eight (48) hours prior to the Closing Date. Closing shall be held at the attorney's office of Buyer's choosing or at such place as designated by Buyer's mortgage lender.

11. WARRANTY DEED: Seller agrees to convey fee simple title of the Property to Buyer by a good and sufficient Warranty Deed subject to the deed(s) of trust listed in Paragraph 4 hereinabove and to any and all provisions of any ordinance, municipal regulation, public or private law, restrictions and easements as appear of record, if any, provided they do not affect marketability of title, current real estate taxes, water and sewer charges, and current water and sewer assessment balance, if any; except in those cases where a fiduciary's Deed or other form of court ordered deed may be required to pass title. Seller warrants that Seller has no notice of any outstanding violations from any town, city or state agency relating to the Property.

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12. MARKETABLE TITLE: Notwithstanding the deed(s) of trust Buyer is taking title subject to, title to be conveyed Seller shall be marketable and insurable without exception for mechanics liens and free of any other liens, encu brances or defects. Seller further agrees to execute such documents as may be reasonably required by Buyer's ti insurance company, attorney or mortgage lender. Should Seller be unable to convey marketable title as defined he in, Buyer may accept such title as Seller can convey, or may reject the unmarketable title, receive back all Depos back, and declare this Agreement null and void. Upon such rejection and repayment to Buyer of all sums paid account hereof, together with the reasonable fees for the examination of title, this Agreement shall terminate and t parties hereto shall be released from all further claims against each other.

13. ADJUSTMENTS: Any accrued loan interest shall be prorated to the date of closing. In the absence of an escrow account, taxes shall be prorated as the date of closing. All other adjustments, including but not limited to homeowners association fees, fuel oil, water and sewer usage, interest on sewer or water assessments, utilities, rent, if any, and issues regarding funds at closing and unavailability of releases at closing and like matters shall be adjusted pro rata as of the Closing Date. Rent security deposits, if any, shall be credited to Buyer by Seller on the Closing Date and shall include, any interest accrued to the tenant.

14. DEFAULT: If Buyer fails to comply with any terms of this Agreement by the time set forth for compliance and Seller is not in default, Seller shall be entitled to the Earnest Money Deposit as liquidated damages as its sole remedy of any type to which Seller is entitled and both parties shall be relieved of any further liability under this Agreement. If Seller fails to comply with any terms of this Agreement by the time set forth for compliance and Buyer is not in default, Buyer shall be entitled to a return of the Earnest Money Deposit as well as reasonable costs actually incurred by Buyer in connection with Buyer's inspection of the Property without affecting any other remedies. Seller understands and acknowledges that Buyer has the right to enforce this Agreement through legal action. If legal action is brought to enforce any provision of this Agreement, the prevailing party shall be entitled to reasonable attorney's fees.

15. RISK OF LOSS, DAMAGE: All risk of loss or damage to said property by fire, theft or other casualty until delivery of Deed shall be upon the Seller. In the event of loss or damage independently appraised at more than Five Thousand Dollars ($5,000.00), Buyer shall have the option to (1) receive any insurance payment on account of said damage and take title to the Property or (2) rescind this Agreement, receive back the Earnest Money Deposit and all rights and obligations of the parties under this Agreement shall terminate.

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15. RISK OF LOSS, DAMAGE: All risk of loss or damage to said property by fire, theft or other casualty until delive of Deed shall be upon the Seller. In the event of loss or damage independently appraised at more than Five Tho sand Dollars ($5,000.00), Buyer shall have the option to (1) receive any insurance payment on account of said da age and take title to the Property or (2) rescind this Agreement, receive back the Earnest Money Deposit and rights and obligations of the parties under this Agreement shall terminate.

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16. ASSIGNMENT: This Agreement may be assigned by Buyer without the consent of Seller. Such assignee sh replace the Earnest Money Deposit held in escrow with the Listing Broker or escrow agent. Once the Earnest Mon Deposit has been replaced by the assignee, the Listing Broker or escrow agent shall release the Earnest Money Deposit paid by Buyer to Buyer. If assigned, then this Agreement shall be binding on the assignee and assignee's heirs and successors.

17. LISTING BROKER: N/A PH#: N/A
Dual Agent—If the Listing Agent is acting as a Dual Agent, consent for dual agency form shall be attached to this Agreement.

18. MEMORANDUM OF CONTRACT: Buyer may file, at Buyer's option, a Memorandum of Contract at the Register of Deeds for the county in which the Property is located.

19. PROPERTY CONDITION REPORT: Seller and Buyer acknowledge that if a written residential property condition report is required by statute and Seller has not provided Buyer with the required report, Seller shall credit Buyer with the statutory fee at closing.

20. EQUAL HOUSING RIGHTS: This Agreement is subject to all local statutory laws prohibiting discrimination in commercial and residential real estate transactions.

Buyer Initials _____
Seller Initials _____ _____

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21. BUYER'S RIGHT TO DEED PROPERTY BACK TO SELLER: If Buyer determines this transaction is not in its best interest, Buyer may, in its sole discretion, deed by General Warranty Deed the Property back to Seller. If Buyer elects to do so, Buyer shall give Seller notice *via* both certified mail and regular mail. This provision shall survive Closing but in no case extend beyond _____ years from the date of closing.

22. ONLINE ACCESS: Seller shall provide Buyer the account name and password for online access to Seller's first mortgage and second mortgage (if applicable) at Closing. Seller agrees that Buyer shall have full online access to Seller's first mortgage and second mortgage (if applicable) at any time after Closing until such mortgage(s) is paid in full. Seller shall fully cooperate with Buyer after Closing if Buyer requests Seller's assistance with said online access. This provision shall survive Closing until such mortgage(s) is paid in full.

23. ADDENDUM: The following attached Addenda and/or Riders are part of this Agreement: N/A

24. ADDITIONAL TERMS AND CONDITIONS: We buy as-is, where is. No repairs expected or implied.

25. FAX TRANSMISSION: The parties acknowledge that this Agreement and any addenda or modification and/or any notices due hereunder may be transmitted between them by facsimile machine, e-FAX, or via email and the parties intend that a faxed document containing either the original and/or copies of the parties' signatures shall be binding and of full effect.

26. COMPLETE AGREEMENT: This Agreement contains the entire agreement between Buyer and Seller concerning this transaction and supersedes any and all previous written or oral agreements concerning the Property. Any extensions or modifications of this Agreement shall be in writing signed by the parties.

27. NOTICE: Any notice required or permitted under the terms of this Agreement by Buyer or Seller shall be in writing addressed to the party concerned using the address stated in Paragraph 1 of this Agreement or to such party's attorney or to the party's Listing Broker or Cooperating Broker designated in Paragraph 17.

28. RECEIPT: Buyer and Seller acknowledge receipt of a copy of this Agreement upon their signing same.

29. TIME TO ACCEPT: Seller shall have until _____ to accept this Agreement.

30. SIGNATURES:

Buyer's Signature	Date	Seller's Signature	Date
		Seller's Signature	Date

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"SUBJECT-TO" ADDENDUM
TO
REAL ESTATE PURCHASE AGREEMENT

THIS IS AN ADDENDUM to the **REAL ESTATE PURCHASE AGREEMENT** with an offer date of _____, including all prior addenda and counteroffers, between Buyer _____, and _____ as Seller, regarding the Property located at _____. The following terms are hereby incorporated as part of the Real Estate Purchase Agreement.

1. **Subject to Existing Financing.** Seller expressly agrees and understands that Buyer is taking the Property subject to mortgages and deeds of trust on the Property and is expressly not assuming responsibility for any underlying loans. Seller and Buyer expressly understand and agree that the existing loan(s) of record shall remain in force on the Property for a maximum of Sixty (60) months following the date of execution of this Agreement. It is further expressly understood and agreed that Buyer may sell or refinance the property at any time.

2. **Monthly Payment of Existing Loan(s).** Buyer shall make monthly payments toward the total value of the existing loan(s) (the "Existing Loan") which is approximately set at a total value of $_____(see paragraph #5 of this ADDENDUM). The Existing Loan is presently payable at $_____per month including principal and interest (presently at _____% per annum. Buyer shall make the monthly payment as presented beginning on _____ for a period not to exceed 60 months, at which time Buyer shall have paid off the Existing Loan, or resold the Property in the manner described in paragraph 2 of this ADDENDUM.

   The above mentioned amounts are approximate, and are subject to Buyer's Review and Acceptance of the terms of the Mortgage and Note. If there are additional sums being paid by Seller as impounds toward taxes and insurance and said impounds cannot be cancelled by Seller, then there is to be an accounting of all escrowed funds at the time of closing with Buyer, and Seller shall receive credit for any portion Seller paid by for said taxes and insurance.

Payment of Existing Loan in full and Payment of Seller's Equity. On or before ___ months of the date of execution of this agreement Buyer shall complete one of the following:

(1) Refinance the Property into Buyer's name and pay off all existing loans and encumbrances on the Property that exist in the name of Seller as of the date of execution and pay Seller Equity (as listed in paragraph 5(e) of this Addendum); or

(2) locate and obtain another purchaser for the property who remits adequate funds to satisfy Buyer's obligation to pay off all existing loans and encumbrances on the Property that exist in the name of Seller as of the date of execution plus pay Seller Equity (as listed in paragraph 5(e) of this Addendum).

Other than the above mentioned ___ months, Buyer has not made any representations as to when the Property will be resold, how the Property will be resold, nor how financing may be structured, and is under no obligation to sell the property or satisfy the Existing Loan within a period of time less than ___ months.

3. Non-Assumption of Existing Loan. Seller acknowledges and agrees that Buyer is NOT assuming the Existing Loan. Seller understands that the Existing Loan will remain a legal obligation of Seller and will continue to be reflected on Seller's various credit reports, until such time as the Existing Loan is paid in full or is otherwise satisfied.

4. Release of Liability. It is expressly understood and agreed that Seller shall remain liable and responsible for repayment of the existing loan. The sale is NOT conditioned upon Seller being released from liability on the Existing Loan. It is further expressly understood and agreed that upon Sellers execution of the Sales and Purchase Agreement, Seller relinquished his ownership interest in the Property despite the fact that title remains in his name. Furthermore, Seller expressly agrees to remain solely liable on the Existing Loan until it is satisfied in full, and agrees to indemnify Buyer against any third party actions regarding this sale. Seller expressly releases Buyer from all liability with regard to the Existing Loan.

5. Existing Loan and Seller's Equity Price Terms (Estimated). All loans shall be combined to determine the Existing Loan amount. This amount shall be included on the Real Estate Purchase Agreement as part of the Purchase Price.

a. **First loan amount**. $_____ (the approximate total amount of the first loan). Lender_____ Loan #_____
b. **Second loan amount**. $_____ (the approximate total amount of the second loan). Lender _____ Loan #_____
c. **Third loan amount**. $_____ (the approximate total amount of the third loan). Lender _____ Loan #_____
d. **Total Existing Loan amount**. $_____ (add lines a, b, & c).
e. **Seller's Equity amount.** $_____ (the total due to Seller at closing.
f. **TOTAL OF EXISTING LOAN AND SELLERS EQUITY**. $ _____ (add lines d & e, and then insert on Real Estate Purchase Agreement, "Purchase Price").

6. Difference in Loan Balance. Any net differences between the approximate total amount owed on the Existing Loan and the actual balance on the Existing Loan at Settlement shall be adjusted as a credit to Buyer at closing.

7. Due on Sale or Transfer Clause. Seller acknowledges that this transfer, conveyance, or sale of interest in the Property, including legal and equitable interests, may violate the terms and provisions of the Existing Loan, and the mortgagee holding said instrument may exercise any acceleration clause in said instrument and demand that any and all amounts remaining due and payable be immediately paid in full.

8. New Debt or Encumbrances. Seller shall not incur any new debt, or further encumber the Property by ay means, including but not limited to loans, pledges, mortgages, security, liens or any other encumbrances to or related to the Property and further shall not modify the terms and conditions of the Existing Loan after the signing of this ADDENDUM. Seller shall indemnify Buyer against any action or encumbrance, pertaining to the Property, which arises from the period Seller owned the Property.

9. Interest Deduction. Seller hereby agrees that as of the date of Closing and thereafter, Buyer shall be entitled to take the interest deduction on Buyer's income tax return for any and all interest paid related to any and all above mentioned mortgages and mortgage payments regardless of the EIN or SSN on any future Form 1098 or any other future statement of interest paid. Seller further agrees that, as of the date of closing, Seller shall not take or deduct any interest payments on his or her tax return or any entity's tax return for any interest paid related to any and all above mentioned mortgages and mortgage payments. Seller does hereby agree to instruct any and all lenders related to this transaction to send any future statements and or information to the Seller in care of the Buyer at the Buyer's address. Seller does hereby agree to continue to work with Buyer in obtaining any future interest statements, payment statements, mortgage statements, or any other information required by Buyer to maintain Buyer's records. This paragraph and agreement shall survive Closing and continue until Buyer sells the property or until all existing indebtedness is satisfied.

10. Taxes and Insurance. Taxes will be prorated to the date of closing, and thereafter, all property taxes shall be the responsibility of the Buyer. Upon closing, the Buyer shall obtain insurance which names the Seller's Lender as Mortgagee.

To the extent the terms of this ADDENDUM modify or conflict with any provisions of the Real Estate Purchase Agreement, including all prior addenda and counteroffers, these terms shall control. All other terms of the Real Estate Purchase Agreement not modified by this ADDENDUM shall remain the same.

5:

STANDARD PURCHASE AND SALES AGREEMENT

Parties James Buyer (BUYER) and Jane Seller (SELLER), which terms may be singular or plural and will include the heirs successors, personal representatives and assigns of Seller and Buyer, hereby agree that Seller will sell and Buyer will buy the following property, upon the following terms and conditions if completed or marked. In any conflict of terms or conditions, that which is added will supersede that which is printed or marked. The Property is in Harris County, and is described as follows (If lengthy, attach legal description)

Address 123 Main St Houston, TX Zip 77070.

It is understood that the Property will be conveyed by General Warranty Deed (unless otherwise required) subject to taxes, existing zoning (unless otherwise specified in paragraph 16), covenants, restrictions and easements of record.

1. Total Purchase Price to be paid by Buyer is payable as follows:
   - A. Binder deposit which will remain as a binder until closing, unless sooner forfeited or returned, according to the provisions in this Agreement. $ 10.00
   - B. Additional binder deposit due within _____ days after date of this agreement. $ _____
   - C. Balance due at closing (not including Buyer's closing cost, prepaid items or prorations) in U.S. cash or locally drawn certified or cashiers check approximately _____ exactly _____. $ _____
   - D. Proceeds of a new loan to be executed by Buyer to any lender other than Seller. $ _____
   - E. Purchase money loan to Seller on terms set forth in Paragraph 2B. $ _____
   - F. Other financing _____. $ _____
   - G. Existing mortgage balance encumbering the Property to be taken subject to by Buyer (approximately). $ 99,990

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may be singular or plural and will include the heirs successors, personal representatives and assigns of Seller and Buyer, hereby agree that Seller will sell and Buyer will buy the following property, upon the following terms and conditions if completed or marked. In any conflict of terms or conditions, that which is added will supersede that which is printed or marked. The Property is in ___Harris_____County, and is described as follows (If lengthy, attach legal description)_____

_____

Address _____123 Main St Houston, TX_____ Zip ___77070_____.

It is understood that the Property will be conveyed by General Warranty Deed (unless otherwise required) subject to taxes, existing zoning (unless otherwise specified in paragraph 16), covenants, restrictions and easements of record.

1. Total Purchase Price to be paid by Buyer is payable as follows:
   - A. Binder deposit which will remain as a binder until closing, unless sooner forfeited or returned, according to the provisions in this Agreement. $__10.00_____
   - B. Additional binder deposit due within _____days after date of this agreement. $_____
   - C. Balance due at closing (not including Buyer's closing cost, prepaid items or prorations) in U.S. cash or locally drawn certified or cashiers check approximately _____ exactly _____. $_____
   - D. Proceeds of a new loan to be executed by Buyer to any lender other than Seller. $_____
   - E. Purchase money loan to Seller on terms set forth in Paragraph 2B. $_____
   - F. Other financing _____ $_____
   - G. Existing mortgage balance encumbering the Property to be taken subject to by Buyer (approximately). $_99,990_____
   - H. Total Purchase Price - approximately___X__ exactly_____ $_100,000_____

2. Financing: If buyer does not obtain the required financing but otherwise complies with the terms hereof, the binder deposit less sales and loan processing costs incurred, will be returned to the Buyer.
   - A. [ ]Application: The application for the mortgage described in paragraph 1D will be made with lender selected by [ ] Seller of [ ] Buyer. Unless such mortgage loan is approved without continued contingencies other than those elsewhere covered in this agreement within _____days of the date of acceptance of this agreement, Seller and Buyer will have the right to terminate this agreement, and Buyer will return to Seller all the title evidence and

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2. Financing: If buyer does not obtain the required financing but otherwise complies with the terms hereof, the binder deposit less sales and loan processing costs incurred, will be returned to the Buyer.

A. [ ]Application: The application for the mortgage described in paragraph 1D will be made with lender selected by [ ] Seller of [ ] Buyer. Unless such mortgage loan is approved without continued contingencies other than those elsewhere covered in this agreement within _____days of the date of acceptance of this agreement, Seller and Buyer will have the right to terminate this agreement, and Buyer will return to Seller all the title evidence and surveys received from Seller. Buyer will make application for financing within _____ days of the date of acceptance of this agreement and in a timely manner furnish any and all credit, employment, financial and other information required by the lender. In the event the original loan application is denied, Buyer, if requested by Seller, will reapply within _____ days of such request at an alternate institution

B. [ ] Seller: The balance due to Seller will be evidenced by a negotiable promissory note of Borrower, secured by a valid purchase money_____ mortgage or Trust Deed on the Property and delivered by Buyer to Seller dated the date of closing bearing annual interest rate of _____ % and payable $_____ per_____ for [ ] _____ years [ ] _____ months. Privilege of prepayment [ ] does apply [ ] does not apply. The loan will be _____ due on sale _____ not due on sale of Property.

3. Buyer Will Pay:

A. Closing Costs [X] Recording fees [ ] Note stamps [ ] Intangible tax [ ] Credit reports [ ] Loan transfer and assumption charges [ ] VA funding fee [ ] Loan origination fee [ ] Loan insurance premium [ ] Loan discount not to exceed_____ [X] Transfer Tax [ ] Wood Destroying Organism Report

B. [ ] Appraisal [ ] Survey [ ] Title Insurance Policy _____ Other_____

4. Seller Will Pay:

A. Closing Costs [ ] Transfer tax [ ] _____ Title insurance policy [ ] _____ Attorney's fee [ ] Real estate brokerage fee [ ] Loan discount not to exceed _____ [ ] Satisfaction and recording fee [ ] Repairs or replacements, in addition to those in paragraph 9, not to exceed $_____. [ ] Wood destroying organism report [ ] Appraisal fee [ ] Survey [ ] Other_____

B. All other charges required by lender which Buyer is prohibited from paying by law or regulation.

C. All mortgage payments or condominium and association fees will be current at Seller's expense at the time of closing.

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4. Seller Will Pay:

A. Closing Costs [ ] Transfer tax [ ] _____ Title insurance policy [ ] _____ Attorney's fee [ ] Real estate brokerage fee [ ] Loan discount not to exceed _____ [ ] Satisfaction and recording fee [ ] Repairs or replacements, in addition to those in paragraph 9, not to exceed $_____. [ ] Wood destroying organism report [ ] Appraisal fee [ ] Survey [ ] Other_____

B. All other charges required by lender which Buyer is prohibited from paying by law or regulation.

C. All mortgage payments or condominium and association fees will be current at Seller's expense at the time of closing.

5. Payment of Expenses: If Buyer fails to perform, all loan and sale processing and closing costs incurred, whether the same were to be paid by Seller or Buyer will be the responsibility of the Buyer, with costs deducted from binder deposit. If Seller fails to perform, all loan, sales processing and closing costs incurred whether same were to be paid by Seller or Buyer will be the responsibility of Seller, and Buyer will be entitled to the return of the Binder deposit This will include, but not be limited to the transaction not being closed because Seller is unable to complete the transaction for a qualified Buyer, or because the property does not appraise for an amount sufficient to enable the lender to make the required loan, or because Seller elects not to pay for the excess amount in paragraphs 4 (with respect to repairs), 9, or 11, or because the zoning is not as required in paragraph 16 or because Seller cannot deliver marketable title.

6. ~~Prorations: All taxes, rentals, condominium or association fees, prepaid hazard insurance premiums (if assumed), monthly mortgage insurance premiums and interest on loans will be prorated as of the date of closing.~~ BUYER SHOULD NOT RELY ON THE SELLER'S CURRENT PROPERTY TAXES AS THE AMOUNT OF PROPERTY TAXES THAT THE BUYER MAY BE OBLIGATED TO PAY IN THE YEAR SUBSEQUENT TO PURCHASE. A CHANGE OF OWNERSHIP OR PROPERTY IMPROVEMENTS TRIGGERS REASSESSMENTS OF THE PROPERTY THAT COULD RESULT IN HIGHER TAXES. IF YOU HAVE ANY QUESTIONS CONCERNING VALUATION, CONTACT THE COUNTY PROPERTY APPRAISER'S OFFICE FOR INFORMATION.

7. Title Evidence: Within _21_days [ ] after acceptance [X] after date of satisfaction of all conditions in paragraph 19. Seller will deliver to Buyer or closing attorney [ ] Title insurance commitment for an owner's policy in the amount of the purchase price. Any expense of curing title including but not limited to legal fees, discharge of liens and recording fees will be paid by Seller

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C. All mortgage payments of condominium and association fees will be current at Seller's expense at the time of closing.

5. Payment of Expenses: If Buyer fails to perform, all loan and sale processing and closing costs incurred, whether the same were to be paid by Seller or Buyer will be the responsibility of the Buyer, with costs deducted from binder deposit. If Seller fails to perform, all loan, sales processing and closing costs incurred whether same were to be paid by Seller or Buyer will be the responsibility of Seller, and Buyer will be entitled to the return of the Binder deposit This will include, but not be limited to the transaction not being closed because Seller is unable to complete the transaction for a qualified Buyer, or because the property does not appraise for an amount sufficient to enable the lender to make the required loan, or because Seller elects not to pay for the excess amount in paragraphs 4 (with respect to repairs), 9, or 11, or because the zoning is not as required in paragraph 16 or because Seller cannot deliver marketable title.

6. ~~Prorations: All taxes, rentals, condominium or association fees, prepaid hazard insurance premiums (if assumed), monthly mortgage insurance premiums and interest on loans will be prorated as of the date of closing.~~ BUYER SHOULD NOT RELY ON THE SELLER'S CURRENT PROPERTY TAXES AS THE AMOUNT OF PROPERTY TAXES THAT THE BUYER MAY BE OBLIGATED TO PAY IN THE YEAR SUBSEQUENT TO PURCHASE. A CHANGE OF OWNERSHIP OR PROPERTY IMPROVEMENTS TRIGGERS REASSESSMENTS OF THE PROPERTY THAT COULD RESULT IN HIGHER TAXES. IF YOU HAVE ANY QUESTIONS CONCERNING VALUATION, CONTACT THE COUNTY PROPERTY APPRAISER'S OFFICE FOR INFORMATION.

7. Title Evidence: Within _21_days [ ] after acceptance [X] after date of satisfaction of all conditions in paragraph 19. Seller will deliver to Buyer or closing attorney [ ] Title insurance commitment for an owner's policy in the amount of the purchase price. Any expense of curing title including but not limited to legal fees, discharge of liens and recording fees will be paid by Seller

8. Survey: Within _____days [ ] after date of acceptance [ ] after date of satisfaction of all conditions on paragraph 19, Seller will deliver to Buyer or closing attorney [ ] A new staked survey dated within 3 months of closing showing all improvements now existing thereon and certified to Buyer, lender and

6:02 / 15:00
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FOR INFORMATION.

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8. Survey: Within _____days [ ] after date of acceptance [ ] after date of satisfaction of all conditions on paragraph 19, Seller will deliver to Buyer or closing attorney [ ] A new staked survey dated within 3 months of closing showing all improvements now existing thereon and certified to Buyer, lender and the title insurer [ ] A copy of a previously made survey of the Property showing all improvements now existing thereon.[X] No survey is required.

9. Wood destroying Organism Report: "Wood Destroying Organism" means any arthropod or plant life which damages a structure. Buyer may have property inspected by a Certified Pest Control Firm to determine whether there is any visible active wood destroying organism infestation or visible existing structural damage from wood destroying organisms to the improvements. If Buyer is informed of either or both of the foregoing, Seller will have seven (7) days from receipt of written notice thereof within which to have all such wood destroying organism damages whether visible or not inspected and estimated by a licensed building or general contractor. Seller will pay costs of treatment and repairs of all structural damage up to one percent (1 %) of the purchase price. If such costs exceed the amount agreed to be paid by Seller and Seller declines to treat and repair, Buyer will have the option of (a) terminating this Agreement or,(b) proceeding with the transaction. in which event Seller will bear costs equal to one percent (1 %) of the purchase price.

10. Title Examination and Time for Closing:

A. If title evidence and survey, as specified above, show Seller is vested with a marketable title, subject to the usual exceptions contained in title insurance commitments (such as exceptions for survey, current taxes, zoning ordinances, covenants, restrictions and easements of record), the transaction will be closed and the deed and other closing papers delivered on or before [ ] _____, [ ] _____ days after the date of

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closing attorney [ ] A new staked survey dated within 3 months of closing showing all improvements now existing thereon and certified to Buyer, lender and the title insurer [ ] A copy of a previously made survey of the Property showing all improvements now existing thereon.[X] No survey is required.

9. Wood destroying Organism Report: "Wood Destroying Organism" means any arthropod or plant life which damages a structure. Buyer may have property inspected by a Certified Pest Control Firm to determine whether there is any visible active wood destroying organism infestation or visible existing structural damage from wood destroying organisms to the improvements. If Buyer is informed of either or both of the foregoing, Seller will have seven (7) days from receipt of written notice thereof within which to have all such wood destroying organism damages whether visible or not inspected and estimated by a licensed building or general contractor. Seller will pay costs of treatment and repairs of all structural damage up to one percent (1 %) of the purchase price. If such costs exceed the amount agreed to be paid by Seller and Seller declines to treat and repair, Buyer will have the option of (a) terminating this Agreement or,(b) proceeding with the transaction. in which event Seller will bear costs equal to one percent (1 %) of the purchase price.

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B. If title evidence or survey reveal any defects which render the title unmarketable, Buyer will have 7 days from receipt of title commitment and survey to notify Seller of such title defects and Seller agrees to use reasonable diligence to cure such defects at Seller's expense and will have 30 days to do so, in which event this transaction will be closed within 10 days after delivery to Buyer of evidence that such defects have been cured. Seller agrees to pay for and discharge all due or delinquent taxes, liens and other encumbrances, unless otherwise agreed. If Seller is unable to convey to Buyer a marketable title, Buyer will have the right to terminate this agreement at the same time returning to Seller all title evidence and surveys received from Seller, or Buyer will have the right to accept such title as Seller may be able to convey and to close this transaction upon the terms stated herein, which election will he exercised within 10 days from notice of Seller's inability to cure.

11. Loss or Damage: If the property is damaged by fire or other casualty prior to closing, and cost of restoration does not exceed 3% of the assessed

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in which event this transaction will be closed within 10 days after delivery to Buyer of evidence that such defects have been cured. Seller agrees to pay for and discharge all due or delinquent taxes, liens and other encumbrances, unless otherwise agreed. If Seller is unable to convey to Buyer a marketable title, Buyer will have the right to terminate this agreement at the same time returning to Seller all title evidence and surveys received from Seller, or Buyer will have the right to accept such title as Seller may be able to convey and to close this transaction upon the terms stated herein, which election will he exercised within 10 days from notice of Seller's inability to cure.

11. Loss or Damage: If the property is damaged by fire or other casualty prior to closing, and cost of restoration does not exceed 3% of the assessed valuation of the improvements located on the Property, cost of restoration will he an obligation of the Seller and closing will proceed pursuant to the terms of this Agreement with cost thereof escrowing at closing. In the event cost of restoration exceeds 3% of the assessed valuation of the improvements and the Seller declines to repair or restore, Buyer will have the option of either taking the Property as is, together with either the said 3% or any insurance proceeds payable by virtue of such loss or damage, or of canceling this Agreement.

12. Seller agrees to deliver the *Property* in its PRESENT AS IS CONDITION except as otherwise specified herein. Seller does hereby certify and represent that Seller has legal authority and capacity to convey the property with all improvements. Seller further certifies and represents that Seller knows of no latent defects to the property and knows of no facts materially affecting the value of the property except the following: Description of problems _____.
Buyer has inspected the property and HAS NOT RELIED UPON ANY REPRESENTATIONS MADE BY ANY REAL ESTATE AGENT in describing the property, and Buyer accepts the property in its PRESENT AS IS CONDITION, except as otherwise specified herein.

13. Occupancy [X] Seller represents that there are no parties in occupancy other than Seller. Buyer will be given occupancy at closing unless otherwise specified herein_____. [ ] Buyer understands that property is available for rent or rented and the tenant may continue in possession following closing unless otherwise agreed in writing. Deposits will he transferred to Buyer at closing.

14. Personal Property: included in the purchase price are all fixed equipment including ceiling fans, drapery hardware, attached lighting fixtures, mailbox, fence, plants and shrubbery as now installed on the property. And these additional items Refrigerator, Range, Washer and Dryer_____. Items specifically excluded from_____ .

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15. Default and Attorney's Fees: If Buyer defaults on this agreement, all deposits will be retained by the Seller as full settlement of any claim, whereupon Buyer and Seller will be relieved of all obligations under this agreement. If Seller defaults under this Agreement, the Buyer may seek specific performance or elect to receive the return of the Buyers deposit(s) without thereby waving any action for damages resulting from Seller's breach. In connection with any litigation arising out of this Agreement, the prevailing party will he entitled to recover all costs including a reasonable attorney's fee

16. [X] Zoning and Restrictions: Unless the Property is zoned____SFR____and can he legally used for __residential____ use, or if there is notice of proposed zoning changes, deed or other restrictions that could prevent such use at time of closing, Buyer will have the right to terminate this Agreement. Buyer will have 10 days from acceptance to verify the existing zoning and current proposed changes, and deliver written notice of objections to Seller or be deemed to have waived objections under this paragraph.

17. The offer of BUYER shall terminate if SELLER has not indicated his acceptance of this Agreement by signing and delivering same or telegraphing acceptance to Buyer or submitting agent before _12_:01[X]AM.[ ]PM Date 5/1/13__

18. Additional Terms, Conditions or Addenda (lettered A, B,.C,.D.etc.)

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15. Default and Attorney's Fees: If Buyer defaults on this agreement, all deposits will be retained by the Seller as full settlement of any claim, whereupon Buyer and Seller will be relieved of all obligations under this agreement. If Seller defaults under this Agreement, the Buyer may seek specific performance or elect to receive the return of the Buyers deposit(s) without thereby waving any action for damages resulting from Seller's breach. In connection with any litigation arising out of this Agreement, the prevailing party will he entitled to recover all costs including a reasonable attorney's fee

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17. The offer of BUYER shall terminate if SELLER has not indicated his acceptance of this Agreement by signing and delivering same or telegraphing acceptance to Buyer or submitting agent before _12_:01[X]AM.[ ]PM Date 5/1/13__

18. Additional Terms, Conditions or Addenda (lettered A, B,.C,.D.etc.)

____Buyer will make first payment in the third month after closing. Seller will make two payments after closing_____

19. Timing: The timing of paragraphs 7,8,9, and 10(A) will become operable after satisfaction of paragraph 2, if applicable, and those additional conditions

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19. Timing: The timing of paragraphs 7,8,9, and 10(A) will become operable after satisfaction of paragraph 2, if applicable, and those additional conditions

lettered in Paragraph 18.

20. There are no other agreements, promises or understandings between these parties except as specifically set forth herein. This legal and binding agreement will be construed under TX__ Law, will not he recorded and if not understood, parties should seek competent legal advice. Seller and Buyer give real estate agent authorization to advise surrounding neighbors who will he the owner of this property. TIME IS OF THE ESSENCE IN THIS AGREEMENT.

21. Signed sealed on the date herein stated

____James Buyer_____ _____ _____
Buyer Date of Offer Buyer

____Jane Seller _____ _____ _____
Seller Date of Acceptance Seller

[ ]Agent [X] Seller, by the signature below, acknowledge receipt of $_10.00_____ [X]Cash [ ] Check, as binder deposit, which is the amount mentioned in paragraph 1A of this Agreement.

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lettered in Paragraph 18.

20. There are no other agreements, promises or understandings between these parties except as specifically set forth herein. This legal and binding agreement will be construed under TX__ Law, will not he recorded and if not understood, parties should seek competent legal advice. Seller and Buyer give real estate agent authorization to advise surrounding neighbors who will he the owner of this property. TIME IS OF THE ESSENCE IN THIS AGREEMENT.

21. Signed sealed on the date herein stated

____James Buyer_____ _____ _____
Buyer Date of Offer Buyer

____Jane Seller _____ _____ _____
Seller Date of Acceptance Seller

[ ]Agent [X] Seller, by the signature below, acknowledge receipt of $_10.00_____ [X]Cash [ ] Check, as binder deposit, which is the amount mentioned in paragraph 1A of this Agreement.

_____ _____ _____Jane Seller_____
Agent Date Seller

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"Subject To" Info Sheet

Property Address: _____

Borrower's Name: _____ **SS #** _____

Borrower's Name: _____ **SS #** _____

Borrower's Address: _____

Borrower's Phone #'s: H: _____ **O:** _____

Lending Institution Name: _____ **Loan #:** _____

Customer Service Address: _____

Phone Number: _____

Principal Balance: $_____

Amount in Arrearage: $_____

Monthly Payment: $_____ **[] PI or [] PITI**

Interest Rate: _____**%**

Start Date of Loan:_____

- **Copy of last statement or coupon book**
- **Copy of the Promissory Note**
- **Copy of the Mortgage**

SUBJECT TO PRE-CLOSING CHECKLIST

Thank you for choosing Tipton Law Firm, PLLC to close your Subject To transaction. In order to start processing your transaction, please ensure that the following documents and forms are filled out and returned at the time you submit your contract.

- ☐ Executed Purchase & Sales Agreement (you may use the one included in the pre-closing package or a contract of your choice)
- ☐ Current Mortgage Statement
- ☐ Payoff/Reinstatement Figures if applicable
- ☐ Obtain all HOA information, transfer fees, balances and dues (we can submit a request for a transfer package for you, but will need the HOA's information)
- ☐ Fully executed Pre-Closing Package (pre-closing disclosures, Texas 5.016 Disclosure, Authorization to Release Information, Seller Info Sheet, and 1099-S Information Sheet)

Seller Info:

Name(s): _____

Phone: _____

Email: _____

Address: _____

Buyer Info:

Name(s): _____

Phone: _____

Email: _____

Address: _____

The above information is **required** in order to process your transaction. Failure to provide the above necessary information may cause a delay in your closing.

AGREEMENT FOR PURCHASE & SALE OF REAL ESTATE
(Subject to Transaction)

AGREEMENT dated this ____ day of _____ 20___, by and between _____ hereinafter "**Seller**", whose address is _____, and _____ hereinafter "**Buyer**" (or its assignee or nominee) whose address is _____.

1. THE PROPERTY. The Seller agrees to sell and Buyer agrees to buy the following property, located in the Bexar County, State of Texas, Lot ____, Block ____, CB/NCB _____ commonly known as _____.
The sale shall also include all windows shades, blinds, screens, shutters, electric and plumbing fixtures and _____ _____.

2. PURCHASE PRICE. Buyer to pay the purchase price as follows (check all that applies):

☐ CASH DOWN PAYMENT due at closing in the amount…… ……..……..…… $_____

☐ REINSTATEMENT TO LENDER/OTHER PMT due at closing in the amount …….....…… $_____

☐ TAKE TITLE SUBJECT TO AN EXISTING **FIRST** TRUST DEED NOTE
held by _____ with an approximate unpaid amount of .....….. $_____
payable $_____ monthly until paid, including interest not exceeding ____%.

☐ TAKE TITLE SUBJECT TO AN EXISTING **SECOND** TRUST DEED NOTE
held by _____ with an approximate unpaid amount of ……..……..... $_____
payable $_____ monthly until paid, including interest not exceeding ____%,

☐ A PROMISSORY NOTE in the principal amount of ..... $_____
For the Terms of the Note, see paragraph 10 below.

TOTAL PURCHASE PRICE IS THE AMOUNT OF ……..…….…….. $_____

Earnest Money: Earnest Money will be delivered and payable to Tipton Law Firm, PLLC in the amount of $_____, within ___ days of signing this contract. Earnest Money will be credited to the sales price and/or closing costs.

3. FINANCING. Buyer will be taking the property subject to deed(s) of trust existing on the property and the underlying existing loans and is not expressly assuming responsibility through a formal assumption of said loans. Commencing on _____, 20____, the Buyer shall pay all monthly obligations on the underlying loans and property taxes, assessments, insurance, and any other expenses related to the property.

If the actual loan balance of said loan is less than as stated herein, the purchase price shall be reduced to reflect the difference; if the actual loan balance is more than as stated herein, then Buyer's required cash payment shall be reduced accordingly. Seller agrees to waive any remaining balance of tax, MIP and insurance escrows, if any, held by the lender(s).

4. CLOSING. Closing will be held on or about _____, 20 _____, at a time and place at the **Tipton Law Firm.**

Responsible for Closing Cost ☐ Seller ☐ Buyer ☐ Shared Between Parties Equally.
The following Items will be prorated at closing: ☐ Homeowner's association dues, ☐ Other _____
The Law Firm will not provide Title Insurance but will perform a title and tax search to determine what if any liens are affecting Title.
Title Insurance companies will not provide Title Insurance when the underlying mortgage is not paid off.

5. POSSESION. ☐ Seller shall surrender possession to the property on day of closing.
☐ In the event possession is not delivered at closing, buyer shall withhold proceeds from the sale in the amount of $ _____ as security deposit (see attached Holdover Occupancy Agreement).

6. ADDITIONAL PROVISIONS.

- Seller is aware that this loan will not be satisfied in full at closing and may continue to appear on Seller's credit file. Seller will provide Buyer with loan payment booklets and written permission to contact the holders of any debt secured by the property. At closing, Seller to execute a Limited Power of Attorney pertaining to the subject property, a Deed to transfer title, and sign a 3-page Disclosure.
- Both Seller and Buyer acknowledge that the deed(s) of trust securing the property stated above may contain a "due on sale" provision giving the lender an option to call the loan immediately payable if all or any part of the Property is sold or transferred without satisfying the said loans.
- _____

7. DEFAULT BY BUYER. If Buyer fails to perform the agreements of this contract within the time set forth herein, Seller may retain, as liquidated damages and not as a penalty, all of the earnest money deposit specified in paragraph 2 above.

8. DEFAULT BY SELLER. If Seller fails to perform any of the agreements of this contract, Buyer shall be entitled to $5,000 for damages resulting from the breach of contract, or the Buyer may bring an action for specific performance.

9. OFFER. This is an offer to purchase the Property on the above terms and conditions. Unless this offer is signed by Seller and personally received by Buyer, by _____, at ___ AM/PM, the offer shall be deemed revoked and the deposit shall be returned.

10. OTHER TERMS: _____

Buyer(s): _____, **Date**: _____ 20_____.

Email: _____ Phone #(s): _____

Seller(s): _____, **Date**: _____ 20_____.

Email: _____ Phone #(s): _____

Tipton Law Firm, PLLC

INTERMEDIARY ACKNOWLEDGEMENT

Property Address:_____

The parties to this transaction have requested that Tipton Law Firm, PLLC ("The Firm") draft the documents for a Subject To real estate closing. For this particular closing I will be acting as an intermediary only and will not be an advocate for either side. This role is different from the traditional one of an attorney; I must remain impartial.

Being an intermediary means that any information disclosed by you to me during this representation will not be protected by attorney-client privilege in a subsequent legal proceeding asserted by or against one of you involving the other.

By using Tipton Law Firm, PLLC as an intermediary to document the agreement between the parties, both parties agree and acknowledge that The Firm cannot and will not give any legal advice to either side. While The Firm can answer general questions regarding the transaction and meaning behind the documents, The Firm will not advise either party to the transaction as to whether this transaction is right for them, or any other issue or question that is not general in nature. Both parties should seek the advice of their own counsel should they need any legal advice regarding the above transaction.

We, the undersigned, hereby acknowledge and agree that we have entered into this transaction, being fully advised of the possible conflicts and/or problems that may arise from using an intermediary, and other possible issues that are not stated above, and forever more INDEMNIFY AND HOLD HARMLESS TIPTON LAW FIRM, PLLC, ALL OF ITS EMPLOYEES, AND ALLISON K. TIPTON INDIVIDUALLY FROM ANY LIABILITY WHATSOVER.

Sellers:

_____ _____
Date

_____ _____
Date

Buyers:

_____ _____
Date

_____ _____
Date

Tipton Law Firm PLLC, Allison K. Tipton, Attorney
PO Box 690876, San Antonio, Texas 78269 P (210) 963-5288,
F (210) 963-5153 www.tiptonlawfirmsa.com, E allison@tiptonlawfirmsa.com

PRE CLOSING DISCLOSURES

I/we, _____ (Seller), on this _____**day of** _____ **20**____, have been presented with a contract to sell the property commonly known as _____ (property) to _____ **and/or assigns** (Buyers) and or assigns. I further state as follows:

_____1. **UNDERLYING MORTGAGE NOT PAID OFF**: I full understand and acknowledge that under the terms of the Contract presented to me that my underlying mortgage will **NOT** be paid off at closing. I agree and acknowledge that this is a "Subject To Transaction" and that the loan could stay in my name for the duration of the loan term.

_____2. **NOT A LOAN ASSUMPTION**: I acknowledge and understand fully that this transaction is not an official assumption of my loan. My loan will remain in my name and could remain in my name for the duration of the loan.

_____3. **LOAN IN NAME**: I understand that the loan for this property will stay in my name and it could stay in my name until the loan is matured. The Buyer has the right to keep the loan in my name for the length of the remaining loan time. This might affect my ability to secure additional credit at some future time.

_____4. **DUE ON SALE**: I fully agree and acknowledge that a transfer of title may be against my loan terms. I understand that there is a possibility that my loan may be called 'due' by the lender upon transfer of title and that the Buyer is not guaranteeing that they will pay the loan off if this happens. The Buyer has no intentions of defaulting on the loan or harming the seller's credit. The Buyer cannot guarantee that the loan will not be called due when this transfer takes place. The Buyer will, however, in good faith, assist the seller in trying to figure out a solution with the mortgage company if this situated were to arise. The Buyer will attempt in good faith to negotiate any secondary liens or additional judgments.

_____5. **DEED OF TRUST TO SECURE PAYMENT**: I understand and acknowledge that I may request that buyer sign a Deed of Trust to Secure payment at closing. I understand and acknowledge that if Buyer and I agree to not have a Deed of Trust to Secure Payment, my only recourse for nonpayment of my loan by buyer is to sue for breach of contract.

_____6. **LEGAL COUNSEL ADVISED**: I acknowledge I am being advised to seek independent legal counsel to review the Offer to Purchase/Agreement.

_____7. **CLOSING LAW FIRM DOES NOT REPRESENT EITHER PARTY**: I acknowledge and understand that this transaction will close through an attorney's office, and that Attorney will be acting in an intermediary capacity and will not be able to give me legal advice. I acknowledge and understand that should I need legal advice, I should seek out my own independent counsel.

_____8. **NO OTHER PROMISES**: I have not been promised anything other than what is described in the Contract I have been presented with. There are no unresolved issues, no other agreements, nor are there other terms not disclosed in the Contract.

_____9. **FULLY INFORMED AND NOT CONFUSED**: I have signed the Contract being fully informed with a sufficient understanding of all terms and conditions contained therein. I am not confused about any aspect of The Contract.

_____10. **ACCEPTANCE**: I have reviewed the terms and conditions contained in the contract and have accepted Buyer's offer to purchase the property.

Acknowledged by:

_____ _____

Date

(Seller)

_____ _____

Date

(Seller)

_____ _____

Date

(Buyer)

_____ _____

Date

(Buyer)

NOTICE OF CONVEYANCE OF RESIDENTIAL PROPERTY ENCUMBERED BY LIEN PURSUANT TO TEXAS PROPERTY CODE SECTION 5.016

WARNING: ONE OR MORE RECORDED LIENS HAVE BEEN FILED THAT MAKE A CLAIM AGAINST THIS PROPERTY AS LISTED BELOW. IF A LIEN IS NOT RELEASED AND THE PROPERTY IS CONVEYED WITHOUT THE CONSENT OF THE LIENHOLDER, IT IS POSSIBLE THAT THE LIENHOLDER COULD DEMAND FULL PAYMENT OF THE OUTSTANDING BALANCE OF THE LIEN IMMEDIATELY. YOU MAY WISH TO CONTACT EACH LIENHOLDER FOR FURTHER INFORMATION AND DISCUSS THIS MATTER WITH AN ATTORNEY

_____, Seller(s), hereby provides notice to _____ _____, as Purchaser(s), pursuant to Texas Property Code, Section 5.016 as follows: The address of the property is_____ _____ and the legal description of the property in question is as follows:_____

1. The name, address and phone number of the lienholder against the Property is as follows:

_____

_____

_____

_____

2. Loan Information(Acct No._____):

a) Principal Balance: $_____ Current Payoff: $_____
b) Interest Rate: _____% Monthly Payment: $_____

3. The lienholder has not consented to transfer of the Property to _____.

4. For the existing insurance policy relating to the Property, the following applies:
a) The name of the Insurer is _____
b) The name of the Insured is _____
c) The amount for which the Property is insured is $_____
d) The Property that is insured is _____

Dated this the _____ day of _____, 201___.

Purchaser(s):_____ **Date:**_____

_____ **Date:**_____

Seller(s):_____ **Date:**_____

_____ **Date:**_____

NOTICE OF CONVEYANCE OF RESIDENTIAL PROPERTY ENCUMBERED BY LIEN PURSUANT TO TEXAS PROPERTY CODE SECTION 5.016

The parties to this transaction have agreed to NOT give notice to the lender of the intended property transfer.

Dated this the _____ day of _____, 201___.

Purchaser(s):_____ **Date:**_____

_____ **Date:**_____

Seller(s):_____ **Date:**_____

_____ **Date:**_____

AUTHORIZATION TO RELEASE INFORMATION

Authorization dated this _____ day of _____, 20___.

Borrower(s): _____

Date of Birth: _____

SSN: _____

Property Address: _____

Lender Name: _____

Loan Number: _____

Lender Phone number: _____

Lender Fax number: _____

I/We the undersigned hereby authorize you to release information regarding the above referenced loan to Tipton Law Firm, PLLC and _____ and/or their agents/assigns. This form may be duplicated in blank and/or sent via facsimile transmission. This authorization is a continuation authorization for said persons to receive information about my loan, including duplicates of any notices sent to me regarding my loan.

_____	_____
Borrower- Print Name	Borrower- Print Name
_____	_____
Borrower- Signature	Borrower- Signature

Information to assist Sellers in the completion of the 1099-S Certification and 1099-S Input Form

To comply with IRS regulations, requiring reporting of the sale or exchange of Real Property, follow the instructions below:

Step 1
Each Seller must complete a 1099-S Exemption Form (Husband and Wife must each complete a separate form).

Step 2

1. A) If all questions are answered "True or Yes" on the 1099-S Exemption Form, return the completed and signed form to Tipton Law Firm, PLLC. DO NOT complete the 1099-S Input Form. No additional steps are required.
2. B) If you answered "False or No" to any question on the 1099-S Exemption Form, continue to Step 3.

Step 3
Each seller who does not answer "True/Yes" to all questions on the 1099-S Exemption form, must complete and sign the attached 1099-S Input form. Return the completed 1099-S Input Form to your escrow officer. (if you do not know all the information, leave it blank and we will fill it in)

Husband and wife filing joint returns need only complete one 1099 Input Form (and one percentage allocation of 100%).
TRUSTS: Trusts are not automatically exempt from receiving 1099s. If the Trust has not been issued it's own Tax I.D. number then each trustee must complete the form with the social security number to be used and the name, as it appears on tax return, with the percentage allocation for each trustee. If the Trust has it's own TIN then enter the Trust Tax I.D. number and the legal name as it appears on the tax return.
ESTATES: If using the decedent's social security to file tax return, then use the decedents name. If the Estate has been issued it's own TIN, then use Estate of John Smith and the TIN assigned to that Estate name.
CONSERVATORSHIPS: If a Minor, use the Name and social security number assigned to that minor. If an Elder, use the Elder's name and social security number that the tax return will be filed under.
PARTNERSHIPS/LLC (Limited Liability Company): Are not automatically exempt. The name and tax I.D. number for the partnership, one 1099 will be issued to one partner. (If volume transferor please provide documentation.)
Corporations, Non-profits, government entities, 1031 Exchanges, Refinance, Bankruptcy, Deed in Lieu of Foreclosure, Bulk Sales and Volume Transferors (more than 25 transactions per year) ***are automatically exempt.***

The IRS wants the social security number that was assigned to the name (as it appears on IRS records) **that will be filing the tax return reporting the sale of this property in this transaction.**

(In some cases this may not be the same name as the Seller(s) on the Grant Deed. i.e. Decedents cannot convey property. Trusts cannot convey property.)

ALL SELLERS - COMPLETE THE 1099-S CERTIFICATION
COMPLETE THE 1099-S INPUT FORM - ONLY IF APPLICABLE

1099-S Exemption Form

EXCLUSION OF PRINCIPAL RESIDENCE FROM 1099-S REPORTING REQUIREMENT

The seller of a principal residence should complete this form to determine whether the sale or exchange should be reported to the IRS on Form 1099 - S, Proceeds from Real estate Transaction.If the seller properly completes Parts I and III, and makes a "true" response to assurances(1) through(6) in Part II(or a "not applicable" response to assurance(6)), no information reporting to the seller or to the IRS will be required for that seller.The term "seller" includes each owner of the residence that is sold or exchanged.Thus, if a residence has more than one owner, the closing agent must either obtain a certification from each owner (whether married or not) or file an information return and furnish a payee statement for any owner who does not make the certification.

Part I. Seller Information Date of Closing:

1. Name:	

2. Address or legal description (including city, state, and ZIP code) of residence being sold or exchange

3. Taxpayer Identification Number (TIN):

Part II. Seller Assurances

True	False	
☐	☐	(1) I owned and used the residence as my principal residence for periods aggregating 2 years or more during the 5-year period ending on the date of the sale or exchange of the residence.
☐	☐	(2) I have not sold or exchanged another principal residence during the 2-year period ending on the date of the sale or exchange of the residence.
☐	☐	(3) I (or my spouse or former spouse, if I was married at any time during the period beginning after May 6, 1997, and ending today) have not used any portion of the residence for business or rental purposes after May 6, 1997.
☐	☐	(4) At least one of the following three statements applies: The sale or exchange is of the entire residence for $250,000 or less. ...OR... I am married, the sale or exchange is of the entire residence for $500,000 or less, and the gain on the sale or exchange of the entire residence is $250,000 or less. ...OR... I am married, the sale or exchange is of the entire residence for $500,000 or less, and (a) I intend to file a joint return for the year of the sale or exchange, (b) my spouse also used the residence as his or her principal residence for periods aggregating 2 years or more during the 5 -year period ending on the date of the sale or exchange of the residence, and (c) my spouse also has not sold or exchanged another principal residence during the 2 -year period ending on the date of the sale or exchange of the principal residence.
☐	☐	(5) During the 5-year period ending on the date of the sale or exchange of the residence, I did not acquire the residence in an exchange to which section 1031 of the Internal Revenue Code applied.
☐ ☐ N/A	☐	(6) If my basis in the residence is determined by reference to the basis in the hands of a person who acquired the residence in an exchange to which section 1031 of the Internal Revenue Code applied, the exchange to which section 1031 applied occured more than 5 years prior to the date I sold or exchanged the residence.

Part III. Seller Certification

Under penalties of perjury, I certify that all the above information is true as of the end of the day of the sale or exchange.

Signature Date 05/08/2020

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Signature Date 05/08/2020

Note to SELLER:

This form does NOT need to be completed if all questions on the 1099-S CERTIFICATION FORM are answered "True". If the property involves a 1031 Tax Deferred Exchange, PLEASE COMPLETE THIS FORM.

FOUR SEASONS ESCROW, INC.

1099-S INPUT FORM

Company Number	Office Number	Type	Escrow Number	Actual Closing Date
		☐ Add ☐ Change ☐ Delete	_____	

SUBJECT PROPERTY INFORMATION

STREET ADDRESS OR BRIEF FORM OF LEGAL DESCRIPTION (FOR VACANT LAND, USE APN, COUNTY AND STATE)

_____

CITY STATE ZIP CODE

_____

TRANSACTION DATA

CONTRACT SALES PRICE	No. OF 1099-S	2 OR MORE 1099 FORMS - S	BUYERS PART OF REAL ESTATE TAX	CONTINGENT TRANSACTION	EXCHANGE
(Line 401 of HUD-1 form) Note: If this is an exchange, provide total dollar value of cash, notes and debt relief received by this exchanger. $ _____	forms required for the sale of this property	If 2 or more 1099-s forms are required for this transaction, record the dollar amount for the seller based on the seller's declaration $ _____	Show any real estate tax, on a residence, charged to the buyer at settlement. $ _____	Is this a contingent transaction wherein gross proceeds cannot be determined with certainty at time of closing? ☐ Yes	Was (or will there be) other property services received? ☐ Yes

SELLER INFORMATION - PLEASE PRINT CLEARLY

SELLER'S LAST NAME FIRST NAME M.I.

_____

SELLER'S **FORWARDING** STREET ADDRESS

_____

CITY STATE ZIP CODE (or country if not USA)

_____ _____

SELLER'S SOCIAL SECURITY NUMBER OR	SELLER'S TAX IDENTIFICATION NUMBER
_____	_____
You are required by law to provide your closing agent with your correct Taxpayer Identification Number. If you do not provide your closing agent with your correct Taxpayer Identification Number; you may be subject to civil or criminal penalties imposed by law under the Tax Reform Act of 1986, under Internal Revenue Code Sections 6045(E), 6676, 6722, 6723 and 7203.	Under penalties of perjury, I certify that the number shown above is my correct Taxpayer Identification Number. _____ Seller's Signature _____ Date Signed

SELLER INFORMATION SHEET

Seller Information

Seller #1 full name (First, Middle and Last):_____

Seller Birthday: ___/ ___/ _____ Seller DL Number: _____ Seller SSN:_____

Current Address:_____

Past Addresses (last 10 years):_____

_____

_____

Marital Status: _____

Seller #2 full name (First, Middle and Last):_____

Seller Birthday: ___/ ___/ _____ Seller DL Number: _____ Seller SSN:_____

Current Address:_____

Past Addresses (last 10 years):_____

_____

_____

Marital Status: _____

Names on Title

Is seller(s) only name on title? ☐ Yes ☐No –if no, who else is on title?_____

Relation to Seller(s)_____

Are they alive? ☐ Yes ☐No –if no, do they have a will? ☐ Yes ☐No –if no, may need Affidavit of Heirship

Marital History

Marriage? ☐No ☐Yes – If yes, Spouses name: _____ Date of Marriage:___/ ___/ _____

Did spouse live in property? ☐No ☐Yes – If yes, include in contract.

Divorce? ☐No ☐Yes – If yes, County/State_____ Date of Divorce: ___/ ___/ _____

Death? ☐No ☐Yes – If yes, need copy of Death Certificate

Is there a will? ☐No ☐Yes – If yes, is it probated? ☐No ☐Yes ☐Currently in probate

Mortgage Info

Do you have a Recent Statement? ☐No ☐Yes

Lender Name_____ Loan Number_____

Delinquent on Payments? ☐No ☐Yes

Please fill out this page and return with completed contract

WRAPAROUND PRE-CLOSING CHECKLIST

Thank you for choosing Tipton Law Firm, PLLC to close your Wraparound transaction. In order to start processing your transaction, please ensure that the following documents and forms are filled out and returned at the time you submit your contract.

- ☐ Executed Purchase & Sales Agreement and Seller Financing Addendum (Financed amount **MUST** be larger than or the same as the underlying loan balance)
- ☐ Current Mortgage Statement
- ☐ Completed Escrow Servicing Contract (to close through this office, the use of an escrow servicer is required)
- ☐ Obtain all HOA information (we can submit a request for a transfer package for you, but you will need to provide the HOA's information)
- ☐ Fully executed Pre-Closing Package (pre-closing disclosures, Texas 5.016 Disclosure, Seller Info Sheet, and 1099-S Information Sheet)
- ☐ Any other closing expense invoices (insurance, home warranty, broker's DA, etc.)

Seller Info:

Name(s): _____

Phone: _____

Email: _____

Address: _____

Buyer Info:

Name(s): _____

Phone: _____

Email: _____

Address: _____

The above information is **required** in order to process your transaction. Failure to provide the above necessary information may cause a delay in your closing.

Tipton Law Firm, PLLC

INTERMEDIARY ACKNOWLEDGEMENT

Property Address:_____

The parties to this transaction have requested that Tipton Law Firm, PLLC ("The Firm") draft the documents for a real estate closing. For this particular closing I will be acting as an intermediary only and will not be an advocate for either side. This role is different from the traditional one of an attorney; I must remain impartial.

Being an intermediary means that any information disclosed by you to me during this representation will not be protected by attorney-client privilege in a subsequent legal proceeding asserted by or against one of you involving the other.

By using Tipton Law Firm, PLLC as an intermediary to document the agreement between the parties, both parties agree and acknowledge that The Firm cannot and will not give any legal advice to either side. While The Firm can answer general questions regarding the transaction and meaning behind the documents, The Firm will not advise either party to the transaction as to whether this transaction is right for them, or any other issue or question that is not general in nature. Both parties should seek the advice of their own counsel should they need any legal advice regarding the above transaction.

We, the undersigned, hereby acknowledge and agree that we have entered into this transaction, being fully advised of the possible conflicts and/or problems that may arise from using an intermediary, and other possible issues that are not stated above, and forever more INDEMNIFY AND HOLD HARMLESS TIPTON LAW FIRM, PLLC, ALL OF ITS EMPLOYEES, AND ALLISON K. TIPTON INDIVIDUALLY FROM ANY LIABILITY WHATSOVER.

Sellers:

_____ _____
Date

_____ _____
Date

Buyers:

_____ _____
Date

_____ _____
Date

Tipton Law Firm PLLC, Allison K. Tipton, Attorney
PO Box 690876, San Antonio, Texas 78269 P (210) 963-5288,
F (210) 963-5153 www.tiptonlawfirmsa.com, E allison@tiptonlawfirmsa.com

WRAPAROUND PRE-CLOSING DISCLOSURES

Address:_____

GENERAL INFORMATION:
A wraparound transaction is a form of creative seller financing that leaves the original(underlying) loan and lien in place when a property is sold. That means that the owner finance note for this transaction will not be the only loan/mortgage on the property. The Seller/Lender in this transaction will be responsible for ensuring that the underlying loan/mortgage remains current.

BUYER: Please review the below disclosures and initial next to each one after you've read and understood it.

_____1. **UNDERLYING MORTGAGE NOT PAID OFF**: I full understand and acknowledge that under the terms of the Contract presented to me that the underlying mortgage will **NOT** be paid off at closing. I agree and acknowledge that this is a "Wraparound Transaction" and that the loan could stay on the property for the duration of the loan term.

_____2. **DUE ON SALE**: I fully agree and acknowledge that a transfer of title may be against the underlying loan terms. I understand that there is a possibility that the underlying loan may be called 'due' by the lender upon transfer of title and that the Seller is not guaranteeing that they will pay the loan off if this happens. However, the Parties agree that should the underlying loan be "Called Due" for any reason, Buyer and Seller/Lender will work together to either refinance the owner finance note to pay off the underlying loan, or work with the underlying lender to fix the situation by any means necessary.

_____3. **INSURANCE COVERAGE:** Buyer is aware that the nature of a wraparound transaction is different than your regular mortgage transaction. Since the underlying loan has the original borrowers name, Buyer understands that the original borrower must be listed on the home owners insurance policy. Seller/Lender will assist Buyer with obtaining an acceptable policy with the right insured information.

_____4. **NOTE SERVICER:** Buyer and Seller/Lender understand that a Note Servicer will be used to service the payments of the note. This will ensure that the underlying mortgage will get paid when Buyer makes their monthly payments.

_____5. **LEGAL COUNSEL ADVISED**: I acknowledge I am being advised to seek independent legal counsel to review the Offer to Purchase/Agreement.

_____6. **CLOSING LAW FIRM DOES NOT REPRESENT EITHER PARTY**: I acknowledge and understand that this transaction will close through Tipton Law Firm, PLLC(Attorney), and that Attorney will be acting in an intermediary capacity and will not be able to give me legal advice. I acknowledge and understand that should I need legal advice, I should seek out my own independent counsel.

WRAPAROUND PRE-CLOSING DISCLOSURES

_____7. **NO OTHER PROMISES**: I have not been promised anything other than what is described in the Contract I have been presented with. There are no unresolved issues, no other agreements, nor are there other terms not disclosed in the Contract.

_____8. **FULLY INFORMED AND NOT CONFUSED**: I have signed the Contract being fully informed with a sufficient understanding of all terms and conditions contained therein. I am not confused about any aspect of The Contract.

_____9. **ACCEPTANCE**: I have reviewed the terms and conditions contained in the contract and have accepted the terms under which I will purchase the property.

Print Names Below:

Seller(s):_____

Buyer(s):_____

Acknowledged by:

_____ _____
(Seller) **Date**

_____ _____
(Seller) **Date**

_____ _____
(Buyer) **Date**

_____ _____
(Buyer) **Date**

WRAPAROUND FEE INFORMATION

Address:_____

Buyer Name(s):_____

Seller Name(s):_____

The standard closing fees for a Wraparound Transaction closed through Tipton Law Firm, PLLC are $1,500.00. These fees are allocated on a flat fee basis, payable by agreement between the parties. Closing fees include title searches, all document preparation, recording fees and post-closing disbursements.

Below, please designate the exact dollar amount of the Wraparound Transaction Fees to be payable by each party.

Buyer: $_____

Seller: $_____

Signatures:

_____ _____
Buyer Date

_____ _____
Buyer Date

_____ _____
Seller Date

_____ _____
Seller Date

NOTICE OF CONVEYANCE OF RESIDENTIAL PROPERTY ENCUMBERED BY LIEN PURSUANT TO TEXAS PROPERTY CODE SECTION 5.016

WARNING: ONE OR MORE RECORDED LIENS HAVE BEEN FILED THAT MAKE A CLAIM AGAINST THIS PROPERTY AS LISTED BELOW. IF A LIEN IS NOT RELEASED AND THE PROPERTY IS CONVEYED WITHOUT THE CONSENT OF THE LIENHOLDER, IT IS POSSIBLE THAT THE LIENHOLDER COULD DEMAND FULL PAYMENT OF THE OUTSTANDING BALANCE OF THE LIEN IMMEDIATELY. YOU MAY WISH TO CONTACT EACH LIENHOLDER FOR FURTHER INFORMATION AND DISCUSS THIS MATTER WITH AN ATTORNEY

_____, Seller(s), hereby provides notice to _____ _____, as Purchaser(s), pursuant to Texas Property Code, Section 5.016 as follows: The address of the property is_____ _____ and the legal description of the property in question is as follows:_____

1. The name, address and phone number of the lienholder against the Property is as follows:

_____

_____

_____

_____

2. Loan Information(Acct No._____):

a) Principal Balance: $_____ Current Payoff: $_____
b) Interest Rate: _____% Monthly Payment: $_____

3. The lienholder has not consented to transfer of the Property to _____.

4. For the existing insurance policy relating to the Property, the following applies:
a) The name of the Insurer is _____
b) The name of the Insured is _____
c) The amount for which the Property is insured is $_____
d) The Property that is insured is _____

Dated this the _____ day of _____, 201___.

Purchaser(s):_____ **Date:**_____

_____ **Date:**_____

Seller(s):_____ **Date:**_____

_____ **Date:**_____

NOTICE OF CONVEYANCE OF RESIDENTIAL PROPERTY ENCUMBERED BY LIEN PURSUANT TO TEXAS PROPERTY CODE SECTION 5.016

The parties to this transaction have agreed to NOT give notice to the lender of the intended property transfer.

Dated this the _____ day of _____, 201___.

Purchaser(s):_____ **Date:**_____

_____ **Date:**_____

Seller(s):_____ **Date:**_____

_____ **Date:**_____

Information to assist Sellers in the completion of the 1099-S Certification and 1099-S Input Form

To comply with IRS regulations, requiring reporting of the sale or exchange of Real Property, follow the instructions below:

Step 1
Each Seller must complete a 1099-S Exemption Form (Husband and Wife must each complete a separate form).

Step 2

1. A) If all questions are answered "True or Yes" on the 1099-S Exemption Form, return the completed and signed form to Tipton Law Firm, PLLC. DO NOT complete the 1099-S Input Form. No additional steps are required.
2. B) If you answered "False or No" to any question on the 1099-S Exemption Form, continue to Step 3.

Step 3
Each seller who does not answer "True/Yes" to all questions on the 1099-S Exemption form, must complete and sign the attached 1099-S Input form. Return the completed 1099-S Input Form to your escrow officer. (if you do not know all the information, leave it blank and we will fill it in)

Husband and wife filing joint returns need only complete one 1099 Input Form (and one percentage allocation of 100%).
TRUSTS: Trusts are not automatically exempt from receiving 1099s. If the Trust has not been issued it's own Tax I.D. number then each trustee must complete the form with the social security number to be used and the name, as it appears on tax return, with the percentage allocation for each trustee. If the Trust has it's own TIN then enter the Trust Tax I.D. number and the legal name as it appears on the tax return.
ESTATES: If using the decedent's social security to file tax return, then use the decedents name. If the Estate has been issued it's own TIN, then use Estate of John Smith and the TIN assigned to that Estate name.
CONSERVATORSHIPS: If a Minor, use the Name and social security number assigned to that minor. If an Elder, use the Elder's name and social security number that the tax return will be filed under.
PARTNERSHIPS/LLC (Limited Liability Company): Are not automatically exempt. The name and tax I.D. number for the partnership, one 1099 will be issued to one partner. (If volume transferor please provide documentation.)
Corporations, Non-profits, government entities, 1031 Exchanges, Refinance, Bankruptcy, Deed in Lieu of Foreclosure, Bulk Sales and Volume Transferors (more than 25 transactions per year) ***are automatically exempt.***

The IRS wants the social security number that was assigned to the name (as it appears on IRS records) **that will be filing the tax return reporting the sale of this property in this transaction.**

(In some cases this may not be the same name as the Seller(s) on the Grant Deed. i.e. Decedents cannot convey property. Trusts cannot convey property.)

ALL SELLERS - COMPLETE THE 1099-S CERTIFICATION
COMPLETE THE 1099-S INPUT FORM - ONLY IF APPLICABLE

1099-S Exemption Form

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1. Name:	

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True	False	
☐	☐	(1) I owned and used the residence as my principal residence for periods aggregating 2 years or more during the 5-year period ending on the date of the sale or exchange of the residence.
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FOUR SEASONS ESCROW, INC.

1099-S INPUT FORM

Company Number	Office Number	Type	Escrow Number	Actual Closing Date
		☐ Add ☐ Change ☐ Delete	_____	

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SELLER INFORMATION - PLEASE PRINT CLEARLY

SELLER'S LAST NAME FIRST NAME M.I.

_____

SELLER'S **FORWARDING** STREET ADDRESS

_____

CITY STATE ZIP CODE (or country if not USA)

_____ _____

SELLER'S SOCIAL SECURITY NUMBER OR	SELLER'S TAX IDENTIFICATION NUMBER
_____	_____
You are required by law to provide your closing agent with your correct Taxpayer Identification Number. If you do not provide your closing agent with your correct Taxpayer Identification Number; you may be subject to civil or criminal penalties imposed by law under the Tax Reform Act of 1986, under Internal Revenue Code Sections 6045(E), 6676, 6722, 6723 and 7203.	Under penalties of perjury, I certify that the number shown above is my correct Taxpayer Identification Number. _____ Seller's Signature _____ Date Signed

SELLER INFORMATION SHEET

Seller Information

Seller #1 full name (First, Middle and Last):_____

Seller Birthday: ___/ ___/ _____ Seller DL Number: _____ Seller SSN:_____

Current Address:_____

Past Addresses (last 10 years):_____

_____

_____

Marital Status: _____

Seller #2 full name (First, Middle and Last):_____

Seller Birthday: ___/ ___/ _____ Seller DL Number: _____ Seller SSN:_____

Current Address:_____

Past Addresses (last 10 years):_____

_____

_____

Marital Status: _____

Names on Title

Is seller(s) only name on title? ☐ Yes ☐No –if no, who else is on title?_____

Relation to Seller(s)_____

Are they alive? ☐ Yes ☐No –if no, do they have a will? ☐ Yes ☐No –if no, may need Affidavit of Heirship

Marital History

Marriage? ☐No ☐Yes – If yes, Spouses name: _____ Date of Marriage:___/ ___/ _____

Did spouse live in property? ☐No ☐Yes – If yes, include in contract.

Divorce? ☐No ☐Yes – If yes, County/State_____ Date of Divorce: ___/ ___/ _____

Death? ☐No ☐Yes – If yes, need copy of Death Certificate

Is there a will? ☐No ☐Yes – If yes, is it probated? ☐No ☐Yes ☐Currently in probate

Mortgage Info

Do you have a Recent Statement? ☐No ☐Yes

Lender Name_____ Loan Number_____

Delinquent on Payments? ☐No ☐Yes

Please fill out this page and return with completed contract

AGREEMENT FOR PURCHASE & SALE OF REAL ESTATE
(Subject to Transaction)

AGREEMENT dated this ____ day of _____ 20___, by and between _____ hereinafter "**Seller**", whose address is _____, and _____ hereinafter "**Buyer**" (or its assignee or nominee) whose address is _____.

1. **THE PROPERTY.** The Seller agrees to sell and Buyer agrees to buy the following property, located in the Bexar County, State of Texas, Lot ____, Block ____, CB/NCB _____ commonly known as _____. The sale shall also include all windows shades, blinds, screens, shutters, electric and plumbing fixtures and _____ _____.

2. **PURCHASE PRICE.** Buyer to pay the purchase price as follows (check all that applies):

☐ EARNEST DEPOSIT (Payable to the **Law Firm, Trust Account**) ……..…….…….....…… $_____

☐ CASH DOWN PAYMENT due at closing in the amount ……..…….....…… $_____

☐ TAKE TITLE SUBJECT TO AN EXISTING **FIRST** TRUST DEED NOTE
held by _____ with an approximate unpaid amount of .....….. $_____
payable $_____ monthly until paid, including interest not exceeding ____%.

☐ TAKE TITLE SUBJECT TO AN EXISTING **SECOND** TRUST DEED NOTE
held by _____ with an approximate unpaid amount of ……..……..... $_____
payable $_____ monthly until paid, including interest not exceeding ____%,

☐ A PROMISSORY NOTE in the principal amount of ..... $_____
For the Terms of the Note, see paragraph 10 below.

TOTAL PURCHASE PRICE IS THE AMOUNT OF ……..…….…….…….. $_____

3. **FINANCING.** Buyer will be taking the property subject to deed(s) of trust existing on the property and the underlying existing loans and is not expressly assuming responsibility through a formal assumption of said loans. Commencing on _____, 20____, the Buyer shall pay all monthly obligations on the underlying loans and property taxes, assessments, insurance, and any other expenses related to the property.

If the actual loan balance of said loan is less than as stated herein, the purchase price shall be reduced to reflect the difference; if the actual loan balance is more than as stated herein, then Buyer's required cash payment shall be reduced accordingly. Seller agrees to waive any remaining balance of tax, MIP and insurance escrows, if any, held by the lender(s).

4. **CLOSING.** Closing will be held on or about _____, 20 _____, at a time and place at the _____ _____

Responsible for Closing Cost ☐ Seller ☐ Buyer ☐ Shared Between Parties Equally.

The following Items will be prorated at closing: ☐ Homeowner's association dues, ☐ Other _____
The Law Firm will not provide Title Insurance but will perform a title and tax search to determine what if any liens are affecting Title.
Title Insurance companies will not provide Title Insurance when the underlying mortgage is not paid off.

5. **POSSESION.** ☐ Seller shall surrender possession to the property on day of closing.
☐ In the event possession is not delivered at closing, buyer shall withhold proceeds from the sale in the amount of $ _____ as security deposit (see attached Holdover Occupancy Agreement).

6. **ADDITIONAL PROVISIONS.**

- Seller is aware that this loan will not be satisfied in full at closing and may continue to appear on Seller's credit file. Seller will provide Buyer with loan payment booklets and written permission to contact the holders of any debt secured by the property. At closing, Seller to execute a Limited Power of Attorney pertaining to the subject property, a Deed to transfer title, and sign a 3-page Disclosure.
- Both Seller and Buyer acknowledge that the deed(s) of trust securing the property stated above may contain a "due on sale" provision giving the lender an option to call the loan immediately payable if all or any part of the Property is sold or transferred without satisfying the said loans.
- _____

7. **DEFAULT BY BUYER.** If Buyer fails to perform the agreements of this contract within the time set forth herein, Seller may retain, as liquidated damages and not as a penalty, all of the earnest money deposit specified in paragraph 2 above.

8. **DEFAULT BY SELLER.** If Seller fails to perform any of the agreements of this contract, Buyer shall be entitled to $5,000 for damages resulting from the breach of contract, or the Buyer may bring an action for specific performance.

9. **OFFER.** This is an offer to purchase the Property on the above terms and conditions. Unless this offer is signed by Seller and personally received by Buyer, by _____, at ___ AM/PM, the offer shall be deemed revoked and the deposit shall be returned.

10. **OTHER TERMS**: _____

Buyer(s): _____, **Date**: _____ 20_____.

Email**:** _____ Phone #(s)**:** _____

Seller(s): _____, **Date**: _____ 20_____.

Email**:** _____ Phone #(s): _____

AGREEMENT FOR PURCHASE & SALE OF REAL ESTATE
(Subject to Transaction)

AGREEMENT dated this ____ day of _____ 20___, by and between _____ hereinafter "**Seller**", whose address is _____, and _____ hereinafter "**Buyer**" (or its assignee or nominee) whose address is _____.

1. THE PROPERTY. The Seller agrees to sell and Buyer agrees to buy the following property, located in the Bexar County, State of Texas, Lot ____, Block ____, CB/NCB _____ commonly known as _____.
The sale shall also include all windows shades, blinds, screens, shutters, electric and plumbing fixtures and _____ _____.

2. PURCHASE PRICE. Buyer to pay the purchase price as follows (check all that applies):

☐ CASH DOWN PAYMENT due at closing in the amount…… ……..……..…… $_____

☐ REINSTATEMENT TO LENDER/OTHER PMT due at closing in the amount …….....…… $_____

☐ TAKE TITLE SUBJECT TO AN EXISTING **FIRST** TRUST DEED NOTE
held by _____ with an approximate unpaid amount of .....….. $_____
payable $_____ monthly until paid, including interest not exceeding ____%.

☐ TAKE TITLE SUBJECT TO AN EXISTING **SECOND** TRUST DEED NOTE
held by _____ with an approximate unpaid amount of ……..……..... $_____
payable $_____ monthly until paid, including interest not exceeding ____%,

☐ A PROMISSORY NOTE in the principal amount of ..... $_____
For the Terms of the Note, see paragraph 10 below.

TOTAL PURCHASE PRICE IS THE AMOUNT OF ……..…….…….. $_____

Earnest Money: Earnest Money will be delivered and payable to Tipton Law Firm, PLLC in the amount of $_____, within ___ days of signing this contract. Earnest Money will be credited to the sales price and/or closing costs.

3. FINANCING. Buyer will be taking the property subject to deed(s) of trust existing on the property and the underlying existing loans and is not expressly assuming responsibility through a formal assumption of said loans. Commencing on _____, 20____, the Buyer shall pay all monthly obligations on the underlying loans and property taxes, assessments, insurance, and any other expenses related to the property.

If the actual loan balance of said loan is less than as stated herein, the purchase price shall be reduced to reflect the difference; if the actual loan balance is more than as stated herein, then Buyer's required cash payment shall be reduced accordingly. Seller agrees to waive any remaining balance of tax, MIP and insurance escrows, if any, held by the lender(s).

4. CLOSING. Closing will be held on or about _____, 20 _____, at a time and place at the **Tipton Law Firm.**

Responsible for Closing Cost ☐ Seller ☐ Buyer ☐ Shared Between Parties Equally.
The following Items will be prorated at closing: ☐ Homeowner's association dues, ☐ Other _____
The Law Firm will not provide Title Insurance but will perform a title and tax search to determine what if any liens are affecting Title.
Title Insurance companies will not provide Title Insurance when the underlying mortgage is not paid off.

5. POSSESION. ☐ Seller shall surrender possession to the property on day of closing.
☐ In the event possession is not delivered at closing, buyer shall withhold proceeds from the sale in the amount of $ _____ as security deposit (see attached Holdover Occupancy Agreement).

6. ADDITIONAL PROVISIONS.

- Seller is aware that this loan will not be satisfied in full at closing and may continue to appear on Seller's credit file. Seller will provide Buyer with loan payment booklets and written permission to contact the holders of any debt secured by the property. At closing, Seller to execute a Limited Power of Attorney pertaining to the subject property, a Deed to transfer title, and sign a 3-page Disclosure.
- Both Seller and Buyer acknowledge that the deed(s) of trust securing the property stated above may contain a "due on sale" provision giving the lender an option to call the loan immediately payable if all or any part of the Property is sold or transferred without satisfying the said loans.
- _____

7. DEFAULT BY BUYER. If Buyer fails to perform the agreements of this contract within the time set forth herein, Seller may retain, as liquidated damages and not as a penalty, all of the earnest money deposit specified in paragraph 2 above.

8. DEFAULT BY SELLER. If Seller fails to perform any of the agreements of this contract, Buyer shall be entitled to $5,000 for damages resulting from the breach of contract, or the Buyer may bring an action for specific performance.

9. OFFER. This is an offer to purchase the Property on the above terms and conditions. Unless this offer is signed by Seller and personally received by Buyer, by _____, at ___ AM/PM, the offer shall be deemed revoked and the deposit shall be returned.

10. OTHER TERMS: _____

Buyer(s): _____, **Date**: _____ 20_____.

Email: _____ Phone #(s): _____

Seller(s): _____, **Date**: _____ 20_____.

Email: _____ Phone #(s): _____

PURCHASE & SALE AGREEMENT FOR REAL ESTATE

AGREEMENT dated this _____day of_____20_____ by and between _____ _____ hereinafter "Seller" whose address is_____ and _____ hereinafter "Buyer" (and/or assigns or nominees) whose address is _____.

1. THE PROPERTY. The parties hereby agree that Seller will sell and Buyer will buy the following property, located in and situate in the County of _____, State of _____, known by street and address as _____, more particularly described as follows (enter legal description below):

EXACT LEGAL DISCRIPTION TO FOLLOW

The sale shall also include all personal property and fixtures, except _____ _____

.

Unless specifically excluded, all other items will be included, whether or not affixed to the property or structures. Seller warrants that property, improvements, building or structures, the appliances, roof, plumbing, heating and/or ventilation systems are in good and working order. **This clause shall survive closing of title.**

2. PURCHASE PRICE. The total purchase price to be paid by Buyer will be $_____ payable as follows:

Earnest money deposit (see below)	$ _____
Owner financing from seller (see below)	$ _____
New loan (see below)	$ _____
Subject to existing loans	$ _____
Cash balance due at closing	$ _____

Said price is subject to appraisal by buyer and/or agent of buyer's choice.

3. EARNEST MONEY. The buyer's earnest money shall be held in escrow by agent of buyer's choice. Upon default of this agreement, seller shall retain earnest money as his sole remedy without further recourse between the parties.

4. NEW LOAN. This agreement is contingent upon buyer's ability to obtain a new loan in the amount of $_____. Buyer is not required to accept any loan with interest rate exceeding _____% amortized over _____years or pay any closing costs or points exceeding $_____. Buyer shall provide seller with written proof of a loan commitment on or before_____, 20_____.

5. SELLER FINANCING. Buyer shall deliver a promissory note in the amount of $_____. In case of default, recourse shall be against the property and there shall be no personal recourse against the borrower. As security for performance of the promissory note, buyer shall provide the seller a security deed which shall be subordinate to a new first mortgage not to exceed $_____.

6. EXISTING LOAN. In the event part of the purchase price is to be satisfied by buyer taking subject to existing financing, buyer shall not be required to pay fees exceeding $_____ nor be required to show income or creditworthiness to the holder of said mortgage or deed of trust. Seller expressly agrees and understands that buyer is taking the property "subject to" such mortgages or deeds of trust, and is not expressly assuming responsibility for the underlying loans. If the actual loan balance of said loan is less than as stated herein, the purchase price shall be reduced to reflect the difference; if the actual loan balance is more than as stated herein, then buyer's required cash payment shall be reduced accordingly. Seller agrees to forfeit tax and insurance escrows held by said lender or its assigns.

7. SETTLEMENT.ISURABLE TITLE & CLOSING: Seller warrants that he/she is vested with full powers and authority to enter into this Agreement. If Seller has marketable & insurable title, no encroachments and property is not in a flood plain/zone, then this Agreement will be closed and the deed and other closing papers delivered within [ ]_____days after the acceptance of this agreement, & key copy given to Buyer, & all stipulations and conditions of this Agreement have been met, OR [ ] _____days after the tenant/owner vacates the house and removes all property/debris & key copy given to Buyer & all stipulations and conditions of this Agreement have been met. In the event that this Agreement is unable to close on or before the above stated date, then Buyer or Seller may, by notice to the other party (notice must be received on or before the closing date) extend this Agreement's closing date up to seven (7) days from the above stated closing date.

If title is not marketable and insurable, title defects or encroachments will be cured at Seller's expense, and Buyer will close within 10 days of cure. If Seller cannot provide marketable/insurable title to Buyer by closing, then the Buyer can, at his sole discretion, either: (1) extend this Agreement or, (2) have Seller return to Buyer all earnest monies paid and fees incurred for curing title and preparing for closing including, but not limited to, surveys, attorneys fees and appraisal. Once these monies are returned to Buyer this Agreement will be null & void. Tenant and/or Seller must: (1) vacate and leases must be legally terminated prior to closing, (2)give 3 weeks advance notice to Buyer, when they're vacating/moving.

Buyer shall pay the following costs in transferring title: [ ] title insurance policy [ ] loan assumption [ ] transfer fee [ ] transfer taxes
[ ] recording fees [ ] attorney closing charges [ ] hazard insurance premium [ ] mortgage insurance premium
[ ] survey

The following Items will be prorated at closing: [ ] Mortgage insurance [ ] Property taxes [ ] PMI Insurance [ ] Hazard insurance
[ ] Homeowner's association dues [ ] Rents [ ] Other _____

The buyer may extend the closing date an additional THIRTY (30) days by paying the seller $_____in cash. Buyer reserves the right
to do a final inspection the day of closing.

8. POSSESSION. Seller shall surrender possession to the property in clean, debris free condition, and free of all personal items on or before _____, 20_____ ("possession date", In the event possession is not delivered at closing, buyer shall withhold proceeds from the sale in the amount of $_____ as security. Seller shall be liable for damages in the amount of $_____ per day for each day the property is occupied beyond the possession date. This paragraph shall survive the closing of title.

9. INSPECTION. This agreement is subject to the final inspection and approval of the property by the buyer in writing on or before _____, 20_____ and is subject to a termite report from the buyer's pest control company that is acceptable to the buyer.

10. ACCESS. Buyer shall be entitled a key and be entitled to immediate access to show partners, lenders, inspectors and/or contractors prior to closing. Buyer may place a sign on the property prior to closing for prospective tenants, contractors and/or assigns.

11. This agreement is subject to the final inspection and approval of the condition of the property by the buyer and/or associates, assigns and/or nominees in writing before closing. This agreement is also contingent upon buyer's inspections, approval and acceptance of all paperwork, leases, appraisals, tenant histories and completed title work.

SPECIAL STIPULATIONS

_____ _____ _____ _____

Seller Date Buyer Date

_____ _____ _____ _____

Seller Date Buyer Date

TEXAS EXAMPLE ONLY
You should seek a competent real estate attorney for review

$_____ _____, 20_____

Note Secured by Wraparound Mortgage

Date:

Maker:

Maker's Mailing Address: **[include county]**

Payee:

Place for Payment: **[include county]**

Principal Amount: $_____. The original principal amount of this Note includes the unpaid principal balances of that certain promissory note, referred to in this Note as the "Underlying Note," dated [date], given by [name of maker], in the original face amount of $_____, and secured by that certain first deed of trust to the Real Property, recorded on [date], in Volume ____, Page _____, of the Official Public Records of _____ County, Texas.

Annual Interest Rate: _____ percent (_____%)

Annual Interest Rate on Matured, Unpaid Amounts: Fifteen percent (15%)

Terms of Payment (principal and interest): This Note and any accrued interest are due in _____ (_____) monthly principal and interest payments of $_____ per month, beginning on _____, 200___ and ending on _____, 20____ [with a final balloon payment of $_____ due and payable on _____, 20_____]. However, if the Underlying Note described below, or any successor or substitute note secured by a first mortgage on the real property ("Real Property") described in the Wraparound Mortgage, shall provide for a different date for the payment of the entire principal balance of the Note, then the entire principal balance payable in this Note shall be payable on that date rather than on the date provided above. In no event shall this other date be earlier than [date].

Security for Payment: a Deed of Trust from _____, Grantor, to _____, Trustee, for the benefit of _____, Beneficiary, of even date herewith, to be recorded in the Official Public Records of _____ County, Texas (the "Wraparound Mortgage").

Maker promises to pay to the order of Payee the Principal Amount plus interest at the Annual Interest Rate. This note is payable at the Place for Payment and according to the Terms of Payment. All unpaid amounts are due by the Maturity Date. After maturity, Maker promises to pay any unpaid principal balance plus interest at the Annual Interest Rate on Matured, Unpaid Amounts.

Payee is obligated to pay and discharge the Underlying Note and, so long as Maker is not in default with respect to any payments required under this Note, Payee shall indemnify, hold harmless, and defend Maker of and from any and all loss, cost, damage, liability, and expense, including attorney's fees, arising out of any actual or alleged default in the payment of any underlying obligation. However, if

Payee is required to pay, or becomes obligated to pay, any penalties, late charges, or interest under the terms of any of the underlying obligations by reason of Maker's failure to make timely payments, Maker promises to pay the amount of any such penalties, late charges, or interest to Payee on demand.

Maker agrees that from time to time the Underlying Note may be refinanced, adjusted, or modified, but only if the following conditions are satisfied:

(a) At no time while this Note is outstanding shall the aggregate obligations secured by mortgages to the Real Property exceed the amount of the then unpaid principal balance of this Note.

(b) At no time while this Note is outstanding shall the total monthly payments required to be made in connection with any obligation secured by mortgages to the Real Property exceed, in the aggregate, the monthly payment required to be made pursuant to this Note.

(c) Unless an earlier due date is provided for, any obligations secured by mortgages to the Real Property shall have a due date for the payment of the unpaid principal balance of any such obligation that is contemporaneous with the due date for the payment of this Note.

Maker may prepay this note in any amount at any time before the Maturity Date without penalty or premium. Prepayments will be applied to installments on the last maturing principal, and interest on that prepaid principal will immediately cease to accrue.

If Maker defaults in the payment of this note or in the performance of any obligation in any instrument securing or collateral to this note, Payee may declare the unpaid principal balance, earned interest, and any other amounts owed on the note immediately due. Maker and each surety, endorser, and guarantor waive all demand for payment, presentation for payment, notice of intention to accelerate maturity, notice of acceleration of maturity, protest, and notice of protest, to the extent permitted by law.

Maker also promises to pay reasonable attorney’s fees and court and other costs if this note is placed in the hands of an attorney to collect or enforce the note. These expenses will bear interest from the date of advance at the Annual Interest Rate on Matured, Unpaid Amounts. Maker will pay Payee these expenses and interest on demand at the Place for Payment. These expenses and interest will become part of the debt evidenced by the note and will be secured by any security for payment.

Interest on the debt evidenced by this note will not exceed the maximum rate or amount of non-usurious interest that may be contracted for, taken, reserved, charged, or received under law. Any interest in excess of that maximum amount will be credited on the Principal Amount or, if the Principal Amount has been paid, refunded. On any acceleration or required or permitted prepayment, any excess interest will be canceled automatically as of the acceleration or prepayment or, if the excess interest has already been paid, credited on the Principal Amount or, if the Principal Amount has been paid, refunded. This provision overrides any conflicting provisions in this note and all other instruments concerning the debt.

Each Maker is responsible for all obligations represented by this note.

When the context requires, singular nouns and pronouns include the plural.

THIS WRITTEN LOAN AGREEMENT REPRESENTS THE FINAL AGREEMENT BETWEEN THE PARTIES AND MAY NOT BE CONTRADICTED BY EVIDENCE OF PRIOR, CONTEMPORANEOUS, OR SUBSEQUENT ORAL AGREEMENTS OF THE PARTIES. THERE ARE NO UNWRITTEN ORAL AGREEMENTS BETWEEN THE PARTIES.

_____
[Name of Maker]

ALL-INCLUSIVE TRUST DEED ADDENDUM

Full Payoff

Prepared by: Agent _____ **Phone** _____
Broker _____ **Email** _____

NOTE: Recommended for use with **ft** Forms 421 and 450.

DATE:_____, 20_____, at_____, California.

Items left blank or unchecked are not applicable.

FACTS:

This is an addendum to the trust deed dated _____, 20_____, at _____, California, between _____, as the Trustor, and _____, as the Beneficiary.

AGREEMENT:

1. This trust deed is subordinate to the following notes and trust deeds referred to as Underlying Obligations:

1.1 A trust deed recorded on _____, as Instrument No. _____, in _____ County Records, California, executed by _____, as the Trustor, in which_____ is the Beneficiary, securing a note in the original amount of $_____ with an unpaid balance of $_____, payable in installments of $_____ monthly, including _____ % interest, ☐ ARM, ☐ plus impounds.

1.2 A trust deed recorded on _____, as Instrument No. _____, in _____ County Records, California, executed by _____, as the Trustor, in which _____ is the Beneficiary, securing a note in the original amount of $_____ with an unpaid balance of $_____, payable in installments of $_____ monthly, including _____% interest, ☐ ARM, all due _____, 20_____.

1.3 Beneficiary to pay all installments and payments called for on the Underlying Obligations.

2. ☐ Check, if applicable:
Trustor to deposit with Beneficiary sufficient funds for the payment of taxes and fire insurance, specifically one-twelfth (1/12) of the annual requirements on each calendar month with installment payment. An advance deposit for such payment in the amount of $_____ from Trustor has been received by Beneficiary.

3. ☐ Check, if applicable: *[This provision may cause adverse income tax consequences for Beneficiary.]*
Beneficiary shall place the Note on contract collection with a bank, savings and loan, escrow or broker authorized to do so. Such collection shall disburse the monies received first toward the current installment on the Underlying Obligations, then to taxes and insurance if provided for herein, and any amount then remaining shall be disbursed to the holders of the Note.

4. If Beneficiary defaults in his performance under this trust deed, Trustor, provided that he is not then in default, shall have the right, at his option, to cure Beneficiary's default including the Underlying Obligations by either; (a) crediting any and all such payments against the principal and interest payments next becoming due under the Note, or (b) immediately recovering from Beneficiary the amount of such payments including interest thereon at the Note rate.

5. In the event of any monetary default by Trustor, Beneficiary's obligations shall be suspended until the default is cured. If Trustor is delinquent in any payments and Beneficiary consequently incurs penalties or expenses on the Underlying Obligations, the amount of such penalties and expenses shall be added to the Note and be payable by Trustor with the next payment.

6. Any additional principal paid on the Note shall, if Trustor so directs Beneficiary in writing, be paid by Beneficiary to the holders of the Underlying Obligations for credit to the unpaid principal thereof. If the prepayment entitles the holders to receive a prepayment penalty, this amount must then be paid by Trustor to Beneficiary for payment of the penalty. The prepayment penalty shall not reduce the unpaid balance of principal or interest under the Note.

7. In the event of foreclosure of this all-inclusive trust deed, Beneficiary will at the Trustee's sale bid an amount representing the amount then due on the obligations secured hereby, plus any advances or other disbursements which Beneficiary may be permitted to include, on which bid Beneficiary to discharge and obtain reconveyance of the Underlying Obligations.

8. When the Note becomes due and payable or Trustor requests a demand for payoff, the principal amount of the payoff shall be the then unpaid principal and interest, and on receipt of payoff funds, Beneficiary to discharge and obtain reconveyance of the Underlying Obligations.

 ©2011 **first tuesday**, P.O. BOX 20069, RIVERSIDE, CA 92516 (800) 794-0494

RECORDING REQUESTED BY:

AND WHEN RECORDED MAILTO:

SPACE ABOVE THIS LINE IS FOR RECORDER'S USE

A.P.N.:_____Order No.:_____Escrow No.:_____

ALL-INCLUSIVE DEED OF TRUST WITH ASSIGNMENT OF RENTS (LONG FORM)

This ALL-INCLUSIVE DEED OF TRUST, made _____, between _____ herein called TRUSTOR, whose address is_____,

_____, a California corporation, herein called TRUSTEE, and _____, herein called BENEFICIARY, WITNESSETH: That Trustor grants to Trustee in trust, with power of sale, that property in the _____, County of _____, State of California, described as:

together with the rents, issues and profits thereof, subject, however, to the right, power and authority hereinafter given to and conferred upon Beneficiary to collect and apply such rents, issues and profits for the purpose of securing (1) payment of the sum of $_____ with interest thereon according to the terms of an all-inclusive promissory note of even date herewith (hereinafter "the Secured Note") made by Trustor, payable to order of Beneficiary, and extensions or renewals thereof, and (2) the performance of each agreement of Trustor incorporated by reference or contained herein.

A. Senior Deed(s) of Trust: This is an All-Inclusive Deed of Trust, securing the Secured Note and is subject and subordinate to the following instruments:

(1) A Deed of Trust recorded _____, as Instrument No. _____, in Book _____, Page _____, of Official Records of _____ County, California, in the original principal sum of _____ Dollars ($ _____) in favor of _____ as Payee, securing a note in the original amount of $ _____.

(2) A Deed of Trust recorded, _____, as Instrument No. _____, in Book _____, Page _____, of Official Records of _____ County, California, in the original principal sum of _____ Dollars ($ _____) in favor of _____ as Payee, securing a note in the original amount of $ _____.

The Promissory Note(s) secured by said Deed(s) of Trust is (are) hereinafter referred to as the "Senior Note(s)."

B. To protect the security of the All-Inclusive Deed of Trust, Trustor agrees:

1) To keep said property in good condition and repair; not to remove or demolish any building thereon; to complete or restore promptly and in good and workmanlike manner any building which may be constructed, damaged or destroyed thereon and to pay when due all claims for labor performed and materials furnished therefore, to comply with all laws affecting said property or requiring any alterations or improvements to be made thereon; not to commit or permit waste thereon; not to commit, suffer or permit any act upon said property in violation of law; to cultivate, irrigate, fertilize, fumigate, prune and do all other acts which from the character or use of said property may be reasonably necessary, the specific enumerations herein not excluding the general.
2) To provide, maintain and deliver to Beneficiary fire, vandalism and malicious mischief insurance satisfactory to and with loss payable to Beneficiary. The amount collected under any fire or other insurance policy may be applied by Beneficiary upon any indebtedness secured hereby and in such order as Beneficiary may determine, or at option of Beneficiary the entire amount so collected or any part thereof may be released to Trustor. Such application or release shall not cure or waive any default or notice of default hereunder or invalidate any act done pursuant to such notice. The provisions hereof are subject to the mutual agreements of the parties as below set forth.
3) To appear in and defend any action or proceeding purporting to affect the security hereof or the rights or powers of Beneficiary or Trustee and to pay all costs and expenses, including cost of evidence of title and attorney's fees in a reasonable sum, in any such action or proceeding in which Beneficiary or Trustee may appear, and in any suit brought by Beneficiary to foreclose this All-Inclusive Deed of Trust.
4) To pay: (a) at least ten days before delinquency all taxes and assessments affecting said property, including assessments on appurtenant water stock;
(b) when due, subject to the mutual agreements of the parties as below set forth, all encumbrances, charges and liens, with interest, on said property or any part thereof, which appear to be prior or superior hereto; (c) all allowable expenses of this Trust.

Should Trustor fail to make any payment or to do any act as herein provided, then Beneficiary or Trustee, but without obligation so to do and without notice to or demand upon Trustor and without releasing Trustor from any obligation hereof, may: make or do the same in such manner and to such extent as either may deem necessary to protect the security hereof, Beneficiary or Trustee being authorized to enter upon said property for such purposes; appear in and defend

any action or proceeding purporting to affect the security hereof or the rights or powers of Beneficiary or Trustee; pay, purchase, contest or compromise any encumbrance, charge or lien which in the judgment of either appears to be prior or superior hereto; and, in exercising any such powers, pay allowable expenses.

5) To pay immediately and without demand all sums so expended by Beneficiary or Trustee, with interest from date of expenditure at the amount allowed by law in effect at the date hereof.

C. It is mutually agreed:
1) That any award of damages in connection with any condemnation for public use of or injury to said property or any part thereof is hereby assigned and shall be paid to Beneficiary who may apply or release such moneys received by him in the same manner and with the same effect as above provided for disposition of proceeds of fire or other insurance.
2) That by accepting payment of any sum secured hereby after its due date, Beneficiary does not waive his right either to require prompt payment when due of all other sums so secured or to declare default for failure so to pay.
3) That at any time or from time to time, without liability therefore and without notice, upon written request of Beneficiary and presentation of this All-Inclusive Deed of Trust and the Secured Note for endorsement, and without affecting the personal liability of any person for payment of the indebtedness secured hereby, Trustee may: reconvey any part of said property; consent to the making of any map or plat thereof; join in granting any easement thereon; or join in any extension agreement or any agreement subordinating the lien or charge hereof.
4) That upon written request of Beneficiary stating that all sums secured hereby have been paid, and upon surrender of this All-Inclusive Deed of Trust and the Secured Note to Trustee for cancellation and retention or other disposition as Trustee in its sole discretion may choose and upon payment of its fees, Trustee shall reconvey, without warranty, the property then held hereunder. The recitals in such reconveyance of any matters or facts shall be conclusive proof of the truthfulness thereof. The Grantee in such reconveyance may be described as "the person or persons legally entitled thereto."
5) That as additional security, Trustor hereby gives to/and confers upon Beneficiary the right, power and authority, during the continuance of these Trusts, to collect the rents, issues and profits of said property, reserving unto Trustor the right, prior to any default by Trustor in payment of any indebtedness secured hereby or in performance of any agreement hereunder, to collect and retain such rents, issues and profits as they become due and payable. Upon any such default, Beneficiary may at any time without notice, either in person, by agent, or by a receiver to be appointed by a court, and without regard to the adequacy of any security for the indebtedness hereby secured, enter upon and take possession of said property or any part thereof, in his own name sue for or otherwise collect such rents, issues and profits, including those past due and unpaid, and apply the same, less allowable expenses of operation, upon any indebtedness secured hereby, and in such order as Beneficiary may determine. The entering upon and taking possession of said property, the collection of such rents, issues and profits and the application thereof as aforesaid, shall not cure or waive any default or notice of default hereunder or invalidate any act done pursuant to such notice.
6) That upon default by Trustor in payment of any indebtedness secured hereby or in performance of any agreement hereunder, Beneficiary may declare all sums secured hereby immediately due and payable by delivery to Trustee of written declaration of default and demand for sale and of written notice of default and of election to cause to be sold said property, which notice Trustee shall cause to be filed for record. Beneficiary also shall deposit with Trustee this All-Inclusive Deed of Trust, the Secured Note and all documents evidencing expenditures secured hereby.
After the lapse of such time as may then be required by law following the recordation of said notice of default, and notice of sale having been given as then required by law, Trustee, without demand on Trustor, shall sell said property at the time and place fixed by it in said notice of sale, either as a whole or in separate parcels, and in such order as it may determine, at public auction to the highest bidder for cash in lawful money of the United States, payable at time of sale. Trustee may postpone sale of all or any portion of said property by public announcement at such time and place of sale, and from time to time thereafter may postpone such sale by public announcement at the time fixed by the preceding postponement. Trustee shall deliver to such purchaser its deed conveying the property so sold, but without any covenant or warranty, express or implied. The recitals in such deed of any matters or facts shall be conclusive proof of the truthfulness thereof. Any person, including Trustor, Trustee, or Beneficiary as hereinafter defined, may purchase at such sale.
After deducting all costs, fees and expenses of Trustee and of this Trust, including cost of evidence of title in connection with sale, Trustee shall apply the proceeds of sale to payment of all sums expended under the terms hereof, not then repaid, with accrued interest at the amount allowed by law in effect at the date hereof; all other sums then secured hereby; and the remainder, if any, to the person or persons legally entitled thereto. However, all costs, fees and expenses set forth in this paragraph shall not be applicable to or charged by the Trustor or his successor in interest.
7) Beneficiary, or any successor in ownership of any indebtedness secured hereby, may from time to time, by instrument in writing, substitute a successor or successors to any Trustee named herein or acting hereunder, which instrument, executed by the Beneficiary and duly acknowledged and recorded in the office of the recorder of the county or counties where said property is situated, shall be conclusive proof of proper substitution of such successor Trustee or Trustees, who shall, without conveyance from the Trustee predecessor, succeed to all its title, estate, rights, powers and duties. Said instrument must contain the name of the original Trustor, Trustee and Beneficiary hereunder, the book and page where this All-Inclusive Deed of Trust is recorded and the name and address of the new Trustee.
8) That this All-Inclusive Deed of Trust applies to, inures to the benefit of, and binds all parties hereto, their heirs, legatees, devisees, administrators, executors, successors and assigns. The term Beneficiary shall mean the owner and holder, including pledgees, of the note secured hereby, whether or not named as Beneficiary herein. In this All-Inclusive Deed of Trust, whenever the context so requires, the masculine gender includes the feminine and/or neuter, and the singular number includes the plural.
9) That Trustee accepts this Trust when this All-Inclusive Deed of Trust, duly executed and acknowledged, is made a public record as provided by law. Trustee is not obligated to notify any party hereto of pending sale under any other Deed of Trust or of any action or proceeding in which Trustor, Beneficiary or Trustee shall be a party unless brought by Trustee.

D. The Parties Further Agree:
1) By Beneficiary's acceptance of this All-Inclusive Deed of Trust, Beneficiary agrees that, provided Trustor is not in default on the Secured Note, Beneficiary shall pay all installments of principal and interest which become due under the terms of the Senior Note(s). In the event Trustor shall be in default on the Secured Note, Beneficiary's obligation under the Senior Note(s) is deferred until the default under the Secured Note is cured. Should the Beneficiary default in any of the installments as to the payment on the Senior Note(s) at a time when Trustor is not in default in the performance of the obligations of the Trustor under the Secured Note or this All-Inclusive Deed of Trust, the Trustor may make said payments directly to the holder of such Senior Note(s); any and all payments so made shall be credited to the Secured Note against the next succeeding installments of principal and interest. Nothing contained herein shall be construed to create a third party beneficiary relationship between the Beneficiary and any other person.
2) Notwithstanding any covenants contained in the Senior Note(s) or Deed(s) of Trust securing same, Beneficiary shall have no further duty under this All-Inclusive Deed of Trust when: (i) the lien of this All-Inclusive Deed of Trust has been extinguished by foreclosure sale or (ii) this All-Inclusive Deed of Trust has

been duly reconveyed after payment in full of the Secured Note and subsequent to the payment by the Beneficiary herein of Trustor's portion of the Senior Note(s) which the Beneficiary herein is required to pay to the holder of said Senior Note(s).
Should Trustor be in default under the terms of the Secured Note and if Beneficiary consequently incurs any penalties, charges, or other expenses on account of the Senior Note(s) during the period of such default, the amount of such penalties, charges and expenses shall be immediately added to the principal amount of the Secured Note and shall be immediately payable by Trustor to Beneficiary.
If at any time the total of: the unpaid balance of the Secured Note, the accrued interest thereon, all other sums due under the terms thereof and all sums advanced by Beneficiary pursuant to the terms of this All-Inclusive Deed of Trust, is equal to or less than the unpaid principal balance of the Senior Note(s) and accrued interest thereon, the Secured Note, at the option of Beneficiary, shall be cancelled and said property shall be reconveyed from the lien of this All-Inclusive Deed of Trust.
3) Trustor and Beneficiary agree that in the event the proceeds of any condemnation award or settlement in lieu thereof, or the proceeds of any casualty insurance covering destructible improvements located upon said property, are applied by the holder of the Senior Note(s) in reduction of the unpaid principal amount thereof, the unpaid principal balance of the Note secured hereby shall be reduced by an equivalent amount and be deemed applied to the last sums due under the Secured Note.
4) At such time as the Secured Note becomes fully due and payable, the unpaid indebtedness of principal and interest owning thereon shall be reduced by the then unpaid balance of principal and interest due on the Senior Note(s).
5) Any demand hereunder delivered by Beneficiary to Trustee for the foreclosure of the lien of this All-Inclusive Deed of Trust may be not more than the sum of the following amounts: (i) The equity of Beneficiary in the note secured hereby being the difference between the then-unpaid balance of principal and interest accrued and unpaid on the Secured Note on the date of such foreclosure sale and the then unpaid balance of principal and interest so accrued and unpaid on the Senior Note(s) as of the date of such foreclosure sale; plus (ii) The aggregate of all amounts theretofore paid by Beneficiary pursuant to the terms of this All-Inclusive Deed of Trust prior to the date of such foreclosure sale, for taxes and assessments, insurance premiums, delinquency charges, foreclosure costs, and any other sums advanced by Beneficiary pursuant to the terms of this All-Inclusive Deed of Trust, to the extent the same were not previously repaid by Trustor to Beneficiary; plus (iii) The costs of foreclosure together with attorneys' fees and costs incurred by Beneficiary in enforcing this All-Inclusive Deed of Trust or the Note secured hereby as permitted by law.
6) Notwithstanding any provision to the contrary herein contained, Beneficiary for himself, his successors and his assigns, agrees that, in the event of a foreclosure of this All-Inclusive Deed of Trust, he will, at the trustee's sale, offset his bid by an amount not exceeding the amount representing the total amount then due under the note secured hereby plus any advances or other disbursements which Beneficiary and his successors or assigns, may, by law, be permitted to include as an offset to his bid, less the then actual total balance due upon any notes or obligations secured by any and all deeds of trust having priority over this All-Inclusive Deed of Trust and covering the above described real property or any portion thereof. The Trustee may rely on any statements received from Beneficiary as to the unpaid total balance, advances or disbursements, and such statements shall be deemed binding and conclusive as between Beneficiary and Trustor, on the one hand, and Trustee, on the other hand, to the extent of such reliance.
7) Trustor covenants and agrees that Trustor shall perform and observe all obligations to be performed and observed by Trustor under the Deed(s) of Trust securing the Senior note(s).

The undersigned Trustor requests that a copy of any notice of default and of any notice of sale hereunder be mailed to him at his address hereinbefore set forth.

_____	_____
Trustor	Trustor
_____	_____
Trustor	Trustor
_____	_____
Beneficiary	Beneficiary
_____	_____
Beneficiary	Beneficiary

Dated _____

STATE OF CALIFORNIA
COUNTY OF _____

On _____ before me, _____, personally appeared _____,
who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under the PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

_____ (Notary seal)
Signature

(IT IS RECOMMENDED THAT, PRIOR TO THE EXECUTION OF THIS ALL-INCLUSIVE DEED OF TRUST, THEPARTIES CONSULT WITH THEIR ATTORNEYS WITH RESPECT TO SAME.)

DO NOT RECORD _____ **REQUEST FOR FULL RECONVEYANCE**

TO _____, TRUSTEE:

The undersigned is the legal owner and holder of the note and of all indebtedness secured by the foregoing Deed of Trust. Said note, together with all other indebtedness secured by said Deed of Trust, have been fully paid and satisfied; and you are hereby requested and directed, on payment to you of any sums owing to you under the terms of said Deed of Trust, to cancel said note above mentioned, and all other evidences of indebtedness secured by said Deed of Trust delivered to you herewith, together with the said Deed of Trust, and to reconvey, without warranty, to the parties designated by the terms of said Deed of Trust, all the estate now held by you under the same.

Dated _____ _____

_____

Please mail Deed of Trust,
Note and Reconveyance to _____

DO NOT lose or destroy this Deed of Trust OR THE NOTE which it secures. BOTH must be delivered to the Trustee for cancellation before reconveyance will be made.

ALL-INCLUSIVE PROMISSORY NOTE SECURED BY DEED OF TRUST

Installment — Interest Included

Prepared by: Agent _____ **Phone** _____
Broker _____ **Email** _____

NOTE: RECOMMENDED FOR USE WITH **first tuesday** FORMS 442 AND 443.

$_____, dated _____, 20_____, at _____, California.

1. In installments as herein stated, for value received, I, jointly and severally, promise to pay to

1.1 _____, as the Payee, or order,

1.2 at _____,

1.3 the sum of _____ DOLLARS,

1.4 with interest from _____, 20_____, on unpaid principal

1.5 at the rate of _____% per annum.

2. Principal and interest payable in installments of _____ DOLLARS, or more,

2.1 on the _____ day of every ☐ month ☐ quarter ☐ year,

2.2 beginning on the _____ day of _____, 20_____,

2.3 and continuing until _____, 20_____, when the principal is due and payable.

2.4 Principal and interest payable in lawful money of the United States.

2.5 Each payment shall be credited first on interest then due and the remainder on principal.

3. The principal amount of this Note includes:

3.1 The present unpaid balance of $_____, on a debt evidenced by a Note and secured by an existing Trust Deed held by _____, in the original amount of $_____, which debt remains the obligation of Payee.

3.2 The present unpaid balance of $_____, on a debt evidenced by a Note and secured by an existing Trust Deed held by _____, in the original amount of $_____, which debt remains the obligation of Payee.

4. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note holder.

5. _____

6. In any action to enforce this Note, the prevailing party shall receive attorney fees.

7. This Note is secured by a DEED OF TRUST.

Payor's Name: _____	Payor's Name: _____
Signature: _____	Signature: _____
Payor's Name: _____	Payor's Name: _____
Signature: _____	Signature: _____

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ALL-INCLUSIVE TRUST DEED ADDENDUM

Equity Payoff

Prepared by: Agent _____ **Phone** _____
Broker _____ **Email** _____

NOTE: Recommended for use with **ft** Forms 421 and 450.

DATE:_____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

This is an addendum to the trust deed dated _____, at _____, California, between _____, as the Trustor, and _____, as the Beneficiary.

AGREEMENT:

1. This trust deed is subordinate to the following notes and trust deeds referred to as Underlying Obligations:

1.1 A trust deed recorded on _____, as Instrument No. _____, in _____ County Records, California, executed by _____, as the Trustor, in which _____ is the Beneficiary, securing a note in the original amount of $_____ with an unpaid balance of $_____, payable in installments of $_____ monthly, including _____% interest, ☐ ARM, ☐ plus impounds.

1.2 A trust deed recorded on _____, as Instrument No. _____, in _____ County Records, California, executed by _____, as the Trustor, in which _____ is the Beneficiary, securing a note in the original amount of $_____ with an unpaid balance of $_____, payable in installments of $_____ monthly, including _____% interest, ☐ ARM, all due _____, 20_____.

1.3 Beneficiary to pay all installments and payments called for on the Underlying Obligations.

2. ☐ Check, if applicable:
Trustor to deposit with Beneficiary sufficient funds for the payment of taxes and fire insurance, specifically one-twelfth (1/12) of the annual requirements on each calendar month with installment payment. An advance deposit for such payment in the amount of $_____ from Trustor has been received by Beneficiary.

3. ☐ Check, if applicable: *[This provision may cause adverse income tax consequences for Beneficiary.]*
Beneficiary shall place the Note on contract collection with a bank, savings and loan, escrow or broker authorized to do so. Such collection shall disburse the monies received first toward the current installment on the Underlying Obligation, then to taxes and insurance if provided for herein, and any amount then remaining shall be disbursed to the holders of the Note.

4. If Beneficiary defaults in his performance under this trust deed, Trustor, provided that he is not then in default, shall have the right, at his option, to cure Beneficiary's default including the Underlying Obligations by either; (a) crediting any and all such payments against the principal and interest payments next becoming due under the Note, or (b) immediately recovering from Beneficiary the amount of such payments including interest thereon at the Note rate.

5. In the event of any monetary default by Trustor, Beneficiary's obligations shall be suspended until the default is cured. If Trustor is delinquent in any payments and Beneficiary consequently incurs penalties or expenses on the Underlying Obligations, the amount of such penalties and expenses shall be added to the Note and be payable by Trustor with the next payment.

6. Any additional principal paid on the Note shall, if Trustor so directs Beneficiary in writing, be paid by Beneficiary to the holders of the Underlying Obligations for credit to the unpaid principal thereof. If the prepayment entitles the holders to receive a prepayment penalty, this amount must then be paid by Trustor to Beneficiary for payment of the penalty. The prepayment penalty shall not reduce the unpaid balance of principal or interest under the Note.

7. In the event of foreclosure of this all-inclusive trust deed, Beneficiary will at the Trustee's sale bid an amount representing the amount then due on the obligations secured hereby less the total balance due on the Underlying Obligations, plus any advances or other disbursements which Beneficiary may be permitted to include.

8. When the Note becomes due and payable or Trustor requests a demand for payoff, the principal amount then unpaid shall be reduced by the then unpaid balance of the Underlying Obligations.

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PURCHASE AGREEMENT

THIS IS A LEGALLY BINDING CONTRACT BETWEEN PURCHASER AND SELLER.
IF YOU DO NOT UNDERSTAND IT, SEEK LEGAL ADVICE.

1. **PARTIES TO CONTRACT - PROPERTY.** Purchaser and Seller acknowledge that Broker is_____ is not_____ the limited agent of both parties to this transaction as outlined in Section III of the Agency Agreement Addendum as authorized by Purchaser and Seller.

   _____, hereinafter referred to as

   Purchaser, offers and agrees to purchase from _____, hereinafter referred to as Seller, upon the terms and conditions set forth, the property legally described as:
   _____

   _____

   also known as_____

2. **EARNEST MONEY DEPOSIT.** Earnest Money in the amount of ($_____)
   _____DOLLARS Cash_____ Check_____, unless otherwise noted herein, shall be deposited into the trust account of the listing _____ selling _____ broker on the next legal banking day after acceptance of this offer.

   Other earnest money provisions: _____

   _____

3. **PURCHASE PRICE.** The total purchase price is to be ($_____)
   _____DOLLARS

   After earnest money herein is credited, the remaining balance is to be paid by Purchaser at closing.

4. **F INANCING.**

   ☐ **New Mortgage**. This offer is contingent upon Purchaser obtaining a new
   ☐ VA, ☐ FHA, ☐ SDHDA, ☐ Conventional, or☐_____ type of loan.
   A letter of Purchaser's loan status from _____
   ☐ is attached or ☐ will be delivered by _____(date).

   Within ____ legal banking days after acceptance of this Agreement, Purchaser will make application for and diligently and in good faith endeavor to secure a new loan, pay all application fees, and to sign all financing documents without delay. Purchaser reserves the right to obtain alternative financing as long as there are no increased costs to Seller.

   ☐ **Assumption.** See attached Addendum.

   ☐ **Contract for Deed/Private Mortgage.** See attached Addendum.

   ☐ **Cash.** This is a cash offer. The remaining balance of $_____ will be paid at closing by certified check. A letter of verification from
   _____
   regarding the availability of funds ☐ is attached ☐will be delivered by _____ (date) or this agreement, at the option of Seller without notice to Purchaser may be voided.

INITIALS: PURCHASER_____/_____SELLER_____/_____

5. **APPRAISAL.** This offer is _____ is not_____ subject to the property appraising for at least the purchase price. If the appraisal reveals repairs, which must be made, Purchaser and Seller will negotiate which party will complete those repairs for any re-inspection fees. If the appraisal is less than the agreed purchase price, Purchaser and Seller may renegotiate the purchase price.

   Appraisal ☐ will / ☐ will not be ordered prior to removal of home inspection contingency.

6. **SALE OF PURCHASER'S PROPERTY**

   A. ☐ **This offer is not contingent** upon the sale or close of property owned by Purchaser.

   B. ☐ **This offer is contingent** upon the sale and close of Purchaser's property located at

   (address, including city & state)_____

   _____

   ☐ within _____ days or ☐ within the time specified for closing the Seller's property. Seller shall have the right to continue to offer the property for sale and accept any offers subject to the rights of Purchaser. If Seller accepts another offer, Seller will give Purchaser written notice of that fact. Within _____ days of receipt of the notice, Purchaser will provide a written waiver of the contingency on the sale and close of Purchaser's property or this agreement will terminate without further notice and deposits will be returned according to paragraph 15 of this agreement. Upon waiver of this contingency, Purchaser warrants and will provide proof that the funds needed for closing will be available and Purchaser's ability to obtain financing is not contingent upon the sale and/or close of any property.

7. **SELLER'S PROPERTY DISCLOSURE.** Purchaser acknowledges receipt of Seller's property condition disclosure statement dated _____ as required by SDCL 43-4-38 through 43-4-57 prior to signing this agreement. (initials)_____/_____
   Purchaser acknowledges that no disclosure statement is required by reason of the following:

   _____

8. **LEAD-BASED PAINT DISCLOSURE.** Purchaser acknowledges receipt of the pamphlet "Protect Your Family From Lead In Your Home" and the Seller's lead-based paint and lead-based paint hazards form according to the Residential Lead-Base Hazard Reduction Act of 1992. This applies only to properties built prior to 1978. (initials)_____/_____

9. **INSPECTION OF PHYSICAL CONDITION OF PROPERTY.** Purchaser acknowledges that it has been recommended that Purchaser engage, at Purchaser's expense, the services of a professional inspector acting within the scope of the inspector's professional license to inspect the property (initials)_____/_____.

   Purchaser and Seller understand the purpose of a property inspection is to inform and educate Purchaser of conditions and future maintenance of property and is not designed to be a point of renegotiation of the purchase price.

   This offer ☐ is / ☐ is not contingent upon Purchaser, at Purchaser's expense, obtaining a property inspection(s) and report(s) which may include, but not be limited to the physical, structural, mechanical, pest, geological and environmental contamination conditions relating to the property. These inspection options will be completed and written notice of the results given to Seller or Seller's agent within ____ business days of acceptance of this agreement. If the inspection(s) has not been completed within the specified time, Purchaser's option to have the inspection(s) shall expire and all other terms of this Purchase Agreement will continue unaffected.

INITIALS: PURCHASER_____/_____SELLER_____/_____

9. ***INSPECTION OF PHYSICAL CONDITION OF PROPERTY (continued from page 2)***
If any inspection(s) reveals conditions unsatisfactory to Purchaser or unknown to Seller, the parties to this Agreement will have the following options: Purchaser will accept the existing condition; Seller will correct the existing condition and provide certification from an inspector that the condition has been remedied; or Purchaser and Seller will negotiate a settlement. If no written agreement can be reached on the results of the Inspection Report(s) within _____ business days of the date and time Seller is notified of the results of the inspection(s), this Agreement may be deemed null and void in its entirety at the option of Buyer within _____ hours after the negotiation deadline.

☐ Purchaser hereby waives the option to have an independent home inspector assess the condition of the property. _____(Purchaser's initials)

10. **HOME PROTECTION PLAN:** Seller _____ has / _____ has not provided a home protection plan. By initialing, Purchaser elects _____ to purchase _____ to not purchase a home protection plan. Purchaser and Seller acknowledge that Broker selling the home protection plan will receive compensation from the home protection plan provider.

11. **SURVEY.** Purchaser acknowledges that it has been recommended to obtain a survey by initialing one of the following:
_____ new location survey depicting all improvements on the property.
_____ existing location survey depicting all improvements on the property.
_____ new boundary survey marking all property corners before closing.
_____ other _____.

Cost of survey, if any, will be paid as follows: _____Seller _____Purchaser

Purchaser waives survey (Initial, if applicable) _____

12. **TAXES/PRORATIONS.** Purchaser is aware that property taxes may or may not be based upon "Owner Occupied Status". Any and all Special Assessments are to be paid by Seller unless otherwise specified in this agreement.

Taxes, rents, road maintenance, water, sewer, and homeowner's association fees, if any are:

☐ To be prorated to _____

☐ Not to be prorated

Tax proration will be based upon the: ☐ previous year's taxes / ☐ agreed upon amount of _____ / ☐ most current county information / ☐ new construction estimate ☐ other _____
_____

13. **TITLE.** Merchantable title shall be conveyed by Warranty Deed or other sufficient conveyance instrument, acceptable to Purchaser, subject to conditions, zoning, restrictions, and easements of record, if any, which do not interfere with or restrict the existing use of the property. An owner's policy of Title Insurance in the amount of the purchase price will be furnished with cost to be distributed: Purchaser_____ Seller_____.

INITIALS: PURCHASER_____/_____SELLER_____/_____

14. CLOSING/POSSESSION. Closing date will be on or before _____ with possession to be given Purchaser at time of closing. Seller agrees to maintain the property in a condition comparable to its present condition and agrees that Purchaser will have the opportunity for a personal inspection prior to closing. Seller agrees to maintain all existing insurance coverage on property until time of closing.

Closing service fees, if any, cost to be distributed as follows: Purchaser_____ Seller_____.

All personal property, including refuse, not included in the purchase price, shall be removed by Seller prior to closing.

15. EARNEST MONEY/DEPOSITS. The broker, as specified in Section 2, shall deposit and hold all earnest money and other deposits until sale is closed. If an accepted offer and agreement to purchase does not close, regardless of the circumstances, both Purchaser and Seller must agree in writing prior to release of earnest money or in the alternative, pursuant to court order in accordance with SDCL 36-21A-81.

16. AGREEMENT TO MEDIATE. Any dispute or claim arising out of or relating to this contract will be submitted to mediation, if available, in accordance with the rules and procedures of the Sellers/Purchasers Dispute Resolution System. Otherwise, mediation will be submitted to a private mediation service. Any costs of mediation will be shared equally between Purchaser and Seller.

Yes_____ No_____ Purchaser_____/_____ (initials)

17. PERSONAL PROPERTY. Any personal property, free of liens and without warranty of condition, shall be transferred to Purchaser by a separate bill of sale. Purchaser ☐ will / ☐ will not compensate seller for fuel oil/propane remaining on date of closing.

18. OTHER PROVISIONS: _____

_____

_____

_____

18. ADDENDA TO THIS AGREEMENT. The following documents are addenda to this contract and are attached and become part of this contract by reference. If none, so state.

_____

_____

_____

19. This agreement is void if not accepted by Seller by the _____ day of _____ , _____ by _____ a.m./p.m.

20. The laws of South Dakota govern this transaction.

INITIALS: PURCHASER_____/_____SELLER_____/_____

21. TIME IS OF THE ESSENCE OF THIS CONTRACT.

Dated this _____day of_____, _____at_____a.m./p.m.

_____ _____

Purchaser Purchaser

On this _____day of_____, _____ the foregoing offer is:

(Initial) **ACCEPTED_____/_____**

NOT ACCEPTED_____/_____

COUNTERED_____/_____

_____ _____

Seller Seller

****

THE FOLLOWING IS FOR INFORMATION PURPOSES ONLY:

_____ _____

Selling Company Selling Licensee

_____ _____

Listing Company Listing Licensee

STANDARD REAL ESTATE RENTAL AGREEMENT

This Agreement made this _____ day of _____, **20____**, is between _____ (hereinafter referred to as "Management") and _____ (hereinafter referred to as "Resident"). Management rents to Resident, and Resident rents from Management, property located at:
Address: _____ City: _____, State: _____, Zip: _____, the full legal description of which is the same as recorded with the Clerk of the Superior Court of _____ **County**, and is made a part hereof by reference (hereinafter referred to as the "Property"), under the following terms and conditions:

1. TERM: The initial term of this Agreement shall be for _____ **months** beginning on the _____ day of _____**, 20____,** and terminating at **12 noon** on the _____ day of _____**, 20____**.

2. POSSESSION: Should Management be unable to deliver possession of the Property at the commencement of this Agreement, Management shall not be liable for damages caused thereby, nor shall this agreement be void or voidable, but Resident shall not be liable for any rent until possession is delivered. Resident may terminate this Agreement if possession is not delivered within seven (7) days of the start of the term hereof. As long as premises are habitable, Resident may not unreasonably refuse to occupy.

_____ **3. RENT:** Rent is payable monthly **in advance** without notice or demand at the rate of _____ **DOLLARS ($_____)** per month, on the _____ day of each and every month during the initial or any extended term of this Agreement, and shall be annually adjusted. Unless otherwise notified in writing, the monthly rental payment shall increase annually by ten percent (10%) payable monthly beginning the month following the initial term and adjusting annually thereafter. Rental payments shall be made at the office of Management or such other place as Management may from time to time designate. ***MAILING THE RENT BY THE DUE DATE DOES NOT CONSTITUTE PAYMENT. RENTS MUST BE <u>RECEIVED</u> at the office of the Management BEFORE 5 O'CLOCK P.M. ON THE <u>DUE DATE</u> of each month to be considered paid. Monies received are applied first to any lost rental discount; second to any outstanding additional rent; third to any unpaid fees or charges, then fourth to any current rent or rent to become due. This could result in unpaid rent, which would be subject to additional rent as contained herein. Cash will not be accepted. Money orders or checks shall be made payable to:***

4. DISCOUNT FOR PROMPT PAYMENT AND MAINTENANCE: Time is of the essence of this Agreement. If the rent, and any previous balance due, is received and accepted on or before the _____ day of the month (due date as described above) and Resident complies with the maintenance requirements contained herein, a _____ **($_____) DOLLAR DISCOUNT** will be credited to the rental payment.

_____ **5. ADDITIONAL RENT & RETURNED CHECKS:** If Management elects to accept rent after the _____ day of the month, resident agrees to pay $5.00 for each day after the _____ day of the month as additional rent. In the event collection of past due rent must be made by the Management at the Property location, the Resident agrees to pay a $30.00 collection fee as additional rent for each such attempted collection. The additional rent shall continue to accrue at the rate of $5.00 per day until all rents, lost discounts, and any other amounts owing under this Agreement are paid in full. In the event any check given by Resident to Management is returned by the bank unpaid, Resident agrees to pay to Management $50.00 as additional rent, forfeit the rental discount for that month, and agrees to pay additional rent of $5.00 per day after the _____ day of the month until Resident's account is brought current. This charge will be waived if the bank verifies, in writing, the check was returned due to their error. Any returned check must be redeemed by cashier's check, certified check or money order. In the event more than one check is returned, Resident herewith agrees to pay all future rents and charges in the form of cashier's check, certified check or money order.

6. EARLY RELEASE AND/OR RETURN OF PROPERTY: Resident may be released from the obligation to pay the rents contained herein, ***as of the last day of a rental month,*** before the expiration of the initial term or any extensions by:

- **(a)** Giving Management a minimum of sixty (60) days ***written*** notice, plus
- **(b)** Paying all monies due through date of release, plus
- **(c)** Paying an amount equal to one month's rent as a release fee, plus
- **(d)** Returning Property in a clean, undamaged ready-to-rent condition as follows:
  - (i) Carpets, walls, floors, appliances, bathroom fixtures and other areas of the house have been cleaned and are ready for the new Resident. Resident shall provide proof that the carpets were professionally cleaned; and, if pets allowed, professionally treated for ticks and fleas.
  - (ii) Yard and shrubbery are neatly trimmed and leaves, trash and other debris have been removed from premises.
  - (iii) Resident allows Management to show premises and post sign during 60-day notice period.
  - (iv) Resident has returned all keys to Management.
  - (v) Resident has given Management his/her forwarding address.
  - (vi) Resident has paid all final bills on all utilities that have been his/her responsibility under this Agreement. Management shall claim damages for any charges for rent, repairs or any other damages sustained by

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Management under the terms of this Agreement. These shall be paid within seven (7) days after vacating premises. If not paid as stated herein, Resident agrees to pay Management eighteen percent (18%) per annum.

7. CONDITION: Resident accepts Property in its present **"AS-IS"** condition and acknowledges that Resident has received a list of any existing damages to Property, been given the right to inspect same, and has approved said list except as previously specified in writing to Management. Resident acknowledges receipt of the "Move-In Inspection Form" and accepts the responsibility to complete said form within seven (7) days of taking possession and return a completed, signed copy to Management. Failure to do so shall be Resident's acknowledgment that Property is in perfect condition in every particular and that any damages, including breakage, burns and wear not shown shall be Resident's responsibility and expense.

_____ **8. MAINTENANCE, REPAIRS:** Resident acknowledges that the premises are in good order and repair, unless otherwise indicated herein. Resident shall, at his own expense, and at all times, maintain the premises in a clean and sanitary manner, including all equipment and appliances therein and shall surrender the same, at the termination hereof, in as good condition as received, normal wear and tear excepted. Resident expressly stipulates and agrees that Management is granting a rental discount *in exchange* for Resident's agreeing to perform and bear the expense of, or have performed, minor maintenance and repairs on the dwelling, therefore, Management shall NOT be responsible for maintenance and repairs of the premises during the term of this Agreement or any extensions, unless otherwise provided for herein. If Resident repair responsibilities conflict with any state laws to the contrary, Resident expressly agrees to fully waive and relinquish any protections so provided. Resident shall be responsible for damages caused by his negligence and that of his family or invitees and guests. Resident shall mow, irrigate and maintain any surrounding grounds, including lawns, shrubbery and gutters, and keep the same clear of rubbish, trash, weeds or leaves if such grounds are part of the Property and are available for the use of Resident. Should Resident fail to do so, Management, after attempting to notify Resident, may, but is not required to, maintain lawns and/or shrubbery by using a professional yard maintenance company. Resident agrees to pay the cost of any such yard maintenance as additional rent.

9. APPLIANCES: All appliances of any kind including window air conditioners are specifically excluded from this Agreement. Such appliances remain as a convenience to Resident and Management assumes no responsibility for their operation. No part of the monthly rent is attributable to them. Any appliance on premises at the signing of this Agreement shall be returned by Resident upon move-out in the same condition as at the signing of this Agreement.

10. ALTERATIONS: Resident shall not make, or allow to be made, any alterations, installations, repairs or redecoration of any kind to the Property without prior written permission of Management, provided, however, that notwithstanding such consent, Resident agrees that all alterations including, without limitation, any items affixed to the Property, shall become the property of Management upon the termination of this Agreement. This includes, but is not limited to, ceiling fans, mini blinds, carpeting, fencing, lighting fixtures, shrubs, flowers, etc. Removal of these items shall be considered theft subject to civil and criminal prosecution.

11. USE: The Property shall be used for Residential purposes only and shall be occupied by the undersigned _____ adults and their _____ children as named in the original application to rent, ***only***. Occupancy by guests staying over 14 days will be considered in violation of this agreement and additional monthly rent of $100.00 per person shall be due, chargeable from the beginning date of this Agreement, unless prior written consent is given by Management. The Property shall be used so as to comply with all state, county, and municipal laws and ordinances and shall be kept in a clean and orderly condition. Resident shall not use the Property or permit it to be used for any disorderly or unlawful purpose or in any manner so as to interfere with neighbors. Resident shall be responsible and fully liable for the conduct of his/her guests. Acts of guests in violation of this Agreement or Management's rules and regulations may be deemed by Management to be a breach by Resident.

_____ **12. SMOKE DETECTORS:** Resident acknowledges the presence of a working smoke detector in the premises, and agrees to test the detector weekly for proper operation, and further agrees to replace any batteries (if so equipped) when necessary. Resident further acknowledges that he/she understands how to test and operate the smoke detector in this Property. Resident also agrees to repair or replace any inoperative smoke detector immediately should it fail to operate properly during any test.

_____ **13. RULES AND REGULATIONS:**

(a) Locks and Burglar Alarms: Resident is prohibited from adding locks to, changing or in any way altering locks installed on the doors of the Property without written permission of Management. If the addition or changing of such lock is permitted, it is mandatory that Resident shall immediately provide Management with keys to such locks. Resident is prohibited from installing a burglar alarm to, changing or in any way altering any existing burglar alarm installed on the Property without written permission of Management. If the installation or changing of such burglar alarm is permitted, it is mandatory that Resident shall immediately provide Management with all codes to such burglar alarm. Resident agrees that Management is not liable for any unauthorized entry into dwelling of any kind whatsoever.

(b) Utilities: Resident is responsible for payment of all utilities, to include water, sewage, garbage collection, cable TV, electricity, gas, local telephone service; even if the bills remain in Management's name. Failing to pay the utility bills will be interpreted as a default and a violation of this Agreement. Any installation costs are the responsibility of Resident. Any wall jacks, telephone or cable installation shall remain with the Property.

(c) Telephones: Resident shall obtain a home telephone and must supply Management with home and work telephone numbers immediately and agrees to immediately notify Management of any change of numbers during the term of this Agreement.

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(d) **Storage:** No goods or materials of any kind or description, which are combustible or would increase fire risk, shall be stored on the Property. Any storage shall be at Resident's risk and expense, Management shall not be responsible for any loss or damage.

(e) **Walls:** No nails, screws or adhesive hangers except standard picture hooks, shade brackets and curtain rod brackets may be placed in walls, woodwork, or any part of the Property.

(f) **GOOD HOUSEKEEPING IS EXPECTED OF EVERYONE:** Resident agrees to keep the Property in a clean and sanitary condition, and to remove any trash or rubbish as it accumulates.

(g) **Pest control:** Resident agrees to provide pest control as needed. Any infestation shall constitute a default of this Agreement.

(h) **Furnace maintenance:** Resident shall change furnace filter(s) monthly during the heating/cooling season.

(i) **Smoke alarm:** Resident shall keep smoke alarm(s) and fire extinguisher (if provided) in working order including replacing the battery as needed. Resident accepts any liability associated with the use and upkeep of all such devises and understands how to and agrees to test same.

(j) **Kerosene Heaters and Appliances:** Resident agrees not to use any form of Kerosene space heater in the dwelling.

(k) **Water beds:** Resident shall not have or keep any waterbed in the dwelling without prior written permission of Management. A condition of approval is a waterbed insurance policy paid by Resident with Management listed as loss payee.

(l) **Vehicles:** Vehicles shall **NOT** be parked on lawn at any time. Non-operative vehicles are not permitted on Property. Any such non-operative vehicle may be removed by Management at the expense of Resident, for storage or public or private sale, at Management's option, and Resident shall have no right of recourse against Management thereafter.

(m) **Yard care:** Resident will be responsible for maintaining the lawn, bushes, and trees in a neat and attractive manner. If not cared for, Management has the right to have this done professionally and Resident herewith agrees to pay for same.

(n) **Gutters:** Resident shall have gutters cleaned each fall or as needed.

(o) **Basements:** Management in no way warrants any basement against any leakage of any kind at any time.

(p) **Septic:** If residence has septic tank, resident shall not abuse system; do not deposit tobacco, coffee grounds or unnecessary food or other wastes or materials, including diapers and sanitary napkins, down sinks or commodes. Resident shall regularly add septic tank treatment, available at home supply stores, to the system to keep it operating properly and efficiently. Resident is prohibited from adding a garbage disposal to any house, which has a septic system.

_____ **14. PETS:** No pets, birds, fish, or other animals of any kind, permanent or visiting, indoor or outdoor, shall be permitted on the property without prior written consent of Management. Any such pets, if allowed, requires the payment of a **non-refundable pet fee of $_____ per pet, plus additional rent of $_____ per pet per month** (this amount may not be included in paragraph 3 above). In no instance will more than two (2) pets be allowed. Authorized pets must be listed below. By this listing, Resident agrees to be fully liable for damages and injuries to property and/or people, which might be caused by pets. Resident agrees that if said pets should at any time become annoying, bothersome, or in any way a nuisance to neighbors, Resident will, upon notice of Management, immediately remove said pets from the premises. Any unauthorized pets found on the premises shall be removed by Resident and above stated pet fees, retroactively to the date of this Agreement, shall be paid immediately to Management. ***Only*** the pets listed below are authorized on premises ***(name(s) and description(s)***: _____

_____ **15. PROPERTY LOSS & LIABILITY:** Management shall not be liable for damage, theft, vandalism, or other loss of any kind to Resident's personal property or the personal property of Resident's family members or guests. Management shall not be responsible or liable for any injury, loss or damage to any person or property of Resident or any other person.

16. RENTERS INSURANCE: Resident agrees to purchase comprehensive insurance, known as a Renter's Insurance Policy, against all perils, including but not limited to insurance on personal property or property of other persons from protection of loss due to or caused by theft, vandalism, bursting or breaking pipes, by or from fire, windstorm, hail, flooding, leakage, steam, snow or ice, by or from running water, backing up of drainage pipes, seepage, or the overflow of water or sewage on the Property. Said policy shall include liability coverage of $300,000.00 minimum.

_____ **17. LEAD, ASBESTOS, MOLD AND/OR RADON:** If Property was constructed prior to 1980 it may contain lead and/or asbestos containing materials. This shall serve as constructive notice that this Property was constructed in approximately _____. Resident may have Property tested for lead, asbestos, mold and/or radon levels prior to occupancy. Should Resident determine that the levels of lead, asbestos, mold and/or radon are unacceptable to Resident, Resident may void this Agreement prior to taking possession of Property, but not later than three (3) days after entering into this Agreement with Management. Resident herewith acknowledges receipt of the Federal Pamphlet ***Protect Your Family From Lead in Your Home*** and the Lessor's disclosure form attached hereto and made a part hereof by reference.

18. NO ASSIGNMENT OR SUBLETTING: Resident may not sub-let Property or assign this Agreement without the prior written consent of Management. Any subletting, if granted, shall not release Resident from their obligations outlined herein.

19. FIRE: If the Property is made uninhabitable by fire or other casualty, not the fault of Resident, this Agreement shall be voidable by either party.

20. HOLDING OVER: Should the Resident hold over on the Property after expiration of the term of this Agreement and with the consent of Management, the possession shall not be construed as a renewal for the same term, but shall be construed as a month to

Resident's Initials _____

month tenancy in accordance with the terms hereof, as applicable, and Rental Rate shall be charged at a rate 50% higher than the Rental Rate as contained in Paragraph 3 hereinabove. There shall be no renewal of this Agreement by operation of law.

21. RIGHT OF ACCESS: Management may enter the Property without notice to Resident for inspection and maintenance during reasonable hours. If locks have been changed without providing Management with a key, Management may forcibly enter without being liable for damage or unlawful entry. In case of emergency, Management may enter at any time. During the last sixty (60) days of occupancy, or upon notification of intent to vacate, Management may place a sign on the Property and/or may install a lock-box and show the Property during reasonable hours. Management will attempt to notify Resident, but has no obligation to do so.

22. DEFAULT BY RESIDENT: Should Resident fail to pay any rent or other charges as and when due hereunder, or if Resident abandons the property or fails to perform any of its obligations hereunder, Management, at its option, may terminate all rights of Resident hereunder, unless Resident, within 24 hours after notice thereof, shall cure such default. If Resident abandons or vacates the Property, while in default of the payment of rent, Management may consider any property left on the Property to be abandoned and may dispose of same in any manner allowed by law, without responsibility or liability therefor. All personal property at the Property is hereby subject to a lien in favor of Management for payment of all sums due hereunder, to the maximum extent under law. Upon the adjudication of Resident in Bankruptcy, or if any facts contained in Resident's application are untrue or misleading, then, upon the happening of any of said events, Resident shall be in default hereunder and Management may, at its option, immediately terminate this Agreement by written notice to Resident. In the event of a default by Resident, Management may elect to **(i)** continue this Agreement and enforce all of Management's rights and remedies hereunder, including the right to recover the rent as it comes due, or **(ii)** at any time, terminate all of Resident's rights hereunder and recover from Resident all damages Management may incur by reason of the breach of this Agreement, including the cost of recovering the Property, and including the worth at the time of termination, or at the time of an award should a suit be instituted to enforce this provision, of the amount by which the unpaid rent for the balance of the term exceeds the amount of such rental loss which Resident proves could be reasonably avoided.

25. ABANDONMENT: Anytime the Property is left unoccupied for more than seven (7) days while rent remains unpaid without notice to Management, Management may consider the Property abandoned. Management may, at its option, declare this Agreement forfeited and re-rent said premises without any liability whatsoever. Resident shall be obligated to pay based on the balance of the rental agreement or the early termination requirement, whichever is greater. If Resident removes or attempts to remove any personal property from the premises other than in the usual course of continuing occupancy, without having first paid Management all monies due, Management shall have the right, without notice, to obtain an injunction to stop removal as Management has an attachment interest in the personal belongings of the non-paying Resident. Management shall also have the right to remove, store or dispose of any of Resident's personal property remaining on the premises after the termination of this agreement. Any such personal property shall be considered Management's property, and title thereto shall vest in Management.

26. CROSS DEFAULT: If Resident has entered into any other agreements concerning Property and Resident defaults on any provisions of those agreements, then this Agreement shall also be considered in default and, at the option of Management, this Agreement may be voided.

27. EVICTION: If rent has not been paid when due, then Management shall automatically and immediately have the right to assert all legal and contractual remedies to enforce this Agreement and, without limitation to any other remedy, may take out a Dispossessory Warrant and have Resident and any other occupants and all possessions evicted and removed from Property. Should Resident answer said Dispossessory Warrant, Resident hereby agrees to pay into the registry of the trial court all monies contained on said Dispossessory Warrant plus all rents due through the court date. Whenever, under the terms hereof, Management is entitled to possession of the Property, Resident will surrender same to Management in as good condition as at present, ordinary use and wear excepted, and Resident will remove all of Resident's effects therefrom, and Management may forthwith re-enter Property and repossess thereof and remove all persons and effects therefrom using such force as necessary without being guilty of forcible entry or detainer, trespass or other tort. Resident is hereby advised that if such action is necessary, a judgment may be rendered against Resident for full damages including rent, eviction costs, and any additional costs. Resident shall also be responsible for the early termination fees as contained in paragraph 7 of this Agreement. If said costs are not paid as ordered, monies may be collected through garnishment against wages and judgments may be recorded with credit bureaus and may be assigned to a collection agency for collection with said costs of collection being the responsibility of Resident

28. FAILURE OF MANAGEMENT TO ACT: Failure of Management to insist upon strict compliance with the terms of this Agreement shall not constitute a waiver of any violation, nor shall any acceptance of a partial payment of rent be deemed a waiver of Management's right to full amount.

29. REMEDIES CUMULATIVE: All remedies under this Agreement or by law or equity shall be cumulative. In the event that either Management or Resident brings legal action to enforce the terms hereof or relating to the rental Property, the prevailing party shall be entitled to all costs incurred in connection with such action including reasonable attorney's fees. In the event a collection agency becomes necessary to collect any accounts due on this Agreement, Resident agrees to pay said commission. If any term or provision of this Agreement or application thereof to any person shall be held invalid or unenforceable, the remainder of this Agreement shall not be affected thereby.

30. NO ESTATE IN LAND: This Agreement shall create the relationship of landlord and tenant between Management and Resident; no estate shall pass out of Management; Resident has only a usufruct and not an estate for years.

31. MORTGAGEE'S RIGHTS: Resident's rights under this Agreement shall be subject to any bonafide mortgage or deed to secure debt, which is now or shall hereafter be placed on Property.

Resident's Initials _____

32. MANAGEMENT'S PERMISSION OR CONSENT: If any provision of this Agreement requires the written permission or consent of Management as a condition to any act of Resident, such written permission or consent may be granted or withheld in the sole discretion of Management and/or may contain such conditions as Management deems appropriate and shall be effective only so long as Resident complies with such conditions. Moreover, any written permission or consent given by Management to Resident may be modified, revoked, or withdrawn by Management at any time, at Management's sole discretion, upon written notice to Resident.

33. NOTICES: Any notice required by this Agreement, except as otherwise set forth shall be in writing and shall be deemed to be given if delivered personally or mailed via first class mail.

(a) If to Resident, to the Property or the last known address of Resident;

(b) If to Management, to the address as contained in Paragraph 3.

34. ACCURACY AND RESPONSIBILITY: Management has relied upon the information contained in Resident's application to enter into this Agreement. Resident warrants that their rental application is true, complete and accurate. Resident agrees that if he/she has falsified any statement in the rental application, Management has the right to terminate this Rental Agreement immediately and further agrees that Management shall be entitled to retain any performance fee and any prepaid rents as fair and just liquidated damages. Resident further agrees in the event Management exercises its option to terminate this Rental Agreement, he/she will remove him/herself, family and possessions from the Property within 24 hours of notification by Management. Resident further agrees to indemnify Management for any damages to Property including, but not limited to, the cost of making residence suitable for renting to another Resident, and waives any right of "set-off" for the performance fee and prepaid rents which shall be forfeited as fair and just liquidated damages. It is expressly understood that this Agreement is between Management and each Resident, whom shall always be jointly and severally liable for the performance of every agreement and promise made herein. In the event of default by any one Resident, each and every remaining Resident shall be responsible for timely payment of full rent and all other provisions of this Agreement.

35. INDEMNIFICATION: Management shall not be liable for any damage or injury to Resident, or any other person, or to any property, occurring on the Property, or any part thereof, or in common areas thereof, unless such damage is the proximate result of the negligence or unlawful act of Management, his agents, or his employees. Resident does hereby indemnify, release, and save harmless Management and Management agents from and against any and all suits, actions, claims, judgments, and expenses arising out of or relating to any loss of life, bodily or personal injury, property damage, or other demand, claim or action of any nature arising out of or related to this Agreement or the use of this Property and premises.

36. SEVERABILITY: In the event any part of this Agreement should be construed as unenforceable, the remaining parts of this Agreement shall remain in full force and effect as though the unenforceable part or parts were not written into this Agreement.

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37. GENDER: All references to Resident herein employed shall be construed to include the plural as well as the singular, and the masculine shall include the feminine and neuter where the context of this Agreement may require.

38. ENTIRE AGREEMENT: This Agreement and any attached addendum constitutes the sole and entire Agreement between the parties and no representation, promise, or inducement not included in this Agreement, oral or written, shall be binding upon any party hereto.

39. SPECIAL STIPULATIONS: The following stipulations shall control in the event of conflict with any of the foregoing:

A. Resident understands and is fully aware property is in need of repairs including _____ _____.

Resident has offered and management herewith agrees to allow resident to repair items as stated herein and more fully described in the "Scope of Work" forms contained in the Independent Contractor Agreement. Resident is fully aware of the extent of the work required, is experienced in these types of repairs and offers to complete stated repairs in a timely manner in exchange for compensation. Failure of Resident to complete the repairs in a timely and workmanlike manner shall result in a default under the Independent Contractor Agreement, requirement for payment in full under the Promissory Note and possible termination of this Rental Agreement at Management's option.

IN WITNESS WHEREOF, the parties hereto have caused these presents to be signed in person or by a person duly authorized, the day and year above written. If this Agreement is not signed by all the Residents named herein and/or on rental application, the one(s) signing warrants that he or she has the authority and is acting as agent to sign for the other.

_____ (SEAL)	_____	_____
RESIDENT **(Print Name)** _____	DATE	Social Security Number
_____ (SEAL)	_____	_____
RESIDENT **(Print Name)** _____	DATE	Social Security Number
_____ (SEAL)	_____	_____
RESIDENT **(Print Name)** _____	DATE	Social Security Number

_____

MANAGEMENT (Authorized Representative):

THIS IS INTENDED TO BE A LEGALLY BINDING CONTRACT

If not fully understood, please seek the advice of an attorney before signing.

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DISCLOSURE OF INFORMATION ON LEAD-BASED PAINT AND LEAD-BASED PAINT, ASBESTOS, MOLD AND RADON HAZARDS

Lead Warning Statement: ***Housing built before 1978 may contain lead-based paint. Lead from paint, paint chips, and dust can pose health hazards if not taken care of properly. Lead exposure is especially harmful to young children and pregnant women. Before renting pre-1978 housing, landlords must disclose the presence of known lead-based paint and lead-based paint hazards in the dwelling. Tenants must also receive a Federally approved pamphlet on lead poisoning prevention.***

Lessor's Disclosure (initial):

_____ **(a)** Presence of lead-based paint or lead-based paint, asbestos, mold and radon hazards (check all that apply)**:**

Known lead-based paint and/or lead-based paint are present in the housing (explain).

_____

_____

Known asbestos ; mold ; and/or radon hazards are present in the housing (explain).

_____

Lessor has no knowledge of lead-based paint and/or lead-based paint hazard in the housing.

Lessor has no knowledge of asbestos ; mold ; or radon hazards in the housing.

_____ **(b)** Records and reports made available to the Lessor (check one below):

Lessor has provided lessee with all available records and reports pertaining to lead-based paint and/or lead-based paint, asbestos, mold and/or radon hazards in the housing (list documents below).

_____

_____

Lessor has no reports or records pertaining to lead-based paint and/or lead-based paint, asbestos, mold and/or radon hazards in the housing.

Lessee's Acknowledgment (initial):

_____ **(c)** Lessee has received copies of all information listed above, if applicable.

_____ **(d)** Lessee has received the pamphlet ***Protect Your Family From Lead in Your Home.***

Agent's Acknowledgment (initial):

_____ **(e)** Agent has informed the Lessor of the Lessor's obligations under 42 U.S.C. 4582(d) and is aware of his/her responsibility to ensure compliance.

Certification of Accuracy:

The following parties have reviewed the information above and certify, to the best of their knowledge, that the information provided by the signatory is true and accurate.

Lessor	**Date**	**Lessor**	**Date**
Lessee	**Date**	**Lessee**	
Date			
Agent	**Date**	**Agent**	**Date**

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RESIDENTIAL LEASE and OPTION TO PURCHASE AGREEMENT

BUYER/TENANT: _____ and/or Assigns. Date: _____

SELLER/LANDLORD: _____

PROPERTY ADDRESS: _____

RESIDENTIAL LEASE

1) **Rent**: $_____ per month
2) **Lease Term**: _____ months, beginning _____ and ending _____.
3) **Maintenance**: Buyer/Tenant will be responsible for all maintenance and repairs of the property, not to exceed $500 per incident.
4) **Sub-Lease:** Buyer/Tenant has the right to sub-lease this property with written consent by the Seller / Landlord, and this shall not be unreasonably withheld.

OPTION TO PURCHASE

1) **Purchase Price**: $ _____
2) **Option Period**: ____ months, beginning _____ and ending _____
3) **Option Consideration**: $10 - All Option Consideration will be credited in full toward the purchase of the property.
4) **Rent Credits**: Buyer/Tenant will be credited $ 0 per month toward the purchase.
5) **Closing Costs**: Buyer/Tenant will pay all allowable closing costs.
6) **Expiration**: If Buyer/Tenant doesn't find another Tenant-Buyer to live in the home by _____, this contract will expire.
7) **Inspection**: This offer is contingent upon physical inspection of property and subsequent completion of a more formal and signed Residential Lease with Option to Purchase Agreement.
8) **Non-Exclusive** – This agreement is non-exclusive and can be canceled anytime by either party.

Assignable – This Agreement is assignable.

No Agency – Buyer/Tenant ____is, or ____ is not, a licensed real estate agent in the State of ____, and does not represent the Seller / Landlord.

X_____ X _____
Seller/Landlord Date Buyer/Tenant Date

X_____ X _____
Seller/Landlord Date Buyer/Tenant Date

Owner Financing Mortgage Contract

This agreement is entered into on the _____ day of _____, 20____ between _____ (hereinafter "Owner") and _____ (hereinafter "Buyer") for the sale of the property located at _____ (hereinafter "property").

At all times the laws of the state in which the property is located govern this contract. This contract is not a sale contract for the property. A separate sale contract for the property must be entered into and executed according to the laws of the state in which the property is located.

Loan Terms

This contract establishes that Owner shall sell and Buyer shall buy the property and that Owner shall finance the balance of the purchase price for the property for Buyer after Buyer delivers a down payment.

The purchase price of the property is _____, as agreed to by the parties to this contract. This amount was agreed to after an appraisal of the property, which occurred on _____ and was conducted by _____.

Buyer is/is not (circle one) obtaining financing for any portion of the purchase price of the property from a third party, such as a bank. Buyer must notify Owner of the amount of financing obtained from any third party and provide the name and contact information of the third party within 30 days of obtaining such financing.

The down payment amount of _____ has been agreed to by the parties and is to be delivered no later than _____, 20_____. Failure to provide this down payment nullifies this contract in its entirety.

The amount that Owner will finance for Buyer for the sale of the property is _____ (hereinafter "Owner finance"). Owner shall carry the promissory note for the entire mortgage term for the amount identified as Owner finance.

Buyer has submitted a mortgage application to obtain this financing and Owner has approved Buyer's finances.

Financing for the mortgage is to last for a period of _____ and carries an interest rate of _____. This interest rate is/is not (circle one) flexible according to the

mortgage rate index chosen by the parties. The parties have chosen _____ as the mortgage rate index to govern this contract. Any changes to interest rate can be made solely by the Owner, but must be provided in writing no less than _____ days prior to the change coming into effect.

Payment for the mortgage is due monthly in the amount of _____. This amount does/does not (circle one) include taxes, insurance, and legal, state, and other fees associated with owning the property. Should this amount include these fees and should these fees change due to changes in rates being set by the governing party, such as the state tax authority, the parties will notify each other of any changes that are brought to their attention within 30 days.

Prepayment of all or a portion of the financing extended to Buyer is allowed and carries no penalties.

This agreement is secured by the home. Buyer's failure to pay the mortgage payment when due as described above entitles Owner to initiate foreclosure proceedings as allowed by state against Buyer. Owner has the right to repossess the property after the conclusion of foreclosure proceedings, as outlined and permitted by the laws of the state in which the property is located.

Loan Servicing

Owner will/will not (circle one) hire a loan servicing company to draw up the mortgage documents and handle the processing of payments. The selection of the servicing company is solely at the discretion of the Owner. Any fees charged by the chosen company for servicing the loan will be handled directly by the Owner. Owner reserves the right to hire a servicing company at any time. Notification of the choice of servicing company will be provided to the Owner no later than 30 days before payment should be sent to the servicing company.

Owner may change servicing companies at any time without giving prior notice to Owner. However, Owner must notify Buyer or have the new servicing company notify Buyer of any changes to choice of loan servicing company at least 30 days prior to the change in mailing address for monthly payment. Any fees incurred due to the Owner's failure to provide Buyer with notice, either directly or from the service company, and the Buyer's sending payment to the incorrect address shall be paid by Owner.

This contract is full in its entirety. Any additions must be made in writing and amended to this contract.

Entered into this _____ day of _____, 20_____.

_____
Buyer

_____
Owner

Notarized or executed according to governing state law this _____ day of _____, 20____.

MEMORANDUM OF CONTRACT
FOR SALE AND PURCHASE OF PROPERTY

This is a Memorandum of that unrecorded Contract for Sale and Purchase of Property ("Contract"), dated _____, between _____, (hereinafter referred to as "Seller"), and _____, (hereinafter referred to as "Buyer") concerning the real property ("Property") described in Exhibit "A" attached hereto and made a part hereof by reference.

For good and valuable consideration, Seller has agreed to sell and Buyer has agreed to buy, the Property upon the terms and conditions set forth in the Contract, which terms and conditions are incorporated in this Memorandum by this reference. Except as provided in the Contract from the date hereof, Seller shall not have the right, with respect to the Property to enter into any new contracts, leases or agreements, oral or written, without the prior written consent of Buyer.

This Memorandum is not a complete summary of the Contract. Provisions of this Memorandum shall not be used in interpreting the Contract. In the event of conflict between this Memorandum and the Contract, the Contract shall control.

IN WITNESS WHEREOF, the parties have executed this Memorandum on _____, 19_____.

Witnesses: SELLER:

_____ _____

_____

_____ _____

_____

PURCHASER:

_____ _____

_____

_____ _____

_____

STATE OF _____

COUNTY OF _____

The foregoing instrument was acknowledged before me this _(13)_ day of _____, 19_____, by _____ as Seller.

_____
Notary Public

My Commission Expires: _____

STATE OF _____(11_____)
)
COUNTY OF _____(12_____)

The foregoing instrument was acknowledged before me this _(13)_ day of _____(14_____, 19_(15)_, by _____(16_____ as Purchaser.

_____(17)_____
Notary Public

My Commission Expires: _____

NOTICE

The information in this document is designed to provide an outline that you can follow when formulating business or personal plans. Due to the variances by many local, city, county and state laws, we recommend that you seek professional legal counseling <u>before entering into any contract or agreement.</u>

LEASE-OPTION

Contract for Deed

Prepared by: Agent _____ **Phone** _____
Broker _____ **Email** _____

NOTE: This form is not for use by an investor acquiring owner-occupied, one-to-four unit residential property in forclosure. [See **ft** Form 156]

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable. References to forms include their equivalent.

FACTS:

1. This lease agreement and option to purchase is entered into by Lessor/Optionor and Lessee/Optionee, regarding property situated in the City of _____, County of _____ California, referred to as

_____

_____

Personal property, ☐ see attached Personal Property Inventory [See **ft** Form 256], _____

2. This agreement is comprised of this three page form and the following checked attachments:

☐ Credit Application [See **ft** Form 302]
☐ Residential Earthquake Hazards Report [See **ft** Form 315]
☐ Occupant's Operating Expense Sheet [See **ft** Form 562]
☐ Addendum — General Use [See **ft** Form 250]
☐ Notice of Your Supplemental Property Tax Bill [See **ft** Form 317]
☐ Agency Law Disclosure Statement [See **ft** Form 305]
☐ Natural Hazard Disclosure Statement [See **ft** Form 314]
☐ Financial Disclosure Statement [See **ft** Form 309]
☐ Brokerage Fee Addendum [See **ft** Form 273]
☐ Lead-Based Paint Disclosure [See **ft** Form 313]
☐ Condition of Property Disclosure [See **ft** Form 304]

3. Term of Lease:
This lease commences _____, 20_____ and continues until _____, 20_____.

3.1 The lease terminates on the last day of the term without further notice.

3.2 If Lessee holds over, Lessee to be liable for rent at the daily rate of $_____.

4. Rent: Lessee to pay, in advance, a base monthly rent of $_____ due on the _____ day of each calendar month.

4.1 Rent to be paid by: ☐ personal check made payable to _____, or ☐ _____.

4.2 Rent to be tendered by: ☐ mail, or ☐ personal delivery.

4.3 Lessee to pay a late charge of six percent of all rent amounts due in the event rent is not received within ten days of the due date.

4.4 Lessee to pay $_____ for each rent check returned for insufficient funds and thereafter pay rent by cash or cashier's check.

5. Additional Rent: In addition to the base monthly rent, Lessee to pay additional monthly rent equal to the increased costs incurred by Lessor after entering into this lease-option, due to:

a. ☐ variable/adjustable interest rate on existing loans secured by the property;
b. ☐ variable/adjustable monthly principal or acceleration of existing loans secured by the property;
c. ☐ property taxes on the property;
d. ☐ fire and extended coverage insurance premiums on the property;
e. ☐ any Homeowners' Association (HOA) assessments;
f. ☐ any special or improvement assessments on the property; and
g. ☐ any other expenditures required of Lessor to protect his interest.

5.1 The additional monthly rent shall be the actual monthly cost increase and 1/12th of any annual cost increase.

5.2 The additional monthly rent is due on, or beginning with, the monthly rent payment next due following notice to Lessee by Lessor.

6. Utilities: Lessee shall pay all costs of public utilities to the property, including any required deposits, installation, or service fees.

7. Maintenance of Premises: Lessee agrees to maintain and perform all necessary repairs to the property during the lease term at his sole expense.

8. Insurance: Lessee shall maintain at his sole expense, naming Lessor as an additional insured:

8.1 ☐ A standard fire insurance policy with extended coverage, vandalism and malicious mischief endorsements, fully covering the replacement cost of all structures on the property during the entire term of the lease; and

8.2 ☐ Public liability and property damage insurance with a single combined liability limit of at least $300,000 and property damage limits of at least $100,000, insuring against all liability of Lessee arising out of Lessee's use or occupancy of the premises.

9. Use of the Property: The property is to be used only as a private residence occupied by Lessee and for no other purpose. Lessee shall comply with all laws regarding the use of the property, and shall not allow any waste or nuisance to occur on the property.

10. Assignment and Subletting: Lessee shall not assign this lease, nor sublet or encumber any interest in the property without the prior written consent of Lessor. Any transfer of an interest in the property by Lessee without the prior written consent of Lessor shall, at the option of Lessor, terminate this lease and call for payment of all sums due.

11. Waiver of Damage: Lessee releases Lessor from liability for loss or damage to Lessee or any property of Lessee caused by water leakage, breaking pipes, theft, vandalism, or any other cause beyond the reasonable control of Lessor.

12. Hold Harmless: Lessee shall indemnify Lessor from liability, damages, and/or expenses arising from the death or injury of any person, including Lessee, or from the damage or destruction of any property, including property owned by Lessee, caused or allegedly caused by some condition of the property, or some act or omission of Lessee or any other person.

OPTION TO PURCHASE:

13. Option Money: Optionor acknowledges receipt of option money in the amount of $_____, given in consideration for this option to purchase the property leased.

14. Option Period: Optionor hereby grants to Optionee the irrevocable option to purchase the Optionor's right, title and interest in the property under the sales terms for a period commencing with the acceptance of this option and expiring on termination of the lease.

15. Exercise of Option: Optionee may exercise this option during the option period by:

15.1 Preparing and signing escrow instructions with _____;

15.2 Depositing cash in Escrow of $_____; and

15.3 Delivering a certified copy of the signed escrow instructions to Optionor within the option period in person or by certified mail.

16. Delivery of Title: Within _____ days after exercise, Optionor and Optionee shall place in Escrow all documents and instruments necessary to close.

17. Sale Terms: The purchase price is $_____, payable:

17.1 ☐ In cash.

17.2 ☐ Down payment in the amount of $_____.

17.3 The cash price or down payment to be credited for $_____ of option money paid, and for _____%, or $_____, of each payment of base monthly rent.

17.4 ☐ Take title subject to, or ☐ Assume, the existing trust deed note with an approximate unpaid balance of $_____, currently payable $_____ monthly, including principal and interest at _____%, ☐ adjustable, monthly impounds being an additional $_____.

17.5 ☐ Take title subject to, or ☐ Assume, a trust deed note with a principal balance of $_____, currently payable $_____ monthly, including principal and interest at _____%, due _____.

17.6 Loan balance differences to be adjusted in: ☐ cash, ☐ §17.8 Note, or ☐ price.

17.7 ☐ Assume bonds or assessment liens of record in the approximate amount of $_____.

17.8 A Note for the balance of the purchase price in the amount of $_____, to be executed by Buyer in favor of Seller and secured by a trust deed on the property, payable $_____ monthly, or more, commencing one month after closing, including interest at _____%, due _____ years after closing.

a. The Note and Trust Deed shall not contain provisions for due-on clauses, prepayment penalties, or late charges.

b. ☐ Optionee to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **ft** Form 412]

c. ☐ The Note is an All-Inclusive Trust Deed Note.

d. As additional security, Optionee to execute a security agreement and file a UCC-1 financing statement on any personal property included in the price.

18. General Provisions:

18.1 Optionee's transfer of any interest in this option terminates the option.

18.2 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

18.3 The prevailing party in any action on a dispute shall be entitled to attorney fees and costs, unless they file an action without first offering to enter into mediation to resolve the dispute.

19. Power of Sale: Should this document be characterized as a security device, on default of rental payments or failure to exercise the option, the Lessor/Optionor may call all sums due and elect to proceed with a power of sale by a trustee substituted under Civil Code §2934(a), noticed and held in accordance with Civil Code §§2924 et seq.

20. Lessor/Optionor Default: Should the Lessor/Optionor default on any obligation impairing the Lessee/Optionee's interest under this agreement, Lessee/Optionee may cure the default and demand reimbursement from the Lessor/Optionor of the amount advanced, and if not paid, deduct the amount paid from periodic payments and the purchase price due the Lessor/Optionor.

21. Expiration of Option: This option to purchase shall be deemed expired if not exercised during the option period, and if not previously terminated, shall automatically expire/terminate on _____, 20_____.

22. Brokerage Fee: Optionor to pay brokerage fees as follows:

22.1 _____% of the option money on receipt; plus

22.2 _____% of each month's base rent on receipt; and

22.3 $_____ on exercise of the option.

22.4 Optionee's Broker and Optionor's Broker, respectively, to share the brokerage fee _____:_____.

23. _____

_____

_____

Lessee/Optionee's Broker: _____

By: _____

Is the agent of: ☐ Lessee/Optionee exclusively, or ☐ both Parties

Lessor/Optionor's Broker: _____

By: _____

Is the agent of: ☐ Lessor/Optionor exclusively, or ☐ both Parties

I agree to the terms stated above.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: _____, 20_____

Lessee/Optionee: _____

Signature: _____

Lessee/Optionee: _____

Signature: _____

Address: _____

_____

Phone: _____

Fax: _____

Email: _____

I agree to the terms stated above.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: _____, 20_____

Lessor/Optionor: _____

Signature: _____

Lessor/Optionor: _____

Signature: _____

Address: _____

_____

Phone: _____

Fax: _____

Email: _____

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Assignment of Contract

_____ (Wholesaler) assigns to _____ (Investor) the Purchase Contract on _____ between _____ (Wholesaler) and _____ (Seller) dated _____.

The Purchase Contract is being assigned for the amount of $_____ (Assignment Fee), to be paid at closing.

Upon execution of this Assignment agreement, Investor hereby agrees to pay Wholesaler non-refundable earnest money in the amount of $_____ (Earnest Money). Earnest money to be credited towards agreed upon Assignment Fee at closing. Investor accepts all rights, obligations and responsibilities of Purchase Contract executed by Wholesaler and Seller of said property.

Investor Shall Close on or before _____, _____.

Wholesaler: _____ dated _____
(Assignor)

Investor: _____ dated _____
(Assignee)

Agreement to Assign Contract for Sale and Purchase

Subject Property: _____

Legal Description: _____

This agreement is made between _____ (ASSIGNOR) and _____ (ASSIGNEE) regarding purchase of the above referenced SUBJECT PROPERTY.

Whereas _____ (BUYER) has entered into a Purchase and Sales Agreement with _____ (SELLER) for the purchase of SUBJECT PROPERTY, and whereas BUYER wishes to assign its rights, interests and obligations in the Purchase and Sales Agreement, it is hereby agreed between ASSIGNOR and ASSIGNEE as follows:

1. ASSIGNEE shall pay ASSIGNOR a NON-REFUNDABLE assignment fee of $_____ (payable $_____ with signing of contract and balance at close).

2. Assignee's inspection period shall expire upon execution of this Assignment. ASSIGNEE accepts all terms and conditions of the contract for Sale and Purchase between BUYER and SELLER in its entirety.

3. ASSIGNEE acknowledges receipt of legible copies of the original Contract for Sale and Purchase in its entirety including all Addendum(s) associated with this transaction.

4. Additional terms and conditions of this Assignment are as follows:

   a) This assignment contract is non-assignable without the express written consent of the ASSIGNOR. No changes to the Purchase Contract can be made without written Consent of BUYER.

   b) Disclosures and Acknowledgement:

      i) ASSIGNOR and affiliated associates make no warranty, expressed or implied, regarding inspection reports or other reports provided to ASSIGNEE by ASSIGNOR or third parties concerning this property.

      ii) ASSIGNEE acknowledges they are conducting a transaction dealing directly with ASSIGNOR for the purchase of SUBJECT PROPERTY. ASSIGNEE is not relying upon or being represented by a REAL ESTATE BROKERAGE in this transaction.

AGREED AND ACCEPTED

_____	_____	_____	_____
Assignee	Date	Assignor	Date
_____		_____	
Print Name		Print Name	
_____	_____	_____	_____
Assignee	Date	Assignor	Date
_____		_____	
Print Name		Print Name	

CONTRACT FOR THE SALE & PURCHASE OF REAL ESTATE

PARTIES: Owner of Record

Their heir(s), successors, administrators and assigns, as seller who's address is _____

and _____ and /or assigns, their heirs, successors, administrators and assigns, as Buyer, whose mailing address is:

WITNESSETH: That Seller, in consideration of the payments, covenants, agreements and conditions herein contained which on the part of the Buyer are to be made, done and performed, has this day sold, upon the conditions hereinafter recited, to the Buyer the real property legally described as:

SUBJECT PROPERTY: _____, hereinafter the property,

LEGAL DESCRIPTION: _____

_____

SALE PRICE: $_____

SUBJECT TO: _____ $_____

_____

EQUITY: $_____

PAYABLE: _____

_____

_____

_____

EXISTING MORTGAGE (S): Existing financing on subject property will be current in all payments of principal, interest, late charges and escrow amounts required by the mortgagee. Escrow balance has been calculated into the price and will transfer to the Buyer along with title. Buyer will take title subject to his debt.

EXPENSES:

INSURANCE: As consideration for this purchase the Seller will assign all insurance policies on the property to the Buyer and Seller will grant a limited power of attorney to the Buyer to deal with the lender(s) and insurance provider(s).

RISK OF LOSS: If subject property is damaged prior to transfer of title, Buyer has the option of accepting any insurance proceeds with title to the property in "as is" condition or of canceling this contract and accepting the return of the deposit.

PRORATIONS: Real property taxes will be prorated based on the current year's tax without allowance for discounts, including homestead or other exemptions. Rents will be current and be prorated as of the date title transfers.

DEFECTS: Seller warrants subject property to be free from hazardous substances and from violation of any zoning, environmental, building, health or other governmental codes or ordinances. Seller further warrants that there is no material or other known defects or facts regarding this property, which would adversely affect the value of said property.

NO JUDGMENTS: Seller warrants that there are no judgments threatening the equity in subject property, and that there is no bankruptcy pending or contemplated by any titleholder. Seller will not further encumber the property and an affidavit may be recorded at Buyer's expense putting the public on notice that the closing of this contract will extinguish liens and encumbrances hereafter recorded.

RADON GAS & LEAD PAINT: Lead based paint and Radon, a naturally occurring radioactive gas that may present health risks to persons who are exposed to it over time, may exist in this property. Buyer may obtain a risk assessment of "the property" by licensed inspectors. Dangerous circumstances and the conditions, which caused said circumstances will be corrected at the Seller's expense before title transfers.

POSSESSION: Possession of the property and occupancy (tenants excepted), with all keys and garage door openers, will be delivered to the Buyer when title transfers. Leases and security deposit will transfer to the Buyer with title.

INSPECTIONS: This contract is contingent upon the Buyer's inspection and approval of the property prior to transfer of title. Seller agrees to provide access to the Buyer's representatives prior to transfer of title for inspection, repairs and to market the property.

ACCEPTANCE: This instrument will become a binding contract when accepted by the Seller and signed by both Buyer and Seller. If it is not accepted and signed by the Seller prior to _____, this contract shall be void.

DEPOSIT: Upon acceptance Buyer will place in escrow an earnest money deposit of _____ with _____ which will be part of the cash paid to the Seller when title transfers. This deposit will be returned to the Buyer if title does not transfer in accordance with this agreement and said title company will close this transaction.

SELLER: Agrees that the buyer may place signs and show the property immediately upon acceptance of this contract by both parties.

CLOSING: Closing will take place on or before: _____ at _____. Subject to a _____ day period in which the buyer/seller shall be permitted to clear any title problems.

OTHER AGREEMENTS: _____

_____

_____

_____

TIME IS OF THE ESSENCE with this agreement. Each contingency contained herein shall be satisfied according to its terms by the closing date or this contract extends to provide time for satisfaction of said contingencies. Each party shall diligently pursue the completion of this transaction. Each warranty herein made survives the closing of this transaction.

PROHIBITION: This agreement establishes a prohibition against transfer, conveyance or encumbrance to the property.

Seller	Date	Buyer	Date
Print Name		Print Name	
Seller	Date	Buyer	Date
Print Name		Print Name	

ASSIGNMENT OF CONTRACT OF SALE

In consideration of the sum of **$_____**and other good and valuable consideration, and the mutual benefits to be derived by all parties to this assignment, the undersigned, _____, Inc. does hereby assign unto _____ all rights, interest, suits, claims and titles in and to a contract of sale, including any and all related amendments, (the "Contract") dated _____ by and between _____, Inc. and/or Assigns as purchaser, and _____ as seller, concerning such property known as _____ and further described as Lot _____, Block _____, _____ Addition to the City of _____, County of _____, Texas.

This assignment does not transfer any earnest monies that the assignor may have on deposit. Assignee understands and agrees closing must be on or before <u>the closing date identified in Contract</u> or assignment of contract is null and void.

Assignee further agrees not to contact, negotiate, or conspire with the seller. Assignor will continue to manage interaction with the seller and title company. Availability of funds must be confirmed by the title company at least 48 hours prior to close. Assignee understands that assignee is only being assigned the right to purchase the subject property under the original terms of the attached contract. This assignment is not valid until deposit is received.

Executed this _____ (day) of _____ (month), 20____

_____
_____, Inc.

This Assignment of Contract of Sale accepted this _____ (day) of _____ (month), 20____.

_____ _____
(Buyer Signature) (Phone number)

DEPOSIT AGREEMENT

In exchange for the right to pursue an assignment of contract on the property located at

_____, _____

(Buyer) agrees to pay a non-refundable deposit fee of $_____ to _____, Inc. If an assignment of contract of sale is successfully executed, the deposit will be applied toward the final assignment price. Deposit will be refunded if title issues prevent the sale from being completed.

_____

(Buyer Signature)

Name: _____

Address: _____

_____

Phone: _____

Email: _____

1) Buyer (assignee) pays all closing costs in accordance with the attached contract.
2) Title has been opened at _____, located at _____ _____. Please contact _____ @ _____ or Call _____ with any title or closing questions.
3) Please endorse and deliver deposit to _____, located at _____ _____.

EARNEST MONEY DEPOSIT RECEIPT

Receipt of $_____ earnest money deposit in the form of _____ is acknowledged by:

_____ (Name)
_____ (Company)
_____ (Date)
_____ (Phone)

AUTHORIZATION TO RELEASE INFORMATION

Authorization dated this _____ day of _____, 20___.

Borrower(s): _____

Date of Birth: _____

SSN: _____

Property Address: _____

Lender Name: _____

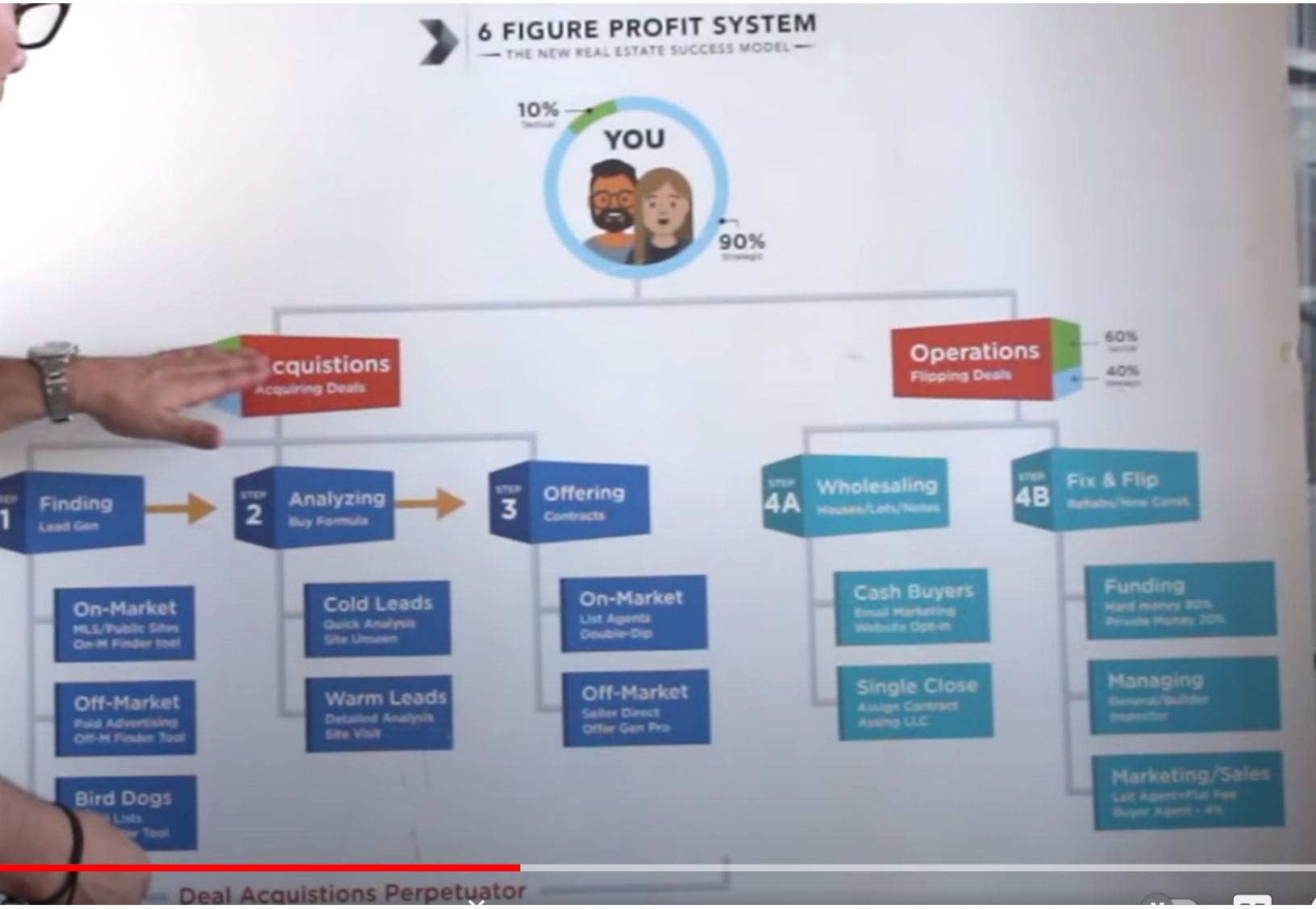
Loan Number: _____

Lender Phone number: _____

Lender Fax number: _____

I/We the undersigned hereby authorize you to release information regarding the above referenced loan to Tipton Law Firm, PLLC and _____ and/or their agents/assigns. This form may be duplicated in blank and/or sent via facsimile transmission. This authorization is a continuation authorization for said persons to receive information about my loan, including duplicates of any notices sent to me regarding my loan.

_____	_____
Borrower- Print Name	Borrower- Print Name
_____	_____
Borrower- Signature	Borrower- Signature


6 FIGURE PROFIT SYSTEM
THE NEW REAL ESTATE SUCCESS MODEL
10%
YOU
90%
cquistions
Acquiring Deals
Operations
Flipping Deals
60%
40%
Finding
Lead Gen
Analyzing
Buy Formula
Offering
Contracts
Wholesaling
Fix & Flip
On-Market
MLS/Public Sites
On-M Finder tool
Off-Market
Paid Advertising
Off-M Finder Tool
Bird Dogs
Cold Leads
Quick Analysis
Warm Leads
Detailed Analysis
Site Visit
On-Market
List Agents
Double-Dip
Off-Market
Seller Direct
Offer Gen Pro
Cash Buyers
Email Marketing
Website Opt-in
Single Close
Assign Contract
Assing LLC
Funding
Managing
Marketing/Sales
Deal Acquistions Perpetuator

OFFER SHEET: 123 Main St

1. BUYER NAME/ADDRESS:
Fountain Hills Investments, LLC And/or Assigns
203036 N Gilbert Rd. Suite 2-188, Mesa, AZ 85203

2. PRICE:
$160,000

3. FUNDING
Cash

4. PROOF OF FUNDS
To be included

5. CONDITION/TITLE:
"as-is" condition with free and clear title/warranty deed

6. INSPECTION CONTINGENCY:
10 days from accepted offer

7. EARNEST MONEY DEPOSIT (EMD):
$1000

8. CLOSING DATE:
30 days from accepted offer

9. ACCESS TO PROPERTY:
Seller to give buyer unrestricted access to via contractor lockbox

10. CLOSING COMPANY:
Seller to close with buyer's title co. of choice

OTHER TERMS:

18:17 / 21:05

my offer sheet

9. CLOSING COMPANY AND CLOSING COSTS:

- Buyer will pay closing costs (less realtor fees)
- Seller agrees to close with buyer's title company of choice
- Seller understands buyer may assign contract to buyer-owned or buyer-related entity

9:51 / 14:18

get my offer sheet template for free (link in description)

ROS Postcard

John Smith
Homebuying LLC
123 Main St
Andover, MA 01810

YOUR LOGO HERE

FIRST-CLASS MAIL
AUTO
U.S. POSTAGE PAID
ANDOVER, MA
PERMIT NO 78

Call to discuss **YOUR** CASH OFFER

781-999-1234

(See offer on Back)

Richard Jackson
90 South St
Andover, MA 01810

CASH OFFER ON:

Address: 90 South St
Name: Richard Jackson

TERMS:

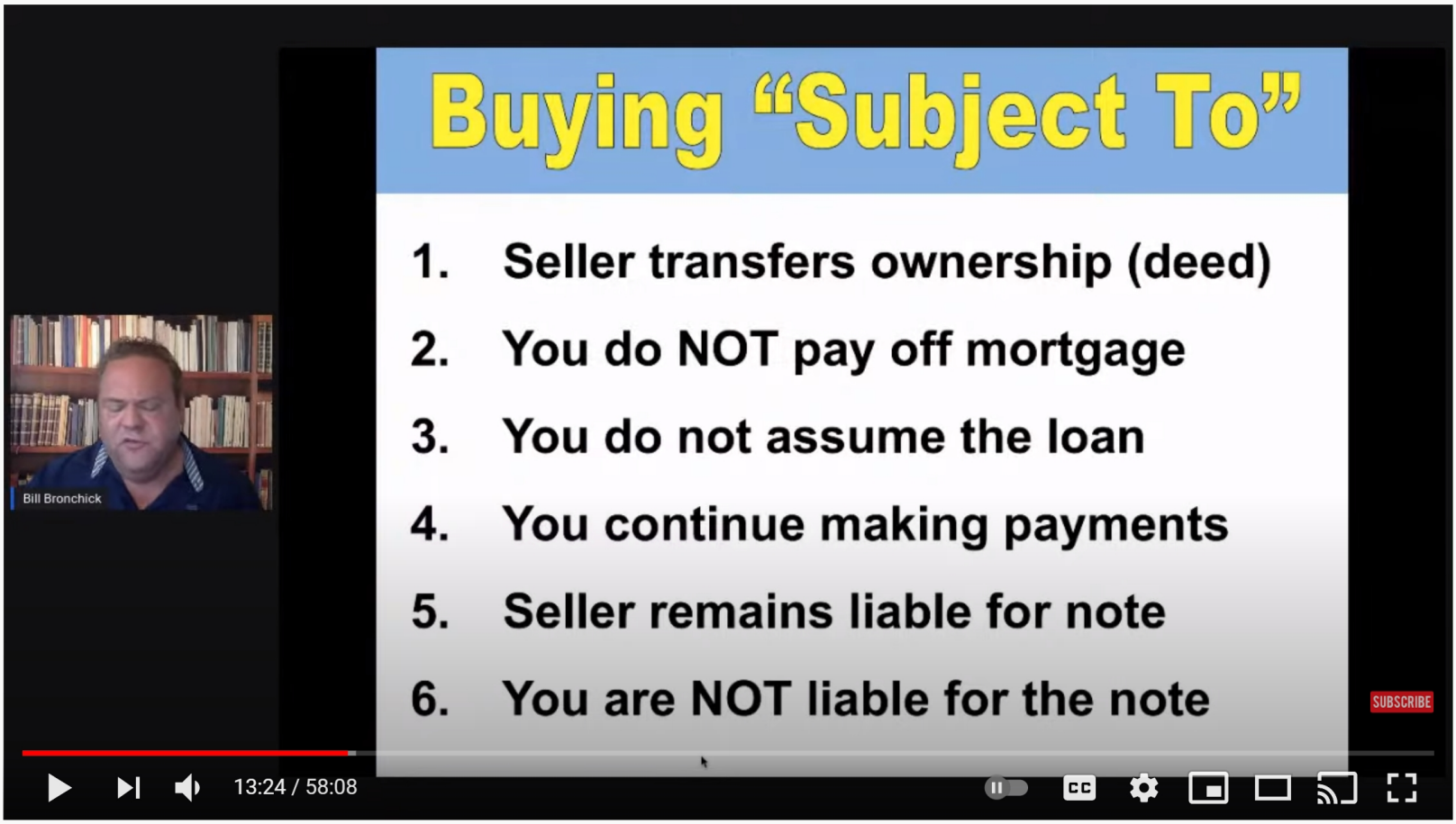
- ✓ ALL CA$H, No Games!!
- ✓ Closing Cost Paid, No Commissions
- ✓ Sell in "AS IS" Condition, No Repairs
- ✓ Close ASAP or on the Day of **YOUR** Choice

Your Cash Offer is $**19,500.00**

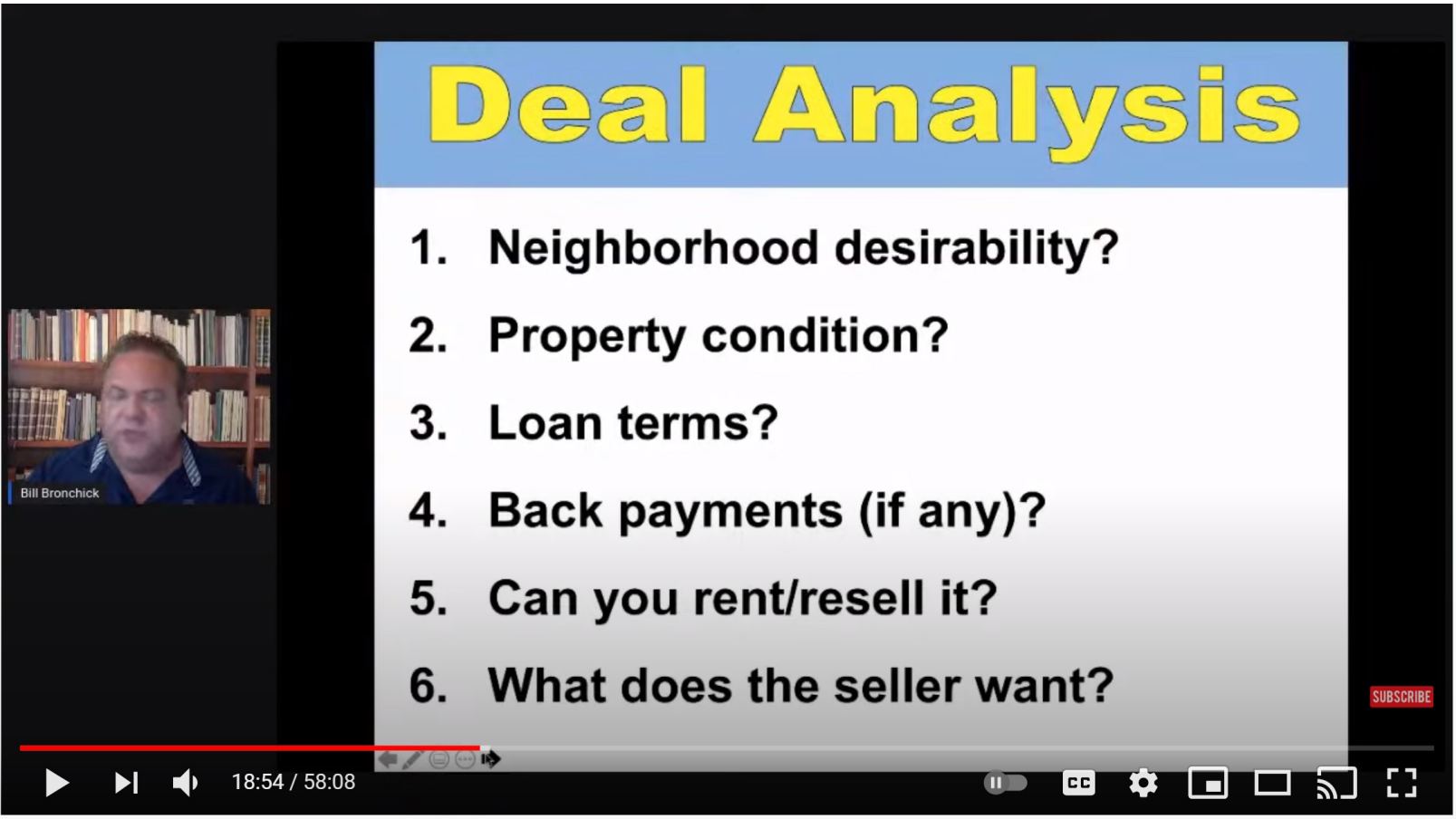
*Call us to Discuss Your Offer **781-999-1234**

***Subject to property condition review*

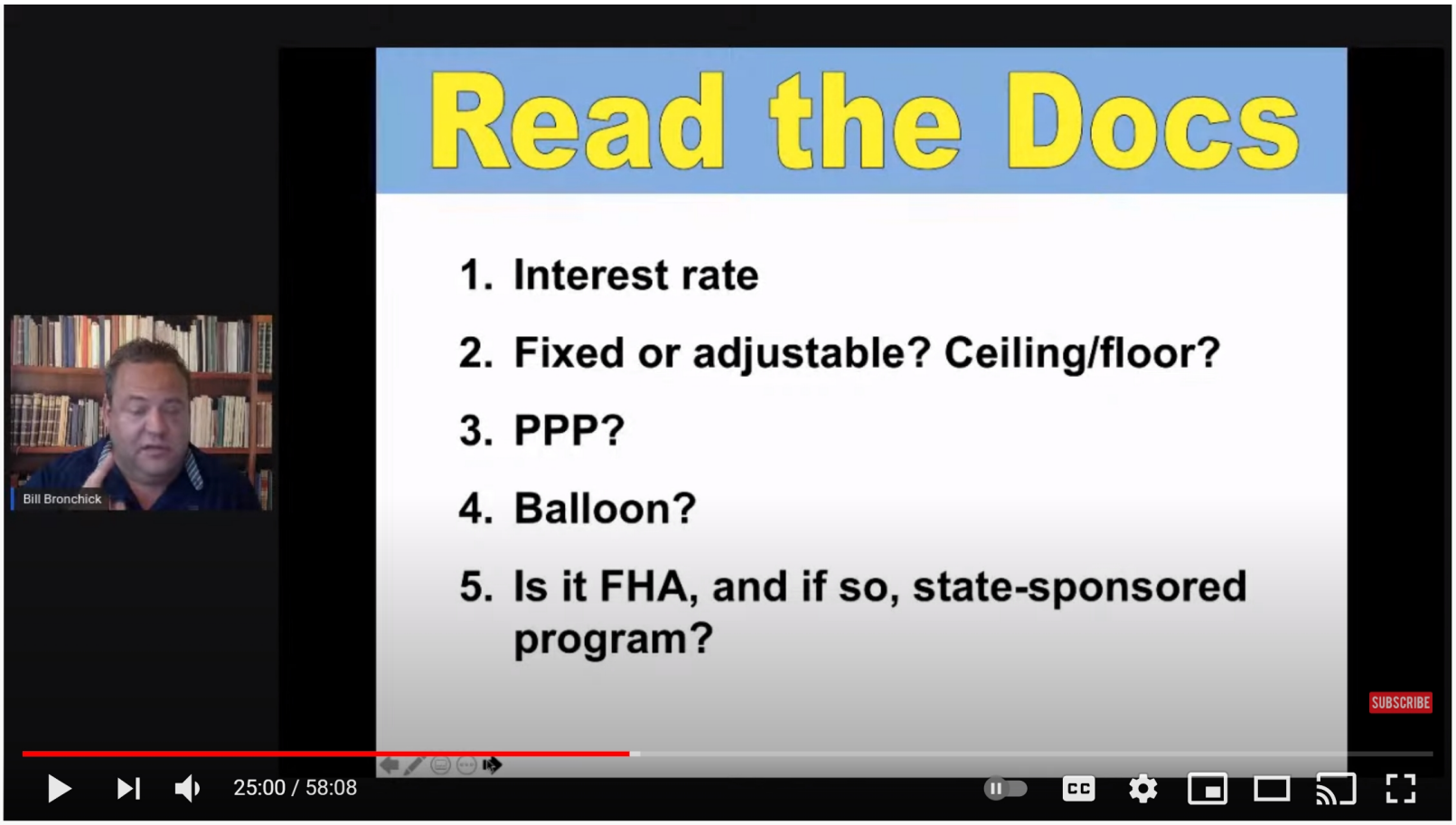
Seller		Description	Buyer	
Debit	Credit		Debit	Credit
		Financial		
	76,000.00	Sale Price of Property	76,000.00	
		Deposit		500.00
		Prorations/Adjustments		
[redacted]		County Taxes 01/01/20 - 10/31/20		[redacted]
		Title Charges and Escrow/Settlement Charges		
		Bankruptcy/FCC Search to Integrity Title and Closing, LLC	85.00	
		Closing Fee (P) to Integrity Title and Closing, LLC	300.00	
		Final Search (P) to Integrity Title and Closing, LLC	250.00	
		Post-Close Processing to Integrity Title and Closing, LLC	175.00	
		Title Exam to Integrity Title and Closing, LLC	350.00	
		UCC Search to Integrity Title and Closing, LLC	75.00	
		Abstract [redacted] to Smith Brothers-Wagoner	550.00	



7 Things to Know About "Subject-To" Deals


Deal Analysis
1. Neighborhood desirability?
2. Property condition?
3. Loan terms?
4. Back payments (if any)?
5. Can you rent/resell it?
6. What does the seller want?
Bill Bronchick
SUBSCRIBE
18:54 / 58:08

Get it Under Contract
1. Use your own contract or the broker form with a good addendum
2. Disclose, disclose, disclose!
3. Be aware of foreclosure protection law requirements if they are in default or in foreclosure
4. Make sure all authorized parties sign the contract!
Bill Bronchick
SUBSCRIBE
21:57 / 58:08


Read the Docs
1. Interest rate
2. Fixed or adjustable? Ceiling/floor?
3. PPP?
4. Balloon?
5. Is it FHA, and if so, state-sponsored program?
Bill Bronchick
SUBSCRIBE
25:00 / 58:08

Title Search
1. Identify all of the owners
2. Identify all of the liens
3. Look for foreclosure notices
4. Check with municipal authorities for liens (water, sewer, etc)
5. Property taxes – homesteaded?
Bill Bronchick
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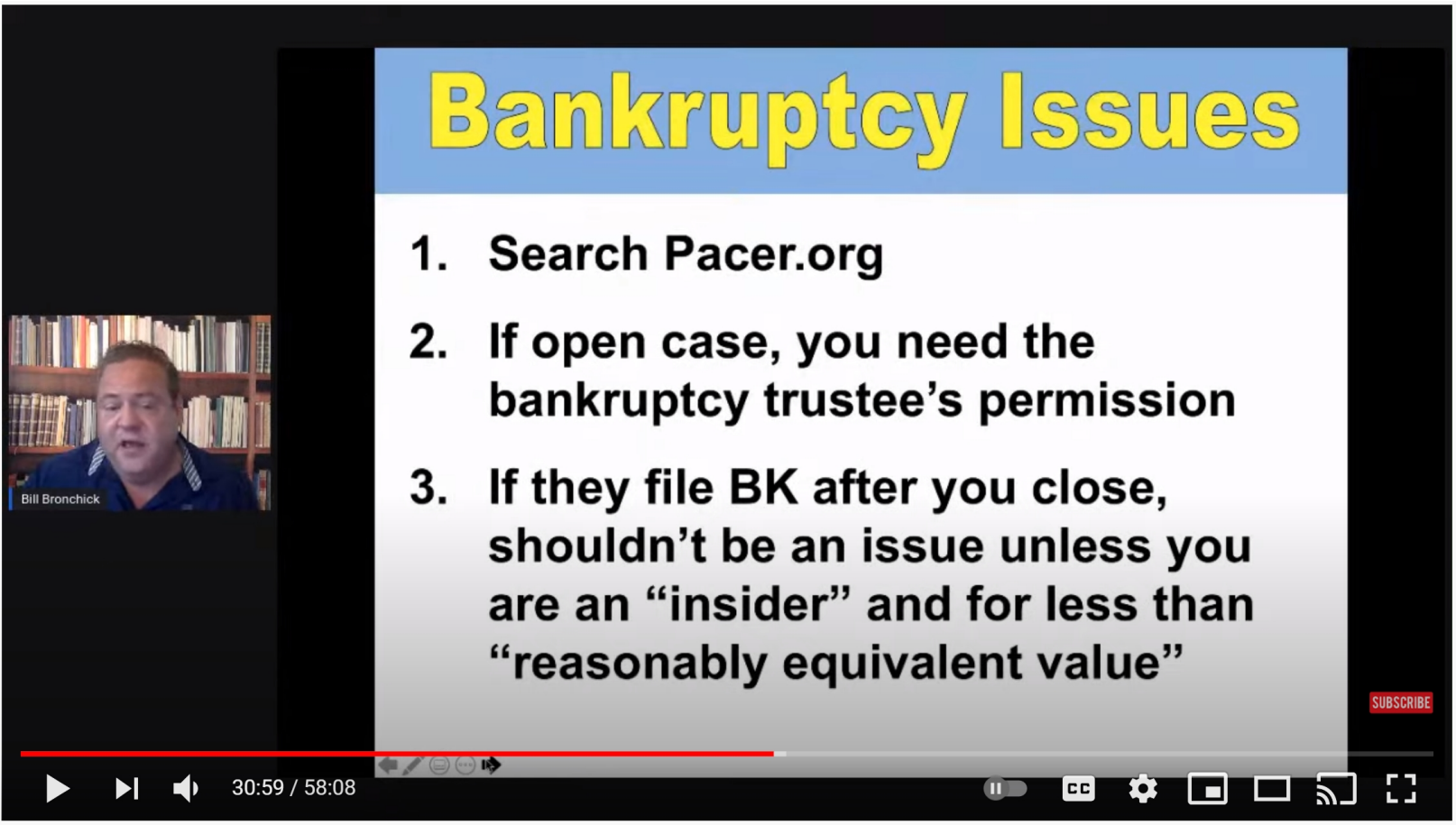
27:43 / 58:08


Bankruptcy Issues
1. Search Pacer.org
2. If open case, you need the bankruptcy trustee's permission
3. If they file BK after you close, shouldn't be an issue unless you are an "insider" and for less than "reasonably equivalent value"
Bill Bronchick
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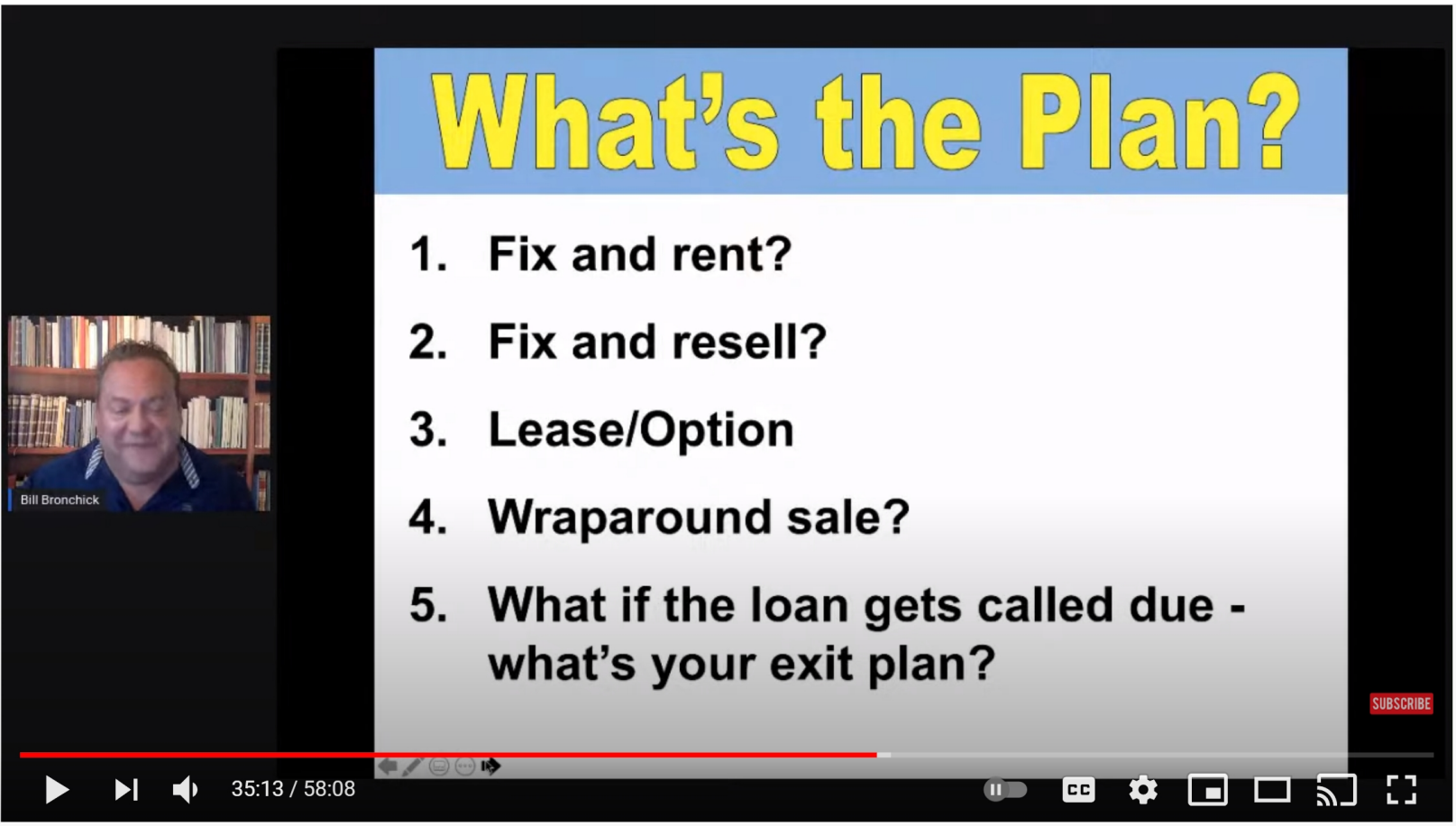
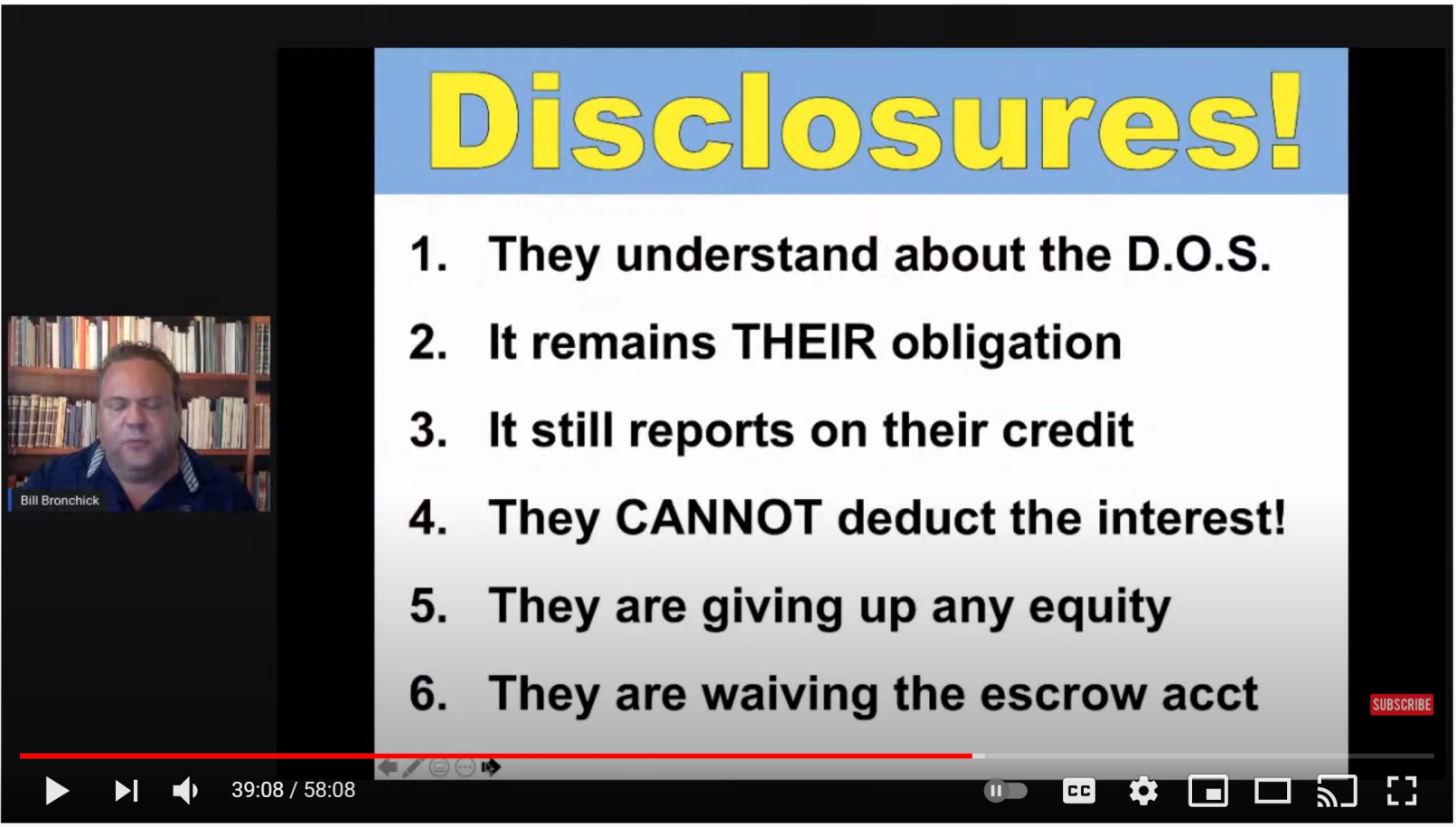
30:59 / 58:08


What's the Plan?
1. Fix and rent?
2. Fix and resell?
3. Lease/Option
4. Wraparound sale?
5. What if the loan gets called due - what's your exit plan?
Bill Bronchick
SUBSCRIBE
35:13 / 58:08


Disclosures!
1. They understand about the D.O.S.
2. It remains THEIR obligation
3. It still reports on their credit
4. They CANNOT deduct the interest!
5. They are giving up any equity
6. They are waiving the escrow acct
Bill Bronchick
SUBSCRIBE
39:08 / 58:08

THE LEGALWIZ GUIDE TO
THE LEGALWIZ GUIDE TO BUYING PROPERTIES SUBJECT TO
Buying Properties Subject To
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William Bronchick
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49:49 / 58:08
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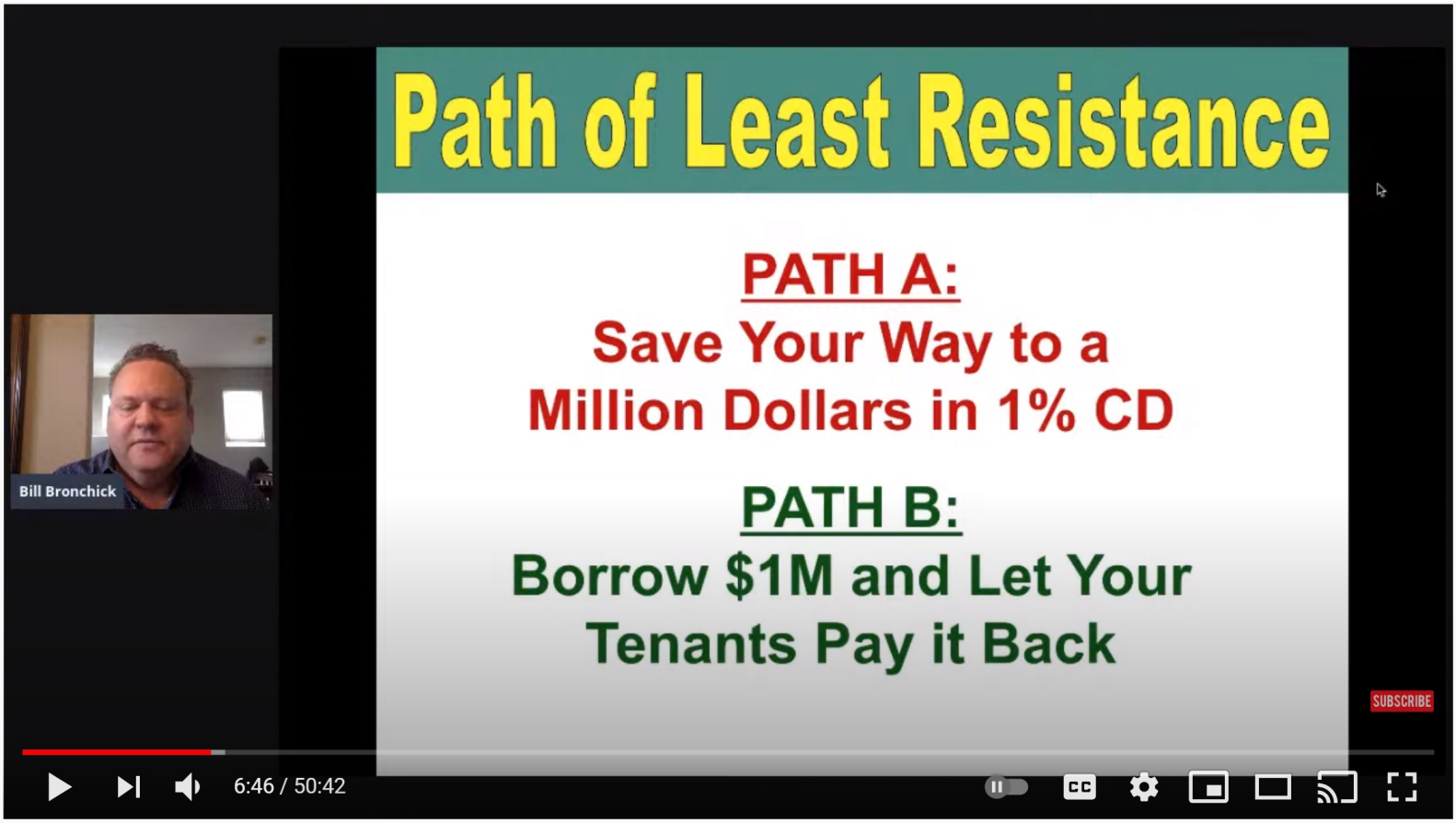
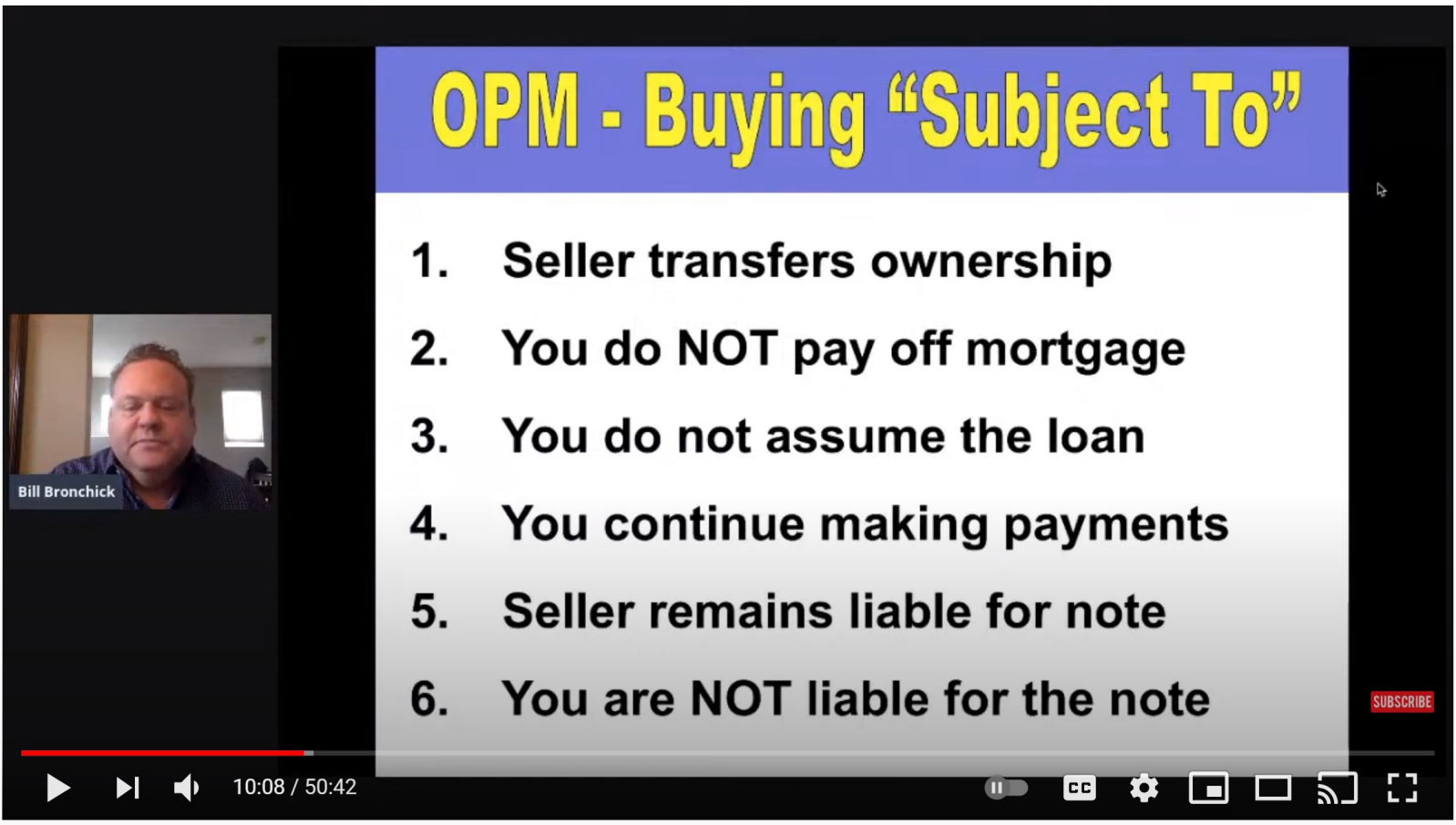
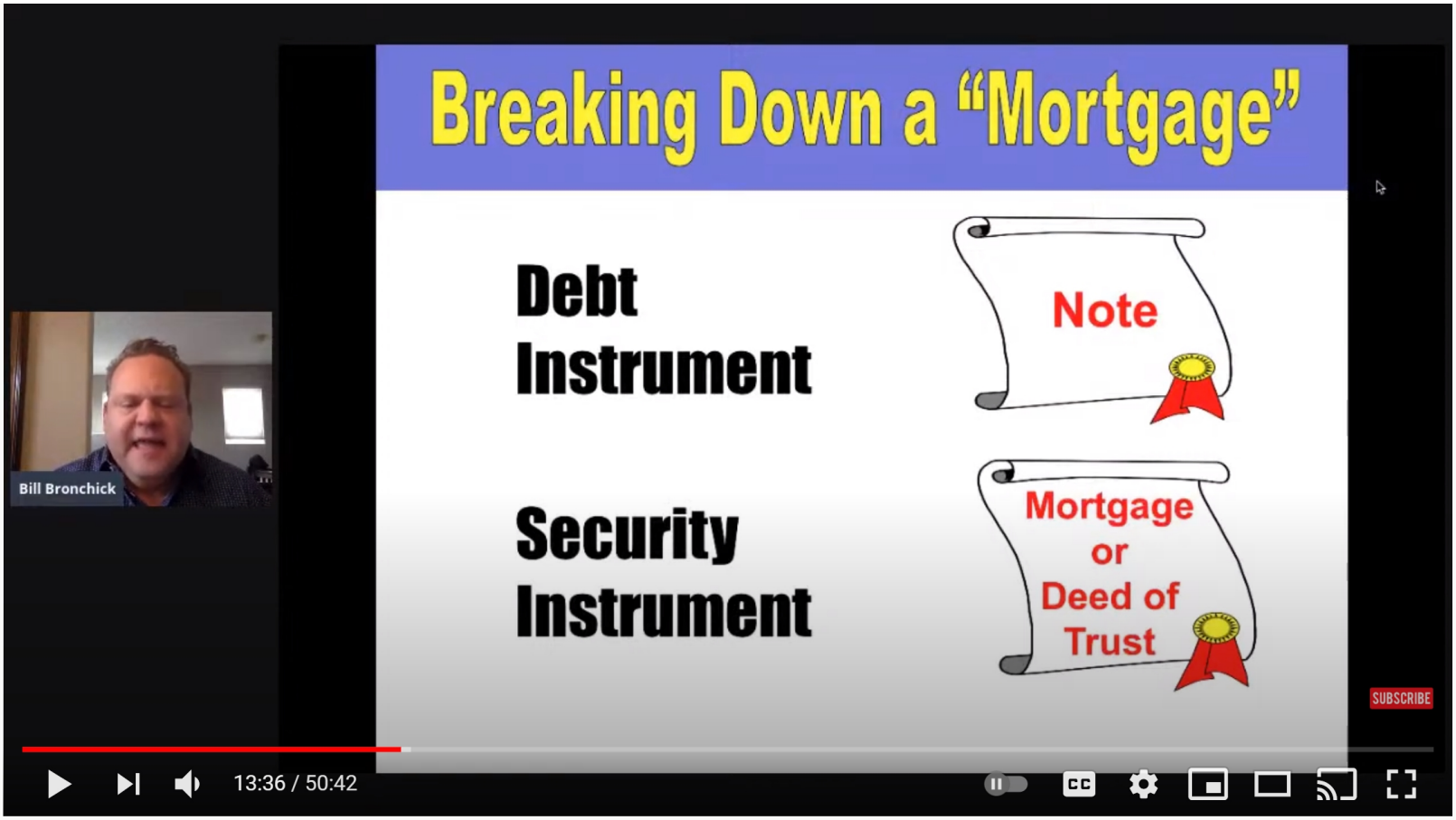
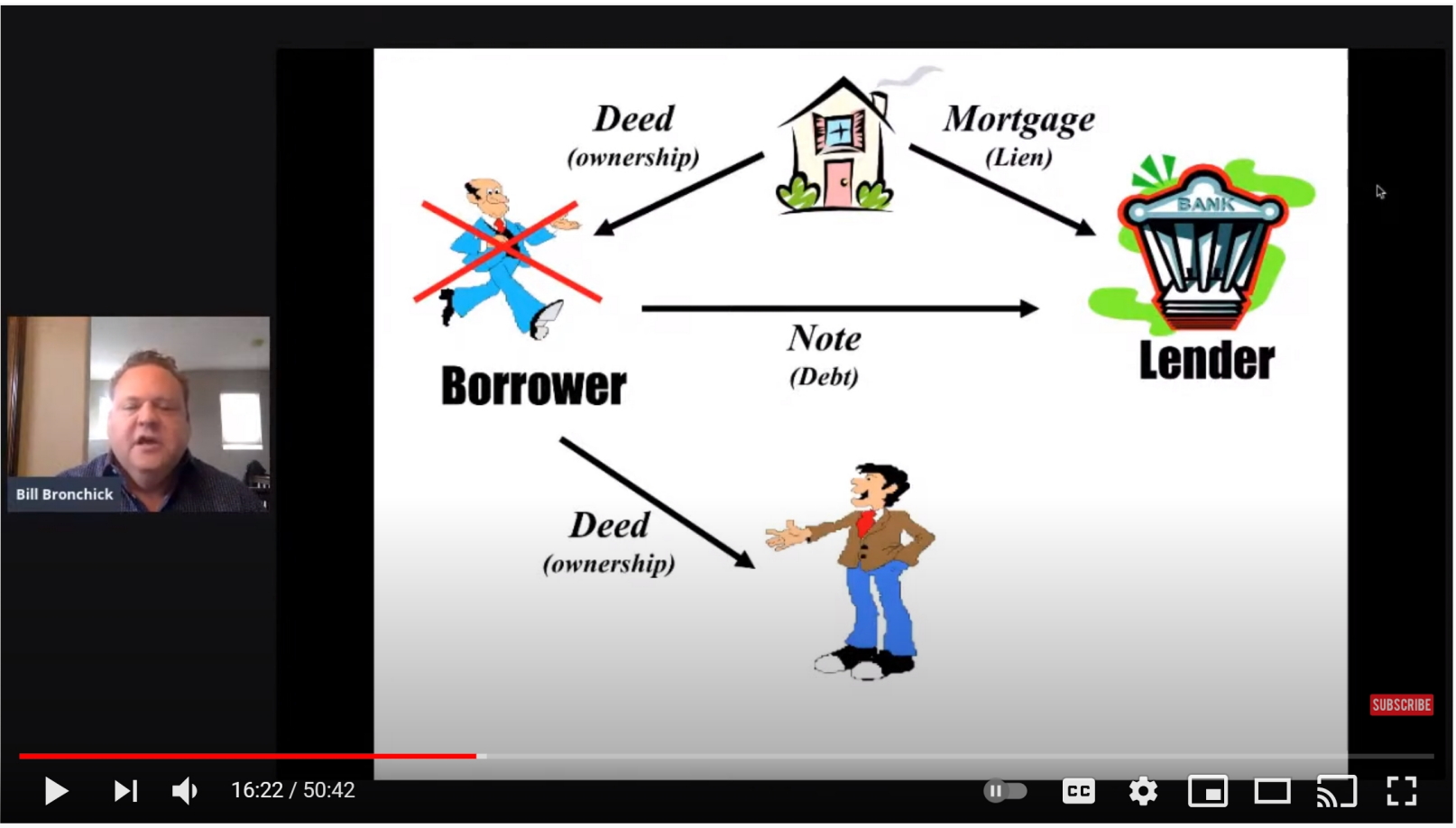


Webinar Weds with William Bronchick - Buying Houses Subject To

1,581 views • Streamed live on Jan 29, 2020


OPM - Buying "Subject To"
1. Seller transfers ownership
2. You do NOT pay off mortgage
3. You do not assume the loan
4. You continue making payments
5. Seller remains liable for note
6. You are NOT liable for the note
Bill Bronchick
SUBSCRIBE
10:08 / 50:42


Breaking Down a "Mortgage"
Debt Instrument
Note
Security Instrument
Mortgage or Deed of Trust
Bill Bronchick
SUBSCRIBE
13:36 / 50:42


Deed
(ownership)
Mortgage
(Lien)
BANK
Borrower
Note
(Debt)
Lender
Deed
(ownership)
Bill Bronchick
SUBSCRIBE
16:22 / 50:42

Advantages of "Subject To"

1. No qualification or credit
2. No liability
3. Not on your credit report
4. Take advantage of loan paydown
5. Lower interest rate
6. No loan origination costs

/ 50:42

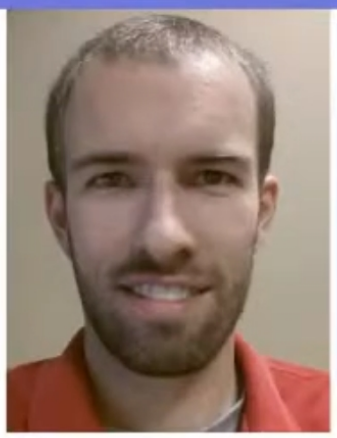
Sub2 Case Study

Byron Walker

- Byron put 4 plex under contract sub2
- ARV $350k, purchase price $240,000 subject to $225k loan, $15k cash to seller
- Byron assigned his contract to BB for $15k, who paid $255k total for a $350k property!

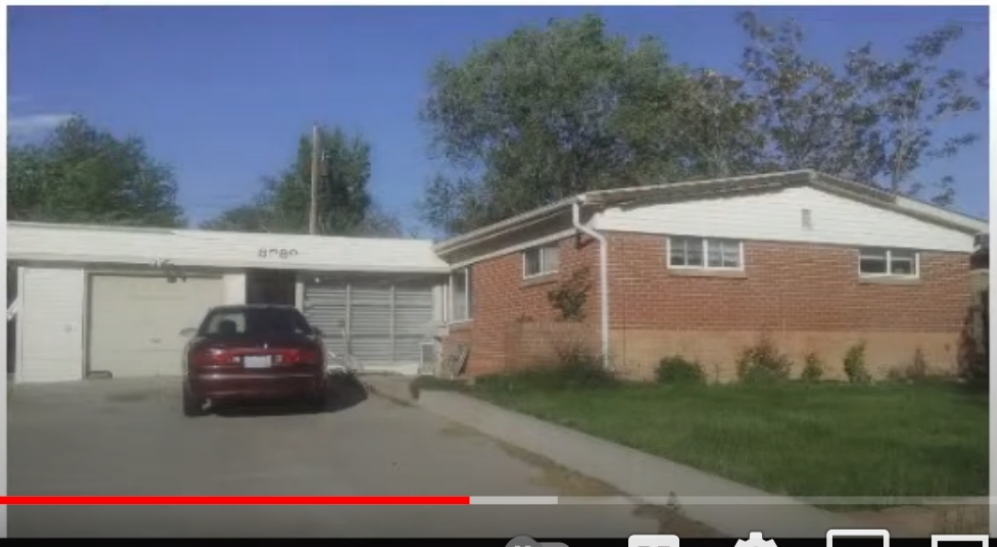
SUBSCRIBE

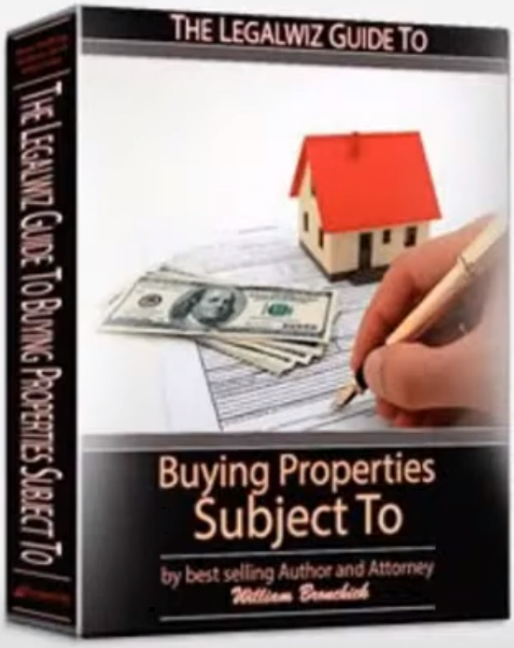
Sub2 Case Study



JOHN GRAHAM

- ARV 175k – needed about $5k of work
- Contract to buy sub2 $138k loan $0 down
- Assigned Contract to another investor
- Walked away with $5,000 assignment fee





Buying Properties "Subject to"

- How to find the deals
- How to analyze them
- How to negotiate them
- How to put them under contract
- How to do due diligence
- How to close and get PAID!

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"…the lender may,
at it's option,
call all sums due
and payable."

SUBSCRIB

There is no "Due on Sale Jail"

Comparable Sales

- 3 sales within 6 months
- Within 1 mile
- Similar Bedrooms and Baths
- Similar style
- Similar age
- Similar size
- Properties for sale

Mistake #3:

No Cash Reserve

Members of Your Team:

- Real estate broker
- Contractor
- Home Inspector
- Attorney
- Title company
- Accountant
- Insurance agent
- Mortgage broker
- Mentor
- Bookkeeper
- IT person
- Appraiser

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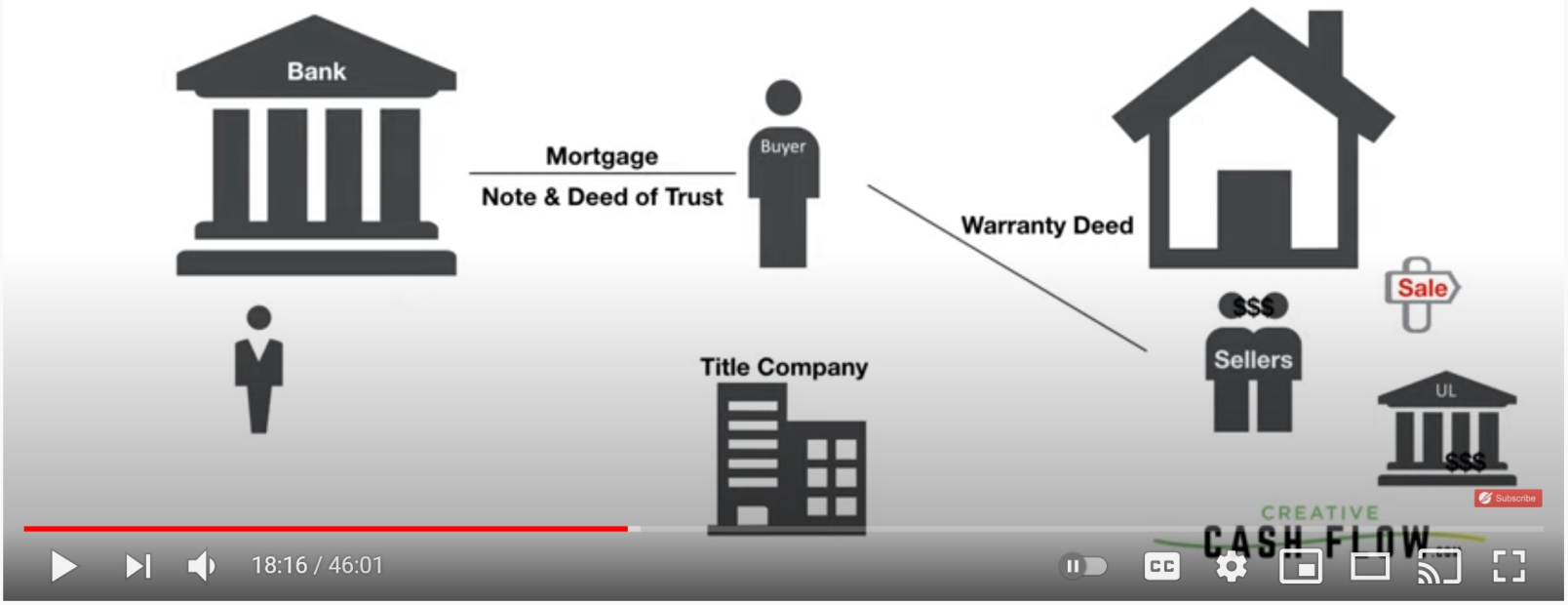
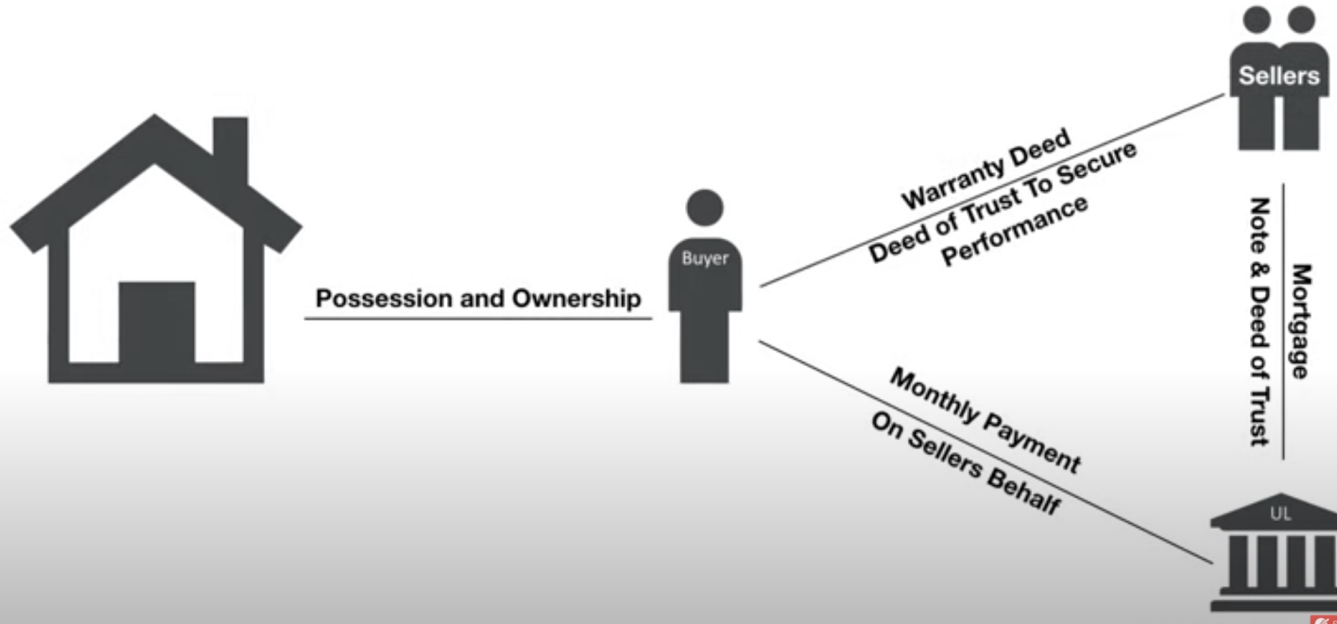
04 / 49:00

Traditional Bank Financing Model



"Subject To" Financing Model

11



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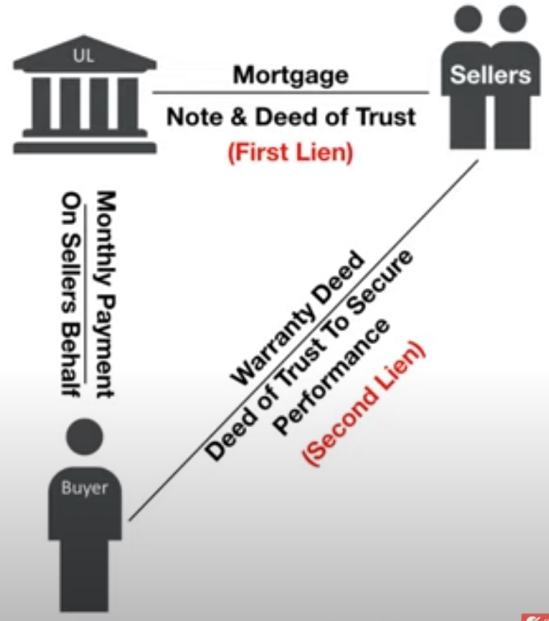
CREATIVE
CASH FLOW
19:16 / 46:01

“Subject To” Financing Model

12



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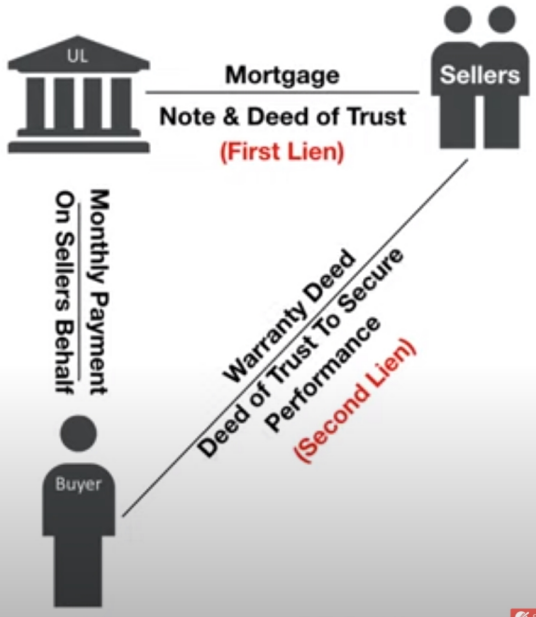
26:10 / 46:01

“Subject To” Financing Model

Date/Time of filing is the
-ONLY-
factor in lien position



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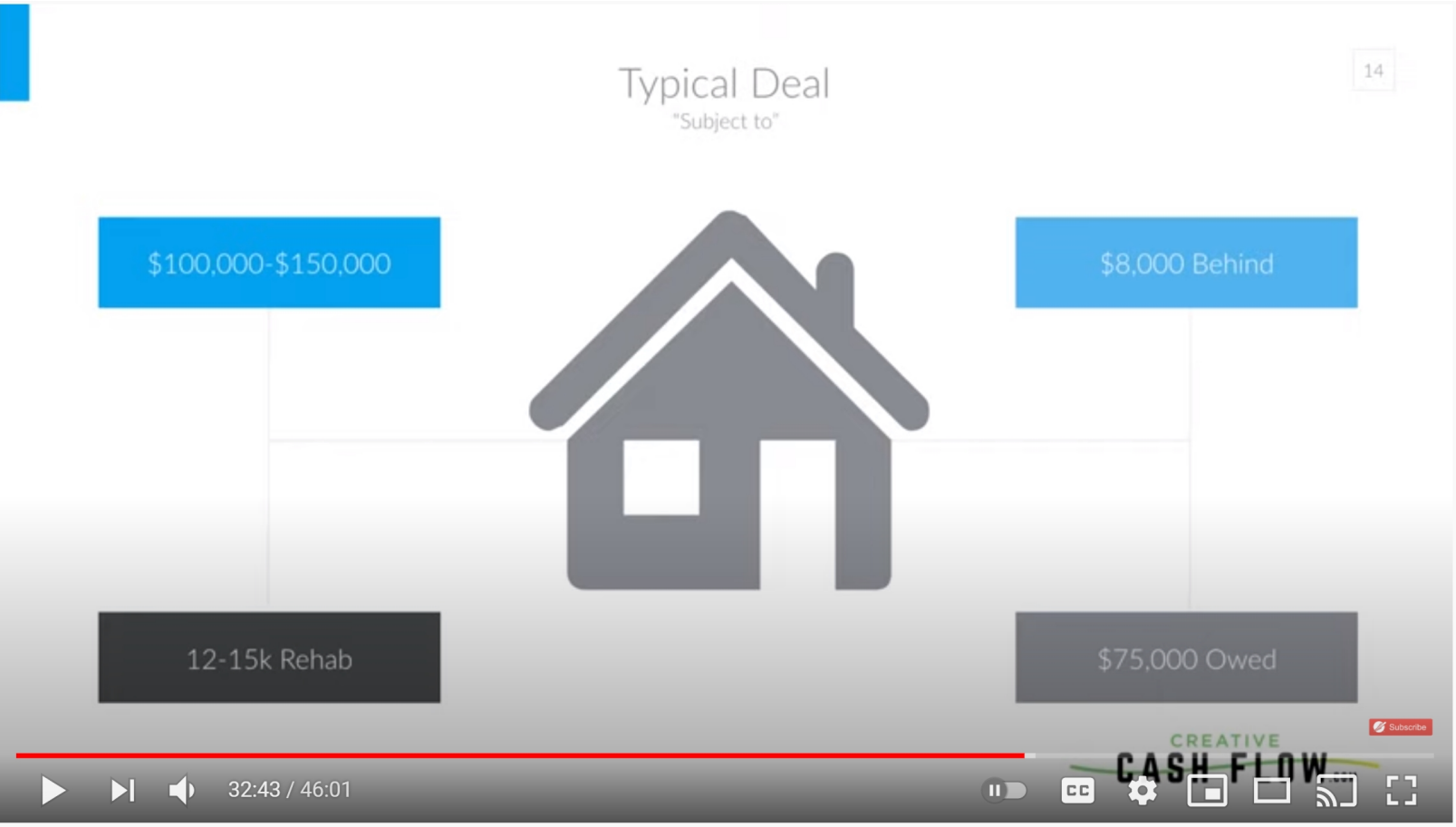
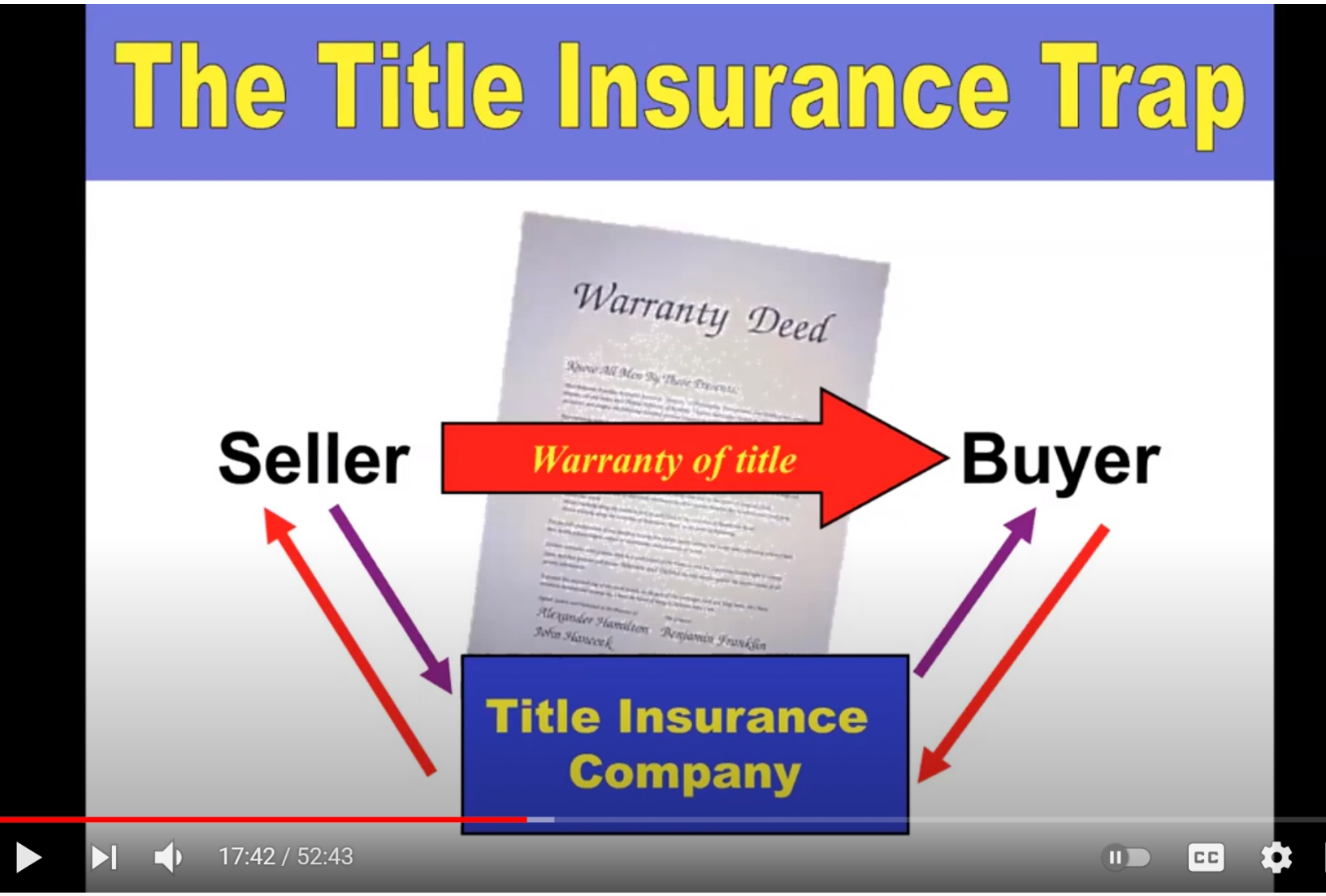
29:49 / 46:01


Typical Deal
"Subject to"
14
$100,000-$150,000
$8,000 Behind
12-15k Rehab
$75,000 Owed
Subscribe
CREATIVE
CASH FLOW
32:43 / 46:01


The Title Insurance Trap
Warranty Deed
Seller
Warranty of title
Buyer
Title Insurance Company
17:42 / 52:43

Land Trusts for Privacy and Protection Webinar with Attorney William Bronchick

1,418 views • May 20, 2020

60 0 SHARE SAVE

Changing Beneficiares

1. Assignment of beneficial interest
2. Not recorded publicly
3. The same as the sale of the property for tax purposes

28:24 / 52:43

Trusts for Privacy and Protection Webinar with Attorney William Brenchick

IMPORTANT!

A LAND TRUST IS

NOT A LIABILITY

SHIELD FOR MOST

LAWSUITS!!!

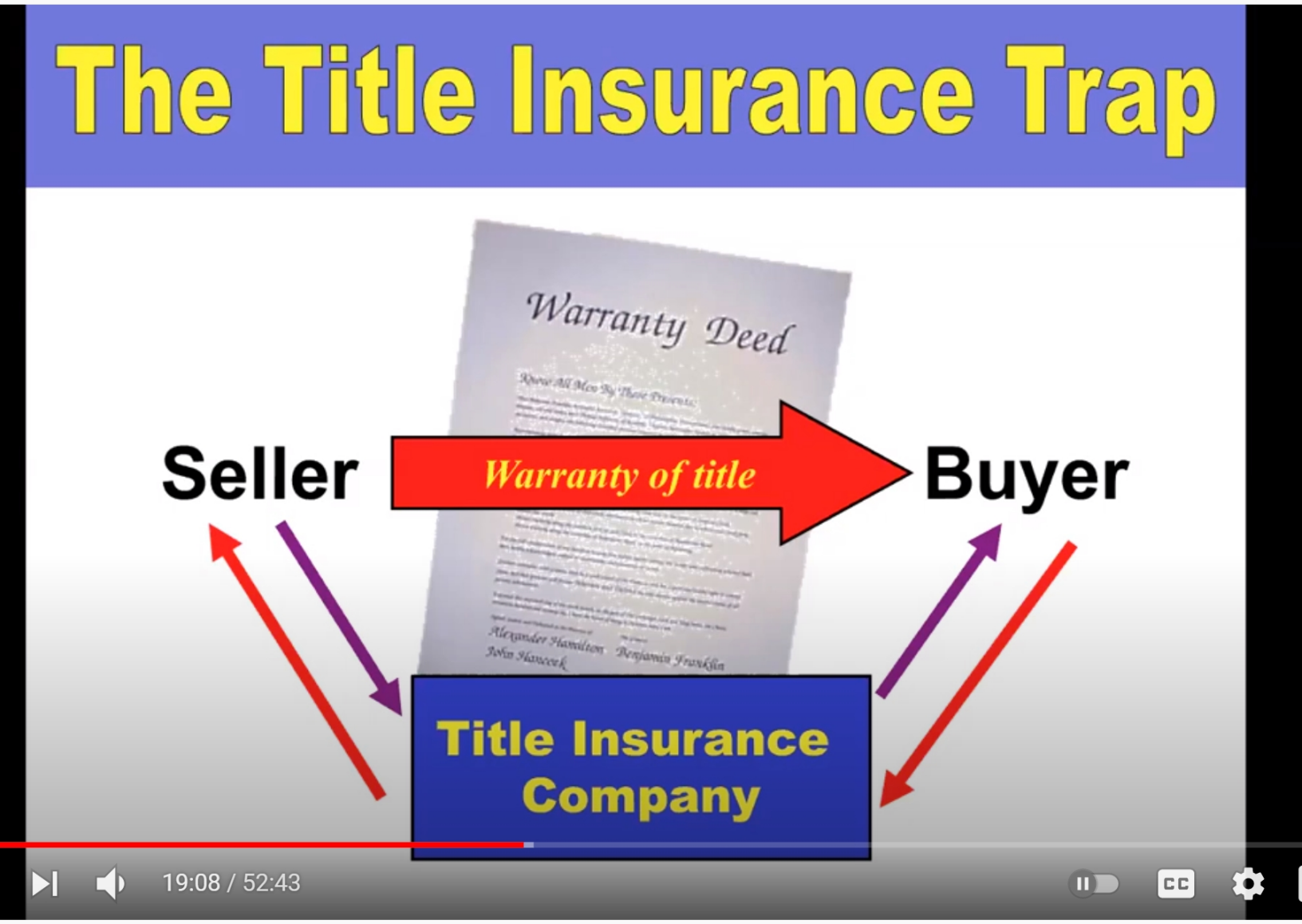
29:23 / 52:43

Land Trusts for Privacy and Protection Webinar with Attorney William Bronchick

Benefits of Land Trusts

- **Discourages Lawsuits**
- **Protects title claims**

14:54 / 52:43



rusts for Privacy and Protection Webinar with Attorney William Bronchick

Who's Watching You?

- Your competition
- The media
- Ex-Spouse
- Attorneys
- The Government!

Trust Basics

- A trust is a contract
- Grantor, Trustee & Beneficiary
- "Self-settled" trust
- Living (Intervivos) vs. Testamentary
- Revocable vs. Irrevocable

23:05 / 52:43

usts for Privacy and Protection Webinar with Attorney William Brenchick

Creating a Land Trust

1. Choose a trustee
2. Execute the trust agreement
3. Fund the trust

26:12 / 52:43

Changing Beneficiares

1. Assignment of beneficial interest
2. Not recorded publicly
3. The same as the sale of the property for tax purposes

28:19 / 52:43

IMPORTANT!

A LAND TRUST IS

NOT A LIABILITY

SHIELD FOR MOST

LAWSUITS!!!

29:15 / 52:43

1. Hold title to other than real estate

2. Create PPT agreement

3. Good for “stacking” trusts

4. Use for membership of LLCs

35:40 / 52:43

1. Create trust w/seller as beneficiary

2. Seller transfers title to trust

3. You are trustee

4. Assigns beneficial interest to you

36:42 / 52:43

“…the lender may,
at it’s option,
call all sums due
and payable.”

Due on Sale Exemptions

(1) the creation of a lien or other encumbrance subordinate to the lender's security instrument which does not relate to a transfer of rights of occupancy in the property;

(2) the creation of a purchase money security interest for household appliances;

(3) a transfer by devise, descent, or operation of law on the death of a joint tenant or tenant by the entirety;

(4) the granting of a leasehold interest of three years or less not containing an option to purchase;

(5) a transfer to a relative resulting from the death of a borrower;

(6) a transfer where the spouse or children of the borrower become an owner of the property;

(7) a transfer resulting from a decree of a dissolution of marriage, legal separation agreement, or from an incidental property settlement agreement, by which the spouse of the borrower becomes an owner of the property;

(8) a transfer into an inter-vivos trust in which the borrower is and remains a beneficiary and which does not relate to a transfer of rights of occupancy in the property;

37:17 / 52:43

Joint Venture

1. A + B want to buy, fix and flip
2. Create land trust w/A & B as bene's
3. A & B are also trustees
4. Draft "co-beneficiary" agreement

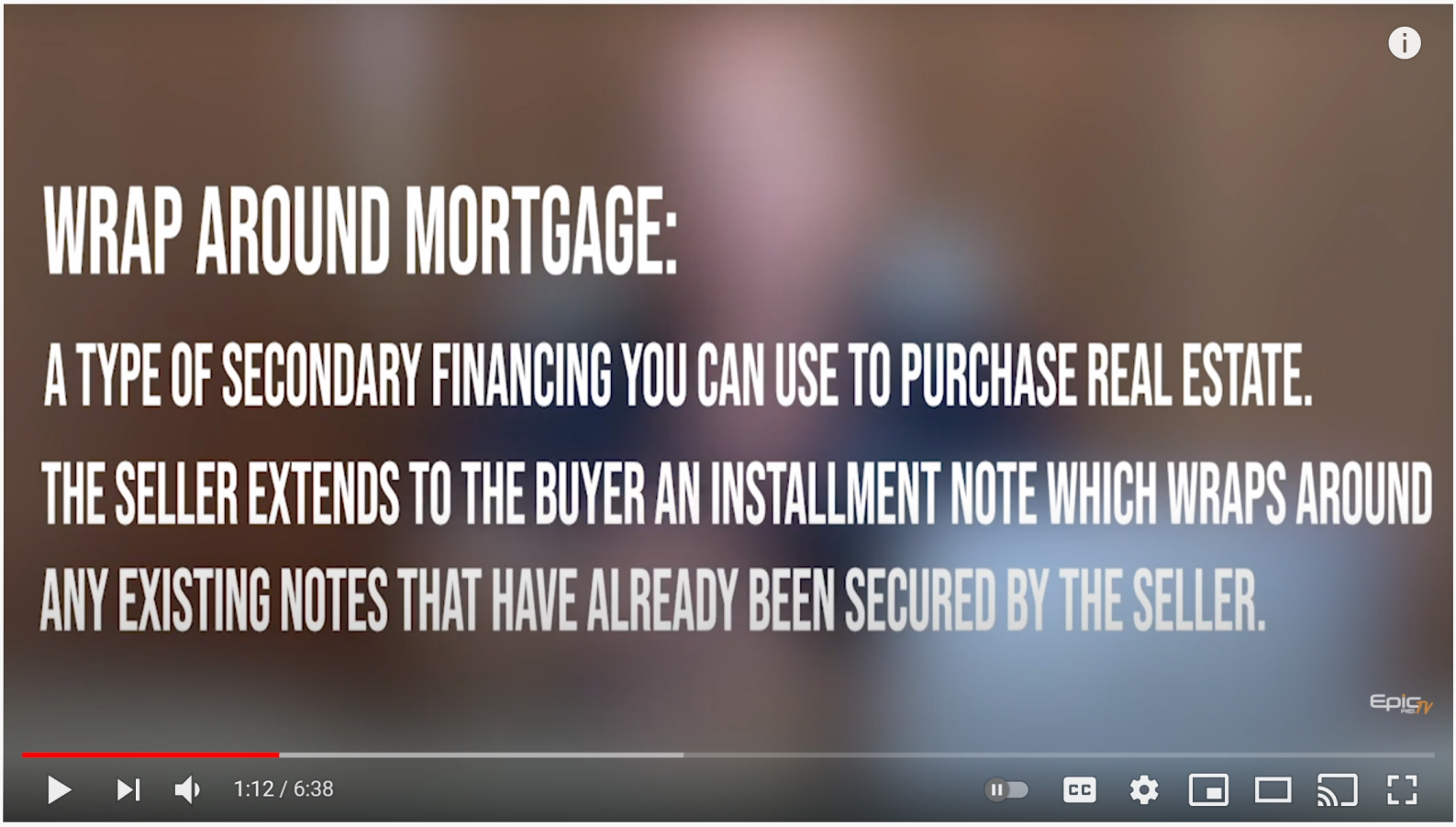
43:43 / 52:43

BONUS – Document Review

$400.00 Value!

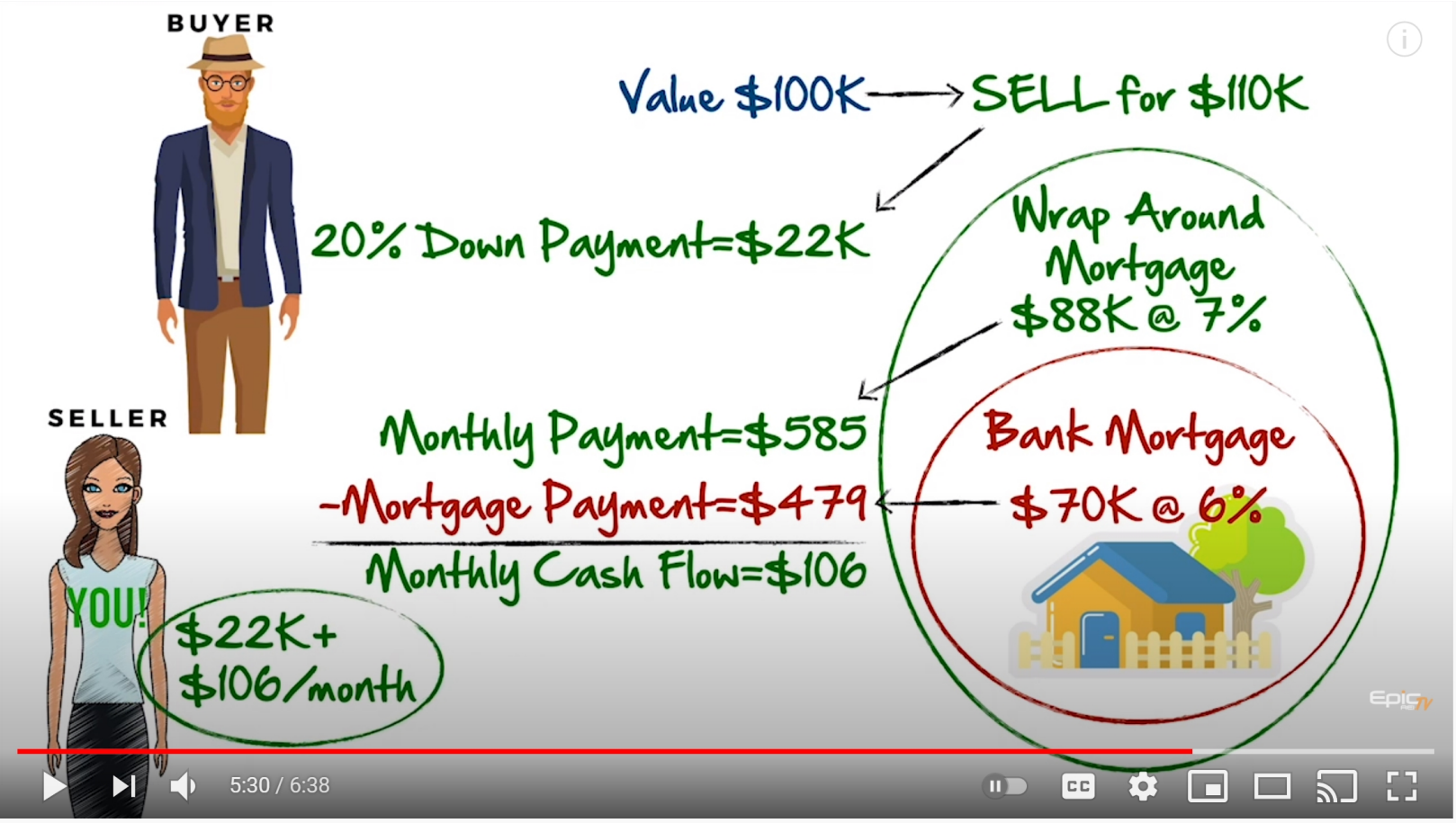
Bill will review your land trust documents for accuracy

44:35 / 52:43



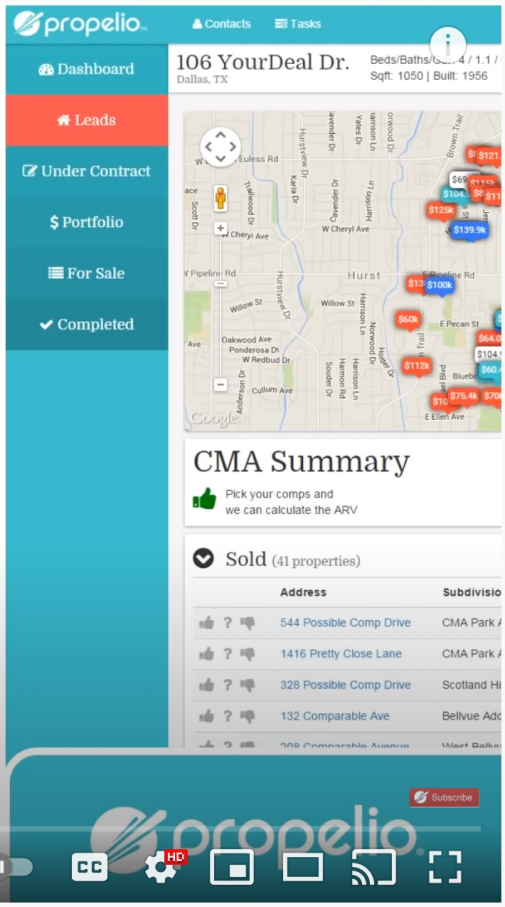
Wrap Around Mortgage (simply explained)

BUYER
Value $100K
$$
NEW Mortgage
$100K @ 6%
SELLER
Bank Mortgage
$50K @ 5%
BANK
$
1:47 / 6:38


BUYER
Value $100K
SELL for $110K
20% Down Payment=$22K
Wrap Around Mortgage $88K @ 7%
SELLER
Monthly Payment=$585
-Mortgage Payment=$479
Monthly Cash Flow=$106
Bank Mortgage $70K @ 6%
YOU!
$22K+ $106/month
5:30 / 6:38

Subject-to Strategy

- One of the most misunderstood/misrepresented
- Can be used on all properties; preferably with equity
- Allows for properties to be purchased with no credit
- Can create both cashflow and capital gains
- Is often coupled with other strategies like wraps, rentals, and rehabs
- Should NOT be used with out significant resources available such as lawyers, capital, loan originators, debt servicers, CPAs, and community banks



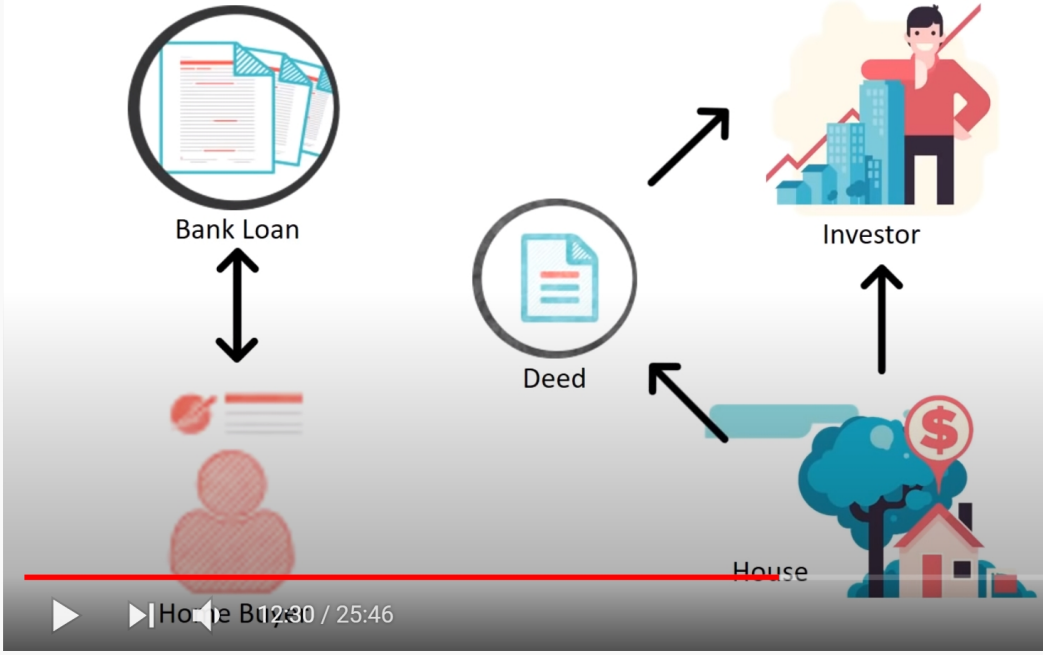
0:37 / 25:46

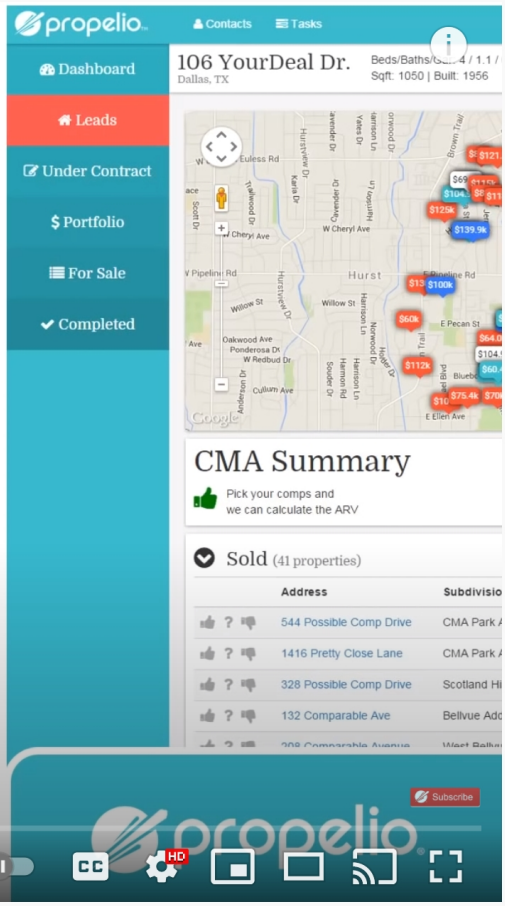
#SubjectTo #RealEstateInvesting #PropelioAcademy

Subject-To Investing | Real Estate Investing Basics

#SubjectTo #RealEstateInvesting #PropelioAcademy

Subject-to Example

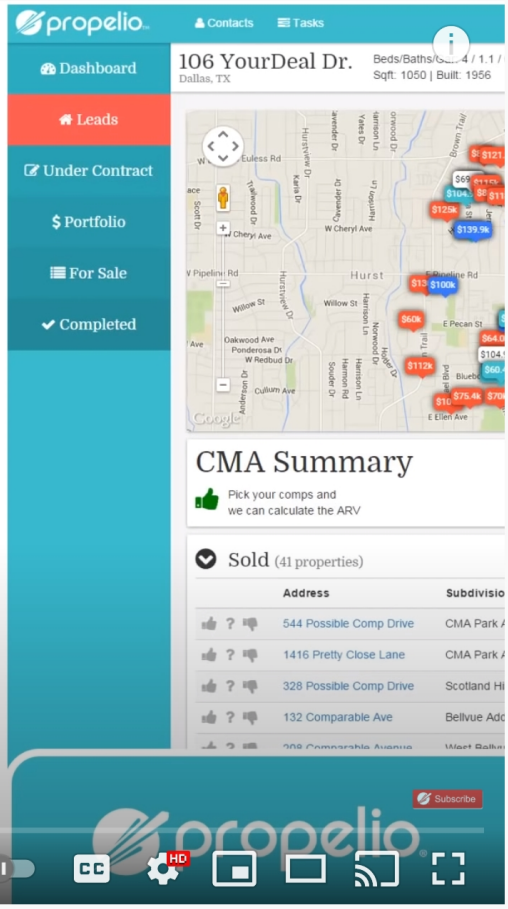




12:30 / 25:46

Subject-to Example

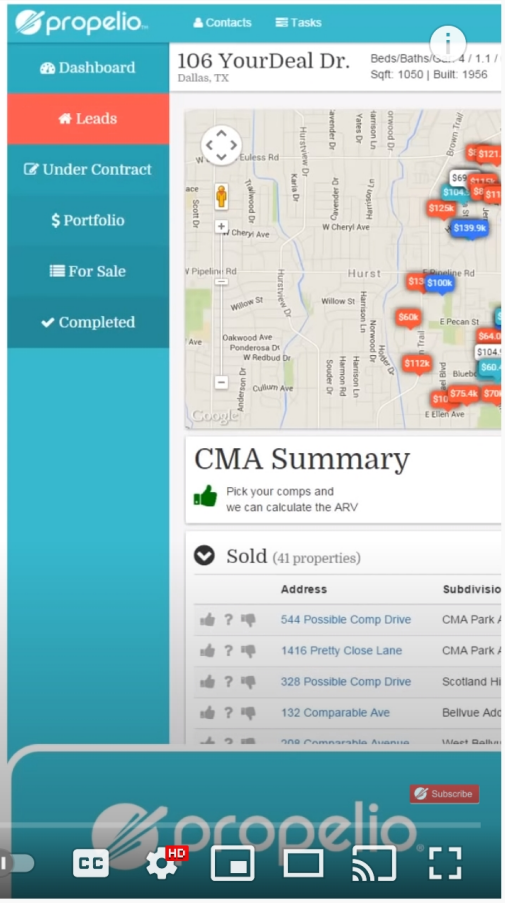
- Investor finds property worth $120,000
- Seller is behind $5,000 on mortgage and owes $95,000 to the bank for the house
- Investor agrees to payoff past due payments and make seller's future payments of $768 to the bank in exchange for deed subject-to existing lien
- Investor then rents the property to a tenant for $1,200 a month for the next 5 years
- Investor then sells the property for $120,000



14:50 / 25:46

Subject-to Example

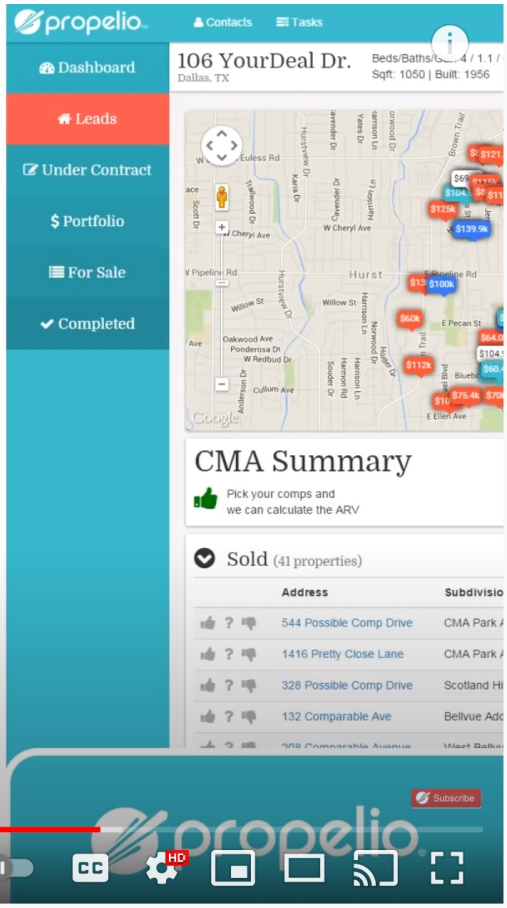
- Total investment of $5,000 to bring loan current
- $1,200 a month in rent minus $768 PITI payment equals $432 a month in positive cashflow
- Five years x $432/month cashflow equals $25,920
- Retail sale at year 5 for $120,000 minus loan balance of $95,000 equals $25,000 in capital gains
- $25,000 capital gain plus $25,920 in cashflow equals $50,920 in gross profits
- Minus initial $5,000 investment equals $45,920 gross profit in 5 years



16:55 / 25:46

Things to Consider

- This is an advanced strategy that should only be used upon adequate legal/financial counsel
- You will need capital and resources to keep this strategy performing while mitigating your risk
- Can be a massive addition to your investing career adding both cashflow and capital gains while not tying up your credit
- Leveraged with other strategies opens up the opportunity for more deals via creative deal structures



19:28 / 25:46

Subject To - Creative Real Estate Investing For Beginners - Video 7

WHERE TO FIND SUB TO DEALS?

1. PRE-FORECLOSURES
2. LOW EQUITY
3. MULTIPLE LISTING SERVICE (MLS)
4. OUT OF STATE OWNERS OF VACANT HOUSES

10:35 / 10:52

HI JACKSON !! :)

SELLER FINANCE ....
WHAT NEXT?

THIS IS HOW I DO IT IN PA :)

DUE DILIGENCE ✓
UNDER CONTRACT ✓

1. CONTRACT → TITLE CO
2. ATTORNEY → NOTE & MORTG.
   - SELLER NAME & ADDRESS
   - PROPERTY ADDRESS & TAX I.D. #
   - BUYER NAME: LLC VS. PERSONAL & ADDRESS
   - MORTG. AMT / INTEREST / MONTHLY PAYMENTS
   - DATE OF CLOSING
3. NAME PML ON INSURANCE
   - LOSS PAYEE ON PROPERTY INSUR.
   - LENDER TITLE POLICY
4. TITLE CO WILL:
   - NOTARIZE NOTE & FILE MORTG. @ STL
   - HANDLE DEED TRANSFER :)
5. YOU:
   - CELEBRATE
   - SET UP PAYMENTS
   - SEND TO YOUR ACCOUNTANT

Types of Offers when Seller Financing Real Estate

@APRIL_CROSSLEY

SELLER FINANCING OPTIONS:

BRET WHISSEL AMORT SCHED

I GIVE 3 OPTIONS

WHAT IS IMPORTANT TO THEM?

TERM? NET? INTEREST RATE? MONTHLY PAYMENT? MONEY DOWN

FINANCE	MONEY DOWN	INTEREST	TERM	MONTHLY PAYMENT	NET
$100K	0	6%	5YR	$599.55	$129,027.36
$90K	10K	5%	5YR	$483.14	$121,634.25
$95K	5K	7%	3YR	$632.04	$119,643.95

THIS GOES ON AND ON!

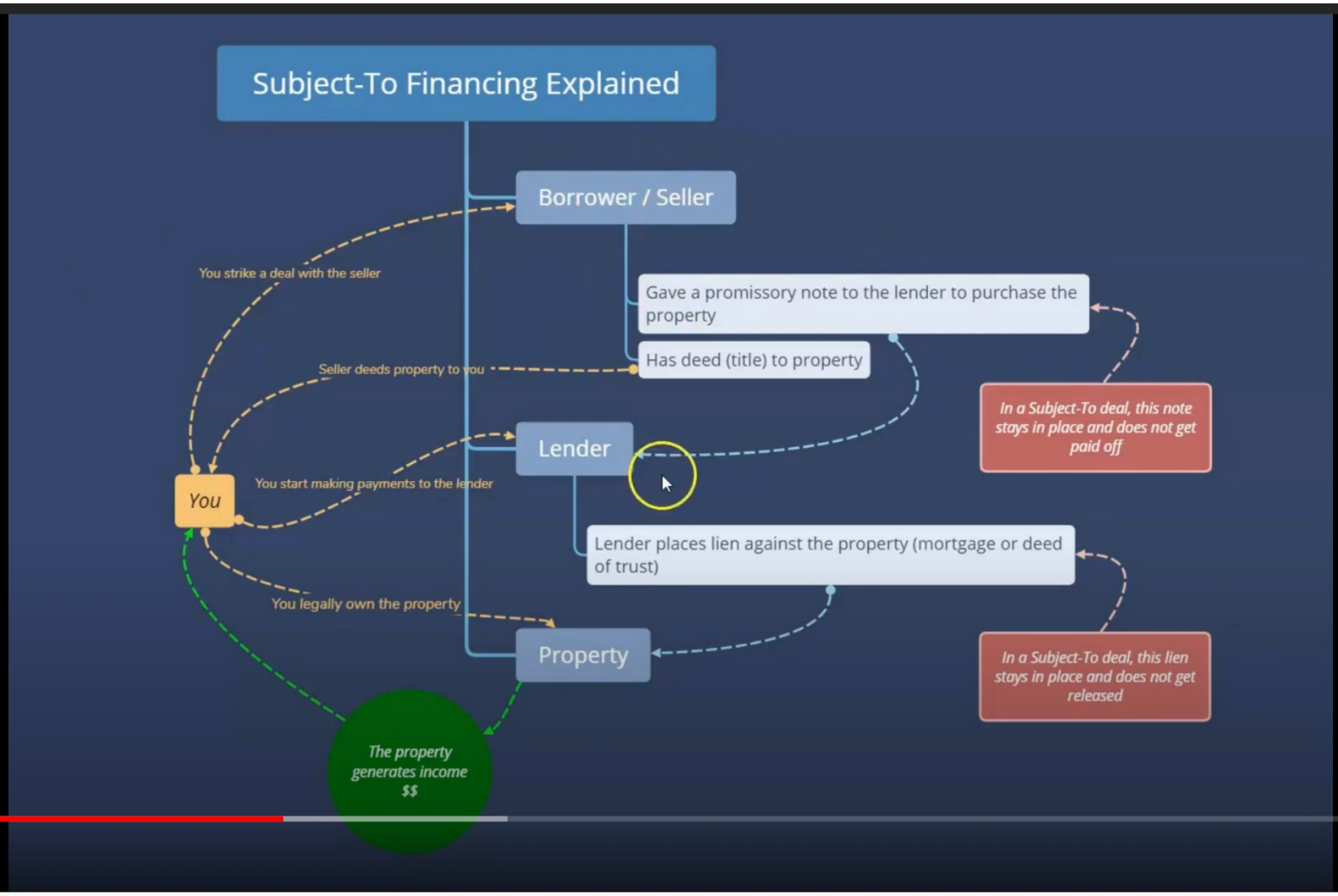
*EDUCATE & NEGOTIATE

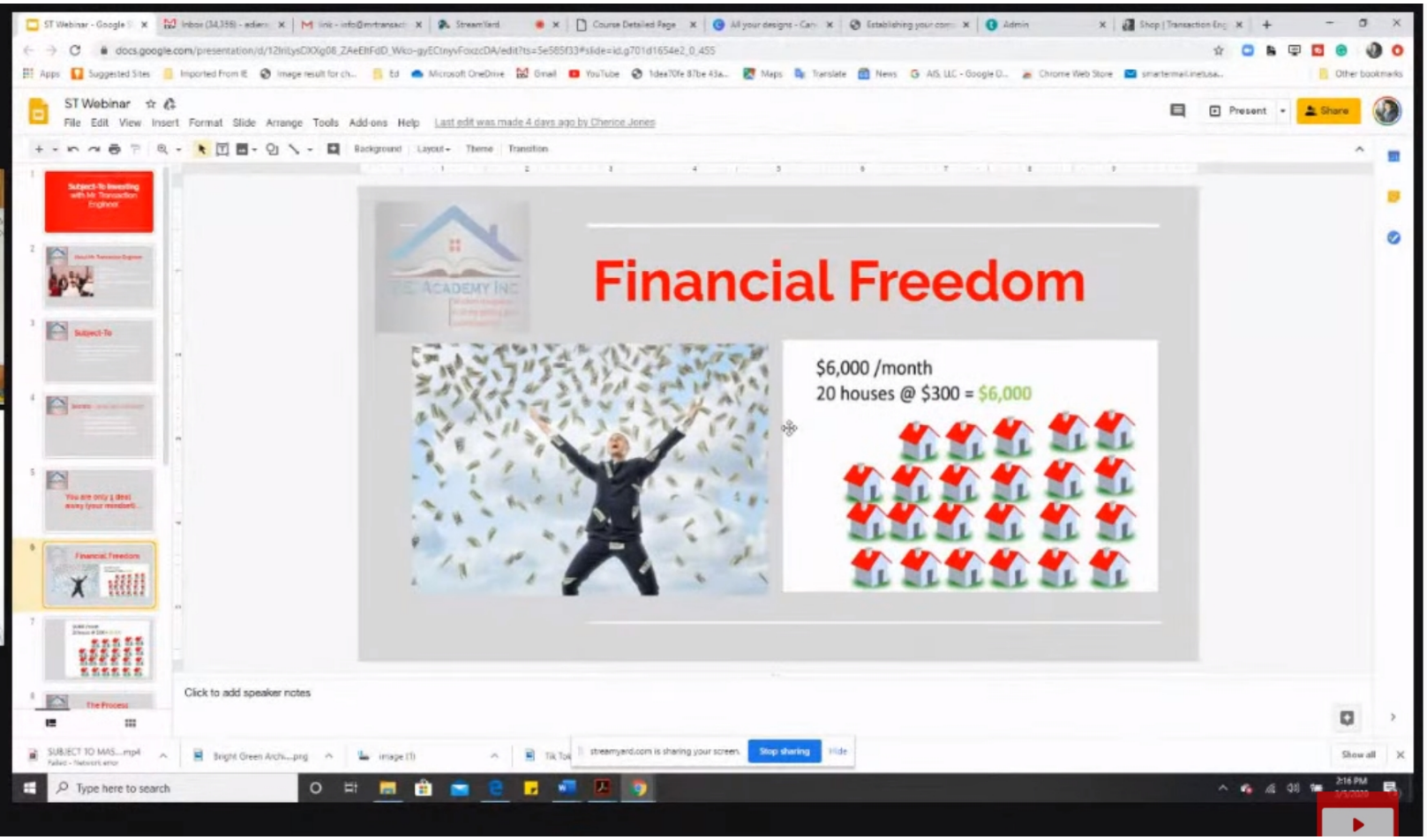
Learn How to Complete Real Estate Investing Documents

- How to complete purchase & sales agreement
- How to complete authorization to release info
- How to complete Sellers Acknowledgement
- How to complete Limited Power of Attorney
- How to complete Letter of Intent to Purchase
- How to complete a Flex Option (co-wholesale)
- How to complete Warranty Deed

FEW HIGHLIGHTS OF ITEMS MY "SUBJECT TO" CLAUSE IT COVERS:

- **"Subject To" Conveyance Clause**
- **Due on Sale Disclosure Clause**
- **Title Policy & Survey Clause**
- **Earnest Money and Default Clause**
- **Non-recourse Note Clause**
  (Watch a video on the importance of a "non-recourse note"***)***
- **Investor Sellers Acknowledgements Clause**
- **Much more...**


Subject-To Financing Explained
Borrower / Seller
You strike a deal with the seller
Gave a promissory note to the lender to purchase the property
Seller deeds property to you
Has deed (title) to property
In a Subject-To deal, this note stays in place and does not get paid off
Lender
You
You start making payments to the lender
Lender places lien against the property (mortgage or deed of trust)
You legally own the property
Property
In a Subject-To deal, this lien stays in place and does not get released
The property generates income $$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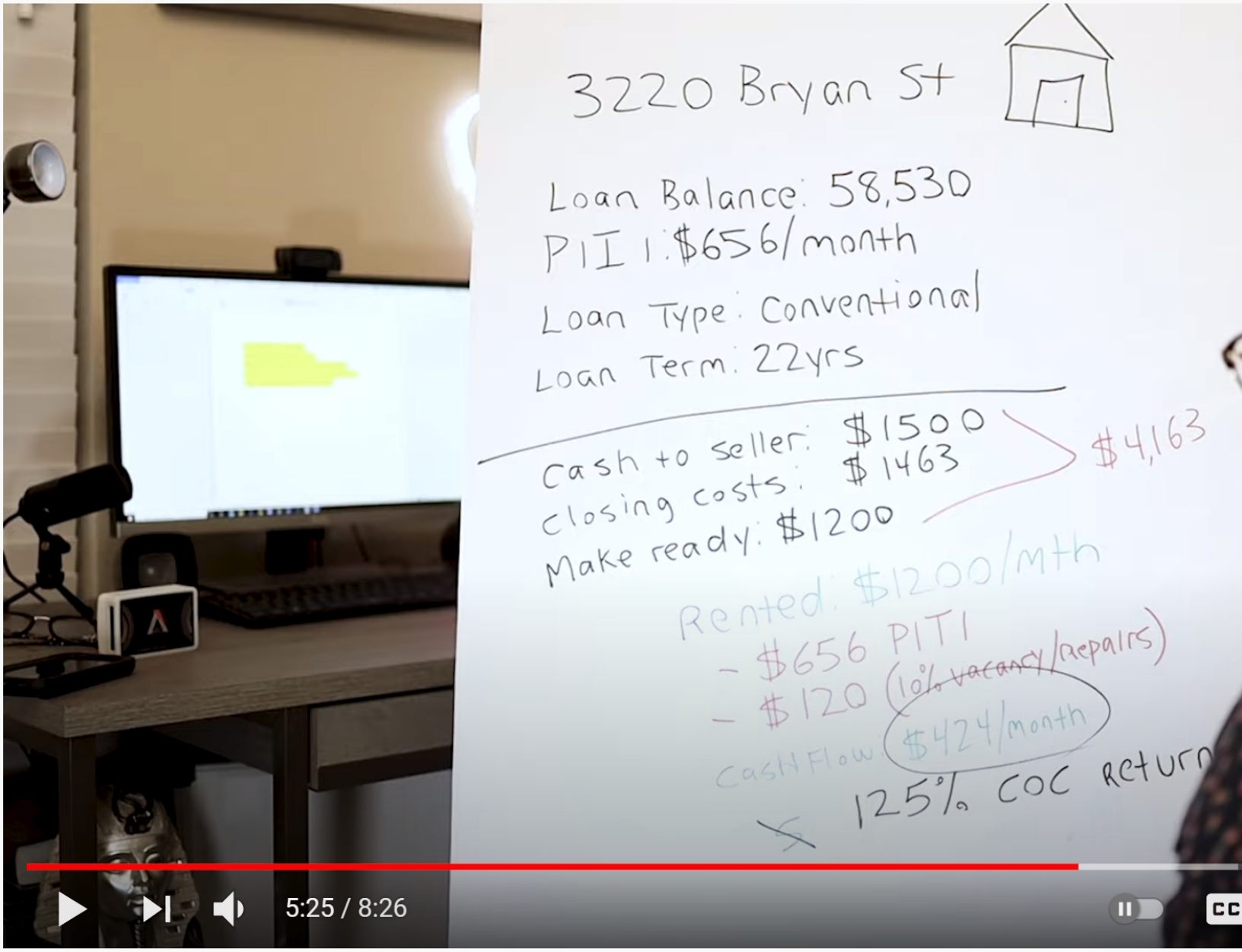
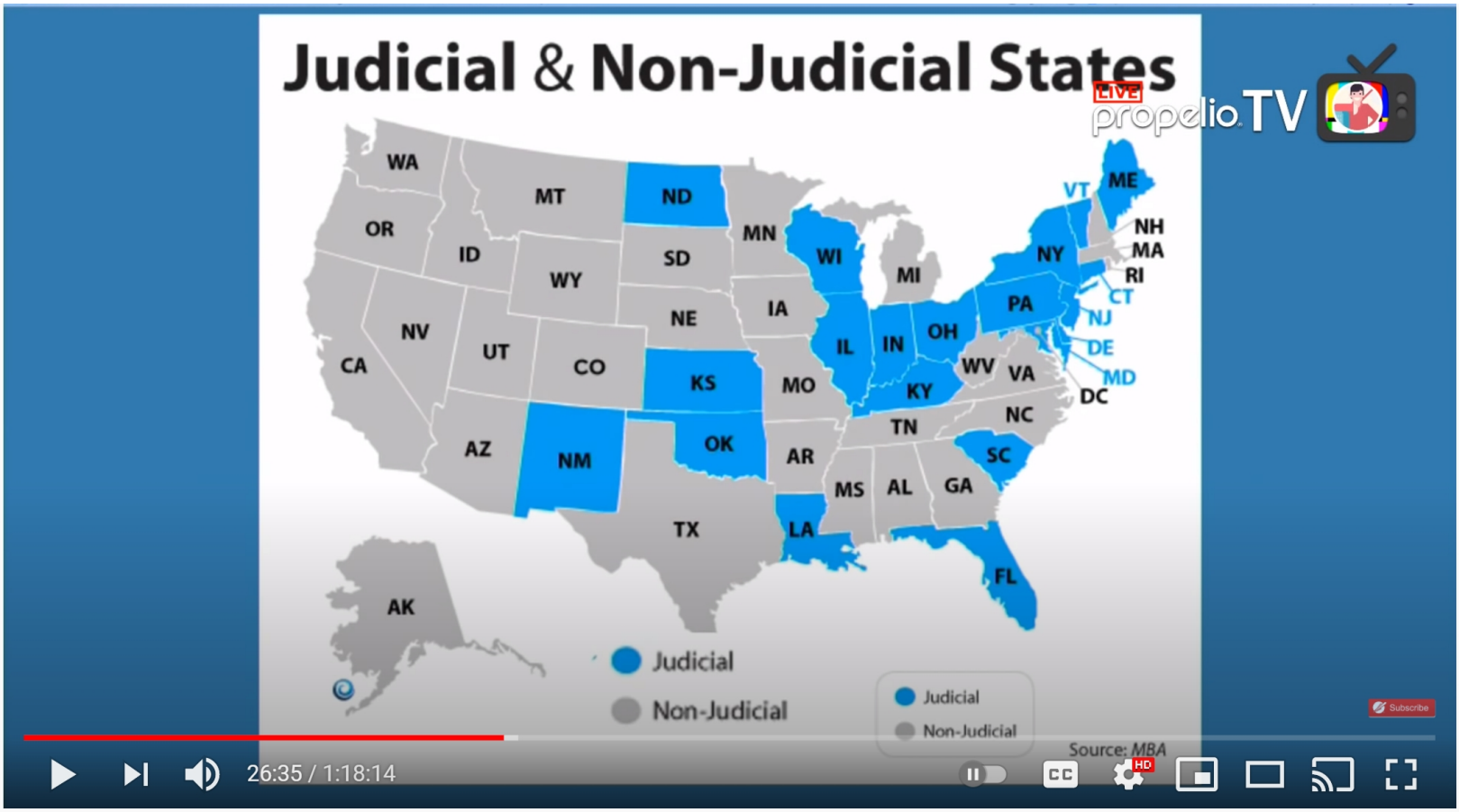
Present
Share
Background
Layout
Theme
Transition
Subject-To Investing with Mr Transaction Engineer
Subject-To
Financial Freedom
$6,000 /month
20 houses @ $300 = $6,000
Click to add speaker notes
Stop sharing
Hide
Type here to search

How to buy houses Subject TO, without getting bank loans

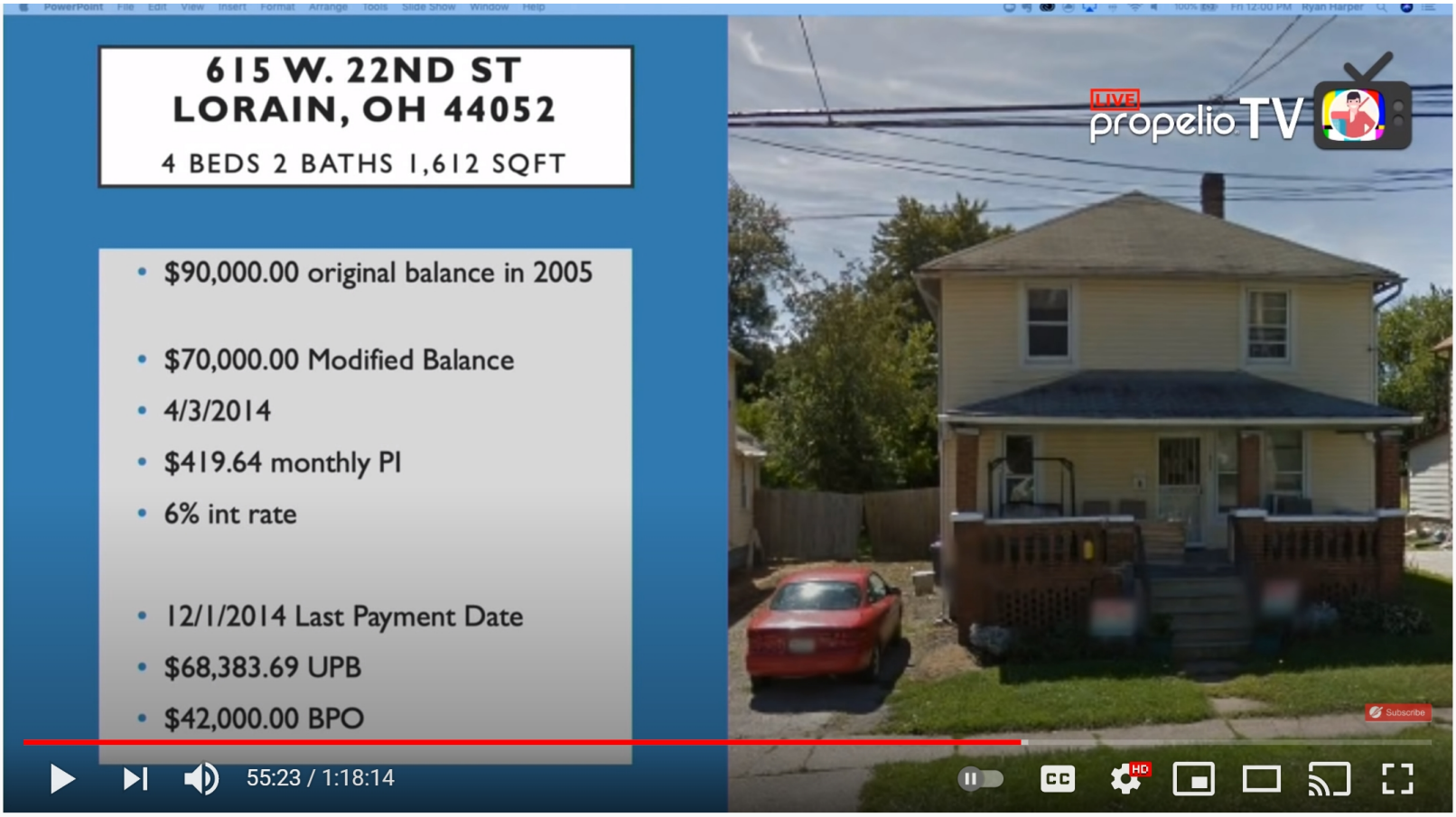


I Bought A New House Subject To



#NoteInvesting #NoteInvesting101 #HowToInvestInNotes

Make Huge Profits with Non Performing Notes | Note Investing 101



#NoteInvesting #NoteInvesting101 #HowToInvestInNotes

Make Huge Profits with Non Performing Notes | Note Investing 101

PowerPoint File Edit View Insert Format Arrange Tools Slide Show Window Help

615 W. 22ND ST
LORAIN, OH 44052

4 BEDS 2 BATHS 1,612 SQFT

UPB = $68,383.69

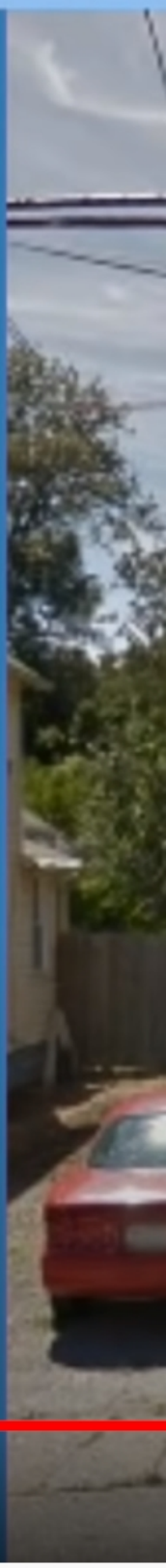
BPO = $42,000.00

How Much to Offer

65% of UPB = $44,449.40

55% of BPO = $23,100.00

Pick the lesser of the two



56:59 / 1:18:14

PowerPoint File Edit View Insert Format Arrange Tools Slide Show Window Help

615 W. 22ND ST
LORAIN, OH 44052

4 BEDS 2 BATHS 1,612 SQFT

Purchase Price = $23,100

Loan Modification Strategy

$50,000 Loan Balance

9% int

30 years is $402.31 per month

$4,827.72 per year

21% ROI

58:01 / 1:18:14

#NoteInvesting #NoteInvesting101 #HowToInvestInNotes

PowerPoint File Edit View Insert Format Arrange Tools Slide Show Window Help

615 W. 22ND ST
LORAIN, OH 44052

4 BEDS 2 BATHS 1,612 SQFT

Purchase Price = $23,100

Short Sale Strategy

Approve short sale quickly

$40,000 Sales Price

$16,900 Profit

73% ROI

1:00:51 / 1:18:14

PowerPoint File Edit View Insert Format Arrange Tools Slide Show Window Help

615 W. 22ND ST
LORAIN, OH 44052

4 BEDS 2 BATHS 1,612 SQFT

Purchase Price = $23,100

Deed in Lieu Strategy

$2,000 Cash For Keys

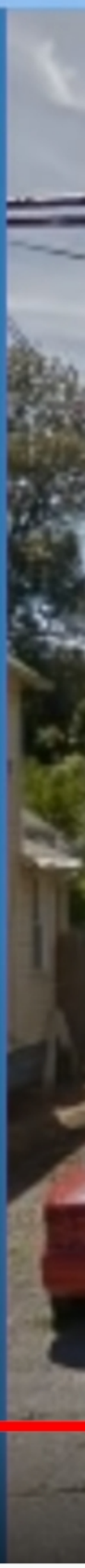
$5,000 Make Ready

Total Investment = $30,100

Rent for $850 per month

NET Annual Rent = $7,700

26% ROI



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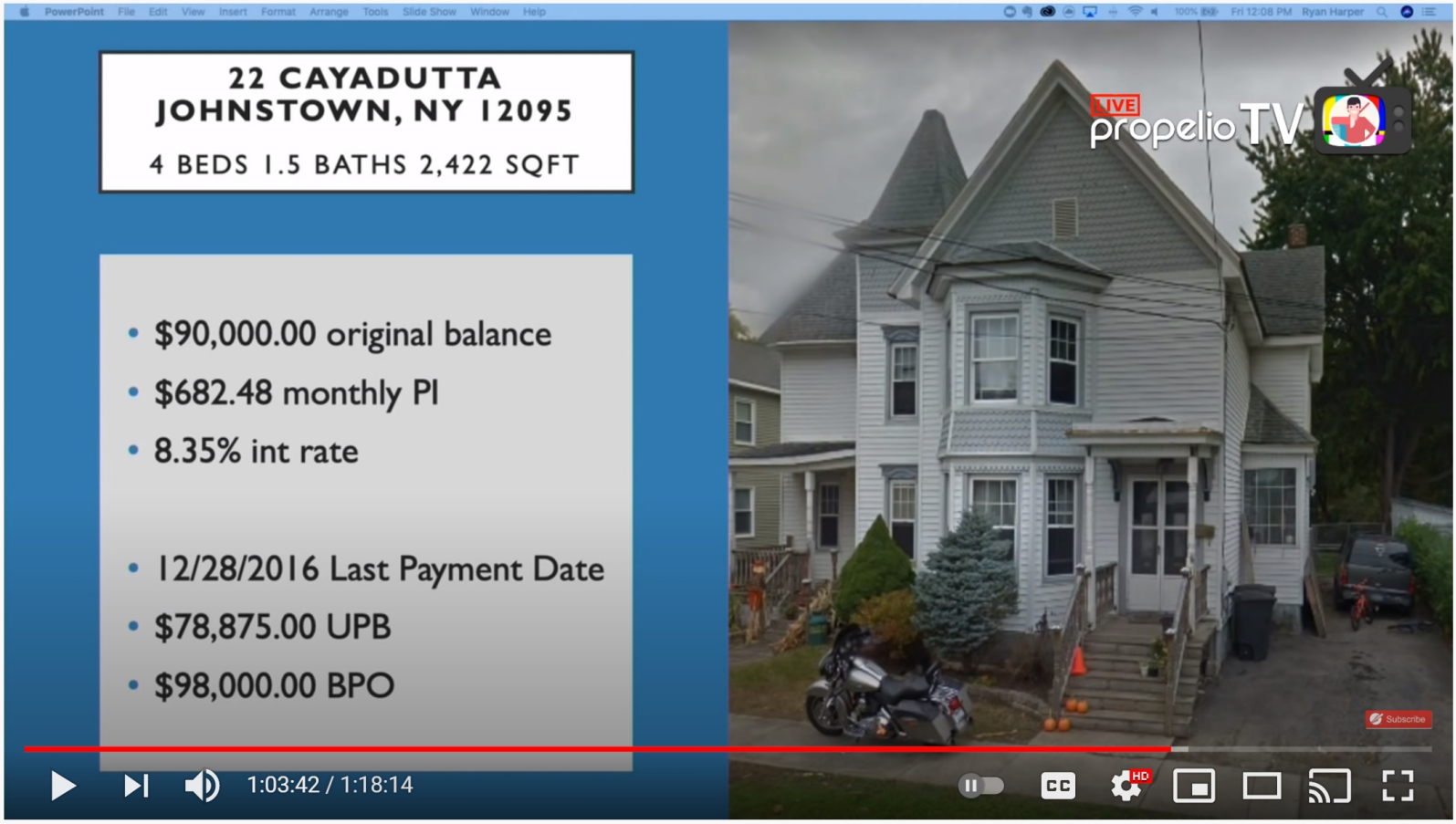

22 CAYADUTTA
JOHNSTOWN, NY 12095
4 BEDS 1.5 BATHS 2,422 SQFT
• $90,000.00 original balance
• $682.48 monthly PI
• 8.35% int rate
• 12/28/2016 Last Payment Date
• $78,875.00 UPB
• $98,000.00 BPO
LIVE
propelio TV
1:03:42 / 1:18:14

PowerPoint File Edit View Insert Format Arrange Tools Slide Show Window Help

22 CAYADUTTA
JOHNSTOWN, NY 12095

4 BEDS 1.5 BATHS 2,422 SQFT

UPB = $78,875

BPO = $98,000

How Much to Offer

60% of UPB = $47,325

50% of BPO = $49,000

Pick the lesser of the two

1:04:26 / 1:18:14

PowerPoint File Edit View Insert Format Arrange Tools Slide Show Window Help

22 CAYADUTTA
JOHNSTOWN, NY 12095

4 BEDS 1.5 BATHS 2,422 SQFT

Purchase Price = $47,325

Loan Modification Strategy

$70,000 Loan Balance

9% int

30 years is $563.24 per month

$6,758.88 per year

14% ROI

1:04:54 / 1:18:14

PowerPoint File Edit View Insert Format Arrange Tools Slide Show Window Help

22 CAYADUTTA
JOHNSTOWN, NY 12095

4 BEDS 1.5 BATHS 2,422 SQFT

Purchase Price = $47,325

BPO = $98,000

Deed in Lieu Strategy

$5,000 Cash For Keys

Total Investment = $52,325

Sell for $80,000

Profit = $27,675

58% ROI

1:07:04 / 1:18:14

D

Dan Smedley 2 years ago

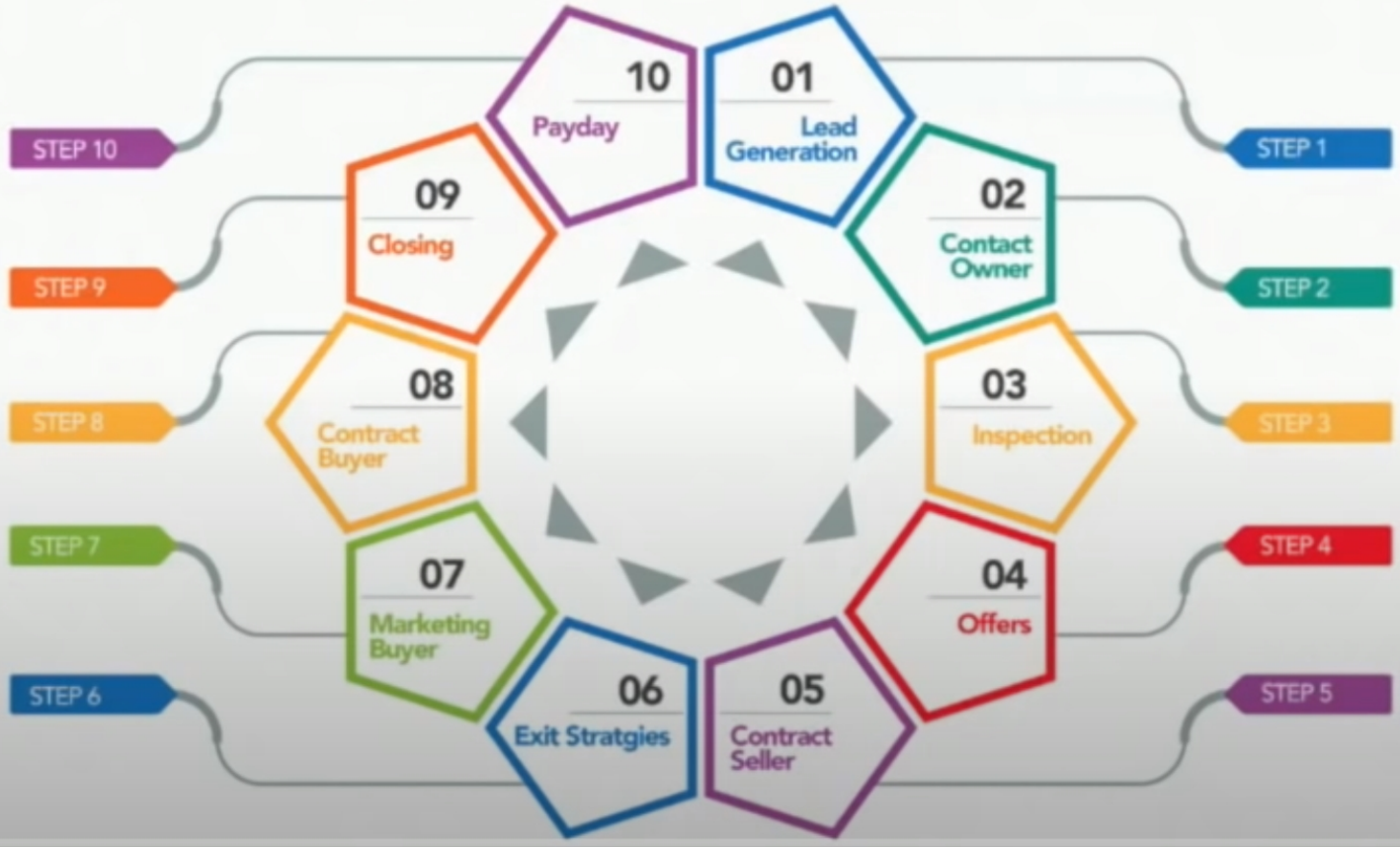
I've been the seller on three seller financed properties, each on ten year notes. I'm now 12 years into it and one out of the three has performed. The only way to get the property back is to initiate a foreclosure. I've been trying to purchase a house since the summer of 2017 and underwriters require some sort of documentation that those payments have been made, because one of my properties is owned by another investor in which he has tenants, he pays my mortgage company directly. This was the worst decision I ever made, to let him pay directly. Yes he's been perfect on payments but to that underwriter, I have a $900 a month liability which destroys my debt to income ratio.

Always use an escrow company to create a paper trail for underwriters.

Show less

10 REPLY

10 Executable Steps



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There are ONLY 5 Real Estate Strategies

Wholesaling

Retailing/Fix and Flip

Lease Options

Seller Financing

Straight Options

3 Financing Techniques

- ✓ All Cash (at a discount)
- ✓ Terms
- ✓ Both Discount & Terms

3 Financing Techniques

It’s very important that you understand all three financing techniques in order to find out seller motivation. Once you have learned all three financing techniques combined with seller motivation, you will profit considerably in the business of Real Estate. If the seller isn’t motivated to sell under these three financing techniques, it’s not a real estate deal that you can profit from. Keep Looking!

Seller Financing

When you seller-finance property from sellers you can buy property without a credit check or applying for a loan. This will allow you to buy as many properties as you can get your hands on.

Reasons Sellers Agree

- They don’t need all cash upfront
- They can’t sell for cash.
- Prevent foreclosure
- Divorce
- Out-of-town owners
- Tired of tenants
- They want a better return on their money than a bank CD
- And many other reasons

Buyer Benefits

- Little to no money down (4 ways)
- Low fixed interest rate
- No bank qualification
- No credit check
- Lower closing costs
- Won’t show up on your credit report
- Easy to sell to another buyer

Profit Centers

- ✓ Down Payment Difference
- ✓ Monthly Payment Difference
- ✓ Sales Price Difference
- ✓ Discounts

Seller-Financing Techniques

- Simple Assumption
- Assumption/Seller Take Back
- Wraparound Mortgage
- Split Funding
- Seller Take Back
- Subordination
- The Friends Cash Flow System
- Substitution Of Collateral
- Land Contract

Wrap-Around Mortgage

Definition:

A **wraparound mortgage**, more commonly known as a "wrap", is a form of secondary financing for the purchase of real property. The seller extends to the buyer a junior **mortgage** which wraps around and exists in addition to any superior **mortgages** already secured by the property.

Wrap Around Agreement Example

This example does not include Taxes and Insurance.

Purchase Price: $125K

$5K Down Payment

Mortgage Wrap: $120K

Mortgage Amount: $120K
Interest Rate: 7%
P&I Payment: $800
Term: 5 Years

Existing Loan

Loan Balance: $100K
Interest Rate: 5%
P&I Payment: $700
20 Years Left

Due On Sale Clause

The due on sale clause is a paragraph in the mortgage or deed of trust which gives the lender the power to call the entire loan due if title is transferred without the lenders permission. This usually requires the buyer to pre-qualify to assume the loan.

Subject - To Existing Financing

Definition: When transferring title to a property encumbered by a mortgage lien without paying off the debt or assuming the note, the buyer is taking title "subject to."

Line 203 of the HUD1 settlement statement reads, "Existing loan(s) taken subject to."

You are promising that you will pay the existing financing.

Step 1 – Lead Generation

Finding deals isn't just about driving around Finding properties, it's finding out the sellers Motivation to sell.

SIGNS OF MOTIVATED SELLERS:

- Behind on Payments
- Tenant Problems
- Divorce
- Health
- Rundown Property
- Job Transfer
- Loss of Job
- Out of State Owner
- Inherited Property

Ways to Find Deals

- Bird Dogs
- Word of Mouth
- Real Estate Agents
- Online Marketing
- Social Media
- Networking, Investment Clubs
- Banks
- Flyers
- Yard Signs
- Courthouse
- Business Cards
- Direct Mail
- Special Reports
- Ask Postal Workers
- Internet
- **Here's a Better Way…**

Traditional Financing

Asking Price: $100,000
After Repaired Value: $180,000
Repairs: $40,000

Bank Loan Terms:
Down Payment: 20% or $20,000
Possible Points up front: 1% - 3%
Interest Rate: 6% - 15%
Term: 1 Year

Seller Financing

Asking Price: $100,000
After Repaired Value: $180,000
Repairs: $40,000

Seller Financing Terms:
Down Payment: $0
(This will save you $20K out of your pocket which you can use for the rehab portion.)
Interest Rate: 0% - 4%
Term: 6-12 Months

Seller starts receiving monthly payments until you rehab and close.

Benefits of Seller Financing

- Less upfront out of pocket expenses
- Doesn't show up on your credit report
- Faster closing with seller
- No contingency on financing
- Lower interest rate
- Lower upfront financing costs/points
- More profitable for owner/interest/payments

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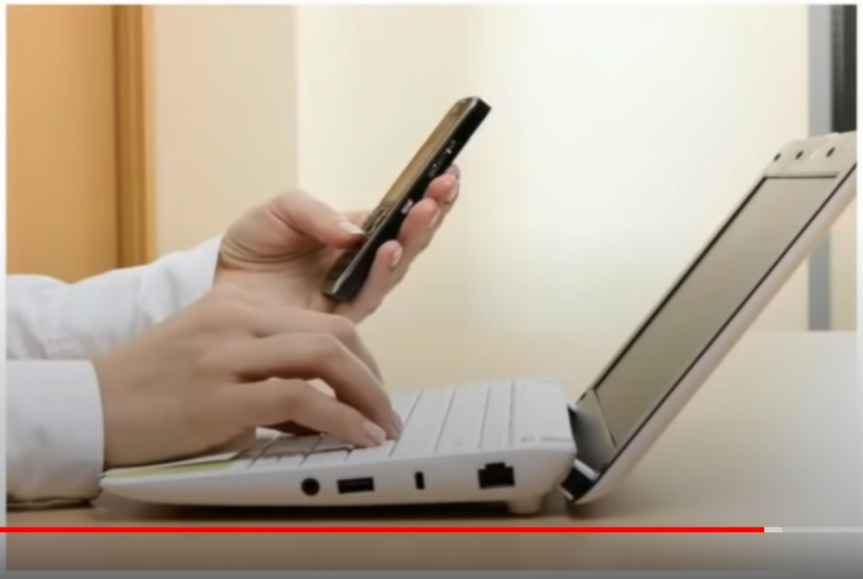
Step 2 – Contact Owner



Step 1 – Research property owner billing address, property details, tax info, transaction history and comparable sales.

Step 2 – Research property owner phone number.

Step 3 – Call property owner or send direct mail. Follow phone scripts in REIPro.

Step 4 – Create a follow up system which should include a 30 day, 60 day and sent letter/postcard.

Subtitl

Pre-Screen Sellers

The name of the game is Information. The Property Research Form will help you gather information from the seller to determine if the property will work for you, and the sellers motivation. Be sure to use the Vacant Phone Script in REIPro when calling.

Step 2 – Negotiating

Negotiating is the process that is an integral part of dealing with people, not restricted to buying and selling. It is managing a situation, beyond merely problem solving, making sure both sides receive the value they need.

1) Know the other sides needs and wants – Ask questions to find out what they want.
   - Sellers – Property Research Form (REIPro Software)
   - Buyers – Buyers Questionnaire Form (REIPro Software)

2) Separate issues from personal feelings – It's negotiating - not life or death.

3) Keep the momentum of the negotiating going.

4) Follow up – don't assume your negotiating worked.

Step 3 – Property Inspection

After speaking with the owner and it looks like this property will meet your criteria, it's time to go and inspect the property using the Property Inspection Sheet.

As you go through the property, write down all repairs that need to be done. Just follow the layout of the form and add any additional information to the back of the Property Inspection Sheet. This will ensure that you didn't miss anything. It's very important that you write everything down because you will be using these numbers to calculate your offer. Go down to your local hardware store to get accurate prices for your Inspection Sheet.

Comparable Sales
Mortgage Amount
Estimated Value
Bedrooms
Transaction History
Tax Value
Bathrooms
Square Footage
Year Built

Establish Property Value

The importance of a good repaired value cannot be stressed enough. Before you can make an intelligent offer, you must have a very good idea of how much you could resell, rent, or option the property for. As the old saying goes, “You make your money when you buy, and you realize your profit when you sell.”

Establish Property Value

The repaired value is the most important number. The entire analysis process is dependent upon this one number.

1) **Appraisal**
2) **Comparable (Comps)**
3) **Current Listings**
4) **FSBO'S**
5) **Internet Sites**

#Flip2Freedom #ExtremeFreedom #WholesaleRealEstate

The Loans You CAN and CAN'T Wrap

All | Real estate investing | Re

DOWN PAYMENT ARBITRAGE

THE LOANS YOU CAN AND CAN NOT WRAP

LOAN YOU CAN NOT WRAP

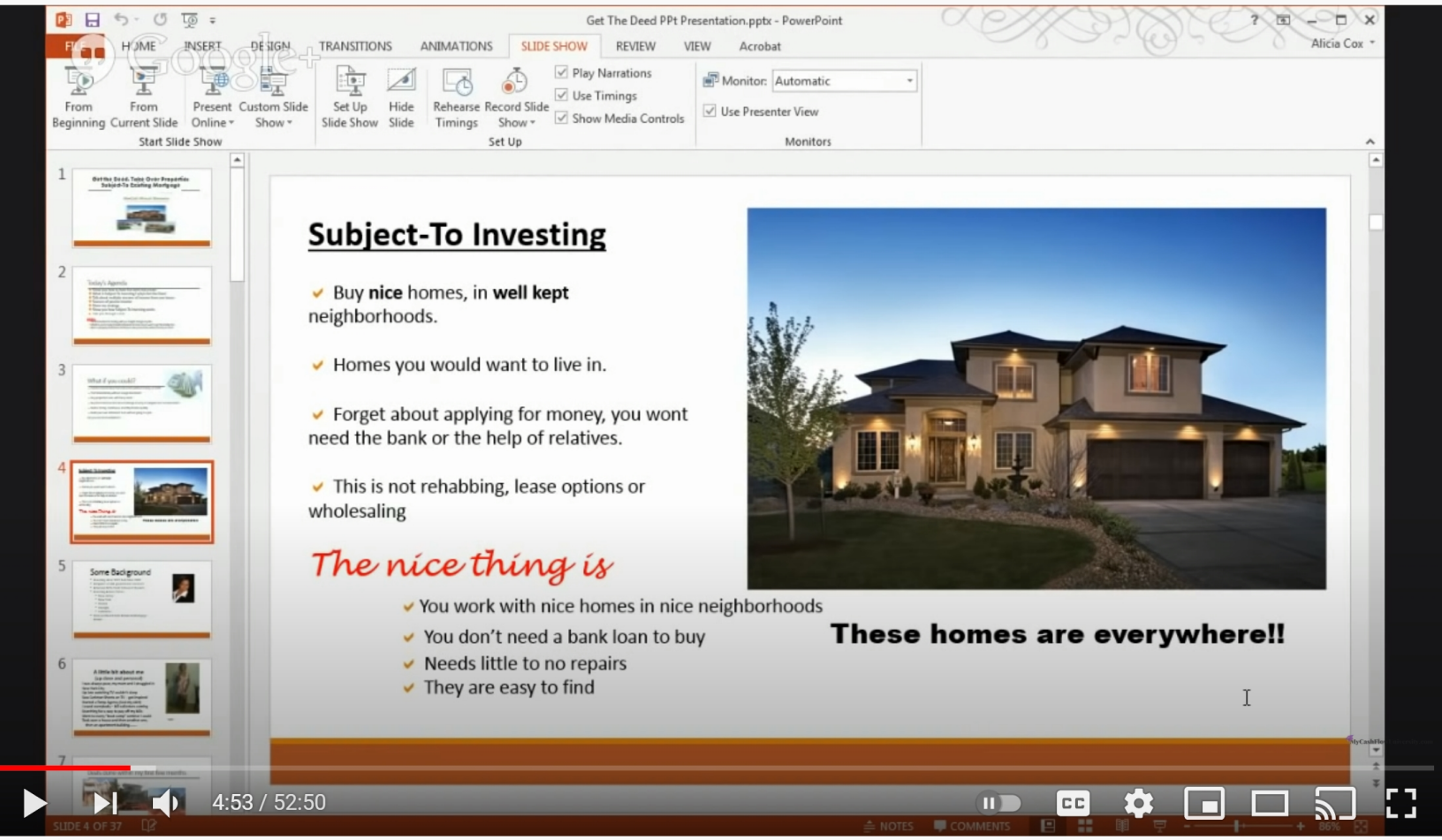
- ✓ FHA Loans
- ✓ Negative Amortizations Loans
- ✓ HELOC: Home Equity Line of Credit
- ✓ USDA Government Loan

DOWN PAYMENT ARBITRAGE

THE LOANS YOU CAN AND CAN NOT WRAP

LOANS YOU CAN WRAP

- ✓ VA Loans
- ✓ Conventional Loan Fixed Rate
- ✓ Interest Only Loans
- ✓ Adjustable Loans
- ✓ Jumbo Loans



ow I Made Over $250,000 Buying Properties Subject-To the Existing Mortgage

3,804 views • Streamed live on May 9, 2015

1.4K 27 SHARE SAVE

Alicia Cox

SUBSCRIBED

Get The Deed PPt Presentation.pptx - PowerPoint

FILE HOME INSERT DESIGN TRANSITIONS ANIMATIONS SLIDE SHOW REVIEW VIEW Acrobat

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From Beginning | From Current Slide | Present Online | Custom Slide Show | Start Slide Show

Set Up Slide Show | Hide Slide | Rehearse Timings | Record Slide Show | Play Narrations | Use Timings | Show Media Controls | Set Up

Monitor: Automatic | Use Presenter View | Monitors

Benefits of Subject-To Investing

- The benefits outweigh the negatives
- Does not involve the use of credit
- Can be done No Money Down
- Generates cash fast!
- No Bank loans needed
- Buy nice homes in nice areas
- Little or no cash required
- Works well if you're bankrupt, have bad credit or you don't have a green card
- No Liability
- Little or no closing costs
- No personal guarantee of loans
- You Own it and can Control it
- You get all the tax benefits
- Profit from appreciation
- You collect all cash flow
- Can refinance and cash out

SLIDE 13 OF 37 NOTES COMMENTS 86%

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Show Media Controls

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Use Presenter View — Monitors

What about the Due on Sale Clause?

- There to protect the lender only
- Most mortgages contain a Due on Sale Clause (DOS)
- The Lender has the right to call the loan due in full in the event title has been transferred
- Bank calls loan mainly when payments stop
- Most Lenders do not call the loan as long as payments are being made.

NOTES COMMENTS 86%

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Start Slide Show | Set Up | Monitors

Is subject-to illegal?

* "Subject-To" is on the HUD-1 Settlement Statement
* Might trigger the due on sale clause but it IS

NOT ILLEGAL!

* Lender can call the loan due
* You have not committed fraud – use disclosures
* You cover yourself (CYA) with disclosures signed by seller

IMPORTANT Make sure you talk to **Real Estate Attorney** when getting **Real Estate** advice

SLIDE 15 OF 37 NOTES COMMENTS 86%

G. Property Location:	H. Settlement Agent:
	Place of Settlement:

J. Summary of Borrower's Transaction		
100. Gross Amount Due from Borrower		
101. Contract sales price		
102. Personal property		
103. Settlement charges to borrower (line 1400)		
104.		
105.		
Adjustment for items paid by seller in advance		
106. City/town taxes	to	
107. County taxes	to	
108. Assessments	to	
109.		
110.		
111.		
112.		
120. Gross Amount Due from Borrower		
200. Amount Paid by or in Behalf of Borrower		
201. Deposit or earnest money		
202. Principal amount of new loan(s)		
203. Existing loan(s) taken subject to		
204.		
205.		
206.		
207.		
208.		
209.		
Adjustments for items unpaid by seller		
210. City/town taxes	to	
211. County taxes	to	
212. Assessments	to	
213.		

K. Summary of Seller's Tran
400. Gross Amount Due to Seller
401. Contract sales price
402. Personal property
403.
404.
405.
Adjustment for items paid by sel
406. City/town taxes
407. County taxes
408. Assessments
409.
410.
411.
412.
420. Gross Amount Due to Seller
500. Reductions in Amount Due
501. Excess deposit (see instructio
502. Settlement charges to seller (l
503. Existing loan(s) taken subject
504. Payoff of first mortgage loan
505. Payoff of second mortgage lo
506.
507.
508.
509.
Adjustments for items unpaid by
510. City/town taxes
511. County taxes
512. Assessments
513.

See Line 203. on HUD-1
Existing loans taken subject to

Why Would Seller Sell Subject-To?

- **Must Be a Motivated Seller**

- Lots of other reasons why people become motivated sellers i.e.,
- Seller is relocating across country – job transfer
- They want to stop making payments and walking away
- Seller bought another home and making 2 mortgage payments
- Seller has personal problems ie Divorce, Bankruptcy, job loss
- Seller downsizing into adult care facility

Why would the seller deed you his property?

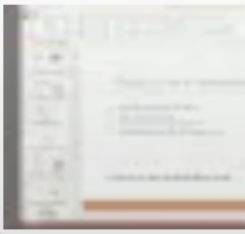
Motivated sellers expect to pay Realty fees when selling.

That's **'if'** the Realtor could even list it.

Sellers would rather sell to you and pay nothing.

This approach relieves the seller's concerns of “when” and “How Much”
Your job is to reduce the seller's stress in selling their home...

That's why they thank you.



49:01

Motivated Sellers are everywhere

New track homes

Luxury properties

FSBO sites

Zillow

Craigslist

Out of State Owners

Pre Foreclosures

Expired MLS Listings

Realtors

How to Get the Deed – Step by Step

1. Find Motivated Seller
2. Have seller sign Authorization to Release Information
3. Call Lender and verify loan balance, loan status and payments
4. Determine if good deal and Make offer for Debt Relief
5. Prepare a contract and disclosures and have seller sign
6. Get title and run deal thru escrow – you're buying SUBJECT TO the existing mortgage
7. Seller goes to settlement agent or you hire a notary.
8. Deal Closed.

Full scree
/ 52:50

Apartment Building Takeover

Would You Buy This?

- For Sale By Owner
- 6 Unit Apartment Bldg
- Deferred maintenance, unruly tenants, state was taking rents, laden with tax liens, owner could not sell

FSBO: $45,000
ARV: $155,000
Mortgage: 0. (Sat not recorded)
Tax Lien: $65,000
Water Lien: $11,000
State Lien: $15,000
Repairs Needed: $60,000

Full scre
/ 52:50

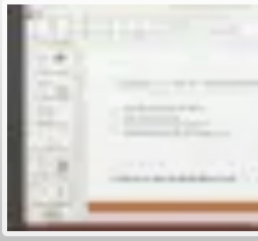
Purchased Subject-To

- Took over deed – Purchased Subject To
- Paid $1,200 for the owner to sign the deed
- Filed the Deed and took pictures
- Negotiated the liens and got some of them reduced
- Water: Reduced
- State: Agreed to wait
- Tax Lien: Wouldn't budge
- Lost the Tenants
- WHOLESALED TO ANOTHER INVESTOR FOR $20,000
- $5,000 Now - $15,000 later

Lancaster, CA 93535

Not Listed
Realtor referral
Market Value: $130,000
Mortgage Bal: $127,000
Int Rate: 7-1/4
Payments: $866.36 P&I - $1,166 PITI
Taxes: $2,600/yr

Purchased Subject To:
Prehab: $500
Foster Care Family - $1,600



49:30

Desert Hawk Drive, East Palmdale, CA

Pre Foreclosure

5 Bedrooms 4 Bath
Mortgages (2): $465,000
Int Rate: 5.25%
Payments: $2,300

Stopped the Foreclosure sale
Negotiated a Loan Mod = New Pymts $986/m
Rented to Section-8 Family = $1,750/m

COULD HAVE:
Created a bigger cash flow with special needs housing
ie Adult Drug Rehab Facility:
2 Beds per Room @ $500 ea = $1,000/room
5 Rooms @ $1,000 = $5000/m

Full screen
/ 52:50

What are the Risks?

TO THE SELLER

Lender could call the loan due

Name and Credit still attached to mortgage

Buyer doesn't make the payments

TO THE BUYER

Lender could call the loan due

Might be other liens against the property

If Buyer does not make payments

The both lose

Full screen

After You Get the Deed

- Contact Homeowner's Insurance company and name yourself additionally insured
- Or Buy a new policy
- Lender must remain the beneficiary
- Contact lender with a special doc to have statements mailed to you.
- Contact Property Tax Dept for changes
- Take title in a land trust or in your LLC

Learn the entire system in one Weekend!!

Full screen
/ 52:50

How to Avoid Due on Sale

Always take title in a land trust

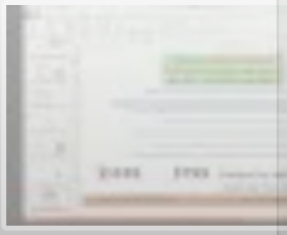
How does this work?

- Property goes into land trust with homeowner as the beneficiary
- Homeowner signs over the beneficial interest to you
- You can be the trustee but I prefer to have my LLC be the trustee
- Trustee controls property and directs all correspondences
- Trustee pays bills, collects payments, sell, rent property

Full scree

Profit Centers...

- Rehab and Flip
- Refinance and get rid of old loan
- Rent out/Lease up
- Sell on owner financing or lease option
- Start a group home / Adult Care Facility (Boucoup de Bucks)
- IN BETWEEN
- Negotiate a short sale
- Negotiate a loan mod



50:31

Your Income Strategy

Create immediate income with Lease Options

- ✓ Buyers who can't qualify for a mortgage right away
- ✓ Previous Bankruptcy
- ✓ Previous Foreclosure
- ✓ First Time Buyers
- ✓ People Relocating to the area
- ✓ Can't qualify for various reasons

Full scre
/ 52:50

Cash Flow

For Example

Took over mortgage balance **$330,000**

Selling price over 2-3 years **$375,000**

Mortgage payment **$1,600**

Incoming Lease Amount **$1850**

Buyer's Option Deposit **$7,500** (2% of selling price)

You collect **$7,500 Now**

$250 x 24 months = **$6,000 During**

$375,000 - $330,000 = **$45,000 Later**

Full scree
/ 52:50

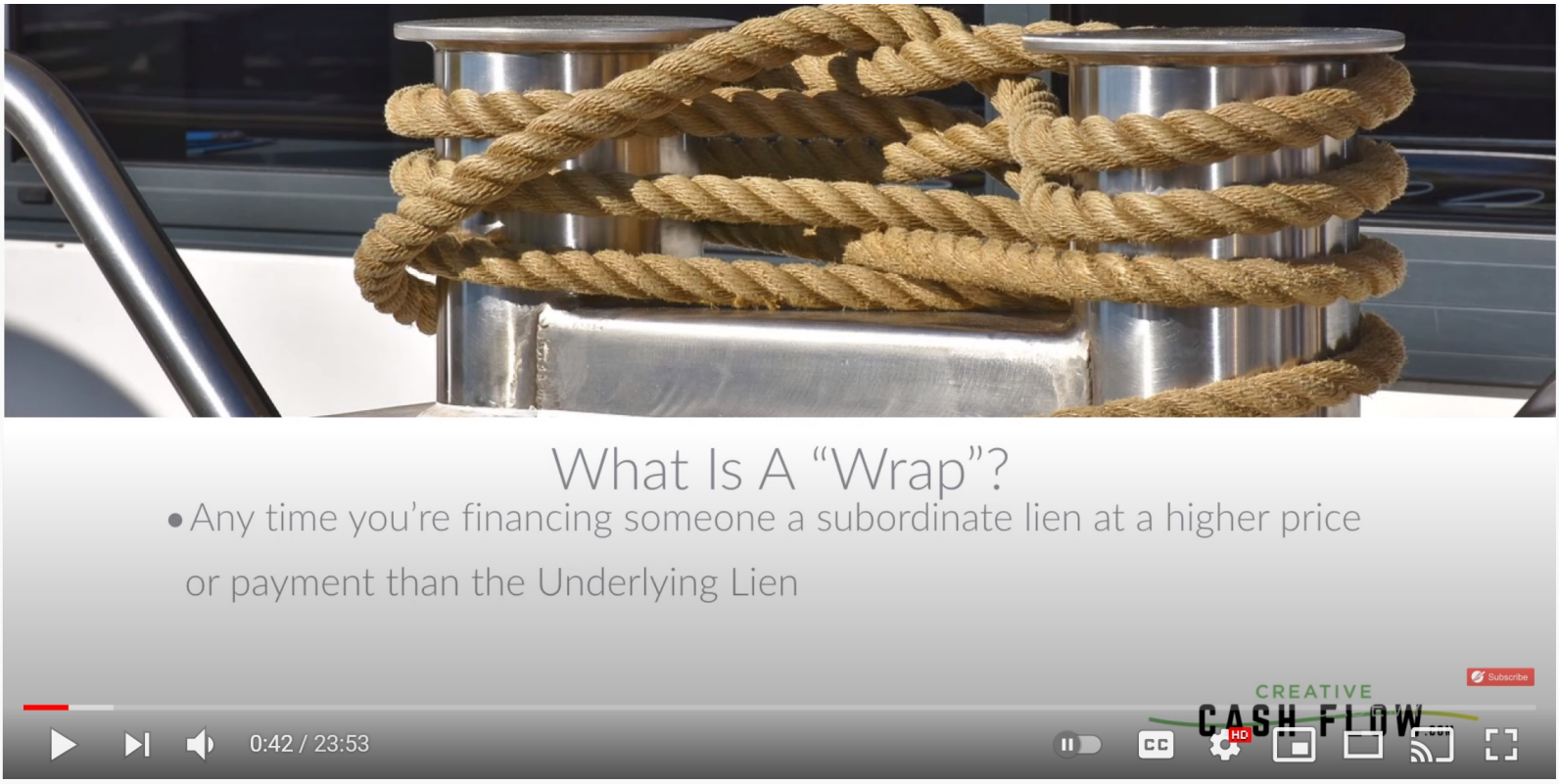
Weekend Class

- Change your investment strategy working with nice houses in nice areas.
- Live in an executive home without qualifying
- Create monthly cash flow and replace your salary
- Create a business using houses you take over
- Take over and get the deed to any property
- Pay full retail price and still make a profit
- Start collecting payments and stop making them

Get the Deed Boot Camp!

Take the "Get the Deed" Class **Reserve your Seat (909) 552-7005 X 1001**

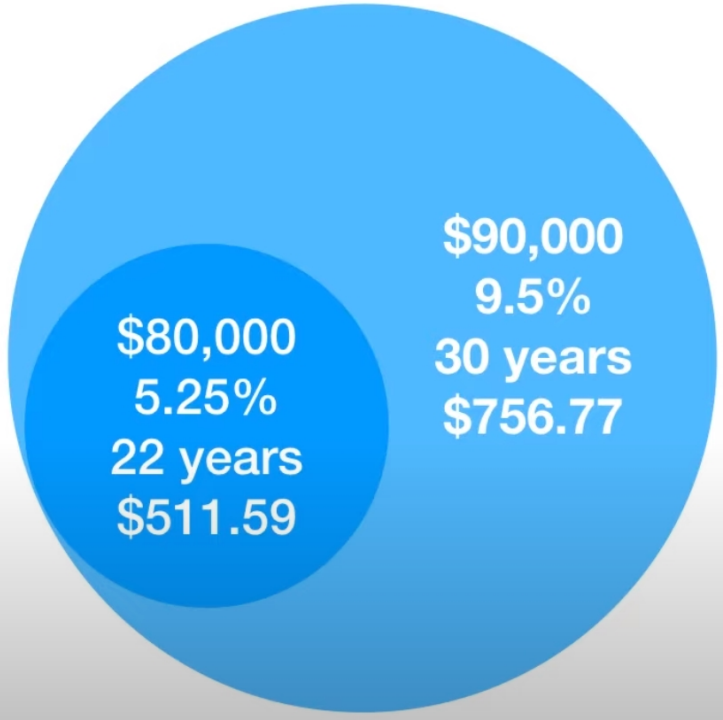
Full scre
/ 52:50



Wrap Around Mortgages | Make Money w/ Subject To & Wraps

Any Debt Qualifies

Sub2, Bank, Private, Etc...



CREATIVE
CASH FL

Sale Strategy

- Sell with wraps
- Buy with sub2

4:10 / 23:53

CREATIVE CASH FLOW

Situation:

Home Worth $100,000

Seller Requires $90k
on the contract

Seller Owes
$60,000
3%
180 months
$414.35

5:12 / 23:53
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CREATIVE CASH FLOW

Why Do I Have Different Payments

UL= $60,000 @ 3%, 180 Months (Pmt: $414.35)

Option 1

$90,000 Contract Price

180 Month Payoff

Total Payment: $759.47

Wrap Lien to seller:
90k @ 6%, 180 $759.47/mo

Option 2

$90,000 Contract Price

180 Month Payoff

Total Payment: $667.51

Sub2 the UL:
$60k @ 3%, 180 $414.35/mo

2nd Lien to seller:
30k @ 6%, 180 $253.16/mo

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CREATIVE CASH FLOW
7:23 / 23:53

Why Do I Have Different Payments

UL= $60,000 @ 3%, 180 Months (Pmt: $414.35)

Option 1

$90,000 Contract Price

180 Month Payoff

Total Payment: $759.47

Wrap Lien to seller:
90k @ 6%, 180 $759.47/mo

$60,000
3%
180 months
$414.35

($91.96)

$345.12

$90,000
6%
180 months
$759.47

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CREATIVE CASH FLOW
8:32 / 23:53

UL= $60,000 @ 3%, 180 Months (Pmt: $414.35)

2nd Lien

$30,000
6%
180 months
$253.16

$60,000
3%
180 months
$414.35

$667.51

Option 2
$90,000 Contract Price
180 Month Payoff
Total Payment: $667.51

Sub2 the UL:
$60k @ 3%, 180 $414.35/mo

2nd Lien to seller:
30k @ 6%, 180 $253.16/mo

CREATIVE CASH FLOW.COM

10:38 / 23:53

Why Do I Have Different Payments

UL= $60,000 @ 3%, 180 Months (Pmt: $414.35)

Option 1			Option 2
$90,000 Contract Price	$759.47	$667.51	$90,000 Contract Price
180 Month Payoff	X 180	X 180	180 Month Payoff
Total Payment: $759.47	$136,704.60	$120,151.80	Total Payment: $667.51
Wrap Lien to seller: 90k @ 6%, 180 $759.47/mo	$46,704.86 Total Interest	$14,582.78+$15,567.87= $30,150.65 Total Interest	Sub2 the UL: $60k @ 3%, 180 $414.35/mo
			2nd Lien to seller: 30k @ 6%, 180 $253.16/mo

11:32 / 23:53
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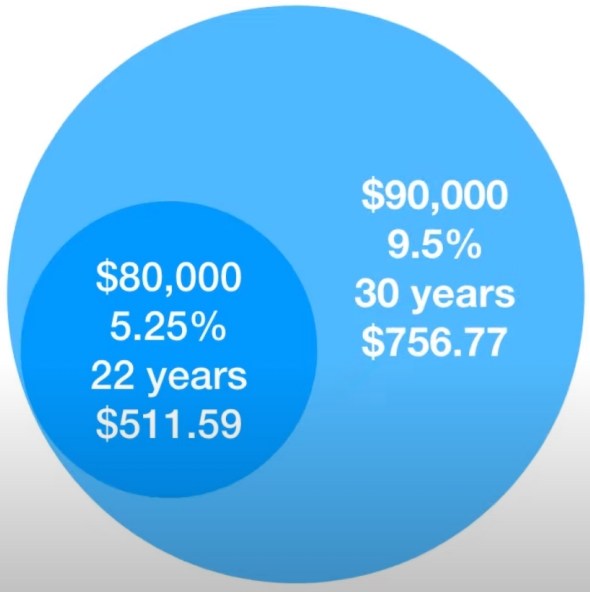
CREATIVE CASH FLOW

Any Debt Qualifies

Sub2, Bank, Private, Etc…



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CREATIVE CASH FLOW
13:28 / 23:53

22 Years
$80,000 @ 5.25%
$511.59 PI

Underlying Lien

30 years
$100,000
$10,000 DP
9.5%
$756.77 PI

14:26 / 23:53
CREATIVE CASH FLOW

30 years
$100,000
$10,000 DP
9.5%
$756.77 PI

22 Years
$80,000 @ 5.25%
$511.59 PI

$245.18 Cashflow!

CREATIVE CASH FLOW
14:48 / 23:53

22 Years
$80,000 @ 5.25%
$511.59 PI

$245.18 Cashflow!

$756.77/mo
for 8 years!

$64,727.52

$72,649.92

30 years
$100,000
$10,000 DP
9.5%
$756.77 PI

15:49 / 23:53
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CREATIVE CASH FLOW

$64,727
Cashflow With UL
$142,377
Net Income
$72,649
Free & Clear Cashflow
$7,000
Down Payment Net
16:10 / 23:53
CREATIVE
CASH FLOW

Principal Over Interest

- Prefer principal over interest
- Our world is dictated by payments

18:39 / 23:53

CREATIVE CASH FLOW

Principal Over Interest

- Prefer principal over interest
- Our world is dictated by payments
  - $90,000.00 @ 6%, 360=$539.60
  - $64,172.30 @ 9%, 360=$539.60

19:05 / 23:53

CREA
CASH

Larger Interest On UL Is OK
• $64,172.30 @ 9.5%, 360=$539.60
• $90,000.00 @ 9.0%, 360=$724.16
21:01 / 23:53
CREATIVE
CASH FLOW
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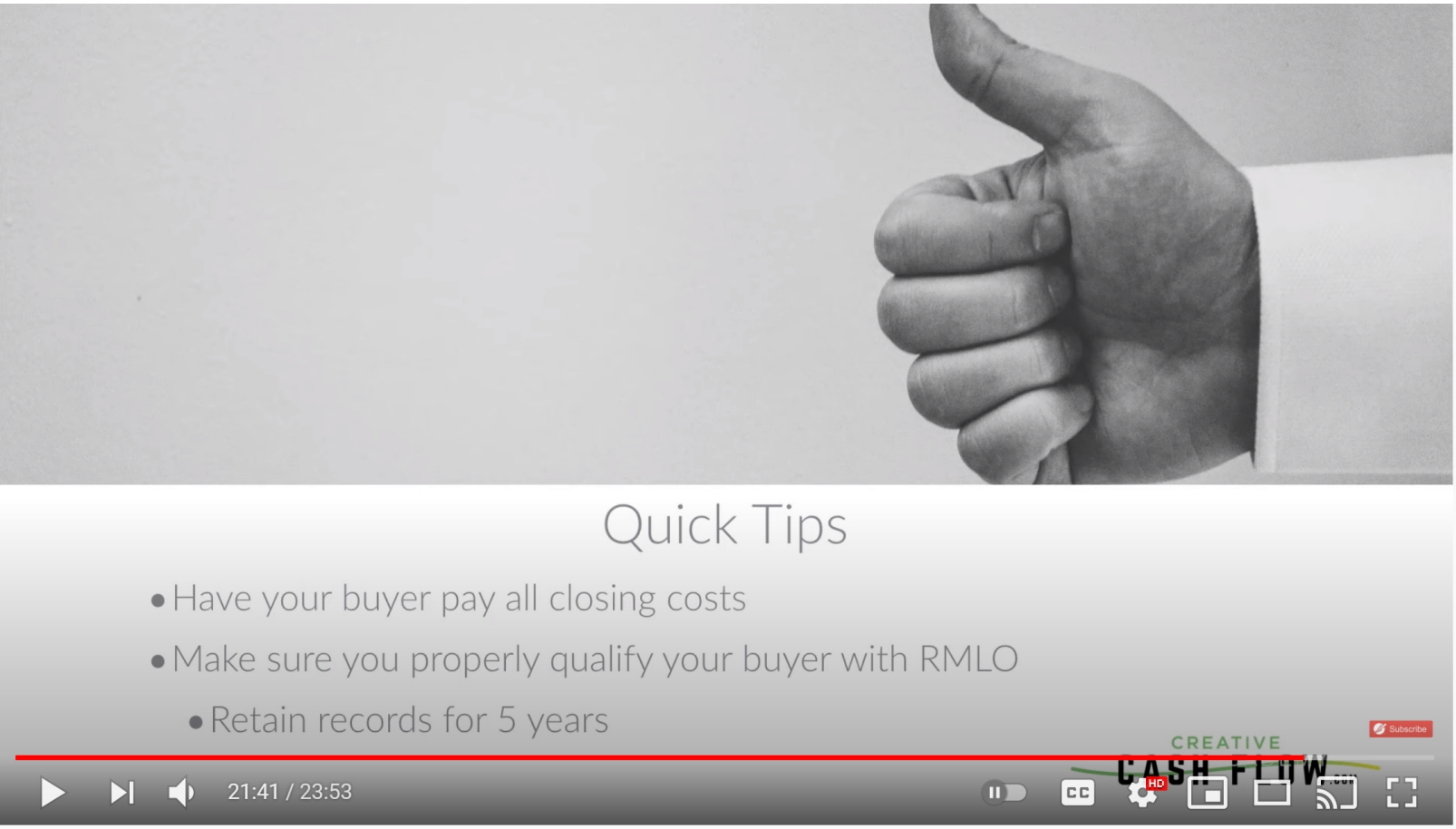
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• Have your buyer pay all closing costs
• Make sure you properly qualify your buyer with RMLO
• Retain records for 5 years
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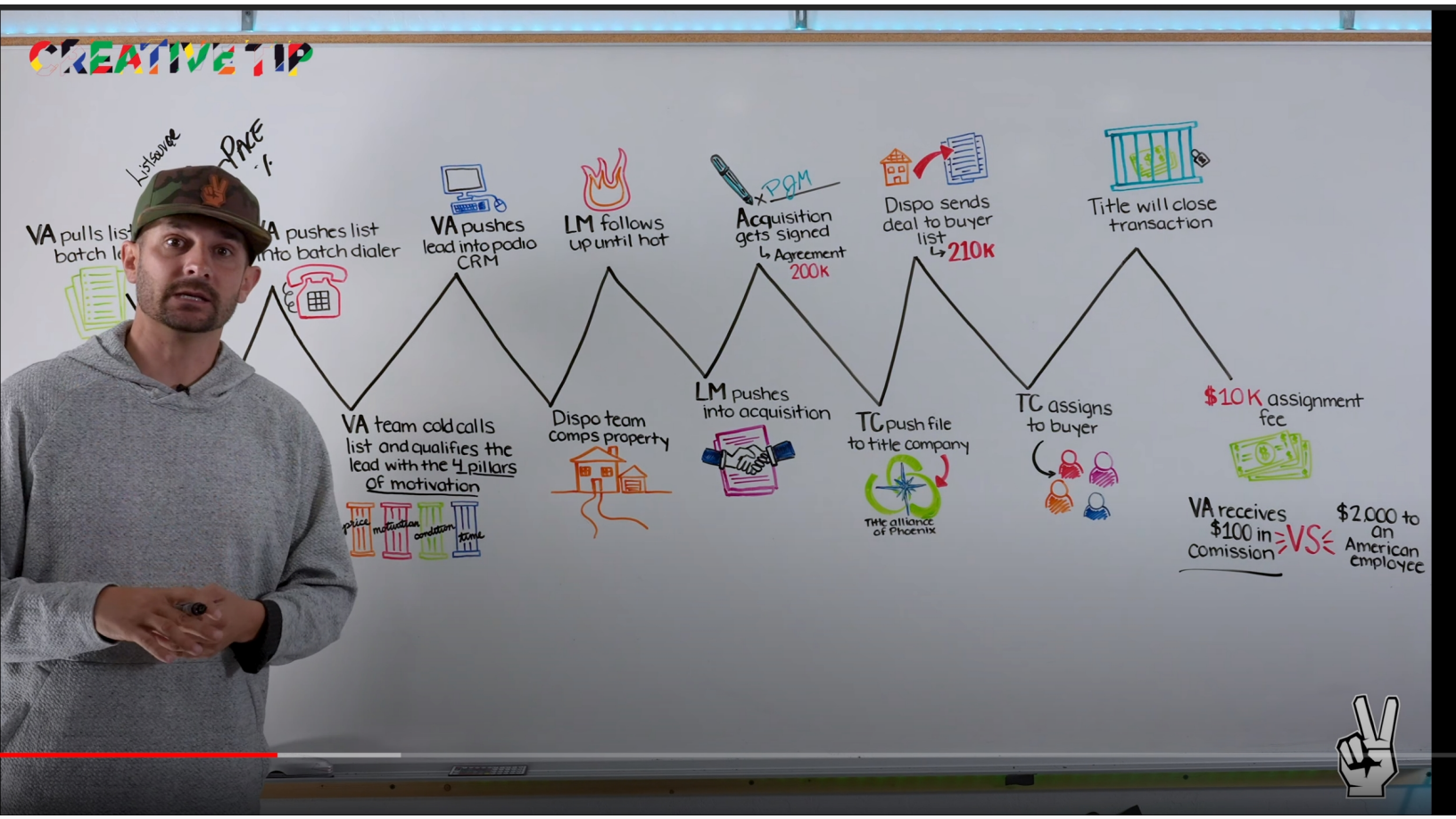
CREATIVE TIP
VA pulls list batch
VA pushes list into batch dialer
VA pushes lead into podio CRM
LM follows up until hot
Acquisition gets signed
Agreement 200K
Dispo sends deal to buyer list
210K
Title will close transaction
VA team cold calls list and qualifies the lead with the 4 pillars of motivation
price
motivation
condition
time
Dispo team comps property
LM pushes into acquisition
TC push file to title company
The alliance of Phoenix
TC assigns to buyer
$10K assignment fee
VA receives $100 in comission
VS
$2,000 to an American employee

ACCESS TO PROPERTY:

"If Property is currently occupied, Seller agrees to give Buyer access to property with 24 hour notice. If Property is currently vacant, Seller agrees to give buyer unrestricted access via a contractor lockbox."

9:52 / 13:42

#FlippingHouses #WholesalingHouses #MakeMoneyInRealEstate

How To Make A Cash Offer On A House Listed With A Real Estate Agent

All | Flipping houses | Rela

5-Step Guide
Wholesale No-Assignment Contracts Using LLCs

- Step 1: Form A Single Member LLC
- Step 2: New LLC is Buyer On The Contract
- Step 3: Find A Cash Buyer
- **Step 4: Execute LLC Membership Purchase Agreement**

6:59 / 12:09

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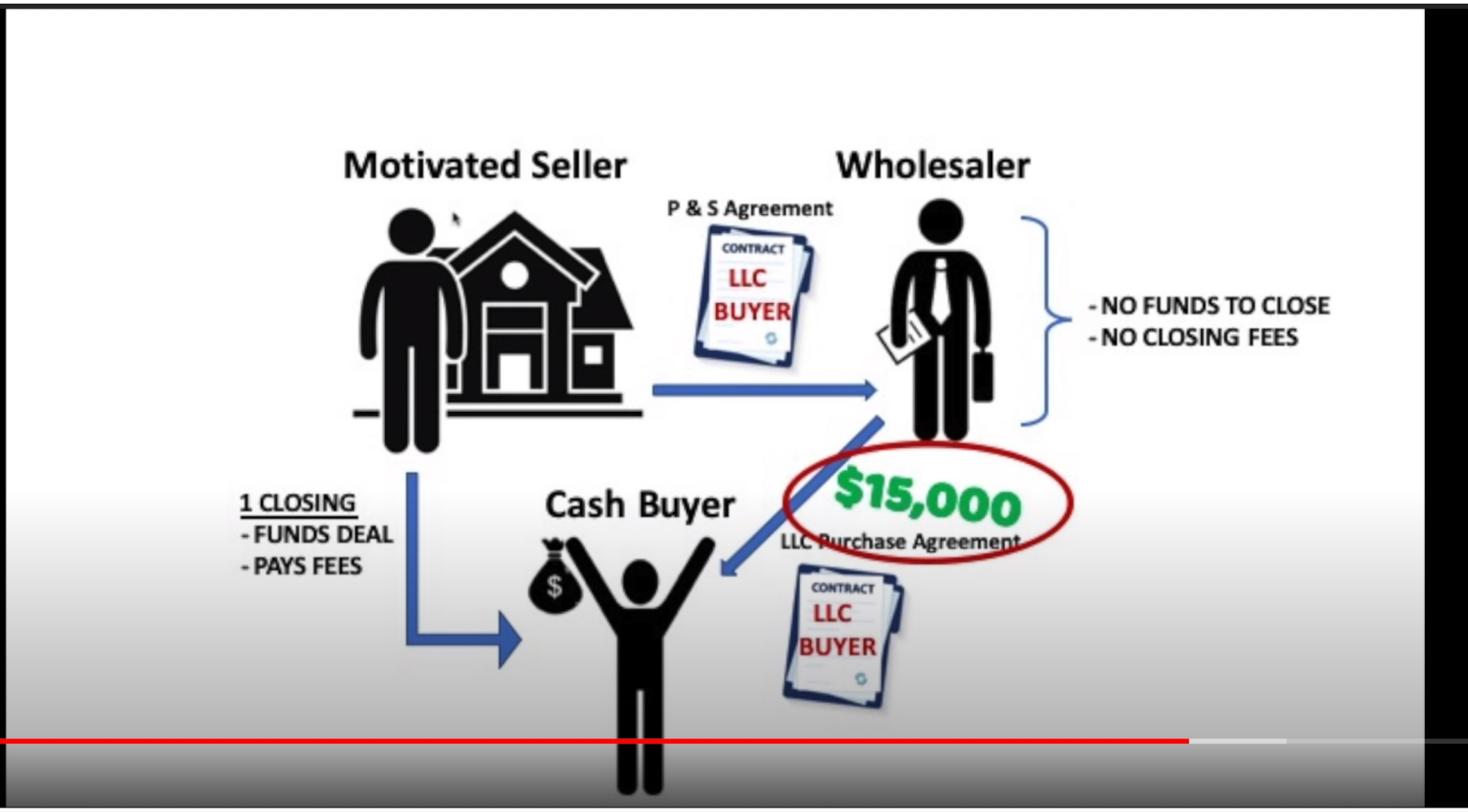
How To Wholesale - When The Contract Clearly Says You Cant!

All

Real estate inves

5-Step Guide
Wholesale No-Assignment Contracts Using LLCs

- Step 1: Form A Single Member LLC
- Step 2: New LLC is Buyer On The Contract
- Step 3: Find A Cash Buyer
- Step 4: Execute LLC Membership Purchase Agreement
- **Step 5: Transfer of LLC Membership**


Motivated Seller
Wholesaler
P & S Agreement
CONTRACT
LLC
BUYER
- NO FUNDS TO CLOSE
- NO CLOSING FEES
1 CLOSING
- FUNDS DEAL
- PAYS FEES
Cash Buyer
$15,000
LLC Purchase Agreement
CONTRACT
LLC
BUYER

What are we focusing on in this Class

- Late payments
- Notice of defaults
- ~~Auctions~~
- ~~REOs~~

SELLING THE LLC TO YOUR CASH BUYER SCRIPT

"Mr. Cash Buyer, because the original contract with the seller has a "no assignment clause," here is how I'd like to do this transaction to avoid having to do 2 closings. I set up a Single Member LLC named _____ (Jerry is a Flipping Genius, LLC), which is the buyer on the executed contract with the seller. I am going to sell you 100% interest in that LLC so you become the new Sole Member. Then on the day of closing, you step in and close directly with the seller. Here's how it works…I have a LLC Membership Purchase Agreement that we sign right now with a copy of my executed purchase contract with the seller. You will give me a deposit of $____ ($5,000) now and the balance of $_____($10,000) on the day of closing. Just prior to closing, we'll sign a Transfer of Membership Interest, where you officially become the new 100% Sole Member of the LLC. I'll also give you an Operating Agreement, which you'll need for the closing. At that point you close directly with the seller."

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Investing in Real Estate with Lease Options and "Subject-To" Deals

Powerful Strategies for
Getting More When You Sell,
and **Paying Less** When You Buy

WENDY PATTON

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Powerful Strategies for
Getting More When You Sell,
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WENDY PATTON

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This book is dedicated to my mother who, in 1985, got me started in real estate investing by giving me my first real estate course. It was her belief that real estate investing was the true way to financial freedom that led me to discover my future direction in life. She believed in me.

I want to thank my husband, Michael, and my children, Brooke, James, Jacob, Rachel, and Sarah, for sacrificing without me during the time I was writing this book and especially during the many times over the years that I was buying and selling real estate. Brooke and James, my twins, were with me through hundreds of homes, when I was a single mother. Their patience was worth its weight in gold!

I want to thank my sister, Jenny, who helped me with most of the editing of my book—for the many long hours she spent. Also, many thanks to Ron Cazier, Scott Teerink, John Hyre, Veronica Johnstone, Kris Mezsets, Amie Leszczynski, and Lyle Reichenbach, for your help in editing and offering your expertise in different sections. I could not have done it without you.

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CONTENTS

INTRODUCTION Lease Options—Anyone Can Do It! vii

PART 1
AN INTRODUCTION TO LEASE OPTIONS AND SUBJECT-TO DEALS

CHAPTER 1 How Lease Options and Subject-Tos Work and How They Can Set You Up for Future Financial Freedom (FX3) 3

CHAPTER 2 Success Stories of Buying on Subject-Tos and Lease Options 18

PART 2
STEPS TO BUYING PROPERTIES ON LEASE OPTIONS AND SUBJECT-TO DEALS

CHAPTER 3 Finding Motivated Sellers for Lease Options and Subject-Tos 31

CHAPTER 4 Lease Options versus Subject-Tos: Choosing the Right Technique for the Right Situation 44

CHAPTER 5 Evaluating the Profitability of the Deal 61

CHAPTER 6 Negotiating the Deal: Steps to Buying on Lease Options and Subject-Tos 76

CHAPTER 7 Getting the Paperwork Ready for a Lease Option Deal 95

CHAPTER 8 Getting the Paperwork Ready for a Subject-To Deal 110

CHAPTER 9 Advanced Concepts and Strategies for Buying on Lease Options and Subject-Tos 120

PART 3
HOW TO GET REALTORS TO HELP YOU DO LEASE OPTIONS

CHAPTER 10	Building Rapport and Sharing Lease Options with Realtors	135
CHAPTER 11	Closing Deals with Realtors	150

PART 4
STEPS TO SELLING PROPERTIES ON LEASE OPTIONS

CHAPTER 12	Finding and Qualifying a Good Tenant-Buyer	161
CHAPTER 13	Getting the Paperwork Ready for the Tenant-Buyer	175
CHAPTER 14	Managing the Property and the Tenant-Buyer	195
CHAPTER 15	Closing: The Big Payday	207
CHAPTER 16	Advanced Concepts and Strategies for Selling on Lease Options	212

PART 5
CREATING FUTURE FINANCIAL FREEDOM—FX3

CHAPTER 17	Business Organization for Lease Option and Subject-To Investments	221
CHAPTER 18	Where to Go from Here: A Step-by-Step Action Plan	232
GLOSSARY		245
RESOURCES		251
INDEX		253

INTRODUCTION

Lease Options—Anyone Can Do It!

Fourteen-year-old John, with his father, attended a seminar that I spoke at in Houston. During one segment of my presentation I usually teach the students how to call sellers directly out of the newspaper. When I teach this part of the class I often make live calls to sellers so that my students can hear how I speak with the seller and how I gather information to determine whether their home is a potential candidate for a lease option. On this day, however, I didn't make any calls—we simply talked about the best techniques for calling leads.

The next day, while John was in school, he began circling the "For Rent" ads. After school he started making calls—with no caller training—and he got a seller lead for a lease option who said, "Yes, I'd like to consider it." However, being only 14 and having no experience, he couldn't and didn't know how to enter into a legal contract. He asked his father, "What do I do?"

John ended up selling the deal to another investor in their local investment group for $500. He gave me a copy of his $500 check. Not bad for a 14-year-old kid and one to two hours of work. John immediately went on to develop a relationship with this local investor, and on his next deal (while still 14!) made 50 percent—$14,000—of profit for his assistance in the deal. He has since done additional deals for much higher profits.

How and why can a 14-year-old kid do this when most adults would not? Fear! I believe that we all have fear of failure and/or fear of success. At 14, he was not afraid of failure. He just applied what he learned and tried it.

You are never too old or too young to start investing. If you can

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do the research and pick up the phone to make the calls, you are on your way. However, many of us stop before we even get started because of our fear. We might have excuses like, "I can't possibly do that. It's a young person's game. It's an older person's game. No one will say 'yes' to me. I have no experience. I don't have a good voice. I don't have money. I don't have good credit." All are negative talk and incorrect statements.

What's going to make you successful in lease optioning or subject-tos is just taking the plunge. You'll make some mistakes along the way, but so what? What's the worst thing that can happen?

John wasn't hampered by fear and so was able to jump in, take the plunge, and make things happen—setting his financial future in motion. His example does not involve a huge amount of money, but it's nothing to sneeze at—it is a fantastic amount for most people and extraordinary for a 14-year-old. The money is important not only because John now can pay for college, but now he also has choices. If he continues on his path in real estate investing, he will have the chance to be independent and work for his own interests, unlike most of his friends. Choices imply options, including personal and financial freedom!

For me, the most exciting facet of real estate investing is Future Financial Freedom—or, as I call it, FX3. Everyone has a different definition of freedom; for some it is financial, for others it means having more control over their time. Let me have one of my boot camp students explain this in their own words to you:

> *Dear Wendy,*
>
> *Our financial future has literally changed within the past couple of months by applying what my husband and I learned from your boot camp and, even more importantly, what we've learned from your ongoing, personalized support—you truly are the best! Keep in mind, my husband thought that I was crazy when I signed us up for your boot camp and flew up from Florida to Michigan to hear you speak. It truly was the best thing we have ever done. Please share my personal testimonial with your classes. I'm a believer, this does work!*
>
> *First off, I have to mention that when we attended your seminar, we had just completed a 1031 exchange, which gave us the great opportunity to start our investing career by buying three houses. Yes, it was so great having three houses sit-*

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ting empty and one with a renter that lived off of us for free! This renter was so nice she gave a whole room to her pet rabbits to roam freely in, after we had just rehabbed the house!

During your boot camp we had a wonderful gathering at your house, in which my name was drawn to purchase a house on a lease option. I jumped for joy like I had just won a prize. The next day, after the [beer] wore off, I figured out what I had just committed to—a house that is 1,000 miles away, where it actually snows, the pipes freeze, and they have things called basements! Yes, being from Florida, this is just what I've always wanted—not*!*

We were up for the challenge, and you made it so easy with your support, along with the great contacts and help that we had from others who attended the boot camp. Not only did we get a great purchase price and terms with the owner, but today we have a pending contract for a lease option that will cash-flow us $600 a month, and at the end of the 18- to 24-month term we will profit $107,400! Gosh, I guess that will cover the cost of the class—truly amazing*!*

When we came home from your class we decided "no more renters." We booted the bad renter out (and no, we didn't keep the rabbits!) and sold all of our houses on lease options. So on our three houses that had been sitting empty, we now cash-flow $700 monthly and we will profit within 18 to 24 months, $227,900!

Now comes the best part. I finally put your class to the test. I went out and found an owner who was willing to do a lease option with me. Every realtor I spoke to (and many investors as well) told me no one in their right mind will do a lease option with you in this market. The Florida market is way too hot. They are right, it is hot. Appreciation in some of our areas is anywhere from 34 to 40 percent.

But I got a gorgeous house that looks brand new, on a lease option. I also got a killer deal on the rent at $950 a month—normal rent would be $1,425! I put $5,000 down, which will come off the purchase price. They were asking $200,000 and it's worth $239,000, so I offered them $210,000. The terms are 14 months, enough time to refinance it if I have to. My new tenants bought it on an 18-month term. We will

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cash-flow on a monthly basis $845 ($500 of that will be applied towards the purchase price), and we are selling it for $299,900. That is a profit of $89,900. Amazing—is this for real? I've since quit my job and I'm doing this full time. Thank you again, Wendy, for changing our lives!

Debra and Eric Larson

Why I Chose Real Estate

Deal making may just be in my blood. I've always loved a deal, and the day I realized that real estate investing was that kind of game was the most important day of my life. My first house was a three-bedroom bungalow in a suburb of Detroit. My principal, interest, taxes and insurance (PITI) was $438. I rented two bedrooms to two girls for $250 each. (By the way, both women are very good friends of mine to this day.) I had cash flow and I was living free! My $62 cash flow per month paid my credit card payment. I was 21 years old and I thought this was pretty cool! So I decided to do it again. I did it three more times that first year. I had no money or assets, but I did have good credit.

At the start of my real estate investing career, I was $20,000 in debt with student loans. In my mind, the worst thing that could have happened was that I would go bankrupt. However, I had good credit and was able to make my down payments on homes with credit cards. It wasn't long before I had a credit line of over $250,000—and too many credit cards. Using credit cards should be the last resort for most investors, as I lost a lot of profit by having huge revolving credit card debt—even though I faithfully made payments on all of them and somehow juggled them so that no payment ever slipped through the cracks. It was, however, an administrative nightmare. Still, I couldn't focus on that. I had to focus on what was the best that could happen: I could end up with *freedom* and *choices*!

When I started investing, I didn't know about lease options or subject-to deals, and I thought what I did was a zero-down deal and something very creative. I didn't know of any gurus at the time who focused on buying on lease options, so I developed my own tools and systems to buy homes with little or no money down, using the same techniques I was using to sell. I have since purchased almost every course available in the market on lease options, and learned extra tid-

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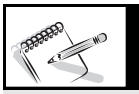
bits from them all to add to how I do my business. I am the only national educator in the country who teaches people how to work with Realtors to find these types of zero-down deals. Over the years I have fine-tuned the techniques that really work. I have completed hundreds of lease option contracts.

I have bought and sold over 600 properties since becoming an investor in 1985. I have had as many as 175 properties in inventory at one time. My current and longer-term goal is to downsize to have 30 in inventory, not including partnerships with students around the country. I have invested in several states and continue to look for new opportunities throughout the country and possibly internationally.

Whether we leave a job to pursue our own dreams of becoming a baker, a pilot, an artist, or a Realtor, we all have the same concerns and fears about starting out in a new business venture where we have to rely on our own efforts to make a payday. The first couple of years can be rough. It takes a while to pay your dues in any new skill—and dealing in real estate is a skill. But real estate not only has immediate profits through lease options, it can also automatically provide investment income by the very nature of appreciation. This appreciation factor isn't built into most other self-employment situations. Real estate builds a tangible future that can set you up for life if you have the passion and the drive to dig in and overcome your fears of trying something new.



Wendy's Advice on When to Leave Your J.O.B. (Just Over Broke)

If you want to pursue real estate investing, and in particular lease options or subject-tos, I don't advise quitting your job and starting with nothing. Instead, I offer two pieces of advice:

1. It is best to start this business while you are still employed at your current job so that you won't have to worry about receiving a paycheck while you are learning the business.
2. Begin to build a second income that can eventually replace your primary income when you are ready to leave your job.

Too many people leave their jobs too early, only to find out they have to go back or can't survive without the income. Don't make that mistake.

INTRODUCTION

I am so glad I pursued my dreams in real estate many years ago. When I left corporate America in the mid-1990s to pursue real estate full time, it was the best career move I had ever made. It has given me financial freedom. Do you want to be free? Real estate can give you Future Financial Freedom (FX3) too!

This book shares my secrets and strategies with you. I suggest you try them all and decide what works best for your personal style and your specific area of the country. As you find your niche, you will perfect it. Real estate investing changed my life and it can change yours, too. May lease options, subject-tos, and zero-down strategies change the way you think and help you live out your dreams so that you may have all the choices and freedom you desire!

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PART I

AN INTRODUCTION TO LEASE OPTIONS AND SUBJECT-TO DEALS

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CHAPTER 1

How Lease Options and Subject-Tos Work and How They Can Set You Up for Future Financial Freedom (FX3)

What Are Lease Options and Subject-Tos?

Lease options and subject-tos are ways to purchase real estate, usually with very little or no money down, sometimes even with money back in the investor's pocket. Sound too good to be true? Well, it isn't. Can an investor end up with money in his pocket and not have to put 10 to 20 percent down to purchase real estate? Yes. These techniques are used commonly today by successful investors. This book will show you how to find motivated sellers and homes that you can purchase with little or no money down—truly the fastest way to Future Financial Freedom (FX3).

A lease option is a strategy that gives an investor the right to lease a home and also the right to purchase the home during or before the end of the lease period. An *option* is a contract that gives its purchaser the right to exercise a privilege. In the case of real estate investing, it gives the investor the right to purchase property during a contracted period of time. It is a technique that involves gaining control of a property without the added burdens of ownership. All money made in real estate is made by controlling property. Owning property is the most obvious way to control it, but control is possible without

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ownership—and control is what brings in the money. It was a dying John D. Rockefeller who shared his secret to achieving great wealth: "Control everything, own nothing." All of the most successful real estate developers today utilize options.

A subject-to is a technique by which the investor gains the title to a property but doesn't have to get a mortgage on the property he is about to control. The seller keeps the mortgage in his own name but deeds the property to the investor. It is deeded to a new owner "subject to" the existing mortgage, which stays in place with this technique. The mortgage company isn't usually made aware of the change or asked about the change. The new owner just starts making the payments on the old owner's loan.

It is important to be aware that there are some risks involved with either technique, and I cover these risks later in the book to help you minimize your exposure. The rewards that can come with either of these techniques far outweigh the risks, as long as you keep aware of all the factors involved. Real estate investing is perhaps the quickest and best way to build lasting wealth. Many of the world's wealthiest people acquire much of their wealth through investing in real estate.

While lease options and subject-tos can build you tremendous wealth, they usually shouldn't be considered a short-term investment strategy. I define a short-term strategy as one in which the time between the start of the transaction and its completion (cashing out) is less than one year. A classic example of this would be a rehabbing project (fixing up a home and reselling it). The other end of the spectrum would be a long-term strategy, such as buying a rental property and renting it over many years. I consider lease options and subject-tos to be in the center of that spectrum, usually requiring one to three years for the best payoff. However, you can always immediately sell the deal to another individual or investor for a profit; this is called *wholesaling*. It can be done if you buy the property at a low enough price that you can turn a profit by selling the deal to another investor where there is still enough room for them to profit as well.

Visualize This Scenario

In every seminar I teach, I ask the students, "Who of you would be willing to purchase a home valued at $200,000 for $100,000?" Of

ccc_patton_ch01_3-17.qxd 4/27/05 2:10 PM Page 5

course all hands shoot up. Then I continue by asking if they would still be willing to purchase the same home if the price was $150,000. Most of the hands stay up. I proceed upward with the price, increasing the increments by $10,000 each time. I always sit and watch with amazement as the hands slowly but surely drop. At the price of $180,000 almost all hands are down. At $190,000, usually, all hands in the room are down. The point I am trying to make to each of them is that most investors are not willing to pay this close to retail price for a home.

I then re-pose the question to each of them: "How many of you would be willing to pay $200,000 for a $200,000 house with no money down, in a market that is appreciating at 10 percent per year, with a 10-year period to pay the $200,0000 to the seller at $1,000 per month?" Now all their hands go back up. I ask, "Why, now, are you willing to pay more for that house that you refused to pay $180,000 to $190,000 for a few minutes ago?" They respond in unison, saying, "Because you added some attractive terms!" My response is always the same: "You didn't ask the terms before!"

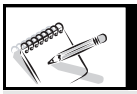
Terms are part of a whole deal, such as price, length of time to pay, monthly payment, and other items negotiated with the seller, which are discussed in more detail in Chapters 5 and 9. Many times even experienced real estate investors don't ask, "When does the seller need his cash?" They say "no" to a price without asking the seller when he needs the money. The previous example illustrates how most investors think: They don't ask all the right questions about the property before they make a decision. They look at the surface but they don't dig deeper for other possibilities.

Lease options provide a creative solution to allow you to negotiate terms that can increase your profits and provide a great investment opportunity. You are able to pay a higher price on a home if you can get reasonable terms, and having this tool at your disposal thus allows you to open up many new possibilities and make money on deals that were before completely ruled out. I am not suggesting that you pay $200,000 for a home worth $200,000, but you can if certain market conditions and terms previously described exist. If your market is flat (not appreciating) and you have only two years to exercise your option to buy the home, then maybe the price you offer should be much less. It's all about terms!

When doing any lease option or subject-to deal, one of my mottos

ccc_patton_ch01_3-17.qxd 4/27/05 2:10 PM Page 6

is that everyone must win or we don't do the deal. There are three people involved: the seller, the investor, and the tenant-buyer. It must be a win-win-win; otherwise, walk away.



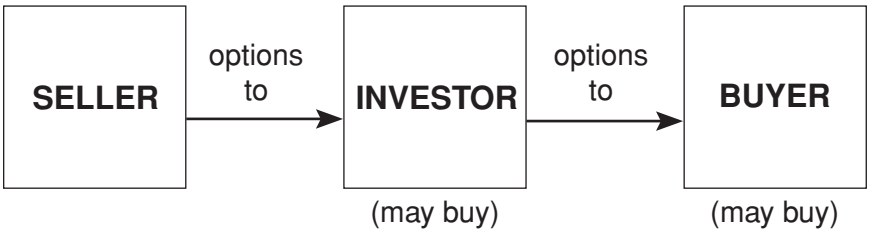
Wendy's Advice about Buying on Lease Option or Subject-To

If it isn't a win-win-win for the seller, the investor, and the tenant-buyer, then walk away from the deal. There are plenty of deals out there where everyone can win.

Standard Lease Option Deals

My typical strategy is to lease option from a seller and then to lease option that home to a buyer.

How Lease Options Work



The above illustration depicts a sandwich lease option. In a sandwich the meat is in the middle—that's the best part. You (the investor) are in the middle of this transaction; your reward is the meat—the difference between what you can pay for the home and what you can then sell it for. There are other ways to make this deal even better and more profitable, which are discussed in Chapters 5 and 9.

A variation of the sandwich lease is the lease purchase. While a lease option gives the investor the right to purchase real estate, the lease purchase *guarantees* that he or she will purchase the property during a given time period. Under some circumstances I will commit

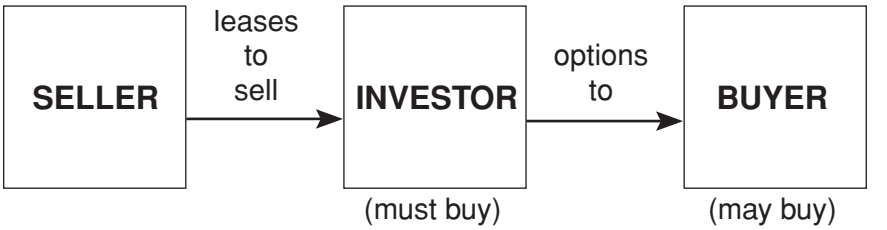
ccc_patton_ch01_3-17.qxd 4/27/05 2:10 PM Page 7

Wendy's Ethics Rule

Don't do lease options with potential buyers who have no way of ever being able to get a mortgage. That's just being greedy and taking advantage of someone. It is not fair to the buyer. If the buyer messes up, shame on them! If you mess them up, shame on you!

to buying certain homes using this technique—for instance, with specific Realtors, with deals that have a very good potential for profitability, when I have a solid buyer lined up, with high appreciating markets, and with very long-term deals. I do not use lease purchases much when I'm selling, because they are hard to enforce. If your buyer defaults, you have to sue him specifically for nonperformance in order to get him to buy your home. It is costly and very time consuming to do this. If your buyer cannot get a mortgage it is also a waste of time. I would recommend moving on and, in most cases, finding a new buyer. I therefore use lease purchases mostly to buy and rarely to sell.

How Lease Purchases Work



Wendy's Ethics Rule

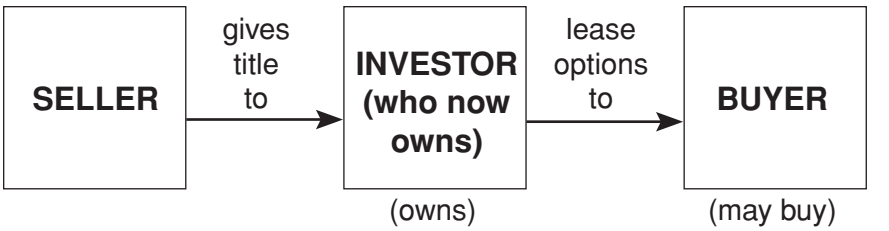
Don't do lease purchases if you don't intend to follow through on the transaction. Do what you say you will do, when you say you will do it. Help keep real estate investing an honest profession.

ccc_patton_ch01_3-17.qxd 4/27/05 2:10 PM Page 8

Standard Subject-To Deals

If I can't get a lease option or lease purchase from the seller, or if it doesn't make sense from a business perspective, then a subject-to is another way to acquire the property. However, it is important to note that a subject-to is a buying strategy only. Though I may acquire the property subject-to, I would still sell it on an option.

How Subject-Tos Work



A Lease Option Deal

Here's a great real-life example from my files of a lease option deal from start to finish—a true win-win-win:

The Seller: Janet

Janet, a seller, answered an ad I had placed in a newspaper.

> Company looking for 3-4 homes in this area, on long-term lease. Call 123-222-2222.

Janet's home had been listed on the market for $189,000 with a Realtor and the contract had recently expired. She saw my ad and

ccc_patton_ch01_3-17.qxd 4/27/05 2:10 PM Page 9

decided to call me. She was exactly the kind of person I was looking for: willing to sell and also willing to do a long-term lease. I still had to determine some other factors to make sure it would be a win-win-win.

Janet's most important area of concern was her price. It was set at $185,000, and she was not going to budge on that portion of the deal. As soon as I knew that Janet was set on this one area of negotiation, I could work with the other areas of the terms for myself (see Chapter 6 on negotiation). I would need to look at the rest of the terms to see if I could still make this a win-win for my side of the deal. These days I do not say no as quickly as I would have years ago; I look at the entire deal now, instead of getting caught up with a traditional style of price-alone deal structuring. Janet had fixed her price, and so I had to look at monthly payments and the time line available. By having all the facts, I was able to analyze the entire deal and thus make sure I would still obtain *my* bottom line of profitability.

At the time of this particular deal, we were in a strong appreciating market—approximately 6 to 7 percent per year. I figured that a 6 percent growth rate on $185,000 would mean approximately $10,000 per year just in appreciation. I had really hoped to get the property for $175,000. Even with the $10,000 in appreciation after the first year, I would still only be where I had originally wanted to be in the first place. I did end up buying the house and putting $4,000 of improvements into the property (basic carpet and paint). I now had $189,000 into the property, including the improvements. Anything above the $189,000 that I could sell it for would be pure profit.

Janet was not in trouble financially but she was motivated to sell. She had a severe shoulder injury that was preventing her from doing the maintenance around the property. She made great money and could have hired someone to do the maintenance, but she decided that with 20-plus surgeries under her belt and more to go, she just wanted some time off from dealing with her large home and yard. She didn't need to pull her money out of the property, but she did ask for $1,000 up front so that she could go rent a lakefront home in the area. The $1,000 I gave her for the option fee, plus the $4,000 for improvements, was a total of $5,000 out of my pocket for this home, which is less than 3 percent down—a small amount for this home.

ccc_patton_ch01_3-17.qxd 4/27/05 2:10 PM Page 10

The Buyer: Roberta

I knew that Janet and I were going to come to terms and do the necessary paperwork on a Sunday, so I ran an ad on that same Sunday, and I got a call from Roberta. I told Roberta that she could drive by the home but that she could not go in or on the property yet, because someone still lived there. Roberta didn't even know I didn't have the deal tied up—I just wanted her to drive by and see if she liked it.

Roberta had credit problems and seven dogs. Most landlords will not rent to someone with seven dogs, and most mortgage lenders won't do a mortgage for someone who has poor credit. With an inability to get a mortgage, she was also unable to work conventionally with a Realtor, so what was she going to do? No one would rent to her, and no one would give her a mortgage. Many people are in this kind of situation, seeking a solution. These are the people I am trying to help. They want the American dream, yet they are unable to obtain it in the usual way. Lease options give people a second chance to improve their credit while working toward the purchase of the home they desire to own.

If you're a landlord, all you get up front on any of your rentals is the security deposit, and that is just not enough cash to take on the risk of someone with poor credit and seven dogs. You can change this scenario by converting these people from tenants to tenant-buyers; then the risk that once was on you is shifted to the tenant-buyer, which is where you want it. With Roberta putting a lot of money down (option fees are not refundable), she was taking on the risk.

Let's look at how the deal transpired:

My out-of-pocket costs:

Option fee to seller	–$ 1,000
Improvements	–$ 4,000
Option fee from Roberta	+$10,000
Left over in my pocket	+$ 5,000

Without even owning this home I now had $5,000 in my pocket. Roberta was the one risking $10,000 with her option fee, as

ccc_patton_ch01_3-17.qxd 4/27/05 2:10 PM Page 11

it was nonrefundable. If she didn't buy, she'd walk away from a lot of money.

Janet asked me for $1,100 per month for rent, and I in turn asked Roberta for $1,450 per month for rent. That way I was able to have cash flow of $350 per month, which would add to my profitability in the deal. In this case Janet had a lot of equity in the home, and I was able to leverage that equity to get her to accept the lower monthly payment of $1,100.

The option sale price I set for Roberta was $225,000. How did I get that figure? I put a 10 percent option premium on top of the retail price (see Chapter 5), plus I added an additional 6 to 7 percent appreciation rate at 18 months, which was approximately another $20,000. I then rounded it up a little to get to $225,000.

What was the property actually worth? Value is always determined by what a buyer is willing to pay. Roberta later had the house appraised at $267,000. Did I lose $42,000? I don't think so. After all, I did make about that much. Was Roberta happy with the appraisal? Of course! Janet was happy because she got the price she wanted, and Roberta was happy because the appraisal gave her an additional $42,000 in equity that she can utilize if she wants. Janet won, Roberta won, and I won. This demonstrates what a classic win-win-win deal is all about.

Here's my profit at closing—not bad for not actually owning the home (except for two hours), but just controlling it!

Front-end cash	$ 5,000
Back-end sale	$31,000
Tax prorations	$ 2,800
$350 cash flow × 14 months	$ 4,900
Total profit	$43,700*

*It is not exactly $43,700. There are transfer fees in most states, title insurance fees, and I give my buyers option credits each month when they pay their rent on time. The extra $2,800 on tax prorations was given as extra profit to me also—a bonus when both the buyer and the seller paid for property taxes at closing. Only one person needed to pay for property taxes; therefore, the extra $2,800 is given to the investor in the middle of the sandwich lease option deal.

ccc_patton_ch01_3-17.qxd 4/27/05 2:10 PM Page 12

A Subject-To Deal

Here's a great real-life example of a subject-to deal from start to finish, another win-win-win.

The Sellers: John and Sally

John and Sally, sellers, answered an ad in a West Palm Beach newspaper, from one of my ads that my student—I'll call him Bob—used. I helped Bob structure the lease option portion of this deal to make the numbers work. Here is the ad:

> Tired of monthly payments? We can help. We will make your payments. Call today. Call 123-222-2222.

The sellers were three months behind on payments of $2,100 each. They saw the ad and called. Their house was worth between $385,000 and $400,000. They owed $268,000 on the first mortgage, which didn't include the three missed payments (one of which was only two days late); a second mortgage of $15,000; and a small assessment fee of $2,000, which could be paid at closing in a year or two. Total owed on the home $285,000 (not including those back payments). These sellers had attempted to sell this home twice in the West Palm Beach market, but both buyers had backed out prior to closing. They had since moved out and rented a place in a better school district for $2,200 per month. They didn't have any savings and could not afford both payments. The home was in pristine condition and needed nothing, unlike many homes in this situation.

These people wanted to work out a deal so that they would be able to get some of their equity out and not lose it all. They wanted to get their equity when their current one-year lease expired so that they could buy a home in the new school district, but they didn't need the equity out immediately. These people were also in a bad situation: They couldn't refinance the property, even with their equity, because with the missed payments they no longer qualified financially for a mortgage; they had no one they could borrow from. These people were in a difficult situation, which required a solution.

An ad like ours will attract some lease option sellers but also

ccc_patton_ch01_3-17.qxd 4/27/05 2:10 PM Page 13

subject-to sellers; this particular couple was a subject-to seller. They were behind on payments. They were willing to take much less than the current value of the house, and to take it at a later date. They did not need their equity immediately. What they needed was a solution.

Bob offered to give the sellers $40,000 on their home, but not until he sold the property. There would be no interest on the $40,000. This would bring his total investment in the home to $331,000 (acquisition cost of $291,000 + $40,000). He also offered to make the three late payments that would bring their mortgage current—a total of approximately $6,300. From this point forward, he agreed to continue making their mortgage payments. This would prevent them from going into foreclosure. Their credit score would improve as he continued to make their house payments on time. While the late payments of 60 days on the mortgage were a negative indicator, they could be explained by the couple's move and the two previous deals falling through.

Bob could have either made their payments until we refinanced the home into a lower rate or until he lease optioned it out. He had several choices. The biggest issue on this particular deal was the payment amount; it was a bit high for a rental, which many times can be a problem for subject-to deals. If the mortgage payment you are taking over is too high, you need to refinance the property at a lower rate or work out a better deal with the seller. On this particular home he lease optioned it out.

The Buyer: Frank

Bob found a tenant-buyer, Frank, with an ad for a lease option for the market rental rate of $1,600. The problem was that this rate left Bob $500 negative per month! He now had two choices: (1) See if Frank could pay more, or (2) do the refinance.

Bob and I came up with an offer that Frank couldn't refuse: He offered Frank 50 percent on his investment (better than most investments). Frank was a high-tech type of guy who had credit issues from the year before when he had suddenly lost his job. Since then he had become reemployed and was making very good money. He could easily afford the payment and more. Bob offered to give him an extra $500 credit plus an additional $250 credit if he paid $2,100 instead of $1,600 per month. He jumped at it. The most it would cost Bob is $750 per month for the 12 months Frank was in the home, if he bought it. If he didn't buy, it would make Bob the $500 per month

ccc_patton_ch01_3-17.qxd 4/27/05 2:10 PM Page 14

cash flow, which he could keep, and because he would not have to refinance he avoided the costs related to that. Frank also had $8,000 to put down as his option fee. He would have liked to put more down, but that was all he had saved since he had been so recently out of work.

Let's examine expenses so far:

Investor's out-of-pocket costs:	
Three months of payments	–$6,300
Improvements	–$0
Option fee from Frank	+$8,000
Left over in our pocket	+$1,700

Bob didn't even own this home but already he had $1,700 in his pocket. Frank was the one risking the $8,000 option fee because it's nonrefundable. If he didn't buy, he'd walk away from a lot of money.

The option sale price we set for Frank was $425,900. How did we get that figure? Bob put a 5 percent option premium on top of the retail price (he started at $385,000 on this one, but it could have been higher—see Chapter 5 about determining the profitability of deals), plus an additional 5 percent appreciation rate at 12 months, which was approximately another $20,000. This was a very conservative appreciation rate for that market. I think he should have gone higher on the appreciation calculation. The appreciation rate at the time he sold the home was 10 to 15 percent in his area. This deal was very good on that account; I just did not like the monthly payment left from the owners' mortgage.

Here is the profit at closing—not bad for not getting a mortgage on a deal and putting only $2,500 down! I wish all of my deals could be so profitable!

Front-end cash	$1,700	
Back-end sale ($425,900 – $8,000)	417,900	(less $8,000 Frank put down)
Option fee credits given away ($750/month × 12 months)	–9,000	
Cash flow (break-even)	0	

ccc_patton_ch01_3-17.qxd 4/27/05 2:10 PM Page 15

What Bob owed owner/lender ($331,000–$6,400 paid)	324,600
Total profit	$86,000*

The sellers in this example were thrilled that their credit rating was improved and restored, so they could once again buy a home. The purchaser was also thrilled that he could buy a home in a beautiful town and restore his credit. This is another classic example of a win-win-win.

Not all subject-to deals or lease option deals are that profitable. It depends on where you start with the seller, how motivated they are, how strong the market is (appreciation), and the price range of the home. If you're looking at a $50,000 home versus a $500,000 one, 10 percent makes a huge difference. The starting number will have a big impact on the total profitability. This is discussed further in Chapter 5.

Financial Freedom—You Can Get There!

These examples show you how lease options and subject-tos can be very profitable. The previous examples are fairly simple versions of the lease option and subject-to techniques, as there are many other creative ideas you can do to make them as profitable and complex as you choose (covered in Chapter 9). Remember, you may need several deals just to lay the groundwork for your Future Financial Freedom (FX3). It doesn't happen with one deal, and it doesn't happen overnight. However, with persistence it will happen!

There are at least three paydays using these techniques:

1. The upfront option fee from your buyer—or anything that your seller pays you to take over a mortgage on a subject-to deal.

*It is not exactly $86,000. There are transfer fees in most states as well as title insurance fees; principal paid on the mortgage during this time period is also kept on a subject-to.

ccc_patton_ch01_3-17.qxd 4/27/05 2:10 PM Page 16

2. The monthly cash flow—the difference between what you pay a seller and what your buyer pays you.
3. The back end—the difference between what you are paying for the home and what you sell it for.

While the option fee is nonrefundable, don't get excited on your first deal by immediately going out and buying that big-screen TV you've always wanted. What if something happens six months down the road? In owning or controlling real estate, things come up that are completely unexpected: broken furnaces, leaking roofs, unpaid rents, and so on. Plan ahead for those things and you will be safe. If you have held the option funds in reserve, you will be able to cover your expenses. That's just good business sense. Yes, the money is yours to keep, but be wise with it because you may need it. You might want to put it aside entirely for an investor's rainy day so that you will be prepared. After the deal closes, you can take another look at the money, because you will have not only that initial option fee but also the back end from the closing.

As you are getting started in this business or any other business, it is important to be conservative with your cash flow and money. I recommend you keep your spending very tight and conservative. Also, you want to be prepared to buy the next property should a good deal be offered to you. Unfortunately, most people in our country do not have good spending habits, and these bad habits allow people to get into financial trouble. It is very important to be on a strict budget for this type of business. If this will be hard for you, then you may want to find some outside help to get you on a system, which can assist you in financial counseling. I cannot stress this enough; it can be a make or break for people!

Let's say you made $30,000 overall on the deal. One positive way to use that money is to reinvest. Reinvestment will continue to bring income, but you will also want to pyramid your income. For example, if your first property made $30,000 overall and you received $5,000 in an up-front option fee, now you're going to want to look for two to three new properties, probably with the same profit ranges. You'll need money up front to pay your option fee to the seller, even though you will reimburse yourself later with the option fees from the buyer. The properties may also need repairs, and that money will have to

ccc_patton_ch01_3-17.qxd 4/27/05 2:10 PM Page 17

come out of your pocket up front, so you need to have the funds available from the previous sale. During this time you will probably still keep your day job, just to keep enough cash flowing in while you are building your new business.

Reinvesting doesn't just mean pouring money into new properties. It can also mean purchasing new office equipment, software, or anything else you need to continue to build your business. Maybe it's time you trashed that clunker computer and got one that was made in the twenty-first century. Install a second phone line or buy bookkeeping software. I cannot stress it enough: Be prepared for your future.

At this time, my average profit is $40,000 per lease option deal. Lease options typically turn over every 12 to 24 months. Depending on what part of the country you reside in, the profit range should vary from $20,000 to $150,000 (Midwest to northern California). Subject-to profit ranges should be equal to or greater than lease options, because you are buying from distressed sellers and might be able to negotiate more on the price; however, you might also have to use more cash to purchase them. You decide how much you need to make, and then you will know how many homes you need to lease option or buy subject-to. Not only can lease options and subject-tos set you up to live well today, but they can set you up for Future Financial Freedom (FX3) and retirement. Just sit back and imagine . . . how would it feel to be completely debt free? Real estate is the vehicle that can allow you to achieve just that.

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CHAPTER 2

Success Stories of Buying on Subject-Tos and Lease Options

The best part of doing subject-to and lease option deals is being able to witness the end results. Unless a deal is a win for each party, walk away from it. The seller must win, the investor in the middle must win, and the tenant-buyer must win. When all three of these people win in a transaction, there is nothing better! This chapter contains stories shared by different investors in different parts of the country. The sellers' and buyers' names have been changed, but the numbers and details reflect the specific transactions. These deals will inspire you and show you how you, too, can be successful and create unique solutions for motivated sellers.

Lease Option Case: Steve's First Deal

This study is important because it describes a first deal. I like it because it highlights how each party to the transaction was able to come away as a winner. Here is how Steve described it:

> *Sara had a house in Fowlerville that she kept after her divorce. She couldn't stand to continue living with the memories from the marriage, so she bought another house in*

ccc_patton_ch2_18-28.qxd 4/27/05 2:11 PM Page 19

Fenton, closer to where she works. She advertised the house as both "For Sale by Owner" and "For Rent." She wasn't excited about being a landlord, but she was looking for debt relief in a quick way.

I called on her "For Rent" ad and we met to discuss some options. I agreed to start paying her $1,100 per month immediately (because that is what she needed to cover her expenses), and for $1,000 I bought an option to buy her home at $155,000 sometime within the next three years.

I put about $300 into the house to fix a few things, plus I paid for a home inspection and a title search, so my costs were minimal, around $500.

Two days after I signed with the owner, a tenant-buyer from my accumulated list paid me an option fee of $5,000 and the first month's rent of $1,195 to move in. The lease term was 18 months and the buyout was $169,900. There was no lease money being applied to the purchase price. The lease started in March and they have been paying early every single month. They have never called me with an issue of any kind, so it is going about as smoothly as I could ever hope.

I liked this deal because the owner was very happy that I took the house off of her hands, and she always receives rent from me by the first of the month. The tenant-buyers were very happy because they were able to get themselves and their three children from an apartment into a nice house on an acre of land. This is a "win" for me also because I made money on the front end, $95 monthly cash flow, and the whole deal will make over $16,000. Not bad for my first deal.

—Steve Giroux, Michigan

Lease Option Case: Rance and Ryan's Buyers Provide Cookies

This is a fun story from two of my students who got off to a great start on their first lease option deal. They did such a great job that their buyer has bought additional properties from them and even sends them Christmas cards and cookies! Here's how they told it:

ccc_patton_ch2_18-28.qxd 4/27/05 2:11 PM Page 20

We attended your seminar on lease options in Seattle. Within one week of your seminar, we located a vacant rental in a nice Seattle neighborhood and were able to negotiate a lease option with the seller. We put the home under contract to purchase it for her full asking price of $175,000. We were willing to pay $190,000 but did not need to go that high. We were to pay $1,000 down, payable in 90 days or when we found a tenant. We paid no interest, with 100 percent of our $900 monthly payment going towards principal reduction. We had three years to cash her out.

We sold it on a one-year lease option in about 10 days for $200,000. That was a great deal for our buyers. We're confident we could have sold it for $220,000. We took $10,000 down, leaving us $9,000 after paying the $1,000 to our seller. We received $1,295 a month from our tenants with no rent credit and none going toward reducing their principal. We got a $395 per month positive cash flow for one year that added up to $4,740 plus $25,800 after one year when our tenants exercised their option.

After making $30,540 on our first deal using the strategies you taught us at a half-day seminar, we signed up for your next three-day Lease Option Boot Camp and ended up acquiring 19 more properties the following year; two of them were clients referred to us by our first buyers, who have now acquired two more properties from us. Our buyers still send Christmas cards and cookies and continue to thank us for helping them buy a home when no one would loan them money because of a previous bankruptcy.

Thank you for sharing your lease option strategy and inspiring us to jump out of our comfort zones.

—Rance and Ryan Barclay, Washington

Lease Option Case: Shaun Reaps What He Sows

This is an interesting case that shows the value of establishing relationships with Realtors. Shaun got a call from a Realtor that he had spoken

ccc_patton_ch2_18-28.qxd 4/27/05 2:11 PM Page 21

to over a year earlier; she had kept his card. This particular house had been listed for six months without luck. The seller had moved out of state, leaving the home empty for the past four months. Shaun was able to lock in very flexible terms to create a terrific deal for himself while relieving the seller of his burden and allowing a new buyer a fresh start.

This deal came as a referral from one of the Realtors that I talked to over a year ago. She called me out of the blue from my card she had kept. Here are the numbers:

$700 per month	*Lease option price from seller*
$850 per month	*Lease option price to buyer*
$150 per month	*Profit on cash flow*
$132,000	*Purchase price from seller (for as long as I want—I can buy this house for this price in a month or in 10 years; he didn't care either way)*
$159,000	*Sales price to buyer within 24 months*

I also got a $7,000 option fee from the lady up front.

Not a bad deal, huh? This is almost a $30,000 deal. The great thing about it is that the buyer has pretty decent credit. She could qualify for a loan on this property right now if she wanted to, but is going to wait about a year to get her score up from a previous divorce (her husband had a few late pays). Not only that, but if she doesn't pay me, it's no big deal. I'll just do this whole thing all over again. I also negotiated with the seller that if for any reason I have a tenant who stops paying me, I don't have to make payments until I get another tenant in the property.

This property was listed on the MLS for six months at $155,000 with no luck. The fact that I offered it on a lease option and had a pretty good marketing plan allowed me to get more than a Realtor could get. The house was in great overall condition—it was just a little bit outdated compared to the rest of the neighborhood. The seller had moved to Texas and it was sitting empty for four of those six months, so he was obviously motivated.

ccc_patton_ch2_18-28.qxd 4/27/05 2:11 PM Page 22

Thanks for showing me the ropes on this one, Wendy! My fiancée moved here from Kansas City about four months ago and immediately started the real estate biz with me. I love it!
—Shaun McClosky, Missouri

Lease Purchase Case: Cleberto Has Multiple Exits

This situation shows that even though Cleberto had an exit in mind when he bought the property, market conditions in combination with the nature of buying on a lease opened up additional opportunities. Cleberto found a property listed with a Realtor. It was in a nice area of Orlando, where he holds most of his properties. He has a good understanding of the market and home prices there. Recognizing the below-market price per square foot, he followed up on the property.

It was a seven-year-old home in a nice gated community in Orlando. It had been listed for two months at $339,000. The following drew our attention:

- *The price per square foot was below the subdivision average.*
- *MLS remarks: Motivated seller, $2,000 bonus.*

Driving by the property, we noticed a recent "For Rent" sign. Now it was becoming really attractive. We figured the owners must need some cash flow soon, and we wrote our offer accordingly.

After some negotiation, the following was accepted:

- *A lease purchase at the $339,000* full *price (to get their attention) for a two-year term.*
- *We would advance three months rent and $2,000 of the listing agent's commission (towards purchase price). These two items would be payable to the owners within 60 days.*
- *$500 in escrow (toward first month's rent).*

ccc_patton_ch2_18-28.qxd 4/27/05 2:11 PM Page 23

- *Rent of $1,895.*
- *We also requested that the $2,000 bonus offered by the owners be paid to the listing agent (that way the agent would have $4,000 of his commission paid soon).*

We had previously experienced problems taking too long to rent or rent-to-own a property, and had decided for this one to have a fallback plan, in case it was taking too long to market.

Our lease option plan to find a buyer was as follows:

- *Rent $1,995 (to move it fast).*
- *Option fee of $10,000.*
- *Price: $379,000 for a 12-month term or $389,000 for an 18-month term. This should give us a profit of more than $35,000 and $45,000 for the 12- and 18-month periods, respectively.*

To our surprise, along came someone offering us $2,295 for a straight 12-month lease. We accepted it because it increased our monthly cash flow to $400/month, and there was an uptrend in our real estate market. We believed that trend would continue over the next couple of years.

As the end of the current 12-month lease with our tenant approaches, the market has experienced the tremendous appreciation that we expected. At this point, these are some of the alternatives we are considering:

- *Sell this property for at least $390,000 and realize more than $40,000 in profit. Comparables are already there to support the price.*
- *Put it back on the market as a lease option with a price increase of some $40,000, providing a future $70,000 or more in profit.*
- *Buy it early from the owners and hold it longer. Since we would be closing earlier, we may request some breaks from them.*

—Cleberto Copetti, Florida

ccc_patton_ch2_18-28.qxd 4/27/05 2:11 PM Page 24

Subject-To Case: Scott Finds a Deal

Scott describes his transaction in terms of the numbers as well as the paperwork involved in this subject-to deal. He goes on to tell of his lease option exit with another investor. Other investors can be your best sources of deals as well as your best customers. Keep your eyes open and stay creative.

> *The owners bought the home new for $155,000. They had paid the mortgage down to $150,000 when we bought it subject-to. The deal was as follows.*
>
> *The purchase price was $150,000 (we took over the loan subject to a 6 percent interest rate). In addition, we gave them a check for $1,500 upon signing the warranty deed and we'll give them another $3,500 when the house sells with a new mortgage. We had them sign a warranty deed (notarized), seller's acknowledgment agreement (two-page disclaimer that they initial), a due on sale acknowledgment (telling them that the property is taken subject to the existing financing and could be called), a notarized general power of attorney, and a purchase and sale agreement. We recorded the warranty deed and now own the house.*

Scott offered the sellers $3,500 at the point in the future when the house closes. His objective was to provide them with additional incentive to follow through with the closing. He goes on to describe the sell side to another investor. Because of the fast appreciation in this particular market, he negotiated a slice of that beyond the profit that he locked in at the time.

> *Within one month of doing the deal, a slightly smaller house sold in the same community for $205,000.*
>
> *We sold this property on a lease option, using your techniques, to another investor for two years with $3,000 down, a positive monthly cash flow of $150, and a sales price of $188,000. We will also receive 25 percent of anything above the $188,000 that the investor sells it for.*
>
> *—Scott Teerink, Arizona*

ccc_patton_ch2_18-28.qxd 4/27/05 2:11 PM Page 25

Subject-To Case: Marti Helps a First-Time Buyer

This next case shows how an investor was able to use the subject-to approach to create happy and satisfied buyers and sellers while creating a nice profit for herself.

> *In June a couple responded to my ad and asked what they needed to do for me to make their house go away. They had bought it on land contract, and when they moved they wanted to give someone else the same opportunity that they had. So they tried renting it with the option, but even the fourth renter with $11,000 down (from an insurance settlement) didn't work out. They'd had enough. It was a mess. They took out 2,000 pounds of trash and cleaned it from top to bottom, so we wouldn't have a reason not to take it.*
>
> *We took the deed (their idea!) on November 19, leased it to a tenant-buyer on December 15, and evicted him on February 29. My renters from South Bend moved in the same day with the idea of buying it on lease option. However, on March 30 we had cleaned up their credit enough that we closed their loan.*
>
> *The balance on the mortgage was $46,000. We sold it for $75,000, having put $4,836.64 into the rehab, holding, and my closing costs. It appraised for $78,000. The buyers needed help with their down payment and closing costs, so they paid $78,000 which covered both. My net profit was $28,037.77.*
>
> *The sellers' nightmare ended and the buyers' dream began, and we made money in the process! The buyers had been married 16 years and had always rented because no one had showed them how they could own a home. What was really great was that no one in the husband's family had* ever *owned a home. Don't you just love this business? Too cool!*
>
> *—Marti Bentley, Indiana*

Subject-To Case: John Partners

This next case shows how an investor got over the hurdle of completing his first deal by partnering with someone else. You don't have to

ccc_patton_ch2_18-28.qxd 4/27/05 2:11 PM Page 26

do everything yourself. John found a good deal and shared it with some people at his local investors club. John worked with one of the investors who expressed interest in the deal. Together they negotiated the transaction, remodeled the home, and then sold it for a generous profit that they were happy to divide.

> *I was excited that Monday when we came back from Wendy Patton's March seminar with other speakers in Houston.*
>
> *I caught up on all my work and then went to the newspaper recycling pile for the classifieds. We marked everything that was interesting and after class started calling. One house was listed way below the property tax appraisal and in a decent part of town.*
>
> *I got a ride to look at it, and then went to a small group meeting that the local investors club had that same night. When we talked about it, three people immediately asked to buy it. The first to speak, Kerry, signed an offer and negotiated a good price.*
>
> *Six weeks later we sold it to the same contractor we used for remodeling.*
>
> *Our profit, net of all costs including interest, closing, insurance, contractors, and everything else, was almost $30,000. Fidelity Title Company gave me a check for $13,845.01.*
>
> *The contractor himself made another $30,000 after he finished it and retailed it through MLS a few months later.*
>
> *—John Ward, Texas*

Subject-To Case: Lyle Uses Creativity and Flexibility

This next case is interesting in the various lessons that are displayed. It shows how Lyle was able to help someone even when it didn't appear to be a great deal for him personally. It highlights how investors can frequently solve a seller's problem creatively where it doesn't make sense for a Realtor to list. It also shows that the first tenant-buyer won't always be the one to conclude the deal. Each deal takes creativity and flexibility from beginning to end.

ccc_patton_ch2_18-28.qxd 4/27/05 2:11 PM Page 27

I received a call from a Realtor I know who had a friend going through a divorce with a small child involved. Since this seller had no equity in the property, my friend was unable to help her, so she brought me in, hoping we could find a creative solution to this dilemma. We paid her $500 to help with moving expenses—she was moving back home to her parents. These were the numbers:

First mortgage balance	*$109,000*
Second mortgage balance	*$ 26,000*
Total encumbrance	*$135,000*
Arrearages	*$ 4,200*
Cash to seller	*$ 500*
Repairs	*$ 500*
Fair market value	*$144,000*
Gross equity spread	*$ 3,800*

The only reason we did this deal was I made the mistake of letting my heart think, not my head. It was very thin, but I felt bad for her and her daughter. If we could help her, even without any profit, we would be doing a good deed. The home was only about four years old and needed nothing other than a good exterior cleanup and carpet cleaning with minor paint touch-up in the interior. We were able to take over subject-to, with no guarantees we could save it from foreclosure. We put it in writing that we would do the best we could, but no payments would be made until we found a buyer.

Lyle was not able to effectively use signs to advertise this house because of the homeowners association restrictions. By running a newspaper ad, he found a couple who wanted to buy on a lease option. The terms for his tenant-buyer were as follows:

- Purchase price (within two years): $149,900.
- Option fee: $5,000. The tenant-buyers paid Lyle $3,000 down and an extra $500 for four months. He applied all of this money toward the arrearages.
- Monthly rent: $1,495 with monthly cash flow of $50.

ccc_patton_ch2_18-28.qxd 4/27/05 2:11 PM Page 28

Lyle continues to the outcome of this case:

This buyer was in the property for about 16 months when the husband lost his job. They knew the terms and they agreed to vacate the property peacefully, leaving all their money on the table. This is a very important point: Make sure you have good, strong paperwork for tenants. We went back in and cleaned up the property and decided to sell outright because our market had turned into a strong seller's market.

—Lyle Reichenbach, Arizona

Lyle's seller was able to rid herself of a difficult situation that would have required her to pay money out of her pocket in order to sell conventionally. She was able to avoid foreclosure and move on with her life. His tenant-buyers were able to build their credit as they worked toward owning a nice home that otherwise would not have been available to them.

Lyle was able to take control of a nice property and market it for very little cash out of pocket. He ultimately sold it for a profit of $28,000 after managing it for less than two years.

These stories are just a small sampling of transactions completed by investors who have used the techniques described in this book to raise their income levels while creatively solving problems for buyers and sellers. The first step in this rewarding process is finding motivated sellers. That's where we're heading in the next few chapters.

These people all started out exactly where you are. You can realize the same type of success and find the same types of deals. These success stories are from some of the hottest and strongest markets in the country, and these people have been successful with the techniques that you will learn about in this book. Congratulations on starting today toward Future Financial Freedom—FX3.

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PART 2

STEPS TO BUYING PROPERTIES ON LEASE OPTIONS AND SUBJECT-TO DEALS

ccc_patton_pt2_29-30.qxd 4/27/05 2:11 PM Page 30

ccc_patton_ch03_31-43.qxd 4/27/05 2:11 PM Page 31

CHAPTER 3

Finding Motivated Sellers for Lease Options and Subject-Tos

Motivated sellers are out there in every city, every town, every state. Finding a seller who will work with you on a lease option or subject-to isn't as difficult as it might seem—if you know which techniques work to attract their attention.

I recommend looking for motivated sellers with nicer homes that require little or no work. This way you spend less time working on the house and less time working to find a good buyer. Also, I like to focus around the median price range and above. In my area of Michigan, the median price range is currently $170,000 to $180,000; therefore I have focused on the $150,000 to $300,000 range. These nicer homes are much easier to resell on lease options and generally much more profitable than less expensive homes. It's also a lot more fun to work on nicer homes for more profit than on dumpy homes in rough areas for less profit—especially when you can buy the nice ones for little or no money down.

What Makes a Motivated Seller

A variety of circumstances and situations in people's lives can make them need to sell their home. These can include a job transfer,

ccc_patton_ch03_31-43.qxd 4/27/05 2:11 PM Page 32

bankruptcy, foreclosure, upgrading to a bigger home, or a number of other reasons. However, the circumstances of the sellers may also be affected by the state of the two vying markets—buyers and sellers—which also affects their motivation. For real estate investors it is crucial to buy homes from truly motivated sellers—sellers who have an extra urgency, usually financial. You can't get a good deal from an unmotivated seller who has no pressing reason to negotiate or give in on any part of a transaction.

There are different degrees of motivation and different reasons people need to sell their homes, but overall there are two basic categories of motivated sellers:

1. Desperate and distressed (bad debt)—someone in trouble financially, behind on payments, going in a bad direction, lost their job, going through a divorce, foreclosure, and so forth.
2. Not desperate or distressed (good debt)—someone not in trouble financially, not behind on payments, but motivated for other reasons: two house payments, inherited a home, burned-out landlord, job transfer, and so on.

Most real estate investors only go after the first category of sellers, but there is also huge profit potential with sellers that fall in the second category. Generally, lease option sellers should be people in the second category, while subject-to sellers will be part of the first category, though this is not a concrete rule. In this chapter we will discuss how to find motivated sellers of either type. In Chapter 4 you will learn the appropriate techniques to use for each kind of seller.

A final factor likely to affect a seller's levels of motivation is the state of the economy itself.

What You Need to Know about Buyer's and Seller's Markets

The economy plays a big role in finding motivated sellers in different parts of the country. I discuss this further in Chapter 6, but for now it

ccc_patton_ch03_31-43.qxd 4/27/05 2:11 PM Page 33

is important to understand how the economy affects motivated sellers. First let's define these two terms:

1. A *buyer's market (weak market)* is one in which real estate is not moving very quickly. There tends to be little or no appreciation, and possibly even depreciation. Sellers tend to be more open-minded about creative ways to sell their homes. There also tends to be higher unemployment in the surrounding area, and overall not a very good economy.
2. A *seller's market (strong market)* is one in which available real estate is moving very quickly. There tends to be high appreciation. Sellers may be getting multiple offers in one day on their homes, and bidding wars are common. There tends to be a high employment rate in the surrounding area, great retirement/vacation facilities, and an overall good economy.

When the market is very strong, people are able to sell their homes more easily, even if they are in the "desperate and distressed" category. In a buyer's market, it can be very difficult to sell a home. Yet, no matter whether it's a buyer's or seller's market, motivated sellers are always available. You just need to look harder and you might find fewer in a strong seller's market, whereas they're much easier to find in a strong buyer's market.

Techniques for Finding Motivated Sellers

The kind of motivation you are looking for is not just someone wanting to sell their house but someone who needs to get rid of their debt. These sellers won't come knocking on your door, however, nor are they ever obvious. You must try several different approaches and determine what works best in your area. It's a bit like fishing: Try a spot and a lure, and see if they work. If they don't work, move to a different spot and try a new lure. Here are some tools that have worked for my students and me over the years:

- Bandit signs. These are the small signs you often see on street corners or telephone poles around your city. They are called

ccc_patton_ch03_31-43.qxd 4/27/05 2:11 PM Page 34

bandit signs because in many cities posting them is illegal and you can be fined, but investors still put them out and risk incurring a fine for the sake of the potential profit of a deal they may bring. The signs might say "Cash for Your Home," "Stop Foreclosure," or the like. One of the advantages of buying a house on a busy street is to be able to advertise with a bandit sign in your own yard, which is generally legal (check your city ordinances). An investor I know who owns 30 houses in a subdivision deliberately bought the one on the busy entrance corner so that she could advertise on the lawn and pull people back into the subdivision to look at the other houses. Many companies make these signs and they are not expensive, so if someone removes them or they blow away, it's not a great loss.

- Advertisements in the newspaper. The way I usually find my sellers is either through ads they have placed in the paper or ads I have placed to fish them out. See the opposite page for several examples of ads that you can run that will attract sellers to call you. Experiment with different types of ads in your area, and also with different types of papers. You can try the smaller local papers, or the larger metropolitan area papers, depending on your budget and your target market. I have also placed ads in both the "for rent" section and the "for sale" section, depending on the ad.
- Tear-off flyers posted in public places like local drug stores, convenience stores, party stores—wherever you can get them posted. These flyers can say the same things as the signs and ads. The tear-off parts should have your phone number, your web address, and a short statement like "We Buy Houses."
- Letters to Realtors. Inform Realtors about what type of homes you buy and how you can help them sell their listings. This is one of my favorite ways of finding deals. I currently find 90 to 95 percent of my lease option sellers through Realtors. I discuss this in more detail in Chapters 10 and 11.

ccc_patton_ch03_31-43.qxd 4/27/05 2:11 PM Page 35

Ads to Attract Motivated Selllers

> Company looking for 3-4 homes in this area for long term lease. Call 123-456-7890.

This ad will draw in sellers who are considering something long term and those who want to rent their homes out. In other words, people who respond to this ad are ready to do the most important part of an option—lease—and to do it for a long period of time. This type of person does not need any cash out or they would not respond to this ad. The ones we're looking for are those who have not been able to sell their home, so they are willing to consider the four-letter word: *rent*. At the end of this chapter is a script that I use when calling about "for rent" ads in the paper. Use the same script, but only after they call you.

> Executive looking in this area for a lease-to-own nice home. Call (123) 456-7890.

This ad will draw in the people who own nicer homes and who will more likely be lease option sellers than subject-to sellers. Regarding the wording of the ad, we are executives in this business, right? I am, and hopefully you are too, so there is nothing dishonest in putting it this way. However, these sellers will naturally assume you are looking to live in the property yourself. Later, you will need to break the full facts to them slowly. This is covered in Chapter 6 in a discussion about handling sellers' objections.

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ccc_patton_ch03_31-43.qxd 4/27/05 2:11 PM Page 36

> Home not selling? We can help! We buy and lease homes. Call (123) 456-7890.

This ad will bring in sellers who are starting to get very motivated. These may be people who are behind on payments or they may be getting motivated for other reasons. They could be either lease option or subject-to sellers.

> Tired of monthly payments? We can help. Call today: (123) 456-7890.

This fourth ad brings in sellers who are behind on payments, threatened with foreclosure, and also people who have two house payments. It brings in sellers with both good debt and bad debt. This is a great ad to bring in both lease option and subject-to sellers.

> Stop Foreclosure! Behind on payments?
> Don't lose your equity. We can help!
> Call us today! (123) 456-7890

The last ad brings in sellers in foreclosure and much more desperate circumstances. It is definitely a stronger ad. This will be used to draw in subject-to sellers only, sellers with bad debt. We will only buy subject-to when a seller has bad debt—this is discussed in Chapter 4.

ccc_patton_ch03_31-43.qxd 4/27/05 2:11 PM Page 37

- Letters in response to "For Sale By Owner" (FSBO) postings. Many times FSBOs (individuals selling their home without the assistance of a Realtor) think it will be easy to sell their own home, but when they start to deal with buyers, lenders, title companies, and so on, it can become overwhelming, and they can start to get motivated to sell quickly. It is not always easy to sell by yourself. Many investors work with FSBOs (pronounced "fizz-bos") in buying deals. According to the National Association of Realtors (NAR), in 2003 a FSBO typically sold for 20 percent less than if sold through a Realtor, so that's a significant savings to the investor.
- School directories, church flyers or directories.
- Long-term Multiple Listing Service (MLS) listings. If you are not a Realtor, you can hire one to do a search for you of listings on the market over 90 or 120 days old. These sellers are getting motivated because their homes are taking too long to sell. Also have the Realtor check for all the expired listings.
- Business cards. Your card should say that you buy or lease homes and give information about how to reach you, including your web site, your fax number, and so forth.
- Out-of-state owners. Many cities have services that allow you to find all out-of-state owners, or houses where tax bills are sent to addresses other than the property itself (non-owner occupied). Because out-of-state owners are far away from their property, they may want to get rid of the faraway headache and move on with their life. Also, they may not really know what the current market is anymore.
- Vacant homes are an indication that someone is making a payment on a home that is not being used. Write the owner a letter. You can send it to the vacant house and hope it gets answered, or you can try to find the owner through the post office, through township tax rolls, or by hiring a private investigation skip-trace service. Skip-trace services are great ways to find not only potential sellers but, later, missing tenants who owe you rent. These searches can be fairly inexpensive—check around for a good company that gives good

ccc_patton_ch03_31-43.qxd 4/27/05 2:11 PM Page 38

prices and reliable service, and ask for a recommendation from a Realtor or a place that does background checks. You'll start to hear a few names again and again, and you'll be able to make an informed choice.

- Through real estate investor clubs you can find other investors with homes they haven't sold and want to sell. Network and let others know what you do. I have bought several very good deals from other investors, either because they had their hands full at the time with their own deals, or the properties were out of their area. You should be a member of a local real estate investor club and regularly attend meetings. It is one of the best places to network.
- Corporate relocation departments have an inventory of homes that have not sold. If the company does not do a corporate buyout, the owners would be great candidates for a lease option. They have already relocated and need to have someone in that home and making payments.
- Your local chamber of commerce can tell you what businesses are leaving town, who is coming in, and so on. If you have many properties, they might also list you as a rental company and refer incoming people in the area to call you.
- Word of mouth. After you have been in this business and networked for a few years, you will start to find deals coming to you by word of mouth. Someone knows someone who knows that you buy homes. I have bought some of my most profitable homes by word of mouth.

Motivated Landlords

Landlords can be great motivated sellers, especially if they are burned out. If the economy is slow, they might have higher vacancies than in a fast or hot market. In my experience, I have found there are two basic types of burned-out landlords. The first type has watched a lot of late-night TV and decided to make millions in real estate. Unfortunately, many people buy real estate with no knowledge or experience, thinking they know it all after hearing a high-powered, adrenaline-rush

ccc_patton_ch03_31-43.qxd 4/27/05 2:11 PM Page 39

sales pitch. There are, however, many state and federal laws that regulate this business. This type of landlord will fall for the professional tenants and their stories and experience, and often end up getting burned. Understanding how to screen tenants and select them is key not only to being a good landlord, but also the business of selling by using lease options. By being a member of a local real estate group, you can get the education and assistance you need to be successful as an investor. If you want to find a group in your area you can check the National Real Estate Investors Association web site. See the Resources section in the back of this book for a group in your area.

The second type of landlord is more tired than burned. These landlords are retiring and ready to move on with their life. They don't need the money from the sale of a home, and in many cases they don't want to receive it yet. They usually have huge capital gains to contend with and may not want to pay those gains yet, or they may want to plan for a 1031 exchange.* By optioning their home to you, they might be able to better plan for a 1031 tax-deferred exchange. There are sellers who will sell to you on an option to avoid the taxes now but gain the benefits of renting their homes. With this solution they can benefit from cash flow and avoid the other issues of being a landlord that they don't like or don't have time for now.

When I purchase a home from a landlord, one of the benefits to him or her is that I usually completely assume the maintenance on the home, or ask them to assume only the first $500. I also take responsibility for the advertising, vacancies, showings, and so on. You can be very creative when structuring a deal with an owner of a home. The benefits for a landlord include but don't have to be limited to:

- *Maintenance*. Sellers don't have to deal with issues and calls. Even if they pay a portion of the costs, I handle the work.

*A 1031 exchange is an IRS section that allows a person to exchange their like-kind property for another property of equal or greater value, and therefore defer (not avoid) the capital gains on the first property. For instance, if a seller has a home that they bought 10 years ago for $80,000 and it is now worth $140,000, and they have depreciated the property from $80,000 down to $40,000, then they would need to realize a $100,000 gain ($140,000 value less the depreciated value of $40,000 equals $100,000 of gain). This would be a long-term capital gain, but with a 1031 the gain could be put off into the future.

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- *Showings*. Sellers never have to show the home again. I do the showings, take the calls, and discuss the home with all prospective tenants.
- *On-time rent*. They don't have to worry about the tenant paying each month. Their rent check comes from me, *regardless of whether the tenant has paid me on time*. My check is good and on time each month.
- *Advertising*. They don't have to advertise the home anymore. I pay for all the advertising and handle all the calls.
- *Vacancies*. They don't have to worry about vacancies anymore. I will pay whether the home is vacant or not. (You can negotiate this if the seller is willing—i.e., you have one month free rent in each X (any number you choose) months of the lease if you don't have it occupied.
- *Insurance*. They have extra liability protection when they lease option to me. I carry a $1,000,000 liability policy on properties that I don't own and am only optioning. This liability policy is really to protect me; however, if something really bad were to happen on this property, this insurance would be utilized in a defense, which would also protect the owner of the home.

These benefits alone will allow a landlord to feel comfortable with selling but also with taking in less rent than they usually charge. Talk about these benefits to help them see the advantage in leasing the home to you with an option. They now have fewer headaches, less overhead, and fewer fees and expenses, so they can afford to lease it for less. Because you are making a lower payment to the seller, you can also rent it to someone and have cash flow.

How to Evaluate Seller Ads in the Newspaper

Besides placing your own ads in the newspaper to attract sellers, you can also answer sellers' ads. In lease options I find that most sellers need or want their cash out. The best way to find a seller for a lease option is not the FSBO section of the newspaper, but the "for rent" section. Your goal is to turn the landlord into a seller.

ccc_patton_ch03_31-43.qxd 4/27/05 2:11 PM Page 41

Wendy's Tip

One trick to finding motivated sellers is to take the current real estate section of your newspaper and file it in your cabinet for a month. After a month, start calling those sellers. If their homes are still available, then they are getting more motivated. The longer a home sits, the more motivated they become.

The reason I don't call on ads in the "for sale" section is that 90 percent of those sellers must get their cash out and most of the other 10 percent won't consider something creative. It is not because they don't want to consider something creative—they would just prefer to cash out and be done with the property. Also, trying something unique will scare most sellers. Call the ads that are for rent, because the two main obstacles have been resolved: These owners apparently do not need to sell or to cash out of the home, and they are obviously willing to lease it.

How to Navigate Successful First Contacts with Sellers

The most effective way to contact sellers is by calling them. Immediately tell them your name to start building rapport, and try to keep your voice calm and soft. Be sure to ask questions appropriate to the area you are calling. What is important to that part of the country? A basement? A pool? A fenced yard? A certain type of landscaping? Updated kitchens or bathrooms?

When you begin to regularly respond to seller ads, consider setting up another phone line, perhaps toll-free or even a voice mail box just for that particular house or ad. I prefer that callers reach a live person, so if they call my office they get someone live. If they call after hours, they get a referral to another number where they can get a live person. However, if this is not feasible for you, be sure to check messages frequently and return calls promptly.

ccc_patton_ch03_31-43.qxd 4/27/05 2:11 PM Page 42

The following script can be useful when calling the owner of a rental home. The words in italics are what you say to the owner. Don't waste the seller's time asking questions that are answered in the ad or from their opening description, but do ask questions applicable to your area of the country, such as whether it is in a flood area, whether it has central air, whether it has ever had termites or been in a fire, how old the roof is, and so on. Ask whatever might be of interest to you and find out as much as you can about the home.

Hi, my name is _____. I'm calling about your home for rent. Can you tell me if it is still available?

Giving your name sounds warmer and will help put the owner at ease with you. It is a great way to begin building rapport.

When is it available?
Can you tell me a little about the home?

Let them volunteer some information about the home or ask them to expand on some of the information in the ad. You are building rapport with the owner. Talk and let them talk. People warm up when they are the ones talking. Listen and sound interested.

When was the home built?

This question gives you an indication of any decorating or maintenance problems you might run into, such as whether it might need to be updated. If the house is older, ask the next question; if not, skip to the one after.

Have the kitchen and bath(s) been updated since it was built?

If it was built in the 1970s, I often ask if the baths or kitchens are yellow/green/brown or if they have been updated.

Does it have a garage or basement?
Is the yard fenced?

This may prompt them to ask whether you have pets. At this point they still think you are the one who will be living there. I don't change that conception until enough rapport and trust have been developed. They may ask how many people will be living in the home. In such case I don't want to lie but I don't want to be totally direct either. If you say, "I don't know, I am going to rent it to someone else," you can be sure they will not show you the home. Each time these questions come up,

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you will answer them differently, based on the owner. Here are three ways you could handle their questions:

1. Answer as if you really were going to live there.
2. Try to change the subject or slightly avoid the question.
3. Try to answer using your best guess of who might be renting from you later.

I am not recommending deliberate deception. I am very honest and straightforward with my sellers—but only after we meet in person or when I feel they are open to discussion about the entire situation. Because everything will eventually be in writing, they will know that you are not occupying the residence before they sign the documents.

If the home sounds like something you would like to own, then pop the question. If it doesn't, just be polite and say you will call back later if you are interested.

Wow, this home sounds really nice, would you considering selling it?

If they say no, then say, "Thanks, but I am really looking for something I can buy." Leave them your name and number so they can contact you later if they change their mind about selling.

Do you know how much you would want for the home?

Start to feel out the owner for the type of terms they would consider, but be careful not to make any verbal offers. This isn't the time for negotiation—you are still just gathering information. Construct your offer later when you are not on the spot.

When could I come and look at the home to see if I would be interested in it?

Make arrangements to go as soon as possible. This shows the seller that you have more than casual interest in the property. Set an appointment and keep it. If you must change your schedule, be sure to let the seller know ahead of time and make alternate arrangements for as close to the original date as possible. This courtesy will also demonstrate your genuine interest.

You have now called sellers, had sellers call you, and perhaps you've accumulated some leads to pursue. Now it's time to go look at the homes, continue to build rapport with the sellers, and gather more information. In the next chapter, you will learn more about which technique to use for each motivated seller you have found.

CHAPTER 4

Lease Options versus Subject-Tos: Choosing the Right Technique for the Right Situation

Acquiring investment real estate can be handled with many approaches. Two very popular zero-down approaches are lease options and subject-tos (also referred to as "getting the deed").

Wendy's Review of Lease Options and Subject-Tos

A *lease option* is a technique that involves gaining control of a property, but not ownership—just the right to take responsibility for a property now and purchase that property at some future date with defined terms.

A *subject-to* involves getting the deed to a property without taking on a new mortgage. Instead, the seller signs over the deed to his home "subject to" the existing mortgage. The buyer makes the mortgage payments on the seller's existing loan but does not take out a new mortgage to acquire the home.

Both of these techniques usually require little or no money down. In both, it is possible for the buyer to get money from the seller or the purchaser (or both) in the beginning of the transaction. These

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techniques, when used properly, can result in large profits for the real estate investor. They are very effective individually and, when used hand-in-hand by investors, are almost an unbeatable pair!

Knowing when to use which technique is important. Many times, investors try to fit one technique into every situation, which can be a very dangerous approach. Choosing the right technique—lease option or subject-to—for your seller's situation can save you tens of thousands of dollars and protect not only you but your tenant-buyer as well.

To make a wise choice, you must have a clear understanding of two critical factors:

1. What type of motivated seller you are dealing with.
2. The techniques of lease options and subject-tos and how they best suit your seller—and you.

Know the Seller Situation

Finding a motivated seller is the first step to any good real estate deal. We tend to think of motivated sellers as people who are financially distressed, but I like to look at motivation from a much wider range. I like to divide motivated sellers into two groups:

1. Sellers who have bad debt. Solution: Get the deed—*no* lease option.
2. Sellers who have good debt. Solution: lease option or get the deed.

Sellers who have bad debt are generally in trouble. They might be behind on a mortgage, out of a job, down with an illness, in the middle of a divorce, and so on. In these situations, *you need to get the deed* with either a subject-to or an outright purchase. Your main concern is that this type of seller may continue to have financial problems that could affect the title to the property if the deed is still in their name. For example, any judgments or debts against such a seller can attach to any real estate the seller owns—and those judgments or debts would have to be paid off before you could exercise your option to buy. That's why you want to get this type of seller off of the title. Otherwise, their future problems could easily become your future problems.

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Sellers who have good debt are not in trouble in the traditional sense, but they do have a reason motivating them to sell. Their problem is not financial desperation—it's simply a change in their lives. They might be transferring to a new location for a promotion, getting married (each owning their own home), building a new home, burned out on being landlords, and so on.

Once you have determined what type of motivated seller you are dealing with, the next step is to determine which technique, lease option or subject-to, best suits both your own circumstances and those of the seller.

The rest of this chapter discusses the advantages of lease options and subject-tos, the risks of each, the types of sellers that will accept these techniques, the benefits to the sellers, and a comparison of the pros and cons of each strategy.

Subject-To Advantages

Subject-tos have at least eight advantages. Some are the same as with buying an option.

1. Minimum or zero down. Usually you only need to pay the seller a small amount to sign the deed over to you. It's even possible that, if they owe more than you are willing to pay, they may pay you to take the deed from them.
2. No financing required. When you do a subject-to, you don't need to get a mortgage because you are taking over the seller's mortgage payments. Technically, you are not assuming the seller's mortgage. You are just making the payments on their existing mortgage.
3. Ownership. The day the seller deeds the property to you it is yours. You are the true owner of the home.
4. No qualifying. If you buy a home traditionally, you have to go to a bank or mortgage company and qualify for a loan.
5. No income or credit checks. Not once has a seller ever asked to look at my income or check my credit. They are more worried about their situation and how to get help from you.

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6. You can buy them with your IRA. Very few companies handle self-directed IRAs. If you use your IRA for the option payment, the rent payment and any other income goes back into the IRA. Remember, the income from the Roth IRAs is tax-free for life. You can also do a subject-to with your IRA when there's a mortgage already in place.
7. Great return on your investment (ROI).
8. The seller will love you. You will be making a positive difference in someone's life.

Subject-To Risks and How to Avoid Them

The biggest controversy for a subject-to is the violation of the due on sale clause. This clause is a provision in the mortgage documents that says if the home is sold or transferred, the mortgage will be paid in full or the lender could call the loan due in full. This means that when the sellers deed the home to you, the lender can demand payment in full on the loan. However, most lenders will never know the seller transferred their title to you, as long as you make the payments on time. Most lenders are only concerned with receiving their regular loan payments in full and on time.

In a rare occurrence a lender, may for whatever reason, choose to call the loan due on a property transferred subject-to, instead of continuing to receive payments from an investor. You should disclose this risk to a seller and also be prepared to refinance the existing mortgage in the unlikely event that this happens. There is some speculation in the industry that many due on sale clauses have not been called because interest rates are currently low. If rates go up, then lenders will have a reason to call loans due: They will want to get the higher rates on these properties.

Most educators teach students to have the owner transfer title into a land trust, claiming this technique will bypass the due on sale issue altogether. Other educators believe that if the owner is putting the property into a land trust just to bypass the due on sale clause (i.e., covering up the breach of the due on sale clause), the transaction could later be considered mortgage fraud. Such educators think that you should be up-front with the lender and send them a

ccc_patton_ch4_44-60.qxd 4/27/05 2:12 PM Page 48

certified letter stating that you are taking the property and making the payments on loan. Most lenders will still not call the loan due (why trade payments for yet another foreclosure?). If the bank later tries to call the loan due, you can argue that they waived their right to foreclose by not calling the loan due up-front. Whichever approach you use, you should consult with a qualified attorney on the issue. The relevance of this issue may vary from state to state.

A land trust is roughly comparable to an entity, such as a limited liability company, except that it provides no liability protection. Like most trusts, there are generally three parties: the grantor, the trustee, and the beneficial owner. The grantor is the person who puts property into the trust. In the case of a subject-to, the seller is generally the grantor. The trustee is the person in whose name the trust's property is held. The trustee is also generally the person who administers the trust (e.g., signs deeds, pays taxes, etc.). The trustee is generally an individual. In most states, the beneficial owner of the trust can be the trustee of the land trust. The beneficial owner is the person who gets any payments or use of the property held by the trust. You or your company is normally the beneficial owner of a land trust in a subject-to transaction. In addition to making a breach of the due on sale clause less obvious, a land trust might prevent transfer fees or revenue stamps (the cost of transferring a deed) in many states. This cost can be many thousands of dollars in some states. Again, consult with a competent local attorney before using a land trust, because trust law varies from state to state. Also, as I mentioned, some experts do not advise concealing a breach of the due on sale clause. You and your attorney need to jointly weigh the benefits and risks of using land trusts.

Instead of a land trust, some investors use two insurance policies to help keep the deed transfer discreet. The lender generally won't know about a deed transfer unless someone tells them, and the way they often find out is when the insurance carrier notifies them of the change in ownership. Therefore, many investors keep two policies in force: first, the old homeowner's policy with the original seller, which really is not any good, since the seller no longer owns the home. Keeping this policy in place simply keeps that insurer from reporting a deed change. Second, the investor purchases a policy for himself, with the net result that he makes two insurance policy payments. Obviously, if you and your attorney decide that directly informing the

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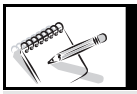
bank of the transfer is the best approach, there is no reason to keep the original homeowner's policy in force.

In my opinion, the best and most ethical way to handle a subject-to deal is to be completely honest. Let the lender know you did it. Send the lender a certified letter informing them of the ownership change. Keep proof of the letter and return receipt in your files. If the lender doesn't respond (most won't), then the law may hold that they have accepted the change by ignoring your letter. If they try to foreclose, then you may need to pay off the existing mortgage and refinance the property into your own name. If the property doesn't have enough equity to justify refinancing into your own name, then it probably was not a worthwhile deal to begin with.

You can also do nothing. Just do the subject-to and don't tell anyone. Wait for the lender/mortgage company to notice or say something. Most loans are never called following a breach of the due on sale clause—but the risk is there.



Wendy's Advice

Don't hide things or get involved in any type of fraud. Subject-tos are getting more attention. Do business by being honest and up-front, and without hurting anyone, and you will make money while making others very happy.

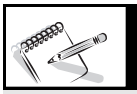
The big risk of using a land trust to hide a due on sale transfer, or of double-paying insurance for the same reason, is that if a court rules that the intent was to keep the bank from exercising its legitimate rights by hiding an important fact (the deed transfer), you can be accused of fraud. Telling the bank what you have done and being able to prove that you did so kills any chance of accusations that you hid the transaction. No deception, no fraud.

Another big controversy with subject-tos, and one reason I struggle ethically with them, is that many investors abuse them. I don't like the paperwork I see on many of the subject-tos and I don't like what I hear in the media. Subject-tos can be the most wonderful thing for some sellers, changing their life and saving their credit, but

ccc_patton_ch4_44-60.qxd 4/27/05 2:12 PM Page 50

unfortunately, they can also do the opposite. Much of the paperwork that I see says, in effect, "Seller, you understand when you deed me your home that I am not guaranteeing anything!" To me, it is distinctly unethical to take someone's home without guaranteeing you can make the payment. Such so-called investors can and do get criminally prosecuted for this, and I completely agree with such prosecution. Subject-tos can't be done by mortgage brokers and Realtors in some states because they violate the code of conduct and ethics. These states feel that assisting a seller to violate or circumvent a contract is wrong.

A subject-to can be a great way to buy property and to help many sellers who might not otherwise be able to find help. Most investors don't mean to hurt a seller, they just get in over their heads. They think that if a seller is willing to deed their home to them, it must be a good deal. Well, it might not be a good deal—check out Chapter 5 before you commit.



Wendy's Ethics Advice on Subject-Tos

A subject-to can really help a seller if done right, by helping improve their credit. If done wrong, it can mess up their life for a long time. Don't do a subject-to if you can't commit to making the payments. Only do subject-tos on what you can commit to, and then do what you say you will do! Only do the deal if the deal is worth doing. If you are unlikely to make a profit, you are more likely to do the wrong thing and default on your solemn promise to the seller.

So what else can I do besides a subject-to when I find a subject-to type of seller? I have three choices (the third is available only to licensed Realtors):

1. I can buy the home outright. I must get the deed, but I don't have to do a subject-to in order to get the deed. I can simply purchase the home, either for cash or by getting a mortgage. But because the seller does not fit the lease option technique, I must get the deed.

ccc_patton_ch4_44-60.qxd 4/27/05 2:12 PM Page 51

2. If the deal is very good, and I know it fits into a subject-to and not a lease option, I can wholesale the deal to another investor. Wholesale means buying very low and selling low. I might sell it for a profit of $3,000 to $10,000 without ever having owned it. Normally I would choose the preceding option, but this one is a great choice for those who want quick cash. You can always find buyers for good deals at your local real estate meetings. Get a buyers list together if you want to wholesale your leads. You can wholesale both lease option and subject-to leads. Normally in a wholesale you sign a contract and then do an assignment of the contract. For example, I would tell an investor, "I have a lead, and for $XXX I will pass it on to you." I would sell the lead, rather than signing on a contract for the deal. Be sure to talk with a competent local attorney, so you can structure your wholesale deal to not run afoul of local real estate brokering statutes.

3. I can also list the home for the seller and get a commission, if the seller has time to stay in the selling process. However, I rarely do this. Although I am licensed to sell real estate, I normally do not do retail real estate. I prefer to buy and sell real estate for investments and not as a broker for others. Also, many sellers don't have the time to wait for a sale to complete if they have financial problems.

Lease Option Advantages

A lease option has at least seven advantages:

1. Minimum or zero down. Whether you are buying from owners directly or through Realtors, there is little or no money required to buy on options.
2. Little or no risk. If you're buying a house on an option, you also maintain the right *not* to buy it. This, to me, is the best benefit of lease options. If the market goes up you can buy; if it goes down, you don't have to buy. It's your choice. If you own the home you don't have this choice—you can't just give it back to the bank. And with a subject-to you can't change your mind later, because you own it.
3. Monthly payment amount (rent paid to owner) is significantly less than a mortgage payment. Typically, I like to get a rental

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payment for 0.5 to 0.6 percent of the value of the home per month. On a $200,000 home, that's $1,000 to $1,200 per month. If you can get that deal, you can get cash flow almost anywhere in the country. Unless you put a lot down on a mortgage, non–owner occupied mortgage payments will be closer to 1 percent per month for the same property (depending on mortgage programs and rates at the time). For instance, on a lease option the owner might owe $100,000 on a home that they lease optioned to me for $200,000 and their payment might only be $800 for principal, interest, taxes, and insurance (PITI). On a subject-to deal, it would not be nearly that low. The seller would not normally deed the home over if they only owed $100,000. In most cases they would owe more and the payment would be higher; therefore the investor would also be paying a higher monthly payment and not receiving as much cash flow.

4. No qualifying. In most cases you will never have anyone ask you for your income or credit information. This is done by building rapport with the seller or the Realtor (discussed in Chapter 6).
5. Great return on investment. The return on investment should be infinite in most cases, because in most cases you would be putting little or nothing down and getting a return and profit.
6. You can buy them with your IRA. You can buy lease options and subject-tos in your IRA. You must have a company that knows how to legally and properly invest and self-direct real estate through your IRA. I use Equity Trust, out of Ohio.
7. The seller will love you. The seller will be thrilled that you helped them with their situation. They won't be able to thank you enough if you looked for a solution that was a win-win. You must be fair.

Lease Option Risks and How to Avoid Them

The biggest risk for a lease option is the possibility of the seller having a problem financially. Although in the beginning we only lease option

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from financially strong sellers, there are things that could go wrong in a seller's life. A lease option is control without ownership. Because the owner still holds the deed or title to the property, if they incur a financial problem, there is a chance the title/deed could have a lien placed on it. A lien can usually be placed on a piece of real estate if a person owes someone money, when certain procedures are followed. This may cause a problem such that it may not be possible for the seller to sell the home easily. This would be horrible not only for you, the investor, but also for your tenant-buyer. Fortunately, there are several things you can do to assist in preventing the repercussions of these things on you as the buyer.

First, make sure the seller is solid when doing a lease option with them. If they want to check your credit, ask to check theirs too. I have never checked any of my sellers' credit, but it is not a bad idea. You can also have a private investigator check them out if you are not sure. Find out where they are moving. Is it a better home? More expensive? Then you will know if they are moving up or down.

Second, make sure you record a memorandum of option. This is a document that gives the world notice that you have an interest in the property. Then the seller can't refinance the home or sell it to someone else. See Chapter 7 for more information about the memorandum. Finally, focus on and pursue primarily the sellers with equity. If the seller has a lot of equity in their home, then even if something bad did happen to them, they would have some cushion to fall on.

Let's look at three scenarios.

1. The seller has $50,000 of equity and has a $30,000 lien placed on their home by the IRS. No problem—the sale will close fine. The IRS will take $30,000 and the seller will get the remaining $20,000 of equity.

2. The seller has $50,000 of equity and the IRS has a $70,000 lien placed on the home. Again, the sale will close fine. The IRS will take the entire $50,000 and the seller will still owe the IRS $20,000. The IRS does not want to stop a closing but it will take what it is owed. You will probably have to coordinate with a title company or attorney, whoever does the closings in your state, to coordinate the payoff on the lien.

3. The seller has $30,000 of equity and has $45,000 of liens placed on them by five different individuals or companies. This one may be a problem if those five companies will not cooperate by taking

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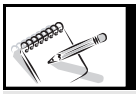
a smaller amount to close out this home. In other words, most lien holders will take something now to get a partial payoff rather than nothing at all. If they are owed $10,000 on a lien, they might take $7,000 now and would still be owed $3,000. In this case, the deal will probably still close, but it will take more work on the seller's part or, more likely, on your part to get these lien holders to cooperate. (Because of emotional tensions between the seller and the lien holders, the seller may not be the best one to negotiate with them to take a little less to make the deal close.) You might even be able to get them to take less as a full payoff—in other words, take $7,000 as full payoff for the $10,000. Either way, I have never heard of a deal where it could not work out. However, this is the risk for a lease option.

The worst thing I have ever had happen on a lease option deal was delinquent property taxes, which I knew about. There was plenty of money to pay for those at closing, and the sellers were not far enough behind to go into foreclosure over the taxes. Had they been in danger of going into foreclosure for back property taxes, I would have paid them myself or the seller would have paid them.



Wendy's Advice on Lease Options

Only buy from financially strong sellers. They are less likely to have any financial problems down the road. Sellers with equity are the best choice because if financial problems do arise they have some cushion to cover the problems.

Matching Motivated Sellers with Lease Options

As discussed previously, subject-to sellers are usually, but not always, motivated by bad debt and a desperation to restore their credit. Conversely, lease option sellers have good credit, and the sellers that would even consider a lease option fall into two categories:

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1. Sellers who don't need their cash out of the home to move on.
2. Sellers who have no equity in their home—they are financed 100 percent.

I prefer a seller in the first category. Why? This seller has some cushion financially if problems arise later. The second category of seller does not have a cushion, and therefore if they get into financial trouble, they are more likely to botch up the deal—either permanently or for a period of time until things can be resolved.

Here are five types of motivated sellers with good debt.

1. *Long-time home owners*. They usually have very low payments, if any, and usually have saved money elsewhere, which enables them to purchase another home without selling the current one. These types of sellers also have the cushion of their home equity, which will mitigate any bad luck on their part. When a seller has a low payment, it creates a good opportunity for the investor to get a lower payment also. This will be good for creating strong cash flow.

2. *Inherited property owners*. Sellers who have inherited properties also have a potential of a lease option sale. If there are many heirs, say five or six, for instance, it is less likely to work out as an investment or rental property because in large families there is always one heir who is broke and needs the cash out. Also, when they divide the rent by five or six, the split of the money on the rental seems too inconsequential to bother with. This is why on inherited properties, I have found that cashing out the sellers (i.e., outright purchasing) is the best way with a large number of heirs, whereas lease optioning is a possibility with a small number of heirs. I have one lease option property now that the seller (one heir) has asked me several times not to pay off. We are now in year five. My price to her has not changed. She likes the cash flow each month and doesn't have to worry about maintenance or bounced checks when working with me. If the tenant-buyer in the home buys soon, then she will be cashed out. If not, she will probably continue to extend as long as I need it.

3. *New home builders*. The sellers have built or bought their new home and their old one hasn't sold yet. These sellers can afford both homes—they qualified for both—but why would they want to pay for two homes when one is vacant? As time goes on and the old home still has not sold, the seller's motivation becomes higher. This does not

ccc_patton_ch4_44-60.qxd 4/27/05 2:12 PM Page 56

mean the seller *must* sell, but that they really *want* to sell or get rid of that old payment. They did not need their cash to buy the new home, and therefore are a good candidate for an option.

4. *Newly married*. The seller has recently gotten married or moved in with someone who owns a home. This seller would not need their cash out to buy a new home, because they are living with someone who has a home. Since this seller could afford to pay the home payment before they moved in with their partner, they can certainly afford it after they moved in with someone. They just don't want to pay for a home that is sitting vacant.

5. *Job transfer*. The seller has been transferred out of state. This type of seller will not necessarily need their cash out of their home (equity) because they may not be sure how long they will be in the new location, whether the job will work out, or even where they would want to live.

Subject-To and Lease Option Pros and Cons: An Overview

Let's examine the comparative pros and cons of subject-tos versus lease options.

Subject-To Pros	*Subject-To Cons*
Title is in your name—full ownership.	You own it and have ethical responsibility to the seller even if the market changes or you can't sell the home. No changing your mind on this one.
Some sellers will pay you to take the deed.	Possible due on sale clause being called—therefore you might have to refinance or sell the property.
Easier to prove "seasoning of title" when you are the title holder; easier to refinance.	In some states, mortgage brokers and Realtors could be fined and/or subject to revocation of their license. It could be considered against

ccc_patton_ch4_44-60.qxd 4/27/05 2:12 PM Page 57

Subject-To Pros (Continued)	*Subject-To Cons (Continued)*
	their code of ethics to assist a person in violating a clause in a contract.
If you are on the title you will have long-term gains versus short-term, if you hold the home for longer than 12 months.	Sellers with lots of equity will be hesitant or completely against relinquishing the deed.

Lease Option Pros	*Lease Option Cons*
You don't have to buy later if the market drops or there is something wrong with the home. You can get out.	Title is not in your name so you are vulnerable to seller error. You must be careful to screen the seller. Only option from strong sellers, not those in trouble or headed for trouble (unless you put the deed in a land trust).
More sellers will do an option rather than give up a deed—especially on nicer homes.	You will have short-term capital gains versus long-term if you are not on the title. This can be avoided if you finance it with 12 months of payments (see the pros column), get on the title, and hold it for 12 months before closing with your tenant-buyer. This solution takes a minimum of 24 months.
After 12 months of payments, many lenders will treat a lease option as a refinance—as if you were on the deed. It would be treated like a land contract refinance.	Some sellers might feel an option is not closure on their home. Some will feel better with a deed being transferred or a lease purchase (which is a guarantee vs. an option).

(Continued)

ccc_patton_ch4_44-60.qxd 4/27/05 2:12 PM Page 58

Subject-To Pros (Continued)	*Subject-To Cons (Continued)*
A way to get nicer homes—more likely the seller is not behind and has taken better care of their home. This type of seller is also more likely to consider a lease option versus signing over the deed.	
Seasoning of title starts when you file a memorandum of option or lien of interest. Most lenders consider this adequate and similar to recording a deed (with the exception of FHA).	
Sellers with lots of equity are more likely to give you the right to buy the home than they are to give you the deed to their home.	Sellers with lots of equity usually want to close and get their equity out.

Putting the Techniques into Practice

Now let's see how you would apply these techniques in different situations.

An Example Where You Must Get the Deed

A seller calls you on the phone and says he is two months behind on payments. Do *not* option this home! This seller is in trouble financially and is not a good risk for an option. Anyone in a bad financial situation is not a good seller for an option. This is the type of seller that you must get off of the deed so that his financial situation will not affect the title to the property in the future.

Not every seller who is in financial trouble will tell you so, which is why you *always* need to do research on the title before you get the

ccc_patton_ch4_44-60.qxd 4/27/05 2:12 PM Page 59

deed or do an option. In this case, you will need to bring the seller's mortgage current. Before you do, you want to make sure that he is the owner of the property and that there are no other liens on the property unknown to you.

An Example Where You Could Get the Deed

A seller calls you who owes $135,000 on his home, which is worth $135,000. Since he has no equity at all, this type of seller might be willing to give you the deed. And if there is high appreciation or a very low payment, you might be able to make a profit even though there's no equity.

On the other hand, if the seller's payment is too high or the market is slow, you might need to have the seller *pay you* to take the deed. Yes, there are sellers who will pay you to take the deed to their home. Think about it: If this seller sells conventionally—that is, through a Realtor—he would have to pay up to $10,000 in commission to sell his home. Plus, he'll have closing costs, transfer taxes, and will probably pay points or fees on behalf of his buyer. If he's willing to pay all this money to an agent to sell the property—and wait 90 to 120 days to sell, too—why shouldn't he just pay you to take over his payments *now*?

If the seller doesn't have the cash to give you, an option would be your best strategy. This way, the seller can pay you the $10,000 over time, or you could arrange for the seller to pay part of the monthly payment during the option period. This way, if he stops paying his portion of the payments, you have the choice of surrendering your option and simply giving the property back to him. When you have the deed, you can't do this.

An Example Where You Should Lease Option or Lease Purchase

A doctor has a new home built for himself. His old home is worth $200,000 and he owes $125,000. He has $75,000 of equity. He is not behind on payments, and he did not need the $75,000 cash out to buy the new home. His old home is sitting vacant and the Realtor has not sold it yet. He qualified for both house payments at the bank and he can technically afford both, but who wants to make an extra house payment?

ccc_patton_ch4_44-60.qxd 4/27/05 2:12 PM Page 60

Although he is motivated to sell because he's paying out of pocket every month to own a vacant property, this type of seller is not going to simply give you the deed and let you take over the mortgage. No way is he going to give up all of his $75,000 in equity, and no way are you going to pay that much cash out of pocket.

When you lease option this house, he gets most of his equity back—although it won't happen until *you* sell the property. The deal might work like this: You option the property for $195,000, and make payments to the seller that equal his total mortgage payments. You sell the property on an 18-month lease option for $228,000 with payments to match. You get cash flow plus $33,000 in profit when your tenant-buyer buys the property; the seller gets his payments taken care of for a few years, then gets the bulk of his equity out. And in the meantime, he doesn't have to worry about management, vandals, frozen pipes, and all the other things that owners of vacant houses have to deal with.

An Example Where You Could Lease Option or Lease Purchase

The seller just inherited a property worth $120,000 from his parents' estate. It is owned free and clear and he doesn't need the cash from a sale but would love some cash flow on this asset. This seller is not going to give you the deed. Let's say you can lease option this property for $700 per month with $300 per month going to the purchase—or the option credit. Your real payment in this case is only $400. You also could do seller financing on this property (like a land contract or mortgage by the seller).

Conclusion

Subject-tos and lease options are great techniques to help sellers in situations that might not otherwise have solutions. If you do your research on the seller and the market, and apply the right technique to the right situation, you will make a profit for yourself and at the same time help a seller who really needs you. Make it a win-win.

ccc_patton_ch05_61-75.qxd 4/27/05 2:12 PM Page 61

CHAPTER 5

Evaluating the Profitability of the Deal

Winner: Stupidest Moves Award

My investors group gives an award called the "Stupidest Moves Award" for the person who makes the most ridiculous real estate move during the year. I didn't even know this award existed until I got it, and the only reason I got it was because I was chatting away about my deals to other investors. I received a mechanical shark, mounted on a plaque, that was devouring a large Monopoly® denomination, to depict the eating away of huge profits.

It was the early 1990s and one of my earliest deals with a Realtor. I was presented with a great deal for a $300,000 lakefront home. I felt I could rent it easily because of its price range and because it was lakefront property. Therefore, I quickly committed to start my option on October 1, whether or not I had secured a tenant-buyer. My rent commitment was $1,400 per month, and of course I planned to charge more in order to make cash flow. October turned into November, November into December, December into January, and January into February. Unfortunately, in Michigan, lakefront properties are not very desirable in the middle of winter. I finally rented it in March. In total I lost more than $7,000 plus utilities for

ccc_patton_ch05_61-75.qxd 4/27/05 2:12 PM Page 62

the winter. I was paying more for a house I wasn't living in than for my own mortgage.

I could have avoided winning this award by either (1) making my contract contingent on securing a tenant, or (2) waiting until spring to start the lease option. Lakefronts rent the best in the spring and summer in my area. People aren't crazy about moving into a property with a frozen piece of water in their backyard—water that may not thaw for months. I was too eager and didn't think it all the way through. Not only did I lose over $7,000 in profit, it was $7,000 in cash out of my pocket. Although I eventually made well over $25,000, it could have been $32,000 with much less stress. That's how I earned the "Stupidest Moves Award" in my investment group. It's not the kind of award you want to get more than once, but everyone has a story like that in their investment portfolio. It's just part of the learning process.

Eagerness to start a deal should never outweigh the need for thoughtful preparation in evaluation and construction of an offer. There are many sellers willing to sell on lease option and subject-to techniques, but they must be profitable for you!

Wendy's Tip

Know your climate. People don't like to move in the winter in a colder climate, so if you live in a place with bone-chilling winters, structure your deals, if possible, to start and end in the spring or summer. Also, try to work around holiday months, especially mid-November and December everywhere in the country.

Creating the Offer

Now that you've considered which technique to use, a lease option or subject-to, you need to step back and take the time to work out the profitability of the deal. Normally you should not throw out numbers to the seller in the excitement of the moment. Even if you feel pres-

ccc_patton_ch05_61-75.qxd 4/27/05 2:12 PM Page 63

sured, tell them you need to go back to your office and crunch the numbers. In the excitement of the moment you may voice a dollar figure that doesn't include all the things you need to consider. In the quiet of your office you will have the time to go through your own profitability worksheet, discussed later in this chapter, and make sure the numbers work for you. Negotiations and offers are an art form—take the time to do them well.

There may, however, be situations where you'll need to respond immediately, such as in the case of a subject-to offer on a pre-foreclosure or other competitive bidding situation. Lease option offers, by their nature, rarely require an on-the-spot response. Therefore, you can respond according to the dictates of each specific situation.

Calculating Your Profit Requirement

As an investor, you must determine your profit requirement for any given deal. It may vary depending on the type of investment. For instance, I will accept less for a rehab than a lease option, because I can be in and out of a rehab within a few months, while lease option transactions typically require 12 to 18 months or more. Do you require $10,000 profit, $50,000, or what? Once you determine your profit requirement, that becomes the bottom-line number that must be reachable in order to take on a transaction. For example, if your required profit is $20,000 and an opportunity comes along that will earn you only $18,000, then you'll need to either negotiate the terms of the deal to meet your $20,000 requirement or pass up the deal. Otherwise it will not be a win-win situation for the seller and yourself. Alternatively, you might be able to wholesale the deal to someone else who has a bottom line that is lower than yours, but learn to walk away from deals that don't work for you.

There are times when a seller will do only X, Y, and Z in terms of price, payment, and length of time. You can input those numbers into the spreadsheet in this chapter to determine if the deal meets your profit requirement. Sometimes, if it doesn't, you can negotiate a little further, as discussed in Chapter 6. Often the seller is not firmly

ccc_patton_ch05_61-75.qxd 4/27/05 2:12 PM Page 64

set on X, Y, *and* Z, just X and Y; therefore you can negotiate the Z. Chapter 6 will help you think of creative ways to help bring deals together. However, there will be some deals where you will need to just walk away. Some sellers are simply not willing to do what you need to make it a win-win; some are not motivated enough or can't go down far enough on price because they owe too much. Wasted time is money to you, so learn to move on quickly and look for another motivated seller.

Profitability for Lease Options

The first thing we'll do is create a worksheet for profitability for a lease option. We will cover subject-to transactions later in this chapter.

Appreciation can't be predicted exactly, so you will need to estimate it. Newspapers are a great source for the appreciation rates in your area. Base your estimates on the predictions of your local writers or Realtor boards. When calculating your option premium, use 5 percent in areas that are very consistent—condos, or in neighborhoods where all the homes are almost identical in size or model. If the neighborhood is very diverse, then you may use up to 10 percent, as the comparables should be there for the appraiser when you go to sell the home.

You also need to determine Cash flow or rental values. You can do rental comparables just like you do sales comparables. Here are three ways to find the rental comparables:

1. Read the local paper. Check all the local rentals. Those are your "comps," or comparables.
2. Check with people in your local landlords group. Many rentals are not on the MLS.
3. Not enough data from the first two sources? Run a test ad in the newspaper. Too many calls? Your price might be too low. Too few? Your price might be too high. It's a little like fishing—change the bait and see what happens.

ccc_patton_ch05_61-75.qxd 4/27/05 2:12 PM Page 65

Now let's use this worksheet to calculate profitability on three example deals.

Profitability Worksheet **Lease Option**		
Purchase Costs		
Purchase price		
Total purchase costs		
Income Sources		
Current value		
Value of lease option premium (5–10%)		
Expected appreciation		
Expected sale price		
Expected monthly cash flow		
Total other income		
Expected Profit		

Example 1

Seller will sell you their home for $185,000. It is currently worth $190,000. The appreciation rate is 5 percent per year. It will be sold on an 18-month option, which will result in 7.5 percent appreciation (5 percent × 1.5 = 7.5 percent). That gives us $14,250 ($190,000 × 7.5 percent) of appreciation value during the 18 months. You'll pay the owner $1,300 in rent. You can rent it out for $1,600, for a cash flow of $300 per month. I usually rent a home for $1,595 versus $1,600 ($1,595 sounds like less than $1,600 and is therefore more appealing to potential tenant-buyers), but it is easier to show even numbers for each of the examples.

The homes in this neighborhood are diverse and unique. Prices range from $170,000 to $285,000. This allows us to build in a higher option premium of 10 percent, or $19,000. The $19,000 option premium and the $14,250 appreciation adds $33,250 to the retail value of

ccc_patton_ch05_61-75.qxd 4/27/05 2:12 PM Page 66

the home. What is your estimated profit in 18 months? Let's view how I would figure out the profit of this deal:

Profitability Worksheet Lease Option	**Example 1**	
Purchase Costs		
Purchase price	$(185,000)	
Total purchase costs	$(185,000)	$(185,000)
Income Sources		
Current value ($5,000 above purchase price)	$ 190,000	
Value of lease option premium (10%)	$ 19,000	
Expected appreciation (5% annually, 7.5% over 18 months)	$ 14,250	
Expected sale price	$ 223,250	$ 223,250
Expected monthly cash flow ($300 per month for 18 months)	$ 5,400	
Total other income	$ 5,400	$ 5,400
Expected Profit		$ 43,650

The resulting profit from this deal, if all payments were made during this option period and it went the full 18 months, would be approximately $43,650, less transfer fees, title insurance, and possible option credits from the investor (you) to the buyer. Does this meet your required profit? If so, then move forward with these terms. If not, you continue negotiations on the deal or pass it up.

Example 2

Seller will sell you their home for $145,000 on a 12-month option. It is worth $145,000. The appreciation rate is 3 percent per year, which will result in an additional $4,350 ($145,000 × 3 percent) after one year. This home is in an area where all the homes are similar and range in price from $140,000 to $152,000. This results in a more modest option premium of only 5 percent, or $7,250 ($145,000 × 5 percent). The appreciation and the option premium total $11,600 ($4,350 + $7,250). You'll pay the owner $1,000 in rent and will in turn rent it out for $1,200. The seller is also willing to give you $200 a month

ccc_patton_ch05_61-75.qxd 4/27/05 2:12 PM Page 67

credit toward buying this home. Let's look at your estimated 12-month profit:

Profitability Worksheet Lease Option	**Example 2**	
Purchase Costs		
Purchase price	$(145,000)	
Total purchase costs	$(145,000)	$(145,000)
Income Sources		
Current value (same as purchase price)	$ 145,000	
Value of lease option premium (5%)	$ 7,250	
Expected appreciation (3% annually)	$ 4,350	
Expected sale price	$ 156,600	$ 156,600
Expected monthly cash flow ($200 per month for 12 months)	$ 2,400	
Option credit from seller ($200 per month for 12 months)	$ 2,400	
Total other income	$ 4,800	$ 4,800
Expected Profit		$ 16,400

This deal would not be nearly as profitable for an investor. It would only generate $16,400 before closing costs, not leaving much room for potential problems. This opportunity does not meet my minimum profit requirement. However, there are ways to renegotiate the deal with the seller. With the appreciation this low, it must be more of a buyer's market. You should be able to negotiate price and terms. Ask for a better price and for additional monthly credit towards the purchase. You can also ask for the equity buy-down of the mortgage during the option period. For example, if the seller owes $100,000 on the home at the start of this option and at the end they only owe $90,000, then you would receive the $10,000 of credit that was paid on the mortgage balance during the option period, because in effect you had been paying that mortgage payment during the option period.

If the seller does not agree to the additional terms, let it sit until their motivation increases enough for them to agree to terms that would make this transaction meet your profit requirement. It must meet your bottom-line number and result in a win for both you and the seller.

ccc_patton_ch05_61-75.qxd 4/27/05 2:12 PM Page 68

Example 3

Seller has a home worth $235,000 and they will sell it to you for $225,000 on an 18-month option. The appreciation rate is 5 percent per year (or 7.5 percent over 18 months), which would generate an additional $17,625. This home is in a very diverse area out in the country. The homes vary widely in square footage and acreage, and prices range from $150,000 to $450,000. These factors let us establish the option premium at 10 percent, or $23,500. The rent you pay the owner is $1,200, and the market rent you expect to receive is $1,450. The seller owes $150,000 on the mortgage and agrees to take $75,000, less closing costs, at the time of closing ($225,000 sales price less $150,000 current mortgage balance). This allows you to get the mortgage equity during the option period. The equity from the principal pay-down during this option period is estimated at about $200 per month or $3,600. What is your estimated profit in 18 months?

Profitability Worksheet Lease Option	**Example 3**	
Purchase Costs		
Purchase price	$(225,000)	
Total purchase costs	$(225,000)	$(225,000)
Income Sources		
Current value ($10,000 above purchase price)	$ 235,000	
Value of lease option premium (10%)	$ 23,500	
Expected appreciation (5% annually, 7.5% over 18 months)	$ 17,625	
Expected sale price	$ 276,125	$ 276,125
Expected monthly cash flow ($250 per month for 18 months)	$ 4,500	
Expected monthly equity ($200 per month for 18 months)	$ 3,600	
Total other income	$ 8,100	$ 8,100
Expected Profit		$ 59,225

Note that no commissions are paid to Realtors in these examples. Working with Realtors is discussed in Chapters 10 and 11. However, if you are paying any Realtor commission or option fee up front to your seller, you will have some out-of-pocket costs. This will

ccc_patton_ch05_61-75.qxd 4/27/05 2:12 PM Page 69

not affect your bottom-line profitability, as option fees are applied to the purchase price at closing, but it will affect your up-front cash out-of-pocket expenses.

Which of the three scenarios will get you to financial freedom? The answer is that they all can, if you do them correctly. The second one would probably require changes from the seller to make it work for you.

The primary profit source is the back end—the difference between the purchase price and your selling price, which is realized at closing at the end of the lease option period. When you're first starting out, you might deal with smaller back ends. That's fine—those deals help you learn the business. As you become more skilled in working with options you will find more ways of improving the numbers to get you higher returns that are still a win-win. Obviously, the higher the back end, the easier it will be to begin working your way towards your financial goals.

Wendy's Tip

There are always unexpected costs in any deal and, so, I like to make sure that I have extra profit built into any real estate transaction. Always plan for something that could go wrong—someone who won't pay rent, a furnace that goes out, a roof that leaks, a septic field that fails, and so on. Plan for the worst and you will be safe.

Profitability for Subject-Tos

Subject-to transactions are similar to lease options except you will be taking over a loan balance and possibly other liens or back taxes. Once you complete a subject-to negotiation, you will be done with the seller. You'll have the deed to the property and you won't close with the seller again the way you do with a lease option. The worksheets seem more complex and there are more numbers to fill in, but they are essentially not much different than lease options.

As with a lease option deal, you will need to determine whether

ccc_patton_ch05_61-75.qxd 4/27/05 2:12 PM Page 70

a subject-to deal is profitable enough to consider. You must run the numbers. Here is an example of a profitability spreadsheet for a subject-to deal.

Profitability Worksheet Subject-To	**Totals**	
Purchase Costs		
Balance owed on first mortgage	$	
Balance owed on second mortgage	$	
Back payments and liens (Up-front cash requirement)	$	
Total debt owed on property	$	$
Income Sources		
Current value	$	
Value of lease option premium (5–10%)	$	
Expected appreciation	$	
Expected sale price	$	$
Expected monthly cash flow	$	
Additional principal from mortgage	$	
Payments during option period		
Escrow balance	$	
Other income	$	$
Expected Profit		$

In addition to the elements of the base option worksheet, this worksheet asks for information about the balances on the loans, other liens, principal of the mortgage during the option period, and escrow balance. The principal on the loan is negotiable on a lease option deal, but it is a given on a subject-to deal because you are now the owner. You will get the principal for as long as it is optioned to a buyer. The exit strategy (selling it on a lease option) will be figured out the same way for a subject-to as in the previous lease option examples.

Any back payments due on a mortgage are also part of the current balance due reflected on a mortgage. In other words, if the lender shows that the balance is $145,500 and the amount currently due is $3,200, then the balance will be reduced after the $3,200 pay-

ccc_patton_ch05_61-75.qxd 4/27/05 2:12 PM Page 71

ment is made. Make sure you show that in your calculations and adjustments. The escrow balance is the amount in the escrow account at the time of the subject-to assumption. The escrow account contains funds set aside to pay the taxes and insurance that will be due in the future. If you complete the applicable paperwork, you can make sure that any outstanding escrow funds go to you, rather than to the previous owner.

Note: Escrow numbers vary monthly. The numbers in these examples are simplified. Also, the cash flow and principal payments have been rounded to even numbers to make the spreadsheet figuring easy to calculate. This is also how I do it in my deals. Tracking numbers down to the penny unnecessarily complicates your analysis.

Example 1

The seller owes $140,000 on their first mortgage and $23,500 on their second. They are behind $3,300 between the two mortgages. Their property taxes and insurance are current and they have no other liens on the home. The home is currently worth $175,000, and it is in a market that is appreciating at 6 percent a year. The neighborhood is diverse and has many comparables. It is comprised of homes ranging from $150,000 to $250,000. We will set the option premium at 10 percent to sell this home to our tenant-buyer.

The payments between the first and the second mortgage are rather steep: $1,050 for the first, which includes taxes and insurance, and $150 for the second mortgage, for a total of $1,200. This home will only rent for $1,100 a month, so you have a negative cash flow situation. It is not uncommon to have negative cash flow on a subject-to for two reasons: (1) Many sellers have two mortgages, which results in higher payments; and (2) many sellers have higher interest rates due to poor credit, which also results in higher payments.

The principal portions of both mortgage payments during the option period are approximately $250/month, or $3,000 for the 12 months ($250 × 12). The escrow balance received from the seller when the home was purchased was approximately $1,750.

ccc_patton_ch05_61-75.qxd 4/27/05 2:12 PM Page 72

Profitability Worksheet Subject-To	Example 1	
Purchase Costs		
Balance owed on first mortgage	$(140,000)	
Balance owed on second mortgage	$ (23,500)	
Back payments and liens (Up-front cash requirement)	$ (3,300)	
Total debt owed on property	$(166,800)	$(166,800)
Income Sources		
Current value ($10,000 above purchase price)	$ 175,000	
Value of lease option premium (10%)	$ 17,500	
Expected appreciation (6% annually)	$ 10,500	
Expected sale price	$ 203,000	$ 203,000
Expected monthly cash flow (–$100 per month for 12 months)	$ (1,200)	
Additional principal from mortgage	$ 3,000	
Payments during option period		
Escrow balance	$ 1,750	
Other income	$ 3,550	$ 3,550
Expected Profit		$ 39,750

Would you do a subject-to deal for $39,750? If so, this is a good deal for you. The numbers do not include the transfer fees, title insurance, and any option credits given to the buyer at closing. You need to keep in mind the up-front funds required to do this deal. It requires $3,300 cash when you take the deed and a negative monthly cash flow of $100.

Example 2

The seller owes $322,000 on the first mortgage and does not have a second mortgage. They are current on their mortgage payments of $1,900 per month PITI. They have no other liens owed on the home. This seller is not in financial trouble but is willing to give you the deed on the home, which is worth approximately $340,000. The neighborhood is fairly consistent with comparables, so only a 5 percent option premium is available on the resale side. Most of the homes range from $340,000 to $350,000 and are similar in size and square footage.

The real estate market in this area is appreciating slowly at 2 percent and the rental rate is $2,000 per month. You can sell it on an

ccc_patton_ch05_61-75.qxd 4/27/05 2:12 PM Page 73

18-month lease option. There is a $2,200 escrow balance available and the mortgage payments have approximately $200 per month going toward principal.

Profitability Worksheet Subject-To	**Example 2**	
Purchase Costs		
Balance owed on first mortgage	$(322,000)	
Balance owed on second mortgage	$ —	
Back payments and liens (Up-front cash requirement)	$ —	
Total debt owed on property	$(322,000)	$(322,000)
Income Sources		
Current value ($10,000 above purchase price)	$ 340,000	
Value of lease option premium (5%)	$ 17,000	
Expected appreciation (2% annually)	$ 6,800	
Expected sale price	$ 363,800	$ 363,800
Expected monthly cash flow ($100 per month for 18 months)	$ 1,800	
Additional principal from mortgage	$ 3,600	
Payments during option period		
Escrow balance	$ 2,200	
Other income	$ 7,600	$ 7,600
Expected Profit		$ 49,400

Why is the profit on this deal better than the prior scenario, when the appreciation rate and option premium are lower here? This one comes out better because of the higher value of the home. The appreciation and option premiums are based on a larger value. This one would be more risky if you couldn't rent it for $2,000 a month, in which case you might want to rent it for less and take the negative cash flow for a few months until you can refinance it with a better rate loan. If the mortgage rates are low enough, you might be able to get a lower payment and make this home generate a positive cash flow.

Example 3

The seller owes $110,000 on a first mortgage and $22,000 on a second mortgage. The payments are $870 for the first mortgage and $150 for the second. The taxes and insurance are an additional $210 per

ccc_patton_ch05_61-75.qxd 4/27/05 2:12 PM Page 74

month. The total of all payments is $1,230 (principal and interest for both mortgages, along with taxes and insurance).

The seller is behind two years in taxes for $4,200 (including penalties) and three months of payments on the first mortgage for $2,610. The home is valued at approximately $135,000. Homes in the area are very similar and the option premium would be only 5 percent. The appreciation in the area has been fairly steady at approximately 4 percent per year. You can do a 12-month lease option and rent this home at the market rate of approximately $900 per month. This would put you in a negative cash flow situation. The payments on the mortgages are going toward principal at approximately $300 per month, and there is no escrow balance on this loan.

Profitability Worksheet Subject-To	**Example 3**	
Purchase Costs		
Balance owed on first mortgage	$(110,000)	
Balance owed on second mortgage	$ (22,000)	
Back payments and liens		
Back payments $2,610		
Taxes owed $4,200 (Up-front cash requirement)		
Total debt owed on property	$(132,000)	$(132,000)
Income Sources		
Current value ($10,000 above purchase price)	$ 135,000	
Value of lease option premium (5%)	$ 6,750	
Expected appreciation (4% annually)	$ 5,400	
Expected sale price	$ 147,150	$ 147,150
Expected monthly cash flow (–$330 per month for 12 months)	$ (3,960)	
Additional principal from mortgage	$ 3,600	
Payments during option period		
Escrow balance	$ —	
Other income	$ (360)	$ (360)
Expected Profit		$ 14,790

This deal does not look good at all. You will only make $14,790, less transfer fees, title insurance, and any option credits you give your buyer. This also assumes nothing else goes wrong with the deal. Along with the low profit margin, you would need to pay $6,810 out of your pocket and endure 12 months of negative cash flow.

ccc_patton_ch05_61-75.qxd 4/27/05 2:12 PM Page 75

What can you do? You must negotiate more with the seller. Chapter 6 discusses in more detail how to negotiate with the seller, but in this example one thing you can do is ask the seller to pay the $6,810 that is behind, or make payments on it to you. You can also ask the seller to continue to make payments on their second mortgage while you make payments on the first mortgage only. Some sellers will even pay you to take the deed to their home so they can move on with their lives. Adjust some things around to see if anything can be done with the seller to make this deal work. But you may just need to say, "Next."

ccc_patton_ch6_76-94.qxd 4/27/05 2:12 PM Page 76

CHAPTER 6

Negotiating the Deal: Steps to Buying on Lease Options and Subject-Tos

Build Rapport and Make a Deal!

In one house I visited for a potential purchase, the woman had a lot of birdcages in her garage, and all of them had price tags. Either she was about to have a garage sale, or she had already had a fairly unsuccessful one. I didn't know anything about birds, but I suddenly had a crazy thought that I could get a parrot and teach it to say, "Hi, welcome to Majestic Realty" when people came through the office doors. I dropped the idea pretty quickly when she told me that birds pick up almost everything they hear you say—I could just imagine it repeating things my office staff say when they hang up the phone from tenant calls: "That tenant is lying"; "Liar, liar"; " Yeah, Grandma died again!" Nevertheless, I continued to chat with the seller about different types of birds while looking around at the house.

This is an example of how to build rapport with a seller. People like to talk about what is important to them. It makes them feel more comfortable with you. As it turned out that day, one of the cages was marked $20 and I decided to buy it, thinking perhaps one day I'd get a bird. I couldn't fit the large cage into my car, so I told her that I'd send some of my work crew back that evening to pick it up in their truck.

ccc_patton_ch6_76-94.qxd 4/27/05 2:12 PM Page 77

At this time, we were in a strong seller's market, and I already had a tenant-buyer who wanted to buy this home, and I was going to try to purchase this home outright. Our market was *very* hot!

I made an offer through the Realtor the very first day. She called me that evening and said, "Well, we have another offer."

I had figured this was possible. That home had just come on the market that morning, but homes don't stay on the market long in a hot market, especially in that price range.

She continued: "But let me tell you the stupidest thing I've ever heard."

I said, "What?"

The Realtor said, somewhat angrily, "She accepted your offer."

I asked, "Why is that so stupid?"

"Because the other offer was $5,000 more than yours with the same terms, and that's just stupid to me, Wendy. But do you know why she accepted yours? She likes you."

Did the birdcage discussion save me $5,000, or did it get me the house? I think it did both. I didn't buy the cage to get the house, but everything you can do to make a prospective seller feel comfortable with you will ultimately be worth it. I always tell my students that if they are not comfortable building rapport with sellers, they should send someone else, because it is such a crucial element to succeeding in this business. That seller was not in position to just give away $5,000, yet it was important enough for her to sell her home to someone she felt good about that she took $5,000 off her price. Make it a point to establish rapport and you will almost always get a better deal.

How to Build Rapport with a Seller

If you were trying to sell your house, who would you give a better price to? The buyer who came in saying, "I don't like your carpet color. Are you going to replace it? The walls won't match my furniture. This kitchen is just not my style"? or the potential buyer who said, "I like the layout. I see there's a ding in the wall. You don't mind if I fix that, do you? I just want to make this my home. I love it." You would choose the second person, of course, because they are reasonable and are trying to work with you. You would instinctively want to work with them.

ccc_patton_ch6_76-94.qxd 4/27/05 2:12 PM Page 78

Building rapport with the seller is key to making a deal. If the seller doesn't like you, the deal will probably never happen. Therefore, if meeting people and being reasonably conversational and interested in the seller's home isn't your strength, take someone with you who is warm and friendly and can bridge that gap for you. The reason this is so important is because, for either lease option or subject-to transactions, you're asking someone to give you control of their house with little or no money down. They must feel comfortable with you.

Wendy's Tip

When you're in the seller's house, tell them what you like about it, not what you don't like. For example, perhaps you'll see something unusual, like older wood work or a nice fireplace. Ask the seller about it. If you see that the seller likes golf, talk about golf, whether you like golf or not. Always focus on the positives, the interesting things. People like to know that you like their house, which builds immediate rapport.

In a rehab situation, while it's still important to establish rapport, it's also appropriate to point out problems in the property. You want the seller to be prepared for your lower offer when it comes. Buying at a low price is more critical to your profitability when doing a rehab and sale than when taking control of a property and holding on via a lease option or subject-to approach. But in a lease option or subject-to, emphasize the positive—you will want the seller on your side.

I start out with rapport building questions. As I enter the house, I quickly look around for items connected to children or pets, or something of significance, like a hobby or a collection—anything that I can use to talk about something of interest, other than the house. Then I ask about those items. I'm seeking to get everyone to lighten up, and talking about something significant in their life will do that.

Then I ask, "What is it that you're trying to accomplish with the house (not "your home"—I want to separate out the emotional ele-

ccc_patton_ch6_76-94.qxd 4/27/05 2:12 PM Page 79

ment) as a result of my help?" And I shut up and listen, using my facial expressions and body language to acknowledge that I understand. I want them to see that I honestly care about them and their situation (and I do—if the deal isn't right for them, I won't do it). This will pay off huge returns when we start talking about the terms of the deal. They don't care that I've been in real estate for over 20 years and they don't care that I've done over a thousand deals. They don't care that I taught the loss mitigation department for the third largest diversified lender in America how to work with investors. What they care about is whether I can help them with the problem that's in front of them.

Some sellers like to feel like they're dealing with an individual rather than a company, while others like to be reassured that there is a company behind the person. Each seller is different, and you need to learn how to read them and accommodate them. The more personal you can be with a seller, the better they will feel about making the deal. Of course, when the paperwork comes through, it will have my company name, but when I'm talking with the seller it's just between them and me.

Books have been written on negotiations with sellers. Read them to get more details on the psychology of negotiating. Some of them have really helped me understand people and why negotiating itself is so important to completing a deal. This chapter offers ideas specifically on building rapport with sellers, presenting informal proposals to them, negotiating terms, and handling their questions and objections for lease options and subject-tos.

Putting Together the Proposal/Offer to the Seller

I tell my students to follow three basic steps in writing a proposal or offer to the seller:

1. Keep it simple.
2. Do your homework.
3. Determine your offer.

ccc_patton_ch6_76-94.qxd 4/27/05 2:12 PM Page 80

Keep It Simple

Sometimes we get too formal. We want to make sure we have the proper letterhead and business cards and look official up front. We feel this gives us the legitimacy a seller expects. However, counterintuitively, there are times when too much polish may in fact be detrimental to us because the seller finds it impersonal. Save the formal documents for after the deal is negotiated, when it needs to be drawn up in detail (see Chapters 7 and 8). For preliminary proposals it's best to outline several scenarios, even handwritten. (Refer to the proposal in Chapter 11 used with Realtors. You can use the same format with a seller—less any commission or Realtor information.) Many deals are made on bar napkins, and they are legitimate and legal as long as they are signed. It's all about personal relationships, not just professionalism. The seller needs to like *you*, not your business card.

Putting out an offer is a lot like fishing. We're trying to find out what's important to the seller, where they are financially, whether they need their cash out, and what terms will work for them. If the seller is not sure, use the proposal format in Chapter 11 and give them a few scenarios in writing to help them evaluate different alternatives. Many times they will know what areas are most important to them. For instance, price might be the most important area to a seller. You then can work around price by negotiating the other areas of terms to make the deal work for you. You will have to tweak the other areas of the lease option or subject-to in order to get your profit requirements, but at least you know where the seller is starting—where they are firm and what is important to them. Then use the profitability worksheets in Chapter 5 and make sure the numbers will work for you.

When you agree on the terms with the seller, then you should formalize the contracts. When I think there is going to be a meeting of the minds, or if the Realtor says they want everything in writing, or if the seller says "I want to see every piece of the contract before I agree," then I put everything together. I try to make my offer in the way the individual seller prefers it. Some like to just discuss it and others want it in writing. Occasionally, timing is critical and negotiations must be done quickly, and contracts are also drawn immediately.

ccc_patton_ch6_76-94.qxd 4/27/05 2:12 PM Page 81

Do Your Homework

You can't put together a proposal without first doing some research, especially if you are in an area of town that is new to you. You can't base your offer purely on what you think the home is worth; you must incorporate the comparables as well. Find out what similar homes in the area are worth, either by checking the newspaper or using the MLS. The MLS is protected by Realtors in most areas of the country; however, it is available to the public in some parts of the country. Ask investors in your local real estate investor club the status of the MLS in your area. If you have a relationship with a Realtor, you can ask them what the comparables (comparable market values) are in a certain neighborhood.

Understanding the current economy is essential to making offers on lease options and subject-tos work, and work effectively. For instance, are you in a strong buyer's or seller's market? Understanding the differences and how they affect the sellers is key to successful negotiations. The techniques I teach will work in either a buyer's or seller's market; however, it is important to know which market you are in so you can establish your offer correctly. (See Chapter 3 for more about buyer's and seller's markets.)

Strong Seller's Market

In a seller's market you're going to buy higher. When things are appreciating in a seller's market, I have no problem paying closer to retail for a property. There are times when you could even pay higher than retail and still be profitable based on favorable appreciation and other terms. You must work the numbers yourself. Your value in the property is going to come from not only the appreciation but also from the lease option when you sell.

Strong Buyer's Market

The opposite is true in a buyer's market. The economy will be slow, probably with higher unemployment rates. Real estate listings aren't moving, in which case you need to buy low—meaning below the retail value—because you can't count on appreciation. When the market is slow, the buyers have less money and are less able to take on more debt. The advantage of the buyer's market is that you can cherry-pick your deals.

ccc_patton_ch6_76-94.qxd 4/27/05 2:12 PM Page 82

Remember this in negotiating with your sellers. If your sellers are unwilling to give, you have to move on, because they are not the motivated sellers that we discussed in Chapter 3. The slower the market, the more you can negotiate. As more properties are languishing on the market, there is a large pool of motivated sellers for you to choose from. You can be selective in order to find deals that work out for you and the seller.

How to Determine Your Offer

The following are potential areas of negotiation for a subject-to:

- Price.
- Seller paying part of payment.
- Seller paying to take over payments.
- Length of term.
- The point at which the agreement locks in.

With lease options, there are too many variations to discuss in detail, so I will mention only the key areas available for negotiation. When structuring your lease option with the seller it is important to understand which of these criteria are most important for them:

- Price.
- Length of contract.
- Monthly payments.
- Option credits.
- Mortgage buy-down—the principal adjustment.
- Automatic renewal periods.

In addition to these criteria, I usually include terms that will limit my risk. One approach is to include a clause that says my lease option can be terminated within 60 days with written notice to the owner. This provides an agreeable exit to problematic transactions.

Another method that I use even more frequently is to make the

ccc_patton_ch6_76-94.qxd 4/27/05 2:12 PM Page 83

start of the lease option contract subject to finding a tenant-buyer. This significantly reduces your overall risk and avoids having to begin funding monthly payments before you have your own funding source in place.

Multiple Offers

Sometimes you will need to create multiple offers on the same property. This is usually for a lease option, but it may also apply to some subject-to offers. For example, let's say I make an offer of three years at $225,000 and pay the seller $1,000 per month. The seller then looks at appreciation rates and says they don't want to lose out on all the appreciation that I will profit from in the next three years. So I then structure a second offer where I might offer to go five years and give them a little more on the sales price as well as a little more each month, but they have to agree to all five years. You might also want to do a step approach based on appreciation with a lower percentage than the market appreciation, so that you aren't giving away the entire profit. For example, one time I purchased a home from a seller who wanted part of the appreciation, which at that time was 10 percent per year. I asked him how much he was expecting. He responded with 2 percent per year, which I felt was fair, and we settled on him receiving part of the appreciation and me receiving most of it. You can give away part of the profit and still make it a win-win.

When objections arise, put yourself in the seller's shoes and reflect on what they say. Always try to come up with creative solutions to keep the discussion going. Find out what their concern is, and if you can fix it, say, "If I could do that for you, would you do the deal this way?" Find the seller's key issues so that you know what terms are more flexible for them. Whenever you give up something, negotiate something back in return. With a seller, usually the first question they ask tells you the most important issue to them. If they mention two or three different issues, find out which is the most important.

Find the Seller's Sticking Point

Sellers will have something that means more to them than anything else. Find out what this is so that you can structure a deal that makes them happy while simultaneously meeting your requirements for

ccc_patton_ch6_76-94.qxd 4/27/05 2:12 PM Page 84

profitability. For instance, the price of the home may be more important to some sellers than when they will receive it. Other sellers might want a very specific monthly payment, but their overall price is negotiable. Work with each seller to understand what makes them tick, so that you can tailor an offer to suit them best.

Handling Rejection

When you make your proposals, sometimes the sellers will accept, and other times they will shake their head and walk away. It's best to soft-pedal their rejection with a comment such as, "Well, things might change for you, so please give me a call somewhere down the line if you're still interested." Many do come back to me that way. Sometimes people don't want to act today because it's not a win-win for them, but a few months down the road they're feeling much more motivated. Always handle all sellers graciously and be accessible. You never know when they will call back and say, "Okay, now we want to accept the proposal that you presented to us a while back."

Wendy's Tip

Time always increases motivation. Sometimes if it's not a win-win for the seller now, it may be in a month or two.

Overcoming Sellers' Objections

If you have properly built rapport and trust with the seller first, their objections should be minimal and can be handled confidently and easily. Too many seller objections usually means you have a seller who is not as motivated as you thought; however, they may just have questions that need to be answered. Learn to *love* objections. Objections are buying signals. The seller is indicating that they need more information before they can make a buying decision—in other words when they have objections, they *want* more information. I have gotten to the end of my presentation and the homeowner had no objec-

ccc_patton_ch6_76-94.qxd 4/27/05 2:12 PM Page 85

tions, and of course I didn't get the home. Obviously I either missed asking the correct question or I didn't pick up on the homeowner's hot button.

Once you have overcome any particular objection, it is part of your repertoire. I can't wait for that question to come up the next time.

One technique that I like to use is to feed their question back to them. Many times we think we understand the question when the intent was something else. For example, if a seller says, "Your offer isn't enough!" I reply, "My offer isn't enough?" and then look at them and don't say another word. What I'm trying to do is see if the question is a smoke screen or if there is another objection. It could be that my offer isn't enough money up front; it could be that my offer is for too many years. By feeding it back, I put the ball in their court and get more information, so that I can give them a correct answer and avoid bringing up another objection they hadn't thought of.

Wendy's Tidbit

Learn to *love* objections—they are buying signals!

There are, however, some common objections and questions that you need to be prepared to handle.

Lease Option Questions and Objections

Here are my recommendations on how to handle each of these objections and questions.

I Don't Want Tenants in My Home.

The number one objection for sellers who are doing FSBOs is that they don't want tenants in their home. They need to understand that future home buyers are people who want a home to take care of. Let the seller know that you understand their concern: "I want you to know that I really screen my tenants and they are hand-selected by me. I also am not going to put just any tenant into your

ccc_patton_ch6_76-94.qxd 4/27/05 2:12 PM Page 86

home. I am putting a future home buyer in your home. These types of tenants take better care of a home, because they are planning to purchase it."

What If You Don't Make My Mortgage Payment?

There are at least three ways you can answer this one. Use the one most comfortable, fitting, and true for your situation.

1. "I understand your concern. I have been in this business a long time and can give you references from other sellers like yourself, if that might make you more comfortable."
2. "I understand your concern. What would make you more comfortable and yet protect us both?"

   If they want to make their own mortgage payment and have you make your payments to them instead of to the bank, you need to protect yourself. They should provide proof to you of their payment, and/or you will want to have bank authorization to check this out yourself. This is a document signed by the seller along with all of the other contracts for the lease option. There should also be a signed agreement that if they don't pay on time, you would have the right to switch your payments from the seller to the mortgage company.
3. "I understand your concern. I could make your payments to the mortgage company and then mail the receipt to you. This way I am protected and so are you. Would this work for you?"

Why Won't You Put More Down in the Option?

Answer: "If I were to put a lot more down, I wouldn't be able to buy more homes, and I'd like to help more sellers and invest in more properties than just one. There's also more risk to me because I do not actually own it, so I don't want to put too much down."

What If You Don't Buy?

Reassure the seller that if the option doesn't get exercised, then the home reverts to the owner in equal or better condition. Also agree to give reasonable notice of 30 days.

ccc_patton_ch6_76-94.qxd 4/27/05 2:12 PM Page 87

What Happens If You Die?

Answer: "The contract has provisions that if I die or the seller dies, the contract still binds our heirs to continue on."

How Long Does It Take for You to Buy the Home?

Be honest. Because tenant-buyers may come and go before one settles in permanently, you need to give yourself time to close the deal, and 20 to 24 months is usually how long it takes for a deal to finalize. We hold the buyer's hand all the way, walk them through the mortgage process, and do everything we can to make the purchase occur. We are not, however, mortgage brokers and we offer no mortgage advice.

Why Do You Need X Years to Buy This Home?

Answer: I need time to find the right tenant-buyer and get them through the mortgage process. Approximately half of my tenants end up exercising. It's very important to have enough time to make it work, and with each new tenant it takes at least a year for them to clean up their credit to qualify for a mortgage."

How Do I Change the Insurance on the Purchase Agreement?

The seller can simply call their insurance agent and they will take care of it for them—it just has to be turned into a non–owner occupied insurance policy. This doesn't affect the rates much (if any) but it gives the seller the proper coverage. Be willing to do a three-way call with the seller and the seller's insurance agent to make sure they get the right coverage. They should also put you on as an additional insured, because you have an additional interest in the property. If you made improvements and then sold it to someone at a different price, you have to be covered for the amount of equity that you have built into that property. You should also be an additional insured on your tenant-buyer's policy so that you're covered if anything happens to the house before they buy it. As an additional insured, you also get notice if the policy ever lapses. If their insurance does run out, you have the right to go buy insurance and then bill the seller for it.

What Kind of People Are Going to Rent My Home?

"*The best kind*." Some sellers want to discriminate regarding the types of tenants that move in, but I have to tell them that by law I

ccc_patton_ch6_76-94.qxd 4/27/05 2:12 PM Page 88

can't discriminate. If discrimination issues are important to the seller, I tell them I'm not the right person to buy their home. On the other hand, I'm going to take care of their property and put someone qualified into their home.

What If the Tenants Trash My Home?

Naturally, this is a major concern to any seller. You can answer, "I can understand why this would be a concern to you, but I want to assure you that I really do screen my tenants carefully. I am putting not just any tenant in your home—I am putting a future home buyer in your home. But if anyone does any damage to your home, then I would take care of it. I am fully responsible for your home." If they need further assurance you can let them know that their home is also *your investment*, so you're looking out for it very carefully.

Can My Attorney Review the Contracts?

A simple answer here: "By all means. I recommend it!"

Can I List My Home with a Realtor Since You're Not Ready to Commit Yet?

"Absolutely, go ahead and list it, but please make sure you list my name as an exclusion, because if I do buy it during this time period, you don't want to pay a commission on me."

Can I Come Look at the Property During the Lease Period?

They can, and it says so in the contract, but they need to go through me to do it. They can't stop by unexpectedly or drop in on the tenants, because that would violate the tenants' rights. They need to call me to coordinate their visit.

Subject-To Questions and Objections

Potential sellers in a subject-to deal have their own set of objections.

This Isn't Enough Money!

This is typically the biggest objection for subject-to sellers. A great way to field this objection is to get a full understanding of the question and then do a cost analysis together. Get out a sheet of paper and give them the calculator. Hand them the comps and ask what the average sales

ccc_patton_ch6_76-94.qxd 4/27/05 2:12 PM Page 89

price of the house is. They will calculate it and give you the figure. Then ask them what commission a Realtor gets in their area. Deduct the commission, then ask them what repairs need to be done to the house (and the cost) to bring the property up to current market standards. Then deduct those costs. Ask how long they think it will take to sell the house and then how long before the house closes. Add up the mortgage payments for that period and deduct those. Then deduct all the closing costs. Try to get them to put down anything else that will reduce the value more and help them be more realistic also—for instance, what is their time worth? As they do this themselves on the calculator it becomes hard for them to then argue about the value of their home. You are now working on something as partners, not adversaries.

Why Should I Give You the Deed and Control of the Property When I'm Left on the Hook for the Mortgages?

This is a legitimate question and one I would certainly be asking if the roles were reversed. And it demonstrates why it is so important to build rapport with the seller and make them feel comfortable with what you are suggesting. Remember, this will not work for everyone. To answer this objection, you might want to offer references or testimonials from other sellers. Here is how my friend Lyle Reichenbach from Phoenix would reply to this question:

> *"I can understand your concern, and I would probably feel the same way if I were in your shoes. All I can tell you is this: The bank will not let me assume your mortgage, and in order for me to make a fair return on this deal, I can offer you $___. I'll be glad to buy it right now at the price I've quoted, but then how would you cover the difference to pay off your current loan? You are actually being very savvy and getting top dollar for the property by letting me take over your payments; we both save all the costs that we'd incur—commissions, closing costs, and so on—if I were to just buy it from you. The minute you okay this paperwork, I kick into owner mode. I will be doing everything possible to sell this house as quickly as I can, using my expertise. I've spent thousands of dollars on training to do this business, legally and morally. It would be futile for me to let this property go back to the bank just because I didn't make the payments."*

ccc_patton_ch6_76-94.qxd 4/27/05 2:12 PM Page 90

I Don't Want Tenants in My Home.

This would get the same answer as with the lease option seller.

I Must Get the Price I'm Asking or I'm Not Selling.

Probably one of the most common challenges is getting the seller from "La-La Land" to reality! Here are some ideas on how to overcome the price objection.

Sellers usually think rigidly about pricing—they have a specific figure in their head. They tend not to think outside the box. But if a deal is properly structured, with the right terms, I can afford to pay full asking price.

First we have to verify that their asking price is within true market value. I usually accomplish this one of two ways. The easiest is to provide comparable sales in their area; sometimes you may want to delete the most expensive one from the list and recalculate. I've found more often than not that the highest-priced houses in the neighborhood are usually in A+ condition, having had new carpet, paint, and so on *before* they sold. The second way is to get the seller to buy an appraisal, which they would ultimately need even if they were able to sell retail as a FSBO. If you have an appraiser that you usually work with, simply let him know that contrary to normal, this time you're looking for as low an appraisal as possible. I've never had a seller balk at using a price that was in writing from an appraiser as a set point for negotiations. Unfortunately, appraisals can be misleading and bumped up in value, especially when done directly for a refinance or for a home owner, so a bit of caution on this: An appraisal is not a true indication of value.

Your explanation to the seller might go something like this:

> *"I understand that you feel the property is worth $XXX, but let me show you what is happening right here in your neighborhood. This house at 123 Main Street is 1,480 square feet with a pool and it sold for $XXX; all the homes on this list are within a few blocks of your house. Remember, these prices are what houses have* sold *for, not what someone is trying to get for a property. Based on these comparables, the program has calculated your house to be worth $XXX. I could be generous and pay you the price you want, but in order for it to make sense for me, I must get the following terms."*

ccc_patton_ch6_76-94.qxd 4/27/05 2:12 PM Page 91

Then spell out the terms you require. Remind the seller of the risk you are taking in assuming responsibility for the property, making payments, and waiting to make your profit at some future time.

I Want to Have My Attorney Look Over This Agreement.

This is reasonably common, normally just a ploy by the seller to stall and not make a final decision. Ask if there is something they don't understand, and offer to go over it again to clarify it. Sometimes they want to just talk about it a little bit more and then they will sign the contract. Your goal is to get the seller to make a decision and get off ground zero.

I'm Thinking of Just Listing It with a Realtor.

This is usually another stalling tactic. You can reply: "If you would like to list your home with a Realtor, that is fine, but if you would like to sell it now, then you have a buyer here in your home and you won't have to pay any commission. This is going to save you $XXX." If they insist on listing it now, then make sure they put you as an "exclusion to the listing contract." This will keep the Realtor from getting any commission on the home if the seller ends up selling it to you. However, don't suggest this immediately, or the seller will see it as a risk-free trial offer to list it with a Realtor. Rather, the exclusion will be a last-ditch effort to save the seller a commission if they choose to list it with a Realtor anyway.

My friend Lyle specializes in subject-tos. He recommends the following to help:

At the onset, there are two critical things to do.

1. *When the seller answers the door, I confidently reach out with a handshake and say, "Hi, I'm Lyle, I'm the Buyer you've been praying for!"*
2. *Typically the seller will want to give you a tour of their house. I politely but firmly say, "I appreciate your kind offer, but after looking at so many houses through the years, I prefer to just wander through by myself. If I have any questions I'll ask them in a few minutes. In the meantime, please sit down and*

ccc_patton_ch6_76-94.qxd 4/27/05 2:12 PM Page 92

look through my Seller's Information Manual." This is my credibility kit. On the front is a full-color photo with a banner stating "It Is Finished" and a giant "SOLD!" sign stamped across the front cover.

Other Negotiation Points

Here are a few more things you can work with in negotiating your deal.

Seller Paying Part of Payment

Many times you will find it necessary to ask the seller to make some of the payment in order for the deal to make financial sense. Usually this happens when a seller has taken all or most of their equity out through a second mortgage. These normally have higher interest rates and therefore higher monthly payments. I've asked sellers to continue to pay that second mortgage for some predetermined time, until either I can get the property resold or appreciation catches up. Bear in mind that the seller has either done some debt consolidation or spent that money on other things; in other words, they have already spent their equity. I use a form of promissory note from the seller to try to influence them to continue the payments. Obviously once you solve a seller's dilemma, they can relax a little, and not all sellers will keep their word about making these payments on a house they no longer own. I've had a couple occasions where the seller did not make the payments as promised, but I kept the deal anyway because I was still in good shape. If you use the following approach, or something similar, it makes sense to the seller to continue these payments.

"I see you have two mortgages on the property. Why did you feel it necessary to take out a second mortgage and where was that money spent? Well, I can certainly empathize with you, but since you have already spent your equity for this reason, not only do you have no equity left, but in order for this deal to make financial sense to me, I'm going to need you to continue to pay only the second mortgage for the next two years.

ccc_patton_ch6_76-94.qxd 4/27/05 2:12 PM Page 93

I'll take care of the first, but as you already know, there is no way I can rent the property for the amount needed to cover these two payments. I won't even have enough to pay any management fees. If you were in my shoes, would you want to take all this risk for a negative cash flow? If I were in your shoes, I would not like to have to do this either. But look at it this way: Isn't it going to be more financially feasible for you to pay just $244 per month instead of the whole $1,179 you are paying now? If you step in and do your part, I'm willing and able to help you by taking the other $935 burden off your back. Together we've created a win-win situation now, don't you agree?"

Seller Paying You to Take Over Payments

If there is not enough room for profit in the deal, there may be a time when the seller will need to give you a sum of money for you to take over the deed.

Length of Term

I usually make sure, and my paperwork spells out the same, that the term could conceivably last the entire length of the note—although in reality that will probably never happen. Most of the time you will have sold the home before the loan is paid off. Sometimes, however, the seller does not need it out of their name or there are other circumstances that require it to be paid off in the length of time more in line with a lease option.

The Point at Which the Agreement Locks In

This is a negotiable point. You can have the seller make several more payments until you take them over. If you don't feel you can or want to take the risk of carrying those payments until you find a tenant-buyer, then put this type of provision in the contract.

Understanding some of the many ways to approach lease option or subject-to negotiations will equip you to creatively solve the seller's problems. There are so many times when one area of negotiation is

ccc_patton_ch6_76-94.qxd 4/27/05 2:12 PM Page 94

very important to a seller, like sales price, that we forget to negotiate the rest of the deal. Investors tend to walk away based on price alone. Many times we can end up with the same bottom line by negotiating the rest of the terms with the seller, if we take the time to work out the details. It is up to you and the rapport you've built with the seller to make it all a win-win situation!

ccc_patton_ch07_95-109.qxd 4/27/05 2:12 PM Page 95

CHAPTER 7

Getting the Paperwork Ready for a Lease Option Deal

Now that you've found a motivated seller who is perfect for a lease option, you've determined the technique, you know the profitability, and you've negotiated the deal, you will need to get the paperwork ready to be signed by the seller. For a lease option deal there are several contracts and forms that need to be signed: there are also more steps that need to be taken to complete and organize the deal. I use a checklist so that I don't forget any step during the process and to ensure that all items are completed. A checklist is crucial when you are new at this or when you have many properties going at one time. With more experience you will know what needs to be done and likely not forget much, but when you are working on many properties at one time, there are things you can't keep straight in your head, things that may slip through the cracks. A checklist will help you keep things straight on each property.

I have a checklist form for each property and I review them every day, or every other day, to see what needs to be completed for any of my properties. A task gets added to my to-do list when it is the appropriate time to work on it, and it doesn't get checked off the list until it is completed.

Let's take a look at the checklist I use for lease options.

ccc_patton_ch07_95-109.qxd 4/27/05 2:12 PM Page 96

Buying on an Option—Checklist

Address:_____
Contact:_____
Phone: _____
Projected starting date: _____

1. Create owner folder for this home ____
2. Order pretitle work ____
3. Check IRS/state tax liens ____
4. Check if mortgage is up to date ____
5. Check if property taxes are paid ____
6. Draft all documents:
   a. Rental Agreement/Lease ____
   b. Offer to Purchase/Purchase Agreement ____
   c. Option Agreement ____
   d. Memorandum of Option ____
   e. Affidavit of Liens ____
   f. Bank Authorization ____
   g. Seller's Disclosure ____
   h. Lead-Based Paint ____
7. Get a key or access ____
8. Get an inspection ____
9. Advertise the home ____
10. Set up utilities ____
11. Water reading (if city water) ____
12. Water softener (if well/rental?) ____
13. Get insurance (liability) ____
14. Owner's proof of insurance—additional insured ____
15. Review title work ____
16. Sign all documents ____
17. Record Memorandum of Option ____
18. Set up automatic payments if paying mortgage payment ____
19. Maintenance/work to be completed (list work that needs to be done):

_____

_____

_____

ccc_patton_ch07_95-109.qxd 4/27/05 2:12 PM Page 97

Using the Option Checklist

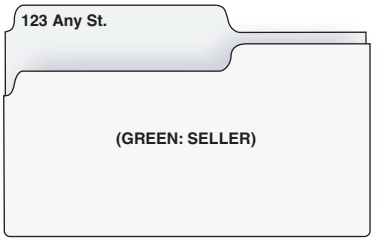
If you have several properties, keep them filed in order of which ones are projected to start first. I would focus my attention on these and would also advertise them more heavily.

Fill out the information at the top of the checklist: the address of the property, owner's name and phone numbers (how you will reach them—if there are several numbers, put them all down), and when the option is projected to start.

Now let's go through the items on the checklist.

Create Owner Folder for This Home

I use a left-tabbed green folder (think green for money!). I set up an owner folder for each property that I buy on an option, outright, subject-to, and so on. I use right-tabbed red folders when I sell on an option later, to hold all the tenant-buyer information. All contracts, memos, notes, surveys, title work, or anything regarding the home will go into this folder. This is strictly for the information that involves the seller and you—nothing concerning the tenant-buyer will go into this folder. (Note: The folder doesn't have to be green—just the tab part or the address.)



Order Pretitle Work

This can also be called a "commitment for title." It is not to be confused with title insurance. You normally cannot get title insurance on property you don't own, but you must do research to see what is on the title and if there are liens on the property. If you order this from a title company, it can take 7 to 10 days, maybe fewer if you have a relationship with the title company. You can also do it yourself if you are knowledgeable in your own state and county about what you need to

ccc_patton_ch07_95-109.qxd 4/27/05 2:12 PM Page 98

research and where to research. This is where you verify that the title is clear of judgments and liens.

Check not only the title liens but the state and IRS tax liens that might go against the person on title. If I go down to my county courthouse to research John Jones on 123 Anystreet, I might only find a mortgage on title, because IRS information is kept at a separate location. However, a title company will pull the information from all relevant sources to give you a complete picture. If there are liens other than the seller's mortgage, this would indicate the seller is not a good candidate for a lease option but rather a subject-to, because this would be considered bad debt on the property.

The title work will also show all owners of the property. It is very important that you purchase the property from *all* its owners. Sometimes I have looked at title work and seen "Joe and Sally" on the title when Joe had said he owned the property. Joe forgot to mention that he had divorced Sally. The problem with this situation is that Sally is still on the deed/title of the home. Sally either has to get off the title by deeding her interest to Joe or agree to all the terms of the lease option and sign the paperwork. Whoever is on the deed/title *must* sign. I also recommend that married people have their spouses sign the documents too. In many states a married man must have his wife sign the deed in order to transfer title, even if she is not on the title, because of her dower rights. However, I recommend that anyone who is married have their spouse sign the agreements.

Check IRS/State Tax Liens

Usually the pretitle work will show these liens, but if you are doing your own research make sure you check for both of these areas. Ask someone at the county office to help you confirm that the seller does not have any IRS or state tax liens against them.

Check If Mortgage is Up to Date

The best information source for the mortgage is the seller. Many mortgage companies will give their seller a statement each month to show what has been paid, what is still owed, and whether any payments are late. If the seller does not have a current account statement, they will have to order one. If taxes and insurance are escrowed in their monthly payment, then you will also know that those are cur-

ccc_patton_ch07_95-109.qxd 4/27/05 2:12 PM Page 99

rent—a mortgage company would not let those go unpaid or be delinquent. (An escrowed payment is a payment that includes the taxes and insurance as part of the monthly payment.)

Check If Property Taxes are Paid

You can call your local county or state building and get proof that taxes are paid. Find out in your state or area how to confirm that *all* property taxes are current on the home. Call your local city assessor's office and ask them about the home. In some states any back taxes might be paid by the county, and the city might not know whether the taxes are paid, so confirm with the assessor and possibly other real estate investors in your area as to how you will know if they are paid up to date. You can also ask the seller to provide proof by showing you a recently paid tax bill: however, that won't mean that a tax bill from two years ago was paid. Find out and protect yourself.

Draft All the Documents

To make a lease option work, three main agreements are needed. It is possible to roll all three into one or two contracts, but I like to keep them separate to make it clean and clear. It is especially important to keep them separate when you sell on an option (see Chapter 13).

1. *The Option Agreement*. On the selling side, the option agreement turns control of the property over to the optionee without ownership. When I am doing a lease option, I sign an option with the seller and they give me control for a specified amount of time (usually 2 to 5 years), during which I will be trying to secure a tenant-buyer for their home.
2. *The Rental Agreement*. The rental agreement specifies how long I will rent their home and how much I will pay them each month for the rental. The rental payment will always go first to their mortgage company, if any mortgage is due on the home, and then to the owner if any rent is remaining. For example, if my rent is $1,200 per month and the mortgage payment is $1,300, the mortgage company will get $1,200 from me and $100 from the owner. If the mortgage payment is $1,200 then the mortgage company will get one check from me for $1,200. If the mortgage payment is $1,100 then I

ccc_patton_ch07_95-109.qxd 4/27/05 2:12 PM Page 100

will write one check to the mortgage company for $1,100 and one to the seller for $100. The check to the mortgage company must have the mortgage account number on it so that it gets applied to the correct mortgage. (The owner could have two mortgages with the same mortgage company.) Protect this mortgage and make sure that it is getting paid.

Majestic Realty
4742 W. Clarkston Road
Clarkston, MI 48348
www.WendyPatton.com
289765
DATE
PAY TO THE ORDER OF
BANK ONE
$ $1,100
Eleven hundred and 00/100
DOLLARS
memo Loan #123456
Wendy Patton

3. *The Purchase Agreement*. This agreement sets the terms of the final sale. Again, there are two of these—one for my deal with the seller, and one for my deal with the tenant-buyer. The deal with the seller has a set sale price, which remains constant regardless of appreciation or even depreciation. However, it is always negotiable up front. For example, you could agree that the price is $150,000 if purchased within two years and $155,000 if purchased between years two and five.

There are five other forms that the seller will need to sign.

1. *Memorandum of Option*. This is the document that gets recorded against the title of the property. It does two things. First, it gives the world notice that you have an interest in the property by "clouding" the title. When you cloud a title, the seller can't refinance or sell the home to someone else and give clear title. A reputable title insurance company would not insure it with this memorandum on the title. This document protects your interest in the property and it is *very* important that it gets recorded. Having it signed and notarized does you no good—recording it is a necessary step.

ccc_patton_ch07_95-109.qxd 4/27/05 2:12 PM Page 101

Secondly, it seasons the title. *Seasoning* is a term that is becoming more and more important to real estate investors. Mortgage underwriters are becoming very strict about the length of time investors or sellers must have owned properties before selling them. There has been so much mortgage fraud in the past few years that the mortgage industry is really cracking down on this, and one way to do it is to make sure that the seller of a home has owned it in their name for 90, 120, even 360 days. Each lender has their own requirements for the number of days to season a title of a property. This is important to be aware of in a lease option strategy, as a lease option is not ownership. You will be selling a home later that you did not own, except for maybe one hour or so. This may be a problem for some lenders, but for most, filing the Memorandum of Option will season the title adequately for them. As I write this book, FHA is the only lender that I know of that will not approve a Memorandum of Option as seasoning. These guidelines and rules are changing constantly, and something you should check into. (The real estate investing world hadn't heard of the word *seasoning* when I started in 1985.)

2. *Affidavit of Liens*. This is a sworn statement, signed by the seller, that discloses all of the liens on the home. It also asks about liens that are not yet recorded but known about; for example, if the roof was replaced last month but the roofer has not been paid yet, this could become a lien. The seller must disclose it or be guilty of fraud.

3. *Bank Authorization*. This document gives you authorization to get information about the mortgage. You can find out at any time the status of the mortgage, balance, payment history, payoff amount, and so on. It gives you authority to find out information from the mortgage company as if it was your own mortgage. Because all payments made in the future should be made directly to the mortgage company and not to the seller, you will want access to the seller's mortgage information. This will protect you from having this home go into foreclosure.

4. *Seller's Disclosure*. This is a statement the seller fills out that discloses the condition of the home. The seller must disclose any problems with the home. Each state has different Seller's Disclosure statements. Ask a local Realtor for a blank Seller's Disclosure statement for your state.

ccc_patton_ch07_95-109.qxd 4/27/05 2:12 PM Page 102

5. *Lead-Based Paint Disclosure*. This disclosure is a federal requirement in the sale or rental of any home. Prior to 1978, lead was a component of paint products used in residential homes. Lead poisoning has caused many problems for people, but primarily permanent damage to children. Therefore the Department of Housing and Urban Development (HUD) passed a law requiring sellers and landlords to have the lead-based paint disclosure signed and to give the pamphlet called "Protect Your Family from Lead in Your Home" to all potential buyers and tenants. If this step is not completed, the fines are significant. Also, if lead-based paint is present in your home and you don't do this step, you can be sued if a child is later found to have suffered brain damage from your negligence. Some states require that you completely remove lead-based paint from your rental homes. Check out your state's lead abatement requirements. You may want to avoid those homes or confirm it has been completed prior to your taking it over.

Get a Key to the Home

Make sure that you have a key or accessibility to the home. If the home is listed through a Realtor, you may be able to get the lockbox combination and have access to show the home anytime, if it is vacant. If the seller is still living in the home, which is often the case for me, I make sure that I either have the ability to call the seller and make an appointment for a showing or that the seller gives me a key and I give them a courtesy call to let them know when I am going to be showing it. If the seller gives you a key, consider keeping it in a lockbox at the house. You can purchase one at most hardware stores.

Advertise the Home

Get the home advertised as soon as you know it has passed your inspection, or even before. You want the period of vacancy to be minimal. Advertise it in the newspaper, with local employers, on a web site, etc. Advertise anywhere you can find a buyer. (See Chapter 12 for more detailed tips on advertising.)

Set Up the Utilities

Do this when you are about to take possession of the property. For example, if it's April 28 and I'm taking the property on May 1, I will go

ccc_patton_ch07_95-109.qxd 4/27/05 2:12 PM Page 103

ahead and turn on the utilities in my name (electricity, water, gas, etc.). Turn on anything that is required to be in your name and out of the seller's name. Be especially careful about winter months in cold parts of the country—you don't want any days to go by without heat. I have discovered ice skating rinks in a few of my homes over the years, because the heat was not turned on.

Water Reading

In some cities and municipalities, a water bill can be a lien against the home if not paid, so get a final reading to make sure it's current and paid from the day that you take possession from the seller. Also, have the water bill mailed directly to you. This way you can either pay it and bill the tenant, or forward the bill to the tenant and know that it is getting paid.

Water Softener

If there is a water softener on the property, make sure you are taking care of it. If it's a rental softener unit, change that contract over to your name. I have a water softener company that I work with, and I will set up a lease to own on the softener equipment. The tenant actually pays the bill, and if they end up not exercising, at the end of their lease the water softener belongs to me. Having a water softener is critical if you have hard water. Most properties with city water will not need a water softener.

Get Liability Insurance

Since you don't own the home, you can't actually insure it. However, you have a liability issue just by being the landlord of the home. As far as the tenant is concerned, you are the landlord, and as far as the owner is concerned, you are the tenant. So you have both tenant and landlord roles without even owning the property. I recommend purchasing some type of commercial general liability policy that would cover you for properties you don't own. This is not going to be a make or break on your first deal or two if you do step 14 on the checklist, but it's something you should consider if you're going to stay in this business. Talk to an insurance agent to get educated, but

ccc_patton_ch07_95-109.qxd 4/27/05 2:12 PM Page 104

do get several opinions and quotes. Some will try to sell you more insurance than you need.

Owner's Proof of Insurance

Make sure the owner has insurance on the home itself. If they have a mortgage, the mortgage company will require it, but if they own it free and clear they may not have insurance. Also make sure that on the insurance policy they name you as an additional insured. Some insurance companies will not want to put you on their policy without you being an actual lien holder (like a mortgage holder—see the "Performance Mortgage" section in Chapter 9 for a way to accomplish this). My rental agreement and my offer to purchase require my owner to list me as an additional insured on their homeowner's policy. They might have to switch insurance companies to find a company that will do this. There are several benefits of being an additional insured: (1) You get liability protection; (2) you should get notified if the seller cancels their insurance policy for any reason, even nonpayment; and (3) you probably will be on any settlement check if the home burns down or any other disaster occurs. Being an additional insured is a great thing, but it should not usually be a deal breaker.

Review the Title Work When It Comes Back

Check for liens and for ownership; make sure the title is clean and clear. You want no surprises. Do understand, however, that some things can show up on the title work in error. I have had several titles show up with old mortgages on them, where it appears that the owner has two mortgages. Don't assume the owner is hiding something from you—ask them about the mortgages showing up on the title work. Many times the owner had refinanced the home and the old mortgage didn't get discharged properly. Don't be alarmed, just get the old one cleared up. The title company can help you with all of this.

Make Sure All Documents Are Signed by the Seller and by You

Have two complete, signed sets: one for them and one for you.

ccc_patton_ch07_95-109.qxd 4/27/05 2:12 PM Page 105

Wendy's Tip

I always recommend having a witness when you are signing a document, but a witness is not necessary to make it valid. Only the Memorandum of Option needs to be notarized so that it can be recorded.

Record the Memorandum of Option

This is usually done at the county building. Once you are certain that you are going to move forward with the deal, if you've got a start date coming up or if you've got a buyer for the property, then you want to record the Memorandum of Option. This will get recorded against the title. It then shows the world that you have a claim against the property and that you have the right to buy it on an option.

Wendy's Tip

Make certain that you leave a 2.5-inch blank margin at the top of your Memorandum of Option or it will not be able to be recorded. Check your state/county recording requirements prior to completion of this form.

Set Up the Payments with the Seller

You can set up an automatic payment with the mortgage company that goes directly out of your bank account. I use Quickbooks for mine. This eliminates the risk of forgetting to write the checks out in a timely fashion.

A List of Maintenance or Work to Be Completed before I Take Possession

This is a list that either you or the seller are responsible for, depending on what deal you have made with the seller—things like replacing linoleum, repainting trim, replacing the mailbox. All repairs are to be done by my contractors (so I can control the quality) unless otherwise

ccc_patton_ch07_95-109.qxd 4/27/05 2:12 PM Page 106

Memorandum of Lease Option

Optionor, whose address is_____, and "Optionee" (your company name or personal name), whose address is_____, entered into an option "the Option" dated as of_____, pursuant to which Optionor has agreed to option to Optionee the right to purchase certain real property "the Property" located in the _____ of _____ , County of _____, State of _____, more particularly described as (insert legal description here—this is needed to record the home).

The Option requires that Optionee shall exercise the Option on, or before, _____, or the Option shall expire. While the Option is in effect, Optionor many not assign, convey, lease, sell, transfer, mortgage, or otherwise encumber the Property or any part thereof, nor shall Optionor do, suffer, or permit any act, deed, or omission which might diminish or encumber the rights of Optionee or the ability of Optionor to perform obligations in accordance with the terms of Option.

IN WITNESS WHEREOF, the Parties have executed this Memorandum of Option on _____.

Optionor:

_____

_____

Optionee:
(Your company name here)
A (your state name) Limited Liability Company

_____

Its Member:

_____

Its Member:

_____

State of _____

County of _____

The foregoing Instrument was acknowledged before me on this _____ day of _____, 20_____, by _____ and _____.

_____

Notary Public, _____ Your county & state
My commission expires: _____

ccc_patton_ch07_95-109.qxd 4/27/05 2:12 PM Page 107

State of _____
County of _____

The foregoing Instrument was acknowledged before me on this _____ day of _____, 20_____, by _____ and _____.

_____
Notary Public, _____ Your county & state
My commission expires: _____

Drafted by:
(Your name and address)

When recorded return to:
(Your name and address)

specified. All repairs, both major and minor, are the responsibility of the tenant except during the first 60 days of the agreement—I leave that responsibility to the owner. For instance, if the furnace went out two days after I took possession, I don't want to be responsible for that. Everything is negotiable, and while 60 days is my standard, it's completely flexible. You can make it longer; you can also make the seller responsible for all repairs, for anything over $500, for anything under $500, for nothing at all—structure it the way you want it.

Wendy's Tip

When juggling the receiving of the rent from the tenant and the payment of the mortgage to the owner, you might want to stagger them a few days to give the tenant's payment time to clear before you make a payment to the owner.

Some of My Favorite Clauses

Each state may require certain information for your rental agreements and purchase agreements. I offer contracts on my web site that are generic and can be used in all states, but these should always be

ccc_patton_ch07_95-109.qxd 4/27/05 2:12 PM Page 108

checked by a local attorney, because each state has its own unique laws. Attorneys can be very expensive. I use Pre-Paid Legal services, which offers plans starting at very reasonable monthly rates to give you legal assistance. I have been a customer since 1998 and have saved thousands of dollars as I obtained help on legal questions, contract reviews, letters, and so on for real estate matters in multiple states. You can find out more at www.prepaidlegal.com/hub/wendypatton. Each state has their own rules and regulations regarding rentals, lead-based paint abatement, evictions, and so on, so some of the following clauses may not apply to your situation, depending also on what you have negotiated with your seller. These are just some examples of things I have used with my sellers, some of the clauses that have been my favorites over the years in my contracts to buy on lease options:

The Option Agreement

- There shall be an additional option consideration of $_____ per month given by Optionor to Optionee as credit towards purchasing the home.
- Optionee has the right to multiple-list, advertise, or resale this property before or during the option period.
- Should the property become uninhabitable at any point during the lease period, the tenant will be released from all rent liabilities until the property is habitable and is re-let. The period of time that the home is uninhabitable will be added to the Option Agreement and attached Rental Agreement and Offer to Purchase.

The Rental Agreement (Lease)

- Tenant will have access to the home on ____ to show the property to prospective tenant-buyers and contractors.
- Tenant will be assigning this agreement to another party, but is still responsible to the owner per this agreement.
- The owner gives the tenant the right to make repairs/improvements to the property at the tenant's expense. All repairs and improvements will be done with the tenant's contractors.

ccc_patton_ch07_95-109.qxd 4/27/05 2:12 PM Page 109

- Landlord agrees to use their homeowner's insurance to cover any items/repairs/damage that would be covered under their policy (i.e., storm damage, fire, etc.) since tenant can't utilize their insurance for these type of repairs.

The Purchase Agreement (Offer to Purchase)

- Purchaser will put $_____ down on this property. Check will be written directly to (realty company of listing office) upon execution of the attached rental agreement. This amount will be applied directly to the purchase price at closing, and to any listing commission owing. The remaining commission, if any, will be paid at closing out of seller's proceeds to the appropriate offices.
- Seller agrees to change their homeowner's insurance policy to a non–owner occupied policy and to name the purchaser as an additional insured within three days of purchaser taking possession of the home.

The paperwork is vital to your successful ability to make a lease option deal, so don't skip any steps, and make sure all areas of the checklist are covered. You will add your own favorite steps and clauses over the years as you do lease options and learn new ideas.

ccc_patton_ch08_110-119.qxd 4/27/05 2:13 PM Page 110

CHAPTER 8

Getting the Paperwork Ready for a Subject-To Deal

The contracts and forms for a subject-to are different from those for a lease option. Again, I use a checklist so that I don't forget any step during the process and I make sure that all items are completed. You should have a separate checklist for each subject-to property.

ccc_patton_ch08_110-119.qxd 4/27/05 2:13 PM Page 111

Buying on a Subject-To—Checklist

1. Create owner folder for this home ____
2. Order pretitle work ____
3. Check IRS/state tax liens ____
4. Check status of mortgage(s) ____
5. Check if property taxes are paid ____
6. Draft all documents:
   a. Offer to Purchase/Purchase Agreement ____
   b. Warranty Deed ____
   c. Seller's Acknowledgments ____
   d. Affidavit of Liens ____
   e. Bill of Sale ____
   f. Escrow Payoff ____
   g. Notice to Insurance Company ____
   h. Limited Power of Attorney ____
   i. Notice to Mortgage Company ____
   j. Bank Authorization ____
   k. Seller's Disclosure ____
   l. Lead-Based Paint ____
7. Get a key or access ____
8. Set up my insurance policy ____
9. Review title work ____
10. Get an inspection ____
11. Advertise the home ____
12. Set up utilities ____
13. Water reading (if city water) ____
14. Water softener (if well/rental?) ____
15. Sign all documents ____
16. Record deed or land trust ____
17. Bring mortgage(s) current ____
18. Set up automatic payments if paying mortgage payment ____
19. Maintenance/work to be completed (list work that needs to be done):

    _____

    _____

    _____

Address: _____
Contact: _____
Phone: _____
Mortgage company name: _____
Mortgage company phone: _____
First mortgage $ _____
Loan # _____
Mortgage company name—second: _____
Mortgage company phone: _____
Second mortgage $ _____
Loan # _____
Projected starting date: _____

ccc_patton_ch08_110-119.qxd 4/27/05 2:13 PM Page 112

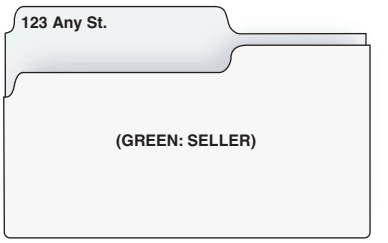
Using the Subject-To Checklist

If you have several properties, keep them filed in order of which ones are projected to close with the owner first (which ones have money owed to the bank first). These are the ones where I would focus my attentions first. I would also advertise them more heavily.

Fill out the information at the top of the checklist: The address of the property, current owner's name and phone numbers (how you will reach them—if there are multiple numbers, put them all down), when you are projected to start the subject-to, and all of the lender information. There might be two mortgage companies, and you will want to put all information down on each of them; contact numbers, loan balance, and loan/account numbers.

Create Owner Folder for This Home

This is a green folder, in contrast to the red tenant's folder.



Order Pretitle Work

This can also be called a "commitment for title," but it is not to be confused with title insurance. You probably won't be able to get title insurance on property that has a loan on it (there are a few companies that will give you title insurance subject to the current mortgages, so do shop around). You may need to rush this title work if you are doing this deal quickly. If you order it from a title company, it can take 7–10 days, maybe less if you have a relationship with a title company. You can also do it yourself if you are knowledgeable in your own state and county about what to research and where. Refer to the corresponding section in Chapter 7 for more information on pretitle work.

ccc_patton_ch08_110-119.qxd 4/27/05 2:13 PM Page 113

Check IRS/State Tax Liens

As stated in Chapter 7, usually the pretitle work will show these liens, but if you are doing your own research, ask for help in checking both of these areas to help confirm that the seller does not have any IRS or state tax liens against them.

Check Status of the Mortgage(s)

Require that the seller get proof from their mortgage companies concerning the status of the mortgages. Don't go by their word—get it in writing or on the phone directly from the companies. You will want to know exactly how much they are behind, if at all. Some sellers are not behind at all on a subject-to or have only one mortgage, but you want to make sure. Confirm all the information they give you. A recent mortgage payment statement might show the exact information, but some mortgage companies don't mail out statements. Because you will be the owner on a subject-to once the seller signs over everything, if you missed something in these steps you will be stuck with it later.

Check If Property Taxes Are Paid

You will want to confirm exactly where the taxes stand on a subject-to deal. Sometimes you will be taking over back taxes, and sometimes there are none due. You need to know the exact numbers so you know your bottom-line profit and out-of-pocket expenses.

Draft All Documents

1. *Offer to Purchase/Purchase Agreement*. As in Chapter 7, this is a full contract describing the terms of the purchase.
2. *Warranty Deed*. This puts your name on the title to the home.
3. *Seller's Acknowledgment*. With this document the seller acknowledges important things about the sale of their home. This way they can't come back later and say they didn't understand what they were doing or didn't realize they were really deeding their home to the investor.

ccc_patton_ch08_110-119.qxd 4/27/05 2:13 PM Page 114

4. *Letter for Due on Sale Clause*. This informs the seller that their home still may be called due, that the investor is not guaranteeing they will pay the loan off in full, and that the owner accepts this risk in selling their home subject-to.
5. *Affidavit of Liens*. This is a sworn statement in which the seller discloses all of the liens on the home, whether recorded or unrecorded.
6. *Bill of Sale*. This document lists all of the personal property to be included in the sale, such as appliances, window coverings, and anything else you want to ask the seller to include in the sale of the home.
7. *Escrow Payoff*. This document authorizes the bank or mortgage company to give you, the investor, any money remaining in the escrow account when the mortgage is paid off. Without this document, the mortgage company will pay the seller any proceeds left after a mortgage payoff because their name is on the mortgage even if it is not on the deed.
8. *Notice to Insurance Company*. This informs them of the land trust or other transfer.
9. *Limited Power of Attorney*. This gives the investor power to act on the owner's behalf as it pertains to the home in question, but it does not give the investor power to act on the owner's behalf on any other matters. An example of this document is shown in Chapter 9.
10. *Notice to Mortgage Company*. This informs them of the transfer of ownership of the home, if you are telling them outright. If not, you will still want to notify them of a change in address for mailing of mortgage payments, year-end interest, and so on.
11. *Bank Authorization*. This document gives you the right to call the bank or mortgage company and get any information on the mortgage, including loan balance, loan history, payoff information, payoff request, escrow balance, and the like.
12. *Seller's Disclosure*—described in Chapter 7.
13. *Lead-Based Paint Disclosure*—described in Chapter 7.

ccc_patton_ch08_110-119.qxd 4/27/05 2:13 PM Page 115

Get a Key or Access

This is described in Chapter 7; it works the same in a subject-to as in a lease option.

Set Up Your Insurance Policy

There must be an insurance policy on the home that matches the owner's name, and you are the new owner. This is for your protection and is also a mortgage requirement. If you can have the seller's policy changed to your name, that would be the best; however, you might need to purchase a new insurance policy.

Review Title Work

Make sure the title work shows the owner of record and the liens that you expected.

Get an Inspection

Just like with a lease option or any other real estate purchase, you should complete a home inspection. Make your offer to purchase contingent upon a good home inspection. This will allow you to get out of the deal if you find too many things wrong with the home or something that would be too expensive to fix. You can always go back and renegotiate if you find something wrong, but not if you don't have this clause in your contract.

Advertise the Home

Once you think this home is going to be purchased on a subject-to, start to get it ready for a lease option to sell. Put the ad in the paper to get it rented to a tenant-buyer.

Set Up Utilities

Set up all utilities when the seller is out of the home. Make sure you know what utilities are used there—gas, oil, propane, electricity, what trash removal company, and so on.

Water Reading

Make sure you do a water reading (ask the city if they do it or if you have to do it) and check to make sure the water bill has been paid. In

ccc_patton_ch08_110-119.qxd 4/27/05 2:13 PM Page 116

many parts of the country, the water bill can become a lien on a home. You might not even know it is a lien until months after the seller has moved out of town.

Water Softener

If there is a rental water softener unit, make sure the rental payments are current. If the seller owns it, make sure it is part of the Offer to Purchase and listed with all of the other appliances in the home.

Sign All Documents

Get all documents signed. The Limited Power of Attorney and the Warranty Deed will need to be notarized. The rest should be witnessed. It would be best to do them all at one time.

Record Warranty Deed

You will record the deed, usually with the county registry of deeds or clerk's office. You will record it when everything is signed and all of your due diligence is completed and all of your other contingencies have been satisfied.

Bring Mortgage(s) Current

Once the documents are signed and the land trust is recorded, then you should bring the mortgage current, if necessary. If the seller is in pre-foreclosure, get the funds wired to the lender immediately. If they are just a month behind, you can send the payment by ordinary mail. Just make sure your check clears and you get a receipt and proof of the payment on the next statement.

Set Up Automatic Payments If Paying the Mortgage Payment

Do something to make sure you don't forget to make those payments on time each month. I set mine up in Quickbooks to be paid at the beginning of the month.

Maintenance/Work to Be Completed

Make a list of repairs and other work that needs to be done on the property.

ccc_patton_ch08_110-119.qxd 4/27/05 2:13 PM Page 117

Some of My Favorite Clauses

Seller's Acknowledgments

- We may be selling the property below market value, but because of our personal circumstances and the immediate need to sell, we are satisfied with the price that we have negotiated.
- We understand this sales contract is final and binding upon all parties. We are bound by the conditions and terms described in the attached offer to purchase.
- We understand that the purchaser is a real estate investor and intends to resell the property at some future date and expects to make a profit.
- We are not signing this contract under duress and have signed this agreement of our own free will, without undue financial pressure. The buyer has in no way pressured us into signing the agreement.

John Hyre, a tax attorney, is involved in many real estate transactions. He uses the following form for his subject-to deals.

Summary of Our Deal

- *You are selling me your house. It is mine now.*
- *The mortgage to the house is staying in your name and on your credit report.*
- *I do not intend to refinance the mortgage, though I may one day choose to do so.*
- *If the bank calls the loan due, as is its right, I will not refinance the loan. As such, the bank could foreclose on the property if it calls the loan due. That would hurt your credit.*
- *I will make the payments on your mortgage in full, on time, every time. That is the payment that I am giving you for the home.*
- *I will pay arrearages on the mortgage in the amount of $_____.*

ccc_patton_ch08_110-119.qxd 4/27/05 2:13 PM Page 118

- *I will also put $_____ of repairs into the house to make it rentable or saleable.*
- *This deal is FINAL. You do not get the house back. The loan stays in your name until such time as I should see fit to pay it off at my sole discretion. You will NOT contact any tenants to whom I rent the house.*
- *The benefits to you:*
  - *A bad house that is going to foreclosure/costing you money/ruining your credit will be off of your hands. The financial bleeding stops right now.*
  - *Your credit will be helped over time by my on-time payments.*
- *The risks to you:*
  - *The loan could be called due by the bank and foreclosed upon.*
  - *The presence of the loan on your credit report could limit your ability to take out future loans.*
- *The benefits to me:*
  - *Like you, I expect to be paid for my work. I intend to profit by selling or renting the house. I have purchased it at a favorable price and/or on favorable terms to make a profit.*
  - *The loan stays in your name, so I do not need to get one in my name, pay closing costs, etc.*
- *The risks to me:*
  - *Tenants could trash the house, in which case I'd have to pay for repairs.*
  - *Tenants could skip out or the house could sit empty, but I still need to make the payments on your loan.*
  - *The house could sell or rent for less than I'd planned, but I'm still on the hook for the payments I promised to make.*

ccc_patton_ch08_110-119.qxd 4/27/05 2:13 PM Page 119

- *The bank could call the loan due and I could then lose whatever I put into the house.*
- *The repairs could cost more than I'd planned.*

The paperwork is vital to your successful ability to make a subject-to deal work smoothly, so don't skip any steps. Make sure all areas of the checklist are covered. You will add your own favorites through your own experiences with subject-tos as you learn new ideas and master the concepts.

ccc_patton_ch09_120-132.qxd 4/27/05 2:13 PM Page 120

CHAPTER 9

Advanced Concepts and Strategies for Buying on Lease Options and Subject-Tos

While I have suggested strategies that you should start with, there are more advanced lease option and subject-to strategies available to help you build your portfolio. These are things I have learned from other students, national speakers, and my own experience. You can succeed with just the basic concepts, but these topics will broaden your capabilities and elevate your business. The strategies shared in this chapter include additional ways to protect yourself and additional methods to increase your profitability on each deal.

Remember that all of your strategies must be negotiated before any paperwork is signed. You will need to determine which, if any, of these strategies make sense for each individual situation. Some of these techniques may be viewed by certain sellers as intimidating or overly complex. Therefore you will need to know your seller and understand them by building the relationship, as discussed in Chapter 6.

Extra Ways to Protect Yourself in a Lease Option

As a lease option holder you are dependent upon the good faith performance of the seller who holds title to the property. In Chapter 7 we

ccc_patton_ch09_120-132.qxd 4/27/05 2:13 PM Page 121

discussed protecting yourself by filing a Memorandum of Option. In this section I discuss some additional techniques to protect yourself and strengthen your position.

Place a Deed in Escrow

This approach can be used along with the filing of a Memorandum of Option. The seller would actually sign the deed at the same time that they sign all of the lease option contracts. However, the deed is not yet recorded on the title. Instead it is held in escrow by an attorney or title company with instructions for its release. While this approach does not protect the title against the potential filing of liens, it tends to give sellers the feeling that they have deeded, or sold, their property, so they are much less likely to try to back out later on their lease option agreement. It can also allow the investor to close on the home without the seller being present.

The instructions included with the deed in escrow specify how and when the deed can be released and recorded. For example: "When Wendy Patton pays $155,000 in certified funds to Joe Smith, this deed can be released to her. These funds must be paid by (date)."

Performance Mortgage

This device would replace the filing of a Memorandum of Option. A performance mortgage strengthens your ability to ensure performance by the seller by having the seller pledge the property as collateral for the lease option agreement. It is recorded at the time the lease option agreement is made. Signing a mortgage to you protects you against them selling to anyone else.

Like the Memorandum, it allows their insurance company to put you on the owner's policy as an additional insured, and it shows you as a lien holder for any type of foreclosure so you should be notified of any proceedings.

While this is a good concept that strengthens your position, many sellers find signing it objectionable, so you may not be able to use it in every case.

You'll want the specific terminology to be reviewed by a local

ccc_patton_ch09_120-132.qxd 4/27/05 2:13 PM Page 122

real estate attorney, but here are some of the key performance mortgage clauses:

- This indenture, made this _____ day of (month), (year) between the Mortgagor (name of optionor), and the Mortgagee, (name of optionee), whose mailing address is: . . . .
- Whereas, the said Mortgagor has executed a certain Option Contract agreement dated _____ under which Mortgagor is obligated to the said Mortgagee to deliver fee simple and clear marketable title to that certain parcel of real estate, legally described below, which obligation is attached hereto and by reference herein made a part hereof. . . .
- To secure to the Mortgagee the compliance and performance of the Mortgagor in meeting both the letter and the spirit of the agreement evidenced by said Option Contract, (name of optionor) does hereby mortgage, grant and convey to Mortgagee the following described land, situate, lying and being in the County of _____, State of _____, more particularly described as (legal description). . . .
- Provided that if Mortgagor, heirs, legal representatives, or assigns, shall with the agreement evidenced by said Option Contract, dated _____, perform and abide by each of the agreements and conditions of said Option Contract and of this mortgage, and shall duly pay all taxes, costs, and expenses, including reasonable attorney's fees, which the Mortgagee may incur in enforcing the Option Contract secured by this mortgage, then this mortgage and the estate hereby created shall cease and become null and void and the Mortgagee shall deliver to the Mortgagor an executed satisfaction of this Mortgage in recordable form.
- Mortgagor shall keep the improvements now existing or hereafter erected on the Property insured against loss by fire, and any other hazards, including floods or flooding.
- Unless Mortgagee and Mortgagor otherwise agree in writing, insurance proceeds shall be applied to restoration or repair of the property damaged. If the restoration or repair is not economically feasible or Mortgagee's security would be lessened,

ccc_patton_ch09_120-132.qxd 4/27/05 2:13 PM Page 123

the insurance proceeds shall be applied to the sums secured by this Security Instrument with any excess paid to Mortgagor.

- The proceeds of any award or claim for damages, in connection with any condemnation or other taking of any part of the property, or for conveyance in lieu of condemnation, are hereby assigned and shall be paid to Mortgagee.

Extra Ways to Protect Yourself in a Subject-To

Chapter 8 suggested several ways of protecting yourself in a subject-to deal, but there is another useful technique to consider: a land trust.

Land Trust

This device is used to minimize potential exposure to litigation by hiding true ownership. The actual owner or beneficiary of the trust is not recorded. Only the name of the trust is recorded in public property records. Thus, the extent of the beneficiary's property holdings is not apparent and not a magnet to potential litigants. While the document is somewhat lengthy, I've listed some key clauses of the trust agreement here:

- This agreement and declaration of trust is made and entered into this (date) by and between (beneficiary name(s)) as Grantors and Beneficiaries (hereinafter referred to as the "Beneficiaries," whether one or more, which designation shall include all successors in interest of any Beneficiary), and (trustee name(s)), whose address is _____ (hereinafter referred to as the "Trustee," which designation shall include all successor trustees).
- The Beneficiaries are about to convey or cause to be conveyed to the Trustee by deed, absolute in form, the property described in the attached Exhibit A, which said property shall be held by the Trustee, in trust, for the following uses and purposes, under the terms of this Agreement and shall be hereinafter referred to as the "Trust Property."

ccc_patton_ch09_120-132.qxd 4/27/05 2:13 PM Page 124

- The persons named in the attached Exhibit B are the Beneficiaries of this Trust and, as such, shall be entitled to all of the earnings, avails, and proceeds of the Trust Property according to their interests set opposite their respective names.
- The interests of the Beneficiaries shall consist solely of the following rights respecting the Trust Property:
  - The right to direct the Trustee to convey or otherwise deal with the title.
  - The right to manage and control the Trust Property.
  - The right to receive the proceeds from the rental, sale, mortgage, or other disposition of the Trust Property.
- The foregoing rights shall be deemed to be personal property and may be assigned and otherwise transferred as such. No Beneficiary shall have any legal or equitable right, title, or interest, as realty, in or to any real estate held in trust under this Agreement, or the right to require partition of that real estate, but shall have only the rights as set out above, and the death of a Beneficiary shall not terminate this Trust or in any manner affect the powers of the Trustee.
- The interest of a Beneficiary, or any part of that interest, may be transferred only by a written assignment and delivered to the Trustee.
- Powers of Trustee including:

  With the consent of the Beneficiary, the Trustee shall have the authority to hold the legal title to all of the Trust Property, and shall have the exclusive management and control of the property as if he were the absolute owner thereof, and the Trustee is hereby given full power to do all things and perform all acts which in his judgment are necessary and proper for the protection of the Trust Property and for the interest of the Beneficiaries in the property of the Trust, subject to the restrictions, terms, and conditions herein set forth.
- This trust may be terminated at any time by the Beneficiaries, and with thirty (30) days written notice of termination delivered to the Trustee, the Trustee shall execute any and all documents necessary to vest fee simple marketable title to any and all Trust Property in Beneficiaries.

ccc_patton_ch09_120-132.qxd 4/27/05 2:13 PM Page 125

The trust document further defines the duties, compensation, liabilities, and other dealings with the Trustee. The document is then signed, witnessed, and notarized.

Additional Creative Ideas and Strategies

Here are some other strategies I have found useful. No doubt you will discover more as you gain experience using lease options and subject-tos.

Nursing Homes

It may sound morbid to you, but consider this in the states where older people can keep their home and be on Medicaid, but can't keep much money. If the person on Medicaid were to sell their home, Medicaid would take the proceeds; however, if they keep their home until they pass away, then their estate can keep the proceeds from the home. This may change in the future in many states, but some states still allow older people on Medicaid to keep their homes when they have moved into nursing homes. If the person can keep their home, this is a good possibility for a lease option on the seller side, but on the tenant side it can be no more than a rental situation since the owner is still living. In other words, you could not actually sell it to a tenant-buyer, you could only rent it until the owner passed away. In this case, your option agreement might be based on the death of the person.

This is a great way to make cash flow in the meantime, because the owner actually would not get to keep rental proceeds either—that would also go to the state. Therefore, you may also be able to negotiate a great rental rate, as it does not really affect the owner. The owner is happy, the renter is happy, and you're happy with the cash flow. Someday you will be able to buy this home, and it could appreciate significantly during this time period. The estate does not have to pay utilities or maintenance during all those years while their loved one is in the nursing home. Those responsibilities can be a huge financial and emotional stress on some families. The freedom of not

ccc_patton_ch09_120-132.qxd 4/27/05 2:13 PM Page 126

having to worry about the monthly expenses and yearly taxes can be an immense relief for many families in this situation. They will still get the money from the sale after the death of the loved one, but without you, they might have to sell the home because they can't afford to keep it. This can truly be a win-win.

Limited Power of Attorney

In many states the transfer fees (the costs to record a deed) are extremely high, and doing a simultaneous closing (discussed in Chapter 15) becomes expensive. In some states the fees can be as high as 3 percent of the sale price of the home. On a home priced at $400,000 this would take an extra $12,000 in profit right off the top of each deal for investors in those states. There are two ways around this.

1. You can have the seller sign a new purchase agreement with your buyer for a higher amount, and you pay the difference in fees for what you paid the seller versus what you sold it for to your buyer. For example, if you paid $350,000 to the seller and you sold it for $400,000, you would have the seller sign a new contract with your tenant-buyer for the $400,000 and you would pay the extra costs on the $50,000 increase in price. This is fine if you don't mind and the seller doesn't mind the entire deal being laid out in front of them. Sometimes it is no big deal, other times it causes bad feelings. The seller already knew you were making a profit, but to put it in front of their faces can diminish their joy in the deal that once was a win-win for them. You can also offer to give them a little bonus with this. For instance, let's say they were going to receive $95,000 in cash at closing. If they sign this document, now you will give them $96,000 at closing. It now becomes more of a win-win. They get more money and so do you. You only pay $1,000 for the first $250,000 in closing costs and then your state's transfer fees and title insurance fees on the additional $50,000 on the raised price.
2. If you decide you don't want the seller to see the details, or if they are out of state anyway, you can have the seller fill out a Limited Power of Attorney. This would allow you to sign documents on their behalf for this home at closing. You can then change the price to the new price, and sign on their behalf. It is completely legal and legitimate as

ccc_patton_ch09_120-132.qxd 4/27/05 2:13 PM Page 127

long as they get the amount they were supposed to receive at closing. The seller will receive a larger 1099 on the sale of their home, so they will need to be aware that it won't affect them taxwise. Talk to a CPA. They will have to sign a payoff letter prior to closing for the title company or attorney. It might have to have the dollar figure of payoff versus the sales price. In other words, it might say something like this:

> *To Whom It May Concern:*
>
> *I am to receive $ _____ in my closing with Wendy Patton (subtract the closing costs and figure out what they should receive). Please mail my check to _____. Call me for any questions at (111) 222-3333. I will not be present at the closing, but Wendy will be signing the documents on my behalf, for which I have signed a Limited Power of Attorney.*
>
> *Sincerely,*
> *Joe Smith*

See the following page for an example of a Limited Power of Attorney form.

Partner with the Seller for High-End or Hot Markets

There are some states and locations where property values are very high and might be cost prohibitive or risky. Consider partnering on those homes with the seller, making the seller a partner in the profit of the sale. If a home is worth $700,000 and the rental rate is $3,000 per month, you may feel hesitant to take on this type of property; however, this home may also net $150,000 or more in profit. A seller of this home may also feel uncomfortable giving away all the profit for this type of property. This might become an objection for a seller in this price range or in a hot market that is appreciating rapidly. You can always offer to partner with this type of seller. A partnership doesn't have to be 50/50, but it can be. If you are doing all the work, the partner should cover all the risks. For instance, if the home is vacant, the seller should continue to cover the monthly mortgage payment, or if the tenant-buyer doesn't pay their rent, then the seller should cover the payment. If they want part of the reward, they need to cover the risk.

Limited Power of Attorney

This limited Power of Attorney is given to _____, for the purpose of Closing, Closing Documents, Contract Changes that don't affect owner's bottom line, Insurance, Mortgage Payments, etc., or any other matters that pertain to the property located at:

_____

This limited Power of Attorney shall become valid as of the date signed below and be in force until the final closing of the property. Photocopies of this document shall hereby be treated as original counterparts.

POWER OF ATTORNEY GIVEN TO: _____

Agreed to by:

_____	_____
Seller's Name	Seller's Name
_____	_____
Date	Date

Notary

STATE OF _____ COUNTY OF _____

Before me personally appeared _____ _____, to me well known and known to me to be the person described in and who executed the foregoing instrument, and acknowledged to and before me that he executed said instrument for the purposes therein expressed. WITNESS my hand and official seal in the State and County aforesaid, this _____ day of _____ 20XX.

_____
Notary Public Signed

_____	_____
My County of Residence	My Commission Expires

ccc_patton_ch09_120-132.qxd 4/27/05 2:13 PM Page 129

Refinance for Cash

Refinancing may not seem like an advanced strategy, but you can make it into a very lucrative tax-deferred strategy. For example, let's say you have a house that's worth $200,000 and you only owe $140,000 on it. You can refinance it (i.e., a new mortgage) and take out some of your $60,000 in equity, which is not a taxable event. Now you have a portion of that $60,000 to reinvest while still holding on to the original property. Talk to a mortgage broker in your area for current programs and your individual situation; most likely you will not be able to take out the entire $60,000, but each case is different.

Lease options and subject-tos are investment strategies that can take nontraditional forms.

Ethics and Capital Gains

There are ethics issues you will need to deal with in the real estate investing business. Many times we as investors will know about certain IRS or other regulations or laws relating to real estate that the seller may not understand or even consider when making a deal with us. It is important to deal with everyone fairly. The IRS rules are constantly changing and you can't give tax advice unless you are a CPA, so have the seller check with their CPA or tax adviser, but you should be aware of the capital gains rules and how they can affect your sellers.

The Capital Gains Rule

If you have lived in a property as your primary residence for more than two years and you sell it, you don't have to pay capital gains. The IRS has changed the capital gains on our personal residences to a rule that, in simplified terms, goes like this: Every two years you can sell your primary residence (yes, the one you *live* in, not your investment deals) and you can keep the profits of up to $250,000 if you are single and $500,000 if you are married, tax-free. Anything above that is taxable, and any time period different than that becomes more complex. Basically, if the seller lives in it for two out of five years, it qualifies for this tax-free gain. This allows the seller to rent the home for three years—but not one day longer. This rule may also change.

ccc_patton_ch09_120-132.qxd 4/27/05 2:13 PM Page 130

Wendy's Ethics Example—Capital Gains

Suppose you have a woman who has lived in a house for 30 years and she has over $200,000 worth of capital gains. The IRS allows you to have up to $250,000 capital gains tax-free if you are an individual and $500,000 if you are a couple. If you buy her house within three years of initiating a lease option deal, she pays no capital gains, but if you go over this by even one day, she'll have to pay taxes on the $200,000 in capital gains—it would not be tax-free anymore. Your inability to close a deal within the three-year period could cost her tens of thousands of dollars, and that's just not fair to her. If you have done a five-year option with her, you have just erased the most recent two years she lived in the home and potentially exposed her to capital gains. Many sellers think the old law of "one sale over age 55 and no capital gains" still exists, but it doesn't, and if you're educated about that, you should be ethical and educate the seller as well. I care about the people who have been in their homes many years and who have a lot of capital gains—and therefore a lot to lose—especially since they probably don't understand the current tax laws. If your seller has a lot of capital gains, advise them to speak with their CPA and attorney if they really want to go for a five-year deal so that they understand the financial risks and liabilities.

However, if I know the seller has little to no gain in the home, I am far less concerned about their capital gains and may do a five-year option.

What to Do When Your Option Comes to an End

Time is running out on your contract—now what? Let's assume you had three years with the seller to purchase their home. The time is fast approaching and you do not have a buyer who can purchase yet. First, make sure you don't end a contract with a potential buyer on the same day that your contract ends with the seller. I recommended

ccc_patton_ch09_120-132.qxd 4/27/05 2:13 PM Page 131

leaving three to six months at the back end of a deal. For instance, if you have three years with the seller, you should give your buyer 12 to 18 months. If they don't exercise, then give the next tenant-buyer only 12 months, thereby leaving yourself six months at the end of your contract with the seller for other possibilities.

Let's say buyer number two doesn't want to exercise either. What are your choices? Surprisingly, there are many—I'll name six here. You can do any of the following, and in any order you choose, but I recommend that you always try number 1 first:

1. *Ask the seller for an extension if you want one*. Most sellers will give you an extension if you ask. Many times the sellers will just give it to you with no costs. Sometimes the extension might cost you more money—a little more now in the form of an option fee, in the future on the sales price, or more each month. If you can work it out for a win-win, do it. Make sure the extension is in writing—don't take their word for it. All real estate contracts *must* be in writing or they are not enforceable.
2. *Buy it yourself*. You can get a mortgage with a lender and purchase the home. You would definitely want to consider this if you can afford to do it and there is enough profit in the deal. Don't give the home back to the seller unless it is not worth the amount you agreed on or there is something wrong with the market or the home (something that you or your tenant didn't create). With 12 months of canceled checks on a lease option, you can get a mortgage that is treated like a refinance rather than a purchase. This type of program is also available to your buyers after 12 months of payments. If your mortgage broker doesn't have this program, find another mortgage broker. You don't always need good credit yourself if there is enough equity in the home. Look around and talk to some lenders, but don't wait until 30 days before the end of your contract—talk to a mortgage broker months in advance. Sometimes these types of loans can take months—I found this out the hard way.
3. *Sell the home directly to another buyer*. You will have to sell the home to another buyer directly, not a tenant-buyer. It may be someone referred by a Realtor or someone you found in the newspaper.

ccc_patton_ch09_120-132.qxd 4/27/05 2:13 PM Page 132

4. *Partner with someone if you can't do the mortgage yourself*. If the home has some equity and you can't refinance it, you can't sell it, and the seller won't extend, then bring in a money partner who can get the mortgage. Give them a part of the equity or a fixed amount for doing the financing. This will give you more time to resell it on the market or to lease option it again. You can find money partners in your local real estate investing group.
5. *Don't exercise your option*. Tell the seller you don't want to purchase, and then you can walk away from the deal. Remember that an option with the seller only gives you the right, not the obligation, to purchase. You must return the home in equal or better condition, less any normal wear and tear. You can't return the home with damage.
6. *Assign the deal to another investor*. You can wholesale this lease option to another investor for a fee, and then they can do one of the above five choices.

ccc_patton_pt03_133-134.qxd 4/27/05 2:13 PM Page 133

PART 3

HOW TO GET REALTORS TO HELP YOU DO LEASE OPTIONS

ccc_patton_pt03_133-134.qxd 4/27/05 2:13 PM Page 134

ccc_patton_ch10_135-149.qxd 4/27/05 2:14 PM Page 135

CHAPTER 10

Building Rapport and Sharing Lease Options with Realtors

Why Work with Realtors?

Approximately 80 to 90 percent of the nice homes on the market are listed with Realtors. The percentage varies from city to city and area to area, but they certainly control most of what's on the market. So they have access to the sellers that I need to get to in order to buy those homes. They will not participate in subject-to deals, because of the risk to their sellers, so I will not talk about that acquisition technique in these next two chapters on dealing with Realtors.

Working with Realtors will change your investment strategy forever. Thanks to Realtors, I get more deal offers than I can go look at—I don't chase them anymore. Once you get the Realtor system working for you, you will only need to evaluate which deals you want to pursue. The Realtor system is getting Realtors bringing you deals.

Many investors believe that real estate agents don't have the best deals, or that the deals have already been picked over by the time they actually hit the market. In many cases, this is true—there are deals that never hit the market, because they are very good. Realtors have clients who buy the best deals before they ever list them on the MLS (Multiple Listing Service). There are also deals that never

ccc_patton_ch10_135-149.qxd 4/27/05 2:14 PM Page 136

get to a Realtor—foreclosures, traditional for sale by owners, the homes investors find by driving by, and so forth. But I believe some of the sweetest deals are sitting on the market, listed with a Realtor, deals that no one even sees because they are looking for traditional or wholesale types of investment homes (meaning paying cash or getting a mortgage on the home) and not lease option homes.

When an investor considers traditional financing or buying with cash, they must be able to purchase the home for a much lower price. However, when they can buy the home on a lease option (terms) then they can pay a higher price, therefore opening up the market to more properties to choose from. When working with Realtors, it is less possible to lowball a home and get the deal through. Realtors typically don't like investors for that reason.

Since most of my lease option deals come from Realtors, it is important that I understand their perspective. Most of them have been trained to sell real estate for a living—traditionally, from beginning to end—in these ways:

Six Steps a Realtor Goes Through on a Traditional Sale

1. List a home for sale.
2. Find a buyer.
3. Get a contract signed.
4. Have the buyer get a mortgage.
5. Close on the home.
6. Get the commission.

Most Realtor deals are done this way, but what about the times when their listings don't sell? or when they don't sell quickly enough for the seller to feel comfortable? They are not taught to bring creative alternatives to the table for their sellers.

In a strong seller's market, Realtors typically don't need to consider anything creative, because homes are selling very quickly. However, even in seller's markets there are some homes that won't sell quickly for some reason. These are the homes that Realtors will need to consider being creative with.

In a buyer's market it is much easier to pursue lease options with Realtors and sellers. They will be more creative and open on

ccc_patton_ch10_135-149.qxd 4/27/05 2:14 PM Page 137

ways to sell their listings. In a buyer's market the Realtors won't get any commission if the home doesn't sell or if the listing expires and the seller lists the home with another Realtor. Also, in a buyer's market, sellers tend to put more pressure on their Realtors to sell their home, which pushes the Realtor to be more open-minded to new ideas and to pursue other alternatives for their sellers. They really do want to sell their customers' homes, to help both their sellers and their own business. That's where I come in. I teach Realtors about the alternatives I offer and how I can help them help their seller.

Finding the Right Realtor

The Realtor you will need to find for lease options will be a seller's agent or what is called a *listing agent*, the one that lists the home for a seller. A listing agent is the one who works with the seller and has his or her name on a sign in the seller's yard. If you want to buy in a certain neighborhood, you can usually find the strong listing agents by driving through and seeing whose names appear on the real estate signs in the yards.

A buyer's agent, on the other hand, represents and works for the buyer. A buyer's agent looks out for the best interests of the buyer whereas a seller's agent (listing agent) looks out for the best interests of the seller. You want a buyer's agent when you're purchasing your own home, but a listing agent is the one to work with when buying lease options or lease purchases—with my strategy.

Realtors have a relationship with their seller that is very unique. Sellers tell their Realtors almost everything about their personal lives. Realtors therefore know who is motivated and why. They know who is getting divorced, if they are in trouble financially, if their builder is almost done with their new home, if they have custody issues, if they are getting worried about double house payments, and how many grandchildren they have—as well as the name of their dog who died last year and what Uncle Ned did at the family reunion. I imagine Realtors sometimes want to say, "That's really more about your personal life than I ever wanted to know," but they don't. They stay as interested as possible in order to build rapport.

Because the Realtor is providing a very necessary service to the

ccc_patton_ch10_135-149.qxd 4/27/05 2:14 PM Page 138

homeowner in helping them sell their house, and because the homeowner so freely tells the agent *everything*, the homeowner is not shy about calling the Realtor and saying the four-letter word after the home has been sitting on the market awhile: "Realtor, if you don't sell my home soon, I am going to have to *rent* it!" This word makes a Realtor cringe. The only thing you can say to a Realtor that's worse is, "Take my home off the market." If the home doesn't sell soon, the Realtor won't get any commission and has lost countless hours in showing the home as well as dollars in advertising and marketing. Although the Realtor is licensed to rent it for the seller, most Realtors don't know how or don't want to rent it. The commission for renting a home is so small, it is generally not worth their time, unless they are a property management company and do a large volume of rentals. Many real estate companies don't handle rental properties at all because it is a such a different type of business and carries one of the biggest liabilities for Realtors.

In my area, when a Realtor hears the four-letter word *rent*, my phone rings. I have spent years developing rapport with the many real estate offices in my area as well as with individual Realtors. They know what I am looking for, and they know how to pique my interest in ways that might get me to drive by the house and see if I'm interested. Why? Because when they work with me to give me leads on potential lease options, they know they can get their commission paid—and paid much more quickly than on a traditional rental deal. Although I don't pay it myself, technically—the seller always pays that—I am willing to front the commission. This creates a win-win-win between the Realtor, seller, and myself: The Realtor sells the listing, the seller sells their home, and I buy another investment home. We all win!

Networking with Realtors

You only need to work with two to four listing agents per year to make a comfortable living. You can find listing agents in the real estate section of your newspaper or through personal contacts or your investor groups. I have one Realtor in my area who gives me only one deal a year, but I make at least $30,000 each time. I stay in touch with

ccc_patton_ch10_135-149.qxd 4/27/05 2:14 PM Page 139

her every few months just to keep my name fresh and to keep the relationship moving forward.

Realtors know lots of other Realtors, so if you have one contact, you can network through that one to access many others. Call the local real estate board to find out when they have local functions, and go mingle. Exchange business cards at the functions. If you don't have cards, get some printed. It's more important at this point for you to have their cards than for them to have yours, but having a card to exchange is more professional. You want them to know who you are and how to get in contact with you. Take a Realtor out to lunch.

Rent a conference room and invite Realtors to a wine and cheese party; then give them a presentation about lease options or lease purchases. Draw them in by focusing on what's important to them: "Would you like to sell more listings and make more money this year? I can teach you for free!" Do something to advertise it that grabs their attention without giving away all the details. Don't be alarmed if only five or six people show up, because those few are very interested in creative solutions. You might even put on your invitations: "Would you like to be more creative than your competition? Would you like to know things that your competition doesn't know about yet? I can teach you some creative ways to sell your listings that your competition hasn't even thought of."

If you are not sure who to call to get started, talk to the people in your local investing group, since there will be some Realtors in your group. These are not the Realtors you will be working with, as these are investors themselves and not traditional listing agents, but they should be able to tell you who the listing agents are in their offices. The top listing agents from the companies are also listed in the paper. It's worth starting a database or spreadsheet to keep up with who is where and what they do, especially with the people you begin to contact and develop relationships with.

Your local investors group can also be a great resource for brainstorming more ideas on drawing people in. Not only will they be interested in giving you feedback, but you may even find a money or managing partner there who is also keen on investing in the lease option strategy. You can then go in as a team and make a presentation.

ccc_patton_ch10_135-149.qxd 4/27/05 2:14 PM Page 140

Sharing the Realtor System and Targeting Realtors

Working the Realtor system is a multistep process. Building a relationship with a Realtor does not happen overnight. Just as you need to build rapport with your sellers, you also need to build rapport and credibility with Realtors. Here are some tools to get the process moving forward.

Letters

I have a couple of letters that I use to contact Realtors, primarily those with homes that have been listed over 90 days on the market. One letter is for use during a buyer's market (lease options) and the other for use during a seller's market (lease purchase). They both explain when a Realtor should consider me and how lease options and lease purchases can help them and their sellers. It is *very* important that a Realtor understands how you will help their seller. Their first obligation, by contract, is to the seller. Then they are concerned about themselves. My letter explains how I will help their seller *and* pay them.

Phone Calls

I will also call Realtors and go over something similar to what my letter says. You might want to catch them after hours so you can get your entire thoughts out on their voice mail and not flub it up, or if your time is limited. Then they can listen to it more than once and call you back for any questions. Also, it doesn't tie you up in a 30-minute call where there may be no interest.

Basically my message will sound something like this:

> *Hi Sally, this is Wendy Patton. I am calling about your listing on 123 XYZ Street. I am wondering if it is still available? I noticed it has been on the market for a while and I wonder if your sellers would consider something a little creative? Something like a lease option? If your sellers don't need their cash out now but would like their monthly pay-*

ccc_patton_ch10_135-149.qxd 4/27/05 2:14 PM Page 141

ment made and you would like to sell their home, and get paid your full commission, please give me a call. Sally, if it won't work for this seller, but if any of your other sellers have said to you that if their home doesn't sell soon, they might have to consider renting it, please give me a call. I buy homes when sellers can consider terms like this. Don't lose your commission to sellers that want to rent. Please call me. Thanks, Sally, for considering this. My number is . . . Again, my number is . . . and my name is Wendy Patton. Thanks, Sally.

This might be what I would say in a buyer's market. If it was a seller's market I might change the wording to a lease purchase. I would add that it's a guaranteed sell for the seller and that the Realtor's commission is paid up front. This makes it a much stronger call, which is necessary in that market. See Chapter 11 for the letter I use in the seller's market, with wording that makes it appealing to the Realtor.

Getting Your Foot in the Real Estate Office Door

Real estate offices get many requests to host speakers and salespeople, so it can be hard to get an appointment. The best way to start is to go to a real estate office where they know you and can recommend you. If you know someone who is a Realtor, ask them if they can assist you in getting into their company meeting agenda so that you can do your presentation. If you don't have a contact, then call the office directly and speak to the office manager or broker, and use an introductory letter. Tell them a little about yourself, keep it brief, and ask if you can present your ideas to their staff. They get bombarded daily by mortgage companies, title companies, and many others trying to get their business, so they don't like a lot of salespeople and they like to keep it short and sweet. However, keep in mind that the lease option or lease purchase system offers something unique and different. The real key is to show them how this system will help them to sell more of their listings.

I like to send a letter to the broker that grabs their attention. That means I leave out stuff about me, my background, and my

ccc_patton_ch10_135-149.qxd 4/27/05 2:14 PM Page 142

credentials, because when it comes down to it, I'm trying to sell a concept more than I'm trying to sell me.

Your letter should be on letterhead and might sound something like this:

> *Dear (broker's name),*
>
> *Would you like to assist your agents in learning new ways to sell their listings? I buy real estate and I have some ideas for your agents on how to sell more of their listings. I buy many homes in this area. I have a professional presentation that I would like to show you and your agents. I understand you get bombarded with salespeople trying to speak to your agents. I am not a salesperson. What I offer is unique and is something every real estate agent should know about.*
>
> *I have some creative ideas that might help you sell some of your office listings. I don't sell anything. I would love to meet with you to explain some of my ideas. My presentation is 10 to 15 minutes, so it will not take up much time, but it will be very valuable for your agents and your company.*
>
> *We have many references from clients like yours and from other real estate agents, including (agent 1, agent 2, agent 3). Please talk to them to find out how easy it is to sell a home to (your company name). Please call me to set up a time when I can meet with you and share the information that I would like to present to your real estate agents. My phone number is (222) 333-2222.*
>
> *Sincerely,*
> *Wendy Patton*

I also have letters that target specific Realtors and their listings, and I send them out constantly.

Educating Realtors

Realtors are not trained to do creative selling, and sometimes investors think they are not very sharp because they don't know how to do unique deals. That's one of the biggest stumbling blocks for in-

ccc_patton_ch10_135-149.qxd 4/27/05 2:14 PM Page 143

vestors trying to work creatively and effectively with Realtors—investors expect something that Realtors are not trained to do. As an investor, you will need to instruct a Realtor if you want them to be able to work effectively with you. This doesn't mean teaching them how to invest, but what key words they should listen for and how it will help their seller and themselves.

When people get real estate licenses, they are trained mostly on the law—seller contracts, lead-based paint, legal issues, fair housing, and things that are required by the state to make a real estate transaction go professionally from start to finish. However, they are not taught things like, "What if the house doesn't sell?" or, "What if the seller says that four-letter word?" It is your job to teach a Realtor what to listen for and how to help you and themselves in these types of deals.

Most of us know at least one Realtor, or we know someone who knows a Realtor. Practice your presentation on lease options or lease purchases with a Realtor, and ask for feedback: "Did I present the lease option concept clearly?" "Was my presentation too long? too short?" "Is there a better way for me to communicate this idea to Realtors?" "May I set up an appointment to present this at your local office?" The last question is especially good if your practice presentation has gone well and you are ready for the next step.

You will then want to go to the Realtor's office meeting. Call their broker or have the Realtor set it up for you to come to one of their meetings.

What to Bring to a Meeting

You must have a presentation prepared before going into a meeting. Don't ever think that you know enough to just wing it. Here's a list of what to bring:

- When you attend a meeting, it is customary to bring donuts or bagels, so call first and ask the office manager or broker what the agents would like.
- Have all your materials organized neatly and accessibly. You don't want to be fumbling for information and making them wait on you. Time is money—they will want you to be in and out quickly.

ccc_patton_ch10_135-149.qxd 4/27/05 2:14 PM Page 144

- Enough handouts of your presentation for everyone who attends the meeting and for the absentee agents. Call first and get a head count. Always have more than necessary in case they ask for extra copies. You won't need to give them a copy of each slide you present, but you can give them a one-page overview of how lease options will help them and their clients.
- Extra business cards (stapled to your handout).
- Make sure all handouts have your name and contact number on them.

Begin Your Presentation

Realtors will be open to the idea of lease options, or lease purchases, if you help them understand how they work and when they are appropriate for their sellers. Lease options are not the right thing for all sellers. The presentation needs to be educational about the benefits of lease options to them and to their sellers. I give a PowerPoint presentation going over the program step by step, and then open it up for questions and answers afterwards. If you don't have a computer to bring with a PowerPoint presentation, you can make overhead slides.

Your presentation might start off something like this: "Thank you for allowing me to come to your meeting today." Always remember to thank them for their time. "I am here to talk to you about some very exciting concepts that I have discovered that work for Realtors and their clients. Specifically, creative options for Realtors—things that you may not have thought about before or may not have considered for your clients. Let's get started."

Here is an outline of what I cover in my 10-minute presentation.

1. Introduction of myself and the name of my company.
2. My agenda: Discuss creative and innovative options for Realtors.
   a. Why I'm not a competitor but a help.
   b. How to help them sell their listings.
   c. Unconventional versus traditional sales approaches.
3. What to look for in a seller who might need my services.

ccc_patton_ch10_135-149.qxd 4/27/05 2:14 PM Page 145

4. What to look for in a buyer whom the Realtors can't help.
5. The lease purchase or lease option—when I do it and the guarantee it brings.
   a. How it works.
   b. How I pay commissions.
   c. Benefits to the seller:
      - I take over payments.
      - I take over maintenance.
      - No rental headaches.
   d. Benefits to the listing agent:
      - Quick sale—saves time and money.
      - Commission paid up front.
6. What types of homes are acceptable to me.
7. What price range I'll consider.
8. Referral fees.
9. Closing statements.
10. Ask if they have any questions.

I don't stay very long once I'm done. Usually the questions are brief, and I'll stay only as long as they continue to ask for more information. But Realtors generally don't have a lot of free time in the office, so they're looking to get as much information from me in as short a time as possible. Many times, after my presentation, they realize how I can help their sellers. Then they start to write down addresses on the back of their business cards for me. I often walk out of presentations with lots of cards and leads to pursue.

Making the Realtor Part of Your Team

If you're new at this business you might feel like a very little fish in a big pond, but when you have established a relationship with a Realtor, they become a part of your team whether they realize it or not. Now you're going to start to work together on finding solutions for the *rent* problem. You will also be able to help them during a buyer's

ccc_patton_ch10_135-149.qxd 4/27/05 2:14 PM Page 146

market when things are slow by cherry-picking their motivated seller deals as investments.

Because they are a part of your team, you will want to build that relationship above and beyond just what they can do for you and what you can do for them. How about sending a thank-you gift every time a deal goes through that they have led you to? These little rewards go a long way in keeping the rapport top-notch and ensuring even more leads in the future!

Building Rapport: The Follow-Up

Follow up monthly with Realtors who might be strong listing agents or who work with lots of sellers. Remind them what you are looking for. Remember, if they are successful they are busy, and they might not always remember you. You might have to remind them of what you do and how you can help them in their business.

I don't like to call Realtors during the day and interrupt them—or interrupt my own day. I prefer to call their offices late at night and leave a voice message. That way they can listen to it first thing in the morning—they start their day off with me reminding them of a creative way to do business. It might sound something like this:

> *Hi Kathleen, this is Wendy Patton. I wanted to say hi and let you know I'm looking for another home that I can buy on a lease purchase. Do you have any sellers right now that might be able to consider this type of solution? If so, please give me a call. My number is _____. Thank you, Kathleen, and I hope to talk to you soon.*

If I haven't done business with them yet but I have been trying to start the relationship with the first deal, I would say something else:

> *Hi Kathleen, this is Wendy Patton. I am still looking for a home and I was wondering if any of your sellers have said that they might consider renting their homes if their home doesn't sell soon? I know most of your sellers do want to sell their home outright, but if you do ever hear one of your sellers say they might rent it, Kathleen, please do call me. I will make sure you get your commission in full.*

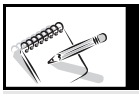
ccc_patton_ch10_135-149.qxd 4/27/05 2:14 PM Page 147

If you aren't a licensed Realtor, you can add:

Also, Kathleen, you will get to double-dip on the commission and receive the full buyer agent portion, too, when it closes on the back end. I don't have a Realtor involved. I will write up the offer, but you can have the entire commission. If your sellers rent out their home, they might not sell it, and neither one of you would really get what you want. I would love to do a lease with an option and make sure you both get paid in full. Please keep me in mind if this type of situation comes up. This usually works well for any type of seller that does not need their cash out at closing to move on to their next home. Thanks so much, Kathleen. Feel free to call me with any questions. My number is. . . . Again, that is. . . .

Follow-up is key with Realtors. However, don't be a pest. I would recommend a reminder call no more than once a month, maybe even every other month, especially after you have the relationship established. And you don't want to say the same thing each time you call. Try another way to explain how options or creative deals work. Here's another example:

Hi Kathleen, this is Wendy Patton. Just checking in to see if you have any sellers who might not need their cash out of their home at closing or who might be financed near 100 percent? If so, my type of solution might work well for them. Give me a call on any listings you have like that so I can set up a time to go and see them. I hope to talk to you soon on one of your listings. Kathleen, thanks for the opportunity to work with you. My number is. . . .



Wendy's Advice

Get the Realtor system shared with some Realtors. The sooner you do this, the sooner you will get Realtors begging you to buy their listings!

ccc_patton_ch10_135-149.qxd 4/27/05 2:14 PM Page 148

Ethics with Realtors

Honesty and integrity with Realtors will be the key to successful relationships with them. If I deal badly with Realtors, it's going to affect my reputation and damage the business for other investors. Real estate is a small world, and word gets around if you stiff a seller or walk away from a contract and tell them, "Go ahead and sue me." Realtors find out, and, as previously mentioned, they control 80 to 90 percent of the homes on the market. Even if your own ethics are good, if Realtors hear horror stories about deals gone bad because of investors who reneged on their lease options or lease purchases, it hurts the market for the rest of us.

If you've committed to something with a Realtor, get back with them and do it. There's nothing worse than going to a group of Realtors with a presentation, getting 10 leads, and then never getting back to them regarding what happened with those leads. The Realtors will wonder what the point of helping you with leads is if you don't follow up. It's the surest way to kill the rapport you have worked to establish. Did you look at the properties? What did you think? Are you interested? Are you going to pursue? Follow up and let the Realtors know! Even if you don't have time to look at the properties, or they weren't what you wanted, communicate that. Keep the lines of communication open so they will continue to provide you with leads. The relationship must be a two-way street. And the more *you* give, the more they are willing to give.

Sometimes a Realtor will call me about what I call a dumpy property. I look at it and know it is overpriced. Now I'm faced with a dilemma: I don't want to insult the Realtor, because I want to keep that relationship positive, however, they were the ones who called me about the property. The best strategy is to be honest with them. I would say something like this:

> *Sally, I looked at the home on 123 Main Street today. Boy, with what it needs, and what I think I can sell it for, and my carrying costs, the most I could offer would probably be an insult to the seller. I certainly don't want to affect your relationship with the seller. I think I will have to pass on this one, unless* you *want me to still write it up. I will leave this up to* you.

ccc_patton_ch10_135-149.qxd 4/27/05 2:14 PM Page 149

See how I keep the door open to them? I explained my reasons in terms that the Realtor can understand without being insulting to her or the property. Not only that, but I've left the lines of communication open in such a way that the Realtor will call me back one way or another regarding the house. This is what I want: I want them to continue to call me because they are my first relationship. Forget the house! Many times they know it is overpriced and they just want an offer to show the seller. If they want me to write up an offer, I will. What often happens in this case is that the seller doesn't think their home is overpriced until they get an offer from me and are shocked into reality. Then the seller reduces the price and the agent can finally sell the home. Thus, I have helped the Realtor make the sale. This might not help me as an investor today, but it will help me when the Realtor thinks of me for their next listing. For me, that one home is just a home. I want the relationship, so that they will bring me five more homes down the road.

Remember that being an investor is a long-term strategy. Building rapport with Realtors is an essential part of the long-term big picture.

ccc_patton_ch11_150-158.qxd 4/27/05 2:14 PM Page 150

CHAPTER 11

Closing Deals with Realtors

Why Aren't Lease Options or Lease Purchases Appealing to Realtors?

When I first started doing lease options with Realtors back in the early 1990s, it was a strong market in Detroit, but I wasn't getting very many leads. This both puzzled and bothered me because I thought I had something great to offer them. I went to my best friend, Debbie, who is and was a local Realtor. I said, "Deb, look what I'm offering these Realtors—it's a great thing for their sellers! Why aren't they all coming to me with their deals?"

She looked at me and said, "Wendy, do you truly believe it's a great deal for the Realtors if they have to wait three to five years for their commission? They might not even be with the same real estate company when the house closes. This is a *hot* market—they can probably sell their listings to someone else and get paid before then. They're not motivated to work with you on these types of deals. Why should they wait for years for their commission when if they just wait for a couple more months, possibly weeks, on the MLS, they'll get their full commission now?"

I replied, "So what should I do?"

ccc_patton_ch11_150-158.qxd 4/27/05 2:14 PM Page 151

She said, "You're creative. Think of something."

I said, "You mean like pay their commission up front?"

She responded, "That would be a really good start."

And that's when I started paying Realtors their commissions up front, and my ability to purchase completely turned around, especially in a seller's market.

Addressing the Commission Issue

Realtors are not greedy, but they do want to be paid for the services they are providing for their sellers.

By contract, they are not entitled to their commission until the sale closes. If closing is a number of years down the road, what's the likelihood that the Realtor will want to wait that long? They may not even be with the same real estate company by then, and because the deal is with the company, not with the Realtor, in most states if a Realtor leaves one agency and goes to another, they may completely forfeit their commissions. This makes the option strategy unappealing for Realtors, primarily in a hot market.

The Realtor's job is to look out for their sellers' best interests, and many Realtors don't feel a lease option is a good solution for the sellers. If a Realtor is simply dead set against it, just move on. There are lots of Realtors who are creative enough to want to work on finding innovative solutions for their clients. You just have to help them understand when these solutions would apply. Likewise, if a seller adamantly won't do it, move on. Only spend your time on the people/sellers open to the idea.

The reason most Realtors don't consider these creative solutions and can't help their sellers move in that direction is because most sellers *can't* consider a lease option or purchase. Most sellers need their cash out in order to buy the next home. I estimate that only 5 to 10 percent of sellers can consider a lease option because these sellers *don't* need their equity out of their home to buy their next home. In my experience, sellers who can consider a lease option or lease purchase will usually do it for two to five years in a seller's market and three to ten years in a buyer's market. The seller's situation will determine the length of the lease option, the payments, price, and other terms.

ccc_patton_ch11_150-158.qxd 4/27/05 2:14 PM Page 152

HOW TO GET REALTORS TO HELP YOU DO LEASE OPTIONS

When a lease option is a viable solution for a seller, the next hurdle is to ensure that their Realtor will benefit from the deal as well. This chapter explains how to keep the Realtor in the win-win formula, and how to keep that positive rapport with the Realtor for future deals.

In a seller's market, my letter to the Realtor would look like this:

Dear Sally,

Would you like to sell your listing at (address of property)?

Maybe we can help. We buy homes . . . especially when your clients can accept terms like a lease purchase. As soon as your client says to you, "If my house doesn't sell soon, I might have to rent or lease it," this is a great indication that our services might help you sell the listing.

When your client sells their home to (your company name) . . .

YOUR COMMISSION IS PAID UP FRONT!
and it would be a guaranteed closing for your seller.

When would a client be able to accept a lease purchase? Here are some situations:

1. *They don't need their cash out yet but would like to either have cash flow or have their payment made.*
2. *They have very little equity (i.e., financed near 100 percent).*

We have many references from clients like yours and from other real estate agents, including (agent 1, agent 2, agent 3). Please talk to them to find out how easy it is to sell a home to (your company name). Give us a call if this type of solution might work for your client.

Sincerely,
Wendy Patton

In a buyer's market I would use the words "lease option" and I would also say their commission is paid "in full" versus "up front." It is not as strong, but still very positive.

After I started to send out this type of letter, the deals started to

ccc_patton_ch11_150-158.qxd 4/27/05 2:14 PM Page 153

come in. The commission was no longer a stumbling block issue for the Realtors—they didn't have to worry about waiting for years to be paid for the work they were doing then.

In a weaker market or a buyer's market, I don't pay the entire commission up front—I might only pay part of it, say 1 to 1.5 percent versus the 3 percent I would pay in a seller's market. They would then have to wait until closing for the remainder of their commission. In a weaker market they realize that they might not get paid at all if their listing doesn't sell. At the same time, I am getting less from my buyers in these markets. Remember, a slower market for sellers means a slower market for buyers; less money for sellers translates to less money for buyers. Realtors understand that when business is slow for them, it is slow for me, also.

Here's an example: I offer $200,000 in a seller's market and I pay 3 percent of the listing portion of the commission up front. This is $6,000. I would owe $194,000 when I pay off the seller (when I exercise my option). However, if I don't exercise my option, I would not get that money back. I am fronting the seller's expense for the real estate commission.

Structuring the Deal for the Realtor

Understanding the current economy is essential for making the offer work effectively. Know whether you are in a strong buyer's market or seller's market so that you can structure your offer appropriately.

Seller's Market

This is the market where things are selling quickly, appreciating strongly, and sometimes multiple offers are made on the same house on the same day. This is also a time when the economy is good, things are happening, there's a lot of new construction, and so on. When homes are selling quickly, Realtors are getting paid quickly and in full, so in the beginning of a lease purchase, I offer to front their commission *in full*. Realtors prefer a lease purchase in

ccc_patton_ch11_150-158.qxd 4/27/05 2:14 PM Page 154

a strong seller's market. A lease purchase means you are guaranteeing you will buy that home, so don't do it unless it's a strong seller's market, with good appreciation, or you're positive you want that home.

Buyer's Market

A strong buyer's market is the opposite: Things are not selling, business is slow, unemployment is higher, homes are sitting and sometimes going from one Realtor to another in an attempt to sell, and there's little or no appreciation, sometimes even some depreciation. Net result: Realtors are not selling their listings. The result is Realtors are much more negotiable because they're likely to lose their listings, and the sellers know that things are slow, which is making them more anxious. This opens up many opporunities for lease options. During this time I only offer part of the commission up front, possibly part in 12 to 18 months, and the rest at closing. Keep in mind, however, the fee is really coming out of the option fees that the tenant-buyer pays to me and not out of my own pocket. When I assist the Realtor in getting paid, they are more likely to work with me again. The rule of thumb is: Weak market, weak offer; strong market, strong offer; but above all, always be fair.

Sequence of Events When Working with a Realtor

The Realtor gets paid when I put someone in the home—in other words, when I get money from someone else. The sequence of events is as follows:

1. The Realtor gets a listing.
2. The seller says the four-letter word, "rent," and the Realtor shares it with me.
3. I look at the property.
4. We negotiate it through a proposal.
5. We agree on the terms.
6. I write up a full offer.

ccc_patton_ch11_150-158.qxd 4/27/05 2:14 PM Page 155

7. The offer gets signed.
8. I find a tenant-buyer.
9. I pay the commission or a portion of the commission to the Realtor.
10. The tenant-buyer moves in.
11. Closing happens at a later date.

Sometimes I say, "I'll commit but not until . . ." and I give them a future date because I need time to find a tenant. Even if my tenant doesn't move in by the start date, I am still responsible for paying the full commission on that date. It is a stronger offer to a Realtor and to the seller if you commit to starting on a certain date, regardless of whether you have a tenant. If there is no tenant-buyer, the commission will come out of your pocket—not exactly zero down for you the investor, but it is still a low down payment on the deal. If you have a tenant-buyer, the commission you need to pay will come out of the option fees from your tenant-buyer. You'll have to decide what risk you can afford when you set the start date.

If a Realtor is working with a non-Realtor on a sale, the Realtor will be glad to wait for half of the commission up front, but they won't wait for all of it on the back end. They'll wait for a double dip, however. A double dip is when the Realtor gets the portion from both the seller and the buyer. If you are not licensed, the Realtor would get both sides of the deal. (I need to be very clear about the payment to Realtors. It isn't the Realtor I pay but the brokerage firm the Realtor works for. The Realtor gets their commission cut through the brokerage.)

Structuring the Deals—the Details

A proposal is used to put together a mock-up offer to a Realtor that they can then present to the home owner or seller. It will put down the overall terms in writing without the specifics. This saves a lot of paperwork because you only fill out the entire offer *after* you have an agreement on the proposal.

Here is what a proposal can look like to a Realtor or a seller. This is a lease purchase example, but it could be modified in format for a subject-to or lease option.

ccc_patton_ch11_150-158.qxd 4/27/05 2:14 PM Page 156

Majestic Realty, LLC

Proposal

123 XYZ Street

Innovative Approaches to Leasing/Selling

Majestic Realty, LLC
has 2 programs to offer you…

ccc_patton_ch11_150-158.qxd 4/27/05 2:14 PM Page 157

Please review the following options that we can offer you as a seller and consider which would serve you best!

Lease/Purchase to Majestic Realty #1
Majestic Realty can guarantee you a monthly fee of $1,100.00 for a lease term of 3 years. We would then guarantee the purchase of your home within the 3-year term at a price of $250,000.00.

Lease Purchase to Majestic Realty #2
Majestic Realty can guarantee you a monthly fee of $1,150.00 for a lease term of 5 years. We would then guarantee the purchase of your home within the 5-year term at a price of $255,900.00.

In options 1 and 2 we would pay the rental amount whether the home is vacant or rented. You would still need to carry your homeowner's insurance and pay your property taxes until the home is closed. We would be responsible for everything else from the date this agreement starts, including all maintenance (minor and major, except the first 60 days). We will do a home inspection prior to taking over the lease purchase agreement. We would like to have all the appliances left with the home. This would not be a VA or FHA type financing, and you would be responsible for nothing when we get our mortgage. You would pay only the seller's title insurance and transfer fees.

We will start this contract when we find someone to lease from us; however, in the meantime the seller has the right to leave the home on the market. If you sell the home first, then this offer would be declared null and void.

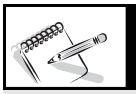
The purchaser will put $7,500 (3 percent) down, which will be paid directly to (realty company name) and applied toward the listing portion of the commission and the purchase price at closing. Any remaining commission due will be paid out of the seller's proceeds at closing, to (realty company name) and Majestic Realty, LLC.

We have many references available upon request. Thank you for considering Majestic Realty!

ccc_patton_ch11_150-158.qxd 4/27/05 2:14 PM Page 158

Don't be anxious on the proposals—make it low pressure. When you're first starting out, you'll want more deals to go through because there's a great excitement in the newness of the game. You'll be revisiting your proposals, wanting a quick response, and thinking of ways to use the money you're going to get on the back end if everything goes as expected. Although I do try to come up with creative solutions if I think there's a profit to be made, I don't keep checking my proposals. It's a bit like testing the doneness of spaghetti: You throw it against the wall, and if it sticks, it's done. If your deals stick, they're done. If they don't stick, hopefully you've got others in your hip pocket that you're working on anyway. Don't get too wrapped up in a deal happening, because a lot of them won't. About 30 percent of my proposals work out—which means that 70 percent come up empty.

With some of the Realtors I know very well, I might even do a verbal proposal. For example, I might say, "See if the seller will go for $1,200 per month, and if they do, then I'll put together a proposal." I'm just fishing a little bit to see if it's even worth sticking around in that spot or moving to another. If the seller goes for it, I hammer out a proposal, and if not, there are plenty of other deals out there!



Wendy's Advice

If it is meant to be, it will be.

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PART 4

STEPS TO SELLING PROPERTIES ON LEASE OPTIONS

ccc_patton_pt4_159-160.qxd 4/27/05 2:14 PM Page 160

ccc_patton_ch12_161-174.qxd 4/27/05 2:14 PM Page 161

CHAPTER 12

Finding and Qualifying a Good Tenant-Buyer

Understanding how to screen and select tenant-buyers is the key not only to being a good landlord, but also to the business of selling and using the lease option technique.

A Story About Working with Buyers

A strange thing about prospective tenant-buyers is that you can't always tell who is going to exercise by how well things are going with their tenancy. Some people struggle to pay their rent but end up getting a mortgage on your home, and others pay perfectly and don't end up buying.

I had perfect tenants in an 18-month lease option and everything was going so smoothly I was sure that they were going to exercise the option. Then in month 17, I received a call from the woman, who was crying. She said, "We have a problem. I can't pay my rent next month."

She was sobbing. She and her husband were getting a divorce and she didn't have the money for the rent. She was very embarrassed and wanted to work things out in any way possible. Thinking she

ccc_patton_ch12_161-174.qxd 4/27/05 2:14 PM Page 162

wouldn't be able to stay, I asked if it would be possible to start showing the house right away, and she said, "No problem. By the way, I do have some jewelry. Would you take that in exchange for my rent?"

My ears perked up. "What kind?" I do like jewelry, but really I was thinking, I might not ever get paid this rent, so maybe I might should consider accepting the jewelry.

The woman answered, "Diamonds and emeralds."

I said, "Really? When can I see them?"

She replied, "Well, how about now?"

When I got to her home, I found out it was her anniversary ring and wedding ring. I said, "I can't take those!"

"Really, I want you to have them. I can't pay the rent."

"But what if you reconcile?"

She answered, "We won't," but I said, " You just don't know. I really hope you will."

Now this kind of thing tugs at your heart a bit, so I said, "Tell you what—I'll keep these for you. I'm a free pawn shop. I'll keep them a couple of years, for free. If you ever want them back, just pay that rent—no late fees, nothing. Just take them. I don't want your rings."

The woman responded, "Oh no, I'm not coming back for those."

I protested, "Well you never know. You might work it out. I want you to work it out."

She answered, "No, no, you don't understand. I've been divorced twice now—from *him*."

She never came back for the rings, and I still have them. Maybe one day I'll have them reset for my daughter. The point is that you just never know what you're going to end up with in this business.

Finding the Best Leads for Tenant-Buyers

Finding good tenant-buyers is the key to making the deal successful. There are many ways to find a good buyer for your home. One of the primary ways that I use to market my houses is to advertise in the newspaper.

Try a few different ads. If you get no response, make changes and try again. Know whether you're in a buyer's or seller's market. I have a friend who said in her ad, "Free pizza." So people would call

ccc_patton_ch12_161-174.qxd 4/27/05 2:14 PM Page 163

her up and say, "What's this about free pizza?" and she would answer, "Every month that you pay your rent on time you get a free pizza." It's amazing what people will do for a free pizza.

How to Post a Successful Ad

When you run an ad in the paper, remember that "romance sells." Beautiful sunsets, bring your canoe—think of something short and catchy for the ad, things that might reflect a holiday or time of the year. Or you can push on the credit issues, location, or special features of the property. There are many ways to reach buyers. Try different approaches to see what works for you. If one ad doesn't work, try another; if one paper doesn't work, try another paper.

> Rent with option to buy this 3 bdrm, 1 bath home in Xyz Town near Xxx Park. Large yard and view of lake. $1595/month and $5000 option fee gets you in. Bad credit OK. (111) 222-3333

This is a very basic, generic ad. It should appeal to a broad range of potential buyers.

> Bad credit, no credit, poor credit? We can help. We have homes in this area to help you get your credit reestablished. Own a home soon! Small amount needed to get in. (222) 333-3333

This ad will bring in the buyer with bad credit. We are trying to find someone with poor credit—not a deadbeat, just someone who needs another chance.

ccc_patton_ch12_161-174.qxd 4/27/05 2:14 PM Page 164

> Sunset views with a bottle of wine help you celebrate your new home. Low monthly payments required $1395. Small option fee gets you a new start. Call today (333) 444-5555

This is the romantic type of ad. It is meant to draw in the romantics, young couples, and the like. Each buyer responds to different ads, just like the sellers.

> Buy your family a new home in 20XX! Start out fresh! Own a home now! 3bdrm 2ba in XYX Town with great schools. $995 month and low amount required to get in. Call today. No bank qualifying. (333) 444-6666

This ad is great to run at the end of the year or the beginning of a new year. It is perfect to work on people's New Year's resolutions.

> Stop Renting! Buy Now! We have several homes available with lease option terms. ABC and XYZ Counties. Start building your future today. Homes ranging from $995 to $1995. We can help YOU! (222) 333-4444 www.MajesticRentals.com

This ad contains my company web site, which is always good to put in an ad if you have one. Web sites are one of the cheapest ways to advertise, as I discuss a little later in this chapter.

Note that if you are a Realtor, you must disclose that in your ads.

ccc_patton_ch12_161-174.qxd 4/27/05 2:14 PM Page 165

> Land Contract Wanted? We have a home available on terms. Call for a unique way to buy a home. 3bdrm home in XYZ Town. $1295 month. $3000 gets you in. (222) 333-4444

This is a great ad for parts of the country where the words "Land Contract" are used for seller financing. If your part of the country doesn't use this term, then substitute the words "Seller Financing." This attracts people who don't feel they can get a mortgage. They know they will need the seller to assist them in their financing. We are not going to give them seller financing or a land contract, but we are attracting them with these words. We will discuss with them later that we are doing a lease with an option to buy and that they can clean up their credit to get a mortgage during this time period.

Referrals from Realtors

You can also get Realtors to refer buyers to you. Realtors usually only work with buyers who can get a mortgage today and can go purchase a home from them. If they don't have a preapproval letter, then they basically throw the buyer's name away. I created a letter with the heading "A Piece of Garbage or $1,000?" The offer in this letter could be $500 or more than $1,000. The intention is to get Realtors to give you the names and numbers of the people who come through their doors that they can't help—people who can't go buy a home traditionally through their office. If they refer them to me and they buy a home using a lease with an option from me, then I will give the referring Realtor the amount stated in the letter when the buyer moves into one of my homes. You can also entice Realtors by offering them more on the back end if the person actually buys the home down the road. Realtors have leads on lots of these types of buyers. If you can't find them yourself, or if you need more, then consider offering to pay more. These are also the Realtors I work with when finding sellers. Now you can see how powerful it can be to work with Realtors. They can bring you sellers *and* they can bring you buyers.

ccc_patton_ch12_161-174.qxd 4/27/05 2:14 PM Page 166

Web Sites

A web site is one of the best ways to show your prospects the details of how options work, but also the details of a particular home. Your web site can also be a place where you show all of your properties, when you have several to offer. It is an inexpensive way to advertise your homes. I am not a technical person, nor do I want to be one. You can buy a web address for a low annual fee and hire high school or college kids to get a web site set up for you. They are not expensive, yet they can provide the viewers with a lot of information on your homes and services that you can't afford to print in a newspaper. Most people have access to the Internet and have an e-mail account, so you have a huge potential audience.

Signs

Post signs in front of your homes that say "Lease to Own," "Rent Option," "Lease or Buy," and so on. Also, if you have a rental home that is on a busy street or on a corner lot, write into the lease with that tenant a clause that allows you to put a sign out front to draw in tenants for other homes you have. Signs in front of homes do bring in calls for that home or for others.

Referrals from Tenants

Offer your current tenant-buyers free rent or option credit if they refer a friend who lease options from you. I prefer the option credit, because it is not cash out of my pocket and it entices them to purchase the home. If they don't purchase it costs me nothing; if they do, it comes out of my pocket later.

There are many other ways to find tenant-buyers, so experiment and see what works best for you.

Types of Tenant-Buyers and Their Credit Situations

People can have many types of credit situations. The four types I discuss here are (1) good, (2) deadbeats, (3) Bad with reason, and (4) unknown.

ccc_patton_ch12_161-174.qxd 4/27/05 2:14 PM Page 167

When a person has perfect or good credit, they don't need to consider a lease option. This technique is not necessary in order to buy a home. People with good credit can work with a Realtor and buy any home they can afford. They can also find a home for sale by owner and work directly with a mortgage broker to get a loan. They have many choices, so they don't need this technique.

The opposite of good is bad. Deadbeats are those who have poor credit and no excuse for it. They have the money but they just choose not to pay their bills on time or at all. They tend to be poor money managers, or they are lazy and don't want to work to pay minimal bills. These are not the type of buyers you want in your home. They need to make habit and lifestyle changes, and you will not be the one to make it happen. Deadbeats are deadbeats—you don't need them!

Then there are the people who have poor credit for a reason. They are good people to whom something bad happened. Bad credit can result from many different situations including loss of job, divorce, medical problems with no medical insurance, disabilities, and so forth. These individuals have hit bottom financially and are on their way up again. They have improved their situation, but not enough to go and buy a home yet. These are the types of buyers you will want buying your lease option homes.

Bankruptcies are at an all-time high in our country, according to www.uscourts.gov/bnkrpctystats/statistics.htm. When people file for bankruptcy they may not be able to get a mortgage for several years after the discharge. People with collections or late pays on their credit report need time to heal these situations. Many people don't want to wait until they can qualify for a mortgage. This situation makes the selling of lease options an opportunity for us real estate investors. People want to buy now but can't. They are willing to pay more for a home on an option and have it now than to wait and save money. It is the common "we want it now" mentality.

There are two things many people ask themselves when buying a car: how much down and how much per month? If those two things fit in the budget, then they buy the car. Whether the price of the car is $28,000 or $26,000 is irrelevant. It's the same way with homes: The end price is not as important as the terms. Lease options give terms to people with less than perfect credit.

The people that fall into the "unknown" category need to be evaluated more carefully. They have poor credit but it is unknown as to

ccc_patton_ch12_161-174.qxd 4/27/05 2:14 PM Page 168

whether they have improved their situation. The credit is still bad, but there is a reason. I recommend you stay away from those people or have a lender evaluate them first. If a lender can't tell you that they are improving and will have a chance to get a mortgage, put them on hold. Wait a few months and then reevaluate their situation to see if it has improved or changed. We want the people who simply had something bad happen to them and are on their way to repair and improvement.

Qualifying the Good Buyer

When you run a credit check, you are looking for someone who had a blip in their credit and now they are on their way to financial stability. When you look at someone's credit record, see if they are on their way up or not. Notice what they have paid recently and what is still behind—this will show up on their credit report. Learn to read credit reports and get set up on a reporting system that works for you. If you don't know which system to use, talk to others in your real estate investors group. They will know which companies provide which services in your area. You can also work with a mortgage broker to run credit and do the lease option approvals.

Your Standards

It is a federal law requirement that landlords put their rental standards in writing. If you don't have your standards in writing (and, unfortunately, few landlords do), you are liable to end up in a pickle if someone accuses you of violating this rule. Your standards do not have to be complex but should be able to be produced if someone at a local or federal agency, or anyone off the street, requests a copy of them.

Written standards can be as simple as this:

Qualifications for Tenant Selection for Majestic Realty, LLC—Lease Options

- No landlord tenant judgments unpaid.
- Ability to pay all outstanding judgments/collections.
- Good landlord reference.

ccc_patton_ch12_161-174.qxd 4/27/05 2:14 PM Page 169

- Gross monthly income equal to three times monthly rental rate.
- If any bankruptcy, it must be discharged.
- Option fee available or must be negotiated/financed.
- Prefer they have spoken with a mortgage representative.

On my lease option standards I don't put a credit score, but I do state that if they have a bankruptcy it must be discharged. I also don't put length of employment, but you can. These are only my standards for lease options—my standards for my regular rentals are stricter. You must establish your standards and they must be in writing.

Screening a Good Buyer

Screening a buyer is extremely important, and yet some of us investors still go by instinct or illegal decisions.

"We liked them," some investors will say to me. We want to buy from sellers that "like" us, but we can't sell that way. There are too many good liars in the world. You may feel you can read people, but relying on your gut feel will set you up for a rude awakening. Many of my worst situations arose from my own desire to believe in people. We should all screen people as if we were blind and deaf. Then we would screen them strictly on the facts and not our opinions or prejudices.

Screen a tenant by reviewing their application thoroughly. Check it for accuracy and make sure they did not lie to you. If someone lies to me, they are denied the occupancy. Check their name—get a copy of their driver's license. Check their landlord history. The current landlord may want to get rid of them, but the previous landlord has nothing to hide. Call them both. Confirm it is the real landlord in one of two ways: check it on county records, or call the person and mention a different amount of rent than on the rental application. For example: "Hi, my name is Wendy, and I'm calling for a reference on your tenant named Joe Smith. Can you tell me how long he has rented from you? How does he keep your home? Has he been a good tenant? Would you rent to him again? Also, I see he pays you $900 per month, right?" Actually the application says $700 or something else. If this is Joe's friend, he will say, "Yes, that is right, $900 per month."

ccc_patton_ch12_161-174.qxd 4/27/05 2:14 PM Page 170

If it is the real landlord he will correct it: "No, Joe only pays $700. Did he say he paid $900?" Then I say, "Oh, no I see you are right. It does say $700—I misread it. Thanks so much for your information."

Check their employment, too. I use the same technique when I verify their income as I do their rental amount. When I contact the employer I say "Joe put on his application that he is making $16 per hour—is this correct?" when he actually put $12 per hour. If the person you reached is his employer and not his buddy, they will correct you on this one. On occasion I will also ask the applicant for recent pay stubs to put in the file. This information is also handy to have in case you ever have to garnish wages. Be sure to verify hours they work and time on the job as well. Also check their banking information—you might need it later.

Know What Are Reasonable and Unreasonable Expectations

Many of my tenants have pets, and most of them smoke. For this reason I never say "No smoking" and "No pets" because I wouldn't have many tenants. Smoking and pets don't make people bad prospective tenants. However, here are some things to look for on their application that are potential smoking guns for bad tenants:

- Why did they move? When prospective tenants say they had a "bad landlord" before, it puts up a red flag for me. I know there are bad landlords out there, but the red flag it raises is that they are blaming someone else for their problems. So I look further to see if there are other instances of blaming. If their business went into foreclosure, are they blaming their accountant? If they have tax liens, are they blaming the IRS? Be especially watchful for the blame game.
- How long have they had their current job, and how long did they have their previous jobs? What salary are they currently making? If they haven't been employed very long in their current situation, call their current employer to get an employment verification. Get the verification from an executive in the company or from the CPA/accountant. Do not get it from the receptionist! Get the start date of employment as well as the current salary.

ccc_patton_ch12_161-174.qxd 4/27/05 2:14 PM Page 171

The Credit Report

Run a credit report and see what's going on with their debts. Some people may have medical issues that have caused their current financial difficulties, but most mortgage brokers will overlook these. What is more important are repossessions, foreclosures, bad credit card debt, judgments from landlords, and the like. If they have a string of bad debts, you could be the next bead on that string.

The credit reports I receive have bad debts shaded and good debts in white. I like to see a lot of white on the page. Too much shading indicates a lot of current and potential future problems. Do they have frauds on their report? Do they have bankruptcies on their report? This is not necessarily a deal breaker, as bankruptcies can happen to even the best people and can sometimes be out of their control. However, the important question is, what are they doing to repair the bankruptcy?

Criminal Background Check

I don't run criminal background checks, even when the tenant looks like what I would consider to be a criminal. If you do one, you must do them for all prospective tenants.

I remember when one of the first homes I ever bought was up for rent. Two rough-looking guys on Harley Davidson motorcycles drove up right onto the lawn and wanted me to show it to them. I was just 21 years old and feeling a little intimidated by these big, scary guys. They ended up renting the house, however, and they paid their rent perfectly and on time every month, as well as leaving the house better than when they rented it. Looks simply don't count. You must turn a blind eye and only focus on the qualifications on paper. In that spirit, you should also be thoroughly versed in the current fair housing laws.

What You Should Know About Fair Housing Laws

Fair housing laws could be the subject of an entire seminar. Realtors around the country have half- to full-day training sessions on this topic alone, because fair housing rights, when violated, can cost the violators hundreds of thousands of dollars. This is not an area where you want to mess up.

ccc_patton_ch12_161-174.qxd 4/27/05 2:14 PM Page 172

The bottom line is this: Select a tenant on their application alone and nothing else. There are federally protected areas and there may be some state protected categories also. Each state has its own protected areas, so check with your state for the details. Your local real estate investors group can help point you in the right direction. The simplest way to be safe is to refrain from judging anyone by the way they look or talk. This is why I say that we should be blind and deaf when selecting a tenant. If we evaluate on the application process alone, we will stay out of trouble. Make the selection based on the facts, not on gut feelings or instincts. Stick with the law and you will be safe.

Some federal and state protected categories include (but may not be limited to):

- Religion.
- Race.
- Nationality.
- Sex.
- National origin.
- Color.
- Sexual preference.
- Marital status.
- Age.
- Weight/height.
- Familial status. While you can't ask potential tenants how many children they have, you can ask how many people total will be residing in the home. You don't have to rent your two-bedroom home to a family of nine.
- Mental and/or physical handicap.

Be extremely careful with this area of federal and state law. Even an inadvertent misstep can haunt your career for a long time.

Rejecting a Rental Applicant

If you reject someone's application, you have to tell them why you rejected them in writing, and there is no need to obscure your reasons.

ccc_patton_ch12_161-174.qxd 4/27/05 2:14 PM Page 173

Be honest but be kind. Let them know that if they can clean up some of their credit difficulties, you may be able to help them in the future. If you feel inclined, you might even suggest they talk to a lender or financial counselor about how they can get their credit report into a more favorable position.

Buyer's Objections

Although tenant-buyers will rarely have any objections to renting from you, there are a few that may come up. You will need to know some ways to handle these objections and what you can say to your tenant-buyers. Here are two of the most common:

1. *What happens to my option money if I don't buy this home?* Answer: "It's nonrefundable. This house is going off the market during the option period, so there's a fee for that. We are providing a service, and for this service there is a fee. If you are not sure you want to buy this home, you should not put an option fee down. You should rent from someone else. We want to rent this home to someone who wants to buy it in the future. You do want to buy one day, don't you?"
2. *What if I can't get a mortgage?* Answer: "Then you would lose your right to buy this home. We do have the right to extend or give you another chance to buy this home, but at this point we are not guaranteeing anything. If the market goes up, we also might increase the price of the home. We are only fixing the price and terms during the time period we have signed here today. You should talk to a mortgage broker before you sign any contracts. It is usually a requirement of all lenders that the applicant pay off judgments, liens, and collections before they can qualify for a mortgage."

I don't want the potential tenant to delay making a decision, so I always say that I have other people looking and that my ad is still running, so they need to decide what they're going to do and how interested they really are. After all, they are the ones in need, not me.

There are times when you will find the buyer does not have the full amount to put down on the option fee. Be creative with the option

ccc_patton_ch12_161-174.qxd 4/27/05 2:14 PM Page 174

fees. I've taken two mobile homes in trade for option fees. I'm not in the mobile home business and I hate them, but it got the deal through! You can also work on monthly payments with them. You can take an extra $200 per month toward the option fee until it is paid in full; however, you should always get more up front than what you would have received if you were getting a security deposit. Don't ever do less than that.

Once you have your terms determined and your good tenant selected, you must get the paperwork ready and signed. Get them locked in and set for the move-in date!

ccc_patton_ch13_175-194.qxd 4/27/05 2:15 PM Page 175

CHAPTER 13

Getting the Paperwork Ready for the Tenant-Buyer

Approved!

Once you have approved a tenant for your lease option home; all you have to do is draft the paperwork and have them sign it all. You need not give more than 12 to 18 months to the buyer on an option. This time frame is most often enough for a good option tenant to get a mortgage. For you, there is a benefit in keeping it short-term in appreciating markets; or if you want them to cash you out. Whatever appreciation is written into the contract is what you have to honor, regardless of whether the market is higher. Additionally, appraisers have a 5 to 10 percent leeway on appraisals. While I could structure a long-term option deal that said the value of the mortgage would be dependent on the appreciation growth rate, by whose appraisal would it be valid? If it's my appraiser, the buyer may feel taken advantage of, and if it's the buyer's appraiser, the appraisal might be too low. So keep the term short and avoid problems.

If at the end of the time period your buyer wants to extend, you can do so at your discretion. This can also be an opportunity to renegotiate. If the homes in that area have appreciated more than you expected, then you would want to extend, but increase the purchase

ccc_patton_ch13_175-194.qxd 4/27/05 2:15 PM Page 176

price somewhat. You could also ask for another $500 to $3,000 option fee for the convenience of extending the option. Finally, you could raise the rent slightly. Sometimes I have given my tenants an extension for free, because of certain circumstances. There are also times when I have said no.

You can't predict what the market will be like in the future, so getting further out than 12 to 18 months can be more risky for you, and you forfeit your ability to sell the property outright at the end of the option.

If it is more than a few days between the end of the option and the day they plan to move into the home, your best bet is to get a nonrefundable deposit from them to hold the home until the move-in date. This protects you from them changing their minds at the last minute. A personal check at this time is okay if it has time to clear before the move-in date. Make a photocopy of the check to get their bank account information. If they end up ditching the home and owing you money, you will know where to garnish their bank account (available in most states).

Have all the forms printed and ready to go. Get the tenant to sign early if possible. Depending on how busy you both are, try to get all the forms signed after they give you the deposit.

When you are working with the buyer, you are the landlord to them. You are also the seller, as far as they are concerned, because you have set the terms for the sale including the option fee, the monthly payment, and the sale price. You need to use pro-seller forms. These are forms that specifically favor your end of the deal as the seller.

At the beginning of this deal you have either optioned the home from the seller and have in turn optioned it to a tenant-buyer or you own the home outright. As with the purchase process, it's helpful to use a checklist to make sure you don't miss any steps.

ccc_patton_ch13_175-194.qxd 4/27/05 2:15 PM Page 177

Selling on an Option—Checklist

Address: _____
Move-in date: _____
Seller name: _____
Phone: _____

1. Advertise home ____
2. Get application fee ____
3. Get application ____
4. Confirm applicant meets criteria ____
5. If not, send rejection letter ____
6. Get nonrefundable deposit and nonrefundable deposit form if accepted ____
7. Create tenant folder ____
8. Draft contracts ____
9. Videotape home or take pictures ____
10. Get check-in/out list ____
11. Sign contracts ____
12. Sign the lead-based paint disclosure ____
13. Sign the seller's disclosure ____
14. Cancel advertising ____
15. Confirm utilities in their name: Water ____ Gas ____ Electric ____
    Water Softener ____ Other ____
16. Confirm check-in/out returned ____
17. Confirm they have renter's insurance ____
18. Remove sign and lockbox ____
19. Make a copy of tenant's check for tenant file ____

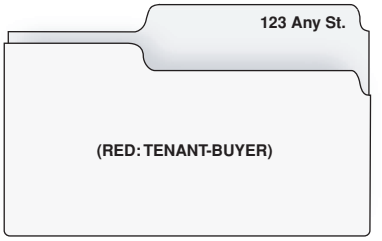
ccc_patton_ch13_175-194.qxd 4/27/05 2:15 PM Page 178

Some of the checklist items will be self-explanatory, but let's look at each of them.

1. *Advertise the Home*. This is discussed in Chapter 12.
2. *Get Application Fee*. You decide how much. I charge $20 per person over 18 years old.
3. *Get Application*. Make sure they fill out all areas of the application completely. My application requests information on each applicant over the age of 18, even if they are not working. It asks for their driver's license number, Social Security number, employment information, banking information, landlord or current address information, and previous landlord information. The more information you can gather, the better off you will be if you ever need it. It is not so much needed for your evaluation, because that is done on the standards you have set in Chapter 12, but if you ever have a problem with a tenant and need to collect from them you will want complete information on this application. Make sure it is completely filled out and signed by all parties.
4. *Confirm Applicant Meets Criteria*. See your standards from Chapter 12—this is a simple yes or no.
5. *If Not, Send Rejection Letter*. A rejection notice is required by law whenever anyone applies for credit or a place to live and is turned down. You must specify why someone is not accepted, whether it be landlord history, income status, credit issues, or anything else not federally protected by law. You must be specific.
6. *Get Nonrefundable Deposit and Nonrefundable Deposit Form If Accepted*. Once someone has decided they want to move into one of your homes but they don't plan to move in for a couple of weeks, be sure to get a nonrefundable deposit. This is separate from an option, but it will be applied toward their option later. The nonrefundable deposit holds the property for them and demonstrates their intent to rent it. Later if they don't sign their contracts or move in, they would lose this deposit.
7. *Create Tenant Folder*. This will be a right-tabbed red folder. I call this the tenant folder, whereas the green ones are for the owners. I use legal size, half-tab folders and put the address on a white label with a red strip above the address; you could also write the address in

ccc_patton_ch13_175-194.qxd 4/27/05 2:15 PM Page 179

red or green. All information about the tenant and their contracts and correspondence will go into this folder.



8. *Draft Contracts*. Draft the rental agreement, option agreement, offer to purchase, pet agreement (if applicable), lead-based paint disclosure, and seller's disclosure, and any other state required forms.

9. *Videotape Home or Take Pictures*. Do this with the tenant if possible. I suggest that you take a video camera with you when you are showing prospective buyers the home. Say things on the video like "Marie, what do you think about the kitchen cabinets? What do you think about the bathroom tile? What do you think about the closet doors?" and have the date recorded on the video to prove everything. Then Marie can't come back later and say, "Those kitchen cabinets were trashed" when she said on the video that they were fine. Any pictures that you take should be kept on a CD in the tenant file for that house. After I take digital pictures of the home, inside and out, I put the CD into a CD holder inside their file. Those pictures are to protect me later if they don't buy the home and have done damage to it.

10. *Give Check-in/out List to Tenant-Buyer*. The check-in/out list is a form the tenant can fill out to evaluate the condition of the home when they move in. This gives a baseline of the home and its condition. It is to protect you both in the event that they don't purchase the home and they decide to move out. It will spell out the condition of the home at the time when they moved in. Each state has different requirements as to what judges will require and allow, but the more you can show on the condition, the better off you will be if you are trying to collect on damages the tenant has done. Go overboard versus "underboard" on documentation and pictures. You

ccc_patton_ch13_175-194.qxd 4/27/05 2:15 PM Page 180

hope you will never need them, but if you do, you will be glad you have them.

11. *Sign Contracts*. The buyer must sign each of the contracts with you. If, however, they have already paid their nonrefundable deposit, I will allow them to take the contracts and review them. They must sign before they move in.

12. *Sign the Lead-Based Paint Disclosure*. See Chapter 7 for more detail. However, you can create a new one that is blank and says you don't know anything about lead in the home, if this is true, and sign it. You can also attach the previous owner's lead-based paint disclosure and have the tenant-buyer initial it to acknowledge they have seen it. This disclosure is required by federal law.

13. *Sign the Seller's Disclosure*. If this is the first time you have rented this home, you may not know much about it, so you can write on the seller's disclosure that you have never lived in the home and that the buyer should do their own inspection. Add that the home is being sold "as is." However, I also recommend that you attach a copy of the previous seller's disclosure to yours and have the tenant initial it. After all, you do know what the seller disclosed to you, and you need to disclose everything you know. Also, if you have had it awhile and the roof has leaked, you must disclose that, even if you fixed it. Don't skimp on this crucial step. Many lawsuits are filed because sellers *knew* about problems and didn't disclose them. If you had a leaking basement and fixed it, you need to put that on the seller's disclosure. It won't stop anyone from buying the home if it was fixed, but if it leaks later and they find out it wasn't disclosed, you will be fixing it again; if it was disclosed, they will be the ones fixing it.

14. *Cancel Advertising*. Cancel any advertising you have been doing for this home. Sounds simple, but it can be expensive. I have forgotten to do this, and it can cut into your profit if this is not on your checklists.

15. *Confirm Utilities Are On*. Once the tenant has moved in, make sure they have transferred the utilities into their name, including gas, water, electricity, and water softener.

16. *Confirm Check-in/out Returned*. Make sure you follow up and get this form returned from your tenant-buyer. If there is anything on the check-in/out list that needs to be addressed, take care of it.

ccc_patton_ch13_175-194.qxd 4/27/05 2:15 PM Page 181

17. *Confirm They Have Renters Insurance*. If not, continue to follow up in writing with them and put a copy of each request in their tenant folder. It probably won't be a make or break for you, but if something were to happen to their personal belongings, for instance, you will have all the proof you need that you tried and tried to protect them, but they failed to protect themselves.

18. *Remove Sign and Lockbox*.

19. *Make a Copy of Tenant's Check for Tenant File*. You might need this later if you need to garnish their bank account, if they are a good tenant who turns bad.

Always Check Your Paperwork!

My partner, Debbie, and I purchased a property on Newman Street. The little house had 900 square feet with a walk-out basement to Paint Creek. The owner was an older woman who had split the lot, and a developer was going to build a home on the vacant part. The vacant lot was the same size as the one with the house. When we bought the property, I knew up front that the owner was going to sell the vacant part to a developer. We lease optioned the house to a couple who gave $5,000. As happens many times, everything was going perfectly and it seemed like they were going to exercise the option. Sixteen months or so into the lease option, the couple called me and insisted, "You have to sell us the other property too."

When the couple first signed the lease option, I had physically walked the property with them and showed them what Debbie and I owned and what we didn't own, including the fact that we did not own the undeveloped part. They still said, "You have to sell it to us."

Standing firm, I reiterated that only the house and the property it sat on were included in the lease option, not the vacant split property.

At the end of their 18-month option they not only didn't exercise the option but they stayed on an additional three weeks without paying and then moved out. I sued them for $900 for unpaid rent. They countersued for the refund of the lease option money, again insisting that it was their right to buy the entire property. It cost me $1,500 in legal fees but the judge awarded me their $900 in unpaid rent. The couple still refused to pay the rent and it ended up being scheduled

ccc_patton_ch13_175-194.qxd 4/27/05 2:15 PM Page 182

with a mediator. Then the day before the mediation for $900, the couple called and paid it. End of story? No!

Two weeks later I got a call from the woman we bought it from, who said, "We've got a problem. You own my vacant lot." It turns out that when I bought it from the seller through Century 21 and the title company, both parts of the property had been deeded to us, although the vacant part was not supposed to have been deeded. We actually *did* own both parts of the property, just as the wife had insisted, and if they had actually exercised their option, they would have owned both parts. It turns out the wife worked for a mortgage company and had probably checked and thus, understandably, thought I was lying about not owning the other part of the property even though I honestly thought Debbie and I only owned half. I had taken the deed I received from closing, copied the legal description for the entire parcel, and put it right on my copy to her. After the case was settled, I deeded the vacant part back to the original owner. The moral of this story is to always check your paperwork, especially legal documents!

What You Need to Know about the Three Essential Contracts

Each state may require certain information for rental and purchase agreements. My contracts are generic enough to use everywhere, but they should still be reviewed by an attorney in your state. Each state also has its own landlord, tenant, and security deposit laws. Therefore, as recommended in Chapter 7, you should seek the advice of an attorney if you are using any generic contracts for your state to buy, sell, or lease real estate. I recommend Pre-Paid Legal attorneys at www.prepaidlegal.com/hub/wendypatton. They have plans starting at very reasonable rates per month to give you legal assistance. I have been a customer since 1988 and have saved thousands of dollars on legal questions, contract reviews, letters, and so on, for real estate matters and in multiple states. Each state has its own rules and regulations regarding rentals, lead-based paint abatement, evictions, and so forth. There are so many more clauses when you are selling, especially the rental agreement, because there are so many more things you will need to do to protect yourself. When you are buying, the

ccc_patton_ch13_175-194.qxd 4/27/05 2:15 PM Page 183

rental agreement is very short; when you are selling it is very long. Here are some of the clauses that have been my favorites over the years in my contracts to sell on lease options:

- *The option agreement:* On the buying side, the option agreement turns control of the property over to the optionee without ownership. When I am doing a lease option, I sign an option with the buyer. I control the property as if I owned it, but I am giving them the right to buy upon exercising the terms of the option, usually in 12 to 18 months.
- *The rental agreement:* The rental agreement specifies how long the tenant will rent the home and how much they will pay each month in rent to me. During the rental period they can purchase the home, unless otherwise specified. A rental agreement also comes in handy if ever taken to court, so that no matter what the tenant has put into the property, the judge will let me evict if necessary rather than foreclose.
- *The purchase agreement:* This agreement sets the terms of the final sale. Again, there are two of these—one for my deal with the buyer, and one for my deal with the tenant-buyer. The deal with the buyer sets the sale price upon exercising of the option. On the tenant side, the contract also has a specific sales price, and because you set the terms of the lease option, that price will be higher than the price you have with the seller.

Points to Consider for the Option Agreement

It is important to get the optionee to be as responsible for the maintenance and well-being of the house and property as possible so that you are not tied down with constant maintenance. Here are some points in my option agreement:

- Optionee agrees to accept the property in "as is" condition.
- Optionee agrees to make all repairs major and minor to the property.
- If the optionor has to make any repairs to the property, the cost of the repairs will be added to the purchase price. (If someone's water heater or furnace goes out and the tenant can't afford to

ccc_patton_ch13_175-194.qxd 4/27/05 2:15 PM Page 184

fix it, you should go ahead and pay for the repairs. In Michigan, you just can't go without heat in the dead of winter.)

- If there is a septic system, the optionee agrees to have it pumped once per year.
- If there is a pool, optionee agrees to open and close the pool each year and to maintain the pool.
- Optionee should pay for all additional assessments, including water, sewage, sidewalks, and road paving.
- The option can become void if the optionee pays their rental payment or any option payment more than 10 days late. (It is important to remind your tenants that their record of payments will have to be submitted to the mortgage company and may damage their ability to secure a mortgage. So, if they're serious about owning the home, they need to be serious about paying on time.)
- If the option is voided for any reason, then the contract becomes a month-to-month rental-only agreement (so that I can take steps to resell the property if I choose to).
- Optionee agrees not to record anything against the title of the property. (In other words, the tenant cannot file a Memorandum on the property. The memorandum is used only when you purchase, not sell.)
- Optionee understands that optionor does not hold title (own) this property, but is transferring their interest in the property. If optionor can't transfer title due to something out of their control (i.e., owner refuses to close or can't transfer clear title), optionor will reimburse optionee the entire option consideration plus an additional $500 for their inconvenience, as full and complete liquidated damages for optionor not being able to close on this property.
- *Equitable mortgage:* This Option to Purchase is not, and shall not be construed as, or interpreted as any form of equitable mortgage. It is hereby declared that it is not the intent of the parties to create a loan of any nature or to create a mortgage of any kind. In the event that the optionee hereunder should ever raise such an issue in a court of law or otherwise this Option shall terminate immediately.

ccc_patton_ch13_175-194.qxd 4/27/05 2:15 PM Page 185

- Optionor has advised the optionee to seek the advice of a mortgage lender and attorney prior to signing this document. (The mortgage broker might look at their credit and their history and tell them that even with an 18-month option they will not be able to clean up their history enough to qualify for a mortgage. They should also always have a lawyer look over any type of document that commits them to an agreement. In my experience, most people talk to neither, but they sign the document saying that they have.)

Points to Consider for the Rental Agreement

The rental agreement gives the tenant the right to occupy the property during a specified time period. It is similar to the rental agreement you signed with the owner/seller, except obviously your rental agreement with the tenant will be very pro-landlord (pro-you).

The rental agreement needs to be separate only for selling on an option. If you are the buyer, you certainly can put them into one document, but when turning the option around, you'll want to use the three different documents. The reason is that if the tenant doesn't pay, or the deal goes south, you will want to be able to evict them as quickly as your state allows. If you have all three agreements in one contract, some judges will look at the lease option as a sale rather than a lease, and therefore make you go through a full foreclosure or forfeiture process versus an eviction. This will take much longer, be more expensive, and may require an attorney.

Anyone who will be residing on the property over the legal age must sign the rental agreement. This includes children of legal age (determined by the state).

A cosigner can be an important safeguard if you have a weak applicant and they have a strong parent or friend who is willing to sign with them on their rental agreement. It works well for giving liability to someone else who will come through with the payments. I have a situation where a mother cosigned for her daughter. It was just a rental but the daughter had terrible credit. The mother, however, had worked for General Motors for 25 to 30 years and made a good guarantee person for me. The daughter stuck me for nearly $5,000 in unpaid rent and damages, and now the mother is paying for it out of her GM checks. In another case, the mother was a local Realtor in Michigan, and she asked

ccc_patton_ch13_175-194.qxd 4/27/05 2:15 PM Page 186

me to help her daughter get a house. Her daughter had been through a rough time, and the mother was willing to cosign. I probably didn't even run the daughter's credit because I knew the mother was a well-known Realtor and was good for whatever might happen. The mother paid the $5,000 option fee, and the rent was $1,300. Eventually the daughter left, owing me $3,000 in unpaid rent, and the mom had to pay it off.

I like to make all rent due on the first day of the month. If a tenant moves in on the seventh, I prorate the rent for the month. My rental agreements specify late fees of $25 for the first day late and $5 per day afterwards, and the tenant, of course, must sign the agreement to this. I can't reiterate enough how necessary it is to have everything in writing, spelled out in detail. That way your tenant can't say, "I never agreed to that." All you have to do is point to the contract and say, "Here it is in black and white, and there's your signature underneath it." I also like to add an incentive to encourage my tenants to pay on the first of the month. My contracts state that if they make their monthly payments on time, including any unpaid option fees, then I will credit them with $100 towards the purchase price of the house.

Your other fees on the property can include a pet deposit, security deposit, cleaning fees, and the like. In a lease option, I usually do not require a security deposit, because if they have an extra $1,500 for a security deposit, which is refundable, I'd rather have them apply that to the option fee, which is nonrefundable. There are some good reasons and areas of the country where even a small security deposit is recommended. It gives the tenant something they can get back if they don't purchase. Some judges like a small amount showing as a security deposit. None of the option fees, however, show up on the rental agreement, as the option agreement is a separate document.

Your rental agreement should state the total cost to move in. For example, if there are fees, you will add them to the first month's rent to get the total for the rental agreement, but that is not the total overall cost since you also need to add in any security deposit. The rental fees plus the security deposit make up the total move-in costs. The rental agreement must also show the total amount of anticipated rent for the contracted period, including prorated months.

You can also state in the agreement that if the rent is more than 10 days late, the agreement may revert to a month-to-month rental (nullifying the option) at the discretion of the landlord. I generally don't do this unless I want to get rid of the tenant, because when this alterna-

ccc_patton_ch13_175-194.qxd 4/27/05 2:15 PM Page 187

tive plan is set in motion it allows the tenant to move out at any time. Be sure your rental agreement states that the keys are due back within 24 hours if the tenant does not exercise the option and/or moves out.

Payments should be postmarked by the post office rather than a Pitney Bowes machine, as these machines can have their dates changed. In my rental contracts I also specify that any bounced checks are subject to an additional fee. Although I start out trusting my tenants and allowing them to pay with personal checks, if one check bounces, all payments after that must be paid in certified funds or bank checks only. I also tell them that if their rent is late twice within a 12-month period, their monthly rent will increase by $25 per month.

You should specify to the tenant how their payments will be applied, and in what order:

1. Outstanding dishonored check fees.
2. Outstanding late fees chargeable to tenant.
3. Outstanding legal fees, court costs or both.
4. Outstanding utility bills that are the tenant's responsibility.
5. Any damage caused by tenant.
6. Collection agency fees.
7. Costs for re-letting the property, if applicable.
8. Option fees owed.
9. Rent.

You should apply their payment toward rent last because it is easier to evict on unpaid rent than on unpaid utilities. So use their money to pay for unpaid utilities, and if the rest doesn't cover the rent, you can begin eviction proceedings in most states. Again, check with your local investor group or a local real estate attorney on landlord eviction laws.

Additional Issues to Cover in Your Rental Contract

Occupancy The contract needs to specify that the premises will be used as a residence with a specified number of adults and children. The premises will be used for no other purpose without written permission by the owner. Having any guest staying more than 14 days

ccc_patton_ch13_175-194.qxd 4/27/05 2:15 PM Page 188

will be considered a breach of the agreement unless the resident tenant receives written consent from the landlord. I also don't allow them to use the premises for a home business without my permission. A lot of people have home-based businesses, and that's not a concern except if they have customers coming in and out of the home, which creates a potential liability issue. So check with your tenant to see what kind of home-based business they will have.

Pets I make sure that they sign an agreement with me about having pets on the premises. I need to know, for example, if they have pit bulls or any other potentially dangerous animals on the property. It doesn't matter to me if they do have pets, and in fact almost all of my tenants have pets—I just need to know about it.

Entry and Inspection This gives you the right to enter the property at reasonable times and with reasonable notice to inspect the premises. It's not that you are inspecting their personal lives but that you want to make sure the home and property, which do not yet legally belong to the tenant, are maintained in accordance with the rental agreement. You also may want to show the home to prospective new tenants or buyers. If the tenant decides not to exercise, you want to have the right to affix "for sale" signs on the front lawn, but you shouldn't even step onto the lawn without calling the tenant first. This is violating their rights to peaceful enjoyment.

Assignment and Subletting I do not let my tenants sublet or rent any portion of the premises without my prior consent. The subletter's name is not on the rental agreement.

Joint and Several Liability Anyone who signs the contract is 100 percent responsible for all the points within the contract up to the total amount due. I had three men who signed the agreement and all three split later. I was only able to find one of them and I told him he was 100 percent responsible to fulfill the agreement. He felt he should only be responsible for one-third, but this inclusion of joint and several liability protects the landlord from having to find all the tenants. If one can be found, that one is 100 percent responsible.

Maintenance, Repairs, and Alterations It is the tenant's responsibility at all times to maintain the residence and property in a clean and san-

ccc_patton_ch13_175-194.qxd 4/27/05 2:15 PM Page 189

itary manner including fixtures, equipment, appliances, furniture, and all other furnishings. If they should choose not to exercise the option, the residence should be left in the same condition as originally rented, normal wear and tear excepted. Residents are responsible for changing the furnace filters and the batteries in the smoke detectors on a regular basis. Residents should be responsible for the maintenance of the property and the house costs. The tenant cannot make major changes to the structure until he owns the property. I had one resident who tore off an upper decking because he decided he didn't want it, and I had to pay for it and then rebill him because I didn't own that house. The resident also cannot paint, hang wallpaper, or make any other changes without my consent. I had one tenant who repainted the inside of the home navy blue, and then left after two months. I had to sue to recoup my costs for repainting the home. Residents must also be responsible for the cleaning of sewers and drains that have become blocked due to their negligence in keeping them cleaned.

If the resident damages any windows or doors, it is their responsibility to replace those items immediately. If the resident hasn't repaired the items within seven days, I will replace the items and charge the resident for the repairs, and these costs will be due immediately. I tell my tenants that any repair under $10 must be reported to me and any repair over $10 must be approved in writing. In other words, they don't have an open checkbook to make any repairs they want. Make sure your tenant also doesn't run off and do repairs and then bill you for them, such as "My furnace went out and I paid the guy $200 to fix it." My furnace company might only charge $100. Also, the tenant may then try to take that repair bill and apply it against their rent. Make it very clear to the tenant that *no* repairs can be made without your consent if the repairs are over $10.

Appliances One of the things I list on the contract is all the appliances already in the home. I make it clear to the tenant that all the appliances in the home are there for my convenience—in other words, they belong to me. If, therefore, one of the appliances stops working and they dispose of it without telling me and then leave the home with that appliance missing, I will bill them for it. If they want to remove the appliance, I have to agree to it and I will cross it off their rental agreement with my initials and the date.

ccc_patton_ch13_175-194.qxd 4/27/05 2:15 PM Page 190

Ordinances and Statutes The tenant must abide by local zoning laws for usage of the property. For example, they can't run a day care business at the home if it isn't zoned that way (not to mention the excessive liability that would incur). A home-based business of web site design, however, violates no zoning laws anywhere in the country. You have the right, as the landlord, to evict immediately for any illegal operations on the premises—for example, drug usage or manufacturing.

Liability of the Tenant The resident is responsible for any personal injury or property damage caused by the resident or tenant or the tenant's visitors. The tenant is also responsible for damage due to negligence in caring for the property. If there is a fire, however, and all the tenant's property is lost, the owner is not responsible to pay for that since the tenant carries his own renter's insurance for just such an event. The tenant must keep all the sidewalks clear and clean, all access to the home free and clear, and should maintain the outside premises to be a safe environment.

Insurance Coverage Because the owner's policy does not cover the belongings of the tenant, the owner requires the tenant to carry their own insurance against the risk of damage to their personal property. This insurance must be in place before the tenant moves in.

Defaults—Landlord Remedies Let the tenant know that failure to comply with even one part of the agreement will constitute a default of the entire agreement. This means that the owner can immediately repossess the property.

Attorney Fees In the event that either party has to take legal action to enforce the terms of the contract, the owner will be allowed to recoup all attorney fees permitted by law.

Security Deposit Act Make sure that the Security Deposit Act (SDA) of your own state is in your rental contract. The SDA varies by state, and you must know what the rules are for your state. You are the one providing the contract, so you are responsible for that information.

Notices Any notices must be in writing for your own protection, and not verbal. Notices should be sent to the residence address. If the ten-

ccc_patton_ch13_175-194.qxd 4/27/05 2:15 PM Page 191

ant is sending you a notice, it should be sent to the address specified in the contract (either office or post office box).

Waiver Failure of the owner to enforce any part of the contract will not constitute a waiver of the contract. For example, if I waive the late fee one month, that doesn't negate my right to enforce it the next month.

Holding Over The tenant must give a 30-day written notice of intent to vacate the property.

Additional Terms and Conditions Some further things you may want to add to your contract include:

- Vehicle limit.
- No motorcycles (some can violate the city noise ordinance).
- No working on the car on the premises. All repair work is to be done off site.
- No permanent stickers on the bathtub, and only nonabrasive cleaners to be used on the tub.
- No carpet cleaners will be used without landlord permission. The reason for this is that some of the over-the-counter cleaning solutions can actually bleach the carpet and leave a white spot.

Make Sure Your Tenants Read and Understand the Agreement

It is very important that you go through the contract line by line with the tenant so that they have heard everything out loud and are fully responsible for the contents when they sign their name. Don't skip over any points of your contract, even if they begin to fidget because it takes a while. You might also ask after each point, "Do you have any questions about that?" If they want to take the contract with them, then that is okay also.

Purchase Agreement—Offer to Purchase

The offer to purchase should be pro-seller. Some things to consider when drafting the purchase agreement include:

- What items that were in the house will remain with the house (for example, appliances)?

ccc_patton_ch13_175-194.qxd 4/27/05 2:15 PM Page 192

- If they get an FHA or other government mortgage, the lender might stipulate improvements to the property before the loan goes through. I don't want to be responsible for that, so I say clearly in my contract that the tenant is responsible for any requirements needed to fulfill their own mortgage.
- Make it clear that the tenant is buying the house "as is."
- Make sure the tax proration clause is pro-seller and is worded for your state's standards. In other words, you want to get any tax advantage and let the buyer pay all the taxes.
- Special assessments come due now if you have paid them out of your own pocket. For example, if the city has required sidewalk repair and you paid for it, now you pass that back to the buyer.
- The tenant should have a home inspection done before moving in. If they waive their right to do so, I mark down the date they walked through the house.
- Make sure to give the tenant the seller's disclosure statement. This not only becomes a part of their history but it will then be handed off to the next buyer as a complete history of the house.
- Include the lead-based paint disclosure and the property inventory check-in/out list.
- If I can't transfer title on their option agreement (due to no fault of my own), they get their option fees back plus an additional $500, as full and complete liquidated damages.
- If you are a licensed Realtor you have to disclose it.
- Anything that I have to do in regards to repairs gets added to the purchase price.
- Advise the purchaser to seek the advice of a mortgage broker and an attorney before signing the purchase agreement.
- The pet policies and agreements are attached to the rental agreement and signed on the same day. I have them list the names of all their pets. If one of their pets dies or is given

ccc_patton_ch13_175-194.qxd 4/27/05 2:15 PM Page 193

away, they don't have the right to just go out and get another one. The animal breeds should also be named. If they can give you a copy of the animals' health and shot/rabies records to have on file, that would be helpful were there ever to be a biting incident. If the local ordinance requires licensing, then you should get a copy of that also. Typically on my option agreements I waive any monthly pet fees, but in a pure rental situation, I would not waive those fees.

- If I get a deposit on a property, it is nonrefundable if they choose not to option it. However, I do refund it they are rejected based on credit or the potential ability to get a mortgage. Most of the time I won't even accept a deposit until I know they're approved.
- On the rental application, verify their Social Security number, and employer information.

Be Prepared for the Tenants

On the move-in date the tenant delivers the final balance in certified funds. Don't take a personal check except on their deposit. Once they have moved in, personal checks are okay, but not on the initial option and move-in date. The day they move in, make sure the following items have been completed:

- You have a copy of their renter's insurance.
- You have enough keys for the home.
- Remove the sign and lockbox, if any.
- Make sure they have the utilities turned on in their name.
- You have the new phone number of the tenants.
- Have the tenant walk through the home and complete the check-in/out list.
- Take pictures of the home.

Give the tenant a move-in gift if you like. It could be a small plant, card, flowers, or the like.

ccc_patton_ch13_175-194.qxd 4/27/05 2:15 PM Page 194

If the optionee wants to exercise the option, they must send a notice in writing to my office. If however, they do not follow all the terms of the rental agreement, I can declare the option null and void.

This may sound like a lot of paperwork and considerations to keep track of, but it's all to protect you. Think of "pro-seller" as also meaning "protect seller." That's pro-*you*!

ccc_patton_ch14_195-206.qxd 4/27/05 2:15 PM Page 195

CHAPTER 14

Managing the Property and the Tenant-Buyer

It's amazing to me how many people will pay an option fee and then walk away a few months later, knowing that they have just forfeited their fees. It is equally amazing how many people will try to get their option fees back, even though they are nonrefundable. The option fees paid are for the *right and privilege* to purchase a home. Whether the tenant-buyer (optionee) meets the terms of the option is up to them. My goal is to get people to buy, and I'll do whatever I can to help them, but I can't make them responsible. I can't make them close on the home either. Approximately half of my tenants ever get to the closing table; some walk away from their option fees after only a few months of tenancy. If they forfeit their rights, that's their choice, but some buyers will try to get that option back in many sneaky ways.

One of the smallest houses I ever lease optioned was in Michigan. It was approximately 700 square feet and had what is called a Michigan basement—a cellar with a dirt floor, stone walls, and a low ceiling. I leased it to a man named Arnold, who moved with his wife from a larger house into this little one. You might say that Arnold was like a customer because this was the second home I'd rented to him, but he was a good renter, always paying his bills on time. However, it wasn't but two weeks into the rental when I got the phone call with

ccc_patton_ch14_195-206.qxd 4/27/05 2:15 PM Page 196

the four dreaded words, "We have a problem." I braced myself and asked, "What's the problem?"

Arnold replied, "There's a snake in the house."

I asked, "What kind of snake?"

Arnold said, "A *big* snake, like a boa or python. We found stool samples in the basement and took them to the pet store and that's what they told us."

Arnold and his wife now wanted their option fee back and said they were going to move out immediately. He asked me, "Wendy, do you know of any snakes in this house?"

I said, "Arnold, hold on just a moment."

I put him on hold and thought about it for a moment. It began to come back to me that the previous owner, a big burly guy with a lot of tattoos, had snakes. I was a little fuzzy on it, though, because I had only been out to the house once, whereas my office manager, Amie, had done many of the visits to that home. I turned to Amie and asked, "Did the previous owner by any chance have snakes?"

She said, "Oh yes, don't you remember? He had cages full of them in the basement. And on the day that we went to close and do the walk-though, I noticed that one of the big cages was empty so I asked him where that snake was and he said he gave it away." We both fell on the floor laughing hysterically. We had never heard of such a thing in all our years of real estate. A big snake loose in a house. Understandably, it was not so funny to the tenant.

We had no idea where to start. We had dealt with leaking roofs, flooded basements, broken furnaces, frozen pipes, anything else, but big snakes? We don't have those in Michigan!

I got back on the phone with Arnold and said, "Well, there's a chance there could be a snake in the house. Let me call the previous owner and see if he knows anything about the snake. I'll call you back." The previous owner was nowhere to be found.

Do you know how hard it is to find a snake expert in Michigan? I called animal experts, the zoo, pet shops, animal control, and exterminators, but I couldn't get help on the situation. I had my handymen go into the house and crawl through everything, including the attic, in an attempt to find the snake. They could not find one.

In the meantime Arnold called and said someone had gone into the home and seen the snake's tail go up into the wall from the crawl

ccc_patton_ch14_195-206.qxd 4/27/05 2:15 PM Page 197

space in the basement. Arnold also told us he and his wife were moving out. I then received a call from their attorney asking for their option fee back. I discussed it with their attorney and several of my friends, who agreed they would not live with a snake either. I told the attorney that when I found the snake I would gladly return the option fee.

After many more weeks of searching, we finally found a guy whom I nicknamed "Mr. Outback" because he was willing to handle any type of critter situation.

Mr. Outback said, "Look, I've got this glue that's $100 per gallon, and I'm going to put it onto a plywood board and put the board on the basement floor. When the snake crawls across it, he'll get stuck and we'll have him!"

I let him put the board down, but, doubting the success of this method, I also called the attorney back and said, "I'll tell you what: If you can get sworn affidavits from the people who examined the stool samples and from the people who saw the tail go up into the wall, I'll refund the option fee."

In the meantime my partner said, "Sell that house."

The house went back on the market, but I forgot that glue board was in the basement. An agent, Susan, was showing the house. She went into the basement and I had forgotten about the glue board. My cell phone rang as she had stepped onto the glue board. "Wendy? What is my foot stuck to in the basement?"

I said, "Oh, that's just the glue board to catch the big snake in the house!"

Susan screamed, and I couldn't stop laughing. I said, "I'll pay for your shoes!" The house did sell not long afterwards, and I wrote on the seller's disclosure, where it asks for history of infestation, "None—confirmed."

I never heard from the attorney or Arnold again.

I think what may have happened in this case is that Arnold and his wife didn't like the smaller home. When the neighbors told them about the previous owner's snakes, they began to imagine noises in the walls. Regardless, with no snake there was no refund. I could have gone after the rest of the rental agreement also, but we sold the home, so I dropped the matter. It is amazing what people will do to get out of an agreement.

ccc_patton_ch14_195-206.qxd 4/27/05 2:15 PM Page 198

Wendy's Lesson

Option fees are *not* refundable, even though some people will try to get them back. They might even make up stories to get their option fees back.

Property Management Issues

If you have tenants in your home, you have certain responsibilities to them. Take care of the house, make sure it's livable, keep open lines of communication. View your sellers and tenants as customers. I'm tougher on the tenants because they botch deals more often, and that's not usually an issue with the sellers, but I still always keep my end of the bargain.

Make sure that you're keeping your Realtors, lenders, and others informed at all times, and that they know where to reach you if they have questions. Communication is key!

Protecting Your Privacy with Tenants

In general you do not want your tenants to know where you live, so have their rent come to either an office or a post office box. In case a deal goes sour and you have to evict them, you don't want a disgruntled, grudge-bearing tenant to show up on your doorstep. You have to protect yourself and your family. I don't give my tenants my home phone, and that number is unlisted. I would only give them my office or cell phone number. Make it difficult for them to find you.

Who Is Responsible for Repairs?

One of the benefits of the lease option is maintenance—the tenant does it all! My lease option contract says that the tenant is responsible for all maintenance, major and minor. However, if I end up having to do any repairs, I'm going to add the cost to the purchase price at clos-

ccc_patton_ch14_195-206.qxd 4/27/05 2:15 PM Page 199

ing. Let them think through their own possibilities first, but if they still don't know what to do, then send your own maintenance people and recoup the cost at closing.

For example, if the tenant's heat goes out in the middle of a Michigan winter, it's crucial to get that fixed. On the other hand, if the air conditioning goes out in the summer, it's unpleasant but livable. Do not make your tenant unduly fix too much, because if you treat the tenant like an owner then the court may treat you like a seller. The tenant can claim that they've put so many dollars into the property, and the court may make you go through a forfeiture or a foreclosure versus an eviction, which in most states is more expensive and much more difficult.

In a buyer's market you can put more of the responsibility for maintenance onto the seller (see Chapter 6 on negotiations). In a seller's market, I don't want my seller to do anything but be free and clear of that issue. However, I have to preapprove in writing any improvements my tenants do.

Keep a copy of any letter regarding maintenance in the tenant's folder. When a tenant calls, I record what was said for their records also. The same goes for maintenance. I track everything. If the roof leaks, and someone slips and falls, accurate files will suddenly become very important!

Transition between Seller Moving Out and Tenant Moving In

Always assume that the tenant won't buy. Otherwise it's like the proverbial counting your chickens before they hatch.

Therefore, always have complete documentation of everything regarding a tenant moving in. Probably your most important thing will be to have a videotaped walk-through check-in with the tenant. It is important that you capture on tape their verbal acknowledgment of the condition of everything, whether good or bad. You also protect yourself with paper documentation of the condition of the house—documentation that they have signed. The tenant always thinks they're going to buy, but things happen, and a checklist protects both you and them. If the window wasn't broken at the time of move-in but is when they move out, you will have paper and

ccc_patton_ch14_195-206.qxd 4/27/05 2:15 PM Page 200

video evidence if you need to take them to court and sue for any damages.

After the seller has moved out, make sure it's ready for the tenant. This includes the following steps:

- Carpets are cleaned if needed (the seller may do this, but if they don't, you need to make sure it happens).
- New paint (if needed).
- Dings are fixed.
- Kitchen and bathrooms are cleaned, regrouted as necessary.
- Kitchen cupboards are cleaned out.
- All appliances left behind are clean and in good working order.

Go through the check-in/checkout sheet with the outgoing tenant—have them check the condition of everything and sign everything. Take pictures at the same time or even videotape the walk-through for future reference if needed.

Keep track of the title during transition, especially if you're not making the mortgage payment, and especially if it's a long-term contract. You want to make sure the title stays clean and clear. Review the title work occasionally if you feel there could be something going on with the seller that might negatively affect it.

Maintenance on the Property

Although the option agreement states that the tenant is responsible for all maintenance, it is still important that you keep the place habitable and treat the current resident like a tenant. If you treat them like an owner, a judge might also treat them like an owner, which will nullify the option.

- Always change the locks after a tenant moves out. If you don't change them and someone still has a key, you could open yourself to serious liability.
- Clean the carpets.
- Repair any paint problems.

ccc_patton_ch14_195-206.qxd 4/27/05 2:15 PM Page 201

When a Good Buyer Turns Bad

Unfortunately, this business is not all perfect. There are times when you will have a tenant that you think is great—you are sure they will exercise their option; they have paid on time, taken care of improvements/repairs, and been nice in all dealings. Then it happens: Either you don't hear from them (they miss a payment) or they start to make things difficult with repairs, complaints, and so on. They were a good tenant and now they are bad.

I recommend trying to work things out on the phone first. If this does not resolve the situation, then put things in writing. If you have a problem with a tenant that can't be resolved over the phone or in writing, then you must go to the next step: eviction and the revoking of their option. In order for you to be able to do this, they must have violated part of the rental agreement, or option agreement.

This is why I use option contracts that are subject to the rental agreement being followed. I include in my option contract this statement: "If any rental or option payment is made 10 days or more late, then this option can be declared null and void by Optionor." It is usually advised to revoke an option in writing before you evict a tenant. This adds only one or two days to the process. Once you revoke their option, you can start the eviction, as there is then no option agreement in place. (In most parts of the country, revoking an option agreement is not necessary to evict someone; however, it is the safest way.)

To revoke an option, you can send the tenant a letter via both first class mail and certified mail, both letters containing the information that the option has been revoked. The certified one is the one you want them to receive and sign for, but if they don't, you sent it first class also. I use this for extra precaution. When you send the revocation letter, you should indicate why you are revoking their option. You might want to attach a copy of their option agreement and highlight the area you are utilizing to revoke their option contract. The letter can be as simple as this:

Dear Joe,

Attached is a copy of the option agreement you signed. Your rent is now 15 days overdue and this is a violation of the option agreement. You have been late many other times

ccc_patton_ch14_195-206.qxd 4/27/05 2:15 PM Page 202

also. We are now voiding your option agreement. Please be advised that you no longer have the right to buy this home.

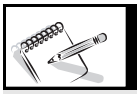
Sincerely,
Wendy Patton, member
Wendy Patton's LLC

If you want to allow them to reinstate their option, you can state that in this letter:

If you want to reinstate your option, you will need to remit the amount of $_____ currently due, by (date).

I recommend this statement if you want to work it out with the tenants. Remember to try other, softer ways to work it out first; the revocation letter should be a last resort. If this is used too early in the negotiations, the buyer may be angered to the point of no return.

The best advice I can give on late payers is to start eviction as soon as possible. My office starts to evict when rent is five days late. From over 20 years in this business, I can tell you that, unfortunately, tenants lie. I tend to want to believe them and want to work with them. It was always hard for me to evict, because I have a soft heart. I want to believe people and I do until they prove me wrong. Unfortunately, I have been burned many times from deceit and promises that could not be kept. Remembering one thing can help you be firm on this policy:



Wendy's Advice on Accepting Sob Stories

If the tenant doesn't pay their rent, you are paying it for them.

You can listen to all the sob stories you want; however, most of us can't afford to carry another family.

If you don't like playing the heavy, you can also have your partner/spouse sign the contracts and you be "the manager." The tenant doesn't know you are the owner also—they only think you manage the

ccc_patton_ch14_195-206.qxd 4/27/05 2:15 PM Page 203

home. This way when they don't pay and they give you a sob story, you can be the good guy. Example: Tenant hasn't paid rent due to husband being laid off, wife is pregnant, it is December and very cold outside, and it is almost Christmas. You can say, "Boy, I really feel for you. This must be a hard time for you. I would let you stay, but I have to start to evict you, or I could lose my job. The owner is very strict on this and is tight on cash too. He/she really needs you to pay soon. Do you think you can do it?"

A special note about receiving payments that are postmarked with a Pitney Bowes machine: The dates can be changed, of course. A tenant can tell you, "I sent you the check," and you may receive it several days late with a Pitney Bowes stamp that precedes the due date. I tell my tenants that their payment has to be stamped by the post office and not a Pitney Bowes machine because of the potential for deceit. When I was first starting out, I didn't realize that the dates could be changed and I got burned a few times until I realized this.

Of course you don't want to have late payments from your tenants, so you lay out the ground rules up front about late fees. However, tenants can feel too intimidated to call their landlord with even a legitimate excuse about why the rent is late. It is important, therefore, to keep a rapport with the tenant, so facilitate a comfort zone and open communication. Be friendly but not friends—at least not until the option is exercised. It's similar to a parent-child relationship—the parent is not the child's best friend. Being a landlord is a business. If the tenant doesn't pay the rent and you don't do anything about it, you will have to pay their rent—and that's not a smart way to run a business.

If you have an arrangement with your tenants that their rent is always due on the first day of the month and you don't get it, call them immediately or send a notice: "Is your rent going to be late? Call in with one of these numbers, so we will know why." When your tenant first moves in, you can give them a list of the most popular excuses you've had for rent being late. It's a little humor but at the same time lets them know you've heard it all before and that you'll be watching. It also shows there is a serious side to paying rent on time. You can add to your own list as you learn through the years. You won't believe the excuses you will hear.

- I lost my job.
- My dog ate the cash.

ccc_patton_ch14_195-206.qxd 4/27/05 2:15 PM Page 204

- My grandmother died.
- My grandmother died again.
- My roommate stole the money.
- My boss didn't pay me.

Wendy's Tip

At the very least, tenant issues provide a great wealth of learning experience, and many times a good laugh! Learn to smile at the stories—it helps relieve the stress.

If you need to take legal steps to collect past-due amounts, be aware that each state has different collection procedures and abilities. In Michigan I can garnish bank accounts, wages, state tax refunds, and so on. In Texas, landlords can't garnish anything. You may want to use a collection service, but be aware that the collection company will take 40 to 60 percent of what is recovered.

Tips to Increase Profits and Protection

Sometimes it pays off to find the tenants before you find the house! Line up some potential tenant-buyers, then go find the homes that will fit them in their price range and in their area. This is especially a good idea in a buyer's market.

Clearly define "on time" to your tenants, and charge for late rent. My rental agreements say that I will charge $5 per day, and I enforce that. Also charge court costs, state fees, legal fees, whatever your state will allow you to charge.

I always pay the water bills myself, then bill the clients for them. This way I make sure they are paid on time. Otherwise the city could put a lien on the property if I left it up to the tenant and the tenant didn't pay. Not all areas of the country are the same, so check this out in your area.

ccc_patton_ch14_195-206.qxd 4/27/05 2:15 PM Page 205

Enforce your maintenance co-pays. If the tenant is supposed to pay the first $50 of maintenance, make sure they do.

When you get a check, call the bank and see if that check is good. The bank won't tell you how much is in the account but they will tell you whether it will clear. If it's not good, call back a few hours later and suggest a lower number, asking if a check for that amount will clear. If the first amount of $1,000 was not good, but the second amount of $800 is good, then you know that the account has between $800 and $1,000 in it. In that case, deposit $200, then cash the $1,000 check, and bill back the tenant for the $200 difference. You *must* call and make sure the check is good before you try to cash it, because the bank will only submit the check twice. My policy is that tenants may use personal checks until one bounces. Thereafter they all must be certified funds or a cashier's check.

Moving a Tenant Out When They Decide Not to Exercise

If the tenant decides not to buy the property, then go through the property with them and check it out.

If you had a security deposit with the tenant, keep in mind that in most states a security deposit cannot be used to cover normal wear and tear on the property. Normally with an option I don't have a security deposit, because I want their money tied up in the option (nonrefundable) as opposed to a security deposit (refundable), but there is a good argument to have money tied up in a security deposit: Then it looks more like a rental agreement. Of course, if they have animals you might also want to charge a security deposit for that. In any rental agreement, if the security deposit isn't enough to cover damages, you would have to sue the tenant to get recovery for damages.

A Success Story

I lease optioned a property to a real estate attorney's daughter, who wanted her dad to review the contracts. I don't mind at all if an attorney reviews my contracts because I know I'm not going to change

ccc_patton_ch14_195-206.qxd 4/27/05 2:15 PM Page 206

them much. The dad called me and said in a stern voice, "I'm not changing one thing."

I said something like, "Oh no, the contracts must not be very good."

He said, "No, you don't understand. My daughter made her bed and she can lie in it. She got the bad credit herself, and she can fix it. Your contracts are tough but they're fair. If she doesn't do her thing, she can lose her money. I'm not bailing her out anymore. I just wanted to make sure they were fair."

Thankfully, the daughter made her payments and ended up buying the house. I made $35,000 on the deal. I saw the daughter again three years after she had closed on the home. She ran up and hugged me and thanked me for her home. She had recently sold it and made over $40,000 herself. She had two children and needed a larger home. This is a true win-win-win!

ccc_patton_ch15_207-211.qxd 4/27/05 2:15 PM Page 207

CHAPTER 15

Closing: The Big Payday

This is when it all comes together! This is the real estate investor's payday. If you have been working with your tenant-buyer from the beginning and keeping them in touch with a mortgage broker, you will know when they are ready to purchase your home—they are finally ready to close. If they want to use a mortgage broker of their own choosing, find out who it is and keep in touch with them, so that you will know where they stand on getting their mortgage completed.

Although the paperwork was signed many months earlier, often the mortgage lender may want you to change something on the contracts in order to get the mortgage approved. For example, the buyer may need more money for closing costs, so the lender may ask if you are willing to pay for some closing costs if you increase the price of the home by the same amount. I am always willing to do this, as long as the home can appraise for the new amount and the changes are fair for all parties involved.

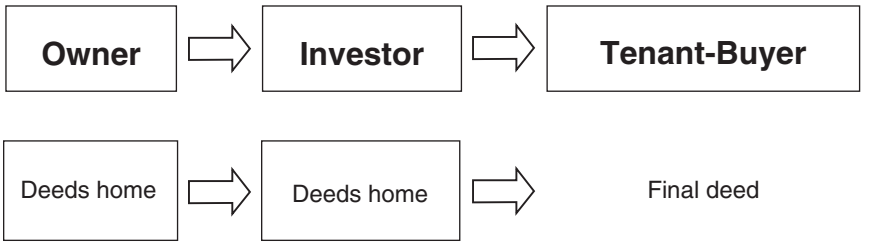
I have also been willing to hold a second mortgage for the buyer. For example, let's say the buyer is purchasing the home for $200,000 and they gave me a $4,000 option fee. Therefore they owe me $196,000 (or possibly less with option credits for paying on time, etc.). However, the lender wants them to have 5 percent plus closing costs

ccc_patton_ch15_207-211.qxd 4/27/05 2:15 PM Page 208

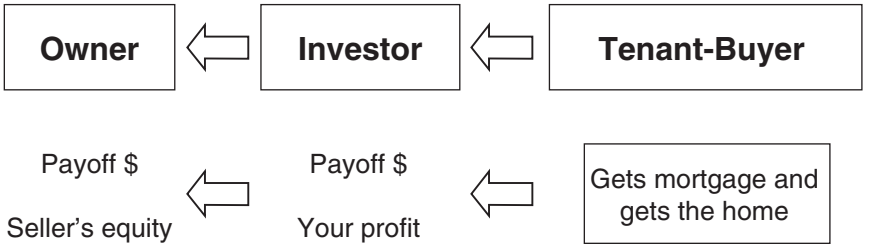
into the home, and they don't have any more money to put down. They need an additional $10,000 to close this home. I might be willing to hold a second mortgage for these buyers for the $10,000 if I believe the home is worth the mortgage and that the people will make their second mortgage payments. I would then get all of my profits out of the home at closing except the $10,000, which I would get out over time with payments on the second mortgage. Many times on the second mortgage I do a one- or two-year balloon so that I get paid off fairly quickly. They would have to refinance the home in that time period and pay me off.

A simultaneous or double closing is when there are two closings on the same home at the same time or on the same day. It is sold and bought the same day. Usually the investor does not need to bring any money to the closing; the money brought in is the tenant-buyer's mortgage or cash. That money is used to pay off both the owner and the investor, as in the following diagrams.

Typical Example of How the Deed Flows



Typical Example of How the Money Flows



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This applies only to lease option deals. (With subject-tos you will already own the home, so there will not be a double closing.) These can be tricky with lenders that require seasoning of title (discussed in Chapter 7). It is essential to show that your interest in the title did not appear overnight. Depending on which state you are working in, closings may be handled by either a title company or an attorney. Some title companies and attorneys don't like simultaneous closings, due to the fraud in the investing industry that has created the seasoning requirements. Make sure you find a title company or attorney who understands how you do this business and what you are doing. If you want a good reference, your local real estate investor group will certainly know who does this type of closing in your area.

Find out when the buyer is going to close, and stay in communication with the seller about it until you get it down to the exact day and hour. *You* need to be the coordinator, not anyone else. You have to make sure all the pieces fall into place. Coordinate the tenant's making arrangements with the mortgage company. Make sure the buyer, the title company or attorney, and the mortgage company are all on the same page. I recommend you reconfirm each party the day before. It would be a shame for the deal to fall through due to a scheduling oversight.

The mortgage lender only sees one half of the transaction—the part between the investor and the buyer. To the lender, I am the seller. The title company sees both parts. Make sure when you are coordinating with the title company or attorney's office that they know both sides of the transaction, as they will need the paperwork on both sides. To them it is two separate files, and two closings.

The mortgage lender will need copies of the contracts, a payoff letter (see the example at the end of this chapter), and copies of canceled checks. From the beginning, ask the tenant to keep copies of their canceled rent checks, if possible. With the banking industry changing and not sending our checks back, they might have to order these, but I also keep a record of all of their checks—check number and date paid—as a backup. Most lenders, if they want to do a lease option refinance type of program, will need 12 months of canceled checks or proof of payments. A letter from me alone is not enough.

I do not like my buyers and sellers to meet. Though intellectually each of them knows I am making a profit and each of them

ccc_patton_ch15_207-211.qxd 4/27/05 2:15 PM Page 210

knows I am a real estate investor, putting that dollar amount in front of them can destroy their enthusiasm. Each of these real estate deals is structured to be a win for each person involved, but imagine what happens if we change the scenario and put us all at the same closing table. The seller and buyer see me get my check for $42,400, and their joy is greatly diminished. They are not as happy about the deal they each received when they know exactly how much I am getting. The psychology of the room changes. I don't want to change the way they each feel about the deal, and therefore I never put them together.

Although it doesn't really matter who goes first, the one who closes first will have to come back a second time. Let me illustrate why.

Scenario 1: tenant buyer first. The tenant buyer comes in with the mortgage papers completed but cannot receive their completed ownership package, because I don't have the deed yet from the seller. I can sign one to them, but I don't have one yet from the seller to me. They will have to come back and get their closing package after the seller closes with me. This is called a "dry closing," or "closing in escrow," meaning that something more has to happen for it to be completed. In this case, the seller's and my closing must take place for it to be completed.

Scenario 2: The seller goes first. The seller can come in and close first with me, but no money changes hands until the closing takes place between me and the buyer. This would also be a dry closing, or closing in escrow. This closing is waiting for funds or money from a mortgage, but not my mortgage—the mortgage of my buyer, which will be completed at the second closing. I am essentially paying cash on this deal, but only when I receive it from selling the property to the tenant-buyer. The seller must come back a second time in order to pick up their check.

I prefer to close with my buyer first so that the money is at the title company or attorney's office. I will usually then call the seller to let them know everything is fine and ready for their closing. Sometimes with mortgage companies the money is not wired into the closing office until hours later or the next day; therefore, the seller might not get their funds until later anyway. I just like to know the money is there and waiting.

ccc_patton_ch15_207-211.qxd 4/27/05 2:15 PM Page 211

Here is an example of a payoff letter for the lender:

To Whom It May Concern:
The payoff for 123 XYZ Street is:

Price	*$200,000*
Less option fee paid on (date)	*–$ 5,000*
Additional option credits earned	*–$ 1,100*
Balance due as of (date)	*$193,900*

Please feel free to call me with any questions.

Sincerely,
Wendy Patton, Member
ABC, LLC
(222) 333-4444

Add anything else if they owe you any repairs during the option period, outstanding utilities, outstanding rent, and so on. Don't forget to put these in the payoff letter also.

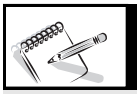
ccc_patton_ch16_212-218.qxd 4/27/05 2:15 PM Page 212

CHAPTER 16

Advanced Concepts and Strategies for Selling on Lease Options

I once bought a parcel of property on a land contract. The property had splittable acres in a town near me, which was fairly rare. One part of the property needed development and the other part had a house. The seller of the house was an older lady who had lived there for 30 years.

Because the house needed some work, I lease optioned it as a handyman special. Along came Steve, who was a licensed builder. Because he was a licensed builder, I had him sign all the contracts under both his personal name and his company name.



Wendy's Advice

When signing contracts, always have the tenant-buyer sign both personally and under their company name, if they have one—especially on the rental agreement. Also have all parties over the age of 18 sign the rental agreement. This puts each person and the companies liable for the debt, if the tenant-buyer does not pay.

ccc_patton_ch16_212-218.qxd 4/27/05 2:15 PM Page 213

For Steve, this seemed like the perfect house. There wasn't anything in it that needed fixing that he wouldn't be able to tackle or have the resources with other contractors to tackle. It wasn't too far into the renovations, however, that Steve called me and said, "We got a problem—this house has been in a fire."

I was unaware of any fire, so naturally my first response was to call the seller and ask if she knew anything about a fire. The seller confirmed that while she lived there, there had never been a fire. Now because the house was built in the 1920s or 1930s, there was a possibility that anything could have happened to it, but she didn't know about it and neither did my inspectors. Steve said, "Wendy, I can't even believe the roof is standing, because all the rafters are completely charred all the way up and through the decking."

I asked him what it would cost to repair, and he said $3,500 in materials. I offered to give him $3,500 off the purchase price when he exercised the contract. This had been advertised as a handyman special, so I hadn't cheated him or lied to him. How could I know what was up under the plaster? He agreed and we signed an addendum.

Everything seemed to go smoothly for months—he was making repairs and improvements, and I was sure he was going to exercise. Month 17 came, and I asked him if he'd been speaking to the lender and if he was going to get a mortgage. He said he had a little glitch in his credit, so I asked if he wanted to extend for another six months. I didn't have a problem with this because he'd been paying perfectly. But he said, "No, I'm moving next month. I don't like all this development happening around me."

Steve had known about the development when he moved in, and it was documented in the contracts that he signed. He moved out and sued me for the option money he had put down in the beginning.

Being sued is scary and nerve-wracking for most people. I don't like it either, but I have been through it a handful of times. It's inevitable, and all the more reason to keep excellent records on every little thing that happens with each house, each conversation, each mailing, and every document.

In court Steve told the judge that there were many problems with the home, and he showed the judge many pictures of the home and of the fire damage. The judge asked him if he thought I had known about the fire. He responded, "No, I couldn't tell either, it was covered in plaster." Then the judge asked me. I said I had not known

ccc_patton_ch16_212-218.qxd 4/27/05 2:15 PM Page 214

and that I did offer to pay the $3,500 to fix it. The judge looked over our contracts very briefly, and noted where it said the home was sold "as is," that it was a handyman special, and that Steve had had the home inspected. The judge pulled her glasses down to her nose, pointed to a paragraph in my contract, and said to Steve, "Wendy did not have to offer to pay anything for the roof—she was more than fair. So, sir, I have just one question for you. What part of 'This option fee is NONREFUNDABLE' do you not understand? Case dismissed."

Advanced Selling Strategies for Lease Options

Having mastered the basics of lease option deals, you might want to add some of these strategies to your repertoire.

Handyman Specials

Handyman specials are homes that are in less than perfect condition and require sweat equity to bring them up to a new level of respectability. A lot of money can be made in a handyman special. The tenant-buyer's overall purchase price, or option fee required, should be lower because they must do the work themselves. I can't provide enough homes for people who want this situation. This technique will work in most areas of the country except in areas where the city requires certification or landlord licensing. In those areas the city won't allow homes that aren't perfectly up to code to be rented. Sometimes these homes might just need paint or a few minor items, but sometimes they may need some major repairs. In areas where the city doesn't require inspections or certifications, this can be a great way to liquidate your properties. Tenants perceive value in the fact that they can do the sweat equity themselves. You'll make just as much money and you won't have to go over budget on doing your own rehabbing.

One word of caution: Make sure the home is habitable. It must be able to be lived in, or you will have problems if the tenant-buyer doesn't pay and decides to fight you on rent or their option. Any judge will expect the landlord to provide a "habitable" home for their

ccc_patton_ch16_212-218.qxd 4/27/05 2:15 PM Page 215

tenant. Generally the tenant-buyer is going to love you because you are giving them the American dream: a nice fixer-upper.

Section 8

Section 8 is a rental-assistance program funded by the federal Housing and Urban Development department (HUD), which gives approved tenants financial assistance by paying a portion of the rent directly to the landlord. Section 8 now has a program for lease options. Section 8 doesn't control the particulars of how the lease option is set up but will make the monthly payments as with their regular program. After the lease option is started, they will help the tenant-buyer get a mortgage that will convert the lease option to a purchase. It's not appropriate for every Section 8 tenant but for a select few that qualify. Talk with your local Section 8 administrators so that you have all the current information.

As a landlord, I love Section 8, because the rent payment, or most of it, comes directly to me from the state.

Ads for Soft Rental Markets

In soft rental markets there will be many rentals and not many good tenants. In order to get a good tenant into your home, you will need to make your rental ads stand out. The ad must contain something that looks better than the competition's ads. One idea that I have used is to offer to rent for a few hundred dollars lower than I actually intend to let it rent for. When the applicants come to the home, I screen them to see if they can afford the extra $200 per month. If so, I offer them a chance to make 50 percent on the additional $200.

I might say, "You really like this home, don't you? And you want to buy it, right?" Of course I know they do. "How would you like to make 50 percent on your money?" When they say yes, then I offer to give them a $300 monthly credit toward buying the home if they pay an extra $200 per month. Now I am getting my $200 more per month, which is what I originally wanted, but I advertised it at $200 per month less to generate the leads. Yes, it does cost me $3,600 in option credits for the entire year, if they purchase, but I was able to rent the home. If they don't purchase the home, I received my entire rental amount. This is a small amount to pay to get someone in during a slow market.

ccc_patton_ch16_212-218.qxd 4/27/05 2:15 PM Page 216

Strategies for Reducing your Taxes

How would you like to have to worry about paying Uncle Sam? Worry about getting into a lower tax bracket because you are making too much money with lease options and subject-tos? When you have been investing for some time and get your pipeline filled with deals, your income will increase and you will need to be creative in finding ways to save on taxes when you sell. You can always keep your properties forever, but if and when you sell, there are tax issues. Here are some things that I have done to reduce taxes for myself.

Exercise Your Option and Hold for Another 12 Months

If you are in a higher tax bracket, you might want to consider exercising your lease options with your sellers prior to your tenant-buyers exercising their options. If you do a simultaneous closing, it is considered a short-term capital gain. You only owned it for one day. Therefore you are taxed at your normal income rate. You can sell your option by assigning it, but if you have held it for more than 12 months it is long-term capital gains, taxed at a much lower rate. Unfortunately, if you assign your option, the profits are not nearly as good as selling it to a tenant-buyer, and very few tenant-buyers can pay an entire assignment fee to get you the profit you would receive if they were to purchase it outright.

Therefore, if taxes or high tax brackets are an issue for you, consider exercising after the 12 months of payments to the seller (treated as a refinance so you don't have to put down cash out of pocket either—see Chapter 4), and then make sure your tenant buyer doesn't close for another 12 months. This would give you long-term capital gains on the ownership of the property and give you a much better tax rate on the profit. This is not a problem with subject-tos, as you are the owner from day one and only have to do a lease option for 12 months to get a long-term capital gain rate.

1031 Tax-Deferred Exchange

A 1031 exchange is an excellent way to defer your taxes and capital gains by taking the profit of your sale and rolling into a property of

ccc_patton_ch16_212-218.qxd 4/27/05 2:15 PM Page 217

higher value, or two or more properties whose combined value is higher than your sale. A 1031 tax-deferred exchange is a great tax strategy, but this takes a bit of planning and foresight because there are time limits to make this happen. In other words, at the time of sale you should have a property lined up already into which you can roll the money.

You won't actually handle the money yourself. A company that does 1031 exchanges will play what is called the intermediary between the current sale and the new property and will move the money from one closing to the next for you. It has to be done very carefully and with a good company or the IRS might not allow the exchange. You can't touch the money. You also can't live in the new, higher-valued property or in any of the combined properties that are in total a higher value. You need to rent the properties or hold them as an investment since a 1031 is for investment exchanges and not personal residences.

This strategy should be used when you need to defer your capital gains. When you are first starting out in the business, you might not be showing much income, so you won't need the 1031 technique, but do remember it exists. When you start needing these techniques, you know you've made it!

ccc_patton_ch16_212-218.qxd 4/27/05 2:15 PM Page 218

ccc_patton_pt5_219-220.qxd 4/27/05 2:16 PM Page 219

PART 5

CREATING FUTURE FINANCIAL FREEDOM—FX3

ccc_patton_pt5_219-220.qxd 4/27/05 2:16 PM Page 220

ccc_patton_ch17_221-231.qxd 4/27/05 2:16 PM Page 221

CHAPTER 17

Business Organization for Lease Option and Subject-To Investments

You might be thinking, "I have a few properties, and keeping track of what's going on isn't difficult with some files on my desk." But apply that thinking to 175 active properties in various stages of buying and selling, renters paying late, evictions, and rehabs, and you've got an administrative nightmare if you don't have systems in place.

Setting Up an Effective System

Whether you have only a few properties or many, you might as well set up your business as if you're planning for many properties. That way you're already in the groove for expansion.

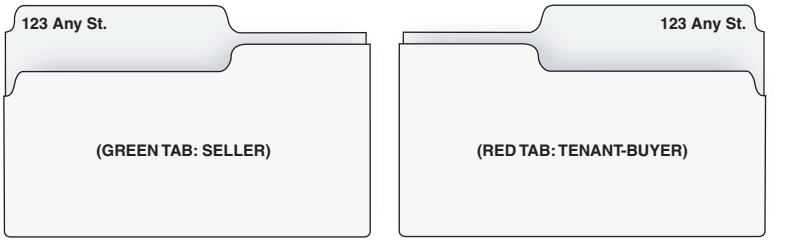
Color Coding Your Files

Have a file cabinet dedicated (or maybe just one of the drawers to start) to your properties. I keep my files in alphabetical order by property address, not by seller or tenant name. Each property has two

ccc_patton_ch17_221-231.qxd 4/27/05 2:16 PM Page 222

files. How you color code your files is up to you, but I use green labels for the seller (think green for money!) and red labels for the tenant-buyer. When I open my file drawers, it's like Christmas! My folders are half-tab, which means the tab goes halfway across the top of the folder. This has been easier for me to deal with, and one color is always on the right and the other color on the left.

Seller Folder ***Buyer Folder***



The seller folder holds all the documents that you signed with the seller—the pro-buyer contracts. If you own the property on a subject-to or a mortgage, it would contain all of the mortgage or subject-to documents. It also contains any correspondence with that seller. This folder would also contain any information about the home such as title work that was done, surveys, inspections, etc.

Tenant-Buyer Folder

The buyer folder holds all of the pro-seller contracts. It also holds all correspondence with the buyer, original application, credit report, copies of payments, all bills, maintenance records, all other related correspondence, and a $3^1/_2$-inch floppy disk or CD with digital pictures of the house. This folder may even contain digital film of a walk-though of the property with the tenant to show the condition of the home when they moved in. Keep a copy of each check they write, any water/sewer bills, and other bills that you have sent them. You will need their check copies for when they get their mortgage, to prove that each payment was made and when. They will need to get their cleared copies from the bank, but your copies will help them know what check numbers to request from their bank.

ccc_patton_ch17_221-231.qxd 4/27/05 2:16 PM Page 223

This folder should also be used to keep track of any communications with the tenant. Anytime one of your tenants calls, record the call on a piece of paper, writing down what they said, what you said, and how you handled the call—whether there was anything to be completed. Document everything with the dates and times, and if you send a maintenance person, make a record of who you sent and what they did to fix or not fix the problem. Hopefully, you will never need the documentation, but if you ever do you will have it there. Don't throw it away until years after you have sold the property to them or to someone else. I had a case where a tenant sued me a year after they moved out for a slip-and-fall case from 2.5 years earlier; however, we had all of our documentation, so it never went to court. Keep your records. I didn't even know they were upset about it and I would never have expected them to try that, but they did. Tenants have a certain number of years in which they can still come back and sue you, so hope for the best and plan for the worst.

Software for Your Business

If you have only a few properties, you don't need any special software for keeping track of their information. A simple spreadsheet in Excel will work just fine. However, if you have many properties, you will want to invest in a property management software program. Talk to someone in your real estate investors group or on one of the real estate web sites to see what program will meet your current needs.

There are also many accounting programs available. The one my office uses is Quickbooks. It writes our checks, keeps our accounts balanced, and at the end of the year we get itemized reports per property, per expense account, per LLC, or whatever we want. All the good accounting programs will do this for you. The key is to make sure the software can track items by property so that whenever an item is paid or received, it is linked to a particular property. If you are using the appropriate software and have religiously assigned the payments and deposits, you should be able to quickly see a summary and/or detail of all income, expenses, improvements, and so on by property. In Quickbooks, using "Class Tracking," with each class being a particular property, you will be able to easily accomplish this.

ccc_patton_ch17_221-231.qxd 4/27/05 2:16 PM Page 224

Another advantage to good bookkeeping records is that your bill with your accountant will actually be lower because so much of their work is already completed.

Work Orders

When something goes wrong in a home, or when you have work to be completed, you will need a process to track the work. We purchase work order books with carbon copies from an office supply company. We put the property address on the work order, the tenant's name and number if it's occupied, and the problem. We keep one copy for us and we give one to the handyman. The handyman must complete the work order, fill it out with details of what was completed, and then bring it back to us in order to get paid. We then follow up with the tenant, if the house is occupied, to make sure the work was completed. If so, we issue a check to the handyman. We keep a copy of the work order in the tenant file. The repair cost may later be added to the purchase price, depending on the terms of the option contract with the buyer and the extent of the repair. The seller may also be responsible, depending on what was negotiated with them.

Tenant Payment Ledger

I set up a tenant payment ledger for each property that is either a rental or an option. Here's an example of what it will look like:

Your Company Name: _____

Address of rental: _____

Tenant Name: _____

Home phone: (buyer) _____

Monthly rent: _____

Other Charges: _____
(if applicable)

Security Deposit: _____

Option Fee: _____

NSF:_____

Lease Dates:_____to_____

Water Softener: (amount if applicable) _____

City Water:_____

City Sewer:_____

ccc_patton_ch17_221-231.qxd 4/27/05 2:16 PM Page 225

The next section of the ledger is the payment history. In the following example, our tenant will have an option fee of $1,500, and their move-in date is November 1, 2XXX. The monthly rent will be $1,095, and there's a quarterly water/sewer bill of $52.50. The "Credit" column is for the tenant payments, the "Debit" column is what the tenant owes, and the "Balance" is the sum of the two.

Date	*Description*	*Debit (owed)*	*Credit (paid)*	*Balance*
11-1-XX	Option fee due	$1,500.00		$1,500.00
11-1-XX	November rent due	$1,095.00		$2,595.00
11-1-XX	Option fee payment		$1,500.00	$1,095.00
11-1-XX	November rent payment		$1,095.00	0.00
11-10-XX	Water/sewer bill due	$ 52.50		$ 52.50
11-23-XX	Water/sewer bill payment		$ 52.50	0.00

Using a Tenant List

I have also created a document showing all of the properties I own, the current tenants, their lease option expiration date, and what utilities they are responsible to pay. I include a column for the owner and their address, if I have purchased it on a lease option, and my contract expiration date. This list allows me to know at a glance who should be working on their financing. I can always stay ahead by checking my list on a regular basis and getting my tenants to a mortgage broker several months before their contract expires.

Property	*Company*	*Owner info*	*Contract End*	*Tenant*	*Lease End*	*Rent*	*Utilities*	*Misc. Info*
123 Flintridge Lake Orion 48359	MR Ltd.	Sally Harris (234) 222-2343	XX/05/31	John & Jane Smith (333) 333-4444	XX/03/31	$ 995	Township water/ sewer	Lease option
123 Genoa Clarkston 48346	MR Ltd.	Joe & Jane Smith (222) 342-4444	XX/02/28	Cary & Jen Edwards (333) 333-4444	XX/03/31	$1,195	Well, septic softener	Lease option
123 Hilberg Oxford 48371	MR Ltd.	Sally Seller (111) 222-2222	XX/03/31	Leroy DuBois (333) 333-4444	XX/04/30	$1,595	Sewer/ well	Lease option
123 Huntington Lapeer 48446	Mill Ltd.	June Taylor 123 Bliss Street Ann Arbor 48123 (333) 333-4444	XX/07/12	Bradford Shue (333) 444-3333	XX/05/31	$1,795	Township water/ sewer	Lease option

ccc_patton_ch17_221-231.qxd 4/27/05 2:16 PM Page 226

123 Hollywood Fenton 48132	Keystone	Fifth Third Bank	—- —- —-	Alan & Kim Wayne (333) 123-4567	XX/05/31	$1,095	Sewer/ well	Rental
321 Crescent Rochester Hills 48561	Keystone	Bank One	—- —- —-	Roger & Sally Smith (333) 123-4567	XX/05/31	$1,495	Well, septic Softener	Rental
481 Kroft Lake Orion 43671	MR Ltd.	Tom and Kim HomeOwner (222) 222-3333	XX/12/31	Jennifer Gale (333) 333-1234	XX/05/31	$1,395	Well, septic Softener	Lease option
321 Hope St. Lake Orion	Mill Ltd.	Mark Money (222) 333-3333	XX/10/31	Lucy McGillicutty (333) 123-4678	0X/07/31	$1,495	Sewer	Lease option

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ccc_patton_ch17_221-231.qxd 4/27/05 2:16 PM Page 228

Keeping Necessary Documents on Hand

It is extremely important to keep documents in your office that you will be using on a regular basis. Nothing is more annoying than needing a document and finding that you don't have it. Spending time searching online or going to your local office supply store to get it is a waste of your valuable time. For instance, depending on your state, you can download tenant or legal documents from the state's web site. Save these documents to your Word program to enable you to pull them up and tailor them as needed. You may want to create a document checklist to make sure that you have what you need; then when your supply gets low you can reorder before you run out.

Good Recordkeeping Is a Must!

In addition to the two folders I've mentioned, one more file should be used to store *every* receipt for each property. There are always expenses that the tenant is not responsible for paying (advertising costs, attorney fees, improvements, etc.). In our office, we use legal size folders or large title company envelopes (free from the title company that we use). Each folder or envelope is labeled with the property address and filed in alphabetical order. Every time an invoice or bill is paid for a particular property, a copy of the invoice is filed under the property address. We note the check number and date paid on each invoice. If the tenant is responsible for reimbursing us, a copy of the invoice is also placed in the tenant file. At year end, these receipt files will contain all documentation needed to substantiate all expenses, improvements, etc. for that particular property.

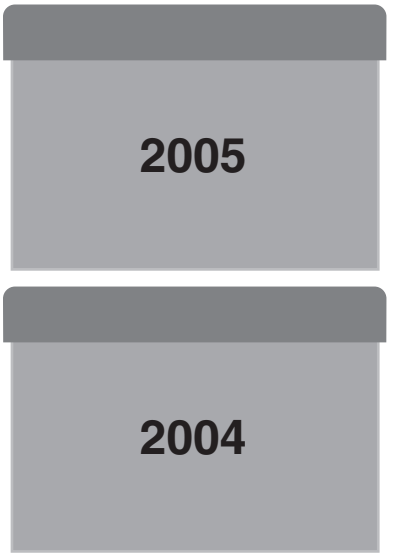
For those items that cannot be associated with a particular property—for instance, general advertising not tied to a particular property ("We Lease Homes," "Office Manager Needed," etc.), postage, office supplies, license fees, or the like—we use a file labeled "General Rentals" and file receipts for those types of expenses in this file.

The last type of file used to document our bookkeeping is a file for each bank account, labeled with the LLC name and "Canceled Checks." We file all the bank statements and canceled checks for that LLC in that file.

At year end, all files are moved to storage boxes. Each box is labeled with the LLC name and year. Placed in this box are all the files

ccc_patton_ch17_221-231.qxd 4/27/05 2:16 PM Page 229

with the receipts for each property under that LLC, as well as the canceled check/bank statement files for that LLC. This may seem like a lot of paper to store away, and some of it may seem redundant (a copy in the tenant file and a copy in the property receipt file), but if you are ever unfortunate enough to go through an audit, everything you need to support your tax filing is in one box, efficiently organized and easy to retrieve. You hope you will never need them, but there are times you will need a copy of a receipt and you want to be able to locate it quickly. I have been audited twice and my audits both had no changes, because my records were so easy to find and they were very clean. The auditor's first words when arriving to my office and getting a tour of our records was, "Wow, you are *very* organized!" You don't want to be audited, but if you are, it's nice to have someone respond that way.



Previous Years Records

When to Hire Someone

At some point you will need to hire someone to help in your business. When your business has grown to the point where you are no longer able to handle all the tenants, bookkeeping, or organization necessary to efficiently run your business, or you are so busy handling the little

ccc_patton_ch17_221-231.qxd 4/27/05 2:16 PM Page 230

stuff that you are not spending enough time on the real money-making end of your business, it is time to get help.

The first thing to do is to evaluate your own strengths and weaknesses. Then hire someone to take over your weak areas. If you are great with tenants but lousy at bookkeeping, get a part-time bookkeeper. If you are a lousy organizer, get someone to help with this. Perhaps the only thing you need at first is someone to handle the phones, correspondence, and busywork. If you have hired the right person, their responsibilities will grow as your business grows. The important thing is to stay focused on the most important part of your business, which is finding new properties.

Qualities to Look for in an Office Manager or Property Manager

Of the many qualities you should consider when hiring an office manager or property manager, I have discovered a few that I feel are the most essential. Pick a person who has the qualities that are most important for the job you need accomplished, and the rest of their skills will be bonuses. This individual will be your right-hand person and a key part of your team, so it is crucial that you select the right one. Here are the skills that I have found to be the most important over the years—not necessarily in order of importance:

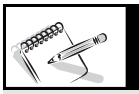
- *Firm.* There are times when a tenant will try to push the limits with being late on rent. You want your assistant to be firm.
- *Pleasant.* Your assistant must be pleasant even when you want to blow up. There are times when I have wanted to lose my temper with someone on the phone, but my assistant will not blow up because she is not personally involved, so she can be nonemotional and pleasant.
- *Detailed.* This person must be able to be very detailed. They will be tracking tenants' rent, late fees, water bills, option fees, correspondence, and many other items. Everything must be documented and detailed.
- *Good follow-through.* This area is very important, as the little details that fall through the cracks can cost you tens of thousands of dollars and many lawsuits. Making sure that nothing

ccc_patton_ch17_221-231.qxd 4/27/05 2:16 PM Page 231

falls through the cracks is critical; for example, did the gas get turned on at your vacant home in January in the Michigan area? If not, you might have an ice skating rink in your home. How do I know? I had some follow-through problems.

- *Organized.* Following the systems you have in place and your checklists will be very important. Also, knowing that your assistant has things well organized, labeled, and filed, so that you can easily find things when you need them, will be very important to you.
- *Computer skills.* It is impossible anymore to not be involved with or able to use computers, so make sure your assistant has computer skills. Basic word processing and spreadsheets are usually the most important parts of property management. Spreadsheets can be taught, but word processing is a must.
- *Take initiative/work independently.* Your assistant must be a self-starter. They must know what to do when you are on the road. You will be in and out of the office much of the time, or you will want the ability to be. Make sure you hire someone capable of running things if you are out of town. Can they handle calls? Make decisions? Make good judgment calls? Will they work when you are not there watching them?

Some of my best part-time employees are women who didn't *need* their jobs; they *wanted* their jobs. This makes a huge difference in the way they perform at work. When someone needs to work, you would think that would be enough motivation; however, if they are not self-motivated it is not enough to keep them doing their best every day. If someone wants to work, that is enough motivation. This is just a guideline—I have also had several full-time employees who did need their jobs who were fantastic workers also.



Wendy's Advice

If you are hiring someone part time, you might want to consider someone who doesn't *need* a job but, rather, someone who *wants* a job.

ccc_patton_ch18_232-244.qxd 4/27/05 2:16 PM Page 232

CHAPTER 18

Where to Go from Here: A Step-by-Step Action Plan

Make $120,000/year in real estate investing, part-time (10 hours per week), starting with less than $5,000 of personal net worth!

I am excited to share my action plan with you, as this is the number one problem for those wanting to get into real estate but are not sure where to begin. Figuring out where to take that first step the day after attending an exciting seminar can be overwhelming. Many people will buy a real estate investing course and then not know what to do next, so they do nothing. They have wasted time and money learning about tools that can yield them much income, but they don't use them.

I have asked many other speakers/educators and students around the country about this problem. "Where do I begin? How do I get started? What exactly do I do to implement the course I purchased?" Most courses assume you understand how to get started and what to do next, but the reality is that most people don't. You are not alone.

The action plan outlined here will guide you to success. If you

ccc_patton_ch18_232-244.qxd 4/27/05 2:16 PM Page 233

want to make more money than the ad indicates, then do more of each task. If making half that amount is fine, then do one-half of the task plan. Tailor the plan to your needs and your abilities. If you work full-time, 10 hours may be all you can do. If you are investing full time, I suggest you beef it up and do more, or add additional strategies (rehabbing, wholesaling, foreclosures, etc.).

Sacrifice is essential in any successful venture. Are you willing to sacrifice something to build wealth? If not, then don't expect to gain financially. Many people wish they could make money, yet they won't do what it takes. These are the same people who continue to believe they will someday win big in the lottery. They want the money thrown in their lap.

I have made many sacrifices over the years. When I first started to invest in real estate in 1985, I was 21 years old. I owned several rental properties. My friends would go out on the weekend and party. I, on the other hand, would spend my weekends painting, cleaning, driving by my homes, looking at new ones, sending letters, and so on. I was building wealth for the future while they were spending theirs. Many nights I would eat popcorn for dinner, when I had spent my paycheck on paint for one of my homes. I learned to be a frugal shopper, use coupons, keep my heat low—all to save money and build for the future. Today I still sacrifice. I watch little to no TV. I don't have time. I travel many times on weekends or do late evening meetings or conference calls. This means time away from my family, and they realize that building for the future affects them too. We all work together for it.

A friend of mine told me a story recently. He said his father was the ultimate story of sacrifice. He had a 3,000-square-foot home in an area that is very nice—home values average approximately $300,000 or more. He was single and had several rental homes, and his sons were all grown and living on their own. He really didn't need much, so he decided to rent out his own home and rent a room from someone else. He could then use the extra cash flow to buy additional homes with his sons and get them started in the business. One night the home he was living in burned down, and he was killed in the fire. Everyone in the house got out but him. It was a horrible tragedy, but his son told me the story of this ultimate sacrifice his father had made for the future. The son is now a motivational speaker and invests full-time in real estate. The sacrifices we make, make us!

ccc_patton_ch18_232-244.qxd 4/27/05 2:16 PM Page 234

This action plan should become part of the goals you have set for yourself. It assumes you have already purchased my course and are planning on buying and selling using primarily lease options as an entrance and exit strategy for real estate investing. You will need to sprinkle some subject-to tasks throughout to add that strategy as well.

From the Wendy Patton Dictionary

Definition: An action plan is a set of steps to be accomplished in order to achieve a goal.

The action plan goal is to earn $120,000 in one year with 10 hours of work per week. This plan assumes no vacations. To take a vacation you must sacrifice—that means putting in an extra 10 hours the week before or the week after. I prefer before, so that you don't get behind in your plan. This plan is meant to be modified and customized to your preferences. For instance, if you find working with Realtors is something you don't like at all, you might want to work more on other areas and develop those in more detail than I have outlined. Also, once you get a personal system going, you can scrap this plan. Use your own system if you find something that works better for you and your personality.

I recommend you attend my intensive three- to four-day boot camp. This boot camp will walk you through many of these steps and give you a huge head start. Check my web site (www.wendypatton.com) for details about the next boot camp.

The Action Plan

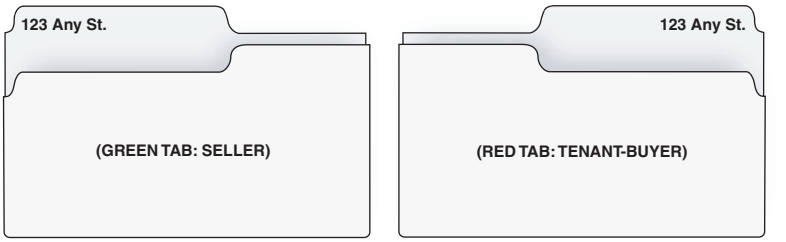
This action plan will be a week-by-week plan for 12 weeks (around 90 days), then month-by-month thereafter.

ccc_patton_ch18_232-244.qxd 4/27/05 2:16 PM Page 235

Week 1: Getting Started

The following seven steps will help you get your system up and running.

1. *Get office supplies set up.* I assume you have a computer, printer, copier, fax, Microsoft Word, and Microsoft PowerPoint (or access to those items), as well as basic supplies like a stapler, scissors, paperclips, notebooks. I recommend that you purchase the legal size file folders with half tabs, alternating left and right. I use right-tabbed folders for my tenant-buyers, and I mark them with a $^1/_8$-inch red line across the top part of the tab. I use the left-tabbed folders for my owners/sellers, and I mark them with a green line across the top part of the tab (green for money). Each property you acquire will have two folders, one red and one green.



Anything that is between me and the owner goes in the green folder, and anything between me and the tenant goes in the red folder. The same property address is on each tab, just on opposite sides with different colors. If a tenant moves out of a home and doesn't buy, I move their papers out and the new tenant's in. I keep the old ones for a couple of years—you can mark them by name or address, your choice. If they end up owing me money, the folder goes in a different drawer, but that's a separate discussion.

Each of the folders will also be equipped with the checklist for buying and selling. This way you are sure to get everything you need in each folder. In all real estate, documentation is key. If I have a conversation with a tenant, I put notes about it in the folder—handwritten or typed is fine. Keep everything documented and filed.

Set up some Realtor folders also, one for strong listing agents and one for agents who need follow-up. Keep any potential agents in

ccc_patton_ch18_232-244.qxd 4/27/05 2:16 PM Page 236

the strong agent folder. Print the listings from homes magazines or when an agent is published in the local paper for being the top listing agent. In the follow-up folder put copies of your letters in order of when they were mailed. You will then be able to see when you should send a second letter out.

You will also need a week-to-week calendar to follow this plan. Put all action items in the calendar as well as any follow up items. For instance, if you have to call a seller or Realtor back in 30 days, put it on the calendar.

You will need some accounting software, such as Quickbooks, or a ledger to track all financial transactions for this business.

2. *Join Pre-Paid Legal.* Pre-Paid Legal will cost you up to $25/month (some states vary with plans and costs) and will be one of your best investments. You will have access to a law firm in your state that is top-notch. You can use this firm to ask any questions you like, review personal documents, draft your will, review your LLC documents, get legal advice, fight moving traffic violations, defend you if you are personally sued, and much more. For most states you can sign up on my web site: www.prepaidlegal.com /hub/wendypatton. See the web site for what is offered in your state.

If you are in a state which will not allow you to sign up on this site, e-mail me or call my office to find out how to sign up. I will be able to help you in some way in any state. (Contact me through www.WendyPatton.com.)

3. *Get your LLC (limited liability company) set up in your state.* Get advice from Pre-Paid Legal to confirm whether the LLC is the best for your situation. Also, find out where in your state to get your name reserved. Once the name is reserved you can use my forms to fill out the operating agreement. Pre-Paid Legal will review one business document per year, unless you have the business rider (which allows many more but is only available in some states). Have them review it after you have filled it out.

4. *Join a local Real Estate Investors Association (REIA) group.* Join a local real estate investors group in your area, if you are not already a member. Be religious about attending meetings. Network, attend one-day seminars that are priced reasonably, and start to get involved in the group by volunteering for group functions. You will soon be voted onto the board, if you want. Just don't overvolunteer—your time is limited! If you do too much for the group, you will lose

ccc_patton_ch18_232-244.qxd 4/27/05 2:16 PM Page 237

focus on your own objectives. If they have a library, check out as many books and tapes as you can on topics related to optioning: landlording techniques, options, subject-tos, and possibly rehabbing. These show up later in this action plan, so don't check out too many up front—it could overwhelm you.

5. *Start your Realtor network.* Contact any Realtors you know and discuss with them on the phone what you are now doing. Use my *Live Realtor Call* CD or the *Working the Realtor System* CD to understand how to explain it to them. Also review the PowerPoint presentation(s) and the script of what to say and how to explain this technique to Realtors.

6. *Read the "for rent" ads in your local newspaper.* This is for two reasons: First, you will find out about your competition, and you will start to learn your rental comparables. Following your local paper will allow you to get a feel for the market. Second, call on 10 ads. Practice. If you get a lead, follow up on it.

7. *Create a credibility kit.* I strongly suggest that you start building a credibility kit if you don't already have one. Although nothing might be in it yet, you will start to fill it soon with pictures of your homes and letters from sellers, Realtors, or possibly tenants.

Week 2

Now that your basic system is in place, here are seven more steps to take you toward setting your business in motion.

1. *Realtor follow-up.* Review "for sale" ads in the paper. Who has several listings? Check out the homes magazines. Who has listings near the area you want to purchase in? Call three Realtors to discuss what you do over the phone. Ask them about any of their current listings. Ask whether any of their sellers have said to them that if their home doesn't sell soon, they might have to rent it. See if they would like you to send them more information. Send three letters to Realtors using the letters in my course. Put these letters in the follow-up folder for four to five weeks from now. You will need to send a second letter at a future date.

2. *Read a book on real estate investing.* I recommend a book on lease options or subject-tos. Get some other perspectives. Search on

ccc_patton_ch18_232-244.qxd 4/27/05 2:16 PM Page 238

Amazon.com to find a good book, or check one out from your club's library.

3. *Set your goals.* Review my goal-setting course. Listen to the CD (one hour) and spend two hours working on your goals and mission statement. Setting goals is essential to what you want to accomplish. This action plan should give you a tremendous start on accomplishing the tasks and on outlining the tasks themselves.

4. *Get an accountability partner.* Find a friend in your local group—or a friend who is also committed to goals. They might be in a different field, but if they are willing to commit to meeting monthly and will hold you accountable on your goals and you on theirs, do it. Be religious about meeting with them monthly to discuss where you are on your goals. In your first meeting each of you will share your goals with the other. You must understand each other's goals so you can assist each other in accomplishment and accountability. If this person won't be comfortable telling you feedback on what you are attempting and on how you are doing, then find someone else. You need someone who is sharp enough to give solid input and tough enough to push you. It will change your life and theirs.

5. *Become licensed or get a Realtor on your team.* This will give you access to the comparables in your area. If you are licensed, then you are set. If not, consider it. Evaluate the pros and cons I have outlined in "Working the Realtor System." I *highly* recommend it! If you are not licensed, you will need to pay a Realtor to help you out or find a web site that will give you enough information to be able to make informed offers. Find a Realtor who is willing to do comps for you—they might be in your real estate group or they might be a friend. You might need to pay them to help you, but only when you are ready to negotiate an offer.

6. *Create five proposals.* Try different offers. On the proposal, try putting together cash-out offers (if you can follow through), lease option, seller financing, or a combination. Put the proposals away to be followed up on later.

7. *Start to build your team.* Meet with a mortgage broker. Find one (or two) who can work with option buyers and with you. Get each of your buyers in to see this person as soon as they move into their home, and have the broker set up a step-by-step plan for each buyer to follow. Get a recommendation on a title company from

ccc_patton_ch18_232-244.qxd 4/27/05 2:16 PM Page 239

them, if you don't already have one. They will know who to work with. If you are not sure where to start with a lender, ask your local investor group.

Weeks 3 through 12

For the next several weeks you will further develop the pieces you have already initiated.

Week 3

- Realtor follow-up. Send three new letters to Realtors using the letter in my course. Put these letters in the follow-up folder for four to five weeks from now, at which time you will send out the second letter. Call one broker in your area to see if you can set up a time to come to their office meeting. Maybe a Realtor friend can work with you to get you into their office. Ideally they should introduce you at their meeting. If you don't want go speak directly to a group, set up an appointment to meet one-on-one with a Realtor.
- Finish goal-setting. Spend another two hours doing soul-searching in a quiet spot and finish your goals. You will review these goals monthly or weekly, depending on how developed you feel they are.
- Read ads. Read the "for rent" ads and call for one to two hours. Follow up on all that seem like good leads. Get in to see as many as you can. Although you may feel many aren't going to work out, it is still worth your time to check them out and practice. Learning how to negotiate and what to look for will be critical.
- Create five proposals.

Week 4

- Realtor follow-up.
- Listen to a real estate course. As you drive to and from work, listen to a taped course on real estate investing on the topics of lease optioning, landlording techniques, options, subject-tos, and possibly rehabbing. Make it something that ties in

ccc_patton_ch18_232-244.qxd 4/27/05 2:16 PM Page 240

with what you're doing or you will start to get distracted in too many directions. The more we learn, the more deals we will find, because the more opportunities we will recognize.

Week 5

- Create five proposals.

Week 6

- Realtor follow-up. Send the follow-up letter to all of the Realtors who received the original letter four weeks ago. If a Realtor said there was no interest for that seller, then send the same Realtor a note on a different listing. Also send letters to three new Realtors.
- Meet with your goal accountability partner.

Week 7

- Create five proposals.
- Review your goals. Update or rewrite them as appropriate. Make sure you are on track.

Week 8

- Realtor follow-up.

Week 9

- Listen to a real estate course.
- Create five proposals.

Week 10

- Realtor follow-up.
- Meet with goal accountability partner.

Week 11

- Read a book on real estate investing. I recommend a book on landlording basics. Learn what you can. Search for one on Amazon.com or check one out from your club's library.
- Create five proposals.

ccc_patton_ch18_232-244.qxd 4/27/05 2:16 PM Page 241

Week 12

- Realtor follow-up.
- Review goals. Review, update, and rewrite your goals as appropriate.

Months 4 through 12

By now you have a good feel for what to do and how to keep your business moving and growing. We'll switch now from weekly to monthly tasks.

Month 4

- Realtor follow-up.
- Listen to a real estate course. Listen to another course or set of tapes/CDs on topics related to lease optioning, landlording techniques, options, subject-tos, or rehabbing.
- Review goals. Review your goals and update them as appropriate. Make sure you are on track. Rewrite or update your goals that need to be updated.
- Attend your local REIA meeting. Make this a monthly priority.
- Meet with your goal accountability partner.
- Create 10 proposals. I recommend 10 if you have not secured enough deals in the previous months. Otherwise, adjust the figure accordingly.

Month 5

- Realtor follow-up.
- Review goals.
- Listen to a real estate course.
- Attend your local REIA meeting.
- Meet with your goal accountability partner.
- Create 10 proposals. Again, adjust this figure as appropriate for your current situation.

ccc_patton_ch18_232-244.qxd 4/27/05 2:16 PM Page 242

Month 6

- Listen to a real estate course.
- Review goals.
- Attend your local REIA meeting.
- Meet with your goal accountability partner.
- Realtor follow-up.
- Read a book on real estate investing. I recommend a book on subject-tos.
- Attend REIA meeting.
- Create 10 proposals. Adjust the number to fit your current situation.

Month 7

- Realtor follow-up.
- Review goals.
- Attend your local REIA meeting.
- Meet with your goal accountability partner.
- Create 10 proposals. Adjust the number to fit your current situation.

Month 8

- Listen to a real estate course.
- Review goals.
- Realtor follow-up.
- Read a book on real estate investing. I recommend a book on rehabbing.
- Attend your local REIA meeting.
- Meet with your goal accountability partner.
- Create 10 proposals. Adjust the number to fit your current situation.

Month 9

- Realtor follow-up.
- Review goals.

ccc_patton_ch18_232-244.qxd 4/27/05 2:16 PM Page 243

- Real estate course.
- Attend your local REIA meeting.
- Meet with your goal accountability partner.
- Create 10 proposals. Adjust the number to fit your current situation.

Month 10

- Realtor follow-up.
- Attend your local REIA meeting.
- Meet with your goal accountability partner.
- Create 10 proposals. Adjust the number to fit your current situation.

Month 11

- Realtor follow-up.
- Listen to a real estate course.
- Attend your local REIA meeting.
- Meet with your goal accountability partner.
- Create 10 proposals. Adjust the number to fit your current situation.

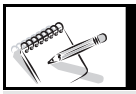
Month 12

- Open Up a Roth IRA. Choose a self-directed IRA management company. Equity Trust in Ohio is a great company. Put in $3,000 (or maximum allowed). This will be the start of year two for you. You will want to purchase a home on an option during year two using your Roth IRA, and one home per year thereafter in your Roth. This will set you up for the future and retirement. You will soon not qualify for a Roth contribution (you will make too much money). Set it up while you can.
- Realtor follow-up.
- Review goals. You made it through year one. Set your goals now for another year. If you can set them for three to five years, do that.
- Attend your local REIA meeting.

ccc_patton_ch18_232-244.qxd 4/27/05 2:16 PM Page 244

- Meet with your goal accountability partner.
- Create 10 proposals. Adjust the number to fit your current situation.

Each month you will want to follow up with any proposals that are still a possibility. Also, call and continue to build relationships with Realtors who are open-minded and are willing to work with you. This business is one day at a time to build your Future Financial Freedom (FX3).



Wendy's Big-Picture Advice for Lease Options and Subject-Tos

- Don't assume the economy will always remain strong. (For the first 15 years I invested, I didn't know anything different than a seller's market. We always had appreciation, everything was hot.)
- Pace yourself (in money and time), so you don't burn out. Buying too many properties too fast can leave you with too much to handle, too many credit cards, and too much debt. Figure out how many houses you can handle based on your current circumstances. Control your growth.
- Be careful choosing homes. Eventually you will have more homes than you will be able to handle. Cherry-pick your deals. Don't get sloppy. Continue to evaluate each deal on its own.
- Find the good tenant buyers.
- Practice good management techniques.
- Don't let anyone tell you that you can't do it!
- Cash the checks and live happily ever after!

ccc_patton_glos_245-250.qxd 4/27/05 2:17 PM Page 245

GLOSSARY

Below are some terms and definitions for real estate investors. These are Wendy Patton's definitions—not Webster's.

1031 exchange an IRS section that allows a person to exchange their like kind property for another property, of equal or greater value, and therefore defer (not avoid) the capital gains on the first property.

CMA Comparative Market Analysis.

dealer status A "Dealer" status makes what you do as a real estate investor, in the eyes of the IRS, self-employment income (which is much worse for taxation rates) versus ordinary income. The IRS can assume that you are not investing but just dealing property. One way this happens is with multiple rapid buys and sells during a short period of time. This is not something to worry about unless you are really doing a tremendous amount of volume in one entity (i.e., LLC). If you are doing various types of investing, at least keep the types separated into different entities (i.e. all rentals together, all lease options together, all rehabs, etc.). Talk to your tax advisor to get more information, but please don't get paranoid on this. Just do the business and make money.

double dip Realtors usually divide commissions 50/50: 50 percent to the agent who works with the seller (the listing agent) and 50 percent to the agent who works with the buyer (the buyer's agent). A double dip is when a Realtor is able to work with both the buyer and seller and collect the entire commission.

due on sale a clause in most mortgages that says if the owner sells the property or conveys interest in it to anyone, the bank can call the

ccc_patton_glos_245-250.qxd 4/27/05 2:17 PM Page 246

entire mortgage due immediately. It is rare that this happens, but both lease options and subject-tos can violate due on sale clauses by passing along an interest in the property.

earnest money money given in good faith by a purchaser of a home; a deposit to purchase a home. Applied to the purchase price at closing or forfeited if the purchaser backs out.

escrow (1) Escrow accounts are non–interest bearing bank accounts in which you can deposit earnest money received on a property.

(2) Escrow can also be a way of closing on a property. To "close in escrow" means that the title company or attorney prepares all the paper work but does not release any of the originals to anyone until something else happens (i.e., another deed is brought in to the title company and shown, another $200 is received from the buyer, etc.).

foreclosure When someone owns a home and they can't pay the mortgage payments, the bank will "foreclose" on the home, taking it back from the owner. In some states the owner would have a redemption period after the foreclosure or sheriff's sale. In most states there is no redemption time. The redemption time gives the owner time to "redeem" the title of their property, but they must pay the entire balance in full in order to redeem. Most owners can't do this without selling to another person or investor. Once foreclosure is started on a seller, only a few lenders will refinance the property for the seller.

FSBO (pronounced FIZZ-bo) an acronym for "for sale by owner," referring to properties that are sold without a Realtor, but by the owner individually.

land contract a contract for deed. In a land contract situation the seller usually owns the property free and clear. The seller in effect becomes the bank and only gives up the deed when the buyer's contract is paid in full. For a buyer, a land contract is better than a lease option because it says that if you make all the payments you get the deed. A land contract is not as strong when you are selling. The reason I don't like land contracts is that they are concrete sales

ccc_patton_glos_245-250.qxd 4/27/05 2:17 PM Page 247

rather than a lease. A land contract violates the due on sale clause, although it will probably never get a loan called, and it requires a foreclosure or forfeiture procedure if the buyer doesn't pay. If you go through a foreclosure or forfeiture, usually you will get only the home back, and not receive any money judgments. It can take months.

land trust a way to hold title to a home that camouflages the ownership. This is not an asset protection tool, but tied in with LLCs it can be very effective in asset protection and camouflage. This is used primarily so that no one will know the real identity of the owner. It is also used many times to avoid due on sale, seasoning, and the like. Many investors use this technique to hold properties. It works like a company and can be named as simply as "Joe Smith's Land Trust." You can deed your property into it and thereby prevent the due on sales. Liens can't be attached to it. I don't use it with my sellers because most of them would find it scary and confusing, but it's an absolutely legitimate way to operate.

lease option A lease option is like a rent-to-own. You have the right to purchase the property, but you are leasing it in the meantime. In a lease option, the seller is obligated to sell, but the buyer is not obligated to buy. An option gives an optionee a right to exercise a privilege. In a lease option it is the right to lease and also the right to purchase a piece of real property—real estate. A lease option involves gaining control of a property but not ownership—just the right to possess a property now and purchase that property at some future date with terms you define today. With a lease option you can get 5 to 10 percent above the retail value of the property just by offering special terms.

lease purchase This is similar to a lease option, but a lease purchase has no option. Technically the buyer is guaranteeing the purchase of the home. Lease purchases work well only when the buyer is actually able to make this guarantee.

Memorandum of Option a document that records the optionee's interest in the property. It prevents the seller from selling the home or

ccc_patton_glos_245-250.qxd 4/27/05 2:17 PM Page 248

refinancing during the option period. It also starts the optionee's seasoning of title.

MLS Multiple Listing Service—a database and computer system which has all of the homes listed by Realtors. In most states only licensed Realtors can access this data.

option An option gives an optionee a right to exercise a privilege. It gives the optionee the right or privilege to buy, within a given time period, for a given price. Options are used heavily in real estate, but most options are used in commercial real estate (i.e., you option a piece of property on the corner of two busy highways, then find a buyer, like Walmart, to come and develop it. That is when you would exercise your option. If you don't find a buyer, then you wouldn't exercise your option).

performance mortgage A performance mortgage is similar to a regular mortgage on the seller's property to guarantee that they will sell you the property. It gives you a lien/mortgage on the property, but only on a dollar figure if they don't perform and sell the home to you. It's only based on performance. It puts you on title, so if their first mortgage goes into foreclosure, you would be notified because you are a mortgage holder.

PITI principal, interest, taxes, and insurance—a full mortgage payment.

PI principal and interest payment. Taxes and insurance are paid by the owner directly.

PMI private mortgage insurance. This is usually required on all mortgages that have less than 20 percent down. It is normally a monthly payment added to the mortgage payment, insuring that part of the loan (the part that is greater than 80 percent of the original purchase price) for the lender.

rehabbing Rehabbing a property is when a person buys a fixer-upper and renovates it, making the property look new and beautiful. Each level of rehab is determined by the investor and price range of

ccc_patton_glos_245-250.qxd 4/27/05 2:17 PM Page 249

the home. A rehabber would not rehab a million-dollar home the same way they would rehab a $15,000 home.

retail value one hundred percent of market value—the price at which Realtors list and sell homes.

sandwich lease option A sandwich lease option is where you have a lease option with the seller and you sell the home on a lease option to another buyer. You are in the middle.

seasoning the time between when an investor buys a property and turns it around to sell it for a profit. Seasoning starts when you record the deed or the Memorandum of Option. When you get an option from the seller, record the Memorandum immediately so that the seasoning can begin. Wherever you record a deed, hand-carry it to the courthouse immediately. Never put it in the mail.

seller financing When the seller owns a property with no existing mortgage on it—free and clear—they can sell the property to a buyer and hold the mortgage on the property themselves, rather than using a bank or other lender. This will work when the seller wants a good interest rate or when the buyer can't qualify for a mortgage yet but has a good down payment.

seller holdback typically a second mortgage on a home the seller is selling. The buyer gets a mortgage for most of the sales price, then the seller holds a second mortgage for the balance or some portion remaining. This is another type of seller financing.

short sale When a bank is owed a certain amount of money on a home, but the owner is going into or is already in foreclosure, shorting means the bank will accept a significant discount on the mortgage balance to get rid of their deal that isn't performing. Banks do not like bad loans. They are in the business of lending, not of owning real estate. They want bad debts off of their books, and quickly, so they can make new loans.

subject-to A subject-to deal is when the seller deeds the property to a buyer, subject to the existing mortgage. The buyer makes the

ccc_patton_glos_245-250.qxd 4/27/05 2:17 PM Page 250

mortgage payments on the old loan but does not get a mortgage themselves to acquire this home. The seller transfers the title but keeps the existing financing in place; therefore, they don't own it, but they are still liable for the existing mortgage if the buyer doesn't make the payments. It stays on the seller's credit report. This is great when the seller is in trouble or wants out very badly. Many sellers will deed you the property, but usually only when (1) they are uneducated about what it really means, (2) they trust you very much to pay their mortgage, or (3) they are in financial trouble and need to get out from under it immediately. This scenario can help a seller improve their credit, when you pay the payments on time, especially if they were in foreclosure before you took over the title and payments.

title insurance insurance insuring the clear ownership and title for the new owner.

ccc_patton_res_251-252.qxd 4/27/05 2:17 PM Page 251

RESOURCES

Wendy Patton: www.WendyPatton.com
Pre-Paid Legal: www.prepaidlegal.com/hub/wendypatton
Fair Housing Act: www.usdoj.gov/crt/housing/title8.htm
NAR (National Association of Realtors): http://Realtor.org
National Real Estate Investors Association: www.nationalreia.com
Neighborhood Scout (subscriber-based service for finding neighborhood appreciation rates): www.neighborhoodscout.com/
Property Buying Tours (hot market buying trips), www.PropertyBuyingTours.com
Real Estate Seminars: www.FortuneMakersSeminars.com
Realty Times (for news and appreciation rates): http://realtytimes.com/
Rental listings: www.rent.com
RentRight property management software (they have a free trial that you can download): www.rent-right.com
U.S. Department of Housing and Urban Development: www.hud.gov

ccc_patton_res_251-252.qxd 4/27/05 2:17 PM Page 252

ccc_patton_index_253-260.qxd 4/27/05 2:17 PM Page 253

INDEX

Abatement, lead-based paint, 102, 182
Accountability partner, 238, 240–243
Accountant, functions of, 130, 224
Action plan:
  defined, 234
  goal of, 234
  importance of, 232–234
  initial 12 weeks, 235–241
  months 4 through 12, 241–244
Advertisements/advertising:
  attracting tenant-buyers, 163–165
  cancellation of, 180
  expenditures, 228
  guidelines for, 40, 102
  information resources, 237, 239
  in newspaper, 34
  sample, 35–36
  soft rental markets, 215
  subject-to deal, 115
  tear-off flyers, 34
Affidavit of Liens, 101, 114
Alterations, responsibility for, 188–189
Appliances, 189, 200
Application review:
  components of, 169–172
  rejected applications, 172–173
Appraiser, functions of, 90, 175
Appreciation/appreciation rates, 64, 72–73, 154, 175
"As is" sale, 180, 192
Assessments, 192
Assignment, 188
Attorney(s):
  fees, 190
  functions of, 48, 88, 91, 108, 121, 130, 182, 184, 187, 192, 209
  Pre-Paid Legal, 182, 236
Audits, 229

Back end, 16
Back taxes, 74
Bad credit, with reason, 166–167
Bad debt, 32, 36, 45, 171
Bad tenants, characteristics of, 170
Balloon payments, 208
Bandit signs, 33–34
Bank account files, 228
Bank Authorization, 101, 114
Bankruptcies, 167, 171
Bathroom maintenance, 200
Beneficial owner, land trust, 48
Beneficiaries, land trust, 123–124
Bill of Sale, 114
Body language, importance of, 79
Bookkeeping records, 223–224
Books, as information resource, 239–240, 242
Budgeting, importance of, 16
Burn out, 244
Business cards, 37, 144
Business organization guidelines:
  documentation, generally, 228
  file system, 221–223, 235–236
  hiring employees, 229–231
  office supplies, 235–236
  recordkeeping system, 223, 228–229

INDEX

Business organization guidelines *(Continued)*
software, 223–224
tenant list, 225–228
tenant payment ledger, 224–225
work orders, 224
Buyer(s), *see* Tenant-buyer
first-time, 25
good, *see* Good buyers
objections of, 173–174
Buyer's agent, 137
Buyer's market:
characteristics of, 32–33, 81, 136–137
deal structure, 154–155
lease options, 152
Buying signals, 85

Capital gains, 57, 129–130, 216
Carpet cleaning, 191, 200
Cash flow, 16
Certified public accountant (CPA), functions of, 130
Chamber of commerce, as information resource, 38
Check(s):
bounced, 186–187
copies of, 176, 181, 222
funds verification, 205
Check-in/out list, 179–180, 193, 200
Cleaning fees, 186
Closing:
characteristics of, generally, 87
costs, 89, 207–208
deed flow, 208
documentation, 209
lease option deals, 209
money flow, 208
subject-to deals, 209
timing of, 210–211
Color-coded files, 97, 112, 221–222
Commission, Realtor, 68, 88–89, 136–138, 150–155
Commitment for title, 97, 112
Communications:
documentation of, 223
with Realtors, 34, 239
Comparables, 72, 81, 88, 90
Contracts:
characteristics of, 80, 82–83, 87
clauses, types of, 107–109, 117–118, 121–123
drafting guidelines, 179
performance mortgage, 121–123
purchase and sale agreement, 93
subject-to deals, 117–118
Control:
without ownership, 52
of property, 183
Corporate relocation departments, 38
Cosigner(s), 185
Creativity, importance of, 26–28
Credibility kit, 237
Credit card debt, 171
Credit check, 46, 52–53, 168
Credit report, 168, 171, 173
Credit score, 171
Credit situations, types of, 166–169
Criminal background check, 171

Damages/damaged property:
collection for, 179–180
protection from, 179
security deposit, 93, 174, 186, 205
Deadbeats, 166–167
Deal structure:
building rapport, 76–79
components of, 155–158
proposal/offer, 79–83
time frame, 130–132
timing of, 62–63
Death, contract provisions for, 87
Deed:
characteristics of, 45, 47, 56, 58–59, 89
in escrow, 121
flow, 208
refinance, 57
transfer, 49, 50–51
Default, landlord remedies, 190
Delinquent taxes, 54
Department of Housing and Urban Development (HUD), 102, 215
Deposit, nonrefundable, 178, 180, 193
Depreciation, 154
Desperate and distressed sellers, 32
Digital photos of property, 179
Disabilities, economic impact of, 167
Discrimination issues, 87–88
Distressed sellers, 17, 32, 58
Divorce sale, 27–28, 45, 167

ccc_patton_index_253-260.qxd 4/27/05 2:17 PM Page 255

Documentation:
Affidavit of Liens, 101, 114
Bank Authorization, 101, 114
Bill of Sale, 114
check-in/out list, 179–180
for closing, 209
contracts, 179, 182–192
copies of, 228
Escrow Payoff, 114
Lead-Based Paint Disclosure, 102, 114, 180, 192
Letter for Due on Sale Clause, 114
Limited Power of Attorney, 114
memorandum of option, 100–101, 106–107
Notice to Insurance Company, 114
Notice to Mortgage Company, 114
Offer to Purchase/Purchase Agreement, 113
option agreement, 99, 108, 183–184
purchase agreement, 87, 100, 109, 126, 183, 191–193
rental agreement, 99–100, 108–109, 182–191, 201
revocation letter, 201–202
Seller's Acknowledgment, 113, 117
Seller's Disclosure, 101, 114, 180, 192
sources for documents, 228
subject-to deal, 113–114, 116
Warranty Deed, 24, 113, 116
Double-closing, 208
Down payment, 46, 51, 86
Driver's license, as identification, 169, 178
Due on sale clause, 47–49, 56

Economic conditions, impact of, 81, 244
Employees, hiring process, 229–231
Employment status, importance of, 170, 178
Entry points, 188, 234
Equity Trust, 52
Escrow account, 71
Escrow Payoff, 114
Ethical guidelines, 50, 56
Ethics:
capital gains, 129–130
Realtors', 148–149
Eviction, 182–185, 187, 201–202
Exercising the option, 194, 216
Exit strategy, 22–23, 70, 234
Extensions, request for, 131

Fair housing laws, 171–172
Federal regulation, 39, 168, 172
Fee(s):
attorney, 190
late, 203
pet, 193
transfer, 72, 126, 157
types of, overview of, 185–187
FHA financing, 58, 101, 157, 192
File system, 221–223, 228
Financially strong sellers, 53–55
Financing, sources of, 46
Fire, 190, 213
First deals, case illustrations, 18–20
First mortgage, 71, 73, 75
First-time buyers, 25
Fixtures, terms and conditions, 191
Flexibility, importance of, 26–27
Flyers, 34
Follow-up, importance of, 146–147, 237, 239–243
Foreclosure, 36, 48–49, 171, 185
Forfeiture, 185
For rent ads, 35
For Sale By Owner (FSBO), 37, 85, 90
Fraud, 49, 171
Future Financial Freedom (FX3) program:
action plan, 232–244
business organization, 221–232

Garnishment, 176, 204
Gifts, move-in, 193
Goal-setting, importance of, 238–242
Good buyers:
qualifications of, 168
who turn bad, 201–204
written standards for, 168–169
Good credit, 166–167
Good debt, 36, 45–46, 55–56
Government mortgage, 192
Grantor, land trust, 48
Growth rate, 244

Handyman specials, 214–215
High-end market, 127

ccc_patton_index_253-260.qxd 4/27/05 2:17 PM Page 256

Holding over, 191
Home-based businesses, 190
Home construction, 46
Home equity, 54–55, 57–58
Home owners, types of:
  inherited, 55
  long-time, 55
  new home builders, 55–56
  newly married, 56
Home selection, 244
Honesty, importance of, 49, 148
Hot markets, 127

Illness, economic impact of, 45
Income check, 46, 52
Inherited property, 55
Inspection, 115, 188, 192
Insurance, generally:
  coverage, 40, 115, 190
  liability, 40, 103–104, 109
  owner's proof of, 104
  policies, types of, 87
  policy payments, 48–49
  renter's, 181, 190, 193
Integrity, importance of, 148
Interest rates, 47
Internal Revenue Service (IRS), 53, 129, 217. *See also* Taxation
IRA, 47, 52. *See also* Roth IRA

Job transfer, 46, 56
Joint and several liability, 188
Judgments, 171

Keys, possession of, 102, 115, 193
Kitchen maintenance, 200

Land contract, 165
Landlord(s):
  history, 169
  motivated, 38–40
Land trust, 47–48, 123–125
Late fees, 185–186, 203
Late payments, 203–204
Lead abatement, 102, 182
Lead-Based Paint Disclosure, 102, 114, 180, 192
Leads:
  for tenant-buyers, 162–163
  wholesale deals, 51
Lease option(s), generally:
  advanced selling strategies, 214–215
  advantages of, 5, 51–52
  case illustrations, 8–11, 59–60
  characteristics of, 3–4
  defined, 44
  matching motivated sellers with, 54–56
  negotiations, 82
  preparation for, *see* Preparation for lease option deal
  profitability of, 64–69
  pros and cons of, 56–58
  questions and objections, 85–88
  Realtor's commission and, 151–153
  risks, 52–54
  standard deals, 6–8, 17
Lease Option Boot Camp, 20, 234
Lease purchase, sample proposal, 156–158
Letter for Due on Sale Clause, 114
Liability:
  insurance policies, 40, 103–104, 109
  protection, 188
  of tenant, 190
Limited liability company (LLC), establishment of, 236
Limited Power of Attorney, 114, 126–128
Listing agent, 137
Litigation, 180, 213–214, 223
Loan qualification, 46
Lockbox, 181, 193
Locks, changing, 200

Maintenance, *see* Property management; Repairs
  co-pays, 205
  responsibility for, 188–189
  types of, 200
  work list, 105–108, 116
Marital status, significance of, 46, 56
Marketing plan, 21
Market value, 81, 90. *See also* Comparables
Mediation, 182
Medicaid, 125
Medical problems, economic impact of, 167

ccc_patton_index_253-260.qxd 4/27/05 2:17 PM Page 257

Memorandum of option:
characteristics of, 53, 58, 100–101, 106–107, 121
filing process, 184
Month-to-month rental agreement, 184, 186
Mortgage, generally:
back payments, 70–71
fraud, 47
non–owner occupied, 52
payments, 44, 86
payoff, 210–211
performance, 121–123
rejection, 173
second, 71, 73, 75, 92, 207–208
sources of, 131
statement, as information resource, 98–99, 113
status, 113, 116
underwriters, functions of, 101
Mortgage broker:
code of conduct, 50, 56
functions of, 168, 173, 184, 192, 238
Mortgage lender:
functions of, 209
payoff letter, 210–211
Motivated sellers:
characteristics of, 31–32
search techniques, 33–38, 41
Move-in costs, 186
Moving in/moving out, preparation for, 173, 193–194, 199–200, 205
Multiple Listing Service (MLS), 37, 64, 81, 135
Multiple offers, 33, 83

National Association of Realtors (NAR), 37
National Real Estate Investors Assocation, 39
Negligence, 190
Negotiations:
economic conditions and, 81–82
guidelines for, 63–64, 67, 75
length of term, 93
lock-in agreement, 93
psychology of, 79
with Realtor, 154
seller paying you to take over payment, 93
seller pays part of payment, 92–93
Networking, 138–139, 237
New home construction, 55–56
Newspaper ads, 34, 40–41
Non–owner occupied mortgage, 52
Not desperate/not distressed sellers, 32
Notices:
characteristics of, 190–191
Notice to Insurance Company, 114
Notice to Mortgage Company, 114
Nursing homes, 125–126

Occupancy, 187–188
Offer, *see* Proposal/offer guidelines
creation of, 62–63
development of, 154–155
Offer to Purchase/Purchase Agreement, 113
Office manager, selection factors, 230–232
Office supplies, 235–236
Option agreement, components of, 99, 108, 183–184
Option fees, 15–16, 21, 173, 176, 192
Ordinances, 190
Out-of-pocket costs, 68–69
Out-of-state owners, 37
Owner folder, filing system, 97
Ownership, 44, 46, 53

Painting, 200
Partial payoff, 54
Partnership(s):
accountability, 238, 240–243
with seller, high-end/hot markets, 127, 132
Part-time employees, 230
Payment(s):
history, 225
late, 203–204
ledger, 224–225
setting up, 105, 107, 116
Payoff letter, 211
Performance mortgage, 121–123
Pet(s):
deposit, 186
fees, 193
policies, 188, 192–193

INDEX

Photographs, for protection, 193
Pools, 184
Pre-Paid Legal attorneys, 182, 236
Preparation for lease option deal:
  advertising, 102
  checklist for, 96–97
  documentation, 99–100, 104–107
  keys, 102
  liability insurance, 103–104, 109
  liens, IRS/state tax, 98
  maintenance/work list, 105–108
  mortgage statement, 98–99
  owner folder, 97
  owner's proof of insurance, 104
  payments, setting up, 105, 107
  pretitle work, 97–98
  property taxes, 99
  title work, review of, 104
  utilities, 102–103
  water reading, 103
  water softener, 103
Preparation for subject-to deal:
  advertising, 115
  checklist, 111–112
  documentation, 113–114, 116
  inspection, 115
  insurance, 115
  key possession, 115
  maintenance/work list, 116
  mortgage status, 113, 116
  owner folder, 112
  payments, setting up, 116
  pretitle work, 112
  property taxes, 113
  "Summary of Our Deal," 117–118
  tax liens, IRS/state, 113
  title work review, 115
  utilities, 115
  water reading, 115–116
  water softener, 116
Presentations, preparation for, 144–145
Pretitle work, 97–98, 112
Price objections, 90–91
Principal, interest, taxes, and insurance (PITI), 52, 72
Privacy issues, 198
Profit(s):
  increase strategies, 204–205
  ranges, 17
  requirement, calculation of, 63–64
Profitability:
  for lease options, 64–69
  profit requirement, calculation of, 63–64
  "Stupidest Moves Award," 61–62
  for subject-to deals, 69–75
Property management:
  case illustration, 195–197
  maintenance, types of, 200
  moving in/moving out, 199–200
  privacy with tenant, 198
  repairs, responsibility for, 198–199
Property manager:
  functions of, 202–203
  selection factors, 230–232
Property taxes, 54, 99, 113
Proposal(s):
  creation of, 238, 240–244
  guidelines for, *see* Proposal/offer guidelines
  sample, 156–158
Proposal/offer guidelines:
  determination of, 82–83
  format, 79–82
  negotiations, 82–84
  rejection of, 84
  research, 81–82
  seller's objections, 84–92
Pro-seller forms, 176
Protection guidelines:
  for lease option, 120–123
  for subject-to deals, 123–125
Purchase agreement, components of, 87, 100, 109, 126, 183, 191–193
Purchase and sale agreement contract, 93

Quickbooks, 223

Rapport-building:
  importance of, 89
  techniques, 76–79
Real estate courses, listening to, 239–243
Real estate investor clubs, 38
Real Estate Investors Association (REIA), 236–237, 241–243
Real estate license, 238
Real estate sales, traditional, 136
Realtor(s):
  closing deals with, 150–158
  code of ethics, 56–57

ccc_patton_index_253-260.qxd 4/27/05 2:17 PM Page 259

contact strategies, 140–141
deal structure and, 153–158
disclosure by, 192
educating, 142–145
ethics, 148–149
follow-up with, 146–147, 237, 239–243
letters to, 34
listing with, 88, 91
meeting with, 143–144
networking with, 138–139, 237
presentation for, 144–145
rapport with, 20–22, 52, 146–147, 152
referrals from, 165
selection factors, 137–138
targeting, guidelines for, 141–142
teamwork, 145–146
traditional sales, 136
training for, 171
working with, 135–137
Recordkeeping system, 213, 223, 228–229
Red flags, 170, 191
References, checking, 169–170
Referrals:
from Realtors, 165
sources of, generally, 21
from tenants, 166
Refinancing, 49, 56–57, 129, 131
Rehabilitation, 78
Reinvestment, 16–17
Rejection, handling strategies, 84–92, 172–173
Rejection letter, 178
Rent, 35, 40, 187
Rental agreement:
components of, 99–100, 108–109, 182–183, 185–191
month-to-month, 184, 186
violation of, 201
Rental fees, 186
Rental payment, 51–52
Renter's insurance, 181, 190, 193
Repairs:
cost of, 211, 213, 224
responsibility for, 16–17, 183, 188–189, 192, 198–199
Repossessions, 171
Research, importance of, 81
Return on investment (ROI), 47, 52
Revocation letter, 201–202
Revoking options, 201
Risk, 51
Roth IRA, 47, 243

Seasoning of title, 56, 58, 101, 209
Second mortgage, 71, 73, 75, 92, 207–208
Section 8 housing, 215
Security deposit, 93, 174, 186, 205
Security Deposit Act, 190
Seller(s), generally:
closing with, 210
financing, 165
first contact with, 41–43
folder, 222
motivated, *see* Motivated sellers
rapport with, 52
situation, 45–46
Seller's Acknowledgment, 113, 117
Seller's Disclosure, 101, 114, 180, 192
Seller's Information Manual, 91
Seller's market:
characteristics of, 28, 32–33, 81
deal structure, 153–154
lease options, 152–153
Selling options checklist, 177–181
Septic systems, 184
Showings, 40
Signs/signage:
attracting tenant-buyers, 166
removal of, 181, 193
Skip-trace services, 37–38
Slide presentations, 144
Sob stories, dealing with, 202–204
Social Security number, as identification, 178, 193
Soft rental markets, 215
Software, selection factors, 223–224
Spreadsheets, 70
State regulation, 39, 56, 172, 182
Statutes, 190
Subject-to deals:
advantages of, 46–47
case illustrations, 12–15, 24–28, 59–60
characteristics of, 4
defined, 44
ethical guidelines, 50
first deals, 25–26
first-time buyer, 25
negotiations, 82

ccc_patton_index_253-260.qxd 4/27/05 2:17 PM Page 260

Subject-to deals *(Continued)*
profitability, 69–75
pros and cons of, 56–58
questions and objections, 88–92
risks, 47–51
standard deals, 8
Subletting, 188
Success story, sample, 205–206
Sweat equity, 214

Taxation:
back taxes, 72
impact of, 53
liens, 98, 113, 170
property taxes, 54, 99, 113
proration, 192
reduction strategies, 216–217
Tax-deferred exchange, *see* 1031 exchange
Tax liens:
implications of, 170
IRS/state, 98, 113
Team-building guidelines, 238–239
Telephone service, 193
Tenant(s), *see* Tenant-buyer
folder, contents of, 178–179
liability, 190
list, 225–228
referrals from, 166
Tenant-buyer:
closing, 210
contract signing, 212
credit situations, 166–169
defined, 19
folder, in filing system, 178–179, 222–223
lease option risks, 53
paperwork, *see* Tenant-buyer paperwork
relationship with, 203
screening process, 169–173
selection factors, 155, 161–166
Tenant-buyer paperwork:
contracts, types of, 182–192
preparation of, 175–181
review of, 181–182
1031 exchange, 39, 216–217
Term, length of, 93. *See also* Extensions
Testimonials, 89
Time line, for action plan:
initial 12 weeks, 235–241
months 4 through 12, 241–244
Title, generally:
characteristics of, 56–57
transfer, 47, 184, 192, 200
work review, 115
Title companies, functions of, 209, 239
Title insurance, 72, 157
Transfer fees, 72, 126, 157
Trustee, land trust, 48, 124

Underwriters, functions of, 101
Unemployment, economic impact of, 45, 167
Unknown credit, 166, 168
Up-front funds, 72
Utilities, 180, 193. *See also* Water

Vacancies, 40
Vacant homes, implications of, 37, 59–60
VA financing, 157
Valuation, *see* Comparables; Market value
Vehicles, terms and conditions, 191
Videotape of property/premises, 179, 199–200

Waiver, 191
Walk-through, 179, 193, 199–200
Warranty Deed, 24, 113, 116
Water, generally:
bills, 204
reading, 115–116
softener, 116
Weak market, 33
Web sites, advertising on, 164, 166
"We want it now" mentality, 167
Wholesale deals, 51, 63, 132
Work orders, 224
Written standards, 168–169

Zoning laws, 190

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Transferring Real Estate Into Your Trust

To transfer real estate (also called real property) into your living trust, you must prepare and sign a new deed, transferring ownership. You can usually fill out a new deed yourself.

Preparing the Deed

First, get a deed form. Try to find one that is specific to your state. You should be able to find one online. Or you may be able to get one at a local law library; look for books on "real property" that have deed forms you can photocopy. You can use a "quitclaim" or "grant" deed form. Nolo sells quitclaim deeds (https://store.nolo.com/products/real-estate/quitclaim-deeds) for a handful of states.

Deed forms vary somewhat, but they all require the same basic information. Type in:

- **The current owners' names.** If you are the sole owner, or if you and someone else co-own the property and you are transferring just your share, only your name goes here. If you and your spouse own the property together and are transferring it to a shared trust, type in both of your names. Use exactly the same form of your name as is used on the deed that transferred the property to you and you used in your living trust document.
- **The new owner's name.** Fill in your name(s), as trustee(s) exactly as it appears in the first paragraph of your trust document, and the date you signed the trust document in front of a notary public.

Special instructions for Colorado: Colorado law makes it advantageous to hold real estate under the name of the trust itself, not the trustee. (Colo. Rev. Stat. § 38-30-108.5.) So if you hold Colorado real estate in trust, the new owner's name should be, for example, "The Jonathan L. Geery Living Trust, dated November 15, 20xx."

- **The "legal description" of the property.** Copy the description exactly as it appears on the previous deed.

If you co-own the property with someone and are transferring only your share, you must also state, with the legal description, that you are transferring only that share (a one-half interest, for example) or that you are transferring "all your interest" in the property.

EXAMPLE: Amanda, who owns a house with her sister, wants to transfer her half of the property to her living trust. When she fills out a new deed, she can insert either "a one-half interest in" or "all my interest in" before the legal description of the real estate.

After everything is filled in, sign and date the deed in front of a notary public for the state in which the property is located. Everyone you listed as a current owner, who is transferring his or her interest in the property to the trustee, must sign the deed.

Recording the Deed

After the deed is signed, you need to "record" it -- that is, put a copy of the notarized deed on file in the county office that keeps local property records. In most places, the land records office is called the county recorder's office, land registry office or county clerk's office.

Just take the original, signed deed to the land records office. For a small fee, a clerk will make a copy and put it in the public records. You'll get your original back, stamped with a reference number to show where the copy can be found in the public records.

Transfer Taxes

In most places, you will not have to pay a state or local transfer tax when you transfer real estate to yourself as trustee. Most real estate transfer taxes are based on the sale price of the property and do not apply when no money changes hands. Other places specifically exempt transfers where the real owners don't change -- as is the case when you transfer property to yourself as trustee of a revocable living trust.

Before you record your deed, you can get information on any transfer tax from the county tax assessor, county recorder or state tax officials. Many counties now make this information available online; check your county's website.

Insurance

After you have transferred ownership of real estate, call your insurance agent to report the change. The company will change its records on the policy, but the change shouldn't affect your coverage or the cost of the policy.

Due-on-Sale Mortgage Clauses

Many mortgages contain a clause that allows the bank to call ("accelerate") the loan -- that is, demand that you pay the whole thing off immediately -- if you transfer the mortgaged property. Fortunately, in most instances, lenders are forbidden by federal law to invoke a due-on-sale clause when property is transferred into a living trust. The lender can't call the loan if the borrower is a trust beneficiary and the transfer is "unrelated to occupancy" of the premises. (Garn-St. Germain Depository Institutions Act of 1982 (96 Stat. 1505).)

California Property Taxes

In California, increases in real estate taxes are limited by constitutional amendment (Proposition 13). The assessed value of the property can't go up more than 2% annually until a piece of property is sold. When the property is sold, however, the house is taxed on its market value. Transferring real property to yourself as trustee of your own revocable living trust -- or back to yourself -- does not trigger a reassessment for property tax purposes. (Cal. Rev. & Tax Code § 62(d).)

You may, however, have to file a form called a Preliminary Change of Title Report with the county tax assessor. Call the assessor to find out.

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Land Trust

Land trusts can provide asset protection benefits by providing you with privacy of ownership for real property. Each piece of real estate can be placed into a separate land trust. If a lawsuit is associated with one piece of real estate, other properties titled to different trusts are not automatically encumbered.

The public records show that a land trust owns the property. But the trust, itself, is not publicly recorded. Thus, a simple search does not show who owns the land trust. Privacy of ownership provides lawsuit deterrence, which is a form of asset protection. By privately owning property an individual who is being sued would appear to have no assets to satisfy a judgment, if no assets can be located by a legal opponent it drastically reduces the odds that a suit will be filed.

To say it a different way, **land Trusts** are private documents that hold title to real property. Although public records can be searched to identify property ownership, only the trust name is public information in this case. They are not **asset protection trusts** but they can help keep prying eyes from knowing what you own.

In addition, an LLC can be formed that records a second mortgage against a property that strips any equity from the real estate. These privacy techniques implement legal instruments that can deter a lawsuit.

We can establish land Trusts very quickly. They are useful tools for at separating real estate from one's personal name. As such, they prized legal tools of homeowners and real estate investors.

Land Trust Documents

To put a property into a land trust, there are two legal documents involved.

1. **The trust itself**. The land trust typically names the trustee, who is in charge of the trust. It names the settlor, who had the trust assembled. This is also usually the one who places the assets inside of the trust. Finally, the beneficiary or beneficiaries are named. These are the ones who benefit from the trust. The trust document can go into a filing cabinet at home or in a safe deposit box. It generally does not need to be filed in the public records.

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2. **A deed.** The deed is the document that is recorded in the public records that conveys the title from the prior owner to the trust, itself. More accurately, the deed transfers the title to the property to the trustee in his, her or its fiduciary capacity. This means that the trustee does not own the property personally. The trustee holds title to the property under the terms of the trust.

Another document often used is an "**Assignment of Beneficial Interest**." This document transfers one's interest in the trust to another party. For example, let's suppose a house is owned by John Smith. John Smith conveys title to the trust. The trustee of the trust is ABC Trustees, LLC, a company owned by John. John might also want Fred Jones, his brother-in-law, to be the trustee.

John wants an asset protection instrument to own the trust. So, if John is sued, there are legal provisions to protect John from losing the trust in a lawsuit. Plus, if there is a lawsuit on the property, John does not want to have personal exposure. So, John signs an Assignment of Beneficial Interest in the land trust. This document transfers his position as beneficiary over to Blue Sky Holdings, LLC, another company owned by John.

The Process

When you order a land trust, first our legal department emails you a questionnaire to complete. The questionnaire will ask you what you would like to name the trust. This is usually the same as the street address of the property with the word "Trust" added to it. If the address of the property is 123 Main Street, you would simply name the trust the "123 Main Street Trust," for example. The address of the property is public record, anyway. So, there is no loss of privacy in naming it in that manner. Plus, you may have multiple properties and trusts. Thus, this nomenclature makes it easy for you to figure out which trust is associated with which property.

Next, we ask you your name and address. This way, we know who to send the documents to once they are completed. We ask you the name and address of the trustee. You can choose a trusted friend or relative to serve as trustee. Alternatively, you can have us establish a private LLC in Wyoming, for example, to serve as trustee. You can opt for nominee managers. This way, you own and control the company serving as trustee. But no one in the general public knows this. This is because you have one of our associates listed in the public records as company manager. Your nominee manager, in turn is contractually obligated to only act at you request. With a company plus nominee service, you maintain your privacy from prying eyes.

We next ask you who is the settlor of your trust. This is the person who is having the trust created. This is typically the one who owns the property now. This must be exactly as listed on the current title document. We utilize this information to draft the deed that transfers the property from your name to the trust name.

Do you want extra protection? We touched on this above. For the home that is not your primary residence, most experts advise that you make the beneficiary of your trust a limited liability company. That is, an LLC.

A land trust is not an asset protection device. It is a privacy device. It keeps your name out of the public records. The beneficiaries of the trust are exposed to liability. So, when you put an LLC in that place, the LLC is exposed rather than you personally. Plus, when

you are sued personally, the LLC can offer true asset protection. That is, there are provisions that allow you to protect your ownership in an LLC and anything that the LLC owns.

As such, the next thing we ask is where you want to assign your beneficial interest in the trust. That is, in addition to your trust and the transfer deed, we include an Assignment of Beneficial Interest document. So, you can transfer the “ownership” of the trust, called your *beneficial interest*, in the trust, to a company.

Most tax advisors recommend against assigning beneficial ownership of your personal residence to a company. That is because a personal residence is a different tax category than investment property. There are certain benefits in maintaining beneficial interest in the land trust that owns your home. Some examples are writing off the interest on our home mortgage. Another is selling the property and not paying taxes on significant portions of the gain if you have lived in the home two years or longer. So, the most common recommendation is to assign your beneficial interest to LLCs for investment property. Keep your personal beneficial interest in the trust on your personal residence.

Naturally, we ask for the property address. We ask for the county in which the property is located. Next, we need to know where you want the county to mail your property tax bill. In addition, we need the tax parcel number. The legal description is helpful, but not necessary. This is because you can typically attach the legal description to the deed for filing.

When You Receive Your Land Trust

We usually email the land trust to you. Once you receive it by email, you will open the attachment, print it and follow the enclosed instructions. You scan through the document to make sure that your name the addresses are correct. You write the date on your trust. Then you and your trustee sign the land trust in front of a notary public.

Some states use Quitclaim Deeds. Some use Grant Deeds. So, we include each. The current owners then sign the appropriate deed in front of a notary.

You next take the deed down to record it in the public records. You usually do this in the county recorder’s office in the county where the property is located. You put the trust itself, however, in a filing cabinet in your home or office or in a safe deposit box. Once you have recorded the deed, the property is now titled to the trust. A public records search will not show you as the current owner of the property.

To put your real estate in land trust, you can call the number above or complete the inquiry form on this page.

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Table Of Contents

Wholesaling Step By Step: What We Will Cover……...……7

Where Will This Work?.....8

Is It Worth Your Time?.....9

Wholesaling Advantages……...10

Wholesaling Disadvantages……...11

The 14 Step Quick Start Guide……..12

- Step 1: Learn The Basics……...13
- Step 2: Identify The War Zone……..14
- Step 3: Determining Market Value……15
- Step 4: Locating Prospects…….17
- Step 5: Prescreening Your Prospects…….32
- Step 6: Constructing Offers……...35
- Step 7: Presenting Offers……...41
- Step 8: Preparing A Standard Purchase And Sales Agreement…….43
- Step 9: Check The Title…….52
- Step 10: Getting Ready To Sell…….54
- Step 11: Attract Buyers……..55
- Step 12: Prescreening Buyers……57
- Step 13: Getting A Commitment……...58
- Step 14: Closing The Sale……..62
- Step 15: Complete The Process…….66

Marketing Houses Wholesale Recap…….67

Contingency Plan If You Don't Find A Buyer……..68

Common Questions From Wholesalers…….70

The Most Common Mistakes…….72

How To Build An Auto Pilot Business……..73

To Whom Are You Listening?.....74

Resources……...75

Wholesaling Step By Step

What We Will Cover

- Where This Will Work
- What Are The Target Properties And Conditions
- Advantages And Disadvantages
- Most Common Mistakes And How To Avoid Them
- How To Prescreen Your Prospects Quickly To Buy And Sell
- How To Construct Offers That Get Accepted And Ensure A Profit
- How To Determine Market Value
- Where To Find The Best Deals In The Shortest Time
- How To Estimate Repairs In Minutes
- How To Sell Quickly To Hungry Buyers
- How To Work With Agents To Leverage Your Time And Increase Your Income
- Most Common Questions From Students
- How To Put Your Business On Automatic Pilot
- How To Write Purchase And Sale Agreements Like A Pro To Buy And Sell

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Where Will This Work?

It will work in all price range houses anywhere in Canada or America. It works best in lower priced markets simply because it's easier for your buyers to raise the cash needed to purchase the property. However, I have students in both high and low priced areas doing very well by simply finding the bargains and passing them on quickly to bargain hunters. The low dollar areas produce much more profit per deal. Both markets can be worked effectively with the ability to structure offers properly.

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Is It Worth Your Time?

The average wholesale deal is worth $10,000 in low priced areas.

Using the $10,000 figure it would only take 10 deals per year to yield a $100,000 income.

When properly trained, an investor should get at least one offer accepted for every 10 – 15 presented when combining FSBO's and bank owned houses.

Therefore, using 15 offers per deal, a whole year's work would consist of making 150 offers to make $100,000.

That's 13 offers a month or 3 per week. And that's assuming you don't get better than 1 out of 15 and you don't make more that $10,000 per house.

Is it worth your time? Perhaps you should be asking…is you job worth your time?

What if you get serious and flip 5 a month at $10,000 each. That's $600,000 per year. Somewhere in here is a real business better then most any franchise and you owe me no royalties or franchise fee.

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Wholesaling Advantages

- Requires very little training
- Need very little money and no credit
- Very little risk
- You can generate lump sums of cash quickly
- Can work from home with minimal overhead
- Requires only small amounts of time
- No tenants or buyers to qualify
- No long term delays
- High income potential
- Fast track to job replacement
- No repairs or contractors
- No license required
- Ample supply in today's market

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Wholesaling Disadvantages

- Limited to houses that can be bought well below market value.
- Only one payday on each property.
- An investor focusing on wholesaling will only achieve 20% - 30% of the total income potential of those using all methods available.
- May be difficult in high priced areas because the buyers must produce larger sums of cash.
- The current market condition generates a lot of competitive activity due to the massive bargains available today.

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The 14 Step Quick Start Guide

The following are guidelines to help you through your first deal. These guidelines contain some easy to follow steps you should be able to complete during your first few days as a real estate entrepreneur. Proceed at your own pace. I realize some people have a lot of things going on in their lives and time is at a premium. Others want to get started immediately and proceed as fast as possible. Regardless of whether you complete these steps in fourteen or thirty days make sure you complete them. Don't skip any. You can't rush success by bypassing the basics. In fact, if you want to create a sure-fire plan for failure, ignore these steps and make up your own rules as you go. I did it and learned my lesson.

My refusal to listen and my rushing to succeed cost me about five hard years of learning from the school of hard knocks as well as several million dollars in stupid mistakes. Don't let this same thing happen to you. I'm recommending these steps because I know they will work if you let them.

There are only two ways to learn anything. The first is the hard way. Inventing the wheel and learning from one battle after another can be a very expensive education, not only in lost money and time.

The second is to learn from someone who has walked before you and smoothed the pathway. If you take this route you'll be glad you did. It's quicker, easier and a whole lot less expensive by far. Following this path may mean the difference between success and failure.

You can improvise a little here and there. I'm a firm believer in testing new things as you grow. Many of my students have done much better in their first year than I did in my first five. The reason is simple:

I Had To Create The Basics, *You Don't!*

The students who quickly excel are those who do much of what I ask and don't constantly work to outsmart me. Spend your time processing deals as I've laid them out for you in your course and you should find yourself making money very quickly.

I've spent almost 30 years and personally done hundreds of deals. I've trained thousands of students nationwide. I'm the best qualified person on earth to help you quickly make money with single family homes, with little or no money, no credit and almost no risk. I know what works and what doesn't and how straying from the basics even a little can make the difference between making money or not. So, for now, trust in your new program and let's get to work.

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Step 1: Learn the Basics

Go ahead and put down this guide and come back to it only after you have completely reviewed the entire course. This means all the audio and study guides. Please, do not take any shortcuts. Regardless of your education, current lifestyle or past experience, you can't learn what I know unless you take the time and make the commitment to do so. Please, make the time and do whatever it takes to absorb the material it has taken me so many years to compile and qualify to offer to you. Your family will be glad you did.

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Step 2: Identify The War Zone

Obtain a map of your city and have it reduced to an 8½" x 11" size. You may use both sides and split the map in half, or, if necessary, use several sheets. Any copy center can do this for you. Identify your residence with a dot and write home above it. Then draw an outline around the areas you consider to be war ones. Write War Zone inside this area.

If you don't know where the war zones (low income, heavy crime) are in your city, get the help of someone who does. This can be a member of you local real estate association, a Realtor, a landlord, an appraiser, a postman, meter reader, or anyone else who is knowledgeable enough regarding your city. You will need to research and pinpoint these areas, which you'll only have to do once. You'll get better as you get out in the field, but most cities have war zones that are common knowledge. Find all you can and indicate them on your map.

If you live in a large city such as Chicago, Los Angeles, Atlanta, the Washington D.C. area, etc., it is not necessary for you to locate every single war zone. You won't need to. The purpose of this exercise is to acquaint you with your city, not to make you a map maker. It won't be difficult to locate these areas in any city with a population of one million or less. In the larger cities, simply locate as many as possible.

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Step 3: Determining Market Value

You must decide how you will determine the After Repaired Value (ARV) of the prospects you will soon be seeking. There are several ways to do this. How you go about it depends on your experiences and current involvement in the real estate field.

Your Choices Are:

1. You're licensed and have access to the Multiple Listing Service (MLS).

2. You know or will find a real estate agent who can do market analysis for you. Since you will be making offers on some listed houses, the listing agent should provide the After Repaired Value (ARV) on these. This can also lead to a relationship to get comparable sales done on non-listed houses.

3. You subscribe to a data base service that allows you to tap into the tax rolls so you can pull up your own market analysis. Do not use the tax assessed value. You should investigate a service of this type in your area. Some choices are included in your course.

4. Look for similar houses in good condition that are on the market in the subject area. Call agents and For Sale By Owner (FSBO's) from the sign in the yard to determine their asking price.

5. If you're contacting the seller directly you should always ask what he/she thinks the house would be worth if it were in excellent condition. This may or may not be a real number, but it's something to go by until you can do a more diligent investigation. Always ask how they arrived at the value. If it came from an agent's analysis or an appraisal. Remember, if the house is ugly it's probably the "as is" value. You're looking for the after repaired value, so it should be higher. If the seller's figures came from the tax assessment, it's usually well below the real market value.

   Here's a list of websites you may find useful in researching your market analysis:

   www.City-Data.com
   www.domania.com
   www.eppraisal.com
   www.RealQuest.com
   www.trulia.com

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How To Determine The True Market Value

The only way to find the market value of a house is to do a:

Comparable
Market
Analysis.

When a CMA is prepared on a house, only houses that are **SOLD** can be used for comparison.

The following items make up a CMA.

1. Recent Sale

2. Close in proximity

3. Close in square footage

If three very close comps came in at $143,000, $139,000, $145,000, what would you price your house at after putting it in excellent condition?

This is the ARV (After Repaired Value)

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Step 4: Locating Prospects

Drive Around

Drive around and find at least twenty prospects you feel are good targets for making offers. You should be looking in the low-priced markets where the cheapest houses in your town are located. These areas should be reasonably well kept and people feel safe living there.

Some Of The Characteristics You Should Include Are:

- Low priced areas but not war zones.
- Needs work, the more the better. Condemned houses are good prospects but all should not be condemned.
- Vacant is preferred, but not mandatory.
- May or may not have a "For Sale" sign by agents or owner. All prospects are acceptable whether the sign exists or not. Some listed properties should be in your first batch. This will help establish a communication line with some agents.
- Single family homes only! We will not work with multi-family or commercial property in this course.
- Asking price is at least 30% below ARV.
- At least 850 square feet.

Take a photo of the front and rear of the house if it's vacant. If not vacant, only take a picture of the front. Take a picture of the front of the houses on each side of the subject property. This will give you a reference of how well the neighbors keep up their house, which could affect the sale value of yours. Complete a property information sheet on each house.

If the house is vacant, look into each window and write down what you see.
Write down a simple description of the color and some other distinguishing feature of the house on your information sheets. This will ensure you're attaching the correct photo on the form.

Once you have inspected twenty or more prospects, staple four pictures to each information sheet; one front view and one rear if the house is vacant, and one of each neighbor. Attach only three photos if the house is occupied. Mark each photo with a felt pen and the words "subject" on you prospect photo and "neighbor" for the two houses flanking the one you're interested in.

Call the listing agent on the houses that display Realtor signs. Use the Realtors script in your course. Persist and keep following up until you get the MLS printout on the house and an estimate of the ARV (After Repaired Value). Tell the Realtor you'll be back in touch shortly with an all-cash offer and follow the instructions under Realtors.

Some Realtors will not fax you the MLS printout. They feel it is an MLS property and not open to the public. If this is the case, you must get the facts you need over the phone to make an offer. This will include asking price, loan balance and their opinion of the ARV. If you have difficulty getting the facts or run into a Realtor who is just impossible to deal with (and you

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will), simply pass to the next prospect. The best thing you can do with uncooperative Realtors, or anyone else for that matter, is nothing.

Call the owner of the houses with FSBO signs or no signs, which need repairs and complete the same information sheet. Obtain as many facts as you can, but don't hang up the phone until you ask the owner the following. ***"If I pay you all cash and close quickly, what is the least amount you'll accept? Is that the best you can do?"***

Don't stop finding prospects until you feel overloaded and are wondering how you will handle them all. Don't worry, you can't find too many. When we get to prescreening, most of them will quickly be disqualified. You'll be left with a handful of good prospects. However, if you only start with two or three prospects and all of these get disqualified during prescreening, you'll be left with nothing. If you're in this business more than 30 days and haven't done a deal, usually you can come right back here for the root of your problem.

Good Deals Begin With Good Prospects

The first step to making money as a real estate entrepreneur is finding and prescreening prospective sellers. Your entire business will hinge on this. You can't make offers until you locate those who need your help and are willing to listen. Let nothing stop you from completing this extremely important first step. We know you will have to talk to several sellers before you find quality leads. It's a number game.

SW – Some Will **SW** – Some Won't **SW** – So What **SW** – Someone's Waiting

Remember, your entire business will be built around locating prospects just like any other business. A service station can't sell gas unless the customer drives up to the pump. An insurance agent, real estate agent, car salesman, hairdresser, doctor, attorney or any other product or service-driven business cannot survive without first locating prospects. Your business is no different. If you fail here, you won't make any money as a real estate entrepreneur. You must understand and internalize that real estate, just like most businesses, is a numbers game.

You Can't Build A Successful Business Around Just One Customer

In our case, the first customer is the seller. The more sellers we find, the more money we'll make. Don't spend your time driving around finding two or three ugly houses then stop looking. Don't call a handful of sellers from the paper and quit calling. You'll need a minimum of twenty ugly houses to work with. It's your job to quickly prescreen them and deal only with those who give you the right answers to your questions. Most ugly, vacant houses will not be purchased for the amount you're willing to offer based on my system discussed in your course. Remember the Funnel Theory. Get the suspects in the top of the funnel, figure out quickly which are prospects and then narrow those down to the few that become deals. Follow up with those that don't. It's really that simple, but if you fail to understand the Funnel Theory and expect everyone you talk with to sell you their house, you're in for disappointment. This is a real business and all real businesses require real work. Most of the work you'll be doing is attached to locating prospects. So don't even think about going to the next step until you have a big pile of prospects.

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Lead/Property Information Sheet

Date _____ Owner's Name _____

Source _____ Day Phone _____

Address _____ Evening Phone _____

★ Asking Price _____

Area _____ ★ Estimated Value _____

★

Existing Mortgage Information

1st - $_____ Lender _____ _____% Pmt _____

2nd - $_____ Lender _____ _____% Pmt _____

Payments Current? _____Yes _____No $_____ in Arrears

Reason For Sale _____

How did you arrive at your asking price? _____

Is the house listed? _____

★ Does it need repairs? _____Yes _____No

★ When do you want to move? _____

Optional: Will you sell the house for what you owe on it? _____Yes _____No

Description:

Bed/Bath: _____ Square Feet: _____ Lot Size: _____

Construction: Frame_____ Brick_____ Block_____ Stucco_____ Other_____

Central Heat/Air? _____Yes _____No

Garage: 0 1 2 Carport: _____ Basement: _____

Appliances: Refrigerator _____ Range _____ Dishwasher _____

Is the house Vacant_____ Occupied_____

Notes:_____

_____

_____

_____

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How To Locate The Owner Of Vacant Houses

There are numerous websites to assist you in locating owners of vacant houses. Some free and some you must pay. You'll usually get what you pay for.

- zabasearch.com
- intelius.com
- address.com
- peoplefinders.com
- ussearch.com
- search.infospace.com
- privateeye.com

You can spend your life on these sites, but I'd suggest you assign that task to someone else, perhaps the agents we discuss next.

There are also skip tracing companies who will find the seller for you for a fee, such as **FindTheSeller.com**. You can buy in bulk to save money, but don't get hung up on the cost. If you have to pay $20 each and you only buy one out of ten you find, wouldn't you spend $200 here to make $10,000 or more? If you're not careful you can cost yourself right out of business. One lost deal will pay for a lot of skip tracing.

You may also wish to mail an ugly letter discussed in my Pretty House Cash Flow System. When you hand address it be sure to put "address correction requested" on the envelope. If they've left a forwarding address, the post office will put it on the envelope when it's returned for less than a dollar. That's a cheap skip trace.

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Now call information and see if a phone number exists. If not, or even if it does, mail another letter to the new address and make sure you put the vacant house address in the letter as the one you want to buy.

Special attention should be given to the houses with hard to find sellers. If you can't find them neither can your competition but a skip tracer can.

These hard to find sellers will be the best deals you'll ever do in the ugly house business and are worth the effort.

If they are free and clear, and many are, you can negotiate some outstanding deals. They don't care about the house or it wouldn't be ugly and vacant. You are a welcome guest and likely the only one who's contacted them.

If the house is in foreclosure you've found a great short sale prospect no one else will know about. Put it under contract and work the short sale.

If it's already bank owned you won't buy it now until it's listed but you should put your letter under the door so you may get contacted by a Realtor when the bank lists it.

Put it in a follow up file to pursue every month until you buy it or it's sold.

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The Ant Farm

This method is called "The Ant Farm." As you read on, you'll probably discover just why I call it that. In a nutshell, it's getting everything we just discussed done for you so you can have a constant supply of houses without leaving your desk.

What I'm going to attempt to do here is to get you in the habit of cultivating ants. Not real ants, but human ants.

You see, an ant's job is to totally serve the queen. They spend their lives building the nest and bringing crumbs to their queen. Now, one ant couldn't undertake this massive job by itself, so the ant has to team up and tackle the job as an organized business. Each ant has his job and contributes his share. While this is going on, a big fat queen sits back, enjoys life, becomes fruitful and multiplies.

Of course, in our little scenario, you're the queen or king, if you prefer. If you get good at inducing your human ants to bring you all the best deals in town then you too can sit back, enjoy life, be fruitful and multiply your bank account.

What we're going to do is set up a referral system. This will not be the old standard system as you know it, where you get people to bring you leads on houses and pay them X number of dollars if you buy it.

That system has one major flaw. It doesn't work very well because no one believes they will actually get paid. When they do believe it, they never know when because they don't know when you will close the purchase. Promised dollars payable sometime in the future just doesn't motivate people. We live in a society of instant gratification.

If this is true, let's find a way to get people excited about what they're doing and get them paid immediately, which is the only way you will keep them excited.

Here it is in a nutshell. Joint Venture with people to bring you leads and pay them for their services immediately.

Let's see how that would work…how many people do you know who own a car and a camera who could use a part time income? I'll bet you know a bunch. How about your own kids or even your own parents? How about all the students, unemployed or handicapped people you know? Something tells me you won't have any trouble finding people who want to make some extra money riding around taking pictures of houses.

All we want these ants to do is look for the right houses, collect a little information and take a picture of the house. We'll tell them where to look and what kind of houses we need. When this is done and they collect several of these leads, they'll be delivered to your home or

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office. Your ants will get paid for each lead they bring you and perhaps even a little more on the ones you buy.

Let's pick this apart and convert it to numbers so you can get a feel for the power of this program.

These are the two key factors in finding the best deals. People who own vacant houses that need considerable work are generally motivated. Therefore, we come right back to what we're looking for, motivated sellers only.

Let's make sure we understand the meaning of ugly. I'm not talking about a few hundred dollars in cosmetic repairs. I prefer several thousand dollars in serious repairs, or what people think are serious repairs. The more work that's needed on the house, the fewer people will be looking at it to buy and produces serious motivation to sell in most cases.

I like: peeling paint, broken windows, rotten wood, tall grass, bad roofs and foul smelling houses. In fact, the worse they smell the better. I love cat and dog urine. It turns off most people, but it turns me on.

You see, I don't think the house stinks at all. I think it smells like money. I've learned that smells are easy to get rid of and what looks like $20,000 in repairs to most people is only $8,000 - $10,000 or less.

When you learn to look past the repairs and ignore the smell and see the house finished, you'll possess a talent that will produce endless cash flow.

What about boarded up houses with condemned signs? Based on what we just discussed, I think they should be prime targets. Don't you? Think about it. The only reason a house gets boarded up or condemned is because the owner can't or won't do the necessary repairs. After several notices from the city, if the repairs aren't done, the owner will then be ordered to board it up themselves or the city will do it for them and put a lien against the house.

Most of these houses can be put back together into excellent repair with a few thousand dollars. As soon as the repairs are completed, the city will come out and inspect the house and release the condemned status. It's not complicated or unusually difficult to deal with condemned houses.

Doesn't it stand to reason that people who own these houses have a problem you just may be able to solve for them? How many offers do you think the owners of boarded up, condemned houses are getting?

The answer is probably none. You'll be in a minority of people who would be interested in the house.

Therefore, instead of shying away from the board ups, perhaps we should be seeking them out. Besides, look at all the free plywood you get with the deal.

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OK. Now we understand what ugly means so we know what to instruct our ants to look for. Remember, they'll be bringing you a photo of every single house they find so you'll know instantly if it's a prime candidate.

To refresh your memory, all we want our ants to do is bring you photos and addresses of ugly houses, with or without for sale signs and go next door and try to find the owners on the ones without signs and go online to find the rest. That's it. That's all you're asking them to do. Now let's see how to pay them.

I use the following schedule of payment and it has worked well.

> $5.00 for each vacant and ugly house if the owner's name is not produced or if it's listed.
>
> $10.00 for each vacant and ugly house if the owner's name or phone number is produced. This can be a FSBO sign or from the ant tracking down the owner from the websites in the last chapter.
>
> $250.00 for each house I buy.

Remember, one or more photos must be attached to each information sheet for them to get paid and it must meet the criteria I gave them to look for. I will also instruct them what neighborhoods to do their research and keep them separate to prevent duplicates.

These figures can be altered to suit your needs, but they have worked well for me.

If you're doing a little multiplying about now, you have probably already figured out what it will cost you if your ants bring you back a pile of leads.

Let's see now. Supposed you get 30 leads in one week. Gosh, that's $300 you have to shell out to your ant. What if you get 50 at one time? My goodness, that's $500, payable now.

My friend, do you have any idea what your life would be like if someone drops 50 leads on your desk with 50 photographs and 50 information sheets on 50 ugly houses that are vacant and ready to steal? Do you have any idea what this will mean to you in profits?

Let's just suppose that out of these 50 prime candidates, you do a lousy job and are only able to buy 5 houses. Let's also suppose that you're only in the wholesale business and you don't want to retail a single one of them. You're going to put them under your contract and sell them cheap to other investors or owner occupants looking for a handyman special.

We'll assume that your average profit will be low because you're not even good at negotiating deals yet. You paid more than you should have on these vacant and sometimes boarded up houses because you haven't been to my boot camp yet. Even though you're new to the business, you don't need to know much to make low all cash offers on ugly houses. So you

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stumble along, screw up and still manage to buy 5 of the 50 at prices reasonable to squeak out a measly $5,000 wholesale profit on each house within 30 days.

The way I figure it, that's a $25,000 income minus the $500 you paid for the leads. A $24,500 profit for a $500 investment. You could do one deal out of 50 and make the same money, if you buy correctly.

The truth is, a $25,000 income on 50 such qualified prospects is minimal compared to what it could be.

Just think, those 50 leads are only the result of 1 or 2 ants working one week. What about the rest of the year and the other few hundred or few thousand houses still out there ripe for the picking? What if we send out more than 2 ants to work?

Maybe you're thinking it won't be long before you cover the whole town. Get serious! By the time you do that, if you ever do, it will be time to start all over again and tap the batch of new ugly houses that are available. You'll never buy them all, in fact, you'll never come close.

Are you beginning to see the potential here? By using my Ant Farm method alone, you can easily produce more hot deals than you can handle without ever running an ad, putting out a flyer, doing a mail out or any other time consuming tasks. Your business is run right from your desk. The only time you go look at a house is after you have found the owner, got the facts and have it under contract.

You can also train the ants to track down the seller's phone number and call them before you get the lead and fill out the property info sheet. This is now a $10 lead for them and a goldmine for you.

Since you don't pay until your receive the leads, you can have as many ants as you can handle and cover your entire city. The more they do, the more you can handle. The more you get, the more you can sell and the bigger your machine can get.

The key is to put it on autopilot so you can do 5-10 deals a month with a minimum profit of $10,000 each. You do the math.

Start Your Ant Farm Today!

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Realtors

All bank owned properties will be listed and most in the MLS. This is a viable source of deals today, but not without a price.

Here's the downside:

- This is the easiest place to find deals so it's the most worked, thus a lot of competition.
- You'll do a lot of legwork on houses you won't buy unless you get someone to do it for you.
- You'll have to make 15 – 30 offers to get one accepted at a price I'd approve (coming up).
- Realtors want to control everything and you'll have to learn to handle them correctly. This will take time and likely a little frustration to learn.
- You'll need larger deposits and proof of funds, unlike FSBO's (coming up).
- Some investors do nothing but use Realtors to buy houses and that's a recipe for frustration and failure. Consider them only one way to find deals…not <u>the</u> way.

Here's the upside:

- There's a plentiful supply of bank owned properties that must be liquidated in all price ranges.
- They're all free and clear and delivered with clean title.
- There's no short sale to negotiate or long time delays.
- No pre-foreclosure laws you'll inadvertently violate because the house is no longer lived in.
- The agents do almost all the work, leaving you free to do other things.

You'll be using Realtors only for buying all cash deals and short sale deals, which are indirect all cash deals. No "subject to", seller financing, options or anything outside all cash.

Do not try to educate agents. Work with them the best you can to make them comfortable with you but don't try to change their comfort zone.

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Finding The Right Realtors

There are only two ways to locate them, either find the agent first and back into the houses or find the houses first and back into the agents. I prefer the later but do both.

If you're driving around looking for houses or have your ant farm set up, you'll find plenty of ugly, vacant houses with agency signs in the front yard. This will back you into the proper agents because they have bank owned houses listed and understand that part of the business.

Now you simply call the listing agent on the sign and ask for the MLS printout so you can make an offer. You should also ask for comps and anything else he/she knows that would be helpful. Here's your script:

"Hello _____, I'm inquiring about the house at 123 Main Street with your sign on it. Could you fax/email me the MLS sheet on it if it's still available so I can get you an offer tomorrow?"

Pause – Wait For Answer

"I buy 2 or 3 a month and I've got some capital I need to put to work quickly. Do you have more like this you can send?"

This dialogue will get their attention if you say it with conviction, but don't assume you've impressed them much. They hear a lot of hot air from so called investors and will need to see some serious intent before their trust level goes up much.

If you do this with all the houses with agency signs, soon you'll have a flood of prospects coming at you every week, all from the listing agents who don't have to share their small commission.

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When you find one or two you like, you can now ask them to find you some good prospects in the MLS from other listings and begin an ongoing relationship.

Here's my search criteria:

- **Area I Want To Work** – You can cover a lot of area with wholesaling because you'll never visit the house more than once and maybe not even once.
- **Price Range** – The wholesaling business is best done in the bottom of the market. That depends where you live. For the majority of the US, that means houses with ARV's from $75,000 - $150,000. Other markets in the US and Canada could go as high as $300,000 - $400,000, but you should still stay at the bottom of your market where people who can qualify for loans want to live.
- **Search Words** – Bank owned, foreclosure, REO, needs work, TLC, special addendum required, etc. – your agent will know them and use them.
- **Time On Market** – The best deals are not those fresh on the market. The longer they've been listed, the better prospect they are and the better price you can get. Once the market has played out for two to four months, the banks are much more flexible and will move the houses, even at prices less than they were offered months or even weeks ago.
- **Square Foot Multiplier** – Here's an easy trick I learned. If the average house in a neighborhood in excellent condition sells for about $100 per foot, ask your agent to pull up all listings less than say $70 a foot. That means the house or the seller likely have a problem.

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Keeping Good Agents

Here's a list of things not to do:

- Never disclose you must sell to raise the money.
- Do not ask them to show you houses. You don't need them to waste their time. You can see them for yourself.
- Don't insist on using your agreement. Use theirs or the lenders or you lose.
- Don't get cheap on the deposit. It's $500 - $1,000, up to $2,000. Any less may not meet seller's requirement and indicates you're broke. <u>You only need one deposit with multiple offers until your second offer gets accepted.</u>
- Don't remove their signs or change locks behind their lock box.
- Don't keep the house off the market for the full escrow period if it becomes obvious you won't close. Tell him/her you can't close and why and release it. Yes, you will lose your deposit. It's the honorable thing to do and you may save the relationship in the process.
- Don't build your business with only one agent in your life. One is the worst number is business.
- Don't let the agent push you into doing things you don't want to do, such as close early. You tell them when to close.
- Don't get cocky and think you have all the answers or assume because an agent wants to do things different than your norm that they are wrong and you're right. Shut up and listen and you'll learn a lot from people who spend their lives with real estate. This includes the right vendors to make your life easier.

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Auctions – Online And Offline

In many cities there are frequent auctions of bank owned properties. These should be made a part of any serious wholesalers business for as long as they continue.

Go to Google and locate auction companies in your area and get on their email and mailing list.

When one is coming up, pull up all the properties in your area and do the same due diligence you would for any other house. Here are the steps for an offline auction:

1. Pick the houses that interest you by area and price range.

2. Have someone visit each to get photos and general repair estimate (coming up), and pull comps to determine the after repaired value.

3. Write down your absolute maximum bid on each (coming up).

4. Attend the auction with certified funds for deposits and proof of funds (coming up). Follow the instructions in the auction brochure.

5. Never bid until the bidding has almost stopped and then in the minimum increment.

<u>Tips</u>

- Do not leave early unless you've bought all you want. Even then you can leave the auctioneer a bid on all unsold houses and will likely get one or more accepted after the sale, especially if you're bidding on several owned by one lender.

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- Do not bid on houses you haven't done due diligence. This one will burn you. Let it go.
- Do not get caught up in the auction frenzy and pay too much. The spotters are not your friend.
- Don't forget to add the buyer's premium to your bid. They will.
- Many contracts will contain a "subject to" addendum which gives the bank 15 days to turn down your bid even if you are high bidder – you will lose some.

Online Auctions

The same rules apply as offline except there is no place to attend the auction. All bidding is done online over a period of several days. This takes the pressure off you but opens it up to the world to bid.

Today there are constant online auctions in cities of size and bargains are sold every week.

Do your homework and enter the bidding in the last hour of the last day if the high bid is still below your max. You won't be alone. You'll see several bids on the last day.

This makes a case for you to wait until the day of or day before to inspect any auction house. Why waste the time if someone has already paid too much?

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Step 5: Prescreening Your Prospects

Actually, you have already done most of the necessary prescreening if you've followed the previous steps as I've laid them out. However, there are things we need to discuss to ensure you have a clear understanding of what constitutes a good prospect. I've thoroughly covered this in the course. It would pay you to review the course again instead of chasing dead end leads. In a nutshell, a good prospect to be purchased wholesale will have the following components:

- Probably vacant (not mandatory)
- Probably needs a lot of repairs (not mandatory but these are usually good prospects)
- Asking price is at least 30% below ARV
- Has a lot of equity or is free and clear (mandatory unless you intend to short sale)
- At least 850 square feet and preferably 3 or more bedrooms

Once you have compiled a list of suspects, the next step is to whittle the list down to the best prospects as described in your course as well as above. We don't have time to chase dead ends. Our objective is to deal only with the prospects that have the best chance of success. The better you get at prescreening the easier your job will become. You'll begin making more money with less work. However, I'm fully aware that all crafts have to be learned by doing things wrong so you can learn to do them right. In the beginning you'll spend time on unqualified prospects. It won't hurt you a bit as long as you don't lose sight of the main objective.

Weed Out And Deal With Only Motivated Sellers, Unmotivated Sellers Will Quickly Destroy Your Confidence.

With FSBO's, when you've found a motivated seller you'll know it. You'll see a whole different attitude. Many times they will ask you if you can help them, not grill you on why they should allow you to buy their home. Just remember, you are in control, you don't beg, drag or plead with anyone. They are either in or out. Your job is to prescreen, not to try making an unmotivated seller motivated. Make or take the call, get facts and control the conversation in a polite and friendly manner. Those who want to play will surface quickly. Remember, some will, some won't, so what, someone's waiting. If speaking to people is a problem for you, you have two choices. Get someone else to do it or make offers only on listed junkers. This way the agent makes the contact with the seller.

Before proceeding to the next step, you should have a pile of prescreened prospects amassed from a heap of suspects. Remember, prescreened prospects only. If at this point you don't feel you have any worthwhile prospects to work with, don't move on until you do. I'd rather you stop here and keep looking than get beat up by an unmotivated seller. If you're a brand new real estate entrepreneur my experience tells me you can't take much rejection before you convince yourself there aren't any motivated sellers out there.

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There are plenty! More than you will ever come in contact with in a lifetime of looking. However, you must look in the right place or the right brand of prospects. Remember, it only takes one little wholesale deal to put several thousand dollars in your pocket. Once you master these steps, you can do several deals per month or just an occasional one. It all starts with:

Locating And Prescreening Prospects

Your prospects will either be **FSBO's** or **Listed**.

For FSBO's, use the script on the next page.

For listed properties, the biggest qualifier I use is all the houses that are listed well below the ARV, at least 30%. Some are listed at MAO or below (coming up). I will instruct the Realtor to seek out only these prospects but there are other considerations to help the search.

- Area I want to work
- Price range I want to stay in
- Search words such as foreclosure, bank owned, needs work, TLC and many more any REO Realtor will know
- Time on market. The longer it's been for sale the easier it is to buy.
- Price per square foot search. If the average house in a neighborhood in good condition is selling for $100 per square foot, I may ask the agent to pull up all houses listed at $70 per square foot or below. That means the house or seller likely has a problem.

Before you can prescreen any house, pretty or ugly, you must know:

- The ARV – After Repaired Value
- The asking price, only seller knows.
- The loan balance, only the seller knows.
- Approximate repair cost, your best guess.

The ARV is easy to obtain and on listed properties the agent will get for you.

The asking price is on all listings and if it's bank owned there is no loan.

The repairs you can do from a photo with a little practice and a visit to Quick Start Real Estate School. See the resource section.

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Script For Prescreening FSBO's That Appear To Be Free And Clear Or With Small Loan Balances

"<u>First Name</u>, if I pay you all cash and close quickly, what's the least you can accept?"

(Regardless of the answer):
"Is that the best you can do?"

(Regardless of the answer):
"So you're saying if I don't pay you _____ you won't sell me the house?"

- If you like the answer, get a contract
- If you don't like the answer, leave the door open

"Well, I'm sorry but I just can't pay you what you're asking. Let me know if things change."

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Step 6: Constructing Offers

By now you should have a list of ugly house prospects. When constructing offers on junkers the formula discussed in the course must be understood and applied. Review it until you feel comfortable with how to arrive at an offer based on the information you've collected on the house. To do this you must know the ARV and an approximate amount needed for repairs. Neither needs to be exact, but both should be in the ballpark. The ARV should be within 10% plus or minus and repairs can be as far off as 50% on most houses.

I've discussed how to determine the ARV in this guide. I will also cover repairs. If you don't feel comfortable estimating repairs after listening to the course, remember, you don't have to be that close. A few thousand dollars off will not destroy the deal if you make offers as I've taught you to do using my system. You'll learn as you grow. We've discussed ARV. Now let's cover estimating repairs and what to offer.

General Rehab Costs For Major Components

The following estimated rehab costs are based on a 1,200 square foot, single story house. These costs are only a guideline. If you intend to buy and rehab the house you should get repair estimates before you close. These numbers include materials and labor.

- **Floor Covering** – $1.50 per square foot, regardless of whether it's carpet, linoleum, or hardwood refinishing, $13.50 per square yard.
- **Windows** – $150 in the south and $200 in the north. The windows actually cost $60 - $80 each.
- **Interior Paint** – $1,000 should cover any 1,200 square foot interior.
- **Exterior Paint** – $2,000 for the whole house including trim.
- **Roof** – $3,500 should totally replace our model roof. This does not include a lot of rotten wood replacement.
- **Central Heat And Air** – $3,500 with all new equipment and duct work. This does not include changing panel box.
- **Kitchen** – $1,200 - $1,500 assuming you're gutting the kitchen and replacing 6' of upper and lower cabinets, sink, counter top, faucet and labor. This does not include appliances.

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- **Bath** – $1,200 assuming you're gutting the bath and replacing tub, toilet, sink and cabinet and wall fixtures. This includes a fiberglass tub unit and/or the wall surrounding the tub if a one piece unit won't fit.
- **Electrical** – $1,000 - $2,000 will replace the panel box with a 200 amp system in most areas. This is usually the biggest electrical expense. All the rest will normally be done by your general rehabber – items like fans, lights and plug replacements.
- **Plumbing** – the only plumbing in our model is kitchen, bath, water heater and pipes. Kitchen and bath are already covered above. A water heater will cost about $400 installed. Pipes are not a major component and are very inexpensive to replace.
- **Garage Doors** – $500 for a single, $1,000 for a double, installed.
- **Concrete** – About $4 per square foot.
- **Asphalt** – About $1.50 per square foot.
- **Rotten Wood** – This is not a major component unless there's an excessive amount of damage. The cost will be in the hundreds as a rule, not the thousands. Wood is relatively cheap to fix. Don't let it scare you away.
- **Miscellaneous** – $1,000 minimum, but usually runs about 20% of total rehab cost. This can only be done on a case by case basis.
- **Foundation** – There's no way to put a figure to this because of the varying degree of situations. However, foundation problems usually cost a fraction of what they appear. This creates opportunity for you and should not scare you off. Once you get a feel for what foundation repairs really cost, you'll probably be looking for them.

Note

These numbers are based on a 1,200 square foot, single story house. You must adjust upward for larger houses.

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Inspection Checklist

Most Common Major Components		Estimated Cost
W	Windows	$200 Each
E	Electric	$1,500 Panel Box
Make	Misc.	20% Of The Total Of Major Components
Killer	Kitchen	$1,800 If Gutted
Bucks	Baths	$1,000 Guest, $2,000 For Master, Gutted
With	Wood	Case By Case
C	Carpet	$1.50 Per Sq. Ft. = $13.50/YD
R	Roof	$3,500 - $4,000 To Remove & Replace
A	A/C – Heat	$3,000 - $3,500 Central Heat & Air
P	Paint	$3,000 Interior & Exterior
P	Plumbing	Case By Case – Usually Simple Repairs

Additional Components

Basement	Case By Case
Foundation	Case By Case – Usually Less Than Appears
Garage Doors	$400 Single/$800 Double – Without Opener
Pool	$3,000 - $4,000 Vinyl Liner Or Repaint And $700 For New Equipment Plus Marcite!
Driveways	$4 Per Sq. Ft. Asphalt

Notice

These numbers are based on a 1,200 square foot single story house and must be adjusted upward as size increases. It would be reasonable to assume a 50% increase in total repair cost if the house is 1,800 square feet (50% larger).

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Miscellaneous Repair List

Interior

Mini Blinds
Glass
Doors and Hardware
Light Fixtures
Wall Repair
Wall Paper
Ceiling Fans
Range Hood
Faucets
Minor Plumbing
Dishwasher
Shower Curtains
Medicine Cabinets
Toilets
Electrical Switch Plates
Broken Tiles
Minor Repairs
Hot Water Heater
Appliances

_____
_____
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Exterior

Screens
Landscaping
House Numbers
Mailboxes
Minor Wood Repair
Termite Treatment
Roof Repair
Gutters
Trash Removal
Outbuildings
Pavement Repair

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Do not try to estimate these items individually. This list serves only as a guideline of items we try to classify as miscellaneous. Usually the miscellaneous estimate will fall between 15 – 25% of all other repair costs. This is strictly case by case.

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Determining The MAO
(Maximum Allowable Offer)

All Cash Offers (ONLY)
(DOES NOT APPLY) To Pretty Houses
Where You Take Over Debt

	% of ARV	Example
1. Determine the After Repaired Value		$100,000
2. Subtract the Repair Costs	Can't use %	- $10,000
3. Subtract the Purchase Costs (This does not include down payment or purchases prices.)	1%	- $ 1,000
4. Subtract the Holding Costs (Add payments when applicable.)	3%	- $ 3,000
5. Subtract the Sales Costs (3% without Realtor)	3%	- $ 3,000
6. Subtract minimum acceptable Profit	20%	- $20,000
7. Subtract a Hedge Factor (Approx. 3% - 5% of sale price.)	3%	- $ 3,000
8. The result will be your Maximum Allowable Offer. (MAO). THIS IS NOT YOUR OFFER, but only a threshold you can not cross without sacrificing profit.	30%	**$ 60,000**

Simple Formula

ARV x 70% - Repairs = MAO

Never Pay MAO

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So What Do I Pay?

It depends!

- The more repairs, the less percentage of ARV you should pay.
- The nicer the neighborhood, the closer to MAO.
- The more the supply, the lower the offer.
- The less competition, the lower the offer, i.e. ant farm and FSBO's. The easier they are to find, the more they cost, i.e. MLS listings and internet houses.
- Your personal objectives and exit plan and willingness to work harder to get at the best deals.
- Canadians will pay closer to MAO than U.S. investors will.

In today's market in the U.S., I would not exceed 80% of MAO and many offers will be less in lower quality areas.

In Canada, I would not exceed 90% of MAO.

Remember, MAO Only Applies
To All Cash Offers.

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Step 7: Presenting Offers

If you're working with agents you should only be dealing with ugly houses or short sales. In this case presenting offers is easy. They will do it for you. Your job is to locate and prescreen the prospect and then tell the agent what you'll pay. They'll do the rest.

Never tell an agent you need a buyer before you can close. This is an instant deal killer. If the agent suspects you don't have funds available they will be very reluctant to work with you. You must act credible and present your offer with conviction. Act like you have the money, even if you don't. If agents become a problem you'd rather not deal with then simply don't make offers on listed houses. There's a whole city full of FSBO's just waiting for you.

If the house is listed be prepared to put up an earnest money deposit with a minimum of $500 to a maximum of $2,000. If any more than this is required, you may elect not to deal with the property or agent until you get a little more experienced.

When making offers with FSBO's on junkers the terms are simple. Will the seller accept what you're willing to pay? If so, write up an agreement. If not, what will they take and will they finance for you or is all cash the only offer they will consider? This can be done in person or by phone. If the seller is out of town then obviously it will be by phone.

If your offer is orally accepted you must get it in writing as fast as possible and send the seller a $10 deposit for consideration. Do not go to the next step until the signed contract is in your hands.

Before sending the contract to the seller, ask if he/she is the only one on title. If not, all sellers must sign.

If one is deceased, ask seller to return a copy of the death certificate and a copy of their deed with the signed contract. Send both to your closing agent in the next step.

Be sure to send the seller a copy of the agreement after they sign and return to you.

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Where Do I Get Proof Of Funds?

In today's market you will not buy bank owned properties without proof of funds. You will need it with all MLS and auction properties.

You can use any bank statement from a relative or friend or even a private lender. The statement usually does not have to come from the buyer's account.

You may also use IRA accounts, stock or money market accounts.

An additional source is a service provided by a few companies who will provide proof of funds for a small fee. One such source is found in the resource section of this manual and it's an online application so you can provide a POF letter at will.

If you can't provide proof of funds or use the service provided here, your only choices are to:

- Make an offer on FSBO's only.
- Get a partner to supply POF and maybe even the capital to close if needed.

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Step 8: Preparing A Standard Purchase And Sales Agreement

If the property is listed, this will be the agent's responsibility. All you need to know is the offering price, size of deposit you're offering, costs you're willing to pay, buyer's name and time you're asking to close. He/she will do the rest. You'll pay customary closing costs and need 30 days to close. You should meet little or no resistance to these guidelines in most cases. If you meet resistance, it will probably be the deposit. Some agents will want more. In today's market, you will need proof of funds to attach to most listed bank owned houses.

Creating your own agreement to buy junkers from FSBO's may seem scary in the beginning. However, if you'll take time to read over the agreement in your course, I think you'll find them manageable. All you do is fill in the blanks based on your understanding of your agreement with the seller. It's always a good idea to have the agreements you intend to use checked by a professional before using them. Some states may require an additional disclosure form or have some provision that should be in your agreement.

Presenting offers and preparing agreements will be quick and easy to learn, but can only be mastered with practice. When the seller is ready to complete the paperwork, you should be prepared to do so on the spot. This involves producing your agreement and briefly discussing the context.

You must make sure all owners of the property sign to have a valid agreement. The best way to verify ownership is to see the seller's deed or other legal documents showing ownership.

Always retain the original agreement and leave the seller a copy. It's not good practice to write up two original contracts by hand.

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ALL CASH
Buying A Junker

Standard Purchase and Sales Agreement

Parties You (BUYER) and Seller (SELLER) which terms may be singular or plural and will include the heirs successors, personal representatives and assigns of Seller and Buyer, hereby agree that Seller will sell and Buyer will buy the following property, upon the following terms and conditions if completed or marked. In any conflict of terms or conditions, that which is added will supersede that which is printed or marked.

The Property is in Clark County, and is described as follows (If lengthy, attach legal description): Lot 12, Block 3 Hartley S/D

Address 1034 Peach St. ZIP _____

It is understood that the Property will be conveyed by General Warranty Deed (unless otherwise required) subject to taxes, existing zoning (unless otherwise specified in paragraph 16), covenants, restrictions and easements of record.

1. Total Purchase Price to be paid by Buyer is payable as follows:
   A. Binder deposit which will remain as a binder until closing, unless sooner forfeited or returned, according to the provisions in this Agreement $ 10.00

   B. Additional binder deposit due within _____days after date of this agreement $_____

   C. Balance due at closing (not including Buyer's closing cost, prepaid items or prorations) in U.S. cash or locally drawn certified or cashiers check approx. _____ exactly ✓ $ 79,990.00

   D. Proceeds of a new loan to be executed by Buyer to any lender other than Seller $_____

   E. Purchase money loan to Seller on terms set forth in Paragraph 2C $_____

   F. Other financing _____ $_____

   G. Existing mortgage balance encumbering the Property to be assumed by Buyer (approximately) $_____

   H. Total Purchase Price approx. _____ exactly ✓ $ 80,000.00

2. Financing: If buyer does not obtain the required financing, but otherwise complies with the terms hereof, the binder deposit less sales and loan processing costs incurred, will be returned to the Buyer.
   A. [ ] Application: The application for the mortgage described in paragraph 1D will be made with lender selected by [ ] Seller of [ ] Buyer. Unless such mortgage loan is approved without continued contingencies other than those elsewhere covered in this agreement within _____days of the date of acceptance of this agreement, Seller and Buyer will have the right to terminate this agreement, and Buyer will return to Seller all the title evidence and surveys received from Seller. Buyer will make application for financing within ____days of the date of acceptance of this agreement and in a timely manner furnish any and all credit, employment, financial and other information required by the lender. In the event the original loan application is denied, Buyer, if requested by Seller, will reapply within _____ days of such request at an alternate institution.

   B. [ ] Loan Assumption: Buyer understands that interest [ ] will [ ] will not, escalate and is [ ] variable [ ] fixed rate. Buyer will within ___days make required application and timely provide qualifying information as required by lender. Buyer's obligation to close is contingent on lender's approval of the assumption within _____days of the date of acceptance of this agreement.

   C. [ ] Seller: The balance due to Seller will be evidenced by a negotiable promissory note of Borrower, secured by a valid purchase money____ mortgage or Trust Deed on the Property and delivered by Buyer to Seller dated the date of closing bearing annual interest rate of _____ % and payable $_____ per_____ for [ ] ___ years [ ] ____ months. Privilege of prepayment [ ] does apply [ ] does not apply. The loan will be ____due on sale ___ not due on sale of Property.

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3. Buyer Will Pay:
Closing Costs [X] Recording fees [ ] Note stamps [ ] Intangible tax [ ] Credit reports [ ] Loan transfer and assumption charges [ ] VA funding fee [ ] Loan origination fee [ ] Loan insurance premium [ ] Loan discount not to exceed _____ [ ] Transfer Tax [ ] Wood Destroying Organism Report [ ] Appraisal [ ] Survey [ ] Title Insurance Policy _____.

4. Seller Will Pay:
A. Closing Costs [X] Transfer tax [X] Fee Title insurance policy [ ] _____Attorney's fee [ ] Real estate brokerage fee [ ]Loan discount not to exceed _____ [ ]Satisfaction and recording fee [ ] Repairs or replacements, in addition to those in paragraph 9, not to exceed $_____ [ ] Wood destroying organism report [ ] Appraisal fee [ ] Survey [ ] Other_____

B. All other charges required by lender which Buyer is prohibited from paying by law or regulation.

C. All mortgage payments or condominium and association fees will be current at Seller's expense at the time of closing.

5. Payment of Expenses: If Buyer fails to perform, all loan and sale processing and closing costs incurred, whether the same were to be paid by Seller or Buyer will be the responsibility of the Buyer, with costs deducted from binder deposit. If Seller fails to perform, all loans, sales processing and closing costs incurred whether same were to be paid by Seller or Buyer will be the responsibility of Seller, and Buyer will be entitled to the return of the Binder deposit This will include, but not be limited to the transaction not being closed because Seller is unable to complete the transaction for a qualified Buyer, or because the property does not appraise for an amount sufficient to enable the lender to make the required loan, or because Seller elects not to pay for the excess amount in paragraphs 4 (with respect to repairs), 9, or 11, or because the zoning is not as required in paragraph 16 or because Seller cannot deliver marketable title.

6. Prorations: All taxes, rentals, condominium or association fees, prepaid hazard insurance premiums (if assumed), monthly mortgage insurance premiums and interest on loans will be prorated as of the date of closing.

7. Title Evidence: Within 5 days [ ] after acceptance [ ] after date of satisfaction of all conditions in paragraph 19. Seller will deliver to Buyer or closing attorney [ ]Title insurance commitment for an owner's policy in the amount of the purchase price. Any expense of curing title including, but not limited to legal fees, discharge of liens and recording fees will be paid by Seller.

8. Survey: Within _____days [ ] after date of acceptance [ ] after date of satisfaction of all conditions on paragraph 19, Seller will deliver to Buyer or closing attorney [ ]A new staked survey dated within 3 months of closing showing all improvements now existing thereon and certified to Buyer, lender and the title insurer [ ] A copy of a previously made survey of the Property showing all improvements now existing thereon.[ ] No survey is required.

9. Wood Destroying Organism Report: "Wood Destroying Organism" means any arthropod or plant life which damages a structure. Buyer may have property inspected by a Certified Pest Control Firm to determine whether there is any visible active wood destroying organism infestation or visible existing structural damage from wood destroying organisms to the improvements. If Buyer is informed of either or both of the foregoing, Seller will have seven (7) days from receipt of written notice thereof within which to have all such wood destroying organism damages whether visible or not inspected and estimated by a licensed building or general contractor. Seller will pay costs of treatment and repairs of all structural damage up to one percent (1 %) of the purchase price. If such costs exceed the amount agreed to be paid by Seller and Seller declines to treat and repair, Buyer will have the option of (a) terminating this Agreement or, (b) proceeding with the transaction in which event Seller will bear costs equal to one percent (1 %) of the purchase price.

10. Title Examination and Time for Closing:
A. If title evidence and survey, as specified above, show Seller is vested with a marketable title, subject to the usual exceptions contained in title insurance commitments (such as exceptions for survey, current taxes, zoning ordinances, covenants, restrictions and easements of record), the transaction will be closed and the deed and other closing papers delivered on or before [ ] _____ [ ] 30 days after the date of acceptance [ ] _____days after date of satisfaction of all conditions in paragraph 19 unless extended by other conditions of this Agreement or this agreement is cancelled by the Buyer.

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B. If title evidence or survey reveal any defects which render the title unmarketable, Buyer will have 7 days from receipt of title commitment and survey to notify Seller of such title defects and Seller agrees to use reasonable diligence to cure such defects at Seller's expense and will have 30 days to do so, in which event this transaction will be closed within 10 days after delivery to Buyer of evidence that such defects have been cured. Seller agrees to pay for and discharge all due or delinquent taxes, liens and other encumbrances, unless otherwise agreed. If Seller is unable to convey to Buyer a marketable title, Buyer will have the right to terminate this agreement at the same time returning to Seller all title evidence and surveys received from Seller, or Buyer will have the right to accept such title as Seller may be able to convey and to close this transaction upon the terms stated herein, which election will he exercised within 10 days from notice of Seller's inability to cure.

11. Loss or Damage: If the property is damaged by fire or other casualty prior to closing, and cost of restoration does not exceed 3% of the assessed valuation of the improvements located on the Property, cost of restoration will be an obligation of the Seller and closing will proceed pursuant to the terms of this Agreement with cost thereof escrowing at closing. In the event cost of restoration exceeds 3% of the assessed valuation of the improvements and the Seller declines to repair or restore, Buyer will have the option of either taking the Property as is, together with either the said 3% or any insurance proceeds payable by virtue of such loss or damage, or of canceling this Agreement.

12. Seller agrees to deliver the Property in its PRESENT AS IS CONDITION except as otherwise specified herein. Seller does hereby certify and represent that Seller has legal authority and capacity to convey the property with all improvements. Seller further certifies and represents that Seller knows of no latent defects to the property and knows of no facts materially affecting the value of the property except the following: Description of problems: _____ Buyer has inspected the property and HAS NOT RELIED UPON ANY REPRESENTATIONS MADE BY ANY REAL ESTATE AGENT in describing the property, and Buyer accepts the property in its PRESENT AS IS CONDITION, except as otherwise specified herein.

13. Occupancy: [X] Seller represents that there are no parties in occupancy other than Seller. Buyer will be given occupancy at closing unless otherwise specified
herein _____
[ ] Buyer understands that property is available for rent or rented and the tenant may continue in possession following closing unless otherwise agreed in writing. Deposits will he transferred to Buyer at closing.

14. Personal Property: included in the purchase price are all fixed equipment including ceiling fans, drapery, hardware, attached lighting fixtures, mailbox, fence, plants and shrubbery as now installed on the property and these additional items range, refrigerator
Items specifically excluded from this agreement: _____.

15. Default and Attorney's Fees: If Buyer defaults on this agreement, all deposits will be retained by the Seller as full settlement of any claim, whereupon Buyer and Seller will be relieved of all obligations under this agreement. If Seller defaults under this Agreement, the Buyer may seek specific performance or elect to receive the return of the Buyers deposit(s) without thereby waiving any action for damages resulting from Seller's breach. In connection with any litigation arising out of this Agreement, the prevailing party will be entitled to recover all costs including a reasonable attorney's fee.

16. [X] Zoning and Restrictions: Unless the Property is zoned SF and can he legally used for SF use, or if there is notice of proposed zoning changes, deed or other restrictions that could prevent such use at time of closing, Buyer will have the right to terminate this Agreement. Buyer will have 10 days from acceptance to verify the existing zoning and current proposed changes, and deliver written notice of objections to Seller or be deemed to have waived objections under this paragraph.

17. The offer of BUYER shall terminate if SELLER has not indicated his acceptance of this Agreement by signing and delivering same or telegraphing acceptance to BUYER or submitting agent before _____:01[ ]AM.[ ]PM., Date _____.

18. Additional Terms, Conditions or Addenda (lettered A.B.C.D.etc.)

_____

_____

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19. Timing: The timing of paragraphs 7, 8, 9, and 10(A) will become operable after satisfaction of paragraph 2, if applicable, and those additional conditions lettered in Paragraph 18.

20. There are no other agreements, promises or understandings between these parties except as specifically set forth herein. This legal and binding agreement will be construed under_____ Law, will not be recorded and if not understood, parties should seek competent legal advice. Seller and Buyer give real estate agent authorization to advise surrounding neighbors who will be the owner of this property. TIME IS OF THE ESSENCE IN THIS AGREEMENT.

21. Signed sealed on the date herein stated

_____	_____	You
Buyer	Date of Offer	Buyer
Seller	_____	_____
Seller	Date of Acceptance	Seller

[ ] Agent [_] Seller, by the signature below, acknowledge receipt of $ 10.00 [ ]Cash [X] Check, as binder deposit, which is the amount mentioned in paragraph 1 A of this Agreement. It will be deposited and held in escrow pending disbursement according to terms hereof, together with all additional binder deposits escrowed by terms of this agreement.

_____	Seller
Agent	Seller

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ALL CASH
Selling A Junker You Own

Standard Purchase and Sales Agreement

Parties Your Buyer (BUYER) and You (SELLER) which terms may be singular or plural and will include the heirs successors, personal representatives and assigns of Seller and Buyer, hereby agree that Seller will sell and Buyer will buy the following property, upon the following terms and conditions if completed or marked. In any conflict of terms or conditions, that which is added will supersede that which is printed or marked.

The Property is in Clark County, and is described as follows (If lengthy, attach legal description): Lot 12, Block 3, Hartley, S/D

Address 1034 Peach St. ZIP_____

It is understood that the Property will be conveyed by General Warranty Deed (unless otherwise required) subject to taxes, existing zoning (unless otherwise specified in paragraph 16), covenants, restrictions and easements of record.

1. Total Purchase Price to be paid by Buyer is payable as follows:
   A. Binder deposit which will remain as a binder until closing, unless sooner forfeited or retuned, according to the provisions in this Agreement $500.00

   B. Additional binder deposit due within _____days after date of this agreement $_____

   C. Balance due at closing (not including Buyer's closing cost, prepaid items or prorations) in U.S. cash or locally drawn certified or cashiers check approx. _____ exactly X $89,500.00

   D. Proceeds of a new loan to be executed by Buyer to any lender other than Seller $_____

   E. Purchase money loan to Seller on terms set forth in Paragraph 2C $_____

   F. Other financing _____ $_____

   G. Existing mortgage balance encumbering the Property to be assumed by Buyer (approximately) $_____

   H. Total Purchase Price approx. _____ exactly X $90,000.00

2. Financing: If buyer does not obtain the required financing, but otherwise complies with the terms hereof, the binder deposit less sales and loan processing costs incurred, will be returned to the Buyer.
   A. [ ] Application: The application for the mortgage described in paragraph 1D will be made with lender selected by [ ] Seller of [ ] Buyer. Unless such mortgage loan is approved without continued contingencies other than those elsewhere covered in this agreement within _____days of the date of acceptance of this agreement, Seller and Buyer will have the right to terminate this agreement, and Buyer will return to Seller all the title evidence and surveys received from Seller. Buyer will make application for financing within ____days of the date of acceptance of this agreement and in a timely manner furnish any and all credit, employment, financial and other information required by the lender. In the event the original loan application is denied, Buyer, if requested by Seller, will reapply within _____ days of such request at an alternate institution.

   B. [ ] Loan Assumption: Buyer understands that interest [ ] will [ ] will not, escalate and is [ ] variable [ ] fixed rate. Buyer will within ___days make required application and timely provide qualifying information as required by lender. Buyer's obligation to close is contingent on lender's approval of the assumption within _____days of the date of acceptance of this agreement.

   C [ ]Seller: The balance due to Seller will be evidenced by a negotiable promissory note of Borrower, secured by a valid purchase money____ mortgage or Trust Deed on the Property and delivered by Buyer to Seller dated the date of closing bearing annual interest rate of _____ % and payable $_____ per_____for [ ] ___years [ ] ____ months. Privilege of prepayment [ ] does apply [ ] does not apply. The loan will be ____due on sale ___ not due on sale of Property.

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3. Buyer Will Pay:

Closing Costs [X] Recording fees [ ] Note stamps [ ] Intangible tax [ ] Credit reports [ ] Loan transfer and assumption charges [ ] VA funding fee [ ] Loan origination fee [ ] Loan insurance premium [ ] Loan discount not to exceed _____ [X] Transfer Tax [ ] Wood Destroying Organism Report [ ] Appraisal [ ] Survey [X] Title Insurance Policy _____.

4. Seller Will Pay:

A. Closing Costs [ ] Transfer tax [ ] _____Title insurance policy [ ] _____Attorney's fee [ ] Real estate brokerage fee [ ]Loan discount not to exceed _____ [X]Satisfaction and recording fee [ ] Repairs or replacements, in addition to those in paragraph 9, not to exceed $_____ [ ] Wood destroying organism report [ ] Appraisal fee [ ] Survey [ ] Other_____

B. All other charges required by lender which Buyer is prohibited from paying by law or regulation.

C. All mortgage payments or condominium and association fees will be current at Seller's expense at the time of closing.

5. Payment of Expenses: If Buyer fails to perform, all loan and sale processing and closing costs incurred, whether the same were to be paid by Seller or Buyer will be the responsibility of the Buyer, with costs deducted from binder deposit. If Seller fails to perform, all loans, sales processing and closing costs incurred whether same were to be paid by Seller or Buyer will be the responsibility of Seller, and Buyer will be entitled to the return of the Binder deposit. This will include, but not be limited to the transaction not being closed because Seller is unable to complete the transaction for a qualified Buyer, or because the property does not appraise for an amount sufficient to enable the lender to make the required loan, or because Seller elects not to pay for the excess amount in paragraphs 4 (with respect to repairs), 9, or 11, or because the zoning is not as required in paragraph 16 or because Seller cannot deliver marketable title.

6. ~~Prorations: All taxes, rentals, condominium or association fees, prepaid hazard insurance premiums (if assumed), monthly mortgage insurance premiums and interest on loans will be prorated as of the date of closing.~~

7. Title Evidence: Within _5_days [X] after acceptance [ ] after date of satisfaction of all conditions in paragraph 19. Seller will deliver to Buyer or closing attorney [ ]Title insurance commitment for an owner's policy in the amount of the purchase price. Any expense of curing title including, but not limited to legal fees, discharge of liens and recording fees will be paid by Seller.

8. Survey: Within _____days [ ] after date of acceptance [ ] after date of satisfaction of all conditions on paragraph 19, Seller will deliver to Buyer or closing attorney [ ]A new staked survey dated within 3 months of closing showing all improvements now existing thereon and certified to Buyer, lender and the title insurer [ ]A copy of a previously made survey of the Property showing all improvements now existing thereon.[ ] No survey is required.

9. ~~Wood-destroying Organism Report: "Wood Destroying Organism" means any arthropod or plant life which damages a structure. Buyer may have property inspected by a Certified Pest Control Firm to determine whether there is any visible active wood destroying organism infestation or visible existing structural damage from wood destroying organisms to the improvements. If Buyer is informed of either or both of the foregoing, Seller will have seven (7) days from receipt of written notice thereof within which to have all such wood destroying organism damages whether visible or not inspected and estimated by a licensed building or general contractor. Seller will pay costs of treatment and repairs of all structural damage up to one percent (1 %) of the purchase price. If such costs exceed the amount agreed to be paid by Seller and Seller declines to treat and repair, Buyer will have the option of (a) terminating this Agreement or, (b) proceeding with the transaction in which event Seller will bear costs equal to one percent (1 %) of the purchase price.~~

10. Title Examination and Time for Closing:

A. If title evidence and survey, as specified above, show Seller is vested with a marketable title, subject to the usual exceptions contained in title insurance commitments (such as exceptions for survey, current taxes, zoning ordinances, covenants, restrictions and easements of record), the transaction will be closed and the deed and other closing papers delivered on or before [ ] _____ [X] _15_ days after the date of acceptance [ ] _____days after date of satisfaction of all conditions in paragraph 19 unless extended by other conditions of this Agreement or this agreement is cancelled by the Buyer.

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B. If title evidence or survey reveal any defects which render the title unmarketable, Buyer will have 7 days from receipt of title commitment and survey to notify Seller of such title defects and Seller agrees to use reasonable diligence to cure such defects at Seller's expense and will have 30 days to do so, in which event this transaction will be closed within 10 days after delivery to Buyer of evidence that such defects have been cured. Seller agrees to pay for and discharge all due or delinquent taxes, liens and other encumbrances, unless otherwise agreed. If Selleris unable to convey to Buyer a marketable title, Buyer will have the right to terminate this agreement at the same time returning to Seller all title evidence and surveys received from Seller, or Buyer will have the right to accept such title as Seller may be able to convey and to close this transaction upon the terms stated herein, which election will he exercised within 10 days from notice of Seller's inability to cure.

11. Loss or Damage: If the property is damaged by fire or other casualty prior to closing, and cost of restoration does not exceed 3% of the assessed valuation of the improvements located on the Property, cost of restoration will be an obligation of the Seller and closing will proceed pursuant to the terms of this Agreement with cost thereof escrowing at closing. In the event cost of restoration exceeds 3% of the assessed valuation of the improvements and the Seller declines to repair or restore, Buyer will have the option of either taking the Property as is, together with either the said 3% or any insurance proceeds payable by virtue of such loss or damage, or of canceling this Agreement.

12. Seller agrees to deliver the Property in its PRESENT AS IS CONDITION except as otherwise specified herein. Seller does hereby certify and represent that Seller has legal authority and capacity to convey the property with all improvements. Seller further certifies and represents that Seller knows of no latent defects to the property and knows of no facts materially affecting the value of the property except the following: Description of problems: No Warranties Buyer has inspected the property and HAS NOT RELIED UPON ANY REPRESENTATIONS MADE BY ANY REAL ESTATE AGENT in describing the property, and Buyer accepts the property in its PRESENT AS IS CONDITION, except as otherwise specified herein.

13. Occupancy: [X] Seller represents that there are no parties in occupancy other than Seller. Buyer will be given occupancy at closing unless otherwise specified
herein _____
[ ] Buyer understands that property is available for rent or rented and the tenant may continue in possession following closing unless otherwise agreed in writing. Deposits will he transferred to Buyer at closing.

14. Personal Property: included in the purchase price are all fixed equipment including ceiling fans, drapery, hardware, attached lighting fixtures, mailbox, fence, plants and shrubbery as now installed on the property and these additional items N/A
Items specifically excluded from this agreement: _____.

15. Default and Attorney's Fees: If Buyer defaults on this agreement, all deposits will be retained by the Seller as full settlement of any claim, whereupon Buyer and Seller will be relieved of all obligations under this agreement. If Seller defaults under this Agreement, the Buyer may seek specific performance or elect to receive the return of the Buyers deposit(s) without thereby waiving any action for damages resulting from Seller's breach. In connection with any litigation arising out of this Agreement, the prevailing party will be entitled to recover all costs including a reasonable attorney's fee.

16. [ ] Zoning and Restrictions: Unless the Property is zoned _____ and can he legally used for_____use, or if there is notice of proposed zoning changes, deed or other restrictions that could prevent such use at time of closing, Buyer will have the right to terminate this Agreement. Buyer will have 10 days from acceptance to verify the existing zoning and current proposed changes, and deliver written notice of objections to Seller or be deemed to have waived objections under this paragraph.

17. The offer of BUYER shall terminate if SELLER has not indicated his acceptance of this Agreement by signing and delivering same or telegraphing acceptance to BUYER or submitting agent before _____:01[ ]AM.[ ]PM., Date _____.

18. Additional Terms, Conditions or Addenda (lettered A.B.C.D.etc.)

_____

_____

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19. Timing: The timing of paragraphs 7,8,9, and 10(A) will become operable after satisfaction of paragraph 2, if applicable, and those additional conditions lettered in Paragraph 18.

20. There are no other agreements, promises or understandings between these parties except as specifically set forth herein. This legal and binding agreement will be construed under_____ Law, will not be recorded and if not understood, parties should seek competent legal advice. Seller and Buyer give real estate agent authorization to advise surrounding neighbors who will be the owner of this property. TIME IS OF THE ESSENCE IN THIS AGREEMENT.

21. Signed sealed on the date herein stated

Your Buyer Buyer	Date of Offer	Buyer
You Seller	Date of Acceptance	Seller

[ ] Agent [X] Seller, by the signature below, acknowledge receipt of $ 500.00 [ ]Cash [X] Check, as binder deposit, which is the amount mentioned in paragraph 1 A of this Agreement. It will be deposited and held in escrow pending disbursement according to terms hereof, together with all additional binder deposits escrowed by terms of this agreement.

Agent	You Seller

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Step 9: Check The Title

Here you are with your first deal under contract to buy. Only a few days or weeks from cashing in. That's great, but before we start the process of selling a junker to a bargain hunter, there is a very important step we must complete.

Either a title company or an attorney must do a little title search to verify there are no liens on the property other than disclosed by the seller. They will also verify the current owner is the only owner and there are no other parties of interest. Until this process is complete, you're not ready to sell. Most states allow title companies to close real estate transactions. Some require attorneys to close. A call to a local title company will acquaint you with the answer.

Ugly Houses To Wholesale

If the property you're buying is an ugly house that was listed with an agent, he/she will want to handle this for you. Simply ask who he/she intends to call for the title work. Tell him/her you'd like to handle the title yourself. If no agent is involved, see **'How Do I Find An Attorney And A Title Company?'** in this manual.

Either call or visit this title company or attorney or pick another of your choice. Hold a short conversation with them about a simultaneous closing and assignment. You must make sure your closing agent won't be a problem when it comes time to close. This is important to ensure the continuity of your deal. Agree on a price for this service before you order a search. The cost should not exceed $100. If it does, shop around. Also, make sure the cost of a search will be deducted from the actual title insurance cost when you close. This is important because you can get a rebate at closing if the seller agreed to pay title insurance or you'll get your policy cost reduced by the cost of the search fee.

Remember, with a wholesale deal you'll be buying and reselling quickly. This will require a title policy for your buyer. Therefore, you won't need a title policy, only a search. Do not let your Realtor get wind you are doing a simultaneous closing. Make certain your title agent doesn't divulge this information either. When you're satisfied the closing agent will perform without being an obstacle, you may order a title check and deliver a copy of your Purchase Agreement if you're doing a closing. If you don't feel comfortable with your

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conversation with the closing agent, find another. This whole process should take place within three days after you get a signed Sales Agreement in your possession.

A title search should not take more than three days to complete. Be sure you clarify this up front. If you're told it will take longer, get the title agent to agree to three days or less, or move on to another. Get a file number for easy reference when you call back to check on the results. All files are referenced with a number, which is assigned at the time of your order. Call back in two or three days to see if the search has been completed. If so, ask if any problems exist. If the answer is no, move on to the next step.

If yes, ask what it will take to clear the title. Report these results to the Realtor, if applicable. Do not go to the next step until you have the clear title. If there is a title problem and no real estate agent is involved, your findings should immediately be relayed to the seller.

At this point, you can void your agreement or get legal help to clear up the problems. The cost should be covered by the seller unless you're willing to cover them yourself. If the seller is not willing to do what's necessary to clear title problems, you can elect to do so or pass. Sometimes title problems can be cleared by a simple document being signed by an affiliated party. Other times, major title problems may occur, which will prevent you from selling the house. That's why this step must take place before your proceed in finding a buyer.

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Step 10: Getting Ready To Sell

Once you know the title is clear, the next move is to prepare the house for sale. This won't be difficult because in most cases you're selling it in "as is" condition if it's an ugly house. So the only concern is when it can be occupied. When wholesaling a house you won't even need to put up a for sale sign. If fact, you shouldn't in most cases since you don't own the house. A sign is not necessary and may attract attention from the seller or agent if placed without permission. If you're using an agent and buying an institutionally owned house, you'll find it difficult to get possession of the property during escrow or permission to clean it up and get a key. It becomes a liability issue. An agent's sign on the house is not a problem once you have a contract.

If the seller is not an institution, it's much easier. You can do pretty much what you can get permission to do. If the yard needs cleaning or the house is trashed and you don't mind getting it done, simply ask. You should be able to get a key as well. However, you are not to spend much money or make any alterations to a house you don't own. Remember, you're selling "as is" for a wholesale price. Your buyer is getting a good deal because of the condition of the house. The most you will do is clean up the premises and secure the doors and windows and usually you won't do that.

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Step 11: Attract Buyers

It's now time to run an ad in the daily paper under "Investment Properties" or a similar column. A three day ad should be sufficient. Before you spend the money on the newspaper, run the ad on Craigslist and every online source you can locate to place the ad. Put "Your City Classified Ad Sources" in Google and make a list of sources. Make sure you're set up with a place for them to go to respond. It could be simply an email to you, which should trigger an auto-responder to them with:

- Location
- Asking price
- Directions
- Bed/Bath and Square Feet
- Your estimated ARV and repairs
- Your contact info, once they see the house
- Instructions to call you after they see the house with your number

Now you've captured their email addresses, which you should now save to build your buyers list, which is your most important asset in this business. See sample email enclosed.

You'll find an info sheet in the resource section about our I-Flip software that automatically locates both buyers and sellers for you. Check it out. The ad should read:

Handyman Special, Cheap, Cash
(Your Phone Number And Email Address)

Don't add anything to the ad. Make sure you or someone working with you is available to take calls or return them.

Don't volunteer any information. Answer only what you're asked and send the prospects to the house you have advertised. Tell them to get in if they can and to just look if they can't. If you have used my formula for making your offer and are reasonably close on your ARV and repairs, your asking price should be below MAO, which should be at least $10,000 more than you agreed to pay.

You are not to visit the house with your callers. They will call back if they're interested or respond by email. Continue this process until you get a buyer who wants to give you a $500 deposit. Make certain they can look into all the windows. You are not to show the house. Let the house show itself.

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Sample Email Auto Responder
(This Will Go To Your Prospect Immediately Upon Their Response To Your Ad)

Thanks for your inquiry. My house is located at 123 Main St. which is in the Northside. It's a 3/2 with 1,283 square feet and concrete block construction. My comps show it's after repaired value to be about $125,000 and our best guess is $10,000 in repairs. The price is $60,000 cash, no terms please. You can see through most of the windows and gain entry once under contract (or you'll find a key over the back door ledge).

Directions – go north on Park St. to Magnolia, left 3 blocks to Main, right 2 blocks to house on your right. There's a Remax sign in yard. Ignore it and call me, Ron Grant at 904-555-5555 if you want the house or email me and I'll submit an agreement.

I get houses like this occasionally and if you would like me to notify you when I do, please answer a couple questions below so I can do so.

What areas would you like to buy houses? _____
_____

When I send you a good deal, can you close within _____ 15 days _____30 days _____ longer?

What's the maximum cash you can raise for a deal? _____

What after repaired price range would you prefer? _____ to _____

Thanks! Contact me as soon as you've seen the house. It won't last long at this price.

Submit Now
(Your Link Here)

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Step 12: Prescreening Buyers

You've run a handyman special ad and you're getting calls and emails from prospective buyers. You've sent several to the property and now one calls you back who shows serious interest and says he/she wants the house. Ask your buyer when he/she would like to close. If the answer is ASAP, you have a real prospect. Any other answer is not acceptable unless you're convinced your buyer is real and can perform. If the buyer needs to see the inside and couldn't gain entry on his/her own, you'll have to make arrangements to get in. If no agent is involved, this can easily be done by getting a key from the owner if you haven't already done so. We do not show houses.

If an agent is involved, ask him/her if you can get a key to show the house to the prospective contractors. Most will cooperate, some will not. If this presents a problem, you may be forced to have an agent meet you at the property with the buyer or instruct the buyer you don't have a key and can't get in at this time.

You'll be surprised to learn when you leave enough profit on the table for your buyer, they will usually find a way in or agree to buy without entry. Your common sense applied to the circumstances surrounding the deal will guide you to the right choice here. Use your own judgment.

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Step 13: Getting A Commitment

Until you have a deposit from your buyer, you have nothing but hot air. Never stop selling the house or building your buyers list and never assume it's sold until your have a check from a closing agent for the full amount.

Even when you get a deposit, you don't know it's sold until you get the money.

There are two key ingredients to ensure that happens. The first is getting a deposit and the second is limiting the closing time so the deal isn't in jeopardy unless you raise the money and buy it.

Deposit – I will not accept less than $500. Anything less quickly tells me it's a time waster trying to tie up my house to flip and chance of closing is 50/50 at best. $500 isn't a lot but it tells me at least there's serious intent from my buyer.

If your asking price is over $50,000, this should be bumped to $1,000 and in some areas more, depending on what's customary and acceptable to your buyers.

However, if you go to the extreme here, you'll lose a lot of good buyers. A $5,000 deposit on a $50,000 sale will meet strong resistance and you'll sit on the house a long time.

The deposit should be made out to you or your entity but don't let it lose a sale if the buyer insists it to be your title company or attorney. Notice I said YOUR title company.

Never let a buyer use their company to escrow your deposit. It's made out to you or your closing agent or tell your buyer to take a hike. NO EXCEPTIONS!

The deposit from your buyer should be the same or more than the deposit you gave the seller if you don't own the house. This may be difficult in the case of some bank owned houses you buy at auction or through the MLS because in today's market, some are asking up to 10% for the deposit. You'll find it very hard to get your buyer to give you a 10% deposit because you don't have the credibility of an auction house or real estate firm with a government regulated escrow

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account. If you go for 10%, you'll likely need to use your title company's escrow account to offset some scrutiny.

Caution

Make sure your title company or attorney produces an escrow agreement that automatically gives you the deposit if buyer doesn't close. This will eliminate his/her signature to get the money. They sign the escrow agreement along with the assignment of contract or sales agreement. This is applicable only if the deposit is not made out to you.

Time For Closing – will determine if your buyer has access to the funds or is simply trying to flip your house. The longer the time requested to close, the less likely they have the money available.

I give my buyers 15 days and often extend to 30, but never longer. You could give them 15 days and build into the agreement a 15 day extension for an additional non-refundable deposit of $1,000 or more.

Do not fall for the stories you'll hear from your prospects on why they need more time. The ones who jerk you around the longest are the ones you'll never close. Your philosophy should be simple, the more time you want, the more money I want up front.

Of course, if you're under a 30 day window to close the purchase, you can't play games with your buyers unless you've lined up the money to close to protect the deal. You'll find it a lot easier to make cash offers and sleep better knowing you can close if you have to. Until you get to that point, a few flippers can pay the bills, but it does mean tighter control over your buyer.

Note

In today's market, many of your buyers will be owner occupants. In this case you can go for a larger deposit and extend more time to close as long as your buyer is not trying to fund your deal with a bank loan. Banks do not loan on ugly houses and your buyer may not know this yet. Don't let them learn at your expense.

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ASSIGNMENT

This assignment is made and entered into this ____ day of _____, 20____ by and between _____, with its principal place of business at _____ ("Assignor"), and _____, (with its principal place of business at/residing at) _____ ("Assignee").

WHEREAS, Assignor is a party to the purchase and sale contract for real property located at _____(address), _____(city), _____(state), _____(zip code) (the "Property"), more specifically described in the contract which is attached hereto, and incorporated by reference, between _____ ("Buyer") and _____ ("Seller") (the "Contract"); and

WHEREAS, Assignor desires to transfer his rights in the Contract to Assignee and Assignee desires to receive such rights under the Contract, and in consideration thereof, Assignee agrees to pay an earnest money deposit in the amount of $_____ upon execution of this Assignment and the balance of $_____ at closing. This deposit shall be non-refundable unless clear title to the Property cannot be delivered to Assignee, in which case the deposit shall be returned within three days after notification of same from the Assignee.

NOW, THEREFORE, in consideration of the mutual covenants herein contained and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Assignor hereby covenants as follows:

1. Assignee hereby accepts said assignment and assumes, covenants, and agrees to carry out and perform all of Assignor's obligations pursuant to the Contract.
2. This Assignment shall bind and inure to the benefit of the parties hereto and their respective successors and assigns.
3. This Assignment shall be governed by and construed in accordance with the laws of the United States and to the extent applicable the laws of the State of _____ exclusive of the choice of law provisions adopted thereby.
4. This Assignment shall expire _____ days from the date of the Assignment if the Property is not purchased by that time. The parties agree that this Assignment may be extended upon Assignee's written request for an additional _____ days with an additional, non-refundable deposit in the amount of $_____ which will be applied to the purchase price.

IN WITNESS WHEREOF, Assignor and Assignee have executed this Assignment as of the date first written above.

ASSIGNOR:

_____

By:
Its:

ASSIGNEE:

_____

By:
Its:

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Assignment Vs. Simultaneous Close

With an assignment of contract there is only one closing. Your seller is selling it to your buyer and your fee will show on the closing statement. You have no closing costs except maybe your attorney fee.

This is the simplest way to wholesale a house but is not always applicable. There will be times when you can't or choose not to close with an assignment and use a simultaneous close.

A simultaneous close is two closings, usually on the same day. You buy and quickly resell. This means you must either put up the funds to close or set it up for your buyer's funds to be used to fund your purchase. This may not be possible in some states and will be determined by your attorney or title company. If they can't, you will have to raise the cash to do a simultaneous closing or use assignments only.

Unfortunately, many banks and all government sellers will not allow assignments as of this writing. This includes FNMA, Freddie Mac, HUD and VA.

Your choices here are to raise the money to close with your own funds, private money or a One Day Dough program, if your buyer can close simultaneously.

With your own funds of course it gets easy. Simply close and get an immediate refund of your money and a profit.

With private money it's more trouble, paperwork for your attorney to do and expense, but it buys you time and the luxury of maybe selling for more or many other exit strategies beyond wholesaling. If you're in and out the same day and using private money, simply tell your lender the facts and pay them $500 – $1,000 for the short use of the money. You may not even need your attorney to create a note and mortgage or deed of trust.

The only reason you're even using private money in this case is to satisfy the closing agents state mandated requirement to have the funds in the escrow account prior to closing. Your attorney will tell you exactly how and what needs to happen on your first deal and any title company can do the same.

There are companies who will send the money to closing for you as long as you have a buyer waiting. It's not a loan. The money never gets disbursed except back to the sender. It's only sent to satisfy the closing agent's requirements. Your credit is irrelevant. No one cares.

These funds will cost you between 1% - 3% of the funding needed. A resource is in this manual.

Remember, have a chat with your closing agent to determine if any of this is an issue. A simultaneous closing is only applicable in the above cases or when you're simply making such a large mark up you don't want your buyers to know. If he/she doesn't see your contract to purchase from your seller, the only way they will know what you're paying is if you or the closing agent tells them. All they see is a contract from you to them, no assignment.

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Step 14: Closing The Sale

Listed Houses – the agent will want to control the closing and push you to do so as soon as the seller is ready. You are under no obligation to close until your contract says you have to and should not yield to agent pressure, unless you're ready. Simply tell him/her you intend to close on or about the last day and will notify them if it changes.

You should also disclose you will set up the closing and have your title company or attorney notify them with the details. If you're closing with a title company appointed by the seller, usually a bank or government agency, you have a choice.

You can let them close and work with them to coordinate the sale to your buyer or the closing of your private money loan, if applicable. If you're writing a check to close, this will be simpler with less potential problems.

I'd suggest you do not close with the seller's appointed company unless your attorney is representing you. A lot of things can happen that are too complicated and lengthy to insert in this course. Let your attorney protect your interest. It's worth the few hundred dollars it cost and will be a critical component to make your wholesale business run smoothly.

"Let Others Do What They Do
Best So You Can Focus
On Doing What You Do Best!"
~ Ron LeGrand

A title company or escrow company is not your attorney. They can close real estate transactions, but they do not represent you, cannot practice law and in most states can't even close unless a title policy is purchased.

Buying and selling houses without an attorney is like entering a sword fight with a switch blade. You're going to get bloody.

In a nutshell, your only responsibility should be to find the buyer, get an assignment or sales agreement signed with a deposit and turn it over to

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your attorney along with your agreement to buy and funds, if you're providing. He/she will do the rest.

They will:

- Coordinate with the Realtor.
- Coordinate with your buyer.
- Prepare the closing package(s) and send to both for signatures and get returned.
- Collect the funds from you or your buyer.
- Disburse to all concerned.
- Send closing packages.

There Is No Closing For You To Attend

Get out of the way and let the professionals do their thing while you oversee to make sure it's getting done.

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When Do I Use An Attorney And When Do I Use A Title Or Escrow Company?

Every deal you do will require a title search, which is what title companies do. You should order the search yourself and get your attorney the results. In some states you don't have that option and if that's so you'll know immediately by asking other investors or your attorney.

Many investors use title companies exclusively and rarely use an attorney in an effort to save a few bucks. I'd suggest you adopt the opposite policy and use mostly attorneys and an occasional title company only closing. You will need a title company.

Here's a list of cases where an attorney is very important to get involved:

- Any purchase of a bank owned property.
- Any purchase from the elderly, military or any seller in foreclosure.
- Any purchase involving seller financing of any kind or taking debt "subject to."
- Any sale involving new financing, seller financing, lease option, option or to the elderly or military personnel.

Since that doesn't leave much to close without an attorney, why not just let him/her close all your deals.

- They'll get proper disclosures signed and do all the paperwork except the assignment or purchase and sale agreement.
- They'll keep you from breaking the law.
- They'll act as a buffer between you and your buyer or seller.
- They make good witnesses if you ever go to court and if they close will likely prevent that from happening.
- If you're paying for a title insurance policy from a title company, it may actually be cheaper for your attorney to close because they get half off on the policy. This is assuming you make him/her know you know, so you can get a break.
- If you're selling with owner financing or lease option and sometimes for cash, you can pass the cost of your attorney on to your buyer so it's free to you.

Only Fools And Attorneys Do Their Own Legal Work

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How Do I Find An Attorney And A Title Company?

1. Ask any active Realtor who they use to close real estate deals.

2. Ask all the investors you know. The active ones have probably done the research for you and found the investor friendly attorneys and title companies.

3. If you have a local real estate investment group, attend a meeting and ask around and you'll likely get several using the same companies. Also see if they have a local resource list you can get.

Deal only with user friendly attorneys and title companies who want your business and work to make the deal happen, not kill it. If they become a roadblock, whack 'em.

Be careful! Is the problem really them or are they giving you good advice and you refuse to listen? If you find other investors successfully using them and not complaining, I think you've found the answer.

Closing Non-Listed Houses – this is much easier because you've eliminated Realtor interference and maintain total control over the closing agent and process.

The steps are simple:

- Get buyer under contract after your title search comes back clean.
- Send sales contract to your attorney with buyer and sellers contact info and tell him/her to get it closed ASAP.
- Monitor the process until you get paid.

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Step 15: Complete The Process

The check and file is in your hand. Put the file in a file cabinet as is and deposit the check in your flipper entity or your own account.

Add a photo of the house to your file and copy of the check, if possible.

Send the legal secretary flowers with a thank you note. Send the buyer a gift of food like Omaha Steaks.

Take your family to dinner in a nice restaurant and tell them why you're there and every time you get a check you'll be returning. They get to pick the next restaurant.

Send Ron a testimonial letter with a copy of the check, your photo and photo of the house. One page please.

Send your Mentor the same, if applicable.

DO IT AGAIN SOON

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Marketing Houses Wholesale Recap

1. Find a good deal and tie it up.

2. Check title.

3. Run online ad "Handyman Special, Cheap, Cash, *Your Email*".

4. Build buyers list while selling houses.

5. Get contract and binder from buyer.

6. Give both contracts to <u>your</u> closing agent then get the time and date for closing. Discuss the whole process with the closer to make sure they know what's going on.

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Contingency Plan If You Don't Find A Buyer

One of the most frightening things for a new entrepreneur is the nagging question of what happens if I can't sell the house. In fact, my experience tells me after years of training, this is such a big concern it keeps many people from even trying. I sure hope this doesn't apply to you. Let's discuss our alternatives if our mystery buyer doesn't appear. There are only a few things that could occur for this problem to become a reality. So using a problem/solution format, we'll discuss them.

Problem: Your asking price is too high. ***Solution:*** Lower it! Either you've paid too much or you're just too greedy. If you've paid too much you must renegotiate a low price or forfeit your deposit and learn from your mistakes. If you find this is the case, fix it early. Don't wait until the end of your escrow period only to make the seller or the agent angry. Fix it quickly, admit your mistakes and move on. If you make offers using my formula your chances are good of never having to concern yourself with this problem.

Problem: The property is in a war zone and no one will buy at the price you're asking because they know people who can qualify for a loan won't live there. ***Solution:*** Find out what your buyers will pay and if they're interested at any price. Then renegotiate a lower price with your seller or simply forfeit your deposit and move on.

Problem: The property is such a serious rehab it scares away even seasoned investors. ***Solution:*** If the house is in that bad of shape perhaps you shouldn't get involved in the first place. Any property needing more that 25% of the ARV for repairs is off limits. Even these houses will sell if you offer them at a low enough price. So it all comes back to paying too much.

Problem: No one calls from the ad you placed. ***Solution:*** this problem will occur only in your head. If you use my Handyman Special ad greed will compel people to call. If not, check your ad. Is it buried where no one can see it? Is the phone number correct? Is it in the Investment

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Property section and/or on enough websites? Are they calling and no one is answering the phone a good part of the time? Are their emails getting through or spam blocked? Have you run the ad I gave you or a creative version you dreamed up? I've never known my ad to fail, why fix it?

Problem: You're offering a multi-family unit and can't get any interest. ***Solution:*** Stick with single family homes for now. The market is large for houses and small for rentals. Stay where the market works best. If you make an offer on multi family properties be prepared to buy it yourself.

Be careful not to sign with a specific performance clause giving the seller the right to sue you in case of default. The agreement in your course calls for the deposit being the only remedy for default. If using a Realtor agreement, which contains this clause, either mark it out or don't make offers through Realtors or just take your chances the seller won't sue for specific performance, which isn't likely. In that regard, the most you can lose is a few dollars to a seller you're working with directly or a few hundred through a Realtor. If you make any of the mistakes above, the solution is not buying the house yourself. Your mistake will only be compounded if you do.

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Common Questions From Wholesalers

1. **Q. How do I get inside vacant houses to inspect?**
   A. In some cases, you don't. You should be able to estimate repairs by looking through windows well enough to submit an offer. In other cases you'll find doors unlocked and windows open. Soon you'll be able to estimate repairs from a brief description of the interior and a photo.

   If you're licensed, you should have a key to the listed houses. Dragging around Realtors to show you vacant, listed houses will end in a very short relationship.

   If you can't see the inside, simply make the offer assuming it needs everything.

2. **Q. What if I'm wrong on repairs?**
   A. If you're so far off on your estimate that it kills the deal…you offered too much. You will be wrong. It doesn't matter if you use my formula. It already contains a margin or error.

3. **Q. How do I know the agents won't steal my deal?**
   A. You don't! Every once in a while it will happen, but as a rule the agents don't want your deal. They are licensed and live by a code of ethics. If you lose one now and then…quit crying over spilled milk and go milk another cow.

4. **Q. Will I need a deposit for every offer I make?**
   A. NO! You should tell the agent you'll either do one of two things, put one deposit in their escrow account to be applied to the first accepted deal, or put on the contract the deposit is due upon receipt of accepted agreement. In the case of a FSBO, your normal deposit is $10 so it doesn't matter. You only hope you need a lot of $10 bills.

5. **Q. Should I assign my contract to my buyer or do simultaneous closing?**
   A. You should assign your contract if you don't care if the buyer knows what you're making and if your contract to purchase is

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assignable. This saves closing costs. If an assignment is not possible or probable, do a simultaneous closing but pass all the costs you can to your buyer. Some institutional sellers will not allow a contract assignment.

6. **Q. What happens if I can't close?**
   A. You lose your deposit. Most contracts clearly state your deposit is the only remedy for default. If it doesn't, you'll have to take your chances, strike it out or don't make the offer. No one can force you to buy a house.

7. **Q. What if my buyer backs out at the last minute?**
   A. Postpone the closing and find another. You should get a non-refundable deposit and close well before your deadline to prevent this from being a concern. Before signing a sales contract, ask your buyer when he wants to close. If the answer is longer than ASAP, get a larger deposit and/or shorter escrow time.

8. **Q. When I get a contract through a Realtor, should I remove their sign?**
   A. NO! It's not yours to remove and it won't hurt you. The house should be listed for more than you're asking, so if your buyer calls the agent, they'll know it's a good deal.

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The Most Common Mistakes

1. Buying in the wrong area
2. Paying too much
3. Working with the wrong agents
4. Worrying too much about repair costs
5. Letting lack of money stop you from making offers
6. Not prescreening prospects
7. Not making enough offers
8. No follow-up system
9. Not building a buyers list
10. Not learning the rest of the business: Options, Getting The Deed, Owner Financing, Work For Equity, Retailing, Short Sales
11. Taking advice from unqualified advisors
12. Listening to the dream stealers who insist you have no right to succeed and want you to fail to keep them company.

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How To Build An Auto Pilot Business

There are really only 5 basic things to master in the wholesaling business. Once you have conquered them, you can train others with very little effort to do most or all of the work.

1. Finding and prescreening prospects

2. Determining the market value

3. Estimating repairs

4. Making offers and counter offers

5. Selling

Your focus should remain on generating revenue. Don't get bogged down in details. Your time is best spent on making offers. All the rest can be delegated.

Pick Out What Only You Can Do
And Hire Someone Else
To Do The Rest

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To Whom Are You Listening?

Listening To The Wrong People Will Put You Exactly Where They Want You To Be…Broke

Never Take Financial Advice From Anyone Who Isn't Making Several Times Your Income!

Free Advice Is Almost Always Worth What It Cost. Good Advice Is Almost Never Free.

Don't Listen To The Morons

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Fast Cash

With Quick-Turn Real Estate

How anyone can quickly turn single family houses into cash without money or credit.

Ron LeGrand

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Fast Cash
With Quick-Turn Real Estate

How anyone can quickly turn single family houses into cash without using money or credit.

Ron LeGrand

Table of Contents

Acknowledgments.....vii
Preface.....viii
Foreword.....x

SECTION I- Winners All Around

1. **Fast Cash in Days, Not Years**.....3
   - You Don't Have to Wait!
   - A Road Map to Success
   - Rewards for Action

2. **Everyone Wins or I Won't Play**.....9
   - No Fun in Foreclosure
   - Saving Houses From the Wrecking Ball
   - Sharing the Wealth

SECTION II - QUICK-TURN TOOLS

3. **Four High-Voltage Cash Generators**.....17
   - Retailing
   - Wholesaling
   - Assumptions
   - Lease/Options
   - Taking Action to Get Started

4. **Good Deals Without Guessing**.....25
   - Four Simple Actions
   - Calculating Profitability
   - Selling to Another Investor
   - Explanation of The Property Acquisition Worksheet

5. **Retailing to Owner/Occupants**.....33
   - Buy Low-Sell High
   - A Universal Mechanism
   - Saleable Houses for Pennies on the Dollar

6. **Wholesaling to Other Vendors** 41
- Buy Low-Sell Low
- Selling a Contract to Another Investor
- Finding Other Investors to Buy From You

7. **Assumptions: Using Non-Qualifying Loan**.....49
- Six Keys to Successful Assumption Deals
- Types of Loans to Seek

8. **Lease Options: Taking Control Without Taking Title**.....57
- Leased to You, Subleased to Your Tenant
- Lease Option Without the Sublease

SECTION III - SMART MARKETING

9. **Finding Motivated Sellers**.....69
- Cards
- Run Ads
- Read Ads
- On The Telephone
- At The House
- FSBO Signs
- Referrals
- Flyers
- Vacant Houses
- Investment Groups
- Bank Auctions
- Lenders
- Mailouts
- FHA/VA Repos
- Out-of-State Owners
- Defaulted Paper
- REALTORS®

10. **Mortgage Lending**.....105
- Pros and Cons of Loaning to Homeowners
- Using Your Own Pension Plan
- Loan Brokering

SECTION IV - SAVVY DEALING

11. **Negotiating Win-Win Deals**.....121
- Understanding the Seller's Motivation
- The Virtues of Patience
- Using Liens and Judgments in Negotiation
- Speaking of Interest
- Being Straight With Sellers

- Tell the Seller Why
- Making Obscene Amounts of Money Without Ever Talking To A Seller

12. **Making An Offer By The Rules**.....129
- Determining Value, the Foundation of Your Offer
- Making Three Offers
- Escape Clauses
- Counteroffers
- No Standard Contract
- Using an Addendum

SECTION V - MONEY AND LAWS

13. **Where To Get The Money**.....145
- Shortcomings of Bank Loans
- Mortgage Brokers and Short-Term Money
- Seller Financing
- More on Zero Interest Loans
- Wraparound Mortgages
- Land Contracts, Contract for Deed, Agreement For Deed
- Split Funding
- Subordination
- Substitution of Collateral
- Raising Money Fast Without Borrowing
- Making the Seller Your Partner
- Back to Basics
- Structuring an Offer

14. **Land Trusts and Legal Considerations**.....181
- Definition of a Land Trust
- Reasons to Use a Land Trust
- Privacy
- Loan Liability
- Lawsuit Protection
- Estate Planning
- Ease of Transfer
- Bank Loans
- Appointing a Trustee
- Avoiding Title Problems

SECTION VI - SUCCESS

15. **Selling Houses Fast**.....191
- Selling Retail
- Planning Your Total Sales Strategy
- Repair Tips
- The Smart Way to Use a Realtor
- Selling the House Yourself
- Running Ads
- Responding to Calls
- Adding Creativity to Action
- Split Funding the Down Payment
- Eliminating the Down Payment
- Seller Financing the Deal
- Finance Companies, Your Ace in the Hole
- Trading the Paper
- Selling on a Wrap
- Selling With Nothing Down
- Adding "Boot," the Gravy on the Deal
- Personal Guarantees for Seller Carryback
- Selling Wholesale
- Assumptions

16. **Profiles Of Success**.....229
- Phil Barnes
- Elizabeth Bowers
- Mark Cousino
- Randy & Charlene France
- Richard Kansa
- Laraine Porter
- Steven Powanda

17. **Succeeding While Others Fail**.....219
- Possible Problems
- Fearing the Unknown
- More Practical Tips
- Success Tips

Glossary of Real Estate Terms..... 258

Appendices..... 271

ACKNOWLEDGMENTS

This book is the result of many years of learning in the school of hard knocks. Its principles have evolved out of my experience buying and selling houses, something I've done every day for 14 years. I wasn't born with this skill. I learned it. And you can learn it, too.

I have been successful in real estate because I took action and because I asked for help when I needed it. Equally important has been the support of people who are close to me. It is important to recognize their contributions to my success in the world of residential property investment.

First, I want to thank my wife, Beverly, for blessing me with a happy, 30-year marriage and for being at my side while I was learning to Quick-Turn houses. We've been through good and bad times together, and we agree the good times are better. But, our true wealth is our four children and eight grandchildren.

Many thanks also to my daughter Vicki, my son-in-law Bobby, and to every member of my great staff for their invaluable help during the making of this book.

I am grateful to Mark O. Haroldsen for being an important influence in my life. Not only have I learned a great deal from Mark personally, but over the years his company, The Financial Freedom Report, has provided the educational format to provide me with the constant stream of information and motivation that was crucial to my success. Thanks, Mark and company! Keep up the good work.

Mark's first book, *How to Wake Up the Financial Genius Inside You*, had a great impact on my early progress. That book has touched the lives of more than two million readers; its message is as fresh and relevant today as it was when it was written.

I also wish to thank Robert Allen for his contribution. One of his two-day seminars first opened my eyes to the world of real estate. That began the legacy I'm now passing on to those whose lives I touch.

Above all, I would like to acknowledge and dedicate this book to you, the reader, and your future success in real estate.

PREFACE

When I began to write this book, I planned to write an autobiography to impress you with my brilliance and success over the past 14 years. Then it occurred to me you could care less about my accomplishments. You want to know IF and HOW this book will help you!

Bear in mind, I've organized the contents clearly and logically so you can quickly achieve a working knowledge of my Quick-Turn real estate business. These pages include all the practical information you need to benefit fast by using the techniques I teach.

If you like what you read, and you put my words into action, this book will be the beginning of your financially rewarding career in Quick-Turning houses.

Whether you are a beginning investor or a pro who has already bought and sold many properties, this book will provide valuable new information about making Fast Cash. Regardless of your level of expertise, you will learn new approaches to making money faster, safer, and easier than you ever dreamed possible. This information will also motivate you to continue to learn and grow by welcoming new ideas and taking action in your everyday life.

One of the hardest things for me to learn as an investor was that I did not have all the answers. (As a matter of fact, I still haven't even heard all the questions!) I continue to buy books and tapes, and I attend seminars regularly even though I have been in the business for 14 years and have turned more than 1,000 houses. But, we all need to learn constantly to be competitive.

Besides giving you new ideas, this book could cause old ideas to resurface and trigger actions that will enable you to reach goals you previously had thought impossible. Pursue your dreams with dogged determination. This is America, and

nobody has to sit in the cheap seats. At the end of your life, you won't regret the things you did, but you will regret what you left undone. Life is too short. Don't grow old lamenting lost opportunities.

You control your life and almost everything that happens in it. You can choose how much fun you have, how much money you make, and how well you'll live when you retire. Riches and fulfillment are abundant for the people who have knowledge and use it wisely. I'll help you gain the knowledge you need, but you are the one who must choose to act on it. What will you choose? A few stale crumbs, or the whole tasty loaf?

Read this material, underline it, and use it. Take maximum advantage of my 14 years on the street honing the techniques I teach. Do what I ask you to do, and you will have the same kind of freedom and abundance in your life that I enjoy. Consistent, persistent action is the key to making this happen. I encourage you to stretch — to do things you haven't done before so you can have things you haven't had before.

Who's in control here? You should be. But if you aren't, I'm going to teach you to take control — of your life and of your destiny. There's no better time to begin than NOW!

Ron LeGrand

FOREWORD

By Robert Allen, Best-Selling author of *Nothing Down*, *Creating Wealth* and *The Challenge*

Everybody has a dream. For many people that dream is making a better life for themselves and their families. And there are as many different ways to make that happen as there are people trying. Some people work eighteen hour days at a mom-and-pop business, some fight their way up the corporate ladder, and others spend their meager paychecks on the weekly lottery. The approaches are drastically different, but the dream is exactly the same. They all want something better.

If you're working for somebody else, you know that reaching that goal is exceedingly hard. You may be able to scrape by, riding someone else's coat tails, but to really make it big, you have to make a leap of faith and do it on your own.

Fourteen years ago, a dirt-poor, bankrupt auto mechanic took that leap of faith. He borrowed four hundred fifty dollars from friends and family, hoping what sounded like an unbelievable promise was the answer to his dream.

That mechanic was Ron LeGrand. And the money that he borrowed all those years ago was to attend one of my seminars. This was the beginning of Ron's real estate education.

Within a few months, Ron owned over 70 properties. He was paper-rich. But soon he sat down to pay his monthly bills, and realized he didn't have the money in his account to cover them. It was a wake-up call for Ron. He realized he needed to develop a way to make cash quickly from real estate. This was the beginning of his Quick-Turn System.

Since that time, Ron has quick-turned over 1100 properties, each one adding to his personal knowledge, wealth, and the Quick-Turn System. Ron doesn't have to scrape anymore. He drives a Mercedes, owns a huge, beautiful home, and never worries about the monthly bills...he's a millionaire, not just on paper, but in real life.

Over the years, Ron has taught his System to thousands, with amazing success. And it's easy for me to see why. His frank style and direct approach appeal to folks who want straight talk on how to make it big.

Realizing his dream of making his life better, Ron's goal now is to help people all over the country do the same thing. And I'm sure he'll succeed. Not since my book *Nothing Down* has there been an educator who knows more about the subject of Quick-Turning houses than Ron LeGrand.

If you're looking for a way to make part-time income; if you want to start your own business; if you're finally ready to make it big, then you've picked up the right book. I encourage you to read on...financial independence is in your hands.

Bob

KEYS TO SUCCESS
in Quick-Turn Real Estate

Anyone, including **YOU**, can profit from Quick-Turning single-family houses in days. You don't need credit or partners, and you need little or none of your own money. But you do need the **KNOWLEDGE** contained on these pages . . . for knowledge, converted to action, is the **KEY TO SUCCESS**!

Section I
Winners All Around

Do what others won't for five years,
and you can do what others can't
for the rest of your life.

Anonymous

Chapter 1

Fast Cash in Days, Not Years

I started in the real estate investment business after attending a two-day seminar back in 1982. Luckily, everything I learned there worked. I quickly discovered that finding the bargains was not difficult, but making the offers — especially the low, low offers — takes a lot of guts.

When you're just starting out, fear is normal, but it shouldn't stop you. If you're not a little scared when you begin to buy houses, you must have nerves of steel. Making money in real estate is not difficult, but it does take persistence, knowledge and courage.

Not long after that seminar, I had 276 rental units. That may sound wonderful, but I sat down to pay the family utility bills one day and discovered there wasn't enough money to cover them, which led me to take a hard look at how I had been investing. I had become a paper millionaire quickly. It had been easy to accumulate equity, but I had no cash. And you can't eat equity or pay bills with it. That's when I started to look for cash flow. It was this chain of events that led me to develop the Quick-Turn method to generate cash.

A person can make $10,000 to $50,000 or more in this business with just one deal, even in a low-priced market. It doesn't take many deals like that each year to make a good living. People often believe that real estate investment is risky, but in reality, many nine-to-five jobs are even riskier. Talk to the thousands of people who have been recently laid off about their marvelous "job security!"

Most people work all their lives to get pensions equal to half the wages they were earning — wages that didn't cover their bills. But you are different. You have the opportunity to take the future into your own hands and build a cash flow that will continue whether you have a job or not.

The first step is to take care of today's financial needs, before you start building your empire. Once those needs are met, and you possess the ability to generate cash, there are countless ways to turn that cash into a consistent flow and provide for a secure retirement.

You Don't Have to Wait

Some people think the only way to make money in real estate is to buy a property, sit on it for 20 or 30 years, contend with bad tenants, plugged toilets and negative cash flow, then sell for a profit. But that assumes there is something left of the house, and that inflation hasn't decreased the property's value. It also assumes that, during the holding period, the owners don't get so frustrated with property management that they just throw up their hands and quit. My experience has shown that happens to many people.

My intention is not to discourage the use of real estate as a retirement tool, or to indicate that people shouldn't hold property for the long term. In fact, I honestly believe that the greatest profits take time to develop. Huge fortunes have been amassed (some accidentally, it must be admitted) by people who have sat on property for a long time, then awakened one day to find the value increased by 10, 20, or even 100 times the purchase price.

But most people don't have the luxury of time, or the blind luck to make money while they sleep. In addition, most people are not properly equipped with knowledge and a clear-cut action plan before they start to buy properties.

I've seen many people who think that owning a few houses will make them rich enough in five years to retire and go fishing all day. More often, the opposite happens. The houses drag down the owners, who weren't properly trained to deal with the

problems of real estate ownership. Those owners didn't have the knowledge you're getting from this book.... Knowledge that will keep you, the investor, in control.

A Road Map to Success

If your intentions are to buy real estate to generate more CASH, and if you want to have that cash now rather than years from now, listen up. There is a way to do just that. It involves "flipping houses fast," which I call "Quick-Turning."

During the past 14 years, I have bought and sold more than 1,000 houses for Fast Cash profit. Along the way, I developed a system that anyone who has the desire and willingness to learn can duplicate and make work for them, regardless of their financial condition. We are going to study all the aspects of this system, step-by-step, in the following chapters.

If you think you need a lot of money and good credit, or that you have to be a genius to make money in real estate, FORGET IT. It just isn't so! In this book, you'll learn how to convert houses to Fast Cash, no matter where in America you live and regardless of whether you are wealthy or flat broke. In fact, if you are broke, you may actually have an advantage because you have no choice but to learn before you leap. Those who have money tend to leap before they learn, then blame their failure on the system, the economy, their spouses, their mothers-in-law, and everyone else except themselves. In this, or any other business, you have to learn the fundamentals before leaping.

The three basic reasons to buy non-owner/occupied real estate are:

1. Quick cash profits
2. Monthly cash flow
3. Long-term growth

"But wait," you say. "What about tax shelter?" FORGET IT! Those days are gone. Many properties bought for tax shelters before the 1986 tax change are now owned by the Resolution Trust Corporation (RTC) or some other lending institution. This

is especially true for the large properties such as apartment and commercial buildings which are being sold for a fraction of their former value. I feel sure we are going to see an escalating national debt and much larger savings and loan problems until the government returns incentives to investors in such properties.

It's wise to have properties in each cash-goal category. Use some deals to generate quick cash now. Those profits can then be used for investing — and for creating other deals to produce a steady monthly cash flow to cover your living expenses. Once you're sure your family's needs are being met, you can afford to invest in some "keepers" for long-term growth. You'll learn more about these strategies in the following chapters. But, for now, I'll assume that you want to know how to make Fast Cash.

Indeed, generating profits quickly through real estate is the primary emphasis of this book. The four key types of Quick-Turn transactions that generate cash will be discussed in detail.

Rewards For Action

One thing is sure: People always need a place to live! Why not be in a business that will never lack customers? Why not work at something that produces paychecks in the thousands, whether you are involved part-time or full-time? How would you like to go where you want, when you want, stay as long as you want, and never worry about what's happening while you're away? And then there's the recognition you'll get for being a person who can find houses for people who never thought they could be homeowners.

Best of all, why not be in a business that's recession proof? You will learn how to make money with real estate in spite of the economy, interest rates, or the market situation. The only real difference between the "haves" and the "have-nots" is knowledge converted to action.

"You May Not Get Rich Quick,
But If You Never Get Started,
You'll Never Get Rich."

RON LEGRAND

It's not the critic who counts: not the man who points out how the strong man stumbles or where the doer of deeds could have done them better. The credit belongs to the man who is actually in the arena, whose face is marred by dust and sweat and blood; who strives valiantly; who errs, and comes short again and again; because there is not effort without error and shortcoming; but who does actually strive to do the deals; who knows the great enthusiasms, the great devotions; spends himself on a worthy cause, who at the best knows in the end the triumphs of high achievement and who at the worst, if he fails, at least fails while daring greatly so that his place shall never be with those cold and timid souls who know neither victory nor defeat.

Theodore Roosevelt

Chapter 2

Everyone Wins or I Won't Play

Some outsiders are under the impression that the only way to make money in Quick-Turn real estate is to take advantage of people. They picture all of us investors literally stealing houses and putting little old ladies out on the street. Or they perceive us as tyrannical landlords wearing big black hats and operating slum properties unfit for human habitation. Such perceptions are not just erroneous — they demonstrate total ignorance.

In all the years I have been an investor, buying more than 1,000 houses, not once have I ever put a gun to a seller's head and said, "Sign or die." In fact, many times I have found myself hoping the seller wouldn't work with me because I didn't like the looks of a deal. But, I went ahead and bought anyway, to get the seller out of a jam.

Many people don't understand the valuable services real estate entrepreneurs perform for the public. Of course, I wouldn't buy a house if I couldn't make a profit from it, but in many cases I could have walked away and been happier than if I was buying. However, the seller's needs pushed me to take on some project or other that may not have been the best use of my time.

No Fun in Foreclosure

In looking at the real estate business, several elements must be considered. It is more than money. Money is only the by-product of a specialized activity that provides one of life's necessities — shelter. Think about the last sad story you heard

about a family home lost to foreclosure. Maybe you, yourself, have been through hard times and lost your house to a bank. How would you have felt about an investor providing you with a solution when no one else could or would? I can tell you from experience that there are few things in life more humiliating and stressful than lenders hounding you almost daily, demanding payments you can't cough up.

Going through that process destroys your self-esteem, breaks up marriages, and can even cause health problems — or worse. I once bought a house whose owner — the father of three children — had committed suicide under the stress of pending foreclosure. That experience gave me a new outlook on life. While I was buying the widow's house at 8 o'clock one Saturday night, trying to help her stop crying, I decided my measly little problems didn't amount to "a hill of beans" compared to hers.

She had three kids, but she had no income, no job, no food, and now no husband. All of a sudden I switched from the mindset of "How cheaply can I get this house?" to "How much can I afford to give this lady?" She owed about $26,000 on a $50,000 house; the monthly payment was $280. She was six months behind on her payments, and the house needed about $2,000 in repairs. She told me that if I would give her $1,000 and make up her payments, she would deed the house to me.

Now, I'm no angel, and I'm usually pretty reluctant to give up a buck unless it's absolutely necessary. But that night was an exception. I reached into my wallet and handed her $500 cash. Then I told her that, once I had checked her title and she was out of the house, I would give her an additional $3,500. That's $3,000 more than she was asking. Needless to say, she was elated, and I had won a friend for life.

But who really got the best of the bargain? Yes, I made money on the house. And I could have made $3,000 more. But the most important result of the deal was that I was on a high for weeks afterward, and I learned a lesson that will stick with me for life: You can't help someone up a hill without getting closer to the top yourself!

Remembering that experience still gives me goosebumps.

And I'm sure that, as your career progresses, you'll have more than one opportunity to help a similar family solve its problems.

Saving Houses From the Wrecking Ball

In addition to the human element, of course, there's also the matter of the houses themselves. Think of all the houses that are rehabbed by investors every week. If investors don't buy them, who will? What happens to them?

The answer is that they get bulldozed, or they just sit there until they are boarded up and condemned, then fall down of their own accord. True, every once in a while an owner/occupant buys a property to fix up and occupy. But for every one of those, 100 get rehabbed for profit by people like us. We are providing a service to our community by improving the looks of the neighborhood, as well as by increasing the stock of houses and the community's tax base. That, in turn, generates more revenue for the city.

In addition, the rehabbing requires contractors and laborers who benefit from the work. All rehabs require materials which are supplied by vendors who buy from manufacturers — all businesses which create jobs and employ people. And the process generates fees for professionals such as surveyors, REALTORS®, appraisers, termite inspectors, closing agents, title clerks, attorneys, etc. Stop the rehabbing of houses, and all those people suffer directly or indirectly. Many could not exist. So, yes, people who buy and fix houses certainly are performing a public service.

Sharing the Wealth

Let's look at aspects of real estate investing that have nothing to do with the rehabbing process itself. Have you ever known someone who has had to make two house payments simultaneously because he purchased a new home before the old one was sold? When I offer a lease/option deal, the seller usually accepts because he is seeking debt relief.

Who besides an investor is going to offer debt relief when a house doesn't sell? The REALTOR® maybe? Hardly. REALTORS® attempt to sell houses at little or no risk to themselves. Making a seller's payments while tying up a house for six months is not part of a REALTOR'S® service.

Could a seller rent the house to a tenant? Possibly! More often than not, all he or she would wind up with is an expensive lesson in landlording, and a bigger problem. Renting the house could also make it extremely difficult to sell. It would rarely be clean, and getting access to it would be complicated. Of course, the tenant would not be cooperating with the seller if it meant that, when the house was sold, the tenant would have to move.

So we investors step in and guarantee payments and repairs, and we usually get the house sold in time. The seller's problem is solved, and we have provided a public service. (Lease options are discussed in detail in Chapter 8.)

Believe it or not, while we're working to help sellers by saving them from the foreclosure machinery of the big bad banks, we're also performing a service for those banks. And that service, too, trickles down to a wider public. If investors didn't buy houses out of foreclosure or afterward, who would? If the only market was owner/occupants, you would see a drastic decline in housing prices. Moreover, the conditions for getting a loan would become terribly stringent. These factors would slow demand drastically, and all related industries would suffer. Many would evaporate.

There's still another very important group of people who benefit from investors' work in real estate. What about all those owner/occupants who wouldn't have a home of their own without us? I have sold hundreds of houses to first- and last-time home buyers. Many of them needed help solving minor problems and overcoming hurdles. I can honestly say some would never have been able to buy had I not made it possible.

Sometimes I helped them get financing. Sometimes I was the bank and owner-financed for them. Without my being the bank and allowing them to bypass rigorous qualifying procedures, most of those people would still be renters today. Usually, investors are the only owner-financing game in town.

Without us, owner financing would be almost nonexistent.

So are we providing a public service by understanding creative financing? You bet. We are providing a service that is extremely important to those families who could not own a home any other way. Incidentally, if it weren't for investors, who would own rental property, and where would all the tenants live?

True, as you become more and more involved with real estate investing, you may get the feeling that you're not always appreciated. Sometimes we catch a lot of flack from government employees, REALTORS®, and other people who don't understand the business. But rest assured, investors will be around as long as people need places to live. There is plenty of business to go around, and investors can make money without making anyone suffer. If any deal is not win/win, just don't do it.

Move on.

Section II
Quick-Turn Tools

The secret of success is constancy of purpose.

Benjamin Disraeli

Chapter 3

Four High-Voltage Cash Generators

Quick-Turn transactions fall into four main categories. Almost everything you do in the house business will follow one of these methods.

RETAILING

Buying houses low and selling them high is called retailing. This is the most easily understood method because there are countless books and tapes on the subject. It is the art of buying at a low price, often doing some repairs, then selling at retail price, usually cashing out. There is a lot of money in this method. Some people do this part-time, turning only two or three houses a year, and make more money at it than they make on their regular jobs. We'll discuss the buy low-sell high method in Chapter 5.

WHOLESALING

The second method is wholesaling. This is an entire business in itself and generates super-fast profits, usually without ever requiring the title to a property. It's not uncommon to pick up a check at closing, with the seller and buyer present at the same time. Many times I have earned thousands of dollars within two or three days of finding a deal. Successful people in the wholesale business are accomplished at locating good deals and marketing them — primarily to people who are in the buy low-sell high business. The first purchaser is willing to take a

smaller, fast profit and leave the larger profit to an investor who has the time and money to buy, repair, and sit on the house until it is sold.

Some of my students are making a good income by buying, then reselling immediately, only once or twice a month. These deals require no money, no credit, no partners, and no bosses. Believe me, if you locate the deal, there is someone waiting to buy it from you. We'll cover all that in detail in Chapter 6.

Assumptions

The third method involves assumptions. Millions of Americans would love to own a home but, for a variety of reasons, either don't qualify for a loan or don't want to borrow from a traditional lender -- even though they do have money for a down payment. With the assumption method, your job is to find good houses with existing no-qualifying loans. Or you can create opportunities through seller financing.

Thousands of existing FHA and VA loans may be assumed by anyone regardless of their credit. The idea is to find houses you can buy with little or no money, and flip them for a few thousand dollars more than you paid for them. Many owners will walk away with virtually nothing just to get the loan out of their names. Because the properties have assumable, no-qualifying loans, they're worth a little more and are easier to turn quickly.

All a purchaser needs to qualify is the down payment you are requesting. This kind of transaction usually takes only a few days to consummate and you don't have to stay in the junk house market to do it. In Chapter 7, you'll learn to manage assumptions with no credit, no partners, and very little training. And, you'll be working in first-class neighborhoods dealing in houses needing no repairs.

Lease/Options

The fourth method is to lease/option properties to control them without taking title. This method works on houses in any

condition, in any price range, and with any underlying financing. You can reap big profits without ever owning the house, while paying no closing costs to buy or sell, doing no repairs, and using very little or no money. In Chapter 8, you'll learn how to lease/option without even making monthly payments.

Taking Action to Get Started

You may be thinking all this is great, but I'm sure you're wondering where and how a person like you might get the money, find the bargains, and then get the houses sold. Relax! All of your questions will be answered in this book, and all your excuses for not taking action will be eliminated. When I began, I was bankrupt and broke, and I had absolutely no previous experience. That was about 1,000 houses ago. When I remember how little I knew when I started, then look at how far I've come, few, if any, excuses make sense.

Some of my students do 50 to 60 deals a year with an average net profit of $15,000 each. Remember, every one of those investors began just where you are today. By the time you finish this book, you will realize all you have to do is find the good deals. If you can find the deals, the money is easy to obtain. In fact, it's easy to obtain everything you need to get started in real estate investing.

The best place to begin, however, is with education. Just reading this book shows you're on the right track. Ignorance costs dearly. Many of the best deals in your real estate career will come from sellers who refuse to read a single book on the subject. They will end up selling their properties for tens of thousands of dollars below value.

> *Don't stop with this book! You should constantly be learning, attending seminars, reading other books on the subject, and using what you learn to polish your real estate investing techniques. My friend James A. Ray once told me an interesting story. When he was starting in the business, he met someone who had bought a real estate seminar package,*

but had never listened to it. James bought it from the man for a small price and took it home that evening.

He listened to all the tapes in one sitting, studying the booklets that came with them until 4 a.m.! The next day he started to apply the principles he had learned, and bought his first investment house for $8,000. After some minor repairs, he lease/optioned the house to a couple for $30,000 at $500 a month. Ever since then, he has been investing in real estate full-time.

He now has a personal collection of about 80 seminar packages. His reason: he feels that he either saves or makes money every time he studies one. What would have happened had he chosen NOT to buy that first course?

As this story illustrates, just reading books and attending seminars is not enough. Like James, you must take action! Get out there and try. Put the principles you learn from this book into immediate practice. It is action that will separate you from the nine-to-five workaday crowd — the same people who will eventually retire on 50% of what they can't live on today!

You must focus on the word "now". You want cash **now** or cash flow **now**, using the four Quick-Turn methods: retailing, wholesaling, assumptions, and lease/options. But, to turn your dreams into reality, you must **TAKE ACTION!** Action determines whether you realize your goals or not. You can do a little and get a little, or you can do a lot and get a lot, but nothing will ever happen for you until you act.

Taking action can be making a phone call to a FSBO (For Sale By Owner - pronounced *"fizz bow"*), or it can be getting a REALTOR® to locate 20 houses that fit your investment parameters. A little action taken every day will grow to a big benefit in time. A lot of consistent action will yield a lot of benefits in a short time. I didn't invent these laws, but I have much more wealth in abundance because I follow them. Take action, ask, go, do, and your life will take a serious turn for the better.

This reminds me of a letter from a student who chose to convert my home study course into action. His name is Dave Doucette, and he is from Long Mont, Colorado. I spoke for the ***Financial Freedom Report*** *in Las Vegas in September 1991. Dave's wife saw me there and became excited about what she heard. Dave did not attend with her, as they tell the story. But after hearing me, she called him to say she was buying my course for him. He told her that if she felt that strongly about it, buying the course was OK. At least that's his side of the story. I haven't confirmed with her whether he put up a fight or not. Anyway, she took the material home, and he began to study it.*

I had no idea Dave and his wife even existed until I received a letter from them some months later. In the letter, they explained how they had used my course to net more than $100,000 in just nine months by Quick- Turning a few houses. Needless to say, that letter was the highlight of my day. But the story gets better. I met Dave and his wife in Las Vegas when I spoke there again, a year later. That's when they announced that the $100,000 profit mentioned in the letter had risen to $175,000 in 11 months!

Yes, I'm extremely proud of the Doucettes, and not because of the large amount of money they made. But they were among the fortunate minority of people who possess the ability to seek knowledge so they can recognize opportunity. Dave and his wife converted opportunity to action and took control of their own financial future. Bravo to the Doucettes!

Yet another example of taking action is illustrated by Phil Barnes of Toledo, Ohio. Phil said, "I recently bought and sold a home that I saw For Sale By Owner while we were on your boot camp bus. The owner was a truck driver and hard to find. The house had an assumable, non-qualifying loan with a

$27,600 balance. After putting $3,500 into repairs, I sold it for $47,900, making a net profit of $16,800. I want to say how much I appreciate the boot camp and the information you gave us. As a result, my wife and I are looking for bigger and better things to happen in the future."

Are you ready? Ready not just to read, but to DO something about what you read? GOOD! Let's begin by examining what constitutes a good investment.

"If The Offers Aren't Getting Made...
You Aren't Getting Paid."

RON LEGRAND

Success seems to be connected with ACTION.
Successful men keep moving. They make mistakes, but they don't quit.

Conrad Hilton

Chapter 4

Good Deals Without Guessing

What is a good deal? It all depends on your objectives. A good deal is making the money you want in the time you allot. For some people that's a few days; for others it may be a few hours, a few weeks, or a couple of months. Some investors who are in the rental business believe it should take years to make a profit. I don't believe that and soon you won't either.

Let's illustrate with a real-life example. I once received a call regarding a flyer we had distributed. The voice on the other end said, "Hey, this flyer I'm holding says you buy houses. Is that true?"

"Yes, I sure do," I replied.

He said he had a house for sale. He wanted all cash, and he wanted to close that day. He told me that his mother had died and left him the house with clear title. He wanted to close fast and leave town. I asked him where the house was and how much he wanted.

When he told me the location and that he was asking only $12,000, I immediately knew that this was a great deal. Houses in that area were worth between $35,000 and $45,000 in good shape.

I told him I was interested and made an appointment to meet him there in a few minutes. Notice, I said minutes, not hours or days. When you smell a good deal, you'd better move FAST! You can't wait until it's convenient. If you don't move, someone else will. You can't Quick-Turn in slow motion.

I quickly met him at the house. His mother had lived there. She had four cats, and judging from the smell of the place, they

had never gone outside. Other than that, I figured the house just needed some cosmetics and about $3,000 to get it into shape to sell. I ran through the house, saw what I wanted, and moved to the front yard to do our talking.

"Look man," I said, "you want me to close today, pay cash, clean up this mess, and get the stink out of the house. That's asking a lot. You've got to cut me some slack here!"

"If you can close today, I'll take $11,000, no less," he countered.

"Sign here" was my response.

I took his contract to the title company and told them to put a rush on it because I needed to close that afternoon. Sure enough, he had good title, and I bought the house that day. I used three credit cards for the purchase and spent an additional $3,200 for repairs.

I sold the property immediately for $39,000. All cash! It took exactly two months to the day to close the sale because the buyer got new financing, and at that time I didn't know how to take control of my buyer's new loan process. Today, it would take only 30 days.

My net profit on that one little house was about $23,000. Not bad, huh? By the way, I discovered that the flyer he had referenced was a year and a half old! We'll talk about flyers more in "Finding Motivated Sellers" in Chapter 9.

Four Simple Actions

To stay focused, I concentrate on my objectives. I constantly review in my mind how to find, buy, and sell single-family houses for cash. That's how I came up with my simple philosophy: **Find 'em, Fix 'em, Flip 'em, Forget 'em.**

Calculating Profitability

You should know, not guess, your net profit on a deal before you make an offer, not after you buy and repair the house! One of the most useful tools I have created is the Property Acquisition Worksheet, which is in Appendix A. Look

that form over carefully. It will save you thousands of dollars by illustrating whether the property you are thinking of buying will fit your objectives.

This worksheet is the one I take along when looking at a property. After 14 years and 1,000 houses, I still use this form to lay out all the numbers I need to determine whether a given house will make money or not. The worksheet is the result of taking these steps repeatedly and becoming very successful at it. If you want to reinvent the wheel, feel free; if you want to make money quickly, learn to use this simple document. It will keep you from being shocked when you see the real bottom line.

For example, I found a house with a purchase price of $20,000. The property was in serious disrepair. That's why it was so cheap. It's estimated sale price was $44,500 after repairs. It had an existing first mortgage of $5,000. I gave the seller $5,000 down, and he took back a second mortgage for $10,000, all due and payable in six months, with no payments and no interest, because I knew he would be paid off within that time frame.

My total cost as calculated on the worksheet showed that it would take $10,000 to develop this deal. I paid $20,000 for the house (including the first mortgage balance) and spent $10,000 for fix-ups and other costs. I had $30,000 in it and sold it for a retail price of $44,000, which left me with a net profit of $14,000. At first glance, it had looked as though my profit would be $16,000 to $18,000, but the true amount was revealed when all the hidden costs were considered. Use this worksheet without exception to save yourself a lot of grief.

Selling to Another Investor

The Property Acquisition Worksheet (Appendix A) will also show an investor looking for a wholesale deal how much he can expect to make if he purchases the contract. Just by looking at the completed form, especially the bottom line, he can decide if he wants to buy the property. All the numbers are on the sheet. Remember, it should be filled out before you decide to buy. In fact, you should complete it before you make an offer.

Explanation of the Property Acquisition Worksheet

- Use comparables, appraisals, or your knowledge of the neighborhood to determine the sale price of property before you ever make an offer. Never buy a property until you know this value after fix-up. If you neglect to be careful about this, you're headed for an expensive lesson in the real world.

- **Items 2-9** relate to the purchase cost. Include every applicable item. The down payment is what you will pay the seller at closing. Closing costs vary depending on the type of financing. Talk to your REALTOR® or a lending officer to determine exact figures for your deal.

  The appraisal may be an FHA, VA, or fee appraisal. It depends on financing obtained and may cost between $250 and $400. The termite inspection is paid by either the seller or the buyer. Prices vary from $20 to $75 depending on the size of the property and type of inspection. The survey is performed by a licensed engineer; fees start at about $250. Miscellaneous costs include bird dog fees and fees for putting utilities in your name, to name a few.

- **Items 10-12** deal with repair costs. You can get formal written estimates from contractors. If it's set up so that the contractor will be responsible for all the repairs, and if you have the estimate in writing, it will be the contractor's problem if the actual cost exceeds the estimate. Nevertheless, allow for cost overruns from hidden problems.

  Sometimes, I use several contractors for the same job, such as a roofer, a plumber, and an A/C contractor. This

requires several estimates. In the beginning, I suggest that you get multiple bids on every deal, but only after you have the property under contract. Don't waste time collecting information on properties you're not buying. See if you have a deal, then spend time on the house. Soon, you'll be able to estimate costs without getting bids. You'll learn to make an offer based on your immediate assumptions and verify those assumptions before closing. You'll be able to buy while others are still collecting information.

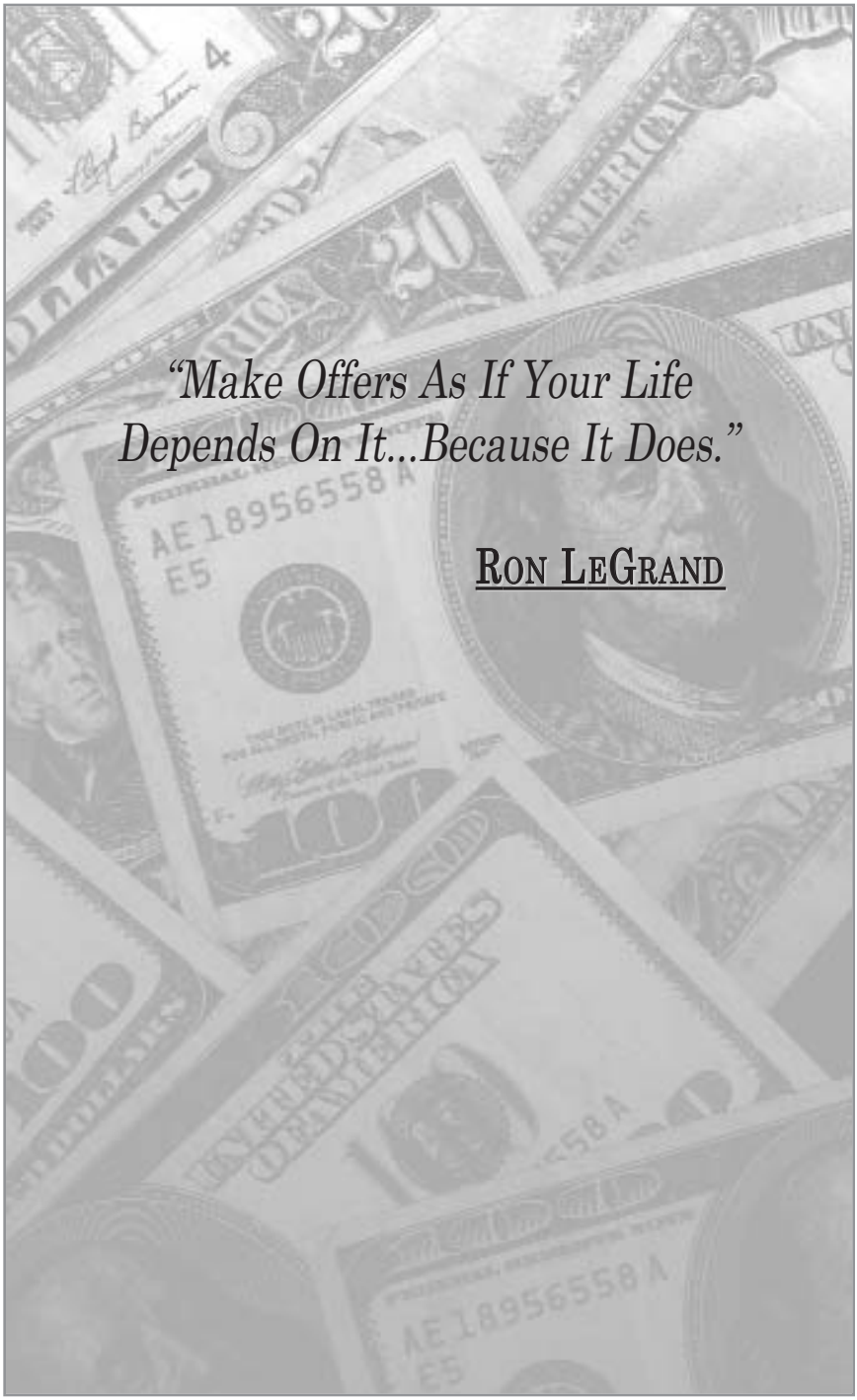
- **Items 13-17** show you what it will cost to hold the property in terms of monthly payments and other expenses. Allow for at least six months' worth of expenses if you're selling retail. The "payments for six months" item refers to the mortgage payment, if any, during the fix-up and sale period. The property tax amount can be found by contacting a title company, an attorney, or a county clerk. In Quick-Turning houses, you will seldom pay any property tax except at closing. Insurance is in reference to a basic hazard insurance policy on the property for the time you own it. Similarly, the figure for utilities refers to the electricity, gas, and water used while the house is in your name.

- **Items 18-21** show you what it will cost to sell the property. This is the cost of actually closing the loan and executing the sale. If you need help estimating these costs, simply call the lender you want to use and give him the sale price. He will prepare a cost estimate for you and tell you what the seller must pay. Remember to use only those costs you are paying, not the total sale costs. Some costs will be covered by the buyer.

Next add lines 9, 12, 17, and 21 and subtract the total from the amount for which you expect to sell the proper-

ty. Then subtract existing mortgages you have to pay off. This gives you your net profit.

Finally, to determine exactly how much cash it will take to buy this property — the bottom line — add items 9, 12, 13, 15, 16, and 20. These are items that require a cash outlay during the holding period. The other items will be deducted at closing.



"Make Offers As If Your Life Depends On It...Because It Does."

RON LEGRAND

The dictionary is the only place where success comes before work.

Arthur Brisbane

Chapter 5

Retailing to Owner/Occupants

Buy Low-Sell High

As noted in the previous chapter, there are really only four ways to turn Fast Cash profits with houses: retailing, wholesaling, assumptions, and lease options. Almost any kind of Quick-Turn transaction you create will fall into one of these categories.

One of the most widely accepted methods for making quick profits with single-family houses is to buy low — well below the after-repaired value — then rehab the property to market to an owner/occupant at retail price via new financing. This retailing method I call "buy low-sell high." This kind of deal is concerned with price, whether it involves an all-cash deal, very little cash down, or no cash at all. Most important is your net — the amount you keep after expenses. This is the type of deal that brings in the most money, but it also has the most headaches.

In Chapter 15, I show you how to market these houses quickly. During the past 14 years, I have bought and sold at least 100 houses using the buy low-sell high method alone. You can earn huge profits in a short time by flipping houses. By "short time" I mean 2 to 6 months, on average. An example of this is a house I bought for $22,000 by putting down $5,000 of a partner's money and taking over existing loans. We spent $5,000 of my partner's money to repair the house, which we sold in 30 days for $49,000 with a new FHA loan for the buyer. This whole transaction took 60 days from the time

we purchased the house to the time we closed the sale. However, this is not always the case. Sometimes you hold properties for several months. Don't let an extended holding period put you in a difficult spot. Plan for it going in. Then, if you can sell the house quickly, you get an added bonus.

A Universal Mechanism

I know you folks in the higher-priced markets are laughing at these figures, but believe me, if prices are much higher in your area, you have a definite advantage. In an area like Los Angeles where the houses start at $100,000, it's much easier to make a lot more money with fewer deals.

On my little house, we netted about a 40% profit. However, I don't want to lead you to believe that you should expect a 40% profit in high-dollar markets. The percent of profit is not important; all that counts is the dollars. Would you rather have 40% of my $49,000, or 20% of $175,000? Tough decision, huh?

> *At one of my recent Los Angeles classes, a student told me how he had made a $50,000 profit on his first investment house, mostly by accident. He had simply bought an inexpensive house and done some work on it so his son could live in it. But when he discovered that the house was worth about $60,000 more than he had paid for it four months earlier, they decided to sell it. It wasn't inflation that increased the value and allowed that kind of profit. It was sweat equity and a smart decision to buy a property well below market price. Their profit was made when they purchased and realized when they sold.*

Sometimes, I wish I had cut my teeth on high-dollar houses. I often wonder how much more money I might have made during the past 14 years had I been dealing in houses costing more than $100,000 rather than less.

A couple of students from the Washington, D.C. area come to mind. Their names are Keith and Kyong Luck.

I remember that the first deal we discussed was a foreclosure in which they were involved. The house was worth about $220,000 and in good condition. The Lucks had gone through a series of negotiations with the seller and the seller's attorney, only to have the attorney blow the whole deal. The Lucks were willing to pay $150,000 to $160,000 for the house with some owner financing, but the attorney had advised the sellers they could do better, and that a miracle would happen before they were foreclosed out of the house.

Finally, the foreclosure auction was looming, and no miracle had occurred, so the Lucks stopped talking to the seller and the attorney and went directly to the lender, the one who was foreclosing. With him, they negotiated a deal in which the bank would create a new loan to the Lucks for the amount of the existing debt if the sale went through and the bank got the house back. Of course, no miracle happened, the sale went through, and the sellers lost their house because they had followed the advice of their brilliant counsel.

All this time, Kyong had been telling me she wanted to buy a house for 50 cents on the dollar. I kept telling her that doing so would be difficult in her high-dollar market. I bet I told her a half dozen times that 20% of $200,000 was better than 50% of my $50,000 houses. I finally got her to agree to stop trying to make a killing on one house and to be happy with a 20% to 30% profit in her area. So she agreed to be less greedy and to stop making ridiculous offers.

Their next call was to tell me they had bought the house from the bank the day after the sale. The bank issued them a new $95,000 loan with good terms, and they had to agree to throw an additional $6,000 into

the pot to get the house. Their total purchase price was $101,000 for a $220,000 house in good condition.

I'll tell you, some of my students just won't listen. Maybe the next time I tell them they can't buy a house for half price they'll pay attention. Then again, maybe not. By the way, after the Lucks bought this house they did a stupid thing. They moved into it. Dumb, huh? The last time I heard, they had refinanced the house for $175,000 to generate about $70,000 of tax-free cash. Knowing Kyong, I'll bet she still has every penny of it.

Any of you, and I do mean any of you, who have a desire to use real estate as your vehicle, coupled with willingness to learn what you need to make it work, can accomplish the same thing and more. If you put forth the effort and stick with it long enough, you will be successful. Most folks start part-time and learn the ropes as they go. After a few successes, some make it their full-time occupation. After all, if you net $10,000 or more per house, how many do you have to turn in a year to surpass your present income?

Saleable Houses for Pennies on the Dollar

The kind of "buy low-sell high" house you're looking for is located in a bread-and-butter neighborhood, the subdivisions that are in the low to mid range-priced houses. This is where most Americans live. This is where you will find the majority of the houses with the most motivated sellers, and that is where most buyers want to live.

If you intend to sell using FHA financing, ascertain the maximum loan for your area and look for houses that will retail in a range from 40% to 65% of that amount. For example, if $90,000 is the maximum loan, then you will look for houses that will appraise for $35,000 to $60,000 in good condition. If you venture above that range, you will have a tough sale on your hands because your buyers will need a large down payment to qualify for financing.

You'll spend much more time trying to market a high priced house than you will if you stick to the low-priced bread-and-butter houses. Why tie up your funds in one really nice house when

you could take the same money and get control of three or four houses in blue-collar neighborhoods? The people who buy higher-priced houses are more sensitive to ripples, bangs, and thuds in the economy than the blue-collar guys.

Think about it. When the vice president of marketing is laid off, how long will it take him to find a comparable position? When the guy who works at the plant or works construction gets laid off, he can usually find a similar job in a lot less time than will the vice president. Another thing to consider is that many houses in the upper end of the market require two incomes to make the mortgage payment. What happens if one spouse gets laid off, pregnant, or dies?

Give this serious thought when you are prospecting for properties. In other words, do your fishing in the pond with the most fish. You need to do everything possible to ensure the success of your investments.

Next, find out how much the property is going to cost. Using the Property Acquisition Worksheet will help you calculate this in a matter of minutes, and it will keep you from forgetting anything. After you have completed the worksheet, the only thing left is to verify your assumptions, which are the cost of repairs and the value after the repairs are made. If the numbers tell you you'll make the desired profit, and the house is in a saleable neighborhood, then proceed to closing.

Summarizing, here are the essentials for a buy low-sell high deal:

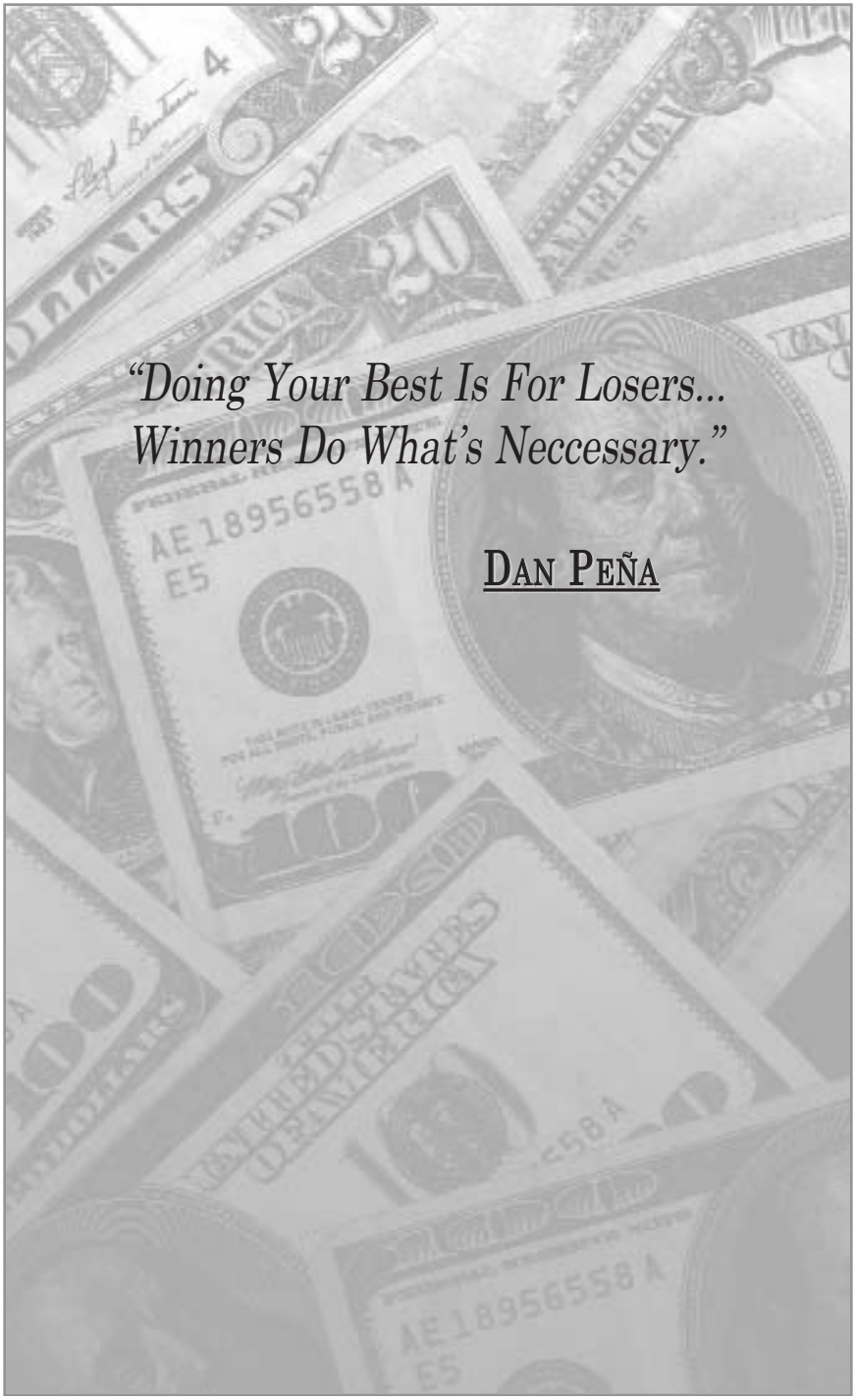
1. You must make sure the house is in a good location for resale — a good, clean neighborhood where people want to live and where you won't need a gun to feel safe while showing the house.

2. Complete the Property Acquisition Worksheet. Make sure you know your bottom line prior to buying the property. Know what you are going to do with the property. The worksheet will show you the profit you can expect if you enter into a particular deal.

3. Perform quality repairs to the house. Don't cheat in this area because you're in a hurry to resell. If you have a buyer who can qualify for a loan, he or she has many houses from which to choose. Your house should be prepared so that it is a cut above the rest.

4. Prepare a complete marketing plan for the house before you put it up for sale. Answer these questions before you buy the house: How are you going to sell it? Who is going to sell it? What lender are you going to use? How will you write the ad? The earlier you decide these matters, the smoother the sale will go and the faster you will make your cash profits.

It may be to your advantage to let a good REALTOR® handle the sale for you if you don't feel comfortable doing it yourself. If you have done a good job of finding a good deal to begin with, you should be able to afford the services of a REALTOR® and still make a handsome profit for yourself. Remember, no one gets anything until the property is sold. Professionals can sometimes help you turn the houses faster than you can do it yourself. Used properly, a REALTOR® can be a real asset in your investment strategy. In later chapters, we'll talk more about REALTORS® and how they can put more cash in your pocket.



"Doing Your Best Is For Losers...
Winners Do What's Neccessary."

DAN PEÑA

Obstacles are those frightful things you see
when you take your eyes off your goals.
A great pleasure in life is doing
what people say you cannot do.

Walter Gagehot

Chapter 6

Wholesaling to Other Vendors

Buy Low-Sell Low

Wholesaling properties is one of the best methods to generate rapid returns. As we said in the previous chapter, although retailing a property will make more money, it requires far more work. To retail, you need money to purchase and repair; you must find a buyer; and you have to arrange a loan. If you are willing to do that much work, retailing is the way to make the most money.

It is wise, however, not to have too many retail houses going at any one time. It is too hard and risky because of carrying costs. On the other hand, just because you have plenty of houses to retail, you shouldn't stop looking for more because wholesale buyers are always available if you find a good deal.

Wholesaling properties is the quickest way to make cash overnight. For example, I recently bought a house from a lender for $5,000 total. The house needed work and was appraised for $32,000 after repairs. I sold it the next day for $10,000 cash without touching it. The lender could just as well have spent $5,000 to fix it up and sold it retail for $32,000. He didn't want to do this, for various reasons, so his loss was my gain.

The hardest part about wholesaling is finding the deals. You will learn how to do that in Chapter 9. When you become good at finding the deals, you are often a retailer's best source for houses. You, as a wholesaler, can look for deals all day, all the

time. You may have to make 20 offers to get one that is acceptable to a wholesale buyer. However, if you are willing to do the hard work, it is not uncommon to make $2,000 to $10,000 in 24 to 48 hours with a good contract. A person can make a good living finding deals to sell to investors and/or owner occupants, without ever retailing a single house.

With this method, you find the properties, put them under contract, then sell the contract to other investors who want to make repairs and sell properties retail. In some cases, you will have to purchase the house to protect the deal and sell it a short time later for a quick profit. Usually, a retailer is our prime customer, but owner occupants are good candidates as well, because many people are looking for inexpensive handyman specials they can fix up and occupy.

Selling a Contract to Another Investor

Four keys to wholesaling your properties:

1. **Don't expect to sell an investor any house you wouldn't buy for yourself.** You have to negotiate good deals if you are going to get into the wholesale business. Remember, investors aren't stupid; they think just like you.

   Ask yourself if you would buy the contract in question if it were presented to you and you had the money, but not enough time to find your own deals. Remember, if buyers are going to do all the work to repair a property and market it at retail, they want to make a good profit, and they are entitled to it.

2. **Complete the Property Acquisition Worksheet,** without exception. Fill out this sheet as if you were the investor who was going to buy the house and retail it. Allow for a reasonable profit for the investor, while making sure that you include your own wholesale profit in your buyer's costs.

3. **Don't be greedy!** Take a small, fast profit, leaving the larger profit to the retailer. You can sell the contract to an investor for a markup of $2,000 to $10,000, letting the investor repair the house and collect the lion's share of profits.

   Remember, there is always a wholesale market and a retail market. It is the wholesale market that lets you turn a deal into quick profits. You should be willing to take less money to complete the deal more quickly. Using this method, you will ultimately make more money by working a larger number of deals, each generating a modest profit.

   The amount of your profit will depend upon the value of each deal, your quickness at finding the great bargains, and your skill at cultivating a list of wholesale buyers who will buy the houses as fast as you can find them.

4. **Construct these deals with low cash down.** For example, in the deal mentioned below, we could have offered the seller $15,000 cash to mortgage, taken over the $5,000 loan, and bought this $20,000 house. But if we had done that, the investor would have had to come up with $17,000 cash to buy this property from us. That would have been too high for some investors.

   Constructing the deal with only $7,000 cash down made it much more marketable. Make your deal acceptable to the seller and agreeable to an investor, so you can turn it around with as little cash as possible. Make your deals work for everybody!

EXAMPLE

OFFER 1		
Purchase Price	$ 20,000	
Take existing debt	$ 5,000	
Cash required	$ 15,000	
Plus my fee	$ 2,000	
TOTAL CASH REQUIRED	$ 17,000	
OFFER 2		
Purchase Price	$ 20,000	
Take existing debt	$ 5,000	
Down to seller	$ 5,000	
Short term seller carry back	$ 10,000	
Cash required	$ 5,000	
Plus my fee	$ 2,000	
TOTAL CASH REQUIRED		$ 7,000

Always be cash-conscious. Make offers as if you have little or no money, even if you have a lot. The smaller amount of cash required, the more attractive the deal will be to an investor. And, of course, always use as much seller financing as possible.

Finding Other Investors to Buy From You

A great place to find buyers for your contracts is your local real estate club. Some clubs in major metropolitan areas have several hundred investors, many of whom are potential buyers for your contracts.

Why would they want to buy your contracts? Many investors don't have the time to find as many deals as they

would like. Some investors are too busy to even follow up on their own leads! Others may be nervous about negotiating and will be thankful for the opportunity to profit from your initiative. Occasionally, investors will have chosen a narrow niche in the market in which they want to work, such as a particular neighborhood or type of building. If you bring in their kind of contract, they will be extremely interested.

To find a club, just check the yellow pages under "clubs" or "associations." Sometimes clubs advertise in newspapers. Be sure to ask REALTORS®, title insurance companies, real estate attorneys, and others who work in the field if they know of any local real estate clubs. If there isn't a club, start one! You will quickly discover just how many other investors that do or want to do the same thing you do. Real estate associations are discussed further in Chapter 9.

In addition to real estate clubs, you can run ads in the local papers. People who call about handyman specials are usually investors. Keep those names and treasure them because they are your most valuable assets. Be sure to complete an information sheet for each investor. Before long, you will have developed a list of serious buyers, and then your problem will be finding deals fast enough to sell to them.

The Property Acquisition Worksheet is one of the best tools in your investor tool kit. First, it will tell you whether the deal makes sense or not. When I say a deal "makes sense," I mean that a property can be bought for a price low enough to cover all costs, then sold high enough to render a profit. Whether I sell a house to an investor or to a home buyer, I have to be able to meet the costs AND realize enough profit to make the deal worthwhile.

When an investor sees that you have taken into account all the costs involved in a piece of property, while allowing a profit margin for both of you, he feels the deal is attractive and you are a pro. Remember, this is not about real estate; it is about money. If your investors don't want to buy or can't buy at the moment, ask them if they know anyone else who might be interested in buying a house for renovation and resale. Even a person who can't afford the deal may know someone who can.

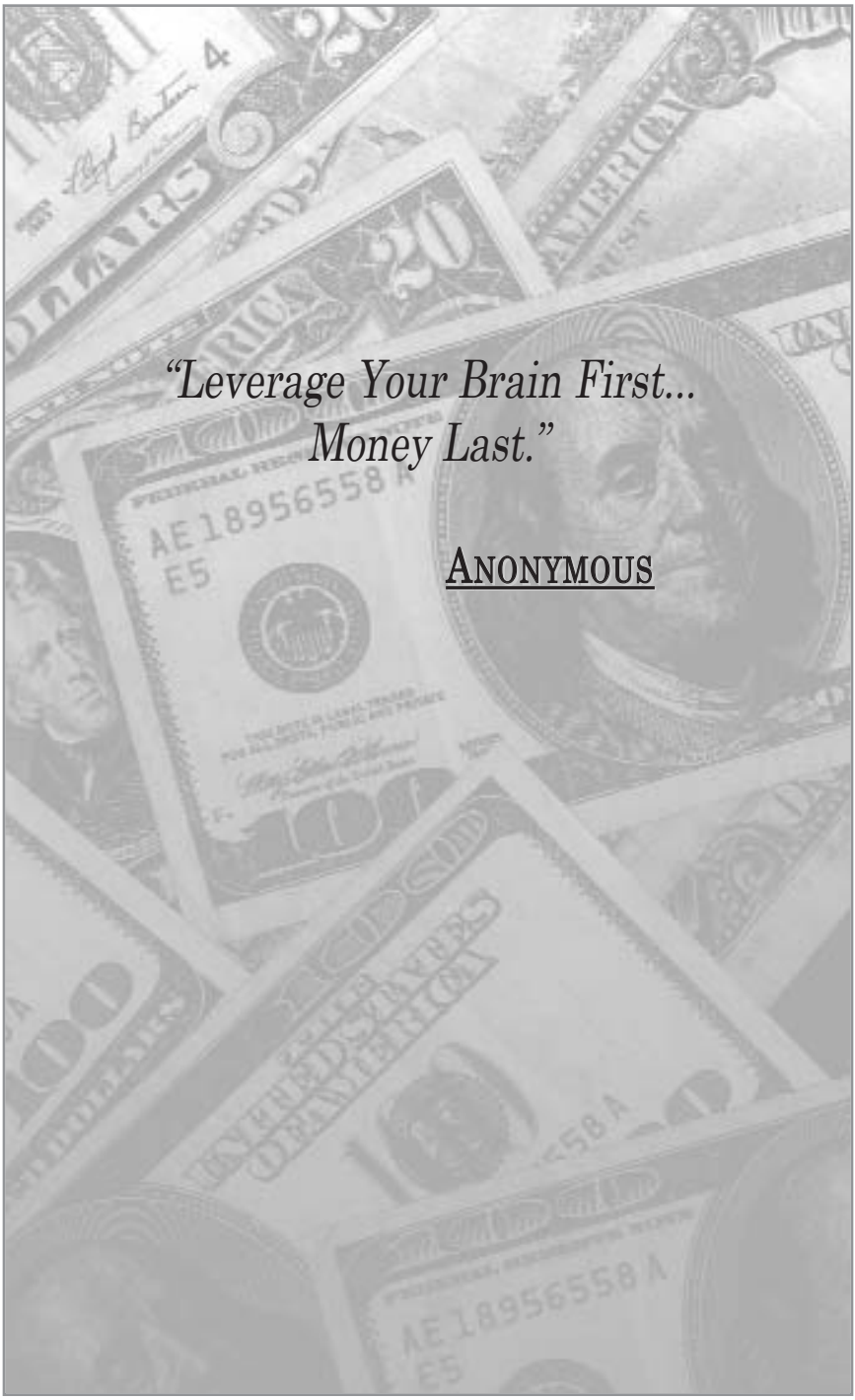
If you are able to find good deals, you won't have trouble selling them. Only time will make you an expert at wholesaling. Don't expect to acquire all the answers in a day.

One mistake many investors make is to stop looking for houses when they have a few on hand. When you become proficient at finding the bargains, you will probably discover that they are much easier to find and buy than they are to sell retail to qualified buyers. However, this should not stop you from wholesaling them as fast as you can find them.

Most of the time, you will have a house sold before you have to buy it. By constantly locating deals for others, a high, consistent cash flow may be obtained by collecting a few thousand dollars per house on simple, hassle-free Quick-Turns. Many of my students are producing $15,000 or more in monthly income by doing just that. They have discovered an important point that others may never figure out . . . NEVER SHUT DOWN THE BUYING MACHINE!

> *This brings to mind a friend from Atlanta, Steve Jordan. In January 1992, Steve was working for IBM. In February that year, he attended our Ft. Lauderdale Boot Camp because his intentions were to go full-time into real estate and he wanted to get a jump start.*
>
> *That's exactly what he got. He recently wrote that he netted more than $64,000 on just four deals in the first five months of his full-time career.*
>
> *One deal in particular sticks in my mind. Steve paid $32,000 for a house worth about $60,000. the house needed about $6,000 to $8,000 in repairs. He repaired it and sold it retail for a $16,000 profit. Later, he discovered the seller had paid only $15,000 for the house. That's a $17,000 easy profit to Steve's seller and a $16,000 profit to Steve all on the same house.*

Who says this is the stuff of fairy tales?



"Leverage Your Brain First... Money Last."

ANONYMOUS

Each problem has hidden in it an opportunity so powerful that it literally dwarfs the problem. The greatest success stories were created by people who recognized a problem and turned it into an opportunity.

Joseph Sugerman

Chapter 7

Assumptions: Using Non-Qualifying Loans

I know from all my experience in buying houses that beginning investors can make good money quickly on assumption deals. I have found this to be one of the easiest and quickest methods of buying and selling a property in weeks, days, or even hours. Using this technique, you will find loans that can be assumed, such as non-qualifying FHA and VA loans, or you can create non-qualifying financing by using seller financing.

The beauty of this is that non-qualifying loans require little money and no credit checks, and you need very little training to do them. A non-qualifying loan is any loan that does not contain a "due-on-sale" clause. (Due-on-sale gives the lender the right to call the loan due when the property transfers ownership.) The absence of this clause takes control away from the lender and makes the loan freely assumable with or without the lender's permission. This creates attractive financing because the buyer does not have to qualify for a new loan to buy the house. If a buyer can satisfy the seller's need for a cash down payment, he or she can buy a house regardless of their credit or inability to qualify under normal standards.

You must get into these deals with very little cash. In fact, you can even buy these with no money down. Sometimes, owners are two or three months behind on the payments, and you just pay the back payments and take over the loan. Often, you can sell the property before you have to take title to it. If you find a buyer before you close, you can often have the property deeded directly to the new buyer and just pick up a check for the

difference. If you buy a property for $1,000 down and sell it for $4,000 down, you keep the fast $3,000 profit.

Here is an example of an assumption deal that was located by my son-in-law, Bobby. Before I tell you about the deal, maybe I should tell you about Bobby.

When he was in his twenties, he had hair down to his shoulder blades. His main ambition in life was to be a rock-and-roll star. That's right, one of those hippie-looking, guitar-banging, noisy rock stars. Now, I don't have a problem with that so long as I don't have to listen to the racket; it drives me up the wall. Hey, a man's gotta do what he likes, right?

Anyway, over the years, Bobby has become proficient at putting together deals when he decides he wants to work, which usually happens only after he runs out of money. Not long ago, a couple called about our ad that we buy houses. They had a house with a $50,000 FHA loan that was assumable with no qualifying, and they wanted $2,000 cash in addition.

Bobby looked at the house and determined that it was in good condition and worth in the mid-$50s. He knew from experience that the less he gave the seller, the more he would make when he found a buyer. He had learned that the only way he could make quick cash on an assumption was to get in with little or nothing down, then find a buyer who would bring a few thousand dollars to the closing and assume the loan without qualifying. He could keep the difference between what his buyer paid down and what he had to give to the seller.

He tried to convince the sellers to deed the house to him. He said he would take over the loan and pay the closing costs, but they wouldn't bite. However, they did agree to accept $1,000 at closing.

Within two weeks, Bobby had found a buyer with $5,000 and set up a closing for a few days later. From

that $5,000, he paid the sellers the $1,000 and put $4,000 in his pocket.

While that wasn't a big deal, it was a fast, easy $4,000 any way you look at it. I forgot to tell you why Bobby wanted this deal. You see, I was about to take a trip to Las Vegas for a speaking engagement, and Bobby and my daughter Vicki wanted to come along. The only way they could afford this was to work a deal such as I've just described. As I said before, Bobby really works when a sense of urgency strikes him.

Incidentally, all the money was gone within 24 hours of landing in Vegas! Oh well, easy come, easy go.

With this type of deal, I recommend that the house be in excellent condition. You also profit most by getting into this property with the least possible down payment. The holding costs can be held to a minimum through negotiation with the seller. For example, if you bought the house in the middle of the month, and the seller expects to be in the house through the start of the next month, you can reasonably ask him to make the next month's payment, thus reducing holding costs and increasing your profits.

This is typical of a retail assumption deal that generates immediate capital. If the house appraised for $55,000, you could still sell it for $56,000, $57,000, or even $58,000 if you wish. The financing makes the house very attractive to the buyer and, consequently, makes the house worth more. In either case, you have no reason to appraise the house and neither will your buyer. It's worth whatever you say it's worth.

But what if the buyer does not have $5,000 cash for a down payment? You can take whatever down payment he has and payments in the form of a second mortgage until it is paid off with interest. Or, let them rent the house until they have paid the entire $5,000 over and above their payment, then deed the house to them.

Six Keys to Successful Assumption Deals

1. **The house must be in good condition,** needing few, if any, repairs. You shouldn't spend more than $1,000 to upgrade and purchase a $50,000 property.

2. **Pass by any deal if you can't get into it with only a small investment of cash**. If it doesn't fit your guidelines, WALK AWAY. There are hundreds of other deals that DO fit.

   On the other hand, don't walk away without leaving an offer. If the seller becomes motivated enough in the future, he may decide that your offer looks pretty good after all.

   The monthly payment on any assumption should be about 1% of the original loan. For example, an $80,000 loan should have a monthly payment of about $800. Similarly, a $55,000 loan should have payments of no more than $550 a month. You would have a problem selling a $55,000 house with a $750 monthly payment.

   People living in $100,000 homes are accustomed to paying $1,000 a month. This type of transaction will work on a $150,000 house as well as a $50,000 house. However, with the more expensive homes, it is even more important to watch your carrying costs and enter into the transaction with very little risk.

3. **The property must have an assumable non-qualifying loan**, or you must have a good working knowledge of seller financing to create it yourself. Creating seller financing is discussed in Chapter 13. It is an excellent means of creating income.

4. **Ask for the right amount of down payment when reselling the house.** I try to match carefully the amount of down payment with what I know about my potential buyer. If you are selling a $150,000 house, then you would expect $10,000 to $20,000 down. Is that too much? Not really. I know from experience that people who would live in a $150,000 home usually have that amount of money to put down. For a $50,000 house, however, you may not be able to get more than $5,000 down. It is usually difficult to get more than a 10% down payment, so a good rule of thumb would be to keep it to 10% or less.

5. **Let your buyer pay all the closing costs.** Just write it into the sales contract and act as though it's normal. The contract determines who pays what closing costs. Remember, buyers of assumptions often can't qualify at the bank, so they tend to be a lot less picky than buyers who can qualify. You are in control, so you make the rules.

6. **Try not to take title to the house.** Ideally, you will have resold the house prior to the closing. As mentioned above, if you find a seller who needs $1,000 to get out of his problem, and you find a buyer who has $4,000 to put down, you can set up a simultaneous closing and make $3,000. If you close and take title, however, you then become responsible for the payments and closing costs. Of course, I would recommend that you always have the house under contract before you try to market it, and you should be prepared to close even if you can't find a buyer before your contract expires.

When you become proficient at finding a buyer first and then find the house to buy, the entire process becomes much easier. I have done many of these assumption deals. Some I had to buy first; on others, I did a simultaneous closing with the new buyer and seller present at the same closing. In that case, all I had to do was pick up my check and look for another good deal.

Either way will work, but your profit will be smaller if you actually take title, because you will probably pay some or all of the closing costs and some holding costs.

Types of Loans to Seek

It is best to look for assumable non-qualifying loans. Those are VA loans closed prior to March 1, 1988, FHA loans closed prior to December 15, 1989, and most private loans that do not contain a due-on-sale clause. VA and FHA loans closed after those dates also can be assumed, but they require qualifying because there is a due-on-sale clause attached to them. This is time consuming and does not fit into our program very well.

Make sure you find out when the loan on a particular property closed. Get in the habit of asking when the owners closed the loan when you take the information over the phone. Assumable private loans also can work very well for investors because they can be below normal interest rates and require no points and other fees to assume.

Thousands of houses with good, non-qualifying FHA and VA loans are available. This means that you just have to be alive to assume the loan. There are no other requirements. Simply take over the loan and make the payments. A corporation, a trust, or any other entity can buy such properties. If there are two homes on the market, one with a non-qualifying loan and the other requiring a new loan, the assumption will sell faster every time. I have seen deals like this in every city to which I have traveled.

You don't have to steal assumptions. You can buy them for what they are worth or a little less. I'm talking about buying them for 80%, 90%, or even 100% of their value and still making money. What makes them worthwhile is the loan. It doesn't require lender's credit checks or other qualifying requirements. It's all in the financing. You can use this technique over and over again to make money. It's an easy-in, easy-out method.

Most old FHA or VA loans may be assumed for a $45-$125 transfer fee. However, do not assume the loan under your own name. Assume it under a trust or corporate name (see

Chapter 14 on taking title and land trusts). This will avoid personal liability.

Failure is not an option. It's just the nagging possibility that helps you stay focused.

Anonymous

Chapter 8

Lease Options: Taking Control Without Taking Title

The fourth way I make quick profits on houses is to use a lease option or just an option. Anyone can cash in big by controlling property while never taking title. This method will work on houses in any condition, in any price range, and with any kind of underlying financing. You can reap large profits without ever owning the house. You don't have to pay any closing costs or do any repairs. You use little or no money and take no risk. There are two versions of this technique.

Leased To You, Subleased to Your Tenant

In the first version, I lease with option to buy and reserve the right to sublease to a tenant/buyer, who will eventually buy from me. There are three profit centers involved in this kind of transaction. Since I have the right to sublease, or sandwich lease, the first profit will be made the day I put a tenant in the house. The objective is to get a non-refundable down payment or earnest money deposit from my tenant/buyer. This will always be more than I gave the seller to secure my lease option, because one of the criteria for this kind of deal is to obtain control of the house with little or no cash. It's non-refundable because I have made it perfectly clear to my tenant/buyer that if he doesn't buy the house, he won't get a refund.

For example, if I gain control of a house in good condition, give the seller $1,000 and get $3,000 from a tenant/buyer a few

days later, I have made an instant $2,000 for renting the house. Pay attention all you readers who need money two weeks from Friday. What I have just told you could be a full-time business, producing $10,000 per month income simply by renting three or four houses you don't even own.

The second avenue of income is the monthly spread I will attempt to create between the amount I collect from my tenant/buyer and the amount I pay my seller to cover his payments. This is raw profit that is also non-refundable. For example, if I am collecting $650 a month and paying $450 a month, I receive $200 a month profit for collecting rent on a house I don't own. That beats the 10% REALTORS® collect, doesn't it?

OK, I know what you're thinking. You're concerned that you need a license to do this, aren't you? Wrong! As long as you have a lease option agreement signed by the seller, you need no license of any kind. This gives you an equitable interest in the house, giving you the right to sell or lease the house without being licensed. In fact, you don't have to be licensed to use any of the strategies and techniques I teach. You don't need a license to buy or sell houses as long as you have them under contract to purchase or option, and your purchase is not contingent on selling the house before you buy it. Let's just keep it simple and successful.

Another advantage of collecting earnest money and a monthly spread is that it's not taxable as income until your buyer either buys the house or defaults, as long as you call it all "option money" and not "rent received."

The third income generator is the spread between the price you negotiate as your buying price and the amount for which you actually sell the house when your tenant/buyer exercises his option to purchase. This could be a substantial sum and frequently is much more than you would make if you actually took title.

Remember, you have only optioned the house. You haven't actually agreed to purchase it. An option is a unilateral agreement giving you control without forcing you to buy. Therefore, if things don't work out as planned, you can back out with no loss.

Lease Option Without the Sublease

What you are about to read in the next few paragraphs is known to only a handful of people in the entire country. This method itself could become a full-time endeavor. If you become adept at marketing houses, what I'm about to tell you could enable you to make $200,000 this year. You need little money, no credit, no partner, no employees, and you'll do no repairs on a house. In fact, you can work in middle- and upper-class neighborhoods if you like, deal only with the cream of the crop, and make no monthly payments in the process.

Before you get too excited, let me emphasize that the key to being successful is to become proficient at marketing houses. First, look for the areas with the most sales activity in any price range. If they're selling fast, I don't care how much they're selling for. Actually, the higher the price, the better, because the higher the values, the more room you have to negotiate a wider spread.

Next, do everything possible to find all the houses for sale in these neighborhoods. Use several of the techniques described in Chapter 9 to find motivated sellers. You're looking for houses in excellent condition, in very marketable areas, and preferably vacant, because they'll be easier to show. These houses must have at least enough equity to make it worth your while to sell them. If they're fully financed, they may work for the lease/sublease method, but not for this one. Use your Property Acquisition Worksheet to determine whether this is a worthwhile opportunity for you, or a deal you should ignore.

Your objective is to find sellers with problems other than necessary major house repairs. For example:

- The owner has moved and still has mortgage payments.
- The house needs minor work (that you're willing to do).
- The seller wants all cash at closing and won't compromise, but will sell below market value.
- The seller hasn't been able to sell because of poor sales techniques. or the REALTOR® is lazy, or nobody is ever around to answer the phone, etc.

Many other circumstances create flexible sellers as well. In this case, your seller doesn't have to be all that motivated because you don't have to be rigid to make a profitable deal. Your main concern is to negotiate a purchase price far enough below market value to make it worth your while to get involved.

The goal is to option the house below market value, sell it at or near market value, then keep the difference.

Let's see how this works in real life. The seller calls me and says he has a house for sale at $125,000, in a lovely area and in excellent condition. He owes $87,000 on the house, has a conventional loan with a due-on-sale clause, would like to leave town in 60 days, but he has to sell before going. He is very credit conscious and won't sign a deed until his loan is paid off and he gets his equity, or at least some of it. This might be our conversation:

Q. "Mr. Seller, you say you want $125,000 and you think that's about what the house is worth. Is that correct?"

A. "Yes."

Q. "You say you need cash and debt relief on a non-assumable loan. The only way I may be able to help you is with our lease option plan where I can cash you out if we can agree on a price and if your house qualifies. It might take me a few months to pay you, but it would be in cash. Would you like to hear about it?"

A. "Yes."

Q. "Actually, it's quite simple. There are two different ways we can work it. One, I can lease your house with the right to sublease to a tenant/buyer who should eventually buy the house. The downside to this, of course, is that someone will be living in the house. The upside is that your payment will be made in the process. The second way I can help you is to option your house at a price we both can live with and leave it vacant until I sell it. I have a good supply of buyers who want to live in your area and, frankly, I don't feel it would take long to sell it. The downside is if I don't have the right to sublease, then I can't

make your payment while I'm selling the house. Which option sounds best to you?"

A."I don't want anyone tearing up my house."

Q. "I don't blame you and I couldn't honestly guarantee you that that wouldn't happen if I put a tenant/buyer in the house. I can prescreen them, but I can't live with them."

A. "You mean you want to take my house off the market and not even pay a monthly payment?"

Q. "Yes, Mr. Seller, that is one of your options. Let's examine it a little further. First, who's making the payment now?"

A. "I am, of course."

Q. "Who will be making it six months from now if the house doesn't sell?"

A. "I guess I will."

Q. "Exactly! Now, let's examine the part about taking your house off the market. I can see where this could be a concern. You don't know I'm going to do anything for sure, do you?"

A. "I sure don't."

Q. "Then let's do it this way. I'll option your house and give it my best efforts. I'll advertise at my expense. I'll eat, sleep, smell, touch, taste, and feel your house until it's sold. It will be on my mind day and night. In fact, since I'm not a REALTOR® with 25 other houses to sell, it will be my only concern until it's sold. All I need from you is an agreement on the price and a key. Are you with me so far?"

A. "Yes! But you still haven't convinced me that I should take it off the market."

Q. "I understand your concern, but what if you don't take it off the market? What if you continue doing what you're doing now to sell it? If you get a buyer before I do, simply cut me a check at closing for $1,000 to cover my time and expenses and we'll part friends. Is that reasonable?"

A. "You mean if I sell it first, I can buy your option for $1,000?"

Q. "Yes, Mr. Seller, that's exactly what I mean. I want you to be in a no-risk situation. It's whichever way you win first."

A. "Why should I pay you $1,000 if I sell the house myself?"

Q. "Mr. Seller, quite frankly, if we can't agree on that, then maybe your house isn't the one I should be devoting my money and effort to selling. It comes down to a simple choice. Do you want someone else aggressively selling your house or do you want to continue fighting the battle yourself? I would think that with a buyout of a measly $1,000, it would be well worth a shot at it, don't you?"

A. "Well, why don't I just list it with a REALTOR®?"

Q. "I have no problem with that, if you're convinced it will help. You can list the house with a REALTOR® while still giving me the option. If the REALTOR® sells first, I'll back off and you only owe me $1,000. However, you should know that if I sell your house first, which is a very real possibility, you will still be responsible for the REALTOR'S® commission, unless you ask the REALTOR® to exclude me. Most REALTORS® are willing to do that if you ask. That simply means they won't get paid if I sell the house first. Why don't you give me just 60 days before listing? If I haven't found a buyer in that length of time, then go ahead and list and I'll even waive the $1,000. Is that fair?"

A. "Yes! That sounds very reasonable."

Q. "Good. Do you think we have a basis for doing business?"

A. "Yes!"

Q. "Great! The only thing left is for me to come look and for us to agree on a price. I think I've made it clear that I have to buy below market value to get involved. You are going to be flexible on your price aren't you?"

A. "Well, just how flexible?"

Q. "As I said, I can't pay full price. The only way I can make a profit is to buy well below market value. I can't say just how much until I see the house, but I'm telling you before I come out there that I will need a low price to get involved. Before I leave, you'll know what I can pay. Should I come look?"

A. "Sure! I'd be pleased to have you come on out. I do need to get the house sold."

I suggest that you go back over this conversation a few times until it becomes perfectly clear what I have done. Look at the questions and answers carefully. This is the way to get what you want from the seller. You should also practice dialogues like this with someone willing to help. You don't want a seller to think this is your first deal, so practice a little. Practice without pressure, and you will feel more confident when you're in front of the seller. It won't take the butterflies out of your stomach, but it will get them flying in formation.

There it is in a nutshell. I have taken control of a lovely home in a nice neighborhood with no money down, no monthly payments, and no closing costs, at a price below market and with no repairs to make. In addition, I've agreed to do nothing but attempt to sell a house and have no liability if I don't. I've put the seller in a no-lose situation, and agreed to pay all cash for the house when I buy.

In the process, I've given the seller the choice of whether he wants his payments made. Either way, I win.

If the seller chooses to leave the house vacant, I won't make the payment. If he allows me to sublease the property, I will make the payment if the house qualifies. He decides. Just think for a moment. All I'm asking the seller to do, if he chooses the vacant route, is to give me a key to show the house and agree on a purchase price. That's it.

I've put the seller in a no-risk situation with positive possibilities without even taking his house off the market. Just how hard do you think you'll have to look to find people who own nice, vacant houses in lovely areas, and who are willing to sell a little below market value for all cash with no risk? I suspect

you know the answer to that question . . . SUCH PEOPLE ARE EVERYWHERE!

Now, my only role is to find a buyer for the house and help the buyer find financing. He or she will bring a check to closing. My seller will be there to get his share after his loan is paid off, and I'll leave with the difference. If I could get my seller to reduce his sales price from $125,000 to $110,000, which, by the way, would be about the most I would pay, I would realize a $15,000 profit on a house I don't own.

I would expect my seller to pay about half the closing costs and my buyer to pay the other half. That leaves yours truly with no costs except advertising.

This is the basic approach to lease options. I have only begun to show you what is possible using this strategy. I have much, much more to share with you, but that is another whole course.

"Focus On The Few, Not The Many.
It Matters Not How Many Deals You Do,
Only How Much Money You Make."

RON LEGRAND

Section III
Smart Marketing

Most people give up just when they're about to achieve success; they quit on the one yard line. They give up at the last minute of the game, one foot from a winning touchdown.

H. Ross Perot

Chapter 9

Finding Motivated Sellers

Finding motivated sellers is vital to your success. A motivated seller is the key to all good deals. Read this sentence again and burn it into your brain forever. It will lead you to increase your profits, make better deals, put more cash in your pocket, and save valuable time. You must learn to understand and identify motivated sellers, or all the other information in this book will be useless. You'll spend all your time chasing dead ends and getting nowhere. And you won't be in this business very long.

Motivation comes in all forms. Some reasons relate to the owners themselves, such as divorce, age, health problems, or a change in family size. Others are more directly related to the property itself. Maybe it needs extensive repairs. In other cases, an owner might be having financial problems, be behind in his payments, or even on the verge of foreclosure.

One of the primary reasons for the failure of a deal is trying to buy from unmotivated sellers. It's like trying to push a rope. It will absorb all your time and energy and will get you nowhere. **Find the seller who really wants to sell**, and you will buy a lot more houses at far better prices. The secret to great deals is to find them before anyone else does.

The **first** thing you must do is let the world know you're in the house business. If you were arrested, would they have enough evidence against you to convict you of dealing in houses? Are you ashamed of being a real estate investor, or are you shouting it to the world?

Don't rely on just one or two methods to get the word out. You should pick at least five ways to find houses and put all five methods to work simultaneously. Remember, you want to make yourself prone to success. The more you put yourself in the way of opportunity, the better your chances of getting what you want.

This is important because if you try to do business only one way and don't find a house in a short time, you'll become frustrated or discouraged and quit. By knowing this from the start, you can avoid falling short and missing out on a fortune. Accept the fact that you have to do more than run an ad and sit back and wait for motivated sellers to call you to come take their houses.

To be honest, if that's all you did, you could still make a living, but you aren't after a living here, are you? You want retirement, fat city, a hammock in sunny Tahiti, travel, no debt, and all the money you can spend, don't you? If that's true, let's treat this like a business and use more than one way to attract customers. The more lines you cast into the pond, the better chance of getting a bite. If you use at least several of the following methods, you will receive more calls from motivated sellers than you can handle. That's right! The sellers will be calling you!

Why is it so important that the seller call you? Because they are always more motivated when they call you first. Knowing this, I suggest you do everything possible to encourage people to call you. Don't spend a lot of time dealing with unmotivated sellers who are just testing the waters.

Following are 15 tools that will aid you in your search for the sellers you need. Use them all, if you can. But experience has shown that you must use at least five simultaneously to succeed.

Cards

Cards are the least expensive, most effective way to advertise. They will cost between $15 and $75 per thousand, depending on how fancy they are and the kind of paper you use. A lot

of your cards will be thrown out. Sorry, but that's real life. Some of them will be saved, and a few will generate a phone call right away.

Here's the bonus question: How many deals do you have to do to pay for your cards? One single card is going to do it. The catch is, you never know which card. Don't be shy about giving out cards and telling everyone what you are doing. Even someone who has absolutely no interest in buying or selling a house might know of others who ARE interested. EVERYONE is either a prospect or a potential source of referrals.

Cards won't do you any good in the box, so hand them out everywhere, to everyone you meet. Leave them in restaurants, barber shops, stores, offices, and wherever else you go. Put them in the envelopes when you pay your local bills. If you have 1,000 cards more than three months, you're not getting the best use from them.

The message on the card should say something like "**I BUY HOUSES, CASH, ANY CONDITION.**" "**I BUY & SELL HOUSES**" also gets a lot of attention. To get double impact from your cards, reprint the message from your flyer on the back.

Make your cards as outstanding as possible. Be different! My card is a bright fluorescent orange. It really attracts attention. People want to keep it because it is unique. When I visit business acquaintances, I often spot my card in their card file, even years later. You might consider using those fancy, four-color, glossy, picture cards. They're expensive, but highly effective.

Your card is a billboard to telegraph your message. Be crystal clear about what you do. Avoid phrases like "Real Estate Investor." That means nothing to a motivated seller. People are only interested in what you can do for them.

Run Ads

The easiest way to find motivated sellers is to run ads in your local newspapers and let the sellers call you. Which papers? As many as possible. Most of the calls you get will be

worthless, but you only need a good one once in a while to make a good income.

You don't need fancy wording or displays to get calls. The ad I have used for years simply says, "We buy houses, fast cash, two-day closing, any condition, any price, phone number." I use a bold headline and avoid crowding my ads. I usually run ads in the "Real Estate Wanted" section. Run your ad in different sections of the paper to see what works in your area. Only practice will tell you what is most effective.

Don't be concerned about the competition advertising in the paper. It's amazing, but even when eight or 10 ads, all saying the same thing, run side by side, we all get calls. Quite often, they're not the same calls, either. Most people will call only one or two ads. But if your phone number is in their area, or there is something in your ad they like, your number is one they'll dial.

Read Ads

The other side of the coin is to call ads yourself. I recommend calling ads that are in the major newspapers, as well as those in shoppers and neighborhood papers.

Don't think there are no good deals in the papers just because many people read them. First, most investors check only a few ads before giving up. Second, you know exactly what to look for, so your search for leads will be much more effective. With assumption-type deals, look for ads that say "no qualifying," "assumption," or something to that effect. For buy low-sell high retail deals, look for wording such as "as-is," "make offer," "estate sale," "needs work," "handyman special," or "investor special."

When calling or answering ads, complete an information sheet to help you remember the details about each property, and to help you decide if the property fits into one of your purchase categories: buy low-sell high, loan assumption, or lease option. Why didn't I mention buy low-sell low here? Because any house that qualifies as a retail house will also qualify as a wholesale house. The difference lies in what you do with it after

putting it under contract. You will either retail the house to a homeowner or wholesale it to another investor.

The following is an example of what you might say when calling to answer an ad. I have these conversations every day, first on the phone and then at the property.

On The Telephone

"I'm calling about your ad in the paper. I see you have a house in (city), you have a mortgage on it of about $54,000, and you are asking for $5,000 down. Will you tell me a little about the house?"

The seller describes the house to you.

"I'm an investor, and I'm looking for houses in your area. I'm very serious, but I can tell you before I come over that I can't pay you $5,000 down on that house. I have to make a profit to be interested in looking at your home, and that just wouldn't be possible if I gave you your full $5,000. If I come over, I will leave you with an offer, but I can tell you before I come that it won't be anywhere near what you're asking. Should I come look?"

"Yes."

If the seller says yes, then skip ahead to the question about loan assumability. But if the seller says no . . .

"I can understand that. If I was in your position, I would want to get all I could, as well. However, would you take my name and telephone number and let me know if things don't work out as planned, so we can get together?"

Leave the door open. You can sometimes get these houses by putting yourself in the second position. If the seller can't find his ideal buyer, then you want to be second in line to buy the property. A lot of houses have been bought using this technique, so remember to use it whenever you have to.

"If the loan is assumable, when did you close on it?"

The date the seller gives us confirms that the loan is assumable without qualifying.

"Tell me how to find your house, and we'll set up an appointment right now so I can look at it. I'll see you at 3 p.m., and I'll let you know what I can do before I leave. By the way, will you and your wife both be home then?"

You must have all owners present because both sellers must sign the contract for the property to change hands.

At the House

"You have a nice house here. It looks like it's in pretty good shape. Your payment is OK; the only problem I have is that I can't give you what you are requiring down. The best I can do is give you $1,000 down, cash to mortgage, and pay your closing costs. Would that be of interest?"

"I want $2,500 cash down, Ron."

"I'd love to give it to you! And you know what, I think you can probably get it, if you want to leave the house on the market until somebody comes along who wants to live in it. I just can't give it to you because what I'm going to do with your house is find that buyer you're looking for, and I've got to have a way to make a profit. If I were selling your house as a REALTOR®, would I make a commission? It's only fair that I make one if I do it as a non-REALTOR®, right? If I give you more than $1,000, then I just wouldn't be able to profit from my efforts. Can you see my point?"

"Well, I guess so, Ron."

"The only way I can do that is if I give you $1,000, get $3,000 from a buyer, and make a profit. If that will work for you, I can do it. If not, you're not mad at me, are you, Mr. Seller? I told you before I came over that I was going to leave you with an offer, didn't I? OK, I'm leaving you with an offer of $1,000 down, and I'll pay your closing costs. I've got to buy some hous-

es by the end of the week, so that offer is only going to be good for another three days."

The probability of the seller's taking this offer is 50/50. He might accept the offer on the spot, wait a couple of days before calling you back, or just say, "no." I do not leave a written offer unless the seller is ready to sign it. This saves time and keeps the seller from having REALTORS® pick my contract apart. I suggest that you write on a piece of paper: "$1,000, cash to mortgage, plus closing cost, and your name, address, and phone number."

If, in the phone conversation, the seller says that he will not take less than $5,000 down, I leave him my name and phone number and tell him to call if a time comes when we should get together. Why go look at houses you know you can't buy? Prequalify the seller before you leave home. Remember, you only work with motivated sellers.

FSBO Signs

It's amazing how many people do not advertise the house they want to sell. Some people are so sure the world will beat a path to their door that they just put up a single, small, hand-made sign, one that sometimes is not even visible from the street. Of course, this can work to your advantage as an investor. If you are the only one who pays any attention, you are also the only one to make an offer. Poorly advertised FSBO homes are excellent prospects for Quick-Turn deals.

Write down the telephone number if it's on the sign, call the owner, and get the information about the house. Better still, get out of the car and knock on the door. Fill out a Property Information Sheet and see if you can make a deal that falls into one of our four categories. If there's no telephone number on the sign, even better! Just knock on the front door and start talking.

Always look for FSBO signs when you're driving around. Take a different route home each day, and make it a point to

cruise the neighborhoods looking for deals. Neighborhoods change every day, and so do the houses for sale

Referrals

Would it benefit you to have 10 people searching for deals on your behalf? How about 100 people? Could you afford to pay them all? The answer is yes! You certainly can afford to pay someone $250 when they bring you a deal that makes you $10,000 or $20,000 in a short time.

Such people are called "bird dogs," and they are a fine source of leads you otherwise would not hear about. It doesn't matter how many bird dogs you have working for you, because you only pay them when you actually close on a good deal. You can mention in all your ads that you also pay $250 for leads, and you'll end up with more bird dogs than you can possibly handle. If you're a serious investor, you should always get people to bird dog for you.

Why would anyone be a bird dog? Why wouldn't they buy the deal themselves? The answer is simple. They lack knowledge! They didn't buy this book, so they believe they can't do a deal because of lack of money, lack of confidence in themselves, and a dozen other reasons. They see being a bird dog as something they can do.

The person seeking out houses for you doesn't need to make any loans or apply for credit. He just has to have a car to find the FSBOs and vacant and run-down houses. All he has to do is collect information. When dealing with vacant houses, he must get the owner's name, address, and phone number to get the $250 at closing. Bird dogs get only $100 without the owner's information. In some cases, you can pay more. This arrangement can be lucrative for both you and your bird dogs. Put them to work! It doesn't cost you a dime unless they bring you a deal that you can turn into cash.

To save their time and yours, educate your bird dogs about your requirements for a good deal. Give them a Bird Dog Sheet and a Property Information Sheet, found in Appendices C and D. They are self-explanatory and easy to complete.

Ask everyone you talk to if they know of anyone selling a house. Tell them that if you buy a house they have referred to you, you will pay them $250 at closing. Let the word get around town that you pay for leads, and you may soon have more than you can handle.

It's possible that you might get some flack from overzealous REALTORS® who think this activity is illegal, because the bird dogs don't have a license. In my opinion, however, you are simply paying for information, since the bird dogs are not performing any of the functions of a REALTOR®.

Let's talk about another method of bird dogging. This one will require a little money out of pocket, but it will bring in more leads than you can process. In fact, if you used this method and nothing else, you could buy five houses a month from it and it alone.

Here's how it works. Instead of paying your bird dogs only after you close on a deal, why not pay them the minute they bring you leads? Let's say you tell 10 people that you will pay them $10 for each lead they furnish about vacant houses in poor condition, provided they supply addresses and 35 mm photos, as well. These houses may or may not be listed with REALTORS®. They might or might not have a sign.

Would you pay $100 for 10 of these kinds of leads? You bet you would. Gladly! That's a small price to pay to get others to do all the driving around while you sit in your office and process the information.

If you train your people to find what you're looking for, and pay only for qualified leads, you'll see that your minimum outgo will produce maximum results. If you're furnished 20 houses that look bad and are vacant, you should be able to buy at least one or two of them and make anywhere from $5,000 to $25,000 or more in profit. Would you pay $200 to make $25,000? Tough question, huh?

Flyers

I love this one. Flyers are even better than direct mail. Design an 8 1/2" by 11" flyer and distribute it door to door in neighborhoods where you want to buy. I promise, if you distribute 3,000 to 4,000 flyers in this manner, you'll be quite pleased with the results. I don't believe I've ever done that and not bought a house as a result.

The best part is that the flyer can last for years and produce results when you least expect them. Remember the house mentioned in Chapter 4? The one on which I made $23,000 from a year-and-a-half-old flyer?

Basically, the flyer should read like your ad. Don't crowd it; just get the message across. You can hire students or people from your local labor board to distribute them. Two people can put out 500 flyers in three hours. Put flyers on every door in the neighborhood. This beats all other forms of advertising, because you know it was delivered where you wanted it to be and that it got read.

Do stay out of trouble. Avoid car windows and mail boxes: they are off limits. People don't like to see strangers touching their cars; it is a kind of invasion of privacy. And it's against federal law to put anything but the U.S. Mail in a mailbox.

Vacant Houses

Whenever you canvass the neighborhood with flyers, you'll also want to be on the lookout for vacant houses and check them out. Vacant houses make motivated sellers and good bargains. They probably aren't even on the market. And few people are willing to hunt for them, so you will have little or no competition.

Telltale signs that a house is vacant: the lawn is not cared for and weeds have begun to take over, the postman may be bypassing the house with the junk mail; the paper boy is no longer delivering; there may be a pile of papers in front, and more than one old coupon flyer may be attached to the doorknob. After looking for vacant houses for a while, you'll begin to see the pattern and spot these properties even faster. Record

addresses of vacant houses, then check with the neighbors for the whereabouts of the owners and information regarding a way to get in touch with them.

If the neighbors can't tell you how to contact the owners, be sure to keep whatever information you have collected. After you have six to 10 addresses of vacant houses, go to the courthouse and look up the owners of each. Each courthouse is set up a little differently, so just ask for help from the clerks in the office that handles tax revenues and plat maps.

They are generally very helpful and willing to guide you through the particular system used in their office, if you ask politely and act humble.

Another way to find house owners is to subscribe to a data service whose database contains the tax rolls and is accessible via your computer.

Send owners of these houses a flyer or letter. If the owner's address and the vacant house address are the same, send a first class letter. If it is first class, it may get forwarded to them. But before you mail a flyer, you should definitely leave one at the house itself, because people sometimes come back to their houses. Even if the owner does not come back, someone who is in contact with him might appear. Leave at least two or three flyers at the vacant house, since there is also a chance a neighbor will take one.

Another way to find out who owns a vacant house is to go to the post office and find out if there is a forwarding address for the property. There is a $3 charge for this information, but you often can learn the name and current address of whoever was living there last. It's worth a try.

Obviously, not all the letters you send to owners of vacant houses will lead somewhere. But a few will. And if one or two of these leads turn into a deal in a three-month period, you can make a fair living.

As an added bonus, if the vacant house is in an estate, an attorney for the family will receive the mail. He may direct you to even more properties.

We conducted a Boot Camp in Pittsburgh and one of the students was a young man from there

named Robert Hunter. Bob had heard me speak at his local association meeting in Pittsburgh a few months earlier, and he had bought my course.

Needless to say, he got fired up with what he heard and quickly decided he wanted to get in the business. So, he registered for our Atlanta Boot Camp in July to get some fast, hands-on training. After attending that week, he went out and found some great deals on houses, but he hadn't learned to move fast enough yet. He knew he had found great deals, but he still hadn't cured his paralysis of analysis. While he was exploring all the angles, other real estate investors were buying the houses. He surely hadn't learned that nonsense from me. In fact, during the whole Boot Camp, I had pounded into him that you can't Quick-Turn in slow motion.

After a couple of tongue lashings from me over the phone for his screw-ups, Bob decided to pay a return visit to the Pittsburgh boot camp. He knew better than to come empty-handed with no leads or motivated sellers. He was fully aware that if he did I would grind him into the dirt during the entire camp.

One week before we arrived, he decided to go to work or face the consequences. During that week, he looked at several vacant houses and made an offer on two of them. While we were in session, he brought in a third one he had found; it was not only vacant — it was boarded up. He tracked down the owner and called from class to see if it was for sale, since there were no signs on the property.

We finally reached the son who had inherited the house and didn't know what to do with it. Bob asked him what he wanted for the house, and the reply was $5,000. Now that may not sound so great on a boarded-up house, but Bob had done his homework, and he knew the house was worth about $50,000

repaired. Moreover, it didn't need more than $7,000 to $10,000 in work.

To make a long story short, this young whipper-snapper made only three offers on three houses during that week, and all three were accepted. Bob was successful in buying about $125,000 worth of houses for a grand total of $30,000. The whole bunch didn't need more than $30,000 in repairs.

Bob quickly decided that he didn't have the money to buy or repair, so he sold the deals immediately to other investors and let them close on them. At last count, Bob figured to make about $20,000 cash on three deals he didn't buy.

I told this punk he was screwing up my averages. Nobody is supposed to make three offers and get three accepted. That's all right, Bob; don't play by the averages. Just go get filthy rich and tell me how wrong my averages were.

Investment Groups

There is an investment group or association in almost every major city in the country, as well as in many smaller cities. The sole purpose of these organizations is to educate real estate investors or would-be investors. Most are non-profit groups; they usually meet once a month. The meetings include varied activities and almost always present a speaker on some real estate-related subject. The members of these groups get together to learn new techniques, polish up old ones, share their knowledge with others, and stay motivated.

I've never met anyone who didn't need to have his or her batteries charged occasionally. There is no better venue for an investor to do that than at the monthly association meetings. In my opinion, they're an absolute must, if you're going to remain in the business, no matter how smart you are or think you are. The dues are minimal, and the information is free, current, and of immeasurable value. You will learn as much or more from the

other members as you do from the speakers, and just being part of the group will help you avoid thousands of dollars in mistakes while helping you make thousands with what you learn.

Why am I bringing up groups when we are discussing how to locate good deals on houses? If the people in these groups are so educated, I am certainly not going to be able to pick up any good deals from them, am I? After all, they're in this for the same reason I am, aren't they? Wrong! That kind of thinking will cost you dearly. If you are retailing houses and not utilizing the group in your area, you are walking past a fortune.

All you have to do is let the group know you're looking for some good deals on houses and that you're a serious buyer. You'll have more deals to consider than you can handle. Try it and see for yourself. You'll soon discover that other members have different motivations than you do. There are people in that same room who would love to wholesale houses to three or four people like you as fast as they can find them. They can take a small, quick, cash profit and leave enough in the deal to satisfy the needs of a retailer like you. Usually, these folks prefer not to be in the house long enough to repair and market it to an owner/occupant. Their sole intent is to flip it in hours or days and go to the next one. They deal in volume and avoid anything complicated.

Wholesaling was covered in detail in Chapter 6. For now, trust me when I tell you that all the deals you can handle are as close as your next association meeting.

If you are in a group, but aren't active, get involved. You'll soon learn that the more you give of yourself, the better your return. You can't help someone up a hill without getting closer to the top yourself.

Bank Auctions

Let's talk about auctions, which are an excellent source of leads. In fact, one of the best ways to get outrageous deals on houses is to attend auctions in which the lender is selling a batch of houses at the same time. These things are normally

real fire sales. The foreclosures are piling up so fast the lenders can't keep up with the pace and often choose to "stack 'em high and sell 'em cheap."

You'll have plenty of advance notice of an auction if you watch the papers. Auctions are always advertised, usually in display ads and usually several times. You can order a brochure that contains all the pertinent information about the houses being sold. Sometimes everything you need to know is right in the newspaper.

You'll need some cash, or at least ready access to cash. All auctions require a deposit when you win a bid. Usually, this is 10% of the bid, but the amount may vary in different parts of the country. If you don't have the money, there are several ways to get it, but that's another chapter. In fact, that could be my next book. Those of you who can raise a deposit should keep your eyes open. Don't miss your next chance to get a smorgasbord of bargains.

One warning: You **MUST** inspect the houses before the auction. Under no circumstances should you bid for a house you haven't seen. The last time I did, it cost me $2,500 because I chose to forfeit the deposit rather than close the deal. The house needed a lot more work than the picture the auctioneer showed us. Inspect first, write down your absolute maximum bid, and stick to that amount at the auction. Don't let the auction frenzy sway your predetermined bid.

Buy the junkers! You are there for the great deals, not the good deals. Your target is all the houses in poor condition, not the ones in good shape and ready to occupy. Your competition for the pretty ones will be fierce from owner/occupants looking for a deal on their next residence or from unskilled investors who don't know where the real money is.

> *I remember attending an FDIC auction that was advertised in the local paper. About 30 houses had to be liquidated. The organizers rented a motel room and auctioned all the houses in one evening. More than 200 people were bidding on about 30 houses, yet*

when it came time for the junkers, fewer than 10 people were in the room bidding.

I had called previously for a brochure and gone to look at the ones I liked — the ugly ones. I've learned from experience that the odds of buying a pretty house at an auction, for a price I'm willing to pay, are pretty slim. I look for the worst-looking houses in the bunch, since I know there won't be many bidders on the ugly ducks.

Anyway, I bought two houses that night. Perhaps I should say I was the high bidder on two houses, because I never actually bought them. The high bid on one was $4,950. It was worth $32,000 after about $5,000 in repairs. The second one was worth about $42,000 and needed $8,000 in work. My high bid on it was $8,600.

Both houses looked bad, which is what had attracted me to them in the first place, but they were in saleable neighborhoods. I had to put 10% down that night for a total of $1,355. I then had 60 days to close with all cash.

The next day, I called a friend who was in the buy low-sell high business. I sold both houses to this young lady for $26,000 cash. In both cases, I never took title. A few days later, we were at the closing table. She had the $26,000, and I had the two contracts. While the title company was doing all the work, I sat there looking dumb while my buyer did all the signing and shelled out the cash.

I had the title company deed the house directly to my buyer. The seller wasn't even there. They just sent the packages to the closing agent with instructions. The closing agent took the $26,000 and subtracted the $13,550 that I had paid for both houses. The only thing for me to do was pick up a check and leave. That looks like $12,450 to me in a few short days without my ever taking title or touching those filthy houses. In fact, I never even went inside them.

Man, this sure beats working for a living. Don't you just love it?

Don't feel sorry for my buyer. Yes, she will do a lot more work than I, and she has some capital outlay, but her profit on those two houses, when she sells them, will be in the neighborhood of $30,000 to $35,000 for both houses. And she will have it in hand within 90 days.

Ask me why my buyer wasn't at the auction. She could have saved $12,000 by being there, couldn't she? Yes, she could, but she didn't. Maybe there was an episode of *Seinfield* on TV that night that she didn't want to miss. Who knows? I'll let the psychologists figure out why people do the things they do.

Incidentally, you normally have 60 days to close if you are high bidder, and you should be able to find a buyer at a higher price within 60 days. The world is full of investors looking for bargains.

Of course, this is assuming you don't want to retail the houses yourself, as I sometimes get in the mood to do.

At a recent auction, I purchased a house for $18,700 cash. I paid the deposit and obtained a private investor loan for the balance. I spent $6,000 to repair it, and it appraised for $52,000 for a $25,000 profit. It's hard to beat those auction deals. Gosh, what if I did one of those every couple of months? How about one per month, or maybe one per week? Sounds crazy, huh?

I've turned more than 1,100 houses in 14 years. You figure out how many that is per month. While you're doing that, I'll be looking for another auction.

Lenders

Lenders have inventories of houses they don't want, but were taken back through foreclosure. These houses are called "REOs," short for Real Estate Owned, or "repos," an abbreviated form of "repossessions." On the bank's financial statement, they point to other nastier names: liabilities, losses, non-conforming assets, failures, bad loans, and inept bank management. Needless to say, bankers hate REOs.

There are so many banks in most areas, it is best to concentrate on those that are really willing to deal with you. Not all will. Some banks want to recover just what was owed on the properties, while others may hope to obtain market value. However, some banks are willing to take losses, if necessary, to liquidate these REOs as fast as possible. They want to remove these embarrassments from their books. It is these you can buy even before they go up for auction. Make all-cash offers.

Buying from a lender can sometimes mean outrageous profits. One house I bought from a lender was sold by the bank at 17% of its true market value! However, you shouldn't worry about the percentages. In high-priced areas, 70% of the value can be a great deal, while in low-priced areas, 50% of the value may not be a good deal. Only the dollars are important, not the percentage of value.

You can work many types of deals when buying from lenders. Your best deals will be closed by paying all cash, but quite often the lenders are happy to create some financing for you with attractive terms, if you qualify.

Mailouts

Investors often neglect to obtain good mailing lists of potential, motivated sellers, because it appears to be impossible. Well, it is possible and very profitable! Although you may not be able to go to a list broker and say, "Give me the motivated sellers in this area," you can generate the list yourself.

First, go to your local courthouse and research all the divorce cases, out-of-state owners, houses with tax liens, mechanics' liens, pre-foreclosures, and Lis Pendens, which is the first step in a lawsuit. Also, as mentioned before, always stay on the lookout for vacant houses, or houses needing repairs.

Second, ask a REALTOR® to give you a list of expired listings with out-of-town owners. You can often make a deal with the Realtor who gives you the list. Tell them you will use them to make some offers, or simply offer to pay them for their services.

Mail all of the above names a letter and/or flyer. These people can be expected to be motivated. This will work with all expired listings, not just those belonging to out-of-towners

FHA/VA Repos

Most people are aware of these potential bargains, but they lack the knowledge to turn a mediocre deal into a good deal. If I were to offer the government's asking price when these houses first hit the market, I would be able to make a little money on some of them, but not enough to make me want to buy them. If this is true, then why do I bother with them? The answer is simple. I don't offer the price being asked! I offer what I am willing to pay!

Now wait a minute, Ron! My brother told me I have to offer the asking price because they won't accept a lower bid. That is true, but only while they are in the bid process. Let's review the process so we can get a better idea of the mechanics.

First, the houses we're talking about are all the FHA/VA foreclosures the lending institution holding the note elected not to keep themselves. Once the foreclosure process is complete, the house may be assigned to HUD or the to VA to liquidate. Or, the lender may now elect to keep it. In some cases, the assignment takes place before the foreclosure, and the government does the foreclosing.

It's totally irrelevant to me who forecloses. I'm only interested after the legal proceedings have ended and the house is on the market. That could take a year or more.

After the process is completed, a broker is hired to appraise the house and affix a value. Sometimes repairs are done, such as installing a new roof, in an attempt to make the house more marketable. Rarely will the repairs be extensive, and the house is almost never 100% renovated. Therefore, the value is usually below market value; sometimes it is considerably below.

Every once in a while, a property will become available so far below value that I'll jump on it at the price they are asking, but this is rare. Remember, I want only the good deals, not the mediocre ones.

Here's the key. If you are going to pick the pearls from this smorgasbord of wealth, you must wait until the initial bid period is up and deal only with the houses that were passed over. These will be the clunkers, the yucks, the handyman specials, the real dirt bags. That's right! The uglier they are, the more they're worth to you. These are the ones all the owner/occupants passed up because they were so ugly. Remember, there are bucks in the yucks!

You must develop the ability to recognize opportunity and picture these houses in good shape. That ability is what will make you different from all the shortsighted people who passed up these deals.

What most investors don't know is that when the houses are placed on the "Extended Listing," the "Reduced for Quick Sale" listing, or the "Z" listing, you can offer any amount you want. The asking price will be published in the newspaper every week, along with the address and the number of bedrooms and baths.

All you have to do is take the list, look at the property, and decide what you are willing to offer. Will all your offers be accepted? I hope not. If they are, you offered too much. Somehow, I don't think that's a problem. I can assure you they won't all be accepted.

The worse the condition of the house, the better your chances are of getting a low offer accepted. The amount of time the house has been on the market is also a determining factor. It's tough to get these properties for much less than 80% of the asking price, but don't let that prevent you from making the offers. The worst thing that can happen is that your offer will be rejected.

On one occasion, I purchased a repo for 60% of the asking price; in reality, that was 20% of the after-repaired value. I sold that one for an instant $6,000 profit, without taking title or touching the house. As a matter of fact, I never even went inside it. You see, when I am buying a house for 20% of its value, I don't care if it has an inside. I bought another one for 85% of its asking price, and after spending $5,000 on repairs, I still was not involved for more than 55% of value.

Don't let these percentages fool you. In high-priced areas such as Los Angeles, Washington, D.C., and many others, you aren't going to get these houses at 50 cents on the dollar. Use common sense.

Again, it's only the dollars that count, not the percent of value. I have to buy at 20% to 50% of value dealing in the $35,000 to $55,000 range here in Jacksonville, Florida to make less money than do investors in Los Angeles who buy at 75% of value.

Here are some tips on how to make the offers. All areas have brokers who will submit offers for you. They have been trained on the forms and procedures and have a list of all the repos. I suggest that you seek one who specializes in HUD repos and work with him or her regularly. Not only have you added a professional to your team who knows the system, you also have someone to help you determine the value and marketability of the houses. Just don't forget that, even though the broker may seem friendly and well intentioned, his or her main concern is his or her commission check.

Each offer will require an earnest money deposit ranging from $500 in some areas to $2,000 in others. This is a non-refundable deposit, so do your homework before you make the offer. Of course, if your offer isn't accepted, you will get a full refund.

If your offer is accepted, you will have up to 60 days to close or find someone else to close. Your broker may push you to close because, in most cases, brokers get a bonus for each day you close early.

This is just one way to locate good deals. Again, I suggest that you keep five or six methods working constantly. Don't rely on just one.

Out-of-State Owners

A good source of motivated sellers is out-of-state landholders. It is difficult for most people to manage a property from a great distance. Even the smallest problems appear large in the mind of a person who is not on the scene.

If a property is vacant, usually no one is available to pick up papers, mow the grass, and make the house appear inhabited. As a result, many owners worry, justifiably, about vandalism, theft, insurance cancellation, weather damage to the property, etc. All this can work to your advantage when negotiating a good deal.

If the property is rented, a host of other problems for the owner comes to mind. Collection of late rents, eviction proceedings, maintenance work demanded by tenants, finding and screening new tenants, and generally just keeping track of the property can all be big worries for the out-of-state owner. Many owners don't trust management companies or believe they can afford one, but they feel they can't handle their affairs alone, either. Send letters to all of them, offering to take away those concerns. You'll find that some of those owners are highly motivated.

A list of out-of-state owners can be obtained from a list service that has downloaded the tax rolls into its computer. Sometimes REALTORS® can generate the names from their MLS service. It may take a bit of a search to find someone who can supply the names, but when you find that person, the results are well worth the effort. Remember, in most cases, no one else knows the house is for sale. In fact, quite often even the seller doesn't know it until your letter plants the seed in his or her mind.

> *I once met a gentleman who had computerized the names of all the out-of-town owners of property in my area. He gave me permission to search for names based on whatever criteria I wanted. I had him pull up the names of all the out-of-town owners of single- family homes, within a certain range of assessed value, in the Jacksonville area. I ended up with a list of 4,445 names.*
>
> *I then wrote a one-page letter and sent it to 500 of those names to see what would happen. It was a simple letter that basically said, "I buy houses in your area, and I noticed that you are from out of*

town. Would you be interested in selling?" I put a little reply card on the bottom so they could easily let me know they were interested. (See Appendix D for a sample letter to mail to absentee owners.)

Of the 500 letters I sent, I got 10 replies; of the 10 replies, I ended up buying one house. One owner wrote back and said she wanted $8,000 for her house. On further investigation, I discovered that she had not even seen the house in 22 years! She had placed it in the hands of a local management company, who had rented it to a tenant who was paying only $150 a month in a market where $400 had been the customary rent for many years.

The house was a concrete block building with a new roof, and it was in fairly good condition. I knew immediately that the property was worth $35,000, which was the low end of the market. I interviewed the tenant, and found that she had been living there a long time and would love to own the house.

To make a long story short, I accepted the owner's offer at once. I sent her a contract and asked her to sign and return it. I took the signed contract to the title company, which then sent a deed, also to be signed, with instructions.

To deliver the money, I obtained a first mortgage loan from a private lender for $17,000 (the owner possessed the house free and clear). The lender didn't even ask for an appraisal. He just looked at the property. The terms of the loan were 18% interest for seven years, with payments of $350 a month.

Why did I go to a private lender with a high interest rate? I didn't want to be personally liable for the loan. It was a corporate loan, and I obtained it as a corporate officer. Also, I didn't want to have to qualify to anybody, and I didn't want such a loan on my credit report. I've designed my life so that I don't have to qualify to anybody for anything. That's one of the things I teach in my courses.

After paying $8,000 for the house and more than $1,500 for closing costs, which were high because it was a private loan and I had used a mortgage broker, I had about $7,500 left. At that point, I visited the tenant and said, "Mary Ellen, would you like to own this house?"

She said, "Mr. LeGrand, I don't have any money to put down on it."

So I said, "What if you not only didn't need any money to put down on it, but if I did these little repairs that need to be done? Would you like to own the house then?"

To which she replied, "Mr. LeGrand, I would love to own this home! I think God sent you!"

Who knows. Maybe he did.

I then explained that the rent she had been paying for years was way below what it should have been. She admitted that this was true. So I made the following deal with her: I immediately raised the rent to $350 per month, which she could afford, and told her that if she paid me $350 a month on time for a year, I would sell her the house for $35,000 with no down payment. I also told her we would work out the terms of the 30-year mortgage payments for the entire term of the loan.

What I did here was create a mortgage on which I would receive $350 a month for 30 years. The cash flow was structured to be a wash during the early years when I would be making loan payments on the seven-year note. But it is obvious that, after I pay off that mortgage, I will continue to receive $350 each month for 23 years thereafter. That's a total of $96,000 in profit.

The only problem was the fact that Mary Ellen was 68 years old when I made the deal with her. I tied up this loose end by having her buy a mortgage life insurance policy naming me as the beneficiary. This policy will pay me the balance of the $35,000 if

she passes away before paying off the mortgage note.

It should be noted that I could have dislodged this lady from the rental home, done a little work on it, retailed it for $35,000 cash to an FHA or VA buyer, and walked away with a lot of cash almost immediately. Why didn't I do that? The fact is that the lady deserved to live in that house. She had already paid for it by living in it for 22 years. She just didn't own it yet. So I chose to leave her there instead of booting her out. As it turned out, I received a payday up front, and I'll get another payday in the future.

While this was a good money maker, it certainly wasn't one of my most profitable deals. But I think of it as one of my best deals because it helped an tenant finally realize the American Dream of home ownership. That has to have something to do with it.

Defaulted Paper

Previously, we've discussed several ways to locate bargains in single-family houses. This section is devoted to a little-known, rarely used technique called "buying defaulted paper."

Every house that carries a mortgage or trust deed is a candidate. And the process is a simple one of seeking out loans that are in foreclosure, or about to be in foreclosure, and buying the paper instead of the property.

You are probably thinking that your biggest fear from taking back a mortgage has always been having to foreclose if the payments aren't made. And now I'm suggesting that you actually go looking for paper in default?

YOU BET I AM!

You are looking for defaulted paper so you can buy it at a deep discount and get into the property through the back door. Once you own the mortgage, you have several choices.

First, you can foreclose and own the house. **Second**, you can renegotiate the note and help the owner avoid foreclosure by ~~adding the back payments to the note. **Third**, you can~~ give the

owner a little cash for a deed, thus letting him avoid foreclosure.

Let's take a look at the second option. What if we cured the foreclosure by restructuring the note, setting up a new payment based on the increased amount from adding all the back due interest to the principal and then selling the note for a quick profit?

Of course, this will only work in those cases where the owner wants to restructure, and where a temporary problem existed that put him or her in arrears. In cases where restructuring won't work, your objective is to take title to the property as fast and as inexpensively as possible.

Recently, I purchased two second mortgages from a bank. Those mortgages were behind FHA firsts in foreclosure.

The first deal involved a $50,000 house with a $10,800 first which was $2,000 behind. The face amount of the second mortgage I purchased was $15,000; it was $1,600 behind in payments, leaving a $16,600 payoff. The bank contacted me and offered to sell me the note for $10,000, so it could get out without foreclosing. After some legwork, I went back to the bank with a $5,000 offer, and we settled on $6,000.

The first thing I tried to do was get the two loans refinanced for the owners. Had I succeeded, I would have received my $16,600 for a nice $10,600 profit. If this failed, I would then try to buy out the owners for a couple of thousand and resell the house for $50,000, making a nice $25,000 profit. If they wouldn't sell, I'd foreclose and sell the houses four or five months later for a hefty profit.

Another alternative would have been for me to make up the first, restructure the second, and let the owners start over again. That would mean I'd have $8,000 cash in this deal, so I'd have to just sit on

it and receive a tremendous yield on my $8,000, or sell the note for a profit. This is assuming, however, that I would want the current owner to remain in the house.

Let me tell you what actually happened on this transaction, since it's now completed.

First, it might be noteworthy to mention that I didn't have a dime in this. I let a friend who had been bugging me for a deal put up all the money. We tried to get the owners refinanced, but their credit was so bad and their balance so high, it wasn't possible.

Finally, we gave up on getting them a loan and tried to buy the house from them. We offered $3,000 net to them and a free month's rent. They refused the offer because they were convinced that some miracle would solve all their problems before they could be put out. This left us with no choice but to foreclose, and that's exactly what we did.

On the day of the sale at the courthouse steps, the owners filed bankruptcy to stop the proceedings. Since they had filed Chapter 13 for reorganization, the judge ordered them to start making payments within 30 days. Arrangements also were made for them to start paying on the arrearages, as well.

Thirty days passed and still no payment was received, so we reinstituted the foreclosure process. Once again we got right up to the sale — and they converted from Chapter 13 to Chapter 7 (total liquidation). This again stopped the sale, but not for very long. Our attorney petitioned the court to continue the sale, and the process resumed. About 45 days later, we owned the house. The owners had run out of tricks.

Look at the following recap of the numbers, so you can see why we got involved in the first place. By the way, the whole process took only 12 months from the time we bought the note

until we sold the house. After you look at the numbers, you decide whether the deal was worth the effort.

Note that the items marked with an * were the only ones requiring a cash outlay. The rest were deducted from the sales proceeds. Therefore, my investor paid only $17,500 in cash to get an $8,250 (50% profit) return on his money in one year. Incidentally, that is much longer than it usually takes.

Note purchase price	$ 6,000*
1st mortgage balance	10,800
Cost to bring 1st current	2,000*
Attorney fees to foreclose	1,500*
Holding costs	2,000*
Repair costs	6,000*
Sales costs (including realtor)	$ 4,200
TOTAL COSTS	$ 32,500
Sales Price	$ 49,000
NET PROFIT	**$ 16,500**

That's a 50% return on investment. Probably just a little higher than the return on my investor's CD at the bank. On the other hand, what was my return? It's called infinite! You can't measure it because I had no investment. Whichever way the deal goes, I always win.

The second note I bought involved a similar deal. It was a $6,000 second behind an FHA first of $22,800 on a $50,000 house. That house needed about $3,000 in work, and both mortgages were about 10 months behind. Since the loan-to-value (LTV) ratio was much higher on this property, I wasn't very motivated to buy when the bank said it wanted $1,500 for the note. But when I offered the bank $300 and it accepted, I just couldn't resist. I figured, for $300, what the heck, go for it. My options were the same as those that applied to the other house. In this case, however, I was a lot more motivated to restructure and just receive payments because I was leaving only $300 on the table rather than $8,000. (In the first deal, I had promised my partner a cash profit, so we had to liquidate.)

In the second case, however, I visited the owner, who was a single lady, and discovered that she had made her first mort-

gage current a few days earlier, thus stopping the foreclosure process. The bank hadn't bothered to check the status of the first before selling the note to me.

This left me in a good position to try to solve the seller's problem, with no further cash outlay, while still making a profit for myself. I discovered she really wanted to keep her house, so I simply offered to add her arrearage to the principal amount she owed, leave her payments the same, and turn the situation into a monthly cash flow. She loved the idea, so I had her sign a mortgage modification to effect the changes.

To this day, she is paying me $149 per month. So far, I've collected 24 payments and still have about 85 more due. I wonder what kind of yield I'm getting, collecting $149 per month on my $300 investment for seven years? I'll leave that up to you computer whizzes to calculate while I'm out looking for some more defaulted paper.

The second deal worked out a lot more easily than the first one. Not bad for a $300 investment. There's gold in defaulted paper, once you learn a few simple rules and how to put them to use.

REALTORS©

Get to know two or three REALTORS® with whom you can work. They have access to hundreds of houses for sale, plus all the necessary information. Once they learn what you're looking for, they'll send you so much information that all you have to do is simply sift through it and pick out the properties on which you wish to make offers. Having all the facts saves everyone a lot of running around. Sometimes REALTORS® will also know the seller's motivation; this can be very valuable to you when you're making an offer.

If you expect to stay on good terms and develop a relationship with a REALTOR®, make sure you inspect the property and can live with your offer before you make it. Act like a professional and the real estate professionals will be at your beck and call. Act like a time waster and you'll soon be on your own.

Be sure to seek out those REALTORS® who deal in bank repos, also. Some of the best deals you will ever make are going to be bank repos. The sellers are motivated and unemotional, and they almost always list with a broker when ready to sell.

REALTORS® are always an excellent source of killer deals. The wise use of a good agent can greatly enhance the number of bargains you find. In fact, if you're busy making a living in another business or job, this could possibly be the only source you need to supply more houses than you can handle.

Most real estate offices that subscribe to the Multiple Listing Service (MLS) have a computer with enough information in it to keep an agent working full-time just finding bargains for you. That computer places a smorgasbord of information right at your fingertips. It contains most of the houses listed in your area and enough information for you to formulate offers.

Just think! Instead of getting on the phone, researching each house, and collecting facts from sellers, you can turn on a machine and get 80% of what you need to know just by punching a button. These listings contain the location, size, construction, mortgage data, amenities, asking price, seller motivation, property condition, and much more information that may be helpful. You can usually even search out vacant houses. Do you think owners of vacant houses are motivated? You bet they are!

What if you make an appointment with a REALTOR® and, together, you sit down at the computer and spend an hour searching for prospects that meet your criteria? Your goal is to end up with 20 prospects that would appear to have motivated sellers. You could, for example, stipulate that you want to know about houses that need repairs. That sort of information usually shows up in the comments section of listings.

Key words that might catch your attention include "handyman special," "as is," "no warranties," "needs work," "investor special," "needs TLC," "estate sale," "foreclosure," and "bank owned."

It's time-consuming to search through these listings to pick out the pearls, but it's to your benefit to do it or have it done

while you're in the REALTOR'S® office, instead of wasting time looking at dead ends.

Here's a suggestion that will let you cut to the chase much more quickly. Look only for houses that need work that are listed well below the after-repair value. That way, when you make a low offer on a house that's already listed low, there won't be such a big spread between the asking price and your offer.

Sometimes lenders will list a house at retail, after-repaired price, even though it needs $10,000 of work. They know they won't get the asking price. Your submitting a sensible offer well below their asking price creates sticker shock, and the large reduction is just too much for them to overcome. Quite often the person responsible for accepting the offer doesn't even know the condition of the house.

If your REALTOR® doesn't use a computer, he or she will probably use the MLS books which contain the same information. The only difference is that you have to browse through the books to find the motivated sellers, rather than have the computer spit them out for you. When I started in this business, I used the MLS book to buy my first 23 houses. Either way will work if you know what you're looking for.

After you have spent one hour with the REALTOR®, you should have 10 to 20 properties to evaluate. Of course, all these prospects show signs of motivation, which is a key ingredient. Your next move is to inspect all 20 houses. You need to see their condition and the area, to get a good idea of the value after repairs, assuming the houses need work. Remember, most of these houses are vacant, if that was one of the criteria you put in the computer.

Usually, you will be able to look in the windows and see 80% of the house. This will give you a good idea of the condition and layout, so you can make an intelligent offer. There is no need to run a REALTOR® ragged showing vacant houses. You can inspect the interior after the seller has shown some interest in your offer. This will save countless hours of your REALTOR'S® time and make him or her more willing to work with you.

With this information in hand, combined with the ability to construct offers, you can now go back to your REALTOR® and make an offer on every house you looked at. I'm not suggest-

ing that the REALTOR® physically write up each offer and submit it. Simply get him or her to call the listing agents to submit your offer orally. If there is any interest on the other end, your REALTOR® will be asked to submit your offer in writing. Again, calling first saves a lot of time and effort for REALTORS® and allows them to submit more offers.

I know! You're saying the REALTORS® will steal the deals from you if there is nothing in writing. Don't sweat it. It just isn't so. If they are licensed and this happens, they won't be licensed long. REALTORS® live by a strict code of ethics, and they are governed closely by the state.They must disclose everything and bear heavy responsibility for their actions. You should be more concerned about finding REALTORS® with positive attitudes than worrying about having a deal stolen from you. Besides, most REALTORS® are so busy making a living they don't have time to make any money. They're only looking for a commission check.

Think about what's been done. You've spent one hour collecting prospects, two hours looking at houses, and one hour getting the offers back to your REALTOR®. Now it's in his or her hands to finish the deal. While you're working or playing, the REALTOR®is submitting your offers and getting either a yes, a no, or a counteroffer.

Let's look at the advantages of using a REALTOR®:

- Someone else is doing most of the work.
- You never deal directly with a seller.
- You are multiplying your efforts.
- Your time is free to do other things.
- You won't have to face rejections.
- Your seller cannot voice objections to you, or try to bump up your offer. He must go through a counteroffer procedure.
- Your liability is reduced because a REALTOR® is involved.
- You saved countless hours not chasing dead ends.

One word of caution, however. A REALTOR® is not obligated to give you any information from the MLS. In fact, in most

areas, it is against MLS policy for the public to have access to the system. It is a privilege paid for by REALTORS® to be used only by REALTORS®. However, most agents will cooperate and give you the information in an effort to make sales, especially if you convince them you are a serious buyer and aren't there to waste their time.

Last month with the help of a REALTOR®, I put six houses under contract to purchase. Four of them were listed. REALTORS® have always been an excellent source of good deals for me, as well as a big help taking care of details. In return, they get their commissions, the seller makes a sale, the MLS collects a fee, the closing agent writes title insurance, the termite man gets a check, a lender ultimately makes a loan, a hazard insurance premium is generated, and a repair crew gets to work. Everybody wins!

Make friends with some REALTORS® in your area. They can play a valuable role in your success. Develop a good working relationship, and it may turn into a lifelong friendship.

If you hold a license yourself and you're working with other REALTORS®, I suggest you let them have the total commission on your purchase, unless you're dealing in high-value areas where there is a big enough check to go around. Remember, a REALTOR® closing a sale at 6 1/2% commission on a $25,000 purchase is only receiving $1,625 total commission.

And he might have to split that with his broker or other agents. He is not getting rich. Give the REALTOR® the commission while you take the big profit. That's fair isn't it? Don't forget, without the services of that REALTOR®, you won't have a profit because you won't have a deal.

Don't be greedy!

The best place to find a compatible REALTOR® is right in your investment club, if you have one. REALTOR® club members are educated in your ways and speak your language. This will make working with them a lot easier. If you don't have a club in your area, just ask around for a REALTOR® who deals with investors, especially those who handle REO®s.

The first question I would ask a REALTOR® is, "Will you be embarrassed to make low offers?" If the answer is yes, keep

looking. You're searching for a professional who is aggressive and serious about getting the job done. He or she must have good follow-up procedures and treat you like the important client you will become. Of course, this should become automatic after you close a couple of deals and prove your value to the REALTOR®.

If you're serious about buying houses and aren't currently working with a good REALTOR®, I suggest that now is the time to find one.

Another good way to generate income and increase your client base is to become a mortgage lender. We'll discuss lending in detail in the next chapter.

"Dealing With Unmotivated Sellers Is Like Kissing A Toad With Warts... It'll Give You A Bad Taste For Toads."

RON LEGRAND

Many receive advice.
Only the wise profit from it.

Syrus

Chapter 10

Mortgage Lending

Few people are aware that mortgage lending is an incredible way to build wealth in a hurry. It is an excellent source of leads, as well. It is called the "backdoor" of foreclosure, and many times it can lead you to acquire good properties at deep discounts and receive a fine return on your investment.

Are you getting a 15% or more yield from your CDs, stocks, savings accounts, IRAs, pension plan, and other investments? You should be! You can control your investments and make them grow safely at three to five times your current rate. Yes, I know that sounds too good to be true, but it isn't.

I'm going to share information with you about a technique that is widely used in real estate circles in every city in America. Smart people have been utilizing this investment tool for years. In fact, entire companies have been built around this technique; those who practice it properly have seen tremendous growth in returns. This is a very safe investment that produces high yields while providing security and liquidity.

Do you know what $25,000 is worth in five years compounded at a 7% yield? It's worth $35,000. Now, let's take that same $25,000 and invest it for the same five years at 15% interest instead of 7%. In this case, it has grown to an amazing $52,000! That's a $17,000 difference, simply by increasing the yield from 7% to 15%; and remember, that's in only five years.

If you look at the figures for a 10-year term, your $25,000 would be worth $50,000 at 7%, but if you change the yield to just 15%, the amount grows to an unbelievable $111,000! Folks,

that's $61,000 free dollars you will actually receive simply by increasing your yield. Can you really afford not to control your own investments? Does it make sense for a bank to manage your investments for you?

There is an alternative to CDs and mutual funds. It involves private mortgage loans. You can loan money, secured by a first or second mortgage or trust deed, and enjoy not only the safety you want, but also the high yield we've discussed, or more!

Pros and Cons of Loaning to Homeowners

First, let's clarify the kinds of loans we might make. I'm not talking about the high LTV (Loan To Value) loans the banks and savings and loans make. We're dealing with very low LTV loans. By that, I mean no higher than 50% or 60% of the value of the property securing the loan. This means that, if a house appraises for $60,000, you wouldn't make a loan for more than $36,000. That's a 60% LTV.

It's clear why this approach is safer than that taken by most lending institutions. The banks are in trouble because they make loans at an 80%, 90%, or even 95% LTV ratio. They have no cushion in case of default. Also, when you're dealing with a 60% maximum LTV, there's so much equity above your loan that, should you foreclose, the property could be sold not only for enough to cover your investment, but often at a huge profit.

If you are real estate oriented, this is just another avenue of income for you. And if you are not real estate oriented, there are always scores of investors who would love to have the property for 50% to 60% of the value if you took it back. I am talking a lot about default here, but the reality is that, when a loan is at such a low LTV ratio, default is not common.

Let me answer some of your questions about making loans. Is this a mortgage pool? No! You make the whole loan yourself. You get a lien against the property. You are the bank. You are in total control.

Do I need a lot of cash? No! I've made loans as small as $2,000. The amount of the loan is determined by the borrower's needs.

Who handles all the details? Well, in my opinion, unless you are highly skilled in real estate matters, you should use a good mortgage broker. They will not only find the borrowers for you, but they will also provide proper documentation and protect your interest. All of this costs you nothing. All costs are paid by the borrower. If you make a $10,000 loan, you send a check for $10,000 to the closing agent and you get a mortgage or deed of trust for $10,000.

Do I have to collect payments? Absolutely not! Your mortgage broker will set up your account with a collection agent, if you wish, who will collect each payment when due and deposit it into your account. This can and should be a hassle-free investment. In fact, I strive to keep my investors as far away from collection as possible, for that reason. You may be surprised to know that your bank will even collect the payments for you if you wish.

Is this a long-term investment? No! It can be any term you want. You're the boss. Usually a private investor wants a five-year term or less, but some don't care if it stretches to 10 or 15 years. You can pick a term that suits your strategy for retirement. Some investors make interest-only loans with a short-term balloon; some will amortize for 10 or 15 years and balloon in five; some people prefer the longer term. It's your money, and it's your choice. Of course, the broker is going to come to you with a term that suits the borrower. If that works for you, it's a go. If not, it's up to him to change your mind or to find another investor.

What if I want to liquidate? Mortgages and trust deeds are purchased every day, like stocks. If you want out, it will take from two weeks to a month to sell your note. Since your interest rate will be 15% or higher, you will take very little, if any, discount when you sell. You really shouldn't make mortgage loans if you feel you will liquidate shortly, but the option is always available. Just call your mortgage broker and he or she will handle all the details.

Who borrows at 15%? All kinds of folks! Some have good credit, some have poor credit. Some are owner/occupants, some are investors. These folks have learned that it's not the cost of

money that counts, but the availability of it. In the case of an owner/occupant, they may not qualify under bank terms for a variety of reasons, such as poor credit, time on the job, or debt ratio. In many cases, they could qualify but just don't want to deal with the banks. They would rather pay the high rates in exchange for the ease of getting the money. This also holds true for investors. I often have made it possible for investors to acquire good deals in houses because the funds weren't available from banks but were available from private lenders.

If an investor becomes skilled at locating good deals, the purchase price will be well below the after-repair value of the house. The bank, however, wants to loan on the purchase price, not the value of the house, thus penalizing the investor for being astute. Having the money available will make or break the deal. Paying a higher interest rate is irrelevant compared to the loss of thousands of dollars in profit if the money was not available.

Remember, as a lender, you will not lend more than 50% to 60% LTV regardless. You're making a safe loan in either case, whether it be to an investor or to an owner/occupant. You should never make a loan without a 40% to 50% safety net. If you don't violate that rule, you should always come out a winner.

What are my options if my borrower doesn't pay? Actually, there are several options in the event of default by your borrower. Foreclosure is only one of those options, and it is usually last on the list.

The first thing you can do, if your borrower's problem is temporary, is restructure the note. For example, let's say your borrower has been out of work for three months and is two months behind on his payments to you. Now he finds a new job and would like to keep this house, but he can't come up with enough money to bring you current in one lump sum. You could let him continue to make regular payments and make an extra payment on his arrearage, or you could simply add the arrearage to the principal balance and extend the term of the loan. This means you would be collecting interest on interest for the entire remainder of the loan. There is almost always a way to work out a payment problem, if both sides are willing.

Incidentally, when this happens, some of my lenders will charge a reinstatement fee as well as the back payments. Remember, it's up to you to decide whether your borrower can reinstate or not. Once a loan is in default, you have the right to call it due or allow reinstatement. It's your choice. You don't have to take the payments unless you want to. Therefore, you are well within your rights to pick up an extra $100, $200, or $300 to allow reinstatement. This is especially true if you elect to add the fee to the loan and don't force the borrower to pay it in cash. That, of course, is also your option. At this point, you are in total control.

Certainly, you would only allow a reinstatement if the borrower has solved his problem and can continue to make payments. In any case, you have other options.

You can offer to buy the house from your borrower in lieu of foreclosure. This is an opportunity for you to get a house at a greatly discounted price and avoid foreclosure at the same time. Your borrower has the option of either taking some money now and selling you the house, or being foreclosed and getting nothing. When this happens, you have created a tremendous profit center by reselling the house.

Some investors make private loans in the hope that this will happen; others would rather not get involved with the real estate at all. Either way you win. As I said earlier, when you can sell a house at 50% to 70% of its value, there are scores of investors who would take it off your hands. In fact, there are businesses built around tracking down these kinds of deals.

If you have an uncooperative borrower and you can't restructure, then you are left with either selling your note or foreclosing.

Yes, there are investors who are willing to buy your note, even if it's in default. In fact, that's the way they want it! They can either force payment of debt or get the house. However, if you sell a note in default, you usually will have to discount it, so this isn't my favorite option.

If I am left with no other choice, I simply foreclose. Foreclosure isn't the evil, time-consuming, costly, legal process that most people think it is. It's as simple as sending your note

to an attorney and saying, "Do it." Then all you have to do is sit back and wait. Nine times out of 10, before foreclosure is complete, someone will be calling your attorney's office requesting a payoff letter. Your loan will get paid off. When this happens, you will collect all accrued interest, your principal balance, and all attorney's fees, court costs, and all other expenses you have incurred in connection with your loan.

You see, when you're into a property at 50% or less, there are always lenders who are willing to refinance, relatives who will bail them out, or scores of buyers who will buy them out.

If none of this happens, you will get the house; then, you will have the options we discussed earlier.

What if my borrower files for bankruptcy? You have a lien against the house. You cannot be wiped out by bankruptcy. If your borrower files Chapter 7, you should be able to continue with the foreclosure process. It will be slowed, but it won't be stopped. You have a secured debt and a right to seize the asset.

If Chapter 13 for reorganization is filed, your borrower will be ordered to continue with his monthly payments and probably an additional payment on his arrearage. In the event that one payment is missed, you then can proceed with the foreclosure process and, usually, within 30 to 60 days, the process will be complete. Bankruptcy will slow the procedure, but it won't keep you from collecting your debt.

What happens if I take a second and the first doesn't get paid? If you are in second position and you aren't getting paid, chances are that the first is also in arrears. In that case, to protect your interests, you would simply bring the first current while starting collection action on your second. In most states, you must be notified of any foreclosure action by the first.

You'll have plenty of time to react. Remember, you are entitled to collect any money you have advanced. That includes any payments you've made on the first. Part of your closing package, if you're loaning on a second, is mortgage verification on the first. This will include all the loan information and the loan's current status.

Frequently, small seconds are made to people who are in foreclosure for just enough to bring their loan current.

Obviously, such a loan stands a much higher chance of going into default. If you're an investor who is not real estate oriented or one who would really rather not own the property, then you wouldn't want this kind of loan. On the other hand, if you see owning the property as a larger profit producer, you might consider specializing in foreclosure loans.

Many investors tend to forget that just because you wind up with the house, you don't have to keep it. It can be sold immediately at a wholesale price, producing a profit over and above the already high yield on your loan. There is no law that says you have to be a landlord and deal with tenants just because you own the house.

Of course, some people will say that you are taking advantage of people in trouble. If that's how you feel, then don't make loans to people in foreclosure. Let them stay in foreclosure and lose their home. Heaven forbid we should ever be accused of taking advantage.

Just remember, they were in foreclosure long before you came along. You had nothing to do with that. Also remember that you are probably their only hope of saving their home. When you bail them out of a foreclosure, they agree to make payments to you on the money you loaned them. If they do, you've supplied them with a valuable service they won't get anywhere else. If they don't pay, are they any worse off than they were before you made them the loan? You decide.

If you are going to make loans to people in foreclosure, let's not forget the basics. The loans must still be low LTV with plenty of equity cushion in case of default. Common sense still prevails.

On the other hand, it doesn't hurt to be a little creative sometimes. For example, what if someone comes along with a house worth $70,000, he owes $50,000 on the first, and he needs $4,000 to stop foreclosure? Under normal circumstances, you wouldn't make the loan because the LTV greatly exceeds the 50% to 60% ceiling. But let's suppose this family has another house with a lot of equity they could use as collateral; or maybe Mom and Dad are willing to offer their house as collateral. This would put you in a very secure position and ensure your repay-

ment. It's as simple as getting enough collateral, so you feel comfortable you will collect one way or the other. It's a matter of whichever way you win first.

What kind of documents should you receive? Your closing package should contain the following:

1. An original note.

2. A copy of the mortgage or trust deed. The original will be recorded and then sent to you.

3. A fire insurance endorsement naming you as mortgagee.

4. An assignment of rents allowing you to collect rents in case of default.

These documents should be drawn up even if the house is owner occupied. If the owner moves out and rents, you don't want him collecting rents while you are foreclosing. This document gives you the right to start collecting immediately upon default.

5. A first mortgage verification (if you're making a second).

6. An application filled out by your borrower.

7. A title insurance policy for the amount of your loan insuring you against any title defects.

8. A recent appraisal of the property.

9. Some lenders like to have a termite report, as well, to ensure there is neither serious damage under the house nor live infestation. If damage exists, money could be put in escrow for the repairs and released to the contractors on completion.

Are there other avenues of income from loans? Yes, there are. We've talked about reinstatement fees and making money

with the property if you get it back. Now, let's discuss some other goodies that occur when the loans are repaid as agreed, which is most of the time.

One of those is transfer fees. Some investors get a $100 to $300 transfer fee if the house is sold and someone else assumes the loan. If you put a due-on-sale clause in your loan, you are in total control upon transfer. The borrower pays the fee or you can call the loan due.

Another nice income can be made from prepayment penalties. These are penalties incurred when a loan is paid off early. It's a technique commonly used by finance companies and small lending institutions to create another profit center. The penalty can be a percentage of the unpaid balance, or several months' interest on the unpaid balance.

For example, the note could be worded in such a way that, if it's paid off before it's due, you would receive three months' interest in addition to the regular interest. Folks, this can amount to a lot of money for a lender, because those loans are almost always paid off before they expire. If you are receiving a three-month interest penalty on a $20,000 loan at 15% interest, you're getting an extra $750 over and above what you're owed. Yes, this is legal; and no it's not usury in most states. Check with your attorney or mortgage broker to make sure you don't cross the line on prepayment penalties.

Late penalties also increase your yield. All loans should contain a late penalty. My late penalty is 10% after five days. This means that, if the $200 payment isn't received by the 5th of the month, the borrower must pay an additional $20.

Can the mortgage broker run off with my money? The broker should never be in possession of your money. Make your check out directly to the closing agent for the gross amount of the loan. The closing agent will then cut a check to the broker. Remember, you aren't paying the broker; the borrower is. You should have no expenses. Your payments should be collected by your bank or a collection company. In short, if your broker never has your money, he can't run off with it.

Is my investment really as safe as it sounds? Yes! As long as you've followed the guidelines that we've discussed and apply

common sense. No, mortgages aren't as hands-off as mutual funds or stocks or other kinds of non-participation investments. But, in return for a little effort on your part, your money will grow two, three, or even four times faster than your current investments, and you maintain control. If you follow some simple guidelines when making loans, your risk will be minimal. **Briefly, these guidelines are:**

- **Make only low LTV loans . . . no exceptions! An appraisal will confirm the value.**
- **Get title insurance for the amount of your loan.**
- **Have professionals close the loan.**
- **Make sure fire insurance is maintained on the property at all times.**
- **Take action immediately in case of default.**

Remember, making loans is a business and should be treated like a business.

If you set up a simple system and let the professionals implement that system, your loan portfolio can be hassle-free and produce staggering yields. And remember, all costs are to be paid by the borrower . . . not you!

Using Your Own Pension Plan

How do I use my IRAs or pension plan? Making real estate loans is an approved and widely-accepted use for IRAs and pension plans. Think of it! Now, you can not only loan money that has been unavailable for you to use, but you can also make it grow rapidly, tax deferred! Since Uncle Sam isn't taking a bite out of your profits until you draw out the money, more money is left in the account to compound and grow. The results are staggering. You'll be receiving interest on interest on interest, and it's all legal and approved by the IRS.

If you are to use retirement accounts for loans, they must be administered by a Third Party Administrator, or TPA. This TPA is set up and approved to administer your loan activities. This means you will probably have to transfer your plan to one of

these TPAs unless, of course, your present administrator is set up to do that. But the likelihood of that happening is slim to none.

When your TPA is located, simply send the transfer form to them and they'll do all the work for you. Once you've done that . . . you're ready to make loans!

When you've located a loan, you simply let your TPA know where to send the check for the gross amount of the loan, and you're in business. There should be no cost to you except your plan administration costs. Your setup fee, for collecting the monthly payments from your borrower, can be collected at closing from the loan proceeds, if you instruct your broker or closing agent to do so. Some TPAs will even collect the monthly payments for you and deposit them into your account.

There are some restrictions when dealing with IRAs, such as provisions against self-dealing, but your TPA will furnish you with all the facts on request.

We've covered a lot of information in just a few pages. I hope I've enlightened you on the awesome power of making real estate loans. If the concept appeals to you, I can't think of a better time to get started than right now. While most people are complaining about the low rates they're getting on their CDs and other investments, you could be receiving a bare minimum return of 15% all the time — not just when you get a hot stock.

What's it going to be? Are you going to continue to let other people control your money so you can get a return that barely keeps up with inflation? Or are you going to take control and make sure that, when you are ready to retire, you can do everything you want to do — without worrying about money?

Loan Brokering

I make a large portion of my income by loaning out other peoples' money. I collect a fee equal to about 10% of the loan and never have to get an OK from a bank. I have hundreds of students nationwide who have discovered this business and turned it into a full-time career. It's an easy business with huge rewards, and it works in all 50 states.

To learn more about private lending and/or becoming a mortgage broker, so you can make huge fees loaning money from other private lenders, you should know about **The Money Tree**, a course I have designed. Its purpose is threefold:

First, it teaches private investors why they should be making mortgage or deed of trust loans for huge yields. **Second**, it shows Quick-Turn house investors how to tap the lender market to get all the money they need to buy the good deals without going to a bank and without qualifying. **Third**, it completely covers the business of being a mortgage broker in any state.

The Money Tree course contains six audiocassette tapes with a complete workbook, software, and a brochure with an accompanying tape that you can hand to a potential private lender to convince him for you. Simply loan out the tape and follow up. I've made it easy to tap the big bucks.

> *I met a fellow named Khalel Gorgi in one of our boot camps in Atlanta. He had bought my course a few months earlier when I spoke in Atlanta and, fortunately, he decided to do something with it. He found a bank repo worth well over $200,000 repaired situated on four acres. He got a contract accepted — $120,000 all cash.*
>
> *He didn't have that kind of money in his account, so he was faced with a minor problem. Where to get the money? Now, Khalel is from Iran and I suspect they forgot to teach him, when he was growing up, that he couldn't buy things without money. What he did was line up a loan from a private lender for $160,000 at 18% interest. This loan was based on the equity in the house, not his personal qualifications.*
>
> *Khalel spent $20,000 in repair costs and $20,000 in other costs before he sold the house and one of the four acres for $230,000. He gave the buyer an option to buy the other three acres for $75,000 cash, which the buyer claims will close within six months. He will net $130,000 on this one house before he's*

through with the deal. I don't know about you, but I think 18% is a lot to pay on his loan. I think he should have passed up this deal and looked for cheaper money, don't you agree? After all, who in his right mind would pay 18% on a loan for six months, just so they could make a measly $130,000 profit?

The answer is me, of course, and you, if you need to. By the way, when we were in Atlanta, Khalel harassed us until we went with him to his favorite Persian restaurant. We really didn't want to go. All I could think about was the last time I had Indian food in Albany, New York, with Paul Bauer and Danny Santucci. I figured Persian food and Indian food were a lot alike and I hate Indian food. As it turned out, it was not only the best food I've had in a long time, but for weeks after I dreamed about returning for more. Khalel doesn't know it yet, but when I return to Atlanta, he's going to take me out for some more fine eating; that is, if he's got time between deals.

Section IV
Savvy Dealing

All people are self made.
Only successful people admit it.

Dan Peña

Chapter 11

Negotiating Win-Win Deals

Most deals work out differently than the way they are initially presented. We have to make a deal work successfully using the knowledge we have. Negotiate with the seller in such a way that both of you leave with a good feeling whether you make the deal or not. Always remember to negotiate from a position of strength.

Understanding the Seller's Motivation

Ascertain the seller's needs and try to fill them. If he or she needs $5,000 cash and you can't get it for them, it doesn't matter how much talking you do. You won't make the deal work.

Listen between the lines. Many times motivation to sell has nothing to do with money. For example, intangibles such as unhappy memories associated with the house, or a long-standing argument with relatives, can cause a person to want to sell fast. Many such reasons will seem irrational to you.

If you listen well, however, you often can meet the seller's needs without cash. A seller may want to leave town by the 26th of the month, and that deadline is more important than the price. If that's the case, then match that requirement with his lowering the price, dropping the interest rate, or making some other concession. Learn the seller's problems and try to solve them.

Remember that one of the seller's understandable, basic needs is to feel safe about your contract offer. Try to use as few

contingency clauses as possible. In fact, try to avoid having any. The more contingencies in a contract, the less chance the seller will sign.

The Virtues of Patience

What do you say to the seller when your gut tells you you have a potentially great deal, but you just don't know how to put it together? One good reply is, "I will work on a way to make it work for both of us and call you back tomorrow."

This is a good line to use if you don't have all the answers and need time to figure out how to make the deal work. Don't be hurried into making an offer you will regret later.

You may be rushed at times, but never make an offer before you find out what the seller wants. This goes for property or anything else. Once you know the seller's needs, make one or more offers at the same time. All these offers are made with the seller's needs in mind, while any one of them will satisfy your own needs.

Always leave the door open if the seller doesn't accept your first offer. Quite often he or she will take less than you were willing to offer in the first place. Some deals age like fine wine, so be patient and work other deals while waiting for a seller to accept.

Using Liens and Judgments in Negotiations

Look for liens on properties. This motivates a seller. Almost any seller who has a lien on his house expects to pay the full amount of the lien when selling. Yet, you can negotiate a deal for half the amount or less with the lien holder to whom the money is owed. Then you can reduce your purchase price by the amount you discounted the liens.

Judgments seldom accrue interest, and, more often than not, they don't attach to the property. If I go to court and get a judgment against someone, the judge hands the judgment to me, and the judgment is recorded at the courthouse. But the judgment may not attach to the property unless I physically get

a recorded copy of that judgment and re-record it. This is called "certifying the judgment." Not many people know this, including most attorneys. Just because a judgment is on file doesn't mean that it is attached to the property. Check the law in your area. You should also check to see if it is a verified or certified judgment.

There are several ways to remove a judgment:

- **Negotiate with the holder of the judgment to remove it from the property for a small fee. This will not pay off the judgment, but it will remove it from the property, which is probably all you're trying to accomplish.**
- **Foreclose it off.**
- **Discount it and pay it off.**

Speaking of Interest

Is it possible to obtain a 0% interest loan? Yes, if you are dealing with motivated sellers. You may negotiate one from a seller by just never bringing up the subject of interest. Just offer to pay a certain amount until the debt is paid off.

For example, suppose a seller has a vacant house which no one has come to see. The seller doesn't want it. You drop by with a solution to his problem. You give the seller most of his asking price, plus a small cash down payment of $4,000, on the condition that he carry a mortgage on this free-and-clear house. You approach the seller and say, "I can give you $4,000 down if you will carry the balance for $125 a month until it's paid. Is that all right?"

If the seller asks for interest you say, "Why do you need interest? You have equity in the house and are not getting any interest on it now. I can only afford to give you $4,000 down and $125 a month to make this deal work for me. I have to make repairs and try to market the house myself. This is all this

house will support. It is the only way I can buy it. If this works for you, fine; if it doesn't, that's OK. I don't want to make you angry, I just want to make a deal that works for both of us."

You imply that, if he doesn't like it, you will walk out on the deal. If you don't mention interest, the seller probably will not mention it either. Show the seller that the deal depends on the house, not on you.

Remember, however, the real key to getting zero interest loans is to deal with motivated sellers only.

Being Straight with Sellers

You don't need to do anything fancy in negotiating. All you have to do is talk to the seller and find out what he or she is trying to accomplish. Be square with them. Tell them honestly what you can do. If it works, fine; if not, that's fine, too. You can't do any more.

If you are resolved that a deal has to meet your conditions or you can't be a part of it, and you relay that idea to the seller in a friendly manner, you don't need to know anything else about negotiation. The negotiation is the easiest part of the process.

Don't waste time with bad leads. If a seller is inflexible, move on to the next lead. If possible, try to negotiate as much as possible over the phone, so that you know if you have the potential for a good deal before you leave your office. I always prequalify a seller thoroughly before I see him or her in person.

Get the facts from the seller; try to fit that information into a deal. Explain exactly what you can do, and why you do what you do. If it doesn't work, move on to the next deal. Don't hide things. Be honest.

> *I keep thinking of my friend and Boot Camp graduate, Sue Butler from Augusta, Georgia. She called me once to talk and talk and talk about a killer deal she had just closed. That deal had even me green with envy. Sue told me how, in response to her ad, she had received a call from a seller in foreclo-*

sure. He owed $69,000 on a house worth $169,000 in good condition. Sue learned over the phone that the man was several payments behind and willing to walk if someone would pay just a fraction of his equity.

Sue visited the house and struck up a deal most people wouldn't believe possible. She will retail the house for somewhere near what it's worth, and she'll make an obscene profit. She indicated she would sell half interest in the house to a partner for $25,000 to $35,000 instant cash to her.

She'll let the partner pay the monthly payments while they are selling the house. Then they'll split the profit above her partner's buy-in price, which means Sue makes $25,000 or $35,000 now and half the profit when they sell.

This lady is fired up. She said she is getting more deals than she can possibly handle. I wonder what it would have cost Sue had she chosen not to attend my Boot Camp.

Tell the Seller Why

You can't make the seller's problems your problems, at least not if you plan to stay in this business! If a seller has so much indebtedness on a property that assumption of the payments would lead to negative cash flow, tell him that plainly. If you need for the price to be dropped, say why. If you need more profit in a transaction to make it work, or want to use very little cash to buy your properties, say so. You will make a lot more money by being straightforward about how you do and do not buy property.

There's no big mystery about negotiating. It's as simple as discovering the seller's needs and working out one or more solutions to meet them. If you can't, leave the door open by explaining why you can't. Quite often your professionalism and straightforward approach will lead you right back into the deal at a later date. That's when the seller calls you back because he

or she can't get the house sold under their terms or at their price.

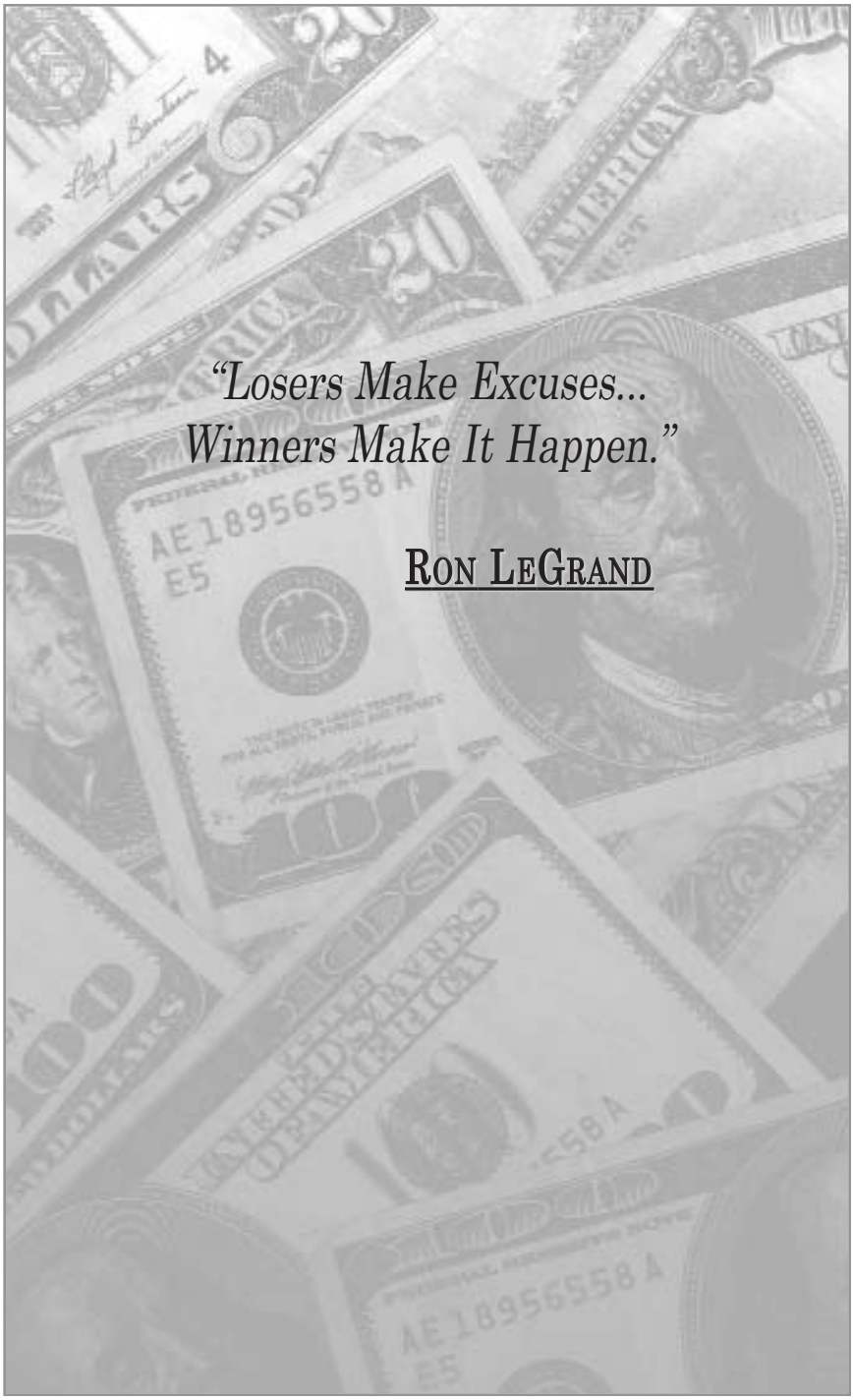
Tell it like it is, tell the truth, and back up what you say. If you don't win this one, at least you'll feel good that you did it the right way.

Making Obscene Amounts of Money Without Ever Talking to a Seller

If dealing with sellers bothers you and makes you feel inept, there is a good solution to the problem: **DON'T DEAL WITH SELLERS!**

How about taking my suggestion about using a REALTOR®? By utilizing a good agent to help you find the junkers, you can make virtually hundreds of offers on houses and never meet the seller, not even at closing. This is especially true if the seller is a bank or the government. When they sell a house, they just send a package to the closing agent. No one ever appears in person.

So, if dealing with people worries you, and you think it's a good excuse to avoid making offers . . . forget it. I've just destroyed that crutch for you. Time to get to work!



"Losers Make Excuses...
Winners Make It Happen."

RON LEGRAND

History has demonstrated that
the most notable winners usually
encountered heartbreaking obstacles
before they triumphed.
They won because they refused
to become discouraged by their defeats.

B.C. Forbes

Chapter 12

Making An Offer By The Rules

The most important thing to remember about offers is to make them! You can learn how to find motivated sellers, negotiate deals, write contracts, and fix up property; but if you don't use that knowledge, you have wasted your time. Leave behind a trail of offers. Gather facts, then use them to formulate deals. If you don't make offers, you won't buy houses. Unfortunately, too many people become professional information gatherers, then never take the next step.

Until you make an offer and get a response, you will never know just how seriously your seller is motivated. For example, I once found a duplex for which the seller owed $17,000. The house was vacant and needed repairs; there were also two unassumable loans on the property. I discovered it just by driving around and noticing a cheap, ratty "FOR SALE" sign. (That sign indicated that the seller was unsophisticated. Chances are always excellent that you will get a better deal from a FSBO displaying that kind of sign.)

The property was worth $40,000 to $45,000. The seller was asking $25,000 with $8,000 cash to mortgage. I offered $1,000 cash to mortgage, and the seller accepted. The seller didn't even think twice about it! The property was put under contract and sold for $24,000 the next day. If I had not made the offer, it would never have been accepted.

It's easy to offer too much. If you have never tried some really outrageously low offers, make a few just for practice. I once bought a house from a lender for $750 total. The house had a

new roof, and it needed no exterior paint and little work on the inside. In jest, I offered $500, and the bank said the minimum it would take was $750. The house appraised for $15,000, as is. It was located in a low-income, high-crime area which made it unattractive to much of the market. I knew, however, that if I bought it cheaply enough, there would be someone who would see it as a good deal regardless of the location. Sure enough, I was right. I sold that house for $5,000 cash.

So, what should you really offer? As a real estate trainer, this is one of the questions I hear most often, and it is not only beginners who ask. Many experienced investors, people who could be expected to know the answer, don't know either. Of course, the definition of "experienced" varies. Having a license and being involved in the real estate industry doesn't qualify anyone to give a definitive answer to "What should I offer?"

The only way to get the correct answer is to learn from someone who really knows. From my years of experience in the business, I have come up with several steps to make this process simple, fast and accurate. Every time I conduct hands-on training in the field, I do the same thing over and over again, no matter what city I'm in or what price range I'm dealing with. My students are shocked to learn how simple it is to make good offers. And it's great to see how fast they catch on after they make a few in real life.

Determining Value, the Foundation of Your Offer

This section closely parallels the Property Acquisition Worksheet discussed in Chapter 4. It is such a valuable tool for determining a sensible offer that I want you to refer to it as we continue our discussion.

First, you must know the value of the house you're buying. When I say "know the value," I mean the after-repaired, in-excellent-condition, ready-to-sell value. What will be the appraisal value after you've made the house the best looking one in the neighborhood? How much will it sell for compared to other houses that have sold recently in the same area, in simi-

lar condition, and with approximately the same amount of square footage?

To find the "comps," or comparables, you must do your homework. Either get a REALTOR® to pull some comps for you or do the research yourself. Don't guess. It's critical for you to determine the real value because everything you do from here on will hinge on that figure.

Some areas have publicly accessible databases of tax rolls and sales. These databases will actually print out a market analysis similar to the MLS service REALTORS® use. If you live in one of those areas, your job will be relatively easy. If not, you must simply do a bit more research prior to making an offer. Please remember that comps come from sales, not asking prices. An easy way to get a REALTOR® to help is to tell him or her that, if you buy the house, you may need his or her services to sell it.

The **second** step is to determine the approximate cost of repairs. This is not as difficult as it sounds. Anyone can do it with a bit of training. I tell my students to separate the work into components, then simply add them up.

For example, a roof on a 1,200-square-foot house will cost $1,500 to $2,000, depending on who does the work. This estimate assumes that you don't use high-priced, union-scale contractors, and that you have shopped a bit before hiring anyone.

Carpet, pad, labor, and linoleum for the same house will cost about $1,000 at $10 per square yard, total price. Interior and exterior painting shouldn't cost more than $1,500. Central heat and air installed shouldn't cost more than $2,500. Window replacement runs anywhere from $75 to $150 per window installed, depending on the size. A complete kitchen can be installed for about $1,000.

I know you're saying that isn't so in your area — that your prices are higher. Well, my friend, it is so in your area when you learn who to hire and what to fix. Just remember, you're not building your dream house here. You're only making your inventory ready to market.

If estimating repair costs is a problem for you, then I suggest that you get help from a friend or a contractor to get a ball-

park figure before you make the offer. Or you can attend one of my Boot Camps, where we take you out in the field and work through the estimating process. We cover every aspect of repairs, before and after, and go into great detail on how to estimate costs. Call my office for more information.

A word of caution: Don't spend too much time trying to get an exact repair figure. You're only trying to ballpark it. The objective is to get the offer made, not analyze it to death. A tolerance for mistakes is figured into the formula, as you'll soon see.

To recap, by now you have estimated the sale value of the house and the cost of repairs. (Before you close, get estimates to verify your assumptions.)

The **third** step is to determine your purchase, holding, and sales costs. You can get your purchase costs from any closing agent, REALTOR®, attorney, or experienced investor. Of course, what you negotiate when making an offer will determine what you really pay.

Figure out how long you think it will take to sell the house, and you can get a handle on holding costs. If you think three months, then figure in three or four payments, plus taxes, insurance, and utilities. Be conservative here. A six- or nine-month holding period is not out of the question. Some properties will move fast; others will be on the market for a while. We don't have a crystal ball.

Allow for the worst, but don't go off the deep end. Being too conservative can and will cost you deals because you weren't realistic with your numbers. Sometimes overestimating costs can be worse than underestimating, because it will cause you to make false judgments and lose a deal that could have been a money-maker.

If, for example, you're looking for a $20,000 profit, and your numbers show that if you hold the house for one year instead of six months you'll make only $17,000, is that any reason to kill the deal? Certainly not! It just means you must work harder to sell that house more quickly.

Your sales costs can be figured by first adding projected advertising expenses to commissions paid. Then call the lender

you plan to use and ask for an estimated cost of your new loan. Simply quote a sales price and, within seconds, they will tell you your selling costs.

The **fourth** step, and the most fun, is to determine how much profit you want in return for doing all this work. What will it be...$10,000, $20,000, $30,000? You name it — but be realistic. The higher the prices of the properties you're dealing with, the bigger the profit you should seek.

For example, if you're selling a $30,000 house, you're going to have a tough time making a $20,000 profit. On the other hand, in selling a $250,000 house, I would expect a minimum profit of $40,000. Frankly, that's on the low side.

Ron's Rule: The higher the stakes, the bigger the payoff. Remember, your costs are going to add up much more quickly when prices are high. If that's true, then your profit potential should be greater, as well. A good rule of thumb is to plug in a 20% profit of the sales price. But remember, that's only a rule of thumb.

A word of caution! My example of a $150,000 house applies in areas where that amount buys only a bread-and-butter, 1,200-square-foot, three-bedroom house. If your area has decent houses in the $40s, $50s, and $60s, that's where you should deal. Stay where the market is. Don't get "big-deal-itis."

Buying a high-priced house in a low-priced area can lead to gray hairs unless you have the skill and holding power to stay until the house is sold, which may take a while. Remember, we're only talking about buying junkers. If you deal in lease options and assumptions, the sky is the limit after you learn to minimize your risk.

In fact, some of you should specialize in high-priced houses, once you learn the ropes. If you have, or can partner with someone who has the holding power to maintain control, there are huge profits in these houses in today's market. In fact, once you get down to the nitty-gritty and really learn this business, you'll soon discover that it's just as easy to make $50,000 on a house as it is to make $10,000.

Now we're getting to the bottom line. I can sum up everything we've learned so far and put it into one simple equation:

sale price (minus) repair costs (minus) buying, holding, & sales costs (minus) projected profit = maximum allowable offer

After you become familiar with your market and learn how to estimate repairs, the whole process I have just described will take you all of five minutes to complete. Spend that five minutes doing it right, and you might just avoid several months or years correcting your mistake.

Don't be concerned about coming up with the exact numbers when you're trying to evaluate a deal. Your objective is to get within a tolerable range so you can make an offer quickly. If you're in the habit of verifying every figure before you even make an offer, your success rate is going to be very low because you haven't learned to make wise use of your time. Don't get "paralysis of analysis"!

Make the offers, get interest from the buyer, then verify your assumption. If the seller is not going to play ball, why waste time being a number-cruncher on a house you won't buy? So what if you are off $2,000 on your repair estimates! All that means is that you make an $18,000 profit instead of a $20,000 profit. If the $2,000 is that critical, then the deal is too close anyway, and you're offering too much.

Your efforts should be concentrated on making a lot of offers, not collecting facts you won't need on houses you won't buy. If you get carried away with the number-crunching, some other investor will put the property under contract while you're trying to decide what to offer. Believe me! I know this, because I am one of the investors who has taken deals from those who couldn't make a fast decision. You can't Quick-Turn in slow motion!

Making Three Offers

It's usually best to make several offers at the same time. This often causes the seller to fix his attention on which offer to accept, rather than on the more logical question of whether any of the offers should be accepted.

Here's an example: I was called once about a property with an asking price of $25,000. The property was worth about $47,000 after repairs. I made the following three offers:

First, a cash offer for $15,000.

Second, $4,000 down and $16,000 in six months for a $20,000 purchase price.

Third, $25,000 on sweet terms with the seller taking most of his equity in long-term monthly payments.

The offer for $25,000 was the seller's full price. However, it was on my terms. I offered $3,000 cash down with the seller's carrying a $22,000 mortgage at $150 a month until the balance is paid off, and I made that mortgage subordinate to new financing. It became, in essence, a second mortgage, thus giving me the right to place a new first on the house without paying off the $22,000 mortgage to the seller. (There's more on subordination in Chapter 13.)

Now, the seller had received three offers: one for $15,000 cash; one for $20,000 if he could take a little now and the rest later; and one for full purchase price if he could live with $3,000 now and a payment of $150 a month until the balance was paid.

Probably, it never occurred to him that he didn't have to accept any of those offers. And I didn't care which he accepted. I didn't put the offers in writing. I used a legal pad and wrote the figures on it, then handed it to the seller and asked him which offer he wanted. Only after a seller picks an offer do I write a formal contract.

This is a conversation you might expect.

"Mr. Seller, these are the three ways I can buy your house. See which one suits you and we'll get it working."

"I can't take just $15,000 cash for this house."

The seller will probably need time to think about it. He may want to talk it over with his wife and call you the next morning.

"Mr. Seller, I don't blame you. I wouldn't either."

"I really don't like the idea of collecting payments, because I have no way of knowing that they'll get paid. And I really don't

like the idea of somebody's having a new first mortgage on my property, putting me in second position."

"I don't blame you, Mr. Seller; I wouldn't do it either. I think you ought to take door #2, where you get some down and the balance within a few months."

This is the offer he did take, because his risks were minimal and he saw that he would get all his cash in a short time. However, there is absolutely no way I would know that unless I gave him a choice. I've found that, quite often, the seller takes the offer I least expect.

In this example, the seller was asking $25,000, and the final negotiated price was $20,000 with $4,000 down and $16,000 within six months. There was no interest and no monthly payments. That's what he accepted. I made the three offers mentioned above, and it took him three days to make up his mind.

Within a few days of closing, I sold the property for $27,000. I made $7,000 on this property and the whole process took less than a month. By the way, the seller never even mentioned interest, and neither did I. You see, receiving interest was not important to him. Show me a bank that will allow you to borrow money at no interest!

Interestingly, someone else had offered that seller $22,000 all cash before I came on the scene, but then backed out of the contract because of some termite damage. The cost of repairs was $1,500. I asked the seller to drop the price $1,500, and he did. By the way, the house appraised for $40,000.

In a situation like this, you must know the value before you make an offer. If you don't know the value because you lack experience with that neighborhood or type of property, get help from a REALTOR®, or anyone else who can provide a market analysis.

With a little experience with a certain type of house in a particular area, you will be able to determine the market value when you make your first walk through. Remember, however, when you're in doubt, get help from others who are more experienced.

The exercises at the end of Chapter 13 will give you some practice in forming three offers. Get in the habit of making multiple offers, and you'll see your acceptance rate skyrocket.

Escape Clauses

Entire books have been written about escape clauses, sometimes known as "weasel clauses" or "contingency clauses." Such clauses help you void a contract when a deal goes bad. You only need one good one. One example might read, "This contract is contingent on approval of buyer's partner." Your "partner" could be anybody you wish. Another example: "This contract is contingent upon financing acceptable to purchaser." This gives you maximum flexibility either to proceed with the deal, or to end it before closing and have your earnest deposit returned.

While we're on the subject of escape clauses, let me explain what I usually use — NOTHING. That's right, none. I've found that every time I put a contingency in a contract, I'm reducing my chances of getting it accepted. Especially if I'm dealing with banks or government sellers. They just don't look favorably at clouded contracts.

While most potential buyers are making offers containing several weasel clauses, and not getting any of those contracts accepted, I'm buying the houses for less than they are offering because my offers are clean. In most cases, they have no contingencies.

I know that sounds dangerous, but is it really? What's the worst that can happen if you make an offer but can't close for some reason? Do they break your kneecaps or hold your kids for ransom? NO! They keep your earnest money deposit. That's the only thing they can do if you've signed a contract that provides for the return of earnest money as the only remedy for default. If your contract contains that clause and you can't close, that's the end of the story. No lawsuits, no broken knees, and no kids held hostage. You lose your deposit and that's it.

Obviously, the best way to reduce the risk of loss is to reduce your deposit. Put up the least amount possible and minimize your risk.

Of course, there are times when a weasel clause is appropriate and perfectly acceptable to the seller. For example, you could make your contract subject to an estimate for repairs if the house has serious damage, or subject to your inspection of the interior if you were unable to gain entry before you made the offer.

Common sense is the key in this area. Once you are proficient at quick analysis of a house prior to making offers, you will seldom need weasel clauses.

Counteroffers

When you receive a counteroffer, be thankful. It is always preferable to a simple rejection. Many deals may require several offers and counteroffers. Sometimes, contracts begin to show so many markings and changes they become difficult to read. Don't worry. Changes to a contract actually strengthen it, because they demonstrate to an even greater degree a "meeting of minds."

The same basic rules apply in responding to a counteroffer as apply in making the original offer. If the counteroffer shows a great deal of resistance, you may not be dealing with a motivated seller.

No Standard Contract

A contract may say at the top "Standard Contract." In reality, there is no such thing. In each area of the country, there are contract forms approved and promoted by REALTOR® organizations and boards, but this does not mean you as an investor have to use them.

Many investors have their own attorney prepare a contract for frequent use. The document is tailored to the investor's particular style of investing and it has as much right to be called a "standard contract" as any other form.

Using an Addendum

Many investors have a "standard" addendum they routinely attach to commonly-used contracts. It typically contains their favorite escape clauses and special clauses that favor the investor, such as limitations on liability, subordination, and many other items.

When an addendum is attached to a contract, that contract often appears to the seller to be a more conventional document. In more complex deals, a contract cannot be expected to be static. Other addendums may be added at any time to change the terms.

An addendum is written with opening language that links it to the main contract. It usually states the date of the contract, the names of both seller and buyer, and the address of the property.

The first paragraph might read, "The parties hereto have agreed to the terms of this addendum to the Sales Contract referenced above. The terms of this addendum shall be deemed to be an integral part of said contract, but where the terms of said contract conflict with the terms of this addendum, the terms of this addendum shall control."

Again, I'm going to suggest in most cases, you not use addendum clauses. The more junk you put in a contract, the more reason your seller will have to turn down your offer. Don't use a weasel clause unless absolutely necessary. If circumstances dictate that you must use one, draw up just one all-inclusive clause that will give you time to do whatever it is you need to do to get the deal closed.

An example of an all-inclusive clause: "Subject to buyer's obtaining an appraisal, at buyer's expense, suitable to buyer, within 15 days of acceptance." That covers anything you want it to, doesn't it? If you don't like the appraisal, you don't have to buy the house. You have 15 days to clear up any details and either proceed or back off.

In my opinion, if you take longer than that to release any contingencies, you should be prepared to lose your deposit if you don't close. It's only fair in most cases. Chalk it up to expe-

rience and forget it. Instead of crying over spilled milk, go out and milk another cow.

"The secret of success is to be ready for opportunity when it comes."

RON LEGRAND

Section V
Money & Laws

No man ever achieved worthwhile success who did not at one time or other, find himself with at least one foot hanging well over the brink of failure

Napoleon Hill

Chapter 13

Where To Get The Money

When I started in real estate in 1982, I thought you had to have money. I had a job, but I was broke. Since then, I have learned you don't need money, credit, or steady employment to do this type of investing. Of course, having a little cash doesn't hurt, but I know some of my readers don't have any, so this chapter is especially for you.

Three basic types of financing are available. **First,** there are bank loans, which are long term, low interest, and tough to qualify for, due to FNMA and FHA guidelines. **Second**, there are alternative sources of short-term money. **Third** is seller financing, which is the ideal source of money as far as an investor is concerned.

Shortcomings of Bank Loans

It seems low-interest, long-term loans are the kind everybody thinks they need and want. The old school of thought was to buy a property cheaply, fix it up, and refinance it. The truth is, if a person had to make a living refinancing every house he bought, he wouldn't be in this business long.

Bank loans have many shortcomings. Sometimes investors, trying to improve their chances of getting loans, will cultivate a particular loan officer, only to discover that the person has quit or the bank has merged with a larger bank that is hostile to investors. Even worse, many banks add "call" provisions to the mortgage note, which means that they can call the loan due at

any time for the slightest reason! In today's climate of failing banks, it could be hazardous to your financial health to be dependent on a particular institution.

Another problem is you can not keep going to a bank and borrowing on investment properties. They will cut you off after a few loans. That makes it harder to get a loan of any kind.

Two other key problems are involved. In most cases, the terms of financing are out of your control, and you are personally liable. It is not desirable to be liable for the loan for the full term. As you increase your business and the number of properties you own, being liable for them for the long term is not necessary. Too much debt load can be hazardous, especially since you are still liable for the loan even if someone else assumes it (unless you've gotten a release of liability). Do not expose yourself to this risk by making yourself liable for the loans; do not become involved for the long term if you are liable; stay away, whenever possible, from personally qualifying for loans.

Also, qualifying for a loan can be a challenge. You must prove income and good credit, and subject yourself to a great deal of financial scrutiny. This often poses great difficulties for self-employed investors.

Traditionally, bankers prefer to make investor loans only on occupied, fixed-up properties with long-term leases. With a signed lease, you can get loans for 70% to 80% of the appraised value. But that doesn't help you to buy vacant houses needing repairs. Furthermore, you are fully liable for such loans during the 15, 20, or 30 years it takes to amortize them. Also, these loans are based on the lower of the purchase price or the appraisal within the first year, which in effect penalizes you when you want to negotiate a really low purchase price.

It will take 30 to 60 days to close on this kind of loan. You have to show a positive cash flow or have enough income to offset the debt, and you will usually be forced by the lender to assume a 25% vacancy factor. The property must be in good condition to qualify. The loans are seldom assumable, and even if they are, the person assuming the loan has to go through the same process of qualification as if they were applying for a new

loan. These loans will show up on your credit report and impact your borrowing ability in the future.

Finally, most of these loans will not allow the cash-outs investors often want. Most lenders will not allow you to go home with a check. Then there's another problem: I've seen too many investors who think borrowed money is profit and proceed to spend it as if it never has to be repaid. There's no profit until a property is sold.

Considering all these factors, why should you allow yourself to become dependent on banks? Use these loans only for long-term keepers so you can recapture your cash, and only if you can't find another way to get the money you need. You don't even have to do this for your own residence. The only time to go into a bank is to deposit money. Take control of your own financial future!

Mortgage Brokers and Short-Term Money

The best place to get short-term money is through a mortgage broker who knows what will and will not work. Brokers know what they can get in the market today. Some of them have access to private funds that require no qualifying by the borrower. Equity in the house is the only concern. These brokers will be a valuable asset when you use their services.

Remember, when I started, I had no credit. I had no choice but to utilize whatever funds were available, so I found a broker who would loan 50% of the appraised price regardless of my financial condition. He charged me 10% of every loan I made, and I paid 18% interest. The costs were high, but the rewards were worth it. I soon learned that it isn't the cost of money that counts, but the availability of it.

Because I had access to those funds, I bought up junkers and made thousands of dollars in profit on each. Let me ask you a question. Would you rather pay a mortgage broker 10% of your loan or pay a partner 50% of your deal? Tough choice, isn't it?

Of course, if you have the money to buy a house, you don't need to take out a loan or be concerned about loan fees.

Mortgage brokers work on a commission. They do not get paid unless you get paid. If you use private money, get used to the idea of paying high points and consider it a cost of doing business.

You can get a high-interest loan and still make money. Remember, it's not the cost of the money that matters; it's the availability that counts. When I went into business, I borrowed on 76 loans at 18% interest, 50% LTV ratio, six months' interest prepayment penalty, seven-year balloon payment, and 10 points up front to the broker who put up the money. I still made money on every single deal! Most of the houses were in poor condition, so I used the borrowed money to repair them before I sold them. You can do that with those kinds of loans.

You need a mortgage broker whenever you are going to deal in short-term money, unless you are going to develop your own private lenders. If you do you will save 10% brokerage to the broker and you might even get a lower rate. Develop your own list of lenders. If the house needs repairs, you may not get all the money at once. Some of it may be escrowed to allow the repairs to be made. As this is a common technique, it will benefit you to understand what it means and how to calculate it.

Here's an example: Suppose your offer is accepted for $15,000 cash on a property whose value after repairs is $45,000. The as-is value is $35,000, and the estimated repair costs are $4,000. You know you can get a loan from a private investor for 50% LTV of the fixed-up property.

Value after fix-up	**$45,000**
As-is value	**$35,000**
Repair estimate	**$ 4,000**
Maximum loan amount*	**$ 22,500**

The cost of the loan**	**$ 3,000**
Net from loan	**$19,500**

*** ($45,000 x 50%) = $22,500**
**** closing costs**

The problem is the loan is based on the after-repaired value. The broker will write the loan for $22,500 even though the property hasn't been repaired yet. You'll close the loan for $22,500. You'll pay the costs on $22,500, and you'll start paying interest on $22,500 as of that day.

The lender, however, will escrow 50% of the difference between the as-is and the after-repaired value. In this case, that amount would be 50% of $10,000, i.e., the $45,000 repaired value minus the $35,000 as-is value. The escrow would then be 50% of $10,000 because it is a 50% LTV loan.

• Held in escrow 50% of difference: $5,000

The closing agent will hold the $5,000 in escrow until the work is completed. If we would normally net $19,500 on this loan, we will now net $14,500 at closing, i.e., $19,500 - $5,000 = $14,500.

After the work is done, the mortgage broker will send an appraiser out to look at the finished house and, if all the work is satisfactorily completed, he will give you the $5,000 that was in escrow.

In the above example, we need $15,000 cash to buy the house and $4,000 to repair it. We need $19,000, but we are going to get only $14,500 from the loan at closing, so we would construct our offer this way:

"Mr. Seller, I'm going to give you $15,000 for this house. I'll give you $10,000 at closing and $5,000 within 60 days. Will that be alright?"

"Yes, that would be OK."

In doing this, we are fully protected. We would get $14,500 from loan proceeds. We would then give the seller $10,000 at closing and still have $4,500 left over. We need $4,000 to repair the house, so we are able to keep the $500 that is left over. Now we have protected ourselves. The seller does not have a problem getting his money. We do not have to get another loan to pay the $5,000 we owe him, because it is sitting in escrow. It will be paid as soon as the house is repaired and we get the money out of escrow.

To make this work, the seller will hold a second mortgage on this property for 60 days because we obtained the first mortgage from a private investor through a mortgage broker. This is known as "subordination." It is a useful tool for any investor.

Another way is simply to give the seller a promissory note for his balance that's not secured against the house. Even better, just have the closing agent prepare an agreement that will allow your seller to pick up the money in escrow after you have completed the work. The seller should feel safe knowing the money can't be released until the work is completed, especially if he or she has the right to collect it directly from the escrow.

You will find the amount to be escrowed varies from lender to lender. Some lenders may require as much as 100% escrow for repairs. Others may require only 50% escrow for repairs. Often, the lender will not escrow 50% of the difference, but instead will escrow what you say it will cost to repair the house. For example, if you can show the repairs will cost $4,000, some lenders will escrow that amount. You don't have much say-so in the matter. Therefore, the golden rule applies: "Those who have the gold make the rules."

Generally, the money these mortgage brokers find for us comes from private individuals. The only consideration for one of these private loans is the LTV ratio. The length of the loan may vary, but generally it's possible to go up to 15 years with a five-year "cap" on the loan. This means that a lot of brokers will amortize the loans as if they were for 15 years, but, in reality, there is a balloon payment due in five years or less. They don't want the risk of having the money out for 15 years. The money

is very liquid; they can sell the note easily if they wish, or receive payments for a short period of time

This short-term money is valuable to us as investors. If you get a good deal on a house, you can get a loan on the value of the house, not what you paid for it. A private investor is very different from a bank, because he usually doesn't care what you paid for the property. There is none of the usual verification ordeal. The only verification is the value of the property. You do not need good credit, these loans are not recorded on your credit report, and there is usually no qualifying. Private investors don't care about your personality or personal history. They are only concerned about LTV ratio and the safety of their investment. A good deal of the time they don't even check your income or credit!

As an example, suppose you buy a house worth $50,000 for $30,000 and you obtain a loan for $25,000. The private individual who makes the loan through the mortgage broker would be in good shape if you were to default because he would take back a $50,000 house. It's hard to lose in a 50% LTV situation. This is why private lenders like to make loans to us, those loans are very safe. Once you understand what you can borrow through mortgage brokers or your own lenders, you will know how to construct better offers.

In the following example, you'll see how to provide all the money needed for a purchase so that it is totally "no money down."

I once found a house with a sale price of $15,000, all cash. The property was in excellent shape and didn't need any work. It would appraise for $32,000 to $35,000. The house was put under contract for $14,500, all cash. A mortgage broker, who was also a private investor, was shown the property and was told that I wanted to borrow $16,000, secured by the property. (It was necessary to borrow $16,000 to cover the closing cost so the house could be bought with no money down.)

The mortgage broker inquired about the sale price. Upon hearing it was $15,000, he said he would loan only $15,000 on this house. I knew that the broker was getting a brokerage fee, and there were going to be other closing costs. I was going to net

$13,500. Knowing I was paying $14,500 and was going to net $13,500, I had to come up with $1,000 out of pocket. I called the seller and told him I could get only a $13,500 loan on the house. So I asked the seller to lower the price $1,000 or take a $1,000 note for $50 a month at 0% interest until the $1,000 was paid.

The seller checked with his partner and agreed to take the $1,000 note. I left that closing with a check for $147.00 with no money invested. I sold the house to an investor for $3,000 cash to mortgage a few days later.

Be careful if you have had problems in the past that lead to a judgment against you. You shouldn't take title to property if you do. As soon as you buy any property and take title to it, the judgment may attach to the property. The only thing you can do is take title in some other name, usually a trust or corporation. This way you can get a loan and not put the property at risk of having a judgment attached.

Here are a few more details about getting money through your mortgage broker. An appraisal usually will be necessary even if the loan is 50% to 55% LTV. If it is less than 50% LTV, say about 20% LTV, an appraisal may not be necessary. It takes five days to two weeks to close the loan, a relatively short time in which to obtain money.

With private loans, the property can be vacant or in poor condition. However, if the property is in poor condition, don't expect to get a loan based on its worth after repairs and be able to take home all that money at closing without escrow of repair funds. That will not happen.

Expect to pay 15% to 18% interest for money obtained through a mortgage broker. Base your business on these rates. It may seem high, but it is a small price to pay to have access to the money, especially if there is no other way to obtain funds. Eighteen percent interest will seem insignificant after a few deals. If you want access to the money necessary to put these deals together, you have to pay the price.

Sometimes you will have personal liability for these loans, and sometimes you won't. Some lenders will require a personal signature for corporate loans and some won't. The reason for

this money is to get in, get out, and pay it off. Personal liability for a loan of this type is not nearly as important as personal liability on an 80% LTV loan. On these low LTV loans, personal liability just doesn't make that much difference, because it is already so safe for the lender. Nobody will be coming after you for a deficiency judgment, even if they were to foreclose on a loan, because the loan is only 50% of the value of the property. There is just too much equity in the property to have a deficiency. And the lender knows that these loans, for the most part, will be out for only a few weeks to a few months.

Seller Financing

Seller financing is absolutely the best financing of all. Your income potential will increase dramatically if you use it properly. Seller financing is being used anytime the seller of a property takes back part of the purchase price in the form of a mortgage. The seller simply collects payments on the mortgage. It's no more complicated than that.

Why do you need it?

- **First,** it's cheaper. You can't get a 0% to 6% interest rate any other way. If you know how to ask for it, you can routinely get 0% or a greatly reduced interest rate.

- **Second**, you do not pay any points or origination fees with seller financing.

- **Third**, you can easily use special clauses in your mortgage note that are profitable to investors. For example, you can be sure that you will be able to transfer the mortgage with a substitution of collateral clause. You can also have the right to subordinate the seller financing to new financing. Both of these techniques are discussed on the following page.

- **Fourth**, an excellent reason for seller financing is there are no due-on-sale or balloon-payment provisions in the mortgage if you do not put them there.

By contrast, all conventional loans have a due-on-sale clause, plus charges for points, application fees, and appraisal charges, and many have prepayment penalties. This puts the lender in control of the loan. When we do seller financing, we don't put the lender in control. We stay in control. The provisions you insert into a privately-held mortgage are entirely between you and the seller. For instance, if we buy a property and the seller carries a second mortgage, you may not put a late penalty in it. Be careful with contracts used by REALTORS® there is usually a space to indicate due-on-sale or not due-on-sale. The problem lies in the fact that they also call for you to qualify to the seller. I white this out on the contracts I use.

Be careful about the wording of the contract because it will govern the way the closing agent handles the transaction. This can work for you or against you. If there is no due-on-sale or a late penalty in the contract, then it shouldn't be on your note.

As an example, let me tell you about a property for which I paid too much and still received a good deal. I paid $35,000 for it, putting $5,000 down and giving the seller a $30,000 mortgage subordinated to a new first mortgage. The interest rate on the mortgage was 0%, and I am paying him $250 a month until it's paid. That's the way it was negotiated going in. (I even negotiated for the contents of the house, and later had a garage sale.)

The house is in a low-income part of town, and the seller believed it to be worth $35,000. Actually, it was worth $45,000 repaired, and needed $3,000 to $4,000 in repairs. The owner had been trying to sell the house for a year, but had received no offers. He owned it free and clear, was moving, and just wanted to get rid of it.

I believe I paid him too much money, but it didn't matter a great deal in this instance. I paid him $5,000 down and borrowed $18,000 on a new first mortgage. This left me owing him $30,000 on a second mortgage for a total of $48,000. On the

other hand, I am paying him $250 a month, and every bit of that is principal. The second mortgage is being paid off at about $3,000 a year. I've owned it for four years and have already paid down the note by $12,000.

More on Zero Interest Loans

Even though I paid retail for the above-mentioned house, I will still make money because of the seller's financing at 0% interest. That is what makes this deal a good deal. When seller financing is done correctly, you can solve negative cash flow. It wouldn't work with a $30,000 loan from an institution such as a bank or mortgage company.

I don't talk about interest unless the seller brings it up. I tell the seller that I will pay him $100 a month for 150 months starting in three months. It is very rare for a seller to ask about interest when the terms are presented this way. The interest rate is not the seller's prime concern unless you make it his prime concern. If the seller had wanted 9% interest, I would have tried for a promise to keep the payments at $250 a month by negotiating a lower interest for a longer time. If the seller was really hard nosed about it, I just wouldn't buy the house. The seller doesn't really have much choice since he would have trouble selling the house as it is anyway, and I really don't have to buy it because there are too many other deals out there.

If you don't talk about interest, the seller may not talk about it either because it's the last thing on his or her mind. Sellers are interested in how much they are going to receive at closing, when they can close, and what their purchase price is going to be. Never mention interest rates and you will be surprised how often the seller won't either, provided you are dealing with a motivated seller.

Wraparound Mortgages

I couldn't talk about seller financing without mentioning wraparound mortgages. They may become an important tool for you in selling houses and sometimes even in buying them.

Simply stated, a wrap is a seller carryback loan that surrounds or "wraps" already-existing financing. You will be collecting an incoming payment from your buyer and paying out an outgoing payment, or payments, to your lender. It is to be hoped for that your incoming payment will be larger than your outgoing payment. If it's not, you need to attend another seminar on seller financing.

For example, let's say you sell a house for $60,000 with owner financing. You get a $5,000 down payment and carry back a $55,000 mortgage paying $550 per month. You owe a $30,000 first mortgage to an institution for which you are paying $300 per month, and a $10,000 second mortgage to a private seller to whom you are paying $75 per month. So in this example, you are collecting $550 per month and paying out $375 per month for a monthly net of $175. In addition, you owe $40,000, and you are owed $55,000, so you have an equity position of $15,000. The $55,000 wraps around the $40,000 so the total debt on the property is only $55,000, not $95,000. The $40,000 is part of the $55,000, not in addition to it.

In addition to the monthly spread and the immediate equity position, you also should be receiving a monthly equity buildup because, normally, the $55,000 the buyer owes you should be being paid down much more slowly than the $40,000 you owe. Sooner or later your outgoing payments will be paid off while your incoming payments keep on coming. This is assuming that you don't get paid off in cash, which is usually what happens. What a problem that would be!

Land Contracts, Contract for Deed, Agreement for Deed

These terms are used everywhere and mean essentially the same thing. Briefly, they mean a promise to pay. Until the debt is paid, the seller retains title and the buyer receives an equitable interest in the property. The buyer feels like an owner and acts like an owner, but legally does not become a title holder until the terms of the contract are satisfied, at which time the seller actually deeds the property to the buyer.

This method of sale is widely used in some states because it makes the repossession process much simpler than foreclosing. In some areas, a buyer can be removed from the house within 30 days for non-payment, with no more legal process required than an eviction.

These contracts can also be good tools to avoid due-on-sale clauses that permit a lender to call the loan due on transfer. In some states, the property isn't considered transferred until a deed is delivered.

Closing costs are another factor. Since a land contract isn't much more than a glorified lease option, there are minimal closing costs. Usually, there is only the cost of checking the title, plus attorney fees. For this reason, some investors choose to buy on a land contract just long enough to sell the house, thus avoiding dual costs. The seller then delivers a deed directly to the new buyer. In some areas, this procedure provides big savings.

Split Funding

The Split Funding method is well suited to very short-term Quick-Turn deals. As seller financing goes, it is a simple technique. The investor offers a small amount of the cash to close the deal, with the remaining amount due months later. No interest is paid and only one lump sum payment is due. You can buy a lot of houses with this one technique. The investor repairs the house and sells it retail, which means the buyer obtains a new loan, either FHA, VA, or conventional. The investor then pays off the seller financing that he negotiated earlier. He just convinces the seller to take a little money now with the rest paid in full in six months, or whatever they negotiate.

Here's an example:

	$50,000 asking price
	$ 5,000 repairs
	$75,000 property value after repairs
The deal:	$45,000 purchase price
	$ 5,000 down payment
	$40,000 no interest, no payments, all due in six months

Most people will not use this method to buy a house because they think they need a lot of cash. But the deal really only took $5,000, and hundreds in interest were saved.

If you can't sell the property in six months, just renegotiate the payment. However, you don't need to wait six months since the note can be renegotiated at any time in the future, even if it's five days after the closing. The only agreement is between the buyer and the seller. Whenever you have two private people involved, there is always room to negotiate.

Another possibility is to give the seller $2,000 toward the principal and get an extension on the $40,000 payment for another three to six months, or whatever you agree on.

Seller financing made this deal possible, but working through a REALTOR® wouldn't be a problem. You might have to put a little more down so the REALTOR® can receive a commission and the seller also gets a little cash. With this method, you can use the REALTOR'S® MLS book to look for deals and make offers. Look for properties that are in need of repair. I used a REALTOR® to make this kind of offer on the first 22 houses that I bought.

The key advantage to this approach is it permits you to make more of those all-cash offers sellers always want. Even if they don't get it all at closing, it's paid shortly thereafter. Here's an example. I was called about a house with an asking price of $30,000.

After repairs of approximately $3,000, it appeared the value would be about $48,000. I handled this one with split funding. I gave some cash at closing and some cash later to satisfy the seller's needs. That gave me time to sell the house.

My offer:	$20,000	purchase price
	$ 2,000	cash down payment
	$18,000	balance due in six months with no interest and no payments

Also note that I could have made a second offer, at the same time, of $15,000 all cash at closing, because I knew I could net at least that amount if I had to borrow it from a private lender.

The offers were stated this way:

"Mr. Seller, I'll give you $20,000 with $2,000 down, and $18,000 within six months, or I'll give you $15,000 cash at the closing table. Which do you prefer?"

In this case, he took the higher, split-funded offer. It is usually better to make both offers at the same time and let the seller decide which one works best for them. In our two offers, either one will work for us. Even though the seller is asking $30,000, we offer him $15,000, all cash, and see if he will take the offer. Cash talks! Neither of these offers is complicated. They don't have a subordination clause or any other difficult-to-understand terms.

I was once called about a property that was owned free and clear. The purchase price was $20,000. I gave $4,000 down, with $16,000 due in 120 days, no interest, no payments, just the principal balance payment.

The property appraised for $42,000, after $3,000 worth of work. I didn't want to do the work, so I sold the property for $27,000. The buyer put $6,000 down. I was able to sell the house before I had even bought it. The buyer and seller were at the closing on the same day, but thankfully, not in the same room!

I took $4,000 from the $6,000 I received from the new buyer and gave that to the original seller. A total of $2,000 went into my pocket at closing. The new buyer paid $27,000, and after the $6,000 at closing, still owed $21,000 to me. After I gave the original seller $4,000 down, I still owed $16,000. When the new buyer paid his debt of $21,000 to me, I paid the $16,000 to the seller and made another $5,000 net on the property.

This deal worked because I gave the seller some cash at closing and the rest in 120 days, with no interest and no payments. Split funding the payment, by giving some down and the rest later, is one of the secrets to short-term Quick-Turns. I had a contract. I told the seller exactly what I was going to do, and I did it. People usually have no problem waiting six to 12 months for their money if you ask them.

SUBORDINATION

"Subordination" is a tool that can make a lot of money for you. The right of subordination is a clause you can insert into your contract. It permits you to get a new first mortgage, even though you already have seller financing in place. In other words, subordination occurs when the seller agrees to take back a second mortgage and allows you to get a new first mortgage on the property.

It works best with houses carrying low or no mortgages. When properly used, subordination combined with seller financing makes short-term Quick-Turn deals possible with the least amount of cash, or even no cash. Many times it even allows you to bring home thousands of dollars the day you buy a house. Subordination also serves as a useful financing tool to make properties saleable to people who might not otherwise qualify.

Before I explain this, let's examine the clause you should incorporate into your purchase and sale agreement to make subordination possible. This clause is included in the contract, or in the addendum to the contract:

> **Subordination Clause**: Seller understands that the buyer(s) or assigns will be getting a first mortgage of a maximum of the appraised value less the purchase money mortgage to the seller(s). Seller(s) hereby acknowledge that they understand that the purchase money second mortgage they will hold is junior to the above-mentioned first.

If an owner sells you his house for $30,000, with $14,000 down, and he agrees to take a subordinated second mortgage back at $16,000 you have the right to go get a new first mortgage on the property without paying the owner his $16,000 at that time. Instead, his mortgage will remain a second, and you will get a new first. You will pay him whatever payments you agreed to pay him, but he does not have to get paid off at the time that you get the new loan.

If you read the clause carefully, you'll see that it protects the seller by preventing you from over-financing the property. The total of your new first and his seller carry-back second can't exceed the value of the house.

Let's examine a typical example of the use of the subordination clause. I once talked with a seller who was asking $30,000 for his house. The owner indicated he would hold paper, that is, he would be willing to take payments for his equity. I knew that his house was really worth $40,000 after repairs, and needed $3,000 in repairs. I made an offer of $25,000 as the purchase price, of which $5,000 would be in cash and the remaining $20,000 would be on a subordinated mortgage.

This meant that the owner was willing to take a $20,000 mortgage that he agreed would be in a second position, giving me the right to go out and put a new first mortgage on the property. The seller was willing to do this to get the $5,000 cash and get rid of his house.

Next, I applied for and obtained a new first mortgage for $15,000, using private lenders, and let the seller hold the second mortgage for $20,000. The property was then financed for a total of $35,000. As it was worth $40,000, it was not over-financed. Of the $15,000 first mortgage I received, I subtracted the $5,000 cash down payment, the $3,000 for repairs, and another $2,000 in closing costs, retaining $5,000 net cash.

$20,000	seller financing is subordinated and becomes a second mortgage
$15,000	new first mortgage, borrowed on $40,000 value
- $ 5,000	down payment
- $ 3,000	repairs
- $ 2,000	closing costs
$ 5,000	net cash

Because the house was worth $40,000, it was easy to get the $15,000 new first mortgage. I sold the house on a wraparound mortgage and made sure the first and second got paid.

I didn't tell the seller how much I was going to borrow on the first, and he didn't ask. I made it clear to him, however, that I

was going to put a new first mortgage on the house. The title company also made it clear to him, so he couldn't come back later and cry foul. The seller must be highly motivated and the property in need of repairs for you to be able to do this. And the property must have a lot of equity. This deal can work even if there is an existing first on the property, and the seller agrees to take a third, allowing you to go out and get a new second, as long as the payments allow adequate positive cash flow.

The seller must understand the subordination! When I do a subordination deal, I tell the seller exactly what I am going to do, why I am going to do it, and, sometimes, how much I am going to borrow. If he doesn't like it, he can go find someone else to buy his house. You can't do this without the seller's knowing what is going on. The title company or attorney will not close the deal unless they know the seller understands.

Why do sellers take a subordination? It works for them for three reasons: **First**, they are extremely motivated. **Second**, they usually have a junker of a house they can't sell, or they don't have the funds for repair. **Third**, in most cases, they are getting more money from you than they would get if they sold all cash to some other buyer. Even though you aren't paying them all cash, quite often the sales price means more to the seller than the amount of immediate money.

In 9 of 10 subordinations I have done, I have made an alternative, all-cash offer at the same time, and I always documented it in writing. If there is ever a dispute later where a buyer claims he was taken advantage of, you can say, "I gave this man a choice of three different ways I would buy his house. He picked this way." More often than not, sellers will take the subordination deal rather than the low, all-cash offer. A motivated seller has a reason to take a subordination deal. If you fail to ask, however, you won't get anyone to do it.

Let me tell you about another deal I negotiated in a low-income part of town. The seller thought his house was worth $30,000. In fact, it was probably worth $45,000 repaired, and needed $3,000 to $4,000 in repairs.

He had been trying to sell this house for a year. He had called all the house buyers who advertised in the newspaper.

None of them made him an offer. He had had it with this house. He was tired of talking to people about it. He was tired of taking phone calls about it. He was tired of paying for ads and getting no response. He was sick and tired of looking at this piece of junk that smelled disgusting and needed a ton of work.

He just wanted someone to come and solve his problem. He believed his house to be worth $30,000, but he was more than willing to take $20,000. I discovered that he had inherited the property from his aunt three years before; he owned it free and clear. When I went to see him, I was the only one who had ever talked seriously to him about buying this property.

This is how the conversation went:

"Mr. Seller, I can buy your property two ways. I can give you $10,000, all cash. That's way number one."

I wrote this out on paper for him. I did not put it in contract form. I wrote it on a legal pad with a big "$10,000 Cash." Before telling him the second option, I wrote the number "2" on the page.

"For option two, Mr. Seller, I can give you $20,000, with $5,000 down, and $15,000 on a second mortgage, paying you $100 a month with the first payment due in four months. Understand now, Mr. Seller, since this house is in such bad shape, I have to have the right to go get a new first mortgage on it to raise the capital to put it back into condition. My experience tells me after I do that, Mr. Seller, I am probably going to put a mortgage on this property somewhere in the neighborhood of $20,000. OK? You understand I have to make a profit at what I do. Or I am not willing to do this. This is a big job, isn't it?"

"Yes, OK."

"What I am going to do is buy your house, repair it, then get a mortgage on it for $20,000 to $25,000, depending on what it's worth when I'm done."

"Yes."

"OK. You see, that is the only way I can buy your house, Mr. Seller. I'll start your payments four months from the time we close. But you need to understand what I am doing and why I am doing it. OK? If that's a problem for you, Mr. Seller, I would rather not do it. Maybe you would be better off taking the $10,000 cash offer. What do you think?"

"No, I'll take choice number two."

"OK, sign here, Mr. Seller."

It was the seller who told me which offer he wanted. I didn't try to make the decision for him. From the above conversation, we can understand why the seller would be willing to take offer number two.

Here is another example of an interesting deal involving subordination. The purchase price was $18,000, with $2,000 down; the seller agreed to carry a subordinated second mortgage of $16,000 at $125 a month with 0% interest until paid. When I sold the property, the new buyer obtained a $15,000 first on it and took over the $16,000 second. There was then a total of $31,000 owed on the property, and it was worth $32,000 to $33,000. I gave the new buyer $3,000 at closing to repair the house, then made him sign that the repairs would be done and he would take personal responsibility and liability on the $16,000 second. With a $15,000 loan, a $3,000 rebate, and a cost of $2,000 to close, the profit was $8,000 net. My knowledge of financing made this transaction work.

The seller agreed to this deal because the house was in a weak selling area. It was in poor condition, and the seller didn't have any other offers. Nobody else offered an alternative solution to the problem. I was paid well for problem solving.

Incidentally, investors are not the only ones who profit from subordination. Builders also use the subordination technique. They make the landowner's mortgage note subordinate to the construction loan, and when the permanent financing is put in place, the landowner gets paid off. I didn't invent the technique, but I use it because it is such an incredible, cash-generating tool.

Substitution of Collateral

Substitution of collateral simply means I am taking an existing mortgage on one property and transferring it to another. I am substituting the collateral from one property to another.

As usual, we have to find a motivated seller or we can't make the deal. We should look for a seller who has a reason to do a substitution of collateral. Without a motivated seller, none of this will work. Here is an example of some typical numbers:

- $30,000 asking price on house "A"
- $3,000 repairs
- $40,000 value after fix-up

My **offer** was:

- $25,000 purchase price for house "A"
- $5,000 down payment
- $20,000 first to seller with substitution of collateral

We have a lot of equity in house "A." We intend to profit on that equity by repairing the house and finding a cash buyer for $40,000. We have to have another property, however, to be able to substitute the collateral. We will call that house "B." House "B" is a house that we own, which has enough equity to support the $20,000 we're transferring from house "A." It has a first mortgage of $25,000 and is worth $45,000. We ask the seller to take $5,000 cash and move the remainder of the first that he holds, $15,000 in this case, from house "A" to house "B," at which time it will become a second. We can do this at the time we close the sale on house "A," or any time prior.

The **negotiation** goes as follows:

"Mr. Seller, I owe you $20,000 on house 'A.' What I'd like to do, instead of taking 20 years to pay you as we agreed on in the beginning, is to give you $5,000 now, in cash. Could you use $5,000 cash now, Mr. Seller?"

"Yes."

"OK, instead of leaving the mortgage on house 'A,' what we're going to do, with your permission, is to take the remaining $15,000 I will then owe you on house "A," and take our payment that I was paying you, $200 a month, and reduce it down to $150 a month. Then we'll move it to my house over on "B" street. My house over on "B" street is worth about $45,000. I have a $25,000 first on it. So I'm asking you to take a $15,000 second on house "B," but I'm giving you $5,000 to make it worth your while. Is that fair?

"Yes, that seems fair to me."

I'm still going to make payments to the seller, but in a lesser amount. I gave the seller $5,000 cash to convince him to do this. I may or may not agree to this prior to purchasing the seller's house. If I had agreed to it, there would have been a substitution of collateral document attached to the mortgage I gave to the seller, and there would be a clause in the contract that says I have the right to substitute this collateral at a later date. You will find a sample of this document in Appendix F.

I am not really asking the seller, in this example, to do anything he had not already agreed on as a condition of the original purchase of this property.

What if I didn't agree on this condition, or didn't want to bring it up at the beginning of negotiations to buy the property from the seller? I can still do it, because $5,000 carries a lot of negotiation punch. I possibly could have done it with $1,000, $2,000, or $3,000. In this example, I am paying the seller 25% of what I owe him. Why wouldn't the seller do it? He most likely would because of the up-front cash. I offered him $5,000 to move his mortgage instead of discounting it because I could put more cash in my pocket by moving the mortgage.

Maybe I could have gotten the seller to discount the mortgage by $5,000 and paid him off the $15,000, but I would only be putting $5,000 more in my pocket. However, if I pay the seller $5,000 and move the $15,000, I would be putting $15,000 more in my pocket. The above deal would work this way, since house 'A' is free and clear after I move the seller's mortgage to house 'B.'

$40,000 cash sale from someone who buys it FHA or VA
-$ 5,000 original down payment
-$ 5,000 additional payment to seller for moving mortgage
-$ 1,500 closing costs
-$ 3,000 repairs
$25,500 cash in my pocket

Not bad for a house that sold for only $40,000!

I found a buyer who obtained a $40,000 FHA loan. I got back my $5,000 original down payment and collected the seller's $5,000 prepayment for the right to substitute at the closing table. Since the money wasn't disbursed until the sale closed, I didn't have to come up with the money to get the seller to do this.

At closing, I received the money from the buyer, who had obtained an FHA loan. The buyer brought a check for $40,000 to the closing. I already had an agreement to move this mortgage, signed by the seller, saying I owed him $5,000. I handed this agreement to the closing agent. The closing agent wrote a check to the seller for $5,000 and had the seller come down, after closing, to sign a substitution of collateral form.

The mortgage was no longer on his house. It had been transferred to house "B," about which I gave the title company a legal description. The seller got his check, and I got my substitution of collateral form signed. The title company could then issue a clean title to house "A," because the seller's mortgage was no longer on the property.

I wouldn't let the seller know I was selling house "A" — and I wouldn't ever approach the seller to substitute the collateral — until I had a buyer for house "A" and was ready to close.

Another twist on this deal was that house "B," which was worth $45,000, had a $25,000 first mortgage and now the seller's $15,000 second mortgage. That makes house "B" financed to 90% with no points and no qualifying. It would be a good house to sell for $45,000 with $5,000 down and a wraparound mortgage created for $40,000. Three years later, if the buyer wants to sell and pay off the mortgage, I can go to the seller and substitute the mortgage again, or pay it off at a discount. With private sellers, as long as you owe, you have flexibility.

You can't do a substitution of collateral without seller financing. It is not complicated to put into effect, but the seller must be informed and aware of what you are doing. You can't sneak this by the seller. Also, make certain that the property to which you move the mortgage is not over financed.

Here is another example of how this technique can put cash in your pocket. I purchased a house for $19,000. I gave the seller an $8,000 down payment, let the seller take back a mortgage note for $11,000, then signed a substitution of collateral form with him.

When I moved the mortgage, I didn't give the seller anything to encourage him to move it. I did about $5,000 worth of repairs to the property and sold it for $41,000. I obtained a new loan for the buyer equal to $32,000, and I took back a $4,900 second mortgage, with the buyer's putting down $4,100.

At the time I did this, I had the seller move the $11,000 mortgage to another property. I put $11,000 more cash in my pocket than if I had paid off the first mortgage held by the original seller. These things work, but only if you ask. The original seller had agreed to the substitution of collateral because her house was in poor condition and was located in a bad part of town, and I gave her the price she was asking.

Both the subordination agreement and the substitution of collateral agreement forms will be filled out by the closing agent. You don't have to know how to complete them.

Raising Money Fast Without Borrowing

When you have the cash, it is so much easier to invest! Those who enjoy instant access to large sums of cash do not need to work with lenders for purchase money. Most of us, however, need to raise the cash to do the deal. We have already discussed ways to reduce the need for cash by split funding, and how to make it easier to raise cash through a seller by using subordination and substitution of collateral. Now, let's talk about raising cash fast, without going to a lender or a seller for a real estate loan.

The most obvious way to accomplish this is just to ask a partner — often another investor — to put up the cash. Before you approach a partner, however, it's wise to have all your numbers worked out and the entire deal planned very carefully, using conservative estimates. It is customary to split equally with the partner whatever profit is made.

Earlier in this book, I told you about investment groups. That's where you can find a great many potential partners. You also can advertise in the newspaper. Many people in every city in America have money to invest in real estate, but they do not have the time or knowledge.

Whenever you want to make an all-cash offer, and don't think you want to use any of the methods listed above, whether it be loans, split funding, subordination, or whatever, you can always team up with a person who has the cash. If you can find the deals, there is an abundance of people to work with you as partners. All that's really necessary are knowledge and persistence.

One clever way to raise a down payment is to trade something you already own. Anything of value, such as a motor home, car, truck, land, or appliances, can be traded for a down payment on property. You can even trade knowledge or services. Find out what the seller wants. See if you can take care of those wants without cash.

Another way to raise cash fast, one that is far too often overlooked, is the careful use of credit cards. Credit cards are an excellent source of money. People worry about the high interest

rate, but when you're in a short-term, Quick-Turn deal, the actual difference in interest dollars is very little.

As I mentioned previously, when I started in this business, I made 76 loans at 18% interest. The availability of the money was important, not its cost. I recommend, however, that you not use credit cards to buy property unless you pay the cards back with the profits. Otherwise, you could get into big financial trouble. But if you use cards wisely, they are an excellent line of credit.

Get as high a credit line as possible on your cards. If you have a $5,000 line of credit, write to ask for a $10,000 limit. Get more credit cards before you actually need them. Don't apply for more than three in any one month. That would necessitate too many credit checks at one time and cause turndowns. Just get a couple at a time. There are thousands of sources of credit cards in this country, many of which have no annual fee. And some of them don't even check your credit.

If you acquire ten cards and each has a credit limit of just $2,000, that's the equivalent of a $20,000 line of credit. If you gradually raise the limits on those cards to $5,000 each, through careful use and periodic asking for increases, you then have access to $50,000 in instant cash.

As your income grows, many of these credit cards can be raised to as high as $25,000 each. Almost all credit cards now permit cash advances up to the credit limit. Since there is no limit on how many credit cards you can have, low initial credit limits need not stop you, and access to $100,000 or more in "Fast Cash" is possible. How many all-cash deals could you do with access to that much cash?

Even if you have poor credit history, you can acquire a secured credit card simply by making a deposit equal to your credit limit. In time, this limit will be increased with no additional deposit.

Making the Seller Your Partner

This section could just as well have been titled "How to buy a big, expensive home that you thought you couldn't afford." The main difficulty in owning an expensive home is that you

cannot buy it with no money down and maintain a reasonable monthly payment. The lower your down payment, the higher the monthly payment will be, and that could cause payment problems. Equity participation is a technique whereby you can make the seller your partner and reduce your monthly payment to a comfortable amount.

Suppose, for example, you wanted to live in a $300,000 house in an area where the average price was $100,000, but you could only afford payments of $1,000 per month. As a general rule of thumb, one would expect payments on a house of that value to be about $3,000. The strategy is as follows: **First**, find a large home with a lot of equity in it. Look for a flexible owner who does not need his cash out of the house, and who is willing to take monthly payments for his equity.

Many houses are free and clear or have a large equity. If the property is free and clear, the chances are good that an owner doesn't need cash from his house. Look for a house that would be hard to move. The payments, alone, on a $300,000 house would put a lot of people out of the market. Look for a house that needs some repairs.

The **second** step is to negotiate a purchase price somewhat below the retail value. Suppose you negotiate a price of $250,000. The conversation might go like this:

"Mr. Seller, I have a way to buy your house and pay you more in the long run, if you are willing to take less per month now. Are you interested in hearing more about this?

"Yes! Tell me more."

"Well, I want to make your house my residence, so I can buy it now for $250,000 and give you back a mortgage, if we can agree on the terms. My only problem is I just can't handle the normal monthly payment that comes with a house in this price range. So what I am proposing we do is, I'll pay you $10,000 down and you take back a mortgage for $240,000. But instead of a high payment that I can't afford, I'll give you $1000 per month which you call interest. I'll make you this interest-only payment each month and still owe you all the principal.

"Now, I know this is a low payment, so in return, I'm willing to compensate you this way:

"I'll do the repairs at my expense and maintain the house. I'll pay the taxes, insurance, and all other costs on this house until I sell it within a five-year period.

"When I do, I will give you one-half the profit above your $250,000 sales price. I feel that, by that time, the house could sell for $350,000. Therefore, you would not only receive your $240,000 balance, but an additional $50,000 profit in lieu of a higher monthly payment now. I believe this would solve my problem and yours, don't you agree?"

You might have to ask three or four people before you get an acceptance. Even if you find people don't trust you enough to do other creative financing, you can still usually lease their house. We don't need to own the house to make money on it. Control is more important than ownership. The owner will get the tax write-off on it. All you have to do is convince the owner you will do what you say you'll do. In effect, you are making the seller your partner.

Place an ad in the paper indicating you're looking for someone with whom to "equity share" a big house. Use the MLS book. Make offers on houses that no one else is looking at — those with high price tags. It is possible to make all kinds of arrangements with a seller. Here is a way to make the seller your partner on a house you don't intend to live in.

"Mr. Seller, I'm not going to buy your house because, frankly, it's too cash intensive, and I don't have the money right now. But this is what I will do. If you'll put up the $3,000 that it takes to repair your house, I'll do all the work, sell it for you, and we'll split the profits above our agreed-on purchase price. Is that fair? I may even make your payments for you while we're doing all this, just to show you my serious intent."

Back to Basics

Of course, let's not forget the absolutely easiest way to raise money with single-family houses. **WHOLESALING**! It just

doesn't get any easier than finding the deal and passing it on to someone else who wants a bargain. It's nothing more than a paper shuffle. Easy in, easy out, no loans, no repairs, no partners, no credit, no long holding period, little or no money needed, no risk, and fast cash profits.

Because wholesaling is such an important part of a serious investor's business, we devote a large portion of each Boot Camp to making sure every single student leaves with a thorough understanding of wholesaling. It's what many of them use to create income that triples the amount they earned in their old jobs.

Another example of unforeseen good things happening from unplanned events is the story of Dave Rogers from Anchorage, Alaska. Dave had purchased my course. The story of how that happened is exactly what I meant when I said many opportunities jump in front of us when we least expect them.

Dave had heard about me from a third party, and he got in touch with me. When I mailed Dave my course in May 1992, I also sent him a letter about my upcoming Boot Camp in Houston. What I didn't know then was there was no way Dave could possibly afford to attend. He had serious problems. He had been divorced for a couple of months and was in deep financial trouble. Since I didn't know Dave at the time, there was no way for me to realize he is one of the most stubborn men on earth, and he hates it when he can't do what he wants when he wants.

Apparently, he really wanted to attend the Houston camp, because he borrowed enough money from his ex-wife and ex-mother-in-law to do it. Then, he returned to Alaska, filed for bankruptcy, and drove here to Jacksonville with the few possessions he could load in his crummy car.

In his first three months in a strange town, he used what I had taught him. He purchased $283,000 worth of houses for $92,000, without spending a dime

of his own money. Of course, he didn't have any to spend, but the point is, it CAN be done by making the effort to match knowledge with opportunity and taking action. Every one of Dave's deals was wholesaled immediately to produce the instant cash needed.

Structuring an Offer

You can use the following two scenarios to practice for making offers before you go out into the real world. Master these scenarios at home first. You must know how to manage the situation when you start for real. It's better if you make a mistake here than in real life. Following the scenarios are some possible answers.

WHAT WOULD YOU OFFER?

SCENARIO 1 : You call about this house after reading an ad in the newspaper. The owners say they inherited the property. It's free and clear, and they are asking $40,000, all cash. After inspection, you determine the house would be worth $50,000 if you spent about $3,000 on it. You have $4,000 left on your Master Card. Your credit is good and you have steady income.

OFFER 1

OFFER 2

OFFER 3

SCENARIO 2 : A REALTOR® brings you a printout about a house whose owners are highly motivated. The house has been neglected. The sellers can't stand each other and are getting a

divorce. The listed price is $49,900, and there is a $12,000 mortgage. You inspect the house and conclude it's worth $49,900, but only after you spend about $5,000 to repair it. You are a full-time investor with poor credit, no rich relatives, no rich friends, no credit cards and no provable income, but you know there is a way, because I said so.

OFFER 1

OFFER 2

SCENARIO 1: **Answers**

Offer 1: ($25,000) all cash. Pay all cash, but get a very low price. Borrow the $25,000 from a finance company and use a charge card to fund the repairs, with the intention of retailing for a large profit. Or, alternatively, simply wholesale the contract to another investor who is better equipped to develop the deal and pick up a quick $3,000 to $5,000 the day he closes. Or, partner with this same investor and pick up an immediate $3,000 finder's fee, then split the retail profit when the house is sold. You do the work; he puts up the money.

Offer 2: ($28,000) $3,000 down, balance due within six months, no payments until due. Use your charge card to buy since it takes only $3,000 down and allows time to implement one of the above solutions. Or take title and sell the property to an owner/occupant as a handyman special for a discounted price of $40,000, leaving you a quick profit of $12,000 without doing any repairs.

Offer 3: ($35,000) $7,000 down, seller to carry back a second mortgage of $28,000 subordinate to a new first mortgage. The

second will bear payments of $250 per month at no interest until paid. The house is worth $50,000 after repairs, so you can borrow up to $22,000 on a new first without over-financing ($50,000-$28,000 seller carryback second = $22,000). A $22,000 new first mortgage, less the $7,000 down to seller, less the $3,000 in repairs, leaves $12,000 cash that you can call profit as soon as the house is sold. Now would also be a good time to sell for $54,000 via owner financing with a wraparound mortgage or land contract of $50,000, getting a $4,000 down payment from your buyer.

This means you now have $12,000 left from your loan, plus $4,000 from the buyer for a total of $16,000 profit. Or, alternatively, instead of your getting the new first mortgage, take your buyer to a lender and let him sign on the new loan for $22,000. He will need very little qualifying to get approval for a loan at such a low LTV ratio.

If this is done, you can have your buyer originate a wraparound mortgage to you, for the same $28,000 you owe the seller, except bearing interest. The buyer pays you; you pay the seller, allowing you to keep the interest and protect the seller at the same time.

You will also be setting yourself up for another payday in the future because, sooner or later, the house will get cashed out, giving you the opportunity to either discount your underlying loan to the seller or move it to another property you own, so you receive all the cash yourself. This process is called substitution of collateral and was discussed earlier in this chapter.

I know that all this fancy talk about seller financing will not sink in the first time to some of you, but don't worry. The more you study and do, the easier it becomes. If the third offer stumps you, just ignore it and work on the first or second options. Either one can make several thousand dollars for you within a few days.

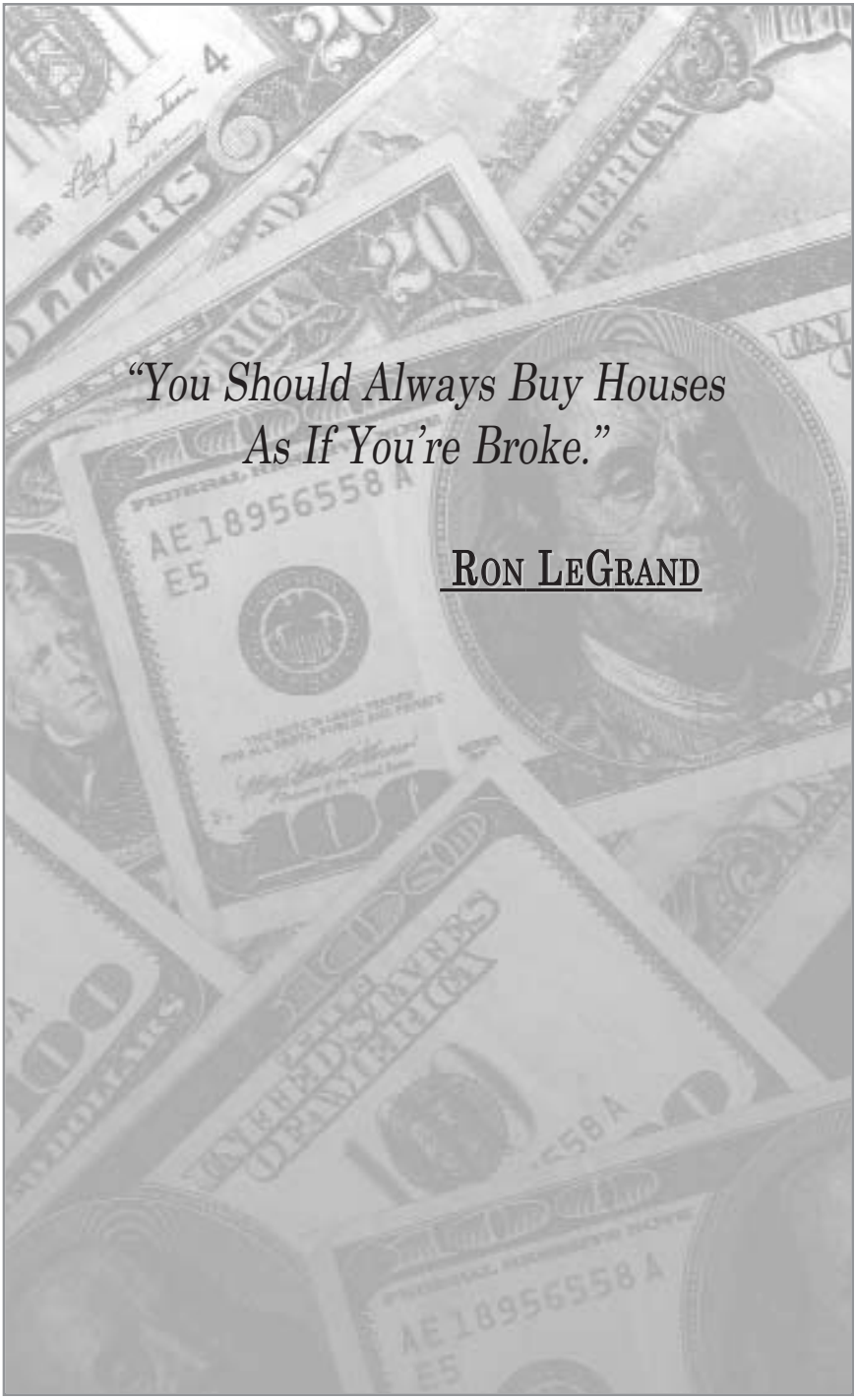
SCENARIO 2: **Answers**

Offer 1: ($20,000) $8,000 cash and assume the $12,000 mortgage.

Offer 2: ($23,000) $3,000 down, assume $12,000 mortgage, and give a second for $8,000, all due within six months, no payments, and no interest.

For both the above offers, re-read the Scenario 1 answers and apply the same solutions. The only difference is that you're assuming a loan for part of the purchase price instead of paying it off with cash.

The best executive is the one who



"You Should Always Buy Houses As If You're Broke."

RON LEGRAND

has sense enough to pick good men
to do what he wants done,
and self-restraint enough to keep
from meddling with them
while they do it.

Our chief want in life is sombody
who will make us do what we can.

Ralph Waldo Emerson

Chapter 14

Land Trusts and Legal Considerations

Are you aware that every time you sign your name on a note, you're risking everything you own to fulfill that debt? Did you know that in most states creditors can sue for default on a mortgage note and come after you personally without even bothering with the house? That's their right. They can look to all your other assets to satisfy your debt in place of, or in addition to, the property you mortgaged.

But don't worry! I have a solution to that problem for some types of financing. This solution also solves several other problems associated with owning real estate. It is simple, yet it is extremely important to all of us who buy houses. Anyone can use it, and it doesn't cost a nickel extra to take advantage of it. This solution is called a "land trust." First, let's learn what it is. Then we'll do a crash course on why and how to use it.

Definition of a Land Trust

It's irrelevant to us, as investors, how the land trust came about, or that there's a lot of history behind it. Such trusts were first used hundreds of years ago, but we only need to focus on how they can benefit us now. For simplicity, consider the land trust a method of taking title to property, nothing more, nothing less.

It is an agreement between the officer of the trust, called the "trustee," and the person who really controls the property. That

person is called the "beneficiary." The trust identifies certain duties that each agrees to perform. The agreement is signed by both parties, and then it becomes the property of the beneficiary, with the trustee sometimes retaining a copy. The beneficiary owns the trust, and the trust owns the property. The trustee has only those powers granted to him or her by the beneficiary, and he or she performs minimal duties — usually just signing the documents. The trustee has no personal liability or responsibility to do anything more than those minimal tasks.

Reasons to Use a Land Trust

Savvy investors use land trusts every day. This powerful document offers personal and legal advantages not associated with any other kind of property ownership. First, I'll list the benefits and then we'll discuss each briefly.

Privacy

Secrecy is an important aspect of a trust. Nobody knows you are the beneficiary, except for you, the trustee, and your closing agent. When somebody checks the title to the property, you don't own the property. In fact, you have no interest in the property as far as the rest of the world knows. All they see is that the property is owned by a trust. They do not know the beneficiary's name. The only way they will find that out is by court order, or if your trustee has a big mouth.

A deed is recorded at the courthouse. It bears the name of the trustee as grantee. Nowhere does it mention the beneficiary's name. The trust document, itself, remains in the possession of the beneficiary. It isn't recorded anywhere, nor does it become public knowledge. Therefore, you have total privacy.

Loan Liability

In the absence of a due-on-sale clause, the trust can be used to eliminate personal liability totally. Most FHA loans closed prior to December 15, 1989, and all VA loans closed prior to

March 1, 1988, do not contain due-on-sale clauses. Therefore, they require no qualifying to assume. So, the trust as a legal entity can assume those loans, thus foregoing the need for you to assume them personally. If, in fact, the trust can assume the loan, then why would you ever want to do it personally? The answer is, of course, you never would. This move keeps the loan off your credit report and your financial statement. You assume no liability for the debt. By the way, it costs no more to handle things the right way.

The trust can and should be used to create seller carryback financing. There is absolutely no reason for you to ever personally sign a note to a seller. If you don't heed this advice, you may very well be headed for an expensive real world seminar.

The process really is simple. The trust takes title to the house, so the trustee signs the note as trustee. Your name appears nowhere on the document. Therefore, you are not personally liable. As long as the words "as trustee" appear after the trustee's signature, he or she is not liable, either. Presto! You have just created a note that won't ever come back to haunt you.

Lawsuit Protection

Another key reason to use a land trust is lawsuit protection. It is not a foolproof plan to keep you from getting sued, because your beneficial interest can be attached. However, it is a lot better than owning property in your own name. The first thing an attorney will do in preparation for suing you is check your assets. All he can do is check your name. If your name doesn't show up, and it won't, he does not have a clue that you have anything to do with this property.

The only way he can find out is to get wind that you own properties in trust, call you in for a deposition, and ask you point blank, "Do you own any interest in any trusts?" At that time, you have to either answer yes, or commit perjury.

Let's assume, however, that you leave your properties titled in your own name, or even worse, jointly with your spouse. Now, you get sued, and the plaintiff is awarded a large judgment over and above your insurance benefits. The minute that judgment

is recorded, it attaches to your properties and prevents any future sale or refinancing until the judgment is satisfied, if ever. In fact, the plaintiff can now start action to attach your assets, and everything you worked for is lost.

On the other hand, let's say your properties were in a land trust before the action started. First of all, a name search will produce nothing because you own nothing, as far as the public records are concerned.

This alone will stop most lawsuits in their tracks. If it is obvious a judgment can't be collected if won, it would be fruitless to pursue a lawsuit and incur the costs unless insurance proceeds were available. Under those circumstances, the case usually would be settled out of court.

But let's assume none of that happens, you get sued anyway, and they get a judgment. It doesn't attach to the properties because you don't own them. The trust owns the house, and you own the trust.

Before we get too smug, be aware this does not prevent a good attorney from coming after your interest in the trust. But first, he must discover you have an interest; and, second, someone must be willing to pay the high costs of another separate, expensive and risky lawsuit. While it's not a foolproof lawsuit protector, it sure beats owning property in your own name.

Estate Planning

A land trust is a good first step to estate planning, but it is by no means a total plan. Many kinds of trusts and other entities are available, but that's a subject I'll deal with in another book.

If your property is in a trust and you die, whoever is your beneficiary now owns this trust. Whatever interest you owned, he or she now owns.

However, to avoid probate, in most cases, this needs to be taken a step further. The most widely used method is to place the land trust in a living trust. Several courses on this subject are available.

Ease of Transfer

When you sell to a buyer who understands trusts, quite often he or she would prefer you to assign him or her the trust, rather than having the trust deed the property to them. This action saves closing costs because nothing changes at the courthouse. The trust still owns the house and you are simply selling the trust. It is done with one sheet of paper called an "Assignment of Beneficial Interest." It's as simple as you signing it, your trustee signing it, and you handing it to the buyer. That's it! Now, of course, your buyer will want to check the title first, and will probably want someone to prepare a closing statement, but all the normal transfer and recording costs have been avoided.

Bank Loans

When you go to a bank to borrow money that is secured by property, the bank will require your personal signature on the note. It will not let you take title in the trust because the bank doesn't understand it. If you have intentions of buying a property and refinancing, don't take title in the name of the trust. The bank will not make a loan to a trust. If you are going to refinance, take title in your name, refinance, and then place the property in a trust. The lender cannot call the loan due as long as you are the controlling interest in the trust, even if the loan contains a due-on-sale clause. In 1982, the Garn - St. Germain Federal Depository Institution Act made it illegal for a lender to call a loan simply because property has been transferred into a trust. If you experience a problem with a lender because of this point, write to me at my office, and I'll send you a copy of a letter you can mail them. It should stop them in their tracks.

Appointing a Trustee

The trustee must be a person you trust. You could make a family member, friend, or title agent your trustee. The trustee can be someone out of state. But remember, the trustee does the

signing for any transactions of the trust. The trustee can close deals for you when you are not in town because of the trust provisions. But the trustee can sign documents only because you, as beneficiary, give him permission. The beneficiary has all the control. The trustee has no control, except to do what the beneficiary tells him to do. The trustee signs all documents at the direction of the beneficiary.

Of course, a dishonest trustee can illegally sign away a deed to your property. Someone taking the deed should check with the beneficiary and even get something in writing from him that taking the deed is, in fact, in keeping with his wishes.

This has been a brief introduction to a few of the key ideas regarding the use of trusts. To really use trusts effectively, you need to learn much more, but it is too extensive a subject for this one book.

I have thousands of students using land trusts nationwide. That is because trusts are simple to use, cost nothing extra, and provide all the benefits previously discussed. Bearing that in mind, please don't let a so-called expert convince you otherwise. Get the facts from the people who know, instead of constantly reinventing the wheel.

If you buy real estate, you should be using land trusts! It's just that simple.

Avoiding Title Problems

Never, repeat, NEVER buy a property without a thorough title check and title insurance. You need the title insurance, in addition to the thorough title check, because no title check can be declared absolutely perfect and complete. A long list of things can go wrong with a title, such as unrecorded documents and forged signatures. Even the best title company can't know everything.

You must order a title check as soon as you put a property under contract. You can't do anything with a property unless it has a good title. Always ask the title insurance company for a written title insurance commitment as soon as you close a deal. It is also wise to evaluate your title insurance company's

strength and ability to pay out in the event of a title problem. A number of title insurance companies have failed in recent years.

Section VI
Success

Opportunity...often it comes in the form of misfortune, or temporary defeat.

Napoleon Hill

Chapter 15

Selling Houses Fast

Selling Retail

It's easy to buy houses at a good price when you know how to do it. But Quick-Turning a house to a retail buyer takes a little more effort. Remember, you don't receive your profit until the property is sold. Even if you refinance, the financing has to be repaid.

Quite frankly, marketing houses to an owner/occupant who qualifies for a loan is the hardest part of our business and the weakest link. But it's also the most profitable method on a per-house basis. Before we go any further, let me point out again it is not mandatory that you get into the retail business. In fact, you shouldn't, unless you have the funds, have access to them, or become skilled at optioning houses so you don't need funds. If you're weak on these points, perhaps you should stick with wholesaling and/or assumptions.

So how do you market a house and sell it fast? After all, you want your money as soon as possible!

Planning Your Total Sales Strategy

If you're buying low to sell high, you're always looking for customers who can qualify for a loan. A house will have to look nice after repairs to attract this kind of buyer. Give buyers a reason to buy your house. Keep in mind you're not going to live in this house; you're only fixing it up to market it.

You will want to do good-quality, but not expensive, repairs. Resist the temptation to spend a lot of unnecessary money. Adding a little wallpaper, paneling, ceiling fans, and so forth, is all it takes to make the property look nice and livable. Don't cheat on repairs, or you could end up having a house on the market for a long time. At the same time, remember this is only inventory and doesn't require the best available materials or craftsmanship.

The whole repair process doesn't take long. The average house takes from two or three days to two or three weeks to completely rehab, depending on the extent of the work, if you use a contractor who has one or two men working with him. Don't over complicate this process. Keep it simple, straightforward, and fast.

The biggest mistake some of my students make is to do the repairs themselves. In my opinion, this is a gross waste of their time. Do you want to get paid as a handyman or as an investor? The answer is investor! The pay is higher, MUCH HIGHER! While you're spending time trying to save a dollar, you're losing $10 in profits. To make this really simple, let me put it another way: we don't do repairs — we write checks!

These basic things must be done to sell a house:

First, the house must be ready to market. It must be in good repair, and the work must be good quality. Act as though it's a buyer's market, whether it is or not. You're trying to attract a buyer who has good credit, so the house must be a cut above the others on the market. After all, buyers who have good credit have the maximum choice available to them in the marketplace. A failure to get the house ready will cost you dearly in the long run, due to holding costs.

Second, plan the whole process ahead of time. Always know what you're going to do with a property before you buy it. Know the way out before you go in. Don't permit yourself to become overloaded with too many properties to sell at the same time. Take care of the first property before moving on to the next.

Plan with the calendar in mind, as well. For example, December may be the worst time of year to sell a house.

Third, you need to know how, when and where you're going to advertise this property. Know which publications you'll use to place ads, the type of ads you'll run, and, most importantly, how you're going to follow up on the calls that come in because of the ads. You'll need a system to handle these calls as they arrive. Prepare a Buyer's Fact Sheet (see Appendix H) for all the calls you receive. Take advantage of them by collecting information about prospective buyers for future use.

When you become adept at gathering buyer information, you'll soon learn to find houses to suit their needs. When you figure this out, selling becomes a cinch.

Fourth, decide which lender you want to be involved. When you need a new FHA, VA or conventional loan on the house, make sure you know who is going to provide that financing. You need to know the interest rates and closing costs. Have a lender in mind ahead of time for your prospective buyer so the loan process will get under way as soon as you have the house under contract. The buyer will want to know how much his payments will be. You should know all of this even before you put the ad in the newspaper.

Fifth, if you use seller financing, play with the numbers before you get the calls. You need to be fully prepared at the time possible buyers respond, or you will lose many opportunities to make the sale. When they call and ask the questions, you need to know all the answers. You only get one shot at them.

Repair Tips

Preparing a house to market is an area where a lot of investors fail. They don't do the repairs properly. The house needs to be in tip-top shape. But I don't fix them up as though I'm going to live in them!

I work on the exterior first. When a buyer drives up, a nice exterior will make him want to look at the interior. Most landscaping money should be spent on the front of the house. I recommend flowers, wood chips, mulch, or anything else that looks nice. If you don't know how to landscape, you can hire someone to do it correctly and inexpensively. In most cases, you shouldn't spend more than $200 to $300 to make the front of a house look presentable.

I use semigloss paint, in two colors, to make the exterior of the house stand out: light blue and a darker blue trim, or light gray with a darker gray trim. Either is quite attractive. I then accent the front with shutters and a fancy front door in burgundy. I give extra care to the front windows because they affect the entire look of the house.

I don't install expensive cabinets in the kitchen since pressboard cabinets are adequate. Redoing a kitchen completely shouldn't cost more than $1,000 to $1,500. I install a double sink with new faucets, but I don't spend a lot of money on appliances, since they're not needed to sell the house.

If you doubt you can remodel a kitchen for this price, as I suspect you do, I suggest you take a trip to your nearest Home Depot, Builders Supply, or other home repair store. Look around and price a whole kitchen containing a sink-base cabinet, counter top, sink, faucet, trap, and three or four upper cabinets. You'll be shocked to learn the whole works, with really nice cabinets, can be purchased for $700 to $800.

While you're in the store, search for other items that can make a house look nice that don't cost much. You'll discover it's the little things that sell a house. For example, I do whatever I can to keep the house smelling nice, like hanging a cinnamon deodorizer. Small items such as fancy electric plug covers are cheap and make the house look richer. Using wallpaper with borders makes a kitchen and bath stand out. I put ceiling fans in just about every room of a house. They cost only $40 to $50 each and really help make the sale. Total cost for fans usually runs about $200 to $300 installed.

I hang mini-blinds on all the windows for an average cost of about $10.00 per window. If you can't find ready-made mini-

blinds that fit, you can have them made to order. If they cost about $10 a window and you have 20 windows, the cost will be approximately $200. If the house is sitting vacant for two weeks or longer because it doesn't have mini-blinds, and your mortgage payment is $400 a month, $200 is money well spent. I don't put curtains in a house because I have had better results by only adding mini-blinds. Generally, I use a color other than white to give the house more warmth.

Here are some more tips that will make a house sell faster. In the living room, I use bright paneling, but not on every wall. Sometimes it's even more effective to panel half and paper the rest. I use molding in the living room, family room and dining room, but I don't use expensive molding unless I'm dealing with a more expensive house.

I almost always carpet my houses with earth tones or solid colors, and I'm careful to avoid gaudy colors. I seldom spend more than $10 a yard total for carpet, pad and installation, with the carpet alone costing about $6 or $7 a yard.

In the bathroom, I usually redo the bathtub at a cost of about $100 to $300. This cost covers professional bathtub refinishing, which gives a better-than-new look. Using this method, I have found it's rarely necessary to replace the tub, and less expensive, too. When a wall can't be fixed with paper or paint, I just put marolite over it. Marolite is a printed or patterned paneling designed for damp areas such as bathrooms. It's also good behind a range in the kitchen. If the toilet has stains that won't come out, I put denture tablets in it. These clean the toilet very well, especially if you use about six or eight tablets and make sure the water level is above the stain. If the toilet is not salvageable, replacement cost is about $70.

In the bedrooms, I use semigloss on the walls, and I paint the trim a couple of shades darker, again avoiding gaudy colors. I do not have my workmen strip the wood and restain it, since this would be too much work and generally not worth the effort.

Some other important things I do, and others that I don't, are worth mentioning here. For example, I almost always add central heat and air before I market a house. You might not think this is necessary on some houses, especially the cheap

ones, but just remember that I'm the guy who has done this more than 1,000 times. I know beyond a shadow of a doubt that houses with CH&A sell faster than those without it. Just ask yourself which you'd rather buy. Your cost for installing a whole system from scratch on a 1,200-square-foot house should not exceed $2,500 total. This, of course, assumes you hire the right people to do the job.

Before you insist that this can't be done for that price in your area, or that I'm full of hot air, just remember: I've been in cities all over the country, and I have successful students in most of them. Everywhere I go, I'm told this can't be done in the area. So when I hear those words, I simply point the skeptics to a student who has done it recently and let that student do the convincing. I've bought hundreds of CH&A systems and, believe me, it can be done and is done for that price on a regular basis. The trick is to hire a one- or two-man crew, one that has little or no overhead and that specializes in heat and air. Don't call the guys with the big, yellow-page ads.

Another important item most investors overlook is the roof. The tendency is to ignore the roof if it's borderline, and try to find a buyer who will ignore it as well. Forget it! Replace the roof in the beginning and see how much faster the house will sell.

If you ignore these two items just mentioned, roof and CH&A, be prepared for a hard lesson as some investors have learned. I know, I was one of them. Do the repairs the right way, and you will end up with more profit. Incidentally, when you add these two items, you are increasing the value of the house by several thousand dollars. More importantly, you are increasing the saleability.

The Smart Way to Use a REALTOR®

When I'm using a REALTOR® to market my property, I get an "exclusive agency listing." That gives the REALTOR® the right to market the property, and I agree that that REALTOR® is the only one I will hire. However, it also gives me the right to market the property at the same time, without paying the

REALTOR® a fee if I find the buyer. Although a great many brokers will not enter into this type of agreement, you can always find one who will, and who is capable of making the sale. As an alternative, though, you could enter into a regular agreement and just add a buy-out clause. That's a clause that states that, if you find a buyer on your own, you will buy the REALTOR® out of the contract for $500, or any other mutually negotiated amount.

A REALTOR® will want a six-month contract with no contingencies, but you don't have to agree to that! Never give a REALTOR® more than a 90-day agreement. You can always extend the agreement if you feel the sales job has been adequate. If you're concerned the house may not be advertised properly, negotiate a lower commission and place the ads yourself, or pay for the ads your REALTOR® runs. That way, you know the house will stay in front of the public, and your REALTOR® won't have the cost or the risk of the ads.

Selling the House Yourself

As soon as the exterior is finished, I recommend putting up a "FOR SALE" sign. Don't use a sign that looks too professional. A simple "FOR SALE BY OWNER" sign with a phone number will get just as many, if not more, calls than will a fancy, expensive sign. Of course, the sign should be easily visible.

When you send a person to look at a house, it's good practice to fill out a "Telephone Questionnaire for Potential Buyers," also known as the "Buyer's Fact Sheet." In doing this, you are "qualifying the buyer," and the process will separate the tire kickers and the would-be buyers from the real customers who have real cash or credit. A few minutes on the phone will save you a lot of gasoline and time.

If this house is not what they want, you might be able to find a property more suited to them. This is one way to have a buyer before you buy your next property. You know what they're looking for, what size payments they can afford, where they want to live, how much money they have to put down, and whether they can qualify for a loan.

Here's an example of qualifying a possible buyer:

Q. "Do you want to look at the house alone, or would you prefer I meet you there?"

A. "We would like to meet at the house, Ron."

Q. "Let me ask you a question. I have advertised the price for this house in the paper as $50,000, and it's going to require a new loan. Do you feel you can qualify for a new loan?"

A."Probably not."

Q."I'll have to get a little information from you. It looks like this one's not going to work for you, but maybe I can find you another one that will. Do you have a minute to give me some answers to a few questions?"

I didn't need to show him this house because I found out he didn't qualify. I would, at this point, ask him a few questions. If I feel he is capable of buying, I would go find him a house based on what he has told me. It would have to be one that wouldn't require new financing where the financing could be assumed without qualifying — the same type of house I discussed in the chapter on assumptions.

If he is qualified for a loan but doesn't have much down payment he is valuable, but obviously not as valuable to us as someone with a lot of cash. The qualified buyer who has good credit, can qualify for a loan, and who has the down payment can have his pick of any house on the market today. This is the kind of buyer everyone is seeking. When you have a pile of fact sheets on potential buyers for your properties, you will be able to match a house you want to sell for all cash with someone who has the credit, down payment, and desire for that type of house in that particular location.

Running Ads

The first thing to be determined about your ad is where you are going to run it. You can advertise in the leading newspaper, the weeklies, and the neighborhood publications. When running

an ad, be sure to check out the contract rates, which are often substantially lower if you agree to run some sort of ad each week. You can save about 25%.

Of course, the point of running an ad is to get prospective buyers to call about it, or you're not going to sell the house. I recommend avoiding the use of too many abbreviations because things that may seem obvious to you may not be easily understood by your prospects. Do you understand this one?

> **"Westside, 3/2, 2C/G, A/P Large D/R and F/R, CH/A, $75,000 Call 999-9999"**

In different parts of the country, abbreviations mean different things. You may still be trying to figure out what all that code means, but believe it or not, I've seen ads even more difficult to decipher than this one.

If you wanted a prospect to understand the above ad, it should have been written more along the lines of

> **"Westside, 3/2, A/ground pool, 2 Car Gar, large dining and family room, Cent. heat and air $75,000, Owner will help. 555-5555."**

What do I mean by "Owner will help?" That's just a phrase I use to get people to call me instead of calling another guy's ad. When people ask what it means, I simply ask in turn, "What kind of help do you need?"

If they don't have enough down payment, I'll suggest some of the ways I can help them get it, as I'll discuss shortly. If they feel their credit is weak, I'll find out why and see if there is a way I can help them overcome any small problems. I frequently get people approved for loans, where others fail to, because I take the time to assist them with things like writing explanation letters, getting old derogatory items removed from their credit reports, or showing them how to restructure their debt so their debt ratio falls in line.

If I see I can't get them a loan because of poor credit, the next thing I want to know is how much they can put down. Quite often, buyers have several thousand dollars for a down payment. If so, I'll shift them to another deal where I can put them in an assumable, no-qualifying house. If that's not possible, I'll keep their Buyer's Information Sheet on hand until I find a house on which we can deal, then give them a call.

If the monthly payment is too high for them I'll suggest a lower, adjustable-rate loan or help them into a less expensive house. If I'm going to spend the money to run the ad, I certainly want to exhaust all angles before giving up on a good prospect.

Responding to calls

If you've done a good job writing and placing an ad, you'll receive a lot of calls. Don't use an answering machine! About 50% of the people calling will not leave a message on a machine. The next best thing, if you can't answer the phone yourself, is to hire a live answering service. They're not expensive and they make it hard for a caller to hang up.

Get the caller's name, address and phone number, and find out what they're looking for. You can build a buyer's list this way. The point is to get as much information as possible from people who call about a particular house you've advertised.

Even if they don't qualify for what you're currently selling, you can always look for something else that will suit them.

Don't over sell! Just give callers the pertinent information. Answer only the questions they ask. Don't rattle on about the house. You can give them the address, so they can go see the house from the outside, then make an appointment to show them the inside. This is preferred to your going with them on their first visit. (Of course, you will have left the blinds open so anyone looking at the house can see inside.)

When they call back to make an appointment to see the inside of the house, it's time to prequalify them. That conversation may go something like this:

"Hi, Ron, I went by your house the other day. I'd like to take a look at the inside."

"Great, Mr. Buyer. When would you like to do this?"

"9 o'clock, Thursday."

"9 o'clock, Thursday, OK. Can I answer any questions before I meet you out there, Mr. Buyer?"

"No, Ron, we can talk when I meet you."

"Let me ask you this, Mr. Buyer. How did you plan to finance the house, assuming that you like the inside?"

"We were hoping that you could help us out with that, Ron."

"What kind of help do you need?"

"I'll probably need some help with some of the closing costs."

OK. We'll talk about that when we get there. In other words, Mr. Buyer, you are going to want new financing?"

"Right."

"Mr. Buyer, you understand that the property is going to require about $3,000 down. Is that a problem?"

"Just $3,000 flat? No closing costs?"

"Well, closing costs are usually split by the buyer and the seller, Mr. Buyer. Are closing costs going to be a problem for you?"

"I can only come up with $3,000."

"We can work with that."

"Good."

"OK. How's your credit?"

"Well, it's been pretty good for the last couple of years."

"About the only other thing I can think of, Mr. Buyer, that would stop you from getting the loan is if your debt ratio doesn't work out. Do you think you're overloaded with debts?"

"Well, I just bought a car."
"What's your gross income, Mr. Buyer?"

"It depends on if it rains, or not. I can't work all the time. I've got $xxx"
"Are you steadily employed, Mr. Buyer?"

"Yes, if it doesn't rain, I can go out and work."
"Can you prove your income, Mr. Buyer?"

"I'm sort of self-employed right now, Ron."
"Can you prove your income?"

"Well I haven't been employed for over a year."
"Are you saying that you can't prove your income for this year, Mr. Buyer?"

"Well I can for the last couple of years. I was employed by someone else."
"Mr. Buyer, can you give me a profit and loss statement for this year showing that you made some money?"

(silence)

"Have you made any money this year, Mr. Buyer?"
"Thanks, Ron."

If the buyer hangs up at this point, it's a blessing, because I have saved myself a trip. On the other hand, if the caller answers all my questions with a yes, I know that I may have a qualified buyer. I would then be willing to show the property. But if the caller can't prove his income, there is no reason to waste time running out there. The exception would be if I'm selling a no-qualifying assumption deal. In that case, the only thing I need to know is whether he has the money.

The key questions you must ask are:

How's their credit? Is it going to be a problem?

Do they actually have the down payment now? Are the funds in the bank now?

Do they feel they are overloaded with debt? What is their income to debt ratio?

Do they have steady, verifiable income?

The above information must be obtained to prequalify the buyer. You should get answers to those questions after the buyer looks at the outside of the house, by himself, and before he gets to see the inside.

As soon as the lender takes the application, a request for verification of funds will be sent to the buyer's bank to make sure the money is really there. If it's not, the loan will not progress until the money is in the buyer's account. This explains why you should ask the question, "Are the funds in the bank now?"

In some cases, a gift letter can be used. That means the buyer can receive a gift from a relative for the down payment. He or she can't borrow the money for the down payment, but money can be given to him using a gift letter. Lenders allow relatives only to give such money, not sellers. In the case of some bank loans, anyone except the seller can gift the funds.

Call your buyer weekly and check with the lender often. Communicate with him, find out what is happening, and keep on top of the situation. Try to solve problems before they become unsolvable.

Two often-forgotten items must be watched by you. **First**, the buyer will need a prepaid insurance policy for one year in advance at closing. Tell the buyer that when you get the contract.

Second, you as the seller shouldn't forget to obtain the payoff letters on the underlying loans. If you wait until the last minute, the closing could be delayed. Most likely, the deal will not close without the payoff letters, so be sure to remember

them. You as the seller should take control and make sure all the documents needed to close are obtained in a timely manner. Failure to do so will delay both the closing and the day you'll be able to put your profits in your pocket.

Adding Creativity to Action

One of the easiest ways to stand heads above the competition in the house business is to show a little creativity in your marketing. Be different! More people will call about your ad, you'll make more profit, and you'll sell houses faster. Here are some ideas and examples of ways to put more cash in your pocket.

First of all, remember that even if you have a nice house in a nice neighborhood, you still may have trouble selling it. Always have at least two different ways to sell the property, if possible. The number of creative selling techniques is limited only by your imagination. The ones I prefer to use include:

- Split funding the down payment
- Eliminating the down payment altogether through trading
- Seller financing the deal

Let's discuss each of these techniques. Remember, these are not the only ones that work — they are just my favorites. When you have mastered these, you'll be able to sell your houses faster than ever before!

Split Funding the Down Payment

Making the down payment smaller for the buyer can be accomplished in several ways. One of the simplest is to split it into two or more parts. Think of it as taking the down payment in installments. For example, if you want a $5,000 down payment and the buyer has only $2,000, put the buyer in the house and let him pay you $500 a month extra, in addition to the regular payments, until the down payment is paid. Anything you and the buyer can agree on will work. It depends on the indi-

vidual situation. Of course, the downside to this method is that it could take months for the sale to go through, while you wait for your buyer to raise the money. This method works only if you can wait.

Eliminating the Down Payment

Eliminating the need for a cash down payment altogether is the next basic method to use when selling your property. How do you do this and still make money? Trade! In essence, you look for something you value more than someone else does, and take it for the down payment. If you're willing to take something on trade, put this in your ad:

"I will take anything on trade for down payment. Car, truck, motor home, mobile home, horses, stock, etc."

You can also receive other real estate in exchange for the down payment. Don't lose sight of the fact that you won't have a house that fits every caller's needs. So what do you do with the potential good buyers who, for one reason or another, can't or won't buy one of your houses? Make money, of course!

Fill out a fact sheet about them and contact other investors to see if they have anything. If they do, give the investor the person's name and fact sheet in exchange for a previously negotiated fee, payable if the deal closes. Shared listings of potential buyers are mutually profitable. However, if you find a good qualified buyer with good credit, cash, or both, I suggest you get busy and find them a house. Buyers are harder to find than good deals on houses. Don't waste them!

Seller Financing the Deal

The next technique is really a whole set of methods that make it easier for the buyer to buy, yet keep the deal profitable for you. That technique is seller financing.

Seller financing has three advantages when used to market your property.

First, it gets the attention of the buyer and sets your house apart from other properties in the marketplace.

Second, it makes it easier for the purchaser to buy your house.

Third, it's highly profitable! Over the life of a loan, you often can double or triple the profit you would otherwise make. The following is just a brief introduction into selling with seller financing.

Finance Companies, Your Ace in the Hole

Any property you own can be owner financed, but your objective should be to get your cash back, not leave it buried in the property. A buyer may not be able to qualify for a loan for the full purchase price. Nevertheless, you can hold a second mortgage and get the buyer a loan for 50%, 60% or 75% LTV from a finance company.

There are finance companies in every major city who will make these lower LTV loans to buyers who simply can't qualify for bank loans or government financing. You'll be shocked at the bad credit some of them will accept. I suggest that you hit the bricks and talk to five or six finance companies, such as Beneficial Finance or ITT, to learn their loan requirements.

It will make your sales job much easier if you buy the property correctly to begin with, so you don't have to cash out at 100% of the sale price to make a profit. The goal is to get whatever cash down payment you can, get the buyer a loan for a percentage of the sale price, and take back a second mortgage. You can keep the second or sell it for quick cash, if you can find a buyer. This could be a better deal for some sellers than all cash. I personally prefer to have all my investment, and then some, out of the property when I do this, so all my paper profit is free.

The downside to using finance companies is that the rates are high, so the payments are high as well. Therefore, this will work only on lower-cost houses — those priced under $60,000. A 75% LTV loan on a $60,000 house is $45,000. Amortized over 15 years at 13%, the payment would be $569 per month, plus whatever you and the buyer can agree on about the second-

mortgage payment you are carrying back. Even though this is still a tolerable payment to a semi-qualified buyer, it is high. It's obvious that the higher the price, the higher the mortgage, but it's still a method worth exploring for several reasons:

1. These loans require minimal qualifying.
2. You get an answer in about 48 hours.
3. These loans usually close in two weeks or less.
4. They have low closing costs and little lender scrutiny.
5. The lender requires little or no down payment.

Trading the Paper

At some point, you're going to wonder what can be done with all those small second mortgages. You can use them to trade for other property. So you find a seller who will take several second mortgages you own for his equity, instead of giving him back a mortgage on the house you're buying. You can buy a property free and clear if you have enough second mortgages to use for trade. The person from whom you are buying the house will take four, five, six or more of these little second mortgages in exchange for his property. Then, he collects the payments from all of them.

Or, if you want to do something really dumb, you can trade them for toys, as I once did. I swapped $30,000 worth of seconds for a free-and-clear motor home worth $30,000. I had run an ad in the paper stating I would trade some real estate for such a vehicle. A man called to say he had a motor home, and wanted to know what I had. After some conversation, I discovered what he really wanted was cash flow, not real estate, so I got the idea to trade five little second mortgages I owned.

My total incoming payments were $450 per month. His motor home was just sitting around, not being used, because his wife didn't want to leave town. We made the swap, and now I'm out $450 per month income and I have a motor home sitting around not being used! Maybe one day, if I keep begging, my wife will let me sell or trade it for something useful before it becomes worthless.

Selling on a Wrap

Another highly effective method I've used to finance properties is the wraparound mortgage. A wraparound is a single mortgage, created by a seller, that wraps around all the underlying mortgages.

For example, if you make a $50,000 sale and take $5,000 as the down payment, and there happens to be an existing $20,000 first mortgage and a $10,000 second mortgage, you can take back a $45,000 mortgage wrapped around the two underlying loans.

The buyer pays you $450 a month on the $45,000, and you pay $300 a month on your underlying payments. You get $150 per month cash flow and a $15,000 equity position in the note. You can then sell the paper for cash, but if you intend to sell wraparound mortgages, you have to become skilled at knowing the price for which you can sell them.

The process isn't complicated. The objective is to create the wraparound mortgage and sell it at a discount, if that's what you want to do. By doing that, you can make the house quite saleable, because the buyer doesn't have to qualify at the bank. In selling the wraparound mortgage, however, be aware that anytime you convert a note to cash, you will suffer a sharp discount because of the time value of money. Cash received in the future is worth far less than cash received today. The further away the due date, the bigger the discount.

The discount is calculated based on the monthly payment you are receiving, the number of payments still to be paid, the LTV ratio, and the buyer's credit. The higher the monthly payments being received for the mortgage, the less the discount you will take. It's just that simple.

However, if you have a buyer whose credit is very bad, you may not be able to sell the mortgage until it ages several years. Your buyer doesn't have to be perfect, but a real bum will make it difficult to convert your note to cash.

You don't have to sell off the whole mortgage. People who buy mortgages are looking for a cash flow that can be bought at

a discount rate. The more quickly they get their money back, the more that cash flow is worth.

Don't worry about a due-on-sale clause on the underlying financing if you intend to sell off the wrap. If you are selling a wraparound mortgage to a traditional mortgage buyer, all the underlying mortgages are going to be paid off before you get paid. The note buyer will simply calculate the amount he or she would pay for the mortgage or trust deed as if it were a first mortgage and there were no underlying liens. When the funds are disbursed, all liens will be paid off, and you will get what remains, so the note buyer will then have a first mortgage or trust deed.

Here's an example: Suppose you are selling a house for $50,000. It's carrying a $20,000 loan with a due-on-sale clause, and it has a balloon payment due in three months. If you know you are going to sell this paper, you don't care about the clauses, because all the underlying loans are paid off as soon as the mortgage is sold. You can wrap it, knowing it is going to be paid off. You had better understand this type of deal well enough, however, to be absolutely sure the underlying loans are going to be paid off.

You should even go so far as to pre-approve that mortgage sale before you close the deal. Get an application, send it to a mortgage buyer with the terms of the note, and let him tell you what he will pay for it before you ever close.

Selling With Nothing Down

If you are feeling really generous and want to sell zero down, be prepared for your phone to ring off the hook! Just be sure to obtain additional collateral. Hold the title to something the buyer owns until some sort of down payment is received. On a zero-down deal, always make sure the buyer will lose something of value if he doesn't live up to the agreement. Additional collateral could come in several forms, but it is usually a mortgage on another property in addition to the one you're selling. That way, if the buyer defaults, both properties are at risk. Of

course, a lien could also be against non-realty things like cars, boats, mobile homes, or motor homes.

Adding "Boot," the Gravy on the Deal

Another advantage of seller financing your property involves selling other personal property. For example, suppose you have a boat you'd like to sell. (From my experience, if you have a boat, you probably DO want to get rid of it.) You can add the value of the boat to that of the house and finance it with the purchase.

Personal Guarantees For Seller Carryback

I strongly urge you to obtain a personal guarantee on all seller carryback notes when you sell. This puts you in a position, in most states, to come after the seller personally to collect the debt. That means you can sue on the note and not foreclose the mortgage, if you wish. Everything the buyer owns is at risk until your debt is paid.

When you get a judgment on such a note, you can attach everything belonging to the buyer. If it is not enough to cover the debt, you still can foreclose on the mortgage and sell the property. Can you see why a personal guarantee is a powerful motivator for your buyer to pay you? And do you understand why you should not guarantee notes personally, if at all possible?

The ideas expressed in this chapter on how to market your houses are just the beginning. Be creative. Get expert advice, so you are always safe, but do have some fun trying different ideas. As I said above, the creative selling techniques available to you are limited only by your imagination.

They say art is a good investment. Learning the fine art of creatively selling your houses will put more real cash in your pocket than you can imagine!

Selling Wholesale

This is the easiest part of marketing houses. Everyone's looking for a bargain, so if you have the knowledge to find those bargains, you are very much in demand. Your objective is simply to locate and tie up a good deal, then quickly sell it to one of two kinds of buyers. Some are investors who like to make a Quick-Turn profit or acquire rentals. Others will be owner/occupants simply hunting a fixer-upper they can buy cheaply to repair and live in.

Let's see if we can't figure out some ways to attract these bargain hunters. First, I'll assume you have located a good deal on a junker, and the seller has given you a signed purchase and sale agreement. Now you're faced with the task of either raising the money yourself to buy it, or selling it before you have to close the purchase. Let's say you found a HUD repo worth $50,000, after repairs, that needs about $7,000 in work. Your offer of $17,000 cash was accepted. The problem is you don't have $17,000 in cash. You decide you want to wholesale the house for $20,000 and let someone else worry about it. All you want is your $3,000 profit and a clean break. You don't want to bother with fixing the house or finding a qualified buyer. Once you have a signed contract to purchase, you have the right to begin the sale. So you run an ad in the paper that says:

"Handyman special, cheap, cash, 999-9999."

This ad doesn't look like much, but it will produce calls from all kinds of buyers, investors, and owner/occupants. The trick is to make full use of all the calls that come in. Most people would ramble on and try to convince the caller this is a really great deal. Then they would ask the caller to go see the house. That's where it would end, unless the caller called back and showed interest.

But since we paid for the ad, we're going to make the best use of it and build ourselves a buyer's list. This list will contain the name, phone number, and qualifying data about every caller. It will be a record of what they want, where they want it,

whether they have cash, and whether they are an investor or occupant. It will have other pertinent information, as well.

My friend, this list could be your most valuable asset. It will be your lifeblood and source of ready money. It will soon become your customer list. It's just as important to you as a doctor's list of patients or an insurance agent's list of clients.

But once you build this list, which will take all of a few days to do, then you will develop a new problem: finding enough deals to supply all the buyers!

That's right. Soon you will be able to spend your time looking for good deals to wholesale instead of looking for buyers, because you'll have more demand than you can supply. All from running an ad to attract the right people, and then collecting that information instead of wasting it.

Soon you will be experiencing the pleasure of taking a call from a prospective long-term customer, rather than from a short-term, one-time buyer. A slight change in your attitude about those incoming calls could mean the difference between a mediocre existence and the creation of more income than you can spend.

Let's assume you find only three deals a month as a full-time investor. Once you learn the ropes, this should mean you're making about 20 to 30 offers a month. If you're not getting those results, you're not doing the right things. The truth is I usually have a higher success ratio than that, but I'll allow you some time to get up to speed.

Let's also assume you wholesale all three deals and make only $5,000 per house. Now, the way I figure it, that's $15,000 a month without ever buying a house, doing repairs, borrowing money, qualifying buyers, making payments, or dealing with tenants.

You paid no franchise fee, took no risks, worked short hours, and had no employees. The best part is that you can begin immediately and start to profit soon after.

All of a sudden your buyer's list becomes a very important part of your life, doesn't it? Of course, this is assuming you take the time and spend the money necessary to get the proper training to make it all possible. But as my students across America

have proven, success will come if you make the right offers on the right houses, then handle your deals the right way.

Assumptions

Dealing in assumptions is a different world than wholesaling houses. In fact, it's on the opposite end of the spectrum. Instead of buying junkers at low wholesale prices, you're looking for nice houses in good, upscale areas. In addition, your buyer's market is owner/occupants only.

To refresh your memory, your objective is to finance a property and pass it along to your buyer without dealing with banks. Your profit will come from the difference between the amount you can collect as a down payment from your buyer and the amount of down payment you have to make to your seller.

What makes these houses easy to market is the buyer doesn't need good credit to qualify. If he or she has enough down payment to suit you, the buyer is qualified. Such buyers tend to be much less picky than qualified buyers, and they're much easier to work with. If you provide them with a nice house, in a nice area, with a reasonable down and monthly payments, you should have an easy sale. In fact, these houses are usually sold before I find them.

This is where I make good use of my buyer's list of people who have several thousand in cash, but who don't qualify for a traditional loan.

It's just a matter of showing the house to everyone on the list until one of them says yes. The process begins just as soon as I get a house under contract. So, by the time I am forced to close on my purchase, I have a buyer lined up, ready to buy. Most of the time, I'll simply have my seller deed directly to my buyer and leave with a check for the difference. This happens frequently when I've assumed an existing, no-qualifying loan that constitutes most of my purchase price, and the seller is getting very little or no cash.

If I'm creating a no-qualifying loan by giving the seller back a mortgage or trust deed, I'll almost always have to close first and then resell, even if only a few minutes later.

Remember, a no-qualifying loan is simply one that does not have a due-on-sale clause that would allow the lender to call the loan due on transfer. Don't forget that I'm taking title in a land trust and having the trust either assume the existing, no-qualifying loan or create the seller carryback note. I'll never become personally liable, and neither should you. If you choose to ignore this suggestion, you are likely to be headed for a very expensive seminar.

Now that we know what we're trying to accomplish, let's discuss how to find these buyers. Actually, it's quite easy. Just run an ad something like this: **"Northside, 3/2, No Qualifying, Low Down, $693 mo, 999-9999."** This little ad should produce tons of calls because of the words "no qualifying" and "low down."

If you create a buyer's list in the way we've previously discussed, you'll soon have a stack of good prospects. When potential buyers call and you have captured the information you want, then give them the address and let them look at the property from the outside. Ask them to call you back and let you know if they like the house so you can make an appointment to show them the inside. Of course, if the house is vacant, leave the shades open so they can look inside. Tell them it's OK to do just that.

When a potential customer, one who has seen the exterior and looked inside, calls you back, chances are excellent he is a genuine buyer. Now's the time to make an appointment to meet him, and his checkbook, and get a written contract signed and an earnest money deposit.

Remember, both the husband and wife must be present when you show the house. You can ask in plain terms:

"Will your wife be present when we meet?"
"No. She can't make it then."

"Let's reschedule a time when you both can be present."
"I don't see why she needs to be there, she always goes along with whatever I say anyway."

"I understand, but in order for me to take the house off the market if you like it, I'll need an OK from both of you. Is that going to present a problem?"

"No, I guess not."

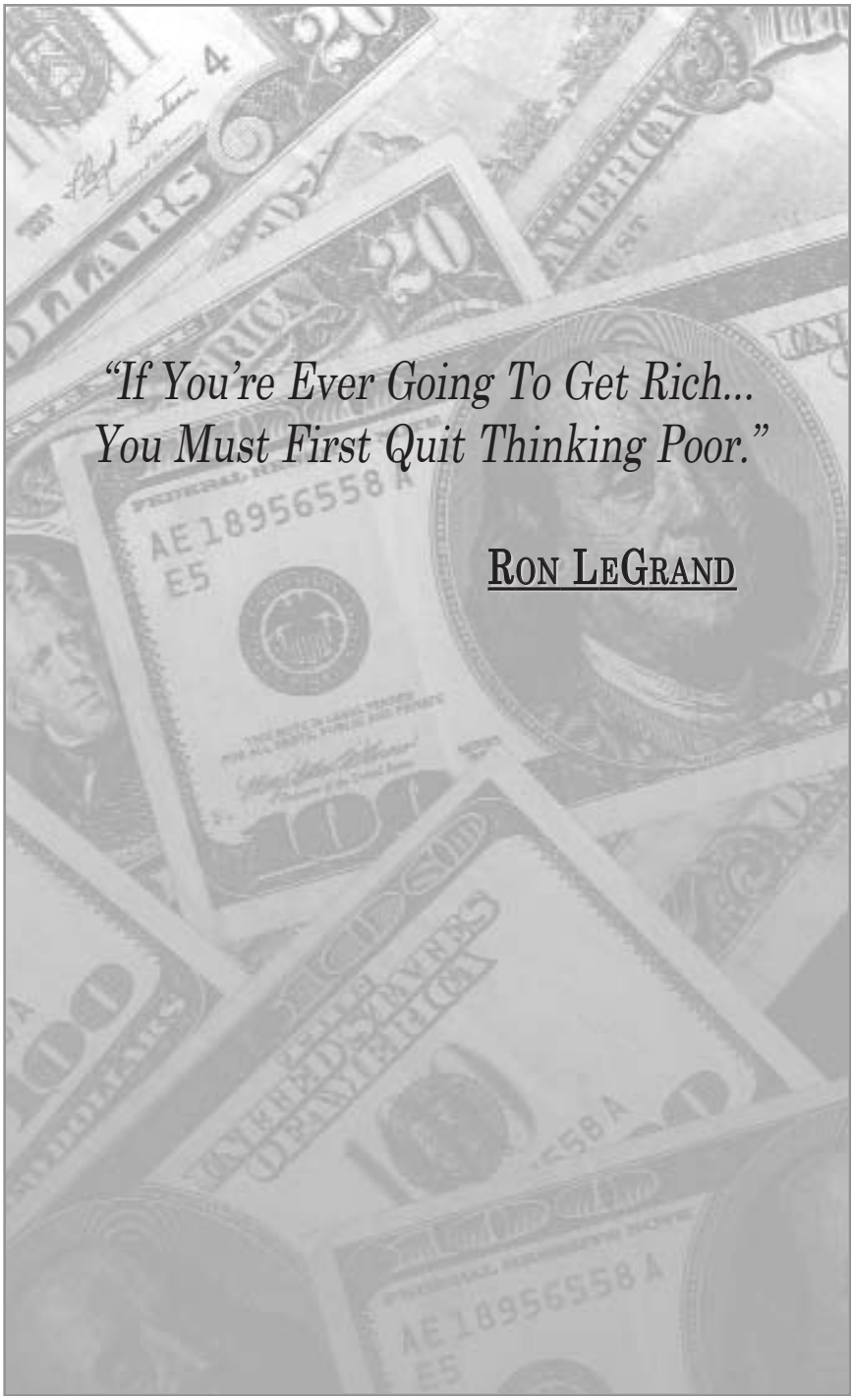
"Good, I'll see you both there at 5:00 p.m. By the way, be sure to bring your checkbook. I'll need a deposit if this is the house you want."

"I don't know for sure I want the house yet."

"I understand. But if it is the one you want, I'll need a deposit to insure you get it, and I don't want to see you have to make another trip. I've had a lot of interest in the house, and the first person with a deposit wins. I'm only suggesting you come prepared."

When you have a nice house in a nice area and can offer great financing, you don't have to beg people to buy. These kinds of houses don't hang around long. There are too many people ready, willing and able to pounce on them as soon as they become available.

There are many variations of the assumption technique, such as selling on a wraparound mortgage and creating monthly cash flow, or selling as handyman specials with good financing. Instead of complicating the issue any more, I'll leave it at that and let you learn the basics first.



"If You're Ever Going To Get Rich...
You Must First Quit Thinking Poor."

RON LEGRAND

Man's mind, once stretched by a new idea,
never regains its original dimensions.

Oliver Wendell Holmes

Chapter 16

Profiles of Success

Phil Barnes

Phil Barnes was a successful major appliance salesman with one of the most prominent retailers in the country for over 23 years. At 55, he felt he had a secure future: a great job, a good living from his first-rate performance in sales volume, and a reliable plan for retirement. Little did he know, all that was about to change.

Rumors began to float along the corporate grapevine that the company was offering top-level management buyouts and planning a major company-wide re-organization. But employees with Phil's tenure and performance record didn't give them much thought. However, over time, the rumors persisted and intensified. Phil began to feel the need to hedge his bets, to diversify his investment activities. His choice? Real estate.

"I'd never even thought about being involved in real estate. I'd made such good money, the thought never crossed my mind," Phil explains. "But with the rumors of impending change, I felt prompted to give it a try." Phil took what most people thought was the solid way to make money in real estate – he bought a few properties and became a landlord.

"I listened to some tapes from different supposed "gurus" I had heard on television," he recalls. "My perception at the time was that real estate investing was buying a piece of property at 20% down, getting a loan from the bank, putting a tenant in there and hoping you wouldn't have any problems. I believed

that's where my income would come from."

But, for Phil, there were problems. "A roof would need replacement, a furnace would blow, and there would go all my profits," Phil recalls. "And I couldn't understand why I wasn't making money! After a few of those, I found out fairly quickly that this was definitely not the way to make money. I had a lot of equity, but I was cash poor. I figured there had to be a better way."

This is when Phil began to look for more information about real estate investing. He became involved in the local Real Estate Investors Association (REIA), a fledgling chapter with only 20 members. "Basically, it was a landlord's gripe group at that time. We were all in the same boat with the same problems. For the most part, the members sat around bemoaning the tax law changes and all the reasons we couldn't get ahead. And nobody wanted to run it, including me. By default, they chose me as president."

Over the next year, Phil's leadership of the local chapter and state chapter involvement paid off in more ways than one. The local chapter's ranks grew to 125 paid members. And through his various activities with the state chapter, he discovered the methods of Ron LeGrand.

"Several of the young investors in the state chapter had heard about some of the hot national-level speakers," Phil recalls. "After investigating several of these speakers, they met Ron. They were so impressed, we arranged for him to come and do a presentation at our state meeting." Phil met Ron at that convention and arranged to have him come speak at an evening meeting of the local chapter. "I was so motivated by what he had to say," Phil explains. "It had that ring of credibility and sincerity that no other real estate investor speaker I had ever heard had."

In the meantime, those rumblings on the corporate grapevine seemed more like prophesy than rumor when company representatives approached Phil and his colleagues with a wage reduction proposal. "It was the beginning of the end as far as I was concerned," Phil states. "They told us that if our earnings were affected negatively by more than 10%, they would offer to

buy us out. My salary would have been cut by almost 25%, plus they would have locked in my retirement at that reduced figure, which I thought was ridiculous. So, I decided to take the buy out. It was quite a leap of faith for me."

As a consequence of Ron's earlier visit to the local REIA chapter, Phil arranged to have Ron come back and present a four-day Boot Camp. "The timing was perfect," Phil laughs. "The Boot Camp was scheduled to take place just a couple of months after I took the plunge to be on my own. It couldn't have been better for me."

In addition to great timing, it was a time of great revelation for Phil. "The Boot Camp changed my entire concept of the business," Phil remembers. "Ron taught me how to get my profit up front and forget hoping to get it at the back end. I realized that doing it Ron's way, you can get control of property without ownership, flip it, make your profit, and let somebody else fix the roof!"

This was exactly the kick-start that Phil needed. "Three weeks after Boot Camp, I went back by a For Sale By Owner house we had gotten some information on during the class, but had never talked to anyone about," Phil explains. "I orchestrated a deal with the owner and bought it for $27,000. I put about $5,000 into it to fix it up and sold it for $48,000. So, I made about $18,000 profit on my first deal only three weeks out of Boot Camp. You could say I was very encouraged!"

That deal led to many others. "The worst deal I've ever done still made me money," Phil laughs. "What more can I say than that? Honestly, there have been some deals where I could have made a bit more money, but one of the biggest satisfactions of this work is helping people out. If I can really make a difference and help someone by just sacrificing a little on my end, and still make a nice profit, that means a lot to me. It's one of the reasons I love doing this business."

Phil has taken every Boot Camp offered by Ron. "Ron arms you with all the ammunition you need. And there are so many different aspects to it. I just constantly opened up to different things Ron presented and it's really been good for me. I figured it this way, why re-invent the wheel? Why not take it from

somebody who's been there?"

Phil cites several reasons why he thinks Ron's courses are superior to others in the marketplace. "These other guys will tell you you're going to make lots of money, and they give you tons of information. What they don't do is tell you the "how" part of it. What sets Ron LeGrand apart from others is the fact that his information is precise, right to the point, and accurate," he says. "Ron provides a step-by-step system that's understandable and complete. He gives you a lot of information with which you can make money, but just getting the information won't make you any money. Ron provides plenty of follow-up to make sure you know how to take action to implement what you've learned. He's very sincere in wanting you to succeed."

A man with a strong belief in God, Phil is very clear about his values and priorities: God first, family second, then work. "Conservatively speaking, I make at least three times as much money now in half the time as I did working as a salesman," Phil confides. "It would be very easy to get extremely greedy doing this business. I've seen some do that. They just can't believe what they're able to accomplish, and they get obsessed about the amount of money they can make. But I think the key to real fulfillment is balance in all things."

Phil firmly believes that a key to success in this business is taking the time to figure out what others want and need. "This business does not mean that one person profits and the other person has to lose," he explains. "Business is contribution and productivity. It's the process of providing goods and services to people. It's helping people. It's fulfilling needs. If you can figure out what people really want, you'll be rewarded. Show the other guy how he can win, and we both will win."

Another source of satisfaction for Phil is that he is now able to give so much more money and time to others. Recently, Phil took off three weeks, traveled to Haiti and assisted in building a mission church there. "The freedom available by doing this business is wonderful," Phil says. "Now I do whatever things I like when I like without having to always worry about fitting in with someone else's schedule, except my wife's, of course."

Phil feels it's never too late for someone to make the transition to this business. "I was into my fifties and I had never seriously considered the notion that I would be anything other than what I was," explains Phil. "I figured I would continue at my job until I retired. My only regret at this point is that I didn't know to do this business sooner."

Elizabeth Bowers

Elizabeth Bowers is now in the driver's seat of the car she's dreamed of owning for years – a pearl-white Lexus 400 SL. And she's quick to tell anyone who asks who helped her make her dream come true.

A woman accustomed to working in what, until recently, has been considered primarily a man's domain, Elizabeth had been working as a real estate investor and landlord for 12 years accumulating over 100 rental properties in her Ohio hometown. Then, she explains, something happened that changed her life forever.

"I met Ron LeGrand and listened to him present information on his approach to real estate investing. Suddenly, I realized I had been doing the business all wrong for all those years," Elizabeth recalls. "Ron told me he knew what I was up against. He had a lot of empathy for me. He assured me he was going to help me 'catch up' and show me how to get my business into the '90's.' Since then, my business and my life have gone from what I describe as inefficient to totally efficient. I give Ron a lot of the credit."

Acquiring all her previous real estate knowledge and training from whom she terms "the gurus of the 1980's," Elizabeth spent years in the basements of houses, wearing jeans and overalls and working along side contractors to rehabilitate properties to resell. She laughs heartily when she recalls Ron telling her to get out of the basement.

"Ron taught me how to get out of the dungarees, wear a dress and be professional," she laughs.

Although glad to be out of basements, that working experience has come in very handy. "There's not a contractor alive who can pull one over on me," she explains. "Working in those basements gave me an eagle eye when it comes to estimating repair work, knowing what needs to be done and knowing when it's done correctly."

In addition to pitching in on many "rehab" projects, Elizabeth spent the majority of her time back then as many landlords do – collecting rents, tracking down late payments, fielding complaints and maintaining her properties.

"My property portfolio covered the whole spectrum," she points out. "From the cream of the crop to those in less desirable areas, I had them all."

After attending the Wholesale/Retail Boot Camp in Chicago in 1993, Elizabeth worked diligently over the next year to perfect Ron's craft and became what she terms "very good" at retailing houses. "Ron's information is presented in such a no-nonsense, straightforward way that it's easy to understand, easy to follow and easy to use. Anyone can become good at what he teaches you to do," she explains. When describing the track record of success she experienced just after attending her first Boot Camp, Elizabeth describes it as "surreal...almost spooky." To elaborate she said, "Success happened immediately. It happened so quickly it was magical!"

During this same year, Elizabeth began acting on Ron's advice to trim a significant portion of her rental properties from her portfolio. "And that's exactly what I did," she says. "I took all 100 properties that I owned, analyzed them by property condition and rated them on an 'A to F' grading system. Then, after getting rid of my 'D' and 'F' properties, I re-analyzed all the remaining properties based on mortgage pay-offs. If the property wasn't going to be paid off by the year 2000, I sold it. This left me with only 'A', 'B' or 'C' condition properties which could be paid off before or by the year 2000. This process eliminated all the stress I had experienced owning those lower-quality houses and allowed me to work more efficiently, freeing me up to pursue real estate as a true entrepreneur."

That process, in and of itself, was eye-opening for Elizabeth.

What she thought was going to be the foundation of her retirement was really the source of stress and worry. "The 'D' and 'F' grade properties were actually a sieve; a virtual money drain. All the money I was making was going right back out the back door into those rentals. So I had to get rid of those money drains, which were also stealing my energy. Once I got rid of them, I was really in a position to benefit from what Ron had taught me."

Although focused on retailing during the early phase of putting her new-found knowledge into practice, Elizabeth realized that the market in her part of the state was shifting. To remain successful, she realized that she needed to shift her focus. And she did.

"Another great thing about Ron and his courses is that he is an expert in a number of different arenas – retailing, wholesaling, lease/option, for sale by owner, mortgage brokering and others," she points out. "As my market shifted, I could shift with it because, first, I was armed with the information I needed to recognize that it was changing and, secondly, I was equipped to change my focus with it." Now she concentrates on wholesaling lower-end properties to bargain buyers.

Whether retailing or wholesaling, Elizabeth has become very successful at this business by concentrating on deals that consistently make a profit in the $10,000 range. "Repetition is definitely the key to success," she emphasizes. "The printed materials are so well written and so clear, and the information on tape and in the courses so well presented, you just need to focus and do what Ron tells you to do – then do it again and again and again."

When giving advice to others who might be contemplating real estate investment as a business, Elizabeth speaks with conviction, "Attend Ron's Boot Camps! And while you're there, focus!" She also advises to never let your materials get too far out of reach. "Don't ignore the tools that Ron gives you. The written material answers everything. I'm constantly reviewing the information, refreshing my knowledge and learning something new every time I do. It's invaluable!"

Elizabeth points out that her biggest obstacle has been to

overcome the tendency to try and re-invent the wheel. "Something in our human nature just urges us to try and improve on something, I'm no exception," she laughs. "But there is no need to do that. And trying to do that just causes problems. He's already been there and done that so you don't have to! If you can just remember that, you're fine!"

Life is very different now for Elizabeth. "I used to wake up and dread every day. Listening to constant complaints from tenants, never-ending maintenance worries on lower-end properties and collecting late rents were all part of what I thought I had to do to be in the real estate business. Since being introduced to Ron's method of real estate, my life has changed. Now, I love my work and I wake up every morning asking myself 'What can I make happen today?'"

Elizabeth is fulfilling all the goals that she ever imagined she could reach through real estate investment – in less than five years she will have no real estate debt, she's making a lot of money, her retirement is already set, and she loves what she does. "I'm solving people's problems and helping them out and that's very fulfilling to me. It makes me happy. I believe happiness is more important than money. And loving what you do is just as important. Now, I have both."

Another reason Elizabeth loves this business is the time it affords her to travel. "I've never been one to yearn for leisure time; however, I do love to travel. I used to travel to try to get away from everything. I would worry the whole time about what was going wrong with those properties. Now, doing the business Ron's way, I travel because I can. And when I go, I actually relax and have fun! I can now honestly say I'm enjoying the journey."

Mark Cousino

Well into his second successful year as a real estate entrepreneur, Mark Cousino points to three primary things that make this business so fulfilling for him: creating win-win situations, being a master of his own time, and achieving a secure foundation for the future.

Mark had always possessed an entrepreneurial spirit and a desire to obtain an income level and quality of life for himself and his family. He tried his hand in two or three businesses including vending, food concession and computer portraits. "One of the reasons I wanted to work on my own was to be able to take control of my time," explains Mark. "Through my experience I found out that a business can easily take control of you! And there's so much more to life than being obsessed and possessed by your work."

Tired of jobs that controlled his time, earning potential and activities, Mark eventually became "sick and tired of being sick and tired." But that experience can be a very powerful motivating force. He kept searching. Consequently, he found and fell in love with real estate.

"I really didn't know anything about real estate except what I had read in a couple of books," says Mark. "I was sure I could do this on my own through trial and error and the school of hard knocks. I started with a single family home which I bought with bank financing and 25% of my own money. I had no idea at that time about no money down strategies. Even though it was in a rough neighborhood and I got into it heavily with my own cash, I still made a profit from it."

Even though Mark was, as he calls it, "just poking at it with a stick," he could see there was a good deal of potential in real estate. But he felt there must be a way to make the kind of money he wanted without so many headaches and hassles and without so much of his money invested. He began to attend a few Real Estate Investor Association (REIA) meetings and a whole new world opened up.

"I wanted to learn something really different about how this business could work. At REIA, I began to hear of methods of acquiring real estate that eliminated the normal headaches associated with buying, holding, renting and so forth, which is what I had been doing up to that point," explains Mark. "Then I heard of Ron LeGrand at one of these REIA functions. He was offering free subscriptions to his "Quick-Turn" newsletter, so I put my name on the list to receive it."

The information presented by Ron in the newsletter was

enough to convince Mark to attend a Real Estate and Entrepreneurs' SuperConference in Orlando, Florida where Ron LeGrand would be a featured speaker. "I heard a number of speakers, each with a specialty. They were experienced, and it was obvious these people had involved themselves directly in the business. They were pros, not just educators," Mark points out. "The conference was a big motivator. To hear some of the newer, cutting edge techniques and strategies that allow you to take control of property without ownership was awesome for me."

After putting quite a bit of money into doing it his own way, Mark was ready to make the necessary adjustments. In December of that year, he proceeded with plans to attend his first Boot Camp. "Ron LeGrand opened my eyes to a whole new world of real estate," says Mark. "I just knew it was going to work. Ron makes it so simple and shows you step-by- step how to produce the results you want. I couldn't compare it to the way I was doing business before."

After the conference, Mark jumped right in. "I got to work right away using the exact ads Ron had shown us in Boot Camp. I created quite a bit of chaos for myself. But I knew I wasn't really going to really learn it until I got in there and did it," he points out. "I got calls immediately. I knew it was going to work. It only took me one deal to know it could be easily duplicated. Ron makes it very simple to follow."

In fact, over the next three months, he had so many successful deals, it dawned on him that this business was really taking off. "I didn't have time to do my old business," Mark explains. "It didn't make sense to continue doing something I had been doing for quite some time that wasn't producing the things I really wanted from work."

The timing was just right. Mark made the decision to sell his seasonal business just before the opening of the 1995 season to pursue real estate full-time. "I couldn't go back to what I was doing. The profit I was realizing from doing real estate on a part-time basis was already far exceeding what I could make from my old business," he explains. "Just like Indiana Jones, it was a step of faith."

In addition to SuperConferences, retreats and seminars, Mark has attended both the MLS and Lease Option Boot Camps. He's gained valuable perspective from both, but prefers to spend most of his time orchestrating lease/option deals.

"I prefer working with the homes that need little or no work to be marketable," he points out. "And my favorite aspect is that I provide a service to people who want to own a home, but might not be able to do it the traditional way because of a credit problem. I love the process of educating them, to convince them what everybody else has told them is wrong and that we can get them in a home. It's an unbeatable feeling, and I generate a great monthly cash flow for myself. What could be better?"

"I didn't have a clue as to what I was doing before Ron," Mark says. "And those other guys that are out there in the market who say they can show you how to make money in real estate sure couldn't show me anything that was workable. Ron's 'been there, done that' – really been out there in the trenches doing this business – and he's a great teacher. He's designed a wonderful education for people. But once you've got it, you've got to get out there and do it."

Mark has no sympathy for people who attend Boot Camps and conferences over and over again, but still haven't gotten started with the business. "Ron gives you everything you need to know. If you've studied the courses and gone to the Boot Camp, you're already prepared. What Ron teaches you is enough to go out and flat kill it! You just have to get rid of any 'stinkin' thinkin.' To use a phrase Ron coined, get over your 'analysis paralysis' and do it!"

Mark is able to produce remarkable results from real estate by working 20 to 25 hours a week, leaving plenty of time for those things he enjoys most: his wife and two small children, hunting, fishing, golf, working out and spending time with friends. "Few dads have the opportunity I do. I'm the only dad that gets to take his kid to pre-school and the only one there for T-ball practice and swimming lessons," he points out. "There are more important things than slaving at work. Being a master of my own time is one of the reasons I love this."

Another reason is what he is able to do for his family. "We've always wanted to build our dream house," Mark says. "Profits from this business have allowed us to go ahead and purchase a beautiful 11-acre piece of property for this purpose. Within the next year, construction will be underway. Now I know the kids' college education is taken care of. We're putting money aside for the future, and we definitely don't worry anymore about how next month's bills will be paid!" he adds.

"When I consider some of the things I've accomplished as a result of the information Ron LeGrand has taught me and shared with me, I can't believe it's really happening for me," shares Mark. "It doesn't take a high degree of education. It just takes a willingness to learn. After putting an awful lot of my money into doing it my way, I discovered there was a better way – and Ron's programs showed me how."

Randy and Charlene France

When Randy and Charlene were married just a few years ago, they had five children between them, were setting up their new household in a 3-bedroom apartment, and borrowed a car from friends to go on their honeymoon.

"Everything used to be a big deal," Charlene remembers. "Grocery shopping or needing to buy shoes for the kids. If the kids needed shoes, then taking them to Burger King was definitely out."

Have things ever changed for the France family over the last few years!

"We've gone from zero to a six-figure income, from a basement apartment to a $125,000 home being paid off in three years, from borrowing a car in order to have a honeymoon to two brand-new vehicles in the driveway paid off in full," Charlene points out. "We can go anywhere we want. We've traveled more this year than we have in our whole lives. And it's because of the business, because of what we've learned from Ron LeGrand."

The Frances first became involved in real estate by investing

in rental properties with a family member. Having heard the concept of quick-turn real estate from various sources, they even tried flipping a couple of houses.

"When we met Ron, we had done a couple of quick-turn deals," explains Charlene. "But we really didn't know what we were doing."

Then a friend invited Randy and Charlene to a Financial Freedom seminar where Ron LeGrand was speaking. "I felt like I was looking at a road map of where we wanted to go," says Charlene. "I couldn't wait to learn more, so I bought the books and tapes right away."

The next step for the Frances was to enroll in an MLS Boot Camp. "It was unbelievable," explains Charlene. "Before the Boot Camp, it was if we were trying to put together a complicated machine or toy with no instructions and we always had pieces left over. You spend a couple of days with Ron and he puts all the missing pieces together. All of a sudden everything fit together. Here was a guy that was doing exactly what I wanted to do and doing it the right way and making money."

"By the time we left the seminar, we knew what to do, we knew how to do it, we knew how to look for them and how to repair them," Randy adds. "The information Ron gave us is complete information. Ron is not 'just a suit', he's one of us. He knows this business so well because he does it himself. He's not dressed up in a $2,000 suit worried about how his hair looks the whole time. He spoon feeds the information to you, but he never looks down his nose at you. He's just an everyday guy that people can relate to."

Immediately following the Boot Camp in Chicago, Charlene had to have emergency gall bladder surgery. She was about to find out just how easy the business can be. Still recuperating in the hospital, she bought and resold her first wholesale house lying on her back. "I made $6,000 from my hospital bed," Charlene laughs. "I bought the house for $15,000 and sold it six days later for $21,000. So we made $1,000 a day! It gave me an attitude of 'My God, I can do this!'"

Prior to progressing from part-time to full time in real estate, Charlene worked in human resources for a retail store making

about $15,000 a year. When one of her first deals brought in about $22,000 profit for the Frances, it was definitely a breakthrough. "It was then that I realized I couldn't afford to work for anybody else," she explains. "It was time for me to go for it!"

"You know, I love this business," she chirps. "It's so much fun! When you find a house, there's so much you can do with it. You can flip it, you can re-hab it and put a family into it, you can keep it, you can lease option it," explains Charlene. "Ron teaches you how to be a real estate entrepreneur, not a real estate investor. He teaches you how to control a property and orchestrate deals. Often, the seller and the new buyer are at the closing table with us or within a few hours and we walk away with cash profits right then and there. Other times, we may take title, hold the property for as little as a few days to a few weeks, then 'turn it' and get instant cash profits."

Charlene is a great believer in attending Ron's conferences over and over again. "You never get done learning," she advises. "And we can make thousands from just one new idea Ron gives us. For instance, Randy and I had been showing homes to almost all interested callers and wasting a lot of our time. Ron advised us to run credit reports prior to showing the home. Now we don't show a home unless it's to a qualified buyer. That one idea has saved us tens of thousands of dollars."

The Frances are maintaining approximately 35 to 40 lease/option properties while they buy and renovate other properties. "Every time we sell a house we pick up another lease/option so we can keep our monthly income coming in while we're rehabbing and selling homes," explains Charlene.

The Frances enjoy the aspect of creating liveable houses. "I could never understand all these houses that looked horrible and were just sitting there vacant.. Now we buy junkers, go in and gut them, re-do them and make them a home for somebody. It's such a rush for me!"

Ninety percent of the homes they re-hab and sell are sold to single mothers. "Having been a single mom with three kids myself, I can remember plenty of tearful times when all I could afford to feed my children was crackers. I know what kind of obstacles these women are up against. It's the greatest feeling

in the world to be able to help these women get into homes of their own."

"Once we bought a house that was condemned and the city was going to tear it down," Charlene continues. "We actually had to get a court order to keep them from demolishing it. We were able to buy this house for $5,000. We fixed it up and sold it. Now, instead of that being an empty lot, it's a home, a family a single mom and her three kids live there. No one would give her a chance. Now those kids are going to remember having Christmas in that living room. And we made a very decent profit on it, too. It doesn't get much better than that!"

Their involvement in real estate has completely changed the lives of the Frances and their children in every way, but one - their values remain totally intact. "We could make a lot more money than we do," Charlene says. "But there's so much more to this for us than just making the money. It's giving a single mom and her kids the chance to move into a decent house in a decent neighborhood. It's about showing other people they can do this, too. It's about giving back what you receive."

Another way the Frances give to others is by supporting them in learning the business. "Once a month we hold meetings to introduce people to real estate entrepreneuring," says Charlene. "One young woman we've been mentoring has a husband who has, until recently, been totally opposed to her involvement in real estate. Once she bought her brand-new 24-foot pleasure boat, he finally realized there might be something of value to this!" The boat's name? "Rent-to-Own!"

"I can't think of how life could get any better for us," Charlene says. "Our home is paid, our cars are paid, college for our kids is already set. This business is the neatest opportunity. Our lives have changed so much! It's given us such freedom. Everything used to be such a big deal – even buying groceries. Now paying for a year of college is one deal! And I get such pleasure from blessing other people. Even though this was years ago when we were just getting started, I'll never forget what a joy it was to be able to go and buy new carpet for my mother. She had always helped me so much, it was such a joy to help her. And I was able to pay for the whole thing with a

check!"

Another big blessing in the Frances' lives is the ability to travel with their family. "We've traveled more in the last two years than we've traveled in our whole lives," Charlene explains. "We've taken two cruises just in the last six months! And none of us will ever forget the Christmas we leased an ocean front condo in Cocoa Beach and spent two weeks at having the time of our lives as a family! The kids were thrilled, especially spending Christmas at Disney World!"

When advising her apprentices, Charlene tells them, "Go to Ron's conferences and seminars and listen, listen, listen! The business can take you wherever you want to go. But don't get greedy; don't do it just for the money. Stay around people that are doing the business, and don't forget where you came from!" Sounds like sound advice.

Richard Kansa

Richard Kansa recently fulfilled a long-standing dream – to underwrite a trip for his mother and aunt so they could return to their homeland of Austria-Hungary. Now in her 70's, Richard's mother had not seen the place where she was born since immigrating (in the early 1940's) at the start of World War II. She'd not seen her cousins since they were all small children. She'd never visited the spot where her grandparents, who had been alive when she left, were buried.

"I had made up a dream list when I first entered the real estate business as a full-time entrepreneur," explains Richard. "I remember telling myself if I didn't identify the things I really wanted to do and start doing them, it simply wasn't going to happen. Accompanying my mother and her sister back to Vienna, treating them to a reunion with the family still in Europe, and being there with them to savor the experience was at the top of my list."

Words escape Richard when he tries to describe witnessing the reunion scene on the train platform in Vienna. "It was worth the whole trip," he says. "I just can't tell you what it was like for these people to see one another again for the first time in

over 50 years. So much emotion, so many tears. Squeals and screams of recognition filled the train platform. They met family they never even knew they had. At her first opportunity after we left the train station, my mom bent down to touch the ground. She was home again."

Richard wants the person who made it possible for the trip to take place to know that he played an important role in making his mom's dream come true.

"Ron LeGrand not only taught me this business, he took a personal interest in my success. Right in the beginning, he gave me his home phone number and encouraged me to call him if I needed help. I found that I did indeed need some help in the beginning and I thought if he was dumb enough to give me his number, I'm going to be brave enough to call him."

The personal support Richard received from Ron helped him over his first hump and two weeks later he had his first house under contract. He flipped it and made his first profit as a real estate entrepreneur – $5,000!

"Ron teaches how to make money in real estate, but he also points out so many things that make such a positive difference in your life," Richard says. "For instance, how valuable time is, how important it is for you to leverage your time in order to do the things you want to do, and that someday is now! If Ron wasn't doing what he does, I wouldn't be doing what I do. And doing what I do gave me the time and money to make my mom's dream come true. Talk about job perks!"

Richard was working as an employee trainer and counselor for various client companies all over the U.S. when he first began to give real estate some thought as an investment opportunity. "A colleague of mine suggested we go to a real estate seminar given by some outfit out of Orlando," Richard explains. "I, along with many other attendees, didn't understand anything that they talked about and found it not at all useful. I left with the feeling that I wasted four days of my life."

Despite that disappointing experience, Richard persisted in his quest to find some usable and credible information about real estate investing. He called the president of the local chapter of the Real Estate Investors Association. "I figured if any-

one could tell me anything worth knowing, it would be him. He told me Ron LeGrand was the best in the business and that copies of his book would be available at their next meeting," recalls Richard. "I came to the next meeting, got my copy of the book, and basically read almost half of it while the speaker was doing his presentation. I was fascinated."

Skeptical since being burned by his first experience, Richard called Ron's office and talked to Ray Rach. "I asked Ray if this stuff really worked and if it would work in my area of the country," Richard explains. "He called and set up conference calls with students from all over the country to talk to me about their successes. I signed up for a Boot Camp right then and there." Thinking Ray had told him the conference would be held in Nashville, Richard made plane reservations to get to the event.

"I called Ray back to ask him what there was to do in Nashville and he asked me why would I be interested in Nashville night life. He informed me that the Boot Camp was being held in Asheville, not Nashville," Richard laughs. "I had to ask Ray where the hell is Asheville? We still laugh about that one!"

However, he did get his reservations straight and made it to Asheville to attend the Boot Camp. It's a good thing he did. "I knew right away, I'd say within an hour, that this was exactly the information I wanted," says Richard. "I knew immediately that it was what I was going to do even though I was about as ignorant as anyone could be in the field. I had never met a REALTOR® and didn't even know what a title company did."

After leaving the Boot Camp, Richard summarized all the segments of real estate he didn't fully understand and made a list. He set a goal for himself to knock one item off the list each week. "I decided that I would learn something every week," explains Richard. "One week I called a couple of different title companies and asked them to explain to me what it was they did. Most were happy to help." Richard was still working full-time at this point and delving into real estate on a part-time basis. "It was like having two full-time jobs," he points out. "But I told myself that if I could make enough money to live on in six months, I would do this business full-time."

By the end of the six-month period, Richard had purchased

three houses, flipped two and had one under contract. He had made $5,000 on his first flip, $3,500 profit on a second flip and $17,000 on his first retail deal. "I thought that was pretty good for my first deals," he adds. "You know a lot of people were telling me a lot of negative stuff during that period, but I just drew on what Ron had told us. Don't listen to negative people and just apply what you learned. He's right. According to Richard, there isn't any niche of this business that hasn't made him money. "It's been a big learning experience and a period of growth. Sure, I've made some mistakes, but that's part of it. I've made a profit on everything I've done. It's been incredible. I'm now moving away from re-habbing and moving more aggressively into owner-financing. I've got some very interesting things happening now in that arena."

"I love this work," Richard continues. "Working at a job was something I found very confining. It goes back to a personality thing. Work should be an extension of who you are. When someone asks me how many hours a week I work at this, I honestly can't say. It's so much a part of who I am. Only when I worked at a regular job did I know how many hours I worked. To me, what I'm doing now is not work. It's a perfect fit for me."

Describing the tangible and intangible changes that have taken place in his life, Richard says, "What life is about now is the difference between just existing and really knowing what it's like to be alive. This business is a progressive business – one where you can certainly get rich, there's no doubt about that. But you know, rich is a relative term. How much is enough? Being able to do what I want to do when I want to do it and having the means to do it makes me a very lucky man."

Steve Powanda

While attending the University of Pittsburgh to obtain a degree in information science, Steve Powanda spent a significant amount of time reading and studying books and tapes focused on a totally different subject: how to be your own boss. It wouldn't be until years later that he would realize his dream.

Having acquired his four-year degree, Steve set off to join the

corporate world as a software designer and computer programmer at a Washington, D.C. area company. Then, back in Pittsburgh, he spent the next six years with a financial services company. Still intrigued and pursuing entrepreneurial information, Steve began to come across books on real estate and to read about those who were good at creating wealth from investing in real estate. He hungered to know more.

Steve began his real estate career by purchasing a few rental properties. Although he describes the deals as "not bad," the enterprise didn't turn out as well as he had hoped. "For the amount of money, time and effort I spent, I sure didn't see the return I wanted," explains Steve. "As a result, I found myself becoming very disillusioned with it."

It was then he joined an American Congress of Real Estate (ACRE) group whose membership consisted primarily of people buying and fixing property and then renting to tenants. "I was hoping to meet people who were doing what I was interested in doing," Steve recalls. "My experience was very limited, but I knew there was a another way to make a living from real estate other than the way I had been doing it."

Just about that time, the ACRE group had a speaker give a presentation on his method of "quick-turning" real estate. "Despite all my reading and searching, I had never heard anything quite like this before," says Steve. "He got my attention with his 'buy and sell' wisdom versus the conventional 'buy and hold' rhetoric offered up by most other so-called experts. I bought a paperback book Ron was offering at his presentation. I began reading it immediately. It was extremely interesting." In fact, the content of that little book fascinated Steve and prompted him to attend the next scheduled SuperConference where Ron would be speaking. "I could tell by reading his book that this guy was the real thing," Steve comments. "I knew he must be a real estate entrepreneur on a very serious level, not just a guy out there making a living on the seminar circuit."

At the SuperConference, Steve was able to hear and meet a number of people doing extremely well in this business, many on a large scale. "I was now considering doing this eventually on a full-time basis," explains Steve. "I was definitely not

interested in any rinky-dink, part-time business opportunity. This SuperConference showed me that Ron LeGrand was offering a system that was valid, something I could master and turn into a legitimate and successful full-time business. It was just what I wanted."

By the end of the SuperConference, Steve made a decision to proceed to the next level by registering for a Boot Camp. "The information presented in the Boot Camp was totally different than anything I had ever heard of," recalls Steve. "It opened up so many doors of possibility for me. And one great thing happened there. I drew first option on a property our group negotiated on during our 'hands-on' bus trip. I took the option. That really helped me because it forced me to do something immediately following the conference."

At the same time he was working on that deal, he began hunting down some deals of his own. He also started setting up goals for himself. "I don't think of goals necessarily as dollar amounts," Steve points out. "That can sometimes work against you. Instead I shoot for the number of deals I want to do, and look to increase it year after year." Steve's initial goals would act as guideposts for him during that first year.

Unfortunately, he actually lost a couple of hundred dollars on the house he inherited from Boot Camp. Steven looks back at it as his chance to get all his mistakes out of the way early on in his career. "I always say, if you're going to make mistakes, make them in the beginning and lose $500 as opposed to making them later on and losing $5,000," laughs Steve. "I play the stock market. Losses are part of the game. You just try to make them as small as possible. Of course, there are a lot of people in this business who make profits right from the very first deal. I just didn't happen to be one of them."

"Actually, in this business your proficiency becomes more keen as you go along," he continues. "I always tell people the more you do the better you get. Your ability increases and your learning continues. The important thing is to get that first one done and over with!"

His next deal was an true inspiration. "The next deal I did was a fixer-upper I bought, renovated and sold," Steve reports.

"I bought it for about $17,000 and sold it for approximately $48,000. I ended up making about $18,000 net profit on it. Just goes to show, you win some, you lose some! Except for that first deal, I've made money on everything I've done." By the end of his first year, Steven had scratched off every item he had placed on his original goal sheet. He was earning almost twice as much in real estate as he did from his regular job. It was decision time. He knew there were new targets to aim for.

Steve announced his plans to his employers and his family. Although it was difficult leaving what Steve considered a good job, an above-average salary, great benefits, a prestigious company and what most people in Pittsburgh view as the ultimate in security, he had reached his decision.

His family thought he was crazy. His friends worried. Trusted colleagues just shook their heads. "It was the hardest thing I'd ever done in my life," admits Steve. "But I had come to the point where I could no longer work what were essentially two full-time jobs at the same time. I was, as they say, at the point of no return. It was time to chart my own destiny; to make as much money as I felt I was worth; to be my own boss," Steve says. "I had diligently sought this opportunity, and the time was now!"

He has no regrets. "Looking back, I only wish I had been more aggressive at the outset," Steve says. I was really extra cautious. Instead of getting one deal complete before beginning to locate the next one, I would have sought them out and stacked them up in the pipeline. There's a lot to be said for going out there and getting four or five things moving at the same time."

Involved in wholesale, retail and a small amount of owner financing, Steve's favorite niche is retail: locating the distressed properties, fixing them up and re-selling them. "Typically, people are willing to let the distressed properties go for a lot less money and this can create good profit margins," advises Steve. "And just like Ron teaches, if you have the ability to look past how ugly it is to its true value and profit potential, you can force the market value up and do really well for yourself."

One of Steve's best deals was a wholesale deal. "It was so easy," recalls Steve. "From the time I bought it to the day I sold

it, everything just fell into place. I sold it three days after I bought it and made a $12,000 profit without ever even touching it! Of course, they don't come along like that every day, but it's a big thrill when it happens every now and then."

Steve's current goals include upping the number of properties he buys during the next year to 50 or 60 and focusing more on owner financing. "I originally thought you needed money to make money, but as I go along I'm finding that when you find good deals, the money will come," he continues. "I mean there are a lot of people who have a lot of money and are more than happy to lend it to you if the deal is good. And one of the things I learned from Ron is how to tell what is a good deal versus a bad one. It's been incredibly valuable knowledge."

Steve attends Ron's live events again and again. "I learn something every time I go," explains Steve. "And Ron teaches exactly what he does himself. I've gone down to Jacksonville and seen where he does his work. He does this on a day-to-day basis. So he's constantly gaining insights and better ways all the time that he continually shares with his students."

Life has changed quite a bit for Steve since becoming an entrepreneur. "Besides leaving my job and waving good-bye to corporate life, it's enjoying the freedom to organize my life the way I want it," says Steve. "It's a business and I manage myself accordingly. But I love being able to take several get away vacations during the year. I take a lot of mini-vacations throughout the year. I just came back from a week at Greenleaf Resort near Orlando where I was playing golf, tennis and just hanging out because it's such a nice place. I enjoy being able to do that."

At twenty-nine years of age, Steven finds himself working at a career he loves, reaping rewards he feels confident will only continue to increase. Completely debt-free, he prefers to pay cash for everything, including new automobiles and those vacations. "Most everybody I know lives with major debt on everything they own," explains Steve. "I'm so thankful I don't have to do that."

Succeeding

Losers labor under the impression that winners never fail.

Anonymous

Chapter 17

While Others Fail

The number-one cause of failure in this business is not trying. The second is ignorance. Just the fact you have bought this book sets you apart from the crowd. I have negotiated with hundreds of real estate owners who have never bought a single book on the subject. You are different. Armed with what you have learned here, you have every reason to succeed in real estate investment. Nothing in this book, however, will do the work for you; you must get out and try. And while you're out there taking action, continue to learn as much as you can from every source possible.

Everybody hits stumbling blocks. Remember, you are not alone in this. Later in this chapter, I have included a list of every possible cause of failure in this business and the way to respond to each. The list will help you pinpoint a problem and then work to correct it. If, for any reason, it seems you're spinning your wheels and getting nowhere, just read this chapter again. The cause of your problem and its solution are mentioned somewhere.

The only failure that counts, because it can stop you cold, is mistakenly believing that winners never fail. Remember, only losers use failure as an excuse for giving up. Winners expect to overcome and learn from their failures. They realize they are problem solvers and believe they will always win somehow. If you think about it, I'll bet you agree that even the bad things that have happened in your life have had a good effect on your future.

Possible Problems

The list of causes of failure is self-explanatory, but it would be useful to highlight some of the key points.

Fear heads the list because of its unique power to paralyze an investor. So many people fear making offers. Why? Fear of rejection. What is the worst thing that can happen to you if you make an offer? Have you ever heard of someone's getting hurt while making an offer? Some owners may get mad if you make a ridiculous, low-ball offer, but so what? Some will accept the offer, and thank you later for it!

Are you afraid of being chased off the seller's property? Unlikely! Especially if you tell people over the phone, even before you go to the house, how you do business. Remind them there is nothing personal about the offer; it's just numbers. If it works for them, great. If it doesn't, you'll buy another house. If you're still scared to make those offers, hire someone else to make them for you. You can promise your negotiator part of the profit you make when you close, or just pay him a flat fee.

Better yet, hire a buyer's broker to work for you. They usually get paid at the closing from the seller's proceeds, thus there's no cost to you. A buyer's broker is simply an agent who declares he or she represents the buyer in the transaction. They are becoming active in most areas of the country and could be a valuable asset if you are afraid to make offers or simply don't have the time or knowledge to do so. You can find buyer's brokers by simply asking agents if they act in that capacity. If they don't, they should be able to refer you to the right people.

I use a simple philosophy that helps keep me on track and helps overcome some of the negative responses from REALTORS® and sellers — **SW SW SW SW**: *Some Will, Some Won't, So What, Someone's Waiting*!

Everybody makes mistakes. Just don't use them to make excuses. So what if you make a mistake? Every successful real estate investor you will ever meet has made more mistakes than you! That's how they know more than you. Just get on with it and accept mistakes as the necessary cost of being alive and in business.

You're going to make mistakes and you know it. Start making them now so you can correct them and make some

more. Another word for mistake is experience. Few wealthy people lack experience.

Fear of financial loss is another big fear. If this is your fear, then only make deals that don't require your own money and protect yourself from all personal liability. No one should feel he or she has to risk vast sums of life savings to succeed in real estate!

You never have to borrow money from a bank. You don't need cash or credit to invest in real estate. Even in the case of a buy low-sell high retail-type deal, which is the only one that might require money, the money can be put up by investors attracted to good deals. Be conservative if you like; work with sandwich lease options, and use no money at all! However, understand that until you overcome that fear of financial loss, you will be missing out on some of the fun and profit. Keep your risks small so you can keep your losses small. If you lose one now and then, so what! Make it up on the next one.

Fearing the Unknown

Fear of the unknown and of how to structure a deal require just one solution: Get help! It seems the more knowledgeable an investor, the more likely they are to call in an expert when they are in unfamiliar territory. Asking for help when you need it is a sign you are on the right track. See to it you get enough education to start moving. You don't have to know everything to start. You will learn as you go. Just get enough information to start, and call in help as you need it. Use competent professionals and experienced investors as your mentors.

The last thing you should do is get help from someone who knows less than you do. Everyone has an opinion. Value only those opinions that come from people who have "walked the walk," not just "talked the talk." Bad advice can cost you much more than no advice.

Procrastination is the big killer. It kills deals, profits and enthusiasm. Make offers, even if just to keep up the momentum of your business. On a part-time basis, you should make four or five offers each week. On a full-time basis, you should make 20

or 30 offers a week. Remember, you don't have to type up a contract to make an offer. Just sketch it out on a piece of paper so the seller gets the idea. If he says yes, then write it up. By using REALTORS®, you literally can submit several offers at once, thus leveraging your time.

Don't try to go it alone. Some people can, but many successful investors work better with partners. It's more fun with partners, especially spouses. You can bounce ideas off them and see their reaction. And this is one business where you can convert a good idea into hard cash in a matter of days. However, it's also important, from the standpoint of motivation, to surround yourself with positive-thinking people. You can form mastermind groups in areas of common interest. This is a powerful resource, particularly when the group is made up of individuals who are working the same business, trying to accomplish the same goals.

I remember when I was a novice investor. All I wanted to talk about was real estate. Consequently, I only hung around with other real estate-minded people. When I met people who wanted to talk about something else, we had a short conversation. I couldn't wait to get started in the morning. I looked forward to every day with a passion.

The message is: **DO SOMETHING YOU LOVE!**

I warn you, though, stay away from negative thinkers and deadheads. It is especially important, as a beginning investor, to avoid taking advice from those who have not succeeded. Have you ever noticed that everyone has an opinion about real estate? Even people who have never owned a piece of property give advice! I recommend you listen only to real investors who are making more than you. When looking for mentors, surround yourself with people who have demonstrated that they possess knowledge and experience.

A mastermind group is a powerful insurance program for success. I received a letter from Joe Bowman in Ft. Lauderdale about the results of just such a group — one that was formed from our Boot Camp there in February 1992.

Joe's letter said this group of six had made 125 offers in the month after I left. They had bought 25 houses, and several hot

offers were still pending. This wasn't done as a partnership or a group effort. It was the sum of their individual offers. He tells me it's much easier to talk with people who have the same training and have the same objectives. Besides, it's so much more fun to celebrate your successes when you get friends involved.

By the way, I didn't hear the profit figures on those 25 houses, but I'd be willing to bet, if my students bought them, there is at least $300,000 to $500,000 net profit involved.

More Practical Tips

Don't try to make repairs yourself. Hire someone to do them. Ask yourself, "Do I want to be paid as a painter or as an investor?" If you repair the houses yourself, you may become discouraged in this business. Your time would be better put to use making offers. One deal that generates $10,000 profit will pay for a lot of labor!

You need to take control of your own life. Good management can free up a lot of your time so you can accomplish more and enjoy life to the hilt. Manage your time; don't let your time manage you. Plan your activities using a daily planner. Chart your course before you start. Know your goals and your destination. Plan how to get there, and take action.

Stay focused and do not allow yourself to get sidetracked. Remember to work in a little time every day to learn something new. Knowledge ultimately saves time as well as money.

Remember the spaghetti theory, and how it applies to making lots of offers. If you throw enough spaghetti against the wall, some of it is bound to stick! Similarly, if you make a sufficient number of good offers, meaning, of course, offers profitable for you yet tailored to the needs of the seller, you can count on some of them being accepted. It matters little if many people say no when all you need is an occasional yes. That one yes can make you more money than some people make in an entire year.

Chasing too many dead leads is a problem that cures itself quickly. Most investors only need a little practice to realize the

value of carefully screening prospects over the telephone. High gasoline bills and lack of time teach very quickly the value of checking out your leads with key questions before committing your time and money.

Life has few certainties, but the greatest hazard in life is to risk nothing. A popular saying among real estate investors is, "If you will do what others won't for five years, you can do what others can't for the rest of your life."

Throughout this book, I have mentioned just a few of my successful students and their stories. I truly wish I could write about them all, but frankly, there are just too many to give all of them the credit they deserve in the space available.

You know who you are, and I hope you understand why your name wasn't mentioned. I'd have to write a book the size of the Los Angeles phone book to include all of you. I truly appreciate your letters and faxes about your successes. It's what makes us tick around my office, and I hope they never stop coming in. Take time to write down your success story and send it to us with your photo. You'll enjoy the process and at the same time brighten our day. Besides, you never know when we'll make you famous like the folks in this book.

I want all of you to be the best you can be, and I hope all your parents have rich children.

Success Tips

- Take care of your cash-flow needs first, before you try to build wealth. Keep working until your real estate cash flow is equal to or exceeds your income from a job. Then you don't have to worry about making a living. You can start making money.

- Stay focused! Stay on track! Stick to your game plan! If it works, don't even think of anything else, just keep doing it. Don't stray and, above all, keep heading for your goal.
- Take advice only from someone who is making more money than you. Learn from people who are doing. Don't

be afraid to ask for help. The experts all use expert advice. It saves money.

- Make your profit going in. Profit is not borrowed money. Borrowed money has to be paid back. Negotiate good deals and don't depend on appreciation.

- Movement is the key. You have to get out and do things. You will make mistakes, but don't let them stop you. You have to keep it moving. Start somewhere. You may not get rich quick, but if you don't start, you'll never get rich.

- Avoid listening to negative thinkers and deadheads. They are everywhere. The people who are closest to you are usually the most negative. Many people will never understand what you're doing, if you're doing it right. Leave them in your dust; don't let them bury you in their dirt.

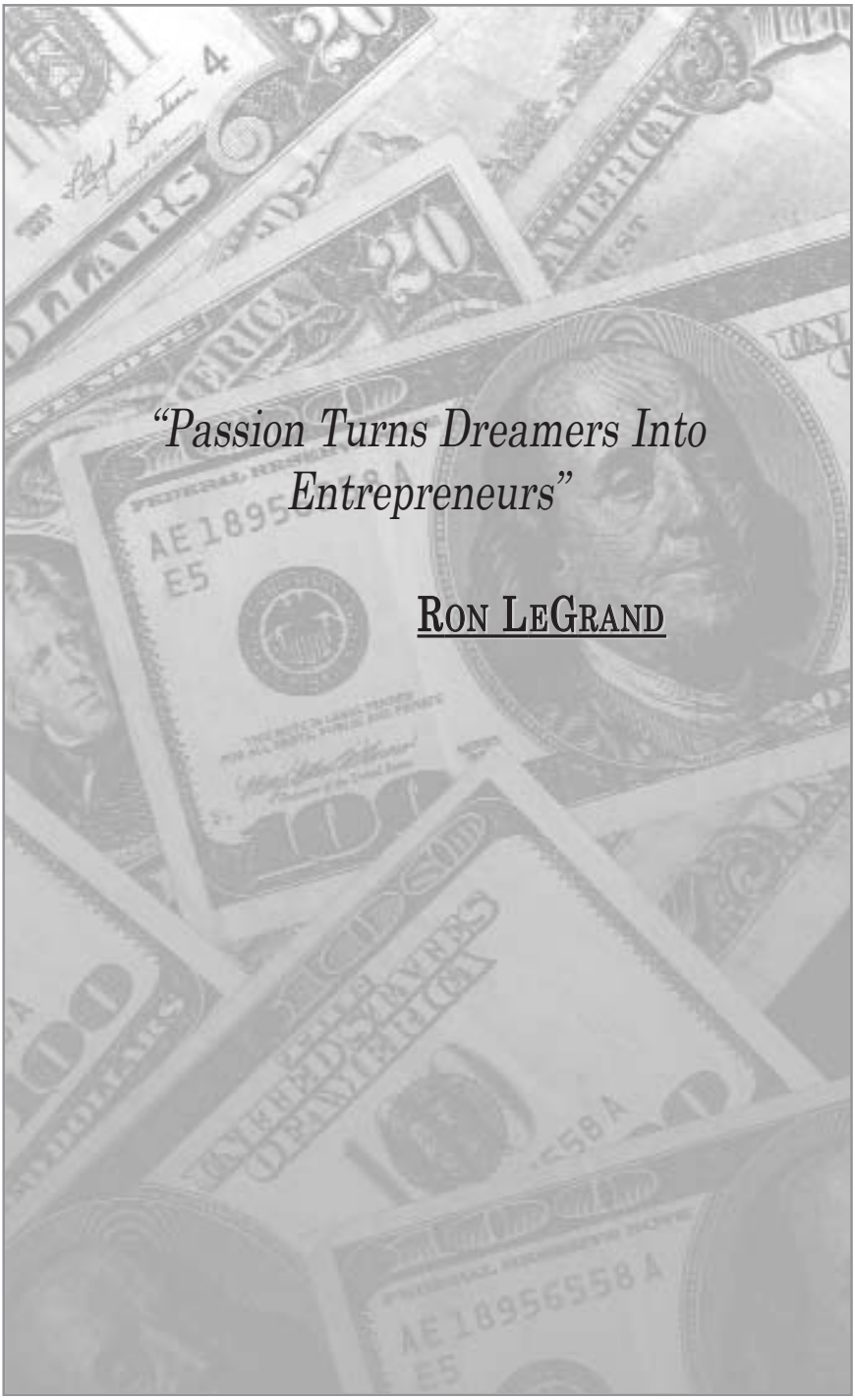
- Deal only with motivated sellers. I probably said this a dozen times in this book. But if you ever catch yourself wasting time with a seller, and feeling generally discouraged in looking for deals, the root of the problem is almost always a lack of seller motivation. You don't want to chase dead-end leads. So screen the sellers well over the phone before you drive anywhere.

- Make a lot of offers. Don't get bogged down in doing the wrong things. Concentrate on activities that produce the most income. Nothing produces more than making offers. If you don't make offers, you won't make deals.

- Make a reservation to attend the very next Boot Camp you can. This valuable hands-on training cannot be found anywhere else. It will save you thousands of dollars in mistakes and give you a focused, easy-to-follow plan to generate cash. You simply cannot afford the mistakes that come with trial and error when such an inex-

pensive Quick-Start opportunity is available. **Take action now. You'll be glad you did.**

- Call or write my office for more information on our full line of training material and events. See page 280 for details.



"Passion Turns Dreamers Into Entrepreneurs"

RON LEGRAND

GLOSSARY OF REAL ESTATE TERMS

Affidavit: A written statement or declaration sworn to or affirmed before an authorized person.

Agreement of Sale: A written agreement in which the purchaser agrees to buy and the seller agrees to sell. Terms and conditions are included in the agreement.

Alienation Clause: Also known as a "due-on-sale" clause. This is a provision that allows a lender to demand payment of the balance of a loan in full if the collateral is sold.

Amortization Mortgage: A debt for which the periodic repayments are used to reduce the principal outstanding as well as to pay off the current interest charges.

Apportionment: The adjustment of the income, expenses, or carrying charges of real estate that is usually computed to the date of closing of title so that the seller pays all expenses to that date. The buyer assumes all expenses from the date on which the deed is conveyed to the buyer.

Appraisal: An estimate of a property's value made by an appraiser who is usually presumed to be an expert in this work.

Appraisal by Comparison: An estimate of value made by comparing the sale prices of other similar properties.

Assignment: The method or manner by which a right or contract is transferred from one person (the assignor) to another (the assignee).

Assumption of Mortgage: This occurs when a person takes title to property and assumes the payment of an existing note or deed of trust.

Balloon Payment: A final installment payment, larger than previous installments, that pays off a debt.

Beneficiary: The person who receives or is to receive the benefits of a certain act.

Bird Dog/Bird Dogger: A person who looks for houses that potentially fit the guidelines of the properties that you prefer to purchase. Bird doggers will bring the information that you require and you will reimburse them for their efforts on whatever basis you have agreed upon.

Bona Fide: In good faith; without fraud.

Capital Gain or Loss: The difference between the basis price (cost plus purchase expenses) of a capital asset and its sales price.

Caveat Emptor: Let the buyer beware. The buyer must examine the goods or property and buy at his or her own risk.

Chain of Title: A history of the conveyances and encumbrances affecting a title from the time the original patent was granted or as far back as records are available.

Client: The principal: the one who employs a broker and who compensates a broker.

Closing Date: The date on which the buyer takes over the property.

Cloud on the Title: An outstanding claim or encumbrance that, if valid, would affect or impair the owner's title.

Codicil: An addition to or amendment of a will.

Collateral: Additional security pledged for the payment of a debt.

Commission: A fee charged for brokerage services.

Commitment: A pledge; a promise; an affirmation agreement.

Complaint: 1. In civil law, the initial statement of the facts on which a complaint is based. 2. In criminal law, the preliminary charge made against the accused.

Comps: See Appraisal by Comparison.

Condemnation: The acquisition of private property for public use with fair compensation to the owner. See also Eminent Domain.

Conditional Sales Contract: A contract for the sale of property stating that although delivery is to be made to the buyer, the title is to remain vested in the seller until the conditions of the contract have been fulfilled.

Consideration: Anything given as an inducement to enter into a contract, such as money or personal services. Any contract, lease, obligation, or mortgage may subsequently be modified without consideration provided that the change is made in writing and signed.

Contract: A legally enforceable agreement.

Covenants: Agreements written into deeds and other instruments promising performance or non-performance of certain acts or stipulating certain uses or restrictions on the property.

Debt Service: Annual amount to be paid by a debtor for money borrowed.

Deed: An instrument in writing, duly executed and delivered, that conveys title to real property.

Deed Restriction: A restriction imposed in a deed to limit the use of the land. A deed might include clauses preventing the sale of liquor or defining the size, type, value, or placement of improvements.

Default: Failure to fulfill a duty or promise or to discharge an obligation; omission or failure to perform an act. In property foreclosure, usually the failure to pay loan installment repayments when they become due.

Defeasance Clause: The clause in a mortgage that permits the mortgagor to redeem his or her property upon payment of the obligations to the mortgagee.

Defendant: The party sued or called to answer in any lawsuit, civil or criminal.

Deficiency Judgment: When the security for a loan is sold for less than the amount of the loan, the unpaid amount (the deficiency) is held by law (the judgment) to be the liability of the borrower unless the new owner has assumed the debt.

Due-on-Sale: See Alienation Clause.

Earnest Money: Down payment made by a purchaser of real estate as evidence of good faith.

Easement: A right that may be exercised by the public or individuals on, over, or through the property of others.

Eminent Domain: A right of the government to acquire property for public use. The owner must be fairly compensated.

Encroachment: A building, part of a building, or obstruction that intrudes on the property of another.

Encumbrance: Any right to or interest in property interfering with its use or transfer or subjecting it to an obligation. In connection with foreclosure property, the most likely encumbrances are mortgages and claims for unpaid taxes.

Equity: In real estate, the difference between the value of a property and the amount owed on it. Also called the owner's interest.

Equity Loan: Junior (subordinate) loan based on a percentage of the equity.

Escrow: A written agreement between two or more parties providing that certain instruments or property be entrusted to a third party to be delivered to a designated person upon the fulfillment or performance of some act or condition.

Estate: The degree, quantity, nature and extent of interest (ownership) that a person has in real property.

Estoppel Certificate: An instrument executed by the mortgagor setting forth the status of and the balance due on the mortgage as of the date of the execution of the certificate.

Eviction: A legal proceeding by a landlord to recover possession of real property.

Exclusive Agency: An agreement to employ one broker only. If the sale is made by any other broker, both are entitled to commissions.

Exclusive Right to Sell: An agreement to give a broker the exclusive right to sell for a specified period. If a sale during the term of the agreement is made by the owner or by any other broker, the broker holding the exclusive right is, nevertheless, entitled to compensation.

Executor: A person or a corporate entity or any other type of organization named in a will to carry out its provisions.

Fee (fee simple, fee absolute): The absolute ownership of real property. This type of estate gives the owner and his or her heirs unconditional power of disposition.

FHA: Federal Housing Administration. See FHA Mortgage Loan.

FHA Mortgage Loan: Mortgage loan insured by the Federal Housing Administration.

Fiduciary: A person who transacts business or handles money or property on behalf of another. The relationship implies great confidence and trust.

First Mortgage: Mortgage that has priority as a lien over all other mortgages. In cases of foreclosure, the first mortgage will be satisfied before other mortgages are paid off.

Foreclosure: A procedure whereby property pledged as security for a debt is sold to pay the debt in the event of default in payments or terms.

Grace Period: Additional time allowed to perform an act or make a payment before a default occurs.

Grantee: The party to whom the title to real property is conveyed; the buyer

Grantor: The person who conveys real estate by deed; the seller.

Habendum Clause: The "to have and to hold" clause that defines or limits the quantity of the estate granted in the deed.

HUD: Department of Housing and Urban Development. This agency has a broad mission in the entire housing industry. The

specific area of interest to you, as an investor, is its involvement in subsidizing rents for low-income housing and the marketing of repossessed houses. Many of the HUD repos provide EXCELLENT investment opportunities.

Hypothecate: To use something as security without giving up possession of it.

Installments: Parts of the same debt, payable at successive periods as agreed; payments made to reduce a mortgage.

Intestate: A person who dies before making a will, or whose will is defective in form.

Irrevocable: Incapable of being recalled or revoked; unchangeable; unalterable.

Joint Tenancy: Ownership of property by two or more persons, each of whom has an undivided interest with or without the right of survivorship.

Judgment: Decree of a court declaring that one individual is indebted to another, and fixing the amount of such indebtedness.

Junior Mortgage: A mortgage second in lien (subordinate) to a previous mortgage.

Landlord: One who rents property to another.

Land Contract: In reality, a land contract is a promise to pay. In other words, if you buy a house under a land contract, you promise to pay an agreed-upon amount on or before a specific date. Once the terms have been fulfilled, the seller will then deed the property to you.

Land Trust: A means of taking control of a property anonymously. The only name that will appear on public records will be the name of the trust and, usually, the name of the trustee. The land trust provides some asset protection in that it requires a good deal of digging via legal channels to discover if a person is the beneficiary of a trust.

Lease: A contract whereby, for a consideration, usually termed rent, one who is entitled to the possession of real property transfers such rights to another for life, for a term of years, or at will.

Leasehold: The interest given to a lessee of real estate by a lease.

Lessee: A person to whom property is rented under a lease.

Lessor: One who rents property to another under a lease.

Lien: A legal right or claim on a specific property that attaches to the property until a debt is satisfied.

Life Estate: The conveyance of title to property for the duration of the life of the grantee.

Lis Pendens: A legal document filed in the office of the county clerk giving notice that an action or proceeding, affecting the title to a property, is pending in the courts.

LTV (Loan-to-Value Ratio): Refers to the amount of money loaned on a property relative to its actual value. For example, a loan of $20,000 on a $40,000 house would be a 50% LTV ratio.

Marketable Title: A title that the court considers to be so free from defect that it will enforce its acceptance by a purchaser.

Mechanic's Lien: A claim made to secure the price of labor done upon and materials furnished for uncompensated improvement.

Moratorium: An emergency act by a legislative body to suspend the legal enforcement of contractual obligations.

Mortgage: An instrument in writing, duly executed and delivered, that creates a lien on real estate as security for the payment of a specified debt, which is usually in the form of a bond.

Mortgage Broker: One who is paid to match borrowers with lenders.

Mortgagee: The party who lends money and takes a mortgage to secure their payment.

Mortgagor: A person who borrows money and gives a mortgage

on his or her property as security for the payment of the debt.

Multiple Listing: An arrangement among members of the Board of REALTORS® whereby brokers bring their listings to the attention of the other members. If a sale results, the commission is divided between the broker providing the listing and the broker making the sale.

Non-Qualifying Assumption: A mortgage or deed of trust that does not contain a due-on-sale clause, thereby allowing transfer of title freely without permission from the lender.

Obsolescence: Loss in value due to reduced desirability and usefulness of a structure because its design and construction has become obsolete.

Open Listing: A listing given to any number of brokers with commissions payable only to the broker who secures the sale.

Open Mortgage: A mortgage that has matured or is overdue and, therefore, is "open" to foreclosure at any time.

Option: A right given for a consideration to purchase or lease a property upon specific terms within a specified time. If the right is not exercised, the option holder is not subject to liability for damages. If exercised, the grantor of option must perform.

Pay-off Letter: A letter from a lender stating the current balance due on an account; also referred to as an estoppel letter or certificate.

Performance Bond: A bond used to guarantee the specific completion of an endeavor in accordance with a contract.

Personal Property: Any property which is not real property.

Plat Book: A public record containing maps of land showing the division into streets, blocks, and lots and indicating the measurements of the individual parcels.

Points: Discount charges imposed by lenders to raise the yields on their loans. One (1) point equals one (1%) percent of the loan amount.

Prepayment Clause: A clause in a mortgage that gives a mortgagor the privilege of paying the mortgage indebtedness before it becomes due, either with or without prepayment penalty.

Proration: Allocation of closing costs and credits to buyers and sellers.

Purchase Money Mortgage: A mortgage given by a grantee or any other lender in partial payment of the purchase price of real estate.

Quiet Title Suit: A suit in court to ascertain the legal rights of an owner to a certain parcel of real property.

Quitclaim Deed: A deed that conveys simply the grantor's rights or interest, if any, in real estate; generally considered inadequate except when interests are being passed from one spouse to the other.

Real Estate Board: An organization whose members consist primarily of real estate brokers and salespersons.

REO (Real Estate Owned): Property acquired by a lender through foreclosure and held in inventory.

Real Estate Syndicate: A partnership formed for a real estate venture. Partners may be limited or unlimited in their liability.

Real Property: Land and generally whatever is erected upon or affixed thereto.

REALTOR®: A term used to identify active members of the National Association of REALTORS® (NAR®), This term is commonly used to refer to anyone licensed to sell real estate. However, the term "REALTOR®" only applies to those dues-paying members of NAR.

Recording: The act of writing or entering, in a book of public record, instruments affecting the title to real property.

Recourse: The right to claim against an owner of a property or note.

Red Lining: The refusal to lend money within a specific area

for various reasons. This practice is illegal because it discriminates against creditworthy people who happen to live there.

Release Clause: A clause found in a blanket mortgage which gives the owner of the property the privilege to pay off part of the debt, and thus free part of the property from the mortgage.

Repo: A shortened or slang version of repossession.

Repossession: Repossession occurs when a lender takes possession of the collateral which was security for a loan.

Right of Redemption: Right to recover property transferred by a mortgage or other lien by paying off the debt either before or after foreclosure; also called equity of redemption.

Right of Survivorship: Right of the surviving joint owner to succeed to the interests of the deceased joint owner. This right is a distinguishing feature of a joint tenancy or tenancy by the entirety.

RTC (Resolution Trust Corporation): An organization set up by the government to market houses from the inventory of federally insured, defunct banks and other lending institutions.

Sales Contract: A contract by which the buyer and seller agree to terms of sale.

Second Mortgage: A mortgage made by a home buyer in addition to an existing first mortgage. The order of recording determines the seniority of the lien.

Seller Financing: Refers to the owner of a property who agrees to carry a mortgage on the property that he or she is selling, so that the buyer doesn't have to obtain any or all of the financing from another source or lending institution.

Specific Performance: A remedy in a court of equity compelling a defendant to carry out the terms of an agreement or contract.

Split Funding: A technique whereby an investor offers a small amount of cash to close the deal with the balance due at a later date in a form other than extended monthly payments.

Statute of Frauds: Law requiring certain contracts to be made in writing or partially complied with in order to be legally enforceable.

Subdivision: A tract of land divided into lots or plots.

Subordination: See Subordination Clause.

Subordination Clause: A clause in a mortgage that gives priority to a mortgage taken out at a later date. The seller agrees to go into a second, third or fourth position allowing you to obtain new financing senior to their lien without paying them off from the proceeds.

Substitution of Collateral: Taking an existing mortgage on one property and transferring it to another.

Survey: The process by which a parcel of land is measured and its area ascertained; also the blueprint showing the measurements, boundaries, and area.

Tax Sale: Sale of real property after a period of non-payment of real estate taxes.

Tenancy in Common: An ownership of realty by two or more persons, each of whom has an undivided interest, without the right of survivorship.

Tenancy by the Entirety: An estate that exists only between husband and wife with equal right of possession and enjoyment during their joint lives and with the right of survivorship.

Tenancy at Will: A license to use or occupy lands and tenements at the will of the owner.

Testate: Condition when a person dies leaving a valid will.

TPA (Third Party Administrator): One who is approved to administer funds from a retirement program. You must use a TPA to access money from your retirement accounts for self-directed activities.

Title Company: A firm that examines title to real estate and/or issues title insurance.

Without Recourse: Words used in endorsing a note or bill to denote that the future holder is not to look to the endorser in case of nonpayment.

Wrap (Wraparound Loan): A new loan encompassing any existing loans.

APPENDICES

A. Property Acquisition Worksheet

B. Bird Dog Flyer

C. Property Information Sheet

D. Letter to an Out-of-State Owner

E. Subordination Agreement

F. Notice of Substitution of Collateral

G. Telephone Questionnaire for Potential Buyers

H. Getting Your House Ready to Market

I. Authorization to Release Information

J. Causes and Cures of Failure

APPENDIX A

Property Acquisition Worksheet

Address:_____

1. Sale price after fix-up	_____	
2. Down payment	_____	
3. Purchase closing costs	_____	
4. Commission	_____	
5. Appraisal	_____	
6. Termite	_____	
7. Survey	_____	
8. Misc.	_____	
9. Total acquisition expense		(-)_____
10. Repair budget	_____	
11. Cost overruns	_____	
12. Total fix-up costs		(-)_____
13. Payments for six months	_____	
14. Property tax	_____	
15. Insurance	_____	
16. Utilities	_____	
17. Total holding costs		(-)_____
18. Sale closing costs	_____	
19. Commission	_____	
20. Advertising	_____	
21. Total sale costs		(-)_____

Sale price less lines 9, 12, 17, 21 $_____

Mortgage payoffs (-)_____

ESTIMATED NET PROFIT $_____

CASH REQUIREMENT
(Lines 9,12,13,15,16,20) $_____

APPENDIX B

BIRD DOG

Make $2,000 A Month

NO CREDIT — NO MONEY — VERY LITTLE KNOWLEDGE

- Write down the phone numbers on all For Sale By Owner (FSBO) signs, then call those numbers and get information sheets completed.
- Fill out information sheets on any and all houses for sale by private owners. Do this for FSBOs and any other houses you can find.
- Submit those sheets to my office.

.

YOU GET $250 IF WE BUY

- Make up an information sheet on all vacant houses not listed with REALTORS®, especially if the houses are run down.
- Try to locate owner's name, address, and phone number.
- Submit sheets to my office.

For Bird Doggers!

YOU GET $250 if we buy and you furnished owner's information.

YOU GET $100 if we buy and you did not furnish owner's information.

APPENDIX C

Property Information Sheet

Submitted by:_____
Date:_____ Phone:_____
Address:_____
Area:_____

This is a FSBO:_____Listed:_____
Other:_____
Owner's name:_____Owner's Phone:_____
Owner's address:_____
_____
Asking price: $_____
Terms:_____

Existing mortgages:
1st
$_____Lender_____Rate____Pmt____FHA/VA/Conv____
2nd
$_____Lender_____Rate____Pmt____FHA/VA/Conv____

Does house need repairs?_____ General description of repairs: _____
_____

Bedrooms_____Baths_____ Construction_____
Central Heat_____ Central Air_____
Garage_____Range_____ Refr_____

Is the house: Vacant_____Occupied_____
EXTRAS: _____
_____
_____
C O M M E N T S : _ _ _

APPENDIX D

Letter To an Out-Of-State Owner

YOUR NAME.
Address
City, State, ZIP

Dear Homeowner:

We are a group of investors who buy and sell houses in the Jacksonville area. Through public records, we are aware of the property you own here in Jacksonville. If you are interested in selling and need FAST CASH, please call Bob at ( ) - or, if you prefer, you can fill out the bottom portion of this letter and mail it to us at the address above. We guarantee you an offer, and we will be in contact with you as soon as we receive the information listed at the bottom.

We are looking forward to doing business with you, and have a GREAT NEW YEAR !

Sincerely,

Your Name

_____ YES, I am interested in selling my property located at
_____
I am asking $_____ for the property.
It is ( ) Occupied ( ) Vacant.
NAME:_____
ADDRESS:_____
CITY:_____ STATE:_____ ZIP: _____
PHONE #: _____
NOTES:_____
_____
_____
_____

We will inspect the property from the exterior and call you shortly with an offer.

APPENDIX E

Subordination Agreement

THIS SUBORDINATION AGREEMENT MADE this _____ day of_____, 19__, by and between _____, mortgagor and_____, mortgagee.

WITNESSETH:

WHEREAS, the mortgagees are the owners and holders of that certain mortgage executed by mortgagor and recorded on _____, in Official Records, Vol_____, Page_____, of the current public records of _____ County_____City_____ State_____, which secures that certain mortgage note in the original principal sum of _____(the "mortgage"), and

WHEREAS, the mortgagor intends to refinance the property secured by said note and requires this Subordination of Mortgage as a condition precedent to purchasing said property.

NOW, THEREFORE, in consideration of the promises and of the advantages to be derived from the execution and delivery of this agreement, the mortgagee further agrees that the mortgagor shall automatically be entitled to refinance any currently existing, prior, or new liens and/or mortgages encumbering the subject real property, and upon the recordation of any mortgages or liens that act as the refinancing of said prior or new mortgages, same shall automatically be considered superior to the lien of the mortgage, no matter when same shall have been recorded. This agreement is intended to operate as an automatic subordination agreement whereby the mortgagee agrees and has agreed to subordinate the lien of their mortgage to the refinancing of any prior liens and/or new mortgages without the necessity of recording an additional subordination agreement.

FURTHER, mortgagees represent and warrant that they are the sole owners of said mortgage and have full power and authority to execute and deliver this Subordination Agreement.

IN WITNESS WHEREOF, the parties have caused this instrument to be executed and their seals affixed the day and year first above written.

_____	_____
Witness	Seal
_____	_____
Witness	Seal
_____	_____
Witness	Seal

STATE OF_____

COUNTY OF_____

On _____, 199___, before me, a Notary Public, personally appeared _____ , _____ and _____ , known to me (or proven to me) to be the persons set forth above who acknowledged that they had executed the foregoing document for the purposes contained therin. Witness my hand and official seal.

_____

NOTARY PUBLIC STATE OF_____

MY COMMISSION EXPIRES_____

APPENDIX F

Notice of Substitution of Collateral

The undersigned herewith files this "Notice of Substitution of Collateral" notifying all interested persons and parties that from this date forward the mortgage dated the _____ day of_____, 19____, and recorded under Clerk's number_____, of the public records of _____County, _____, is herewith modified and amended to substitute for the collateral therein described as the security for said mortgage to the real property more particularly described as:

Hereinafter, the real property currently described in said mortgage and note are forever released from the lien of this mortgage, and the lien of same is herewith transferred to the real property described herein above.

This notice is filed pursuant to the terms of that certain "Agreement for Substitution of Collateral" previously filed herein and recorded under Clerk's number_____, of the public records of _____ County, _____.

IN WITNESS WHEREOF, I have set my hand and official seal on the_____day of _____, 19_____.

Signed and sealed in our presence as witnesses:

_____ _____

_____ _____

STATE OF_____

COUNTY OF_____

BEFORE ME personally appeared_____to me well known and known to me to be the individual described in and who executed the foregoing instrument, and acknowledged to and before me that he executed the same for the purposes therein expressed.

WITNESS my hand and official seal this _____day of_____, 19___, at_____County and State aforesaid.

_____
NOTARY PUBLIC, STATE AND COUNTY AFORESAID

My commission expires:

APPENDIX G

Telephone Questionnaire for Potential Buyers

Date:_____ Source of call: _____
Name:_____
Address:_____
City:_____State:_____ ZIP:_____
Phone: W _____ H _____
What is the maximum down payment available?_____
What price range?_____
Maximum payment affordable?_____
What areas are acceptable?_____
How many bedrooms and bathrooms required?_____
Construction preferred?___Frame ___Brick ___Concrete block
Is a garage mandatory?_____
How is credit?____Good ____Fair ____ Poor
When are you ready to buy?_____
What is the problem (If there is one)?_____
_____
How many square feet are needed? _____
Other requirements:_____
_____
_____
_____
_____
_____
_____
Comments:_____
_____
_____
_____
_____
_____

APPENDIX H

Getting Your House Ready to Market

A checklist of suggestions for fixing up your property

EXTERIOR
Fix up front first
Landscape, clean yard, trim trees and shrubs, edge driveway
Paint using semi-gloss, two colors
Hang shutters
Hang large house numbers
Install fancy front door
Put in new windows if needed, at least in front

KITCHEN
Replace cabinet fronts
Install nice-looking sink, new knobs
Hang wallpaper with borders
Lay shiny new linoleum floor
Hang up a deodorizer (cinnamon spice)
Appliances not mandatory
Install fancy wall plugs
Install ceiling fan
Put up mini-blinds
Install smoke alarm

LIVING ROOM
Add some bright paneling
Add molding at ceiling
Hang inexpensive curtains or mini blinds
Lay carpet and pad (have a professional do the work)
Install ceiling fans

BATHROOMS
Refinish tub and sink if necessary

Put marolite over bad walls
Hang wallpaper with border
Replace ugly faucets
Hang shower curtain
Install mini-blinds
Use denture tablets to clean toilets

BEDROOMS
Paint with semi-gloss, trim in different shade
Do not strip wood and restain
Consider cedar in closet
Install ceiling fan
Wallpaper at least part of master bedroom
Install mini-blinds
Lay carpet and pad

APPENDIX I

Authorization to Release Information

(Use for credit check
or acquiring information concerning a loan)

I/We hereby authorize you to release to _____ any and all information that they may require for the purpose of a credit transaction. You may reproduce this document to acquire reference from more than one source.
Thank You

_____	_____	_____
Signature	Soc. Sec. #	Date
_____	_____	_____
Signature	Soc. Sec. #	Date

APPENDIX J

Causes and Cures of Failure

Cause:	Cure:
• Fear of making an offer.	• Hire someone else
• Fear of making a mistake.	• You will — Do it and get on with it, but keep them small.
• Procrastination! Poor time management.	• Daily planner — breaks big tasks into small pieces. You must convert knowledge to action!
• Don't do your homework.	• Property Acquisition Worksheet.
• Not around the right people.	• Join a real estate association. Stay away from deadheads.
• Don't have the necessary education.	• Investment clubs, partners, books, my Boot Camp, tapes, seminars. Inexpensive education is all around you.
• Try to go it alone.	• It's more fun with a companion.
• Try to do repairs yourself.	• Job out everything. It's cheaper.
• Not aware of how to raise money.	• Read this book. Find a partner. Do deals that don't require money: See *Money Tree* (Chapter 10).

Cause:	Cure:
• Dealing with unmotivated sellers.	• Pre-screen your sellers.
• No goals; no plan; no road map.	• Chart your course before you start. Use a planner.
• Forget the spaghetti theory.	• If you make enough good offers, some will accept. Remember: SW SW SW SW (Chapter 16).
• Cannot communicate with people.	• Get someone to do it for you. Not required for you to ever talk to a seller.
• Chase too many dead leads.	• Practice and a high gasoline bill will soon cure this one.

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Script To Call Back A FSBO

With a Yes on "Will you sell for what you owe?"

Examples 1 - 5 - 8 - 13A

Hi_____, this is_____calling about your home you discussed with my assistant yesterday. Do you have a minute? OK, I've got all the facts here and you've indicated you'd sell the house for what you owe on it. Is that correct?

→ No! Then what did you have in mind?

→ Yes! OK, I can come see the house and likely buy it and close as soon as you're ready and pay closing costs, but the only way for me to do so is to take over your debt. That means I'll buy your house and make the payments when you and I agree I'll start but the loan will stay in your name until sometime in the future when I get it cashed out. Will that be a problem for you?

→ No! Appointment script.

→ Yes! Well, if that's an issue I can also lease purchase it or buy with owner financing and cover your payment with rent and handle all the repairs. Does that seem more appealing?

→ No! So you're saying the only way you'll sell is if your loan is paid off? (<u>If yes</u>, get off phone) (<u>If no,</u> appointment script)

→ Yes! Appointment script.

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Script To Call Back A FSBO With a Yes on Lease Option Question on Property Info Sheet

Not over Leveraged

Example 1C - 2C - 9

Hi_____, this is_____calling about your house you discussed with my assistant yesterday. Do you have a minute?

OK, I've got all the facts here and you're indicated you'd entertain a lease purchase if I cover your payment and maintenance. Is that correct?

NO! Are you saying you won't lease purchase?

→ If yes – well would you rather I buy it with owner financing if we can work out the terms? Ok, what's the least sales price you could accept if we can agree on terms? Is that the best you can do? May I assume you will sell with nothing down? (If no) what's the least you could take down?

What's the lowest monthly payment you could take?

→ If no — get off the phone

→ YES! Ok, I can probably lease it and cover your payment with rent and we can work on the price when I get there after I do a little homework. As long as I know you're flexible and realistic I'm ready to move forward.

May I assume you are?

Appointment Script

Collect any missing facts you want

Make Appointment.

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Script To Call Back A FSBO With a Free and Clear House with a Yes on Owner Financing Question Property Info Sheet

Example 3A

Hi_____, this is_____calling about your house you discussed with my assistant yesterday. Do you have a minute?

OK, I've got all the facts here and you've indicated you'd entertain taking monthly payments if we can agree on a price and terms. Is that correct?

→ NO! So you're saying you won't? Well then would you consider a lease purchase if I accept all responsibility for repairs?

→ If no — So are you saying all cash is the only way you'll sell?

→ Yes — OK, the only way I can do that and get you anywhere near what you're asking is for you to refinance and keep the cash and I'll take over your debt or lease purchase from you immediately. Is that something you want to discuss further?

→ No—Get off the phone.

→ Yes — Appointment script.

→ YES—OK, I can lease your home with an option to buy and release you from all repairs after 30 days. We'd have to agree on a price and terms after I see the house. Should I come look?

No—Get off the phone.

Yes—Discuss terms and set appointment.

→ YES! Ok, what's the least you could accept on the price if we can agree on terms? Is that the best you can do?

May I assume you will sell with nothing down? (If no) what's the least you could take down? What's the lowest monthly payment you could take?

Appointment Script

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Appointment Script

Ok, but I have a couple more questions.

Are you the only owner of the house?

I'll need all owners present when I come and anyone else you need there involved in making the decisions, OK?

Ok, last question, if I come to your house and like what I see and we agree on the details are you ready to make a decision now and get some paperwork done while I'm there?

(If you get all the right answers set the appointment. If not, no need to go until the seller is ready.)

I'm sorry, I just can't make two trips so I'd rather come when_____.

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Script to Capture Mortgage Info on Property Info Sheet

Seller: That's none of your business

I understand your concern but we buy houses with either owner financing or a lease purchase and both will require that information for us to analyze if your house fits any.

What we won't do is pay all cash at full market value so if you tell me that's the only way you wish to sell then I won't need the information. But if you're flexible enough to let us offer you one or more options at no cost or risk to you I will need this information.

Should we proceed or not?

Get this info or get off the phone.

Without it, the deal is dead.

No Script

We've found a lot of sellers want to work with us once they get clarity on why it's in their best interest which I can do in 90 seconds. We can get you cashed out at full price but it won't be immediately so if you must cash out now we can't help. If you don't need the money now we can. Do you want to hear how?

- No—Get off phone
- Yes—Continue

Our specialty is working with quality buyers for good homes in all price ranges who need terms and time to qualify for a loan to cash you out. They're quality people and we screen them heavily before they move in. Of course they'll make a monthly payment and will be responsible for 100% of the maintenance and we close everything with an attorney.

We can do either a lease purchase or owner financing, both of which will have a deadline for them to refinance and obviously it's in their best interest to do so.

The good news is there's no commission to you and you'll get full price because we're offering terms, and sometimes (***name***) while searching for a good terms buyer we get an all cash buyer.

There's no cost to you and if a buyer doesn't come along we approve, nothing is lost but a little time. Your odds of selling with terms are ten times better than selling for cash. Actually it's really just a delayed cash sale at full price.

We are not Realtors. Our compensation comes from the difference between what our buyer brings in for a down payment or option deposit and the amount you're willing to accept and usually because we can offer terms we raise the price enough to cover our cost so it costs you nothing.

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All we need from you to move forward is an acceptable terms agreement with a 90 day window and we'll get to work to see what the market will bring with an extensive online campaign and a search of our current database of buyers or we'll purchase it ourselves right away if my boss approves the terms.

If this interests you my boss will need to see the house. Should I set an appointment now?

NO: So you're saying it's all cash now or nothing?

YES: So if we found a quality buyer with a substantial down payment who could cash you out at full price in a year or two you'd rather not hear about them?

No I Wouldn't—(Get off phone)

Yes I Would—So should we set an appointment for a visit?

No—(Get off phone)

Yes—(Set Appointment, Then)

YES: (Set appointment, then) OK, just a couple more questions so I can relay to my boss.

What's the lowest price you'd sell it for?

May I assume you'd sell it for nothing down if we buy it now?

NO: What's the least you can accept?

What's the lowest monthly payment you can accept?

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Ron LeGrand's

Seller Financing Boot Camp

How To Eliminate Banks, Sell Houses Faster, Double Your Cash Flow And Eliminate Costly Entanglements

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Client Agreement

I understand and agree that no guarantee has been made or could be made that I will actually consummate a transaction involving a property during or after the class or that I will be guaranteed any kind of monetary refund, rebate, commission, or any other monies if I don't.

Acknowledgment Required/Initial Here _____

I agree to send a letter or fax to GPI describing my successes from what I learned and put into action from this event. This correspondence will take place within ten (10) days of the close of sale of the property.

Acknowledgment Required/Initial Here _____

I understand and agree that any technique, form, trade secret or agreement furnished by me and shared with the group can be reproduced and used at a later date. I further consent to the reproduction of any photograph and taped conversation, including testimonials and agree to the use of the same for educational or promotional use. This consent is given with no expectation of compensation thereof.

Acknowledgment Required/Initial Here _____

I understand that solicitation of any type of goods or services to GPI clients is strictly prohibited. Furthermore, the passing of petitions and distribution of written information are not allowed. Commercial activity including: solicitation, interviewing, recruiting, selling and distribution of flyers, petitions or other written information is also prohibited unless you are given specific written permission by GPI prior to the event.

Acknowledgment Required/Initial Here _____

I acknowledge that neither GPI nor Ron LeGrand function as my agent, personal accountant, lawyer or financial advisor. I acknowledge that I am responsible for my actions and hereby release Ron LeGrand, GPI and affiliated companies and any of their staff, employees, officers or agents, from liabilities for any of my actions or comments influenced by information contained in products and services received.

Acknowledgment Required/Initial Here _____

I also understand by breaking this agreement there will be absolutely no grounds for a refund of any kind, all fees will be forfeited and I will be asked to leave the training event immediately. I also agree that there are no grounds to contact my credit company since my refund has been forfeited.

Acknowledgment Required/Initial Here _____

I understand and agree to the conditions above.

Signed _____

Print Name _____

Date Attended _____

Class Attended _____

Location _____

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Table Of Contents

Buying With Seller Financing	**1**
Lead Property Info Sheet	**19**
Seller Financing Test I	**49**
Selling With Seller Financing	**51**
Applicant Information Sheet	**61**
Seller Financing Test II	**75**
Application Receipt Agreement	**89**
Letter of Agreement and Addendum	**94**
Trust Agreement	**96**
Seller Financing Test III	**120**
Seller Financing Test Answers	**123**
Resource Section	**129**

Buying With Seller Financing

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What Is Seller Financing?

When a sale is made where any part of the sales price becomes a note back to the seller, it is considered seller financing.

<u>What's The Difference Between A Note And A Mortgage Or Deed Of Trust?</u>

The note is the debt instrument containing the amount, interest, payment and term. It's the document requiring a guarantee by most lenders, and the one you may get sued to collect.

The mortgage or deed of trust is a document used to attach the note to the house as collateral.

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Advantages Of Seller Financing

1. Lower rates and lower payments when buying.
2. Lower closing costs buying and selling.
3. No banks to deal with buying and selling.
4. Doesn't show on your credit report.
5. Flexibility buying and selling.
6. No personal liability when using trusts.
7. Solves negative cash flow.
8. Can eliminate due on sale clauses or balloons when buying.
9. Sets up future profit center by discounting, substituting collateral or subordination.
10. Can close quickly buying and selling.
11. Eliminates seller's and seller's attorney's anxiety about selling subject to.
12. Makes the house much easier and faster to sell.
13. Let's you create almost instant profits and huge monthly cash flows very quickly.
14. Gives the seller a provable income stream to wash out their debt payment so they can qualify for another loan.
15. No maintenance, taxes, insurance or vacancies when you sell.

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How Can I Buy With Owner Financing If There Is A Due On Sale Loan?

A bank cannot stop a seller from selling with owner financing. However, they can call the loan due because it will trigger the due on sale clause.

You must make sure this is disclosed to your seller in writing (CYA letter), so the risk stays with the seller.

It's unlikely to be called due if payments are made and there is a way to cash out and pay off the loan if necessary, even if you sell on installments. The risk is small but still cannot be ignored.

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CYA Letter For Buying With Seller Financing

The Seller's Acknowledgements letter attached is a modified version of a CYA letter submitted by Brian Rhodes. It's been adapted to include buying on a wrap or land contract.

This document should be signed at closing with each line initialed. Give it to your attorney and ask to be included in the closing package. He/she may want to add more or modify.

If the property is in foreclosure, you must add the special CYA letter attached and get both signed. It costs nothing extra and may save you future expense and grief if the seller develops memory loss.

Do not leave this out because you think the seller won't sign. If they won't, you're better off not doing the deal. Full disclosure must be present or certain problems will follow.

Prospects will gladly sign. Suspects will not. Let them sell to someone else.

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Seller's Acknowledgements

I, _____ (Seller), on this ____ day of _____, 20_____, have agreed in writing to sell the property commonly known as _____, (The Property) to_____ (Buyer) and or assigns, according to the terms and conditions contained in the Purchase and Sale Agreement (The Agreement) of even date, a copy of which is attached hereto. I further state as follows:

_____ 1. OWNERSHIP OF THE PROPERTY: I am the owner of The Property (or I have an equitable interest in The Property) and am able to contract for its sale.

_____ 2. ACCEPTANCE: I have reviewed the terms and conditions contained in The Agreement and have accepted Buyer's offer to purchase The Property.

_____ 3. GOOD AND VALUABLE CONSIDERATION: I have received good and valuable consideration in signing The Agreement, and I acknowledge both the receipt and the sufficiency of the consideration.

_____ 4. IN MY BEST INTEREST: I am satisfied with The Agreement and have agreed to sell The Property because it is in my best interest to do so.

_____ 5. FULLY INFORMED AND NOT CONFUSED: I have signed The Agreement being fully informed and with sufficient understanding of all terms and conditions contained therein. I am not confused about any aspect of The Agreement.

_____ 6. SATISFIED WITH THE SALES PRICE: I understand I may be selling The Property for less than market value but have chosen to do so because circumstances dictate that an immediate sale, even at a discounted price, is in my best interest. I am satisfied with the sales price I have negotiated.

_____ 7. SALE IS FINAL: I understand by signing The Agreement, I have agreed to sell The Property to Buyer and am now bound by the terms and conditions described in The Agreement. I further understand that I cannot change my mind or cancel the contract at some later date, nor can I continue to market The Property to any other buyer.

_____ 8. I understand my loan has a due on sale clause, which means the lender could call the loan due and payable upon transfer, which could affect my credit and/or financial situation.

_____ 9. NOT A LOAN: I understand The Agreement I have signed is for the outright sale of The Property and is not intended to be a loan of any kind.

_____ 10. AGREEMENT MAY BE ASSIGNED: I understand Buyer may assign The Agreement to another party and I may be closing the sale with someone other than Buyer.

_____ 11. I understand the loan will stay in my name until paid in full and I have not been promised a specific date that will happen unless so stated in other closing documents.

_____ 12. I understand the buyer may sell the house with owner financing and I have no control over his/her/its choice to do so.

_____ 13. BUYER ENTITLED TO MAKE A PROFIT: I understand Buyer may resell The Property and may realize a profit in doing so. I agree Buyer is entitled to any profit that may ultimately result from the subsequent resale of The Property.

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_____ 14. LEGAL COUNSEL ADVISED: I acknowledge Buyer has advised me to seek independent legal counsel to review The Agreement.

_____ 15. FINANCIAL REVIEW ADVISED: I acknowledge Buyer has advised me to seek an independent financial advisor to review The Agreement.

_____ 16. FAIRLY NEGOTIATED: I understand Buyer has negotiated on his own behalf and likewise, I have negotiated on mine. I acknowledge The Agreement has been negotiated fairly and Buyer has not taken advantage of me or my current situation.

_____ 17. NO PRECLUDING AILMENTS: I have no physical, mental or emotional ailments that preclude me from signing The Agreement.

_____ 18. NOT UNDER THE INFLUENCE: I am not now under the influence of alcohol or any other mind-altering substance, nor am I taking medication that would cloud my judgment or make me unable to think clearly.

_____ 19. NO OTHER PROMISES: I have not been promised anything other than what is described in The Agreement. There are no unresolved issues, no side agreements, nor are there other terms not disclosed in The Agreement.

_____ 20. NOT UNDER DURESS: I am not under duress and have signed The Agreement of my own free will, without any undue financial pressure. Buyer has in no way pressured me into signing The Agreement.

_____ 21. FULLY SATISFIED WITH AGREEMENT: I am fully satisfied with all terms and conditions contained in The Agreement.

Dated this _____ day of _____, 20____.

_____ Seller (Signature)

_____ Seller (Signature)

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CYA Letter For All Houses You Buy With Payments In Arrears

DISCLOSURE REGARDING REAL ESTATE TRANSACTION

This document serves as an explanation and disclosure regarding the property at _____.

The purchase of your property was made possible because we may be able to negotiate with the Lender/Lenders to have them take less than what was owed as a payoff.

In some cases, the Lender with whom we negotiated may require you as the original mortgagor to pay the difference of what was remaining owed as a deficiency judgment.

This document in no way guarantees we have completed or promise to complete this transaction or close on the above property before the foreclosure auction. If negotiations are unsuccessful and we cannot close and consequently the property goes to sale, you agree to hold harmless _____ and his, her, their, or its agents, servants, successors, heirs, executors, administrators and all other person(s), corporations, firms, associations or partnerships of and for any and all claims, actions, causes of action, demands, rights, damages, costs, loss of service, expenses and compensation whatsoever, which the undersigned now has/have or which may hereafter accrue on account of or in any way growing out of any and all known and unknown, foreseen and unforeseen from the sale of property located at _____.

If the Lender refuses to honor the approved discount(s) and closing the purchase is not possible the property could go to foreclosure. If this occurs the seller agrees to hold harmless the buyer, trustee or agents.

In the event the short sale is successful and there is no deficiency judgment the discount received may become a taxable event to you. This may or may not be disclosed or followed through by your Lender.

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The buyer in no way is acting as a "Foreclosure Consultant" and has not promised you they would guarantee payments, guarantee to bring the loan current, guarantee that the property will be paid off or kept out of foreclosure.

You herein acknowledge the property would be lost at the foreclosure if this transaction did not take place.

The buyer has the ability to re-sell said above property through a contractual interest or as principle owner and holder of the deed and is not acting as Real Estate Broker capacity.

THE UNDERSIGNED HAS READ THE FOREGOING RELEASE AND FULLY UNDERSTANDS IT.

Signed, sealed and delivered this _____ day of _____ 20 _____.

_____ _____
Witness (Seller)

_____ _____
Witness (Seller)

_____ _____
Witness (Buyer)

STATE OF

COUNTY OF

On the _____ day of _____, 20 _____, before me personally appeared _____
To me known to be the person(s) named herein and who executed the foregoing Release and who acknowledge to me that they have read the foregoing release and understands the contents thereof and that they voluntarily executed the same.

My term expires:
_____ _____
Notary Public

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What Is A Wrap
Or Wrap Around?

It's simply one loan that encompasses another loan or loans of smaller value.

Example:

You buy a house and take over a $160,000 first mortgage and a $30,000 second mortgage, $190,000 total price.

Now you sell the house for $210,000 with $20,000 down and take a mortgage, land contract or AITD (All Inclusive Trust Deed) for $190,000.

Note to you	$190,000	10% - 30 yrs	$1,667.39 month income
Existing First	$160,000	7% - 30 yrs	- $1,064.48 month outgo
Existing Second	$ 30,000	9% - 15 yrs	- $ 307.28 month outgo
			$ 295.63 Net

The $190,000 note wraps around the $160,000 and the $30,000. The total debt is $190,000. The $160,000 and the $30,000 are part of the $190,000. You have no equity in the note. You collect $1,667.39 and pay out $1,371.76 and keep the difference. When you're paid off, you must pay off the $190,000 to clear the title.

So Why Sell On A Wrap With No Equity?

1. To make sure the underlying note gets paid.
2. To receive $295.63 per month cash flow.
3. Possible default of buyer and forfeiture of 20K.

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The Three Basic Ways To Buy Houses With Seller Financing

Example 1—Long Term Seller Financing: (House Free And Clear)

Seller calls you with a house worth $150,000 in good condition. He's asking $150,000, has no loan and, after prescreening, you find he would be willing to owner finance with a 10% down payment.

Asking:

$150,000	Value
$150,000	Asking Price
$ 15,000	Asking Down
$135,000	Mortgage, Land Contract or Deed of Trust to seller at a requested rate of 6% for 30 years with a 10 year balloon.

You Offer:

$135,000	Price
$ 5,000	Down
$130,000	5%, 30 years, 10 year balloon, payment of $697.87 principal and interest with the first one due in 3 months, no due on sale clause.

You Sell:

$159,900	Sales Price
$ 20,000	Down From Buyer
$139,900	Deed of Trust, Wraparound Mortgage or Land Contract to you at 9.9% for 30 years with a 5 year balloon. Payments to you of $1,217.40 P & I.

Results:

1. $15,000 profit on down payment ($20,000 from buyer less $5,000 to seller), plus two months income of $1,217.40 with no payment.
2. $519.53 per month on payment spread ($1,217.40 incoming less $697.87 outgoing).
3. $9,900 minimum on back end ($139,900 owed you less $130,000 you owe seller). This profit increases each month because the incoming debt pays off slower than the outgoing due to the differences in interest rates.
4. ? discount when you get ready to pay off the seller due to your buyer refinancing or selling.
5. When possible you close the sale the same day you purchase.

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Example 2—Subject To Plus Second To Seller

A seller calls you with a house in good condition worth $150,000. There is a due on sale loan for $82,000 with a payment of $855.20 per month, including taxes and insurance. The seller is asking $150,000 cash for the house. Upon questioning, you learn she would consider carrying a second for her equity if she gets a $15,000 down payment.

Asking:

$150,000	
$ 15,000	Down
$ 82,000	Take loan subject to
$ 53,000	2nd to seller

You Offer:

$135,000	Purchase Price
$ 5,000	Down Payment
$ 82,000	Take loan subject to Payment $855.20 PITI ($700 principal and interest + $155.20 taxes and insurance).
$48,000	Second mortgage to seller at 5% for 30 years with 10 year balloon. Payment $257.67 beginning in 3 months Total outgoing payments $1,112.87 PITI ($855.20 + $257.67 = $1,112.87)

You Sell:

$159,900	Sales Price
$ 20,000	Down Payment
$139,900	Land Contract, Trust Deed or Wraparound Mortgage 9.9% with a 5 year balloon. Payment $1,372.60 PITI ($1,217.40 P&I + $155.20 taxes and insurance).

Results:

1. $15,000 instant profit from down payment spread, plus 2 months income of $1327.60 with no payment due.
2. $259.73 per month payment spread.
3. $9,900 when your buyer pays off the loan to you ($139,900 - $48,000 - $82,000).
4. ? large discount possibility.
5. When possible, close the sale the same day.

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Example 3—Long Term Wraparound Seller Financing:

Use same problem as example 2 except you buy on wraparound mortgage, land contract or deed of trust so the seller knows their first mortgage payment will get paid. You pay them. They pay their lender and keep the difference. Then you sell the same way.

Asking:

$150,000	
$ 15,000	Down
$ 82,000	Take subject to - $805.20 PITI
$ 53,000	2nd to seller

You Offer:

$135,000	
$ 5,000	Down
$130,000	Wrap, L/C, Deed of Trust
	5% - 30 Yr. – Interest begins in 60 days
	$697.87 P & I
	$155.20 T & I
	$853.07 PITI Total payment to seller

You Sell:

$159,900	
$ 20,000	Down
$139,900	Wrap, L/C, TD
	9.9% - 30 yr.
	$1,217.40 P & I
	$ 155.20 T & I
	$1,372.60 Total payment due you

Results:

1. $15,000 instant profit from down payment spread, plus 2 months free income of $1,327.60 before payment due.
2. $519.53 monthly spread. ($1,372.60 - $853.07)
3. $9,900 when you pay the seller off.
4. ? larger discount possible.
5. When possible, close the sale the same day as purchased.

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Target Properties

1. Pretty houses in good areas at median price or above. Low priced properties attract buyers with no money and incur large default rates.

2. Any property where the seller will agree to wait for their money until you cash out or accept payments.

3. Ugly properties with a lot of equity where seller will subordinate so you can raise cash on their house.

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High Priced Houses
Vs. Low Priced Houses

If you conduct your business with little or no risk, why not deal in the best houses in the best areas. Here are some reasons why.

1. Better quality tenants and buyers

2. Nicer houses in nicer areas, no junk.

3. You'll make much more profit on all income streams:

    - You'll get bigger down payments because the houses are worth more.
    - You'll get bigger monthly spreads.
    - Much larger back end paydays. The higher values make it easier to negotiate bigger spreads.

4. If you sell with owner financing there's less chance of buyer default because they're in a higher income bracket and have more money at risk.

5. When buying with seller financing you can create larger paydays by discounting the note later.

6. Your friends and relatives will think you're very rich. Prove them right.

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Beware When Dealing In Higher Priced Homes

In most markets a home above $250,000 would be considered a higher priced home. We can and should deal in these homes as long as we reduce or eliminate our risk and understand the rules.

1. They'll probably take longer to sell for cash because fewer people can qualify, but offering seller financing will escalate the sale.

2. Never use an appraisal offered by the seller, especially if it was used to refinance. It's almost always unrealistic.

3. Buyers don't want to do any work to upper priced houses. They should be ready to sell and need nothing but decorating to buyers taste. No projects please.

4. If you agree to make large payments, make sure you get large equity. Also, make sure you can make these payments or have a plan to get them made if necessary because you may be doing so before you can sell.

5. On houses above $1,000,000 in most markets selling with owner financing has less effect on the marketplace, but there still is a market. These buyers are programmed to pay cash or get new financing and can qualify. These buyers tend to negotiate, so prepare to give away equity if necessary to move the house, but never do so unless you collect a large down payment.

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The Tools For Buying And Selling With Owner Financing

Wraparound Mortgage

An all-inclusive loan encompassing underlying financing. You collect a larger payment from your buyer than you pay your lender. Seller deeds to buyer and takes back a note and mortgage. This must all be prepared by a professional and will vary from state to state.

Land Contract, Land Installment Contract, Agreement For Deed, Contract For Deed, Bond For Deed

All these terms mean the same thing but the name will vary from state to state. Serves the same purpose as a wraparound, but the deed remains with the seller until paid. Buyer has equitable interest in property. This is a very simple process. It's no more complicated than completing a Purchase and Sales Agreement.

Deed Of Trust Or All Inclusive Trust Deed (AITD)

A Deed of Trust is a contract by which title of the property is conveyed to a Trustee for the repayment of a loan who is usually a non-related entity. This contract involves three parties. The Trustor is the owner who borrows from the lender. The Beneficiary is the lender. This document should always be prepared by a professional and varies from state to state.

WE RECOMMEND YOU ACQUIRE GOOD LEGAL COUNSEL ANY TIME YOU ARE PREPARING OR HAVING PREPARED ANY LEGAL DOCUMENT INVOLVING FINANCING A PROPERTY.

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Lead/Property Information Sheet

Student _____

Date _____ Owner's Name _____

Source _____ Cell Phone _____Evening _____

Address _____ ★ Asking Price _____

City _____State_____ ★ Sellers Estimated Value _____

Area of town_____ ★ Your comps _____

Existing Mortgage Information (must have)

★ 1st - $_____ Lender _____ _____% Pmt _____

2nd - $_____ Lender _____ _____% Pmt _____

Is Payment PITI ____Yes _____No Current? _____Yes ____No$_____ in Arrears

If asking price and loan balance are within $35,000:
Will you sell the house for what you owe on it?
___Yes ___No

If the house has a Mortgage:
If we can agree on a price and we accept all responsibility for future repairs would you consider a lease purchase? ***Yes / No (circle one)***
YES – OK, I'll have my boss call to discuss terms. When is the best time?_____(***get info below)***
NO – So you're saying if you don't get full price and all cash you won't sell? ***Yes/No (circle one)***
YES – OK, I understand but that wouldn't make sense for us. Thanks ***(stop here)***
NO – OK, I'll have my boss call to discuss several ways he can buy your home. What's the best time to call?_____(***get info below)***

If the house is Free & Clear:
If Yes – Will you consider taking monthly payments for your equity? ***Yes/No (circle one)***
If No – Would you consider a lease purchase making us responsible for all repairs? ***Yes/No (circle one)***
YES – I'll have my boss call to discuss terms. When is the best time?_____(***get info below)***
NO – So you're saying if you don't get full price and all cash you won't sell? ***Yes/No (circle one)***
YES – OK, I understand but that wouldn't make sense for us. Thanks ***(stop here)***
NO – OK, I'll have my boss call to discuss several ways he can buy your home. What's the best time to call?_____(***get info below)***

How did you arrive at your asking price? _____Reason for selling?_____

Does it need repairs? _____Yes _____No

★ When do you want to move? _____Is the house listed? _____

Description:

Bed/Bath: _____ Square Feet: _____ Lot Size: _____

Construction: Frame_____ Brick_____ Block_____ Stucco_____ Other_____

Garage: 0 1 2 Carport: ____ Basement: ___ Refrigerator _____ Range ____ Dishwasher _____

Is the house Vacant___ Occupied_____Is this a house or a Condo? Yes/No Association fee$_____

Notes:_____

_____

_____

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Five Ways To Structure Seller Financing

1. No interest – No payments
2. Principal payments only
3. No payments, accruing interest
4. Interest payments only
5. Amortizing, principal plus interest

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Work Hard To Get The Payments As Low As Possible

The two key ingredients in negotiating purchases with seller financing are:

- Low Down Payments
- Low Monthly Payments

If you don't do everything you can to get the payments low, the excitement of a new deal will soon be overtaken by the regret you didn't do better.

One of the biggest advantages of becoming the bank is the free cash flow from the spread on an asset you have no investment to get.

The lower the outgo, the bigger the spread. When you combine the art of getting low outgoing payments with the art of getting larger than normal incoming payments, it's pretty easy to create $1,000 plus monthly spreads per house.

My first choice is no payments with a balloon several years off. My second choice is a monthly principal payment as low as possible.

You're probably better off not doing the deal than agreeing to a high payment. Make it clear to the seller it's not an option and stand your ground.

I'd rather pay a higher price than have a high payment. I'd even pay more down if necessary than yield on the payment. It will come back quickly.

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Your goal should be $1,000 or more on each house. Simple math will show it only takes 20 incoming payments to net $240,000 a year.

Now, let's get in the big leagues and see what happens if we dare to deal in the big stuff.

$200,000 House

Purchase	$175,000
Down	$ 10,000
Note To Seller	$165,000

$1,000 mo.

You Sell	$200,000
Down	$ 20,000
Note to You	$180,000

$2,000 month

Monthly Spread $1,000

$1,000,000 House

Purchase	$800,000
Down	$ 25,000
Note To Seller	$775,000

$2,500 mo.

You Sell	$1,000,000
Down	$ 100,000
Note to You	$ 900,000

$6,920 month
(8 ½ % interest – 30 yr.)

Monthly Spread $4,420
Plus $75,000 net cash

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Who Will Sell With No Payments Or Interest And Why?

The answer is sellers who need to sell. These are flexible people who need a sale more than payments or interest. The list of reasons can be long.

Usually, debt relief is the most compelling reason and sometimes an urgent need of cash.

For some, a monthly payment is very important, but collecting interest is not.

Sometimes the balloon you offer is short term, so the seller doesn't have to wait more than a year or two.

The big mistake you can make is to try to do the thinking for the seller. You're not qualified and really have no idea what really bugs them, regardless of what they say.

The only way to cut to the chase is to make an offer. Their response will dictate your next move. What will shock you is how little many people care about interest or payments, even the so-called sophisticated ones you'd expect to object.

Your job is to open the door and let them decide to pass or play, not think for them.

If you offer interest, you won't get no interest. If you offer payments, I'm sure they will accept them.

If You Offer Neither, You Might Not Pay Either.

You can always add interest or payments, but it's hard to take them away once you open your mouth. **SHUT UP!**

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Here's Why The Banks Have The Big Buildings

Let's look at how your equity builds when you negotiate a no interest loan when you buy and sell at 9% interest.

You Buy

$200,000.00	Note To Seller
$ 800.00	Monthly Payment, Zero Interest

You Sell

$200,000.00	Note To You
$ 1,609.25	9%, 30 Years

EOY	Outgoing Balance	Incoming Balance
1	$190,400	$198,634
3	$171,200	$195,504
5	$152,000	$191,760
8	$133,200	$184,722
10	$104,000	$178,860
15	$56,000	$158,661

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Key Questions To See If The Seller Will Owner Finance Long Term And At <u>No Interest</u>

(This should be done in the home)

OK, I'll give you $_____ per month until you're paid off.

(Simply decide what you want to pay per month and divide the principal amount by the payment to get the term. Don't mention the term unless they ask.)

Q. What about interest?

A. Interest! Why do you need interest? My offer was based on not paying interest. If you need interest, I'll have to take another look, besides, if I pay you interest, you'll have to pay taxes on it. Are you sure you need interest?

If seller insists on interest –

OK, what did you have in mind?

Now's your chance to get something in exchange for interest.

Lower The Price – *If I give you interest, how much can we lower the price?*
***Lower The Payment –** *If I give you interest, how much can you lower the payment?*
***Lower The Down Payment Or None –** *If I give you interest, will you sell with nothing down?*

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Script For Negotiating Short Term, No Interest Or Payment

You—I'll take over your debt now and give you _____ when I cash out secured with a second mortgage on your house.

Seller—What about payments?

You—Your house can't afford them. I'll have to make the payment on your existing loan and I won't do this with a negative cash flow. Does that make sense?

Seller—What about interest?

You—If I pay you interest, I'd have to reduce the amount of the second to you. Is interest really that important to you?

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Down Payments
Thinking Outside The Box

There are a lot of ways to produce down payments other than writing a check. Here's a list.

1. Credit cards and credit lines.

2. Borrow on your personal or real property.

3. Offer additional collateral on your property in lieu of down payment.

4. Trade any asset for down payment such as car, boat, motor home, mobile home, plane, jewelry, livestock, stocks, mortgage receivables, business, etc. If you don't have it, find out what the seller wants and buy at wholesale and trade at retail.

5. Equity share and cut the seller in for a piece of the profit in lieu of down payment.

6. Find a buyer with a large down payment and close simultaneously.

7. Get a friend to put up the down payment for a 25% return when you sell in a few days.

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How To Get Your Seller Some Cash And A Monthly Payment With No Money Down From You

This will only work if the house is free and clear or close. Let's assume you're buying a house for $200,000 and your seller is willing to owner finance, but needs $20,000 cash and at least $800 a month income.

There is actually two ways to structure it—the first is to give the seller a first and a second and sell off the first to raise the cash.

Here's how it works:

Your Offer	$200,000	
1st To Seller	$ 25,000	9 ½%, 30 Year, $210.21 mo.
2nd To Seller	$175,000	$800 mo. Until Paid

Now you sell off the first for $20,436 at a 12% yield and close the sale of the note with your purchase.

The second method is to just give the seller one note for $200,000 at $1,200 a month until paid and sell off part of the payments.

If the seller needs $800 a month, you have $400 a month to sell, so if the seller needs $20,000 it would look like this if your note buyer needs a 12% yield.

N	I	PV	PMT
70	12%	$20,000	$400

Your seller must give up $400 a month for 70 months to get $20,000 cash now.

The note buyer would get priority lien status, do all the paperwork, and approve this deal in about 20 seconds.

Your no down payment is irrelevant to them since they're so well secured. Your seller gets what they want. You get a house with no money down and a huge discount opportunity later.

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Here's A List Of National Note Buyers

- Themortgagebuyer.com
- Nationalcontractbuyers.com
- Notenet.com
- Cascadefunding.com
- Notefundingcenter.com

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Here's How To Buy With Seller Financing And Cash Out The Seller

Let's say a seller will accept $140,000 cash for a $200,000 house in good condition. Your offer is simple…I'll pay you $140,000, cash but we'll have to be a little unconventional.

I'll write it up at $200,000 purchase with $20,000 down, a $160,000 first to you at 9%, 30 years, $1,287.40 a month. The second will be for $20,000 with no payments and a 5 year balloon. At closing, you will sell your note of $160,000 and assign your second to me and you'll get a check for $140,000 less your closing costs.

If the seller agrees, and they should, you'll have to bring in $20,000, but here's how it will work.

You'll sell the note to SMI.	$160,000
	X 91%
Cash at closing	$145,600
Plus your down payment	$ 20,000
	$165,600
Less sellers proceeds	-$140,000
Cash back to you	$ 25,600

Any debt on the property less than $140,000 will be paid off at closing. The seller will get the difference. This is a good way to liquidate underlying loans.

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Reverse Interest Loan

If you can't get the seller to take no interest, this is probably the next best thing. You'll have to create it by hand, but it's easy to calculate if you understand it.

It's laid out so you pay most of the interest at the end of the loan and mostly principal in the beginning, the opposite of amortizing loans.

If the loan doesn't go the distance, and it probably won't, you'll pay little interest. You can always refinance if the payments get too high (never my recommended solution).

Let's assume you're giving the seller a $100,000 note at 5% interest. Here's how it would lay out:

Loan Payment Schedule

Property: 123 Main Street
Loan Amount: $100,000
Interest Rate: 5% ***Term***: 10 Years

Year	Principal	Interest	Payment
1	$10,000	$ 500	$ 875.00
2	$10,000	$1,000	$ 916.70
3	$10,000	$1,500	$ 958.33
4	$10,000	$2,000	$1,000.00
5	$10,000	$2,500	$1,041.67
6	$10,000	$3,000	$1,083.33
7	$10,000	$3,500	$1,125.00
8	$10,000	$4,000	$1,166.67
9	$10,000	$4,500	$1,208.33
10	$10,000	$5,000	$1,250.00

Prepare the schedule on a single page and attach it to your Purchase Agreement as an addendum.

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Splitting The Note To The Sellers

Sometimes you'll buy from an estate with multiple owners or a divorced couple who can't stand each other. In this case, your offer to make sure they don't have to do business with each other after the sale may get the deal done for you and fix a sensitive issue.

Let's say a couple has a $500,000 house free and clear and will sell for $400,000 if you put 10% down, but don't trust each other and neither wants to talk to the other.

Your Offer:

$400,000		
$ 20,000	Down	
$380,000	Mortgage With Two Separate Notes	
	Husband	$190,000
	Wife	$190,000

You'll make two payments and hopefully avoid later arguments. I'd get both to sign a satisfaction to put in attorney's escrow so you don't have to chase them when you're ready to pay off.

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Structuring Your Seller Financed Purchase For Resale

- Always know your back door(s) when making an offer. The offer to purchase hinges on the method of sale.

- You must get in light. The down payment from your buyer should be much larger than your down payment to your seller. More than 5% down to the seller puts you at risk.

- Don't leave cash in the house when you sell unless you clearly understand your exit and expect to recapture it quickly.

- Property should be in good condition or you're willing to repair at your expense because your down payment from buyer will cover your costs, or you're offering a subordinated offer allowing you to raise cash on the seller's asset.

- Insure monthly cash flow by negotiating low or no interest and low or no payments. This is the only way to get monthly cash flow. Work hard for big spreads.

- Make sure the property is freely transferable upon resale with no seller interference, which means no due on sale clause on your note to the seller.

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Subordination

What Is It?

When a seller agrees to take back a second mortgage and allow you to get a new first mortgage without paying them off.

Example:

You get a call from a seller with a free and clear house worth $180,000 after repaired but it needs $15,000 in work. The MAO is $111,000. You agreed to pay $110,000 as long as the seller will take a $10,000 down payment and subordinate the remaining $100,000 at $500 per month until paid. Could add a balloon if you wish.

Now you borrow a $40,000 first from a private lender at 12% interest only payment with a five year balloon.

$ 40,000	New First Mortgage	$400 month
$100,000	Second To Seller	$500 month
$140,000		$900 month

Let's look at our cash at closing, the day we buy.

$40,000	New First
- $10,000	Down Payment To Seller
- $15,000	You Set Aside For Repairs
- $ 2,000	Closing Costs
$13,000	Net Cash To You

What's Your Exit?

Lease Option or owner finance after repairing.

$189,900	Sales Price
$ 10,000	Deposit Or Down Payment
$179,900	$1,500 Monthly Rent Or Payment To You
	-$ 900 Your Payment
$ 600	Cash Flow

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Subordination Twist

Now take the same house and almost the same offer, but change the terms on the $100,000 second to seller to no payments and no interest with a five year balloon.

$ 40,000 New First Mortgage
$100,000 Second To Seller
$140,000

$400 month
$ 0 month
$400

Use The Same Exit

$189,900 Sale Price
$10,000 Down Payment
$179,900 - $1,500 Monthly Payment To You
- $ 400 Your Payment
$1,100 Cash Flow

Caution – If you have a 5 year balloon to your seller, you must put a shorter term balloon in your buyers note.

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Substitution Of Collateral

What is it?

The mortgagee allows you to transfer your mortgage from one property to another (a transfer of collateral).

Criteria?

You must have substantial equity in another property to make it possible. The seller must have a strong motivation to allow it. You should make it worth their while.

Make sure the receiving property is not over-financed or payment too high.

How do we profit?

When cashing out a sale, move the mortgage you owe a seller to another property and pocket the cash. This would now be a great time to sell the highly financed property on a wrap or land contract.

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Substitution Of Collateral

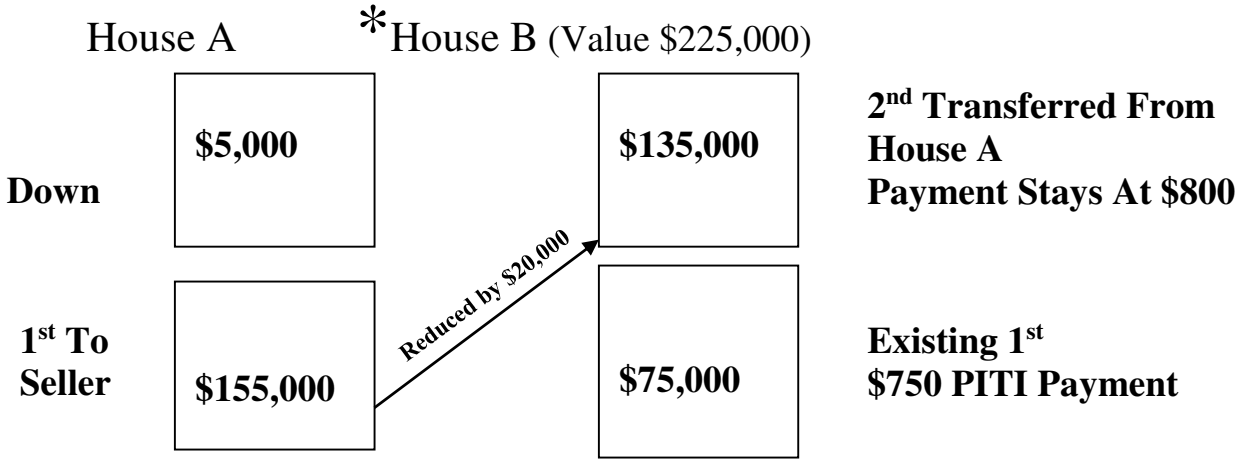
Asking Price $180,000 House A

House needs $5,000 in repairs and will be worth $200,000.

Offer	$160,000	
Down	$ 5,000	
1st to seller		$155,000 - $800 a month with substitution of collateral

Sell House – A – For $200,000 cash

Give seller of House A an additional $20,000 and move mortgage to House B at closing.



Results – House A has no loan to payoff so all the cash goes to you.

- $200,000 Cash sale
- $ 5,000 Original down payment on House A
- $ 20,000 Additional payment to seller for moving mortgage
- $ 2,500 Closing cost of sale of House A
- $ 5,000 Repairs

$167,500 Profit (actual cash received $177,500) ($200,000 - $20,000 to seller - $2,500 closing)

($135,000 is tax deferred because it's still borrowed money)

Results– House B

$225,000 Value

1st	$ 75,000 -	$ 750 mo. PITI
2nd	$135,000 -	$ 800 mo.
	$210,000 -	$1,550 PITI

This may be a good time to sell House B for $229,000 and wrap the underlying debt.

*You may move the $135,000 to several properties with smaller equities and break it up into several second mortgages.

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Why Would The Seller Substitute The Collateral To Second Position?

1. $20,000! That's plenty reason.

2. Because you asked and you've kept your word in the past.

3. Because you've given him no reason to believe he'll get paid off in full. If you do, you probably won't get a yes.

<u>What If He Won't Say Yes?</u>

1. Offer more money.

2. Raise the amount you owe.

3. Raise his payments.

4. Shorten his term.

5. Get a big discount and pay him off at closing.

6. Throw in boot like a car, boat, motorcycle, trip to Disney World or your vacation rental, use of your time share.

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Script For Requesting Substitution Of Collateral

"Mr. Seller, could you use a little extra money right now? If you're OK with it, I'd like to transfer the mortgage I owe you on _____ street house to a house I own at 123 Main St. You'll be in second position behind a $75,000 first, but I'll leave the payment at $800 and still owe you _____ payments, and I can give you $20,000 cash now if you'll approve the transfer. How does that sound?"

Answer only questions you're asked.

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Notice Of Substitution Of Collateral

The undersigned, herewith files this "Notice of Substitution of Collateral" notifying all interested persons and Parties that from this date forward the mortgage dated the ____ Day of _____, 20____., and recorded under Clerk's number _____. To substitute the collateral therein described as the security for said mortgage to the real property more particularly described as:

Hereinafter, the real property currently described in said mortgage and note are forever released from the lien of this mortgage, the lien of same is herewith transferred to the real property described hereinabove.

IN WITNESS WHEREOF, I have set my hand and official seal on the ____ day of _____, 20____.

Signed and sealed in our
Presence as witnesses:

_____ _____

_____

STATE OF _____
COUNTY OF _____

BEFORE ME appeared _____ who is personally known to me (or) provided proper identification to be the individual described herein and who executed the foregoing instrument, and acknowledged to and before me that he/she executed the same for the purposes therein expressed.

WITNESS my hand and official seal the _____ day of _____, 20_____, at County and State aforesaid.

_____
NOTARY PUBLIC, STATE AND COUNTY AFORESAID

My Commission expires:

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Here Are Some Money Making Clauses To Add To Your Offer When You Buy With Owner Financing:

You will never use all of these clauses on any one deal. They are listed below to scan as you're making the offer and apply when possible.

1. Delayed Payment

   Interest will begin in ____ months and the first payment is due _____.

   This will buy you several free months of payments by adding one sentence.

   OR

   In case of no interest loans bearing monthly payments:

   The first payment of _____ will be due on _____ and on the ____ day of the month thereafter for ____ consecutive payments until paid in full.

2. First Right Of Refusal

   The maker of this note will have the first right of refusal to match any bonafide offer received by the seller to purchase all or part of the payments.

This will ensure if anyone offers to buy the note at a discount, you'll get the chance to do so yourself. No professional note buyer will do so until you waive that right.

3. Discounts

   If this note is paid off within the first year after closing, the maker will receive a ____% discount of the principal balance. If paid off in year two, the maker will receive a ____% discount and year three a ____% discount.

   This clause will insure you get a discount before you even buy the property.

4. Satisfaction

   Seller will execute a satisfaction of mortgage at closing to be held in buyer's attorney's escrow to be recorded upon full payment of this note.

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This will keep you from chasing the seller upon payoff, unless they die in the interim. Your attorney will prepare the escrow agreement or advise against. Follow his advice.

5. Subordination

Seller will carry a second mortgage in the amount of $_____ with no payments or interest to be subordinated to a new first mortgage initiated by buyer.

OR

Seller will carry a second mortgage in the amount of $_____ with monthly payments in the amount of $_____ beginning 90 days after closing in ____ equal installments until paid in full. This mortgage will be subordinated to a new first initiated by the buyer.

6. Substitution Of Collateral

Buyer reserves the right to substitute collateral at any time in the form of a first or second mortgage, as long as the equity in the substituted property is of equal or greater value than the equity in the seller's property. Seller will execute a Notice Of Substitution Of Collateral within three business days upon request of buyer.

Caution

These clauses are meant to be placed in your purchase agreement. Your attorney will want to modify them to add to the actual closing documents. If you clarify the intent, he/she will handle the legalities.

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Discounting Seller Held Mortgages And Trust Deeds

Wherever there is seller-financing lies the strong possibility of a discount. Never pay off a seller held loan without asking. Always take over the loan when buying if it already exists so you can discount it later. Don't pay it off at purchase if you can avoid it.

When you're ready to sell or refinance the property is when you'll usually want to negotiate the discount.

Never let the mortgage holder know you're selling or you'll lose your leverage. They have no reason to discount if they know you're about to cash out.

Here are some reasons you may use to ask for a discount:

1. I'm coming into some cash within the next two weeks and I'm trying to decide what my best use is for it. Remember, I'm in the real estate business and capable of getting huge returns on my capital, so I'd have to have a large discount to throw the cash your way. If I paid you off now, what's the least you'd take for all cash?

2. We've got a problem and I need your help. The property I bought from you is a negative cash flow and the only way I can keep it is to pay off the loan to you and reduce the monthly outgo, and to make that work I'd have to get a big discount to be able to borrow enough. What's the least you could take if I were to do so?

3. (Hard Nose Close)
   Mr. Seller, it comes down to this. I'm simplifying my life and most of my properties have to go, or my wife will. I can either get your consent to pay your note off at $_____ or I can give you the property back. If you'll recall the note is not personally guaranteed, so I'll let you decide if you want the cash I can offer you or if you'd rather have the property back. Please give it some thought and let me know your decision.

<u>Note</u>

You won't get private lenders to discount except in cases of default. This only works in seller carry back notes.

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Should You Buy Houses With Small Equity With Seller Financing?

The answer is maybe. It depends on the interest rate and payment on the underlying mortgage.

If the payment is high and you can't make a spread, you probably won't wrap it. If the payment is low and you can see a sizable spread, you probably will.

Example

ARV	$200,000
Mortgage	$175,000 – 8 ½% – 30 Years
Payment	$1,345.60 P&I

You can easily get more from a buyer at a higher rate, but not much. If you raise the rate to 9 ½% on the $175,000, the payment is $1,471.49. You'll have to decide if the responsibility, accounting, etc. is worth it to you for the $126 a month.

Now let's assume the underlying loan is at 6%. The payment would be $1,049.21. So if you charge 9 ½% and get $1,471.49 it's a no brainer with a $422.80 spread.

If you've made a promise to the seller to make their payments, you should wrap both examples above to protect their interest.

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When Buying On A Wrap, What Could Go Wrong And How Do I Fix It?

The bank could call the loan due. Your options are:

- Ask your seller to sell the note and pay off the bank. Get them in touch with SMI.

- Show the bank you're the buyer and ask them to stop the action. Don't let them talk you into assuming the loan.

The seller could collect your payment and not make the underlying:

- All wraps or land contracts should have a provision for you to make them and penalize the seller. Simply do so and pay the bank directly from that point forward. Your attorney should handle the notice to seller.

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What If My Seller Files Bankruptcy After I Buy

If you buy a house with any kind of seller financing and then the seller files bankruptcy, you still own the house. If you're wrapping a due on sale loan, the seller will likely name the loan in the bankruptcy, but that doesn't necessarily jeopardize your position. If this occurs, the only action for you to take is to hire an attorney to represent your interests. The court will likely order your payment made to the trustee.

One of three things will happen:

1. You (your attorney) can petition the trustee to release the property on the grounds the seller doesn't own it and you are paying the creditor. This should be a simple and inexpensive process if there are no complications.

2. The bankruptcy will end on its own accord.

3. The seller can stop the bankruptcy or remove your house if they wish, since they have no equity. If they do, it's up to the court how to handle it, but it will likely end in your favor.

If you've already sold the house and your buyer gets notified, immediate action will be required on your part to put your buyer and your attorney together to assure them they will not lose their house.

Unless they are ready to cash out during this process, it doesn't affect their rights. Nothing will change on their end.

If they are ready to cash out, your attorney will notify the trustee you're ready to pay off the creditor and the trustee should allow it to take place. In a bankruptcy, secured creditors come first. Your seller's lender is a secured creditor.

If this ever happens to you, don't overreact. It's just due process. The sky is not falling.

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What Is A Dealer?

The IRS definition of a real estate dealer is:

Anyone who buys with the intent to resell.

The reality is everyone buys with the intent to resell. We just don't know when. The intent of this rule is to apply to those who are in business to buy and sell immediately as their chief occupation.

That definitely includes you if what we're teaching in this class dominates your business and you don't have a job or other profession.

Here's why you never want to be a dealer:

1. You lose installment sale taxation.

2. You lose long term capital gains.

3. You lose depreciation.

4. No 1031 exchanges.

5. You must pay a self employment tax on your net income (about 15%).

Here's how to mitigate the risk of ever becoming a dealer.

1. Never do business in your name. If anyone gets named a dealer let it be an entity, not you. That entity can then be shut down and you can form a new one.

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2. Mix some keepers with your flips you sell on installments. This makes a case your entity is an investor, not a dealer.

3. Do installment sales in several entities so as to spread the load. Each will have its own tax return and K-1 to include in yours. It wouldn't hurt to change ownership and control on some with your spouse and maybe other family members.

4. Have other businesses so it's obvious real estate flipping isn't all you do.

This is not a major concern for you unless you really turn it into a large business, at which time your attorneys and CPA will advise you on the best plan.

Caution

Never let your CPA call you or your entity a dealer. This is grounds for termination to me because it will be hard to rid yourself of the stigma and there is no reason for him to do so.

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Seller Financing Test I

1. Name three advantages of buying with seller financing.

   _____

   _____

   _____

2. Name one reason to do a wrap around an underlying loan of the same amount.

   _____

3. What are the three basic tools (financing documents) used to buy or sell with owner financing?

   _____ Mortgage

   _____ Contract

   _____ Of _____

4. What's the best kind of seller financing?

   _____

5. What are the two main ingredients you should focus on when buying with seller financing?

   _____ and _____

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6. Name two ways to raise down payments other than writing a check:

   _____ and _____

7. What is subordination?

   _____

8. What is substitution of collateral?

   _____

9. When buying a house with small equity, what's the key ingredient we discussed that should influence your decision to do so?

   _____

10. Define a real estate dealer.

   _____

   _____

   _____

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Selling With Seller Financing

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Advantages When Selling With Owner Financing

1. Minimal qualifying.

2. No requirements for seller to own property for 6 months or a year.

3. Quicker than conventional financing. Close in 3 days.

4. You can hold the note until you need cash and sell out anytime. It's a liquid asset producing passive income.

5. You're taxed on installment sale until you sell the note.

6. You have help structuring the deal on the other end of the phone.

7. Easy to attract prospects with owner financing.

8. You'll probably get a free second mortgage you can use in numerous ways and get full face value when you learn how.

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Can I Sell With Owner Financing And Wrap A Due On Sale Loan?

Yes, but only if the buyer receives a CYA letter and signs it in front of an attorney and accepts the risk.

What If The Lender Calls The Loan?

1. You can sell the note for cash and pay off the lender.

2. You can negotiate with the lender and change their mind.

3. You can help your buyer get refinanced, even if not the full amount, and take back a second if necessary.

4. You can hire an attorney and sue the lender and probably force them to come to terms.

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Do I Sell With Owner Financing Or Lease Option To Tenant Buyer?

The following contains some guidelines to help you decide:

- If you own the property, you can do either. If you have lease optioned from seller your only exit should be sub-leasing or cashing out now.

- You'll get a bigger down payment from a sale than a deposit from a lease.

- If you own the property and lease it, you can depreciate it for a tax deduction. You can't depreciate a house you don't own. If depreciation is a concern, you'd be better off retaining ownership and leasing.

- If repossession takes more then a couple of months, you should strongly consider leasing instead of selling with owner financing. The harder it is to foreclose, the more reluctant you should be to transfer ownership. It's usually easier to evict than to foreclose.

- If your buyer does not have enough of a down payment to make you feel comfortable, (at least 10%), you may wish to lease until they do and then owner finance.

- If you have guaranteed the loan, you should lease and eliminate the risk of the lender calling the loan due, or you may sell with owner financing if you structure it correctly so you can sell the note to SMI if necessary to pay off the underlying debt.

- If you sell you'll lose appreciation, depreciation and probably long term capital gains, but you get no repairs, property taxes, insurance or vacancies to deal with.

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When Is It Best Not To Sell On A Wrap?

Let's assume you get a call from a seller who has a $200,000 house with a $160,000 first with a $1,588 payment that's four behind. He'll give you the house since it's vacant, his credit is shot, he's living with his mother and his wife divorced him. He wants $1,000.

You could wrap the house for about $200,000 and get a down payment and bring the first current and continue to make payments until you're cashed out.

Another alternative is much simpler, with no costly entanglements. Simply sell the house to a new buyer, get as much cash as possible, let them take over the first subject to and you take back a second for the balance.

Example

Sale	$200,000
Down	$ 20,000
1st Subject To	$160,000
2nd To You	$ 20,000

This works because the person you bought from had bad credit, so your responsibility to protect it doesn't exist and the underlying payment is so high you'd have difficulty creating a monthly spread on a wrap.

If you've made no promises and there's no long term benefit to wrap, it may be best to eliminate the collection hassle and get out.

How you construct the second is not important. It could be with no payments and a five year balloon. It's free money! You were really after the $20,000 down.

Don't forget the payments must be brought current from the proceeds.

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Qualifying Your Buyers

There are only a few things I care about when choosing my buyers. Great credit is not on that list. Good credit is not required; in fact, the lack of it is what will attract most buyers to you.

However, atrocious credit is a concern and you should not sell until you know what their credit looks like. A long history of evictions and/or foreclosures will eliminate your buyer, regardless of how big the down payment.

Nowadays, anyone can go to Freecreditreport.com and pull their own, or you can get your mortgage broker to do it for you for free.

The other considerations are:

1. Income—If they can't afford the payment, you shouldn't set them up to fail. Use a 50-50% total debt ratio as a gauge. Beyond that is almost certain default. Note this does not include items like insurance, food, recreation, medical bills and a long list of other monthly expenses. That's why a 50-55% cap is important. A home is not their only expense. Even then, you must apply common sense and a little math. Someone making $2,000 a month cannot afford a $1,000 house payment; therefore, 50% won't apply. Someone making $10,000 a month may afford a $3,000 payment, but only if their other fixed expenses are below $2,000, because after income taxes and non-fixed costs are added, it doesn't leave much to live on.

2. Down Payment—This is at the top of my list and the easiest qualifier. I will not sell for less than 10% down, and you can get much more than that on nice houses if you're patient. This is your front end profit center and the easiest money you'll make in real estate. Don't underestimate it. This is the number one qualifier.

3. Criminal Record—It's easy to get a report on your buyer to look for undisclosed issues, such as a criminal record. Use FindTheSeller.com or an investigative service for small money. You can't learn too much, and from there common sense will guide you.

4. Size Of Family And Pets—A family with 6 kids and four dogs can only mean the house will take a beating. You have to assume you'll get it back, so are you getting enough down to justify the risk?

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Your Next Step

- ☐ **Yes, I like this home!**
- ☐ **No, I'm not interested in this home. I'm forwarding this form and the application. Please call me with other homes you have available.**

It's **FREE**, **it's EASY** and there is **NO Obligation** to find out if we can work together to make this your home and all you have to do is fill in the blanks below and get the application(s) along with this form to our office right away! In most cases, you'll have an answer **TODAY!** What do you have to lose? Stop thinking about buying a new home and do it today. Your friends will be green with envy when you tell them you just got the deal of a lifetime on a new home and you didn't get hassled by a mortgage broker, Realtors, closing attorneys or anyone else. Our investors want to sell this home and will pull out all the stops (as long as they are legal, moral and ethical) to sell you this home **TODAY!**

Don't Snooze & Lose!

To get an answer today, we need to have the following information:

Your Name _____Phone # _____

1. How much money do you have as a down payment today? $_____
   (We can work with tax refunds, equity in other homes, bonuses, future settlements, retirement funds, 401K, etc. and we take personal property you may want to trade such as cars, boats, RV's, motorcycles, trucks, etc.)

2. What additional down payment funds will you have available throughout the year? $_____
   (i.e. tax refunds, bonus checks, 2nd job commission, insurance claims, lawsuit settlements, etc.)

3. What date do you want to move in? _____
4. What do you need your monthly payment to stay under? _____
5. Is your credit _____Good _____Fair _____Ugly Credit Score _____

Please complete the information requested above and return this note with your application/s.

You can return your application to us four ways.

1. Fax to us at 770-555-5555 (No cover sheet needed and if you do not have a fax, most grocery stores will send it for you) Please call us to verify we got all the pages.
2. Drop it off at our office. Please give us a call if you need direction tour office. We're located just 2 minutes from I-85 in the Carter Center office complex at 5555 **Jimmy Carter Blvd. Norcross, GA 55555.**
3. Mail it to us at the above address.
4. Call 770-555-5555 with the information.

Please be aware faxing is preferable because we accept applications on a 1st come 1st serve basis. We can usually let you know if your offer is accepted the same day we receive it.

Thank you so much for your interest in this home. We look forward to overcoming any obstacle standing in the way of you and your new home.

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Applicant Information Sheet

Primary Applicant (A) **Joint Application (B)**

Property Address: _____

Name: _____ Name: _____

D.O.B.: _____ D.O.B.: _____

S.S. No: _____ S.S. No.: _____

Drivers License No.: _____ Driver's License: _____

Home Phone: _____ Home Phone: _____

Street Address: _____ Street Address: _____

City: _____ City: _____

How Long At This Address: _____
(Month / Years)

EMPLOYMENT:

Employer's Name: _____ Employer's Name: _____

Employer's Address: _____ Employer's Address: _____

_____ _____

Work Phone: _____ Work Phone: _____

How Long On Present Job: _____ How Long On Present Job: _____

Gross Monthly Salary: _____ Gross Monthly Salary: _____

Other Monthly Income: _____ Other Monthly Salary: _____

Source: _____ Source: _____

By my signature below I hereby give my permission for the lender to investigate my credit and employment history and I authorize release of all credit related information to them.

_____
Signature

Date:_____

By my signature below I hereby give my permission for the lender to investigate my credit and employment history and I authorize release of all credit related information to them.

_____
Signature

Date:_____

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Buyer's Objections

How Do I Know You'll Make The Underlying Payment?

I'll have an escrow company collect yours and pay mine, so if you pay yours, mine will get paid. They'll send you a 1098 at year end.

What If I Can't Refinance By The Balloon Date?

We'll work it out based on your circumstances at the time and it will depend on how well you keep your promises between now and then.

Why Is The Late Penalty So High?

Do you intend to be late?

No!

Well then it shouldn't be an issue, should it?

What If The Bank Calls Your Loan Due?

There are several ways to resolve this issue, including getting you financed or I can sell your note to pay them off or simply persuade them to cease. I'll work it out, but you should know that it's a very remote possibility and frankly after we establish a track record of them accepting my payments, they have little or no real legal grounds to do so. However, it's still a possibility and there will be a disclosure to that effect at closing.

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Work Hard To Get Big Down Payments

The size of the down payment you collect will probably be the difference between a good and bad deal and will certainly dictate your cash flow.

If you give yourself plenty of time to make payments when you buy, your back is not against the wall to sell. If you can't get several months with no payments, you should prepare to make one or two to give yourself time to play the market.

Accepting the first buyer to come along to cover a payment can be a costly mistake and lead to bigger problems than you fixed.

Better To Have A Vacant House Than A Non-Paying Occupant.

If you accept small down payments, you **WILL** have to fix the problem later and you **WON'T** get paid as agreed.

Violate this rule and you're going to a seminar.

Here are some guidelines when buying to help you sell to the right buyers:

1. Stay away from the cheap stuff. Cheap houses means cheap, broke buyers. Buy at median price or above so you attract the best buyers with money.

2. No problem houses if you expect to attract money. Repairs may be okay, but odors in the neighborhoods, functionally obsolete houses, gas station next door, one bedroom or one bathroom houses, etc., are problems. If you are turned off, so will your buyers with money.

3. The nicer the house, the easier the sale and the higher the price, the more important this becomes.

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Helping Your Buyer Raise More Down Payment

Here are a few things you can discuss to get all you can on a down payment:

1. Do you have money in an IRA or 401K?

2. Can you get cash on your credit cards or credit line?

3. Can you borrow from family or friends?

4. Do you have anything to trade: car, truck, boat, RV, mobile home, stocks, bonds, gold, jewelry, time share, other real estate, motorcycle, receivables, inventory, script from your business, etc?

5. Are you getting a tax refund or any lump sum settlements?

6. Do you have a skill I may use to help you work off some down payment: roofer, plumber, carpet layer, other contractor, etc?

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Here's A Tip If You Accept Anything On Trade

You should not give a credit for full face value if you accept real or personal property on trade. You can't sell it for face value, so you're entitled to a discount. How much is up to your negotiating skills.

When taking real estate, you should have it appraised and give no more than 50% of the value of the equity, especially if you're taking over debt in the deal.

You have every right to make a profit on trade-ins and shouldn't feel bad about doing so. Remember, it's you that will liquidate it and usually the desire to buy a home is much more important to your buyer than equity in their asset.

What other seller do you know that will be this flexible and make it so easy to buy?

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Why Getting Big Monthly Payments Is Important

There's more than meets the eye that goes into a decision about when an incoming monthly payment is acceptable. Obviously, more is better and the larger the payment, the bigger the cash flow.

But the size of your receivable monthly will also determine the value of the note if you wish to cash out.

The interest rate you charge is irrelevant to a note buyer. What is critical to them:

- Size of monthly payment
- How many you want to sell
- Their investment to value
- Collateral quality
- Buyer's down payment

Let's say you're taking back a note. In one example, your incoming payment is $2,000 and the other example it's $1,500. Both have 240 payments remaining and the note buyer is looking for a 14% yield. Let's see how they compare.

Note Amount $200,000

N	I	PV	PMT
240	14%	$120,625	$1,500
240	14%	$160,833	$2,000

That's a $40,000 difference in today's cash, with only a $500 difference in payment.

To me, the large monthly payment is worth more that the interest rate. You can use a low rate to entice buyers, but the downside is you'll have to shorten the term to keep the payments high. That won't matter if you intend to sell off the note or if the buyer refinances in the short term, which you can insure if you add a balloon.

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Here's A Way To Lower The Payment For Your Buyer

Sometimes a buyer will have a big chunk of cash but want a lower payment than you can offer with a principal and interest payment with a normal amortization.

As long as you can cover the underlying payment and then some, it's irrelevant whether you're collecting principal and interest or just interest only or even if you're not collecting all the interest.

Let's say you're selling a $500,000 house with $50,000 down and receiving a $450,000 wrap at 8 ½% interest. At 30 years, the payment would be $3,460.11 P&I.

You have an underlying loan with a payment of $2,500 P&I. However, your buyer just can't live with a payment above $3,000 and you do some calculating and discover that even at interest only payments it would take $3,181.50 a month.

That's okay! Simply tell your buyer you'll do it at $450,000, 8 ½% with a $3,000 a month payment toward interest. That means he/she would have a $187.50 a month negative amortization and owe you more at the five year balloon than $450,000. Actually, the amount would be $461,250, which shouldn't be hard to sell.

This way, you didn't lower your rate to make the payment work. You did decrease your cash flow, but save a $50,000 down payment in the process.

Caution

You must be exempt from Dodd Frank 2010 to make this work. A negative amortization is not permitted.

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Should You Add A Balloon?

The answer is yes. Here's why:

1. If you don't add a balloon, your only exit from the note is to wait until the buyer refinances or sells.

2. If you add a balloon, you have leverage when it's due to call the full amount due and payable, or extend it with or without a fee.

3. Adding a balloon may increase the value of your note if you choose to sell it.

Caution

Whether buying or selling, nothing can be added to a mortgage, land contract or deed of trust unless it's disclosed in a purchase and sales agreement. This includes any special clauses, balloons, unusual late penalties, collection clauses, etc.

You must be exempt from the 2010 Dodd Frank legislation to add a balloon.

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Can We Wrap An ARM?

Yes you can! By applying common sense, you will simply have your attorney add language to your incoming mortgage that the payments will adjust the same amount and at the same time as the underlying loan.

This may be a little harder to sell your buyer, but certainly fixable if the objection arises.

You won't do the wrap unless you have a good monthly spread, so here are your choices:

1. Leave the buyers loan fixed and absorb the increase. It will eat at your spread, so you'd add a shorter balloon than normal, i.e. two or three years.

2. Cap the incoming payment to satisfy the buyer and add a provision the buyer will have a choice of absorbing any increase above the cap or six months after your outgoing payment exceeds the cap to pay off the entire balance.

3. Add a provision that any reduction in your monthly spread will be added to the purchase price at the same interest rate as the note so you collect it when you get cashed out.

Don't lose a good buyer just because you inherited an ARM. Fix it so the buyer is happy.

Don't worry about the language. That's your attorney's job. All you have to do is write down the agreed solution in your words and let the buyer initial and make sure your attorney understands your intent.

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Selling On A Wrap With A Split Note

Value	$150,000
Existing First "Subject To"	$ 90,000
Existing Second	$ 20,000
Give Seller	$ 10,000
Your Purchase Price	$120,000

<u>You Sell The Home:</u>

(And split the note so you don't lose the high ITV second.)

$159,000
$ 20,000 Down
$139,900 Wrap
$128,000 First (80% Of Value)
$11,900 Second

<u>You Sell One Note And Keep The Other:</u>

		$135,000
	X	91%
	=	$122,850
	-	$ 90,000 Underlying 1st
	-	$ 20,000 Underlying 2nd
	Net	$ 12,850
Down Payment From Buyer	+	$ 20,000
Note From Buyer	+	$ 11,900
Less Down Payment To Seller	-	$ 10,000
Net To You	=	$ 34,750

You can be in and out very quickly with no rehab to do or costly entanglements. Don't forget to try to discount the underlying loans before paying off if they are in default or seller carry back notes.

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How To Construct Second Mortgages To You To Help Your Buyer Afford The Payments

There are several things you can do to help your buyer reduce their payment when you're taking back a second and getting them a new loan for less than the sales price.

Example

You Sell	$200,000
Buyer's New Loan	$170,000
Down Payment	$ 10,000
2nd To You	$ 20,000

Your main objective is getting the $180,000 cash. The $20,000 second is a free gift, and if debt ratio or income will prevent your buyer from qualifying, you can get flexible on how you collect the $20,000.

1. *No payments with accruing interest and a balloon later.
2. *Partial interest payments with a balloon.
3. Delayed payments with interest accruing and P & I payments to begin in a year or two.
4. Take something in trade worth $20,000 or more. The lender will accept as down payment.
5. Let the buyer work off the note.

***Must be exempt from Dodd Frank.**

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What You Can Do With The Second Mortgages You Receive From Your Property Sales

Anytime you sell a house with owner financing and carry back a second, it should be free to you. That means you should have retrieved any cash you laid out and made a cash profit in addition. If that's not the case, there was a flaw in your deal. Most likely you paid too much for the house.

When you get these notes, there is nothing that says you have to sit back and collect payments. There are alternatives. Here are a few:

1. Trade the note for personal property, i.e.—car, truck, boat, R.V., mobile home, etc.

2. Put several notes together and trade a package for other real estate or trade one or two for the down payment on a house.

3. Use your notes for collateral in lieu of down payments to sellers who are more concerned about safety than cash up front.

4. Pay off some of your debts with your notes.

5. Pool your notes and borrow against them.

6. Offer a discount to the person making the payments to cash you out.

7. Add a note as boot to a buyer of one of your hard to sell properties.

8. Donate to charity for a tax "write off" of face value.

9. Give to your parents or children to help them build cash flow.

10. Get your buyer refinanced and cash out at full value.

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Hypothecation

This is a fancy word that simply means borrowing against receivables.

Instead of selling a note you receive, another option is to use it for collateral for a loan. How much you can borrow will depend on the quality of the note and your strength. The amount can range from 50-75% of the face value.

The lender will want a full package on the note, which you should have anyway, and it shouldn't take more than a few days to get the money.

This works well when you package several notes and it reduces the lender's risk if one defaults.

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Seller Financing Test II

1. Name three advantages of selling with owner financing.

   _____

   _____

   _____

2. If you sell on a wrap around a due on sale clause name two solutions if the loan is called due.

   _____

   _____

3. When is it best not to sell on a wrap?

   _____

4. What's the number one qualifier we discussed when prescreening a buyer with owner financing?

   _____

5. Name two ways to help your buyer get more down payment.

   _____ and _____

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6. Should you add a balloon to your incoming notes?

   _____

   Why? _____

7. If you wrap an ARM, name one way to satisfy a buyer's concern about increased payment.

   _____

8. Name two ways to construct an incoming second mortgage to help your buyer afford the total monthly payment.

   _____

   and _____

9. Name three things you can do with second mortgages you receive.

   _____

   _____

   _____

10. Define hypothecation.

    _____

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Calculating The Value Of A Balloon Note

Let's use our previous example of a $200,000 note with 240 payments left at $2,000 a month. That would put the interest rate at about 10 ½%.

Now, let's add a 5 year balloon and see what happens to the present value at a 14% yield.

It will take two calculations, one for the 59 payments and the other for the remaining present value of the balloon amount:

N	I	PV	PMT	FV
59	14%	$84,957	$2,000	

Calculate the balance due on the 60th payment:

N	I	PV	PMT
181	10 ½%	$181,343	$2,000

Now calculate the present value of a note due in 60 months with a $181,343 payoff and no payments until then:

N	I	PV	PMT	FV
60	14%	$90,418	$0	$181,343

Now if we add the present value of the 59 payments ($84,957) to the present value of the balloon in 60 months ($90,418) we get a total of $175,375 at a 14% yield.

In our previous example where we sold the whole note at the same yield without a balloon, the present value was only $160,833.

The sooner a note buyer gets back their money, the more the note is worth.

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What If I Don't Intend To Sell Off My Mortgage When I Sell A House With Owner Financing?

Split the note anyway. You never know what the future will hold, so you should structure the sale as if you may want to someday. This also gives you the freedom to creatively use the seconds and still keep the first.

If you later sell the note, you'll wind up giving away the top portion because the ITV (Investment To Value) will be too high.

It also helps lower the payment to your buyer if you elect to structure the second with very low or no payment to you.

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Figuring Monthly Payments On Escrowed Loans When Selling With Owner Financing

When you buy a house and take over a mortgage with taxes and insurance escrowed and then want to sell it on contract, you must collect the same amount for T & I as you're paying the existing lender. You cannot charge more. You're only a pass through.

Example

$100,000	Existing Loan
$ 950	PITI Payment
$ 800	Principle And Interest
$ 150	Taxes And Insurance

Now you want to sell on Land Contract for $130,000 with $15,000 down and take back $115,000 in payments. You decide 9.9% is a good rate and 30-year financing is normal. Get out your financial calculator and put in $115,000 PV (present value), 9.9% I (interest) 360 N, (number of months) and solve for payment (pmt). Your answer is $1,000.72.

But that's principal and interest, so you must add the same amount of taxes and insurance to the incoming payment as you're paying on the $100,000 underlying loan.

So $1,000.72 plus $150 gives you a total incoming payment of $1,150.72.

You Collect	$1,150.72
You Pay	$ 950.00
You Net	$ 200.72

Most sellers have paperwork showing the payment breakdown so you can see the amount paid into escrow. If they don't, simply look at their note to determine the principal and interest and subtract that from the amount the seller is paying. That's how much you must collect from your buyer.

If you don't have the note, any title company can produce a copy while doing a title search.

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Work For Equity

This is an exit strategy designed to sell a house in need of repairs at retail price allowing the owner occupant buyer to complete the repairs at his/her expense in exchange for some equity.

Example

$150,000	After Repaired Value
$ 15,000	Repairs needed if you do them. About $3,000 if buyer does them because they only need to buy materials since they're doing the work and they won't do the degree of repairs you would to retail.
$90,000	MAO
$70,000	Your Purchase Price ALL Cash

Your Exit Strategy

$100,000	Private Loan To Buy – (12% - Int. Only, $1,000 Mo.)
$ 15,000	Escrowed For Repairs
$ 70,000	Cash To Purchase
$ 15,000	Cash At Closing (Less Costs)

Sell On Lease Option Or Owner Financing, Work For Equity

$135,000	As Is
$ 5,000	Deposit Or Down Payment
$130,000	Due You At Closing Or Refi
$ 1,200	Rent To You

Results

1. You buy property with none of your own money.
2. You get $15,000 out of repair escrow as soon as tenant repairs house and $15,000 at purchase closing.
3. You get $5,000 from tenant up front with $1,200 first month's rent ($6,200). If you sell the same day you buy you keep the $1,200 because your first payment isn't due for 30 days.
4. You get $30,000 when tenant buys or refis ($130,000 - $100,000 private loan.)
5. Your monthly cash flow is about break-even if you add taxes and insurance.
6. You get future deposits if tenant defaults and possibly some free repairs.
7. You have no holding costs if you lease or sell quickly.
8. Most of the closing costs will pass to your buyer.
9. No contractors to jerk you around or create costly delay.
10. No repairs to do after the sale.
11. At least 50% more net profit.
12. You're freed up to do more houses because you don't have to repair or suffer delays.

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Net Profit Comparison Of Work For Equity To All Cash Sale Immediately

	All Cash Sale Now	Work For Equity
Sale Price	$150,000	$135,000
Purchase Price	--$ 70,000	--$ 70,000
Repairs	--$ 15,000	0*
Interest 6 mo.	--$ 6,000	0**
Misc. Costs	--$ 10,000	--$ 2,000***
Net Profit	$ 49,000	$ 63,000

* Tenant or buyer does repairs and buys materials

** You will pay interest on WFE but it's covered with rent or payment.

*** When holding an empty house you must pay taxes, insurance, utilities, maintenance and you'll pay more in advertising to find qualified buyer and more in closing costs when you deal with picky buyers.

Note

If you lease option for more than a year, you'll qualify for long term capital gains and pay half the taxes.

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Your Cash Flow Analysis Of Work For Equity Example

1. Loan closing	$15,000
2. Release of repair escrow	$15,000
3. Day you lease	$6,200 ($5,000 & $1,200 rent)
4. Day you cash out	$30,000
Total Cash	$66,200 (Less $2,000 in costs)

Cash Flow Analysis Of All Cash Now Deal

$49,000 the day of sale and not one dime any sooner.

Results – Over 30% more profit.

This doesn't include forfeited option deposits along the way which will add additional income. You can expect less than 50% of these buyers to actually cash you out.

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Work For Equity Program

Q & A

What are the qualifications? You must have the ability to complete repairs such as painting, installing cabinets, minor plumbing, replacing rotten wood, etc. You must also pay rent during this process and have credit and income suitable to acquire some kind of permanent financing. This doesn't mean your credit has to be good, but it does mean not everyone will get approved. Before you're considered for a Work for Equity home you'll know if this is a problem. Once you're approved for the Work for Equity program, you're automatically approved for permanent financing or our in house financing when the house is repaired unless your circumstances change due to loss of income or non-payment of your current obligations.

How do I pay for repairs? A list of repairs will be presented to you prior to any commitment from you. These will be the repairs needed for permanent funding. You may wish to do more than what is on this list, but the list must be completed first. You must fund the cost of the materials. You should have at least $500-$1,000 available to begin the process, in addition to the first month's rent. The repair list will be divided into a maximum of four phases. Each inspection will be done at your request after each phase is completed.

How long do I have to get the work completed? The time for repairs will be agreed upon on a case-by-case basis depending on the amount of repairs needed and your personal situation. No repair schedule will exceed three months and most are done in considerably less time.

When will I be given possession? Possession will be delivered immediately; however, the house may be flagged by a utilities company or condemned. In these cases, the house must be repaired before it can be inspected by the city and released for occupancy. The repairs will be your responsibility. We'll handle the inspection. You may not live in the home without prior consent from us and such consent will not be given until the repairs are completed or in some cases you may put up a deposit and live in the home while repaired if it doesn't require a city inspection before occupancy.

Please make sure you're clear on your occupancy rights. In a nutshell the property must be code compliant in all cases and you will have either completed the repairs before occupying or made arrangements to pay a deposit so you can move in while repairing.

We have no homes you can move in with no money or commitment on your part.

Utilities - You will be responsible for turning on utilities in your name. In those cases where the city must inspect first, we'll handle the details with your assistance.

How much equity will I get? The purchase price will be set up front allowing you more than adequate consideration for your participation. You'll receive a lot more equity in the home than what your labor would cost. The price will be well below the after repair value. The discount will be determined based on the degree of work the home needs. You must agree on the price in advance and all facts will be covered in detail and be in writing. No surprises!

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Who pays for insurance? We'll insure the dwelling until you become the owner. Our policy will not cover your contents but it will cover any renovations. You should insure your contents and in some cases you may be required to buy some liability insurance.

Who pays for taxes? We'll pay the taxes until you purchase the home.

How long will I have to purchase? That's a case-by-case answer. Some folks purchase right away, others take months. It depends on your needs and ability to get financing. Sometimes our buyers must live in the home for 6 – 12 months to show a pattern of prompt rent payments to the lender. Other times the loan process is started while the work is in progress. Sometimes we finance the home ourselves permanently and no other lenders are needed. We'll look at what your needs are and structure financing to suit. You'll know all these answers up front.

What if I do the repairs and can't get a loan? Our objective is to sell the home, not rent it long term. You live up to your agreement and complete the repairs and pay rent on time, you will be approved for permanent financing. Again, all these details will be discussed up front and agreed upon in writing by both parties. Since we own the homes, we're very flexible and willing to make it work.

If there's a big problem, we'll know it up front. Of course, we can't be responsible for your financial situation after you take possession of the house. A loss of income or future credit problems can prevent you from qualifying for a loan, but even then we'll help you work it out as long as you pay the rent and keep your promises.

What do I do next? If you haven't already, please fill out our short application and fax to us or call (904) XXX-XXXX. This is not necessary if we've taken your application over the phone.

Once you've found a home you like, call us immediately and let us know. Obviously, when we're offering homes that folks can buy cheap with very little money and built in financing, they don't take long to sell. Call now to ensure availability.

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A Good Plan When Offering Work For Equity

When advertising a house needing work you can offer it with an after repaired price or an as is price. If you make the gap between the two attractive enough it shouldn't be hard to attract someone capable and willing to do the work themselves.

Before renovating a house put it on the market "as is" while getting repair estimates. This can be done in most cases before you close the purchase.

The ideal situation is for you to close the purchase and the lease option or owner financing to your buyer on the same day. This frees you up to do a lot more deals and avoid costly entanglements.

If the house doesn't attract a buyer within a reasonable time (30 – 60 days) you can always rehab it after you've played the market.

Another option is to fix whatever is turning off your buyers and offer it on a WFE again at a higher price.

If you still don't get any takers caution is advised. At this point the problem may not be the repairs but something else about the house turning off buyers. Examples – location, too small, weird layout, etc.

You'd be well advised to find the real problem before renovating and discovering the house is still tough to move.

It costs nothing to offer all houses needing work on a WFE program. It may save you a lot of grief and make you a lot more money.

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Getting A Commitment

When you find the buyer you like, set an appointment for them to meet you at your office or another location of your choice to sign the Application Receipt Agreement. They should be instructed to bring the full down payment or as much as you can get.

When selling to a couple, be sure both parties are present so you can explain the terms and make sure all parties have a meeting of minds.

Explain the important points and allow the buyers as much time as they need to question you. When this process is complete there should be no questions unanswered and no loose ends left.

If you feel uncomfortable doing this yourself it would be advisable to hire an attorney to handle it for you. If you do, make sure you use an attorney of your choice who represents you.

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Checklist For Buyer Meeting For All Seller Financed or Lease Options

This meeting should not take place until you know how much the buyer has to put down and if you accept their credit and income. Here's a list to acquire and items to cover.

Things To Collect:

- Application And Receipt Agreement (executed)
- Pay check stubs
- Deposit check
- Purchase And Sale Agreement if you're ready

Things To Discuss:

- Down payment and ways to increase or trades
- Maximum monthly payment
- Interest rate and term (including balloon) if you can calculate onsite
- 30 day repair warranty or home warranty plan if you wish to offer
- Late penalty
- Any additional collateral or co-signors
- Underlying loan disclosure
- They must get insurance
- Closing procedure and time frame

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The Magic Agreement

The Application Receipt Agreement attached is a work of art I wish I had years ago. In a nutshell here's what it does…

- Allows you to take a deposit from a buyer and bind them to an agreement to purchase without you taking the house off the market.

It's simply an agreement to keep their deposit if you accept them and return it if you don't, but nowhere does it say you must sell them the house.

You can literally take several applicants at the same time and release all but the winner with no risk to you.

A purchase and sale agreement is then initialed only when you know it's a go, which will be just before or even at closing.

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APPLICATION RECEIPT AGREEMENT

A non-refundable application fee of $_____ and reservation/earnest money fee of $_____are required for processing the application, and is being paid herewith. This Application Receipt Agreement must be signed by all adults who will occupy the property before the Application can be considered by Management. The undersigned expressly agree that if Application is approved they herewith agree to purchase the property located at:

ADDRESS: _____, CITY: _____, STATE: _____, ZIP: _____

Applicant(s) further agree that if Applicant(s) are accepted by Management and then decide, for any reason, not to move into the premises, then all monies paid herewith shall be retained as liquidated damages since other prospective purchases may have been turned away and it will be necessary for Management to re-advertise the property and evaluate other applicants. Processing of Application shall be timely as possible and the results may be delivered via telephone, fax or mail. Once approved, Applicant(s) agree to pay the balance of funds and complete the paperwork within 48 hours, otherwise, Management will assume that Applicant(s) have decided to forfeit the reservation/earnest money payment and will begin re-marketing the property. If Applicant(s) are not approved, all monies given herewith, less application fee shown above, shall be returned to Applicant.

A PHOTOSTAT COPY OF MY (OUR) DRIVER'S LICENSE(S) OR PICTURE IDENTIFICATION CARD(S), SOCIAL SECURITY CARD(S), LATEST PAY CHECK STUB(S) AND LAST YEARS W-2(S) OR COPY(IES) OF LAST YEARS INCOME TAX RETURN(S) ARE ATTACHED TO THE APPLICATION [ ], OR WILL BE PROVIDED [ ]. I (we) declare that the Application is complete, true and correct and I (we) herewith give my (our) permission for anyone contacted to release the credit or personal information of any of the undersigned Applicant(s) to Management and their Authorized Agents, at any time, for the purposes of entering into and continuing to offer or collect on any agreement and/or credit extended. I (we) further authorize Management or their Authorized Agents to verify all application information including but not limited to contacting creditors, present or former landlords, employers and personal references, whether listed or not, at the time of the Application and at any time in the future, with regard to any agreement entered into with Management. Any false information will constitute grounds for rejection of the Application, or Management may be at any time immediately terminate any Agreement entered into in reliance upon misinformation given on the Application.

I/WE HAVE BEEN PROVIDED A COPY OF THIS APPLICATION RECIEPT AGREEMENT AND HEREWITH AGREE TO THE TERMS STATED HEREIN. ACCEPTANCE OF APPLICATION AND ANY MONIES HEREWITH ARE NOT BINDING UPON MANAGEMENT UNTIL APPLICATION IS APPROVED BY MANAGEMENT.

Signed: _____ Date: _____

Applicant (Print Name): _____ Social Security Number: _____

Signed: _____ Date: _____

Applicant (Print Name): _____ Social Security Number: _____

Do Not Write Below This Line – To Be Filled Out By Management

Receipt of $ _____ form Applicant(s) is herewith acknowledged.

_____, As Agent _____

Management Company Date

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Getting The Buyer To The Closing Table With Owner Financing

Step 1 - Get short application, Application Receipt Agreement and deposit from committed buyer, along with paycheck stub or other verification of income.

Step 2 - Have a mortgage broker pull a credit report or have the buyer pull their own. If your intention is to have the buyer refinance in the near future you should fax the application to a leader for his/her opinion and find out what LTV he/she feels will work and the time required before a refinance can be done.

If you don't care about a refinance, your own judgment will be all you need to proceed. The debt ratio should not exceed 50% or extreme caution is recommended.

Step 3 - If it's a go, your attorney should now complete Owner Financing docs based on your direction and you should review well before closing.

Step 4 - Arrange the closing for three or four days later, notify the buyer of the time and fax the info to your attorney. Tell the buyer to get insurance during this time and put them in touch with your attorney who will tell them what to bring. Make sure your buyer pays your attorney.

Step 5 - Follow up after closing to get your originals and a check from your attorney's escrow account for the balance of the down payment.

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When To Buy Insurance

You must buy a landlord's policy if you purchase and install a tenant buyer. But if you're selling with owner financing on any kind of an installment sale, that responsibility falls on your buyer.

You Cannot Insure A House You Don't Own

Your buyer must name your entity as a mortgagee as well as all underlying loans and their insurance company will send them notice.

Do Not Sell Until Buyer's Insurance Is In Place And The Premium Is Paid For A Year

The gap between buying and selling can only be filled two ways. Either the seller can leave it insured until you sell, or you can buy a policy.

If you have a claim during this interval and the seller's insurer finds out title has transferred, you may have a problem collecting and if you do collect it will require the seller's signature.

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Protect Yourself When Selling

Wraparound, Land Contracts, Trust Deeds

- Collection Clause – See next page
- Due on Sale – See next page
- Late penalty – See next page
- Have all buyers sign personally, no exceptions
- Get at least 10% down or additional collateral or Lease/Option until you do.
- Assignment of Rents – Provided by your closing agent

Lease Option

- Use good lease option agreement, protecting your interest (on Gold Club website-www.RonsGoldClub.com)
- Late penalty
- The deposit is non-refundable option fee, not a security deposit
- Do not make the lease recordable
- Option subject to the terms of the lease agreement being met. This language must be in the option agreement.
- Let your attorney close. Why?
    1. It's free to you. The buyer pays the fee.
    2. They do all the work.
    3. Less future problems.
    4. Great witness if needed.
    5. They'll keep you legal.

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Protection Clauses When Selling

Due On Sale Clause (Put In Mortgage)

Lender shall have the right at its option, to declare any indebtedness and obligations secured hereby irrespective of the maturity date specified in any note or agreement evidencing the same, due and payable within 30 days after such declaration if: (a) Borrower or any successor in interest to Borrower in such property sells, enters into a contract of sale, conveys or alienates such property, or any part thereof, or suffers his title or any interest therein to be divested, whether voluntarily or involuntarily, or leases such property, or any part thereof for a term of more than 3 years, or changes or permits to be changed the character or use of the property, or drills or extracts or enters into a lease for the drilling for or extracting of oil, gas or other hydrocarbon substance or any mineral of any kind or character on such property; or (b) Borrower is a partnership and the interest of a general partner is assigned or transferred; or (c) Borrower is a corporation and more than 25% of the corporation stock thereof is sold, transferred or assigned during a 12 month period; or (d) Borrower is a trust and there is a change of beneficial interest with respect to more than 25% of such property, or (e) Borrower has made any material misrepresentation or failed to disclose any material fact in those certain financial and other written representations and disclosures made by Borrower in order to induce Lender to enter into the transaction evidenced by the promissory note or notes or agreements which this mortgage secures.

Collection And Late Fee Clause (Put In All Incoming Notes Or Land Contracts)

If an installment called for under the terms of this note is not made within five (5) days after its due date, whether voluntary or involuntary, a late charge amounting to ten cents for each dollar or fraction thereof of said installment shall be paid by the makers. The makers hereof also agree to pay any and all set-up fees and collection charges and escrow account charges issued by any institution employed to collect and/or receive the payments due hereunder.

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Letter of
Agreement and Addendum

Concerning Purchase of _____

By _____ Date _____

I have been made aware that the existing loan on the property I am purchasing contains a due on sale clause which means the lender has the right to call the entire loan due upon transfer of the property to me.

I agree that if this should happen it will be my responsibility to either assume the loan or pay it off. If I am unable to do either or make arrangements with the lender I may lose the house to foreclosure.

If this should happen, I will hold the seller completely harmless for any loss that may occur.

_____ _____
Date Buyer's Signature

_____ _____
Date Buyer's Signature

Notice

Your attorney should prepare his/her version of this language and include it in the closing documents if you intend to sell with owner financing or simply deed the house to a new buyer leaving the existing loan in place.

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Paper Trust

Anytime you're selling a property or making a loan to a borrower, you should take ownership of that debt instrument in a paper trust. This applies to land contracts, unencumbered mortgages, promissory notes, single debt payments or tax liens.

This gives you the same protection as a land trust does for property ownership. Very simply, take title to the property in a land trust and take ownership of paper in a paper trust.

All you have to do is insert or have inserted the name of your trustee on the debt instrument in the slot where your name would normally be placed.

Do not try to explain the trust to the closing agent; it's none of their business. They don't need to see the trust agreement until it's time for you to satisfy the debt because you've been paid off. Even so, you'll rarely be asked to produce the trust.

In short…shut up and don't create problems stemming from their ignorance.

When you get home from the closing, fill out the trust agreement and file it in the property file.

This will create privacy of ownership and some degree of protection from creditors and predators. You name will not be on any public records as the owner of any easy to attach asset.

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TRUST AGREEMENT

THIS TRUST AGREEMENT is made this _____ day of _____, 20_____ by and between

_____, Grantors and Beneficiaries, (hereinafter collectively referred to as the "Beneficiaries") and

_____, Trustee of the _____ Trust, (hereinafter referred to as the "Trustee," which designation shall include all successor trustees).

WHEREAS, the Beneficiaries are about to convey or cause to be conveyed a certain note and mortgage to the Trustee and

WHEREAS, the Trustee has agreed to accept such conveyance and hold the note and mortgage in trust under the terms and conditions set forth below.

NOW, THEREFORE, the parties, intending to be legally bound hereby, agree as follows:

1. TITLE. The trust created by this instrument shall be known as the _____ Trust.

2. OBJECTS AND PURPOSES OF TRUST. The purpose of this trust is for the Trustee to take and hold title to the note and mortgage conveyed to the Trustee and to preserve the same until its sale or other disposition.

The Trustee shall not undertake any activity which is not strictly necessary to the attainment of the foregoing objects and purposes, nor shall the Trustee transact business within the meaning of applicable state law, or any other law, nor shall this Trust Agreement be deemed to be, or create or evidence the existence of a corporation, de facto or de jure, or a Massachusetts Trust, or any other type of business trust, or an association in the nature of a corporation, or a co-partnership or joint venture by or between the Trustee and the Beneficiaries, or by or between the Beneficiaries.

3. TRUST PROPERTY. The Beneficiaries are about to convey or cause to be conveyed to the Trustee in trust a certain note and mortgage as described more particularly in Schedule "A" attached hereto and made a part hereof. This property, together with any property later added to the trust, shall be designated as the "Trust Property". The Trustee will hold the Trust Property according to the terms and conditions of this Trust Agreement for the purposes, terms and conditions contained herein until such time as all of the Trust Property has been sold or otherwise conveyed, or until this trust has been terminated.

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4. POWERS AND DUTIES OF TRUSTEE. The Trustee shall have all of the powers allowed to him by the provisions of the state law governing this Trust (see Paragraph 18). The Trustee shall specifically have the power to make and execute contracts for the sale of the Trust Property, option agreements for the sale of the Trust Property and to otherwise dispose of the Trust Property as the Trustee shall be directed by the majority in interest of the Beneficiaries. In addition, the Trustee shall have the power to perform any act that the majority in interest direct the Trustee to perform. The Trustee shall exercise his powers only upon the written direction of a majority in interest of the Beneficiaries.

The Trustee shall have the duty to maintain an accurate record of the Beneficiaries of this Trust, which record shall include the names and addresses of the Beneficiaries and their respective interests in the Trust and be designated as Schedule "B". The Trustee shall only have such other duties as required in writing by a majority in interest of the Beneficiaries.

The Trustee shall not have the power to bind any of the Beneficiaries personally to any debt or obligation without the express written consent of the Beneficiary.

5. COMPENSATION OF TRUSTEE. The Trustee shall be compensated for his actions as Trustee according to the Schedule of Compensation set forth in Schedule "C" attached hereto and made a part hereof. The Trustee shall be promptly reimbursed by the Beneficiaries for the expenses incurred by the Trustee in the administration of the Trust. The Trustee shall have a lien on the Trust Property for any unpaid compensation or unreimbursed expenses.

The Trustee shall not be obligated to advance any money on account of this Trust. The Trustee shall not be obligated to commence any legal action or to defend against any legal action unless the Trustee, in his sole discretion, is satisfied with the security provided by the Beneficiaries for the payment of the Trustee's costs and expenses in connection with the litigation.

If the Trustee shall pay or incur any liability to pay any money on account of this Trust, or incur any liability to any money on account of being made a party to any litigation as a result of holding title to the Trust Property or otherwise in connection with this Trust, without regard to the cause of action asserted or complaint filed, the Beneficiaries, jointly and severally, agree that on demand they will pay to the Trustee all such payments or liabilities, his expenses incurred in connection therewith, including reasonable attorney's fees, and any other sums advanced by the Trustee on behalf of the Trust for any reason whatsoever. These amounts, if not immediately paid to the Trustee, shall bear interest at the rate of ten (10%) percent per annum until paid in full. These amounts and any compensation due to the Trustee, until paid in full to the Trustee, shall constitute a lien on the Trust Property. Further, as long as these amounts or any compensation due to the Trustee remain unpaid, the Trustee shall not have any obligation to take any action with regard to the Trust Property.

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6. LIABILITY OF TRUSTEE. The Trustee shall not be personally liable for any obligation of the Trust. No Beneficiary shall be able to bind the Trustee nor contract on his behalf without the Trustee's express written consent. The Trustee and any successor Trustee shall not be required to give a bond. Each Trustee is liable only for his own actions and then only as a result of his own gross negligence or bad faith.

7. REMOVAL OF TRUSTEE. A majority in interest of the Beneficiaries shall have the power to remove the Trustee from his office and appoint a successor to succeed him.

8. RESIGNATION AND SUCCESSOR. The Trustee may resign by giving written notice to each of the Beneficiaries of his intention to resign.

The majority in interest of the Beneficiaries shall have the power to elect a successor trustee. If the Beneficiaries have not elected a successor trustee within thirty (30) days of the date of the notice from the Trustee of his resignation, then the Trustee shall have the right to convey the Trust Property to the Beneficiaries in the same proportion as their interests in the Trust may appear at the time of said conveyance.

If the office of the Trustee shall become vacant for any reason, then the Beneficiaries shall proceed to elect a successor trustee. Said election shall occur within thirty (30) days of the occurrence of the vacancy. Upon election, the new Trustee shall cause to be prepared a certificate of his election containing a notice of election and his acceptance thereof in a form acceptable for recording in the office of the register of deeds of all of the counties in which the Trust Property is located. The certificate of election shall be filed in the office of the register of deeds of all of the counties in which the Trust Property is located.

A successor Trustee shall have all of the rights, duties and powers of the original Trustee as if the successor Trustee was the original Trustee.

The removal, resignation or death of the Trustee shall not affect the lien of the Trustee upon the Trust Property for compensation or expenses owed to the Trustee.

9. INCOME TAX RETURNS. The Trustee shall not be responsible for the preparation and/or filing of any tax returns which may be due for the reporting of income and expenses of the Trust, although he will sign such returns upon request. The Beneficiaries shall each individually report receipt of their respective share of the profits, earnings, avails and proceeds.

10. INDEMNIFICATION OF THE TRUSTEE. The Beneficiaries agree to indemnify, hold harmless and defend the Trustee from any and all liability incurred in his capacity as Trustee. If the Trustee shall pay or incur any liability to pay any money on account of this Trust, or incur any liability to any money on account of being made a party to any litigation as a result of holding title to the Trust Property or otherwise in connection with this Trust, without regard to the cause of action asserted or complaint filed, the Beneficiaries, jointly and severally, agree that on demand they will pay to the Trustee all such payments or liabilities, his expenses

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incurred in connection therewith, including reasonable attorney's sees, and any other sums advanced by the Trustee on behalf of the Trust for any reason whatsoever. These amounts, if not immediately paid to the Trustee, shall bear interest at the rate of ten (10%) percent per annum until paid in full. These amounts and any compensation due to the Trustee, until paid in full to the Trustee, shall constitute a lien on the Trust Property. Further, as long as these amounts or any compensation due to the Trustee remain unpaid, the Trustee shall not have any obligation to take any action with regard to the Trust Property.

11. DEALINGS WITH TRUSTEE. No party dealing with the Trustee, in relation to the Trust Property in any matter whatsoever, including, but not limited to, a party to whom the Trust Property or any part of it or any interest in it shall be conveyed, contracted to be sold, by the Trustee, shall be obligated to see to the application of any purchase many or money borrowed or otherwise advanced on the property; to see that the terms of this Trust Agreement have been complied with; to inquire into the authority, necessity or expediency of any act of the Trustee; or be privileged to inquire into any of the terms of this Trust Agreement Every contract, assignment of mortgage or other instrument executed by the Trustee in relation to the Trust Property shall be conclusive evidence in favor of every person claiming any right, title or interest under the Trust that at the time of its delivery the Trust crested under this Agreement was in full force and effect; and that the instrument was executed in accordance with the terms and conditions of this Agreement and all its amendments, if any, and is binding upon all Beneficiaries under it; that the Trustee was duly authorized and empowered to execute and deliver every such instrument; if a conveyance has been made to a successor or successors-in-trust, that the successor or successors have been appointed properly and are vested fully with all the title, estate, rights, powers, duties and obligations its, his or their predecessor in Trust.

12. BENEFICIARIES. The beneficiaries are the persons or legal entities identified, along with their respective interests, on Schedule "B" which is attached hereto and made a part hereof.

The beneficiaries are entitled to all of the profits, earnings, avails and proceeds of the Trust Property.

13. INTEREST OF BENEFICIARIES. The interests of the Beneficiaries shall consist solely of (a) the right to manage and control the Trust Property; (b) the right to direct the Trustee with regard to the disposition of the title to the Trust Property; and (c) the right to receive the profits, earnings, avails and proceeds from the sale or other disposition of the Trust Property.

The foregoing rights of the Beneficiaries are hereby declared to be personal property and may be assigned or otherwise transferred as such. The death of any Beneficiary shall not affect the existence of the Trust nor in any way diminish or alter the powers of the Trustee. No Beneficiary shall have any right, title or interest, whether legal or equitable, in the property which is held as Trust Property. No Beneficiary shall have the right to require partition of the Trust Property.

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The Beneficiaries shall not use the name of the Trustee for advertising or other publicity purposes without first obtaining the written consent of the Trustee.

The Beneficiaries shall be required to carry liability insurance in such forms and in such amounts as the Trustee, in his sole discretion, shall deem necessary to insure the Trust Property and the Trustee. If the Beneficiaries fail to obtain or maintain the required insurance policies, then the Trustee shall have the right, in his sole discretion, to advance the money necessary to pay for said insurance policies. The Beneficiaries will reimburse the Trustee for the insurance as set forth above in Paragraph 5.

No Beneficiary shall have right to bind or otherwise contract for any other Beneficiary except as provided for elsewhere under this Agreement.

14. ASSIGNMENT OF BENEFICIAL INTERESTS. The Beneficiaries have the right to assign any part or all of their interests under this Trust. No Assignment shall be valid or affect the interest of a Beneficiary hereunder until the original of the assignment shall be delivered to the Trustee and the Trustee's acceptance acknowledged thereon. The trustee shall revise and update Schedule "B" as necessary. Any assignment of the right to direct the Trustee by a person who is not a Beneficiary hereunder shall not be valid unless all of the Beneficiaries consent in writing to said assignment.

15. DISCLOSURES OF BENEFICIARIES. The Trustee and the Beneficiaries shall not disclose the identity of any Beneficiary without the written consent of said Beneficiary except as may be required by law or at the direction of an order of court issued by a court of competent jurisdiction. Any party who discloses the identity of a Beneficiary shall be personally liable for any and all losses and damages incurred by that Beneficiary as a result of the disclosure.

16. RECORDING OF AGREEMENT. This Trust Agreement shall not be placed of record in any jurisdiction. If this agreement is placed of record, then it shall not be notices of any interest which may affect the title or the powers of the Trustee.

17. ENTIRE AGREEMENT. This Trust Agreement contains the entire understanding between the parties hereto and may be amended, revoked or terminated only be written agreement signed by the Trustee and all of the Beneficiaries at the time of the amendment, revocation or termination.

18. GOVERNING LAW. This Agreement shall be governed by, construed and enforced in accordance with the laws of the State of _____. In the event that litigation shall rise between parties to this Agreement, then it is agreed that the losing parties shall reimburse the prevailing parties for all of those parties' reasonable attorney's fees, costs and expenses in addition to any other relief to which the prevailing parties may be entitled.

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19. BINDING EFFECT. This agreement shall be binding upon and inure to the benefit of the Trustee, any successor trustee, the Beneficiaries, and the Beneficiaries' successors, heirs, executors, administrators and assigns.

20. ANNUAL STATEMENTS. The Trustee shall be required to furnish annual statements to the Beneficiaries of the income and expenses of the Trust for each calendar year. The statements shall be provided to the Beneficiaries no later than March 1st of the following year.

21. PERPETUITIES. If any portion of the Trust Property is in any manner or time period capable of being held in this Trust for longer period of time than is permitted under the laws of the state law governing this Trust Agreement (See Paragraph 18), or the vesting of any interest under this Trust could possibly occur after the end of such permitted time period, then, upon the occurrence of the foregoing, the Trustee is directed to immediately terminate the Trust and to distribute the Trust Property to the Beneficiaries as their respective interests may appear at the time of the termination of the Trust. As much as possible, the Trustee will maintain the Trust Property intact and not liquidate it, but, rather, distribute the Trust Property in kind.

22. TERMINATION. This Trust may be terminated thirty (30) days or more after the date upon which all of the Beneficiaries agree in writing to said termination. The Beneficiaries shall immediately give the Trustee written notice of the effective date of termination. The Trustee shall execute any and all documents necessary to effectuate the transfer of the Trust Property to the Beneficiaries as their interests may appear.

23. NOTICE. Any notice that is given in connection with this Trust Agreement shall be given (a) to the Beneficiaries at the address set forth in Schedule "B" as shall be changed from time to time upon notice to the Trustee from the Beneficiaries; and (b) to the Trustee at such address as he may hereafter specify. The notice shall be deemed to be validly given if personally delivered or mailed to a person by first class mail, postage prepaid, at the above specified address.

24. DEFINITION OF MORTGAGE. The term "Mortgage" as used herein also includes any Trust Deed used to secure the lien of a trust-owned note against real property.

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IN WITNESS WHEREOF, we have executed this Trust Agreement on the day and year first above written.

WITNESS	BENEFICIARIES
_____	_____
_____	_____
_____	_____
_____	_____
	TRUSTEE:
_____	_____

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ACKNOWLEDGMENTS

State of _____

County of _____

Before me, the undersigned officer in and for said county and state, personally appeared _____, known to me (or satisfactorily proven) to be the person(s) whose name(s) (is) (are) subscribed to the foregoing instrument and acknowledged that (he) (she) (they) executed the same for the purposes contained therein.

IN WITNESS WHEREOF, I have hereunto set my hand and official seal this _____ day of _____, 20____.

_____
Notary Public

My Commission expires:

State of _____

County of _____

Before me, the undersigned officer in and for said county and state, personally appeared _____, known to me (or satisfactorily proven) to be the person(s) whose name(s) (is) (are) subscribed to the foregoing instrument and acknowledged that (he) (she) (they) executed the same for the purposes contained therein.

IN WITNESS WHEREOF, I have hereunto set my hand and official seal this _____ day of _____, 20____.

_____
Notary Public

My Commission expires:

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SCHEDULE "A"

The following is the legal description of the Trust Property contained in the foregoing Trust:

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SCHEDULE "B"

The following are all of the Beneficiaries who own all of the beneficial interest in the foregoing Trust:

Name	Address	Percentage of Interest
1.		

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SCHEDULE "C"

The Trustee will be compensated in the following manner:

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Buyer's Package You Should Collect For Your File

Here's a list of items to assemble before and after closing for your benefit and for anyone else you may want to sell the note to or borrow against or maybe trade:

1. The original note
2. Recorded mortgage, deed of trust or land contract
3. Credit report on buyer(s)
4. Application on buyer(s)
5. CYA letter from buyers(s)
6. Paycheck stubs or proof of income
7. Proof you collected the down payment
8. Appraisal (if you have one, comps if you don't)
9. Home inspection (if you have one)
10. WDO report (if you have one)
11. Survey (if you have one)
12. Title report
13. All other docs from closing
14. Buyer's insurance
15. Purchase agreement

Put these items in a package to a buyer or lender and their job will be easy.

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What Gets Recorded

Buying

You always want to make sure any mortgage, land contract or deed of trust gets recorded, along with the deed to you if applicable. This is not your concern if you close with an attorney, as you should. He/she will insist it's recorded right after closing.

Selling With Owner Financing

Recording a mortgage, deed of trust or land contract with a debt owed to you is required by most states and your attorney will insist on doing so.

Selling With A Lease Option

You never want a lease option agreement recorded to needlessly cloud your title. It should not contain a notary section or have room to add one so it can't be done without your knowledge.

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Collecting Payments And Maintaining Insurance Coverage

If you'll follow my plan of doing less to make more, you will not become a collection agent or need to write checks every month to make underlying payments.

There are companies that will do this for you if you'll let them and the buyer will pay the cost if you add my collection clause to their note.

Here's a list of companies that you can contact to do it for you:

- www.escrowserv.com
- www.noteservicingcenter.com
- www.sellerloans.com
- www.bankersescrow.com
- www.notecollection.com

They'll send the 1099 to your buyer and you and make sure the insurance doesn't lapse.

Make your buyer add your trust name as the insured, but use the collection company's address. The insurance company will send the notice to them if the policy is close to lapsing and they'll notify you to take action.

This is not applicable if your seller's loan has an escrow account, since the bank will make sure it stays enforced.

You must add the bank as first mortgagee and you as second so the bill goes to the bank and it gets paid. As long as you're making the payment, it will.

If the bank doesn't get evidence of insurance, they will force place a policy that will cost more and not cover you or your buyer.

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When an escrow account exists, you simply become a pass through for taxes and insurance. Don't worry about the paperwork, since any wraparound mortgage, All Inclusive Trust Deed (AITD) or land contract will contain language that allows you to collect 1/12 the taxes and insurance each month. You should verify the language is present.

Whatever the bank is collecting each month for taxes and insurance, you simply add to your principal and interest payment you collect. This number will change each year. When it does, you notify the buyer, unless your collection company will do it for you.

The rule is simple:

You Collect What You Pay!

Don't try to collect more. This is not a profit center.

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Tax Consequences Of Selling On Installments

If you own the property less than a year, you'll pay short term capital gains at your current tax bracket. Over a year gets you long term gains at 20% max bracket as of this writing.

You'll pay the taxes as you receive the profit.

Example

You buy a house for $150,000. How you buy is irrelevant.

You now sell for $200,000 with $20,000 down and wrap $180,000 with monthly payments.

Your capital gain is $50,000 ($200,000 minus $150,000). That's 25% of your sales price.

You'll be taxed on 25% of the $20,000 down payment in the year of the sale. Each principal payment you receive will be taxed only on 25% as they are received. You'll be taxed on 100% of the interest received and may deduct 100% of the interest you pay.

How much debt you owe when you buy the house or when you refinance does not define your taxable income. You're taxed on the difference between what you pay and what you sell for. If you depreciate along the way, it will be recaptured upon the sale.

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What Can Go Wrong When Selling With Owner Financing?

There are several things you should consider and do your best to prepare for prior to the sale. You'll never eliminate all the risk; you can only mitigate it and be ready if it's an issue.

1. The buyer can stop making payments.

2. The buyer can file bankruptcy.

3. The buyer could sue you for misrepresentation, fraud, something in the agreement, faulty equipment or building, or anything else they could conceive.

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Avoiding Defaults By Buyers You Owner Finance

The size of the buyers' down payment and their ability to pay is your only insurance against default.

The minimum down payment you should take on any sale you owner finance is 10%. It's usually not hard to get considerably more. The better quality house, the easier time you'll have getting larger down payments.

If you find a buyer you like who doesn't have enough down to make you feel comfortable, simply take what they have and lease option to them until they pay in the balance.

The longer it takes to foreclose in your state, the more this rule becomes important.

If it takes more than 90 days, use Lease/Option or use a technique below to help insure you'll collect.

- Additional collateral—Does the seller have other property he can add to your collateral?
- Personal guarantee by parents or friend.
- Personal or real property to trade for all or part of the down payment.

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Handling Defaults From Owner Financed Buyers

1. When the payment is 5 days late send out a late notice immediately adding the late penalty. (Get your collection service to do it for you.)

2. After 15 days late have your attorney send a default notice.

3. After 30 days late have your attorney file foreclosure.

All costs must be made up by the buyer to reinstate the loan. You must get their attention quickly and set a pattern of fair but firm rules.

If you see you're not going to get paid it's time to contact the buyer to make arrangements for them to deed the house back to you and move.

Again, it's cheaper to buy them out than foreclose them out.

Be sure to do a title check before taking a deed in lieu of foreclosure to insure no liens have been filed against your buyer that may attach to the house.

Have your attorney prepare the deed in lieu to insure it's done properly.

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What If My Buyer Files Bankruptcy

If your buyer files bankruptcy, there's nothing to do but tell your attorney. This will stop incoming payments. It's likely the bankruptcy will name the underlying lender, which will also stop your outgoing payment until it's resolved, and the lender cannot foreclose if the owner (your buyer) is in bankruptcy. In any case, you should be preparing to bring the lender current when the bankruptcy is over. If it's a Chapter 7, you'll get the property back at foreclosure when the court clears the way. If it's a Chapter 13, the court will order the debtor to make payments at some time. If they don't, you can move toward sale.

In either case, the underlying will be several months in arrears and it will consume a lot of equity. Therefore, a smart investor will build an escrow fund to provide for bad debt so if and when the time comes, you'll be prepared and not lose the house.

Bankruptcy is the biggest risk to any lender and a cost of doing business. There is no way to sell with owner financing and eliminate the risk.

If you feel your buyer is going to file, the best strategy is to buy them out before they do. Even if it costs you $5,000, $10,000, or more, it's cheaper than a bankruptcy.

Every case will be different and each state has its own rules, so your attorney will guide you through it and do all the paperwork. Don't even think about navigating a bankruptcy without good legal advice.

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What If My Buyer Sues?

The risk of being sued goes along with any business, including real estate. The only thing you can do is the best you can to prevent it going in and prepare for it if it happens anywhere along the way.

If you do everything you say, live a good life with a gentle heart and treat others as you want to be treated, you still may get sued…or you may have to sue.

Litigation Is A Business Tool

No one likes it, except attorneys, but it's part of our society and sometimes becomes a reality.

Here's all you can do to prevent being sued:

1. Don't make promises you can't keep.

2. Get everything in writing on rock solid contracts.

3. Use the best lawyer you can't afford.

4. Go over everything that can go wrong with your attorney and add provisions in your agreements to prevent it and/or resolve if possible.

If you get sued, you do not answer it or have communication with the other party. Turn it over to your lawyer immediately and let him/her advise you.

Any action you take other than this can jeopardize your position.

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Traps To Avoid When Buying And Selling In Your IRA

You should learn the rules and get help to avoid costly errors here. We'll discuss some areas of concern.

Buying And Selling

If you take over debt subject to and sell with owner financing, it will trigger UBIT (Unrelated Business Income Tax). This means you will get taxed on the gain. The same holds true if you buy on a wrap, even if the note is not personally guaranteed and your IRA cannot guarantee debt.

However, the new rule as of 2010 is if the underlying debt is paid off for a year before you cash out, it will not trigger UBIT.

Even if you pay taxes on a gain, remember the remaining profits grow tax free for the rest of your life.

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Seller Financing
Mistakes To Avoid

Here's a list of items you could scan when buying and selling:

Buying

1. Don't put out more cash than you get from a buyer's down payment.

2. Don't agree to payments that kill your cash flow. Work hard to reduce them.

3. Don't personally guarantee debt.

4. Always close with your attorney and let him/her prepare the docs.

5. Any deed or other document to be escrowed must be held with an escrow agent or your attorney, not sellers.

6. Never pay a seller more than a small deposit directly. Funds should go in your attorney's escrow account.

7. Don't pay too much just because the seller will finance. Get free equity.

8. Don't forget to check my clauses to add to your offer.

9. Don't make any promises that would prevent you from selling with owner financing, i.e., when you'll pay off the debt, due on sale clause.

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Selling

1. Work to get large down payments and high monthly payments.

2. Add a balloon, 5 year minimum.

3. Get personal guarantee and/or co-signers.

4. Try for additional collateral.

5. Always let your attorney close.

6. Take title in a paper trust.

7. Don't take the first applicant. Play the market until you're satisfied. Check them out.

8. Let a professional collect payments.

9. Get help structuring the note if you intend to sell it.

10. Don't waste good buyers because you're not flexible enough to help them with payments they can afford and raising down payments.

11. Be sure to add collection clause.

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Seller Financing Test III

1. When you sell on a wrap and are trying to determine the total PITI incoming payment, where do you find out how much to collect for taxes and insurance?

   _____

2. Name two advantages of a Work For Equity sale.

   _____

3. What should you be doing during the first 30 days incase a WFE buyer doesn't appear?

   _____

4. Name two items you should collect at a buyer's meeting:

   _____ and _____

5. Name two things you should discuss at a buyer's meeting:

   _____ and _____

6. What agreement should you get the buyer to sign when collecting a deposit?

   _____

7. When is it okay to close your own sale?

   _____

8. Who buys insurance when you sell with owner financing?

   _____

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9. Who must be named on the policy besides the owner?

_____

10. Name two important items you should have added to your closing docs that won't get added unless you see to it.

_____ and _____

11. What important disclosure should be in your sales package and signed by the buyer?

_____ Letter

12. How do you take title to a receivable?

_____

13. When should a land contract get recorded?

_____

14. Who should collect incoming payments?

_____ your spouse

_____ your lawyer

_____ a collection service

15. What should you do if a buyer defaults?

_____

16. Name the three most important things you learned here. (You can't miss this one.)

_____

_____

_____

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Seller Financing Test I Answers

1. Name three advantages of buying with seller financing.

   Lower rates and payments when buying.

   Doesn't show on your credit report.

   Can close quickly buying and selling.

2. Name one reason to do a wrap around an underlying loan of the same amount.

   So the seller can make sure the underlying note gets paid to protect their credit.

3. What are the three basic tools (financing documents) used to buy or sell with owner financing?

   Wraparound Mortgage

   Land Contract

   Deed Of **Trust**

4. What's the best kind of seller financing?

   No interest, no payments.

5. What are the two main ingredients you should focus on when buying with seller financing?

   Low down payments and **low monthly payments.**

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6. Name two ways to raise down payments other than writing a check:

   Subordination and **selling part of a note to seller.**

7. What is subordination?

   When a seller agrees to take back a second mortgage and allow you to get a new first without paying them off.

8. What is substitution of collateral?

   The mortgagee allows you to transfer your mortgage from one property to another (a transfer of collateral).

9. When buying a house with small equity, what's the key ingredient we discussed that should influence your decision to do so?

   Payment on underlying mortgage.

10. Define a real estate dealer.

    Anyone who buys with the intent to resell.

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Seller Financing Test II Answers

1. Name three advantages of selling with owner financing.

   Minimal qualifying.

   Quicker than conventional financing.

   Easy to attract prospects.

2. If you sell on a wrap around a due on sale clause name two solutions if the loan is called due.

   Sell the note for cash and pay off the lender.

   Negotiate with lender and change their mind.

3. When is it best not to sell on a wrap?

   When there's little or no monthly spread or equity left in the note.

4. What's the number one qualifier we discussed when prescreening a buyer with owner financing?

   Down payment or income.

5. Name two ways to help your buyer get more down payment.

   Trade and **borrow from family/friends.**

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6. Should you add a balloon to your incoming notes?

   Yes.

   Why? **You have leverage when it's due; increase the value of your note.**

7. If you wrap an ARM, name one way to satisfy a buyer's concern about increased payment.

   Cap the incoming payment and add a balloon to protect yourself.

8. Name two ways to construct an incoming second mortgage to help your buyer afford the total monthly payment.

   No payments with accruing interest and a balloon later and **partial interest payments with a balloon.**

9. Name three things you can do with second mortgages you receive.

   Trade the note for personal property.

   Use as collateral.

   Pay off some of your debts with your notes.

10. Define hypothecation.

    Borrowing against receivables.

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Seller Financing Test III Answers

1. When you sell on a wrap and are trying to determine the total PITI incoming payment, where do you find out how much too collect for taxes and insurance?

   The sellers note or bank statement.

2. Name two advantages of a Work For Equity sale.

   No repairs to do after the sale, at least 50% more net profit.

3. What should you be doing during the first 30 days in case a WFE buyer doesn't appear?

   Put on market "as-is" while getting repair estimates.

4. Name two items you should collect at a buyer's meeting:

   Pay check stubs and **Application and Receipt Agreement.**

5. Name two things you should discuss at a buyer's meeting:

   Down payment and **increasing monthly payment.**

6. What agreement should you get the buyer to sign when collecting a deposit?

   Application Receipt Agreement.

7. When is it okay to close your own sale and not use an attorney?

   NEVER.

8. Who buys insurance when you sell with owner financing?

   Buyer.

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9. Who must be named on the policy besides the owner?

Your entity.

10. Name two important items you should have added to your closing docs that won't get added unless you see to it.

Collection clause and **high late fee.**

11. What important disclosure should be in your sales package and signed by the buyer?

CYA Letter.

12. How do you take title to a receivable?

Paper Trust.

13. When should a land contract get recorded?

Always.

14. Who should collect incoming payments?

_____ your spouse

_____ your lawyer

__**X**__ a collection service

15. What should you do if a buyer defaults?

Buy them out or foreclose them out.

16. Name the three most important things you learned here. (You can't miss this one.)

_____

_____

_____

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Resource Section

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Resources

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Ron LeGrand's Gold Club Membership – Through this exclusive membership, you'll have access to countless investor resources including everything from the latest articles on money-making techniques in real estate and on the internet to eye-opening case studies. It'll also give you access to the best resource of all, me.

Eagle VA– Ron's own Virtual Assistant service to help you run your Real Estate investing business.

LeGrandYellowLetters.com– Yellow Letters are the best way to get sellers to call you about their homes.

PATLive.com/signup/Ron – Your 24 hour answering service to take your calls and fill in information sheet for you and they will email to you as they receive them.

Consulting With Ron LeGrand – One day consulting with Ron LeGrand

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Useful Websites and Contacts

Rentometer.com—find rental rates and lots of other useful info

TLO.com—background checks cheap

MyFICO.com, **annualcreditreport.com**, **creditkarma.com**—sites for free credit reports

Wholesalebannerz.com—banners

Callfire.com—text 3¢ each

Evernote.com—$456 one time fee, take pictures of license plate and enter and get full report on owner and if car is stolen

Escrow Service Inc.—800-654-7870

Escrowserv.com—$50 set up, $15 a month to collect rent or payments and pay underlying nation wide

Escrow Specialists, Inc.—800-427-8698, escrow specialists.com—same service

Insurance for landlords, cheap—**Chuck Jurgens** 919-880-0101

C Mobile/app—sends you new craigslist ads

Homesnap/app— take picture of house at site and it tells you all the information about it instantly

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What states have tenants by the entirety ownership?

States that allow legally married couples to own property as "tenants by the entirety," a type of joint ownership that offers protection from creditors:

Alaska
Arkansas
Delaware
District of Columbia
Florida
Hawaii
Maryland
Massachusetts
Mississippi
Missouri
New Jersey
Mississippi
Oklahoma
Pennsylvania
Rhode Island
Tennessee
Vermont
Virginia
Tennessee
Wyoming

States that allow tenancy by entirety for real estate only:

Illinois
Indiana
Kentucky
Michigan
New York
North Carolina
Oregon

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Ron LeGrand's
Gold Club Membership

Our Virtual Assistants are fully trained on completing Property Information Sheets, whether from finding & calling FSBOs or from other marketing campaigns (yellow letters, ads, signs, etc.). We can also place your online ads, screen buyer calls, and many other tasks to save you more time to close your deals.

✓ *Yes, sign me up!* **I understand I'll get will be charged a one-time set-up fee of $500 if I elect the G*old Elite VA* or the *Gold Plus VA* membership levels.**

❒ BEST DEAL: Gold Elite VA

Includes All Gold & Gold Plus Benefits Plus…

- Includes up to 40 hours of VA service
- We'll Call FSBOs and Run Your Office
- E-mail Real Estate Deal Hotline
- Ron LeGrand's Automatic Lead Service

❒ $997 Per Month

1st County_____2nd County_____

❒ GOOD DEAL: Gold Plus VA

Includes All Gold & Gold Plus Benefits Plus…

- Includes up to 20 hours of VA service
- We'll Call FSBOs For You
- Ron LeGrand's Automatic Lead Service

❒ $497 Per Month

1st County_____2nd County_____

❒ Gold Plus Membership

Includes All Gold Club Benefit Plus...

- Ron LeGrand's Automatic Lead Service

❒ Pay in Full 1 Year - $1,067 (1 free month)
❒ Pay Monthly - $97 monthly
❒ You receive your choice of 2 Counties for Ron's Automatic Lead Service Select;

1st County_____2nd County_____

❒ Gold Club Membership

- Gold Club Membership Website
- Ron LeGrand's Lesson Videos
- Webinars & Events: Calendar and Mailings
- Open Line Monday Q & A Calls with Ron
- The Gold Club Weekly Report
- The Mentor Newsletter

❒ Pay in Full 1 Year - $649 (1 free month)
❒ Pay Monthly - $59 monthly

Name:_____ Master /Mentor_____**Y or N**_____VA Start Date:_____

Address:_____

City: _____State: _____ Zip: _____ Phone: (_____) _____

Fax: (_____) _____ Email :_____

Payment - Please charge the following credit card as indicated above: Set-up Fee $_____ $_____Per Month

Card #_____ Exp. Date: _____

Name on card: _____ Billing Address: _____

I have read and understand the terms and conditions on the reverse side and authorize the charges referenced above.

Signature (Required): _____ Date:

Please Note: *Your credit card statement should reflect a purchase from* ***RONLEGRANDTRAINING.COM***

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Terms of Agreement – Gold Club Members, LLC (d.b.a. Eagle Virtual Assistant Services) and its assistants, also referred to as "Virtual Assistants" or "VA", agrees to provide professional virtual assistance as outlined on the specific membership level indicated on the front side of this order form. By engaging in this contract, Client agrees to the contract terms of **12 Months** continuous services beginning at execution of this agreement. At the conclusion of the 12 Month term, this agreement will automatically renew for an additional term of **12 Months** unless Client notifies otherwise per the normal course of membership cancelation outlined elsewhere on this agreement. The monthly billing will begin upon acceptance of a VA and continue until client cancels agreement. If client does not accept a VA offered by company within 45 days the set-up fee will be forfeited and this agreement void.

Services/Rates – Gold Club Members, LLC (d.b.a. Eagle Virtual Assistant Service)s offers a variety of services including researching and calling: FSBOs, Craigslist ads, yellow letters & buyer calls. Other services include answering calls, appointment setting, quality control follow ups, database updates, ad placements, and other real estate business support. The exact services offered to Client are dependent on the level of membership elected via this order form, the Client's active participation in marketing the methods taught by Ron LeGrand, and the Client's active role in guiding their assigned VAs in the types of services they require for their individual needs.

All services will be billed in advance based on the membership level elected. Setup Fees and Monthly Membership rates billed are noted on the membership level elected on this order form. The Rates of Service beyond what is included in the election of membership level through the completion of this order form will be as follows: Client agrees that all usage of VA service time beyond the monthly service cap for Client's membership level time will be billed in hourly increments of **$21.00/hour ($.35/minute)** to the credit card on file on which the monthly service charges are billed. Engagement in this contract is agreement that services provided are authorized to be billed as described.

Cancellation – Gold Club Members, LLC (d.b.a. Eagle Virtual Assistant Services) offers a compelling list of benefits, but should Client wish to discontinue services for any reason, we offer a generous cancellation policy. Client may terminate this agreement at any time within the 12-Month term by providing a one-week (7 days) prior written notice given by return receipt requested via email to: **clientservices@eaglevirtualassistants.com** or providing the same written notice with fax confirmation via fax to **904-407-3960.**

Client agrees that any setup fees, applicable as noted by the membership level elected on this order form, are *non-refundable* beyond a 3-day grace period, for any reason. Client also acknowledges that non-receipt of VA Services is not a condition for refund of monthly membership fees and that due to the 12-Month term of this agreement, no refunds will be given for any monthly membership fees incurred, even once cancellation is made. Client agrees and acknowledges that cancelations received by Eagle Virtual Assistant Services are terminations for *future* services and billings and will not be retroacted or prorated into refunds for *previous* billings incurred.

Additional Terms and Conditions – By engaging in this agreement, Client acknowledges that Gold Club Members, LLC (d.b.a. Eagle Virtual Assistant Services) and its staff does not function as Client's real estate broker, personal accountant, attorney or financial advisor. If Client has a tax or legal question, they will seek the advice of an accountant, attorney, financial advisor or real estate broker. Client is responsible for Client's actions and hereby releases Gold Club Members, LLC (d.b.a. Eagle Virtual Assistant Services) and any of its staff, employees, officers or affiliates from liability for any of Client's actions or comments that may be influenced by the information contained in products and services received through this or any other products, services, or affiliations. From this day forward, Client assumes full responsibility for Client's personal, physical, emotional and financial well-being.

Providing the information on the other side of this form gives Global Publishing, Inc. permission to communicate with Client via fax, email, or phone to relay special offers, announcements and/or information that Client may need and/or find valuable in Client's business.

By my signature below, I accept under this agreement given to me that I have a duty to read and understand the terms and conditions as set forth above and have done so, including but not limited to the cancelation/refund policy and procedures. I attest to this duty by my signature below that I accept and execute this document as set forth. Furthermore, I understand and accept that I am prevented from using lack of reading as a defense against all remedies so contained herein.

_____	_____	_____
Client's Signature	Client's Printed Name	Date

Gold Club Members, LLC.
9799 Old St Augustine Rd. Jacksonville, FL 32257 ·
Toll Free Phone: 1-888-840-8389 (904-262-0491) · Toll Free Fax: 1-888-840-8385 (904-262-1464)
www.RonLeGrand.com®

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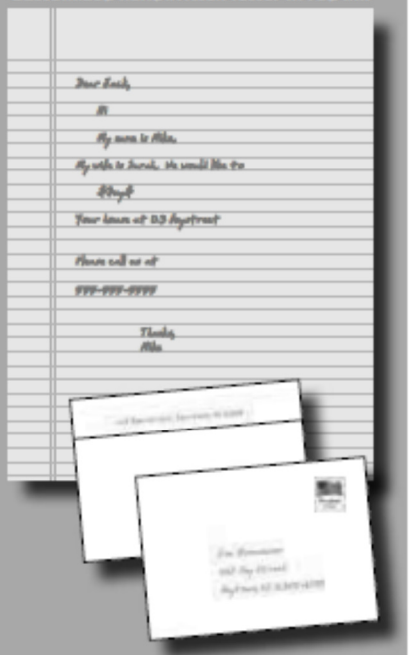
REAL ESTATE INVESTMENT YELLOW LETTER MARKETING

Customized handwritten letter in red ink



Invitation A7 envelope
with handwritten red addressing
and 1st Class commemorative stamp

Receive a 15-30% response rate with this "handwritten" letter from AMG!

We will print, address and ship your letters to you to drop in your mailbox as needed.

Most successful real estate investors drop 250 letters per week. Real estate investors with a high performance team drop 500+ per week or more.

Program Description

- Yellow letter paper
- Red handwriting on letter
- Invitation sized envelope
- Red handwritten return address on flap
- Hand stuffed with flap tucked in and unsealed for 100% open rate
- Red handwritten addressing on front side of envelope
- First Class Commemorative stamp applied to envelope
- Shipped directly to real estate investor that placed the order

Unsealed envelopes results in a 100% open rate!!

This program was developed and is copyright protected by Ron LeGrand. Allegiant Marketing Group has been endorsed by Ron LeGrand to fulfill your yellow letter mail campaign.

Ron LeGrand®

Millionaire maker Ron LeGrand backs his advice with 30 years and millions of dollars of hands-on experience.

Go To: www.LeGrandYellowLetters.com
Orderform on back!

LeGrand®
Yellow Letters

1-888-711-5185
Ask for Eric Weisgarber or
his assistant Chris Fleming

www.LeGrandYellowLetters.com

Yellow Letter Campaign V2 NP0813

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Fax this form to 1-888-256-3131 to get started today!

ORDER FORM

REAL ESTATE INVESTMENT YELLOW LETTER MARKETING

LeGrand® Yellow Letters

1-888-711-5185
Ask for Eric Weisgarber or his assistant Chris Fleming
www.LeGrandYellowLetters.com

Company Name: _____

Name: _____

Phone Number: _____

eMail address: _____

SHIPPING ADDRESS:

Street: _____

City: _____

State: _____ Zip: _____

BILLING ADDRESS: ☐ Check if same as shipping

Street: _____

City: _____

State: _____ Zip: _____

☐ Check by Fax (Fax copy of check to 1-800-391-7437)

CREDIT CARD AUTHORIZATION FOR $_____

☐ I hereby authorize Allegiant Marketing Group, Inc to charge my creditcard the above amount for products and services.

☐ Visa ☐ Mastercard

Name on Card: _____

Credit Card Number: _____

CVS Code: _____

Expiration Date: _____

Date: _____

Signature: _____

Fax this form to 1-888-256-3131 to get started today!

Quantity

Includes red variable print on yellow paper, postage, list, and shipping.

☐ 1,000 (minimum order) ☐ 2,500
☐ 5,000 ☐ 10,000

Filters

We will run counts for you. Purchase a list or supply your own. You may mix your lists from the list below for $1.25 per mailpiece.

☐ 2004-2007 Mortgage Origination Dates (with home values $200-500K)
Quantity: _____

☐ Absentee Owner Lead List
Quantity: _____

☐ Free and Clear Lead List (Properties that have 91-100% Equity)
Quantity: _____

Mail Piece Information

Zip Codes/Counties requested in order of preference:

_____

_____

_____

This letter is from: _____

Spouse? ☐ No ☐ Yes Name: _____

Phone number inside letter: _____

Return address on envelope

Street: _____

City: _____

State: _____ Zip: _____

Campaign Name: _____

To inquire about additional lists, contact Eric Weisgarber or his assistant Chris Fleming.

- Non-Owner Occupied Properties
- Divorce
- Probate
- Pre-Foreclosure
- Homeowners and Financial Distress List
- Auto Loans
- Home Equity Loans
- Taxes
- Credit Cards
- Over Mortgaged

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Ron LeGrand - PATLive
Live Receptionist Application

How PATLive's live answer service can help you:

PATLive's highly-trained Live Receptionists will answer all of your calls 24/7/365 according to your custom scripts. They will pre-qualify your leads, answer FAQ's and save you money and valuable time!

PATLive has answered calls for Ron and his students since 1995:

"PATLive helped me solve the age-old problems my students had: talking to unmotivated sellers and taking incoming calls while trying to work. PATLive's service is the difference between success and failure, and is a godsend to the art of prescreening."

– Ron LeGrand

Ron's Recommended Package

❒ $149.95 Monthly Fee

- Includes 250 live answer minutes per month
- Includes up to 5 local or toll-free numbers
- $149.95 one-time setup fee
- $0.95 per additional Live Receptionist minute

Unlimited Package

❒ $2,995 One-Time Annual Fee

- Unlimited Live Receptionist minutes
- Best deal for higher volume users
- Fair usage rules apply*

Additional Unlimited Package Information:

* Please note that PATLive reserves the right to adjust our agreement with you, at any time, should your advertising produce extremely high call volumes (i.e. running widespread TV or radio ads) and prevents PATLive from serving all of its customers with high service levels.

Once your PATLive unlimited service has completed its 1-year term, your account will be converted to PATLive's standard monthly service: $149.95 per month for 250 Live Receptionist minutes, $0.95 each add'l minute.

Sample Script Questions: SELLER CALL

If not using a Virtual Assistant:

1) May I get your name please?
2) Your phone number including the area code?
3) What do you think your house will appraise for?
4) What are you asking for the house?
5) What do you owe on the house?
6) How did you hear about us?
7) What's the address?
8) When do you want to move?
9) Are your payments current or behind?
10) Does the house need any repairs?

If using a Virtual Assistant:

1) Do you have a house for sale?
2) What is your phone #? Cell phone #?
3) What is the address?
4) What is the best time to reach you?

Sample Script Questions: BUYER CALL

If not using a Virtual Assistant:

1) May I get your name please?
2) Your phone number including the area code?
3) In which area are you looking to buy a home?
4) How many bedrooms and baths would you like?
5) What is the maximum monthly payment that you can afford?
6) How much money do you have for the down payment?
7) Are you ready to buy now?
8) How soon are you looking to move?
9) Is your credit good, fair or ugly?

If using a Virtual Assistant:

1) Are you interested in buying a house?
2) What is your phone #? Cell phone #?
3) What is the best time to reach you?

Cedars Bldg B, Suite 200 · 2639 N. Monroe St. · Tallahassee, FL 32303
800.775.7790 · Fax 800.800.6126 · pat@patlive.com · www.patlive.com

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Ron LeGrand - PATLive
Live Receptionist Application

Customer Information:

Subscriber Name _____ **SS/Fed ID #** _____

Mailing Address _____

City _____ **State** _____ **Zip** _____

E-mail Address _____ **Fax** _____

Home Phone _____ **Business Phone** _____

Live Receptionist Script Information:

You will be using PATLive Receptionist for: ❒ Callers wanting to buy a home ❒ Callers wanting to sell a home ❒ Callers wanting to buy and/or sell a home ❒ Yellow Letter scripts

Will you be using a Virtual Assistant (VA) to do follow up for you? ❒ Using a VA ❒ NOT Using a VA

Send caller information by: ❒ Email after each call ❒ Email once a day ❒ Fax after each call ❒ Fax once a day

Will you receive more than 50 calls per week? ❒ Yes ❒ No

Are you planning television or radio ads? ❒ Yes ❒ No

PATLive will answer your calls using either your name or your business name.
Example 1: "Thank you for calling ABC Realty." Example 2: "Thank you for calling John Smith's office."

Please provide the name or business name to use when we answer your calls: _____

What script should callers hear while being sent to PAT? Example: "Please hold for an ABC Realty representative."
❒ I would like this sample script with my business name. ❒ I do not want any message at all.
❒ I would like the script to read: _____

Payment Method:

❒ **VISA** ❒ **MasterCard** ❒ **Discover** ❒ **American Express**

Credit Card # _____ Cardholder's Signature _____

Expiration Date _____ Name As It Appears On Card (please print) _____

Customer Signature:

Customer Signature _____ **Date** _____

Your signature indicates consent to the terms of agreement found on www.patlive.com or requested from PAT at 1-800-775-7790.

Fax this form to 1-800-800-6126
You may also sign up online at www.patlive.com/ronlegrand

Thank you for using PATLive!

Cedars Bldg B, Suite 200 · 2639 N. Monroe St. · Tallahassee, FL 32303
800.775.7790 · Fax 800.800.6126 · pat@patlive.com · www.patlive.com

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Consulting With Ron LeGrand

I am available on a limited basis to do one day or half day consulting on the following topics:

1. **Building a speech and close to drive your platform sales through the roof.**

2. **Building a marketing system to sell seminars and/or products and how to implement in a cost effective way. This does not include copywriting, but I am available to select clients on a limited basis.**

3. **How to build and grow your personal real estate investing business.**

Consulting will be done in Jacksonville, FL and the cost is $10,000/$20,000.

Half payment is due upon booking and balance 2 days prior to consulting.

For further details, please see me or return this form to me by fax at (904) 421-0181 or email to ron@legrandprojects.com and I'll call you to discuss.

□ Ron, please call me.

Name: _____

Phone: (_____)_____

Fax: (_____)_____

Email:_____

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Lead/Property Information Sheet

Student _____

Date _____ Owner's Name _____

Source _____ Cell Phone _____Evening _____

Address _____ ★ Asking Price _____

City _____State_____ ★ Sellers Estimated Value _____

Area of town_____ ★ Your comps _____

Existing Mortgage Information (must have)

★ 1st - $_____ Lender _____ _____% Pmt _____

2nd - $_____ Lender _____ _____% Pmt _____

Is Payment PITI ____Yes _____No Current? _____Yes ____No$_____ in Arrears

If asking price and loan balance are within $35,000:
Will you sell the house for what you owe on it?
___Yes ___No

If the house has a Mortgage:
If we can agree on a price and we accept all responsibility for future repairs would you consider a lease purchase? ***Yes / No (circle one)***
YES – OK, I'll have my boss call to discuss terms. When is the best time?_____(***get info below)***
NO – So you're saying if you don't get full price and all cash you won't sell? ***Yes/No (circle one)***
YES – OK, I understand but that wouldn't make sense for us. Thanks ***(stop here)***
NO – OK, I'll have my boss call to discuss several ways he can buy your home. What's the best time to call?_____(***get info below)***

If the house is Free & Clear:
If Yes – Will you consider taking monthly payments for your equity? ***Yes/No (circle one)***
If No – Would you consider a lease purchase making us responsible for all repairs? ***Yes/No (circle one)***
YES – I'll have my boss call to discuss terms. When is the best time?_____(***get info below)***
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How did you arrive at your asking price? _____Reason for selling?_____

Does it need repairs? _____Yes _____No

★ When do you want to move? _____Is the house listed? _____

Description:

Bed/Bath: _____ Square Feet: _____ Lot Size: _____

Construction: Frame_____ Brick_____ Block_____ Stucco_____ Other_____

Garage: 0 1 2 Carport: ____ Basement: ___ Refrigerator _____ Range ____ Dishwasher _____

Is the house Vacant___ Occupied_____Is this a house or a Condo? Yes/No Association fee$_____

Notes:_____

_____

_____

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Lead/Property Information Sheet

Student _____

Date _____ Owner's Name _____

Source _____ Cell Phone _____Evening _____

Address _____ ★ Asking Price _____

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Notes:_____

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Notes:_____

_____

_____

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"This is the best how-to-invest-in-real-estate book available."
—Robert Bruss

INVESTING *in* REAL ESTATE

Sixth Edition

Opportunities in a buyer's market

15 new investment techniques

Creative financing strategies

GARY W. ELDRED, PHD

Praise for Gary Eldred

"Donald Trump and I have created Trump University to offer the highest quality, success-driven education available. Our one goal is to help professionals build their careers, businesses, and wealth. That's why we selected Gary Eldred to help us develop our first courses in real estate investing. His books stand out for their knowledge-packed content and success-driven advice."

—Michael W. Sexton, CEO
Trump University

"Gary has established himself as a wise and insightful real estate author. His teachings educate and inspire."

—Mark Victor Hansen, Coauthor,
Chicken Soup for the Soul

"I just finished reading your book, *Investing in Real Estate, Fourth Edition*. This is the best real estate investment book that I have read so far. Thanks for sharing your knowledge about real estate investment."

—Gwan Kang

"I really enjoyed your book, *Investing in Real Estate*. I believe it's one of the most well-written books on real estate investing currently on the market."

—Josh Lowry
Bellevue, WA
President of Lowry Properties

"I just purchased about $140 worth of books on real estate and yours is the first one I finished reading because of the high reviews it got. I certainly wasn't let down. Your book has shed light on so many things that I didn't even consider. Your writing style is excellent. Thanks again."

—Rick Reumann

"I am currently enjoying and learning a lot from your book, *Investing in Real Estate*. Indeed it's a powerful book."

—Douglas M. Mutavi

"Thanks so much for your valuable book. I read it cover to cover. I'm a tough audience, but you've made a fan here. Your writing is coherent, simple, and clean. You are generous to offer the benefits of your years of experience to those starting out in this venture."

—Lara Ewing

INVESTING *in* REAL ESTATE

Sixth Edition

GARY W. ELDRED, PhD

WILEY

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CONTENTS

Prologue: Invest in Real Estate Now! xix

Acknowledgments xxvii

I WHY INVESTING IN REAL ESTATE PROVIDES YOU THE BEST ROUTE TO A PROSPEROUS FUTURE I

22 Sources of Returns from Investment Property 3

Will the Property Experience Price Gains from Appreciation? 4

Will You Gain Price Increases from Inflation? 5

Earn Good Returns from Cash Flows 6

Magnify Your Price Gains with Leverage 6

Magnify Returns from Cash Flows with Leverage 7

Build Wealth through Amortization 7

Over Time, Returns from Rents Go Up 8

Refinance to Increase Cash Flows 9

Refinance to Pocket Cash 10

Buy at a Below-Market Price 10

Sell at an Above-Market-Value Price 10

Create Property Value Through Smarter Management 11

Create Value with a Savvy Market Strategy 11

Create Value: Improve the Location 12
Convert from Unit Rentals to Unit Ownership 12
Convert from Lower-Value Use to Higher-Value Use 12
Subdivide Your Bundle of Property Rights 13
Subdivide the Physical Property (Space) 14
Create Plottage (or Assemblage) Value 14
Obtain Development/Redevelopment Rights 15
Tax Shelter Your Property Income and Capital Gains 15
Diversify Away from Financial Assets 16
Is Property Always Best? 16

2 FINANCING: BORROW SMART, BUILD WEALTH 18
The Birth of "Nothing Down" 18
Should You Invest with Little or No Cash or Credit? 19
What's Wrong with "No Cash, No Credit, No Problem"? 20
Leverage: Pros and Cons 22
What Are Your Risk-Return Objectives? 27
Maximize Leverage with Owner-Occupancy Financing 28
Owner-Occupied Buying Strategies 28
Current Homeowners, Too, Can Use This Method 29
Why One Year? 29
Where Can You Find High-LTV Owner-Occupied Mortgages? 30
What Are the Loan Limits? 30
High Leverage for Investor-Owner Financing 32
High Leverage versus Low (or No) Down Payment 32
Creative Finance Revisited 32
Are High-Leverage Creative-Finance Deals Really Possible? 38
What Underwriting Standards Do Lenders Apply? 39
Collateral 40
Loan-to-Value Ratios 40
Recourse to Other Assets/Income 41
Amount and Source of Down Payment and Reserves 41
Capacity (Monthly Income) 42

Credit History (Credibility!) 43
Character and Competency 44
Compensating Factors 45
Automated Underwriting (AUS) 46

3 APPRAISAL: HOW TO DISCOVER GOOD VALUE 47
Make Money When You Buy, Not Just When You Sell 48
What Is Market Value? 48
Sales Price Doesn't Necessarily Equal Market Value 49
Sound Underwriting Requires Lenders to Loan Only Against Market Value 50
How to Estimate Market Value 51
Property Description 52
Identify the Subject Property 52
Neighborhood 52
Site (Lot) Characteristics 59
Improvements 60
The Cost Approach 61
Calculate Cost to Build New 61
Deduct Depreciation 61
Lot Value 62
Estimate Market Value (Cost Approach) 63
The Comparable Sales Approach 64
Select Comparable Properties 64
Approximate Value Range—Subject Property 65
Adjust for Differences 65
Explain the Adjustments 66
The Income Approach 67
Income Capitalization 69
Net Operating Income 69
Estimate Capitalization Rates (R) 72
Compare Cap Rates 72
The Paradox of Risk and Appreciation Potential 73
Compare Relative Prices and Values 74

Valuation Methods: Summing Up 74
Appraisal Limiting Conditions 75
Valuation versus Investment Analysis 76

4 MAXIMIZE CASH FLOWS AND GROW YOUR EQUITY 77

Will the Property Yield Good Cash Flows? 77
Arrange Alternative Terms of Financing 79
Decrease (or Increase) Your Down Payment 80
Buy at a Bargain Price 82
Should You Ever Pay More than Market Value for a Property? 83
The Debt Coverage Ratio 84
Numbers Change, Principles Remain 85
Will the Property Yield Profitable Increases in Price? 85
Low-Involvement versus High-Involvement Investing 86
Compare Relative Prices of Neighborhoods (Cities) 87
Undervalued Neighborhoods and Cities 88
Beverly Hills versus Watts (South Central Los Angeles) 88
Demographics 89
Accessibility (Convenience) 90
Improved (Increased) Transportation Routes 90
Jobs 91
Taxes, Services, and Fiscal Solvency 91
New Construction, Renovation, and Remodeling 91
Land-Use Laws 92
Pride of Place 93
Sales and Rental Trends 93
Summing Up 95

5 HOW TO FIND BARGAIN-PRICED PROPERTIES 96

Why Properties Sell for Less (or More) Than Market Value 96
Owners in Distress 97
The "Grass-Is-Greener" Sellers 97

Stage-of-Life Sellers 98
Seller Ignorance 99
Prepare Screening Criteria 100
Bargain Sellers 101
Networking/Get the Word Out 102
Newspapers and Other Publications 102
Cold Call Owners 103
Agent Services 105
Internet Listings 107
Seller Disclosures 107
The Disclosure Revolution 108
Income Properties 108
Summary 109

6 PROFIT WITH FORECLOSURES 110
The Foreclosure Process 110
Lender Tries to Resolve Problem 111
Filing Legal Notice 111
The Foreclosure Sale 112
REOs 112
Buy Preforeclosures from Distressed Owners 112
Approach Owners with Empathy 113
The Difficulties of Dealing Profitably with Owners in Default 113
Prequalify Homeowners and Properties 115
Finding Homeowners in Default (Prefiling) 117
Networking 117
Mortgage Collections Personnel 117
Drive Neighborhoods 117
Find Homeowners (Postfiling) 118
Cultivate a Relationship with Property Owners 118
Two More Issues 119
Vacant Houses 120

Satisfy Lenders and Lien Holders 121
All Parties Are Better Off 123
Win by Losing Less 123
Profit from the Foreclosure Auction 124
Why Foreclosures Sell for Less than Market Value 124
Make the Adverse Sales Efforts Work for You 125
How to Arrange Financing 126
The Foreclosure Sale: Summing Up 127

7 PROFIT FROM REOs AND OTHER BARGAIN SALES 128

Bad News For Sellers/Builders, Good News For You 128
How to Find REOs 129
Follow Up with Lenders after Foreclosure Sales 129
Locate Specialty Realtors 130
HUD Homes and Other HUD Properties 131
Homeowners versus Investors 132
"As-Is" Condition 132
Potential Conflict of Interest 133
Buyer Incentives 133
The Bid Package 134
Department of Veterans Affairs (REOs) 134
Big Advantages for Investors 135
Fannie Mae and Freddie Mac REOs 136
Agent Listings 136
Investors Invited 137
Federal Government Auctions 137
Buy from Foreclosure Speculators 138
Probate and Estate Sales 138
Probate 138
Estate Sales 139
Private Auctions 139
How to Find Auctions 141

8 QUICK PROFITS THROUGH FIX AND FLIP 142

Fix, Flip, Profit! 142
Look for "Fixers" 143
The Browns Create Value in a Down Market 144
Research, Research, Research 145
Improvement Possibilities 146
Thoroughly Clean the Property 146
Add Pizzazz with Color Schemes, Decorating Patterns, and Fixtures 147
Create Usable Space 147
Create a View 148
Capitalize on Owner Nearsightedness 148
Eliminate a Negative View 149
Enhance the Unit's Natural Light 149
Reduce Noise 150
Required Repairs and Improvements 150
Plumbing 151
Electrical System 151
Heating and Air-Conditioning 151
Windows 152
Appliances 152
Walls and Ceilings 152
Doors and Locks 152
Landscaping 152
Storage Areas 153
Clean Well 153
Safety and Health 153
Roofs 153
Improvements and Alterations 154
You Can Improve Everything about a Property—Including Its Location 154
The South Beach Example: From Derelicts to Fashion Models 154
Community Action and Community Spirit Make a Difference 155
Neighborhoods Offer Potential 156

What Types of Improvements Pay the Greatest Returns? 157
How Much Should You Budget for Improvements? 157
Beware of Overimprovement 158
Other Benefits 158
No-No Improvements 159
Budgeting for Resale Profits 159
Estimate the Sales Price First 159
Estimate Costs 160
Future Sales Price Less Costs and Profit Equals Acquisition Price 160
Comply with Laws and Regulations 162
Should You Buy a "Fixer"? 162
Too Little Time? 163
Put Your Creativity to Work 163

9 MORE TECHNIQUES FOR HIGH YIELDS AND QUICK PROFITS 165

Lease Options 165
Here's How Lease Options Work 165
Benefits to Tenant-Buyers (An Eager Market) 166
Benefits to Investors 167
The Lease Option Sandwich 168
How to Find Lease Option Buyers and Sellers 169
A Creative Beginning with Lease Options (for Investors) 170
Lease Purchase Agreements 170
"Seems" More Definite 171
Amount of the Earnest Money Deposit 171
Contingency Clauses 171
Conversions 172
Condominium Conversion 172
Tenants in Common 174
Convert Apartments to Office Space 175

Master Leases 176
Assignments: Flipping Purchase Contracts 178
Summary 179

10 NEGOTIATE A WIN-WIN AGREEMENT 180
Win-Win Principles 181
The Purchase Contract 183
Names of the Parties 184
Site Description 184
Building Description 184
Personal Property 185
Price and Financing 185
Earnest Money Deposit 186
Quality of Title 187
Property Condition 187
Preclosing Property Damage (Casualty Clause) 188
Closing (Settlement) Costs 189
Closing and Possession Dates 189
Leases 190
Contingency Clauses 191
Assignment and Inspection 192
Public Records 193
Systems and Appliances 193
Environmental Hazards 193
No Representations 194
Default Clause 194
Summary 197

11 MANAGE YOUR PROPERTIES TO INCREASE THEIR VALUE 199
The 10:1 Rule (More or Less) 199
Think First 200
Know Yourself 201

Know Your Finances 201
Know Your Capabilities 202
Smart Strategic Decisions 202
Local Markets Require Tailored Strategies 203
Craig Wilson's Profit-Boosting Market Strategy 203
How Craig Wilson Used Market Information to Enhance the Profitability of His Property 206
Results 210
Cut Operating Expenses 210
Energy Audits 210
Property Insurance 211
Maintenance and Repair Costs 214
Property Taxes and Income Taxes 214
Increasing Value: Final Words 215

12 DEVELOP THE BEST LEASE 216
The Mythical "Standard" Lease 216
Your Market Strategy 216
Search for Competitive Advantage 218
Craft Your Rental Agreement 219
Names and Signatures 219
Joint and Several Liability 219
Guests 220
Length of Tenancy 220
Holdover Tenants (Mutual Agreement) 220
Holdover Tenants (without Permission) 221
Property Description 221
Inventory and Describe Personal Property 221
Rental Amounts 222
Late Fees and Discounts 222
Multiple Late Payments 222
Bounced Check Fees and Termination 223
Tenant "Improvements" 223

Owner Access 223
Quiet Enjoyment 224
Noxious Odors 224
Disturbing External Influences 224
Tenant Insurance 225
Sublet and Assignment 225
Pets 226
Security Deposits 226
Yard Care 228
Parking, Number, and Type of Vehicles 228
Repairs 228
Roaches, Fleas, Ants 229
Neat and Clean 229
Rules and Regulations 229
Wear and Tear 230
Lawful Use of Premises 230
Notice 230
Failure to Deliver 231
Utilities, Property Taxes, Association Fees 231
Liquid-Filled Furniture 231
Abandonment of Property 232
Non-waivers 232
Breach of Lease (or House Rules) 232
No Representations (Full Agreement) 233
Arbitration 233
Attorney Fees (Who Pays?) 234
Written Notice to Remedy 235
Tenants Rights Laws 235
Tenant Selection 235
Property Operations 237
Evictions 237
Landlording: Pros and Cons 238
Possibilities, Not Probabilities 238
Professional Property Managers 238

13 CREATE SALES PROMOTIONS THAT REALLY SELL 240

Design a Winning Value Proposition 240
Yet Generic Prevails 240
USP versus WVP 241
Craft Your Selling Message 243
Use a Grabber Headline/Lead 244
Reinforce and Elaborate 244
Add Hot Buttons 244
Establish Credibility 245
Compare to Substitutes 245
Evoke Emotional Appeal 245
Reduce Perceived Risks 245
Make It Easy for Prospects to Respond 245
Follow Up with Your Prospects 247
Reach Potential Buyers 247
For Sale Signs 247
Flyers/Brochures 248
Networking (Word of Mouth) 249
Web Sites/Links 249
Sales Agents 249
Should You Employ a Realty Agent? 249
Services to Sellers 250
Services to Buyers 251
Co-Op Sales 252
Listing Contracts 252

14 PAY LESS TAX 255

The Risks of Change and Complexity 255
Homeowner Tax Savings 256
Capital Gains without Taxes 256
Rules for Vacation Homes 257
Mortgage Interest Deductions 258

Credit Card Interest 258
Rules for Your Home Office 259
Depreciation Expense 259
Land Value Is Not Depreciable 259
Land Values Vary Widely 260
After-Tax Cash Flows 260
Passive Loss Rules 261
Taxpayers in the Real Property Business (No Passive Loss Rules) 262
Alternative Minimum Tax 262
Capital Gains 263
A Simplified Example 263
The Installment Sale 264
What's the Bottom Line for Sellers? 265
Implications for Buyers 265
Tax-Free Exchanges 265
Exchanges Don't Necessarily Involve Two-Way Trades 266
The Three-Party Exchange 266
Exchanges Are Complex but Easy 266
Are Tax-Free Exchanges Really Tax Free? 268
Section 1031 Exchange Rules 268
Reporting Rental Income and Deductions 269
Tax Credits 271
Complexity, Tax Returns, and Audits 272
Use a Tax Pro 275
Property Taxes 276
Summary 278

15 MORE IDEAS FOR PROFITABLE INVESTING 280

Lower-Priced Areas 281
What about Property Management? 283
Tenant-Assisted Management 283
Property Management Companies 283

Emerging Growth Areas 284
The Creative Class 284
Implications for Investing in Real Estate 284
Right Place, Right Time 285
Emerging Retirement/Second-Home Areas 285
Which Cities and Areas? 286
Income Investing 286
Commercial Properties 286
Property Management 287
The Upside and Downside 287
Opportunity for High Reward 287
Commercial Leases Create (or Destroy) Value 289
Triple Net (NNN) 290
Self-Storage 291
Mobile Home Parks 292
Profitable Possibilities with Zoning 294
Tax Liens/Tax Deeds 294
Localities Differ 294
Are Tax Liens/Tax Deeds an Easy Way to Make Big Profits? 295
Discounted Paper 295
What Is Discounted Paper? 295
Here's How It Works 296
Broker the Note 296
Do Such Deals Really Occur? 296
Due Diligence Issues 296
Should You Form an LLC? 297
Different Strokes for Different Folks 297
Insufficient Court Rulings 297
One Size Doesn't Fit All 298

16 AN INCOME FOR LIFE 299

Less Risk 301
Personal Opportunity 301

Index 304

Prologue

INVEST IN REAL ESTATE NOW!

Nearly everywhere I speak these days, someone from the audience asks, "Do you feel the real estate market will drop further? Have we reached bottom yet? When do you think property prices will fully recover?"

I answer, "I do not know. I really do not care. And neither should you."

Why do I give such seemingly flip answers? First, because they are true. All investment pros encourage you to focus on your wealth-building goals—not profit maximization per se. Waiting for the bottom merely gives you an excuse to procrastinate. I've seen would-be investors make this mistake a thousand times.

And second, because the questions are ill-formed. They miss identifying the multiple ways that you can profit with property. To invest successfully in real estate, you need not, and should not, focus on predicting market valleys (or peaks). More productively, think in terms of possibilities, probabilities, and strategy—not merely the lowest price.

WHAT ARE YOUR POSSIBILITIES?

If you asked financial journalists (or their quotable experts) whether you should now invest in real estate, you would likely receive a variety of answers. But nearly all of their answers would focus on one central point: the expected direction of short-term price movements.

Journalists and their media molls love to play the game of short-term forecasting. They do it with stocks, gold, commodities, interest rates, and, for the past 10 years, properties. Are prices climbing? Buy. Are prices

falling? Get out and go sit on the sidelines. As a result of their obsession with short-term price movements, the media have distorted and confused the idea of investing in real estate.

In contrast to media hype, the most experienced and successful real estate investors do not weight their deal analysis with any significant emphasis on short-term price forecasts. Instead, we typically look to an investing horizon of three to 10 years (or longer). More important, we realize that in addition to price increases, property provides us with many possible sources of return. Here are some (but certainly not all) of these profit possibilities.

- Earn price gains from appreciation.
- Earn price gains from inflation.
- Create unleveraged cash flows.
- Use leverage to magnify returns from price gains.
- Use leverage (financing) to magnify returns from cash flows.
- Grow equity gains through amortization.
- Refinance to increase cashflows
- Refinance to generate cash (lump sum).
- Buy at a below-market-value price.
- Sell at an above-market-value price.
- Create value through smarter management.
- Create value through savvy market strategy.
- Create value by improving the location.
- Subdivide your bundle of property rights.
- Subdivide the physical property.
- Create plottage (assemblage) value.
- Convert the use (e.g., residential to offices, retail to offices).
- Convert type of tenure (e.g., rental to ownership).
- Shelter income from taxes.
- Shelter capital gains from taxes.
- Create and sell development/redevelopment rights.
- Diversify away from stocks and bonds.

I explain each of these possible sources of return in Chapter 1 and then illustrate and elaborate to varying degrees in the chapters that follow. With this extensive range of possibilities in view, you can always find profitable ways to invest in real estate.

Unlike investing (or speculating) in stocks, bonds, gold, or commodities, you can generate returns from properties through research, reasoning, knowledge, and entrepreneurial talents. In contrast, when you buy stocks,

you had better pray that the market price goes up, because that's your only possibility to receive a reasonable return.*

WHAT ARE YOUR PROBABILITIES?

In the correction part of the real estate cycle, fear looms. Cash balances in banks build up. Investors and savers join in a flight to quality. They willingly accept certificates of deposit (CDs) that pay low-single-digit interest rates. Investors think, "Who cares about return *on* capital? I just want to feel confident that I receive a return *of* capital.

In his highly regarded book *The Intelligent Investor*, Benjamin Graham created the parable of Mr. Market. Mr. Market represents that crowd mentality whose moods swing like a pendulum from irrational exuberance to bewildered fear and confusion. Which market mood provides the best investment opportunities/possibilities? Which market mood throws investors the highest amount of actual risk? Which market mood corresponds to the least amount of actual risk?

Booms Increase Actual Risk

You know the answers. During the irrationally exuberant boom times, investors perceive little risk, but actual risks loom larger and larger as prices climb higher and higher, income yields fall, and unsustainable amounts of mortgage debt pile up.

In Las Vegas, so-called investors (actually speculators) believed that flipping properties paved their way to wealth. Few perceived that their property risks actually laid down poorer odds than the slots at Harrah's. And who but a fool (or Panglossian optimist) would borrow money to play the slots? Yet Las Vegas property buyers loaded up with excessively high loan-to-value (LTV) ratios of 90, 95, and 100 percent (or more). They merely assumed that the future would continue to pay off as they had experienced in the recent past.

On many of their properties, loan payments (principal, interest, taxes, and insurance [PITI]) approached $2,000 a month. Potential rents for the same properties would reach no more than $1,200 a month. When an alligator is chewing your leg off, you are in a world of danger (and a world of hurt). As I have written in nearly every one of my books, high debt, low income yields, and exaggerated hopes for outsized continuing

* With property, I have earned per annum returns of 25 percent or more—without a single dollar of price gain.

increases in price (for either stocks or properties) always trigger a reversal of fortune. (See especially my *Value Investing in Real Estate*, John Wiley & Sons, 2002.)

The speculative buying of Las Vegas houses serves as an outside-the-norm example. Few other areas experienced such heightened frenzy among both builders and buyers. Nevertheless, irrational exuberance infested the moods and minds of property buyers throughout many of the world's principal cities (though during the boom of late, not Dallas, Berlin, or Tokyo—each had suffered its own irrationally exuberant property market 15 to 20 years back, and sat out this most recent party). In nearly every instance, borrowed money fueled property prices upward without commensurate growth in rent collections or personal incomes.

Market Corrections Vanquish Market Risk

Within a few short years, many property markets have shifted from sellers' markets driven by loose lending and buoyant dreams of fast, easy money to buyers' markets sustained by stricter credit standards, record numbers of foreclosures, a 25-year high in unemployment, and multiple major banks taking hits for unprecedented amounts of losses. No wonder fear and confusion have chased many potential property investors out of the game.

So here is the $64,000 question: How should you interpret these and other dismal facts from the dismal science? Do lousy economic conditions diminish your chance to build a prosperous and secure future by investing in property? Or do they vanquish market risk?

To make this question of risk easier, first address the following 10 issues. When is the best time to acquire investment property:

1. (a) When builders are bringing to market near-record numbers of new houses, condominiums, and condominium conversions, or (b) when new housing starts have fallen to the lowest level since before 1959?
2. (a) When buyers flock to open houses and beg sellers to accept their above-asking-price bids, or (b) when investors and home buyers remain relatively scarce?
3. (a) After economic recovery pushes interest rates higher, or (b) when interest rates sit near the low end of the past 40 years?
4. (a) When inflation seems subdued (as occurred during the past eight years), or (b) (as today) when massive amounts of

government borrowing and huge increases in the money supply seem sure to push inflation (and interest rates) to higher levels within the coming decade?

5. (a) When properties sell for prices at a 20 to 50 percent *premium above* their replacement costs, or (b) when you can buy properties at a 20 to 50 percent *discount below* their replacement costs?
6. (a) When millions of home buyers overleverage to purchase houses that they cannot afford, or (b) when stricter credit and high unemployment lead many people to double up (or even triple up) on their housing?
7. (a) When most sellers can hold out for top dollar, or (b) when financial distress and more than one million foreclosures/REOs create millions of desperately motivated sellers?
8. (a) When property prices sit in the clouds well above the level that rents will support, or (b) when market values fall to the point where income yields make sense and investors can reasonably expect to achieve positive cash flows—either immediately or within a few years?
9. (a) When hundreds of thousands of new investors overleverage themselves to buy rental properties that they do not know how to manage, or (b) when those same starry-eyed investors rudely awaken to the fact that successful investing requires reserves of cash and credit, knowledge, thought, and an operating system and strategy?
10. (a) When economic recovery and increasingly positive news propel millions of backbenchers into the game, or (b) now?

If you've answered (b) to each of these 10 issues, you display the courage and foresight to become a great investor. You know that market corrections vanquish risk and multiply your possibilities for profit.

Never Wait for Market Peaks or Bottoms

To invest successfully, never try to time a market bottom—or a market top. Neither you, I, nor anyone else can develop that skill. Why? Because more often than not, random events trigger short-term turns in markets. We can tell when markets are becoming too pricey. We can tell when market conditions greatly favor investors. But only by extraordinary luck can we pick the one best time to sell or buy. (Just as importantly, the way you negotiate a deal can create as much or more opportunity for you than the market conditions themselves.)

My Texas Example I owned properties in Texas in the early 1980s. By mid-1984, I had sold all of them (at substantial gains). The market continued to go up. Property agents told me that I shouldn't have sold. Later, after the crash in 1985, they told me that I had sold too soon. What do you think?

When do you replace the tires on your car? At the last possible moment before they blow out? Or when you see the tread wearing down and the risk of a blowout increasing? If you want to save your life, do not try to run your tires until the last possible moment.

Likewise with property, when irrational exuberance fuels prices ever higher and these prices are unsupported by rent levels or personal income growth, risk builds excessively. Prudence sells to save profits. Only fools hold on to capture the last dollar—or the last 1,000 miles from that risky, worn tire. And only bigger fools believe that tires or booms will last forever.

Look for Solid Value—Not Necessarily a Market Bottom or Market Boom Today's markets offer multiple low-risk, high-profit possibilities. Over a time horizon of three to five years—if you follow the principles laid out in this book—you will enjoy strong profits. I encourage you to get in the game now. No one can predict the course of prices during the next year or two. But today, you can certainly find solid values in most markets.

In my experience, two major mistakes prevent people from profiting with property: (1) They wait too long to exit an irrationally exuberant market, and (2) they wait too long to take advantage of the possibilities that are theirs for the taking.

DEVELOP AND EXECUTE YOUR STRATEGY NOW

As you read through the following pages, you will discover how property provides at least 22 sources of financial returns. Plus, you will discover multiple ways to harvest those returns.

Buying, improving, and holding income properties—especially when you purchase them at bargain prices and finance with smart leverage—offers the surest, safest, and, yes, even the quickest way to build wealth. But even long-term investors such as myself will venture along other avenues when clear opportunities arise.

In addition to the buy, improve, and hold approach, other techniques include discounted paper, real estate investment trusts (REITs),

condominium conversions, fix and flip, adaptive reuse, tax liens, mobile home parks, self-storage centers, lease options, triple net leases, and other possibilities to profit through property.

If you want a secure future—a future free of financial worries, a life that you can live as you would like to live—property, especially property in today's markets, provides a near-certain route to wealth. All that remains is for you to choose, develop, and execute your own strategy now.

ACKNOWLEDGMENTS

Many people have contributed directly and indirectly to this sixth edition of *Investing in Real Estate*. Because of their efforts, this best-selling classic text on property investing has been made even better.

Accordingly, I thank Donald Trump and Michael Sexton for inviting me to work with Trump University to help create some of the best real estate educational products and services available (e. g., Trump University books—all published by John Wiley & Sons—CDs, seminars, online courses, webinars, and coaching programs). Working with the Trump team and Trump University students has broadened and deepened my perspectives on property investing as well as how to simply and effectively convey that knowledge to property investors at all levels of experience.

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Gary W. Eldred

Vancouver, Canada
August 2009

1

WHY INVESTING IN REAL ESTATE PROVIDES YOU THE BEST ROUTE TO A PROSPEROUS FUTURE

"Older workers rush back into the jobs market as downturn wrecks their retirement portfolios," so headlined a recent front-page article in the *Financial Times* (May 9, 2009). Other major newspapers such as the *Wall Street Journal*, the *New York Times*, and *Investor's Business Daily* have run similarly disconcerting articles.

The *Financial Times* article (and others similarly written) depart from the mainstream media view that dominates. For the past 15 years, most major media—and especially personal finance magazines such as *Money, Smart Money,* and *Kiplinger's*—have primarily served up inept mantras for the masses disguised as financial wisdom. Such widely read magazines and newspapers have published hundreds (quite likely thousands) of articles that promise investors that they can achieve wealth without work, effort, or thought.

Just keep pouring monthly payments into your IRAs, 403(b)s, and 401(k)s and you will enjoy financial security. "Over the long run stocks outperform all other investments. Over the long run stocks will protect you against inflation."

Indeed, just as I was about to write this chapter, voilá, my local paper obliged with a perfect example. A reader, Nasir Iqbal, posted this comment: "I don't trust stocks. I think I will receive higher returns with property. With property, I will feel financially secure when I retire."

The journalist, Cleofe Maceda, responded as follows:

> Is buying property the right way to secure your retirement? Experts [sic] say people like Iqbal are better off looking into other avenues for capital growth—which can reduce the long-term risk of running out of income in retirement.

Maceda (the journalist writing the article) then quotes one of his so-called experts,

> The challenge with property is that you can only sell it for what people are willing to pay. [Duh?] It can take two years or longer to sell a property. There is no liquidity with property.

Continuing a bit further in this article, the journalist again quotes his expert.

> Stock markets offer the best possibility to beat inflation over periods of five years or more. This is because shares produce dividend income in addition to the ability to grow in price.

As to volatility—that other big issue that confronts investors—the mantra persists. No need to worry about 30 to 50 percent drops in the stock markets. . .

> . . . that volatility can work for an investor's advantage because it allows them to maximize their buying power [i.e., when stock prices fall, your $1,000 a month deposits (or whatever) buy more shares].

In one short article, Maceda scores six out of six widely popularized, yet false claims:

1. Stocks outperform all other assets.
2. Liquidity favors stocks.
3. Stocks pay you good income.
4. Stocks protect you against inflation.
5. Stocks reduce the risk of running out of money in retirement.
6. You don't really lose when your stock portfolio crashes, you gain.

Evidently, Maceda—like a majority of journalists (and investors)—prefers not to think for himself. He prefers not to look at the actual

historical record of stocks. He prefers to remain ignorant of property. Standing against conventional wisdom, the *Financial Times* (at least in the article quoted) has captured the sad reality of stocks. Maceda only perpetuates the mantra manufactured by Wall Street.

This chapter sets the record straight. It provides you (and Nasir Iqbal) a more enlightened perspective on property, stocks, and several other asset classes (bonds, annuities) that investors might turn to as they strive to build wealth and achieve financial security.

22 SOURCES OF RETURNS FROM INVESTMENT PROPERTY

When so-called experts compare property with stocks, they rarely get their comparisons right. More often than not, they assume that property yields only one source of return that counts: potential gains in price. For example, in his acclaimed book, *Winning the Loser's Game*, Charles Ellis concludes that:

> Owning residential real estate is not a great investment. Over the past 20 years, home prices have risen less than the consumer price index and have returned less than Treasury bills.

Leaving aside for a moment how and where Ellis came up with his long-term house price figures—no statistics I have ever seen report that housing, relative to incomes or consumer prices, has become cheaper—Ellis (and other finance/economics types) err most egregiously in how investors should measure the total potential returns that property offers. Ellis omits at least 20 other sources of financial returns that investors can earn from their portfolio of properties.[1]

To evaluate property, certainly weigh the possibilities for price gains, but go further. You can earn double-digit rates of return (and sometimes much more) from your property investments—even without any gain in price.

It's up to you to decide which sources of returns best fit your investment goals—and correspondingly, for each property you evaluate, which sources of return seem doable. Few properties present a full range of possibilities. But to fully see potential, apply each test of possibility

[1] His two-decade time horizon also fails as a representative period because it includes the late 1970s and the 1980s—treasuries paid record-high interest rates during those years.

to all properties you consider. Every property presents multiple sources of returns.

Will the Property Experience Price Gains from Appreciation?

In everyday speech, most people do not differentiate price gains that result from appreciation and those that result from inflation. Appreciation occurs when demand grows faster than supply for a specific type of property and/or location. Inflation tends to push prices up—even if demand and supply remain in balance.

Homes in Central London, San Francisco's Pacific Heights, and Brooklyn's Williamsburg neighborhood have experienced extraordinarily high rates of appreciation during the past 15 to 20 years. And just since 1990, houses within a mile or so of the University of Florida campus have tripled in market price—primarily because UF students and faculty alike now strongly prefer "walk or bike to campus" locations.

Areas Differ in their Rate of Appreciation. Although properties located in Pacific Heights and Williamsburg have jumped in value at rates much greater than the rise in the Consumer Price Index (CPI), some neighborhoods in Detroit have suffered major declines in value. Appreciation does not occur randomly. You can forecast appreciation potential using the right place, right time, right price methodology discussed in Chapter 15.

Likewise, you need not get caught in the severe and long-term downdrafts that plague cities and neighborhoods that lose their economic base of jobs. Just as various socioeconomic factors point to right time, right place, right price, similar indicators can signal wrong place, wrong time, wrong price.

You Do Not Need Appreciation. Should you always invest in properties that are located in areas poised for above-average appreciation? Not necessarily. Throughout the rest of this chapter, I show you many ways to profit with property. Some investors own rental properties in deteriorating areas—yet still have built up multimillion-dollar net worths. My first properties did not gain much from price increases (appreciation or inflation)—but they consistently cash flowed like a slot machine payoff.

If you choose a fast money, flip and fix strategy, appreciation doesn't count for much either. Also, when you buy at a price 10 to 30 percent below market value, you earn instant appreciation that is not related to market temperature. Throw away the urge to believe that you can't make good money with property unless its market price appreciates.

Will You Gain Price Increases from Inflation?

In his book, *Irrational Exuberance*, the oft-quoted Yale economist, Robert Shiller, concludes that houses perform poorly as investments. According to his reckoning, since 1948, the real (inflation-adjusted) price growth in housing has averaged around 1—at best 2—percent a year.

"Even if this $16,000 house sold in 2004," says the eminent professor, "at a price of $360,000, it still does not imply great returns on this investment . . . a *real* (i.e., inflation-adjusted) annual rate of increase of a little under 2 percent a year."

Shiller Thinks Like an Economist, Not an Investor. Every investor wants to protect his wealth from the corrosive power of unexpected inflation. Even if we accept Shiller's numbers—and I believe them reasonable, though certainly not beyond critique—the data do show that property has kept investors ahead of inflation in every decade throughout the past 75 years.

Not true for stocks (or bonds). Consider the most inflationary period in U.S. history: 1966–1982. In 1966, the median price of a house equaled $25,000; the Dow Jones Index hit 1,000. During the next 18 years the CPI jumped from 100 to 300. In 1982, the median price of a house had risen to $72,000; the DJIA closed the year at 780—below its *nominal* level of 18 years earlier.

Inflation Risk: Property Protects Better than Stocks. No one knows what the future holds. Will the CPI once again start climbing at a steeper pace? At the runaway rate the U.S. government prints money and floats new debt, the odds point in that direction. During periods of accelerating inflation, most people would rejoice at just staying even.

Imagine that in the early to mid-1960s you were a true blue "stocks for retirement" kind of investor—and you were then age 45. In 1982, as you approach age 65, your inflation-adjusted net worth sits at maybe 30 percent of the amount you had hoped and planned for. What do you do? Stay on the job another 10 years? Sell the homestead and downsize? Borrow money from a wealthy friend who invested in real estate?

Property Investors Do Not Buy Indexes and Averages. Economists calculate in the netherland of aggregates and averages. Investors buy specific properties according to their personal investment objectives. An economist's average does not capture the actual price gains (inflation plus appreciation) that real investors earn.

No investor who intelligently chooses properties for their wealth-building potential selects such properties randomly. Investors apply some variant of right time, right place, right price methodologies (see page 285). If you want to outperform the average price increases of real

estate—even though the averages themselves look quite good—you certainly can.

Earn Good Returns from Cash Flows

Unlike the overwhelming majority stocks, income property typically yields (unleveraged) cash flows of 5 to 12 percent.[2] If you own a $1,000,000 property free and clear of financing, you can pocket $50,000 to $120,000 a year. If you owned a $1,000,000 portfolio of stocks, you might pocket cash flows (dividend payments) of $15,000 to $30,000 a year.

Historically, the largest source of return for unleveraged properties has come from cash flow. If you want to grow a passive, inflation-protected stream of income, own income properties.

Economists and financial planners greatly embarrass themselves when they sleight or ignore this critical source of return. Before Charles Ellis, Robert Shiller, and others of their ilk again take up their pens to write on real estate, they might set aside their misguided claims of expertise on realty returns and first learn something about the actual practice of investing in real estate. If they did, they would also learn that nearly all property investors magnify their returns with leverage.

Magnify Your Price Gains with Leverage

Know-nothing economists, financial analysts, and various media-anointed experts claim that price gains from property provide real (inflation-adjusted) returns of one to two percent a year. In doing so, they omit the return-boosting power of OPM (other people's money—typically, mortgage financing).

Low Rates of Price Gain Create Big Returns. Assume you acquire a $100,000 property. You borrow $80,000 and place $20,000 down. During the following five years, the CPI advances by 50 percent. Your property, though, lagged the CPI. Its price only increased by 25 percent. Your real wealth fell, right? No, it increased.

You now own a property worth $125,000, but your equity wealth—your original $20,000 cash equity in the property—has grown to $45,000 (not counting mortgage amortization of principal). You have more than doubled your money. To have stayed even with the CPI, your equity only needed to grow to $30,000.

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[2] Yields in the U.K., Asia, and most of Europe often fall somewhat below those available throughout the United States.

Acorns into Oak Trees. Real estate investing builds wealth because it grows acorns (small down payments) into free and clear properties worth many multiples of the *original* amount of invested cash. Let's go back to that Shiller example.

The homebuyer paid a price of $16,000 in 1948. Did that homebuyer pay cash? Not likely. Ten to 20 percent down set the norm—say, 20 percent or $3,600 (.2 × $16,000). At Shiller's hypothetical 2004 value of $360,000, the homebuyer multiplied his original investment 100 times over. Even if we say the 2004 property value comes in at $180,000—the homeowner enjoyed a 50-fold increase of his $3,600 down payment.

What about stock gains during that period of 1948 to 2004? In 1948 the DJIA hovered around 200 (by the way, still about 40 percent below its 1929 peak of 360). In 2004, the DJIA stood at about 8,000—a 40-fold gain. Not bad, but still less than the gains from property (and much, much less when we bring cash flows into the comparison of returns). [Note: As I write in mid-2009, the DJIA still sits around 8,000—whereas property prices (in all but the most distressed areas) are still up from 2004 and way up from 1998, which is the year that the DJIA first hit 8,000.]

Magnify Returns from Cash Flows with Leverage

Traditionally, investors not only magnify their equity gains from leverage, they also magnify their rates of return from cash flows. You pay $1,000,000 cash for an apartment building that yields a net income (after all operating expenses) of 7.5 percent (no financing). Not bad. But if you finance $800,000 of that $1,000,000 purchase price at, say, 30 years, 5.75 percent interest, you invest just $200,000 in cash. Your net income equals $75,000 (.075 × 1,000,000) and your annual mortgage payments (debt service) will total around $56,000. You pocket $19,000 ($75,000 less $56,000). You've boosted your cash flow return (called cash on cash) from 7.5 percent to 9.5 percent (19,000 ÷ 200,000).

Build Wealth through Amortization

Assume for a moment that your $1,000,000 apartment building throws off zero cash flows. You apply every dollar of net operating income to paying down your mortgage balance of $800,000. After 20 years, you own the property free and clear. This property experienced no gain in price. It's still worth $1,000,000.

No price gains from inflation, no price gains from appreciation, and no money pocketed from cash flows. Quite unrealistic and pessimistic, right? Yet, over a 20-year period, you grew your equity from $200,000 to

$1,000,000—a five-fold gain, and annual compound growth rate of more than 8 percent.

Your tenants just bought you a $1,000,000 property. That's why I tell my students, "Rent or buy?" asks the wrong question. All tenants buy—the real question is one of ownership. If you rent, you still pay your landlord's mortgage. Your landlord reaps the rewards of ownership—while tenants bear the cost. Seems to me a great deal for property investors.

Over Time, Returns from Rents Go Up

Most property owners raise their rents. Maybe not this year. Maybe not next year. But over a period of five years or more, increasing rents yields increasing cash flows. If you've selected a right time, right place, right price location, demand will push rents up as more people want to live in the neighborhood where your property is located. Or perhaps, as government floods the economy with paper money, inflationary pressures force rents up. Either way, you gain. In fact, you can gain even if your rent increases fail to match the inflationary jumps in your expenses.

Let's return to our apartment building example. Gross rent collections equal $125,000; net operating income equals $75,000; mortgage payments equal $56,000; your cash flow equals $19,000.

Gross rents	$125,000
Vacancy and expenses	50,000
Net operating income	75,000
Annual mortgage payments	56,000
Cash flow	19,000

First, assume your rents and expenses each increase by 8 percent. Here are the revised amounts:

Gross rents	$135,000
Vacancy and expenses	54,000
Net operating income	81,000
Annual mortgage payments	56,000
Cash flow	25,000

An 8 percent increase in rents and expenses boosts your cash flow by 31 percent:

$$25{,}000 \div 19{,}000 = 1.31$$

If expenses had increased by 12 percent and rents stepped up mildly by just 6 percent per annum (p.a.), you would still increase your cash flow:

Gross rents	$132,500
Vacancy and expenses	56,000
Net operating income	76,500
Annual mortgage payments	56,000
Cash flow	20,500

$$20{,}500 \div 19{,}000 = 1.08$$

[Note: You can run multiple scenarios with these numbers and other numbers presented throughout this chapter. No results are guaranteed. Through your own market and entrepreneurial analysis, you will both estimate and create the potential returns for the properties you buy.]

But I do encourage you to realistically envision the return possibilities that property investing offers. Then as you evaluate markets, properties, and the economic outlook for your geographic areas of interest, figure the probabilities. Which sources of return look most promising? Which sources of return seem remote? What risks could upset the applecart?

Refinance to Increase Cash Flows

You increase your cash flows when you increase your rents (or decrease your expenses). You also increase your cash flows when you refinance to lower your annual mortgage payments. Today, a future refinancing at rates lower than those currently available seems somewhat remote.

But who knows? From 1930 until the early 1950s, interest rates on long-term mortgages ranged between 4.0 and 5.0 percent. A refi from a 6.5 percent, 30-year loan into a 4.5 percent, 30-year loan would not only slice your mortgage payments by 20 percent, it would lift your cash flows by an even greater percentage.

In some future time, we might again confront mortgage interest rates of 8 to 10 percent. Under those market conditions, a later refinance at lower interest rates becomes ever more likely.

(Note: Chapter 2 introduces a technique called a wraparound mortgage whereby investors can obtain the benefit of a lower-than-market interest rate through seller financing. Wraparounds give buyers a reduced interest rate and at the same time, from a seller's perspective, the wraparound creates another source of return, cf. p. 34.)

Refinance to Pocket Cash

Unless history makes a U-turn, buy a property today and within 10 to 15 years, you can sell it for 50 to 100 percent more than the price you paid. You gain a big pile of cash. But what if you do not want to sell? Can you still get your hands on some of that equity that you have built up? Sure. Just arrange a cash-out refi.

Here's how this possible source of return works. Say after 10 years your $1 million property is now worth $1.5 million. You've paid down your loan balance to $650,000. Your equity has grown from $200,000 to $850,000 ($1.5 million less $650,000). You obtain a new 80 percent loan-to-value ratio (LTV) mortgage of $1.2 million. You pocket $550,000 tax free!

But don't spend that cash. Reinvest it. Buy another income property. Yes, you now owe higher monthly mortgage payments on your first property, and your cash flows from that property will decrease. But with the additional cash flows from your second property, your total cash flows will go up. How's that for having your cake and eating it too?

Buy at a Below-Market Price

When the economists (mis)calculate the returns that property investors receive, they omit the fact that savvy buyers often acquire great properties for less than their market value. Opportunity (grass-is-greener) sellers, don't-wanter sellers, ill-informed sellers, incompetent sellers, unknowledgeable sellers—and most importantly in today's markets—financially distressed sellers all will sell at below-market prices.

And unlike in normal times, the financially stressed and distressed today not only include individual property owners but also the mortgage lenders themselves. Financial institutions now own more than a million foreclosures (called REOs) that they must sell as quickly as they can line up buyers to take these properties off their books.

How do you find and buy these properties for less than they are worth? See Chapters 5, 6, and 7.

Sell at an Above-Market-Value Price

How do you sell a property for more than market value? Find a buyer who is unknowledgeable, incompetent, or pressed by time. Offer seller financing, a wraparound, or perhaps a lease option. Develop your skills of promotion and negotiation (see Chapter 13). Match the unique features and benefits of the property. Sell the property with a below-market-interest-rate assumable (or subject-to) loan.

Sometimes buyers pay more than market value because they don't know (or do not care) what they're doing. Sometimes they pay more to obtain a much-desired feature or terms of purchase/financing. Whatever their reason, if you wish to exploit this possibility, you've created another source of return.

Create Property Value Through Smarter Management

When you manage your properties and your tenants more intelligently, you increase your rent collections (without necessarily raising your rents); you reduce tenant turnover; you increase prospect conversions; you spend less, yet spend more effectively for maintenance, promotion, and capital replacements. You enjoy peaceful, pleasant, and productive relations with tenants.

Fortunately for you, most owners of investor-size (as opposed to institutional-size) rental properties manage their investments poorly. Why fortunately? Because their mal-management provides opportunities for you. Upon acquiring a property, you can execute a more effective and competitive management strategy to increase the property's cash flows and, simultaneously, lift its market value.

How can you achieve such performance? Rely on Chapter 11 to develop your profit-maximizing management *and* market strategy.

Create Value with a Savvy Market Strategy

Although investors tend to manage their properties poorly, they show even less skill as savvy marketers. Go to the property web site, loopnet.com. Click through to a sample of listings. Look at the listing promotional information provided. Look at the property photographs. Does the agent tell a persuasive story about the property? Does the sales message position that property against the tens of thousands of competing properties that also hunger for attention? Do the photographs of properties reveal a well-cared-for property—a property that invites tenants to call it home?

I will give you the answers. No! No! No! The implication? More opportunities for you to gain competitive advantage. When you combine the management know-how and marketing strategy lessons of Chapters 11 and 13, you earn higher cash flows; you provide a better home for your tenants; and when the time to sell arises, your property will command a higher price.

Create Value: Improve the Location

A famous cliché in real estate says, "You can change anything about a property except its location." True or false? Absolutely false. As Chapter 8 shows, not only can you improve a location, but doing so also offers one of your most powerful sources of return.

Think for a moment. What does the concept of location include? What makes the location where you live desirable or undesirable? Accessibility, aesthetics, quiet, good public transportation, cleanliness, the people who live in the neighborhood, schools, parks, shopping, nightlife . . . the list could go on and on. What's the best way to improve any or all of these attributes? Community action. Examples abound throughout the United States and throughout the world.

Convert from Unit Rentals to Unit Ownership

Buy wholesale, sell retail. A grocer buys a 48-can box of tomato soup and then sells each can individually along with a retail mark-up. Property investors can execute a similar wholesale-to-retail strategy.

Buy a 48-unit apartment building; then, after completing legal approvals and documentation, sell each apartment individually. In principle, you can apply a similar condo-conversion strategy to office buildings, neighborhood strip centers, self-storage warehouse units, mobile home parks, hotels, marinas, boat storage facilities, private aircraft hangars, and other types of rental real estate where potential users might prefer to own versus rent. In each case, you typically pay less per unit (or per square foot) for an entire building than retail buyers are willing to pay for the smaller quantities of space that they require to meet their needs.

Opportunities for conversion profits never remain constant. As property markets change, potential profit margins swing between "make an easy million" to "call the bankruptcy lawyer."[3]

To capitalize on this source of return, monitor the relative per-unit prices of properties sold as rentals (income property investments) and comparable space sold in smaller sizes to end users (see pp. 172–175).

Convert from Lower-Value Use to Higher-Value Use

Assume that in your city, single-family residential (SFR) space rents for, say, $2 per square foot (psf) (due to a severe shortage)—offices rent for

[3] In such distressed market conditions, you might profit from reverse conversions. Buy a fractured condo and operate it as a rental property.

$1 psf (due to excess supply). Five years from now, single-family space rents for $1.50 psf (due to excessive overbuilding), and because of strong economic and job growth, office space rents for $3.00 psf. What might you do (if zoning permits)? Convert your SFR to offices.

Conversions of use typically require you to renovate (at least to some degree) the old, lower-value space use to fit the market needs of the higher-value use. But when relative prices and/or rent levels grow progressively wider, conversion of use can generate a lucrative source of returns (see p. 175).

Subdivide Your Bundle of Property Rights

When you own a freehold estate in property, you actually own an extensive bundle of divisible property rights. Such rights may include (but are not limited to):

- Air
- Mineral
- Oil and gas
- Coal
- Access
- Subsurface
- Development
- Water
- Leasehold
- Grazing
- Timber
- Solar/sunlight
- Easement

When Donald Trump built his United Nations World Tower, several nearby property owners pocketed several million dollars. Why? Because Trump paid these owners to transfer a portion of their air rights to him. After purchasing their air rights, the City of New York permitted Trump to build 80 stories instead of 40 stories, as the zoning law then specified.

When you are in Hong Kong, notice that high-rise apartments tower directly above some of the MTR stations. Developers paid the Hong Kong government for the right to use that airspace—even though the government retained ownership and use rights of the land beneath the apartment buildings.

Nearly everyone understands that property owners can sell leasehold rights to earn revenues. (Not all governments, though, permit leaseholds

for all properties—and when they do, they may severely limit the terms and price of the leasehold agreement.) However, in addition to leasehold, you might sell, lease, or license other rights that derive from a freehold estate. Transferring one or more of these other rights can generate another source of return.

Subdivide the Physical Property (Space)

In one sense, condominium conversions represent one form of subdividing. But usually subdividing refers to selling or leasing land or buildings in smaller parcels, most commonly, a developer who buys 500 acres and cuts it up and sells off half-acre lots to homebuilders. For another example, consider a shut down Kmart store. A still-thriving big box retailer might pay $10 per square foot to let the entire now-vacant building.

Instead, a property entrepreneur could master lease the property and subdivide the interior space into a variety of uses such as childcare, offices, and/or smaller retail merchants. Each small tenant pays a higher ppsf (price per square foot) rental rate than would the Best Buy or Lowe's who might otherwise lease the total building. If the new space users require lower parking ratios than the old Kmart, the entrepreneur might subdivide some of the parking lot area for additional retail/restaurant uses.

Thoughtful entrepreneurs steeped in market knowledge and possibility thinking persistently search for properties to subdivide. In such cases, the sum of the parts exceeds the value when viewed as a whole.

Create Plottage (or Assemblage) Value

You create plottage or assemblage value when you combine smaller parcels into a larger parcel of land or space. Say you discover a perfect site to build a new neighborhood shopping center. Zoning and planners require a minimum of four acres for such a development. The site equals four acres but it is owned by eight different persons in one-half acre lots. Individually, the lots are worth $10,000 apiece—or $80,000 in total.

However, as a four-acre shopping site, the land would sell for $250,000. You now see how to earn a good profit. Persuade each of the current owners to sell you his lot at its current market value (or even at a price that sits somewhat above market value). Perhaps the champion assembler to create plottage value was the Walt Disney Company. Over a period of 10 years, Disney secretly accumulated 25 square miles of Central Florida land at agricultural-valued prices. Once they completed this assemblage, the value of the aggregate site probably exceeded cost by a factor of 20 (or more).

Obtain Development/Redevelopment Rights

Return to the four-acre neighborhood shopping center example. You succeed. You acquire all eight lots at a total price of $130,000 (several of those owners did not want to sell—so you sweetened your offer). Can you start building the center? No. You must first secure a long list of government permits and approvals. So, your $250,000 current site value stands independent of a government go-ahead.

With permits in place, the land could command a price of $500,000. You could sell now and take your profit. Or you could stay in the game. Spend $50,000 (or so) for lawyers, soil tests, public hearings, environmental clearance, traffic studies, and whatever else the city powers throw at you. This permit process requires (with luck—and no unanticipated delays) 6 to 12 months. If all goes as planned, you earn another $200,000.

In real estate, government approvals add to the value of any property that is ripe for development, redevelopment, renovation, conversion—or destruction.[4] Obtain those necessary permits and you earn a good-sized return.

Tax Shelter Your Property Income and Capital Gains

To build wealth, protect your income and capital gains from the greedy grasp of government. Fortunately (under current tax law), investing in real estate provides you more opportunity to avoid paying taxes than any other asset class.

Depreciation (noncash) deductions shelter all (or nearly all) of your positive cash flow. A Section 1231 exchange shelters your capital gain as you pyramid your investment properties. The $250,000/$500,000 capital gain exclusion provides you tax-free gains from the sale of your personal residence(s). A cash-out refinance (that your tenants will repay for you) deposits tax-free cash into your bank account. And if you buy a "first-time" home, the newly enacted $8,000 tax credit provides part (or maybe all) of the cash for your down payment.

Some naïve souls might object. "I can build my stock market wealth tax free through my 401(k), 403(b), and IRA plans. That tax break beats property."

Well, even if that tax break did beat property—which it doesn't—you forget that when you begin to draw on that cash during retirement, the

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[4] Yes, government even requires permits to tear down buildings. In Sarasota, Florida, the Ritz Carlton fought a four-year battle to obtain permission to tear down a historic house located on part of the site where the Ritz planned to build. In compromise, the Ritz eventually paid to move the house to another site.

government will tax every penny as ordinary income. In addition, if you want to tap into that cash kitty prior to reaching age 59-1/2 (as nearly 50 percent of Americans do), the IRS will grab 35 to 50 percent of those amounts (taxes plus penalties). If you die before you withdraw, the IRS still reaches in and pulls out its share.

To minimize loss of income and wealth to the IRS, buy investment real estate. (For a discussion of property taxes and income tax laws, see Chapter 14.)

Diversify Away from Financial Assets

Although some investors prefer stocks, those investors would prove themselves wise to diversify part of their portfolio into property.

As investment experience shows, during periods of expected and unexpected inflation, property prices have kept pace with or exceeded the rate of growth in the CPI. Even better, leverage transforms small price gains into double-digit rates of increase in your equity wealth.

Property prices show much less volatility than stock and bond prices. The recent depression, surfeit of foreclosures, and price downturns for many properties seem mild compared to the precipitous periodic drops in stock prices. Even in the hard-times property markets, prices have only fallen back to their 2004-2005 levels. As I write, all major stock indices sit below their levels of 1998.

Today, most financial planners encourage asset diversification. Historical as well as recent experience support that view. The mantra "stocks, stocks, and more stocks for retirement" does not meet the test of experience. Add property to your investments—if not for its superior returns, then to reduce your portfolio risks.

IS PROPERTY ALWAYS BEST?

Some people think that I serve as head cheerleader for investing in real estate. In one sense, they are right. The record shows that more average people have built sizeable amounts of wealth through property than any other type of savings or investment.

However, I do not say, "Property investments will beat stocks or bonds any time, any place, at any price." As early as 2005, I told my investor audiences that I would not buy property in the then-current hot spots such as Las Vegas, Miami, Singapore, Dublin, or Dubai. Speculative frenzy drove those markets—not reasoned fundamental evaluation of risks and rewards.

So, when people ask me, as they often do, "Which investment provides the best returns —stocks or real estate?" I answer, "It all depends."

Certainly, in 1989, I would rather have invested in the S&P 500 index fund than Tokyo real estate. In 1993, I would have preferred the DJIA to property in Berlin. In 1997, I would rather have bought Apple Computer stock than a Hong Kong condominium located on the Peak.

You must rely on investment and market analysis. Investors do not always make more money with property than they do with stocks. I have never said otherwise. But that begs the question, "Which investment offers the best possibilities and probabilities today?"

Given today's bargain property prices relative to where property values will likely stand 6 to 10 years from now; given the fact you can build large increases in property wealth (equity) without big gains in price; given the relative income yields of property versus stocks (or bonds); given the tax advantages of property relative to all other investments; given the multiple sources of returns that property offers; and last—but far from least—given the entrepreneurial talents that you can apply to property to increase its price and cash flows; then, yes, in today's market, I am willing to lead the cheers for investing in real estate.

2

FINANCING: BORROW SMART, BUILD WEALTH

To build wealth fast, use borrowed money. Used smart, financial leverage magnifies your gains. Used dumb, leverage not only increases your chance of loss, it magnifies the loss you incur. Smart borrowing leads you to financial security. Dumb borrowing leads to sleepless nights, drained bank accounts, and forced property sales.

As recent experience shows, excessive debt has drowned the hopes and dreams of many investors and homebuyers. To help understand why, look back to the faulty advice that (until recently) enticed millions of naïve and ill-prepared Americans to borrow dumb.

In the early days of the get-rich-quick real estate gurus, property prices were escalating 10 to 20 percent a year. Just as occurred during 2001–2006, back then nearly every would-be investor wanted to get a piece of the property action. Yet a majority of these hopeful buyers lacked cash, credit, or both. They possessed the will, but they lacked the means.

THE BIRTH OF "NOTHING DOWN"

Enter Robert Allen, Carlton Sheets, Tyler Hicks, Al Lowry, Mark Haroldson, and other promoters of "nothing down." To sell their books, tapes, CDs, DVDs, and seminars, these pundits promised the ill prepared a solution to their dilemma. "No cash, no credit, no problem." Just learn the tricks and techniques of creative finance and you too can become a real

estate millionaire.[1] Not surprisingly, the property boom of late reinvigorated those guru promises of easy wealth. Scores of books, CDs, seminars and boot camps have promoted all types of get-rich schemes that tell wannabe investors that they can win big in real estate through lease options, short sales, foreclosures, flipping, and a sundry collection of other so-called no cash, no credit techniques.

In his book *Multiple Streams of Income: How to Generate a Lifetime of Unlimited Wealth* (John Wiley & Sons, 2004), Robert Allen recounts his famous boast to the skeptical *Los Angeles Times*: "Send me to any city," Allen told the newspaper. "Take away my wallet. Give me $100 for living expenses. And in 72 hours, I'll buy an excellent piece of property using none of my own money." (p. 140)

In response, the *L.A. Times* hooked Allen up with a reporter, and off they went. "With this reporter by my side," Allen writes, "I bought seven properties worth $722,715. And I still had $20 left over." The *Times* ate crow and headlined a follow-up article "Buying Homes without Cash: Boastful Investor Accepts Challenge—and Wins." "Yes, these techniques do work," Allen writes.

No question, Robert Allen and others who have preached a similar gospel are right. You *can* buy with nothing down, but that begs the real question. The real question is whether you *should* buy with little or no cash or credit.

SHOULD YOU INVEST WITH LITTLE OR NO CASH OR CREDIT?

If investing in real estate with little or no cash or credit were a sure route to wealth, this country would be awash in real estate millionaires. Indeed, more than 10 million people have bought various nothing-down books, tapes, videos, courses, and seminars. With all this knowledge of creative finance floating about, you might think that the secrets of building real estate wealth were available to almost everyone.

So where's the catch? Why, among so many who have signed up, can so few boast of success, and why have so many perished?

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[1] The term *creative finance* eludes precise definition. In general, it refers to the use of multiple sources of credit (e.g., sellers, real estate agents, contractors, partners) and out-of-the-norm financing techniques such as mortgage assumptions, subject-to purchases, land contracts, lease options, second or third mortgages, credit card cash advances, master leases, and so forth. In some circumstances, investors can use creative financing to buy real estate even though they lack cash or good credit. Each of these topics is discussed in this chapter.

What's Wrong with "No Cash, No Credit"?

To begin with, let me emphasize that many smart, experienced, and successful investors and homebuyers do use various forms of creative finance. I endorse creative finance. I use it myself.

However, we have all seen so many deals crash and burn that I advise caution. Many promoters of creative finance have oversold its advantages and underplayed its potential perils. Before you imbibe such an intoxicating elixir, think through the following issues:

Do You Live below Your Means? In their bestseller *The Millionaire Next Door* (Longstreet, 1997), Thomas Stanley and William Danko reveal that self-made millionaires typically live *below* their means. More often than not, they avoid prestige spending. They do not drive new Jaguars or BMWs, dress for success in Armani suits, spend lavishly with their platinum American Express cards, or wear $200 (let alone $2,000) wristwatches. Serious wealth builders display no foolish affectations of conspicuous consumption.

In contrast to the typical wealth builder, many of the dreamers who were attracted to the schemes of the real estate gurus never learned to spend (or invest) wisely. They primarily see real estate as a means to circumvent their money and credit problems—a quick and painless way to live the envied lifestyles of television's rich and famous.

In fact, promoters of "no cash, no credit" shamelessly encourage this lavish image. They typically display themselves in fabulous settings. Mark Haroldson's photo on the cover of his book *(How to Wake Up the Financial Genius Inside of You)* shows him lounging on the hood of a Rolls Royce. Irene and Mike Milin *(How to Buy and Manage Rental Properties)* instead chose a Mercedes 600 for their photo backdrop. And, of course, nearly everyone has seen the TV infomercial where Carlton Sheets sat by the pool enjoying a beautiful Florida bay-front estate.

Take a hard look at yourself. Is your goal to sensibly pursue the inner security and confidence of a millionaire next door? Do you presently live *well below* your means? Do you save a large percentage of your earnings? Or do you frequently fail to discipline your fiscal frivolities? Do you try to show the world you've "made it"? Do you believe creative finance techniques can override your need to shape up your financial fitness?

If a borrow-and-spend personal profile describes you, align your motives and priorities. The "no cash, no credit" gurus have lured too many people into believing that, as one such promoter puts it, "nothing down can make you rich." Wrong! Nothing down can help get you started in real estate, but only fiscal discipline can pave your path to long-term wealth and financial security. Before you look to creative finance, critically

review and adjust (revolutionize, if necessary) your habits of spending, borrowing, and saving.

Price versus Terms. Some creative-finance gurus urge their students to talk sellers into creative-finance schemes with this gambit: "You set the price, let me set the terms." In this way the seller will (ostensibly) receive a price that exceeds his property's market value (along with great bragging rights). In exchange, the creative-finance buyer asks for terms that may include seller financing, little or nothing down, a below-market interest rate, lease option, or other seller concessions.

In their eagerness to jump into a "your price/my terms" deal, novice investors frequently fail to adequately inspect the property for problems. In addition, they end up owing more than their properties are worth. When problems develop that a buyer can't afford to pay for—or otherwise remedy—he or she also faces the problem of owning a property that can't be sold for a price high enough to pay off the mortgage balance. Experience shows that the financially weak and ill-prepared flock to property during boom times with no idea that (in the short run) quick advances in price often signal a coming downturn.

The lesson: Anytime you agree to pay more than a property is worth, you invite financial trouble. The terms of creative finance can seldom overcome the tenuous position that an overfinanced, overpriced property presents. (You'll see a specific financial example of "you name the price, I'll set the terms" later in this chapter.)

Credibility versus Creativity. Many would-be investors use creative financing techniques not just to buy with little or nothing down but also to work around credit problems (no credit record, slow pay, write-offs, bankruptcy, foreclosure, self-employment, etc.). Nevertheless, regardless of your credit history, before you can arrange any type of sensible financing, establish your credibility.

Yet credibility and creativity often clash. In contrast to the boom years, today's dealmakers have wised up. If you suggest a deal that seems strange, risky, or simply off-the-wall, other would-be participants in the transaction (broker, seller, mortgage lender) may doubt that you really know what you're doing. Or they may come to believe that you lack financial resources, experience, or both.

Before you try to negotiate a creative-finance scheme, sound out the views and possible responses of the other players in the deal. If you go too far from the reasonable, others may simply walk away and dismiss you as a fake (big hat, no cattle). For your failure to establish credibility, you'll lose good properties.

Perseverance versus Productivity. Nearly all "no cash, no credit" gurus admit (at least in their fine print) that the majority of sellers, brokers,

and mortgage lenders will reject most of their financing techniques. "How often does a transaction like this happen?" Robert Allen (*Multiple Streams of Income,* p. 142) asks rhetorically after explaining one of his zero-down techniques. "Very rarely. One in a hundred. It takes luck, chutzpa, and quick feet."

Now, ask yourself: Will the search for creative finance lead to success? For many in the past, that answer has been no. When these previously eager investors have met repeated rejection and disappointment, they gave up. They came to see real estate "investing" as a waste of time.

In doing so, they missed the success they could have enjoyed had they prepared themselves financially and pursued conventional financing and acquisitions. In other words, if you chase after deals that stand little chance of profitable completion, steel yourself against slammed doors and fatigue. To achieve creative possibilities, persevere. Realize, too, that most investors who build long-term wealth and financial security not only design and forecast their potential rewards from a deal, they anticipate risks. They build contingency plans to follow when events turn against them.

Leverage: Pros and Cons

Never assume that good refinance possibilities will exist at the time you most need them. Never let anyone tempt you into believing any deal represents a sure thing. Rents can fall. Vacancies can increase. In the short run, you may not be able to sell your property at a price high enough to pay off your loan(s). Interest rates can go up, and loan-underwriting standards can tighten. Today's foreclosures are multiplying (in part) because of the false beliefs and assumptions that lay behind "no cash, no credit, no problem."

Leverage Magnifies Returns. With risks in view, now the good points. The term *leverage* means that you employ a proportionately small amount of cash to acquire or control a property. To illustrate: you buy a $100,000 rental property that produces a net operating income (NOI) of $10,000 a year.[2] If you finance this unit with $10,000 down and borrow $90,000 (a *loan-to-value ratio* of 90 percent), you highly leverage your purchase.

You own and control a property. Yet you put up only 10 percent of the purchase price, whereas if you paid $100,000 cash for the property, you would not have leveraged your purchase (no OPM).

But leverage can magnify your cash-on-cash returns. The following four examples calculate rates of gain in equity from price increases based on alternative down payments of $100,000 (an all-cash purchase), $50,000, $25,000, and $10,000.

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[2] Obviously, in high-priced areas of the country, $100,000 won't buy a studio apartment. But to illustrate, it's an easy figure to work with.

Example 1: $100,000 all-cash purchase

$$\begin{aligned}\text{ROI (return on investment)} &= \text{Income (NOI)/Cash investment}\\ &= \$10{,}000/\$100{,}000\\ &= 10\%\end{aligned}$$

In this example, you pocket the full $10,000 of net operating income (rental income less expenses such as insurance, repairs, maintenance, and property taxes). Now, if you instead finance part of your purchase price, you will make mortgage payments on the amount you borrow. If we assume you find financing at 8 percent for 30 years, you will have to pay your lender $7.34 a month for each $1,000 you borrow. Now, using various percentages of leverage, the subsequent examples show how to magnify your rates of return.

Example 2: $50,000 down payment; $50,000 financed. Yearly mortgage payments equal $4,404 (50 × $7.34 × 12). Net income after mortgage payments (which is called cash throw-off) equals $5,596 ($10,000 NOI less $4,404).

$$\text{ROI} = \$5{,}596/\$50{,}000 = 11.1\%$$

Example 3: $25,000 down payment; $75,000 financed. Yearly mortgage payments equal $6,607 (75 × $7.34 × 12). Net income after mortgage payments (cash throw-off) equals $3,394 ($10,000 NOI less $6,606).

$$\text{ROI} = \$3{,}394/\$25{,}000 = 13.6\%$$

Example 4: $10,000 down payment; $90,000 financed. Yearly mortgage payments equal $7,927 (90 × $7.34 × 12). Net income after mortgage payments (cash throw-off) equals $2,073 ($10,000 NOI less $7,927).

$$\text{ROI} = \$2{,}073/\$10{,}000 = 20.7\%$$

With the figures in these examples, the highly leveraged (90 percent loan-to-value ratio) purchase yields a cash-on-cash return that's double the rate of a cash purchase. In principle, the more you borrow, the less cash you invest in a property, and the more you magnify your cash returns. Of course, the *realized* rate of return you'll earn on your properties depends on the actual rents, expenses, interest rates, and purchase prices that apply to your properties. Work through those numbers at the time you buy to see how much you can gain (or lose) from leverage.

Now, for better news. Here's a greater way that leverage can magnify your returns and help you build wealth faster.

Over the years (if well-selected), your rental properties will increase in price. If the price of that $100,000 property we've just discussed increases at an average annual rate of 3 percent, you earn another $3,000 a year. If its price increases at an annual rate of 5 percent, you'll gain $5,000 more a year. And at a 7 percent annual rate of appreciation, your gains will hit $7,000 a year.

Add together annual rental income *and* annual price gains, and you'll gain these combined returns:

$$\text{Total ROI} = \text{Income} + \text{Appreciation}/\text{Cash investment}$$

Example 1: $100,000 all-cash purchase and (a) 3 percent, (b) 5 percent, and (c) 7 percent rates of appreciation:

(a) Total ROI = $10,000 + $3,000/$100,000 = 13%
(b) Total ROI = $10,000 + $5,000/$100,000 = 15%
(c) Total ROI = $10,000 + $7,000/$100,000 = 17%

Example 2: $50,000 down payment and (a) 3 percent, (b) 5 percent, and (c) 7 percent rates of appreciation:

(a) Total ROI = $5,596 + $3,000/$50,000 = 17.2%
(b) Total ROI = $5,596 + $5,000/$50,000 = 21.2%
(c) Total ROI = $5,596 + $7,000/$50,000 = 25.2%

Example 3: $25,000 down payment and (a) 3 percent, (b) 5 percent, and (c) 7 percent rates of appreciation:

(a) Total ROI = $3,394 + $3,000/$25,000 = 25.6%
(b) Total ROI = $3,394 + $5,000/$25,000 = 33.6%
(c) Total ROI = $3,394 + $7,000/$25,000 = 41.6%

Example 4: $10,000 down payment and (a) 3 percent, (b) 5 percent, and (c) 7 percent rates of appreciation.

(a) Total ROI = $2,073 + $3,000/$10,000 = 50.7%
(b) Total ROI = $2,073 + $5,000/$10,000 = 70.7%
(c) Total ROI = $2,073 + $7,000/$10,000 = 90.7%

When you combine returns from annual net rental income and price increases, highly leveraged properties *may* produce quite strong annual rates of return—*even without unrealistically high average annual rates of price increases.* That's why even small investors in rental properties have (over time) built net worths that run into the millions of dollars. When you own rental properties, steady rent and price increases grow acorns (relatively low down payments) into oak trees (property equity worth hundreds of thousands [or millions] of dollars). As the years pass and you pay down your mortgage balances, a property portfolio of just 6 or 8 houses or perhaps 12 to 16 apartment units (sometimes less) can build enough wealth to guarantee a secure and prosperous future. (Note, too, how these income property rates of return outshine the widely believed [yet overstated] 10 percent average annual gains that the stock market has supposedly produced since 1926.)

Manage Your Risks. The advocates of get-rich-quick real estate schemes often fail to warn their followers that highly leveraged real estate magnifies risks as well as returns. As a result, many naïve real estate investors have lost their shirts. These buyers optimistically expected the market values of their properties to show price gains of 10 to 20 percent a year. They lost touch with reality. In fact, many "investors" barely cared what purchase prices they paid, what rent levels they collected, or how they financed their properties. They just knew that they would be able to sell their properties in a few years for twice the amount they had paid.

One such investor, for example, bought a $300,000 fourplex with a down payment of $30,000. After paying property expenses and his mortgage payments, the investor faced an alligator (negative cash flow) that chewed up $1,000 a month. But the investor figured that $1,000 a month was peanuts because he believed the sales price of the property would go up 15 percent a year. Based on that rate of gain, here's how this investor calculated the annual returns that he (unrealistically) expected to receive:

$$\begin{aligned}\text{ROI} &= \text{Income} + \text{Appreciation/Cash investment}\\ &= -\$12{,}000\ (12 \times -\$1{,}000) + \$45{,}000\ (.15 \times \$300{,}000)/\$30{,}000\\ &= \$33{,}000/\$30{,}000\\ &= 110\%\end{aligned}$$

As it turned out, this investor, like so many others, could not continue to feed his alligator $1,000 a month. He fell behind with his mortgage payments, and as the market slowed, he was unable to sell the property.

The lender foreclosed, and the investor lost the property, his down payment of $30,000, the $24,000 of monthly cash outlays he had made before his default, and his once-high credit score.

Here are four lessons you can take away from this investor's bad experience:

1. Never expect the value of real estate, stocks, gold, antique automobiles, old masters, or any other type of investment to increase by 10, 15, or 20 percent year after year. When you need high rates of price gain to make your investment look attractive, you set yourself up for a big loss. (Avoid dot-com mania.)

2. Beware of negative cash flows. If the income you earn from an asset does not support the price you pay, you magnify your risk and chance of loss. You are speculating more than investing. That's okay if that's what you want to do. Just recognize that speculators (whether they realize it or not) play in a high-risk game.

3. Beware of financial overreach. High leverage (a high loan-to-value ratio) usually requires large mortgage payments relative to the amount of net income that a property brings in. Even if at first you don't suffer negative cash flows, vacancies, higher-than-expected expenses, or large rent concessions intended to attract good tenants can push you temporarily into the swamps where alligators feed.

Over a period of, say, 10 to 20 years, owning real estate will make you rich. But to get to that long-term future, you will likely pass through several cyclical downturns. Without cash (or credit) reserves to defend against alligator attacks, you may get eaten alive before you find the safety and comfort of high ground.

I first offered this advice in the 1995 (2nd) edition of this book. Unfortunately, many recent investors did not heed it. The more times change, the more they stay the same.

4. *Even when the financing looks "good," avoid overpaying for a property.* Overly optimistic investors buy overpriced properties with little or no down payment deals. In the earlier fourplex example, the investor agreed to pay $300,000 for his fourplex not because the property's net income justified a price of $300,000. Rather, he paid $300,000 because he was excited about his easy-credit, low, 10 percent down-payment financing. Compared with the $600,000 sales price that he expected to reap after just four or five years of ownership, his $300,000 purchase price looked cheap.

Again, I emphasize: I do not want to discourage you from making low down payments. But when you do, anticipate possible setbacks. To

successfully manage the risks of high-leverage finance, follow these six safeguards:

1. *Buy bargain-priced properties.* You build a financial cushion into your deals when you pay less than market value or pay less than a property is worth—not quite the same thing. Discover how in Chapters 4 through 7.

2. *Buy properties that you can profitably improve.* To build wealth fast and reduce the risk of leverage, add value to your properties through creativity, sweat equity, remodeling, and renovation (see Chapter 8).

3. *Buy properties with below-market rents that you can raise to market levels within a relatively short period (six to twelve months).* As you increase your rental income, your mortgage payments will eat up a lower percentage of your net operating income (NOI).

4. *Buy properties with low–interest-rate financing such as mortgage assumptions, adjustable-rate mortgages, interest-rate buydowns, or seller financing.* Low interest rates help you manage high debt. Of course, high rates make debt less affordable—so beware of low interest rates that may disappear within just a few years or less.

5. *Buy right time, right price, right place properties.* "All real estate is local" is an oft-cited cliché that contains some kernel of truth. Various neighborhoods and cities offer unique differences with respect to price, location, and market timing. To reduce risk and increase rewards, proactively study and select from such opportunities (see Chapter 8).

6. *When high leverage presents an anxious level of risk, increase your down payment to lower your loan-to-value ratio and lower your monthly mortgage payments.* If you don't have the cash, bring in a money partner. Don't act penny-wise and pound-foolish. Share gains with someone else rather than risk drowning in the swamps where the alligators prey.

What Are Your Risk-Return Objectives?

Little- or nothing-down finance creates opportunities for you to magnify your returns. Smart borrowing and smart investing pyramids your real estate wealth. But the more you borrow (other things equal), the more you research and prepare for an adverse turn in the market or your property operations. When you highly leverage your properties, a slight fall in rents may push you into negative cash flows. A decline in your property's value can pull you underwater. Steer clear of sunshine-every-day optimism. Work through the numbers for the deals that come your way with various potential market changes. Decide what profits are worth pursuing and what risks you prefer to avoid.

If you can't find properties in your favored area(s) that yield the numbers you would like to see, look elsewhere. Sift your discovery from low-promise cities (neighborhoods to areas that offer better income/appreciation potential.

MAXIMIZE LEVERAGE WITH OWNER-OCCUPANCY FINANCING

You now know the pros and cons of high leverage (little or nothing down). Use it; do not abuse it. In this respect, you can pursue low-down good possibilities with owner-occupied property financing.

The easiest qualifying and often the lowest-cost way to borrow most (or even all) of the money you need to buy a property remains owner-occupied mortgage financing. Even at the height of the credit crisis, high-LTV (loan-to-value) owner-occupied loan programs were readily available on single-family homes, condominiums, townhouses, and two- to four-unit apartment buildings. LTVs of 90, 95, 97, or even 100 percent financing populate this financial arena. If you do not arrange for owner-occupied financing (i.e., you choose not to live in the property), most lenders (banks, mortgage bankers, savings institutions) limit their mortgage loans on investment properties to a 70 percent to 80 percent loan-to-value ratio.[3] So, owner-occupied loans provide great advantage (as to LTV) relative to loans to finance rental properties. (However, some higher 85 to 90 percent investor loans are available, such as VA REOs—see Chapter 7.)

As another benefit, owner-occupants pay lower interest rates than investors. If lenders charge 6.0 to 6.5 percent for good credit, owner-occupied loans, the interest rate for investor properties will probably range between 6.5 and 7.5 percent. As a beginning real estate investor, weigh the possibilities of owner-occupied mortgage loans.

Owner-Occupied Buying Strategies

If you do not currently own a home, here's how to begin your wealth building in rental properties with little or nothing down—if you favor

[3] From the late 1990s to 2006, some lenders offered investor loans with total LTVs as high as 100 percent. When the property boom receded, such liberal lenders either went broke due to excessive borrower defaults, or tightened their qualifying to match or exceed more conservative (safer) underwriting standards.

this approach. Select a high-LTV loan program that appeals to you.[4] Buy a one- to four-unit property. Live in it for one year, then rent it out, and repeat the process. Once you obtain owner-occupied financing, that loan can remain on the property even after you move out. Because the second, third, and even fourth homes you buy and occupy will still qualify for high-LTV financing (low or nothing down), within a period of 5 or 6 years, you can accumulate as many as 8 to 16 rental units in addition to your own residence—all without large down payments.

You can work this homeowner gambit three or four times, possibly more. But you may not be able to pursue it indefinitely. At some point, lenders may shut you off from owner-occupied financing because they will object to your game plan. Nevertheless, serial owner-occupancy acquisitions make a great way to accumulate (at least) your first several income properties.

Current Homeowners, Too, Can Use This Method

Even if you own your own home, weigh the advantages of owner-occupied financing to acquire your next several investment properties. Here's how: Locate a property (condo, house, two- to four-unit apartment building) that you can buy and move into. Find a good tenant for your current house/condo. Complete the financing on your new property and move into it. If you like your current home, at the end of one year, rent out your most recently acquired property and move back into your former residence. Alternatively, find another "home" to buy and again finance this property with a new owner-occupied, high-leverage, low-rate mortgage.

Why One Year?

To qualify for owner-occupied financing, you must assure the lender that you intend to live in the house for at least one year. *Intend,* however, does not mean *guarantee.* You can (for good reason, or no reason) change your mind. The lender may find it difficult to prove that you falsely stated your intent at the time you applied for the loan. Beware: Do not lie about your intent to occupy a property. Lying violates state and federal laws, and governments will prosecute.

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[4] Many of these programs are described with more detail in my book, *The 106 Mortgage Secrets That Borrowers Must Learn—But Lenders Don't Tell, Second Edition* (John Wiley & Sons, 2008).

During the past property boom, borrowers lied and loan reps winked. Many borrowers and loan reps failed to comply with the "intent-to-occupy" rule. In fact, a loan rep at Wachovia (a bank that subsequently went bust) suggested that I finance a new rental house that I was buying as if it were a second home. I declined.

To succeed in real estate over the short and long term, establish, maintain, and nurture your credibility with lenders—and everyone else with whom you want to make deals or build a relationship of trust. To slip through loopholes, make false promises, sidestep agreements, or engage in other sleights will destroy your reputation for integrity. Unless you encounter an unexpected turn of events, honor a lender's one-year occupancy requirement.

Where Can You Find High-LTV Owner-Occupied Mortgages?

Everywhere! Even in today's tighter credit market: Look through the yellow pages under "mortgages." Then start calling banks, savings institutions, mortgage bankers, mortgage brokers, and credit unions. Mortgage lenders advertise in local daily newspapers and on the Internet. Check with your state, county, or city departments of housing finance. Many homebuilders and Realtors know of various types of low- or nothing-down home finance programs. Explore the web sites, hud.gov, va.gov, homesteps.com (Freddie Mac), and fanniemae.com.

WHAT ARE THE LOAN LIMITS?

The specific maximum amount you can borrow under these high-LTV programs varies by type of loan and area of the country. However, the loan limits are high enough to finance properties in good neighborhoods. For example, Freddie Mac and Fannie Mae programs nationwide will lend up to the following amounts (usually adjusted upward each year):

No. of Units	Contiguous States, District of Columbia, & Puerto Rico	Higher-Priced Areas
1	$417,000	$729,750
2	$533,850	$934,200
3	$645,300	$1,129,250
4	$801,950	$1,403,400

FHA varies its loan limits by county. Here are several examples:

Low-Cost Areas (FHA/HUD)

Type of Residence	*Loan Limits*
One-unit	$271,050
Two-unit	347,000
Three-unit	419,425
Four-unit	521,250

High-Cost Areas (FHA/HUD)

Type of Residence	*Loan Limits*
One-unit	$729,750
Two-unit	934,200
Three-unit	1,129,350
Four-unit	1,403,400

For VA loans, eligible veterans may originate—and veterans and nonveterans alike may assume—up to the following amounts:[5]

Lowest-Price Areas	Highest-Price Areas
$737,500	$417,000

Unlike Fannie/Freddy and FHA, the VA applies a single loan limit for all 1–4 unit properties. However, VA has significantly boosted its loan limit and like FHA, varies each specific limit according to the prevailing local price levels. One- to four-unit properties that are priced higher than these stated limits seldom bring in rents high enough to cover expenses and mortgage payments. So, when you select rentals that pay for themselves—even with a small down payment—the limits set by the respective insurers and guarantors should not unduly restrict your choice of properties.

[5] When a veteran makes a down payment, these loan amounts may be higher. Also, higher limits may apply in selected high-cost areas. Periodically, VA increases its limits.

HIGH LEVERAGE FOR INVESTOR-OWNER FINANCING

Assume you've reached as far as you want to go with high-LTV (low down payment) owner-occupancy financing possibilities. Or maybe you're happy in your present home. No way will you (or your spouse) move (even temporarily) to another property. Without owned occupied, what other ways help you avoid placing 20 to 30 percent of the purchase price in cash from your own savings? In other words, what high-leverage (low down payment) OPM (other people's money) techniques can you use to buy and finance your investment properties?

High Leverage versus Low (or No) Down Payment

Before we go through various low- and no-down-payment techniques, note this distinction: High leverage does not necessarily require a low down payment. High leverage means that you've acquired a property using little cash (say, 10 to 20 percent of the purchase price, or sometimes less) from your own funds.

You find a property priced at $400,000, and your lender agrees to provide a first mortgage in the amount of $280,000. Because you can't (or don't want to) draw $120,000 from your savings to make this large down payment, you need another way to raise all (or part) of these funds. If successful, you will have achieved a highly leveraged transaction. You will control a $400,000 property with relatively little cash coming out of your own pocket.

You gain the benefits (and risks) of high leverage in either of two ways: (1) Originate or assume a high-LTV first mortgage, or (2) originate or assume a lower-LTV mortgage, then to reduce (or eliminate) your out-of-pocket cash input, use other sources (loans, equity partners) to cover some (or all) of the difference between the amount of the first mortgage and the purchase price of the property.

Creative Finance Revisited

Creative finance encourages you to think through multiple financing alternatives. The term gained popularity when property prices shot up and millions of hopeful buyers felt shut out of the fast money because they lacked sufficient cash, credit, or both to enter the game. "The central theme of my course," wrote Ed Beckley in *No Down Payment Formula*, "is to teach you how to acquire as much property as you can without using any of your own money. . . . Starting from scratch requires that you become extremely resourceful. You need to *substitute ideas for cash*" (p. 69).

How might investors use creative thinking and resourcefulness to substitute for cash?

Look for a Liberal Lender. Under today's tighter underwriting, most banks and savings institutions loan only 70 to 80 percent of an (non-owner-occupied) income property's value. However, some specialty lenders will make 90 percent (or higher) LTV loans. As credit markets ease, lender competition will most likely (once again) edge up LTVs.

In addition, some wealthy private investors provide high-LTV mortgages. Find these private investors through newspaper classified ads: Advertise in the "Capital Wanted" section, or telephone those who list themselves in the "Capital Available" section. Also call mortgage brokers who may have contacts with as many as 20 to 100 sources of property financing. Through their extensive roster of lenders, mortgage brokers may find you the high LTV you want. Beware: Read the fine print. Many of these nontraditional (subprime, hard money) mortgages include costly upfront fees, high interest, and steep prepayment penalties. Foolish optimism plus subprime loan equals foreclosure.

Second Mortgages. In the past, some income property lenders permitted what are called 70–20–10 loans, or some other variation such as 75–15–10, or maybe even 80–15–5. The first figure refers to the LTV of a first mortgage; the second figure refers to the percentage of the purchase price represented by a second mortgage; and the third figure refers to out-of-pocket cash contributed by the buyer. A 70–20–10 deal for the purchase of a $100,000 property would require the following amounts:

First mortgage	$70,000
Second mortgage	$20,000
Buyer's cash	$10,000

More often than not, the property seller makes the best source for second mortgage loans. Typically referred to as "seller seconds" or seller "carrybacks," these loans require less red tape, paperwork, and closing costs. You can sometimes persuade a seller to accept an interest rate that's lower than what a commercial lender would charge. At a time when first mortgage rates were at 11 percent, and commercial second mortgage rates were at 16 percent, my seller carried back a $75,000 interest-only second at a rate of 8 percent.[6] (Sellers are more likely to offer below-market interest rates when market rates climb upwards—unlike today's low market rates.)

[6] In this case, the seller second primarily served to reduce my overall cost of borrowing thanks to its low interest rate.

My deal looked like this:

Purchase price	$319,500
First mortgage at 11%	$180,000
Seller second at 8%	$75,000
Cash from buyer	$64,500

If the sellers won't cooperate, look to private investors, mortgage brokers, banks, and savings institutions. Before you do turn to "loan-sharking" commercial second mortgage lenders, think of friends or family members who might like to earn a relatively safe return of 7 to 10 percent (more or less) on their money. Compared to certificates of deposit and passbook savings that in most times pay interest between 2.0 and 5.0 percent, a 7 to 10 percent rate of interest could look pretty good.

Borrow against Other Assets. If you're a homeowner with good credit, you can raise seed money for investment real estate by taking out a home equity loan (i.e., second mortgage) on your home. Through an equity line of credit you might raise a fair amount of cash—but remember, stay prepared for adverse changes in the market or your own finances. Alternatively, consider a high-LTV refinance of your first mortgage.

What other assets can you borrow against? Retirement accounts, cars, jewelry, artwork, coin collection, life insurance, or vacation home? List everything you own. You may surprise yourself at what you discover.

Convert Assets to Cash (Downsizing). Rather than borrow against your assets, downsize. Friends of mine sold their 6,000-square-foot Chicago North Shore residence for $1,050,000. With those proceeds they bought a vacation home, a smaller primary residence, and an in-town condominium. In the U.K., they call this popular practice "mouse-holing."

Could you live comfortably in a smaller or less expensive home? Are you wasting money on unproductive luxury cars, jewelry, watches, or clothing? Are you one of the many Americans who live the high life—for now—but fail to build enough wealth to support the twin goals of financial security and financial independence?

In their study of the affluent, Thomas Stanley and William Danko *(The Millionaire Next Door)* interviewed a sample of high-income professionals whom the authors named UAWs (underaccumulators of wealth). They chose a sample of PAWs (prodigious accumulators of wealth)—who worked in less prestigious jobs and earned less income. Because of wise budgeting and investing, the PAWs' net worths far surpassed those of the high-income prodigious spenders. Downsizing now pays big dividends later.

Wraparound Mortgage. A wraparound mortgage helps buyers obtain a high LTV while it provides a seller with a good yield. Investors use

wraparounds to gain some benefit from a below-current-market-rate loan that exists against a property—and, yet also obtain a relatively high LTV.

To accomplish these twin goals, the investor "wraps" the existing below-market loan with a new wraparound loan at a higher interest rate. The seller continues to pay the existing low interest rate loan while the buyer pays the seller on the new wraparound loan. The seller profits on the spread in interest rates. The wraparound works best during periods when interest rates shoot up. Figure 2.1 provides an example.

In Figure 2.1, the seller creates and carries a new loan of $210,000 at 9.0 percent. Payments on the seller's existing first mortgage total $1,077 per month. Payments on the new wraparound loan are $1,691 per month. Therefore the seller earns a $614 per month profit. As a return on the $60,000 the seller has left in the deal, he or she earns a return of 12.28 percent ($12 \times 614 \div 60{,}000 = 12.28$). The investor gains because the interest rate charged by the seller falls below the then-prevailing market interest rate on newly originated loans. (If you wrap a "nonassumable" mortgage, the seller's underlying mortgage lender may choose to exercise its "due-on-sale" clause. If that happens, you and the sellers would have to pay off the seller's mortgage and work out some other type of financing. However, during the past 25 years—and especially during periods of high foreclosures, lenders rarely throw their performing loans into default by demanding full payment.)

Use Credit Cards. Although this is one of the more risky techniques of creative finance, some investors take advantage of every credit card offer they receive in the mail. Then when they require quick cash to close a deal, they raise $10,000, $25,000, or even $50,000 from cash advances. Investors sometimes even pay cash for a property with the entire sum raised from credit cards.

Naturally, it makes no sense to use cash advances for long-term financing. On occasion, though, you might find plastic a quick and

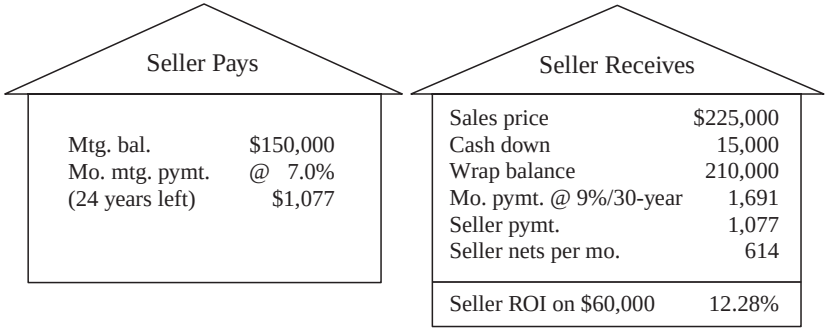

Figure 2.1 Wraparound Loan Example

convenient source to cover short-term needs. For example, you might find a steal of a deal that you can buy (and renovate?), then immediately flip (resell) the property at a profit. For my taste, credit card cash costs too much and generates too much risk. But it's still a possibility– if you clearly calculate that the rewards decisively trump the risks—and you can see multiple unlocked exit doors.

Personal Loans. In the days before credit card cash advances (which are now the most popular type of personal loan), personal loans were called signature loans. As you build your wealth through growing real estate equity, you'll find that many lenders will grant you signature loans—at much lower fees and interest rates than credit card cash advances—in amounts of $10,000, $25,000, $50,000, or even $250,000, if your credit record and net worth can support repayment. Use the money from these signature loans for down payments or renovation funds.

Although mortgage lenders do not favor borrowers who use personal loans for down payments, investors routinely find ways to use this technique. OWC (owner will carry) sellers who finance property sales probably won't inquire (and maybe won't care) about the source of your down payment. If you're short on cash, compare the risks and benefits of using a cash advance or signature loan to raise money for your down payment.

But again, weigh the risk factors. Ill-conceived borrowing can push you into those ugly toss-and-turn, sleepless nights, if not financial ruin. Make sure repayment does not depend on some speculative (uncertain or unpredictable) contingency.

Land Contracts. A land contract—sometimes referred to as a contract for deed, contract of sale, or agreement of sale—permits buyers to pay sellers for their property in installments. Under a land contract, a buyer agrees to buy a property and pay principal and interest to the seller. Unlike mortgage financing, title to the property remains in the seller's name until conditions of the contract are fulfilled. The buyer takes possession of the property. If a buyer defaults on the agreement, the seller can typically repossess (not foreclose on) the property. Sellers favor repossessions because they're quicker, easier, and less costly than foreclosure.

Land contracts may be useful in "wrapping" existing low interest rate financing (see the previous discussion of wraparounds). Caution: These contracts include pitfalls for buyers and sellers. State law governs land contract sales, so consult a competent, local real estate attorney before accepting this form of financing.

Often, properties sold on land contracts are "nonconforming" properties such as storefronts with living quarters in the rear or above, farmhouses with acreage, older properties in need of repair, or larger house that have been split up into multiple apartment units. My first investment was

a five-unit property—a large, old house split into four one-bedroom apartments and a one-bedroom, one-bath carriage house that sat on the rear of the lot. I paid $10,000 down, and the seller (an elderly widow) financed the balance at 5 percent interest. She said that was the same rate she could get on a savings account in a bank so she didn't think it would be right to charge more than that. (I would like to find sellers like her today.)

In the present market, land contracts serve the same purposes they always have (nonconforming properties or subpar cash/credit buyers). Yet, as many traditional mortgage lenders reach out to attract more diverse homebuyers and neighborhoods, people and properties that might not have gained lender approval in decades past might now qualify at credit unions, banks, and other types of mortgage companies. In addition, two types of seller-assisted financing have become widespread: lease-purchase and lease-option agreements (see Chapter 9). To some degree, these "rent-to-own" alternatives have substituted for the use of land contracts.

Nevertheless, land contracts can play a role in your property acquisition strategy. Properly written, land contracts are low cost and relatively easy to complete; they offer maximum flexibility in price and interest rate; and they can give sellers quick remedies for borrower default while they protect buyers against unfair forfeiture and future title problems. If you find (or create) a good deal using a land contract, don't pass it up without thoughtful review (and informed legal advice).

Sweat Equity (Create Value through Renovations). You might buy some properties with 100 percent financing if you can enhance their value through improvements and renovations. Say you find a property that should sell (in tip-top condition) for around $240,000. Yet because of its sorry state of repair, as well as an eager seller, you can buy the property at a price of $190,000 with short-term, no-money-down owner financing. You then contribute labor and $15,000 in materials that you pay for with credit cards.

After you complete your work and bring the property up to its $240,000 market value, you arrange a 70 percent LTV mortgage with a lender. With your loan proceeds of $190,000, you pay off the seller and your credit card account. Voilà—you have not only achieved 100 percent financing for your acquisition price and rehab but also created $35,000 of instant equity (wealth).

Use Your Imagination. In addition to the high leverage techniques discussed, here are several others:

- *Bring in partners.* If you can't (or don't want to) draw on your own cash or borrowing power, find a good deal and then show potential money partners (friends, family, contractors, wealthy investors) how they will benefit if they join you in the transaction.

- *Agree to swap services or products.* Would the seller accept some service or expertise that you can provide? Take stock of your skills (law, medicine, dentistry, writing, advertising, carpentry, accounting, landscaping, architecture, etc.). How about products? Say you own a radio station or newspaper. Trade off advertising time or space for a down payment. Anything you can produce, deliver, or sell wholesale (at cost) might work.
- *Borrow (or reduce) the real estate commission.* Most brokers and sales agents generally hate this technique. Still, sometimes buyers and sellers do ask the agents involved in a transaction to defer payment until some later date. A few agents actually prefer to have their commissions in the deal. In doing so, they avoid paying income taxes on these fees, and at the same time they build wealth through interest payments or their receipt of a "piece of the action" (future profits from a sale).
- *Simultaneously sell (or lease) part of the property.* Does the property include an extra lot, a mobile home, or timber, oil, gas, air, or mineral rights? If so, find a buyer who will pay you cash for such rights. In turn, this money will help you close the deal.
- *Prepaid rents and tenant security deposits.* When you buy an income property, you are entitled to the existing tenants' security deposits and prepaid rents. Say you close on June 2. The seller (of a fourplex) is holding $4,000 in tenant security deposits and $3,800 in rent money that applies to the remaining days in June. Together, the deposits and prepaid rents amount to $7,800. In most transactions, you can use these monies to reduce your cash-to-close.
- *Create paper.* You've asked the seller to accept owner financing with 10 percent down. She balks. She believes the deal puts her at risk. Alleviate her fears and bolster her security. Offer her a lien against your car or a second (or third) mortgage on another property you own. Stipulate that when principal payments and property appreciation (added together) lift your equity to 20 percent (LTV of 80 percent), she will remove the security lien she holds against your other pledged asset(s).
- *Lease options.* To discuss creative finance, one must include lease options. And because of their widespread usage, Chapter 9 addresses the pros and cons of this technique.

Are High-Leverage Creative-Finance Deals Really Possible?

Yes, definitely. I have used some type of creative finance (as either buyer or seller) in more than one-half of the property transactions in which I've

been involved. To make creative finance work, however, you must know what you are doing. Clearly envision all possible ways the deal might turn against you. Stay calm. Do not become so excited to make the deal that you concede too much. Beware: Low down, creative-finance deals frequently tempt new investors into buying troubled properties or paying excessive prices. Honor commitments—and, just as important, critically affirm that the commitments you make are worth honoring.

Fewer Sellers. Because creative finance violates so-called standard operating procedures, your property choices become fewer. While nearly every seller will accept all cash, smaller numbers are willing to provide financing with little or nothing down.

Nevertheless, look for profit-packed high-leverage creative-finance deals, which are out there. Sellers who first claim they're not interested will soften their attitude once you persuasively explain what's in it for them and then hand them your signed offer.

Lower-Quality, Overpriced Lemons. Keep a sharp eye out for property owners who want to entice you into buying overpriced lemons. These sellers have read the nothing-down books. They know that advertising come-ons like "owner financing," "nothing down," "no qualifying," "make offer," and "EZ terms" will bring dozens of calls from the latest "graduates" of the Ima Guru School of Creative Finance.

Just standing by to fleece the sheep, these sellers surreptitiously lead eager buyers into ill-advised purchase contracts. Maintenance and repair problems, disappearing tenants, phantom leases, illegal units, neighborhood crime, short-term balloon mortgages, troublesome neighbors, and undisclosed liens represent just a few of the setbacks naïve buyers have run into. (For many other types of potential problems, see my book *The 106 Common Mistakes Homebuyers Make (and How to Avoid Them)* (John Wiley & Sons 2008, 4th ed.) In other words, don't let the siren call of creative finance crash your boat into the shoals soon after leaving port.

WHAT UNDERWRITING STANDARDS DO LENDERS APPLY?

To decide whether to grant your request for a mortgage, lenders apply a variety of mortgage underwriting guidelines.[7] The more you can learn

[7] For a more extensive discussion of financing properties, see my book *The 106 Mortgage Secrets That All Homebuyers Must Learn—but Lenders Don't Tell, Second Edition* (John Wiley & Sons, 2008).

about these guidelines, the greater the chance that you'll locate a lender (or seller) who will approve the property financing you want.

In times of cheap and easy money, lenders shovel out money to almost anyone who rolls a wheelbarrow into the bank. In periods of tight money (which always follow periods of loose underwriting), lenders tighten their standards.

1. Collateral (LTV, property characteristics, recourse personal notes)
2. Amount and source of down payment and reserves
3. Capacity (monthly income)
4. Credit history (credibility!)
5. Character and competency
6. Compensating factors

Collateral

Lenders set underwriting standards for *properties* (not just borrowers). Although such standards vary, all lenders specify the types of properties as collateral for their mortgage loans. Some lenders won't finance properties larger than four units. Some won't finance properties in poor condition or those located in run-down neighborhoods. Many lenders verify that a property is serviced by all utilities (e.g., some lenders avoid properties with septic tanks instead of sewer lines). Lenders set standards that apply to paved streets, conformance with zoning and building regulations, and proximity to schools, public transportation, shopping, and job centers.

Before you look at properties and write up an offer to buy, verify whether that property meets the criteria of the lender and loan program that you intend to use. Otherwise you may waste time and money (loan application costs, appraisal, and other miscellaneous fees). Often, lenders will not refund these prepaid expenses.

Loan-to-Value Ratios

As discussed, lenders loan up to a specified percentage of a property's market value (or contract price—whichever is less). After your property meets the lender's feature profile, the lender will order an appraisal.

To calculate loan-to-value requires an independent estimate of value, which, as you learned in Chapter 3,may or may not prove accurate or reasonable.

In good times, appraisers tend to "overappraise." In tough markets, they "underappraise." Thus, as an investor, you face two potential pitfalls: (1) In loose money, the lender may approve a loan that actually exceeds the

safe amount you should borrow (without accepting undue risk); and (2) in tough times, the appraisal may come up short. It will either kill your deal or force you to increase the amount of your down payment. To avoid any or all of these underwriting issues, carefully review the lender's appraisal. (See Chapter 3.)

Recourse to Other Assets/Income

In addition to the mortgaged property, lenders might also require you to pledge other assets (property, bank accounts, stocks, etc.) to enhance their security. Indeed, at times you might even offer cross collateralization (or pledged collateral) to a bank in exchange for an LTV that's higher than you might otherwise receive. In close (and sometimes not so close) calls, a boost in the collateral you provide will tip loan approval in your direction.

In addition to collateral, banks (and sellers) will ask property investors to sign a personal note to further guarantee repayment of the monies owed. If you default, such a recourse loan gives the lender (noteholder) the right to go after not just the mortgaged property or other pledged assets, but also, more generally, other assets in which you own an interest or income you are entitled to receive. Odd as it might sound, though, once you advance from smaller properties to larger apartment buildings, offices, and retail centers, lenders typically grant nonrecourse mortgages. The pledged collateral stands as sole security for repayment. In case of payment shortfalls, the lender cannot make a claim against your income or other assets. Other things equal, you should definitely prefer nonrecourse mortgages. When possible, negotiate for a nonrecourse clause in your loan agreements.

Amount and Source of Down Payment and Reserves

Assume that your lender sets a 70 percent LTV for its first mortgage. Plus your seller will carry back a second mortgage for the balance of the purchase price. Will the lender approve your loan application? Maybe; maybe not.

Regardless of LTV, lenders like to see their borrowers put at least some of their own cash into their properties at the time they buy them. Moreover, the lender will probably ask you where you're getting the cash. The best source is ready money from a savings account (or other liquid assets). In contrast, most lenders would not want to hear that you're taking a $10,000 cash advance against your credit card.

Likewise, most lenders want you to retain cash (or liquid assets) after you close your loan. Often, they like to see enough reserves to cover two or three months of mortgage payments. However, the more cash you have available, the better you look.

Capacity (Monthly Income)

As another underwriting guideline, mortgage lenders evaluate your monthly income from employment and other sources, as well as the expected NOI of the property you want to finance. For owner-occupied properties, a lender will (directly or indirectly) emphasize "qualifying ratios." A qualifying ratio is the percentage of your income that you can safely allocate to mortgage payments (principal, interest, property taxes, and insurance, or PITI). If a lender sets a 28 percent housing-cost qualifying ratio and you gross $4,000 a month, the lender may limit your mortgage payments (PITI) to $1,120 a month.

If you are buying your first or second rental house, the lender may count 75 percent of the rents towards your qualifying ratios—but on this point lenders differ. Some will count more and some will count less. Also, for your first few investment property loans, lenders look more to your personal credit and income to support the loan. As you gain investment experience, they become more willing to look at your individual property mortgages on a stand-alone basis. However, the lender will likely still require a personal guarantee from you, thus placing your net worth/earned income as additional backup to the collateral property itself.

For apartment buildings and commercial rental properties, lenders apply a debt coverage ratio (DCR). A debt coverage ratio shows the lender whether the property brings in enough rental income to cover operating expenses and debt service (principal and interest). Here's an example of DCR for a fourplex whose units each rent for $750 a month:

Gross annual income (4 × $750 × 12)	$36,000
less	
Vacancy @ 6% p.a.	$2,160
Operating expenses and upkeep	$7,200
Property taxes and insurance	$2,360
equals	
Net operating income (NOI)	$24,280

If a lender sets a 25 percent margin of net income over debt service, you calculate your maximum allowable mortgage payment by dividing the property's annual NOI by a debt coverage ratio (DCR) of 1.25:

$$\text{NOI/DCR} = \text{Annual mortgage payment}$$
$$\$24{,}280/1.25 = \$19{,}424$$

To check, we reverse the calculations:

$$\text{NOI/Debt Service} = \text{Debt coverage ratio}$$
$$\$24{,}280/\$19{,}424 = 1.25$$

Table 2.1 Monthly Payment Required per $1,000 of Original Mortgage Balance

Interest (%)	Monthly Payment	Interest (%)	Monthly Payment
2.5	$3.95	7.5	$6.99
3.0	4.21	8.0	7.34
3.5	4.49	8.5	7.69
4.0	4.77	9.0	8.05
4.5	5.07	9.5	8.41
5.0	5.37	10.0	8.77
5.5	5.67	10.5	9.15
6.0	5.99	11.0	9.52
6.5	6.32	11.5	9.90
7.0	6.65	12.0	10.29

Note: Terms = 30 years

From these figures, you can see that with a required 1.25 DCR, the property will yield enough income to support a monthly mortgage payment of $1,619 ($19,424 annual mortgage payment ÷ 12). To figure how much loan a mortgage payment of $1,619 a month will pay off (amortize) over a 30-year term, refer to Table 2.1.

At mortgage interest rates of, say, 6.0, 7.5, or 9.0 percent, the lender could loan you up to $270,284, $231,617, or $201,118, respectively.

6.0% Mortgage Interest Rate
$1,619/$5.99 = $270,284 loan amount
7.5% Mortgage Interest Rate
$1,619/$6.99 = $231,617 loan amount
9% Mortgage Interest Rate
$1,619/$8.05 = $201,118 loan amount

Lower interest rates dramatically boost your borrowing power. The interest rate and debt coverage ratio will partially determine how much financing a lender will provide (subject to how well you look vis-á-vis the lender's other underwriting criteria).

Credit History (Credibility!)

Must you produce high credit scores to buy and finance rental houses, condos, and apartment buildings? No, but good credit expands your possibilities. Without a strong credit score, you'll be limited to seller financing, "subject to" loan/purchase agreements, or "B," "C," or "D" loans that carry higher discount points, origination fees, and interest rates (if they are even

available). If you show an excellent credit score and credit record, lenders will welcome your business with competitive rates and terms. You become a sought-after customer.

Strengthen your credit score. Satisfy your monthly credit obligations on or before their due dates. Recently, we have heard so much about "lenders making loans tough to get." But for investors who show strong credit scores—say 720 or higher—even troubled lenders have rolled out the red carpet.

Nevertheless, in our highly competitive mortgage market, some mortgage lenders will accept borrowers who have experienced foreclosure, repossession, and bankruptcy. To qualify with these lenders, you typically need (1) to have paid on time, every time for the past 18 to 24 months; (2) to attribute previous adverse credit to divorce, unemployment, accident, illness, or other outside-your-control misfortune; and (3) to persuade the lender that your present and future financial well-being is planted on a firm foundation.

If you've faced serious credit problems in the past, you need not wait 5, 7, or 10 years before a lender will qualify you for a new mortgage—especially if you live in the property you buy. (Remember, lenders provide their easiest qualifying, lowest costs, and best terms for owner occupants.)

Character and Competency

Although U.S. lenders cannot legally underwrite by age, race, religion, sex, marital status, or disability as they evaluate your loan application, they can and do look at other personal characteristics such as the following:

- Education level
- Career advancement potential
- Job stability
- Stability in the community
- Saving, spending, and borrowing habits
- Dependability
- Dress and mannerisms
- Experience in property ownership

A mortgage lender might not arbitrarily reject your loan application because you dropped out of high school, dyed your hair purple, wear a silver nose ring, change jobs every six months, or have not registered a telephone in your own name. Nevertheless, subtle (and not so subtle)

influences still count—especially for investors, and especially when tight underwriting prevails.

Property ownership requires commitment. Smart lenders trust you to fulfill your responsibilities. Convince the lender that you are a solid and dependable worker, investor, and borrower. When appropriate, assure the lender via a business plan (or other means) that you'll manage the property to enhance its value.

The legendary banker J. P. Morgan once told a U.S. congressional committee, "Money cannot buy credit. A man I do not trust could not get credit from me on all the bonds of Christendom." J. P. Morgan knows lending: character does count. As "liar's loans" proliferated during 2001–2006, many lenders ignored (to their later regret) J. P.'s sound advice. Although during some future boom period lenders will again lose their common sense, in all loan markets you are wise to play it straight.

Compensating Factors

As you study a lender's underwriting guidelines, remember, these are *guidelines.* Most lenders do not evaluate their mortgage loan applications by inflexible rules. Lenders weigh and consider. You can help persuade a lender to approve your loan. Emphasize your positives and play down or explain away negatives.

If your debt coverage ratio falls below a lender's desired minimum, show the lender how you plan to improve the property and increase rents. If you have accumulated credit problems, compensate with a higher down payment or pledged collateral. If you've frequently changed jobs, point out the raises and promotions you've received. If you lack experience in property ownership or property management, tell the lenders how you've educated yourself by reading real estate books and how you've developed a winning market strategy (see Chapter 11).

Use employer letters, references, prepared budgets, a business plan, or any other *written* evidence that you can come up with to justify your loan request. Anything in writing to persuade the lender that you are willing and able to pay back the money you borrow may help. Compensating factors can make the decision swing in your favor.

Remember, lenders differ—especially when they underwrite investors. What one rejects, another accepts. To get the loan you want, search the mortgage market. With thousands of lenders and loan brokers competing for loans, chances are you can find a lender (or seller) who's right for you. If not, those lenders have just sent you a powerful signal: You must improve your financial fitness and borrower profile.

Automated Underwriting (AUS)

For the past 10 to 15 years, mortgage lenders have relied on automated underwriting. Using such a system, a loan rep gathers pertinent underwriting facts and enters them into a software program.

If your borrower (and property) profile matches the standards written into this loan approval program, great. It means a faster, less costly path to closing, and a shorter stack of paperwork. But if your profile needs outside-the-box attention, work with a savvy loan rep who can apply the skill and knowledge necessary to get your loan approved—or at least tell you the reasons why your application falls short and how you can work to overcome deficiencies.

To see how you might fare with automated underwriting, go to myfico.com. From this site, you can learn your credit scores and obtain pointers on how to improve them.

Automated underwriting (AUS) looks at more than your credit score. These programs incorporate calculations that evaluate your qualifying ratios, earning power, cash reserves, debts, and assets. When your trimerged credit scores exceed, say, 720 (or so), the AUS will loosen up on other standards. Conversely, a score of, say, 640 (or so) will cause the AUS to subject your financial profile to stricter standards and more documentation of income, savings, and other pertinent financial data.

Exactly how AUS programs balance and trade off individual underwriting criteria remains a guarded secret. But savvy loan reps have developed some rule-of-thumb insights. So ask them. Benefit from their experience.

3

APPRAISAL: HOW TO DISCOVER GOOD VALUE

Apply the know-how of Chapter 2, and you will find ways to finance your investment properties. But financing provides only a means to a goal. Your goal is to buy and finance properties that offer strong potential for profit. And to invest *profitably* requires you to estimate (present and future) market value.

Experience shows that many real estate investors (and homebuyers) have glossed over this critical point. Most popular how-to books on real estate investing give short shrift to valuing properties. Why? Because many authors and investors have mistakenly assumed that "inflation cures all mistakes." Naïvely, many investors (speculators) have thought that to make money in real estate, all you have to do is buy it. Even if you pay too much, price increases will eventually bail you out. As example, here's what multimillionaire investor and author, David Schumacher, once advised:

> The amount I paid for this property is inconsequential because of the degree to which it has appreciated [sic: he means increased in price due to inflation and appreciation] in value. . . . In my opinion, it is ridiculous to quibble over $5,000 or even $50,000 in price if you are buying for the long term. . . . In 1963, I bought a four-unit apartment building for $35,000. Suppose I had paid $100,000 for it. It wouldn't have made any difference because the property's worth $1.2 million today. (*The Buy and Hold Real Estate Strategy,* John Wiley & Sons, 1992)[1]

[1] Assuming 20 percent down at 5 percent interest, 30 years, for Schumacher's example property, the monthly payment on $80,000 (assuming a $100,000 purchase

Other top-selling real estate authors advise would-be investors to tell sellers, "You name the price, I'll name the terms." If the property owner agrees to sell on easy terms (usually little or nothing down), the buyer will agree to the seller's price. "Who cares about the price you pay today? What's important is all that money you're going to make when you sell." During the go-go boom years 2001–2006, I witnessed this mistake hundreds of time in places as diverse as Dubai, Dublin, and San Diego.

MAKE MONEY WHEN YOU BUY, NOT JUST WHEN YOU SELL

Long-term price increases (inflation, appreciation) will typically boost a property's eventual selling price. But before you can profit from the long run, you must survive the short run. If you overpay, you may have to wait five years (or more) for the market to catch up.

Even worse, during that wait, negative cash flows (the alligators) may eat you alive. You lose the property. Someone else picks up the same property at a much lower price. Even when investors do struggle through a swampland of alligators, they still miss the rewards they could have obtained if they had chosen a surer and safer route.

Want to profit? Buy right! Long-term successful investors make money when they buy, not just when they sell. You reduce risk and increase your chance for great returns when you buy properties at or (preferably) below their market values. But this tactic requires that you know what the term "market value" really means. (Note: When you buy at a bargain price, you often pay less than market value for a property. However, I also encourage you to buy "undervalued" properties. In this sense, undervalued refers to all properties and/or locations that are loaded with strong potential for gains that may result from a variety of sources. You'll learn how to find and evaluate "undervalued" properties in later chapters.)

WHAT IS MARKET VALUE?

To the uninformed, "appraised value," "sales price," and "market value" all refer to the same concept. In fact, "Appraised value" could refer to an insurance policy appraisal, a property tax appraisal, an estate tax appraisal, *or* a market value appraisal. Sales price itself merely identifies the nominal

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price) would equal $430, whereas a $28,000 loan ($35,000 purchase price) would have required a payment of just $150 a month.

price at which a property has sold. That sales price could equal, exceed, or fall below market value. Market value reliably reflects sales price only when a property is sold according to these five stipulations:

1. Buyers and sellers are typically motivated. Neither acts under duress.
2. Buyers and sellers are well informed about the market and negotiate in their own best interest.

The marketing period and sales promotion efforts are sufficient to bring the property to the attention of willing and able buyers.

3. No atypically favorable or unfavorable terms of financing apply. (During the most recent property boom, lenders offered dangerously easy financing, thus pushing sales prices far above their natural market value.)
4. Neither the sellers nor the buyers offer any extraordinary sales concessions or incentives. (For example, the builders in many countries offered off-plan buyers three years of rent guarantees—clearly a red flag that the builders' prices exceed market value.)

To further illustrate the stipulated conditions underlying the concept of market value, say that two properties recently sold in a neighborhood where you're interested in buying:

Thirty-seven Oak sold at a price of $258,000, and 164 Maple sold at a price of $255,000. Each of these three-bedroom, two-bath houses was in good condition, with around 2,100 square feet. You locate a nearby house of similar size and features at 158 Pine. It's priced at $234,750. Is that a bargain (below market value) price? Maybe; maybe not. Before you draw a conclusion, investigate the terms and conditions of the other two sales.

What if the sellers of 164 Maple had carried back a nothing-down, 5 percent, 30-year mortgage for their buyers (i.e., favorable financing)?

What if the buyers of 37 Oak had just flown into Peoria from San Francisco and bought the first house they saw because "It was such a steal. You couldn't find anything like it in San Francisco for less than $1.2 million" (i.e., uninformed buyers)?

What if the sellers of 37 Oak had agreed to pay all of their buyer's closing costs and leave their authentic Chippendale buffet because it was too big to move into their new condo in Florida (i.e., extraordinary sales concessions)?

Sales Price Doesn't Necessarily Equal Market Value

When you buy real estate, go well beyond merely learning the prices at which other similar properties have sold. Investigate whether the buyers

or sellers acted with full market knowledge, gave any unusually favorable (or onerous) terms of financing, bought (or sold) in a hurry, or made concessions that pushed up the nominal selling price—or perhaps pulled it down. If you find that the sales of comparable properties do not meet the conditions of a "market value" sale, weigh that information before you write your contract offer on a property.

In other words, before you rely on comp sales prices to value a property: (1) verify the accuracy of your information; (2) verify the date of sale; and (3) verify the terms and conditions of the sale. Faulty information about a comp property's features or terms of sale can make bad deals look good (or vice versa). Also, market value assumes no hidden defects or title issues. A comp (or subject) house with a termite infestation should sell at a price below market value (see later discussion).

Sound Underwriting Requires Lenders to Loan Only Against Market Value

Financial institutions loan against market value, not purchase price, unless your purchase price falls below market value. When you apply for a mortgage, you may tell the lender that you've agreed to a price of $200,000 and would like to borrow $160,000 (an 80 percent LTV). Yet the lender will not necessarily agree that this price matches the property's market value.

First, the lender will ask about special financing terms (e.g., a $20,000 seller second) and sales concessions (e.g., the seller's plan to buy down your interest rate for three years and pay all closing costs). If your transaction differs from market norms, the lender won't loan 80 percent of your $200,000 purchase price—even if it routinely does make 80 percent LTV loans. The lender may find that easy terms of financing or sales concessions are worth $10,000. So, the lender may calculate your 80 percent LTV ratio against $190,000, not the $200,000 purchase price.

Second, to verify that your purchase price of $200,000 equals or exceeds market value, the lender will order a market value appraisal. If that appraisal report comes back with a figure that's less than $200,000, the lender will use the lesser amount to calculate an 80 percent LTV loan. Take notice: You don't have to passively suffer the results of a low appraisal. Critique the original. Ask the appraiser to correct errors. Or you can ask the lender to order a new appraisal with another firm. The lender needs a file document (appraisal) to justify its lending decision. If you provide an acceptable (revised or remade) appraisal of a satisfactory amount, you'll often get the loan you want.

Danger: Just because a lender's appraiser comes up with a market value estimate that matches your purchase price, never assume that the

appraisal accurately sets market value. Accept personal responsibility for your offering price. Loan reps routinely tell their appraisers the value estimate they need to make a deal work. In return, appraisers know that if they fail to "hit the desired numbers," loan reps will select another, more accommodating appraiser to prepare their reports.

If you're a good customer of a bank (or if the bank would like you to become a good customer), the loan rep may encourage the appraiser to issue an MAI (made as instructed) appraisal. I know of many instances where appraisers have acquiesced to not-so-subtle hints from a loan rep and submitted appraisals that overstated a property's value. (Indeed, as early in the property boom as 2003, government investigators found that loan reps were pressuring appraisers to lift their value estimates.)

You will work with appraisers, and you will solicit their opinions, but never accept those opinions as the final word. To protect yourself against inaccurate appraisals (your own, as well as others), understand how to calculate, apply, and interpret the three technical methods used to estimate market value.

HOW TO ESTIMATE MARKET VALUE

Investors, lenders, and appraisers rely on three techniques to value properties.

1. *Cost approach.* (1) Calculate how much it would cost to build a subject property at today's prices, (2) subtract accrued depreciation, and (3) add the depreciated cost figure to the current value of the lot.

2. *Comparable sales approach.* (1) Compare a subject property with other similar (comp) properties that have recently sold, (2) adjust the prices for each positive or negative feature of the comps relative to the subject property, (3) via this detailed and systematic comparison, adjust for positive and negative property differences, and (4) estimate market value of the subject property from the adjusted sales prices of the comps.

3. *Income approach.* (1) Estimate the rents you expect a property to produce, and (2) convert net rents after expenses (net operating income) into a capital (market) value amount.

You evaluate a property from three perspectives to check the value estimates of each against the others. Multiple estimates and techniques enhance the probability that your estimate reflects reality. If your three value estimates don't reasonably match up, either your calculations err, the figures you're working with are inaccurate, or the market is acting "crazy" and property prices are about to head up (or down).

Figure 3.1 shows a sample appraisal form for a single-family house. Refer to this form as you read the following pages and you'll see how to apply these three techniques to appraise properties. Photocopy this form (or print a copy from the Internet). Use the forms to fill in property and market information as you value potential property investments.

PROPERTY DESCRIPTION

To accurately estimate the value of a property, first describe the features of the property and its neighborhood in detail. List all facts that might influence value favorably or unfavorably. Investors err in their appraisals because they casually inspect rather than carefully detail and compare. Focus on each of the neighborhood and property features listed on an appraisal form. You will value properties more profitably.

Identify the Subject Property

To identify the subject property seems straightforward. Nevertheless, you might experience some pitfalls. For example, the street address for one of my previous homes was 73 Roble Road, Berkeley, California 94705. However, that property does not sit in Berkeley. It is actually located in Oakland. The house sat back from Roble Road (which is in Berkeley) about 100 feet—just far enough to put it within the city limits of Oakland. As a result, the city laws governing the property (zoning, building regulations, permits, rent controls, school district, etc.) were those of Oakland, not Berkeley.

Similarly, Park Cities (University Park and Highland Park) are high-income, independent municipalities located within the geographic boundaries of Dallas, Texas. Among other amenities, Park Cities are noted for their high-quality schools. Yet (in the past) if you lived in Park Cities on the west side of the North Dallas Tollway, your children would attend the lesser-regarded schools of the Dallas Independent School District.

The lesson: Street and city addresses don't always tell you what you need to know about a property. Strange as it may seem, a property may not be located where you think it is. (See also forthcoming discussion of site identification.)

Neighborhood

As the appraisal form shows, a neighborhood investigation should note the types and condition of neighborhood properties, the percentage of houses

Uniform Residential Appraisal Report

File #

The purpose of this summary appraisal report is to provide the lender/client with an accurate, and adequately supported, opinion of the market value of the subject property.

SUBJECT

Property Address | City | State | Zip Code
Borrower | Owner of Public Record | County
Legal Description
Assessor's Parcel # | Tax Year | R.E. Taxes $
Neighborhood Name | Map Reference | Census Tract
Occupant ☐ Owner ☐ Tenant ☐ Vacant | Special Assessments $ | ☐ PUD | HOA $ | ☐ per year ☐ per month
Property Rights Appraised ☐ Fee Simple ☐ Leasehold ☐ Other (describe)
Assignment Type ☐ Purchase Transaction ☐ Refinance Transaction ☐ Other (describe)
Lender/Client | Address
Is the subject property currently offered for sale or has it been offered for sale in the twelve months prior to the effective date of this appraisal? ☐ Yes ☐ No
Report data source(s) used, offering price(s), and date(s).

CONTRACT

I ☐ did ☐ did not analyze the contract for sale for the subject purchase transaction. Explain the results of the analysis of the contract for sale or why the analysis was not performed.

Contract Price $ | Date of Contract | Is the property seller the owner of public record? ☐Yes ☐No | Data Source(s)
Is there any financial assistance (loan charges, sale concessions, gift or downpayment assistance, etc.) to be paid by any part y on behalf of the borrower? ☐ Yes ☐ No
If Yes, report the total dollar amount and describe the items to be paid.

NEIGHBORHOOD

Note: Race and the racial composition of the neighborhood are not appraisal factors.

Neighborhood Characteristics			One-Unit Housing Trends				One-Unit Housing		Present Land Use %	
Location	☐ Urban	☐ Suburban	☐ Rural	Property Values	☐ Increasing	☐ Stable	☐ Declining	PRICE	AGE	One-Unit	%
Built-Up	☐ Over 75%	☐ 25–75%	☐ Under 25%	Demand/Supply	☐ Shortage	☐ In Balance	☐ Over Supply	$ (000)	(yrs)	2-4 Unit	%
Growth	☐ Rapid	☐ Stable	☐ Slow	Marketing Time	☐ Under 3 mths	☐ 3–6 mths	☐ Over 6 mths	Low		Multi-Family	%
Neighborhood Boundaries								High		Commercial	%
								Pred.		Other	%

Neighborhood Description

Market Conditions (including support for the above conclusions)

SITE

Dimensions | Area | Shape | View
Specific Zoning Classification | Zoning Description
Zoning Compliance ☐ Legal ☐ Legal Nonconforming (Grandfathered Use) ☐ No Zoning ☐ Illegal (describe)
Is the highest and best use of the subject property as improved (or as proposed per plans and specifications) the present use? ☐ Yes ☐ No If No, describe

Utilities	Public	Other (describe)		Public	Other (describe)	Off-site Improvements—Type	Public	Private
Electricity	☐	☐	Water	☐	☐	Street	☐	☐
Gas	☐	☐	Sanitary Sewer	☐	☐	Alley	☐	☐

FEMA Special Flood Hazard Area ☐ Yes ☐ No | FEMA Flood Zone | FEMA Map # | FEMA Map Date
Are the utilities and off-site improvements typical for the market area? ☐ Yes ☐ No If No, describe
Are there any adverse site conditions or external factors (easements, encroachments, environmental conditions, land uses, etc.) ? ☐ Yes ☐ No If Yes, describe

IMPROVEMENTS

General Description	Foundation	Exterior Description materials/condition	Interior materials/condition
Units ☐ One ☐ One with Accessory Unit	☐ Concrete Slab ☐ Crawl Space	Foundation Walls	Floors
# of Stories	☐ Full Basement ☐ Partial Basement	Exterior Walls	Walls
Type ☐ Det. ☐ Att. ☐ S-Det./End Unit	Basement Area sq. ft.	Roof Surface	Trim/Finish
☐ Existing ☐ Proposed ☐ Under Const.	Basement Finish %	Gutters & Downspouts	Bath Floor
Design (Style)	☐ Outside Entry/Exit ☐ Sump Pump	Window Type	Bath Wainscot
Year Built	Evidence of ☐ Infestation	Storm Sash/Insulated	Car Storage ☐ None
Effective Age (Yrs)	☐ Dampness ☐ Settlement	Screens	☐ Driveway # of Cars
Attic ☐ None	Heating ☐ FWA ☐ HWBB ☐ Radiant	Amenities ☐ Woodstove(s) #	Driveway Surface
☐ Drop Stair ☐ Stairs	☐ Other Fuel	☐ Fireplace(s) # ☐ Fence	☐ Garage # of Cars
☐ Floor ☐ Scuttle	Cooling ☐ Central Air Conditioning	☐ Patio/Deck ☐ Porch	☐ Carport # of Cars
☐ Finished ☐ Heated	☐ Individual ☐ Other	☐ Pool ☐ Other	☐ Att. ☐ Det. ☐ Built-in

Appliances ☐Refrigerator ☐Range/Oven ☐Dishwasher ☐Disposal ☐Microwave ☐Washer/Dryer ☐ Other (describe)
Finished area **above** grade contains: Rooms | Bedrooms | Bath(s) | Square Feet of Gross Living Area Above Grade
Additional features (special energy efficient items, etc.)

Describe the condition of the property (including needed repairs, deterioration, renovations, remodeling, etc.).

Are there any physical deficiencies or adverse conditions that affect the livability, soundness, or structural integrity of the property? ☐ Yes ☐ No If Yes, describe

Does the property generally conform to the neighborhood (functional utility, style, condition, use, construction, etc.)? ☐ Yes ☐ No If No, describe

Freddie Mac Form 70 March 2005 | Page 1 of 6 | Fannie Mae Form 1004 March 2005

Figure 3.1 Appraisal Report

Uniform Residential Appraisal Report

File #

There are comparable properties currently offered for sale in the subject neighborhood ranging in price from $ to $.

There are comparable sales in the subject neighborhood within the past twelve months ranging in sale price from $ to $.

FEATURE	SUBJECT	COMPARABLE SALE # 1		COMPARABLE SALE # 2		COMPARABLE SALE # 3	
Address							
Proximity to Subject							
Sale Price	$		$		$		$
Sale Price/Gross Liv. Area	$ sq. ft.	$ sq. ft.		$ sq. ft.		$ sq. ft.	
Data Source(s)							
Verification Source(s)							
VALUE ADJUSTMENTS	DESCRIPTION	DESCRIPTION	+(-) $ Adjustment	DESCRIPTION	+(-) $ Adjustment	DESCRIPTION	+(-) $ Adjustment
Sale or Financing Concessions							
Date of Sale/Time							
Location							
Leasehold/Fee Simple							
Site							
View							
Design (Style)							
Quality of Construction							
Actual Age							
Condition							
Above Grade Room Count	Total / Bdrms. / Baths	Total / Bdrms. / Baths		Total / Bdrms. / Baths		Total / Bdrms. / Baths	
Gross Living Area	sq. ft.	sq. ft.		sq. ft.		sq. ft.	
Basement & Finished Rooms Below Grade							
Functional Utility							
Heating/Cooling							
Energy Efficient Items							
Garage/Carport							
Porch/Patio/Deck							
Net Adjustment (Total)		☐ + ☐ -	$	☐ + ☐ -	$	☐ + ☐ -	$
Adjusted Sale Price of Comparables		Net Adj. % Gross Adj. %	$	Net Adj. % Gross Adj. %	$	Net Adj. % Gross Adj. %	$

SALES COMPARISON APPROACH

I ☐ did ☐ did not research the sale or transfer history of the subject property and comparable sales. If not, explain

My research ☐ did ☐ did not reveal any prior sales or transfers of the subject property for the three years prior to the effective date of this appraisal.

Data source(s)

My research ☐ did ☐ did not reveal any prior sales or transfers of the comparable sales for the year prior to the date of sale of the comparable sale.

Data source(s)

Report the results of the research and analysis of the prior sale or transfer history of the subject property and comparable sales (report additional prior sales on page 3).

ITEM	SUBJECT	COMPARABLE SALE # 1	COMPARABLE SALE # 2	COMPARABLE SALE # 3
Date of Prior Sale/Transfer				
Price of Prior Sale/Transfer				
Data Source(s)				
Effective Date of Data Source(s)				

Analysis of prior sale or transfer history of the subject property and comparable sales

Summary of Sales Comparison Approach

Indicated Value by Sales Comparison Approach $

Indicated Value by: Sales Comparison Approach $ Cost Approach (if developed) $ Income Approach (if developed) $

This appraisal is made ☐ "as is", ☐ subject to completion per plans and specifications on the basis of a hypothetical condition that the improvements have been completed, ☐ subject to the following repairs or alterations on the basis of a hypothetical condition that the repairs or alterations have been completed, or ☐ subject to the following required inspection based on the extraordinary assumption that the condition or deficiency does not require alteration or repair:

Based on a complete visual inspection of the interior and exterior areas of the subject property, defined scope of work, statement of assumptions and limiting conditions, and appraiser's certification, my (our) opinion of the market value, as defined, of the real property that is the subject of this report is $, as of , which is the date of inspection and the effective date of this appraisal.

Freddie Mac Form 70 March 2005 Page 2 of 6 Fannie Mae Form 1004 March 2005

Figure 3.1 (*Continued*)

Uniform Residential Appraisal Report

File #

ADDITIONAL COMMENTS

COST APPROACH

COST APPROACH TO VALUE (not required by Fannie Mae)

Provide adequate information for the lender/client to replicate the below cost figures and calculations.

Support for the opinion of site value (summary of comparable land sales or other methods for estimating site value)

ESTIMATED ☐ REPRODUCTION OR ☐ REPLACEMENT COST NEW	OPINION OF SITE VALUE.....= $
Source of cost data	Dwelling Sq. Ft. @ $ .....=$
Quality rating from cost service Effective date of cost data	Sq. Ft. @ $ .....=$
Comments on Cost Approach (gross living area calculations, depreciation, etc.)	
	Garage/Carport Sq. Ft. @ $ .....=$
	Total Estimate of Cost-New .....= $
	Less Physical Functional External
	Depreciation =$( )
	Depreciated Cost of Improvements.....=$
	"As-is" Value of Site Improvements.....=$
Estimated Remaining Economic Life (HUD and VA only) Years	Indicated Value By Cost Approach..... .....=$

INCOME

INCOME APPROACH TO VALUE (not required by Fannie Mae)

Estimated Monthly Market Rent $ X Gross Rent Multiplier = $ Indicated Value by Income Approach

Summary of Income Approach (including support for market rent and GRM)

PUD INFORMATION

PROJECT INFORMATION FOR PUDs (if applicable)

Is the developer/builder in control of the Homeowners' Association (HOA)? ☐ Yes ☐ No Unit type(s) ☐ Detached ☐ Attached

Provide the following information for PUDs ONLY if the developer/builder is in control of the HOA and the subject property is an attached dwelling unit.

Legal name of project

Total number of phases Total number of units Total number of units sold

Total number of units rented Total number of units for sale Data source(s)

Was the project created by the conversion of an existing building(s) into a PUD? ☐ Yes ☐ No If Yes, date of conversion

Does the project contain any multi-dwelling units? ☐ Yes ☐ No Data source(s)

Are the units, common elements, and recreation facilities complete? ☐ Yes ☐ No If No, describe the status of completion.

Are the common elements leased to or by the Homeowners' Association? ☐ Yes ☐ No If Yes, describe the rental terms and options.

Describe common elements and recreational facilities

Freddie Mac Form 70 March 2005 Page 3 of 6 Fannie Mae Form 1004 March 2005

Figure 3.1 (*Continued*)

Uniform Residential Appraisal Report

File #

This report form is designed to report an appraisal of a one-unit property or a one-unit property with an accessory unit; including a unit in a planned unit development (PUD). This report form is not designed to report an appraisal of a manufactured home or a unit in a condominium or cooperative project.

This appraisal report is subject to the following scope of work, intended use, intended user, definition of market value, statement of assumptions and limiting conditions, and certifications. Modifications, additions, or deletions to the intended use, intended user, definition of market value, or assumptions and limiting conditions are not permitted. The appraiser may expand the scope of work to include any additional research or analysis necessary based on the complexity of this appraisal assignment. Modifications or deletions to the certifications are also not permitted. However, additional certifications that do not constitute material alterations to this appraisal report, such as those required by law or those related to the appraiser's continuing education or membership in an appraisal organization, are permitted.

SCOPE OF WORK: The scope of work for this appraisal is defined by the complexity of this appraisal assignment and the reporting requirements of this appraisal report form, including the following definition of market value, statement of assumptions and limiting conditions, and certifications. The appraiser must, at a minimum: (1) perform a complete visual inspection of the interior and exterior areas of the subject property, (2) inspect the neighborhood, (3) inspect each of the comparable sales from at least the street, (4) research, verify, and analyze data from reliable public and/or private sources, and (5) report his or her analysis, opinions, and conclusions in this appraisal report.

INTENDED USE: The intended use of this appraisal report is for the lender/client to evaluate the property that is the subject of this appraisal for a mortgage finance transaction.

INTENDED USER: The intended user of this appraisal report is the lender/client.

DEFINITION OF MARKET VALUE: The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby: (1) buyer and seller are typically motivated; (2) both parties are well informed or well advised, and each acting in what he or she considers his or her own best interest; (3) a reasonable time is allowed for exposure in the open market; (4) payment is made in terms of cash in U. S. dollars or in terms of financial arrangements comparable thereto; and (5) the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions* granted by anyone associated with the sale.

*Adjustments to the comparables must be made for special or creative financing or sales concessions. No adjustments are necessary for those costs which are normally paid by sellers as a result of tradition or law in a market area; these costs are readily identifiable since the seller pays these costs in virtually all sales transactions. Special or creative financing adjustments can be made to the comparable property by comparisons to financing terms offered by a third party institutional lender that is not already involved in the property or transaction. Any adjustment should not be calculated on a mechanical dollar for dollar cost of the financing or concession but the dollar amount of any adjustment should approximate the market's reaction to the financing or concessions based on the appraiser's judgment.

STATEMENT OF ASSUMPTIONS AND LIMITING CONDITIONS: The appraiser's certification in this report is subject to the following assumptions and limiting conditions:

1. The appraiser will not be responsible for matters of a legal nature that affect either the property being appraised or the title to it, except for information that he or she became aware of during the research involved in performing this appraisal. The appraiser assumes that the title is good and marketable and will not render any opinions about the title.

2. The appraiser has provided a sketch in this appraisal report to show the approximate dimensions of the improvements. The sketch is included only to assist the reader in visualizing the property and understanding the appraiser's determination of its size.

3. The appraiser has examined the available flood maps that are provided by the Federal Emergency Management Agency (or other data sources) and has noted in this appraisal report whether any portion of the subject site is located in an identified Special Flood Hazard Area. Because the appraiser is not a surveyor, he or she makes no guarantees, express or implied, regarding this determination.

4. The appraiser will not give testimony or appear in court because he or she made an appraisal of the property in question, unless specific arrangements to do so have been made beforehand, or as otherwise required by law.

5. The appraiser has noted in this appraisal report any adverse conditions (such as needed repairs, deterioration, the presence of hazardous wastes, toxic substances, etc.) observed during the inspection of the subject property or that he or she became aware of during the research involved in performing this appraisal. Unless otherwise stated in this appraisal report, the appraiser has no knowledge of any hidden or unapparent physical deficiencies or adverse conditions of the property (such as, but not limited to, needed repairs, deterioration, the presence of hazardous wastes, toxic substances, adverse environmental conditions, etc.) that would make the property less valuable, and has assumed that there are no such conditions and makes no guarantees or warranties, express or implied. The appraiser will not be responsible for any such conditions that do exist or for any engineering or testing that might be required to discover whether such conditions exist. Because the appraiser is not an expert in the field of environmental hazards, this appraisal report must not be considered as an environmental assessment of the property.

6. The appraiser has based his or her appraisal report and valuation conclusion for an appraisal that is subject to satisfactory completion, repairs, or alterations on the assumption that the completion, repairs, or alterations of the subject property will be performed in a professional manner.

Freddie Mac Form 70 March 2005 Page 4 of 6 Fannie Mae Form 1004 March 2005

Figure 3.1 (*Continued*)

Uniform Residential Appraisal Report

File #

APPRAISER'S CERTIFICATION: The Appraiser certifies and agrees that:

1. I have, at a minimum, developed and reported this appraisal in accordance with the scope of work requirements stated in this appraisal report.

2. I performed a complete visual inspection of the interior and exterior areas of the subject property. I reported the condition of the improvements in factual, specific terms. I identified and reported the physical deficiencies that could affect the livability, soundness, or structural integrity of the property.

3. I performed this appraisal in accordance with the requirements of the Uniform Standards of Professional Appraisal Practice that were adopted and promulgated by the Appraisal Standards Board of The Appraisal Foundation and that were in place at the time this appraisal report was prepared.

4. I developed my opinion of the market value of the real property that is the subject of this report based on the sales comparison approach to value. I have adequate comparable market data to develop a reliable sales comparison approach for this appraisal assignment. I further certify that I considered the cost and income approaches to value but did not develop them, unless otherwise indicated in this report.

5. I researched, verified, analyzed, and reported on any current agreement for sale for the subject property, any offering for sale of the subject property in the twelve months prior to the effective date of this appraisal, and the prior sales of the subject property for a minimum of three years prior to the effective date of this appraisal, unless otherwise indicated in this report.

6. I researched, verified, analyzed, and reported on the prior sales of the comparable sales for a minimum of one year prior to the date of sale of the comparable sale, unless otherwise indicated in this report.

7. I selected and used comparable sales that are locationally, physically, and functionally the most similar to the subject property.

8. I have not used comparable sales that were the result of combining a land sale with the contract purchase price of a home that has been built or will be built on the land.

9. I have reported adjustments to the comparable sales that reflect the market's reaction to the differences between the subject property and the comparable sales.

10. I verified, from a disinterested source, all information in this report that was provided by parties who have a financial interest in the sale or financing of the subject property.

11. I have knowledge and experience in appraising this type of property in this market area.

12. I am aware of, and have access to, the necessary and appropriate public and private data sources, such as multiple listing services, tax assessment records, public land records and other such data sources for the area in which the property is located .

13. I obtained the information, estimates, and opinions furnished by other parties and expressed in this appraisal report from reliable sources that I believe to be true and correct.

14. I have taken into consideration the factors that have an impact on value with respect to the subject neighborhood, subject property, and the proximity of the subject property to adverse influences in the development of my opinion of market value. I have noted in this appraisal report any adverse conditions (such as, but not limited to, needed repairs, deterioration, the presence of hazardous wastes, toxic substances, adverse environmental conditions, etc.) observed during the inspection of the subject property or that I became aware of during the research involved in performing this appraisal. I have considered these adverse conditions in my analysis of the property value, and have reported on the effect of the conditions on the value and marketability of the subject property.

15. I have not knowingly withheld any significant information from this appraisal report and, to the best of my knowledge, all statements and information in this appraisal report are true and correct.

16. I stated in this appraisal report my own personal, unbiased, and professional analysis, opinions, and conclusions, which are subject only to the assumptions and limiting conditions in this appraisal report.

17. I have no present or prospective interest in the property that is the subject of this report, and I have no present or prospective personal interest or bias with respect to the participants in the transaction. I did not base, either partially or completely, my analysis and/or opinion of market value in this appraisal report on the race, color, religion, sex, age, marital status, handicap, familial status, or national origin of either the prospective owners or occupants of the subject property or of the present owners or occupants of the properties in the vicinity of the subject property or on any other basis prohibited by law.

18. My employment and/or compensation for performing this appraisal or any future or anticipated appraisals was not conditioned on any agreement or understanding, written or otherwise, that I would report (or present analysis supporting) a predetermined specific value, a predetermined minimum value, a range or direction in value, a value that favors the cause of any party, or the attainment of a specific result or occurrence of a specific subsequent event (such as approval of a pending mortgage loan application).

19. I personally prepared all conclusions and opinions about the real estate that were set forth in this appraisal report. If I relied on significant real property appraisal assistance from any individual or individuals in the performance of this appraisal or the preparation of this appraisal report, I have named such individual(s) and disclosed the specific tasks performed in this appraisal report. I certify that any individual so named is qualified to perform the tasks. I have not authorized anyone to make a change to any item in this appraisal report; therefore, any change made to this appraisal is unauthorized and I will take no responsibility for it.

20. I identified the lender/client in this appraisal report who is the individual, organization, or agent for the organization that ordered and will receive this appraisal report.

Freddie Mac Form 70 March 2005 Page 5 of 6 Fannie Mae Form 1004 March 2005

Figure 3.1 (*Continued*)

Uniform Residential Appraisal Report

File #

21. The lender/client may disclose or distribute this appraisal report to: the borrower; another lender at the request of the borrower; the mortgagee or its successors and assigns; mortgage insurers; government sponsored enterprises; other secondary market participants; data collection or reporting services; professional appraisal organizations; any department, agency, or instrumentality of the United States; and any state, the District of Columbia, or other jurisdictions; without having to obtain the appraiser's or supervisory appraiser's (if applicable) consent. Such consent must be obtained before this appraisal report may be disclosed or distributed to any other party (including, but not limited to, the public through advertising, public relations, news, sales, or other media).

22. I am aware that any disclosure or distribution of this appraisal report by me or the lender/client may be subject to certain laws and regulations. Further, I am also subject to the provisions of the Uniform Standards of Professional Appraisal Practice that pertain to disclosure or distribution by me.

23. The borrower, another lender at the request of the borrower, the mortgagee or its successors and assigns, mortgage insurers, government sponsored enterprises, and other secondary market participants may rely on this appraisal report as part of any mortgage finance transaction that involves any one or more of these parties.

24. If this appraisal report was transmitted as an "electronic record" containing my "electronic signature," as those terms are defined in applicable federal and/or state laws (excluding audio and video recordings), or a facsimile transmission of this appraisal report containing a copy or representation of my signature, the appraisal report shall be as effective, enforceable and valid as if a paper version of this appraisal report were delivered containing my original hand written signature.

25. Any intentional or negligent misrepresentation(s) contained in this appraisal report may result in civil liability and/or criminal penalties including, but not limited to, fine or imprisonment or both under the provisions of Title 18, United States Code, Section 1001, et seq., or similar state laws.

SUPERVISORY APPRAISER'S CERTIFICATION: The Supervisory Appraiser certifies and agrees that:

1. I directly supervised the appraiser for this appraisal assignment, have read the appraisal report, and agree with the appraiser's analysis, opinions, statements, conclusions, and the appraiser's certification.

2. I accept full responsibility for the contents of this appraisal report including, but not limited to, the appraiser's analysis, opinions, statements, conclusions, and the appraiser's certification.

3. The appraiser identified in this appraisal report is either a sub-contractor or an employee of the supervisory appraiser (or the appraisal firm), is qualified to perform this appraisal, and is acceptable to perform this appraisal under the applicable state law.

4. This appraisal report complies with the Uniform Standards of Professional Appraisal Practice that were adopted and promulgated by the Appraisal Standards Board of The Appraisal Foundation and that were in place at the time this appraisal report was prepared.

5. If this appraisal report was transmitted as an "electronic record" containing my "electronic signature," as those terms are defined in applicable federal and/or state laws (excluding audio and video recordings), or a facsimile transmission of this appraisal report containing a copy or representation of my signature, the appraisal report shall be as effective, enforceable and valid as if a paper version of this appraisal report were delivered containing my original hand written signature.

APPRAISER

Signature_____
Name_____
Company Name_____
Company Address_____
_____
Telephone Number_____
Email Address_____
Date of Signature and Report_____
Effective Date of Appraisal_____
State Certification #_____
or State License #_____
or Other (describe)_____State #_____
State_____
Expiration Date of Certification or License_____

ADDRESS OF PROPERTY APPRAISED
_____
_____

APPRAISED VALUE OF SUBJECT PROPERTY $_____

LENDER/CLIENT
Name_____
Company Name_____
Company Address_____
_____
Email Address_____

SUPERVISORY APPRAISER (ONLY IF REQUIRED)

Signature_____
Name_____
Company Name_____
Company Address_____
_____
Telephone Number_____
Email Address_____
Date of Signature_____
State Certification #_____
or State License #_____
State_____
Expiration Date of Certification or License_____

SUBJECT PROPERTY

☐ Did not inspect subject property
☐ Did inspect exterior of subject property from street
Date of Inspection_____
☐ Did inspect interior and exterior of subject property
Date of Inspection_____

COMPARABLE SALES

☐ Did not inspect exterior of comparable sales from street
☐ Did inspect exterior of comparable sales from street
Date of Inspection_____

Freddie Mac Form 70 March 2005 Page 6 of 6 Fannie Mae Form 1004 March 2005

Figure 3.1 (*Continued*)

and condominiums that are owner occupied, vacancy rates, property price (and rental) ranges, the types and quality of government services, and the relative convenience of the property to shopping, schools, employment centers, parks and recreational areas—the appeal of the neighborhood to potential buyers.

Next, imagine the future. Envision the changes that are likely to occur in the neighborhood during the coming three to five years. Is the neighborhood stable? Is it moving toward higher rates of owner occupancy? Are property owners fixing up their properties? Do neighborhood residents and local merchants take pride in their properties and the surrounding area? Is a neighborhood (or homeowners') association working to improve the area? If not, could such an association make the neighborhood a better place to live, shop, work, and play?

When you invest in property, you buy the future even more than the present. View the neighborhood with both a crystal ball as well as a magnifying glass. Visualize how the neighborhood will (or could be made to) look, feel, and live five years into the future.

Site (Lot) Characteristics

Depending on the neighborhood, the size and features of a lot can account for 20 to 80 percent of a property's current and future value. Smart investors pay as much attention to the lot (and its potential) as they do to the building(s).

In addition to site size and features (see appraisal form), review the rules and restrictions that govern a site. Determine whether the buildings conform to zoning, occupancy, environmental, and safety regulations. Many two- to four-unit (and larger) properties have been modified (rehabbed, cut up, added to, repaired, renovated, rewired, reroofed, etc.) in ways that violate current law. Of course, laws change. Even if the property did conform, it may now violate today's legal standards.

Land use law classifies properties as (1) legal and conforming, (2) legal and nonconforming, and (3) illegal. When a property meets all of today's legal standards, it's called legal and conforming. If it met past standards that don't meet current law, but have been "grandfathered," the property qualifies as legal but nonconforming.

If the property includes features or uses that violate standards not grandfathered as permissible, those features or uses remain illegal. Even work that conforms to the law might place the owner in jeopardy if such work was performed without a valid permit.

If you buy a property that fails to meet current law, buy with your eyes open. Lower your offering price to reflect risk. At some future time,

inspectors may require you to bring the property up to code. Just as important, health, safety, and environmental violations may:

- Subject your tenants to injury
- Motivate a rent strike
- Expose you to a lawsuit
- Expose you to civil or criminal penalties (fines, and in serious cases, prison)

Before you decide upon the price to pay for a property, verify code compliance. To bring a nonconforming property up to code (or to tear out and reinstall unpermitted work) can cost thousands (or even tens of thousands) of dollars.

Improvements

After you investigate the legal restrictions relative to site size, features, and improvements (e.g., parking, driveways, fencing, landscaping, utilities, sewage disposal), detail the size, condition, quality, and appeal of the house or apartment units located on the site. Building size itself ranks as one of the most important determinants of value. To determine size (room count, square footage) requires more than mere counting or pulling out a tape measure.

As you inspect properties, you'll see converted basements, garages, and attics; you'll see heated/cooled and unheated/uncooled living areas; you'll see "bedrooms" without closets and "dining areas" without space for a family-size table and chairs, let alone a buffet or china cabinet; you'll see rooms with 6-foot ceilings or lower, and rooms with 12-foot ceilings or higher; you'll see some storage areas that users can access easily and others that you can reach only by crawling on your hands and knees or standing on a ladder. You'll see decks, patios, and porches that display uniquely strange designs.

In sum, you'll see that all space is not created equal. Go beyond comparisons of size, purported space use, or room count. Judge the quality, livability, traffic patterns, and storage areas within the property.

Even more challenging, not everyone measures square footage in the same way: A builder recently asked five appraisers to measure one of his new homes. In sales promotion literature, the builder listed the home as 3,103 square feet. One appraiser came up with a square-footage count of 3,047 square feet. The other appraisers came up with measures that ranged between 2,704 square feet and 3,312 square feet. Differences such as these occur not just from mistakes but because no "square-footage police" prescribe or enforce measurement methods.

When you read or hear a property's room count or size, do not blindly trust that information. Judge the quality, size, and desirability of

the space. Here's another example. I once owned a lakefront house with a large master bedroom (MBR) that faced the lake through a full wall-sized window. In valuing that house, an appraiser rated as equivalent another lakefront home—only its MBR was much smaller and faced street-side.

In his report, the appraiser made no note of that huge difference (as perceived by most would-be buyers). To compound his errors, the appraiser also rated the "lakefront" lots equivalent—even though one (mine) was 40,000 square feet with 165 feet of frontage versus the "comp" site at 20,000 square feet with 100 feet of lake frontage. Never accept—without verification—an appraiser's comp data or feature adjustments.

THE COST APPROACH

The cost approach recognizes that you can either build (or buy) a new property or buy an existing one. Replacement cost typically sets the upper limit to the price you would pay for an existing property. If you can build a new property for $380,000 (including the cost of a lot), then why pay $380,000 for a like-kind existing property located just down the street? In fact, why even pay $380,000 for that older property? It suffers (at least some) deterioration.

Calculate Cost to Build New

To follow the logic of the cost approach, refer to the appraisal form. First, calculate the cost to build the property using dollars per square foot. Use a figure that would apply in your area for the type of property you're valuing. To learn these per-square-foot costs, talk with local contractors or consult the Marshall & Swift construction cost manuals in the reference section of your local library or on the Internet.

Because replacement costs correlate directly with the size and quality of buildings, accurate measurement precedes accurate valuation. Notice, too, that you add the expense of upgrades and extras (crystal chandelier, high-grade wall-to-wall carpeting, Italian tile, granite countertops, high-end appliances or plumbing fixtures, sauna, hot tub, swimming pool, garage, carport, patios, porches, etc.) to the cost of the basic construction.

Deduct Depreciation

After you calculate today's building costs for the subject property, deduct three types of depreciation: (1) physical, (2) functional, and (3) external.

As a building ages, it becomes less valuable than new construction because of *physical* depreciation (wear and tear): The property is exposed to time, weather, use, and abuse; it deteriorates. Frayed carpets, faded paint,

cracked plaster, rusty plumbing, and leaky roofs bring down a property's value when compared with new construction. Exactly how much remains your call. To fill in a physical depreciation figure for a building in good condition, estimate, say, 10 percent or 20 percent; if the property appears run-down, you might justify 50 percent depreciation or greater. Or instead of applying a percentage depreciation figure, itemize the costs of the repairs and renovations that would restore the property to like-new condition.

Itemized repairs do not work as well as percentage estimates, because you can't economically upgrade an eight-year-old roof, four-year-old carpeting, or a nine-year-old furnace to like-new condition. Nevertheless, in one way or another, figure how much you think the subject property has depreciated relative to a newly built property of the same size, quality, and features.

Next, estimate the amount of *functional* depreciation. Unlike wear and tear, which occurs naturally through use and abuse, functional depreciation creates loss of value due to undesirable features such as outdated dark wood paneling, a faulty floor plan, low-amperage electrical systems, out-of-favor color schemes, or weirdly unique architectural design. A property may show little physical depreciation but still suffer large functional obsolescence. The features of the property just do not appeal to potential buyers or renters.

External (locational) depreciation occurs when a property fails to reflect the highest and best use for a site. You find a small, well kept house located in an area now dotted with offices and retail stores. Zoning of the site has changed. More than likely, the house (as a house, per se) may not add much to the site's value. The investor who buys the "house" would likely tear it down or renovate it and create a retail store or office building.

For such duck-out-of-water properties, external (locational) factors make the buildings obsolete. External depreciation can approach 100 percent. With or without the building, the site should sell at approximately the same price. This principle also applies when neighborhoods move upscale, and well-kept three-bedroom, two-bath houses of 1,600 square feet are torn down and replaced with 5,000-square-foot McMansions. Investors and builders refer to these smaller existing houses as *teardowns*—even though their owners may have lovingly maintained them.

Lot Value

To estimate lot value, find similarly zoned (vacant) lots that have recently sold, or lots that have sold with teardowns on them. When you compare sites, note all features such as size, frontage, views, topography, legal restrictions, subdivision rules, and other features that can affect the values of the respective sites.

Estimate Market Value (Cost Approach)

As you can see on the appraisal form, after you've completed the steps discussed (calculate a property's construction cost as if newly built, deduct depreciation, and add in site value), you have computed market value. Because you can't precisely measure construction costs, depreciation, or site value, the cost approach won't give you a perfect answer (of course, neither do the comp sale or income approaches—reason and judgment rule). But the cost approach will provide a reference point to use with the comp sales and income approaches. Here's a simple example of the cost approach:

Property description: Six-year-old, good-condition, single-family house of 2,200 square feet. The house includes a two-car, 500-square-foot garage, a deck, in-ground pool, sprinkler system, and premium carpets, appliances, and kitchen cabinets. Nearby vacant lots have recently sold for $60,000.

Dwelling (2,200 × $108 per-square-foot base construction costs)	$237,600
Upgrades	13,500
Deck, lap pool, sprinklers	21,750
Garage (500 × $33 per square foot)	16,500
Total	$289,350
Less	
Physical depreciation at 10%	(28,935)
Functional depreciation at 5%	(14,438)
Depreciated building value	$245,978
Site improvements (sidewalks, driveway, fencing, landscaping)	18,750
Lot value	60,000
Equals	
Indicated market value, cost approach	$324,728

Typically builders build only when they think they can construct properties that will sell (or rent) to yield enough revenue to cover their construction costs and desired profit margin. Therefore, you can usually expect sales prices to go up when construction costs significantly exceed the market values of new properties. Why? Because without expected profit, builders stop building. When growing demand begins to push against a scarce supply, eventually builder profits return. The real estate construction cycle starts anew. The opposite also applies. When builder profits fatten, sooner or later, they overbuild. High expected profits lead to a

surplus of new construction. Too much housing inventory brings down market values for new as well as existing properties.

Did I hear someone say Las Vegas, Miami, coastal Spain, or Dubai? Easy financing encouraged buyers to pay prices that (temporarily) supported inflated builder profit margins. Builders overbuilt. Buyers overleveraged and overpaid. Together they lit the torch for the current market meltdown.

Investors rejoice. Overbuilding leads to underbuilding. During the recent downturn, new housing starts nosedived to fewer than 400,000 units—down from 1,600,000 units in 2006. Only large price gains will bring builders back into the game. Until market values significantly increase, homebuilders will not build many new houses. As new supply remains depressed—and as inventories of foreclosures and REOs are worked down—the market generates the conditions to support the next cyclical upswing.

THE COMPARABLE SALES APPROACH

For houses, condominiums, co-ops, townhouses, and apartment buildings, the comparable sales approach generally provides the most accurate estimate of market value. If you want to know the probable price at which a specific property will sell, find out the recent selling prices, terms of sale, and physical features of similar properties.

As explained later, investors rely on the income approach to value apartment buildings, shopping centers, and offices. However, to apply the income approach requires good comp sales. The income approach does not stand independent of the market.

Select Comparable Properties

The accuracy of the comparable sales approach depends on your ability to find recently sold properties that closely match a subject property. Ideally, find comp sales in neighborhoods or developments that resemble each other in property size, age, features, condition, quality of construction, room count, and floor plan. As a practical matter, you seldom find perfect comp matches because each property, each location, displays unique characteristics.

Nevertheless, you don't need a perfect match. When you find comp sales that reasonably match a subject property, you ballpark a value estimate by comparing price per square foot of living area.

Assume that you research three comp sales: (Comp 1) 1,680 square feet, (Comp 2) 1,840 square feet, and (Comp 3) 1,730 square feet. These

properties sold recently for the respective prices of $225,120, $213,440, and $211,060. To figure the selling price per square foot of living area for these homes, divide the sales price of each house by its total square footage.

Comp 1
$225,120/1,680 = $134

Comp 2
$213,440/1,840 = $116

Comp 3
$211,060/1,730 = $122

If the house you're interested in has 1,796 square feet of living area, it will probably sell in the range of $120 to $130 per square foot, or $215,520 to $233,480.

Approximate Value Range—Subject Property

$120 × 1,796 = $215,520
$130 × 1,796 = $233,480

Sales price per square foot helps ballpark your value estimate. To gain deeper insight, compare and contrast similar properties to your subject property on a feature-by-feature basis.

Adjust for Differences

After you, your real estate agent, or an appraiser finds appropriate comparables, adjust the comp sales prices up or down to compensate for the features that appear inferior or superior to a subject property. Here's a brief example of this adjustment process:

Adjustment Process (Selected Features)

	Comp 1	Comp 2	Comp 3
Sales price	$225,120	$213,440	$211,060
Features			
Sales concessions	0	−10,000	0
Financing concessions	−15,000	0	0
Date of sale	0	10,000	0
Location	0	0	−20,000
Floor plan	0	5,000	0
Garage	11,000	0	17,000
Pool, patio, deck	−9,000	−13,000	0
Indicated value of subject	$212,120	$205,440	$208,060

As you adjust the selling prices of similar houses to reflect their differences as per the subject property, you move toward your best estimate of the market value range for the subject property. Although our preliminary price-per-square-foot estimated market value for the subject to be worth between $215,520 and $233,480, after adjustments, a price range between $212,120 and $205,440 seems reasonable.

Explain the Adjustments

To adjust for differences in size, quality, or features, you equalize a subject property and each of its comparables: "At what price would the comparable have sold if it *exactly* matched the subject property?" For example, consider the $15,000 adjustment to Comp 1 for financing concessions.

In this sale, the sellers carried back a 90 percent LTV mortgage (10 percent down) on the property at an interest rate of 6.5 percent. At the time, investor financing usually required a 75 percent LTV (25 percent down) and a 7.75 percent interest rate. Without this favorable owner financing, Comp 1 would probably have sold for $15,000 less than its actual sales price of $225,120. Because the definition of market value assumes financing on terms typically available in the market, the premium created by this OWC (owner will carry) financing is subtracted from Comp 1's actual selling price. Here are the explanations for other adjustments:

Comp 1 garage at (+) $11,000. The subject property stands superior with its oversize double-car garage, whereas Comp 1 has only a single-car garage. With a larger garage like the subject's, Comp 1 would have brought an $11,000 higher sales price.

Comp 1 pool, patio, and deck at (–) $9,000. Comp 1 is superior to the subject property on this feature because the subject lacks a deck and tile patio. Without this feature, Comp 1 would have sold for $9,000 less.

Comp 2 sales concession at (–) $10,000. The $213,440 sales price in this transaction included the seller's custom-made drapes, a washer and dryer, and a backyard storage shed. Because these items aren't customary in this market, the sales price is adjusted downward to equalize this feature with the subject property, whose sale will not include these items.

Comp 2 floor plan at (+) $5,000. Unlike the subject property, Comp 2 lacked convenient access from the garage to the kitchen. The garage was built under the house; residents must carry groceries up an outside stairway to enter the kitchen. With more conventional and convenient access, the selling price of Comp 2 would probably have increased by $5,000.

Comp 3 location at (–) $20,000. Comp 3 was located on a cul-de-sac, and its backyard bordered an environmentally protected wooded area. In contrast, the subject property sits on a typical subdivision street, and its rear yard abuts that of a neighbor. Because of its less-favorable location, the subject property could be expected to sell for $20,000 less than Comp 3.

At this point, you may be asking, "How can I or anyone else come up with the specific dollar amounts for each of these adjustments?" To that question, there's no easy answer. You accrue such knowledge by talking with sales agents and tracking sales transactions over a period of months and even years.

Nevertheless, even without experience, you still can weigh the opinions of others against your own judgment. Ask questions. Explore their reasoning. Verify their facts. As you look at properties, discipline your mind to list and detail all features that make a difference. Before you attach adjustment numbers to each property's unique features, first observe those differences.

THE INCOME APPROACH

Near the bottom of page 3 of the appraisal form, you can see a line labeled "Indicated Value by Income Approach (If Applicable)." As shown there, the income approach refers to an appraisal technique called the gross rent multiplier (GRM).

To calculate market value using the GRM, find the monthly rents and sales prices of similar houses or apartment buildings. For example, through market research, you discover the following rental houses: (1) 214 Jackson rents for $1,045 a month and sold for $148,200; (2) 312 Lincoln rents for $963 a month and sold for $156,000; and (3) 107 Adams rents for $1,155 a month and sold for $168,400. With this information, you calculate a range of GRMs for rental houses in this neighborhood:

GRM = Sales price/Monthly rent

Property	Sales Price		Monthly Rent		GRM
214 Jackson	$148,200	÷	$1,045	=	142
312 Lincoln	156,000	÷	963	=	162
107 Adams	168,400	÷	1,170	=	144

If the house you value could rent for $1,000 a month, calculate a value range using the GRMs indicated by these other neighborhood rental houses:

Subject House (Estimated Value Range)

GRM		Monthly Rent		Value
142	×	$1,000	=	$142,000
162	×	1,000	=	162,000
144	×	1,000	=	144,000

Thus, the value ranges between $142,000 and $162,000.

The GRM method does not directly adjust for sales incentives, financing concessions, different features, location, property condition, or property operating expenses. So this technique yields a rough appraisal. Nevertheless, real estate investors use it as a quick rule of thumb. As with the comp sales approach, the GRM works best when you find similar properties in the same neighborhood.

For apartment buildings, the gross rent multiplier is calculated from *annual* rent collections rather than monthly. For example:

Multi-Unit Income Properties

Property	Sales Price		Total Annual Rents		GRM
2112 Pope (fourplex)	$280,000	÷	$35,897	=	7.8
1806 Laurel (sixplex)	412,000	÷	56,438	=	7.3
1409 Abbot (sixplex)	367,000	÷	53,188	=	6.9

The GRMs shown in these examples *do not necessarily* correspond to the GRMs that apply in your city. Even within the same city, neighborhoods differ in their GRMs. In the San Diego area, GRMs for single-family homes in La Jolla can exceed 400; in nearby Claremont, you may find GRMs in the 250 to 300 range; and in National City, GRMs can drop below 200. Even within the same neighborhood, GRMs for single-family houses often exceed those of condominiums. In San Francisco, small multi-unit buildings can sell with annual GRMs of 14 or higher. In Detroit, MI, I have seen annual GRMs of less than 4.

As with all appraisal methods, search out relevant *local* data before you calculate gross rent multipliers. To estimate market value, know the local (micro) submarkets (type of property, neighborhood, features, and condition). No set answer rules.

INCOME CAPITALIZATION

To value apartment buildings, investors use the direct capitalization technique. Recall that the direct capitalization method applies the following value formula:

$$V = NOI/R$$

V represents the value estimate. NOI represents the net operating income of the property. R represents the overall rate of return on capital that buyers of similar income properties typically require. Here's an example.

Net Operating Income

Investors define net operating income as annual gross potential rental income from a property less vacancy and collection losses, operating expenses, replacement reserves, property taxes, and property and liability insurance. Study this net income statement for an eight-unit apartment building where each unit rents for $725 a month:

Income Statement (Annual)

1. Gross annual potential rents ($725 × 8 × 12)	$69,600
2. Income from parking and storage areas	6,750
3. Vacancy and collection losses at 7%	(5,345)
4. Effective gross income	$71,005
Less operating and fixed expenses	
5. Trash pickup	$1,440
6. Utilities	600
7. Registration fee	275
8. Advertising and promotion	1,200
9. Management fees at 6%	4,260
10. Maintenance and repairs	4,000
11. Yard care	650
12. Miscellaneous	3,000
13. Property taxes	4,270
14. Property and liability insurance	1,690
15. Reserves for replacement	2,500
Total operating and fixed expenses	$23,885
16. Net operating income (NOI)	$47,120

The following list explains each of the lines in the net income statement:

1. *Gross annual potential rents.* This amount is the largest possible sum of rents that you could practically bring in at current market rent levels and 100 percent occupancy.

2. *Income from parking and storage areas.* This property has a 16-car parking lot. A shortage of on-street and off-street parking in the neighborhood makes it profitable for the owner to rent the parking spaces independently of the apartment units. Also, the owner built storage bins in the basement of the building that are available for rental to tenants.

3. *Vacancy and collection losses.* Market vacancy rates in the area typically range between 5 and 10 percent. Currently, all units in this building are rented. But even the best-managed apartments experience some vacancies when apartments turn over. Add in some losses for tenants who disappear owing rents that exceed the amounts of their security deposits.

4. *Effective gross income.* This term refers to the actual amount of cash that an owner receives net of vacancy and collection, but before operating, fixed, and financing expenses.

5. *Trash pickup.* Self-explanatory.

6. *Utilities.* In this property, tenants pay their own unit utilities. The property owner pays for lighting in the hallways, basement, and parking area.

7. *Licenses and permit fees.* Apartment building owners must sometimes pay for business licenses and other fees. For this property, the owner pays a rental property registration fee.

8. *Advertising and promotion.* These units generally rent by word of mouth, Craigslist.org, or a *For Rent* sign that's posted on the property. However, to be safe, an advertising and promotion expense of $150 per year per unit is allocated to the operating budget.

9. *Management fees.* The owner of this apartment building self-manages the property. Nevertheless, he should pay himself the same amount he would otherwise have to pay a property management firm. Keep returns for labor distinct from returns on investment. Do not reward the seller for the work that you will contribute to the property.

10. *Maintenance and repairs.* The current owner and her husband clean, paint, and make small repairs around the property. These labors deserve payment from the property's rent collections.

11. *Yard care.* The owner pays this amount to one of the tenants to keep the grass cut, rake leaves, and shovel snow off the walks.

12. *Miscellaneous.* This expense covers legal fees, supplies, snow removal from the parking lot, municipal assessments, auto mileage to and from the property, and other items not accounted for elsewhere in the income statement.

13. *Property taxes.* This item includes city, county, and state taxes annually assessed against the property. BEWARE: Tax assessors periodically revalue properties to reflect increases in market prices. Future tax bills could jump 30 to 40 percent over the amount of the previous tax years. Similarly, if your purchase price comes in less than the assessor's current assessed value, you may see a reduced tax bill.

14. *Property and liability insurance.* This insurance reimburses for property damage caused by fire, hail, windstorms, sinkholes, hurricanes, and other perils. It also pays to defend against, and compensate for, lawsuits alleging owner negligence (e.g., slip-and-fall cases).

15. *Reserves for replacement.* Building components wear out. The roof, plumbing, appliances, and carpeting must be replaced periodically. As per the income statement, average out these nonroutine costs on a per-year basis.

16. *Net operating income (NOI).* After you itemize and total all operating expenses, subtract this sum from the effective gross income. The resulting figure equals net operating income (NOI).

When you calculate NOI, include all expenses for the coming year. Never accept a seller's income statement as accurate. Sellers notoriously omit and underestimate expenses. (Corporate CEOs aren't the only ones who try to dress up their numbers to paint a pretty picture.)

Ask to see the seller's tax return IRS Schedule E for the subject property. The truth will probably sit somewhere between the owner-prepared income statement for sales purposes (where income is likely to be overstated and expenses understated) and a tax return (where you might detect understated income and overstated expenses). Even if the seller truthfully reports *last* year's income and expenses, estimate how each of those figures might move up or down in the coming years. You buy the future, not the past.

Are property tax assessments headed up? Are vacancy rates (or rent concessions) increasing? Have utility companies scheduled any rate increases? Has the seller deferred maintenance on the property? Has the owner allocated enough maintenance expenses to cover replacement reserves? Has the seller self-managed or self-maintained the property and therefore failed to include items as cash expenses? When calculating NOI, never accept numbers on faith. Savvy investors realistically reconstruct seller-prepared NOIs.

Estimate Capitalization Rates (R)

After figuring NOI, next decide what capitalization rate (R) to use. When you buy an income property, you pay now for the rents the property will produce over the next 20, 30, or 40 years (or longer). The question becomes how much these future rents are worth in today's dollars (i.e., the property's market value). If the appropriate capitalization (cap) rate is 8.5 percent, then the market (capital) value of this eight-unit apartment building equals $554,365:

$$\$47{,}121\ (\text{NOI})/.085\ (\text{R}) = \$554{,}365\ (\text{V})$$

But where does that .085 percent "cap rate" come from? You estimate it from the cap rates that other investors have applied to buy similar properties. Say a real estate agent gives you NOI and sales price data on four similar apartment buildings that recently sold:

Market Data

Comparable Property	*Sales Price*	*NOI*	*R*
Hampton Apts. (8 units)	$533,469	$43,211	.081%
Woodruff Apts. (6 units)	427,381	35,900	.084
Adams Manor (12 units)	694,505	63,200	.091
Newport Apts. (9 units)	671,241	53,700	.080
Subject (8 units) (estimated)	544,365	47,121	.085

From these data, calculate a market-derived cap rate for each property (provided sale meets the criteria of a market value transaction). When investors in this area buy small income properties similar to the subject property, they figure cap rates between 8.1 and 9.1 percent. So it appears that the market of comp sales indicates a cap rate of around 8.5 percent for the subject property.

Compare Cap Rates

In your market, you may not discover sufficiently similar properties with such a narrow range of cap rates. You might find that some apartment buildings have sold with cap rates of 5 to 6 percent (or lower) and others have sold with cap rates of 8 to 9 percent (or higher). Why such differences?

You pay for a *quantity* of future rental income, and you pay for the *quality* of that income. Today's price also incorporates expectations about

the future price/income gains for that property. The greater its *expected* rate of appreciation, the higher the price you pay now. Therefore the higher the quality of the income stream, and the larger the expected gain in price, the lower the capitalization rate (or the lower the quality of the property's income and price gain potential—in the eyes of the market—the higher its cap rate).

To illustrate: You compare two fourplexes. One is a relatively new property located in a well-kept neighborhood near a city's growth corridor. Several nearby office towers are under construction. The other fourplex is located in a deteriorating part of town. Major employers have moved out, closed, or laid off workers. Crime rates are high and moving higher. Two recent drug-related murders made front-page news.

If the annual NOIs for these two fourplexes are, respectively, $24,960 and $12,480, how much would investors pay for each property? If investors applied a 10 percent cap rate to each property's income stream, they would value the properties as follows:

$$\$24{,}960\ (\text{NOI})/.10\ (\text{R}) = \$249{,}600\ (\text{V})$$
$$\$12{,}480\ (\text{NOI})/.10\ (\text{R}) = \$124{,}800\ (\text{V})$$

But investors would not apply a like cap rate to these very unlike properties because the quality of their income streams differs. The better-located property offers more stable rents, less neighborhood risk, and greater expected gains in price. Investors might actually capitalize the respective NOIs of these two fourplexes at rates of, say, 6 percent and 15 percent.

$$\$24{,}960\ (\text{NOI})/.06\ (\text{R}) = \$416{,}000\ (\text{V})$$
$$\$12{,}480\ (\text{NOI})/.15\ (\text{R}) = \$83{,}200\ (\text{V})$$

Because most investors would rather own a property in a prospering area as opposed to a troubled area, they will pay significantly more *for each dollar of income* produced by such a property.

The Paradox of Risk and Appreciation Potential

Odd as it may seem, the higher-priced "low-risk, high-appreciation" properties may actually produce more risk and lower gains in price than their low-rent, highly troubled cousins who are located in the wrong part of town.

Compare Relative Prices and Values

Consider this stock market analogy. If you could buy a quality, high-growth company's stock at a P/E of 10 or a low-growth company's stock at a P/E of 10, by all means invest in the high-growth company. If you could buy a low-risk, high-appreciation-potential property with a cap rate of 10 percent or a higher-risk, lower-appreciation property with a cap rate of 10 percent, buy the low-risk, high-appreciation property. However, that's not how markets typically price either real or financial assets.[2] In the real world, investors bid up prices for high-quality, growth-area properties and reduce their bids for so-called high-risk properties in less desirable neighborhoods. To figure out which type of property and location offers the most profit potential, compare their relative prices and cash flows.

When investors optimistically bid up the prices of some properties, neighborhoods, and cities relative to other properties, neighborhoods, and cities, you can sometimes profitably redirect your investment strategy. In other words, don't calculate market cap rates for just one type of property or neighborhood. Learn as much as you can about a variety of submarkets and areas of the country. For instance, do you believe that San Francisco apartments can continue to command a four- to eight-fold price premium over those of Charlotte, North Carolina?

You overpay for a property when: (1) you apply a cap rate that's too low for the property and neighborhood you're buying into, or (2) you fail to realize that market cap rates themselves may sit too low relative to other types of properties or locations. On the other hand, you can earn extraordinary profits when you discover lesser-publicized (high cap rate) properties (locations) that yield high rents relative to the price you have to pay. (We further explore this opportunity in Chapter 15.)

VALUATION METHODS: SUMMING UP

"Market value" does not necessarily equal "appraised value" or "sales price." Market value refers to the sale price of a property when a sale meets the criteria of a market value transaction. To estimate the market value of a subject property as it compares with other similar properties that have sold, first investigate the terms and conditions under which

[2] If you bought Microsoft and JC Penney stock in 1998 and sold in 2004, JC Penney stock would have paid you higher returns. As a high-profile growth company, in 1998, Microsoft's stock price already included a hefty premium for its expected growth.

the comparative properties sold. A property down the street that sold for $200,000 after just three days on the market does not necessarily indicate that a similar property nearby will sell for $200,000. It depends on the terms of sale and the detailed features of each property.

Even though you can use three approaches to value a property, those three approaches do not result in the same value estimates. You work with imperfect data. You need to decide which approach(es) best serves your purposes. The accuracy of your market value estimate directly relates to how well you identify and evaluate a property's features. Observe the differences (positive or negative) that make a difference. Investment decisions require you to know features, properties, neighborhoods, construction costs, and lot values. Technique never substitutes for knowledge, close reasoning, and wise judgment.

Past price increases (decreases) do not forecast the future. It's tougher to make money when you buy a property that's about to fall in value—even if you buy it at a "bargain price." And you can make great returns—even when you pay market value (or above)—if you have identified a property (or location) that's about to gain increased popularity.

Appraisal Limiting Conditions

One final note on appraisal reports: Property appraisers hedge their estimates of value with many limiting conditions. Especially relevant (Figure 3.1) are limitations 1, 2, 6, and 7:

- Appraisers do not investigate title. They assume that a property's bundle of fee simple rights is good and marketable. For a legal guarantee of property rights, consult a title insurance company.
- Appraisers do not survey the boundaries of a site, nor do they necessarily note encroachments or other potential site problems. To precisely identify site dimensions, encroachments, and some easements, employ a surveyor and walk the property lines.
- Appraisers assess the condition of a property that they see through casual inspection. To thoroughly assess the soundness of a property and its systems (heating, cooling, electrical, plumbing), hire a professionally competent building inspection service or skilled tradesperson.
- Appraisers gather much of their market information from secondhand sources (real estate agents, government records, mortgage lenders, and others). Appraisers seldom go inside the comp properties that they include in their appraisal reports. Because they incorporate nonverified secondhand data, appraisals often

err in fact and interpretation. Accept an appraisal report as "for-what-it's-worth" information. Never give it more weight than it deserves. (At a minimum, I verify the appraiser's comp property data before I decide how much respect I should give to an appraiser's estimate of value.)

Valuation versus Investment Analysis

Before you buy, accurately understand the property's market value. Yet market value itself does not tell all you need to know to make profitable investment decisions. Besides figuring out what a property is worth today, answer these questions:

- Will the property generate adequate cash flows?
- Can you expect the property to increase in price?
- Can you add value to the property?

To address these investment issues, we turn to the following chapters.

4

MAXIMIZE CASH FLOWS AND GROW YOUR EQUITY

To value income properties, investors capitalize net operating income (NOI) by dividing it by the capitalization rate (R). But because you will finance your investment properties, you won't pocket the full amount of NOI that your property produces. Nor does the capitalization rate itself reveal your actual yearly cash return on your actual amount of invested cash (i.e., your down payment). So, now you will learn how to calculate the returns you can achieve through leverage.

WILL THE PROPERTY YIELD GOOD CASH FLOWS?

From Chapter 2 recall that you calculate before-tax cash flow (BTCF) as follows:

NOI less debt service (annual mortgage payments) equals BTCF

Now let's return to the eight-unit apartment building example from Chapter 3. We calculated NOI for that property at $47,121. Applying an 8.5 percent cap rate, we figured the property's market value as $544,365:

$$\$544{,}365\,(V) = \$47{,}121\,(NOI)/.085\,(R)$$

If you finance this property with a mortgage loan-to-value (LTV) ratio of 80 percent (20 percent down) at 7.5 percent interest, amortized over a

term of 25 years, figure your mortgage balance and annual payments as follows:

$544,365 (value)
.80 LTV
$435,492 loan amount

With mortgage terms of, say, 7.5 percent, fully amortized over 25 years, the monthly mortgage factor equals $7.39 per $1,000 borrowed. Because you originally borrowed $435,492, your monthly payments equal $3,218 for a yearly total amount of $38,618:

$435,492 ÷ 1,000 = 435.492
435.492 × $7.39 (mo. pymt. per 1,000 borrowed) = $3,218
12 × $3,218 = $38,618 (yearly amount paid)

Given the above amount of mortgage payments (debt service), this eight-unit apartment building brings in a first-year BTCF of $8,503:

$47,121 (NOI)
less $38,618 (yearly debt service)
$8,503 (BTCF)

To calculate your annual cash-on-cash return on investment (i.e., your annual rate of return on the actual amount of out-of-pocket cash that you have invested), divide the down payment (original cash investment) into your annual before-tax cash flow (BTCF):

Cash ROI = $8,503 (BTCF)/$108,873 (down payment) = 7.81%

Does this first-year cash-on-cash rate of return look attractive? That would depend on the property's potential. Can you add value to the property through creative improvements? Is the property strategically positioned for appreciation? If you see strong potential for the property, you might accept a relatively low return from cash flows. But maybe you're not happy with an annual BTCF of $8,503 and a cash-on-cash ROI of 7.81 percent. Does this mean you should cross this property off your list? Not necessarily. Before you reject a property that fails to produce satisfactory cash flows, look for ways to increase those returns:

- Could you arrange alternative financing with lower annual payments?

- Should you decrease (increase) your down payment?
- Can you buy at a bargain price?

Arrange Alternative Terms of Financing

As explained in Chapter 2, smart investors think through their financing alternatives. You can restructure the cost and/or terms of financing to improve cash flows. In a first pass through the numbers for this eight-unit apartment building, we assumed a 7.5 percent interest rate amortized over 25 years with a 20 percent down payment. To improve the cash flows, try the following:

- Seek a lower interest rate.
- Lengthen the term of the mortgage.
- Use some type of balloon second mortgage.
- Combine several of these alternatives.

To obtain a lower interest rate, switch to an adjustable-rate mortgage, ask for below-market seller financing, buy down the interest rate, or perhaps assume a seller's lower-interest-rate mortgage. Here's how an interest rate of, say, 6.7 percent would boost cash flows:

Monthly payment per $1,000 at 6.7% for 25 years = $6.88
435.492 × $6.88 = $2,996 monthly payment
12 × $2,996 = $35,954 annual payments (debt service)
$47,121 (NOI)
less $35,954 (yearly debt service)
$11,167 (BTCF)
ROI = $11,167 (BTCF)/$108,873 (down payment) = 10.26%

If this BTCF and ROI still fall short of your investment goal, extend the amortization period from 25 to 40 years (with, say, a balloon at year 10 or 15, if necessary).

Monthly payment per $1,000 at 6.7% for 40 years = $6
435 × $6 = $2,610 per month
12 × $2,610 = $31,320
$47,121 (NOI)
less $31,320 (debt service)
$15,801 (BTCF)
ROI = $15,801 (BTCF)/$94,242 (down payment) = 16.77%

Now return to the first calculation, when you borrowed mortgage money from a bank at 7.5 percent interest with a 25-year term. Say the sellers won't carry back the entire amount of the financing but will give you a $100,000 balloon second mortgage due in five years, with interest only payable at 6 percent. You borrow $335,492 from the bank on its terms, and $100,000 from the sellers on their terms. Here's what your cash flow would look like under this financing arrangement.

335.492 × $7.39 × 12 = $29,775 (to the bank)
.06 × $100,000 = $6,000 (to the seller)
Total annual debt service = $35,775 ($29,775 + $6,000)
$47,121 (NOI)
less $35,776 (debt service)
$11,345 (BTCF)
ROI = $11,345 (BTCF)/$108,873 (down payment) = 10.42%

Although the cash flow here falls below the seller-financed transaction, it still beats the baseline bank financing. My intent here is not to show which type of financing seems best. Rather, it is to encourage you to calculate possible returns via alternative financing scenarios, and then discover which (if any) financing might make a deal work—for you and the sellers. In just the few possibilities shown here, the first-year BTCF ranged from a low of $8,502 to a high of $15,765. Change the terms of financing and you might materially improve (or diminish) the financial performance of a property.

Decrease (or Increase) Your Down Payment

You also change cash flow and correspondingly, cash-on-cash return, when you decrease (or increase) your down payment. Instead of placing 20 percent down ($108,873) on this eight-unit property, you close the deal with a 10 percent down payment of $54,436.50. The seller finances the balance of $489,928 at 7.5 percent interest for 25 years (with perhaps a shorter term balloon payoff):

489.9285 × $7.39 × 12 = $43,446 (debt service)
$47,121 (NOI)
less $43,446 (debt service)
$ 3,675 (BTCF)
ROI = $3,675 (BTCF)/$54,436 (down payment) = 6.75%

In this case, a lower down payment gives you a thin margin of cash flow and drops your cash-on-cash ROI to 6.75 percent. By comparison,

here's what happens to cash flow and ROI if you buy with 10 percent down, seller financing at 6.5 percent interest, amortized over 40 years:

459.928 × $5.85 × 12 = $32,287 (debt service)
$47,121 (NOI)
less $32,287 (debt service)
$14,834 (BTCF)
ROI = $14,834 (BTCF)/$54,436.50 (down payment) = 27.25%

This outcome looks attractive. Combine the benefits of the lower interest rate with the leveraged gain from higher LTV and you beat the returns realized with the baseline bank financing (20 percent down, 7.5 percent, 25 years).

In areas of the country with generally high property prices, you may find that well-kept properties (single-family houses, duplexes, fourplexes, small apartment buildings), when financed with high LTV loans, produce negative cash flows. Say that our eight-unit building is located in a prime neighborhood that's in high demand by both owner-occupants and investors. Instead of a cap of 8.5 percent, the market values properties in this neighborhood with a 7.0 percent cap rate. Given this lower cap rate, this building commands a higher value ($673,157 versus $544,365):

$673,157 (V) = $47,121 (NOI)/.07 (R)

If you finance with an 80 percent loan, you'll put down $134,631 and secure a mortgage of $538,526. With a 7.5 percent interest rate and a 25-year term, your annual mortgage payment would total $47,756:

538.526 × $7.39 × 12 = $47,756 (debt service)
$47,121 (NOI)
less $47,756 (debt service)
$ –635 (BTCF)

In situations of negative cash flow (an alligator), search for low-cost financing. If that doesn't work, cover the negative (feed the alligator) from other income or increase the amount of your down payment. With 30 percent down ($201,947.1) on a price of $673,157, you would borrow $471,210 and then pay back $43,242 a year:

471.210 × $7.39 × 12 = $41,786 (debt service)
$47,121 (NOI)
less $41,786 (debt service)
$ 5,335 (BTCF)
ROI = $5,335 (BTCF)/$201,947.10 (down payment) = 2.645%

At least the larger (30 percent) down payment converts your negative cash flow into a positive, but your cash on cash looks anemic. Buy such a property if you can profitably improve it, or when neighborhood property values are about to escalate. Alternatively, to combat low cap rates or negative cash flows, ferret out bargain-priced properties or move your search for properties to lower-priced (higher cap rate) geographic areas.

Buy at a Bargain Price

To increase your cash flow (or avoid a negative cash flow), locate properties that you can buy at less than market value. Although this technique requires hustle, knowledge, and creativity, you can do it. Motivated sellers, lender-owned properties (REOs, i.e., bank-owned real estate), foreclosures, tax sales, uninformed sellers, trade-in properties, and other sources of bargains routinely account for between 10 and 20 percent of property sales. More recently, such distress sales—in some cities—have exceeded 50 percent of total sales.

Sources of bargains are discussed in later chapters, but at least here you can see how a below-market price can lead to higher cash flows.

Return to the eight-unit example that was valued with an 8.5 percent cap rate at $544,365. With the hypothetical baseline bank financing of 20 percent down and 7.5 percent, 25-year terms, the property produced a first-year cash flow of $8,502. But what if you could buy that property (or a similar one) at a bargain price (say 10 percent under market)? You would pay $489,928.50, put $97,935.70 down, and borrow $391,942.80 (80 percent). Your annual debt service would fall to $34,757, and your cash flow (BTCF) would increase to $11,539:

391.943 × $7.39 × 12 = 34,757 (debt service)
$47,121 (NOI)
less $34,757 (debt service)
$12,364 (BTCF)

Your first-year ROI would increase to 12.62 percent:

$$\text{ROI} = \$12{,}364\,(\text{BTCF})/\$97{,}985.70\,(\text{down payment}) = 12.62$$

In markets where properties typically fail to give you the cash flows you want, don't give up your search. Instead, discover a property you can buy at a bargain price. In today's markets, distressed sellers have

multiplied. Careless property management, dumb financing, and a down economic cycle have conspired to force the sale of hundreds of thousands of properties at bargain prices.

Should You Ever Pay More than Market Value for a Property?

Recall the negotiating ploy where you tell sellers that you will pay their price if the owner will sell on your terms. You stroke the sellers' egos and give them a price they can brag about. But (ostensibly) you'll earn good cash flows and a high ROI because you receive a high LTV and low-cost financing.

Staying with the eight-unit example, say the sellers accept your offer and set a price of $600,000 ($544,365 market value). You say, "Fine, here are my terms: $25,000 down, 5.75 percent interest, and 40-year payoff period with a balloon note due in 12 years." This arrangement means that the sellers would carry back a mortgage (or contract for deed) in the amount of $575,000. Here's how the numbers work out:

575.000 × $5.33 × 12 = $36,777
$47,121 (NOI)
less $36,777 (debt service)
$10,344 (BTCF)
ROI = $10,344 (BTCF)/$25,000 (down payment) = 41.38%

Wow! These numbers look terrific. Compared with a market value price and bank financing, you've achieved three important objectives: (1) You reduced the cash you need to buy the property; (2) you increased your cash flow; and (3) you lifted your ROI into superstar territory. You can readily see why some authors encourage you to trade off a higher price for a low down payment, low-cost OWC financing.

Nevertheless, you created a serious problem. You owe more than the property is worth. Absent a strong increase in market price, you could not sell the property for an amount high enough to pay off the outstanding mortgage balance (a dilemma faced by millions of buyers in the country's recent downturn). Just as troubling, if market interest rates drop, you could not refinance your outstanding mortgage balance. Your one-time favorable financing now locks you into a higher than market rate for what could turn out to be an extended period (especially in a less-than-robust market).

To protect against these risks, negotiate these two financing clauses:

1. *The right to assume.* If a buyer can take over your 5.75 percent financing, you increase your ability to sell the property without coming up with cash out of your own pocket.

2. *The right to prepay the loan balance at a discount.* To help you overcome the owe-more-than-you-own mortgage problem, insert a prepayment discount clause into your financing agreement. If you pay off the seller within the first five years (for example), the seller will discount the payoff balance by, say, 5 or 10 percent. Sellers who are eager to cash out their loan on a property may agree to this discount. (Even when an OWC mortgage does not include a prepayment discount clause, sellers may later accept such an offer. But if you offer a discount, play it coy. First raise the possibility of early payoff to prompt a reaction from the seller. Generally, the more eager the seller, the greater the discount you negotiate.)

"You set the price, I'll set the terms," can work to decrease your down payment, increase your annual cash flow, and leverage up your ROI. Yet if such prices and terms leave you with negative equity, you've crossed into risky territory. Calculate whether the benefits of the deal outweigh these risks. Most importantly, never assume that market appreciation rates of 6 or 8 percent a year will bail you out of the excessive mortgage problem. Maybe you will get lucky, but don't bet the ranch on it.

The Debt Coverage Ratio

You've seen how financing (mortgage amount, interest rate, amortization period) can increase or decrease your annual cash flows and ROI. In addition, recall that the lender may apply a debt coverage ratio (DCR) as one of its underwriting criteria. The lender wants to see whether the property's NOI is large enough to amortize the loan and provide a margin of safety. For example:

$$\text{DCR} = \$47{,}121\ (\text{NOI})/\$38{,}618\ (\text{debt service}) = 1.22$$

Among lenders who incorporate debt coverage ratios into their underwriting decisions, for moderate to high-quality apartment buildings, a DCR range of 1.1 to 1.3 usually proves acceptable. If a property's NOI fails to provide enough cushion for the lender, rework the terms of the financing. Investors frequently work their deals not only to meet their own cash flow requirements but also to meet a lender's required DCR.

Numbers Change, Principles Remain

Previous discussions focused on the cash flows of an eight-unit apartment building with a variety of interest rates, loan balances, amortization periods, cap rates, and purchase prices. The numbers used in these examples illustrate techniques and principles—not the specific numbers you should apply in your market or for your investment goals.

In Tulsa, not long ago, you could buy a good eight-unit rental property for less than $300,000. In San Francisco, you can pay $2 million for a similar building. In Tulsa I've seen cap rates over 10 percent. In San Francisco, I've seen them at less than 4 percent. Property markets differ. Even within the same city, properties, neighborhood quality, gross rent multipliers, and terms of financing vary.

When you buy condos, single-family houses, or small apartment buildings, search throughout your local area. Talk with well-informed realty agents, mortgage loan officers, real estate appraisers, property managers, and real estate investors.

As you learn the numbers that apply to proposed deals, work through your value estimates and ROI figures as illustrated in this chapter (and Chapter 3). To a certain degree, investing profitably means *structuring* deals to yield positive cash flows and high ROIs while avoiding foolish financial risk. When you buy at a below-market price, you increase your odds of success. But "price" represents one variable. Without positive cash flows and sufficient cash-on-cash returns, even a "bargain-priced" deal can turn sour.

WILL THE PROPERTY YIELD PROFITABLE INCREASES IN PRICE?

In addition to yearly cash flows, property investors expect their properties to sell at prices substantially greater than they paid. Over longer periods, even price increases of 3 or 4 percent per year can add hundreds of thousands of dollars to your net wealth.

Buy just one rental unit at a price of $100,000 and finance it with a $90,000 mortgage at 6.5 percent interest and a 30-year term at an annual appreciation rate of 4 percent. After 15 years, that $100,000 unit would be worth $180,000. Subtract your outstanding mortgage balance of $64,803, and your $10,000 down payment has grown 11-fold to $115,197. After 30 years, your mortgage balance would drop to zero, and the value of the property (at a long-term 4 percent yearly average rate of appreciation) would total $324,340. In a down cycle, price increases may express hope

more than reality. But over a period of 15 to 30 years, an average price gain of 4 percent per year matches past experiences. In fact, experience shows that investors who acquire bargain-priced properties during down cycles typically gain long-run price increases that average greater than 4 percent a year.

Buy just three or four $100,000 rental units within the next several years, and at retirement (if you're under age 50), your net wealth from those units will total somewhere between $400,000 and $1 million. With only modest increases in rents, your income from those properties could reach $6,000 to $10,000 a month. And that's from only three or four units! After 18 years, today's monthly rent of $1,000 would grow to $2,000 a month—assuming a 4 percent average increase each year.

[To Californians and residents of other high-priced areas, these purchase figures look quite low, so double or triple them. The same principle applies. To improve your cash flows, look for properties in lower-cost geographic areas. Also, join with others and buy multi-unit buildings. Commercial properties provide another option (see Chapter 15). "Fixers," too, offer a good alternative. (See especially Chapter 8 herein and my book *Make Money with Flippers, Fixer-Uppers, and Renovations,* John Wiley & Sons, 2008, 2nd ed.)]

Low-Involvement versus High-Involvement Investing

Hold properties for income and appreciation for a period of 15 to 30 years (or more) and you've put in place a low-involvement investment strategy. Anyone who is serious about building wealth can come up with the limited time and money necessary to make this modest strategy pay off. However, if you want to build wealth over a shorter period, then pursue high-involvement strategies to boost value. High involvement won't necessarily require more cash, but it will require more time, effort, and knowledge.

To beat the market average price increases, spot communities, neighborhoods, and properties that are positioned for increased popularity and faster appreciation.

Most everyone now realizes that short-term price increases are never guaranteed. Job layoffs, speculative overbuilding, high interest rates, tight credit, and other factors can temporarily push property prices into a tailspin. Yet especially in perilous times (when fear and confusion drives others to the sidelines), opportunities to score large price increases multiply. Look for areas that signal strong potential. Here's how to find these star performers.

Compare Relative Prices of Neighborhoods (Cities)

An oft-cited cliché in real estate tells investors to "buy in the best neighborhoods you can afford; the best neighborhoods always appreciate the fastest." On closer inspection, this advice makes no sense. No neighborhood or community can persistently outperform all others. The law of compound interest proves the statement false. (Similarly, recall that the stock price of Microsoft—a great company—was higher in 1999 than it was in the fall of 2008.)

Say that you can choose between a neighborhood where apartment buildings are priced at $100,000 per unit (College Park) and a neighborhood where apartment buildings are priced at $50,000 per unit (Modest Manor). Within the recent past, properties in College Park jumped in value by 8 percent a year. Units in Modest Manor have moved up by only 3 percent a year. Can College Park outpace Modest Manor forever? Not likely. A look at projected values shows why.

Future Appreciated Values: College Park versus Modest Manor

Years	$100,000 Units at 8% p.a.	$50,000 Units at 3% p.a.
3	$125,970	$54,635
6	158,690	59,700
9	199,900	65,200
12	251,820	71,250
15	317,222	77,900
20	466,100	90,300

Today, rental units in College Park cost *twice as much* as those located in Modest Manor. But after 20 years of (assumed) faster appreciation, these superior higher-priced units would cost *more than five times as much* as their "inferiors." Unless some rare market forces were at work, such an unbalanced situation would not occur.

Long before such exaggerated price differences could result, increasing numbers of potential investors (and tenants) would become priced out of College Park. In response, they would switch their buying (or renting) to Modest Manor. Price gains in College Park would slow. Price gains in Modest Manor would accelerate.

The intelligent investor never assumes that future rates of appreciation will mirror the recent past. (Nor do they assume recent price declines can be trend-lined into the future.) Intelligent investors compare the prices

and features of a variety of properties, neighborhoods, and cities. They compare local economies. They note changes up or down in the number of for sale and for rent properties. Then they search for properties and locations that show the best possibilities for price gains.

Undervalued Neighborhoods and Cities

At any time and in any area, no fixed relationship applies to neighborhood or community appreciation potential. Sometimes lower-priced areas represent a great buy. At other times, higher-priced areas look best. Sometimes new developments beat established neighborhoods; sometimes established beats new. Nor can anyone advise definitively about close-in versus far-out, well-kept versus run-down, or low-crime versus high-crime. Neither racial nor ethnic composition, nor household income level, nor occupational status necessarily relates to the potential price gains of a neighborhood.

The neighborhood or city that offers the best outlook for price gains is the neighborhood (city) where growth prospects, property prices, and rent levels look good relative to the growth prospects, prices, and benefits offered by other areas. Consider one of my favorite examples of how modest can appreciate faster than classy.

Beverly Hills versus Watts (South Central Los Angeles)

Between 1985 and 1989, property prices in prestigious Beverly Hills had shot up by 50 percent or more. During the same period, property prices in the troubled neighborhood of Watts had barely budged. But by 1995, $5 million (1989) properties in Beverly Hills were selling at reduced prices of $3 million to $4 million, whereas $85,000 (1989) properties in Watts were selling at the increased price of $125,000. Between 1989 and 1995, property investors who owned units in troubled South Central Los Angeles outperformed investors who owned properties in the movie star haven of Beverly Hills.

In response to this fact, here's what I wrote in 1995 in the second edition of this book: "Will appreciation rates in South Central continue to outpace Beverly Hills? I don't think so. Relative to other premier neighborhoods in world-class cities, homes in Beverly Hills now stand as terrific bargains. With the California economy at last climbing out of recession, house prices and rentals in Beverly Hills may now be positioned to hit new record highs."

Looking back now, you can see that my forecast proved correct. Between 1995 and 2005, upscale property prices in California did hit

record highs. Although South Central prices also continued to climb, you would have made far more money had you invested in Beverly Hills. Between 2008 and 2009 in Dubai, the multimillion-dollar villas located on world-famous Palm Jumeira suffered price declines of nearly 50 percent off their peak. During this same period the modest town homes of Dubai's International City held their value. Dubai was running a huge excess of top-end villas and apartments, whereas affordable units such as those of International City remained in short supply relative to the demographics of the population.

As these examples show, investors can profit (or avoid loss) when they study neighborhood home prices relative to features, benefits, and buyer/renter demographics. Savvy buyers never prejudge. They gather facts about supply and demand. They reason. They forecast the future. They neither extrapolate the past into the future nor do they apply clichés and slogans to anticipate price movements.

Apart from relative prices, what facts should you compare?

- Demographics
- Accessibility
- Job centers
- Taxes, services, and fiscal solvency
- Construction and renovation
- Land-use laws
- Civic pride
- Sales and rental trends

Demographics

Demographics refer to the income levels, occupations, education, ages, household size, household composition, and other population characteristics. You can obtain such data from the U.S. Bureau of Census and commercial market research firms (see www.census.gov). The magazine *American Demographics* alerts its readers to emerging demographic trends. Truly news you can use.

More important than *current* neighborhood demographics, learn who is moving *into* the area. A historically lower-income area that's attracting middle- or even upper-middle-income younger residents points towards appreciation potential. Likewise, an area where many residents are moving from welfare to jobs signals turnaround.

To learn about the people in an area, get out of your car. Talk with residents who are working in their yards or walking their dogs. Talk with Realtors, mortgage loan officers, retail shop owners, schoolteachers,

postmen, taxi drivers, policemen, government planners, and others whose firsthand, everyday experience places them in the know about an area. Ask anyone and everyone how the area is changing and whether they see these changes as positive or negative. Ask the people you talk to what they like least and what they like most about the neighborhood. Evaluate what you hear, see, and research. Then form your own conclusions. Do you think the people moving into the neighborhood are likely to push up home prices and rental rates? Or does "filtering down" point to deterioration?

Accessibility (Convenience)

Areas don't change their position on the face of the earth. Nevertheless, they can become more or less convenient relative to other areas and relative to their own past. Several years back, I chose to buy property in the southeast part of town rather than the more popular northwest corridor. Why? Lower prices, similar quality, and easier accessibility. Because of rapid growth and development, the freeway leading to the northwest corridor had become congested. What had been a 15- to 20-minute drive to town from those neighborhoods was now taking 45 to 60 minutes. And traffic was getting worse.

As a result, increasing numbers of renters and homebuyers decided that they did not want the hassle of fighting traffic every day. They switched their preferences to the east and southeast developments. Within three years, my properties jumped in value by 40 percent. Momentum feeds upon itself for a while.

Improved (Increased) Transportation Routes

Find out whether an area might become more convenient because of changing (or lower cost) transportation routes. Are any new or expanded freeways or toll roads planned or under construction? What about bridges, ferries, subways, commuter trains, or bus service? Will travel to and from a neighborhood or community become easier, cheaper, or faster? After the Euro tunnel connected England to France, British demand for vacation homes doubled the (historical) appreciation rate of attractive French properties. Discount airline fares increased the demand for Florida properties—especially among New Yorkers and Chicagoans.

Can you recall 15 or 20 years ago when some of those "outlying" developments were built in your area? Are they still outlying? More than likely they're now just minutes from shopping centers, office complexes, and restaurants. Because growth moves outward, identify how

convenience will change. Developments, cities, or even countries that today seem far away may tomorrow sit just minutes from everything.

Jobs

Most people prefer to live close to their jobs. As you search for appreciation potential, discover neighborhoods that are situated near employers or employment centers that are adding jobs to their payrolls. Look for new or expanding office districts, factories, shopping centers, and distribution facilities. As these job sites fill up with employees, they will push up the prices and rents of nearby housing. When Sarasota Regional Medical Center underwent a major expansion, home prices in nearby neighborhoods jumped 40 percent within just a few years.

Taxes, Services, and Fiscal Solvency

As you ferret out neighborhoods, communities, and even countries in which to invest, check their property taxes, government services, political stability, and fiscal fitness. Does the area offer a high level of services and social programs? Are the public finances of the area well managed? Does the tax/benefit ratio for the community compare favorably with other areas? Consider all taxes and services. Do community governments provide residents relatively good value?

Co-ops, condos, and housing developments governed by homeowners' associations present another layer of inquiry. A homeowners' association functions as a government within a government. It issues rules and regulations, it provides services and recreational amenities, and it charges legally enforceable fees and assessments.

If you plan to buy into property development that is governed by a property owners' association, check out the association's "laws," services, fees, financial reserves, and fiscal solvency in the same way that you would check out a local government. Some property owners' associations have failed to put aside enough money to fund repairs and improvements. Owners will suffer costly assessments. (See my book, *Make Money with Condominiums and Townhouses,* John Wiley & Sons, 2003).

New Construction, Renovation, and Remodeling

Are neighborhood owners (especially those who have recently bought into the area) upgrading their properties? Are they painting exteriors, remodeling interiors, building additions, or installing amenities such as central heat and air, decks, patios, hot tubs, or skylights? Do you see

properties brought back to life after years of neglect? Do you see front yard dumpsters loaded with remodeling debris? Check with contractors, home improvement stores, and government building inspectors. Note trends in building permits for the area. Learn whether spending for property improvements is increasing.

Look for new construction of housing, office buildings, manufacturing plants, retail stores, or parks and recreational facilities. New construction not only creates jobs, but if properly integrated into an area, it increases the area's desirability. Note, too, the prices or rental rates of any housing that's newly built or under construction. Is the new housing more expensive than the existing homes and apartments? If so, these higher prices indicate that a neighborhood is moving upscale.

Watch carefully, though. Too much new housing can temporarily pull prices and rental rates down. Although everyone thinks Oil Belt property values fell in the 1980s because of the collapse in oil prices, that's only a small part of the story. In fact, *overbuilding* (especially apartments and condominiums) proved far more damaging. In Houston, during the early- to mid-1980s, developers brought more than 100,000 new multifamily units to market. Apartment vacancy rates ran close to 20 percent. Rent levels for new luxury two-bedroom apartments fell to less than $300 a month. Low rents for apartments pulled down the prices of condominiums and houses.

In response to such an excess of competition, lenders tightened financing for new subdivisions, condominiums, and apartments. During the 1990s, fewer new rental units were built than in any other 10-year period since the 1960s. The stage was set for the 2000–2006 property boom.

After 2002, construction took off into the stratosphere. Builders set new records for construction of housing units—especially in such hot spots as Miami, Phoenix, and Las Vegas. Even worse, much of this excess was sold to speculators and shaky credit buyers. Just as we have experienced multiple times in the past, a downturn was sure to follow such excesses. (And as in the past, recovery and growth will again send property prices up to new peaks within a decade or so.) Before you invest, check whether new housing in competing areas is renting (selling) without difficulty and that vacancy rates aren't flying up toward 10 percent or higher. (Your local planning and building permits agency keeps detailed records of past, present, and planned construction.) Smart investors position themselves to profit from a down cycle. When foreclosures and REOs pile up and new housing starts collapse, they grab the bargains.

Land-Use Laws

Land-use laws include zoning, building codes, health and safety rules, occupancy codes, rent controls, environmental protection, historical

preservation, architectural review boards, and many other laws, rules, and regulations. These laws may restrict growth and increase costs of development.

To forecast price gains for an area, learn community attitudes toward growth. Do current (or pending) land-use laws limit construction and drive up building costs? Is government restricting new supply? Is the amount of buildable land in short supply over the mid- to long run? While debates rage between pro-growth and no-growth forces, experience shows that in desirable areas where no- or slow-growth attitudes prevail, over time, rent levels and housing prices are pushed up. Compare the rate of increase in housing starts to the rate of growth in new households. A shortage of zoned, buildable land positions an area for above-average price gains—as long as the jobs, incomes, and desirability of the area increases.

Pride of Place

You're not buying the past, you're investing in the future. You and other property owners in an area can join together to improve the future of an area. Civic pride, community spirit, and community action can upgrade a neighborhood with a poor reputation into one that becomes "the place to be." Contrary to received opinion, you can change and improve the location of a property.

To evaluate price gain *potential,* assess the pride of place for neighborhood residents. Are they working individually and collectively to make their community a better place to call home? Are they cooperating with the people responsible for government services such as schools, libraries, police, street maintenance, parks and recreation, and public health? Are residents and public officials solving problems such as crime, graffiti, school quality, traffic congestion, or littered public areas?

Locate a neighborhood with genuine possibilities for improvement, and you locate a neighborhood with strong potential for price gains. When you, other property owners, and tenants work together, civic pride and community action can transform an ugly duckling to a peacock. (For dozens of examples, see *Fixing Broken Windows,* by George Kelling and Catherine Coles [Free Press, 1996].)

Sales and Rental Trends

Among the leading indicators of rising (or falling) property prices are sales trends and rental trends. As you move forward to a profitable career in real estate investing, create a system for tracking and recording trend data such as the number of "for sale" listings, new housing starts, sales prices, time on market, rent levels, and vacancy rates. Watch these trends.

You can detect market changes as they occur and sometimes score large short-term gains.

Sales Trends. As prices begin to increase in a neighborhood, time-on-market data will show increasingly faster sales. In slow markets, properties can sit unsold for months (180, 270, or 360 days, or longer). More positively, as average time on market falls from, say, 270 days to 180 days to 120 days, prices are about to go up. A decreasing inventory of "for sale" properties also points the way to rapid advances in property prices.

When the numbers of For Sale and For Rent signs dwindle, sellers soon raise their prices and rental rates. At the ebb of San Diego's major recession of the early 1990s, the local MLS included 18,000 homes for sale. By 2004, that number had fallen to 6,000. No wonder prices increased as "for sale" properties declined in number while jobs, population, households, income, and wealth continued to grow.

Rental Market Trends. Four major rental market trends include: (1) vacancy rates, (2) time on market, (3) annual rent increases (or rental concessions), and (4) rates of owner occupancy. Review the past 12 to 24 months. Are area vacancy rates falling or increasing? How long do vacant apartments or rental houses sit empty before they're rented? Visit a sampling of vacant units. Then follow up to learn their lease-up periods. What types of units rent the quickest? How do vacancy rates differ among various neighborhoods and communities? Do some types of buildings or units enjoy waiting lists? What are their features and locations?

Are rents steady or increasing? Or are property owners giving concessions like one or two months' free rent for a 12-month lease? Are homes in the area primarily owner occupied or tenant occupied? In which direction is the area trending? Look for areas where tenants are being squeezed out by homebuyers. Increasing numbers of homeowners usually signal higher property prices and higher rental rates for the relatively few rental units that remain.

Of course, every general principle gives rise to exceptions. For example, during the latest boom, houses in family-dominated neighborhoods close to the University of Florida jumped 50 to 100 percent in value within less than 5 years—even though renters were increasingly displacing homeowners.

Why? Investors had discovered that they could lease these houses out to groups of students and collect rents of $1,500 to $2,500 per month. Accordingly, they bid up prices. Out-of-town parents of students also entered the market. They would buy a house for a son or daughter—who would then bring in several other students as roommates and charge each one $400 to $600 per bedroom.

The lesson: Learn trends early. Track the data. Talk with those who live and work in the area. Act on inside information.

SUMMING UP

To discover properties that will gain from higher-than-average appreciation, thoroughly track market data. Monitor changes in selling prices, accessibility, pride of place, and community action. Property prices and rent levels gallop ahead or fall behind because buyers and tenants persistently shop neighborhoods and communities to discover the best *values*—not necessarily the best features or lowest prices per se. When you locate relatively undervalued, undiscovered, and underappreciated areas, price increases will surely follow.

5

HOW TO FIND BARGAIN-PRICED PROPERTIES

When stockbrokers and financial planners compare the profit potential of property to stocks, they err in many ways. They ignore leverage; they omit cash flows from rents; they fail to understand the gains achieved through entrepreneurial research and talent. And they miss the fact that (unlike with stocks) you can buy property at a price less than its current market value.

If Wal-Mart stock sells for $20 per share, you will pay $20 per share. No one will sell for less. The same principle applies for every stock from Apple to Xerox.

In contrast, if you want to pay $200,000 to $225,000 for a property that's valued at $250,000, you can find sellers who will oblige. In fact, one popular axiom of real estate goes like this, "In real estate, you not only make money when you sell, you can make money when you buy." Although you do not really "make money" when you pay less than market value, you do fast track your profit potential.

WHY PROPERTIES SELL FOR LESS (OR MORE) THAN MARKET VALUE

Recall from Chapter 3 that a *market value* sale specifies these five criteria:

1. Buyers and sellers are typically motivated. Neither acts under duress.
2. Buyers and sellers are well informed and knowledgeable about the property and the market.

3. The marketing period and sales promotion efforts are sufficient to reasonably inform potential buyers of the property's availability (i.e., no forced or rushed sales).
4. No unusual terms of purchase (e.g., low-down seller financing, all cash, below-market interest rate) apply.
5. No unusual concessions are made by either the seller or the buyer (e.g., sellers are not permitted to stay in the house rent free for three to six months until their under-construction new house is completed, buyers' offer contingent upon the sale of their current residence).

Owners who sell in a hurry may have to accept a price lower than market value. Likewise, a FSBO (someone who sells "for sale by owner") who doesn't know how to market and promote a property will not likely receive top dollar. Or say the sellers live out of town. They don't realize that recent sales prices have jumped up, or maybe they don't realize that their property (or the neighborhood) is ripe for profitable improvement.

Owners in Distress

As news stories so vividly report, every day people hit hard times. They lose their jobs, file for divorce, suffer accidents or illness, experience setbacks in their business, fall behind on their car loans, credit cards, and mortgage payments, and get hit by a freight train of other problems. Any or all these calamities can create financial distress. For many of these property owners, their only way out of a jam is to raise cash by selling their property fast at a bargain price.

Some investors find it distasteful to prey on the down-and-out. Yet owners who find themselves in financial distress long to get rid of their sleepless, toss-and-turn nights. If that means selling their property for "less than it's worth," then that's what they're willing to do. These people do not just sell a property; they buy relief.

Under such circumstances, when the sellers believe they have gained more from a sale than they've lost, both parties win. If you want to help people cope with adversity—as opposed to fleecing them—seek out distressed owners who will give you the bargain price (or favorable terms) you want.

The "Grass-Is-Greener" Sellers

One day Karla Lopez is sitting in her office, and in walks the executive vice president of her firm. "Karla," she says, "Aaron Stein in the Denver

branch just quit. If you want his district manager's job, you can have it. We will pay you $40,000 more a year plus bonus. But you have to be relocated and on the job within thirty days."

"Do I want it?" Karla says. "Of course I want it. A promotion like this is why I've been working seventy-hour weeks for these past four years."

Think about it. In this situation, does Karla think, "Well, the first thing I must do is put my house up for sale and go for top dollar?" Hardly. More than likely, Karla wants to strike a deal with the first buyer who gives her any type of offer she can live with. Karla has her sights set on the greener grass of Denver. Optimistic about her career and facing a time deadline, Karla wants to get her home sold as quickly as possible.

Grass-is-greener sellers stand opposite to the financially distressed. Whereas distressed owners sell on bargain terms or price to relieve themselves of pain, grass-is-greener sellers will accept an offer of less than market value so they can quickly grab better opportunities that lie elsewhere.

On one occasion when I was a grass-is-greener seller, I not only gave my buyers a slight break on price, but more importantly from their perspective, I let them assume my below-market interest rate first mortgage and carried back an unsecured note for the amount of the difference between the price they paid and the outstanding balance on the mortgage they assumed (i.e., they bought with nothing down and below-market terms). On various occasions, I've bought from sellers who were eager to pursue better opportunities elsewhere. Each time, I negotiated a good (if not great) price and favorable financing.

If looking for distressed owners doesn't appeal to you, turn your search in the opposite direction. Sellers who want to move to greener pastures (especially under a deadline of time) are frequently the easiest people to work with and the most accommodating in price and terms.

Stage-of-Life Sellers

When shopping for below-market price deals, find bargains among stage-of-life sellers. These sellers include owners whose lifestyle now conflicts with their property. They may no longer enjoy a big house or yard, collecting rent, or dealing with tenant complaints. They eagerly anticipate their move to that condo on the 14th green at the Bayshore Country Club. Or perhaps they would rather not go through the trouble of updating and repairing their current property. Whatever their reasons, stage-of-life sellers are motivated to get on with their lives.

In addition—and this fact makes these sellers good prospects for a bargain price or terms—stage-of-life sellers have typically accumulated

large amounts of equity in their properties. And because they're older, they may have substantial sums in savings or other investments. Stage-of-life sellers are open to offers. They don't need to squeeze every last penny out of their sale—or pocket all cash from the deal. Because stage-of-life sellers often do not face a pressing need for cash, they make excellent candidates for OWC (owner will carry) financing. Not only will OWC terms help them sell their property more quickly, but an installment sale reduces or defers the capital gain taxes that a cash sale might otherwise trigger (if the property does not qualify for the principal residence tax exclusion benefit; see Chapter 14). As another advantage, OWC financing—even when offered at below-market interest rates—will often net the sellers a higher cash income return than they could earn in a savings account, certificate of deposit, bonds, money market fund, or stocks.

Case in point: As a college student who wanted to invest in real estate, I sought stage-of-life owners of rental properties. These people were tired of managing their properties. Yet, they valued a monthly income and (most) didn't want to settle for the meager interest paid by banks or the low-income yield and big risks of stocks. They also didn't want to sell their investment properties and get hit with a tax bill for capital gains.

Their solution: Sell on easy OWC terms to an ambitious young college student who was willing to accept the work of rental properties in exchange for an opportunity to start building wealth through investment real estate. This opportunity remains today. Because properly selected, well-managed rentals will pay for themselves, if you are willing to work, you can substitute ambition and perseverance for a large down payment and high earnings.

Seller Ignorance

Some sellers underprice their properties because they don't know the recent prices at which similar properties have been selling. Or they do not know of a unique advantage that favorably distinguishes their property from others. I confess that as a seller, I have made the mistake of selling too low because I was ignorant of the market.

Some years ago, I lived in Palo Alto, California. The rental house I decided to sell was located across the country. A year earlier, this house had appraised for $110,000, which at the time of the appraisal was about right. So I decided to ask $125,000. I figured that price fair and still left some room to negotiate.

The first weekend the house went on the market, three offers came in at my asking price of $125,000. Immediately, I knew I had underpriced. What I had not known but soon learned was that during the year I'd been

away, property prices in that neighborhood had jumped 30 percent. After learning of my ignorance, I could have rejected all the offers and raised my price. Or I could have put the buyers into a bidding war. But I didn't.

I decided to sell to the person with the cleanest offer (no contingencies). I was making a good profit; why get greedy? In addition, at that time I was teaching at Stanford University, writing a book, and consulting for Wells Fargo Bank. In other words, I did not want to give this property sale much attention. So, in part, my grass-is-greener-in-California attitude also contributed to my desire to go for the quick dollar rather than top dollar.

Sellers sometimes mistakenly and sometimes intentionally underprice their properties. Stay on the lookout for this possibility. When you spot a good deal, jump on it. Underpriced properties often get snapped up quickly.

Although good deals go fast, not all bargain-priced properties represent good deals. You receive a good deal only if you can sell the property for substantially more than you have put into it. Watch out for long-term declining markets where a seemingly low price today morphs into an even lower price tomorrow. Also, accurately calculate fix-up expenses, hidden defects, and environmental problems (e.g., lead paint, underground oil storage tanks, asbestos, contaminated well water). Ration your cash. Keep your improvements in line with the rent levels your prospective tenants are willing and able to pay.

Temper your eagerness to buy a bargain-priced property with a thorough physical, financial, market, and legal analysis. Go slowly for low- or nothing-down seller financing. Delay the temptation to jump without looking. First put on your Sherlock Holmes hat. Act quickly—with caution. The less you know about a property and the more you assume, the greater your risk. Balance eagerness to buy with an explicit and realistic view of potential pitfalls. *Prepare* to buy before you buy.

PREPARE SCREENING CRITERIA

Select properties to bid on in an area. Even if you could, you would not buy every property (bargain-priced or not) that strikes your attention. Before you move to the "buy" stage, narrow your choices:

What neighborhoods look promising?

Do you want a single-family house, condominium, co-op, town house, or multi-unit rental property? If multi-units, how large a property will you accept?

Would you prefer to occupy and invest simultaneously? If owner occupancy is important, how does this fact limit your choice of neighborhoods and properties?

How much repair, renovation, or remodeling work are you willing and able to take on?

What types of improvements will you try? Structural? Cosmetic? Environmental? Fire damaged? Earthquake damaged? Other?

Which is most important: a bargain price or bargain terms? Would you buy a property with negative cash flows? If no, what is your minimum cash-on-cash return on investment?

Would you accept a property occupied by problem tenants?

How much risk will you tolerate? When buying fixer-uppers, your repairs and renovation costs may exceed your estimates. If you buy into a turnaround neighborhood, the turnaround may take longer than you expect.

How much cash or borrowing power can you draw on to carry you through a period of impaired rent collections (vacancies, bad tenants)?

What's the minimum time period you would accept on a balloon mortgage or other short-term financing?

How long do you plan to own the property? When all costs are considered, will the property command a selling price or rent level high enough to meet your profit objectives?

What are your profit objectives? What sources of return seem possible with this property?

Focus on properties that match your requirements. Eliminate the wild-goose chases that steal the time of many beginning real estate investors. Clarify goals and circumstances. Resist the temptation to grab a deal just because it is a deal. Go after those properties that suit your abilities, finances, and inclinations.

BARGAIN SELLERS

Now that you have developed your screening criteria, how do you start finding potential sellers?

Networking/Get the word out
Newspapers and other publications
Cold call owners
Agent services
Internet listings

Networking/Get the Word Out

Some time back, I was leaving the United States for several years and decided to sell my house with a minimum of hassle. Coincidentally, the Ph.D. student club at the university where I was teaching was looking for a faculty member to host the upcoming faculty-student party. "Aha," I thought—what better way to expose my house to more than 100 people? So I volunteered. In the week following the party, I received two good offers and accepted the best.

The buyers received a good price and excellent financing. I avoided the hassle of putting the property on the market and did not pay a sales agent. Win-win for buyers and seller.

Draw on the power of networks. Yet, few buyers and sellers consciously try to discover each other through informal contacts among friends, family, relatives, coworkers, church groups, clubs, business associates, customers, parent-teacher groups, and other types of acquaintances. Make your search common knowledge. Tell everyone you know. Describe what you're looking for.

Why search alone when you can enlist dozens of others to help you? Nearly all property owners prefer a quick direct sale—even at a lower than market price. Like me, they prefer to bypass the hassles and costs of listing and selling through a realty firm.

In addition, network searches often awaken sleeping sellers—owners who are open to offer, but for various reasons are not yet marketing their property(ies). Indeed, right now I am a sleeping seller on a property located in North Carolina.

Newspapers and Other Publications

Some investors browse the real estate classified display and ads with a highlighter, then call owners or Realtors, obtain cursory information, and when a property sounds promising, set up an appointment to view it. This method might work, but it can fail for two reasons: (1) If a property isn't advertised, you won't learn about it; and (2) you may pass by ineffectively written ads—even though the property itself might actually deserve your attention.

The solution: Run your own advertisement in the real estate "wanted to buy" column. Describe the type of property and terms that you seek. You will invite serious sellers to contact you. When I began investing, I used this technique to locate about 30 percent of the properties I bought.

As another way to use the newspaper, read the "houses for rent," "condos for rent," and "apartments for rent" ads. This research helps you

gauge rent levels. You will also see properties advertised as "lease-option" or "for rent or sale." These kinds of ads generally indicate a flexible and motivated seller.

When you search for bargain sellers, look beyond the real estate classified ads. Identify potential sellers from the public notices: births, divorces, retirements, deaths, bankruptcy, foreclosure, or marriage. Each of these events can trigger the need to sell real estate. If you contact these potential sellers before they list with a sales agent, you stand a fair chance of buying at a bargain price. (In addition, subscribe to your area's "default" or "foreclosure" newsletters published in print or via the Internet. Chapter 6 tells you how to profit from foreclosures.)

Cold Call Owners

To cold call productively, adopt the Realtor technique and cultivate a neighborhood farm. Many top-selling realty agents select a neighborhood (or other geographic area) and cultivate relationships to find sellers who will list their properties for sale with that agent. Agents telephone property owners from names listed in a crisscross directory, walk the neighborhood, talk with residents, circulate flyers by mail or door-knob hangers, and participate in neighborhood or community-sponsored events. By cultivating a neighborhood farm, an agent becomes known in the area. He positions himself as the first person property owners think of when they decide to sell their house.

You can beat the agent at his own game. Cultivate your own neighborhood (or community) farm. Among residents and businesses, circulate a flyer that reads:

> Before you list your property for sale, please call me. I plan to buy a property in this neighborhood directly from the owners. Let's see if we can sit down together and work out an agreement that will benefit both of us.

When property owners learn how they can save time, effort, and money selling direct, they may offer you a favorable price or terms. Also, if you get to them before they talk with an agent, they may even quote you a below-market price because they lack reliable market comp data. (Of course, uninformed sellers may also quote you an above-market price—especially if comparable prices are below their previous peaks.)

Vacant Houses and Out-of-the-Area Owners. Your farm area will include some properties (vacant or tenant occupied) that are owned by

people who do not live in the neighborhood. These owners may not see your flyers, nor will you find them listed in a crisscross directory. To reach these potential sellers, ask neighbors and talk with the tenants who live in the property.

If this research doesn't reveal the owners' names and addresses, contact the tax assessor's office. There you can learn where and to whom the property tax statements are mailed. It's not unusual to find that out-of-the-area property owners are actually "sleeping sellers" (as I am with my North Carolina property). They will sell but haven't as yet awoken to the idea. You can become their alarm clock.

Broker Listings. For any number of reasons, properties listed with real estate agents do not sell during their original listing period. When this failure occurs, the listing agent will try to persuade the owners to relist with his or her firm. And quite likely, agents from other brokerage firms also will approach the sellers. Here's what you can do to cut them off at the pass and perhaps arrange a bargain purchase.

When you notice a listed property that looks as if it might fit your requirements, do *not* call the agent. Do *not* call or stop by to talk to the owners. Instead, write the owners a letter stating the price and terms that you would consider paying. Then ask the owners to contact you *after* their listing has expired. (If a seller goes behind his agent's back and arranges a sale while the property is listed, the owner is still legally obligated to pay the sales commission.)

Consider this possibility: You find a property listed at its market value of $200,000. The listing contract sets a 6 percent sales commission. The sellers have told themselves that they will accept nothing less than $192,500, meaning that after paying the expenses of sale they would net around $180,000. You offer $175,000. Would the sellers accept it? Or would they relist, postpone their move, and hold out for another $5,000 to $10,000?

They just might accept your offer. It depends on their finances, their reason for moving, and any pressures they may face. But you can see that even though your offer is low relative to the market value of the house, it still provides the sellers almost as much as they could expect to net if their agent found them a buyer. (Naturally, your letter would not formally commit you to purchase the property. It would merely state the price and terms that you have in mind.) Also, when you make such offers, emphasize the relative amounts the seller will net—not price per se.

Although agents can provide you services, if you want to buy at a bargain price or buy on bargain terms (especially with low- or no-down-payment seller financing), where is the agent's fee going to come from? To negotiate a bargain price, at times, forego an agent's services and do your own legwork.

Agent Services

As to agent services, investor and renovator Suzanne Brangham wants to rely on them. In her book, *Housewise* (HarperCollins, 1987, p. 163), Suzanne exclaims:

> You need realty agents as much as they need you. After you have narrowed your choice to one or two neighborhoods or towns, enlist the aid of an expert. Your real estate agent will guide you so that you can sit back, take out your notebook, ask questions, and learn. . . . Good agents know what prices properties are selling for, which areas are strong, and which neighborhoods are getting hot. . . .
>
> If you let your agent know that you plan to buy and sell several properties over the next few years, he (or she) will do everything short of breaking and entering to show you the properties that are available. . . . I'd been lusting after a beautiful two-unit building, but it had never been up for sale. My agent called me the minute it was listed and I bought it in less than an hour. In fact, I soon became notorious for signing offer forms on the roof of my agent's car. When there's a race to get in your bid on a particularly juicy piece of property, a faithful agent who knows exactly what you want can make all the difference.

Although my experience with agents does not reach the gushing praise that Suzanne extols, a skilled agent can assist you with at least eight helpful tasks:

- Suggest sources and techniques of financing and help you run through the numbers.
- Research comp sales and rent levels so that you can better understand values.
- Act as an intermediary in negotiations.
- Recommend other professionals whose services you may need (lawyer, mortgage broker, contractor, designer, architect, property inspector).
- Handle innumerable details and problems that always seem to pop up on the way from contract to closing.
- Clue you in about what type of interest and market activity has developed around various properties.
- Give you an insider's glimpse into an area to let you know who's doing what and where.
- Disclose negatives about a property or neighborhood that might otherwise have escaped your attention.

Agents will sort through your neighborhood and property trade-offs, suggest possibilities for value-creating improvements, and try to persuade sellers to accept your price and terms. The best agents, as Brangham points out, "[are] those who listen when you explain what you are looking for. They will take you directly to the buried treasure you want to find."

Civil Rights Caveat. Real estate agents (like everyone else) must constantly guard what they say out of fear of lawsuits alleging discrimination. If you ask, "What's the quality of the schools in this neighborhood?" the agent may hedge an answer if, say, at one time school busing or racial strife spurred exodus to suburbia, and correspondingly, student achievement test scores fail to meet acceptable levels.

Likewise, if the ethnic, religious, or racial composition of a neighborhood affects property values (either up or down), a sales agent would not mention this fact. The U.S. Department of Justice (DOJ) and the U.S. Department of Housing and Urban Development (HUD) have decreed that neither ethnic, religious, nor racial demographics affect property values.

Real estate agents (or property appraisers) who disagree with HUD or the DOJ can find themselves liable for civil and/or criminal penalties—including monetary damages, fines, and even prison. When your inquiries clash with fair housing mandates, do not expect straight talk from your realty agent.

Property Condition Caveat. In addition to fair housing issues, most agents tread lightly in response to questions about the condition of a property. "How's the roof?" you ask. The agent answers, "As far as I know, it's eight years old and hasn't had any leaks." You buy the property, and three months later the roof begins to leak. On the basis of the agent's statement, you sue the brokerage firm for misrepresentation and fraud. Even though the agent told the truth as far as he or she knew it, many judges or juries would find the agent liable.

Buyers have sued agents so many times for giving "to the best of my knowledge" answers concerning property condition that smart agents avoid such questions. They prefer to refer you to appropriate property specialists and inspectors. In one major precedent-setting case in California, a realty agent was held liable for not informing his buyers that a property was located in a mud slide area—even though the agent did not know that the area was risky. In response to this case, the California Association of Realtors convinced the California legislature to enact a *seller disclosure* law. Most other states have followed California's lead.

To buy at a (true) bargain price, rely on accurate information about neighborhoods and properties. A top real estate agent will provide you with some of these data, but not all that you need. Recognize the practical and legal limits that restrain even the most knowledgeable agents.

Buyer Loyalty. For every real buyer they work with, most agents encounter a dozen pretenders—wannabe investors who steal an agent's time and knowledge but feel no obligation to buy from that agent. Or if they do buy, the first thing they do to make a deal work is to try to cut the agent's commission. Such an approach does not build a relationship. To gain the benefits Suzanne Brangham celebrates, demonstrate buyer loyalty.

Show loyalty to your agents, and in turn, they will favor you as a client who gives them repeat business (as well as referrals). In return, they provide top service and include you among the first to learn of those "juicy deals" as soon as they hit the market—and sometimes even before a listing goes into the MLS (Multiple Listing Service).

Internet Listings

Property investors not only cruise neighborhoods, they cruise the Internet to look for properties. Thousands of web sites now list properties for sale. Property buyers (or browsers) can directly access the Realtors' Multiple Listing Service (MLS) at www.realtor.com.

A huge entrepreneurial industry of content providers publish specialized listings of everything from foreclosures to commercial properties to FSBOs. Online, you can locate investors looking for money—or money looking for properties. Nearly all real estate information that in the past has been available from Realtors—government records, newspaper ads, newsletters, and other sources—is now (or will soon be) accessible. Electronic shopping for real estate (and mortgages) has rendered the MLS book as obsolete as a slide rule. In addition to the web sites referenced in this book, search engines can guide you to a cornucopia of useful data and topical discussions.

SELLER DISCLOSURES

What you see is not all that you get. That below-market price won't seem like such a great deal once you learn the roof leaks, the foundation is cracking, and termites are munching on floor joists for their dinner. Moreover, if the next-door neighbors make Animal House look tame, quality tenants will not rent your property—or if they do move in, they will not stay.

Prepare against such unwanted surprises. Thoroughly inspect the property, talk to existing tenants, walk the neighborhood, and avail yourself of knowledgeable and trustworthy real estate agents. Get the property checked out by a property inspector, a structural engineer, a pest control expert, or other specialists who accurately assess the condition of

the property. And last but not least, ask the sellers to complete a seller disclosure statement.

The Disclosure Revolution

More than 40 states now require (or encourage) sellers to complete a seller disclosure statement that lists and explains all *known* problems or defects that may plague a property. But even if your state doesn't yet mandate seller disclosure, obtain a disclosure form (most realty firms keep blank copies on hand) and ask the sellers to fill it out. (Or google "seller disclosure statements." Your hits will include blank forms from multiple states.)

As you review a seller-completed disclosure statement, watch for these five issues:

1. Sellers cannot disclose facts or conditions of which they are unaware. Disclosures do not substitute for inspections.
2. Disclosures reveal the known past. They make no guarantees. Sellers do not warrant the present or future condition of the property. They report only what they know.
3. Disclosure questions permit subjective answers. Are playing children a neighborhood "noise" problem? Is a planned street widening an "adverse" condition?
4. Disclosure statements may not require sellers to disclose property defects that you can readily see. Keep your eyes attentive.
5. Beware of seller (or agent) statements that begin, "I believe," "I think," "as far as we know," and other similar hedges. Do not accept these answers as the final word. Follow up hedged statements or assertions with definitive inquiry or inspection.

Seller disclosures help you accurately understand and value properties. But even so, give them only as much weight as they deserve. Independently check out the property to verify that you know what the property is worth more than the price you are agreeing to pay.

Income Properties

Some seller disclosure laws apply only to one- to four-family owner-occupied properties. If you buy an apartment building or shopping center, the law may not require the seller to fill out a disclosure statement. If, in this situation, the seller refuses, offset this additional risk by scaling down the price you offer—and enhance the rigor of your pre-purchase inspections.

Verify rental income and operating expenses. Ask the sellers to sign a statement whereby they swear that the income and expense figures that they have reported to you are true and factual. Some owners place friends, relatives, and employees into their buildings at inflated rent levels. These tenants do not pay the rents shown in the lease (or if they do, they get kickbacks in cash or other benefits), but their signed leases sure look attractive to unsuspecting buyers.

SUMMARY

To find owners who will sell at a below-market price is like panning for gold. Even when you know a stream is loaded with potential, you will probably sift through a ton of muck and rock before you discover the nuggets that yield the profits. When searching for below-market deals, expect to work. As you gain experience and reputation, deals will start coming to you. But as stock speculator Gordon Gekko (Michael Douglas) tells Bud Fox (Charlie Sheen) in the movie *Wall Street*, "Kid, I look at 100 deals a day. I may choose one." Prepare yourself.

Among the properties that sellers (or agents) promote as bargains, many turn out otherwise. Through skillful negotiation and financial structuring, you can sometimes transform an apparently mediocre deal into a winner. Except in cases of luck, putting gold nuggets into your pocket will require intelligence, knowledge, and possibility thinking. But like the industrious and fortuitous miner who pans for gold, those bargain-priced properties you do find will generously reward you for your diligence.

6

PROFIT WITH FORECLOSURES

For the past several years, the news media have given the topic of foreclosures more pages of coverage than at any time since the early 1930s. In the beginning of this current financial downturn, journalists positioned their foreclosure stories in terms of human hardship. "Greedy bankers ruin lives."

More recently, stories highlight the extraordinary (one could almost say "chance of a lifetime") opportunities that many of today's property markets offer (especially foreclosures/REOs).

But as with all property investing, foreclosures present pitfalls as well as potential. Do not fall for the "easy money" media stories or the inflated "pennies on the dollar" claims of the foreclosure gurus.

To profit big with foreclosures—and at the same time steer clear of big risks—requires you to gain knowledge of the foreclosure process, market research, valuation, reliable "cost to cure" estimates, and the power of persuasion. Develop your talents within each of these skills and today's market will present you with more good possibilities than any market I have experienced throughout my career. The low risk/high reward foreclosure opportunities are best captured by investors who prepare.

THE FORECLOSURE PROCESS

Borrowers default because they fail to make their mortgage payments. But defaults also occur when owners fail to pay their property taxes; fail to pay some related obligation (homeowners' association fees, a superior mortgage claim, special assessments); transfer a mortgaged property without lender approval; or undertake renovations, remodeling, or demolition that diminish the value of the property.

Lender Tries to Resolve Problem

In contrast to the late 1980s and early 1990s, most lenders today give delinquent borrowers generous opportunity to restructure, reinstate, or refinance their mortgages. That's why even though the number of mortgages in default is now approaching six million, the number of properties actually sold at foreclosure auctions comes in below two million. With more loan workouts, a smaller percentage of troubled borrowers lose their properties via a foreclosure sale. Nevertheless, mortgage lenders (or guarantors) will get the keys to more than one million properties this year. And the number of borrowers who have fallen behind in their payments (and thus are in need of a workout) now exceeds 4 million. Given these huge numbers, the foreclosure business (preforeclosure workouts including short sales, government foreclosures, and postforeclosure REOs) provides a cornucopia of profit potential.

Filing Legal Notice

When a lender finally gives up on a preforeclosure workout, its lawyers file either a legal "notice of default" or a "lawsuit to foreclose" (depending on the state). This legal filing and its subsequent posting of notice on the Internet or in newspapers formally announce to (1) the property owners, (2) any other parties who may have legal claims against the owners or their property, and (3) the public in general, that legal action is moving forward to force a "courthouse" sale of the property.

At least one month passes between the date of legal filing and the foreclosure sale. More typically, this waiting period ranges between 60 and 180 days. If the property owners file a legal defense to the lender's foreclosure action (e.g., lender violated due process, fraud, consumer rights, truth in lending), the foreclosure sale may have to wait for a lender victory in settlement or trial. These kinds of litigation battles can drag on for a year, two years, or even longer. The sheer volume of defaults today is also extending the period between the date of the original default and the actual day of the foreclosure sale. Lenders and mortgage servicing companies lack the personnel necessary to steer a defaulting borrower into foreclosure (or workout) in a timely manner. In addition, to halt the foreclosure sale for *at least* a month or two longer, defaulting property owners sometimes file for bankruptcy. Bankruptcy filing by the property owners immediately and automatically stays a foreclosure action. To proceed further in its efforts to force a sale, the lender petitions the bankruptcy court. Only after the court grants permission will the foreclosure process start running again. (In fact, in some situations, a bankruptcy court can annul a foreclosure sale that has already occurred.)

The Foreclosure Sale

Eventually, when defaulting property owners run out of legal defenses or delaying tactics, the foreclosure sale date arrives. At this point, the property is auctioned to the highest cash bidder. Sometimes a real estate investor (foreclosure specialist), speculator, or even a homebuyer submits the winning bid. More likely, the lender who has forced the foreclosure sale bids, say, one dollar more than the amount of its unpaid claims (mortgage balance, late fees, accrued interest, attorney fees, foreclosure costs) and walks away with a sheriff's deed to the property. Next, the lender eventually sells the property directly through a real estate brokerage firm, or in troubled times like these through some type of auction sale where dozens—or even hundreds—of REO properties meet the rap of the auctioneer's gavel.

REOs

Remember these words: LENDERS DO NOT WANT TO OWN FORECLOSED REAL ESTATE. For a lender (or institutions such as the Federal Housing Administration [FHA], Department of Veterans Affairs [VA], Fannie Mae, Freddie Mac), holding onto an REO that has been acquired through foreclosure rarely seems like a good idea. No matter how much potential the property offers, owners of REOs want to sell quickly. Lenders expect to lose money on their sales of REOs—but they would lose even more by holding onto these properties. Lenders find themselves quite ill-suited to operate as property management companies.

Therefore, to profit with foreclosures, pursue one or more of these three approaches:

1. Negotiate with the distressed property owners and, if necessary, the foreclosing lender (i.e., to obtain a short sale or refinance).
2. Bid at the foreclosure auction.
3. Buy an REO from the lender or the "insuring" agency (FHA, VA, Fannie Mae, Freddie Mac) that owns the property. (This topic is covered in Chapter 7.)

BUY PREFORECLOSURES FROM DISTRESSED OWNERS

Each year in every community, hundreds (sometimes thousands) of property owners hit the financial skids. Divorce, job loss, accident, illness, business failure, payment shock (ARMs), and other setbacks render people unable to make their mortgage payments. Rather than effectively deal with their problems as soon as default is imminent, most owners hang on

too long, hoping for a miracle to bail them out. Since miracles are rare, most of these people end up staring foreclosure in the face.

At that point, you may be able to help them salvage their credit record and part of their home equity and at the same time secure a bargain for yourself. Faced with pressures of time and money, distressed property owners accept a quick, credit-rescuing sale at a price less than market value.

Approach Owners with Empathy

No one can give you a magic system to buy property from people who face foreclosure. These owners must contend with financial troubles, personal anguish, and indecisiveness brought on by emotional depression. They have probably been attacked by foreclosure sharks, speculators, bank lawyers, and recent attendees of get-rich-quick foreclosure seminars. These owners live with the public shame of failure. For all these reasons and more, they are not easy people to deal with.

To succeed, develop a sensitive, empathetic, problem-solving approach. Think cooperation. Think win-win. You gain a bargain price. The sellers will shed their burdens and limit their potential losses. To find and persuade sellers, you compete against foreclosure specialists. A "Here's my offer—take it or leave it" approach antagonizes the owners. It does not favorably distinguish you from a dozen other potential buyers (sharks). Design your negotiations and offer to preserve what little may be left of the owner's dignity and self-esteem. Share personal information about setbacks you have lived through. Emphasize win-win outcomes. Dire straits or not, no one wants his or her home (property) stolen away.

The Difficulties of Dealing Profitably with Owners in Default

Some "get rich in foreclosures" seminars, CDs, and books exaggerate the possibilities of profiting from property owners who face foreclosure. The enticing scenarios imagined by these promoters place you in the picture with high-equity sellers who hold a nonqualifying assumable mortgage. You offer the sellers a few thousand dollars in cash and agree to make up their past-due mortgage payments. The sellers deed you their property and move out. You then put a tenant in the property, collect rents, and pay the property expenses and scheduled mortgage payments. Or, alternatively, you fix up the property, put it on the market, and sell for a fat profit. Regardless of which strategy you choose, buying foreclosures can make you wealthy fast—at least that's the pitch of the foreclosure gurus.

Admittedly, such easy pickings are great when you can find them. As you might expect, though, deals rarely move forward with step-by-step simplicity. When you talk with property owners in foreclosure, you

uncover a minefield of problems that you must crisscross with skill and creativity. Here are some of the issues you will need to deal with.

Mortgage Debt Exceeds Market Value. Property owners who contend with foreclosure often owe more than their properties are worth. To make a deal work, you must talk the lender into a "short sale"; that is, the lender voluntarily reduces the balance due on its loan so that you receive a "fair" profit for agreeing to make up past-due payments and take over the loan.

Today, increasing numbers of lenders do accept short sale investors, but you must thoroughly prepare your short sale package. Then you wait, suffer runarounds, and sometimes lose the deal to a higher bidder.

Nonquals Are Tough to Find. Few mortgages today automatically permit assumptions. Finding a homeowner in foreclosure who actually has a nonqualifying assumable is like finding the proverbial needle in a haystack.

Qualifying Assumptions Are Limited. Today's FHA and VA mortgages do permit assumptions, but only by credit-qualifying owner-occupants. If your credit or income is shaky, or if you plan to "flip" the property without taking occupancy or hold the property as a rental, neither FHA nor VA will let you assume an existing mortgage.

Multiple Creditors, Multiple Title Problems. Property owners who suffer foreclosure often get hit by claims of other creditors. Check to see if one or more of these creditors has filed a *lis pendens*, a tax lien (Internal Revenue Service or other taxing authority), or has secured a judgment against the homeowners. To clear title, you may have to clean up and settle with several creditors—not just one mortgage lender.

Workout with Credit Counselors. Most lenders today (especially FHA, VA, Fannie Mae) encourage financially troubled property owners to seek credit counseling and loan workout with nonprofit agencies such as CCCA (Credit Counseling Centers of America). Neither the homeowners nor the lenders may need a profit-minded workout specialist. The new "foreclosure rescue" program that Congress enacted will also compete to a degree with profit-motive investors.

Save Equity through Bankruptcy. In many states, homeowners can file bankruptcy and save all or part of their home equity. Fifteen or 20 years ago, only the most bold or financially ruined Americans pursued bankruptcy. Now, bankruptcy serves as just another tool of financial planning. Approximately 1.5 million couples and individuals elect to file for bankruptcy each year.

When someone can get rid of all those credit card balances and unpaid medical bills—and at the same time save their most valuable asset (their home equity)—why let a foreclosure investor come through the door?

Note: In 2005, Congress passed a revised bankruptcy law that intends to make debtors pay back more of the money they owe as well as to tighten the bankruptcy homestead exemption. Because bankruptcy combines both state and federal law, talk with an attorney in your area. My guess is that this tightening of bankruptcy law will increase your opportunities for profitable preforeclosure workouts.

Bankruptcy Doesn't Ruin Credit. The threat of "ruined" credit doesn't instill the same fear in Americans today that it did two decades ago. In fact, it's not easy to actually *ruin* your credit. After a bankruptcy discharge, people with steady jobs can shortly thereafter obtain credit cards (albeit secured), car loans, and home loans (e.g., lease option, seller financing). After bankruptcy, with two years of clean credit, FHA, VA, and sometimes even Fannie Mae/Freddie Mac lenders will approve reestablished borrowers. The somewhat easy credit-rebuilding techniques reduce the probability that you can persuade homeowners to transfer a large chunk of their home equity to you so that they can "save their credit." (In decades past, a bankruptcy or foreclosure would turn a debtor into a credit leper—no longer does this shunning occur.)

Estimate Repair and Renovation Costs. Before you finalize a preforeclosure purchase with a property owner, thoroughly inspect the property and accurately estimate the costs of necessary repairs, renovations, and perhaps environmental cleanup. In their enthusiasm to do a foreclosure deal, unsuspecting buyers gloss over the inspection and make only an eyeball guesstimate of expected costs. Much to their dismay, they soon learn that slick foreclosure sellers can put one over on unsophisticated buyers, just as slick foreclosure sharks may at times take advantage of distressed property owners.

PREQUALIFY HOMEOWNERS AND PROPERTIES

By warning you of some potentially difficult preforeclosure issues, I do not intend to discourage you. Rather, I want to educate you. Investors who close their minds to facts rarely earn long-term (or even short-term) profits. You *can* gain outstanding rewards through foreclosures—but only if you prequalify the homeowners and the property. Before moving forward toward a workout, evaluate your possibilities and probabilities. Answer these eight questions:

1. What amount of equity have the owners built up in their property?
2. If necessary, will the lender cooperate in a short sale?

3. Will the lender permit you to assume the mortgage? As an investor? As an owner-occupant? At what interest rate? If no assumption, will the lender waive the mortgage prepayment penalty (if any)?
4. Can you satisfy yourself, through a title check or title insurance, that the sellers can convey a marketable title, that is, a title free of consequential clouds (actual and potential)?
5. Will the homeowners work to avoid bankruptcy or foreclosure to alleviate their financial distress? (When sellers refuse to cooperate—as they sometimes do—your chance to succeed drops close to zero.)
6. Would the property owners lose more economically in a bankruptcy than they would stand to gain? (As noted, bankrupts may emerge from bankruptcy with their unsecured debts extinguished and their most valuable assets [IRA, 401(k), home equity, life insurance cash value, furniture, clothing, car] preserved.)
7. Can you *firmly* establish how much you must spend to repair, redecorate, and renovate the property?
8. Is the potential profit margin large enough to justify your investment of time, money, effort, and opportunity cost (i.e., the profits of other deals you pass up to invest in this one)? Complete the following revenue and cost schedule to evaluate risk and profit potential:

Sales price after improvement	$_____
Less	
Acquisition price (cash, notes, assumed mortgages)	$_____
Mortgage assumption fee	$_____
Legal fees	$_____
Back property taxes and assessments	$_____
Back payments and late fees	$_____
Closing costs	$_____
Cost of improvements	$_____
Holding costs until sold or rented	$_____
Miscellaneous	$_____
Time and effort (imputed value)	$_____
Opportunity costs (imputed value)	$_____
Equals	
Profit potential	$_____

Do your answers to these eight questions reveal any serious unknowns, uncertainties that magnify risk? Does the amount of profit look

high enough to offset cost and market uncertainties? Yes? Then you've created a good deal you should go for.

FINDING HOMEOWNERS IN DEFAULT (PREFILING)

Ideally, learn the names of homeowners who have defaulted on their mortgages before their lender files formal legal notice. Although such discovery can prove difficult, these techniques often work:

Networking

Choose an area that offers potential. Then develop strong networking relationships with some of the people who know the neighborhood, such as mail carriers, delivery truck drivers, school personnel (teachers, principals), social service workers, busybody residents, real estate agents, local merchants, church leaders, and credit counseling personnel. Through this network of contacts, find out who's thinking about selling their home, who's been recently laid off, who spends above their means, who can't pay their bills.

Mortgage Collections Personnel

Some foreclosure specialists develop personal relationships with the lending personnel who collect delinquent accounts. Of course, lenders prohibit their employees from revealing private information about customers. But we all know that what is prohibited and what is practiced can run opposite to each other—especially when "it's just between friends."

An obstacle even greater than privacy now detours this approach. That obstacle is distance. In the good old days, local lending personnel handled a majority of mortgage lending and collections. Today, a mortgage loan in Peoria, Illinois, may be owned by a bank headquartered in San Francisco and serviced by a company located in Boston. When out-of-town personnel deal with the early stages of homeowner default, your chances of nurturing a confidential relationship becomes more difficult.

Drive Neighborhoods

When you really get to know your territory, keep your eye out for properties that appear unkempt, or perhaps suffer a sudden, mysterious, or extended vacancy. Such indicators may signal a property owner who faces financial distress. Ask a neighbor or two to confirm your suspicions.

Informal inquiry may turn up a prime prospect with whom you can negotiate—before a flock of foreclosure vultures land to compete for the pickings.

FIND HOMEOWNERS (POSTFILING)

Once a lender files suit, you can learn the names and addresses of distressed property owners in at least four ways:

1. Visit the clerk of civil court's office and ask to see the list(s) of foreclosure filings.
2. Subscribe to a specialized legal newspaper or e-mail newsletter that reports court filings.
3. Read the "legal notices" section of your local daily (or weekly) newspaper.
4. Go online. Although currently many counties throughout the United States lag behind in the Internet revolution, within a few years even the most backward (or obstinate) will post foreclosure filings on the Web.

As soon as the foreclosure shows up in the public records, competition for quality deals gets heated. To succeed, present yourself and your offer to the distressed property owners in a way that distinguishes you (not merely differentiates you) from the crowd.

Cultivate a Relationship with Property Owners

During periods of stress, property owners often hide the truth about their personal matters. Understandably, the loss of home or property stirs the emotions. As a result, you cannot rely on owner statements. Verify all details about the property and its liens.

Here are several suggested approaches to open negotiations with an owner in foreclosure:

> "If you'll allow me to complete a financial analysis of the property, I can be back within twenty-four hours with a firm offer that might solve your current dilemma."
>
> "I would like to pay you cash for your equity, which you otherwise will likely lose in a foreclosure sale. By working together, we can rescue your credit and you can begin to reestablish your life."

"May I review the loan documents on your home? Can you locate a copy of the mortgage, the title policy, and the monthly loan statements?"

Act faster and offer better results than anyone else. Do not insult or criticize the owners or their property—even though their house may show cosmetic blemishes and deferred maintenance. (In fact, the worse it looks, the better for you.)

As you inspect the property, realistically estimate costs and evaluate its potential market value. You are now prepared to begin discussions of price and terms.

Position your critique as polite inquiry. "Do you think I might have to replace the roof?" "I wonder how I can remove those stains from the carpet?" "Do you think most buyers today prefer the dark kitchen cabinets like these—or the lighter ones like I see in many new model homes?" In this way, you lead the owners to the deficiencies of their property without sharp-edged complaints.

Two More Issues

Up to this point, we have assumed that you were able to: (1) meet directly with the property owners; (2) explore the exact nature of their situation; (3) evaluate the financials of the property; and (4) work through potential win-win-win (owners-lender-you) possibilities. But you may not be able to meet directly with the owners if they are represented by a realty firm, or if they have abandoned the property and relocated away from the community.

Sales Commissions Eat up Owner's Equity. I have found it difficult to work with property owners in foreclosure when they have listed their home for sale with a realty firm. Most run-of-the-mill real estate agents know next to nothing about bank workouts, though I see this lack of knowledge changing. Given the market today, more agents are honing their skills in foreclosure opportunities. Still, rather than help, many do hinder the creative, cooperative process that workouts require.

In addition, real estate agents want to be paid in cash at closing. When a sales agent expects to pull six percent of the sales price—an amount that eats up a large chunk of owner's equity (providing the owner has accumulated any equity), it squeezes your negotiating range. The amount of that commission comes straight from monies that could otherwise go to you, the lenders, or the property owners.

On occasion, I have dealt with savvy agents who understand that if they insist on a full commission they will kill the deal. In one such

transaction, the agent agreed to accept just $1,000 in lieu of $4,500. (As this agent realized, he wasn't giving up a fee of $4,500 for a fee of $1,000. Instead he was earning a fee of $1,000 in lieu of earning nothing at all.)

Realty Agents Can Price Too High. Sometimes realty agents hurt the property owners' chance to sell their home when they overprice the listing. Say the distressed owners owe $280,000 on a property with a market value of $300,000. To get the listing, an agent may lead the owners into falsely believing that they can sell the property at a price of $325,000. "Great!" the owners think, "We will net $20,000 to $25,000."

Sixty to 90 days pass, and the overpriced property doesn't sell. The owners panic. The foreclosure lawyers are closing in for the kill. But now the listing is stale. To really grab buyer attention requires a severe price cut to maybe $275,000. By this time, the unpaid mortgage balance along with missed payments and late fees could total $300,000. There's no way a sale will clear out the mortgage debt and the sales commission. More often than not, the foreclosure sale date rushes closer like a speeding freight train.

Quick FSBO Beats Realty Listing. When you talk with low-equity distressed sellers, persuade them not to list with a realty firm in hopes of getting some pie-in-the-sky sales price. Property owners almost always stand a better chance of minimizing loss by going for a quick, discounted FSBO (for-sale-by-owner) sale. In some cases, they should even *pay* someone (cash, note, barter) to take over their loan—or to buy the property and arrange new financing.

Property owners in foreclosure must forget the idea of maximizing gain. Rather, they must eliminate the possibility of severe loss. You must lead distressed property owners to see that time is not their friend. Time is their enemy. The frequently heard homeowner refrain, "We're going to try this for a while and see what happens," does not make sense. What does happen? They lose the property to foreclosure.

Sometimes you fish; sometimes you cut bait. Foreclosure means it's time to cut bait. It's not prudent for property owners to keep throwing the line into new waters. To work successfully with these distressed property owners, repeatedly encourage them to act now. Delay brings regret. Action brings relief.

Vacant Houses

When you discover a vacant house in foreclosure, you discover both a problem and an opportunity. It's a problem because you may have to do some detective work to locate the owners. Unless the owners have

purposely tried to disappear, though, you can probably locate them in one of the following five ways:

1. Contact nearby neighbors to learn the owners' whereabouts, or the names of friends or family who would know.
2. Call the owners' telephone number and see if you get a "number changed" message.
3. Ask the post office to provide the owners' forwarding address.
4. Find out where the owners were employed and ask coworkers.
5. Contact parents, friends, teachers, or students at the school the owners' children attended.

After you locate the owners comes opportunity. Because they have abandoned the property, they probably aren't entertaining any fanciful hopes for a sale at an inflated price. At this point, they may view any offer you make them as "found money."

In some cases, you will learn that the owners have split up and gone their separate ways. This type of situation raises another problem: Especially in hostile separations, working out an agreement with one owner in the belief that you can convince the other(s) to go along often proves futile. To avoid this difficulty, bring all owners into the negotiations early. Never rely on, "Oh, she will go along with whatever deal you and I work out."

SATISFY LENDERS AND LIEN HOLDERS

Before you talk numbers in your preforeclosure negotiations, identify who holds legal claims against the property and in what amounts. Ask the property owners for this information. However, do not commit yourself to a deal. Verify the owners' figures through a preliminary title report issued by a lawyer or title insurer. Also verify claims through direct contact with claimants. Your investigation may turn up claimants in the following categories:

Mortgage holders (first, second, third . . .)
Taxing authorities (federal, state, local)
County or city special assessments
Homeowners' association fees and assessments
Unpaid sewage or water bills
Special assessment or bonding districts
Judgment creditors

Mechanics liens for labor or materials provided to the property
Spouse (or ex-spouse) rights, including dower and curtsey
Unfound heirs

One way or another, you will have to decide how you want to satisfy the claimants you find. You can use some combination of the following four techniques:

1. Pay off immediately any or all claimants for the full amount of their claims.
2. Pay off over time any or all claimants for the full amount of their claims.
3. Pay off immediately any or all claimants at a mutually agreed discount.
4. Pay off over time any or all claims at a mutually agreed discount.

Consider a preforeclosure in Phoenix that would likely sell for $110,000. The owner agrees to deed the property to you if you pay off all outstanding liens, which total $105,000:

First mortgage	$78,000
Second mortgage	$18,000
Roofing contractor	$3,000
Credit card judgment	$6,000
Total	$105,000

Facing these numbers, the deal won't get off the ground. The potential profit margin of $5,000 is much too low. But what if you could persuade the first mortgage lender to extinguish its old $78,000 balance and write you a new loan on the property in the amount of $88,000 (80 percent loan-to-value ratio) and waive all closing costs? You then work out discount deals with the other creditors. After negotiations, your total *payoff* looks like this:

First mortgage	$78,000
Second mortgage	$10,000
Roofing contractor	$2,000
Credit card judgment	$1,500
Total	$91,500

By combining $88,000 in proceeds from the new loan and $3,500 in out-of-pocket cash, you have just bought a $110,000 property for $91,500.

All Parties Are Better Off

If this property had completed its trip through foreclosure, only the first-mortgage lender stood a chance of emerging whole. But more than likely, after adding up continuing lost interest payments, late fees, attorney fees, foreclosure expenses, and REO risks and carrying charges, the first-mortgage lender, too, may have ended up worse off. As for the other parties, here's how they would gain from this workout proposal:

> *The property owners.* Theoretically they lost $5,000 in equity, but as a practical matter, that was $5,000 they were never going to see. Far more important, the workout not only kept a foreclosure entry off their credit record but also rescued them from a possible deficiency judgment.
>
> *The second-mortgage holder.* Again, theoretically the property held enough value to liquidate the full $18,000. As a practical matter, this second mortgagee was better off to take a quick and sure $10,000 and cut its potential losses. Owing to the low prices bid at foreclosure sales, in all likelihood, this lender would have ended up empty-handed.
>
> *Roofing contractor.* Not a chance of collecting any money from a foreclosure sale. (Accepting $2,000 beats nothing.)
>
> *Credit card judgment.* Not a chance of collecting any money from a foreclosure sale. (Again, $1,500 beats nothing. Besides, at this point this debt is probably held by an asset-recovery company who paid less than 5 cents on the dollar to buy the claim.)

In any specific deal, the numbers could come out better or worse for the respective parties—including you. It all depends on the parties' relative negotiating power and skills, their need for cash, their need to avoid risk, and their capacity for understanding. To succeed in the face of this ambiguity, entrepreneurial workout specialists size up people and situations. You have to figure out fast whether a deal looks doable.

Who is willing to settle for how much? Who stands to lose the most? Who needs cash now? Who is willing to wait? What concessions will the first-mortgage lender make, if any? Do the parties understand the likely adverse outcome of a foreclosure sale?

Win by Losing Less

In a foreclosure sale, more often than not, everyone loses except the lawyers. But think what happens when all principals agree to work

with—rather than against—each other. You can create an outcome where everyone walks away better off. Maybe they receive less than they hoped for, certainly less than they were theoretically entitled to, but far more than they could expect from a bidder at a foreclosure auction.

PROFIT FROM THE FORECLOSURE AUCTION

Although foreclosure sales typically lose money for lenders, lien holders, and property owners, savvy bidders can turn these sales into big profits. But you must prepare. Bidding blind can buy you problems you do not see.

Why Foreclosures Sell for Less than Market Value

Foreclosure (court ordered) properties sell at prices much lower than their market values. Why? Because court sanctioned auctions do not satisfy the criteria of a market value transaction:

Sale Characteristics

Market Value Sale	Foreclosure Auction
No seller or buyer duress	Forced sale
Buyer and seller well informed	Scarce information
60- to 120-day marketing period	5 minutes or less selling time
Financing on typical terms	Spot cash (or within 24 hours)
Marketable title	No title guarantees
Warranty deed	Sheriff's (or trustee) deed
Seller disclosures	No seller disclosures
Close inspection of physical condition	No physical inspection
Yard sign	Rarely a yard sign
"Homes for sale" ads	Legal notice posting
Sales agent services	No sales agent services

Foreclosure auctions seem purposely designed to sell at the *lowest possible sales price.* They take place under conditions that run contrary to all principles of effective marketing.

Adverse Sales Conditions. The auction sellers (sheriff's office, clerk of court, trustee) provide potential buyers no information about a property other than its legal description. They insist on cash. They offer no "contingency" contracts to allow buyers time to arrange financing. The seller

rarely holds an open house or sets up appointments to show the property. Buyers must take the property "as is" with no guarantees or assurances about title quality, physical condition, or environmental hazards. No sales agents offer advice, counseling, MLS listing, or persuasive reasons to buy.

No Guarantee of Vacancy. The foreclosure authorities don't even agree to convey the property free of occupants (owners, tenants, squatters). You may buy a property at a foreclosure auction and spend several months (or longer) to evict the people staying there. Clever occupants use delay tactics. Here are several:

File bankruptcy.
Claim that the foreclosure sale violated due process.
Organize a "people's protest" of some sort.
Continuously make idle promises, "We'll be out by the end of next week."
Seek intervention from some type of child welfare office or other social service agency.
Claim a female in the household is pregnant.
Seek protection under a lease agreement (even though foreclosure sales nullify leases if made after the mortgage on the property was recorded in the public records).
Threaten you or the property with physical harm unless you permit the occupants to stay on for "just a little while."

It's rarely a question, though (in the United States), of *if* you can get the people out—as a rule you can—it's more a question of *when,* and at what cost and effort—and in what condition will you receive the property?

For most would-be buyers, the risk, expense, and aggravation of foreclosure sales deter them from even showing up to bid. When you consider the lame marketing efforts, the adverse conditions/risks of sale, and the potential occupancy problem, is it any wonder that foreclosed properties deserve to sell at a fraction of their market value?

Make the Adverse Sales Efforts Work for You

You might look at the foreclosure sales process and say, "Too many potential problems. No way do I want to take those risks. Besides, how could I ever come up with so much cash on short notice?" That's the attitude of most real estate investors. It explains why at most sales the foreclosing lender "wins" the bid at a price equal to (or slightly above) its outstanding balance.

Overcome the Risks of Bidding. Risk looms large to block your path to foreclosure profits. To bid smart, know as much about the property as due diligence demands.

How can you obtain this information? First, meet with the defaulting property owners to talk over preforeclosure workout possibilities. Even when those discussions end without agreement, you still learn about the property (market value, fix-up needs, improvement opportunities), the neighborhood, and the owner's intentions. This step places you ahead of the game. Second, research the title records. Look for recorded liens and encumbrances, You can research property records in the clerk of court's office or, increasingly, on the clerk of court's web site. If you find no obvious title problems, ask for preliminary opinion of title from a lawyer or title insurer.

Time and Money. To meet with owners and check the title will cost you time, legwork, and perhaps several hundred dollars. Yet, if you buy only one property out of every ten you investigate, you still gain a good payback for your efforts. Just confirm your numbers. Question whether the sales price of the fixed-up property will exceed the total amount of your bid price and fix-up costs by a healthy profit margin.

Inferior Liens Wiped Out. When you buy a property in foreclosure, all liens inferior to the one foreclosed will usually get wiped out. Assume that the first mortgagee is forcing the foreclosure. You win the auction by outbidding this lender by $1,000. The first mortgagee takes what it's owed. The next claim in line takes whatever money is left.

Judgment creditors, mechanic's liens, second mortgagees, tenant leases, and any other claims disappear. Only existing tax liens, special assessments, and perhaps past-due homeowners' association fees may survive. (Lien priority and survival laws differ throughout the United States and throughout the countries of the world.)

For any specific property, discuss the "priority" and "wipeout" issues with legal counsel. But realize that many (if not all) of those preforeclosure liens that clouded the title will vanish. This fact torques up the preforeclosure negotiating leverage that you hold with lienholders. Creditors who don't settle before foreclosure will likely end up with nothing after foreclosure—unless, of course, they also plan to show up at the foreclosure auction and bid.

How to Arrange Financing

After you put together enough information to adequately manage the risks of buying at foreclosure, you face the problem of financing. How are you going to get the cash to close the sale? If you lack wealth or credit, you're

probably out of luck. Unless you bring in a money partner, it's difficult to buy at the foreclosure sale.

If you can temporarily raise cash—for example, take out a home equity loan, get a cash advance on a credit card, sell (or borrow against) stocks, or maybe take out a signature loan—you can bid at a foreclosure auction. Then, after the foreclosure paperwork clears, you can place an interim or longer-term mortgage loan against the property (as long as your lawyer or title insurer can clear liens or clouds) and pay off your short-term creditors.

Investors who buy foreclosed properties sometimes establish a line of personal credit at a bank. Then they draw on the money whenever they need it. Or they maintain cash balances in amounts sufficient to cover their usual buying patterns.

THE FORECLOSURE SALE: SUMMING UP

Few real estate investors bid regularly at foreclosure sales. Most prefer to avoid the time, expense, risks, and financing difficulties that foreclosure buying entails. You, too, may agree with this view.

But if you will learn the foreclosure game (as it's played in your locale), do your homework, and manage your risks, you can build profits quickly. You can buy properties at foreclosure auctions for less (sometimes much less) than their market value. Your challenge is to learn which of these properties meet the test of a true bargain—and which ones carry outsized risks, expensive problems, or excessive (upside-down) financing.

Naturally, too, foreclosure opportunities expand and diminish as real estate markets weaken or strengthen. In strong real estate markets, foreclosure bargains become more difficult to locate. In contrast, cyclical downturns like we find today provide boom times for foreclosure buyers. Don't fret about pessimistic news reporting. Prepare yourself mentally and financially to enter and win the foreclosure game.

7

PROFIT FROM REOs AND OTHER BARGAIN SALES

As anyone who reads newspapers or watches television knows, banks now hold more than one million foreclosed properties (REOs). In addition, VA, FHA, Fannie Mae, Freddie Mac, private mortgage insurers, and even OWC sellers have taken back perhaps another million houses, condominiums, small apartment buildings, retail stores, mobile home parks, and vacant lands.

Although RTC sales/auctions during the early 1990s created huge REO opportunities in some areas (mostly Texas, Oklahoma, Southern California, and Arizona), today's REO bargains extend more broadly throughout the United States, Canada, and other countries of the world (especially Spain and the U.K.).

Indeed, sales of REOs at distressed prices account for much of the more general drop in property prices. As REOs pile up, even sellers free of financial distress must cut their prices to compete. Likewise for new homebuilders. In many newly built subdivisions, homebuilders' houses now compete directly with the same houses that the builders sold a year or two ago—only at the much lower distressed seller prices.

BAD NEWS FOR SELLERS/BUILDERS, GOOD NEWS FOR YOU

As discussed in the Prologue, bad news for sellers means good news for homebuyers and investors in two ways: (1) You can buy properties today at prices that not only sit 15 to 50 percent below peak prices, but also at prices less than replacement cost. And (2) during the next several years, the

high numbers of REOs that now crowd the market will gradually fall back to much lower levels. Their depressing effect on market prices will slow and eventually disappear. Accordingly, until REOs dwindle and property prices climb substantially above replacement costs (the costs of construction), new housing starts will remain well below long-term demand (as supported by growth in population, immigration, household formations, incomes, and jobs).

As emphasized throughout this book, you now enjoy the perfect right time, right price opportunity to buy low and sell for a nice-sized gain within 5 to 10 years (or fewer). Even better, REOs provide these benefits without unusual risks. Unlike a foreclosure auction where you face uncertainty about property condition and title defects, REOs provide a safer alternative. As standard operating procedure, lenders clean up title problems, evict unauthorized occupants, and bring all past-due property tax payments and assessments up to date. REO lenders may also permit buyers to write contingency offers subject to appraisal, financing, and professional inspection. You can buy REOs without fear of nasty surprises.[1]

HOW TO FIND REOs

In desperate times like these, REO lenders often sell REOs through highly advertised auctions. Property agents even organize foreclosure bus trips to tour distressed neighborhoods and properties. (In stable and strong markets, lenders play it low key. No lender likes to publicize the fact that it's "throwing down-on-their-luck families out of their homes.") In addition to big auctions, you can find REOs in two other ways: (1) Follow up after court-ordered foreclosure sales, and (2) locate Realtors who specialize in REO listings.

Follow Up with Lenders after Foreclosure Sales

Attend the sheriff's foreclosure sale. When a lender wins the bid for a property that interests you, buttonhole the bidder and start talking business. Also, visit the REO (loss mitigation) departments of lenders. Show

[1] Several exceptions might include (1) states where the foreclosed owners may have a right of redemption; (2) cases where the foreclosed owners still retain some legal right to challenge the validity of the foreclosure sale; or (3) instances where a bankruptcy trustee or the Internal Revenue Service (tax lien) is entitled to bring the property within their powers. Rarely would any of these potential claims be worth losing sleep over. But before closing an REO purchase, talk over these issues with a real estate attorney.

a lender how your offer saves (makes?) the bank money. If you run into a bureaucratic stone wall, persevere. Today, many lenders do not know what they are doing. Your perseverance may not only reward you with a good property, but more importantly, you'll build personal relationships that open the bank's doors for future transactions.

Sometimes, too, lenders acquire REOs without foreclosure. Lenders occasionally open their morning mail to find the keys to a house, a deed, and a note from the distressed owners, "We're out of here. It's your problem now."

To learn about REOs that lenders now hold in their portfolio of properties, cold call mortgage lenders. Ask for a list of their REOs. Or, rather than ask for a complete list of REOs, narrow your focus. Tell lenders what you're specifically looking for in terms of location, size, price range, floor plan, condition, or other features. In that way, a lender can answer your request without disclosing the full number of REOs within its inventory.

Locate Specialty Realtors

Many mortgage lenders do not sell directly to REO investors for two reasons: (1) As mentioned, they do not want to invite unfavorable publicity; and (2) they do want to promote good relations with Realtors.[2] Because most mortgage lenders expect Realtors to bring them new loan business, the lenders can't then turn around and become FSBO (for sale by owner) dealers. "You scratch my back and I'll scratch yours" sets the rules in this business. Network relations stimulate mutual referrals.

Cultivate relationships with Realtors who specialize in this market. (In fact, HUD, VA, Fannie Mae, and Freddie Mac almost always sell their REOs through Realtors.) In most cities, you can easily find REO specialists by looking through newspaper classified real estate ads and the foreclosure web sites. Increasingly, too, some Realtors are creating foreclosure listing brochures and even office window displays.

Hire a Foreclosure Pro. Once you have identified several advertised foreclosure specialists, call them or stop by for a visit. Learn their backgrounds. Do they only dabble in the field of REOs and foreclosures? Or do they make this field their full-time business? When I telephoned REO specialist John Huguenard in Orlando, Florida, he talked with me for an hour and a half about property availability, detailed financing and

[2] Also, most lenders don't want to waste time with all of those investor wannabes who have just read a "nothing-down" book or "graduated" from a foreclosure guru's seminar.

purchase procedures, hot areas of town, rehab potential, estimating repair costs, portfolio lenders, strategies for buying and managing properties as well as selecting tenants, and a dozen other related topics.

At one point during our conversation, he asked, "I'll bet you haven't talked to any other agents who know as much as I do about REOs and foreclosures, have you? I've been doing this for twenty-three years. Last year, I sold 90 houses and rehabbed 16 others for my own account."

John is the kind of REO pro you want to work with. When you build a relationship with an agent who's really in the know, you won't have to do your own legwork and door knocking. Your REO agent will screen properties as soon as—if not before—they come onto the market. He will then notify you immediately.

Specialty agents stay on top of the finance plans that portfolio, government, and conventional lenders offer to homebuyers and investors. John Huguenard knew of portfolio lenders doing 100 percent LTV investor loans for investor acquisition and rehab. Tighter underwriting makes such loans more difficult—if not impossible—to find now. But a good REO specialist will know the best loan products available no matter what phase of the credit/property cycle we are going through.

HUD HOMES AND OTHER HUD PROPERTIES

Each year the FHA (Federal Housing Administration), a division of HUD, insures hundreds of thousands of new mortgage loans. (Nationwide, the total number of outstanding FHA mortgages runs into the millions.) FHA loans are originated by banks, savings institutions, mortgage bankers, mortgage brokers, and credit unions.

If borrowers fail to repay their FHA loans, the owner of the mortgage may force the property into a foreclosure sale. Rather than keep the property in its own REO portfolio, that lender turns in a claim to HUD (FHA's parent). HUD then pays the lender the amount due under its mortgage insurance coverage and acquires the foreclosed property. Next, HUD puts the property (along with all the others it has acquired in similar fashion) up for sale to the general public. To see HUD's inventory, go to hud.gov and follow the HUD homes link.

Although HUD is best known for selling single-family houses, it also sells:

- Vacant lots
- Duplex or two units on one lot

- Triplex (three units)
- Fourplex (a four-unit building)
- Condominiums
- Apartment complexes

Homeowners versus Investors

In the contest for HUD homes,[3] HUD favors owner-occupants over investors in two ways: (1) Owner-occupants get the first right to bid; and (2) HUD offers FHA low- or nothing-down insured mortgages only to owner-occupants of 1–4 family properties. HUD does not presently finance HUD homes for those who do not intend to live in the property. (Do not lie to HUD and falsely claim that you plan to occupy a property. Do so and you commit a felony, which HUD will prosecute.)

Given HUD's owner-occupant bias, you might think that homebuyers snap up all of the great buys and investors are stuck with the dregs. On the one hand, that may be true. If as an investor you look for "red ribbon deals" at a bargain price, your HUD pickings might prove few and far between. That type of HUD home typically sells fast at a good price. When HUD homes pile up in an area, your chances go up substantially. On the other hand, if a "fixer" fits your fancy, you can find great HUD buys because first-time homebuyers (HUD's primary market) scare easily.

As one HUD investor told me, "I always look for properties with the highest fear factor. Most homebuyers are afraid of homes that need work. They don't want the risk of cost overruns. They think they lack the knowledge and time to handle the fix-up. And they're right. But I do know how to deal with these things—and that knowledge gives me the advantage to earn good profits through HUD home rehabs for either rental or resale."

"As-Is" Condition

HUD does not warrant the condition of any of the properties that it sells. Even when HUD/FHA offers insured financing, HUD inspects the property for its own benefit only, *not* for the benefit of the buyer.

HUD Recommends Professional Inspections. Because HUD sells its properties "as is," HUD encourages prospective bidders to obtain professional independent inspections *before* they submit a bid. HUD does not accept offers with an inspection contingency. What you see (or don't see) is what you get.

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[3] This section discusses procedures for HUD homes. We address other types of properties later.

However, HUD's refusal to accept inspection contingencies does make buying somewhat risky. Because professional inspections cost $150 to $300, hopeful buyers are expected to incur this fee up front without knowing whether they will actually win the bid.

This fact explains why most first-time buyers avoid HUD "fixers." Inspection fees can easily get wasted. HUD's policy of "as is—no contingencies" favors experienced investors who can accurately estimate fix-up costs and can afford to accept the risks.

Disclosures and Repair Escrows. Although HUD refuses to permit offers with an accept inspection contingency, prior to closing a sale, HUD does allow the winning bidder to run a lead paint assessment on the property if it was built pre-1978. HUD may disclose property defects that it knows about. In some instances, HUD will agree to insure a mortgage for a property only if a buyer agrees to make specified repairs.

None of these actions by HUD cancels HUD's "as is—no warranties" policy. Partial disclosure doesn't mean full disclosure. At HUD, caveat emptor (let the buyer beware) rules.

Potential Conflict of Interest

Although most foreclosure specialists will work to find you a good deal, potential conflict of interest does arise in the sale of HUD properties. First, if you do not submit a winning bid, your sales agent does not earn a commission. An unethical agent could pressure you to raise your bid even if the value of the property doesn't justify a higher price. Second, sales agents may submit bids from competing buyers who bid on the same property. If you bid $80,000, an agent could tell another more favored buyer to bid $80,100. You lose. Third, HUD typically pays brokers who submit a winning bid a 5 percent sales commission plus, on occasion, a $500 (or more) selling bonus for designated properties. Again, this reward may encourage your agent to push you to bid high on a property because she will receive an extra reward.

Although you should not unjustly insinuate that your agent is likely to engage in underhanded sales tactics, it shows good sense to ask your agent how she handles these potential conflicts.

Buyer Incentives

When hard times hit, HUD foreclosures accumulate to unmanageable and costly numbers. To reduce this big inventory of REOs and create quicker sales, HUD may offer buyers easy financing, cash bonuses, and steep

discounts. If unsold HUD properties pile up in your area, you might land a particularly good deal.

The Bid Package

As might be expected of a government agency, HUD does not make buying simple. Unlike a private purchase, where you simply write out your offer on any valid contract form, HUD requires a specific contract submission package. Bidders must use only HUD-approved forms and documentation. To bid, complete the required forms, addenda, and enclosures fully and accurately. In addition, your contract package must arrive in HUD's regional office according to HUD's posted schedule.

HUD may (and does) refuse to accept bid packages that do not conform to its instructions. Given HUD's well-known inflexibility, work only with conscientious foreclosure pros who know in detail the ins and outs of HUD's requirements.

DEPARTMENT OF VETERANS AFFAIRS (REOs)

To sell its foreclosed properties, VA follows rules similar to those of HUD. For example, here are 12 major ways the programs resemble each other:

1. The VA sells through a sealed bid process. Likewise, as either a potential homeowner or an investor, you may submit multiple bids during the same bid period.
2. You cannot *directly* negotiate with, or submit a bid to, the VA. You must submit your bid through a VA-approved broker (your foreclosure pro).
3. The VA sells its homes on an as-is basis. Even though it may partially disclose a home's defects, it offers no warranties. Caveat emptor.
4. The VA does guarantee title, and it permits buyers to obtain a title policy.
5. The VA accepts bids that yield it the highest net proceeds (not the highest price). If you agree to pay closing expenses or sales commissions, you can win the bid over others who offer higher prices, but pass these costs (a lower net) on to the VA.
6. Just as HUD/FHA charges FHA buyers an insurance fee, the VA charges buyers who choose its financing a guarantee fee of around 2 percent of the amount financed.

7. The VA accepts bids only on VA forms. If you err in completing the forms, your bid gets tossed out.
8. The VA publicizes its properties through a combination of newspaper ads, broker lists, and Internet postings. You can access VA REOs via the links at hud.gov.
9. Local VA offices report to regional directors, who may issue policies and procedures that differ from those in other regions throughout the country.
10. The VA may choose to keep your earnest money deposit if you fail to close a winning bid for any reason other than inability to obtain financing.
11. As with HUD sales contracts, VA purchase offers do not include a contingency for post-bid property inspections. You may, though, inspect a property before you bid.
12. When necessary, the VA evicts holdover tenants or homeowners before placing a VA property on the market. At closing, you receive the keys to a vacant property.

Big Advantages for Investors

Although the VA follows rules similar to HUD, investors gain more from the VA in two ways:

1. The VA gives equal status to investors. The VA looks for the highest net offered by any credible buyer—homeowner or investor.
2. Unlike HUD, the VA offers financing to investors. At present in my area, for example, investors can close financing on a VA home with total cash out-of-pocket of less than 6 percent of a property's purchase price. In addition, the VA typically applies "relaxed" qualifying standards. VA buyers (who need not qualify as veterans) must show *acceptable,* not perfect, credit records. (For specifics in your area, talk with your foreclosure pro.)

With relatively attractive investor/homebuyer financing, VA homes in good (and even not-so-good) repair sometimes sell at or near market value prices. However, at today's depressed market values, even market value can look good to investors for these three reasons:

1. Leverage permits you to accelerate your wealth-building returns.
2. Even at market value prices, many VA properties pull in rents high enough to provide a positive cash flow from day one of ownership.

3. The VA allows future buyers to assume your VA financing. For investors who want to "fix and flip," an assumable loan makes a great benefit. Plus, when market interest rates go up, a lower-rate assumable VA loan gives your sales efforts a big competitive advantage over other for-sale properties.

VA REOs provide an excellent source of properties and financing for beginning and experienced investors alike. Investigate this opportunity.

FANNIE MAE AND FREDDIE MAC REOs

Fannie Mae and Freddie Mac are the two largest players in the nation's secondary mortgage market. These mortgage companies don't make loans directly to buyers, but they do provide the loan funding for more than 50 percent of the one-to-four family properties that are made by other mortgage lenders.

Sometimes when these loans go bad, Fannie (or Freddie) may force the lender to buy back its loan. Then the primary lender ends up with a foreclosed property in its REO portfolio. Typically, however, lenders who faithfully met Fannie's (or Freddie's) underwriting guidelines can require Fannie (or Freddie) to take ownership of the foreclosed property. (At this time, just in the state of Florida Fannie holds nearly 1,000 properties for sale.)

Agent Listings

Fannie and Freddie do not often use the sealed-bid sales procedure that's common to HUD and VA. Instead, both companies choose a realty firm and give that firm an exclusive right-to-sell listing. The realty firm then places that REO into MLS. The realty agent who takes on responsibility for a foreclosed property first inspects it and then recommends the best way to fix it up to maximize its sales price.

Price to Market. Fannie and Freddie might spend thousands of dollars to recondition and repair a property, and then price that property aggressively. So, typically, you won't buy Fannie or Freddie properties at a steep discount to market value.

But these times are not typical. Fannie and Freddie hold record numbers of REOs that they must sell. Especially in markets hardest hit, Fannie and Freddie are open to offers. Talk with local foreclosure pros. You will likely find some bargains.

First-Time Homebuyers—Special Financing. Fannie and Freddie direct their marketing efforts toward credit-qualified homebuyers (especially

first-time homebuyers). In addition to the bargain price appeal, these companies attract buyers with well-presented homes and special financing.

Freddie even permits homebuyers to "customize your Homesteps home." Under this option, Freddie invites buyers (for a price, of course) to upgrade their home's carpeting, padding, vinyl, appliances, and window blinds. Freddie also sells most of its owner-occupied properties for 5 percent down, no private mortgage insurance (which saves buyers $50 or $80 per month, possibly more), lower closing costs, and an attractive interest rate.

All Properties Sold "As Is." Even though Fannie and Freddie often fix up their properties, neither warrants nor guarantees the condition of a property. Unlike buying from HUD or the VA, though, as a Fannie/Freddie buyer, you may submit a purchase contract offer that includes an inspection contingency. You can purchase a home warranty plan, too, just as you (or the sellers) can with most other property sales.

Investors Invited

Both Fannie and Freddie invite offers from investors with no priority-listing period that applies only to owner-occupants. Both companies also offer favorable financing for credit-qualified investors. You pay just 15 percent down (in contrast to the conventional down payment of 20 percent to 30 percent for investor-owned properties). Closing costs may come in a little lower, too. Investor interest rates usually sit on the low side of market. You can locate Freddie and Fannie properties, and their latest loan programs, at www.homesteps.com and www.homepath.com. You can also access them through links at hud.gov.

FEDERAL GOVERNMENT AUCTIONS

Each year the federal government (in addition to HUD/VA) sells seized and surplus real estate, including houses, apartment complexes, office buildings, ranches, and vacant and developed land. Among the most active sellers are the Internal Revenue Service (IRS), Government Service Administration (GSA), and the Federal Deposit Insurance Corporation (FDIC). On occasion, you can also find properties offered by the Small Business Administration (SBA). You can locate government agency properties and sales procedures at the following web sites:

Internal Revenue Service at www.treas.gov/auctions/irs Government Services Administration at http://propertydisposal.gsa.gov/propforsale

Federal Deposit Insurance Corporation at www.fdic.gov/buying/owned/real/index
Small Business Administration at http://app1.sba.gov/pfsales/dsp

You can also find links to agency-listed properties at hud.gov.

BUY FROM FORECLOSURE SPECULATORS

A speculator wins the bid for a foreclosed property at $135,000. The property would sell for $195,000 if it were fixed up and marketed effectively. Soon after the foreclosure sale, you offer the speculator $150,000 (or whatever). To minimize risk, you attach several contingencies to your offer that permit you to get the property thoroughly inspected, evict any holdover owners or tenants, clear up title problems, seek title insurance, and arrange financing. If the property checks out satisfactorily, the sale closes, and the speculator makes a quick $15,000 (more or less). You obtain the property at a big discount without costly surprises that can turn a superficially promising foreclosure into a loss.

PROBATE AND ESTATE SALES

Probate and estate sales present another potential source of bargain-priced properties. When owners of properties die, their property may be sold to satisfy the deceased's mortgagee and other creditors. Even when the deceased leaves sufficient wealth in cash to satisfy all claims against the estate, most heirs prefer to sell the property rather than retain ownership.

Probate

To buy a property through probate, submit a bid through the estate's administrator (usually a lawyer) or executor. Then all bids are reviewed by the probate judge assigned to the case. Depending on local and state laws, the judge may then select a bid for approval or reopen the bidding. Because of legal procedures and delays, bidding on probate properties can require you to persevere. Judges wield discretion about whether to accept a probate bid. You cannot know for sure where your bid stands.

For example, a probate property came up for sale in an area of $150,000 houses. The probate administrator listed the house for sale at $115,000. A flurry of bids came in that ranged from a low of $105,000 up to a high of $118,000. Several months later the judge looked at the bids,

announced the high bid at $118,000, and then solicited additional offers. Eventually, the judge approved the sale at a price of $129,850 to someone who had not even been involved in the first round of bidding. You cast your bid and take your chances.

Estate Sales

Sometimes, an estate's assets need not be dragged through the probate process. You can buy directly from the heirs or the executor of an estate. Some investors regularly read the obituary notices, contact heirs, and try to buy before the property is listed with a real estate agent. To succeed in this approach, develop an empathetic approach.

Estate sales frequently produce bargain prices because heirs eagerly want cash. They may also need the money to pay off a mortgage, other creditors, or estate taxes. Out-of-town heirs (especially) may not want to hold a vacant property for an extended period until a top-dollar buyer is found. Once again, pressures of time or money can lead to sales prices that fall below a property's market value.

PRIVATE AUCTIONS

In these times of REO stress, Freddie/Fannie, HUD/VA banks, and other owners of distressed properties are increasingly holding auctions. Attend one. Observe. You'll have fun. Often a band is playing, and food and drinks are served. A festive mood prevails. The auction company works to make potential bidders feel good. Beyond this display of cheer, though, the auction company is really setting up its prey. The auctioneer wants to sell every property at the highest possible price. Auctioneers earn a percentage of the day's take, plus, perhaps, a bonus for exceeding a certain level of sales.

To gain a bargain price, enjoy—but remain aloof from —the festive frenzy. Attend the auction armed with market and property information. Prepare to walk out a winner—not merely a buyer. Here's how you can make that happen:

- *Thoroughly inspect a property*. During the weeks before most private auctions, the auction company will schedule open houses at the properties to be sold. If you can't visit an open house, contact a real estate agent and ask for a personal showing. (Many auction companies cooperate with Realtors. If an agent brings a winning bidder to the auction, that agent earns a 1 percent or

2 percent sales commission.) Sometimes auction properties sell cheap because they are nothing more than teardowns waiting for a bulldozer. Or they may suffer any of a number of other defects. Even new properties aren't necessarily defect-free. Inspect before you bid.

- *Appraise the property.* If the property is free of defects, you still can't assume value. Study recent selling prices of comparable properties. Don't count on the auctioneer's list price to guide you. Just because you buy a property 25 percent below its previous asking price doesn't mean you have bought at 25 percent below the property's market value. Asking price doesn't equal market value—past, present, or future.
- *Set a maximum bid price.* Remember, you seek a bargain. Market value tells you what a property might sell for if fixed up and marketed by a competent and aggressive real estate agent. Market value does not tell you the price you should bid. Before the auction, set your maximum bid price. Don't let the auctioneer's "boosters" (often attractive younger women) cajole, excite, romance, bamboozle, or intimidate you into going higher.
- *Review the paperwork that will accompany a successful bid.* Before the auction begins, review the property tax statements, environmental reports, lot survey, legal description, and purchase contract you'll be asked to sign.
- *Learn what type of deed the seller will use to convey the property.* A general warranty deed assures title subject to certain named exceptions. Other types of deeds convey fewer warranties. Understand a deed's limitations (liens, easements, encroachments, exceptions, missing heirs, etc.). Title insurance is your best safeguard. If a property's title is uninsurable, consult a real estate attorney or title company to obtain an opinion of the title risks a buyer might take on.
- *Pay the deposit.* To become eligible to bid, register with the auction company before the auction begins, and present a cashier's check or other acceptable proof of deposit funds (amount and verifications differ by auction). You will then receive a bid card that tells the auctioneer that you are approved to bid. Without a bid card, the auctioneer won't recognize your bid.
- *Find out if financing is available.* Often auction companies prearrange financing on some or all of their properties. Find out terms and qualifying standards. If no financing is provided, determine how much time the auction company gives you to arrange your own financing. Unlike most government agency property

auctions, private auction companies often do not require bidders to pay cash for their properties within, say, 24 to 48 hours.

- *Learn whether bid prices are absolute or subject to a reserve minimum.* Auction properties are priced absolute or with reserve. If absolute, the property sells no matter how low the top bidder's price. With a reserve price, the top bid must exceed a prearranged minimum amount, or the property is pulled out of the auction. On occasion, the owner of a property may "nod" to the auctioneer and approve a bid that does not meet the reserve minimum.

How to Find Auctions

Most auction companies advertise their upcoming auctions in local and sometimes national newspapers (e.g., *The Wall Street Journal*). Fannie/Freddy announce their auction times, dates, and places on their web sites. Auction companies not only want to attract as many bidders as possible, they want to draw large crowds so that they can create a sense of anticipation and excitement. In addition to advertising, most auction companies will place your name on their e-mail lists.

Local auction companies are listed in the Yellow Pages. Large-scale local auctions, though, are frequently handled by auction companies that operate nationwide. These include, among many others, Fisher Auction Company, Hudson and Marshall, J. P. King, Kennedy-Wilson, Larry Latham, NRC Auctions, Ross Dove and Company, and Sheldon Good and Company. Even if you decide not to bid, large auctions are fun to attend. Try one. You'll learn the tricks of the trade as you watch the professional auctioneers and investors vie with one another.

8

QUICK PROFITS THROUGH FIX AND FLIP

During the boom years, speculators flocked to property shows, model homes, hotel rooms, and any other venue where builders sold off-plan. These buyers/speculators typically placed 5 or 10 percent down to book a new house or condominium unit. Then, within months, they flipped the purchase contract to score a quick $25,000 to $100,000 gain. Great way to make a pile of fast, easy money (but not nearly as risk-free as buyers thought).

Those giddy days have disappeared. But flipping itself has not disappeared. In fact, your opportunities to earn quick profits have actually multiplied. Only now, instead of buying off-plan, you buy a bargain-priced property. Then work your magic.

FIX, FLIP, PROFIT!

Are you willing to thoroughly research properties? Do you enjoy creative work? Then fix, flip, and profit will advance you toward real estate wealth building. To see the possibilities of fix and flip, follow the examples of Pat Williams and the Browns (Ray and Annie B.).

As California was heading into its last deep recession, Pat Williams and her husband split up. Out of work and with two kids to support, Pat needed money. She chose to invest in real estate. At the time, given the deteriorating economy of the Golden State, you might think that Pat was off her rocker. Not at all: Pat learned how to capitalize on adversity.

During the next five years, as California home prices fell by 20 to 30 percent or more, Pat bought and resold six homes. After each sale, she

banked between $20,000 and $40,000. Her total profits exceeded $150,000. What was her secret? A keen eye for a bargain, hard work, and perseverance. "The best deals are not marked with a big red flag," Pat says. "I had to weed through a lot of properties and get up to speed on the market."

When Pat says she had to "weed through" a lot of properties, she means that literally as well as figuratively. Relying on seller financing, Pat ferreted out run-down, bargain-priced properties. She studied market values and competing properties, and then renovated and revitalized the houses she had bought. Next, Pat sold for a nice-sized gain. Applying her newly acquired market savvy, Pat didn't wait for the California real estate market to turn around. She created her own property appreciation.

Would you like to earn an extra $25,000, $50,000, or more during the next year or two? Would you like to create instant equity and boost your potential rental income? Then buy a bargain-priced fixer-upper. Locate a property that offers great promise for improvement. Don't worry about whether you personally like or dislike the property's features. Just find a house, condo, or apartment building that you can buy low, design improvements, boost rents, and then sell to realize the extra value that you have created.

While the media moan about foreclosures, failing banks, and unemployment, self-starters are not waiting for "things to get better." They know that today's property and mortgage markets offer a dynamic combo of profit-generating possibilities. Won't you join then? (For a more detailed example, see the value-creating strategy of Craig Wilson on pages 203–210.)

LOOK FOR "FIXERS"

When you shop neighborhoods and properties, open your eyes to ideas you can use to improve the properties you see. Make a list. Describe every noteworthy feature—desirable or undesirable. Notice color schemes, floor plans, renovations, and out-of-date turnoffs. Inspect basements, attics, and garages. Know the relevant zoning codes.

Most books and articles on real estate investing merely tell you to buy fixer-uppers, but realize that *any property* that you can redecorate, redesign, remodel, expand, or romance might qualify as a "fixer-upper." The property improvement game refers to profitable creativity. You can make nearly any property live better, look better, and feel better.

Throw away the false belief that only run-down houses and apartments make good "fixer-uppers." Sure, poor maintenance offers potential for value-enhancing improvements. But to savvy investors, even well kept

properties aren't immune to profitable change. Stay alert to opportunity, and you will find ways to make a property more desirable to potential buyers or tenants. For proof, turn to the experience of Raymond and Annie Brown.

The Browns Create Value in a Down Market

When Raymond Brown and his wife, Annie B., bought a vacation retreat they called Woodpecker Haven, Raymond says, "I thought it was a done property. It was only five years old."

To Annie B., though, the house challenged her talents. An interior designer with a forward-looking imagination, Annie B. modestly observed that the home "presented great potential." As Raymond tells the story, "Here are some of the improvements my enterprising wife accomplished to transform a livable property into an exquisite home":

- Landscaped the front and rear yards.
- Installed a drip irrigation system.
- Built a stone fence around the pool.
- Added decks around the rear of the house.
- Installed French doors in both bedrooms that led out to the decks.
- Remodeled the guest bedroom and bath to create a master bedroom for visitors.
- Built a fireplace, bookshelves, and cabinets and installed track lighting in the living room.
- Trimmed overgrown trees and shrubs to enhance a picture-perfect view from the front porch.

Although Raymond and Annie B. invested $75,000 in these and other improvements, they added around $175,000 in value—throughout a rapidly falling market. "We bought our Sonoma retreat," says Raymond, "just as home prices were peaking, and sold several years later, two months before market prices again turned up. . . . Yet we made a $100,000 profit. Our secret? Woodpecker Haven was a fixer-upper we renovated inside and out."

The experience of the Browns shows that any property that could look better, live better, and/or feel better than it does might qualify as a fixer. (Remember, at the time they bought, Woodpecker Haven was only five years old. Recall, too, both the Browns and Pat Williams made their big gains in a *falling* market.) To fix up a property may require you to scrape encrusted bubble gum off floors and counters, patch holes in the roof, fight a gnarled mass of weeds and debris in the backyard, or pull out and

replace rusted and obsolete kitchen and bathroom plumbing fixtures. But fixing up a property also should push you to visualize ways to redecorate, redesign, remodel, expand, or bring romance into the property.

To profit from fix-up work, don't believe that you must dirty your hands. Sweat equity does pay big dividends, but creativity and imagination backed by market research pays more. To create value: (1) look for properties that obviously need work; (2) focus on properties whose creative possibilities are overlooked by most buyers; or (3) find a property and improve its physical condition, appeal, and livability. The more clearly you perceive opportunities that other potential buyers pass by, the greater your profit.

Research, Research, Research

When you invest to create value, no set rules apply to all cities, all types of properties, or all kinds of tenants or buyers. Features that one person loves, another may hate. What's popular in California may look out of place in Kansas. Today's fads may become outdated tomorrow. What suits you may not appeal to the tastes and lifestyles of most people. Money spent for a remodeled bath in Atlanta may pay back $3 for each $1 invested. In Milwaukee, returns for the same improvements may fall to 50 cents per dollar spent.

Many variables enter the value equation. Learn what features your future tenants or buyers will pay for. Plan for profits. Refuse to let your personal tastes or preconceived notions stand unchallenged. Like smart homebuilders who want their homes to sell for top dollar, research your market. Develop a market-based improvement strategy.

Ask Realtors and property managers to tell you the turn-ons and turn-offs for tenants, homebuyers, and property investors. Identify unique niches for uncommon yet highly desired features. Tour new home developments and popular apartment complexes. Watch house makeover TV shows. Notice colors, decorating themes, floor coverings, and floor plans. Discover the models, room counts, features, and amenities that sell best. Which ones stand lonely and unloved? Which features are functional, rather than mere glitz? What types and sizes of apartment units command the highest rents and display the lowest vacancies?

Use open houses to excite your creative impulses.[1] Look for ways other property owners have remodeled, redecorated, or redesigned their properties to make them more livable or more appealing.

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[1] Plus, on slow traffic days you can often talk in-depth about the market with the on-duty sales agent.

Talk to your friends, relatives, and acquaintances who have remodeling experience. Buy a boxful of those supermarket and bookstore guides with titles like *1,001 Ideas to Improve Your Home or Apartment.* Stockpile creative ideas. The greater the number of ideas you can draw from, the more easily you can design a profit-generating improvement strategy.

IMPROVEMENT POSSIBILITIES

When you shop properties with an eye toward creating value, corral your enthusiasm as well as your negative first impressions. Don't dwell on whether you like or dislike a property. Instead, answer this question: Based on what you've learned from market research, can you spend $5,000 to reap a return of $15,000? Or maybe $50,000 to reap a return of $150,000? In other words, don't judge a property through your personal lens. Judge its potential profitability. Would any of these possibilities boost the value of the property?

- Clean thoroughly.
- Add pizzazz.
- Create usable space.
- Create a view.
- Capitalize on owner (builder) nearsightedness.
- Eliminate a negative view.
- Bring in more natural light.
- Reduce noise.

Thoroughly Clean the Property

Whether you plan to hold or flip a property, before you advertise it for sale or rent, clean it thoroughly. You may think I'm stating the obvious, but I'm not. Go out and look at vacant rentals. You'll see that many owners of small rental properties don't thoroughly clean their units. Many owners say to themselves, "Why clean this place thoroughly? The tenants will leave it like a pigsty anyway." As you can guess, owners who express such belief generate a self-fulfilling prophecy.

Uncared-for rentals turn off (and turn away) top-quality tenants. They go elsewhere. Tenants who do accept units with dirt-encrusted windows and light fixtures, stained carpets, grease-layered stoves, and dust-laden window blinds are likely to treat your property as a pigsty.

Display pride-of-ownership cleanliness. You attract better-quality tenants; you show your tenants the degree of cleanliness you expect. When

I first became a landlord, I did operate with the "why clean thoroughly?" attitude. After seeing how badly undesirable tenants can wreck a property, it's easy to reduce maintenance standards. But I soon learned that this attitude brings about a downward drift. Once I offered units that stood clearly above the competition, I could choose the best tenants from a list of qualified applicants.

The cleanliness principle applies not just to investors who buy, fix, and rent. Fix-and-flip investors must also apply it. Whether you plan to flip (sell) the property to another investor or to a homebuyer, a spotless unit will sell (rent) quicker and at a higher price. Tenants and buyers alike discount heavily for dirt and debris. Cleaner units attract higher-quality tenants, and investors pay more for properties with better tenants because better tenants mean lower risk, less trouble, and surer rent collections.

Add Pizzazz with Color Schemes, Decorating Patterns, and Fixtures

Before you paint or redecorate your properties, get out and tour several new home developments and recently built upscale apartment projects. Look through home decorator magazines. Can you add to the appeal of your units with modern color schemes, wallpapers, or special touches like chair moldings, mirrors, faucets, light fixtures, or patterned tile floors? Don't go wild with creativity or personal flair, but add just the right amount of pizzazz (or romance) to distinguish your units from competitors.

Create Usable Space

Have you seen the ads of the California Closet Company or any of its imitators? This company transforms messy closets into masterpieces of design and utility. Beginning with this simple mission, CCC has grown into a $50-million-a-year business. Now the company applies the same design/utility principle to garages, workshops, and home offices. You can do the same thing. Figure out how to create more usable space (or how to make space more usable), and you've increased the value of your property.

But also look beyond the current use of existing space. Can you convert an attic, garage, or basement to additional living area? Can you enclose a porch or patio, add a second story, or build an accessory apartment? Ask yourself, "How can I use or create space to enhance sales appeal or generate more income from these units?"

Think about "right-sizing" the living area within the units. "Right-sizing" the living area means that you reduce the size of large rooms by adding walls, room dividers, or separate areas, or perhaps you can combine

small rooms to make larger areas. To a practical and profitable degree, every storage and living area within a house or apartment should be sized proportionally to market tastes and preferences. When tenants perceive areas of space as "too large" or "too small," they won't pay top rents or a top price. By rightsizing, you fit the space to buyer or tenant needs.

You right-size when you enlarge (or reduce) the total size of the living area. Several years ago a Manhattan investor noticed that two-bedroom apartments glutted the market and depressed rent levels. Those few buildings that did offer four-bedroom apartments enjoyed long waiting lists. So this savvy investor bought a building of two-bedroom apartments at a steep discount, combined apartments into four-bedroom units, and rented all of them immediately at premium rent levels. He then sold the property for twice the price that he had paid 18 months earlier.

Create a View

In the early 1980s, when I was looking for a lakefront home in Winter Park, Florida, I discovered a startling fact. Nearly all lakefront houses (having been built in the 1960s and earlier) failed to fully capture the view potential of their sites. I found closed-in kitchens, master bedrooms on the street side of the houses, and unbelievably (to me), even the lakefront rooms of these houses often lacked large windows.

Not long ago I was touring a new housing development in northwest Albuquerque and came across a house situated such that it could have offered spectacular views of the Sandia Mountain Range. But it didn't. Although I entered the house full of anticipation, disappointment soon set in. None of the windows in the rooms downstairs faced the mountains. Surely, though, the upstairs would prove different. I imagined a master bedroom suite with large windows and perhaps a deck facing out to the mountains. But again, no. The master bedroom was situated to look straight at the house next door. And on the mountain side of the house was a small child's bedroom with no view window.

The mass production builder of this house had just plopped down a standard model with no attention to the differential advantages of the individual lots within the development.

When you find properties that fail to fully capture a potential view of a lake, ocean, mountain range, park, woods, or other pleasant surroundings, you discover a great way to add value to a property.

Capitalize on Owner Nearsightedness

Often the owners of ill-designed properties become accustomed to the property as it exists and they don't realize its possibilities. After remodeling

the lakefront home (that I did buy) in Winter Park to achieve expansive views from eight of the nine rooms in the house, the previous owners stopped by and exclaimed, "Wow! If we had imagined the house could have looked this good, we might never have sold it."

Profitable improvements begin with creative imagination. Don't rush into fixing up a property before you inventory all types of possibilities. Many fix-and-flip investors think property improvement means slapping on a fresh coat of white paint and laying down laminate flooring. These improvements might help, but don't limit yourself to such commonplace ideas. Open your mind. Then close your eyes and imagine how to transform the property—not merely "fix it up."

Eliminate a Negative View

Some buildings suffer diminished value because their windows look directly out into an alley, another building, or perhaps a tangle of power lines. For such properties, eliminate the negative view and convert it into something attractive. Can you change the location of a window? Can you plant shrubbery, bamboo, or leafy trees? Can you add decorative fencing?

At the Black Oak Bookstore in Berkeley, California, the owners transformed an area that had looked out directly into a plain concrete block wall. To remedy this negative, the owners planted ivy to run up the wall, added hanging plants, a rock garden, and a wooden lattice. These changes created a stunning improvement over the drab concrete wall.

You can even turn a backyard into a beautiful view. The owner of a house I almost bought in La Jolla, California, did just that. In her backyard, this seller had created a large, spectacular shrub, flower, and plant arrangement designed and built up within 8″ × 8″ lawn timbers. To create a view from inside the home, she had replaced the rear walls and windows with sliding glass doors. (This feeble description fails to convey the buyer impact this improvement actually achieved.)

This owner had spent around $15,000 to create this eye-pleasing landscape, but in doing so, she added $35,000 to $50,000 to the price. Her house clearly displayed a competitive advantage over other so-called similar houses in the neighborhood.

Enhance the Unit's Natural Light

Most homebuyers, investors, and tenants prefer properties with loads of natural light. To achieve this effect, add or enlarge windows, change solid doors to those with glass, or install skylights. In addition to the positive influence of sunshine itself, brighter rooms seem more spacious. To enhance

this effect, determine if you can add volume to interior rooms by tearing out a false ceiling; at times it can even pay to eliminate an attic area. When you create a brighter, more spacious look, you dramatically improve the way a home lives and feels.

Consider the experience of home seller Joan Phelps: "The previous owners fully bricked an inside wall of the house, so it was very dark and dreary," says Joan. To solve this problem, Joan and her husband invested $2,620 to tear out much of the brick and add windows on each side of the fireplace. The result was terrific. When the couple put their home up for sale, "We had two offers and a backup buyer the first weekend. First impressions really sell," Joan advises.

Not only did the Phelpses get the price they wanted, but another nearby house with the same old design sat on the market unsold for months. Tenants and buyers will pay a premium for a bright, cheery property. Can you add windows, skylights, and light-colored window treatments in place of those heavy, dark drapes? Can you rip out low ceilings? With more height, you can bring in more light as well as vanquish that closed-in feeling that low ceilings create.

Reduce Noise

Homebuyers, investors, and tenants pay for quiet and discount for noise. Insulation, caulking, earth berms, trees, shrubs, and soundproof windows can help restore quiet. I recently attended a home improvement fair where one exhibitor had a boom box blasting hard rock music. But this offensive noise machine sat behind the exhibitor's product: sound-insulating windows. As shoppers approached, the man at the exhibit closed the window. The noise disappeared. Quite an effective demonstration of how soundproof windows can muffle or eliminate outside noise. Many window manufacturers now offer a line of noise reducing windows. For a sampling, google "soundproof windows."

Before you buy a multi-unit building, test the soundproofing between units. If you can hear a television, people walking or talking, or toilets flushing, beware. Unless you can solve the noise problem, tenants will complain and you will suffer higher turnover.

REQUIRED REPAIRS AND IMPROVEMENTS

Market your properties in tip-top condition. Creative, appealing improvements add to value. But to realize those potential profits, the property should not show unsightly signs of wear or abuse; all systems must

operate; and the property must not display any hazards to health or life. When thinking about how to improve your property, look carefully at the following areas. The more problems you overcome, the fewer criticisms buyers (renters) will raise during property showings and negotiations.

Plumbing

Check faucets for leaks and drips. Where washers are needed, replace them. Avoid tightening the handle down until the seat is damaged. Buyers (and renters, too) may turn all the faucets on and off to detect damage in the internal workings. All sinks should drain quickly. Check the toilets to determine whether the water shuts off automatically as it is supposed to. Replace toilet seats that are discolored or cracked. Check the perimeters of all bathroom fixtures, showers, and bathtubs. Repair cracks with caulking compound, especially where leaks are present. If it is cold outside, protect pipes exposed to the weather. Remove stains that were caused by previous leaks. A stain tells buyers that your plumbing needs work.

Electrical System

Verify the condition and location of all electrical outlets. Older properties often lack a sufficient number of outlets to handle today's electrical demands. Check the adequacy of the amperage and the circuit breakers (or fuse boxes). Replace burned outlets. Residents should never need to overload outlets or circuits with adapters and extension cords. Bring outdated electrical systems up to code and up to modern standards.

Heating and Air-Conditioning

The heating and air-conditioning system should heat and cool effectively and efficiently. Install new filters before you show a property to potential buyers. Some prospects will inspect the filters. If they find a dirty filter, they'll assume that the filters have not been changed regularly and that the system itself suffers damage. New filters signal that you have properly cared for the equipment. Also clean the heating and air-conditioning duct outlets. If the property has gas heat or a gas water heater, throw away old matches from previous manual pilot lightings. Otherwise, it will appear that the pilot fails to work right.

Windows

Replace all cracked or broken windows. Repair broken pulleys and damaged frames and sills. Test all windows to see if they lift up and down easily. Never show a property where the windows have been painted shut. That's a turnoff to buyers. Replace broken screens.

Appliances

Appliances, such as a built-in oven, range, garbage disposal, dishwasher, or refrigerator, that are to be included in the sale (or rental) should operate properly. Keep refrigerators defrosted and ovens clean while the property is on the market. (If tenants occupy the property, ask them to cooperate. They must maintain the appliances and their living units in neat and clean condition during the sales effort. Unkempt tenants reflect poorly on a building.)

Walls and Ceilings

Repair cracks in plaster. Repaint or wallpaper faded or dark-colored walls. Aim for a bright, cheerful look to the property. To reduce your work, buy prepasted wallpaper and good-quality paint that will cover with just one coat. Paint and wallpaper, relative to their cost, pay back a high return. Use color schemes that strengthen the overall effect that you want to achieve for the property.

Doors and Locks

Inspect screen or storm doors. Replace screens, door panels, and closing springs as needed. Doors must open and close easily without being too tight or too loose. Replace cheap, flat-panel hollow-core doors with doors more substantive in strength and decor. Plane tight doors that drag. Because security ranks high with many buyers (or tenants), replace worn locks or locks that are easily picked or broken, with a sturdier variety. Strike a balance. Excessive locks, chains, and bolts prompt buyers (tenants) to question the safety of the neighborhood.

Landscaping

Well-kept yards magnify resale potential. Cut the grass and rake the leaves. Remove dead or unattractive shrubbery. Add privacy fences and hedges. If the season permits, plant flowers and install flower boxes. Google images

"before and after landscaping." You immediately will realize the powerful effect of landscaping to create award-winning curb appeal.

Storage Areas

Clean all storage areas and throw away items of questionable value. You'll have to do it before you hand over the property to a buyer anyway. Empty storage areas appear far more spacious than full ones of the same size. Buyers can't imagine the real size of a closet, attic, or basement when that area is crammed full. Buyers love space. When flipping/selling a rental, persuade your tenants to cooperate.

Clean Well

Clean the property from top to bottom. Most buyers (tenants) want a property that looks like it has been well taken care of. Bathrooms and kitchens are especially important. Special efforts to remove stains on sinks, toilet bowls, and bathtubs, as well as countertops and cabinet areas can add luster to the property. Potted flowers in bathrooms and kitchens also add appeal. Scrub floors. Vacuum and shampoo carpets. Wash windows and mirrors. (One more reminder: if tenants occupy the property, encourage them to keep it in top condition. Investors judge the quality of your tenants from how neat and clean they maintain their units. If your tenants won't practice tidy housekeeping, replace them with tenants who will honor your requests. (See lease clauses in Chapter 12.)

Safety and Health

When you clean and repair the property, notice danger. Watch out for loose carpeting, broken steps, torn linoleum, loose handrails, and scattered wires and cords. You are responsible for the safety of all the people who enter your property. Safety also helps to sell a property. Likewise for environmental concerns such as asbestos, lead paint, radon, or underground oil tanks. Check with state and federal EPAs to get their booklets that tell property owners how to safely and legally remedy environmental hazards.

Roofs

Inspect the roof for aesthetics and function. If the roof leaks, repair it. Don't do a quick fix to hide a serious problem for just long enough to get the property sold. Clear the roof of debris and plant growth. If the roof

is discolored, see if you can use some type of roof "paint" to enhance its appearance. Buyers hate old roofs. Buyers love new roofs. If the roof is near the end of its life, replace it. As with repairs, don't go the cheapest route. Search out the most cost-effective solution, not merely the lowest cost. Smart buyers will pay for quality.

Improvements and Alterations

If you add a room, modernize a bath or kitchen, or convert a garage to a recreation room, position your redo within range of other properties in the neighborhood. Use designs that flow naturally throughout the property. Seek harmonious improvements that you integrate (blend together into a unified form and aesthetics).

YOU CAN IMPROVE EVERYTHING ABOUT A PROPERTY—INCLUDING ITS LOCATION

"What should you look for when buying a house?" asks the *Dallas Morning News* in one of its feature articles: "Location, location, location." Why? Because, as the article reports through interviews with so-called experts, "You can change nearly anything about a property—anything except its location. That's why location is so important."

What do you think? Are these so-called experts right? Is it true that "you can't change the location of a property"? If you answer yes, you have fallen for a clichéd falsehood. Opposite to conventional wisdom, you can improve a property's location. Location does not merely refer to a fixed position on the face of the earth. It includes a complex set of attributes such as neighborhood demographics, appearance, prestige (reputation), school quality, crime rates, convenience to shopping, accessibility to employment, zoning laws, deed restrictions, property tax rates, government services, and dozens of other influences. Acting together, you and neighboring property owners (and tenants) can favorably impact any or all of these neighborhood features. One of my favorite examples is South Beach, Florida.

The South Beach Example: From Derelicts to Fashion Models

In the mid-1980s, the South Beach area ("SoBe", as locals call it) of Miami Beach had deteriorated to the point where crack dealers and prostitutes openly sold drugs and sex. Derelicts and criminals filled SoBe streets and flophouse hotels. Tourists visited the area at their own peril. Most locals

wrote off the neighborhood as another loss to urban decay. But visiting New York entrepreneur Tony Goldman saw things differently. "I took a ride around the area, and it was love at first sight. I was smitten," recalls Tony.

Instead of problems, Tony focused on potential. In his mind's eye, he imagined rehabbing the neighborhood buildings to highlight their art deco architecture. He envisioned sidewalk cafés and restaurants. He saw a tree-lined, beautiful Ocean Drive that would invite tourist visits. He saw streets free of criminals. He imagined new residents exhibiting pride of place.

To bring this dream to life, Tony, along with friends, investors, and Miami civic leaders, formed a community action group. The group persuaded the police to rid the neighborhood of crime. They began a cleanup and rehab campaign. They convinced the city to issue $3 million in bonds to fund public improvements. They generated enthusiasm and community spirit.

How successful were they? As one resident remarked, "Tony put the chic back into SoBe." Within just a few years, SoBe became one of the sought-after "in-crowd" neighborhoods in the Miami area. Condo sales, rent levels, and home prices jumped. Restaurants, cafés, and clubs filled the neighborhood. Because of these improvements, SoBe has become one of the foremost locations in the country for fashion photography shoots. Hundreds of former New York models now call South Beach home. Desirable condos in South Beach are now priced upwards of $500,000 (though in today's market, lower-priced REOs and foreclosures can offer much better bargains—yet such bargains will not last indefinitely).

Community Action and Community Spirit Make a Difference

In his review of the book *Safe Homes, Safe Neighborhoods,* real estate advisor Robert Bruss says, "This is an action book. . . . This is a welcome and a long-overdue book for activists who want to learn how to improve a neighborhood." *Safe Homes* illustrates perfectly how community action and community spirit can improve the quality of neighborhoods and lives. Many city and suburban neighborhoods must tackle problems of one sort or another. Besides crime, such problems can include anything from barking dogs to speeding high-schoolers to a lack of parks, sidewalks, or storm sewers. But regardless of the specific problems to be solved (or prevented), as Tony Goldman proved with South Beach, people acting together can make a difference.

"While it may seem that everywhere crime is on the rise," observe Stephanie Mann and M.C. Blakeman, authors of *Safe Homes, Safe*

Neighborhoods (Nolo Press, 1993, p. 143), "in many neighborhoods, residents are revitalizing and renewing their properties and the quality of their living environment. In cities and towns across the country, local crime prevention groups have reduced burglaries and car break-ins; helped catch muggers, rapists, and kidnappers; established Block Parents and other child-safety projects; driven out drug dealers; eliminated graffiti; and, in general, made their homes and streets safer. All it takes is a few people to get things started. By identifying and focusing on a neighborhood's main concerns—and working with police, schools, and city planners, and each other—neighbors can make a difference."

For more ideas, see George Kelling and Catherine Coles's *Fixing Broken Windows* (Free Press, 1996).

Neighborhoods Offer Potential

When you search and compare neighborhoods, see beyond the present. Imagine potential. "Fixing" neighborhoods can create far more value than merely fixing properties.

List all of a neighborhood's good points. How can you and other property owners, tenants, police, concerned citizens, and community leaders join together to highlight and take advantage of these features? List the neighborhood's weak points. How can you and others eliminate negative influences? Who can you enlist to promote your cause? Can you mobilize mortgage lenders, private investors, Realtors, not-for-profit housing groups, church leaders, builders, contractors, preservationists, police, local employers, retail businesses, schoolteachers, principals, community redevelopment agencies, elected officials, civic groups, and perhaps students, professors, and administrators of a nearby college or university?

Throughout the United States and in cities throughout the world, people of all income levels, occupations, races, and religions have joined together to revitalize and reinvigorate hundreds of neighborhoods. From South of Market in San Francisco, to Madison Valley in Seattle, Lakeview in Chicago, Boston's North End, Manhattan's SoHo, Miami's SoBe, and the "M Street" neighborhood in Dallas; neighbors, merchants, real estate investors, homeowners, and tenants have organized campaigns to make living, working, and shopping in these areas more desirable. "We liked the community," says real estate investor Rob Rowland of Cumberland (Atlanta), "but the community association was too passive. It needed some oomph, so we incorporated and worked hard to get to know people and inspire them to upgrade their yards and properties."

In speaking of a San Diego neighborhood that's poised for turnaround and redevelopment, Lori Weisberg says, "To the outsider,

there's very little here that seems inviting. . . . Yet, where most people see a shabby area . . . visionaries see an exciting new downtown neighborhood adorned with a grand, tree-lined boulevard, a central plaza, artisans' studios, loft housing, and crowned with a sports and entertainment center. . . . [Already] there are pockets of gentrification—a budding arts district, scattered loft conversions, and . . . structures well suited for preservation. . . . But [the total revitalization and redevelopment] does have to be imagined."

"There's no doubt," says Pam Hamilton, an executive with San Diego's Centre City Development Corporation, "this project will happen—it's just a question of when." What's true of San Diego is true in cities throughout the United States. When you locate a neighborhood that's poised for turnaround or gentrification, your property fix-ups will pay double (or even quadruple) dividends.

WHAT TYPES OF IMPROVEMENTS PAY THE GREATEST RETURNS?

Newspaper and home improvement magazines periodically run articles that tell you a remodeled kitchen will pay back, say, 75 percent of its cost; a remodeled bath, 110 percent of its cost; or a swimming pool, 40 percent of its cost. Absurd! Never rely on any of these specific payback figures. They're nonsense. Instead, evaluate every property and every project on its own merits.

Before you estimate potential returns, research competing properties and tenant (buyer) preferences. Learn what you need to do to design a cooperative advantage. Budgets for any project can vary enormously depending on who does the work, what materials are selected, and the skill and creativity with which the job is undertaken.

Never forget: Your profits flow directly from how much your tenants (buyers) value your units relative to what other owners offer. Relative comparisons differ in time, place, and pricing.

How Much Should You Budget for Improvements?

As you plan improvements for income properties, develop a cost/income estimate. Study market-housing prices and rent levels. Figure out how much you can increase the sales price or rents for each project you undertake. As one rule of thumb, each $1,000 you invest in improvements should increase your net operating income at least $200 a year. You can see

the logic of this rule by applying the value formula explained in Chapter 3:

$$V = NOI/R \text{ or } NOI/V = R$$

(Recall that V is the value to be estimated, NOI is net operating income, and R is the overall rate of return on unleveraged capital.)

If your improvements of $1,000 yield $200 more a year in net income, you earn 20 percent on your investment.[2] Choose whatever rate of return you want to aim for. Some investors use 10 percent; others may go as high as 40 percent. The profit margin you use is not my point. What matters is that before you jump into renovating a property, temper your enthusiasm with a realistic look at the amount of increased rents (or selling price) your investments of time, effort, money, and entrepreneurial talents are likely to produce.

Beware of Overimprovement

When you budget costs of improvements, guard against overimproving your property relative to its neighborhood and relative to the prices (rent levels) your buyers (tenants) are willing and able to pay. Survey the top rental rates in the neighborhood relative to the size and quality of units you intend to offer. If $850 a month is tops and your inferior units now rent for $700 a month, using the 20 percent rule, you should limit costs to no more than, say, $6,000 to $9,000 per unit. These amounts assume that after renovations you could raise your rents to $800 or $850 a month and pocket another $100 to $150 a month in income:

$1,200 (12 × $100)/.20 = $6,000 cost of improvements
$1,800 (12 × $150)/.20 = $9,000 cost of improvements

These illustrative returns won't necessarily apply in your market, but apply the same methodology. Run your numbers to verify whether the market supports the selling price or rent level you ask. These calculations also inform you whether your hoped-for rent level (if realized) will give you an adequate payback on your investment.

Other Benefits

On some occasions, you may want to invest more in your improvements than rent increases would seem to justify. Besides higher rents, your

[2] With smart leverage (financing), of course, your returns will jump up greatly.

renovated units should attract a better quality of tenant, reduce tenant turnover, and cut losses from bad debts and vacancies. More attractive units provide greater pride of ownership. Notwithstanding these points, still work the numbers. Good tenants and pride of ownership will prove desirable only if you collect enough rents to pay your property expenses and mortgage payments.

No-No Improvements

Some real estate investors have developed their no-no list of improvements. Robert Bruss, for example, says, "Smart fixer-upper homebuyers and investors look for properties with 'the right things wrong.'" To Bruss, the "right things wrong" include cosmetic improvements such as painting, landscaping, carpets, and lighting. On his list of no-nos are roofs, foundations, wiring, and plumbing.

Although Bruss makes sense, you deal in specifics. Whether you can profitably improve a property depends on the price you pay for that property, the amounts you spend to improve it, and its value (or rent levels) after you complete the work. By this standard, cosmetic fixers can be overpriced, and serious fixers may be underpriced. No universal rule governs. Analyze the financial details of the deal in front of you.

I know of a house that sat on the market for nearly a year because of serious foundation problems. No one wanted it. Eventually, an investor bought the property at a near give-away price. He then jacked the house up 12 feet, repaired the foundation, built a new first story, set the old house (renovated) back on top, and resold the completed two-story house for an $82,000 profit. Not bad pay for three months' work.

BUDGETING FOR RESALE PROFITS

To budget formally for fix-and-flip profits, estimate (1) the eventual sales price of the property, and (2) the total amounts that you will invest from purchase until resale.

Estimate the Sales Price First

Buyers (tenants) decide the price at which you can sell (or rent) your rehabbed property. Never add fix-up costs to your purchase price to estimate a future sales price. Cost-plus pricing seldom works. Yet how many times have I heard sellers say, "We have to get $395,000. We have at least that much invested. We just put $40,000 into the kitchen"?

No one will care how much money you put into the kitchen. Buyers only care whether you offer the best value for the money. When you plan for profits, start with the price that a reasonably well-informed buyer will pay for your creation.

Price your beautifully rehabbed property relative to the properties in the neighborhood where it is located. Aim for a sales price that sits at least 20 percent below the highest-valued property on the block. As you push toward (or above) the top price limit of the neighborhood, you will find it difficult to attain your price (or rents)—even when your property towers over the others.

(Yes, exceptions do test this rule. Donald Trump prides himself on "breaking through the comps." But before you mimic Donald Trump, check and recheck your market research and cost/revenue calculations.)

Estimate Costs

After you set a realistic value for your upgraded property, add up your cost estimates. You start with these two reasons: First, when you set a realistic price, you intuitively recognize that extravagant expenses will blow the budget and vanquish any possibility of profits. Second, a realistic future value helps you figure out the most you could pay for a property and still earn a profit.

Future Sales Price Less Costs and Profit Equals Acquisition Price

You find a property that after improvements would quickly sell for $280,000. You further figure that your costs and desired profit add up as follows:

Acquisition expenses and closing costs	$3,750
Cost of borrowed funds (interest)	4,000
Selling expenses @ 6%	16,800
Materials for fix-up	22,000
Labor	12,000
Closing costs at sale	2,500
Profit	25,000
Total	$86,050

Because $280,000 equals the realistic sales price, you calculate that you can pay no more than $193,950 for the property:

Your future selling price	$280,000
Less	
Costs of fix-up	61,050
Profit goal	25,000
Equals	
Maximum acquisition price	$193,950

When you subtract costs and desired profit out of your expected (realistic) sales price, you set a top limit for your acquisition price. This technique guarantees you a profit—as long as you accurately estimate all costs necessary to buy, hold, fix up, and market the property.

Accurate and Comprehensive Cost Estimates. At this point, you might think, "Okay, so how do I learn how much my rehab will cost?" Good question. Although experience counts heavily, so will these six guidelines.

1. *Shop till you drop.* Visit home improvement suppliers, lumberyards, and hardware stores to learn the various costs of materials. Talk with knowledgeable store personnel. Compare price/quality tradeoffs. Learn alternative solutions to common problems.
2. *Attend classes.* Community colleges and home improvement centers offer classes and seminars for beginning remodelers, renovators, and rehabbers.
3. *Read.* Property improvements now total more than $150 billion a year. An entire industry of book and magazine publishers caters to the DIY homeowner and investor.
4. *Consult property inspectors.* Accompany your property inspector as he performs your prepurchase inspections. Ask for advice about potential costs and remedies.
5. *Obtain multiple estimates.* Contractors and tradespersons typically provide free cost estimates. Use this opportunity not only to solicit bids but also to discuss alternative ways of curing a property's deficiencies.
6. *Talk with other property owners.* You know people who have improved their properties. Ask them to tell you what they learned from experience. Learn from their experiences.

Estimating and executing requires knowledge. To reach the sweet-tasting berries, you may get stuck by the thorns. And that explains why fixers can prove lucrative. Most people prefer not to make the effort and deal with the risks.

COMPLY WITH LAWS AND REGULATIONS

Plan your improvements to comply with all laws. Your plans may fall within a variety of rules and regulations stipulated by homeowners' associations, zoning boards, health officials, fire marshals, and environmental agencies. Obtain all mandated permits. Repairs or improvements that fail to comply with code place you at great risk.

How will the authorities find out? Complaining neighbors, drive-by patrol, your buyer's prepurchase property inspector, your seller's disclosure statement, property tax assessment appraisers, and tradespeople who may at some later date visit the property to give repair estimates—to name just a few. Build the cost of regulations and permits into your cost estimates. Noncompliance can transform expected profits into actual losses.

SHOULD YOU BUY A "FIXER"?

As I travel throughout the United States (and other countries), I talk with realty agents, investors, and homebuyers. I'm amazed at the number of people I meet who have bought homes that sat on the market for months, if not years. After buying these properties that had been rejected by dozens of other lookers, these buyers turned that lump of coal into profits of tens (sometimes hundreds) of thousands of dollars.

I'm not saying that just because a property sits unsold for months or years it offers undiscovered promise. Many properties remain unsold because they're overpriced money traps. And certainly, many bargains sell within days after the For Sale sign goes up (which is one reason why you might want a market-savvy sales agent working for you to identify these gems before they're picked up by someone else).

Nevertheless, many buyers reject properties too quickly. They walk in, do a quick-take with a pass-through tour, and then say something like, "Let's get out of here. It's way too dark, the rooms are too small, and did you notice that awful dark green carpet in the bedroom?"

"Yes," the spouse replies, "and how about those pink kitchen appliances and that green linoleum floor—not to mention the garbled floor plan and water stains on the ceiling? This house needs too much work. Anybody would be crazy to buy this nightmare."

Well, yes, anybody would be crazy to buy that house—unless, of course, you could buy it at a steep discount, rehab, redecorate, and resell it for a quick profit of $25,000 to $100,000 (or more). Or perhaps a discounted

fixer might get you started in a neighborhood that otherwise was priced beyond your limit. Then no one would call you crazy—and I would call you smart.

Too Little Time?

If you are busy with kids, jobs, church, clubs, charities, social engagements, or school activities, investing in properties that need work may seem like a chore to avoid. But it's for this very reason that buying a fixer—remember, a fixer is any property you can improve, not just those that are run-down—can yield good profits. Owing to lack of time, many investors (and homebuyers) want red-ribbon deals. Move in the tenants (or furniture) and start collecting rents. On top of that immediate benefit, buyers lack creativity, imagination, and knowledge. They see things they don't like. They can't see value-enhancing solutions. With relatively few buyers who will imaginatively renovate and redesign properties, fixers can get discounted steeply.

You can't expect to easily find a $400,000 house discounted $75,000 simply because it needs paint, carpets, and cleaning. Properties with readily solved problems tend to sell with smaller discounts. So, as one tactic, look for properties that spark rejection—a "Forget it, let's move on" reaction within moments of driving up to the curb or walking through the front door. With persistence, you can locate a bargain that others will come to envy—once you've worked your magic.

Put Your Creativity to Work

Educate and discipline yourself to think through questions such as "How can I overcome these shortcomings?" and "What opportunities for improvements can I create?"

Now, return to the question, "Should you buy a fixer?" and listen to the wisdom of career fix-and-flip investor Suzanne Brangham.[3] In her book *Housewise* (HarperCollins, 1987, p. 185), Brangham tells beginning investors:

> Your buying power does not depend on the amount you can pay today with the funds sitting in your bank account. . . . As

[3] Suzanne began her fix-and-flip career with a $40,000 condo in the early 1970s. Less than 10 years later, she was fixing and flipping million-dollar-plus houses. Although dated, *Housewise* still makes for a great read.

you learn more about real estate . . . you will understand that a little money can buy a lot—if you know how to pick the right house, bargain properly, and roll over your profits [possibly tax free, I might add] from one sale to another. . . . So get started now in property improving and property flipping so you can eventually own the properties you want, but can't afford right now. Start small and repeatedly step up from one [lower-priced] property into another [higher-priced] property. You will quickly build a magnificent net worth.

9

MORE TECHNIQUES FOR HIGH YIELDS AND QUICK PROFITS

Along with fix and flip, you can employ other techniques to boost your returns and build profits. Tune your possibility thinking to these channels:

Lease options
Lease purchase
Conversions
Master leases
Assignments: Flipping purchase contracts

LEASE OPTIONS

Many tenants would like to own their own homes. Yet for reasons of blemished credit, self-employment (especially those with off-the-books income or tax-minimized income), unstable income (commissions, tips), or lack of cash, they believe that they can't qualify for a mortgage from a lending institution. For these renters, the lease option (a lease with an option to purchase) solves their dilemma. Properly structured, the lease option permits renters to acquire ownership rights. Simultaneously, it gives them time to improve their financial profile and eventually meet the underwriting standards of a bank.

Here's How Lease Options Work

As its name implies, the lease option blends two types of contracts into one. Under the lease, the tenants sign a rental contract that covers terms

and conditions (see Chapter 12), such as the following:

- Monthly rental rate
- Term of lease
- Responsibilities for repair, maintenance, and upkeep
- Sublet and assignment
- Pets, smoking, cleanliness
- Permissible property uses
- House rules (noise, parking, number of occupants)

The option part of the contract gives tenants the right to buy the property at some future date. As a minimum, it will include (1) the amount of the option payment, (2) the option purchase price for the property, (3) the date on which the purchase option expires, (4) right of assignment, and (5) the amount of any rent credits that will count toward the purchase price of the house.

Benefits to Tenant-Buyers (An Eager Market)

The benefits of lease options to tenant-buyers have been pointed out by the late syndicated real estate columnist Robert Bruss as well as most books written for first-time homebuyers. For example, written in the early days of lease options, my book *Yes! You Can Own the Home You Want* (John Wiley & Sons, 1995, p. 59), advises:

Lease options help open possibilities for home ownership in at least six ways:

1. *Easier qualifying.* Qualifying for a lease option may be no more difficult than qualifying for a lease (sometimes easier). Generally, your credit and employment record need meet only minimum standards. Many property owners will not place your financial life under their magnifying glass, as would a mortgage lender.

2. *Low initial investment.* The initial investment to get into a lease option agreement can be as little as one month's rent and a security deposit of a similar amount. At the higher end, move-in cash rarely exceeds $5,000 to $10,000, although I did see a home lease optioned at a price of $1.5 million that asked for $50,000 up front.

3. *Forced savings.* The lease option contract typically forces you to save for the down payment required when you exercise your option to buy. Often, lease options charge above-market rental rates and then credit perhaps 50 percent of your rent toward the down payment. The exact amount is negotiable. And once you commit to buying, you will find it

easier to cut other spending and place more money toward the "house account."

4. *Firm selling price.* Your option should set the selling price for the property, or it should include a formula (perhaps a slight inflation-adjustment factor) to calculate a price. Shop carefully, negotiate wisely, and when you exercise your option in one to three years (or whenever), your home's market value could exceed its option price.

5. *100 percent financing possible.* Reduce the amount of cash investment you will need to close your purchase in another way: Lease-option a property that you profitably improve through repairs, renovation, or cosmetics. Given the property's increased value, you may be able to borrow nearly all the money you need to exercise your option to buy and pay off the seller.

Assume your lease option purchase price is $175,000. Say by the end of one year your rent credits equal $5,000. You owe the sellers $170,000. Through repairs, fix-up work, and redecorating, you increased the property's value by $25,000. The property is now worth around $200,000. If you have paid your bills on time during the previous year, you should be able to locate a lender who will finance your purchase with the full $170,000 you need to pay off the sellers. Or, as another possibility, sell the property, pay the sellers $170,000, and use the profit from the sale to invest in another property.

6. *Reestablish credit.* A lease option can help renters buy who need time to build or reestablish a solid credit record. Judy and Paul Davis wanted to buy a home before prices or interest rates in their area once again rose above their reach. But the Davises needed time to clear up credit problems created by too much borrowing and Judy's layoff. The lease option helped the Davises achieve their goal of home ownership.

When prospective tenants and homebuyers evaluate this list of benefits, they become a ready market for lease options. You just need to offer them the right property and terms.

Benefits to Investors

Although you can structure lease options in many ways, they nearly always provide these benefits to *investors:* (1) lower risk, (2) higher rents, and (3) guaranteed profits.

Lower Risk. Typically, tenants who shop for a lease option care for your property better than average renters. Because they intend one day to own the home, they will treat it more like homeowners than tenants. Also, they know that to qualify for the lowest available mortgage interest rate,

they need to pay their rent on time every time. (If your tenant-buyers don't know that fact, burn it into their consciousness.) Lease option tenants can expect to pay first and last month's rent, a security deposit, and, more than likely, an option fee (a payment for the right of purchase) of $1,000 to $5,000 (possibly more). Taken together, all of these up front payments create lower risk for you the property owner.

Higher Rents. Lease option tenants agree to pay higher-than-market rents because they know you will apply a part of that monthly rent to the property's purchase price. The tenants view these "rent credits"—actually you should name them *purchase price credits*—as forced savings that may count toward a lender's required down payment.

The higher rent payments increase your cash flow and lift your cash-on-cash return. In high-priced areas where newly bought rental properties awaken a huge alligator, the increased rent of a lease option can work to alleviate his hunger.

Guaranteed Profits. Experienced investors know that fewer than 50 percent of lease option tenants take advantage of their right to buy the subject property. Sometimes they change their mind. Sometimes their finances fail to improve as much as they'd hoped. Sometimes their personal circumstances shift (separation, divorce, job relocation, additional children).

Whatever the reason, the tenants forfeit (at least in part) their rent credits, option fee, and any fix-up work they have performed around the house. As a person, you may feel badly for the tenants. But as an investor, their loss means your gain. You end up with more profit than you would have earned under a traditional rental agreement.

Even if the tenants do buy, you still win, because in setting your option price, you built in a good profit margin over the price you originally paid for the property. This technique works especially well in transactions where you have bought at a bargain price. In addition, you gain more than you would have from a listed sale of the property because you didn't have to pay costs of promotion or Realtor commissions. You also save time and effort.

For investors, the lease option makes for a win-win agreement. You win if your tenants buy. You win when the tenants don't buy and walk away from their investment in the property.

The Lease Option Sandwich

The lease option sandwich magnifies your *potential* profit. Instead of buying a property, you find sellers who will lease-option their property to you

at both a bargain rental rate and a bargain price. Typically, these sellers were not advertising their property as a lease option. In fact, they may not even have thought of the idea until you put a proposal in front of them.

Through this lease option, you control the property for two to five years. Your cash out of pocket totals less than you would probably have paid in closing costs had you immediately bought the property.

Next, you spend some money on spruce-up expenses (if desirable) and re-advertise the property specifically as a lease option. You find tenant-buyers and sign them up on a lease option with you as the lessor. Your tenant-buyers agree to pay you a higher monthly rent and a higher option price than you've negotiated for yourself in your role as lessee/optionee with the property owners. You profit from the difference.

Your rate of return skyrockets because you gain control of a property with almost no cash investment. The up-front money you've collected from your tenant-buyers exceeds the amount you paid to the property owners. Essentially, you buy wholesale and sell retail—without investing much cash in inventory.

Does the Lease Option Sandwich Really Work? Theoretically, it can work. Robert Allen and James Lumley, for example, two well-known real estate investors and book authors, claim to have used this technique successfully to generate big returns with little or no cash.

Although I have bought and sold with lease options, I hesitate to use or recommend the lease option sandwich. For my taste, giving someone an option to buy a property that I don't yet own seems fraught with dangers. *In theory*, though, it can yield high returns. If you're interested in biting into a lease option sandwich, read James Lumley's *5 Magic Paths to Making a Fortune in Real Estate Second Edition* (John Wiley & Sons, 2004).

How to Find Lease Option Buyers and Sellers

To discover the best deal on a lease option, look beyond sellers who advertise lease option. These sellers are retailing their properties. You might find it tougher to negotiate a bargain here. So, also contact motivated for-sale-by-owner (FSBO) sellers in the "Homes for Sale" ads. Or try property owners who are running "House for Rent" ads. As noted, the best lease option sellers may not realize how the idea can benefit them until you suggest it.

In your search for tenant-option-buyers, you might see three ad categories from which to choose: (1) homes for sale, (2) homes for rent, and (3) the specific category "lease option" that some newspapers and web sites include. No one can say which ad category works best in your market. Experiment with each of these choices. To learn which one is pulling the

best responses, ask your callers to tell you in which category they saw the ad. Research which listings draw the largest number of qualified callers.

A Creative Beginning with Lease Options (for Investors)

To start building wealth fast without investing much cash up front, try the lease option approach of Suzanne Brangham. Although Brangham stumbled fortuitously into her investment career, you can follow her path more purposefully. From her book *Housewise* (p. 39), here's Suzanne's story:

> While searching for the ideal career, I was also looking for a place to live. I located a lovely but dilapidated apartment house. The building was making a painful transition from rentals to condominiums. Units were for sale or rent. But sales were practically nonexistent.
>
> With my head held high, preliminary plans, and a budget tucked under my arm, I decided to make the manager an offer he couldn't refuse.
>
> I told him that in lieu of paying the $800-a-month rent that was asked for a 2-bedroom, 2-bath unit, I would renovate the entire apartment. I would agree to spend $9,600 for labor and materials, the equivalent of a full year of rent payments. Along with a 12-month lease, I also requested an option to buy the unit at its $40,000 asking price.

Three months later, Brangham was on her way. She bought her renovated condo unit at her lease option price of $40,000. Then, simultaneously, she sold the unit to a buyer for $85,000. After accounting for renovation expenses, closing costs, and Realtor's commission, she netted $23,000. Brangham no longer had a home, but she had found a career.

Twenty years, 23 homes, and 71 properties later, Brangham had become not just independently wealthy, but a nationally recognized author, speaker, and entrepreneur, as well. In *Housewise,* she tells about her renovation experiences and the career she found by chance. *Housewise* includes hundreds of profit-making ideas that you can apply to buy and renovate fixers.

LEASE PURCHASE AGREEMENTS

As a practical matter, the lease purchase agreement works about the same as a lease option. However, instead of gaining the right to either accept or

reject a property, the lease purchaser *commits to buying.* As an investor, you might persuade reluctant sellers to accept your lease purchase offer, even though they could shy away from a lease option. The lease purchase seems more definite because you are saying that you will buy the property—but you would like to defer closing until some future date (six months to five years, more or less) that pleases you and the sellers.

"Seems" More Definite

I say "seems" more definite because you might escape through a loophole. You can (and should) write a clause into your purchase contract called "liquidated damages." With a liquidated damage clause, the sellers could not sue you to force you to complete your purchase if you later choose to back out. Nor could they sue you for any monetary damages that they may suffer that arise out of your failure to buy. Instead, the liquidated damage clause permits your sellers to pocket your earnest money deposit (or some other specified amount).

In effect, your liquidated damage money acts like an option payment. No matter what the purchase contract appears to say, in reality you have not firmly committed to buy.

Amount of the Earnest Money Deposit

The real firmness of either a lease option or a lease purchase contract lies in the amount of the up-front money the seller receives—regardless of whether it's called an option fee, liquidated damages, or an earnest money deposit. If you want to convince a seller that you intend to complete a lease option or a lease purchase transaction, put a larger amount of cash on the table. At the same time, to keep some flexibility, negotiate the smallest walk-away fee that you can, even if it means yielding more concessions in the other terms of your agreement.

Contingency Clauses

You can also escape from your obligation to buy a property through the use of contingency clauses. If the contingency (property condition, ability to obtain financing, lawyer approval, sale of another property, etc.) isn't met, you can walk away from a purchase and rightfully expect the return of your earnest money or option fee. Contingency clauses, option fees, and earnest money deposits are discussed in Chapter 10.

CONVERSIONS

Rental apartments now sold as condominiums. . . . Gas stations now operating as retail outlets (7-Elevens). . . . Old homes converted to office space. . . . Farm acreage now occupied by a shopping center. These properties are examples of adaptive use of both land and buildings brought about by a locale's growth and change.

Conversions provide opportunities for entrepreneurial investors. Converting an old house located in the downtown area can earn you good profits. Small offices sometimes rent at twice the per-square-foot rental rate of housing. The opposite can also prove true. In London and New York City, housing prices climbed so high that investors converted retail, warehouse, and offices into apartments (rental and condominium).

Several years ago, Badger Development in Lansing, Michigan, bought strategic corner locations in the path of the city's outward growth. The company purchased single-family homes on a good corner location, with the long-term intent to convert these homes to a more profitable rental use. This method proved superior to buying similarly located vacant land. The houses generated rental income until growth made conversion profitable.

Converting land and buildings weaves straw into gold. But how can you take advantage of these changes in land use? First, obtain a zoning map from your city's planning department. Each part of the city zones areas (single-family residential, multi-unit, mixed-use, agricultural, commercial, and industrial) into districts. An existing house located within a commercial zone offers good prospects. If the property you wish to convert is located in a residential zone, it requires a change in zoning to accomplish your objective. To apply for a variance or zoning change costs money, time, and effort. Somewhat easier to convert are those properties that sit near the class of zoning district that you wish to convert to. Check with your local planning department and ask about the probabilities and procedure. Also, see the book, *The Complete Guide to Zoning* (McGraw-Hill, 2005).

Condominium Conversion

To convert an apartment building into individual condominium units, purchase the apartments inexpensively enough so that each unit can be easily converted to a saleable condo. Because of legal procedures and incidental costs to convert, not to mention the time and effort, as much as a 1.5× to 2.0× rule of thumb is sometimes required. In other words, to earn a good profit, a $100,000 rental unit might have to sell for $150,000 to $200,000 as a condo. Conversions require a large price markup to cover marketing,

renovation, and legal costs, plus the risk necessary to make such a conversion. Notwithstanding these financial realities, last year nationwide investors converted more than 250,000 rental apartments into condo units.

To convert rental apartments into condominiums, submit plans to the planning and zoning office that show how you intend to make the conversion. If the city planners decide that your plan complies with applicable laws, they advance your project to the public hearing stage. If not in compliance, changes, such as additional parking, bathrooms, or more handicap access may be needed before they move you to the next step. Planners may also raise the "affordable housing" objection. In the San Francisco Bay Area, apartment building owners could convert their rental units to condos and reap large profits. But alas, the city tightly limits the numbers of conversions to maintain the supply of rentals. Few other cities restrict conversions with such strict controls.

To prepare for a condo conversion, study the market to learn what comparable condo units are selling for. If you can purchase an apartment building at a low enough price, renovate it, sell the converted units, and earn a profit while absorbing time and costs to convert, then you can earn some fast (not easy) money.

To calculate potential profits from a condo conversion, consider this 8-unit apartment building example:

Acquisition price	$480,000
Rehab at $15,000 per unit	120,000
Attorney fees (condo document preparation, government permitting process, sales contract preparation, closing document review)	40,000
Marketing costs (advertising, sales commissions)	45,000
Mortgage interest (12-month renovation and sellout)	50,000
Incidentals (architect, interior design, landscaping, government permits)	35,000
Total costs	$770,000
Cost per unit	$96,250

In this example, the investor paid $480,000 ($60,000 per unit) to acquire this 8-unit rental property. After all costs of conversion, her total investment increased to $770,000 ($96,250 per unit). But these figures haven't yet considered profits. If the investor wants to net $20,000 per unit, she will need to sell the units at a price approaching $120,000 each (twice the amount of her original per unit purchase price).

The figures in this example merely illustrate this conversion technique. Every cost item from acquisition to incidentals varies widely. Each depends on the local market, the specific property, the amount of

renovation work, the complexity of the condo conversion laws and procedures, and the marketing strategy adopted. To estimate whether such a project is feasible in your area, research rental properties, condo prices, and conversion laws. Do some scratch-pad feasibility calculations. If estimates look promising, talk with a monied investor, contractor, attorney, and/or real estate consultant experienced in the conversion process. With the knowledge gained from these talks (and follow-up research), decide whether this investment approach offers enough profit potential to compensate for risks such as cost overruns, slow sales, and government permitting delays.

Tenants in Common

In some parts of the country, oppressive rent control and tight condo conversion laws make it difficult to convert rental apartments into condominiums even though such conversions would prove profitable. However, innovative real estate investors and entrepreneurs created ways to circumvent these restrictive regulations. In Berkeley, California (commonly known as the People's Republic of Berkeley), and other left-wing-dominated cities in the San Francisco Bay Area, innovative investors pioneered a conversion concept called TIC.

The term "TIC" (pronounced T-I-C) stands for tenant in common and is a popular form of joint ownership that's been given a unique twist to create a hybrid property—something between, say, a co-op and a condominium.

As the plan typically has worked in the Bay Area, an investor (or group of investors) locates, say, an older four-unit rental house that, because of rent controls, suffers a depressed market value of $600,000 ($150,000 per unit). As individual condo units, the apartments would sell for $250,000 each, for a total building value of $1,000,000; however, restrictive conversion laws eliminate this possibility.

But here's where creativity counts. Investors buy the property. They then advertise for four households (individuals, married couples, partners, friends, families) who would like to own one of the individual units. Once found, they sell them pro rata shares of ownership in the total building at a price of, say, $200,000 each (if the units are of unequal quality, the pro rata division would charge some owners more and others less). Next, the respective joint owners enter into long-term leases for "their" units with all the other owners. Also, they would need to follow the law to end the tenancy of the building's current residents.

Although all of the TIC members jointly own the entire building, in a practical sense, each becomes the proprietor of a specific unit. Later, if one

of the co-owners wishes to sell his or her share of the building, she can do so. The buyer pays the seller an agreed price for her ownership interest in the total property and obtains long-term leasehold rights to the unit.

Besides sidestepping condo conversion restrictions, you can legally form and market a TIC with much less cost and documentation than a condo conversion. In fact, with a TIC you merely sell a building to a group of co-owners; no special laws may apply.

Although the TIC concept in rental properties has been implemented primarily as a response to excessive government, you need not be limited to that use. Even if you don't live in a "People's Republic," explore this investment technique in your area. Because you can more easily structure a TIC than a condo conversion, it can provide you experience in "buying wholesale" and "selling retail." As drawbacks, though, you might find it tough to locate a lawyer who can provide competent legal counsel—and explaining the concept to potential buyers and building co-owners can require patience and close instruction.

To discover more about the TIC concept, take a tax-deductible trip to the San Francisco Bay Area and talk to investors, unit owners, and attorneys who have firsthand experience with these types of properties. Maybe you can pioneer the concept in your area.

Convert Apartments to Office Space

Office space can sometimes rent for twice the rental rate of comparable quality apartments. From this fact, it appears profitable to convert apartments to office space. But first answer these questions:

Is the property you wish to convert within a commercial zone? If not, will the city change the zoning?

What is the vacancy rate for office space in the area and the specific neighborhood of the subject property? If empty space remains available, what market strategy can strengthen your competitive advantage?

Do you have adequate parking for office space? The city may require one parking space for every 500 to 1,000 square feet of rentable office space—depending on the specific use.

How much will it cost to convert? Can you borrow money to finance the conversion? Will your costs, legal procedures, time, and effort pay off?

Study the property and the market. Figure the finances of the projected conversion. If you can convert at a reasonable cost and earn a good profit, weigh risks and rewards. Then decide.

MASTER LEASES

To control a property, own it. But you can control a property through use of a master lease, as well.

Say you locate a 12-unit apartment building that is poorly managed—as most are. You consider buying the property. But you don't have the financial power to arrange new financing, and the owner doesn't want to sell the property using a land contract or purchase money mortgage. At present, the property brings in barely enough rents to pay expenses, property taxes, and mortgage payments. The owner wants to turn this money pit into a moneymaker but lacks the will to invest time, effort, money, and talent.

The solution: Master lease the entire building and guarantee the owner a steady, no-hassle monthly income. In return, you obtain the right to upgrade the building and property management to increase its net operating income (NOI).

A master lease gives you possession of the property for a period of 3 to 15 years and an option to buy at a prearranged price. During the period of your lease, you pocket the difference between what you pay to operate the property, including lease payments to the owner, and the amounts you collect from the individual tenants who live in each of the apartments. Here's how the before-and-after numbers might look:

Before (Owner Management)	
Gross potential income at $500 per unit	$72,000
Vacancy losses at 15%	10,800
Effective gross income	$61,200
Expenses	
Utilities	14,400
Maintenance	8,360
Advertising	2,770
Insurance	3,110
Property taxes	6,888
Miscellaneous (evictions, attorney fees, bad debts, vandalism, pest control, bookkeeping, etc.)	5,000
Total expenses	40,528
Net operating income	20,672
Mortgage payments	19,791
Before-tax cash flow (cash throw-off)	$881

After (New Management)	
Gross potential income at $575 per unit	$82,800
Vacancy losses at 4%	3,312
Effective gross income	$79,488
Expenses	
Utilities	2,230
Maintenance and upkeep	13,200
Advertising	670
Insurance	2,630
Property taxes	7,300
Miscellaneous (evictions, attorney fees, bad debts, vandalism, pest control, bookkeeping, etc.)	2,500
Total expenses	28,530
Net operating income	50,958
Leasehold payments to owner (master lessor)	25,000
Before-tax cash flow (master lessee)	$25,958

How can you achieve such a profitable turnaround? (1) Upgrade the property and implement a systematic maintenance program; (2) attract and retain better tenants through improved aesthetics and attentive management; (3) individually meter the apartment units to reduce utility expenses; (4) raise rents to reflect the appealing condition of the property and the pleasant ambiance created by higher-quality, neighbor-considerate, rule-abiding tenants; (5) shop for lower-cost property and liability insurance coverage; and (6) reduce turnover and encourage word-of-mouth tenant referrals to eliminate advertising expenses.

Not only did this property turnaround increase the NOI, but correspondingly, the higher NOI, lower risk, and more attractive apartments added value to the property. When you execute your option to buy, you can borrow 100 percent financing to pay off the owner, yet still give the lender a 70 to 80 percent loan-to-value ratio as measured against the property's now higher market value.

In lieu of buying the master-leased property, you could sell your leasehold and option rights to another investor. Given the higher NOI that you've created, these rights will command a premium over the amounts you pay. In effect, an investor would invest to acquire the right to earn $25,958 per year (plus future increases) for the remaining term of the master lease, as well as the right to buy the property at the below-market, option-stipulated price.

The master lease follows the same principle that Four Seasons and other hotel operating companies use. Investors build and own the hotel building and then contract with a name brand hotel to manage the room rental operations. In turn, the management company may "sublease" out the bar and restaurant businesses to specialized operators. Some retailers operate similarly.

A master lease (i.e., essentially a management contract) with option to buy can create significant profit opportunities for investor-entrepreneurs who will work to turn a poorly managed, run-down property into an attractive, effectively operated apartment building. You can also apply this strategy to offices, retail, self-storage, and mobile home parks. Harry Helmsley, the late New York property mogul, operated the Empire State Building under a master lease.

ASSIGNMENTS: FLIPPING PURCHASE CONTRACTS

Some contracts to buy or option a property permit you to assign that contract to another investor. This technique, which is called contract flipping, offers profit opportunities with relatively little up-front cash investment.

A developer announces plans to build a high-rise condominium project with units priced from $225,000 to as much as $775,000. The builder promises delivery of the completed units within 18 months. With an earnest money deposit of $20,000 you contract to buy an apartment. You pick a choice-view unit priced at $500,000. During the construction period, this project receives rave reviews and wonderful publicity. Buyers sign up on waiting lists. The value of your reserved unit jumps to $600,000. Yet your purchase contract gives you the right to buy that unit at a mere $500,000. What do you do? If you want a quick $100,000 profit, "flip" your contract. Assign your right to buy this unit for a payment of $100,000. You've just made a quick five-fold return on your original investment.

If this new project receives bad reviews, if mortgage interest rates skyrocket, or if the local economy goes into the tank, if the builder does not deliver as promised (quality, timing), the market prices of these units could fall, and you may have to forfeit your $20,000 deposit. Though often called investors, contract flippers speculate; they do not invest.

You need not limit use of this technique to projects under construction. Some savvy investors scout the market for bargain-priced existing properties, place the seller under contract with a small deposit, and then locate another buyer who will pay them a fee (premium) for the right to step in and buy the property on the favorable terms previously negotiated. Although any type of contract flipping creates risks, for those who

are skilled in spotting underpriced properties, this technique can yield high returns in short time periods.

During the hot housing markets of the recent past, flipping properties became almost as popular as the super bowl. In Dubai, UAE, where I have worked off and on for the past 5 years, investors (speculators) flipped more than 50,000 new units at premiums of 30 to 100 percent. In Las Vegas, house-flipping bets were thought risk free—a better deal than the casinos.

With fortuitous timing, flipping can make you some big piles of fast money. But when you rush for the exit too late—as many did—you can lose much more than your deposit when prices fall and your contract obliges you to pay $500,000 for a property now worth—at most—$300,000. That's why off-plan property flippers in Las Vegas, Miami, and Dubai are searching for lawyers who can find a purchase contract loophole that will permit the flippers (now stuckees) to escape from their deals.

SUMMARY

Buy, manage, and hold for increased rents and property appreciation remains the best time-tested, effective way to build wealth in real estate. As an alternative strategy, however, you can buy, fix up, and resell your properties using a lease option purchase contract. Under the right market conditions, this technique can increase your returns two ways:

The option price you offer your tenants should exceed the price you paid for the property plus the amounts you paid for improvements, and during the rental period, your rent collections and option fee monies will exceed the monthly income you would receive from a straight rental. Once you develop a system that will work in your market, the lease option investment technique can prove to be a real moneymaker.

In addition to lease option, other investment tactics include the fix and flip, property conversions, TICs, master leases, and contract assignment. Although each of these techniques involves risk, specialized expertise, and market knowledge, in the right circumstances, any one of them can pay off with high profits.

If high property prices and negative cash flows appear to block your efforts to make money in real estate, keep trying. Put one of these alternative strategies to work. Yet even these great ideas don't complete your possibilities. Chapter 15 illustrates other attractive real estate opportunities. As promised in Chapter 1, if you educate yourself and put a plan into action, real estate rewards you with multiple possibilities to profit.

10

NEGOTIATE A WIN-WIN AGREEMENT

Negotiators typically combine, in differing degrees, three negotiating styles: (1) adversarial, (2) accommodating, and (3) win-win. Most lawyers rely on the adversarial style. They make outrageous demands. Then they push, pull, or threaten to move you as close as possible to their position. Adversarial negotiators don't care whether their opponents end up satisfied. All they care about is winning for themselves.

In contrast to the adversarial approach, the accommodating negotiator easily gives in to every request. Accommodators feel powerless to create the outcome they really want. They often feel the lack of money, time, information, knowledge, or experience. Accommodators detest conflict. They would rather lose than stand their ground. When negotiating through a real estate agent (or other third party), accommodators shed their responsibility. "Oh, just do whatever you think is best" or "Let's just agree and get the whole thing over with" are two responses of accommodators.

To pursue a win-win negotiation, adopt a little of the adversarial style and a little of the accommodating style. Most importantly, adopt a more complex perspective. Win-win negotiators recognize that every negotiation brings forth multiple issues, priorities, and possibilities. You must identify and respect the other party's (not opponent's) concerns, feelings, and needs. Win-win negotiators do not think along a single line of contention—especially that of price.

Win-win negotiators work to secure a firm, mutually beneficial agreement. Everyone commits most of all to finding a way to make the agreement work well for all parties. As you read through this chapter, learn

to stand strong. Learn to shape a win-win agreement. Learn to stand against the win–lose mindset of the adversarial hardballers. Learn to accept responsibility. Stand clear of becoming a "passive-accommodator" whose eagerness to do a deal traps them into unwise concessions.

WIN-WIN PRINCIPLES

To negotiate win-win, adopt these 15 principles:

1. Before negotiations begin, find common interests to explore. Postpone talk about price and terms. Chitchat to warm the relationship before you get down to business. Engage in a cooperative spirit. You win the game when you invest at a good price, not when you drive a potential seller away because you insist on scoring a minor point.
2. To negotiate, cooperate. Negotiations set off an emotional experience with each party feeling his own needs, wants, and ego. Learn the seller's perspectives. Express empathy.
3. Sense when to stop. Feel tension building. Push for that last dollar in purchase price or that last concession and you can kill agreement and the working relationship. Push too hard and you destroy trust. When parties lose trust in each other, they knock win-win off the table.
4. Listen to the seller reject, object, and propose. Determine what the seller really wants. Often people seek results indirectly. Bring forth real wants/needs and the negotiations will yield a more rewarding outcome. Disagreements can arise because two parties do not communicate what they think they are communicating. Listen more than you talk.
5. Use questions to identify needs. Know that the way you phrase questions can rank as important as knowing what questions to ask. A priest asked his bishop, "May I smoke while praying?" Permission was denied. Another priest asked, "May I pray while I am smoking?" Of course, you know the answer. Phrase questions to identify a seller's needs without causing offense. ("Why did you paint the walls with such tasteless colors? I will have to repaint everything. You've got to knock another five grand off your price.")
6. Provide reasons and benchmarks to support your viewpoints. Likewise, learn the seller's factual foundation, sources, and interpretations.
7. Never quickly say no to a proposition suggested by a seller, even when you think the offer ridiculous. Take time to reflect so that the seller's views seem important. Return the negotiations to the overarching goals you hold in common with the seller.

8. Remind the seller of the property's negative features, but do so in a way that doesn't provoke retaliation—especially when you negotiate with a homeowner. Speak of the market, the features, or the decorating schemes that tenants prefer. Say nothing to insult the seller's tastes or handiwork. Say, "Tenants usually prefer tile or laminate flooring." Don't say, "How do you think I could get this place rented with that marbled purple carpet and that pink foil wallpaper?"

9. Sellers expect to negotiate (as opposed to agreeing flat out with your requests). Remain flexible. Even though price and terms may rank most critical to the negotiations, possession date, closing costs, closing date, personal property, repair escrow, and other issues provide trade-off points.

10. Stay realistic. You may face a seller's market or a buyer's market. You may face a timid seller or an assertive one. You may meet sellers where the wife is eager to sell, but the husband couldn't care less. Each negotiation differs. Focus on the context of the transaction. When markets get so hot they provoke bidding wars, you stay cool. Heated competition makes it difficult to obtain a good buy. When buyers beg sellers to accept their offers, property prices have shot up too far.

11. Concede slowly with reservation. Say yes too quickly and a sophisticated seller will press on for more easy victories. Hesitate. Suggest tit for tat. Give, but ask for something in return.

12. Beware of oral concessions. Oral concessions tip your hand to a higher price or other unfavorable terms that you might accept. Or sellers may encourage you to commit orally to a price. Then, once the seller feels you are committed that far, he or she will write his offer for an even higher amount. Each time you offer or counteroffer, write out your price and terms. Use a contract-of-sale form and adjust the relevant terms that are subject to the negotiation. Each party then initials those changes.

13. Negotiate with risks in sight. When you reject a seller's counteroffer, that counteroffer dies unless the seller chooses to revive it. Likewise, when you counter a seller's offer, your counter kills the seller's proposal. A seller or buyer may withdraw an offer or counteroffer without obligation—even if the withdrawing party has promised to keep the offer open for a stated period. (If someone pays to keep an offer open for a specified time, then that person has purchased an option to buy [or sell].)

14. Stockpile information early. The more you learn about a seller's financial capabilities, family situation, likes and dislikes, priorities, time constraints, available alternatives, previous offers (accepted or rejected), past real estate experiences, perceptions about the property's condition and value, and any other factors that might bear on the transaction, the

better you can design your offer and negotiating strategy to the seller's situation and personality.

> You not only need to collect this information; you need to collect it as early as possible while you are in the relationship-building stage of your negotiations. When you incite a contentious debate over price and terms before you stockpile the information you want, sellers clam up. They guard their disclosures closely. Most sellers can play coy. They put forth their own information agenda in terms of what they would like you to believe. Don't accept seller admissions or explanations as fact. Look for nuggets of truth, but finely tune your bunkum detector.

15. Set reference points and benchmarks for the negotiation. Sellers base their asking price and terms on reference points. The seller may believe that comparable properties have sold with a monthly gross rent multiplier of 175, or maybe a cap rate of 6.5 percent, and will therefore apply those norms to figure a fair price for his or her property.

To negotiate effectively with a seller who holds ideas contrary to yours, learn the reference points the seller is using, and why. Once you gain this information, explain why those norms aren't applicable and why the reference points you've selected are appropriate. Point out that the comp properties with cap rates of 6.5 percent are newer (better location, more stable tenants, better condition, etc.) than the seller's property. In fact, the comps most similar to the seller's property have typically sold with cap rates in the range of 7.0 to 7.5 percent.

The seller may know the house down the street just sold for $380,000, but doesn't realize that its owners carried back financing at 5.0 percent and included $35,000 worth of personal property. You can try, "I'll give you $355,000. That's my top offer. Take it or leave it." But you only set the stage for win-win if you first persuade the seller to accept a reference point that's favorable to your offer. Then edge the seller toward the agreement you want.

THE PURCHASE CONTRACT

No "standard" purchase contract exists—even though many purchase contract forms include the word "standard" in their title. Read each clause of any purchase contract you use to write your offer. The following discussion identifies some—but not all—issues to look for in a sales agreement.

Names of the Parties

Name all parties to the transaction. Ideally, all of the named property owners should sign your offer as soon as you've reached an agreement. Do not negotiate with a seller whose co-owner spouse or partners do not join the negotiations. Later on, if they don't sign, you lose the deal and you've wasted time and effort.

Some sellers claim that their co-owners will go along with whatever agreement they set. Yet after you commit, the seller will come back and say, "Gee, I'm terribly sorry. My partner refuses to sign. He thinks I'm giving the property away. He wants another $250,000, but I've told him I can't renege and change the terms. But he insists. So I'll tell you what—if you can just move your offer up by a mere $100,000, I'll go back to my partner and do my best to convince him to go along. I'm really sorry, but sometimes this guy's a jerk, and there's little I can do to reason with him."

This "good-guy-bad-guy" ploy stands as one of the oldest tricks in the book. But it often works. Sellers (and buyers) continue to use it. Just don't be surprised when sellers try it on you—if you negotiate with someone who lacks the legal authority (or feigns to lack authority) to sign off on the agreement.

Site Description

Identify the subject property by street address *and* legal description. Walk the boundaries of the property as you refer to a survey or a plat. When walking the boundaries, note any encroachments. Verify that the size of the lot you're buying actually matches the size you think you're getting. Especially where a subject site borders a vacant lot, field, creek, or other unclear property line, assume nothing. The lot lines may not run where they appear to run. Physically verify where surveyed boundaries actually lie.

Building Description

As a matter of law (except for condominiums), a real estate agreement only needs to specify site description—not the building itself. The legal definition of real estate (a legally described site by definition) includes all structures permanently attached to that site.

If the seller represents that the buildings are of a specific size or are built of certain materials, or of a certain historic date or design, then write those features (whatever they are) into the property description. In Berkeley, California, buyers sued the sellers of a gracious old home because the sellers had (mistakenly) told the buyers that the home had

been designed by Julia Morgan, a famous Bay Area architect of the early 1900s. The buyers claimed that they had not just agreed to buy a house on a specific site. Rather, they had contracted to buy a Julia Morgan house. Because the house lacked the Julia Morgan prestige, the buyers believed they were entitled to damages. (The court agreed and awarded damages to the buyers.)

If you buy a pre-war brownstone, or maybe the house where Dwight Eisenhower was raised, write it into your agreement. Detail what you expect to receive. Should your expectations (the seller's material representations) prove false, you can rescind the contract, claim damages, or perhaps both.

Personal Property

Although real estate includes land and buildings, it does not necessarily include the personal property that may form part of your agreement with the sellers. (Generally, the term "personal property" refers to items that are not "permanently" attached to a building or the land.) Say the sellers of a fourplex provide their tenants window air conditioners, miniblinds, ranges, refrigerators, and ceiling fans. If you offer to buy that property, expressly list these items in your written purchase contract.

While it's true that many courts have broadened the concept of real estate to include personal property that is "adapted for use" with a specific property, do not depend on litigation to force the sellers to convey the personal property that you believed to be included in the sale. Leave no doubt—write it out. Walk through every room of the property and identify and list every item that the sellers might plausibly maintain was not a part of your purchase agreement because it was their "personal property" and therefore not included with the sale of the real estate.

You list personal property for another purpose, too. You want the sellers to identify what personal property belongs to them and what belongs to their tenants. Property investors who do not obtain an accurate list of the seller's personal property may later find themselves in dispute with tenants when the tenants claim, "That refrigerator is ours. That junk icebox the landlord provided was carted off to the dump two years ago. We bought this refrigerator from Betty's parents." To deter such claims, ask the tenants to sign off on any list of personal property that the sellers prepare.

Price and Financing

When you write your offer, spell out precisely the purchase price of the property and the terms of the financing. List the amounts payable, how

payable, when payable, and the interest rate(s). Make it easy for a disinterested third party to interpret your meaning. Leave nothing to decide at some later date. "Seller agrees to carry back $20,000 on mutually agreeable terms" does not meet the contractual requirements of specificity.

If you plan to arrange new financing, or even if you assume the seller's mortgage, the same advice holds: Clearly state the amount and terms of financing. Several years ago, I agreed to purchase a property and assume the seller's below-market-rate mortgage. However, just before closing, the lender pointed out that it intended to increase the interest rate to the market level. Fortunately, my contract with the sellers specified that the mortgage assumption would come to me at the same below-market interest rate that the sellers were then paying. Rather than lose the sale and risk a lawsuit, the sellers had to buy down the mortgage interest rate from the rate the lender would otherwise have charged me.

If you agree to arrange new financing, spell out the maximum terms (e.g., 7 percent, 25 years, 20 percent down). Then, if it turns out that (in good faith) the best loan you can find is at 7.75 percent, 20 years, 25 percent down, you need not complete the purchase. You can walk away and obtain a return of your earnest money deposit. (But be sure your financing contingency seems reasonable to the sellers. As noted elsewhere, savvy sellers won't accept unrealistic contingencies.)

Earnest Money Deposit

Contrary to popular belief, the validity of your purchase offer *does not* depend on the amount of your earnest money deposit or, for that matter, whether you pay a deposit. Earnest money represents nothing more than a good-faith showing that you intend to complete your purchase. Choose your deposit amount as part of your negotiating strategy.

Large deposits position you as a serious buyer. Some investors use large deposits to offset their lowball offers. A large earnest money deposit affirms that "You can count on me to buy your property. This large deposit proves that I mean what I say. Wouldn't you rather go for a sure thing now rather than wait for a better offer that may never come along?"

A small deposit signals that you're financially weak, or that you're trying to tie up the property cheaply while you review your alternatives. But here's the rub: Smart sellers won't accept contracts that don't commit.

Whether sellers judge your deposit as large or small, serious or trifling, depends on local custom. Judge the desirable size of your deposit by the amounts local sellers and realty agents think reasonable for the type of transaction you're entering.

Just keep in mind that a seemingly low deposit diminishes your credibility. A relatively high deposit bolsters credibility. For the best of both worlds, employ a low deposit strategy and rely on other factors to support your credibility as a buyer, such as current ownership of multiple properties, strong FICO credit score (see www.myfico.com), high net worth, and personal integrity. But this tactic is not so easy to pull off. Ready cash persuades best.

Quality of Title

For assurance of title, retain a title insurer. Your purchase agreement will specify the title guarantees and exceptions that govern your transaction. Before you close the deal, review the title report. Especially when you buy properties through foreclosure, tax sales, auctions, probate, or other sales where the seller (title holder) of the property does not sign a general warranty deed, your risks of title issues increase.

Probate judges, clerks of court, sheriffs, and bank officials do not warrant a title in the same way that the previous owners could. You partially overcome these risks by purchasing title insurance.[1] But like all insurance contracts, title policies list a variety of limits, exceptions, and conditions. They do not cover everything. Although a title policy offers protection, you (or your attorney) must still identify title risks that remain.

Property Condition

Address the issue of property condition in two ways: First, ask the owners to complete a seller disclosure statement that lists every conceivable problem or defect that has now or ever affected the property or the neighborhood. In addition, ask what efforts the sellers, previous property owners, or neighbors have implemented to solve the problem. ("Oh yes, we kept blowing fuses, so we just rewired around the fuse box. Now we never have any problems." Or maybe, "Well, there was a crack cocaine house down the street, but the Neighborhood Watch group got the police to close it down.") The more you can get the sellers to tell you about the property and the neighborhood, the more accurately you can judge the property's potential risks, rewards, and value.

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[1] If available. Title insurers will not issue policies on some properties when too many uncertainties cloud the quality of the title. In such cases, you would buy the property only at a steeply discounted price. Once purchased, you would then try to resolve the title issues. If successful, you win big. A property offered with a clear title will bring a higher price than one that is burdened by major clouds or defects.

Second, although you can learn much from the sellers, you can't learn everything. Sellers can't disclose what they don't know. As added protection, include a property inspection contingency in your offer. Check out the property with one or more specialists who can verify the condition of the plumbing, heating and air-conditioning, electrical system, roofing, and foundation.

Your contingency clause can state that repair costs should not exceed some designated amount (say $1,000). Ideally, the sellers should pay these costs. But if you've negotiated a bargain price, you might expect to pay them. If repair costs exceed your specified amount, your contingency clause should give you the right to cancel the purchase agreement and obtain a refund of your earnest money deposit. (Remember, though, when you present a firm, no-contingency offer to the sellers, along with a large earnest money deposit, your power to extract price and other concessions goes up.)

Preclosing Property Damage (Casualty Clause)

Most purchase agreements require the sellers to deliver a property to the buyer on the date of closing (or the date of possession) in essentially the same condition as it stood on the date the purchase agreement was signed. If the property suffers damage (fire, earthquake, vandalism, hurricane, flood) after the purchase contract has been signed, but prior to closing, the sellers must repair the property at their expense. Alternatively, in the event of damage, the sellers may be allowed to terminate your purchase agreement and return the earnest money deposit to you.

Some purchase contracts used by HUD, VA, and Fannie Mae REOs, for example, shift this risk of preclosing damage to buyers. Read the precise language of your contract. If you accept the risk of preclosing property damage, check with your insurance agent. See if you can secure coverage to protect against property losses during this interim period.

Also, you may not want contract language that gives sellers the right to return your earnest money and terminate the purchase agreement should they find themselves unwilling or unable to repair any property damage. Say you bargain hard and get the sellers down to a price of $335,000. After accepting your offer, they begin to harbor second thoughts. Then along comes another offer at $355,000. Mysteriously, the property suffers a $5,000 fire. Now what will the sellers do?

They may drag their feet on repairs and claim problems settling with their insurer. Because they "can't" restore the property to its previous condition in time to meet the scheduled closing date, they cancel your contract and return your deposit. The sellers effectively used the casualty clause to shut you out of your bargain price.

To eliminate unwanted seller withdrawals, set the right to cancel the contract as your option, not the option of the sellers. And/or the contract could impose financial penalties on the sellers for failure to repair—or it could set up an escrow repair credit to compensate for the amount of the damage.

If you plan on bank financing, the bank may refuse to close your loan until the damage has been satisfactorily repaired. That puts you in a catch-22. You can't repair the property until you close your loan, but the lender won't close your loan until after you've made the repairs. This type of problem doesn't occur often, but if you prepare for this risk ahead of time, you and your attorney can draft a casualty clause that adequately protects your interests. (To resolve this issue with a lender, you could set up a $5,000—or some other appropriate amount—repair escrow account.)

Closing (Settlement) Costs

Property transactions can eat up thousands of dollars in closing costs. Title insurance, appraisal, mortgage points, buy-down fees, application fees, lender-mandated repairs, lawyers' fees, assumption fees, recording fees, transfer taxes, document stamps, survey, property inspections, escrow fees, real estate brokerage fees, and other expenses can quickly add up to a fair-sized chunk of money. Who pays each of these costs—the buyers or the sellers? Local custom suggests, but negotiation can override custom. If the sellers won't drop their price as low as you'd like, shift your emphasis to settlement costs.

Sellers who won't cut $5,000 off their asking price will sometimes agree to pay that much or more in settlement costs that are traditionally borne by buyers. (Indeed, a 3–2–1 interest rate buy-down that costs the sellers $5,500 might prove more advantageous to you than a $5,500 reduction in price. A reduced interest rate improves your cash flow and/or qualifies you for a larger mortgage.) When it can work to your benefit, give the sellers their price, but as trade-off. Request that they pay all (or most) of the closing costs. (Caution: Recall the pitfalls of "you name the price, I'll set the terms.")

Closing and Possession Dates

Purchase agreements set dates for settlement and possession. When sellers (or buyers) strongly prefer a quick (or maybe delayed) closing date, that date can play a role in the negotiations. Because of a need for ready cash, the sellers might trade a lower price for a fast settlement. Or for tax reasons, the sellers may prefer to delay settlement for six months or more.

The same goes for the date of possession. The sellers could prefer to close quickly, but they might want to hold onto the property (especially if it's their home) for some period that extends beyond the settlement date. Maybe the construction of their new house isn't yet complete. Maybe they would like to postpone moving until their children finish the school term. Reasons vary, but as a smart negotiator, feel out the sellers on their preferred closing and possession dates. Then use this information to shape your offer. If you're willing to meet the sellers' needs on this issue, they will more likely move closer to the price and/or terms that make the deal acceptable to you.

Leases

When you buy rental properties, read each of the tenant's leases before you write your offer. Especially weigh these issues:

- *Rent levels.* How much do the tenants pay in rents? Are any tenants in arrears? Have any tenants prepaid? How long have the current rent levels been in effect? Are today's market rents above or below the rental amounts tenants currently pay?
- *Concessions.* Did the tenants receive any concession for signing their leases such as one month's free rent, a new 18-speed bicycle, or other incentives that lower the effective amount of rents the tenants pay? Do any tenants "pay" high rents only because of an under-the-table agreement with the sellers to help improve the income statement that the sellers show prospective buyers? Sometimes sellers pad their rent rolls.
- *Utilities.* Do the leases require the tenants to pay all of their own utilities? If not, which utilities do the owners provide?
- *Yard care, snow removal, and other services.* Who provides yard care, snow removal, or other services such as small repairs within the rental units? Who pays for garbage and trash pickup? Do the leases obligate the sellers to provide tenants laundry facilities, off-street parking, a clubhouse, exercise room, childcare center, or transportation?
- *Furniture and appliances.* Is the owner obligated to provide tenants with window coverings, furniture, or appliances? If so, precisely which ones? What quality? Who retains responsibility for maintenance, repairs, and replacements?
- *Duration.* What term remains on each lease? Do tenants enjoy the right to renew? If renewed, does the lease (or do rent control laws) limit the amount of rent increase that you can impose? Will the market and/or tenant relations support a rent increase?

- *Security deposits.* What amount of security deposits has the owner collected from the tenants? Have tenants prepaid their last month's rent? Do the sellers retain an inspection sheet that shows the condition of each of the units at the time the tenants moved in? Have the tenants signed those inspection sheets?
- *Tenant confirmation.* Ask the tenants to confirm the terms of their leases as the sellers have represented them. Determine whether the sellers (or their property manager) have entered into side agreements with tenants that would modify or override the terms of the written lease. Learn whether the sellers have orally promised any of the tenants special services, rent relief, or other dispensations.

When you buy a rental property, you must honor valid leases. Such obligations not only affect the amounts of your future rental income and operating expenses, but they also restrict your plans to re-tenant, renovate, or convert (e.g., converting rentals into condominiums). Although you own the property, the tenants were there first. Their valid leasehold rights trump your rights of ownership.[2]

Contingency Clauses

Most investors hedge their purchase offers with contingencies that relate to financing and property inspections. If an investor can't get financing, or if the condition of the property doesn't meet the investor's standards (as written into the purchase contract), the investor can walk away from the contract and receive a return of his or her earnest money.

Other Contingencies. In addition to financing and inspection contingencies, you can condition your purchase offer on any number of other issues. If you plan to renovate the property, you might include a contingency for government permits. If government doesn't approve your plans, you can pull out of the purchase without penalty. You might include contingencies when your plans are subject to regulatory review (e.g., converting apartments to condominiums, rehab with rent increases, increasing or decreasing the number of rental units, eliminating on-site parking, asbestos removal, etc.).

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[2] Some owners place a "cancellation upon sale" clause into their leases. Except under unusual circumstances, most tenants should reject a lease with such a clause—if they noticed it. (As with all lease clauses, if found "unconscionable," "deceptive," or "unfair" or contrary to government-issued landlord tenant laws, courts can refuse to enforce such clauses.)

Other types of contingencies pertain to attorney review, the sale of another property, raising funds from coinvestors, professional market value appraisal, or even some type of market study (feasibility analysis). Indeed, as a buyer, you can condition your purchase offer on anything you want to, ranging from the approval of Uncle Harry to an eclipse of the sun.

Contingencies and Negotiation Strategy. Even though you *can* condition your offer on anything you want, that doesn't mean the sellers will accept it. They may tell you, "No way are we going to take our property off the market for several months while you try to put together a syndication deal. Come back and talk to us after you've raised the money." The more you hedge your offer with deal-threatening contingencies, the less likely the sellers will sign it. Whereas a clean "no-strings-attached" offer might gain the sellers' approval even when price or terms you have offered don't meet their hopes or expectations.

Sellers prefer firm offers. Selectively choose your contingencies. Weigh them into your negotiating strategy. Write an offer that looks certain to close. You may find that your sellers will relax demands on other important contract issues.

Assignment and Inspection

Buyers may (or may not) be permitted to freely assign their purchase contracts to another buyer. Talk this issue over with qualified counsel. As a buyer who (at least on some occasions) would like to flip a contract, verify whether the sellers can contractually object. To avoid conflict, insert an assignment clause similar to the following: "Buyers may assign this Contract and all rights and obligations hereunder to any other person, corporation, or trustee."

The sellers should oppose such broad language and try to negotiate language such as: "Buyer may assign this Contract only with the written approval of the sellers. Consent by the sellers shall not be arbitrarily withheld."

The sellers should normally want the right to approve your assignees just to satisfy themselves that the assignees possess the credit and financial capacity to complete the purchase. The sellers may want you to remain liable for damages (or specific performance) should your assignees default. You would like to avoid (or limit) that liability.

When you obtain the right of assignment, insert a clause that permits you reasonable access and entry to the property so that your potential assignees can inspect and evaluate it. Without the right to show the property, the right to assign loses some of its effectiveness. (When flipping

off-plan properties—as was so popular during the boom years—the "right of entry" clause becomes a moot point.)

Public Records

When you contract for a lease option, lease purchase, contract for deed, or some other type of purchase offer that delays closing of title for, say, more than six months, consider a clause that permits you to record a notation of your contract in the public records. Recording serves notice to the world of your rights in the property.

Without this notice, the sellers could place mortgages or other liens against the property that could jeopardize your interests. Also, without a recording, the sellers' judgment creditors, or perhaps the Internal Revenue Service, might gain a priority claim to the property. Discuss these issues with competent local legal counsel. Do not make payments to the sellers over a period of years, only to find later that the sellers cannot deliver clear title.

Systems and Appliances

Whether your closing occurs within 30 days or three years, your contract should lay out who is responsible for interim maintenance, repair, and replacement of malfunctioning systems (heating, air-conditioning, electrical, waste disposal, well water) or appliances. For example, if the air-conditioning (AC) stops working, the sellers may want to repair it at a cost of $450 in lieu of a new replacement unit that costs $4,200. Yet if a repair only keeps the old AC clanking and clunking for, at best, 6 to 12 months, you should insist on replacement—or discount the contract price.

Environmental Hazards

Heightened costs for environmental cleanups and extensive regulatory controls mean that your contract must address environmental hazards that could affect the property. Lead paint, asbestos, urethane formaldehyde, underground heating oil tanks, radon—and who knows what other dangers the Environmental Protection Agency may discover—can cost property owners thousands in remedial or replacement expenses.

Include a contract clause as follows: "Sellers warrant that the property complies with all current federal, state, or local environmental laws, rules, or regulations. Sellers agree to indemnify buyers for all required cleanup costs that shall be necessary to remedy environmental hazards that existed during the sellers' period of ownership."

This language only suggests, but it covers two main questions that you want answered: (1) Is the property free of hazards? (2) If hazards are discovered, who pays for the cleanup? Under federal (and many state) laws, any owner of a property may be personally required to pay for environmental cleanup—even when that owner is completely innocent of creating the hazard.

No Representations

Up to this point, we've looked at contract clauses from the buyer's perspective. When you sell a property, include a clause something like the following: "All oral or written representations or promises of the sellers pertaining to this agreement, or material to inducing this agreement, are listed herein."

Why is this clause necessary? To protect you from property buyers who falsely claim that you made promises such as—"We'll leave all of the appliances for you" or "The roof's in perfect condition." In their attempt to void a contract or force you (the seller) to pay for repairs or replacements, buyers (and especially their lawyers) know that claims of "fraud in the inducement" can justify damages or contract rescission in court.

Will the buyers win their lawsuit against you? Are you prepared to spend $10,000 or $20,000 in legal fees and court costs to find out? Don't believe for a minute that old saw, "It's just their word against mine." Yes, it is. But that's no guarantee a judge or jury will believe you over them. Remove from your buyers the chance to falsely claim you lured them into a contract through deception.

Default Clause

Your contract default clause should spell out what happens if you or the sellers fail to carry through the terms of your purchase agreement. These clauses address at least four areas:

1. Method of resolution
2. Damages
3. Specific performance
4. Who bears the expenses

Method of Resolution. Many people are quick to file a lawsuit when another party breaches an agreement. Other options for resolution include mediation and arbitration.

If you pursue a lawsuit, you will probably lose even if a court's decision goes in your favor: You will spend tens of thousands of dollars in legal fees; you will see truth and justice perverted beyond recognition; you will encounter lawyers whose dishonesty and incompetence are exceeded only by their arrogance; you will expose yourself and your private life to public view through intrusive discovery procedures that permit lawyers to question you (admissions, interrogatories, depositions) in minute detail about anything that could *in any way* be related to your character or the issues being litigated.

The litigation process itself can require you to live through years of anxious uncertainty, and even winning verdicts can be overturned on appeal for purely technical reasons, thus starting the trial process all over again.

Lawsuits enrich lawyers, judges, and a myriad of expert witnesses, jury consultants, court reporters, legal secretaries, and photocopying services. They do little to settle disputes in a fair, timely, and cost-effective manner.

Admittedly, mediation and arbitration also fail in many ways. But to their advantage, they are less costly, less adversarial, more timely, and more likely to emphasize substance over procedure. Talk with people who have sought redress through litigation. Then decide for yourself whether to specify mediation and arbitration to resolve contract disputes.

Damages. A party who breaches a real estate contract may be held liable for either compensatory damages or liquidated damages. In theory, compensatory damages are supposed to make the innocent party financially whole. Such damages measure the economic loss you've suffered because the other party didn't live up to his or her part of the bargain. Translating the theory of compensatory damages into an actual dollar amount is subject to legal argument. Because of indefinite calculation, no one can predict how much money a jury might award, or whether an appellate court will uphold that amount.

To avoid this legal wrangling over how much you (or the sellers) lost because of the other party's breach, some contracts specify an amount called *liquidated damages.* For example, in case of buyer default, some real estate contracts permit sellers to keep the earnest money deposit as liquidated damages.

I won't go into all the specific pros and cons of compensatory versus liquidated damages. But as a rule, liquidated damage clauses seem superior because (properly written) they reduce ambiguity and, in the case of buyer default, limit liability to a knowable amount (e.g., typically, the earnest money deposit). Nevertheless, if you can locate an experienced real estate attorney who is competent, trustworthy, and bills reasonably

(not an easy task), discuss this issue with him or her. Understand the type of damage clause included in your purchase offer. Use this clause to limit your liability.

Note: In some states, and in some types of contract cases, winning litigants may also recover damages for emotional distress, but this is rarely the rule. In cases of fraud or other egregious behavior, some states permit awards for punitive damages. In contrast to compensatory damages, punitive damages punish the losing party for reprehensible conduct. These issues involve technical interpretations of statutes and case law in light of the facts of a particular transaction.

Specific Performance. In addition to a claim for damages, some contracts (or contract laws) give buyers (and less frequently, sellers) the right to seek specific performance. This right means that through legal proceedings (arbitration or lawsuit), a court could order defaulting property owners to sell their property on the terms specified in your purchase contract. You would pursue this remedy when only a subject property fits your special need (e.g., to compel the sale of a vacant lot next door to your apartment building so that you can satisfy the city's off-street parking requirements).

Who Bears the Expenses? Whether you pursue mediation, arbitration, or litigation, the dispute resolution process can easily run up thousands (or tens of thousands) of dollars in costs and expenses. Therefore, look to your purchase contract to see what it says about who pays. Even though today we hear about "loser pays" types of laws and contract terms, don't accept such a clause without really thinking through what you are agreeing to.

First, lawyers lose many cases where their clients are in the right. Lawyers fail to prepare; they err in tactics or strategy. Judges may rely on their biases rather than on the weight of the evidence. Or perhaps key witnesses come across poorly on the witness stand. The other side may lie in a convincing and unshakable manner. Even in the most righteous cases, victory seldom triumphs without risk.

Second, if the other side can easily spend more money than you, they can hire the best and most expensive counsel to overwhelm and intimidate you and your counsel. With such firepower against you, even if you are willing to risk losing your case, you may not be willing or able to face the opponents' legal expenses of, say, $50,000 or $100,000 (yes, even lawyers in small-time litigation can run up fees of this size if someone has the money to pay them). Regardless of the merits of your case, the potential outcome of bearing the other side's legal expenses may force you to accept an unfavorable settlement.

My purpose here is to inform, not advise. Your purchase contract will include important clauses that govern the relationship between you and the sellers. Read these contract clauses before you sign your offer. Only

then can you (or your counsel) rewrite, amend, or strike out unacceptable language. Once you and the sellers commit, you're both bound to the extent of the law. Protect yourself. Fashion your offer so that you know and understand the full import of your agreement—including what recourses and costs apply if the deal falls apart.

SUMMARY

You don't just find great deals—often you create them. Regardless of the sellers' asking price and terms, investors should elicit and sort through the sellers' real needs and emotions. Then, negotiate an agreement that gives both parties a win-win agreement.

Although all negotiations touch upon personal and situation-specific issues, you improve your bargaining skills when you adopt the 15 negotiation principles presented at the beginning of the chapter. Negotiators frequently place too much emphasis on price and terms. Your contract will govern many other issues. As a minimum, address the following 14 areas of concern:

1. Does the contract include the names and signatures of all buyers and sellers?
2. Are the site boundaries accurately delineated? Have you walked the site boundary lines?
3. Are the building and other site improvements adequately identified and described?
4. Does the contract or contract addendum list all personal property and fixtures included in the sales price? Should you ask the sellers to prepare a separate bill of sale for these items? Does the seller hold clear title to all the personal property that is to be conveyed?
5. Have the sales price, term, and financing contingency been spelled out so precisely that a disinterested third party could unambiguously interpret the agreement?
6. What is the amount of the earnest money deposit? Under what conditions will it be returned to the buyers?
7. What types of deed must the sellers use to convey title to the property? Is the title free of encumbrances? If not, what liens, easements, encroachments, or other encumbrances cloud the title? Is the title insurable? What exceptions apply?
8. What is the condition of the property? Have you obtained adequate seller disclosures and professional inspections? Have you negotiated an escrow credit for repairs?

9. Who bears liability for preclosing casualty losses? Under what conditions can the buyer (or seller) terminate the sales contract as the result of preclosing casualty losses? Who has responsibility for preclosing repair or replacement of systems and appliances?
10. What settlement costs are to be paid by the sellers? The buyers?
11. What are the dates of closing and possession?
12. Have you examined all leases that apply to the units occupied by tenants? Has the present owner of the property entered into side agreements with any of the tenants? Have you confirmed with the tenants the rental information provided by the sellers? Have you identified the tenants' personal property?
13. How many contingency clauses have you included in your offer? Are your contingencies consistent with the negotiation strategy you have adopted?
14. Have you protected yourself against environmental hazards that may require expensive clean-up costs? What methods of dispute resolution are provided by your offer? What types of default remedies are available to you and the sellers? Who pays the costs?

You are negotiating an agreement that includes many issues. Negotiate a full complement of trade-offs and conciliations. When you hit a negotiating impasse, shift your focus. Rethink and rework the contract terms. Keep searching cooperatively to satisfy the critical issues of concern for all parties.

11

MANAGE YOUR PROPERTIES TO INCREASE THEIR VALUE

When you invest in real estate, you directly influence—for better or worse—the cash flows that your properties yield and the values of those properties. Market conditions matter, but you matter more. You need not wait for a decline in market vacancy rates. You need not wait for improved market rental levels. You need not wait and hope for market appreciation. Through more effective property management, you can boost the rents, occupancy, and value of your properties within just 3 to 12 months after your purchase—even with no favorable change in the market.

THE 10:1 RULE (MORE OR LESS)

Recall the value (V) formula:

Value = NOI (net operating income)/R (capitalization rate)

If your property acquisition yields an annual net operating income of $25,000 and the applicable R equals .10 (10 percent), its market value equals $250,000. After you acquire ownership, you apply the ideas from Chapter 8 to figure out ways to boost your property's rental income and cut its operating expenses to increase your NOI by $5,000 a year. You've just added $50,000 to the market value of your property:

Added value = $5,000/.10 = $50,000

Or, alternatively,

$$V = 25{,}000 + 5{,}000\ (NOI)/.10\ (R)$$
$$= \$300{,}000\ \text{(versus the old value of } \$250{,}000)$$

Can you achieve such gains in NOI? Yes! Here's why: Most small income properties suffer from subpar management. Ill-informed, poorly motivated, and inattentive property owners dominate the field. (In fact, to build wealth fast, aggressively seek out undermanaged and ill-managed properties. You can multiply your beginning equity 10 times over within a short few years.

Think First

Under-managed properties dominate because investors often fail to clarify their personal and financial objectives. These investors know that they want to "make money in real estate," but they don't think through the types of tenants, properties, and neighborhoods that best fit their temperament and lifestyle.

Instead they buy their properties according to whether they can get a "bargain price" or "easy financing." Or worse, they buy a property because some professed guru has urged them to "get started now." (Notice those testimonials on the TV infomercials where people enthusiastically remark, "We were able to buy our first property just three weeks after studying your course. Thank you, guru." Do "get started now," but start now means to research properties and areas—it does not urge you to rush out and buy within a matter of days or weeks.)

Through some combination of work and luck, a few of these guru protégés do achieve long-term success. Many more, though, aren't prepared for the potential problems, difficulties, and downside of unwise acquisitions. They find that they hate dealing with their tenants and their properties. Disappointment sets in. Neglect becomes their standard operating procedure. Their properties deteriorate, and their tenant relations sour. Eventually these investors sell out and then lament to anyone who will listen, "Owning rental properties takes too much time and creates too many headaches. It's a never-ending stream of things going wrong."

To avoid this trap, know yourself, know your finances, and know your capabilities. To succeed in real estate (as well as in any other endeavor), pick through your likes and dislikes, strengths and weaknesses. Affirm that your properties, tenants, and neighborhoods match up well with who you are and how you want to live your life. Otherwise you, too, can end up frustrated, careless, and burned out.

Know Yourself

Do you seek pride of ownership? Would you like to point out the properties you own to friends and relatives? Would you deal effectively with tenants who sit below (or above) your socioeconomic status? (For example, some owners detest their low-income Section 8 tenants, while other blue-collar owners detest their well-to-do, arrogant, college student tenants.) Do some neighborhoods or types of tenants threaten your sense of safety? Are you the kind of person who easily gets suckered by a hard-luck story?

Before you invest, think about the types of properties that you would enjoy owning. No matter how good the price or how easy the financing, avoid properties that clash with your MMPI.

Trust me. I know from experience. When I began to buy properties, I looked at the financials of a deal—not my personal psyche. Accordingly, my portfolio grew to include an eclectic mix of single-family houses, duplexes, and fourplexes with differing price ranges, types of tenants, and neighborhoods.

This odd collection of properties taught me a great deal. I learned that I liked some of the tenants and that some of the properties were great to own. Other types of tenants and properties seemed to evoke a long list of hassles. I also fell for many hard-luck stories.

However, once I settled on an acquisition and management strategy (including tenant selection) that better fits my personality, I enjoy my properties, my profits, and my life. At that time, middle- to upper-middle-income single-family houses proved most desirable to me. In terms of cash flow, this strategy reduced my cash-on-cash return, but I felt the trade-off was worth it.

Nevertheless, some prosperous investors do seek out low-end tenants (see Roger Neal's *Streetwise Investing in Rental Housing*, Panoply Press, 2000). In most cities, low- to moderate-priced properties offer the highest rental yields. And these types of properties serve up potential for management turnarounds on a silver platter. Choose the type of property that will work for you. You will make good money—as long as the property fits your personal (and financial) profile. Properties that disappoint and frustrate seldom yield satisfactory returns.

Know Your Finances

Property ownership requires a safe level of cash reserves. Without cash (or wise credit), you'll fail to invest in upkeep, maintenance, and improvements. Properties grow in value only when you give them the TLC they need. Shortchange upkeep only if you primarily hold a property for its land value (i.e., a potential teardown or a major rehab). To manage your

properties profitably, you just can't pull money out—you must also put money back in. Many "no down payment" gurus neglect to emphasize the need to reinvest.

Know Your Capabilities

During my early years in property ownership, I attempted some property repairs, remodeling, and renovations myself. For me, bad idea! I lacked the required talent and skills. I lacked the temperament. Rather than save money (my goal), many of these "do-it-myself" projects ended up over budget and low-quality.

Projects that I thought I could complete in a week often lasted a month or more. Sometimes I lost more in rent collections than I would have paid for a competent contractor. In fact, if I had hired a contractor in the first place, I would have saved myself substantial aggravation. (Admittedly, working with contractors can aggravate, too.)

The moral: Assess your capabilities before you buy a property. Many investors fudge a property's expense numbers to persuade themselves that a proposed deal looks better than it really does. They omit expenses for this and that because of their "I can do it myself" self-talk. But even if you can do it yourself, at least enter a bookkeeping expense for the value of your own labor.

If you focus on management operations and let others execute, you'll typically make more money and avoid the burnout that plagues so many owners who try to do everything themselves (and then sell at a distress price to rid themselves of their headaches and money traps).

Moreover, when you delegate the manual labor, you free your own time to think, research, and plan your investment strategy. I am convinced that most owners of small income properties could improve their bottom line if they would manage their strategy more than they fret over the small stuff. Think more, work less. That approach leads to effective, value-creating property management.

(Note: Do-it-myself did provide valuable knowledge and experience in everything from air conditioning to zoning and building permits. For this reason—rather than save money per se—do-it-myself gave me the practical ability to manage, supervise, and negotiate the work I now have performed by others.)

SMART STRATEGIC DECISIONS

Owners of modern apartment complexes research their market strategy. These owners know that market strategy can pay big returns. Yet real

estate books aimed at small investors rarely mention the terms "strategy" or "market strategy."

Why? Because most authors of such books seem to believe they have discovered the "one true way" to buy and manage properties. They believe that what has worked for them will work for you. Maybe it will. But more than likely, you can do better if you formulate your own strategy to match your capabilities, your finances, and the current market conditions that you face.

By "strategy," I mean that you should collect market data and design a value proposition (rent level, property benefits, location, promotion, lease clauses) to profitably differentiate your properties and management services from those of competing owners. With a well-positioned strategy, you can collect more rents and experience less turnover, quicker rent-ups, and more satisfied tenants.

Local Markets Require Tailored Strategies

Real estate markets differ in time and place: types of properties, price ranges, price movements, inventories, rent levels, expenses, laws, tenants, tenant preferences, employment trends, vacancy rates, and dozens of other variables. You can't mimic an investment plan created by someone who gained his or her experience in a different city at a different time. To enhance your rent collections and property values, monitor the ever-changing characteristics of a specific market(s). Then adapt.

Craig Wilson's Profit-Boosting Market Strategy

To see strategy in action, follow the experience of Craig Wilson. Craig bought an undermanaged eight-unit apartment building located within one mile of a small college. Craig felt that he should direct his marketing efforts toward college students.

Yet Craig also knew that "college students" did not define a true market segment. You cannot accurately stereotype college students any more than you can stereotype any other group of people who happen to share one characteristic. Recognizing this fact, Craig set out to learn about those diverse college students who rent off-campus.

Discovering Student Beliefs and Attitudes. Like all smart small business owners, Craig knew that to begin his market research, he needed to understand his potential customers. To achieve this end, Craig:

- Thumbed through back issues of the campus newspaper to read articles and letters to the editor that addressed student-housing issues.

- Met with the director of the off-campus student housing office.
- Talked with a sampling of students who stopped by the off-campus housing office to look at property listings.
- Talked candidly with each of the current tenants of his newly acquired building.
- Hired a marketing student to solicit responses to a student-housing survey (questionnaire).
- Reviewed "for rent" ads in the newspapers and on the web.

Although none of Craig's survey techniques followed the sampling techniques of a Gallup Poll, they did provide insights about student attitudes and the property choices available to them. Students levied these complaints about their residences and living conditions.

Too much noise
No laundry facilities
Too little closet space
Rents too high
Inadequate parking
Authoritarian/obnoxious landlords
Unkempt appearance
Inadequate security
Lack of privacy
Plumbing/hot water problems
Too little storage space
Outdated kitchens/baths
Inadequate heating/cooling
No pets
Slow repairs
Cockroaches, ants
Too few electrical outlets
Lack of cleanliness

With this customer feedback in hand, Craig collected more data on competing properties.

Collect Details about Competing Properties. Most rental property investors never personally evaluate their competitors' offerings. You must avoid this error. Without firsthand knowledge of competitors, you're shotgunning in the dark. You may hit your target, but not likely.

How can you create a competitive edge if you don't personally inspect and evaluate the features, benefits, and rent levels of competing rental units? You can't. Lacking this knowledge, you will set your rents

too low or too high. Or you miss easy ways to improve your property's features to achieve comparative advantage.

To manage proactively, Craig researched competitors: (1) He phoned in response to two dozen ads and recorded basic property and rental information; (2) he made appointments and visited a dozen properties; and (3) he performed follow-up research after one-, two-, and four-week intervals.

Telephone Advertisers. After a search of listings from newspaper ads, property signs, Internet listings, and the off-campus housing office, Craig telephoned 24 property owners or managers. From these calls, Craig learned:

- The ease or difficulty of reaching these owners and managers
- Their degree of competency with telephone selling skills (courteous, informative, pleasant, persuasive)
- The addresses of their units and the specific types of property (single family, duplex, fourplex, etc.)
- Property amenities
- House rules
- Important lease terms, clauses, and rental rates
- Amount of deposit
- Repair, lawn care, and utility expenses (who pays, how much?)

As expected, some owners and managers were more forthcoming than others. But overall, this research gave Craig a knowledgeable feel for the rental housing market. To make sure he didn't forget (or ignore) pertinent facts, Craig recorded competitive data on a survey form that he had prepared for this task.

Inspecting Properties. To follow-up this research, Craig scheduled viewing appointments or attended open houses for 12 of these competing rental units. During these property visits, Craig sized up both the specific property and its owner/manager. He gathered information about floor plans, bathrooms, kitchens, total square footage, room sizes, decorating patterns, cleanliness, appearance, soundproofing, views, ceiling heights, electrical capacity, laundry facilities, appliances, parking, storage, and security.

When possible, he picked up copies of leases and application forms. He also judged the personality and demeanor of the owner/manager. Would this person's attitudes, words, and behavior attract or repel good tenants? Did he or she seem eager to please and sincerely interested in providing tenants a pleasant place to live? Or did he or she seem to issue dos and don'ts like a boot camp drill sergeant?

The Callbacks. After property inspections, Craig ranked each of the properties according to its appeal. Then he affirmed his impressions with market feedback. To learn how quickly (or slowly) each unit rented, he checked back during the month to see which units remained on the market. This information added to his knowledge of tenant turnoffs and turnons. He also figured out which units the prospects rejected due to excessive costly, or perhaps, undesirable features.

As you develop a market strategy for your property, exploit the weaknesses of competitors and strengthen your own offering in the eyes of the customers (residents) you plan to attract. Market data gives you clues and insights.

Without such details, your strategic decisions (if the term "strategic" even applies) evolve merely from guesstimates or intuition. Or all too often, they arise from default—"Well, that's the way we've always done it," or "That's the way everyone else does it." Maybe so. But you can figure out a more profitable approach when you derive your decisions from thorough information about prospects and properties.

How Craig Wilson Used Market Information to Enhance the Profitability of His Property

The methods you use to position your property will differ from the strategy that Craig Wilson (or anyone else) has adopted for his properties. Nevertheless, follow through the ways Craig chose tenants and designed his property features and operations to gain competitive advantage. By adopting similar methods, you can plan your own strategy.

Tenant Segment. After Craig stacked up the housing complaints and comments of students against the typical rental property and owner/manager, he decided to design his property operations to appeal to students who placed high value on quiet, aesthetics, cleanliness, security, and a pleasant, easy-to-get-along-with owner. In addition, he wanted students who showed responsibility in managing their finances, studies, college activities, and employment. From among the many students who were searching for apartments, Craig wanted to select the top tier. To attract this tenant segment, Craig knew that he had to offer the features and benefits that these students would value highly.

Privacy, Quiet, and Storage. To provide his tenants with privacy, quiet, and storage, Craig modified his property three ways:

1. *Study room.* On a portion of the roof, he built a heavily soundproofed 20-foot-by-30-foot study room. Many students in his target market had complained that they found it difficult to read

or study in their apartments while their roommates watched television, played CDs, or entertained friends. This study room also eliminated another problem: Students who wanted to get in just a couple of hours (or less) of study time no longer had to bear the inconvenience of returning to campus in the evenings.

2. *Party room.* As another benefit, residents could reserve the study room on weekend nights for parties or other group gatherings. This use met the needs of not only the tenants who wanted to party, but also those who did not want to hear the party noise.
3. *Storage.* To overcome market complaints of inadequate storage space, Craig bought eight seven-foot-by-six-foot-high gabled storage sheds and placed them behind a wooden fence on each side of his building. These facilities could store skis, infrequently used sports equipment, bicycles, boxes of books, and other assorted items.

Security. To enhance the safety and security of his building, Craig replaced the hollow-core entrance doors to each unit with solid doors equipped with double dead-bolt locks and peep scopes. In addition, he equipped all windows with burglar pins and made certain that all window locks were strong and secure. To bolster fire safety, Craig placed a fire extinguisher in each unit and a smoke alarm in every room.

Landscaping, Grounds, and External Appearance. Although from a street and walk-up view this property looked reasonably good, Craig decided he wanted its attractiveness to stand out. He painted its wood trim; added decorative flowers, shrubs, rocks, mulch, and fencing; and replaced the building entrance doors with heavier carved-wood doors. While from a narrow economic perspective such changes might seem unnecessary, Craig believed they would help achieve four related purposes.

First, these improvements accented his pride of ownership as well as his goal to provide residents a desirable place to live. Second, since most prospective tenants judge a building from the outside before they look inside, these improvements would entice students to come in and view the vacant units when they became available. Third, by keeping the outside especially attractive, Craig felt he could appeal to students who would take better care of the property. (You cannot expect tenants to care for your property more than you do.) And fourth, by noticeably improving the exterior appearance of the property, Craig encouraged other nearby owners to do likewise and thus begin a spruce-up campaign that would benefit all of the neighborhood's tenants and property owners.

Laundry Facilities. The basement area of College Oaks provided space to install three sets of washers and dryers. Craig leased these units

from a commercial vendor. Under this lease, the vendor supplied and maintained the machines, and Craig earned a percentage of all revenues. While this operation was not expected to earn much (or any) profit for Craig, it did provide convenience for tenants.

Heating. College Oaks lacked individual furnaces in each unit. This deficiency created tenant discomfort. In winter months some apartments always seemed hot. Others felt cold. Nearly all apartments experienced a chill from 6:30 A.M. to around 8:00 A.M. To solve this problem, Craig removed the wall air-conditioning units and replaced them with units that included heating and cooling elements. Although these heating units could not produce heat as efficiently as the central gas boiler, tenant control did provide a cost-effective, much-appreciated improvement.

Kitchens and Baths. Craig knew that aesthetics and functional utility of kitchens and baths lead to tenant satisfaction (or dissatisfaction). To improve appearance, Craig painted the kitchens and added a splash of color with wallpaper borders. To enhance function, he added two electrical outlets and six linear feet of counter and cabinet space, and by changing the location of the refrigerator, he improved the efficiency of the kitchen work triangle (see Figures 11.1 and 11.2). To sharpen the bathrooms, Craig added new fixtures, artful decorating patterns, and spacious storage cabinets and shelving.

Upkeep and Cleanliness. Following the advice of George Kelling and Catherine Coles's book *Fixing Broken Windows,* Craig implemented a cleanliness and upkeep program for his building that never tolerated trash, dirt, cobwebs, or deferred maintenance. Lack of care invites tenants to drop their respect for the property. (*Fixing Broken Windows* shows

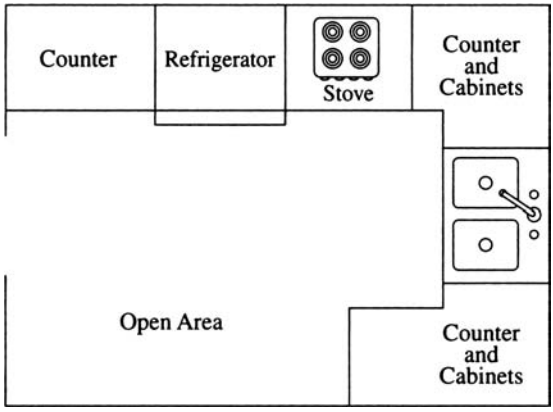

Figure 11.1 Old Kitchen Design

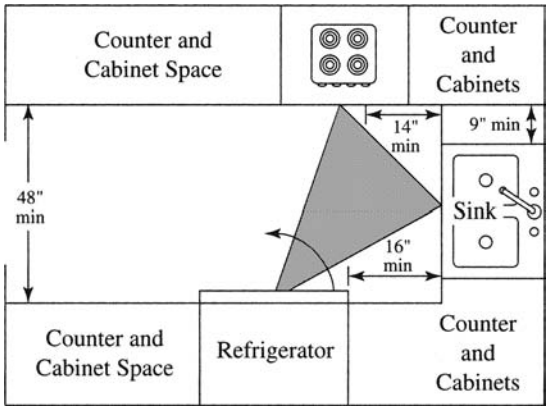

Figure 11.2 New Kitchen Design

that neighborhood and property condition drifts ever lower when "little things" are left unattended, or as my mother would say "Leave one dirty dish sit in the kitchen sink, and before you know it, you got a sinkful of dirty dishes.")

Tenant Selection. Craig knew from his research that many students preferred his management style vis-à-vis those of competing owners. He also knew that to execute profitably, he must choose tenants carefully. To achieve his goal, Craig adopted four practices:

1. *Appropriate conduct.* In talking with prospective residents, Craig emphasized the nature of his property operations and the strict types of resident conduct that he expected and required. In stressing these strict policies, Craig explained the benefits that would flow through to all tenants who lived in the building.

2. *Screening.* Craig emphasized that he wanted residents to exhibit personal responsibility. He requested credit references, references from present and past landlords, and employers. He also sought tenants who did not smoke or use drugs. He did not permit ear-splitting motorcycles or other loud vehicles. Applicants also needed a 3.0 or better grade point average.

3. *Rent level.* Because Craig wanted to offer his residents a strong value proposition, he kept his rent levels in line with other competing (yet inferior) properties. In this way, Craig received more tenant applications than he could accommodate; he pushed down the costly burden of vacancies and tenant turnover.

4. *Deposit.* Although Craig did not fully exploit the superiority of his property through higher rent levels, he did request a security deposit that was double the going rate. He explained to tenants that the large deposit discouraged applicants who would not live by house rules. One or two inconsiderate people can spoil the peace, quiet, and cleanliness of a property. Steering these people to other buildings enhances the quality of life for all of Craig's residents.

Results

When combined with expense reductions, Craig's market strategy paid off. Every indicator of success (NOI, property value, tenant retention, occupancy rates, word-of-mouth referrals, maintenance costs, pride of ownership, management time and effort) changed for the better.

Can you achieve similarly improved results for your property or properties? Definitely! Your opportunities remain wide open because so few owner/managers of small rentals think market strategy. Yet in every housing market, some types of tenants remain underserved. In every housing market, some property features, benefits, and management services remain in relatively short supply. Discover these market gaps, shape your property operations to fill them, and you will profit personally and financially.

CUT OPERATING EXPENSES

Every dollar you slice from your property's operating expenses adds $10 (more or less) to your building's value. With figures like that, meticulously keep track of all expenses. Then reduce, shift, or eliminate them. The following discussion provides some ideas.

Energy Audits

Nearly all utility companies will show you how to reduce your gas or electric bills. Some will perform an energy audit and inspection of your property. Others provide booklets or brochures and perhaps a customer service department to answer questions. You can find articles and books at your local library that discuss energy conservation. Google "energy audit" or "energy savings" and you'll get more than enough ideas.

Each type of building construction and area of the country presents different problems and opportunities. Seek how-to advice that fits your situation. Site placement and window positions can increase or diminish

energy costs. Energy-audit a building before you buy it. Judge beforehand the extent to which you can feasibly reduce these costs. Avoid energy-hog buildings for which no solution exists.

Property Insurance

When you buy property insurance: (1) Obtain enough coverage to protect your property, your rental income, and your other assets; (2) within your basic protection, reduce premiums by increasing deductibles or eliminating uneconomical coverage; and (3) shop among agents and companies for the best combination of service and low premiums.

Basic Protection. If you own a home, you obtained a homeowner's insurance policy. If you're like most homeowners, you haven't given that policy much thought. I know of this common oversight from a frightful experience. In the early 1990s, I was living in the Berkeley-Oakland, California, hills when a wildfire swept through and destroyed 3,300 houses and apartment units. Nearly one-half of the property owners who suffered losses discovered that they lacked sufficient insurance coverages and policy limits.

Property and liability insurance for income properties requires even more attention than policies written for owner-occupied residences. Rental property policies are subject to less standardization of coverage and greater variance in premiums. Before you "buy a fire insurance policy" and think you're covered, answer these seven questions with the insurance agents you're considering:

1. Who is covered? Typically, your insurance coverage protects only the named insureds within the policy. Therefore, take care to "name" all persons or companies (co-owners, mortgage lenders) whose financial interest in the property deserves protection.

2. What property is covered? On this point, insurance policies distinguish between the property you own and the property your tenants own. Policies seldom (if ever) cover tenants' property (advise or require them to buy their own tenant policy). Also, policies distinguish between personal property (appliances, lawn care equipment, assorted tools, and other items stored in the garage) and real property (the building itself, plants, shrubs, fencing).

Generally, the real/personal-property distinction most affects rental property owners who rent their units furnished. But if you keep personal property around or within a rental property, verify coverage.

3. What time period applies? Insurance policies don't just begin and end on specified dates. They begin and end at specified *times* on specified

dates. Assume you close a property purchase at 9:00 A.M. on 3 June. A fire breaks out at 10:30 A.M. You've ordered insurance coverage to begin on 3 June. You're covered, right? Not necessarily. That 3 June policy may not begin coverage until 12:00 noon. So don't assume; verify the exact dates and times of your protection.

4. What perils are covered? People think that fire represents the most critical peril to protect against. But what about flood, earthquake, vandalism, tenant abuse, windstorm, hail, mud slides, sinkholes, riot, theft, accumulation of snow and ice (on roofs that collapse), termite infestation, lawsuits, "trip and fall" accidents, and other potential losses too numerous to mention? Your policy will list covered perils. Read them. If not adequate, your insurer may add coverage through a rider or endorsement.

5. What losses are covered? Usually insurers classify losses as direct or indirect. A fire that damages your building creates a direct loss. The fact that you can no longer collect rents until the damage is repaired represents an indirect loss. Your basic policy will not cover many types of indirect losses. For these losses (if coverage is available) you need to buy a rider or endorsement.

6. What locations are covered? Normally, this question pertains to personal property that you may move from location to location. But also consider the following possibility: You've just loaded your F-150 with $4,000 worth of appliances, plumbing fixtures, and carpeting from Lowes. You plan to install these items at a fourplex you own. But while you're in the restroom at a gas station, someone steals your truck and its $4,000 worth of contents. Does your policy cover these contents? Maybe, maybe not.

7. How much will the insurer pay? Every insurance contract restricts how much it will pay for losses. Most policies include some combination of deductibles, limits, and coinsurance. In addition, for real or personal property, your policy might pay to replace, repair, or rebuild the damaged items with new materials (100 percent of replacement cost). Or the policy might only reimburse you for actual cash value (replacement cost new, less depreciation).

Within the same policy, different types and amounts of restrictions apply to the various types of coverages. For example, fire damage might subject you to a $500 deductible, whereas earthquake damage subjects you to a $10,000 deductible. Don't merely assume that your policy provides the amounts of coverage you want or need. Ask your insurance agent to explain *all* of the ways the company may restrict or limit its payment for your covered losses.

Also, even when you buy replacement coverage for your building, your insurer will probably not pay for repair or construction costs mandated by stricter building codes. Without an endorsement, your policy will pay only to replace your current building as it existed before it suffered damage. If, to rebuild, current code requires additional fire sprinklers or an upgraded 200-amp electrical system, without specific coverage, you'll pay these costs out of pocket.

Improve Coverage and Reduce Premiums. After choosing your basic coverages and endorsements, search through various policy deductibles and limits. Fine tune to identify the most cost-effective combinations. Avoid paying a lot for a little: Save money; increase deductibles and eliminate trivial coverages that disproportionately raise your premiums. Also avoid risking a lot for a little. Don't skimp on coverages that could protect you against large-scale, budget-busting losses such as huge liability claims.

It's more economical to avoid coverages for small frequent losses and extend coverage and limits for those rare but catastrophic exposures. To further save money wisely, ask your insurance agent to suggest loss prevention and loss reduction measures that you can undertake. Some insurers reduce premiums for properties equipped with hurricane shutters, fire sprinkler systems, burglar bars, and dead-bolt locks. In earthquake-prone areas, special foundation support systems merit a premium discount. What discounts for loss prevention (reduction) are available in your area?

Shop Till You Drop. Do not automatically place your rental property insurance with your current homeowner's insurance agent. By all means, discuss your needs with whomever you're already doing business. But don't stop there. Secure competitive quotes from at least three or four other sources. You might also solicit bids through several insurance web sites that are operating, such as www.insurance.com.

Of course, don't jump for the company with the lowest premium. Through *Best's Guide* or other consumer rating reports, verify the company's financial strength and its service in paying claims. Because property and liability insurers are licensed by state governments, check the company's record of performance with your state department of insurance. (Insurance company financial data and performance records can be obtained at your local library or through your state department of insurance web site.)

Insurance bores most people. But buying the right insurance at the right price not only affects your NOI, it just may save your net worth. Although property insurance premiums may cost thousands of dollars, failure to obtain needed coverages can cost you tens, or possibly hundreds, of thousands of dollars. Invest a few hours to review the costs and scope

of your protection. For your efforts, you will receive piece of mind and smart cost savings.

Maintenance and Repair Costs

Smart investors reduce and eliminate money-wasting property maintenance and repair expenses in at least five ways:

1. *Low-maintenance properties.* Your life will prove easier when you own properties that are built to require low maintenance. The same advice applies to yards, shrubs, and landscaping. Some require frequent pruning, cutting, watering, and fertilizing. Others fend for themselves quite well.

2. *Low-maintenance tenants.* Just as with properties, you'll also find low-maintenance and high-maintenance tenants. You will enjoy life more when you watch out for and avoid chronic complainers as well as people who show no "house sense." In my experience, you can slice at least one-half of your maintenance, repair, cleaning, and wear-and-tear costs when you select only those tenants who consistently accept personal responsibility. Contrary to the pleadings of tenants, things seldom break by themselves—nor do toilets stop up and overflow as an act of God.

3. *Repair clauses.* To promote house sense and tenant responsibility, a growing number of property owners shift the first $50 or $100 of every repair cost onto their tenants' shoulders. High security deposits also encourage care.

4. *Handyman on call.* Ease the drain on your time and pocketbook. Employ a trustworthy and competent all-around handyman (or persons) to take care of your property maintenance and repairs. On-site service calls in many cities now cost upward of $100. Establish a relationship with a person on whom you can regularly depend. This caretaker can save you cash—and worry.

5. *Preventive maintenance.* You take your car in for regular servicing. Apply the same principle to your income properties. Anticipate and alleviate problems when the cost is relatively small. Ask property maintenance experts how you might replace high-maintenance materials and components with low-maintenance substitutes.

Property Taxes and Income Taxes

Rely on a variety of tactics to reduce your property and income taxes. In total, taxes can eat up a large chunk of your rental income and gains in equity wealth. Fortunately, you can adopt a variety of tax-reducing plans to obtain partial relief. We cover these tips and tactics in Chapter 14.

INCREASING VALUE: FINAL WORDS

For at least the past 15 to 20 years, corporate managers have downsized, right-sized, outsourced, restructured, and slashed expenses, all the while searching for new customers, new products, and new ways of doing business. In some companies, such "strategizing" proved to be nothing more than cheap tricks to excite cheers from Wall Street and mislead investors. Yet, when executed in good faith, such corporate refocus does illustrate how strategic thinking and the never-ending search to cut costs wisely can boost net income and add value to businesses.

The same principle applies to investment property. When you approach your rental business with the attitude "I can design and develop more profitable (less costly, higher-yielding) ways to manage these properties," your results will improve. Professional managers of large shopping malls, office buildings, and apartment complexes have long benefited their properties through market research, strategy, property improvement, and cost reduction.

It's now past time for owners and managers of smaller investment properties to adopt a similar entrepreneurial pattern of thinking—and doing. For investors who follow the entrepreneurial approach, increased NOIs, cash flows, and property values remain easily available.

12

DEVELOP THE BEST LEASE

In the not-too-distant past, many owners of rental houses and smaller apartment buildings relied on oral rental agreements. Today that practice has mostly disappeared. Lawyers and their legalisms have pervaded ever-greater areas of American society—including the relations between property owners and tenants. Now, to protect themselves, property owners need to draft written rental agreements.

THE MYTHICAL "STANDARD" LEASE

By "draft," I mean that you must read and adapt any lease form that you might use. Do not fall for the myth of a "standard" lease. Lease forms vary. They omit clauses that you should include. They include clauses that you will want to omit or rewrite. Before you use any lease, explicitly think through the following issues.

Your Market Strategy

As part of your value proposition to tenants (your market strategy), I advise you to become known as a friendly, caring property owner and avoid using multipage fine-print lease forms written in legal jargon. Yes, these lengthy leases seem to thoroughly lay out your contracted rights and remedies. But their long lists of authoritarian dos and don'ts intimidate tenants and tear down trust and cooperative spirit.

To justify such leases, lawyers claim "you want to get everything in writing so that there's no room for dispute or faulty memory." Sounds good, but reality differs.

Legalisms Bite Both Ways. If you push your tenants to accept an oppressively legalistic approach, at some point, expect them to push back in kind. The more pages your lease entails and the more arcane its language, the more likely your tenants (or *their* lawyers) will find some word or clause to argue about. If lawyer and former president Bill Clinton could legally argue the meaning of "is," you can bet that, when confronted, your tenants and their lawyers (or some tenant activist group or housing agency) will creatively interpret your incomprehensible lease clauses in ways to favor their own arguments.

The Myth of a "Strong" Lease. According to lawyers, a "strong" lease is one where every clause binds the tenants into doing exactly what you want them to do. (If it were only that easy.) All too often, tenants do what they want to do—lease or no lease. Don't believe in the myth of a "strong" or "airtight" lease. In most cases, it's not the strength of the lease that determines whether your tenants conduct themselves in a manner consistent with your wishes. Rather, it's the quality of the tenants themselves.

A strong lease never substitutes for tenant selection. When push comes to shove, a strong lease *may* help you mitigate the aggravation and losses caused by troublesome tenants. But regardless of the language in your lease, only good tenants will make your days as a property owner profitable and enjoyable. As with all contracts, the parties—not the written words—bear primary responsibility for making the relationship work.

Joint Responsibilities? Because most leases are drafted to advance the contractual advantage of property owners, they routinely slight tenant rights and owner responsibilities. As part of your market strategy to attract quality tenants, your lease might display a more balanced treatment.

Many tenants view landlords critically. When you adopt a just approach, you display your good faith. Such an approach also reveals you as a cut above other property owners. And, since you do intend to fulfill your responsibilities, a listing of these responsibilities helps to educate tenants. More than a few tenants believe that owners of rental properties do little more than collect rents and get rich. You gain when you disabuse tenants of this notion. List your responsibilities and the expenses you agree to pay for within the lease (e.g., property insurance, property taxes, maintenance, appliances, replacement of capital items).

Joint Drafting? People feel more committed to agreements when they help shape them. Put this fact to your advantage. Discuss and draft your lease agreement with tenant participation. Naturally, you'll have a good idea of which clauses, conditions, and responsibilities you want to address (see "Crafting Your Rental Agreement" later in this chapter). But

some give-and-take encourages the tenants to feel like customers rather than serfs.

Win-Win Negotiating. Joint drafting provides another benefit. Your proposed tenant may suggest issues and trade-offs whereby you both win. When I first moved to Florida, I tried to rent a place to live for a period of three to six months. Before buying a home, I wanted time to learn the market and explore options. But because I desired a short-term tenancy and I owned a pet (a Yorkshire terrier), I faced slim pickings. As a result, I bought without as much search and research as I would have liked—and stayed in a motel for more than 8 weeks.

However, had I been able to secure a satisfactory rental house or apartment, some landlord would have gained a perfect tenant. I would have paid a premium rent and security deposit. Instead of this win-win approach, the property owners and rental managers I talked with stated their "no pets" policy. None even hinted at trade-offs that could have benefited all parties.

Think carefully before you adopt a lease. Even if you prefer not to draft a rental agreement jointly, keep the negotiating door open. Let the prospective tenants know that you can draft mutually advantageous changes. "Does this seem fair . . .?" "Are you agreeable to . . .?" "What if we . . .?" "How does this sound . . .?"

Search for Competitive Advantage

Most property owners view their lease strictly as a document that compels tenant performance. Although imperfect in that respect, written leases protect better than an oral agreement. But your leases should serve another important purpose: They should help you achieve competitive advantage over other owners of rental properties.

Your Lease Clauses. Before you decide on the specific clauses within your lease, review the leases of other property owners. Look for ways to differentiate your rental agreement that would encourage tenants (your target market) to choose your property over competing properties. To gain cooperative advantage, lower your up-front cash requirements, offer a repair guarantee, shorten (lengthen) your lease term, guarantee a lease renewal without an increase in rent, or place tenant security deposits and last month's rent in the investment of the tenant's choice to earn interest for the tenant's benefit.

Alternatively, develop "tight" or "restrictive" lease clauses that position your property as rentals that cater to discriminating and responsible tenants. Severely restrict noise and other nuisances common to rentals. Promote your property as "the quiet place to live."

You create cooperative advantage when you adapt the features of your property to the wants of your tenant market but also tailor the clauses, language, and length of your lease to match tenant preferences.

Explain Your Advantages. When you adapt leases to match the needs of your target market, you increase your rental revenues, achieve a higher rate of occupancy, lower your operating expenses, or some combination thereof. To realize these benefits, inform prospective tenants of the advantages you offer. Adopt the tactics of a successful salesman. Rather than show your property by rote, point out (from the tenants' standpoint) the desirable features of both the unit and your lease.

CRAFT YOUR RENTAL AGREEMENT

To craft a lease to fit your market strategy, you might draw from dozens of terms, issues, and contingencies. Although the following pages discuss "typical" practices, stay alert for ways to adapt (or omit) items to attract more profitable tenants. Feel free to ignore any of my advisories if you see a better way to structure the risk–reward balance of any specific clause. Indeed, I vary my own leases to match the tenants or the situation.

Properly drafted, your lease attracts premium tenants. Archaic legal jargon and an authoritarian demeanor drive good tenants into the rentals offered by your more market-savvy, tenant-responsive competitors.

Names and Signatures

Most property owners require a lease to name all residents who are permitted to live in the unit—including children, if any. All adult residents should sign the lease. Do not permit tenants to freely bring in additional tenants or to substitute new cotenants for those moving out. Require new tenants to pass your application and qualification process. (In some instances, the law might hold you liable for the negligent or illegal acts of your tenants.)

Joint and Several Liability

When you rent to cotenants (even if they are husband and wife—divorces do happen), include a "joint and several liability" clause. This clause makes all tenants individually responsible for all rents and tenant damages.

Without joint and several liability, individual cotenants often claim that they're liable only for "their part of the rent." Or alternatively, "I didn't burn that hole in the carpet. Jones did. Collect from him." In such cases,

Jones may have already moved out and disappeared. Joint and several liability at least gives you the contractual right to force payment from any other tenants who have the money.

Guests

When they take in additional roommates, some tenants fail to notify and gain your written approval. When you show up at the property and ask who these new people are, you'll be told "They're *guests.*" "Joe's just staying for a couple of weeks until he's called back to work at Ford." Two months later, Joe's still there, and now his girlfriend, Jill, has also taken up "guest" status.

Whether you might have to contend with these kinds of tenants depends on the type of people your property attracts as well as your qualifying standards. As a precaution, place a "guest clause" in your lease that limits occupancy for the unit and the time period that guests can stay.

Length of Tenancy

Many rental owners reflexively set their tenancies at one year. In some markets, the preponderance of properties requiring one-year leases creates a shortage (relative to demand) of properties available for shorter terms. Because short-term (especially seasonal) tenancies command higher rents, you might boost your rental revenues by appealing to such a potentially underserved market.

As another possibility, to reduce turnover and vacancy expenses, give tenants a slight discount on their rents. In exchange, the tenants would sign up for a lease term of, say, two or three years. Either way, leases for terms shorter or longer than one year might yield higher net income.

Holdover Tenants (Mutual Agreement)

A holdover tenant remains in his rental unit after the rental period expires. In some cases, leases for holdover tenants automatically renew for the same period as the original lease. In other instances, the lease converts to a month-to-month tenancy.

Unless your properties are located in an area with strong peak and valley rental seasons—as are college towns and vacation areas—consider leases that convert to month-to-month tenancies. In my experience, month-to-month holdover tenants often end up staying for years. But even if they stay for only two to six additional months, you still gain because you've

postponed unit turnover. If, however, you require your tenants to commit for another year—or move out—you may force a move that the tenants otherwise would have postponed.

Holdover Tenants (without Permission)

Sometimes tenants notify you (or you notify them) that their tenancy is ending. If they move on schedule, all is well. On occasion, tenants decide to stay on contrary to your permission or desire. To reduce this possibility, and compensate for any problems this delay causes, consider placing a penalty in your lease for unauthorized holdovers of, say, $50 or $100 per day.

Property Description

Misunderstandings sometimes arise over the exact physical property your tenants are leasing. So, to avoid this issue, describe precisely the space they are entitled to. For example, do they obtain the right to use the garage, attic, basement, or outdoor storage shed? Or do you plan to reserve areas for your own use or for others?

In addition, your lease (usually through a signed addendum) should list existing damages or imperfections that the property currently suffers. Your prospective tenants should accompany you (or your rental agent) while making this inspection. Without this written and signed inventory of prior damages, your tenants may deny responsibility for damages they have caused, "Those holes in the wall were already there when we moved in. We're not paying. We didn't do it."

Inventory and Describe Personal Property

If you provide personal property for your tenants (washer, dryer, refrigerator, stove, microwave, blinds, drapes, curtains, furniture), inventory and describe (with photographs or serial numbers where possible) each separate item and include the list as a lease addendum. Unbelievable as it may sound, I know of vacating tenants who have taken their landlord's almost-new appliances and left in their place appliances that would soon find their way to a landfill.

Without a signed inventory and description of personal property, the tenants may get away with such theft. If the lease merely says, "owner provides washer and dryer," you may find it difficult to prove the exact washer and dryer that you originally placed in the rental unit. (Purchase

receipts provide evidence that you bought the items. They do not prove what you did with them.)

Rental Amounts

Some owners set low rent levels to reduce their turnover, vacancy losses, and tenant complaints. (Complaints fall in number because tenants realize they are receiving a good deal and prefer not to give you reason to raise their rent.) In addition, slightly below-market rents permit you to select tenants from a larger pool of qualified applicants. Naturally, you need not merely use below-market rents to attract quality tenants. You can offer desirable features that are otherwise scarce. Features can lure in quality tenants even though your rents sit near the top of the market.

Late Fees and Discounts

Ideally, your well-selected tenants will pay their full rent on or before its due date. To even further encourage timely payment, some owners offer their tenants an "early payment discount." Others penalize tenants with late fees if the tenant's check is received, say, three to five days past its due date. Many owners say that the "carrot" approach creates better tenant relations, works more effectively, and is easier to enforce.

Regardless of which method (or combination) you choose, do not permit tenants to take the discount, or avoid the late fee, unless they satisfy the respective due date requirements. And never, never, *never* allow tenants to get behind in their rent. Evict as soon as your lease and local ordinances allow it. It is a fact of human nature that tenants who can't pay today, won't pay tomorrow. (Experience has taught me this lesson.)

To gain peace of mind and financial prosperity, rent only to people who pay their rent on time, every time. Reject excuses. Terminate swiftly.

Multiple Late Payments

What about the tenant who regularly pays on the eighth or ninth of every month—even though the rent falls due on the first? As long as the late fee is included, some owners tolerate this behavior. I would not. I want rents paid on time, every time.

Therefore, to enforce the "on time, every time" requirement, either I work out a new payment date with the tenants that better matches their cash flow needs, or I enforce the "multiple late payment" clause. This clause sets forth a "three strikes and you're out" rule. I realize that anyone can suffer a lapse of memory or cash shortfall once or twice, but

chronic lateness warrants termination of the lease, forfeiture of deposit, and any other damages the tenant's breach of contract entails (and the law enforces).

Bounced Check Fees and Termination

Likewise for bounced checks. Do not tolerate them. Once or twice, maybe. Three times warrants termination. In my experience, tenants who won't pay their rent on time with good checks don't just create problems in this one area. As often as not, you can expect them to give you other kinds of trouble. In fact, tolerate this behavior and you ask for trouble. Don't do it. Get rid of these tenants quickly.

Tenant "Improvements"

"If we buy the paint, is it okay for us to paint the living room?" As an owner of rental properties, you will receive requests like this from tenants. Or you may end up with tenants who don't ask. They redecorate first and wait for you to ask questions later—like, "How could you paint the living room deep purple?" or "What happened to the oak tree that was in the back yard?" (True story: Tenants of a friend of mine cut down a lovely large oak tree because they didn't like it.)

To prohibit tenants from diminishing the value of your property with their "improvements," include a lease clause that requires them to obtain your written permission before they paint, wallpaper, redecorate, renovate, repanel, remove, or in any other way modify your property. If left to their own accord, some tenants will treat your property as if it were their own. (This may sound all right until you see how little care they give their own property.)

Owner Access

Under many laws of tenancy, you cannot enter your tenants' premises without their permission—unless their lease grants you that right. If you do want access to conduct periodic inspections, make repairs, take care of emergencies (e.g., an overflowing toilet), show the unit to prospective tenants (or buyers), or for any other reason, include an "owner access" clause.

This clause will not typically give you unlimited access at any time, night or day. Few tenants would like such an intrusive demand. But an access clause can give you an automatic right of entry within certain specified hours, say, 8:00 A.M. to 8:00 P.M. daily with 24-hour notice (emergencies excepted). Without an owner access clause, a difficult tenant may give you

the runaround for days, or even weeks. Or worse, they may answer your requests for entry with a "No!"

Quiet Enjoyment

Do you want to guarantee your tenants that they will not suffer from noise and disturbances created by other tenants? Then heavily restrict their neighbor-disturbing partying, fighting, arguing, loud lovemaking, and playing of television, radio, stereo, computer, or other electronic devices. Or simply place a general clause within your lease such as:

> Residents agree not to create, generate, broadcast, or otherwise cause sounds or disturbances to emanate from themselves, their vehicles, their guests, or their residences into the residences of others. All residents agree to respect and promote the quiet enjoyment of the premises by all other residents.

As an additional warning, beware of buying buildings with those notorious "paper-thin" walls. While performing your prepurchase inspection, turn on a portable radio and carry it from room to room and unit to unit. Do sound volumes at reasonable levels penetrate into other rooms or other units? If so, that property presents a large source of aggravation to you and your future tenants. Unless you can economically silence the problem, don't buy the property.

Noxious Odors

As with noise and disturbances, noxious odors wafting throughout a building can stir up tenant complaints. Noxious odors include smoking, cooking (especially some types of ethnic foods), and heavy use of perfumes. If any of these (or other types of noxious odors) could present a problem, draft a lease clause that excludes the causes of these odors.

Disturbing External Influences

In some instances, your tenants may be disturbed by noises or odors whose source lies outside your property. If you know of such problems (trains, heavy traffic, school band practice, factory emissions), place a rider in your lease whereby tenants acknowledge and accept notice. If you know of potential sources of disturbance but don't disclose them, your tenants may be able to lawfully terminate their lease and sue you for the damages they incur because of their "forced" relocation—sometimes called constructive eviction.

In fact, even if you've had no prior knowledge of neighborhood noise or odors, such disturbances may give rise to a tenant claim of constructive eviction. If successful in pursuit of this claim, your tenants may also be able to terminate their lease and collect relocation expenses from you. Therefore, with or without actual knowledge of these adverse external influences, you may want to include a lease clause that limits both your responsibility for damages and the tenants' right to terminate their lease.

Tenant Insurance

Because a property owner's insurance does not cover the personal property of tenants, some landlords require their tenants to buy a tenants' insurance policy. These owners have learned through experience that when uninsured tenants suffer damage to their property through fire or theft (or other peril), they may accuse the owner of negligence. Even if the building burns after being hit by lightning, these tenants (or their lawyers) will claim that you should have installed a better lightning rod.

Sublet and Assignment

When tenants plan to be away from their residence for an extended period (summer in Europe), they may want to *sublet* their unit. When tenants plan to relocate permanently (job change, bought a house), they may want to *assign* their lease to someone else. To deal with these contingencies, your lease might adopt one of four positions:

1. No right to sublet or assign.
2. Right to sublet or assign with owner's written permission. Original tenants and new tenants both assume liability for rent payments and damages.
3. Right to sublet or assign with owner's written permission. Original tenants are released from any liability for future rent payments or damages. Owner must look exclusively to new tenants for financial performance.
4. Unlimited right to sublet or assign. Original tenants remain liable.

Absent a specific lease clause, many courts rule that option 4 is the controlling default option. Because owners dislike this default option, they typically write in a sublet/assignment clause based on choice 2 or 3.

Obviously, most owners prefer number 2. When the original tenants remain liable for rents and damages, they choose their subletees and

assignees with far more care. As a negotiating tactic, use lease language that reflects the position of number 1 or 2. But in response to tenant objection, ease up and adopt number 3. Or, as is perhaps most common, stick with the approach of number 2 for subletees and permit number 3 for assignees.

Pets

Too many property owners reflexively prohibit pets. In my experience, responsible tenants maintain pets in a responsible manner. Irresponsible people treat pets in an irresponsible manner. If you filter out irresponsible people, you can eliminate "pet problems" without excluding all pets.

When you accept responsible people who keep well-behaved pets, you can boost profits. Because of widespread "no pet" restrictions, owners who do permit pets can often charge a "pet premium" in both the amount of monthly rents and the amount of the security deposit.

Of course, if you do accept pets, draft a pet rules addendum and attach it to your lease. When drafting your pet rules, though, please consider the needs of the pet. I have seen pet rules that require dogs to be kept tethered in a backyard on a six- or eight-foot chain, or perhaps kept only within the confines of a basement or on a back porch.

If you feel so little for the lives of animals, exclude them from your rental properties. Any pet owner who accepts such cruel restrictions does not qualify (in my opinion) as a responsible person or a responsible pet owner.

Security Deposits

Security deposits present at least five issues that you may want to address in your lease:

1. Amount of the deposit.
2. When payable.
3. Rate of interest, if any.
4. Under what conditions tenants will forfeit all or part of their deposit.
5. When you will refund the deposit if tenants satisfy all terms of the lease.

To eliminate dispute, your lease (or lease addendum) should clearly spell out answers to each of these issues. (Remember, too, that as you learn the practices of other rental property owners, you can craft a security deposit policy that gives your property a cooperative advantage.)

Amount and When Payable. As to amount, I typically favor high security deposits plus first and last month's rent—*always* payable in advance.

(This lesson I learned the hard way.) You will undoubtedly get prospects who want to pay their deposit piecemeal over one to three months. Yield to this request, and you invite trouble. (Ditto for postdated checks.)

By urging you to require your money up front, I mean that whatever amount you set, collect it before your tenants move into the unit. I favor a large amount because I'm leasing desirable properties to people with financial capacity. However, you may find that your tenant segment doesn't (or can't) meet this requirement.

Interest. Some local and state laws require owners to pay interest to their tenants. If this law applies in your area, make sure your tenants know they'll be receiving interest. In fact, I recommend paying interest to tenants even if the law doesn't require it. Today, many tenants get upset if you insist on a deposit (especially a large one) but refuse to pass along its earnings to its "rightful" owner. (When short-term interest rates are low this issue does not stir up much conflict.)

Forfeiture. To minimize controversy, some owners develop a schedule of costs that they levy against tenants who fail to satisfy their lease obligations. This schedule might list broken windows at $25, wall holes at $50, dirty appliances at $35, and general cleaning at $150. Other owners levy actual costs after the remedial work has been performed. And some severe owners try to keep the full security deposit as liquidated damages—even when the actual damages fall substantially below the amount of the security deposit.

No matter which approach you favor, to avoid potential problems, (1) Inform your tenants of your deposit forfeiture policy *before* they take possession of your property, and (2) as soon as they vacate the property, perform a thorough property walkthrough inspection with the tenants. In this final walk-through, compare the property item by item with the inspection sheet you prepared at the time they took possession.

Always perform a final inspection with the tenants present. Never let several days pass between the date tenants move out and the date you inspect. If you ignore this advice, expect tenant denials and dispute. At the time tenants sign their lease, let them know that their security deposit does not limit their liability for rent or damages. If their actual damages exceed their deposit, they must pay the higher amount.

Deposit Return. As a courtesy to your tenants, return their deposits with interest as soon as you know the correct amount. The best time is at the end of the final walk-through. You pay. The tenants accept. You shake hands with them and wish them well in their new home.

Too many owners needlessly delay returning deposits. That practice sours tenant relations and may subject you to legal penalties. In some jurisdictions, if you miss the law-imposed deadline to return a deposit of, say, $1,000, your tenants can go to court and force you to pay them

$3,000. Many areas now legislate security deposit procedures. Read and follow these laws. As the treble damage penalty shows, violations can cost you plenty.

Yard Care

When you rent out a house or duplex, you will probably require the tenants to care for the yard. But don't just say, "Tenants are responsible for yard care." I once made this mistake with otherwise excellent tenants. To these tenants, "yard care" meant cutting the grass. To me it meant watering the lawn when needed, tending the flowers and shrubs, and trimming the hedges to maintain them at their existing height of four feet.

Because the house was located in Florida and I was living in the San Francisco Bay Area, my visits to the property were not frequent. When after two years I did return, the hedges had grown wildly, many flowers and shrubs were dead, and the lawn suffered scattered brown spots.

If you want your tenants to care for the yard, spell out exactly what care they must provide.

Parking, Number, and Type of Vehicles

Some tenants believe that if they can't find parking in a driveway or street, it's okay to park in the front yard. Or they may routinely block other people's driveways. Or they leave unsightly junk (inoperable) cars to accumulate around the property. RVs, boats, and trailers also can create aesthetic and parking problems.

To head off such trouble spots, place a "parking clause" in your leases. Specify exactly the number and types of permitted vehicles. Then designate the *only* places where tenants are permitted to park. You may also want to deter the backyard (or front yard) mechanic who disassembles his car and leaves the parts scattered about for days, weeks, or months.

Repairs

Increasingly, owners of rental properties shift costs of repair onto their tenants. Stopped-up toilets, slow drains, and broken garbage disposals seldom occur without tenant abuse. As a minimum, owners may charge their tenants, say, a $50 repair fee for each time a repair becomes necessary. In other instances, owners declare tenants fully responsible for certain types of repairs—unless the service provider establishes that the tenants were not to blame.

Appliances. Some owners tell their tenants that they may use the appliances currently in the property, but the owner will not pay for repairs or replacement. If the tenants don't agree to accept the appliances on those terms, the owner then removes them, and the tenants provide and maintain their own appliances.

Which Approach Is Best? As stands true for every lease clause, no single approach to repairs works best in all situations. It depends on the types of tenants and properties that you're dealing with. Some people will mistreat your property. At the same time, they expect you to jump into action whenever their abuse or neglect creates a problem. These are the people at whom you want to aim your tenant repair clauses. (Ideally you want to avoid these kinds of tenants.)

Roaches, Fleas, Ants

On occasion, roaches, fleas, ants, and other similar pests will invade a house on their own without apparent reason. Usually, tenants invite them in through careless handling of food, unwashed dishes, trash, garbage, or pets. Especially in single-family houses, you may want your lease to shift the cost of extermination to the tenants.

In apartment buildings, the source of such pests may prove more difficult to determine. All it takes is one unsanitary tenant, and their roaches or ants can quickly spread to everyone else's units. As a precaution, spray periodically to reduce this potential problem.

Neat and Clean

Regardless of whether you rent out houses or apartments, your lease should recite standards of cleanliness. Proper disposal of trash and garbage are bare minimums. Other dos and don'ts may address unwashed dishes; disposal of used motor oil, broken furniture and appliances; materials awaiting pickup for recycling; bicycle storage; and vehicles that drip motor oil or transmission fluid.

Rules and Regulations

Especially for apartment buildings—or for rental units in co-ops or condominium projects—prepare a list of rules and regulations that you direct tenants to follow. Incorporate these rules into your rental agreement (usually by addendum). Note within your lease that you (or the homeowners' association) reserve the right to reasonably amend or modify the listed rules.

Wear and Tear

Leases often state that tenants retain responsibility for all damages *except* normal wear and tear. I never use such a clause. It invites tenant neglect and abuse. Many tenants believe that soiled and stained carpets, cracked plaster, broken windows, and other various damages reflect nothing more than "normal wear and tear."

I disagree. If a tenant properly cares for a property, that property will not suffer any noticeable wear and tear during a tenancy of one year or less. For such short-term periods of residence, tenants should leave the property in essentially the same condition in which they accepted it. Eliminate the "wear and tear" clause. It will save you money and argument.

Lawful Use of Premises

As good business, and as a good-neighbor policy, require tenants to abide by all applicable laws, ordinances, and regulations. For example, enforce a zero-tolerance rule against illegal drugs. Various ordinances also apply to property use, parking, noise, pet control, occupancy limits, yard care, and a multitude of other issues.

In some instances, the law not only punishes tenants but also property owners who tolerate those tenants who violate government rules. In addition, this clause will give you authority to stop behavior that causes offense—even though the police or other government authorities choose to let it slide from their enforcement.

Notice

To reduce rent loss during periods of turnover, require tenants to give advance notice of the exact date they plan to end their tenancy and completely vacate the property. In that way, you can begin to publicize the unit's upcoming availability. Ideally, you'll find a new tenant who will move in within a day or two after the previous tenants have moved out.

Most owners require 30 days' *written* notice. If you're operating in a weak or seasonal rental market, you might ask for 45 or 60 days' notice. If you expect strong and immediate demand for your rental property, you could reduce your advance notice to, say, 15 days. Tie your written notice requirement to the length of time it will take to locate a new, highly desirable tenant (or to avoid missing a peak rent-up period as exists in college and resort towns).

Failure to Deliver

Sometimes tenants will tell you that they're vacating on the 28th. Yet as of the 31st, they're still packing boxes. This holdover could create turmoil if you've already signed a lease with new tenants and promised them possession on the 30th. Although your "holdover penalty" clause should help avoid this dilemma, it sometimes occurs.

So what do you do? Given this possibility, some property owners include a "failure to deliver" lease clause. This clause typically accomplishes two objectives: (1) It voids the liability of the property owner to the new tenants for any expenses they might suffer (motel room, furniture storage, double moving costs) as a result of the owner's failure to deliver, and (2) it does not permit the new tenants to immediately cancel their lease. Rather, it pushes back their move-in date (and accrued rentals) until the previous tenants do vacate and the owner completes her "make ready" efforts.

If your current tenants continue to remain in the property, you can't hang your new tenants up indefinitely. In that case, your lease might release the new tenants after your failure to deliver extends beyond, say, 10 days. Fortunately, you won't often experience the holdover problem. But it's a good idea to anticipate the possibility and draft a lease clause to deal with it.

Utilities, Property Taxes, Association Fees

Often tenants pay all of their own utilities and waste disposal charges. Owners pay all property taxes and homeowners' association fees. However, this "typical" practice is not written in stone. Sometimes in longer-term residential leases, tenants pay all of these expenses. And frequently in short-term rentals, owners pay all expenses. Also, some multi-unit properties don't meter individual tenants. This situation can shift utility costs to owners.

Regardless of which practice you adopt, spell out who pays what with respect to these or other similar types of expenses (e.g., heating oil, pest spraying, window washing). Clarity helps two types of tenants: (1) people who are new to renting and may not fully understand their responsibilities, and (2) people who relocate and tend to base their expectations on the local practices they experienced elsewhere.

Liquid-Filled Furniture

Although waterbeds and other types of liquid-filled furniture aren't as common as they once were, they still remain popular within a niche

market. The water damage created when one of these beds bursts is typically excluded from coverage under most rental-property insurance policies.

Consequently, you may want to forbid this kind of risk. Or, alternatively, require that your tenants' liquid furniture meet industry safety standards *and* require your tenants to pay a "waterbed premium" for the insurance endorsement you buy to obtain coverage.

Abandonment of Property

Sometimes tenants move out and leave some of their personal property. They promise, "We'll come back next Tuesday and pick up those boxes in the garage." Next Tuesday comes and goes, and the boxes remain.

What can you do? That depends on your lease. If it's silent on the issue, the law may require you to safeguard the items for some specified period. Then you will have to dispose of the items according to the applicable legal procedure. With a lease clause, you can contractually agree with the tenants that any items not removed by the end of the lease will go straight to the dump or (if of any value) to the Salvation Army. (Note: I emphasize again, verify applicable laws. In many instances a law that regulates a specific issue can trump a lease clause that runs to the contrary (e.g., security deposits, fair housing, rent increases, eviction, late fees, abandoned property, and so forth).

Non-waivers

For reasons of courtesy or practicality, you may, on occasion, permit tenants to temporarily breach a lease clause or house rule. To prevent tenants from stretching this courtesy beyond your intent, your lease can include a "non-waiver clause." In this clause, you make clear that your obliging actions today in no way waive your right to enforce the letter of the lease tomorrow.

Likewise, this clause can deal with rent collections in a similar way. Say you accept a rent check even though you know your tenant is sharing his apartment with an unauthorized cotenant. The non-waiver clause dissuades your tenant from later claiming, "Well, you took our rent check. So you can't tell me now that Joe has to move out." Yes, you can. Your non-waiver clause voids that tenant defense.

Breach of Lease (or House Rules)

In a breach-of-lease clause, you reinforce your right to terminate the lease of tenants who breach *any* lease requirement or house rule. Absent this

clause, tenants sometimes believe that if you accept the rent, you waive your enforcement of other tenant violations. Together, the non-waiver and breach-of-agreement clauses impress on tenants their obligation to comply 100 percent—or suffer the consequences of eviction, loss of their security deposit, and/or your claim for monetary damages.

No Representations (Full Agreement)

On occasion tenants try to extricate themselves from their lease obligations by claiming that you misled them with false promises. They could claim that when you induced them to sign their lease you promised to completely paint and re-carpet their unit. You know that the tenants are lying, but a judge may not. To the judge, it's your word against the tenants'.

To prevent such a charade, include a lease clause that states the lease and its addenda set the full extent of the rental agreement. Further, this clause should state that the tenants did not rely on any oral or written representations or promises not explicitly included within the lease. (For example, "Tenant acknowledges that owner has made no promises or representations other than those included within this agreement.")

Arbitration

In many cities, the legal process is too slow, expensive, and complex to effect timely and affordable justice. As a result, some property owners include an arbitration clause in their leases. This clause steers unresolved owner-tenant disputes away from the courthouse and into a more informal arbitration hearing. (Alternatively, many cities have set up housing courts or panels who decide landlord-tenant disputes in a more timely and less costly procedure than the regular court system.)

An arbitration hearing typically differs from trial litigation in that it (1) requires less time; (2) costs less; (3) avoids formal rules of legal procedure; (4) reduces or eliminates pretrial discovery such as depositions, interrogatories, and requests for production of documents; and (5) severely limits the right to appeal. All of these features may sound like a pretty good trade-off against litigation. But, "the proof of the pudding is in the taste." Before you adopt this clause for your leases, investigate how well arbitration works in your area. Learn whether your local courts show any noticeable bias for or against property owners. Arbitration tends to work best for landlords faced with courts that generally side with tenants. (Unfortunately, some pro-tenant judges—at the urging of lawyers who fear a loss of business—refuse to enforce contract arbitration clauses.)

Attorney Fees (Who Pays?)

Many form leases include an "attorney fees" clause that strongly favors property owners. In cases where you prevail in court, this clause requires losing tenants to pay your "reasonable" attorney and court costs. In contrast, when your tenants prevail, the clause (through its silence) leaves attorney fees and costs on the shoulders of each party who incurred them.

Will the Court Enforce It? Courts that honor the principle "judges shall not rewrite lawful contracts" will generally enforce this one-sided attorney fees clause. Such courts reason that any tenant who wanted to modify or eliminate this clause was free to negotiate the point before signing the lease.

On the other hand, so-called activist judges may use this clause to hold you liable for a winning tenant's attorney fees and costs. These judges declare "what's good for the goose is good for the gander." They often see their cases as "'powerful greedy landlords' versus 'powerless victimized tenants'." They like to upset this supposed imbalance of power by placing their thumb on the scales of justice in favor of tenants.

Include or Not? Whether you should include such a clause remains an open question. As a starting point, note whether courts in your area will enforce it as written. Also, consider how your prospective tenants might view this clause. Will it cause them to mark you down as just another "landlord" rather than see you as "a fair provider of housing services"?

What about the solvency of your tenants? Even if you prevail in court, is it likely you could collect a judgment? Does your area permit wage garnishments? Beware of "activist" tenants. These types of tenants love going to court and often get their legal fees advanced by some government agency or "nonprofit" tenants' rights group. Should you eventually fail to win your claim (or defense), these activists know how to work the system to stick you with thousands (or even tens of thousands) in legal bills.

Explore Your Options. Don't insert (or omit) any type of attorney fees clause until you explore its practical and legal implications. Learn from the experiences of other property owners. Investigate the legal procedure that's typically used for settling owner-tenant disputes in your area. Also, some courts follow a "loser pays" rule regardless of what your lease says—even when it's silent on the issue of attorney fees.

Offer of Settlement Rule. In other areas, courts may follow some type of "offer of settlement" rule. In these cases, a party who turns down a pretrial settlement offer may end up having to pay the other party's fees and costs—regardless of who wins. Say your tenants offer to settle your $8,000 claim for $5,000. You reject the offer and go to trial. The court awards you $6,000.

Guess what? In some areas, you would pay the tenants' legal costs and fees because your court victory didn't win you at least 25 percent more than the tenants offered to settle. (So much for justice!) Of course, this rule does cut both ways. In some cases it can benefit you. Just realize that in many jurisdictions, the question of who pays costs and fees is far more complex than a simple clause in a lease may seem to indicate.

Written Notice to Remedy

A "written notice to remedy" requires an owner (or tenant) to give written notice before taking action to legally enforce a lease provision that the tenant (or owner) is currently breaching. From your perspective, written notice can help you in two ways: (1) When you wish to evict a tenant for cause, previous written notices give you a paper trail to strengthen your case, and (2) if in defense of an eviction (or suit for rent) a tenant falsely claims, "We didn't have any heat for most of January," you can force the tenants to prove that they sent you written notice of this problem. Because their claim is false, no such proof will be forthcoming. Their defense typically fails.

TENANTS RIGHTS LAWS

Historically, many laws governing landlord-tenant relationships originated in feudal England (a time of serfs and royal, can-do-no-wrong landlords). Consumerism and expansive tenant rights lacked legal standing. As a result, reformist lawmakers, courts, and government agencies have frequently stepped in to "update" this legal relationship. Such statutes, ordinances, court decisions, and regulations can supersede written clauses in your lease. Such contemporary laws broaden tenant rights and landlord responsibilities in the following areas: (1) tenant selection, (2) property operations, and (3) evictions.

Tenant Selection

Market strategy tells you to target your rental units to defined market segments. However, laws in many countries do not permit owners (managers) to exclude rental applicants because of their race, religion, sex, ethnicity, national origin, disability, or family status (households with children). In addition, *some* laws have lengthened this list to include other categories such as homosexuals, welfare recipients, and lawyers. (Yes, some property owners do not rent to lawyers because as a class, lawyers rank among

the most troublesome tenants. Note, too, that federal civil rights law and nearly all State and local fair-housing ordinances exempt owner-occupied properties of one to four units. If they choose, exempt property owners may discriminate without legal penalty.)[1]

Conduct and Creditworthiness. Laws against unfavorably stereotyping people because of their race, religion, or occupation do not mean that you must accept individuals who do not meet your legitimate standards of conduct and creditworthiness. You may turn down any person—regardless of protected status—whose credit, employment, income, or rental record falls below your minimums. Also, you need not accept any individual who fulfills your minimum standards but nevertheless ranks below the superior qualifications of other applicants.

Unlike employers who are sometimes coerced into quota hiring, small landlords are not subject to such laws or regulations. You are free to select those tenants (among all applicants) who *best* match or exceed your standards. (If you own a rental complex of 200 three-bedroom apartments that includes only two units with children—now that's a different story. Prima facie, you are discriminating against households with children.)

Beware of Inconsistency. You are not free to arbitrarily change your standards, or to arbitrarily apply them. To a large degree, discrimination laws restrict a property owner's flexibility. Assume you meet with a nice young couple from your church whose credit score has plunged about as low as it can go. You believe they're good people and make an exception to your credit standards.

Subsequently, a nice young couple of a different religion applies to rent a unit in the same building. You turn them down because of their prior credit problems. You've just opened yourself up to a lawsuit. Under the law, you must apply your standards consistently. Exceptions and flexibility can land you in trouble.

Beware of Testers. To trap property owners who set and apply their tenant selection standards in an arbitrary or illegally discriminatory manner, various government agencies and activist "nonprofits" employ testers. Generally, these "tenant" testers differ from each other in terms of race, religion, or family status, but they remain similar in terms of income, credit, and other lawful tenant selection criteria.

When applying to rent from you, various testers record your words and actions. If you treat any tester differently from the others ("I don't think

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[1] However, some lawyers argue that an 1866 civil rights law voids some of these exceptions. So, beware and be wary of unlawful discrimination. On this issue, adhere to the law precisely. Legal costs and monetary damages for unlawful discrimination can ruin your net worth.

this would be a good building for your children; mostly singles live here"), you invite a charge of discrimination. To avoid trouble with testers and their vigilant search for racist, sexist, and homophobic landlords, apply your tenant-selection standards consistently. Do not encourage or discourage rental applicants because of any protected status.

"I think you'd be happy here, we have many Jewish tenants," and "I don't think you'd be happy here, we have very few Jewish tenants," are equally discriminatory under the law. For your own peace of mind and financial well being, never say or do anything that takes notice of a person's difference if that difference is covered under some type of discrimination law or regulation. (Of course, this advice applies equally to all leasing agents or property managers that you employ. As a principal, you can face legal responsibility for the discriminatory acts of your agents and employees.)

Property Operations

Various laws will govern the operation of your properties. You must abide by zoning, environmental, occupancy, health, and safety codes. Local laws may apply to snow removal, trash receptacles, waste disposal, tenant parking, smoke alarms, heat, security locks, and burglar bars. Some cities enforce "repair and deduct" statutes. These laws give tenants the right to pay for necessary property repairs and then deduct these costs from their rent check.

Typically, laws governing property owners operate as a normal part of doing business. They don't impose any great costs or problems on landlords. Occasionally, however, compliance can cost big money (lead paint or asbestos abatement, underground oil tank cleanup, earthquake retrofit). So before buying a property, investigate whether such laws might increase the amount of money that you must spend on your property to satisfy compliance issues.

Evictions

Governments set the legal steps property owners must follow to terminate a lease and evict a tenant. This procedure typically applies to (1) lawful reasons, (2) written notice, (3) time to cure breach, (4) time elapsing before a hearing, (5) allowable tenant defenses, and (6) time to vacate after adverse ruling.

Learn this legal procedure for your area. Then follow it precisely. Failure to dot your i's and cross your t's can get your case thrown out. You must then go back and start again. Never resort to "self-help." Never

threaten or assault a tenant; change door locks; turn off the tenant's water, heat, or electricity; or confiscate tenant property. Follow lawful procedure. "Self-help" exposes you to personal injury lawsuits and possibly criminal charges. (Watch the video or DVD *Pacific Heights.*)

LANDLORDING: PROS AND CONS

From the preceding collection of possible lease clauses and tenant rights laws, you might say, "Forget it! Landlording involves too many potential hazards, headaches, and risks." But read about the laws, regulations, accidents, breakdowns, repairs, lawsuits, hassles, and expenses that go along with driving a car. If you focus only on the negatives, you might park your car in a garage and leave it there.

Possibilities, Not Probabilities

By discussing various rental issues, I do not mean to scare you away from landlording; I want to present possibilities for your concern. It is the naïve and unknowing property owners who most often experience landlording difficulties.

In more than 20 years of dealing with rentals, I have rarely suffered through the eviction process. Nor have I ever used a lease that included all of the previously mentioned clauses. Nor have I been sued by a tenant, experienced a charge of discrimination, or run into any break-the-budget environmental or building safety and health code problems.

The chances are that you won't, either—if you develop leases, systems for tenant selection, and property operations that anticipate, alleviate, and mitigate potential problems. Think of the concerns discussed as possibilities to prepare for and guard against, not as certainties sure to make landlording a constant source of anxiety and expense.

Professional Property Managers

If you choose, you can employ a property manager or caretaker to deal with routine tenant relations and property maintenance. For relatively low cost, you can delegate everyday concerns. As long as you design and retain approval of leasing standards and property operations, delegating tasks to others will save you time, money, and effort. However, I advise you not to employ a property management firm that manages hundreds or even thousands of units for dozens of property owners. How can such a firm closely watch your best interests and develop a marketing strategy to

beat your competition? It can't and it won't. At its best, a large property management company will deliver mediocre performance. Expect nothing more and anticipate something less.

To operate profitably and proactively, set high standards. Show your hired help how to achieve the performance results you want. Pay them well. Tell them how much you value their work and appreciate the job they're doing. With this respectful, long-run approach, you can count on your properties to bring you peace of mind, security, wealth, and financial freedom.

13

CREATE SALES PROMOTIONS THAT REALLY SELL

You invested wisely. You worked smart. You created value. Inflation and appreciation have played their roles. Now it's time to harvest the wealth that you have built through property equity.

Just one last hurdle to jump: Create a sales promotion that attracts buyers who will pay the price you want. How do you attract these buyers? Design a winning value proposition.

DESIGN A WINNING VALUE PROPOSITION

More than 50 years ago, the marketing maven, Rosser Reeves, coined the phrase, "Unique Selling Proposition." In that era of mass marketing, Reeves tried to pull away from traffic. He encouraged firms to differentiate—"make your products and services stand out in a unique way," he advised.

Over the years, Reeves' ideas have become so well known that marketing pros around the world now recognize the USP concept. In fact, just ask a pro, "What's your firm's USP?" and he will know what you are referring to. Reeves and his concept of USP have achieved universal acclaim.

Yet Generic Prevails

Although Rosser Reeves holds an esteemed position among marketing hall-of-famers, and even though every textbook of marketing advocates USP, the majority of all businesses still fail to reach the standard that

Reeves set. Generic prevails. "Me-tooism" dominates. Think of banks, for example. How many really offer a uniquely desirable level of services? Think of real estate brokerage firms. Most meander in mediocrity.

And more to our point in this chapter: What about the investors who own small rental properties? Most fail to stand out from that crowd of property owners against whom they compete for tenants—and eventually buyers. This generic mindset that prevails—either consciously or unconsciously—explains why Craig Wilson (Chapter 11) operated his property more profitably and with less effort than other property owners who also offered "student" rentals.

Craig Wilson's principle of success should also guide your sales promotions. To achieve the price (and terms) you seek, you cannot merely stroll down the same path that others crowd onto. You compete most successfully when you design a winning value proposition (WVP)—a value proposition that attracts, persuades, and closes the perfect buyer.

USP versus WVP

Reeves' idea of unique selling proposition (USP) moved marketing thought forward. But we can improve on his idea. A unique selling proposition might not win customers (renters, buyers). Different may not translate into desirable (much less most desirable). In my years of looking at properties, I have found many owners who promote "unique" or different" without offering a desirable difference—a difference that I or anyone else was willing to pay for.

And that brings us to my second point: Even if you create a desirable uniqueness, you must offer that benefit at a price your target market will pay, and at a price that provides you a profit. Here in Dubai, I see dozens of planned residential and office towers that remain unbuilt, unsold, or unrented. Yet in advertisements, builders and architects celebrated their iconic designs, their Ritz Carleton level of services, and their "close to everything" locations.

Unfortunately, these "iconic" projects (a most popular promotional tagline) failed because no sufficient market of buyers or tenants would pay a price high enough to cover the costs of construction. You've seen similarly ill-conceived marketing when homeowners try to recover the costs of their (unique) $45,000 kitchen makeover when selling a $250,000 house.

In contrast to USP, a winning value proposition (WVP) integrates four essential elements: (1) the buyer, (2) your competitors, (3) the benefits you will offer, and (4) your pricing (and terms, if any). To create a WVP, think interactively.

Think Interactively. In my grade school, some kids would tease and torment their classmates who wore glasses by calling them "four eyes." In fact, to sell your property at the best price, four eyes would provide great advantage. Why? So that you could focus on four sets of details simultaneously.

1. Which buyers should you appeal to? Like tenants, buyers come in all varieties. Toward which types of buyers should you design your value proposition? No-cash, no-credit buyers? First-time homebuyers? Move-up homebuyers? Old/young/disabled homebuyers? Lease-option buyers? First-time investors? Professional investors? Group housing operators? Conversion specialists?
2. Who are your potential competitors (houses, condominiums, apartments, new home builders, foreclosures, distressed sellers)? What locations? What features and benefits do each of your potential competitors offer? What price and terms do each of the potential competitors offer?
3. What features and benefits should you emphasize and offer? Room counts, floor plans, amenities, landscaping, special touches? Seller financing? Fast (or delayed) closing? Strong appreciation potential? Positive cash flows? Low amount of cash to close?
4. How should you compare and contrast, mix and match the types of potential benefits, potential buyers, and potential competitors to arrive at your price (and/or terms)—a price that provides the target buyer great competitive value? Plus, provides you the profit (wealth) you seek?

Think interactively. Think to find (or create) a niche where you can outperform your competitors such that your buyers will reward you with a deal that meets or exceeds your profit expectations. What features/benefits remain relatively scarce among competitors—yet highly prized by some segment(s) of potential buyers?

How do you answer these questions? In the same way that Craig Wilson answered similar questions when he designed a Winning Value Proposition for his College Oaks tenants: Ask market players. Inspect, compare, and contrast properties. Discover the properties that sell fastest and at the best prices. Read articles on property decoration and renovation. Talk with or employ a home stager. Think! What features/benefits/contract clauses will provide me a competitive edge against other properties and a cooperative edge with my buyer segment(s)?

Work versus Reward. Will these research efforts pay back enough to justify the time and effort required? In my view, absolutely! But decide for yourself. Give systematic and organized research a try. In a property market dominated by inept sales agents, ill-informed sellers, unimaginative

buyers, and woefully deficient promotions and advertising, you can create a unique selling proposition that also generates a winning value proposition.

CRAFT YOUR SELLING MESSAGE

"Build a better mousetrap and the world will beat a path to your door." Maybe Emerson correctly describes the mousetrap market, but his advisory falls way short of the mark with property. To effectively sell properties requires thought and effort. To sell at the best possible price, craft a winning value proposition—then go out and tell the world about it. You cannot wait for the world to find you.

When I say "tell the world about it," I mean craft a selling message that grabs attention, stirs interest, excites desire, and motivates action. How do you accomplish this goal? Apply the following 10 criteria:

1. Use a grabber lead/headline
2. Reinforce and elaborate
3. Add more hot-button benefits
4. Establish credibility
5. Compare to substitutes
6. Arouse emotions
7. Reduce perceived risks
8. Make it easy to respond
9. Provide reasons to act now
10. Follow up

"Wait a minute," you might object. "How can I write a sales message that packs in all of that information? I just want to run a four-line newspaper ad." Or you might say, "I don't plan to sell 'by owner.' I'll let my real estate agent deal with advertising and sales."

True, in their print and web site ads, most sellers merely recite a few facts about their property and expect their prospects to call and learn more. But in a sea of ads, you must first get your ad noticed, interest the prospect enough to call, and then know what to say when you answer the telephone. A "just the basic facts" approach rarely sells effectively. Nor will it likely generate an offer that matches what you could otherwise obtain if your sales message proved more persuasive.

As to working with sales agents (discussed later in this chapter), never walk away from your responsibility to supervise, direct, and critique

their sales efforts. Even high production sales agents often fail to craft effective sales presentations.

Experience proves what common sense supports. You will close more deals on better terms when you craft your total sales message (ads, flyers, brochures, personal selling, networks, word of mouth) to incorporate all 10 principles of effective selling.

Use a Grabber Headline/Lead

What do your prospects want more than anything else? What do most competitors fail to offer? When you design your WVP, discover the most salient benefits or features that would excite a targeted buyer. Choose the most critically important.

The most famous book title in real estate, Robert Allen's *Nothing Down,* illustrates this point perfectly. In just two words, he hit the burning, intense need of millions of people who wanted to buy real estate—but lacked the cash to make a down payment. The book shot to the tops of the bestseller charts within a matter of weeks.

Does your property proposition offer seller financing, low price per square foot, strong potential for appreciation, easy qualifying, mountain view, a great yard for kids . . . ? Match the feature/benefit to the intensely perceived need/desire of your target market. Your headline should immediately grab your prospects' attention and pull them in to learn more about your offer.

Reinforce and Elaborate

Once you have hooked the potential buyer, reel him in. Explain more details—details that flow from and support the original promise. Provide enticing information about the financing, features, views, and so on, information that reinforces the buyer's understanding of what you offer and why your offer provides just what he would love to find.

Add Hot Buttons

What other features/benefits of your proposition would excite potential buyers? List and describe more key benefits. If you are selling an investment property, for example, emphasize the quality of the tenants, the low maintenance expenses, or the possibility of rezoning to commercial. Is it the lowest-priced property in the neighborhood? Does it include generous amounts of parking? Are condo conversion documents all ready for government approval? What else?

Establish Credibility

Back up your claims with facts. If you cite numbers, show where they came from. If you say the rents sit below market, identify other rental units of equal or lesser quality that bring in higher rents. When you talk price, reveal your benchmarks of value. Know the sales prices, terms, and features of all comp properties that sold recently. Steer clear of puffing, exaggerations, and unsupported/unverified opinions or rumors.

Compare to Substitutes

Know the facts, features, and prices of currently for sale (or rent) listings. Point out the attributes and features of your property as compared to these others. Explain why your price/terms provide superior value to the competition. If selling to a first-time buyer, show how over time (because rents will increase) owning costs them less than renting. Plus, owning builds wealth while renting yields worthless piles of paper receipts.

Evoke Emotional Appeal

Does the neighborhood offer a friendly, social environment? Will parents feel their children are safe? Can you help that first-time investor feel the joy of financial freedom? Will owning bolster feelings of prestige, security, or independence? Does the recreation room offer a great place for parties or family gatherings?

Reduce Perceived Risks

What fears block your prospect's commitment? Do you offer a homeowner's warranty? Do you credibly support your assurances that the buyer is gaining a great deal? Do all of your words and actions build a sense of trust between you and the prospect? Have you arranged for an escrow account in which you will place the buyer's earnest money deposit?

All prospects—investors and homebuyers alike—hesitate when they fear risk and uncertainties. Identify those fears. Then bring forth facts, benchmarks, historical trends, warranties, guarantees, and explanations to alleviate them.

Make It Easy for Prospects to Respond

I recently telephoned four times about an ad for a property. No answer. No voice mail. Eventually on another try, I reached voice mail. One week

later I received the call back. I finally scheduled an appointment and showed up at the property on time. The person showing the property called 20 minutes later. "I'm running late. Sorry. I'll be there within 10 minutes."

My response: "I'm leaving. I must go to another meeting."

You might think that these FSBO sellers weren't motivated to sell. But that was not the case. They were overleveraged; they were badly managing the property; and they were running negative cash flows that they could not afford. They wanted to sell. They were just incompetent.

Prepare for the Phone Calls. Make it easy for your prospects to contact you: Land line, mobile, e-mail—and prepare all of your backup information ahead of time. Open large windows of opportunity for prospects to reach you. Avoid such putoffs as "call 6 to 9 P.M. Tuesday through Thursday evening." When you do take the call, know every fact that a buyer might want to learn and every fact you want the buyer to learn.

During your first voice contact, you either build trust and credibility—or you lose it. In my experience, most sellers lose it. Make it easy for buyers to respond to your promotion. Then meticulously prepare for that response.

Arrive for the Appointment Prepared and Ahead of Time. When you meet the buyers personally, continue to build trust, reinforce your credibility, and don't merely show the property—sell it. Bring documents, facts, newspaper articles, government data, exhibits, whatever helps support the value of your value proposition.

Think, "I am not here to show this property. I am here to sell this property." Many agents and owners confuse the idea of showing with selling. Lead the prospect through your value proposition; bring a blank purchase offer contract; set up an escrow account before you begin to market the property. Encourage the offer.

Provide Reasons to Act Now. More often than not, your prospect will demur. Every salesperson has heard buyers utter those words of delay with, "Let me think it over." Do not acquiesce. Use the buyer's delay tactics to question the prospect further.

"Mr. Prospect, perhaps I can help you weigh the pros and cons of your decision." Reiterate facts that support your value proposition. Use competitive benchmarks to illustrate relative merits of your WVP. Explore other possibilities the buyer favors. Ask for objections or critique. Isolate and address buyer fears. Then provide reasons to act now.

Are interest rates poised for increase? Are you scheduled to present the property to other prospects within the next few days? Can you sweeten the deal? Can you entice any type of offer to at least open negotiations? Before you let the prospect walk out the door and drive away, go for the close.

Banish this dialogue: Buyer: "Well, let me think it over." You: "Sure, just let me know if you have any other questions." No! Never!

Learn the objections. Learn how the proposition excites. Go for the close. If the buyer still leaves without an offer—or without making an offer you want to accept, then follow up.

Follow Up with Your Prospects

Never let a prospect vanish from your radar screen. Maintain contact for as long as the prospect willingly permits you to do so. As a prime reason, of course, restate (or improve) your value proposition. Continue to solicit an offer.

Additionally, use this contact time to: (1) Enhance your knowledge of competitive offerings. If the prospect is viewing other properties and talking with agents, sellers, and perhaps lenders, discover what he's learning. Vary your prospecting and value proposition accordingly. And, (2) invite the prospect to bird dog for you. "Mr. Prospect, based on all you've told me, this property and the price/terms offered really seem to match your needs. But if not, perhaps we can still work together. I will pay a $5,000 [or whatever] finder's fee if you refer a buyer to me."

REACH POTENTIAL BUYERS

You crafted a winning value proposition (WVP). You prepared a selling message that attracts attention, stirs interest, stimulates desire, and motivates action. Now, bring that sales message to your target market(s).

1. For sale sign(s)
2. Flyers/Brochures
3. Networking
4. Web Sites/Links
5. Sales agents

For Sale Signs

Place the largest for sale sign on your property that zoning or HOA rules permit. Reduce the size of space devoted to the words "For Sale." (Passers-by know a sign in a front yard most often indicates that the property is up for sale.) Instead of emphasizing "For Sale," emphasize your lead benefit. Then bullet some hot buttons. Include e-mail, web site, and telephone number(s). Attach a hanger container and fill it with color flyers/brochures that persuasively convey your selling message.

Flyers/Brochures

In addition to your sales message, include in your flyer or brochure multiple color photographs that show the property in its most favorable light. (If selling in the dead of winter, use a summer photo with vibrant landscaping and flowers blooming. Of course, if selling in summer, still use a summer photo.) Print the address of the property on the flyer—amazing how many sellers omit this vital piece of information.

Organize Your Sales Points. Many sales agents and FSBO sellers randomly slop assorted features across the page. Or worse, some agents merely photocopy the barely readable MLS sheet with its cryptic abbreviations.

You can make your flyer more readable, more informative, and more effective. Organize features/benefits into categories. Not just features, but the benefits such features will deliver to the buyer. Such categories might include exterior, yard/lot, interior, garage/outbuildings/basement/attic, neighborhood amenities, financing, warranties/guarantees, etc.

Provide your prospect a sales message that conveys unity, clarity, and coherence. Fit all photos and narratives together such that your flyer convincingly communicates a winning value proposition.

Distribute Flyers/Brochures. Place your flyers wherever your target market(s) might see them.

- Neighborhood bulletin boards (such as those in grocery stores, libraries, and coffee shops)
- Neighborhood residents
- People you know at work, church, and clubs
- Neighborhood churches
- Mortgage companies and real estate firms
- Technical schools and colleges
- Homebuyer counseling agencies
- Apartment complexes (if you don't get thrown off the property)
- Investor clubs
- Employers
- Hospitals

Don't make buyers find you. Become proactive. Bring your opportunity to them. At any moment, many prospects for your property aren't actively searching. They procrastinate. They wait for your sales message to motivate them.

Multiple Targets, Multiple Sales Messages, Multiple Flyers. You can craft multiple flyers for a variety of target markets. Prepare one sales

message that targets investors, another one directed toward parents of students who are attending the nearby state university.

Each of these markets might respond to their own uniquely defined hot buttons. A one-size sales message rarely fits all. Investors might get excited over positive cash flow and low vacancy rates. A first-time homebuyer might favor properties for their affordability, school district, or spacious yard. Your market research will tell you.

Networking (Word of Mouth)

Recall my "networking" word-of-mouth examples from Chapter 5. Word of mouth can help you find properties, and it can help you sell them. Get the word out. Tell most anyone you meet or know. Carry flyers in your car, briefcase, or backpack. Emphasize your bird-dog fee.[1] Never speak *per se* about "selling a property." Speak of features, benefits, and your winning value proposition.

Web Sites/Links

At today's low cost for IT services, set up a web site for your property. Fill it with complimentary photos, your sales message, and links to articles, reports, and government records that add power and credibility to your value proposition. Weigh the cost and availability of other property-for-sale sites. At a minimum, post on Craigslist. In fact, create a variety of postings with alternative leads and sales messages. Tailor sales messages for multiple types of buyers.

Sales Agents

I have saved the most controversial part of the sales effort question for last: the question of agents. Agents charge high fees. Yet, a majority of property sellers (homeowners, investors) do employ a real estate agent to list and sell their properties. But should they? Should you? Let's examine this issue.

SHOULD YOU EMPLOY A REALTY AGENT?

Most owners who try to sell their own properties fail. They put out their cardboard front-yard sign, run a newspaper ad for a month or two, and

[1] Check the law in your area. Sometimes real estate licensing laws restrict referral payments to unlicensed persons.

then give up. Do these failures mean that you should forget FSBO and list your property with a realty agent? Not at all; but it does mean that to succeed where others fail, you must avoid their mistakes.

Most FSBOs do not realize that to sell properties, *top* sales agents go beyond yard signs and newspaper ads. To get properties sold, top agents provide services to sellers and buyers.

Services to Sellers

1. *24/7*. Sales agents tend to work whenever they get called, and they remain on call morning, noon, and night, every day of the week.

Advice for FSBO sellers: Arrange to show the property ASAP at the convenience of the prospect. Consider yourself on call.

2. *Multiple media*. Agents use yard signs and newspaper ads, but they rely on referrals, networking, web sites, cold calls, floor time, and personal and business relationships.

Advice for FSBO sellers: Get the word out about your property to everyone you know or come in contact with. Circulate those flyers.

3. *Pricing*. Agents inspect and show dozens of properties every week. They know properties. They know the details of purchase contracts. They know prospect hot buttons.

Advice for FSBO sellers: Look at properties in the neighborhood and nearby areas. Monitor sales prices, terms, and time on market. Price your property realistically in the context of other transactions. Your goal: A winning value proposition.

4. *Prepare the property*. Agents obtain feedback about properties from dozens of buyers each month. They learn the likes and dislikes of the market. They can use this knowledge to help sellers dress their property for success.

Advice for FSBO sellers: Monitor buyer feedback. Talk with realty agents, contractors, home remodelers, and sales consultants at home improvement centers. Provide buyers what they want most.

5. *Sales presentations*. Top agents don't show properties, they sell them. They know how to encourage buy signals. They know how to alleviate buyer objections. They diplomatically buffer hard-edged negotiations and persistently create trade-offs, options, and alternatives. They maintain a supply of purchase agreements. They know how to get buyers to commit and sign.

Advice for FSBO sellers: Encourage your prospects. Ask them to buy. Shy and passive won't make it. Remain flexible and open to offers. Give and take with tact and good nature. Persuasively lead your prospects into a buying decision. Don't wait for them to ask you.

6. *Troubleshoot problems*. Agents know that signed contracts do not close themselves. Someone must monitor the flow of paperwork and solve problems that can throw a sale off course.

Advice for FSBO sellers: Don't assume that you can walk the path from contract to closing without hitting a few potholes. Monitor the flow. Rely on a sharp escrow agent to diligently control the document shuffle.

Services to Buyers

1. *Market knowledge*. Agents know listings and can prescreen properties to save the buyers effort.

Advice for FSBO sellers: Compare and contrast your property with others on the market. Especially highlight its competitive advantages. Know and show why your value proposition stands superior to other sellers.

2. *Agents help buyers with neighborhood selection*. People don't just buy houses, they buy locations. Agents know demographics, schools, trends, commuting distances, shopping, and culture. Buyers depend on agents to compare and contrast the pros and cons of neighborhoods.

Advice for FSBO sellers: Understand the neighborhood. Know how it compares to others. What are its advantages? Prepare a neighborhood flyer to complement the flyer you've prepared for the property itself. Buyers who are new to a city especially need this information.

3. *Price*. Buyers depend on agents to advise about price. In turn, agents provide buyers comp sales data. Agents help buyers choose their offering price.

Advice for FSBO sellers: Provide prospects with comp sales data. Emphasize how your price, terms, and property features/benefits beat those offered by the competition. Do not expect prospects to learn these facts on their own. Other owners (and their agents) will spin facts to their own advantage—not yours.

4. *Financing*. Agents either qualify buyers or refer them to a loan rep who provides this service. Buyers often need someone to figure out how much property they can afford, the quality of their credit profile, and how well they and the property match other loan underwriting criteria.

Advice for FSBO sellers: Establish a relationship with several loan reps. Discuss the features and costs of loan programs with prospects. Refer prospects to www.myfico.com, where for around $39.95 they can look at three credit reports, learn their FICO (Fair Isaacs Company) credit score, and gain tips on how to improve their credit profile. Even better, help buyers with owner-assisted financing or a mortgage assumption.

5. *Negotiating assistance*. Many buyers, and especially first-time buyers, do not feel comfortable or competent when negotiating. In their role as facilitator and mediator, agents ease their buyers through the offer–counteroffer emotional roller coaster.

Advice for FSBO sellers: Play softball, not hardball. Contemplate and conciliate. Help prospects feel comfortable in talking with you. Nurture trust. "Let's see if we can work out an agreement that will make us all happy," not, "Look, take it or leave it. If you don't want the property, I'm sure someone else will."

6. *Follow through*. Agents help buyers follow through to submit their mortgage application and obtain a professional inspection of the property. They may hand hold or troubleshoot for the buyers. The agent remains on call to provide assurances and intervene when an obstacle arises (low appraisal, mortgage turndown, lot encroachments, etc.).

Advice for FSBO sellers: A sharp escrow agent can assist with some of these details. But invite the buyers to call at any time, as you want to assist with problems or answer questions about the property, the neighborhood, the mortgage loan process, or anything else that concerns them. Provide the buyers with the names of respected property inspectors, pest control companies (for termite clearance), and surveyors (if necessary).

In this section, I have reiterated points made earlier. I have done so because I want you to succeed as an FSBO seller. If you practice the 10 steps to an effective sales message, and if you get the word out, you will outperform most agents. You will earn a higher profit, give your buyers a better deal, sell quicker, or achieve some combination of all of these benefits.

Co-Op Sales

If going it alone as an FSBO seller doesn't appeal to you, offer sales agents a 3 percent (more or less) commission to bring you a buyer. Act as your own listing agent and pay the co-op percentage to the buyer's agent. With this approach, you increase the chance of a sale, but if you find a buyer yourself, you owe the agents nothing. Indeed, as soon as your FSBO sign goes up on your property, agents will flood you with telephone calls. Invite them to take a look. Thoroughly go over your value proposition. Solicit critique and improvements. Inform the agent of your co-op policy.

Listing Contracts

When you agree to list your property for sale with a real estate agent, the agent will usually ask you to sign a listing contract. Read that contract.

Especially review the following clauses:

- Type of listing
- Commission payable
- Listing period
- Description of property
- Automatic renewal/cancellation rights
- Obligations of the agent

Types of Listings. Common types of listing contracts include: (1) open listing, (2) exclusive agency, and (3) exclusive right to sell. Under the first two listing agreements, owners retain the right to sell their property themselves without paying a brokerage fee. Under an exclusive-right-to-sell listing, owners agree to pay a sales fee no matter who sells the property—as long as the sale takes place within the listing period.

Which contract is best? It depends on whether you want to reserve the right to sell your property yourself. Many agents hesitate to accept an open or exclusive listing. These agents prefer an exclusive-right-to-sell listing to protect the time and money that they will invest in their efforts to sell your property.

Assume you sell FSBO—but agree to co-op with an agent; when that agent arranges a showing, sign a "named buyer" listing. A named buyer listing assures the agent that you won't go behind his back to deal with his buyer and cut him out of a commission. Such an agreement also protects you against agent claims that your buyer was actually someone he had brought to you first.

Commission Payable. Any listing you sign should state the amount payable to the agent—possibly a stated percentage of the selling price of the property, or perhaps a flat fee. Either way, the percentage or amount represents a negotiated agreement. Forget the notion of a "standard" fee. You can offer less—or more; sometimes to create an incentive, you might agree to pay a bonus for quick success.

Your agreement should set payment at closing—and only if closing occurs. Some listings in the past have specified that the agent earns his commission whenever he brings an able and willing buyer to you—even if you decide not to sell to that buyer (e.g., in the meantime, before signing with the agent's buyer, you receive a better offer. Or perhaps, you choose to pull your property off the market).

Listing Period. Like commissions, listing periods are negotiable. I've seen listing periods as short as 24 hours and as long as two years. On a co-op, named buyer showing, I advise a time limit of 30 to 90 days. If the agent can't get his buyer to commit within that period, then he loses the

right to that buyer. You are then free to deal direct—without the obligation to pay a commission—should you succeed where the agent has failed.

Within an exclusive-right-to-sell listing, a period of 30 to 90 days seems reasonable. Some agents want 180 days. That's too long for a condo, house, or 2-4-unit rental property—except, perhaps, when the market is slower. Still, if you've crafted a winning value proposition, your property will sell within 90 days—if the agent does her job.

Describe the Real Estate and Personal Property. At the price you ask, what do you offer? Describe the house, lot, and personal property that you plan to include with the sale. If you plan to remove any items that buyers normally might expect (drapes, blinds, refrigerator, ceiling fans, chandelier, etc.), specifically exclude them in writing.

Automatic Renewal/Right of Cancellation. If a clause in the listing agreement automatically renews the listing at the end of the listing period, strike it out. Some contracts require you to notify the agent, say, 10 days before the listing expires to cancel. If you fail to provide this written notice, the listing renews for the same period set earlier. If with the first listing period the agent has not sold the property, the listing should die—unless you positively affirm its renewal.

What if during the listing period the agent does not work effectively? The agreement should give you the right to cancel, list with another agency, or sell the property yourself with no obligation to pay that realty firm. Cancellation rights should include the right to terminate the listing and take your property off the market.

Agent Obligations. Most listing agreements sleight agent obligations. No surprise there. Agents (or their lawyers) drafted the contract. Remedy this omission.

You now know how to carry out an effective sales effort. You know what services a top agent should perform. You know how to design a sales message that sells. Now write these obligations into the listing contract.

For the past 20 years, real estate sales agents have tried to cast out the word "sales" from their job title. They prefer to call themselves real estate professionals. But to deserve such recognition, they must accept responsibility to think and act like the real professionals they claim to emulate. Your "obligations and responsibilities" clause will spell out the professional performance you expect, and the professional performance for which you are paying.

14

PAY LESS TAX

Property taxes and income taxes (especially income taxes levied against capital gains) can eat up large chunks of your net worth. Indeed, for my own investment properties, property taxes represent by far my largest operating expense. And if I were to pay the full capital gains tax instead of electing a Section 1031 exchange—see later discussion—in years of profitable sales such a tax could double or triple my income tax liability.

Consequently, to protect your earnings and net worth, learn the many ways in which you can pay less tax. Without tax-saving tactics, you do the work and take the risks while the U.S. government spends the wealth that you have produced through your sustained efforts. Unfortunately, developing and executing such tax-saving tactics continues to challenge even the most tax-savvy investors.

THE RISKS OF CHANGE AND COMPLEXITY

At the Constitutional founding of the United States, Publius (John Jay, Alexander Hamilton, and James Madison) wrote in *The Federalist:*

> It will be of little avail to the people that the laws are made by men of their own choice if the laws be so voluminous that they cannot be read, or so incoherent that they cannot be understood; if they be repeated or revised before they are promulgated, or undergo such incessant changes that no man who knows what the law is today can guess what it will be tomorrow.

Can anything contradict these founding principles more than the current federal income tax laws? At present, the Internal Revenue Code

(IRC) court cases, regulations, interpretive rulings, and journal commentary take up more than one million pages of text. Moreover, Congress, the Internal Revenue Service (IRS), and the U.S. Department of the Treasury change or threaten to change the tax laws on an almost daily basis.

Given this high degree of complexity and instability, you may decide to shun the field of taxation and turn over all of your financials to a tax pro. Unfortunately, experience shows that such planned ignorance of the tax laws can cost you thousands (or even hundreds of thousands) of dollars. Instead, as a smart, tax-savvy investor, at least learn the basics. As you develop savvy and insight, you will discover what tax questions to ask your adviser, and perhaps, even more importantly, you will learn how to plan your tax strategy to legally reduce or avoid the amounts governments extract from you.

Unsuspecting investors act, and then ask their tax pro to calculate their taxes. The tax savvy investor anticipates the tax effects of various alternatives. Then he or she chooses to act with tax payments or tax savings precisely calculated for their effect on the investor's total after-tax cash returns.

With that tax-saving principle to guide us, we now review income tax law. First, we review some of the ways that owning a personal residence can save you income taxes. For most people, a home represents their first investment in property.

HOMEOWNER TAX SAVINGS

Because government policy favors home ownership over renting, Congress provides homeowners several tax breaks.

Capital Gains without Taxes

Under current tax law, you can sell your principal residence and pocket up to a $500,000 gain tax free (married filing jointly). If you're single, your maximum untaxed profit is capped at $250,000.

Although the law generally requires you to have lived in the home (house, condo, co-op) for two of the past five years, it does not limit the total number of times that you may use this exclusion. It merely limits you to one capital gains exclusion every two years. In other words, over the next 24 years, you could buy and sell a personal residence up to 12 times—and escape capital gains taxes every time (subject, of course, to the $250,000/$500,000 limits).

Flipper's Paradise. For investors who would like to buy properties, improve them, sell, and move up to bigger and better, this law offers a "flipper's paradise." Granted, most people do not want to change residences every several years. But for those willing to tolerate this inconvenience, even an 8- or 10-year plan could easily help you gain $500,000 to $1,000,000 in tax-free profits.

Suzanne Brangham, author of *Housewise* (HarperCollins, 1987), earned her fortune buying, renovating, and flipping. She first bought a $40,000 condominium and over a period of 16 years, she rehabbed herself up to a $1.8 million mansion (1987 prices). However, in contrast to Brangham's day, the beauty of the law now is that when you sell these "flippers," you avoid paying taxes on the gain. (Under previous tax law, homeowner capital gains were primarily deferred, not excluded.)

Tax-Free Capital. In addition to flipping personal residences, you can benefit from this capital gains exclusion another way. You own a home with substantial equity. The kids are gone; you want to downsize. You can now sell that large, expensive house and unlock your equity tax free (up to $500,000). Then, split your cash proceeds into several piles. Use your proceeds as down payments on a lower-priced replacement home as well as several income properties. Finance all of the newly acquired properties with 15-year mortgages. With price gains and an accelerated mortgage payoff building your net worth, you'll be financially set for life within a relatively short time frame.

Rules for Vacation Homes

Increasingly, Americans are buying vacation homes for personal use and investment. As covered by income tax laws, vacation homes are defined quite broadly and can include a condominium, apartment, single-family house, house trailer, motor home, or houseboat. Unlike a personal residence, the IRS will tax your profits from the sale of a vacation home as a capital gain. No exclusion allowance applies. However, if you earn rental income from this vacation property, you may deduct some of your expenses according to the following three rules:

1. If the vacation home is rented for less than 15 days, you cannot deduct expenses allocated to the rental (except for interest and real estate taxes), but the rental income doesn't have to be reported to the IRS.
2. If the vacation home is rented for 15 days or more, then determine if your personal use of the home exceeds a 14-day or 10 percent time test (10 percent of the number of days the home is rented). If it does, then

the IRS assumes you used the home as a residence during the year. You may deduct rental expenses only to the extent of gross rental income. The amount of rent collected in excess of expenses becomes taxable.

3. If you rent the vacation home for 15 days or more, but your personal usage is less than the 14-day/10 percent test, then tax law ignores this minor usage of the property during the year. In this case, the amount of expenses that exceed your gross rental income may be deductible against your other salary or business income. Court cases have allowed deductions for losses when the owner made little personal use of the vacation home and primarily bought the property to earn a profit on resale.

This brief description shows that the income tax laws that apply to vacation properties directly relate to how many days you use the property relative to how many days it is available for rental. Plus, your principal reason for buying the property can affect your tax owed. Advance planning with your tax pro in each of these areas can help you avoid or reduce your vacation home tax bill.

Mortgage Interest Deductions

You will probably finance at least part of your property acquisition costs (purchase price, settlement fees, loan points) and property improvement expenses with mortgage money. Accordingly, you may deduct the interest you pay on these borrowed funds. However, if you later do a cash-out refinance on your home, you may not deduct interest on the cash-out portion of that loan unless you use the money for property improvements, reinvestment, or for certain other costs such as medical or education expenses.

Credit Card Interest

Tax law typically treats credit card interest as a personal expense. As such, you may not deduct it from your income to reduce your taxable income and, correspondingly, your taxes (as you can with mortgage interest). But you can benefit from a special exception. If you use credit card borrowings or cash advances to help fund your rental property acquisitions, improvements, or operations, then you can deduct the interest you pay on those funds.

If you commingle personal and business credit card charges, fully document the business portion. For ease of record keeping and documentation, reserve one of your credit cards exclusively for business charges. In times of cash flow shortfalls, you may have to violate this practice and dip into the credit available on your personal cards. If (or when) you resort to

your personal cards, though, don't get sloppy. Accurately segregate business from personal. Otherwise the IRS may try to invoke the general rule against deducting credit card interest.

Rules for Your Home Office

As an owner of rental properties (and possibly other investment and business interests), you may be able to set up a tax-deductible home office. To legally claim a deduction for a home office, the area must be used *exclusively* and on a regular basis for work (a room where your spouse watches television or works puzzles while you use the telephone does not qualify).

When you do qualify for a home office, you're entitled to deduct pro rata amounts for property depreciation, insurance, telephone, computer, office furniture, and any other items that relate to your work. If your rental properties don't show a taxable income (because of other allowable deductions), you can't deduct office expenses for that year. You can, however, carry these expenses forward and use them as deductions in later tax years.

Depreciation Expense

Real estate investors deduct a noncash expense called depreciation. Income tax law assumes that your rental buildings, their contents (appliances, carpeting, HVAC), and various on-site improvements (parking lot, fencing, sidewalks) wear out over time. Accordingly, various IRS depreciation schedules permit you to reduce your taxable income to allow for this (assumed or actual) deterioration.

Note that this deduction stands on top of already deductible expenses for repairs, upkeep, maintenance, and property improvements. That's why investors call depreciation a tax benefit. You don't have to write a check to pay for it, but it knocks down your taxable income as if you did.

Land Value Is Not Depreciable

Tax law does not permit you to depreciate the land on which your rental buildings sit. So, when you buy a property, to calculate depreciable basis, first subtract the value of the land from your purchase price. If you buy a property for $200,000 and its lot value equals $50,000, your original depreciable basis equals $150,000. Tax law permits an assumed life for residential rental units of 27.5 years. Divide $150,000 by 27.5 and you get $5,455. That's the amount of (noncash) depreciation that you can deduct each year to reduce your otherwise taxable rental income. (If you held this

or any other residential property for 28 years, your annual depreciation deduction would then cease.)

Land Values Vary Widely

To maximize the deduction for depreciation, look for properties in neighborhoods with relatively low land values. Or, holding land value constant, look for lots with the largest quantity (or quality) of improvements. At the other extreme, several years ago, I looked at a small (900 square feet) 100-year-old rental house in Berkeley, California. That house was priced at $525,000. At that time, the land value alone probably totaled $500,000. The actual building was a potential teardown. As a result, even though the property was worth in excess of a half million, a buyer who placed a tenant in that house could legally deduct less than $1,000 per year depreciation expense ($25,000 ÷ 27.5).

No set percentages apply to land/building value ratios. You must scout neighborhoods and geographic areas. Talk with appraisers and sales agents. Other things being equal, the larger your deduction for depreciation, the larger your annual after-tax cash flow. Yet the "other things being equal" caveat seldom applies. So when you compare properties and estimate returns, the potential depreciation deduction becomes just one more factor among others that you weigh and trade off.

After-Tax Cash Flows

Here's an example to illustrate how depreciation serves to reduce your taxable income. You own a property that produces a net operating income (rent minus operating expenses) of $10,000 a year. Your mortgage payments total $9,500 a year, of which $9,000 represents deductible mortgage interest (hence $500 goes to reduce the balance on your mortgage). With building and site improvement value of $135,000, you're entitled to a depreciation deduction of $4,909. Furthermore, assume you're in a 30 percent marginal tax bracket, and without your rental property, your taxable wages (and other income) equal $75,000. Here's how these numbers work out to save you taxes:

NOI	$10,000
Less	
Mortgage interest	9,000
Depreciation	4,909
Tax loss	(3,909)

You use this tax loss from your rental property to offset your taxable income from a job (or other sources).

Taxable income	$75,000
Tax rate	.30
Taxes owed (excluding "loss")	$22,500
Now with the tax loss from the property:	
Taxable income	$75,000
Tax loss from rental property	(3,909)
New taxable income	71,100
Tax rate	.30
	$21,330
Taxes saved because of rental property:	
Taxes owed without property	$22,500
Taxes owed with property loss	21,330
Tax savings	$ 1,170
Total yearly benefit (without appreciation):	
NOI	$10,000
Mortgage payment (principal and interest)	$ 9,500
Before tax cash flow	**$ 500**
Principal reduction	**$ 500**
Tax savings	**$1,170**
Total benefit (not including appreciation)	**$2,170**

For any specific property and investor, the tax savings could end up higher or lower than those shown here. However, this example illustrates how investors can gain from a property—even when, for tax purposes, that property records a tax loss. Because it's a noncash expense, tax-deductible depreciation helps investors reduce their tax payments and thus increase their after-tax cash flows.

Passive Loss Rules

The tax law described in the previous section applies to many real estate investors, but not all. If you fall into a technical tax swamp called the "passive loss rules," a different set of laws applies to you. Although too complex to detail here, the passive loss rules generally ensnare investors who report adjusted gross incomes in excess of $100,000 a year. Investors who take no role in the operational or managerial decisions that affect their properties may also fall under the passive loss rules.

The passive loss rules were enacted to keep high-wage earners from sheltering their earnings through depreciation—a widely adopted practice

before the 1986 Tax Reform Act (TRA). (Unfortunately, the amounts that investors, as well as other taxpayers, now must pay to CPAs and tax attorneys to figure their taxes far exceeds any revenue gains to the U.S. Treasury.)

Taxpayers in the Real Property Business (No Passive Loss Rules)

More complexity: Congress has created another investor tax category called "taxpayers in the real property business." This category includes (but is not limited to) real estate agents, contractors, property managers, leasing agents, converters, and owners of rental properties. If you can fit yourself into this category, you are exempt from the passive loss rules and may use your rental property tax losses to offset the taxable income you receive from any other source including wages, commissions, dividends, interest, and royalties.

However, here's the catch: You must work in a real estate–related trade or business at least 750 hours per year (around 14 hours per week for 52 weeks). More than one-half the personal services you perform each year must fall within the definition of a real property trade or business. In other words, you can't simply go out and get a license to sell real estate and automatically qualify for this preferred tax treatment. Nevertheless, for people who actually do (or can) work in real estate, the "hours worked" test won't prove difficult to meet.

Even if you work as, say, a schoolteacher or an auto mechanic, once you begin to build a portfolio of properties, you may be able to meet the "hours worked" test if you can somehow spend at least one-half the hours you work each year on your real estate activities. To do so, you could cut back on the hours you work in your regular job, and work a second job with your properties. If you put a lot of time into fixing up and renovating your properties, you might qualify. The time you spend searching, buying, renting, and selling also count.

ALTERNATIVE MINIMUM TAX

The alternative minimum tax (AMT) defies human reasoning. You must turn to a tax pro (or tax software) for guidance. Both passive losses and capital gains may throw you into the AMT. Originally, only the wealthiest and most heavily tax-sheltered taxpayers would run into serious AMT tax liabilities. Today the reach of the AMT has pulled in millions of other unsuspecting taxpayers. (For basic information on the AMT for individuals, see IRS Publication 909, Alternative Minimum Tax.)

CAPITAL GAINS

Lower tax rates for capital gains benefit real estate investors. Under current rules, gains realized in the sale of a property will be taxed at a maximum rate of 15 percent.

A Simplified Example

As repeated throughout this chapter, the tax law incorporates far more complexity and technical nuances than I can explain here. Still, the following example illustrates the basics of the capital gain tax:

Sales Price	$600,000
Tax Calculation	
Original cost	$300,000
Less: Accrued depreciation	100,000
Adjusted basis	200,000
Total gain	400,000
Less: Depreciation recapture	100,000 at 25% = $25,000
Capital gain	300,000 at 15% = 45,000
Total taxes	$70,000

Current law recaptures accrued depreciation at a tax rate of 25 percent, and your capital gain is taxed at a rate of 15 percent (or less). If you fit into the 15 percent ordinary income tax bracket (as opposed to the higher brackets), your capital gains are taxed at 10 percent rather than 15 percent. The depreciation recapture remains at the 25 percent rate.

To qualify for capital gains tax rates, you must own the subject property for at least one year. In addition, your property buying and selling activities must not occur so frequently that they throw you into the IRS "dealer" category.

How often and how many deals? No one knows for sure. Occasional sales by rental property investors clearly don't cross into dealer tax territory. However, investors who fix and flip numerous properties (other than their successive personal residences) may get tagged as dealers. Don't unknowingly get caught in the "dealer" trap. Anticipate this potential problem. Seek the advice of a tax pro. To isolate "dealer" properties from your investment properties, you can set up segregated corporations (or other differential ownership entities).

The Installment Sale

If you carry back financing (owner-will-carry, or OWC) when you sell an investment property, you need not pay all of your capital gains taxes at that time. Instead, you spread them out on a pro rata basis as you actually receive principal payments from your buyer.

Assume that at closing you accept 20 percent down and finance the balance of the buyer's purchase price over 15 years. Your total taxable capital gain equals $300,000, which accounts for 50 percent of your selling price. You would immediately incur a tax liability on $30,000 (15% × 50% × $300,000). Thereafter you would owe taxes on the pro rata amount of gain you would receive in each of the following years. (For simplicity, I have ignored recapture of depreciation.) The exact formula for calculations is shown on IRS Form 6252.

Pros and Cons. In his book *Aggressive Tax Avoidance for Real Estate Investors* (Reed Publishing, 2005), John Reed argues that investors should not sell their properties on the installment plan. Reed maintains that with the now lower tax rates on capital gains, postponing the day of reckoning doesn't really save a great deal of money. Moreover, because of technical complexities, use of installment sales may expose you to the black hole of the AMT.

Reed's points are misguided and incomplete. Although he rightfully encourages investors to look more carefully at whether an installment sale will produce the large tax savings that are popularly expected, tax strategy alone should not drive your investment decisions. (That's why so many pre-1986 TRA investors ended up with real cash losses. Their deals were driven exclusively by tax-shelter benefits. After the tax shelters were reduced or eliminated by the passive loss rules, the tax shelter value of their investments collapsed.) Reed alludes to this point in bringing up the issue of opportunity costs. He says, "Why leave your money tied up in OWC financing just to save taxes when you could instead use those sales proceeds to buy more properties and earn much higher returns?"

Here's the Answer. As the late Robert Bruss frequently pointed out in his real estate articles, owners should consider OWC financing because it can help them sell their properties faster and at a higher price. This is especially the case when (as today) mortgage lenders are going through one of their tight money phases and insist that investor loans carry lower LTVs and tougher qualifying standards. So, don't measure your profit from the installment sale by just the tax savings and mortgage interest your buyer pays you. Also judge whether OWC financing will get you a quicker sale and a higher price. It probably will. (Of course, as a buyer, avoid paying an excessive price just because a seller offers you OWC terms.)

As another advantage to OWC sellers, those buyer interest payments can prove lucrative to you, especially when you're able to use wraparound financing. Moreover, interest earnings on a buyer mortgage (depending on creditworthiness, amount of down payment, and the quality of the collateral) typically deserve a lower risk premium than does property ownership.[1] And you devote less effort to pull a mortgage payment from your mailbox each month than you would to manage apartments and collect rents.

What's the Bottom Line for Sellers?

That old equivocating answer "It all depends" applies to installment sales. As John Reed points out, the tax savings from an installment sale may not loom as large as many sellers anticipate. However, the benefits of an installment sale extend beyond tax savings. When you reach the stage in life where you want to enjoy a stable monthly income without the risks and efforts of property ownership, then when compared with long-term bonds at 4 to 6 percent interest, a seller mortgage that earns, say, 7 to 10 percent interest might look pretty good. And if OWC financing helps you get a faster sale and better price for your property, all the better.

Implications for Buyers

Nothing in this discussion of installment sales should discourage you from seeking OWC financing. As a buyer, whether you borrow from a bank or a seller will not change your federal income tax liabilities. However, if you agree to pay the seller a higher price in exchange for favorable terms, make sure you include a prepayment discount. If you refinance or sell the property early, you won't want to pay the seller for favorable OWC terms that you end up not using. In addition, when you arrange seller terms, negotiate assumable financing that you can pass along to your buyers when you sell (or exchange) the property.

TAX-FREE EXCHANGES

When you own a corporate stock that has had a big run-up in price, you may think that now is the time to sell before the market stalls or turns down. But selling stocks creates a serious problem. Federal income taxes can grab

[1] In terms of risk-reward, to a degree, mortgages tend to pay lower returns than equity investments in property because investments in debt (when issued according to sensible rules of loan underwriting) present less risk than equity.

a big part of your gain. As a result, many stock market investors hold their stocks long after they should have sold them because they can't bear the thought of immediately throwing away part of their profits in taxes.

Real estate investors need not face this dilemma. As noted, the installment sale can help you defer, and perhaps reduce, the amount of the profits you lose to taxes. Just as important, but not nearly as well known, real estate investors can eliminate or defer their federal income tax liabilities by trading up. These two techniques—installment sales and exchanging—give owners of investment properties a tax advantage over investors who choose stocks and bonds.

Exchanges Don't Necessarily Involve Two-Way Trades

Many real estate investors who have heard of tax-free exchanges mistakenly believe that to use this tax benefit, they must find a seller who will accept one or more of their currently owned properties in trade. Although a direct trade represents one way to carry out a tax-free exchange, it does not represent the most commonly used exchange technique. In fact, most exchanges involve at least three investors.

The Three-Party Exchange

Three-party transactions outnumber two-party "trade-in" exchanges because it's difficult to find an owner of a property you want who will accept the property you plan to trade up. True, you might negotiate a two-way exchange by convincing an unwilling seller to accept your property in trade and then turn around and sell it. But to do so may cause you to spend too much negotiating capital that you could otherwise devote to issues such as a lower price or OWC financing.

Instead, most real estate investors arrange a three-party exchange through the following steps: (1) Locate a buyer for the property you want to trade; (2) locate a property you want to buy; and (3) set up an escrow whereby you deed your property to your buyer, the buyer pays cash to your seller, and your seller conveys his or her property to you. In effect, no property has really been "exchanged" for another property. Because of this anomaly, some observers suggest renaming this technique the "interdependent sale and reinvestment" strategy. Not surprisingly, that terminology has not caught on.

Exchanges Are Complex but Easy

As you might suspect, anything that involves federal tax laws will entangle you in a spider web of rules and regulations, and Section 1031 exchanges

(as they are called in the Internal Revenue Code) prove no exception. Yet even though exchanges must adhere to complex rules, when you work with a pro who is experienced in successfully setting up and carrying out tax-free exchanges, they need not create difficulty.

Due to intense competition among Section 1031 accommodators, the total extra costs (including fees and escrow charges) of conducting an exchange are often less than $1,000. Professional Publishing Company (now taken over by Dearborn Real Estate Education in La Crosse, Wisconsin) even publishes standard forms that may be used to complete the required paperwork according to law. Even if you rely on standard forms, use a tax or realty exchange pro. Be aware, too, that the great majority of CPAs and real estate attorneys know little about Section 1031 exchanges. Unless your accountant or lawyer has definitively mastered this area of law, find someone else who has this expertise. (If you live in at least a midsize city, there's probably an exchange club whose members include investors and commercial realty brokers who can recommend competent and experienced exchange professionals.)

Note: Some accountants and lawyers have frequently told me things like "Oh, you don't want to get involved in something like that," or "That's more trouble than it's worth," or "Sure, I can handle it, no problem." In my naïve and inexperienced days, I simply accepted such comments without question. "Surely, I can count on the wisdom and good faith of my accountant or lawyer." (Okay, those of you who have worked with lawyers and accountants can now stop laughing.) Note these words of wisdom: (1) To hide their own ignorance, lawyers and accountants who do not understand an issue will often advise against "getting involved with that," whatever "that" may be, so as not to disclose that they really don't know what they are talking about; or (2) depending on how much they need the business (or perhaps they don't want to lose you as a client), accountants and lawyers frequently claim competency in areas where they lack expertise.

Either or both of these tendencies can cost you. (Yes, you can sue for malpractice. But that's not an easy remedy.) To reduce the chance of professional error, misinformation, or just plain bad advice, don't let your accountant or attorney bluff you. Pepper them with detailed and specific questions about the issue at hand and their actual experience in dealing with Section 1031 exchanges. Whatever you do, never naïvely accept the counsel of any professional (lawyer, accountant, real estate agent, medical doctor, etc.). These are not demigods but people with limited and biased knowledge and abilities. Require them to *earn* your trust and respect through performance. Do not grant trust merely because your advisors list a string of initials after their names.

Are Tax-Free Exchanges Really Tax Free?

Some people quibble with the term "tax-free exchange." They say that an exchange doesn't eliminate taxes but only defers payment to a later date. This view is wrong on four counts:

1. The exchange itself is tax free if you follow the rules.
2. Whether you must pay taxes at a later date depends on how you divest yourself of the property. If you hold it until death, the property passes into your estate free of any capital gains taxes.
3. As another alternative, you could arrange a sale in a later year in which you have tax losses that you can use to offset the amount of your capital gain.
4. If Americans are sensible enough to elect legislators who understand the importance of productive investment, we may see the income tax, or at least the capital gains tax, abolished. (I would not bet on this outcome—especially with the multi-trillion-dollar deficits and debts the U.S. government is accumulating.)

Exchanges do eliminate taxes for both capital gains and depreciation recapture in the year you exchange the property. Whether you pay in future years depends on how savvy you are in developing your tax-avoidance strategies, and on the tax law that exists in some future year. By exchanging, you eliminate a certain tax liability in the year of sale and accept an uncertain and contingent future tax liability. That's a tax trade-off you should always try to make.

Section 1031 Exchange Rules

Stated simply, Section 1031 tax-free exchanges must comply with five principal rules:

1. *Like-kind exchange.* Tax law states that only exchanges of "like-kind" properties qualify for the preferred tax treatment. However, "like-kind" doesn't mean fourplex to fourplex, or even apartment building to apartment building. Like-kind actually includes "all property [types] held for productive use in a trade or business or for investment." As a matter of law, you are permitted to exchange nearly any type of real estate for any other type of real estate and still arrange your transaction to fall within Section 1031 guidelines.

2. *45-day rule.* If all parties to an exchange are known and in agreement, you can close all properties simultaneously. Otherwise you can use a delayed exchange procedure that specifies two separate time deadlines. One of these is the 45-day rule, which says you must identify the property

you want to acquire within 45 days after the date of closing with the buyer of your present property (i.e., before midnight of the 44th day).

3. *180-day closing.* The second time-period requirement requires you to close on your purchase property within 180 days of closing the disposition of the property that you are "trading up." Or if sooner, from the date your income tax filing is due for that tax year.

4. *Escrow restrictions.* Tax-free exchanges generally require exchange proceeds to be paid into and distributed out of an escrow arrangement. The escrow agent must stand independent of you (e.g., not your attorney, real estate agent, bank officer, spouse, company's employees, or anyone else who is subject to your exclusive control or direction). Most importantly, you must not touch any money held by the escrow or otherwise pull out of the exchange agreement before the date the escrow agent has scheduled disbursements and property transfers.

Beware of with whom you place your escrow monies. Choose a well-established escrow holder. During the recent boom, many exchangors lost their money when their escrow agents misappropriated, misinvested, or stole the funds that had been deposited with that escrow agent.

5. *Trading up.* To gain the benefit of a tax-free exchange, you must trade for a property of equal or greater price. Trading down or accepting a cash "boot" exposes you to a liability for capital gains taxes. If because of this tax liability, your "seller" doesn't want to trade down or accept a cash sale, then you can create a daisy chain of exchange participants until a property owner is found who wants to cash out or trade down real estate holdings and is willing to pay his or her capital gains tax. (A seller who has planned a total tax strategy may not have to pay any taxes despite realizing taxable income from a specific transaction. Also, because heirs receive properties on a stepped-up basis, they will incur little or no capital gains tax liability unless they sell their inherited property for substantially more than its estimated market value at the time it entered the deceased's estate.)

To keep lawyers and accountants fully employed, the tax law embellishes the preceding rules with various details, definitions, regulations, and requirements. So, use an experienced exchange professional to guide you *before* you enter into any purchase or sale agreement, and also to keep the exchange process in compliance throughout each step until all closings are completed.

REPORTING RENTAL INCOME AND DEDUCTIONS

You report rental income and expenses on Schedule E of your federal tax return. You report the gross rents received, then deduct operating and

financing expenses such as mortgage interest, property taxes, maintenance costs, and depreciation. Add any net income to your other taxable income. If you book a loss, you may reduce the amount of your other taxable income within certain limitations (see passive loss limitation rules, discussed earlier).

To pay less tax, keep detailed records for all allowable deductions. Don't shortchange yourself with sloppy bookkeeping. Deduct every expense that you believe reasonable and necessary to operate and maintain your properties. Among the most common deductions are the following:

- *Real estate taxes.* Property taxes are deductible, but special assessments for paving roads, sewers, or other public improvements may have to be depreciated or added to the cost of the land.
- *Depreciation.* Be sure to deduct depreciation; it is the tax-shelter benefit of real estate ownership.
- *Maintenance expenses.* These expenses include repairs, pool service, heating, lighting, water, gas, electricity, telephone, and other service costs.
- *Management expenses.* You may deduct all fees paid to a professional management firm. However, you can't pay yourself a deductible fee unless the property is owned by a separate corporation or partnership. You could, though, pay your spouse or kids for helping out and then deduct these amounts.
- *Traveling expenses.* These include travel back and forth from properties for repairs or showing vacancies.
- *Legal and accounting expenses.* These could include the costs of evicting a tenant, negotiating leases, or keeping financial records and filing tax returns.
- *Interest expense.* This category includes interest on mortgages and other indebtedness related to the property or property operations.
- *Advertising expense.* This includes the cost of signs, newspaper advertising, web sites, and referral (bird dog) fees.
- *Insurance expense.* This includes the cost of premiums for property and liability coverages.
- *Educational investment.* To consistently improve your motivation and performance, read books, attend seminars and conferences, join investor organizations, and subscribe to magazines and newsletters. These educational costs are legitimate tax deductions.
- *Capital improvements.* Income tax law does not permit you to expense a new roof, a new heating, ventilating, and air-conditioning

(HVAC) system, a major kitchen remodeling, or other long-life expenditures in the year you make the improvement. Instead, the law requires you to depreciate the cost over, say, 5 to 20 years, depending on the precise nature and useful life of the improvement. (For specifics, talk with a tax pro.)

TAX CREDITS

On occasion, tax law may offer property investors (or homebuyers) tax credits. A tax deduction reduces taxable income; tax credits reduce your tax liability dollar for dollar. They're much more valuable than tax deductions.

Assume you deduct all tax-deductible expenses from your gross income and calculate your taxable income at $40,000. If you are in the 28 percent tax bracket, you would owe $11,200 (.28 × 40,000) in income taxes. But let's assume that you are entitled to a tax credit of $4,000. After accounting for this credit, your tax liability falls from $11,200 to $7,200 (11,200 − 4,000).

How do you get these tax credits? As tax law stands today, tax credits aren't as easy to come by as they once were. However, Congress and state governments periodically add (or delete) tax credits. So stay alert for updates. Among the tax credits available now are these six possibilities:

1. *Mortgage credit certificates (MCCs).* These tax credits are available only to first-time homebuyers whose state or local governments participate in a program Congress created in 1984 (and has continued to reauthorize since then). To calculate the amount of tax credit permitted, you multiply 0.2 times the amount of your annual mortgage interest. If you paid $9,000 in mortgage interest this year, in addition you would receive a $1,800 tax credit (0.2 × 9,000). If your area offers an MCC and you haven't yet invested in your first home, get the details on this program as they apply to homebuyers where you live (or plan to live). This is truly free money.

2. *Low-income housing tax credits.* These tax credits are available to real estate investors who build new or substantially rehabilitate rental housing that is rented to households with low incomes.

3. *Nonresidential rehabs.* Nonresidential rehabilitation tax credits are available to investors who substantially renovate commercial buildings that were originally constructed before 1936.

4. *Certified historic rehabs.* Historical societies in various states have the authority to certify residential and nonresidential buildings as

"historically significant." Investors who rehabilitate and restore these structures to meet historical preservation standards are entitled to tax credits.

5. *ADA building modifications.* The Americans with Disabilities Act (ADA) requires owners (or lessees) of some existing public or commercial buildings (not including rental housing) to adapt their properties to meet the accessibility and use needs of people who are physically disabled. Meeting the financial burden of these ADA requirements may entitle the owner (lessee) to tax credits to partially offset these expenses.

6. *The Obama first-time buyer tax credit.* As part of the Obama economic stimulus legislation, Congress has enacted the American Recovery and Reinvestment Act of 2009, which provides an $8,000 first-time homebuyer tax credit. At present, this tax credit applies only to home purchases (the property must serve as the buyer's principal residence) closed prior to December 1, 2009. However, if at that time the housing market still seems weak, Congress may extend this credit for an additional period. So, even if you read this book after 2009, check on the hud.gov or irs.gov web sites to see if this credit still exists. Industry lobbyists are pushing to extend and expand this tax benefit, but not the others.

This tax-credit legislation defines a first-time homebuyer as any purchaser of a principal residence who has not owned his or her own home during the preceding three years. The credit is fully refundable—even if you owe income taxes of less than $8,000. In other words, say your income tax bill equals $5,000. For a qualified purchase, the IRS will not only cancel the taxes you would otherwise pay, but it will send you a check for the difference of $3,000. [Beware: If the house ceases to serve as your principal residence within 36 months of closing, you must repay the full $8,000 with the following year's tax return.]

As with all IRS tax credits, this first-time homebuyer tax credit comes wrapped up with detailed rules, regulations, and forms that go beyond the brief description offered here. Nevertheless, if you have not owned a principal residence within the past three years, you definitely want to try to take advantage of this $8,000 "gift" from the U.S. government.

Complexity, Tax Returns, and Audits

Tax complexity creates some risk of noncompliance. Income tax laws have grown "so voluminous that they can't be read, and (in many ways) so incoherent that they can't be understood."

Several years ago, *Money Magazine* created an income and expense profile for a hypothetical investor and sent the same figures to 50 certified

public accountants (CPAs), tax lawyers, and the IRS. *Money* asked these tax pros to calculate this hypothetical household's federal income tax liability. Guess what? Among these 50 separately prepared tax returns, no two produced the same answer. In fact, the difference between the high and low tax bill was a whopping $66,000.

What does this mean to you? The complexity of tax law renders the rules uncertain and incomprehensible, not just to average citizens, but also to tax preparers. This doesn't mean that some parts of the law aren't relatively certain (for example, the deductibility of mortgage interest paid to finance rental properties). It does mean that in many instances, figuring your tax liability will require judgment calls (e.g., the allocation of property value between land and improvements for purposes of calculating depreciation).

Therefore you choose whether to take an aggressive stance on matters of judgment to reduce your taxes to the lowest possible level, or to play it safe, pay more, take less than the law *might* allow, and reduce your chance of an audit.

You and your tax pro can answer this question only after you weigh your total personal situation in light of current IRS audit standards and the contemporary "hot issues" that may flag your return for audit. Nevertheless, before you choose to play it safe and pay more than you owe, review the following points.

Audits Intend to Intimidate. The IRS prefers that you "play it safe." The IRS operates primarily through intimidation. It wants taxpayers to fear an audit. The fewer the number of people who push the envelope, the more money the IRS collects for the government. However, under the law, Congress did not authorize the IRS to maximize government revenues. Rather, statutorily, Congress authorized the IRS to enforce the tax code. As long as you support an aggressive position that reduces your taxes, you have little to fear from the audit result itself. (Of course, the time, effort, and expense an audit requires remain a valid concern—especially for investors who lack organized and documented records.)

Renegotiate Your Assessment. Even if an audit goes against your position, that doesn't mean you completely lose. When the IRS assesses more taxes, you can renegotiate the amount (based on the facts of your case and applicable tax law, not simply, "I'll give you 50 cents on the dollar") with the examiner, another examiner, or the manager of the IRS office responsible for your audit. In many cases, you (or your tax pro) can persuade the IRS to reduce its additional assessments.

Appeal Your Assessment. Absent a satisfactory resolution at the local level, you can ask the district appeals office to reduce or eliminate the

additional assessment. Although theoretically the appeals office could reopen your file and bring new challenges and even higher assessments, it rarely does so. The appeals office works to settle cases quickly. Appeals officers acquiesce (on the merits) to lower assessments in more than 50 percent of the cases that come before them.

Litigate Your Assessment. Some cases aren't settled on appeal. But again, you aren't compelled to accept the decision of an appeals officer. You have further appeal rights through several different court procedures. Furthermore, because of the large cost of litigating tax cases and the limited number of government lawyers to handle them, few tax cases actually go to trial.

Represent Yourself without Worry or Large Costs. You may think that audits, appeals, and court litigation will cost you far more than you could possibly save in taxes. While that may be true, it's not *necessarily* true. Up through the appeals office, you can represent yourself as long as you are willing and able to prepare your case (facts, records, laws) in a way that meets IRS standards. This task is not difficult (see the excellent book by tax attorney Fred Daly, *Stand Up to the IRS,* Nolo Press, 2008).

Furthermore, if you move your case from the appeals office to the small-claims tax court (tax assessments of less than $10,000 for each year in question), you still can represent yourself. If you choose to litigate in regular tax court or a U.S. district court, however, retain a tax pro to carry on your battle. At that point, your legal expenses will shoot up. But do not measure the time, effort, and expenses you incur to win your position against the tax savings of just one year. If the issue affects your future tax returns (or past returns that are still open to audit), then you have more at stake than just the initial assessment. Argue for the position you believe is correct or you could pay additional taxes over a number of years.

Relatively Few Returns Are Audited. Your (law-derived) aggressive position to minimize income taxes won't be challenged automatically. Even if IRS computers flag your return, that doesn't mean they will call you in for an audit. In recent years, the IRS has scheduled office or field exams for less than 1 percent of all tax returns filed. Even then, most returns are not examined comprehensively. More often, only some items are questioned as a matter of law or documentation.

This brings us back to where we started this IRS discussion. Because it has the personnel to investigate (not to mention litigate) less than 1 percent of all tax returns filed, the IRS realizes that it must appear more formidable than it actually is. Don't let the intimidating image of the IRS deter you from lawfully minimizing your tax payments. Even when the IRS does examine your return, as long as you (or your tax pro) can plausibly support your

positions by citing case law, statutes, or revenue rulings and provide some legally acceptable (not perfect) records, you need not fear the audit.

At the worst, you will have played the game with odds in your favor. And even when you roll the dice, over the long run, an aggressive (but arguably lawful) tax position will yield more wins than losses.[2]

"Plausible" Position. By taking an aggressive tax position, you should *avoid* paying taxes that you do not owe—not *evade* paying the taxes that you do owe. Do not spend $20,000 to renovate your personal residence and then claim this expense was invested to upgrade your rental properties. Do not collect rents in cash so that they will leave no paper trail for the IRS to follow. Do not sell your properties privately on contract so that you can try to hide your capital gains and interest income from the IRS.

Before you take action to reduce your taxable income (or, correspondingly, increase your deductible expenses), verify your position with a tax pro. A plausible position is supported by one or more recognized tax authorities (cases, statutes, regulations, or revenue rulings) and some personal records (contemporaneous or ex post). When you fail to report rental income or run personal expenses through your rental property accounts, you do not meet this test. Interpret facts and law to favor your position, and at most you'll owe more in taxes (plus interest and maybe some penalties). Purposely misrepresent the facts, and you expose yourself to steep penalties, fines, and criminal prosecution.

Use a Tax Pro

Although you can represent yourself at an audit or appeal, consult a tax pro to help you plan your tax strategy, prepare your returns, and, if necessary, prepare for an audit. Tax law complexity makes it nearly impossible for the great majority of Americans to fully understand the tax laws.

This chapter goes through some basics of income tax law as they apply to property owners. But this discussion remains a starting point—not the last word.

I again encourage you to consult a tax pro *before* you buy or sell a property, and *before* you develop your operating budget or plans for capital improvement or exchange. You can arrange your transactions and

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[2] John Reed, author of *Aggressive Tax Avoidance for Real Estate Investors* (self-published, 2005), says that he was subjected to the excruciatingly detailed Taxpayer Compliance Management Program (TCMP) audit, but emerged from this torture with zero additional tax liability.

document your spending to whittle down your federal (and state) income tax liabilities.[3]

PROPERTY TAXES

"If you think that your property taxes are too high," writes tax consultant Harry Koenig, "you're probably right! Research shows that nearly half of all properties may be assessed illegally or excessively" (*How to Lower Your Property Taxes,* Simon & Schuster Fireside Books, 1991). While Koenig may overstate his point, no doubt millions of property owners do pay more in property taxes than they need to. With planning, you can avoid falling into this trap by taking several precautions:

- *Check the accuracy of your assessed valuation.* Tax assessors usually base their tax calculations on a property's market value. Look closely at the assessor's value estimate on your tax bill. Can you find comp sales of similar properties that would support a *lower* value for your property? Given the cyclical downturn in many cities, determine whether your properties might appraise for less today than in the past. If so, you may have grounds to request a tax reduction. (See Chapter 3 to review appraisal techniques.)
- *Compare your purchase price to the assessor's estimate of market value.* Apart from providing comp sales, if you can show the assessor that you recently paid $190,000 for a property that he or she has assessed at $240,000, you have a prima facie case for a lower tax assessment.
- *Look for unequal treatment.* Under the law, assessors must tax properties in a neighborhood in an equal (fair) and uniform manner. This means that you might argue successfully for lower taxes even though the assessor has accurately estimated the market value of your property. How? Show that the assessor has assigned lower values to similar nearby properties. (All property tax data are publicly available.) If faced with this issue, the assessor will have to

[3] A former secretary of mine was billed $12,500 by the IRS to recover tax benefits she had previously claimed from the sale of a property. She had timed a second sale two months too soon. Although she had been represented in both transactions by the same lawyer, he claimed that tax issues were not his specialty. So, if taxes were her concern, she should have asked specifically about them. Lesson: Don't assume! Inform yourself. Then ask. Lawyers, and to a lesser degree accountants, rarely admit that they failed to advise you competently—even when their error is obvious to common sense.

cut your taxes because after everyone's tax notices have been sent out, it's not politically feasible (even if lawful) for the assessor to start telling people he or she has made a mistake and property owners owe more than their tax bill shows.

- *Recognize that assessed value and market value may differ.* Typically, property taxes are based on assessed value, which may be calculated as a percent of market value. If your tax notice shows an assessed value of $380,000 and you know your property is worth $680,000, don't necessarily conclude that you've been underassessed. If property tax law sets assessed values at 50 percent of market value, then your assessed value should come in at $340,000 (.50 × $680,000), not $380,000.
- *Does your property suffer any negative features that the assessor has not considered?* Even though comp properties may appear similar, might they actually differ? Does your property abut railroad tracks or a noisy highway? Does it lack a basement, built-in appliances, a desirable floor plan, or off-street parking? Does it have a flat roof? (In some areas, flat roofs reduce value because they tend to leak and are costly to replace.)
- *Do you or your property qualify for any property tax exemptions?* Many property tax laws offer lower taxes to various persons or properties. For example, homeowners, military veterans, age 65+, blind people, and hardship cases may benefit from reduced assessments. Historic properties, properties located within areas designated for revitalization, energy-efficient properties, or properties rented to low-income households may qualify for reduced assessments. Check with your assessor's office to see what exemptions apply in your area.
- *Verify that your property assessment meets all technical requirements specified in the law.* Tax assessors and the legislative bodies that levy property taxes must operate within a set of rules, regulations, laws, and even constitutional requirements. For instance, some technical or procedural requirements may pertain to assessed value ratios, property classification, land-improvements ratio, procedures for public hearings, notice of public hearings, permissible valuation techniques, and allocation of assessed value between real and personal property.
- *Learn tax assessment laws before you improve or rehabilitate a property.* The property tax laws of every state list the types of property improvements that are taxed and the applicable rates. Once you discover the detailed nature of these laws, you can plan improvements that add value without adding taxes. For an excellent

discussion of this topic and numerous case examples, see the dated, but useful book by Steve Carlson, *The Best Home for Less: How to Drastically Reduce Your Taxes, Utility Bills, and Construction Costs When You Build, Remodel, or Redecorate* (Avon Books, 1992).

Some investors (and homeowners) who remodel or renovate do not obtain the appropriate permits. These owners think that the government can't tax what it doesn't know. Actually, though, nonpermitted work runs the risk that someday a building inspector may discover the illegal work. In some cities, that means the inspector can require a property owner (even if the unpermitted work predates his ownership) to tear out the work and do it over. This risk arises especially when unpermitted work doesn't meet code requirements. In the past, governments often overlooked unpermitted work and failed to keep their property tax records up to date. But now, with computer data banks, buyer prepurchase inspections, and mandated seller disclosure statements, such illegal work will become known.

Furthermore, in their quest for more taxes, local governments realize that unreported remodeling and renovations are costing them billions of dollars each year in lost tax revenues. The trend throughout the country is drifting toward more thorough property investigations and harsher penalties. While many city and county governments still lack the personnel or political will to change their practices, don't foolishly bet that assessment inefficiencies will continue forever.

SUMMARY

Income taxes and property taxes take large chunks out of your earnings. To reduce this drain on your livelihood and wealth building, you can practice tax evasion or tax avoidance. Tax evasion results when you maintain two sets of books, fail to report rent collections, overstate expense deductions, or run personal expenses through your tax-deductible property accounts. Tax avoidance refers to legal strategies and tactics that you can use such as depreciation, tax credits, installment sales, tax-free exchanges, and income shifting (e.g., timing of receipts and converting ordinary income into capital gains).

If you evade taxes, line up trusted and competent property managers who will look after your properties while you go to prison. To avoid taxes, know the law; structure your income, expenses, and transactions to minimize, if not eliminate, income tax liabilities. Before you act, ask your accountant three questions: (1) How can I arrange and document this spending to make sure it's tax deductible? (2) How can I structure my

income or capital gains to keep from losing it to the IRS? (3) Can I arrange this spending or investment to qualify for any allowable tax credits?

Although income taxes remain a fact of life, the amount of income tax you pay does not. Through careful planning at the *start* of each year, you will find that you can slice your income tax bill at tax time by thousands of dollars or more.

Likewise, property owners must pay property taxes. But the amount of taxes you pay need not equal the amount indicated on your property tax bill. Through negotiations with the tax assessor's office or through formal appeal procedures, you may be able to pay less than the sum the assessor originally said you owed. Learn the details of property tax laws and assessment practices *before* you remodel or renovate a property. You can then make your improvements with an eye toward keeping your assessments down while enhancing the desirability of the property for your tenants.

Although tax avoidance should not drive your investment strategy, you should develop an investment strategy that explores opportunities to keep more money for yourself. The stakes have climbed too high. With governments' insatiable appetites for more taxes, your best defense stands as a strong offense. And a strong offense requires wisely informed tax planning.

15

MORE IDEAS FOR PROFITABLE INVESTING

Throughout this book, we discuss multiple ways that you can invest in property. You might go for buy and hold, lease options, master leases, fix and flip, create value and hold, foreclosures, REOs, contract assignments, condo conversions, wraparounds, or some combination of any or all of these. We discuss more than 20 sources of financial returns such as inflation, appreciation, leverage, cash flows, amortization, subdivision of rights, subdivision of the physical property, smarter management, and savvy marketing. But before we close, I would like to introduce (or expand upon) even more ideas that you might find appealing and profitable.

- Lower-priced areas of the United States (and Canada)
- Emerging growth areas
- Emerging retirement areas
- Commercial properties (office, retail)
- Triple net leased properties
- Self-storage
- Mobile home parks
- Zoning changes
- Property tax liens/tax deeds
- Discounted paper

In covering so many types of investing in one chapter, I intend only to introduce you to these possibilities. But before you move forward with any of these investments, educate yourself about the local market data, the

specific opportunity, and the realistic numbers that are necessary to make a proposition attractive.

In the next section, for example, I encourage you to look at properties in lower-priced areas.

Still, do not buy simply because the asking price of a distant property sits well below (and cap rates well above) those available in your area. A $200,000 quad in Peoria might look like a steal relative to La Jolla. Yet that $200K price tag could tower above the comparable properties available in the Peoria market. It's underpriced relative to La Jolla—yet still overpriced relative to Peoria. Before you buy, understand the pricing and the popular/unpopular features and market niches of the local market.

LOWER-PRICED AREAS

If you live in San Diego or Boston, you've seen small residential properties priced with cap rates as low as 4 or 5 percent. But, shift your search to the Midwest, Southwest, and South and you will find similar properties (except for location, of course) valued with cap rates of 7, 8, 10 or sometimes 12 percent. Figure 15.1 shows several examples of current listings.

Go to loopnet.com. Click on those states located away from the East and West coasts. Troll through for sale listings. You'll find hundreds of properties similar to those shown in Figure 15.1 (residential as well as offices, retail, mobile, home parks, self-storage, industrial, etc.) with comparably attractive financials. Look closely at the price per unit and price per square foot figures for the example properties I have provided. On a price per unit basis, prices range from a low $25,800 up to a high of $59,000. On a price per square foot basis, prices range from a low of $29 (possibly an error) up to a high of $61.

All of these "price per" figures come in way below replacement costs. Recall from Chapter 3 (Appraisal), purchase prices that sit well below replacement cost generally protect you against direct competition from new construction. Any builder who would try to match the rent levels of these lower-priced properties would soon go broke—as many are—as foreclosures/REOs, and other distressed sales pull down the current market values of SFRs as well as the price per unit (PPU) for a multifamily.

Within comparable ranges of quality, features, and locations, the PPU for apartments must fall below the prices of houses. Thus, the distress sales of houses push down the market value of apartment buildings. You can now negotiate terrific multifamily bargains. Buy now, well below replacement cost, and position yourself for reasonable cash flows today and strong potential for appreciation and inflationary price gains in the future.

Phoenix, Arizona (Bank Owned)	Status:	Active
Excellent shape (Built 1984)		
some new appliances, new mini blinds,	Price:	$184,500
some new toilets, doors, tubs, & sinks.		
Units in well-kept condition.	Bldg.Size:	7,896SF
	Units:	4
	Cap Rate:	9.60%
	Primary Type:	Garden/Low-Rise
Austin, Texas	Status:	Active
3,584 SF, built 1973. Faces 1902	Price:	$177,500
Hearthstone which allows a large, fenced	Bldg. Size:	3,584 SF
grassy area in between. Seldom have a	Units:	4
vacancy. All units remodeled in 2001.	Cap Rate:	10.29%
	Primary Type:	Fourplex
Rockwall, Texas	Status:	Active
21% Cash on Cash. 3 very nice units in a	Price:	$135,000
park-like setting in the fastest growing	Bldg. Size:	2,586 SF
county (Rockwall) in the U.S. Rockwall	Units:	3
has a moratorium on new construction.	Cap Rate:	9.47%
	Primary Type:	Garden/Low-Rise
Omaha, Nebraska	Status:	Active
Mid-city unit, brick, 8 courtyard and 3	Price:	$330,000
below grade. 3 built-in garages. Boiler	Bldg. Size:	6,000 SF
(owner pays heat and water).	Units:	11
One-quarter acre.	Cap Rate:	30.00%
	Primary Type:	Garden/Low-Rise
Roanoke, Virginia	Status:	Active
10-unit brick apartment building with	Price:	$258,000
efficiency, 1 bedroom, and 2 bedroom	Bldg. Size:	7,500 SF
apartments. Centrally heated, with	Units:	10
updated electrical and new roof.	Cap Rate:	9.3%
	Primary Type:	Mid/High-Rise
Fort Myers, Florida	Status:	Active
Updated duplex, consists of two	Price:	$118,000
2-bedroom, 2-bath units. Each unit is	Bldg. Size:	1,943 SF
over 900 sq. feet. The exterior has been	Units:	2
repainted and re-roofed. Two parking	Cap Rate:	8.7%
spaces per unit.	Primary Type:	Garden/Low-Rise
Tonawanda, New York	Status:	Active
Nearly new 8-unit apartment complex,	Price:	$349,900
13 years young, all 2-bedroom	Bldg. Size:	8,305 SF
apartments. Separate utilities, central	Units:	8
air-conditioning. Laundry rooms and	Cap Rate:	9.50%
parking on site.	Primary Type:	Garden/Low-Rise

Figure 15.1 Sample Listings for Small Apartment Buildings

Some properties do sell at prices far below the costs of new construction because they've fallen into disrepair, or their locations are trending into neighborhood decline and/or deterioration. Most often, low prices result from the down *cycle* (not deterioration)—and until market prices increase substantially, builders will hold back on constructing new SFR or apartment developments. So as long as an area will experience (over time) growth in its jobs, economic base, and population, you are primed for extraordinary returns from multiple sources.

What about Property Management?

A colleague who is working with me in Dubai owns four rental properties that are located in France. She does not employ a local property manager. Another Dubai colleague owns rentals in Alabama. And another owns a few rental houses located in Perth. No one employs a property management firm. I currently rent out my Florida home to a family. I do not employ (for that house) a property manager (although I do employ a caretaker/jack-of-all-trades handyman).

You can self-manage rental properties from anywhere in the world. Here's the secret: Offer good value, select great tenants. Do not fear long distance property management. Set up a system to manage repairs, vacancies, and emergencies. You should not encounter serious difficulties.

Tenant-Assisted Management

Notwithstanding the fact that you can "self-manage," you may need local assistance if you expect intermittent vacancies—as would be the case with multi-unit buildings. (If you're located within several hours of your property, you could fill vacancies yourself.) Typically, for that task—as well as general property oversight—enlist the help of one of your longer-term tenants. In exchange, give that tenant discounted (or free) rent and a variety of upgrades for his or her living quarters.

Property Management Companies

I seldom recommend large residential property management companies—although other investors I know do seem to find them satisfactory. I don't think this type of firm will strive to give my properties the competitive advantage that I'm seeking while they simultaneously work for dozens of my competitors. Nevertheless, if self-management issues deter you from out-of-your-area investing, by all means, employ a property management

company. Just make sure you develop your own market strategy (see Chapter 11) and guide your management company accordingly.

EMERGING GROWTH AREAS

In San Francisco, a few years back I shared the speaker's platform with Richard Florida (author of *The Rise of the Creative Class*) and Rich Karlgaard (publisher of *Forbes* magazine and author of *Life 2.0*). Neither of these authors claims expertise in real estate investing per se, but both share insights that can benefit real estate investors.

The Creative Class

In different ways, Florida and Karlgaard have both sought to identify the areas of the country (as well as specific cities) that will experience the most long-term profitable growth. Although I do not necessarily agree with some of their picks, that's not the value of their work. Their value lies in pointing out that today, people do not so much move to where the jobs are; rather jobs (at least the best paying jobs) move to where people (especially members of the population that Richard Florida dubs the creative class) want to live. (See, too, Florida's book, *Who's Your City*.)

Implications for Investing in Real Estate

As you evaluate areas for their growth (i.e., appreciation) potential, do not rely exclusively on traditional statistics such as jobs, incomes, and household size. Look more closely at the types people moving into the area; the types of employment; the restaurants, cafes, and bookstores that are opening. Discover what festivals, tournaments, outdoor activities, and sports events are gaining in size and recognition.

Is the area—whether neighborhood, city, or rural outpost—attracting people who in turn will serve as drawing cards for others? In other words, look for areas that are developing a certain cachet. Look for areas where increasing numbers of people say they would like to live—even if when their possibility of actually moving seems remote.

Why? Because such dreams encourage conversations and positive word of mouth. Such talk reinforces the decisions of those who do decide to make the move. Many of us do like to provoke at least a mild amount of envy from our friends, relatives, and acquaintances. As we all know, where we live and where we're moving to say a lot about us to those we know.

Right Place, Right Time

When I read Richard Florida's book, I could see myself writ large. Throughout my career, I never accepted a job anywhere that I did not want to live. And those places where I have chosen to live (Vancouver, Palo Alto, Berkeley, Charlottesville, Williamsburg, and now Dubai) all fit the profile as creative class growth centers.

Yet oddly enough, before reading Richard Florida, I thought of "where to locate" decisions more as personal choices, not a "class" choice—nor that millions of other members of the boomer generation would like to choose the same (or similar) locations—and thus push up their property prices at an accelerated rate.

Learn from my experience, as well as Florida's and Karlgaards's research and observations. Don't just personalize. Generalize. What places do you like that have yet to hit their full stride? What places do you hear others talking about? What locations have you read about in favorable articles? During the city's ascent, a front-page article in *The Wall Street Journal* extolled the appeal of Dubai. The *New York Times* and *Chicago Tribune* published similar articles.

Although Dubai remains—as does Abu Dhabi—a creative class favorite, massive overbuilding has deflated its property boom. Identify these "creative class" areas before they become high-profile, front-page stories and you've probably identified a promising area to invest. (As Dubai, Miami, Las Vegas, and Kuala Lumpur illustrate, beware when high growth in demand propels even higher growth in supply.)

EMERGING RETIREMENT/SECOND-HOME AREAS

During the next 15 to 20 years, the number of persons over age 60 will double. It's the largest age-wave retirement shift in U.S history. Just as important, millions of these emerging age-wavers rank among our country's wealthiest households. Many others of the 45+ age still seek to build up their wealth and incomes through property investment. Thus, demand for retirement/second home property will remain strong from both retirees and older investors.

Combine these numbers with increasing longevity and you can see a longer-term appreciation in prices—especially when measured against today's down-cycle market values—for properties located in areas that become favored vacation/retirement spots. If you wish to invest for high appreciation, search out the towns, cities and rural retreats that will be favored by this coming age wave. (As a case in point, for investors looking

at a five- to ten-year horizon, I believe Sarasota, Florida now represents a screaming buy opportunity.)

Which Cities and Areas?

You can identify soon-to-be vacation/retirement meccas in the same way that you can identify emerging creative class locations. Talk with future retirees. What newfound areas are achieving attention and increasing popularity? Personalize, then generalize. What locations seem attractive to you, your family, your friends, and your co-workers?

Pick up a pile of those books and magazine with titles such as "where to retire." View entries as suggestive, not definitive. Anytime someone "data crunches" hundreds (or thousands) of locations to find "winners" and "losers," or the "top ranked" and "bottom ranked," errors and silly results often pop out. In one widely reported survey of cities, Sarasota, Florida—a top 20 pick on any sensible list— ranked number 156.

Look for ideas, not final answers per se. Whether you rely on information from publications or people you know, invest only in areas where your reliable market research reveals promise.

Income Investing

Many people who buy vacation retirement properties plan to rent them out part of the year and personally enjoy the property at other times. Although this strategy can work well, watch out for exaggerated estimates of rental revenues.

Demand for seasonal rentals varies according to weather (too much rain, too much snow), traffic and transportation issues (road construction, cost and availability of flights, etc.), and publicity (the SARS scare slashed travel to Toronto and Hong Kong). In addition, firms typically charge high fees to manage vacation and seasonal rentals. It's not unusual for vacation management companies to charge 20 to 40 percent of gross rental receipts. (For a full discussion of issues relevant to this investing strategy, see my book, *The Complete Guide to Second Homes for Vacations, Retirement, and Investment,* John Wiley & Sons, 2000.)

COMMERCIAL PROPERTIES

When most people think of investing in real estate, they think residential. Everyone's familiar with houses, condos, and apartments. In contrast,

many potential investors lack knowledge of commercial properties. Or they think such properties cost too much.

But, individual investors now realize that in today's real estate market, many smaller commercial properties offer lower prices and higher yields (i.e., higher cap rates, higher cash on cash returns) than houses, condominiums, and small apartment buildings. Read through the sampling of "for sale" office and retail listings from around the country (Figure 15.2).

As you can see, none of these commercial properties is priced above $500,000. Their cap rates range between 6 and 12 percent, which is typical.

Property Management

Depending on the type of property and the terms of your leases (see later discussion) you may not need a property management company. Likewise, you may or may not need a leasing agent.

For example, say you own a medical office condominium that is leased to a doctor for a remaining term of five years. This MD has three five-year renewal options. If she chooses not to relocate, you enjoy a long-term, virtually carefree investment. The condo association maintains the building common areas. The doctor accepts maintenance responsibility for the interior of her offices.

The Upside and Downside

One strong upside of commercial properties is that (in most, but not all situations) your tenants operate businesses or professional practices. They establish themselves in a set location. Therefore, commercial properties experience lower tenant turnover than houses and apartments. On the other hand, when you do get a vacancy, that vacancy can last for months—or if you own a specialized property (or a property in an inferior location)—a vacancy can last for years.

When you buy a commercial property with expiring leases on the near horizon, verify the marketability of the units (price and time on market). Without competent research to rely on, never assume that you or your leasing agent can quickly rent vacant commercial units.

Opportunity for High Reward

Vacant (or high vacancy rate) commercial properties sell at steep discounts. When you value a zero (or depressed) NOI by using a high (risk-adjusted upwards) cap rate you obviously compute a relatively low price. (Of course you would also use the comparable sales and replacement cost appraisal

Longview, Texas Property consists of approx. 4 acres of land with two separate income-producing buildings.	Status Price: Bldg. Size: Cap Rate: Primary Type:	Active $185,000 6,374 SF 11.87% Office-Warehouse
Apopka, Florida This is a 1,540 sq. ft. 2-unit office building located in Wekiva Commons Office Park in Apopka, Florida. It was completed at the end of 2004 and is fully leased with 3-year terms.	Status: Price: Bldg. Size: Cap Rate: Primary Type:	Active $289,000 1,540 SF 6.50% Office Building
Naples, Florida This highly visible retail center with up to seven condominium units is situated in a very high growth area with 107,000 residents within 5 miles.	Status: Price: Bldg. Size: Cap Rate: Primary Type:	Active $225/SF ($264,825) 1,177 SF 8.00% Retail (Other)
Ridgecrest, California A 2,970 sq. ft. professional office building. It is divided into 4 independently metered office sites. Suite A & B are leased by a medical doctor.	Status: Price: Bldg. Size: Cap Rate: Primary Type:	Active $180,000 2,970 SF 7.20% Office Building
Edison, Georgia 7,500 sq. ft. Dollar General completed in February 2001. Dollar General has a 10-year lease with three 5-year options. Year 6 of initial lease (2/2006).	Status: Price: Bldg. Size: Cap Rate: Primary Type:	Active $295,000 7,500 SF 8.14% Free Standing Bldg.
Roanoke, Virginia Historic rehab of early 1900's Queen Anne Victorian with all of the modern conveniences. Internet cabling and telephone wiring throughout.	Status: Price: Bldg. Size: Cap Rate: Primary Type:	Active $319,950 4,980 SF 7.80% Office Building
Orem, Utah Two-story office building.	Status: Price: Bldg. Size: Cap Rate: Primary Type:	Active $251,174 4,096 SF 9.00% Office Building
Phoenix, Arizona Property is a small, freestanding retail/office building with street frontage on Hatcher Road.	Status: Price: Bldg. Size: Cap Rate: Primary Type:	Active $325,000 2,816 SF 8.00% Office Building
Denver, Colorado Free standing office in downtown Denver golden triangle. Leased to bail bond office for 1 year. Great upside potential. Own a piece of downtown.	Status: Price: Bldg. Size: Cap Rate: Primary Type:	Active $250,000 1,300 SF 6.00% Free Standing Bldg.

Figure 15.2 Sample Listings for Small Commercial Properties

techniques to value such a property.) Nevertheless, after balancing the three appraisal methods, you can still negotiate a low purchase price. Next, turn this lemon into lemonade. Through research of the market, develop a profitable profile of a tenant (or use) for the property. Bring that idea to life and you're created value two ways:

1. You've raised rent collections and NOI; and
2. You've reduced the riskiness of the property (which justifies a lower cap rate).

If you can see realistic leasing possibilities that others miss, you will be richly compensated for your insights.

Commercial Leases Create (or Destroy) Value

Generally, tenants who rent *residential* units sign leases of one year or less. If you don't like the lease (or the tenants) of the previous property owner, no problem. You can get your own lease and tenant policies up and running within a short time.

With commercial properties you face a different situation. Many commercial leases run for 3, 5, or 10 years or longer. Plus, commercial tenants often enjoy the right to renew for multiple periods (e.g., an original 5-year lease with three 5-year renewal options).

Just as important, commercial leases differ greatly in their terms. Even tenants who rent units within the same office building or shopping center might sign very different leases. That's because the terms of commercial leases depend on the market conditions when the lease is signed and the negotiating powers of the tenant vis-à-vis the property owner. You can bet that tenants who sign office rentals in Silicon Valley today negotiate much sweeter deals than those tenants who signed at the peak of the tech boom in 1999–2000.

How Leases Differ. Lease terms determine your NOI. Great leases keep your NOI high. Leases with adverse terms drive your NOI down. Here are several examples:

1. Who pays what? In commercial leases, property owners often shift some (or all) of the property's operating expenses to the tenant. In some leases—especially long-term, single tenant properties—the tenant pays for operating expenses, building repairs, and major replacements (e.g. roof, parking lot, HVAC).

2. On what space does the tenant pay rents? Commercial tenants frequently pay rent psf. But the rentable, square footage may exceed the

tenant's private usable space. Some leases require tenants to pay rent for hallways, common areas, HVAC rooms, storage areas, public restrooms, and so on. The lease may even specify the precise way the space is to be measured. The method of measurement can add or subtract 5 percent (or more) to the quantity of rentable space.

3. Are the rents inflation protected? If the property is leased to a tenant for 5, 10, or 15 years (or longer) will your rent collections increase with appreciation/inflation? When and by how much?

4. Are the property owners entitled to percentage rents? Especially in retail, leases may require tenants to pay a base amount of rent plus a percentage of the tenant's business revenues (which also should be precisely defined—e.g., must the tenant pay a percentage of their off-premises sales?)

Read Each Lease Precisely. I don't want to make this issue of leases sound too complex. Some owners of small commercial properties write relatively simple, three or four page leases that involve month-to-month tenancies. However, unless you read each tenant's lease, you won't know what pitfalls lurk within the fine print.

Beware of buying a property only to learn later that an undesirable tenant can stay put for eight more years at a rent level $6 psf under market. Beware of buying a small retail center with the idea of bringing in a Dollar General store only to learn that an existing tenant had negotiated an exclusive "general merchandise" clause in its lease.

Note: To learn more about leases for small commercial properties, I recommend Thomas Mitchell, *The Commercial Lease Guide Book,* and Janet Portman and Fred Steingold, *How to Negotiate Leases for Your Small Business.*

TRIPLE NET (NNN)

If you would like to invest in real estate with virtually no managerial responsibilities, look into acquiring properties that are leased to retail, office, or industrial tenants under a triple net (NNN) lease. Triple net means that the tenant pays all operating, maintenance, and fixed costs (property taxes, insurance) that are associated with a property. You pay only the mortgage payment, if any, which typically is covered by the rental amounts paid by the tenant.

To see some of the types of NNN deals available, Google triple net leases. One company active in this field of investment, Westwood Net Lease Advisors, for example, has listed for sale hundreds of properties with tenants such as Applebee's, Pizza Hut, Dollar General, Union 76,

Taco Bell, Rite Aid, West Plains Corporate Park, Walgreens, Starbucks, Kindercare Learning Centers, Pep Boys, and Rivertown Commons Shopping Center. As with other types of income properties, NNN deals are priced by dividing a cap rate into the NOI the property produces.

In practice today, the respective cap rates for individual NNN properties typically range between a low of 6 and a high of 12 percent—though both higher and lower cap rates are possible. Strong credit and national tenants with established businesses (Walgreens, McDonald's) tend to command low cap rates because these tenants present little risk to the investor or the mortgage lender who finances the property for the investor. Higher cap rates (due to increased risk of default) apply to deals involving local companies or businesses that show high rates of failure (i.e., locally owned and operated restaurants). The remaining term of the lease, option-to-renew clauses, above or below market lease rates, the quality of the property's location, property appreciation potential, and the cost and availability of property financing also influence the cap rate investors apply to a stream of NNN income.

Favorable deal issues tend to drive cap rates lower, and unfavorable issues tend to drive cap rates higher. So, no single rule applies as to the "right" cap rate or the best deal. For example, a Walgreens property priced with a 5.5 percent cap rate might prove to offer more long-term profit potential than a mom-and-pop-operated, locally-owned Chinese restaurant priced with a 12 percent cap rate. Before deciding, go through your full due diligence for each property that you are considering. Then relative to the pros and cons, choose the one that seems to fit your risk/reward goals best. To assist in deriving the appropriate cap rate (and corresponding pricing) for any given deal, experienced and beginning investors solicit advice from an experienced, active NNN real estate sales agent.

Most triple net deals offer little possibility for entrepreneurial property improvement during the period of the lease (though exceptions exist), but they do offer the ultimate in carefree property investing—yet still provide returns from cash flows, appreciation, amortization, leverage, tax shelter, and inflation. As more boomers near their retirement years, I see increasing demand for NNN properties. In a point-by-point comparison to stocks or bonds, NNN properties often yield more returns with less risk.

SELF-STORAGE

Americans have become a population of pack rats. Their want of storage space grows larger every year. As a result, the self-storage industry has continued to grow. Although big players such as Shurgard attract much of

Savannah, Tennessee A-1 Mini Storage consists of 79 total units with a good unit mix and is situated on 3 acres of land providing lots of room for expansion.	Status: Price: Bldg. Size: Cap Rate: Primary Type:	Active $350,000 14,340 SF 9.5% Self/Mini-Storage Facility
Redding, California 3,500 SF of construction buildings/ offices/bathrooms with yard space. Space to add approximately 100 storage units on unused land.	Status: Price: Bldg. Size: Cap Rate: Primary Type:	Active $295,000 3,500 SF 10.80% Flex Space
Denison, Texas 83 watertight mini storage units on 1.7 Acres in Denison TX, near Lake Texoma. Good visibility, fenced with electronic gate. Construction 2003.	Status: Price: Bldg. Size: Cap Rate: Primary Type:	Active $335,400 9,575 SF 9.30% Self/Mini-Storage Facility
Klamath Falls, Oregon Built to suit Mini and RV storage facility in high-density Mobile Home community and Residential neighborhood. Cost includes 48 self-storage spaces.	Status: Price: Bldg. Size: Cap Rate: Primary Type:	Active $150,000 5,200 SF 8.00% Self/Mini-Storage Facility

Figure 15.3 Sample Listings for Small Self-Storage Centers

the attention, smaller investors, too, can profit in this business. Figure 15.3 shows several sample listings from loopnet.com. You can see from these listings that self-storage can yield reasonably high cap rates.

Earn even more if the site will accommodate expansion. Alternatively, self-storage can provide a profitable way to hold land while you wait, say 3 to 10 years, until you redevelop the site into a more valuable use (e.g., retail, offices).

MOBILE HOME PARKS

You can invest in mobile home parks in two ways:

1. Own the pads, provide utilities, and maintain the site; or
2. Own the pads and the mobile homes. Figure 15.4 shows a sample of listings.

Fort Worth, Texas Twenty-seven rent trailers in the middle of a well-established single-family neighborhood. Primarily older tenants in this quiet, heavily treed area.	Status: Price: Bldg. Size: Spaces: Cap Rate: Primary Type:	Active $350,000 N/A 27 17.54% Mobile Home/RV Community
Sedgwick, Maine This new, seven-acre Mobile Home Park is being offered for sale to settle the estate of the original developer, now deceased.	Status: Price: Bldg. Size: Spaces: Cap Rate: Primary Type:	Active $195,000 N/Z 20 8.5% Mobile Home/RV Community
San Marcos, Texas This is a unique investment opportunity. The owner is offering to either lease the mobile pad sites to investors to either lease or do an owner finance.	Status: Price: Bldg. Size: Spaces: Cap Rate: Primary Type:	Active Not Disclosed 9,000 SF 200 12.00% Mobile Home/RV Development
Ridgecrest, California 18 spaces and 2 houses will transfer with sale. All spaces have full hookups. Property is a turnkey operation with very low maintenance.	Status: Price: Bldg. Size: Spaces: Cap Rate: Primary Type:	Active $221,000 1,111 SF 18 9.50% Mobile Home/RV Community
Wilder, Idaho NEW TERMS! SELLER MAY CARRY WITH $40,000 down. 12-space mobile home park with one park-owned mobile. On city services, paved street. Can assume loan.	Status: Price: Bldg. Size: Spaces: Cap Rate: Primary Type:	Active $219,000 43,560 SF 12 9.30% Mobile Home/RV Community

Figure 15.4 Sample Listings for Small Mobile Home Parks

As with self-storage investments, you can hold mobile home parks for cash flow until more intensive land development becomes profitable. It's also common practice to delegate day-to-day management to a park tenant. Park tenants frequently desire to earn extra money.

If you buy a park that includes mobile home rentals (rather than just the pads), value the park land separately. Capitalize the site rental NOI.

Add to that figure the depreciated market value of the trailers. Rental mobile homes generate strong cash flows. But they can wear out quickly. If you capitalize their rental income to figure their worth, you will overpay. You can easily buy repossessed mobile homes for a fraction of their cost new and at a fraction of their capitalized value.

PROFITABLE POSSIBILITIES WITH ZONING

Investigate whether you can upgrade a property's use and profitability within current zoning and regulatory rules. Sometimes zoning changes and the property owners don't notice—or they just don't investigate the maximum usage permitted. Alternatively, figure out a way to persuade the planners and pertinent elected officials to grant your property (or area) a higher and better use. I mentioned this tactic in Chapter 9, but I want to re-emphasize it here.

As property investors struggle to boost their yields, zoning and land-use opportunities are becoming more important. If you can add another floor to a rental house, sell off extra land as a buildable lot, or convert a house to an Adult Congregate Living Facility (ACLF), you can pocket thousands of dollars of found money. (For more details on the types of changes you might seek, see pages 54 to 88 in my book, *Make Money with Flippers, Fixer-Uppers, and Renovations, Second Edition*, John Wiley & Sons, 2008. To help you navigate the approval process, I recommend *The Complete Guide to Zoning* by Dwight Merriam, McGraw-Hill, 2005.).

TAX LIENS/TAX DEEDS

Throughout the United States, nearly every state and county levies taxes against properties. If an owner fails to pay his or her tax assessment, the county authorities (sooner or later) begin to enforce their claim. Generally, this enforcement involves a tax lien, a tax deed, or some combination of both.

Localities Differ

Each jurisdiction proceeds according to local and state law. In my county in Florida, the assessor's office sells tax liens to investors in a reverse bid auction. The bid winner pays the tax of the defaulting property owner. That investor then earns interest on his tax lien of 18 percent a year or less—in recent years much less.

The county starts the bid at 18 percent. Then investors bid down the rate. The lowest rate bidder wins. In an auction that I recently attended, most tax liens were sold at an interest rate of less than eight percent.

If the property owner does not repay the investor including interest accrued within four years, the investor can petition the court to order a tax sale auction. The investor who bids the highest purchase price at the tax deed sale (who may or may not be the tax lien investor) is then issued a tax deed to the property. The tax lien investor is paid from the tax sale proceeds. If the auction's sales proceeds do not cover the full amount of the tax lien (with interest), tough luck for the tax lien investor.

Upon being awarded a tax deed, the tax deed investor then employs a lawyer at a cost of around $2,000 to try to clear the legal issues that will cloud the title. (Tax deeds rarely qualify for title insurance.) If successful, the tax deed investor then moves to the next stage of his strategy (sell, renovate, rent out, whatever).

Are Tax Liens/Tax Deeds an Easy Way to Make Big Profits?

If you believe that you can easily earn big profits through tax liens or tax deeds, you've been watching too many infomercials. You can earn profits in this arena only if you work hard to research markets, research properties, and research legal procedures. Then bid selectively when your research indicates a satisfactory trade-off between risk and reward. For a realistic view of tax liens/tax deeds and a state-by-state listing of legal procedures, see *Profit by Investing in Real Estate Tax Liens* by Larry Loftis (Dearborn, 2005).

DISCOUNTED PAPER

Discounted paper represents another investment technique famously promoted by the moguls of mentoring, boot camp gurus, and infomercial pitchmen. In fact, one such "trainer" was put out of business by the U.S. Department of Justice and is serving time in federal prison. Does this clampdown mean that discounted paper itself offers no opportunities to individual investors? No. But it does indicate that some of the gurus of discounted paper—like their compatriots who infest other fields of real estate gurudom—overpromise, underdeliver, and overcharge.

What Is Discounted Paper?

To entice a buyer, property sellers frequently carry back financing which investors refer to as "paper." If, in the future, that seller wants to convert

his buyer's paper (a mortgage debt or contract-for-deed) to ready cash, he offers to assign the financing paperwork to an investor at a price that's discounted from the balance owed by the debtor (the property's current investor/owner).

Here's How It Works

Assume that a seller carries back a 7 percent, $100,000 second mortgage, 25-year amortization. Based on those terms, the buyer pays the seller $707 a month. After 3 years the seller needs cash. At that time, the remaining balance on the buyer's note equals $95,100. If a note investor wants to earn 12 percent on his money, he would pay the seller $65,588—which equals the present value of $707 per month for 22 years discounted at 12 percent. The buyer then makes his monthly payments to the note buyer.

Broker the Note

Assume that you're not interested in holding this buyer's note for 22 years. You want fast money. In such a situation you can pursue two alternatives. One—find a note investor who will accept a 10 percent return. For the right to receive $707 per month for 22 years, this investor would pay $75,353. Flip the note to this investor and pocket a quick $9,765.

Alternatively, if you want to broker the note at the going rate of 12 percent, locate a truly eager seller who will discount the note to you at, say, $60,000. You then flip it in the paper market at its 12 percent discounted value of $65,588. You pocket $5,588.

Do Such Deals Really Occur?

Yes, such deals occur everyday. Nationwide, thousands of individual investors, investment firms, and note brokerage companies *work* in this field. Notice, though, that I emphasize the word work. As you can imagine, it's not easy to locate sellers who will accept discounts of thousands (or tens of thousands) of dollars. But difficult as that may be, finding sellers doesn't end your work—not by a long shot. Your next step is due diligence.

Due Diligence Issues

What's the true market value of the mortgaged property? (Remember, the seller may have jacked up the selling price and sucked in a naïve buyer with easy financing). Is the buyer (borrower) a good credit risk? What's the buyer's payment record to date? What's the quality of the property's

title? Is the buyer currently paying off senior liens (i.e., the first mortgage, property tax, assessments) on time, every time?

Do the mortgage agreement and note comply with applicable state and federal law? Did the seller originate the loan with any and all required disclosures and a truth-in-lending statement? If the buyer defaults, what procedures must the note holder follow to foreclose? How long will it take? How much will it cost? Can the note holder collect a deficiency judgment? If so, under what circumstances?

No doubt about it. You can earn good money buying and/or brokering discounted paper. You *earn* these profits through effort and knowledge.

Look in the yellow pages or the classified section of your local newspaper. You'll probably see "We buy mortgages, trust deeds, and contract-for-deeds" types of ads. Call these folks. Meet and talk with them. Learn how the business operates in your area. If what you learn sounds promising, persuade a practitioner to take you under his or her wing. Perhaps in a year or two, you can e-mail me about your successes. Also, Google *discounted mortgage notes.* (But as forewarned, beware of sales pitches and con artists.)

SHOULD YOU FORM AN LLC?

Here's another topic that the gurus have popularized during the past several years: "Don't build your wealth only to lose it to a lawsuit or judgment creditor. Protect your assets through limited liability companies (LLCs)." I receive more e-mail queries about LLCs than any other single topic.

Nearly everyone asks me the same question, "Should we hold our property (or properties) in LLC(s)?"

Different Strokes for Different Folks

Neither I nor anyone else can answer that question for you until we study your legal, financial, and tax situation in light of your goals and what you want your LLC(s) to accomplish. Many mortgage lenders will not permit you to borrow against a property that's held by an LLC, nor will they permit you to transfer a property to an LLC after you have closed your loan. Holding a property in an LLC might also bear upon income tax and estate-planning issues.

Insufficient Court Rulings

To what degree will an LLC protect your assets against lawsuits or creditors? Those remain open questions. They have not yet been litigated

enough to establish a clear body of case law. Moreover, LLC statutes are enacted by states, not congress. What proves true for Texas may not protect in the same way for New York or Indiana.

Even within the same state, the different district courts of appeals may rule inconsistently with each other. Until (if ever) the high court of the state clarifies or overrules, the LLC law in, say, Tampa (2nd DCA) could differ from the LLC law in Orlando (5th DCA) even though both courts presumably apply the same Florida statute.

One Size Doesn't Fit All

You need asset protection; LLCs represent one potential means to achieve it. Whether it's the best means for your situation, no one knows until they closely review your financial, tax, and legal situation, each of the asset protection alternatives that are available to you; and the applicable law. In contrast to the hype surrounding LLCs, one size doesn't fit all.

Please do not misunderstand. You need asset protection. But look further than off-the-shelf LLC solutions. Your circumstances and state laws will control what works best for you. This is one area where you need tailored, expert advice. Remember, too, liability insurance plays a necessary part of any comprehensive asset protection program. Do not merely "buy insurance." Read your policy perils, coverages, limits, and exclusions. To guard against lawsuits and other calamities, insurance stands as your first and most important risk management technique. Even within LLCs, property and liability insurance provides the critical component of your wealth protection plan.

16

AN INCOME FOR LIFE

No one knows or can know the future for Social Security, stock prices, bond returns, or inflation. Social Security must change its tax/benefit structure or it will go broke. Stock prices, bond prices, interest rates, inflation all show big, volatile swings. In fact, down cycles for stocks can endure for decades. (Remember, the stock market peak of 1929 was not surpassed nominally until 1954—and in inflation-adjusted terms, not until the late 1980s. The DJIA highs of the mid-1960s were not surpassed until the mid-1990s—on an inflation-adjusted basis.) Stock price indices in 2009 had fallen below the levels reached 10 years earlier.

Property differs from this volatile experience. History shows that well-selected income properties (purchased at non-speculative prices) provide the surest, most consistent path to both long-term wealth and spendable-cash returns. A $10,000 to $20,000 down payment today multiplies itself into an equity of $50,000 to $100,000 over a period of 5, 10, or at most 20 years. During this same period, expect your rent collections to increase by 50 percent or more, and your rent collections could even double if you choose a soon-to-be hot area—that is, if you invest in the right place, at the right price, and at the right time. (For potential returns at historically reasonable growth rates, see Figure 16.1.)

Or alternatively, choose an area that shows great long-term growth potential that currently offers you market value prices that have fallen below replacement costs. And to score greater returns in such distressed markets, go for foreclosures and REOs at prices discounted from the currently depressed market values. When the excessive supply of "for sale" houses is sliced down to normal levels, your properties will begin to show nice-sized gains in value. At no time in the history of the United States since the 1930s have rents and property prices failed to significantly increase during any 10-year period (usually less). Remember, too, with sensible leverage,

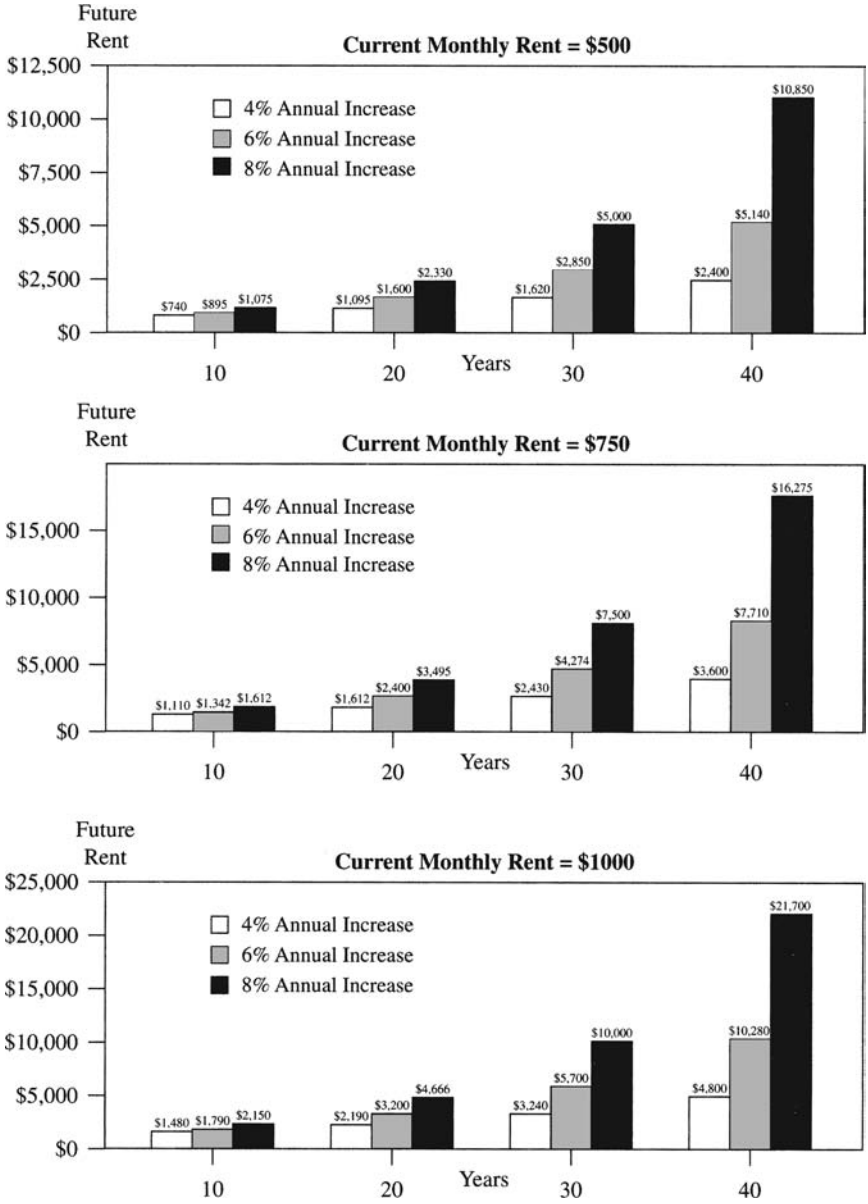

Figure 16.1 Future Rent Levels at Various Rates of Increase (For higher amounts of rent, simply multiply proportionately.)

a 3 percent to 5 percent increase in the price of your property can often result in a 20 percent gain (or more) in your equity (see Chapter 2).

LESS RISK

When you buy right, you achieve safety of capital with property. Although values and rents can fall temporarily during recessions and down cycles, home building and apartment construction also fall, thus slashing new housing supply. Hard times also tend to draw more households toward renting and away from home buying. Then, when we return to a thriving economy, rising employment, incomes, and general prosperity push rents up. Plus, households "unbundle." Many of those roommate households and boomerang kids become able to afford a place of their own. Demand for property actually grows faster than the increased economic growth rate itself. (The reverse may also prove true, which provides even more opportunities to buy on the cheap during a down cycle.)

One more fact to prove the typically low-risk nature of income properties: At what interest rate and on what terms can creditworthy borrowers (say 720 credit scores) obtain mortgages on property? At this time, a 30-year fixed rate loan goes for 5.5 to 6.75 percent interest, 70 to 80 percent LTV (or higher with some type of mortgage insurance/guarantee). Now, go to a bank and offer to pledge any other asset (stocks, bonds—even U.S. government bonds, gold, a collection of rare coins, Old Masters artworks, whatever you can think of). Ask for the same loan terms and costs that lenders routinely offer borrowers who pledge property as collateral. How will the lenders respond? Not just no, but ***NO WAY!***

The current financial morass says nothing ill about the merits of property as a long-term investment. More than anything else, it reminds lenders not to make loans to people who cannot afford to pay the money back (though one would have thought that lenders could figure out that bit of underwriting wisdom on their own and would not need reminding.)

PERSONAL OPPORTUNITY

When you rely on stocks, bonds, or Social Security, your fate spins out of your control. Other than buying, selling, or perhaps voting (for Social Security increases), you can do nothing to influence the returns you would like to receive from these assets. Not so with properties.

When you depend on properties to build wealth and a lifetime of income, you can achieve good returns, even in a recession. (Or, as some

might say, especially in a recession, because that's when you can pick up bargain-priced properties.) Even better, investing in property provides profit opportunities that stock or bond investors can never achieve (see also Chapter 1):

- Buy properties at prices substantially less than their current market value.
- Through creative finance, acquire properties with little of your own cash (but recall the caveats here).
- Improve properties to enhance their current market value.
- Improve your market strategy to boost rents and lower vacancies.
- Cut operating costs to increase net operating income.
- Sell your existing properties and trade up without paying tax on your capital gains.
- Change the use of a property from one that's less profitable to one more profitable (apartments to condo, residential to office).
- Refinance your properties and pull out tax-free cash. (You can borrow short-term against a stock portfolio. But margin requirements, price volatility, and little or no cash flow overload that choice with costs and risks.)

To profit from real estate opportunities requires some time, knowledge, effort, and market savvy. Unlike those who buy stocks, real property investors don't whimsically follow hot tips from Internet chat rooms, barbers, hair stylists, auto mechanics, neighbors, or the chatter of talking heads on cable TV. You can't buy, own, or sell real estate with the click of a mouse. (Of course, the last boom did attract many who did think they could profitably invest in property while maintaining a stock gambling mentality.)

But the so-called disadvantages of work, research, and reason explain why, over a period of years, real estate provides a safer, surer path to wealth and income. Today many fanciful dreamers still foolishly believe that they *and* tens of millions of other Americans can achieve wealth without work. Just buy stocks, and voilà—their portfolio will grow. Supposedly, easy wealth awaits all who faithfully contribute to their 403(b)s, 401(k)s, Keoghs, 529s, and IRAs. But it won't happen. It can't happen.

At some time in the future, Americans will realize that the income they receive from their stock portfolios can never exceed the amount of corporate dividends. And these dividends will never grow large enough to support the more than 50 million individuals and households who continue to send their monthly retirement contributions to Wall Street. (Talk about risky behavior!)

At present, income property provides true *investment* opportunities. You can *speculate* in stocks. You can *speculate* in real estate. You can buy lottery tickets. You can shoot craps in Las Vegas. Maybe any or all of these wealth-without-work techniques will pay off, but the odds are stacked against you. In contrast, selectively acquire just four or five rental properties (residential or commercial), and you will build an income for life—a monthly cash flow that will generously finance the quality of life you would like to enjoy.

I wish you success. And if you get the chance, let me know how you're progressing. I like to hear from my readers (gweldred.com).

INDEX

Abandonment, 232
Above-market price, 10–11
Accessibility, 90
Acorns into oak trees, 7
Adjustments, 66–67
After-tax cash flows, 260–261
Agent services, 105–107, 249–252
Allen, Robert, 18, 19
Amortization, 7–8
Appraisal form, 53–58
Appraisal limiting conditions, 75–76
Appraisal vs. investment, 76
Appreciation, 4, 73–74
Arbitration, 233
Assemblage, 14
Asset protection, 298
Assignments, 178–179, 192–193
Attorney fees, 234–235
Auctions, 137–138, 139–141
Automatic underwriting (AUS), 46

Bargain price, 82
Bargain search, 101–104
Bargain-priced properties, 96–100
Below-market price, 10
Bid package, 134
Booms, xxiii
Borrow smart, 18
Bounced check, 223
Brangham, Susan, 163–164, 170, 257
Brown, Raymond, 144–146
Bundle of property rights, 13–14
Buy and Hold Real Estate Strategy, 47

California Closet Company, 147
Capacity (income ratios), 42
Capital gains tax, 263
Capital gains, 15
Capitalization rates, 72–73
Cash flows, 6, 77–78, 85
Cash-out refinance, 10
Casualty clause, 188
Character, 44–45
Cheerleader for property, 16–17
Cleaning, 146–147
Closing costs, 189
Closing date, 189–190
Cold call, 102–104
Collateral, 40
Commercial leases, 289–290
Commercial properties, 286–289
Community action, 155–156
Comparable sales approach, 64–67
Compensating factors, 45
Competency, 44–45
Condo conversion, 172–174
Contingencies, 171, 191–192
Conversions, 12–13, 172, 175
Co-op sales, 249
Cost approach, 61–64
Craig Wilson, 203
Create value, 11–12, 145–146

Creative class, 284
Creative finance, 18–19, 32
Creative improvements, 163–164
Credibility, 245
Credibility vs. creativity, 21–22
Credit history, 43–44
Credit score, 44

Daly, Fred, 274
Debt coverage ratio, 42–43, 84–85
Default clauses, 194–197
Demographics, 89–90
Depreciation expense, 259
Development rights, 15
Discounted paper, 295–297
Distressed owners, 97–99, 112–115
Diversification, 16
Dow Jones Industrial Average, 5, 299
Dubai, 16, 179
Dumb leverage, 18–19

Earnest money, 171, 186–187
Economists, 4–6
Emerging growth areas, 284–285
Emotional appeal, 245
Energy audit, 210–211
Entrepreneurial talents, 11–12, 14, 16
Environmental hazards, 193–194
Estate sales, 139
Evictions, 237–238
Exclusive listing, 252
Exclusive right to sell, 252

Fannie Mae, 30–31
Fannie Mae REOs, 136–137
Federalist, *The*, 255
FHA loan limits, 31
Financial assets, 16
Financial journalists, xxi, 1
Financial Times, 1
Financing terms, 79–82
Fiscal condition, 91
Fix and flip, 142–143
Fixer, defined, 143–144
Flipping contracts, 178–179
Florida, 14
Florida, Richard, 284, 285
For sale signs, 247
Foreclosure auction, 124–126
Foreclosure financing, 126–127
Foreclosure gurus, 110
Foreclosure pro, 130–131
Foreclosure process, 110–112
Foreclosure speculators, 138
Freddie Mac, 30–31
Freddie Mac REOs, 136–137
Fundamental evaluation, 16

Get-rich-quick gurus, 18, 200
Grabber headline, 244
Grass-is-greener sellers, 97–98
Gross rent multiplier (GRM), 67–68
Guests, 220

Holdover tenants, 220–221
Home office expense, 259
Homeowner tax savings, 256–257
Hot buttons, 244–245
Housewise, 163–164, 170, 257
HUD buyer incentives, 133
HUD homes, 130–132

Improvement budget, 157–158, 159–161
Income approach, 67–73
Indexes and averages, 5
Inflation, 5, 299
Inflation risk, 5
Installment sale, 264–265
Insurance, property, 211–214, 298
Intelligent Investor, *The*, xxiii
Internal Revenue Code, 255–256
Investment strategy, xxvi
IRAs, 1
Irrational exuberance, xxvi

Jobs, 91
Joint and several liability, 220–221

Kiplinger's, 1
Kitchen design, 207–208
Kmart, 14
Know yourself, 200–202

Land contract, 36–37
Landlording (pros and cons), 238–239
Las Vegas, 16
Late fees, 222

Lease option, 165–168
Lease option benefits, 165–168
Lease option sandwich, 168
Lease purchase, 170–171
Lease, standard, 216–217
Leases, 190–191
Legal compliance, 162
Leverage, 6, 7–9, 18, 22–23,
Leveraged gains, 21–23
Lienholders, 121–123
Limited liability Company (LLC), 297–298
Listing contracts, 252–254
Loan-to-value (LTV), 10, 28–30, 40–41
Location, 154–157
Long-term vs. short-term investing, 47–48
Lower-priced areas, 281–284

Maintenance expense, 214
Mantra for the masses, 1, 3, 16
Market bottom, xxi
Market corrections, xxiv
Market information, 206–207
Market risk, xxiv-xxv
Market strategy, 203–206, 216–219
Market timing, xxiv-xxv
Market value, 48–49
Market value requirements, 96–97
Market value vs. sales price, 49–50
Master lease, 14
Master leases, 176–178
Media molls, xxi
Monthly payment tables, 43
Mortgage interest, 258
Mortgage loan limits, 30–31
Mr. Market, xxiii

Natural light, 149–150
Negotiation styles, 180–181
Neighborhood, 156–157
Net operating income, 69–71
Networking, 102,117
New construction, 92
No cash, no credit, no problem, 18, 20–22
Noise, 150
Nonrecourse loans, 41
Nothing Down, 18–19

Odors, 224
Off-plan flipping, 179
Open listing, 252
Operating expenses, 211–214
Overimprovements, 158
Overpriced listings, 130
Owner-occupancy financing, 28–30

Paradox of risk, 73–74
Parking, 228
Passive loss rules, 261–262
Personal property, 183, 221–222
Pizzazz, 147
Plottage value, 14
Postfiling foreclosure records,
Prequalifying homeowners, 115–117
Price increases, 85–86
Price vs. terms, 21
Pride of place, 93
Probate sales, 138–139
Profit possibilities, xxi–xxii, 3, 301–302
Profit probabilities, xxiii–xxvi
Promotional flyers/brochures, 248–249
Property description, 52–53
Property management, 238–239, 283–284, 287
Property price gains, 4–5, 6
Property rights, 13–14
Property taxes, 276–278
Property taxes/services, 91
Property vs. financial assets, 16
Public records, 193
Publius, 255
Purchase contract, 183

Quiet enjoyment, 224

Real Estate Owned (REOs), 112
Recourse loans, 41
Red ribbon deals, 163
Redevelopment rights, 15
Reeves, Rosser, 240
Refinance, 9
Relationship building, 118–119

Relative prices/values, 74, 87–88
Rent growth, 299–300
Rent increases, 8
Rent or buy, 8
Rent or own, 8
Rental agreement, 219–238
Rental trends, 93–94
REO Realtors, 130–131,133
REOs, 128–130
Representations, 194, 233
Research, 145–146
Reserves, 42
Retirement areas, 285–286
Return on investment (ROI), 22–28
Right time, right place, 285
Rise of the Creative Class, The, 284
Risk, xxiii, 16, 301
Risks and rewards, 16, 25
Risks, perceived, 245

Safe Homes, Safe Neighborhoods, 155
Sales commissions, 119–120
Sales trends, 93
Schedule E, 269
Second mortgages, 33–34
Secure future, xxvii
Security deposits, 226–228
Self-storage, 291–294
Seller disclosures, 107–109
Seller ignorance, 99–100
Sheets, Carlton, 18
Shiller, Robert, 5–7
Short-term prices xxii–xxiii
Site characteristics, 59–60
Smart Money, 1
Sources of returns, 3
South Beach, 154–155
Space usage, 147–148
Speculate, 203
Speculative frenzy, 16–17
Stage-of-life sellers, 98–99
Stand Up to the IRS, 274
Stock investing falsehoods, 2–3
Stock prices vs. CPI, 5
Stocks for retirement, 2–3, 16
Stocks vs. property, 2–3, 16–17, 299, 301
Strategic decisions, 201–203
Subdividing, 14–15
Subject property, 52
Sublet, 225–226
Sweat equity, 37, 146

Tax audit, 272–275
Tax complexity, 255–256, 272–275
Tax credits, 271–272
Tax deeds, 295
Tax liens, 294–295
Tax shelter, 15
Tax-free exchange, 265–269
Tenancy period, 220
Tenant insurance, 224
Tenants in common, 174–175
Tenants' rights, 235–238
Texas, xxvi
Title, 187
Transport routes, 90–91
Trend tracking, 93–95
Triple net (NNN) leases, 290–291

Undervalued neighborhoods/cities, 88–89
Underwriting standards, 40–46, 50–51
Unique selling proposition (USP), 240–243

VA REOs, 134–136
Vacation homes, tax break, 257
Value-creating improvements, 146–154
Views, 148–149

Walt Disney Company, 14
Wealth without work, 1
Wear and tear, 230
Who's Your City, 284
Winning the Loser's Game, 3
Winning value proposition (WVP), 240–243
Win-win negotiating, 181–183
Woodpecker Haven, 144–145
Wraparound finance, 9, 34–36

Zoning changes, 294

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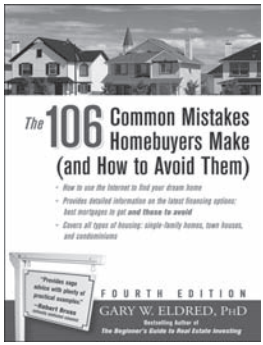

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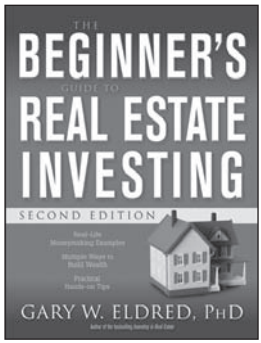

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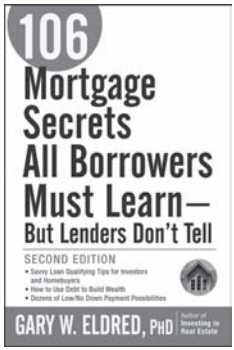

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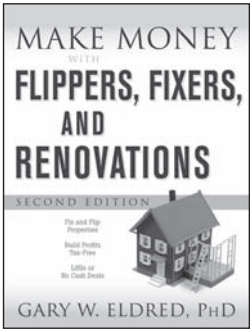

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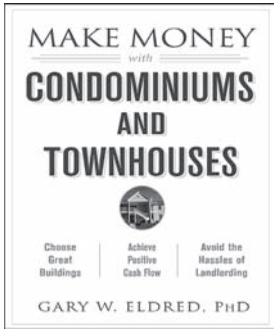

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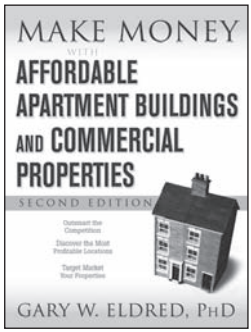

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Table of Contents

for Online and CD-ROM Versions

Buying Homes in Foreclosure
Sixth Edition

Table of Forms 5
Introduction. 6

Section A

Guidelines for an Equity Purchase Investor

Chapter 1 — Equity purchase investments
The home equity sales scheme 7

Chapter 2 — The equity purchase agreement
Requirements for all EP investors 12

Chapter 3 — The EP investor operates with or without an agent
The equity purchase scheme evolves 34

Chapter 4 — The unconscionable advantage some investors create
The suppression of further marketing 42

Section B

Equity Purchase Time Frame

Chapter 5 — Reinstatement and redemption periods during foreclosure
Recession-induced defaults 51

Section C

Property Analysis

Chapter 6 — Condition of property: disclosure by seller-in-foreclosure
Mandated on sales of one-to-four units 62

Chapter 7 — Verify the seller's disclosures: retain a home inspector
Protection for the prospective investor 68

Chapter 8 — Hazard disclosures by the broker
A unified disclosure for all sales 76

Chapter 9 — Property operating data investigation
Profiling a property by its expenses 85

Section D

Title Conditions

Chapter 10 — Preliminary title reports
An offer to issue title insurance 91

Chapter 11 — Title insurance coverage
Identifying a recoverable loss 94

Chapter 12 — Clearing a lien-clouded title
Negotiate a release to create equity. 103

Chapter 13 Automatic and declared homesteads
Home-equity shield against judgments *110*

Section E

Assuming the Loan

Chapter 14 Taking over a due-on-sale trust deed
Events triggering the call provision *120*

Chapter 15 FHA and VA loan assumptions
Avoiding fees and investor prohibitions *126*

Chapter 16 Assumptions: formal and subject-to
A loan takeover by an EP investor *131*

Section F

Escrow

Chapter 17 Opening escrow
The process of closing the sale *137*

Chapter 18 Assigning your purchase rights
Syndicating or flipping a property *150*

Chapter 19 Syndicating the equity purchase
Blind pool funding and property selection *156*

Chapter 20 Beneficiary statements and payoff demands
Confirming loan conditions *160*

Chapter 21 Equity purchase: sale-leaseback, no option
A mortgage or tenancy on breach? *164*

Section G

Short Sales

Chapter 22 Short payoffs on loans in foreclosure
The discount: income, profit, or loss? *169*

Chapter 23 Anti-deficiency: past, present, and future
Rational owners have nonrecourse options *176*

Table of Forms

for Online and CD-ROM versions

No.	Form Name	Page
519	Affiliated Business Arrangement Disclosure Statement Residential Broker (Reg X (RESPA) 24 CFR §3500.15)	147
352	Annual Property Operating Data Sheet (APOD)	89
401-2	Assignment of Purchase Rights - Supplement Escrow Instructions	151
431	Assumption Agreement - Unsecured and Subrogated	135
130	Authorization to Inspect and Prepare a Home Inspection Report	70
415	Beneficiary Statement	162
318	Comparable Market Analysis for Setting Values (CMA)	45
527	Conflict of Interest (Kinship, Position, or Undue Influence)	40
465	Declaration of Homestead	114
156	Equity Purchase Agreement	17
401	Escrow Instructions - Buyer and Seller Instructions	142
365	Estimated Profit on Resale - Property Acquired for Immediate Disposition	158
270	Final Walk-Through Inspection - Final Condition-of-Property Confirmation	74
314	Natural Hazard Disclosure Statement	77
562	Property Expense Profile	87
269	Property Inspection - Buyer's Request for Repairs	72
409	Release of Recorded Instrument	105
403	Sales Escrow Worksheet - For Use on Seller-Occupied SFR Properties	138
274	Short Sale Addendum - Loan Discount Approval Contingency	171
401-1	Title Insurance Advisory Notice - Calif. Civil Code §1057.6 Disclosure Statement	146

Introduction

Buying Homes in Foreclosure is part of the **first tuesday** series of California-specific real estate study materials. Each title in the series of advanced study has a different topic as its primary content. As part of a comprehensive real estate education program, the series includes Real Estate Matters; Landlords, Tenants, and Property Management; The §1031 Reinvestment Plan; Creating Carryback Financing; Tax Benefits of Ownership; Forming Real Estate Syndicates and Due Diligence and Disclosures.

first tuesday's real estate series uses words of plain language and eliminates the extensive overlap of identical course material commonly offered by other educators.

Buying Homes in Foreclosure is written for real estate licensees, attorneys, and investors. The material focuses on investor transactions. This course material is designed to be an educational tool for use in the classroom and as a technical research and reference tool.

The objective of this study is to fully provide licensees, whose clients include buyers, owner-operators, and sellers of real estate, with complete knowledge of the statutory scheme that governs the interaction between sellers-in-foreclosure and equity purchase (EP) investors. Public policy now protects sellers-in-foreclosure from the transfer of their equity to EP investors at advantageous prices when the conduct of the EP investor is *unconscionable*, and future legislation will likely require brokers representing the EP investor to be bonded.

Further, an EP investor engaged in buying a home in foreclosure must know and apply all the EP rules while personally handling the negotiations and documentation necessary to contract for, escrow, and acquire a home during the period an owner-occupied residence is in foreclosure.

On completion of this study, listing brokers and EP investors, whether they are licensed or unlicensed individuals acting as principals, will be prepared to handle all aspects of the sale and acquisition of owner-occupied, one-to-four unit residential property in foreclosure.

Chapter 1 Equity purchase investments

This chapter introduces the equity purchase (EP) restrictions that must be known to and applied by all investors who purchase owner-occupied, one-to-four unit residential property during a foreclosure.

The home equity sales scheme

An equity purchase (EP) transaction is the sale or other transfer of title by an owner-occupant of a one-to-four unit residential property when:

- the property is in foreclosure under a recorded and un-rescinded Notice of Default (NOD); and
- title to the property is acquired by either a buyer for rental, investment, or dealer purposes, or a person advancing funds which are to be repaid, called an EP investor.

Conversely, an EP transaction does not occur and the EP rules do not apply if the buyer acquires the property to occupy it as his *personal residence* or a lender originates a trust deed loan. The EP codes distinguish *principal residence* of the seller from the buyer's acquisition of a property to be used by the buyer as his **personal residence**. Thus a buyer's acquisition of a second home or vacation home for "personal use" is legislatively intended to be exempt from the EP laws.

Equity purchase statutes apply to all investors regardless of the number of EP transactions the investor completes. The investor need not be **in the business** of purchasing or advancing funds on homes in foreclosure for the EP statutes to apply. [**Segura** v. **McBride** (1992) 5 CA4th 1028]

The investor and all brokers involved must use a written agreement configured and containing notices as required by EP law. Failure to use the correct forms subjects the investor and the brokers to liability for all the losses incurred by the seller-in-foreclosure, plus very severe penalties. [Segura, *supra*]

Printed EP form and language

For example, the **EP agreement** signed by an EP investor must be printed in *bold type*, minimum size ranging from 10-point to 14-point. Also, the printed agreement must be in the *same language* used in negotiations with the seller-in-foreclosure. [Calif. Civil Code §§1695.2, 1695.3, 1695.5]

Additionally, the EP investor and all brokers and agents involved in an EP transaction must use a written agreement containing statutory EP notices. Failure to use **correctly structured forms** subjects the EP investor and the brokers to liability for all losses incurred by the seller-in-foreclosure, plus penalties. [Segura, *supra*]

*Editor's note — **first tuesday's** Equity Purchase Agreement, Form 156, complies with all statutory requirements, and properly sets forth the seller-in-foreclosure's right to cancel*. [See Chapter 2]

Equity loan arranged during foreclosure

Consider an owner whose home is in foreclosure due to a default under a trust deed lien on the property. He asks a friend to make him a loan.

The friend advances all funds necessary to cure the default under the trust deed and take the property out of foreclosure, called *reinstatement*.

As security for repayment of the friend's advance of funds, the homeowner conveys title to the friend. As part of the arrangement, the owner is to remain in possession under a lease agreement and is granted an option to recover title to the residence on a final payoff to the friend.

Later, the owner defaults on the rent and voluntarily vacates. The friend takes possession and locates a buyer, enters into a purchase agreement and conveys title to the buyer.

The owner, now out of possession, seeks to recover the value of his lost equity from his (former) friend. The owner claims a person who takes title and grants an option to the owner to repurchase the property is an *investor* who must first obtain the owner's consent before he conveys any interest in the property to another person since the financing arrangement was entered into while the home was in foreclosure.

The friend claims EP law does not apply to him since he is not in the business of lending money, much less buying homes in foreclosure.

However, EP law applies to all persons whose conduct constitutes that of an EP investor, regardless of the number of EP transactions the person completes. The investor, on selling the property to the buyer, conveyed title to the property without first obtaining written consent from the owner (even though the investor held title), a conveyance in violation of equity purchase law. [CC §1695.6]

The EP investor's failure to obtain the owner's written permission prior to conveyance of the property on a resale imposes liability on the EP investor for breach of the owner's (redemption) rights since a loan is involved. The money losses collectible by the owner are based on the value of the property at the time the EP investor first transferred title to the property without the owner's consent. [Segura, *supra*]

Locating properties in foreclosure

To locate properties in foreclosure and begin an investigation of ownership, debt, and value of the properties, an equity purchase (EP) investor needs data on the recording of Notice of Defaults (NODs), Notice of Trustee's Sales (NOTS), rescission of a NOD and trustee's deed, and the content of these documents.

Services exist which gather and publish the daily recording of foreclosure-related documents, their contents, and ancillary information on the properties available from public records. The reporting is available primarily on the internet, and is updated daily. Title companies are also a source of the recorded information.

The foreclosure data are obtained directly from recorded documents or from providers of the data who collect and enter the data directly from the county recorder's records. One such company collecting statewide data available by subscription on their web site is Real Estate Transaction Network at www.retran.net or (877) 711-1147. Monthly fees range from $99 to $159 for access. Other web sites that provide similar services include: www.countyrecordsresearch.com; www.foreclosures.com; and www.redloc.com.

Foreclosure data from providers can be sourced and sorted in any manner, such as by address, ZIP code, city, county, type of property, improvements (bed/bath/lot size), recording dates of the trust deed/NOD/NOTS, original loan amount, delinquency amount, Thomas Guide coordinates, etc. Data includes plat maps and photos of some properties.

Additionally, consider an owner-in-foreclosure who is in **bankruptcy** and conveys his property to an investor. The transaction is structured as a grant deed conveyance to the investor with a leaseback agreement and the grant of a repurchase option to the owner. Specially printed equity purchase forms with right of rescission notices to the owner-in-foreclosure are not entered into by the owner and the investor.

The transaction is approved as a sale of the property by a trustee acting on behalf of the bankruptcy court.

The owner-in-foreclosure is not able to repurchase the property on expiration of the repurchase option. A notice to vacate is served by the owner.

The owner now seeks to quiet title to the property in his name, claiming the sale-leaseback agreement violated of the Home Equity Sales Contract Act (HESCA) EP law since the investor, knowing the home was in foreclosure, acquired title to the property without complying with the notice requirements of the EP law.

The investor claims the sale was authorized by the equivalent of a court order, and thus exempt from equity purchase laws, since the sale was approved by a **bankruptcy trustee** acting on behalf of the court. [CC §1695.1(a)(5)]

Here, the sale by the owner-in-foreclosure to the investor was subject to EP law since the exemption for court-ordered sales does not apply to sales of property approved by a mere bankruptcy trustee. [**Spencer** v. **Marshall** (2008) 168 CA4th 783]

Cancellation within five business days

After entering into an EP sale, a **seller-in-foreclosure** has a statutory five-business day *right to cancel* the sales agreement he has entered into with an investor. Cancellation avoids the sale entirely.

The seller-in-foreclosure's five-business day **right to cancel** does not commence until proper notice of the cancellation period is given to the seller. Thus, the notice is contained in the purchase agreement forms designed for equity purchase transactions, to trigger the running of the cancellation period from the moment the seller accepts an offer. [CC §§1695.4, 1695.5]

When the notice of the seller-in-foreclosure's cancellation rights are properly contained in the EP agreement, the seller's **cancellation period** ends:

- midnight of the fifth business day following the day the seller enters into any type of purchase agreement with an EP investor; or
- 8:00 a.m. of the day scheduled for the trustee's sale, if it is to occur first. [CC §1695.4(a)]

The buyer's failure to give notice of the seller's right to cancel allows the seller to cancel the sales agreement and escrow. Further, and more critical, the seller has the right to *rescind* the sale after the sales escrow has closed. The right to cancel or rescind continues until the notice is ultimately given by the investor and the five business days have run — without cancellation by the seller before the five-business day period expires. [See **first tuesday** Form 156 §18]

A **business day** is any day except Sunday and the following business holidays: New Year's Day, Washington's Birthday, Memorial Day, Independence Day, Labor Day, Columbus Day, Veterans' Day, Thanksgiving Day, and Christmas Day. Thus, Saturday is considered a business day under EP law, unless it falls on an enumerated holiday. Many state holidays are not included as holidays. [CC §1695.1(d)]

No performance until notice expires

Until expiration of the seller-in-foreclosure's right to cancel the transaction, the **EP investor** may not:

- **accept a conveyance** from the seller of any interest in the property;
- **record a conveyance** of the residence with the county recorder;
- **transfer an interest** in the property to a third party;
- **encumber any interest** in the residence; or
- **hand the seller** a "good faith" deposit or other consideration. [CC §1695.6]

Thus, escrow may be opened on acceptance, and deeds and funds may be deposited with escrow, since the seller-in-foreclosure is not delivering a conveyance (to the buyer) and will not receive funds until the close of escrow.

In negotiations with the seller-in-foreclosure, the EP investor's or his agent's **representations** may not mislead the seller regarding:

- the *value of the property* in foreclosure;
- the *net proceeds* the seller will receive on closing escrow; [See **first tuesday** Form 310]
- the *terms of the purchase* agreement or any other document the EP investor uses to induce the seller to sign; or
- the *rights of the seller* in the EP transaction. [CC §1695.6(d)]

Cancellation of the purchase agreement by the seller-in-foreclosure prior to the expiration of the cancellation period is **effective on delivery** of the signed written notice of cancellation to the EP investor's address in the purchase agreement. [CC §1695.4(b)]

If the EP investor receives the seller-in-foreclosure's written notice of cancellation before expiration of right to cancel, he must return, *without condition*, all original contract documents, such as the EP agreement bearing the seller's signature, to the seller within 10 days following timely receipt of the cancellation notice. [CC §1695.6(c)]

Accordingly, the EP investor should not place **funds in escrow** before either expiration of the cancellation period or a call from escrow for closing funds, since the EP investor is prohibited from coupling the release of funds to the return of documents on cancellation.

When the cancellation period expires for lack of cancellation, the purchase agreement becomes enforceable and escrow may be closed — unless other conditions exist which must first be eliminated.

Post-closing rescission rights, penalties

After escrow closes on a property documented EP transaction, and while the EP investor remains the owner, his title is subject to the seller-in-foreclosure's **right of rescission** for two years. The rescission must be based on some *unconscionable conduct* the EP investor engaged in with regards to the transaction. The seller's two-year right to **rescind and recover** the property from the EP investor cannot be *waived* by the seller. [CC §§1695.10, 1965.14]

Also, any provision in an EP agreement or escrow instructions that purports to **limit the liability** of the EP investor for money losses claimed by the seller due to misrepresentations of the EP investor or his broker is void. [See **first tuesday** Form 150 §10.8]

Further, the EP investor is liable for all losses incurred by the seller-in-foreclosure due to misrepresentations made by himself or his broker. [CC §1695.15]

The EP investor is liable for any of the seller's money losses caused by the investor's failure to comply with the EP statutes. The seller-in-foreclosure has **four years** from the date of the EP investor's violation to recover his money losses and penalties. If the EP investor is found to have transferred or encumbered the property before the cancellation period expires, he is subject to a statutory penalty of three times the amount of the seller's losses or a minimum $2,500 civil penalty. [CC §1695.7; see Chapter 2]

An EP investor who violates the five-day cancellation period or takes *unconscionable advantage* of the seller-in-foreclosure is subject to imprisonment and a fine no greater than $25,000 or both for each violation. [CC §1695.8]

Chapter 2 The equity purchase agreement

This chapter sets forth the guidelines for an equity purchase (EP) investor's acquisition of an owner's principal residence in foreclosure, the harsh penalties for violation of the EP laws, and the preparation of an EP offer.

Requirements for all EP investors

A homeowner defaults on a note secured by a trust deed lien on his principal residence, a one-to-four unit residential property. A **Notice of Default** (NOD) is recorded as agreed under the power-of-sale provision in the trust deed, placing the property in foreclosure status.

An investor, having good credit and **no knowledge** of equity purchase (EP) laws, orally agrees to sell the use of his creditworthiness to the owner. The investor will qualify to refinance the property in exchange for receiving a fee from the owner. The owner agrees to convey title as security for the deferred payment of the extension-of-credit fee charged by the investor for the refinancing.

It is additionally agreed the owner will **remain in possession** and make monthly payments to the investor. Title will be reconveyed to the owner when he pays off the investor and assumes the refinancing placed on the property by the investor. Coincidentally, the investor holds a real estate license, but at no time acts as an agent in the transaction. He acts only as a principal for his own account.

The investor erroneously believes he is purchasing ownership to the real estate when he receives and records a grant deed conveying title into his name. He will be the vested title holder of record until title is repurchased and reconveyed to the owner.

Without a written agreement or escrow instructions to document the terms of their extension-of-credit and refinancing arrangement, the owner conveys title to the investor by handing the investor his signed grant deed. The investor immediately records the deed.

Concurrent with the conveyance, the owner enters into a written sale-leaseback agreement with the investor, calling for the payment of monthly rent. The lease agreement includes a purchase option. The option allows the owner to repurchase title to the property on payment of a fixed sum of money within three years. The amount is the fee due the investor for the investor's extension of credit for the refinancing. This reverse **lease-option sales agreement** also states the investor reserves the right to sell the property on the owner's default.

The owner receives no funds for the conveyance of his equity. On acquiring title, the investor pays off the existing trust deed loan with his own funds. The foreclosure process has advanced to a Notice of Trustee Sale (NOTS) and no sufficient time remains to process the refinancing before the date set for the trustee's sale.

The investor then transfers the property's title to himself and his spouse as requested by the lender originating the first trust deed loan to refinance the property. The loan is recorded and the investor recovers the funds he advanced to payoff the delinquent loan. All costs relating to the new loan — including title insurance premiums, escrow fees and loan charges — are paid by including them in the new loan amount.

Later, the investor again refinances the property when interest rates drop. Thus, he increases his cash flow differential between the loan payments he makes and the rent he receives as set by the lease-option sales agreement. Prepayment penalties are incurred on the payoff, as well as origination costs for the new loan, all of which are also added to the new loan balance.

As the real estate recession deepens, the owner defaults on the monthly payments due on the lease agreement. A 3-day notice to pay rent or quit is served on the owner. Eventually, the owner is evicted from the property.

The investor then sells the now unoccupied property. The buyer is a *bona fide purchaser* (BFP), unaware of the owner's unrecorded option rights to repurchase the property. No sales proceeds remain after the loan payoff due to a decline in the property's value after the investor first took title. The owner receives no money from the sale.

The owner now makes a demand on the investor to pay the owner the dollar value of his **equity in the property** based on its value at the time the investor first violated the state's EP laws — the transfer of title to the investor.

Is the owner entitled to recover the value of his equity from the investor?

Yes! The owner is entitled to recover money equal to four times the sum of the fair market value of his equity at the time he conveyed title to the investor, minus any funds he received from the private lender. [**Segura** v. **McBride** (1992) 5 CA4th 1028]

Recovery of the owner's lost equity is allowed since the **investor violated** the EP laws repeatedly by:

- **failing to document** in writing (a note) the terms for repayment of the funds he was owed [Calif. Civil Code §1695.3(d)];
- **acquiring recorded title** to the owner's principal residence, consisting of a one-to-four unit residential property in foreclosure, without first entering into a written purchase agreement that conforms to EP statutes [CC §1695.6(a)]; and
- further **transferring title** to the property (to the spouse and again to the resale buyer) without the written consent of the owner. [**Boquilon** v. **Beckwith** (1996) 49 CA4th 1697; CC §1695.6(e)]

Editor's note — The investor in our facts should have structured the transaction as a first trust deed loan, so his advance of payoff funds would be evidenced by a note in his favor and secured by a trust deed on the property, and then collaterally assigned or sold the note and trust deed to recover his advance. Note and trust deed documentation of the loan would have avoided compliance with EP laws and the penalties for failure to comply due to the transfer of title.

Title to real estate is not transferred when a trust deed lien is created to encumber the property. [**Monterey S.P. Partnership** v. **W.L. Bangham, Inc.** (1989) 49 C3d 454]

The equity purchase transaction

An *equity purchase* (EP) transaction occurs when a one-to-four unit residential property occupied by the owner as his principal residence is **in foreclosure** (due to an NOD, not just a delinquency) and is then acquired by a buyer for investment (rented) or dealer (resale on a flip) purposes.

Although an investor may not be *in the business* of purchasing homes in foreclosure, a financing transaction structured as a "reverse" lease-option sale is a violation of EP law since **title is acquired** by the investor without the use of equity purchase documentation. On a conveyance in violation of EP law, the seller recovers four times the value of his equity at the time of the transfer plus attorney fees. [Segura, *supra*; CC §1695.7]

Editor's note — The use in this chapter of the real estate jargon "seller-in-foreclosure" or "owner-occupied" will always indicate the occupancy is of a one-to-four unit residential property by the owner as his principal residence.

The Boquilon court interpreted the legislative intent behind one of the EP statutes differently than the legislature expected by denying the seller-in-foreclosure an additional award of treble damages against the equity purchaser, a private lender under a lease-option sale agreement. The court concluded the lender should not be charged with constructive knowledge of EP law, and eliminated the award of treble damages.

However, in 1997, the legislature reacted abrasively to the holding in Boquilon by modifying the statute to mandate equity purchasers be charged with *constructive knowledge* of EP law, whether or not they have actual knowledge of the law's existence, and then mandatorily penalized them with a minimum additional award to the seller of at least treble damages. Hence, the minimum recovery of four times the value of the equity at the time of the first transfer of title. [CC §§1695.6(e), 1695.7]

Now consider an EP investor who properly documents his purchase of an owner-occupied, one-to-four unit residential property that is in foreclosure.

The property will be acquired either for the purpose of flipping it in an immediate cash resale (dealer property) or holding it as a continuing investment in real estate (rental). It will not be occupied as the investor's principal residence. The investor is not represented by a broker.

An EP agreement form that complies with the EP statutes is used by the EP investor to properly document the transaction in writing. [See Form 156 accompanying this chapter]

Escrow is immediately opened, conditioned on the running of the five-business-day right of the seller to cancel. Deeds are deposited in escrow, but the investor will not place any funds in escrow until escrow makes a demand for funds on closing. [See Chapter 1]

The seller-in-foreclosure's five-business-day right to cancel expires without the seller exercising his right to cancel. Thus, the EP agreement is now enforceable since no contingencies remain to be eliminated. The EP investor funds escrow, which closes as agreed.

Right of rescission, recovery of residence

However, once the cancellation period runs under a properly documented EP agreement and the transfer occurs (escrow closes), the EP investor has an additional risk to be concerned with — his title is subject to the seller-in-foreclosure's *two-year right of rescission*. This right of rescission after closing is held by the seller and is separate from the five-business-day right to cancel before closing.

The **two-year rescission right** is based on any *unconscionable advantage* the investor-buyer may have introduced into the negotiations that brought about the transaction. The two-year right of rescission cannot be *waived* by the seller. [CC §§1695.10, 1695.14; see Chapter 4]

However, the seller-in-foreclosure cannot rescind his closed sale and recover the property if the EP investor has:

- resold the property to a buyer who is classified as a *BFP*; or
- further encumbered the property with a loan originated by a lender classified as a *BFP*.

A *BFP* or lender is allowed to know that the investor acquired the property from a seller-in-foreclosure. That knowledge does not affect BFP status. However, they are not a BFP if a recorded lis pendens notifies them of the seller's claim or the seller is still in possession of the property and, on inquiry, would have stated his claim of unconscionability against the EP investor and right to title to the property under his lease-option. [CC §1695.14(c)]

Instead, when the EP investor (or private lender) has resold the property to a BFP, the recovery by the seller-in-foreclosure is converted to a **recovery of money**. [Segura, *supra*]

Money recovered on an EP law violation

Although the investor in the opening scenario violated three separate aspects of EP law over an extended period of time, the date of the first violation is the **valuation date** of the equity for the owner's money recovery. [Segura, *supra*]

Regardless of whether the EP investor still holds title to the property, the amount of money the seller-in-foreclosure can recover as his loss is:

- the dollar value of the property on the date of the EP investor's first violation, usually the transfer of title to the EP investor;

less

- the unpaid principal and accrued interest on the existing loan at the time of the violation;

less

- any money advances received by the seller-in-foreclosure from the EP investor. [Boquilon, *supra*]

More importantly, the seller will automatically recover *punitive money damages* not less than three times his actual money losses for his equity. [CC §1695.7]

The seller-in-foreclosure is also entitled to the statutory rate of interest (10%) on the value of the equity he lost from the date of the first violation, the day he was separated from his equity by a transfer of title. [Segura, *supra;* CC §3288]

Conversely, the EP investor is not entitled to any offsets against the dollar amount of the seller's equity. Disallowed offsets include escrow costs, prepayment penalties, carrying costs of the property, maintenance and improvement costs, or any post-violation decline in the property's value due to adverse market conditions.

However, the owner is not entitled to a refund of rental payments paid to the investor since he may not occupy property rent-free, regardless of the illegality of the circumstances. [Boquilon, *supra*]

Any recovery of money by the seller must be settled or an action filed within four years of the first violation of the EP laws, usually the conveyance of title. [CC §1695.7]

One further issue: the seller, due to the conveyance in violation of EP laws, has an alternative to seeking money during the four year statute of limitations period. He may seek "equitable relief." One such equitable relief is *rescission and restoration* of his ownership — in addition to the two-year restoration based on unconscionable advantage claims. [CC §1695.7]

Structuring the EP agreement

An individual, not intending to be an owner-occupant buyer, wants to purchase single-family residences (SFRs) for investment purposes.

Acting as an investor, the individual locates an owner-occupied SFR encumbered by a trust deed lien on which an NOD has been recorded. The NOD places the property in foreclosure by commencing a trustee's foreclosure proceedings.

Because the seller occupies the residential property as his principal residence and an NOD has been recorded, the **investor realizes** — or one of the agents realizes and advises him — that he must comply with California's EP laws when preparing and submitting an offer to purchase the property. [See Form 156]

Terms of the purchase

The EP investor is willing to purchase the SFR by:

- **paying** $10,000 cash to the seller-in-foreclosure for his equity in the property;
- **taking over** the existing loan with a total of $316,000 due the lender in unpaid principal, delinquent installments, and foreclosure costs; and
- **paying** the delinquent installments of principal, interest, taxes and insurance (PITI), and the foreclosure costs totalling approximately $15,180 — all of which are included in the $316,000 owed the lender on the loan.

An EP agreement is then prepared, calling for a $10,000 cash down payment.

Also, the EP investor will take title to the property "subject to" the existing first trust deed note with a 28-year amortization remaining, in spite of the due-on clause in the lender's trust deed.

The conditions of the trust deed note are:

- $300,000 remaining principal on closing (after the delinquent payments have been brought current);
- 6.5% fixed rate of interest;
- $1,896 monthly principal and interest payments;
- $360 monthly taxes/insurance (TI) impounds payments;
- five months of delinquent payments on PITI of $12,280; and
- foreclosure costs of $2,900.

The first trust deed is a loan insured by the Federal Housing Administration (FHA) subject to the Department of Housing and Urban Development (HUD) due-on-sale rules controlling investor purchases. However, only HUD, not the lender, has the right to call a HUD-insured loan. The likelihood of HUD calling any loan that is kept current is remote. Thus, the EP investor may take over the loan "subject to" with minimal interference from the lender — assumption fees and loan modification are avoided. [See Chapter 14]

Editor's note — As of February 2009, the FHA is suffering a 7% overall delinquency rate on its insured loans, up 1% from the prior year.

The seller-in-foreclosure will not be carrying back a portion of the purchase price since this is a cash-to-loan transaction. As an alternative, negotiations could have arranged for the seller to carryback paper in the EP transaction.

Tax-wise, the payment of the delinquent principal and interest (PI) payments (not the TI impounds) is reported as part of the EP investor's original **costs of acquisition**. The interest paid by the investor that accrued **before acquiring** the property is an expense of the seller-in-foreclosure, not the investor. Thus, the payment of the seller's debts assumed/taken over by the investor must be capitalized as part of his *cost basis* in the property. [Internal Revenue Code §1012]

EQUITY PURCHASE AGREEMENT

NOTE: For use by Buyers of one-to-four residential units which are owner-occupied and in foreclosure when the Buyer does not intend to occupy the property. [Calif. Civil Code §1695]

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. Received from _____, as the Buyer(s),

1.1 the sum of $_____, evidenced by ☐ personal check, or ☐ _____, payable to _____, for deposit only on acceptance of this offer.

1.2 Deposit to be applied toward Buyer's obligations under this agreement to purchase property

1.3 situated in the City of _____, County of _____, California,

1.4 referred to as _____,

1.5 including personal property, ☐ see attached Personal Property Inventory. [See ft Form 256]

2. This agreement is comprised of this six-page form and _____ pages of addenda/attachments.

TERMS: Buyer to pay the purchase price as follows:

3. Cash payment through escrow, including deposits, in the amount of. . . . . $_____

4. Buyer to obtain a ☐ first, or ☐ second, trust deed loan in the amount of . . . . . $_____ payable approximately $_____ monthly for a period of _____ years. Interest on closing not to exceed _____%, ☐ ARM, type _____.

5. ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by _____ with an approximate unpaid principal balance of . . . . $_____ payable $_____ monthly, including interest not exceeding _____%, ☐ ARM, type _____, plus a monthly tax/insurance impound payment of $_____. _____

5.1 The unpaid amount includes delinquent payments, late charges and foreclosure costs to be the responsibility of Buyer in the amount of $_____, including unpaid delinquent monthly payments beginning with the payment due _____, 20_____.

5.2 The impound account to be transferred without charge.

6. ☐ Take title subject to, ☐ or Assume, an existing second trust deed note held by _____ with an approximate unpaid principal balance of. . . . . $_____ payable $_____ monthly, including interest not exceeding _____%, ☐ ARM, type_____, due _____, 20_____.

6.1 The unpaid amount includes delinquent payments, late charges and foreclosure costs to be the responsibility of Buyer in the amount of $_____, including unpaid delinquent monthly payments beginning with the payment due _____, 20_____.

7. At closing, loan balance differences from those stated above as disclosed by beneficiary statement(s) to be adjusted into the purchase price unless the balances exceed the amount stated, in which case the difference is to be adjusted into the cash payment.

8. Assume a tax bond or assessment lien with an unpaid principal balance of. . . . . $_____

9. Note for the balance of the purchase price in the amount of . . . . . $_____ to be executed by Buyer in favor of Seller and secured by a trust deed on the property junior to any above referenced financing, payable $_____ monthly, or more, beginning one month after closing, including interest at _____% per annum from closing, due _____, 20_____, after closing.

9.1 This note and trust deed will not contain provisions for due-on-sale, prepayment penalty or late charges.

9.2 A Carryback Disclosure Statement is attached as an addendum. [See ft Form 300]

10. Total Purchase Price is . . . . . $_____

11. ACCEPTANCE AND PERFORMANCE:

11.1 This offer to be deemed revoked unless accepted in writing ☐ on presentation, or ☐ within _____ days after date, and acceptance is personally delivered or faxed to Offeror or Offeror's Broker within this period.

11.2 After acceptance, Broker(s) are authorized to extend any performance date up to one month.

11.3 On failure of Buyer to obtain or assume financing as agreed by the date scheduled for closing, Buyer may terminate the agreement.

11.4 Buyer's close of escrow is conditioned on Buyer's prior or concurrent closing on a sale of other property, commonly referred to as _____.

11.5 Any termination of the agreement shall be by written Notice of Cancellation timely delivered to the other party, the other party's Broker or escrow, with instructions to escrow to return all instruments and funds to the parties depositing them. [See ft Form 183]

11.6 Both parties reserve their rights to assign and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow on either party's written notice. [See ft Form 171 or 172]

11.7 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

11.8 Should Buyer breach the agreement, Buyer's monetary liability to Seller is limited to $_____.

12. PROPERTY CONDITIONS:

12.1 Seller to furnish prior to closing:

a. ☐ a structural pest control inspection report and certification of clearance of corrective conditions.

b. ☐ a home inspection report prepared by an insured home inspector showing the land and improvements to be free of material defects.

c. ☐ a one-year home warranty policy:
Insurer _____
Coverage _____

d. ☐ a certificate of occupancy, or other clearance or retrofitting, required by local ordinance for the transfer of possession or title.

e. ☐ a certification by a licensed contractor stating the sewage disposal system is functioning properly, and if it contains a septic tank, is not in need of pumping.

f. ☐ a certification by a licensed water testing lab stating the well supplying the property meets potable water standards.

g. ☐ a certification by a licensed well-drilling contractor stating the well supplying the property produces a minimum of _____ gallon(s) per minute.

h. ☐ _____

i. ☐ _____

12.2 Seller's Condition of Property Disclosure —Transfer Disclosure Statement (TDS) [See ft Form 304]

a. ☐ is attached; or

b. ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may either cancel the transaction based on a reasonable disapproval of the disclosure or deliver to Seller or Seller's Broker a written notice itemizing any material defects in the property disclosed by the statement and unknown to Buyer prior to acceptance. [See ft Form 269] Seller to repair, replace or correct noticed defects prior to closing.

c. On Seller's failure to repair, replace or correct noticed defects under §12.2b or §12.4a, Buyer may tender the purchase price reduced by the cost to repair, replace or correct the noticed defects, or close escrow and pursue available remedies. [See ft Form 183]

12.3 Seller's Transfer Fee Disclosure Statement [See ft Form 304-2]

a. ☐ is attached; or

b. ☐ is to be handed to Buyer on acceptance for Buyer's review. Withing ten days after receipt, Buyer may terminate this agreement based on a reasonable disapproval of the Transfer Fee Disclosure.

c. Seller to pay any transfer fees arising out of the transaction.

12.4 Buyer to inspect the property twice:

a. an initial property inspection is required on acceptance to confirm the property's condition is substantially the same as observed by Buyer and represented by Seller or Seller's Agents prior to acceptance, and if not substantially the same, Buyer to promptly notify Seller in writing of undisclosed material defects discovered. [See ft Form 269] Seller to repair, replace or correct noticed defects prior to closing; and

b. a final walk-through inspection is required within five days before closing to confirm the correction of any noticed defects under §12.2b and §12.4a and maintenance under §12.14. [See ft Form 270]

12.5 Seller's Natural Hazard Disclosure (NHD) Statement [See ft Form 314] ☐ is attached, or ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days of Buyer's post-acceptance receipt of the NHD, Buyer may terminate the agreement based on a reasonable disapproval of hazards disclosed by the Statement and unknown to Buyer prior to acceptance. [See ft Forms 182 and 183]

12.6 Buyer acknowledges receipt of a booklet and related seller disclosures containing ☐ *Environmental Hazards: A Guide for Homeowners, Buyers, Landlords and Tenants* (on all one-to-four units), ☐ *Protect Your Family from Lead in Your Home* (on all pre-1978 one-to-four units) [See ft Form 313], and ☐ *The Homeowner's Guide to Earthquake Safety* (on all pre-1960 one-to-four units). [See ft Form 315]

12.7 The property is located in: ☐ an industrial use area, ☐ a military ordnance area, ☐ a rent control area,or ☐ airport, farmland, or San Francisco Bay area, see attached Notice Addendum. [See ft Form 308] ☐ _____

12.8 On acceptance, Seller to hand Buyer the following property information for Buyer's review: ☐ Property Operating Cost Sheet [See ft Forms 306], ☐ _____

a. Within ten days of receipt, Buyer may terminate the agreement based on a reasonable disapproval of the property information received.

12.9 If a Homeowners' Association (HOA) is involved, ☐ Buyer has received and approves, or ☐ Buyer on acceptance to be handed, copies of the association's Articles, Bylaws, CC&Rs, collection and lien enforcement policy, operating rules, operating budget, CPA's financial review, insurance policy summary and any age restriction statement.

a. No association claims for defects or changes in regular or special assessments are pending or anticipated. Current monthly assessment is $_____.

b. Seller is not in violation of CC&Rs, except _____.

c. Seller to pay association document and transfer fees.

d. Buyer to approve the association's statement of condition of assessments and confirm representations in §12.9a as a condition for closing escrow.

e. Within ten days of Buyer's post-acceptance receipt of the association documents, Buyer may terminate the agreement based on a reasonable disapproval of the documents. [See ft Form 183]

12.10 Seller's Criminal Activity and Security Disclosure Statement [See ft Form 321]

a. ☐ is attached, or

b. ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may terminate this agreement based on a reasonable disapproval of the Criminal Activity and Security Disclosure Statement.

12.11 Smoke detector(s) and water heater bracing exist in compliance with the law, and if not, Seller to install.

12.12 If this property or an adjoining property contains a solar collector authorized by the Solar Shade Control Act (California Public Resources Code §25980 et seq.) and notice of its existence has been sent or received by Seller, then on acceptance, Seller to hand Buyer copies of the notices sent or received by Seller or provided to Seller by prior Owners of the property for Buyer's review. Buyer may, within ten days after receipt, terminate this agreement based on a reasonable disapproval of the conditions disclosed by the solar shade control notices.

12.13 Possession of the property and keys/access codes to be delivered: ☐ on close of escrow, or ☐ as stated in the attached Occupancy Agreement. [See ft Forms 271 and 272]

12.14 Seller to maintain the property in good condition until possession is delivered.

12.15 Fixtures and fittings attached to the property include but are not limited to: window shades, blinds, light fixtures, plumbing fixtures, curtain rods, wall-to-wall carpeting, draperies, hardware, antennas, air coolers and conditioners, trees, shrubs, mailboxes and other similar items.

12.16 Notice: Pursuant to Section 290.46 of the Penal Code, information about specified registered sex offenders is made available to the public via an Internet Web site maintained by the Department of Justice at www.meganslaw.ca.gov. Depending on an offender's criminal history, this information will include either the address at which the offender resides or the community of residence and ZIP code in which he or she resides.

13. CLOSING CONDITIONS:

13.1 This transaction to be escrowed with _____. Parties to deliver instructions to escrow as soon as reasonably possible after acceptance.

a. ☐ Escrow holder is authorized and instructed to act on the provisions of this agreement as the mutual escrow instructions of the parties and to draft any additional instructions necessary to close this transaction. [See ft Form 401]

b. ☐ Escrow instructions, prepared and signed by the parties, are attached to be handed to escrow on acceptance. [See ft Form 401]

13.2 Escrow to be handed all instruments needed to close escrow on or before _____, 20_____, or within _____days after acceptance. Parties to hand escrow all documents required by the title insurer, lenders or other third parties to this transaction prior to seven days before the date scheduled for closing.

a. Each party to pay its customary Escrow charges. [See ft Forms 310 and 311]

13.3 The amount of any taxes, liens, bonds, assessments or other encumbrances on the property not referenced are, at Buyer's option, to remain of record and be deducted first from the cash payment and then from any carryback note.

13.4 Buyer's title to be subject to covenants, conditions, restrictions, reservations and easements of record.

_____.

13.5 Title to be vested in Broker or Assignee free of encumbrances other than those set forth herein. Buyer's interest in title to be insured under a policy issued by _____ title company on a(n) ☐ Homeowner(s) policy (one-to-four units), ☐ Residential ALTA-R policy (vacant or improved residential parcel), ☐ Owner's policy (other than one-to-four units), ☐ CLTA Joint Protection policy (also naming Carryback Seller or purchase-assist lender), or ☐ Binder (to insure resale or refinance within two years).

a. Endorsements _____

b. ☐ Seller, or ☐ Buyer, to pay the title insurance premium.

13.6 Buyer to furnish a new fire insurance policy covering the property.

13.7 Taxes, assessments, insurance premiums, rents, interest and other expenses to be pro rated to close of escrow, unless otherwise provided.

13.8 Bill of Sale to be executed for any personal property being transferred.

13.9 If Seller is unable to convey marketable title as agreed, or if the improvements on the property are materially damaged prior to closing, Buyer may terminate the agreement. Seller to pay all reasonable escrow cancellation charges. [See ft Form 183]

14. Buyer's Broker and sales agent hereby confirms under penalty of perjury that:

14.1 ☐ he holds a valid, current California real estate license;

14.2 ☐ he has provided proof of his license to the seller-in-foreclosure by attaching:

a. ☐ a copy of his license as issued by the DRE; or

b. ☐ a printout of the DRE's Current License Status for the licensee; and

14.3 ☐ he holds adequate coverage via bond, errors and omissions insurance, or whatever other means which may become required by Equity Purchase laws.

15. FURTHER CONDITIONS: _____

_____

_____

_____

16. NOTICE OF YOUR SUPPLEMENTAL PROPERTY TAX BILL:

California property tax law requires the Assessor to revalue real property at the time the ownership of the property changes. Because of this law, you may receive one or two supplemental tax bills, depending on when your loan closes.

The supplemental tax bills are not mailed to your lender. If you have arranged for your property tax payments to be paid through an impound account, the supplemental tax bills will not be paid by your lender. It is your responsibility to pay these supplemental bills directly to the Tax Collector.

If you have any questions concerning this matter, please call your local Tax Collector's Office.

17. BROKERAGE FEE:

17.1 Parties to pay the below mentioned Broker(s) a fee now due of _____ as follows:

a. Seller to pay the brokerage fee on the change of ownership.

b. The party wrongfully preventing this change of ownership to pay the brokerage fee.

17.2 Buyer's Broker and Seller's Broker, respectively, to share the brokerage fee _____:_____.

17.3 Attached is the Agency Law Disclosure. [See ft Form 305]

17.4 Broker is authorized to report the sale, its price and terms for dissemination and use of participants in brokerage trade associations or listing services.

18. CANCELLATION PERIOD:

18.1 Seller has the below noticed right to cancel this agreement until midnight of the fifth business day following the day Seller signs this agreement, or until 8 a.m. on the day scheduled for a trustee's foreclosure sale of the property, whichever occurs first.

NOTICE REQUIRED BY CALIFORNIA LAW:

Until your right to cancel this contract has ended,

_____(Buyer)

or anyone working for

_____(Buyer)

CANNOT ask you to sign or have you sign any deed or any other document.

You may cancel this contract for the sale of your house, without any penalty or obligation at any time before _____:_____, _____.m. on _____, 20_____.

See attached Notice of Cancellation form for an explanation of this right.
(To be filled out by Buyer)

Buyer's/ Selling Broker: _____

Broker's DRE Identification #: _____

Selling Agent: _____

Agent's DRE Identification #: _____

Signature: _____

Is the agent of: ☐ **Buyer exclusively.** ☐ **Both Seller and Buyer.**

Address: _____

_____

Phone: _____

Fax: _____

Email: _____

Seller's/ Listing Broker: _____

Broker's DRE Identification #: _____

Listing Agent: _____

Agent's DRE Identification #: _____

Signature: _____

Is the agent of: ☐ **Seller exclusively.** ☐ **Both Seller and Buyer.**

Address: _____

_____

Phone: _____

Fax: _____

Email: _____

I agree to the terms stated above.	**I agree to the terms stated above.**
☐ See Signature Page Addendum. [ft Form 251]	☐ See Signature Page Addendum. [ft Form 251]
Date: _____, 20_____	Date: _____, 20_____
Buyer: _____	Seller: _____
Signature: _____	Signature: _____
Buyer: _____	Seller: _____
Signature: _____	Signature: _____

NOTICE OF CANCELLATION

(To be filled out by Buyer)

Seller signed the Equity Purchase Agreement on _____, 20_____.
You may cancel this contract for the sale of your house, without any penalty or obligation, at any time before _____:_____, _____.m. on _____, 20_____.
To cancel this transaction, personally deliver a signed and dated copy of this cancellation notice, or send a telegram to _____ (Buyer)
at _____ (Business Address)
NOT LATER THAN _____:_____, _____.m. on _____, 20_____.

I hereby cancel this transaction.

Date: _____, 20_____
Seller's Signature: _____
Seller's Signature: _____

NOTICE OF CANCELLATION

(To be filled out by Buyer)

Seller signed the Equity Purchase Agreement on _____, 20_____.
You may cancel this contract for the sale of your house, without any penalty or obligation, at any time before _____:_____, _____.m. on _____, 20_____.
To cancel this transaction, personally deliver a signed and dated copy of this cancellation notice, or send a telegram to _____ (Buyer)
at _____ (Business Address)
NOT LATER THAN _____:_____, _____.m. on _____, 20_____.

I hereby cancel this transaction.

Date: _____, 20_____
Seller's Signature: _____
Seller's Signature: _____

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The investor's cost basis on acquisition of the property will be the purchase price of approximately $325,000, which includes the down payment, the seller's delinquent (PI) installments, foreclosure costs, the principal balance on the loan, and transactional costs, less the impound account balance assigned to the investor.

A prudent EP investor will determine the total cash funds needed to close escrow before making an offer. Cash expenditures of the EP investor on closing include:

- a down payment of $10,000;
- delinquent principal, interest, taxes, and impounds of $11,280;
- foreclosure costs of $2,900; and
- escrow fees and charges of $1,000.

Thus, the EP investor's total cash investment is $25,200. [See **first tuesday** Form 311]

Analyzing the EP agreement

The Equity Purchase Agreement, **first tuesday** Form 156, is used to prepare a written offer to be submitted by an investor or dealer to purchase a one-to-four unit residential property which is occupied by the owner as his principal residence and is in foreclosure. As required by EP law, the form contains bold print, minimum size type and the statutory notice of the five-business-day right of cancellation, as well as the actual Notice of Cancellation for use by the seller who chooses to cancel the agreement.

A purchase of the owner-occupied residence in foreclosure by a buyer who will occupy the property as his residence does not require the use of an EP agreement as the purchase is not subject to EP law. However, an equity purchase requiring the use of an EP agreement does occur when a buyer is acquiring the property for business, rental, investment or dealer purposes.

The terms for payment of the price are structured to include a lump sum amount of cash to be paid to the seller for his equity in the property. Thus, all adjustments, prorations, credits and offsets are formulated to deliver to the seller this lump sum amount unchanged since it is based on the seller's representations of sums owing on all encumbrances affecting title to the property.

Each section in Form 156 has a separate purpose and need for enforcement. The sections include:

1. *Identification:* The date of preparation, the real estate and any personal property to be purchased, and the number of pages comprising the entire agreement, including addenda, are set forth in sections 1 and 2.

2. *Price and terms of payment:* All the typical variations for payment of the price are set out in sections 3 through 10 as a "checklist of provisions." The EP investor selects the terms of purchase by checking boxes and filling blanks in the desired provisions. While the subject matter of the various provisions is typical, the terms each contain are not. All financial aspects are biased in favor of the buyer, such as prorates and adjustments, since EP transactions are structured as the payment of a lump sum for the conveyance.

3. *Acceptance and performance:* Aspects of the formation of a contract, excuses for nonperformance and termination of the agreement are provided for in section 11, such as the time period for acceptance of the offer, the broker's authorization to extend performance deadlines, the financing of the price as a closing contingency, procedures for cancellation of the agreement, a sale of other property as a closing contingency, cooperation to effect a §1031 transaction and limitations on monetary liability for breach of contract.

4. *Property conditions:* The EP investor's confirmation of the physical condition of the property as disclosed prior to acceptance is provided for in section 12 by the seller's delivery of reports, warranty policies, certifications, disclosures statements, an environmental, lead-based paint and earthquake safety booklet, any operating cost and income statements, and any homeowners' association (HOA) documents not handed to the EP investor prior to entry into the purchase agreement, as well as by the EP investor's initial inspection, personally or by a home inspector, and final inspection at closing to confirm the seller has eliminated defects known, but not disclosed, prior to acceptance.

5. *Closing conditions:* The escrow holder, escrow instruction arrangements and the date of closing are established in section 13, as are title conditions, title insurance, hazard insurance, prorates and loan adjustments.

6. *Brokerage and agency:* The release of sales data on the transaction to trade associations is authorized, the brokerage fee is set, and the delivery of the agency law disclosure to both EP investor and seller and the disclosure of compliance with proof of licensure and any future bonding requirements is provided for as set forth in sections 14 and 17, as well as the confirmation of the agency undertaken by the brokers and their agents on behalf of one or both parties to the agreement.

7. *Seller's right to cancel:* Mandated by law, the notice to the owner-occupant seller whose home is in foreclosure (NOD has been recorded) is set forth in section 18, disclosing the seller' right to cancel the entire transaction within five business days after he enters into this agreement. The notice is one of two major additions imposed on standard purchase agreements by EP law. The other is the Notice of Cancellation used by the seller to implement the right to cancel during the five-business-day period following the seller's acceptance.

8. *Notice of supplemental property tax:* Notifies the buyer he will receive one or two supplemental property tax bills he is to pay when the county assessor revalues the property after a change in ownership, as set forth in section 16.

9. *Signatures:* The seller and EP investor bind each other to perform as agreed in the purchase agreement by signing and dating their signatures to establish the date of offer and acceptance.

10. *Cancellation notice:* Separate from the actual EP purchase agreement is the form completed by the EP investor, in duplicate, that the seller will use if he chooses to cancel the agreement. By signing and delivering one of the easily detachable cancellation forms to the EP investor at any time before midnight of the fifth business day after the date the seller signs the agreement, the seller effectively cancels the entire EP purchase agreement, with or without reason.

Preparing the EP agreement

The following instructions are for the preparation and use of the Equity Purchase Agreement, **first tuesday** Form 156. Form 156 is designed to comply with EP law when used by an investor to purchase a one-to-four unit, owner-occupied residential property which is in foreclosure.

*Editor's note — See **first tuesday** Form 156-1 for an Equity Purchase Agreement with short sale provisions.*

Each instruction corresponds to the provision in the form bearing the same number.

*Editor's note — **Check** and **enter** items throughout the agreement in each provision with boxes and blanks, unless the provision is not intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Document identification:

Enter the date and name of the city where the offer is prepared. This date is used when referring to this purchase agreement.

Facts:

1. *Buyer, deposit and property:* **Enter** the name of each buyer who will sign the offer.

   1.1 **Enter** the dollar amount of any good-faith, earnest money deposit. Check the appropriate box to indicate the form of the good-faith deposit. Enter the name of the payee (escrow, title company, or broker).

   1.3 **Enter** the name of the city and county in which the property is located.

   1.4 **Enter** the legal description or common address of the property, or the assessor's parcel number (APN).

   1.5 **Check** the box to indicate personal property will be included in the sale. The seller's trade fixtures to be purchased by the buyer must be listed as inventory if they are to be acquired by the buyer. [See **first tuesday** Form 256]

2. *Entire agreement:* **Enter** the number of pages comprising all of the addenda, disclosures, etc., which are attached to the purchase agreement.

Terms for payment of the purchase price:

3. *Cash down payment:* **Enter** the dollar amount of the buyer's cash down payment toward the purchase price. The down payment represents the amount of cash the seller-in-foreclosure will receive on closing, less any adjustments, escrow charges and fees.

4. *New trust deed loan:* **Check** the appropriate box to indicate whether any new financing will be a first or second trust deed loan. **Enter** the amount of the loan, the monthly PI payment, the term of the loan and the rate of interest. **Check** the box to indicate whether the interest will be adjustable (ARM), and if so, **enter** the index name. **Enter** any limitations on loan points.

5. *First trust deed note*: **Check** the appropriate box to indicate whether the transfer of title is to be "subject to" an existing loan or by an "assumption" of the loan if the buyer is to take over an existing first trust deed loan. **Enter** the lender's name. **Enter** the remaining balance, the monthly principal and interest (PI) payment and the interest rate on the loan. **Check** the box to indicate whether the interest is adjustable (ARM), and if so, **enter** the index name. **Enter** any monthly impound payment made in addition to the PI payment. **Enter** any due date or other terms unique to the loan.

   5.1 *Delinquencies:* **Enter** the dollar amount required to cure all defaults on the loan. **Enter** the date the loan payments became delinquent.

   5.2 *Impound balances:* **Authorizes** the impound account to be transferred without charge to the EP investor.

6. *Second trust deed note*: **Check** the appropriate box to indicate whether the transfer of title is to be "subject to" an existing loan or by an "assumption" of the loan if the buyer is to take over an existing second trust deed loan. **Enter** the lender's name. **Enter** the remaining balance, the monthly PI

payment and the interest rate on the loan. **Check** the box to indicate whether the interest is adjustable (ARM), and if so, **enter** the index name. **Enter** the due date for payment of a final/balloon payment.

6.1 *Delinquencies:* **Enter** the dollar amount required to cure all defaults on the loan. **Enter** the date the loan payments became delinquent.

7. *Loan balance adjustments:* **Authorizes** any adjustments due to differences between the loan balances stated in the agreement and actually existing at the time of closing to be made into the purchase price. However, if the balance on the loans exceeds the amount stated in the purchase agreement, the difference is subtracted from the cash down payment.

8. *Bond or assessment assumed:* **Enter** the amount of the principal balance remaining unpaid on bonds and special assessment liens (such as Mello-Roos or 1915 improvement bonds) which will remain unpaid and become the responsibility of the buyer on closing.

*Editor's note — Improvement bonds are obligations of the seller which may be assumed by the EP investor in lieu of their payoff by the seller. If assumed, the bonded indebtedness becomes part of the consideration paid for the property. Some purchase agreements erroneously place these bonds under "property tax" as though they were **ad valorem taxes**, and then fail to prorate and charge the unpaid amount to the seller.*

9. *Seller carryback note:* **Enter** the amount of the carryback note to be executed by the EP investor as partial payment of the price. **Enter** the amount of the note's monthly PI payment, the interest rate and the due date for the final/balloon payment.

9.1 *Special carryback provisions:* No transfer restrictions or charges for early payoff or late payment will be included in the carryback note and trust deed.

9.2 *Carryback disclosure:* **Fill out** and **attach** a Seller Carryback Disclosure Statement as an addendum. [See **first tuesday** Form 300]

Editor's note — Further approval of the disclosure statement in escrow creates by statute a buyer's contingency allowing for cancellation until time of closing on any purchase of one-to-four unit residential property.

10. *Purchase price:* **Enter** the total amount of the purchase price as the sum of lines 3, 4, 5, 6, 8 and 9.

11. **Acceptance and performance periods:**

11.1 *Delivery of acceptance:* **Check** the appropriate box to indicate the time period for acceptance of the offer. If applicable, **enter** the number of days in which the seller may accept this offer and form a binding contract.

Editor's note — If "on presentation" is used, the seller still has a statutory period of five business days to cancel the agreement after the seller's acceptance.

11.2 *Extension of performance dates:* **Authorizes** the brokers to extend the performance dates up to one month to meet the objectives of the agreement — time being of a reasonable duration and not the essence of this agreement as a matter of policy. This extension authority does not extend to the acceptance period.

11.3 *Loan contingency:* **Authorizes** the EP investor to cancel the transaction at the time scheduled for closing if the financing for payment of the price is not obtainable or assumable.

11.4 *Sale of other property:* If the closing of this transaction is to be contingent on the EP investor's receipt of net proceeds from a sale of other property, **enter** the address of the property to be sold by the EP investor.

11.5 *Cancellation procedures:* **Provides** the method of cancellation required to terminate the agreement when the right to cancel is triggered by other provisions in the agreement, such as contingency or performance provisions.

11.6 *Exchange cooperation:* **Requires** the parties to cooperate in an IRS §1031 transaction on further written notice by either party. **Provides** for the parties to assign their interests in this agreement.

11.7 *Mediation provision*: **Provides** for the parties to enter into non-binding mediations to resolve a dispute remaining unsolved after 30 days of informal settlement negotiations.

11.8 *Liability limitations:* **Provides** for a dollar limit on the EP investor's liability for the EP investor's breach of the agreement. **Enter** the maximum dollar amount of money losses the seller may recover from the EP investor for breach of the EP agreement.

Editor's note — Liability limitation provisions avoid the misleading and unenforceable forfeiture called for under liquidated damage clauses included in most purchase agreement forms provided by other publishers of forms.

12. **Property Conditions:**

12.1 *Seller to furnish:* **Check** the appropriate box(es) within the following subsections to indicate the items the seller is to furnish prior to closing.

a. *Pest control:* **Check** the box to indicate the seller is to furnish a structural pest control report and clearance.

b. *Home inspection report:* **Check** the box to indicate the seller is to employ a home inspection company and furnish the buyer with the company's home inspection report.

c. *Home warranty:* **Check** the box to indicate the seller is to furnish an insurance policy for home repairs. **Enter** the name of the insurer and the type of coverage, such as for the air conditioning unit, etc.

d. *Local ordinance compliance:* **Check** the box to indicate the seller is to furnish a certificate of occupancy or other clearance required by local ordinance.

e. *Sewer or septic certificate:* **Check** the box to indicate the seller is to furnish a certificate of the condition of the sewage disposal system stating it is functioning properly.

f. *Potable well water:* **Check** the box to indicate the seller is to furnish a certificate stating the well supply meets water standards.

g. *Well water capacities:* **Check** the box to indicate the seller is to furnish a certificate stating the amount of water the well supplies. **Enter** the number of gallons per minute the well is expected to produce.

h. *Other terms:* **Check** the box and **enter** any other report, certification or clearance the seller is to furnish.

12.2 *Property condition(s):* **Check** the appropriate box within the following subsections to indicate the status of the Transfer Disclosure Statement (TDS).

a. *Attached TDS:* **Check** the box to indicate the seller's TDS has been prepared and handed to the buyer, and if so, **attach** it to this agreement. Thus, the property's condition is accepted by the EP investor upon entering into the purchase agreement offer.

*Editor's note — Use of the TDS form is mandated on one-to-four unit residential property. [See **first tuesday** Form 304]*

b. *Later delivered TDS:* **Check** the box to indicate the TDS is to be **delivered later** to the EP investor to confirm the condition of the property is as disclosed prior to entry into the purchase agreement. On receipt of the TDS, the EP investor may either cancel the transaction for failure of the seller or the listing agent to disclose known property defects prior to acceptance of the purchase agreement (or counteroffer), or give notice to the seller of the defects known and not disclosed prior to acceptance and make a demand on the seller to correct them prior to closing.

c. *Repair of defects:* **Authorizes** the EP investor to either cancel the transaction or adjust the price should the seller fail to correct the defects noticed under sections 12.2b or 12.4a.

12.3 *Transfer Fee Disclosure Statemen*t: **Check** the appropriate box within the following subsections to indicate the status of the seller's Transfer Fee Disclosure Statement (TFDS). [See **first tuesday** Form 304-2]

a. *Attached TFDS:* **Check** the box to indicate the seller's Transfer Fee Disclosure Statement has been prepared and handed to the buyer, and if so, **attach** it to this agreement.

b. *Later delivered TFDS:* **Check** the box to indicate the TFDS is to be **delivered later** to the buyer to confirm the existence of a transfer fee as disclosed prior to entry into the purchase agreement. On receipt of the TFDS, the buyer may terminate this agreement based on a reasonable disapproval of the TFDS.

c. *Transfer fee:* **Requires** the seller to pay any transfer fees arising out of this transaction.

12.4 *EP investor's inspection:* **Authorizes** the EP investor to inspect the property twice during the escrow period to verify its condition is as disclosed by the seller prior to the time of acceptance.

a. *Initial property inspection:* **Requires** the EP investor to inspect the property immediately after acceptance to put the seller on notice of material defects to be corrected by the seller prior to closing. [See **first tuesday** Form 269]

b. *Final walk-through inspection:* **Requires** the EP investor to inspect the property again within five days before closing to confirm repairs and maintenance of the property have occurred. [See **first tuesday** Form 270]

12.5 *Seller's Natural Hazard Disclosure (NHD) Statement:* **Check** the appropriate box to indicate whether the NHD statement disclosing the seller's knowledge about the hazards listed on the form has been prepared and handed to the EP investor. If it has been received by the EP investor, **attach** a copy to the purchase agreement. If the NHD will be handed to the EP investor after acceptance, the EP investor has ten days after the EP investor's receipt of the NHD statement in which to approve it or cancel.

Editor's note — Disclosure by the seller is mandated on one-to-four unit residential property. [CC §1103]

12.6 *Hazard disclosure booklets:* **Check** the appropriate box(es) to indicate which hazard booklets have been received by the EP investor, together with the seller's prepared and signed disclosures accompanying each booklet.

12.7 *Other property disclosures:* **Check** the appropriate box(es) to indicate other disclosures made by the seller regarding the location of the property. **Enter** a reference to any local (option) ordinance disclosure statement attached as an addendum to the purchase agreement and **attach** it. [See **first tuesday** Form 307]

12.8 *Operating costs and rents:* **Check** the appropriate box(es) to indicate the information the seller is to disclose regarding the operating expenses of ownership. [See **first tuesday** Form 306]

a. *Disclosure approval*: **Authorizes** the EP investor to cancel the purchase agreement and escrow if the operating expense disclosure is unacceptable.

12.9 *Homeowners' association (HOA)*: **Check** the appropriate box to indicate whether any HOA documents have been or are to be delivered to the EP investor.

a. *Monthly payments*: **Enter** the dollar amount of the monthly payments assessed by the HOA.

b. *CC&Rs*: **Enter** the nature of any violation of the CC&Rs by the seller.

c. *HOA charges*: **Provides** for the seller to pay all HOA charges on the transaction.

d. *Condition of assessments*: **Provides** for the EP investor to approve the HOA's condition of assessments statement prior to closing.

e. *Disapproval of HOA documents*: **Authorizes** the EP investor to terminate this purchase agreement within ten days after his receipt of HOA documents when the disclosures are made after entering into the purchase agreement. Disclosure of HOA conditions in escrow trigger a statutory contingency allowing the EP investor to cancel the purchase agreement.

12.10 *Criminal Activity and Security Disclosure*: **Check** the appropriate box within the following subsections to indicate the status of the seller's Criminal Activity and Security Disclosure Statement. [See **first tuesday** Form 321]

a. *Attached disclosure*: **Check** the box to indicate the seller's Criminal Activity and Security Disclosure Statement has been prepared and handed to the buyer, and if so, **attach** it to this agreement.

b. *Later delivered disclosure:* **Check** the box to indicate the Criminal Activity and Security Disclosure Statement is to be **delivered later** to the buyer. On receipt of the disclosure, the buyer may terminate this agreement based on a reasonable disapproval.

12.11 *Safety compliance:* **Requires** smoke detectors and water heater bracing to exist or be installed by the seller.

12.12 *Solar Collector Notice:* **States** the seller will hand a copy of the notice received from any neighbor to the buyer. If the seller sent neighbors a notice, a list of everyone who was sent a notice is to be handed to the buyer. The buyer is authorized to terminate this purchase agreement for cause within ten days after receipt.

12.13 *Buyer's possession:* **Check** the appropriate box to indicate when possession of the property will be delivered to the EP investor, whether at closing or under an **attached** buyer's interim occupancy or seller's holdover agreement. [See **first tuesday** Forms 271 and 272]

12.14 *Property maintenance:* **Requires** the seller to maintain the present condition of the property until the close of escrow.

Editor's note — See section 12.3b for the buyer's final inspection to confirm maintenance at closing.

12.15 *Fixtures and fittings:* **Confirms** this agreement includes real estate fixtures and fittings as part of the property purchased.

Editor's note — Trade fixtures are personal property to be listed as items on an attached inventory.

12.16 *Sex offender disclosure:* **Complies** with requirements that the seller disclose the existence of a sex offender database on the sale (or lease) of one-to-four residential units.

Editor's note — By the existence of the disclosure in the form, the seller and brokers are relieved of any duty to make further disclosures regarding registered sex offenders.

13. **Closing conditions:**

13.1 *Escrow closing agent:* **Enter** the name of the escrow company handling the closing.

a. *Escrow instructions*: **Check** the box to indicate the purchase agreement is to also serve as the mutual instructions to escrow from the parties. The escrow company will typically prepare supplemental instructions they will need to handle and close the transaction. [See **first tuesday** Form 401]

13.2 *Closing date:* **Check** the appropriate box to indicate the method to be used to set the date on which escrow is scheduled to close. Following the checked box, **enter** the specific date for closing or the number of days anticipated as necessary for the parties to perform and close escrow. Also, prior to seven days before closing, the parties are to deliver all documents needed by third parties to perform their services by the date scheduled for closing.

a. *Escrow charges*: **Requires** each party to pay their customary escrow closing charges, amounts any competent escrow officer can provide on inquiry.

13.3 *Undisclosed lien adjustments:* At the EP investor's option, adjustments for liens not disclosed in the agreement will be made first into the down payment and then into any carryback note for any amounts remaining.

13.4 *Title conditions:* **Enter** wording for any further-approval contingency provision the EP investor may need to confirm that title conditions set forth in the preliminary title report will not interfere with the EP investor's intended use of the property, such as "closing contingent on EP investor's approval of preliminary title report."

13.5 *Title insurance:* **Provides** for title to be vested in the name of the EP investor or his assignee. **Enter** the name of the title insurance company which is to provide a preliminary title report in anticipation of issuing title insurance. **Check** the appropriate box to indicate the type of title insurance policy to be issued on closing.

a. *Policy endorsements*: **Enter** any endorsements to be issued with the policy.

b. *Payment of premium*: **Check** the appropriate box to indicate whether the EP investor or seller is to pay the title insurance premium.

13.6 *Fire insurance:* **Requires** the EP investor to provide a new policy of hazard insurance.

13.7 *Prorates and adjustments:* **Authorizes** prorations and adjustments on the close of escrow for taxes, insurance premiums, rents, interest, loan balances, service contracts and other property operating expenses, prepaid or accrued.

13.8 *Personal property:* **Requires** the seller to execute a bill of sale for any personal property being transferred in this transaction at section 1.

13.9 *Property destruction:* **Provides** for the seller to bear the *risk of loss* for any casualty losses suffered by the property prior to the close of escrow. Thus, the EP investor may terminate the agreement if the seller is unable to provide a marketable title or should the property improvements suffer major damage.

14. *Licensing disclosure:* **Check** the boxes to indicate the EP investor is represented by a licensed real estate broker, exclusively or as a dual agent, and the broker has provided proof of his licensure to the seller-in-foreclosure.

Editor's note — Should the California Legislature reinstate some form of bonding, please check the box indicating the broker is properly bonded or insured.

15. *Other terms:* **Enter** any special provision to be included in the purchase agreement.

16. *Supplemental property tax bill:* **Notifies** the buyer he will receive one or two supplemental property tax bills he is to pay when the county assessor revalues the property after a change in ownership.

17. **Brokerage fee:**

17.1 *Fee amount:* **Enter** the total amount of the fee due all brokers to be paid by the seller. The amount may be stated as a fixed dollar amount or a percentage of the price.

Editor's note — The defaulting party pays all brokerage fees and the brokerage fee can only be altered or cancelled by mutual instructions from the EP investor and seller.

17.2 *Fee sharing:* **Enter** the percentage share of the fee each broker is to receive.

Editor's note — The percentage share may be set based on an oral agreement between the brokers, by acceptance of the listing broker's MLS offer to a selling office to share a fee, or unilaterally by an agent when preparing the buyer's offer.

17.3 *Agency law disclosures:* **Attach** a copy of the Agency Law Disclosure addendum for all parties to sign. The disclosure is mandated to be acknowledged by the EP investor with the offer and acknowledged by the seller on acceptance as a prerequisite to the brokers enforcing collection of the fee when the property involved contains one-to-four residential units. [See **first tuesday** Form 305]

17.4 *Disclosure of sales data:* **Authorizes** the brokers to report the transaction to trade associations or listing services.

18. **Cancellation period:**

18.1 *Statutory cancellation period:* The seller has the **right to cancel** the EP agreement until midnight (12 a.m.) of the fifth business day (Monday through Saturday, excluding specified holidays) following the day the EP agreement is accepted or until 8 a.m. on the day scheduled for a trustee's foreclosure sale of the property, whichever occurs first. [CC §1695.4(a)]

Notice of right to cancel

Enter the EP investor's name and the appropriate time and date for the expiration of the seller's cancellation period of five business days after acceptance.

Editor's note — See explanations for time and date given in section 18.1 above and in the Notice of Cancellation section below.

Agency confirmation:

Buyer's broker identification: **Enter** the name of the buyer's broker and Department of Real Estate (DRE) identification number. **Enter** the name of the broker's selling agent and his DRE license number. **Obtain** the signature of the buyer's broker or the selling agent acting on behalf of the buyer's broker. **Check** the appropriate box to indicate the agency which was created by the broker's (and his agents') conduct with the parties. **Enter** the broker's address, phone, fax, and email information.

Listing broker identification: **Enter** the name of the listing broker and Department of Real Estate (DRE) identification number. **Enter** the name of the listing agent and his DRE license number. **Obtain** the signature of the listing broker or the listing agent acting on behalf of the listing broker. **Check** the appropriate box to indicate the agency which was created by the broker's (and his agents') conduct with the parties. **Enter** the broker's address, phone, fax, and email information.

Signatures:

Buyer's signature: **Enter** the date the buyer signs the purchase agreement and each buyer's name. **Obtain** each buyer's signature on the purchase agreement and on each attachment which requires his signature. **Enter** the buyer's address, telephone and fax numbers, and email address.

Seller's signature: **Enter** the date the seller signs the purchase agreement and each seller's name. **Obtain** each seller's signature on the purchase agreement and on each attachment which requires his signature. **Enter** the seller's address, telephone and fax numbers, and email address.

Notice of Cancellation:

Editor's note — The Notice of Cancellation is not part of the actual EP agreement. It is the notice the seller-in-foreclosure signs and delivers to cancel the transaction. It must be filled out, ***in duplicate****, by the* ***buyer*** *and handed to the seller with the EP agreement.*

Enter the date the seller signs his acceptance of the EP agreement. **Enter** the time (12 a.m. or 8 a.m.) and the date on or before which the seller may cancel the agreement (five business days after acceptance or the date set for the trustee's sale, if earlier).

Enter the EP investor's name and the address where the Notice of Cancellation is to be delivered if the seller-in-foreclosure chooses to cancel the EP agreement by signing it. **Enter** the time (12 a.m. or 8 a.m.) and the date by which the seller may cancel the agreement (five business days after acceptance or the date set for the trustee's sale, if earlier).

The EP investor is to also **complete** the second, duplicate Notice of Cancellation which follows.

Editor's note — The Notices of Cancellation at the end of the EP agreement are not dated or signed by the seller on acceptance. The seller will later sign and deliver a Notice of Cancellation to the EP investor only if the seller actually decides to cancel the transaction.

Observations

As a policy of the publisher, this EP agreement **does not contain** clauses which tend to increase the risk of litigation or are generally felt to work against the best interests of the buyer, seller and broker. Excluded provisions include:

- an *attorney fee provision*, which tends to **promote litigation** and inhibit contracting; and
- a *time-essence clause*, since future performance (closing) dates are, at best, estimates by the broker and his agents of the time needed to close and are too often **improperly used** by sellers in rising markets to cancel the transaction before the buyer or broker can reasonably comply with the terms of the purchase agreement.

Chapter 3 The EP investor operates with or without an agent

This chapter examines how equity purchase (EP) legislation has affected the marketplace relationship between real estate brokers, investors, and sellers of owner-occupied, one-to-four unit residential properties in foreclosure.

The equity purchase scheme evolves

California legislation houses a scheme that regulates real estate brokers and their agents when they act as **agents for investors** in negotiations to acquire one-to-four unit residential properties in foreclosure which are occupied in whole or in part by the owner as his principal residence. This transaction is called an *equity purchase (EP) transaction.*

The EP scheme was recently altered by the courts to dramatically open up the use of brokers by EP investors.

Consider a selling broker representing an equity purchase (EP) investor. He does not advise the seller-in-foreclosure of a one-to-four residential property occupied by the seller that he is bonded, since he is not. After the sale closes, the seller-in-foreclosure claims the purchase agreement is void and makes a demand on the EP investor to **return the property** to the seller since the selling broker representing the EP investor did not provide any proof that he was bonded — as required by legislation. [Calif. Civil Code §1695.17(a)]

The equity purchase bonding provision does not address conditions needed to obtain a bond, including:

- the total amount of the bond;
- the number of bonds, be it one blanket bond for at least the fair market value of any property the broker dealt or a separate bond for each transaction;
- the type of bond;
- who are to be the beneficiaries of the bond; and
- the terms, conditions, delivery, or acceptance requirements of the mandated bond or bonds.

As a result, the seller-in-foreclosure cannot *rescind* the sale to the EP investor and the investor retains ownership of the property when the buyer's broker does not have a bond. The bonding required by legislation when a buyer's broker represents an investor on purchases controlled by EP laws was declared void in December of 2007. The bonding law is too vague to be enforceable. Thus, the investor's selling broker does not need a bond when negotiating an EP transaction. [**Schweitzer** v. **Westminster Investments** (2007) 157 CA4th 1195; CC §§1695 et seq.]

The EP law otherwise remains enforceable

Even though the bonding requirement has been declared void, all other provisions of the Home Equity Sales Contract Act (HESCA) remain enforceable, called the EP law. [CC §1695.11]

While a broker representing the EP investor no longer needs to provide proof he is bonded, he still needs to:

- provide **evidence** to the seller-in-foreclosure that he has a valid, California real estate license; and

- provide a **written statement** under penalty of perjury to all parties to the EP transaction, and do so prior to the transfer of any interest in the property that:
  - he has a valid California real estate license; and
  - that he has provided proof of this fact to the seller-in-foreclosure. [CC §1695.17]

The selling agent employed by the buyer's broker must also provide both the evidence he is licensed and a written licensing declaration. [CC §1695.15(b); see **first tuesday** Form 156, §14]

The **license disclosure** code does not state what evidence constitutes proof of licensure. However, a print-out from the Department of Real Estate's (DRE's) Real Estate License Lookup at www2.dre.ca.gov/ will suffice. A photocopy of the official license, both front and back, will also work. If the seller-in-foreclosure wants something more official looking, the DRE's Current License Status Request Form RE 291 can be filled out and submitted to the DRE, who will then send an official print-out to the seller-in-foreclosure via mail.

Failing to provide both the evidence of licensure and the written licensing declaration can result in the seller-in-foreclosure voiding the EP agreement and the EP investor liable to the seller-in-foreclosure for all losses caused by the broker's failure to provide proof of licensure. [CC §1695.17(b)]

However, the EP investor who is not at fault for the broker's failure to comply with the EP disclosures, but liable to pay for the seller-in-foreclosure's losses created by his broker's nondisclosure, is entitled to indemnity from his broker for any judgment against him, plus attorney fees. [**San Francisco Examiner Division, Hearst Publishing Company** v. **Sweat** (1967) 248 CA2d 493]

Proposed reinstatement of the bonding requirement

Two different bills were put forth during the 2007-2008 session of the California Legislature, however both bills were canceled at the request of their respective authors, and so were not voted on or passed during the 2007-2008 session.

Both bills proposed similar changes. Due to the vagueness which plagued the voided original incarnation of the bonding requirement, the two bills both addressed the deficiencies.

The proposed bond requirements were as follows:

1. A bond is required for each EP contract in an amount equal to at least one-third of the median home price for the metropolitan area or county the property is located.

2. The bond must be made in favor of the homeowner or, if the homeowner cannot be found, to the State of California for the benefit of a homeowner for damages resulting from any statement made or act committed by the representative:
   - in connection with the EP investor's acquisition of property;
   - in receipt of any consideration or property from or on behalf of the seller-in-foreclosure; or
   - the performance of any act prohibited by the EP law.

The median home price charts are generated from DataQuick Information Systems. The bills contain no instructions on what to do if the median home price chart is unavailable for the month the parties enter into the EP agreement.

The proposed bills also give an alternative to obtaining a surety bond. Professional liability (errors and omissions) coverage equal to $1,000,000 will suffice in lieu of obtaining a bond.

As of the editing of this material, neither house of the California State Legislature has resurrected the re-legislation of the bonding issue. However, as it is likely some form of the bonding requirement will be signed into law in the future, it remains a topic worthy of discussion.

Broker as principal

For all its unintended negative consequences, the unenforceable bonding requirement did not restrict the ability of an individual coincidentally licensed as a broker or sales agent to act solely as a **principal** purchasing property in an EP transaction for his own account.

Thus, a licensed real estate broker or sales agent may himself be the EP investor, eliminating agency law addenda, licensee disclosures, and any future bonding compliance from the purchase agreement since no licensee is acting as an agent for the buyer in the transaction. The licensed real estate broker or sales agent acting solely as an EP investor is a buyer who merely happens to hold a real estate license — an irrelevant fact that need not be disclosed to the seller-in-foreclosure.

Here, the licensee is not acting as an agent for anyone. One cannot act as their own agent as an agent acts only on *behalf of another*. Thus, no conflict of interest exists to the disclosed.

Conversely, a real estate licensee, while **employed** as the listing broker by a seller-in-foreclosure to locate a buyer, may decide to directly or indirectly buy his client's property. This is not prohibited, however the broker must disclose to his seller-client that the broker or an associate is **also acting as a principal** in the transaction, in addition to being, or having been, the seller's agent. [Calif. Business and Professions Code §§10176(d), 10176(g), 10176(h); see Form 527 accompanying this chapter]

Representing the seller

As a result of the EP scheme, prudent brokers are less inclined to solicit and accept a listing from a seller-in-foreclosure than from an owner of comparable property not in foreclosure. Several factors contributed to this reluctance.

One reason behind a broker's reluctance to accept a listing from a seller-in-foreclosure is the unacceptable exigency arising from the fact the property must be sold and escrow closed before the date of the trustee's foreclosure sale. For anything less, the broker has failed to **fully perform** the employment by meeting the seller's expectations under the listing. The difficulty for the agent is that foreclosure periods are roughly four months in length and during recessionary periods, houses take an average of ten to twelve months to sell. Some sell quickly if aggressively priced; others never sell.

Further, the seller has **solvency issues**. Unless the delinquent loan is either brought current (or a forbearance agreement entered into) prior to five business days before the trustee's sale, called *reinstatement*, or paid in full before the trustee's sales, called *redemption*, the home will be sold at the trustee's sale. The typical seller-in-foreclosure can do neither unless a buyer comes to the rescue with cash. Also at issue is the owner's lack of funds to maintain the property to provide the necessary "curb appeal" to draw homebuyers (rather than investors). [CC §§2924c(e), 2903]

The listing broker for a seller-in-foreclosure needs time to find a buyer and close escrow. The time constraints of marketing a property in foreclosure place the broker under extra pressure to locate a buyer if he is to earn a fee for his efforts. Many millions of homes in California (2010) have negative equities encumbered by lenders with no present desire to realistically entertain a short-sale discount, and won't until legally-compelled cramdowns are again available in bankruptcy.

As always, the listing broker must diligently perform his agency duty to care for and protect the seller while marketing the property, something of a learning experience for most in a recession. The seller-in-foreclosure **initially expects** the broker he listed with to convert his remaining equity to cash by

negotiating a sale of the property that will close before the property is lost to the foreclosing lender. This expectation exists in spite of huge monthly inventories of unsold homes of ten or more per buyer over a period of years.

If the insolvent seller loses his property by foreclosure, he may well make a demand on the broker for the amount of his lost equity, claiming a lack of due diligence or unprofessional conduct on the part of the broker — a risk brokers do not lightly undertake when listing any property.

EP agents in MLS submissions

The listing of a property must be placed in a Multiple Listing Service (MLS) publication to initially broadcast to the brokerage community that a property is available for sale. But when a property in foreclosure is placed in a MLS, fairness to the other MLS members dictates that additional information must be released regarding the property's foreclosure status.

A broker placing a listing in a MLS of an owner-occupied residence in foreclosure needs to also inform brokers representing buyers that the property is owner-occupied and in foreclosure, and advise these selling agents to:

- represent a buyer-occupant; or
- submit an EP-compliant offer on behalf of an investor or as a principal themselves.

Only a **buyer-occupant** who purchases the property avoids complying with EP law. However, buyer-occupants are frequently unwilling to purchase property in foreclosure since the property is often:

- *improperly encumbered* — a buyer-occupant may not want to assume the existing loan, or the property cannot be financed for an amount sufficient to pay off the existing loan requiring short-sale negotiations to avoid foreclosure (which will continue to be extremely difficult to arrange until bankruptcy courts are re-authorized to cram down loans); and
- *physically unattractive* — due to deferred maintenance by a financially impaired owner.

Thus, a property in foreclosure is attractive primarily to investors. Investors are willing to buy property and take risks presented by delinquencies and maintenance requirements during what is usually a recessionary sales market — but the price must be sufficiently "back-of-market" to cover the risks. The property must be rehabilitated, and financing and operating costs carried until the property is resold or rented — at a profit or a loss. Homeowners losing their homes are often hostile and unwilling to put money into their homes, an attitude reflected in the maintenance of the property, if not outright waste.

To further complicate the seller's plight, the legislature placed marketplace restrictions on the sale of a residence-in-foreclosure by reducing the ability of the listing broker to locate a buyer through **advanced fee** restrictions and foreclosure consultant rules controlling the conduct of brokers and agents.

Foreclosure consultants for owners

Often, an owner-in-foreclosure will do anything in his power to prevent his residence from being sold at a foreclosure sale.

In this situation, owners-in-foreclosure often prudently seek the services of a financial advisor or investment counselor, called a *foreclosure consultant*.

Editor's note — While this discussion deals with the paid foreclosure consultants, free foreclosure consulting services are available through the Department of Housing and Urban Development's HOPE NOW alliance.

A **foreclosure consultant** is any person who, for a fee from the owner-in-foreclosure, agrees to:

- stop or postpone the foreclosure sale;
- prevent lienholders from enforcing or accelerating their note;
- help the owner reinstate the loan or negotiate an extension of the reinstatement period;
- advance funds to the owner; or
- arrange a loan for the owner. [CC §2945.1(a)]

The dramatic increase in foreclosures during the current recession provoked additional legislation regulating **foreclosure consultants**. To be a foreclosure consultant an individual must:

- obtain a surety bond of $100,000 in favor of the state of California for the benefit of homeowners for damages caused by the foreclosure consultant's violation of any applicable laws. One copy must be filed with the Secretary of State, and a second copy must be provided to the DOJ; and,
- register with the Department of Justice (DOJ) by submitting the required fees and a completed registration form, which includes:
  - all names, addresses, telephone numbers, web sites, and email addresses which will be used in connection with foreclosure consultant activities;
  - a statement that the person has not been convicted of any crime, or subject to a criminal judgment for misrepresentation, dishonesty, or a violation of the requirements;
  - copies of all print and electronic advertising material and scripts of all telephone or broadcast advertising to be used in connection foreclosure consultant activities; and,
  - a copy of the required surety bond.

The DOJ has the power to deny or revoke a certificate of registration if:

- there is any misstatement on the registration form;
- the consultant has violated a law;
- the consultant has failed to maintain the required bond; or
- the consultant has violated the foreclosure consultant law.

Any individual who acts as a foreclosure consultant without meeting the above requirements will be punished for each violation by:

- a fine of $1,000 to $25,000;
- imprisonment in the county jail for up to a year; or,
- both fine and imprisonment. [CC §2945.45]

Contracts entered into between an owner-in-foreclosure and a foreclosure consultant must be translated into the language used in negotiation between the two parties.

Additionally, the owner-in-foreclosure is given five days after the date of signing the contract to cancel the contract with the foreclosure consultant. The owner-in-foreclosure can cancel the contract by mailing, faxing, or emailing his cancellation request to the foreclosure consultant. [CC §§2945.3, 2945.2]

The licensee exemption

However, a licensed real estate broker (or his licensed agent) acting on behalf of a seller-in-foreclosure is not acting as a *foreclosure consultant* when the broker:

- receives only a **contingency fee** (paid on closing) from the owner for selling the residence in foreclosure;

- receives **no advance fees or costs** from the owner, an activity converting the broker to a foreclosure consultant;
- **makes a loan** as a principal for an amount sufficient to cure defaults, or **arranges a loan** as a mortgage loan broker employed by the owner; and
- receives **no ownership interest** in the property from the owner, except as a principal making a loan as a lender (beneficiary) secured by a trust deed. [CC §2945.1(b)(3)]

Regarding the impermissible acquisition of an ownership interest in the property from the owner, consider a real estate broker who *arranges* a loan for an owner-in-foreclosure. The loan is funded by a trust deed investor and secured by a trust deed lien on the owner's residence. The loan's closing statement notes the broker is acting as a real estate licensee arranging the loan transaction.

Later, the trust deed investor forecloses on the trust deed by a trustee's sale. The high bidder at the trustee's sale is the loan broker and the trust deed investor. Thus, the trustee's deed **conveys title** to both the broker and the trust deed investor.

The owner now claims the broker has breached his duties while acting as a *foreclosure consultant* since the broker later obtained an interest in the owner's residence, directly from the owner, by purchasing the residence at the trustee's foreclosure sale under the trust deed loan previously arranged by the broker.

The broker claims he is exempt from being classified as a foreclosure consultant since he was acting in the capacity of a licensed real estate broker when the loan was arranged for the owner and the trustee's sale was a public auction at which anyone can bid and buy the property.

Here, the broker breached his duties owed to the seller both as a foreclosure consultant and as a real estate licensee when he acquired an ownership interest at the trustee's sale and was not the foreclosing lender. To have properly acquired ownership of the property at a trustee's sale (a voluntary sale under trust deed provisions), he would have had to first lend his own funds and have been named as the beneficiary in the trust deed when the loan was made.

The broker arranged a loan for which a real estate license was required by real estate law. However, he became a foreclosure consultant and violated that law at the same time simply because he acquired an ownership interest at the foreclosure sale. [**Onofrio** v. **Rice** (1997) 55 CA4th 413]

Again, owners who are in foreclosure are the losers. Normally a broker can bid and acquire property at a foreclosure sale, and often do so when the lender is a client, except he cannot if he arranged the loan for the owner-in-foreclosure.

Such cases make doing EP business risky for brokers and reduce the available buyers at the trustee's sale — a *voluntary sale* contracted for in the trust deed and initiated (exercised) by the property owner by defaulting, called a *put option*.

Advance fees

When a broker collects a fee or any marketing costs **in advance** from a seller-in-foreclosure, the broker is considered a *foreclosure consultant* subject to statutory foreclosure consultant restrictions, in addition to broker licensing laws.

However, a foreclosure consultant may not collect an advance fee, a legal "catch-22" for the loan broker attempting to be paid a fee or collect loan costs up front that is typical of a loan broker's arrangement with borrowers. If as a broker he does accept an advance of costs (appraisal fees, credit report charges or property inspection report fee), he is at once classified as a consultant and violator of that law. Also, a foreclosure consultant cannot secure his contingent fee by a lien on the property. [CC §§2945.4(a), 2945.4(c)]

CONFLICT OF INTEREST

(Kinship, Position or Undue Influence)

NOTE: Licensed Brokers and Sales Agents when acting on behalf of a client may not act in a manner which might cause the client to conclude that others, or a position held by the Broker or his Agents, can improperly influence or cause the Broker or his Agents to fail to properly act in their fiduciary capacity as an agent without first disclosing to the client the facts which might otherwise lead to that conclusion and obtaining their consent.

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This disclosure is made in connection with the following agreement:

☐ Listing (Employment) Agreement ☐ Purchase Agreement

☐ Escrow Instructions ☐ _____

1.1 ☐ of the same date, or dated _____, 20_____, at _____, California,

1.2 entered into by _____, as the _____, and

1.3 _____, as the _____,

1.4 regarding real estate referred to as _____.

2. The client(s) represented by the undersigned Broker with regard to the above referenced agreement is/are identified as the _____.

DISCLOSURE OF CONFLICT OF INTEREST:

3. Broker provides the following information as a disclosure to the client of relationships or positions held by Broker or his Agents, and their family members, in investments, business activities or real estate interests which present circumstances that might, if not disclosed, appear to be in conflict with the agency duty owed the client to care for and protect the interests of the client.

Check the following items and enter information on facts which are believed might create a conflict of interest for Broker or his Agents in performing their agency duties on behalf of the client.

3.1 ☐ Real estate

Property type: _____

Address: _____

Interest held: _____

Activity creating conflict: _____

3.2 ☐ Government agency

Agency name: _____

Position held: _____

Activity creating conflict: _____

3.3 ☐ Business position

Business name: _____

Goods or services provided: _____

Position held: _____

Activity creating conflict: _____

3.4 ☐ Business investment

Company name: _____

Type of trade or business: _____

Interest held: _____

Activity creating conflict: _____

3.5 ☐ Representation of others in transaction

Name of person also owed agency duties: _____

Activity creating conflict: _____

3.6 ☐ Kinship and employee relationships

Name of individual(s): _____

Relationship with Broker or employee: _____

Activity creating conflict: _____

4. Other disclosures of direct or indirect compensation or economic benefits may have previously been made, such as exists for additional compensation and controlled business arrangements. [See **ft** Forms 119 and 519]

BROKER:

5. I certify that the above information is true and correct.

Date: _____, 20_____ Broker's Name : _____

By: _____

Agent's Name: _____

CLIENT: I have received a copy of this disclosure and consent to continue the relationship with the broker as my agent.

☐ See attached Signature Page Addendum [**ft** Form 251]

Date: _____, 20_____

Name: _____ Name: _____

Signature: _____ Signature: _____

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Editor's note — If passed, Senate Bill (SB) 94 currently being considered during the 2009 Legislative Session would prohibit any person (including real estate licensees and attorneys) from charging advance fees for loan modification services, regardless of whether the seller is in foreclosure or merely delinquent.

A broker taking a listing from a seller-in-foreclosure without an advance fee arrangement assumes the risk that the uncreditworthy seller will be unable to pay the fee should he refuse a full listing offer or be unable or unwilling to close should he enter into a purchase agreement.

Living "rent-free" can quickly become habit-forming for a seller-in-foreclosure with little or a negative equity. A seller-in-foreclosure who is no longer making monthly payments may retain possession without any obligation to pay rent — except for those days he remains in possession after the trustee's sale — when he no longer owns the property.

The foreclosure consultant law is another example of how EP legislation works to the detriment of the seller-in-foreclosure — by closing out an unrestricted access to the brokerage community.

For example, EP legislation overlooks the fact the broker who takes an advance fee is already **heavily regulated** by the Department of Real Estate (DRE). The broker must place any advance fees in a trust account, provide accounting to the client before withdrawing funds and use a fee agreement cleared by the DRE. [Bus & P C §10085]

But to do so as authorized by the DRE violates a different law when the homeowner is in foreclosure — as the broker then becomes a foreclosure consultant controlled by harsh rules of conduct.

Broker for a foreclosure consultant

When a broker arranges for a seller-in-foreclosure to employ a foreclosure consultant, or pay a fee or transfer title to a foreclosure consultant, the broker is considered the agent of the foreclosure consultant, a sort of *subagent* of the seller who has retained the foreclosure consultant. [CC §2945.9(b)]

Further, a foreclosure consultant retained by a seller-in-foreclosure is barred from acquiring any interest in a residence in foreclosure — even if he hires a broker to represent him to buy the property. [CC §2945.4(e)]

Unbelievably, a foreclosure consultant's agent or employee can only be a licensed real estate broker who:

- provides the seller-in-foreclosure with a written statement under penalty of perjury that he is a licensed real estate broker; and
- is bonded by a surety insurer for an amount equal to twice the value of the residence in foreclosure. [CC §2945.11(a)]

Failure of the foreclosure consultant's broker to provide the broker's statement to the seller-in-foreclosure will, at the seller's option, void the advisory agreement with the foreclosure consultant. [CC §2945.11(b)]

Further, an agreement between the foreclosure consultant and the seller-in-foreclosure cannot contain provisions attempting to limit the liability of the foreclosure consultant for money damages caused by the foreclosure consultant's broker. [CC §2945.10]

Chapter 4 The unconscionable advantage some investors create

This chapter analyzes a seller-in-foreclosure's after-closing right to rescind the sale and recover his home, or money, when a buyer-investor takes unconscionable advantage of the seller.

The suppression of further marketing

As the strength of real estate sales deteriorate and the previous virtuous cycle of a real estate boom turns vicious, it is the best of times for buyers with cash who are eager to invest. With the rapid increase in stocks of inventory for sale and prices dropping, they can find opportunities to either build up their holdings with good real estate on the cheap, or acquire and flip property for a handsome profit.

An investor then seeks out a match in an seller-in-foreclosure who does not have the good fortune of the investor or the time to maneuver. Both find themselves in their present financial position because of decisions they made in the recent past.

The opportunity allowing investors to bottom fish and acquire real estate with low-ball offers submitted to the financially down-and-out homeowners will also cause a few investors to also overreach. In doing so, they might suppress the owner's ability to further market the property and locate a better match for himself than the one offered by the investor.

In this emotional environment, the investor is buoyed by his success of the moment's negotiations. Conversely, the seller-in-foreclosure is humiliated by his financial failure to provide homeownership for his family. These forces occasionally drive some investors to suppress any further marketing of the property by the seller-in-foreclosure as a condition of entering into a purchase agreement with the investor.

The use of a *confidentiality agreement*, while prudent in contracting between a buyer and seller of somewhat equal bargaining positions, serves only to interfere with the seller's chances to use the investor's offer to shop around and locate another buyer at a better price. Even the foreclosure sale the owner will soon face is a very public auction with every bid made known to each prospective bidder — until the highest bidder takes home the property.

On the other hand, the investor has no duty to be charitable about the terms of his offer or to bail out a homeowner who was not sufficiently grounded in economics to see his plight coming. Most first-time homeowners lack proper education to give them a clue that a recession will affect them adversely, much less an appreciation for the economic forces that control the valuation of all ownership and trust deed interests in real estate.

Yet, the investor's proper view of an equity purchase (EP) transaction is an exchange of cash for property. By taking the risk of investing now, it is his opportunity to get more cash out of an immediate resale of the real estate than he invested, or as a long-term investor building his net worth and cash flow, by ownership of the real estate as a rental.

An EP investor has greater burden placed on his duty to care for and protect his interests when purchasing a home of a seller-in-foreclosure than had the seller not been in foreclosure. Being able to justify that he paid a **reasonably fair price** for the property will be of great help later should the seller decide to exercise his right to rescind the sale within two years after closing based on a claim of *unconscionable advantage* taken by the investor. The claim of unconscionable advantage has two components, one of which is the price paid. Both must be present to **rescind the sale** and recover the property.

A **fair price** calls for an analysis of the property's condition, the price trend in the resale market, the costs of carrying the ownership, and a discounted amount to cover a reasonable profit for the risk taken to buy, fix up, and resell or rent the property.

A prudent step when setting a price to pay for a property, regardless of whether or not it is in foreclosure, is an investor's (or any buyer's) location of comparable properties that have been sold within six months. With the use of a valuations spread sheet, called a *comparable market analysis* (CMA), the investor checks out the amenities of the comparable properties which have sold and calculates by comparison the value of the property he is interested in buying.

From the value set by the use of the CMA, the investor calculates the price he must pay to provide room to accomplish his resale or rental objective — a profit from his investment. [See Form 318 accompanying this chapter]

The un-American, low-price combination

The procedures used or conduct employed by the EP investor may deprive the seller-in-foreclosure of *a reasonable choice* between different buyers and their offers. By inhibiting the seller from actively seeking out an alternative to the investor's offer, the investor may have deprived the seller of a meaningful choice in the marketing of the property.

The second component of the *unconscionable advantage* arises when the investor acts to deprives the seller of a reasonable choice of action. When the EP investor *exploits* the elements of **oppression or surprise** while at the same time exacting an unreasonably low and highly favorable purchase price, **unconscionable advantage** has been taken of the seller.

Oppression by the EP investor arises out of the inequality in bargaining power resulting in no real negotiations between the seller-in-foreclosure and the EP investor — a "take-it-or-leave-it" environment devoid of **competing buyers**. The economics of a foreclosure environment naturally produce a one-sided bargaining advantage for the investor. This power is improperly used by the investor when he insists that his offer is not "shopped around" in a marketing effort by the seller or the seller's listing agent to solicit a better deal during the five-business-day cancellation period — a confidentiality issue.

Surprise occurs due to the post-closing discovery of terms that are hidden in lengthy provisions of the purchase agreement used by the investor. The price and how it will be paid is not a surprise as it is well known to the seller-in-foreclosure. However, on a later rescission, it is the price that will likely be the only provision in the agreement contested by the seller.

The greater the marketplace oppression or post-closing surprise in the transaction, the less an unreasonably favorable price paid by an EP investor will be tolerated. [**A & M Produce Co.** v. **FMC Corporation** (1982) 135 CA3d 473; **Carboni** v. **Arrospide** (1991) 2 CA4th 76]

Prudent investor conduct

Thus, to lessen the ability of the seller to later show an unconscionable advantage existed in the investor's conduct, the investor begins negotiations by entering into an EP agreement on a form that meets all statutory requirements. [See **first tuesday** Form 156]

Also, an EP transaction involving the seller's **listing broker** or a **counteroffer** lessens and certainly weakens any future attempt by the seller to show an unconscionable advantage was exercised by the investor. They actually negotiated, and a middle man (agent) was involved as a gatekeeper representing the seller.

The investor might be called upon to further defend his actions by demonstrating the EP agreement was not entered into through:

- misrepresentation of facts or law in *deceitful conduct* by the investor;
- *undue influence* arising out of a prior or special relationship with the seller; or
- *duress* applied in the negotiations by the investor to obtain the seller's acceptance and close the transaction.

Two-year right of rescission

Consider the consequence of recording a Notice of Default (NOD) on a homeowner's personal residence after several months of unpaid installments.

The homeowner, now in foreclosure, is willing to sell on almost any terms to salvage whatever remains of his credit and investment in the property.

The property is listed for sale with a broker. The broker promptly markets the property to locate a buyer, both indirectly through MLS and directly to buyers who will occupy the property as their personal residence.

After nearly a month in foreclosure, an offer is submitted directly to the seller by an equity purchase (EP) investor, acting on his own account without broker representation. Under the offer, the seller-in-foreclosure will receive cash for his equity. Additionally, the investor agrees to cure the seller's loan delinquencies on close of escrow.

The seller contacts his listing broker for advice. After reviewing the offer, the broker recommends the seller accept the investor's offer. The broker has no leads or potential buyers who have shown an interest in the property. However, the listing broker will use the existence of the cancelable purchase agreement to entice potential buyers to make an offer — at a better price. If an acceptable backup offer is received within the cancellation period, the seller will accept the backup offer and cancel the EP agreement.

The broker advises his client he has five business days after his acceptance of the EP offer to cancel the sale, and may do so for any reason, since the sale involves the seller's home which is in foreclosure.

The seller-in-foreclosure accepts the EP investor's offer. The five-business-day **cancellation period** expires without generating a backup offer, and escrow is opened on the EP agreement. The EP transaction is later closed and the property conveyed to the investor.

Does the EP investor receive good title when he accepts the grant deed?

No! The EP investor's title remains subject to the seller-in-foreclosure's *right of rescission* for two years after closing. If at any time during the two years following the close of escrow the seller believes the **price paid** and **the investor's conduct** — both components — gave the investor an unconscionable advantage, the seller may attempt to rescind the transaction and recover the home he sold, or money. [Calif. Civil Code §1695.14]

However, a seller is not likely motivated to repurchase his home simply because he came by funds sufficient to do so within two years of closing the sale. Market conditions must be such that the property is now worth more than the price the seller received. The closer the timing of the investor's purchase to the lowest point for the pace of sales in the real estate cycle, the more likely the pace of sales and pricing will soon pick up and be followed by price increases (possibly within the two-year rescission period).

In 2009, the **volume of sales** (and prices) appears likely to continue on a downward trend and not stabilize until well into 2011. The demographics of the buying-age portions of the population do not indicate we will see a surge in household formations and home demand by user-occupants until the year 2014-2019 as Generation Y children of post-World War II boomers come of age, nor will the retiring boomers be able to sell their more expensive homes and buy less expensive replacement homes until the household formation surge.

COMPARABLE MARKET ANALYSIS FOR SETTING VALUES

This Comparable Market Analysis (CMA) worksheet is prepared by the seller of a property, or his agent, to provide an estimate of the value of the seller's property based on the sales price of other similar properties sold within the past few months, each adjusted in price to reflect the dollar valuation of their distinctions from the seller's property. On locating recent sales through the County Records and completing a visual inspection of the comparable sales, note in the column for each comparable property, at any itemized features which is distinguishable from the seller's property, the dollar amount of the adjustment to the comparable property's price by, 1) deducting the dollar value of the feature the comparable property has which the seller's property does not, or, 2) adding the dollar value of the feature the comparable property does not have which the seller's property has.

Date prepared _____, 20_____, by _____. Application/order # _____.

Features:	Subject property	Comparable No. 1		Comparable No. 2		Comparable No. 3	
Address:							
Proximity to Subject							
Sale Price	$		$		$		$
Sale Price/Gross Living Area	$ per sq. ft	$ per sq. ft		$ per sq. ft		$ per sq. ft	
Data Source							
Verification Source							
1. Sales Information:							
1.1 Date of sale							
1.2 Concessions (sales/financing)							
1.3 Fee simple/ leasehold							
1.4 Age of improvements							
1.5 Special HOA assessments							
1.6 Bonded assessments							
2. VALUE ADJUSTMENT:	**DESCRIPTION**	**DESCRIPTION**	**+(-)$**	**DESCRIPTION**	**+(-)$**	**DESCRIPTION**	**+(-)$**
2.1 Zoning Compliance (nonconforming/ illegal)							
2.2 Easement/ encroachment							
2.3 Use restrictions (CC&Rs)							
2.4 Retrofitting/water conservation							
3. Location/area:							
3.1 Neighborhood trend:							
3.2 Street amenities							
3.3 Lot size/shape							
3.4 Vehicle access							
3.5 Schools/churches /institutions							
3.7 Inside/corner lot							
3.8 Utilities available							
3.9 Environmental hazards/ nuisances							

PAGE ONE OF TWO — FORM 318

VALUE ADJUSTMENT	DESCRIPTION	DESCRIPTION	+(-)$	DESCRIPTION	+(-)$	DESCRIPTION	+(-)$
4. Landscaping:							
4.1 Quality							
4.2 Maintenance							
4.3 Soil condition/ drainage							
4.4 Topography							
5. Improvements:							
5.1 Age of improvement							
5.2 Construction type							
5.3 Highest and best use							
5.4 Design/style							
5.5 Energy efficiency							
5.6 Maintenance/ obsolescence							
5.7 Exterior conditions							
5.8 Interior conditions							
5.9 Garage/carpet							
5.10 Central AC/heating							
5.11 Gutters and downspouts							
5.12 Windows/ screens							
6. Livable Space:							
6.1 Gross livable sq. ft.							
6.2 No. of bedrooms							
6.3 No. of baths							
6.4 Kitchen/ appliances							
6.5 Living room							
6.6 Dining room							
6.7 Family room							
6.8 Basement/ storage							
6.9 Attic/access							
7. Amenities:							
7.1 Fireplace/ woodstove							
7.2 Pool							
7.3 Fences							
7.4 Patio/porch/deck							
8. TOTAL Price Adjustment:		☐ + ☐ -	$	☐ + ☐ -	$	☐ + ☐ -	$
9. Adjusted Price of Each Comparable:		%	$	%	$	%	$
10. Value of Subject Property:	$						

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Seller's right to rescind a closed sale

To protect owners who are selling their homes while in foreclosure from buyer-investors who are "rip-off artists," the California legislature gave sellers-in-foreclosure who sold their personal residences a two-year **right of rescission** after closing a sale with an investor.

During the two-year period following closing, a seller-in-foreclosure rescinds the completed EP transaction by:

- notifying the EP investor of his decision to rescind the transaction, called a *notice of rescission*; and
- returning all funds and items of value received from the investor/buyer under the EP agreement, called *restoration*. [CC §§1691, 1695.14(b)]

To *perfect* his claim for restoration of the property to his ownership, the seller-in-foreclosure also records the **notice of rescission** in the county in which the real estate is located.

The notice of rescission describes the real estate and contains the names of the rescinding seller, the EP investor and any *successor-in-interest* of the investor who is not a *bona fide purchaser* (BFP).

Once served with a notice of rescission, the EP investor (or his non-bona fide successor) has 20 days to reconvey title to the rescinding seller, free of any encumbrances he or his non-bona fide successor placed on title after acquiring the property. [CC §1695.14(b)]

If an investor, after acquiring ownership, **further invests** any amount of money or effort into rehabilitating or carrying the expenses of property ownership, the rescinding seller has no obligation under EP law to reimburse the investor for any expenditures.

The investor's improvements during the two-year rescission period are not considered *good faith improvements*. The expenditures are made while the investor holds a **voidable ownership** interest in the property. The investor's conduct, which created the *unconscionable advantage* over the seller-in-foreclosure, charges him with the knowledge of his defective title. Equity purchase law then acts to sanction him, if the seller establishes the two requirements to prove an unconscionable advantage was taken: a shockingly low price and the investor's offending conduct.

If the EP investor fails to timely reconvey title to the seller on notice of rescission, the seller can sue the investor to enforce the rescission and recover the residence. The prevailing party in the rescission action is entitled to his attorney fees. Remember, the seller-in-foreclosure is basically insolvent, but he has reason to believe the return of the property will be financially rewarding. [CC §§1695.14(b), 1695.14(d)]

Unconscionable advantage and restoration

A seller's notice of rescission during the two-year rescission period after closing is effective to recover the property only if the seller can demonstrate the EP investor took *unconscionable advantage* of him when negotiating the purchase of the property.

Showing the existence of and defending against the component of an unconscionable advantage demonstrated by the **investor's conduct** is problematic for both the seller-in-foreclosure and the EP investor. The legislature has not specifically defined what activities constitute acts of unconscionable advantage.

What was a reasonable sales price under the circumstances surrounding the transaction when the EP purchase agreement was entered into might appear to be unconscionable to the seller in the future — due only to fast fluctuating market factors and rapid asset inflation following the sale. Thus, an investor assumes the risk a fast rising economy or a quick downward shift in interest rates, or both, may provoke the seller to attempt to rescind (without a valid legal reason).

If real estate values rise rapidly and measurably after closing, the "greed factor" may set in, turning a formerly desperate, thankful seller-in-foreclosure into an astute rescinding seller.

However, any **increase in the value** of the property after acceptance of the EP investor's offer may not be considered in the restoration of the parties to their original position. The test for the property's value — one component of **unconscionable advantage —** is not determined based on events taking place after the seller enters into the EP purchase agreement when the property value has changed.

Market circumstances existing at the time of negotiations, or when the parties entered into the agreement, are the economic considerations that form one of the two elements used to test for unconscionable advantage. [**Colton** v. **Stanford** (1890) 82 C 351]

Unconscionability has two linked aspects:

- the lack of a **meaningful choice of action** for the seller-in-foreclosure when negotiating to set the price and sell the home to the EP investor, legally called *procedural unconscionability*; and
- a purchase price or method of payment that is **unreasonably favorable** to the EP investor, legally called *substantive unconscionability*.

Price, like any other provision in a purchase agreement, can be considered unconscionable. When determining the unconscionability of the purchase price, the justification for the price at the time of the sale will be examined. [**Perdue** v. **Crocker National Bank** (1985) 38 C3d 913]

While a low sales price may be justified, the investor may have employed terms that constitute an unconscionable **method of payment** for that price, including:

- a carryback note held by the seller with an unreasonably low interest rate, long amortization or no due date, bearing no relationship to current market rates and payment schedules and lacking any understanding of imputed interest at applicable federal rates for the seller's income tax reporting;
- an exchange of worthless land, stock, gems, or zero coupon bonds, at face value with a 20-year maturity date; or
- any form of payment that is uncollectible, unredeemable, and lacking any present value.

However, the existence of **unreasonable pricing** and payment alone is not enough to show an unconscionable advantage sufficient for rescission of the closed transaction. Both the lack of a meaningful choice and reasonable terms must exist to show an unconscionable advantage existed.

Title insurance

Title insurance companies have few qualms about insuring property purchased during the foreclosure period. The reason: title insurance does not defend or cover the insured investor against the seller's rescission claims. By definition, the seller's claim is based on the conduct of the buyer, an exclusion from coverage.

Some title companies insist the seller-in-foreclosure sign an **estoppel affidavit** declaring the seller:

- fully understands the nature of the equity purchase transaction;
- appreciates the finality of the consequences of the sale;
- agrees the purchase price is reasonable and fair under the circumstances; and
- the transaction is not merely financing that allows the seller to reacquire title to the property.

The signed affidavit makes it a little more difficult for the seller-in-foreclosure to later decide to rescind the transaction and recover his home, since it would increase the seller's burden of proving unconscionable advantage.

However, the affidavit does not and cannot waive the seller-in-foreclosure's two-year right of rescission if unconscionable pricing and an oppressive negotiating environment on the part of the buyer actually existed. Any *waiver* of the seller's rescission rights is void as a violation of the home equity sales law. [CC §1695.10]

The BFP on a flip of the property

Consider an investor who acquires ownership in an EP transaction with a seller-in-foreclosure. The investor then resells (flips) the property for a fair market price to a **BFP** before the seller's two-year right of rescission expires and before the seller records a *notice of rescission*.

The seller then seeks to recover title to the residence and follows the necessary steps to rescind the transaction.

However, rescission is not available to the seller-in-foreclosure against the BFP or an encumbrancer for value (money lender) if the property is purchased or encumbered prior to the seller recording a notice of rescission. [CC §1695.14(c)]

A BFP is a person who, in good faith, purchases property and pays a fair price without knowledge of a claim against title. The BFP's **knowledge** of the fact the property was previously purchased by the investor during the foreclosure period does not affect the resale buyer's status as a BFP since no claim has been made by recording a notice of rescission. [CC §1695.14(c)]

Despite the BFP status preventing the seller from recovering the property, the seller can **recover money** from the EP investor. The dollar amount of the recovery is based on the value of the lost equity at the time of the sale to EP investors, not the resale value. The money recovery claim must be filed within four years of the investor's violation of the EP statutes.

Further, and more menacing for the EP investor, is the automatic entitlement of the seller to additionally recover three times his actual loss as punitive damages mandated by statute. [CC §1695.7]

The BFP's title insurance

Obtaining title insurance poses no problem for the BFP. A title insurance company will insure over the seller-in-foreclosure's two-year right of rescission, unless a notice of rescission has been recorded (or the title company has other knowledge of the seller's claim).

Title insurance only insures against what is not known by the buyer at the time the insurance is obtained or not listed as an exclusion from coverage.

Yet, the title insurance company has a duty to defend the BFP against any later rescission claim made by the seller-in-foreclosure against the BFP.

Also, a BFP must deal at **arms length** with the EP investor.

If the title insurance company can show the insured buyer is not a BFP, but a successor-in-interest involved in a title flipping scheme with the EP investor for the purpose of avoiding the seller-in-foreclosure's right of rescission, the title insurance company can refuse to defend the insured buyer against the seller's enforcement of his right of rescission. [Calif. Insurance Code §330 et seq.]

Sale-leaseback to the insolvent seller

A resale buyer from an EP investor (or any seller) has a duty owed to himself to inquire as to the property rights of any **person in possession** of the property before the resale buyer can qualify as a BFP. [CC §1695.14(c)]

The seller-in-foreclosure may still occupy the property under a sale-leaseback arrangement. The BFP must inquire as to the occupant's rights (as must the title company under an ALTA policy).

If the seller-in-foreclosure holds an option to purchase under the sale-leaseback, then the sale-leaseback is in law a mortgage, not a sale, and the investor is a lender, not a buyer. Thus, the lender vested as the title holder has nothing to sell beyond his right to receive money as holder of a lien on the property for repayment of a debt under the grant deed as a mortgage-in-fact. [CC §1695.12; see Chapter 21]

Possession of property by any person other than the current vested owner of record imparts *constructive notice* to a potential buyer to inquire as to the right, title, and interest of the person in possession. [**Gates Rubber Company** v. **Ulman** (1989) 214 CA3d 356]

Chapter 5 Reinstatement and redemption periods during foreclosure

This chapter reviews the time periods for curing delinquencies on a real estate loan and when the loan must be paid in full.

Recession-induced defaults

A government-declared recession is defined as two quarters of declining gross domestic product. A recession period commences roughly 24 to 30 months into a regime of a continuous incremental rise in short-term rates orchestrated by the Federal Reserve (the Fed).

August of 2004 (and of 1988 and 1999) saw the planting of the first seeds of one such recession when the Fed started what became a process of continuously bidding up short-term rates. Thus, the Fed deliberately engineered a pace of slower growth for the economy, decelerating economic activity — and by natural consequence, reducing the volume of real estate sales.

Raising short-term rates until they match or exceed long-term rates reduces the long-term growth of price inflation in (among other things) real estate assets. The real estate boom in sales volume was over as of August 2005, commencing a recognition of the plight of those who acquired real estate during the boom and were then unable to unload it for the price they paid.

Flipping property within six months of purchase and seeking a profit based solely on an inflating market ran its course by the end of 2005; the nation-wide *Ponzi scheme* fed primarily by home builders, Wall Street bankers, and the underlying Federal Reserve was over. The process will occur again following the next real estate boom — most likely during 2015-2020. The boom will be a repeat of the baby boomers' acquisitions in the late 1980's, but this time fueled by Generation Y's household formations and the retirement of the boomers into condos they will purchase.

*Editor's note — The **first tuesday** online journal contains current articles examining the economic trends of real estate. The journal can be viewed at blog.firsttuesday.us.*

As a recession takes its toll by driving down real estate prices, the attitudes of sellers, brokers and their agents, lenders, and the media (for merely reporting the adverse economic and financial conditions of the market) turn decidedly gloomy. Further, the general public (for lack of a basic understanding of economic principles) has a long-standing pessimistic view of the market place, an *anti-market bias*.

This **anti-market bias** only hastens and deepens the recession's effect on real estate prices. During real estate recessions, sellers panic as their efforts to find a buyer consume ever more months, lenders grow paranoid and seize up in an aversion to all risk, and brokers and agents (especially those new to the business) look for work in other fields in droves — annually, 40% of sales agents or more will let their licenses expire.

Popular thought, expressed in a variety of ways, is that real estate will never be as good again, that it cannot recover to match the action of the boom-time days, and that the market has gone permanently south and no right-minded person is fool enough to venture into the quagmire.

Well, permanence is never the case, and with their tolerance of risk, investors as well as educated individuals who are informed on economic principles do not view real estate events as do the masses.

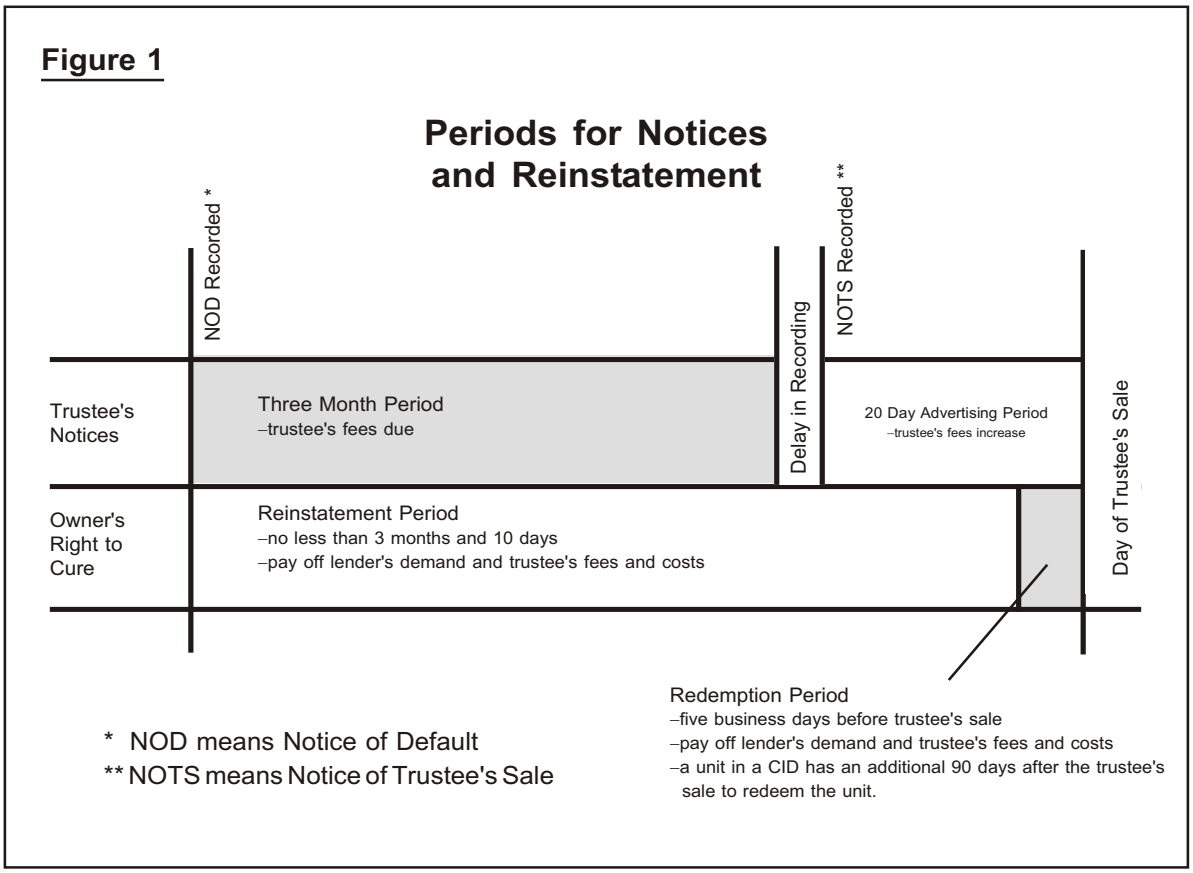
A stretch too far by the seller

A recession is also the time when sellers experimentally talk of lease-option sales and land sale contracts in an occasionally self-destructive effort to do everything possible to eliminate the **entry barriers** for buyers that cripple an owner's sales efforts. Specifically, owners openly collaborate with buyers to avoid brokers, escrow, title insurance, lender involvement, and disclosures such as those regarding inspections, city occupancy compliance, pest control, property conditions, and natural hazards. The list of gatekeeper obstructions goes on and on — all avoided in an effort to attract buyers.

It is not that the equity purchase (EP) investor wants any part of these short-sighted but well-intended sales devices to encourage him to buy; he is paying cash (mortgages are equivalent to cash). But it is into this environment he will step to make offers, at or near the bottom of the recession when volume and prices neutralize, just before or as the sales volume starts to consistently increase. Price movement follows within 12 to 18 months of a permanent pick up in sales volume.

The specific circumstances surrounding the seller's foreclosure are another set of conditions which fine tune the timing of a purchase offer. The foreclosure process is mechanical; for the seller, it's a ticking clock counting down to a detonation event: the foreclosure sale. [See Figure 1 accompanying this chapter]

Meanwhile, the EP investor, with a more talented approach and certainly a less gloomy outlook, is tracking those owners who are victims of the public's overreaction to the real estate bust. At the same time, investors see that property prices have been dragged down below the historical trend line of market values, a condition aggravated by more property being placed on the market than should be sold or listed to form a stable real estate market.



With monthly inventories of homes for sale stacked up at 10 to13 per buyer per month, brokers seem totally unaware that excessive listing activity only exacerbates already depressed prices and declining sales volume, a supply and demand issue not overlooked by EP investors and other scavengers and collectors of real estate.

The culmination of these events creates a profitable environment for risk-tolerant buyers; some acting for the short term, all benefitting in the long term. At some point during the decline in sales volume and sales prices, roughly 24 to 30 months after the start of a methodical decline in short-term rates (August 2007), the pace of declining sales volume and prices begins to slow. Soon, prices and sales volume neutralize, dropping no further and becoming stable for a time.

Gradually, more buyers gain confidence as they learn the market has stabilized and they begin to buy real estate in greater numbers. As the volume of sales picks up, sellers realize the prices they have been receiving are too low. Twelve to 15 months into a clear trend of increasing sales volume, the prices of comparable properties start to increase. Thus, the seeds of yet another real estate boom sprout and take root.

The time for offers

In this matrix of **recessionary market activity**, the EP investor will locate profitable acquisitions and make offers.

The timing for the submission of EP offers is set by two conditions:

- current sales volume in the real estate market; and
- foreclosure circumstances of the seller.

As the recession deepens and fewer buyers compete to pocket real estate, a window is created through which the EP investor makes an easy entry as a cash buyer. At that moment, cash is recognized as king of the transaction.

The period of price stabilization at the bottom of the recessionary period is the best time for a long-term investor to submit an offer on a property in foreclosure with an equity sizable enough to justify the price of a few thousand dollars.

The foreclosure circumstances unique to each property in foreclosure during this window period control the proper time to submit an offer on that property.

Timing for **submitting an offer** to purchase a property in foreclosure conveniently breaks down into three phases:

- the period of foreclosure ending before the trustee's auction sale is held;
- the trustee's auction sale itself; and
- the real estate owned (REO) status of the property immediately after the trustee's sale when it is acquired by the lender.

The period following the recording of a Notice of Default (NOD) before the trustee's sale provides little opportunity for an investor when the loan amount exceeds the property's value. Thus, the property has no equity for the investor to buy, a condition called *negative equity*. The opportunity that does then exist is a generally troublesome *short sale* effort. Lenders are not emotionally capable of taking a loss while they still hold a note and trust deed, and without bankruptcy court authority to cram down loans to property values, lenders have no legal incentive to discount.

By waiting until the trustee's sale to bid and acquire a property, an investor might be able to acquire the property at the right price — if the lender allows an underbid. Of course, he will need to pay cash to buy the position in title held by the lender.

Especially juicy are foreclosures on first trust deed loans that have a loan-to-value ratio of 60% to 70% and are in foreclosure because the property is over-encumbered with second trust deeds, abstracts of judgment, and tax liens.

The first trust deed foreclosure sale wipes out the junior lienholders who over-encumber the property. Thus, to acquire the property for a cash bid in the amount of the first, the trustee's sale eliminates all junior lienholders and leases. The trustee's deed clears from title all liens except for property taxes, any Mello-Roos-type improvement district bonds, and trust deed loans senior to the foreclosed trust deed. (The Internal Revenue Service has later redemption rights.)

For the owner of a property in foreclosure with a principal loan amount exceeding the property value (negative equity) and the inability to negotiate a short pay on a sale, the trustee's sale provides little opportunity for the investor to bid in the property at the right price. Lenders typically bid in the property for all amounts due, called a *full credit bid*, including principal, accrued interest, prepayment penalties, late charges, and foreclosure costs.

The lender who takes title to the real estate at the trustee's sale puts the investor tracking the property at the third stage — the time to submit a purchase agreement offer to the lender.

Hopefully, the investor has conducted some due diligence investigation into the condition and merits of the property and is ready to submit an offer to the lender immediately following the trustee's sale. A delay in submitting an offer will likely find the property's management already assigned to the lender's REO department. Money will then be spent clearing out occupants, cleaning up the property, and eliminating deferred maintenance. Without offers to consider, the property is soon listed with MLS-type brokers at full retail prices.

Unlike acquiring property at a trustee's sale, a purchase from the seller-in-foreclosure or from the lender reselling an REO will be escrowed, disclosures will be made, and, most importantly, a policy of title insurance will cover defects in title (like strange liens with priority) that would not be covered on a trustee's sale.

Editor's note — Information about recorded NODs and scheduled trustees' sales in California can be purchased at the following web sites: www.countyrecordsresearch.com; www.foreclosures.com; www.redloc.com; and www.retran.net.

Residential NODs through 2012

Special mortgage rules apply if a lender records an NOD and starts foreclosure prior to January 1, 2013 on a loan recorded between January 1, 2003 and December 31, 2007 (the period during which many of the "toxic" loans were made) and secured by **residential property**.

On these residential loans, at least 30 days prior to recording an NOD the lender must attempt to contact the owner-occupant to:

- assess the borrower's financial situation;
- explore options for the borrower to avoid foreclosure;
- advise the borrower of his right to an additional meeting within 14 days to discuss his financial options;
- provide borrowers with the toll-free Department of Housing and Urban Development (HUD) phone number to find a HUD-certified housing counseling agency; and

- in the event personal or phone contact cannot be made, the lender must exercise due diligence through further attempts to contact the borrower, including:
  - sending a letter via first-class mail to the borrower/owner containing HUD's toll-free number used to find and contact a HUD-certified counseling agency;
  - after sending the letter, the lender may employ an automated dialing system to telephone the borrower on at least three different days and at different hours, provided a live representative is available if the borrower answers the call; and
  - make at least three attempts to reach the borrower by phone, unless the lender determines all the borrower's telephone numbers on file have been disconnected.

If the lender still fails to make contact with the borrower via any of those methods, the lender must send the borrower a certified letter with return receipt requested containing a toll-free number with access to a live representative during business hours.

When **contacting a borrower** whose principal residence loan is in default:

- a lender's loss mitigation personnel may participate in any telephonic communication;
- the borrower may select a HUD-certified agent to represent him during any meeting with a lender to discuss ways of avoiding foreclosure; and
- any loan modification or plan to avoid foreclosure devised or offered by the lender is subject to the borrower's approval.

NOD compliance declarations

The lender may record an NOD on a loan without complying with any of these 30-day pre-NOD requirements when the borrower has:

- surrendered the property to the lender either by letter confirming the surrender or by delivery of the keys to the lending institution;
- contracted with a person who helps borrowers who have decided to leave their home to extend the foreclosure process and to avoid enforcement of the loan by the lender; or
- filed a bankruptcy petition which is pending.

The NOD controlled by these rules must include a declaration stating:

- the lender succeeded in contacting the borrower according to the above guidelines;
- the lender was unable to contact the borrower, despite exhausting all due diligence efforts; or
- the borrower has surrendered the property to the lending institution.

To be due-diligence compliant, the lender must, prior to the 30-day pre-NOD recording, post a prominent link on the lender's web site containing information, including:

- options available for a borrower unable to afford his mortgage payment and who wishes to avoid foreclosure;
- a list of financial documents a borrower needs to have when discussing alternatives to foreclosure with the lender;
- a toll-free telephone number for a borrower to call to discuss alternatives to foreclosure with their lender; and
- the toll-free number made available by HUD for the borrower to find and contact a HUD-certified housing counseling agency. [Calif. Civil Code §2923.5]

Nullifying the call during foreclosure

The lender holding a trust deed and note, called the *beneficiary*, may call the entire principal balance of the note due and immediately payable on any default in the terms of either the note or trust deed. Trust deeds contain a boilerplate provision called an *acceleration clause* that authorizes the lender to call the loan on a default.

Another provision in the trust deed, called the *power-of-sale provision*, authorizes the beneficiary to instruct the trustee appointed under the trust deed to initiate a non-judicial trustee's foreclosure to sell the property described in the trust deed.

As a result of the tandem effect of the power-of-sale provision and the acceleration clause, the trustee's *recording* of an NOD both initiates the trustee's foreclosure procedures and causes all sums left to be paid on the note and trust deed to become due and payable.

Consider a homeowner who has defaulted on the payment of principal and interest due on the note and property taxes due under the trust deed. An NOD has been recorded, commencing foreclosure to enforce payment of all sums owed under the note and trust deed.

An investor submits an EP offer, which the homeowner accepts. The terms include the transfer of ownership to the investor subject to the existing note and trust deed that is in foreclosure. The owner will pay all delinquencies and foreclosure charges at the close of escrow from equity purchase funds received from the investor.

Escrow is opened and a request for a beneficiary statement is sent to the beneficiary holding the note and trust deed by escrow. The beneficiary is a private party who has commenced foreclosures before on this trust deed and cancelled the NOD when the homeowner paid all the foreclosure costs and brought the delinquent payments and late charges current.

The beneficiary responds to the request for a beneficiary statement by sending a payoff demand, not a beneficiary statement. The beneficiary claims he is enforcing the acceleration clause in the trust deed and will only accept payment in full now that the NOD has been recorded, triggering the call.

The NOD states the amount of the delinquencies, past, present, and future. Thus, escrow is able to determine the amount due to cure the defaults stated in the NOD. The trustee is contacted and the total of the foreclosure fees and charges incurred by the date scheduled for close of escrow are determined.

Between the information in the NOD and the stage of the foreclosure proceeding, escrow can determine the amount due to cure the defaults and pay foreclosure costs. The investor deposits closing funds with escrow on escrow's call for funds. Escrow is closed and the delinquencies and foreclosure costs are forwarded to the trustee, payable to the beneficiary, a tender of the homeowner's proceeds of the sale to cure the defaults.

The beneficiary rejects the tender, claiming the entire amount of his note is due as agreed in the trust deed. Further, the beneficiary claims the due-on clause in the trust deed has been triggered by the buyer's failure to obtain the beneficiary's consent and now requires a full payoff of the note.

Can the escrow, by tendering only the amount of the delinquencies and foreclosure costs necessary to cure the defaults, cause the note and trust deed to be brought current and reinstate the trust deed as though a default had not occurred?

Yes! After the NOD has been recorded and prior to five business days before the trustee's sale, the owner (or any junior lienholder or buyer) of the real estate encumbered by the trust deed lien that is in foreclosure can terminate the foreclosure proceedings by paying:

- the **delinquent amounts** due on the note and trust deed as described in the NOD and foreclosure charges, called *reinstatement* [CC §2924c]; or
- the **entire amount** due on the note and trust deed, plus foreclosure charges, called *redemption*. [CC §2903]

Since the call triggered by a violation of the due-on clause based on the unconsented-to transfer to the investor is not stated in the NOD, the due-on call cannot be enforced under this NOD.

Note defaults and reinstatement

A trust deed on which a foreclosure has been initiated is considered **reinstated** when the beneficiary receives:

- all amounts referenced as delinquent in the NOD, including principal, interest, taxes, insurance, assessments, and advances;
- installments that become due and remain unpaid after the recording of the NOD, and any future advances made by the beneficiary after the recording of the NOD to pay taxes, senior liens, assessments, insurance premiums, and to eliminate any other impairment of the security; and
- costs and expenses incurred by the lender to enforce the trust deed, including trustees fee's or attorney fees. [CC §2924c(a)(1)]

After an NOD is recorded, an owner or any junior lienholder of real estate can bring current any monetary or curable default stated in the NOD at any time **prior to five business days** before the trustee's sale, called the *reinstatement period*. If the sale is postponed, the **reinstatement period** is extended, ending the day before the five business days prior to the postponed sale date. [CC §2924c(e)]

Up until the time the NOD is recorded by a trustee, the tender of all delinquencies must be accepted by the beneficiary.

After recording the NOD, the lender's trustee must allow **three months** (not 90 days) to pass before advertising and posting notice of the date of the trustee's sale. [CC §2924; see Figure 1]

The lender's trustee must begin advertising and post a *Notice of Trustees Sale* (NOTS) at least 20 days before the date of the sale. The property can be sold by the trustee no sooner than the twenty-first day after advertising begins and the posting of notice occurs. [CC §2924f(b); see Figure 1]

Additionally, if the billing address for the borrower is different than the address of the residential property in danger of foreclosure, the NOTS must be accompanied by a notice to the occupants regarding their rights in foreclosure. [CC §2924.8; see **first tuesday** Form 471-1]

The owner in foreclosure is not allowed to delay the trustee's sale by requesting a postponement. [CC §2924g]

Thus, the owner, or junior lienholder, has a minimum of approximately 105 days to cure the default and reinstate the note and trust deed before foreclosure.

To determine the last day for reinstatement of the note and trust deed, consider a trustee's sale that is scheduled for a Friday. Count back **five business days** beginning with the first business day prior to the scheduled Friday sale. Since weekends are not business days, the fifth day counting backward from the scheduled trustee's sale is the previous Friday (if no holidays exist). Thus, the very last day to reinstate the loan is on the Thursday eight calendar days before the trustee's sale.

The lender's failure to identify or include the dollar amount of all known defaults in the NOD does not invalidate the NOTS for the defaults stated in the NOD. Further, the lender can enforce payment of any omitted defaults by recording another, separate NOD. [CC §2924]

On reinstatement of the note and trust deed, the NOD is rescinded by the trustee, removing the recorded default from the title of the property. [CC §2924c(a)(2)]

Additionally, any **call is eliminated** and the loan is returned to installment status when the note and trust deed have been reinstated. Upon reinstatement, the owner continues his ownership of the property as though the loan had never been in default.

Redemption

Failure to cure a default before the reinstatement period expires allows a trust deed holder to require the owner to **redeem the property** by:

- paying all sums due under the note and trust deed; and
- reimbursing the costs of foreclosure prior to completion of the trustee's sale.

The owner's *right of redemption* exists until the moment the trustee completes the bidding and announces the property has been sold. Any owner, junior lienholder, or other person with an interest in the property may satisfy the debt and redeem the property prior to the completion of the trustee's sale. [CC §2903]

To redeem the property, the owner or junior lienholder are required to pay the principal and all interest charges accrued on the principal, permissible penalties, foreclosure costs, and any future advances made by the foreclosing lender to protect his security interest in the property.

Unless all amounts due on the note and trust deed resulting from the owner's default are paid in full during the redemption period, the owner will lose the property at the trustee's foreclosure sale.

Lender remedies on a default

An owner's default on a trust deed loan encumbering his property can arise under a provision in either the note or the trust deed. However, a default on the note triggers a default on the trust deed. It is the default on a trust deed that permits a foreclosure.

When the owner fails to pay installments of principal and interest as they become due under the terms of the note, he is then in default on the note. Thus, a default also exists on the trust deed.

The owner's default prompts the trust deed noteholder to immediately call the loan due under the acceleration clause in the note and trust deed by commencing foreclosure proceedings and recording an NOD.

Additionally, when the owner fails to meet his obligations regarding the **care, use, and maintenance** of the secured real estate, he is in default under the *waste provision* in the trust deed. The default on the trust deed exists even though the owner may be current on all payments and the note is not in default.

The owner's failure to maintain the property or pay property taxes, hazard insurance premiums, assessments, and amounts due on senior trust deed liens is considered a default on the current trust deed.

When the owner defaults on the trust deed, the lender may simply call the note due by recording an NOD that initiates a trustee's foreclosure sale.

A trust deed noteholder may advance funds to cure a default on the trust deed, such as the owner's failure to pay hazard insurance premiums, and then add the advance to the debt owed by authority of the trust deed's *future advances provision*. The trust deed noteholder may then demand the immediate repayment of the advance from the owner.

Let the grace period run before NOD

Consider a trust deed note held by a carryback seller that calls for installments to be paid by the first day of each month. A provision in the note imposes a charge when the monthly installments are not received within 10 days after the installment's due date. No mention of a *grace period* for a late payment exists in the note.

The seller consistently receives installments within the 10-day period after the installments become due, but never by the **due date** itself. Eventually, the carryback seller gives the buyer reasonable advance notice (30 days) that the installment for the following month **must be paid** by the first day of the month, the payment's actual due date. If it is not paid by the first, the seller advises the buyer he will begin foreclosure proceedings by recording a notice of default (NOD).

The following month, the buyer fails to deliver the installment by the first. The carryback seller records an NOD beginning foreclosure proceedings within the 10-day no-charge period.

The payment is received by the seller within 10 days after the due date.

The seller claims the monthly installment was delinquent since it was not paid by the first day of the month, thus placing the buyer in default on the second day of the month.

The buyer claims a default did not exist when the NOD was recorded since the NOD was recorded prior to incurring the agreed-to late charge.

Can the carryback seller begin foreclosure proceedings for the past-due monthly installment before the late charge is incurred?

No! The payment, while due, is not yet considered *delinquent* due to the existence of a late charge provision. Foreclosure proceedings may not be initiated for a past due payment during the period before a late charge is incurred. When a note provision imposes a late charge on the expiration of a specified time period without receipt of the amount due, this extended time for payment without penalty qualifies as a *grace period*.

Since a **grace period** exists, a foreclosure may not be initiated to enforce payment of the installment until after the grace period runs, when the payment becomes *delinquent* if unpaid. [**Baypoint Mortgage Corporation** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818]

Trust deed defaults and reinstatement

A property owner's *ability to reinstate* a loan by curing a default under a trust deed provision relating to the property and its title, not the note, depends on the trust deed provision in default.

For example, an owner of real estate encumbered by a trust deed fails to pay property taxes. The trust deed lender records an NOD, describing the delinquent property taxes as the owner's default under the trust deed.

Can the property owner reinstate the loan and retain the property by eliminating the default?

Yes! The default is *monetary*, entitling the owner to reinstate the loan by simply paying the delinquent property taxes and the trustee's fees and charges incurred in the foreclosure proceeding.

Also, **monetary defaults** on trust deed provisions, such as the owner's failure to pay assessments, ground lease rent, or hazard insurance premiums, may be cured and the loan reinstated on the owner's tender of the full dollar amount of the default. [CC §2924c]

Defaults cured only by redemption

Some trust deed defaults do not allow an installment debt to continue since reinstatement of the note on those defaults is only available if voluntarily agreed to by a lender. Defaults triggering a call and requiring *redemption* of the property by a payoff of the entire debt include a breach of a due-on clause, a waste provision, or a violation of law provision.

For example, consider real estate that is encumbered by a trust deed that requires the owner to maintain his property in good condition and repair.

The owner fails to repair the aging improvements on his property and allows the trees and lawn to die.

The trust deed lender becomes concerned since the owner's activities causing waste on the property has decreased the value of his security, called *impairment*. Due to the owner's failure to maintain the property in good condition (and thus the loan-to-value ratio due to a reduced property value), the lender records an NOD against the property.

Unlike a failure to maintain hazard insurance, here the owner cannot cure the default in the trust deed (waste) by tendering less than the entire remaining balance of the debt. Thus, the owner is unable to reinstate the loan.

In order to retain ownership of the property after the loan had been called due to waste, the owner must **redeem the property** by tendering full payment of **all sums due**, including foreclosure costs.

Alternatively, the trust deed gives the lender the authority to cure the waste and add that cost to the principal balance of the note, under the **future advances clause**.

However, when waste by the owner is committed in **bad faith**, the lender foreclosing by a trustee's sale must consider an *underbid* in a dollar amount equal to the property's reduced fair market value should the lender acquire the property at the trustee's sale. With an **underbid** for an amount equal to the property's fair market value, the lender can sue the owner to recover the reduction in the property value below the amount due, which was caused by the bad faith waste, even if the note is a nonrecourse debt. [**Cornelison** v. **Kornbluth** (1975) 15 C3d 590]

Foreclosure of CID assessment lien

Special foreclosure rules apply when a condo owner fails to pay his assessment fees to a common interest development (CID). If this happens, the association for the CID can initiate foreclosure procedures (or sue for money only, no foreclosure). However, the CID foreclosing must first notify the owner that his condo will be sold at a trustee's sale if the fees are not brought current. [CC §1367.1(a)]

If the assessment fees and related charges are not paid within 30 days of the initial foreclosure notification, the association can then record a notice of delinquent assessment as a *trust deed lien* on the owner's condo. The association must send the owner a copy of the notice of delinquent assessment within ten calendar days of recording the delinquent assessment notice. [CC §1367.1(d)]

After the notice of delinquent assessment is recorded, the owner has 30 days to bring the assessments current before the association can initiate foreclosure proceedings by recording an NOD. [CC §1367.1(g)]

The owner's right to redeem the condo lasts until 90 days after the trustee's sale. Further, the NOTS must include a statement advertising that the condo is being sold subject to the owner's *90-day right of redemption*. [CC §1367.4(c)(4)]

This **90-day redemption period** following a trustee's sale on an HOA assessment lien is available only on the CID assessment fees foreclosure process and does not extend to a lender's trust deed foreclosure

on a condo. However, a homeowner's association may request a copy of the trustee's deed on a lender's trustee's foreclosure sale by recording a request with the county recorder prior to the lender's recording of an NOD. [CC §2924b]

Chapter 6 Condition of property: disclosure by seller-in-foreclosure

This chapter explains the affirmative duty imposed on a seller-in-foreclosure and his listing agent to disclose their knowledge about the property's condition to prospective equity purchase (EP) investors.

Mandated on sales of one-to-four units

Any seller of a one-to-four unit residential property, whether or not the property is their principal residence or in foreclosure, must **complete and deliver** to prospective buyers a statutory form called a *Transfer Disclosure Statement* (TDS), more generically called a Condition of Property Disclosure Statement. [Calif. Civil Code §§1102(a), 1102.3; see **first tuesday** Form 304]

The seller must prepare the mandatory TDS with **honesty and in good faith**, regardless of whether he retains a broker and listing agent to assist in its preparation. [CC §1102.7]

When the seller prepares the TDS, he must set forth any material property defects **known or suspected** by him to exist.

Any adverse conditions known to the seller that **negatively affect** the value and desirability of the property are *material defects*. These defects must be disclosed even if they may are not itemized in the preprinted TDS. Disclosures to an investor or any other buyer are not limited to the items listed on the form. [CC §1102.8]

A buyer may recover the dollar amount of his losses caused by the seller's non-disclosure. However, when the seller is in foreclosure and without sufficient funds to shelter himself and his family, a judgment is of little financial relief to the equity purchase (EP) investor. The likelihood of collecting money from an insolvent seller is remote.

Thus, the investor must take all steps readily available to him to complete a due diligence investigation into the property's physical improvements so the purchase price will be based on the **actual condition** of the property, not just facts the seller is willing to disclose. [See **first tuesday** Form 156 §12.2]

Delivery of the TDS

While it is the seller who must prepare the TDS, it is the agent who obtains the EP offer from the investor who must hand the seller's TDS to the investor. When no agent participates in the negotiations and the sales transaction is directly between the seller-in-foreclosure and EP investor, it is the seller's obligation to deliver the TDS to the investor. When the circumstances of foreclosure are in the mix, the investor may need to provide the form and insist it be prepared and returned to him before he submits an offer. [CC §1102.12]

The failure of the seller or any of the agents involved to **deliver** the seller's TDS to the investor will not invalidate a sale of property after it has closed. However, the seller and the listing broker will be liable to the investor for the amount of actual monetary losses (e.g., the cost to cure or a reduced property value) caused by undisclosed defects known to them at the time the investor's **offer is accepted**, a point of law that has always existed in California. [CC §1102.13]

For the seller's disclosure statement to be an effective pronouncement to the investor, **material defects** in the integrity of the property must, as a practical matter, be disclosed to the investor before the price of the property is set by the acceptance of an offer or counteroffer. [Calif. Attorney General Opinion 01-406 (August 24, 2001)]

Thus, when the seller's TDS on a one-to-four unit residential property is dilatorily delivered to the investor after the seller enters into a purchase agreement, the investor has the right to:

- **cancel** the purchase agreement on discovery of undisclosed defects known to the seller and unobserved by the investor or the investor's agent (on an inspection) prior to acceptance [CC §1102.3];
- **make a demand** on the seller to correct the defects or reduce the price accordingly before escrow closes [See **first tuesday** Forms 156 §12.2 and 269]; or
- **close escrow** and make a demand on the seller for the costs to cure the defects known to the seller or his agent and not disclosed prior to acceptance. [**Jue** v. **Smiser** (1994) 23 CA4th 312]

Closing escrow without resolving the issue of previously undisclosed property conditions is not a viable method for settling a claim for corrections of defects or a price adjustment since the seller-in-foreclosure is basically insolvent.

The EP investor's right to cancel

The TDS is to be delivered to a prospective buyer *as soon as practicable*, and in any event, before closing. **Delivery** of the seller's TDS to the investor is fully satisfied and no right to cancel exists for the investor (due to the disclosures) if the TDS is previously delivered or attached to the purchase agreement offer made by the investor or the counteroffer entered into by the seller. [CC §1102.3]

If the TDS is belatedly delivered to the investor — after the EP agreement has been entered into — the investor may, among other remedies, **elect to cancel** the purchase agreement under a statutory three-day right to cancel. The investor's statutory cancellation right runs for three days following the day of the in-escrow delivery of the TDS. [CC §1102.3]

However, an investor is not left merely to cancel the purchase agreement and "go away" on his in-escrow receipt of an unacceptable TDS or home inspector's report.

As an alternative to canceling the purchase agreement due to a delayed receipt and review of the seller's TDS (or a home inspection report), the investor may **make a demand** on the seller to cure any material defect (affecting value) that was known to the seller and not disclosed or known to the investor prior to entering into the purchase agreement.

The same rule holds for the listing agent who has knowledge of defects and does not disclose the facts to the investor before the investor and seller enter into the purchase agreement. Here, the agent's broker provides a "deep pocket" for the investor's recovery of his money losses, since the seller is insolvent. [See **first tuesday** Form 269]

If the seller will not cure the defects, the investor may tender a **price reduced** by the cost to repair or replace the defects known to the seller and undisclosed on the date the purchase agreement was entered into. [See **first tuesday** Form 156 §12.2]

Reliance limited to seller's awareness

On listing his principal residence for sale, the seller of a one-to-four unit residential property in foreclosure signs and hands his listing agent a completed TDS — at his agent's request.

A pre-printed limitation-of-liability provision contained in the statutory TDS states the disclosures made by the seller on the form:

- **may not be relied on** by an investor as a *warranty* of the actual condition of the property; and
- are **not part of the terms** of the purchase agreement (even though the disclosure statement may be attached to it).

On the disclosure statement, the seller indicates by not checking the box that he is **unaware** of any building code violations on the property. The listing agent adds nothing as he has no knowledge to the contrary and his visual inspection brought no violations to his attention.

An EP investor is located and an EP agreement entered into. During the seller-in-foreclosure's five-business-day right to cancel, the investor is handed the TDS, which he approves. After the seller's right to cancel expires and prior to closing escrow, a county building inspector contacted by the investor during his *due diligence investigation* advises the investor that building code violations exist on the property.

Here, the seller **disclosed his lack of actual knowledge** of any code violations in the TDS. The disclosure in the statement enables the seller to avoid liability for building code violations that actually existed, were adverse to the value of the property, and were unknown to the seller.

A seller completes the mandatory TDS only as a disclosure of his **state of awareness** (actual knowledge) regarding the condition of the property. Thus, the statement does not itself disclose the **actual conditions** that may exist on the property. In a word, it is not a *warranty* of the actual state of the property's condition. Instead, it is a statement of the state of the seller's **awareness** of the property's condition.

Since the TDS is not a warranty, the TDS itself is not a basis for a price adjustment to cure the actual defects if the TDS was honestly prepared.

Again, the EP investor must look beyond the TDS to his alternative remedies, which include:

- canceling the transaction on discovery of a material adverse property condition not previously disclosed;
- requiring the violations be cured before closing escrow; or
- reducing the price to cover the cost to cure the violations. [See **first tuesday** Form 156 §12.2]

Excuse my state of mind

Serving as a **lack-of-awareness** disclosure, the statutory TDS has become discredited as the primary source of information for buyers about the integrity of the physical condition of the property being purchased. However it does contain those defects the seller is willing to disclose and the listing agent includes.

In practice, a listing agent hands the seller's TDS to a prospective investor (or the investor's agent) to **induce reliance** on its content as establishing the level of integrity of the property's physical condition. With the TDS in hand, the investor then sets the price, terms and conditions in his offer to purchase the property, or, if delivered after he is under contract, waive contingencies and proceed to close escrow in reliance on its content.

The listing agent has no duty owed the buyer to present the disclosure to the investor as a "red flag warning," accompanied by advice to include a *contingency provision* in the EP agreement calling for the investor to hire a home inspector since the TDS is only the seller's state of awareness. A home inspector's report states the **actual condition** of the property and *warrants* that condition to the buyer of the property.

However, the EP investor, mindful of the lack-of-awareness limitation on the effectiveness of the TDS, cannot give any weight to the seller's disclosure statement, except for the defects actually disclosed.

Thus, the "not-a-warranty" limitation-of-liability provision in the TDS puts every buyer on notice that the TDS is not a part of any purchase agreement. The fact the TDS is an addendum to the purchase agreement or counteroffer documents its timely delivery to the investor before they enter into the purchase agreement is entered into.

Attaching the TDS to the purchase agreement does not make the TDS a representation of the actual condition of the property. Thus, the question remains: just what role ought the TDS play, other than to get the seller on record as to the defects he will disclose in his effort to salvage something from his equity?

Investors must learn not to use the seller's TDS, handed them by the listing agent, as a basis for setting a definitive price and terms of purchase. To everyone's benefit, the well-informed investor will require a *home inspection report* as the subject of a further approval contingency provision in the EP agreement, whether the report is obtained by the seller or the investor.

With the home inspection report, the investor is fully *informed and guaranteed* about the actual physical condition of the property. The need for price adjustments or corrections based on the "in escrow" discoveries is then remedied under purchase agreement provisions for defects first discovered or disclosed after entering into the purchase agreement. [See **first tuesday** Form 156 §12.2]

Include a home inspector

A competent listing agent will aggressively recommend to his seller that a **home inspector** be retained at the earliest opportunity, before the property is marketed. The inspector conducts a physical examination to determine the actual condition of the property and issue a report on his findings. [See Chapter 7]

A home inspector typically detects and reports property defects overlooked by the seller and not observed by the investor or during the listing agent's mandatory **visual inspection**. Significant defects that remain undisclosed tend to surface after closing as claims made by the investor against the listing broker for *deceit*. A home inspector troubleshoots for defects discovered by a **physical inspection** of the property's grounds and improvements that may not generally be observable on a visual inspection by the untrained eye of a broker and his listing agent.

Listing broker's mandatory inspection

A **seller's broker** (or the broker's listing agent) is obligated to personally carry out a *visual inspection* of the property — and do so competently. The seller's disclosures on the TDS prepared by the seller are then reviewed by the broker or the listing agent for discrepancies. The broker or his agent then add any information about material defects that have gone undisclosed by the seller (or the home inspector) and were known to the listing agent or observed during the agent's visual inspection of the property.

An EP investor has **two years** to pursue the seller's broker and listing agent to recover losses caused by the broker's or his agent's **negligent failure** to disclose observable and known defects adversely affecting the physical condition and value of the property. Undisclosed defects permitting recovery are those that would have been observed by a *reasonably competent* broker during a visual on-site inspection. A listing agent is expected to be as competent in his visual inspection and reporting as a reasonably competent broker would be. [CC §2079.4]

However, the investor will be unable to recover money from the seller's broker if the broker or listing agent did not actually know a defect existed, and did conduct what would be considered a competent visual inspection of the property. [CC §1102.4(a)]

Following their mandatory visual inspection, the seller's broker or his listing agent may include on the TDS **specific items** disclosures in a home inspector's report. Should the items relied on later be contested by the investor as incorrect or inadequate, the broker and his agent are entitled to *indemnification* from the home inspection company issuing the erroneous report for his share in the responsibility for the omission. [**Leko** v. **Cornerstone Building Inspection Service** (2001) 86 CA4th 1109]

Nondisclosure by the seller

Now consider a residence that has a defect in its foundation adversely affecting the value of the property. The defect is known to the seller, but it is not readily observable by a buyer or broker.

The seller's TDS does not reflect the seller's knowledge of the defective foundation.

An EP agreement is entered into between the seller-in-foreclosure and EP investor. The TDS is attached to the EP agreement to acknowledge the investor's receipt and avoid a right-to-cancel contingency triggered by a delayed TDS disclosure. Escrow is opened, the EP cancellation period expires and the property is conveyed to the investor on closing.

Within four years after escrow closes, the defective foundation worsens and becomes obvious to the investor. The investor makes a demand on the seller for his costs incurred to cure the defect. The seller's two-year period for rescission due to an unconscionable advantage has expired. Further, all aspects of the EP procedure and documentation were complied with at the time of purchase. Thus, the EP investor does not feel threatened by the seller claiming he violated EP laws.

Is the seller-in-foreclosure liable to the EP investor for the cost incurred to repair the defective foundation?

Yes! Any seller, whether or not he is represented by a listing broker, has a duty to the buyer to disclose on the statutory TDS all facts **known to the seller** about the condition of the property that:

- are **not readily observable** by a buyer on the buyer's inspection of the property; and
- **affect the value and desirability**, and thus the integrity, of the property in the hands of the buyer. [**Prichard** v. **Reitz** (1986) 178 CA3d 465]

The illegal "as-is" sale

Consider a listing agent who, on conducting his visual inspection of a property, has reason to believe the property fails to conform to building and zoning regulations due to the conversion of the garage to living space and the addition of a carport.

The listing agent knows a prospective EP investor who is interested in purchasing the property, but is unaware of the possible violations. The listing agent also knows that if the investor learned of the violations, he might view the property's value differently.

The investor submits an EP offer. The listing agent prepares a counteroffer and includes an "as-is" disclaimer provision that the seller-in-foreclosure signs. The provision states the agent "makes no representations regarding the property and incurs no liability for any defects, and the EP investor is agreeing to purchase the property "as is." The counteroffer is submitted to the EP investor and accepted.

After closing, the city refuses to provide utility services to the property on the change of ownership due to building code and zoning violations.

The investor makes a demand on the seller's broker and listing agent for the investor's money losses due to overpricing and the cost of corrective repairs. The investor claims the seller's broker and listing agent breached their *general agency duties* owed the investor since they failed to disclose material defects that adversely affected the value of the property, facts **known** to the listing agent but not the investor.

The broker claims the investor waived his right to collect any money losses when he signed the counter-offer with the "as-is" disclaimer.

Does use of an "as-is" disclaimer provision shield a listing broker from liability for the investor's loss of money and property value caused by the building and zoning violations that were **suspected to exist** by the broker's listing agent and not known or suspected by the EP investor?

No! The seller's broker and listing agent have a **general duty**, owed to all parties in the transaction, not just their seller, to personally conduct a competent visual inspection of the property sold. Based on their duty to conduct a reasonably competent inspection, they are to disclose to prospective buyers **all known and observable** property conditions that adversely affect the value and desirability of the property and are not already known to the buyer on entering into a purchase agreement.

A breach of the seller's listing broker's general duty owed to a buyer occurs when the buyer's offer is accepted and the broker or his listing agent has not yet disclosed his knowledge or observations about **potential adverse conditions** existing on a property. The breach of the duty owed the buyer is not excused by writing an "as-is" disclaimer into the purchase agreement in lieu of factual disclosures about his suspicions concerning the property's condition. [**Katz** v. **Department of Real Estate** (1979) 96 CA3d 895]

The term "as is" should never be used. "As is" implies a failure to disclose something known to the seller or the listing agent. A buyer purchases property in its condition "as disclosed" at the time his offer is accepted, in spite of the seller's urgency to negotiate a sale and his need for an early closing due to the pressure of foreclosure. Any failure to disclose material defects before the buyer acts (setting the price) based on the information he has received subjects the seller to liability for the decreased value of the property or the cost to eliminate the undisclosed defect. [CC §1102.1(a)]

"As is" provisions are repugnant disclaimers; they do not explain the condition of the property. Information regarding defects is included in the seller's TDS and handed to the investor before the price is set by contract. The seller simply discloses the defects, whether or not the seller eventually agrees to make repairs when accepting an offer to buy.

Further, public policy prohibits the sale of one-to-four unit residential property "as is," whether or not the property is occupied by the owner as his principal residence or is in foreclosure. All buyers purchase property in the condition "as disclosed" by the seller, the seller's broker, and the broker's agents, and as actually observed by the investor, **prior to entering** into the purchase agreement, unless negotiations on entering into a purchase agreement call for the seller to correct some or all of the previously disclosed defects. [CC §1102.1(a)]

Chapter 7 Verify the seller's disclosures: retain a home inspector

This chapter reviews the equity purchase (EP) investor's use of a home inspector to confirm the physical condition of the property is as represented by the seller-in-foreclosure and listing agent prior to entering into an EP agreement.

Protection for the prospective investor

An equity purchase (EP) investor locates an owner-occupied, one-to-four unit residential property that is in foreclosure and appears to qualify for the investor's ownership purposes. A walk-through of the property with the listing agent confirms the property suits the investor's needs.

The EP investor then requests information on the property from the listing agent, including a title profile, a transfer disclosure statement (TDS) and a home inspection report (HIR). The listing agent responds by suggesting the investor should first submit an offer. He explains the "necessary disclosures for closing" will be delivered after an acceptable offer has been submitted to the seller.

The indication the investor gets is that the listing agent is dilatory, failing to have prepared a **listing package**. Worse, no information on the property will likely be made available until it is nearly time to close escrow. As for the listing agent, he felt it was a waste of his time to do any of the paperwork until a sale had been agreed to. Negotiations by use of a letter of intent would have been more to the liking of the listing agent. [See **first tuesday** Form 185]

The investor decides he should make an offer at a price and on terms he believes are justified. The investor has checked out comparable sales from information provided to him by online sources. Also, he has some knowledge about properties in the immediate area. As a result of the walk-through and no adverse disclosures by the seller or the listing agent, the investor knows of no problems presented by the physical condition of the property.

The offer anticipates nondisclosures

In any event, an EP agreement is prepared with *contingency and remedy provisions* regarding disclosures and investigation into the condition of the property.

Contingency and remedy provisions included in the EP agreement, among others, call for:

- the seller to furnish an HIR prepared by an insured home inspector showing the land and improvements to be free of material defects [See **first tuesday** Form 156 §12.1(b)];
- the seller and the listing agent to prepare, sign and deliver a condition of property disclosure (TDS) [See **first tuesday** Form 156 §12.2(b)]; and
- the investor to inspect the property twice — once to initially confirm the condition of the property and once again before closing escrow to confirm maintenance has not been deferred and material defects discovered after entering into the EP agreement have been corrected or eliminated. [See **first tuesday** Form 156 §12.4]

The offer is submitted and promptly rejected by the seller. Eventually, a purchase agreement is entered into that eliminates the provision calling for the seller to furnish an HIR. No previous offer has been submitted to the seller HIR on the property that the EP investor could review.

The investor contacts a home inspection company and orders an inspection and report. [See Form 130 accompanying this chapter]

The inspection takes place and the HIR is received and reviewed by the investor. The seller and the listing agent have not delivered a TDS or any of the other disclosures or inspection reports that both the seller and the listing agent are duty bound to deliver to prospective buyers. [Calif. Civil Code §§2079, 1102]

The home inspector's written report lists significant defects he has observed during his physical inspection of the property's condition, all of which the seller should have known about. Repair/replacement costs are estimated by a building contractor at $4,500 to eliminate the defects not disclosed by the seller or observed by the investor on his cursory review of the living and storage space within the structure.

Remedies keep the deal alive

The investor makes a **written demand** on the seller to cure (repair) the defects discovered by the home inspector based on the terms agreed to in the EP agreement. [See **first tuesday** Form 156 §12.4(a) and Form 269 accompanying this chapter]

A copy of the HIR and a contractor's estimate of the cost to cure the itemized defects are attached to the investor's request for repairs. Thus, the investor substantiates his demand on the seller to cover previously undisclosed defects.

The seller and his listing agent now prepare a TDS. On it, they note all the defects listed in the HIR and on the investor's notice demanding repairs. The TDS is delivered to the investor. The seller then refuses to make any of the corrections demanded by the investor, claiming he has disclosed the defects in the TDS as he agreed he would do in the EP agreement.

Eventually, the investor is told by the listing agent to either close escrow or cancel. Meanwhile, the seller's five-business-day right to cancel has expired without his having cancelled the EP agreement. [See **first tuesday** Form 181-1]

Can the EP investor require the seller to cure the *material defects* found by the home inspector and close escrow?

Yes! The seller must deliver the property to the investor in the condition as disclosed by the seller and his listing agent and observed by the investor at the time the investor's purchase agreement offer was accepted, not in the condition stated in an **untimely disclosure** made in the TDS handed to the investor during escrow.

The seller's and listing agent's **failure to disclose** the adverse conditions existing on the property that affect its value prior to acceptance is an omission of material facts, called *negative fraud*.

For the investor, the most significant issue arising out of the discovery of defects concerns the price he agreed to pay in the EP agreement. The seller and investor agreed on a price for the property based on the conditions **disclosed and known to the investor** at the time the offer was accepted.

Thus, the price represents the agreed value of a used but defect-free property, except for any defects observed by the investor or disclosed to the investor and therefore known prior to entering into the EP agreement. The price, as it turns out, exceeds the property's fair market value by the amount of the costs that will be incurred to cure the defects and deliver the property in the condition "as disclosed" prior to acceptance.

Confirm the seller's disclosures

A seller and his listing broker's TDS must disclose to a prospective buyer all known and observable property conditions that adversely affect the value of the property. The TDS must be handed to the prospective buyer **as soon as possible**.

AUTHORIZATION TO INSPECT AND PREPARE A HOME INSPECTION REPORT

(Business and Professions Code §7195)

DATE: _____, 20_____, at _____, California.

Home Inspector/Rep. _____	Agent's Name _____
Home Inspection Company _____	Broker's Name _____
Address _____	Address _____
Phone _____	Phone _____
Fax _____	Fax _____
Email _____	Email _____

FACTS:

1. Property address _____

_____

1.1 Type of property _____

_____

2. Owner's name _____

Phone _____

3. The home inspection report is for use in the agent's preparation of a transfer disclosure statement and reporting of the property conditions to prospective buyers.

4. Your contract for inspection and report will be entered into by ☐ the Owner, ☐ the Buyer, or ☐ the Agent.

4.1 ☐ Include a copy of the binder with dates of effectiveness for your professional liability insurance coverage.

5. Call ☐ the Agent, or ☐ the Seller, to set up the day and time for your inspection.

5.1 ☐ The Agent will be present during the inspection.

5.2 If the Agent is not present, call the Agent to discuss your findings before preparing the report.

6. Your inspection and report to include the following items:

6.1 An energy efficiency inspection.

6.2 Any improvements that are not in compliance with building permits or codes and any improvements for which no permit exists.

6.3 The property's compliance with safety codes for child resistant pool barriers, hot tub covers, automatic garage doors, door locks/latches, gas valves, residential security bars and water heaters.

7. Your fee for this service will be paid in full on your delivery of your report to the Agent.

7.1 It is anticipated the amount of your fee will be $_____.

8. You are authorized to open an order and process this inspection.

Submitting Agent's Signature: _____

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A TDS completed by the seller and listing agent without the benefit of a HIR too often inaccurately or entirely fails to reveal significant property defects or code violations that actually exist and are not known to the seller or listing agent.

When the seller has not obtained an HIR prior to entering into a purchase agreement, the EP investor should always order one on either opening escrow or the expiration of the seller-in-foreclosure's five-business-day right of cancellation. In any event, the EP investor should get an HIR before the expiration of any contingency regarding his confirmation that the property is in the condition he was led to expect during the negotiations leading up to entry into a purchase agreement.

An investor needs an HIR in the interest of avoiding:

- after-closing discoveries of defects that require correction; and
- after-closing claims he may have against the seller, who borders on insolvency, or the broker, to recover the value lost or the costs incurred to correct the defects.

Armed with an HIR containing findings of material defects not disclosed, observed, or known to the investor at the time the EP agreement was accepted, the investor can then make the necessary demands on the seller to cure or correct defects. Thus, the investor ensures the property will be delivered in the condition **as disclosed** by the seller on entering into the EP agreement, including defects known to the seller or the agent and disclosed in the TDS received prior to acceptance of the investor's offer.

An **HIR** is undoubtedly the single most welcomed bit of information a buyer can get on a property that appears suitable to acquire. With it, the buyer has assurance no defects or shortcomings in the improvement exist outside those identified in the report — if not already corrected and eliminated by the seller.

As a cover for the physical condition of the improvement, which represents roughly 75% of the price paid for the property, the HIR is equivalent to title insurance covering the deed to the property. If conditions are not as stated in a property inspection report or title policy, they are cured or paid for by the companies issuing the report or the policy. The seller (or investor) should only consider using home inspectors who carry errors and omissions (E&O) insurance to cover their failure to locate and report defects.

The inspection and report

A home inspection is a **physical examination** conducted on site by a home inspector. Unlike the listing agent's mandatory *visual inspection* and report on his observations in the TDS, the physical inspection of a one-to-four unit residential property by a home inspector is performed in exchange for payment of a **noncontingent fee**.

The purpose of the physical examination of the premises is to identify *material defects* in the condition of the land and the structure, systems and components of the improvements on the property. **Material defects** are conditions that affect the property's:

- market value;
- desirability as a dwelling;
- habitability from the elements; and
- safety from injury in its use as a dwelling.

The **home inspection** is a *noninvasive examination* of the mechanical, electrical and plumbing systems of the dwelling. Also covered are the components of the structure, such as the roof, ceiling, walls, floors, and foundations. **Noninvasive** indicates there will be no intrusion into the roof, walls, foundation, or soil by dismantling or taking apart the structure that would disturb components or cause repairs to be made to remove the effects of the intrusion. [Calif. Business and Professions Code §7195(a)(1)]

PROPERTY INSPECTION

Buyer's Request for Repairs

DATE:_____, 20_____, at_____, California.

TO SELLER: _____

FACTS:

1. Buyer entered into a purchase agreement with you dated _____, 20_____ agreeing to buy real estate referred to as _____

_____.

2. The purchase agreement calls for an **initial inspection** of the real estate by Buyer, or a representative of Buyer.

2.1 The inspection is to confirm that the condition of the real estate is substantially the condition reasonably expected by Buyer based on observations by Buyer and representations made by Seller or Seller's Agent to Buyer or Buyer's Agent prior to acceptance of the purchase agreement.

3. The purchase agreement calls for Buyer to notify Seller, on completion of Buyer's initial inspection, of any material defects discovered by Buyer which were undisclosed and unknown to Buyer prior to acceptance of the purchase agreement.

4. The purchase agreement further calls for Seller to repair, replace or correct the noticed defects prior to closing the transaction and delivering possession to Buyer.

5. By this notice of material defects in need of repair, replacement or correction, Buyer does not intend to cancel the purchase agreement or avoid Buyer's obligation to perform on the purchase agreement.

5.1 Buyer will close as scheduled or as soon thereafter as any noticed defects have been eliminated by repair, replacement or correction and completion has been verified by Buyer.

THUS:

6. Buyer hereby confirms the condition of the property on the initial inspection satisfies Buyer's expectations of its physical condition regarding both the land and its improvements, **except** for the following itemized material defects in the condition of the property.

6.1 Buyer hereby notifies Seller of the material defects in the condition of the property which were undisclosed and unknown to Buyer prior to acceptance of the purchase agreement and makes a demand on Seller to repair, replace or correct the following itemized defects prior to closing:

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____.

I agree to the terms stated above.	**Seller hereby acknowledges receipt of a copy.**
Date:_____, 20_____	Date:_____, 20_____
Buyer: _____	Seller: _____
Buyer: _____	Seller: _____

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The **HIR** is the written report prepared by the home inspector to set forth his findings during his physical examination of the property. The report identifies each system and component of the structure inspected, describes any material defects the home inspector finds or suspects, and makes recommendations about the conditions he observed. The report will suggest any further evaluation needed to be undertaken by other experts for conditions observed by the inspector that are beyond his expertise or the scope of his inspection. [Bus & P C §7195(c)]

When ordering the report, the investor should also request that the home inspector conduct an inspection on the energy efficiencies of the property and include his findings in the report. On a request for an **energy efficiency inspection**, the home inspector will report on items including:

- the R-value of the insulation in the attic, roof, walls, floors and ducts;
- the quantity of glass panes and the types of frames;
- the heating and cooling equipment and fans;
- water heating systems;
- the age of major appliances and the fuel used;
- thermostats;

Existing home inspection reports and liability limitations

Prospective buyers of a property are **entitled to rely** on an existing home inspection report (HIR) when they decide to buy the property, waive their right to cancel escrow, or require corrections before closing.

The investor's reliance on an existing HIR, obtained by the owner or a prior prospective buyer, imposes liability on the home inspector for his failure to exercise the level of car expected of a home inspector when examining the property and reporting its defects. Liability for the unreported defects is imposed even though the home inspection contract or report contains provisions restricting use to the person who requested it. [**Leko** v. **Cornerstone Building Inspection Service** (2001) 86 CA4th 1109]

Further, any provision in the home inspection contract or condition in the HIR that purports to waive or limit the home inspector's liability for the negligent investigation or preparation of the HIR is unenforceable. The home inspector is liable for the full amount of losses caused by his failure to locate defects and report them. [Calif. Business and Professions Code §7198]

Occasionally, a boilerplate provision in the home inspector's contract or the HIR will state the buyer's period for recovery is limited to one year after the inspection occurred. However, any limitation the home inspector may place on the **time period** for the buyer to discover the defect and make a claim is also unenforceable. The statutory four-year period is needed to provide time for buyers to realize the home inspector produced a faulty report. [**Moreno** v. **Sanchez** (2003) 106 CA4th 1415]

An investor ordering out or relying on an existing home inspection report needs to verify the home inspection company has **professional liability insurance coverage**. Do not rely on the home inspection company's word that the insurance coverage exists; get a copy of the declaration page from the insurance policy. The existence of the home inspectors errors and omissions (E&O) coverage reduces the risk of loss when acquiring one-to-four unit residential property.

FINAL WALK-THROUGH INSPECTION

Final Condition-of-Property Confirmation

DATE:_____, 20_____ at _____, California.

TO SELLER: _____

FACTS:

1. Buyer entered into a purchase agreement with you dated _____, 20_____, agreeing to buy real estate referred to as _____

_____.

2. The purchase agreement calls for a **final walk-through inspection** of the real estate by Buyer, or a representative of Buyer.

2.1 The purpose of the final walk-through is to verify that the condition of the real estate at the time of closing is substantially the condition reasonably expected by Buyer based on observations by Buyer and representations made by Seller or Seller's Agent to Buyer or Buyer's Agent prior to acceptance of the purchase agreement.

3. The purchase agreement calls for Buyer to notify Seller on completion of Buyer's final walk-through inspection of the following:

3.1 any lack of maintenance during the escrow period; or

3.2 failure of Seller to make repairs and correct defects, which Seller was given notice of after Buyer's receipt of the Condition of Property — Transfer Disclosure Statement TDS — and Property Inspection — Request for Repairs. [See **ft** Forms 269 and 304]

4. By this notice of the need for repair or maintenance, Buyer does not intend to cancel the purchase agreement or avoid Buyer's obligation to perform on the purchase agreement.

4.1 Buyer will close as scheduled or as soon thereafter as completion of any repairs and maintenance can be verified by Buyer.

ACCORDINGLY:

5. Buyer hereby confirms the condition of the property on the final walk-through inspection satisfies Buyer's expectations of its physical condition regarding both the land and its improvements, **except** for the following list of items regarding the condition of the property.

5.1 Buyer hereby notifies Seller of the condition of the property which is not in working order or has not been corrected as previously requested and makes a demand on Seller to repair, replace or correct the following itemized condition(s) prior to closing: _____

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____.

I agree to the terms stated above.	**Seller hereby acknowledges receipt of a copy.**
Date:_____, 20_____	Date:_____, 20_____
Buyer: _____	Seller: _____
Buyer: _____	Seller: _____

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- energy leakage areas throughout the structure; and
- the solar control efficiency of the windows. [Bus & P C §7195(a)(2)]

The EP investor's remedies for deceit

If a home inspection report reveals property defects previously undisclosed and unknown to the investor, the investor may:

- make a demand on the seller to correct or eliminate the defects, and refuse to close escrow until the seller has either complied or agreed to an adjusted price [See Form 269]; or
- refuse to close escrow for lack of the seller's compliance with the demand for corrections.

An option available to an EP investor, though not financially viable due to the seller's insolvency, is to close escrow and then make a money demand on the seller for his losses. The losses will be either the difference between the purchase price set in the EP agreement and the price adjusted for the undisclosed defects as called for in the EP agreement, or the cost incurred to cure the defects. [**Jue** v. **Smiser** (1994) 23 CA4th 312]

If the EP agreement entered into by the seller and investor contains a **price adjustment provision**, the investor can, before closing, enforce a reduction of the purchase price. The price adjustment will be for the amount of the costs necessary to bring the property into the condition as disclosed by the seller or the listing agent at the time of acceptance. [See **first tuesday** Form 156 §12.2]

Also, when the seller fails to convey the property in the condition as disclosed by his conduct prior to acceptance, he has failed to deliver the property as agreed. Thus, the investor is justified in refusing to close escrow until the seller compensates the investor for or corrects the defects discovered during escrow.

However, if the investor is made aware of basic facts which would indicate adverse conditions existed on the property at the time the investor enters into the EP agreement, facts that would cause an ordinary buyer to be put on notice to investigate into their consequences, the investor has no grounds for claiming a loss for the condition he knew existed on entering into the EP agreement.

Final pre-closing inspection

An EP investor must personally **reinspect the property** just before close of escrow to confirm:

- the quality of any repairs made by the seller; and
- the maintenance of the general condition of the property after entering into the EP agreement.

The investor's right to a final pre-closing inspection of the property is agreed to in the EP agreement. [See **first tuesday** Form 156 §12.4(b)]

On final inspection of the property, the investor lists any property defects not already addressed, such as equipment and fixture malfunctions or deferred maintenance, on the final walk-through inspection statement. [See Form 270 accompanying this chapter]

Chapter 8 Hazard disclosures by the broker

This chapter discusses the use of the Natural Hazard Disclosure (NHD) Statement by a seller-in-foreclosure and listing agent to fulfill their obligations to inform prospective equity purchase (EP) investors about the nature of a property's location.

A unified disclosure for all sales

The listing broker in transactions involving the sale of any type of real estate owes a duty to a prospective buyer **to disclose**:

- the broker's **actual knowledge** of any *natural hazards* affecting the value of the property; and
- information contained in **public records** concerning *natural hazards*. [Calif. Civil Code §1103(c)]

If a seller has not listed the property with a broker, then the seller must disclose any natural hazards known to him or contained in public records. The seller in a for-sale-by-owner (FSBO) transaction must disclose his knowledge of the natural hazards of his property's location on a statutorily mandated form. [See Form 314 accompanying this chapter]

Natural hazards come with the **location** of a parcel of real estate, not with the man-made aspects or conditions of the property, as are environmental hazards. Locations where a property might be subject to natural hazards include:

- special flood hazard areas, a federal designation;
- potential flooding and inundation areas;
- very high fire hazard severity zones;
- wildland fire areas;
- earthquake fault zones; and
- seismic hazard zones. [CC §1103(c)]

The existence of a hazard presented by the geographic location of a property affects its value and desirability to prospective EP investors. Hazards, by their nature, limit an investor's ability to develop the property, obtain insurance, and receive disaster relief.

Whether a seller markets his property himself or lists the property with a broker, the seller must disclose to prospective investors any natural hazards **known to the seller**, as well as those **contained in public records**.

To unify and streamline the disclosure by a seller (and his listing agent) about those natural hazards that affect a property, the California legislature created a statutory form entitled the *Natural Hazard Disclosure (NHD) Statement*.

The NHD form is used by a seller and his listing agent for their preparation (or acknowledgement of their review of a report prepared by an NHD expert) and disclosure of natural hazard information. The information is either known to the seller and listing agent (and the NHD expert) or available to them as shown on maps in the public records of the local planning department. [CC §1103.2; see Form 314]

NATURAL HAZARD DISCLOSURE STATEMENT

NOTE: The seller's listing broker (and the seller) of one-to-four residential units shall prepare a Natural Hazard Disclosure (NHD) and deliver it to prospective buyers prior to making a purchase agreement offer and indicate compliance in the purchase agreement or a counteroffer. If not so disclosed, the buyer has the right to cancel the purchase agreement within three days of delivery of the disclosure in person. [Calif. Civil Code §1103.3]

DATE:_____, 20_____, at_____, California.

This disclosure statement is prepared for the following:

☐ Seller's listing agreement

☐ Purchase agreement

☐ Counteroffer

☐ _____

dated _____, 20_____, at _____, California,

entered into by _____, as the _____,

regarding real estate referred to as _____

_____.

Natural Hazard Disclosure Statement:

Seller and Seller's Agent(s) or a third-party consultant disclose the following information with the knowledge that even though this is not a warranty, prospective buyers may rely on this information in deciding whether and on what terms to purchase the subject property.

Seller hereby authorizes any agent(s) representing any principal(s) in this action to provide a copy of this statement to any person or entity in connection with any actual or anticipated sale of the property.

THE FOLLOWING ARE REPRESENTATIONS MADE BY SELLER AND SELLER'S AGENT(S) BASED ON THEIR KNOWLEDGE AND MAPS DRAWN BY THE STATE AND FEDERAL GOVERNMENT. THIS INFORMATION IS A DISCLOSURE AND IS NOT INTENDED TO BE PART OF ANY CONTRACT BETWEEN BUYER AND SELLER.

THIS REAL PROPERTY LIES WITHIN THE FOLLOWING HAZARDOUS AREA(S): (Check appropriate response)

1. A SPECIAL FLOOD HAZARD AREA (Any type Zone "A" or "V") designated by the Federal Emergency Management Agency.

Yes____ No____ Do not know/information not available from local jurisdiction____

2. AN AREA OF POTENTIAL FLOODING shown on an inundation map pursuant to Section 8589.5 of the Government Code.

Yes____ No____ Do not know/information not available from local jurisdiction____

3. A VERY HIGH FIRE HAZARD SEVERITY ZONE pursuant to Section 51178 or 51179 of the Government Code. The owner of this property is subject to the maintenance requirements of Section 51182 of the Government Code.

Yes____ No____

4. A WILDLAND AREA THAT MAY CONTAIN SUBSTANTIAL FOREST FIRE RISKS AND HAZARDS pursuant to Section 4125 of the Public Resources Code. The owner of this property is subject to the maintenance requirements of Section 4291 of the Public Resources Code. Additionally, it is not the state's responsibility to provide fire protection services to any building or structure located within the wildlands unless the Department of Forestry and Fire Protection has entered into a cooperative agreement with the local agency for those purposes pursuant to Section 4142 of the Public Resources Code.

Yes____ No____

5. AN EARTHQUAKE FAULT ZONE pursuant to Section 2622 of the Public Resources Code.

Yes____ No____

6. A SEISMIC HAZARD ZONE pursuant to Section 2696 of the Public Resources Code.

Yes (Landslide Zone)____ Yes (Liquefaction Zone)____

No____ Map not yet released by state____

THESE HAZARDS MAY LIMIT YOUR ABILITY TO DEVELOP THE REAL PROPERTY, TO OBTAIN INSURANCE OR TO RECEIVE ASSISTANCE AFTER A DISASTER.

THE MAPS ON WHICH THESE DISCLOSURES ARE BASED ESTIMATE WHERE NATURAL HAZARDS EXIST. THEY ARE NOT DEFINITIVE INDICATORS OF WHETHER OR NOT A PROPERTY WILL BE AFFECTED BY A NATURAL DISASTER. BUYER(S) AND SELLER(S) MAY WISH TO OBTAIN PROFESSIONAL ADVICE REGARDING THOSE HAZARDS AND OTHER HAZARDS THAT MAY AFFECT THE PROPERTY.

Check only one of the following:

☐ Seller and their agent represent that the information herein is true and correct to the best of their knowledge as of the date signed by Seller and Seller's Agent.

☐ Seller and their agent acknowledge that they have exercised good faith in the selection of a third-party report provider as required in Civil Code Section 1103.7, and that the representations made in this Natural Hazard Disclosure Statement are based upon information provided by the independent third-party disclosure provider as a substituted disclosure pursuant to Civil Code Section 1103.4. Neither Seller nor their agent has independently verified the information contained in this statement and report or is personally aware of any errors or inaccuracies in the information contained on the statement. This statement was prepared by

Third-Party Disclosure Provider_____ Date _____

Date:_____, 20_____	Date:_____, 20_____
Seller: _____	Seller's Broker:_____
Seller: _____	Agent: _____

Buyer represents that he has read and understands this document. Pursuant to Civil Code Section 1103.8, the representations made in this Natural Hazard Disclosure Statement do not constitute all of Seller's or Seller's Agent's disclosure obligations in this transaction.

Buyer:_____ Date: _____

Buyer:_____ Date: _____

Actual use of the form NHD Statement by sellers and their agents is **mandated** on the sale of **one-to-four unit residential properties**, called *targeted properties*. While some sellers of targeted properties are excluded from mandatory use of the form, their listing agents are not. Thus, the form, filled out and signed by the seller and the listing agent, must be included in listing packages handed to prospective EP investors on every one-to-four unit residential property.

Editor's note — Any attempt by a seller or listing agent to use an "as-is" provision or otherwise provide for a buyer to agree to waive his right to receive an NHD statement signed by the seller is void as against public policy. [CC §1103(d)]

Regarding sales of property other than one-to-four unit residential property, use of the statutory NHD Statement is **optional**. However, regardless of the form used, delivery of the information is *not* optional. A natural hazard disclosure is mandated on all types of property. [CC §1103.1(b)]

All sellers, and any listing or selling agent involved, have an initial common law duty owed to prospective buyers to disclose conditions of a property that are **known to them** and might adversely affect the EP investor's willingness to buy or influence the price and terms of payment he is willing to offer.

Natural hazards, or the lack thereof, irrefutably affect a property's value and desirability. If a hazard is known to the seller or his agent or noted in public records, the hazard must be disclosed to prospective buyers before they agree to purchase the property. If not disclosed, the buyer can cancel the transaction, called *termination*. If the transaction has closed escrow, the buyer may *rescind* the sale and be **refunded** his investment, called *restoration*. [**Karoutas** v. **HomeFed Bank** (1991) 232 CA3d 767]

The NHD is to be prepared, signed, and available for delivery to prospective buyers before the seller accepts an offer or makes a counteroffer, requisites to the requirement that the NHD be delivered to the prospective buyer *as soon as practicable*. [Calif. Attorney General Opinion 01-406 (August 24, 2001); CC §1103.3(a)(2)]

Investigating the existence of a hazard

Natural hazard information is available from public records. To obtain the natural hazard information for delivery to the EP investors, the seller-in-foreclosure and his listing agent are required to exercise *ordinary care* in gathering the information. They may gather the information themselves or the seller may employ an NHD expert to gather the information. The expert then prepares the NHD form for the seller and the listing agent to review, add any comments, sign, and deliver to the EP investor. [CC §1103.4(a)]

For the seller-in-foreclosure and the listing agent to rely on an NHD report prepared by others, the listing agent need only:

- **request** an NHD report from a reliable expert in natural hazards, such as an engineer or a geologist who has studied the public records (as some natural hazards clearly do not pertain to engineering or geology);
- **review** the NHD form prepared by the expert and **enter** any actual knowledge the seller or listing agent may possess, whether contrary or supplemental to the expert's report, on the form prepared by the expert or in an addendum attached to the form; and
- **sign** the NHD Statement provided by his NHD expert and **deliver** it with the NHD report to the EP investor. [CC §1103.2(f)(2)]

When prepared by an NHD expert, the NHD report must also note whether the listed property is located within two miles of an existing or proposed airport, an environmental hazard zone called an *airport influence area* or *airport referral area*. Property within the influence of an airport facility may be affected by noise and use restrictions, now or later, which may be imposed on the EP investor's uses as set by the airport's land-use commission. [CC §1103.4(c)(1)]

Also, the expert's report must note whether the property is located within the jurisdiction of the San Francisco Bay conservation and development commission.

Broker's use of expert limits liability

The NHD scheme encourages brokers and their agents to use a natural hazard expert since, by statute, neither the seller-in-foreclosure nor any agent in the transaction is liable for the erroneous preparation of an NHD Statement they have delivered to the EP investor, if:

- the NHD report and form is prepared by an **expert in natural hazards**, consistent with his professional licensing and expertise; and
- the seller and listing agent used **ordinary care** in selecting the expert and in their review of the expert's report for any errors, inaccuracies, and omissions of which they have **actual knowledge**. [CC §§1103.4(a), 1103.4(b)]

The seller and the listing agent need not enter into an *indemnification agreement* with the natural hazard expert to avoid liability for errors. However, if brokers are sued based on the inaccuracy of the expert's report, an indemnity agreement entered into by the expert, given in exchange for the request to prepare a natural hazard report, will cover the cost of any litigation that might unnecessarily haul the uninsured broker into court. [See **first tuesday** Form 131]

The listing agent's dilatory delivery of an expert's NHD to the EP investor after the offer has been accepted will not protect the broker from liability for the EP investor's lost property value due to the nondisclosure before acceptance. If the agent **knew or should have known** of a natural hazard based on the readily available local planning department's parcel list, he is exposed to liability. Liability exposure

includes costs the EP investor may incur to correct or remedy the undisclosed hazardous condition and the dollar amount of the price agreed to that exceeds the property's fair market value when taking the undisclosed hazard into consideration. [CC §1103.13]

Further, the seller's agents and the expert who originally prepared the NHD are not exposed to liability from others affiliated with the transaction, such as lenders or insurers, who might receive the erroneous NHD Statement and rely on it to analyze the risk they undertake by their involvement. [CC §1103.2(g)]

Documenting compliance with NHD law

Compliance by the seller-in-foreclosure and listing agent to deliver the NHD Statement to the EP investor is required to be documented by a provision in the purchase agreement. [CC §1103.3(b); see **first tuesday** Form 156 §12.5]

However, should the seller or the listing agent fail to provide the investor with an NHD before entering into the EP agreement, the seller is statutorily penalized for the untimely disclosure in escrow. The EP investor, on an **in-escrow disclosure**, is allowed either a three-day right of cancellation should he be handed the NHD Statement, or a five-day right of cancellation should the NHD Statement be mailed to the investor. [CC §1103.3(c)]

Further, delivery of the NHD after acceptance of an offer imposes liability on the seller and listing agent. Liability is based on any money losses (including a reduced property value) inflicted on the EP investor by the disclosure should the EP investor choose not to exercise his right to cancel and instead perform on the agreement and close escrow. [CC §1103.13; **Jue** v. **Smiser** (1994) 23 CA4th 312]

Delivery of the NHD to the EP investor

If the EP investor has a selling agent, the selling agent has the duty to hand the EP investor the NHD Statement received from the seller or the listing agent, called *delivery*. [CC §1103.12(a)]

The **EP investor's agent**, on receiving the NHD form from the listing agent, owes the EP investor a special agency duty to care for and protect his EP investor's best interest by reviewing the NHD Statement himself for any disclosure that might affect the property's value or desirability. The EP investor's agent is then required to deliver the NHD to the EP investor and make any recommendations or explanations the EP investor's agent may have regarding the consequence of its content. [CC §§1103.2, 1103.12]

If the EP investor does not have a broker, the seller-in-foreclosure's agent is responsible for delivering the NHD Statement to the investor.

However, the listing agent is not required to understand the effect hazards have on the property or the EP investor. Also, the listing agent has absolutely no duty to voluntarily explain to a prospective EP investor the effect a known natural hazard (which is itself disclosed) might have on the property or the EP investor. The task of voluntarily explaining the consequence of living with a natural hazard is the duty of a EP investor's agent.

Delivery may be in person or by mail. Also, delivery is considered to have been made if the NHD is received by the spouse of the EP investor. [CC §1103.10]

Sellers-in-foreclosure acting as FSBOs are responsible for preparing or obtaining and signing an NHD statement and delivering the NHD Statement to the prospective EP investor.

No warranty, just awareness

A seller-in-foreclosure's NHD Statement is **not a warranty or guarantee** by the seller-in-foreclosure or listing agent of the natural hazards affecting the property. The NHD Statement is a report of the seller-in-foreclosure's and listing agent's (or the NHD expert's) knowledge (actual and constructive) of any natural hazards affecting the property.

However, the NHD Statement may be relied on by the EP investor. The NHD is designed to assist in the decision to buy the property, and at what price and on what terms. These conditions all need to exist before entering into a purchase agreement to avoid misleading the EP investor, called *deceit*. [AG Opin. 01-406]

Disclosures concerning the value and desirability of a property, such as an NHD Statement, contain **price-sensitive information**. Thus, the statement must be delivered to the investor before he enters into a purchase agreement in order to accomplish the legislatively intended result of the disclosure. If not timely disclosed, the seller and listing agent subject themselves to claims for price adjustments (offsets) that may be made by the investor either before or after closing. Alternatively, the investor may cancel the purchase agreement and have his deposit refunded.

Good brokerage practice is to deliver the NHD to a prospective buyer before he makes an offer or accepts a counteroffer, while he is still considering pricing and the terms of purchase. Disclosures should not be delayed until later when the investor is under contract to buy and entitled to ownership of the property at the price and on the terms agreed.

If properly prepared, the investor's offer in an EP agreement will include a copy of the seller's NHD Statement as an addendum (along with all other disclosures), noting the transaction is in compliance with NHD law.

As for an **escrow officer** handling a sale in which the listing agent fails to provide the investor with the NHD prior to opening escrow, the escrow officer has no duty to the seller or investor to prepare, order out, or deliver the NHD to the investor. The obligation remains that of the seller and listing agent. However, escrow may accept instruction to perform any of these activities, in which case escrow becomes obligated to follow the NHD instructions agreed to by the escrow officer. [CC §1103.11]

Other disclosure statements distinguished

The NHD Statement handed to a prospective EP investor of one-to-four unit residential property is an additional disclosure unrelated to the environmental hazards and physical deficiencies in the soil or improvements located on or about a property that are presented in the Transfer Disclosure Statement (TDS) or the purchase agreement. [See **first tuesday** Form 304 §C(1)]

The TDS discloses health risks resulting from **man-made** physical and environmental conditions affecting the use of the property. They are limited to facts known to the seller and listing agent without concern for a review of public records on the property at the planning department or elsewhere. The NHD Statement discloses risks to life and property that exist **in nature** due to the property's location and are known and readily available from the public records.

Editor's note — The following discussion details the different hazards that must be disclosed on the NHD Statement.

Flood zones

Investigating flood problems was facilitated by the passage of the National Flood Insurance Act (NFIA) of 1968.

The NFIA established a means for property owners to obtain flood insurance with the National Flood Insurance Program (NFIP).

The Federal Emergency Management Agency (FEMA) is the administrative entity created to police the NFIP by investigating and mapping regions susceptible to flooding.

Any flood zone designated with the letter "A" or "V" is a *special flood hazard area* and must be disclosed as a natural hazard on the NHD Statement. [See Form 314 §1]

Zones "A" and "V" both correspond with areas with a 1% chance of flooding in any given year, called 100-year floodplains, e.g., a structure located within a special flood hazard area shown on an NFIP map has a 26% chance of suffering flood damage during the term of a 30-year mortgage.

However, Zone "V" is subject to additional storm wave hazards.

Both zones are subject to mandatory flood insurance purchase requirements.

Information about flood hazard areas and zones can come from:

- city/county planners and engineers;
- county flood control offices;
- local or regional FEMA offices; or
- the U.S. Corps of Engineers.

Additional information concerning flood hazard areas can be obtained in the Community Status Book. The book lists communities and counties participating in the NFIP and the effective dates of the current flood hazard maps available from FEMA.

The Community Status Book can be obtained via the web at www.fema.gov/fema/csb.shtm.

Flood Insurance Rate Maps and Flood Hazard Boundary Maps are all available at the FEMA Flood Map store by calling (800) 358-9616 or via the web at: msc.fema.gov.

Another flooding disclosure that must be made on the NHD Statement arises when the property is located in an area of **potential flooding**. [See Form 314 §2]

An area of potential flooding is a location subject to partial flooding if sudden or total **dam failure** occurs. The inundation maps showing the areas of potential flooding due to dam failure are prepared by the California Emergency Management Agency. [Calif. Government Code §8589.5(a)]

Once alerted by the listing agent to the existence of a flooding condition, the EP investor or his agent must inquire further to learn the significance of the disclosure.

Very high fire hazard severity zone

Areas in the state that are subject to significant fire hazards have been identified as *very high fire hazard severity zones*. If a property is located in a very high fire hazard severity zone, a disclosure must be made to the prospective EP investor. [See Form 314 §3]

The city, county, or district responsible for providing fire protection have designated, by ordinance, very high fire hazard severity zones within their jurisdiction. [Gov C §51179]

The fire hazard disclosure on the NHD form mentions the need to maintain the property. Neither the seller-in-foreclosure nor the listing agent need to explain the nature of the maintenance required or its burden on ownership. Advice to the EP investor on the type of maintenance and the consequences of owning property subject to the maintenance are the duties of the EP investor or his agent.

For example, an EP investor acquiring a residence located in a very high fire hazard severity zone must:

- maintain a firebreak around the structure of a distance of no less than 100 feet on each side of the property or up to the property line, whichever is nearer, unless the local agency allows and/or requires more;
- remove tree branches extending within 10 feet of any chimney or stovepipe;
- clear dead or dying wood from trees, shrubs, or plants adjacent to or overhanging the structure;
- remove leaves, needles or other dead vegetative material from the roof; and
- maintain a screen over the chimney or stovepipe. [Gov C §51182]

State Fire Responsibility Areas

If a property is in an area where the financial responsibility for preventing or suppressing fires is primarily on the state, the real estate is located within a *State Fire Responsibility Area*. [Calif. Public Resources Code §4125(a)]

Notices identifying the location of the map designating State Fire Responsibility Areas are posted at the offices of the county recorder, county assessor, and the county planning agency. Also, any information received by the county after receipt of a map changing the State Fire Responsibility Areas in the county must be posted. [Pub Res C §4125(c)]

If the property is located within a **wildland area** exposed to substantial forest fire risks, the seller-in-foreclosure or his listing agent must disclose this fact. Property located in a wildland area requires maintenance by the owner to prevent fires. [Pub Res C §4136(a); see Form 314 §4]

In addition, the NHD Statement advises the investor the property is located in a **wildland area** and that the **state has no responsibility** for providing fire protection services to the property, unless the Department of Forestry and Fire Protection has entered into a cooperative agreement with the local agency. No further disclosure about whether a cooperating agreement exists need be made by the seller or listing agent. [See Form 314 §4]

However, if property disclosures place the property in a wildland area, the EP investor or his agent needs to inquire and investigate into what agency provides fire protection to the property.

Earthquake fault zones

To assist the seller's agent or the expert preparing the NHD in identifying whether the listed property is located in an earthquake fault area, maps have been prepared by the State Geologist.

The State Mining and Geology Board and the city or county planning department have maps available that identify special studies zones, called *Alquist-Priolo Maps*. [Pub Res C §2622]

The maps are used to identify whether the listed property is located within one-eighth of a mile of a fault.

Also, the NHD Statement requires both the seller and the listing agent to disclose to the investor whether they have knowledge the property is in a fault zone. [See Form 314 §5]

Seismic hazards

A *Seismic Hazard Zone* map identifies areas that are exposed to earthquake hazards, such as:

- strong ground shaking;
- ground failure, such as liquefaction or landslides [Pub Res C §2692(a)];

- tsunamis [Pub Res C §2692.1]; or
- dam failures. [Pub Res C §2692(c)]

If the property for sale is susceptible to any of the earthquake (seismic) hazards, the seismic hazard zone disclosure on the NHD Statement must be marked "Yes." [See Form 314 §6]

Seismic hazard maps are not available for all areas of California. Also, seismic hazard maps do not show Alquist-Priolo Earthquake Fault Zones. The California Department of Conservation creates the seismic hazards maps.

The seismic hazard maps that exist are on the web at www.conservation.ca.gov/cgs/shzp/Pages/Index.aspx.

If the NHD indicates a seismic hazard, the EP investor or his agent must then determine which type of seismic hazard exists, the level of that hazard, and the distinctions. The listing agent has no obligation to voluntarily explain his disclosure to the EP investor, but must respond honestly to an inquiry.

For example, property located in Seismic Zone 4 is more susceptible to **strong ground shaking** than areas in Zone 3. But which zone the property is located in is a question the EP investor or his agent must answer. Most of California is in Zone 4, except for the southwest areas of San Diego County, eastern Riverside and San Bernardino Counties, and most of the Northern California Sierra Counties.

Homes in Zone 4 can be damaged even from earthquakes that occur a great distance away.

Ground failure is a seismic hazard that refers to landslides and liquefaction. Liquefaction occurs when loose, wet, sandy soil loses its strength during ground shaking. Liquefaction causes the foundation of the house to sink or become displaced. The condition is prevalent in tidal basins that are fills.

A **tsunami** is a large wave caused by an earthquake, volcanic eruption, or underwater landslide. Coastal areas are at risk for loss of property and life in the event of a tsunami.

Tsunami inundation maps are available from the National Oceanic and Atmospheric Administration (NOAA) led National Tsunami Hazard Mitigation Program (NTHMP) at: www.pmel.noaa.gov/tsunami-hazard.

FEMA's Flood Insurance maps also consider tsunami wave heights for Pacific coast areas.

Dam failure results in flooding when an earthquake causes a dam that serves as a reservoir to rupture. The city or county planning department has maps showing areas that will be flooded if a local dam fails.

Areas susceptible to inundation due to dam failure caused by an earthquake are also noted on the NHD Statement as a potential flooding area.

Chapter 9 Property operating data investigation

This chapter advises equity purchase (EP) investors to evaluate an owner-occupied residential property in foreclosure based on expenses and rent generated by ownership of the property.

Profiling a property by its expenses

On acquiring a single-family residential property, the buyer will either:

- **retain ownership** and occupy the property or rent it to a tenant; or
- **flip ownership on a resale** to another buyer who will occupy the property or rent it to a tenant.

When acquiring a property, the buyer will pay or cause tenants to pay the monthly expenses incurred to maintain and occupy the property. The buyer who occupies the property as his residence will pay all of these expenses. The tenant who leases the property from the buyer will directly or indirectly pay all these operating costs; those paid directly will be paid in addition to rent owed, those paid indirectly will be paid by the landlord from the rent.

All expenditure for the costs of maintaining a property and expenses of occupying and using it are known to the seller of every property sold. These maintenance costs and occupancy expenses affect a property's value, be the costs low and advantageous, high and adverse, or neutral in effect when weighed against the costs and expenses of owning and occupying comparable properties. Thus, costs and expenses have an impact and must be gathered and analyzed as guidance to establishing a property's:

- present value;
- rental rate; and
- resale value.

Logically, a prudent investor acquiring a residence in foreclosure should request that the seller provide him with the information before he makes an offer to buy the property, as should well-advised buyers of any property. When making the request for the seller-in-foreclosure to disclose the monthly costs and expenses of ownership and occupancy (exclusive of loan information), the EP investor should hand the seller a Property Expense Profile sheet to fill out and return to the investor. [See Form 306 accompanying this chapter]

Duties owed the EP investor

A listing agent owes a *general duty* to a prospective buyer of any property to gather and present readily available data on the costs and expenses the buyer will experience on acquiring the listed property. These data are components of ownership obligations and may adversely affect the property's value. Thus, they might influence a buyer's decision about his purchase of the property.

The **property operating data** submitted to the buyer by a listing agent can be relied on and need not be investigated for their accuracy by the investor, unless it is noted to be a forecast. However, estimates involve reasonableness and require a high degree of accuracy as they cannot be the product of conjecture.

In turn, the duty of care a buyer owes to himself when he does not have an agent to advise him requires the buyer to review the skeletal property operating data received from the seller and listing agent. From the data he must determine what inquiry or investigation is needed to understand and appreciate the ramifications of the data disclosed.

In essence, the seller's listing agent literally hands off to the EP investor the decision of which points raised by the operating figures need to be checked out to get a better picture of the property's ongoing costs and expenses he will incur on his acquisition of ownership.

The monthly operating expense data are one basis for comparing different available properties and their respective values with the seller's property. Comparison allows the EP investor to select the best overall value.

Prior to December 2007, a broker's participation in negotiating on behalf of the EP investor was (and will, in the future, most likely become again) effectively eliminated by EP statutes due to broker bonding requirements.

But a broker could be hired by the EP investor to independently advise him on a particular property. Bonding requirements, past and future, for investment brokers will dissuade these brokers from also acting on behalf of the EP investor and directly negotiating with the seller-in-foreclosure or the seller's broker. [See Chapter 3]

Thus, an investor who wants an operating analysis of a property he is considering for purchase has the burden of investigating and completing or confirming the numbers on the operating expense form himself. Alternatively, he could hire a broker to investigate and analyze the operating costs without interfacing with the seller or listing agent. [**Kendall** v. **Ernest Pestana, Inc.** (1985) 40 C3d 488]

However, while the seller-in-foreclosure will know the costs and expenses incurred to own and occupy the property, he may not know about the property's possible rental income rate, data needed by an EP investor to analyze the property as a long-term investment. A seller who provides *good faith estimates* about the property's operating potential as a rental cannot be held liable for inaccuracies as long as the estimated figures are labeled as "estimates." [Calif. Civil Code §1102.5]

Seller's good-faith assistance

To assist a listing agent in marshalling information about a property's operations for the preparation of an operating expense statement to be handed to prospective buyers, the seller must, *in good faith*, provide the listing agent with the costs and expenses he is incurring as the owner.

A seller, having employed a listing agent to market his property and locate a buyer willing to pay the listed price, owes a duty to the listing agent to make a good-faith effort to cooperate and assist the agent in meeting the objectives of the employment. Otherwise, the seller *wrongfully interferes* with the agent's ability to successfully market the property (and earn a fee). Without accurate ownership expense data, property cannot be honestly marketed to prospective buyers.

In turn, the listing agent's duty is to deliver to his seller the best business advantage **legally achievable**. This duty is tempered by the listing agent's *general duty* owed to prospective buyers to provide them with accurate factual information, e.g., reasonable operating estimates, about the integrity of the property that may adversely affect the value of the property, and do so before the buyer enters into a purchase agreement.

To meet this affirmative disclosure duty owed prospective buyers, the listing agent must provide prospective buyers or their agents with information **known or readily available** to the seller or listing agent about the operations of the property that **might affect** the decisions of a reasonably prudent buyer regarding acquisition of the property. As a result, the listing agent must present known facts to a prospective buyer in a manner that will not mislead or deceive the buyer. He must not omit known factors that adversely affect the property's value.

If the seller is the source of the property's operating cost and expense data entered on the operating expense sheet and no reason exists for the listing agent to believe the data is false, the listing agent has

PROPERTY EXPENSE PROFILE

DATE: _____, 20_____, at _____, California.

Prospective Buyer _____

1. PROPERTY TYPE _____

1.1 Location _____

1.2 Expense figures are estimates reflecting:

a. ☐ current expenses of occupancy.

b. ☐ forecast of anticipated expenses of occupancy.

2. MONTHLY OPERATING EXPENSES:

2.1 Electricity . . . . . $_____

2.2 Gas. . . . . $_____

2.3 Water . . . . . $_____

2.4 CATV . . . . . $_____

2.5 Phone . . . . . $_____

2.6 Rubbish . . . . . $_____

2.7 Sewage. . . . . $_____

2.8 Insurance _____. . . . . $_____

2.9 Taxes _____. . . . . $_____

2.10 General obligation bonds . . . . . $_____

2.11 Lawn/Gardening . . . . . $_____

2.12 Pool/Spa . . . . . $_____

2.13 Homeowners' Association (HOA) . . . . . $_____

2.14 Maintenance and repair . . . . . $_____

2.15 Other _____ . . . . . $_____

2.16 **Total Operating Expenses**. . . . . $_____

2.17 Monthly Loan Payment . . . . . $_____

2.18 **Total Monthly Expenses** . . . . . $_____

3. DEPOSITS:

3.1 Rental Security Deposit . . . . . $_____

3.2 Electricity Deposit . . . . . $_____

3.3 Water Deposit . . . . . $_____

3.4 Sewage and Rubbish Deposit. . . . . $_____

3.5 Gas Service Deposit . . . . . $_____

3.6 Phone Service Deposit. . . . . $_____

3.7 Other _____ . . . . . $_____

3.8 **Total Deposits**. . . . . $_____

OWNER: I have read and approve this information.

Date_____, 20_____

Owner's Name _____

Signature _____

Date Prepared: _____, 20_____

Broker:_____

Agent: _____

Phone: _____, Cell: _____

Fax: _____

Email: _____

PROSPECTIVE BUYER:
I have received and read a copy of this estimate.

Date: _____, 20_____

Name: _____

Signature: _____

Name: _____

Signature: _____

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no duty to prospective buyers to investigate the truthfulness (accuracy) of the information. However, for the agent to avoid liability for erroneous data obtained from others, the **source of the data** must be disclosed.

Estimating rental income

Residential properties controlled by EP statutes include properties containing one-to-four residential units, **one of which is occupied** as the seller-in-foreclosure's principal residence.

With a multi-family income property, the income producing capacity of the property is established by:

- the **scheduled rental income** for each rented unit;
- the market rental rate for the unit occupied by the seller-in-foreclosure; and
- the uncollectible portion of the scheduled rents based on prospective vacancies and nonpayment of rent, called a **vacancy factor**.

For the seller-occupied unit, its scheduled rental income must be estimated based on the rental rates charged for comparable properties in the area. As always, the EP investor or his broker must do some investigation into the rental rates charged by landlords of comparable units.

The EP investor should be warned: *estimated, anticipated, forecasted, or projected rental income* and expense figures provided by most listing brokers are highly suspect due to generally negligent guesswork in their preparation. However, the EP investor cannot hold the seller-in-foreclosure or the seller's broker liable for estimates made in good faith and based upon the best possible information when they later prove to be erroneous. [CC §1102.5]

The seller-occupied unit in a triplex or fourplex structure is typically grander in proportion and usually contains better amenities than those found in other units. The upgraded seller-occupied unit typically will not command a rent that is pro rata to the size/square footage of the other units, a condition called *over-built*. Thus, the estimates of rental income scheduled for the upgraded seller-occupied unit must be viewed with some suspicion. Comparable units for setting the rent should be of same size and occupancy design.

Completing the APOD

After the EP investor receives the property's income and expense information and confirms or prepares the annual property operating data (APOD) sheet, he can calculate expenses as a percentage of rental income to reveal the property's cost-effectiveness as compared to other like-type properties. [See Form 352 accompanying this chapter]

Expenses, as a percentage of scheduled income, are calculated on the APOD in the column to the right of the dollar amount. Percentages are obtained by dividing each expense item by 100% of the scheduled income.

Percentages calculated for each operating expense alert the EP investor to costs that vary from a standard cost range used for income property analysis.

For example, if the percentage allocated to utility expenses is abnormally large compared to other units, this cost should be evaluated to determine:

- what can be done, if anything, to bring the utility expenses within the normal percentage range; and
- what effect the expense has on the value of the property based on its **net operating income** (NOI).

ANNUAL PROPERTY OPERATING DATA SHEET
APOD

DATE: _____, 20_____, at _____, California.

1. PROPERTY TYPE: _____

1.1 Location _____

1.2 APOD figures are estimates reflecting:

a. ☐ Current operating conditions.

b. ☐ Forecast of anticipated operations.

c. Prepared by _____

		%
2. INCOME:		
2.1 **Scheduled Rental Income**	$_____	100 %
a. Less: Vacancies, discounts and uncollectibles	– $_____	_____%
b. Less: Credit card charges	– $_____	_____%
2.2 **Effective Rental Income** [Lines 2.1 less 2.1 a and b]	$_____	_____%
a. Other income	+ $_____	_____%
2.3 **Gross Operating Income**	$_____	_____%
3. EXPENSES:		
3.1 Electricity	$_____	_____%
3.2 Gas	$_____	_____%
3.3 Water	$_____	_____%
3.4 Rubbish	$_____	_____%
3.5 Insurance	$_____	_____%
3.6 Taxes	$_____	_____%
3.7 Management Fee	$_____	_____%
3.8 Resident Manager	$_____	_____%
3.9 Office Expenses/Supplies	$_____	_____%
3.10 Advertising	$_____	_____%
3.11 Lawn/Gardening	$_____	_____%
3.12 Pool/Spa	$_____	_____%
3.13 Janitorial	$_____	_____%
3.14 Maintenance	$_____	_____%
3.15 Repairs and Replacements	$_____	_____%
3.16 CATV/Phone	$_____	_____%
3.17 Accounting/Legal Fees	$_____	_____%
3.18 _____	$_____	_____%
3.19 _____	$_____	_____%
3.20 **Total Operating Expense** [Lines 3.1 to 3.19]	– $_____	_____%
4. NET OPERATING INCOME: [Line 2.3 less 3.19]	$_____	_____%

— PAGE ONE OF TWO — FORM 352 —

— PAGE TWO OF TWO — FORM 352 —

5. SPENDABLE INCOME (annual projection): ⇧

5.1 **Net Operating Income** (enter from section 4) $_____ _____%

5.2

	Loan	Principal Balance Amount	Monthly Payment	Rate	Due Date
a.	1st	$_____	$_____	_____%	_____
b.	2nd	$_____	$_____	_____%	_____
c.	3rd	$_____	$_____	_____%	_____

5.3 Total Annual Debt Service [Lines 5.2 a, b and c] – $_____ _____%

5.4 **Spendable Income** [Lines 5.1 less 5.3] $_____ _____%

6. PROPERTY INFORMATION:

6.1 Price $_____; Loan amounts $_____; Owner's equity $_____.

6.2 Current vacancy rate or vacant space _____%.

6.3 Assessor's allocations for depreciation schedule:
Improvements _____%; Land _____%; Personal property _____%.

6.4 Property disclosures:

a. ☐ Rental Income Rent Roll available; [See **ft** Form 380] ☐ need confidentiality agreement.

b. ☐ Rent control restrictions.

c. ☐ Condition of improvements available: ☐ by owner [See **ft** Form 304-1], ☐ by inspector.

d. ☐ Environmental report available.

e. ☐ Natural Hazard Disclosure Statement available. [See **ft** Form 314]

f. ☐ Soil report available.

g. ☐ Termite report available.

h. ☐ Building specification available.

i. ☐ _____

j. ☐ _____

7. REPORTABLE INCOME/LOSS (annual projection): For Buyer to fill out.

7.1 **Net Operating Income** (NOI) (enter from section 4) $_____

7.2 Deductions from NOI

a. Annual interest expense $_____

b. Annual depreciation deduction $_____

c. Total deductions from NOI – $_____

7.3 **Reportable Income/Loss** (annual projection) $_____

Broker: _____
Address: _____
_____
Phone: _____ Cell: _____
Fax: _____
Email: _____

I have reviewed and approve this information.
Date: _____, 20_____
Owner's name: _____
Signature: _____
Signature: _____

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Subtracting the operating expenses from income calculates the NOI. The NOI represents the income used to determine the **property's value** *before* payments on the financing secured by the property or depreciation.

The NOI, when divided by the EP investor's desired annual yield — called the *capitalization rate* or "*cap rate*" of, say 99% — gives the EP investor an alternative basis for establishing the value of the property.

Loan payments

Loan payments entered on the APOD should only include the principal and interest payments, separated from any impounded (escrowed) funds collected by the lender with the principal and interest payment. Impounds are merely a **reserve** for some of the owner's operating expenses that will be paid through the lender from the impounded funds. Impounds paid are not a loan charge, they are the owner's operating expenses.

Impounds typically change on transfer of the property, primarily due to an increase in property taxes triggered by reassessment on a change of ownership. Calculate the increase in the impounds and enter the estimated future impound payment, not the seller-in-foreclosure's present impound payment.

The exact balances and terms of existing financing are forwarded to escrow in the *beneficiary statement* provided by the lender on request. Information from the beneficiary statement confirms the seller-in-foreclosure's representations of the loan amount, payments, interest impounds, and delinquencies. [See Chapter 20]

An *assumption* of the loan by the EP investor will likely include some modification of the loan payment schedule, particularly in a high or rising long-term interest rate market relative to the loan on the property. [See Chapter 16]

Other valuation considerations

In addition to the ongoing monthly ownership costs and occupancy expense information collected, the EP investor should consider other **facts affecting** the marketability of the property, including:

- the *physical condition* of the property's improvements and soil;
- *title conditions* and *zoning* use restrictions;
- the *area surrounding* the property location and the natural and environmental hazards of the location; and
- the *capital investment* required to own the property.

The EP investor should **physically inspect** the property for any deferred maintenance and rehabilitation costs. Additionally, a home inspector's investigation and report of the property condition helps avoid surprise discoveries after escrow closes. [See Chapters 6 and 7]

A **preliminary title report** will expose any recorded title problems, such as judgment liens, assessment bonds or easements.

Further, the EP investor should confirm with local agencies the uses allowed by the current zoning, as zoning affects the future income and expenses of the property. [See Chapter 10]

In addition to all the various property analyses, an EP investor who intends to flip the property for a profit should prepare a **capital cost analysis** of the residence he is considering acquiring to ensure the property's economic feasibility as a profitable investment. [See **first tuesday** Form 365]

Chapter 10 Preliminary title reports

This chapter examines the use of a preliminary title report by an equity purchase (EP) investor to review the condition of title and eliminate contingency provisions, and by escrow to prepare closing documents.

An offer to issue title insurance

An investor enters into an equity purchase (EP) agreement to acquire a one-to-four unit residential property that is the seller's principal residence. The property is encumbered by a trust deed and a notice of default has been recorded.

Closing of the transaction is contingent on the investor's receipt and review of a preliminary title report, commonly called a *prelim*. He wants to confirm the property is subject only to the liens disclosed by the seller before he proceeds further with his due diligence investigation.

Any taxes or monetary liens of record not disclosed in the EP agreement are to remain of record. However, the amount of any undisclosed lien will be deducted from the cash down payment. [See **first tuesday** Form 156 §13.3]

Escrow is instructed to order a prelim from a title insurance company for approval of the condition of title by the investor. To keep acquisition costs at a minimum, escrow is also instructed to close without obtaining a policy of title insurance. As a result, the escrow office attaches an advisory notice to the instructions as mandated to warn that title insurance is necessary to ensure the buyer's interest. [Civil Code §1057.6; see **first tuesday** Form 401-1]

The prelim received by escrow indicates the title is clear of all encumbrances, except those disclosed by the seller. Believing the title condition is as represented by the seller, the investor waives the further-approval contingency regarding approval of the prelim. Escrow closes on receiving a "date-down" on the prelim from the title company — without the issuance of an abstract or policy of title insurance.

However, the preliminary title report failed to disclose a recorded abstract of judgment that had attached to title as a judgment lien. Later, the judgment creditor enforces his judgment lien by commencing a foreclosure on the property. The investor makes a demand on the seller to pay the judgment and obtain a release of the lien, but the seller rejects the demand.

The investor then clears title of the lien and makes a demand on the title company for the amount of the payoff since he relied on their erroneously prepared prelim. The investor claims the title company is liable for his losses since it failed to disclose the judgment lien on the preliminary title report, a negligent misrepresentation of title.

Can an investor, escrow officer, or agent rely on the preliminary title report as assurance the title condition is "as represented" in the report?

No! A preliminary title report is not a representation of the condition of title. Unlike an *abstract of title* issued by a title company, a prelim cannot be relied on by anyone. A title insurer has no duty to accurately report title defects and encumbrances on the preliminary title report (as exceptions in the proposed policy). [**Siegel** v. **Fidelity National Title Insurance Company** (1996) 46 CA4th 1181]

A preliminary title report prepared by a title insurance company is no more than a conditional **offer to issue** a title insurance policy based on the terms and conditions stated in the prelim. The offer is subject to any modifications later made by the title company before the policy is issued, and thus is a very conditional offer. [Calif. Insurance Code §12340.11]

Use of the prelim

A preliminary title report discloses the current vesting, including general and special taxes, assessments and bonds, covenants, conditions and restrictions (CC&Rs), easements, rights of way, liens, and any interests of others that may be reflected on the public record as affecting title, collectively called *encumbrances*.

The closing of the purchase escrow should be conditioned on the investor's approval of the prelim. The investor, real estate agent, and escrow officer review the report on its receipt for encumbrances on title inconsistent with the terms for the seller's delivery of title as stated in the EP agreement and escrow instructions.

Also, agents are looking for title conditions that might interfere with any **intended use or change in the use** of the property known to be contemplated by the investor. Interferences could be in the form of unusual easements or use restrictions obstructing the investor's announced plans to add improvements.

Finally, escrow relies on the preliminary report to carry out its instructions to record grant deeds, trust deeds, leaseholds, or options that will be insured.

Escrow instructions typically call for closing when the deed can be **recorded and insured**, subject only to taxes, CC&Rs, and other encumbrances specified in the instructions such as a loan.

Ultimately, it is the escrow officer who, on review of the prelim, must advise the seller of any need to eliminate encumbrances on title that will interfere with closing as instructed.

The prelim and a last-minute *date-down* of title conditions are used by escrow to reveal any additional title problems to be eliminated before closing and, as instructed, obtain title insurance for the documents being recorded.

Should the date-down of the prelim reveal encumbrances not previously reported in the prelim, either due to error or a later recording, the title company can **withdraw its offer** and issue a new prelim — a different offer to issue a policy that will include the recently discovered encumbrances, unless removed.

Prelim vs. abstract of title

Title companies have long been aware of the public's reliance on the prelim. This reliance was consistently reinforced by the California courts holding title insurers liable for their erroneous reports. However, in 1981 legislation drafted by the title insurance industry and enacted into law eliminated liability for their faulty preparation of preliminary title reports.

Prelims were once compared to abstracts of title. An *abstract of title* is a written statement that may be relied on by those who order them as an accurate, factual representation of title to the property being acquired, encumbered, or leased. [Ins C §12340.10]

An abstract of title is a **statement of facts** collected from the public records. An abstract is not an insurance policy and does not have a dollar limit on the title company's liability for indemnity. Since the content of an abstract is intended by the insurance company to be relied upon **as fact**, the insurer is liable for all money losses of the policy holder flowing from its failure to properly prepare the abstract. Not so under a policy of title insurance, which limits the dollar recovery to policy limits. [**1119 Delaware** v. **Continental Land Title Company** (1993) 16 CA4th 992]

To shield title companies from an *abstractor's liability* on the issuance of a defectively prepared prelim, the prelim is now defined as being neither an abstract of title nor a representation of the condition of title. The prelim is a report furnished in connection with a buyer's **application** for title insurance. [Ins C §12340.11]

Chapter 11 Title insurance coverage

This chapter discusses the risks covered by title insurance under the different types of policies available to the equity purchase (EP) investor.

Identifying a recoverable loss

A policy of title insurance is the means by which a title insurance company *indemnifies* — reimburses or holds harmless — a person who acquires an interest in real estate against a monetary loss caused by an **encumbrance on title** that:

- is not listed in the policy as an *exception*; and
- the insured was unaware of when the policy was issued. [Calif. Insurance Code §12340.1]

A policy of title insurance is issued on one of several forms, which are the prototypes used by the entire title insurance industry in California. The policies are typically issued to **buyers** of the fee simple interest in real estate, **tenants** acquiring long-term leases on real estate, and **lenders** whose loans are secured by real estate.

A title policy is a contract since it is an **indemnity agreement**. The terms of coverage in the policy set forth the extent of the title insurance company's obligation, if any, to indemnify the named insured for a *money loss* caused by an **encumbrance on title** that is not listed in the policy's exceptions. [Ins C §12340.2]

An insured lender or buyer cannot recover a **loss of profits** caused by an unlisted defect in title as lost profits are not covered by title insurance. The title policy only indemnifies the insured against a **reduction in the value** of the property below the policy limits, not a reduction in future profits on either a foreclosure or resale of the property. [**Karl** v. **Commonwealth Land Title Insurance Company** (1993) 20 CA4th 972]

Encumbrances unknown, undisclosed

Almost all losses due to the reduction in value of real estate below the policy limits arise out of an encumbrance. An encumbrance is any condition that affects the ownership interest of the insured, whether the interest insured is a fee, leasehold, life estate, or the security interest of a lender.

The word encumbrance is all-encompassing. Any right or interest in real estate held by someone other than the owner that diminishes the value of the real estate is an encumbrance.

Encumbrances on title include:

- covenants restricting use;
- restrictions on use;
- reservations of a right of way;
- easements;
- encroachments;
- trust deeds or other security devices;
- pendency of condemnation; and
- leases. [**Evans** v. **Faught** (1965) 231 CA2d 698]

Use of property not covered

Physical conditions on the property itself are not encumbrances affecting title, they are existing uses affecting ownership. Uses that exist and are visible (open and notorious) as physical features on the property include:

- canals;
- highways;
- irrigation ditches; and
- levees.

Accordingly, title policies do not insure against observable physical conditions existing on the property. Observable physical conditions are not encumbrances, although they may be authorized by an encumbrance on title, such as an easement. A buyer is always presumed to have contracted to acquire property subject to physical conditions on the property that impede its use or impair its value. In the case of encumbrances, recorded or not, no such presumption knowledge exists.

Consider an EP investor who under an EP agreement contracts to acquire title free of all encumbrances except those agreed to in the purchase agreement. Even if the investor is on notice of an encumbrance affecting title and he has not agreed in the purchase agreement to take title subject to the encumbrance, the seller is responsible for its removal, extinguishment, or compensation.

However, for title insurance purposes only, the buyer/investor's knowledge of an encumbrance affecting title at the time of closing **removes the known encumbrance** from coverage even if it is not listed as an exception. Thus, the insured buyer assumes the risk of loss due to the known encumbrance, but only as to the title insurer, not the seller.

Lost profits recovered, not lost profits

A title insurance policy is not an *abstract of title*. Thus, a policy of title insurance does not *warrant* or *guarantee* the nonexistence of title encumbrances, as does an abstract. Instead, the insured is *indemnified*, up to the policy's dollar limits, against a money loss caused by a title condition not listed as an exception or known to the insured prior to issuance of the policy.

Under a title insurance policy, the title company only assumes (covers) the risks of a **monetary loss** caused by an encumbrance not listed as an exception to coverage, and unknown to the insured buyer or lender at the time of closing. The title company has no obligation to clear title of the encumbrance.

Consider an owner who discovers the size of an easement was understated in the title policy.

Due to the actual dimensions of the easement, the owner cannot develop the property as anticipated.

The owner makes a claim on the title company for the **lost value** of the property based on its potential for development as allowed by the understated easement, not for his loss of value on the price he paid for the property (which is the dollar amount of the title policy limits).

Instead, the title company only pays the owner an *inflation adjusted price* based on the price the owner paid for the property — an amount set by the policy limits and the inflation endorsement.

The owner claims the title company's *negligence* in the disclosure of the easement caused a loss in property value equal to the difference between the purchase price paid and the potential value of the property for development.

However, the title company is not liable under a policy for lost profits in the unrealized potential value of the property. It was the existence of the easement that caused the loss of profits, not the issuance of a title insurance policy. [**Barthels** v. **Santa Barbara Title Company** (1994) 28 CA4th 674]

Introduction to title policy forms

Title insurance is bought to assure real estate buyers, tenants, and lenders the **interest in title** they acquire is what they bargained for from the seller, landlord, or borrower. While title insurance is not a guarantee of the condition of title acquired, it does provide a **monetary recovery** up to the policy's dollar limits for the conveyance of any lesser interest than the interest insured.

On closing a real estate transaction, a policy of title insurance is issued on one of several forms used throughout the entire title insurance industry in California. The policies are typically issued to **buyers** of real estate, **tenants** acquiring long-term leases, and **lenders** whose loans are secured by real estate.

Two basic forms exist and are the industry prototypes for:

- insuring the condition of record title only, accomplished by the issuance of a *California Land Title Association (CLTA) policy*; and
- insuring both the record title conditions and observable on-site activities that affect title, accomplished by the issuance of an *American Land Title Association (ALTA) policy*.

In analysis, a **policy of title insurance** is broken down into six operative sections, including:

- the risks of **loss covered**, called *insuring clauses*, which are based on an unencumbered title at the time of the insured transfer;
- the risks of **loss not covered**, comprising encumbrances arising after the transfer or known to or brought about by the insured, called *exclusions*, which are a boilerplate set of title conditions;
- **identification** of the insured, the property, the vesting, the estate in the property, the dollar amount of the coverage, the premium paid, and the policy (recording) date for the conveyance insured, called *Schedule A*;
- the **recorded interests**, i.e., any encumbrances affecting title (and for an ALTA policy any observable on-site activities) that are **listed as risks** agreed to and assumed by the insured and not covered by the policy, called *exceptions*, which are pre-printed for CLTA coverage and itemized for all types of coverage in *Schedule B*;
- the **procedures**, called *conditions*, for **claims made** by the named insured and for *settlement* by the insurance company on the occurrence of a loss due to any encumbrance on title that is not an exclusion or exception to the coverage granted by the insuring clauses; and
- any **endorsements** for additional coverage or removal of exclusions or pre-printed exceptions from the policy.

Insuring clauses

The coverage under the broadly worded **insuring clauses** of a policy of title insurance indemnifies the named insured for risks of loss **related to the title** due to:

- anyone making a claim against title to the real estate interest;
- the title being unmarketable for sale or as security for financing;
- any encumbrance on the title; and
- lack of recorded access to and from the described property.

Exclusions from coverage

All title insurance policies, in the **exclusions section**, exclude from coverage those losses incurred by the insured buyer, tenant, or lender due to:

- **use ordinances** or zoning laws;
- **unrecorded claims known** to the insured, but not to the title company;
- encumbrances or adverse **claims created** or attached **after** the date of the policy;
- claims arising out of **bankruptcy** laws or due to a **fraudulent conveyance** to the insured;
- police power and **eminent domain**; and
- **post-closing events** caused by the insured.

Schedule A data

All policies of title insurance in their Schedule A set forth:

- the property interest the insured acquired (fee simple, leasehold, life estate, security, etc.);
- the legal description of the insured property;
- the date and time the insured conveyance or lien recorded and coverage began;
- the premium paid for the policy; and
- the maximum total dollar amount to be paid for all claims settled.

Exceptions to coverage

In addition to the policy exclusions, a policy's coverage under its "no-encumbrance" insuring clause is further limited by Schedule B exceptions in the policy. The **exceptions section** contains an itemized list of recorded and unrecorded encumbrances that are known to the title company and affect the insured title. While the existence of these known encumbrances are insured against in the insuring clauses, they are removed by Schedule B as a basis for recovery under the policy.

In addition to the itemized list of exceptions, a CLTA policy includes a set of **pre-printed exceptions** setting forth risks assumed by the insured buyer, tenant, or lender, which include:

- taxes, assessments, liens, covenants, conditions, and restrictions (CC&Rs), or any other interests, claims, or encumbrances that have not been recorded with the county recorder or tax collector on the date of closing;
- any unrecorded and observable on-site activity, including conflicts regarding boundary lines, encroachments, or any other facts that a correct survey would disclose;
- unpatented mining claims; and
- all water rights.

Claims and settlements

Lastly, a policy of title insurance includes a **conditions section** outlining the procedures the named insured must follow when making a claim for recovery under the policy. Also set forth are the settlement negotiations or legal actions available to the title company before they must pay a claim.

Owner's policies for buyers

Several types of title coverage are available for a buyer to choose from when entering into a purchase agreement with the seller, including:

- a CLTA standard policy;
- an ALTA owner's extended coverage policy;
- an ALTA residential (ALTA-R) policy; and
- an ALTA homeowner's policy.

When making an offer, a prospective buyer is informed by his agent about the coverage each type of policy provides. The buyer's need for title coverage must be reviewed when the buyer enters into a purchase agreement since the agreement's title insurance provision calls for the buyer to designate the type of title insurance policy on closing and states who will pay its premium. [See Figure 1 accompanying this chapter]

The CLTA standard policy

The CLTA standard policy is purchased solely by buyers, carryback sellers, and private lenders, not institutional lenders or builders who generally need extended coverage offered by an ALTA policy and endorsements.

The CLTA standard policy insures against all encumbrances affecting title to the property that can be discovered by a search of **public records** prior to issuance of the policy. Any encumbrance not recorded, whether or not observable by an **inspection or survey** of the property, is not covered due to the CLTA policy exclusions and standard exceptions.

Public records include those records imparting *constructive notice* of encumbrances affecting title to the property.

For example, a deed conveying a parcel of real estate that is actually **recorded and indexed** by the county recorder's office imparts constructive notice to buyers and lenders who later acquire an interest in the property. [Calif. Civil Code §1213]

Also, the CLTA standard policy (as well as the ALTA policy) protects the buyer against:

- the unmarketability of title or the inability to use it as security for financing;
- lack of ingress and egress rights to the property; and
- losses due to the ownership being vested in someone other than the buyer.

All title insurance policies provide coverage forever after the date and time the policy is issued, limited in recovery to the dollar amount of the policy, which is generally adjusted for inflation. Coverage is further limited by the **exclusions, exceptions, and conditions on claims**.

The CLTA standard policy (as well as the ALTA policy) contains Schedule A *exclusions to coverage* barring recovery by the buyer or joint protection carryback seller for losses due to:

Figure 1 *Excerpt from **first tuesday** Form 156 — Equity Purchase Agreement*

13.5 Title to be vested in Buyer or Assignee free of encumbrances other than those set forth herein. Buyer's interest in title to be insured under a policy issued by _____ title company on a(n) ☐ Homeowner(s) policy (one-to-four units), ☐ Residential ALTA-R policy (vacant or improved residential parcel), ☐ Owner's policy (other than one-to-four units), ☐ CLTA Joint Protection policy (also naming Carryback Seller or purchase-assist lender), or ☐ Binder (to insure resale or refinance within two years).

a. Endorsements _____

b. ☐ Seller, or ☐ Buyer, to pay the title insurance premium.

- zoning laws, ordinances, or regulations restricting or regulating the **occupancy, use, or enjoyment** of the land;
- the character, dimensions, or location of any **improvement erected** on the property;
- a **change in ownership** or a parceling or combining of the described property by the insured buyer;
- **police power**, eminent domain, or violations of environmental protection laws, unless a notice or encumbrance resulting from the violation was recorded with the county recorder before closing;
- encumbrances **known** to the insured buyer or lender that are not recorded or disclosed to the title company;
- encumbrances not resulting in a **monetary loss**;
- encumbrances that are created or become encumbrances **after issuance** of the policy;
- encumbrances (equitable liens) resulting from the buyer's payment of **insufficient consideration** for the property or delivery of improper security to the carryback seller also insured under the policy; and
- the unenforceability of the insured trust deed lien due to the lender's **failure to comply** with laws regarding usury, consumer credit protection, truth-in-lending, bankruptcy, and insolvency.

The CLTA standard policy contains **pre-printed exceptions** listed in the policy as Schedule B, also called *standard exceptions* or *regional exceptions*. It is the inclusion of these pre-printed boilerplate exceptions that makes the CLTA policy a standard policy. An ALTA owner's policy does not contain pre-printed exceptions, only the typewritten exceptions listing the encumbrances that are known to the title company and affect title to the property.

The **pre-printed standard exceptions** in Schedule B of the CLTA standard policy eliminate coverage for losses incurred by the buyer due to:

- taxes or assessments not shown as existing liens in the records of the county recorder, the county tax collector, or any other agency that levies taxes on real property;
- unrecorded rights held by others that the buyer could have discovered by an inspection of the property or inquiry of persons in possession;
- easements or encumbrances not recorded and indexed by the county recorder;
- unrecorded encroachments or boundary line disputes that would have been disclosed by a survey; and
- recorded or unrecorded unpatented mining claims or water rights.

A lower premium is charged to issue a CLTA policy since the title company undertakes a lower level of risk for indemnified losses due to the CLTA pre-printed exceptions as compared to the extended risks covered by the more expensive ALTA owner's policy.

The ALTA owner's policy

Most policies issued today are of the ALTA variety. The CLTA policy format with pre-printed standard exceptions does not provide protection for **unrecorded encumbrances or claims** to title.

The ALTA owner's policy provides greater coverage (and premiums) than the CLTA policy since the exceptions in Schedule B do not include the pre-printed standard exceptions. If the pre-printed exceptions are included in Schedule B and attached to the ALTA policy, the policy becomes an ALTA standard policy, comparable in cost and coverage to the CLTA standard policy since unrecorded encumbrances will not be covered.

The ALTA owner's policy covers **off-record matters** not covered under the CLTA standard policy. As a result, the title company may require the parcel to be surveyed, and those in possession to be interviewed or estopped, before the title company will issue an ALTA policy. Unrecorded interests in title are most often observable by an on-site inspection of the property.

Typewritten exceptions for existing encroachments or boundary conflicts are occasionally added to the ALTA policy (Schedule B) based on the survey.

The exclusions section of an ALTA owner's policy are identical to exclusions in the CLTA policy, except for additional exclusions relating to an insured lender or carryback seller. The ALTA owner's policy is not issued to lenders. Further, a **joint protection ALTA** policy is never issued.

Thus, separate policies and **duplicate premiums** are required for ALTA coverage when a buyer of property records a new loan, a most common event.

The premium for an ALTA owner's policy is larger than the premium for a CLTA standard policy. The ALTA owner's policy provides additional coverage and may, as a requisite to issuance, require costs to be incurred for a survey. Further, the premiums are nearly double to pay for both a lender's policy and the buyer's policy when a new loan is recorded to fund the purchase of real estate acquired by the buyer. This is not the case for a CLTA joint protection policy, one policy insuring both the lender (or carryback seller) and the buyer.

The ALTA residential policy

For buyers of parcels containing one-to-four residential units, an ALTA residential (ALTA-R) policy is available in lieu of the ALTA owner's or homeowner's policies. Parcels insured include lots and units in common interest developments (CIDs), such as condominiums.

The ALTA-R is referred to by the title companies as the "plain language" policy. The ALTA-R is written using wording that avoids legalese. The policy is structured and written to be easily read and understood by the buyer. The ALTA-R form policy contains a **table of contents** and an **owner's information sheet** outlining the policy's features.

The coverage, exclusions and exceptions in the ALTA-R policy are similar to the ALTA owner's policy. In addition, the ALTA-R policy also covers losses due to:

- mechanic's liens incurred by someone other than the buyer; and
- the inability of the buyer to occupy the property should the single family residence violate the CC&Rs listed in the Schedule B exceptions in the policy or existing zoning.

The premium for an ALTA-R form policy is priced lower than the premium for an ALTA owner's policy since the policy is usually issued only on parcels in an existing subdivision or CID that historically has no known problems with easements, encroachments, or access.

The ALTA homeowner's policy

A homeowner's policy now exists to provide **more coverage** than the ALTA owner's or the ALTA-R policies. In addition to the risks covered by the ALTA owner's and ALTA-R policies, the homeowner's policy covers several risks to ownership that could arise **after closing**, including:

- the **forging** of the buyer's signature on a deed in an attempt to sell or encumber the buyer's property;
- the construction on an adjoining parcel of a structure **encroaching** onto the buyer's property, excluding a boundary wall or fence;

- the recording of a document preventing the buyer from obtaining a secured loan or selling the property;
- claims of **adverse possession** or **easement by prescription** against the buyer's property; and
- claims by others of a right in the buyer's property arising out of a lease, contract, or option **unrecorded and unknown** to the buyer at the time of closing.

The ALTA homeowner's policy also covers losses arising out of a lack of vehicular and pedestrian access to and from the property. Other owner's policies only cover losses resulting from the lack of a legal right to access, not a practical means of access, which is covered by the ALTA homeowner's policy.

Also covered by the ALTA homeowner's policy are losses incurred due to many other risks that may exist at the time of closing, including:

- the correction of any pre-existing violation of a CC&R;
- the inability to obtain a building permit or to sell, lease, or use the property as security for a loan due to a pre-existing violation of a subdivision law or regulation;
- the removal or remedy of any existing structure on the property if it was built without obtaining a building permit, excluding a boundary wall or fence;
- damage to existing structures due to the exercise of a right to maintain or use an easement;
- damage to improvements due to mineral or water extraction;
- the enforcement of a discriminatory CC&R;
- the assessment of a supplemental real estate tax due to construction or a change of ownership or use occurring before closing;
- an incorrect property address stated in the policy; and
- the map attached to the policy showing the incorrect location of the property.

Binders, when contemplating a resale

An investor who buys property and plans on reselling the property within two years after his purchase should consider a **binder**, also called a *commitment to issue.*

A binder entitles the investor to title insurance coverage until the investor requests a policy be issued to a new buyer on resale of the property or to a new lender on a refinance, such as occurs when an investor takes title to a residence intending to flip it in a sale to the ultimate user.

Although the binder is 10% to 15% more expensive than a policy, it will cost less than buying two policies — one when the property is purchased, and another on the later resale or refinance.

With a binder, the resale policy will be at no further charge, except for the premiums for any additional liability coverage requested for any increase in the resale price.

Lender's policies

The CLTA and ALTA form title policies available to insure the priority of the lien a lender holds to secure their loan, include:

- a CLTA standard joint protection (JP) policy; and
- an ALTA loan policy.

The CLTA standard JP policy

A lender or a seller who carries back a note and trust deed for part of the sales price has options when calling for title insurance.

The lender or carryback seller can either:

- be named as an additional insured on a CLTA standard JP title insurance policy with the buyer; or
- request a separate ALTA loan policy as a sole named insured.

The JP policy enables one or more individuals or entities to be named as insured.

However, the JP policy is only available under a CLTA standard policy. If either the buyer or the lender in a cash-to-new-loan transaction requests ALTA coverage, a separate ALTA loan policy will be issued to each at approximately double the cost.

The ALTA lender's policy

An institutional lender will usually require its trust deed lien on a parcel of real estate to be insured under an ALTA loan policy as a condition for making a loan secured by real estate.

The ALTA loan policy insures against money losses incurred by lenders and carryback sellers due to the loss of priority of the insured trust deed lien, unless listed in the exceptions, to encumbrances such as:

- a mechanic's lien, if the work was commenced prior to recording the trust deed (which is the same date and time as the date of the policy) and the trust deed did not secure a loan to pay for the construction;
- a mechanic's lien arising out of work financed by proceeds from the construction loan secured by the insured trust deed, if no part of the construction work was commenced before the trust deed was recorded; and
- assessments (Mello-Roos) for street improvements under construction or completed prior to recording the trust deed.

The ALTA loan policy comes at a higher (and separate) premium than the CLTA standard JP policy due to the extended mechanic's lien and assessment coverage. The buyer who borrows to finance his purchase usually pays the premium for the lender's policy.

Endorsements

Endorsements of great variety can be added to the form policies to provide coverage for title conditions and use or economic conditions not covered by the prototypical policies. Endorsements are usually issued only to lenders, though modified endorsements can be used in owner's policies as well, particularly for developers and builders.

Endorsements cover losses incurred due to violations of CC&Rs, damage from extraction of water or minerals, mechanic's liens, encroachments (conditions covered in an ALTA-R policy), and the effects of inflation. Endorsements are also issued to remove an exclusion or exception that is an unwanted boilerplate provision in a policy

Chapter 12 Clearing a lien-clouded title

This chapter instructs a prospective equity purchase (EP) investor on how to negotiate the release of judgments or discharge of state/federal tax liens that may encumber a homeowner's residence that is in foreclosure.

Negotiate a release to create equity

An investor enters into an equity purchase (EP) agreement to buy an owner-occupied residence that is in foreclosure, called an *equity purchase* (EP) transaction. [See **first tuesday** Form 156]

After expiration of the seller-in-foreclosure's five-business-day cancellation period, escrow is opened and a preliminary title report is ordered. The title report discloses an *abstract* has been recorded referencing a **money judgment** against the seller that has attached to the residence, called a *judgment lien*. The seller did not record a declaration of homestead prior to the creditor recording the abstract.

The **judgment lien** was not specifically referenced in the purchase agreement. However, the general terms of the EP agreement call for the down payment to be reduced by the amount of any unreferenced lien and the responsibility for payment of the lien shifted to the investor. The EP agreement makes it optional for the investor to take title subject to the recorded judgment lien rather than having the debt satisfied and the lien released prior to closing. [See **first tuesday** Form 156 §13.3]

Further, the title insurance company demands either a *partial* or *full release* be recorded clearing title of the lien before they will issue a title insurance policy eliminating the judgment lien as a listed exception, as it now shows in the prelim. The investor chooses to have the lien released before closing, rather than offsetting the down payment and leaving the lien on title and later negotiating its release.

However, the seller is uninformed about **lien avoidance**. Accordingly, the EP investor, with written authority from the seller, takes control by contacting the judgment lienholder, directly or through escrow, to negotiate a partial or full release of the lien so the purchase transaction can be closed. These negotiations are allied to those for a short payoff of a trust deed loan.

The lienholder initially demands full payment of the debt, which is the very reason he recorded his lien.

However, the investor has economic leverage over the creditor in his negotiations for a lien release. When the first trust deed on the property is in foreclosure, the creditor's risk of loss of his abstract lien on the property is greatly increased. Further, the seller qualifies for an automatic homestead exemption depriving the creditor of any ability to collect by forcing the sale of the property.

Both the trust deed and the homestead claims on title are senior to the creditor's right to recover the amount of his judgment from the property's value.

The trustee's foreclosure sale, should it take place, will wipe out the judgment lien. Unless excess funds flow from the trustee's sale to be distributed to junior lien holders, the judgment creditor will receive nothing.

Also, the homestead exemption available to the head of a household protects up to $75,000 of the homeowner's equity, freeing that amount of equity from collection on the judgment by a court-ordered sale.

The lien about to be wiped out

Generally, a good bargaining tactic for obtaining a **release of a lien** from a seller's residence is a combination of:

- a "gentle reminder" that the lien is on the verge of being *wiped out by foreclosure* of the first trust deed without the likelihood of an overbid to provide funds for the creditor;
- a review of the homeowner's $75,000 *homestead exemption* rights as having a claim on equity senior to the creditor's lien, leaving no ability for the creditor to collect by forcing a judicial sale; [See Chapter 13]
- an *offer to pay* a lesser amount in full satisfaction of the debt owed to the lienholder; and
- a partial (or full) satisfaction and the execution of a partial (or full) release, allowing the abstract of judgment to remain of record (unless fully released) while *releasing the residence* from its lien so escrow can close.

The objective of the investor's negotiations is to give the lienholder sufficient incentive to cooperate and release the property from the lien without the homeowner filing a bankruptcy petition to approve the sale and remove the lien. The investor (or the seller's agent) is in a better position to deal with the lienholder in an aggressive manner than the seller-in-foreclosure, who has exhausted his goodwill with the judgment creditor.

A financially advantageous situation is created for all parties when:

- the **lienholder** collects a portion of the money owed, which is not available from a sale of the residence if a foreclosure wipes out the judgment lien, or a recorded or automatic homestead exemption exists;
- the **seller** closes the sale of his residence, avoiding the loss of his equity to the lender's foreclosure, and receives any proceeds protected by his homestead exemption; and
- the **equity purchase (EP) investor** keeps his purchase agreement alive by negotiating a release of the lien in exchange for a less-than-full payoff of the lienholder's judgment out of the seller's proceeds from the sale.

Release of recorded instrument

When a judgment lienholder agrees to release a residence from his lien, a signed and notarized **release of recorded instrument** must be obtained from the lienholder and recorded. All aspects of the paperwork can be handled through escrow after negotiations have been completed. [See Form 409 accompanying this chapter]

The release contains all the information necessary to clear the judgment lien from the record title to the property.

When the release is notarized and recorded, the judgment lien attached to the residence is removed from the record and a policy of title insurance can be issued covering title free of the lien.

The abstract of judgment lien

A judgment creditor creates a valid lien on real estate owned by the debtor by recording an *abstract of judgment* issued by a state court. [Calif. Code of Civil Procedure §697.310(a)]

A judgment lien continues in effect for 10 years from the date it is recorded, unless the money judgment is either satisfied or released. [CCP §697.310(b)]

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

RELEASE OF RECORDED INSTRUMENT

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

1. From the Document entitled _____,

2. dated _____, and recorded on _____, as Instrument No. _____, in the Official Records of _____County, California,

3. pursuant to the judgment entered in the _____ branch of the _____County _____ Court, dated _____, renewed _____, in a legal action entitled _____, docket number _____,

4. held by _____ and against _____,

5. is hereby released:

5.1 ☐ all interests in real property situated in the County of record, owned or hereafter acquired by _____

5.2 ☐ the real property situated in the County of record described as

_____

_____

THIS FORM IS NOT A RECONVEYANCE OF A TRUST DEED. DO NOT USE THIS FORM TO RECONVEY A TRUST DEED FROM RECORDED TITLE.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: _____, 20_____ _____ (Print name) _____ (Signature)

Date: _____, 20_____ _____ (Print name) _____ (Signature)

STATE OF CALIFORNIA
COUNTY OF_____

On _____ before me,

_____
(Name and title of officer)

personally appeared _____

_____,

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraphy is true and correct.

WITNESS my hand and official seal.

Signature _____
(Signature of notary public)

(This area for official notarial seal)

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However, the recording of a certified copy of a judgment awarded by a federal court attaches without the need to record an abstract of judgment.

For example, a judgment creditor obtains a federal district court money judgment against an individual. A **certified copy** of the judgment is recorded in the county where the individual is the vested owner of real estate.

The owner later obtains a loan secured by recording a trust deed on the property. A dispute between the lender and the judgment creditor arises over who has priority and is entitled to funds remaining after a payoff of the first trust deed.

The second trust deed lender claims the recorded federal judgment is not a valid lien since it is not documented by a recorded abstract of judgment to give the lien priority to the lender's trust deed.

Does the judgment creditor hold a valid lien senior to the lender's trust deed?

Yes! The judgment creditor holds a valid lien senior to the lender's trust deed. A federal judgment creditor creates a lien on real estate owned by the judgment debtor on recording a **certified copy** of the federal judgment. [**In re McDonell** (9th Cir. BAP 1996) 204 BR 976]

A money judgment from a court of the United States becomes a valid lien on real estate on the recording of:

- an abstract of judgment; or
- a certified copy of the money judgment. [CCP §697.060]

The FTB as a judgment creditor

A personal income tax lien on a residence recorded by the Franchise Tax Board (FTB) is enforced under the same procedure as any creditor's judgment lien. The FTB issues and records a *warrant* for the amount claimed due by the state. The **warrant** has the same force and effect as an abstract of judgment issued by a court. [CCP §688.020]

The FTB lien created by recording the **warrant** attaches to real estate owned by the tax payer in the same priority as would a judgment lien. More importantly, the tax payer who is a homeowner and head of the household has a homestead exemption that is senior to the FTB lien and shields $75,000 of the seller's equity from seizure by the FTB. [CCP §688.030; Calif. Government Code §§7170 et seq.]

Unfortunately for the seller and the investor, no statutory or regulatory authority exists for the FTB to negotiate a partial payment of the tax bill in exchange for releasing the residence from the tax lien. At first glance, it appears to be an all or nothing situation.

However, California's **Taxpayer Bill of Rights** provides some relief. Under it, the FTB must release its lien from the residence if the proceeds from the sale would not result in a reasonable reduction of the seller-in-foreclosure's debt to the FTB. Again, negotiations are an all or nothing analysis for a release of the FTB lien on a short sale of the property. [Calif. Revenue and Taxation Code §21016(a)(3)]

Nevertheless, no case law exists testing whether the statute may be used as an offensive weapon by the seller to quiet title to real estate and eliminate the cloud of a state income tax lien when a declaration of homestead was recorded prior to the FTB warrant.

Releasing an IRS lien

Consider an EP investor whose preliminary title report reveals the existence of a **federal tax lien** junior to a trust deed loan that is in foreclosure.

When property is sold at a trustee's sale and a timely recorded and junior federal tax lien exists, the Internal Revenue Service (IRS) may later *redeem* (purchase) the property from the successful bidder at the trustee's sale by paying him the amount of his bid within 120 days, plus interest and foreclosure costs. Thus, the equity can be acquired by the IRS after the trustee's foreclosure sale to satisfy the delinquent payment of income tax owed by the now wiped-out owner. The IRS will later hold its own auction and resell the residence.

When a second trust deed or judgment lien exists on the residence, the IRS will typically wait until the first trust deed lender completes its foreclosure, wiping out the junior lienholder and **creating an equity** where none existed before the trustee's sale. The IRS then steps in within 120 days after the trustee's sale and acquires the residence from the buyer at the trustee's sale.

On a regular sale of property, the IRS has the *authority to negotiate* with the seller/taxpayer or his authorized agent (or the EP investor after closing the EP transaction) to accept partial or no payment in exchange for a **certificate of discharge** from the income tax lien. The discharge is authorized when the IRS's recovery under its lien and redemption and resale rights would be economically unfeasible beyond the amount available to the IRS from a sale of the property at current value. [Internal Revenue Code §6325(b)(2)]

Thus, the discharge of the IRS tax lien from title can be negotiated by the investor (or other authorized person) on behalf of the taxpayer by using some of the same persuasive facts used to negotiate a release of a judgment lien with a creditor or a short payoff with a trust deed lender.

To release the tax lien from title when the property is in foreclosure, the seller submits a written request to the district director of the IRS for a discharge of the residence from the federal tax lien. Instructions and format for application for a Certificate of Discharge are available in IRS Publication 783 at *www.irs.gov*. [Revenue Regulations §301.6325-1(b)]

General information the IRS wants with the Application for a Certificate of Discharge is a preliminary title report, proposed closing statement (HUD-1), two opinions of value (appraisals), and a declaration and signature of the payer under penalty of perjury.

Current IRS policy dictates the IRS, not the seller, must receive all of the proceeds from any equity remaining in the residence up to the amount of the lien.

Additionally, the EP investor should consider whether it is more advantageous to take the residence subject to the IRS tax lien, especially if the property is a "fixer-upper." If little or no equity exists beyond the encumbrances senior to the IRS lien, the EP investor, as the new owner, can negotiate with the IRS for the release of the lien in exchange for a small cash payment — often an amount less than the IRS would have been willing to accept from the seller prior to the EP investor becoming the owner.

However, taking the residence subject to the IRS lien entails a risk of loss for the investor that must be analyzed. The IRS may decide to leave its lien intact on the property since the property is no longer in foreclosure. Thus, they would then be able to participate in the future property value added by inflation, appreciation, or the efforts of the investor. [**Han** v. **United States of America** (9th Cir. 1991) 944 F2d 526]

The homestead exemption coup

A homeowner's equity of up to $75,000 for a head of household is protected by California homestead exemption laws. [CCP §704.710 et seq.]

Editor's note — Assembly Bill 1046 currently being considered in the 2009 California legislative session would, if passed, increase the homestead exemption amounts by an additional $15,000.

The homestead protection is **automatic** when the judgment lienholder or the FTB attempts to enforce its money judgment by a sheriff's sale of the homeowner's residence. The residence cannot be sold by the lienholder when the net proceeds of the sale will be less than the homestead exemption amount.

However, the automatic homestead exemption only applies to execution sales ordered by a court to satisfy money judgments against the homeowner and to any sale of the home in a bankruptcy proceeding.

While merely a defensive tool for the homeowner, the **automatic homestead** exemption becomes a powerful offensive tool in a bankruptcy proceeding. Through bankruptcy proceedings, the homeowner can clear his title of judgment and state tax liens that impair the value of his $75,000 homestead equity in the property. [**In re Herman** (9th Cir. BAP 1990) 120 BR 127; 11 United States Code §522(f)].

However, the automatic homestead exemption is not enforceable against an IRS tax lien in bankruptcy. [**U.S.** v. **Heffron** (9th Cir. 1947) 158 F2d 657; 11 USC §545]

Alternatively, the homeowner may have recorded his **declaration of homestead** prior to the date a judgment or FTB lien was recorded. If the recorded homestead is senior to the judgment creditor's or FTB's lien and the net proceeds of a voluntary sale entered into by the owner of the residence will be less than the homestead amount, the owner can quiet title to the property and eliminate the effect of the judgment or FTB tax lien on that property.

However, like the automatic homestead exemption, the recorded homestead has no priority over an IRS tax lien. Thus, the IRS can still force the sale of the residence under its tax lien if a certificate of discharge is not arranged. [**U.S.** v. **Rodgers** (1983) 461 US 677]

In practice, the release of an IRS lien under a Certificate of Discharge from title is always negotiated based on whether it has recorded priority over voluntary encumbrances and judgment liens on the residence. The homestead has no effect on the **lien rights of the IRS**.

Whether it is by an automatic exemption or recorded declaration, the homestead is leverage to be used to induce judgment lienholders and the FTB to voluntarily release their lien from the title to the residence. The effects of foreclosure, a bankruptcy, or quiet title action to enforce the homestead exemption and clear title gives lienholders an incentive to negotiate the release.

Preparing the Release of Recorded Instrument

The numbers on the instructions correspond to the numbers given to the provisions in Form 409.

Check and **enter** only the items to be included as provisions in the release.

1. **Enter** the name of the document that created the lien on the property, e.g., *abstract of money judgment.*

2. **Enter** the date the document creating the lien was prepared, and the date, instrument number and county of its recording.

3. If the document is a release of an abstract of money judgment:

   - **enter** the identification of the branch (i.e. Pasadena), county name (i.e. Los Angeles) and court (superior) that entered the judgment;

   - **enter** the date of the judgment and the date of any renewal;

   - **enter** the title of the cause of action in the case, e.g., *breach of contract, negligent misrepresentation, unlawful detainer,* etc.; and

- **enter** the docket number the court assigned to the case. [CCP §697.370]

4. **Enter** the names of the lienholder and owner named as the judgment debtor. [Gov C §27288.1(b)]

5. **Check** the box indicating whether the release is:

   5.1 a blanket release of all recorded interests in real estate in the county. If all property is released, **check** the box and **enter** the name of the seller again, thus identifying him as the owner whose property interests are being released from the judgment lien; or

   5.2 a partial release only for a specific property. If only a specific property is released, **check** the box and **enter** the legal description of the property released.

The lienholder unilaterally executes the release by **signing** it and **dating** his signature. If more than two signature lines are required, check the box to indicate a signature page addendum is attached. [See **first tuesday** Form 251]

Notarize the release for recording. **Record** the release to clear the seller's title of the lien. [Gov C §27287]

Chapter 13 Automatic and declared homesteads

This chapter demonstrates the equity purchase (EP) investor's application of the various homestead exemptions available to sellers to create net equity where a judgment or tax lien affects title.

Home-equity shield against judgments

A real estate investor tracks *abstracts of judgment* recorded by creditors against owners of real estate as his method for locating financially distressed real estate he might be able to buy.

The investor finds an abstract attached as a lien on the principal residence of an owner who owes the creditor $80,000 on the judgment. The owner recorded a **declaration of homestead** before the abstract was recorded. Also, the property is not presently listed "For Sale."

On completing a *comparable market analysis* (CMA), the investor concludes the property has a value for his investment purposes of approximately $20,000 more than the first trust deed lien. When considering the $80,000 abstract of judgment that is attached as a lien, the property appears to be over-encumbered and have no equity.

After being contacted by the investor's form letter, the owner indicates he needs to sell the home. He has other creditor problems as well as being delinquent on his home loan. He is aware he has a $75,000 homestead to protect him from the judgment creditor selling his home. However, he does not know how his home can be sold when title is clouded by the abstract.

The investor prepares an offer on a regular purchase agreement form since a Notice of Default (NOD) has not been recorded commencing foreclosure. The price is payable $20,000 cash (down payment) to a new loan. Two contingency provisions are attached to the purchase agreement:

- one calling for a 10% discount on a short payoff of the first trust deed loan from cash funds provided by the investor; and
- the other calling for a release of the property from the **abstract of judgment** held by the creditor.

When submitting the offer to the owner, the investor explains that the approximate $30,000 in down payment and lender discount belongs to the seller (less closing costs), not the judgment creditor, due to the recorded homestead of $75,000.

The investor obtains written authorization to negotiate with the lender and the judgment creditor to arrange for the short pay and the release. The investor and the owner understand the owner's receipt of cash on a short sale may trigger the interference of the lender's moral bias with their mitigating a loss by avoiding a foreclosure.

The lender will be induced to discount since the title is encumbered with liens of $50,000 in excess of the property's market value. Alternatively, a more compelling reason for a discount is the fact the lender will have to complete a foreclosure due to the existence of the junior lien (abstract). A short pay would be in their best interest to mitigate losses they will otherwise certainly incur due to deteriorating real estate prices in the current phase of the real estate market.

As for the judgment creditor, he will be asked for a release of the owner's home on the close of escrow since he has no claims against the property due to the recorded homestead declaration and the lack of

more than $75,000 in equity over the amount of the lender's trust deed lien. It is possible that negotiations for the release of the lien may necessitate the payment of $5,000 to $10,000 to motivate the judgment creditor to release the property from his lien if the threat of a quiet title action to clear title of his cloud does not do so.

Thus, the seller now has the incentive to accept this offer. He will net some cash from a sale in which the buyer (investor) will be handling negotiations to clear up title and perfect an equity in the property.

Homestead by type and amount

A homeowner is sued by a creditor for money owed on an unsecured debt. A **money judgment** is awarded to the creditor who becomes a *judgment creditor*. The homeowner becomes a *judgment debtor*.

An **abstract of judgment** is recorded by the **judgment creditor** in the county where the homeowner's residence is located.

Can the homeowner prevent the recorded abstract from attaching as a lien against the title to his home?

No! However, the type of homestead the homeowner claims — there are two — and the amount of the homestead exemption he qualifies for — there are three — determine the homeowner's ability to:

- **voluntarily sell** the home and buy another home with the homestead amount he has in his equity; or
- bar the judgment creditor from **forcing a sale** of the home to satisfy the judgment.

The owner's homestead interest in title

A *homestead* is the dollar amount of the equity in a homeowner's dwelling that the homeowner qualifies to hold. The amount of the homestead held by the homeowner has priority on title over most judgment liens and some government liens.

Two types of **homestead** procedures are available to California homeowners to establish the priority of the homestead equity they hold in their home:

- the *declaration of homestead*, which is recorded [Calif. Code of Civil Procedure §704.920]; and
- the *automatic homestead*, also called a *statutory homestead exemption*, which is not recorded. [CCP §704.720]

Both homestead arrangements provide the same dollar amount of home-equity protection given to all homeowners in California. However, a homeowner must record a **declaration of homestead** to receive the additional benefits available under the homestead laws allowing the homeowner the right to sell and to reinvest the dollar amount of the homestead in another home.

Neither the declared nor the automatic homestead interfere with:

- *voluntary liens* later placed on the property by the homeowner, such as trust deeds; and
- *involuntary liens* given priority to the homestead exemption under public policy legislation.

Involuntary liens and encumbrances that are given priority by statute and can be enforced as senior to the amount of the homestead exemption include mechanic's (contractor's) and vendor's (seller's) liens, homeowners' association (HOA) assessments, judgments for alimony or child support, real estate taxes, and Internal Revenue Service (IRS) liens.

Involuntary liens that are subordinate and junior to the homestead amount include:

- Franchise Tax Board (FTB) personal income tax liens;
- Medi-Cal liens; and

Declaring a homestead as asset preservation

The **recorded homestead declaration** includes:

- the name of the homeowner declaring the homestead;
- a description of the property homesteaded; and
- a statement that the declared homestead is the principal dwelling in which the homeowner resides on the date the homestead is recorded. [Calif. Code of Civil Procedure §704.930(a); see Form 465 accompanying this chapter]

The declaration must be signed, notarized, and recorded to take effect. [CCP §704.930]

The homestead declaration may be **signed and recorded** by any one of several individuals, including:

- the owner of the homestead;
- the owner's spouse; or
- the guardian, conservator, attorney in fact, or a person otherwise authorized to act for the owner or the owner's spouse. [CCP §704.930(b)]

An individual's personal residence that is vested as a revocable inter vivos (living) trust, or other type of title holding arrangement established for the benefit of the homeowner, can also be declared a homestead by anyone who has an interest in the property and resides there. [**Fisch, Spiegler, Ginsburg & Ladner** v. **Appel** (1992) 10 CA4th 1810]

Additionally, a declaration of homestead in no way restricts the homeowner's ability to voluntarily sell, convey, or encumber his homesteaded property. [CCP §704.940]

A recorded homestead declaration does not appear in credit reports or impact the homeowner's credit reputation or ability to borrow funds. Title companies disregard recorded homestead declarations, except in litigation guarantee policies.

- judgment creditor's liens.

Automatic and declared homesteads

An **automatic homestead** is always available on the principal dwelling occupied by the homeowner or his spouse when:

- a judgment creditor's abstract is recorded against the homeowner and attaches as a lien on the property; and
- the occupancy by the homeowner continues until a court determines the dwelling is a homestead. [CCP §704.710(c)]

The **automatic homestead exemption** applies to the equity in a real estate dwelling (and its outbuildings), a mobilehome, a condominium, a planned development, a stock cooperative, or a community apartment project together with the land they rest on, as well as a houseboat or other waterborne vessel used as a dwelling. [CCP §704.710(a)]

On the other hand, a **recorded declaration of homestead** applies only to real estate dwellings. Thus, mobilehomes not established as real estate and houseboats are not protected by a recorded homestead, only the automatic homestead. Also, a leasehold interest in real estate with an unexpired term of less than two years is not protected by a recorded homestead declaration. [CCP §704.910(c)]

Real estate to be homesteaded

As long as the homeowner claiming the exemption actually uses the homesteaded property as the principal residence for himself and his family, the type of real estate qualifying for a homestead includes:

- two five-room flats [**Viotti** v. **Giomi** (1964) 230 CA2d 730];
- an 18-unit apartment building where the owner occupies only one unit [**Phelps** v. **Loop** (1944) 64 CA2d 332]; and
- 523 acres of rural land with a house and water rights for the land. [**Payne** v. **Cummings** (1905) 146 C 426]

Amount of equity protected

The dollar amount of whichever home equity protection a homeowner qualifies for is protected whether the homeowner relies on the automatic homestead or records a declaration of homestead.

Homeowners qualify for one of three dollar amounts of **net equity** homestead protection:

- a $50,000 equity for a homeowner with no dependents;
- a $75,000 equity for a head of household; or
- a $150,000 equity for the aged or disabled. [CCP §704.730]

Editor's note — Assembly Bill 1046 currently being considered in the 2009 California legislative session would, if passed, increase each homestead exemption amount by an additional $15,000.

An individual homeowner with **no dependents** other than himself qualifies for the $50,000 homestead exemption. [CCP §704.730(a)(1)]

A homeowner qualifies for the $75,000 homestead exemption as the **head of a household** by providing support for a spouse, dependent children, grandchildren, parents, grandparents, or in-laws. [CCP §704.730(a)(2)]

An aged or disabled homeowner qualifies for the $150,000 homestead exemption if the homeowner or his spouse is:

- 65 or older;
- physically or mentally disabled; or
- 55 or older with an annual income of less than $15,000 or, if married, a combined gross annual income of no more than $20,000. [CCP §704.730(a)(3)]

Both a husband and a wife may be the declared homestead owners in the same homestead declaration when both husband and wife own an interest in the property. [CCP §704.930(a)(1)]

However, a couple's combined homestead exemption cannot exceed the exemption limit for a head of household ($75,000), unless one or both qualify as an aged or disabled person ($150,000). [CCP §704.730(b)]

Further, if both spouses are entitled to a homestead exemption, the homestead proceeds will be apportioned to each spouse according to their share of the ownership in the homesteaded real estate. [CCP §704.730(b)]

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

DECLARATION OF HOMESTEAD

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

1. The name of the owner or owners of the real estate subject to this declared homestead

_____

(Enter the name of the individual entitled to the Homestead Exemption)

2. The declared homestead regards real estate situated in the City of _____, County of _____, California, referred to as:

2.1 The property is more commonly referred to as

_____.

(Enter the street address and the city)

3. The declared homestead is the principal dwelling and is now resided in as the residence of:

☐ A declared owner of the homestead;

☐ The declared owners of the homestead; or

☐ The spouse of the declared owner of the homestead.

4. I execute this declaration of homestead as:

☐ a declared homestead owner.

☐ the spouse of the declared homestead owner.

☐ the guardian or conservator of the person or estate of the:

☐ declared homestead owner; or

☐ spouse of the declared homestead owner.

☐ an attorney in fact for the:

☐ declared homestead owner; or

☐ spouse of the declared homestead owner.

4.1 As a guardian, conservator or attorney in fact acting on behalf of the declared homestead owner or the spouse of the declared homestead owner, I am authorized to execute this declaration under the authority vested in me by _____hkjhlkjhlkjh_____.

(Enter identification of the source of your authority)

5. The facts stated above are known to me to be true as of my own personal knowledge.

Date: _____, 20_____ _____

(Print name) (Signature)

Date: _____, 20_____ _____

(Print name) (Signature)

STATE OF CALIFORNIA
COUNTY OF_____

On _____ before me,

_____

(Name and title of officer)

personally appeared _____

_____,

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature: _____

(Signature of notary public)

(This area for official notarial seal)

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Abstract avoids homestead increases

The dollar amount of the homestead exemptions is periodically increased to keep up with consumer price inflation (not property price inflation). A homeowner who has recorded a declaration of homestead does not need to record a new declaration to avail himself to the increased amounts. The increased homestead exemption amounts apply to the old declaration.

However, when an involuntary lien is recorded prior to an increase in the amount of the exemption, the amount of equity protected from the attachment is the homestead amount available when the lien was recorded, whether the homeowner is claiming an automatic or declared homestead. Thus, inflation or appreciation in the value of the residence may eventually create a home equity large enough to exceed the homestead amount and provide some recovery for a judgment creditor. [**Berhanu** v. **Metzger** (1992) 12 CA4th 445]

Combating a creditor's sale

A judgment creditor with a recorded abstract of judgment cannot force the sale of an owner's home to collect on a money judgment without first petitioning a court for its sale, whether the homestead is automatic or by recorded declaration. The court must confirm the owner's net equity in his home is a dollar amount greater than the amount of the owner's homestead exemption before the creditor's judgment can be judicially foreclosed by an *execution sale*. [CCP §704.740(a)]

For example, the head of a household owes $325,000 on trust deed loans encumbering his home. An unsecured creditor is awarded a money judgment against the homeowner and an abstract is recorded, attaching as a lien on title to the property.

Before the creditor can begin judicial proceedings against the equity in the home to collect on the judgment from the net proceeds of its sale, the home needs a **net value** in excess of $400,000 — the $325,000 owed on the existing trust deeds plus the $75,000 homestead exemption.

A home with a **net equity** (after transactional costs) of less than the homestead amount leaves nothing for the creditor to sell in order to collect on the judgment.

Forced sale by court order only

The sale of a homesteaded dwelling can be forced by a creditor if a net equity exists beyond the amount of the homestead the home owner holds in the property. To force the sale of a homeowner's dwelling, the creditor must first **file an application** for a judicially ordered sale, called an *execution sale*, stating under oath:

- a description of the property;
- whether a declared homestead has been recorded on the property;
- the names of the person or persons who claim the homestead;
- the amount of the homestead; and
- the dollar amounts of all liens and encumbrances recorded on the property and the names and addresses of the lienholders. [CCP §704.760]

If the homestead is declared and the creditor challenges the **validity of the declaration**, the creditor must prove the property does not qualify for a homestead.

However, if the homeowner has not recorded a declaration of homestead on the property, the homeowner must prove his residency in the dwelling qualifies the property for the automatic homestead exemption. [CCP §704.780(a)(1)]

If the execution sale of the property is ordered by the court and the bids received at the sale are insufficient to satisfy the senior liens and encumbrances, plus the homestead amount and the sales costs, the dwelling will not be ordered sold. [CCP §704.800(a)]

Additionally, a winning bid must exceed **90%** of the fair market value (FMV) of the property as set by the court. [CCP §704.800(b)]

A real estate appraiser is often appointed by the court as a *reference* to assist in determining the FMV of the dwelling. Compensation for the appraiser may not exceed comparable fees for similar services in the community. [CCP §704.780(d)]

If the dwelling is jointly owned by the judgment debtor/homeowner and another person as joint tenants or tenants in common, only the judgment debtor's interest in the property will be sold. [CCP §704.820(a)]

The proceeds from an execution sale of the dwelling are disbursed in the following order:

- pay all senior liens and encumbrances on the property;
- disburse the amount of the homestead equity to the homeowner;
- cover the costs of the sale;
- pay the judgment creditor's court costs; and
- pay the amount due to the creditor from the judgment. [CCP §704.850]

Any remaining proceeds from an execution sale go to the homeowner.

"Drawing down" the homestead amount

Consider a homeowner who records a **declaration of homestead** on his principal residence that is encumbered by a trust deed. A creditor is later awarded a money judgment against the homeowner and records an abstract of judgment.

The homeowner then records a second trust deed on the residence to secure another loan for an amount less than the dollar amount of his homestead exemption.

The homeowner defaults on the first trust deed loan and the first trust deed holder forecloses on the residence. The residence is sold at a trustee's sale on a bid in excess of the amount owed to the first trust deed holder.

The judgment lien creditor claims he is entitled to the excess funds since the judgment lien is prior in time to the later recorded second trust deed.

The second trust deed holder claims he is entitled to the remaining funds since the second trust deed lien is a voluntary encumbrance on the homeowner's equity protected by the homestead exemption, which entitles him to be paid from funds due the homeowner under the recorded declaration of homestead exemption.

Is the second trust deed holder entitled to the excess funds?

Yes! The second trust deed holder is entitled to payment from the funds remaining after satisfaction of the first trust deed debt since:

- the dollar amount of the homestead exemption held by the owner and created by his recorded declaration was **voluntarily encumbered** by the second trust deed lien; and
- the judgment creditor's lien is subordinate to the recorded declaration of homestead exemption. [**Smith** v. **James A. Merrill, Inc.** (1998) 64 CA4th 94]

Automatic homestead as a shield

An **automatic homestead** exempts some or all of the equity in a homeowner's dwelling up to the dollar amount of the homestead exemption from money judgments obtained by the homeowner's creditors. However, use of the automatic homestead is limited to providing a **shield**, raised by the homeowner, to defend the equity in his house against a forced sale sought by an involuntary creditor.

For example, a homeowner claims his automatic exemption and receives funds in the amount of the homestead equity from a creditor's forced sale of his home. The homestead funds are protected from the creditor's attachment during a six-month reinvestment period. Further, an automatic homestead exemption is provided on the replacement residence to protect the reinvested funds. [CCP §704.720(b)]

Editor's note — Although the proceeds are protected from attachment by the creditor's lien for the six-month reinvestment period, if the property purchased is in the same county where the lien is recorded, it will not prevent the lien from attaching to new property (subject to the homestead exemption) the instant title is transferred into the buyer's name.

Thus, a homeowner/debtor intending to purchase a replacement home in the same county with his protected funds will probably not be able to obtain title insurance for a new loan. Title companies will not make a determination as to whether an exemption on the residence is valid. Also, the abstract lien will attach to the property as a lien senior in time to the new lender's trust deed, unless it is a trust deed carried back by a seller.

The best way to deal with the intervening (judgment) lien in counties where the abstract of judgment is recorded is to purchase property either subject to an existing trust deed or by creating a carryback trust deed. Carryback trust deeds have priority over any lien attaching to the title when the buyer takes title. [Calif. Civil Code §2898]

With the automatic homestead exemption, a homeowner who **voluntarily sells** his residence while title is clouded by a creditor's lien leaves the sales proceeds unprotected by the automatic exemption. This is not the case for a sale subject to a recorded declaration of homestead. The declaration with priority allows the homeowner to first withdraw his homestead amount from the sales proceeds before the judgment creditor receives any funds.

The exemption in bankruptcy sales

For an individual who files a bankruptcy petition, any sale of the individual's home during the bankruptcy, whether voluntary or court ordered, is considered a **forced sale**. Thus, a bankruptcy petitioner who voluntarily sells his home (even if the sale is against the bankruptcy court's order) is entitled to an automatic homestead exemption on the proceeds of the sale. [**In re Reed** (9th Cir. 1991) 940 F2d 1317]

Consider a homeowner whose home is in foreclosure under a lender's first trust deed. A judgment creditor holds a recorded judgment lien which is junior to the trust deed lien. The homeowner did not record a declaration of homestead prior to the recording of the judgment lien.

At the trustee's sale, a bid in excess of the loan leaves funds to be disbursed to junior lienholders.

A **foreclosure** under a power-of-sale provision in a trust deed is a **voluntary sale** agreed to by the owner, not a forced sale by a judgment creditor. Thus, the automatic homestead exemption does not protect the homeowner's equity which exists above the trust deed lien being foreclosed. The homeowner whose home is lost to foreclosure exposes any excess proceeds from the trustee's sale to the creditor's lien, unless a declaration of homestead was recorded prior to recording the creditor's abstract of judgment. [**Spencer** v. **Lowery** (1991) 235 CA3d 1636]

Editor's note — A homeowner in foreclosure will receive his automatic homestead exemption if he files a bankruptcy petition before the foreclosure is completed. In a bankruptcy proceeding, all sales are considered forced sales. Through bankruptcy, the dollar amount of the equity covered by the automatic homestead exemption is protected from the claims of involuntary creditors. [In re Reed, supra*]*

Additionally, the creditor holding a judgment lien (a recorded abstract of judgment) can simply wait until the equity in the home increases due to inflation, appreciation, or loan reduction. Once the value of the home exceeds the amount of the homestead exemption, the creditor can then begin a forced sale. Thus, the homeowner who relies solely on the automatic homestead exemption to protect his equity is imprisoned in his own home unless he files a bankruptcy petition since he cannot voluntarily sell and avoid the judgment lien.

Although a sufficient net equity may not exist to allow the judgment creditor to force a sale of the home, the homeowner claiming only an automatic homestead exemption may not use a *quiet title action* to remove the lien, unlike under a declared homestead.

Declared homestead allows resale

A recorded declaration of homestead, in contrast to an automatic homestead exemption, allows a California homeowner to take the offensive against his creditors. Used as a sword, the declaration of homestead coupled with a quiet title action allows the homeowner to **sever the liens** attached to his title.

Unlike the automatic homestead exemption, judgment liens **do not attach** to the exempt homestead amount in the equity under a declared homestead if the homestead declaration is recorded prior to the recording of the creditor's abstract of judgment. [CCP §704.950(a)]

Judgment liens do, however, attach to any equity exceeding the amount of the declared homestead exemption and all liens and encumbrances on the property at the time the abstract of judgment is recorded. [CCP §704.950(c)]

With prior planning, priority of the declaration over judgment creditors can be accomplished by the homeowner. While it takes the creditor several months to obtain and record an abstract of judgment, a declaration of homestead can be prepared and recorded on readily available forms in a matter of minutes. [See Form 465 accompanying this chapter]

Once recorded, a declaration of homestead lasts until:

- the homestead owner records a declaration of **abandonment of the homestead**; or
- the homestead owner records a **new declaration** of homestead on another residence. [CCP §§704.980, 704.990]

If a homeowner wishes to **sell his declared homestead** that has become clouded with a creditor's lien, the homeowner may either:

- negotiate a release of the lien with the creditor [See Chapter 12]; or
- clear title to the home through a quiet title action based on the priority of his declaration of homestead.

Clearing title of a lien

A *quiet title* action determines the priorities of the creditor's lien and the recorded homestead on title. If the homeowner demonstrates the homestead declaration is valid and was recorded prior to the creditor's lien, the title will be cleared of the lien, provided no equity remains in the property above the homestead amount. [Viotti, *supra*]

Judgment creditors junior to a declared homestead where no excess equity exists soon realize their futility in litigation. Thus, they are generally receptive to a negotiated release. Consequently, the homeowner can usually "buy" a partial (or full) release from the creditor — typically for less than the costs of a **quiet title** action. [See **first tuesday** Form 409; see Chapter 12]

After title is cleared and the homeowner sells his property, he has six months to reinvest the homestead proceeds in another home. If the proceeds are reinvested in a new residence within six months, the new residence may then be declared a homestead by recording a homestead declaration within six months after the purchase.

When the homeowner records a new homestead declaration on his replacement residence, the recording *relates back* to the time the prior homestead was recorded. This leaves no gap for the creditor's lien to gain priority over the homestead declaration on the new residence. [CCP §704.960]

If the homestead equity exemption has increased after the creditor recorded his abstract of judgment, the amount of exemption the property owner is entitled to in his **new residence** is the amount that was in effect when the abstract of judgment was recorded, not the current increased amount.

However, if the homeowner has not invested the proceeds of the sale in a new homestead after six months, and the proceeds are still in the State of California, the proceeds of the homestead sale can be attached by the judgment creditor.

An alternative to vesting title in the judgment debtor's name is to use a title holding arrangement, such as a corporation or limited liability company (LLC) created by the homeowner to hold title. Thus, the abstract of judgment against the homeowner will not automatically attach to the title held by these entities.

The homestead exemption and CIDs

Consider a prospective buyer of residential unit in a common interest development (CID). When entering into the purchase agreement, the buyer agrees to the CID association's covenants, conditions, and restrictions (CC&Rs). The CC&Rs include a clause limiting the owner's ability to claim a homestead exemption senior to any judgment obtained by the association.

The buyer, now an owner, fails to pay the association's assessment fees, and the association obtains a money judgment against the owner for the unpaid assessment. The association claims the CC&Rs bar the homestead exemption from taking a senior position ahead of the association's judgment.

Is the waiver of the homestead exemption enforceable?

No! A waiver of homestead is against long-standing public policy and is unenforceable. Since the CID's money judgment is an **involuntary lien**, it does not have priority over the homestead exemption.

However, *a foreclosure by a trustee's sale* on an assessment lien for delinquent assessments recorded by the association in lieu of the alternative money judgment is considered a **voluntary lien** that is always senior to the owner's homestead exemption. [CCP §703.010(b)]

Chapter 14 Taking over a due-on-sale trust deed

This chapter identifies the ownership activities that trigger the due-on-sale clause in a trust deed, and the negotiations necessary with the lender to avoid a call or recast of the loan on a sale.

Events triggering the call provision

An existing first trust deed encumbering a one-to-four unit residential parcel of real estate contains a due-on clause.

An investor in small residential units becomes aware of the property since a Notice of Default (NOD) has been recorded commencing a foreclosure. The investor contacts the owner who occupies the property as his residence.

The investor submits an equity purchase (EP) offer to the owner that calls for the investor to:

- make a lump-sum **cash payment** for the owner's equity;
- **acquire title** to the property *subject to* the existing first trust deed lien that is in foreclosure; and
- **reinstate,** negotiate a short payoff, or **refinance** the trust deed loan.

The owner-in-foreclosure accepts the offer and escrow is opened.

Following expiration of the five-business-day seller cancellation period, escrow closes. The EP investor takes possession intending to fix up the property and immediately:

- resell the property in a cash or installment (carryback) sale; or
- sell it and acquire §1031 replacement property for a continuing reinvestment in real estate.

The lender discovers the transfer and *calls the loan due*, giving the EP investor 30 days to pay the loan off or make other arrangements with the lender — or the lender will start another foreclosure for the investor's failure to pay on the call.

If the lender enforces the call by refusing to allow the EP investor to assume the loan, the EP investor will need to refinance the property unless he can promptly resell the property to a new buyer for cash or cash to a new loan. The worst scenario: all fails for the EP investor and the lender proceeds to foreclosure based on the unsatisfied call.

Editor's note — A grant deed sale of encumbered property is not the only transfer that triggers the due-on clause. The due-on clause is triggered on the ***transfer of any interest*** *in the real estate, except*:

- *leases for a current term no longer than three years and without a purchase option; and*
- *intra-family transfers of single-family, owner-occupied residential property on the death of an owner or an encumbrance for equity financing. [12 Code of Federal Regulations §§591.2(b), 591.5(b)(1)]*

Thus, regardless of whether the transaction is labelled a lease-option, AITD, or land sales contract, the EP investor has triggered the lender's right to call the loan.

Economic recessions and recoveries

In times of stable or falling interest rates, lenders, when requested, usually permit assumptions of loans at the existing note rate, unless a prepayment penalty clause exists. Lenders have no financial incentive to recast loans, or call and re-lend the funds at a lower rate.

However, in times of steadily rising rates, with rates exceeding the note rate on the loan, lenders seize any event that triggers the due-on clause as an opportunity to increase the interest yield on their portfolio. Once the due-on clause is triggered, the lender requires the loan to be recast at current market rates as a condition for allowing an assumption, lease, or further encumbrance of the property.

Thus, real estate ownership encumbered by due-on trust deeds become increasingly difficult to transfer during periods when interest rates rise. Lender due-on interference is virtually guaranteed since the interference results in an increase in the lender's portfolio yield, which permits them to remain solvent in spite of their self-inflicted plight.

However, the *inhibiting effect* on buyers who are required to assume the existing financing at higher interest rates has an adverse economic effect on real estate sales, as well as the availability of private junior financing and long-term leasing. Ultimately, as rates and lender interference rise, many buyers, equity lenders, and tenants are driven out of the market, which further depresses property values.

Meanwhile, owners are faced with the prospect of watching the value of their property fall below the remaining balance on their loans, leaving owners with no equity in the property. It is a vicious cycle, the upshot of which is an increase in loan foreclosures.

Due-on interference has been an obscure issue after 1982 when *automatic enforcement of the due-on clause* became federal law. Since 1982, mortgage rates declined from 15% to less than 5%, buyers earned more money as employee productivity rose, their standard of living increased (in California) as inflation dropped, and mortgage money became more plentiful due to reduced government (until 2002) and corporate borrowing. When these virtuous conditions change and interest rates rise on fixed-rate 30-year real estate loans, the due-on issue will no longer be obscure.

Check the trust deed provisions

In 1982, the Federal Depository Institutions Act created due-on-sale interference rights for lenders, including:

- *a right to call* the loan automatically; or
- a *right to recast* the loan terms and conditions.

Thus, a due-on-sale clause became fully enforceable by any real estate lender or carryback seller regardless of *impairment* of the security or the buyer's *creditworthiness* standards previously required to call a loan under the due-on clause. [12 CFR §591.5(b)(5)]

The EP investor's first step in analyzing the financing encumbering a property is to request and review a copy of the trust deed of record. The document is acquired from a title company, usually part of a title profile they provide as a customer service.

Examining the trust deed allows the EP investor to determine whether a due-on-sale clause exists.

If a due-on-sale clause does not exist, the loan is **fully assumable**. In which case, the EP investor can order a beneficiary statement from the lender through escrow and close without further contact or concern for lender interference with the sale. Payments are tendered to the lender after closing.

FHA-insured 203(b) loans and the no-investor rule

Investors are prohibited from owning property financed under Section 203(b), the Owner-occupied, One-to-Four Family Home Mortgage Insurance Program, the most common Federal Housing Administration (FHA) insurance program. All loans insured under Section 203(b) give the FHA the authority to approve the potential buyer.

Loans insured by the FHA contain a due-on-sale clause which allows the FHA to accelerate the loan if the property is sold in violation of assumability requirements. The lender, however, may not impose the restrictions on the resale of the property or automatically call the loan due-on-sale without the permission of the FHA. If property encumbered by an FHA-insured loan is sold to an unapproved buyer (such as an investor), the lender must request permission from the Department of Housing and Urban Development (HUD) to accelerate the loan.

However, HUD does not call loans unless payments on the loan are delinquent.

The EP investor need not be concerned with negotiating an assumption and note modification with the lender who does not have a due-on clause in the trust deed, or paying any fees to the lender except the statutory amount for their preparation of a beneficiary statement.

Without a due-on-sale clause, the lender has no right to demand a change in the interest rate or payment schedule, a shortening of the loan period, or any other change in the original loan terms.

While the owner-in-foreclosure may want a buyer-seller subject-to assumption agreement, the lender cannot interfere with a subject-to purchase without a due-on clause. [See **first tuesday** Forms 431 and 432]

However, most trust deeds today contain due-on clauses due to the adhesion by all lenders (and thereby for consumers) to the use of unmodified standardized forms, a result of secondary money market requirements for the resale of trust deed loans.

Depending on the lender, these loans may be *assumed* — usually recast with a few modifications — or *called*, forcing the EP investor to refinance or close a resale of the property within four to five months.

Assumptions under the due-on-clause

Whether the lender will allow an assumption, and on what terms, depends on a number of general economic factors.

When current interest rates are substantially the same or lower than the interest rate on the loan, or the lender is merely servicing a loan that he previously sold, the lender will likely be willing to negotiate an assumption with the EP investor — waiving its due-on rights for a price, an exaction called an *assumption fee*.

However, if current rates are much higher than the note rate, the lender is more likely to refuse the assumption or condition the assumption on an increase in the interest rate and payments with points and assumption fees.

When a junior trust deed exists, the assumption and modification of the first trust deed raises the entirely separate and resolvable issue of subordination.

A junior trust deed holder exists

Lender assumptions usually involve material modification of the loan (by increased or variable interest and payments, shortened due date, introduction of prepayment penalties, etc.).

Consider the position of a lender who holds a note secured by a first trust deed on a parcel of real estate. The property is also encumbered by a second trust deed. The first trust deed lender enters into a modification of the trust deed note by extending the due date, raising the interest rate and increasing the amount of principal due. The second trust deed holder does not consent to the modification.

Later, a note secured by a second trust deed on the property becomes delinquent. The second trust deed holder initiates judicial foreclosure proceedings, and claims the first trust deed lost its priority since the senior lienholder substantially modified the terms of the trust deed note.

The senior trust deed holder claims only the modified portion of the note loses priority since only the modifications impair the secured position of the second.

Can the second trust deed holder entirely avoid the first trust deed?

No! Only the modified portion of the note secured by the first trust deed is unenforceable against the second trust deed holder since the second trust deed remained unimpaired in the same position as when the second trust deed lien was recorded. [**Lennar Northeast Partners** v. **Buice** (1996) 49 CA4th 1576]

Now consider a seller who carries back a second trust deed on the sale of property **without the consent** of the holder of the first trust deed to waive enforcement of its due-on clause.

The first trust deed lender learns of the sale and calls the loan. To avoid the call, the buyer assumes the first trust deed loan and the note's due date is shortened. The carryback seller then claims his second trust deed now has priority over the entire amount of the modified loan since the modification substantially impairs the carryback seller's security by increasing the potential for default.

The lender claims its trust deed retains priority since the lender owes the carryback seller no duty to obtain the seller's consent to a modification.

Here, the modification of the senior loan without the consent of the junior carryback seller does not result in a change in trust deed priorities since the seller sold and accepted as security a second trust deed without the lender's written consent, events which trigger the due-on clause. [**Friery** v. **Sutter Buttes Savings Bank** (1998) 61 CA4th 869]

When negotiating with any existing second trust deed holder to waive its due-on-sale rights and allow an assumption, the EP investor should also negotiate for the second's consent to any modification demanded by the first trust deed lender.

The assumption offer

Before bringing the loan current, the EP investor should consider negotiating with the lender, preferably before closing, for the most favorable assumption terms available. The lender must be made aware an assumption is considered a trade-off — the investor will bring the loan current and keep it current. Possibly, the investor will allow the lender to recast the loan to the current market rate of interest, all in exchange for the lender agreeing not to call the loan on the EP transaction.

If the investor intends to assume the loan prior to closing, the EP agreement between the investor and the seller must set out, as specifically as possible, the parameters of the assumption and modification agreement (recast) to be negotiated with the lender. Then, if the terms demanded by the lender are excessive, the investor may cancel the EP transaction.

Terms for **recasting** a loan include numerous items such as:

- interest rate adjustment on the loan;
- amortization period for the loan;
- monthly payments to amortize the loan; and
- the fees to be paid for assuming the loan. [See **first tuesday** Form 156 §§5 and 6]

Wording for the loan assumption parameters to be included in an assignment addendum attached to the purchase agreement can be seen in **first tuesday** Form 401-2.

If the terms of the assumption and modification of the note are not included in the EP agreement, the seller-in-foreclosure may be able to enforce the purchase agreement if the buyer wants to cancel the sale and the lender's terms and conditions are reasonable under current market conditions. [**Kadner** v. **Shields** (1971) 20 CA3d 251; Calif. Civil Code §3390]

Also, by being as specific as possible about the assumption terms to be obtained from the lender, the EP investor limits the rates the seller-in-foreclosure can force him to accept to close the transaction.

Contacting the lender

On opening escrow, the EP investor should promptly contact the lender to begin assumption negotiations — while the loan is delinquent and reportable to government agencies by the lender. Escrow should immediately request the beneficiary statement, a concurrent ability.

Of course, the assumption terms demanded by the lender will depend on a combination of the current market rates, the lender's seniority, and the creditworthiness of the EP investor.

If current interest rates are higher than the note rate on the loan, most lenders will want to raise the interest rate on the loan to the current market level. At the very least, expect the lender to demand up-front fees, including points and assumption fees. "Buy-down" points are sometimes demanded to lower interest rates and provide the lender with current earnings (and a less valuable loan).

On the other hand, if current market rates are at levels below the note rate, the EP investor is in a prime position to negotiate for more favorable terms.

Because the lender is interested in maintaining its high yield loans, the lender will be more willing to waive or redraft provisions in the note and trust deed, such as the prepayment penalty or variable interest rate, or even eliminate or modify the due-on-sale provision.

Before approving the assumption, the lender may also ask the EP investor to provide credit information and an appraisal of the property to ensure its value has not deteriorated to an unacceptable level.

Once the assumption terms are settled, the EP investor must make sure the terms are confirmed in writing. The assumption agreement should be signed and delivered to escrow, together with any subordination agreements from junior trust deed holders to be delivered to the lender and the title company on closing.

In negotiating an assumption/waiver of the due-on rights with the lender, the EP investor may never rely on the lender's oral promises. The lender's promise to waive its due-on rights is not enforceable unless in writing. [Calif. Civil Code §1624]

If the modification demanded by the lender on the assumption does not fall within the loan assumption parameters spelled out in the EP agreement, the EP investor may:

- assume the loan at the lender's rate, thereby waiving his contingency;
- close the transaction by taking title subject to the loan without a formal assumption;
- negotiate a cash-to-new-loan arrangement with the seller, and obtain new financing; or

- cancel the transaction based on the assumption/modification demands exceeding the limitation in the purchase agreement.

Waiver by conduct

While a lender's promise to waive its due-on-sale clause must be in writing to be enforceable, a lender can also waive its due-on rights by its conduct.

For example, an investor purchases property taking title subject to an existing loan and without a formal assumption with the lender.

A beneficiary statement is ordered by escrow, but the lender is not informed when the actual transfer occurs. However, the lender later becomes aware of the transfer, but does not call the loan.

The lender continues to accept several monthly payments from the investor after its discovery of the transfer of ownership to the investor.

Later, interest rates climb and the lender calls the loan based on the sale. The EP investor refuses to pay off the loan and the lender begins foreclosure. The EP investor seeks to stop the foreclosure, claiming the lender waived its due-on rights by accepting payments after it became aware of the transfer.

Can the lender call the loan and foreclose on the property?

No! The lender has, by its conduct, *waived* its due-on-sale rights regarding the transaction. The lender failed to take steps to call the loan, or if it called the loan, it failed to act on the call, while continuing to accept several monthly payments from the investor after becoming aware of the transfer. [**Rubin** v. **Los Angeles Federal Savings & Loan Association** (1984) 159 CA3d 292]

Chapter 15 FHA and VA loan assumptions

This chapter reviews Federal Housing Administration (FHA) and Veterans Administration (VA) enforcement of assumption rules for loans they have insured.

Avoiding fees and investor prohibitions

An investor and his real estate agent discuss the investor's intent to add more single family residences (SFRs) to the pool of rentals he has owned for some time, a client situation called *counseling*. The investor is interested in inexpensive homes in foreclosure financed with maximum loan-to-value (LTV) fixed-rate loans insured by the Federal Housing Administration (FHA).

Specifically, the investor wants to **take over** existing financing rather than obtain new financing to fund his purchase of the SFRs. His cash reserves will be used to upgrade the properties. The investor is aware that the interest rate and the mortgage insurance premium (MIP) on FHA loans is higher by approximately 0.6% than conventional loans with private mortgage insurance (PMI), the result of greater leverage.

The investor's agent explains that the trust deeds FHA uses for loans insured by the Department of Housing and Urban Development (HUD) include *due-on-sale clauses*. In order to prevent investors from acquiring SFRs with FHA-insured financing, the **due-on-sale** provision allows HUD to call loans taken over by investors. The reason for discouraging investors from taking over loans is HUD's need to reduce the number of defaults on FHA loans, since investor-owners generally have a high default rate compared to owner-occupants of SFRs.

However, the investor is made aware that before the lender can *call* an FHA-insured loan on the sale of the SFR property, the lender must first obtain HUD's approval. [HUD Mortgagee Handbook 4155.1 Chapter 7.1.b]

In practice, HUD does not grant the right to call unless a default already exists. Thus, lenders are limited to using the due-on clause as a device to pressure an investor to assume the loan, typically accomplished by contacting the seller prior to the close of escrow. The objective of lenders is *revenue*; they obtain it by demanding and receiving an assumption fee of one-half point or more on the sale and ignoring HUD's late-80s no-investor rule.

Taking over an FHA loan

Prudent long-term investors seek out desperate property owners who are in default, then pay little or no money down and convert the property to a rental unit based on the investment fundamentals of "price, time, and location." The best time for property acquisition is during a crisis, such as a recession, when the market is temporarily devoid of sufficient buyers to keep prices at their past levels and selection within prime rental areas is extensive.

However, some individuals entering the real estate market are not in the ownership of real estate for long-term income benefits, but are *speculators* entering the market during boom times intending to immediately flip the property upon buying it, without investing any further capital. In doing so, they often do not make payments to the lender, looking only to pay off the loan on a prompt resale. Homeowners' associations (HOAs) and the local tax collector (supplemental tax billings) also get burned by the conduct of speculators as they sandwich themselves in between sellers and homebuyers or rental investors to withdraw wealth from the real estate market.

Speculators often collect and keep rent without making payments on the loan, called *rent skimming*, or *equity skimming* if done on a scale of five or more units. **Rent and equity skimming** is a crime under federal and state laws. [12 United States Code §1709-2; Calif. Civil Code §§890 et seq.]

In response to the activities of rent-skimming speculators during the 1980s, HUD prohibits investor assumptions on FHA-insured SFR loans. Thus, FHA will only allow the assumption or take-over of an FHA-insured SFR loan by qualified owner-occupant buyers. HUD has the right to call the loan if taken over by anyone other than a homebuyer. [HUD 4155.1 Chapter 7.1.b]

However, in spite of the HUD due-on enforcement policy, only with HUD's prior approval can the servicing lender call the loan on a subject-to transfer to an investor. As a matter of practice, HUD has not authorized a call when an investor acquires the property, unless the investor defaults on loan payments.

Closing sales subject to FHA-insured loans

Rental investors and unqualified buyers who have the financial ability to make payments on an FHA loan encumbering property they have agreed to purchase should obtain a beneficiary statement from the lender, through escrow, to confirm the seller's representation of the loan terms.

The buyer then closes escrow, taking over the loan by either:

- cashing out the seller's equity; or
- combining cash and a note carried back by the seller to pay for the seller's equity.

The seller's risk of FHA recourse

Sellers must be made aware of their **risk of loss** when permitting a buyer to take title subject-to their FHA loan.

The downside risk for a seller of a property encumbered by an FHA-insured loan is his **personal liability** for any loss the FHA may incur due to a deficiency in the property value at the time of a default by the buyer. This deficiency in the property value might occur after the close of escrow.

If the subject-to buyer fails to make payments on the FHA loan, and the property's value becomes insufficient to satisfy the remaining loan balance, HUD has the right to collect a deficiency from the original borrower.

The right to pursue the original borrower for any deficiency belongs to HUD, not the lender.

Borrowers under programs insured by the FHA or Veterans Administration (VA) do not receive California **anti-deficiency protection** for losses sustained by these federal agencies. The federal statutory right to collect losses on the HUD loan insurance program preempts state law to the contrary. [**Carter** v. **Derwinski** (9th Cir. 1993) 987 F2d 611]

Thus the seller, on a transfer of title subject to an FHA loan, should consider entering into an *assumption agreement* with the buyer and securing the agreement by a performance trust deed. [See **first tuesday** Forms 432 and 451]

Then, if the buyer does not perform on the **assumption agreement** by making payments on the loan, the seller may call all amounts due by the terms of the assumption agreement and foreclose under the trust deed to protect his interests.

Release of liability

To be released from liability for any deficiency on an FHA-insured loan taken over by a buyer, a seller must obtain a formal *release of liability* as part of the assumption package presented by the lender on an FHA-insured loan. [HUD 4155.1 Chapter 7.1.e]

A **release of liability** will be granted by the lender if:

- the seller requests a release from personal liability;
- the prospective buyer is creditworthy;
- the prospective buyer assumes the loan; and
- the lender uses an FHA-approved form to release the seller from personal liability. [HUD Form 92210.1; 24 Code of Federal Regulations §203.510(a)]

If the conditions for a release of liability exist, but the seller does not request the release from personal liability, the seller remains liable to the FHA for any losses due to a default occurring within five years after the sale. [12 USC §1709(r)]

However, after five years pass from the time the property is resold, the seller is released from personal liability, if:

- the buyer assumes the loan with the lender;
- the loan is not in default at the end of the five-year period; and
- the seller requests the release of liability from the lender. [24 CFR §203.510(b)]

Many owners sell their homes subject-to FHA-insured loans knowing full well the risks of a deficiency. However, sellers generally believe future appreciation and HUD's recent refusal to pursue collection of loan losses minimize any real risk of value-deficiency exposure.

In economically depressed parts of the country, property is conveyed subject-to FHA-insured loans as a way to obtain buyers, an activity which tends to decrease the level of foreclosures against homeowners who can no longer afford to own the home or must relocate for job opportunities.

Conversely, a demand for a substitution of liability and assumption fees on a loan takeover tends to drive potential buyers away. Thus, the price of homes is driven down, adversely affecting the level of foreclosures and increasing the risk of loss in homeownership.

FHA inactivity on a sale

Any hesitation a seller may have about selling an SFR subject-to an FHA-insured loan is put at ease by HUD's internal policy not to collect deficiencies against owners who made loan payments in **good faith**.

After foreclosure by a lender, the FHA pays the lender for any loan losses under their MIP or acquires the property by paying off the loan. If acquired, the FHA resells the properties to offset its losses. FHA then sends collection letters but does not have a history of otherwise contacting the homeowner.

Sellers who receive cash for their entire equity occasionally ignore the loan assumption provision and lender threats, and close subject to an FHA-insured loan.

Sellers with well-seasoned loans, or who are extremely motivated to sell, might disregard the due-on clause when selling their home.

HUD, with its **no-investor policy**, severely cripples a defaulting seller's ability to sell his home and financially right himself, or obtain mobility to relocate to a better job.

If HUD's no-investor policy were enforced, it would tend to increase the number of FHA repossessions and cause unemployment levels to remain higher than if owners could move to where the jobs are, which are undesirable effects.

Thus, buying a residence subject-to an FHA-insured loan, regardless of when the loan was originated, will likely continue without government interference and lender assumption threats, so long as the loan is kept current.

Assuming a VA loan

The VA loan assumption policy is entirely different from the HUD/FHA assumption policy.

A buyer of property secured by a VA-guaranteed loan may take over the loan if:

- the loan is **current**;
- the buyer **assumes** the loan; and
- the buyer is **creditworthy**. [38 USC §§3713(a); 3714(a)(1)]

For a buyer to assume a VA loan, a fee of 0.5% of the loan balance is to be paid to the VA by the buyer. [38 USC §3729(b)]

The VA **assumption fee** is to be paid to the lender on closing the sale with the buyer. The lender has 15 days to forward the fee to the VA or the lender will face late charges. [38 CFR §36.4312(e)(2)]

Additionally, the lender can charge and retain an assumption fee of the lesser of:

- $300, plus the costs of a credit report; or
- the maximum amount for an assumption fee allowed under state law. [38 CFR §36.4312(d)(8)]

While no statutory rule exists in California for calculating assumption fees, the fees should reflect actual out-of-pocket costs, or reasonable cost estimates for processing the assumption.

When an assumption application is approved by the lender, the VA borrower is released from further liability to the VA under the mortgage insurance program, including liability for losses caused by the buyer's default in payments. [38 CFR §36.4323(h)]

However, the veteran who is released by the VA is not necessarily released by the lender from further liabilities for the loan. For instance, the veteran who **refinances** his home with a VA insured loan has liability under the loan (as well as to the VA) for any deficiency in the property value to cover the loan.

The veteran exposed to refinancing liability should consider negotiating and entering into a *novation agreement* with the lender in order to be relieved of liability for a potential deficiency. Liability to a lender for a loan used to refinance a property is different from the mortgage insurance liability the veteran has with the VA.

A **novation agreement** requires the consent by three parties — the buyer, seller, and lender — to release the seller from further liability to the lender when the seller is released from mortgage insurance liability by the VA under a *substitution of liability*.

If the lender refuses to allow the buyer to assume the loan, the VA may review the findings and determine whether the buyer is entitled to assume the loan.

If the veteran is unable to make payments on his VA-insured loan, but finds a qualified buyer to assume the loan, the VA may require the lender to agree to the loan assumption since it is in the best interest of the VA. [38 USC §3714(a)(4)(B)]

However, neither the lender nor the VA have to release the seller from liability on the loan when the assumption is granted to avoid foreclosure. [38 CFR §36.4323(h)]

If the VA refuses to allow the buyer to assume the loan, and the veteran borrower sells the property nonetheless, the lender may call the loan and demand payment of the remaining principal and interest without prior approval from the VA. [38 USC §3714(a)(4)(C)]

Also, the lender may call the VA loan if the veteran borrower sells his personal residence and fails to notify the lender of the sale. [38 USC §3714(b)]

However, when a lender becomes aware the veteran borrower sold the property secured by a VA loan and the lender fails to notify the VA, then the lender, not the seller, will be liable for any VA losses on the loan. [38 USC §3714(c)(1), (2)]

Chapter 16 Assumptions: formal and subject-to

This article explores the takeover of an existing loan by an investor on his purchase of a homeowner's residence during the period it is in foreclosure.

A loan takeover by an EP investor

On the sale of a parcel of real estate, any existing financing encumbering the property may remain of record and be taken over by a buyer under one of four procedures:

- a **formal assumption** between the lender and the buyer;
- a **subject-to assumption** between the seller and the buyer;
- a **subject-to transfer** of ownership without an assumption agreement of any type; and
- a **novation** on the loan between the lender, seller and buyer.

Consider a seller of his personal residence that is encumbered by a first trust deed in foreclosure. The seller enters into an equity purchase (EP) agreement and escrow instructions that provide for an investor to **take title subject-to** the existing first trust deed loan. [See **first tuesday** Form 156 §5]

The investor plans to close escrow on the transfer without entering into a written assumption agreement with the lender, often called a *formal assumption*. The investor intends to negotiate with the lender after closing and before he brings the loan current to determine whether the lender will call the loan or demand an assumption and modification of loan terms. If negotiations are unsuccessful, the EP investor can refinance with another lender.

The interest rate on the seller's existing loan is at or above current market levels. The experience of the investor and his broker indicates the lender will not call the loan and demand a payoff or assumption under the circumstances. If it calls the loan, the investor reasons the lender will lose either its servicing fees or its high portfolio yield on the loan, and will still have an uncured delinquency, depending on whether the lender is servicing the loan for another lender or owns the loan.

A beneficiary statement is requested by escrow. The lender properly complies with the request by sending a statement of the loan condition to escrow within 21 days of its receipt of the request. [Calif. Civil Code §2943(e)(3); see Chapter 20]

However, the lender unilaterally **instructs escrow** not to close until the investor has been approved by the lender and has assumed the loan since the lender's trust deed contains a due-on clause.

Can the lender interfere with the closing of a subject-to transaction when the investor and seller do not also instruct escrow to process a lender approval or loan assumption?

No! Escrow instructions for the sale of property subject to the existing loan are entirely between the investor, seller, and escrow. The lender has no legal right to interfere with the transaction to prevent the closing since it is not a party to the escrow.

More importantly, escrow has no authority from its principals to follow any lender instructions attached to the beneficiary statement. The lender's remedy is limited to calling the loan under its due-on clause in the trust deed after the subject-to transaction is closed. [**Moss** v. **Minor Properties, Inc.** (1968) 262 CA2d 847]

The subject-to transaction

A subject-to transaction is initially structured by use of a financing provision in a purchase agreement form. The subject-to provision provides for entry of the principal amount of the loan and the terms for its payment, applying the amount to the purchase price the investor will pay for the property. The financing provision states the investor is to take title to the property subject to the existing loan. [See **first tuesday** Form 156 §§5 and 6]

The seller's representation of the terms of the loan is confirmed by the investor on receipt of the lender's **beneficiary statement** by escrow. The investor can rely on the beneficiary statement for future payment schedules, interest rates, and loan balances in spite of the lender's attempts to stipulate escrow's use of the beneficiary statement is conditioned on the investor's assumption of the loan. [CC §2943(d)(1)]

Some investors instruct escrow not to request a beneficiary statement, fearing the request may cause the lender to **call or modify** the loan after escrow closes. The seller's most recent loan payment receipt or annual loan statement might then be used as the source of loan information. However, the investor must be aware the lender is not bound by the content of the payment statements as it is bound by the beneficiary statement. [See Chapter 20]

Some investors acquire their ownership rights to property under **unrecorded sales documents** such as lease-option agreements or land sales contracts. Thus, the seller and investor completely avoid conveyances, escrow, title insurance, and most other customary (and expensive) transfer activities until they can either work out an assumption or originate new financing.

However, these unrecorded sales transactions do trigger due-on clauses and property reassessments, as well as create risks of loss inherent in an unrecorded transaction and leave room for misunderstandings about who owns the property.

During periods when current market interest rates are comparable to or lower than the note rate on an existing loan:

- a **beneficiary statement** should be ordered to confirm the loan amount and loan terms;
- the change of ownership conveyance should be **recorded and insured**; and
- the conveyance should promptly be brought to the **lender's attention** so it cannot wait and later call the loan when rates rise by claiming the transfer went undisclosed.

Conversely, when current interest rates are rising or higher than the note rate on an existing loan, the lender is often not notified of a subject-to sales transaction. Notice of the transaction would allow the lender to gain financially from a call or recast of the loan at the expense of both the seller and the investor.

However, the lender can enforce its due-on clause and call the loan on its *future discovery* of any sale, regardless of how the sale was structured. Also, on a later discovery of the transfer, any brokers, attorneys, or accountants whose **primary objective** in negotiating the sales transaction was to induce the investor and seller to avoid the due-on clause may be liable to the lender (in tort) for any *retroactive interest differential* (RID) lost by the lender based on market rates at the time of the transfer. A *hold harmless agreement* from the seller or the investor would be appropriate for providing indemnity to the agents and brokers negotiating the undisclosed transaction.

The seller of property, which was sold either subject-to or on an assumption of the existing loan, should be concerned about his liability for the loan after it is taken over by the investor. Seller liability initially depends on whether the loan is a *recourse* or a *nonrecourse loan*. However, the seller is liable for the lender's loss resulting from its error on a beneficiary statement or a payoff demand, up to the value of the property.

Nonrecourse debt

A seller is not liable for a deficiency in property value on the foreclosure of a *purchase-money* loan previously taken over by a buyer under any procedure. The loan is a nonrecourse debt subject to *anti-deficiency* laws.

Purchase-money loans secured by real estate include:

- seller carryback financing on the sale of any type of real estate which becomes the sole security for the carryback note;
- a loan or debt which funded or financed the purchase of an owner-occupied, one-to-four unit residential property, also called a *purchase-assist loan*. [Calif. Code of Civil Procedure §580b]; and
- a loan made for the construction of an owner-occupied, single family residence (SFR), and perhaps a loan made to improve the structure (the legal status of dwelling improvement loans remains uncertain).

A trust deed lender on a default in a **purchase-money** loan may only resort to the property by foreclosing to recover the balance due. [CCP §580b]

Even if the property has insufficient remaining value to satisfy the balance of the purchase-money loan on foreclosure, the lender cannot hold the original borrower (seller) or an assuming buyer personally liable for any deficiency in the property value, unless:

- the buyer inflicts *waste* on the property; and
- the lender *underbids* to provide for the judicial recovery of the dollar amount of the waste.

On the take-over of a purchase-money loan by an investor, the loan retains its original nonrecourse purchase-money characteristics, regardless of whether the investor takes title subject-to or assumes the loan, or a novation occurs. [**Jackson** v. **Taylor** (1969) 272 CA2d 1]

Thus, an investor who takes over a purchase-money loan under any procedure is entitled to the anti-deficiency protection embedded in the loan. In contrast, **purchase-assist** financing originated by a non-occupying investor on any type of residential property, including one-to-four unit residential property, would be a recourse loan, not a *purchase-money loan*.

However, while the lender may have no recourse to the buyer, if the loan is insured by the Federal Housing Administration (FHA) or the Veterans Administration (VA), either of those entities has recourse to the borrower who signed the note for losses under their mortgage insurance programs on foreclosure and resale of the property. [See Chapter 15]

Recourse real estate loans

Recourse loans are all loans not classified as **purchase-money loans** as reviewed above.

Consider an investor who takes title to property subject to an existing home equity loan, a recourse (liability) loan. The loan proceeds were not used to purchase or improve the seller's residence.

The investor defaults on the loan and the lender initiates and completes a judicial foreclosure (not a trustee's sale) on the property. The fair market value of the property at the time of the judicial foreclosure sale is insufficient to fully satisfy the loan, resulting in a deficiency.

The lender now seeks a money judgment against the seller for the amount of the deficiency in the property's value since the fair market value bid at the judicial foreclosure sale did not fully satisfy the loan amount. The seller claims he is not responsible for the loan since it was taken over by the investor.

Is the seller liable for the deficiency on the recourse loan after the investor takes title to the secured property subject to the existing loan?

Yes! When property is sold and its title is conveyed to a buyer **subject-to** an existing recourse loan, the seller remains liable for any deficiency on the recourse loan should the buyer fail to pay. [**Braun** v. **Crew** (1920) 183 C 728]

Further, unless the buyer enters into an **assumption agreement** with either the seller or the lender, the buyer is not liable to either the seller or the lender for a drop in the property's value below the loan balance (unless the buyer damages the property resulting in a decrease in its value, called *waste*). [**Cornelison** v. **Kornbluth** (1975) 15 C3d 590; CC §2929]

However, if the subject-to investor and the lender later enter into an assumption agreement that includes a significant modification of the terms of the recourse loan without the seller's consent, the seller cannot be held liable for the loan. [Braun, *supra*; CC §2819]

Buyer-seller assumption

A seller can reduce his risk of loss when a buyer takes over a **recourse loan** by including a provision in the purchase agreement that requires the buyer to enter into an **assumption agreement** with the seller, called a *subject-to assumption*.

A subject-to assumption agreement is not to be confused with a so-called *formal assumption* entered into between the buyer and the lender.

The subject-to assumption, initially agreed to in the purchase agreement and documented in escrow, is a promise given by the buyer to the seller to perform all the terms of the loan taken over by the buyer on the sale. [See Form 431 accompanying this chapter]

The subject-to assumption agreement gives the seller the right to be held harmless — *indemnified* — by the buyer for the amount of any deficiency judgment a recourse lender might be awarded against the seller in a judicial foreclosure. To be enforceable by the seller, the assumption agreement must be in writing. [CC §1624]

Although the buyer's promise to pay the loan under a subject-to assumption is given to the seller, the buyer also becomes liable to the recourse lender under the legal doctrines of *equitable subrogation* and *third-party beneficiaries*. [Braun, *supra*; see Form 431 §6]

Even though the buyer, upon entering into any type of assumption agreement, takes over the primary responsibility for the recourse loan, the seller remains **secondarily liable** to the lender. The seller's risk of loss arises when the buyer fails to pay the recourse loan and the market value remaining in the property is insufficient to cover the loan amount. [**Everts** v. **Matteson** (1942) 21 C2d 437]

To avoid the delay in pursuing reimbursement from the buyer for any loss covered by the subject-to assumption, purchase agreement provisions calling for the buyer to enter into an assumption agreement with the seller may also call for the investor to secure the assumption agreement by a **performance trust deed** carried back by the seller as a lien on the property sold. [See **first tuesday** Forms 432 and 451]

With a recorded trust deed held by the seller to secure the subject-to assumption agreement, any default by the investor on the loan allows the seller to:

- demand the investor to tender the entire balance remaining due on the assumed loan, subject to the investor's right to reinstate the delinquencies; and
- proceed with foreclosure under the performance trust deed to recover the property and cure the default on the loan assumed by the investor.

ASSUMPTION AGREEMENT

Unsecured and Subrogated

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This assumption agreement is entered into by

1.1 _____, as the Buyer,

1.2 and _____, as the Seller,

1.3 regarding Buyer's acquisition of real estate referred to as _____

_____.

2. FIRST TRUST DEED NOTE:

2.1 Buyer is acquiring title to the real estate subject to a first trust deed dated _____,

2.2 executed by _____, as the Trustor,

2.3 in which _____ is the Beneficiary,

2.4 recorded on _____, as Instrument No._____, in the Official Records of _____ County, California, and

2.5 given to secure a promissory note of the same date for the principal sum of $_____.

3. SECOND TRUST DEED NOTE:

3.1 Buyer is acquiring title to the real estate subject to a second trust deed dated _____,

3.2 executed by _____, as the Trustor,

3.3 in which _____ is the Beneficiary,

3.4 recorded on _____, as Instrument No._____, in the Official Records of _____ County, California, and

3.5 given to secure a promissory note of the same date for the principal sum of $_____.

AGREEMENT:

4. Seller hereby assigns and delegates to Buyer all rights and obligations in the above note(s) and trust deed(s).

5. Buyer hereby assumes and agrees to timely pay the debt evidenced by the above promissory note(s) and to perform all of Trustor's obligations under the trust deed(s) securing the note(s).

6. This agreement is made for the benefit of the Beneficiary(ies) of the trust deed(s) securing the note(s).

7. Should Buyer or Buyer's successors default in the performance of this agreement, the whole sum of the principal and interest on the assumed indebtedness(es) shall become immediately due at the option of the holder of this assumption agreement.

7.1 On default, Seller shall become subrogated to the interest of Beneficiary under the defaulted note and trust deed.

8. In any action to enforce this agreement, the prevailing party shall receive attorney fees.

I agree to the terms stated above.	**I agree to the terms stated above.**
Date:_____, 20_____	Date:_____, 20_____
Seller: _____	Buyer: _____
Seller: _____	Buyer: _____

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A **subject-to assumption**, like any subject-to transaction, does not alter the lender's right to enforce its *due-on clause* on discovery of the unconsented-to conveyance, unless the lender has waived its due-on rights by failing to call the loan after acquiring knowledge of the transfer of ownership or to act on a prior call made. [See Chapter 14]

Novation

Consider an EP investor who is willing to cash out a seller-in-foreclosure's equity and assume an existing recourse loan with a lender. However, the seller is unwilling to sell the property and remain liable for the loan after closing when he no longer has an interest in the property and is unable to protect himself.

Can the sale be closed without the seller remaining liable on the recourse loan assumed by the investor?

Yes! The lender can enter into an agreement with both the investor and the seller providing for both the investor's **assumption** of the loan and a **release** of the seller's liability, an agreement called a *novation* or *substitution of liability*. The lender typically charges a fee and may demand a modification of the loan terms if the interest rate on the loan is below current market rates.

On a formal investor-lender assumption of a loan secured by an owner-occupied, one-to-four unit residential property, the lender is required to **release the seller from liability** for the loan assumed by the investor. [12 Code of Federal Regulations §591.5(b)(4)]

A **novation agreement** is comparable to the existing lender originating a new loan with the investor, except the trust deed executed by the seller remains of record and the note remains unpaid.

Thus, the lender under a novation agreement (or a formal assumption) will review the investor's credit status, probably demand a modification of the interest rate to current levels, and charge an assumption fee. So the lender receives all the benefits it would have received on a new-loan origination made to the investor.

However, any fees or increase in the interest rate received by the lender on the loan, called *portfolio yield*, defeats most of the advantages an investor and seller have when the investor takes title subject to the seller's existing loan.

Welcome to economic Darwinism.

Chapter 17 Opening escrow

This chapter explains the equity purchase (EP) investor's use of checklists and pre-printed instructions to better prepare for opening and closing an escrow.

The process of closing the sale

Escrow is a process employed to facilitate the closing of a real estate transaction entered into between two parties, such as an equity purchase (EP) investor and a seller-in-foreclosure, who have agreed to the transfer of real estate, typically under a primary underlying agreement such as a purchase agreement.

An **escrow consists of**:

- **one person**, such as a seller of real estate, who delivers written instruments (or money when he is the buyer) to an escrow company for the purpose of the person fully performing his obligations owed another person under an agreement they previously entered into for the sale, financing, or leasing of real estate; and
- the **escrow company**, who delivers the written instruments (or money) to the other person, such as the EP investor, on the occurrence of a specified event or the performance of prescribed conditions, such as the issuance of title insurance. [Calif. Financial Code §17003(a)]

For an individual to engage in the business of acting as an **escrow agent**, he must himself be licensed and employed by a corporation also licensed by the California Commissioner of Corporations, unless exempt.

Individuals exempt from the escrow licensing requirements include:

- a licensed real estate broker, either individual or corporate, who represents a party to a transaction (an owner, buyer, lender or tenant) in which the broker will perform escrow services;
- a licensed attorney who is not actively engaged in conducting (holding himself out as) an escrow agency;
- a bank, trust company, savings and loan association (thrift), or insurance company; and
- a title insurance company whose principal business is preparing abstracts or making searches of title used for issuing title insurance policies.

Duties of an escrow officer include:

- receiving funds and collecting necessary documents, such as appraisals, disclosure statements, and title reports called for in escrow instructions;
- preparing documents necessary for conveyancing, encumbrancing, and evidencing the creation of debts required for escrow to close;
- calculating prorations and adjustments; and
- disbursing funds and transferring documents when all conditions for their release have been met.

Opening escrow

Consider an investor and seller-in-foreclosure who enter into an EP agreement for the sale of the seller's one-to-four unit principal residence. As agreed, escrow now needs to be opened to handle the closing of the transaction. [See **first tuesday** Form 156 §13.1]

SALES ESCROW WORKSHEET

For Use on Seller-Occupied SFR Properties

DATE: _____, 20_____, at _____, California.

BY: _____

1. PARTIES, PROPERTY AND PRICE:

1.1 Date escrow to close _____

1.2 Property address _____

_____

Parcel number _____

City _____ County _____, California.

1.3 Price $_____

Down payment $_____

Initial deposit into escrow $_____

Loan amount on closing $_____

1.4 Seller's name _____

Address _____

_____

Phone _____ Fax _____ Email _____

Seller's Broker _____

1.5 Buyer's Name _____

Address _____

_____

Phone _____ Fax _____ Email _____

Buyer's Broker _____

2. LIENS OF RECORD:

	First Trust Deed	Second Trust Deed
Original amount	$_____	$_____
Current balance	$_____	$_____
Interest rate	_____% ☐ ARM	_____% ☐ ARM
	Type _____	Type _____
Monthly payments	$_____	$_____
Due date	_____	_____
Assumed or reconveyed	_____	_____
Loan number	_____	_____

Lender(s) name and address(es) _____

_____

2.1 Bond or assessment lien balance of $_____, payable $_____ annually, including interest at the rate of _____%.

District Name _____

Address _____

_____

Phone _____ Fax _____ Email _____

2.2 New Trust Deed loan in amount of $_____, payable approximately $_____ monthly, including interest at the annual rate of _____% ☐ fixed; ☐ ARM.

Loan charges to be paid by _____.

2.3 Seller Carryback Note and Trust Deed $_____ payable $_____ monthly, or more, including annual interest of _____%, all due _____ years from close.
First payment due _____, 20_____.

☐ Contract collection clause [See **ft** Form 442 §3]
☐ 90-day balloon payment notice provision (mandatory on one-to-four residential units) [See **ft** Form 418-3]
☐ Late charge of $_____ after _____ days [See **ft** Form 418-1]
☐ Prepayment penalty [See **ft** Form 418-2]
☐ Due-on-sale clause
☐ All-inclusive Note and Trust Deed addendum [See **ft** Form 442 or 443]
☐ Tax reporting service charge to be paid by _____
☐ Request for Notice of Default/Delinquency on senior Trust Deed [See **ft** Form 412]

3. DISCLOSURES CHECKED ARE YET TO BE MADE TO BUYERS:

3.1 Lead-based paint disclosure for pre-1978 residences — right to inspect/waiver. [See **ft** Form 313]
☐ Buyer's receipt ☐ Seller's compliance
☐ Buyer's Broker acknowledgement ☐ Listing Broker acknowledgement

3.2 Condition of Property — Transfer Disclosure Statement (TDS). [See **ft** Form 304]
☐ Buyer's receipt ☐ Seller's compliance
☐ Buyer's Broker visual inspection ☐ Listing Broker visual inspection

a. Environmental Hazards Guide for Homeowners and Buyers.
☐ Buyer's receipt

b. Home Energy/Rating Information Booklet.
☐ Buyer's receipt ☐ Seller's compliance report
☐ Buyer's Broker acknowledgment ☐ Listing Broker acknowledgment

3.3 Natural Hazard Disclosure Statement — three-day right to cancel. [See **ft** Form 314]
☐ Buyer's Receipt ☐ Seller's compliance ☐ Listing Broker acknowledgement

a. Homeowner's Guide to Earthquake Safety (pre-1960 housing, woodframe, no slab). [See **ft** Forms 315 and 316]
☐ Buyer's receipt ☐ Seller's compliance

b. Commercial Guide to Earthquake Safety for pre-1975 housing (unreinforced masonry, woodframe roof or floors).
☐ Buyer's receipt ☐ Seller's compliance
☐ Buyer's Broker acknowledgment ☐ Listing Broker acknowledgment

3.4 Mello-Roos bond conditions — Notice of Special Tax [District _____].
☐ Buyer's receipt

3.5 Criminal activity and security statement. [See **ft** Form 319]
☐ Buyer's receipt ☐ Seller's compliance

3.6 Certificates for
☐ Well Water ☐ Septic System
☐ Buyer's approval ☐ Seller's compliance

3.7 Tax withholding disclosures. [See **ft** Forms 301 and 301-1]
☐ Seller's compliance ☐ State ☐ Federal ☐ Escrow's Receipt

3.8 Homeowners' association (HOA) documentation: articles, by-laws, CC&Rs, current and approved/additional assessments and unpaid assessments, fines, charges on Seller, unenforceable age restrictions, notice of Owner's violation, list and status of property defects, operating budget, operating rules, CPA's financial statements, insurance policy summary, notice of litigation, and collection and lien enforcement policies.
☐ Buyer's receipt ☐ Seller's compliance

3.9 Financial Disclosure Statement — For Entering into a Seller Carryback Note. [See **ft** Form 300]
☐ Buyer's receipt ☐ Seller's receipt
☐ Buyer's Broker acknowledgment ☐ Listing Broker acknowledgment

3.10 Estimated closing statement — approved prior to closing. [See **ft** Form 402]
☐ Buyer's approval ☐ Seller's approval

3.11 Ordinance Compliance — Local Option Disclosure: city occupancy report, water conservation, retrofit. [See **ft** Form 307]
☐ Buyer's receipt ☐ Seller's compliance
☐ Buyer's Broker acknowledgment ☐ Listing Broker acknowledgement

3.12 Property operating data. [See **ft** Form 352]
☐ Buyer's receipt ☐ Seller's compliance

4. SELLER COMPLIANCE:

4.1 ☐ Termite report and clearance
4.2 ☐ Water heater strapping/bracing installed
4.3 ☐ Smoke detector installed/operative
4.4 ☐ Home warranty policy
insurer _____
coverage _____
4.5 ☐ Payoff demand
☐ Seller's approval [See **ft** Form 429-2]
4.6 ☐ Beneficiary Statement approval by Buyer [See **ft** Form 415]
4.7 ☐ Bill of sale on personal property sold [See **ft** Form 408]
4.8 Holdover Occupancy Agreement [See **ft** Form 272]
☐ Buyer's receipt ☐ Seller's receipt
4.9 ☐ Release of Recorded Instrument [See **ft** Form 409]
4.10 ☐ _____

5. BUYER COMPLIANCE:

5.1 ☐ Preliminary title report approval ☐ Buyer's receipt
5.2 New financing approval.
☐ Buyer's receipt ☐ Seller's receipt
5.3 Interim Occupancy Agreement (pre-closing occupancy). [See **ft** Form 271]
☐ Buyer's compliance ☐ Seller's compliance
5.4 Submission of credit application for carryback note. [See **ft** Form 302]
☐ Seller approval ☐ Buyer's compliance
5.5 ☐ Beneficiary statement on loan takeover or assumption
☐ Buyer's approval
5.6 ☐ Fire/hazard insurance agent _____
☐ Carryback Seller as loss payee
5.7 ☐ Appraisal of property's fair market value
☐ Buyer's approval
5.8 ☐ Home inspector's report [See **ft** Form 269]
☐ Buyer's approval
5.9 ☐ Final pre-closing walk-through inspection [See **ft** Form 270]
☐ Buyer's approval ☐ Seller's compliance
5.10 ☐ _____

6. PRO RATES, ADJUSTMENTS AND MISC. INSTRUCTIONS:

6.1 Impound account on loan takeover to be:
☐ Charged to Buyer and credited to Seller.
☐ Transferred without adjustments.
6.2 Pro rates and credits from ☐ date of closing, or ☐ other date _____:
☐ Property taxes and Mello-Roos type bonds ☐ Rents/Security deposits
☐ Balance/Interest on loan takeover ☐ Association assessments
6.3 ☐ _____

PAGE FOUR OF FOUR — FORM 403

7. TITLE POLICY:

7.1 Seller's vesting _____

7.2 Buyer's vesting _____

Taking title as:
☐ Joint tenants
☐ Separate property
☐ Community property with right of survivorship
☐ Community property
☐ An individual
☐ Tenants in common
☐ An unmarried person

7.3 Title company _____

7.4 Title policy _____

☐ ALTA
☐ ALTA-R
☐ Joint protection
☐ CLTA
☐ Homeowners(s) (one-to-four units)
☐ Lenders
☐ Abstract
☐ Binder
☐ Owners (other than on-to-four units)

Premium to be paid by _____

7.5 Other title conditions _____

8. BROKERAGE FEES: ☐ in mutual instructions ☐ in supplemental Seller instructions

$_____ to _____ paid by _____

$_____ to _____ paid by _____

Agent: _____ Date:_____, 20_____

FORM 403 01-08 ©2008 **first tuesday**, P.O. BOX 20069, RIVERSIDE, CA 92516 (800) 794-0494

In modern real estate practice, **opening escrow** simply means establishing a depository for the deed, the money, and other items, collectively called *instruments*. These deposits accompany instructions signed by all necessary parties authorizing escrow to transfer or hand those items to particular parties or others on closing.

Before accepting any instruments as an escrow holder for a transaction, the escrow officer will need to be informed, i.e., *dictated instructions*, by an agent of one of the parties (or a party himself) regarding precisely when and under what circumstances the documents and monies deposited with escrow are to change hands. Escrow then prepares (drafts) instructions that are signed by the principals to the escrow transaction to authorize escrow to accept and deliver the deposited instruments.

Any number of details (preparation, receipt, and transfer of monies and documents) must be attended to by the escrow holder before the transaction can be completed, called a *closing or settlement*.

As a checklist for "going to escrow," a worksheet helps to organize the collection of facts, data, and supporting papers the escrow officer will need to prepare instructions and clear the conditions to be met to close escrow. [See Form 403 accompanying this chapter]

The documents work together

Modern real estate sales transactions depend on the purchase agreement and the escrow instructions working in tandem to close a transaction.

Both the purchase agreement and the escrow instructions are *contracts* regarding interests in real estate. To be enforceable under the Statute of Frauds, both documents must be **in writing**. [Calif. Civil Code §1624; Calif. Code of Civil Procedure §1971]

A purchase agreement sets forth the sales price and terms of payment, together with conditions to be met before closing.

ESCROW INSTRUCTIONS

Buyer and Seller Instructions

DATE: _____, 20_____.

Items left blank or unchecked are not applicable.

Escrow number _____

Escrow/Brokerage company _____

Licensed by the Department of _____, State of California, license # _____

Escrow officer _____

Address _____

Phone number _____

Fax _____

Buyer _____

Seller _____

An escrow administrative fee will be charged each principal for postponement of closing by two months or more beyond the originally scheduled closing date in these instructions or on cancellation of these instructions, due to acts or omissions of either principal.

Postponement Fee . . . $_____

Cancellation Fee . . . . $_____

Buyer's Initials	Seller's Initials
_____ _____	_____ _____

TERMS OF SALE: (for escrow use only)

$_____ TOTAL Consideration Seller to receive from Buyer

$_____ Assessment Bond paid with property taxes

$_____ 1st Trust Deed of Record

$_____ 2nd Trust Deed of Record

$_____ Trust Deed to record

$_____ Trust Deed to record

$_____ Cash through Escrow

$_____ Other Consideration _____

1. You, the escrow officer, are authorized and instructed as follows:

1.1 Buyer deposits herewith the sum of $_____.

1.2 On or before _____, 20_____, the date set for closing, Buyer will deposit with You on your request the additional sum of $_____, to make a total deposit of $_____.

1.3 Buyer will deliver to You prior to the date set for closing any additional funds and instruments required which You request.

1.4 You may thereafter use these funds and instruments until such time as You have received written instruction not to do so. Brokers are authorized to extend any performance date up to one month.

1.5 Close of escrow is the date instruments are recorded.

2. Upon the use of these funds and instruments, You are to obtain the following policy of title insurance, with the usual title company exceptions, in the following checked type and form:

Title to be vested in Buyer or Assignee free of encumbrances other than those set forth herein. Buyer's interest in title to be insured under a policy issued by _____

as a(n) ☐ Homeowner(s) policy (one-to-four units), ☐ Residential ALTA-R policy (vacant or improved residential parcel), ☐ Owner's policy (other than one-to-four units), ☐ Joint Protection policy (also naming the Carryback Seller or Purchase-assist Lender), or ☐ Binder (to insure resale or refinance within two years).

Endorsements _____

_____

2.1 With title insurance in the amount of $_____ covering the following described real property, commonly known as _____

and legally described as _____

_____

_____

_____,

2.2 Showing title vested in _____

2.3 Subject to the following only:

a. All General and Special taxes for the _____ fiscal year, including any special district taxes or personal property taxes collected with the ad valorem taxes.

b. Assessments and Bonds with an unpaid balance of $_____.

c. Any covenants, conditions, restrictions, reservations, rights, right of ways and easements of record, or in deed to record, and EXCEPTIONS of water, minerals, oil, gas, and kindred substances, on or under said real property, now of record, or in deed to record.

d. First encumbrance now of record with an unpaid balance of $_____, payable $_____ monthly, including interest of _____% per annum. ☐ ARM

e. Second encumbrance now of record with an unpaid balance of $_____, payable $_____ monthly, including interest of _____% per annum, all due and payable _____, 20_____.

f. Deed of Trust to record in the amount of $_____.
Execution of loan documents under §2.3f or §2.3g shall be Buyer's approval of their terms. Should Seller carry back under §2.3h, You are to obtain Seller's written approval of the loan terms for any Deed of Trust to record.

g. Deed of Trust to record in the amount of $_____.

h. Purchase money Deed of Trust with Assignment of Rents on standard form, executed by Buyer securing a note for $_____ in favor of Seller as their interests appear on the preliminary title report, with interest at _____ % per annum from close of escrow, principal and interest payable in installments of $_____, or more, each on the same day of every calendar month, beginning one month from ☐ close of escrow, or ☐ _____, 20_____, and continuing until _____.
You, as escrow holder, are instructed to prepare the note and Deed of Trust and insert the correct principal amount and correct first payment date, interest accrual date and due date as soon as they can be determined. The address for deliver of note payments is _____
_____.

3. You are to obtain at Seller's expense beneficiary statements on the Deed(s) of Trust (or mortgage) now of record (§2.3d and §2.3e above). If the principal balances shown by the statements are more or less than the amount shown above, You are to make adjustments as checked below:

☐ cash through escrow, ☐ total consideration, or ☐ purchase-money Deed of Trust.

3.1 You are to deliver to Buyer for Buyer's approval prior to close of escrow a copy of the beneficiary statement for each Deed of Trust to remain of record on closing.

3.2 You are to deliver to Seller prior to close of escrow, any payoff demand necessary to eliminate encumbrances so You can comply with conditions in §2.3 for title insurance.

4. You are to obtain at Seller's expense a UCC-3 clearance on the following described personal property
_____
_____
_____

and cause title thereto to be vested in Buyer subject to the following UCC-1 financing statements:

a. A UCC-1 obligation in the approximate amount of $_____, payable $_____ per month, including an annual percentage rate of _____%, all due and payable _____, 20_____.

b A UCC-1 form in favor of Seller at Buyer's expense as additional security for any note carried back under §2.3h above.

5. Prior to close of escrow, Buyer is to hand You a sufficient hazard insurance policy. In the event Seller carries back under §2.3h above, then Seller is to be named as additional loss payee. The policy is to be in an amount sufficient to cover all lien balances or the coverage demanded by the new lender if greater in amount.

6. ☐ Prior to the close of escrow and at Seller's expense, Seller to hand You a structural pest control clearance on the subject property.

7. ☐ Prior to close of escrow and at Seller's expense, You are to obtain a one-year policy of homeowner's warranty issued by _____, in favor of Buyer, covering _____.

8. Prior to the close of escrow and at Seller's expense, You are to obtain from the homeowners' association (HOA) of any common interest development which includes the described property the following checked item(s) for Buyer's approval:

8.1 ☐ A statement of condition of assessments;

8.2 ☐ Copies of the association's articles, bylaws, CC&Rs, collection and lien enforcement policies, operating budget, operating rules, CPA's financial review, insurance policy summary and any age restriction statement;

8.3 ☐ Copies from the association of any notice to Seller of CC&R violations, any list of construction defects, and any assessment charges not yet payable.

9. ☐ You are authorized and instructed to prepare assignments for all existing lease/rental agreements.

10. The following checked prorations and adjustments shall be computed by You on a monthly basis of 30 days as of ☐ close of escrow, or ☐ _____, 20_____, on which date Buyer is to be treated as the owner for the entire day:

a. ☐ Taxes, based on latest tax statement available and Seller warrants that no reassessment or reassessment activity has since occurred

b. ☐ Hazard (fire) insurance premium

c. ☐ Interest on existing note(s) and Deed(s) of Trust

d. ☐ Rents and deposits based on rental statement handed to You and approved by Buyer and Seller prior to close of escrow

e. ☐ Impounds, under §2.3d or §2.3e above, together with an assignment of these impounds to Buyer through escrow

f. ☐ Association assessments for any common interest development which includes the property

g. ☐ _____

10.1 You are to account for the above prorations and adjustments into the item checked below:
☐ cash through escrow, ☐ total consideration, or ☐ purchase-money Deed of Trust.

11. You are to promptly obtain and hand Buyer a preliminary title report on the property from title company for Buyer's approval or disapproval and cancellation of this transaction within _____ days of receipt by Buyer or Buyer's Broker of the report.

12. The Grant Deed to state the tax statements are to be mailed to _____

_____

at _____.

13. Escrow is herewith handed a purchase agreement dated _____, 20_____ and (a) counteroffer dated _____, 20_____, entered into by Buyer and Seller regarding the sale of the property which authorizes and instructs escrow to act on the provisions of the agreement as mutual escrow instructions to close this transaction.

13.1 Any inconsistencies between the provisions in the purchase agreement and provisions in the instructions prepared by escrow shall be controlled by the instructions prepared by escrow.

14. The close of escrow and disbursement of funds can be affected based on the form of the deposit with escrow. Funds deposited in cash or by electronic payment allow for closing and disbursement on or after the business day of deposit with the escrow's financial institution. Funds deposited by cashier's check allow for closing and disbursement on or after two business days after deposit with the escrow's financial institution. All other forms of deposit cannot be disbursed and thus, the closing cannot occur until the funds are made available to escrow by the escrow's financial institution.

15. Buyer is required to withhold 10% of each Seller's share of the sales price for payment of Seller's federal income taxes on this transaction, unless Seller meets one of the following conditions:

15.1 Each Seller provides Buyer with their taxpayer identification number and declares under penalty of perjury to be a citizen of the United States or a resident alien [**ft** Form 301];

15.2 Buyer declares under penalty of perjury the property will be used as their residence and the sales price is $300,000 or less [**ft** Form 301]; or

15.3 Seller requests and obtains a withholding certificate from the Internal Revenue Service (IRS) authorizing a reduced amount or no amount be withheld.

16. Buyer is required to withhold 3⅓% of each Seller's share of the sales price for payment of Seller's California income taxes on this transaction, unless one of the following exemptions exists:

16.1 Seller executes a real estate withholding certificate, FTB form 593-C, declaring the sale is exempt due to:

a. The property sold is or was last used as Seller's principal residence;

b. The property sold was the decedent's principal residence;

c. The property was sold as part of an IRC §1031 exchange;

d. The property was taken by involuntary conversion and will be replaced under IRC §1033; or

e. The property was sold at a taxable loss.

16.2 Buyer is also exempt from withholding 3⅓% of Seller's share of the sales price if:

a. The property was sold for less than $100,000;

b. Buyer is acquiring the property by a deed-in-lieu of foreclosure; or

c. Seller is a bank acting as a trustee under an agreement other than a Deed of Trust.

16.3 On an installment sale, Buyer may agree to withhold on each payment on the carryback note and thus defer withholding. [FTB Forms 593-I and 597]

17. In the event You become involved in litigation between Buyer and Seller arising out of this transaction, Buyer and Seller shall pay a reasonable fee for attorney services which You may be required to incur.

17.1 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

18. You are authorized to use Seller's instruments when You hold and can deliver to Seller the money and instruments to be delivered to Seller under these instructions.

18.1 You are authorized to pay and charge Seller for the following checked item(s):

a. ☐ Bonds, assessments, taxes and other liens of record to show title as called for.

b. ☐ Documentary transfer taxes as required.

c. ☐ Brokerage fees: $_____ to _____
$_____ to _____
$_____ to _____

d. ☐ Transaction coordinator's fees:
$_____ to _____
$_____ to _____

e. ☐ Title insurance premium on the policy to be issued to Buyer.

f. ☐ Costs of recording Seller's Grant Deed.

g. ☐ Escrow fees for your services and any charges incurred by escrow on Seller's behalf.

h. ☐ Payables submitted to escrow for payment by Seller or Seller's Broker.

i. ☐ Attorney fees: $_____ to _____

j. ☐ _____

19. You are authorized to pay and charge Buyer for the following checked item(s):

a. ☐ Escrow fees for your services and any charges incurred by escrow on Buyer's behalf.

b. ☐ Costs of and lender's charges for recording or assuming any Deed of Trust, including a policy of title insurance for any new lender.

c. ☐ Attorney fees: $_____ to _____

d. ☐ Brokerage fees: $_____ to _____

e. ☐ Title insurance premium on the policy to be issued to Buyer.

f. ☐ _____

20. _____

_____

_____

I hereby agree to perform all acts called for above to be performed by Seller.	**I hereby agree to perform all acts called for above to be performed by Buyer.**
Date: _____, 20_____	Date: _____, 20_____
Seller: _____	Buyer: _____
Signature: _____	Signature: _____
Seller: _____	Buyer: _____
Signature: _____	Signature: _____
Address: _____	Address: _____
_____	_____
Phone: _____	Phone: _____
Fax: _____	Fax: _____
Email: _____	Email: _____

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TITLE INSURANCE ADVISORY NOTICE
(Calif. Civil Code §1057.6 Disclosure Statement)

To Buyers acquiring real estate under escrow instructions
number _____, dated _____, 20_____,
with _____, as the Escrow/Broker Company.

NOTICE: IMPORTANT: IN A PURCHASE OR EXCHANGE OF REAL PROPERTY, IT MAY BE ADVISABLE TO OBTAIN TITLE INSURANCE IN CONNECTION WITH THE CLOSE OF ESCROW SINCE THERE MAY BE PRIOR RECORDED LIENS AND ENCUMBRANCES WHICH AFFECT YOUR INTEREST IN THE PROPERTY BEING ACQUIRED. A NEW POLICY OF TITLE INSURANCE SHOULD BE OBTAINED IN ORDER TO ENSURE YOUR INTEREST IN THE PROPERTY THAT YOU ARE ACQUIRING.

I have received a copy of this disclosure statement.

Date:_____, 20_____
Buyer: _____
Signature: _____
Buyer: _____
Signature: _____

FORM 401-1 12-07 ©2008 **first tuesday**, P.O. BOX 20069, RIVERSIDE, CA 92516 (800) 794-0494

Escrow instructions constitute an additional agreement between the EP investor and seller-in-foreclosure that includes an escrow company. Instructions do not replace the purchase agreement, but are merely directives with which an escrow agrees to comply to carry out the terms of the purchase agreement by coordinating a closing on behalf of both the EP investor and the seller-in-foreclosure.

However, escrow instructions occasionally add exactness and completeness that provide the enforceability sometimes lacking in purchase agreements prepared by brokers or their agents, usually the failure of a signed and delivered acceptance.

The purchase agreement is the primary underlying document in a real estate sales transaction and is considered the original contract. All further agreements, including the escrow instructions, must comply with the primary document, unless **intended to modify** the original agreement.

When agents negotiate a transaction, they and their brokers are responsible for ensuring the escrow instructions, whether prepared or dictated by themselves or others, conform to the purchase agreement.

To provide for a smooth, timely closing, the person dictating instructions needs to collect and hand escrow, at his earliest opportunity, all of the information the escrow officer needs to prepare the instructions and documents. The person dictating instructions should use a **checklist** to mark off the items and information escrow might need to process and close the transaction. [See Form 403]

The escrow officer will prepare the instructions from information provided to the officer. These activities of dictating, reviewing, and conforming instructions to the purchase agreement become the responsibility of the investor and seller-in-foreclosure when no agent is involved.

Of note, an escrow officer does not have an obligation to notify the parties of any suspicious fact or circumstance detected by the officer before close of escrow, unless the fact **affects closing**. However, as is the policy of many an escrow officer selected by the agent (or investor) to handle the closing, the officer will alert the agent (or investor) to potential problems that lie outside the escrow instructions that have been brought to the attention or observed by the escrow officer. [**Lee** v. **Title Insurance and Trust Company** (1968) 264 CA2d 160]

AFFILIATED BUSINESS ARRANGEMENT DISCLOSURE STATEMENT

Residential Broker (Regulation X (RESPA); 24 CFR §3500.15)

NOTE: This notice is for use by Brokers acting as a licensee for a fee negotiating a transaction which involves the financing of one-to-four residential units when referring the Owner or Buyer to providers of other settlement services whose earnings are shared with the Broker. An additional fee to the Broker for the referral is prohibited.

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

1. NOTICE:

1.1 To _____, as the Owner or Buyer,

1.2 from _____, as the Referring Party,

1.3 regarding real estate referred to as _____.

2. This is to give you notice that _____, as the Referring Party, has business relationships with the following settlement service providers:

	Provider	Percentage of Ownership	Description of Relationship
2.1	_____,	_____%,	_____ _____.
2.2	_____,	_____%,	_____ _____.
2.3	_____,	_____%,	_____ _____.

3. Because of these relationships, these referrals may provide _____, as the Referring Party, a financial or other benefit.

4. Set forth at section 5 below is the estimated charge or range of charges for the settlement services listed.

4.1 You are not required to use the listed providers as a condition for the purchase or sale of the subject property.

4.2 **THERE ARE FREQUENTLY OTHER SETTLEMENT SERVICE PROVIDERS AVAILABLE WITH SIMILAR SERVICES. YOU ARE FREE TO SHOP AROUND TO DETERMINE THAT YOU ARE RECEIVING THE BEST SERVICES AND THE BEST RATE FOR THOSE SERVICES.**

5.

	Provider	Settlement Service	Charges or Range of Charges
5.1	_____,	_____ _____.	_____ _____
5.2	_____,	_____ _____.	_____ _____
5.3	_____,	_____ _____.	_____ _____

6. ACKNOWLEDGMENT:

I/We have read this disclosure form and understand that _____, as the Referring Party, is referring me/us to purchase one or more of the above described services and may receive a financial or other benefit as the result of this referral.

The above stated information is true and correct.

I am the ☐ Owner. I am the ☐ Buyer.

Date: _____, 20_____.

Name: _____

Signature: _____

Name: _____

Signature: _____

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Conforming modified instructions

If the escrow instructions drafted and signed are vague or incomplete on any point, the underlying purchase agreement must be reviewed by the agents and the parties before dictating amended or supplemental instructions. The **terms of the purchase agreement supersede** any inconsistencies between the purchase agreement and the escrow instructions, unless a modification of the original purchase agreement is intended and so stated in the instructions.

If the point in dispute is not addressed in the purchase agreement, then it is not part of the contract and must, if agreed upon, be added to the escrow instructions by amendment.

Naturally, amended instructions adding terms that are new or modifications of provisions in the purchase agreement should note they modify the purchase agreement.

Escrow instructions that **modify** the intentions stated or implied in the purchase agreement must be **written, signed, and returned** to escrow by both parties. Proposed modifications signed by some but not all parties are **not binding on a party** who has not agreed to them.

If, before closing escrow, an agent discovers any aspect of the escrow instructions that is in conflict with the intentions expressed in the purchase agreement or the expectations of the EP investor or seller-in-foreclosure, the agent is duty-bound to immediately bring these discrepancies to the attention of the escrow officer and his client. On notification of an error in instructions or a need for clarification, the escrow officer must hold up the close of escrow until the discrepancy is clarified and corrective escrow instructions have been prepared, signed by the investor and seller, and returned to escrow. [**Diaz** v. **United California Bank** (1977) 71 CA3d 161]

Required escrow disclosures

All written escrow instructions signed by an EP investor and seller-in-foreclosure must contain a statement, in not less than 10-point type, setting forth the licensee's name and the name of the state agency issuing the license or granting the authority for the person conducting the escrow to operate.

In addition, all escrow transactions for the purchase of real estate where a **policy of title insurance** will not be issued to the buyer must include an **advisory notice**, prepared in a separate document and signed by the buyer, regarding the need for title insurance. [CC §1057.6; see Form 401-1 accompanying this chapter]

Should the broker hold an ownership in the escrow company the buyer and seller are referred to or using, the broker must disclose the source of additional potential income. [See Form 519 accompanying this chapter]

Finally, escrow has a duty to advise the EP investor in writing of the Franchise Tax Board (FTB) requirements for withholding 3 1/3% of the price paid the seller-in-foreclosure, unless the seller-in-foreclosure certifies he is exempt from state income tax withholding. [Calif. Revenue and Taxation Code §18662(e)(3)(B); FTB Form 593C]

Use of the escrow instructions

The sales escrow instructions, **first tuesday** Form 401, contains all the typical provisions expected in a set of instructions prepared by an independent escrow company for a California sales transaction.

The instructions may be used as an addendum to the purchase agreement for the sales transaction. Both the escrow instructions and the purchase agreement are to be prepared by the agent or EP investor and

signed at the same time by each party. Thus, the need to dictate instructions to the escrow officer and wait for them to be prepared and submitted to the seller and investor for signatures is avoided. [See Form 401 accompanying this chapter]

Chapter 18 Assigning your purchase rights

This chapter analyzes the assignment of the investor's purchase rights held in a property to a substitute buyer, be it an investment group or a resale buyer on a flip.

Syndicating or flipping a property

An enterprising, but undercapitalized equity purchase (EP) investor locates a residence in foreclosure he would like to buy. However, the investor is not financially able to buy, rehabilitate, and carry the property by himself.

If he can make a deal with the seller to buy the property, the investor will sell or exchange his purchase rights to:

- a user who will pay cash to acquire the investor's purchase rights and become a substitute buyer — an activity called *flipping*; or
- a group of cash investors, formed by the investor as a limited liability company (LLC) to fund the purchase price and carrying costs of ongoing ownership — called *syndication*. [See Chapter 19]

On the sale of his property to a buyer (other than his investment group), the investor will either:

- **assign** his contract right to purchase the real estate to a *substitute buyer* and escrow will close in the name of the substitute buyer; or
- **resell** the property by entering into a separate purchase agreement and escrow instructions with the *resale buyer* and close concurrent with the closing of the investor's purchase escrow with the seller, a process called *double escrowing*.

Contracting to control the property

As an individual, the investor contracts to control the residence by entering into an EP agreement with the seller-in-foreclosure. Escrow is opened after the seller's five-business-day cancellation period expires.

Prior to closing, the investor will **assign** his purchase rights either to his investment group or another person as the substitute buyer. That buyer will perform all the remaining obligation of the buyer and close escrow. Since the assignment affects all the closing documents to be prepared by escrow, the assignment and related instructions needed to close escrow are best handled in supplemental escrow instructions. [See Form 401-2 accompanying this chapter]

On receiving the assignment instructions, escrow will prepare all closing documents in the name of the substitute buyer. To close the transaction in the name of the substitute buyer, the seller will need to **cooperate** by signing the supplemental escrow instructions and the deed naming the substitute buyer as the grantee.

Assignment provision and vesting

A buyer's contract rights under a purchase agreement (and escrow instructions) to acquire a property are initially presumed to be assignable, called a *rebuttable presumption*. Thus, assignability can be restricted by a provision in the purchase agreement or escrow. Further, an assignment is barred if the assignee's performance of the purchase agreement will differ from any personal performance promised by the original buyer. [Calif. Civil Code §1457; **Masterson** v. **Sine** (1968) 68 C2d 222]

ASSIGNMENT OF PURCHASE RIGHTS

Supplemental Escrow Instructions

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

TO: _____
(Escrow holder)

_____
(Address)

_____

1. This assignment, assumption and supplemental instructions pertain to

1.1 your escrow number _____,

1.2 entered into by _____, as the Seller, and _____, as the Buyer

1.3 dated _____, 20_____, at _____, California,

1.4 regarding real estate referred to as _____
_____.

2. Buyer _____, as the Assignor, hereby assigns to _____, as the Assignee, all of Assignor's interest in the following:

2.1 the property referenced above;

2.2 the above referenced escrow and any funds deposited by Assignor in escrow; and

2.3 An underlying agreement pertaining to Assignor's acquisition of the property entitled:
☐ Purchase agreement, ☐ Purchase option, ☐ Exchange agreement, ☐ _____,

a. dated _____, 20_____, at _____, California,

b. entered into by _____, as the _____, and _____, as the _____.

3. Assignor, as consideration for this assignment, is to receive the sum of _____.

3.1 Consideration is to be delivered ☐ outside of escrow, or ☐ through this escrow on the occurrence of (enter condition for payment) _____
_____.

4. Assignee hereby assumes and agrees to perform all obligations of Buyer acquiring the property under your instructions and the above referenced underlying agreement for the acquisition of the property.

5. Assignee acknowledges receipt of the following items:

5.1 your escrow instructions consisting of (identify each separate instruction signed by Buyer): _____
_____
_____
_____
_____
_____;

5.2 the underlying acquisition agreement referenced above;

5.3 property disclosures, delivered to Assignor by the owner of the property, consisting of (identify each by its name and date): _____
_____
_____
_____
_____;

5.4 property disclosures prepared by Assignor or third parties for Assignor consisting of (identify each by its name and date): _____
_____
_____.

— PAGE TWO OF TWO — FORM 401-2 —

6. You are authorized and instructed to:

6.1 Prepare a grant deed from _____,
showing the grantee vesting as _____.

6.2 Other _____
_____
_____

I agree to the terms stated above.	**I agree to the terms stated above.**
☐ See attached Signature Page Addendum. [**ft** Form 251]	☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: _____, 20_____	Date: _____, 20_____
Assignor's name: _____	Assignee's name: _____
Signature: _____	Signature: _____
Assignor's name: _____	Assignee's name: _____
Signature: _____	Signature: _____

7. Seller hereby releases the original buyer(s) from all obligation under the escrow instructions and underlying acquisition agreement.

8. Seller consents to this assignment and accepts Assignee as the substitute buyer in these instructions and underlying acquisition agreement.

I agree to the terms stated above.
☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: _____, 20_____
Seller's name: _____
Signature: _____
Seller's name: _____
Signature: _____

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When the purchase agreement states the buyer's purchase rights are assignable, the assignability presumed is not rebutted and no limitation exists allowing the seller to require the original buyer to close escrow in his name without assignment.

To put the seller on notice of the investor's right to assign his purchase rights to a substitute buyer who will perform under the purchase agreement and close escrow, the vesting provisions in the purchase agreement call for the conveyance of title by the seller to be insured in the name of the *buyer or assignee*. [See Figure 1 accompanying this chapter]

Understanding this assignment discussion is essential since the seller needs to cooperate for the buyer to implement an assignment. Having agreed in the purchase agreement that title may be vested alternatively in the name of a substitute buyer, by assignment, the seller must then *cooperate in good faith* to convey title to the substitute buyer by signing closing instructions so escrow can close in the name of the substitute buyer. [See **first tuesday** Form 156 §13.5]

Having entered into an agreement that imposes a duty on the seller to cooperate in an assignment, the investor then:

- seeks out a substitute buyer;
- negotiates the amount he is to be paid for his purchase rights; and
- enters into an agreement for the sale of his right to buy the property under the purchase agreement and escrow instructions with the seller.

The resale by assignment

An investor, by an **assignment**, transfers his purchase rights to the substitute buyer, called the *assignee*. [See Form 401-2 §2]

Figure 1 *Excerpt from first tuesday Form 156 — Equity Purchase Agreement*

13.5 Title to be vested in Buyer or Assignee free of encumbrances other than those set forth herein.

The substitute buyer agrees to fully perform all of the investor's obligations under the EP agreement and escrow instructions. By the assignment, the substitute buyer takes legal responsibility for the buyer's obligations *delegated* to the substitute buyer, an action called an *assumption*. [See Form 401-2 §3]

Documentation of the assignment is typically handled through escrow as supplemental escrow instructions. [See Form 401-2]

On the investor's assignment of his purchase rights, the substitute buyer "steps into" the investor's position as the buyer in escrow. Having been assigned all the purchase rights, the substitute buyer may enforce the EP agreement requiring the seller to close escrow by conveying the property to the substitute buyer. [**San Francisco Hotel Co.** v. **Baior** (1961) 189 CA2d 206]

Also, the substitute buyer, on accepting the assignment, assumes all of the investor's obligations under the EP agreement. On elimination of all contingencies and other rights to cancel, the substitute buyer must perform by paying the purchase price and closing escrow on the transaction. If not, he is liable to the seller for wrongfully failing to close escrow. [**Fanning** v. **Yoland Productions, Inc.** (1957) 150 CA2d 444; CC §1589]

The substitute buyer who fails to close escrow without legal excuse, a breach, is also liable to the investor under the assumption provisions in the assignment for losses caused by the breach. This investor may suffer money losses if the seller pursues the investor for money losses or specific performance on the breach, unless a release of liability or novation was entered into by the seller and the investor at the time of the assignment. [**Bank of America National Trust and Savings Association** v. **McLaughlin** (1957) 152 CA2d Supp. 911]

A separate resale by grant deed

An investor flipping a property may not want to disclose to a substitute buyer the purchase price the investor is paying for the property. Also, the seller might refuse (wrongfully) to cooperate and close escrow with a substitute buyer following the investor's assignment of his purchase rights for a quick profit (which the seller feels he should get).

Instead of **assigning** his purchase rights under the EP agreement and escrow instructions to a substitute buyer, the investor can simply **resell** the real estate. In some counties, the resale will be additionally taxed on recording the second grant deed, a tax the assignment avoids.

On the investor's resale of the property, the investor and his perspective buyer will enter into an entirely new purchase agreement and escrow instructions, separate from the investor's contract with the seller.

In the context of a resale, the investor undertakes the duties a seller owes a buyer to make all the **disclosures** required of a seller of real estate. The investor may use the disclosures he received from the owner, noting any additional or contrary information known to him.

A **separate escrow** will be opened for the resale that will be funded by the resale buyer.

The primary purchase escrow with the seller and the separate resale escrow with the buyer will close concurrently. The closing of the resale escrow should be contingent on the close of the primary purchase escrow. The investor's net sales proceeds from his resale escrow will be the source of the funds he will use to concurrently close his purchase escrow with the seller.

Through this legitimate double-escrow process, two grant deeds will be concurrently recorded — one from the seller to the investor who, in turn, will further convey the property by grant deed to the resale buyer in this variety of a flip.

Only one title insurance policy will be issued, and one set of loan assumptions or loan origination documents will be completed — all in the name of the resale buyer.

The seller in an EP transaction has a two-year right of rescission when investor misconduct exists under the EP statutes. On an **assignment** of the investor's purchase rights, the seller-in-foreclosure retains his **rescission rights** against the substitute buyer since the right to rescind arose under the contract taken over by the substitute buyer.

However, if the investor conveys the real estate to a third-party buyer in a separate *arms-length* resale, the buyer is a **bona fide purchaser (BFP)** exempt from the seller's two-year right of rescission under equity purchase law. [See Chapter 4]

Disclosures on a resale

The EP investor offering to sell a one-to-four unit residential property must make a full disclosure of the physical, operating, and title conditions, as well as the natural and environmental hazards of the property. The substitute buyer on an assignment of the EP investor's right to buy the property receives copies of the purchase agreement, escrow instructions, and all disclosures received by the investor from his seller.

On agreeing to the assignment, the substitute buyer acknowledges receipt of the documents delivered to him by the investor. [See Form 401-2 §5]

Consider an owner of a one-to-four unit residential property who agrees to sell the property to an investor. The investor, acting as a dealer, intends to flip the property by selling and assigning his contract position in escrow or selling the property through a separately escrowed transaction. [See **first tuesday** Form 156 §13.5]

The owner hands the investor a condition of property disclosure statement (TDS). The TDS does not disclose night-time noise conditions known to the owner, but not the investor.

The investor locates a buyer prior to closing. The buyer is handed the owner's condition of property disclosure statement, along with all the property disclosures the investor has received.

On closing escrow and occupying the residence, the buyer discovers the undisclosed noise condition. Due to the noise, the price paid for the property exceeds its value, a loss suffered by the buyer.

The buyer makes a demand on the owner who prepared and signed the TDS for the loss, not the investor.

The buyer claims he is entitled to recover the loss from the prior owner since the owner intended by including an assignment provision in his purchase agreement with the investor that his TDS be relied on by a buyer other than the investor.

The owner claims he owed no duty and incurred no obligation to the investor's buyer since the owner did not contract to sell the property to the buyer, only to the investor.

However, the owner contracted with the investor without restricting the investor's right to assign the property. Thus the owner is liable for the buyer's lost value due to the owner's nondisclosure of the noise in the TDS. The owner knew or should have known the condition of property disclosure statement would be relied on by a buyer the investor located and who acquired the investor's purchase rights by an assignment or by grant deed. [**Shapiro** v. **Sutherland** (1998) 64 CA4th 1534]

Carryback transactions

Consider an EP agreement that calls for the seller-in-foreclosure to carry back a portion of his equity in a note and trust deed.

The agreement contains an assignment clause noting title will be vested in the buyer or "assignee."

Prior to the close of escrow, the investor assigns his right to purchase the real estate to a substitute buyer. However, the seller refuses to carry back a note and trust deed to be executed and paid by the substitute buyer.

Must the seller extend credit to the substitute buyer in the form of a carryback note and trust deed?

Not automatically! A principal-based standard of reasonableness guideline applies to any refusal of the seller to contract or cooperate with the investor's assignment of his purchase rights to a substitute buyer unless it has been agreed a due-on clause will be in the carryback trust deed. The seller may refuse to permit the substitute buyer to undertake the **personal obligation** of executing and performing on a carryback note and trust deed if the substitute buyer, unlike the EP investor, is not equally or more creditworthy than the investor, or would mismanage the property under his ownership. [**Madison** v. **Moon** (1957) 148 CA2d 135]

The carryback seller may require the substitute buyer to meet the same standards of creditworthiness (performance on the note) and property maintenance (performance under the trust deed) required of the investor who was accepted as the buyer on entering into the purchase agreement.

When a purchase agreement imposes obligations on the buyer to perform activities of a *non-personal nature* only, an assignment of acquisition rights can be enforced by the substitute buyer.

For example, when a purchase agreement provides for payment **in cash** in exchange for the seller's equity in the property, which may include a loan assumption or funding by a purchase-assist loan taken out by the investor, all rights under the EP agreement may be assigned and enforced by the substitute buyer without the seller's consent. [**King** v. **Stanley** (1948) 32 C2d 584]

Nor may a seller refuse to cooperate in the investor's assignment of his purchase rights to a title warehousing agent so the investor can complete a reverse IRC §1031 transaction, which the IRS calls a *parking transaction*. The warehousing agent is not a substitute buyer, but a middleman who will merely hold title and deed the property on to the investor at a later date. [**Nicholson** v. **Barab** (1991) 233 CA3d 1671]

Release of liability

When obtaining the seller's consent on assigning the purchase rights and obligations under an EP agreement to a substitute buyer, the investor should also seek a release from the seller of the investor's obligations under the EP agreement and escrow instructions. [CC §1530; see Form 401-2 §§7 and 8]

A **release and substitution agreement** requires the seller to look solely to the substitute buyer for performance of the purchase agreement and escrow, an arrangement called a *novation*. [**Gates** v. **Quong** (1906) 3 CA 443]

To comply with escrow instructions after the assignment of the investor's purchase rights, escrow prepares all closing documents in the name of the substitute buyer. Closing documents include deeds, carryback notes and trust deeds, closing instructions and statements, approvals and assumptions of any existing loans, title insurance, and clearance of any other items necessary for escrow to close.

Chapter 19 Syndicating the equity purchase

This chapter applies the syndication process to the funding of an equity purchase (EP) transaction.

Blind pool funding and property selection

The purchase of an owner-occupied residence in foreclosure is typically negotiated in the space of hours and closed in the course of a few days — requiring the availability of purchase funds at the outset of negotiations.

Consider an individual who forms small investment groups to gather funds to buy property, called a *syndicator*. To control property, he contracts in his own name to buy an owner-occupied one-to-four unit residential property in foreclosure by entering into an equity purchase (EP) agreement with the owner, called a *seller-in-foreclosure*. [See **first tuesday** Form 156]

Escrow is opened on expiration of the seller's five-business-day cancellation period without the syndicator's receipt of a cancellation notice.

The syndicator then *assigns* his rights as a buyer under the purchase agreement to an investment group which becomes the **substitute buyer**. He will form the group and structure ownership as a limited liability company (LLC) before the close of the purchase escrow. [See Chapter 18; and **first tuesday** Form 370]

During the short escrow period, the syndicator will not have sufficient time to create an investment circular, prepare the LLC documents, locate investors, and fund the acquisition of the investment, all steps normally taken when syndicating the acquisition of real estate.

Thus, the syndicator solicits contribution commitments or receives funds from investors before locating the real estate their funds will acquire, called a *blind pool investment program*. The syndicator is said to have been given a "blank check" by the investors to later locate, analyze, and expend their funds to acquire suitable property on behalf of the group.

Creating a securities risk

After the group members fund the LLC, the syndicator locates the property, negotiates the purchase terms, arranges financing, closes escrow, and rehabilitates and manages the property as a rental or for immediate resale.

The blind pool arrangement is thus a **corporate security**. Here, the investors hand over their capital to the syndicator before the investment property is selected, a *risk of loss* controlled by the securities law, not the economics of the real estate market. Thus, the investors rely entirely on the investment expertise of the syndicator to later select a suitable property of sufficient value and quality for the placement of their investment funds. [**Underhill** v. **Royal** (1985) 769 F2d 1426]

Having created a **security** in the form of a blind pool investment program, the syndicator wants to:

- avoid the creation of a *public offering* under the securities statutes; and
- *minimize the risk of loss* of the cash investment by making a full disclosure of the investment when the property selected for investment is acquired. [See Form 365 accompanying this chapter]

A closely knit group

The **blind pool** syndicator avoids regulatory activity governing corporate securities by not offering the investment program to the public, called a *nonpublic* or *private offering exemption*.

To comply with the **nonpublic exemption** rules when forming a group investment, the program must:

- include no more than 35 members (a husband and wife being one member);
- all members must have a deep-rooted, **pre-existing** personal or business relationship with the syndicator, or be **sophisticated investors** with prior experience in similar investments;
- each member agrees he is purchasing his interest in the LLC for his own account and not for resale; and
- no member is solicited by *advertisement*. [Calif. Corporations Code §25102(f)]

The blind pool syndicator who fails to comply with all elements of the *private offering exemption* must qualify and obtain a securities permit from the Department of Corporation before accepting funds from members — no matter how the members are solicited. [**People** v. **Humphreys** (1970) 4 CA3d 693]

Assessable LLC interests

In an EP investment program, the property is often intended to be held for immediate resale — but if the price-to-income ratios are fundamentally sound, it might be held as a rental for investment.

The members of the EP investment program do not expect to receive spendable income from any rental operations during the period of ownership prior to flipping it to another buyer. Specifically, the members expect a **negative cash flow** situation until the property acquired is resold.

Also, an EP investment program may incur unforeseen rehabilitation expenses or carrying costs beyond those anticipated by the syndicator, exhausting the reserve fund initially established for ongoing LLC ownership and operating expenses.

Figure 1 *Excerpt from first tuesday Form 372-2 — Operating Agreement (Equity Purchase Transaction)*

2.1 Capital Contributions: The Limited Liability Company's capital shall be: ($_____) as set forth in Exhibit "A".

a. Use of Contributions and Dissolution: The LLC will be funded prior to the selection and purchase of the property. Should the LLC be unsuccessful in acquiring property, the Manager may refund the capital contributed, less any expenditures made by the LLC toward the unsuccessful acquisition of property.

b. Additional Contributions: Additional contributions in the aggregate sum not to exceed $_____ may be required from time to time of the Class "A" member(s) on thirty (30) days' written notice from the Manager. If a member does not deliver up his share of the additional contribution within thirty (30) days of receipt of the notice, the Manager may elect to terminate the member under Section 6 of this agreement.

ESTIMATED PROFIT ON RESALE

Property Acquired for Immediate Disposition

DATE: _____ 20_____, prepared by _____.

Property description _____

_____

Title to be acquired on _____, 20_____. Date of anticipated resale _____, 20_____.

ESTIMATES:

1. Fair Market Value (estimated as of date of purchase) . . . . . $_____

2. Encumbrances:

2.1 First trust deed . . . . . $_____

2.2 Second trust deed . . . . . $_____

2.3 Other liens/encumbrances . . . . . $_____

2.4 **TOTAL encumbrances** . . . . . $_____

3. Acquisition/Fix-up Costs:

3.1 Cash to Seller . . . . . $_____

3.2 Loan reinstatement . . . . . $_____

3.3 Loan assumption fees . . . . . $_____

3.4 Broker's fees . . . . . $_____

3.5 Legal fees . . . . . $_____

3.6 Escrow closing costs . . . . . $_____

3.7 Fix-up/rehabilitation costs . . . . . $_____

3.8 Other _____. . . . $_____

3.9 **TOTAL acquisition costs** . . . . . $_____

4. Carrying Costs (until anticipated resale date):

4.1 Loan payments . . . . . $_____
for _____ months.

4.2 HOA assessments . . . . . $_____
for _____ months.

4.3 Property taxes due . . . . . $_____

4.4 Hazard/bond insurance premium . . . . $_____

4.5 Utilities . . . . . $_____

4.6 Accounting/legal fees . . . . . $_____

4.7 Management fees . . . . . $_____

4.8 Maintenance/upkeep . . . . . $_____

4.9 Repair/replacements . . . . . $_____

4.10 Lawn/gardening . . . . . $_____

4.11 Other _____. . . . $_____

4.12 **TOTAL carrying costs** . . . . . $_____

5. Resale Expenses:

5.1 Title insurance . . . . . $_____

5.2 Escrow fees/charges . . . . . $_____

5.3 Documentary stamps . . . . . $_____

5.4 Termite inspection/repairs . . . . . $_____

5.5 Loan prepayment penalty . . . . . $_____

5.6 Loan reconveyance fee . . . . . $_____

5.7 Beneficiary statement . . . . . $_____

5.8 Points (FHA-VA) _____% . . . . . $_____

5.9 Broker's fees _____% . . . . . $_____

5.10 **TOTAL resale expenses** . . . . . $_____

6. **Expenditure to buy, own and sell** (Sum of lines 2,3,4 and 5) . . . . . $_____

7. **Estimated net resale profit** (Line 1 minus line 6) . . . . . $_____

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To provide for the solvency of the investment program, an **additional contributions** provision is included in the LLC operating agreement. The additional contributions provision enables the syndicator to periodically request additional capital contributions from the members should the EP investment program face a deficit cash flow during the ownership of the property.

Use of the additional contributions provision

The EP syndicator exercises the additional contributions provision by giving written notice to the members of the amount of funds each member is to additionally contribute to cover deficits in cash flow and reserves. The members must choose to either comply with the request or face the agreed-to termination or participation limitations for failure to meet the call. [See Figure 1 accompanying this chapter]

Thus, the sanctions encourage members to make additional contributions to keep the LLC solvent.

The members have the option of rejecting the contribution request and accepting the sanctions as a consequence. The EP syndicator will not be able to force the non-contributing members to advance the additional contributions.

Each member must make a sober business decision — whether to subject his interest to termination or limitations, or to invest more to protect his original investment, sometimes considered a "good-money-after-bad-money" analysis.

But the dilemma, while troublesome, does not affect the member's limited liability status.

The additional contributions provision, triggered by the EP syndicator's call for funds, is not a promise to pay. The member has already contributed the amount required to become a member. Each member now has a choice to make. He can either:

- increase the amount of his original contribution to the LLC; or
- risk the buy-out consequences or limitations for refusing to meet the call.

Thus, a member does not breach the LLC operating agreement by failing to come up with the additional money — he simply exercises his **option** not to make **future contributions** as agreed in the operating agreement. [See Figure 1]

Provisions for EP syndication

The EP syndicator will include provisions in the LLC *operating agreement* and disclosures in his *investment circular* (marketing package) regarding the existence and risks of the blind pool funding.

The EP provisions are designed for use in California. However, no two sets of syndication circumstances are identical. The formulas and arrangements members contract for must, by necessity, vary from transaction to transaction.

Accordingly, **legal counsel** is recommended to advise on the necessary adjustments to wording in the operating agreement so it conforms to the specific facts of each EP syndicator's program, and to lend the experience developed by advising others on syndication programs. A template of an operating agreement accompanies the **Forming Real Estate Syndicates** text published by **first tuesday** and is intended for use as a basis for seeking further advice from the reader's legal counsel.

Chapter 20 Beneficiary statements and payoff demands

This chapter addresses requests made on the holder of a trust deed note for a report on the current status of the secured debt or a statement of the amounts due for a payoff and reconveyance of the trust deed.

Confirming loan conditions

A *beneficiary statement* is a written disclosure made by a lender or other creditor regarding the condition of a debt owed them, usually evidenced by a note, that is secured by a trust deed lien on real estate. [See Form 415 accompanying this chapter]

A complete **beneficiary statement** includes information and data regarding:

- the amount of the *unpaid balance*;
- the *interest rate* of the loan;
- the total of all *overdue payments* of principal and/or interest;
- the amounts of any *periodic payments*;
- the *due date* on the loan;
- the date to which *real estate taxes* and special assessments have been paid, if known;
- the amount of *hazard insurance* and its term and premium, if known;
- any *impound* balance reserve for the payment of taxes and insurance;
- the amount of any *additional charges* incurred by the beneficiary that have become part of the trust deed lien; and
- whether the trust deed debt can be *assumed* by a new owner (which was added following federal deregulation of lenders beginning 1982). [Calif. Civil Code §2943(a)(2)]

On adjustable rate mortgage (ARM) notes, the beneficiary statement must list the **note rate** as variable, and reference and attach a copy of the note containing the interest rate formula.

Formulas for ARM adjustments and payment options vary extensively from note to note. Thus, the seller or buyer relying on the beneficiary statement for an ARM needs greater detail than the current interest rate and payment amount. Thus, the lender must **attach a copy** of the ARM note to the beneficiary statement for full disclosure.

Lender response time to a request

Any *entitled person* may request, in writing, a beneficiary statement.

An **entitled person** includes:

- the *original borrower* on the note and trust deed;
- the *successor-in-interest* (new owner) to the original borrower; or
- an *authorized agent* of either, such as a real estate broker, attorney, or escrow agent. [CC §2943(a)(4)]

The lender must, within 21 days of the receipt of the written request by an entitled person, prepare and deliver a beneficiary statement. [CC §§2943(b)(1), 2943(e)(6)]

The lender's intentional failure without legal excuse to send the statement within 21 days of receipt of request results in a $300 forfeiture by the lender to the person making the request. Also, the lender is liable for all damages resulting from its intentional failure to comply. [CC §2943(e)(4)]

However, the lender's failure to timely deliver the statement must be proven to be an intentional failure, a difficult task.

*Editor's note — Previous to deregulation, mere administrative failure to send the beneficiary statement within the 21-day period resulted in an automatic forfeiture of $300 by the lender. [**Anderson** v. **Heart Federal Savings** (1989) 208 CA3d 202]*

The request for a beneficiary statement may be made by an **entitled person** before or within two months after a Notice of Default (NOD) is recorded. [CC §2943(b)(2)]

The lender may charge no more than $30 for each beneficiary statement, with the exception of loans insured by the Federal Housing Administration (FHA) or the Veterans Administration (VA). Occasionally, the trust deed states a lesser amount that controls the beneficiary statement charge. [CC §2943(e)(6)]

Payoff demand

A *payoff demand statement* is a written demand, made by a lender, for the total dollar amount required on the date of preparation to pay off the loan as a requisite for recording a reconveyance of the property from the trust deed lien. [See **first tuesday** Form 415-1]

The **payoff demand statement** includes information and formulas to calculate the total payoff amount due after the date the demand is issued to account for and pay interest accruing on a per diem basis up to the date paid. The statement is valid for up to 30 days unless the loan terms change, such as may occur on loans with adjustable interest and payments. [CC §2943(a)(5)]

The payoff demand, as with the beneficiary statement, is required to be delivered within **21 days of receipt** of a written request from an entitled person. Additionally, and similar to the beneficiary statement, the charge for the service of preparing and delivering a payoff demand is limited to $30, unless the loan is insured by the FHA or VA. [CC §§2943(c), 2943(e)(6)]

As with the beneficiary statement, the lender's intentional failure, without legal excuse, to timely reply results in the forfeiture of $300 and liability for any resulting money damages. [CC §2943(e)(4)]

The request for a statement

Unless an entitled person, such as an owner-in-foreclosure, **specifically requests** a beneficiary statement, a lender need only send a payoff demand statement. [CC §2943(e)(1)]

The request for either statement must be in writing and sent to the lender at the address given in the payment notice or payment book. [CC §2943(e)(5)]

Before delivering the beneficiary statement or payoff demand, the lender may require proof the request is being made by an entitled person, such as evidence of ownership or authority as an agent of the owner. The written request by escrow should be accompanied by the escrow's written authorization from the owner to order out a beneficiary statement. [CC §2943(e)(3)]

If a request for either a beneficiary statement or a payoff demand includes a request for a copy of the trust deed, the lender must supply a copy of the document at no extra charge. [CC §2943(e)(2)]

The statutory scheme for beneficiary statements does not require that a payoff demand include delivery of a copy of the note.

BENEFICIARY STATEMENT

DATE:_____, 20_____, at _____, California.

TO: _____

(Name and address of party requesting statement)

_____

Loan No._____

We are the holder(s) of a promissory note for $_____, dated _____,
made by _____,
and secured by a Trust Deed recorded on _____, as Instrument No._____,
in _____ County, California,
as a lien on property referred to as _____
_____.

1. Present principal balance . . . . . $_____

1.1 Additional charges, costs or expenses advanced by Lender under its lien . . . . . $_____

2. Balance in impound/escrow accounts . . . . . $_____

3. Rate of interest:

3.1 Annual fixed rate of interest is _____%

3.2 Present note rate of interest adjustable per the note is _____%

☐ Attached is a copy of the note containing adjustment formulas.

4. Interest is paid through _____, 20_____.

5. Taxes and special assessments are paid through _____, 20_____.

5.1 Taxes and special assessments for the fiscal year of _____ and _____ were . . . . . $_____

6. Payments are delinquent for the months of _____.

6.1 Total amount of delinquencies to bring the loan current is . . . . . $_____
which includes any late charges and foreclosure costs.

7. Monthly payments are due on the _____ day of each month.

7.1 Monthly payment in the present amount of . . . . . $_____

Comprised of:

Principal and interest . . . . . $_____

Tax impounds of . . . . . $_____

Hazard insurance premium impounds . . . . . $_____

The taxes and premiums are subject to change.

8. The principal balance is all due and payable on _____, in the amount of $_____.

9. Hazard insurance is described as follows:

Amount of Coverage $_____

Insurance Company _____

Policy No. _____

Expiration Date _____, 20_____

Policy Term from _____ to _____

Amount of Premium $_____

Insurance Agent _____

10. ☐ The Trust Deed securing the note contains a due-on-sale clause requiring Lender's consent and approval on any transfer of an interest in the secured real estate.

11. ☐ As requested, a copy of the Trust Deed securing this note is attached.

Date:_____, 20_____

Beneficiary: _____

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The lender may issue either the beneficiary statement or the payoff demand statement to set forth the amounts necessary to pay a loan in full. [CC §2943(d)(1)]

Any **oral amendment** to either statement given by the lender must be followed up by delivery of a written amendment by the next business day. [CC §2943(d)(2)]

In addition to a beneficiary statement or a payoff demand, amended statements can also be relied on to establish payoff amounts. [CC §2943(d)(1)]

An erroneous statement or demand

Any error in the statements from a lender regarding the amount owed on a loan becomes an *unsecured obligation* of the **original borrower** after the close of escrow or completion of the trustee's sale. If the lender amends its loan statement prior to the close of escrow or the trustee's sale, the amount listed in the amended statement is valid and replaces the original amount. [CC §§2943(d)(3)(A), 2943(d)(3)(B)]

For example, an owner funds the payoff of a trust deed note by obtaining refinancing from a new lender. The payoff demand for the existing trust deed note erroneously understates the amount due. The new lender funds the amount stated in the payoff demand and the existing trust deed is reconveyed.

Later, the paid-off lender realizes the mistake in the amount of the payoff and seeks to recover the underpayment from the new lender. The paid-off lender claims the new lender is liable for the unpaid amount since it funded the payoff.

The new lender claims the real estate owner who signed the note is liable for the unpaid amount since the statutory beneficiary's payoff scheme only allows the lender to recover amounts remaining unpaid on reconveyance from the borrower obligated on the note.

Here, the lender issuing an erroneous payoff demand can only recover amounts remaining unpaid from the **original borrower**. The named borrower on the note is the sole source of recovery for amounts understated in the payoff demand. [**Freedom Financial Thrift & Loan** v. **Golden Pacific Bank** (1993) 20 CA4th 1305]

Nonrecourse debt payoff errors

A lender who makes a purchase-assist loan to a buyer of a one-to-four unit residential property he will occupy as his principal residence is barred from obtaining a money judgment for any deficiency in the value of the property to fully payoff the loan on a foreclosure. These loans are **nonrecourse loans**, called *purchase-money obligations*.

Likewise, carryback notes secured only by the property sold are nonrecourse *purchase-money* paper. Further, those who hold a purchase-money note by assignment are also barred from obtaining a deficiency judgment.

The carryback seller or lender who makes a mistake in the amount of a payoff demand or beneficiary statement issued on a *nonrecourse note*, is limited in its recovery to the value of the property at the time of the erroneous payoff demand.

Initially, the amount of the error on payoff becomes an *unsecured purchase-money* obligation of the original borrower. The amount unpaid remains a **nonrecourse debt**. The character of the remaining unpaid debt did not change; it only became unsecured. [CC §2943(d)(3)]

Thus, the lender or carryback seller on a nonrecourse debt is limited in his recovery of the error to the difference between the amount received and the value of the property at the time of the erroneously calculated payoff. [**Ghirardo** v. **Antonioli** (1996) 14 C4th 39]

Chapter 21 Equity purchase: sale-leaseback, no option

This chapter digests the legal and tax consequences which arise due to the recharacterization of a sale-leaseback arrangement as a loan transaction when the leaseback is coupled with a repurchase option.

A mortgage or tenancy on breach?

A homeowner defaults on loan payments secured by a trust deed on his home. The lender begins foreclosure proceedings by recording a Notice of Default (NOD).

The NOD recording is picked up by a foreclosure reporting service. The service's subscribers are then advised of the NOD. An equity purchase (EP) investor tracking NOD recordings contacts the homeowner, intending to investigate the property for suitability and acquisition.

An offer to purchase the residence is prepared and submitted to the homeowner on an EP agreement form as mandated by state law.

However, the homeowner advises the EP investor he really wants to retain possession of the residence and **buy back** the ownership when his personal finances pick up.

As an alternative to the EP investor's offer, the homeowner proposes a **sale/lease-option** arrangement in which:

- the investor acquires title to the property by investing only the funds needed by the owner to cure the delinquent loan payments and property taxes, and pay the annual property insurance premium and foreclosure costs;
- the seller-in-foreclosure would remain in possession under a lease with sufficient rental payments to cover the investor's costs of ownership; and
- the owner would be given an *option to repurchase* the residence at a price to include a profit for the investor.

The EP investor refuses to go along with the owner's proposal to be granted an option to repurchase the property. The investor claims the grant of a purchase option to the owner would:

- transform the investor's intended purchase into a loan transaction;
- bar the investor from conveying title or encumbering the property at any time without the owner's further consent; and
- deprive the investor of the investment and tax benefits of owning real estate.

As a result, the investor and the owner reach a compromise. They enter into an EP agreement that provides the owner with a six-month holdover tenancy — no repurchase option included.

Has the EP investor correctly represented the mortgage and tax consequences of holding title subject to a repurchase option as a loan, called a *mortgage-in-fact*?

Yes! A sale-leaseback and purchase option arrangement is a *mortgage*. Thus, the EP investor would have made a loan, not a purchase of ownership of the property. When an owner occupying a one-to-four unit residential property as his principal residence conveys title in exchange for money to cure delinquencies and the right to retain possession with an **option to repurchase** the property, a loan has been negotiated, not a sale.

The financial arrangement of the lease-option sale contains all the elements of a loan: a yield (interest and principal paid as rent) and a due date (final/balloon payment of principal on exercise of option) as a condition for returning (re-conveying) title. Thus, the investor becomes a lender holding title as security for repayment of a debt, not a buyer receiving the possessory rights and economic risks and benefits of an owner. [Calif. Civil Code §1695.12]

As a lender, the EP investor is not able to take depreciation or other **tax benefits** available to an owner of rental property. [**Haggard** v. **Commissioner** (9th Cir. 1956) 241 F2d 288]

An investor who takes title to property while allowing the owner the right to remain in the property and the right to repurchase the property under an **option to buy** does not own the property. The grant deed the investor receives merely conveys title as security for repayment of a debt, a *mortgage-in-fact*. Despite any additional set of agreements or circumstances (even using EP agreements and fully complying with right to cancel notices), the investor taking title must not give the owner-in-foreclosure an option to recover title to the property.

However, the investor taking title who does not grant an option to buy to the owner must later obtain **written permission** from the owner before the investor may:

- encumber the property; or
- grant any interest in the property to another person. [CC §1695.6(e)]

Thus, when the owner defaults on the lease and vacates the property, the investor is left with naked title, unable to refinance the property, convey title to another person or create a leasehold interest under a rental or lease agreement with a tenant—without the owner's prior approval. [CC §1695.12]

Equity loan during foreclosure

Consider an owner whose home is in foreclosure due to a default under a trust deed lien on his home. He asks a friend to make him a loan.

The friend advances all funds necessary to cure the default under the trust deed and take the property out of foreclosure, called *reinstatement*.

As security for repayment of the friend's advance of funds, the homeowner conveys title to the friend. As part of the arrangements, the owner is to remain in possession under a lease agreement and is granted an option to recover title to the residence on a final payoff to the friend.

Later, the owner defaults on the rent and voluntarily vacates. The friend locates a buyer, enters into a purchase agreement and conveys title to the buyer.

The owner now out of possession seeks to recover the value of his lost equity from his (former) friend. The owner claims an investor who takes title and grants an option to the owner to repurchase the property must first obtain the owner's consent before the investor may convey any interest in the property to another since the transaction was entered into while the home was in foreclosure.

The friend claims EP law does not apply to him since he is not in the business of lending money, much less buying homes in foreclosure.

However, EP law applies to all persons whose conduct constitutes that of an EP investor, regardless of the number of EP transactions the person completes. The investor conveyed title to the property without first obtaining written consent from the owner (even though the investor held title), in violation of EP law. [CC §1695.6]

The EP investor's failure to obtain the owner's written permission prior to conveyance on the property's resale imposes liability on the EP investor for breach of the owner's (redemption) rights when a loan is

involved. The money losses collectible by the owner are based on the value of the property at the time the EP investor first transferred the property without the owner's consent. [**Segura** v. **McBride** (1992) 5 CA4th 1028]

Additionally, consider an owner-in-foreclosure who is in bankruptcy and conveys his property to an investor at a price lower than its market value. The transaction is structured as a grant deed conveyance to the investor with a leaseback agreement and the grant of a repurchase option to the owner. Specially printed EP forms with right of rescission notices to the owner-in-foreclosure were not entered into by the owner and the investor.

The transaction is approved as a sale of the property by a trustee acting on behalf of the bankruptcy court.

The owner-in-foreclosure is not able to repurchase the property on expiration of the repurchase option. A notice to vacate is served by the owner.

The owner now seeks to quiet title to the property in his name, claiming the sale-leaseback agreement violated of the Home Equity Sales Contract Act (HESCA) EP law since the investor, knowing the home was in foreclosure, acquired title to the property without complying with the notice requirements of the EP law.

The investor claims the sale was authorized by the equivalent of a court order, and thus exempt from equity purchase laws, since the sale was approved by a bankruptcy trustee acting on behalf of the court. [CC §1695.1(a)(5)]

Here, the sale by the owner-in-foreclosure to the investor was subject to EP law since the exemption for court-ordered sales does not apply to sales of property approved by a mere bankruptcy trustee. [**Spencer** v. **Marshall** (2008) 168 CA4th 783]

Continued occupancy by the owner-in-foreclosure

Any leaseback agreement negotiated with a n owner-in-foreclosure must be reduced to a written addendum as part of the EP agreement, or by amendment prior to funding by the EP investor and conveyance of title by the seller. [CC §1695.3(f)]

The owner-in-foreclosure and EP investor structuring a transaction occasionally consider one of several occupancy arrangements for the owner:

- a sale-leaseback, typically a *holdover tenancy* for a fixed time period at which point the owner must vacate [See **first tuesday** Form 272];
- a sale-leaseback with an option to purchase as an addendum (which is a mortgage-in-fact), sometimes called a *reverse lease-option*. [See **first tuesday** Forms 161 and 550]; or
- an unexecuted purchase agreement coupled with a lease-option agreement with the seller, a variation on the prior arrangement but does not call for immediate conveyance. [See **first tuesday** Form 163]

In a straightforward lease arrangement, a security deposit and the first month's rent are payable to the EP investor at the closing of an EP sale since the seller will holdover for a specified time period. The seller usually prepays rent and a security deposit through escrow from his net sales proceeds. So long as the EP laws calling for the use of special EP agreements and right-of-rescission notices are complied with, the sale-leaseback arrangement does not violate the EP laws. It is the repurchase option given under any circumstances which sets the investor up for a future violation of the EP law.

Sale-leaseback recharacterized

Inherent in an EP sale-leaseback and option to repurchase the property is the risk the loan transaction will be misinterpreted by the local assessor, the existing lender or the Internal Revenue Service (IRS).

Reassessment of the property occurs on execution of a sale-leaseback. [**Pacific Southwest Realty Company** v. **County of Los Angeles** (1991) 1 C4th 155]

However, if the "two-step" financing scheme is brought to the attention of the assessor, a sale-leaseback intertwined with an option to repurchase is correctly recharacterized by all agencies (and the seller) as a single **financing arrangement**, rather than two consecutive sale and repurchase transactions. Thus, no change of ownership occurs, even though the vesting of title is altered, and no reassessment takes place. [Calif. Revenue and Taxation Code §62(c)]

Existing lenders view a sale-leaseback, with or without a repurchase option, as an opportunity to **call or recast** a loan under their *due-on clause* — should they become aware of the facts. An EP investor should consider including a contingency in the EP agreement calling for a *due-on waiver* to be negotiated with the existing lender prior to closing. [See Chapter 28]

An existing lender usually will not demand a modification or call its loan unless the current market rates are so high as to allow the lender to increase its portfolio yield through points or an increased interest rate, either by loan modification or a payoff and reinvestment in a new loan.

Federal tax consequences

The **IRS** also treats sale-leasebacks as loan transactions, not a sale or a purchase, when the seller remains in possession and is given an option to repurchase title to the property. Tax-wise, the sale-leaseback is a **financing arrangement** when:

- rental payments under a long-term lease equal an amortization of the fair market value over the term of the lease when title is to be reconveyed to the seller/tenant; or
- the final/balloon payment required to exercise a repurchase option equals principal and accrued interest that would be financially similar to the due-date payoff under a note and trust deed. [**M & W Gear Co**. v. **Commissioner** (7th Cir. 1971) 446 F2d 841]

The EP investor's tax consequences on **recharacterization** of a sale-leaseback and purchase option as a financing arrangement include:

- denial of any depreciation deductions;
- imputing of interest income reportable at 110% of the applicable federal rate (AFR) [Internal Revenue Code §1274(e)];
- reporting of would-be rental income as investment/portfolio category interest income on a loan; and
- denial of any rental operating expenses (impound for taxes and insurance premiums belonging to the seller), since the transaction is a loan.

For the EP investor to receive the tax benefits of owning real estate, he must limit the leaseback to a periodic tenancy (month-to-month) or a tenancy with a fixed date at which time the tenant is to vacate the premises (lease agreement)—no repurchase option allowed either way.

No repurchase options granted

An EP investor structuring a sale-leaseback, which does not include a repurchase option, eliminates the risk the transaction will be recharacterized as a financing arrangement if:

- the seller-in-foreclosure is given the lease in full or part exchange for his equity (or for his payment of rent); or
- the rent charged is the current fair market rate; and
- the leaseback agreement sets a "fixed" time period for the lease to terminate and possession to be transferred to the EP investor. [**Camp** v. **Matich** (1948) 87 CA2d 660]

If the seller-in-foreclosure is not given a repurchase option and remains in possession of the property after the lease expires, the EP investor can begin an unlawful detainer (UD) action without prior notice to the seller to vacate, and proceed to have the prior owner evicted. [**Ryland** v. **Appelbaum** (1924) 70 CA 268]

As in any lease, the leaseback agreement should provide for payment of increased rent if the seller-in-foreclosure does not vacate upon either the expiration of the lease or a notice to vacate used to terminate the tenancy under a month-to-month rental agreement. A reminder: The seller-in-foreclosure has defaulted on home payments. Thus, he is a serious adverse credit risk as a tenant for the EP investor.

Chapter 22 Short payoffs on loans in foreclosure

This chapter examines the income and profit reporting on a sale by a seller-in-foreclosure when the price received is less than the balance due on loans encumbering the property and the loans are paid off at a discount.

The discount: income, profit, or loss?

An owner whose residence is now in foreclosure purchased it for the price of $450,000 with a down payment of $25,000. The remaining $425,000 of the purchase price he paid was funded by a fixed-rate, **purchase-assist loan** covered by default insurance, called *private mortgage insurance* (PMI).

The homeowner's cost basis in the residence is the $450,000 price he paid, plus transactional costs he incurred to acquire the property. When the property sells, through a broker or by foreclosure, his cost basis will be subtracted from the **net sales price**, called the *price realized* by the Internal Revenue Service (IRS). The difference between his cost basis and net sales price is the **profit or loss** he takes whether he resells the property or disposes of it by foreclosure or a deed-in-lieu.

The residence was purchased at the peak of the recent real estate boom. Due to the cyclical decline in real estate values following the excessive, speculator-driven rise, the owner's residence is now worth $250,000. However, while the monthly mortgage payments have remained the same, the owner's combined household income from bonuses and wages has declined. Nearly all of the homeowner's **disposable income** is now consumed by payments on the loan. Thus, the owner can no longer afford to make those payments.

Editor's note — The same reduction of a household's disposable income occurs for homeowners who experience an increase in the dollar amount of monthly installments when payments for a negative amortization adjustable rate mortgage (ARM) loan (euphemistically called a subprime, toxic, or speculator's loan) reset, while at the same time the homeowner is receiving normal pay raises.

The loan balance is now $400,000, an amount far greater than the current market value of the property.

The owner lists the residence with a broker in an attempt to sell it and get out from under the excess debt. As agreed with the broker, any purchase agreement entered into will be *subject to* the lender's acceptance of the net sales proceeds as the payoff amount and full satisfaction of the loan, colorfully called a *short sale contingency provision*. [See Form 274 accompanying this chapter; see **first tuesday** Form 150-1]

*Editor's note — Equity purchase (EP) investors who will not be occupying the property in foreclosure they purchase in a short sale would use an equity purchase agreement with a short sale provision. [See **first tuesday** Form 156-1]*

The broker taking the listing understands that since the fair market value (FMV) of the residence is below the outstanding debt encumbering it, he must, as additional effort required to sell the property, negotiate with the lender for a *discount* on a loan payoff demand, called a *short payoff*. If the lender agrees to accept a short payoff by discounting the amount due to fully satisfy the loan, the property will have gone through what has become known as a "short sale."

The **income tax issue** confronting the seller when reporting the sale of his principal residence to the IRS and the California Franchise Tax Board (FTB) is whether the amount of the discount is reported:

- as a reduction in his cost basis, which produces either a reduced capital loss or a profit, with any profit being excluded from taxation by the home profit exclusion of $250,000 per homeowner; or
- as *discharge-of-indebtedness income* taxable at ordinary income tax rates.

During tax years 2008-2012, for the sale of all properties other than a principal residence, and for all loans other than a purchase-assist or refinance of the purchase-assist debt on a principal residence, the *debt discharged* — the discount — will be subject to *ordinary income tax rates* unless the loan has **non-recourse status**.

On a sale of property after tax year 2012, discharge-of-indebtedness income, whether or not the property is a principal residence, will be subject to regular income tax rates — depending, as always, on the loan's recourse or nonrecourse status.

The short sale and accompanying discount

A **short sale** is a sale of property that:

- generates net proceeds for the seller in an amount *less* than the total amount(s) owed on the loan(s) of record; and
- the lender accepts the seller's net proceeds from the sale in *full satisfaction* of the loan(s).

The difference between the principal balance on the loan and the lesser amount of the net sale proceeds accepted by the lender in exchange for its canceling the trust deed note is called a *discount*, an arrangement more commonly called a *short payoff*.

If the broker is unable to negotiate a **short pay** (discount) with the lender, the seller will make no further payments, if he has not already ceased doing so. Thus, the lender is forced to foreclose and cancel the debt if it fails to arrange a compromise before the foreclosure sale, called a *pre-foreclosure workout*, *loan modification*, cramdown, or *short pay*.

Most lenders require the seller to default on payments for at least three months before they will consider a discounted payoff to accommodate a short sale. A default in payments is the legal step taken by the owner to **exercise** the "put option" he holds, a contract right inherent in all trust deed loans. The **put option** allows the owner to force the lender to buy the property through the foreclosure process (or consider a compromise) should the lender refuse a deed-in-lieu, loan cramdown, etc. [See **first tuesday** Form 406]

The broker's ability to successfully negotiate a short payoff with the lender depends in part on the type of loan that encumbers the seller's property.

If the loan is an FHA-insured loan on an owner-occupied, single family residence, the lender may only accept a short payoff if the owner qualifies for FHA pre-foreclosure sale treatment. To qualify, the homeowner must be in default on at least three months' payments, in addition to meeting other financial ability requirements. [HUD Mortgagee Letter 94-45]

Likewise, if the loan is a conventional loan covered by PMI, the lender's willingness to negotiate a short pay will be influenced by the lender's ability to settle their claim with the private mortgage insurer to cover the lender's loss on the short payoff. Much documentation on the seller's solvency (hardship) and the property's value (by a comparable market analysis) must be produced for analysis by the lender and PMI carrier. [See **first tuesday** Form 318]

SHORT SALE ADDENDUM

Loan Discount Approval

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to the following agreement:

☐ Purchase Agreement ☐ Counteroffer

☐ Escrow Instructions ☐ _____

1.1 ☐ of same date, or dated _____, 20_____, at _____, California,

1.2 entered into by _____, as the Buyer, and

1.3 _____, as the Seller,

1.4 regarding real estate referred to as _____

_____.

AGREEMENT:

In addition to the terms of the above referenced agreement, Buyer and Seller agree to the following:

2. Close of escrow under this agreement is conditioned on Seller obtaining payoff demands at a discount from the lienholders of record in full satisfaction of all amounts owed them.

2.1 The discounts are to be amounts which collectively allow Seller to fully perform on this agreement and escrow instructions without the need for escrow to call for funds from Seller to close escrow.

2.2 Seller on opening escrow to promptly request payoff demands from the lienholders, directly or through escrow, and diligently assist each lienholder in their analysis of their discount and processing of their payoff demand by providing them with information and documentation on themselves and this transaction.

3. After _____, 20_____, this agreement may be terminated by either Buyer or Seller should Seller be unable to obtain written payoff demands, or consent from the lienholders, to accept Seller's proceeds from this transaction which remain after disbursement of all costs incurred by Seller in the full performance of this agreement and escrow instructions. [See **ft** Form 183]

4. Seller may accept backup offers contingent on the cancellation of this agreement.

4.1 If backup offers are received, they will be submitted to the lienholders for payoff demands which may be accepted by the lienholders in lieu of a payoff demand on escrow complying with this agreement.

4.2 Should lienholders submit a written payoff demand in a backup offer acceptable to Seller, Seller may terminate this agreement. [See **ft** Form 183]

5. The Seller understands a discount by a lienhold in full satisfaction of the debt owed will likely have consequences on the Seller's creditworthiness and income tax reporting, and other unforseen difficulties, including,

5.1 The delinquencies on payments due the lienholders and the discount allowing for payment of a lesser amount then owed may be reported by the lienholder to credit reporting agencies and adversely affect the Seller in the future.

5.2 The amount of the interest on the discount on the principal will be reported by the lienholder to the IRS as a 1099 Form receipt of income, and depending on the recourse or nonrecourse nature of the debt discounted, or whether secured by the Seller's principal residence, will be reported by the Seller as discharge of indebtedness income, part of the price realized on the sale or a reduction in cost basis.

5.3 ☐ Seller may terminate this agreement within five days of acceptance, based on Seller's reasonable disapproval or the disapproval of tax or legal advisors to the Seller, of the consequences of this discount on Seller's credit or tax reporting, or on legal issues arising due to the discount. [See **ft** Form 183]

I agree to the terms stated above.	**I agree to the terms stated above.**
Date: _____, 20_____	Date: _____, 20_____
Buyer: _____	Seller: _____
Signature: _____	Signature: _____
Buyer: _____	Seller: _____
Signature: _____	Signature: _____

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The discount reduces the homeowner's basis

Consider the seller-in-foreclosure who owes $400,000 on the **purchase-assist** trust deed loan encumbering his residence. The property's FMV is $250,000. The original purchase price, and thus the seller's cost basis, is $450,000 (plus closing costs).

The seller has received information by an advertisement that implies he will incur taxes at ordinary income tax rates on any discount taken by the lender on the sale or foreclosure of the property, called *discharge-of-indebtedness income* by the IRS.

The ad then claims the homeowner will avoid the **tax liability** resulting from income generated by the discount on a short sale if title to the property is transferred to the person offering the service, called a *coordinator*.

The coordinator offers to take title to the real estate subject to the foreclosure and either:

- complete or arrange a short sale of the property himself; or
- allow the lender to foreclose against the coordinator's title for nonpayment of installments.

Does the advertisement correctly represent the homeowner's tax reporting and tax liability exposure from a short sale handled by whomever takes title subject to the loan?

No! The short sale of an owner-occupied one-to-four unit residential property encumbered by a purchase-assist or improvement loan, called a *nonrecourse loan* under California anti-deficiency law, **does not trigger** IRS reporting of ordinary income by the seller for the discounted and discharged portion of the loan.

For reporting discounts on purchase-assist and improvement (nonrecourse) loans, the owner closing a sale of his principal residence after January 1, 2007 and on or before December 31, 2012 no longer adds the amount of the lender's discount to the price paid by the buyer to set the *price realized* on the sale — as has been the rule since the 1930s.

Instead, the **discount** on purchase-assist and home improvement loans, in this case $150,000, is now deducted from the seller's cost basis ($450,000) to establish an *adjusted cost basis* of $300,000. Thus, the sale produces a capital loss of $50,000 — the price realized ($250,000) minus the owner's adjusted cost basis ($300,000). This capital loss is a personal loss (principal residence) and cannot be used (written off) to reduce taxable income.

This tax result is congruous with the prior tax reporting rule on a short sale: the **discount** is not to be reported as *discharge-of-indebtedness income*, and instead produces a "personal loss" on the sale. [Internal Revenue Code §108(e)]

Discounts on refinancing or equity loans

The accounting for a discount on a short payoff of a **loan that refinanced** a purchase-assist or improvement loan is very different. Consider an owner who originally purchased his principal residence for $450,000, taking out a $425,000 purchase-assist loan. He later refinances the property for $525,000. The $100,000 in funds received in excess of the loan payoff is not used to improve the property. Thus, the owner's cost basis in the property remains at $450,000 after the refinancing.

Further, the refinancing is a *recourse* (deficiency) loan that carries with it different tax consequences than the owner's original purchase-assist and improvement loans that were **nonrecourse** (anti-deficiency) loans.

*Editor's note — **Equity loans** and **refinancing** are always recourse loans under California's anti-deficiency law. The net proceeds from these loans do not themselves finance the owner's purchase or improvement of the one-to-four unit residence that, in whole or in part, he occupies as his principal residence. [Calif. Code of Civil Procedure §580b]*

The residence's current FMV is now only $250,000. Further, the owner is no longer able or willing to make his monthly mortgage payments.

The owner hires a listing agent who sells the property for $250,000. Eventually, a **short payoff** with the lender at a **discount** of $275,000 is negotiated by the agent.

Unlike purchase-assist and improvement (nonrecourse) loans on a principal residence, the amount of the discount on the refinancing (recourse) debt is not first subtracted from the homeowner's cost basis to determine the seller's profit or loss on the short sale price. Instead, the portion of the refinancing greater than the amount of the homeowner's purchase and improvement loans paid off by the refinancing ($100,000) is reported as **discharge-of-indebtedness income**, limited in amount to the discount.

Thus, $100,000 of the discount is taxable as discharge-of-indebtedness income at personal income rates. The remaining discount amount of $175,000 is then excluded from the owner's gross income.

However, the remaining $175,000 amount of the discount excluded from income is then subtracted from the owner's cost basis ($450,000), as in the case of discounted purchase-assist and improvement loans. [IRC §108(h)]

Editor's note — Had the property been sold before January 1, 2007, the entire amount of the discount ($200,000) on the recourse loan refinance would have been reported as income and taxed at a rate of up to 35%.

Recourse loans taxed as income after 2012

The preferential federal tax reporting currently available for a discounted payoff of both nonrecourse and recourse loans based on the amount of purchase-assist and improvement loans will not be allowed on short sales of real estate involving *recourse loans* after December 31, 2012. No portion of the discount on a **recourse loan** will be subtracted from the owner's cost basis nor be included in the price realized.

Editor's note — This lenient tax reporting originally applied to any discharge-of-indebtedness income forgiven in calendar years 2007 through 2009, but was extended through 2012 by the Emergency Economic Stabilization Act of 2008. [IRC §108(h)]

California partially adopted the federal principal residence discharge of indebtedness in September of 2008, however, the California rules limit the discharge-of-indebtedness income to:

- *debt discharged in a short sale closed in 2007 or 2008; and*
- *a maximum debt discharge of $250,000 for purchase-assist loan amounts up to $800,000 (or, for married individuals filing separately, a maximum discharged debt reduction of $125,000 for purchase-assist loan amounts up to $400,000). [Calif. Revenue and Taxation Code §17144.5]*

Assembly Bill (AB) 111 currently being considered in the 2009 legislative session, if passed, would extend the favorable tax reporting through January 1, 2013.

Instead, the recourse loan discount will be reported after 2012 as gross income, as it was reported before January 1, 2007. Thus, the owner will not even be entitled to the 15% (capital gain) to 25% (recapture of depreciation gains) tax rate on profit for that portion of the discount representing a portion of the original purchase-assist or improvement loans. Instead, the full discount will be taxed at ordinary income rates (10% to 35% in 2008).

When a short sale occurs after December 31, 2012 on real estate encumbered by a recourse loan, the seller will incur a tax liability at **ordinary income rates** on the discount reported by the lender on an IRS 1099 Form, which is labelled *discharge-of-indebtedness income.* Conversely, when a nonrecourse debt is discounted on a short sale, the seller's tax liability, if any, will still be on any profit taken on the price realized. That **price realized** will be set as the principal amount of the nonrecourse loan without concern for the discount or the property's FMV. This rule currently applies to property other than the principal residence. [Revenue Regulations §1.1001-2(a)(2)]

For example, an owner's property is encumbered by a $400,000 trust deed loan. The loan is a **recourse debt** that exposes the owner to a deficiency judgment if the value of the secured real estate becomes less than the amount of the debt. The real estate is now worth only $250,000, $150,000 less than the loan amount, which is the deficiency. However, the owner's cost basis in the real estate is $450,000.

The owner sells the real estate on a short sale. The net amount the buyer pays for the real estate is $250,000. The lender accepts the net proceeds from the sale as a short payoff and in full satisfaction of the **recourse note**. The remaining unpaid balance of $150,000, the discount, is forgiven by cancellation of the note since the lender does not judicially foreclose as is first required to pursue a deficiency judgment against the borrower. However, the lender must report the discount to the IRS.

The owner's tax consequences, calculated based on both the sale of the property and the discount of the **recourse loan**, include:

- a **capital loss** of $200,000 ($250,000 price received from the buyer minus the $450,000 owner's cost basis); and
- a **discharge-of-indebtedness** income of $150,000 ($400,000 loan amount minus the $250,000 price realized and paid to the lender), reported as ordinary income.

Again, since the owner's cost basis is greater than the sales price and the property sold is the owner's *principal residence*, the resulting capital loss is a **personal loss**. Since it is not a loss on the sale of a property that falls within an income category due to its personal nature, it cannot be written off to offset the taxation of other income — specifically to offset and reduce the discharge-of-indebtedness income. Not so for business use or income/investment property short sales.

After December 31, 2012, a discount on the payoff of a recourse loan (refinancing) encumbering a principal residence will result in taxable discharge-of-indebtedness income. Ironically, this income produced by the short sale of the principal residence cannot be offset by the capital loss produced by the same principal residence on the sale. The loss is classified as personal. [**Vukasovich** v. **Commissioner of Internal Revenue** (9th Cir. 1986) 790 F2d 1409; IRC §165(c)]

Discount reporting for investor-owners

The new tax reporting rules in effect until December 31, 2012 only apply to the short sale of the owner's principal residence. Discount reporting for the short sale of investor-owned property is still controlled by treasury regulations.

For an investor, the debt discharged by a discount of a loan paid off on a short sale of property other than the investor's principal residence will be a recourse loan producing discharge-of-indebtedness income, unless the investor:

- assumed a nonrecourse loan;
- executed a *carryback note* secured by the property when acquired; or
- executed a note containing an *exculpatory clause* releasing the investor from any personal liability.

When the discount is on any type of nonrecourse loan, the investor's discharged debt will be added to the price the buyer pays for the property, setting a **price realized** at the amount due the lender. Thus, the discount becomes a profit taxed at capital gains rates, not income taxed at personal income rates. [Rev. Reg. §1.1001-2(a)(2)]

Foreclosure avoids the discount

An alternative of great importance to a seller, such as an investor, faced with discharge-of-indebtedness income on a recourse loan, now or after 2012, is to avoid a short sale, and thus a short payoff, by forcing the lender to foreclose and acquire the property. Lenders nearly always foreclose by a trustee's sale.

Further, lenders at a trustee's sale usually bid in the property for the amount of all monies owed them, regardless of the property's present market value. Thus, they have been fully satisfied by their bid without a discount or uncollectible amount remaining due from the owner. Thus, there is no discharge-of-indebtedness income.

Listing brokers, take note. You are duty bound to care for and protect your client-seller from adverse consequences known to the broker or his agent. Also, consider a §1031 transaction that transfers the over-encumbered property to another person who is willing to deal with the over-encumbered position in exchange for receiving some cash (or other inducement – sweetener) on the exchange.

Chapter 23 Anti-deficiency: past, present, and future

This chapter discusses the history, purpose, and application of anti-deficiency laws as a borrower's complete defense to personal liability for payment of debts secured by real estate.

Rational owners have nonrecourse options

Consider a homebuyer who obtains a purchase-assist loan from a lender to fund the purchase of a one-to-four unit residential property he will live in. The homebuyer puts up only the minimum down payment required by the lender to buy the property.

A few years later the local economy becomes depressed, causing the fair market value (FMV) of the property to drop below the amount of the loan balance, a financial condition called *negative equity*. The homeowner, as a rational person, is concerned about his continuing ownership of a home with negative equity. On consulting with his real estate broker, the homeowner considers his financial options, which include:

- **sell** the property in a *short sale arrangement*, contingent on the lender accepting the net proceeds of the sale in full satisfaction of the loan and cancelling the remaining unpaid loan balance [See **first tuesday** Forms 150-1, 156-1, and 274];
- **continue to pay** on the loan and retain ownership, maintaining his credit score but drowning under a debt which is no longer supported by the value of the mortgaged real estate; or
- **default** on the loan and force the lender to foreclose and buy the property, bruising his credit but freeing himself of a dead-end debt, with payments greater than the rental value of the property (known as implicit rent which the lender cannot collect from the homeowner).

The homeowner knows that if he remains in the property until the lender completes a foreclosure, he will be able to accumulate savings by not making payments. He can later use the savings as a down payment on another home. The owner decides to exercise the loan's **put option** by defaulting and the lender taking the property as contracted for in the trust deed. [Calif. Code of Civil Procedure §726]

The lender now forced to take the property by foreclose, eventually acquires the property at a foreclosure sale. At the foreclosure sale, the lender does not make a full credit bid but underbids. The result is a balance remaining unpaid on the debt.

Can the lender holding a purchase-assist loan secured by a one-to-four unit residential property which was occupied by the borrower, enforce collection of the remaining principal balance still owed on the note?

No! The loan is a *nonrecourse debt.* Thus, it is subject to **anti-deficiency laws**, a complete bar to the lender obtaining a money judgment in any amount of the loan. The loan proceeds funded the purchase of a one-to-four unit residence which was the sole security for the loan and was occupied by the buyer–borrower on acquisition, called a *purchase-money* loan, in contrast to a "hard-money" loan which is *recourse paper*. [CCP §580b]

The lender's risk of a deficiency in value

The anti-deficiency laws, first enacted during the Great Depression of the 1930s, were designed to protect an individual who loses his home in foreclosure from being subjected to personal liability for any deficiency in the value of the home to cover the balance due on the mortgage.

In the late 1920s, the economy was booming. Real estate prices were high and rising, and real estate prices and public confidence in the future were even higher, not unlike the giddy early 2000s.

However, the rip-roaring economy in the 1930s devolved into a depression which, due in part to the abrasive foreclosure practices of lenders and carryback sellers (as well as the penurious, moral-stricken Congress and Federal Reserve), further devastated values in the real estate market.

For example, a lender holds a note which evidences a debt secured by a trust deed on the borrower's principal residence (one-to-four units). The residence was purchased by the loan funds advanced by the lender. The note and trust deed lien held by the lender is generally called a *mortgage*.

The homebuyer stops making monthly payments on the loan, which is a default by the terms of the trust deed. The lender forecloses by a trustee's sale and recovers the property by entering a credit bid for less than the dollar amount due on the loan, called an *underbid*.

Prior to the mid-1930s, the lender on completing the trustee's sale sued the borrower and obtain a money judgment for the unpaid principal balance, the difference between the amount of the **underbid** and the amount due on the loan. Also, the money judgment was awarded without regard for the FMV of the real estate at the time of the foreclosure sale (and the underbid).

On later payment of the money judgment, the homebuyer would not be entitled to recover the property. Foreclosure by a trustee's sale barred any later redemption or recovery of the real estate by the wiped-out homebuyer.

Thus, in addition to losing the secured real estate, the homebuyer or investor remains burdened with the responsibility of paying off the balance of a debt he incurred to buy property he no longer owns.

This scenario of the Great Depression, allowing the lender to acquire the secured property on an underbid at a trustee's sale and also obtain a money judgment against the borrower for any remaining balance owed on the note, came to an end in California in the late-1930s. Mortgage lenders in California soon learned to factor the risk of loss on default into the interest rates they charged on 30-year fixed rate loans.

Editor's note — As with all rules, there are exceptions to the anti-deficiency provisions. [See Chapter 16]

Purchase-money debts are not personal

To curb the **negative impact** that the dramatic increase in the number of foreclosure sales, and the resulting money judgments and displacement of owners were having on California's economy, the state legislature in the mid-1930s enacted anti-deficiency laws which included:

- a **prohibition** against money judgments when the debt was a *purchase-money* debt, which includes:
  - a **carryback note** on the sale of any type of property when the debt is secured solely by the property sold; or
  - the **purchase-assist funding** of a one-to-four unit residential property occupied by the buyer. [CCP §580b]; and

- a **prohibition** against money judgments by any creditor secured by any type of real estate on completion of a **trustee's foreclosure sale**. [CCP §580d]

Even if the property has insufficient value to satisfy the balance of the *purchase-money* debt on foreclosure, the lender cannot hold the original borrower, or an assuming buyer, personally liable for any deficiency in the property value, unless:

- the owner inflicts *waste* on the property, reducing its value; and
- the lender *underbids* to provide for the later judicial recovery for the dollar amount of the waste (not the debt).

A trust deed lender on a default in a **purchase-money debt** may only resort to a foreclosure of the property to recover the balance due. This contractual condition establishes the *put option* held by the owner to default (the exercise of the option) and force the lender to buy the property in exchange for the amount owned on the loan. [CCP §580b]

On an investor's taking title to real estate encumbered by a purchase-money note and trust deed, the debt retains its original nonrecourse purchase-money characteristics, regardless of whether the investor *takes title subject-to or assumes* the debt, or a novation (release of liability) occurs. [**Jackson** v. **Taylor** (1969) 272 CA2d 1]

An investor who buys property and takes over a purchase-money debt under any procedure is entitled to the anti-deficiency protection imbedded in the note and trust deed. Thus, purchase-money debts are tied exclusively to the property as the source of repayment, never a person. [See Chapter 16]

Marketplace drop in property value

The value of the real estate securing a **purchase-money** note may become inadequate to cover the debt due to a drop in real estate values brought about by a local or general economic downturn, which follows a cycle of inflated real estate prices.

Here, anti-deficiency laws are intended to ensure that an economic downturn is not aggravated beyond the usual cyclical increase in foreclosure sales. Thus, to avoid the vicious deepening of a recession into a depression, and as a matter of California public policy, the homebuyer taking out a purchase-assist loan, as well as any buyer of real estate on an installment plan, are not personally liable for these purchase-money debts. [**Roseleaf Corporation** v. **Chierighino** (1963) 59 C2d 35]

Consider a seller who carries back two notes on the sale of a single parcel of real estate after a 5% down payment. Each note evidences **separate amounts** of the debt owed the seller, totaling 95% of the property's total sales price. One note in an amount equal to 80% of the sales price is secured by a trust deed on the property sold. The other note for 15% of the sales price is secured by a trust deed on **other property** owned by the buyer. The notes are not *cross-collateralized* and a default on one note does not constitute a default on the other under the *dragnet clause* in the trust deeds.

The buyer defaults on both notes.

The seller completes a trustee's foreclosure sale under the trust deed lien on the property he sold to the buyer. A judicial foreclosure is then initiated against the buyer's other property under the separate note and trust deed in an effort to recover what will be a deficiency in the other property's value to cover the amount due on the separate note at the time of the judicial foreclose sale.

The buyer claims the foreclosure on his other property violates anti-deficiency law. The second foreclosure he claims is an attempt to recover a money judgment for a portion of the price paid for property the seller has already recovered by a trustee's sale and the buyer no longer owns and cannot redeem.

Can the seller foreclose on the buyer's other property which is security for the separate debt?

Yes! The foreclosure on the other property does not violate anti-deficiency law. A carryback debt secured by a property other than the property sold is not avoidable under anti-deficiency law. [**Hodges** v. **Mark** (1996) 49 CA4th 651]

In this example, the buyer providing a lien on property other than (or in addition to) the property purchased as security for the seller's carryback note and trust deed should consider negotiating the inclusion of an *exculpatory clause* in the note when entering into a purchase agreement with the seller. An **exculpatory clause** converts recourse paper into nonrecourse paper by eliminating personal liability for a deficiency in the value of the secured property to cover the principal owed the seller. [See **first tuesday** Form 418-5§2.2]

Waiver prohibited on forbearance

Consider a seller who carries back a note secured by a second trust deed on the property he sold. The debt evidenced by the note is classified as a *purchase-money debt*, sometimes called *purchase-money paper*. Later, during a real estate recession, the buyer of the property defaults and is unable to sell the property for a price sufficient to pay off the note. The seller commences foreclosure by recording a Notice of Default (NOD).

Prior to the trustee's sale, the buyer and seller *modify* the note to include a provision stating the buyer waives his anti-deficiency protection in exchange for the seller canceling the NOD and reinstating the note, called a *forbearance* or *pre-foreclosure workout*.

Ultimately, the first trust deed holder forecloses, wiping out the seller's second trust deed. The carryback seller now seeks to recover a money judgment for the amount owed him on the note since his security interest in the property established by the trust deed lien has been *exhausted* by the first trust deed lienholder's foreclosure and no longer exists.

The buyer claims the seller is barred from any recovery on the note since **enforcement of the debt** evidenced by the carryback note is subject to anti-deficiency defenses which cannot, as a matter of *public policy*, be waived.

The seller claims the buyer *waived* his anti-deficiency protection under the waiver provision in the written modification of the trust deed note the seller received in exchange for the seller's forbearance from foreclosure by canceling the NOD and reinstating the note.

Can the seller recover on the carryback debt based on the modification and waiver agreement?

No! Recovery on the modified note which evidences a carryback debt and is secured only by the property sold is barred by anti-deficiency rules, even though the buyer in writing waived his anti-deficiency protection. Any waiver of anti-deficiency protection by the buyer while the debt remains secured solely by the property sold is unenforceable since it is against public policy. [**DeBerard Properties, Ltd.** v. **Lim** (1999) 20 C4th 659; CCP §580d]

Deficiency judgments and redemption

The public policy objective behind anti-deficiency legislation is to protect property owners and dissipate the "debtor's prison" aura which otherwise surrounds defaulting owners since they would both lose their property and be subject to a money judgment, a situation called a *recourse note*. [**Palm** v. **Schilling** (1988) 199 CA3d 63]

The shift in the risk of loss

Anti-deficiency rules are used as a defense by a property owner to avoid liability for payment of a *purchase-money* note. Anti-deficiency rules shift the **risk of loss** for the unpaid loan balance or credit/installment portion of the price paid for real estate from the buyer to the lender or carryback seller holding the note. **Purchase-money** notes are also called *nonrecourse* notes.

When the real estate securing *purchase-money* paper drops in value, the potential for loss increases for the holder of the paper. Then, on a default, the lender or the carryback seller often minimize their loss through pre-foreclosure workouts. The lender or seller might realistically go so far as to accept a *short payoff* on a sale of the property by the owner, in full satisfaction of the debt.

By accepting the net proceeds from the owner's sale of the secured property in exchange for cancelling the outstanding loan balance — sometimes called a **short payoff** — the lender or carryback seller avoids the costs of both:

- foreclosure; and
- ownership resulting from acquisition of the property at foreclosure.

While prompting lenders and carryback sellers to minimize their potential losses, anti-deficiency rules protect the property owner by balancing the risks of each other's losses during times of economic reversal.

Tax-wise, an owner who participates in a short payoff of a **nonrecourse loan** incurs no reportable *discharge-of-indebtedness income* when the owner's original purchase price of the secured property is greater in amount than the principal remaining on the debt prior to the payoff. [**Commissioner of Internal Revenue** v. **Tufts** (1983) 461 US 300]

A lender holding a **recourse note** can foreclose judicially and obtain a money judgment if the fair market value of the secured property at the time of the foreclosure sale is less than the amount of the debt, called a *deficiency*. However, the borrower has the right to **redeem the property** within one year after the judicial foreclosure sale by paying the amount of the bid (plus interest) when a money judgment for any deficiency in value is obtained by the lender. The judgment, now being a separate debt from the redemption price, would remain to be paid. [CCP §729.030]

As a consequence of setting the fair market value and allowing for the one-year redemption, a **judicial foreclosure** is costly to the lender both in time and money. Also, the lender faces the risk of a further decline in the property's value during the one year following the foreclosure sale, as well as the risk of not being able to recover the separate money award.

Thus, a trust deed lender holding a recourse (or nonrecourse) note can foreclose quickly and inexpensively through the trustee's sale procedure. The owner's *right to redeem* the property by payment of the debt in full is terminated on completion of the trustee's sale.

To counterbalance the lender's beneficial right to a swift foreclosure by use of a trustee's sale, the lender is **barred from obtaining** a deficiency judgment after foreclosing nonjudicially (by trustee's sale) on the property. While an owner has no right to redeem the property after a trustee's sale, he does have the right inherent in a deficiency judgment to redeem the property for one year after completion of a judicial foreclosure sale. [CCP §580d]

The guarantor is not protected

Whether called a "co-signer", "surety", or "guarantor", individuals contracting as such are not protected by the anti-deficiency status of the buyer's nonrecourse debt. The statutory purchase money protection is extended only to buyers who sign both the purchase-money note and trust deed.

A co-signer or guarantor is someone other than the buyer. A *guarantor* promises to pay the buyer's purchase-money debt, but does so under a separate agreement which is not part of the note and trust deed signed by the buyer. Accordingly, the guarantor has no basis for claiming anti-deficiency protection since he is not the buyer. [See **first tuesday** Form 439]

Since guarantors are not protected by anti-deficiency laws, guarantors are exposed to liability for the entire amount of the debt, even when the property owner is not. [Calif. Civil Code §2810]

The watering-down of anti-deficiency law

When faced with an economic downturn, such as the 2007-2011 sales depression, homeowners and installment sale buyers need the protection of anti-deficiency laws against claims of lenders and carryback sellers if they are to continue to live in California and contribute to the state's economy.

However, signs of a legislated erosion of the long-standing public policy behind the anti-deficiency defense against excess lending on secured debt can be seen in California. Legislation was passed to benefit lenders and carryback sellers in 1994, as well as changes in the federal bankruptcy law in 2005 adverse to owners (and, ironically, mortgage lenders).

Lenders are very good at lending too much money. When losses build up, they simply lobby governments to cover for their mistakes, called privatizing profits and socializing (nationalizing) losses.

Lenders and carryback sellers are now able to circumvent California's anti-deficiency protection by requiring borrowers and buyers to provide a *letter of credit* as a condition for originating financing, unless the financing funds or extends credit for the purchase of a buyer-occupied, one-to-four unit residential property. [CCP §§580.5; 580.7]

The mortgage lender or carryback seller holding the letter of credit is no longer barred from drawing on the letter of credit after they have completed a **trustee's foreclosure** to recover any deficiency due to an underbid. This procedure is quicker and slicker than a judicial foreclosure, which calls for appraisals, a money judgment and pursuit of its collection. Ultimately, under a letter of credit, the borrower is liable for repayment of any amounts drawn by the lender or carryback seller on the **letter of credit** — after a trustee's foreclosure sale.

Additionally, a letter of credit has been legislatively re-classified as something it is not. It is no longer legally considered a guarantee or additional security, although the economic function of enforcing a letter of credit has the same economic function as the enforcement of a guarantee or additional security since it is a source of recovery unrelated to the property or the foreclosure process.

Unlike a guarantor, the issuer of a letter of credit, usually a bank, does not receive the same protection a guarantor receives under a guarantee. A guarantor is entitled to a notice of foreclosure and an opportunity to purchase the guaranteed note before the completion of a foreclosure on the property, unless the guarantor waives his right to a notice in writing.

Further, and unlike additional security, a letter of credit can be drawn on by a lender or carryback seller before completing a judicial foreclosure. The draw does not then bar the foreclosure for having enforced collection **without first resorting** to the secured property, a protection long available to owners called the *one-action rule*.

Borrowers who are currently protected from the letter of credit device include homebuyers, small-time investor/occupants of one-to-four unit residential properties, and those borrowers who refuse to provide a letter of credit that would allow the lender to draw on it without the borrower's further approval.

Ironically, the state legislature passed laws diminishing the publicly beneficial effects of the 1930s legislation which were designed to protect borrowers and create a viable financial environment for borrowers who have gone bust owning real estate to remain in California as contributing residents.

A letter of credit is now legislatively considered a **source of payment**, not a form of security. The letter is available to be called on by the lender at any time, before and after a foreclosure sale. Thus, a borrower defaulting on any debt secured by real estate (excluding an owner-occupied, one-to-four unit residence) and accompanied by a letter of credit, has lost the much needed protection that anti-deficiency law provides against reckless lending, boom-time mentality and dramatic declines in the value of real estate.

The borrower's anti-deficiency shield and economic cushion has been diminished by the permissible use of a letter of credit by a mortgage lender, in addition to the lender's use of a trust deed lien on real estate. The letter now circumvents the right of redemption which follows an award of a money judgment under judicial supervision for any deficiency in the value of the secured property.

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CONTENTS

Acknowledgments *ix*

Chapter 1 Introduction **1**
Background *2*
Real Estate: A Sound Investment *4*
Leverage: The OPM Principle *6*
Economic Housing Outlook for the Next Decade *8*

Chapter 2 Flipping Properties Defined **11**
Three Primary Classes of Flippers *13*
Scouts *13*
Dealers *15*
Retailers *17*
Using Options To Flip Properties *19*
Clearly Defined Objectives *20*
Entry Strategy *22*
Postentry Strategy *23*
Exit Strategy *23*

Chapter 3 The Value Play Strategy **25**
Buy-and-Hold Strategy *26*
The Value Play Strategy *29*
The Value Play Selection Process *31*
Property Location *33*
Price Range *35*
Physical Condition *35*

Chapter 4 Ten Ways to Locate Properties **45**
Real Estate Agents *45*
Classified Advertising *49*
Real Estate Publications *51*
Local and National Web Sites *51*
Real Estate Investment Clubs *54*
Bank REOs *55*

Marketing 56
For Sale by Owners (FSBOs) 60
Vacant Properties 61
Foreclosures 62

Chapter 5 Valuation Methodologies 65
How to Know How Much Is Too Much 66
Valuation Methodologies 66
Replacement Cost Approach 66
Income Capitalization Approach 68
Sales Comparison Approach 70

Chapter 6 Financial Analysis 73
The Texas Two-Step 73
Multiply Your Efforts by 22 82
From Residential to Commercial 93

Chapter 7 Seven Steps of Successful Negotiations 111
The Psychology of Negotiating 111
Comprehensive Knowledge of Market 114
Degree of Seller's Motivation 115
Backdoor Exits 119
Concessions 121
The Red Herring Technique 122
The Money-Talks Approach 123

Chapter 8 Financing and Closing Considerations 127
Conventional Mortgages 127
Mortgage Brokers 129
Local Banks 130
Lines of Credit 131
Owner Financing 133
Partnerships 135
Your Business Plan 136
What Every Borrower Should Know about Credit Scores 137
Underwriting Guidelines 140
The Closing Process 142

Chapter 9 Assemble a Winning Team of Professionals 149
Scouts and/or Dealers 150
Office Manager 151
Property Rehab Manager 152
Local Lender or Mortgage Broker 153

Real Estate Attorney 153
Title Company 154
Real Estate Agents 155

Chapter 10 Three Keys to Maximizing Your Potential **157**
Postentry Planning 157
Doing It Yourself versus Hiring It Out 159
Increasing Your Property's Marketability 163
Preplanning 163
Heightening Visibility through the MLS 164
Offering a Marketable Product 166
Competitive Pricing 167
Offering Incentives 167
Summary 168

Chapter 11 The Three Principles of Power **169**
The Principle of Vision 172
The Principle of Passion 178
The Principle of Autonomy 180

Appendix A Property Inspection Checklist 183

Appendix B Owner and Subcontractor Agreement 195

Appendix C Sample Real Estate Forms 201

Appendix D Sample Personal Financial Statement 219

Appendix E www.thevalueplay.com 223

Appendix F www.symphony-homes.com 225

Index 227

Acknowledgments

Much of my life has been profoundly influenced by not one, but two, loving fathers. The first father is the father of my spirit. He is my Heavenly Father. It is with deep humility and eternal gratitude that I acknowledge His hand in all that is good and virtuous in my life. The second father is the father of my body. He is my earthly father. It is with intense love and great respect that I acknowledge his hand in all that is pure and decent in my life.

The principle of parenthood, and more particularly, fatherhood, is an eternal principle. It is a pattern that was established in our premortal existence, continues in our earthly existence, and shall endure throughout our postmortal existence. It is with all the sincerity of my heart that I pray I may continue the righteous and loving pattern of fatherhood previously established to the beloved children who have been entrusted into my care—Philip, Samuel, and Benjamin.

Chapter 1

Introduction

Buying and selling real estate can be one of the most profitable and lucrative investments activities an individual can participate in. There are many approaches to investing in real estate, most of which are centered around various time horizons. On one end of the investment spectrum is the buy-and-hold strategy, where an investor might purchase a property and hold it for many years. On the other end is the buy-and-sell strategy, where an investor might hold the property for only a few months, weeks, or even days. It is the latter of these two strategies that I focus on in this book.

While readers of this book are likely to have broad and diverse backgrounds, you do share one thing in common—that being your interest in real estate and, in particular, your interest in flipping properties. I try to be as thorough as possible since some of you are likely to have little to no experience, while others of you are seasoned professionals searching for that edge. This being the case, those of you who have a great deal of experience may find some of the material to be a bit basic. It is vital, however, that I lay the proper foundation for those who are not as experienced. Many of you have most likely purchased single-family houses at one time or another and have at least a minimal degree of rental property experience.

In Chapter 2, the concept of flipping properties, along with specific types of flipping, is more fully discussed. Then in Chapter 3

we examine the notion of a term I coined in a previous book, *The Complete Guide to Buying and Selling Apartment Buildings:* the *value play.* I love using the value play strategy, as it is the quickest and surest way I know of to build wealth when it comes to real estate. In Chapter 4, we explore several methods you can begin using immediately to locate prospective investment properties, and in Chapter 5, we study in depth the most common methods of determining value and examine the most appropriate one for use in your analysis. Proper understanding of the valuation process will greatly facilitate building your real estate portfolio. Then in Chapter 6, we examine more fully the practical application of the valuation methods described in Chapter 5 by using various financial analysis models that were created to analyze potential purchase opportunities.

Chapter 7 helps you to more fully understand the rules of engagement as they apply to buying and selling properties, as we examine the seven steps of successful negotiating. In Chapter 8, we study the advantages and disadvantages of many of the methods of financing. We also take a look at the key elements of writing a professional business plan, as well as credit scores, underwriting guidelines, and the closing process. Then in Chapter 9, we discuss how you can assemble a winning team of professionals to help you maximize your potential. In Chapter 10, we examine the merits of three keys that will help you to maximize your potential as a real estate investor. Finally, Chapter 11 discusses what I refer to as the three principles of power. These three principles are not just limited to helping you succeed in real estate, but, when properly applied, will benefit you in many aspects of your life and will lead to an increase in your level of fulfillment and happiness.

BACKGROUND

A convergence of events from my own life experiences over the past 20-plus years has provided me with unique insight into the

real estate market. Three primary components have contributed to my experience. First and foremost, like many of you, I have bought and sold a number of both single-family and multifamily properties over the years, and I am currently an active investor.

Second, my experience as a financial analyst at one of the largest banks in Texas has provided me with a comprehensive understanding of cash flow analysis. Working in the mergers and acquisitions group for the bank, I reviewed virtually every line item of financial statements of related income and expenses for potential acquisition candidates of numerous banks that we had an interest in at any given time. I spent several hours a day using a sophisticated model and a specific set of assumptions to determine the market value of these banks. Since leaving the bank some years ago, I have developed my own proprietary model that I now use to facilitate the valuation process for single-family, multifamily, and development opportunities. The beauty of understanding cash flow analysis is that once you grasp the concept, it can be applied to anything that generates some type of cash flow, whether it be banks, single-family houses, manufacturing businesses, or retail outlets. The type of business is not important provided you understand the key assumptions relative to the specific industry you are evaluating. Finally, my experience as a commercial mortgage broker has provided me with an inside look at the lending process and, more specifically, what the lenders' underwriting departments typically require to get a loan approved.

I believe the culmination of my own skill sets and life experiences will be of great advantage to you as you seek to enlarge your personal real estate portfolio. I should mention one additional characteristic of mine that I attribute more to my personality than to any other factor. It is my inability to be satisfied with any single real estate purchase or acquisition. In other words, the traditional process of buying and holding a property, quite frankly, bores me. Who in their right mind wants to buy a piece of real estate and then just sit on it for 10 or 20 years? I know, I know—a lot of people do, including some of you, I'm sure. As for me, however, I can't sit still long enough to hold an investment

that long. I am more of a trader of sorts, or as that applies to real estate, a *flipper.* My personality is much better suited to buying, creating value, selling, and then doing it all over again. It is the thrill of the hunt that I most enjoy. It is finding that next deal, then exploring every possible way to maximize the value of it. In all honesty, I really don't even care for the work and the repairs that are often required to add value to the property. I prefer to delegate as much of that part of the process as possible to those whose skills are more closely suited to those types of activities.

REAL ESTATE: A SOUND INVESTMENT

The concept of buying and selling real estate properties, or *flipping,* is indisputably one of the surest means for the accumulation of wealth. Although the strategy involving flipping is itself short term in nature, let me emphatically state that this is *not* a get-rich-quick book. I am not aware of any so-called get-rich-quick books that are worth the price paid for them. Garnering a sizable real estate portfolio is a process that can take anywhere from a few years to many years. The patient and diligent investor who applies a well-defined and systematic approach over time will enjoy a high probability of earning above-average returns for his or her efforts. As a real estate investor, the fruit you enjoy, however, is directly related to the amount of effort put forth on your part. One is unquestionably a function of the other.

Just as a beautiful and healthy tree requires sunlight, food, and water for proper nourishment, so does the process of building wealth. Leave your fortune to chance, and chances are you will have no fortune to leave. To build wealth, you must plant the proper seeds and then nourish them with food and water over time. An occasional pruning will also be required. Almost before you realize it, a strong and magnificent tree will begin to take shape right before your very eyes. Although the grand and noble oak tree exhibits towering beauty and strength above the surface of the earth, it is the tree's root system, extending deep beneath

the surface and unseen by human eyes, that gives it the ability to withstand the mighty forces of nature. Like the oak tree, you, too, must be well rooted in fundamentally sound principles of real estate before your branches can grow. As you apply the principles you learn from this book, you will eventually be able to enjoy a sweet comfort from the shade that your branches will provide. Although the winds of adversity may descend on you with great vigor, if you are prepared, they shall not prevail.

To be successful in real estate does not happen by chance. You must have a well-defined plan outlining your specific objectives. Determine exactly what it is you want out of your real estate investment activities and identify your time horizon for accomplishing your goals. Be realistic as well as specific about your objectives. You must begin with the end in mind. In other words, you must know where you are going before you can begin the journey to your destination. If you don't know where you are going, how will you know when you get there? I recently traveled to Manhattan Island in New York for a business meeting on Wall Street just down from the New York Stock Exchange. Since I had never been to New York before, the first thing I did was to map out a plan for my trip. I began with the end in mind. The end, the twenty-second floor of 67 Wall Street, New York City, New York, was my specific objective. Since I knew that was my destination, it was simple enough to map out a precise plan on how to get there from my point of origin. Inasmuch as I was well prepared, when the day for the trip arrived, I was able to travel directly to the city and arrive well ahead of my scheduled time. Only you can determine your destination in life. If you don't have one, then you'll end up exactly where you intended to go, which is nowhere.

You must carefully analyze each property you consider for investment. You cannot afford to shoot from the hip. Proper analysis requires more than a simple review of the property's physical condition and location. To be successful in this business, you must use a comprehensive approach. This book is intended as a guide to help you develop a format for a complete analysis of each property you consider for flipping. This format, when prop-

erly applied, will provide you with a significant competitive edge for the simple reason that most investors do not have a system in place. They may have bits and pieces of a system that they use from time to time, but that is usually the extent of it. By following the guidelines in this book you will no longer arbitrarily buy and hold or buy and sell, but rather, you will truly understand the keys to successful real estate investing. By the time you are finished reading this book, you will know when to pass on a deal and when not to, and even more important, you will know *why.* You will have a better understanding of the principles of valuation and how to apply them to your specific market. Proper understanding of this single principle can be the difference between success and failure. Use the tools at your disposal to make prudent business decisions, and real estate will prove to be one of the best and most sound investments you will ever make.

LEVERAGE: THE OPM PRINCIPLE

Most likely you are already familiar with the OPM principle: *other people's money.* Your objective is to control as much real estate as possible while using as little of your own capital as possible, and this means that you have to use other people's money. The name of the game in this business is leverage. The more of it you have, the more property you can control. Borrowed money can come from many sources, including traditional sources such as a bank, a family member, a business partner, or even the seller (carrying back a note in the form of a second).

Another popular source of borrowing is to use a home equity line of credit (HELOC). Still another is using a line of credit against credit cards. I don't know about you, but I get several offers a week from various credit card companies, oftentimes offering credit of $10,000 or more. In a favorable interest rate environment, there is nothing at all wrong with using these cards as a source of financing for your investments. Be careful though! Don't get caught in the credit card trap by maxing out your cards

on consumer goods. In addition, make sure that you have structured the purchase of your property in a manner that will allow you to service the debt on it, whatever the source of that debt is. Debt is a wonderful tool, but, as with any tool, you must exercise caution and respect when using it. Otherwise, you can quickly find yourself in trouble. You must be in control of your debt and manage it wisely. Do not allow your debt to control you.

Whatever the source of your funding, the idea is to use as little of your own money as possible, because that is what your returns are based on. Your return on investment, or cash on cash return, is derived from the simple ratio of the net cash left over after all expenses have been paid over the amount of your original investment plus any out-of-pocket improvements or expenses that require an additional owner's contribution. In a very simple example, if you paid all cash for a $100,000 house that generated $6,000 of income, your return on investment is 6 percent. You might as well leave your money in the bank and save yourself the time and energy that investing in real estate will require. On the other hand, if you invested only $10,000 in the deal and borrowed, or leveraged, the remaining $90,000, assuming the same $6,000 of income, your return on investment now jumps to 60 percent. That's how the concept of leverage works. It allows you to take a little bit of your own money and maximize the return on it.

A number of popular books explain how to apply no-money-down techniques. Many of them are well written and have sound principles. While I am a firm believer in the use of other people's money, in my opinion these methods carry the concept of leverage to an extreme. That's not to say that they don't work. I'm sure in many cases they do. By relying solely on these techniques, however, you are restricting yourself to a much more limited pool of properties from which to choose. Let's face it. You are in the real estate business to make money, and time is money. Why spend all of your time trying to find a no-money-down deal when there are far more houses that can easily be purchased with 5 to 10 percent down? I realize that some of you may not have even that much to start with; if that is the case, then you may have to search

for that nothing-down deal. I would encourage you to build as large a capital base as possible so that you can quickly and easily purchase some of the more attractive properties as they become available. For every one or two nothing-down deals that are available, there are at least a hundred deals that can be purchased with 10 percent down. The pool of investment properties available is much larger at this level. In the end, having more choices means greater opportunity, which can potentially mean much more money, and that's why you're in the real estate business, right?

ECONOMIC HOUSING OUTLOOK FOR THE NEXT DECADE

I recently attended the American Housing Conference in Chicago. Although the theme of the conference was centered around mergers, acquisitions, and valuation methods, Dr. David Berson, vice president and chief economist for Fannie Mae, was there to present the *Long Term Economic, Housing & Mortgage Outlook to 2010.* In his presentation, Berson noted several key points with respect to a favorable outlook for the housing industry as a whole over the next decade.

Berson's forecast calls for average real gross domestic product (GDP) growth of 3.4 to 3.5 percent, versus 3.2 percent during the 1990s (see Table 1.1). In addition, his forecast for fixed-rate

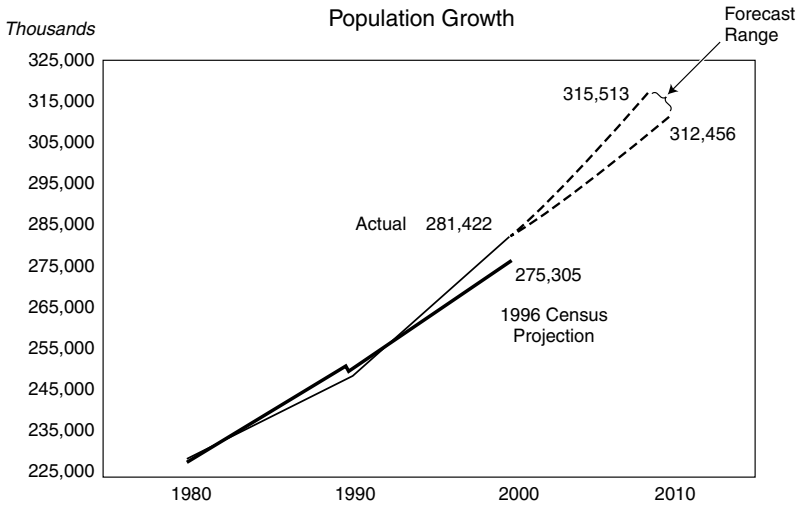
Table 1.1 Historical and Projected Economic and Housing Activity

	1980s	1990s	2000s
Real GDP growth	3.2%	3.2%	3.4–3.5%
30-year FRM rates	12.3%	7.9%	7.2–7.5%
Housing starts	1.48 million	1.41 million	1.64–1.68 million
New home sales	0.61 million	0.73 million	0.91–0.93 million
Existing home sales	2.98 million	4.21 million	5.50–5.64 million
Mortgage originations	$325.5 billion	$934.6 billion	$1,599.4–$1,808.1 billion

Sources: Commerce Department, Federal Reserve Board, HUD, National Association of Realtors, Fannie Mae Economic Projections.

Exhibit 1.1

Population is likely to continue growing at 1990s rates.



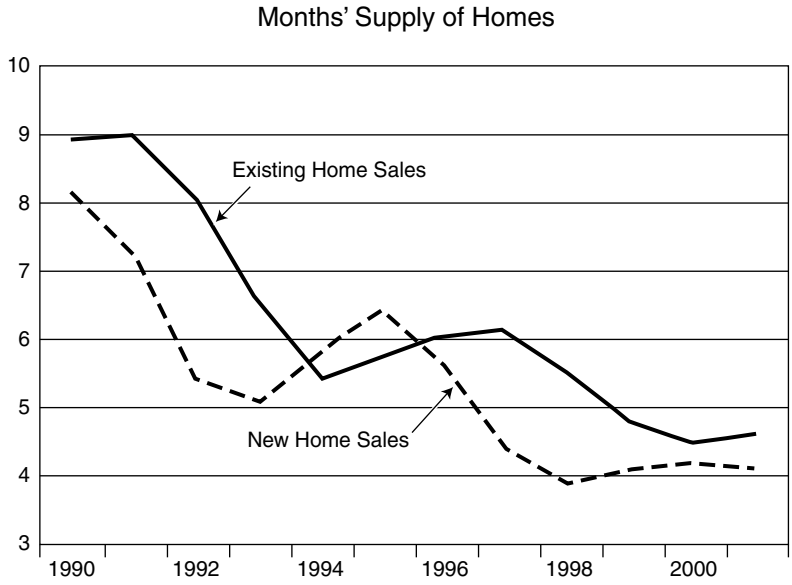
Sources: Bureau of the Census and Fannie Mae.

mortgages is 7.2 to 7.5 percent, versus 7.9 percent during the 1990s (see Table 1.1). Furthermore, census data for 2010 projects a total population of 315 million, representing an increase of 35 million residents (see Exhibit 1.1). Finally, the national average of unsold homes is at historically low levels, providing for a tight supply-demand relationship (see Exhibit 1.2). All of these factors combine to present an extremely positive outlook for real estate investors.

There you have it. The stage has been set. According to Berson, you should be able to enjoy many opportunities over the next decade to successfully participate in one of the most exciting

Exhibit 1.2

Unsold home inventory is historically low.



Source: Months' supply of existing homes is from National Association of Realtors; months' supply of new homes is from the Bureau of the Census.

industries of all, the real estate industry. The methods outlined in this book enable you to effectively and profitably capture a portion of the many profits that will be generated over the coming years. It is up to you to use the tools provided herein to achieve the level of success you desire.

> **What lies behind us and what lies before us are tiny matters compared to what lies within us.**
>
> ***—Ralph Waldo Emerson***

Chapter 2

Flipping Properties Defined

While there are a number of strategies and techniques used to invest in real estate, there is one thing they all share in common—the element of time. Most investors have some idea of the length of the holding period for properties they intend to acquire. Time can have a significant impact on the growth rate of your real estate portfolio. Time affects such things as the tax rate applied to your gain or loss. The long-term capital gains tax rate has historically been more favorable than the short-term tax rate. Time is also the variable in the rate of inventory turnover. Large retailers are willing to accept lower profit margins on items they merchandise in exchange for a higher inventory turnover rate. Would you rather earn 20 percent on each item or house you sell and have a turnover rate of 1, or would you rather earn 8 percent on each item you sell and have a turnover rate of 3? Let's do the math.

$$\text{Turnover ratio} = \frac{\text{turnover}}{\text{years}} = \frac{1}{1} \times 20\% = 20\% = \text{total return}$$

or

$$\text{Turnover ratio} = \frac{\text{turnover}}{\text{years}} = \frac{3}{1} \times 8\% = 24\% = \text{total return}$$

This simple example clearly illustrates that an investor can accept a lower rate of return on each property bought and sold and earn a higher overall rate of return provided that the frequency, or turnover rate, is increased. I should mention that this example does not, of course, take into consideration transaction costs. These costs may or may not be significant depending on your specific situation, but they must be factored in when analyzing a potential purchase.

Long-term investors may purchase real estate properties and keep them in the family for generations. They will typically hold them for a minimum of five years. Long-term investors seek gains through capital appreciation by simply holding and maintaining their investments while making improvements on an as-needed basis. They often seek to minimize the associated debt and maximize the cash flow. Long-term investors are quite often not fully leveraged. They generally prefer the positive cash flow over being excessively leveraged. When the property is finally sold, the more favorable long-term capital gains tax rates will apply. In addition, long-term investors may or may not elect to take advantage of deferring the tax liability indefinitely through a provision outlined in the Internal Revenue Code, referred to as a *1031 exchange.*

Intermediate-term investors most often hold their properties for at least two years but no more than five years. This class of investor typically seeks gains through a combination of increases in property values resulting from overall price appreciation in real estate, as well as by making modest improvements to the property. Reducing debt to increase cash flow is not as high a priority for intermediate-term investors as it is for their long-term counterparts. This class of investor also tends to be more highly leveraged. Finally, since intermediate-term investors hold their investment properties for a minimum of two years, they are able to take advantage of the lower and more favorable capital gains tax rate.

Short-term investors are defined as those who buy and sell real estate with a shorter duration. They typically hold their investments less than two years. This class of investor most often seeks gains through direct improvements to the property. The shorter

holding period does not allow enough time for gains through increases in the overall market. The short-term investor seeks to profit using the higher inventory turnover strategy and may be willing to accept smaller returns, but with greater frequency, realizing the overall rate of return can be considerably higher than with the long-term approach. Since current tax codes penalize short-term investors by imposing higher tax rates on short-term capital gains, they must factor this into their analysis before purchasing any property.

Short-term investors can be further subdivided into different classes. Investors with an extremely short time horizon are known as *flippers* and are the subject of this book. A flipper's primary objective is to locate properties that are undervalued (for any number of reasons), add some measure of value to the property, and then quickly resell it for a profit. Flippers may hold a property for a few months, a few weeks, or even a few days. In some cases, they may not even hold title to the property and may never take possession. This is perfectly legal and can be done through options. The use of options is more fully discussed as we explore the different classes of flippers.

THREE PRIMARY CLASSES OF FLIPPERS

The three primary classes of flippers are the *scout,* the *dealer,* and the *retailer* (see Exhibit 2.1). Each class has its own unique characteristics and serves a valuable function in the world of real estate investing.

Scouts

Scouts serve an important role in the process of flipping and can be very useful to the other two types of flippers, the dealer and the retailer. A scout does exactly what the name suggests—scouts for investment opportunities. Scouts were used many years ago during

Exhibit 2.1
Three primary classes of flippers.

1. Scouts
2. Dealers
3. Retailers

the Civil War, as well as other wars, by the United States Army. They were sent out in advance of the troops to gather information about what might lie ahead. The scouts then faithfully and diligently reported back to their captain to disperse key facts gathered during their journey. Important decisions were then made based on the information gathered by the scout. Good scouts were worth their weight in gold. The military today uses a much more sophisticated type of scout, relying on technology such as radar and satellite imagery to report the enemy's position and other vital information. The process itself is much the same though, with key information being provided to those empowered to make decisions.

Just as the scouts in the military report vital information to those who have the power to act on it, so do real estate scouts report key facts regarding potential investment opportunities to dealers and retailers. A good scout will gather as much of the relevant data as possible so that the investors can make well-informed decisions. Scouts provide pertinent information such as the following:

- General condition of the house or property and its location
- General condition of the neighborhood

- The price the seller is asking
- The terms the seller is seeking
- The seller's reason for selling
- The seller's time frame for selling and degree of urgency
- Comparable sales for other homes in the neighborhood if possible

Armed with this information, the investor is in a better position to decide whether or not to buy. The dealer or retailer can quickly analyze the data and proceed with a purchase depending on the results of the analysis.

Scouts do not purchase or take legal title to the property. They leave that part of the process to those they report to. Since scouts do not take legal possession, they typically will not be entitled to participate in the profits. This is not always the case, as the individual performing the duties of the scout may belong to a partnership in which the profits are shared. Most often, though, scouts are paid a referral fee, or finder's fee. Just as a real estate agent does not earn a commission unless a sale is made, neither does a scout earn a referral fee unless a deal is consummated. Scouts compensated on this basis will work extra hard to bring you only the best deals. Scouts can be very valuable to investors, as they help them to make the best and most effective use of their time.

Dealers

Much like scouts, dealers also play an important role in bringing opportunities to investors. They often act as wholesalers for retailers and other investors looking to buy property at below-market prices. Dealers are frequently licensed real estate agents and make their money off of the commission and sometimes a slight markup in the price of the property. They know that the markup must be minimal to leave enough profit in the deal to make it attractive to other investors to whom they will sell. Deal-

ers are also in a position to earn money from both sides in the transaction. They are usually both the listing agent and the selling agent. Furthermore, if a dealer sells to a retailer, many times that retailer, after making the required improvements, will turn around and list the property for sale again with the dealer. This provides the dealer with a perfectly legitimate opportunity to double-dip with his or her inventory of listings.

Dealers usually have an extensive network of contacts they work with who provide them with inventory to sell. For example, I know several dealers who have established relationships with various banks' real estate owned (REO) departments, which deal with properties that have been foreclosed on by local banks and remain on their books. The banks are not in the real estate business, but rather they are in the lending business. They have no desire to retain REOs on their books, because REOs represent uncollected loans, or bad debts. Banks prefer to sell these assets and recoup as much as possible. Many times, they will sell the property at the book value of the bad debt—or even below. This practice is not at all uncommon, as most every bank in the country has REOs in its portfolio.

An example of how the real estate owned process works is as follows:

1. Investor A, a novice real estate investor, purchases a rental house for $100,000, puts down $20,000, and borrows the balance of $80,000 from local bank B.
2. After three years of ownership, investor A discovers that the real estate rental business is more difficult than he thought and stops making payments to local bank B.
3. Approximately six months lapse before local bank B is able to repossess the rental house, which it doesn't want and will gladly sell.
4. Local bank B calls dealer C for help to get the bad debt off its books, knowing that dealer C has a large pool of investors she works with who will gladly consider picking up an investment at well below market.

5. Dealer C contacts retailer D, who in turn negotiates a deal with local bank B to take it off the bank's hands at a discounted price of $65,000.

Local bank B is happy because it has converted a nonperforming loan into one that is now performing and collecting interest. Dealer C is happy because she earned a commission from the sale of the property. Retailer D is happy because he bought a house at well below market value and will profit handsomely at the time of resell.

Much like the scouts, dealers specializing in REOs do not, in most cases, take title to the real estate. There is no need to, because their primary role is to act as agents representing sellers who desire to dispose of unwanted assets. Buying real estate owned properties directly from banks would create unnecessary transaction costs for the dealer and greatly increase the amount of time expended. It's more efficient for the dealer to act as an agent for the bank, thereby allowing the bank to sell directly to the retailer or investor. Dealers can make up in volume what they may give up in profit margin.

While some dealers specialize in REOs, others focus on the foreclosure market. Buying and selling foreclosures requires that an individual have a working knowledge of that market. While there are a number of good books written on the subject, many investors do not have the expertise or the time to find undervalued foreclosures. Furthermore, they are unfamiliar with the auction and/or bidding process and may lack the resources to purchase properties in this manner. Dealers who understand the mechanics of buying foreclosed properties can easily make a market by wholesaling to their network of retailers. Dealers participating in foreclosures will most likely take title to the property.

Retailers

The concept of retailing involves buying houses, fixing them up by making various improvements, and then reselling them. As the

name suggests, retailers purchase properties at wholesale and subsequently sell at retail. They represent the end of the food chain for flippers. The scout and the dealer serve a vital function in bringing opportunities to the retailer, who will then usually flip the property to a more permanent type of buyer, whether it be another investor who wants to hold it as a rental unit or a homeowner who will be moving into the home to use as a primary residence.

Unlike scouts and dealers, retailers most often take title to the property. They typically hold it anywhere from 30 to 90 days while they make any necessary improvements to the property, then offer it for sale to a more permanent type of buyer. Retailers must have more capital available to work with than the scout or dealer. They need whatever funds are required for the down payment, plus additional funds for property improvements. In addition, the retailer must have adequate capital to sustain the property during whatever holding period may be required. The retailer can plan and hope to have the house sold within 30 days after making all the improvements, but in reality it may take up to six months or, in some cases, even longer. Holding costs during this period include the interest on the debt used to acquire the property, taxes, insurance, and utilities. Since the retailer usually takes title to the property and has more capital at stake, his or her level of risk relative to the scout and dealer is significantly higher.

Of the three primary classes of flippers, it is the retailer who stands to gain the most financially. The relationship between risk and reward is in most cases directly correlated. This means that the greater the risk an investor is willing to assume, the greater the potential reward. This application holds true among the classes of flippers. Scouts assume virtually no risk, and their reward is most often limited to a referral fee. Dealers assume a greater degree of risk than do scouts, and they stand to gain substantially more. Risk for retailers is significantly greater than that for scouts and dealers. They most often take title to the property, have a longer holder period, and invest more capital. It is the retailer, therefore, who stands to enjoy the greatest reward from flipping properties.

In Chapter 3, we more fully explore the concept of retailing the *value play way.*

USING OPTIONS TO FLIP PROPERTIES

An *option* is a legal instrument that gives you the right to buy at a predetermined price. This is done millions of times a day in the stock market. For example, investors can buy a call option on MSFT with a strike price of, let's say, $55. As with all options, time, or *t,* is one of the variables that determine the value of an option using the Black-Scholes model. Investors have the right to exercise an option at their discretion within a specified period of time. It is possible that the outcome will be favorable, and it is also possible that the option will expire worthless. So it is with real estate. Investors may enjoy the legal right to buy a piece of property at a predetermined price through the use of options, then turn around and sell their interest in the property without ever taking title to it.

Some of my real estate investment activities include the use of options for the development of new residential construction in single-family-home communities. The name of the company founded by my partner and me is Symphony Homes (www.symphony-homes.com), chosen because of my love for great music. Within this entity, we use options to acquire rights to undeveloped property without ever taking legal title. We do, however, have a recordable interest. We just don't take title, at least not initially.

Just recently, I optioned 28 lots in phase I of a particular community. This gave Symphony Homes a legal interest in the property and the right to acquire all 28 lots at a predetermined price. When we get a purchase agreement to build a new home for a client on one of our lots, we then exercise our option on that lot and take legal title to it. The advantages of using an option in this case are twofold. The first is that if we have difficulty selling new homes to prospective buyers, we are not stuck with the burden

and cost of ownership. The only thing we have at risk is our option money. The second reason is that if we were to actually purchase the lots, the sale would trigger an increase in taxes due to a new and much higher assessed value. As the new owners, we would then be obligated to assume the tax liability.

As you can see, options are one of many valuable tools available to the real estate investor who is interested in mastering the art of flipping. Options enable you to gain control of property with very little money down, thereby allowing you to maximize the use of leverage. I recommend, however, that they be used with prudence. Remember that time is one of the variables—when *t* expires, so does your option. Carefully analyze the market as it applies to your particular investment opportunity to determine that you have a high probability of a favorable outcome before committing your resources.

CLEARLY DEFINED OBJECTIVES

If you are serious about being successful in the real estate industry, you need to establish clearly defined objectives. You need to determine if you are going to be a long-term, intermediate-term, or short-term investor. If you are going to engage in the practice of flipping, will you be a scout, a dealer, or a retailer? Perhaps your real estate investment activities will include a combination of these strategies. Real estate is like any other business with respect to defining your objectives. You must have a business plan in place. Taking the time to do so will help you stay the course. If you don't know where you are going, how will you know when you get there?

Think of an aircraft about to embark on an intercontinental flight to Europe. The pilot will use an established flight plan to chart his course. His navigator will input key coordinates into the aircraft's navigation system. Once in flight, the crew will rely primarily on the plane's instruments to arrive safely at an exact destination thousands of miles away from the point of origination.

Now try to imagine the crew making this same trip with no flight plan whatsoever. They would greatly jeopardize their ability to reach their destination safely. The crew would also place in danger the very people who have hired them fly to Europe, the passengers.

Like the pilot, as a real estate investor you must also rely on an established flight plan. That flight plan will be your plan of attack, your clearly defined objectives, your business plan. Like the pilot of an aircraft who must occasionally adjust course, so will you, too, occasionally have to adjust your course. You cannot afford to undertake a journey in your real estate profession without having some idea of where you want to go. Many people go through their entire lives in a rather random and indiscriminate fashion, with no sense of direction; hence, they end up precisely where they set out to go—nowhere.

The process of proper planning in this business is critical to your success. Yes, you may have to think a little bit, and it will require some effort on your part to formalize your plans, but I can assure you that any time spent developing a plan will greatly contribute to your success. By mapping out your strategy in advance, like pilots who direct aircraft across vast expanses of the earth, you will eventually reach your destination. You may run into a few storms along the way, but like the aircraft, you will ultimately reach your destination safely.

Three primary components that must be considered when defining your objectives are your entry, postentry, and exit strategies. Let's take our pilot as an example. His entry strategy would include the preparation of his flight plan, crew, and aircraft. The captain would take every precaution to ensure that all was in order before departing on his journey. In fact, pilots and their crews (ground crew included) use what is referred to as a *preflight checklist* before each and every flight to make sure that not a single item is overlooked. The checklist takes into consideration everything the pilot will need in order to have a safe flight, including fuel requirements, weight limitations, and maintenance status. The pilot must also be certain that the weather is conducive to his flight. The pilot's post-

entry strategy begins as soon as he starts the engines. He and the crew are now fully engaged in the process of flying the aircraft and must focus completely on flying the plane to its destination in the safest and most efficient manner possible. The crew may be able to fly directly to their destination if all goes as planned; however, in the event that their radar indicates turbulence ahead, they may be required to alter their course slightly. It is better for them to adjust their postentry strategy by flying around the turbulent weather than to run the risk of flying directly through it. On successfully navigating to the intended destination, the crew members then implement their exit strategy, which includes landing the aircraft at its predetermined destination and unloading the cargo.

Entry Strategy

To define your entry strategy you will need to start by determining what type of property you are looking for, the price range you are considering, and the holding period. Are you going to buy a single-family house, fix it up, and turn around and sell it, or are you going buy a more expensive small apartment building to hold for a number of years? Are you going to use flipping techniques as part of your investment strategy? If so, you must decide if you are going to act in the capacity of a scout, dealer, retailer, or some combination of the three. How do you intend to finance your purchase? You must, of course, take into consideration the investment capital you have to work with. If you don't initially have the adequate resources required for retailing, you may have to start as a scout or a dealer while progressively building up your capital base. The important thing to remember about having a well-defined entry strategy, regardless of what all that may entail, is that like the pilot, you have a predetermined plan based on specific criteria established by you. Since you have already determined factors such as price range, location, financing, and holding period, you will not waste any unnecessary time examining opportunities that do not match your criteria.

Postentry Strategy

While the postentry strategy begins the moment you close on the property, you should have established your specific objectives long before the closing. You cannot wait until after you purchase the property to decide what you are going to do with it. You absolutely must know that before ever spending a single dollar. Your postentry agenda should include things such as property improvements, rental increases, and management changes, if applicable, and lease or sell preparations as required. If you know, for example, that your strategy is to be a retailer and flip properties, the time to procure estimates for the needed improvements is during the inspection period, while the property is under contract, not after it closes. As a prudent investor, you know almost exactly how much it will take to repair the property and make it ready for resale. If you are contracting the work out, then your contractors should already be scheduled and should be ready to start the work the day after your closing. Don't let a week go by before having the painter come out. Have your painter ready to go as soon as you close! Since you want your investment operations to run as efficiently as possible, it is imperative that you plan as much of your postentry strategy in advance as possible.

Exit Strategy

Your exit strategy is probably the most important of the three components. You should specifically define your intentions before you even purchase a property. Whether you are going to hold it short term or long term, you must determine in advance how you will eventually unwind your position in the property. If you are a short-term investor and are going to flip the property, you want to be certain the market is conducive to your planned activities. In other words, is there sufficient demand? Are interest rates going up or down? Or are they stable? If you are going to hold the property for a number of years, these factors are not as

critical. If you elect to maintain your interest in the property and choose not to sell, an alternative to consider is refinancing. This will allow you to unlock some of the equity that has accumulated over the years to invest in additional properties. An advantage of accessing your equity in this manner is that you avoid paying any capital gains taxes. As a flipper, however, you will not be as concerned about long-term holding periods, since your objective is to dispose of the property as quickly as possible. You should determine in advance, however, your method of disposal. Do you plan to sell the property yourself or list it with a real estate sales agent? Regardless of the methods you choose, the criteria for your exit strategy should be established long before you invest any of your valuable resources.

Just as the pilot and crew use a comprehensive flight plan to successfully fly their aircraft, so must you, too, use a comprehensive business plan to be successful in your real estate activities. From start to finish, it is important to plan as much of your strategy as possible in advance. Thus, when you are alerted on your radar screen to unforeseen circumstances ahead, you will be able to adjust your course as necessary and complete your journey for a safe and successful landing in your real estate career.

I would sooner have the approval of my own conscience and know that I had done my duty than to have the praise of all of the world and not have the approval of my own conscience. A man's conscience, when he is living as he should, is the finest monitor and the best judge in all the world.

—Heber J. Grant

Chapter 3

The Value Play Strategy

In my experience of working with other investors and previous clients, I have often heard comments like, "Yes, Mr. Berges, I prefer the buy-and-hold approach to investing in real estate. My idea is to buy a property, pay it off, and live off of the income." Sound familiar? While this method of building a real estate portfolio is a valid one, in my estimation it is certainly not the best method. If you have another source of income that is fairly substantial and therefore allows you to make investments in real estate on a periodic basis, then this may be the method for you, or at least the one that you are the most comfortable with. This approach, however, precludes you from maximizing the utility of your investment resources.

In *The Complete Guide to Buying and Selling Apartment Buildings,* I described an aggressive real estate acquisition campaign for apartment buildings based on a term I coined: the *value play.* The value play strategy as it relates to apartment buildings is very similar to the concept of the retailer who flips single-family properties. The primary difference is that the concept is applied to income producing properties on a much larger scale. The fundamental premise of this strategy is based on finding an undervalued apartment building, large or small, creating value through one or more of many mechanisms, and reselling, or flipping, the property. The value play strategy is undeniably one of the quickest and surest methods available to investors to create and build wealth.

Many real estate books embrace the buy-and-hold strategy of building long-term wealth. Proponents of this approach claim that for individuals to retire with a leisurely lifestyle, all they have to do is buy one property a year for, let's say, 10 years, rent the units out, and pay down the debt. At the end of 25 years, all of the debt will be paid off and the investor can live off of the rents. This strategy may work fine for many; some may find that this is all they are comfortable with. But as I will demonstrate, investors who maximize their efforts through use of the value play concept, especially as it applies to the retailer, will end up with far greater wealth than those who implement a simple buy-and-hold strategy.

The financial implications of value-added measures can be quite significant for the retailer. The examples in Tables 3.1 and 3.2 illustrate just how powerful the value play strategy can be. Investor A implements a simple buy-and-hold strategy of acquiring one property a year for 10 years and holds all 10 properties through year 25. He chooses not to sell any of them, but ensures that all mortgages are fully paid by the end of the 25-year period. Investor B implements the value play methodology over the same 25 year period. She, on the other hand, buys and sells two value play properties for each one sold in the prior period for 10 years, with the exception of the last year. In year 10, she retains all properties purchased, which she will keep and maintain through year 25. Like investor A, she will ensure that the mortgage is fully paid by year 25. Take a minute to review the following assumptions and then carefully study Tables 3.1 and 3.2.

BUY-AND-HOLD STRATEGY

Investor A Assumptions

- Investor A saves enough to purchase one house each year for 10 years.
- Each house costs $75,000.

Table 3.1 Investor Strategies

	Investor A Buy-and-Hold Strategy										
Year	Unit 1	Unit 2	Unit 3	Unit 4	Unit 5	Unit 6	Unit 7	Unit 8	Unit 9	Unit 10	Combined Values
1	75,000										75,000
2	78,000	75,000									153,000
3	81,120	78,000	75,000								234,120
4	84,365	81,120	78,000	75,000							318,485
5	87,739	84,365	81,120	78,000	75,000						406,224
6	91,249	87,739	84,365	81,120	78,000	75,000					497,473
7	94,899	91,249	87,739	84,365	81,120	78,000	75,000				592,372
8	98,695	94,899	91,249	87,739	84,365	81,120	78,000	75,000			691,067
9	102,643	98,695	94,899	91,249	87,739	84,365	81,120	78,000	75,000		793,710
10	106,748	102,643	98,695	94,899	91,249	87,739	84,365	81,120	78,000	75,000	900,458
11	111,018	106,748	102,643	98,695	94,899	91,249	87,739	84,365	81,120	78,000	936,476
12	115,459	111,018	106,748	102,643	98,695	94,899	91,249	87,739	84,365	81,120	973,935
13	120,077	115,459	111,018	106,748	102,643	98,695	94,899	91,249	87,739	84,365	1,012,893
14	124,881	120,077	115,459	111,018	106,748	102,643	98,695	94,899	91,249	87,739	1,053,409
15	129,876	124,881	120,077	115,459	111,018	106,748	102,643	98,695	94,899	91,249	1,095,545
16	135,071	129,876	124,881	120,077	115,459	111,018	106,748	102,643	98,695	94,899	1,139,367
17	140,474	135,071	129,876	124,881	120,077	115,459	111,018	106,748	102,643	98,695	1,184,941
18	146,093	140,474	135,071	129,876	124,881	120,077	115,459	111,018	106,748	102,643	1,232,339
19	151,936	146,093	140,474	135,071	129,876	124,881	120,077	115,459	111,018	106,748	1,281,633
20	158,014	151,936	146,093	140,474	135,071	129,876	124,881	120,077	115,459	111,018	1,332,898
21	164,334	158,014	151,936	146,093	140,474	135,071	129,876	124,881	120,077	115,459	1,386,214
22	170,908	164,334	158,014	151,936	146,093	140,474	135,071	129,876	124,881	120,077	1,441,662
23	177,744	170,908	164,334	158,014	151,936	146,093	140,474	135,071	129,876	124,881	1,499,329
24	184,854	177,744	170,908	164,334	158,014	151,936	146,093	140,474	135,071	129,876	1,559,302
25	192,248	184,854	177,744	170,908	164,334	158,014	151,936	146,093	140,474	135,071	1,621,674
Income	9,600	9,984	10,383	10,799	11,231	11,680	12,147	12,633	13,138	13,664	255,920

Assumptions for investor A

1. Saves enough to purchase one house per year for 10 years by putting down $7,500, or 10%, on each house
2. Holds each property through year 25
3. Arranges mortgage payments so all units are owned free and clear by year 25
4. Assumes annual growth rate of 4 percent
5. Assumes rental income of $800 per month in year 1 that grows at the annual rate of 4%

Table 3.2 Investor Strategies

	Investor B The Value Play Strategy										
Year	Units 1	Units 2	Units 4	Units 8	Units 16	Units 32	Units 64	Units 128	Units 256	Units 512	Combined Values
1	75,000										75,000
2	20%	150,000									150,000
3	15,000	20%	300,000								300,000
4	15,000	30,000	20%	600,000							600,000
5	30,000	30,000	60,000	20%	1,200,000						1,200,000
6	20%	60,000	60,000	120,000	20%	2,400,000					2,400,000
7	150,000	20%	120,000	120,000	240,000	20%	4,800,000				4,800,000
8		300,000	20%	240,000	240,000	480,000	20%	9,600,000			9,600,000
9			600,000	20%	480,000	480,000	960,000	20%	19,200,000		19,200,000
10				1,200,000	20%	960,000	960,000	1,920,000	20%	38,400,000	38,400,000
11					2,400,000	20%	1,920,000	1,920,000	3,840,000	39,936,000	39,936,000
12						4,800,000	20%	3,840,000	3,840,000	41,533,440	41,533,440
13							9,600,000	20%	7,680,000	43,194,778	43,194,778
14								19,200,000	20%	44,922,569	44,922,569
15									38,400,000	46,719,471	46,719,471
16	Example									48,588,250	48,588,250
17	Purchase Price		75,000							50,531,780	50,531,780
18	Value Created Percent		20%							52,553,052	52,553,052
19	Value Created Dollars		15,000							54,655,174	54,655,174
20	Original Equity		15,000							56,841,381	56,841,381
21	Accumulated Equity		30,000							59,115,036	59,115,036
22	LTV Ratio		20%							61,479,637	61,479,637
23	Next Purchase(s)		150,000							63,938,823	63,938,823
24										66,496,376	66,496,376
25										69,156,231	69,156,231
Income	0	0	0	0	0	0	0	0	0	13,664	13,103,119

Assumptions for investor B
1. Starts with initial $15,000 equity
2. Buys and sells two value play properties for each one sold, but holds all properties purchased in years 10 through 25
3. Creates value on each deal of 20 percent
4. Maximizes leverage on each new property purchased using a loan-to-value ratio of 80 percent (or 20 percent down on each deal)
5. Assumes annual growth rate of 4 percent
6. Assumes no rental income except in years 10 through 25

- He obtains a 90 percent loan on each house, which means he puts a down payment on the property of 10 percent, or $7,500.
- Investor A holds each property purchased over the 10-year period all the way through year 25 and does not sell any of them.
- He arranges his mortgage payments to be paid down to zero by year 25. In year 1, he gets a 25-year loan; in year 2, he gets a 24-year loan; and so on. Finally, in year 10, investor A gets a 15-year loan so that all loan balances will be zero in year 25, enabling him to live off the income as planned.
- All properties purchased appreciate in value at an annual growth rate of 4 percent so that by the end of year 25, the 10 units purchased have a cumulative value of $1,621,674.
- The rental income on a house purchased for $75,000 in year 1 is assumed to be $800 per month, or $9,600 for the year. The rental income grows at an annual growth rate of 4 percent so that by year 10, the income per unit has grown to $13,664, and by year 25 the rental income per unit has grown to $25,592, or $255,920 combined income for all 10 units owned.

THE VALUE PLAY STRATEGY

Investor B Assumptions

- Investor B starts with $15,000 of equity.
- Each house costs $75,000. She is able to use the $15,000 of equity for both the down payment and minor improvements that will be required.
- She buys and sells two value play properties for each one she sells, in effect doubling the number of houses bought and sold each year for years 1 to 10. All properties purchased in year 10 are retained in her real estate portfolio.

- Investor B creates value of 20 percent on each property purchased.
- She arranges her mortgage financing so that all loan balances will be zero by year 25, thereby enabling her to live off the income.
- All properties purchased and retained in her real estate portfolio appreciate in value at an annual growth rate of 4 percent so that by the end of year 25, the 512 units purchased have a cumulative value of $69,156,231.
- The rental income on a house purchased for $75,000 in year 1 is assumed to be $800 per month, or $9,600 for the year. The rental income grows at an annual growth rate of 4 percent so that by year 10, the income per unit has grown to $13,664, and by year 25 the rental income per unit has grown to $25,592, or $13,103,119 combined income for all 512 units owned.

After reviewing Tables 3.1 and 3.2, I think you will agree that the difference between the two investment strategies is quite significant. Using the assumptions outlined in Table 3.1, investor A's buy-and-hold strategy has netted him an equity in the combined properties of $1,621,674. In addition, he will enjoy an annual income of $225,920. That actually sounds pretty good, doesn't it? All he has to do is buy one property a year for 10 years, hold them for 25 years, and he can retire very comfortably. Investor A's buy-and-hold strategy sounds good, that is, until you compare his value with investor B's. Investor B, using the value play strategy, has managed to accumulate a sizable fortune of $69,156,231. Furthermore, she will enjoy a very comfortable annual rental income of $13,103,119. What a fantastic difference between the two! To fully take advantage of the value play methodology, you must have a well-defined plan that you strictly adhere to, and you must be willing to execute it, that is, to take action. This kind of wealth accumulation is possible only through the systematic application of a well-designed plan.

It could be argued that the assumption of 20 percent appreciation is not reasonable, but I can tell you from my own experience that not only is it reasonable, but it is conservative. A 22-unit property I purchased, for example, was subsequently sold within a year for approximately 80 percent more than I paid for it. Creating value in single-family houses is actually much easier to do than in apartment buildings, and you should have no trouble earning 20 percent or more on your real estate transactions.

It should be noted that Tables 3.1 and 3.2 are, of course, hypothetical tables. The example is used to demonstrate the full potential of an investor who diligently applies the value play strategy, given certain assumptions, over a period of many years. The volume of units bought and sold in years 1 to 8 is entirely feasible and quite manageable. In the latter years, in which many more properties are acquired, the value created of 20 percent or more is still achievable; however, the sheer volume will be more difficult to achieve. To buy and sell that many properties in a single year requires a team of investors working together, with each one performing a unique set of functions. If we were to take Table 3.2 and reduce assumption 3 for investor B from 20 percent down to 15 percent, the resulting value at the end of year 25 would be $20,792,360. That still represents a value of wealth equating to roughly 13 times greater than the wealth created by investor A. Clearly the value play strategy warrants every investor's consideration.

THE VALUE PLAY SELECTION PROCESS

As you may recall, the retailer is in the business of buying real estate at wholesale or below and subsequently reselling it at retail. The principal mechanism that enables the retailer to do this is the process of creating value through any number of methods. Since multifamily properties such as apartment buildings derive their value primarily from the income they generate, there are many ways to enhance the revenues while simultaneously reducing

expenses to improve the overall net operating income (NOI). The price an investor is willing to pay for an apartment building is almost always a function of the NOI divided by a given capitalization rate for similar income-producing properties. The following illustrates a simplified example of how this valuation formula works.

$$\text{Property value} = \frac{\textit{net operating income}}{\textit{capitalization rate}} = \frac{\$100{,}000}{0.10} = \$1{,}000{,}000$$

For the retailer dealing with single-family houses, however, income is not as important because the resell value is based more on market comparables rather than the income it generates. This means that the buying public will evaluate the house you have for sale based on what is currently available in your immediate market. Buyers will compare and contrast your property to many others and will ultimately select the one that best fits their needs. Their buying decisions will be based on factors such as the property's location, its condition, the price at which it is being offered, its proximity to major streets and shopping areas, and the quality of schools in the area. In addition, many personal factors affect the buying decision, such as proximity to work, church, and Grandma and Grandpa's house. Some factors that affect a buyer's decision-making process fall outside the realm of your control, because not all buyers are searching for the same set of conditions that may compel them to choose one house over another.

Three factors that you as the retailer do have some control over, however, include the property's *location,* its *price range,* and its *physical condition.* Although a prospective buyer's needs will vary, you can still make sound investment decisions based on market generalizations. You must recognize that the products you have available to sell cannot, and will not, be all things to all people. Nevertheless, you can make certain assumptions, based on objective data, that will greatly improve your chances of success.

Property Location

As an investor who is in the business of flipping properties, you are not interested in carrying your inventory any longer than necessary. That means you should carefully study your area to determine which vicinities are selling with the fewest average number of days on the market. If you have lived in a particular area for a while, you are likely to already know which areas of town are hot and which are not. You do not have to rely solely on your intuition, however, as most real estate agents in your area will have access to the local Multiple Listing Service, or MLS. They can provide you with objective data to support your analysis. Most real estate agents will gladly furnish this information to you free of charge. They are in the business of earning commissions by representing buyers and sellers, and to do this, they must also be able to provide information that will enable them to make a well-informed decision. Sales agents know that if they can give you the facts you need that will support your decision to buy, it will bring them one step closer to earning a commission.

The type of location best suited for a retailer seeking to flip properties is typically a neighborhood between 10 and 30 years old. These are the neighborhoods in which the average middle-class citizen lives. Neighborhoods less than 10 years old tend to have larger and more expensive homes, which offer fewer retailing opportunities. Neighborhoods older than 30 years often consist of run-down properties in declining areas of town. This is not always the case, of course, as I have seen some areas 40-plus years old that continue to be well maintained and where pride of ownership exists. The 30-year rule is a generalization. The propensity is for homes and neighborhoods older than that to be declining in value, and they may require a longer holding period. (See Exhibit 3.1.)

The ideal location is an area not suffering from functional obsolescence in which the majority of homes are well maintained. Ideally, the neighborhood is established, has good schools nearby, and continues to have homes that sell in a shorter-than-average

Exhibit 3.1
Property location checklist.

- The neighborhood is between 10 and 30 years old.
- The majority of the homes are well cared for and not run down.
- Mature landscaping and pristine lawns are the norm.
- No junk cars parked in the driveway or in front of the house.
- Boats (if allowed) are properly stored.
- The neighborhood is free of trash and debris.
- Low crime rate in the area.
- Close proximity to schools, churches, and shopping.
- The neighborhood should not be located in a declining area of town.
- Home sales should be moderate to strong.

number of days compared to surrounding communities. Visible characteristics often include mature landscaping, pristine lawns, and well-cared-for homes. What you are looking for is a home in obvious need of repair in a community such as this. The grass is often overgrown, the house looks run down (and usually is), and the neighbors shake their heads in disgust as they pass by. Believe me, they are waiting for someone just like you to come along and get rid of that eyesore in their neighborhood!

Price Range

Most opportunities for flipping properties are at the lower to middle end of the price range. The lower end of the price range is, of course, relative to your area. In California and New York, it may be $250,000, while in Texas $75,000 to $100,000 represents the lower end of the price range.

There are three primary reasons for concentrating your efforts in this price range. The first reason is that there tend to be many more opportunities available. Homes selling in this price range tend to be older and are frequently in greater disrepair than newer and more expensive homes. The second reason to focus on the lower to middle end of the price range is that there is a larger pool of buyers available to purchase these types of homes. Many prospective buyers in the lower price range are younger couples, who may be first-time buyers, or working-class people simply looking for affordable housing. The higher up the price scale you go, the smaller the pool of buyers. Finally, homes in this price range are easier for you as the investor to afford. Why tie up your capital in larger, more expensive homes that are harder to resell when you can buy smaller, more affordable homes? In addition, if you have a limited amount of investment capital to work with, financing will be easier to obtain on less expensive homes.

Physical Condition

A property's physical condition can range from extremely poor, as in condemned, to very good. Your focus should be on those properties that fall somewhere in between. This category will prove to be the most profitable, as you will be able to minimize the amount of capital required for improvements, thereby allowing you to maximize your return on investment. Another key consideration is the time involved in making the more extensive repairs. The turnaround time for houses that require only minor

repairs is much shorter than for those that require major repairs. A thorough understanding of what to look for is key to your success in this business. Ideally, you want to find properties that look a lot worse than they really are. In other words, you are looking for houses that are in need of cosmetic-type repairs such as new paint, landscaping, and perhaps a good, thorough cleaning. Cosmetic repairs are quick and easy to make and are often the least expensive.

While properties in extremely poor condition can frequently be purchased at bargain-basement prices, they will typically require much more money for improvements. When it comes to houses, cheaper is not necessarily better. The initial price may be much less than other homes in the area, but the time and resources required for property improvements will often outweigh any advantage gained from the purchase price. Houses that fall into this category are usually in need of major repairs, which can be quite expensive.

The following inspection items are things to look for in your assessment of a property's physical condition. For a more comprehensive checklist, please see Appendix A, "Property Inspection Check List."

A bad foundation is one problem that can be very costly to repair. If the house is built on a concrete slab where major settling has occurred, the house will have to be leveled. Leveling a house can be very costly, and it can also be time-consuming. Furthermore, houses with foundation problems are likely to have other structural damage caused by the settling. A close inspection of the interior walls will almost always show evidence of settling, as the drywall will crack and separate. It is common to see hairline cracks in walls, especially around the seams, so don't be alarmed if you see small cracks such as these. If, on the other hand, you see large cracks running down the wall, you can almost bet the house has a foundation problem.

If the house was not built on a slab, but was built with a basement foundation instead, you must be particularly aware of moisture problems. This is fairly common, especially in older

homes. Look for cracks in the basement walls that may have evidence of leaking around them, such as staining or mildew. Leaks in the walls can also create a buildup of mold in the basement area, an issue that is becoming a major liability for some homeowners. It is not at all unusual to observe hairline cracks in the basement floor or even in the walls. In fact, I don't believe I've ever seen one without some kind of small cracks. You don't need to be overly concerned about these types of cracks, as they are usually just surface cracks that do not go all the way through the floor or the wall. Any house with foundation problems can be very costly to repair, whether built on slabs or on basements. As a general rule, your best bet is to avoid houses with these types of issues.

Roofs are another area that may require major repairs. The cost to repair a roof can vary widely with age and condition. Most composition shingles have a minimum life of 25 years, so if the existing shingles are less than 15 years old, it's a pretty safe bet that repairs will be minimal. After 15 years, the shingles can begin curling up and wearing to the point where leaks may begin to develop. Newer roofs can show signs of discoloration, but this is a problem that can be easily and inexpensively resolved by applying a chemical cleaning process. The discoloration is usually caused by a buildup of mildew, which can be killed and removed with a solution of water and bleach (available at most hardware stores). If a new roof is needed, the cost to replace it may not be prohibitive. If, for example, a new layer of shingles can be applied over the existing layer, the cost and time involved is minimal. On the other hand, if two or three layers of shingles already exist, then a teardown will almost certainly be necessary. This can effectively double the price of a new roof, as the labor required for the teardown can be quite expensive due to the additional time that is needed. Furthermore, older homes with several layers of existing shingles may require additional work. The roof deck may be damaged as a result of water leaks that have occurred over time. If the house needs to be completely redecked, this will certainly drive up the cost.

Other repairs that may prove costly include replacing equipment, windows, and exterior surfaces such as brick or siding. If the furnace and air conditioner are worn out, replacing them can quickly add up. New windows for the entire house can also be quite expensive. Replacing the siding or brick on a house can add thousands of dollars to the cost of your repairs. A close inspection of these items is essential for the success of your project. It may be that only minor repairs are needed, that only one or two windows need to be replaced, or that the exterior of the house just needs a fresh coat of paint. These types of improvements are easy to make, do not require much time, and most of all, do not require as much money as major repairs.

The house's plumbing should also be carefully checked for proper operation. The plumbing can be checked by flushing toilets, inspecting underneath sink cabinets, and looking for leaky faucets. You will also want to check the age and condition of the home's hot water heater. Leaky faucets and hot water heaters are fairly easy to repair and/or replace and can be done quickly and inexpensively. With homes older than 20 years, you will want to make a special note to determine if the roots from mature plants or trees are causing any blockage. Recurring problems in the same line are usually symptomatic of root damage. Some older sewage lines are made of a claylike material, and the roots of nearby trees can literally grow right through the sewer lines. When that happens, it creates a blockage within the line and causes the sewer system to back up. I bought a house a number of years ago that was 40 years old or so, which I then rented out. Sure enough, I had one line in particular that kept getting backed up. It cost me $75 every time the plumber came out to clear the line. As it turned out, the line was severely blocked with roots that had grown through it. I finally had the plumber dig up the backyard line, which was made of clay, and replace it with a new PVC line.

Sewer lines that run through a concrete slab foundation or through concrete driveways can get backed up as a result of settling. As the concrete settles, the sewer lines, which are usually

PVC, will crack and break. The separation in the line does not allow the sewage to drain properly and can also cause the line to back up. In another house I bought, the driveway had a large crack in it due to settling. When I purchased the house, I wasn't really too concerned about the crack because initially I thought I would just patch the driveway with a little cement. As it turns out, the repair was much more costly. The concrete driveway had to be chiseled out with a jackhammer to replace the broken sewage line. Once the line was repaired, a new driveway had to be poured. As an investor, you will want to minimize dealing with the more severe types of plumbing problems such as these. Leaky faucets and hot water heaters are generally easy to repair or replace. Broken sewer lines, on the other hand, are harder to detect and can be much more expensive to repair. A careful inspection of the plumbing system can potentially save you thousands of dollars.

Finally, the home's electrical wiring should be checked for proper working condition. A simple check of outlets and light switches can tell you a great deal about a house's electrical condition. If they are working properly, chances are the system is okay. Homes older than 30 to 40 years tend to have more problems, as breakers and switches may eventually wear out. In some homes, the wiring may be so old that it will have to be completely replaced. Installing an entirely new electrical system can be very expensive, due in part to the fact that much of the wiring runs behind the walls of a house. The new wiring will either have to be fished or pulled through openings from the attic or basement, if there are any, or cuts will have to be made in the drywall, which will then have to be repaired and repainted.

As you gain more experience and look at more and more properties, you will be able to quickly assess a house's physical condition and know within a short time whether it meets your investment criteria. If you lack experience or are not yet comfortable with the inspection process, you may want to hire a professional house inspection company. These companies perform a very thorough inspection and give you a written report when they

are finished. Their services commonly cost anywhere between $150 and $500, depending on the area of the country you live in and the size of the house. I seldom use professional inspectors anymore because, more often than not, they end up telling me what I already knew from my own inspection. About the only time I do use them is if the house is well beyond the 30-year age mark. In fact, just recently I had an inspection performed on a house I had under contract that was built in 1903. The main reason I wanted an inspection in this particular case was to ensure that the wiring was up to current code. As previously mentioned, replacing the entire wiring in a house can be very expensive. As it turned out, the electrical wiring did in fact meet current code requirements. The $335 I spent on the inspection was well worth it to me.

In summary, the ideal property will look as though it's in a lot worse shape than it actually is. You should focus your efforts on finding houses that are in relatively good condition, but that look like dumps. This is difficult for many people to do, and that is exactly why an astute investor such as yourself can profit handsomely from the retailing business. It's hard to look beyond that first impression of a house, especially if it's a negative one. Most people will keep right on driving. They won't even stop to look at such a house! They absolutely cannot see the hidden potential just waiting to be unlocked in properties like these. As an investor who is serious about flipping properties, you *must* be able to look beyond what you see on the surface. In fact, you will come to enjoy driving up to a house that appears to be run down and lacking in care, because experience has taught you that these houses are actually diamonds in the rough. While most people see a lump of coal, you will come to recognize it as a diamond that just needs a little polishing. Ideally, you will be able to buy houses at coal-like prices and sell these highly polished gems at diamond-like prices.

This same concept can be applied on a larger scale. For example, I have used it in the apartment business as well as in the residential home construction business. As a principal in Symphony

Homes, I recently took over an entire community that was partially completed with new homes and successfully applied the value play strategy. The community was only about three years old, but the original builder there apparently ran into financial difficulties that caused the progress of new home construction to come to a standstill. As a result, the entranceway and all of the remaining vacant lots became neglected. Weeds and grass went uncut and grew as high as four to five feet. Many of the vacant lots were littered with debris left over from the previous builder. In short, the community was a real eyesore! The developer of the subdivision had tried unsuccessfully for over six months to get another builder to come in and take over where the previous builder had left off. No one would touch it. In fact, you would probably be considered foolish to go in and take over something like that. Discussions with the city inspectors led me to believe that even they had written off this project.

However, experience has taught me to look beyond what is visible on the surface. Let's take a closer look at the facts of this particular community.

First we'll look at the negatives:

- The entrance into the community was overgrown with weeds.
- The weeds were overgrown on all of the vacant lots.
- Many of the lots were littered with debris left over from the previous builder.
- The residents and city officials were in despair and had given up hope.

Now let's look at the positives:

- Landscaping improvements to the entrance would be quick and easy to make.
- Weeds can be easily cut, and this is an inexpensive and quick way to improve a property's appearance.

- Debris is easy to remove.
- The community was ideally situated immediately off of a main road that provided terrific visibility to passersby.
- A brand-new post office was located directly across the street, which meant that no less than once or twice a month, everyone in town would drive by the community and see the improvements being made along with all the new construction activity.
- The community was located only one-half mile from a major state road that was heavily traveled and only a mile or so from a major interstate highway. Both of these roads served as major traffic arteries for commuters and would be easily accessible from the community.
- The homes in the community were only three years old or less, which meant that our new homes would fit in perfectly.

As it turned out, our company was able to negotiate a very favorable price and subsequently took over the remaining lots. As a condition for doing so, the developer agreed at his expense to have all of the vacant lots mowed, the debris removed, and the entranceway cleaned up immediately upon closing. Within one week, the community was cleaned up and a sense of pride was restored to the residents who lived there. In fact, the existing residents in the community treated us like knights in shining armor who had come to their rescue. They were thankful that finally another builder had taken enough interest in their community to come in and make a positive difference. Their sincere expression of gratitude toward us meant a great deal and was certainly appreciated by the Symphony Homes team. Our ability to envision the hidden potential in that community has allowed us to enjoy a substantially higher profit margin on a per-unit basis than we otherwise would have.

In summary, don't underestimate the power of the value play strategy. It is indisputably one of the most effective means avail-

able to you to create wealth and to enjoy a fuller and more rewarding life.

I believe life is constantly testing us for our level of commitment, and life's greatest rewards are reserved for those who demonstrate a never-ending commitment to act until they achieve. This level of resolve can move mountains, but it must be constant and consistent. As simplistic as this may sound, it is still the common denominator separating those who live their dreams from those who live in regret.

—Anthony Robbins

Chapter 4

Ten Ways to Locate Properties

Finding exactly the right property can sometimes prove to be challenging. The application of a comprehensive and all-inclusive approach will provide you with the greatest chances for success. You must be willing to exercise patience and diligence in your search. Doing so will enable you to minimize your risk and maximize the return of your hard-earned investment capital. The more selection options you have available to you, the better your odds for locating the type of property most suited to your objectives. In my experience, brokers, classified ads, real estate publications, web sites, real estate investment clubs, and lenders have all proven to be useful at one time or another. Advertising, for sale by owners, vacant properties, and foreclosures can also generate good leads. (See Exhibit 4.1.)

REAL ESTATE AGENTS

Having several real estate agents scouting properties for you is one of the most effective ways to quickly and efficiently identify potential properties that can be flipped. I must stress that it is *critical to your success* to ensure the competency level of the brokerage team you put together. I have worked with many brokers and agents whose range of expertise and experience varies greatly.

Exhibit 4.1
Ten ways to locate properties.

1. Real estate brokers and agents
2. Classified advertising
3. Real estate publications
4. Local and national web sites
5. Associations and real estate investment clubs
6. Bank REOs
7. Marketing
8. For sale by owners (FSBOs)
9. Vacant properties
10. Foreclosures

Most residential brokers focus primarily on the more traditional single-family-housing sales. They act in a fiduciary capacity to represent buyers and sellers who have a broad and diverse range of needs. The sales process typically goes something like this:

SALES AGENT: Mr. Buyer, what type of home are you looking for?
BUYER: We're looking for a three-bedroom, two-bath ranch.
SALES AGENT: Great! Have you been prequalified?
BUYER: Yes, Ms. Agent. Our loan officer has preapproved us for $150,000.
SALES AGENT: That's terrific, Mr. Buyer! What area of town do you prefer?

BUYER: I work on the north side of town, so something within 15 minutes or so would be ideal.

SALES AGENT: That's wonderful! The MLS shows there are 12 homes available in the area you prefer and 8 of them are within your price range!

The sales agent will then schedule time with the buyer and the sellers to visit as many of the homes as possible. If the buyer sees something he likes, the agent writes it up and presents the offer to the seller. There is often a counteroffer or two before a deal is consummated. The broker collects her commission on closing and the buyer lives happily ever after . . . well, maybe.

While this is a simplified example of how the sales process works, the process for locating properties that can be flipped does share a few similarities with the more traditional role the sales agent plays. The sales agent will locate the types of properties you are looking for, present them to you, and if an opportunity makes financial sense, you will make an offer for the agent to present to the seller. Significant information that traditional sales agents are *not* used to providing is data specific to the market you are buying in. If requested, they may provide a few comparables, or *comps* as they are known, but you need lots of hard data that will support your investment decision. Housing prices vary widely from city to city and from community to community. Prices are relative. For example, an identical house selling for $85,000 in one neighborhood might be worth $110,000 in another neighborhood. That's a difference of $25,000 for two identical houses. You must have market data that will enable you to make sound investment decisions.

In addition to traditional real estate sales agent, there are agents who specialize in investment properties and nothing else. These are the dealers we discussed in Chapter 2. These are the people you want on your team! Dealers play an important role in bringing opportunities to investors. They often act as wholesalers for retailers and other investors looking to buy property at below-market prices. Dealers are oftentimes licensed real estate agents

and earn their money from commissions generated. These agents are generally experts in their industry who have migrated from single-family residential sales for one reason or another—usually because of a shared interest they have for investment properties. Their specialized knowledge can save you a great deal in time, energy, and money. While traditional sales agents are not used to providing their clients with market data, dealers know exactly what you need. They understand the nature of the business of flipping properties and recognize that you will need key market information for proper financial analysis.

Dealers are well informed and are in direct contact with buyers and sellers every single day. They know which areas of town are hot and which are not. They also know when new properties are about to be made available for sale, so if they know what you are looking for, they can notify you immediately when a property meeting your criteria hits the market. Since dealers are plugged into a network of relationships—people who provide them with information and inventory—they will be among the first to know when a new opportunity becomes available. An additional advantage dealers can offer is that they often have an extensive database of other investors, both buyers and sellers, whom they can contact. Even if a house is not officially listed for sale, the broker may know from a prior conversation that the owner would entertain an offer should the right buyer come along with the right price.

Furthermore, dealers will often know how to use the MLS in ways that traditional real estate agents may not be aware of. For example, they can search the description fields of homes available for sale for keywords like "handyman special" or "TLC needed." Other keywords include "needs work," "as is," and "seller motivated." One additional term your dealer can search for is "VLB," which means "vacant on lock box." This frequently indicates that the seller has already moved into another house for any number of reasons (transfer, new home, etc.) and is now in the unenviable position of making two house payments. The house is likely to be in fairly good condition, with only minimal repairs needed, but a seller making two house payments may be willing to take consid-

erably less than the true market value. I found myself in that very position several years ago. My wife and I bought a new house in Michigan and were required to close on it even though we had not yet sold our home in Texas. After about six months of making payments on both houses, a buyer offered me much less than similar houses in the neighborhood were selling for. I wasn't at all excited about taking less than I thought the house was worth, but I was thankful for the opportunity to be relieved of the mortgage obligation on the other residence. Meanwhile, the buyer got a great deal, and I am certain he could sell the house today for much more than he paid for it.

CLASSIFIED ADVERTISING

Almost all newspapers, large or small, carry a section in their classified advertising specifically for selling real estate. Many of these ads are placed by real estate agents and are designed to prompt you to call their office. Most homes listed for sale in the newspaper by agents are active listings and will typically be priced at full retail. You might notice some ads, however, that use keywords like "motivated seller" or "must sell, owner transferring." These types of classified advertisements are worth following up on. Even if the home is no longer available or it does not meet your investment objectives, it can provide you with an opportunity to create a dialogue with a sales agent who might be able to find investment property that will meet your needs. The agent may even refer you to someone in his or her office who specializes in investment property (e.g., a dealer).

Many of the ads listed in the classified section are for sale by owners (FSBOs). Again, you will want to look for any keywords that may indicate the owner is anxious to sell or that the property may be offered at a price below retail. Some of these keywords include "handyman special," "needs work," or "as is." You should be prepared to take the time to call on as many of these property owners as possible. You must also have the self-discipline to exer-

cise restraint in your selection and analysis process. It is easy to get excited about an opportunity and to become emotionally engaged in the buying process. To be successful, you have to be able to remain impartial and objective in your analysis. Sooner or later, your patience will pay off and you will find that diamond in the rough.

Another way to use the classified advertising section is to place your own ad in the real estate wanted section. You don't need to spend a lot of money on these ads. A well-written small ad can be just as effective as a larger and more expensive ad. Your goal is to motivate people who want to sell their house to call you. Your ad should be designed to solicit only those callers who are likely to be selling the type of property that you are seeking. Following are some sample ads you may want to consider using.

NEED QUICK CASH?
I BUY HOUSES!
FAST CLOSINGS! ALL CASH!
CALL (800) 123-4567

MOTIVATED SELLERS WANTED!
ANY CONDITION! FAST CLOSINGS!
WE BUY HOUSES!
CALL (800) 123-4567

VACANT AND HANDYMAN SPECIAL
PROPERTIES WANTED!
ANY AREA! ANY CONDITION!
(800) 123-4567

REAL ESTATE PUBLICATIONS

Almost all areas periodically publish books or magazines specifically designed for residential real estate sales. Some of these are local, while others are regional. The magazines can often be found in racks or newsstands located outside real estate offices, convenience stores, and grocery stores. These real estate publications can be a very good source for locating potential deals. You will also find many helpful real estate–related advertisers in these publications—real estate agents, mortgage companies, appraisers, surveyors, title companies, real estate legal services, and insurance companies.

The majority of ads in these magazines are placed by real estate agents who tend to place all of their listings on one page. The ads usually feature a photo of the agent along with some compelling reason why you should contact that person for your real estate needs. Although the bulk of the ads in real estate magazines are placed by agents and brokers, some do offer an FSBO section. While most of the sales agents with listings in these publications focus on the traditional retail housing segment, there are usually a number of agents who specialize in different niches within the real estate market. For example, some firms focus solely on commercial real estate, while others specialize in vacant land. Still others (e.g., dealers) specialize in the wholesale market. As discussed in Chapter 2, dealers can be an excellent source for you. A good dealer can fax 20 or 30 wholesale listings to your office within minutes of receiving your call. Don't overlook these easy-to-find real estate publications, as they can provide you with lots of leads and lots of information vital to your success!

LOCAL AND NATIONAL WEB SITES

A number of web sites offer all kinds of information about houses for sale. You can do a local search by keying in a phrase such as "homes for sale Dallas, TX," for example. A search like this will

usually generate results of 20 to 30, maybe even more, web sites with listings in your area. The most comprehensive and well-known web site related to single-family properties for sale is hosted by the National Association of Realtors. You can find it at www.realtor.com. Realtor.com boasts over 2 million listings for various types of properties, including single-family homes, condominiums, town houses, multifamily apartments, mobile homes, vacant land, farms, and rentals. The data derived for these listings comes from the Multiple Listing Service, so it will not include any properties for sale by owner. The web site is available to the general public, so you don't have to be a real estate agent to access its listings. It is very much like a public MLS for properties available to the general population—or at least anyone with a computer and access to the web. You can also search by property type, state, city, zip code, price range, minimum and maximum square feet, age of home, number of floors, and several other criteria. Most listings provide a descriptive overview of the property, photos, and offering information. Exhibit 4.2 illustrates how very specific you can be by using the search criteria available at Realtor.com.

Other good Internet sources include your local newspapers. Almost all major newspapers now list their entire classified section on web sites. The information is often updated daily. This is usually determined by how often the paper is published. For example, a daily paper is most likely to be updated daily. A weekly paper would be updated weekly. An advantage the newspaper web sites offer over a site such as Realtor.com is that in addition to providing ads placed by real estate agents, many ads are also placed by individuals or owners. In fact, other than placing a sign out in the front yard, this is really about the only way an individual can market his or her property. Newspaper classifieds are not nearly as comprehensive as a site like Realtor.com, but they do provide you with a good mix of properties for sale by both real estate agents and individual homeowners.

These are only two of many web sites that can help you locate investment opportunities. The best way to locate properties in

Exhibit 4.2

Web site of Realtor.com.

REALTOR.com

Official Site of the National Association of REALTORS®

REALTOR.com® is the World's Largest Real Estate Database of Homes

DEBT? NEED IT TO GO AWAY?

Reduce Interest Rates Go

AME

Find a Home | Apartments & Rentals | Home Finance | Moving & Storage | Home & Garden

CHOOSE NEARBY AREAS

Basic Search Options

City: Davison State: MI or Zip: 48423

Price Range: $150,000 to $200,000

Beds: 3 or more Baths: 2 or more

Property Types

- [x] Single Family Home
- [ ] Mfd/Mobile Home
- [ ] Rentals
- [ ] Condo/Townhouse/Co-Op
- [ ] Land
- [ ] Multi-Family Home
- [ ] Farms

Property Features

Minimum Square Feet: 1200

Age of Home: Newer Home(0-

Number of Floors: Two or More Sto

Parking/Garage: Garage - 2 or more

- [x] Basement
- [x] Fireplace
- [ ] Main Floor Bathroom
- [x] Central Air
- [x] Forced Air
- [ ] Main Floor Bedroom
- [ ] Den/Office
- [ ] Hardwood Floors
- [ ] Spa/Hot Tub
- [x] Dining Room
- [ ] Horse Facilities
- [ ] Swimming Pool
- [ ] Disability Features
- [ ] Horses Allowed
- [ ] Family Room
- [x] Laundry Room

Lot Features

Lot Size: Any Size

- [ ] Corner Lot
- [ ] Waterfront
- [ ] River View
- [x] Cul-de-Sac
- [ ] City Lights View
- [ ] Ocean View
- [ ] Golf Course Lot
- [ ] Mountain View
- [ ] Water View

Community Features

- [x] Clubhouse/Rec. Room
- [ ] Recreation Facilities
- [ ] Spa/Hot Tub
- [ ] Exercise Area
- [ ] Security Features
- [x] Swimming Pool

HOMEOWNERS: Want to lower your monthly payments? AMERIQUEST MORTGAGE COMPANY Click Here

LESS THAN PERFECT CREDIT? NO PROBLEM! Select a Loan Go

Mortgage Rates At Historic Lows! Click Here Now AMERIQUEST® MORTGAGE COMPANY

(Continues)

Exhibit 4.2
(Continued)

☐ Golf ☐ Senior Community ☑ Tennis

Financial Options

☐ Lease Option Considered

☐ Trade Considered

MLS ID Search

MLS ID

(You'll need to fill in the City and State fields at the top of the page to complete an MLS search.)

Show Properties

FREE MATERIAL LIST FOR YOUR DREAM HOME

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your own area is to use a search engine like Yahoo, Google, or MSN to do a specific search.

REAL ESTATE INVESTMENT CLUBS

Most cities have a number of real estate investment–related associations and clubs. These clubs provide an excellent opportunity for you to network with others who share similar interests. Members often include investors like yourself, real estate brokers, tax and real estate attorneys, architectural engineers, appraisers, and other real estate professionals. Clubs and associations usually meet on a periodic basis, such as monthly, to discuss current events and share information. In addition, they frequently feature guest speakers who provide insight into a given area of expertise. You can find real estate associations in your area by looking in the yellow pages or by doing a search on the Internet. One site that I

have used is called Real Estate Promo.com and is located at www.realestatepromo.com. Click on the link titled "Investment Clubs" to locate a club near you. Clubs listed include almost all 50 states, so you should be able to find something near you. A similar site is offered by a company called Creative Real Estate Online, located at www.real-estate-online.com. Go to the home page and click on "Real Estate Clubs" to find an investment association in your area.

BANK REOs

Smaller local or regional banks can also be a good source for locating properties. Lenders are not in the business of managing real estate, nor do they want to be. The very nature of their business, however, demands that they assume risk with each and every loan extended to borrowers. Unfortunately for the banks, sometimes those borrowers default. When they do, the lender forecloses on the property and the real estate is transferred into the lender's real estate owned (REO) portfolio.

Most people don't event know that REOs exist. Banks certainly don't promote the fact that they've had to foreclose on real estate, which is now listed on their books as a nonperforming loan. After all, their customers come to them for banking services, not real estate services. Although almost all banks have REOs, very few will publicize that information. Small local banks usually have one individual who is responsible for the real estate owned portfolio, while regional banks may have several people, or even a whole department, responsible for REOs. Banks divest these properties through a network of private investors who have expressed an interest in them and also through real estate agents (e.g., dealers who specialize in wholesale property). The network of private investors can include anyone. If you are interested in acquiring properties in this manner, then you will need to be prepared to do some initial legwork to establish the proper contacts. There is no limit to the number of banks you can contact. I rec-

ommend establishing relationships with 8 to 10 banks in your area to provide you with a large of a pool of houses for sale.

Lenders are often quite flexible in the terms and conditions they are willing to offer, which may result in an opportunity for you to reach an agreement that is acceptable to both of you. The basis for the lender's initial asking price will likely be determined by the hard costs the bank has put into it, or its book value. While the bank will no doubt make every effort to minimize its losses, if it is anxious to get the property off its books, there's a good chance it will be willing to negotiate in your favor by agreeing to write down a portion of the loan. You should take time to physically inspect the property, then determine the costs required for repairs, the carrying costs, and the transaction costs and make your offer to the bank based on your analysis. In other words, determine the maximum amount you can invest in the deal and still make money based on a rate of return that is acceptable to you. If the deal doesn't make sense for you as an investor, you're better off letting the bank keep it. After all, there are many more banks with just as many REO properties available that may meet your investment criteria.

MARKETING

As you graduate from buying and selling real estate on a part-time basis to a full-time business, you will want to give serious consideration to promoting your company and the services you offer. Just as other business owners budget a certain portion of their expected revenues for marketing purposes, so will you, too, want to allocate a portion of your resources to promoting your real estate investment company. The more people who know that you are in business to buy and sell houses, the more opportunities you will have presented to you.

There are numerous ways to market your business and just as many books written about how to do so. Since this is not a marketing book, I will mention just a few of the many ways you can promote your company. Some of these include advertising in

newspapers and magazines, implementing a direct mail campaign, using signs, and doing a broadcast fax.

As previously mentioned, you can place small ads in the classified section of the newspaper, which can be highly effective. As your company grows, however, you will want to consider placing larger display ads in newspapers and in real estate publications. You can advertise in the same newspapers and magazines that you use to search for properties to buy. It should be easy enough for you to make your ad stand out from all of the others because you are in the business of buying houses at wholesale, while most all of the other advertisers are buying and selling houses at retail. The sample ad shown in Exhibit 4.3 is just one of many ideas you can use to promote your company. The focus of this ad is to generate referrals by offering a $500 reward for each and every referral received. You should be sure to qualify your offer, however, by stating that the referral must result in the signing of a purchase agreement by both the buyer and the seller.

Another very effective method of promoting your company is to implement a direct mail campaign. Since the cost of printing and postage can quickly add up, your direct mail piece should be targeted to the people who can best help you—real estate agents. You can purchase a list of names and addresses for the agents in your area from a reputable company, or, if you have the time, simply use your local telephone book to build your own list. Much of the content used in your display ads in newspapers and real estate publications can also be used in your direct mail piece. The literature mailed can be in the form of a letter that introduces you and the services you offer, a flyer containing the same information, a sales brochure, or any combination of the three. I suggest that you also include at least two to three of your business cards. While the recipients of your mailing may discard the enclosed letter or flyer, they will most likely save your business cards, and if you include more than one, there's a good chance they may pass one along to a business associate.

Signs are a cost-effective way of marketing your company. Smaller signs, perhaps 18 by 24 inches and made out of corrugated plastic, are fairly inexpensive to buy. You can buy them with wire-

Exhibit 4.3

Example of a promotional ad.

frame stands, which makes them easy to place in high-traffic locations. I recommend not putting too much information on your signs. Just stick to the basics, such as "I buy houses," your company name, and a telephone number. I've seen some real estate signs that are so overloaded with information that it's difficult to make out anything, especially when people are driving by and may have only a few seconds to glance at the sign. Use large letters and keep your sign simple. I would also suggest using a color that works well in both winter and summer. For example, white signs with blue lettering look great in the summer; however, in the winter the white sign will blend in with the snow and barely be visible. Likewise, a green sign with white lettering looks great in the wintertime because the colors are sharply contrasting. Once again, though, in the summer the green sign blends in with grassy roadsides and surrounding foliage. I suggest using colors that work well year-round, such as a red or blue sign with white letters.

As your company grows and you have more available in your advertising budget, you may also want to consider using billboards. These signs can be very effective, especially in areas of town where the traffic count is known to be high. It is also helpful if the posted speed limit is 40 miles per hour or less. That way, the passersby have more time to read the information on the signs. As with the smaller roadside signs, don't try to put too much information on billboards. Drivers usually have only a couple of seconds to read your message. Again, keep it simple.

Finally, you may want to consider faxing your message to as many recipients as possible. Your primary target market should be real estate offices. A number of good fax programs allow you to generate what is known as a *broadcast fax* directly from your computer. These programs are easy to use and easy to set up. A broadcast fax, also known as a *blast fax,* allows you to send a document via facsimile to multiple recipients. The fax program allows you to set up telephone directories. For example, you could set up a directory named Genesee County Real Estate and enter the fax numbers of 100 real estate agents. When you get ready to send your letter, flyer, or other document from your com-

puter, the fax program allows you to select the entire directory. All you do is click on it, hit Send, and the program will do the rest. It will spend the next two to three hours dialing every number in your directory and sending the fax. If you live in an area where the calls are all local, then the faxes cost you only a little bit of your time. One cautionary note I will add is that many people do not want to receive faxes they consider to be advertisements. As a general rule, the real estate community will be receptive to your message; however, be respectful of those who do not wish to receive faxes and promptly remove them from your list.

FOR SALE BY OWNERS (FSBOs)

Individuals who prefer to sell their own houses are frequently referred to as *for sale by owners,* or FSBOs. This group of homeowners represents an important segment of the potential properties available to you, so be sure to give them the attention they deserve. They can be located by looking through the classified section of your local newspaper or by driving through neighborhoods and looking for FSBO signs. FSBOs typically maintain the attitude that they can sell their houses on their own without any professional help from the real estate community, thereby enabling them to save thousands of dollars on the cost of the commission. What they fail to realize, unfortunately, is that although they may save money on the commission, they may lose more money on the overall transaction than if they had listed with an agent. This results from their lack of experience and lack of knowledge of local market prices.

FSBOs all have an idea of how much they think their houses are worth, but in reality, their houses are usually priced too high or too low. For example, some owners have lived in their homes for 20 years or more and have no idea how much homes have appreciated during that time. Another homeowner may have heard that a neighbor down the street sold her house for *X;* therefore his house must be worth *Y.* In truth, neither seller really

knows the true market value of their home. Guess what? That's good news for you as an investor. Since you will be intimately familiar with market values in the neighborhoods you will be prospecting, you will know immediately from your initial telephone conversation with a potential seller whether the price of the house fits your investment criteria. If you find a seller who is willing to sell his or her home at a price 10 or 15 percent below market, that can certainly work to your advantage. For those of you who may think this is taking advantage of the seller, I disagree. You have no moral obligation to tell sellers that their house may be worth more than they are asking. FSBOs set their asking price at a value they believe to be fair for any number of reasons. As a buyer willing to meet their terms, you have become an important component of a relationship that is amenable to both parties. Finally, for sale by owners are often flexible on terms and may be able to provide you with a more favorable and creative deal structure, one that permits you to minimize your cash outlay in the property.

VACANT PROPERTIES

As you drive through neighborhoods in your search for investment opportunities, be sure to pay special attention to those houses that appear vacant. Vacant houses are more of a liability than an asset for their owners, so they are oftentimes available at bargain prices. For any number of reasons, the seller has moved out and is no longer around to care for the house. It may be that he or she just went through a divorce, had a new house built, or was transferred to another area. Whatever the reason, the end result is the same. If the owner is to prevent the house from going into foreclosure, he or she must not only make the payments on the new house, but must also keep up the payments on the old one. After just a few months of making double house payments, sellers of vacant properties become very motivated. In some cases, they are happy just to have somebody relieve them of their

monthly obligation, regardless of any equity they may have built up in the house.

Obvious signs of empty houses include overgrown weeds and shrubs, newspapers in the driveway, and a general rundown appearance. Sometimes these houses have only recently been vacated; other times they have been sitting empty for several months. They may have an FSBO sign or a real estate firm's sign in the front yard. If so, this makes your job of finding the owner much easier. If there is no sign out front, you may have to do a little research. Usually, a telephone call to the local taxing authority can provide you with the information you need. The clerks who work in the tax offices and who are responsible for maintaining the tax roles can quickly and easily provide you with the current owner's name and the address (to which the tax bill is mailed). With the name and address, you can call information to obtain a phone number for the owner. If the number is unlisted, you can express your interest in the property through the mail since you at least have the owner's address. Be sure and provide owners with your telephone number so that if they are interested in selling, they can contact you with as little effort as possible.

FORECLOSURES

While vacant properties can be an excellent source of finding investment opportunities, properties that sit vacant for too long often become foreclosed properties. This, too, can be another great source for finding potential deals. Buying and selling foreclosures requires an individual to have a working knowledge of that market. While a number of good books have been written on the subject, many investors do not have the expertise or the time to find undervalued foreclosures. Furthermore, they are unfamiliar with the auction and/or bidding process and may lack the resources to purchase properties in this manner. An investor who understands the process of buying foreclosed properties can potentially make substantial profits. Buying foreclosures, how-

ever, is not as easy as many would have you believe. In many markets, the bidding process is very competitive and therefore the property is difficult to buy at an attractive price. The investor participating in this market must have specialized knowledge, patience, and enough investment capital to be successful.

The best approach to identifying the property best suited to your specific needs will include using as many of these tools as possible. The most important thing to remember is to *be patient.* You will find the right property at the right price with the right terms. As the employer of your capital, your task is to have your employees (your capital) working as hard for you as possible. That means your investment must offer an acceptable rate of return to you. Only you can determine what is acceptable. It is best to establish an acceptable rate of return early in the process so you don't make the mistake of lowering your standards because you think you have found a property that is okay. Determine your investment criteria and objectives, implement them as an initial filtering device, and when the time comes, be prepared to execute your acquisition strategy.

The heights by great men reached and kept,
Were not attained by sudden flight,
But they, while their companions slept,
Were toiling upward in the night.

—Henry Wadsworth Longfellow

Chapter 5

Valuation Methodologies

Now that you understand the concept of flipping properties, how to create value, and what types of properties to look for, the next step is to learn how to analyze potential value play opportunities to determine whether they meet your investment criteria. This chapter is probably the most critical chapter in the entire book. The key to your success in buying and selling single-family houses is to have a thorough and comprehensive understanding of value. Proper valuation is the basis for all investment decisions, whether they be investments in the stocks of various companies, in commodities, or in real estate. You absolutely must be able to understand how value is derived in order to make rational and balanced investment decisions. Without these essential skill sets, you will find yourself at a tremendous disadvantage.

Before you even make an offer on a prospective investment property, you will want to know beforehand the potential value that can be created from it. Creating value in single-family houses can be accomplished in several ways. Your review of a prospective flipping opportunity will consist of examining the variable components of the property that affect its value—in other words, anything at all about the property that can be changed to add value. For flipping or rehab properties, this would primarily include, for example, the physical condition of the property, but not its location. While the property's location is certainly important, it is not a variable that can be changed to add value.

HOW TO KNOW HOW MUCH IS TOO MUCH

In this chapter, you learn how to determine whether a house priced at $50,000 is in fact worth the seller's asking price. How do you know? It may in reality be worth only $40,000, or it could actually be underpriced and may be worth $65,000. The bottom line is you need to know and understand the difference for yourself and not rely solely on what the sales agent and/or seller is telling you. In my experience, I have seen many agents who believe their client's property is worth more than it really is. I have also seen inexperienced investors attempt to justify the value imbued in the price the agent is asking. Somehow they think if they could only buy the property, they are going to be able to unlock all that extra value that really doesn't exist. The truth is, however, they will have overpaid for the property. Paying too much for a rehab property is the quickest way I know to put you out of business.

VALUATION METHODOLOGIES

Three traditional approaches are used to determine the value of a property: the *sales comparison approach,* the *cost approach,* and the *income capitalization approach.* (See Exhibit 5.1.) Each approach has its place and serves a unique function in determining value. Depending on the type of property being appraised, the majority of the weight may be given to a particular approach, as the other two methods may not be relevant.

Replacement Cost Approach

In an appraisal report conducted by Butler Burgher, Inc., a well-known appraisal firm based in Houston, Texas, the replacement cost approach is defined as follows:

Exhibit 5.1
Three traditional valuation approaches.

1. Replacement cost approach
2. Income approach
3. Sales comparison approach

The cost approach is based on the premise that the value of a property can be indicated by the current cost to construct a reproduction or replacement for the improvements minus the amount of depreciation evident in the structures from all causes plus the value of the land and entrepreneurial profit. This approach to value is particularly useful for appraising new or nearly new improvements.

The replacement cost approach is usually not used to value investment properties such as single-family houses. It is most appropriately used when estimating the actual costs associated with replacing all of the physical assets. For example, if a house was partially or completely destroyed by fire, the value established from the cost approach would be useful in helping to determine exactly how much an insurance company would pay for the resulting damages. Depending on the type of policy you have in place, the insurance company may only pay for the remaining useful life of the item damaged. For example, if the roof on the house is 20 years old and is damaged as a result of high winds, the insurance company may not pay 100 percent of the cost for a brand-new roof. If the estimated life of the shingles is 25 years,

insurance may only reimburse you for the remaining useful life, which in this case would be 20 percent.

$$\text{Remaining useful life} = 1 - \frac{20}{25} = 20\%$$

When buying insurance for your investment properties, be sure to determine exactly what your policy covers and what it does not cover.

Income Capitalization Approach

I again refer to the appraisal firm of Butler Burgher to define the income capitalization approach, or income approach, as it is also known.

> The income capitalization approach is based on the principle of anticipation which recognizes the present value of the future income benefits to be derived from ownership of real property. The income approach is most applicable to properties that are considered for investment purposes, and is considered very reliable when adequate income/expense data are available. Since income producing real estate is most often purchased by investors, this approach is valid and is generally considered the most applicable.
>
> The income capitalization approach is a process of estimating the value of real property based upon the principle that value is directly related to the present value of all future net income attributable to the property. The value of the real property is therefore derived by capitalizing net income either by direct capitalization or a discounted cash flow analysis. Regardless of the capitalization technique employed, one must attempt to estimate a reasonable net operating income based upon the

> best available market data. The derivation of this estimate requires the appraiser to 1) project potential gross income (PGI) based upon an analysis of the subject rent roll and a comparison of the subject to competing properties, 2) project income loss from vacancy and collections based on the subject's occupancy history and upon supply and demand relationships in the subject's market . . . , 3) derive effective gross income (EGI) by subtracting the vacancy and collection income loss from PGI, 4) project the operating expenses associated with the production of the income stream by analysis of the subject's operating history and comparison of the subject to similar competing properties, and 5) derive net operating income (NOI) by subtracting the operating expenses from EGI.

The preceding technical description by Butler Burgher defining the income approach may initially appear somewhat complex to those of you who may not be familiar with the methodologies used for the analysis of financial statements. The income approach can be broken down to its most basic and fundamental level by examining a simple financial instrument such as a certificate of deposit. For example, assuming a market interest rate of 5 percent, how much would you be willing to pay for an annuity yielding $10,000 per annum? The answer is easily solved by taking a simple ratio of the two values as follows:

$$\text{Present value} = \frac{\text{income}}{\text{rate}} = \frac{\$10{,}000}{0.05} = \$200{,}000$$

In other words, if you purchased a certificate of deposit for $200,000 that yielded 5 percent annually, you could expect an income stream of $10,000. It doesn't matter how long the income continues. The present value remains the same and will continue to generate an income stream of $10,000 as long as you continue to hold the $200,000 certificate of deposit. If at some point in

your real estate career you decide to invest in income-producing properties such as apartments, strip centers, or office buildings, I urge you to thoroughly acquaint yourself with the income capitalization approach and to become proficient in its application. In *The Complete Guide to Buying and Selling Apartment Buildings,* I expound on these principles in depth and provide many examples of this particular valuation approach.

Sales Comparison Approach

Once again, I rely on Butler Burgher to define the third valuation approach, which is the sales comparison approach:

> The sales comparison approach is founded upon the principle of substitution which holds that the cost to acquire an equally desirable substitute property without undue delay ordinarily sets the upper limit of value. At any given time, prices paid for comparable properties are construed by many to reflect the value of the property appraised. The validity of a value indication derived by this approach is heavily dependent upon the availability of data on recent sales of properties similar in location, size, and utility to the appraised property.
>
> The sales comparison approach is premised upon the principle of substitution—a valuation principle that states that a prudent purchaser would pay no more for real property than the cost of acquiring an equally desirable substitute on the open market. The principle of substitution presumes that the purchaser will consider the alternatives available to them, that they will act rationally or prudently on the basis of his information about those alternatives, and that time is not a significant factor. Substitution may assume the form of the purchase of an existing property with the same utility, or of acquiring an investment which will produce an income stream of the same size with the same risk as that involved in the

> property in question. . . . The actions of typical buyers and sellers are reflected in the comparison approach.

In essence, the sales comparison approach examines like properties and adjusts value based on similarities and differences. This method is used most often in valuing single-family houses. Let's say, for example, you decide to sell your house. To help you determine a listing price, your sales agent will pull up all of the current listings in your neighborhood, as well as recent sales, and calculate a range of prices based on the average sales price per square foot. Then the agent will consider factors such as the overall condition and the various amenities of your house. Does it have a fireplace or a swimming pool? Is it a two-car or a three-car garage? And so goes the process, adding and subtracting until a final value is determined. The use of sales comps, as they are called, is the most important factor in the overall analysis of determining the value of single-family properties. It is very much like shopping for a new car. You consider all the alternatives that each manufacturer has to offer, compare each and every feature, and match them to your specific needs. As an investor in value play opportunities, you should rely heavily on the sales comps in your particular market. It is the basis that every buyer looking at your houses will use to make purchase decisions.

In summary, each of the traditional valuation methods serves a unique function by estimating value using one of three different approaches. In some cases, all three approaches may be used, applying varying weights to each. Butler Burgher affirms, "The appraisal process is concluded by a reconciliation of the approaches. This aspect of the process gives consideration to the type and reliability of market data used, the applicability of each approach to the type of property appraised and the type of value sought."

This is the mark of a really admirable man: steadfastness in the face of trouble.

—Ludwig van Beethoven

Chapter 6

Financial Analysis

Now that you have a good understanding of the three primary valuation approaches, let's look at some examples of how to apply them. In particular, we examine more closely how to use the comparable sales approach in estimating the potential resale value of various properties. Then we look at an example in which a multifamily property is converted into individual single-family units. Finally, we examine the conversion of a single-family house to income-producing commercial use and evaluate its effect on the property's value.

THE TEXAS TWO-STEP

More than 20 years ago I bought my very first investment property. I was living in Texas at the time. Actually, I bought two houses at the same time from an older gentleman who had owned the houses for years and had maintained them as rental units. The houses were located in the same neighborhood and were right around the corner from each other. They were about 40 years old and in need of minor repairs such as paint and cleanup. All of the real estate books I had read at the time advocated the traditional buy-and-hold approach, so my intentions were to do exactly that—buy the two houses and hold them, much the same as the gentleman whom

I was buying them from had done. I decided I would spend a little bit of money fixing them up and then rent them out.

The seller owned the two houses free and clear, which means that there were no underlying obligations such as mortgages on them. Since he was retiring, he did not want to sell them for all cash, but instead preferred to receive regular monthly payments. He was more than glad to carry the financing, which worked out well for me. That meant I wouldn't have to bother with getting a mortgage from a more traditional lending source, such as a bank. We agreed on a sales price of $20,000 apiece for the two houses. The deal was structured as shown in Exhibit 6.1.

A few weeks later, we closed on both houses simultaneously, and before I knew it, I was in the real estate business! Since I was young and full of energy at the time, I decided to take on the painting and cleanup myself. I spent the next month painting the exteriors of both houses, cutting down the weeds, mowing the grass, and giving the interiors a thorough cleaning. It didn't take long after that to locate tenants and rent out the houses. Since these were my first two rental houses, I didn't have any property management

Exhibit 6.1
Deal structure,
Part 1: Two houses in Texas.

1. Sales price: $20,000 each
2. Down payment: $1,000 (5%)
3. Term: 15 years
4. Interest rate: 10%

experience. The only training I had came from a couple of books I had read.

After a few months of being in the rental business, I was beginning to have second thoughts about my new career in real estate. Actually, the tenants weren't that bad. It just seemed to me that this so-called buy-and-hold approach was going to be a long and painstaking process. At the rate I was going, it would be a long time before I could even begin to think about retirement. After about a year, I began to consider the idea of selling the houses to the tenants who lived there and thought about how I could structure the sale in a manner that would be agreeable to them. I decided to carry the note myself, or provide owner financing, as it is sometimes referred to. I agreed to let the tenants apply a portion of the rent they had been paying. Take a look at Exhibit 6.2 to see how the deal was structured.

Now take a minute to study Table 6.1. The worksheet you see is a proprietary model I developed that I use to quickly and easily analyze potential value play investment opportunities. I call it The Value Play Rehab Analyzer. Once I have gathered the necessary

Exhibit 6.2
Deal structure,
Part 2: Two houses in Texas.

1. Sales price: $29,500 each
2. Rent applied toward down payment: $1,000
3. Term: 20 years
4. Interest rate: 12%

Table 6.1 Property Analysis Worksheet: The Value Play Rehab Analyzer

Purchase Assumptions		Financing Assumptions—Primary			Financing Assumptions—Secondary		
Project Name:	Two Houses in Texas	Primary Mortgage or Loan:			Secondary Financing/Line of Credit:		
Address:	123 South State St.	Total Purchase	100.00%	20,500	Total Imprvmnts	100.00%	1,085
City, State, Zip:	Baytown, TX 77520	Down Payment	7.32%	1,500	Down Payment	100.00%	1,085
Contact:	Mr. Retired Gentleman	Balance to Finc	92.68%	19,000	Balance to Finc	0.00%	0
Telephone:	(800) 555-1234						
Land	2,500		Annual	Monthly		Annual	Monthly
Building/House	17,500	Interest Rate	10.000%	0.833%	Interest Rate	8.000%	0.667%
Closing Costs	500	Amort Period	15	180	Amort Period	15	180
Other Related Costs	0	Payment	2,450	204	Payment	0	0
Total Purchase Price	20,500	Interest Only	1,900	158	Interest Only	0	0

Estimate for Improvements

Appliances		Flooring		Lighting	0
Dishwasher	0	Carpet	0	Masonry	0
Disposal	0	Ceramic Tile	0	Other	0
Microwave	0	Hardwood	0	Other	0
Range	0	Vinyl	0	Other	0
Refrigerator	0	Subtotal	**0**	Painting: Exterior	450
Subtotal	**0**			Painting: Interior	0
		Foundation	0	Permits	0
Architectural Drawings	0	Framing	0	Subtotal	**450**
Cabinets	0	Garage	0		
Caulking	25	Gas & Electric Hookup	0	Plumbing	
Subtotal	**25**	Glass: Mirrors, showers	0	Commodes	0
		Gutters	0	Drain Lines	0
Cement Work		Subtotal	**0**	Faucets	0
Basement Floor	0			Fixtures	0
Driveway	0	HVAC	0	Hot Water Heater	0
Garage Floor	0	Air Conditioner	0	Showers	0
Porches	0	Duct Work	0	Tubs	0
Sidewalks	0	Filters	10	Water Lines	0
Subtotal	**0**	Furnace	0	Subtotal	0
		Subtotal	**10**		

Estimate for Improvements

Cleaning	225	Insulation	0	Roofing	0
Counter Tops	0	Insurance Premiums	250	Siding	0
Decorating	0	Subtotal	**250**	Site Planning & Engineering	0
Doors	0			Steel	0
Drywall	75			Trim	0
Electrical	0	Landscaping		Utility: Gas & Electric	0
Engineering	0	Irrigation System	0	Utility: Water & Sewer	0
Equipment Rental	0	Lot Clearing	0	Warranty	0
Excavation Work	0	Mowing Services	35	Windows	0
Fences	0	Sod	0	Subtotal	**0**
Fireplace	0	Trees, Plants, & Shrubs	15		
Subtotal	**300**	Subtotal	**50**	Total Cost of Improvements	**1,085**

Comp #1		Comp #2		Comp #3	
Address:		Address:		Address:	
Sales Price	0.00	Sales Price	0.00	Sales Price	0.00
Adjustments to Price	0.00	Adjustments to Price	0.00	Adjustments to Price	0.00
Adjusted Price	0.00	Adjusted Price	0.00	Adjusted Price	0.00
Square Feet	1.00	Square Footage	1.00	Square Feet	1.00
Price Per Square Foot	0.00	Price Per Square Foot	0.00	Price Per Square Foot	0.00

Comp Averages	
Sales Price	0.00
Adjustments to Price	0.00
Adjusted Price	0.00
Square Feet	1.00
Price Per Square Foot	0.00
Turn Comps Off/On	OFF
Est Price/Sq Ft If Turned OFF	39.33

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Subject Property 123 South State St.		Description	Adjustment to Comps Best Case	Most Likely	4.25 Worst Case
Square Feet	750.00	Est Sales Price	32,688	29,500	26,313
Price/Sq Ft	27.33	Purchase Price	20,500	20,500	20,500
Imprvmnts/Sq Ft	1.45	Improvements	1,085	1,085	1,085
Total Price/Sq Ft	28.78	Interest Charges	0	0	0
		Taxes	0	0	0
		Closing Costs	350	350	350
		Total Costs	21,935	21,935	21,935
Estimated Time To		Profit Margin	**10,753**	**7,565**	**4,378**
Complete Project	0.00	Return On Inv	**415.96%**	**292.65%**	**169.34%**

data, I can input the information into the model and, in less than five minutes, know within a reasonable degree of accuracy whether a deal makes sense based on my investment criteria. All I have to do is key in the information and the model automatically makes all of the calculations.

Under the Purchase Assumptions section in Table 6.1, the basic property information is listed, including a project name, address, and pricing information. The value of the land does not really matter as long as the price of the land plus the price of the house is equal to the total purchase price. There are two sections for Financing Assumptions—one for primary financing and another one for secondary financing. The primary financing section is used for the main source of lending, which can be a mortgage company, a bank, or a private individual, as this example illustrates. The secondary financing section is used for any additional loans you may secure. For lower-cost improvements, such as the one in this example, you may use all cash. On the other hand, if the cost of the improvements is greater than the amount of capital you want to use, then this is the section to use. Rates and terms are typically different for a line of credit, such as a home equity line or a credit card, than they are for a regular mortgage, so having two sections for financing allows you to more accurately determine your carrying costs.

Under the Estimate for Improvements section, there is quite a bit of detail that allows you to estimate the costs for virtually everything in a house. Estimating these costs accurately is, of course, vitally important for the proper analysis of an investment rehab opportunity. The more experience you have, the easier estimating costs will become. At first, you may need to procure bids or estimates from contractors to help you determine how much the required improvements will cost. As you gain experience, however, you'll be able to estimate many of the costs on your own. The total cost of improvements in this example is only $1,085.

The next section of the model allows you to enter information for comparable home sales. This information is needed to help you make accurate projections of the estimated resale value of your investment property. Any sales agent can provide you with

comparable sales data for your area. In addition, a provision in this section allows you to make adjustments to the sales price of the comps, which permits you to compare apples to apples. For example, if the home you are buying has a two-car garage and the comparable home sale has a three-car garage, you will need to revise the price downward in the Adjustments to Price section. This is exactly how real estate agents and appraisers derive the market value of a house. They start with an average price per square foot for several similar houses and make compensating adjustments to estimate value.

The Comp Averages section simply takes an average of the three comps' sales prices to come up with an average sales price. This number is then divided by the average price per square foot. The result is a weighted average price per square foot. This section also has a provision that allows you to turn the comps section off or on. As you become familiar with a specific market or neighborhood, you are likely to already know what the average sales price per square foot is, so you really don't need to key in sales comp data. Instead, you can turn off the comps section and plug in your own estimate. In this example, I had only one comparable sale and that was the house I lived in. I paid $40,000 for a 1,000-square-foot house located in the same neighborhood just a few blocks away. I reasoned that since I paid $40 per square foot for my house and had just had a recent appraisal on it, then I should be able to get close to $40 per square foot for the houses I was selling. I liked the number $29,500 because it was less than $30,000 and sounded more affordable. Therefore, in the example in Table 6.1, the comparable sales section is turned off.

The average sales price per square foot is then fed into the Subject Property section. All of the information keyed into the rest of the model is summarized in this section. You must know the square footage of the house you are buying so that you can make an accurate comparison. The purchase price per square foot is automatically calculated, as is the total cost of the improvements per square foot. The two numbers are then added together to give you the total cost of the project. In this example, the total cost of improvements of $1,085 was added to the total purchase price of

$20,500. The resulting sum was then divided by 750 square feet to give me a total price per square foot of $28.78. Below that is a provision that allows you to estimate the total time (in months) for completion and resale. In other words, it calculates the carrying costs for interest, a factor that many less experienced investors do not consider. In the example here, the number of months is set to zero since the house was occupied as a rental.

The Adjustment to Comps cell is used to create the estimated sales price for three different sales scenarios: best case, most likely, and worst case. In this example, $4.25 per square foot is used. For the best-case sales price, the model adds $4.25 to the price per square foot cell in the Comp Averages section, then multiplies the sum of the two by the square feet of the subject property. Here's how it works:

Best-case sales price

$$= (\text{average price per square foot} + \text{adjustment to comps})$$
$$\times \text{subject property square feet}$$
$$= (\$39.333 + \$4.250) \times 750 = \$32{,}688$$

The most likely sales price calculation in the model neither adds nor subtracts the value of $4.25 to the price per square foot cell in the Comp Averages section. It is simply the product of the average price per square foot and the square feet. Take a moment to examine the following equation:

Most likely sales price

$$= \text{average price per square foot} \times \text{subject property square feet}$$
$$= \$39.333 \times 750 = \$29{,}500$$

For the worst-case sales price, the model subtracts $4.25 from the price per square foot in the Comp Averages section, then mul-

tiplies the difference between the the two by the square feet of the subject property. Take a minute to review the following equation:

Worst-case sales price

$$= (\text{average price per square foot} - \text{adjustment to comps})$$
$$\times \text{subject property square feet}$$
$$= (\$39.333 - \$4.250) \times 750 = \$26{,}313$$

The purpose of creating three different scenarios in the model is to provide us with a range for the estimated sales price. This allows you to evaluate the very minimum you might expect on the low end of the price range, and the very most you might expect on the high end of the price range. Take a moment to refer back to Table 6.1. The purchase price, improvements, interest charges, taxes, and closing costs remain constant across all three scenarios since these values are not affected by the adjustment to comps variable of $4.25. The *profit margin* is the dollar amount that you can expect from your investment after all costs have been accounted for. The *return on investment* (ROI) is calculated as the ratio of the profit margin divided by the total cash you have invested in the property. It is calculated as follows for the most likely scenario:

Return on investment

$$= \frac{\text{profit margin}}{\text{primary down payment} + \text{secondary down payment}}$$

$$= \frac{\$7{,}565}{(\$1{,}500 + \$1{,}085)} = 292.65\%$$

My very first investment in the two houses in Texas proved to be a classic example of just how effective the value play strategy can work. I was able to find two houses priced below market that

needed minimal repairs from a seller who was willing to carry the note and who also only required $1,000 down on each house. With a little bit of sweat equity on my part, I was able to substantially improve the two houses, rent them out, and later sell them for a respectable profit of $7,565 each. As shown in the preceding calculation, this represented a return of 292.65 percent on my invested capital. Not bad for a rookie.

Since I had not yet developed the Value Play Rehab Analyzer, the output depicted in Table 6.1 was not available to me at that time. Although I had done my homework with respect to market prices and believed that I was purchasing the two houses at a good price, I did not have the foresight to look ahead and determine exactly how much profit could be unlocked from this investment. Selling the houses for a profit early in the game really came as an afterthought. I'm sure you'll agree with me that there is great value in having a dynamic model such as the one illustrated in Table 6.1. By keying in the basic assumptions, you can very easily change a few variables to quickly identify any upside potential. Additional information about the the model used in this example and the ones following may be found in Appendix C.

MULTIPLY YOUR EFFORTS BY 22

Now let's look at another example. Those of you who have read *The Complete Guide to Buying and Selling Apartment Buildings* may recognize this as one of the examples I used in that book. The example is one of a multifamily property I acquired that falls into both the income-producing category and the rehab, or flipping, category. For those readers who have been involved in a condominium conversion, you will understand why. With a condo conversion, you are taking an income property such as an apartment building and converting it to non-income-producing units to be sold on an individual basis. You are removing the income aspect from the property and converting it to a different use; therefore, the valuation method changes from the income capitalization

approach to the market comparables approach. This example illustrates how the value play concept can be applied on a larger scale.

Several years ago, I came across a 22-unit multifamily property that at first glance appeared to be very reasonably priced. The seller was asking $350,000. The 22 units consisted of 11 duplex buildings that were lined up neatly in a row side by side. Also included in the sale was an empty lot that was located adjacent to the units. The apartments enjoyed an occupancy of greater than 95 percent with very little turnover. A drive by the property revealed that the buildings had not seen any new paint since their construction approximately 17 years earlier. The lawn was in dire need of attention. Shrubs and hedges lined each building, but had not been trimmed for years. Trees planted in between each driveway offered nice shade for the tenants, but they, too, were overgrown. Each unit had its own private cedar-fenced yard, but, like the worn paint, the fences appeared to be poor condition. So far, this was shaping up to be the kind of deal I liked. Paint, landscaping, and fencing are all fairly inexpensive improvements and could be made quickly.

While the $350,000 asking price sounded very reasonable, I needed something to compare it to that would provide me with an idea of the potential value that could be created after the property was cleaned up. As I drove around the neighborhood, I came across an entire street just a few blocks away that was lined with duplexes very similar to the ones I was looking at. One of them had a For Sale sign out front, so I jotted down the number and returned to my office to inquire about the property. I visited with the seller at length, and it turned out that he represented the owner who had at one time owned all 36 duplex buildings on the street, a total of 72 units. The owner had initially maintained them as rentals, but over the past three years began selling them off to individuals who lived in them or to other investors who rented them out. Out of his original inventory of 72 units, he had sold 68 and now had only four left. His asking price was $39,000 per unit or $77,000 for two units. This information was critical in that it told me two important things. First, the owner had sold 68 units

over a three-year period. This meant there was a market for these properties. Second, the price of $77,000 per building had been established and could be used as a valuable comp for appraisal purposes. Since both properties had two bedrooms and two baths and were comparable in size, I knew immediately what the potential upside was. The 22 units I was looking at suddenly began to look very attractive, as the seller was asking only $31,818 per building.

The seller of the 22-unit building I was interested in was a partner in a surveying and engineering company that kept him quite busy. He was not in the apartment business, nor did he care to be. He ended up taking over the duplexes quite by chance. The seller had helped design the project years earlier for an out-of-state investor who eventually came back to him for help in managing the property. As it turned out, the seller ended up taking over the units altogether.

An elderly couple who occupied one of the units served as full-time caretakers, collecting the rents and performing some light maintenance, for which the seller paid them a salary. His objective was to completely minimize his involvement in dealing with tenants, upkeep, and pretty much anything to do with the property. In short, the seller was a bona fide "don't wanter." Fortunately for me, he was not aware of the underlying value that could be unlocked from his property, and even if he were, I don't think he would have been inclined to undergo the process required to create the value. I sincerely believe he was interested only in unloading what had become a source of stress for him.

After brief negotiations with the seller through my real estate broker, I put the duplexes under contract for an agreed-upon price of $333,000. This included all 22 units as well as the vacant tract of land adjacent to them. One unique attribute of this transaction was that all 11 duplex buildings were separately platted and surveyed. This meant that as long as the right type of financing was in place going into the deal, the buildings could all be sold separately or parceled out in any number of ways. For example, an individual could purchase one unit (half of a duplex), two units

(all of a duplex), or any combination of units he or she wanted. Proper financing for this type of purchase was a key factor. Most lenders financing multifamily apartments will place a single loan on the entire property and use all of it as collateral. When it comes time to sell, it is either all or none. In other words, you cannot sell off individual units or buildings because the entire purchase is being used to secure the loan or mortgage. After numerous phone calls, I finally found a local bank that was willing to work with me and structure the purchase in a manner that would facilitate my objectives. The loan was set up so that each time I sold a unit, building, or group of buildings, a portion of the loan was paid off and the respective collateral was released to the new lender. As previously mentioned, this transaction was very similar to a condominium conversion, with similar financing being required. The sale was structured as shown in Exhibit 6.3.

As soon as I had the duplexes under contract, I performed the usual due diligence. This included an examination of the seller's record of income collected and expenses paid (e.g., taxes, utilities, and repairs). The next step was a thorough physical inspec-

Exhibit 6.3
Deal structure,
Part 1: Multiply your efforts by 22.

1. Sales price: $333,000
2. Down payment: $33,300 (10%)
3. Term: 25 years
4. Interest rate: 8%

tion of each unit inside and out. After carefully examining the property, I was able to assess more precisely the amount of repairs needed to bring the duplexes up to a level I thought was suitable. As was true for the exterior, the needed interior repairs were largely cosmetic. There was the usual—worn carpets, leaky faucets, marred paint—but nothing of major importance.

After I was satisfied with the due diligence, the next step was to order the required third-party reports. This particular lender required a survey, an appraisal, an inspection, and a Phase I environmental report. All reports came in satisfactory. An added bonus was the appraised value, which was determined to be $520,000 with the property in its existing condition. I was, of course, pleased with the report because it served to validate my beliefs about the upside potential that existed in this deal.

After all reports were sent to the lender, a final review of the loan package was completed and subsequently approved. The seller and I closed a few days later. It was truly a win-win situation for all parties involved. The seller was relieved of his headache; I had just purchased a superb value play opportunity; and the banker had made a sound loan. Now the real fun was about to begin. It was time to get to work and unlock the hidden value in this little gem!

I have described at length the entry strategy implemented to acquire the 22 units. Now let's take a look at the postentry process. During the period I had the duplexes under contract, I procured several estimates from contractors for all of the work I wanted performed. Before the deal closed, I had most all of the contractors lined up to begin working the week after the closing. The tenants were notified that the property was under new management and that they would begin seeing some much needed improvements. The flurry of activity actually created some excitement among them, and they were genuinely enthusiastic that someone was finally taking an interest in their community.

The property was a real eyesore when I bought it. My intent was to clean it up and make it as aesthetically appealing as I could for the least amount of money possible. As an investor, my goal

was to maximize the use of each and every dollar spent on the project. Over the next 60 to 90 days, the contractors were busy cleaning up the property. My very first priority was to get a professional landscaping crew started. You'd be amazed at what a difference it can make to simply mow down the weeds. They didn't stop there though. They trimmed all of the hedges, edged along the sidewalks, and cleaned up the grounds. I also had the landscaping crew bring in several truckloads of fresh mulch to place around the bushes and hedges. By signing an annual contract with these landscapers, they assumed responsibility for all mowing, hedging, and edging on a weekly basis and at a very reasonable rate. The large, beautiful trees planted in between each of the driveways were so overgrown that they, too, had become an eyesore. A tree-trimming service promptly alleviated that problem. Within a single day, workers had all of the trees trimmed and most of the branches hauled away.

With the landscapers and tree trimmers were busy with their work, I also engaged the services of a painting crew. The painters did an excellent job of painting the exteriors of all 11 buildings, using a combination of four different color schemes to give each building its own unique look while still maintaining a standard of uniformity throughout the community. The painters had the most work to do, and consequently their job took the longest. As previously mentioned, all 11 buildings were side by side. Each one had a fence running down the middle to separate the units, which gave each tenant a small private yard with a gate that could be locked for privacy. Most of the fences were run-down and the gates were barely functional. I had another crew replace all of the worn-out fencing with brand-new cedar fencing. Each unit also got a new entry gate for its backyard. Meanwhile, I hired a sign maker to build signs for the two entryways into the community. There were no signs when I acquired the duplexes, so there was no way for prospective tenants or buyers to call for information. The sign maker built two professional signs out of two-inch-thick redwood and installed one at each entryway. In this manner, the name of the community and the telephone number were prominently displayed.

Since the community was family oriented, I thought a nice amenity to offer the tenants would be a playground where they could bring their children. As it was, there was not any playground equipment close by. I had determined the vacant lot included in the purchase, which was immediately adjacent to the buildings, would be the perfect place for such a playground. I started off by having a concrete crew come in and pour a large 20- by 30-foot slab of concrete, complete with goalposts. This gave the tenants a new basketball court. I also had a company that made professional playground equipment install a swing set, monkey bars, and two animal rides that were mounted on springs and anchored in concrete. For the parents, new vinyl-coated park benches were installed. When all of the work had been completed, the 22 units looked like new and the tenants lived in a complex they could truly take pride in.

I knew before I ever bought the duplexes that my exit strategy would be to either sell or refinance the property within 12 months of purchase. The market research I did before I purchased the duplexes proved to be right on target. Since I had just spent a considerable amount of time and money improving the overall condition of the property, I now had a very attractive community to offer to prospective families.

To unlock the newly created value in the duplexes, I considered several approaches. The first was to sell the units either individually or as a package deal to an investor. My original intent was to sell the units individually for $77,000 per building or $38,500 per unit—similar to the method used by the seller of the other 72 units. With this in mind, I decided to set up one unit as an office that would also double as a model. The initial response from my existing tenants as well as others was quite favorable. Within the first 90 days, I had commitments for 17 of the units. However, I was not prepared for the poor credit quality that most of them had. I was working through a mortgage company that could provide financing for A-, B-, or C-quality paper, but the majority of those who expressed an interest couldn't even come up with the necessary down payment, which was minimal. I could have put together some creative

carryback financing of my own, but I really was not interested in doing so at the time. Of the original 17 interested parties, only one made it all the way to closing.

Shortly afterward, I decided to advertise the units in the classified section of the newspaper. I offered them as a package deal to investors. The ad generated quite a bit of interest. I had the remaining 21 units under contract with one investor who assured me he could close the deal in 30 days. As it turned out, he couldn't, and the deal fell out of contract. I then received a call from two investors who were partners. They told me they were interested in all remaining 21 units and wanted to meet me at the property. I agreed to meet with them, but really didn't take them too seriously, as I had already had a number of prospective buyers come by and kick the tires. I initially met with one of the two partners and later met with the second one. As it turned out, the two investors were eager to put a deal together.

I knew that each building would easily appraise for a minimum of $77,000 since I had an entire neighborhood of comps right down the street. Inasmuch as the investors agreed to buy all remaining 21 units in a package deal, I agreed to what was an attractive discount for them, but also left plenty of profit for me. Here's how the deal played out. I agreed to sell each building at a net discounted price of $66,364. Since the buyers were receiving a discount of more than $10,000 per building, they agreed to pay all closing costs. Over the next six to eight months, the buyers followed through and purchased all remaining 21 units from me. It took that long because they used several lenders for their financing. They could have gotten a commercial loan to cover all 21 units, but they would have had to put down 15 to 20 percent. Instead, they placed several single-family housing loans on the property, which provided 90 percent financing rather than the 80 percent a commercial lender would have offered. Furthermore, since the properties appraised for well over the contract price, the buyers did not have to come up with the full 10 percent down payment, because the 90 percent financing was based on the appraised value and not the net sales price. The buyers had to use

Table 6.2 Property Analysis Worksheet: The Value Play Rehab Analyzer

Purchase Assumptions			Financing Assumptions—Primary			Financing Assmptions—Secondary		
Project Name:	Multiply Your Efforts By 22		Primary Mortgage or Loan:			Secondary Financing/Line of Credit:		
Address:	123 South State St.		Total Purchase	100.00%	350,000	Total Imprvmnts	100.00%	60,000
City, State, Zip:	Houston, TX 77520		Down Payment	10.00%	35,000	Down Payment	25.00%	15,000
Contact:	Mr. I Don't Want Her		Balance to Finc	90.00%	315,000	Balance to Finc	75.00%	45,000
Telephone:	(800) 555-9876							
Land		50,000		Annual	Monthly		Annual	Monthly
Building/House		283,000	Interest Rate	8.000%	0.667%	Interest Rate	8.000%	0.667%
Closing Costs		10,000	Amort Period	25	300	Amort Period	25	300
Other Related Costs		7,000	Payment	29,175	2,431	Payment	4,168	347
Total Purchase Price		350,000	Interest Only	25,200	2,100	Interest Only	3,600	300

Estimate for Improvements

Appliances		Flooring		Lighting	0
Dishwasher	1,000	Carpet	4,200	Masonry	0
Disposal	250	Ceramic Tile	0	Other—Playground Equipment	15,000
Microwave	0	Hardwood	0	Other—Signage	5,000
Range	500	Vinyl	1,450	Other	0
Refrigerator	0	Subtotal	**5,650**	Painting: Exterior	12,000
Subtotal	**1,750**			Painting: Interior	0
		Foundation	0	Permits	0
Architectural Drawings	0	Framing	0	Subtotal	**32,000**
Cabinets	0	Garage	0		
Caulking	0	Gas & Electric Hookup	0	Plumbing	0
Subtotal	**0**	Glass: Mirrors, showers	0	Commodes	0
		Gutters	0	Drain Lines	0
Cement Work		Subtotal	**0**	Faucets	0
Basement Floor	0			Fixtures	0
Driveway	1,200	HVAC	0	Hot Water Heater	0
Garage Floor	0	Air Conditioner	1,800	Showers	0
Porches	0	Duct Work	0	Tubs	0
Sidewalks	0	Filters	50	Water Lines	0
Subtotal	**1,200**	Furnace	700	Subtotal	**0**
		Subtotal	**2,550**		

Estimate for Improvements

Cleaning	800	Insulation	0	Roofing	0
Counter Tops	0	Insurance Premiums	0	Siding	0
Decorating	0	Subtotal	**0**	Site Planning & Engineering	0
Doors	450			Steel	0
Drywall	0	Landscaping		Trim	0
Electrical	0	Irrigation System	0	Utility: Gas & Electric	0
Engineering	0	Lot Clearing	350	Utility: Water & Sewer	0
Equipment Rental	600	Mowing Services	400	Warranty	0
Excavation Work	0	Sod	0	Windows	0
Fences	7,000	Trees, Plants, & Shrubs	7,250	Subtotal	**0**
Fireplace	0	Subtotal	**8,000**		
Subtotal	**8,850**			Total Cost of Improvements	**60,000**

Comp #1

Address:		
Sales Price	Per duplex bld	77,000.00
Adjustments to Price		0.00
Adjusted Price		77,000.00
Square Feet		2,000.00
Price Per Square Foot		38.50

Comp #2

Address:		
Sales Price	Per duplex bldg	77,500.00
Adjustments to Price		0.00
Adjusted Price		77,500.00
Square Footage		2,000.00
Price Per Square Foot		38.75

Comp #3

Address:		
Sales Price	Per duplex bld	78,000.00
Adjustments to Price		0.00
Adjusted Price		78,000.00
Square Feet		2,000.00
Price Per Square Foot		39.00

Comp Averages

Sales Price	77,500.00
Adjustments to Price	0.00
Adjusted Price	77,500.00
Square Feet	2,000.00
Price Per Square Foot	38.75
Turn Comps Off/On	OFF
Est Price/Sq Ft If Turned OFF	33.47

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Subject Property
123 South State St.

Square Feet	22,000.00
Price/Sq Ft	15.91
Imprvmnts/Sq Ft	2.73
Total Price/Sq Ft	18.64
Estimated Time To Complete Project	0.00

Adjustment to Comps 5.28

Description	Best Case	Most Likely	Worst Case
Est Sales Price	852,500	736,318	620,136
Purchase Price	350,000	350,000	350,000
Improvements	60,000	60,000	60,000
Interest Charges	0	0	0
Taxes	0	0	0
Closing Costs	0	0	0
Total Costs	410,000	410,000	410,000
Profit Margin	**442,500**	**326,318**	**210,136**
Return On Inv	**885.00%**	**652.64%**	**420.27%**

several lenders because the lenders' underwriting guidelines did not permit them to loan money on more than a maximum of four units to any one individual. Although their decision to use this type of financing prolonged the sale, they did follow through. Within a year of my purchase, I had sold all 22 units. Take a look at Exhibit 6.4 to see how the deal was structured.

On the one hand, my willingness to take less than the appraised value meant that I would leave a lot of money on the table. On the other hand, however, it allowed me to offer a very attractive deal to two willing buyers who could purchase the property with very little money down and have built-in equity on the day of closing. Take a moment to study Table 6.2.

After reviewing Table 6.2, you can see that this is another powerful example of the potential of the value play strategy. This strategy can obviously be quite effective. In this case, my out-of-pocket capital would have been about $100,000; however, since the bank financed 75 percent of the cost of improvements, I ended up tying up about $50,000 of my own money. The total increase in value to

Exhibit 6.4
Deal structure,
Part 2: Multiply your efforts by 22.

1. Sales price of all 22 units: $736,318
2. Down payment: $22,000 (3%)
3. Term: varied
4. Interest rate: varied

the property was almost 80 percent (($736,318 – $410,000)/ $410,000). By using some very basic techniques that are fundamental to the value play strategy, I was able to effectively increase the value of the property by more than twice the original sales price that I had paid. Although I may have left money on the table for the two investors, there was still plenty left in it for me. In about a year's time, I netted over $326,000 from the deal. While it is true that I could have held out for another buyer who may have been willing to pay full price, I place a lot of faith in the old adage that a bird in the hand is worth two in the bush.

FROM RESIDENTIAL TO COMMERCIAL

Now let's look at a conversion process that is exactly the opposite of the previous example. In the case of the 22 duplex units, the property was converted from an income-producing property to that of a single-family residential. Even though two investors ended up buying the majority of the units, it was still valued by using a market comparison approach rather than an income approach. In this example, we will study the conversion of a single-family residence to a commercial income-producing property and examine the differences in the two valuation approaches.

The house in this example is one that I currently have under contract to purchase. It is located in the downtown area of a small but growing community with a population of about 42,000 residents. The street on which it is located is actually a state highway that runs right through the heart of the city. It is considered to be a high-traffic location, with an average daily traffic count of about 22,000 vehicles. When the house was originally built back in 1903, it was probably inconceivable at the time that the street running in front of the house would eventually become a state highway. It is a very charming two-story house with approximately 2,400 square feet of living space. There is a large basement that can be used for storage. The house has been fairly well maintained over the years (although some work is needed), and the

inside is full of charm and character reminiscent of a bygone era. It has a beautiful handcrafted wooden stairway leading to the upstairs and many other features characteristic of early-1900s architecture.

For literally the past 100 years, the house has been occupied as a residence. The current owner has lived there since 1980, and even since then, there has been significant growth in the area. The owner had been trying to sell the house for nearly a year with the assistance of a real estate agent, but with no success. With new communities springing up all around, who wants to live on busy state highway? Not many people, that's for sure. You can just about rule out any family with small children. Being that close to a busy road would be too dangerous for little ones. Rule out the seniors, too. They prefer quiet communities with sidewalks and streetlights. Who does that leave? No one, really, except maybe a guy like me looking for cheap office space.

The house is actually in an ideal location for an office building. The high-traffic location is particularly appealing in that it will enable our company, Symphony Homes, to greatly increase its brand identity and name recognition in that market. Approximately 22,000 motorists will pass by our brightly lit sign each and every day, 365 days a year. As they do, they will become more and more familiar with our name. Eventually, many of them will come to us seeking the services we offer. With 2,400 square feet, the building is large enough to meet our current needs. In addition, it is much cheaper than leasing office or retail space in the same area, and certainly much cheaper than purchasing office or retail space.

As previously mentioned, this is why understanding the differences of the three market valuation approaches is so important. If you can grasp the underlying logic and understand the fundamental principles of each method, you can use them to your advantage to create value. In its current state of use as a single-family house, the most appropriate valuation method is to use the comparable sales approach. This is the method that will be used when the appraiser comes out to appraise the property. He will examine like

properties, make adjustments as necessary, and derive a value that is most appropriate for this property in its current state of use. When the house is converted to an income-producing office building, its usage will change from residential to commercial. At that time, the value of the building will no longer be based on comparable sales of similar houses. Instead, it will be based on the income generated from the rents, in which case the income capitalization approach will be the most appropriate method of valuing the property.

My objective going into this transaction is, as always, to apply the OPM principle—that is, to use as much of other people's money as possible and as little of my own money as possible. Since the house is literally a century old, it is in need of some repair work. There will also be additional costs involved to convert the property from residential to commercial use. The owner and I agreed on a sales price of $188,000, with a repair and/or improvement allowance of $40,000, making the effective sales price $148,000. Since I will borrow 90 percent of the sales price, my down payment will only be 10 percent, or $18,000. At closing, I will receive an allowance for the necessary repairs and improvements in the amount of $40,000. Now take a look at Exhibit 6.5 to see how the deal was structured.

Structuring the transaction in this manner will allow me to limit the amount of out-of-pocket cash to only 10 percent of the total deal value, including the improvements. This is a creative and effective way to pull cash out of a deal at closing, especially when you have an immediate use for the cash such as for property improvements. To use this financing strategy, you should be aware of two caveats. The first is that the house has to appraise for a high enough value in its existing condition. In this example, the house must appraise for the sales price of $188,000 before any repairs or improvements are made. That means there must be existing comparable sales the appraiser can use to support the value. We are already aware of several comps that will support the sales price. The second caveat is that you must have a lender who is willing to work with you in allowing the credit at closing.

Exhibit 6.5
Deal structure,
Residential to
commercial conversion.

1. Sales price: $188,000
2. Down payment: $18,800 (10%)
3. Term: 30 years
4. Interest rate: 6.5%
5. Cash back at closing: $40,000

While most lenders will allow the buyer to receive some type of credit, they generally limit it to anywhere from 3 to 5 percent of the sales price. I usually have the most success using a mortgage broker when trying to structure a deal like this rather than going directly to a lender. Many small community banks, however, will work with you as long as they understand what you are trying to do. In addition, they may require the funds credited at closing to be placed into an escrow account and paid only after the work has been completed. Now take a moment to examine Table 6.3.

In the Purchase Assumptions box, I used $152,000 ($33,000 + $115,000 + $3,650 + $350) for the purchase price since that is the net effective sales price of the house. The loan terms for the purchase price are reflected in the Financing Assumptions (Primary) box. The total of $40,000 for improvements has been entered into the Estimate for Improvements section and is captured in Financing Assumptions (Secondary). In this case, since the primary and secondary financing will be combined into one note, the same

interest rate and term is used. To calculate the total payment, simply add the two together. The information in the Comp Averages section suggests a weighted average price per square foot of $81.92. When multiplied by 2,400 square feet, the resulting value is $196,609, which is well above the required value of $188,000 necessary to make the deal work. After factoring in transactions costs, the profit margin in the most likely scenario reflects a small profit of $712. Remember that the value shown here is *before* any improvements have been made. Now let's take a few minutes to study Table 6.4. Although this model is similar to The Value Play Rehab Analyzer, it is really quite different. This model is The Value Play Income Analyzer and is used to measure the value of an income-producing property such as an apartment building—or our soon-to-be-converted office building.

In Table 6.4, notice that we have the same sales price of $148,000 plus $40,000 in improvements, plus $4,000 in closing costs and other costs for a total of $192,000 just as we did in Table 6.3. Notice also that the information in the Financing Assumptions is exactly the same, except for the fact that it is consolidated into one section rather than two. The Key Ratios section in Table 6.4 captures important data relative to an income-producing property. The most important number to focus on for this example is the capitalization rate. The capitalization rate, or *cap rate* as it is referred to, is the ratio between net operating income and sales price:

Capitalization rate

$$= \frac{\text{net operating income}}{\text{sales price}}$$

or

Sales price

$$= \frac{\text{net operating income}}{\text{cap rate}}$$

Table 6.3 Property Analysis Worksheet: The Value Play Rehab Analyzer

Purchase Assumptions		Financing Assumptions—Primary			Financing Assmptions—Secondary		
Project Name:	Residential to Commercial	Primary Mortgage or Loan:			Secondary Financing/Line of Credit:		
Address:	123 South State St.	Total Purchase	100.00%	152,000	Total Imprvmnts	100.00%	40,000
City, State, Zip:	Anywhere, TX 77520	Down Payment	10.00%	15,200	Down Payment	10.00%	4,000
Contact:	Mr. Please Buy My House	Balance to Finc	90.00%	136,800	Balance to Finc	90.00%	36,000
Telephone:	(800) 555-1234						
Land	33,000		Annual	Monthly		Annual	Monthly
Building/House	115,000	Interest Rate	6.500%	0.542%	Interest Rate	6.500%	0.542%
Closing Costs	3,650	Amort Period	30	360	Amort Period	30	360
Other Related Costs	350	Payment	10,376	865	Payment	2,731	228
Total Purchase Price	152,000	Interest Only	8,892	741	Interest Only	2,340	195

Estimate for Improvements

Appliances		Flooring		Lighting	750
Dishwasher	0	Carpet	2,000	Masonry	0
Disposal	0	Ceramic Tile	0	Parking Lot & Drive	8,400
Microwave	0	Hardwood	0	Other	0
Range	0	Vinyl	1,500	Other	0
Refrigerator	0	Subtotal	**3,500**	Painting: Exterior	1,200
Subtotal	**0**			Painting: Interior	2,100
		Foundation	0	Permits	250
Architectural Drawings	0	Framing	0	Subtotal	**12,700**
Cabinets	0	Garage	500		
Caulking	450	Gas & Electric Hookup	0	Plumbing	
Subtotal	**450**	Glass: Mirrors, showers	0	Commodes	0
		Gutters	0	Drain Lines	0
Cement Work		Subtotal	**500**	Faucets	250
Basement Floor	0			Fixtures	250
Driveway	0	HVAC	0	Hot Water Heater	0
Garage Floor	0	Air Conditioner	1,800	Showers	0
Porches	0	Duct Work	0	Tubs	0
Sidewalks	1,200	Filters	25	Water Lines	0
Subtotal	**1,200**	Furnace	225	Subtotal	**500**
		Subtotal	**2,050**		

Estimate for Improvements

Cleaning	1,000	Insulation	0	Roofing	7,800
Counter Tops	0	Insurance Premiums	525	Siding	0
Decorating	1,500	Subtotal	**525**	Site Planning & Engineering	2,200
Doors	500			Steel	0
Drywall	250	Landscaping		Trim	0
Electrical	500	Irrigation System	0	Utility: Gas & Electric	250
Engineering	0	Lot Clearing	0	Utility: Water & Sewer	125
Equipment Rental	0	Mowing Services	50	Warranty	0
Excavation Work	0	Sod	0	Windows	500
Fences	2,500	Trees, Plants, & Shrubs	1,400	Subtotal	**10,875**
Fireplace	0	Subtotal	**1,450**		
Subtotal	**6,250**			Total Cost of Improvements	**40,000**

Comp #1		Comp #2		Comp #3	
Address:		Address:		Address:	
Sales Price	179,900.00	Sales Price	186,500.00	Sales Price	189,450.00
Adjustments to Price	1,200.00	Adjustments to Price	1,800.00	Adjustments to Price	(2,200.00)
Adjusted Price	181,100.00	Adjusted Price	188,300.00	Adjusted Price	187,250.00
Square Feet	2,200.00	Square Footage	2,320.00	Square Feet	2,275.00
Price Per Square Foot	82.32	Price Per Square Foot	81.16	Price Per Square Foot	82.31

Comp Averages	
Sales Price	185,283.33
Adjustments to Price	266.67
Adjusted Price	185,550.00
Square Feet	2,265.00
Price Per Square Foot	81.92
Turn Comps Off/On	ON
Est Price/Sq Ft If Turned OFF	80.00

Subject Property 123 South State St.		Description	Adjustment to Comps Best Case	Most Likely	5.00 Worst Case
Square Feet	2,400.00	Est Sales Price	208,609	196,609	184,609
Price/Sq Ft	63.33	Purchase Price	152,000	152,000	152,000
Imprvmnts/Sq Ft	16.67	Improvements	40,000	40,000	40,000
Total Price/Sq Ft	80.00	Interest Charges	1,872	1,872	1,872
		Taxes	450	450	450
		Closing Costs	1,575	1,575	1,575
		Total Costs	195,897	195,897	195,897
Estimated Time To		Profit Margin	**12,712**	**712**	**(11,288)**
Complete Project	2.00	Return On Inv	**66.21%**	**3.71%**	**–58.79%**

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Table 6.4 Property Analysis Worksheet: The Value Play Income Analyzer

Cost and Revenue Assumptions		Financing Assumptions			Key Ratios	
Land	33,000	Total Purchase	100.00%	192,000	Total Square Feet	2,400.00
Building	115,000	Owner's Equity	10.00%	19,200	Avg Sq Ft/Unit	2,400.00
Improvements	40,000	Balance to Finc	90.00%	172,800	Avg Rent/Sq Ft	1.00
Closing Costs	4,000				Avg Cost/Sq Ft	80.00
Total	192,000				Avg Unit Cost	192,000.00
			Annual	Monthly	Capitalization Rate	14.25%
Number of Units	1	Interest Rate	6.500%	0.542%	Gross Rent Multiplier	6.67
Average Monthly Rent	2,400	Amort Period	30	360	Expense/Unit	0.00
Gross Monthly Revenues	2,400	Payment	13,107	1,092	Expense/Foot	0.00

Rental Increase Projections			0.00%	4.00%	4.00%	4.00%	4.00%
Average Monthly Rent			2,400	2,496	2,596	2,700	2,808
Operating Expense Projections			0.00%	0.00%	0.00%	0.00%	0.00%
		Actual	Projected				
Operating Revenues		Monthly	Year 1	Year 2	Year 3	Year 4	Year 5
Gross Scheduled Income		2,400	28,800	29,952	31,150	32,396	33,692
Vacancy Rate	5.0%	120	1,440	1,498	1,558	1,620	1,685
Net Rental Income		2,280	27,360	28,454	29,593	30,776	32,007
Other Income		0	0	0	0	0	0
Gross Income	100.0%	2,280	27,360	28,454	29,593	30,776	32,007
Operating Expenses							
Repairs and Maintenance	0.0%	0	0	0	0	0	0
Property Management Fees	0.0%	0	0	0	0	0	0
Taxes	0.0%	0	0	0	0	0	0
Insurance	0.0%	0	0	0	0	0	0
Salaries and Wages	0.0%	0	0	0	0	0	0
Utilities	0.0%	0	0	0	0	0	0
Trash Removal	0.0%	0	0	0	0	0	0
Professional Fees	0.0%	0	0	0	0	0	0
Advertising	0.0%	0	0	0	0	0	0
Other	0.0%	0	0	0	0	0	0
Total Op. Exp.	0.0%	0	0	0	0	0	0

Net Operating Income	100.0%	2,280	27,360	28,454	29,593	30,776	32,007
Interest on Loan	41.1%	936	11,175	11,046	10,908	10,761	10,603
Dep. Exp.—Building		348	4,182	4,182	4,182	4,182	4,182
Dep. Exp.—Equip.		0	0	0	0	0	0
Net Income Before Taxes		996	12,003	13,227	14,503	15,834	17,222
Income Tax Rate	0.0%	0	0	0	0	0	0
Net Income After Taxes		996	12,003	13,227	14,503	15,834	17,222
Cash Flow From Operations							
Net Income After Taxes		996	12,003	13,227	14,503	15,834	17,222
Dep. Exp.		348	4,182	4,182	4,182	4,182	4,182
Total CF From Ops.		1,344	16,185	17,409	18,685	20,016	21,404
Interest on Loan		936	11,175	11,046	10,908	10,761	10,603
Total Cash Available for Loan Servicing		2,280	27,360	28,454	29,593	30,776	32,007
Debt Service		1,092	13,107	13,107	13,107	13,107	13,107
Remaining After Tax CF From Ops		1,188	14,253	15,348	16,486	17,670	18,901
Plus Principal Reduction		161	1,931	2,061	2,199	2,346	2,503
Total Return		1,349	16,185	17,409	18,685	20,016	21,404
CF/Debt Servicing Ratio		208.75%	208.75%	217.10%	225.78%	234.82%	244.21%
Net Income ROI			62.52%	68.89%	75.54%	82.47%	89.70%
Cash ROI			74.24%	79.94%	85.86%	92.03%	98.44%
Total ROI			84.30%	90.67%	97.32%	104.25%	111.48%
Net CFs From Investment—1 Yr Exit		(19,200)	135,385				
Net CFs From Investment—3 Yr Exit		(19,200)	14,253	15,348	161,877		
Net CFs From Investment—5 Yr Exit		(19,200)	14,253	15,348	16,486	17,670	199,141

	Exit Price	Gain on Sale	Cap Rate		IRR
Estimated Exit Price/Gain On Sale—1 Yr	292,000	100,000	9.37%	Annualized IRR—1 Yr	605.13%
Estimated Exit Price/Gain On Sale—3 Yr	312,000	120,000	9.48%	Annualized IRR—3 Yr	146.02%
Estimated Exit Price/Gain On Sale—5 Yr	342,000	150,000	9.36%	Annualized IRR—5 Yr	104.29%

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As you can see, this ratio is really a very simple calculation used to measure the relationship between the income generated by the property and the price it is being sold for. This ratio measures the same relationship as that of the certificate of deposit we discussed in Chapter 5. The *price* we are willing to pay for the CD is a function of its *yield,* or rather, the *income* the instrument generates. This is precisely consistent with the relationship between the *price* of an income-producing property, the *yield* an investor expects to receive on his or her investment, and the property's ability to generate *income.*

The capitalization rate, or yield on an income-producing property, will vary within a given range, generally 8 to 12 percent depending on a variety of market conditions, including supply and demand for real estate, the current interest rate environment, the type and condition of the property, its location, and tax implications imposed by local, state, and federal authorities. Under the Key Ratios section in Table 6.4, notice the cap rate of 14.25 percent. This number represents the yield of the property as a whole since it is based on the sales price and not the equity. Remember that return on investment (ROI) measures that relationship. A yield of 14.25 percent would be exceptional on a certificate of deposit. It is also considered high on real estate. This indicates the property's sales price is low relative to its ability to generate income. Translated, it means we are buying the property at a bargain price and that there is plenty of upside in the deal.

The average monthly rent is based on a rate of $1 per square foot per month, or $12 per square foot annually, multiplied by the square feet of the house, which gives us $2,400 of rental income per month. In the market in which the building is located, that rate is a conservative number. A vacancy rate of 5 percent is applied for lender purposes. Since the lease will be a net lease, there are no expenses, as they will all be paid by the tenant. Now take a look at the bottom of Table 6.4 at the three different estimated exit prices. Based on the information we know to be true regarding market rates and capitalization rates, we can sell the property at the end of year 1 at an exit price of $292,000 at a very conserva-

tive cap rate of 9.37 percent, which will produce a very nice gain on sale of $100,000, excluding transaction costs. The internal rate of return (IRR) is derived by measuring the rate of return over time given a series of cash flows (taken from net CFs from investment, one year exit). In this example, the IRR is an astounding 605 percent in year 1! For those of you who think this kind of return is wishful thinking, may I remind you that these numbers are actually quite conservative and are on the low end of the market based on the rate of $12 per square foot. Now take a moment to study Table 6.5, the Refinance Analyzer.

The Refinance Analyzer provides you with an alternative to selling your income-producing property. Given a certain set of assumptions, it calculates the maximum loan amount that an investor could borrow based on the income produced by the property. In Table 6.5, the maximum loan amount based on an 80 percent loan-to-value (LTV) ratio is $228,540. It also tells us that we have to be able to get an appraisal in the amount of $285,675, which shouldn't be too difficult based on the cap rate of 9.577 percent indicated in the Key Ratios section. Since the new loan would be a commercial loan and not a residential mortgage, I applied a higher interest rate of 7.5 percent and a shorter amortization period of 25 years. Okay, so you can refinance the property. Big deal, right? Let's see just what the effect of our handiwork is:

NEW LOAN AMOUNT:	**$228,540**
PAY OFF EXISTING LOAN:	**$172,800**
CASH BACK TO INVESTOR:	**$55,740**

Refinancing the property based on the income approach has allowed us to justify a much higher value than the one based on the comparable sales approach. In this example, refinancing would put $55,740 cash back in your pocket I'm sure you would agree that you can find something to do with that much money!

Let's look at one more example. We'll make a quick change in

Table 6.5 Refinance Analyzer

Maximum Refinance—Cash Out		
Max Refinance	80.00%	228,540
Owner's Equity @	20.00%	57,135
Required Appraisal	100.00%	285,675
	Annual	Monthly
Interest Rate	7.500%	0.625%
Amortization Period	25	300
Payment	20,267	1,689

Operating Revenues		Year 1
Gross Scheduled Income		28,800
Vacancy rate		1,440
Net Rental Income		27,360
Other Income		0
Gross Revenues	100.0%	27,360

Operating Expenses		
Repairs and Maintenance	0.0%	0
Property Management Fees	0.0%	0
Taxes	0.0%	0
Insurance	0.0%	0
Salaries and Wages	0.0%	0
Utilities	0.0%	0
Trash Removal	0.0%	0
Professional Fees	0.0%	0
Advertising	0.0%	0
Other	0.0%	0
Total Op. Exp.	0.0%	0
Net Operation Income	100.0%	27,360
Dep. Exp.—Building		4,182
Dep. Exp.—Equip.		0
Net Income Before Taxes		23,178
Income Tax Rate	0.0%	0
Net Income After Taxes		23,178

Cash Flow From Operations	
Net Income After Taxes	23,178
Dep. Exp.	4,182
Total Cash Available for Loan Servicing	27,360
Debt Service	20,267
Remaining After Tax CF From Ops	7,093
Plus Principle Reduction	3,236
Total Return	10,329
CF/Debt Servicing Ratio	135.0%

Key Ratios	
Total Square Feet	2,400.000
Avg Sq Ft/Unit	2,400.000
Avg Rent/Sq Ft	1.000
Avg Cost/Sq Ft	119.031
Avg Unit Cost	285,674,738
Capitalization Rate	9.577%
Gross Rent Multiplier	9.919
Expense/Unit	0.000
Expense/Foot	0.000

Refinance Matrix	
Max Refinance	CF/DS
308,529	100.0%
302,479	102.0%
296,662	104.0%
291,065	106.0%
285,675	108.0%
280,481	110.0%
275,472	112.0%
270,639	114.0%
265,973	116.0%
261,465	118.0%
257,107	120.0%
252,892	122.0%
248,813	124.0%
244,864	126.0%
241,038	128.0%
237,330	130.0%
233,734	132.0%
230,245	134.0%
226,859	136.0%
223,572	138.0%
220,378	140.0%
217,274	142.0%
214,256	144.0%
211,321	146.0%
208,465	148.0%
205,686	150.0%
202,979	152.0%
200,343	154.0%
197,775	156.0%
195,271	158.0%
192,830	160.0%
190,450	162.0%
188,127	164.0%
185,861	166.0%
183,648	168.0%
181,487	170.0%
179,377	172.0%

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the Income Analyzer by adjusting the rental income from $12 per square foot to $16 per square foot, which is at the upper end of market rates, to see how that affects the property's value. All other assumptions remain the same. Take a minute to review Table 6.6.

As you can see, by increasing the rents, we are significantly increasing the value of the property. This is similar to increasing the income generated by a certificate of deposit. Since the yield is held constant, the value of the certificate must be increased. With the cap rate in the Income Analyzer held constant at about 9.5 percent, the estimated exit price increases from $292,000 in Table 6.4 to $385,000 in Table 6.6. If the property is sold at the end of year 1, the estimated gain on sale is $193,000, which represents an increase of $93,000 more than the estimated gain on sale in Table 6.4. We now have two different versions, or scenarios, of this property—one at the lower end of the income-per-square-foot range and one at the higher end of the income-per-square-foot range. This provides us with a broad spectrum of values ranging $292,000 to $385,000. These values are a direct function of the income produced by the property, so the higher the rental income that can be justified by local market rates, the more valuable the property. Now let's examine the effect of these changes in our Refinance Analyzer in Table 6.7.

The same assumptions we used in the example in Table 6.5 have been applied to the model in Table 6.7. The maximum loan amount based on an 80 percent LTV ratio is $304,720. The output also tells us that we have to be able to get an appraisal in the amount of $380,900 based on holding the cap rate constant at 9.577 percent as indicated in the Key Ratios box. Here's how it looks:

NEW LOAN AMOUNT:	**$304,720**
PAY OFF EXISTING LOAN:	**$172,800**
CASH BACK TO INVESTOR:	**$131,920**

In this instance, we are able to obtain a new loan in the amount of $304,720, pay off the old loan of $172,800, and pocket the

Table 6.6 Property Analysis Worksheet: The Value Play Income Analyzer

Cost and Revenue Assumptions		Financing Assumptions			Key Ratios	
Land	33,000	Total Purchase	100.00%	192,000	Total Square Feet	2,400.00
Building	115,000	Owner's Equity	10.00%	19,200	Avg Sq Ft/Unit	2,400.00
Improvements	40,000	Balance to Finc	90.00%	172,800	Avg Rent/Sq Ft	1.33
Closing Costs	4,000				Avg Cost/Sq Ft	80.00
Total	192,000				Avg Unit Cost	192,000.00
			Annual	Monthly	Capitalization Rate	19.00%
Number of Units	1	Interest Rate	6.500%	0.542%	Gross Rent Multiplier	5.00
Average Monthly Rent	3,200	Amort Period	30	360	Expense/Unit	0.00
Gross Monthly Revenues	3,200	Payment	13,107	1,092	Expense/Foot	0.00

Rental Increase Projections			0.00%	4.00%	4.00%	4.00%	4.00%
Average Monthly Rent			3,200	3,328	3,461	3,600	3,744
Operating Expense Projections			0.00%	0.00%	0.00%	0.00%	0.00%
		Actual	Projected				
Operating Revenues		Monthly	Year 1	Year 2	Year 3	Year 4	Year 5
Gross Scheduled Income		3,200	38,400	39,936	41,533	43,195	44,923
Vacancy Rate	5.0%	160	1,920	1,997	2,077	2,160	2,246
Net Rental Income		3,040	36,480	37,939	39,457	41,035	42,676
Other Income		0	0	0	0	0	0
Gross Income	100.0%	3,040	36,480	37,939	39,457	41,035	42,676
Operating Expenses							
Repairs and Maintenance	0.0%	0	0	0	0	0	0
Property Management Fees	0.0%	0	0	0	0	0	0
Taxes	0.0%	0	0	0	0	0	0
Insurance	0.0%	0	0	0	0	0	0
Salaries and Wages	0.0%	0	0	0	0	0	0
Utilities	0.0%	0	0	0	0	0	0
Trash Removal	0.0%	0	0	0	0	0	0
Professional Fees	0.0%	0	0	0	0	0	0
Advertising	0.0%	0	0	0	0	0	0
Other	0.0%	0	0	0	0	0	0
Total Op. Exp.	0.0%	0	0	0	0	0	0

Net Operating Income	100.0%	3,040	36,480	37,939	39,457	41,035	42,676
Interest on Loan	30.8%	936	11,175	11,046	10,908	10,761	10,603
Dep. Exp.—Building		348	4,182	4,182	4,182	4,182	4,182
Dep. Exp.—Equip.		0	0	0	0	0	0
Net Income Before Taxes		1,756	21,123	22,712	24,367	26,093	27,891
Income Tax Rate	0.0%	0	0	0	0	0	0
Net Income After Taxes		1,756	21,123	22,712	24,367	26,093	27,891
Cash Flow From Operations							
Net Income After Taxes		1,756	21,123	22,712	24,367	26,093	27,891
Dep. Exp.		348	4,182	4,182	4,182	4,182	4,182
Total CF From Ops.		2,104	25,305	26,893	28,549	30,275	32,073
Interest on Loan		936	11,175	11,046	10,908	10,761	10,603
Total Cash Available for Loan Servicing		3,040	36,480	37,939	39,457	41,035	42,676
Debt Service		1,092	13,107	13,107	13,107	13,107	13,107
Remaining After Tax CF From Ops		1,948	23,373	24,833	26,350	27,928	29,570
Plus Principal Reduction		161	1,931	2,061	2,199	2,346	2,503
Total Return		2,109	25,305	26,893	28,549	30,275	32,073
CF/Debt Servicing Ratio		278.33%	278.33%	289.47%	301.05%	313.09%	325.61%
Net Income ROI			110.02%	118.29%	126.91%	135.90%	145.27%
Cash ROI			121.74%	129.34%	137.24%	145.46%	154.01%
Total ROI			131.80%	140.07%	148.69%	157.68%	167.05%
Net CFs From Investment—1 Yr Exit		(19,200)	237,505				
Net CFs From Investment—3 Yr Exit		(19,200)	23,373	24,833	274,741		
Net CFs From Investment—5 Yr Exit		(19,200)	23,373	24,833	26,350	27,928	317,810

	Exit Price	Gain on Sale	Cap Rate		IRR
Estimated Exit Price/Gain On Sale—1 Yr	385,000	193,000	9.48%	Annualized IRR—1 Yr	1137.00%
Estimated Exit Price/Gain On Sale—3 Yr	415,000	223,000	9.51%	Annualized IRR—3 Yr	211.13%
Estimated Exit Price/Gain On Sale—5 Yr	450,000	258,000	9.48%	Annualized IRR—5 Yr	148.68%

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Table 6.7 Refinance Analyzer

Maximum Refinance—Cash Out		
Max Refinance	80.00%	304,720
Owner's Equity @	20.00%	76,180
Required Appraisal	100.00%	380,900
	Annual	Monthly
Interest Rate	7.500%	0.625%
Amortization Period	25	300
Payment	27,022	2,252

Operating Revenues		Year 1
Gross Scheduled Income		38,400
Vacancy rate		1,920
Net Rental Income		36,480
Other Income		0
Gross Revenues	100.0%	36,480

Operating Expenses		
Repairs and Maintenance	0.0%	0
Property Management Fees	0.0%	0
Taxes	0.0%	0
Insurance	0.0%	0
Salaries and Wages	0.0%	0
Utilities	0.0%	0
Trash Removal	0.0%	0
Professional Fees	0.0%	0
Advertising	0.0%	0
Other	0.0%	0
Total Op. Exp.	0.0%	0
Net Operation Income	100.0%	36,480
Dep. Exp.—Building		4,182
Dep. Exp.—Equip.		0
Net Income Before Taxes		32,298
Income Tax Rate	0.0%	0
Net Income After Taxes		32,298

Cash Flow From Operations	
Net Income After Taxes	32,298
Dep. Exp.	4,182
Total Cash Available for Loan Servicing	36,480
Debt Service	27,022
Remaining After Tax CF From Ops	9,458
Plus Principal Reduction	4,315
Total Return	13,772
CF/Debt Servicing Ratio	135.0%

Key Ratios	
Total Square Feet	2,400.000
Avg Sq Ft/Unit	2,400.000
Avg Rent/Sq Ft	1.333
Avg Cost/Sq Ft	158.708
Avg Unit Cost	380,899.651
Capitalization Rate	9.577%
Gross Rent Multiplier	9.919
Expense/Unit	0.000
Expense/Foot	0.000

Refinance Matrix	
Max Refinance	CF/DS
411,372	100.0%
403,306	102.0%
395,550	104.0%
388,086	106.0%
380,900	108.0%
373,974	110.0%
367,296	112.0%
360,852	114.0%
354,631	116.0%
348,620	118.0%
342,810	120.0%
337,190	122.0%
331,751	124.0%
326,485	126.0%
321,384	128.0%
316,440	130.0%
311,645	132.0%
306,994	134.0%
302,479	136.0%
298,095	138.0%
293,837	140.0%
289,698	142.0%
285,675	144.0%
281,761	146.0%
277,954	148.0%
274,248	150.0%
270,639	152.0%
267,124	154.0%
263,700	156.0%
260,362	158.0%
257,107	160.0%
253,933	162.0%
250,836	164.0%
247,814	166.0%
244,864	168.0%
241,983	170.0%
239,170	172.0%

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difference of $131,920. This is another powerful example of the effectiveness of the value play strategy. We have taken an existing property and increased its value substantially by changing its use from residential to commercial. The ROI on our original investment, if sold using the assumptions in Table 6.5 is a phenomenal 1,005 percent.

$$\text{Return on investment (ROI)}$$

$$= \frac{\text{profit margin}}{\text{primary down payment} + \text{secondary down payment}}$$

$$= \frac{\$193{,}000}{\$19{,}200} = 1{,}005.21\%$$

By now you should have a good understanding of the different valuation approaches and their proper application. We have analyzed in depth three real-life examples of how these approaches can be applied. We have examined (1) a residential property using the comparable sales approach, (2) 22 duplex units that were sold based on the comparable sales approach rather than the income approach, and (3) a residential property that was converted to an income property and valued using the income approach. A comprehensive understanding of these valuation methodologies is vitally important to your success in this business.

> **Firmness of purpose is one of the most necessary sinews of character, and one of the best instruments of success. Without it genius wastes its efforts in a maze of inconsistencies.**
>
> ***—Lord Chesterfield***

Chapter 7

Seven Steps of Successful Negotiations

In Chapter 5, we examined the three most commonly used approaches for appraising real estate and determined that the comparable sales method was the most appropriate approach to use for single-family houses. In Chapter 6, we studied three examples showing how to apply those approaches to real-world transactions. In this chapter, we examine seven techniques that will enable you to negotiate the best possible price and terms for the purchase of a property. (See Exhibit 7.1.) As you will discover over time, many of the buyers and sellers with whom you negotiate are amateurs, meaning that they do not buy or sell real estate with any degree of frequency. They participate in the market out of necessity. Professional real estate investors, on the other hand, have mastered the seven steps of successful negotiations and use them to their advantage at every opportunity.

THE PSYCHOLOGY OF NEGOTIATING

One of the most important things to remember when negotiating with others is that you are dealing with people, many of whom develop an emotional attachment somewhere in the process. Most

Exhibit 7.1
Seven steps
to successful negotiations.

1. The psychology of negotiating
2. Comprehensive knowledge of market
3. Degree of seller's motivation
4. Backdoor exits
5. Concessions—when to make them and what to expect in return
6. The red herring technique
7. The money talks approach

of the buyers and sellers you deal with are not professionals and often find it difficult to separate their emotions from the rational aspects required to conduct business. After a certain point in the process, people become emotionally engaged, which causes them to act in a manner they otherwise wouldn't. This is especially true for sellers.

For example, an individual who has had his property listed for sale for several months begins to worry about whether his house will ever sell. Then one day a buyer comes along who expresses a sincere interest in the house. Mr. Seller begins to think there is hope, after all. His real estate agents suggests that an offer might be forthcoming. Mr. Seller becomes eager with anticipation at the thought that he can sell his house and move on with his plans. He thinks about all the things he can do with the money he will make from the sale—the new car, paying off some old debts, and

buying a nice gift for his wife. Just as Ms. Buyer is getting ready to make an offer, she discovers another house that she likes better and buys it instead. Feelings of despair immediately set in with Mr. Seller. There go all of his hopes and dreams, for once again it seems as if he will never sell his house.

I recall one time when I was negotiating for a tract of land in a prime location. The sellers were two older gentlemen who had owned the land for a number of years. They were asking $400,000 for the land. I had expressed a strong interest in the property and had preliminary discussions with the sellers indirectly, through a broker. The time came for all of us to sit down at the table to work out the details. I thought the property was priced too high relative to other tracts of land in the area and felt a more reasonable price was closer to $350,000. The two gentlemen, who were brothers, were well into their retirement years. It was apparent to me that one of the brothers was very eager to sell and was willing to consider the lower price. Sitting across the table from them, it was easy to read their facial expressions. The brother willing to consider the lower price was practically salivating with anticipation at the thought of cashing out. My guess is that in his mind, he perhaps had visions of being out on the water off the coast of Florida in his new boat. Had I been negotiating only with him, the $350,000 price would easily have been achieved. Unfortunately, his brother was not as eager to sell and held out for close to full asking price. I decided that the deal was overpriced and indicated my unwillingness to proceed. The brother who had visions of retirement was crestfallen as I announced my decision to terminate the negotiations.

Remember that at some point in the negotiating process, the parties you are dealing with will most likely become emotionally engaged. Once they do, it is difficult for them to turn back. In their mind, the property is sold and they are already spending the money. As a professional, you should watch closely for signals sent by the other party's facial expressions and body language. Use these subtle, yet very real, signals to negotiate the best price and terms possible.

COMPREHENSIVE KNOWLEDGE OF MARKET

To be successful in this business, you must have a comprehensive knowledge of your market. It is impossible to negotiate for the best price without it. You must understand property values in your respective market as well as, or better than, the parties with whom you are conducting business. You can use your knowledge to make sound arguments that support the price and terms you are negotiating for. By showing the other parties what similar properties are selling for, you present reasonable and logical data that will help convince them of your position.

I am very familiar with both housing prices and land prices in my particular market and therefore am better prepared to negotiate for the best possible price. One example that comes to mind centers around several vacant lots in a new residential community that a developer had available for sale. His initial asking price was $46,000 per lot. My research indicated that although a number of lots were for sale at $46,000 (and even more), this seller's lots were considerably smaller. The lots selling for $46,000 in that area typically ranged in size from a third to a half of an acre, and some included other features such as trees or a site that would accommodate a walkout basement. The lots I was considering were much smaller in size, probably no more than a fifth of an acre, and had no trees. Since I had done my homework and was familiar with the market, I knew that comparable lots in another new community within a mile of this one were selling for $35,000 to $37,500. I presented this information, complete with the community plat plans, lot sizes, and prices, to the seller to make a valid argument for a lower price. We eventually settled on a price of $36,000 per lot, $10,000 less than his initial asking price.

As Symphony Homes is a residential builder in a very competitive marketplace, it is imperative that we control costs through each and every step of the building process, beginning with the acquisition of land. If I had agreed to pay the extra $10,000 per lot the seller was asking, I would have been at an immediate disadvantage compared to other sellers in the area. To compensate for

the difference in price, I would have had to do one of two things—raise the price of the house by $10,000 or absorb the cost within the company. Raising the price would have meant the turnover time for each house sold would increase significantly, which adds directly to carrying costs such as interest, taxes, and insurance. Absorbing a cost of $10,000 per house is not feasible, either, as it would quickly put our company out of business. Although I really liked the lots being offered for sale, had the seller not conceded, we would not have had a deal. I have enough experience to know that there is always another opportunity just around the corner. To overpay for a particular property just because you have fallen in love with it or have become emotionally engaged would border on suicide for your company.

Whether you are buying vacant lots, single-family houses, or apartment buildings, you cannot afford to overpay for a piece of property. As a professional real estate investor, you must be intimately familiar with the market in which you are dealing. Only by possessing a comprehensive knowledge of it can you be truly successful. Without this key information, you will soon discover that you cannot survive in the business of buying and selling real estate.

DEGREE OF SELLER'S MOTIVATION

As a professional real estate investor, it is important for you to know why a particular seller is selling a property. Knowing the underlying reasons for the sale can potentially give you an advantage during the negotiation process. For example, you want to know if the seller has just lost a job and can no longer afford the payments or is perhaps simply testing the market to see how much the property is worth. In other words, you want to know if your seller is a motivated seller and, if so, to what degree. The more motivated the seller, the more likely he or she will be flexible on both price and terms. While there are many reasons for selling, they typically fall into one or more of the seven categories shown in Exhibit 7.2.

Exhibit 7.2
Seven reasons sellers sell their property.

1. Life-changing events
2. Changes in financial condition
3. Relocation
4. Retirement
5. Tax considerations
6. Investor burnout
7. Investor gains

The primary reason that sellers sell their properties is because of *life-changing events.* Life-changing events include such things as marriage, the birth of a baby, divorce, illness in the family, accident, or death of a loved one. These types of events are what I refer to as *high-degree motivators* meaning that one or more family members are highly motivated to sell their house. They need and want to do so quickly and are unlikely to hold out for top dollar. The sellers who are affected by these circumstances often have a very real and immediate need to sell and are therefore more likely to be flexible about both price and terms. Life-changing events often create an urgent need to sell, which outweighs the need to profit from the transaction.

Going through a divorce, for example, often creates a financial hardship for the family, especially in a more traditional household in which the father is the provider and the mother is the primary

caregiver to the children. In such a situation, all members of the family are affected. Where one larger house was adequate before, two smaller houses or apartments will be necessary now.

Another reason sellers sell their properties is directly related to *changes in their financial condition.* These changes may also be a high-degree motivator, depending on the degree of financial change. The most likely cause of financial hardship is a change in employment circumstances. The seller may have been caught in the latest round of downsizing or right-sizing or whatever the current buzzword may be. The bottom line is that the seller is now unemployed and therefore no longer able to meet his or her financial obligations. Changes in a seller's financial condition may also be a result of a life-changing event, as previously discussed.

Relocation is a third reason for selling property. It is not at all uncommon for an individuals to be required by employers to move to another area for one reason or another. Sometimes the employee knows well in advance of the impending move and has plenty of time to plan and prepare. Other times, however, the employee is given very little notice and must price the house for a quick sale. Some employers actually compensate their employees for moving expenses and also offer to purchase the house at market value if it does not sell. This, however, is the exception rather than the rule. The majority of employers give their employees a choice of absorbing these costs (if they want to keep their jobs) or being terminated.

Another reason for selling is *retirement.* Everyone reaches a point in life at which they are ready to retire. With the aging baby boomers, more people than ever are retiring. Several years ago, I purchased a 25-unit apartment building from an older couple who had reached retirement age. Ironically, the couple had owned the apartment complex for exactly 25 years and had just made their very last mortgage payment. Selling the apartments would provide them with a considerable lump sum of cash that would allow them to more comfortably retire.

Another reason for selling property might be the *tax considerations* of the seller. For example, if someone is selling investment property such as rental units or commercial space and is also

involved in an exchange of like properties, then that person is limited by law to a predetermined number of days to close on another investment property. These strict time constraints can impact the seller on both ends of the transaction, meaning the property being sold and also the one being acquired. A seller who has not yet identified a new property to purchase may not be motivated to sell—and may in fact stall the sale of his or her property. On the other hand, a seller who has identified another property that must soon be closed on due to the expiration of that seller's time must be prepared to rapidly strike a deal with a buyer of his or her property.

Investor burnout is another primary reason people sell their houses. They excitedly purchase their first few rental houses with the notion that at last they have made it. Then reality sets in. The tenants call complaining about the broken air conditioner or the dishwasher that needs replacing. Then there's Uncle Joe who just died and your tenants have to help Aunt Sally with the funeral expenses, so they don't have this month's rent. I've heard enough excuses in my experience to fill a book. I remember one lady who did everything she could to avoid paying her rent. On one occasion, she stopped by our office to pay her rent on her way to work, so she was in a hurry. In the blink of an eye, she dropped off a check and was out the door. "Thank you," I called out to her as she whisked away. The amount of rent due from this lady was $575.00. I vividly remember glancing down at the check and feeling my anger rise as I realized the amount of the check she wrote was $5.75, not $575.00! Since I knew she worked right down the street, I quickly hopped in my car and confronted her about the error. She acted surprised by her "oversight," but I think she was more surprised by the fact that I caught up with her than anything else. She wrote another check on the spot, this time for the correct amount. In the case of investor burnout, the degree of the seller's motivation will correlate directly with the degree of distress. This is where subtle clues can be detected by direct communication with the seller. If the seller is suffering from burnout related to managing his or her property, that person will most likely be highly motivated, and a highly motivated seller is a flexible seller.

Finally, one of the most compelling reasons for sellers to divest themselves of property is for *investor gains.* Value players like yourself are ready to take their gains on the sale and move on to the next value play opportunity. The degree of motivation will vary depending on factors such as how much value was created in the deal and timing for entry into the next investment. If, for example, sellers have identified another retail opportunity but need the cash out of their current house, then they may be willing to strike a bargain, knowing that they will make up for it, and then some, on the next transaction. Investors buying and selling in volume are not interested in holding out for top dollar. They prefer to take a little less and keep their turnover high, knowing that the more houses they buy and sell, the more financially rewarding it will be.

As you work with and talk to sellers, ask them why they are selling. Listen both to what they do tell you and to what they don't tell you. Sometimes they will be very direct, as in, "My wife and I just got a divorce." Other times, however, you must watch and listen for subtle clues about their true reason for selling. They may tell you, for example, that they are retiring, but leave out the part about having already purchased a condo in Florida that's forcing them to make two payments and really beginning to stretch the budget and "Oh, if we could only sell this house we could move to Florida." A little probing can often uncover the seller's underlying motives to sell.

BACKDOOR EXITS

Backdoor exits, or *escape clauses* as they are also referred to, allow you to back out of a purchase agreement at various times throughout the contract period. You should always take care to ensure that several escape clauses are built into the contract, with at least one of these clauses giving you the right to back out right up to the point of closing. The proper application of these techniques can provide the shrewd investor with tremendous bargaining power.

A contingency is a common backdoor exit used by many investors. The types of contingencies are limited only by your imagination. Some examples include "contingent upon purchaser selling her residence" and "contingent upon seller making repairs prior to closing as indicated in Addendum A." There are also many provisions and conditions that must be satisfied before the purchaser's earnest money "goes hard," or becomes nonrefundable. You can easily protect yourself with a provision such as "subject to satisfactory inspection of the property and acceptance thereof by purchaser." Typically, you have anywhere from 14 to 30 days to accept the property based on its physical condition. The number of days is usually a fill-in-the-blank type of provision, so you can ask for more time if necessary. The seller may not give you more time, but it doesn't hurt to ask. In some instances, approvals may be required by state and local authorities. For example, if there is a change in use of the property from residential to commercial, the city board of zoning appeals must review and subsequently approve the change. You certainly want to include language in the agreement that will fully protect you in the event that the approvals are not granted.

One of my favorite techniques is a very simple, yet powerful, backdoor exit. On the first page of most purchase agreements are several paragraphs outlining the financing provisions. Buyers are given the right to obtain suitable financing within a certain number of days of signing the agreement. They usually have anywhere from 3 to 7 days to apply for financing and 7 to 14 days to obtain an approval. Since most sellers assume they are working with a buyer who is fully qualified and will be approved for the required financing, this section of the purchase agreement is often glossed over. Throughout the standardized purchase agreements most often used, there are ample opportunities to fill in the blanks. Under the financing provisions section, there is almost always a blank to fill in for the interest rate not to exceed a certain amount and also one for the loan-to-value percentage. Here is where you protect yourself in not one, but two places. If you know that the prevailing market interest rate for loans is 6.5 percent, for example, you fill in the blank with

6.0 percent. Since it is not at all uncommon for buyers to get 95 percent loans, and even 97 percent loans, on houses they purchase, you fill in the blank with 95 percent. You comply with the time requirements as outlined in the financing section, but as a real estate professional buying investment property, you will most likely be able to get a loan for only up to 90 percent of the value. When your approval comes back from the lender offering an interest rate of 6.6 percent and a loan-to-value ratio of 90 percent, the seller believes that you have been approved. While it is true that you have in fact been approved, you have not been approved under the terms and conditions as set forth in the purchase agreement. You can use this very simple, but very powerful, technique as a backdoor exit on almost any property you enter into a contract on, right up to the very last minute. The seller won't like it one bit, but it is a very real legal out for you.

CONCESSIONS

Concessions can be another very effective method of getting exactly what you want during the negotiation phase. My approach is initially to ask for more than I expect to get. For example, I may ask sellers to accept a price substantially below the asking price, to include all of the appliances, to carry back a second mortgage for 15 percent of the deal value, to allow an additional credit at closing for repairs, and to pay for all of the closing costs. I know going in that I will most likely not get all of what I ask for, but then again, you never know. Sellers may be just anxious enough to agree to everything you ask for. On the other hand, they may instead present a counteroffer to partially reduce the price, pay for the closing costs, and give you a credit for repairs, but not carry back a second mortgage or include the appliances. In counteroffering, the sellers may make several concessions, which you can then decide whether to accept.

Concessions can also be used as a kind of bargaining chip. You tell the seller, "I will agree to X if you will agree to Y." One

example of this kind of bargaining is an agreement to pay the seller's full asking price if he in turn agrees to accept only 5 percent down instead of the 20 percent originally desired. Another example is a seller who must have all cash and is pushing for a quick closing. You agree to her request, but only if she concedes to accept $10,000 less than the asking price. Concessions are most effectively used to gain something in your favor related to the transaction in exchange for something else.

THE RED HERRING TECHNIQUE

One of my favorite negotiating methods is one I refer to as "the red herring technique." The phrase can be traced back to the practice of escaped convicts who used pickled herring to throw bloodhounds off their scent. In essence, the red herring technique creates a distraction that is completely irrelevant to the subject at hand. As a professional real estate investor, you can use this technique to create a distraction from the real issue you are negotiating. The technique works like this. Let's say the seller is asking $90,000 for his house and that he wants all cash. You inspect the property and determine that although the asking price appears to be fair, you are going to make a concerted effort to purchase it for 10 percent below market value. During the course of your inspection, you happen to notice stored in the garage a pair of prized Yamaha WaveRunners. You decide to write an offer structured as follows:

- Sales price of $81,000
- Seller to carry back a second mortgage for $10,000
- Seller to include two Yamaha WaveRunners
- Seller to pay for all closing costs

Now then, can you guess which provision is the red herring? Of course you can! It's the inclusion of the pair of WaveRunners! Can you imagine how the seller will react when your offer is presented

to him? He's likely to breeze right past everything with the exception of the WaveRunners. He'll probably say something like, "What's this? Include my WaveRunners? That buyer must be crazy! There's no way he's getting my WaveRunners!" Meanwhile, he signs off on everything else, but he absolutely refuses to include those WaveRunners. You, of course, didn't care about them to begin with. Your objective was to get your price and terms by creating a distraction that had nothing at all to do with the original transaction.

I recently used this technique to shave $5,000 off of an already below-market asking price. We named our company Symphony Homes because we have an interest in most anything related to music, especially classical music. While inspecting the seller's property, I noticed a very old violin that was carefully mounted on the dining room wall. Because it was so proudly displayed, I figured it had probably been in the seller's family for some time. I wrote the offer for $5,000 less than the seller's asking price. To create a distraction, I wrote in the special provisions section, "Seller to include violin hanging in dining room." I can only imagine the look of surprise as the seller's agent presented the offer to him. The seller countered the very next day. His agent brought the counteroffer to my office and stated rather emphatically on the seller's behalf that there was no way I was getting that violin, as it was a family heirloom. The agent didn't say a word, however, about the lower price. In an effort to mask my true motives, I insisted to the agent that I must have that violin. She reaffirmed the seller's position and again stated that he would not part with it. I finally conceded and signed the counteroffer. The red herring technique is a simple, yet powerfully effective tool in your arsenal of negotiating tactics. Use it wisely to get what you want!

THE MONEY-TALKS APPROACH

The money-talks approach can be an effective negotiation tool to help ensure that more of your offers are accepted. While the approach is simple in its application, the results can be quite

powerful. There is a great deal of truth in the phrase "money talks." It works like this. After you have written your offer to include some of the other negotiation techniques previously described, it is time to present it to the seller. When presenting your offer, attach a large check to it to demonstrate to the seller that you are a serious buyer. As a general rule, the check should be written for between 5 and 10 percent of the deal value. This will depend on the housing prices in your particular market, but generally speaking, a check written for at least $5,000 and perhaps up to $25,000 will most certainly get the seller's attention. A large earnest-money deposit sends a strong and immediate signal to the seller that he or she is dealing with a buyer who is both serious and capable of putting together a deal.

Think about it. How many offers have you received where the buyer attached a $500 or $1,000 earnest-money check? Probably three out of four of the offers you receive have minimal deposits attached. When I have a buyer interested in one of my houses show up with a $1,000 deposit, I usually don't get too excited. On the other hand, if someone shows up with a check for 5 to 10 percent of the purchase price, it gets my immediate attention. I once had a buyer who made an offer of $228,000 on a house valued at $235,000. I watch the profit margins pretty closely, so this is a deal that I would normally pass on. In this particular case, however, the buyer attached an earnest-money check in the amount of $12,000. That check immediately got my attention because I knew I was working with a buyer who was both serious and capable of purchasing the house. It took me all of about five minutes to think it over before accepting the offer.

Obtaining the best possible price and terms for the purchase of real estate requires a combination of both art and skill. As a master negotiator, you must take care to exercise each one of the seven steps of successful negotiations discussed in this chapter. To summarize, they are as follows:

1. The psychology of negotiating
2. Comprehensive knowledge of market

3. Degree of seller's motivation
4. Backdoor exits
5. Concessions—when to make them and what to expect in return
6. The red herring technique
7. The money-talks approach

A thorough and comprehensive understanding of each one of these principals can literally save you thousands of dollars on your real estate transactions. The more familiar you become with these principles, the more skilled you will become when negotiating with others.

You can have anything you want—if you want it badly enough. You can be anything you want to be, do anything you set out to accomplish if you hold to that desire with singleness of purpose.

—Abraham Lincoln

Chapter 8

Financing and Closing Considerations

The ability to obtain proper financing for the purchase of your investment property is vital to your success. In this chapter, I examine several financing alternatives available to you and discuss the differences of each. (See Exhibit 8.1.) In addition, I have included a sample outline for a business plan you can use to better prepare yourself when initiating new relationships with lenders or partners. I have also included a section about credit scores and underwriting guidelines. Finally, I provide you with information to better enable you to understand and prepare for the closing process.

CONVENTIONAL MORTGAGES

Conventional mortgages represent an excellent source of financing for your real estate investments. There are a number of loan programs available at any given time that offer a wide range of terms and conditions. Depending on the interest rate environment, conventional mortgage rates can be among the most competitive types of financing. Unlike bank loans, which are usually based on the prime lending rate, mortgage loans are typically based on 10-year T-bills, or Treasury notes, plus some additional spread or

Exhibit 8.1
Financing alternatives.

1. Conventional mortgages
2. Mortgage brokers
3. Local banks
4. Lines of credit
5. Owner financing
6. Partnerships

margin. The result is that conventional mortgage loans generally carry a more favorable interest rate than do other types of financing instruments.

Conventional mortgages are usually available with 30-year amortization periods as well. The longer amortization period helps you to minimize your monthly cash flow requirement to the lender by reducing the amount you must pay back each month. By way of comparison, a loan through your local bank may offer only a 15- or 20-year amortization period. This is not always the case, however, as sometimes interest-only loans are available from a bank. Since no principal payments are being made, the monthly cash flow out can be reduced even further.

Another advantage of using a conventional mortgage company to finance your purchase is that a number of companies will lend up to 90 percent of the purchase price on investment properties. This means you have to come up with only 10 percent for your down payment. For those of you who are accustomed to reading the nothing-down types of books, keep in mind that the selection

of available investment opportunities is much narrower. You may spend more time searching for the deal that requires very little down and discover that the upside for creating value and subsequently flipping the property is limited. I prefer to use a little more of my cash and have a much broader selection than to spend time looking for that proverbial needle in a haystack.

While conventional mortgage companies are generally a good source of financing, there are some drawbacks to using them. One such drawback is the documentation required by the lender on each and every transaction. Mortgage companies are notorious for demanding excessive documentation. For example, if a large deposit has recently been made into your bank account, the lender will want documentation to determine its source. Other disadvantages to using a conventional mortgage company are the fees charged for the loan. Depending on the lender, these may or may not include a loan application fee, an underwriting fee, a loan origination fee, and whatever other creative fees the lender can come up with.

MORTGAGE BROKERS

Just as real estate brokers play an important role in matching up buyers and sellers, so do mortgage brokers play an important role in matching up buyers and lenders. Mortgage brokers usually have many contacts in the industry; they know which lender is best suited for the type of financing you are seeking, and they know who's offering the best deal. Experienced brokers have well-established relationships directly with the lenders and usually have two or three with whom they do a large volume of business. While you can generally expect to pay 1 percent to the broker for his or her services, the fee can be well worth it if you are working with a professional broker who has solid relationships with several lenders.

The broker's service can sometimes make the difference in whether the financing for your deal will be accepted. Furthermore, brokers know how to qualify your particular property before ever

sending it to a lender because they know what each lender will accept and what they will not accept. Good mortgage brokers can usually tell you if they can place your loan after spending only 10 to 15 minutes with you on the phone. They know what questions to ask to qualify your property and which lender is likely to be the most interested in financing it.

LOCAL BANKS

Conventional bank financing is commonly available through smaller local banks. These types of banks may operate with just a single branch and $15 million in deposits, or they may be somewhat larger with as many as 5 to 10 branches and $150 million in deposits. One advantage of using a local bank is they can often offer borrowers a greater degree of flexibility than other lenders such as mortgage companies. For example, they may provide the money for your rehab improvements, or a percentage thereof, in addition to the financing for the property itself.

Smaller banks are also likely to be much more familiar with the local area and would therefore have a greater degree of confidence in the specific market than would a larger regional or national lender. Personal relationships with your local banker are more easily established than with other types of lenders such as conventional mortgage companies. You can go into the bank, introduce yourself, and sit down and talk directly with the lender. This gives you the opportunity to sell yourself and your project. Once a relationship has been established and the banker gets to know you and is comfortable with you, future loan requests will be much easier and likely require less documentation, possibly as little as updating your personal financial statement.

Local banks are good sources for rehab loans because the lender knows the loans are short term in nature. The banks are also able to generate more fees because of the shorter duration of these types of loans. Local banks may not give you the best terms initially, but the more business you do with them and the more

comfortable they become with you, the more leverage you will develop in negotiating more favorable terms with them.

As your relationship with a lender matures, you should seek to establish a predetermined line of credit. This will enable you to borrow money up to your credit limit. For example, with a $1 million line of credit, you will have the ability to purchase several properties at one time. With an average selling price of $100,000 you can effectively purchase up to 10 houses. This depends, of course, on the specific terms the lender has set with respect to the loan-to-value ratio and the collateral required, if any, on each house. Since the lender knows you are in the rehab business, money from your line of credit can usually be used for the repairs also. Again, the lender may limit the percentage of borrowed funds by a predetermined loan-to-value ratio.

LINES OF CREDIT

Several types of credit lines are available to almost anyone. Some of the more common ones are home equity lines of credit, national credit cards like MasterCard and Visa, and individual store credit cards. The terms and conditions vary widely with these types of credit. The most favorable interest rates and the longest terms are typically found with home equity lines of credit, while national credit cards and store credit cards tend to offer higher rates and shorter repayment terms.

Many of you already own your own home. For those who do, you are most likely to be familiar with home equity lines of credit (HELOC) loans. These are merely second mortgages secured by your principal place of residence that allow you to borrow against the equity in your home, oftentimes up to 100 percent of the value of your home, sometimes even more. Since this type of loan is secured by your residence, the interest rates are usually lower than with other types of credit. HELOC loans provide you the flexibility of borrowing against your home at will by simply writing a check. These funds can be used for just about anything you

want and represent a good source of funds to be used as down payments and for rehab money.

For those of you who insist on that nothing-down deal, you can easily borrow money against your home equity line of credit and use it for the down payment on an investment property. Since those funds are borrowed funds, they do not represent your cash equity. If, for example, you purchase a house for $85,000 and then borrow $70,000 from your local bank and the remaining $15,000 from your home equity line of credit, you have in essence a nothing-down transaction because 100 percent of the funds used to purchase the house are borrowed funds. You should be aware, however, that this is easier to do with a local bank than with a conventional mortgage lender. Mortgage companies tend to require more documentation and often want to know where the money for your down payment is coming from. You can easily overcome this requirement, however, by depositing the funds at least two months in advance into your bank account. Lenders usually do not require more than the two most current bank statements, and as long as the money is in your account prior to those two periods, the lender will not see the deposit and will therefore not question it. This practice is in no way dishonest. You are simply borrowing money against an approved line of credit and placing the funds into your bank account. The borrowed funds will, however, show up on your credit report and will therefore increase your overall debt-to-income ratio, so if you are already maxed out on credit cards, this may not be the way to go.

National credit cards like MasterCard and Visa also represent a good source of funds. Credit cards are available to almost anyone and can be used for just about anything. Most credit cards offer you the capability of getting a cash advance against your credit limit. You can also write checks that can be used for almost anything, including your investment property. National credit cards tend to carry higher interest rates than do other forms of borrowing, so you should use this source of funds prudently.

Individual store credit cards can provide you with even more buying power. National hardware stores like The Home Depot

offer credit cards to their customers enabling them to purchase materials from their stores. If you are in the rehab business, this can be an excellent source of short-term credit that can be used to finance up to 100 percent of the required repairs on your rehab project.

While lines of credit can be a great source of borrowing power, I caution you to use them wisely. Remember that you are using these funds for investment purposes, so be sensible and responsible in the way you use them. Don't go out and max out all of your cards thinking you can conquer the world. Remember that the money has to be repaid at some point in time. Your objective is to earn a predetermined rate of return on all funds borrowed for investment purposes, including the many types of credit lines available to you.

OWNER FINANCING

In an owner financing arrangement, the sellers do exactly as the name implies. They provide the buyer with some form of financing. It may be that they carry the entire note or only a portion thereof. If the sellers own the property free and clear, for example, then they may be willing to provide you with 100 percent financing. More than likely though, the sellers will want a minimal down payment, even if it is only $1,000. If a seller still has a large underlying mortgage on the property, then he or she may be agreeable to carrying back a second mortgage for a smaller amount—10 percent of the purchase price, for example. You will still have to obtain a mortgage for the property from a more traditional source such as a mortgage company, but having the seller carry back a second allows you to get into the deal with less money down. One caveat you should be aware of, though, is that not all lenders will allow a second of any kind to be attached. Before you proceed with this option, make sure the mortgage company does not have a provision in place that would prevent you from attaching a second mortgage to the deal.

There are several advantages of an owner finance arrangement.

One benefit is that the buyer need not conform to all of the underwriting guidelines required of banks and mortgage companies. The seller is likely to require very little in the way of documentation. Unlike conventional mortgage companies, the seller providing owner financing doesn't care where the money for the down payment comes from as long as it comes from somewhere. On the other hand, traditional lenders like banks and mortgage companies can be very particular about where your down payment comes from. In many cases, the money cannot come from a family member or a friend. Moreover, you must be able to prove that the money is your own and did not come from a relative. Another advantage of using owner financing is that it enables you to save a considerable sum by avoiding the fees and transaction costs commonly assessed with new loans. There are no loan application fees, no underwriting fees, and no loan origination fees. Finally, the time needed to close a deal involving owner financing is much less than for traditional financing arrangements since virtually no loan approval process is required.

Another form of owner financing is known as a wraparound mortgage. Under this arrangement, the seller retains title and continues to make mortgage payments to the lender while the new owner makes mortgage payments directly to the seller. Be careful of any due-on-sale clauses in the deed of trust that may expressly prohibit this type of financing arrangement. Lenders normally are not very fond of the transfer of ownership interests without their knowing about it.

Although second-lien positions are the most common form of owner financing arrangements, owners or sellers are not limited to just debt financing. They may be open to an equity agreement wherein they retain a small portion of ownership interest. Instead of being required to make monthly payments to the seller, the buyer and seller agree to share in the profits of the newly formed entity. Depending on the specifics of the agreement, the original seller may also be entitled to a share of any capital gains when the property is later resold.

PARTNERSHIPS

Using the resources of a partner can be an excellent form of secondary financing. The type of partner I am referring to in this section is a friend, family member, or business acquaintance. Partnerships can be structured in any number of ways. For instance, capital injections by partners can take the form of debt or equity, partners can play an active or passive role, and terms for the repayment provisions can be defined in various creative ways.

If your partner agrees to invest in your project using equity, then he or she will share the risk with you. If you lose, your partner loses, but if you win, your partner also wins and shares in the profits. On the other hand, if you don't want to give up any of your profits, then you would have your partner participate on the debt side by making a loan to you. In this case, the loan can be secured by the property or by any other collateral you may have, or it may be an unsecured loan as well. You may decide to have your partners actively participate by using whatever skill sets they may have. Partners who are mechanically inclined, for example, may be able to perform some of the maintenance. Conversely, you may choose to have partners play a passive role wherein their only function is to provide capital. Repayment provisions can be made in any number of ways. For example, debt payments can be made periodically (e.g., monthly, quarterly, or annually). You might also agree to repay the debt with all interest due when the property is sold. If, on the other hand, you are flipping several properties a year, it may not make sense to repay the debt when the first property is sold. You will likely want to have your partner agree to an ongoing arrangement that provides you the flexibility to buy and sell at will with a predetermined repayment date agreed to by both parties. In summary, allowing a partner to participate can benefit you by providing additional capital for a project that otherwise may have been out of reach and by contributing services or specific skills that you may be lacking.

YOUR BUSINESS PLAN

Preparing a professional-looking, comprehensive business plan and presenting it to potential lenders and partners is certain to set you apart from the dozens of applicants they meet day in and day out. Preparing a business plan will also compel you to clearly define your real estate investment objectives. Physically going through the motions of formalizing your business plan forces you to think through each and every step of the process and subsequently assess the soundness of your plan. Your vision of where and how you want to grow your company begins in your mind with your thought processes. Recording your thoughts in a formalized manner allows you to crystallize them. You can refer to your business plan as often as needed to make sure you are on track to reach your objectives and also to adjust your course as necessary.

Furthermore, presenting your business plan directly to potential lenders or partners demonstrates that you are a serious investor who is looking to establish a long-term relationship. By following the step-by-step process outlined in your business plan, potential lenders will also be able to judge the soundness of your plan. In short, it will enable them to establish a level of comfort with you and your transaction that may not otherwise be possible. You must remember that prospective lenders and partners are human beings who will judge you not only by what they see on your loan application, but also by what they see in the way you present yourself to them. You must be prepared to sell yourself and your abilities to them. Their assessment of you is based on both objective evidence and subjective qualities they observe about you. The objective evidence is drawn from the items that are in black and white before them, such as your loan application and credit scores. The subjective qualities you will be judged on are more subtle in nature and include such things as the way you present yourself, your level of professionalism, and whether they perceive you to be credible.

The use of a sound business plan is most effective when dealing with local banks or partners. These are the people you are

most likely to get to know on a more personal level. A business plan is of little or no value to mortgage brokers, since they are more interested in packaging your loan request and shipping it off to any one of many underwriting departments. Although formalizing your business plan will require a good deal of time and effort on your part, a comprehensive and professional-looking plan can pay big dividends by providing you with the much needed capital to fund your purchases.

Exhibit 8.2 provides a sample outline for some of the more essential items you will want to include in your business plan. These items can be organized in a very professional manner in a notebook that contains tabs and dividers.

WHAT EVERY BORROWER SHOULD KNOW ABOUT CREDIT SCORES

Most lenders today use what is known as FICO scores to determine your ability to borrow money and repay a loan. FICO is an acronym for Fair, Isaac, and Company, which uses an elaborate model to calculate data collected over a period of time about specific individuals. This historical data is then used to assign a credit score to that individual. The scoring system uses factors such as payment history, number of creditors, debt-to-income ratios, outstanding balances relative to credit limits, length of credit history, types of credit, and reported income. Before the final score is calculated, previously established weights are assigned to each variable according to the criteria set forth in the model. When lenders order your credit history, they typically get it from all three of the following sources: Equifax, Experian, and TransUnion. All three services may not have exactly the same information, so the credit scores may vary among them. Lenders often use either an average of the three scores or the median score.

The credit score range is from 300 to 850, with 300 being extremely poor and 850 being a perfect score. It is highly recommended that you do everything within your power to maintain as

Exhibit 8.2
Components of an effective business plan.

1. *Executive summary.* A one- or two-page summary of your plan.
2. *Company profile.* Background information about yourself, including experience and education, and information about your company.
3. *Financial statements.* Personal and company financials.
4. *Primary market.* Define your intended market area.
5. *Business strategy.* Provide in detail your specific short-term and long-term objectives for your company.
6. *Marketing strategy.* Define your target market and include specifics of how you intend to market your services and/or properties.
7. *Capital requirements.* List short-term and long-term anticipated capital requirements.
8. *Financial analysis.* Provide supporting financial tables.
9. *Summary.* Summarize your proposal and close with sound reasons about why the lender or partner should work with you.
10. *Exhibits.* May include photographs, surveys, tax returns, purchase agreements, addendums, and so on.

high a score as possible. If your score is 700+, you are considered to be an A borrower and will have no problem qualifying for a loan, provided you meet whatever other criteria the lender has set forth.

Credit scores are used much like scholastic aptitude test (SAT) or graduate management admission test (GMAT) scores. The first thing university administrators want to know when students apply for entrance is how well they did on the required standardized tests. The tests are used to measure students' knowledge and aptitude in various subjects and the results are quantitatively summarized in the form of a numeric score. Just as administrators use these scores to set minimum standards for matriculation into their schools, so do lenders use credit scores to set minimum standards for loaning money to prospective borrowers. Credit scores serve as a valuable tool to lenders because they are purely objective in measuring the ability of a borrower to repay a loan and the probability that he or she will default. They remove all elements of subjective judgment that could be considered discriminatory, such as race or religious preferences.

Some lenders will make loans to just about anyone. They don't care what your score is as long as the property is generating adequate income to service the debt. These lenders will, however, adjust their interest rates accordingly by applying a matrix grid that matches your ability to repay with the condition of the property. You can see by looking at Table 8.1 that borrowers who fail to maintain good credit are usually penalized as a result. The logic

Table 8.1 Interest Rate Matrix

	Borrower Rating			
Property Rating	A	B	C	D
A	6.00%	6.50%	7.00%	7.50%
B	6.50%	7.00%	7.50%	8.00%
C	7.00%	7.50%	8.00%	8.50%
D	7.50%	8.00%	8.50%	9.00%

is quite simple. Lenders charge a higher rate of interest to offset the higher risk associated with borrowers who have poor credit. The bottom line to you as an investor is to work hard to maintain the best credit rating possible. Doing so will enable you to borrow money more easily than those who have poor credit—and also at much more favorable terms and conditions.

UNDERWRITING GUIDELINES

All lenders have established criteria for making loan decisions. These criteria are referred to as the lender's *underwriting guidelines.* These guidelines form the basis for all decisions made to either approve or decline a loan applicant's request. They represent the lender's policies and procedures to which all new loans under review must conform before being granted final approval. A lender's underwriting guidelines may include elements such as the loan-to-value (LTV) ratio, the debt service coverage ratio (DSCR), a borrower's debt-to-income ratio, the size and term of the loan, and information about the subject property.

To assure that its underwriting guidelines are conformed to, a lender will require specific information about the property and the borrower in order to do a full and proper analysis of a loan request. This information includes items such as the purchase agreement for the property, credit reports from no fewer than three independent agencies, verification of employment and income, bank statements, and tax returns. See Exhibit 8.3 for a more complete list. Providing the lender with a complete documentation package enables it to expedite the processing of your loan in a timely and efficient manner. Once the lender has all the necessary documentation, you can usually have an approval within two or three days. This is, however, a general time frame and may vary depending on the volume of loans being processed at any given time. Oftentimes the underwriter will come back and ask for more information, primarily to clarify something you have already submitted. For example, if your bank statement shows an unusually large deposit being made into

your account, the underwriter is likely to require supporting documentation about the source of those funds.

You should be aware that smaller local banks are usually not as sticky about requiring you to document the source of funds. Banks customarily require only the first page of your account statement to document the amount of funds you have and not necessarily their source. You can use this to your advantage if you wish to deposit borrowed funds, such as those from a home equity loan or a credit card. Making a deposit of this sort does not mean you are being dishonest or breaking any laws. Unless the bank

Exhibit 8.3
Required loan documentation.

1. Formal loan application
2. Purchase agreement and all related addendums
3. Personal financial statement
4. Income tax returns for a minimum of two years
5. Credit reports from three reporting agencies
6. Bank statements for a minimum of two months
7. Verification of employment, wages, and earnings
8. Verification of property taxes
9. Property insurance binder
10. Third-party reports, including survey and appraisal

asks you specifically about the source of the deposit, you are not required to disclose it to them. Even if your bank asks, local banks are often not as particular about your using borrowed money (e.g., from a home equity line of credit) as a conventional mortgage company might be.

After securing financing for your property, the next step is to begin preparing to finalize and close the transaction. Depending on the size of your acquisition, the closing process can be fairly simple and straightforward, or it can be quite involved, with extensive documentation required. It is also time to begin planning and defining your role as a strategic manager. This, too, will depend on the size of the transaction and your level of experience.

THE CLOSING PROCESS

The closing process is the point in time when everything comes together to finalize your transaction. You have studied the market and analyzed numerous investment opportunities; you have successfully negotiated terms and conditions acceptable to both you and the seller; and you have sought out the best financing alternative for your property. It is now time to bring all the parties together to close the sale. Before you commit yourself by signing on the dotted line, however, you should take time to thoroughly review all related closing documents—in particular, the title report, closing statement, deed of trust, and promissory note.

The *title report,* also known as the *abstract of title,* provides information about the property's chain of title. In other words, it gives a history of ownership, judgments, liens, and anything else that may have been recorded against the property over time. The title insurance company issues an insurance policy to the buyer and a separate policy to the lender. These guarantee the title is clean and that there are no encumbrances that may adversely affect the new owner.

Closing statements, also known as *settlement statements,* are commonly prepared by the title company handling the closing.

They detail by line item all associated debits and credits assessed to both buyer and seller. These include such items as the sale price, amount of earnest money deposit, principal amount of the new loan, any existing loans or debts that must be satisfied, prorated adjustments for taxes and interest, and various fees charged by the title company. Tables 8.2 through 8.5 collectively provide you with some of the detail from a commonly used closing settlement statement form.

You should take the requisite time to review each and every charge on the settlement statement to verify its accuracy. Errors are often inadvertently made for one reason or another. The title company may, for example, have the incorrect payoff amount of the seller's loan or may calculate the prorations incorrectly or may not be aware of a credit you are entitled to because of a specific clause in the purchase agreement negotiated by you and the seller. Don't assume that because closing officers work at title companies and act as facilitators in numerous closings that "they must be right because they are closers and they should know." Precisely the opposite is true. Because closers do act as facilitators in numerous closings each and every day is all the more reason they must rely on you to provide accurate information for the settlement statement.

Neglecting to review the closing statement can be very risky and potentially cost you hundreds or even thousands of dollars. Here in Michigan, for example, the state and county assess what is referred to as a *transfer tax.* The transfer tax is calculated as a percentage of the sales price and is collected at closing on all real estate sold. It is just like paying tax on a new car, new furniture, school supplies for the kids, or just about anything else Uncle Sam can get his hands on. The tax rate applied is usually about 1 percent or just a little less, so for every $100,000 in property value sold, approximately $1,000 in taxes is assessed. Unless otherwise stated, the seller is responsible for paying this tax. In my purchase agreements, however, I require the buyer to pay the tax. Unless the title company has been made aware of this, the transfer taxes will be placed, incorrectly, on my side of the settlement statement. This error, which has been made many times, could easily cost me $2,000 to $3,000.

Table 8.2 Settlement Statement

U.S. Department of Housing and Urban Development

OMB No. 2502-0265

B. Type of Loan

1. ☐ FHA 2. ☐ FmHA 3. ☐ Conv. Unins.
4. ☐ VA 5. ☒ Conv. Ins.

6. File Number	7. Loan Number	8. Mortgage Insurance Case Number

C. NOTE: *This form is furnished to give you a statement of actual settlement costs. Amounts paid to and by the settlement agent are shown. Items marked "(p.o.c.)" were paid outside the closing; they are shown here for informational purposes and are not included in the totals.*

D. NAME OF BORROWER:
ADDRESS OF BORROWER:

E. NAME OF SELLER: **Symphony Homes Real Estate Group, L.L.C.**
ADDRESS OF SELLER:

F. NAME OF LENDER:
ADDRESS OF LENDER:

G. PROPERTY LOCATION: **Davison, Genesee County, Michigan 48433**

H. SETTLEMENT AGENT:
PLACE OF SETTLEMENT:

I. SETTLEMENT DATE: **10/30/2002** **PRORATION DATE: 10/30/2002**

J. SUMMARY OF BORROWER'S TRANSACTION		K. SUMMARY OF SELLER'S TRANSACTION	
100. GROSS AMOUNT DUE FROM BORROWER:		**400. GROSS AMOUNT DUE TO SELLER:**	
101. Contract sale price	42,000.00	401. Contract sale price	42,000.00
102. Personal property	167,700.00	402. Personal property	167,700.00
103. Settlement charges to borrower: *(from line 1400)*	5,234.28	403.	
104.		404.	
105.		405.	
ADJUSTMENTS FOR ITEMS PAID BY SELLER IN ADVANCE:		ADJUSTMENTS FOR ITEMS PAID BY SELLER IN ADVANCE:	
106. City\Town taxes 10/30/2002 to 07/01/2003	12.11	406. City\Town taxes 10/30/2002 to 07/01/2003	12.11
107. County taxes 10/30/2002 to 01/01/2003	5.70	407. County taxes 10/30/2002 to 01/01/2003	5.70
108. Assessments to		408. Assessments to	
109. Condo Dues Pro-Rata 10/30/02-12/31/02	17.01	409. Condo Dues Pro-Rata 10/30/02-12/31/02	17.01
110.		410.	
111.		411.	
112.		412.	
120. GROSS AMOUNT DUE FROM BORROWER: >>	214,969.10	420. GROSS AMOUNT DUE TO SELLER: >>	209,734.82
200. AMOUNTS PAID BY OR IN BEHALF OF BORROWER:		**500. REDUCTIONS IN AMOUNT DUE TO SELLER:**	
201. Deposit or earnest money	10,600.00	501. Excess deposit *(see instructions)*	10,600.00
202. Principal amount of new loan(s)	199,215.00	502. Settlement charges to seller *(line 1400)*	6,350.00
203. Existing loan(s) taken subject to		503. Existing loan(s) taken subject to	
204.		504. Payoff of first mortgage loan Payoff Ln.	153,316.56
205.		505. Payoff of second mortgage loan	
206.		506. Sewer & Water Due 11/5/02	14.02
207.		507. Sewer & Water Escrow	75.00
208.		508.	
209.		509.	
ADJUSTMENTS FOR ITEMS UNPAID BY SELLER:		ADJUSTMENTS FOR ITEMS UNPAID BY SELLER:	
210. City\Town taxes to		510. City\Town taxes to	
211. County taxes to		511. County taxes to	
212. Assessments to		512. Assessments to	
213.		513.	
214.		514.	
215.		515.	
216.		516.	
217.		517.	
218.		518.	
219.		519.	
220. TOTAL PAID BY\FOR BORROWER: >>	209,815.00	520. TOTAL REDUCTIONS IN AMOUNT DUE SELLER: >>	170,355.58
300. CASH AT SETTLEMENT FROM\TO BORROWER:		**600. CASH AT SETTLEMENT TO\FROM SELLER:**	
301. Gross amount due from borrower *(line 120)*	214,969.10	601. Gross amount due to seller *(line 420)*	209,734.82
302. Less amount paid by\for borrower *(line 220)*	209,815.00	602. Less total reductions in amount due seller *(line 520)*	170,355.58
303. CASH (☒ *FROM*) (☐ *TO*) BORROWER:>>	5,154.10	603. CASH (☒ *TO*) (☐ *FROM*) SELLER: >>	39,379.24

TAXPAYER IDENTIFICATION NUMBER SOLICITATION: SELLER

You are required by law to provide settlement agent with your correct taxpayer identification number. If you do not provide settlement agent with your correct taxpayer identification number, you may be subject to civil or criminal penalties imposed by law.
Under penalties of perjury, I certify that the number shown on this statement is my correct taxpayer identification number.

Seller's Signature Seller's Signature Seller's Signature

The information contained in Blocks E,G,H,I and on line 401 (or if line 401 has an asterick, line 403 and 404) is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if this item is required to be reported and the IRS determines that it has not been reported.

Table 8.3 Settlement Charges

			PAID FROM BORROWER'S FUNDS SETTLEMENT	PAID FROM SELLER'S FUNDS SETTLEMENT
700.	TOTAL SALES\BROKER'S COMMISSION: BASED ON PRICE $ @ %=			
	DIVISION OF COMMISSION (LINE 700) AS FOLLOWS:			
701.	$ to			
702.	$ to			
703.	Commission paid at settlement			
704.				
800.	ITEMS PAYABLE IN CONNECTION WITH LOAN:	POC		
801.	Loan origination fee %		2,600.00	
802.	Loan discount %			
803.	Appraisal fee to:	250.00		
804.	Credit report to:			
805.	Lender's inspection fee			
806.	Mortgage insurance application fee to			
807.	Assumption fee			
808.	**Commission 3% of $209700.00** to			6,291.00
809.	**Underwriting Fee** to		315.00	
810.	**Yls.Sprd.Pd. by Investaid** to	1992.15		
811	**Processing Fee** to		395.00	
900.	ITEMS REQUIRED BY LENDER TO BE PAID IN ADVANCE:			
901.	Interest from **10/30/2002** to **11/01/2002** @ $ **47.0400** \day		94.08	
902.	Mortgage insurance premium for mos. to			
903.	Hazard Insurance premium for yrs. to **Insurance**	415.		
904.	Flood Insurance Premium for yrs. to			
905.				
1000.	RESERVES DEPOSITED WITH LENDER:			
1001.	Hazard insurance months @ $ per month			
1002.	Mortgage insurance months @ $ per month			
1003.	City property taxes months @ $ per month			
1004.	County property taxes months @ $ per month			
1005.	Annual assessments months @ $ per month			
1006.	months @ $ per month			
1007.	months @ $ per month			
1008.	months @ $ per month			
1100.	TITLE CHARGES:			
1101.	Settlement or closing fee to		300.00	
1102.	Abstract or title search to			
1103.	Title examination to			
1104.	Title insurance binder to			
1105.	Document preparation to			
1106.	Notary fees to			
1107.	Attorney's fees to *(includes above items Numbers:*			
1108.	Title insurance to *(includes endorsements:*		925.00	25.00
1109.	Lender's coverage $ **199,215.00** (**$925.00)**			
1110.	Owner's coverage $ **209,700.00** (**$25.00)**			
1111.				
1112.				
1113.				
1200.	GOVERNMENT RECORDING AND TRANSFER CHARGES:			
1201.	Recording fees: Deed $ **12.00** Mortgage $ **37.00** Releases $		49.00	
1202.	City\county tax \ stamps: Deed $ **46.20** Mortgage $		46.20	
1203.	State tax\stamps Deed $ **315.00** Mortgage $		315.00	
1204.	**Recording Realease of Lien** **Title Company**			9.00
1205.				
1300.	ADDITIONAL SETTLEMENT CHARGES:			
1301.	Survey to		125.00	
1302.	Pest inspection to			
1303.	**Courier Fee** to		50.00	25.00
1304.	**Flood Certification** to		20.00	
1305.				
1306.				
1307.				
1400.	TOTAL SETTLEMENT CHARGES *(Enter on line 103, Section J and line 502, Section K)* >>		5,234.28	6,350.00

I have carefully reviewed the HUD-1 Settlement Statement and to the best of my knowledge and belief, it is a true and accurate statement of all receipts and disbursements made on my account or by me in this transaction. I further certify that I have received a copy of the HUD-1 Settlement Statement.

Borrower _____ Date: 10-30-02 Seller: Stephen H. Berges Date: 10/30/02

Symphony Homes Real Estate Group, L.L.C.

Borrower _____ Date: 10-30-02 Seller: BY: _____ Date: _____

Stephen Berges
Co-Manager

The HUD-1 Settlement Statement which I have prepared is a true and accurate account of this transaction. I have caused or will cause the funds to be disbursed in accordance with this statement.

Settlement Agent _____ Date: 10/30/2002

WARNING: It is a crime to knowingly make false statements to the United States on this or any other similar form. Penalties upon conviction can include a fine and imprisonment. For details see: Title 18 U.S. Code Section 1001 and Section 1010.

PAGE 2

Table 8.4 Purchaser's Statement

FILE NUMBER:
CLOSER:

SETTLEMENT DATE: 10/30/2002
PRORATION DATE: 10/30/2002

NAME OF PURCHASER:	
NAME OF SELLER:	Symphony Homes Real Estate Group, L.L.C.
NAME OF LENDER:	
LOCATION OF PROPERTY:	Davison, Genesee County, Michigan 48433 LAUREL HEIGHTS CONDOMINIUM as recorded in Liber 3485, Pages 942 to 1002 Genesee

	POC	AMOUNTS	TOTALS
Contract sales price			42,000.00
Personal property			167,700.00
PLUS CHARGES:			
Proration of City/Town taxes from 10/30/2002 to 07/01/2003		12.11	
Proration of County taxes from 10/30/2002 to 01/01/2003		5.70	
Condo Dues Pro-Rata 10/30/02-12/31/02		17.01	
Loan origination to Corporation		2,600.00	
Underwriting Fee to Corporation		315.00	
Processing Fee to Corporation		395.00	
Interest from 10/30/2002 to 11/01/2002: 2 days @ 47.0400/day to		94.08	
Settlement Fee to Title		300.00	
Title Insurance Premium to Company		925.00	
Lender's Coverage 199,215.00 ($925.00)			
Deed Recording Fee to Company		12.00	
Mortgage Recording Fee to Company		37.00	
City/County Deed Conveyance Tax to Genesee County Treasurer		46.20	
State Deed Conveyance Tax to Genesee County Treasurer		315.00	
Survey to Engineering Inc		125.00	
Courier Fee to Title		50.00	
Flood Certification to Corporation		20.00	
TOTAL CHARGES			5,269.10
GROSS AMOUNT DUE FROM PURCHASER			214,969.10
LESS CREDITS:			
Deposit or earnest money		10,600.00	
Principal amount of new loan		199,215.00	
TOTAL CREDITS			209,815.00
BALANCE DUE FROM PURCHASER			$5,154.10

Table 8.5 Seller's Statement

FILE NUMBER: SETTLEMENT DATE: 10/30/2002
CLOSER: PRORATION DATE: 10/30/2002

NAME OF PURCHASER:

NAME OF SELLER: Symphony Homes Real Estate Group, L.L.C.

NAME OF LENDER:

LOCATION OF PROPERTY: Davison, Genesee County, Michigan 48433
LAUREL HEIGHTS CONDOMINIUM as recorded in Liber 3485, Pages 942 to 1002 Genesee

	POC	AMOUNTS	TOTALS
Contract sales price			42,000.00
Personal property			167,700.00
PLUS CREDITS:			
Proration of City/Town taxes from 10/30/2002 to 07/01/2003		12.11	
Proration of County taxes from 10/30/2002 to 01/01/2003		5.70	
Condo Dues Pro-Rata 10/30/02-12/31/02		17.01	
TOTAL CREDITS			34.82
GROSS AMOUNT DUE TO SELLER			209,734.82
LESS CHARGES:			
Deposit or earnest money		10,600.00	
Payoff Ln. #1534/Acct.#211-Stock Building Supply, LLC		153,316.56	
Sewer & Water Due 11/5/02		14.02	
Sewer & Water Escrow		75.00	
Commission 3% of $209700.00 to Company		6,291.00	
Title Insurance Premium to Company		25.00	
Owner's Coverage 209,700.00 ($25.00)			
Recording Realease of Lien to		9.00	
Courier Fee to		25.00	
TOTAL CHARGES			170,355.58
BALANCE DUE TO SELLER			$39,379.24

Symphony Homes Real Estate Group, L.L.C.
By: Stephen H. Berges By: _____
Stephen Berges
Its: Co-Manager Its: _____

Although I thoroughly review all of the charges on the statement, this is one in particular that I am very careful to check for accuracy.

The lender is responsible for preparing the *deed of trust* and the *promissory note.* These documents outline the terms and conditions under which the lender has agreed to loan you money. Repayment terms are specified, including the amount of the loan, the interest rate and amortization period, and any prepayment penalties that may be imposed. Other lender requirements that may also be included are escrow conditions for taxes and insurance, minimum insurance amounts, standard of care for property condition, and default provisions.

By taking the time to more fully understand all of the requisite closing documents, you will be better prepared to ensure that the closing for the investment property you are purchasing will go smoothly. For the most part, you can have confidence in the expertise of those individuals who are preparing all of the related forms, but you must also keep in mind that these individuals are human and prone to make mistakes just like anyone else. Protect your interests by carefully reviewing all of the closing documents. Doing so may potentially save you thousands of dollars.

Set a goal to become a millionaire for what it makes of you to achieve it. Do it for the skills you have to learn and the person you have to become. Do it for what you'll end up knowing about the marketplace, what you'll learn about the management of time and working with people. Do it for the ability of discovering how to keep your ego in check. For what you have to learn about being benevolent. Being kind as well as being strong. What you have to learn about society and business and government and taxes and becoming an accomplished person to reach the status of millionaire is what's valuable. Not the million dollars.

—Earl Shoaf

Chapter 9

Assemble a Winning Team of Professionals

To truly be successful as a real estate investor, you need to assemble a winning team of professionals. If you are buying and selling only one or two properties a year, as is true for most investors, you will be involved in much of the work yourself. As you begin to participate in more and more transactions, however, you will soon discover that you can no longer do everything by yourself. In fact, you will find that the best use of your time is coordinating the efforts of others. By delegating some of the responsibilities to your team, you are able to achieve much more than if you try to do everything yourself. For example, an ox by itself can pull only a single covered wagon, but two oxen yoked together can pull several wagons. This well-established principle can be summarized as, "The sum of the parts is greater than the whole." It is a phenomenon known as *synergy.* Synergistic effects are created when individuals who might otherwise work independently instead work together. The individuals are able to achieve much more working together in a collective effort than they can on their own. (See Exhibit 9.1.)

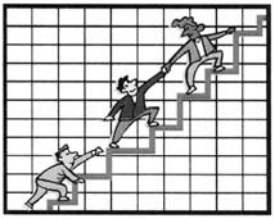

Exhibit 9.1
Your winning team of professionals.

1. Scouts and/or dealers
2. Office manager
3. Property rehab manager
4. Local lender or mortgage broker
5. Real estate attorney
6. Title company
7. Real estate agents

SCOUTS AND/OR DEALERS

Perhaps the most important element of your winning team of professionals is to have dedicated scouts and dealers working in your behalf. You may recall from Chapter 2 that both scouts and dealers can provide you with a steady source of property leads. Leads from these sources and others are the lifeblood of your business. Without them, it will be very difficult to be successful in the business of flipping properties. You should work to build relationships with several different scouts and dealers. You also need to take time to establish investment criteria that best suits your objectives so that the individuals you are working with know what types of opportunities to present to you. You don't want them spending needless time on deals that you have no interest in. Furthermore, you don't want to waste your time by looking at deals that don't meet your needs.

The relationship between you and other scouts and dealers is mutually beneficial. The more opportunities they bring you, the more you will buy from them or from those they recommend, and the more you buy from them, the more money they will make. It is a win-win relationship. You may also decide to hire a full-time scout of your own. In addition to paying a small base wage, I recommend implementing an incentive system in which your scout is rewarded for every deal he or she brings you that you end up buying. Your scout will quickly learn exactly what kind of opportunities you are most interested in and bring you only the cream of the crop.

OFFICE MANAGER

An effective office manager is another key individual on your winning team of professionals. Before you can have a good office manager, though, you first have to have an office. Most people who invest in real estate start out buying and selling a little at a time. As their capital base grows, so does their ability to increase the volume of transactions. At some point in the process, it will become necessary to discontinue your part-time operation out of your home office and begin a full-time operation out of an office building. When you reach that point in your business, I recommend that one of the first people you hire is an office manager. You can delegate many of the lesser responsibilities to him or her, which in turn enables you to focus on growing your business. Office managers can handle many of the more repetitive day-to-day tasks that can take up so much of your time. They can furthermore be trained over time to take on greater responsibilities, such as some of the accounting and marketing functions.

A good office manager can also be trained to perform functions like scheduling and coordinating all of the necessary parties involved in a closing, as well as attending the closings for you. You may initially be uncomfortable turning that responsibility

over to another person, but after your fiftieth or so closing, chances are you'll be more receptive to the idea of having someone attend them for you. I find that while most closings go smoothly, they typically require a minimum of no less than two hours of my time. By the time I drive to the title company, wait for the closing officer to finish preparing the documents, sign off on everything, and drive back to my office, I have at least two hours invested in the process, and sometimes more. While selling and closing the deal excites me, I find sitting around in title companies to be quite boring. Hire a good office manager and use your time where it counts the most, buying and selling properties.

PROPERTY REHAB MANAGER

I cannot stress enough the importance of hiring a rehab manager. This person will "take the rehab out of rehabbing" for you. The property rehab manager's primary role is to coordinate and schedule the subcontractors for all of the required renovations. A handyman is often the most well-qualified person for this type of job. You want somebody managing the crews who can determine what exactly needs to be done, and then to make sure that the repairs are done correctly. A handyman can also save you money by doing a lot of the smaller repairs personally; however, this depends on the number of houses you have undergoing repairs at any given time. If you have several houses being worked on simultaneously, a rehab manager may not have time to do any of the repairs. On the other hand, if you only have two or three in progress at any given time, then your rehab manager will most likely be able to make some of the repairs while at the same time scheduling the other contractors. Remember that the most effective use of your time is not to fix the houses yourself, but rather to oversee the efforts of those who do. By hiring a property rehab manager, you are in effect delegating that responsibility to someone else. This allows you to focus on building your business.

LOCAL LENDER OR MORTGAGE BROKER

Another very important component of your real estate business is financing. For this reason, it is essential for you to have one or more lenders or mortgage brokers as members of your winning team of professionals. You must have access to capital—and preferably to large sources of it. It usually becomes necessary to establish relationships with several lenders or mortgage brokers to meet your growing needs for financing. In the initial stages of your relationship, you will most likely secure financing on a case-by-case basis. As the lender becomes more comfortable with you, however, the process of obtaining financing becomes much easier.

Unless you already have a strong personal balance sheet, these types of relationships are not formed overnight. They can sometimes take years to form. I am very fortunate in that I currently have the ability to pick up the phone and secure financing within about five minutes for many of the projects I am involved in. Access to capital is vital to your success in this business. Work hard to establish sound relationships with lenders in your area who can provide you with the financing needed to enable you to be successful.

REAL ESTATE ATTORNEY

Another member of your winning team of professionals that you will want to consider is a real estate attorney. The yellow pages are full of attorneys, most of whom advertise the area of law they specialize in. Look for one who specifically advertises real estate services. A few minutes on the phone will give you an idea of an attorney's level of expertise. Don't be intimidated just because someone carries the title of attorney. It is quite likely that you know as much about real estate in general as any given attorney. You hope, of course, that the one you choose is more knowledgeable about real estate law. I prefer to work with attorneys who own investment property themselves. This gives them an added

level of experience. Adding this individual to your team of professionals will provide you with the legal expertise needed from time to time during the course of your business.

TITLE COMPANY

A competent title company is another essential member of your winning team of professionals. While most title companies offer similar services (providing title insurance and closing services, etc.), they vary greatly on the degree to which they can provide those services. Over the years, I have worked with many different title companies. Each one seems to have its own unique set of nuances.

Until recently, I had a relationship with a national title company that had a deplorable operations department. The firm's outside salesman contacted me and wooed me over to this company. The salesman, Derek, was himself a shining example of what it means to be customer focused. He was extremely attentive to me individually and was proficient in addressing all of my needs and concerns. "This is great," I thought. "Here's a guy who really cares about his customers and is always willing to go the extra mile for them." What I didn't know, however, was that while Derek was about as good an outside salesman you could hope for, the company's operations department was just the opposite. I sent them seven or eight deals right off the bat and ended up having problems with almost every one of them. I had problems with scheduled closings that had been confirmed for a certain date and then mysteriously disappeared from the company's book. I had problems with the people in operations who were supposed to be capable of preparing all the title work, but just couldn't seem to get it right. And finally, I had problems with incapable closing officers. Derek was great. The rest of the company was a mess.

Now that I've lamented my poor experience with this particular (unnamed) company, let me conclude on a more positive note. The title company that I have since switched to is quite the opposite. For the most part, I can send this company a deal,

schedule it, and show up at the closing with everything properly prepared and in order. Although I pay a little more for the title services of this company, it's worth it to me. I don't have nearly the headaches and frustrations that I did with the previous company. Find a competent title company in your area and include it on your winning team of professionals.

REAL ESTATE AGENTS

Top-producing real estate agents are vital elements of your winning team of professionals. You should plan to include as many of them as possible on your team. If an agent knows you are a serious buyer, he or she will work to bring you the types of deals you are most interested in. As with scouts and dealers, you must establish predetermined criteria that meet your investment objectives. The better your sales agents understand exactly what you are looking for, the better they will be able to meet your investment needs.

If you limit yourself to just one agent, then you have only one set of eyes and ears on the lookout for good deals to bring to you. On the other hand, if you enlist the aid of several real estate agents, you will increase the number of potential investment opportunities that you can take advantage of. Each agent has his or her own sphere of influence—friends and associates with whom they interact on a daily basis. You never know when one of them will come across that gem of a deal just waiting to be discovered.

When it becomes time for you to sell your property, you will also likely want to have more than one agent working in your behalf. Those of you who are licensed agents are likely to disagree with me on this point, but please allow me to explain. The reason I prefer to use more than one agent is because I know that agents tend to specialize in certain areas by farming specific communities. Yes, I know, you can list the property for sale in the MLS just like any other agent and gain access to a broad spectrum of buyers, which is certainly very important, but unless you are familiar with the area in which you have the listing and physically work that area, you are doing your seller a disservice.

I have seen, for example, agents take listings clear across the county and even into the neighboring counties. These areas may be as far as 50 miles from where they live and work. No matter how hard you try, you can't convince me that you can effectively sell a house for me in an area about which you know little or nothing. Your marketing efforts will be limited to a few newspaper ads and to the MLS. Agents selling in faraway markets are likely to have no personal contacts or relationships in that area. They know absolutely nothing about the town or city except the name of it. They know nothing about the school district, which is vital information to anyone with children. Chances are, they haven't even been to the community except to write the listing agreement. Yet I see this all the time—a real estate sign placed in a homeowner's yard by someone I know good and well is not from that area. To be successful in the business of buying and selling investment properties, it is essential for you to include several real estate agents who can create a pipeline of inventory for you, as well as represent you effectively when it becomes time to sell.

In summary, we have examined the merits of building a first-class team of people who can help mobilize you to effectively reach your investment objectives. Each member of the team is vital for your success in the real estate business. You may initially go through a trial-and-error period in which some members of the team have to be replaced for one reason or another. In time, however, you will eventually assemble a winning team of professionals who when working together can help you achieve much more than you could ever hope to on your own.

Few people are capable of expressing with equanimity opinions which differ from the prejudices of their social environment. Most people are even incapable of forming such opinions.

—Albert Einstein

Chapter 10

Three Keys to Maximizing Your Potential

There are three important keys that when properly applied will empower you to maximize your potential as it relates to buying and selling houses. In this chapter, I examine several postentry strategies that you should seriously consider long before you close on the property. I also analyze the advantages and disadvantages of doing the required repairs yourself versus hiring others to do it. Finally, I review several methods to increase the marketability of your property. The proper and systematic application of the three precepts outlined in this chapter will enable you to maximize your potential in the real estate arena. (See Exhibit 10.1.)

POSTENTRY PLANNING

Your postentry strategy is the specific plan of action you will take immediately after the closing of your property. I want to emphasize the word *immediately.* Remember that time is of the essence and every day that passes by without being fully used costs you money. This is why you must plan well in advance of the closing date for the work required to prepare the property for its eventual

Exhibit 10.1
Three keys to
maximizing your potential.

1. Postentry planning
2. Doing it yourself versus hiring it out
3. Increasing your property's marketability

resale. Minimizing the turnaround time on each deal is crucial to helping you maximize your profits.

One of the best ways to begin preparing is by scheduling the contractors who will be making the repairs (assuming you are not doing the work yourself) two to three weeks before the scheduled closing date if possible. Don't make the mistake of waiting until after you close to begin thinking about scheduling. You will lose valuable time by doing so, and remember, time is money because you are paying interest on the borrowed funds. The best time to tentatively begin the scheduling process is when the contractors first come out to the property to provide you with bids for the work to be performed. This data, as you recall, is used in your assessment of the viability of the project. After factoring in all the costs and expenses related to the project, as well as market comparables, then and only then are you able to accurately measure the expected return in profits that a particular project will generate.

When you meet with the contractors, you can provide them at that time with a general idea of when you expect to close. Be sure to express to the contractors how important it is for them to be

available when you need them. Explain to them that you prefer not to lose even a single day. Once you have established a firm closing date with the seller and the title company, you can then schedule a specific date and time for your contractor to make the repairs. The key is to establish your postentry plan well in advance and to be prepared to execute it as soon after the closing as possible.

DOING IT YOURSELF VERSUS HIRING IT OUT

Is it better to do the work yourself and try to save money or to hire as much of the work out as possible and try to save time? This is a question that many real estate investors struggle with, especially those who are just starting out. While there is no single right answer, it's important to understand the advantages and disadvantages of both methods.

For those of you who may be more mechanically inclined, it is natural for you to feel and believe that you should do much of the work yourself in an effort to save money. Allow me to share a personal example with you of the differences between two individuals who have different skill sets. The first individual is my brother, Tim, who has very strong mechanical skills and can fix almost anything. In fact, one of my earliest memories of him "fixing" something occurred when I was about three years old. Tim would have been five at the time. I remember coming outside to play one day only to discover that he had taken all the wheels off my shiny red tricycle. Another time, he completely disassembled our swing set. While Tim was exceptionally good at taking things apart, he had unfortunately not yet learned how to put them back together, thereby rendering my tricycle and the swing set useless. Tim has come a long way since that time. Not only has he become an expert at taking things apart, but he is now extremely proficient at putting them back together.

The second individual in this example is none other than yours truly. While I lack the natural mechanical skills that Tim has, I do

have very good organizational and management skills. I recall that in my teenage years I was always very particular about keeping my bedroom as neat and orderly as possible. I was probably the only child in the family who made my bed without having to be asked to do so. My personality demanded structure and order. Later, my service in the U.S. Air Force reinforced these concepts, especially the training I received at boot camp (also known as basic training) at Lackland Air Force Base in San Antonio, Texas. Our beds had to be made perfectly with blankets folded taut enough to literally bounce a quarter off of. Everything in our footlockers had to be placed in exact and precise order according to our training manuals. If it wasn't, believe me, you would hear about it from the drill sergeant.

I never will forget one experience in my early days in basic training. I had only been there a few days and had just received my air force fatigues, which were all green. Since they were brand new, none of the insignia had been sewn on yet. With our heads freshly shaven and our new uniforms not yet adorned with insignia, we were referred to as "pickles," because that is exactly what we looked like, a bunch of green dill pickles running around. Anyway, being brand new in the service, I was not fully aware of all the rules. My drill sergeant's name was Sergeant Carter, and believe it or not, he bore a strong resemblance in both manner and appearance to the Sergeant Carter in the old TV sitcom, *Gomer Pyle.* One afternoon while wearing my fatigues, I put a pencil in my shirt pocket. After all, that's what pockets are for, right? Wrong! Little did I know that I was out of uniform. That's right, that little pencil sticking out of my pocket was not supposed to be there, and boy, did Sergeant Carter let me know about it. He literally stood nose to nose with me and bellowed out something like, "Airman, what's wrong with you!?! Don't you know you're out of uniform! You better get that #*!#*!#*! pencil out of your #*!#*!#* pocket and don't ever let me see it in there again! Do you understand me?" "Yes, sir!" came my immediate reply, and believe me, he never did see that pencil in my pocket again because I wasn't about to put it in there and run the risk of another

verbal thrashing. In fact, to this very day, I sometimes have second thoughts about putting a pencil in my shirt pocket.

With Tim's strong mechanical skills, he has quite naturally developed a mind-set to fix or repair things himself, including his rental properties. After all, why pay somebody to come in and rehab a house when you can do it yourself and save money? I must say that I have to give him credit for taking on some tough jobs. Over the years, I've observed Tim take on bathroom and kitchen remodeling, replace badly worn flooring, do tiling, and perform painting, roofing, plumbing, and air-conditioning work. I'm sure I've left some things out of that list, but you can name just about anything having to do with repairing a house and Tim has done it.

On the other hand, I have done a few things such as painting and mowing the lawn, but I don't hesitate to call in the pros to take on the other work. First, I don't have the skills necessary to perform some of the more involved repairs. Second, I don't have the desire to do them. This is not to say that I couldn't learn how to make some of the more complex repairs, but I have no desire to. As one who is naturally well organized and possesses good management skills, I much prefer to call in the proper tradesperson and pay him or her to do the work. I consider this to be a much better use of my time than trying to do the work myself. Because I naturally enjoy planning and preparing for upcoming events, I take the time (long before I close on a property) to ensure that my tradespeople, who are all more skilled than I am when it comes to fixing houses, are ready to perform the work as soon as I need them. For me, this is a much more efficient process than trying to do everything myself.

I recall one time in particular when Tim had just purchased a single-family house that he was going to renovate and subsequently flip. About the same time, I had just purchased an apartment building that was also in need of some extensive rehab work. Tim, Mr. Do-It-Yourself, was committed to doing most of the rehab work by himself. Although he did have a little bit of help, Tim did most of the work on his own. I, on the other hand,

Mr. Hire-Everything-Out, was committed to doing none of the work myself and hiring all of it out. Since Tim had a full-time job, he was able to work on the house only after work and on weekends. As I recall, he gave up nights and weekends for three or four months to make the necessary renovations and prepare the house for resale. Meanwhile, I had all of the bids in for the required repairs on my apartment building before I had even closed, and I was ready to go the day after closing. Within about 30 to 45 days, the tradespeople were completely finished with the repair work and my property was ready for resale. In addition, since the building was fully occupied by tenants, I began initiating increases in the rents, which were justified by the recently completed improvements.

This example is meant to be an observation of fact only and is certainly not intended as a criticism of my brother, Tim, whom I love dearly. It is instead intended to illustrate the differences in the way the same tasks can be accomplished. Tim has his way of doing things, and I have my way of doing things. While Tim is saving money, I am saving time. To me, time is money, so I am really saving both time and money. To flip properties on a large scale, you cannot possibly do all of the required repairs yourself. You must decide if you are in the business of fixing houses or of buying and selling houses. If it is the latter, then you cannot afford to spend your time doing the repairs. The only exception to this may be when you are first getting started and are only doing one or two houses a year. At that level, you can probably justify taking the time to do some of the work on your own, but once you start ramping up your operation, you must begin scaling back your hands-on involvement and take care to make the best and most valuable use of your time, which is to organize and manage. Once you have your tradespeople in place and have fine-tuned your system, you have the ability to do 10, 20, 50, or even 100 houses per year.

Although it may initially appear that an investor would be giving up some of the profits by hiring out the rehab work, this is not necessarily the case. The key is to purchase the property at the

right price to begin with. In Chapter 6, I provided several examples of appropriate analysis methods to be used when selecting an investment property. I recommend that you factor into your analysis of potential investment opportunities the cost of having contractors do the required repairs. If your analysis does not provide an acceptable rate of return on your invested capital, then you simply pass on it and move on to the next deal. Do *not* fall into the trap of rationalizing your analysis by saying that since you really like this deal, you will go ahead and do all of the painting, for example, just to make the numbers work out. You are much better off passing on it and waiting for another opportunity, for it will surely come.

INCREASING YOUR PROPERTY'S MARKETABILITY

Congratulations! You've worked hard over the past few weeks or months renovating your investment property. You have increased the house's value by a significant amount, and it is now time to sell it and capture the profit margin that you have created! You can do several things to enhance the marketability of your property and to increase the exposure it receives. These include preplanning, heightened visibility through the MLS, offering a marketable product, pricing your property competitively, and offering incentives. (See Exhibit 10.2.)

Preplanning

Proper planning from start to finish is essential for you to be successful in this business. This includes planning for the sale of your property. After all, you are not rewarded for your efforts until the sale has been completed. Only then do you profit from your labors. You may be thinking that of course you are going to plan to sell your house, but you'd be surprised at how many investors wait until they get to that phase of the process before

Exhibit 10.2
Increase your property's marketability.

1. Use proper planning
2. Heighten visibility through MLS
3. Provide a marketable product
4. Price competitively
5. Offer incentives

they even begin to consider how they will sell their property. Earlier in this chapter ("Postentry Planning"), I discussed the necessity of scheduling your subcontractors long before the actual closing occurred so that you would be ready to go with your improvements immediately following the consummation of the sale. Planning your exit strategy is equally important, if not more so, than the postentry strategy. Ideally, you should begin thinking about how you are going to sell your house even before you purchase it. You should already have taken the steps to establish a well-defined sales plan so that you are ready to implement it immediately at the appropriate time.

Heightening Visibility through the MLS

The Multiple Listing Service (MLS) is a requisite tool to provide your property with maximum exposure. This means, of

course, that you will have to list your property for sale with a licensed real estate agent, unless you happen to be a licensed agent yourself. When your house is placed in the MLS, you gain immediate access to hundreds and even thousands of sales agents who have a potential interest in your property. Any one of them may have a prospective buyer with whom they are working who may be interested in exactly what you are selling. You cannot afford to forgo having your house listed for sale in the MLS. Remember that you are in the business of buying houses, refurbishing them, and selling them as quickly as possible. Your role in this business should be that of a manager. You are there to facilitate the process and to ensure that things happen when they are supposed to happen. You can certainly make the argument that you can save money by not having to pay the sales agent's commission, but that would be a weak argument at best. Using that logic, you are reverting to the "I can do it myself and save money" mode. Trying to sell the house yourself and save money is no different than trying to do all of the repairs yourself and save money. That rationale is shortsighted and will prevent you from maximizing your potential in this business. If you are not a licensed real estate agent already, I recommend you find a top-producing agent who has a proven track record of being a mover and a shaker. In other words, look for a competent agent who is serious about helping you sell your properties as quickly as possible. In Chapter 2, I described the role of the dealer as it relates to flipping properties. I mentioned that while dealers can be a good source for bringing you investment opportunities, they can also be a good source for selling those properties for you once the necessary improvements have been made. Dealers are particularly fond of this type of relationship as it enables them to double-dip, meaning that not only do they earn a commission when they sell the property *to* you, but they also earn a commission when they sell the property *for* you. If you have a good relationship with sales agents or dealers and are listing several properties with them on a continuing basis, chances are they will be willing to negotiate their fee structure with you. The

most important thing for you here is to maximize the visibility of the property you are selling so that you can gain ready access to as large a pool of buyers as possible.

Offering a Marketable Product

To further enhance the marketability of your house, you must offer a product that people want. As simple as this may sound, this is an important point that shouldn't be taken lightly. Recall from Chapter 3 that as an investor who is in the business of flipping properties, you are not interested in carrying your inventory any longer than necessary. That means you should carefully study the area in which you are considering investing to determine which vicinities are selling with the shortest average number of days on the market. The type of location best suited for selling your properties in a timely manner is typically a neighborhood between 10 and 30 years old. These neighborhoods are where the average middle-class citizen lives. The ideal location is one in which the majority of homes are well maintained and that is is not suffering from functional obsolescence. The area should be well established, have good schools nearby, and continue to have homes that sell on average in fewer days than those of surrounding communities. Characteristics of this kind of neighborhood often include mature landscaping, pristine lawns, and well-cared-for homes. Be sure that the house you purchase fits in with the rest of the houses in the neighborhood. I have seen, for example, an ultracontemporary house in a mostly traditional neighborhood sit on the market much longer than other houses in the same neighborhood. You can't wait, of course, to make these kinds of decisions when it's time to sell. They must be made long before you even buy. In addition, your investment property should be presented to prospective buyers in its most favorable condition. Common sense dictates that after all of the subcontractors have finished their work, you must be willing to spend a little extra on a good cleaning service to put the finishing touches on your house

to make it really look like new. Housecleaning services typically do not cost much, and it is money well spent.

Competitive Pricing

If you did your homework before purchasing your investment property, you should already be intimately familiar with pricing in your market. I recommend making your house available for sale at a price just below market. As an investor who is in the business of flipping properties, you do not have time to sit on your house for an indefinite period in an attempt to hold out for top dollar. Remember that you have carrying costs, including interest, taxes, and insurance, so the quicker you sell the quicker you can relieve yourself of those obligations. In addition, you have an *opportunity cost,* meaning that as long as your investment capital is tied up in one property, you are limited in your ability to take advantage of other opportunities. You have become capitally constrained. Time is money in this business, so the quicker you can sell your property, the more money you will be capable of making.

Offering Incentives

If you are like most people, chances are you are motivated by money. Your prospective buyers will be motivated by money, too. You can use many different types of incentives that have some monetary value to encourage prospective buyers to purchase your house instead of the one down the street. For example, you can offer a credit at closing for landscaping. This will enable the buyers to beautify the exterior of their new home shortly after they move in. For many buyers, especially those who are first-time home buyers, it takes everything they have financially just to move in, so they will greatly appreciate having a little extra at closing. Whether the money is used for landscaping or any other purpose is really irrelevant. Your objective

is to give them a reason to buy your house now rather than continuing to shop around. Other incentives include agreeing to pay the buyer's closing costs (or a portion of them), offering to throw in free appliances, or giving them a gift certificate from a local moving company to help offset their moving expenses.

SUMMARY

In summary, we have discussed the three most important keys that, when properly applied, will enable you to maximize your potential in the real estate business. We examined a variety of postentry strategies, analyzed the advantages and disadvantages of doing the necessary repairs yourself versus hiring the work out, and reviewed several methods to increase the marketability of your property. The three principles outlined in this chapter will enable you to maximize your potential in the real estate arena when regularly and consistently applied. Each of these essential elements takes time to master. You must be willing not only to apply yourself, but to be patient as you do so. Life is full of adversities and challenges that can test the measure of who we are. We must be willing to meet these challenges with courage and determination. We must be prepared to respond, not to react, to adverse circumstances. When we rise up to meet whatever challenges life presents us with, then and only then do we become victorious. Then and only then are our characters and our moral fiber strengthened. Then and only then can we become the kind of people that we truly wish to become.

> **I hope that I shall always possess firmness and virtue enough to maintain what I consider the most enviable of all titles, the character of an honest man.**
>
> ***—George Washington***

Chapter 11

The Three Principles of Power

In Chapter 10 of my previous book, *The Complete Guide to Buying and Selling Apartment Buildings*, I wrote about the five keys to your success as follows:

> The central focus of this book is on arming you with the specific tools necessary to identify potential acquisition candidates, to acquire and manage those properties once identified, to implement sound techniques for creating value, and finally, to capture all of that value, or as much of it as possible, through various exit strategies. The process by which all of this can be accomplished rests, I believe, on five keys that are crucial to success. These keys do not deal with the mechanical processes involved in buying and selling apartment buildings, but are grounded in principles fundamental to life itself. These laws deal with the human psyche. They govern our thoughts, which in turn, direct our actions. The failure to understand these keys—which can provide the foundation of happiness, and ultimately of success—will almost certainly guarantee your defeat.

The Five Keys to Success

1. Understanding risk
2. Overcoming fear of failure
3. Accepting responsibility
4. Willingness to persevere
5. Defining your sense of purpose

Although the book was comprehensive in dealing with the subject of apartment buildings, I received more correspondence from individuals who were moved and inspired by this chapter than by any other material in the book, a factor that I believe has largely contributed to its success. One such reader, David S. of West Hollywood, California, writes, "Your book has truly taught me about investing in apartment buildings, but more importantly it has taught me about life. . . . The words not only inspired this reader, but allowed me to see the importance of having a purpose." This chapter is much like Chapter 10 in *The Complete Guide to Buying and Selling Apartment Buildings.* In this chapter, I discuss what I refer to as the three principles of power. (See Figure 11.1.) These three principles have absolutely nothing to do with real estate in particular, yet everything to do with your success in it. For that matter, the three principles of power can be applied to any business or profession and are not just limited to real estate. Furthermore, these laws can be used in your personal life and, when properly applied, can be a source of great joy and happiness to you and to those with whom you associate.

Although I have a passion for investing in real estate, the things that I write in this chapter are far more important to me than finding the next house to buy or sell. These principles lie at the very core of my belief system. They are an integral part of who I am. They compel me each and every day to strive for a perfection that I know I will never achieve in this life. It is my hope to inspire you to incorporate these three principles of power into your belief system. Doing so will enable you to reach the highest level of achievement of which you are truly capable. You will be empow-

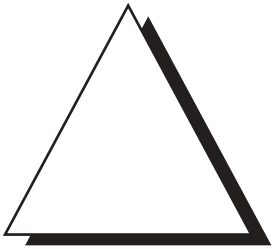

Exhibit 11.1
The three principles of power.

1. The Principle of Vision
2. The Principle of Passion
3. The Principle of Autonomy

ered to fulfill the measure of your creation, to reach your potential, and to enjoy the abundant gifts life has to offer.

The three principles of power can best be illustrated by sharing with you an example of how one man I knew applied them in his life. The principle of vision, the principle of passion, and the principle of autonomy are all embodied within his story. Although this individual is relatively unknown in corporate America's public business circles, he has had a profound impact on the retailing industry. He is, in fact, directly responsible for creating the largest and most successful single retail store in America! You may be thinking of Sam Walton, the founder of Wal-Mart. This is not Sam's story, however. It is instead the story of Jim "Mattress Mack" McIngvale. "Who is he?" you ask. If you've lived in or visited Houston, Texas, in the past 20 to 25 years, chances are you know who Mattress Mack is. His 30-second commercials on radio and television air continuously, averaging one every seven minutes of every hour, or about 200 a day! Jim McIngvale is the creator and founder of Houston-based Gallery Furniture. With annual sales in excess of $200 million, his single-site furniture store sells more furniture per square foot of retail space than any other store in the world!

I lived in Houston for a number of years and was thus exposed to at least a portion of Gallery's 200-plus commercials a day. I had always been impressed with the remarkable success of Jim McIngvale. Although I didn't know Jim personally, his face became a familiar sight, as he did all of his own commercials, which were always the low-budget type, with no paid actors. They featured Jim jumping up and down with a wad of money in his hand and shouting, "Gallery Furniture really will save . . . you . . . money!!" Jim is also a well-known community activist and participates in and supports many events in the Houston area. For example, Jim and Gallery Furniture are official sponsors of the Houston Rockets, and they are known for purchasing the grand champion steer each year at the Houston Livestock and Rodeo Show.

It wasn't until McIngvale's *Always Think Big* was published (Dearborn Trade, 2002) that I was able to learn more about what made Mattress Mack so successful. *Always Think Big* is the story of Jim's life experiences as they relate to his business and includes the factors that contributed to his extraordinary accomplishments. The three principles of power—vision, passion, and autonomy—are exemplified in his story. Jim McIngvale, who personifies these three principles, outlines his vision for what he intends to be the largest and most successful furniture store in Houston, which he vigorously and passionately carries out through a series of independent-minded and autonomous decisions, acting against the advice of other professionals.

THE PRINCIPLE OF VISION

The principle of vision is a fundamental and essential component of the three principles of power, as it provides the very foundation that enables you to enjoy and exercise the other two precepts—passion and autonomy. The principle of vision is a priceless treasure for which there is no substitute because it enables us to see where we are going long before we get there. Vision is the tool that gives us the power to create our own destiny.

Jim McIngvale's story of building the world's most productive

retail furniture store began with a vision. At the age of about 22, Jim, who had played football in high school and college, yearned to be like his father, "independent and self-reliant." In *Always Think Big,* Jim's vision of the person he wanted to become and what he wanted to do with his life had already begun. He states, "The 30-year plan of going to work for someone else was never a consideration for me. I'm an entrepreneur. I knew that I was going to start and run my own business."

Before going into the furniture business, however, Jim had suffered a devastating setback in the health club industry. His love of sports coupled with his entrepreneurial spirit led him to open six health clubs in Dallas, Texas, within a five-year period. Jim recalls, "Sometime after opening my third club, I realized I wasn't paying attention to my customers, couldn't watch or examine the business details, and failed to make many scheduled meetings." It wasn't long after that the cash flow from the health clubs began to dry up, and Jim knew that the stores were in trouble. He writes, "Finally, when the cash could no longer be shuffled from club to club, and from club to creditors at a satisfactory rate, I had to file for bankruptcy protection. I was devastated." To make matters even worse, Jim was served with divorce papers by his wife's attorney shortly thereafter. The financial stress and pressure had not only ruined him financially, but it had also ruined his family.

Jim McIngvale sold his car, broke the lease on his luxury apartment, and moved back in with his parents, stripped not only of all his worldly possessions, but also of his pride and self-esteem. He began to sink into a dark state of despair and depression. He had lost all hope and sense of purpose. His life became meaningless. In his despondent state, Jim's battered spirit suffered greater and greater emotional trauma with each passing day. His love of life, his dreams of success, his hope for a brighter future were all but lost. In *Always Think Big,* Jim writes,

> I spent days at a time without leaving my parent's house. I felt like a failure. When I looked in the mirror, I thought to myself that I even looked like a failure. A mostly shy and private person already, I was now becoming even

> more withdrawn. Talking became a burden. My depression began to feed on itself. The more depressed I got, the less functional I became. The less functional I became, the more depressed I got. It became a vicious cycle that anyone who has suffered from depression knows all too well. I had always had something to lift my spirits when things weren't going well—football, weight lifting, business. Now I wasn't sure what to do.

After several months of moping around his parent's house, Jim's dad had finally had enough. Although he had tried to be understanding of what Jim was going through, he decided that in order for Jim to climb out of the hole of self-pity, he was going to need a good kick in the pants. Actually, what he gave Jim was a kick right out of the front door. That's right. Just like a mother bird, Jim's dad pushed him right out of the nest to force him to fly—or in this case, to get back on his feet. He gave him exactly one week to find a place and get out.

The nudge Jim's father gave him turned out to be just what he needed. With very little money, Jim decided to approach his sister, who was married and had a family to care for, about staying with her for a few days until he could figure out what he wanted to do with his life. The following Sunday morning while watching TV, Oral Roberts happened to come on. Although Jim didn't much care for television evangelism, something was different on this day. It seemed as though Oral Roberts was speaking directly to him:

> Are you feeling as if you don't have the power to change? Do you feel as though you've lost control of your life? What should you do about it? Many people feel this way. The problem is, most people think small, and small results are what they get. The solution is to always think big. Think big and believe good things will happen. Think big and strive to achieve greater things each day. You have the choice. Think small and keep on getting small results, or think big and strive for goals that stretch your limits.

Oral Roberts's message was exactly what Jim needed to hear at that moment in his life. Jim had always been in the habit of thinking big and having vision, as he had with his health clubs. He had just suffered a minor and temporary setback. That was all. It was now time to get back on track. By the following Tuesday morning, he had already made up his mind about what he wanted to do. From the time he was a small boy, Jim had always been fascinated with furniture. He wasn't sure where that fascination stemmed from, but thought it probably had something to do with his mother. She constantly rearranged the furniture in the house, and from time to time, she bought new and unusual pieces with which to decorate. Jim determined right away that if he was going to open his own furniture store, he would first need to learn something about the business. He got a job at one of the local furniture stores in Dallas as a salesman and began to immediately apply himself to studying and learning everything he could about the business. After only five months, Jim McIngvale became the top sales producer in the store and was already planning his next move, which was to open his own store.

Jim had firmly believed in the message Oral Roberts delivered on that dark and lonely Sunday morning, the message of thinking big. Jim had a plan. He had a vision of opening the most successful furniture store in the city. The only problem was, he wasn't sure which city. He didn't want to compete against his former employer, who had given him an opportunity to prove himself. To fulfill his dream of owning the most successful furniture store in the city, that meant that it would have to be a different city. Jim had heard that Houston was experiencing strong growth, so he decided that's where he would have the best chance of becoming furniture king.

One of my all-time favorite quotes is by Zig Ziglar. He says, "Go as far as you can see, and when you get there, you can always see farther." Think about Zig's statement for a moment. While it is simplistic in structure, it is profound in meaning. Imagine traveling on a ship across the ocean and looking out across the vast expanse of water to the point where the sky meets the ocean. It is

referred to as the *horizon.* In this case, if you "go as far as you can see," you will travel on the ship to the point where you first saw the horizon. As you travel closer to that specific point, however, you realize that the horizon is now at a point beyond where you first saw it; hence, "when you get there, you can always see farther."

Zig Ziglar's quote aptly applies to having a vision of what you want to become or of how large you want to grow your real estate business. You will naturally not have all of the answers when you first start out. Your vision begins as a tiny seed. As you water and nourish it, it will begin to grow. Just like the seed, your vision needs food and nourishment. This means that in addition to being a dreamer or a visionary, you must also be a doer. You must act on your vision or it will never bear fruit. The more you act on achieving your dreams, the clearer they will become to you. As you take steps toward fulfilling your vision, the vision will begin to crystallize and become more well defined with each passing day. "Go as far as you can see, and when you get there, you can always see farther."

That is exactly what Jim McIngvale did. He had a vision of owning and operating the largest and most successful furniture store in Houston. When Jim first started out, he didn't have all the answers. His vision was but a tiny seed. It was through his continued efforts to nourish the seed that he was able to successfully achieve his dream. With each passing day, Jim's dream became more and more vivid. It was beginning to take shape. The steps he needed to take to solidify and fulfill his dream were becoming crystal clear. Jim's approach was to do absolutely everything he could to delight the customer. His customers told him again and again that they didn't like having to wait four to six weeks for their furniture to be delivered, as was typical at other furniture stores. In *Always Think Big,* Jim describes this important aspect of his vision:

> The trickle of customers started to pick up over time, and I learned immediately that delivering furniture when the customer wants it had to become a Gallery promise. I wanted Gallery to be totally committed to same day

> delivery. This was an important anchor in my plan and vision of how to succeed in the furniture business.

As Jim listened intently each and every day to what his customers were telling him, he became absolutely convinced that the same-day approach to delivering furniture was the key to his success. Not only did Jim listen to his customers for information that would help fuel the growth of his business, he also observed other successful businesses to learn what steps they had taken to achieve success. Regarding Southwest Airlines, Jim notes,

> I had observed carefully and occasionally firsthand one particular segment of Southwest Airlines' approach to customers and how they repeatedly turned around and cleaned planes to meet schedules. I believed that Southwest's approach to meeting schedules could be applied to the furniture business. Even today, the practice of most furniture stores is to take a customer's order and deliver it in about six, ten, or fifteen weeks. I knew that this gap between purchase and delivery was disappointing and frustrating to customers. Southwest Airlines cut out all the frills and provided passengers with better, faster, and cheaper service. Why not better, faster, and cheaper delivery of furniture?

That is exactly what Jim "Mattress Mack" McIngvale did. He had a vision of becoming the most successful store in Houston. He didn't start out with all of the answers, but by going as far as he could see, he was always able to go farther when he got there. Jim watered and nourished his vision by acting on the feedback his customers were giving him and by observing other successful business. Jim's vision is no longer a dream. It has become a reality. By acting on his intense vision, Gallery Furniture of Houston now delivers furniture "better, faster, and cheaper" than any other furniture store in the world. The first principle of power, the principle of vision, enabled Jim McIngvale to achieve remarkable

heights in the furniture business. This principle can no doubt empower you to achieve extraordinary success in the real estate business as well. To those who would dare to dream, and dream big, Jim offers this wise counsel:

> Dreams can be powerful motivators for taking action. . . . Before you start to assemble your own plan and lessons to follow, think about what you want. . . . Don't hold back. Let your dream evolve. Most people have to learn how to dream again. When you were young, dreams were a natural process. Try to reestablish your ability to dream. Practice, practice, practice dreaming each day.

THE PRINCIPLE OF PASSION

Although having a vision is a good place to start, it is simply not enough. You must be absolutely *passionate* about that vision. To be passionate about a vision, an idea, or a cause means that you feel very strongly about it. You believe in that idea or vision with every fiber of your soul. In fact, you feel so strongly about your vision or your dream that you are compelled to act on it. It is that level of enthusiastic belief in a principle or idea that will enable you to be successful.

A vision often starts as an idea or strong belief in something. Over time it begins to take shape. The vision becomes more distinct and pronounced and as it does, your feelings about it begin to intensify. They become so strong, in fact, that you begin to pursue your dream with a passionate and zealous fervor. Jim "Mattress Mack" McIngvale is a perfect example of one who pursues his dreams with great passion. In *Always Think Big,* Jim asserts,

> My plan and dedication to success was burning and passionate. I would sell furniture, move furniture around, help deliver furniture, treat customers like royalty, and think up ways to outsell the competition. . . . I spent

> every minute selling, selling, selling. Each day required 100 percent focus on and attention to customers. . . . I had a powerful desire and determination to succeed. What I possessed was deeper than a goal or destination. I had a determination to be successful.

One of the benefits of being passionate about your vision is that the enthusiasm you exert is often contagious. If you believe with all your heart and soul in what you are trying to accomplish, that belief will begin to be shared by others. When you are passionate about your dreams, your actions tend to reflect a level of zeal and fervor that others can't help but notice. Although many of your associates will share your beliefs, there are those who will have no interest whatsoever in your ideas. While it is okay to share your vision with others, be careful not to impose it on them. Writing of his own personal experience, Jim affirms,

> One thing I learned through reading and observation is that there is a degree of fanaticism in some individuals that allows passion to actively destroy them in the long run. . . . Over the years I have learned to back off when others are smothered by my passion and determination. . . . I finally learned that not everyone can work at my pace. So what? As long as they treat customers right, delight them, and give Gallery their best, I can live with it. It took me years to learn the lesson that everyone is different and to respect these differences.

I encourage you to adapt the second principle of power, the principle of passion, in your pursuit of success. Believe with all of your heart, might, mind, and soul in the principles for which you stand. Transform your enthusiasm into determination and focused action tempered by respect for others. The fervent application of this principle has propelled many individuals to success. The principle of passion can help you to achieve your dreams.

THE PRINCIPLE OF AUTONOMY

The principle of autonomy is a crucial component of the three principles of power and is necessary to carry out and implement the first two, the principles of vision and of passion. Autonomy has to do with your ability to think and *act* independently of what others may think of you or your ideas. While it is imperative that you have a vision and are passionate about that vision, you must be confident enough within yourself to carry out that vision regardless of what others may say.

There are and will always be the naysayers of the world who will tell you that what you are trying to achieve simply cannot be done. They know because they have tried to do the same thing and have failed. This is not to suggest that you completely disregard what other people have to say. You should always be open-minded and welcome the input of others. To be autonomous, however, means that you are capable of making up your own mind. You listen to the suggestions of others, objectively evaluate the information, and then determine what course of action best fits your needs. In *Always Think Big,* Jim McIngvale describes the approach of traditional furniture establishments in delivering furniture and how he was told time after time that his vision of "buy it today and we'll deliver it tonight" would never work. In *Always Think Big,* Jim writes,

> Our competitors doubted that we could stick with the same day delivery approach. Gallery did, and we continue to prove them wrong. We enjoy being able to occasionally beat the customer to their home with their new furniture. Even today the Gallery delivery truck is waiting for some of our customers as they pull up to their homes. What a treat!

There you have it. Time after time, Jim McIngvale's competitors told him that it just couldn't be done. No one had succeeded in doing it before, and Gallery Furniture wouldn't be able to do it now. If Jim had listened to all the well-respected so-called experts in the furniture industry, he never would have succeeded in his

dream to build the largest and most successful furniture store in Houston. As it turns out, Jim was able to far surpass his original goal by building the most successful furniture store in the world!

The third principle of power, the principle of autonomy, is vital to your success in real estate. You must be able to think and act independently of what others may advise. Don't be afraid to stand up for what you so passionately believe in—your visions, your dreams, your aspirations. Business acquaintances, friends, and even family members will tell you that it "just simply can't be done." I encourage you to politely ignore their pessimistic remarks and exercise your own free will. The ability to act autonomously is what distinguishes a leader from a follower. You already have the seed of leadership within you. Now you must water it and nourish it. You can do that by standing up for the principles you so firmly believe in. As you do, your leadership skills will grow, enabling you to achieve your goals. Jim "Mattress Mack" McIngvale offers this sage advice to those who dare to pursue their dreams in spite of what others may say.

> The principle of thinking big should be another part of your personal plan. . . . If you believe that your body is what it is fed, so is your mind. If your mind only thinks small or is uncertain, then you will act accordingly. In addition to doing the necessary small things, you should also think big and think bold. Telling me that it was impossible to adhere to my promise of same day delivery was like a jump start to me. Instead of accepting the naysayers' views about furniture delivery, I made up my mind to prove the doubters wrong. I never doubted that Gallery could be the business that brings same day delivery into the furniture industry. I refused to accept the noise coming at me for being "foolish," a "huckster," and "crazy dreamer."
>
> Surrendering to the doubters and naysayers would have been easy. Surrendering or changing my big dream was never an option. The pessimistic, negative, can't-do-it thinking of others required me to focus, pay attention to

details, and to work around the clock. To me, pessimism, small thinking, and ridicule are poisons to be avoided.

In summary, adapting the three principles of power into your real estate investment strategy can mean the difference between success and failure. First, you must have a clear and distinct vision of what you want to achieve. While your vision may lack clarity and detail initially, remember that as you work toward fulfilling it, the vision will eventually become crystal clear as you draw closer to accomplishing it. Once again, in the words of Zig Ziglar, "Go as far as you can see, and when you get there, you can always see farther." Second, you must be passionate about your dreams and aspirations to be successful. Your passion and enthusiasm for your dreams demonstrate to others your level of commitment. Pursuing your vision with passion and zeal is a manifestation to them that you are indeed determined to succeed. Finally, you must be able to act autonomously. You must break the shackles of dependence that so easily bind the commoners. You have the power to set yourself free! By incorporating the three principles of power—vision, passion, and autonomy—into your life, you will not only be able to achieve your goals, but you will be able to far surpass them. Implementing these principles will enable you to attain the highest level of achievement of which you are capable. You will be empowered to fulfill the measure of your creation, to reach your true potential, and to enjoy the generous gifts life has to offer. Your capacity to soar to magnificent heights far beyond the reach of the general masses will become infinite in scope, unlimited in magnitude, and vastly immeasurable by ordinary standards. You have the power within you to create your destiny. I encourage you to apply these principles in your life, for, by doing so, you will not only be able to create your destiny, you will also be able to fulfill it.

What lies behind us and what lies before us are small matters compared to what lies within us.
—Ralph Waldo Emerson

APPENDIX A

PROPERTY INSPECTION CHECKLIST

Date _____

Property Information: Seller's Name
Address
Phone Number

For the Project: Project Name
Address
Other Information

INSTRUCTIONS: Inspect the project and carefully check whether all items meet the project specifications. Initial in the space marked Satisfactory if the item meets with your approval. If an item is not satisfactory, describe the problem in the Comments field. Add additional information where necessary. Modify the list to fit your finish schedule. After work on the noted items has been completed, you will need to make a second inspection and initial in the last box for final approval.

Item	Satisfactory	Comments	Est Cost
Foyer			
Floors			
Ceilings			
Walls			
Light fixtures			
Windows			
Doors			
Trim moldings			
Other			
Dining Room			
Floors			
Ceilings			
Walls			
Light fixtures			
Windows			
Doors			
Trim moldings			
Other			
Living Room			
Floors			
Ceilings			
Walls			
Woodwork			
Light fixtures			
Windows			
Doors			

Initialed by: Buyer __ Seller __

Item	Satisfactory	Comments	Est Cost
Trim moldings			
Fireplace			
Other			
Kitchen			
Floors			
Ceilings			
Walls			
Light fixtures			
Windows			
Doors			
Trim moldings			
Cabinets			
Countertop			
Sink			
Oven and range			
Hood and exhaust fan			
Microwave			
Dishwasher			
Disposal			
Trash compactor			
Other			
Breakfast Room			
Floors			
Ceilings			
Walls			
Light fixtures			
Windows			

Initialed by: Buyer __ Seller __

Item	Satisfactory	Comments	Est Cost
Doors			
Trim moldings			
Other			
Family Room			
Floors			
Ceilings			
Walls			
Light fixtures			
Windows			
Doors			
Trim moldings			
Woodwork			
Other			
Powder Room			
Floors			
Ceilings			
Walls			
Light fixtures			
Windows			
Doors			
Trim moldings			
Vanity			
Toilet			
Towel bar			
Paper holder			
Other			

Initialed by: Buyer __ Seller __

Item	Satisfactory	Comments	Est Cost
Utility Room			
Floors			
Ceilings			
Walls			
Light fixtures			
Windows			
Doors			
Trim moldings			
Hot water heater			
Furnace/heat pump			
Washer hookup			
Dryer hookup			
Other			
Master Bedroom			
Floors			
Ceilings			
Walls			
Light fixtures			
Windows			
Doors			
Trim moldings			
Other			
Master Bath			
Floors			
Ceilings			

Initialed by: Buyer __ Seller __

Item	Satisfactory	Comments	Est Cost
Walls			
Light fixtures			
Windows			
Doors			
Trim moldings			
Vanity			
Toilet			
Whirlpool/garden tub			
Shower			
Shower door			
Towel bar			
Paper holder			
Other			
Bedroom 2			
Floors			
Ceilings			
Walls			
Light fixtures			
Windows			
Doors			
Trim moldings			
Other			
Bedroom 3			
Floors			
Ceilings			
Walls			
Light fixtures			

Initialed by: Buyer __ Seller __

Item	Satisfactory	Comments	Est Cost
Windows			
Doors			
Trim moldings			
Other			
Bedroom 4			
Floors			
Ceilings			
Walls			
Light fixtures			
Windows			
Doors			
Trim moldings			
Other			
Bedroom 5			
Floors			
Ceilings			
Walls			
Light fixtures			
Windows			
Doors			
Trim moldings			
Other			
Bath 2			
Floors			

Initialed by: Buyer __ Seller __

Item	Satisfactory	Comments	Est Cost
Ceilings			
Walls			
Light fixtures			
Windows			
Doors			
Trim moldings			
Vanity			
Toilet			
Shower			
Shower door			
Towel bar			
Paper holder			
Other			
Bath 3			
Floors			
Ceilings			
Walls			
Light fixtures			
Windows			
Doors			
Trim moldings			
Vanity			
Toilet			
Whirlpool/garden tub			
Shower			
Shower door			
Towel bar			
Paper holder			
Other			

Initialed by: Buyer __ Seller __

Item	Satisfactory	Comments	Est Cost
Bath 4			
Floors			
Ceilings			
Walls			
Light fixtures			
Windows			
Doors			
Trim moldings			
Vanity			
Toilet			
Whirlpool/garden tub			
Shower			
Shower door			
Towel bar			
Paper holder			
Other			
Hallway			
Floors			
Ceilings			
Walls			
Light fixtures			
Windows			
Doors			
Trim moldings			
Other			

Initialed by: Buyer __ Seller __

Item	Satisfactory	Comments	Est Cost
Garage			
Floors			
Ceilings			
Walls			
Light fixtures			
Windows			
Doors			
Trim moldings			
Garage door			
Garage door opener			
Storage area			
Other			
Study / Library			
Floors			
Ceilings			
Walls			
Light fixtures			
Windows			
Doors			
Trim moldings			
Other			
Additional Room			
Floors			
Ceilings			
Walls			
Light fixtures			
Windows			

Initialed by: Buyer __ Seller __

Item	Satisfactory	Comments	Est Cost
Doors			
Trim moldings			
Other			
Exterior			
Paint			
Exterior veneer			
Chimney			
Roof			
Doors			
Walkways			
Driveway			
Light fixtures			
Outlets			
Vents, dryer, fans, etc.			
Deck			
Porches			
Brick			
Siding			
Other			
HVAC Equipment			
Furnace			
Air conditioner			
Filters			
Ducts and vents			
Other			
Electrical			
Outlets			

Initialed by: Buyer __ Seller __

Item	Satisfactory	Comments	Est Cost
Wall switches			
Wiring			
Breaker panel			
Circuit breakers			
Other			
Foundation			
Concrete slab			
Basement			
Cracks			
Settling			
Evidence of leaks			
Mold or mildew			
Other			

First Inspection

Having inspected the project listed herein, except for those specific items listed above, the Buyer accepts the project as is, in satisfactory condition and understands the Buyer will not have a claim against the Seller for any overlooked items not listed above that could have been seen in the Buyer's inspection. The Buyer has discussed the specific items with the Seller and understands that the Seller makes no guarantees or warranties other than those that are stated in the contract documents.

Seller's Signature _____ Date _____

Buyer's Signature _____ Date _____

Initialed by: Buyer __ Seller __

Appendix B

Owner and Subcontractor Agreement

This Agreement, Made as of January 2, in the Year of 2004.

Between the Owner:	Mr. H. A. Stephens 1234 N. Main St. (555) 555-5555
And the Subcontractor:	Cool's Air Conditioning Service License #123456 1234 S. Main St. (555) 555-4444
For the Project:	Sample A/C Project 4321 E. Main St.

Article 1. Scope of Work

1.1 Subcontractor has heretofore entered into a contract with said Owner to furnish all labor, materials and equipment to perform all work described below according to the construction documents.

Initialed by: Buyer __ Seller __

Article 2. Payment Terms

2.1 The Owner agrees to pay the Subcontractor within 14 days after the completion of the work and payment by the owner for such work.

2.2 Subcontractor understands and agrees that progress payment requests shall be written and given to the owner before Wednesday for payment on the following Friday. All work for the portion requested must be completed prior to the request for payment. The Owner will request a draw and payment will be made to the Subcontractor after the draw is received. Please note that a certificate of Workmen's Compensation Insurance must be received before the first payment is made or the Owner will hold a percentage needed to cover the labor portion of the job.

2.3 The Total Contract Amount shall be $3687.00

Article 3. Time of Completion

3.1 Subcontractor shall keep both an adequate size and properly trained crew on the job site so as to complete the project within 30 days and work within the project schedule.

Article 4. Change Orders

4.1 Subcontractor understands and agrees that no change orders or contract additions will be made unless agreed to in writing by Owner. If any additional work is performed and not covered in this contract, the Subcontractor proceeds at his own risk and expense. No alterations, additions, or small changes can be made in the work or method of the performance, without the written change order signed by the owner and Subcontractor.

Initialed by: Buyer __ Seller __

ARTICLE 5. CLEANUP

5.1 Subcontractor will be responsible for cleaning up the job on a daily basis, including all generated construction debris, drink cans, food wrappers, and/or other trash. If it becomes necessary, the Subcontractor will be back-charged for appropriate cleanup by deducting cleanup costs from payments.

ARTICLE 6. TAXES AND PERMITS

6.1 The Subcontractor understands and agrees to be responsible for all taxes, fees, and expenses imposed directly or indirectly for its work, labor, material, and services required to fulfill this contract. The Subcontractor is responsible for all permits pertaining to the law, ordinances, and regulations where the work is performed.

ARTICLE 7. INSURANCE

7.1 The Subcontractor shall maintain, at his own expense, full and complete insurance on its work until final approval of the work described in the contract. The Subcontractor shall not hold the Owner liable for any and all costs, damages, fees, and expenses from any claims arising on the project. Failure of the Subcontractor to maintain appropriate insurance coverage may deem a material breach, allowing the Owner to terminate this contract or to provide insurance at the Subcontractor's expense.

ARTICLE 8. LIQUIDATED DAMAGES

8.1 If the project is not substantially completed on the stated completion date, the Subcontractor shall pay to the Owner the

Initialed by: Buyer __ Seller __

sum of $100 per day for each calendar day of inexcusable delay until the work is substantially completed, as liquidated damages.

Article 9. Warranty

9.1 Subcontractor shall warranty all labor, materials, and equipment furnished on the project for one year against defects in workmanship or materials utilized. The manufacturer's warranty will prevail. No legal action of any kind relating to the project, project performance, or this contract shall be initiated by either party against the other party after five years beyond the completion of the project or cessation of work.

Article 10. Hazardous Materials, Waste, and Asbestos

10.1 Both parties agree that dealing with hazardous materials, waste, or asbestos requires specialized training, processes, precautions, and licenses. Therefore, unless the scope of this agreement includes the specific handling, disturbance, removal, or transportation of hazardous materials, waste, or asbestos, upon discovery of such hazardous materials the Subcontractor shall notify the Owner immediately and allow the Owner to contract with a properly licensed and qualified hazardous material owner.

Article 11. Arbitration of Disputes

11.1 Any controversy or claim arising out of or relating to this contract, or the breach thereof, shall be settled by arbitration administered by the American Arbitration Association under its Construction Industry Arbitration Rules, and judgment on the award rendered by the arbitrator(s) may be entered in any court having jurisdiction thereof.

Initialed by: Buyer __ Seller __

ARTICLE 12. ATTORNEY FEES

12.1 In the event of any arbitration or litigation relating to the project, project performance or this contract, the prevailing party shall be entitled to reasonable attorney fees, costs, and expenses.

ARTICLE 13. ACCEPTANCE

WITNESS our hand and seal on this ____ day of _____, 20__.

Signed in the presence of:

_____	_____
Owner's Name	**Date**
_____	_____
Subcontractor's Name	**Date**

Initialed by: Buyer __ Seller __

Appendix C

Sample Real Estate Forms

APPROVED BY THE TEXAS REAL ESTATE COMMISSION (TREC) 10-25-93

SELLER'S DISCLOSURE OF PROPERTY CONDITION

(SECTION 5.008, TEXAS PROPERTY CODE)

CONCERNING THE PROPERTY AT _____
(Street Address and City)

THIS NOTICE IS A DISCLOSURE OF SELLER'S KNOWLEDGE OF THE CONDITION OF THE PROPERTY AS OF THE DATE SIGNED BY SELLER AND IS NOT A SUBSTITUTE FOR ANY INSPECTIONS OR WARRANTIES THE PURCHASER MAY WISH TO OBTAIN. IT IS NOT A WARRANTY OF ANY KIND BY SELLER OR SELLER'S AGENTS.

Seller ☐ is ☐ is not occupying the Property. If unoccupied, how long since Seller has occupied the Property? _____

1. The Property has the items checked below [Write Yes (Y), No (N), or Unknown (U)]:

__Range	__Oven	__Microwave
__Dishwasher	__Trash Compactor	__Disposal
__Washer/Dryer Hookups	__Window Screens	__Rain Gutters
__Security System	__Fire Detection Equipment	__Intercom System
__TV Antenna	__Cable TV Wiring	__Satellite Dish
__Ceiling Fan(s)	__Attic Fan(s)	__Exhaust Fan(s)
__Central A/C	__Central Heating	__Wall/Window Air Conditioning
__Plumbing System	__Septic System	__Public Sewer System
__Patio/Decking	__Outdoor Grill	__Fences
__Pool	__Sauna	__Spa__Hot Tub
__Pool Equipment	__Pool Heater	__Automatic Lawn Sprinkler System
__Fireplace(s) & Chimney(Woodburning)	__Fireplace(s) & Chimney (Mock)	__Gas Lines (Nat./LP)
__Gas Fixtures	Garage:__Attached __Not Attached	__Carport
Garage Door Opener(s):	__Electronic	__Control(s)
Water Heater:	__Gas	__Electric

Water Supply: __City __Well __MUD __Co-op

Roof Type:_____ Age:_____(approx)

Are you (Seller) aware of any of the above items that are not in working condition, that have known defects, or that are in need of repair? ☐ Yes ☐ No ☐ Unknown. If yes, then describe. (Attach additional sheets if necessary): _____

2. Are you (Seller) aware of any known defects/malfunctions in any of the following? Write Yes (Y) if you are aware, write No (N) if you are not aware.

__Interior Walls	__Ceilings	__Floors
__Exterior Walls	__Doors	__Windows
__Roof	__Foundation/Slab(s)	__Basement
__Walls/Fences	__Driveways	__Sidewalks
__Plumbing/Sewers/Septics	__Electrical Systems	__Lighting Fixtures

__Other Structural Components (Describe) _____

01A TREC No. OP-H

Seller's Disclosure Notice Concerning the Property at _____ Page 2 10-25-93
(Street Address and City)

If the answer to any of the above is yes, explain. (Attach additional sheets if necessary): _____

3. Are you (Seller) aware of any of the following conditions? Write Yes (Y) if you are aware, write No (N) if you are not aware.

__Active Termites (includes wood-destroying insects)
__Termite or Wood Rot Damage Needing Repair
__Previous Termite Damage
__Previous Termite Treatment
__Previous Flooding
__Improper Drainage
__Water Penetration
__Located in 100-Year Floodplain
__Present Flood Insurance Coverage
__Previous Structural or Roof Repair
__Hazardous or Toxic Waste
__Asbestos Components
__Urea-formaldehyde Insulation
__Aluminum Wiring
__Landfill, Settling, Soil Movement, Fault Lines
__Radon Gas
__Previous Fires
__Subsurface Structure or Pits
__Lead Based Paint
__Unplatted Easements

If the answer to any of the above is yes, explain. (Attach additional sheets if necessary): _____

4. Are you (Seller) aware of any item, equipment, or system in or on the Property that is in need of repair? ☐ Yes (if you are aware) ☐ No (if you are not aware). If yes, explain (attach additional sheets as necessary). _____

5. Are you (Seller) aware of any of the following? Write Yes (Y) if you are aware, write No (N) if you are not aware.

__ Room additions, structural modifications, or other alterations or repairs made without necessary permits or not in compliance with building codes in effect at that time.

__ Homeowners' Association or maintenance fees or assessments.

__ Any "common area" (facilities such as pools, tennis courts, walkways, or other areas) co-owned in undivided interest with others.

__ Any notices of violations of deed restrictions or governmental ordinances affecting the condition or use of the Property.

__ Any lawsuits directly or indirectly affecting the Property.

__ Any condition on the Property which materially affects the physical health or safety of an individual.

If the answer to any of the above is yes, explain. (Attach additional sheets if necessary): _____

Date _____ Signature of Seller _____ Date _____ Signature of Seller _____

The undersigned purchaser hereby acknowledges receipt of the foregoing notice.

Date _____ Signature of Purchaser _____ Date _____ Signature of Purchaser _____

01A TREC No. OP-H

PROMULGATED BY THE TEXAS REAL ESTATE COMMISSION (TREC) 9-22-97

ONE TO FOUR FAMILY RESIDENTIAL CONTRACT (RESALE)
ALL CASH, ASSUMPTION, THIRD PARTY CONVENTIONAL OR SELLER FINANCING

NOTICE: Not For Use For Condominium Transactions

1. **PARTIES:** _____ (Seller) agrees to sell and convey to _____ (Buyer) and Buyer agrees to buy from Seller the property described below.

2. **PROPERTY:** Lot _____, Block _____, _____ Addition, City of _____, _____ County, Texas, known as _____ (Address/Zip Code), or as described on attached exhibit, together with the following items, if any: curtains and rods, draperies and rods, valances, blinds, window shades, screens, shutters, awnings, wall-to-wall carpeting, mirrors fixed in place, ceiling fans, attic fans, mail boxes, television antennas and satellite dish system with controls and equipment, permanently installed heating and air-conditioning units, window air-conditioning units, built-in security and fire detection equipment, plumbing and lighting fixtures including chandeliers, water softener, stove, built-in kitchen equipment, garage door openers with controls, built-in cleaning equipment, all swimming pool equipment and maintenance accessories, shrubbery, landscaping, permanently installed outdoor cooking equipment, built-in fireplace screens, artificial fireplace logs and all other property owned by Seller and attached to the above described real property except the following property which is not included: _____

_____

_____.

All property sold by this contract is called the "Property." The Property ❑ is ❑ is not subject to mandatory membership in an owners' association. The TREC Addendum For Property Subject To Mandatory Membership In An Owners' Association ❑ is ❑ is not attached.

3. **SALES PRICE:**
   A. Cash portion of Sales Price payable by Buyer at closing . . . . . $_____
   B. Sum of all financing described below
      (excluding any private mortgage insurance [PMI] premium) . . . . . $_____
   C. Sales Price (Sum of A and B) . . . . . $_____

4. **FINANCING:** Within _____ days after the effective date of this contract Buyer shall apply for all third party financing or noteholder's approval of any assumption and make every reasonable effort to obtain financing or assumption approval. Financing or assumption approval will be deemed to have been obtained when the lender determines that Buyer has satisfied all of lender's financial requirements (those items relating to Buyer's net worth, income and creditworthiness). If financing (including any financed PMI premium) or assumption approval is not obtained within _____ days after the effective date hereof, this contract will terminate and the earnest money will be refunded to Buyer. Each note to be executed hereunder must be secured by vendor's and deed of trust liens.
   The portion of Sales Price not payable in cash will be paid as follows: (Check applicable boxes below)
   ❑ A. THIRD PARTY FINANCING:
      ❑ (1) This contract is subject to approval for Buyer of a third party first mortgage loan having a loan-to-value ratio not to exceed _____ % as established by such third party (excluding any financed PMI premium), due in full in _____ year(s), with interest not to exceed _____ % per annum for the first _____ year(s) of the loan. The loan will be ❑ with ❑ without PMI.

Initialed for identification by Buyer_____ and Seller_____ **01A** TREC NO. 20-3

❑ (2) This contract is subject to approval for Buyer of a third party second mortgage loan having a loan-to-value ratio not to exceed _____ % as established by such third party (excluding any financed PMI premium), due in full in _____ year(s), with interest not to exceed _____ % per annum for the first _____ year(s) of the loan. The loan will be ❑ with ❑ without PMI.

❑ B. TEXAS VETERANS' HOUSING ASSISTANCE PROGRAM LOAN: This contract is subject to approval for Buyer of a Texas Veterans' Housing Assistance Program Loan (the Program Loan) of $_____ for a period of at least _____ years at the interest rate established by the Texas Veterans' Land Board at the time of closing.

❑ C. SELLER FINANCING: A promissory note from Buyer to Seller of $_____, bearing _____ % interest per annum, secured by vendor's and deed of trust liens, in accordance with the terms and conditions set forth in the attached TREC Seller Financing Addendum. If an owner policy of title insurance is furnished, Buyer shall furnish Seller with a mortgagee policy of title insurance.

❑ D. ASSUMPTION:

❑ (1) Buyer shall assume the unpaid principal balance of a first lien promissory note payable to _____ which unpaid balance at closing will be $ _____ . The total current monthly payment including principal, interest and any reserve deposits is $ _____ . Buyer's initial payment will be the first payment due after closing.

❑ (2) Buyer shall assume the unpaid principal balance of a second lien promissory note payable to _____ which unpaid balance at closing will be $ _____ . The total current monthly payment including principal, interest and any reserve deposits is $ _____ . Buyer's initial payment will be the first payment due after closing.

Buyer's assumption of an existing note includes all obligations imposed by the deed of trust securing the note.

If the unpaid principal balance(s) of any assumed loan(s) as of the Closing Date varies from the loan balance(s) stated above, the ❑ cash payable at closing ❑ Sales Price will be adjusted by the amount of any variance; provided, if the total principal balance of all assumed loans varies in an amount greater than $350.00 at closing, either party may terminate this contract and the earnest money will be refunded to Buyer unless the other party elects to eliminate the excess in the variance by an appropriate adjustment at closing. If the noteholder requires (a) payment of an assumption fee in excess of $ _____ in D(1) above or $ _____ in D(2) above and Seller declines to pay such excess, or (b) an increase in the interest rate to more than _____ % in D(1) above, or _____ % in D(2) above, or (c) any other modification of the loan documents, Buyer may terminate this contract and the earnest money will be refunded to Buyer. A vendor's lien and deed of trust to secure assumption will be required which shall automatically be released on execution and delivery of a release by noteholder. If Seller is released from liability on any assumed note, the vendor's lien and deed of trust to secure assumption will not be required.

NOTICE TO BUYER: The monthly payments, interest rates or other terms of some loans may be adjusted by the lender at or after closing. If you are concerned about the possibility of future adjustments, do not sign the contract without examining the notes and deeds of trust.

NOTICE TO SELLER: Your liability to pay the note assumed by Buyer will continue unless you obtain a release of liability from the lender. If you are concerned about future liability, you should use the TREC Release of Liability Addendum.

❑ E. CREDIT APPROVAL ON ASSUMPTION OR SELLER FINANCING: Within _____ days after the effective date of this contract, Buyer shall deliver to Seller ❑ credit report ❑ verification of employment, including salary ❑ verification of funds on deposit in financial institutions ❑ current financial statement to establish Buyer's creditworthiness for assumption approval or seller financing and ❑ _____
_____.

If Buyer's documentation is not delivered within the specified time, Seller may terminate this contract by notice to Buyer within 7 days after expiration of the time for delivery, and the earnest money will

be paid to Seller. If this contract is not so terminated, Seller will be deemed to have accepted Buyer's credit. If the documentation is timely delivered, and Seller determines in Seller's sole discretion that Buyer's credit is unacceptable, Seller may terminate this contract by notice to Buyer within 7 days after expiration of the time for delivery and the earnest money will be refunded to Buyer. If Seller does not so terminate this contract, Seller will be deemed to have accepted Buyer's credit. Buyer hereby authorizes any credit reporting agency to furnish to Seller at Buyer's sole expense copies of Buyer's credit reports.

5. **EARNEST MONEY:** Buyer shall deposit $_____ as earnest money with _____ _____ at _____ (Address), as escrow agent, upon execution of this contract by both parties. Additional earnest money of $_____ must be deposited by Buyer with escrow agent on or before _____, 19____. If Buyer fails to deposit the earnest money as required by this contract, Buyer will be in default.

6. **TITLE POLICY AND SURVEY:**

❑ A. TITLE POLICY: Seller shall furnish to Buyer at ❑ Seller's ❑ Buyer's expense an owner policy of title insurance (the Title Policy) issued by _____(the Title Company) in the amount of the Sales Price, dated at or after closing, insuring Buyer against loss under the provisions of the Title Policy, subject to the promulgated exclusions (including existing building and zoning ordinances) and the following exceptions:

(1) Restrictive covenants common to the platted subdivision in which the Property is located.
(2) The standard printed exception for standby fees, taxes and assessments.
(3) Liens created as part of the financing described in Paragraph 4.
(4) Utility easements created by the dedication deed or plat of the subdivision in which the Property is located.
(5) Reservations or exceptions otherwise permitted by this contract or as may be approved by Buyer in writing.
(6) The standard printed exception as to discrepancies, conflicts, shortages in area or boundary lines, encroachments or protrusions, or overlapping improvements.
(7) The standard printed exception as to marital rights.
(8) The standard printed exception as to waters, tidelands, beaches, streams, and related matters.

Within 20 days after the Title Company receives a copy of this contract, Seller shall furnish to Buyer a commitment for title insurance (the Commitment) and, at Buyer's expense, legible copies of restrictive covenants and documents evidencing exceptions in the Commitment other than the standard printed exceptions. Seller authorizes the Title Company to mail or hand deliver the Commitment and related documents to Buyer at Buyer's address shown below. If the Commitment is not delivered to Buyer within the specified time, the time for delivery will be automatically extended up to 15 days. Buyer will have 7 days after the receipt of the Commitment to object in writing to matters disclosed in the Commitment.

❑ B. SURVEY: (Check one box only)

❑ (1) Within_____ days after Buyer's receipt of a survey furnished to a third-party lender at ❑ Seller's ❑ Buyer's expense, Buyer may object in writing to any matter shown on the survey which constitutes a defect or encumbrance to title.

❑ (2) Within_____ days after the effective date of this contract, Buyer may object in writing to any matter which constitutes a defect or encumbrance to title shown on a survey obtained by Buyer at Buyer's expense.

The survey must be made by a Registered Professional Land Surveyor acceptable to the Title Company and any lender. Utility easements created by the dedication deed and plat of the subdivision in which the Property is located will not be a basis for objection.

Buyer may object to existing building and zoning ordinances, items 6A(1) through (8) above and matters shown on the survey if Buyer determines that any such ordinance, items or matters prohibits the following use or activity: _____
_____

Buyer's failure to object under Paragraph 6A or 6B within the time allowed will constitute a waiver of Buyer's right to object; except that the requirements in Schedule C of the Commitment will not be deemed to have been waived. Seller shall cure the timely objections of Buyer or any third party lender within 15 days from the date Seller receives the objections and the Closing Date will be extended as necessary. If objections are not cured by the extended Closing Date, this contract will terminate and the earnest money will be refunded to Buyer unless Buyer elects to waive the objections.

NOTICE TO SELLER AND BUYER:

(1) Broker advises Buyer to have an abstract of title covering the Property examined by an attorney of Buyer's selection, or Buyer should be furnished with or obtain a Title Policy. If a Title Policy is furnished, the Commitment should be promptly reviewed by an attorney of Buyer's choice due to the time limitations on Buyer's right to object.

(2) If the Property is situated in a utility or other statutorily created district providing water, sewer, drainage, or flood control facilities and services, Chapter 49 of the Texas Water Code requires Seller to deliver and Buyer to sign the statutory notice relating to the tax rate, bonded indebtedness, or standby fee of the district prior to final execution of this contract.

(3) If the Property abuts the tidally influenced waters of the state, Section 33.135, Texas Natural Resources Code, requires a notice regarding coastal area property to be included in the contract. An addendum either promulgated by TREC or required by the parties should be used.

(4) Buyer is advised that the presence of wetlands, toxic substances, including asbestos and wastes or other environmental hazards or the presence of a threatened or endangered species or its habitat may affect Buyer's intended use of the Property. If Buyer is concerned about these matters, an addendum either promulgated by TREC or required by the parties should be used.

(5) Unless expressly prohibited in writing by the parties, Seller may continue to show the Property for sale and to receive, negotiate and accept back up offers.

(6) Any residential service contract that is purchased in connection with this transaction should be reviewed for the scope of coverage, exclusions and limitations. **The purchase of a residential service contract is optional. Similar coverage may be purchased from various companies authorized to do business in Texas.**

7. PROPERTY CONDITION:

A. INSPECTIONS, ACCESS AND UTILITIES: Buyer may have the Property inspected by an inspector selected by Buyer, licensed by TREC or otherwise permitted by law to make such inspections. Seller shall permit access to the Property at reasonable times for inspection, repairs and treatment and for reinspection after repairs and treatment have been completed. Seller shall pay for turning on utilities for inspection and reinspection.

B. SELLER'S DISCLOSURE NOTICE PURSUANT TO SECTION 5.008, TEXAS PROPERTY CODE (Notice) (check one box only):

❑ (1) Buyer has received the Notice.

❑ (2) Buyer has not received the Notice. Within _____ days after the effective date of this contract, Seller shall deliver the Notice to Buyer. If Buyer does not receive the Notice, Buyer may terminate this contract at any time prior to the closing. If Seller delivers the Notice, Buyer may terminate this contract for any reason within 7 days after Buyer receives the Notice or prior to the closing, whichever first occurs.

❑ (3) The Texas Property Code does not require this Seller to furnish the Notice.

C. SELLER'S DISCLOSURE OF LEAD-BASED PAINT AND LEAD-BASED PAINT HAZARDS is required by Federal law for a residential dwelling constructed prior to 1978. An addendum providing such disclosure ❑ is ❑ is not attached.

D. ACCEPTANCE OF PROPERTY CONDITION: (check one box only):

❑ (1) In addition to any earnest money deposited with escrow agent, Buyer has paid Seller $_____ (the "Option Fee") for the unrestricted right to terminate this contract by giving notice of termination to Seller within _____ days after the effective date of this contract. If Buyer gives notice of termination within the time specified, the Option Fee will not be refunded, however, any earnest money will be refunded to Buyer. If Buyer does not give notice of

termination within the time specified, Buyer will be deemed to have accepted the Property in its current condition and the Option Fee ❑ will ❑ will not be credited to the Sales Price at closing.

❑ (2) Buyer accepts the Property in its present condition; provided Seller, at Seller's expense, shall complete the following repairs and treatment: _____

_____

_____.

E. LENDER REQUIRED REPAIRS AND TREATMENTS (REPAIRS): Unless otherwise agreed in writing, neither party is obligated to pay for lender required repairs or treatments for wood destroying insects. If the cost of lender required repairs exceeds 5% of the Sales Price, Buyer may terminate this contract.

F. COMPLETION OF REPAIRS AND TREATMENT. Unless otherwise agreed by the parties in writing, Seller shall complete all agreed repairs and treatment prior to the Closing Date. Repairs and treatments must be performed by persons who regularly provide such repairs or treatments. At Buyer's election, any transferable warranties received by Seller with respect to the repairs will be transferred to Buyer at Buyer's expense. If Seller fails to complete any agreed repairs and treatment prior to the Closing Date, Buyer may do so and the Closing Date will be extended up to 15 days, if necessary, to complete repairs and treatment or treatments for wood destroying insects.

8. **BROKERS' FEES:** All obligations of the parties for payment of brokers' fees are contained in separate written agreements.

9. **CLOSING:** The closing of the sale will be on or before _____, 19____, or within 7 days after objections to matters disclosed in the Commitment or by the survey have been cured, whichever date is later (the Closing Date). *If financing or assumption approval has been obtained pursuant to Paragraph 4,* the Closing Date will be extended up to 15 days if necessary to comply with lender's closing requirements (for example, appraisal, survey, insurance policies, lender-required repairs, closing documents). If either party fails to close this sale by the Closing Date, the non-defaulting party will be entitled to exercise the remedies contained in Paragraph 15. At closing Seller shall furnish tax statements or certificates showing no delinquent taxes and a general warranty deed conveying good and indefeasible title showing no additional exceptions to those permitted in Paragraph 6.

10. **POSSESSION:** Seller shall deliver possession of the Property to Buyer on _____ in its present or required repaired condition, ordinary wear and tear excepted. Any possession by Buyer prior to closing or by Seller after closing which is not authorized by a temporary lease form promulgated by TREC or required by the parties will establish a tenancy at sufferance relationship between the parties. *Consult your insurance agent prior to change of ownership or possession as insurance coverage may be limited or terminated. The absence of a written lease or appropriate insurance coverage may expose the parties to economic loss.*

11. **SPECIAL PROVISIONS:** (Insert only factual statements and business details applicable to this sale. TREC rules prohibit licensees from adding factual statements or business details for which a contract addendum, lease or other form has been promulgated by TREC for mandatory use.)

12. SETTLEMENT AND OTHER EXPENSES:

A. The following expenses must be paid at or prior to closing:

(1) Appraisal fees will be paid by _____.

(2) The total of loan discount fees (including any Texas Veterans' Housing Assistance Program Participation Fee) may not exceed _____% of the loan of which Seller shall pay _____ and Buyer shall pay the remainder. The total of any buydown fees may not exceed _____ which will be paid by _____.

(3) Seller's Expenses: Releases of existing liens, including prepayment penalties and recording fees; release of Seller's loan liability; tax statements or certificates; preparation of deed; one-half of escrow fee; and other expenses stipulated to be paid by Seller under other provisions of this contract.

(4) Buyer's Expenses: Loan application, origination and commitment fees; loan assumption costs; preparation and recording of deed of trust to secure assumption; lender required expenses incident to new loans, including PMI premium, preparation of loan documents, loan related inspection fee, recording fees, tax service and research fees, warehouse or underwriting fees, copies of restrictions and easements, amortization schedule, premiums for mortgagee title policies and endorsements required by lender, credit reports, photos; required premiums for flood and hazard insurance; required reserve deposit for insurance premiums and ad valorem taxes; interest on all monthly installment notes from date of disbursements to one month prior to dates of first monthly payments; customary Program Loan costs for Buyer; one-half of escrow fee; and other expenses stipulated to be paid by Buyer under other provisions of this contract.

B. If any expense exceeds an amount expressly stated in this contract for such expense to be paid by a party, that party may terminate this contract unless the other party agrees to pay such excess. In no event will Buyer pay charges and fees expressly prohibited by the Texas Veterans' Housing Assistance Program or other governmental loan program regulations.

13. PRORATIONS: Taxes for the current year, interest, maintenance fees, assessments, dues and rents will be prorated through the Closing Date. If taxes for the current year vary from the amount prorated at closing, the parties shall adjust the prorations when tax statements for the current year are available. *If a loan is assumed* and the lender maintains an escrow account, the escrow account must be transferred to Buyer without any deficiency. Buyer shall reimburse Seller for the amount in the transferred account. Buyer shall pay the premium for a new insurance policy. If taxes are not paid at or prior to closing, Buyer will be obligated to pay taxes for the current year.

14. CASUALTY LOSS: If any part of the Property is damaged or destroyed by fire or other casualty loss after the effective date of the contract, Seller shall restore the Property to its previous condition as soon as reasonably possible, but in any event by the Closing Date. If Seller fails to do so due to factors beyond Seller's control, Buyer may either (a) terminate this contract and the earnest money will be refunded to Buyer (b) extend the time for performance up to 15 days and the Closing Date will be extended as necessary or (c) accept the Property in its damaged condition and accept an assignment of insurance proceeds. Seller's obligations under this paragraph are independent of any obligations of Seller under Paragraph 7.

15. DEFAULT: If Buyer fails to comply with this contract, Buyer will be in default, and Seller may either (a) enforce specific performance, seek such other relief as may be provided by law, or both, or (b) terminate this contract and receive the earnest money as liquidated damages, thereby releasing both parties from this contract. If, due to factors beyond Seller's control, Seller fails within the time allowed to make any non-casualty repairs or deliver the Commitment, Buyer may either (a) extend the time for performance up to 15 days and the Closing Date will be extended as necessary or (b) terminate this contract as the sole remedy and receive the earnest money. If Seller fails to comply with this contract for any other reason, Seller will be in default and Buyer may either (a) enforce specific performance, seek such other relief as may be provided by law, or both, or (b) terminate this contract and receive the earnest money, thereby releasing both parties from this contract.

16. **DISPUTE RESOLUTION:** It is the policy of the State of Texas to encourage the peaceable resolution of disputes through alternative dispute resolution procedures. The parties are encouraged to use an addendum approved by TREC to submit to mediation disputes which cannot be resolved in good faith through informal discussion.

17. **ATTORNEY'S FEES:** The prevailing party in any legal proceeding brought under or with respect to the transaction described in this contract is entitled to recover from the non-prevailing party all costs of such proceeding and reasonable attorney's fees.

18. **ESCROW:** The earnest money is deposited with escrow agent with the understanding that escrow agent is not (a) a party to this contract and does not have any liability for the performance or nonperformance of any party to this contract, (b) liable for interest on the earnest money and (c) liable for any loss of earnest money caused by the failure of any financial institution in which the earnest money has been deposited unless the financial institution is acting as escrow agent. At closing, the earnest money must be applied first to any cash down payment, then to Buyer's closing costs and any excess refunded to Buyer. If both parties make written demand for the earnest money, escrow agent may require payment of unpaid expenses incurred on behalf of the parties and a written release of liability of escrow agent from all parties. If one party makes written demand for the earnest money, escrow agent shall give notice of the demand by providing to the other party a copy of the demand. If escrow agent does not receive written objection to the demand from the other party within 30 days after notice to the other party, escrow agent may disburse the earnest money to the party making demand reduced by the amount of unpaid expenses incurred on behalf of the party receiving the earnest money and escrow agent may pay the same to the creditors. If escrow agent complies with the provisions of this paragraph, each party hereby releases escrow agent from all adverse claims related to the disbursal of the earnest money. Escrow agent's notice to the other party will be effective when deposited in the U. S. Mail, postage prepaid, certified mail, return receipt requested, addressed to the other party at such party's address shown below. Notice of objection to the demand will be deemed effective upon receipt by escrow agent.

19. **REPRESENTATIONS:** Seller represents that as of the Closing Date (a) there will be no liens, assessments, or security interests against the Property which will not be satisfied out of the sales proceeds unless securing payment of any loans assumed by Buyer and (b) assumed loans will not be in default. If any representation in this contract is untrue on the Closing Date, this contract may be terminated by Buyer and the earnest money will be refunded to Buyer. All representations contained in this contract will survive closing.

20. **FEDERAL TAX REQUIREMENT:** If Seller is a "foreign person," as defined by applicable law, or if Seller fails to deliver an affidavit that Seller is not a "foreign person," then Buyer shall withhold from the sales proceeds an amount sufficient to comply with applicable tax law and deliver the same to the Internal Revenue Service together with appropriate tax forms. IRS regulations require filing written reports if cash in excess of specified amounts is received in the transaction.

21. **AGREEMENT OF PARTIES:** This contract contains the entire agreement of the parties and cannot be changed except by their written agreement. Addenda which are a part of this contract are (list): _____
_____
_____
_____
_____
_____.

22. **CONSULT YOUR ATTORNEY:** Real estate licensees cannot give legal advice. This contract is intended to be legally binding. READ IT CAREFULLY. If you do not understand the effect of this contract, consult your attorney BEFORE signing.

Buyer's Attorney is:_____ Seller's Attorney is:_____

One to Four Family Residential Contract Concerning _____ Page Eight 9-22-97
(Address of Property)

23. **NOTICES:** All notices from one party to the other must be in writing and are effective when mailed to, hand-delivered at, or transmitted by facsimile machine as follows:

To Buyer at:	**To Seller at:**
_____	_____
_____	_____
_____	_____
Telephone:(___) _____	Telephone:(___) _____
Facsimile:(___) _____	Facsimile:(___) _____

EXECUTED the _____day of _____, 19___ (THE EFFECTIVE DATE). (BROKER: FILL IN THE DATE OF FINAL ACCEPTANCE.)

_____ Buyer	_____ Seller
_____ Buyer	_____ Seller

The form of this contract has been approved by the Texas Real Estate Commission. Such approval relates to this contract form only. No representation is made as to the legal validity or adequacy of any provision in any specific transaction. It is not suitable for complex transactions. Extensive riders or additions are not to be used. Texas Real Estate Commission, P.O. Box 12188, Austin, TX 78711-2188, 1-800-250-8732 or (512) 459-6544 (http://www.trec.state.tx.us) TREC NO. 20-3. This form replaces TREC NO. 20-2.

BROKER INFORMATION AND RATIFICATION OF FEE

Listing Broker has agreed to pay Other Broker _____ of the total sales price when Listing Broker's fee is received. Escrow Agent is authorized and directed to pay Other Broker from Listing Broker's fee at closing.

Other Broker _____ License No.	Listing Broker _____ License No.
represents ❑ Seller as Listing Broker's subagent ❑ Buyer only as Buyer's agent	represents ❑ Seller and Buyer as an intermediary ❑ Seller only as Seller's agent
	Listing Associate _____ Telephone
Associate _____ Telephone	Selling Associate _____ Telephone
Broker Address _____	Broker Address _____
Telephone _____ Facsimile	Telephone _____ Facsimile

RECEIPT

Receipt of ❑ Contract and ❑ $_____ Earnest Money in the form of_____is acknowledged.

Escrow Agent: _____ Date: _____, 19___

By:_____

Address _____ Telephone: (____) _____

City _____ State _____ Zip Code _____ Facsimile: (____) _____

01A TREC NO. 20-3

10-29-01

EQUAL HOUSING OPPORTUNITY

PROMULGATED BY THE TEXAS REAL ESTATE COMMISSION (TREC)

THIRD PARTY FINANCING CONDITION ADDENDUM

TO CONTRACT CONCERNING THE PROPERTY AT

_____

(Street Address and City)

Buyer shall apply promptly for all financing described below and make every reasonable effort to obtain financing approval. Financing approval will be deemed to have been obtained when the lender determines that Buyer has satisfied all of lender's financial requirements (those items relating to Buyer's assets, income and credit history). If financing (including any financed PMI premium) approval is not obtained within ____ days after the effective date, this contract will terminate and the earnest money will be refunded to Buyer. Each note must be secured by vendor's and deed of trust liens.

CHECK APPLICABLE BOXES:

❑ A. CONVENTIONAL FINANCING:

❑ (1) A first mortgage loan in the principal amount of $ _____ (excluding any financed PMI premium), due in full in _____ year(s), with interest not to exceed _____% per annum for the first _____year(s) of the loan with Loan Fees not to exceed _____ % of the loan. The loan will be ❑ with ❑ without PMI.

❑ (2) A second mortgage loan in the principal amount of $_____(excluding any financed PMI premium), due in full in _____year(s), with interest not to exceed _____% per annum for the first _____year(s) of the loan with Loan Fees not to exceed _____ % of the loan. The loan will be ❑ with ❑ without PMI.

❑ B. TEXAS VETERANS' HOUSING ASSISTANCE PROGRAM LOAN: A Texas Veteran's Housing Assistance Program Loan of $_____ for a period of at least _____years at the interest rate established by the Texas Veteran's Land Board at the time of closing.

❑ C. FHA INSURED FINANCING: A Section _____ FHA insured loan of not less than $_____ (excluding any financed MIP), amortizable monthly for not less than _____years, with interest not to exceed _____% per annum for the first _____year(s) of the loan with Loan Fees not to exceed _____ % of the loan. As required by HUD-FHA, if FHA valuation is unknown, *"It is expressly agreed that, notwithstanding any other provision of this contract, the purchaser (Buyer) shall not be obligated to complete the purchase of the Property described herein or to incur any penalty by forfeiture of earnest money deposits or otherwise unless the purchaser (Buyer) has been given in accordance with HUD/FHA or VA requirements a written statement issued by the Federal Housing Commissioner, Department of Veterans Affairs, or a Direct Endorsement Lender setting forth the appraised value of the Property of not less than $_____. The purchaser (Buyer) shall have the privilege and option of proceeding with consummation of the contract without regard to the amount of the appraised valuation. The appraised valuation is arrived at to determine the maximum mortgage the Department of Housing and Urban Development will insure. HUD does not warrant the value or the condition of the Property. The purchaser (Buyer) should satisfy himself/herself that the price and the condition of the Property are acceptable."*

If the FHA appraised value of the Property (excluding closing costs and MIP) is less than the Sales Price, Seller may reduce the Sales Price to an amount equal to the FHA appraised value (excluding closing costs and MIP) and the sale will be closed at the lower Sales Price with proportionate adjustments to the down payment and loan amount.

Initialed for identification by Buyer_____ and Seller_____ **01A**

_____
(Address of Property)

☐ D. VA GUARANTEED FINANCING: A VA guaranteed loan of not less than $_____ (excluding any financed Funding Fee), amortizable monthly for not less than_____years, with interest not to exceed_____% per annum for the first _____year(s) of the loan with Loan Fees not to exceed _____ % of the loan.

VA NOTICE TO BUYER: *"It is expressly agreed that, notwithstanding any other provisions of this contract, the Buyer shall not incur any penalty by forfeiture of earnest money or otherwise or be obligated to complete the purchase of the Property described herein, if the contract purchase price or cost exceeds the reasonable value of the Property established by the Department of Veterans Affairs. The Buyer shall, however, have the privilege and option of proceeding with the consummation of this contract without regard to the amount of the reasonable value established by the Department of Veterans Affairs."*

If Buyer elects to complete the purchase at an amount in excess of the reasonable value established by VA, Buyer shall pay such excess amount in cash from a source which Buyer agrees to disclose to the VA and which Buyer represents will not be from borrowed funds except as approved by VA. If VA reasonable value of the Property is less than the Sales Price, Seller may reduce the Sales Price to an amount equal to the VA reasonable value and the sale will be closed at the lower Sales Price with proportionate adjustments to the down payment and the loan amount.

_____	_____
Buyer	Seller
_____	_____
Buyer	Seller

This form has been approved by the Texas Real Estate Commission for use with similarly approved or promulgated contract forms. Such approval relates to this form only. TREC forms are intended for use only by trained real estate licensees. No representation is made as to the legal validity or adequacy of any provision in any specific transactions. It is not suitable for complex transactions. Texas Real Estate Commission, P.O. Box 12188, Austin, TX 78711-2188, 1-800-250-8732 or (512) 459-6544 (http://www.trec.state.tx.us) TREC No. 40-0.

PROMULGATED BY THE TEXAS REAL ESTATE COMMISSION (TREC) 10-29-01

EQUAL HOUSING OPPORTUNITY

SELLER FINANCING ADDENDUM

TO CONTRACT CONCERNING THE PROPERTY AT

_____

(Street Address and City)

A. CREDIT DOCUMENTATION. Within_____days after the effective date of this contract, Buyer shall deliver to Seller ❑ credit report ❑ verification of employment, including salary ❑ verification of funds on deposit in financial institutions ❑ current financial statement to establish Buyer's creditworthiness and ❑ _____
_____.
Buyer hereby authorizes any credit reporting agency to furnish to Seller at Buyer's sole expense copies of Buyer's credit reports.

B. CREDIT APPROVAL. If Buyer's documentation is not delivered within the specified time, Seller may terminate this contract by notice to Buyer within 7 days after expiration of the time for delivery, and the earnest money will be paid to Seller. If the documentation is timely delivered, and Seller determines in Seller's sole discretion that Buyer's credit is unacceptable, Seller may terminate this contract by notice to Buyer within 7 days after expiration of the time for delivery and the earnest money will be refunded to Buyer. If Seller does not terminate this contract, Seller will be deemed to have accepted Buyer's credit.

C. PROMISSORY NOTE. The promissory note (Note) described in Paragraph 4 of this contract payable by Buyer to the order of Seller will be payable at the place designated by Seller. Buyer may prepay the Note in whole or in part at any time without penalty. Any prepayments are to be applied to the payment of the installments of principal last maturing and interest will immediately cease on the prepaid principal. The Note will contain a provision for payment of a late fee of 5% of any installment not paid within 10 days of the due date. The Note will be payable as follows:

❑ (1) In one payment due _____ after the date of the Note with interest payable_____.

❑ (2) In _____ installments of $ _____ ❑ including interest ❑ plus interest beginning _____ after the date of the Note and continuing at _____ intervals thereafter for _____when the balance of the Note will be due and payable.

❑ (3) Interest only in _____ installments for the first _____ month(s) and thereafter in installments of $_____ ❑ including interest ❑ plus interest beginning _____ after the date of the Note and continuing at _____ intervals thereafter for _____ when the balance of the Note will be due and payable.

D. DEED OF TRUST. The deed of trust securing the Note will provide for the following:

(1) PROPERTY TRANSFERS: (check only one)

❑ (a) Consent Not Required: The Property may be sold, conveyed or leased without the consent of Seller, provided any subsequent buyer assumes the Note.

❑ (b) Consent Required: If all or any part of the Property is sold, conveyed, leased for a period longer than 3 years, leased with an option to purchase, or otherwise sold (including any contract for deed), without the prior written consent of Seller, Seller may declare the

Initialed for identification by Buyer_____ and Seller_____ **01A**

(Address of Property)

balance of the Note, to be immediately due and payable. The creation of a subordinate lien, any conveyance under threat or order of condemnation, any deed solely between buyers, the passage of title by reason of the death of a buyer or by operation of law will not entitle Seller to exercise the remedies provided in this paragraph.

(2) TAX AND INSURANCE ESCROW: (check only one)

❑ (a) Escrow Not Required: Buyer shall furnish Seller annually, before the taxes become delinquent, evidence that all taxes on the Property have been paid. Buyer shall furnish Seller annually evidence of paid-up casualty insurance naming Seller as an additional loss payee.

❑ (b) Escrow Required: With each installment Buyer shall deposit with Seller in escrow a pro rata part of the estimated annual ad valorem taxes and casualty insurance premiums for the Property. Buyer shall pay any deficiency within 30 days after notice from Seller. Buyer's failure to pay the deficiency constitutes a default under the deed of trust. Buyer is not required to deposit any escrow payments for taxes and insurance that are deposited with a superior lienholder. The casualty insurance must name Seller as an additional loss payee.

(3) PRIOR LIENS: Any default under any lien superior to the lien securing the Note constitutes default under the deed of trust securing the Note.

Buyer	Seller
Buyer	Seller

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PROMULGATED BY THE TEXAS REAL ESTATE COMMISSION (TREC) 10-29-01

EQUAL HOUSING OPPORTUNITY

LOAN ASSUMPTION ADDENDUM

TO CONTRACT CONCERNING THE PROPERTY AT

_____

(Street Address and City)

A. CREDIT DOCUMENTATION. Within_____days after the effective date of this contract, Buyer shall deliver to Seller ❑ credit report ❑ verification of employment, including salary ❑ verification of funds on deposit in financial institutions ❑ current financial statement to establish Buyer's creditworthiness and ❑ _____ _____. Buyer hereby authorizes any credit reporting agency to furnish to Seller at Buyer's sole expense copies of Buyer's credit reports.

B. CREDIT APPROVAL. If Buyer's documentation is not delivered within the specified time, Seller may terminate this contract by notice to Buyer within 7 days after expiration of the time for delivery, and the earnest money will be paid to Seller. If the documentation is timely delivered, and Seller determines in Seller's sole discretion that Buyer's credit is unacceptable, Seller may terminate this contract by notice to Buyer within 7 days after expiration of the time for delivery and the earnest money will be refunded to Buyer. If Seller does not terminate this contract, Seller will be deemed to have accepted Buyer's credit.

C. ASSUMPTION.

❑ (1) The unpaid principal balance of a first lien promissory note payable to _____ _____ which unpaid balance at closing will be $ _____. The total current monthly payment including principal, interest and any reserve deposits is $ _____. Buyer's initial payment will be the first payment due after closing.

❑ (2) The unpaid principal balance of a second lien promissory note payable to _____ _____which unpaid balance at closing will be $ _____. The total current monthly payment including principal, interest and any reserve deposits is $ _____. Buyer's initial payment will be the first payment due after closing.

Buyer's assumption of an existing note includes all obligations imposed by the deed of trust securing the note. If the unpaid principal balance(s) of any assumed loan(s) as of the Closing Date varies from the loan balance(s) stated above, the ❑ cash payable at closing ❑ Sales Price will be adjusted by the amount of any variance; provided, if the total principal balance of all assumed loans varies in an amount greater than $350.00 at closing, either party may terminate this contract and the earnest money will be refunded to Buyer unless the other party elects to eliminate the excess in the variance by an appropriate adjustment at closing. Buyer may terminate this contract and the earnest money will be refunded to Buyer if the noteholder requires (a) payment of an assumption fee in excess of $ _____in (1) above or $ _____in (2) above and Seller declines to pay such excess, (b) an increase in the interest rate to more than _____% in (1) above, or _____% in (2) above, (c) any other modification of the loan documents, or (d) consent to the assumption of the loan and fails to consent. A vendor's lien and deed of trust to secure assumption will be required which will automatically be released on execution and delivery of a release by noteholder. If Seller is released from liability on any assumed note, the vendor's lien and deed of trust to secure assumption will not be required.

If noteholder maintains an escrow account, the escrow account must be transferred to Buyer without any deficiency. Buyer shall reimburse Seller for the amount in the transferred accounts.

NOTICE TO BUYER: The monthly payments, interest rates or other terms of some loans may be adjusted by the noteholder at or after closing. If you are concerned about the possibility of future adjustments, do not sign the contract without examining the notes and deeds of trust.

NOTICE TO SELLER: Your liability to pay the note assumed by Buyer will continue unless you obtain a release of liability from the noteholder. If you are concerned about future liability, you should use the TREC Release of Liability Addendum.

_____	_____
Buyer	Seller
_____	_____
Buyer	Seller

This form has been approved by the Texas Real Estate Commission for use with similarly approved or promulgated contract forms. Such approval relates to this form only. TREC forms are intended for use only by trained real estate licensees. No representation is made as to the legal validity or adequacy of any provision in any specific transactions. It is not suitable for complex transactions. Texas Real Estate Commission, P.O. Box 12188, Austin, TX 78711-2188, 1-800-250-8732 or (512) 459-6544 (http://www.trec.state.tx.us) TREC No. 41-0.

01A

10-29-01

EQUAL HOUSING OPPORTUNITY

PROMULGATED BY THE TEXAS REAL ESTATE COMMISSION (TREC)

NOTICE OF TERMINATION OF CONTRACT

To: Seller(s)

In accordance with the unrestricted right of Buyer to terminate the contract between

_____

as Seller and _____

as Buyer dated _____, 20____ for the Property located at _____

_____,

Buyer notifies Seller that the contract is terminated.

Buyer	Date	Buyer	Date

This form has been approved by the Texas Real Estate Commission for use with similarly approved or promulgated contract forms. Such approval relates to this form only. TREC forms are intended for use only by trained real estate licensees. No representation is made as to the legal validity or adequacy of any provision in any specific transactions. It is not suitable for complex transactions. Texas Real Estate Commission, P.O. Box 12188, Austin, TX 78711-2188, 1-800-250-8732 or (512) 459-6544 (http://www.trec.state.tx.us) TREC No. 38-1. This form replaces TREC No. 38-0.

01A

Appendix D

Sample Personal Financial Statement

PERSONAL FINANCIAL STATEMENT

SECTION 1A: INDIVIDUAL INFORMATION				SECTION 1B: SPOUSAL INFORMATION			
Name:	Benjamin Investor			Name:	Barbara Investor		
Residence:	123 North 2nd Street			Residence:	123 North 2nd Street		
City, State, and Zip:	Anywhere, PA 12345			City, State, and Zip:	Anywhere, PA 12345		
Position or Occupation	Real Estate Investments			Position or Occupation	Real Estate Investments		
Business Name:	Benjamin Real Estate Group			Business Name:	Benjamin Real Estate Group		
Business Address:	456 East Main			Business Address:	456 East Main		
City, State, and Zip:	Anywhere, PA 12345			City, State, and Zip:	Anywhere, PA 12345		
Residence Phone:	(212) 396-1234	Bus. Phone:	(212) 396-1235	Residence Phone:	(212) 396-1234	Bus. Phone:	(212) 396-1235
SSN:	123-45-6789	Date of Birth:	08/06/1959	SSN:	987-65-4321	Date of Birth:	08/06/1959
Driver's License #:	082812477			Driver's License #:	082812478		

SECTION 2: BALANCE SHEET

ASSETS				LIABILITIES		
Cash (from Schedule 1)			313,000		Secured	10,155
		Marketable	275,300	Notes Payable to Banks (Sched 5)	Unsecured	72,665
Securities (from Schedule 2)		Nonmarketable	485,000		To Relatives	3,200
Notes and Accounts Receivable (Schedule 3)			50,000	Other Accounts and Notes Payable	To Others	0
Professional Accounts Receivable			42,000	Outstanding Credit Card Balances (Sched 6)		12,000
Real Estate (from Schedule 4)			405,000	Real Estate (from Schedule 4)		198,000
Cash Surrender Value Life Insurance			2,500		Income Taxes	0
	Year: '96	Make: GM	11,500	Taxes Owed	Other Taxes	0
Autos	Year: 2000	Make: Toy	16,000			
	Year:	Make:				
Oil Interests/Production Leases			4,200			
Personal Property/Household, etc.			145,000	Other Liabilities		
	Computer Equipment		14,800	(Itemize)		
	Software & Peripherals		3,600			
Other Assets	Jewelry		8,500			
(Itemize)						
				Total Liabilities		296,020
				Net Worth		1,480,380
TOTAL ASSETS			1,776,400	TOTAL LIABILITIES AND NET WORTH		1,776,400

CURRENT ANNUAL INCOME		CONTINGENT LIABILITIES			
Gross Annual Salary	82,000	As Endorser			
Bonuses and Commissions	16,000	As Guarantor			
Dividends and Interest	13,000	On Leases or Contracts			
Real Estate Income	145,000	Legal Claims or Judgments			
Oil Income	0	Provision for Federal Income Tax			
Other Income	1,500	Other (Itemize)			
TOTAL INCOME	257,500				
COMPARISON OF MONTHLY INCOME TO EXPENSES					
Net Monthly Income	21,458				
Rent or Home Payment	3,475	Have you ever declared bankruptcy?			
Food and Utilities	850	Yes		No	X
Incidentals, Travel, Insurance, etc.	1,400	If yes, please explain.			
Credit Cards and Loans	1,917				
TOTAL EXPENSES	7,642				
DISCRETIONARY INCOME	13,816				

The information contained in this statement is provided for the purpose of obtaining or maintaining credit on behalf of the undersigned or for the guarantee of debt by the undersigned. Each undersigned understands that the Bank is relying on the information provided herein (including the designation made as to the ownership of property) in deciding to grant or continue credit. Each undersigned represents and warrants that the information provided is true and complete and that the Bank may consider this statement as continuing to be true and correct until a written notice of a change is given to the Bank by the undersigned. I/we authorize the Bank to make all inquiries deemed necessary to verify the accuracy of the statements made herein, and to determine my/our credit worthiness. I/we authorize the Bank to answer questions about the Bank's credit experience with me/us.

Signature (Individual) _____ Signature (Spouse) _____

Date _____ Date _____

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SECTION 3: SCHEDULES

SCHEDULE 1: CASH IN BANKS AND OTHER INSTITUTIONS

Name and Location	Type of Account	Current Balance
ABC Federal Credit Union	Checking	4,500
My Favorite Bank	Money Market	210,000
E Bank	Savings	98,500
	TOTAL	313,000

SCHEDULE 2A: MARKETABLE SECURITIES/LIQUID ASSETS

Number of Shares	Description of Security	Cost	If Pledged, To Whom	Current Market Value
2,500	GOLD	12,500		28,000
5,000	DROOY	5,700		22,000
10,000	SSRI	18,900		29,800
4,500	Mutual Fund	45,000		48,500
	Precious Metals	125,000		147,000
			TOTAL	275,300

SCHEDULE 2B: NONMARKETABLE SECURITIES

Number of Shares	Description of Security	Cost	If Pledged, To Whom	Current Market Value
50% ownership	Symphony Homes, L.L.C.			485,000
			TOTAL	485,000

SCHEDULE 3: NOTES AND ACCOUNTS RECEIVABLE

Name and Address of Debtor	Is Debtor a Relative?	Origination Date	Nature or Description of Debt	Collateral Held	Final Payment Date	Current Balance
J.P. Smithers	No	02/01/2002	real estate loan	land	N/A	50,000
					TOTAL	50,000

SCHEDULE 4: REAL ESTATE, Legal & equitable title to real estate listed is solely in the name of undersigned unless otherwise noted.

Legal Description Or Street Address	Date Acquired	Type of Property	Mortgage or Lien Holder	Monthly Payments	Purchase Price	Remaining Loan Balance	Current Market Value
1234 Milcrest	06/01/1995	residence	Wells Fargo	800	147,500	70,000	265,000
5678 Angels Cove	07/01/1985	rental	None-1/2 interest	0	76,000	41,000	140,000
1234 Milcrest	12/10/2001	residence	Ntl City - HELOC	150		87,000	0
					TOTAL	198,000	405,000

SCHEDULE 5: NOTES PAYABLE

Holder's Name and Address	Original Amount	Date Opened	Collateral	Maturity Date	Monthly Payments	Current Balance
Larry Peabody	100,000	01/01/1998	unsecured line of credi	Open	742	44,265
GMAC	12,500	03/01/2000	GM auto	03/01/2004	245	10,155
SLAS - student loan	35,000	07/25/1992	none	07/25/2012	375	28,400
				TOTAL	1,362	82,820

SCHEDULE 6: CREDIT CARDS

Company's Name and Address	Credit Limit	Date Opened	Type (MC, Visa, Discover)	Maturity Date	Monthly Payments	Current Balance
Wells Fargo	2,500	04/08/1995	MC	Open	255	3,600
Citibank	15,000	09/09/1999	MC	Open	300	8,400
				TOTAL	555	12,000

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APPENDIX E

WWW.THEVALUEPLAY.COM

Current ordering information for The Value Play Rehab Analyzer can be found at www.thevalueplay.com.

INSPIRATIONAL QUOTES AND STORIES

Although many of the inspirational quotes and stories are taken from the author's personal favorites and life experiences, material submitted by readers is welcomed. If you would like to submit one or more of your favorite inspirational quotes and/or stories for use in a future book, please visit the web site address located at www.thevalueplay.com. Anything submitted through this site will be considered by the author for possible future use. Proper credit will be given to contributors whose quotes or stories are used in future books.

Appendix F

WWW.SYMPHONY-HOMES.COM

For information regarding Symphony Homes, please log on to our web site at www.symphony-homes.com.

INDEX

Average monthly rent, 102

Backdoor exits, 119–121
Broadcast fax, 59
Business plan, 20, 21, 136–137
Buy-and-hold strategy, 25, 26, 27

Capital gains, 11, 12
Capitalization rate, 32, 97, 102
Cash flow, 3, 12, 68
Cash flow analysis, 3, 12, 68
Classified ads, 45
Classified advertising, 49, 50
Clearly defined objectives, 20, 21
Closing process, 2, 27, 142–148
Concessions, 121
Conventional mortgages, 127
Cost approach, 66, 67
Credit score, 137–140

Dealer, 13, 14, 15, 16, 17, 18, 20
Direct mail, 57

Entry strategy, 21
Escape clauses, 119
Exit strategy, 23

Financial statements, 2, 69
Financing, 127–135
Flipper, 13–19
Flipping, 1, 2, 4, 6, 11, 13, 18, 20, 22, 25, 33, 35, 48, 65, 82, 128, 135, 150, 166, 167
For sale by owners, 45, 49, 52, 60–61
Foreclosures, 17, 45, 46, 62

Handyman, 48, 49, 152
HELOC, 6, 131

Income capitalization approach, 66, 68, 69, 82, 95

Inspection, 23, 36, 38, 39, 40, 85, 86, 120, 122
Intermediate-term investors, 12
Internal rate of return, 103
IRR, 103

Leverage, 6, 7, 20
Local bank, 85, 128, 130, 131
Long-term investors, 12

Marketing strategies, 56–59
Model, 2, 3, 19, 75, 78, 79, 82, 137
Money-talks approach, 123
Mortgage brokers, 129
Multifamily, 3, 31, 52
Multiple Listing Service, 33, 52, 164

OPM, 6
Office manager, 151, 152
Options, 13, 19, 20, 45
Other people's money, 6, 7
Owner financing, 133

Partnerships, 135
Postentry strategy, 21, 22, 23
Preplanning, 163
Price range, 35
Profit margins, 11
Property location, 33, 34
Property's physical condition, 35–40
Proprietary model, 3, 75

Real estate agents, 45–49
Real estate investment clubs, 45, 46, 54
Real estate owned, 16, 17
Real estate portfolio, 2, 3, 4, 11, 25, 29
Real estate publications, 51
Red herring technique, 122
Refinance Analyzer, 103, 105
Rehab manager, 152
REO, 16, 55
Retailer, 13, 14, 15, 16, 17, 18, 20, 22, 23, 25–26, 31, 32, 33, 35
ROI, 81, 102, 109
Roofs, 37

Sale price calculations, 80–81
Sales comparison approach, 66, 70
Scout, 13–15, 17, 18, 20, 22
Seller motivation, 115–119
Settlement statements, 142
Sewer lines, 37, 38
Short-term investors, 12
Single family, 1, 3, 19, 22, 25, 31, 32, 46, 48, 52, 65, 67, 71
Symphony Homes, 19, 40, 42, 94, 114, 123

Time horizon, 5, 13
Title company, 143, 152, 154
Title report, 142
Transfer tax, 143, 152

Underwriting guidelines, 2, 90, 140

Vacant properties, 45, 61, 62
Value play, 2, 19, 25, 26, 29, 30–31, 41, 42
Value Play Rehab Analyzer, The, 75, 82, 90–92
Value play selection process, 31
Value play strategy, 25–31

Web sites, 45, 51, 52

01_769193 ffirs.qxp 5/18/06 8:19 PM Page iii

Getting Started in REAL ESTATE INVESTMENT TRUSTS

Richard Imperiale

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01_769193 ffirs.qxp 5/18/06 8:19 PM Page vi

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Getting Started in

REAL ESTATE INVESTMENT TRUSTS

The *Getting Started In* Series

Getting Started in Online Day Trading by Kassandra Bentley
Getting Started in Asset Allocation by Bill Bresnan and Eric P. Gelb
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01_769193 ffirs.qxp 5/18/06 8:19 PM Page iii

Getting Started in REAL ESTATE INVESTMENT TRUSTS

Richard Imperiale

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To Sue, Emily, and Mary

01_769193 ffirs.qxp 5/18/06 8:19 PM Page vi

Contents

Preface xi
Acknowledgments xv

PART 1
Getting Started in REITs

Chapter 1
Real Estate as an Asset Class 3

Chapter 2
The History of Real Estate Investment Trusts 15

Chapter 3
REITs as an Asset Class 27

Chapter 4
REITs as a Portfolio Diversification Tool 41

Chapter 5
Integrating REITs into an Investment Portfolio 53

PART 2
Real Estate Economics and Analysis

Chapter 6
Real Estate Market Characteristics 67

02_769193 ftoc.qxp 5/18/06 8:20 PM Page viii

Chapter 7

Real Estate Development 79

Chapter 8

Partnerships and Joint Ventures 91

Chapter 9

Analyzing REITs 101

Chapter 10

Advanced Financial REIT Topics 115

PART 3

Public Real Estate Sectors

Chapter 11

Residential REITs 129

Chapter 12

Manufactured Home Community REITs 139

Chapter 13

Office REITs 149

Chapter 14

Industrial REITs 161

Chapter 15

Retail Property REITs 169

Chapter 16

Hotel REITs 187

02_769193 ftoc.qxp 5/18/06 8:20 PM Page ix

Chapter 17

Health Care Properties 199

Chapter 18

Self-Storage REITs 223

Chapter 19

Other REIT Sectors 229

Appendix A

Real Estate Mutual Funds 241

Appendix B

Real Estate Investment Trusts 251

Glossary 273

Index 277

02_769193 ftoc.qxp 5/18/06 8:20 PM Page x

03_769193 fpref.qxp 5/18/06 8:20 PM Page xi

The Easy Way to Own a Vast Real Estate Portfolio

How do you make a small fortune in real estate? Answer: Start with a large fortune! Unfortunately that is the experience of many small real estate investors. Real estate is a business of size and scale, and without a large amount of capital and knowledge, it is a risky business. In fact, it is a risky business even with capital and knowledge. So how is an investor able to get involved in a portfolio of real estate without having a vast fortune? The answer is *real estate investment trusts,* known best by their acronym REITs (pronounced *reets*). This book provides an explanation and analysis of real estate investment trusts to help the average investor get started in REIT investing.

Real estate is one of the largest and most pervasive industries in the country and we are exposed to the business of real estate every day. The homes and apartments in which we live, the offices and factories in which we work, the stores we shop in, the hospitals in which are children are born, even the nursing homes in which some will spend their remaining years are part of the real estate investment landscape.

This vast landscape of real estate investment takes many forms. Large institutional investors such as pension plans and insurance companies own vast portfolios of real estate holdings. Private individuals also

03_769193 fpref.qxp 5/18/06 8:20 PM Page xii

own large and small portfolios of real estate. In fact, about two-thirds of all American households own their homes, which in many ways is a real estate investment.

In the recent past, real estate investing picked up a bad reputation. During the inflation-prone, tax-motivated real estate days of the 1970s, many people and institutions invested and lost money in a variety of tax-motivated real estate investments. Real estate developers and promoters were often thought of as hucksters and charlatans, and many were. Developers also got a bad reputation as real estate cowboys who would build anything if they could get the money. This too was true.

Real estate promoters and developers were the dot-com executives of the 1970s. They became rich as investors directed an ever-growing stream of capital into the industry. The Tax Reform Act of 1986 changed the real estate landscape by ending the tax incentives that were fueling capital formation in the real estate industry. The resulting bubble in real estate ended with the largest glut of property ever seen in the U.S. real estate market. The property glut was financed in large part by the savings and loan industry. The collapse in the real estate bubble precipitated the savings and loan crisis as property owners defaulted on their highly leveraged real estate holdings. With little or no equity in these properties and falling property values and rents, there was little incentive not to turn the keys back to the mortgage holders. The Resolution Trust Company worked during the late 1980s to resolve the S&L crisis. By the early 1990s, the excesses of the 1970s had been resolved, but real estate investments continued to have a bad reputation among small investors. The Tax Reform Act of 1986 had set the stage for a more financially rational real estate marketplace. Legendary value investors like Sam Zell and many others saw this rationalization of assets and invested early in what has turned out to be one of the most stable and well-defined real estate recoveries in modern history. Real estate investors have become far more disciplined, demanding returns on invested capital that reflect the level of investment risk associated with a real estate asset. Mortgage lenders are also far more conservative. They will not lend capital on projects that they do not view as highly feasible. This has brought a capital market discipline to the commercial mortgage arena. The net result has been longer, more stable real estate expansions and less severe real estate cycles. From this crucible of industry reshaping has emerged a new real estate paradigm. Disciplined owners, rational lenders, and higher returns on capital have resulted. Among the new class of disciplined owners are real

03_769193 fpref.qxp 5/18/06 8:20 PM Page xiii

estate investment trusts, which collectively own over 10 percent of the investment-grade real estate in the United States. REITs offer the opportunity for small investors to participate in a broad range of real estate opportunities across most major property sectors and in most geographic locations. Disciplined real estate professionals whose financial interests are largely aligned with those of the shareholders generally manage REITs.

REITs and real estate investing have endured a checkered history. In general terms, REITs were historically a small and misunderstood part of the real estate investment landscape. Over the past decade, however, this has changed. Now REITs are major owners of investment-quality real estate and a major force in the institutional investment arena. REITs are a viable and competitive investment option for investors who are looking to broaden and diversify their investment portfolios. They provide returns that are competitive with—and independent from—stocks and bonds. This fact allows REITs to add an additional element of diversification when they become part of a portfolio along with stocks and bonds.

This book describes these features and attempts to put them into a framework that examines the critical investment aspects of REITs and the theoretical real estate principles that drive the REIT investment decision. As a professional investor in REITs, I noticed that the average investor largely misunderstood REITs. Many professional investors and portfolio managers also had little knowledge of REITs. In addition, very few books had been written on the subject of REITs. Those books that were available provided either a very simplistic overview or a highly complex academic treatment of the topic. Most did not address the fundamental real estate concepts that underlie the basics of real estate investing or the methods of integrating REITs into an investment portfolio. This book is an attempt to address these very issues.

We begin in Part One with a general discussion of real estate as an asset class. Then the legal and financial history of REITs is examined. The section ends with a discussion of how REITs behave as an investment class and how they are best integrated into an investor's portfolio. Part Two describes the fundamental economic issues that affect real estate in general and analyzes these issues in the context of the REIT investment vehicle. The section concludes with specific methods for analyzing REITs as an investment and advanced investment topics involving REITs. Part Three uses the theoretical constructs developed in the first

03_769193 fpref.qxp 5/18/06 8:20 PM Page xiv

two parts to examine each major property category within the REIT universe. In virtually every chapter, you will find sidebars featuring key terms and "REIT Idea" concepts—and, at the end of the book, I have provided directories for both real estate mutual funds (Appendix A) and real estate investment trusts (Appendix B). All things considered then, I believe this book fills a void in the available current literature about REITs and promotes a better understanding of an emerging asset class. It is my hope that you will feel the same.

RICHARD IMPERIALE

Union Grove, Wisconsin
May 2006

Acknowledgments

Although the author ultimately gets the credit for writing a book, there is an army of others who contribute to the process. I would like to recognize them. This book is dedicated to my wife, Sue, and our two daughters, Emily and Mary, who put up with my absence from family and school functions and during many evenings and weekends. Their support and encouragement made the completion of this project possible. Every day they make me realize how fortunate I really am.

Of course, it is not a book without a publisher. In the middle of the dot-com frenzy, David Pugh at John Wiley was open-minded enough to listen to my ideas about real estate, give me critical feedback, and go to bat for me on my first book project about real estate. David has been an excellent coach and critic and helped me shape this book and two others into better and useful texts. I now consider him a good friend and thank him for all his help.

The book contains a fair amount of data compiled from company reports and industry trade associations. Much of that data was processed by my assistant, Rochell Tillman, and my research associates, Farid Shiek, Tom McNulty, Jackie Hughes, Isac Malmgren, and Jeff Lenderman, who collectively reviewed the SEC filings of over 200 real estate investment trusts and real estate operating companies. Their diligence and hard work provided consolidated data that is not found in any other single place. Lastly I thank David Howard, Michael Grupe, and Tony Edwards, all from the National Association of Real Estate Investment Trusts (NAREIT). They have each assisted me with critical comments, data, and analysis as well as industry contacts who were helpful in providing insights and information.

R. I.

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Part 1

Getting Started in REITs

Chapter 1

Real Estate as an Asset Class

More money has been made in real estate than all industrial investments combined.

—Andrew Carnegie, 1902

To understand *real estate investment trusts* (REITs), an investor needs a basic understanding of the real estate asset class. The recent popularity of real estate investing has helped to bring the investment opportunities in real estate broader exposure to noninstitutional investors. Until recently, real estate was one of the best kept secrets in the investment community. It is an asset that major investment institutions have formally embraced as a part of their portfolios for the last century. Among institutional investors it is no secret that well-located, high-quality real estate can provide an excellent return on investment, high current income, and a significant hedge against inflation.

real estate investment trust (REIT)
a tax conduit company dedicated to owning, managing, and operating income-producing real estate, such as apartments, shopping centers, offices, and warehouses. Some REITs, known as mortgage REITs, also engage in financing real estate.

Characteristics of Real Estate as an Investment

Institutional real estate investors own the vast majority of the estimated $11.0 trillion of

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A Brief History of REITs

REITs actually date back to the trusts and robber barons of the 1880s. Investors could avoid taxation because trusts were not taxed at the corporate level if income was distributed to the trust beneficiaries. Over time this tax advantage was reversed. In 1960, President Eisenhower signed the tax provisions into law with the Real Estate Investment Trust Act of 1960, which reestablished the special tax considerations for qualifying REITs as pass-through entities. This allowed REITs to avoid taxation at the corporate level on income distributed to shareholders. This law formed the basis for present-day REITs.

REIT investment increased throughout the 1980s as the Tax Reform Act of 1986 eliminated many real estate tax shelters. The Tax Reform Act of 1986 allowed REITs to manage their properties directly, and in 1993 REIT investment barriers to pension funds were eliminated. This history of reforms continued to increase the opportunity for REITs to make high-quality property investments. Currently there are more than 200 publicly traded REITs in the United States and the REIT structure is being adopted in many countries around the world.

Real Estate Investment Trust Act of 1960
the federal law that authorized REITs. Its purpose was to allow small investors to pool their investments in real estate in order to get the same benefits as might be obtained by direct ownership, while also diversifying their risks and obtaining professional management.

investment-grade *commercial real estate* in the United States. By comparison, the total capitalization of all public U.S. equities is estimated to be $12.9 trillion, and the nominal value of all non-government U.S. bonds is estimated to be $36.4 trillion. U.S. domestic real estate as an asset class ranks third, behind stocks and bonds, and represents 18 percent of the total of the three asset classes (see Figure 1.1).

Positive Attributes of the Real Estate Asset Class

Each institution generally has its own particular investment policy when it comes to real estate. Normally, institutions are attempting to match the life of assets they own with that of forecast liabilities.

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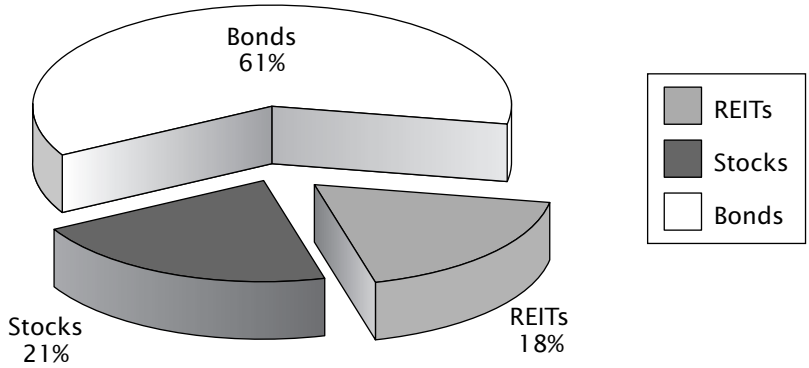

FIGURE 1.1 Commercial Real Estate versus Stocks and Bonds

Retirement funds, insurance companies, and commercial banks are among the major private sector investors in real estate. They all have projected liabilities that must be met at some future date.

The consistent and relatively predictable cash flows associated with real estate allow for a high degree of confidence when matching future liabilities. The cash flow comes in the form of rent paid to the building owner. The buildings that are owned by institutional investors tend to have *credit tenants*. (There will be more about credit tenants in Chapter 15.)

commercial real estate
all real estate excluding single-family homes and multifamily buildings up to four units, raw land, farms and ranches, and government-owned properties. About half of commercial real estate as defined is considered to be of sufficient quality and size to be of interest to institutional investors. This real estate is known as *investment grade*.

Consistent and predictable cash flow is just one attractive feature of the real estate asset class. Real estate also tends to perform better than financial assets in an inflationary environment. In reviewing the history of real estate performance, a number of studies have found that returns from real estate were higher during times of inflation and lower during periods of disinflation. Thus, a portfolio of largely financial assets can be hedged—to some extent—against the corrosive effects of inflation through the ownership of real estate. Taxable investors can also derive some additional tax benefits from the real estate asset class. For tax accounting purposes, the value of real estate other than land can be depreciated at a rate that is generally greater than the actual economic life of the property. In most

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cases, the value of a well-maintained property in a good location actually increases over time at a rate similar to inflation. This accelerated tax depreciation results in a partial sheltering of cash flow as well as the deferral of taxes, which can usually be treated as a more favorable long-term capital gain for tax purposes. So real estate can create current income in the form of cash flow that is partially sheltered from taxation until some future date. It is possible to capture some of the benefits of real estate's unique tax qualities for tax-exempt investors such as pension funds. Structuring partnerships and operating agreements in ways that allow taxable benefits to flow to those who can use them, while allocating higher levels of cash flow to tax-exempt investors, is one way tax-exempt investors can benefit from the tax advantages of real estate. In some instances, the tax benefits of certain real estate projects can be sold to taxable investors by tax-exempt investors, which allows incremental total return to be enhanced.

credit tenant
a tenant that has the size and financial strength to be rated as investment grade by one of the three major credit rating agencies: Moody's, Standard & Poor's, and Fitch. The investment grade rating increases the probability that the financial strength of the company will allow it to continue to pay rent even during difficult economic times.

There are some other primary reasons that large institutional investors are attracted to real estate. One factor that is often cited by institutions is that real estate returns behave very differently from stock and bond returns. How investment returns behave relative to one another is known as *correlation*. This low correlation of returns provides an added diversification benefit within an investor's portfolio. In general, adding real estate to a portfolio of stocks and bonds enhances return and lowers risk in a given portfolio. There is a large body of academic and professional work that suggests that investing 5 percent to 15 percent of a portfolio in real estate increases the total return and lowers the portfolio risk. This is consistent with the fact that the largest 200 retirement plans have an average total of 17 percent of their assets invested in real estate.

Attribution of Return in Real Estate

A fancy way of explaining where the return of a particular investment comes from is known as the *attribution of return.* The return attribution

05_769193 ch01.qxp 5/18/06 8:21 PM Page 7

of real estate can be identified by a number of features, some of which are unique to real estate and some of which are common to other classes of investments such as stocks and bonds. As discussed previously, the value of well-maintained real estate in a good location will actually increase over time. This capital appreciation aspect of real estate is similar to the long-term growth in value seen as a primary component of return in the equity asset class. Investors buy stocks because they expect over time that the price will go up. The same is true of investors who buy real estate. But, unlike stocks, most real estate also has some bondlike characteristics. It is the consistent and predictable cash flow associated with rents paid on real estate that is the primary focus of most institutional investors. This steady stream of rental income attributable to a given property or portfolio is much like the regular interest paid as the coupon of a bond. The terms of these bondlike payments are typically detailed in a lease agreement between the owner of the real estate and the user or tenant of the real estate. It is the quality and completeness of these terms and conditions as stated in the lease that allow for the analysis of the underlying cash flows of a given property. The *term,* or length, of the rental payments as stated by the lease also produces duration characteristics similar to those of a bond investment. In a bond, the duration is, in part, a function of the term remaining before the bond matures. In real estate, the duration of the rental income is a function of the length of the underlying lease or remaining period of the rental stream. Rents derived from hotel and motel properties, which can change on a daily basis, have the shortest duration, followed by apartment rents, which are generally set for a term of one or two years (see Table 1.1). Office, retail, and industrial properties tend to have longer duration leases that can extend for a term of 10 years to 30 years or more.

TABLE 1.1 Average Lease Duration by Property Type

Hotels	1 to 3 days
Self-storage	6 months
Apartments	1 year
Offices	5 to 15 years
Industrial	5 to 20 years
Retail	10 to 30 years

05_769193 ch01.qxp 5/18/06 8:21 PM Page 8

Real estate also has a credit profile, much like the credit rating of a bond. This credit profile is determined by the credit quality of the underlying tenants that pay the lease and occupy the real estate. For example, an office building with 50,000 square feet leased on a long-term basis to IBM will have a much better credit profile than the same space leased to Bob's Pretty Good Computer Company, a new enterprise with an operating history of less than five years. Similarly, an IBM bond would presumably have a better credit rating than a loan to Bob's Pretty Good Computer Company, which would most likely be considered a higher-risk proposition.

There are also return attribution features that are unique to the real estate asset class. The physical attributes of a given piece of real estate can have an impact on value. For example, visualize two suburban office buildings, of the same size and age, in a similar location. One is built of brick and stone, the other using simple wood construction. It is likely that because the brick-and-stone office building has a higher replacement cost, it may also have a higher value than the wood-frame office building. Thus a building's physical quality can have a unique impact on its value.

Location is also a unique feature that can ascribe greater or lesser value to real estate. Because any given piece of real estate can only occupy a single location, each piece of real estate is, in essence, unique. Real estate in a highly desirable location may have a much greater value than identical real estate in a different, less desirable location. This location factor can be so important in that in some cases it is the overall value determinant of a real estate parcel. That is why companies like Walgreen's will close a store on the southwest corner of an intersection and reopen the store on the northeast corner of the same intersection! Location, Location, Location—always remember how important it is in real estate.

There is also the situation of what are called *externalities* in the economics of real estate. An externality occurs when an activity or event affects (for good or bad) another that is external to it. If Donald Trump builds a shining new skyscraper in the middle of a marginal neighborhood, this is a positive externality for the owners of many adjoining properties, who see the value of their holdings increase overnight as a result of no direct activity on their part. Conversely, if the house next door to an apartment building in an urban neighborhood is converted to a homeless shelter, it is likely to be considered a negative externality that lowers the value of the apartment building.

05_769193 ch01.qxp 5/18/06 8:21 PM Page 9

Because the problem of externalities is so crucial to real estate value, a high degree of zoning and entitlement exists in the real estate marketplace. Normally zoning considers what is commonly referred to as *highest and best use.* This is a use that is economically and physically feasible when considered relative to other adjoining real estate, economic activities in the area, the size of the site, and the intended design and use of the new building. Zoning and entitlement also extend to the regulatory level when examining real estate. Many localities have low- or no-growth policies that make it difficult to develop new real estate. Some localities adopt master plans that strictly limit the size, style, design, and use of a building in any given area of the planned community.

In some communities there is simply no more available vacant space on which to build. These are referred to as *urban infill* or *redevelopment* communities. Any *entitlement* in these areas becomes part of the removal and redevelopment of an existing site or the expansion and refinement of an existing property. The ever-growing political sentiment of "not in my backyard" among the residents of many communities often creates a situation of externalities that can have significant positive or negative impact on the value of a property. These are unique aspects of the real estate asset class. The features that are unique to real estate, physical attributes, location, local externalities, zoning, and entitlement, contribute to real estate's low correlation of return relative to stocks and bonds. The value of real estate is driven by supply and demand in the local real estate market. The best building imaginable might sit empty in a market where supply exceeds demand for that type of real estate. Because of its permanent physical nature, real estate cannot be moved to a market where the demand is greater than the supply. In its simplest terms, real estate is a very local asset class driven by all the macroeconomic and microeconomic factors of the local and regional marketplace.

This is not to say that real estate is insulated from more national economic factors. The aggregate demand for real estate in general is driven by the overall growth in the national economy. Population

entitlement
the legal right as granted by state and local real estate zoning authorities to build or improve a parcel of existing real estate, normally unimproved land. The grant of entitlement to improve property can take long periods of time and be expensive from a legal standpoint. But entitlement can create immediate value for previously unentitled parcels of real estate.

05_769193 ch01.qxp 5/18/06 8:21 PM Page 10

REIT Idea: *Kelo et al. v. City of New London et al.*

This supply and demand struggle was showcased in the recent Supreme Court case of *Kelo et al. v. City of New London et al.*, which was argued February 22, 2005, and decided June 23, 2005.

After approving an integrated development plan designed to revitalize its ailing economy, the city of New London, Connecticut, purchased most of the property earmarked for the project from willing sellers, but initiated condemnation proceedings when Kelo and the owners of the rest of the property refused to sell. The city claimed the proposed taking of their property qualified as a "public use."

Prior court rulings were clear that the city could not take the land simply to confer a private benefit on a particular private party. However, the property at issue here would be claimed pursuant to a carefully considered development plan, which was not adopted to benefit a particular class of identifiable individuals.

The city determined that the area at issue was distressed and that their program of economic rejuvenation was entitled to proceed. The city had carefully formulated a development plan that it felt would provide appreciable benefits to the community, including new jobs and increased tax revenue. The Supreme Court agreed with the city and the taking of the private land was allowed.

demographics, job creation, and the general business cycle all have an impact on the final demand for real estate. However, this demand manifests itself in very local ways. For example, the Internet frenzy that gripped San Francisco and San Jose in the late 1990s had a huge impact on the final demand for real estate in those cities, driving real estate prices to unsustainable levels. During the same time period, real estate prices in Atlanta, Georgia, remained relatively soft due to an excess supply of local property, which had to be absorbed before prices could again advance.

Real estate seems to have a litany of positive investment characteristics. It has both stock- and bond-type attributes as well as performance features that enhance portfolio diversification. It tends to perform well in an inflationary environment and achieves good outcomes in both rising and falling interest rate environments. Taxable investors also enjoy certain tax advantages when investing in real estate. These are the beneficial features that have made real estate a favorite among institutional investors.

05_769193 ch01.qxp 5/18/06 8:21 PM Page 11

Negative Attributes of the Real Estate Asset Class

Although real estate has a long list of positive investment attributes, there are also some negative characteristics related to direct investments in real estate. Lack of liquidity is the single most negative factor that goes along with owning a real estate investment portfolio. The process of buying and selling real estate can be long and involved. An investment-class property can easily take six months to a year to sell, depending on market conditions and the prevailing economic environment. The marketability of a property will often depend on the terms and conditions of a sale. The terms are often subject to negotiation at times, lengthy negotiation between any given number of potential buyers and the seller. Because real estate is often financed in part with debt, the type and amount of financing that is readily available for a given property or in a given marketplace will often affect these negotiations. This lack of liquidity, when compared to other financial assets such as stocks or bonds, adds to the potential risk inherent in the real estate asset class.

An investor in a share of IBM common stock is buying one share out of millions of identical common shares that trade freely on a daily basis. The buyer of an office building in Detroit faces an entirely unique set of facts and circumstances that are largely different from the facts and circumstances that may affect a similar office building in Denver. Furthermore, office buildings in Detroit and Denver similar to those described may only change hands every few years. At times it may be difficult to establish a relevant market price with which to compare similar real estate. This lack of liquidity, when coupled with the local market nature of real estate, can create a situation where real estate is a less efficient asset class. This is due in part to the uniqueness of each property as it is situated in each market. Local economic factors can lead to real estate values rising in one area of the country while falling in others. These same factors can lead to rising prices for industrial buildings and falling prices for office buildings in the very same market. The uniqueness of real estate causes these inefficiencies. The lack of liquidity and the less efficient local characteristics of real estate also create problems when attempting to measure the performance of real estate. Performance is most accurate when measured over the period the real estate is owned, which may be 5 to 10 years or longer. However, measuring annual or quarterly

05_769193 ch01.qxp 5/18/06 8:21 PM Page 12

returns from a property or a portfolio can be difficult given the lack of market information. Appraisals are sometimes used to estimate periodic values over shorter periods of time, but this is not as accurate as the data from actual transactions. And it still leaves unanswered the question of how a real estate portfolio is performing relative to other similar portfolios. These inefficient aspects of direct real estate investment manifest themselves in the higher potential returns that result from superior market knowledge. The inefficiencies create advantages for investors who have cultivated local market knowledge and use it to the disadvantage of the less informed owner. This use of material inside information that may be gleaned from political and business relationships is not illegal in real estate transactions, as it is in securities transactions. On this basis, some observers argue that real estate is a less than level playing field for the small investor. This perception may have some basis in the recent history of the small investor and real estate.

The late 1970s and early 1980s saw a confluence of events that hurt the general credibility of the real estate asset class in the eyes of the small investor. The federal tax code had created a situation of positive incentives for the ownership of investment real estate. The inflationary environment of the period led to ever-escalating real estate prices, which, in turn, led to an excess amount of capital from small investors flowing into the real estate market. This took the form of a large number of private limited partnerships that were created to invest in real estate. Federally insured savings and loan institutions became lenders to the partnerships in an environment where lenders had little incentive not to lend. There was little regulatory oversight of the situation and a great deal of leverage and liquidity. This led to a speculative real estate bubble that resulted in a real estate crash during the mid 1980s and a near collapse of the entire U.S. savings and loan system.

It took nearly a decade for the economy to absorb the excess supply of real estate, and an entire generation of small investors was left with painful financial losses and a negative outlook on real estate as an investment. Many small investors view real estate as an institutional arena. Given the large amount of capital required to buy a real estate portfolio diversified by property type and geography, it is easy to understand the continuing negative sentiment of the small investor. The aftermath of the limited partnerships and the savings and loan crisis has led to a real estate market with a new sense of order. Tax law changes have resulted in more

05_769193 ch01.qxp 5/18/06 8:21 PM Page 13

modest capital formation in the real estate markets. The increased regulation and scrutiny of lenders and their loan portfolios has lowered the propensity for excess leverage in the real estate sector by requiring more equity and higher loan underwriting standards. This has resulted in a more balanced real estate economy. Wall Street has also made a contribution to the real estate sector. The growth in *securitization* of real estate assets through such vehicles as *commercial mortgage-backed securities* (CMBS) and real estate investment trusts has created a public market discipline that has resulted in better transparency of the real estate markets and a more moderate real estate cycle.

securitization
the process of financing a pool of similar but unrelated financial assets (usually loans or other debt instruments) by issuing to investors security interests representing claims against the cash flow and other economic benefits generated by the pool of assets.

The growth of REITs as an asset class has created an opportunity for small investors to participate in the ownership of institutional-quality real estate. REITs have created a solution to the lack of liquidity, lack of efficiency, and lack of relevant performance measurement that confront real estate investors in general. In addition, they provide an efficient mechanism for small investors to participate in real estate portfolios that offer diversity by property type and geography. The advantages and benefits of REITs as an asset class and how to integrate them into a portfolio strategy are the focus of this book.

Points to Remember

- Real estate has been an important component of large institutional investment portfolios for the last century.
- Well-located, high-quality real estate provides excellent return on investment, high current income, and a significant hedge against inflation.
- Real estate behaves very differently from stocks and bonds. Its value is driven by supply and demand in the local real estate market.
- Real estate performs well in both rising and falling interest rate environments.

05_769193 ch01.qxp 5/18/06 8:21 PM Page 14

- Returns in the real estate asset class rival those of stocks on a long-term basis.
- Because it is a hard asset, real estate provides an inflation hedge, but, unlike most hard assets, real estate provides current income.
- In 1960, a vehicle was created by Congress that enabled groups of investors to collectively own real estate portfolios similar to those of institutions. This vehicle was known as the real estate investment trust (REIT).

Chapter 2

The History of Real Estate Investment Trusts

There are two areas where new ideas are terribly dangerous: economics and sex.

—Felix Rohatyn, 1984

In 1960, the concept of real estate investment trusts (REITs) was a new and bold advance. The idea was to allow groups of small investors to pool their resources to invest in large-scale, income-producing commercial property, which had historically been the domain of wealthy investors and large institutions. The enabling legislation for REITs was modeled after the *registered investment company* (RIC), more commonly known as a mutual fund. The idea behind the enabling legislation was simple: Let shareholders create a commonly owned, freely traded portfolio of buildings just like they create a portfolio of commonly owned stocks through a mutual fund.

The REIT Structure

A REIT begins as a simple business trust or corporation. If a number of requirements are met on a year-by-year basis, the business trust or corporation may elect to be considered a REIT for federal income tax purposes. The general requirements fall to four areas:

06_769193 ch02.qxp 5/18/06 8:21 PM Page 16

1. *Organizational structure.* The REIT must be organized as a business trust or corporation. More specifically, it must be managed by one or more trustees who have fiduciary duty over the management of the organization. The organization must have evidence of beneficial shares of ownership that are transferable by certificates. The beneficial ownership must be held by a minimum of 100 persons, and the five largest individual shareholders in the aggregate may not own more than 50 percent of the shares outstanding.
2. *Nature of assets.* The company's assets are primarily real estate held for long-term investment purposes. The rules require that at the end of each taxable year, at least 75 percent of the value of a REIT's total assets must be represented by real estate assets, cash, and government securities. Also, a REIT may not own non-government securities in an amount greater than 25 percent of the value of assets. Securities of any single issuer may not exceed 5 percent of the total value of the REIT's assets or more than 10 percent of the securities of any corporate issuer, other than taxable REIT subsidiaries.
3. *Sources of income.* At least 75 percent of the company's income is derived from real estate or real estate-related investments. A REIT must actually satisfy two income tests. First, at least 75 percent of a REIT's annual gross income must consist of real property rents, mortgage interest, gain from the sale of real estate assets, and certain other real estate-related sources. Second, at least 95 percent of a REIT's annual gross income must be derived from the income items from the preceding 75 percent test plus other passive income sources such as dividends and any type of interest.
4. *Distribution of income.* Ninety percent of net income must be distributed to shareholders. This is defined as net taxable income as determined by the Internal Revenue Code. If the required conditions are met, a REIT may deduct all dividends paid to its shareholders and avoid federal taxation at the corporate level on the amount distributed.

Unlike the case for other corporations, which tend to retain most of their earnings and pay tax at the corporate level, the income tax burden

06_769193 ch02.qxp 5/18/06 8:21 PM Page 17

for REITs is substantially shifted to the shareholder level. The REIT only pays federal income tax on any of the 10 percent of undistributed net income it elects to retain. Unlike partnerships, REITs cannot pass losses through to their investors. Despite the legislative intent of the REIT structure, the industry experienced a tortuous and checkered history for its first 25 years. In the early days, REITs were seriously constrained by policy limitations. They were mandated to be passive portfolios of real estate and were allowed only to own real estate, not to operate or manage it. This early requirement dictated that REITs needed to use third-party independent contractors to operate and manage their investment properties. This arrangement often came with built-in conflicts of interest, and the investment marketplace did not easily accept this passive paradigm. As mentioned in Chapter 1, during these early years the real estate investment landscape was driven by tax shelter-oriented investment characteristics. Overvalued properties, coupled with the use of high debt levels, created a significant artificial basis for depreciation and interest expense. These interest and depreciation deductions were used to reduce or eliminate taxable income by creating so-called paper losses used to shelter an individual taxpayer's earned income. In an era of high marginal tax rates, the idea of using these real estate tax shelters became an industry unto itself. Investment real estate was analyzed, developed, packaged, and sold on the basis of its ability to structure and generate paper losses, which were used to shelter ordinary taxable income. This environment removed any sound economic rationale from the real estate investment equation.

Because REITs are most often geared specifically toward generating taxable income on a regular basis, and a REIT, unlike a partnership, is not permitted to pass losses through to its owners, the REIT industry simply could not compete effectively for investment capital against tax shelters. The idea of receiving regular income then from an investment was not usually considered favorable unless there were losses available to offset that income because most individual investors were subject to high marginal tax rates.

The REIT industry has suffered some debacles that resulted from the tax environment of the early years. Because of the inability to pass losses through, many REITs focused on making mortgages of various types during the tax-motivated era in real estate. A large number of mortgage REITs made loans to builders and developers who in turn developed property that was intended for use as tax shelters. When interest rates rose to double-digit levels in the mid-1970s, many mortgage REITs

06_769193 ch02.qxp 5/18/06 8:21 PM Page 18

were unable to access capital and collapsed, leaving the REIT industry with a bad reputation. The bankruptcies included many REITs that were associated with large, well-known (and allegedly conservative) financial institutions.

The tax-motivated environment also led to the creation of *finite-life real estate investment trusts* (FREITs). The idea behind these was to create a type of REIT that would liquidate its property portfolio (arguably for a large gain) at some certain time in the future. The FREIT would then use a very high degree of leverage to buy properties. The high interest expense would substantially reduce the REIT's current income available for distribution. Then the portfolio would be liquidated and the capital gains would be distributed to shareholders. Most FREITs were not able to liquidate their holdings for any meaningful gain. In fact, most lost all the equity of the shareholders. Perhaps the most infamous aspect of REIT history is the story of the paired-share and stapled REITs, which were also born in the era of tax-motivated investing. For a more detailed discussion, see Chapter 10.

Tax Reform Act of 1986

With the *Tax Reform Act of 1986*, Congress changed the entire dynamic of the real estate investment landscape. By limiting the deductibility of interest, lengthening depreciation periods, and restricting the use of passive losses, the 1986 Act drastically reduced the potential for real estate investment to generate tax shelter opportunities. This policy change at the legislative level meant that the new dynamic in real estate investment needed to be on a more economic and income-oriented footing. More importantly, as part of the 1986 Act, Congress also modified a significant policy constraint that had been imposed on REITs at the beginning. The new legislation modified the passive aspects of the original REIT rules. The change permitted REITs not simply to own, but also to operate and manage most types of income-producing commercial properties by providing "customary" services associated with real estate ownership. This new legislation finally allowed the economic interests of the REIT's shareholders to be merged with those of its operators and managers. The change applied to most types of real estate other than hotels, health care facilities, and some other businesses that provide a high degree of personal service.

06_769193 ch02.qxp 5/18/06 8:21 PM Page 19

The results of the new legislation in 1986 set the stage for significant growth of REITs as an asset class. From a policy standpoint, the new legislation achieved three important milestones:

1. It eliminated the artificial tax-motivated capital flows to the real estate sector that skewed the investment rationale and distorted the economic basis for real estate activities.
2. It eliminated any artificial bias in the formation of capital by applying uniform policy guidelines to all real estate, thereby leveling the playing field for all participants in the real estate capital market.
3. It eliminated the inherent conflict of interest that kept REIT property owners from managing their own portfolio holdings, thus removing one of the key public market objections to the REIT structure.

Suddenly, dispassionate and rational economic operation returned to the world of real estate.

Tax Reform Act of 1986
federal law that substantially altered the real estate investment landscape by permitting REITs not only to own, but also to operate and manage most types of income-producing commercial properties. It also stopped real estate tax shelters that had attracted capital from investors based on the amount of losses that could be created by real estate.

The New REIT Era

The Tax Reform Act of 1986 dramatically realigned the economic and legislative policy forces that shape the real estate markets. The new economics of real estate and the positive changes to the REIT format set the stage for the modern era of the REIT. However, as with any new market dynamic, it took time for the market participants to analyze and understand the new market forces. In addition, the excesses of the old real estate markets needed to be cured.

The aftermath of the change in tax policy was the real estate recession of the early 1990s. Until the late 1980s, banks and insurance companies continued real estate lending at a significant pace. Foreign investment in U.S. real estate, particularly from Japan, also continued to distort the market dynamics in the late 1980s.

06_769193 ch02.qxp 5/18/06 8:21 PM Page 20

By 1990, the combined impact of the savings and loan (S&L) crisis, the 1986 Act, overbuilding during the 1980s by non-REITs, and regulatory pressures on bank and insurance lenders led to a nationwide recession in the real estate economy. During the early 1990s, commercial property values dropped between 30 and 50 percent. Market conditions largely impeded the availability of credit and capital for commercial real estate. As a result of the recession and the ensuing capital crunch, many real estate borrowers defaulted on loans. The resulting losses by financial institutions triggered the S&L crisis and created a huge expense for the federal government. In order to maintain confidence in the banking system, the *Federal Deposit Insurance Corporation* (FDIC) undertook a massive bailout of the nearly bankrupt S&L system. Under government oversight, many insolvent S&Ls were forced to merge with stronger, better-capitalized S&Ls. In order to induce this consolidation, the government guaranteed the financial performance of the insolvent S&Ls. In many other cases, insolvent S&Ls were liquidated with government oversight. The massive restructuring of the S&L system flooded the market with nonperforming real estate assets during the late 1980s. This major dislocation of the real estate markets exacerbated the decline in commercial property values during the early 1990s.

The 1990s to the Present

The real estate market excesses of the 1980s began to fade by the early 1990s. A higher standard was now required of real estate lenders. Market participants were no longer artificially motivated by tax policy to invest in real estate. This marked the starting point for what is considered by most industry observers to be the modern era of REITs. Starting in November 1991 against this backdrop, many private real estate companies decided that it might be more efficient to access capital from the public marketplace utilizing REITs. At the same time, many investors, realizing that recovering real estate markets were just over the horizon, decided that it was potentially a good time to invest in commercial real estate. This has led to a relatively long and stable sustained growth in the REIT asset class.

Since 1992, many new publicly traded REITs have infused much needed equity capital into the overleveraged real estate industry. As of June 30, 2005, there were over 200 publicly traded REITs and real estate

06_769193 ch02.qxp 5/18/06 8:21 PM Page 21

operating companies, with an *equity market capitalization* exceeding $800 billion. This compares with $16.4 billion of market capitalization at the start of 1992. The dramatic growth can be seen in Figure 2.1. Today REITs are essentially owned by individuals, with an estimated 30 percent of REIT shares owned directly by individual investors. Thirty-eight percent of REIT shares are owned by mutual funds, whose shares are in turn primarily owned by individual investors. But REITs certainly do not just benefit individual investors, nor should they be considered as investments only suited for retail-type individual investors.

equity market capitalization
the market value of all outstanding common stock of a company.

The debt levels associated with new-era REITs are lower than those associated with overall real estate investment. This has had a positive effect on the stability of the REIT asset class. Average debt levels for REITs are typically 45 to 55 percent of market capitalization, as compared to leverage of 75 percent and often higher when real estate is privately owned. The higher equity capital level of REITs helps to cushion them from the negative effects of the cyclical fluctuations that have historically occurred in the real estate market. The ability of REITs to better withstand market downturns creates a stabilizing effect on the real estate industry and its lenders, resulting in fewer bankruptcies and loan defaults. Consequently, the general real estate industry has benefited from reduced real estate losses and more consistent investment returns. This has helped real estate regain credibility with the investing public. It has fostered continued capital flows to the REIT sector and real estate in general.

REITs currently own approximately $1 trillion of commercial real estate. This represents less than 20 percent of the estimated $5.5 trillion of institutional-quality U.S. domestic real estate. Consistent with the public policy underlying the REIT rules, many industry observers believe that the trend over time will continue to show the U.S. commercial real estate economy moving toward more and more ownership by REITs and publicly traded real estate operating companies. This public securitization of real estate is the hallmark of the new REIT era. With the current trend in place, there are very few reasons to believe that the growth in public real estate will not continue.

06_769193 ch02.qxp 5/18/06 8:21 PM Page 22

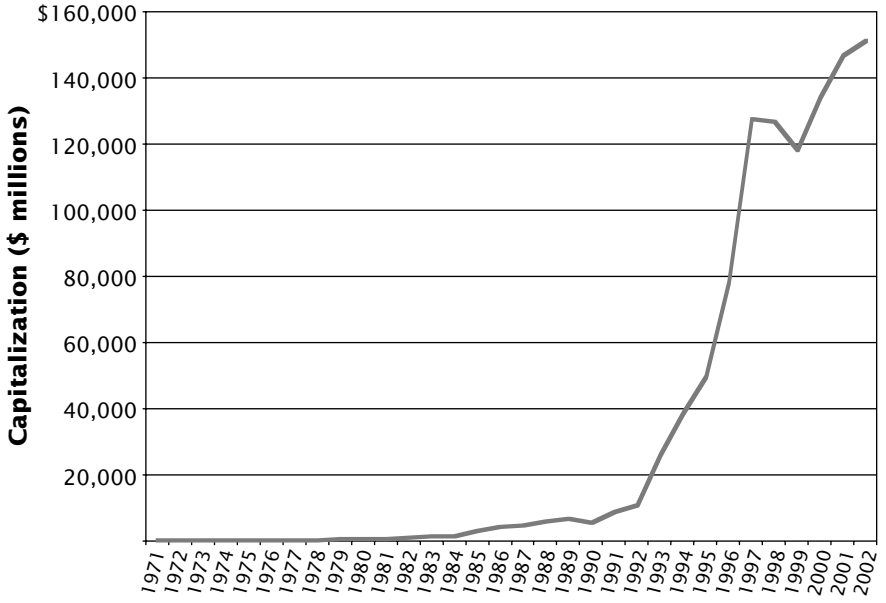

FIGURE 2.1 Equity Capitalization of REITs
Source: NAREIT.

The 1986 Act effectively married REIT management to REIT assets, and the Taxpayer Relief Act of 1997 included additional helpful REIT reforms, but members of the REIT industry still believed they were required to operate under limitations that increasingly made them noncompetitive in the emerging customer-oriented real estate marketplace. They believed that the real estate industry, like other major businesses in the United States in the 1990s, was rapidly evolving into a customer-oriented service business. REIT landlords that provide new services to their tenants, only after such services have become "usual and customary," risk losing their competitive edge in attracting and retaining top-quality tenants. Nevertheless, regulations restricted what services REITs could offer. As REITs grow larger, they automatically affect what services are considered customary in a geographic locale. Under the old rules, some services might never be considered customary because REITs are prevented from providing leading-edge services. Businesses have also discovered that providing ancillary services with good quality control produces customer loyalty. Under the law as it existed, a REIT was required to use independent contractors to provide noncustomary services

06_769193 ch02.qxp 5/18/06 8:21 PM Page 23

to its tenants, so REIT management had little control over the quality of the services rendered by the independent contractor to the REIT's tenants. Income from these potential revenue-producing opportunities would accrue to the benefit of a third party, not to the REIT's shareholders. The ability to provide potential new services to tenants would have three key benefits for the competitive posture of REITs within the real estate industry:

1. The availability of the new service to the tenant would generate greater customer loyalty and allow the REIT landlord to remain competitive with non-REIT owners that had no limitation on the type of services they could offer.
2. The new services (offered either by the landlord or by a third party licensed by the landlord) could generate an additional stream of income for the REIT shareholders.
3. The REIT management could maintain better quality controls over the services rendered to its tenants.

Over the last decade, new-era REITs have performed services for their tenants so well that third parties began to retain REITs for that purpose. The original REIT legislation contemplated that REITs could earn up to 5 percent of their income from sources other than rents, capital gains, dividends, and interest. However, many REITs were now being presented with the opportunity to maximize shareholder value by earning more than 5 percent from managing joint ventures with service providers and from selling other third-party services. Prior to the most recent changes in REIT rules, many REITs invested in non-REIT C corporations to capture part of this income flow. These corporations provided to unrelated parties services that were already being delivered to a REIT's tenants, such as landscaping or the management of a shopping mall in which the REIT owned a joint venture interest. These arrangements often involved the use of a REIT's management personnel and were often constructed in very complex ways in order to maintain REIT status.

The industry argued that these rules were too restrictive and put REIT operators (and their shareholders) at a distinct disadvantage against non-REIT operators in the industry. At the time, the REIT asset rules were patterned after the asset diversification rules applicable to mutual funds. Under those rules, a REIT could not own more than 10

06_769193 ch02.qxp 5/18/06 8:21 PM Page 24

percent of the voting securities of another company (other than a "qualified REIT subsidiary" or another REIT), and the securities of another company could not exceed 5 percent of the value of a REIT's total assets. In response to these constraints, Congress enacted the *REIT Modernization Act (RMA) of 1999*. The centerpiece of this legislation was the creation of rules and guidelines for *taxable REIT subsidiaries* (TRSs). The legislation allows a REIT to own 100 percent of the stock of a company know as a TRS. The TRS can provide services to REIT tenants and third parties within certain limitations without jeopardizing the REIT status of the parent. The limitations contained in the TRS rules provide for size limits on TRSs to ensure that REITs continue to focus on property ownership and operation. The key provisions are that the TRS may not exceed 20 percent of a REIT's assets and the amount of debt and rental payments from a TRS to its affiliated REIT are limited. The TRS rules and a series of minor technical adjustments to the old rules should allow REITs to enjoy the same advantages and benefits of service and operating strategies that non-REIT real estate competitors may employ.

REIT Modernization Act (RMA) of 1999
federal tax law change whose provisions allow a REIT to own up to 100 percent of stock of a taxable REIT subsidiary that can provide services to REIT tenants and others. The law also changed the minimum distribution requirement from 95 percent to 90 percent of a REIT's taxable income—consistent with the rules for REITs from 1960 to 1980.

These legislative initiatives, along with the steady growth in REIT assets, have not gone unnoticed by the institutional investment community. Modern-era REITs now have sufficient size and history to be considered a viable alternative to direct real estate investments. Institutional investors have also acknowledged the advantage of the liquidity characteristic that REITs bring to the real estate asset class. (In Chapter 3, we explore the modern REIT as an independent asset class and the impact of REITs in a multi-asset portfolio.)

Points to Remember

- A real estate investment trust (REIT) is a company dedicated to owning and managing income-producing real estate, such as apartments, shopping centers, offices, and warehouses.

06_769193 ch02.qxp 5/18/06 8:21 PM Page 25

- REITs are legally required to pay virtually all of their net income (90 percent) to their shareholders each year in the form of dividends.
- REITs confer all the advantages and characteristics of owning real estate. In addition, REITs provide current liquidity for shareholders because their shares are freely traded on major stock exchanges. An investor can obtain all the benefits of owning real estate and enjoy complete liquidity of the investment.
- The Tax Reform Act of 1986 radically changed the investment landscape for REITs. The new laws drastically reduced the potential for real estate investment to generate tax shelter opportunities by limiting the deductibility of interest and lengthening and restricting the use of passive losses. This meant that real estate investment had to be economic and income oriented rather than tax motivated.
- When commercial property values dropped in the early 1990s, it became difficult to obtain credit and capital for commercial real estate. Many private real estate companies decided that the best way to access capital was through the public marketplace using REITs.

Chapter 3

REITs as an Asset Class

The best investment on Earth is earth.
—Louis Glickman, 1957

Behind bonds and stocks, commercial real estate is the third-largest asset class available to investors with an estimated value of $11.0 trillion in the United States. Institutional-quality real estate—real estate large enough for an institutional buyer to consider purchasing—is estimated to be worth $5.5 trillion or approximately half the value of the commercial real estate universe. Real estate investment trusts (REITs) and *real estate operating companies* (REOCs) own and operate approximately $1.0 trillion worth of institutional-quality investment real estate, or roughly 20 percent of the total.

The Real Estate Asset

As discussed in Chapter 1, real estate is an asset class that has provided institutional investors with many positive attributes over time. Real estate investment trusts are competitors with other institutional investors in the real estate market. They pool the financial resources of a large number of investors for the specific purpose of investing in real estate. In many ways, a REIT is like a mutual fund except that it invests in real estate. As discussed in Chapter 2, companies that meet certain requirements can qualify as REITs and avoid federal taxation on all net income that is distributed as dividends to their shareholders. REITs that directly

07_769193 ch03.qxp 5/18/06 8:22 PM Page 28

own real estate share the principal investment benefits of real estate ownership that all other institutional real estate owners enjoy. The three key investment benefits provided by most real estate are:

1. *Cash flow.* Consistent and predictable cash flow generated from rents paid is an attractive benefit of the real estate asset class.
2. *Inflation hedging.* Real estate tends to act as a hedge against inflation, increasing in value at a rate faster than inflation over the long term.
3. *Portfolio diversification.* The independent local-market nature of real estate produces returns that behave very independently from both stocks and bonds. This low correlation of return provides an added diversification benefit when real estate is added to a multi-asset portfolio.

Real estate is also subject to some potentially negative qualities. As discussed in Chapter 1, here is a brief summary of these negative attributes:

- *Real estate lacks liquidity.* Because the process of buying and selling real estate is negotiated directly between buyers and sellers in local markets and often involves financing arrangements, transactions can be long and involved. Six months to a year is not an uncommon transaction time.
- *Real estate's performance is difficult to measure.* Because real estate values are determined upon sale, it is difficult to calculate total performance of a real estate portfolio prior to the sale of the properties.
- *Real estate cannot be moved.* With very few exceptions, such as mobile homes, it is not feasible to relocate existing real estate to markets where demand is better or supply is constrained.
- *Real estate is unique.* The physical attributes of a building and its location are unique to that building. This can have both positive and negative aspects when dealing with a specific piece of real estate.
- *Real estate is subject to externalities.* Events or activities beyond the control of the property owner affect (for good or bad) the value of a property.

As stated before, real estate is also subject to some *potentially* negative qualities. The emphasis on the word *potentially* is added because, as a substitute for the direct ownership of real estate, the unique characteristics of

07_769193 ch03.qxp 5/18/06 8:22 PM Page 29

REITs solve some of these problems. The remaining potential problems can be effectively managed in the REIT format. These benefits give REITs a series of distinctive qualities that make them in many ways superior to direct real estate investment.

REIT Idea: Liquidity

The most important dilemma solved by REITs with regard to real estate is the issue of liquidity. Each market day over $800 million of REITs trade in the public markets. Compare this with the weeks or months it can take to sell a single property in the private market and the single advantage of liquidity becomes apparent.

The biggest issue solved by the REIT asset class is that of liquidity. Unlike direct real estate investments, REITs are generally public companies. They trade on major stock exchanges such as the New York Stock Exchange and the American Stock Exchange as well as on NASDAQ and over-the-counter markets. The dramatic growth in the number of publicly traded and the related growth in public equity market capitalization (see Figure 3.1) have converged to make the liquidity benefit of REITs a major

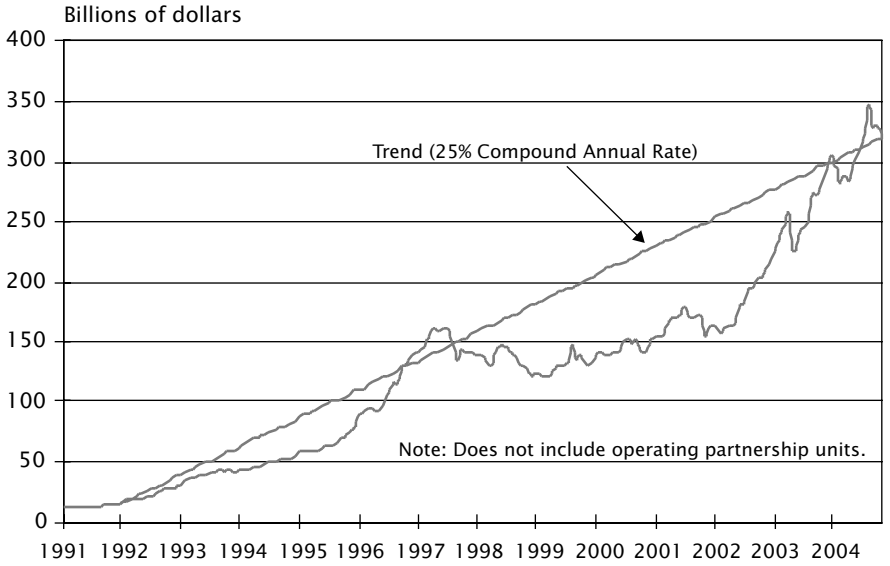

FIGURE 3.1 Equity Market Capitalization of U.S. REITs (as of October 31, 2005)
Source: Uniplan, Inc.

07_769193 ch03.qxp 5/18/06 8:22 PM Page 30

differentiating factor for the asset class. As seen in Figure 3.2, the average daily trading volume in REITs exceeds $800 million. The public markets have provided between $300 million and $500 million of daily liquidity since 1996. When compared to a six-month liquidity window for direct real estate investment, the advantage of daily liquidity becomes apparent.

The liquidity advantage becomes a useful tool for the REIT investor under a number of different circumstances. The daily liquidity of REITs allows an investor to move into or out of a property category such as apartments. This can be useful to an investor who wants to diversify an existing portfolio of other real estate investments. For example, an investor who directly owns an interest in a portfolio of shopping centers can easily add apartments, industrial buildings, or other property sectors that are represented by REITs trading in the public markets. This ability to "tilt" the sector exposure of a direct real estate portfolio by adding REITs to a real estate allocation is a useful tool for all real estate investors.

The liquidity advantage of REITs extends in the same way to the geographic diversification of a direct real estate portfolio. As mentioned earlier, the physical attributes of real estate preclude moving property from a local market where demand is falling or supply is in excess to a location where supply-and-demand characteristics are better. However, REITs provide the direct property owner with the option of diversifying a portfolio by geography. By simply adding REITs with exposure in

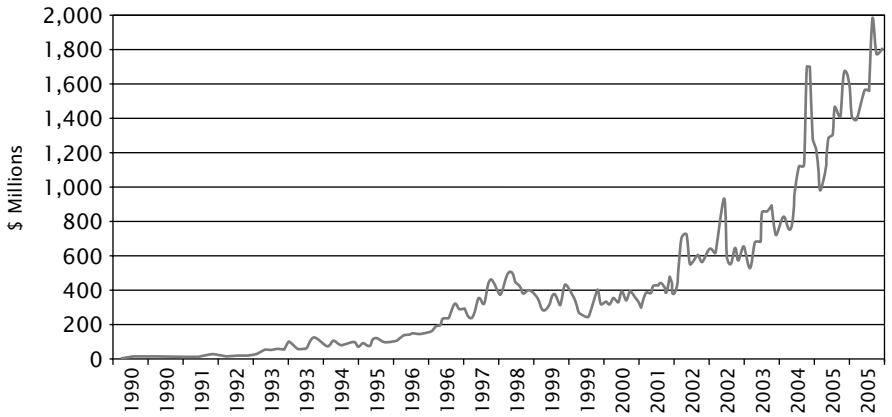

FIGURE 3.2 Monthly Average Daily Trading Volume of REITs (March 1990–October 2005)
Source: NAREIT.

07_769193 ch03.qxp 5/18/06 8:22 PM Page 31

other geographic regions, additional geographic diversification can be achieved. For example, an owner of an interest in a diversified portfolio of investment real estate in the Chicago area can add property in other locations, such as California or New York City, by adding to the portfolio REITs that have property holdings in those geographic markets. This ability to tilt the geographic exposure of a direct real estate portfolio by adding REITs to a real estate allocation allows direct real estate investors to gain exposure in locations that have better fundamental supply-and-demand characteristics than those in their current portfolio.

When applied to a portfolio made up exclusively of REITs, the liquidity advantage of REITs becomes even more pronounced. A pure REIT portfolio can largely eliminate the liquidity issue involved with direct real estate investments, while retaining the positive attributes of cash flow, creating an inflation hedge, and providing the additional portfolio diversification of similar direct real estate investments. In addition, the liquidity advantage of REITs allows an investor to easily add sector tilt or geographic tilt within a portfolio of REITs. The ability to migrate easily between geographic regions and property categories should not be underestimated.

Over time the property types and geographic regions most favored by direct institutional investors have shifted. These shifts are often dictated by changes in supply and demand, which are driven by local market events and macroeconomic trends. During the 1970s, regional malls were highly sought after by direct institutional investors. In the late 1970s, growth in retail sales began to fall behind the rate of inflation, and the general economy began to enter a recession in 1979. This resulted in regional malls falling out of favor with direct institutional investors. Office buildings went through a similar cycle during the 1980s. Similar local market and macroeconomic trends related to the Internet revolution made San Jose and the San Francisco Bay area a highly regarded and popular geographic region for direct real estate investors during the second half of the 1990s.The collapse of the dot-com economy during 2000 resulted in a change in investor sentiment toward the region and a corresponding change in the valuation levels of properties within the region. The ability to migrate easily between geographic regions and property categories can allow the REIT investor to capitalize on the shifts in property types and geographic regions that are the result of local market events and macroeconomic trends.

07_769193 ch03.qxp 5/18/06 8:22 PM Page 32

The direct institutional investor can make similar portfolio changes. However, the lack of liquidity and the high frictional cost of making those changes often preclude an active management style at the direct investment level. For a few cents per share, a REIT investor can actively change geographic or property exposures with a phone call to a brokerage firm. (Chapter 6 creates a framework for the geographic and sector decision-making process that supports such real estate portfolio changes.)

The measurement of period-to-period performance in a direct real estate portfolio is difficult. Information about specific real estate market performance is harder and more expensive to obtain than that about the performance of stocks and bonds. Because real estate values are determined upon sale, the only way to know the true performance of a direct real estate investment is to calculate it at the time of sale of the portfolio or a particular property within the portfolio.

Data for developing performance measures over shorter periods in the direct portfolio, such as quarterly or annual returns, is often the result of estimates. These estimates are often based on capitalization rates derived from examining sales of similar properties in the local market. When used prudently, these estimates help assess the performance of a direct real estate portfolio; but they tend to smooth out the fluctuations that might be observed in the actual values. For this reason, the estimate approach tends to understate the measurement of risk or the standard deviation of returns. The true performance results will only really be known at the time of sale.

Because of the long-term policy mandates of many institutional portfolios, a periodic estimate of value in the real estate allocation is often sufficient for fiduciary purposes. The real performance measurement problem begins to surface when a fiduciary must assess how a particular real estate portfolio is doing relative to other real estate portfolios. Because other direct real estate portfolios are subject to the same estimate bias, it is not possible to rank the performance of a given portfolio until the portfolios in question have been liquidated. This makes the assessment of relative portfolio performance particularly difficult. By contrast, REITs pose far fewer performance measurement issues. Because REITs and related securities trade like stocks, it is relatively simple to calculate the periodic investment returns. In addition, the same periodic pricing data can be used to calculate risk or standard deviation of returns for any given period. The readily available pricing data makes the calculation of

07_769193 ch03.qxp 5/18/06 8:22 PM Page 33

periodic performance and portfolio risk a simple matter in a portfolio composed of REITs.

The assessment of relative portfolio performance is also readily available for the REIT investor. There are a large number of real estate securities indexes that are generally available through various public sources on a daily real-time basis. These indexes, which are also described in this chapter, are typically unmanaged or passive in construction and are composed of broad-based aggregates of REITs. Some also include real estate service and homebuilding companies. When used as an appropriate benchmark, these indexes can help in assessing the performance of a REIT portfolio or its manager.

There are over 70 mutual funds and several exchange traded index shares that invest specifically in REITs or more generally in the real estate sector. These funds are listed in the Appendix A at the end of this book. Performance data on these funds is widely available in various publications such as the *Wall Street Journal* or through mutual fund rating services such as Morningstar and Weissenberger's. The performance data from these funds can also be used to make comparative measurements of the performance of actively managed real estate securities portfolios. The fund companies themselves can also be a source of additional performance-related data, including operating expenses and comparative portfolio characteristics.

The unique positive characteristics of the REIT asset class help it overcome the liquidity and performance issues related to direct real estate investment. As discussed, the liquidity advantage also mitigates the negative issues regarding the fixed physical nature of property. Thus the issues of uniqueness and externalities remain. These issues can have both good and bad aspects. Like any real estate investor, the REIT investor can attempt to manage the risks of uniqueness and employ strategies to defend against and monitor possible externalities. The physical attributes of a building and its location that is unique to that building can have both positive and negative aspects when dealing with a specific piece of real estate. Some buildings are built with very specific objectives in mind. When given the right mix of circumstances, this can justify a higher expected return from a given real estate project. Conversely, the wrong mix of circumstances can quickly create an underperforming asset.

A Wal-Mart store is physically a very specific type of real estate project. That said, owning a portfolio of Wal-Mart stores that are leased on a

07_769193 ch03.qxp 5/18/06 8:22 PM Page 34

long-term basis to Wal-Mart might be a good investment. The credit quality of Wal-Mart helps to overcome the specific physical limitations of the actual real estate. Conversely, owning a portfolio of industrial warehouses that were designed and built specifically to accommodate the Internet grocer Web Van might not be as appealing. The credit quality of Web Van is likely not sufficient to overcome the negative attributes of the physical real estate. The various aspects of managing these types of physical issues are discussed in detail in Part Three of this book, which deals specifically with each property category available in the public REIT format.

Externalities are a group of risk factors that are difficult to manage. The fact that they are external to the activity makes the management of externalities a defensive process, because the causal agent is external and beyond the control of the affected items. The best defense against externalities in real estate is location. The externalities that will negatively affect a class-A high-rise office building on Park Avenue in New York City are far fewer than those that could affect a class-B office building at a little known intersection in suburban Cleveland. The highest-and-best use doctrine will likely prevent a garbage dump or chemical factory from appearing in Manhattan; but this may not be the case in Cleveland. These risk factors are also discussed at more length at the property-specific level in each chapter of Part Three. The old real estate adage cannot be stressed enough—"Location, location, location"—because it is a key factor when anticipating external effects.

externality
an activity or event that affects (positively or negatively) something that is external to the activity.

Publicly traded REITs have a particular type of risk that is less of a factor in the direct real estate sector. *Systematic risk* or *market risk* is a form of risk that the direct real estate investor never encounters. This market risk affects REITs because they are part of a group of companies within a larger asset market known as the stock market or the public capital markets. Events that may be completely unrelated to REITs or the local real estate markets in which they operate can have a negative (or positive) affect on the value of publicly traded REIT shares. The unexpected default of Russian government bonds in 1998 caused a severe dislocation in the world capital markets. This resulted in a sharp decline in stock prices across global markets, including a decline in the market price of REIT shares. Although the default may have had some negative

07_769193 ch03.qxp 5/18/06 8:22 PM Page 35

implications for the price of real estate in general, the direct real estate investor did not suffer the immediate market price decline that impacted REIT shares. It could be argued that systematic risk is an externality in real estate that is specific to publicly traded REIT shares.

Public Market Real Estate Indexes

There are a large number of real estate securities indexes that are generally available through various sources on a daily real-time basis. These indexes are typically unmanaged or passive in construction and are composed of broad-based aggregates of REITs and other real estate-related companies. Some also include real estate service companies and home building companies. The following is a brief description of the major public market real estate indexes.

The *National Association of Real Estate Investment Trusts* (NAREIT) is the primary trade association for REITs. It is recognized as the leading public resource on the REIT industry and has performance data on REITs extending back to 1972. The organization compiles and publishes a group of indexes that are composed exclusively of publicly traded REITs:

- *NAREIT Index.* This is NAREIT's index of all publicly traded REITs. It is the best-known and most referenced index of REIT performance. The broadest pure REIT index, it includes all publicly traded REITs in relative market weightings. This index is available on a real-time basis. It rebalances on a monthly basis for new and merged REITs and new issuance of equity by existing REITs.
- *NAREIT Equity Index.* This is the same as the NAREIT Index, except that it excludes mortgage REITs to reflect a pure equity real estate benchmark. This index is available on a real-time basis. It rebalances on a monthly basis for new and merged REITs and new issuance of equity by existing REITs.
- *NAREIT 50 Index.* This is an index of the 50 largest publicly traded REITs. It is a benchmark more suited to the institutional investor because of the liquidity issues surrounding smaller-capitalization REITs. This index is available on a real-time basis. It rebalances on a monthly basis for new and merged REITs and new issuance of equity by existing REITs.

07_769193 ch03.qxp 5/18/06 8:22 PM Page 36

- *NAREIT Mortgage Index.* This is an index of all publicly traded mortgage REITs. This index is available on a real-time basis. It rebalances on a monthly basis for new and merged REITs and new issuance of equity by existing REITs.

Other financial organizations also track and publish statistics on REITs and publicly traded real estate securities:

- *S&P REIT Composite Index.* This index comprises 100 REITs, including mortgage REITs. It covers approximately 75 percent of REIT market capitalization. This index requires high-quality financial fundamentals, good liquidity, and strong earnings and dividend growth as characteristics for inclusion. It is reweighted on a quarterly basis, and returns are computed on a daily basis.
- *Morgan Stanley REIT Index.* This is a tradable real-time market index. It is constructed by Morgan Stanley. This index has a laundry list of inclusion requirements, such as minimum market capitalization, shares outstanding, trading volume, and share price. To be included, a REIT must have a six-month trading history and must be listed on a major exchange. This index is rebalanced quarterly and does not include mortgage or health care REITs. Its ticker symbol on the AMEX is RMZ.
- *Wilshire Real Estate Securities Index.* This index is composed of REITs and other real estate operation companies. The composition is determined on a monthly basis by Wilshire Associates. This index includes hotel operating companies and development and homebuilding companies. It does not include specialty, health care, or mortgage REITs. Wilshire publishes returns on a monthly basis, with details available on a subscription basis. There is no real-time information available on this index.

The public market real estate indexes are primarily derived from the approximately 200 publicly traded REITs—a selection of these are listed in Appendix B of this book—and other real estate-related companies that invest primarily in real estate but for various reasons have not elected REIT status (see Table 3.1). *Equity REITs* provide investment opportunities in all

07_769193 ch03.qxp 5/18/06 8:22 PM Page 37

major property types. The large number of publicly traded REITs provides real estate exposure in most major geographic regions.

Table 3.2 describes the distribution of properties owned by publicly traded REITs by geographic region and property type. It comes as no surprise that the distribution of REIT assets is skewed toward the largest major metropolitan markets. In fact, about 50 percent of public REIT property holdings are in the top 25 metropolitan markets. This gives the REIT investor the potential to diversify widely by geographic location and to focus on major markets with the most favorable supply and demand characteristics.

equity REIT
a REIT that owns or has an "equity interest" in rental real estate and derives the majority of its revenue from rental income (rather than making loans secured by real estate collateral).

These local supply and demand factors tend to drive the performance of specific REITs. Performance is generally more of a function of local market conditions and less a function of the stock and bond markets. Because REITs have a low correlation to both stocks and bonds, they provide additional diversification to an investment portfolio. It is this diversification benefit as it fits into the framework of modern portfolio theory that REITs provide in a multiasset-class portfolio. In Chapter 4, we examine these aspects of the REIT asset class.

TABLE 3.1 Public REIT Sectors (as of June 30, 2005)

Office	16%
Industrial	9%
Residential	15%
Retail	25%
Diversified	8%
Hotels	6%
Health Care	5%
Self-Storage	4%
Specialty	4%
Mortgage	8%

TABLE 3.2 Geographic Distribution of REIT Property Ownership

Region	*Apartment Units*	*Retail Sq. ft.*	*Office Sq. ft.*	*Industrial Sq. ft.*	*Hotel Rooms*	*Health Care Rooms*
Pacific	12%	19%	20%	21%	17%	12%
Mountain	8%	16%	3%	2%	11%	9%
West North Central	2%	4%	0%	1%	7%	7%
East North Central	15%	11%	6%	28%	10%	7%
Southwest	19%	9%	19%	18%	3%	19%
Southeast	18%	19%	15%	15%	16%	20%
Mid Atlantic	14%	11%	18%	8%	14%	12%
Northeast	12%	11%	19%	7%	22%	14%
Total	100%	100%	100%	100%	100%	100%

Region 1—Pacific
Alaska
California
Hawaii
Oregon
Washington

Region 2—Mountain
Arizona
Colorado
Idaho
Montana
Nevada
Utah
Wyoming

Region 3—West North Central
Iowa
Kansas
Minnesota
Missouri
Nebraska
North Dakota
South Dakota

Region 4—East North Central
Illinois
Indiana
Michigan
Ohio
Wisconsin

Region 5—Southwest
Arkansas
Louisiana
Oklahoma
Texas

Region 6—Southeast
Alabama
Florida
Georgia
Mississippi
North Carolina
South Carolina
Tennessee

Region 7—Mid Atlantic
Delaware
District of Columbia
Kentucky
Maryland
Virginia
West Virginia

Region 8—Northeast
Connecticut
Maine
Massachusetts
New Hampshire
New Jersey
New York
Pennsylvania
Rhode Island
Vermont

Source: Uniplan, Inc.

07_769193 ch03.qxp 5/18/06 8:22 PM Page 39

Points to Remember

- In the public market there are about 180 publicly traded real estate investment trusts (REITs) that deal with office, industrial, apartment, shopping center, regional mall, hotel, health care, and specialty properties. Their holdings include some of the finest properties in America, such as Mall of America in Minneapolis and the Embarcadero Center in San Francisco.
- Because real estate values are driven by local supply-and-demand factors, REITs allow an investor to isolate property categories and local market conditions that are improving while avoiding markets and properties that are deteriorating.
- It is possible to gain investment exposure to most regional markets or major cities and property categories within those areas simply by investing in REITs.
- Because local supply and demand factors drive the performance of specific REITs, REITs generally behave more as a function of local market conditions and less as a function of the stock and bond markets.
- Because REITs have a low correlation to both stocks and bonds, they provide additional diversification to an investment portfolio.

Chapter 4

REITs as a Portfolio Diversification Tool

Never have so many been paid so much to do so little.
—Anonymous investment manager on consultants

Over the past 20 years an entire industry has been born of the simple concept that the majority of the total performance of a portfolio results from the mix of investment asset classes contained in the portfolio. This simple concept is the cornerstone of *modern portfolio theory* (MPT). The industry spawned by the advent of MPT is known as the investment management consulting industry. This group of consultants stands ready to advise the investing world at large on the correct allocation of different investment vehicles that should be held in a portfolio to achieve the stated investment policy with the least risk to principal and the lowest volatility.

modern portfolio theory (MPT)
based on the idea that when different investments such as stocks, bonds, and REITs are mixed together in a portfolio, it improves the return and lowers the risk over time.

Asset Allocation and Modern Portfolio Theory

As is true of most objectives, there is normally a multitude of ways to achieve the stated goal. Through careful study and analysis, the investment consultant will craft a portfolio allocation model that will drive the

08_769193 ch04.qxp 5/18/06 8:22 PM Page 42

portfolio returns to the stated goal. For a modest additional fee, the consultant will assist the investor in developing a stated goal or policy that is consistent with the asset allocation model.

Large investors such as pension plans, endowments, and wealthy individuals have historically engaged investment consultants to address long-term investment objectives and policy questions related to those issues. These large investors have a fiduciary obligation to protect the interests of their investors, and one way to accomplish this (as well as reduce their own potential liability) is to hire a consultant to monitor investment-related issues. The consultant's job is to advise the client on the correct mix of investments and monitor the underlying performance of those investments to be certain they remain consistent with the objective.

In the past, the high level of mathematics embedded in the consultants' practice, along with the myriad of data required to make the analysis, limited the accessibility of investment consulting to larger institutions. The rapid growth in the power of the personal computer and the democratization of data via the Internet and the availability of modestly priced software have combined to put asset allocation modeling within the reach of even the smallest investor. Websites offering asset allocation advice and online calculators have proliferated. Modestly priced financial planning and asset allocation software is widely available. Traditional Wall Street brokers as well as discount brokerage firms all have asset allocation investment programs available to their investment clients. Mutual fund complexes and 401(k) providers offer asset allocation advice to their clients. Although the conceptual theory of asset allocation is simple, the practical application and administration of the process is much more difficult than most people grasp. As mentioned, there are often many ways to arrive at the same goal, but the devil is in the details.

Asset Allocation Theory and REITs

Total portfolio performance is impacted by three variables that can be attributed to any given investment asset class:

1. Long-term expected and historical rate of return.
2. Volatility of return, often referred to as the *standard deviation of return.*
3. Correlation of returns.

08_769193 ch04.qxp 5/18/06 8:22 PM Page 43

When consultants consider an asset class as a possible investment in a portfolio, they first study the rate of return to determine if the historic and expected returns are high enough to compete with other available investments. This return analysis is tempered with a review of how volatile the return patterns are over time. The higher the volatility of a potential return (often called *risk*), the higher the required rate of return becomes in order to achieve a slot in the investment program. Finally, the pattern of returns, or the correlation of the asset class as it compares to all other asset classes in the portfolio, must be considered. If the correlation is sufficiently different from the other asset classes in the portfolio, the returns are high enough, and the volatility is low enough, then the investment class might gain an allocation position within the portfolio.

standard deviation
measures how spread out the values in a set of data are. In the investment world, the standard deviation is the most commonly used measure of investment volatility over time. Lower standard deviation helps to moderate portfolio risk, but it also tends to provide lower returns.

The classic implementation of asset allocation is in the stock-and-bond mix of a typical balanced portfolio. The stock-and-bond asset classes both have reasonable expected and historical rates of return and are the two largest available asset classes. Over the long term, bond returns are lower than stock returns, but bond returns are far less volatile than stock returns. And the correlation between stocks and bonds is relatively low. When stocks underperform their historical expected rate of return, bonds tend to outperform theirs. This trade-off between risk and return tends to lower the volatility of the entire portfolio and increase the *total return* per unit of risk undertaken. As seen in Figure 4.1, the return for real estate investment trusts (REITs) has historically been higher than that for bonds and slightly lower than that for stocks over most periods of time. We can conclude by studying the numbers that the REIT asset class has historically provided competitive returns when compared to stocks and bonds. It would be expected that in the future REITs will continue to provide returns that are higher than bond returns and slightly lower than common stock returns.

total return
a stock's dividend income plus capital appreciation before taxes and commissions.

08_769193 ch04.qxp 5/18/06 8:22 PM Page 44

Volatility is measured by calculating the standard deviation of the quarterly returns, as a percentage, over a given period of time for a particular asset class. The volatility of REITs is compared to that of large and small stocks and bonds in Table 4.1. As you would expect, because REIT returns are higher than those of bonds, the volatility of REITs is higher than that of bonds when measured over most time periods. REIT volatility is slightly lower than that of large stocks and significantly lower than that of small-cap stocks, while the returns are only slightly lower.

When looking at the data in Figure 4.1 and Table 4.1, it could be concluded that REITs offer returns competitive with those of stocks, while involving substantially less risk or volatility than stocks in general. Correlation is where REITs clearly distinguish themselves as an asset class when compared to stocks and bonds. The correlation coefficient of REITs compared to large and small stocks and bonds is surprisingly low. As summarized in Figure 4.2, REITs have a low correlation to stocks and bonds, and over the 1970s through 1990s the correlation has continued to decline.

When measured in rolling five-year periods, the correlation of REITs to small and large stocks has been steadily on the decline since the early 1990s. This roughly corresponds to the modern era in REITs as discussed in Chapter 2. Table 4.2 shows the declining trend in REIT correlation.

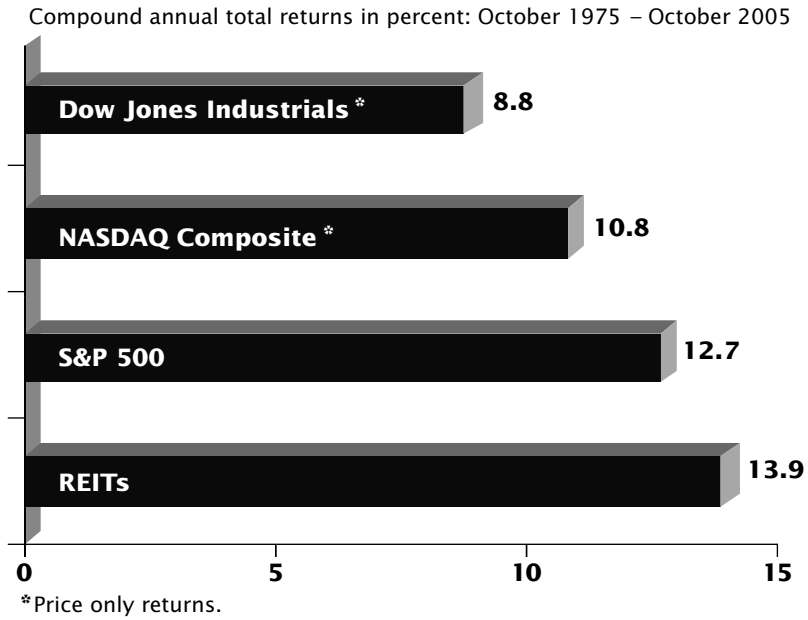

FIGURE 4.1 REITs Measure Up over Time

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TABLE 4.1 Standard Deviation of Quarterly Returns

Period	*REITs*	*Large Stocks*	*Small Stocks*	*Bonds*
1972–2005	14.7	16.3	25.5	11.8
1972–1992	15.0	17.1	26.3	12.7
1993–2005	14.1	13.8	22.1	9.5

Note: REITs: NAREIT Equity Index; Large Stocks: S&P 500; Small Stocks: Russell 2000; Bonds: 20-year U.S. government bond.
Source: Uniplan, Inc.

TABLE 4.2 Monthly Correlation of REIT Total Returns to Other Assets

Period	*Large Stocks*	*Small Stocks*	*Bonds*
1972–2005	0.51	0.58	0.19
1970s	0.64	0.74	0.27
1980s	0.65	0.74	0.17
1990s	0.45	0.58	0.26
1993–2005	0.22	0.26	0.14

Note: REITs: NAREIT Equity Index; Large Stocks: S&P 500; Small Stocks: Russell 2000; Bonds: 20-year U.S. government bond.
Source: Uniplan, Inc.

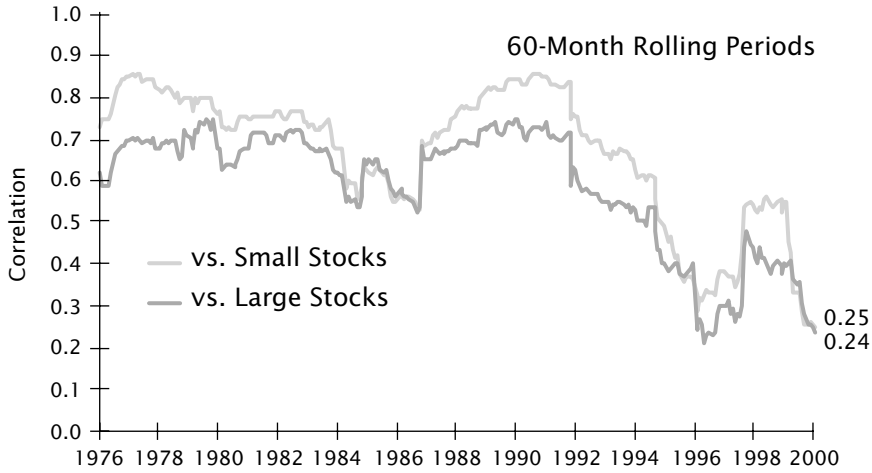

FIGURE 4.2 Declining Equity REIT Correlation
Source: Uniplan, Inc.

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When linked with competitive returns and reasonable volatility, investment return correlation provides the basic rationale for asset allocation and portfolio diversification. The highly noncorrelated nature of the REIT asset class provides a powerful means of additional portfolio diversification. In the now-famous study "Determinants of Portfolio Performance" (*Financial Analysts Journal,* July/August 1986), Gary Brinson makes the case that asset allocation policy determines 91.5 percent of the investment performance of a given portfolio. In other words, the mix of assets in the underlying investment portfolio determines most of the investment performance. The actual security selection process, which most people consider paramount to investment performance, contributes a mere 4.6 percent of portfolio return. So it is not which stocks you own, but the fact that you own stocks, that determines most of the return in a portfolio. Simply put, asset allocation drives portfolio return.

The Portfolio Contribution of REITs

In Figure 4.3 we return to the classic balanced portfolio. For this example, we use a portfolio policy of 50 percent large stocks as defined by the S&P 500 Index, 40 percent 20-year U.S. government bonds, and 10 percent 30-day U.S. T-bills. From 1972 through 2000, the portfolio returns 11.8 percent annually and has a volatility of 11.2 percent. When the stock and bond allocations are each reduced by 5 percent and 10 percent REITs as defined by the NAREIT Equity Index are added, the return over the same period rises to 12 percent and the risk or volatility drops to 10.9 percent. Taking the experiment one step further, when the stock-and-bond allocation are each reduced by 10 percent and a 20 percent REIT allocation is added, the return over the same period rises to 12.2 percent and the risk or volatility drops to 10.8 percent.

Figure 4.4 examines the potential investment contribution of REITs in a classic bond portfolio. In this case, we use a portfolio policy of 90 percent 20-year U.S. government bonds and 10 percent 30-day U.S. T-bills. From 1972 through 2000, the portfolio returns 9.5 percent and has a volatility of 11.3 percent. When the bond allocation is reduced by 10 percent and an allocation of 10 percent REITs as defined by the NAREIT Equity Index is added to the portfolio, the return over the same period rises to 9.9 percent and the risk or volatility drops substantially to 10.6 percent. Taking the experiment one step further, when the

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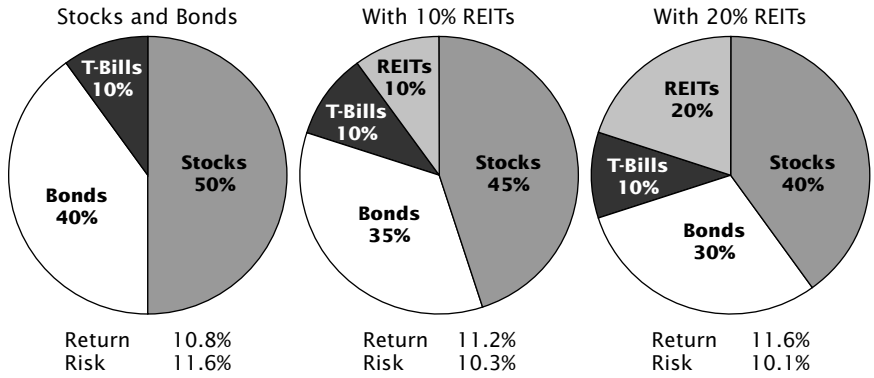


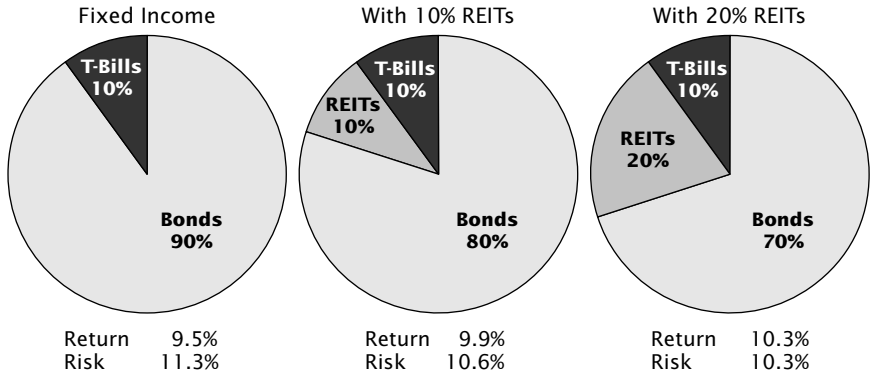
Data source: Large Stocks—Standard & Poor's 500; Bonds—20-year U.S. government bond; T-Bills—U.S. 30-day T-Bill; REITs—NAREIT Equity Index.

This is an illustration of hypothetical results, not indicative of future returns.

FIGURE 4.3 Diversify to Reduce Risk or Increase Return: Stock and Bond Investors, 1972–2004

bond allocation is reduced by 20 percent and a 20 percent REIT allocation is added, the return over the same period continues to rise to 10.3 percent and the risk or volatility drops to 10.3 percent.

This type of what-if simulation demonstrates the beneficial effect of noncorrelated asset classes. In this instance, REITs are examined, but the analysis can extend to other noncorrelated asset classes such as small



Data source: Bonds—20-year U.S. government bond; T-Bills—U.S. 30-day T-Bill; REITs—NAREIT Equity Index.
This is an illustration of hypothetical results, not indicative of future returns.

FIGURE 4.4 Diversify to Reduce Risk or Increase Return: Fixed Income Investors, 1972–2004

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stocks and international stocks. The examples are designed to be simple and to prove the case that REITs as an asset class add value in a multiasset-class portfolio. In most real-life situations, investors and consultants put constraints on the minimum and maximum asset allocation for a given asset class. The specific investment policy and nature of the portfolio dictate these constraints. The tax status of the portfolio has an effect on the allocation and constraints of income producing assets. In a taxable portfolio, it is normally preferable to minimize ordinary income and maximize capital gains to lower the current tax burden and defer taxes into the future at the lower capital gains rate. Conversely, owners of tax-exempt portfolios are more willing to hold a larger percentage of assets that produce high current income, because current taxation is not a factor in calculating actual net return. Total asset size is also a potential constraining factor. Very large institutional portfolios may not be able to effectively use smaller or more illiquid asset classes as a part of their overall strategy due to their sheer size or need for liquidity.

A simple way to explore the potential investment contribution of REITs in an allocation-constrained setting (again, while avoiding complex math) is to construct a set of what-if portfolios using REITs and other asset classes that are constrained at levels that are common among institutional investors. These what-if simulations take constrained portfolio allocations and add REITs in varying amounts over differing time periods in an attempt to determine their potential investment contribution to portfolio performance. In this simulation, the following portfolio constraints are used for the following asset classes:

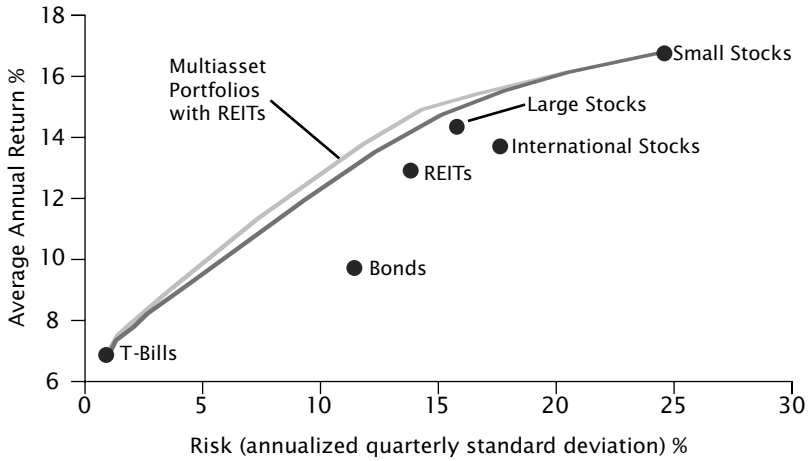
- *Small stocks:* Ibbotson U.S. Small Stock Series minimum 0 percent, maximum 20 percent.
- *Large stocks:* S&P 500; minimum 15 percent; maximum 60 percent.
- *Bonds:* 20-year U.S. government bonds minimum 5 percent maximum 40 percent.
- *International stocks:* Morgan Stanley Capital International's Europe Asia Far East Index; minimum 0 percent; maximum 20 percent.
- *T-bills:* Minimum 0 percent; maximum 15 percent.

Using these constraints for the period from 1972 through 2000, an allocation of 10 percent and then 20 percent REITs is added into the portfolio while adjusting all other asset allocations to create a series of

08_769193 ch04.qxp 5/18/06 8:22 PM Page 49

return and risk (standard deviation) outcomes within the constraints described previously. This process of optimization then creates a series of outcomes while increasing risk as defined by standard deviation in 1 percent increments. This is the type of what-if analysis a consultant might create for an institutional client.

As can be seen in Figure 4.5, REITs in a typical multiasset-class portfolio help add return across the efficient frontier. As discussed earlier in the chapter, measured in rolling five-year periods, the correlation of REITs to small and large stocks has been steadily declining since the early 1990s. This decline roughly corresponds to the modern era of REITs discussed in Chapter 2. The argument could be made that as the correlation of REITs to stocks has declined, their contribution to portfolio risk reduction and return should become greater. To examine this theory, we performed the same efficient frontier analysis using 10 percent and 20 percent REIT allocations. Using the same minimum and maximum asset class constraints as in the 1972 to 2000 analysis, the risk outcomes were examined for the modern REIT era of 1993 through 2000. Although this is a much shorter period, due to the declining correlation of REITs to large and small stocks, the risk and return outcomes improve dramatically.



Data source: Small Stocks—Russell 2000; Large Stocks—Standard & Poor's 500; International Stocks—MSCI EAFE Index; REITs—NAREIT Equity Index; Bonds—20-year U.S. government bond; T-Bills—U.S. 30-day T-Bill.

FIGURE 4.5 Efficient Frontier with and without REITs: Stocks, Bonds, Bills, and REITs, 1972–2004

08_769193 ch04.qxp 5/18/06 8:22 PM Page 50

Conclusion

In reviewing the data presented in this chapter, it is easy to conclude that REITs offer an attractive risk/reward trade-off. With a risk profile slightly higher than that of bonds and a return profile slightly lower than that of stocks, REITs offer competitive returns for the risk assumed. Further analysis shows that in addition to competitive returns, REITs as an asset class offer a low correlation to other financial assets, including large and small stocks, bonds, international stocks, and T-bills. This low correlation of returns to those of other asset classes has continued to increase over the modern REIT era of the last 12 years. Attractive returns and low correlation help reduce risk and increase total return when REITs are added to a multiasset-class portfolio. An allocation of 5 percent to 20 percent in REITs will increase return and lower risk in most portfolios, which makes owning and understanding REITs as an asset class important for anyone who deals with investments within a multiasset-class setting.

REIT Idea: Diversification

After all the technical jargon, there is one thing to remember about REITs. Adding an allocation of 5 percent to 20 percent of REITs in a diversified portfolio increases returns and lowers the risk (standard deviation) of the portfolio.

Points to Remember

- Asset allocation is the cornerstone of modern portfolio theory.
- Long-term returns, volatility, and correlation of returns among portfolio holdings affect total portfolio performance.
- Real estate investment trusts (REITs) offer competitive returns, reasonable volatility, and low correlation with other financial assets.
- REITs lower volatility and increase total return when added to a multiasset-class portfolio.

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- When considered in a constrained investment equation, REITs continue to improve performance outcome in multiasset-class portfolios.
- An allocation of 5 percent to 20 percent in REITs increases return and lowers risk in most portfolios.
- Understanding REITs as an asset class is important for anyone who deals with investments within a multiasset-class portfolio setting.

Chapter 5

Integrating REITs into an Investment Portfolio

Real estate is the closest thing to the proverbial pot of gold.
—Ada Louise Huxtable, 1970

As the data shows, a 5 percent to 20 percent allocation of real estate investment trusts (REITs) in the typical diversified portfolio lowers volatility, increases total return, and normally increases risk-adjusted return in the portfolio over most time horizons. With that fact established, the question arises as to how to best integrate REITs into an investment portfolio. For the large institutional investor, this is an asset class decision that is often incorporated into a portfolio through the use of an investment policy statement. The policy objective gives careful consideration to the specific objectives, constraints, and goals of the investor. These same considerations apply to smaller institutional investors and individual investors as well.

Investment Policies That Utilize REITs

All investment policies, whether simple or complex and whether for large or small institutions, should reflect the needs of the people who are represented within the pool of assets. Many of the policy objectives are qualitative and some are quantitative, but the goal of both is to create an efficient portfolio that addresses the needs and objectives of the individuals who are reflected in the policy statement.

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Rational investors always seek higher returns and lower risks in their investment portfolios. Integrating REITs creates an opportunity to gain higher returns with a lower risk profile. There are five basic strategies for integrating REITs into a diversified portfolio:

1. *Direct investment in REITs.* For investors who wish to make their own decisions on REITs, the prospect of selecting and owning individual REITs can be of interest. This process entails the selection of an adequate number of REITs to create and maintain diversification by property type and geographic location. In most instances, this requires a minimum 7 to 10 REITs. Chapter 9 deals extensively with the fundamental concepts used in analyzing REITs. The direct investor uses these concepts to monitor the ongoing business activities of the REITs.
2. *Managed real estate accounts.* Under this alternative, a percentage of the value of a diversified portfolio is targeted for REITs and that amount of money is managed by a portfolio manager at a firm that has a specialized real estate investment portfolio. This is typically how most institutional investors would undertake the addition of REITs into their broader portfolio allocation.
3. *Real estate mutual funds.* For the smaller investor, this option allows the opportunity to invest in real estate securities in a professionally managed portfolio. There are currently over 70 mutual funds dedicated to real estate securities and the real estate sector. These funds usually focus on investing in REITs, real estate operating companies, and housing-related stocks. In most cases, the portfolio is actively managed to take advantage of emerging trends in the real estate markets. In the aggregate, these funds had $52.2 billion of shareholder assets as of June 30, 2005. (Appendix A contains a list of publicly traded mutual funds that focus on the real estate sector.)
4. *Real estate unit investment trusts (UITs).* Much like mutual funds, these trusts offer small investors the advantage of a large, professionally selected and diversified real estate portfolio. However, unlike the case for a mutual fund, the portfolio of a UIT is fixed on its structuring and is not actively managed. It is a self-liquidating pool that has a predetermined time span. After issue, shares of UITs trade on the secondary market much like shares of closed-ended mutual funds. Under this scenario, it is sometimes possible

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to buy shares of a UIT at a discount on the underlying value of the actual shares contained within the trust on the open market.

5. *Exchange traded funds (ETFs).* Much like UITs, ETFs represent a share that reflects a portfolio of stocks. Normally the shares track a market index and can be traded like a stock. ETFs represent the stocks that are in an index, although a few ETFs track actively managed portfolios of stocks. Investors can do just about anything with an ETF that they can do with a normal stock, such as short selling or buying on margin. Because ETFs are exchange traded, they can be bought and sold at any time during the day. Their price will fluctuate from moment to moment just like any other stock's price. ETFs are more tax efficient than most mutual funds because you as the shareholder have the final decision on when to buy and sell them. The downside is that each time you trade ETF shares there is a brokerage commission, which is why they do not make sense for a periodic investment plan.

REIT Idea: The Pros and Cons of REIT Investment Options

1. Direct *REIT investment*
   Pro: Low cost and total tax control
   Con: Investor must select REITs and monitor their performance
2. *Managed accounts*
   Pro: Professionally managed and usually tax controlled
   Con: Higher expenses
3. *Mutual funds*
   Pro: Professionally managed
   Con: Lack of tax control
4. *Unit investment trusts (UITs)*
   Pro: Fixed portfolio lessens tax events
   Con: Passive management prevents value-added investing
5. *Exchange traded funds (ETFs)*
   Pro: Low expenses and total tax control
   Con: Generally passive strategy with commissions on each share traded

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Relevant Characteristics of REITs

Investors' portfolio policies and strategies are often influenced by their capital market and economic expectations. These expectations are a reflection of the relevant social, political, and economic data that are available to investors at any given time. To the extent that investors monitor these economic and market factors and modify their portfolio allocations according to their perceptions, it is important to consider the key factors that may impact REITs as an asset class.

Interest Rates and REITs

Because of a generally higher than average dividend yield, many investors consider REITs to be bondlike in their characteristics. To some extent, this is true with regard to the fact that REITs provide a high level of current income, as do bond investments. However, REITs are not like bonds in their response to changing interest rates. In fact, REITs tend to be less sensitive to changes in the interest rate environment than both bonds and the broader stock market.

Real estate investment trusts and many other high-yielding stocks, such as utility and energy stocks, are often perceived to be substitutes for fixed-income securities. Conventional wisdom about interest rate sensitivity suggests that, compared to fixed-income investments such as bonds and Treasury bills, high-yielding stocks are attractive during periods of declining interest rates and in low-interest rate environments. Many investors believe that during periods of increasing interest rates, high-yielding equity securities and REITs are relatively less attractive because the rising interest rate environment might have a negative impact on the underlying value of the stock's price. Just as rising interest rates diminish the current value of a bond's market price, investors perceive that rising interest rates will have the same impact on the underlying price of a stock. However, numerous studies have shown that the total returns generated by the NAREIT Equity Index have a lower correlation to changing interest rates than the S&P 500 or long-term government bonds. For example, a study completed by Uniplan Real Estate Advisors indicates that for the period of January 1989 through June 2005, the *correlation coefficient* between government bonds and the S&P 500 was measured at 0.42, as compared to the correlation coefficient of total return from the NAREIT Equity Index and government bonds, which was 0.24. This

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suggests that, contrary to popular belief, REITs are less sensitive to changes in long-term interest rates than the broader equity market.

correlation coefficient
a statistical measure that shows the interdependence of two or more random variables. The number indicates how much of a change in one variable is explained by a change in another. A score of 1.0 is perfect correlation with each variable moving in unison; a score of –1.0 is perfect noncorrelation with each variable moving opposite one another.

Correlation of REITs to Other Market Sectors

Chapters 3 and 4 revealed that REITs as an asset class provide a low correlation to the equity market in general and to large-capitalization equities in particular. It is worth noting that when the large-cap equity market, as represented by the S&P 500, is divided into its various subgroups, it is possible to further compare the correlation of REITs to other sub sectors of the market. In reviewing Table 5.1, it is interesting to note that REITs had a lower correlation to technology stocks than to any other industry sector in the S&P 500. In theory, the lack of correlation between asset classes provides the ability to combine those securities into portfolios that reduce risk without sacrificing return. This, as discussed in Chapter 3, is the cornerstone of modern portfolio theory. Securities that show a negative correlation provide the highest level of benefit when used to reduce portfolio risk. Negative correlation means that when returns are up on one security, they are negative or down on the other security. It is interesting to note that the correlations between REITs and technology stocks as well as between REITs and communication services and REITs and the health care sector provide a negative correlation coefficient during some periods. This relationship is particularly significant to investors whose portfolios may include high exposure to technology, communications, or health care-related industries.

Inflation and REITs

Real estate and REITs provide a hedge against inflation. In an environment where inflation is rising, the value of real estate and real estate securities can be expected to increase as well. In times of high and rising inflation, investors have historically been rewarded by changing their asset allocation strategy to increase their investment in the real estate asset class. In contrast, treasury securities and fixed-income securities such as

TABLE 5.1 Correlation Coefficients, January 1995–June 2005

	NAREIT Equity	*S&P 500*	*Energy Stocks*	*Materials Stocks*	*Industrial Stocks*	*Consumer Disc.*	*Consumer Staples*	*Health Care*	*Financial Stocks*	*Information Technology*	*Utilities*
NAREIT Equity	1.00										
S&P 500	0.24	1.00									
Energy stocks	0.39	0.56	1.00								
Materials Stocks	0.37	0.62	0.63	1.00							
Industrial Stocks	0.33	0.87	0.64	0.76	1.00						
Consumer Discretionary	0.19	0.85	0.41	0.60	0.78	1.00					
Consumer Staples	0.24	0.47	0.32	0.38	0.49	0.35	1.00				
Health Care	0.11	0.51	0.34	0.19	0.41	0.31	0.65	1.00			
Financial Stocks	0.34	0.78	0.55	0.59	0.74	0.69	0.59	0.54	1.00		
Information Technology	0.02	0.79	0.28	0.32	0.50	0.63	0.04	0.16	0.34	1.00	
Utilities	0.37	0.22	0.48	0.23	0.37	0.08	0.29	0.32	0.38	-0.08	1.00

Source: Uniplan, Inc.

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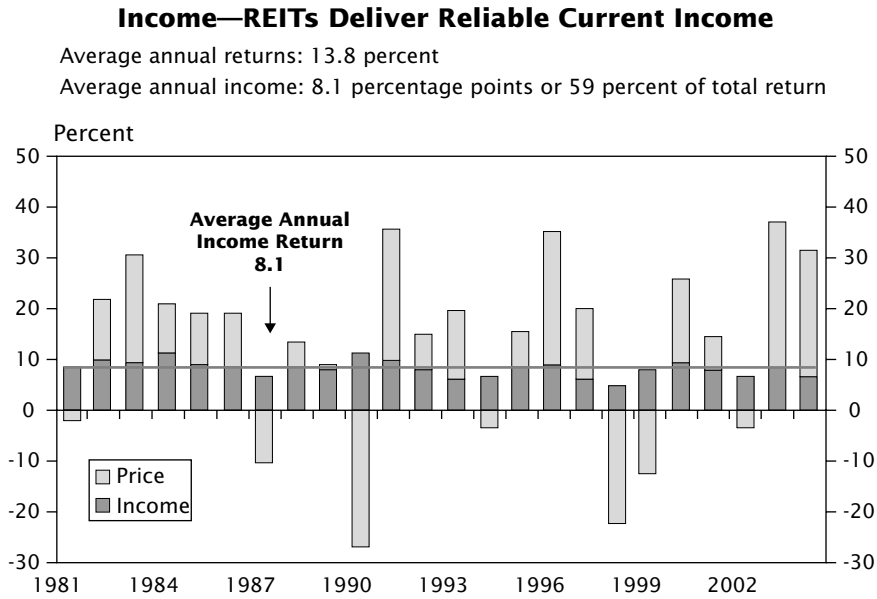

FIGURE 5.1 Equity REIT Annual Returns (1981–2002)
Source: NAREIT.

bonds have performed poorly during periods of high and rising inflation. Therefore, fixed-income portfolio investors may want to consider REITs as a substitute for a fixed-income portfolio during periods of expected and high inflation.

Just like bonds, REITs derive a large percentage of their total returns from the dividend component of the investment. However, unlike the case with bonds, the dividend component of REITs tends to increase over time. Since 1981, the average annual income return on equity REITs has been 8.54 percent (see Figure 5.1). In addition, the dividend growth rate of the NAREIT Equity Index has exceeded the growth rate of inflation in every year since 1994.

Considerations for Taxable Investors

The high current dividend yield of REITs may be a disadvantage to taxable investor portfolios. For income tax purposes, dividend distributions from REITs may consist of ordinary income, return of capital, and long-term capital gains. When not held in nontaxable accounts, REITs have a disadvantage with respect to other common stocks. For the taxable investor, the greatest portion of total return expected by REIT holders

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consists of dividend yield, whereas common stock returns consist largely of appreciation. An appreciated stock that is held long enough to meet the holding period requirements for long-term capital gains is currently taxed at a maximum rate of 15 percent. Returns on REITs, having such a high portion of dividend income reflected as current income, may increase a taxable investor's marginal tax rate.

REIT shares, however, do offer taxable investors some advantages over dividends from other high-yielding stocks and dividends from corporate or government bonds. It is not unusual to have a high percentage of the dividends received each year from a REIT issued as a return of capital. This return of capital portion of the Equity REIT Price Index versus Consumer Price Index, monthly, dividend is not currently taxable to the shareholder, but rather reduces the shareholder's cost basis in the shares and defers the tax liability until the shareholder ultimately sells those shares. If the holding period of the shares is long enough to meet the requirements for long-term capital gains, then the maximum tax rate on that portion of the dividend return, which was used as a reduction in cost basis, would currently be 15 percent. This presents an advantageous situation to the extent that income-oriented investors can spend their current interest income now and may have the opportunity to defer a portion of the taxes on that current income until a later date. Not only are the taxes deferred, the investor may have the opportunity to pay taxes on the return of capital portion of the dividend at the long-term capital gains rate.

As discussed, for income tax purposes, dividend distributions paid to shareholders of REITs can consist of ordinary income, return of capital, and long-term capital gains. If a REIT realizes a long-term capital gain from the sale of a property in its real estate portfolio, it may designate a portion of the dividend paid during a tax year as a long-term capital gains distribution. This portion of the dividend is taxed to the shareholder at the lower long-term capital gain rate.

Historically, it is estimated that the return of capital component of REIT dividends has typically been approximately 30 percent of the total dividend return. It is important to note that this aggregate percentage has declined in recent years as a result of REITs reducing their overall payout ratio to investors in order to retain capital within the REIT operating structure. The taxable investor therefore may want to consider the implications of a high current dividend yield component of REITs.

09_769193 ch05.qxp 5/18/06 8:22 PM Page 61

However, the high yield should be considered in light of the fact that REIT dividends are often characterized by the REIT to the shareholder as return of capital or long-term capital gains. To some extent, this provides a modest tax advantage to the individual investor who may invest directly in REITs as opposed to other high yielding securities such as bonds or *master limited partnerships* (MLPs).

The Net Asset Value Cycle

Capital markets that include stocks, bonds, or real estate-related securities historically go through periods in which they attract considerable marginal new capital. This results in valuations rising to high levels. Such examples of this can be seen in the Internet stock bubble of the late 1990s or the Nifty-50 stock market bubble of the early 1970s. Conversely, there are other periods when asset classes go out of favor, thereby creating very low valuations, such as in the real estate markets of the early 1990s. Real estate is a cyclical industry, and these valuation extremes may be considered cycles or mean reversion situations. In either case, investors are often looking for the opportunity to buy low and sell high by shifting their portfolios among various asset classes to take advantage of valuation disparities.

When considering REITs for investment, it may be useful to look at the aggregate value of REITs as an asset class relative to the net asset value of their underlying properties. Historically, the performance of REITs after periods when they traded at a significant discount to net asset value has often been superior.

The opportunity to buy REITs at a discount to their net asset value is said to be an opportunity to buy real estate cheaper on Wall Street than it can be purchased on Main Street. In addition, when REITs trade at a substantial discount to net asset value, dividend yields are often higher than average for the real estate group. This offers the opportunity to be "paid to wait." As expected, real estate values eventually recover to private-market-level valuation prices or revert back to mean valuation levels. From a timing point of view, repositioning money into the REIT asset class, at a time when REITs trade at a large discount to net asset value, and migrating money out of the REIT asset class when a significant premium to net asset value becomes apparent may simply be good timing

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indicators within the REIT market. It should be noted however, that real estate as an asset class should be considered a long-term investment, and that, for the average investor, the concept of dollar cost averaging into the REIT sector has some appeal.

REIT Idea: Your Home as a Real Estate Investment?

Investors often ask: Should I include my home in my real estate investment allocation?

The simple answer is no. Although a home is real estate, it should be considered a consumption item on your personal balance sheet. It produces no current return and must be sold to realize gains. However, it is worth noting that single-family residential real estate has a low correlation to stocks and bonds as well as REITs. So, by owning your home it helps to continue the process of portfolio diversification.

Conclusion

Numerous ways exist to gain portfolio exposure in REITs. Investors may choose to invest directly in REITs or to use accounts that are professionally managed by portfolio managers specializing in the real estate sector. Real estate mutual funds and real estate UITs and ETFs offer the opportunity for smaller investors to invest in REITs through pooled opportunities. Integration of REITs into an investment portfolio should be considered in light of the current economic environment. The fact that REITs provide a hedge against inflation and have a low correlation to other asset classes can make them particularly attractive in a diversified portfolio. The particularly low correlation to technology, communication, and health care sectors of the large-capitalization market also makes REITs of particular interest to investors who may have excess exposure in those areas. For investors with higher exposure to the bond market, the lower sensitivity to interest rates of REITs, when considered in conjunction with their high current yield, may offer some attractive opportunities to diversify a fixed-income portfolio. Taxable investors may want to consider REITs over other high-dividend-yielding sectors of the equity market because of the potential tax deferral advantages inherent in the REIT dividend structure.

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Points to Remember

- An allocation of 5 percent to 20 percent in real estate investment trusts (REITs) will increase return and lower risk in most portfolios.
- An investment policy statement reflects the long-term needs and objectives of the investor.
- Rational investors seek to increase total return while decreasing total risk within a portfolio.
- REITs lower volatility and increase total return when added to a multiasset-class portfolio.
- There are five basic strategies for integrating REITs into a diversified portfolio:
  1. Direct investment
  2. Managed accounts
  3. Mutual funds
  4. Unit investment trusts (UITs)
  5. Exchange traded funds (ETFs)
- Portfolio policies are influenced by investor expectations, and REITs should be viewed in that context.
- REITs have a low sensitivity to changing interest rates.
- REITs act as a hedge against inflation.
- REITs have a negative correlation to certain stock market sectors.
- REITs may offer a modest tax advantage to certain taxable investors.

10_769193 ch06.qxp 5/18/06 8:23 PM Page 65

Part 2

Real Estate Economics and Analysis

Chapter 6

Real Estate Market Characteristics

What marijuana was to the sixties, real estate is to the seventies.
—Ron Koslow

Before investors can make an assessment of a real estate investment trust (REIT), they need to understand the supply-and-demand characteristics of the markets in which that particular REIT operates. In a local real estate market, supply can generally be defined as vacant space currently available for lease, plus any space available for sublease, plus new space under construction, plus space that will soon be vacated. The total reflects the available supply of space in a given local real estate market. Demand for space in a local real estate market can generally be derived from new businesses being formed, plus existing businesses expanding, plus new companies moving into the region, plus net new household formations, less closing, moving, and downsizing businesses. The total reflects the aggregate marginal demand for space within a region. In the simplest terms, supply is the total space available and demand is the total space required. In the final analysis, it is supply and demand for a given property type in the local real estate market that drives property valuation.

Real Estate Market Dynamics

Local real estate market dynamics are driven by supply and demand for a particular property type. There are a wide range of factors that affect

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supply and demand in the local market. Values tend to be broadly affected by the general level of business activity and population growth. Interest rate trends, because of their impact on business activity, also have a general impact on real estate market dynamics.

The residential housing market and commercial real estate markets differ with respect to changes in the overall economy. The residential housing market has historically tended to lead the overall real estate market into and out of recessions. Conversely, the commercial real estate market has a tendency to follow rather than lead the overall economy. Although real estate is impacted by the overall economy, it is highly local in nature. Economic activity at the local level or within the region will have a larger impact on property valuations than general overall economic activity. The health of a regional economy normally depends in part on the diversity of business and the base of employment within the region.

A region's regulatory environment is another factor that impacts real estate activity. Many cities have adopted low-growth or no-growth strategies that have made it difficult to develop new real estate. Restrictions on land use and limited access to city utilities, along with the imposition of development fees, school fees, and related activity fees, have made for difficult and limited development. Some local governments have mandated rent control or targeted particular set-asides for low-income housing that are coupled with new development activities. This has had the effect of lowering general expected returns on real estate development and therefore has slowed the growth of development within certain geographic regions. So, in addition to the broad economic factors that impact real estate, many very specific local factors can affect the performance of a real estate market. Indeed, the supply-and-demand characteristics of the local market have the greatest impact on real estate valuations at the local level.

Any local real estate market can be viewed as a quadrant chart (see Figure 6.1). At the intersection of the four quadrants is the point at which demand for and supply of real estate in the local market are at a perfect equilibrium. That intersection can be expanded to create an *equilibrium zone.* This zone reflects a market dynamic where, in general terms, the visible supply of real estate available and the current and forecasted demand for real estate are approximately equal. When supply-and-demand characteristics for a particular property category within a particular local market fall within the equilibrium zone, property and rental prices tend to be relatively stable at a market level.

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Quadrant One	Quadrant Two
The Recovery Phase ▪ Demand begins to exceed supply ▪ Rents begin to rise ▪ Property prices recover	*The Supply Phase* ▪ Higher rents cause new building ▪ Rents continue to rise ▪ Speculative building begins ▪ Supply begins to exceed demand
Quadrant Three	**Quadrant Four**
The Rollover Phase ▪ New supply outstrips demand ▪ Vacancy rates begin to move higher ▪ Rental rates start to decline ▪ Property prices soften	*The Trough Phase* ▪ Rents are declining or stable ▪ No new meaningful building activity ▪ Above-average vacancy rates ▪ Soft economic environment

FIGURE 6.1 The Real Estate Market Cycle

As we go on to examine each of the four quadrants of the Real Estate Market Cycle quadrant chart, we can see a particular series of characteristics that can be attributed to each quadrant. Quadrant 1 (see Figure 6.2) represents the beginning of the real estate cycle in a given market or property type. This is the phase where demand begins to exceed available supply. It is sometimes termed the *recovery* phase. In this phase, rents begin to rise as demand begins to exceed supply available in the local market. Rents will continue to increase to a level where economic yields on new property development will become sufficiently attractive to cause developers to begin to consider adding property to the market. Prices on individual properties also begin to rise as occupancy levels increase and the available supply of new space decreases. As vacancy rates fall and available supply tightens, rents may begin to rise rapidly. At some point, higher rents precipitate new construction activity that leads to the phase depicted in Quadrant 2 (see Figure 6.3). This is the *development* or *supply* phase in the local market. If financing is available, speculative developers may begin construction in anticipation of continued rising rents, allowing for new building activity to begin, initially on a largely speculative basis. As supply continues to increase, the local market moves through the zone of equilibrium and into a pattern in which the current space available begins to exceed current demand for space. While this occurs, the growth rate in rent levels begins to subside,

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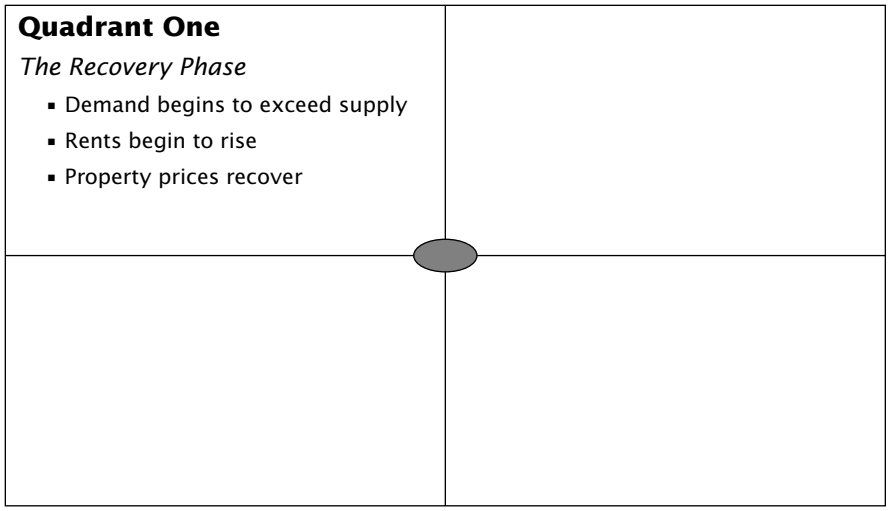

FIGURE 6.2 The Real Estate Market Cycle: Quadrant 1

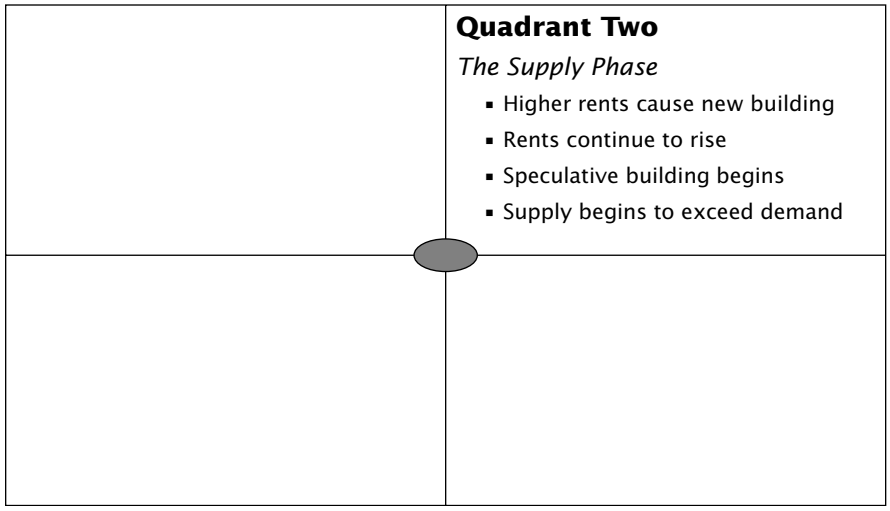

FIGURE 6.3 The Real Estate Market Cycle: Quadrant 2

and vacancy rates, which had been decreasing, begin to increase slowly. As more incremental space is delivered into the market, rental growth begins to slow more dramatically and vacancy rates begin to rise more quickly.

The local market now moves into Quadrant 3 of the real estate cycle (see Figure 6.4).This is the *rollover* phase or *down cycle* of the market. New supply arrives more quickly than it can be absorbed and

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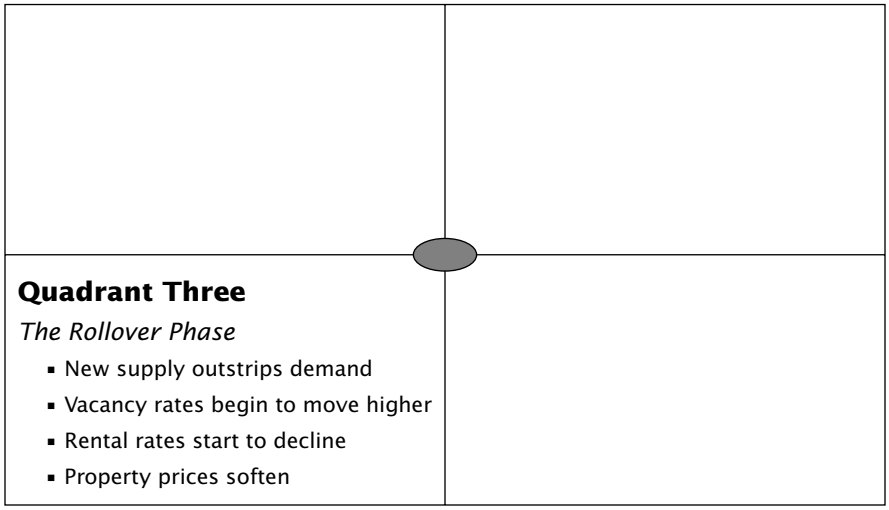

FIGURE 6.4 The Real Estate Market Cycle: Quadrant 3

begins to push rents downward. Vacancy rates begin to move higher than average for the market, causing property values to begin to soften and move lower. As the market continues to soften, property owners understand that they will quickly lose tenants or market share if their rental rates are not competitive.They begin to lower rents in an attempt to retain or attract tenants as well as to help cover the fixed expenses of operating a given property. This phase is also characterized by little or no activity with regard to transactions in commercial properties. The disconnect between what buyers are willing to pay for properties due to the uncertain outlook and what sellers feel properties are worth becomes wider.

This leads the market into Quadrant 4 of the real estate cycle, or the *trough* (see Figure 6.5). In this phase, rents are generally flat to lower, there is no new supply activity, and there is likely to be a large amount of excess space available in the local market. This might be coupled with lower economic activity or weak demand for space in the local market, which tends to prolong the trough stage and make it deeper and more severe. The market cycle eventually reaches a bottom as new construction dissipates and demand increases and begins to absorb existing supply, moving the cycle back into Quadrant 1.

In a theoretical perfect market, supply and demand would remain in the equilibrium zone and real estate returns would remain stable over the long term. However, in the real world, a combination of local market

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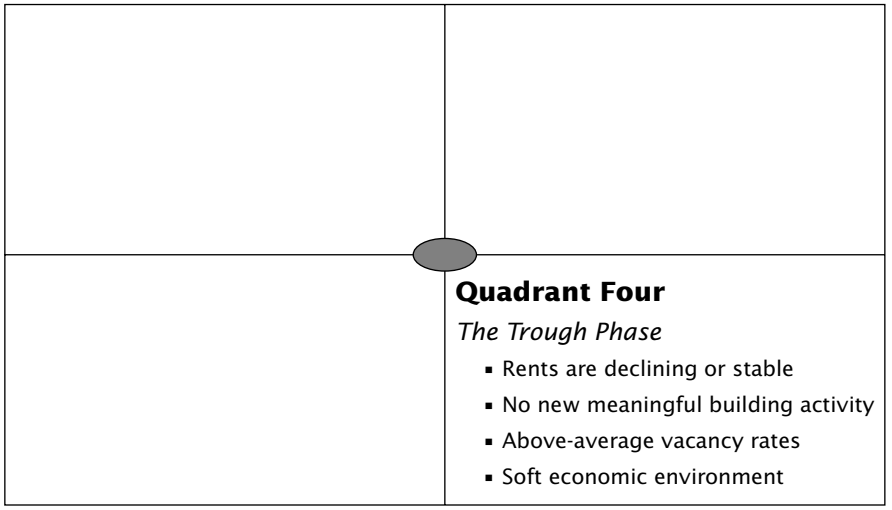

FIGURE 6.5 The Real Estate Market Cycle: Quadrant 4

supply-and-demand factors can have an impact on the real estate cycle in a local market. Local markets that are less inclined to give entitlements to build or to create variances for building purposes tend to remain in supply-and-demand equilibrium for a longer period than markets that are prone to rapid and uncontrolled development activity.

Local real estate markets may not move through the quadrants in a one through four sequence. Demand and supply at the local level will likely ebb and flow, causing the local market dynamic to move in and out of the equilibrium zone. From an analysis standpoint, it is normally possible to determine which quadrants a given real estate property category occupies within a local market and to determine in which direction the supply-and-demand fundamentals are moving. One of the primary functions of management professionals in the real estate community is knowing and understanding which phase of the real estate cycle a local market is in.

Trends in Market Dynamics

One general fact is apparent in regard to the real estate cycle: Over the last decade, the cycle has become less severe than it was in the past. As mentioned in Chapter 2, higher underwriting standards on the part of real estate lenders coupled with the public market discipline that has

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resulted from the commercial mortgage-backed securities market have led to real estate cycles that are far more subdued than in the distant past. This market discipline has helped most local real estate markets avoid the severe boom-and-bust cycles that were evident prior to the 1990s. In addition, local economic factors that drive the local real estate economy often create a series of local markets that at any given time may be in any quadrant of the real estate cycle. If a local market is in Quadrant 1 or 2 or in the equilibrium zone, the real estate environment is generally considered to be positive. When markets are in Quadrant 3 or 4, the real estate environment is considered to be negative. The thing to remember is that there are opportunities in each phase of the cycle

REIT Idea: Cycle Opportunities

At each stage of the real estate cycle there are opportunities for REIT investors.

- *Recovery Phase*. Bad fundamentals often provide the chance to buy REITs at a substantial discount to the net asset value of the properties owned in the REIT portfolio.
- *Supply Phase*. Well-positioned REITs will have the chance to raise rents and build new properties in the recovering market area, thus driving earnings.
- *Rollover Phase*. Good REIT management teams will be active sellers of noncore holdings at the point they believe property prices have peaked in a local market, thus harvesting gains and protecting portfolio performance.
- *Trough Phase*. For the patient value investor this is the time to buy. Well-capitalized, well-managed REITs can trade at below the physical replacement cost of their underlying buildings and often offer a high yield on the REIT shares.

Although real estate markets in general are driven by growth of the overall U.S. domestic economy, any particular local market might be in any phase at any time. As this dynamic plays itself out in local markets and within each property group, it can be difficult to generalize about where in the cycle the overall real estate market is at a given time. There may be a shortage of industrial space in Houston and a shortage of apartments in Denver, while at the same time there is an excess supply of hotel

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rooms in San Francisco and too much office space in Atlanta. This suggests that there are generally local market opportunities available for the real estate investor in some markets and in some property categories at any particular time. Local market knowledge is the key to making these specific market determinations. That market knowledge and skill is what a high-quality REIT management team will bring to the real estate investment equation. In addition, a REIT portfolio that is diversified across property types and geographic regions allows its owner to moderate risk that may result from changing local market dynamics. Here is where the liquidity available to the shareholder of a REIT is a key advantage over the direct property owner. If, as in our earlier example, the office space market in Atlanta were deteriorating rapidly and supply looked as if it might outstrip demand for a long period, REIT shareholders could liquidate their shares in the REIT that holds property in Atlanta and reinvest the proceeds in a local office market that seems to have a better supply-and-demand profile. For a direct owner of office buildings in Atlanta, the option to liquidate is available but normally not practical. Due to the time and expense involved in the direct sale of a real estate portfolio, practical consideration generally dictates that the owner stay in place for the downward duration of the local market cycle. Direct real estate owners usually attempt to mitigate local market cycles by diversifying their property holdings across a number of different geographic regions. In addition, a local owner might diversify across different property types within the local market to help manage local market risk.

Local Market Information Dynamics

Real estate firms have unique institutional characteristics that generally distinguish them from non-real estate firms and give them a comparative advantage when dealing in a local market. These institutional characteristics also give local real estate firms an advantage over real estate firms that may not be present in the local real estate markets. These advantages are normally referred to as *market locality* and *market segmentation* advantages. The market locality advantage suggests that there is a certain information advantage for participants in a local real estate market that results from the local nature of the real estate market itself. There are a series of factors that contribute to the market locality advantage, such as a lack of standardized product, the absence of a centralized exchange for clearing

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information, and the increased research costs for nonlocal firms to develop data about a local market. In addition, a general understanding of the local political process also creates a local market advantage that a real estate firm from outside the area might not enjoy. Under these conditions and in local markets where information can be costly and not generally available to all participants, local real estate firms are likely to be familiar with and have an information advantage.

Market segmentation suggests that different market segments require different types of expertise and management skills that may be very expensive and not easily transferred from other market segments. Management skills help to reduce the uncertainty associated with business risks resulting from physical operation of real property. This suggests that a firm specializing in a specific real estate segment may gain a competitive advantage as a result of superior managerial expertise acquired through time and experience. This market segmentation knowledge directly addresses the old adage that says: "If I had known how difficult it was, I wouldn't have tried to do it in the first place." Thus the ability to develop superior local market knowledge or the access to those who possess that knowledge can create a significant advantage in real estate investment.

Consider the local real estate developer who normally attends city planning commission meetings as well as city development and urban planning meetings given by local and state municipalities. Formally or informally, this developer may, through intimate knowledge of the planning process, understand that certain projects such as road extensions or the expansion of municipal services are part of a long-range plan. This same developer may use that information to contact a landowner that may not be in the local market or have similar local knowledge and make an offer to purchase a given parcel of land at prevailing market rates. The transaction could likely be consummated without any of the unknowing parties ever learning of the knowledge that the real estate developer possessed. The subsequent extension of a road or the development of an area could then turn into a highly profitable transaction for the developer, who was armed with deep local market knowledge that an uninformed observer may not have been able to obtain. It is this specific information advantage that local real estate operators bring to the table.

Geographic diversification can increase the efficiency of structuring a real estate portfolio. In fact, research indicates that regional diversification provides more portfolio benefits than diversification by property type. Geographic diversification within a portfolio provides a certain level

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of economic diversification as well. This economic diversification results from economic specific industry exposure as it relates to a geographic region. For example, San Jose, California, and the San Francisco Bay area are widely considered to be the center of geographic activity for Internet-based companies. Contrast San Jose with Detroit, Michigan, which is the center of economic activity as it relates to the U.S. automotive industry. Compare that to New York City, which has a diverse economy but is also considered to be the center of activity for the financial community. Now compare that to Washington, D.C., which is the center of activity for the federal government. Each of these geographic locations will respond differently to changes in the general economic environment. Therefore, diversifying across geographic regions can provide a certain level of economic diversification within the real estate portfolio. This type of geographic diversification is not normally possible for direct real estate investors unless they are of very significant size. An investor in a portfolio of REITs, however, can accomplish geographic diversification as well as diversification by property with a modest investment, while enjoying a level of liquidity not available to the direct real estate investor.

Real Estate Data Resources

There is a wide range of data available for researching local market real estate activity. Most data take the form of secondary data, which are data that have been gathered for some other purpose and are generally available for review. Secondary data are generally less costly and less time consuming to obtain than primary data. In general, secondary data are widely available at a low cost through libraries or firms that specialize in generating such information. Primary data may be gathered by communication or observation and are designed to answer specific research questions. Real estate operators within a local market often gather primary data. Primary data may take the form of rent surveys or market surveys done by local brokerage firms. These firsthand data are valuable in assessing the primary supply-and-demand fundamentals of the local market. There are a number of primary and secondary data sources that compile local market statistics that are worthy of reviewing.

All data are subjective in the end. The quality and purity of the data are generally considered a function of the source of the data. In the final analysis, the data must be analyzed and interpreted within the context of

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the local market dynamic. This requires making assumptions about the market and the data to end up with a forecast of local market activity for both supply and demand within a particular property category. This type of forecasting and analysis is embodied in the development process that is discussed at length in Chapter 7.

Points to Remember

- Supply and demand drive value in local real estate markets.
- Business and economic growth within a region drives overall demand for real estate.
- Development activity is the principal driver of new real estate supply.
- A local region's regulatory environment will impact real estate development activity in that market.
- The real estate market cycle can be divided into four stages:
  1. Recovery phase
  2. Supply phase
  3. Rollover phase
  4. Trough phase
- Real estate firms have unique institutional characteristics that give them an advantage over non-real estate firms in the local market.
- REIT management provides a local market knowledge advantage.
- Liquidity gives REITs an advantage when dealing with the local market cycle.
- A wide range of sources can be found that document local market supply-and-demand dynamics.

Chapter 7

Real Estate Development

The trick is to make sure you don't die waiting for prosperity to come.

—Lee Iacocca, 1973

Real estate development is the high-stakes poker of the real estate industry. When most people think of real estate they associate it with real estate development. In part this is because of such names as Donald Trump and John Zeckendorf. It seems, too, that every regional real estate marketplace has its own Trump-style real estate developer who is always proposing a bigger and better project with his name firmly attached. There is a certain blend of entrepreneurship and ego that goes into the development of real estate. The key to success is to make sure that your real estate development activities involve more entrepreneurship and less ego.

The Real Estate Development Process

Real estate development is at the high end of the risk scale, but when successfully implemented it is also on the high end of the return scale. The development process is worth understanding if you want to get involved in real estate investments. Development is essentially the supply side of the local real estate market. Understanding the development process also leads to additional insights into the local market supply-and-demand dynamics. In order to make an accurate assessment of the local market, you

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need to have an assessment of current development activity as well as of the impact of potential competitive building activity that may not be apparent in the local market. A thorough understanding of the development process allows for a better and more complete assessment of the local market economics.

Historically, real estate investment trusts (REITs) with the best earnings performance have often made development activity an important part of their business strategy. The incremental yield available in a development project over the comparable market yields for existing properties makes development a high value-added proposition for REITs. For example, the unleveraged cash-on-cash return for an existing industrial warehouse in a particular local market might be 9.5 percent. A developer may see the opportunity in that same market to build a similar industrial warehouse with a projected unleveraged cash-on-cash return of 14.5 percent. Thus the opportunity to deploy capital is available at 9.5 percent with minimal risk or at a potential return of 14.5 percent for a riskier development project. Here is where the real estate expertise of the REIT's management either adds value and earns a higher overall return for the shareholder—or overreaches for return and puts the shareholder's capital at risk.

The development of real estate is very entrepreneurial in nature. Different types of development activities have distinct differences: Developing warehouses is different from developing offices, and developing apartments is different from developing hotels. It is worth noting that the substantial redevelopment of an existing property can be as difficult as, if not more difficult than, a ground-up new development project. Development is the aspect of real estate in which the greatest number of risk variables must be simultaneously managed. It encompasses the challenge of managing a myriad of legal, financial, market-related, and construction risks, as well as managing the many people-related risks related to the project. The challenges can be daunting. In many ways, developing real estate is like creating a new product for retail distribution. Not only does the real estate developer have to envision the "product" from concept through completion, but the product must also be positioned among competing products within the local real estate market.

Timing is critical when it comes to the development process in real estate. The development process has a very long cycle. In some instances, it can take as long as five years to go from concept through completion of a large real estate project (see Table 7.1). The project might start out with

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TABLE 7.1 Timetable of Development Stages

Activity	*Expected Time*
Market analysis	1–3 months
Location analysis	3–6 months
Site acquisition	6–9 months
Entitlement and zoning*	12–18 months
Design and construction	12–18 months
Leasing	6–18 months
Total development time	40–72 months

*Longer in some locations.

a market analysis and location analysis to determine the viability of the project. This can in turn lead to negotiations to control a particular parcel of land. That initial phase of development activity can easily take 12 to 18 months.

Following the site analysis and acquisition is likely to be the entitlement process. As discussed in Chapter 2, various communities have different appetites and varying standards for the creation of new real estate projects. It is not unusual for the entitlement process to run 12 to 18 months or longer. Once the project is entitled for building, design through construction and completion can take another 12 to 18 months. Finally, leasing activities can take 6 to 24 months, depending on the property type. When all is said and done, a project can easily take three to five years to complete.

The real estate cycle plays a significant role in the timing of development activities. Because of the long lead time involved in the typical real estate project, it is critical for the developer to know where the local market stands at each phase of the project. The ideal outcome is for the developer to deliver the project at a time when the market is very tight and there is little available supply. The least desirable outcome is when bad timing results in delivering new supply into a soft market with increasing vacancy and declining demand. The ultimate timing of delivery can make the difference between the financial success—or failure—of a project.

In addition to ground-up real estate activities, a developer may achieve high rates of return through projects that involve major redevelopment of properties. This type of redevelopment can encompass upgrading an underutilized property or a property that may be involved in

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a lower use. Converting a large urban warehouse to office space or residential lofts might be a redevelopment project with high potential. The real estate may be acquired at a very low cost and the redevelopment may provide for substantially increased earnings after capital expenses. The risks associated with redevelopment activities are similar to those of ground-up development except that redevelopment sometimes includes an additional layer of design and construction risk. The developer never knows what will be found until the actual demolition process begins. A redevelopment building might contain hazardous materials such as asbestos that must be properly abated, or unforeseen structural problems might be found. These types of construction-related issues can lead to increased costs and delays.

Inertia

In nearly all instances, development or redevelopment activity requires overcoming political and local inertia with regard to a project. Overcoming inertia or dealing with opposition to a project requires a high level of skill on the part of the developer. In terms of diplomacy, the developer must be adept at obtaining the best outcome from all participants in the process. He or she must also be an effective champion of the project, continually selling and promoting it throughout the development process. In any given situation, the developer must know what the desired outcome is and how much room is available for compromise. In addition to using diplomacy, the developer needs to know when to resort to hardball tactics such as litigation. These factors must all be measured in the context of project timing, financial impact, and project feasibility.

For example, adding landscaping might increase the overall cost of a project but have little impact on the overall timetable. However, requiring a higher ratio of parking to building area might substantially alter the financial feasibility of the project. A good developer will know when a project is not going to be feasible and will terminate the entire project rather than create a situation that provides an inadequate return on invested capital. In the final analysis, the numbers have to work.

Overcoming the inertia of the entitlement process allows the developer to begin managing the dynamic process of development and its associated risks. These risks take many forms and may include preleasing activities, maintenance of adequate financial resources, and the general management of the development or redevelopment process. The developer

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must control an extremely dynamic process while managing financial and business risks.

Land Acquisition

The development process generally begins with the acquisition or control of land that is targeted for the intended use. In the case of a REIT, this may mean the acquisition of a parcel of real estate or land, or it may result from redevelopment opportunities on land or buildings already owned by the REIT. If acquisition of land is required as a part of the process, it is vital to acquire the land quickly and quietly in order to avoid the possibility *holdouts.*

holdouts
occur when key property owners refuse to sell at any price or demand prices that are so far out of line that they make the financial feasibility of the project unacceptable. Quickly and quietly assembling a land package and avoiding holdouts is a key part of the development process.

Alternatively, real estate developers and REITs may own land inventories. These land inventories are typically parcels of land adjoining existing real estate projects owned by the developer or REIT. These lands have usually been entitled to build and are held in inventory awaiting market conditions that will support development activities. This preentitlement allows the developer to substantially shorten the cycle time of a project because the site analysis, acquisition, and entitlement process is substantially complete. Often this land is perpetually for sale, offered as a build-to-suit site where an interested buyer can acquire the land and the developer will build a building or complex to suit the buyer.

There is some debate among analysts who follow REITs over the merits of land inventory. There are those who argue that land inventories are costly to maintain and come at the expense of the overall performance of the REIT's existing property portfolio. The other side of the argument suggests that land inventory provides the opportunity for build-to-suit developments as well as speculative building by the REIT when market conditions support such activity, and therefore the higher potential returns are generally worth the risks to the shareholder. In most cases, the value added is a function of how skillfully the real estate management team handles the land inventory. In many circumstances, land is acquired under a conditional purchase agreement or contingent purchase agreement. This is usually prefaced on a series of conditions being met

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in order to facilitate the eventual land transaction. In most instances, the developer pays a fee to the landowner to obtain an option on the land subject to certain conditions. The option has a limited term and the developer must complete the conditional process by the end of the option term or risk losing the ability to control the land. In other scenarios, the landowner may participate by contributing the land to a joint venture with the developer.

Large development projects may also be undertaken using staged payments to the landowner, meaning the landowner is paid as each phase of the development is completed. Here the seller might receive a monthly option fee to compensate for staging of payments over time as well as an overall higher price for the land.

eminent domain
a legal term referring to the right of a public entity, such as a state or local municipality, to seize a property for public purposes in exchange for compensation to the property owner. (See also REIT Idea: *Kelo et al. v. City of New London et al.* in Chapter 1.)

Land can also be acquired through a process known as *eminent domain.* In some instances, this occurs when a holdout is threatening the viability of a large-scale project that has been embraced by a community. If the holdout controls a key parcel, the local municipality may use its power of eminent domain to acquire that parcel, thus allowing the project to move forward.

Sometimes land acquisition is not really an acquisition at all. There are cases where the land on which a building is built is leased on a long-term basis. This is particularly true in areas where there is a scarcity of buildable land. In such situations, a landowner might, rather than sell a parcel, be inclined to engage in a long-term lease. The lease is normally structured in a way that allows the property owner to participate in the success of the real estate project. In many land leases, annual lease payments are supplemented by the landowner's participation in the upside rental growth of the underlying property.

The Entitlement Process

Overcoming inertia to allow a property to be developed for its highest and best use is normally the beginning of the entitlement process. Local governments often perceive development activities to be a threat to the

11_769193 ch07.qxp 5/18/06 8:23 PM Page 85

status quo and are generally reluctant to support new development projects. In addition, many local residents view development activity as a "not in my backyard" proposition. Well-organized citizen groups often turn up en masse to oppose development projects. In many instances, circumstances dictate that the local governmental authorities must weigh the gain in tax revenue against the community standard to determine whether a project proceeds and in what form. This is because almost all projects involve some type of variances from local building codes. A real estate project built in complete conformance with all local zoning standards and building codes is normally the exception. Generally speaking, in order to make a project work, the developer needs some changes in regulation or some compromise to allow the project to proceed. This may be an adjustment to the required number of parking spaces, an exception to the required maximum height standards, or a specific variance to route storm or drainage water in a particular manner. In any case, most projects require variances of one form or another.

When it comes to zoning exceptions in many communities, some items tend to be more negotiable than others. In general terms, the larger the scale of the variance that is required, the more difficult it is to obtain from a political standpoint.To overcome these entitlement issues, most developers attempt to form a political coalition with the local government. Again, the diplomatic and political skills of the developer are required to be at their best during the entitlement process. Normally time is of the essence during the entitlement phase. By this stage of the development process, the developer needs to keep negotiations moving along in order to sustain the project. In most cases, compromises are struck in order to save time and move the project forward. A good developer knows in advance what compromises may need to be made and what compromises he or she is willing to make to move the project forward.

In many instances, REITs and large landowners focus on creating improvements in their land inventory to add value. Management may obtain for option a parcel of real estate and facilitate necessary zoning variances. In addition, some level of infrastructure, such as sewer and water, may be installed to go along with zoning changes. This land is then considered ready for development and staged as a potential project when market conditions dictate the opportunity.

The entitlement process is as much an art as it is a science. Overcoming inertia and opposition and obtaining variances and building political support for a project require developers to have political and

11_769193 ch07.qxp 5/18/06 8:23 PM Page 86

diplomatic skills. Moving the project along a time line and understanding the financial risks involved require a high level of risk management skills.

Feasibility Planning and Production

Planning and design are the most important aspects after entitlement. Early in the planning process, the developer needs to position the project within the broader context of the community at large. This means the developer needs to work with the community to understand which groups have an interest in a project and what those interests are. This dialogue with the community helps to position the project and build political coalitions.

Once a master plan has been developed, the design process can begin. This process is often difficult to understand, particularly for people who are not involved in the real estate business. It is complicated and involves a high level of input by a large number of parties at interest. The architect goes through a discovery process aimed at determining needs and solutions and then takes this discovery through several different stages using input from the parties at interest in order to formulate a specific solution.

The first stage of the process, known as *programming,* defines the purposes the facility will be designed to serve. Depending on the size and scale of the project, the programming stage may be formal or more relaxed. The programming process attempts to gather input from all the local users of the end product and incorporate that input into the design.

The next stage of the process is known as the *layout phase.* Information from the programming stage is used to lay out a preliminary plan for the project. The architect attempts to determine what goes where, how traffic will flow through and around the building, what materials are suitable for the project, and the allowable size of the project.

In the next phase, known as *design development,* the architect uses feedback from the programming and preliminary design phases to formulate a more definite plan. There is a cost-benefit approach to the design development phase. From a financial point of view, project costs begin to materialize in this development phase. Trade-offs are made as less expensive materials are substituted for more expensive materials and amenities are added or deleted based on budget considerations. At the end of this phase, there is a set of drawings for the development that is fairly complete and encompass a level of detail that illustrates how the facility will function.

11_769193 ch07.qxp 5/18/06 8:23 PM Page 87

Design drawings are then translated into construction documents, which are also known as *working drawings.* These documents enable building contractors to see a level of detail that allows them to make a construction cost estimate and to begin to determine pricing estimates for the project. The working drawings are the most complicated portion of the architectural process. Many other experts, such as site engineers, structural engineers, and mechanical contractors, have some level of input into the working drawings. These subcontractors are paid by the architect for their work. This is the phase in which most of the design costs are incurred. In many instances, REITs have developed pools of in-house talent that can facilitate to a large extent the design- and cost-estimating portion of the feasibility and planning for a new project. This is a valuable resource for REITs.

At the end of the design process, the developer has a detailed set of working drawings. These drawings include specifications and a sufficiently high level of detail to allow building contractors to put a firm price estimate on the cost of building the project. In the development process, it is important that the developer understand the construction process sufficiently to manage these negotiations. Most REITs that are active in the development arena have the in-house talent to manage the construction process.

At this point, the bidding begins. The developer circulates documents requesting bids from subcontractors. These subcontractors, in turn, try to develop a bid that is low enough to get the job, yet high enough to allow for a fair return on their work. Again, this is an area that requires a high level of knowledge about the construction process in order to understand the bids—as well as the ability to negotiate effectively in order to obtain the fairest level of bids. Once the bidding process is complete, financing for the project needs to be put in place. (Financing is discussed in more detail in Chapter 9.) Finally, the construction process must be managed from planning through production in order to bring the real estate development online and available for market use.

Adding Value and Taking Risks

In the world of REITs, there is an ongoing debate over development activity and whether it adds value for the REIT shareholder. For the most part, REIT management attempts to create value through management

11_769193 ch07.qxp 5/18/06 8:23 PM Page 88

activity at the property level, but can it create value at the development level? In a stable real estate market environment, there are very few ways to create additional value. Value creation lies in the skill set of management personnel and their ability to properly develop or redevelop new product. It all comes down to a risk profile. Lower-risk development activities include building to suit and development projects with a high level of preleasing activity. Also, there is less risk in short-cycle building activities such as industrial warehouses, which by their nature can be designed and developed very quickly. This allows the developer to end development activity at the first signs of market weakness. Speculative construction is the highest-risk development activity. However, risk assessment really needs to be done on a project-by-project basis.

Each sector of the real estate market generally has specific problems with regard to development risk. Offices that may be built on spec are definitely impacted by changes in the economic outlook and also have a higher level of risk because of the long development time frame. Retail malls have many of the same problems as office space. There is a long timeframe with regard to development and construction, and inline retail tenants typically will not sign a lease until the project is within six months of opening. Industrial REITs suffer from low barriers to entry. Generally, industrial buildings are simple to build and therefore are characterized by higher levels of speculative activity. Apartments, because of the short duration of the tenants' leases, typically two years or less, have the opportunity to quickly capture tenants from other projects. Unfortunately, new apartment supply tends to be felt across the local apartment market very quickly. And if apartments spread the pain quickly, hotels spread the pain instantaneously. New hotels have a very fast impact on other hotel properties in the local market. Self-storage has a short building period; however, there is a long lease-up that has the effect of leaving the developer exposed to any potential economic downturn over a fairly long period. Manufactured home communities also suffer from a long initial lease-up period. But, unlike self-storage, manufactured home communities are generally in more limited supply, and the political implications of "not in my backyard" also make entitlement increasingly difficult for manufactured housing communities.

11_769193 ch07.qxp 5/18/06 8:23 PM Page 89

Assessing Development Activity

When it comes to REITs, the best way to assess development activity is as follows:

- Study the history of development activity as a firm and how it integrates into the REIT's overall business strategy.
- Study the level of development activity as it relates to the size of the REIT
- Conduct sensitivity analysis to examine the outcome or exposure created by development activity.
- Assess the risk exposure for the REIT on a project-by-project basis. The risk assessment should extend to the property category, the supply and demand for that property in the local market, the preleasing activity of the REIT, the expected cycle time for the development, and the pro forma return expectations on the project. (These issues are discussed in more detail in Chapter 9.)

REIT Idea: Merchant Builders

Recently, some development-oriented REITs have become *merchant builders*. Merchant builders develop properties and then sell them immediately on completion in order to make a profit. Merchant building can be viewed as a way for REITs to enhance their earnings while continuously recycling capital on the balance sheet. Merchant building activity will have a positive impact on a REIT's funds from operation. Nevertheless, a high level of merchant building activity makes it difficult to assess the ongoing performance of the REIT's underlying real estate portfolio. It can be argued that there is an intrinsic value through the merchant development activities, although it is hard to assess the level of value this might add to a REIT's market valuation. Merchant building activities add risk but also add return, and the question remains whether the return is sufficient to justify the risk.

11_769193 ch07.qxp 5/18/06 8:23 PM Page 90

Conclusion

Development activity takes a high level of skill and also requires financial resources. In many instances, developers may have the skills but lack the required financing to put a project in place. Joining together a skill set and capital can be viewed as the quintessential element necessary to formulate a real estate development deal. In Chapter 8, we discuss the many potential deal structures available in the real estate world.

Points to Remember

- Real estate development is the riskiest area in real estate.
- The high risk level is rewarded with high potential returns on successful development activities.
- Development activity is a central part of the business strategy for some real estate investment trusts (REITs).
- Understanding the development process is critical to analyzing local real estate markets.
- Because of long lead times, project timing is critical in real estate development.
- Managing the entitlement process is crucial to the ultimate success of a development.
- The design and construction process requires a high level of risk management skill.
- Successful development activity can add value and earnings for REIT shareholders.

Chapter 8

Partnerships and Joint Ventures

Mr. Morgan buys his partners; I grow my own.
—Andrew Carnegie, 1906

In Chapters 6 and 7 we discussed the real estate community's methods of analyzing local markets and creating new product—that is, new real estate—in those markets. We learned that a high level of local market knowledge is required when estimating the supply and demand dynamics of a given property type in a local market. We also learned that development activity requires a high level of skill on the part of the local real estate developer. Indeed, the amount of skill and effort necessary to participate successfully in the real estate marketplace inhibits many investors from directly owning, operating, and developing real estate.

The good news is that there are other ways for large institutional investors to participate in the real estate investment process. These are more passive approaches that allow institutions that do not have the skill set to place capital directly in the real estate sector. The heart of this passive approach involves the concept of joining together the skill set and knowledge of the local market experts with the capital resources of major institutions to formulate a joint venture in real estate.

12_769193 ch08.qxp 5/18/06 8:24 PM Page 92

How Joint Ventures and Partnerships Operate

Joint ventures (JVs) or partnerships in the real estate world are the preferred methods for marrying financial capital and real estate expertise. There is a spectrum of real estate opportunities available for investment purposes designed specifically to create capital and efficiently allocate that capital through joint ventures and partnerships. These ventures range from direct investment partnerships formed between institutional capital sources and real estate experts all the way to syndications and pooled funds with a number of investors participating in a group format. Whatever the legal format—whether it be a partnership, a limited liability corporation, a joint venture or a syndication of some type, either public or private—the basic theory is always the same. Essentially the project identifies the expertise of a real estate investor that possesses market knowledge and experience and aligns that expertise with a pool of capital in the form of equity, and possibly debt, to create a common real estate venture. The venture invests the resources in a variety of properties or developments that are initially agreed on in a statement of intent or general purpose for the partnership or joint venture. The second half of the equation, which is often subject to a higher level of negotiation and analysis, determines who will get paid as a result of the financial operation of the partnership—more importantly it determines how much each participant will get paid and when those payments will occur.

The basic provisions of the agreement outline the responsibilities and expectations of the parties involved. The agreement defines the concept of project cash flow, which is defined and analyzed. The notion of a preferred rate of return is detailed. Debt structure and the limitations of the use of debt are outlined. The potential tax benefits and their distribution are also agreed on. In addition, the term of the agreement is memorialized and the provisions for termination of the venture activity are outlined. Finally, a discussion of fees, acceptable expenses, and third-party management arrangements is detailed, agreed on, and disclosed in the basic partnership or joint venture document.

Cash flow is at the heart of any real estate deal. The real estate partner in a given deal often has limited personal and financial exposure in a project. Therefore, it is important for all parties to understand the deal structure and to create a structure that aligns the interests of the various parties to the transaction. Aligning interests allows everybody within the

12_769193 ch08.qxp 5/18/06 8:24 PM Page 93

investment to have the same motivation and to be in general agreement as to the direction of a given project.

Cash flow is normally defined as revenues on the project less expenses of the project, which yields net operating income. By adding back depreciation and amortization expenses, it is possible to arrive at cash flow. Cash flow is the actual net cash generated from the real estate activities. In a normal joint venture structure, the financial participants receive an annual cash preference with regard to the cash flow. A financial participant that commits $1 million of capital to the project may be entitled to a preferential return of 10 percent per year on its invested capital; thus the first $100,000 of cash flow would be paid to the financial partner to satisfy the preferential return requirements.

After the preferential rate of return has been met, the remaining cash flow is divided on a formula basis between the financial investor and the real estate partner. This excess distribution structure might have several different levels to provide for a higher percentage participation in the cash flow as the financial investors receive a higher net return on their investment. In many partnership structures, after a preferential return of 20 percent has been achieved, the balance of the cash flow might possibly inure to the real estate partner. This cash flow arrangement typically remains in place until such time as the original financial investors have fully recovered their initial investment through cash flow. At that time, the cash flow sharing arrangement might shift to a structure such as 50/50 or may allow for a preferential return to flow to the real estate partner.

Again, it is important to note that deals are often negotiated on an individual basis, and there is no standard format for structuring who gets paid how much and when. These elements are generally reflective of the level of risk and the profile of the particular deal at hand. Beyond allocating current cash flow, the partnership agreement must also determine how the final profits of the project are ultimately divided. In most instances, these backend-sharing arrangements reflect the percentage of capital each partner has committed to the deal. If the financial partner has committed 90 percent of the net capital and the real estate partner has committed 10 percent, then typically the profits on the project are divided similarly, with 90 percent going to the financial partner and 10 percent going to the real estate partner. It should be noted that in most instances the real estate partner receives no final distributions until all the initial capital of the financial partners has been recovered in total. This creates an incentive for the real estate partner to provide for a high

12_769193 ch08.qxp 5/18/06 8:24 PM Page 94

preferential rate of return for the financial partners as well as providing for the complete return of the financial partner's capital. This type of structure aligns the financial interests of all participants involved in the project.

Most deals use some form of debt in addition to the equity provided by the financial partners to fund the total capital amount required to complete the real estate deal. Debt structure is often defined at the initial phases of the deal, and the ability of the real estate operating partner to change the debt level or modify the debt terms of the partnership is often subject to the approval of the financial partner. Debt structure is an important aspect of the overall agreement. A higher level of debt can provide for higher potential total returns; however, higher debt also creates a higher risk level for the project. More conservative financial partners may require lower leverage debt structures. Lower debt levels are normally reflected in the hurdle rates and annual cash preferences for the financial partners.

Tax benefits are also identified and distributed in most joint venture situations. As discussed earlier, a major part of the structural problems within the real estate community in the 1970s and 1980s resulted from a tax policy that created an excess supply of real estate. The Tax Reform Act of 1986 lengthened depreciation schedules and increased the useful life over which properties could be depreciated. It prevented investors from deducting real estate losses against non-real estate income. These changes substantially decreased many of the favorable tax aspects of investing in real estate. However, there are still tax-related issues surrounding joint ventures and tax benefits available to certain participants.

In the case of tax-exempt investors such as the Employee Retirement Income Security Act of 1974 (ERISA) plans, the tax benefits have little value. It is not unusual to see the tax benefits, if any, being delivered to the real estate operating partners in exchange for higher cash flow benefits being delivered to the tax-exempt financial partners. The implications of the tax adjustments in the Tax Reform Act of 1986 are quite substantial. Prior to 1986, typical commercial investment properties would be depreciated over a 15-year useful life. Under the Tax Reform Act and subsequent revisions in 1993, a 39-year useful life was enacted. This change in depreciation made a substantial difference in the noncash portion of the depreciation expense, effectively lowering the net cash generating ability of most real estate properties.

12_769193 ch08.qxp 5/18/06 8:24 PM Page 95

Depreciation allowances defer taxation until the time the property is sold. At the time of sale, the gain is calculated using the depreciated property value and the taxes are calculated using a capital gains rate that is currently 15 percent rather than 25 percent or 28 percent in effect prior to the 1986 act. The tax disadvantage resulting from the change in depreciation can be partially mitigated by using higher leverage. If higher loan-to-value ratios are used, or higher leverage is employed, the added mortgage interest expense becomes deductible and the amount of equity capital required to finance the property decreases. This in effect creates a higher return on invested capital and a higher cash flow return on capital. The relative advantage of higher leverage depends entirely on the cost and availability of mortgage financing. It should be noted that higher leverage may look attractive from a return on capital standpoint when the property is operating in a positive mode, but leverage also magnifies the potential downside in a property that is not operating well. Thus debt should be analyzed not just on the upside but also on the downside when considering capital structure.

Termination of a Joint Venture or Partnership

Beyond operating provisions, the partnership or joint venture agreement must address termination provisions. Termination provisions are usually created to facilitate the financial investor's recovery of capital within a certain time horizon. Because real estate is a long-term investment, most partnerships or joint ventures have relatively long time horizons. Because of its nature, real estate is a long-term asset class. For that reason, real estate joint ventures tend to have a longer term. Most develop-and-hold or buy-and-hold venture strategies have a minimum life span of 10 years. The idea of a predetermined time horizon has a particular appeal for financial investors because it means that real estate partners cannot tie up capital and extract management fees over an indefinite period of time. The finite time horizon also presents certain disadvantages, which are generally related to the cyclical nature of the real estate industry. Financial partners might find that real estate partners are not inclined to dispose of real estate at any time prior to the termination period of the partnership. Thus, looking at a 10-year partnership, seven or eight years into the partnership might be the ideal time to dispose of real estate held in the partnership. However, the real estate partner may not want to dispose of the property at that point and lose two or three years of

12_769193 ch08.qxp 5/18/06 8:24 PM Page 96

partnership fees. Also, because it is impossible to predict where the real estate cycle will be at the end of a partnership term, almost any reasonably long period of time might find a partnership ending in an unfavorable real estate market.

Because of this, it is not unusual for partnership agreements to have optional extension periods that can increase the life of the fund for one to three years. These extension options are designed to provide an additional holding period that allows real estate market fundamentals to recover. In most instances, these extension periods require the agreement of the financial partner in order to be implemented.

Conclusion

It is apparent that no predetermined financial structure can readily be applied to partnerships and joint ventures in the real estate arena. Each joint venture must take into consideration the properties for the development and the local market factors in determining the general structure of the partnership agreement. More conservative financial partners such as pension plans tend to have more conservative deal structures that provide for lower leverage and more uniform predictable cash flow to the financial partner. Conversely, opportunity funds that reflect a more aggressive pool of investors might prefer higher levels of debt and require a more aggressive initial sharing of cash flow benefits. Again, each joint venture deal is structured to reflect the general posture of all the deal participants. At the end of the process, the union of money and expertise should enable the participants to negotiate an agreement that substantially aligns the interests of all parties involved.

REITs and Joint Ventures

Joint ventures allow real estate investment trusts (REITs) to expand their business model and employ their substantial real estate expertise while preserving the flexibility of capital on the balance sheet. A REIT operates a *direct investment portfolio* (DIP) of real estate. By participating in joint ventures and partnerships, the REIT management team can increase the return on capital invested in the DIP.

In increasing numbers, REITs are marrying their broad real estate expertise with ever-larger pools of investment capital. Partnerships and

12_769193 ch08.qxp 5/18/06 8:24 PM Page 97

joint ventures allow REIT management teams to extend the use of balance sheet capital, increase potential returns to investors, and create a greater level of diversification, thereby reducing risk in the DIP. Real estate markets have unique institutional characteristics that differentiate them from non-real estate markets and accordingly are expected to produce results that diverge from results observed in the non-real estate sector. These characteristics include local market knowledge and market segmentation, development knowledge that may give real estate firms an information advantage regarding local real estate markets, and better management and technical expertise regarding real estate ventures.

A number of academic studies have examined the effect of joint venture programs and their impact on the shareholder value of REITs. In general, these studies report positive and statistically significant increases in shareholder value as a result of joint ventures in the real estate community. The research concludes that there are several factors that make the real estate joint venture successful. The first is the synergies that result from combining the resources of two or more enterprises. Under the assumption that the capital market is efficient, real estate joint ventures are normally interpreted as positive by shareholders of the participating firm because of their perceived financial synergies resulting from the joint venture. The operating synergies can be attributed to economies of scale, better competitive position in local markets, higher levels of primary research, and more efficient use of managerial and human resources as well as reduction of business risk through diversification. In addition, the ability of the joint venture to increase the overall debt capacity of the participants is perceived as a financial synergy that is positive for the shareholder.

The other unique institutional characteristics that can be attributed to the joint venture in the real estate market are the characteristics of market locality and market segmentation. In the local real estate market, the lack of standard real estate product and the absence of a central market exchange require a higher level of research knowledge for nonlocal firms competing in a local real estate market. In local markets where information can be difficult and costly to obtain and may not be available to all participants, real estate firms are likely to be more familiar with the market and have an informal advantage. The theory is the higher value attributed to joint ventures reflects the comparative information advantage that local real estate firms have within the local marketplace.

Taking the knowledge advantage a step further, it seems logical that different market segments require different skill sets and managerial

12_769193 ch08.qxp 5/18/06 8:24 PM Page 98

talent that may not be easily transferable. A high level of management skill can help to reduce the uncertainty associated with business risks that result from operation of real estate properties. That knowledge can also be efficiently leveraged over a larger DIP, which can be produced through the joint venture structure. Therefore it is not unreasonable to expect that the real estate joint venture, when properly structured, can produce a comparative local market advantage for the participants of the venture.

REIT Idea: Where REITs Add Value in Joint Ventures

The following list details the areas where a REIT's local market knowledge and management expertise can add value in a joint venture program:

- *Acquisitions.* Area local market knowledge and a long-term market strategy helps the local real estate partner complete due diligence and acquisition negotiations at a lower cost than a nonlocal competitor.
- *Local market strategy.* The local market partner can better define local market niches, thereby understanding local market opportunities at a higher level than the nonlocal participant.
- *Adjustment in strategy.* The local market participant is more sensitive to changing local market conditions and can react quickly to changes in the local market dynamic.
- *Primary research.* The local market participant has a better institutional knowledge of the local market history, which translates into better and lower-cost direct research in the local market.
- *Dispositions.* The local market participant has an advantage in completing negotiated transactions with other local market participants as a result of superior local market knowledge.

Through local market knowledge and management expertise, REITs have historically availed themselves of the opportunity to participate in joint ventures with capital partners in order to add shareholder value and extend balance sheet leverage and portfolio diversification for shareholders.

12_769193 ch08.qxp 5/18/06 8:24 PM Page 99

Points to Remember

- The high level of skill required to participate successfully in the real estate market inhibits many financial investors from directly owning or developing property.
- In the real estate world, joint ventures are the preferred methods for marrying financial capital and real estate expertise.
- The terms and conditions of joint ventures are detailed in joint venture agreements.
- The basic provisions of joint venture agreements outline the responsibilities and expectations of the parties involved.
- The agreements address the treatment of cash flow, debt structure, operating objectives, lifetime of the venture, and distribution of profits.
- Joint ventures allow real estate investment trusts (REITs) to expand their business model while preserving the flexibility of their balance sheet.
- Academic studies report positive and statistically significant increases in shareholder value as a result of joint ventures in the real estate community.
- Joint ventures are interpreted as positive by shareholders of the participating firm because of their perceived resulting financial, management, and information synergies.
- Because of their market knowledge, REITs are in a unique position to participate in joint venture activities.

Chapter 9

Analyzing REITs

The only dependable foundation of personal liberty is the economic security of private property.

—Walter Lippmann, 1934

The valuation methodologies applied to publicly traded real estate investment trusts (REITs) are roughly comparable to those used in the private real estate markets. There are a number of public-market-based valuation approaches that can also be applied to the financial analysis of REITs. These approaches are all loosely categorized into a group of valuation methodologies that can be called *quantitative analysis.* Like the direct valuation approaches used in private real estate, the quantitative approaches used in public real estate each have certain positive and negative attributes. Just as in private valuation methodologies, a conclusion of value is more accurate when it is considered in light of multiple valuation approaches rather than a single evaluation method. In addition to quantitative methods, there are a range of qualitative factors that must be considered when valuing public real estate. These quantitative and qualitative approaches are examined in the following sections.

Basic Methodologies

The direct real estate investment market has three basic methodologies for arriving at the value of a given piece of real estate. First is the *replacement cost* method. This form of valuation contemplates what it would

13_769193 ch09.qxp 5/18/06 8:24 PM Page 102

cost in the current market environment to replicate a building of similar size and quality in a similar location. This analysis includes the value of the land on which the building sits, along with site improvements and general neighborhood amenities. It is relatively simple to discover the general replacement cost of a building; however, because each property is so unique, there is no exact substitute for any given property per se. This makes replacement cost a useful tool for obtaining broad generalizations about a property's value, but further analysis is normally required to make a definite conclusion about value.

The second approach to real estate valuation is the *market comparable* approach. This method attempts to estimate a property's current market value by analyzing recent sales of similar properties in the general area of the property being valued. Again, because each property is unique, it is difficult to draw a definite conclusion about market value using the comparable approach alone. The data on reported sales is based on recent historical sales activity and thus may not reflect recent changes in the local real estate market. Although a price agreed on by a buyer and seller in an arm's-length transaction is typically the best indicator of value, other issues come into play. Is the seller under some financial or personal pressure to sell a property? Is the buyer willing to pay a premium because of specific aspects of the property that may be of use only to that buyer? These transaction-related dynamics are difficult to determine when studying comparable sales. The solution is to study a range of recent transactions and draw conclusions from a larger sample of data. This is effective in a local market where there is a reasonable level of real estate activity. However, some markets produce a limited volume of comparable real estate transactions, which makes the comparable method less precise.

Finally, real estate value can be derived by the capitalization of net income approach. This *capitalization rate* or *cap rate* approach considers the net income after expenses of a property as a current return required or generated on the price of the property. For example, a property with net operating income (NOI) of $120,000 and an asking price of $1.0 million would have a cap rate of 12 percent ($120,000/$1.0 million = 12 percent).The cap rate approach generally allows for an independent estimate of value that is somewhat more precise than either the replacement cost or market comparable approaches. The cap rate of any property that trades hands as an investment vehicle reflects the competitive real estate investment alternatives in a given local market, giving the appraiser a

13_769193 ch09.qxp 5/18/06 8:24 PM Page 103

larger pool of candidates to examine when making a comparable cap rate analysis. In addition, slight adjustments in cap rate allow for a more precise valuation when considering the merits or flaws of a particular property.

capitalization rate or cap rate for a property is calculated by dividing the property's net operating income after property level expenses by its purchase price. Generally, high cap rates indicate higher returns and possible greater risk.

In a local market it might be simple to conclude from the available data that community shopping centers trade in a cap range of 10 to 12 percent. The newer, bigger, better located properties are in the 10 to 11 percent range, and the older, smaller, less favorably located properties are in the 11 to 12 percent range. This allows the appraiser to apply a more precise cap rate once it is determined where the subject property falls on the quality spectrum.

Each of the standard appraisal methodologies has its advantages and drawbacks. Therefore, in normal valuation analysis, the subject property is examined using each methodology. More or less consideration is ascribed to each approach based on the relevant facts and circumstances about the property. At the end of the process, a synthesis of all the methods rather than one single approach usually determines a value. The valuation methodology is as much an art as a science, and most appraisers say that the actual market sale price may be higher or lower based on many subjective factors that are difficult, if not impossible, to quantify.

REIT Idea: Approaches to Valuing Real Estate

There are three commonly used approaches to valuing real estate:

1. Replacement cost approach
2. Comparable sales approach
3. Capitalization rate (cap rate) approach

None of these always yields a perfect answer, but when taken together they normally provide a good indication of real estate value.

Net Asset Value Analysis

Net asset value (NAV) analysis is the public real estate version of the replacement cost approach. There are two schools of thought among REIT

13_769193 ch09.qxp 5/18/06 8:24 PM Page 104

analysts: those who believe that this approach provides the least accurate measure of the value of an equity REIT and those who believe this is primarily the best method for valuing REITs. At its essence, the NAV approach involves estimating whether a stock trades at a discount or premium in comparison to an estimate of the private market value of the company's real estate assets.

The first step in estimating the NAV of a REIT requires capitalizing the NOI of the properties. This can be done either before or after making a reserve for expected capital expenditures. The key to this process is estimating NOI, because many REITs own interests in dozens of properties located in many different local markets. Although local market conditions may vary widely, REITs often do not disclose the NOI for each building, and therefore an overall capitalization rate must be applied to the entire real estate portfolio of the REIT.

The cap rate selected considers a component for expected real return, an inflation premium, a risk premium, and an amount to compensate for the expected decline in property value due to depreciation or obsolescence, often called the *recapture value.* There is the potential for a large error factor that may result from estimating a portfolio-wide capitalization rate. A significant difference can result depending on whether the analysis is made using current or estimated forward NOI. Generally, using a blend of past and future estimated NOI helps to moderate the error of an estimate.

To capitalize a future income stream to estimate the total private market value of a company, the next step is to deduct the debt associated with the estimated NAV and adjust the number of shares outstanding if any equity issuance is assumed as part of the analysis. Generally, NOI earnings models assume that future acquisitions and development costs are funded by debt, and projected average future liabilities (as opposed to current liabilities) are deducted. One of the better factors of public real estate company analysis is that a relatively efficient private transaction market coexists for income-producing, investment-grade property. Other private companies may change ownership on a regular basis, but the selling prices are seldom known. Privately negotiated investment-grade commercial real estate transactions total an estimated $250 billion annually, and most are a matter of public record. Thus a cap rate for an individual property can be estimated with a relatively high degree of accuracy. A small error factor for a single asset, however, compounds when applied to an entire portfolio, so great care is required when making these estimates.

13_769193 ch09.qxp 5/18/06 8:24 PM Page 105

REITs often have other nonrent income that must be considered in the valuation of NOI. Most analysts apply a high capitalization rate that translates into a low value being placed on the net property management fees. This reflects the fact that management contracts can normally be canceled on short notice, usually 30 to 90 days. Thus a relatively high cap rate of 20 to 30 percent is applied to this income to reflect the possible variability. Then adding to this total other REIT assets, normally cash and marketable securities, results in an estimate of total private market value of the entity. Then the total liabilities are deducted, including the aggregate debt, preferred stock, and pro rata share of any unconsolidated joint ventures. This results in an estimate of a REIT's NAV. Finally, the results must be divided by the total diluted shares or operating partnership units outstanding that would result from a conversion to common shares.

From an NAV perspective, the publicly traded REIT universe has been priced by the public markets at a discount of as much as 31 percent on NAV to a premium of 39 percent of NAV over the last 10 years based on estimates made by Uniplan Real Estate Adivsors. The average value over that time has been about 103 percent of NAV or a 3 percent premium to the NAV of the underlying portfolio.

The discount or premium to NAV is often partly accounted for by the fact that the equity market is forward looking and views REITs as ongoing business enterprises rather than direct portfolios of real estate assets. If REITs are struggling and earnings or rent growth look flat or even lower in the coming year, then the prospective valuation mechanism of the market might put a discount on the value of the underlying real estate held by the REIT. Conversely, if real estate market conditions are improving rapidly, that forward-looking market mechanism might put a premium value on the future value of a REIT's property holdings. This should be considered when evaluating the NAV of any REIT.

Drawbacks of NAV Analysis

The principal drawback of NAV analysis is that NAV calculation involves the analysis of the cash flow at a given moment in time and applies it to a fixed collection of real estate assets. The approach can be very helpful in a situation where a REIT owns a few properties that account for a significant proportion of a portfolio's overall value. However, in a very large portfolio of properties, it is less useful due to the differing nature of the properties.

13_769193 ch09.qxp 5/18/06 8:24 PM Page 106

The other key weakness of the NAV approach is its inability to accurately value a rapidly changing local market or a quickly growing REIT. For a fast-growing REIT, NOI may increase rapidly as the company acquires or develops new properties, and the REIT shares may appear very over- or undervalued depending on whether an analyst chooses to capitalize trailing or forecasted NOI. NAV analysis can also be criticized as a successful standalone REIT stock selection mechanism because it fails to acknowledge the different risk profiles of various REIT capital structures.

For instance, two companies with a $40 per share NAV might appear equally attractive from an NAV-only perspective. Unsecured debt, however, may comprise 10 percent of one company's capital structure and 90 percent of the other's, placing the latter in much greater risk category. In the latter example, the NAV could be significantly lower if there were to be a small change in the value of the underlying property values. In the 10 percent case, a small change in the property value would have a small impact on NAV due to the lower *leverage*. So NAV has its drawbacks and is only one in a number of was to evaluate REITs.

leverage
the amount of debt in relation to either equity capital or total capital.

Enterprise Value/EBITDA Multiple Analysis

Another method of valuing a REIT that addresses part of the flaw in NAV analysis involves looking at cash flow generated by the REIT. In this approach, a measure of cash flow composed of earnings before interest, taxes, depreciation, and amortization is used. The methodology involves dividing the *total market capitalization* of equity and the nominal value of company debt of the REIT by the total *earnings before interest, taxes, depreciation, and amortization* (EBITDA) or cash flow to the company. One advantage of this approach is that it normalizes the ratio across most normal capital structures and may be used to compare firms with differing amounts of balance sheet leverage. As was the case with the NAV calculations, the enterprise value/EBITDA multiple is normally calculated us-

total market cap
the total market value of a REIT's (or other company's) outstanding common stock and indebtedness.

13_769193 ch09.qxp 5/18/06 8:24 PM Page 107

ing an estimated forward capital structure. The enterprise value/EBITDA ratio usually reflects the market's sentiment regarding the expected near-term and long-term growth rate of a sustainability of growth and quality of cash flow. The multiple may also reflect the amount of anticipated or budgeted capital expenditures and future obsolescence of the property. Some analysts prefer to use EBITDA less capital expenditure reserve as a measure of operating cash flow. The EBITDA approach is widely used when looking at companies in general and is not limited to real estate companies or REITs.

EBITDA
earnings before interest, taxes, depreciation, and amortization. This measure is sometimes referred to as *operating margin*.

Multiple-to-Growth Ratio Analysis

Multiple-to-growth ratio analysis helps to answer two REIT specific valuation issues: (1) How much is the market willing to pay for each unit of growth? (2) Can value and growth be available in the same REIT? It is important to understand that profitability and growth are not the same. Growth of earnings or *funds from operations* (FFO) growth alone cannot provide a valid single measure for assessing investment value. However, some investors implicitly assume that this is a valid single measure when they apply the current period's price/FFO multiple to some terminal year's earning rate. Growth only adds value to a REIT when the return on investment exceeds the *cost of capital*. However, some REITs may be focused on growing the portfolio simply to expand in size. That business strategy depends on a company's ability to sell shares or raise additional capital at frequent intervals at higher and higher prices. As the enterprise continues to expand in size, the amount of acquisitions necessary to sustain the per-share FFO growth rate also expands in size and often becomes

cost of capital
the cost to a company, such as a REIT, of raising capital in the form of equity, preferred stock, or debt. The cost of equity capital generally is considered to include both the dividend rate as well as the expected capital growth as measured either by higher dividends or potential appreciation in the stock price. The cost of debt capital is the interest expense on the debt incurred plus any fees incurred to obtain the debt.

13_769193 ch09.qxp 5/18/06 8:24 PM Page 108

funds from operations (FFO)
the most commonly accepted and reported measure of REIT operating performance. Equal to a REIT's net income, excluding gains or losses from sales of property, and adding back real estate depreciation. It is an approximation of cash flow when compared to normal corporate accounting, which is a better measure of operating performance than GAAP earnings that might include (sometimes large) noncash items. The dilemma is that there is no industry standard method for calculating FFO, so it is difficult to use it as a comparison across all REITs.

unsustainable. Thus growth rate falls and with it the premium multiple that the stock may have commanded.

The opposite of an upward growth spiral is the collapsing death spiral. In a traditional growth industry, a company's P/E ratio is often compared with its long-term expected growth rate; firms with P/E ratios less than their growth rate are often considered to be undervalued. The multiple-to-growth ratio forms a relative perspective when used to rank a universe of REITs on the ratio of price/FFO multiple versus sustainable growth rate. The central problem confronting a REIT analyst is the sustainability of a high-growth period for a given REIT. Because REITs must distribute at least 90 percent of their taxable income, in most instances there is only modest free cash flow and almost all acquisition and development growth must be financed from external sources. Typically, this has been accomplished through the repeated sale of primary shares along with the expansion of balance sheet leverage. Most REITs fund incremental acquisitions and developments via debt and then turn to the capital markets to deleverage with equity.

The sustainable, internally generated operating cash flow growth rate for most equity REITs is realistically 3 to 5 percent, based on the constraints of the REIT structure. Adding an appropriate level of balance sheet leverage may increase cash flow growth to an average of 5 to 8 percent. REIT FFO growth rates in excess of 10 percent are thus not sustainable over an extended period without the use of higher than average leverage or repeated trips to the capital market for more equity capital. Some analysts actually place a multiple penalty on REITs with a growth rate that exceeds about 10 percent due to the financial risk of ongoing capital requirements.

13_769193 ch09.qxp 5/18/06 8:24 PM Page 109

REIT EPS

Operating *earnings per share* (EPS) has relevance in the valuation of REIT equity securities. It is incorrect to dismiss the EPS measure as simply not appropriate for real estate companies because accounting depreciation overstates physical depreciation of the real property asset.

The EPS measure is widely used across many industries. Analysts covering other sectors often supplement EPS results with alternative valuation metrics. In general it is important not to overemphasize the importance of, or place too much focus on, any one figure. Thus the very popular Wall Street focus on EPS figures, or any other single statistics, can be misleading. In using the EPS figure, an analyst should always be alert to the components of the net income figure and how that figure is used for comparative purposes.

Using operating EPS as a measure of REIT earnings power has drawbacks. Calculations for some companies involve predecessor entities with different tax bases requiring step-up depreciation adjustments and adjustments for distributions to minority partners in excess of net income that dramatically lower EPS. Other companies make acquisitions for cash and have componentized depreciation, lowering reported net income and allowing the REIT to retain more capital to fund development activity. In conclusion, despite various drawbacks, EPS can be a useful device in assessing the valuation of REIT securities but again only in the context of other comparative valuation methods.

Positive Earnings Revision Analysis

REIT valuation by positive earnings revisions involves identifying and valuing REIT shares based on owning companies where Wall Street earnings estimates are being revised upward. The basic application of this method involves choosing stocks with earnings revisions that are rising, thus creating unexpected positive earnings. Another form involves buying stocks in companies whose sequential earnings growth rates are accelerating. This is often known as an *earnings momentum* strategy. These two approaches are less classic real estate valuation approaches and more Wall Street-based valuation approaches. The idea is that public market

13_769193 ch09.qxp 5/18/06 8:24 PM Page 110

investors are more willing to pay a premium on any company when it delivers sequential earnings growth at a level higher than expected by the consensus of analysts covering a stock. This approach is most useful in the real estate sector to detect or confirm the beginnings of a real estate market recovery within the local markets where a REIT owns property.

Return on Capital versus Cost of Capital Analysis

The earnings life cycle for a REIT that continually issues new common equity is inextricably linked to its price/FFO multiple. From 1998 through 2004, average REIT price/FFO multiples ranged between 7 and 15.5 times forward four-quarter FFO, reflecting a nominal cost of 14.3 to 6.45 percent for raising new common equity, before factoring in the cost of underwriting. On a purely mathematical basis, a REIT that sells new shares at such multiples and invests the proceeds in properties with initial capitalization rates that equal or exceed the nominal cost of capital will have completed a transaction that is additive to earnings. The more equity issued and the more properties acquired, the higher the year-by-year FFO growth, provided that increasingly large amounts of stock can be sold at equal or higher multiples. A company that buys a business trading at a lower multiple than the buying company itself will by definition enhance its EPS growth rate. After the purchase, the low cash flow multiple attributable to the operations of the acquired company is often revalued at or close to the original firm's higher multiple. This is the accounting definition of accretion.

Although such a transaction may be additive to earnings from an accounting perspective, it may be dilutive to true shareholder value in the economic sense. A review of a variety of valuation parameters is needed when analyzing real estate stocks. Such items include property type and geographic portfolio characteristics; growth rates in net income, FFO, *funds available for distribution* (FAD) and dividends; earnings momentum; relative price multiples for an individual company versus peer companies and sector averages; current and anticipated dividend yield and dividend safety; leverage; trading volume; and management track record and capability.

Measures of corporate performance based on return on capital are often cited as means of distinguishing among REITs. When evaluating

13_769193 ch09.qxp 5/18/06 8:24 PM Page 111

REIT performance, it is important to include return on capital and cost of capital analysis. The specific value of comparing *weighted average cost of capital* (WACC) with *cash yield on cost* (CYC) for a real estate company is that it relates a firm's capital structure decisions to its operating business results as measured by true economic (as distinguished from accounting) profitability.

Cash Yield on Cost

A company's CYC is equal to NOI from the property portfolio (essentially operating property revenues less operating property expenses) divided by gross (undepreciated) investment in real estate. This is a measure of a company's unit profitability as distinguished from its sales growth. Simply put, it is a measure of return on assets or return on invested capital.

Weighted Average Cost of Capital (WACC)

The WACC is the weighted average of the costs of a REIT's debt and equity. The WACC represents the rate at which projected cash flows may be discounted to determine net present value (NPV). If the present value of the expected future cash flows, using WACC as the discount rate, is positive, then a potential investment should be pursued. Similarly, if the NPV of an investment is negative, then the investment should be rejected. In other words, a positive NPV is equivalent to a project's total return on internal rate of return exceeding WACC. Alternatively, WACC may be considered a hurdle rate for evaluating the minimum acceptable rate of return for a potential investment. From an equity investor's perspective, companies that consistently pursue business opportunities with positive NPVs increase firm value by boosting the growth rate and, hence, share value. Investors will buy REITs with positive and rising investment spreads between CYC and WACC. All REIT acquisitions may not be immediately accretive to shareholder value (exceed a company's WACC). However, a property investment should be able to generate a sustainable cash yield above the REIT's WACC within some reasonable time period, perhaps 24 to 36 months. This demonstrates the value-added ability of a REIT management team to deploy capital at a positive to the firm's cost of capital.

13_769193 ch09.qxp 5/18/06 8:24 PM Page 112

Positive Spread Investing (PSI)

What is the value of comparing WACC with CYC? First, until recently, REITs rarely sold properties. Although capital appreciation in assets may occur, it is often not realized, and therefore the focus is on current and future cash flow from real estate investments. Second, a REIT that operates with low leverage will have a higher WACC and thereby implicitly raise the hurdle rate it must achieve on new real estate investments. There are many potential attributes of a successful REIT investment, some of which we have just discussed. Nevertheless, because of the importance of income generation in a REIT's total return, comparing CYC to WACC is a useful method of evaluating potential or existing REIT investments.

positive spread investing (PSI) the ability to raise funds (both equity and debt) at a cost significantly less than the initial returns that can be obtained on real estate transactions.

Some REITs derive significant value from potential capital appreciation on assets. In such cases, the usefulness of the investment spread methodology may be limited. In these instances, this analytical tool should be used in conjunction with other, more traditional measures of equity valuation such as operating cash flow growth, relative earnings multiples, and *net asset value* (NAV) analysis.

net asset value (NAV) the net market value of all a company's assets, including but not limited to its properties, after subtracting all its liabilities and obligations.

Drawbacks of the Methodology

As in all the other evaluation methods, there are several potential drawbacks to this methodology. First, current-period cash yields may not remain at the same starting value—they may go up or down over time; sustainability or growth in NOI is key to this method of analysis. The individual company cost of capital reflects a dynamic process that incorporates growth in revenues and expenses from existing properties, acquisitions, development of new buildings, and management expertise. Second, the length of time between the original investment and the current period may have an impact on the reported CYC. This is particularly true in the case of *umbrella partnership REITs* (UPREITs), where the original investment may have taken place years previously. In fact, research has shown that the CYC-less-WACC investment spread is larger in the case of

13_769193 ch09.qxp 5/18/06 8:24 PM Page 113

UPREITs than for traditional REITs or real estate operating companies. The difference is almost entirely a function of UPREITs having greater leverage, and thus a lower WACC, because the CYC is similar for UPREITs and non-UPREITs. Third, fast-growing REITs that may have low leverage today and have a negative or marginally positive spread between WACC and CYC may add debt in the future, lowering their WACC, and may boost NOI over time, eventually reversing the investment spread.

A REIT's development activity can also have an impact on this analysis. Depending on a firm's capitalization policy for new construction, some heavily development-oriented REITs may have below-average current cash yields on invested assets. However, given that property development generally entails greater risk than acquisitions, investors should expect such developer REITs to obtain above-average return on assets within some reasonable period following completion of a project.

Thus, just as in the private market, there is no single method in the public market that can be used as a stand-alone valuation tool. Rather, REIT values should be considered in light of all the various methods to determine a range of possible outcomes when valuing public REIT shares.

REIT Idea: Approaches to Valuing Publicly Traded REITs

There are three common approaches to valuing publicly traded REITs:

1. Net asset value (NAV) analysis
2. Enterprise value/EBITDA multiple analysis
3. Multiple-to-growth ratio analysis

Just as in real estate appraisal, none of these methods yields a perfect answer. When taken together, however, they normally provide a good indication of REIT value.

umbrella partnership REIT (UPREIT)

a complex but useful real estate structure in which the partners of an existing partnership and a newly formed REIT become partners in a new partnership termed the *operating partnership*. For their respective interests in the operating partnership, the partners contribute the properties (or units) from the existing partnership and the REIT contributes the cash proceeds from its public offering. The REIT typically is the general partner and the majority owner of the operating partnership units. After a period of time (often one year), the partners may enjoy the same liquidity of the REIT shareholders by tendering their units for either cash or REIT shares (at the option of the REIT or operating partnership). This conversion may result in the partners incurring the tax deferred at the UPREIT's

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13_769193 ch09.qxp 5/18/06 8:24 PM Page 114

formation. The unit holders may tender their units over a period of time, thereby spreading out such tax. In addition, when a partner holds the units until death, the estate tax rules operate in such a way as to provide that the beneficiaries may tender the units for cash or REIT shares without paying income taxes.

Points to Remember

- Analyzing and valuing a REIT is a blend of conventional real estate valuation and securities analysis.
- Conventional real estate valuation considers replacement cost, local market comparable sales, and capitalization of net income as the primary valuations methods.
- Valuing a REIT applies similar valuation methods to the underlying portfolio of properties owned by the REIT along with public market approaches to REIT valuation.
- The calculation of a net asset value for a REIT portfolio is similar to the replacement cost and capitalization methods in private real estate.
- REIT valuation that uses a multiple of EBITDA helps compare value across differing REIT capital structures.
- More conventional stock market-type valuation approaches apply multiple-to-earnings growth analysis, return on capital, and weighted cash yield methods to estimate REIT valuations.
- No single valuation method is the definitive answer, but all are very useful when applied in combination to estimate a range of value.
- Looking at the relative public valuations of other REITs is also a method for estimating a REIT's current value.
- The qualitative value added by the REIT management team is also an important factor to consider when estimating REIT valuations.
- Ultimately REIT valuation, like private real estate appraisal, is as much an art as a science and requires a thorough understanding of all valuation methodologies.

Chapter 10

Advanced Financial REIT Topics

Figures don't lie, but liars do figure.
—Old accounting saying

If an investor is going to analyze and select their own REIT investments, then there are a number of advanced accounting issues that should be understood with regard to real estate investment trusts. This chapter covers these technical issues. For readers who are not going to do their own REIT analysis, this chapter can be skipped.

REIT Accounting Issues

The steady and predictable earnings and consistent dividends generated by REITs have created a high level of interest. However, investors not familiar with the REIT sector may find it confusing to compare earnings because many REITs report quarterly results using *funds from operations* (or FFO—defined in Chapter 9), as opposed to *earnings per share* (EPS), which is the typical measure of profitability used in almost all other industries. Recently, several Wall Street brokerage firms have announced that they create EPS estimates for REITs rather than FFO estimates. This move has touched off a debate over the best way to measure the earnings capacity and financial performance of REITs.

Currently most REITs report quarterly results using FFO numbers. Calculating FFO begins with earnings calculated in accordance with

14_769193 ch10.qxp 5/18/06 8:24 PM Page 116

generally accepted accounting principles (GAAP), also known as *GAAP earnings.* These earnings are then adjusted to exclude gains or losses resulting from the sale of portfolio properties or from debt or financing activities. Then depreciation and amortization charges are added back to the resulting number to come up with FFO. FFO actually reflects operating cash flow generated as a result of portfolio activities of a REIT. In one sense, FFO reflects the cash-generating ability of a REIT portfolio; in another sense, it can overstate the economic performance of most REITs. Because FFO does not reflect recurring capital expense items—and because it allows the adding back of a wide range of expense items that management might deem to be nonrecurring—it often overstates for practical reasons the cash-generating ability of a real estate portfolio. Observers of and participants in the REIT industry have been engaged in a long debate over the correct metrics and methodologies that should be used to value REIT earnings.

In 1995 and 1999, the National Association of Real Estate Investment Trusts (NAREIT) published a white paper commenting on potential changes to the definition of FFO. In general, the industry's trade association seeks to move FFO into a more structured form that would more closely resemble GAAP net income. Originally created in the early 1990s, FFO was intended to be a supplemental performance-measuring device available to the management of REITs. It was promoted by NAREIT to help investors better understand and measure the performance of REIT earnings.

NAREIT has recommended that the industry adopt standard accounting practices with regard to a number of broad areas. The first area of recommended change is nonrecurring items. NAREIT suggests ending the practice of allowing REIT management to add back a variety of one-time expenses as an adjustment to the calculation of FFO. Historically, REIT management has been able to add back any items deemed nonrecurring. As would be expected, some REIT management teams are far more aggressive than others about adjusting for nonrecurring items. Studying real estate financial statements, it can be noted that a broad range of items are often added back as nonrecurring expenses. These typically include losses on interest rate hedging transactions, costs related to failed acquisitions, employee severance packages, and advertising and public relations costs related to building brand identities. Under GAAP, most of these items would not be considered nonrecurring or extraordinary. In addition, some REIT management teams routinely add these

14_769193 ch10.qxp 5/18/06 8:24 PM Page 117

items back as nonrecurring, whereas other management teams reflect them as ongoing business expenses. This adds to the confusion when attempting to compare FFO across a universe of REITs. The second broad area that NAREIT has targeted for modification is gains and losses from property sales and debt restructurings. While gains and losses as well as debt restructuring expenses are included in net income under GAAP, gains on sale are often included in FFO by aggressive REIT management teams. To the extent that gains on sale are not related to merchant building activities or build-to-suit transactions, it could be argued that they are not usual and customary in the context of direct real estate portfolio operations and therefore should be excluded. In 1999, some industry observers suggested the inclusion of gains and losses on property sales in the new FFO calculation. It is safe to say that gains and losses from property sales are a part of GAAP net income and are an issue in industries other than real estate. Critics of the practice suggest that including gains and losses on property sales will allow REITs to manipulate FFO by manipulating the timing on property sales. Because many REIT portfolios contain a large number of easily salable properties, the criticism is that REITs may engage in such sales in order to enhance FFO.

In an attempt to calculate the actual financial performance of REITs, several other common measures of operating earnings have been promulgated in addition to FFO. *Adjusted funds from operations* (AFFO) is calculated by beginning with FFO and making an adjustment for the *straight-lining* of rents. AFFO typically reflects a reserve expense that accounts for costs that may not necessarily be recurring or routine but that are typically not recoverable directly from tenants. In most instances, this includes nonrecurring maintenance costs and costs related to leasing activities. When adjusted for these expenses, the resulting figure is AFFO, at times referred to as *cash available for distribution* (CAD). This is the actual cash flow created by a REIT.

It should be noted that in any activity that adjusts REIT earnings, gains created by the sale of portfolio properties are typically not added back to reflect operating cash flows. This is because gains

adjusted funds from operations (AFFO)

a computation made to measure a real estate company's cash flow generated by its real estate operations. AFFO is usually calculated by subtracting from FFO normal recurring expenditures that are then capitalized by the REIT and amortized, and an adjustment for the "straight-lining" of rents. This calculation is also called *cash available for distribution* (CAD) or *funds available for distribution* (FAD).

14_769193 ch10.qxp 5/18/06 8:24 PM Page 118

straight-lining
real estate companies such as REITs straight line rents because generally accepted accounting principles (GAAP) require it. Straight-lining averages the tenant's rent payments over the life of the lease.

cash available for distribution (CAD)
or *funds available for distribution* (FAD), a REIT's ability to generate cash that can be distributed as dividends to its shareholders. In addition to subtracting from FFO normalized recurring real estate-related expenditures and other noncash items to obtain AFFO, CAD (or FAD) is usually derived by also subtracting nonrecurring expenses.

on property sales are not generally considered recurring cash flows. Gains and losses on debt restructuring, however, are generally added back to calculate FFO or funds available for distribution. Debt restructurings are extraordinary events, and, to the extent they are not regular activities, there should be adjustments in FFO or items considered extraordinary when calculating GAAP earnings.

It could be concluded that gains from the sale of residential land development activities should be included in AFFO reporting. The rationale suggests that AFFO numbers are used in conjunction with capitalization estimates by investors when estimating share values of REITs as discussed in Chapter 9. Operating properties produce income that is reflected in AFFO and therefore in capitalized valuations. The argument can be made that adding gains on the sale of income-producing properties would mix recurring rental operating income with capital gains from underlying real estate properties, making it more difficult to use AFFO in capitalized valuation methodologies. It could further be argued that, when using the capitalized earnings approach to valuing real estate, a real estate appraiser would not include gains and losses when valuing an overall property portfolio. However, residential land sales generate no recurring income stream. If the gains resulting from the sale of land are not included in AFFO, then value created through raw land activities would not be reflected in REIT valuation when using a capitalized earnings approach.

Recently, 15 major Wall Street firms including Merrill Lynch, Morgan Stanley, and Solomon Smith Barney announced that they would forecast REIT financial performance using GAAP earnings in addition to FFO. These firms uniformly suggested that GAAP earnings are calculated through a standardized set of rules and therefore are most helpful in comparing operating performance. In addition, the use

14_769193 ch10.qxp 5/18/06 8:24 PM Page 119

of GAAP earnings makes it easier to compare REIT operating performance to the earnings performance of stocks and other industry sectors. It seems clear that the industry is slowly moving toward a more uniform GAAP EPS calculation. It is simply a matter of time until the industry participants debate and agree on a methodology that all participants can embrace.

The final area addressed by NAREIT is changes in depreciation rules. It is generally agreed that typical GAAP depreciation overstates the correct charge for the true economic depreciation of real estate. It could also be argued that adding back all depreciation to arrive at FFO understates the actual economic expense of property depreciation. The underlying issue is how best to calculate the actual economic depreciation experienced by the property owner. Although NAREIT suggests a number of different methods to adjust depreciation, each has positive and negative aspects. Estimating the useful life of real estate assets is difficult, and many industry participants would argue for the least costly adjustments with regard to impact on earnings. Real estate investment trusts that engage in a high level of ground-up development activities generally have less flexibility in categorizing depreciable items as compared to acquisition-oriented REITs. Many companies have differing definitions as well of what might fall into shorter-term categories, such as tenant improvements, and what items might be classified as long-term building improvements. These factors make the standardization of the depreciation calculation a more complex issue for the REIT industry.

Revised depreciation standards are expected to put a heavier burden on certain REIT sectors. Office properties and hotels, which typically have higher ongoing capital expenses, will likely suffer more than the industrial or manufactured home sectors, which have fewer capital expenses. Beyond that it is hard to predict what, if any, impact depreciation changes will have on the public market's level of valuation of REITs.

Real Estate Dividend Accounting Issues

For income tax purposes, dividend distributions paid to shareholders by REITs may consist of ordinary income, return of capital, and long-term capital gains. Because REIT management teams are becoming more active in managing their direct investment portfolios, REITs are more frequently realizing long-term capital gains in their underlying property

14_769193 ch10.qxp 5/18/06 8:24 PM Page 120

portfolios. A REIT may designate a portion of the dividend paid during the fiscal year as a long-term capital gain distribution that may have resulted from property portfolio transactions. The advantage to shareholders is that they will pay taxes on that portion of the dividend at the current lower capital gains rate. The return of capital portion of the dividend is not declared as current income or capital gain on an investor's tax return, but rather is used to lower investors' original cost basis in their shares of the distributing REIT.

It is generally not possible to calculate the amounts of dividends that are tax deferred by examining the GAAP accounting statements of a REIT. The return of capital portion of the dividend distribution is based on distributions that are in excess of the REIT's taxable income as reported for federal income tax purposes. The differences between net income available to common shareholders for financial reporting purposes and taxable income for income tax purposes relate primarily to timing differences between taxable depreciation (which is usually some form of accelerated depreciation) and straight-line depreciation (which is generally used for book accounting purposes). Accruals on preferred stock dividends can also create differences between taxable and book net income. In addition, realized gains and losses on the sale of investment properties that are deferred through the use of tax deferral trusts and methodologies also create differences in book financial income as related to taxable financial income. These capital gains and losses are typically distributed to shareholders if they are recognized for income tax purposes; otherwise they are considered return of capital. Thus it is generally not possible to calculate in advance the portion of the dividend distribution from a REIT that will be taxed as ordinary income. As noted, the principal problem revolves around differences between financial income as defined by GAAP and taxable income as defined by the federal tax statutes. It would require extensive tax disclosure by a REIT for shareholders to be able to calculate the return of capital portion of the dividend distribution.

Interestingly enough, the notion of return of capital dividend allocation creates a situation where a REIT shareholder could conceivably avoid the income tax that is payable with respect to the portion of dividends from a REIT holding that were classified as a return of capital. On the death of the shareholder, federal income tax laws currently allow for a step-up in basis to the current market value of the REIT share. Under this scenario, the death of a long-term shareholder could result in elimination of income taxation on a significant portion of a

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REIT's return of capital dividends that had been paid out to the deceased shareholder, while the estate takes a step-up in basis to the current market value of the shares. This can be of interest to income investors who consider REITs as an integral part of a long-term income investment portfolio. If a shareholder sells REIT shares prior to his or her death, the difference between the tax basis and the net sales price is recognizable as a capital gain. To the extent that the final capital gains rate is lower than the ordinary income tax rate, REITs provide a modest tax shelter for taxable investors by allowing the deferral of tax on current cash receipts as dividends and taxing it at a potentially lower rate on the disposal of the REIT shares.

Alternative Corporate Structures for REITs

The REIT structure comes with some requirements. To avoid corporate income tax, REITs must operate within the tax code. The ownership of apartment buildings, shopping centers, and office buildings allows REITs to enjoy the full economic benefit of those property categories. As the real estate industry becomes more operations intensive, such as in hotels and nursing homes, REITs are limited with regard to the income they can generate from certain restricted assets. These restrictions apply as a result of the management-intensive nature of restricted assets. Generally speaking, the net operating income from these real estate investments does not qualify under REIT rules as rent. While leases based on revenues generated from these restricted assets are not uncommon, these leases create certain practical difficulties. For example, because of the high operating leverage, many hotel properties might experience increases in net operating revenues that outpace revenue growth. Shareholders of hotel REITs with leases based on hotel revenues would not enjoy the full benefit of the upsurge in the cash flows. In addition, these more complex lease structures make it difficult for REITs to fully control properties and therefore add value at the property level.

Given their desire to make investments in the restricted asset class, REITs have sought to craft solutions that comply with REIT rules but allow the ability to invest in restricted assets while maintaining control over those assets and participating in a greater share of the economic benefit generated by those assets. The *taxable REIT subsidiary* (TRS) is the most common method of investing in a small number of restricted

14_769193 ch10.qxp 5/18/06 8:24 PM Page 122

assets. To facilitate larger investments that represent a higher percentage of the operating income of REITs, REIT managements created several different investment alternatives that complied with the REIT operating rules. These investments are known as *paired-share and paperclip REITs.*

Paired-Share and Paperclip REITs

Both paired-share and paperclip REITs involve two separate companies, a REIT and a C corporation. The REIT operates within the limitations of the REIT rules and thus structures leases that are generally based on gross revenues rather than net income. The corporate side of the structure is free to engage in the management and operation of the real estate asset with an eye toward maximizing the total return and economic value of the asset. The C corporation structure also allows property management and franchising to be in-house activities and allows the REIT, through its corporate affiliate, to invest in businesses unrelated to real estate. In the paired-share structure, investors may not own a share in the REIT without owning a correlating share in the C corporation. This creates an economic situation where whatever operating benefits are lost by the REIT due to the revenue-based lease structure are returned to shareholders through their ownership interest in the C corporation. Historically, there were five paired-share REITs. These were grandfathered in as an exception in the REIT laws; but in 1998, Congress eliminated them unless they were willing not to acquire new assets or engage in a new line of business. The paperclip structure, however, does continue to exist. Unlike the paired-share structure, the paperclip structure does not require that the REIT shareholder own a correlating share of the C corporation affiliated with the REIT. Therefore an investor in the REIT side of the paperclip structure would be subject to all the operating negatives that result from the REIT structure. However, the investor could voluntarily create a paperclip structure by simply buying shares in the publicly traded C corporation that represents the paperclip side of the REIT structure. Hotels, because of their management-intensive operations, are often prime examples when discussing the paperclip structure. During the 1980s and early 1990s, hotel management companies were paid on a percentage of hotel revenues. As a result, nonowner managers had an incentive to generate high revenues without regard to the net income or profits of a property. Rules require that hotel REITs structure leases in which the lessee pays rent based on revenue rather than net profit. These

14_769193 ch10.qxp 5/18/06 8:24 PM Page 123

requirements create conflict of interest problems because there is an incentive for the lessee to increase net income as opposed to increasing revenues. While focusing on net income is normally a desirable corporate activity, it may result in REIT shareholders not participating in the total economic benefit that can be created by a particular property. If net income were to increase rapidly while revenues increased at a slower rate, shareholders in the REIT would receive only modest increases in cash flows from the property.

The paperclip structure uses the same executive management team at both the REIT and the C corporation affiliate. Executive management can operate the real estate in a manner that maximizes the overall economic benefit. The only caveat is that, because of the decoupled nature of the REIT and the C corporation, the REIT side of the structure may not have the same shareholders as the C corporation. Thus the officers and directors of each company have a fiduciary obligation to ensure that deals between the two sides of the structure are equitable. Unlike the paired-share structure, under the paperclip structure, shareholders of each entity do care and are concerned with the operating outcomes of each independent company. Because REITs do not pay taxes at the corporate level and C corporations do, the common management of the paperclip REIT has some incentive to transfer expenses to the C corporation in an attempt to minimize taxes paid by the overall entity. Investors can deal with this situation by owning both REIT shares and C corporation shares. In this way, they effectively create a synthetic paired-share REIT. The loss of investment returns to a REIT that is caused by expenses paid to a service provider or lessee is known in the real estate industry as *leakage* or *profit leakage.* Profit leakage occurs when revenues leak out to a service provider based on management contracts or service arrangements. They often result from lease structures that do not allow the REIT to fully participate in the cash flow growth of a restricted investment. It should be understood that leakage is a true economic loss if the property owner could provide a similar service at or below the cost of the outside service provider. Leakage is avoided in a paperclip structure because a C corporation is able to bring property management and franchising in house if the economics suggest these would be profitable for the C corporation. While the REIT continues to suffer from leakage under the paperclip structure, the leakage inures to the benefit of a sister company with the same management and the ability for the REIT shareholder to own shares in the affiliated company. A possible risk of the

14_769193 ch10.qxp 5/18/06 8:24 PM Page 124

paperclip structure is that, over time, the business pursuits of the REIT may diverge from those of the C corporation to such an extent that the two are no longer effectively operated as one entity with a combined management team. This is typical of what happened to the paperclip structure in the health care REIT area. A number of health care REITs were spun out of large health care companies in the 1980s. Over time, these health care REITs became less dependent on the parent companies and more independent in terms of their real estate activities. A number of these companies now operate independently of their original sponsors. The paperclip REIT structure begins to lose its effectiveness as this change begins to happen. Without an ongoing synergy between the REIT and the C corporation, investors in either receive no special benefit from the relationship.

Taxable REIT Subsidiaries (TRS)

Real estate investment trusts utilize taxable subsidiaries that are typically C corporations to conduct business activities that may not be allowed under the REIT operating rules. By migrating non-REIT activities such as property management into taxable subsidiaries, REITs are able to continue to engage in these businesses and still be in compliance with the tax code. The REIT Modernization Act that became effective on January 1, 2001, created the TRS. The new rules allow a REIT to own 100 percent of the common stock of a TRS. The TRS allows the REIT to provide services to the REIT's tenants that might otherwise be considered nonqualifying income under the REIT structure. Dividends from the TRS do not qualify under the 75 percent income test, and TRS securities may not exceed 20 percent of a REIT's total assets. However, within these guidelines, the TRS allows the REIT to participate in property-related service opportunities that would not be possible under the former REIT structure. The following areas of nonrent revenues are thought to be of most interest to REITs:

- Real estate brokerage fees
- Construction management fees
- Joint venture development fees
- Merchant building sales
- Property management fees

14_769193 ch10.qxp 5/18/06 8:24 PM Page 125

Although REITs may enjoy the benefit of some of these fees, which may currently flow into the REIT through other allowable structures, the TRS is expected to make these arrangements simpler in structure and easier to administer for REIT management.

Points to Remember

- REIT accounting requires an understanding of generally accepted accounting principles (GAAP) and the difference between GAAP earnings and funds from operations (FFO).
- The industry is moving toward a more standardized form of earnings reporting.
- Dividend distributions paid to shareholders by REITs may consist of ordinary income, return of capital, and long-term capital gains.
- It is generally not possible to calculate in advance the portion of the dividend distribution from a REIT that is taxed as ordinary income.
- Real estate investment trusts provide a modest tax shelter for taxable investors by allowing the deferral of tax on current cash receipts and taxing them at a lower rate on the disposal of the REIT shares.
- There are several alternative REIT corporate structures that help REITs operate more efficiently for tax purposes.
- The paired-share REIT has been eliminated by legislative action but is worth examining.
- The paperclip REIT structure can effectively create the benefits of a paired-share structure.
- Taxable REIT subsidiaries allow REITs to engage in certain revenue-generating activities and still be in compliance with the REIT tax rules.

15_769193 ch11.qxp 5/18/06 8:25 PM Page 127

Part 7

Public Real Estate Sectors

Chapter 11

Residential REITs

Rent's a waste of money. It's so much cheaper to buy.
—Fran Lebowitz, 1981

The total value of all *apartments* and *multifamily properties* in the United States is estimated to be $2.2 trillion or approximately 24 percent of the aggregate commercial real estate market. Real estate investment trusts own an estimated 8 percent of all apartment units. As a group, apartment real estate investment trusts (REITs) represent 18 percent of the total capitalization of the National Association of Real Estate Investment Trusts (NAREIT) Equity Index (see Figure 11.1).

apartment and multifamily properties
apartment buildings are defined as residential dwellings consisting of five or more units in a single building or complex of buildings. *Multifamily* is more commonly used when describing buildings of four or fewer units.

Quality Classifications

For investment purposes, apartment buildings, like most other commercial structures, are often classified by quality level. Individual properties are judged in terms of quality and are classified as class A, class B, or class C. There is often a very strong correlation between the age of a given property and its classification.

The construction quality of a property, the location within the local market, and the level of amenities are all factored into a property classification. Local standards also have a bearing on quality ratings. A newer

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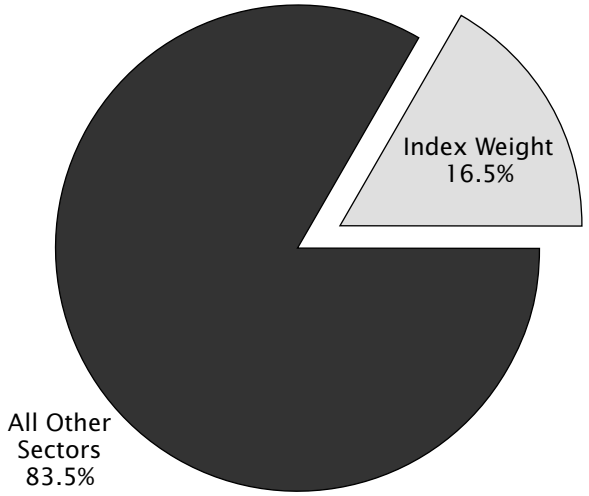

FIGURE 11.1 Apartment REITs as a Percentage of the NAREIT Equity Index
Source: Uniplan, Inc.

suburban garden apartment complex in Milwaukee might be considered a class A project based on prevailing local market standards. But replicate that same complex in suburban Phoenix or Palm Springs and it might be considered a class B project because it lacks amenities that are part of a higher local market standard in Phoenix. There are no hard-and-fast criteria for grading properties or defining the distinctions between class A, class B, and class C. The classifications are partially subjective and leave room for some degree of interpretation.

Class A apartment buildings are the newest structures built of high-quality materials and are in the best locations by local market standards. Class A buildings normally also offer amenities over and above those of average or typical apartment buildings. Luxury lobbies, doormen, concierge services, party facilities, health club facilities, and other lifestyle amenities are typical of class A properties. The rents at class A properties tend to reflect the level of amenities and service that a tenant could expect. Class B buildings tend to be slightly older. In many instances, class B properties are between 10 and 20 years in age. The new building luster has faded, and they typically offer a more limited range of the lifestyle amenities than those found in class A buildings. The location of a class B building might be in an average or even less desirable local market. The building materials and improvements found in class B properties also

15_769193 ch11.qxp 5/18/06 8:25 PM Page 131

tend to be average relative to community standards, whereas class A properties often have above-average construction features when compared to local community standards.

Class C buildings tend to be the oldest buildings in a given community. These buildings are often "recycled" properties that were originally built for a given use and then rehabilitated and adapted for another use. Old multistory urban warehouse buildings that are renovated into loft apartments are typical of class C properties. These buildings are often located in less desirable neighborhoods that might have a mix of low- and middle-income families. Class C buildings have few amenities and are often functionally obsolete for the current use. Class C buildings are seldom owned by publicly traded REITs unless they are purchased for renovation or redevelopment to class B or better levels.

These classifications are subjective at best. They attempt to broadly group properties into general categories that are easily recognized by knowledgeable observers. Buildings are often classified as class B by a potential buyer and class A by the seller for purposes of negotiations. To further complicate matters, real estate professionals often create categories within a class. For example, better-quality class B properties are often called "high-B" buildings, or lesser class A buildings are termed "low-A" buildings. These distinctions are helpful to real estate professionals but often confusing to the uninitiated. However, in general, REITs tend to invest in class B or better apartment buildings, and the majority of apartment REITs focus on class A properties.

Physical Structure Classifications

Apartment buildings are often classified in broad terms by their size and style:

- *Low-rise*. Normally under three stories, often in attached townhouse style.
- *Mid-rise*. Over three stories, but subject to relative local standards. For example, a 10-story building in Cleveland is a high-rise, but in Chicago or New York it is a mid-rise.
- *High-rise*. Normally 10 stories or over in most local real estate markets.
- *Infill*. Often termed *urban infill,* these properties are normally built on smaller parcels of land in higher-density urban locations.

15_769193 ch11.qxp 5/18/06 8:25 PM Page 132

- *Garden*. Sprawling suburban complexes with low- to mid-rise buildings on a campuslike setting. These often have higher levels of amenities such as swimming pools, tennis courts, and clubhouses.

The number of stories is a simple way to classify because it is an easily identified building feature. The height of a building also has an impact on the building's operation cost. Generally, the taller the building, the higher the cost of operation due to the more complex building systems and the higher initial cost of development. High-rise and mid-rise properties are most often found in higher-density urban locations where land value is high and availability is scarce. Low-rise and garden projects tend to be located in suburban locations where density and land cost are less of an issue. Submarket dynamics also have an impact on building type. Land use restrictions and other zoning laws such as maximum densities and height restrictions ultimately affect the type and style of project that is built. These limitations are more apparent in some markets and have an impact on what gets built and where it is located.

Apartment Demand and Residential Market Dynamics

The demand for residential housing, and more particularly apartments, is driven by population growth and household formation. Increases in the population of a geographic area tend to drive the demand for housing in that locale. According to the U.S. Census Bureau, population growth averages 2.1 percent annually. This steady and stable growth in population drives the demand for housing. Demand for housing from population growth is further affected by household formation, which is a result of people moving into their own residence. These formations usually occur due to newly married couples starting new households or people moving out on their own, normally young adults leaving existing households or the breakup of existing households due to divorce. In any case, it is highly likely that people forming new households initially rent for some length of time. This drives the need for multifamily units. Relocation of existing households to a new area also drives the demand for housing in a local market. Relocation may benefit the growth statistics of a given market while having a negative affect on another locale. The classic paradigm of this relocation trend is the movement of households out of rural Midwestern communities. Some of the older population in many of these communities chooses to migrate to warmer retirement destinations such as Florida

15_769193 ch11.qxp 5/18/06 8:25 PM Page 133

and Arizona. Many of the younger people in these same places often leave to look for better employment opportunities in larger urban centers. The net result is population migrations that create shifting regional demand trends for residential real estate.

Shifting regional demand patterns tend to drive the general real estate cycle as discussed in Chapter 5. In the case of residential real estate, the cycle is relatively smooth and stable when compared to other real estate sectors. Household formation and population migration stimulates demand in a local market. The existing supply of available residential options becomes absorbed causing a general tightness. Demand exceeds available supply and prices begin to rise. Prices rise to the point that they stimulate building activity to meet the increased demand, thus creating a growth trend in the local market. This pattern often creates expanding demand in other sectors of the local real estate market as the increasing population requires places to work, eat, and shop, which stimulates additional demand for all the private and public services that support the growing economic base. At this stage of the growth pattern, local market dynamics begin to have a large bearing on the supply and demand outcomes in a given local market.

Affordability is a key component of the local housing market dynamic. If you need a place to live, the options are to own or to rent. Certain factors such as consumer confidence, mortgage interest rates, economic growth, and employment trends all have an effect on the decision to own or rent. But the ultimate rent versus buy decision in a local market is largely driven by affordability. The affordability factor then impacts the tone and outlook for the local multifamily housing market.

An example of how affordability affects the rental market dynamic is the rise of the Internet and the dot-com revolution. The growth of Internet-related businesses in the San Jose and San Francisco Bay area was a large driver of the local economy for the last half of the 1990s. Large flows of capital into the local economy supported the explosive growth of Internet-related businesses. This led to a high level of job formation, which fueled a rapid growth in household formations. The median household incomes generated were the highest in the country, exceeding $83,000 per year in 1999. But a confluence of local market factors including limited amounts of developable land, difficult entitlement requirements, stringent local zoning regulations, and a shortage of skilled construction tradesmen made housing affordability a major issue in the region. This created a large demand for affordable rental housing as the price of local rents rose to very high levels and vacancies declined

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to near zero. Contrast this with local markets in other parts of the country where land is available, entitlement is easy, zoning is relaxed, and there is an adequate supply of skilled construction tradesmen, resulting in better housing affordability even when median household incomes are far lower than the national average.

Demographics and Amenity Trends

In the aggregate, current demographic trends have created a favorable outlook for apartment demand. In 1998, the first of a generation known as the Echo Boom began to graduate from college. These are the children of the 78 million post–World War II babies well known as the Baby Boom generation. It is expected that about 4 million of these well-educated, affluent Echo Boom consumers will graduate from college this year and join the workforce. And we can expect to see about 4 million a year for the next 18 years. This dynamic should lead to a strong trend in household formations over the next decade. Couple that with the fact that the parents of the Echo Boomers are living a longer and more active life, and the trend in demand for residential real estate looks strong. Substantially all of the expected growth in rental unit demand over the next decade will come from the emerging Echo Boom and the over 45-year-old portion of the Baby Boom generation. These two groups have already begun to influence the trends in design and amenities of newly developed apartment communities.

REIT Idea: Echo Boomers Will Drive Residential Demand Through 2020

Expect about 4 million Echo Boomers a year for the next 18 years. This dynamic will support strong household formations over the next decade.

Providing state-of-the-art technology connections is the major trend among most apartment owners. The Echo Boom generation has been raised with computers and comes from educational settings where high-speed Internet service is abundantly available. They want this same amenity, along with cable television and the availability of multiple telephone lines. These amenity categories are consistently among the most

15_769193 ch11.qxp 5/18/06 8:25 PM Page 135

requested by Echo Boomers. Business centers and conference rooms are also in demand by the Echo Boomers, who often work from home. In fact, the business center has become a social gathering spot for many hardworking young professionals.

The number one requested amenity among both Baby Boomers and Echo Boomers who rent is fitness centers. With the growing trend toward better fitness, apartment communities are adding well-equipped fitness centers that rival freestanding health clubs. The other frequently requested amenity is an in-unit washer and dryer. Most new communities now include this feature in every unit. As in any other business, changing consumer preferences continues to drive the amenities offered by apartment owners. This has given rise to much more segmented marketing strategies among owners and developers of apartments. Lifestyle strategies that target older renters-by-choice, which include gated communities with higher levels of security and larger, more well-appointed units, and common areas, have experienced a growth in demand. The recent change in capital gains tax laws that has eliminated the first $500,000 in gains on homes sold seems to have encouraged a generation to consider alternatives to home ownership. These tax policies and other legislative attempts to influence housing policy are worth monitoring because this is a favorite area of legislative tinkering at the federal as well as the state level. When the demographic trends are coupled with the changing consumer attitude toward renting, it is expected that demand for multifamily units will average 570,000 units per year over the next 10 years. This takes into account increasing household formations and the obsolescence of existing apartment stock over the next decade.

Operating Characteristics

The good news is that apartment rents are adjusted to market levels about once a year for each unit. This is also the bad news about apartment rents. The most challenging aspect of apartment ownership is the tenant turnover. The average tenure of an apartment tenant is about 18 months. This means apartment owners must find a new tenant for each unit in their portfolio every 18 months. The only operators in the real estate community who experience a shorter rental duration are hotel operators, who are forced to rerent their rooms about every other day.

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In most cases, apartment owners require either a six-month or one-year lease, depending on the local market. This short duration rental cycle allows the apartment owner to reprice rents to market frequently, so loss-to-lease expenses tend to be modest for apartment owners. Most apartment owners also have several other smaller rental streams from their tenants such as fees from cable television and local telephone operators for allowing them access to their tenants on a preferred basis. Covered parking and concierge services also provide additional income for some owners. Because most apartment complexes have hundreds of units and most owners hold thousands of units, the relocation changes of a small number of tenants have a minimal affect on the operation of most apartment portfolios. Because most people need a place to live, apartments are considered one of the most defensive of the real estate sectors. The physical interiors of apartment units provide another advantage: They are permanent in nature—and the expense of tenant improvements is not often a material factor when considering the operating performance of a property. Contrast that with an office building, where the owner may be required to spend $15 to $30 per square foot on tenant improvements in order to lease vacant space. In fact, the largest variable expense for most apartment owners is the cost of remarketing vacant units when a tenant leaves.

Summary Data

Returns on residential REITs are among the most stable of those for all REIT sectors (see Table 11.1). Over the last five years the residential sector produced an average annual return of 16.3 percent, the highest for any REIT sector. The volatility of the residential sector as measured by the standard deviation of returns is 16 percent, second only to that of manufactured home communities. The stable and defensive nature of residential property, along with positive demographic trends, makes the long-term outlook for the residential sector very positive.

Points to Remember

- The total value of all apartments in the United States is estimated to be $2.2 trillion.

TABLE 11.1 Historical Sector Data for Residential REITs (as of December 2005)

	2005	*2004*	*2003*	*2002*	*2001*	*2000*	*1999*	*1998*	*1997*
Panel A									
Total return on sector	14.7%	34.7%	25.5%	−12.9%	7.4%	35.5%	10.7%	8.8%	16.0%
Dividend yield	8.1%	8.2%	8.3%	6.7%	7.0%	9.1%	7.9%	5.6%	7.2%
Estimated NAV	106.0%	112.0%	118.0%	98.0%	105.0%	97.0%	85.0%	98.0%	114.0%
Panel B									
Market cap of sector ($ billion)	$55.3								
Index weight	16.5%								
All other sectors	83.5%								
Volatility	16.0%								
5-year return	16.3%								

Source: Uniplan, Inc.

15_769193 ch11.qxp 5/18/06 8:25 PM Page 138

- Apartments are approximately 24 percent of the aggregate commercial real estate market.
- REITs own an estimated 8 percent of all apartment units.
- Apartment REITs represent 18 percent of the NAREIT Equity Index.
- The demand for apartments is driven by population growth and household formation.
- Current demographic trends have created a favorable outlook for apartment demand.
- Returns on apartment REITs are among the most stable for all REIT sectors.

Chapter 12

Manufactured Home Community REITs

A house is a machine to live in.
—Charles Le Corbusier, 1923

The manufactured home industry is often misunderstood and has long been maligned by many casual observers. The terms *trailer park* and *trailer trash,* which are used to refer to *manufactured home communities* (MHCs) and the people who live in them, certainly suggest less than a positive image. Although the negative perception of the industry is pervasive, the economics of MHC ownership are compelling. In many respects MHCs have most of the positive attributes of multifamily or apartment ownership with fewer of the negative features. In fact, the economics of the sector are so compelling that Sam Zell, the legendary real estate investor, was a founder of the first public MHC real estate investment trust. The company went public in 1993, offering Zell's portfolio, which he had been accumulating since the early 1980s. In spite of its much maligned reputation, there is some smart money involved in this real estate sector. It is important to draw a distinction between a manufactured home and an MHC. At an MHC, the owner provides the land and improvements on which manufactured homes are located. As MHC owner, the community provides the streets and utilities as well as the amenities of the common areas along with the location

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or site where the manufactured home will be located. The MHC owner does not own the actual manufactured homes; the residents of the community own their own homes. These homeowners pay rent to the MHC owner for the use of the site where their manufactured homes are located. The MHC owner therefore maintains the common area and infrastructure, and the homeowner is responsible for maintenance of the home itself. This is the key distinction between MHC REITs and apartment REITs. It is also the principal economic advantage of MHC ownership over apartment ownership.

A Brief History of Manufactured Homes and MHC REITs

Investors in REITs had one of the first chances to participate in a publicly offered MHC REIT in 1993. One of the first owners to go public was Sam Zell. Three other private MHC owners were quick to follow into the public arena later in the same year. Prior to 1993, owners included a few syndicators dedicated to MHC properties and some limited partnerships. Nevertheless, small private owners were then and still are the vast majority. Little or no ownership of these properties was attributable to institutional real estate investors. The negative reputation of manufactured housing had kept the often skeptical institutional players out of the sector. The industry of building manufactured housing emerged during the 1940s when mobile homes and camper trailers became widely used as temporary housing and vacation homes. After World War II, the demand for housing exploded as returning veterans flooded the existing housing market. The sudden demand for housing led to the widespread use of mobile homes as permanent housing. The fact that the manufactured home industry has it origins in the recreational vehicle business may account for part of the reason why the industry has not gained wider acceptance within the residential arena. Had the sector been conceived in the home-building or multifamily arena, it might be better understood and accepted by consumers and real estate investors. The manufactured housing industry is regulated by the U.S. Department of Housing and Urban Development (HUD). These regulations, which became effective in June of 1976, preempted any existing state or local construction and safety codes

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applying to the product defined as manufactured housing. To qualify as manufactured housing, HUD requires that manufactured homes have a chassis and undercarriage that support their own wheels, on which they are transported from the factory. The lack of this factory-installed self-transporting feature moves the dwelling into the category of prefabricated homes and removes regulation from HUD into the hands of less predictable local building inspectors. The goal of the federal regulations was to more clearly define mobile homes as buildings rather than vehicles. The Housing Act of 1980 adopted this change officially, mandating the use of the term *manufactured housing* (or *factory-built home*) to replace *mobile home* in all federal law and literature for homes built since 1976. This ushered in a new era for the manufactured housing industry.

It is estimated that there are 9.3 million manufactured homes and 28,000 MHCs in the United States. The vast majority of the million homes are located on sites within MHCs. The National Association of Real Estate Investment Trusts (NAREIT) Equity Index includes five publicly traded MHC REITs. These REITs are a subgroup of the residential sector and represent about 2 percent of the total index (see Figure 12.1),

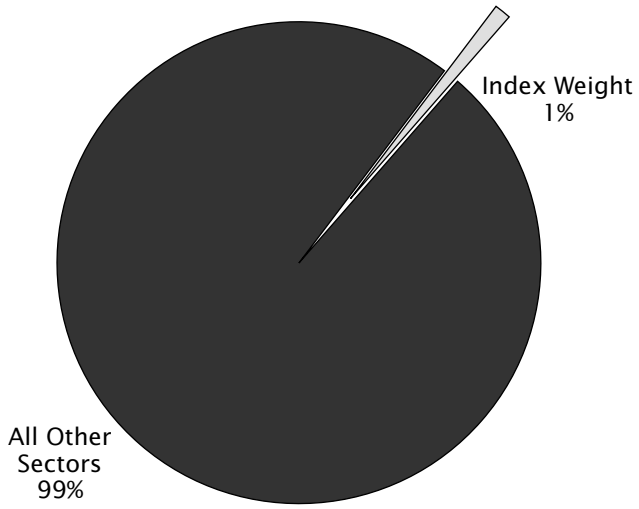

FIGURE 12.1 Manufactured Home Community REITs as a Percentage of the NAREIT Equity Index

Source: Uniplan, Inc.

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or about $2.3 billion in market capitalization, as of September 30, 2001. When combined with the apartment REITs, the residential sector in total represents about 22 percent of the NAREIT Equity Index.

Quality Classifications

For investment purposes, MHCs occupy a very wide quality range. Class A communities have resort-level quality. Amenities similar to and in some cases even exceeding those of class A apartment communities are the norm. Manicured lawns, golf courses, swimming pools, and tennis courts are among the features found in some of the better MHCs. On the low end of the quality spectrum are the class C communities. These are little enclaves of long, thin old mobile homes squeezed tightly together in narrow rows with no amenities. The class C communities are the ones that contribute to the seedy image of MHCs.

As with other kinds of structures and properties so far discussed that use a system of grading and distinctions between class A, B, and C, it is the same for MHCs. The classifications are partially subjective and leave room for interpretation. They simply attempt to classify properties broadly into groups or general categories that are recognized by knowledgeable observers. In general, MHC REITs tend to invest in class B or better communities, and the majority of these REITs focus on class A communities.

Types of Communities

MHCs fall into two broad categories. The first are general communities that accept residents without restrictions. The second are senior living communities for adults age 55 and over. Each type of community has its own specific set of advantages and challenges.

Homeowners of more modest means normally populate general communities. The average resident has a median household income of about $27,000, with 65 percent of the households having only one or two members. These residents are more transient than those who reside in the senior communities. The financial demographic requires a higher

16_769193 ch12.qxp 5/18/06 8:25 PM Page 143

level of diligence on the part of management when considering new tenants and makes it difficult to raise rents aggressively. The transient nature of these residents can create higher turnover of tenants in general communities. Senior communities tend to have more stable populations and lower turnover rates than general communities. Although senior communities have residents who are on fixed incomes, they tend to be more financially affluent than their general community counterparts. Many seniors own homes in class A senior communities that are second homes and are occupied on a seasonal basis. Because the majority of these residents are retired, they have more time on their hands, giving rise to strong homeowner associations that can effectively organize against rent increases as well as increased management costs in the area of maintenance and amenities.

Each type of community has its own specific set of advantages and challenges. However, the most critical element in successful MHC ownership is diligent, high-quality on-site management. Without a high management standard, the character of the community is likely to decline. This results in an increasing number of less desirable residents who displace the quality community-oriented owners. This *death spiral,* as it is often called, is hard to reverse and can take years of intensive management to correct. Good quality of management, then, is particularly important in the MHC arena.

MHC Demand and Residential Market Dynamics

The growth in demand for manufactured housing is driven by its affordability when compared to conventional site-built homes of similar size. The final cost of a manufactured home is about half that of a conventional site-built home. This affordability factor drives demand in two key segments of the residential market: retirees and moderate-income households.

Over the last decade, the quality of manufactured housing has made significant strides. Features and amenities such as balconies and patios are common. New-generation homes are often built in two or more sections that are assembled on site. This *double-wide* feature, when coupled

16_769193 ch12.qxp 5/18/06 8:25 PM Page 144

with add-on architectural details such as garages and porches, make these manufactured homes nearly indistinguishable from conventionally built properties.

These product improvements have resulted in growing consumer demand for both new and existing manufactured homes. This has been helped by the availability of a wide array of better financing options. In the past, manufactured homes were often financed as personal property, which made the financing arrangements available only through a specialized lender. Now conventional financial institutions offer a large array of lending programs that are structured much like the terms on a conventional home. Buyers may select loans with terms ranging up to 30 years. The house can be financed as personal property, on leased land, in an MHC, or on a private site. This growth in flexible financing options has also aided the growth of demand in this housing sector.

Demographics and Amenity Trends

In the aggregate, current demographic trends have created a favorable outlook for MHC demand. The 78 million post–World War II babies known as the Baby Boom generation are rapidly approaching retirement. This generation's members have a more stable financial outlook than their parents' generation. They tend to be more leisure oriented and demand a generally higher level of amenities. This has fueled a rapid growth in class A MHCs in resort and retirement areas. These communities cater to the growing percentage of Baby Boomers who are buying second homes in leisure areas. The affordability of manufactured housing has made this a growth area for MHC owners.

Expanded affordability and increased quality have also made manufactured housing popular among working households earning under $30,000 annually, by providing the opportunity for home ownership at affordable levels. When the demographic trends are coupled with the changing consumer attitude toward manufactured housing, it is expected that demand for manufactured housing units will average 370,000 units per year over the next five years. It is predicted that about 20 percent of this will represent replacement housing, while 80 percent will be additions to the pool of existing manufactured homes.

16_769193 ch12.qxp 5/18/06 8:25 PM Page 145

Operating Characteristics

Lower turnover of tenants is a key differentiation factor when comparing MHCs to apartments. The average annual turnover in MHCs is about 20 percent. This means the owner of an MHC only needs to replace a site renter about every five years, compared to about every 18 months in the apartment sector. And, even if there is tenant turnover in an MHC, it is likely that there will be no interruption of rental income because only 5 percent of manufactured homes are moved between communities each year. It is more likely that the home will be sold to another owner who will begin paying rent on the day the sale closes. Until then, the seller pays rent on the unit that occupies the site. Very low static vacancy rates are another interesting aspect of MHCs. Once a community is filled, it normally remains filled. A site is only vacant if an owner moves the manufactured home to another site, which happens less than 5 percent of the time. This creates a very stable occupancy level once the community is full. The likelihood of being impacted by new construction is also minimal. Even if a new community were to open nearby, owners are not likely to relocate units due to the high cost (as much as $8,000).

The primary advantage for REITs in the MHC sector is the low rate of capital expenditure. MHCs tend to expend about 5 percent of their net operating income on capital expenses. Because the owner is responsible for only the common area and infrastructure, the capital expenses tend to be minimal. With a trend toward higher levels of amenities among MHCs, the amount of capital expenditure is expected to increase over the next five years. However, rental growth is expected to exceed growth capital expenses by a comfortable margin. Some of the positives also lead to the negative aspects of the MHC sector. The nature of the residents and the stable occupancy characteristics make it very difficult to grow rent at a rate of much more than one or two percentage points over the consumer price index. The same factors make increasing profitability during a positive market environment less of a possibility. The ability to translate demand into operating leverage is minimal. Expanding an existing community through the addition of more sites is the primary means of achieving operating leverage in the sector.

16_769193 ch12.qxp 5/18/06 8:25 PM Page 146

Real estate investment trusts have also seen their growth in the MHC area constrained by the scarcity of good acquisition possibilities. The lack of any meaningful number of large private owners has made acquisition strategies difficult. It is estimated that there are about 3,500 privately owned class A communities that would be of acquisition interest to the MHC REIT sector. But the high margin associated with stabilized class A portfolios creates very few purchase opportunities for the bigger REITs—there simply are not many sellers at any given time. The large numbers of highly fragmented mom-and-pop owners remain largely unconsolidated, and most single communities do not offer the size or scale to be of interest to institutional buyers. This makes development of new communities the primary driver of external growth. This is a lucrative avenue, but it requires a large initial capital expense for land and improvements, and it often takes five years to lease a big community fully.

Summary Data

Although it is a small part of the total residential REIT sector, MHC ownership offers some very positive attributes when compared to apartment ownership and is certainly worth reviewing for inclusion in a diversified REIT portfolio. Returns on MHC REITs have been the most stable of those for all REIT sectors for the past five years (see Table 12.1). During that time, the manufactured housing sector produced an average annual return of 7.9 percent, the third highest five-year return of any REIT sector. The volatility of the manufactured housing sector as measured by the standard deviation of returns was 15.5 percent, indicating that this has been the most stable sector. The general growth in the volume of manufactured housing along with the generally constrained availability of home sites makes the long-term outlook for this sector generally favorable.

TABLE 12.1 Historical Sector Data for Manufactured Housing (as of December 2005)

	2005	*2004*	*2003*	*2002*	*2001*	*2000*	*1999*	*1998*	*1997*
Panel A									
Total return on sector	–2.6%	6.4%	30.0%	–4.8%	8.7%	20.9%	–2.8%	–0.9%	18.7%
Dividend yield	4.2%	11.2%	8.5%	5.1%	7.0%	8.3%	6.0%	5.2%	7.0%
Estimated NAV	110.0%	104.0%	99.0%	100.0%	97.0%	84.0%	86.0%	105.0%	119.0%
Panel B									
Market cap of sector ($ billion)	$2.7								
Index weight	1.0%								
All other sectors	99.0%								
Volatility	15.5%								
5-year return	7.9%								

Source: Uniplan, Inc.

16_769193 ch12.qxp 5/18/06 8:25 PM Page 148

Points to Remember

- There are an estimated 9.3 million manufactured homes in the United States, with an estimated value of $12 billion.
- There are estimated 28,000 manufactured home communities (MHCs) in the United States.
- Real estate investment trusts (REITs) own an estimated 5 percent of all manufactured housing sites.
- Manufactured home community REITs represent 2 percent of the National Association of Real Estate Investment Trusts (NAREIT) Equity Index.
- The demand for manufactured housing sites is driven by the growth in sales of manufactured housing.
- The affordability of manufactured housing has created a favorable outlook for unit demand.
- Returns on MHC REITs are among the most stable for all REIT sectors.

Chapter 13

Office REITs

I yield to no one in my admiration for the office as a social center, but it's no place to actually get any work done.

—Katharine Whitehorn, 1962

The aggregate value of the total U.S. office market building sector is estimated to be $1.05 trillion. This figure includes all owner-occupied corporate office properties, which are estimated at roughly $200 billion. The remaining $850 billion of office properties are investor owned. This overall total, including owner-occupied buildings, is about 20 percent of the total commercial real estate market. Real estate investment trusts are estimated to own approximately 8 percent of the noncorporate-owned office sector. Publicly traded office real estate investment trusts (REITs) as a group represent about 21 percent of the National Association of Real Estate Investment Trusts (NAREIT) Equity Index (see Figure 13.1).

The Office Sector

Although it is not the biggest sector in the REIT universe or in the total real estate pie, a great deal of time and attention is devoted to the office sector. This is due to the fact that this sector offers perhaps the widest array of opportunities and challenges of any real estate category. For owners and investors, the challenge is to forecast economic demand, assess and

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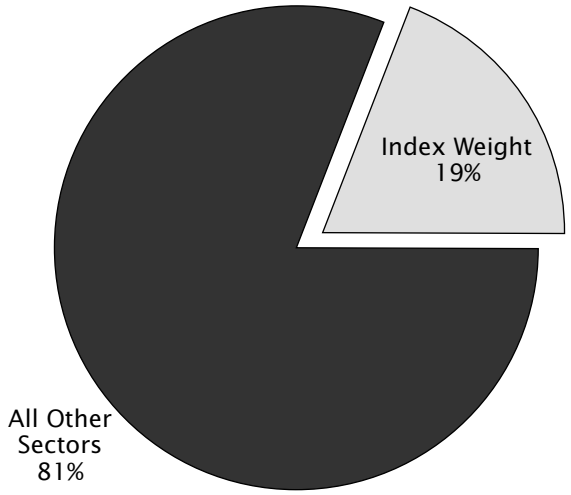

FIGURE 13.1 Office REITs as a Percentage of the NAREIT Equity Index
Source: Uniplan, Inc.

use the capital markets, and deal with tenants and prospective tenants whose need for space and financial conditions change on a continuous basis, all while assessing current and future supply and demand trends. Owners and investors who manage this complex set of challenges well can realize excellent returns and create a high level of value-added return on investment through management and financial leverage.

The myriad of factors that influence the office sector and the number of owners and investors involved make it the most volatile and cyclical of the real estate segments. The primary customers of office building owners are businesses. The only other sector in real estate whose primary users are business tenants is the industrial sector. This is why the office and industrial sectors are often lumped together for purposes of discussion and analysis. In addition, a large number of commercial buildings combine both office and industrial space in a single facility. For purposes of the discussion in this chapter, office and mixed-use office-industrial properties are considered as a single group. The pure industrial property sector has many of the same issues as the office sector, but it is unique enough in terms of physical and investment attributes to warrant a separate discussion in Chapter 14.

17_769193 ch13.qxp 5/18/06 8:26 PM Page 151

Quality Classifications

For investment purposes, office buildings, like most other commercial structures, are classified by subjective quality level. Individual properties are judged in terms of quality and are classified as class A, B, or C. As in other sectors of the real estate market already discussed in this book, there is a very strong correlation between the age of a given property and its classification. The construction quality of a property, the location within the local market, and the level of amenities are all factored into a property classification. Local standards also have a bearing on quality ratings. A newer office building in downtown Minneapolis might be considered a class A project based on its age and prevailing local market standards, but that exact building in downtown Houston might be considered a class B project because it lacks construction materials and amenities that are part of a higher local market standard in Houston. The A-B-C classifications are subjective for office buildings as much as they are for apartments and manufactured home communities and leave just as much room for interpretation.

Class A office buildings tend to be the newest structures in a local market. They are generally built of higher-quality materials (marble, granite, and the like) and are in the best locations by local market standards. Class A buildings normally also offer a higher level of amenities than the average office building. A large luxury lobby with soaring vaulted spaces displaying prominent, well-staffed security stations is an amenity in most class A buildings. Concierge services, meeting facilities, health club facilities, retail and food service offerings, and other lifestyle amenities in demand by the professionals that occupy the building are typical of class A properties. The rents at class A properties are similar to those of newly constructed buildings in the same local market.

Class B buildings tend to be slightly older than class A properties. In many instances class B properties are slightly older than the average property in the local office market. In some markets, where there has been a lot of recent construction, this could mean a building over 10 years old. In other markets it could mean a building over 20 years old. Either way, the class B building is one whose new building luster has faded. Class B buildings offer a more limited range of lifestyle amenities

17_769193 ch13.qxp 5/18/06 8:26 PM Page 152

than class A buildings. A class B building might be in a more average location within the local market. And the building materials and improvements found in class B properties tend to be average relative to community standards, whereas class A offices have above-average construction features when compared to local community standards.

Class C buildings tend to be the oldest buildings in a given community. These buildings are often recycled properties that were originally built for a given use and then rehabilitated and adapted for another use. Old multistory urban warehouse buildings that are renovated into loft-style offices or live-work spaces are typical of class C properties. These buildings are often located in less desirable neighborhoods that might have a mix of office and industrial properties. Class C buildings have few amenities and are often functionally obsolete for the current use. Class C buildings are seldom owned by publicly traded REITs unless they are purchased for renovation or redevelopment to class B or better levels.

Again, classifications are subjective at best. They attempt to divide properties into groups or general categories that are easily recognized by knowledgeable observers. For purposes of negotiations, buildings are often classified as class B by a potential buyer and class A by the seller. To complicate matters further, real estate professionals often create categories within classes. For example, better-quality class B properties are often called "high-B" buildings, or lesser class A buildings are termed "low-A" buildings. These distinctions are helpful to the real estate professional but often confusing to the uninitiated. However, in general, REITs tend to invest in class B or better office properties.

Physical Structure Classifications

In addition to the quality classifications just discussed, office buildings are also classified by size and style. In broad terms, these classifications are as follows:

- *Low-rise.* Normally under three stories, often in attached townhouse style.
- *Mid-rise.* Over three stories but subject to relative local standards. For example, a 15-story office building is a high-rise in Milwaukee, but in Chicago or New York it is a mid-rise.

17_769193 ch13.qxp 5/18/06 8:26 PM Page 153

- *High-rise.* Normally 15 stories or over in most local real estate markets.
- *Flex.* Often termed *R&D,* these properties are normally built on smaller parcels of land in mixed-use areas and combine office and light industrial space in one building.
- *Office park.* Sprawling suburban complexes with low- to mid-rise buildings on a campuslike setting, often with additional land available for expansion of existing facilities.

The number of stories is a simple way to classify a building because it is an easily identified feature. The height of a building also has an impact on the building's operation cost. Generally, taller buildings have a higher cost of operation and are more expensive to build. High-rise and mid-rise properties are most often found in higher-density urban locations where land value is high and availability is scarce. Low-rise office park projects tend to be located in suburban locations where density and land cost are not so much an issue. In many instances, suburban office parks are built in phases to keep the supply and demand equation in balance. The style and design of a given phase of a suburban office project may be the result of a single tenant or of the type of tenant that the developer is seeking for a particular location. Submarket dynamics also have an impact on building type. Land use restrictions and other zoning laws such as maximum densities and height restrictions ultimately affect the type and style of property that is built. These limitations are more apparent in some markets, and they have an impact on what gets built and where it is located.

Market Dynamics

During the tax-motivated era of real estate, the most overbuilt and volatile sector was the office sector. When the era started in 1982, the national office vacancy level stood at about 6 percent. The demand outlook was forecast to be strong as the economy moved away from industrial production and into the information age. Construction started in the mid-1980s and did not stop until the early 1990. To make the problem worse, as the 1990s started, U.S. industry began a long period of corporate downsizing. By the end of that era, the office vacancy rate in some

17_769193 ch13.qxp 5/18/06 8:26 PM Page 154

major markets had soared to well above 25 percent. It took over five years for the national office markets to absorb the excess and return to a more normal historic long-term supply and demand balance. Those who bought office property in the early 1990s made spectacular returns as the office markets normalized later in the decade.

The demand for office space is highly correlated to the expected growth in office employment or job growth. This growth is driven by general macroeconomic trends in the local and national economy. In general terms, local economic demand for office space is impacted by:

- The location of suppliers and customers
- The available pool of skilled labor
- Infrastructure such as roads, parking, airports, and public transportation
- Quality of life amenities for employees
- The relative location of areas where executive officers live
- Local government attitude toward business

Supply dynamics begin with the current market and submarket vacancy rates. This is the beginning point in the analysis of any business looking for new or additional space. The mix of available space is also a factor. For example, there may be a large amount of class C space on the market, while at the same time little class A and B space may be available. Or there may be a large number of small spaces containing less than 10,000 square feet available, but no single blocks of space of over 50,000 square feet. The available space mix issues can impact the market dynamic at any given time depending on what the demand side of the equation for a given type and size of space might be. Sublease space (often called *shadow space*) plays an important role in the supply side dynamic. This is space that a tenant that is legally obligated on a lease is attempting to release or sublease to another tenant. In the worst instances, a property owner may be competing against an existing tenant to lease in the same building. Imagine a five-story, 200,000-square-foot suburban office building with a single 40,000-square-foot floor that is vacant and advertised for lease by the building's owner. Then imagine a tenant in the same building leasing two floors totaling 80,000 square feet with five years remaining on the lease. That tenant decides to downsize its suburban operation and consolidate it at another location, thus

17_769193 ch13.qxp 5/18/06 8:26 PM Page 155

vacating one of the two floors. The tenant is obligated to continue to pay rent because of the lease, but it will be in the market trying to sublease those 40,000 square feet against the building's owner, who also has a floor to rent. This is not an uncommon problem in large, active office markets.

In addition to vacancy rates and shadow space, another important factor in local market analysis is visible supply of new space. Planned developments, building permits approved, and projects under construction all total to indicate new supply. The good news is that this new supply tends to be very visible because of the size and scale of most new office real estate projects. In addition, it is very visible because it takes a relatively long time to plan and construct an office building. When vacancy rates and sublease space are added to new development, the total is the supply profile for the market.

Forecasting long-term future demand for office space is notoriously difficult. As mentioned, the multitudes of changing factors that impact the complex office market dynamic are hard to predict and gyrate wildly in the short term. Over the long term, the U.S. economy is expected to demand an average of about 225 million square feet per year. (Keep in mind, however, that this number can go up or down quickly.) Of that amount, 45 million square feet of annual demand is expected to result from obsolescence of existing office properties.

Trends Impacting the Office Sector

In the early 1980s, an interesting event occurred. The aggregate total amount of suburban office space exceeded the aggregate total amount of *central business district* (CBD) or downtown office space. Since then suburban space has grown at twice the rate of CBD space. This clearly points up the ever-growing trend toward the suburbanization of American cities. The trend started in the 1950s, when people followed large new highways out to new single-family homes. Then we witnessed the *malling* of America in the 1960s and 1970s, when the shopping amenities followed the population out to the suburbs. Since the early 1980s, growth in suburban office buildings has resulted in jobs moving to the suburbs, creating large metro areas of suburban mass that surround dozens of CBDs. These suburban cities are bigger than many of the major old cities they surround. The widely accepted explanation for this shift in locational demand is the theory of urban labor markets, which

17_769193 ch13.qxp 5/18/06 8:26 PM Page 156

suggests that cities tend to develop outward before they ever develop upward. Once housing is constructed outward, it presents a fixed asset base with an opportunity cost associated with its replacement. This cost delays any eventual replacement for decades and even centuries. The idea is that residential development normally moves outward first. Upward redevelopment only happens after outward movement is constrained by geography or by distance. With outward development, the commuting time of residents into the CBD becomes increasingly burdensome, much more so than if development occurred vertically. As commuting increases, firms begin to consider the prospect of a suburban location. At a suburban location, firms can, in theory, attract workers for a lower wage, because such workers have less of a commute. This theory predicts that the wages paid for comparable workers in the CBD will be higher than wages in the closer suburbs, and, in turn, higher than wages paid by firms even further out. Studies of wage patterns suggest this is true.

Why is this important? In the real estate world, this trend alarms the multitude of institutional real estate investors, including REITs that own A-class CBD office buildings, because it means most firms will ultimately move to the suburbs and cause decay in value of CBD office properties. However, there are several factors limiting this process. The first is that employers using a diverse labor force cannot always find a wide range of workers in a single suburb. Workers with different skills often are spread across different suburbs because of the historic patterns by which housing developed. Community zoning standards often reinforce these patterns. If executives live on the North Shore while administrative workers live on the South Shore, as is the case in Milwaukee, the location of easiest access may still be the CBD. A second factor is the public transportation system and existing road patterns. In some metropolitan areas, the transportation systems were built to move workers between suburbs and the CBD. Rail transit systems often provide strong radial links that help the CBD and slow the development of the suburbs. Thus the historic development of a city's transportation system strongly influences the ability of firms to decentralize.

The other big topic of debate in the office real estate sector is the impact of telecommuting on the demand for office space. The telecommunications and information revolution has correlated closely with the trend of suburban office decentralization. The Internet, computers, mobile phones, e-mail, and faxes all mean that face-to-face interpersonal

17_769193 ch13.qxp 5/18/06 8:26 PM Page 157

communication is much less important in the operation of many businesses. It is very easy today for various branches of a company to be situated at widely different locations. Sales, marketing, and other forms of business communication have also become less dependent on direct personal contact. As business contact costs and needs are reduced, firms will be able to take advantage of the lower wage and cost structure that suburban sites offer. An unfortunate and tragic example is the loss of the World Trade Center, which, despite its name, was an economic wound healed quickly by decentralization.

It is not certain that telecommuting has altered the demand structure for office space. However, it has aided in expanding the ability of most businesses to decentralize their operations. It has also affected the type and style of space used by businesses. For example, increased computer usage creates a demand for more complex floor and wiring systems. Employees who travel frequently and use laptop computers as their link to the organization are seldom given permanent offices; rather, they use an office or cubicle designed to accommodate transient employees who happen to be at the office.

These factors and trends have led to a basic change in standard working conditions. Companies are putting employees into open offices, which allow more employees to populate a smaller space. The allocation of space per person in an office setting has dropped from 350 square feet in the mid-1970s to about 225 square feet today. This trend is expected to continue as technology allows more workers to telecommute and remain in smaller decentralized locations.

Summary Data

Returns on office REITs are the most volatile of those for the major REIT sectors (see Table 13.1). Over the last five years the office sector produced an average annual return of 14.5 percent, the highest five-year return of any REIT sector other than residential. However, the volatility of the sector as measured by the standard deviation of returns was 20.8 percent, making it the most volatile of the major sectors. The basic characteristics of the office sector make it more sensitive to economic and business conditions, and the long lead time on office construction makes timing the cycle for offices more difficult than for sectors with shorter cycle times.

TABLE 13.1 Historical Sector Data for Office REITs (as of December 2005)

	2005	*2004*	*2003*	*2002*	*2001*	*2000*	*1999*	*1998*	*1997*
Panel A									
Total return on sector	13.1%	23.3%	34.0%	–6.8%	-0.8%	35.5%	4.3%	–17.4%	29.0%
Dividend yield	5.1%	6.1%	9.7%	5.9%	7.7%	8.8%	7.9%	4.6%	6.3%
Estimated NAV	105.0%	108.0%	110.0%	88.0%	90.0%	93.0%	79.0%	100.0%	122.0%
Panel B									
Market cap of sector ($ billion)	$62.6								
Index weight	18.8%								
All other sectors	81.2%								
Volatility	20.8%								
5-year return	14.5%								

Source: Uniplan, Inc.

17_769193 ch13.qxp 5/18/06 8:26 PM Page 159

Points to Remember

- Office buildings represent 20 percent of the total commercial real estate market.
- Publicly traded office REITs represent about 21 percent of the National Association of Real Estate Trusts Equity Index.
- Real estate investment trusts own approximately 8 percent of the investment-grade office properties in the United States.
- The complex and volatile nature of the office segment make it one of the most analyzed sectors.
- The U.S. economy is expected to create demand for about 225 million square feet of office space per year.
- Communication technology and modern lifestyles have changed the pattern of office demand.
- Office and industrial space is the only space used primarily by businesses.
- Investment returns on offices are among the most volatile for any real estate sector.
- There are 27 publicly traded office REITs in the NAREIT Equity Index.

Chapter 14

Industrial REITs

Industry is the soul of business and the keystone of prosperity.
—Charles Dickens, 1841

The estimated aggregate value of industrial buildings in the United States is $2.2 trillion. That total includes owner-occupied industrial real estate valued at $1.2 trillion. The remaining $1.0 trillion of properties is investor owned. Research suggests that about 10 percent of industrial space is classified as flex space, which contains both office and industrial areas and could be considered either office or industrial depending on the criteria employed when classified. Investor-owned industrial buildings represent about 15 percent of the total commercial real estate market. Real estate investment trusts (REITs) are estimated to own about 8 percent of investor-owned industrial properties.

Industrial REITs as a group represents about 8 percent of the National Association of Real Estate Investment Trusts (NAREIT) Equity Index (see Figure 14.1). Keep in mind the fact that within the office segment of the index, about 5 percent is made up of flex properties that have components of both office and industrial space in a single property. These could be categorized as either office or industrial. If they were classified as industrial, the weighting of this category within the NAREIT Equity Index would approach 14 percent.

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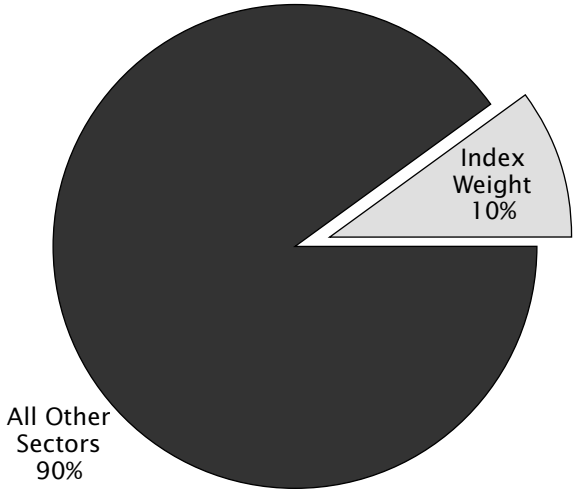

FIGURE 14.1 Industrial REITs as a Percentage of the NAREIT Equity Index
Source: Uniplan, Inc.

Building Classifications

There is no standard classification system for industrial buildings. In many ways the term *industrial property* represents a generic concept that covers a vast array of real estate. It describes buildings that are used for the production or manufacture of products as well as properties whose function is distribution or warehousing. In most instances, industrial buildings fall into one of the following categories. Each category services a particular type of industrial tenant by providing a specific type of building functionality.

Warehouse

This is the most common type of industrial property. It is estimated that there are over 6 billion square feet of warehouse space in the United States. Warehouse space is the most commonly tenant occupied, with over 70 percent of all warehouse space being classified as rental space. For a building to classify as a true warehouse, no more than 10 percent of the total square footage can be office area. Warehouse buildings have multiple loading docks to accommodate the rapid loading and unloading of trucks. Some warehouses may also have rail siding for the movement

18_769193 ch14.qxp 5/18/06 8:26 PM Page 163

of freight by railroad. In general, modern warehouses have high ceilings to accommodate the vertical loading of content. Ceiling heights are normally in the range of 18 to 40 feet.

Manufacturing

This is the second most common type of industrial building. It is estimated that there are over 3.1 billion square feet of manufacturing space in the United States. Unlike warehouses, manufacturing space is owned more often than rented, with an estimated 60 percent being owner occupied. The highly specialized nature of most manufacturing buildings makes these types of buildings of less interest to the investment community. Also, the larger the manufacturing facility, the more likely it is to be owner occupied. The ever-changing, capital-intensive nature of big manufacturing facilities also makes large-scale users unlikely to want to be involved in a leasing situation.

Flex and R&D

These properties are normally built on smaller parcels of land in areas of mixed-use buildings and combine office and light industrial space into one building. They are most often one-story buildings with ceiling heights in the range of 10 to 15 feet. The ratio of office to industrial space is not set and is usually dependent on the end use of the tenant. Buildings of this style usually have a truck loading dock and also have floor-height loading to facilitate the easy use of smaller vehicles. About 40 percent of this type of space is owner occupied and 60 percent is leased. Because it combines general offices along with warehouse and manufacturing space, this style of building is very popular among smaller private companies that lack the size or scale to support separate office and manufacturing space.

Special Purpose

This category is normally reserved for any building that does not fit into the preceding classifications. For the most part these are either manufacturing buildings that are custom-built to meet a specific need, such as cold storage warehouses, or obsolete buildings that have been recycled for industrial use. Loft buildings, which may have started as industrial

18_769193 ch14.qxp 5/18/06 8:26 PM Page 164

buildings in the early 1900s and subsequently have been converted into live-work areas or studio space for artists or advertising agencies, are a prime example of special-purpose buildings. *Incubator buildings,* which are normally large obsolete manufacturing facilities that have been subdivided into multi-tenant structures with very affordable rents aimed at new small businesses, are another example of special-purpose buildings. Unlike most other commercial structures, industrial buildings are not classified by quality level for investment purposes. Instead, they are normally classified by age and use. For example, a building might be referred to as a newer flex building or an older warehouse. Local market standards are very much a part of the industrial building description. What is considered older in some markets would be considered obsolete in other locales. These classifications are almost completely subjective and leave much room for interpretation.

Market Dynamics

Industrial markets are among the most stable when it comes to the supply of and demand for space. Because of the special nature of industrial space, most space is not created until a demand exists. And, due to the very short amount of time required to construct industrial space, the supply can be very responsive to demand or lack of demand. For example, in an area zoned for industrial use, construction permits can usually be obtained within 60 days, and a building can be constructed in three to six months. Contrast that with an office building, which can take two years (or more) from permit to completion. Because of the short cycle time, supply and demand for industrial space does not normally get too far out of balance. This supply and demand constancy translates into very stable occupancy patterns. Historically, industrial vacancies usually run in the 5 to 6 percent range. In extreme periods, vacancies have run up to 11 percent, but rarely do they exceed these levels for long, even in very competitive local markets.

Final demand for industrial space is highly correlated to the growth of the U.S. economy. An expanding economy produces increasing demand for products and services. Economic growth also tends to stimulate corporate profitability. Increased profits often lead to increased capital spending among businesses, which also translates into demand

18_769193 ch14.qxp 5/18/06 8:26 PM Page 165

for more and often better or newer industrial space. Conversely, any general slowing in the economy will usually translate into a quick decline in demand for industrial space. However, because of the long-term capital-intensive nature of most industrial projects, end users, whether owners or renters, normally project their need for space based on long-term projections of final demand. This long-term characteristic of industrial users also tends to stabilize the supply-demand cycle in the industrial sector by moderating spikes in the final demand for space.

The special nature of certain industrial operations often creates locational factors that affect the demand for space at the local market level. For example, the Chicago area, with its geographically central location, its major hub for interstate highways, large international airports, multiple railroad operations, and easy access to the Great Lakes and Mississippi River waterways, is a favorite location among distribution-intensive businesses. Other industries that require large amounts of raw materials or power will consider these needs in their location decision. Industrial space users such as commercial baking and bottling operations will want to locate near their final markets to reduce transportation costs. These locational factors can create particular demand dynamics in the local marketplace. Because of the stable nature of the demand profile in industrial space and the general correlation of demand to economic growth, forecasting long-term future demand is less difficult for industrial space than for other real estate sectors such as office or retail. Over the long term, the U.S. economy is expected to demand, on average, about 270 million square feet per year. This is a reasonably stable number and includes approximately 40 million square feet of annual obsolescence.

Summary Data

The nature of the supply and demand cycle for the industrial sector makes it one of the more stable and predictable segments of real estate. Over the last five years the industrial REIT sector produced an average annual return of 31.9 percent (see Table 14.1). The volatility of the sector as measured by the standard deviation of returns was 16 percent, making it among the most stable sectors. The demand for industrial real estate and the performance of the sector will rise and fall primarily with general economic growth.

TABLE 14.1 Historical Sector Data for Industrial REITs (as of December 2005)

	2005	*2004*	*2003*	*2002*	*2001*	*2000*	*1999*	*1998*	*1997*
Panel A									
Total return on sector	15.4%	34.1%	33.1%	17.3%	7.4%	28.6%	3.9%	−16.3%	19.0%
Dividend yield	4.3%	6.9%	7.6%	7.1%	6.9%	8.8%	7.9%	4.6%	6.3%
Estimated NAV	106.0%	111.0%	104.0%	98.0%	95.0%	93.0%	79.0%	100.0%	122.0%
Panel B									
Market cap of sector ($ billion)	$21.1								
Index weight	10.2%								
All other sectors	89.8%								
Volatility	16.0%								
5-year return	31.9%								

Source: Uniplan, Inc.

18_769193 ch14.qxp 5/18/06 8:26 PM Page 167

Points to Remember

- Industrial buildings represent about 15 percent of the total commercial real estate market.
- Publicly traded REITs represent about 14 percent of the National Association of Real Estate Investment Trusts Equity Index.
- REITs own about 8 percent of all U.S. industrial properties.
- There is no uniform system for categorizing industrial space.
- Industrial space, like office space, is primarily used by businesses.
- Industrial properties are among the most stable sectors of the commercial real estate market.
- Final demand for industrial space is expected to be about 270 million square feet per year.
- Changes in industrial patterns affect the final demand for industrial space.
- There are eight purely industrial REITs and eight REITs that own primarily flex properties.

Chapter 15

Retail Property REITs

If you think the United States has stood still, who built the largest shopping center in the world?

—Richard Nixon, 1969

The retail property sector is broken down into three broad categories in the National Association of Real Estate Investment Trusts (NAREIT) Equity Index. Shopping center real estate investment trusts (REITs), which number 28, are the largest single category. There are 10 REITs that specialize in regional malls and seven REITs that focus on freestanding retail properties. Retail REITs make up about 20 percent of the NAREIT Equity Index (see Figure 15.1).

Publicly traded REITs own an equity interest estimated to be over one-third of all regional malls. REITs represent the ownership of approximately 50 percent of super-regional malls (regional malls with over 800,000 square feet of gross leasable area) and approximately 14 percent of all nonmall retail properties in the country.

Retail Sector Categories

Due to the size of the retail real estate sector and the complex nature of retail operations, a description of retail REITs and retail properties could fill a book by itself. This chapter tries to generally quantify and categorize the various aspects of retail real estate. The retail sector can be broken down into three large subgroups, each of which comprises a number of smaller categories:

19_769193 ch15.qxp 5/18/06 8:26 PM Page 170

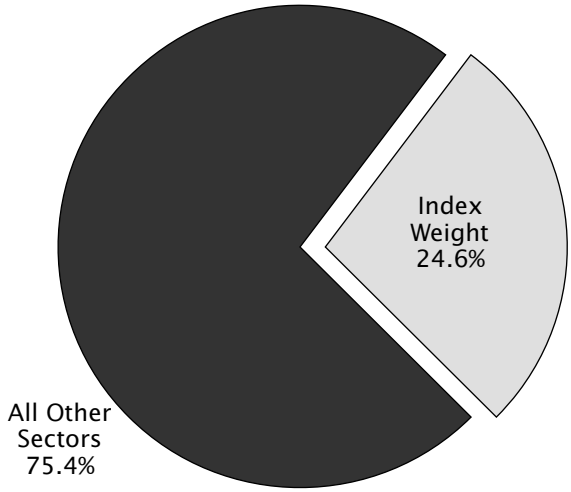

FIGURE 15.1 Retail REITs as a Percentage of the NAREIT Equity Index
Source: Uniplan, Inc.

1. Shopping malls include the following property types:
   - Super-regional malls
   - Regional malls
   - Destination or theme malls
   - Specialty malls
   - Outlet centers
2. Shopping centers include two broad groups:
   - Neighborhood centers
   - Community centers
3. Freestanding retail is divided into two groups:
   - Power centers
   - Big box retail

The regional mall category includes super-regional malls, regional malls, destination or theme malls, specialty malls, and outlet centers. Shopping centers include two broad groups, neighborhood centers and community centers. Freestanding retail is divided into two groups known as power centers and big box retail.

19_769193 ch15.qxp 5/18/06 8:26 PM Page 171

In the United States, the consumer, as defined by the U.S. Department of Commerce represents over two-thirds of the domestic economy. Nowhere in the world, except perhaps Japan, is retail activity such a large part of the domestic economy. Each month, nearly 200 million U.S. shoppers visit shopping centers. American culture is dominated by consumerism, and the United States has by far the highest amount of retail space per person of any country in the world. The American landscape is covered with shopping centers of various shapes and sizes. Because of the vast array of different shopping centers, it can be difficult to classify these into groups and subgroups.

In general terms, the quality of retail property is judged by the quality of the retail tenants that occupy the property. Large, high-quality retail organizations tend to have an excellent ability to understand local markets and trade areas. Therefore, when they commit to a particular location, it tends to be a primary driver of retail traffic to a particular location. The type and quality of tenants can be one way in which a retail property can be classified. From a financial point of view, the best tenants are frequently referred to in the real estate industry as *credit tenants.* These are typically retail operators that are part of a large, national, publicly traded retail organization with access to the public credit markets as well as an investment-grade credit rating from a major credit rating agency such as Moody's, Standard & Poor's, or Fitch Investor Services. Credit tenants tend to represent the best and most successful organizations in the retail industry and tend to attract other credit tenants of a complementary nature to a retail real estate project. Thus, in general terms, a retail project that is dominated by credit tenants is normally described as a class A retail property. Retail properties that are dominated by noncredit tenants are normally classified as class B retail properties.

The size and age of a retail complex is also used as a method of categorizing retail properties. Larger and newer properties tend to receive a higher quality rating than smaller and older properties. Older, smaller properties often face what is known as the *death spiral.* The typical situation involves an older mall that begins to lose its prime credit tenants. These credit tenants tend to move into newer, larger space that might be within the local market area of the older property. The older property then has difficulty in attracting new tenants of either credit quality or noncredit quality as a result of the vacant space left behind by the credit-quality tenant. This tends to be the beginning of a downward spiral as the obsolete property is slowly abandoned by the retail tenants.

19_769193 ch15.qxp 5/18/06 8:26 PM Page 172

The decline makes it increasingly difficult to attract new tenants or new investors and thereby ultimately results in high, if not complete, vacancy of the mall and often abandonment of the property.

Malls or retail properties can also be classified in terms of their market location and the distance from which they are able to draw shoppers to the retail center. Neighborhood shopping centers tend to be located in or near residential neighborhoods and have a primary trade area of three to five miles. Community shopping centers tend to be in larger urban neighborhoods and have a trade area of three to eight miles. Regional shopping centers tend to rely on a metropolitan region for most of their retail activity and have a primary trade area that can be 5 to 20 miles in range. The various classifications of retail shopping centers and their age, size, and location characteristics are summed up in Table 15.1.

Neighborhood Shopping Centers

Neighborhood shopping centers tend to be the smallest in size, ranging from 30,000 to 150,000 square feet. The primary concern of the neighborhood shopping center is convenient access for local market users to obtain the necessities of daily life. Neighborhood shopping centers tend

TABLE 15.1 Retail Property Subcategories and Related Data

Name	*Size (sq. ft.)*	*Market Area (mile radius)*	*Primary Function*
Neighborhood shopping centers	230,000–100,000	3–5	Convenient access to local population
Community shopping centers	100,000–300,000	5–10	One-stop shopping for most daily needs
Regional malls	250,000–650, 000	25	Enclosed shopping with general merchandise
Super-regional malls	800,000 or larger	25 or more	Entertainment and destination shopping
Outlet malls	50,000–400,000	Up to 75	Focus on manufacturer-direct off-price items
Power centers	300,000–600,000	15	Dominant anchor tenant located on major roads

19_769193 ch15.qxp 5/18/06 8:26 PM Page 173

to be anchored by grocery stores and are located on sites that range from 3 to 15 acres in size. They normally encompass a primary trade area of three to five miles.

Community Shopping Centers

Community shopping centers tend to be approximately 100,000 to 350,000 square feet in size, located on sites of 10 to 50 acres. They usually focus on general merchandise, with convenience of daily necessities being the primary motive. The community shopping center may be considered a one-stop shopping center for daily needs and may include a department store, a drugstore, and a grocery anchor on the same site. The primary trade area is a 5- to 10-mile range.

Regional Malls

Regional malls tend to cover general merchandise, fashion, and some type of entertainment as well. Regional malls are normally enclosed, whereas neighborhood and community shopping centers are frequently not enclosed and have a more uniform design. Regional malls tend to be from 250,000 to 600,000 square feet in size and occupy sites that range from 50 to 100 acres in size. The primary trade area for a regional mall can extend to as much as 25 miles.

Super-Regional Malls

Super-regional malls are very much like regional malls in terms of merchandise mix. They have a larger variety of merchandise than regional malls and also tend to have more entertainment activities. Super-regional malls are defined generally as 800,000 square feet or larger, located on sites of 60 to 120 acres or more. The super-regional mall's market area is 25 miles or perhaps even farther depending on its location.

Fashion or Specialty Malls

As the name implies, these properties are fashion or clothing oriented and tend to attract higher-end retail tenants. Because of their specialty nature, fashion malls tend to be 100,000 to 250,000 square feet in size and are located on sites of 5 to 25 acres. Their primary trade area can

19_769193 ch15.qxp 5/18/06 8:26 PM Page 174

extend for as much as 25 miles and is largely dependent on competition from regional or super-regional malls

Outlet Malls

Outlet malls tend to focus on off-price merchandise being sold directly through manufacturers' outlet stores. They are normally 50,000 to 400,000 square feet in size and occupy sites of 10 to 50 acres. Because of the specialty nature of outlet malls, they tend to draw from even larger market areas than super-regional malls. Consumers are often willing to drive as much as 75 miles to visit outlet malls.

Theme or Festival Malls

Also termed *lifestyle malls,* these malls focus on leisure activity or tourist-oriented activities and tend to have a high percentage of space dedicated to restaurants and other types of entertainment. The size tends to be 100,000 to 250,000 square feet on a 5- to 25-acre site. They are often located in or around areas with high levels of tourist activity. For example, a large number of leisure or lifestyle properties are found in locations in such regions as Orlando, Florida, and Las Vegas, Nevada.

Power Centers

Power centers have a category-dominant anchor tenant and may have a few smaller inline tenants as well. They are familiar as big national chain stores like Wal-Mart or Home Depot. Power centers are typically 300,000 to 600,000 square feet in size and are located on 25- to 100-acre sites. Power centers tend to have a trade area of 5 to 15 miles and are generally located on the edge of higher-density residential areas with nearby access to major highways.

Supply and Demand in the Retail Sector

As with other categories of real estate, demand for retail space is driven by the general growth of the domestic economy, with a high sensitivity to growth in demand for retail and consumer goods and services. The demand for retail goods and services is a function of household income and growth in the demographic segments that tend to be higher consumers

19_769193 ch15.qxp 5/18/06 8:26 PM Page 175

of retail goods and services generally the 15- to 25-year-old and the over-50 segments. However, it should be noted that demographic and consumer spending habits change over time and that good retail property operators are sensitive to the impact of changing lifestyle demographics on their retail properties. Normally, a healthy domestic economy will produce a consumer who is willing to spend at a higher level and at a higher rate than that of a slowly expanding or quiet economy.

The seemingly ever-expanding supply of retail property is part of the retail property cycle. Since 1996, on average 250 million square feet of retail space have been delivered into the U.S. real estate market. With approximately 6 billion square feet of existing space, the base of retail space is expanding nearly twice as fast as the U.S. economy. However, it is important to note that of that 250 million square feet of annual delivery, approximately 125 million square feet replaces obsolete retail property that is in some stage of the death spiral and ultimately will be vacant and off the market for practical purposes. It is estimated that over the next seven years, nearly 1 billion square feet of the aggregate retail market total will become functionally obsolete and be removed from the aggregate retail property pool. The long-term demand for retail space over the same period is estimated to be approximately 290 million square feet per year. The overall demand for retail space will be directly impacted by the level of economic growth as well as the financial health of the consumer and changing trends within the retail industry. Any of these factors could have a large impact on the overall demand for retail space.

Industry Dynamics

The dynamics of the U.S. retail property industry are inextricably intertwined with the dynamics of the U.S. retail sector. In general terms, much like hotel operators, retail real estate operators provide a very high value-added management component. Retail property owners must know and understand the dynamics of the retail sector, which they deal with from a tenant basis. They generally have a marketing plan for their entire portfolio of retail properties as well as a specific marketing plan for each individual property and perhaps even for each space within a property. These marketing plans are often driven by the marketing plans of one or more anchor tenants that may dominate the location of the retail

19_769193 ch15.qxp 5/18/06 8:26 PM Page 176

property. The overall marketing plan considers factors such as property location relative to population density, the current and projected population growth, local household income levels and buying habits, and the age demographics of the area. Competitive retail centers in the same market area, as well as land available for retail expansion within a retail center's marketing area, are also taken into account. Thus the retail property owner tends to analyze all the market factors and attempt to position a retail property for maximum value in the local real estate market. This high value-added component of retail operations can be critical in extracting value on the margin from the retail property. Because each retail property operates at such a different level, the best way to examine the industry dynamic is by property type.

Dynamics of Regional Malls

Regional and super-regional malls tend to be the largest retail structures, typically having two or more anchor tenants that may account for as much as 60 percent of the gross leaseable area. The anchor tenants draw retail traffic to a location, and the malls are configured so that the majority of retail shoppers enter the mall through an anchor store. Anchor tenants are generally credit tenants and are very sophisticated in their ability to analyze the local real estate market. They understand and recognize their traffic-drawing ability and use it to their advantage. In a typical regional or super-regional mall, the anchor tenant pays little or no rent to the landlord and generally makes a below-average per-square-foot contribution to cover maintenance expense. Anchor tenants usually own their own stores, which they build on the mall site on land that is leased from the landlord over a long period.

Specialty Tenants

The specialty tenants, often referred to as *inline tenants,* represent the majority of the income available to the retail regional or super-regional mall operator. In most situations, the heavy promotional activity of the anchor tenant in turn draws the foot traffic for the inline tenants that populate the balance of the mall's gross leaseable area.

Specialty tenants provide the majority of mall income, which is usually based on a minimum per-square-foot rental rate, with fixed periodic increases that are indexed to the consumer price index or a minimum annual rate increase. In addition to minimum rents, a shopping center

19_769193 ch15.qxp 5/18/06 8:26 PM Page 177

owner sets a base rental rate that increases as the tenant's sales volume increases. This is typically known as the *percentage rent clause* in a lease. In many ways, the percentage clause creates a powerful incentive for the shopping center owner to contribute to the success of the retail tenant. These percentage rents typically run in the range of 6 to 8 percent over a base amount of aggregate revenues on an annual basis. In addition, specialty tenants pay a common area maintenance and insurance charge that represents their pro rata share of all maintenance expenses for the shopping center. Real estate taxes are also handled on a pro rata share based on square footage. In addition, tenants are required to make a fixed contribution on an annual basis to a marketing and promotion fund, which is generally used to develop the marketing plan for the specialty tenants in a mall or regional mall. In many ways, the mall owner is attempting to align the financial success of the mall with the financial success of the retail tenants. Tenants' ability to pay rent is determined by their level of sales and profitability. In general, rents run at an average level of 8 to 10 percent of sales. Rents plus all other tenant costs typically run from 12 to 15 percent of sales. The mall owner, of course, enjoys the benefit of having higher-productivity tenants or tenants with more popular products and services. In some lease situations, tenants with per-square-foot sales that fall within a target range might pay 7 to 8 percent of sales as a minimum rental payment; as sales increase to higher levels this may grow to 9 to 10 percent or more. As the sales and success of the property grow, the rents grow as well.

The Leasing Relationship

This unique relationship between the retail landlord and the retail property user requires some special analysis. Of all property types, retail properties are most likely to generate long and detailed lease negotiations prior to the actual signing of a lease for space. The retailer in general understands that every dollar in percentage sales or every expense that is not paid to the landlord will essentially fall to the bottom line for the retailer. National credit tenant organizations that lease retail space across the country normally have an experienced real estate department that negotiates every aspect of a retail lease. Independent real estate brokers generally handle rental activities in smaller properties. Rental activities in major regional malls and large retail complexes are typically handled by the local office of the mall, or, in the case of national credit tenants, directly between the tenant's organization and the national real estate organization. It is also not uncommon for a national credit tenant to arrive at a

19_769193 ch15.qxp 5/18/06 8:26 PM Page 178

standard lease structure for all locations with a large owner of multiple retail properties. In many instances, lease negotiations are bundled to cover a portfolio of retail centers and administered on a uniform basis. These factors suggest that skilled retail property management can add a high level of value in the area of property management and lease negotiations.

Regional mall owners are very focused on the sales performance of their properties. Mall owners monitor very closely the same-store sales levels for tenants that have occupied the mall for a period of 12 months or more. This year-by-year performance in same-store sales is a measure of the mall's retail activity as well as of the performance of the individual tenants. In monitoring the same-store sales levels of individual tenants, the landlord may begin to develop a profile of underperforming tenants that occupy the retail portfolio. This can lead to selective targeted negotiations at the time the space is re-leased, or to a mall owner simply making the decision not to re-lease space to an underperforming tenant. In general terms, mall management measures total sales for all tenants on an average per-square-foot basis, regardless of their tenure at the mall, in order to provide a comparative measure of the mall's ability to draw consumer traffic.

Retail malls that generate higher levels of per-square-foot activity as a result of location, tenant mix, or other factors will demand a rental premium over malls whose performance is more average. Because the leases of inline retail tenants contain a percentage clause that requires the tenant to pay the higher of a base rent or a percentage of sales that is fixed in advance, the mall operator is truly a partner of the tenant.

Dynamics of Shopping Centers and Freestanding Retail Markets

There are three major subcategories of shopping centers. Neighborhood and community shopping centers are anchored by promotional tenants that tend to be discount retailers or power retailers. In these instances, the anchor may use as much as 70 percent of the entire gross leaseable area of the center. Power centers, which are anchored by similar discount retailers, are in the same category; however, power centers tend to be 90 percent occupied by anchor tenants with only a few or no other retail tenants. These are often referred to as *freestanding* or *big box* retail centers. Finally, there are neighborhood and community shopping centers, anchored by supermarkets or drugstores, that typically find as much as 70 percent of their

19_769193 ch15.qxp 5/18/06 8:26 PM Page 179

gross leaseable space occupied by one or two major anchor tenants. The supermarket and drugstore may be separate or combined.

As in malls, the anchor tenant in shopping centers tends to be the tenant that relies on heavy promotional activity to stimulate retail traffic to the property. However, anchor tenants pay their share of property expenses. In a typical strip shopping center, anchor tenants pay a minimum annual rent and a percentage of sales that in total produce a minimum rent level for the landlord. The major distinction is that, unlike mall tenants, anchor tenants at strip shopping centers pay a much smaller percentage of sales as rent, typically in the range of 2 to 5 percent. In many instances, these anchor tenants build and operate their own units and, in fact, may directly own the real estate. Although shopping centers may not obtain the rental revenue growth component that regional mall operators enjoy, well-anchored shopping centers enjoy a highly stable rental stream. In addition, grocery- or drugstore-anchored shopping centers tend to have very long-duration lease structures. It is not unusual to find a grocery-anchored retail center with an initial lease term of 15 to 20 years with extensions of up to 10 years available. Although the rental growth for these units may not be as rapid as that for regional malls, they tend to have longer, more predictable cash flow durations.

Trends in Retail Real Estate

In the long run, a shopping center is successful only if it is able to create and maintain a competitive position in its local market. In many ways, this success is driven by a property owner's ability to reinvent the real estate on a periodic basis. One issue that continues to be at the forefront in the retail property sector is the level of maintenance capital an owner must spend to maintain or increase existing rental cash flow from a property. In particular, this is a big challenge for the mall sector, due to the dynamic and ever-changing nature of the U.S. retail economy. In the last 10 years, the amount of capital expense required to maintain a regional mall in a competitive way has been increasing. In the early 1990s, capital expenses of 3 to 5 percent of net operating income were typical for regional malls. This number has increased substantially to 7 or 8 percent, and many experts believe that on a long-term basis, 10 percent of net operating income will be required. Most mall owners agree that in order for a regional mall to remain competitive, a capital renovation of the property must take place

19_769193 ch15.qxp 5/18/06 8:26 PM Page 180

every 8 to 12 years. Based on the current cost of construction, it is not unusual for mall owners to spend between $12 and $24 per square foot every 8 to 12 years in order to reposition, reinvent, or remodel their retail properties. It is generally believed that this trend toward redeveloping existing properties helps them avoid the death spiral. Investors and retail REITs should consider the increasing level of capital expenditures required to maintain properties as a situation that could lower cash flow available for distribution to REIT shareholders.

Obsolescence

Like regional malls, shopping centers are also faced with recurring capital expense items that need to be considered. Over the last decade, capital expense reserves for shopping centers have grown from about 4 percent to about 7 percent of net operating income, and many experts believe this trend will continue until levels reach approximately 9 to 10 percent. Functional and competitive obsolescence are primarily to blame for increasing capital expense in the shopping center sector. Obsolescence results from a physical property requiring a major structural overhaul in order to remain competitive in a local market. *Competitive obsolescence* is a part of retooling an existing property in order to accommodate a new tenant replacing a major tenant that may be leaving the property. It also results from changing retail dynamics. For example, a well-maintained grocery-anchored shopping center can become competitively obsolete when a new Wal-Mart opens just several miles down the highway. This competitive obsolescence often requires a major capital expenditure to retool the property in order to become competitive again. This form of obsolescence accounts for the generally higher level of capital expense in the shopping center area.

Functional obsolescence can be seen throughout the retail real estate community and is embedded in a number of trends within the retail property sector. For example, supermarkets now tend to be much larger than just a decade ago. Some stores average over 70,000 square feet, whereas just 10 years ago the average figure was about 28,000 square feet. Drugstores, another major tenant of community shopping centers, have also revised their operating strategy. Today, drugstores prefer to be freestanding units based on the edges of large shopping complexes rather than being a part of the in-line tenant mix. Part of the reason is to accommodate the newest trend in pharmacy delivery: the drive-through pharmacy. Big box retailers are also getting bigger. Wal-Mart's average per-store square footage has grown from

19_769193 ch15.qxp 5/18/06 8:26 PM Page 181

about 55,000 square feet 10 years ago to about 130,000 square feet today. As retail formats change, properties with older formats become functionally obsolete and require capital expenditures in order to bring them up-to-date and keep them competitive. The low-inflation environment of the mid- and late 1990s has also been a problem for retail REITs. As mentioned, most retail leases contain a clause stating that the tenant will pay the higher of a base rent or a percentage of sales. In an environment where retail prices have been stable or even declining, inflation-driven increases in rental revenue have not materialized as many retail owners may have anticipated in the early 1990s. However, it should be noted that this tame inflationary environment has been somewhat offset by very strong consumer demand, which has translated into higher general retail sales.

Consumer Income and Retail Revenue

Another interesting trend in the retail sector is that sales of goods typically purchased in stores and shopping centers have been growing at a rate slower than the growth rate of consumer income. This supports the problematic notion that growth in personal income drives demand for retail space. Growth in retail sales has been about half that in retail space. This trend has contributed to a lower level of growth in per-square-foot sales for most major retail operators. Due to the participating nature of most retail leases, lower growth and per-square-foot sales have negatively impacted the returns in the retail real estate sector.

The Internet and Retail

There is much debate about the impact of the Internet on retail sales and on the value of retail real estate. Internet sales are building at a steady pace. Industry reports put Internet retail sales as follows:

1999	$17.5 billion
2000	$37.9 billion
2001	$56.5 billion
2002	$78.1 billion
2003	$109 billion
2004	$138 billion (est.)

19_769193 ch15.qxp 5/18/06 8:26 PM Page 182

This is impressive sales growth, and holiday-related sales have been the fastest. These sales gains occurred because more people became Internet users during 1999 and 2000.That increase, however, was somewhat mitigated by a slight decline in the average amount purchased by Internet shoppers. It may be that the increase in Internet shoppers lowered the average purchase amount as more new shoppers entered the marketplace during the course of 2003 through 2005.

Projections of longer-term e-commerce sales continue to rise. A number of forecasters have raised their Internet retail sales projections for 2005 and 2006 from an average of $140 billion and $158 billion to $149 and $182 billion, respectively. The strongest e-commerce categories include books, video, and music; computer hardware and software; and gifts and flowers. These three categories could capture a double-digit market share of total retail sales by 2006. Other categories such as apparel, housewares, and food look to achieve low- to mid-single-digit penetration over the next five years. As mentioned, holiday purchases are very strong on the Internet. The following is an estimate of the top online holiday purchases as projected by several different surveys:

Books and magazines	58 percent
Music and movies	55 percent
Computers and related	42 percent
Toys and video games	42 percent
Electronics	40 percent
Clothing	36 percent

The bursting of the Internet bubble has been the most notable setback for the e-commerce business. The diminished funding prospects for business-to-consumer Internet companies have slowed the growth of sales in the sector. Many existing Internet companies are in a cash squeeze, as cash burn rates are exceedingly high and profitability in most cases is a long time out. Without funding, the competitive threat to store-based retailers from pure-play e-commerce companies will be significantly reduced. To the surprise of the Internet elite, old bricks-and-mortar retailers are often proving to be better equipped than their e-commerce competitors in developing Internet business in their respective product categories. These store-based retailers are leveraging their

19_769193 ch15.qxp 5/18/06 8:26 PM Page 183

established brand names and retail distribution presence online without spending millions on incremental marketing and distribution. Although this is great news for existing retailers, it is only good news for the landlords. Although it is preferable for clicks-and-bricks business models to prevail over pure plays, a significant shift in volume away from traditional formats would still result in store closings.

Although the Internet's emergence may have a negative impact on the sales of retail tenants, it seems books, music, videos, and electronics are the categories that will suffer the most. Many REITs and their retail customers are implementing Internet initiatives to aid in the efficiencies of their operations, increase the availability of product information to consumers, and in some cases enhance top-line growth through the convergence of the Internet and shopping centers.

Overall the Internet continues to grow as a new channel of retail sales. It is not unlikely that Internet sales will have a penetration rate in the range of 7 to 10 percent of total retail sales. This emergence might negatively impact both existing mail-order and store-based retailers. Experts estimate that e-commerce will reduce retail rental growth by 50 to 60 basis points over the next five years. It is not a disaster, but it is certainly a trend worth watching. Investors in REITs should be aware of the risk that e-commerce poses to retail real estate. However, the tactile and social nature of much shopping activity should also be considered. It seems that e-commerce has yet to produce a measurable impact on prospective retail leasing activity, but the Internet will remain a topic of debate in the retail property sector for many years to come.

Summary Data

Returns and volatility for retail REITs are average (see Table 15.2). Over the last five years the retail sector produced an average annual return of 28.5 percent, the lowest for the major REIT sectors. The volatility of the retail sector as measured by the standard deviation of returns was 19.1 percent. The basic characteristics of the retail sector make it very sensitive to economic and business conditions. The long lead times on major retail construction along with general competitive conditions in the retail community make the outlook for this sector less favorable than in the recent past.

TABLE 15.2 Historical Sector Data for Retail REITs (as of December 2005)

	2005	*2004*	*2003*	*2002*	*2001*	*2000*	*1999*	*1998*	*1997*
Panel A									
Total return on sector	11.8%	40.2%	46.7%	21.1%	30.4%	18.0%	−18.9%	−4.9%	17.0%
Dividend yield	5.2%	7.0%	8.3%	7.0%	9.8%	10.2%	7.1%	5.9%	7.1%
Estimated NAV	114.0%	121.0%	124.0%	114.0%	98.0%	79.0%	75.0%	106.0%	116.0%
Panel B									
Market cap of sector ($ billion)	$94.9								
Index weight	27.0%								
All other sectors	73.0%								
Volatility	19.1%								
5-year return	28.5%								

Source: Uniplan, Inc.

19_769193 ch15.qxp 5/18/06 8:26 PM Page 185

Points to Remember

- Retail properties represent 30 percent of all investment-grade commercial real estate.
- There are approximately 43,000 retail properties across the country, comprising over 6 billion square feet of gross leasable space.
- REITs are the largest sector in the National Association of Real Estate Investment Trusts Index, representing approximately 20 percent of the entire index.
- There are 45 publicly traded REITs that focus exclusively on retail properties. In addition, approximately 50 percent of the investment activity of diversified REITs (REITs that own properties in more than one sector) is focused on retail properties.

Chapter 16

Hotel REITs

When I feel like getting away from it all, I just turn on the TV to a Spanish channel and imagine I'm on vacation in a hotel in Mexico.

—Charles Merrill Smith, 1981

Hotel properties have an aggregate total value of approximately $225 billion. The hotel investment universe represents approximately 5 percent of all investment-grade commercial real estate. Hotel real estate investment trusts (REITs) make up about 5 percent of the National Association of Real Estate Investment Trusts (NAREIT) Equity Index (see Figure 16.1). The hotel sector has historically been the most volatile sector of the commercial real estate universe; however, demand for hotel rooms is easily predicted because it tracks very closely with general levels of economic activity. The problem in the industry has long been supply, which is prone to boom-and-bust cycles driven by overbuilding. Hotels have a real estate component that contributes to their performance. To the extent that location and property type contribute to a successful hotel, the real estate component is obvious.

The Hotel Real Estate Sector Challenge

Mastering the hotel operating business is the key factor for success in the hotel sector. Operations are more critical to the overall success of hotel properties than properties in any other real estate sector. The other major challenge for hotel owners and operators is their near-total dependence

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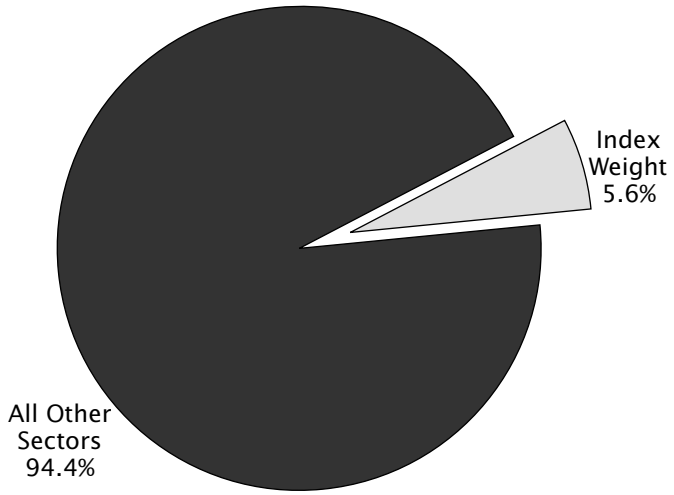

FIGURE 16.1 Hotel REITs as a Percentage of the NAREIT Equity Index
Source: Uniplan, Inc.

on the economic cycle, which provides ongoing incremental demand for rooms.

Management is the one critical element over which a hotel owner has a high level of influence. (The other critical element is the economy, over which the hotel owner has little or no control.) Thus, more than in any other sector of real estate, the opportunity presents itself in the hotel sector for a high level of operational skills to enable an owner to add value in the sector. These excellent operational skills are often translated into hotel brand names such as Marriott or Hilton. Poor management of hotel operations does not only hurt a brand name; it will attract well-managed competitors into the local market of the inferior operator. Therefore management skill and the hotel REIT's ability to capitalize on that management skill are critical in determining what kind of a return profile can be expected from a hotel REIT.

The revenue stream of hotels clearly has the shortest duration of all real estate. Room rates (rents) are literally reset on a daily basis as guests come and go from a property. When demand declines, room rates decline right along with it. When demand increases, room rates rise with it and can be repriced very quickly, literally overnight. As mentioned, hotel REITs are very highly leveraged to economic growth, which represents final demand for hotel rooms. If demand is increasing in a supply-constrained

20_769193 ch16.qxp 5/18/06 8:27 PM Page 189

market, a hotel has the ability to immediately reprice rooms and leverage rental returns. A successful hotel REIT operator affiliates with hotel brands and management teams that have the ability to manage through economic downturns as well as capitalize on upturns.

There are a wide range of investors in the hotel sector. As a result, there are a wide range of deal structures. Both property companies and hotel companies invest in hotel properties, along with hotel REITs and private investors. In a typical private situation, a local real estate investor may build and own a hotel and then contract with a national hotel company for management services. In other cases, the investor and the hotel company might form a joint venture to share in the equity and return on investment. In another common format seen in the 1980s, pioneered by the Marriott Corporation, the hotel company develops the property and then spins off the real estate into a syndication while retaining a management contract.

Moving the real estate into a limited partnership is a way of reducing the amount of capital needed to expand or grow a hotel business. The management company in turn creates a predictable earnings stream, which makes it more attractive to Wall Street.

Traditional hotel REITs cannot operate the assets they own. Because of the operating company rules, assets must be leased and managed by a separate company. This makes analysis of the hotel REIT sector more difficult, because it often has to be taken in the context of an operating company or several affiliated operating companies. In addition, brands or assets that normally do not have a legal or ownership affiliation with the hotel are also an important factor to consider when analyzing hotel REITs.

Asset Quality

Hotels are not assigned class rankings like apartment and office buildings. Instead, the quality criterion is the price range or price segment of rooms that the hotel provides. Hotel room price segments are typically grouped into three broad classifications know as *budget* or *economy, midpriced,* and *upscale* or *full service.* Economy rooms are the least expensive and full-service hotels tend to have the most expensive rooms. However, local markets play a role in the actual room price. For example, a $150-a-night room in New York City is likely to be in an economy-class hotel. But $150 a

20_769193 ch16.qxp 5/18/06 8:27 PM Page 190

night in Des Moines is likely to be a full-service or upscale hotel room. Hotel asset types are also broken into descriptions of property types. The following are some of the more common property descriptions in the hotel sector:

- *Conference center or convention hotels*. Have 500 or more rooms.
- *Full-service hotels.* Offer restaurant and bar facilities, room service, catering, and banquets and may provide meeting space.
- *Limited-service properties.* Do not have food and beverage operations and may or may not offer meeting space.
- *Extended-stay properties.* Resemble apartments; have studio and suite accommodations that are designed for the business traveler who may have a lengthy stay in a given location.

Hotels are also classified by the local market they serve or their location within a local market. This can add another level of description when dealing with hotel properties. The following are some of the local market classifications often applied to hotels:

- *Urban hotels.* Generally located in downtown central business districts.
- *Suburban hotels.* Often located in suburban areas contiguous to large groups of office and industrial buildings.
- *Motor inns.* Usually located at the intersections of major highways to accommodate auto travelers.
- *Airport hotels.* Typically located at or near airport locations for ease of meeting and transportation purposes.
- *Tourist or resort hotels*. Normally provide a full compliment of resort and luxury services at a single location.

Brand affiliation is another way to position or describe hotel properties. Users can easily identify a price point or property type that is normally affiliated with a particular brand. There are numerous national hotel brands that offer access to reservation systems, advertising programs, and management on a national scale. A number of regional brands focus their operations in specific geographic regions. To further confuse the process of hotel description, industry observers may use compound classifications to describe properties. A property may be classified as a

20_769193 ch16.qxp 5/18/06 8:27 PM Page 191

budget-priced suburban hotel, or a limited-service midpriced urban hotel. Any compound description might also be associated with a brand. A property might be described as a budget-priced suburban Holiday Inn. This shows how highly segmented the market has become.

Supply and Demand for Hotel Rooms

Estimating aggregate demand for hotel rooms in the United States is relatively straightforward. There are three basic types of travelers who use hotels: the business traveler, the convention or meeting traveler, and the leisure traveler. For each type, demand is largely related to the state of the economy. A robust economic environment leads to more business travel as a result of a higher level of business activity. In addition, higher economic growth leads to more leisure travel, resulting in a greater demand for resort hotel rooms. Higher levels of economic activity also tend to create larger turnouts for business conventions, which also translates into more demand for hotel rooms. The high correlation between growth of the domestic economy and hotel room demand can be affected by a number of factors. The cost of oil, which drives the underlying cost of most modes of transportation, generally affects hotel occupancy rates. The value of the dollar also has an impact on U.S. domestic hotel operations because a higher dollar tends to discourage foreign tourism whereas a lower dollar makes U.S. destinations more affordable to foreign tourists. Bad weather can also create a negative environment for certain hotel operators. The profitability of a particular industry can have an impact on its policy toward employee travel. For example, the dot-com industry was booming in the late 1990s, precipitating a high level of business travel among members of the industry. Because the industry has experienced a severe downturn, travel policies have been focused on a reduction in travel expenses and therefore have translated into less business travel by a large sector of the business economy.

The supply of hotel rooms is also impacted by a number of economic factors. In some markets, crowded urban areas with little available land and difficult entitlement processes create a local market that is generally supply constrained. Many resort destinations fall into this category during the tourist season.The Napa Valley wine region of California, for example, is generally supply constrained during the wine season. The local market and infrastructure do not lend themselves to new hotel

20_769193 ch16.qxp 5/18/06 8:27 PM Page 192

development, and growing grapes is a higher and better economic use of land than hotel development. Thus room demand generally exceeds supply in Napa at all times except the off-season. Supply-constrained markets tend to be highly profitable in an economic expansion and tend to be more insulated from an economic downturn because of the generally limited supply in the local market.

This set of factors is less true in nonurban areas or locations that are not supply constrained. Hotels in the economy, midrange, and budget price ranges are simple and easy to build, especially in suburban areas where land and zoning provide few barriers to entry. Hotel construction can begin quickly in response to strong economic demand. This new supply can quickly erode profit margins of all hotels in a good economic environment and can create a supply glut in a bad economic environment.

Hotels tend to track their occupancy level in a figure called *RevPar,* which is an acronym for *revenue per available room.* This figure is calculated by taking the average daily room rate and multiplying it by the occupancy level of the hotel level on a given day. These daily revenues are then aggregated to come up with the average RevPar per period. A hotel that operates at 75 percent occupancy is considered to be nearly fully occupied. Few hotels are strong in both weekday and weekend operations and tend to have more success either during the week with business travelers or on the weekends with leisure travelers. There are often seasonal differences in occupancy as well. As mentioned, resort hotel locations may be overbooked during the tourist season and may be virtually empty during the off-season. Demand at the local level for a given hotel is often linked to its physical proximity to local attractions or businesses that generate travel. Airport hotels, for example, often provide a convenient location for groups of business travelers to meet. Being next to or part of a convention center can also be a positive factor. In addition, resort hotels depend heavily on their natural or man-made attractions such as golf courses and water parks, and on ease of access.

The operating component is more critical in the hotel business than in any other category of real estate. The benefits of economies of scale have been tested and proven within the hotel industry, and all of the leading hotel companies having a national portfolio tend to perform well in both economic expansions and economic declines. Being national in scope creates buying power, but the real key to economies of scale

20_769193 ch16.qxp 5/18/06 8:27 PM Page 193

in hotels is a recognizable and well-respected brand name. Branding gives hotel operators leverage in booking reservations and in attracting and creating relationships with a large number of customers who identify the brand with a particular quality level. These factors provide a real advantage when the hotel company expands its market or brand into other locations. The extension or presence of strong brands in a particular market niche often serves as an effective barrier to entry for potential competitors in a particular market segment.

The hotel business and the airline business share many of the same operating characteristics. Both hotel and airline operators require large capital investments in plant and equipment. They also involve large fixed operating expenses for staff and infrastructure such as reservation call centers. Airlines and hotels have to fill the seats or rooms on a daily basis in order to remain economically viable. The more complex issue for operators of both hotels and airlines is a concept called *yield management.* This requires finding the right combination of price and occupancy level to maximize profits. Airlines were the pioneers of yield management systems, often charging dozens of different prices for seats of the same type on the same flight. Hotel operators and rental car companies have also adopted this practice. The idea is to selectively adjust the offering price until a particular economic result is achieved. It is better financially to fill a seat or a room with a lower-paying customer than to have that seat or room vacant. That unused room-night or seat can never be recaptured. Yield management is slowly making its way into the residential real estate sector, with the owners of some apartment REITs beginning to price available units on a yield management basis.

Technical Aspects to Remember

There are a number of technical aspects to examine when looking at a hotel REIT and its relationship to a hotel operating company. The following are the key items that should be reviewed when examining hotel REITs:

- The lessee must have a legitimate business goal in terms of the hotel project.
- The hotel must be leased to a company that is separate from the REIT.

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- Gross revenue leases must be designed to deliver most of the economics to the REIT.
- Leases must be based on percentage or participating rents, not net income.
- Hotel REITs collect 15 to 25 percent of room revenues up to a predetermined break point and 60 to 70 percent beyond that point.
- Food and beverage rent may be approximately 5 percent of revenues if the business is operated by lessee, or 95 percent of rent from a subcontractor.
- Break points adjust upward annually by a formula normally based on the consumer price index.
- Leased revenues may represent 30 to 35 percent of hotel revenues, but beyond the break point, the REIT collects rent at twice the level of the typical weighted average margin. (This situation creates a high level of operating leverage for hotel REITs.)
- Typically a 1 percent change in RevPar may result in a 1.5 to 2 percent change in lease revenues to the REIT.
- Lease leverage disappears when hotel revenues and break points change at the same rate.
- Seasonality amplifies quarterly volatility, as a lease formula is applied to each quarter's annualized rents.
- Hotel REITs may collect excess rent during seasonally strong second and third quarters, but differences are made up during the seasonally slow fourth quarter.
- The affiliated lessee is separate from the REIT but is owned and operated by senior management, in many cases the REIT's founders.
- An independent lessee reduces the potential for conflicts of interest.
- The lessee may pay franchise, licensing, and management fees to the owner of a hotel flag for use of a brand, reservation system, and property management.
- Hotel REITs are responsible for insurance and property taxes.

20_769193 ch16.qxp 5/18/06 8:27 PM Page 195

- Hotel REITs or lessees typically reserve 4 percent of hotel revenues for furniture and equipment replacement, but 6 to 7 percent may be a more appropriate long-term level.
- Very few hotel REITs do any meaningful development work.

Performance

On a long-term basis, the performance of hotel REITs has been among the best relative to other REIT asset classes. However, the volatility of earnings or return, when measured by standard deviation, has been very large when compared to the growth rate. Profits in the hotel business are very difficult to maximize because of the need to return capital into the enterprise to refine and upgrade hotel facilities. In addition, high volatility of returns is due to a combination of very high operating leverage and very high financial leverage, which are often present in the hotel sector. The significant fixed cost of hotel operation, as well as high leverage, makes hotel operators very vulnerable to excess supply or a downward shift in demand. Hotel financing is generally a more specialized form of funding, which means fewer lenders are willing to become involved in the sector. Generally, for hotel REITs, this allows for a higher operating margin on invested capital.

Summary Data

Returns on hotel REITs are the most volatile of those for all property REIT sectors. Over the last five years the hotel sector produced an average annual return of 11.6 percent (see Table 16.1).This is the worst five-year return of any single property sector other than specialty REITs, which include a number of different property types. The volatility of the hotel sector as measured by the standard deviation of returns is 41.1 percent, making it the most volatile of the property REIT sectors. The basic characteristics of the hotel sector make it extremely sensitive to economic and business conditions. Whether hotel REITs have an up or a down year, the performance tends to be very extreme.

TABLE 16.1 Historical Sector Data for Hotel REITs (as of December 2005)

	2005	*2004*	*2003*	*2002*	*2001*	*2000*	*1999*	*1998*	*1997*
Panel A									
Total return on sector	9.8%	32.7%	31.7%	−1.5%	−16.3%	45.8%	−16.2%	−52.8%	30.1%
Dividend yield	4.8%	4.4%	7.7%	5.5%	6.9%	14.9%	7.9%	2.2%	6.8%
Estimated NAV	105.0%	108.0%	91.0%	79.0%	89.0%	107.0%	74.0%	89.0%	146.0%
Panel B									
Market cap of sector ($ billion)	$19.06								
Index weight	6.0%								
All other sectors	94.1%								
Volatility	41.1%								
5-year return	11.6%								

Sources: National Association of Real Estate Investment Trusts; Uniplan, Inc.

20_769193 ch16.qxp 5/18/06 8:27 PM Page 197

Points to Remember

- Hotels represent about 4 percent of the total commercial real estate market.
- Publicly traded REITs represent about 5 percent of the National Association of Real Estate Trusts (NAREIT) Equity Index.
- Real estate investment trusts own about 19 percent of all U.S. hotel properties.
- Hotels are usually classified by room price, size, and location.
- Operations are more critical to the overall success of hotel properties than properties in any other real estate sector.
- Hotel properties are among the most volatile in the commercial real estate market but have high relative returns.
- Demand for hotel rooms is largely related to the state of the economy.
- There are 15 publicly traded hotel REITs.

Chapter 17

Health Care Properties

A hospital's reputation is determined by the number of eminent men who die there.

—George Bernard Shaw

Health care properties are generally not as familiar to the investing public as yet another kind of property in which real estate investment trusts (REITs) can invest. Many of the health care providers that operate these properties are not well known and the regulatory environment in which they operate is often complex. These factors can make health care REITs seem more difficult to analyze than other property sectors.

There are several common misconceptions about the health care REIT segment. First is the popular belief that health care REITs lack value-adding ability because they do not actively manage their properties. This idea is not based on fact. Health care REITs often add value largely through the careful selection and negotiation of their ultimate investment in a health care property. The sector has experienced a fair amount of growth over the last decade and its returns in general have been better than those for many other sectors of the REIT industry. The health care REIT sector represents about 5 percent of the National Association of Real Estate Investment Trusts (NAREIT) Equity Index (see Figure 17.1) and has a market capitalization of approximately $7 billion. The sector's capitalization grew steadily through the 1990s at an average annual rate of approximately 15 percent and then declined through 1998 to 2000 as changes in Medicare and Medicaid reimbursement and highly fragmented ownership in the health care industry caused some dislocations of capital.

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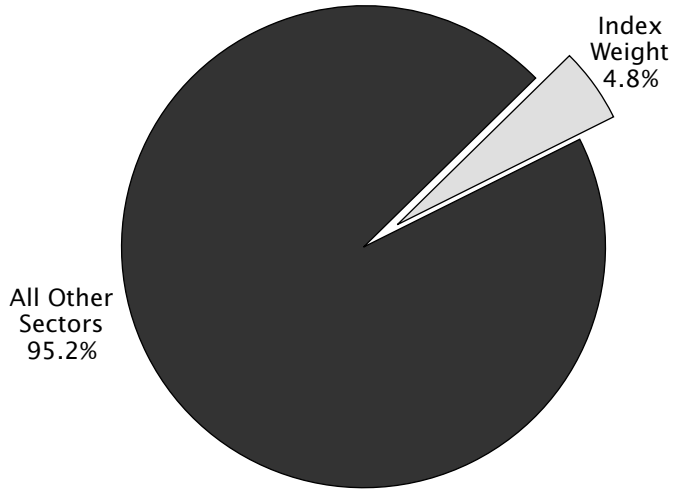

FIGURE 17.1 Health Care REITs as a Percentage of the NAREIT Equity Index
Source: Uniplan, Inc.

The Economics of Health Care

Real estate investment trusts represent an opportunity for investors to participate in the growth of the health care or services industry but remain one level removed from the operational and regulatory risks that face frontline health care providers. Health care, as a percentage of gross domestic product, is about 13 percent of the U.S. domestic economy, and health care services account for about two-thirds of that 13 percent. Investor interest in the health care industry in general has increased over the last decade because of a number of factors. First, reform of the government health care system has provided an opportunity for many fragmented sectors of the health care industry to consolidate. Second, growth in the health care industry is expected due to demographics. The aging of the U.S. population also creates a level of investment interest in the sector. Real estate investment trusts are impacted by government policy and government regulations regarding the payment process and other market dynamics, but the share prices of health care REITs generally experience less volatility than the shares of publicly traded health care providers, largely because of the recurring earning streams and the long-term structure of leases and mortgages from REITs to health care providers. The trade-off for investment in health care REITs versus in the health care industry directly is a lower total return.

21_769193 ch17.qxp 5/18/06 8:27 PM Page 201

Health care REITs generate profits by providing capital to the health care services industry. Generally this capital is gathered by the REIT at a lower cost and provided to the health care industry at a higher cost. The nature of health care REITs would be termed *spread investing,* and it is possible because health care real estate trades at yields from 50 to 500 basis points over the cost of capital for a well-run REIT. In turn, a REIT that carefully structures each transaction with a health care provider to create increasing future cash flows can also increase its total rate of return above the initial spread. In this way a health care REIT may add value in its capital structure.

While health care REIT providers can often find capital sources such as banks and finance companies, these REITs provide a stable source of long-term real estate capital for the health care industry. Their superior understanding of the industry and the economics of health care properties allow REITs to provide better capital resources than other financial competitors in the health care sector.

Demographics for the aging population in the United States have been instrumental in creating demand for additional health care properties. Approximately half of all health care REIT investments are directed toward the nursing home property sector. The high percentage of investment in this property type has resulted from the supply and demand characteristics of the nursing home industry. Many health care REITs started as spin-offs of property portfolios from nursing home operators. The other half of health care REIT investment dollars have flowed to a wide range of properties in the health care sector, including assisted living, which provides long-term care for the elderly and is the fastest-growing segment of the health care infrastructure industry.

The health care REITs have also financed acute care hospitals, psychiatric and substance abuse hospitals, rehabilitation hospitals, freestanding medical and surgical hospital facilities, medical office buildings, and physicians' clinics. The financing possibilities in the health care sector for REIT operators generally take one of two structures. First is the sale/leaseback structure, which is put in place as a long-term renewable triple-net lease in which the tenant pays property taxes, insurance, maintenance, and upkeep on the building. The second structure is the long-term mortgage loan to the direct health care provider. Under either form of financing, the health care facility operator benefits by being able to reinvest capital into the growth of its operations rather than tying up capital in its physical plant and facilities or buildings.

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There are positives and negatives that go along with each financing structure. Under the sale/leaseback approach, the operator wishing to improve the financial statement by lowering leverage can remove depreciation charges from the income statement and leverage from the balance sheet, resulting in higher net income and lower leverage. Conversely, under the mortgage loan scenario, an owner/operator wishing to defer taxes on a low-basis investment can generate capital from that asset by mortgaging it. Therefore the incremental capital from the mortgage becomes available to finance continuing operations of the health care REIT.

Mortgages may also be preferred in states where operators might incur limitations on medical reimbursement for lease payments under the state's Medicaid plan structure. Economic terms tend to be structured in a similar manner for underlying leases and mortgage loans. The lease or loan typically has a 10- to 15-year term with one or more renewal options of 5 or more years. Payments escalate in future periods in accordance with a number of different formula computations. A percentage of the operator's revenue at the facility may be payable under a lease or mortgage finance arrangement. There may also be fixed percentage increases in either the interest rate or the lease payment.

Finally, there may be some kind of indexing to the consumer price index (CPI) or another measure of inflation. Escalation clauses in many deals have what are termed *transition points.* Once the total cost structure reaches a transition point, there are limits on future escalations. In any case, growth of cash flow is built in from the owner/operator to the capital provider for the real estate services.

In addition to sale/leaseback structure or long-term mortgage structure, some health care REITs offer development financing options. These options often come in the form of equity extended to the health care provider through the REIT, which allows the health care provider to complete a capital project. The project is then subject to a long-term sale/leaseback agreement on completion. A number of REITs provide small amounts of accommodation financing as well, which allows health care operators to leverage some personal property and even accounts receivable in some instances as a package with their real estate financing arrangements.

Risk

An important distinction between health care REITs and REITs that invest in other property sectors is that, for a given investment, health care REITs receive rent or lease payments from a single operator and not a

21_769193 ch17.qxp 5/18/06 8:27 PM Page 203

number of tenants using a single property. Health care REITs are therefore a step removed from operational risk at the property but also very much exposed to the credit quality of the property operator, which allows them to hedge or lower their exposure to single-property-level operational issues that health care operators have to deal with. For example, an owner/operator of nursing homes may have a large portfolio of several hundred facilities. While the occupancy of any particular nursing home may drop, causing the health care operator to have financial difficulty at the unit level, the health care REIT that has financed that facility will not suffer a drop in revenue because the operator is required to pay through on the overall portfolio that is financed. The REIT's fixed base rent or lease revenue cushions the impact on total revenue, which is only affected by percentage rents that may be precipitated at a property-level basis, but the base rents or lease revenues generally are not subject to these property-level adjustments. Therefore the real risk for the REIT is in a default by the operator because of poor results across the whole portfolio.

Health Care Service Industry Economics and Demographics

As mentioned, health care makes up about 13 percent of the nation's gross domestic product. The health care services industry accounts for about two-thirds of that total. From a demographic point of view, there are two segments of the population that are growing faster than the population in total (see Figure 17.2). First, the over-85 segment is the fastest-growing segment of the overall population. Its growth rate is currently running at about 4 percent, whereas that for the overall population is running at a little over 1 percent. Over the next 15 years, it is expected that the 65- to 85-year-old segment of the population (essentially the front end of the Baby Boomers) will begin to grow at a very rapid rate. The growth rate for this segment will rise from approximately 1 percent in 2000 to 4 percent by 2015. Therefore, many of the services required by an aging population will need to be provided through health care services. The primary feature of the current health care service industry is a high level of uncertainty regarding future growth and operational issues. This uncertainty is due to high fragmentation within the industry and very high levels of competition among providers, which have resulted in low margins for health care service providers. In addition, cost control efforts by managed care companies and state and federal providers have

21_769193 ch17.qxp 5/18/06 8:27 PM Page 204

helped keep margins in the health care area very slim. Increasing competition from new forms of health care delivery, such as assisted living facilities or outpatient medical/surgical centers, also raises issues about which modes of health care delivery are most likely to succeed and therefore about which type of capital investment in plant and equipment will ultimately be rewarded from an economic point of view and which will become obsolete and therefore essentially of little or no value. These issues have resulted in a lower-quality financial profile for many operators in the health care services industry. This is of concern to the health care REIT community because managing credit exposure is the primary objective of the health care REIT.

In light of the current uncertainty, it is only fair to point out that the industry does have a number of positive characteristics from an investment point of view. Consolidation, which is going on at a furious rate, is creating financially stronger and larger participants. Demand for health care services is generally inelastic, and therefore on the margin when people need health care services, price is not going to stop the demand for services. Also, a major portion of industry revenues come from government programs, primarily Medicare and Medicaid. These are essentially low-risk programs from a credit point of view because they tend to pay the bills to the health care providers.

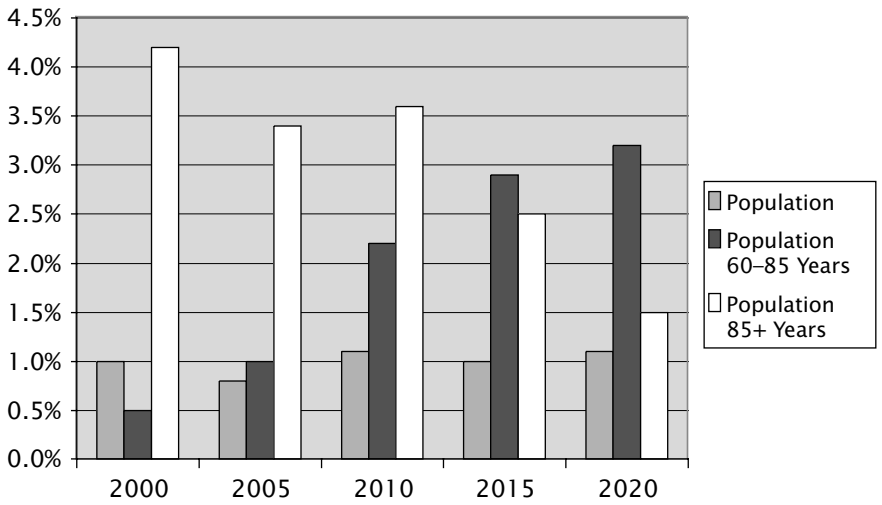

FIGURE 17.2 Growth of Population versus Expected Growth of Seniors (2000–2020)

Source: U.S. Census Bureau.

21_769193 ch17.qxp 5/18/06 8:27 PM Page 205

Because Medicare and Medicaid have an ever-increasing number of complex rules and requirements for program providers to meet, the number of health care providers that operate under those programs is declining, leaving larger operators with more scale and capability to administer large, complex programs. These providers tend to have higher credit profiles than smaller, more fragmented providers. Finally, the continued growth in the older segments of the population will require higher amounts of health care services and therefore a larger number of physical facilities to service this growing number of older adults.

Medicare and Medicaid Economics

Two federally mandated programs provide approximately half of the revenues of the health care services industry. *Medicare*, which is federally funded, provides for health care other than long-term care for all Americans over age 65. *Medicaid*, which is jointly funded by federal and state programs, provides health care for the poor and also provides long-term skilled nursing home care for those who cannot afford it. Although officially designated for the poor, Medicaid winds up paying the majority of all bills for the nation's nursing home care and continues to provide an increasing level of support for the nation's population in nursing homes. Because of increasing scrutiny of costs by the federal and state governments and managed care companies, the delivery of health care services has been shifting from higher-cost settings to lower-cost settings. Treatment for less complex conditions has been moving from hospitals to outpatient clinics or skilled nursing facilities. Even complex treatments such as heart surgery and related cardiac care are now even being delivered in lower-cost specialty care facilities such as heart clinics and outpatient surgical centers. In addition, custodial care for the elderly has been moving from nursing homes to assisted living environments. Where feasible, care has

Medicare

a U.S. government program available for people age 65 or older and younger people with disabilities, the latter of whom must be receiving disability benefits from Social Security for at least 24 months. Medicare provides health care coverage for 41 million Americans as of year-end 2003. Enrollment is expected to reach 77 million by 2031, when the Baby Boom generation is fully enrolled. Medicare is partially financed by a tax of 2.9% (1.45% withheld from the worker and a matching 1.45% paid by the employer) on wages or self-employed income.

21_769193 ch17.qxp 5/18/06 8:27 PM Page 206

Medicaid
a program managed by the states and funded jointly by the states and federal government to provide health care coverage for individuals and families with low incomes and resources. Medicaid is the largest source of funding for medical and health-related services for people with limited income. Among the groups of people served by Medicaid are eligible low-income parents, children, seniors, and people with disabilities. Medicaid pays for nearly 60 percent of all nursing home residents and about 37 percent of all births in the United States.

been even shifting into the home setting of the person being cared for. Health care consumers often prefer these new settings because they are easier to use than traditional settings and they also have a greater focus on better outcomes for the patients. The competition in the health care services industry will be won by the lowest cost provider of the highest-quality services. Health care REITs are aware of this and have invested in industry segments that tend to be low-cost providers. In many ways, health care REITs are providing capital to service providers who are creating alternative, lower-cost channels to provide health care in nontraditional forms.

REIT Underwriting and Investment Criteria

For health care REITs, the credit quality of the health care provider is a major factor in the underwriting decision. In addition, the quality of the underlying real estate becomes secondary when analyzing a health care real estate transaction. Well-located and functional properties can be of value even if their operating performance is substandard. If an existing operator fails, a high-quality property can often be transferred to a new operator or a serviceable property can be readapted for other uses. Any poorly located or structurally inadequate property will always create problems for the real estate owner.

Health care REITs look to property level cash flow coverage of a lease or debt payment as a principal ratio in determining the credit quality of the property and the operator. The target ratio depends on several factors such as the credit quality of the operator, any credit enhancements that may be a part of the financing package, and the property location; however, the coverage ratio for a typical pool of nursing homes is usually a 1.5 to 1.9 multiple of the total rent, based on cash flow, before deducting the operator's management fees.

21_769193 ch17.qxp 5/18/06 8:27 PM Page 207

Because the credit characteristics of most health care providers are subject to the difficult operating environment discussed earlier, health care REITs have developed a number of property-level strategies either in the sale/leaseback or mortgage area to help protect their investment portfolios. It is not unusual for health care REITs to bundle leases or mortgages of a single tenant into a unified portfolio and to preclude the tenant from "cherry-picking" the best leases or mortgages on renewal or expiration. This structure forces the tenant to renew all of the leases or none of them, making it a single decision on the part of the health care operator. Real estate investment trusts also typically cross default lease arrangements.

For noninvestment credits, REITs often require a cash deposit or letter of credit to cover three to six months of lease or mortgage payments. In addition, REITs typically retain the authority to approve any changes in tenant or borrower, including those occurring due to mergers, acquisitions, or spin-offs. These credit protections have helped health care REITs manage credit losses and reduce the negative impact of leases rolling over or mortgage maturities in a given health care portfolio. In addition, they often provide opportunities for the health care REIT to revisit terms and conditions of a deal with a health care operator that may be involved in a merger or acquisition and become affiliated with a higher-quality credit provider.

Increasing Competition Among Health Care Capital Providers

Historically, health care REITs have succeeded in part because of their ability to offer niche financing to health care operators that may have been overlooked by other capital providers. Currently, health care REITs face increasing competition from various non-REIT capital sources. Finance companies, mortgage companies, commercial banks, insurance investment portfolios, pension funds, and opportunity funds sponsored by investment banking firms have all become active in the health care property financing sector. These non-REIT investors and lenders are seeking to finance attractive elements of the health care industry at higher cost-of-capital spreads than are available in other, more traditional real estate sectors.

The uncertainty of legislation concerning the health care reform that has lingered around the industry seems to be subsiding. The continued consolidation among existing health care providers is, in the end, creating

21_769193 ch17.qxp 5/18/06 8:27 PM Page 208

more creditworthy health care operating companies. Over the last five years there have been initial public offerings by 25 assisted living or nursing home providers that continue to add legitimacy to the industry segment and also create larger and better-financed pools of capital for these operators. When you combine these factors with improvements and profitability in many of the health care provider segments, the continued availability of capital from more traditional sources should increase rather than decrease in the future.

Although REITs have always had competition from other capital suppliers in the health care segment, such as commercial banks and investment banking companies, there are new sources of competitors that could possibly make things more difficult for health care REITs in the future. One new competitor is existing REITs that are diversifying into the area of financing health care assets. These REITs hope to increase their growth rate and total return on capital by moving into what appears to be the higher-margin area of health care specialty financing. In addition, health care operators who are spinning off their real estate assets are also becoming competitors in the health care real estate financing arena. These operators create an operating affiliate that owns and manages the health care properties and normally attempt to expand their business by owning, operating, and financing health care properties of other nonaffiliated health care operators. These two new sources of competition for traditional health care REITs probably pose more problems than the more mainstream commercial banks and investment companies, which tend to operate under far more limited capital allocation criteria. The fact that there are additional competitors for mainstream health care REITs indicates that the margin on capital may continue to decline in the future.

Health care REITs offer a type of financing not typically available from other capital sources. Health care REIT financing is generally long-term in nature, with initial terms of 10 to 15 years that extend through renewal options for another 10 to 20 years. Health care REITs offer a range of deal structures, beginning with conventional mortgage loans and sale/leasebacks and extending to *hybrid REIT* financial structures such as participating mortgages and direct finance leases.

hybrid REIT
a REIT that combines the investment strategies of both equity REITs and mortgage REITs.

Health care REITs also provide a high ratio of leverage, which is normally not available through more conventional real estate lenders. Sale/leasebacks are usually for 95 to 100 percent of asset

21_769193 ch17.qxp 5/18/06 8:27 PM Page 209

value and thus require very little equity on the part of the real estate operator. Mortgages are generally higher than typical loan-to-value requirements for commercial banks, and it is not unusual to see leverage of 90 to 95 percent on conventional mortgages. Historically, health care REITs have developed functional working relationships with key industry participants, and they understand the health care provider's business model and weaknesses better than other financial institutions that may compete for the investment. This leaves health care REITs with a continuing competitive advantage over more traditional financial sources, which is not easily overcome by existing outside financial providers.

Physical Property Characteristics

Health care REITs finance a wide variety of health care property types. Each property type constitutes a separate group within the health care services industry, and although some common analytical themes carry between the segments, each segment requires its own analysis in order to evaluate the credit implications from a REIT investment standpoint. The following is a review of the major property categories in which health care REITs are involved.

Long-Term Care Nursing Homes

Nursing homes, usually referred to as *skilled nursing facilities* by the industry, represent about half of the total investment of REITs in health care properties. Long-term care facilities have been a very stable property sector, making them attractive to health care property investors.

The nursing home industry provides long-term ongoing care to elderly persons who require frequent medical supervision and attention. The industry consists of about 2.1 million skilled nursing beds in facilities that average about 120 beds apiece. Skilled nursing homes compete with hospitals for long-term treatment of patients and with assisted living facilities for the care of residents who may not require medical supervision but, rather, assistance in conducting day-to-day living activities. The average daily cost of skilled nursing care runs roughly at $118 per day, making skilled nursing homes far less costly than acute care hospitals but more expensive than assisted living facilities. It should be noted that in response to changes in reimbursement policies, many large acute care hospitals with excess capacity have restructured some of their existing

21_769193 ch17.qxp 5/18/06 8:27 PM Page 210

space into subacute treatment centers. At these hospitals, subacute treatment can be competitive in terms of price with average nursing home costs. Nursing home operators favor sicker patients over patients that you would typically find in assisted living, because sicker patients essentially generate higher revenue streams through additional services such as physical therapy and pharmacy services.

Although the nursing home industry has gone through a tremendous consolidation over the last 10 years, half of all nursing homes are still run by single-facility operators. The other half of the industry is run by multiple-facility operators. The four largest public operators own and control approximately 15 percent of the total industry beds. The remaining public operators comprise roughly another 20 percent of available industry beds. Medicaid reimbursements account for over half of the revenues of the skilled nursing home industry.

This high level of government funding has had mixed results for the industry. On the one hand, profit margins in the industry are very small, averaging 3 percent after taxes. Because state governments pay approximately half of the Medicaid reimbursements, they attempt to set their cost and reimbursement levels as low as possible while still providing a marginal return on capital for nursing home operators. Reasonably efficient operators, however, have largely been assured of long-term survival due to the cost-based reimbursement structure found at the state level. Thus larger nursing home operators with higher scales of economy are able to survive better on the average cost-based reimbursement system that exists in most state-funded programs. Although the nursing home industry has historically attempted to fight low reimbursements through various lobbying and legislative efforts, it has lost out to the cost containment methodologies that continue to proliferate in the health care reimbursement area.

The supply and demand situation in the nursing home industry has been the attraction for the involvement of health care REITs. On the supply side, the number of nursing home beds has historically grown at about a rate of about 2.5 percent per year. This slow growth rate reflects the attempts by state and local governments to slow the reimbursement costs of their Medicaid programs by restricting the development and construction of new nursing homes. This process, which is known as the Certificate of Need process, is often required by states before they will allow developers to create incremental supply in nursing home beds. Thus, many states have effectively limited new supplies of beds at levels that

21_769193 ch17.qxp 5/18/06 8:27 PM Page 211

support very high average occupancy rates in existing facilities. On the demand side, the rapid increase in the population over 85 years of age and the soon-to-be increasing level of 65- to 85-year-olds should continue to support the demand side for nursing home beds for the next 5 to 15 years. As a result, the national average occupancy among nursing homes has remained in the mid- to high 80 percent range, depending on the time period.

Long-Term Care Assisted Living Facilities

Assisted living facilities make up about one-third of the investment of health care REITs in the health care property segment. This has grown from a level of less than 5 percent just seven years ago. The development of the assisted living industry continues to be a growth-oriented area for health care REITs seeking new venues for the placement of capital. The industry, it should be noted, is still in a growth phase and is less mature and less regulated than the skilled nursing home segment, but offers a higher growth rate than the traditional skilled nursing care industry.

Assisted living projects cater to older persons who want to retain their independence but who also need assistance with one or more *activities of daily living* (ADLs). These ADLs may take the form of bathing, dressing, or assistance in mobility. Typical residents in assisted care facilities are about 83 years of age and ambulatory but are frail and often require a high level of assistance with daily tasks. These residents tend to have stays of about three years before they either move into a skilled nursing care environment or require hospitalization that may result in not returning to the facility. Residents in assisted living facilities live in a homelike apartment environment but are assisted with daily activities by staff members. Meals are served in a communal dining room, and transportation for other activities is often provided by the facility's operator.

The industry consists of approximately 500,000 beds in 4,800 facilities across the country, although it is difficult to get exact numbers because the industry is largely unregulated and the definition of assisted living spans other nontraditional elderly residential structures. The typical assisted living facility has 70 living units with shared common areas such as dining and activity areas.

Costs average between $70 and $80 per day, making assisted living generally less costly than nursing homes and competitive with home health care for patients who require more than three visits per week. The

21_769193 ch17.qxp 5/18/06 8:27 PM Page 212

assisted living industry has grown very rapidly because there are very low barriers to entry. A typical facility may cost $4 million to $7 million to construct and equip.

Employees are not required to have any certifications or high levels of health care skill, and therefore are easily found. Minimal regulations exist because revenues come primarily from private pay situations rather than Medicaid reimbursements. The assisted living industry remains highly fragmented, with the top four operators controlling less than 5 percent of the total industry beds. Including nursing home operators that also run assisted living facilities, the total market capture of all the public companies is approximately 16 percent of beds.

Continued consolidation among assisted living operators will create and achieve economies of scale and consistency of delivery in addition to some level of brand identity among operators. In many ways, because the industry is largely unregulated, operators are focusing on the consumer, who will ultimately be making decisions about assisted living care. The net outcome is likely to be an industry that looks to some degree like the hotel industry where scale and brand are well established.

It is expected that government involvement in assisted living will continue to increase. State governments seeking to reduce Medicaid costs are starting to view assisted living as an attractive, lower-cost alternative to nursing home care. Care provided at assisted living facilities typically costs two-thirds of the total cost of nursing home care, and, assuming that even just 10 percent of current nursing home patients could be eventually moved into assisted living facilities, the savings could be several billion dollars a year.

It is not unusual to find that Medicaid has provided waivers that permit states to use long-term Medicaid funds outside of nursing homes and specifically for assisted living. The transition from private pay to government pay is already under way in the assisted living facilities sector, and over time a higher percentage of revenues will probably flow to this sector from state and federal programs. The assisted living industry has been very active in lobbying state and federal governments for receipt of these funds. The growing level of state and federal funding will provide a primary growth vehicle for the industry. If the 10 percent of nursing home patients eventually migrate into the assisted living environment, it will increase the industry's current size by about 40 percent and provide an ongoing level of industry growth in the future.

21_769193 ch17.qxp 5/18/06 8:27 PM Page 213

Retirement Care Communities

Retirement care communities, also known as *continuing care communities,* account for approximately 10 percent of health care REIT investments and health care properties. This area deserves some analysis because it has a different operating imperative than the assisted living or skilled nursing sectors. When reviewing the spectrum of senior housing alternatives, retirement communities lie in the middle. At the beginning of the spectrum is senior housing, where adults rent units in an age-restricted community but receive few or no additional services.

Retirement communities provide basic services such as meals, transportation, and housekeeping, but otherwise allow residents to conduct their lives in a fairly independent manor. Therefore they provide fewer services than assisted living but more than age-restricted or adult communities.

The retirement care industry consists of approximately 5,500 communities across the country, many of which were built in the 1980s as a result of anticipated market demand. This demand was expected from a demographic segment that would have suggested a rapid growth in the over-65 population in the late 1980s and mid-1990s. Market demand was largely overestimated during that period because residents were typically much older than originally anticipated. The overbuilding of retirement communities resulted from the expectation of demand from people in the 65-to-75 age group, when the reality was the average age of the retirement community resident was 82 years or older.

Retirement communities have found that they are subject to a certain softness in demand in the spectrum of housing available to senior citizens. Many elderly persons do not consider a retirement community as a desirable residential situation. Most seniors who might live in a retirement community could also live independently in their home. Thus many older people are reluctant to leave their homes and only do so when there is no alternative in terms of their required assistance in daily activities. This tends to move seniors further down the spectrum into either assisted living or skilled nursing care, and they largely avoid retirement communities all together. Those seniors who do move to retirement facilities often do so as a lifestyle choice and find the atmosphere from a social and economic perspective more beneficial than maintaining their own separate residence.

21_769193 ch17.qxp 5/18/06 8:27 PM Page 214

Because retirement community care is more elastic than the demand for long-term care, it is difficult to quantify the acceptable investment return levels. Therefore selective investments in retirement care communities may provide acceptable returns, but REITs have been reluctant overall to invest in this sector. Many retirement care communities have transformed themselves into *congregate care retirement communities.* These communities combine retirement care, assisted living, and nursing facilities all in one building or in a single campus setting. The goal is to provide an environment in which the elderly can remain in place throughout their senior years. There are an estimated 2,200 congregate care retirement communities nationwide. The economic risk of these communities often requires that they be run more like an insurance vehicle rather than a real estate vehicle. Congregate care retirement communities provide for a large prepayment or endowment in exchange for a guarantee of continuing care for the balance of a resident's life. As a result, these communities generally appeal to elderly persons of higher financial means who plan to stay for the remainder of their lives. The more stable private-pay nature of these communities can make them unattractive investment opportunities for health care real estate investors.

Acute Care Hospitals

Acute care hospitals make up about 10 percent of the investment of health care REITs. In recent years, health care REITs have generally focused on lower-cost providers rather than acute care hospitals. This is primarily because Medicare, Medicaid, and managed care companies have targeted acute care hospitals as part of their cost cutting.

Acute care hospitals provide medical and surgical care for the population as a whole. The acute care hospital industry consists of about 5,300 hospitals with about 875,000 beds nationwide. One-third of all health care service spending takes place in acute care hospital facilities. The costs of acute hospital care are high, averaging about $1,200 per day, making the acute care industry one of the primary targets for cost cutting.

There has been a trend among acute care hospitals for shorter stays and lower occupancy levels. As a result, revenues from inpatient services have been largely flat or only consistent with CPI for the last five years. In contrast, outpatient revenues have been growing at a rate of 10 to 12

21_769193 ch17.qxp 5/18/06 8:27 PM Page 215

percent per year as hospitals have responded to the requirements to provide more cost-efficient services and therefore have moved many procedures to outpatient status.

The acute care hospital industry is somewhat fragmented, but not as fragmented as other health care sectors. Publicly held acute care hospitals account for about 14 percent of all hospital beds, with the top 10 acute care hospital systems accounting for about 15 percent of all hospital beds. Although publicly traded for-profit hospital companies account for a large percentage of hospital beds, the majority of the industry consists of nonprofit hospitals affiliated with religious and secular organizations. Consolidation is ongoing among for-profit and not-for-profit hospitals because of the large cost savings normally generated by economies of scale in the hospital industry.

Because of the economic trends impacting acute care hospitals, health care REITs have not been actively investing in this sector. Because of their high cost structure, hospitals remain very much the target of competitors attempting to provide less costly delivery systems. Even in such areas as surgery and critical care, other providers are now available to provide less costly and more focused businesses such as outpatient surgery or specialty care hospitals. These facts tend to leave health care REITs largely uninterested in investing in acute care hospitals.

Rehabilitation Hospitals

Rehabilitation hospitals make up approximately 8 percent of health care REIT investments. These investments originated in the 1980s, when rehabilitation hospitals were viewed as a lower-cost alternative to acute care hospitals. During the 1990s, however, rehabilitation hospitals have come under some level of scrutiny.

Rehabilitation hospitals provide treatment aimed at correcting physical and cognitive disabilities often due to work or sports injuries or accidents. The industry consists of approximately 200 facilities with about 18,000 beds. Rehabilitation hospitals compete with outpatient treatment centers and inpatient rehabilitation centers located at acute care hospitals.

Rehabilitation hospitals are generally subject to Medicare cost reimbursement systems, in contrast to Medicare's perspective payment system,

21_769193 ch17.qxp 5/18/06 8:27 PM Page 216

which is a fixed-fee system applicable to acute care hospitals. Managed care plans have been exerting pressure on rehabilitation hospitals to keep costs down by contracting for large, continuous blocks of service for certain procedures. Unlike other areas of the health care services business, which are highly fragmented, the rehabilitation health care service sector has several dominant players. It is unlikely that REITs will make any new investments in the rehabilitation hospital area, given that the high-cost segment is subject to many of the same managed care pressures as the acute hospital sector.

Psychiatric Care Hospitals

Psychiatric care hospitals make up about 3 percent of the assets of health care REITs. Psychiatric hospitals provide inpatient treatment for behavioral disorders, drug addiction, and alcohol abuse. The industry consists of about 340 facilities with 34,000 beds. Facilities compete with outpatient treatment programs and with acute care hospital segments dedicated to the same services. The fallout from the industry's excess capacity has decreased the number of operators; four operators now account for about 60 percent of the total beds. Occupancies are low and operators continue to report pricing pressures from managed care plans.

Medical Office Buildings/Physicians Clinics

Medical office buildings make up on average about 9 percent of the assets of health care REITs. Medical office buildings are properties that contain physician's offices and diagnostic service providers. These buildings come in two varieties. Some are located at or near acute care hospitals and are leased entirely to the hospital, which in turn re-leases space to individual physicians, often at a low cost, as an incentive for physicians to locate their practices within the building. In these cases, the medical office buildings are really a part of the hospital's health care delivery system. As a result, investment in this type of medical office building is completely dependent on the credit strength of the hospital operator.

21_769193 ch17.qxp 5/18/06 8:27 PM Page 217

In the other situation, medical office buildings are leased directly to medical practitioners and small group practices on a multi-tenant basis. These medical office buildings may be located near a hospital or may be independently located within a community. In either case, these buildings carry a somewhat higher level of risk from an investment standpoint due to the lower credit quality of the independent physician tenant. In addition, these types of buildings experience greater leasing turnover and probably have a higher level of recurring capital expenditures. Managed care is also driving many small physician groups to lower margins or even to affiliation with larger managed care providers, therefore making the credit quality of medical office buildings populated by individual physician tenants to be a declining proposition at best.

Physicians' clinics are facilities leased to a single physician's practice, rather than to several solo group practices. These practices may be long-standing local or regional business enterprises, or they may be newer affiliates of national physician practice management companies. The tenant credit quality is generally better than that of unaffiliated group practices. Ancillary hospital facilities, typically adjacent to a hospital, are medical office buildings that contain not only physicians' offices but also space for additional services such as outpatient surgery, medical labs, or rehabilitation. These facilities may also house hospital administrative departments or hospital pharmacies and are typically leased to hospital operators but may be leased to a third-party investor that, in turn, subleases space to the hospital and the physicians.

The investment quality depends on the credit strength of the tenant or subtenants and on the long-term stability of the adjacent hospital. There are an increasing number of ancillary hospital facilities in remote locations from hospitals. These facilities are designed to provide a spectrum of medical services in a different market while drawing on the brand recognition or regional dominance of the hospital system. These are most typically leased to investor managers who, in turn, sublease the space to the hospital.

Because these medical office buildings and ancillary hospital facilities are such an integral part of the hospital health care delivery system, REITs are likely to continue to increase their exposure selectively to this segment. While medical office buildings in general carry a higher level of

21_769193 ch17.qxp 5/18/06 8:27 PM Page 218

risk than other health care properties, the total return on a medical office building tends to be somewhat higher than that for other health care real estate segments.

Expected Returns for Health Care REITs

Unlike other REITs, which actively manage property, REITs in the health care area create a structural rate of return at the time of their initial investment in a specific health care property. The management of a health care REIT has little ability to create any more internal growth than is initially structured into the deal. In the past, the most common arrangement for payment escalation was a percentage of operating revenue above a base level, which typically resulted in internal growth rates of 3 to 6 percent. Percentage of revenue escalations frequently include a cap such that, after a certain transition point, the health care REIT will participate at a lower level in rental growth (usually 1 to 2 percent). More recent deals have been structured with fixed percentage increases of 2 to 3 percent that are constant throughout the life of the financing. This is driven by competition among REITs and also by the desire of health care REITs to obtain more predictable cash flows. Across the health care real estate spectrum, it is expected that unleveraged internal growth should run in the 2 to 3 percent range for health care REITs. As a result, health care REITs are looking more and more to external projects to help stimulate growth.

External Growth

In view of the slower pace of internal growth, health care REITs, are looking more toward external growth projects to provide added value for their shareholders. Several key management factors determine a health care REITs ability to create high risk-adjusted returns through external growth projects. Management's knowledge of the health care segment is very important to sustaining external growth at a reasonable risk level. Another factor is management's ability to access low-cost capital from the capital markets. In addition, management's ability to manage the risk exposure level of a given new project is also important when evaluating health care REIT operators. The final factor is management's ability to

21_769193 ch17.qxp 5/18/06 8:27 PM Page 219

evaluate the credit quality of a health care service provider when reviewing the external growth prospects of a health care REIT.

The fragmented nature of health care real estate ownership and operation suggests that health care REITs will have ample opportunities for future investment in a consolidating health care industry. External growth in the health care REITs' traditional niche long-term care is also becoming more difficult as health care REITs grow larger and outside competition for these financings grows more intense. This has fueled a trend in which health care REITs will increasingly turn to more diverse opportunities such as medical office buildings or specialty care facilities involved in faster-growing segments of the health care arena in order to create added value for shareholders through higher external growth rates. It should be noted that these alternatives tend to carry a higher level of risk, both financial and market risk, and may be more management intensive when taken in total.

Summary Data

Like hotel REITs, health care REITs tend to have big up and down price movements. Unlike the hotel sector, however, the health care sector has managed to deliver modestly good incremental returns. Over the past five years, returns on health care REITs have averaged 32.5 percent (see Table 17.1).The volatility of the sector as measured by the standard deviation of returns is 37.7 percent, making it the second most volatile of the property REIT sectors behind hotels. The political outlook for the health care delivery system and the demographics of the local population drive the performance of this sector.

Points to Remember

- Health care REITs represent approximately 5 percent of the National Association of Real Estate Investment Trusts Equity Index.
- Health care REITs are typically an overlooked sector of the REIT universe.
- Health care makes up 13 percent of the U.S. gross domestic product.

TABLE 17.1 Historical Sector Data for Health Care REITs (as of December 2005)

	2005	*2004*	*2003*	*2002*	*2001*	*2000*	*1999*	*1998*	*1997*
Panel A									
Total return on sector	1.8%	21.0%	53.6%	−3.1%	43.2%	25.8%	−24.8%	−17.5%	15.8%
Dividend yield	6.5%	6.2%	7.6%	7.8%	6.8%	15.9%	7.1%	6.2%	8.2%
Estimated NAV		114.0%	123.0%	112.0%	104.0%	91.0%	72.0%	108.0%	132.0%
Panel B									
Market cap of sector ($ billion)	$15.12								
Index weight	4.9%								
All other sectors	95.1%								
Volatility	37.7%								
5-year return	32.5%								

Source: Uniplan, Inc.

21_769193 ch17.qxp 5/18/06 8:27 PM Page 221

- Health care REITs operate in a complex regulatory environment.
- The aging U.S. population should drive continued growth in the health care sector.
- Health care REITs offer the chance to participate in the growth of health care services with less risk.
- One-half of all health care REIT investments are in nursing homes.
- One-half of health care REIT investments are in medical office buildings, hospitals, and clinics.

Chapter 18

Self-Storage REITs

Only in America would people rent a place to store boxes packed full of stuff they can't remember.

—Yakov Smirnov, 1998

According to the self-storage industry association, there are 58,000 self-storage locations across the country, totaling 8.5 million self-storage units. Self-storage real estate investment trusts (REITs) represent about 4 percent of the capitalization of the National Association of Real Estate Investment Trusts (NAREIT) Equity Index (see Figure 18.1). There are four publicly traded REITs in the self-storage sector, with an aggregate market capitalization in excess of $6 billion.

The Self-Storage Sector

The real estate segment known as self-storage is very much like the manufactured housing community segment. By first appearance, self-storage seems to be far less interesting and less dynamic than other segments of the real estate market. However, once economic occupancy is achieved, the self-storage center becomes a very stable and consistent money-making opportunity. The origins of the self-storage industry in the United States can be traced back to the late 1950s, when a number of self-storage facilities were built in the Southwest. These facilities were targeted at military personnel who were required to relocate frequently. Since then, the demand for self-storage space has been driven by the general nature of the American consumer to accumulate large quantities

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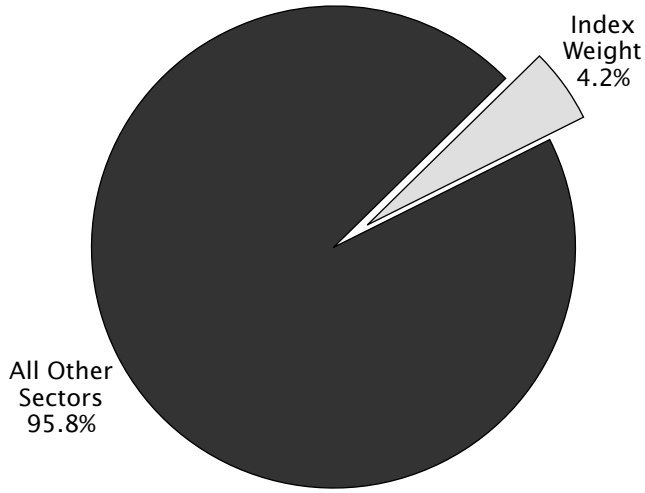

FIGURE 18.1 Self-Storage REITs as a Percentage of the NAREIT Equity Index
Source: Uniplan, Inc.

of material goods. In addition, the increased mobility of the American population, along with higher numbers of apartment and condominium residential units, has created a need for easily accessible storage of consumer items.

Self-storage operations are generally located at high-visibility intersections and along high-traffic corridors in major urban areas. In the early era of the self-storage industry, these complexes were designed to help create a revenue stream from vacant land. The intention was to populate a vacant parcel of real estate with self-storage units that created a rental income stream. The idea was to create revenue for a certain period of time and then to develop the real estate into a higher and better use. Interestingly, the landowners found that, over a long period of time, the return on capital invested in self-storage was often very competitive with the returns of other real estate investment activities. This not only led to a proliferation of new self-storage properties, but also to the conversion of older multilevel buildings, which were often obsolete, into self-storage facilities.

The practical market area for a self-storage property is usually a radius of five to seven miles around the existing site. Because of the limited market nature of the self-storage property, it is important that a high level of care be taken when selecting the self-storage site. Self-storage operators attempt to locate their properties on high-visibility roads with

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access to small business as well as high-density residential areas. This allows the self-storage operator to target the two primary users of the facility. Residential customers typically comprise two-thirds to three-quarters of unit users, and one-quarter to one-third of unit users tend to be small business customers.

Self-storage units are typically large continuous units of garagelike structures with separate overhead garage-door access for each tenant. Self-storage customers rent fully enclosed storage units for their personal use. These units range in size from 5 × 5 feet to 20 × 20 feet, with varying sizes in between. Most self-storage facilities are fully enclosed by fencing and have on-site management. Access is provided 24 hours a day, seven days a week through digitally controlled security gates that allow renters to enter and exit using a security code system. Access to individual units is controlled by the unit renter through the use of padlocks or combination locks provided by the renter.

The renters of self-storage units indicate that the primary consideration when looking for self-storage units is a location that is nearby the self-storage user. The security provided at the property tends to be the second most important factor, followed by the ease of accessibility and availability of the suitable rental space. Rental rates in most markets are not among the top five factors listed by self-storage users. This relatively low sensitivity to rental rates often translates into a high per-square-foot rental revenue when compared with other property types.

The self-storage business is a highly fragmented industry with many different quality levels and many different types of owner/operators. The vast majority of self-storage operations are owned and operated by individuals. It is estimated that REITs own approximately 12 percent of all self-storage units. Other estimates suggest that as much as 48 percent of units are owned and operated by individuals. The remaining 40 percent is owned and operated by small businesses, limited partnerships, and real estate operating companies. Institutional investors other that REITs own less than 2 percent of all self-storage units. Because of the low barriers to entry into the self-storage business, along with the modest capital requirements to begin a self-storage operation, competition within this segment of the real estate industry is quite high. The image of the industry has kept most traditional institutional real estate investors from participating at a significant level. The low barriers to entry have kept the industry relatively fragmented.

22_769193 ch18.qxp 5/18/06 8:28 PM Page 226

Trends in the Self-Storage Industry

During the last five years, the self-storage industry has moved toward building climate-controlled units in various markets. Climate-controlled spaces offer tenants the option of leasing storage space within which the storage operator will guarantee a constant temperature and humidity. This lends itself to the storage of items of higher value. The demand for climate-controlled space started in the southeastern United States, where demand has been the highest, and has spread throughout the country. Currently climate-controlled space represents about 3 percent of the self-storage space available but is growing much faster than regular self-storage space.

The self-storage industry has struggled with many of the same issues as the manufactured housing industry. The primary concern is the creditability of self-storage as a long-term real estate option. As the self-storage industry has spread, the general consumer market has become more familiar with the industry. In some regions, familiarity has led to a higher level of consumer acceptance than in others. Again, the southwestern United States, the region where self-storage in the United States began, is also the region with the highest level of self-storage awareness among consumers.

Newer self-storage facilities emphasize esthetics and construction designs that attempt to blend with the nature of the neighborhood that they serve. Landscaping has also become a prime consideration in the development of new self-storage facilities. In addition, the development of self-storage has been tailored to work in conjunction with planned office, industrial, and retail parks, combining office space or industrial space with storage as a part of the overall design concept.

Summary Data

The nature of the self-storage sector makes it behave like a blend of industrial and residential real estate. The physical nature of the buildings is much like that for industrial real estate.

The lease structure, typically an annual term, is similar to that of the residential sector. Over the last five years the self-storage REIT sector produced an average annual return of 27.7 percent (see Table 18.1).The volatility of the sector as measured by the standard deviation of returns

TABLE 18.1 Historical Sector Data for Self-Storage REITs (as of December 2005)

	2005	*2004*	*2003*	*2002*	*2001*	*2000*	*1999*	*1998*	*1997*
Panel A									
Total return on sector	26.6%	29.7%	38.1%	0.6%	43.2%	14.7%	–8.0%	–7.2%	15.8%
Dividend yield	3.6%	4.8%	7.1%	5.7%	6.8%	8.2%	6.0%	3.7%	8.2%
Estimated NAV	139.0%	131.0%	136.0%	108.0%	114.0%	78.0%	79.0%	108.0%	132.0%
Panel B									
Market cap of sector ($ billion)	$14.45								
Index weight	4.7%								
All other sectors	95.3%								
Volatility	27.8%								
5-year return	27.7%								

Source: Uniplan, Inc.

22_769193 ch18.qxp 5/18/06 8:28 PM Page 228

was 27.8 percent, making it a stable sector with returns that exceed those for industrial real estate. The demand for self-storage and the performance of the sector will rise and fall primarily with general economic growth.

Points to Remember

- The total value of all self-storage facilities in the United States is estimated to be $6 billion.
- REITs own an estimated 12 percent of all self-storage units.
- Self-storage REITs represent 4 percent of the National Association of Real Estate Investment Trusts Equity Index.
- Demand for self-storage is driven by a more mobile population living in smaller dwellings.
- Location and ease of access are the features that local self-storage consumers deem most important.
- Returns for self-storage REITs are stable and higher than those for many other REIT sectors.

Chapter 19

Other REIT Sectors

The big house on the hill surrounded by mud huts has lost its awesome charm.

—Wendell Wilkie, 1940

There are a select group of real estate investment trusts (REITs) contained in other sectors within the National Association of Real Estate Investment Trusts (NAREIT) Index. These REITs, which make up about 13 percent of the NAREIT Index, fall into three categories:

1. Specialty REITs
2. Diversified REITs
3. Mortgage REITs

Specialty REITs

Specialty REITs represent approximately 3 percent of the NAREIT Equity Index (see Figure 19.1). The specialty REIT sector comprises eight publicly traded REITs.

Specialty REITs engage in various activities, all of which are real estate-related but more highly focused than other REIT categories. For example, the ownership of timber-producing properties is represented in the specialty sector of the index. The ownership and operation of movie theaters, golf courses, prisons, gas stations, and automobile dealerships, and the rental of rooftops for the use in wireless communications are other specialty REIT sectors.

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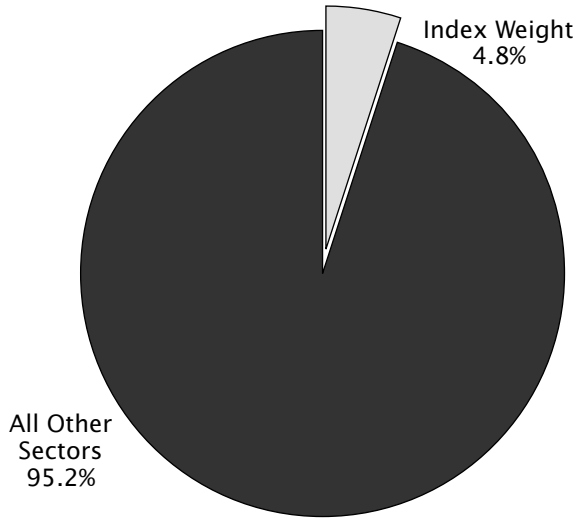

FIGURE 19.1 Specialty REITs as a Percentage of the NAREIT Equity Index
Source: Uniplan, Inc.

The specialty REIT sector has had operating problems. Because these REITs are considered out of the mainstream and are very focused in their operational objectives, specialty REITs are often considered supplemental to more mainstream real estate opportunities. The specialty category often reflects a real estate-related trend that might be going on in the broader economy.

During the early 1990s, the specialty REITs with the highest expectation were the golf course REITs. There were three publicly traded golf course REITs. The golf course industry had a number of characteristics that made it appealing to the specialty REIT segment. It showed positive demographic and growth trends. Between 1982 and 1995, the number of golfers increased from 16 million to 32 million, a 100 percent increase. The number of rounds of golf played in the United States increased by approximately 40 percent during the same period. Despite the tremendous growth in the number of golfers and the rounds of golf played, the number of golf courses only grew by approximately 10 percent. Since the mid-1990s, the situation has reversed itself. New golf courses continue to be developed while the number of golfers has remained relatively flat. The supply and demand equation has reached a state of equilibrium, and it is expected that demographic trends such as the retirement of Baby Boomers will continue to drive the demand for golf.

Table 19.1 provides historical data for specialty REITs.

TABLE 19.1 Historical Sector Data for Specialty REITs (as of December 2005)

	2005	*2004*	*2003*	*2002*	*2001*	*2000*	*1999*	*1998*	*1997*
Panel A									
Total return on sector	10.4%	26.9%	38.6%	–5.4%	7.6%	–31.6%	–25.7%	–24.3%	15.8%
Dividend yield	5.3%	6.2%	7.0%	5.5%	9.8%	3.1%	6.7%	4.4%	8.2%
Estimated NAV	107.0%	110.0%	98.0%	88.0%	89.0%	68.0%	71.0%	96.0%	132.0%
Panel B									
Market cap of sector ($ billion)	$14.49								
Index weight	4.8%								
All other sectors	95.2%								
Volatility	20.9%								
5-year return	19.5%								

Source: Uniplan, Inc.

23_769193 ch19.qxp 5/18/06 8:28 PM Page 232

Diversified REITs

Diversified REITs are REITs that own a portfolio of diversified property types. These REITs, which make up 8.6 percent of the NAREIT Index (see Figure 19.2), normally focus on a specific geographic region and own a diversified portfolio of properties within that geographic region. The idea behind the diversified is to focus on a specific property market from a geographic point of view and know and understand the dynamics of all the real estate activity within that market. This will lead the operator of a diversified REIT portfolio within a specific geographic market to gain a market knowledge advantage over other REITs or other real estate investors that may not be as focused on the region.

There are just a few larger diversified REITs, and their size and scale within a particular geographic focus makes them of interest. Smaller diversified REITs are typically too small to create any significant interest on Wall Street. They are likely to be merger candidates; however, because they maintain diversified portfolios, REITs that focus on specific property sectors may not be interested in acquiring them. The trend among diversified REITs is actually to focus more specifically on a particular property sector within a geographic region and recycle portfolio capital

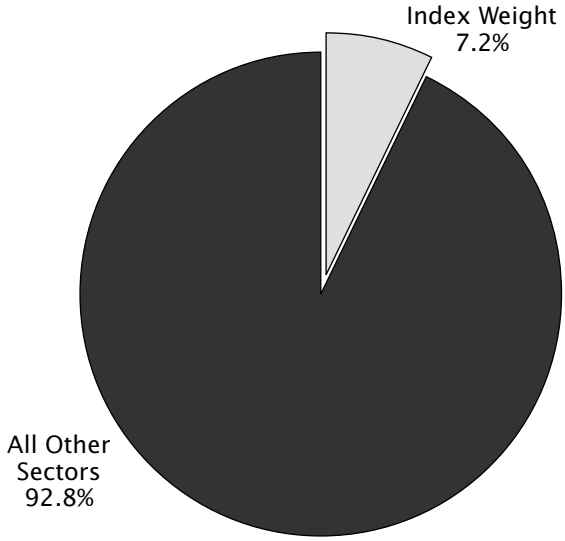

FIGURE 19.2 Diversified REITs as a Percentage of the NAREIT Equity Index
Sources: National Association of Real Estate Investment Trusts; Uniplan, Inc.

23_769193 ch19.qxp 5/18/06 8:28 PM Page 233

out of those noncore property types into the core property holdings. For example, a REIT that owns community shopping centers and apartment buildings within a specific geographic region may make the decision to sell its apartment holdings and recycle that capital into community shopping centers in order to more narrowly focus the investment activities of the REIT.

Historically, many REITs began as portfolios of a single property category focused within a geographic region. These single-property category REITs were eventually absorbed into larger REITs with the same single-property focus in other geographic regions. The result of this has been the creation of the super-regional and nationally focused REITs. Table 19.2 provides historical data for diversified REITs.

Mortgage REITs

Mortgage REITs represent 3 percent of the NAREIT Index (see Figure 19.3). During the late 1960s and early 1970s, mortgage REITs dominated the REIT industry. Essentially, mortgage REITs stood in place of commercial banks as the primary lending source for real estate developers. Many mortgage REITs were affiliated with bank holding companies. The joke within the industry at the time was that if you could not get construction financing by going through the front door of the bank, you could go in through the side door and talk to the bank's REIT about that same construction financing, and normally you would get it. As mentioned in Chapter 2, the mortgage REIT era came to a bad ending in the recession of 1973 and 1974 when higher interest rates and the inability of developers to obtain permanent financing created widespread defaults in the mortgage REIT industry.

mortgage REIT
a REIT that makes or owns loans and other obligations that are secured by real estate as collateral.

The mortgage REITs of today are vastly different from those of the 1960s and 1970s. It could be argued that there may be more efficient mortgage investment vehicles than REITs. However, mortgage REITs have developed into vehicles that finance specific niche areas.

Mortgage REITs may originate mortgage loans on income-producing commercial real estate, create syndications or pools of mortgages on commercial properties, or originate and package for resale mortgages on

TABLE 19.2 Historical Sector Data for Diversified REITs (as of December 2005)

	2005	*2004*	*2003*	*2002*	*2001*	*2000*	*1999*	*1998*	*1997*
Panel A									
Total return on sector	9.9%	32.4%	40.3%	1.5%	8.6%	24.1%	–14.4%	–22.1%	15.8%
Dividend yield	5.2%	9.8%	11.2%	5.4%	7.5%	8.9%	9.3%	3.9%	8.2%
Estimated NAV	106.0%	119.0%	96.0%	84.0%	88.0%	92.0%	84.0%	112.0%	132.0%
Panel B									
Market cap of sector ($ billion)	$24.30								
Index weight	7.2%								
All other sectors	82.8%								
Volatility	26.5%								
5-year return	25.0%								

Source: Uniplan, Inc.

23_769193 ch19.qxp 5/18/06 8:28 PM Page 235

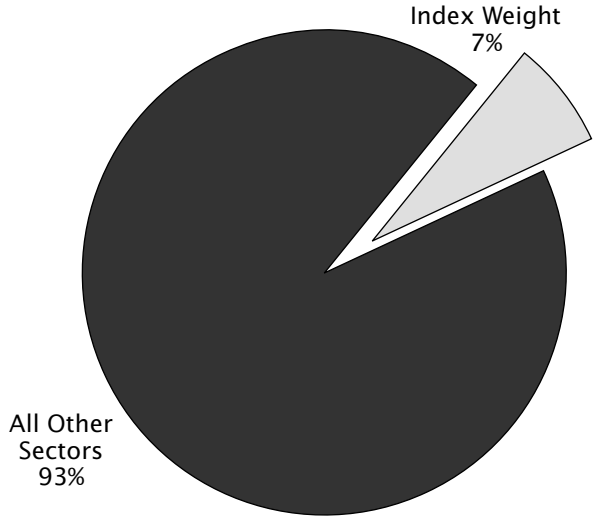

FIGURE 19.3 Mortgage REITs as a Percentage of the NAREIT Equity Index
Source: Uniplan, Inc.

single-family residential homes. In general, mortgage REITs tend to specialize in what are known as *nonconforming loans.* These are mortgage loans on residential or commercial properties that do not meet the criteria to be packaged into pools of mortgage-backed securities that are then sold in the mortgage-backed securities markets. Nonconforming loans are typically held in the loan portfolios of the lenders that originate them with no opportunity to package and resell the mortgage. As a result, many mainstream lenders do not make nonconforming mortgage loans.

The focus of current mortgage REITs is far more conservative than that of the mortgage REITs of the early REIT era. The principal concern of mortgage REITs is typically with the quality of the borrower and the value of the underlying real estate, which the mortgage will collateralize. Real estate investment trusts that originate and create mortgage loans establish underwriting guidelines and criteria that define the risk level of the mortgages they undertake. The acceptable credit standard of the borrower and the value of the collateral vary widely between mortgage REITs. Some attempt to manage the risk in a mortgage portfolio by requiring government or private insurance on the underlying mortgage.

Government mortgage insurance programs originated during the Depression as part of the federal government's effort to stimulate the

23_769193 ch19.qxp 5/18/06 8:28 PM Page 236

domestic economy. This mortgage insurance was made available through a federal agency called the Federal Housing Administration (FHA). Since the Depression, the FHA has had a positive affect on the mortgage industry by helping to create an active, standardized market for mortgage securities and instruments. This has allowed lending institutions to package and sell their mortgages into the capital markets, thereby recycling capital and making more money available for real estate investment activities.

Private mortgage insurance is also available through a large number of private mortgage insurance companies. Private mortgage insurers tend to offer products that are available to different segments of the mortgage marketplace. Private mortgage insurance is often preferred over government mortgage insurance because the terms and conditions required under private mortgage insurance are often more flexible than those of government mortgage insurance programs. Lower down payments and higher debt-to-equity ratios often make private mortgage the only alternative under some mortgage scenarios.

Some mortgage REITs accomplish risk management through the packaging and sale of their secured mortgages into the commercial mortgage-backed securities marketplace. In most instances, the REIT packages the mortgages and, in conjunction with the services of a debt rating agency such as Standard & Poor's or Moody's, obtains an investment-grade debt rating on the pool of mortgages. This rating then allows the pool of mortgages to be easily sold into the commercial mortgage loan market.

To facilitate liquidity in the mortgage markets, there are several quasi-governmental agencies that are buyers of mortgage portfolios. The Federal National Mortgage Association (FNMA), often referred to as Fannie Mae; the Government National Mortgage Association (GNMA), often referred to as Ginny Mae; and the Federal Home Loan Mortgage Association (FHLMA), commonly called Freddie Mac; as well as private insurance companies, pension plans, and mutual fund portfolios are all potential buyers of securitized mortgage pools.

The secondary market for mortgage portfolios is very large. Savings and loans, commercial bankers, mortgage bankers, and credit unions all participate to some extent in the commercial mortgage-backed markets. Secondary markets have developed not only for single-family mortgages, but for multifamily commercial properties as well. Fannie Mae and Freddie Mac have programs that guarantee mortgages on multifamily

23_769193 ch19.qxp 5/18/06 8:28 PM Page 237

properties and commercial properties as part of their overall portfolio strategy. The credit and collateral risk associated with specific mortgage loans is known as specific risks. In addition, there is market risk associated with mortgage loan investments.

Market risk is principally interest rate risk in mortgage loan portfolios. Mortgage loan values move in the opposite direction of interest rates. Thus, as interest rates move higher in the market, mortgage loan portfolio values decline and, conversely, when interest rates decline in the marketplace, mortgage portfolio loan values increase. For this reason, when analyzing mortgage REITs, the interest rate environment must be considered carefully.

Some mortgage REITs specialize in *adjustable rate mortgages* (ARMs). An ARM is a mortgage that has an interest rate that is periodically adjusted according to a predetermined index. The interest rate is based on an index that typically reflects the cost of funds to the REIT. That index is then marked up or a spread is added in order to reflect a profit margin for the underlying mortgage REIT. Indexes for ARMs may be the *London Interbank Origination Rate* (LIBOR), which is the prime rate charged by commercial banks; the government bond yield; or any number of mortgage indexes that are published on a regular basis.

Usually the only factor related to the index is that it must be broad enough to be out of the control of the lender and must be readily verifiable by both the borrower and the lender. The index is used to set the base rate on the loan, and then an additional margin that represents the lenders profit is added to the index rate. The index rate may be adjusted monthly, quarterly, semiannually, or annually. Features known as *caps* and *collars* may be applied to the ARM loan. Caps limit the amount of interest rate increases over a specific period of time, and collars limit the level of decreases in interest rates over a specified period of time. Caps and collars provide some level of certainty for the borrower and the lender with regard to the minimum and maximum interest rates that can be charged on the underlying mortgage loan. Through the use of ARMs with caps and collars, a mortgage portfolio can be protected to some degree from interest rate fluctuations.

Because of the highly sophisticated nature of the commercial mortgage-backed securities marketplace, it is possible for lenders to obtain interest rate protection on their portfolios through the use of derivative financial instruments and/or interest rate swaps. This is often referred to as

23_769193 ch19.qxp 5/18/06 8:28 PM Page 238

interest rate insurance and may be affixed on a mortgage portfolio for a given period of time with a given level of protection for a predetermined price to be paid to the institution that will guarantee the insurance protection. Although a complete analysis of the mortgage-backed securities marketplace and derivative interest rate protection is beyond the scope of this book, an excellent discussion can be found in *Handbook of Financial Engineering,* by Clifford W. Smith Jr. and Charles W. Smithson (New York: Harper & Row, 1990).

Another form of mortgage loan that attempts to mitigate the market risk of increasing interest rates is known as a *participating mortgage.* In this type of mortgage, the lender will participate in the increased value of the property over the term of the mortgage and may also participate in the increasing cash flow of the property over the mortgage period as well. The idea is that in an environment of rising interest rates, typically property values and cash flows are rising as a result of inflation. This rising property value and cash flow are captured as a part of the mortgage participation, thus mitigating the long-term effect of rising interest rates on the mortgage holder. As mentioned in Chapter 8, participating mortgages are one form of partnership and joint venture remedies that can help to facilitate the real estate investment process.

Participating mortgage loans were fairly common in the inflationary era of the 1970s and 1980s. During the same period, higher levels of leverage were used in real estate transactions. Participating mortgages allowed the lender to offer lower-than-market interest rates in order to facilitate mortgage lending and higher leverage levels on properties. The lower rates allowed borrowers to acquire properties profitably at higher leverage levels and provided lenders with certain protection against rising interest rates. In the lower interest rate environment of the 1990s, participating mortgages were less typical.

In addition to rising interest rates, investors and mortgage portfolios must also be aware of the risk in a decreasing interest rate environment. Decreasing interest rates tend to create a significant level of refinancing activity in the mortgage marketplace, resulting in higher-yielding mortgage instruments being refinanced at lower interest rates to capture the current declining interest rate environment. This results in the return of mortgage proceeds to the lender, which must then reinvest those proceeds in a lower interest rate environment.

To deal with the prepayment situation in the mortgage marketplace, collateralized mortgage obligations were created. These instruments divide

TABLE 19.3 Historical Sector Data for Mortgage REITs (as of December 2005)

	2005	*2004*	*2003*	*2002*	*2001*	*2000*	*1999*	*1998*	*1997*
Panel A									
Total return on sector	–23.2%	18.4%	57.4%	31.1%	77.3%	16.0%	–33.7%	–29.3%	15.8%
Dividend yield	8.7%	10.0%	18.9%	14.9%	28.7%	12.6%	7.1%	4.8%	8.2%
Estimated NAV	109.0%	115.0%	134.0%	119.0%	121.0%	92.0%	84.0%	98.0%	132.0%
Panel B									
Market cap of sector ($ billion)	$23.96								
Index weight	7.2%								
All other sectors	92.8%								
Volatility	47.8%								
5-year return	19.5%								

Source: Uniplan, Inc.

23_769193 ch19.qxp 5/18/06 8:28 PM Page 240

a pool of mortgages into various tranches. The tranches receive the return of principal from prepayment activity at different time intervals based on which tranch is owned. Thus, holders of tranch 1 will receive prepayment principal as first priority, then prepayment principal flows to tranch 2, and so on. This division of mortgage pools into tranches provides the mortgage investors with a higher degree of certainty as to the final maturity range of their mortgage investment.

Major commercial mortgage lenders have devised an alternative method of dealing with the declining interest rate environment. Many large commercial mortgages are created on a nonprepayable basis. Thus, in the commercial mortgage marketplace, a lender may impose restrictions or prepayment penalties on a commercial mortgage in order to realize a certain fixed return on the mortgage over a given period of time. Table 19.3 provides historical data for mortgage REITs.

Points to Remember

- Specialty, diversified, and mortgage REITs make up the balance of the National Association of Real Estate Investment Trusts Index.
- Specialty REITs are engaged in various real estate-related activities but are more highly focused than other REITs.
- The specialty REIT sector has had operating problems in the past.
- Specialty REITs represent 3 percent of the NAREIT Equity Index.
- Timber REITs are the largest and fastest-growing group within the specialty category.
- Returns for the specialty REIT sector have been more volatile than those for other REIT sectors.
- Diversified REITs own a portfolio of varied properties with a specific geographic focus and are often smaller market capitalization REITs.
- Mortgage REITs have developed into vehicles that finance specific niche areas in the real estate industry.
- Mortgage REITs must manage credit risk and interest rate risk.
- Mortgage REITs have the most volatile returns of all REITs.

Appendix A

Real Estate Mutual Funds

ABN-AMRO Real Estate Fund

http://www.abnamro.com
1-800-443-4725

Advantus Real Estate Securities Fund

http://www.advantusfunds.com
1-800-665-6005

AIM Real Estate Fund

http://www.aiminvestments.com
1-800-959-4246

AllianceBernstein Real Estate

http://www.alliancecapital.com
1-800-227-4618

24_769193 appa.qxp 5/18/06 8:28 PM Page 242

Alpine Funds

Alpine International Real Estate Equity Fund
Alpine Realty Income and Growth Fund
Alpine U.S. Real Estate Equity Fund
http://www.alpinefunds.com
1-888-785-5578

American Century Real Estate Investments

http://www.americancentury.com
1-800-345-3533

AssetMark Real Estate Securities

1-888-278-5809

Brazos/JMIC Real Estate Securities

http://www.brazofund.com
1-800-426-9157

Brown Advisory Real Estate Fund

http://www.brownadvisory.com
1-800-540-6807

CDC Nvest AEW Real Estate Fund

http://www.cdnvestfunds.com./fund_info/aew_realestate.asp
1-800-862-4863

CGM Realty Fund

http://www.cgmfunds.com
1-800-345-4048

Cohen & Steers Funds

Cohen & Steers Institutional Realty Fund
Cohen & Steers International Realty Fund

24_769193 appa.qxp 5/18/06 8:28 PM Page 243

Cohen & Steers Realty Focus Fund
Cohen & Steers Realty Income Fund
Cohen & Steers Realty Shares
http://www.cohenandsteers.com
1-800/437-9912

Columbia Real Estate Securities

http://www.columbiafunds.com
1-800/547-1707

Davis Real Estate Funds

1-800-279-0279

Delaware Funds

Delaware Pooled Real Estate Investment Trust I
Delaware Pooled Real Estate Investment Trust II
Delaware REIT Fund
Delaware REIT Institutional Fund
http://www.delawarefunds.com
1-800-231-8002

Deutsche Real Estate Securities

http://www.dfafunds.com
1-800-730-1313

DFA Real Estate Securities

1-310-395-8005

Dividend Capital Realty Income Fund

1-866-DCG-REIT

Dividend Capital Securities

http://www.dividendcapital.com

24_769193 appa.qxp 5/18/06 8:28 PM Page 244

EII Realty Securities Fund

1-888-323-8912

Excelsior Real Estate Funds

http://www.excelsiorfunds.com
1-800/446-1012

FBR Realty Fund

1-888-888-0025

Fidelity Real Estate Investment

http://www.fidelity.com
1-800-544-8888

First American Real Estate Investment Securities

http://www.firstamericanfunds.com
1-800-677-3863

Firstar Select REIT Fund

1-800-677-3863

Forward Uniplan Real Estate Investment Fund

http://www.forwardfunds.com
1-800-999-6809

Franklin Real Estate Fund

http://www.franklintempleton.com
1-800-342-5236

Frank Russell Real Estate Securities

http://www.russell.com
1-800-787-7354

24_769193 appa.qxp 5/18/06 8:28 PM Page 245

Fremont Real Estate Securities Fund

http://www.fremontinstitutional.com
1-800-548-4539

Gabelli Westwood Realty Fund

http://www.gabelli.com
1-800-937-8966

GMO REIT Fund

http://www.gmo.com/index.html
1-617-346-7641

Goldman Sachs Real Estate Fund

http://www.gs.com
1-800-621-2550

Heitman Real Estate REIT Portfolio

http://www.heitman.com
1-877-826-5465

ING Equity Trust Real Estate Fund

1-800-334-3444

Inland Real Estate Income and Growth Fund

1-800-828-8999

INVESCO Advisor Real Estate Opportunity Fund

http://www.invescofunds.com
1-800-525-8085

John Hancock Real Estate Funds

1-800-225-5291

24_769193 appa.qxp 5/18/06 8:28 PM Page 246

Johnson Realty

1-800-541-0170

Kensington Funds

Kensington Real Estate Securities
Kensington Select Income Fund
Kensington Strategic Realty Fund
http://www.kig.com
1-800-253-2949

LaSalle U.S. Real Estate Fund

1-800-527-2553

Lend Lease Funds

Lend Lease European Real Estate Securities Fund
Lend Lease U.S. Real Estate Securities Fund
http://www.lendlease.com
1-877-563-5327

Mercantile Diversified Real Estate Fund

http://www.firstarfunds.com
1-800-551-2145

Merrill Lynch Real Estate Funds

1-800-995-6526

Morgan Stanley Institutional Real Estate Fund

http://www.morganstanley.com
1-800-548-7786

Munder Real Estate Equity Investment Fund

http://www.munder.com
1-800-469-6337

24_769193 appa.qxp 5/18/06 8:28 PM Page 247

Neuberger Berman Real Estate Fund

http://www.nbfunds.com
1-800-877-9700

Oppenheimer Real Estate Fund

http://www.oppenheimerfunds.com
1-888-470-0862

PBGH REIT Fund

http://www.pbghfunds.com
1-800-433-0051

Phoenix-Duff & Phelps Real Estate Securities

http://www.phoenixfunds.com
1-800-243-4361

Phoenix Seneca Real Estate

http://www.senecacapital.com
1-800-403-5000

Pioneer Real Estate Shares

http://www.pioneerfunds.com
1-800-225-6292

Principal Real Estate Fund

http://www.principal.com./funds/index.htm
1-800-247-4123

ProFunds Ultra Real Estate Ultrasector

http://www.profunds.com
1-888-776-3637

Scudder RREEF Real Estate Securities

http://www.scudder.com
1-888-897-8480

24_769193 appa.qxp 5/18/06 8:28 PM Page 248

Security Capital Real Estate Shares

http://www.securitycapital.com
1-888-732-8748

Spirit of America Investment Fund

1-800-367-3000

SSGA Real Estate Equity Fund

http://www.ssga.com
1-800-647-7327

Strategic Partners Real Estate Securities

http://www.prudential.com
1-800-225-1852

Stratton Monthly Dividend REIT Shares

http://networth.galt.com/www/home/mutual/100/s
1-800-634-5726

T. Rowe Price Real Estate Fund

http://www.troweprice.com
1-800-638-5660

Third Avenue Real Estate Fund

http://www.thirdavenuefunds.com
1-800-443-1021

Undiscovered Managers Fund

http://www.undiscoveredmanagers.com
1-888-242-3514

Vanguard REIT Index Portfolio

http://www.vanguard.com
1-800-662-7447

24_769193 appa.qxp 5/18/06 8:28 PM Page 249

Van Kampen Real Estate Securities Fund

http://www.vankampen.com
1-800-421-5666

Victory Real Estate Investment Fund

http://www.victoryfunds.com
1-800-539-3863

Wells S&P REIT Fund

http://www.wellsref.com
1-800-282-1581

Appendix B

Real Estate Investment Trusts

Company	*Ticker Symbol*	*Stock Exchange*
Acadia Realty Trust	AKR	NYSE
1311 Mamaroneck Avenue, #260		
White Plains, NY 10605		
(914) 288-8100		
www.acadiarealty.com		
Affordable Residential Communities	ARC	NYSE
600 Grant Street, Suite 900		
Denver, CO 80203		
(303) 291-0222		
www.aboutarc.com		
Agree Realty	ADC	NYSE
31850 Northwestern Highway		
Farmington Hills, MI 48334		
(248) 737-4190		
www.agreerealty.com		

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25_769193 appb.qxp 5/18/06 8:28 PM Page 252

Company	*Ticker Symbol*	*Stock Exchange*
Alexander's, Inc. 210 Route 4 East Paramus, NJ 07652 (201) 587-8541 www.alx-inc.com	ALX	NYSE
Alexandria Real Estate Equities Inc. 135 North Los Robles Avenue Pasadena, CA 91101 (626) 578-0777	ARE	NYSE
AMB Property Pier 1 Bay 1 San Francisco, CA 94111 (415) 394-9000 www.amb.com	AMB	NYSE
American Campus Community 805 Las Cimas Parkway, Suite 400 Austin, TX 78746 (512) 732-1000 www.americancampuscommunities.com	ACC	NYSE
American Financial Realty Trust 1725 The Fairway Jenkintown, PA 19046 (215) 887-2280 www.afrt.com	AFR	NYSE
American Land Lease 29399 U.S. Highway 19 N., #320 Clearwater, FL 33761 (727) 726-8868 www.americanlandlease.com	ANL	NYSE
Amerivest Properties 1780 South Bellaire Street, #100 Denver, CO 80202 (303) 297-1800 www.amvproperties.com	AMV	AMEX

25_769193 appb.qxp 5/18/06 8:28 PM Page 253

Company	*Ticker Symbol*	*Stock Exchange*
AmREIT	AMY	AMEX
8 Greenway Plaza, Suite 1000		
Houston, TX 77046		
(713) 850-1400		
www.amreit.com		
Apartment Investment Management	AIV	NYSE
4582 S. Ulster Street, #1100		
Denver, CO 80237		
(303) 757-8101		
www.aimco.com		
Archstone-Smith Trust	ASN	NYSE
9200 E. Panorama Circle, #400		
Englewood, CO 80112		
(303) 708-5959		
www.archstonesmith.com		
Arden Realty	ARI	NYSE
11601 Wilshire Boulevard, 4th Floor		
Los Angeles, CA 90025-1740		
(310) 966-2600		
www.ardenrealty.com		
Arizona Land Income	AZL	AMEX
2999 North 44th Street, #100		
Phoenix, AZ 85018		
(602) 952-6800		
Ashford Hospitality	AHT	NYSE
14180 Dallas Parkway, 9th Floor		
Dallas, TX 75254		
(972) 490-9600		
Associated Estates	AEC	NYSE
5025 Swetland Court		
Richmond Hts., OH 44143-1467		
(216) 261-5000		
www.aecrealty.com		

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25_769193 appb.qxp 5/18/06 8:28 PM Page 254

Company	*Ticker Symbol*	*Stock Exchange*
AvalonBay Communities 2900 Eisenhower Avenue, #300 Alexandria, VA 22314 (703) 329-6300 www.avalonbay.com	AVB	NYSE
Bedford Property Investments 270 Lafayette Circle Lafayette, CA 94549 (925) 283-8910 www.bedfordproperty.com	BED	NYSE
Biomed Realty Trust 17140 Bernardo Center Drive, #195 San Diego, CA 92128 (858) 485-9840 www.biomedrealty.com	BMR	NYSE
BNP Residential Properties 301 South College Street, #3850 Charlotte, NC 28202-6032 (704) 944-0100 www.bnp-residential.com	BNP	AMEX
Boston Properties 111 Huntington Avenue Boston, MA 02199-7610 (617) 236-3300 www.bostonproperties.com	BXP	NYSE
Boykin Lodging 45 W. Prospect Avenue, #1500 Cleveland, OH 44115-1027 (216) 430-1200 www.boykinlodging.com	BOY	NYSE
Brandywine Realty Trust 401 Plymouth Road Plymouth Meeting, PA 19462 (610) 325-5600 www.brandywinerealty.com	BDN	NYSE

25_769193 appb.qxp 5/18/06 8:28 PM Page 255

Company	*Ticker Symbol*	*Stock Exchange*
BRE Properties 44 Montgomery Street, 36th Floor San Francisco, CA 94104-5525 (415) 445-6530 www.breproperties.com	BRE	NYSE
BRT Realty Trust 60 Cutter Mill Road, #303 Great Neck, NY 11010 (516) 466-3100 www.brtrealty.com	BRT	NYSE
Camden Property Trust 3 Greenway Plaza, Suite 1300 Houston, TX 77046 (713) 354-2500 www.camdenliving.com	CPT	NYSE
CarrAmerica Realty 1850 K Street NW, Suite 500 Washington, DC 20006 (202) 729-1700 www.carramerica.com	CRE	NYSE
CBL & Associates Properties 2030 Hamilton Place Boulevard, #500 Chattanooga, TN 37421 (423) 855-0001 www.cblproperties.com	CBL	NYSE
Cedar Shopping Centers 44 South Bayles Avenue, #304 Port Washington, NY 11050 (516) 767-6492	CDR	NYSE
Centerpoint Properties Trust 1808 Swift Road Oak Brook, IL 60523-1501 (630) 586-8000 www.centerpoint-prop.com	CNT	NYSE

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25_769193 appb.qxp 5/18/06 8:28 PM Page 256

Company	*Ticker Symbol*	*Stock Exchange*
Centracor Properties Trust 3300 PGA Boulevard, Suite 750 Palm Beach Gardens, FL 33410 (561) 630-6336 www.CorrectionalPropertiesTrust.com	CPV	NYSE
Colonial Properties Trust 2101 Sixth Avenue North, #750 Birmingham, AL 35203 (205) 250-8700 www.colonialprop.com	CLP	NYSE
Commercial Net Lease 450 South Orange Avenue, #900 Orlando, FL 32801-2813 (407) 650-1000 www.cnlreit.com	NNN	NYSE
Corporate Office Properties 8815 Centre Park Drive, #400 Columbia, MD 21045 (410) 730-9092 www.copt.com	OFC	NYSE
Cousins Properties 2500 Windy Ridge Parkway, #1600 Atlanta, GA 30339-5683 (770) 955-2200 www.CousinsProperties.com	CUZ	NYSE
Crescent Real Estate Equities 777 Main Street, Suite 2100 Fort Worth, TX 76102 (817) 321-2100 www.crescent.com	CEI	NYSE
Developers Diversified 3300 Enterprise Parkway Beachwood, OH 44122 (216) 755-5500 www.ddrc.com	DDR	NYSE

25_769193 appb.qxp 5/18/06 8:28 PM Page 257

Company	*Ticker Symbol*	*Stock Exchange*
Digital Realty REIT 2730 Sand Hill Road, #280 Menlo Park, CA 94025 (650) 233-3600	DLR	NYSE
Duke Realty 600 East 96th Street, #100 Indianapolis, IN 46240 (317) 808-6000 www.dukerealty.com	DRE	NYSE
Eagle Hospitality Properties Trust 100 E. River Center Boulevard, #480 Covington, KY 41001 (859) 292-5500 www.eaglehospitality.com	EHP	NYSE
Eastgroup Properties 188 East Capitol Street Jackson, MS 39201 (601) 354-3555 www.eastgroup.net	EGP	NYSE
Education Realty Trust 530 Oak Court Drive, #300 Memphis, TN 38117 (901) 259-2500 www.educationrealty.com	EDR	NYSE
Entertainment Properties 30 W. Pershing Road, Suite 201 Kansas City, MO 64108 (816) 472-1700 www.eprkc.com	EPR	NYSE
Equity Inns 7700 Wolf River Boulevard Germantown, TN 38138 (901) 754-7774 www.equityinns.com	ENN	NYSE

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25_769193 appb.qxp 5/18/06 8:28 PM Page 258

Company	*Ticker Symbol*	*Stock Exchange*
Equity Lifestyle Properties Two Riverside Plaza, #800 Chicago, IL 60606-2608 (312) 279-1400 www.mhchomes.com	ELS	NYSE
Equity Office Properties 2 North Riverside Plaza, #2100 Chicago, IL 60606 (312) 466-3300 www.equityoffice.com	EOP	NYSE
Equity One 1696 N. E. Miami Gardens Drive North Miami Beach, FL 33179 (305) 947-1664 www.equityone.net	EQY	NYSE
Equity Residential Two North Riverside Plaza Chicago, IL 60606 (312) 474-1300 www.equityapartments.com	EQR	NYSE
Essex Property Trust 925 East Meadow Drive Palo Alto, CA 94303 (650) 494-3700 www.essexpropertytrust.com	ESS	NYSE
Extra Space Storage 2795 E. Cottonwood Parkway, #400 Salt Lake City, UT 84121 (801) 562-5556 www.extraspace.com	EXR	NYSE
Federal Realty Investment Trust 1626 East Jefferson Street Rockville, MD 20852-4041 (301) 998-8100 www.federalrealty.com	FRT	NYSE

25_769193 appb.qxp 5/18/06 8:28 PM Page 259

Company	*Ticker Symbol*	*Stock Exchange*
Felcor Lodging Trust 545 E. John Carpenter Freeway Irving, TX 75062 (972) 444-4900 www.felcor.com	FCH	NYSE
Feldman Mall Property 3225 North Central Avenue, #1205 Phoenix, AZ 85012 (602) 277-5559 www.Feldmanmall.com	FMP	NYSE
First Industrial Realty 311 South Wacker Drive, #4000 Chicago, IL 60606 (312) 344-4300 www.firstindustrial.com	FR	NYSE
First Potomac Realty Trust 7200 Wisconsin Avenue, #310 Bethesda, MD 20814 (301) 986-9200 www.first-potomac.com	FPO	NYSE
General Growth Properties 110 N. Wacker Drive Chicago, IL 60606 (312) 960-5000 www.generalgrowth.com	GGP	NYSE
Getty Realty 125 Jericho Turnpike, # 103 Jericho, NY 11753-1016 (516) 478-5400	GTY	NYSE
Gladstone Commercial 1616 Anderson Road, Suite 208 McLean, VA 22102 (703) 286-7000 www.gladstonecommercial.com	GOOD	NASDAQ

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25_769193 appb.qxp 5/18/06 8:28 PM Page 260

Company	*Ticker Symbol*	*Stock Exchange*
Glenborough Realty 400 S. El Camino Real, #1100 San Mateo, CA 94402-1708 (650) 343-9300 www.glenborough.com	GLB	NYSE
Glimcher Realty Trust 150 East Gay Street Columbus, OH 43215 (614) 621-9000 www.glimcher.com	GRT	NYSE
Global Signal Inc. 301 North Cattlemen Road Sarasota, FL 34232-6427 (941) 364-8886 www.gsignal.com	GSL	NYSE
GMH Communities Trust 10 Campus Boulevard Newtown Square, PA 19073 (610) 355-8000 www.gmhcommunities.com	GCT	NYSE
Health Care Property Investors 3760 Kilroy Airport Way, #300 Long Beach, CA 90806 (562) 733-5100 www.hcpi.com	HCP	NYSE
Healthcare Realty Trust 3310 West End Avenue, #700 Nashville, TN 37203-1058 (615) 269-8175 www.healthcarerealty.com	HR	NYSE
Health Care REIT One Seagate, Suite 1500 Toledo, OH 43603-1475 (419) 247-2800 www.hcreit.com	HCN	NYSE

25_769193 appb.qxp 5/18/06 8:28 PM Page 261

Company	*Ticker Symbol*	*Stock Exchange*
Heritage Properties Investment Trust 131 Dartmouth Street Boston, MA 02116 (617) 927-2109 www.heritagerealty.com	HTG	NYSE
Hersha Hospitality Trust 148 Sheraton Drive, Box A New Cumberland, PA 17070 (717) 770-2405 www.hersha.com	HT	AMEX
Highland Hospitality 8405 Greenboro Drive McLean, VA 22102 (703) 336-4901 www.highlandhospitality.com	HIH	NYSE
Highwoods Properties 3100 Smoketree Court, #600 Raleigh, NC 27604-1052 (919) 872-4924 www.highwoods.com	HIW	NYSE
HMG Courtland Properties 1870 S. Bayshore Drive Coconut Grove, FL 33133 (305) 854-6803	HMG	AMEX
Home Properties Clinton Square, Suite 850 Rochester, NY 14604 (585) 546-4900 www.homeproperties.com	HME	NYSE
Hospitality Property 400 Centre Street Newton, MA 02458 (617) 964-8389 www.hptreit.com	HPT	NYSE

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25_769193 appb.qxp 5/18/06 8:28 PM Page 262

Company	*Ticker Symbol*	*Stock Exchange*
Host Marriott 6903 Rockledge Drive, #1500 Bethesda, MD 20817 (240) 744-1000 www.hostmarriott.com	HMT	NYSE
HRPT Properties Trust 400 Centre Street Newton, MA 02458-2076 (617) 332-3990 www.hrpreit.com	HRP	NYSE
Inland Real Estate 2901 Butterfield Road Oak Brook, IL 60523 (630) 218-8000 www.inlandrealestate.com	IRC	NYSE
Innkeepers USA Trust 306 Royal Poinciana Way Palm Beach, FL 33480 (561) 835-1800 www.innkeepersusa.com	KPA	NYSE
iStar Financial 1114 Avenue of the Americas New York, NY 10036 (212) 930-9400 www.istarfinancial.com	SFI	NYSE
Kilroy Realty 12200 W. Olympic Boulevard, #200 Los Angeles, CA 90064 (310) 481- 8400 www.kilroyrealty.com	KRC	NYSE
KIMCo Realty 3333 New Hyde Park Road New Hyde Park, NY 11042-0020 (516) 869-9000 www.kimcorealty.com	KIM	NYSE

25_769193 appb.qxp 5/18/06 8:28 PM Page 263

Company	*Ticker Symbol*	*Stock Exchange*
Kite Realty Group Trust 30 South Meridian Street, #1100 Indianapolis, IN 46204 (317) 577-5600 www.kiteco.com	KRG	NYSE
LaSalle Hotel Properties 4800 Montgomery Lane, #M25 Bethesda, MD 20814 (301) 941-1500 www.lasallehotels.com	LHO	NYSE
Lexington Corporate Properties One Penn Plaza, Suite 4015 New York, NY 10119 (212) 692-7200 www.lxp.com	LXP	NYSE
Liberty Property Trust 500 Chesterfield Parkway Malvern, PA 19355 (610) 648-1700 www.libertyproperty.com	LRY	NYSE
LTC Properties 22917 Pacific Coast Highway, #350 Malibu, CA 90265 (805) 981-8655	LTC	NYSE
The MacErich Company 401 Wilshire Boulevard, #700 Santa Monica, CA 90401 (310) 394-6000 www.macerich.com	MAC	NYSE
Mack-Cali Realty Trust 11 Commerce Drive Cranford, NJ 07016-3501 (908) 272-8000 www.calirealty.com	CLI	NYSE

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25_769193 appb.qxp 5/18/06 8:28 PM Page 264

Company	*Ticker Symbol*	*Stock Exchange*
Maguire Properties 333 South Grand Avenue, Suite 400 Los Angeles, CA 90071 (213) 626-3300 www.maguirepartners.com	MPG	NYSE
Maxus Realty Trust 104 Armour Road North Kansas City, MO 64116 (816) 303-4500	MRTI	NASDAQ
Meristar Hospitality 6430 Rockledge Drive, #200 Bethesda, MD 20817 (703) 812-7200 www.meristar.com	MHX	NYSE
MHI Hospitality 814 Capital Landing Road Williamsburg, VA 23185 (757) 229-5648 www.mhihotels.com	MDH	AMEX
Mid-America Apartment Communities 6584 Poplar Avenue, Suite 300 Memphis, TN 38138 (901) 682-6600 www.maac.net	MAA	NYSE
The Mills 1300 Wilson Boulevard, #400 Arlington, VA 22209 (703) 526-5000 www.themills.com	MLS	NYSE
Mission West Properties 10050 Bandley Drive Cupertino, CA 95014-2188 (408) 725-0700 www.missionwest.com	MSW	AMEX

25_769193 appb.qxp 5/18/06 8:28 PM Page 265

Company	*Ticker Symbol*	*Stock Exchange*
National Health Investors, Inc. 100 Vine Street, Suite 1402 Murfreesboro, TN 37130 (615) 890-9100 www.nhinvestors.com	NHI	NYSE
National Health Realty 100 Vine Street, Suite 1400 Murfreesboro, TN 37130 (615) 890-2020 www.nationalhealthrealty.com	NHR	AMEX
Nationwide Health 610 Newport Center Drive, #1150 Newport Beach, CA 92660 (949) 718-4400 www.nhp-reit.com	NHP	NYSE
New Plan Excel Realty 1120 Avenue of the Americas New York, NY 10036 (212) 869-3000 www.newplan.com	NXL	NYSE
Omega Healthcare Investors 9690 Deereco Road, Suite #100 Timonium, MD 21093 (410) 427-1700 www.omegahealthcare.com	OHI	NYSE
One Liberty Properties 60 Cutter Mill Road Great Neck, NY 11021 (516) 466-3100 www.onelibertyproperties.com	OLP	NYSE
Pan Pacific Retail Properties 1631-B South Melrose Drive Vista, CA 92081-5498 (760) 727-1002 www.pprp.com	PNP	NYSE

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25_769193 appb.qxp 5/18/06 8:28 PM Page 266

Company	*Ticker Symbol*	*Stock Exchange*
Parkway Properties 188 East Capitol Street Jackson, MS 39225-4647 (601) 948-4091 www.pky.com	PKY	NYSE
Pennsylvania REIT 200 South Broad Street, 3rd Floor Philadelphia, PA 19102-3803 (215) 875-0700 www.preit.com	PEI	NYSE
Pittsburgh & West Virginia Railroad #2 Port Amherst Drive Charleston, WV 25306-6699 (304) 926-1124	PW	AMEX
Plum Creek Timber 999 Third Avenue, Suite 4300 Seattle, WA 98104-4096 (206) 467-3600 www.plumcreek.com	PCL	NYSE
PMC Commercial Trust 17950 Preston Road, Suite 600 Dallas, TX 75252 (972) 349-3200 www.pmccapital.com	PCC	AMEX
Post Properties 4401 Northside Pkwy, #800 Atlantic, GA 30327 (404) 846-5000 www.postproperties.com	PPS	NYSE
Prologis 14100 East 35th Place Aurora, CO 80011 (303) 375-9292 www.prologis.com	PLD	NYSE

25_769193 appb.qxp 5/18/06 8:28 PM Page 267

Company	*Ticker Symbol*	*Stock Exchange*
PS Business Parks 701 Western Avenue, Suite 200 Glendale, CA 91201-2397 (818) 244-8080 www.psbusinessparks.com	PSB	AMEX
PS Public Storage 701 Western Avenue, Suite 200 Glendale, CA 91201-2394 (818) 244-8080 www.psbusinessparks.com	PSA	NYSE
Ramco-Gershenson Properties Trust 27600 Northwestern Highway, #200 Southfield, MI 48034 (248) 350-9900 www.rgpt.com	RPT	NYSE
Rayonier 50 North Laura Street Jacksonville, FL 32202 (904) 357-9100 www.rayonier.com	RYN	NYSE
Realty Income 220 West Crest Street Escondido, CA 92025-1707 (760) 741-2111 www.realtyincome.com	O	NYSE
Reckson Associates Realty 225 Broadhollow Road Melville, NY 11747-4883 (631) 694-6900 www.reckson.com	RA	NYSE
Regency Centers 121 West Forsyth Street, #200 Jacksonville, FL 32202-3842 (904) 598-7000 www.RegencyCenters.com	REG	NYSE

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25_769193 appb.qxp 5/18/06 8:28 PM Page 268

Company	*Ticker Symbol*	*Stock Exchange*
Roberts Realty Investors 8010 Roswell Road, Suite 280 Atlanta, GA 30350 (770) 394-6000 www.robertsrealty.com	RPI	AMEX
Saul Centers 7501 Wisconsin Avenue, # 1500 Bethesda, MD 20814 (301) 986-6200 www.saulcenters.com	BFS	NYSE
Senior Housing Properties Trust 400 Centre Street Newton, MA 02458-2076 (617) 796-8350 www.snhreit.com	SNH	NYSE
Shurgard Storage 1155 Valley Street, Suite 400 Seattle, WA 98109 (206) 624-8100 www.shurgard.com	SHU	NYSE
Simon Property Group 115 W. Washington Street #51 Indianapolis, IN 46204 (317) 636-1600 www.simon.com	SPG	NYSE
Sizeler Property 2542 Williams Boulevard Kenner, LA 70062 (504) 471-6200 www.sizeler.net	SIZ	NYSE
SL Green Realty 420 Lexington Avenue New York, NY 10170 (212) 594-2700 www.slgreen.com	SLG	NYSE

25_769193 appb.qxp 5/18/06 8:28 PM Page 269

Company	*Ticker Symbol*	*Stock Exchange*
Sovran Self Storage, Inc.	SSS	NYSE
6467 Main Street		
Buffalo, NY 14221		
(716) 633-1850		
www.sovranss.com		
Spirit Finance	SFC	NYSE
14631 North Scottsdale Road, #200		
Scottsdale, AZ 85254		
(480) 606-0820		
www.spiritfinance.com		
Strategic Hotel REIT	SLH	NYSE
77 West Wacker Drive, #4600		
Chicago, IL 60601		
(312) 658-5000		
www.shci.com		
Sun Communities	SUI	NYSE
27777 Franklin Road, Suite 200		
Southfield, MI 48034		
(248) 208-2500		
www.suncommunities.com		
Sunstone Hotel Investors, Inc.	SHO	NYSE
903 Calle Amanecer, Suite 100		
San Clemente, CA 92673-6212		
(949) 369-4000		
www.sunstonehotels.com		
Tanger Factory Outlet	SKT	NYSE
3200 Northline Avenue, #360		
Greensboro, NC 27408		
(336) 292-3010		
www.tangeroutlet.com		
Taubman Centers	TCO	NYSE
200 East Long Lake Rd., #300		
Bloomfield Hills, MI 48303-0200		
(248) 258-6800		
www.taubman.com		

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25_769193 appb.qxp 5/18/06 8:28 PM Page 270

Company	*Ticker Symbol*	*Stock Exchange*
Town & Country Trust 100 South Charles Street, #1700 Baltimore, MD 21201-2725 (410) 539-7600 www.tctrust.com	TCT	NYSE
Trizec Properties 233 South Wacker Drive, 46th Floor Chicago, IL 60606 (312) 798-6000 www.trz.com	TRZ	NYSE
Trustreet Properties 450 South Orange Avenue Orlando, FL 32801 (407) 540-2000 www.trustreetproperties.com	TSY	NYSE
United Dominion Realty 1745 Shea Center Drive, #200 Highlands Ranch, CO 80129 (720) 283-6120 www.udrt.com	UDR	NYSE
United Mobile Home 3499 Route 9 North, Juniper Plaza Freehold, NJ 07728 (732) 577-9997 www.umh.com	UMH	AMEX
Universal Health Realty 367 South Gulph Road King of Prussia, PA 19406 (610) 265-0688 www.uhrit.com	UHT	NYSE
U-Store-It Trust 6745 Engle Road, Suite 300 Cleveland, OH 44130 (440) 234-0700 www.u-store-it.com	YSI	NYSE

25_769193 appb.qxp 5/18/06 8:28 PM Page 271

Company	*Ticker Symbol*	*Stock Exchange*
Ventas, Inc. 10350 Ormsby Park Place, #300 Louisville, KY 40207-1642 (502) 357-9000 www.ventasreit.com	VTR	NYSE
Vornado Realty Trust 210 Route 4 East Paramus Paramus, NJ 07652 (212) 894-7000 www.vno.com	VNO	NYSE
Weingarten Realty 2600 Citadel Plaza Drive, #300 Houston, TX 77008 (713) 866-6000 www.weingarten.com	WRI	NYSE
Windrose Medical Properties Trust 3502 Woodview Trace, Suite 210 Indianapolis, IN 46268 (317) 860-8180 www.windrosempt.com	WRS	NYSE
Winston Hotels 2626 Glenwood Avenue, #200 Raleigh, NC 27608 (919) 510-6019 www.winstonhotels.com	WXH	NYSE
Winthrop Realty Trust 7 Bulfinch Place, Suite 500 Boston, MA 02114 (617) 570-4614 www.firstunion-reit.net	FUR	NYSE
WRIT: Washington Real Estate Trust 6110 Executive Boulevard, #800 Rockville, MD 20852 (301) 984-9400 www.writ.com	WRE	NYSE

Glossary

adjusted funds from operations (AFFO) a computation made to measure a real estate company's cash flow generated by its real estate operations. AFFO is usually calculated by subtracting from FFO normal recurring expenditures that are then capitalized by the REIT and amortized, and an adjustment for the "straight-lining" of rents. This calculation is also called *cash available for distribution* (CAD) or *funds available for distribution* (FAD).

apartment and multifamily properties apartment buildings are defined as residential dwellings consisting of five or more units in a single building or complex of buildings. *Multifamily* is more commonly used when describing buildings of four or fewer units.

capitalization rate or cap rate for a property is calculated by dividing the property's net operating income after property level expenses by its purchase price. Generally, high cap rates indicate higher returns and possible greater risk.

cash available for distribution (CAD) or *funds available for distribution* (FAD), a REIT's ability to generate cash that can be distributed as dividends to its shareholders. In addition to subtracting from FFO normalized recurring real estate-related expenditures and other noncash items to obtain AFFO, CAD (or FAD) is usually derived by also subtracting nonrecurring expenses.

commercial real estate all real estate excluding single-family homes and multifamily buildings up to four units, raw land, farms and ranches, and government-owned properties. About half of commercial real estate as defined is considered to be of sufficient quality and size to be of interest to institutional investors. This real estate is known as *investment grade*.

correlation coefficient a statistical measure that shows the interdependence of two or more random variables. The number indicates how much of a change in one variable is explained by a change in another. A score of 1.0 is perfect correlation with each variable moving in unison; a score of –1.0 is perfect noncorrelation with each variable moving opposite one another.

cost of capital the cost to a company, such as a REIT, of raising capital in the form of equity, preferred stock, or debt. The cost of equity capital generally is considered to include both the dividend rate as well as the expected capital growth as measured either by higher dividends or potential appreciation in the stock price. The cost of debt capital is the interest expense on the debt incurred plus any fees incurred to obtain the debt.

26_769193 glossary.qxp 5/18/06 8:29 PM Page 274

credit tenant a tenant that has the size and financial strength to be rated as investment grade by one of the three major credit rating agencies: Moody's, Standard & Poor's, and Fitch. The investment grade rating increases the probability that the financial strength of the company will allow it to continue to pay rent even during difficult economic times.

EBITDA earnings before interest, taxes, depreciation, and amortization. This measure is sometimes referred to as *operating margin*.

eminent domain a legal term referring to the right of a public entity, such as a state or local municipality, to seize a property for public purposes in exchange for compensation to the property owner.

entitlement the legal right as granted by state and local real estate zoning authorities to build or improve a parcel of existing real estate, normally unimproved land. The grant of entitlement to improve property can take long periods of time and be expensive from a legal standpoint. But entitlement can create immediate value for previously unentitled parcels of real estate.

equity market capitalization the market value of all outstanding common stock of a company.

equity REIT a REIT that owns or has an "equity interest" in rental real estate and derives the majority of its revenue from rental income (rather than making loans secured by real estate collateral).

externality an activity or event that affects (positively or negatively) something that is external to the activity.

funds from operations (FFO) the most commonly accepted and reported measure of REIT operating performance. Equal to a REIT's net income, excluding gains or losses from sales of property, and adding back real estate depreciation. It is an approximation of cash flow when compared to normal corporate accounting, which is a better measure of operating performance than GAAP earnings that might include (sometimes large) noncash items. The dilemma is that there is no industry standard method for calculating FFO, so it is difficult to use it as a comparison across all REITs.

holdouts occur when key property owners refuse to sell at any price or demand prices that are so far out of line that they make the financial feasibility of the project unacceptable. Quickly and quietly assembling a land package and avoiding holdouts is a key part of the development process.

hybrid REIT a REIT that combines the investment strategies of both equity REITs and mortgage REITs.

leverage the amount of debt in relation to either equity capital or total capital.

Medicaid a program managed by the states and funded jointly by the states and federal government to provide health care coverage for individuals and families with low incomes and resources. Medicaid is the largest source of funding for medical and health-related services for people with limited income. Among the groups of people served by Medicaid are eligible low-income parents, children, seniors, and people with disabilities. Medicaid pays for nearly 60 percent of all nursing home residents and about 37 percent of all births in the United States.

26_769193 glossary.qxp 5/18/06 8:29 PM Page 275

Medicare a U.S. government program available for people age 65 or older and younger people with disabilities, the latter of whom must be receiving disability benefits from Social Security for at least 24 months. Medicare provides health care coverage for 41 million Americans as of year-end 2003. Enrollment is expected to reach 77 million by 2031, when the Baby Boom generation is fully enrolled. Medicare is partially financed by a tax of 2.9% (1.45% withheld from the worker and a matching 1.45% paid by the employer) on wages or self-employed income.

modern portfolio theory (MPT) based on the idea that when different investments such as stocks, bonds, and REITs are mixed together in a portfolio, it improves the return and lowers the risk over time.

mortgage REIT a REIT that makes or owns loans and other obligations that are secured by real estate as collateral.

net asset value (NAV) the net market value of all a company's assets, including but not limited to its properties, after subtracting all its liabilities and obligations.

positive spread investing (PSI) the ability to raise funds (both equity and debt) at a cost significantly less than the initial returns that can be obtained on real estate transactions.

real estate investment trust (REIT) a tax conduit company dedicated to owning, managing, and operating income-producing real estate, such as apartments, shopping centers, offices, and warehouses. Some REITs, known as mortgage REITs, also engage in financing real estate.

Real Estate Investment Trust Act of 1960 the federal law that authorized REITs. Its purpose was to allow small investors to pool their investments in real estate in order to get the same benefits as might be obtained by direct ownership, while also diversifying their risks and obtaining professional management.

REIT Modernization Act (RMA) of 1999 federal tax law change whose provisions allow a REIT to own up to 100 percent of stock of a taxable REIT subsidiary that can provide services to REIT tenants and others. The law also changed the minimum distribution requirement from 95 percent to 90 percent of a REIT's taxable income—consistent with the rules for REITs from 1960 to 1980.

securitization the process of financing a pool of similar but unrelated financial assets (usually loans or other debt instruments) by issuing to investors security interests representing claims against the cash flow and other economic benefits generated by the pool of assets.

standard deviation measures how spread out the values in a set of data are. In the investment world, the standard deviation is the most commonly used measure of investment volatility over time. Lower standard deviation helps to moderate portfolio risk, but it also tends to provide lower returns.

straight-lining real estate companies such as REITs straight line rents because generally accepted accounting principles (GAAP) require it. Straight-lining averages the tenant's rent payments over the life of the lease.

26_769193 glossary.qxp 5/18/06 8:29 PM Page 276

Tax Reform Act of 1986 federal law that substantially altered the real estate investment landscape by permitting REITs not only to own, but also to operate and manage most types of income-producing commercial properties. It also stopped real estate tax shelters that had attracted capital from investors based on the amount of losses that could be created by real estate.

total market cap the total market value of a REIT's (or other company's) outstanding common stock and indebtedness.

total return a stock's dividend income plus capital appreciation before taxes and commissions.

umbrella partnership REIT (UPREIT) a complex but useful real estate structure in which the partners of an existing partnership and a newly formed REIT become partners in a new partnership termed the *operating partnership*. For their respective interests in the operating partnership, the partners contribute the properties (or units) from the existing partnership and the REIT contributes the cash proceeds from its public offering. The REIT typically is the general partner and the majority owner of the operating partnership units. After a period of time (often one year), the partners may enjoy the same liquidity of the REIT shareholders by tendering their units for either cash or REIT shares (at the option of the REIT or operating partnership). This conversion may result in the partners incurring the tax deferred at the UPREIT's formation. The unit holders may tender their units over a period of time, thereby spreading out such tax. In addition, when a partner holds the units until death, the estate tax rules operate in such a way as to provide that the beneficiaries may tender the units for cash or REIT shares without paying income taxes.

Index

Accelerated depreciation, 6, 120
Accounting issues, 116–117, 119–125
Accretion, 110
Acquisition-oriented REITs, 119
Acquisitions, 83, 98, 104, 109, 116, 207
Activities of daily living (ADLs), 211
Activity assessment, 89
Adjustable rate mortgages (ARMs), 237
Adjusted funds from operations (AFFO), 117, 273
Advertising expenses, 116
Affiliation, health care industry, 208
Affordability, significance of, 61, 133–134, 144, 148
Aging population, implications of, 203–206
Agreements
  joint venture, 96, 99
  operating, 6
  partnership, 6, 92–93, 96
  purchase, 83
Airline industry, 193
Amenities
  in manufactured home communities, 144–145
  neighborhood, 102
  office buildings, 151–152
  residential, 134–136
American Stock Exchange, 29, 36
Amortization, 93
Anchor tenant, retail properties, 173–174, 176, 178–179
Ancillary services, 22
Annual cash preferences, 94
Annual returns, 11–12, 32, 44, 59, 165
Apartment buildings
  apartment demand, class A/class B/class C, 130–131
  defined, 129, 273
  development process, 88
  lease duration, 7
  ownership of, 30, 121, 233
  types of, 131–132
Appraisals, 114
Appraiser(s), 102–103, 118
Appreciated stock, 60
Arm's-length transactions, 102
Asset allocation, 42–49
  guidelines for, 63
  modern portfolio theory and, 41–42, 49
  significance of, 46, 49
  standard deviation, 45, 49
Asset classes, trends in, 61
Asset diversification, 23–24
Assisted living facilities, 201, 204, 209, 211–212
Attribution of return, 6–10
Automobile dealerships ownership, 229
Average annual income returns, 59

Baby Boom generation, 134–135, 144, 203, 205, 230
Backend-sharing arrangements, 93
Balanced portfolio, 43
Balance sheet
  components of, 62, 89, 97–99
  leverage, 106, 108
Bankruptcy, 21
Benchmarks, 33, 35
Bidding process, development projects, 87
Big box retail centers, 170, 178, 180
Bond(s), 43–47, 62. *See also* Bond investments
Bond investments
  characterized, 48, 50, 56
  compared with real estate investments, 4–5, 11, 32, 39
Boom-and-bust cycles, 73
Brinson, Gary, 46
Brokerage firms
  commissions, 55
  discount, 42
  functions of, 76
Building codes, 85
Build-to-suit developments, 83
Business cycle, impact on real estate market, 10
Business risk, 97

27_769193 bindex.qxp 5/18/06 8:29 PM Page 278

Buy-and-hold ventures, 95
Buying process, disadvantages of, 11
Buy low, sell high strategy, 61

Capital
  appreciation, 112
  cost of, 107, 110, 112, 201, 207, 274
  dividends, 121
  expenditures, 145, 180–181, 217
  gains, *see* Capital gains
  markets, 34, 61
  partners, 98
  requirements, 12
  reserve, 104
Capital gains
  dividend accounting, 119–120
  implications of, 23, 48, 118, 125
  long-term, 60–61
  tax, 95, 120, 135
Capitalization, *see also* Market capitalization
  equity market, 274
  methods, 114
  rate (cap rate), 102–105, 273
  total market, 276
Cap rate, *see* Capitalization, rate
Caps, 237
Cash available for distribution (CAD), 117–118, 273
Cash flow, 5–7, 28, 92–94, 96, 99, 106–107, 206, 238
Cash-on-cash returns, 80
Cash yield on cost (CYC), 111–113, 114
C corporation, 23, 122–124
Central business district (CBD), 155–156
Certificate of Need process, 210
Class A/Class B/Class C
  apartment buildings, 130–131
  manufactured home communities, 142
  office buildings, 151–152, 154, 156
  residential properties, 129–130
  retail property, 171
Collars, 237
Collateralized mortgage obligations, 238–240
Commercial banks, 5, 237
Commercial investment properties, depreciation of, 92
Commercial mortgage-backed securities (CMBS), 13, 73, 237
Commercial mortgage loan market, 236, 240
Commercial properties, mortgage loans, 235
Commercial real estate
  defined, 5, 273
  during recession, 20
  investment-grade, 3–6, 104
  market dynamics, 68
  publicly traded REITs, 20–21
  stocks and bonds versus, 4–5
Commissions, 55
Common stock, 43, 60, 106
Communications sector, 57
Community shopping centers, 103, 170, 172–173, 178, 180, 233
Competitive advantage, 75
Competitive obsolescence, 180–181
Competitive returns, 46
Computer software programs, applications of, 42
Conditional purchase agreement, 83
Congregate care retirement communities, 214
Construction
  costs, mall renovations, 179–180
  management fees, 124
  risk, 81–82
Consultants, functions of, 42–43, 48
Consumer confidence, impact of, 133. *See also* Consumer Price Index (CPI)
Consumer Discretionary, correlation coefficients, 58
Consumer Price Index (CPI), 60, 145, 176, 202, 214
Consumer Staples, correlation coefficients, 58
Contingent purchase agreement, 83
Continuing care communities, 213–214
Conversions, 82
Corporate accounting, 274
Corporate structures, 121–125
Correlation
  of asset class, 43–45
  characterized, 37, 49
  coefficient, 44, 56–57, 62–63, 273
  of return, 6, 9
  significance of, 46, 50
Cost of capital, 107, 110, 112, 201, 207, 274
Credit
  enhancement, 206
  exposure, 204
  profile, 8
  quality, 203, 206, 219
  rating agencies, 6, 171
  risk, 240
  tenants, 5–6, 171, 177–178, 274
Creditworthiness, 208
Current liabilities, 104
Customary services, 22
Customer-oriented real estate market, 22

27_769193 bindex.qxp 5/18/06 8:29 PM Page 279

Data resources, 76–77
Death spiral, 143, 171, 175, 180
Debt
  cost of capital, 107
  rating agencies, 236
  restructuring, 117–118
  structure, 92, 94, 99, 104
  TRS provisions, 24
Decentralized businesses, 156–157
Deferred taxes, 6, 48, 60, 95, 113–114, 120–121, 125, 202
Demographics
  aging population, 134–135, 144, 203–206, 230
  health care industry, 201, 203–205, 219, 221
  impact on real estate market, 10
  lifestyle, 175
  trends, residential REITs, 135–137
Depreciation, 5–6, 93–95, 104, 108–109, 119–120, 202, 274
Derivatives, 237
Design, 81–82, 86–87
Destination malls, 170
"Determinants of Portfolio Performance," 46
Develop-and-hold ventures, 95
Development
  characterized, 77
  costs, 104
  health care facilities, 202
  -oriented REITs, 113
  phase, 86–87
  projects, 80–81, 82, 90, 92
Direct investment partnerships, 92
Direct investment profile (DIP), 96, 98
Direct investment REITs, 54–55, 63
Direct ownership, 4, 74
Direct real estate portfolio, 12, 29–30, 32
Discount brokerage firms, 42
Discovery process, 86
Disinflation, 5
Diversification
  asset rules, 23–24
  geographic, 30–31, 75–76
  significance of, 10, 28, 37, 39, 46–48, 54, 62, 97–98
Diversified portfolio, REIT integration strategies, 54–55, 63
Diversified property, publicly traded, 37
Diversified REITs, 232–233
Dividend(s)
  accounting issues, 119–121
  characterized, 25, 27, 56, 107, 110
  distribution, 60, 125
  growth rate, 59
Dividend yield, historical data
  diversified REITs, 234
  health care REITs, 220
  hotel REITs, 196
  industrial REITs, 166
  manufactured housing, 147
  mortgage REITs, 239
  office REITs, 158
  residential REITs, 137
  retail REITs, 184
  self-storage REITs, 227
  specialty REITs, 231
Dollar cost averaging, 62
Double-wide, defined, 143–144
Dow Jones Industrials, 44
Down cycle, 70–71

Earnings, 82, 109–110
Earnings before interest, taxes, depreciation, and amortization (EBITDA)
  characterized, 106–107
  multiple analysis, 106–107, 113–114, 273
Earnings per share (EPS), 109, 115
Echo Boomers, 134–135
E-commerce, 181–183
Economic conditions, impact of, 9–11, 62, 68, 133, 149–150, 153–155, 159, 164–165, 191
Economic diversification, 76
Economies of scale, 97, 192–193, 210, 212
Efficient frontier, 49
Embarcadero Center (CA), 39
Eminent domain, 84, 274
Employee Retirement Income Security Act of 1974 (ERISA), 94
Employee severance packages, 116
Employment opportunities/trends, 133
Endowments, 42
Energy stocks, 56, 58
Engineers, role in development project, 87
Enterprise value, 106–107, 113–114
Entitlement/entitlement process, 9, 72, 80–86, 90, 274
Equilibrium zone, 68–69, 72, 73
Equity
  asset class, 7
  capital, 95
  capitalization, 21–22
  cost of capital and, 107
  investors, 111
  market, 62

27_769193 bindex.qxp 5/18/06 8:29 PM Page 280

Equity (*continued*)
market capitalization, 21, 29–30, 274
REIT Price Index, 60
REITs, 36–37, 45, 274
Estate tax, 114
Excess distribution structure, 93
Exchange traded funds (ETFs), 55–55, 62–63
Exchange traded indexes, 33
Existing property, entitlement terms, 9
Expectations, 62
Expected growth rate, 108
Expected returns, 43
Expenditures, types of
advertising, 116
capital, 145, 180–181, 217
nonrecurring, 116–117
Extended-stay hotel properties, 190
Externalities, impact of, 8–9, 28, 33–35, 274

Factory-built home, 141
Fannie Mae, 236
Fashion malls, 173–174
Fast-growing REIT, 106
Feasibility planning, 82, 86–87
Federal Deposit Insurance Corporation (FDIC), 20
Federal Home Loan Mortgage Association (FHLMA), 236
Federal Housing Administration (FHA), 236
Federal income tax, 120
Federal National Mortgage Association (FNMA), 236
Federal tax code, 12
Fees
franchise/licensing, 194
management, 95, 105, 194, 206
option, 84
partnership, 96
taxable REIT subsidiaries (TRS), 124–125
Festival malls, 174
Fiduciary
functions of, 32
obligation, 42, 123
Financial partners, 93–94, 96
Financial resources, for developers, 87, 90
Financial statements, 116, 202
Financial stocks, correlation coefficients, 58
Financing, health care industry, 201–202, 208
Fitch Investor Services, 6, 171
Fixed income
investors, asset allocation, 48
portfolio diversification of, 62
portfolio managers, 59
securities, 56–57
Flex space, in office/industrial buildings, 153, 161, 163
Foreign investors, 19
401(k), 42
Franchising, 123
Freddie Mac, 236
Freestanding retail properties, 169–170, 178–179
Functional obsolescence, 180–181
Funds available for distribution (FAD), 110, 118, 273
Funds from operations (FFO), 107–108, 110, 115–117, 125, 274
Future cash flow, 112, 201

Gains and losses, 117. *See also* Capital gains
Garden apartments, 132
Gas station ownership, 229
Generally accepted accounting principles (GAAP)
components of, 116, 118–120, 125, 274–275
earnings, 108, 116, 119
net income, 117
Geographic distribution, REIT property ownership, 37–38
Geographic diversification, 30–31, 75–76
Geography, significance of, 12–13
Ginny Mae, 236
Golf course ownership, 229–230
Government bonds, interest rates and, 56
Government mortgage insurance programs, 235
Government National Mortgage Association (GNMA), 236
Gross domestic product, 200, 219
Ground-up development, 80–82, 119
Growth rate
enterprise value/EBITDA multiple analysis, 106–107, 113–114
multiple-to-growth rate analysis, 107–108, 114

Handbook of Financial Engineering (Smith/Smithson), 238
Hazardous materials, dealing with, 82
Health care property, publicly traded, 37
Health care reform, 200
Health care REITs, 200–221
characterized, 46, 124
misconceptions about, 199
NAREIT Equity Index weight, 199–200, 219
Health care sector, 57–58
High-dividend-yielding sectors, 62
Highest-and-best use doctrine, 9, 34
High-growth period, sustainability of, 108
High-rise, defined, 131, 153

27_769193 bindex.qxp 5/18/06 8:29 PM Page 281

High-risk development, 88
High-yielding stocks, 56, 60
Historical perspectives, 12, 15–25, 80
Historical rate of return, 42–43
Historical sales, 102
Holding period, 60, 96
Holdouts, 83–84, 274
Holiday Inn, 191
Home Depot, 174
Home health care, 205–206
Hospitals, health care REITs, 201, 210, 214–217, 221
Hotel REITs, 7, 197–197
Hotels, 37, 88, 121, 122, 189–192. *See also* Hotel REITs
Housing, for the elderly, 213
Housing Act of 1980, 141
Housing-related stocks, 54
Hurdle rate, 94, 111–112
Hybrid REIT, 208, 273

Illiquid asset classes, 48
Improvements, 9, 102, 119, 136
Income investment portfolio, 121
Income-producing assets, 48
Income-producing properties, 18, 104, 118, 233
Income statement, 202
Income taxes, 121
Incremental yield, 80
Incubator buildings, 164
Indebtedness, 106
Independent contractors, 22–23
Industrial buildings, 30
Industrial property, 7, 37, 162
Industrial REITs, 88, 161–167
Industrial sectors, 150
Industrial stocks, correlation coefficients, 58
Industrial warehouses, development process, 88
Inertia, 82–83
Infill apartment buildings, 131
Inflation/inflationary environment
  health care REITs, 202
  hedge, 5, 13–14, 28, 62
  impact on REITs, 5, 12, 57, 59, 181, 238
  premium, 104
Information resources, 33, 42
Information technology, correlation coefficients, 58
Inline tenants, 176, 178
Inside information, 12
Institutional investment, 13
Institutional investors, 3–4, 6, 10, 31, 35, 91
Institutional-quality real estate, 13, 27
Interest rate
  environments, 10, 13
  hedging, 116
  impact on REITs, 13, 56–57, 62–63
  insurance, 238
  mortgage loans, 237–240
  risk, 240
  swaps, 237
  trends in, 68
Internal rate of return, 111
International stocks, 48, 50
Internet
  bubble, 61, 182
  impact on retail sector, 181–183
Intrinsic value, 89
Investment-class property/real estate, 3–6, 11, 185
Investment grade, defined, 273
Investment policies
  REITs utilization, 53–55, 62–63
  statement, purpose of, 53, 63
Investors, types of
  direct, 54
  direct institutional, 32
  equity, 111
  fixed income, 48
  foreign, 19
  income-oriented, 60
  individual, 61
  institutional, 3–4, 6, 10, 31, 35, 91
  noninstitutional, 3
  private sector, 5
  rational, 54, 63
  small, 12
  taxable, 5, 59, 61–63, 215
  tax-exempt, 6
  third-party, 217

Japanese investors, 19
Job creation, impact on real estate market, 10
Joint ventures (JVs), 95–99
  characterized, 23, 84, 92–95, 99
  development fees, 124
  documents, 92
  real estate development, 84
  unconsolidated, 105

Kelo et al. v. City of New London et al., 10

Land, 83–84, 85
  valuation of, 102
Landlord
  ancillary services provided by, 22–23
  retail properties, 177

27_769193 bindex.qxp 5/18/06 8:29 PM Page 282

Landscaping, 23, 82
Large-cap equity market, 57
Large-capitalization marker, 62
Large stocks, 44–45, 48–49
Layout phase, of discovery process, 86
Leading-edge services, 22
Lease, *See also* Leasing
  average duration of, 7, 136, 179
  health care facilities, 201, 203, 206–207
  hotel properties, 193–195
  long-term, 84
  restricted assets and, 121
  retail property, 177–179, 181
  structure requirements, 122–123
  terms of, 7
Lease-up period, 88
Leasing
  costs related to, 117
  project timing, 81–82
Legislation
  Employee Retirement Income Security Act of 1974 (ERISA), 94
  Housing Act of 1980, 141
  Real Estate Investment Trust Act of 1960, 4, 275
  REIT Modernization Act (RMA) of 1999, 24, 124, 275
  Taxpayer Relief Act of 1987, 22
  Tax Reform Act of 1986, 4, 18–19, 25, 94–95, 276
Leverage
  defined, 106, 274
  health care REITs, 202
  hotel REITs, 188, 194–195
  implications of, 12, 21, 108
  joint ventures/partnerships, 95, 98
  mortgage REITs, 238
  net asset value (NAV) analysis, 106
Liabilities, in net asset value (NAV) analysis, 105
Lifestyle malls, 174
Limited liability corporation, 92
Limited partnerships, 12, 189
Limited-service hotel properties, 190
Liquidity
  advantage of, 30–31, 33, 74, 77
  lack of, 11, 13, 28–29, 32
  need for, 48
Loan defaults, 21
Loan-to-value ratio, 95, 209
Local building codes, 85
  externalities, 9
  government, role in development projects, 84–85
  market dynamics, 133
  market knowledge, benefits of, 97–99
  market niches, 98
  real estate market, 34, 39, 72, 74–76, 90, 102
Location
  analysis, 81–82
  significance of, 5, 7–9, 34
Loft apartments/buildings, 131, 163–164
London Interbank Origination Rate (LIBOR), 237
Long-term care, 201, 203–205, 209–212, 221
Long-term expected return, 42
Long-term policy mandates, 32
Low-income housing, 68
Low-rise, defined
  apartment buildings, 131–132
  office buildings, 152–153
Low-risk development, 88

Macroeconomic trends, 9, 154
Mall of America (MN), 39
Managed care, 203, 214, 216–217
Managed real estate accounts, 54–55, 63
Management
  aggressive, 117
  fees, 95, 105, 206
  nonowner, 122
  quality, 143
  skills, 75, 97–98
Manufactured home communities, development process, 88
Manufactured home community REITs, 139–148
Manufacturing space, industrial REITs, 163
Marketability of property, 11
Market analysis, 81–82
Market capitalization
  historical data, *see* Market capitalization historical data
  public equity, 29–30
  significance of, 21, 36, 141
Market capitalization, historical data
  diversified REITs, 234
  health care REITs, 220
  hotel REITs, 196
  industrial REITs, 166
  manufactured housing, 147
  mortgage REITs, 239
  office REITs, 158
  residential REITs, 137
  retail REITs, 184
  self-storage REITs, 227
  specialty REITs, 231
Market comparables, 102–103, 114
Market conditions, impact of, 21, 83, 85
Market locality, 74–75

27_769193 bindex.qxp 5/18/06 8:29 PM Page 283

Market price, 11
Market risk, 34, 237
Market sectors, REITs correlated to, 57–58
Market segmentation, 74–75, 97–98, 135
Marriott Corporation, 188–189
Master limited partnerships (MLPs), 61
Master plan, 9, 86
Materials stocks, correlation coefficients, 58
Mean reversion, 61
Medicaid, 199, 202, 205–206, 210, 212, 274
Medical office buildings, 201, 216–218, 221
Medical/surgical centers, 204–205, 214
Medicare, 199, 205–206, 215, 275
Merchant builders, 89
Merchant building sales, 124
Merged REITs, 35
Mergers, 207, 232
Merrill Lynch, 118
Metropolitan markets, 31, 37, 155, 172
Microeconomics, 9
Mid-rise, defined
  apartment buildings, 131–132
  office buildings, 152–153
Minority partners, 109
Modern portfolio theory (MPT), 41–42, 57, 275
Moody's, 6, 171, 236
Morgan Stanley
  Capital International's Europe Asia Far East Index, 48
  REIT Index, 36, 118
Morningstar, 33
Mortgage-backed securities, 73, 235
Mortgage loans, 95, 133, 201–202, 207–209
Mortgage pools, 236, 240
Mortgage property, publicly traded, 37
Mortgage REITs, 3, 35–36, 208, 233, 235–240, 275
Motel properties, lease duration, 7
Motor inns, 190
Movie theater ownership, 229
Multiasset-class portfolio, 37, 48, 50, 63
Multifamily commercial properties, 236–237
Multifamily properties, 129, 132, 135, 273
Mutual funds
  asset diversification rules, 23–24
  characterized, 33, 42, 54–55, 62–63
  directory of, 241–249
  publicly traded, 54

NAREIT Equity Index weight
  characterized, 35, 46, 56, 58–59
  diversified REITs, 232, 234
  health care properties, 199–200, 219
  hotel REITs, 187–188, 196–197
  industrial REITs, 161–162, 166–167
  manufactured home community REITs, 141–142, 147–148
  mortgage REITs, 233, 235, 239
  office REITs, 149–150, 159
  residential REITs, 129–130, 137–138
  retail property REITs, 169–170, 184–185
  self-storage REITs, 223, 228
  specialty REITs, 229–230, 240
NASDAQ Composite, 29, 44
National Association of Real Estate Investment Trusts (NAREIT), 116–119
  Equity Index, *see* NAREIT Equity Index weight
  50 Index, 35
  Mortgage Index, 36
National economy, impact on real estate market, 9–10. *See also* Economic conditions; Market conditions
Negative correlation, 57, 63
Negotiations
  bidding process, 87
  development projects, 81, 85
  influential factors, 11
  joint venture/partnership agreements, 96, 99
  joint ventures/partnership operations, 92–93
  retail property leases, 177, 179
Neighborhood shopping centers, 170, 172–173, 178
Net asset value (NAV)
  analysis, 103–106, 112–114
  cycle, 61–62
  defined, 275
  historical data, *see* Net asset value (NAV), historical data
Net asset value (NAV), historical data
  diversified REITs, 234
  health care REITs, 220
  hotel REITs, 196
  industrial REITs, 166
  manufactured housing, 147
  mortgage REITs, 239
  office REITs, 158
  residential REITs, 137
  retail REITs, 184
  self-storage REITs, 227
  specialty REITs, 231
Net income, 27, 108, 117, 122–123
Net operating income (NOI), 102, 104–106, 111, 121
Net present value (NPV), 111
Net return, 48
New development, 68–69

27_769193 bindex.qxp 5/18/06 8:29 PM Page 284

New-era REITs, 20–21, 23
New REITs, 35
New York Stock Exchange, 29
Nifty-50, 61
Nonconforming loans, 235
Noncustomary services, 22–23
Nonperforming real estate assets, 20
Non-real estate firms, 74, 77
Nonrecurring expenses, 116–117
Nonrent income, 105
"Not in my backyard" mindset, 9, 85, 88
Nursing homes, 121, 201, 203, 205, 209–212, 221

Obsolescence, 104, 107, 135, 163–164, 171, 180–181
Office buildings
  development process, 88
  impact of externalities, 34
  medical, *see* Medical office buildings
  ownership of, 121
  tenant improvements, 136
Office park, defined, 153
Office REITs, 149–159
Office space
  demand for, 149–150, 154–155
  lease duration, 7
  publicly traded, 37
Operating agreements, 6
Operating cash flow, 107–108
Operating earnings, 117
Operating EPS, 109
Operating income, 122
Operating margin, 107
Operating partnership, 113
Operating performance, 108
Operational risk, 203
Operations, TRS provisions, 24
Opportunity cost, 156
Optimization process, 49
Options, land acquisition process, 84
Ordinary income, 48, 120, 125
Outlet centers, 170
Outlet malls, 172, 174
Outstanding shares, 36
Overbuilding, 20
Overleveraged real estate industry, 20
Owner-occupied industrial real estate, 161, 163
Ownership
  direct, 4, 74
  geographic distribution of REIT property, 37–38
  implications of, 30, 121, 229–230, 233
  TRS provisions, 24

Paid to wait opportunity, 61
Paired-share REITs, 122–125
Paperclip REITs, 122–125
Participating mortgage, 238
Partnership(s), 6, 92–97, 99. *See also specific types of partners*
Passive investments, 33
Passive losses, 25
Pass-through entities, 4
Payout ratio, 60
Pension funds/plans, 4, 6, 42
Percentage rent clause, 177
Performance measurement, 11–12, 28, 32
Physical attributes, significance of, 9, 33–34
Physical depreciation, 109
Physicians' clinics, 201, 216–218, 221
Political support/coalitions, for development projects, 85–86
Pooled opportunities, 62, 92
Population migration, impact of, 132–133. *See also* Demographics
Portfolio
  contribution, 46–49
  diversification, 10, 28, 37, 39, 46, 54, 62, 98
  manager, functions of, 54
  performance, influential factors, 46–49
  risk, 6, 33, 57
Positive earnings revision analysis, 109–110
Positive spread investing (PSI), 112, 275
Power centers, 170, 172, 174
Preferred rate of return, 92, 94
Preferred stock, 105, 107, 120
Preleasing activities, 82, 88
Prepayment, mortgage loans, 238–240
Price, 10, 12, 55
Price/FFO multiple, 107–108, 110
Price-to-earnings (P/E) ratio, 108
Primary data, 76
Primary research, 97–98
Prime rate, 237
Prison ownership, 229
Private market value, 104–105
Private mortgage insurance, 236
Private real estate agencies, 25
Production planning, 86–87
Professional management, 62, 72
Pro forma return expectations, 89
Profit, 99, 123
Profitability, 111, 115, 191, 208
Programming stage, of discovery process, 86
Property
  appraisal, 114
  exposure, 32

27_769193 bindex.qxp 5/18/06 8:29 PM Page 285

management, 124
prices, 68
type, significance of, 12–13
uniqueness, 11, 28–29, 102
value/valuation, 8, 106, 238
Publicly traded REITs
for-profit hospitals, 215
hotel, 197
office, 149–159
characterized, 4, 20–21, 34–35
retail property, 185
Public-market-based valuation, 101
Public market real estate indexes, 35–38
Public real estate sectors
diversified REITs, 232–233
health care properties, 199–221
hotel REITs, 187–197
industrial REITs, 161–167
manufactured home community REITs, 139–148
mortgage REITs, 233, 235–240
office REITs, 149–159
residential REITs, 129–138
retail property REITs, 169–185
self-storage REITs, 223–228
specialty REITs, 229–231, 240
Public relations costs, 116
Purchase agreement, 83

Quadrant chart, 68–72
Qualified REIT subsidiary, 24
Qualitative value, 114
Quality controls, types of, 23
Quantitative analysis, 101
Quarterly returns, 11–12, 32, 44, 45

Rate of return, 43, 92, 94, 111
Rational investors, characteristics of, 54, 63
Real estate
as asset class, 3–14, 19
attribution of return, 6–10
bubble, 12
characteristics as an investment, 3–4
credit profile, 8
cycles, 61, 68–69, 77, 81, 95–96
externalities, 8–9
location, 8
Real estate asset class, 27–35
credibility of, 12, 21
negative attributes of, 11–14
positive attributes of, 4–6, 14
property ownership, geographic distribution of, 38
public market real estate indexes, 35–37
Real estate brokers, 124, 177
Real estate development, 79–90, 93–94
influential factors, 9
securities indexes, 33
Real estate investments
benefits of, 28
feasibility of, 9
risk factors, 6
stock and bond investments compared with, 4–8, 11, 32, 39
Real Estate Investment Trust Act of 1960, 4, 275
Real estate investment trusts (REITs), *See also specific sectors*
as asset class, 27–39
business model, 99
daily trading volume, 30
defined, 3, 24, 275
directory of, 251–271
growth of, 13, 21, 24
historical perspective, 4, 13–14
legislation, 18–19, 24
structure of, 15–18
Real estate market, 67–76, 90. *See also* Real estate, cycles; Supply and demand
Real estate mutual funds, directory of, 241–249
Real estate operating companies (REOCs), 21, 27, 54
Real estate sector
publicly traded property, 37
regulation of, 13
Recapture value, 104
Recession, historical perspectives, 19–20, 233
Recovery phase, in real estate market cycle, 69–70, 77
Recycled properties, 131
Redevelopment, 9, 80–81
Regional economy, impact of, 68
Regional malls, 169, 172–173, 176–180
Regional markets, 39
Regional shopping centers, 172
Regulatory environment, 68, 77. *See also* Legislation
REIT Modernization Act (RMA) of 1999, 24, 124, 275
Renovated buildings, 131
Rent
control, 68
health care facilities, 203, 206
hotel properties, 194
implications of, 5
income from, 7, 118
manufactured home communities, 145
office buildings, 151
payments, TRS provisions, 24
prices, 68–69, 71

27_769193 bindex.qxp 5/18/06 8:29 PM Page 286

Rent (*continued*)
retail properties, 177, 179
self-storage units, 225
versus buy decision, 133
Replacement cost, 8, 101–103, 114, 156
Residential properties
development trends, 155–156
land sales, 118
mortgage loans, 235
publicly traded, 37
Residential REITs, 129–138, 142
Restricted assets, 121
Retail industry, 103
Retail malls, development process, 88, 155
Retail property, *see also* Retail property REITs
lease duration, 7
publicly traded, 37
Retail property REITs, 169–185
Retirement care communities, 213–214
Retirement destinations, 132
Retirement funds, 5–6
Return(s)
on capital, 60–61, 82, 95–96, 120, 125, 208
competitive, 50
on real estate, attribution of, 6–10
significance of, 13–14, 50–51
RevPar (revenue per available room), 192, 194
Risk
assessment, 89
avoidance strategies, 48
exposure, 89
management of, *see* Risk management strategies
mitigation, 31
premium, 104
profile, 88, 93, 106
risk-reward analysis, 50
systematic, 34–35
Risk management strategies
health care REITs, 202–203
implications of, 33–35, 51, 113
mortgage REITs, 235–236
real estate development, 80, 82, 87–88, 90
Rollover phase, in real estate market cycle, 69–70, 71, 77
Rooftop rentals, 229
Russian bond default crisis, 34

Sale/leaseback, health care facilities, 201–202, 207–209
Sale of property
gains and losses, 117
implications of, 108
terms and conditions of, 11
S&P 500
correlation coefficients, 58
as information resource, 44, 46, 48
interest rates and, 56
S&P REIT Composite Index, 36
Savings and loan (S&L) crisis, 12, 20
Secondary data, 76
Secondary market, mortgage portfolios, 236
Securitization, 13, 21, 275
Security selection process, 46
Self-liquidation, 54
Self-storage facilities/property, *see also* Self-storage REITs
development process, 88
publicly traded, 37
Self-storage REITs, 223–228
Selling process, disadvantages of, 11
Senior living communities, 142–143
Sensitivity analysis, 89
Shadow space, 154
Shareholder(s), 120–123
value, 23, 97–99, 110–111, 219
Share price, 36
Shopping centers
characterized, 30, 169, 178–179
classification of, 170
ownership of, 121
Shopping malls, 23, 170
Single-family mortgages, 236
Single-family residential real estate, 62
Single-property-category REITs, 233
Site
acquisition, 82
analysis, 83
improvements, 102
selection factors, 224–225, 228
Skilled nursing facilities, 205, 209
Skilled nursing home care, 205, 209–210
Small-capitalization REITs, 35
Small-cap stocks, 44
Small investors, historical perspectives, 12
Small stocks, 44–45, 48–49
Soft market, 71, 81
Solomon Smith Barney, 118
Special purpose buildings, industrial REITs, 163
Specialty care facilities, 205
Specialty malls, 170, 173–174
Specialty property, publicly traded, 37
Specialty REITs, 36, 229–231, 240
Speculative construction, 88
Spin-offs, 201, 207–208
Spread investing, 201
Staged payments, 84

27_769193 bindex.qxp 5/18/06 8:29 PM Page 287

Standard & Poor's, 6, 171, 236
Standard deviation, 42–44, 49, 275
Step-up depreciation, 109
Stock(s), *see also* Common stock; Preferred stock
  allocation, 46
  exchanges, 29
  investments compared with real estate investments, 4–5, 11, 32, 39
  market bubbles, 61
  returns, 43–44
  selection, 106
Stock-and-bond asset classes, 43
Straight-line depreciation, 120
Straight-lining rents, 117–118, 275
Strip shopping centers, 179
Structured partnerships, 6
Subleases, 154, 217
Suburban properties, *see also* Residential properties; Residential REITs
  hotels, 190–191
  office buildings, 155
  office decentralization, 156–157
  office parks, 153
Super-regional malls, 170, 172–174
Supply and demand
  apartment buildings, 132, 138
  health care REITs, 201, 204, 210–211, 213
  impact of, 9, 13, 30–31, 37, 39, 68–69, 72, 76–77
  industrial buildings, 164–165, 167
  office buildings, 149–150, 153
  office space, 149–150, 153–155, 159
  real estate development and, 79–80
  residential REITs, 133
  retail properties, 174–175
Supply phase, in real estate market cycle, 69–70, 77
Swaps, 237
Syndications, 92
Synergy, in joint venture/partnerships, 97, 99
Systematic risk, 34–35

Tax/taxation
  basis, stepped-up, 120–121
  benefits, for joint ventures and partnerships, 92
  deduction for mortgage interest, 95
  deferral, *see* Deferred taxes
  dividend distribution, 60
  legislation, 18–19, 22, 25, 94–95, 276
  rate, 60
  REIT advantages, 4, 10
  retail properties, 177
  shelters, 4, 18, 121, 125
  status, 48
Taxable investors, 5, 59–61, 63, 215
Taxable portfolio, diversification and, 48
Taxable REIT subsidiaries (TRS), 24, 121, 124–125
Tax-exempt investors, 6
Tax-exempt portfolios, 48
Taxpayer Relief Act of 1987, 22
Tax Reform Act of 1986, 18–19, 25, 94–95, 276
Technology stocks, 57
Telecommuting, 156–157
Tenant(s)
  anchor, 173–174, 176, 178–179
  attraction strategies, 22–23
  credit, 274
  health care facilities, 201, 203, 207
  improvements, 119, 136
  inline, 176, 178
  medical offices, 217
  office space, 154–155
  retail properties, 171
  retention strategies, 22–23, 71
  straight-lining rents, 117–118
  turnover, 135–136, 143, 145
Theme malls, 170, 174
Third-party investors, 217
Third-party services, 22–23
Timber REITs, 229, 240
Time horizon, significance of, 53, 95
Timeline of development stages, 81
Time management, development projects, 80, 90
Total market capitalization, 106, 276
Total return
  defined, 276
  historical data, *see* Total return, historical data
  influential factors, 43–44, 50, 63, 112
Total return, historical data
  diversified REITs, 234
  health care REITs, 200, 220
  hotel REITs, 196
  industrial REITs, 166
  manufactured housing, 147
  mortgage REITs, 239
  office REITs, 158
  residential REITs, 137
  retail REITs, 184
  self-storage REITs, 227
  specialty REITs, 231
Trading volume, 36
Transition points, 202, 218
Transportation costs, 165
Transportation system, significance of, 156
Treasury bills (T-bills), 46, 48, 50, 56
Treasury securities, 57

27_769193 bindex.qxp 5/18/06 8:29 PM Page 288

Triple-net lease, 201
Trough phase, in real estate market cycle, 69, 71, 77
Trump, Donald, 8, 79

Umbrella partnership REITs (UPREITs), 112–113, 276
Underperforming assets, 33
Underwriting, 13, 206–207, 235
Uniplan Real Estate Advisors, 56, 105
U.S. bonds
  government, 46
  nongovernment, 4
U.S. Department of Commerce, retail property statistics, 171
U.S. Department of Housing and Urban Development (HUD), 140–141
U.S. domestic economy, 73
U.S. domestic real estate, 4
U.S. equities, 4
U.S. Small Stock Series, 48
U.S. Treasuries, *see* Treasury bills (T-bills)
Unit investment trusts (UITs), 54–55, 62–63
Unsecured debt, 106
Urban infill communities, 9, 131
Utility stocks, 56, 58

Vacancy rates
  implications of, 69–71
  industrial buildings, 164
  office buildings, 154–155
Valuation
  basic methodologies, 101–103
  capitalization rate, 102–103, 114
  cash yield on cost (CYC), 111–114
  earnings per share (EPS), 109
  enterprise value/EBITDA multiple analysis, 106–107, 113–114
  influential factors, 60–61
  market comparables, 102–103, 114
  multiple-to-growth ratio analysis, 107–108
  net asset value (NAV) analysis, 61–62, 103–106, 112–114
  positive earnings revision analysis, 109–110
  replacement cost, 101–103, 114
  return on capital vs. cost of capital analysis, 110–111, 114
  supply and demand and, 67
Value-added, in real estate development, 80, 87–88
Value creation, 9, 87–88, 90
Value of real estate, *see also* Valuation
  influential factors, 8–9
  supply and demand, 9–10, 13
Variances, 85
Volatility
  historical data, *see* Volatility, historical data
  impact of, 43, 46, 50, 63
  measurement of, 44
  portfolio diversification and, 48
Volatility, historical data
  diversified REITs, 234
  health care REITs, 220
  hotel REITs, 195–196
  industrial REITs, 166
  manufactured housing, 147
  mortgage REITs, 239
  office REITs, 157–158
  residential REITs, 136–137
  retail REITs, 184
  self-storage REITS, 227
  specialty REITs, 231

Wall Street Journal, 33
Wal-Mart, 174, 180
Warehouse space, industrial REITs, 162–163
Web sites, as information resource, 42
Weighted average cost of capital (WACC), 111–114
Weissenberger's, as information resource, 33
What-if analysis, 49
What-if simulations, 47–48
Wilshire Associates, 36
Wilshire Real Estate Securities Index, 36
World Trade Center, 157

Yield
  cash yield on cost (CYC), 111–114
  dividend, 137, 147, 158, 166, 184, 196, 220, 227, 231, 239
  incremental, 80
  management, 193

Zeckendorf, John, 79
Zell, Sam, 139–140
Zoning
  codes, 9, 81
  externalities and, 9
  office buildings, 153
  standards, 156
  variances, 85

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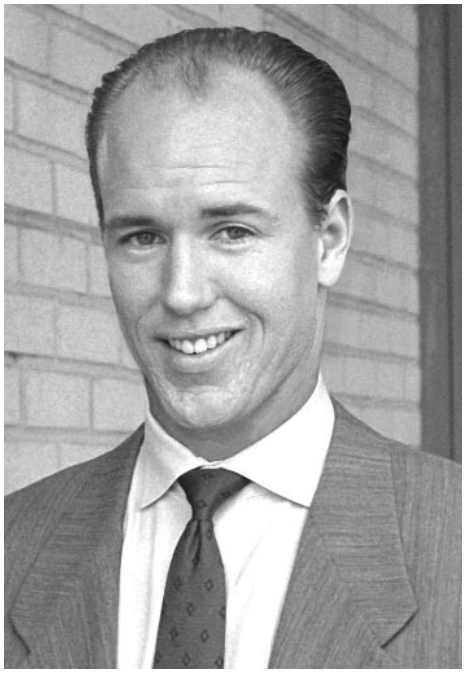

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Most people don't know how to successfully maximize their investment dollars and others are not able to accumulate those additional dollars to invest. It becomes a revolving turnstile few of us are able to change. Additionally, it is well known that two thirds of America's population lives from paycheck to paycheck and less than three percent of us are considered financially secure at retirement.

We can write books and talk for hours on how difficult our financial circumstances are, but the bottom line is "We" have to take responsibility to change our future.

The purpose of this material is to give each and everyone, who is willing to take a little time, a chance to improve their financial situation with discounted real estate notes. I know you will succeed and earn quick cash profits of $2,000 to $5,000 and 20% or more on your own investments. If for any reason you are not satisfied with this information and opportunity of a life-time, please return it within thirty-days for a full refund of your purchase price, less shipping and handling

I truly hope my sincerity shines through in this presentation. My staff and I follow the old saying, "By helping others become successful you will become successful yourself". This statement truly captures our philosophy.

Warmly,

Russ Dalbey
Founder

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Overview Of This Business

The discounted mortgage business has been in existence since people owned real estate. Currently there are over $90,000,000,000 in owner-financed trust deeds and mortgages nationwide.

The majority of people holding "paper" would like to sell it if only they knew the option existed. For the educated note Buyer, this creates an enormous profit potential.

There are two unique, yet easy to understand, ways to make money in this business. First, you can do what is known as "flipping" which is how most people get started in this industry because it requires no capital outlay. This is where you locate the Note Holder and place them with a Buyer and you earn a fee for your services.

The other way is to buy these discounted notes for yourself. It is not uncommon to receive returns of 20% or more on your money. These are extremely safe investments, secured by valuable real estate.

To give you an example of the safety of trust deeds and mortgages we would like to highlight the fact that insurance companies and most pension funds invest more than fifty (50%) of their assets in real estate notes.

Until recently, the real estate note industry has only been utilized by large conglomerates and very few individuals or small companies have been able to participate, due to lack of knowledge. Now however, this powerful information is available to you. You can make as much money as you wish due to the information provided to you in this course. It's the most important education you can ever receive!

Discounted Real Estate Notes

Investing in discounted paper is the practice of purchasing notes, secured by real estate, at an amount less than the remaining balance of the note, so that the return to the investor will be maximized by a combination of the interest and the discount received.

For example, a Seller sells his property for $60,000, the Buyer pays $12,000 cash as a down payment and the Seller carries the financing. So there is a Seller carry back trust deed/mortgage for $48,000 secured by the property.

In most cases, the Seller would rather have had cash at the time of sale. The investor, who purchases the trust deed / mortgage from the Seller, will offer an amount less than the balance due on the note. The Seller will accept immediate cash instead of years of monthly payments. As a result, the note investor will receive the benefit of a cash discount plus the principle and interest due on the note. Additionally, the person who finds the note and line up a Buyer by listing in on the America's Note Network's web site will earn $2000 and more for doing so – and all without using any money of his own.

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Table Of Contents

<u>Section One</u> – Overview Of The Real Estate Note business **1**

No money needed when referring the note - $2,000 to $5,000 per transaction
Find ‘em, list ‘em on America’s Note Network and make money
Full time income part time work
Best hassle free way to make money in real estate today
Your check arrives in three weeks or less

You have the “Note Know-How”
No work and monthly checks come to you
Earn 20% or more on your investments

Guaranteed return
The most powerful wealth-building program ever
A $4 Trillion industry
Tax Savings
Good no matter what the economy is doing

<u>Section Two</u> – Quick Cash Profits - How To Refer Notes And Make Profits Of $2000 - $5000 Not Using Any Money Of Your Own **19**

40 Ways To Find Notes And That
Referral Marketing Is A Money Machine
The Ten Simple Steps To Close A Transaction
I Help People Get A Lump Sum Of Cash For Their Future Income.
The Paper Work Necessary To Close & Earn $2,000 And More
List The Notes On America’s Note Network’s web site For A Fast Sale

<u>Section Three</u> – What To Do First! 40 of the Best Way To Have The Deals Find You! **34**

What To Do First! 40 of the Best Way To Have The Deals Find You!
The note business is one of the greatest businesses in the world.
Part Time Work With Full Time Pay
Few Are Doing This Business
Success Stories - Over $50,000
Easily Earn $2,000 To $5,000
The Future Of The Note Business
Tools To Earn As Much As You Wish
Marketing Magic - Turn Your Business Into A Money Machine

Bonus Gift One – Money Math & Magic - Learn the inside secret to making even higher commissions on every deals. **51**

Bonus Gift Two – Creative Deal Structuring For Big Profits - How To Earn 20% And More On Your Own Investments **73**

The Order Of Business For Note Purchase **107**

Appendix **135**

Court House Lead Sheet
Eight Telephone Scripts
High Response Post Cards
Blue Print For Your Note Business
Note Pricing Guideline
Note Brokers Resource Kit
Ten Special Custom Cash Clause
Sixty Different Cash Flows To Broker

Glossary **173**

Terms Of This Business

Mortgage: A legal document executed by an owner of real estate by which the property is given as security for a payment of a debt.

Mortgagee: The Seller of the property who receives the monthly payments and holds the mortgage contract as security.

Mortgagor: The owner of the real estate. Also the borrower making monthly payments to the mortgagee.

Note: A written document that states a promise to pay, and the terms which include the amount, interest rate and length of time.

Trust Deed: Or Deed of Trust. A deed given by the borrower to a trustee to be held pending fulfillment of an obligation. This is the security instrument which pledges the property to insure payment on the note.

Trustee: One who holds property in trust for another to secure the performance of an obligation. An example of a trustee would be a title company or attorney.

Trustor: The person who conveys property in trust. One who deeds his property to a trustee to be held as security until he has performed under the terms of a deed of trust.

Payor: The person who makes the monthly payments to fulfill the terms of a note. It is also the mortgagor with a mortgage contract or a Trustor with a trust deed.

Yield: Your total return on an investment over a given period of time.

LTV: Loan To Value is the percentage ratio between the amount of the total loans on a property and the property value.

ITV: Investment To Value is the percentage ratio between the total loans on the property, less your investment cost and the value of the property.

Flipping: Slang for referring a note to an investor and making a quick cash profit.

End Buyer: The person who purchases the real estate note you find.

The Security

Promissory Note	+	Trust Deed Or Mortgage
Obligation to Pay		Security Instrument

The promissory note states the terms in which the obligation is to be paid. Also, this is where you can state additional terms or clauses. For example, the property may not be sold or transferred without the loan being paid off or the permission of the Note Holder.

Some states use the trust deed as the primary security instrument and others states use a mortgage contract. The major difference between the two instruments is the manner in which the property is foreclosed.

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Calculating A Yield

Example:
Using an HP-12C Calculator;

An existing $27,000.00 note and trust deed or mortgage at 9% interest in second position (meaning a first loan has been recorded prior to this loan).

There are twenty-five (25) monthly payments of $202.50 interest only (meaning no monthly principle reduction, the payment is all interest). Below find that "N" stands for number of payments remaining, "I" is interest rate, "PV" is for present or face value of the note, "PMT" is the payment amount and "FV" stands for future value.

N	I	PV	PMT	FV
Number of Pmts 25	Interest Rate 9%	Present Value $27,000	Payment Amt $202.50	Futiure value $27,000

PV		YIELD
$14,800	=	41.8%
Discounted Purchase Price		Total Return on Investment

The yield is the total return on the investment over a period of time. It represents a combination of the 9% interest rate on the note and the discount received. In this example the investor is paying $14,800 now for a balloon payment of $27,000 in twenty five (25) months. Plus, he is receiving the monthly interest payments.

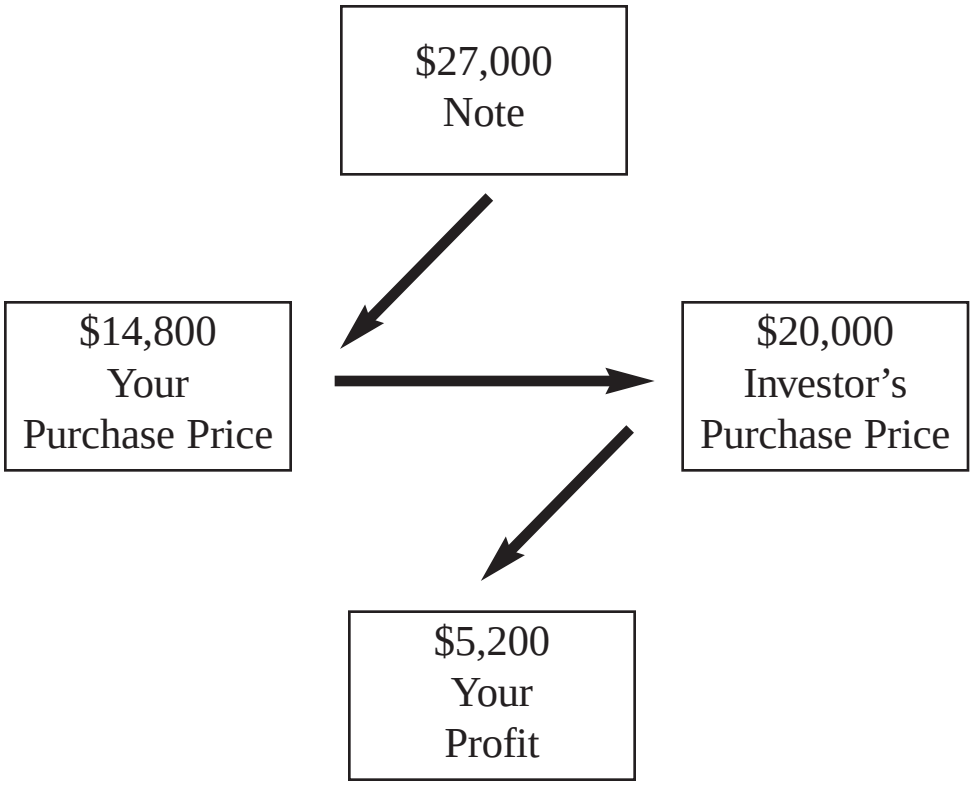
Referring A Real Estate Note Or Flipping

* No Capital Needed

* Produces A Large Monthly Income

* Average Of $2,000 To $5,000 Per Deal

* Creates A Cash Flow To Put You In The Investor Category



So, what if you don't have any money to invest at all? You could act as the middleman by finding the note. You have a confirmed purchase price of $14,800 and a sales price of $22,804.28 to an investor — you keep the difference. This is reasonable because your investor will still get eighteen (18) percent yield on his money, and you pocket the $8,004.28.

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Possibilities & Considerations

1. The Payor makes the monthly payments until the note is paid off.

2. The Payor refinances the property and you get paid off the full amount early.

3. The payments stop coming in and you foreclose, keeping the property and all the equity.

Protective Equity:

Protective equity is the difference between the value of the property and the loans against it, including yours. The greater the equity, the more secure your investment will be.

Seasoned:

A loan is "Seasoned" when the Payor consistently makes his or her payments over a period of time. The textbook definition is twelve (12) months.

Property Location:

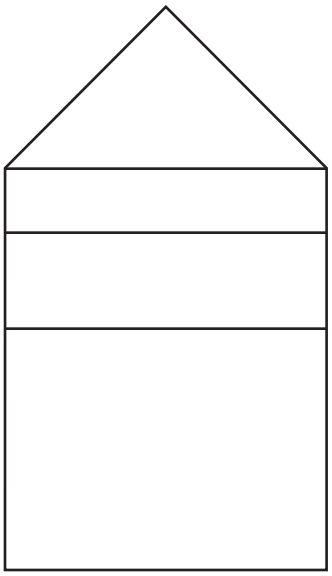
Know the area. Never buy a note on a property you would not mind owning.

Foreclosure:

If the investor purchases a note with good equity in the property, his investment is protected. The property is the security. Foreclosure is the legal process safeguarding his interest.

Creating A Note

The selling price $100,000



Total Loans
$80,000

The Seller has a $100,000 house for sale. There is an existing first loan of $50,000 to the bank and equity of $50,000.

The Buyer agrees to the Seller's purchase price, but only has $20,000 cash for a down payment. The Buyer has good credit and is able to assume the first loan from the bank.

To complete this sale, the Seller will carry back a $30,000 second loan.

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DO NOT DESTROY THIS NOTE: When paid, this note, with Deed of Trust securing same, must be surrendered to Trustee for cancellation before reconveyance will be made.

NOTE SECURED BY DEED OF TRUST

(INSTALLMENT - INTEREST INCLUDED)

$ _____ _____, California _____, 20____

In installments as herein stated, for value received, I promise to pay to _____

_____

_____

_____

_____

_____

_____

_____ or order

at _____ _____ the principal sum of

_____

_____ dollars

with interest from _____ on unpaid principal at the rate of _____ per cent

per annum, principal and interest payable in installments of _____

_____ _____ dollars or more on the _____ day of

each _____ month, beginning on the _____ day of _____, 20____

and continuing until

Special Custom Cash Clauses Go Here:

(Generally not available from your Attorney, Real Estate Agent, Title or Escrow Company)

1. First Right Of Refusal: Buyer has the first right to buy this note back at the maximum discount Seller offers to anyone else.

A. Buyer has thirty (30) days from written notice by seller to act.

B. Seller will pay attorney fees if Buyer has to litigate to enforce this right.

Each payment shall be credited first on interest then due, and the remainder on principal, and the interest shall thereupon cease upon the principal so credited. Should default be made in payment of any installment of principal and interest, the whole sum of principal and interest shall, at the option of the holder of this note, become immediately due. Principal and interest payable in lawful money of the United States. If action be instituted on this note, the undersigned promise _____ to pay such sum as the Court may adjudge as attorney's fees. This note is secured by a DEED OF TRUST to SAFECO TITLE INSURANCE COMPANY, a corporation.

_____ _____

_____ _____

_____ _____

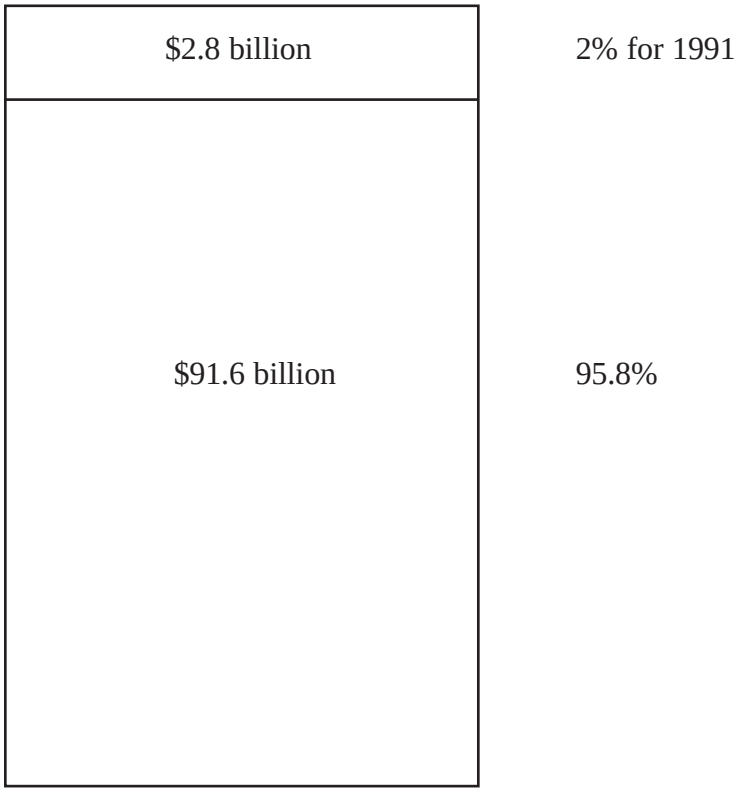
Where To Look For Real Estate Notes

The HUD Housing Survey shows 1.8 million homes totaling $94.4 billion of existing private owner financing.

In 1991, there was approximately $2.8 billion of new owner financing created.

98% of the note Buyers and brokers are focusing on these newly created notes, which represent only 4.2% of the market.

Only 2% of the notes Buyers and brokers are accessing this remaining 95.8%.



You will be one of the 2% of the note Buyers and brokers accessing the 95.8%, which represents over $90 billion of this market.

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Your Typical Discounted Note

Let's look at a typical note and why the Note Holder would want to sell it.

- Original Amount: $25,000
- Ten (10%) Percent Interest
- Amortized Over 15 years
- Monthly Payment: $268.65
- 18 Payments Made - 162 Remaining
- Present Balance: $23,833

These figures represent the average note.

You are looking for a twenty- five (25%) percent yield on your money, representing a purchase price of $12,438. Why would the Note Holder take $12,438 cash now for his $25,000 note?

* They get a lump sum of cash now, not a small monthly payment
* Medical Emergencies
* Taxes
* Credit Card Debt
* College Education
* Buying New Home Or Business
* Vacation

First, you could refer the note for a quick $3,866.19! Second, you could purchase the note and your total return would be $43,521.51 or 25%! And third, the note could pay off early and you could earn 40% on your investment!

As you can see, there are any number of situations that arise where the Note Holder would need your services to cash them out. The most important reason is that they didn't want the note in the first place.

The Note Network Paper Work Sheet

Name : JOHN SELLER Date: 3-7-2000

Address: 1616 SAGAMORE AVE.

Phone #: 459 - 8214

Property Information

Property Address: 124 WALNUT ST. HOUSTON TX.

Type Of Property: SINGLE FAMILY RESIDENCE. Owner Occupied: YES

Property Value: $ 112,000 Established By: SALE Date: SEPT. 1 1992

1st loan Amount: $ 62,000 Monthly Pmt: $ 391.88 New / Assumed

2nd loan Amount: $ 25,000 Monthly Pmt: $ 268.65 New / Assumed

Down Pmt Amount: $ 25,000 LTV: 78 % ITV: 66 %

Note Information

Original Amount $ 25,000 Balance $ 23,833.85 As of: 3-1-2000

Interest Rate : 10 %

Payment Amount : $ 268.65 Date of 1st Payment : 10-1-1998

Original Length: (15 YRS) 180 mos. Type: Amort, I/O, Other ~~0~~

Number of Payments Made: 18 Number Remaining: 162

Are the payments on time: YES What day of the month are they due 1

Balloon Payment if any: $ ~~0~~

Are there any Clauses: DUE ON SALE.

Seller Information

Note Seller's Motivation: BUYING A NEW HOME.

When Needs To Close: 30-45 DAYS Received other Offers: $ 11,850

What does the Payor do for a living MANAGES A RETAIL STORE

Is there anything else I should know PAYOR has GOOD CREDIT

25% YIELD — PAY $ 12,438

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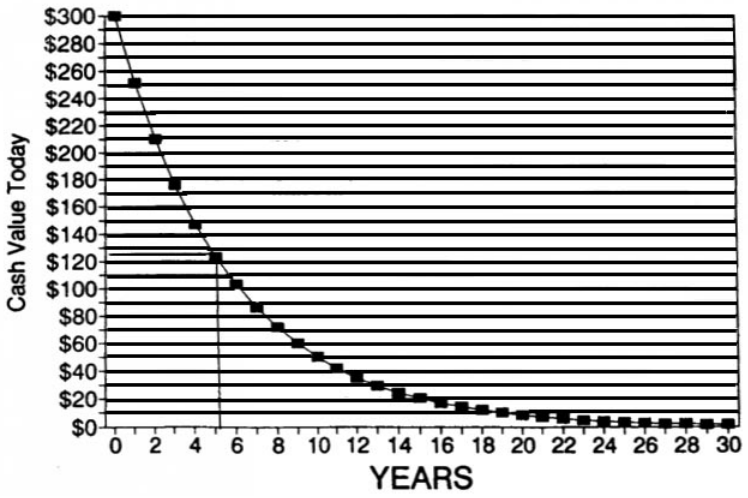
The Time Value Of Money

When determining a cash value for a trust deed or mortgage we must consider the following:

* Where is it located?
* What type of property and its value?
* What is the interest rate on the note and terms?
* How long will it take to collect all the payments?

One of the most important factors is usually the length of time it will take to collect all the payments. The longer we wait, the less value or buying power the money has, due to inflation and economic conditions. This is what is referred to as the *Time Value of Money*. Immediate cash is more valuable than money in the future.



Above is a graph that gives an example of the *Time Value of Money*. It plots the diminishing cash value of a $300 monthly payment over thirty years (30). As the chart shows, the cash value of the payment rapidly diminishes as it stretches into the future. For example, an investor, looking for an eighteen (18) percent yield, would pay $123 today for a $300 payment due in five (5) years.

Rule of 72

An interesting concept to help you understand the power of compounding money is the Rule of 72. This rule calculates how long it will take to double your money at the respective interest rates compounded yearly. To determine the number of years it will take, simply divide the interest rate of your investment into 72. The answer equals the number of years necessary for your money to double.

At	3%	it would take	24	years
At	6%	it would take	12	years
At	12%	it would take	6	years
At	20%	it would take	3.6	years
At	25%	it would take	2.8	years
At	40%	it would take	1.8	years

To help you better understand the power of this example consider this example of investing $100 per month for thirty-years at the following interest rates.

At 3 %	$58,273
At 12%	$349,496
At 15%	$692,327
At 20%	$2,297,783
At 35%	$107,140,942

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Loan Payoff vs. Discounted Notes

Would it be more profitable to pay off a $100,000 home loan or to take that same amount of money and invest it in discounted notes?

Example of Loan Payoff:

$100,000 home loan with an eight (8%) percent annual interest rate, amortized over 30-years, with a monthly payment of $733. If the home loan were paid off you would save or make eight (8) percent per year.

Example Note Purchase:

Taking the same $100,000 and investing it safely in discounted trust deeds with an average yield of twenty (20%) percent you could buy $191,000 in notes.

Your monthly income from $191,000 is $1,676, based on the average note having a ten (10%) percent interest rate.

Compare:

* Pay off the home loan and make $733 per month

* Buy discounted notes and make $1,676 per month

* If you have the know-how, your profit is $943 per month

* Refer the note for a quick $8,000 + profit

Investment Alternatives

Source	Rate of Return	Comments
Stock Market		
Banks & Savings		
Real Estate		
Limited Partnerships		
Discounted Paper	15% to 50% Yield And More	Safe Secure Growth Of Investment High Monthly Income Self-Managed

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Advantages

Real Estate Secured Notes The Reason They Are The Best Investment And Why People Will Stand In Line To Buy Every One You Find.

Safety

High Yield

Live Anywhere

No Management

Monthly Income

Full Or Part Time

No Money Needed

Never A Bad Time

Unlimited Profit Potential

High Probability Of Early Payoff

Returns Both Interest & Principle

No Employees, Inventories Or Overhead

Benefits Of Real Estate Ownership Without The Hassle

Bill Buyer Makes $12,000 With Custom Cash Clause

Right Of First Refusal Clause

The maker of this note reserves the right of first refusal to purchase this note back, at a discount (at the price a third party would pay), in the event the holder decides to sell it at a discount. You will want to include these factors: Holder shall deliver written notice of such proposed sale to maker by certified mail at (**address**); maker shall have (**number**) working days from delivery of said notice to buy the note at the discount offered to the third party; holder shall pay maker's legal fees in the event maker has to sue because of violation of this provision.

- Bill gets the note at the maximum discount offered
- He saves $12,000 on the note
- The bank loans Bill $30,000
- Bill pays Sue Seller $18,000 and pockets the $12,000 balance
- Bill's payments each month are now made to the bank
- This clause could be worth over $80,000 in a single transaction
- You can make money as the Buyer or the Seller of real estate and by referring or purchasing the note
- You will win in the cash flow business with your "Note Know-How"

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The Psychology Of Discounting Real Estate Notes

- Which would you rather have the $50 in my left hand or the $100 in my right?
- What if you had to wait seven years for the $100, but you could have the $50 now, which would you rather have? The $50, of course!
- Note Holders feel the same way. They want their money now!
- Expect annual returns or yields of 20 % to 30%, and up to 90% on problem notes.
- Referring notes to **America's Note Network**, you'll earn $2,000 to $5,000 per transaction. Deal with regular people not the big companies.
- Keep a list of all your filled out **Paper Analysis Work Sheets** to call back in three years — they will need money in the future/
- Increase your income by 20% or more!

More Reasons They Discount

- They can make a lot of money if they had their money from the note now!
- Big Dollars vs. Little Dollars – Small monthly payment – Here's a lump sum of cash now.
- Fear of Delinquent Payments – The note won't be worth anything.
- Tangible vs. Intangible – They won't discount the house, but they will discount the note.
- Relatives or Friends – Won't foreclose and will sell at a steep discount.
- Don't know how to foreclose – It's easy — get a real estate attorney.
- The process – Recognize the opportunity, act fast and lock up the deal.

Solving A Problem Pays You Well

You Win Because You Solve A Problem

Every time — even if it's not real

Find a problem and solve it

You will be rewarded richly

Lack of Confidence

In the person making the payments

In the real estate securing the note

In the economy

Deferred Gratification

People don't like to wait for their money

Give them what they want — the "now" benefit

Don't Wanters

Most Note Holders never wanted the note

They feel as if they are stuck with the note

Imperfect Market

Seller is not aware that he can sell his note

Negotiate freely

Outstanding Bills

Need to pay a medical emergency, taxes, high interest on credit cards, college, vacation — the list goes on and on

The biggest reason is that they never wanted the note in the first place

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Review Section 1

1. Refer The Note

- No money needed when referring the note - $2,000 to $5,000 per transaction
- Find 'em, list 'em on **America's Note Network** and make money
- Full time income – part time work
- Best hassle free way to make money in real estate today
- Your check arrives in three weeks or less

2. Buy The Note

- You have the "Note Know-How"
- No work and monthly checks come to you
- Earn 20% or more on your investments
- Guaranteed return

3. This is the most powerful wealth-building program ever –you will be just like the bank, only better! What do you say when someone asks you what you do? "I help people get lump sums of cash for their future income. Do you have any future income?"

4. You learned how to make several thousands of dollars on your next real estate transaction. And, that real estate notes are the basis of creative real estate financing.

5. Nine little words that can make you $500 or more, for ten seconds of work!

a. What to say to the Note Seller after you've agreed on a price: "Of course this includes the next monthly payment, right?"

b. What to say to the Note Buyer when referring a note, after you've agreed on a price: "And, of course, you get the payment beginning on _____"

6. Deal with only private party Note Holders and not big companies.

7. People discount notes for many reasons – they didn't want them in the first place.

8. The cash flow industry is a $4 trillion industry and you are one of the lucky few who are involved.

9. Tremendous tax savings by having your own in-home note business.

10. Goal is one thing – find real estate notes. The more you find the more you'll make.

11. Good no matter what the economy is doing – The worse the economy, the more you'll make.

Section 2

Quick Cash Profits

How To Refer Notes And Make Profits

Of

$2000 - $5000

Not Using Any Money

Of Your Own

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Ten Simple Steps To Making Quick Cash Profits

1. Find a note

a. Find notes for sale on America's Note Network's web site – Membership
b. Look in the newspaper for Sellers – Large metropolitan areas are best
c. Newspaper for Buyers - offer to purchase the deals they don't
d. Talk with Attorneys, CPAs, Mortgage Brokers, and Realtors and solicit referrals
e. Marketing Magic section will give you 40 of the best ways to find real estate notes

2. Determine the value of the real estate note

a. List the note on America's Note Network
b. Receive offers within a few hours
c. You'll know exactly what the note is worth
d. Accept best offer
e. Use the Note Pricing Guidelines found in the back of this manual
f. Use software program www.notenetwork.com/helptips

3. Call Seller back to make an offer to purchase the note

a. Note Seller agrees to sell - proceed
b. Note Seller declines to sell – follow up with Seller in 3-months

4. Send Commitment Letter to Seller and Request For Information

a. Include Commitment Letter – Filled out with Seller's information
b. Cover to the Commitment Letter
c. Information Request Form

5. Get signed paper back from Seller along with necessary documentation

a. Look through the paper work to be sure that you've received everything

6. Send a Non-Circumvent Agreement to Buyer protecting your interest

a. Buyer sends back the signed Non-Circumvent Agreement

7. Forward all documents you've collect from the Seller to end Buyer

8. End Buyer will open escrow to purchase

a. Buyer handles all the paper work – you do nothing from this point on

9. Transaction takes place

a. Buyer get the real estate note and future payments
b. Seller receives his check for the sale
c. You receive a check of $2,000 to $5000.00 or more

10. Good job! Let's find some more deals just like this one!

On the following pages you will find all the documents you need to earn quick cash profits of $2,000 to $5,000 and more! I would like for you to **pause the tape now** and read through these next few pages. This is an important step in understanding what's involved and just how simple it will be to earn an ongoing income.

The Note Broker Resource Kit

On the next several pages you will find six valuable resources that you may print and use over and over. Please be note, America's Note Network nor its employees are giving legal advice or recommending you use these documents. These sample documents are provided to you for educational purposes only.

1. Telephone Script

2. Paper Analysis Worksheet

3. Commitment letter – Contract With The Note Seller

4. Cover Letter to the Commitment Letter

5. Information Need From Note Seller – Information Request Form

6. Non-Circumvent Agreement – Contract With Your Buyer

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#1

Telephone Script

The telephone Script is designed to give you an idea of what to say to your prospective note Seller. Remember, you want to be comfortable with what you are saying and not come across as reading. Once you have obtained the information required, you can then post that information on the America's Note Network web site for an immediate sale. The web address is: www.notenetwork.com or you may fax or mail us the information

Note Seller's Name _____ Date_____

Address _____ Your Name_____

Phone # _____

SCRIPT FOR CALLING

Their 1st name, this is your 1st name (speak with excitement). I'm calling because I have an interest in the property you sold in (state). Do you remember? The Buyers weren't able to pay you off in full so you had to carry back a promissory note, right?

I would like to cash you out of what you're owed.

Did you know that you have a right to sell your contract and get cash now? YES NO

Would you be interested in finding out today's value of your note? YES go on / NO stop

(Paper Analysis Worksheet Questions)

1. What is the property address? _____

2. What kind of property is it? _____

3. Do the Buyers live there? _____

4. What is the property worth? _____

5. How much did you sell it for? _____

5. a. What are the loans on the property?

a. 1st Loan $_____ Mo PMT $_____ NEW or ASSUMABLE LOAN

Lender? _____

b. 2nd Loan $_____ Mo PMT $_____ NEW or ASSM

Lender? _____

d. What was the Down PMT$_____

6. What is the original amount of your note? _____

7. What is the interest rate on your note? _____

8. What is the monthly payment amount you receive? _____

9. What is the original length of time on the note? _____

10. When did you receive your first payment? (Mo & YR) _____

11. What day of the month is your payment due? _____

12. How many payments have you received? _____

13. Have all of your payments been received on time? YES / NO

(if no) number of months late? _____

14. What does the Payor do for a living? _____

15. If we were to agree upon a price, how soon would you need the cash? _____

Ok, let me analyze your information and I'll call you back in a few minutes with an exact price.

(Now post this information on America's Note Network's web site at www.notenetwork.com. By posting this information you will gain an immediate idea of what the nose is worth from the end Buyer. Once you know what a Buyer will pay for the note simply deduct $2000 to $5000 from that price and offer it to the Seller. The amount you deduct will be the amount you earn for your efforts. Be sure to check with the Buyer to be sure that the price offered is total price you will receive. Some Buyer will make you pay from $500 to $800 in closing costs, which will come out of your check, so be sure to ask the Buyer what your "net price" is. One more point is to ask for two different prices – a price for the full sale of the note and a price for a partial sale or some of the payments from the notes.

Also, if you don't have Internet access, you can fill out the "Paper Analysis Worksheet", which you will find in the next section. Transfer information from script to Paper Analysis Work sheet. Once the Paper Analysis Worksheet and then you can either mail or fax us the information.

What To Say When You Call Back The Note Seller

Hi, Bob this is _____. I have a purchase price for your note. Do you have a piece of paper and a pencil handy? You never know when I might say something important.

Have you ever sold a note before? Let me just briefly explain to you how this process works and how we determine the cash value of your note.

We are analyzing each monthly payment you receive and calculating its value into the future. In other words, dollars today will buy more than dollars in the future. If it's ok with you, I would like to give you a couple of examples about what I'm talking about.

Looking back 15 to 20 years ago, we could go to the movies for what? About $.50, right! And gasoline was about $.65 a gallon? Now look at what we pay. This is what I mean when I say dollars today are worth more than dollars in the future. So we have to factor that into the price.

I have another example: Suppose I have $10 in my left hand and $5 in my right. Which bill would you like? The $10 in my left hand, right? But now, let's add this to the equation: you have to wait (the remaining number of monthly payments on their note, lets say 96) 8 years to get the $10 or you can have the $5 now. Which one would you rather have? Of course the $5 now, right?

So, let me give you some numbers, now that you understand how we determine the cash value of your note.

There are two ways you can sell a note. The first way is through a partial sale of your note, which is the most profitable way for you. You can sell a portion of the remaining payments on it. For example, you sell me the next 60 of your 96 remaining monthly payments you are owed. At the end of the 60 months, the note payments revert back to you, and you would receive the remaining 36 payments. At that time, the balance will still be $_____.

So, you are getting a lump sum of cash now and you still have $_____ coming to you in 5 years. With this option you are still in the deal. If the Payor doesn't pay, I'm going to come back to you and say, "Bob, I gave you all that money, so you need to keep me whole by keeping those payments current. They sound as if they are good Payors from what you described, so I'm sure there shouldn't be any problem.

The Second option is to cash you out in full. So, if the Payors don't pay or the property burns down or blows away, you don't care because you are out of the deal. I will give you $_____ for the full sale of your note.

Which one of these options sounds the best to you? (Be quiet and listen in order to solve their problem).

If they say, “I need to think about it”. You can say, ok, I can understand that. Bob let me just explain one other thing to you. I want you to understand how the papers are actually transferred and how you are guaranteed to get paid.

When you decide to go ahead with this sale, I will send you out a Commitment Letter that states my obligation to you, along with a list of copied documents I will need back from you.

Then I’ll deposit a check in the amount of $_____ (purchase price) into an escrow account at a title or escrow company of your choice. They’ll close the transaction and make sure you get the right amount of money and that I get the right paper work. This way you are guaranteed to get paid - Sounds pretty good, doesn’t it?

Would you like me to send you this information package today? If yes: Ok, you should receive it in the next _____day. Would it be ok if I called you back on that day to go over it with you and answer any questions you may have. (Set an appointment or don’t send it out).

If No: Ok, when should I call you back? Incidentally, I haven’t said anything to offend you have I?

(Be quiet! They’ll tell you their problem and what you need to do to solve it).
If the Seller says yes, you will send him a Commitment Letter, A Cover Letter and an Information Request Form all of which you will find in this section.

Additionally, to save you time you might log on to our web site, www.notenetwork.com - then click on the How-to Reports section and look for “The Note Brokers Resource Kit”. Once you are there, you’ll be able to copy and paste this information into a word document and save time from having to retype these documents. Please note, only copy the information on the site that state that you can. Never copy anything that states our copyright, which is 99.9% of our web site. We take copyright violations seriously and will prosecute to the fullest extent of the law.

#2
The Paper Analysis Worksheet

The Paper Analysis Worksheet will always need to be completed in order to determine what the note is worth. Please make sure that you gather all the information on this worksheet. If you follow the script above you will have all the information necessary to list it on www.notenetwork.com

America's Note Network Paper Work Sheet

Name Of Note Seller: _____ Date:_____

Address: _____

Phone #: _____

Property Information
Property Address: _____

Type Of Property: _____ Owner Occupied: _____

Property Value: $_____ Established By - Sale/Other:_____ Date: _____

1st loan Amount: $_____ Monthly Pmt: $_____ New / Assumed

2nd loan Amount: $_____ Monthly Pmt: $_____ New / Assumed

Down Pmt Amount: $_____ LTV: _____% ITV: _____% (internal use only)

Note Information

Original Amount $_____ Balance $_____ As of -Date:_____

Interest Rate : _____% Payment Amount : $_____ Date of 1st Pmt: _____
(internal use only)
Original Length: _____ mos. Type: Amortized, Interest Only, Other_____

Number of Payments Made:_____ Number Remaining:_____

Are the payments on time:_____ What day of the month are they due:_____

Balloon Payment if any: $_____ Balloon Payment Date: _____

Are there any Clauses: _____

Seller Information
Note Seller's Motivation: _____

When Does H/She Need To Close: _____ Received other Offers: $_____

What does the Payor do for a living: _____

Is there anything else I should know about this note:_____

#3
Commitment letter – Send To The Seller

The Commitment letter is a letter that you will send the Seller of the note as soon you have an agreed upon price. This letter will tie up the note and take it off the market. If the Seller cancels the agreement, then you will receive $125 minimum for your efforts (if you choose, you can even replace the $125 with a flat rate percentage of the note, I.e. 10% of the note balance). If for any reason you or your Buyer cancels the agreement you may also cancel your agreement with the Seller without penalty.

THIS COMMITMENT TO PURCHASE, is made _____ by and between you, (**their name**), the undersigned (Seller), and (**your name**), (Purchaser), and/or its successors and assigns, whose address is your address.

This commitment is made in (**your county**), subject to and contingent upon (**your name**), and/or its investor's inspection and approval of the property and all documents including, but not limited to, credit, appraisal and title work.

Seller agrees to sell and convey to Purchaser, and Purchaser agrees to buy, upon the terms and conditions set herein, that certain (Trust deed / Mortgage / Land Contract - **the name of the instrument**) , wherein the Payor owes a current principal balance of (**$balance amount**) as of this month, carrying interest on the principal balance at the rate of (**interest rate %**) per annum, and requiring a monthly principal and interest payment of (**payment amount**).

The agreed purchase price is the sum of (**$purchase price**) provided there are no underlying problems. If the contract has to be renegotiated a verbal commitment from the Seller will be binding.

The subject property is located in (**county**) and is legally described as follows;

Property Address

_____

ADDITIONAL LEGAL DESCRIPTION TO BE PROVIDED AND VERIFIED BEFORE CLOSING

Seller warrants that:

1. There are no prior liens or encumbrances on the property subject to the Instrument except as stated below:

SUBJECT TO: NO OTHER LIENS OR ENCUMBRANCES

2. It has full power, authority and legal right to execute, deliver, and perform, its obligation under this letter;

3. This Letter and the Instrument are legally valid and binding, and enforceable in accordance with their terms, and there are no claims or defenses, personal or otherwise, or offsets whatsoever to the enforceability or validity of the Instrument;

4. There are no lawsuits or legal proceedings pending, or to the best of Seller's knowledge, threaten regarding encumbrances on, or the ownership, use or possession of, the property or the Instrument;

5. No brokerage or other commission is due and unpaid in connection with the Instrument; and,

6. Seller has, as of the date of this Letter, and will have as of the date of the closing, good, marketable title to the Instrument.

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During our processing period any additional payments made to Seller on the Instrument which cause a reduction in the principal balance below $100 will also cause a minor adjustment in the purchase price at closing. Seller agrees to return any payments received after the closing of this Instrument.

Seller understands that (**your name**), is not acting as an advisor for Seller in connection with this transaction, nor as Seller's agent, but rather is dealing with Seller at arms length, at all times. Seller acknowledges that it has sought and received whatever independent legal, tax, accounting or other advice it desires concerning this transaction. Further, Seller is not relying on (**your name**), in entering into this transaction, but is acting on its own best judgment.

Seller agrees to execute all necessary documents to effect the assignment and conveyance to Purchaser of its interest in the Instrument. Seller agrees to furnish any and all documents in its possession necessary to consummate this transaction. If, after closing, it is discovered that errors, omissions, or loss of documents has occurred, Seller agrees to cooperate with the Purchaser to correct any and all errors, omissions, or losses with in ten (10) days of receipt of notice from Purchaser.

Upon our receipt of all the necessary closing documents related to this transaction, we should be able to close within 21 to 30 days.

All normal closing cost will be the responsibility of the Purchaser with the exception of any additional, or unexpected, legal cost necessary to clear or perfect title.

Should the Seller fail to close, after signing this agreement, Seller shall be obligated to reimburse Purchaser for all out-of-pocket expenses incurred related to this transaction, up to the time of cancellation. These expenses should normally be limited to title and/or appraisal fees, plus the processing fee of 10% of the remaining balance of the of the note as of today's date.

Purchaser hereby gives Seller a specific period of ten days to complete, and return, this Commitment Letter, and agrees to keep this offer open for that period of time. If Seller is unable to complete, and return this agreement within the allotted time , this agreement shall be canceled. Purchaser may extend the time period, upon conditions it deems acceptable.

By_____
Your Name & Signature

ACCEPTED:

_____ _____
Sellers Signature

Social Security Number Of Seller

SSN:_____ SSN:_____

DATE:_____

#4
Cover To The Commitment Letter

Date

Seller's Name
Seller's Street
Seller's City, State, Zip

Dear First Name:

Thank you for the opportunity to be of service to you. We will do everything possible to expedite your closing once you return the enclosed "Information Request Form" and copies of the requested documents.

The cash you will receive is (**dollar amount**) for the full sale of your interest, or (**dollar amount for partial sale**) for the next _____ number of payments.

A typical transaction takes 21 to 30 days to process provided there are no unusual circumstances that arise. The normal closing process includes a credit evaluation on the Buyer, a drive-by appraisal and a title insurance review. We pay for the normal closing costs.

Occasionally, purchases have to be renegotiated or canceled if the review process reveals underlying problems that cannot be corrected. Thankfully, this situation doesn't happen very often! If it does, you retain the right to cancel the transaction without any obligation on your part.

Also find enclosed a formal "Commitment Letter" which begins the closing process and states our obligation to you. Please sign it and return it with the above requested documents. If you have any questions please call me at (**1-XXX-XXX-XXXX**). Thank you.

Warmly,

Your Name
V.P. Operations

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#5

Information Request Form – Goes To Seller

The Information Request Form indicates the documents and information that you will want the note Seller to send to you. You may want to send this form to the Seller along with the Commitment Letter and the Commitment Cover Letter.

INFORMATION FOR YOUR CONTRACT SALE

The sale of your real estate contract CAN ONLY be processed when you follow these requirements. The information you provide on the front and back of this sheet is necessary to process your contract sale.

We will need a copy of the documents listed below:

- ☐ Copy of Note
- ☐ Copy of Trust Deed, Mortgage or Land Contract
- ☐ Payment History – Payment Book or Bank Deposit
- ☐ Escrow instructions from real estate sale in which the "Contract" was created
- ☐ Escrow closing statement from real estate sale in which the "Contract" was created
- ☐ Title insurance policy that insures the "Contract"
- ☐ Fire insurance information on the property which secures the "Contract" (Insurance Company, Policy Number, Agent's Name and Address)
- ☐ Loan Payment Record
- ☐ Please provide two (2) pictures of subject property
- ☐ Copy of street or city map showing property location
- ☐ Plans, surveys or other documents in your possession

Your signature is required for us to confirm balances, payment history and to obtain copies from your title or escrow company in the event we need further information. Thank you.

_____	_____	_____
Seller's Signature	Title / Escrow Company	Policy Number

#6
Non-Circumvent Agreement – Send To Buyer

The Non-Circumvent Agreement is designed to protect your interest when you are brokering a note to an investor or the end Buyer. You will have a commission due you for referring the note to the end Buyer. This document will protect you. Please have your attorney review this sample agreement that is used as an example and for educational purposes only.

NON-CIRCUMVENTION, NON-DISCLOSURE AND CONFIDENTIALITY AGREEMENT

THIS AGREEMENT entered into on this _____ day of _____, 20___ is for the Professional Association and arrangement of Non-Circumvention, Non-Disclosure and Confidentiality between _____whose office is at_____ and _____ whose principal place of business is at _____ hereinafter, called the "The Parties."

The Parties with this agree to respect the integrity and tangible value of this agreement between them.

THIS AGREEMENT is a perpetuating guarantee for five (5) years from the date of execution and is to be applied to any and all transactions present and future, of the introducing party, including subsequent follow-up, repeat, extended, renegotiated, and new transactions regardless of the success of the project.

Because of THIS AGREEMENT, the Parties involved in this transaction may learn from one another, or from principals, the names and telephone numbers of investors, borrowers, lenders, agents, brokers, banks, lending corporations, individuals and/or trusts, or Buyers and Sellers hereinafter called contacts. The Parties with this acknowledge, accept and agree that the identities of the contacts will be recognized by the other Party as exclusive and valuable contacts of the introducing Party and will remain so for the duration of this agreement.

The Parties agree to keep confidential the names of any contacts introduced or revealed to the other party, and that their firm, company, associates, corporations, joint ventures, partnerships, divisions, subsidiaries, employees, agents, heirs, assigns, designees, or consultants will not contact, deal with, negotiate or participate in any transactions with any of the contacts without first entering a written agreement with the Party who provided such contact unless that Party gives prior written permission. Such confidentiality will include any names, addresses, telephone, telex, facsimile numbers, and/or other pertinent information disclosed or revealed to either Party.

The Parties agree not to disclose, reveal or make use of any information during discussion or observation regarding methods, concepts, ideas, product/services, or proposed new products or services, nor to do business with any of the revealed contacts without the written consent of the introducing party or parties.

The Parties agree that due to the many variables surrounding each Business Financial Transaction that will occur because of this agreement, the commission to be paid and/or the fee structure between the Parties can vary. A separate fee/commission agreement will outline compensation for each Business/Financial Transaction. The fee or commission agreement must be drafted and acknowledged by signature before all Business/Financial Transactions.

In case of circumvention, the Parties agree and guarantee that they will pay a legal monetary penalty that is equal to the commission or fee the circumvented Party should have realized in such transactions, by the person(s) engaged on the circumvention for each occurrence. If either party commences legal proceedings to interpret or enforce the terms of THIS AGREEMENT, the prevailing Party will be entitled to recover court costs and reasonable attorney fees.

The parties will construe THIS AGREEMENT in accordance with the laws of the State of Oklahoma, County of Oklahoma. If any provision of this agreement is found to be void by any court of competent jurisdiction, the remaining provisions will remain in force and effect.

THIS AGREEMENT contains the entire understanding between the Parties and any waiver, amendment or modification to THIS AGREEMENT will be subject to the above conditions and must be attached hereto.

Upon execution of THIS AGREEMENT by signature below, the Parties agree that any individual, firm company, associates, corporations, joint ventures, partnerships, divisions, subsidiaries, employees, agents, heirs, assigns, designees or consultants of which the signee is an agent, officer, heir, successor, assign or designee is bound by the terms of THIS AGREEMENT.

A facsimile copy of this Non-Circumvention, Non-Disclosure and Confidentiality Agreement shall constitute a legal and binding instrument. By setting forth my hand below I warrant that I have complete authority to enter into THIS AGREEMENT.

For: Company Name Here

_____ _____

Buyer's Signature Date

Although it is not necessary, if you would like a more complete list of documents for closing and managing your own personal transactions, I recommend that you go to the link below for more information: www.notenetwork.com/helptips - The documents enclosed in this section of the course are all you need.

Review Section 2

1. We learned a few of over 40 ways to find notes and that building referrals are the key to finding deals.

2. Ten simple steps to close a transaction – they are always the same for every note transaction.

3. Gathering the necessary information to determine the value of the note.

4. What do you say when someone asks you what you do? "I help people get lump sums of cash for their future income. Do you have any future income?"

5. Simply agree on a price with a Note Seller, send her a Commitment Letter, list the note on **America's Note Network**, collect the documents, and forward them to the Buyer! That's it. You will find 'em, list 'em and make money! We'll discuss this in more detail in the next section.

6. You can easily list notes on **America's Note Network**'s web site to determine the value quickly and to receive an instant sale for the notes you find.

7. Calling back the Seller and making the offer. Once the verbal offer is received, you will prepare the "Commitment Letter" and Federal Express it to the Note Seller for signatures and additional documentation.

8. How to send the Note Buyer a Non-Circumvent Letter, which protects you and insures you will get paid.

9. You will receive your check within three weeks. Average check is between $2,000 and $5,000 per transaction.

10. You've learned about **America's Note Network**'s web site and how it is a valuable resource for you to use daily.

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Section 3

What To Do First!

40 of the Best Way

To

Have The Deals Find You!

What To Do First!

Spend five to seven hours a week following my plan – you will see results in as little as 60 to 90 days

1. Get a list of 400 Note Holders – Mortgagees

2. Get a list of 400 professionals – Attorneys, CPAs, Mortgage Brokers & Real Estate Agents

Getting Your Target Lists

1. This is your target market that you will market to every 6 to 8 weeks. Don't change your target market! This is where everyone makes mistakes. When marketing, if people don't see an immediate response they do one of two things: First, they quit altogether and say, " It just doesn't work!" Or, second they get a new list thinking the grass is greener on the other side. Don't make this mistake! Part of the magic of marketing is repetition.

2. To find professional referral sources you can either look them up in your phone book or call a local list broker for those names. You will find list brokers in your local phone book under "mailing services".

3. For Note Holders you can also call a list broker or you can go to our web site to access the largest list broker, at www.notenetwork.com/helptips - Another way to find Note Holders is by going to your local Court House and looking up "Mortgagees". See the Court House worksheet in the Appendix.

4. When someone sees your name in print five times, they feel as if they know you even if they have never met you. This is a marketing statistic that all good marketers know and understand. Your success comes from marketing over and over to the same audience.

5. Your goal is to have ten professionals sending you cash flow deals. If you have ten professionals sending you deals you will make a nice six-figure income with little effort.

Many of my marketing secrets won't cost you a dime to implement! Remember, if you are not marketing your business then you are not in business! Marketing is the key to success in any business and I'll show you how to make $11 dollars for every $1 you spend in marketing! And, you will be able to automate the whole process so all that you are doing is answering the phone! This is the greatest business in the world because you can build a huge monthly income in only a few hours each week!

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Professional Image

1. Business Cards
2. A Brochure
3. An Informational Newsletter

Personally, my favorite way to market, and the most cost effective way to continually market, is by having your own personalized newsletter. You can receive a lot of ideas and information about how to create your own personal newsletter at our web site. Go to www.notenetwork.com/info to receive a free report on how to create your own newsletter. Of course, we can also create a highly effective newsletter for you.

Our research indicates that for every dollar someone spends on marketing with our newsletter they will receive, on average, $11.00 in income.

Finding A Coach To Help You

1. You have found someone who truly cares about your financial success. My staff and I will help you succeed.

2. Never give up! The only way anyone can ever fail is if they quit. Remember this!

3. This is an "earn as you learn" business. Make money while applying what you learn and remember you don't have to do everything in this book to get started.

4. Don't let paralysis of analysis hold you back.

A Specific Plan Of Action

1. Write down what you would like to achieve in this business.

_____

_____

_____

2. Get a list of your target markets.

3. Mail to your target markets every 6 to 8 weeks.

4. Follow up with calls to your target markets. If you don't like doing the calls yourself you can hire a local college student to do them for you.

5. Sample calling scripts are at the back of the manual and they are very casual, friendly and short. You will simply develop a friendship and they will refer business to you for doing just that. It's simple, fun and will never feel like selling someone something. It's a nice way to create a business!

The Best 40 Ways To Market Your Cash Flow Business

It is important to remember when looking for notes that massive action produces massive results. If you concentrate on only one method you probably will not get the results you desire. If you focus on several methods at one time you will see great results. Sure, some methods will work better than others and you will want to focus on those areas specifically that work for you and suit your personality.

What I'd love to see you do is purchase notes for your own account and those that are too large to purchase — broker them. The reason I would like you to purchase notes is very simple — you will gain a level of understanding that you can only appreciate by doing. Brokering notes is a great business. Sure, you can earn $2000 and more on a deal, but even better is buying notes for your own account — learning how to get the payer to pay you more per month or to pay off the note early — this is where you will find the really big returns! So, please keep this in mind.

Now let's talk about the four biggest problems you will face are:

1. Lack of credibility,
2. Lack of deals crossing their desk,
3. Lack of experience and confidence, and
4. Lack of capital to continually market and promote their business.

By having many notes come across your desk each day you will solve the first three biggest problems. Lack of capital, can be overcome by marketing your business intelligently. The purpose of this marketing course is to teach you 40 of the best ways you can market your business intelligently – and I will tell you a few of my favorites.

When it comes to marketing, it is very important to remember: I said it before and I'll say it again because it's so important, if someone sees your name in print five times they feel as if they know you, even if they've never met you. So, the key to successfully marketing your cash flow business is repetition! Repetition to the same group of people...

You will market to only two groups:

1. To Note Holders and
2. To referral sources

Marketing To Note Holders

Marketing directly to Note Holders can be profitable, but you have to remember — it's most likely a one shot deal. In other words, you will only get *one* deal when marketing to a Note Holder. So, this, although a good way to market, is very expensive. It costs you a lot just to get *one* deal and you will not receive any referrals or additional transactions from the note Seller, in most instances. However,

this is a very fast way to receive deals, but it is, as I mentioned, expensive. Don't rule this way of marketing out; however, just bear in mind what I have said. If I had known what I'm telling you now when I started this business back in 1990 I would have saved, or made, a lot more money.

Marketing To Referral Sources

Marketing to referral sources is not as fast as marketing directly to Note Holders, however, it is much more cost effective. It may take you 90 days to get a good referral source, but that one good source could potentially refer ten deals to you next year, and in years after. So, you will want to market to both referral sources and Note Holders. As I mentioned before — massive action produces massive results!

The 40 Best Ways To Market Your Cash Flow Business

I would like to break up the "40 Best Ways To Market Your Cash Flow Business" into two sections: the people you will market to and the methods to market your business.

These are the people you will market to in alphabetical order are:

Appraisers	CPAs	ExchangeGroups	Mobile Home Park	Real Estate Agents
Attorneys	Collection Agency	FSBO Ads*	Mortgage Brokers	Retirement Homes
Bail Bondsmen	Contractors	Financial Planners	Nursing Homes	Simultaneous Sale
Board of Realtors	Developers	Loan Service Co.	Other Paper Buyers	Title Officers
Builders	Escrow Officers	The MLS	Property Management	Water Filtration Companies

*FSBO means "For Sale By Owner"

These are methods to market your business:

Billboards	Direct Mail	Newspaper Ads	Radio	Word of Mouth
Business Cards	Internet	Postcards	Seminars	Write Articles
Court House	Newsletters	Postcard Decks	Telemarketing	Voice Mail

Your Marketing Targets

Appraisers: Appraisers place values on real estate properties. They may know of notes that are available on properties. Locate appraisers in the Yellow Pages. **Marketing**: Send them a postcard, newsletter, or business card telling them what you do and follow up with a telephone call.

Attorneys: Attorneys are great sources of notes. Most people overlook attorneys as referral sources but believe me; they come across *more* notes than even real estate agents. This is one of the best groups to market to. **Marketing**: The best way to get attorneys to refer business to you is to offer them a free informational newsletter on a topic they may be interested in. I have found great success sending them a newsletter on real estate investing. Remember, everyone loves and is interested in real estate. You will not get through to them with letters, postcards or phone calls. The only way to capture their attention is to send them an informational newsletter.

Bail Bondsperson: A Bail Bondsperson is someone who puts up bail for people in jail. Often a Bail Bondsperson will secure his/her investment by creating a note secured by real estate. Many Bail Bondspeople have lots of notes for sale. Again, they are easy to locate in your Yellow Pages. **Marketing**: You can market to Bail Bondspeople using letters, postcards telemarketing, newsletters, or a personal visit to his/her office. One of the most effective ways to market to Bail Bondspeople is to mail a brochure or informational letter and then give them a follow up telephone call.

Board Of Realtors: The Board of Realtors is an excellent source for securing referrals. Become a member of your local Board of Realtors. As a member, you are entitled to names and addresses of other members. In some locations they have mailboxes for each of the board members and you can simply put your flyer, brochure, newsletter or other information about your services right in each mailbox. Here, in Boulder Colorado, we have over 200 mailboxes, side-by-side. So, it takes only a few minutes to put a message in each box. Another way you can market to this group is through the mail. As a board member you can obtain the list of other members and mail your message to them. **Marketing**: You have to realize that this is a difficult market to crack. You will need to mail to the realtors in your area at least five times before you start receiving a response. Mail them a newsletter or postcard telling them what you offer.

Builders: Builders are often a good source for notes and cash flows. Many times these folks carry back paper to facilitate a real estate sale. In most instances, builders need cash to complete their projects; and are, therefore, an excellent source for paper. A word of caution, however, builders take small down payments and carry the majority of the balance in the form of a note. Remember, if there is a small down payment you want a large discount on the note. The reason for this is simply that the Buyer of the property can easily walk if they have only a small down payment in the property. **Marketing**: There's only two effective ways to reach builders — telemarketing and direct mail. Look in your area for a builders association. Often you can purchase this list with contact information. Otherwise, look in your phone book for this information. I will talk more about telemarketing and direct mail shortly.

CPAs: Certified public accountants, bookkeepers and financial planners are other excellent sources for finding cash flows. Of all referral sources, I rank CPAs as number two (attorneys being number one) as the best people for referrals. They work with a variety of people and their clients often need to liquidate a cash flow or real estate note. Contact them through professional organizations that are listed in your phone book. **Marketing**: The only way to reach CPAs is to use direct mail and follow-up phone calls. The most effective direct mail method is to send a personalized newsletter every quarter (four times a year) and a follow-up postcard six weeks later (four times a year).

We at America's Note Network have created an incredible high response newsletter, just for you. This newsletter is called "*Update On Real Estate* ™" and people across the country have had great success

sending this newsletter, personalized with their information, to their contact list. For more information about how to get your own personalized newsletter, go to: www.notenetwork.com/helptips You will find complete details on this exciting money making program.

Collection Agencies: Collection agencies are a good source of notes and cash flows. Frequently, collection agencies collect from people who have real estate investments. You will be surprised at how often you find debtors with real estate notes. Again, look them up in your local phone book. **Marketing**: First call these companies to make personal contact and tell them what you do ("I buy notes and other cash flows — I help people who have future income and liquidate it for a lump sum of cash, now"). Next, follow up with a personal letter, newsletter and postcard reminders every six weeks.

Contractors: Contractors are much like builders — they may be forced to carry back notes on completed projects. **Marketing**: Like builders, there are only two ways to reach contractors — telemarketing and direct mail. Look in your area for a contractor association. Often, you can purchase this list with a contact name, address and phone. Otherwise, look in your phone book for contact information. I will go more into telemarketing and direct mail in a moment.

Developers: Developers purchase land to build upon. It is common for developers to carry back paper in order to sell properties that they build. Developers are much like builders, only on a much larger scale. There are three levels of developers: small developers; medium-sized developers; and large developers. Generally, developers most in need of money are small-sized companies and, therefore, the best deals will be from these developers. **Marketing**: Again, there's only two ways to reach developers: telemarketing and direct mail. Look in your area for a developer association — you can often purchase a list with contact information. Otherwise, look in your phone book for this. I will talk about telemarketing and direct mail in more depth in a moment.

Escrow officers: Escrow officers put together real estate transactions; they are the ones who do all the paper work. For the sake of clarity, in some states title officers facilitate these transactions. Often, escrow officers come across a situation where cash is needed at closing where notes are generated. And remember, nine times out of ten, when somebody sells real estate, they want their cash. Therefore, escrow officers would be happy to know about your services. **Marketing**: There are two ways you can market to escrow officers: One, meet them in person and explain what you do ("I buy notes and other cash flows — I help people who have future income to liquidate it for a lump sum of cash now"). Be sure to leave the escrow officer a business card and either a brochure or a newsletter with your contact information on it. You may even ask if you can leave a handful of brochures or newsletters in their waiting area. You can purchase an acrylic rack for about $5.00 to place your brochures or newsletters in. You can also market to escrow officers with direct mail or telemarketing.

Exchange Groups: An exchange group is a group of people who get together to help one another facilitate 1031 tax-deferred exchanges on real estate properties. An exchange often requires the creation of real estate notes and *you* can purchase these notes. **Marketing**: I highly recommend that you attend exchange group meetings in your area, which you can find through your local Board Of Realtors. You will find many deals and they cost nothing to find. You may even do a short presentation to a group explaining that you purchase real estate notes. At the end of your presentation give them your card, brochure or newsletter. Also, call the president of the group and ask him/her if s/he would be kind enough to pass along your brochures and notify the group about your services.

FSBO Ads: FSBO means "for sale by owner". In many areas there are little newspapers called FSBO, which is an advertising center for sales in that area. **Marketing**: Call the Sellers and explain that they can sell their property quicker, and for more money, by using Seller financing. Send the Seller your newsletter — nothing will impress him/her more than to receive an informational newsletter about real estate.

Financial Planners: Financial planners know about their clients' financial affairs; they are, therefore, good sources of referrals, which you can find in your local phone book. **Marketing**: When marketing to financial planners, send them a newsletter or brochure in the mail and follow up with a phone call.

Loan Servicing Companies: A loan servicing company collects payments on notes for Note Holders. In other words, the person who is collecting the payments chooses to have a company manage the collecting process, because the person receiving the monthly payments doesn't want the added hassle involved. **Marketing**: Contact these companies and ask them if you may include a flyer or brochure with the statements they send out. Most loan servicing companies send out monthly statements updating account information to the mortgagee or the Seller of the property. This is an excellent opportunity for you to get in front of the person receiving monthly payments. In fact, it's an implied endorsement from the loan servicing company on your behalf. Of course, arrange to pay the loan servicing company a fee for every deal you close.

The MLS: The Multiple Listing Service shows the real estate listed in that area and is available to realtors. What is nice about the MLS is that it shows all the listings that are advertised as "owner will carry". **Marketing**: Get this list and mail over and over again (once every six weeks), this will be an excellent source of note deals.

Mobile Home Parks: Mobile home parks and dealers are a great niche market to exploit. In fact, the mobile home market is one of the best niche markets available to anyone in this business. You can buy notes secured by mobile homes at pennies on the dollar because you're the only one in town who will buy. This is such an exciting market for those of you who work it. Remember, you are helping people get cash. In every instance, with every cash flow, and in everything you do, it is always the same — "getting people cash." **Marketing**: You can purchase a list of mobile home parks or find them in your local phone book. The best way to market to this group is through direct mail. Additionally, there is an exceptional course written by David Butler called, The Complete Guide To Making Money With Mobile Home Notes - Tin Can Alley. This 400-page course is available on our web site at www.notenetwork.com/helptips

Mortgage Brokers: Mortgage brokers make traditional loans on real estate. They can be an excellent source of referrals because they run across people who need money to purchase property. Many times, these people in need of money have carried back a note in the past. You can refer people to the mortgage broker and the mortgage broker can refer people to you. Each time either of you refer someone to the other you should get a fee. **Marketing**: Mortgage brokers are easy to find, just look in your local phone book. Contact them via the phone or through direct mail.

Nursing Homes: Often when people move into a nursing home they have to liquidate all of their assets. It is highly recommended that you contact these seniors *just* prior to their being admitted into

such a home. **Marketing**: Contact nursing homes in your area and tell them what you do. They will be happy to hear from you. Also, arrange to go to the nursing home to make a presentation about what you do. This will be an excellent source of referrals for you. Contact nursing homes via the telephone and direct mail.

Other Paper Buyers: Contacting other paper Buyers is a great way to build referrals. These paper Buyers often spend a lot on advertising for notes. You can benefit from their marketing efforts. **Marketing**: Call the paper Buyer and explain that you will purchase any notes that s/he doesn't purchase. Remember, other paper Buyers come across many notes that they themselves are not interested in. These notes are not bad notes, they merely do not meet the criteria of this note Buyer. So, use this information to your advantage — get these notes referred to you from paper Buyers and list them on America's Note Network. See, your affiliation with America's Note Network gives you a great advantage to buy or sell *any* note. All notes are sellable at the right price!

Property Management: Property management companies manage properties for their owners. It is common for these owners to have notes and, if they knew about your services, it is likely they'd be interested in selling their notes. **Marketing**: Find a list of property management companies in your local phone book. Solicit them using direct mail and telemarketing.

Real Estate Agents: Real estate agents can be a good source for note referrals. However, you need to educate them about Seller financing. Many realtors carry back their commissions when selling a property and, therefore, realtors may know of other realtors that have notes. **Marketing**: There are a few ways to market to realtors — all are good — all work. Giving a presentation is one way to market to realtors. Call and make an appointment (usually Tuesdays) to present to realtors in a given office. Explain that they can sell properties quicker using Seller financing. Be sure to present the following: loan to value, partial purchases, how Seller carry back notes can increase the price, what agents can do with notes received as commission, and what is a good, or bad, note. Remember, when you make a presentation always bring something to eat like doughnuts or sandwiches. Mailing a brochure or newsletter with your contact information on it is another way to reach realtors.

Retirement Homes: Many large retirement homes have their own newspaper. **Marketing**: Place a small advertisement in these newspapers for minimal cost.

Simultaneous Closings: A simultaneous closing is simply creating a note at the point of purchase and then reselling that note to an investor. Although it's called a simultaneous closing it's not really done simultaneously. What happens is this: A person sells a property and goes through the normal closing process and a note is created. Then, another closing takes place later that day for the purchase of the note. The note purchase is pre-arranged and pre-determined. When the note closing occurs, the property Seller receives cash from the note sale and the investor receives the monthly payments. And, of course, the note broker gets a commission. **Marketing**: Your market is FSBO and real estate agents — those who were involved at the point of sale. Market to these groups as we have already discussed in the appropriate sections.

Title Officers: Title officers, in many states, handle closings on property sales and make their money when the deal closes. Title officers are a good source for referrals because many times real estate

transactions do not close on time and the solution is the sale of a note. **Marketing**: There are two ways you can market to title officers: One, meet them in person. During this meeting explain what you do ("I buy notes and other cash flows — I help people who have future income liquidate it for a lump sum of cash now"). Be sure to leave a business card and either a brochure or a newsletter with your contact information on it. You may even ask if you can leave brochures or newsletters in their waiting area. You can purchase an acrylic rack for about $5.00 to place your brochures or newsletters in. You can also market to title officers using direct mail or telemarketing.

Water Filter Companies: OK, remember you are in the cash flow business and there are more than 60 identified cash flows. Companies that sell water filtration systems are a great source of paper. These companies often sell expensive systems to purify water in homes. Frequently, notes are created or money is owed to these companies — these notes can be sold. **Marketing**: Find a list of these companies in your local phone book and contact them via telephone and direct mail.

Marketing Methods

Billboards: I have heard of a few companies using billboard advertising to get deals. Although I have personally never used this form of advertising, I hear that it works well. With this type of marketing, you can place some kind of direct response ad on a billboard in a high traffic area. This can be a cost effective way to market if you have the right message on your billboard advertisement.

Business Cards: There are many things you can do with your business card. For example, you can insert your business card with every bill that you pay. If you are paying your telephone bill insert your card. Your card might say, "I buy notes, trust deeds and mortgages". Another way to market with your business card is to stick it on local bulletin boards located in your grocery store, coffee shop, realtor office, etc.

Court House: Remember, every note secured by real estate is recorded at the local County Court House. The Court House has names and addresses of mortgagees. Who is a mortgagee? It's the Seller of the property who receives the monthly payments and holds the mortgage contract as security. In other words, it's the person you want to solicit to purchase their note. Go to your local Court House and look up property Sellers or mortgagees who have carried back paper *at least* twelve months ago. Why do we want to look for mortgages twelve months old? Simply, because research shows that most note Sellers sell their note after twelve months. You will get a list of mortgagees that you can market to over and over. The best way to accomplish this is to send them a postcard. A postcard is what I call, "The mail they always read". Send them a postcard once every six to eight weeks that states, "I have been trying to contact you about the trust deed or mortgage you own. Please call me at: XXX-XXX-XXXX". The key to postcard marketing is to make the postcard look personalized. Use a stamp and make your message look like it was handwritten.

Another thing I would like to tell you about Court House Records is that large list companies have compiled stats on mortgagees for many states and counties. In other words, they have already done the work to get these names that they then sell to anyone who will buy them. It is not uncommon for

a company to sell their list fifteen times per year. So, if you purchase a list from one of these companies realize that although there is little work for you to do, you will have more competition with this type of list.

The largest company that sells mortgagee lists is Experian. You can purchase your own list by going to www.notenetwork.com/helptips - the cost is approximately $0.10 per name, address, and phone number. Having the note Seller's phone number is a great asset!

If Experian does not have names and addresses of Note Holders in your area then you will have little competition going to the courthouse yourself. One downside to looking up names and addresses, though, is that it's very time consuming and it's difficult to get phone numbers. This is because Court Houses do not have phone numbers of Note Holders. So, instead, mail them a postcard. When gathering names and addresses of Note Holders from the Court House you can expect to find ten to fifteen leads per hour. This will be a great list for you, but it will take time to accumulate. If you use this form of marketing, I recommend that you mail at least a thousand postcards per week. You might want to hire a local college student to go to the Court House for you. This can be an inexpensive way for you to accumulate a list that is solely yours.

Direct mail. Many of the most successful note brokers use direct mail to find deals. This is an excellent way to go, however, you must have some money behind you to see this through. There are several ways you can use direct mail. You can send either a letter, postcard, brochure, or newsletter to potential note Sellers or referral sources. And remember, the reason this is a long-term commitment is because your customer must see your name *at least* five times before they feel as if they know you.

Internet: Marketing on the Internet can be very tricky. There are very few companies earning profits on the Internet. Why is this? Because it's difficult to get a message out to your target group! The best way to market on the Internet is to have a professional-looking web site and then research methods to bring traffic to your site. Not only do you want traffic, you want the right kind of traffic. If you do not have a professionally designed web site with articles about the cash flow business you can obtain one very easily. Go to www.cash4cashflows.com — for less $500.00 you can have a site that is customized just for you with information that educates your target market. I highly recommend this service.

Remember one thing when using the Internet — the Internet is used for one purpose — finding information. Giving out good, high quality information is your key to becoming successful on the Internet. Another way to market using the Internet is to take advantage of all the resources at America's Note Network www.notenetwork.com - There you will find hundreds of notes listed each month to buy or broker. Membership is limited and is available on a first come first served basis. To be considered for membership, go to the URL above.

Newsletters: Having a personalized newsletter is a must. There's no better way for you to obtain credibility than to have personalized contact information on your own newsletter. We have found that the average note broker using this marketing approach will earn $11.00 for every $1.00 spent on marketing! This is phenomenal! In other words, if you send 400 newsletters out to attorneys, CPAs, mortgage brokers or realtors, on average, you will get two deals. The average commission per deal is $3,000. So, for those two deals you can make $6000 in commissions! And it only costs $450 – with a net-profit of $5,500!

The best part is that the entire process can be automated. A mailing house can mail out your newsletters. All that is left for you to do is to answer the phone. And, what's even better, is that you will not receive thousands of calls — you will receive a few calls — each one bringing you a deal. This is what you want — little time involvement with high profit potential. The more newsletters that you mail, the more money you will make. For information about creating your own newsletter or to have America's Note Network create it for you, go to www.notenetwork.com/info

Newspaper Ads: Most note brokers, when they get started, place newspaper ads; however, their commitment to running an ad is not long enough to make it worthwhile. Newspaper ads can be good if you look for little niche newspapers in your area. You want to avoid big newspapers like the LA Times, the Wall Street Journal or USA Today unless you have a lot of money behind you. Place small ads in many newspapers. Your ad can read, "Private party has cash for your trust deed. Call XXX-XXX-XXXX." Believe it or not, this ad is the best I've found.

You may also want to write a short article for some of these newspapers. It can be an article without pay, in exchange for exposure. At the end of each of your articles say something like, "To receive my free newsletter on real estate investing, a $29.00 value, for free, call XXX-XXX-XXXX." Have a voice mail message attached to that phone number stating that the person should leave their name, address, email address and phone number and you will be happy to send your newsletter. This will save you a lot of time, and we all know — time is money. You want to capture all of this information so that you can continually market to this group of people as they will refer notes to you in the future.

Postcards: Postcard marketing is used mainly to remind people about what you do. It can also be used to market directly to Note Holders. It's an inexpensive way to put your message into the hands of potential customers. The key to postcard marketing is to make the postcard appear personalized. Accomplish this by placing a stamp on the card and make your message look handwritten. Do this by writing your message on a postcard and take that card to your local printer, they can print thousands of them for next to nothing. Have it printed in blue ink to make it look personalized.

If marketing to Note Holders, use a message like, "I have been trying to contact you about your mortgage. Please call me at XXX-XXX-XXXX. Thank you!" This is an example of a high response postcard; one out of ten people who call will say, "Yes, I want to sell my note". And, out of those people who say, "Yes" four to five of them will close. So, you see, you will have to get several calls to get a deal. This is, however, an excellent long-term approach.

Postcard Decks: We've all seen in the mail those decks of cards advertising people's specialties. One thing to remember, when doing this type of marketing, is that you want to target your customers. In other words, you want to be sure that your message is going to the right people. Contact direct mail companies in your area to find out more. Look in your phone book under mailing services to find a list of direct mail companies. Ask them about postcard deck advertising. Offer your potential customer to cash out of their mortgage or note, or a free newsletter on real estate. The idea here is to get potential customers to sell you their note.

Radio: You can use radio to get deals in two ways. The first way is to advertise during specific real estate shows. In other words, you can have a 30-second ad telling listeners, "Private party has cash for

your trust deeds or mortgages. Please call XXX-XXX-XXXX" or, something catchy to grab your audience's attention. Another great way to use radio is to be a guest host discussing real estate and Seller financing. There are many radio stations that have talk shows about real estate and they always need people who can speak intelligently about the subject. This is an excellent way to gain credibility, exposure and deals.

Seminars: This is a great way to find both notes for sale as well as investors. Hold a seminar in your area — teach concepts such as loan to value, partial purchases, and what good or bad notes look like. Advertise in newspapers or hook up with your local "Learning Annex" to reach potential attendees. I recommend that you charge for this seminar. You can charge $12.00 to $29.00 and have a short two- to three-hour class. There will be anywhere from ten to 20 people attending your class. The money you make from it will cover all your costs. In other words, you are getting the word out about what you do for free.

Telemarketing: Telemarketing to Note Holders is one of the most overlooked ways to market your note business. I started telemarketing back in 1993, and on my first day, about four hours into it, I found a deal that paid me a commission of $10,000.00. Telemarketing is a gold mine! Many people are afraid of the telephone (boy, I know I was), but the telephone is going to become your best friend. Every time you pick up the phone or make a call you will make money. What I found is that the average note broker just starting out can earn $65.00 per hour on the phone.

Telemarketing is a numbers game — for every thousand calls you make you will get one deal. When you get good at telemarketing you will get one deal out of 500 calls. Now remember just because you dial the phone a thousand times doesn't mean that you've talked with a thousand people. Most likely, you will only talk to about 250 people.

Now, what if you don't make the telephone calls yourself? Hire a local college student at $8.00 - $10.00 per hour to call for you. When s/he finds someone who is interested, you will give that person a call to close the deal. If the deal closes, you give $25.00 bonus to your college helper. Don't overlook the power of telemarketing! Additionally, there are several valuable articles and sample telephone scripts on the web site. Go to www.notenetwork.com and click on "How-To Reports". Lastly, we have an excellent book on telemarketing. If you'd like more information go to www.notenetwork.com/helptips.

Word of Mouth: Remember, tell everyone you meet, everywhere you go, that you buy notes and cash flows. You can go so far as joining your local Chamber of Commerce and attend their meetings. There, pass out business cards, brochures and newsletters. Becoming known as an expert on real estate notes in your area is important to your success. Before long, many people will refer notes to you.

Write Articles: We've talked a little about writing articles to gain exposure, let's go into a little more detail. Write articles for your local newspaper dealing with investments and finance. You can go to America's Note Network's website at www.notentwork.com and read some of the over 450 articles to get some ideas. (Of course — Don't take our articles and use them as this would be a violation of copyright laws and we take copyright violations very seriously!). But, do go there to get ideas of what

you would like to write about. Remember, end each of your articles with something like, "To receive my free newsletter on real estate investing, a $29.00 value, for free, call XXX-XXX-XXXX." Have a voice mail message attached to that phone number stating that the person should leave their name, address, email address and phone number and that you are happy to send your newsletter. This will save you a lot of time and, we all know — time is money. You want to capture all this information to continually market to this group of people. They will refer notes to you in the future.

Voice Mail: An extremely helpful sales tool is using voicemail to state a specific message. In our business, we use the voicemail system a lot. Set up a voicemail-box message that states what you do, how you do it and why they should leave their contact information. This is an exceptional time saver and tool for selling your services. Your job is to get your phone to ring, as mentioned above.

America's Note Network: Don't forget one of the most cost effective ways for you to buy and sell cash flows is to become participate on America's Note Network's. We have articles, discussion board and much more. And once you get to the place where you are excelling in this business. You can apply for membership and become one of the dealmakers on our site. For more information, and to be considered for membership, go to www.notenetwork.com/helptips

Summary: To summarize, I have shared 40 of the very best ways for you to market your note business. It's true that there are 100s of different ways you can do this business but I've pulled together the best of the best. The reason I've done this is to help you be efficient and successful — as quickly as possible.

Allow these ideas to percolate in your mind and I'm sure you will come up with some additional ones. You don't have to reinvent the wheel. The wheel has been created for you. Just follow my simple step-by-step plan and you will be successful.

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And I would like to share with you my **10 Favorite Marketing Techniques** as promised:

I'm frequently asked, "Russ, what's the best, most effective way for me to market?" These are the ways I like to market for notes, from best to worst is:

1. Newsletter Marketing
2. Telemarketing To Note Holders
3. Referrals From Professionals, Around Town
   a. Attorneys
   b. CPAs
   c. Mortgage Brokers
   d. Realtors
   Escrow Officers
   Loan Servicing

4. Internet Marketing – Go to www.notenetwork.com/helptips

5. Niche Marketing
   a. Mobile Home Paper –Go to www.notenetwork.com/helptips - click on Tin Can Alley.
   b. Business Notes - Go to www.notenetwork.com/helptips - click on Business Notes

I like the above methods more personally because they are a little more proactive, but all methods are good and each one works. Pick the techniques that best suit your personality.

6. Court House Records
7. Newspaper
8. Postcards
9. Voice Mail
10. Letters

It's important to know that some of these marketing approaches are expensive and require very little time, while others require a bit more time and are less expensive. So, which way are you most inclined to go?

Please remember — we are here to support you 100%. There are many ways in which you can get answers to any questions you may have immediately:

Utilize our **Website Search** option. From any page on our site, enter a keyword or phrase and you will automatically get a list of related material that you can study on the chosen topic.

FAQ Section – We have created an extensive list of the most commonly asked questions. Go to www.notenetwork.com/FAQ.php3 and you will find the answers to the questions we hear the most.

Post your questions on our **Message Board** at www.notenetwork.com/messageboard — we have a network of professionals who monitor the board specifically to answer your questions immediately.

This is the best way for you to get quick support from the experts. You can also utilize a search mechanism on the Message Board. Notice the link that states "Search" – click on this to access previous posts and their responses.

Send an **email** to support@notenetwork.com where you will receive a quick response, usually within approximately 60-minutes.

Call us at 303-499-7064. There you will be transferred to voicemail and someone will call you back within 24-hours.

Wrap up

I have spent much of my life researching the most effective ways to market products and services and I have put them into an easy-to-follow format that will surely help get your phone ringing off the hook. Follow these suggestions and you too will find that they work – and work incredibly well. You can earn as much as you wish to earn, buying and selling cash flows. $2000 to $5000 per transaction is common and 20% or more on your investments if you are purchasing them for yourself.

The note business is one of the greatest businesses in the world. It allows you the flexibility and freedom to work when you want, with whom you want, earn as much as you want, and the best part is, you can do it *all* from home. In fact, I just returned from being with 12 of my students in California and I was *truly* amazed at what they had to say. One woman shared how she made $51,000 in just one transaction. One man told me about an $80,000 deal, another guy described how he became a millionaire in the note business and several others explained how they work part-time and earn $2000 to $5000 a month. .

Another exciting aspect to this business is that there is very little competition as a cash flow broker. For example, there are more than 700,000 real estate brokers in California alone and approximately 140,000 in Florida. Many of these real estate brokers do well earning an above average living. Whereas with cash flow brokers there are less than 25,000 in the *entire* country!

I see the next 5 to 10 years being extremely profitable for the average cash flow broker because we are in a growing market, I.e. more cash flows are created each year than sold, little competition, and more awareness brought to everyone about the possibility of selling cash flows. These cash flows will be sold. Who will the cash flows be sold to? You! And you will make a superb living because you were in the right place at the right time with the right company.

My Hidden Motivation Revealed!

I know that if I can help you find and broker notes many of those notes will get listed on my website, www.notenetwork.com - You see — having hundreds and hundreds of notes listed each month on my

website for my members is my hidden motivation, and why I'll do everything in my power to help you find deals! It's a win / win in it's truest form!

You now have the tools to truly make as much money as you wish. You can earn a few extra thousand dollars each month or 10's of thousands of dollars each month – working only a few hours a week – starting today.

We've included two additional bonuses in this manual for you – "**Money Math & Magic - Learn the Inside Secret To Making Even Higher Commissions On Every Deals!**" The second bonus is about how to purchase real estate notes for yourself and earn 20% and more on your investments. It's entitled "**Creative Deal Structuring For Big Profits - How to earn 20% And More On Your Own Investments!**" Both of these valuable bonuses are specifically geared towards purchasing notes for yourself, for free! These advanced techniques will be excellent resources for you to reference for years to come!

It's time to move on to the last, the most important and the most fun part of this course - the video on marketing magic and how to get your phone ringing off the hook with money making deals.

You will also find in the Appendix following this section telephone scripts, more moneymaking tips, forms and an extensive Glossary of additional terms that will provide you with everything you need to **Win In The Cash Flow Business.**

Again, please let us know if there's anything we can do to help you grow your business. My staff and I truly care about your success and we'll do everything we can to help you. We look forward to working with you and hearing about your successes!

Bonus #1

Money, Math & Magic

Learn The Inside Secret To Making

Even Higher Commissions

On

Every Deal

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Money, Math & Magic

I am going to show you how to use the Hewlett Packard 12C calculator to make the financing work for you *every* time in private party financing and discounted paper. You will want to have a calculator to follow along.

As I have mentioned before, many modern investors leave the property behind and invest directly in existing financing or real estate paper. Notes or IOUs carried back by Sellers are valuable forms of money secured by mortgages, deeds of trust, or land contract on good real estate. Why? Because this money can often be purchased at a discount producing quick cash profits of $2,000 per transaction or annual returns of 20% or more with monthly cash flow. This can be done with no cash of your own in a good or bad economy, which makes the note business, the best business in the world.

In order to be proficient at arranging your own private party financing and dealing profitably in discounted paper, one cannot afford to make decisions blindly by rules of thumb or guesstimates – you must operate based on facts.

Knowing how to use the calculator will help you earn large cash profits in discounted cash flows. And, you'll discover some astonishing facts about money and financing. You'll see that what you don't know about financing could cost you a bundle. You'll learn how to avoid the mistakes others make and how to be sure that the financing will always work for you rather than against you. When you know what to do, and then do it, you'll win every time. You'll never again be intimidated by fancy sales tactics used by lenders, real estate agents or financial calculations. Whole new areas of profit will open up to you when you can do the calculations yourself with confidence.

There are two purposes for this portion of the course. The first is to show you how to use a very simple pocket calculator (the Hewlett Packard 12C) to compute loan terms, loan balances, paper discounts, and rates of return. These financial analyses will make it possible to maximize your profits. You will learn how to do it easily, quickly, and accurately. You might even find out that it's fun.

We are also going to cover creative deal structuring – an extremely important part of this business. You will soon learn many ways to structure a deal to make a profit.

When working out loan questions almost any loan has five different factors that we are going to talk about. They are: number of payments, interest rate, the principle amount now, the monthly payments, and the balloon payment at the end. When you enter any four of those into the HP12C it will give you the fifth one in just a few seconds. The HP is easy to learn and fast because most questions can be worked out in one step. It is very simple to do.

At this point I am going to presume that you've got your HP12C sitting in front of you. If you don't have one, you will need to do one of three things. First, you can go out and purchase this calculator for about $75. Second, you can go to our web site at www.notenetwork.com/calc. Please note the downside with the web site is that it will not be able to calculate balloon payments for you, which I will talk more about shortly. The third option (if you are not mathematically inclined) is to use one of the software

packages that I will name at the end of this section.

Regardless of your choice of method I want you to still go through this part of the course, because you will learn valuable real life examples of how to apply this information for maximum deal structuring and profit.

Now we are ready to go on and do some financial applications. There are five very important keys considering financing. N is the number of payments or compounding periods. I is the interest rate per period. It must agree with N and PMT, which we will talk about soon. PV is the present value and that means principle now or at the beginning of the loan, it's also the value of a series of payments discounted to a single price today. PMT stands for payment. It must agree with N and I. FV stands for future value or balloon payment.

N Number Of Payments Or Compounding Periods

I Interest Rate Per Period. Must Agree With N And PMT

PV Present Value. Principal Now Or At The Beginning. Value Of A Series Of Payments Discounted To A Single Price Today

PMT Payment. Must Agree With N and I

FV Future Value. Balloon Payment

Let's talk about cash flow just a little bit, because that's what financing is all about. You know there are two ways to count money. You can count money coming in - that's where you get to count all the money, put it in your pocket and spend it yourself. The other way to count money is outgo. That's where you count it, put it in an envelope, and send it to somebody else. Then they enjoy the benefit of it. The first way of counting money is income or positive cash flow. That's obviously the most enjoyable way to have it. The other way is called outgo or negative cash flow.

One party has a negative cash flow and the other has a positive cash flow. So from your point of view you could be either one of those parties. And when you know what you are doing, you can win either as a borrower or a creditor.

Cash Flows

Two Ways To Count Money

Income/Positive Cash Flow

Outgo/Negative Cash Flow

Let's talk about finding the monthly payments on an amortized loan. You give the calculator any four-loan variables and it finds the fifth**.**

Let's take this example, the principle amount $20,000 the period of the loan 30 years, interest rate 12% per year and the payments are to be fully amortized over 30 years, that means the loan will pay itself off over 30 years. What is the monthly payment?

Clear the calculator gold registers. Now let's plug in the four variables into the calculator. So, we push 20000 and then PV, that's the principle amount of the loan. Now we are going to push 30 and then blue N. You see pushing the blue key multiplies by 12 and that tells us 30 years is actually 360 monthly payments. The interest rate is 12% per year so we push 12 blue I, which gives us 1% per month. By clearing the calculator we actually stored zero in future value, but, just to let you know what we are doing here, let's take zero and push FV for future value of zero. That means the loan is totally paid off by the end.

Now we have input four factors of this loan. Watch how easy it is to find the payments — just push PMT and then watch your calculator while it says "running, running…" and then it shows minus 205.72. This means that your payment is $205.72 per month and after 360 payments the loan will be completely paid off.

Finding The Monthly Payments On An Amortized Loan

You give the calculator any 4 loan variables and it finds the 5th:

Example: Principal amount $20,000 - Period 30 years - 12% annual interest - Payments fully amortized 30 years - What is the monthly payment?

Gold	REG		
20000	PV		
30	Blue	N	
12	Blue	I	
0	FV		
PMT	(Display -205 .72)		Monthly payment

Let's do a sample problem: The principle amount $60,000, period 30 years, 10% annual interest, payment amortized 30 years. What is the monthly payment? Let's go ahead and work that out, see if you can get it. I'm going to work it with you but I won't tell you what I'm doing this time.

Sample Problem

Did you get $526.54? Good. If you didn't get that, go back and work it out again. Principle amount $60,000 under PV, 30 blue N, 10 blue I, zero FV, and push payment. You should get $526.54, and it would have a minus sign in front of it because payments are negative cash flow.

Sample Problem: Principal amount $60,000 - Period 30-years - 10% Annual interest - Payments fully amortized 30 years. What is the monthly payment?

Answer: $526.54

Finding How Many Payments It Will Take To Amortize A Loan

We want to find out how many payments it will take to amortize a loan or to pay a loan off. This will only work if the payments are greater than the interest. You can't amortize the loan if the payments are equal to the interest or less than the interest. In other words, to work this problem, the payments in your example must be greater than the interest rate and the interest per month.

Here is the example: Principle amount $20,000, 12% annual interest and payments of $250.00 per month. Let's clear the calculator, gold registers, and punch $20,000, 20000 PV. 12 blue I. $250 CHS, PMTs zero, FV and let's ask the calculator how many payments that will take: push N. It says, "running, running…", 162 months. Now if we want to know approximately how many years it is: recall blue N and that tell us 13.5 years. That converts years into months and months into years.

Payments Must Be Greater Than The Interest

Example: Principal amount $20,000. 12% annual Interest. Payments of $250/Month

Gold	REG		
20000	PV		
12	Blue	I	
250	CHS	PMT	
0	FV		
N	(Display 162 Months)		
RCL	Blue	N	(Display. 13.5 Years)

One thing that you have to keep in mind is this: If you are working a problem and you put in I, PV, PMT and FV, and you ask it to find N, it rounds N off to the next higher number. In our case it told us 162, but we might suspect that it's 161 rounded up to 162.

You would have 161 payments of $250, or a total of $40,250.00 plus one last payment of $187.03 for a total payment of $40,437.03

"N" is rounded off to the next highest number. Let's check it out…

162	N
FV	(Display 62.97)

So let's do this. Let's push 162 N (Now it's not rounded off), and ask it what the balloon payment would be at the end. Push FV. It tells us plus 62.97. We know that balloon payments ought to be negative, so that indicates that if we make 162 payments of $250 per month we would have paid $62.97 too much.

Okay, let's try this: 250 CHS, enter, that's the normal payment 62.97, plus. That gives us 187.03 as the correct last payment that we would make. So you could make 161 payments of $250 that would be a total of 40,250 dollars plus one last payment of $187.03, for total payments on that loan of $40,437.03.

Since the future value is positive for 162 payments, we have over paid. This means that the last payment is smaller than the normal -$250 by $62.97.

250	CHS	ENTER
62.97	+	(Display -187.03)

<u>How To Determine The Price To Pay For A Note</u>

Now we are going to get into some of the fun things about discounting paper. How do you determine the price of a discounted note to get a certain rate of return on your money? When buying a note at discount you buy the remaining payments. It doesn't matter what portion of the payment is principle or interest. You are just concerned with the amount of money that is coming in to you. Let's take a look at how discounting actually works.

Let's presume that you have a bank account just like the one here in your workbook with a balance of $1,000. Each year it earns $100 interest, now work this out in your head, what interest rate are you getting? That's right, you are getting 10% per year. If you had a way of getting $100 a year in earnings, but only had to put $500 in the bank that year, what rate of return or interest rate would you get? You would get 20% because you invested half as much. This is exactly how discounting works.

When buying a note at discount you are buying the remaining payments. It doesn't matter what parts of the payments are principal or interest.

Bank Account Example

Bank Balance	Yearly Earnings	Interest Rate
$1,000	$100	10%
	$100	

You are offered a note with 36 payments of $200 per month remaining plus a balloon of $20,000 at the end. What is the highest price you could pay (your upper negotiating limit), and still get a yearly return of 30%? Let's do the calculator: Gold registers, 20,000 CHS, FV, 200 CHS, PMT, 36 N, and what rate of return did you want? 30%. So we push 30 blue I and watch this. You push PV and it says, "running, running, running", and the price that you would pay to get 30% per year return is $12,933.12. Wasn't that quick?

Gold	REG	
20000	CHS	PV
200	CHS	PMT
36	N	
30	Blue	I
PV	(Display 12,933.12)	

Here's another sample problem. You are offered a note with 26 payments remaining of $157 per month and no balloon, what is the price you pay to get a 30% annual return? I'll work it with you but you go ahead and work it out by yourself and see if you get the right answer.

Did you get $2,975.25? I hope so, because that's the right answer. Here is what you do. We put in 26 N, 30 blue I, PV is what we're looking for, 157 is the monthly payment CHS, PMT, zero FV, and push PV, you'll get the answer of $2,975.25.

Gold	REG	
157	CHS	PMT
26	N	
30	Blue	I
0	FV	
PV	(Display 2,975.25)	

How To Determine Your Annual Return

Another question that we might want to work out here is how do you determine your annual return on a note that's discounted to a certain price?

Example, you have an opportunity to buy a note with the following payments remaining: 36 monthly payments of $200 a month and then a balloon of $20,000. The discount price you are offered is $14,000, so let's clear the calculator, gold registers, 20000, CHS FV for the balloon, 200 CHS PMT, 36 N for the remaining number of payments and the price we are going to pay is 14000 PV,

Gold	REG	
20000	CHS	FV
200	CHS	PMT
36	N	
14000	PV	

Push I. It says "running, running, running…" (this is the hardest question that we will ask it, so it takes a while to compute). The answer is 2.22. That means 2.22% per month return. If we want to figure out what that is per year, we do recall blue I, and that gives is 26.62% return per year.

I	(Display 2.22)	Percent Per Month	
RCL	Blue	I	(Display 26.62) Percent Per Year

Pop Quiz

You can buy the following 22 payments of $157 per month plus a balloon of $17,000. The discount price you are offered is $11,500. What rate of return would that provide? Remember to clear the calculator.

You should get 2.94 percent per month or recall, blue, I - 35.30% per year. The way we worked that out was we put 22 N, 157 CHS PMT, 17000 CHS FV, 11500 PV, and then we push I to get the interest rate or rate of return or yield. When we get that answer and the calculator gets done working that out, we push recall, blue, I – and that gives us 35.30% per year. Not too bad.

Finding The Remaining Payments

Let's take a look at how to find the remaining payments on a seasoned note. What I mean by a seasoned note is one that has been in existence for a while, and some of the payments have been made on it. In the real world you usually don't buy a brand new note —- usually some payments have already been made. And, perhaps the principle balance has changed. In our previous examples we presume that we knew what the remaining payments were. Now you will learn how to figure them out by yourself.

Example, a note had an original balance of $20,000 with interest at 12% per annum, the payments are $322.44 per month and the original term of the note was 5 years. The note was created on June 1, 1998. Let's presume all payments have been made as agreed so far. Today's date is September 15, 2000. What is the current principle balance of the note?

First we clear the calculator gold registers, then input the data about the original loan as it existed when it first started out. 20000 PV, 12 blue I for the interest rate, 5 blue N for the number of payments. We had 60 original payments. Then we put the monthly payment in of 322.44 CHS PMT, now we push FV and find out what the balloon payment is, if any.

Gold	REG	
20000	PV	
12	Blue	I
5	Blue	N
322.44	CHS	PMT
FV	(Display -10,000.37)	

The calculator tells us that it is minus $10,000.37, indicating a balloon payment. If it were positive it wouldn't make any sense because payments and balloon payments are negative in the way the calculator thinks.

Next we need to determine how many payments are gone and how many remain. The first payment was July 1, 1998. Remember, interest is paid in arrears, so although the note started on June 1, the fist payment wasn't until July 1st.

How many payments are gone? The first payment was 7/1/98.

1998:	6	Payments
1999:	12	Payments
2000:	9	Payments
Total:	27	Payments Gone
Total:	33	Payments Remaining

Since we started with 60 payments, 60 minus 27 leaves 33 payments remaining.

Now we want to find out what the current principle balance is. Let's think about this a little bit. Consider payment number 1 made July 1, 1998. Part of that payment went to interest and what was left over went to principle. Now let's work the calculator. Now the N key, number of payment or compounding periods also works as a counter. It will count the number of times the calculator does a transaction. Put zero in N, because we are going to use N as a counter at this point. The way to find out how much of a payment went to interest, how much went to principle, and then how much of the remaining principle balance is works like this:

Push 1 gold Amortize to ask the calculator to amortize one payment, to show us what happened when one payment was made.

Now it displays minus 200, which is how much interest was paid out of the very first payment. Now we punch the XY key and it says minus 122.44. That's how much money went towards principle.

Now we want to find out what the remaining principle balance was after that first payment, so we push recall PV and that tells us 19,877.56 is the remaining principle balance after the first payment has been made.

O	N	(To Act As A Counter, Counting Number Of Payments Amortized)
1	Gold	Amort (Display-200) Interest
X	Y	(Display-122.44) Principal

RCL PV (Display 19,877.56) Remaining Principal Balance

Now back to the present question. We want to find out how much is remaining after 27 payments have been made. Now we did this one time for the first payment, but to do that 26 more times certainly would be a chore, so here is the easy way to do it:

Recall N and it says "1" that's what we put in there. We want to amortize 27 payments. We've already amortized 1 payment, so we need to do 26 more. So we are going to push 26 gold Amortize and the calculator starts running.

Now the first thing that it flashes is minus $4,732.18, and that's how much more interest was paid with the next 26 payments. Now we push XY and get minus 3651.26, which is how much principle we've paid. Now let's push recall PV to give us the remaining principle balance of $16,226.30, the current principle balance of that loan.

Now let's recall N just to make sure that we amortized 27 payments and sure enough that's what it says. 27 is the N so we have the remaining principle balance after 27 payments have been made.

RCL N (Display 1)

26 Gold Amort (Display- 4,732.18) Interest

X Y (Display-$3,651.26) Principal

RCL PV (Display 16,226.30) Current Balance

RCL N (Display 27) Payments Amortized

Here's a very important point when discounting paper — always start with the current principle balance, not the original face amount of the note. Often, the owner of the note has received payments that went to interest and principle, thereby reducing the principle. Or, maybe they had a large payment that came in and was applied completely to principle, reducing that principle balance. So when we say "Buy a note at a discount", we mean at a discount from the remaining principle balance, and **not** the original balance.

Getting 30% Return On Your Investments

Now you are ready to do any kind of discount calculation with your calculator. Let's use the above example. Keep everything in the calculator as it is but reset N to the number of payments remaining. We put in 33 N, and now the calculator is all set to work on our discounting question.

What would be the maximum price to pay in order to get a 30% yearly return on this note?

30 Blue I

PV (Display 11,614.99) Price To Pay

What percentage discount is this?

11614.99 ENTER

16226.30 DIVIDE (Display .72)

1 Minus (Display –0.284) Or 28.4% Percent Discount

Remember again, the discount is from the current principle balance not the face amount. Also remember when you figure out the discount after you have amortized a loan from its original balance down to the current principle balance, always reset N so it equals the remaining number of payments.

Pop Quiz

We have a note with an original face amount of $10,000, the interest is at 14% per annum, the payments are $273.27 per month and the original term was 4 years. The beginning date was June 17, 1998 and, let's presume, today's date is January 7, 2000. What is the current principle balance? Also what is the highest price you can pay and still get a 30% annual return on that note?

Here's a clue: The beginning number of payments was 48, 4 years times 12 payments a year and in 1998, 6 payments are gone, in 1999, 12 payments were gone and in 2000 one payment is gone. Now consider one payment gone due to the transaction processing time that it will take in January to close this transaction.

1998: 6 Payments Gone

1999: 12 Payments Gone

2000: 1 Payment Gone

Total: 19 Payments Gone

Beginning There Were 48 Payments

Payments Remaining 29

Answer: Principal Balance As Of January 7, 2000 Payment Was $6,690.46

Maximum Price For 30% Annual Return: $5,589.18 - Did you reset the number of payments?

So we have a total of 19 payments gone and 29 payments remaining. Lets see if you got the right answer.

Okay, here's what we did.

Gold	REG	
10000	PV	
14	Blue	I
4	Blue	N
273.27	CHS	PMT
FV	(Display .33)	

Working from there we want to amortize 19 payments. We simply push 19 gold amortize. It says, "running, running, running…" and then it says minus 1882.59. We don't really care how much interest was paid, but let's go recall present value, 6,690.46, which is the principle balance as of January 17, 2000.

Now, what maximum price are you willing to pay to get a 30% return on your money?

30	Blue	I

Remember we need change the number of payments to 29. So, push 29 N, then let's solve or press PV.

29 N

Press PV (Display 6690.46)

It says, “running, running…”, and the answer we get is 5,889.18 — the price you would need to pay to get a 30% annual return on that note. This isn’t too hard at all, is it?

Negative Amortization

What negative amortization means is that the interest on the loan is bigger than the loan payments. The loan payments don’t even cover the interest so the unpaid interest adds on the principle and the loan itself grows larger rather than smaller. A banker might allow this condition to last for a couple of years or so if you needed to keep your payments down while awaiting some form of expected windfall (for instance, you have a trust fund that will start paying you at a future date). Here is an example of negative amortization.

You have a 60,000 loan at 14% annual interest and the loan is to run for 30 years. However, payments are based on 11% interest. So we clear the calculator gold registers 60000 PV 30 blue N - 11 blue I and get 571.39 per month payment. But, since the real interest rate is 14 blue I, what would be the balloon payment at the end of that loan?

Push FV and we find out that the balloon payment on a 60,000 loan would be 766,428.82 but we couldn’t do that. Let’s take a look and find out just how much of our first payment goes to principle and how much goes to interest. Push 1 gold Amortize and we see that out of our first payment of 571.39 we would have 700 going to interest.

Push XY 128.61 to add on to the principle. Recall PV and we find out 60,128.61 is the remaining balance, which is larger than when we started on our loan. Obviously, one would not want to do that except in some extraordinary situation, and only for a limited time.

I want to mention one other aspect regarding negative amortization since we are looking at it right now, and that is that your HP calculator handles it with no unusual adjustments at all. You’ll notice that when we found out that the interest was 700 and payment was only 571.39, it just added on to the principle.

Negative Amortization Means That The Interest Is Larger Than The Loan Payments; The Unpaid Interest Adds On To The Principal And The Loan Grows Larger Rather Than Smaller.

Example: $60,000 Principal Amount - 14% Annual Interest - Loan Term 30 Years
Payments Are Based On 11% Interest.

Gold	REG		
60000	PV		
30	Blue	N	
11	B	I	
PMT	(Display-571.39)		
14	Blue	I	
FV	(Display-766,428.82)!		
1	Gold	Amort	(Display-700) Interest.
X	Y	(Display 128.61) Added On To Principal.	
REC	PV	(Display 60,128.61) Larger Than When We Started!	

Quick Resale Of Discounted Notes

Now let's talk about more techniques to **Win With Cash Flow**s – to make quick cash profits. You should know that one of the highest rates of profit returns you can earn investing in discounted paper is with the quick resale of discounted notes that you find. Another advantage is that you can do it without any cash of your own.

This works using the Buyers on **America's Note Network**. Working with them will make your life simple and you can earn more profits because you will not spend your time searching high and low for someone who'd like your note. The time you save using **America's Note Network** will allow you to find more deals and earn more money.

Here's an example:

You find notes that have yields of 25% and 30% and resell them to an investor to yield 18% and keep the spread of 7 to 12%.

a. You List The Notes You Find On **America's Note Network**
b. One Of The Highest Profit Returns
c. No Money Of Your Own

Here's an example of what you might do: Find a $20,000 note at 12% interest with payments of $200 per month and a balloon payment of $20,000 due in 30 months at the end. Let's enter that into the

calculator. Gold registers 20000 PV 12 blue I, 200 change sign payment 30 N –what is the future value? Press FV — it displays $20,000. We now have the note entered in the calculator and want to price it to be attractive to an investor who wants 16 percent on their money.

Let's try it at 16%, 19 blue I and then push PV. The calculator tells us that the price to yield 16% per annum is 18,360.47. Round that off to make it an even $18,300 and put that in PV. That's good enough for our investor who is happy with 16 percent on his money.

We know how to make our investor smile, don't we? When they get 16 percent they are happy, which means they would be happy paying a price of 18,300 for this particular note that we are talking about. So much for the happy investor – now how do we get happy? It's simple! With our newfound wisdom we will calculate what price we would need to pay to buy this note so it has a built in profit for us.

Gold	REG		
20000	PV		
12	Blue	I	
200	CHS	PMT	
30	N		
FV	(Display -20,000)		
16	Blue	I	Investor's Desired Yield
PV	(Display 18,360.47)		Price To Yield 16% Per Year

We have a policy that we want to get at least 20% to 30% on our money. That makes a deep enough discount that we can resell the note at a 16 to 18 percent yield and still make a good profit.

How To Make Yourself Smile Also

30	Blue	I
PV	(Display 13,720.91)	Price To Yield 30% Per Year

The Easiest Math There Is:

18,300	ENTER	Investor Pays
13720.91 -		(Display 4,579.09) Cash Profit!

One more thing I want to mention about this transaction is that until you are familiar with your note Buyer from **America's Note Network**, you'll want to have a "Non-disclosure – Non-circumvent" agreement signed. This will protect you and tell the escrow company, those doing the closing, to pay you the amount you expect. 99.9% of the time you will not have any problems with the members of **America's Note Network** because they are honest and forthright. It is, however, good practice to know how to protect yourself in every aspect of buying and selling notes.

You can find this agreement on the web site. Go to www.notenetwork.com, click on the "**How to Reports"**, and locate the **"Note Brokers Resource Kit."** I have also enclosed the contract for you in this course. All you need to do to earn quick cash profits is…

a. List The Note On **America's Note Network** For A Quick Sale
b. Gather The Necessary Paper Work From The Seller
c. Forward The Paper Work To The Buyer
d. Buyer Handles Escrow And Closings
e. Receive A Check In The Mail In About Three Weeks
f. Find More Notes Just Like This One
g. Find 'em - List 'em - And Cash Your Check!

Receiving Monthly Income On A Note Using No Money

Let's look at another example of selling a note. This time you are going to sell the note and receive part of the payment without any of your own money. Here's how it works.

Assume that you locate a 3,000 second at 15% interest 5 years with monthly payments of $60.00 per month it has a balloon payment of $1,007.07 at the end of five years, and that you can buy it for $1,000. Let's enter this note into the calculator.

Gold	REG		
3000	PV		
15	Blue	I	
60	CHS	PMT	
5	Blue	N	
FV	(Display –1,007.07)		Verifying The Balloon Payment
1000	PV		
I	(Display 6.00)		Percentage Return Monthly
RCL	Blue	I	(Display 72.02) Percentage Return Yearly

This is going to be better than we expect — it's going to be a lot better than our normal 30%. The answer we come up with is 6.00. That's the monthly percentage return. It certainly is a good buy! Recall blue I tells us that we will make 72.02 percent return yearly! We wish we could do this one more often!

The strategy is this – sell 1/2 interest in the note to an investor at what price? Why not pluck it from the air – say $1,000? Let's see what he or she will get for their investment.

Why Not $1,000?

Gold	REG	
5	Blue	N
503.54	CHS	FV
30	CHS	PMT
1000	PV	

I	(Display 2.65)	Percentage Return Monthly	
RCL	Blue	I	(Display 31.86) Percentage Return Yearly

Our investor will get 2.65 percent percentage return monthly or recall blue I, 31.86 percent yearly return. They are certainly happy with that! That's good enough for our investor and that's even what we like. As a matter of fact we could have charged our investor a little bit more, but we are not too greedy.

So, what's our rate of return on this real estate note transaction? You paid zero PV for payments of $60 a month and your half of the balloon payment of 503.54. Let's push I and see what it is. It says, "running, running, running, error 5". You know what that means? You divided by zero. You had nothing invested, and you got a rate of return of **infinity**.

0	PV	(Your Cost)
I	(Display ERROR 5) Infinite Yield!	

Error 5 means infinite yield, three cheers for error 5

<u>Buying A Series Of Payments / A Partial</u>

When we buy a series of payments on a note it is call a partial. For example, let's say that you have the following note: A 75,000 property with a 43,750 first loan. The note you are considering buying is a 20,000 second note. That leaves 11,250 worth of equity securing that second. You notice the total loans on the property are 63,750 which equates to an 85% loan to value ratio (divide 63,750 by 75,000 to get 85%). That immediately causes a bit of concern, but let's continue and take a look at the note terms. The terms are 20,000 current principle balance with 12% annual interest fully amortized over 15 years, with monthly payments of 240.33. Let's enter this information into the calculator:

$75,000 Property

$43,000 First Loan

Total Loans: $63,750 (85% LTV or Loan To Value)

$20,000 Second Loan

$11,250 Equity

The Note Terms Are - $20,000 Current Principal Balance - With 12% Annual Interest - Amortized 15 Years - With Monthly Payments Of $240.03

Gold	REG	
20000	PV	
12	Blue I	
15	Blue N	
PMT	(Display-240.03)	Verifying That The Quoted Terms Are Consistent With Each Other
30	Blue I	
PV	(Display 9,488.62)	The Price To Obtain A 30% Annual Yield

We find that we only have two problems. Problem Number one is the loan to value ratio exceeds 80% — the safe rate that we and our investors might be happy with. Number two is that the Seller won't discount the note by $10,511.38. How do we handle this dual problem?

First, in handling the loan to value ratio you will need to keep your cash involvement in the transaction to a level where the balance of Loan 1 plus your cash costs for Loan 2 at discount are *less* than 80% of the property value. This is call ITV or Investment To Value. That way you can maintain a 20% equity cushion in real equity beyond your investment.

Second, rather than offering to buy all the remaining payments and have the Seller of the note take such a horrendous discount (from his point of view), you offer to buy only the next 36 payments. And, this happens to be the 36 best payments on that entire loan because they are the closest to the present. Let's look at this further:

<u>The Answer</u>:

1) Loan To Value Ratio —

KeepYour Cash Involvement To Where Loan 1 Plus Your Cash Are Less Than 80% Of The Property Value. This Is Called ITV or Investment To Value

2) Rather Than Offering To Buy All The Remaining Payments, Offer To Buy Only The Next 36!

Gold	REG		
36	N		
240.33	CHS	PMT	
30	Blue	I	
PV	(Display 5,661.27)	The Price For The Next 36 Payments At A 30% Annu Return.	
ENTER			
43750	+	(Display 49,411.27)	Your Offer Plus Loan 1.
75000	+	(Display .66)	66% Loan To Value Ratio!

Offer The Note Seller $5,600 For The Next 36 Payments.

Your Point Of View: Great!

His Point Of View: He Still Gets 144 X $240.33 = $34,607.52. Great!

You make the note Seller an offer of 5,600 for the next 36 payments. From your point of view this is very nice — you get a 30% rate of return on your investment. From his point of view, he still gets 144 payments after your 36 are gone, times 240.33 which equals 34,607.52. He doesn't feel like he had a very bad discount after all. The only thing that he doesn't recognize is the time value of money. You just bought the best payments. Now you are both happy and everybody **wins**. Isn't that great? You'll find that partial purchases will open up many, many opportunities for you in terms of buying notes that you otherwise couldn't buy.

Protecting Yourself

You must protect yourself when buying paper. If you refer this cash flow note, then the eventual Buyer will worry about this. But if you are the Buyer, you will want a full assignment of the note to ensure that you collect those next 36 payments. After the 36 payments the note will be assigned back to the Seller (we'll discuss this in great detail in the next section of this manual).

What happens if the person that owes the money on the note for which you just bought the next 36 payments defaults? You give the note Seller the right to buy his note back for what you still have coming, and then he can foreclose on it himself. However, in the event that such right is not exercised

within a reasonable time (like maybe 30 or 60 days), you get to foreclose on the note and the note Seller's rights are forfeited. Do you remember the $31,250 equity that was remaining after the first loan? If you foreclosed and got the property you would get all that equity, or at the foreclosure auction you would at least get the full 20,000 remaining principle balance, or whatever the principle balance was at that time. Be sure and work this out by having your attorney write up the details and make sure that you are doing it right in the beginning. Or, you can find some sample contracts to use on our web site.

And remember, if referring this type of a deal to someone on our web site, you don't have to worry about a partial contract because the end Buyer will have one for you.

Summary Of Bonus #1 - Money Math & Magic

Let's summarize what we've done so far. You have now learned how to use the HP12C pocket financial calculator to quickly and accurately get answers to financial questions. That opens the doors to getting the facts on moneymaking opportunities. Next, you have taken the important step beyond the math. You have learned how to apply the math to practical financial situations that will make you money. Such as – Find the monthly payment on a loan – How many payments it takes to amortize a loan – How to figure your yield on a note – About Negative amortization – How to own part of a note without any money of your own - How you can calculate and offer to purchase a specific number of payments to overcome the Seller's concern about the discount, or a partial sale.

Now you can make the best decisions – that will make you thousands of dollars and save you thousands of dollars in the real world. With this knowledge and newly acquired abilities you are now ahead of the rest of the investors. When you operate your business and calculations based on this knowledge, you will **win** every time. That's **Winning In the Cash Flow Business**.

Bonus #2

Creative Deal Structuring For

Big Profits!

How To Earn 20% And

More On

Your Own Investments!

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Creative Deal Structuring

This section will give you what you need to know about creative deal structuring and the paper work that you need for discounted paper transactions to earn 20% on your own real estate note investments.

You are going to use the same paper work that you received when referring notes for quick cash profits of $2-$5000. Remember the Information Request Form? The paper work is always the same. However, to purchase notes, you will need to understand what this paper work means.

On the next page you will find a copy of the Information Request Form. Take a look at this form and we will go over it together. This is the form you will send to the note Seller. It very clearly indicates what is needed to proceed with the sale of their note.

We will need:

- ☐ Copy of the note
- ☐ Copy of the deed of trust, mortgage or land contract
- ☐ Payment history
- ☐ Copy of the escrow instructions from the real estate sale in which the contract was created
- ☐ Copy of the closing statement from the real estate sale
- ☐ Copy of the title insurance policy
- ☐ Copy of the fire or hazard insurance policy
- ☐ Loan payment record or copies of bank deposits

The next three items are not as important, but if they have them they will be nice to have:

- ☐ Two pictures of the property
- ☐ Copy of city map showing the property location (nowadays you can get this easily on the Internet)
- ☐ Plans, surveys or other documents in their possession

At the bottom of the request form you will notice there is a place for the Seller to sign. Also you want the name of the Title or Escrow Company and the policy number. You will want this information because if the Seller doesn't have any, or all, of the paper work, you may simply call this company to request what you need. They will get you the information, at no charge — why? Because they want to sell you a title policy, and they want to help you close the note transaction — which you ought to have them do so it will be easiest.

Information Request Form

The Information Request Form indicates the documents and information that you will want the note Seller to send to you. You may want to send this form to the Seller along with the Commitment Letter and the Commitment Cover Letter.

INFORMATION FOR YOUR CONTRACT SALE

The sale of your real estate contract CAN ONLY be processed when you follow these requirements. The information you provide on the front and back of this sheet is necessary to process your contract sale.

We will need a copy of the documents listed below:

- ☐ Copy of Note
- ☐ Copy of Trust Deed, Mortgage or Land Contract
- ☐ Payment History – Payment Book or Bank Deposits
- ☐ Escrow instructions from real estate sale in which the "Contract" was created
- ☐ Escrow closing statement from real estate sale in which the "Contract" was created
- ☐ Title insurance policy which insures the "Contract"
- ☐ Fire insurance information on the property which secures the "Contract" (Insurance Company, Policy Number, Agent's Name and Address)
- ☐ Loan Payment Record
- ☐ Please provide two (2) pictures of subject property
- ☐ Copy of street or city map showing property location
- ☐ Plans, surveys or other documents in your possession

Your signature is required for us to confirm balances, payment history and to obtain copies from your title or escrow company in the event we need further information. Thank you.

_____	_____	_____
Seller's Signature	Title / Escrow Company	Policy Number

© 2001, America's Note Network

My First Transaction From Start To Finish

Using my very first transaction I will show you the paper work that was involved. This is a real life transaction, not something that is made up, and is a complete transaction from start to finish.

On the next page you will notice a copy of the note titled, "Note Secured By Deed Of Trust". Under this says, "straight note" — you will find this interesting, in a moment. Next, notice that the dollar amount in the upper left hand corner is $28,000.00; the date in which it was created December 21, 1989; the date that it is to be paid by: December 28, 1993, four years later. "Place designated by beneficiary" is where the payments are to be sent.

The dollar amount of the note is written out and is followed by the date in which the interest will begin on — December 28. The interest rate on this note is 9% and is paid monthly, in the amount of $210.00, from January 28, 1990 until December 28, 1993. At this time the full principal balance and accrued interest will be due and payable in full.

That the note is interest only means that the monthly payment is only enough to cover the monthly interest. In other words, this $28,000 note will have a balance of $28,000.00 at the end of four years. What will the balance be at the end of three years? It would still be $28,000.00, right? Yes! An interest only note will always have a balloon payment and that balloon payment will be the very same amount of the original note amount.

"Trustor has an option to extend the final due date for an additional year." This is a little unusual. When calculating the purchase of this note using my optimal yield, I had to expect that this clause would be exercised and that I would have to wait an additional year to receive the balloon payment of $28,000.00.

Another clause is a late payment fee, which means if the Payor or Trustor was more than fifteen days late a 5% late charge would apply to their monthly payment amount.

An additional clause is a "due on sale clause" — if the Payor was to sell the property he would have to pay off this note completely even if it was prior to the due date.

In the next paragraph is some boilerplate information stating that if the Payor does not pay the Trustee, a neutral third party, can file foreclosure (in this case is the title company).

The note is signed by the Payors as their promise to make these payments.

Another interesting part of this note — you will notice that on the 29th of December the principal balance of the note was adjusted from $28,000.00 to $27,000 and that the monthly payment decreased from $210.00 per month to $202.50 per month.

NOTE SECURED BY DEED OF TRUST

STRAIGHT NOTE

$ 28,000.00, California December 21, 19 89

On OR BEFORE: December 28, 1993 and for value received I promise to pay

to LONG KIM AND TUONG VAN THI , Husband and Wife

or order at Place designated by beneficiary the sum of

TWENTY EIGHT THOUSAND AND NO/00 ---------- Dollars

with interest from December 28, 1989 until paid, at the rate of 9% percent per annum,

payable INTEREST ONLY MONTHLY, OR MORE, in the amount of $210.00, beginning January 28, 1990, and continuing until December 28, 1993 at which time the remaining principal balance and accrued interest will be due and payable in full.

Trustor herein has the option to extendthe final due date for an additional year (1 year), and in consideration for same Trustor agrees to reduce the principal balance of the Note by a 10% reduction.

In the event that any installment shall be overdue in excess of 15 days a late charge of 5% of the payment due shall be charged by the holder of the note.

In the event of sale, transfer, conveyance, or alienation of the property described in the deed of trust securing this note, or any part thereof, or any interest therein, whether voluntary or involuntary, beneficiary shall have the right of acceleration, at its option to declare this note, irrespective of any maturity date expressed herein,**

Should the interest not be so paid it shall thereafter bear like interest as the principal. Should default be made in payment of any installment of interest when due, the whole sum of principal and interest shall, at the option of the holder of this Note, become immediately due. If action be instituted to enforce payment of this Note, I promise to pay a reasonable sum as attorney's fees. Principal and interest payable in lawful money of the United States. Notwithstanding anything contained herein to the contrary, the amount of interest payable under the terms of this Note shall in no event exceed the maximum amount of interest permitted to be charged by law date hereof. This Note is secured by a deed of trust to South Coast Title Company, Trustee.

**and without demand or notice immediately due and payable, including any prepayment charge provided for herein.

David J. — Denise R.

David J. — Denise R.

December 29, 1989, The principal balance on the within note is adjusted to be $27,000.00, through escrow number 2-5769 WM, the payment monthly is adjusted to be $202.50, or more.

Wanda Minini

South Coast Title Escrow by Wanda Minini

© 2001, America's Note Network

When I purchased this note, what did I purchase? It was a $27,000.00 note with a $202.50 monthly payment. I bought in for $14,720.50 — a pretty steep discount, right? I received an annual return of 33%. Not too bad, right? Well, you too will do this! It's not that hard, as you'll soon see!

One of the reasons I received this return is because I noticed there was an error in the paperwork. Did you notice the error? The note was written on the wrong document! It was written a straight note document. Remember, a straight note is one with no monthly payments.

We noticed on this document that there were monthly payments of $202.50 each month. I brought this point up to the note Seller and he was willing to give me a good price. Would I have bought this note for more? Absolutely! As long as my investment is protected and my yield or return is 20% or more per year, I would have purchased this note. In other words, I would gladly have paid $20,000 for this note, or a 20% return, but, because I mentioned this one little point (which by the way, you can find one in nearly every deal, and doesn't hurt the note one bit), I receive an additional $5300 discount, or put $5300 more in my pocket. Not bad for simply knowing the paperwork, wouldn't you say?

By the way, if I was to refer this note and not purchase it myself I could turn around and sell the note to an investor for a yield of 17% or approximately $22,000.00. I would have had an agreement with the Seller for $20,000.00 and an agreement with the Buyer for $22,000.00 and made a quick cash profit of $2,000.00. But, because I knew a little about the paper work, I got the note for $5300, less! In other words, my quick cash profit would have been $7,300 instead of $2000! It's the same amount of work either way. Now that's powerful!

I am providing this information to you for three very important reasons. First, I want to provide you with information you can use the rest of your life. You may not buy real estate notes when you start, but eventually that is where you stand to make huge returns with very little work. You can build so much wealth in the next five to ten years and actually live off your investments.

The second reason is, as I said in the beginning, because you can turn any of your $2000 transactions into $4000 and $5000 transactions, and more.

And, lastly, I'm teaching you this information because you may want to earn 20% and more on your investments right away. This is where the big profits are made.

The Security Instrument

You may call the security instrument in your state a deed of trust, a mortgage, a land contract, a security deed, a mortgage deed or a real estate contract or some other name. This may sound a little complicated, but really it's not.

Remember, the property owner is called the Trustor – in a trust deed state – or the mortgagor in mortgage states — and gives his residence address or address to where any notice is to be mailed.

The security instrument has to be notarized before it is recorded. In this case, when the borrower signs

the note and security instrument in front of the notary, the notary puts his/her seal on that document to make it official. It can now be recorded at the county recorder to protect the Note Holder's interest.

If you buy a trust deed on a property believing that it is a second trust deed, and if someone else already has a second trust deed recorded on that same property, you lose! You didn't check the legal records. That's why it is very important to get a preliminary title search and get title insurance showing the liens — I will show you how to do this shortly.

Recording is very important. Let's say someone owes you on a note and you sell the property, carrying back a $28,000 note secured by a mortgage. That mortgage is worth just about nothing until you take it down and record it. If you don't record it promptly, somebody else could record another one before you and they are going to be ahead of you in priority. You don't need to run down to the recorder's office, the register of deeds, or the courthouse; you can have the title insurance company or your attorney take care of the recording. But, it needs to be done as soon as possible.

Generally, we want the money to change hands after the recording takes place so you know you have a valid lien on the property that is properly recorded. This is what the escrow company will do to protect your interest.

Another aspect of recording is this: Recorded documents are open to the public for review. You can go to the recorders office, register of deeds, or the courthouse to look them up yourself. This is also the main source of information for title insurance companies. They organize the data into a form that is much easier to understand and assure that the information is correct.

Title insurance insures that title to the property is clear. If you purchase title insurance and they make a mistake — they would have to pay you. In other words, title insurance protects you and takes away the risk of someone else making a claim. Later, I will show you how to save hundreds of dollars on title insurance. You will learn how to pay as little as $.30 on the dollar.

Lets take a look at the copy of the deed of trust, the security instrument. I will explain some of the features. If you use a mortgage, your security instrument is called a mortgage and you can get a copy from a title insurance company, attorney, real estate office, or your local stationary store.

Looking at the trust deed, look at the top left hand corner where it says when recorded mail to "the following address". This address is the address of the Note Holder for the mortgagee. At the top right, notice a stamp from the county recorders office, stating the date and time that this document was recorded.

Notice the date when this document was prepared — it's different than the date it was recorded. This is normal. The date in which it is recorded is always later than the date in which the document was prepared.

Next, is mentioned the name of the Payors. Below that is the trustee, or the name of the title insurance company. The trustee is a neutral third party such as a title insurance company or an attorney. That's interesting — we have a third party in here. They are not the lender, they are not the borrower but they are named in the document anyway. That is because, in the event there is a foreclosure on this trust

deed, the Trustee is the one who conducts it. They are paid a fee for this. The trustee is named here and they have something called “bear legal title”. This means that they can sell the property in the event the borrower or Trustor defaults on the loan. The Trustor has the deed to the property as long as he makes the payments.

Below that the beneficiaries, or Note Holder, are the ones receiving the payments. And, below that is a legal description of the property address.

Again is mentioned the due on sale clause that is followed by the assignment, in the event that the Payor fails to make the payments, the beneficiary has the right to collect the rent during default because this is a deed of trust and assignment of rents. When foreclosing on one of these, you can collect rent from the tenants in the property during the foreclosure process or the foreclosure period.

You will notice that next is mentioned securing the $27,000.00 note with this document. Remember, $27,000 is the original amount and not necessarily the balance today.

There are several counties in which this document is considered valid. What they have done is created a fictitious deed of trust. Instead of writing all the terms of every trust deed, they have recorded this one master trust deed in all those different counties and then incorporated all those terms into this one, just by referring to it.

Below you will see notice of default being mailed to the Trustor or property owner at that address. If the owner, or person who owes the money, defaults on the loan — this is how he is notified that he is being foreclosed on. A notice will be mailed to that address.

Finally, in the lower left is the notary information. This document is going to be signed by the Trustor (the property owner) and the notary seal is going to be placed at the bottom right of the form. In order for this document to be recorded it must be notarized.

This is to familiarize you with security instruments, namely trust deeds. Mortgages and other documents are similar too.

Additionally, there is usually a clause stating that the property owner will not commit waste on the property. That means they are not going to destroy the property, tear it down, burn it down or any other damages. That would be a default on the agreement, similar to not making the payments. Also, there will be a clause stating that the property owner will keep hazard insurance on the property to protect it against fire, flood, or any other local hazards.

The Trustor, or the owner of the real estate, agrees to pay the taxes and any special assessments against the property levied by governmental agencies. That could be sewer bonds or street bonds for example. There is also a provision in the security instrument, on the back, explaining what happens when the obligation is paid off. In this case, it is called reconveyance.

You’ll see on the back of the security instrument down in the lower 1/3 it says, “request for full reconveyance”. When you pay off the note, the deed of trust is submitted to the trustee (remember the neutral third party) for full reconveyance to remove the lien from the property.

RECORDING REQUESTED BY
SOUTH COAST TITLE COMPANY

RECORDED IN OFFICIAL RECORDS
OF ORANGE COUNTY, CALIFORNIA

AND WHEN RECORDED MAIL TO

Name

Address

City
State & Zip

Long Kim
W. Balboa Bvd
Newport Beach, Ca. 92663

$5.00
C16

10 30 AM JAN 02 '90

Lee A. Branch RECORDER

Title Order No. _____ Escrow No. _____

SPACE ABOVE THIS LINE FOR RECORDER'S USE

DEED OF TRUST AND ASSIGNMENT OF RENTS

(SHORT FORM) ADDITIONAL ADVANCE

This Deed of Trust, Made this 21 day of December, 19 89, between

DAVID J. AND DENISE R., herein called TRUSTOR,
Joint Tenants
whose address is N. Adlena Dr, Fullerton, Ca. 92633
(Number and Street) (City) (State) (Zip Code)

and SOUTH COAST TITLE COMPANY, a California Corporation, herein called TRUSTEE, and

LONG KIM AND TUONG VAN THI, Husband and Wife
as Joint Tenants, herein called BENEFICIARY,

WITNESSETH: That Trustor irrevocably grants, transfers and assigns to trustee in trust, with power of sale, that property in City of Fullerton, Orange County, California, described as:

Lot 16 of Tract No. 9599 as per map recorded in Book 402 pages 47 & 48 of miscellaneous maps in the office of the County recorder of said County.

(aka: N. Adlena dr, Fullerton, Ca. 92633)

In the event of sale, transfer, conveyance, or alienation of the property described herein, securing the note, or any part thereof, or any interest therein, whether voluntary or involuntary, beneficiary shall have the right of acceleration, at its option to declare the note, irrespective of any maturity date expressed herein, and without demand or notice immediately due and payable, including any prepayment charge provided for herein.

4936

TOGETHER WITH the rents, issues and profits thereof, SUBJECT, HOWEVER, to the right, power and authority given to and conferred upon Beneficiary by paragraph (5) of Section A of the provisions incorporated herein by reference to collect and apply such rents, issues and profits.

FOR THE PURPOSE OF SECURING: 1. Performance of each agreement of Trustor herein contained; 2. payment of the indebtedness evidenced by one promissory note of even date herewith in the principal sum of $ 27,000.00 executed by Trustor in favor of Beneficiary or order; 3. payment of any money that may be advanced by the Beneficiary to the then record owner of said property with interest thereon evidenced by additional notes (indicating they are so secured) or by endorsement on the original note, executed by the then record owner of said property.

TO PROTECT THE SECURITY OF THIS DEED OF TRUST, TRUSTOR AGREES: By the execution and delivery of this Deed of Trust and the note secured hereby, that provisions (1) to (5), inclusive, of Section A and provisions (1) to (9), inclusive, of Section B of the fictitious deed of trust recorded in the office of the county recorder of the county where said property is located, noted below opposite the name of such county, vis:

County	Date	File Number	County	Date	File Number
Los Angeles	April 21, 1989	89-626684	San Bernardino	April 19, 1989	89-139423
Orange	April 18, 1989	89-202777	San Diego	February 1, 1989	89-055616
Riverside	April 20, 1989	89-125037			

(which provisions, identical in all counties, are printed on the reverse hereof) hereby are adopted and incorporated herein and made a part hereof as fully as though set forth herein at length; that he will observe and perform said provisions; and that the references to property, obligations, and parties in said provisions shall be construed to refer to the property, obligations, and parties set forth in this Deed of Trust.

THE UNDERSIGNED TRUSTOR requests that a copy of any notice to default and of any notice of sale hereunder be mailed to him at his address hereinbefore set forth.

David J.
David J.

Denise R.
Denise R.

STATE OF CALIFORNIA
COUNTY OF Orange } SS.
On December 21, 1989 before me, the undersigned, a Notary Public in and for said County and State, personally appeared David J. and Denise R.

_____, personally known to me (or proved to me on the basis of satisfactory evidence) to be the person~~s~~ _____ whose name~~s~~ are subscribed to the within instrument, and acknowledged that they executed the same.

Signature Pat Whisnant
Pat Whisnant

OFFICIAL SEAL
PAT WHISNANT
NOTARY PUBLIC—CALIFORNIA
ORANGE COUNTY
My Comm. Exp. Sept. 21, 1990

(THIS AREA FOR OFFICIAL SEAL)

This document filed for recording by South Coast Title Company Inc., as an accommodation only. It has not been examined as to its execution or as to its effect on the title.

SC-35B

DO NOT RECORD—Provisions incorporated from Recorded Fictitious Deed of Trust.

A. TO PROTECT THE SECURITY OF THIS DEED OF TRUST, TRUSTOR AGREES:

1. To keep said property in good condition and repair; not to remove or demolish any building thereon; to complete or restore promptly and in good workmanlike manner, any building which may be constructed, damaged or destroyed thereon, and to pay when due, all claims for labor performed and materials furnished therefor; to comply with all laws affecting said property or requiring any alterations or improvements to be made thereon; not to commit or permit waste thereof; not to commit, suffer or permit any act upon said property in violation of law; to cultivate, irrigate, fertilize, fumigate, prune and to do all other acts which from the character or use of said property may be reasonably necessary, the specific enumerations herein not excluding the general.

2. To provide, maintain and deliver to Beneficiary fire insurance satisfactory to and with loss payable to Beneficiary, the amount collected under any fire or other insurance policy may be applied by Beneficiary upon any indebtedness secured hereby, and in such order as Beneficiary may determine, or at option of Beneficiary, the entire amount so collected, or any part thereof, may be released to Trustor. Such application or release shall not cure or waive any default or notice of default hereunder, or invalidate any act done pursuant to such notice.

3. To appear in and defend any action or proceeding purporting to affect the security hereof, or the rights or powers of Beneficiary or Trustee; and to pay all costs and expenses, including costs of evidence of title and attorney's fees in a reasonable sum, in any such action or proceeding in which Beneficiary or Trustee may appear, and in any suit brought by Beneficiary to foreclose this Deed.

4. To Pay: At least ten days before delinquency all taxes and assessments affecting said property, including assessments on appurtenant water stock; when due, all encumbrances, charges and liens, with interest on said property or any part thereof, which appear to be prior or superior hereto; all costs, fees and expenses of this Trust.

Should Trustor fail to make any payment or to do any act as herein provided, then Beneficiary or Trustee, but without obligation so to do and without notice to or demand upon Trustor and without releasing Trustor from any obligation hereof, may make or do the same in such manner and to such extent as either may deem necessary to protect the security hereof, Beneficiary or Trustee being authorized to enter upon said property for such purposes, appear in and defend any action or proceeding purporting to affect the security hereof or the rights or powers of Beneficiary or Trustee; pay, purchase, contest or compromise any encumbrances, charge or lien which in the judgment of either appears to be prior or superior hereto; and, in exercising any such powers pay necessary expenses, employ counsel and pay his reasonable fees.

5. That Beneficiary shall be entitled at any time, at its option, either by itself or by a receiver, to be appointed by a court therefore, to enter upon and take possession of said premises, or any part thereof, and to do and perform such acts of repair, cultivation or protection as may be necessary or proper to conserve the value therefor, to rent or lease the same or any part thereof for such rental, term and upon such condition as its judgment may dictate, and to collect and receive for rents, issues, and profits thereof, which said rents, issues and profits, present and future, are hereby assigned to the Beneficiary as further security, but which assignment Beneficiary agrees not to enforce so long as Trustor is not in default hereunder, and the Beneficiary shall apply such rents, issues and profits thereof, in the manner hereinafter specified in respect of proceeds of sale of said premises. In the event that the Beneficiary shall exercise the option hereby granted, Trustor agrees to surrender to the Beneficiary peaceable possession of said premises and not to interfere in any manner with the exercise of the rights hereby granted; and the expenses therein incurred, including compensation to said Beneficiary and receiver, and attorney's fees and costs and disbursements shall be deemed to be a portion of the expense of this Trust, and secured hereby and Trustor agrees to pay immediately and without demand, all sums so expended by Beneficiary or Trustee, with interest from date of expenditure at the legal rate of interest.

B. IT IS MUTUALLY AGREED THAT:

1. Should the property hereinbefore set forth ever become subject to any lien for the purpose of securing the payment of any taxes levied upon personal property of any kind or character other than household goods and furniture located in/or situated on said real property above described, then the Beneficiary shall have, and is hereby given the right, at his option, to declare all sums secured hereby immediately due and payable.

2. Any award of damages in connection with any condemnation for public use of or injury to said property or any part thereof is hereby assigned, and shall be paid to Beneficiary who may apply or release such moneys received by him in the same manner and with the same effect as above provided for disposition of proceeds of fire or other insurance.

3. By accepting payment of any sum secured hereby after its due date, Beneficiary does not waive his right either to require prompt payment when due of all other sums so secured or to declare default for failure so to pay.

4. At any time, or from time to time, without liability therefor, and without notice upon written request of Beneficiary and presentation of this Deed of Trust and the note or notes secured thereby for endorsement, and without affecting the personal liability of any person for payment of the indebtedness secured hereby, Trustee may reconvey any part of said property, and upon written request of Beneficiary, stating that all sums secured thereby have been paid, and upon surrender of this Deed of Trust and the note or notes secured thereby to the Trustee for cancellation and retention, and upon payment of its fees, Trustee shall reconvey without convenant or warranty, the property then held hereunder. The recitals in any such partial or full reconveyance of any matters or facts shall be conclusive proof of the truthfulness thereof. The grantee in any such reconveyance may be described as "the person or persons legally entitled thereto". Five years after issuance of a full reconveyance, Trustee may destroy said note and this Deed of Trust, unless directed in such request to retain them.

5. Upon endorsement of this Deed of Trust and the note or notes secured thereby denoting any extension agreements; or any agreement subordinating the lien or charge of said Deed of Trust, or any agreement modifying the note or notes secured by said Deed of Trust; or the deeding of any easement on said property; or the making of any map or plot of said property; the consent and joinder of the Trustee in such subordination agreement, deed or map, shall not be required.

6. Upon default by Trustor in payment of any indebtedness secured hereby or in performance of any agreement hereunder, Beneficiary may declare all sums secured hereby immediately due and payable by delivery to Trustee of written declaration of default and demand for sale and of written notice of default and of election to cause said property to be sold, which notice Trustee shall cause to be filed for record. Beneficiary also shall deposit with Trustee this Deed of Trust, said note and all documents evidencing expenditure secured hereby. After the lapse of such time as may then be required by law following the recordation of said notice of default, and notice of sale having been given as then required by law, Trustee, without demand on Trustor, shall sell said property at the time and place fixed by it in said notice of sale, either as a whole or in separate parcels, and in such order as it may determine, at public auction to the highest bidder for cash in lawful money of the United States, payable at time of sale.

Trustee may, from time to time, postpone the sale of all, or any portion of said property by the publication, prior to the date of sale so advertised, of one notice of postponement in the same newspaper or newspapers in which the original notice of sale was published, or by one public announcement thereof at the time and place of sale so advertised or postponed. If the sale is so postponed, or is postponed in any manner, or if the sale for any reason is not held within one year from the time set for the first sale, the Trustee, at his election shall have the right to again give notice of sale as then required by law for an original sale. Trustee shall deliver to such purchaser its deed conveying the property so sold, but without any convenant or warranty, express or implied. The recitals in such deed of any matters or facts shall be conclusive proof of the truthfulness thereof. Any person, including Trustor, Trustee, or Beneficiary as herein defined, may purchase at such sale.

After deducting all costs, fees and expenses of Trustee and of this Trust, including costs of evidence of title in connection with sale, Trustee shall apply the proceeds of sale to payment of all sums expended under the terms hereof, not then repaid, with accrued interest at seven percent per annum; all other sums then secured hereby; and the remainder, if any, to the person or persons legally entitled thereto.

7. Beneficiary may from time to time, by instrument in writing, substitute a successor or successors to any Trustee named herein or acting hereunder, which instrument when executed, acknowledged and recorded in the office of the Recorder of the county or counties where said property is situated, shall be conclusive proof of proper substitution of such successor Trustee or Trustees, who shall, without conveyance from the Trustee predecessor, succeed to all its title, estate, rights, powers and duties. Said instrument must contain the name of the original Trustor, Trustee and Beneficiary hereunder, the book and page where this Deed of Trust is recorded, and the name and address of the new Trustee. If notice of default shall have been recorded, this power of substitution cannot be exercised until after the costs, fees and expenses of the then acting Trustee shall have been paid to such Trustee, who shall endorse receipt thereof upon such instrument of substitution. The procedure herein provided for substitution of Trustees shall be exclusive of all other provisions for substitution, statutory or otherwise.

8. This Deed of Trust applies to, inures to the benefit of, and binds all parties hereto, their heirs, legatees, devisees, administrators, executors, successors and assigns. The term "Beneficiary" shall mean the owner and holder, including pledgees, of the note secured hereby, whether or not named as Beneficiary herein. In this Deed of Trust, whenever the context so requires, the masculine gender includes the feminine and/or neuter, and the singular number includes the plural.

9. Trustee accepts this Trust when this Deed of Trust, duly executed and acknowledged is made a public record as provided by law. Trustee is not obligated to notify any party hereto of a pending sale under any other Deed of Trust or of any action or proceeding in which Trustor, Beneficiary or Trustee shall be a party unless brought by Trustee.

REQUEST FOR FULL RECONVEYANCE

To be used only when note has been paid.

To SOUTH COAST TITLE CO. Trustee:

Dated _____

The undersigned is the legal owner and holder of all indebtedness secured by the within Deed of Trust. All sums secured by said Deed of Trust have been fully paid and satisfied; and you are hereby requested and directed, on payment to you of any sums owing to you under the terms of said Deed of Trust, to cancel all evidences of indebtedness, secured by said Deed of Trust, delivered to you herewith together with the said Deed of Trust, and to reconvey without warranty, to the parties designated by the terms of said Deed of Trust, the estate now held by you under the same.

Mail Reconveyance To:

_____

_____

_____

_____

_____

_____

Do not lose or destroy this Deed of Trust OR THE NOTE which it secures.
Both must be delivered to the Trustee for cancellation before reconveyance will be made.

I will also mention the foreclosure process as it relates to this deed of trust. There is a trustee named in this document but you don't have to use that trustee if you are foreclosing on the note. The person foreclosing obviously would be the holder of the note, right? So, if you are the holder, you can appoint somebody else. This option is called a substitution of trustee. If for any reason you don't like the trustee that's named in the document, it's quite simple to appoint another trustee instead, and is quite common. You can call a real estate attorney in your area to handle this for you.

By the way, recording has an additional feature of providing security in the event that you lose the original document. Suppose you had a trust deed and you lost it. Luckily, since it was recorded, you can go to the recorder's office to obtain a certified copy. A certified copy is just as good.

Escrow Instructions

What we're looking for here, in the escrow instructions, is basically to ensure that there was a sale of real estate. We check to see that the information matches on both the note and trust deed. As you see at the bottom of the page when the note was created and all the details

The escrow closing statement is very important. It will give you a detailed analysis of how the money was spent on the real estate transaction. You are looking to prove that there was indeed a down payment made on the property and that money went through escrow (a neutral third party) when it was sold. If not, you will not want to purchase the note since nothing is verifiable and you will really have a hard time determining what you are purchasing

Seller copy

SOUTH COAST TITLE COMPANY 714-898-1800 213-594-4621

ESCROW INSTRUCTIONS

12752 Valley View Ste S

Garden Grove, Ca. 92645

Page One	Paid Outside of Escrow $
Date September 26, 1989	Cash Through Escrow 27,400.00
	Encumbrances of Record
Escrow Number 2-5402 WM	New Encumbrances 221,600.00
	" " 28,000.00
Escrow Officer Wanda	TOTAL PURCHASE PRICE $ 277,000.00

PRIOR TO October 31, 1989 Buyer will hand you or cause to be handed you $ 249,000.00, of which a portion will be proceeds of a new loan more completely described below and of which $1,000.00 will be handed you representing Buyer's deposit of earnest money. Balance of down payment and necessary closing costs to be deposited herein by the Buyer prior to close of escrow.

and any additional funds and instruments necessary on Buyer's part to enable you to comply with these instructions, which you will deliver, provided on or before the date set forth above, you hold the money and documents, if any, deliverable to Buyer under these instructions and instruments have been filed for record entitling you to procure CLTA STANDARD COVERAGE FORM policy of title insurance issued by South Coast Title with title company liability under terms of its policy, for the amount of total Purchase Price (or in the amount required by new Lender, whichever is greater) on real property in the County of Orange State of California, viz:

Lot 16 of Tract No. 9599 as per map recorded in Book 402 pages 47 & 48 of miscellaneous maps in the office of the County Recorder of said County.

(commonly known as 827 N. Adlena Dr. ca.

Showing title vested in DAVID J. AND DENISE R. , Husband and Wife(More complete vesting to be handed you prior to close of escrow which you are to insert on the Deed of conveyance without further approval from the Seller)

SUBJECT TO:

[X] General and special taxes for all fiscal 19 89-19 90 and subsequent years, including reassessments if any and including any special district levies or personal property taxes, payment for which are included therein and collected therewith, and improvement bond assessments, when applicable.

[ ]

[X] Covenants, conditions, rights of way, easements and reservations of record.

The consummation of this escrow is contingent upon the Buyer obtaining and qualifying fro a new first trust deed loan in the amount of $221,600.00, and subject to the property appraising at the purchase price of $277,000.00. New loan to have a FIXED rate of interest NOT to exceed 10.5% per annum, payable approximately $1,944.70 monthly, including principal and interest, amortized over 30 years. Buyer to pay loan fee NOT to exceed $3,000.00. Buyer's signature on lender loan documents shall indicate Buyer approval of all terms and conditions therein and your instructions to comply therewith.

As a portion of the purchase price herein Buyer to execute a Note and Deed of Trust, in favor of the Seller as title now stands and to be recorded as a Second Trust Deed against the subject property. Note to be in the amount of $28,000.00, with interest at 9% per annum, all due 4 years from of escrow.

Escrow holder is authorized to insert the interest on the Note to accrue from close of escrow, at 9% per annum, payable $228.90 per month, or More. First payment shall be 1 year from close of escrow.

Note to Contain: " All unpaid interest accruing for the first year shall be added to the principal balance of the NOte and the interest of 9% per annum, shall be charged thereon". Escrow holder is authorized to insert the first payment date on the note to be 1 year from close of escrow and insert the final payment date to be 4 years from close of escrow.

Note to also contain the following: "In the event that any installment shall become overdue in excess of 10 days a late charge of 6% of the payment amount shall be charged by the holder of the note thereof".

"Trustor on the Note reserves the prvivilege to pay in part or in whole the principal balance plus any accrued interest, at any time prior to the maturity date without a prepayment penalty for so doing".

Preliminary Title Policy

On the next few pages you will notice that I ordered a preliminary title policy report. It's easy — all you do is call up the title company and request a preliminary title report. And guess what? It's free. Why you might ask? The title company wants to sell you one of their title policies. They are a great help in protecting you and giving you the information you need to make an informed decision as to whether or not you'd want to purchase the note. Use them to your advantage!

On the second page of the preliminary title report we see that there's some information that describes the property and the Payor. On the third page of this title report we see some general information endorsed. At the end, in Paragraph Number Five we see an indebtedness of $221,000.00. That's the first loan on the property. Okay, so far so good.

On the following page in Paragraph Number Six, we see the $27,000.00 trust deed that I purchased. If there were another trust deed before my $27,000.00 trust deed then I would not have purchased the note because I would have been in third position. Third position can be OK if there is enough protective equity in the property, but in this case, third position would have killed the deal.

That's all there is to it to protect yourself and handles the title insurance policy. As you can see, I was protected. Remember, when purchasing a note, you want to ask for a 104.1 endorsement policy to the existing policy. This will save you hundreds of dollars.

SOUTH COAST TITLE COMPANY

888 West Santa Ana Boulevard, Suite 220
Santa Ana, California 92701
(714) 973-1441

Russell Dalbey

Issuing Policies Of
NORTHERN COUNTIES TITLE INSURANCE COMPANY

* * * **PRELIMINARY REPORT** * * *

Your No.:
Our No.: 80033-3

In response to the above referenced application for a policy of title insurance, South Coast Title Company hereby reports that it is prepared to issue, or cause to be issued, as the date hereof, a policy or policies of Northern Counties Title Insurance Company describing the land and the estate or interest therein hereinafter set forth, insuring against loss which may be sustained by reason of any defect, lien or encumbrance not shown or referred to as an exception below or not excluded from coverage pursuant to the printed schedules, conditions and stipulations of said policy forms.

The printed exceptions and exclusions from the coverage of said policy or policies are set forth in Exhibit A attached. Copies of the Policy forms should be read. They are available from the office which issued this report.

This report (and any supplements or amendments hereto) is issued solely for the purpose of facilitating the issuance of a policy of title insurance and no liability is assumed hereby. If it is desired that liability be assumed prior to the issuance of a policy of title insurance, a binder or commitment should be requested.

Dated: December 2, 1991 at 7:30 A.M.

Marilyn Firman

Marilyn Firman, Title Officer

SCHEDULE A

The estate or interest in the land described or referred to in this schedule covered by this report is:

A Fee

Title to said estate or interest at the date hereof is vested in:

DAVID J. and DENISE R. , husband and wife as joint tenants

The land referred to in this report is situated in the State of California, County of Orange, and is described as follows:

Lot 16, of Tract No. 9599, in the City of Fullerton, as per map recorded in book 402, page(s) 47 and 48 of Miscellaneous Maps, in the office of the County Recorder of said County.

Except therefrom all oil, gas, minerals and other hydrocarbons, below a depth of 500 feet, without the right of surface entry, as reserved in instruments of records.

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SCHEDULE B

At the date hereof Exceptions to coverage in addition to the printed exceptions and exclusions contained in said policy form would be as follows:

A. General and special county and city taxes for the fiscal year 1991-92.

Total	:	$2,843.00
First Installment	:	$1,421.50 open
Second Installment	:	$1,421.50 open
Exemption	:	$7,000.00

Code Area: 03003 Parcel No.: 281-141-01

B. The lien of Supplemental Taxes, if any, assessed pursuant to the provisions of Chapter 3.5, (commencing with Section 75) of the Revenue and Taxation code of the State of California.

1. The fact that the owners of said land have no rights of vehicular access to BASTANCHURY ROAD except the public right to travel on same. Said rights having been relinquished by the dedication provisions on the map of said Tract. Said land, however, abuts on a public street, other than the one referred to above, over which rights of vehicular access have not been relinquished.

2. An easement for purposes shown and incidental purposes

Affects	:	The Northeasterly and the Southwesterly 4 feet of said land
Purpose	:	Public Utilities
Recorded	:	In book 12280, page 525, Official Records

3. An easement for purposes shown and incidental purposes

Affects	:	The Southeasterly 6 feet of said land
Purpose	:	Public Utilities
Recorded	:	In book 12328, page 1872, Official Records

Said deed provides that no building or structure shall be placed or maintained on said easement.

4. An easement over that portion of said land as shown on the map of said tract,

For	:	Landscaping
Affects	:	The Northwesterly portion of said land

5. A Deed of Trust to secure an indebtedness of $221,000.00, and any other amounts as therein provided, recorded December 28, 1989, as Instrument No. 89-700921, Official Records.

Dated	:	December 15, 1989
Trustor	:	David J. and Denise R. , husband and wife as joint tenants
Trustee	:	Citicorp Savings Service corporation, a California corporation
Beneficiary	:	Citicorp Savings, a Federal Savings and Loan Association

6. A Deed of Trust to secure an indebtedness of $27,000.00, and any other amounts as therein provided:

Dated	:	December 21, 1989
Trustor	:	David J. and Denise R. , husband and wife as joint tenants
Trustee	:	South Coast Title Company, a California corporation
Beneficiary	:	Long Kim and Tuong Van Thi , husband and wife as joint tenants
Recorded	:	January 2, 1990, as Instrument No. 90-000511, of Official Records.

The amounts due, terms and conditions of the indebtedness should be determined by contacting the owner of the debt.

7. The effect of documents, proceedings, liens, decrees, or other matters which do not specifically describe said land, but which, if any do exist, may affect the title or impose liens or encumbrances thereon. The name search necessary to ascertain the existence of such matters has not been completed and requires a statement of identity from all parties in order to complete this report.

NOTE: Section 12413.1, California Insurance Code, commonly known as Assembly Bill 512, became effective January 1, 1990. This legislation deals with the disbursement of funds deposited with any title entity acting in an escrow of subescrow capacity. The law requires that all funds be deposited and collected by the title entity's escrow and/or subescrow account prior to disbursement of any funds. Some methods of funding may subject funds to a holding period which must expire before any funds may be disbursed. In order to avoid any such delays, all fundings should be done through wire, transfer, certified check or checks drawn on California financial institutions.

WIRING INFORMATION

TO WIRE FUNDS TO SOUTH COAST TITLE COMPANY:

HARBOR BANK-11 Golden Shore, Long Beach, CA 90802 Fed Reserve #122234152 for further credit to HARBOR BANK-IRVINE BRANCH-9 Executive Circle, Irvine, CA for the Benefit of South Coast Title Company Trust Acct. #041-032-251

Said Seller does qualify for short term rate.

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Hazard Insurance

All right let's look at the next page to see the fire insurance information for hazard policy. You will notice my company, Southwest Funding, was added to the homeowner's policy as an additional payee. Once I purchased the note, the escrow company sent a letter to the Payor's insurance company adding me on to their hazard insurance policy. This policy will pay you off and the other lenders in the event that damage happens to the property to destroy its value. Whatever is left over will go to the owner of the property.

This protects me in the event of fire or other events that could destroy the property. I'd get paid before the homeowner gets paid in the event of a disaster. Why? Because we are acting as the bank, and the bank always gets paid first.

HO 717 25 81 ***** MORTGAGEE 2 COPY ***** 012192-3AS-019-1

20th Century Insurance Company
1 Owensmouth Avenue / Woodland Hills, California 91367
DECLARATION PAGE

AMENDED DECLARATION
EFFECTIVE DATE 01/21/92

REASON FOR AMENDMENT -
ADD MORTGAGEE

HOMEOWNERS POLICY

WHEN ATTACHED TO THE HOMEOWNERS POLICY, THESE DECLARATIONS COMPLETE THE POLICY AND REPRESENT THE CURRENT STATUS OF YOUR COVERAGES AND LIMITS OF LIABILTY ACCORDING TO OUR RECORDS.

POLICY NUMBER	POLICY PERIOD (12:01 A.M. STANDARD TIME)		TERM
HO 7172581	FROM 12/22/91	TO 12/22/92	12 MO

NAMED INSURED AND ADDRESS	MORTGAGE SERVICE CO./MORTGAGEE (SEE REVERSE)
DAVID J	SOUTHWEST FUNDING LN# 1933

COVERAGE IS PROVIDED WHERE A LIMIT OF LIABILITY IS SHOWN, SUBJECT TO ALL CONDITIONS OF THIS POLICY

COVERAGES AND LIMITS OF LIABILITY	SECTION I				SECTION II	
	A. DWELLING	OTHER STRUCTURES ON PREMISES	B. PERSONAL PROPERTY	C. LOSS OF USE	L. PERSONAL LIABILITY EACH OCCURENCE	M. MEDICAL PAYMENTS TO OTHERS
	$ 121,000	$ 12,100	$ 90,750	INCLUDED	$ 300,000	$ 5,000 EACH PERSON
DEDUCTIBLES	SECTION I	EARTHQUAKE	IN CASE OF LOSS UNDER THIS POLICY, WE COVER ONLY THAT PART OF THE LOSS OVER THE DEDUCTIBLE STATED.			
	$ 250	N/A				
PREMIUMS	BASIC POLICY PREMIUM	OPTIONAL COVERAGES	SCHEDULED PERSONAL PROPERTY	TOTAL PREMIUM		
	$ 289.45	$ 20.00	$ .00	309.45		

---- FORMS, OPTIONS, AND ENDORSEMENTS ----

*** GUARANTEED REPLACEMENT COST POLICY
*** THIS POLICY DOES NOT INCLUDE
EARTHQUAKE COVERAGE

OPTION H, COMPUTERS $10000 $ 20
CALIFORNIA SURCHARGE (CIGA) $ 1.45

LOCATION OF PREMISES -
SAME AS ABOVE

*** NOTICE ***
THIS POLICY MEETS OR EXCEEDS
THE COVERAGES PROVIDED BY
STANDARD HOMEOWNERS FORM HO-3.

438BFU *05/42--TCPE7 *06/89--TCPE6 12/89

James O. Curley
PRESIDENT

01/21/92
DATE

POLICY SERVICE PHONE: 818 704-3700
CLAIMS SERVICE PHONE: 714 836-8660

STATEMENT OF ACCOUNT 7172581 2
ADDITIONAL PREMIUM.... $ .00
PRIOR BALANCE..... $ 172.91
* OUTSTANDING BALANCE 172.91

PAYMENTS ARE REVISED AS FOLLOWS-
* PAYMENT DUE $ .00
FUTURE INSTALLMENTS DUE
02/22/92 $ 82.91 04/22/92 $ 90.00

INCLUDES 3 PER PAYMENT SERV CHARGE

FORM HOO-1 (5/91)

DETACH HERE

POLICY NUMBER	AMOUNT DUE
HO 7172581 2	

**** THIS IS NOT A BILL *****
ADDRESS INQUIRIES TO -
20TH CENTURY INS CO
P.O. BOX 4150
WOODLAND HILLS CA 91365

MAY 28 1992

▲ RETURN THIS STUB WITH PAYMENT ▲

There are three more things to get on the information request form: pictures, copy of a street map, and plans or surveys that are available. These are not deal breakers. If purchasing a real estate note, I recommend that you do so in your local proximity when starting out. This way you can drive by the property to ensure that it's something you wouldn't mind owning. Remember — never buy a real estate note on a property you wouldn't mind owning because you just might get it back through foreclosure.

Escrow Instructions

Write up your escrow instructions (a sample is on the next page), and send them to the escrow or title company. To simplify further, have the escrow company or title company or attorney who prepared the papers on the property sale handle the paper work for your note sale as well! This will save you time, money and hassle.

Remember, the escrow company or title company or attorney who did the original escrow on the property sale will do all of the following paper work for us. Additionally, they help protect you and the Seller of the note to insure that everyone receives what's coming to them.

On the next two pages I will show you the escrow instructions, stating what the escrow company will fill out for you.

Escrow Instructions

Your Name Here
Street Address
City, State & Zip Code

Telephone #
Purchase Date

Escrow Company
Street Address
City, State & Zip Code
Telephone #
Attn:

Regarding Your Escrow Number: _____

Property: **Property Street, City, State & Zip Code**

SALE OF $**Face Value of Note** PURCHASE MONEY SECOND TRUST DEED

Your Name Here is to be the Buyer of the following purchase money second trust deed secured by the above property:

- ☐ $**Face Value of Note**
- ☐ _____% interest
- ☐ Payable $_____ or more per month
- ☐ For _____ payments (**# of remaining payments)**

With a DUE ON SALE CLAUSE and

With a late charge of $_____ for any payment not received within 10 days of the due date.

For the following price: $**Purchase Price**.

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DETAILS TO HANDLE RIGHT AWAY

- ☐ Prepare an Assignment from the note Sellers to **Your Name Here**.
- ☐ Prepare a Request For Special Notice Of Default in favor of **Your Name Here** regarding the first loan.
- ☐ Order Title Insurance (104.1 endorsement) to cover **Your Name Here** as being the assignee in second position and mail a copy of the Title Insurance to **Your Name Here**
- ☐ Have the Hazard Insurance cover **Your Name Here**
- ☐ Mail copies of the Second Note, Trust Deed, Assignment, Request For Special Notice, Property Sale Escrow Instructions and any Amendments to **Your Name Here** for review and approval.
- ☐ Mail property Owner's / Debtor's Offset Statement confirming unpaid balance, interest rate, payment amount, next payment due, maturity date, taxes & insurance has been paid and that any senior liens are current.
- ☐ Mail Note Holder's Offset Statement confirming unpaid balance, interest rate, payment amount, next payment due, maturity date, taxes & insurance has been paid and that any senior liens are current.

DETAILS TO HANDLE AT CLOSING

- ☐ Mail Original Note, Copy Of Trust Deed and Assignment, Request For Special Notice Of Default, and copy of Escrow Closing Statement to **Your Name Here**
- ☐ Mail a copy of the First Note and First Trust Deed to **Your Name Here**
- ☐ Original Trust Deed, Original Assignment, Request For Special Notice Of Default, Hazard Insurance, and Title Policy to follow.
- ☐ Mail notice to Debtor of transfer of loan and new payee **Your Name Here at Your Address**

If you have any questions, please call **Your Name Here** at **Your Telephone #**.

Thank you,

Your Name Here, Loan Supervisor

By the way, what are your closing costs or the costs associated with the sale of the note? The 104.1 title endorsement policy will cost about $50.00 to $100.00. To close the transaction is another $150-$200 to pay the escrow company, title company or attorney.

Total costs to close on a note purchase are approximately $200-$300. Of course, this does not include a drive-by appraisal, which will run another $150.00. Figure about $500.00 total for out-of-pocket expenses when purchasing a note. When you make your offer to the Seller of the note be sure to add in these costs. I usually discount the note $500 more to give the Seller one final price. And, what are your closing costs if brokering a note? That's right, nothing!

The Assignment

The Assignment transfers ownership from the Seller of the note to you.

At the top you'll notice, "When recorded mail to" – this is where you'd put your address or the address of the person purchasing the note. Below is stated, "For value received the undersigned." This refers to the Seller of the note and grants a transfer to South West funding, my company.

Next is the information about the original trustee and the property address. Lastly, it must be signed by the note Seller, notarized, and recorded. Once recorded, it takes about 2 to 4 weeks before you receive it back in the mail. Some counties are faster than others.

AND WHEN RECORDED MAIL TO

#1933

Name: Southwest Funding

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

CAT. NO. NN00610
TO 1935 CA (2-83)

Assignment of Deed of Trust

THIS FORM FURNISHED BY TICOR TITLE INSURERS

ALL | PTN.

For Value Received, the undersigned hereby grants, assigns and transfers to Southwest Funding

all beneficial interest under that certain Deed of Trust dated December 21, 1989
executed by DAVID J. AND DENISE R.
Joint Tenants, Trustor,
to SOUTH COAST TITLE COMPANY, Trustee,
and recorded as Instrument No. 90000510 on Jan. 2, 1990 in Book/Reel _____,
Page/Image _____, of Official Records in the County Recorder's office of ORANGE
County, California, describing land therein as:

More particularly described in said deed of trust.
Commonly known as 827 N. Adlena Dr. , CA

Together with the note or notes therein described or referred to, the money due and to become due thereon with interest, and all rights accrued or to accrue under said Deed of Trust.

Dated December 10, 1991

Long Kim — Tuong Van Thi

FOR CORPORATE ACKNOWLEDGEMENT

Through the Courtesy of — SOUTH COAST TITLE COMPANY

STATE OF CALIFORNIA)
County of Orange)

On December 11, 1991 before me, the undersigned, a Notary Public in and for said State, personally appeared LONG KIM personally known to me or proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS my hand and official seal.

Signature Elizabeth L. Williams

Notary Public in and for said County and State

Notary Seal

OFFICIAL SEAL
ELIZABETH L. WILLIAMS
NOTARY PUBLIC - STATE OF CALIFORNIA
PRINCIPAL OFFICE IN
ORANGE COUNTY
My Comm. Expires April 30, 1994

personally
the within
the person
executed
to its by-
personally
the basis
owledged

Long Kim

FOR PARTNERSHIP ACKNOWLEDGEMENT

STATE OF CALIFORNIA
COUNTY OF _____ } ss.

On _____ before me, the undersigned, a Notary Public in and for said State, personally appeared _____

personally known to me or proved to me on the basis of satisfactory evidence to be the person____ who executed the within instrument as _____ of the partners of the partnership that executed the within instrument, and acknowleged to me that such partnership executed the same.
WITNESS my hand and official seal.

Signature _____

(This area for official notarial seal)

Title Order No. _____ Escrow or Loan No. _____

Before a note purchase you will want to be sure that what the Seller of the note has told you is consistent. We therefore have them fill out an "Offset Statement". This is a simple form stating the terms of the note and the balance. You can send this to the Seller and the Payor yourself, or you can have the escrow company do it for you.

Property Owners Offset Statement - The Payor

This is a very important form. When you buy discounted paper there are several crucial points to include in an agreement. You want to be sure that the person selling the note and the person who owes the money agree as to what the latest status of payments on the note is, including the interest, how much the payments are, when the next payment is due, when the note matures, the balance due, and other important note features.

You can have them sign it or have your representative (closing agent, escrow company, title company, or attorney) contact the person who owes the money on the note and have them fill out and sign a Property Owners Offset Statement. This way there won't be any disputes later about the principle balance, etc..

You will want one of these statements signed by the property owner who owes the money and another by the person that is selling the note. What if the property owner or Payor, one and the same, do not agree with the offset statement and do not sign it? What can you do? You can buy that note based on what the Seller represented. If the Payor does not pay you for any reason, for example, he disputes the amount he owes, he would have to work that out with the note Seller. In the mean time, the note Seller would have to keep your note current, or you could foreclose. You are guaranteed to get paid.

In the middle of that form notice it says the note contains the following provisions. You may want to specify, if it applies, some of the custom cash clauses that we have in the back of the book. You will find that these to be quite useful.

Any given clause put in or left out could mean thousands of dollars to the Buyer or the Seller of a property and also to the holder of the note. Not only do you want to determine the numbers regarding a note you also want to check to see which special clauses it has and which clauses are missing.

Sometimes people ask, "Can I change the terms of the note"? The answer is no. When selling or buying an existing note, the terms are fixed. When you buy a note — you buy it as it existed, the day it was made.

Another question that comes up very often, in regards to the Property Owners Offset Statement is, "How can I get the person that owes the money to sign a statement like this?" Well, I've never had a problem getting someone to sign. Have your escrow agent, title company or attorney fill out the documentation and most people are willing and agreeable to sign it. If there are any objections to filling it out, simply point out, or have your agent point out, "This is for the property owners protection". This way, the new holder of the note won't claim that more money is due, they won't claim that payments are behind, that the interest rate is higher or anything else like that. This actually protects all parties involved. The property owner should be more than happy to sign this offset statement. Here's an example of the Property Owner's Offset Statement:

Property Owner's (Note Payors's) Offset Statement

We, the undersigned, are the owners of the property located at **Property Street, City, State & Zip Code**, which is the collateral for the $**Face Value of Note** note and trust deed dated _____ and recorded with Serial Number _____ on _____ in the official records of _____ County, **State**.

The current unpaid balance on said note is $_____ as of **Purchase Date**.

The rate of interest is _____% per annum.

Scheduled payments are $_____ or more per month on the **Day Spelled Out** of each month, including interest and principal.

The next payment is due on the **Day Spelled Out** of **Month, Year**.

The interest on said note has been paid to the **Day Spelled Out** of **Month, Year**.

The note matures on __**End Date**__.

The payments are currently up to date and no extra payments have been made.

To the best of our knowledge there is neither default on senior loans, taxes or insurance.

The note contains the following provisions: _____

_____

Payments are currently being made to **Note Sellers' Name, Address, City, State & Zip Code**.

Copies of the note, security instrument, loan payment records, hazard insurance policies, title insurance policy, assignment or other information which I/we have in my/our possession are attached.

We understand that we are making this statement for the benefit and protection of myself and the parties to the sale of the above-referenced note and with the understanding that all parties are relying hereon regarding such note sale.

_____

Note Payor's First & Last Name

Read and hereby accepted **Purchase Date**

_____**Your Name Here**

Note Seller's Offset Statement

On the next page we have the notes Sellers offset statement. It's similar to the property owner's offsets statement. Again, you will have the Seller of the note sign this document so everything is clear up front and there is never anything that can come back to haunt you.

Note Seller's Offset Statement

We, the undersigned, are the owners of the $ __**Face Value of Note**__ note and trust deed executed by **Note Seller's First & Last Name** dated _____ and recorded with Serial Number _____ on __**Recorded Date**__ in the official records of _____ County, **State**.

The current unpaid balance on said note is $ _____ as of **Purchase Date**.

The rate of interest is _____% per annum.

Scheduled payments are $ _____ or more per month on the **Day Spelled Out** of each month, including interest and principal.

The next payment is due on the **Day Spelled Out** of **Month, Year**.

The interest on said note has been paid to the **Day Spelled Out** of **Month, Year**.

The note matures on ___**End Date**___.

The payments are currently up to date.

No extra payments have been made.

To the best of our knowledge there is no default on senior loans, taxes or insurance.

The note contains the following provisions: _____

_____

Payments are currently being made to **Note Seller's First & Last Name**.

Copies of the note, security instrument, loan payment records, hazard insurance policies, title insurance policy, assignment or other information which I/we have in my/our possession are attached.

We understand that we are making this statement for the benefit and protection of myself and the parties to the sale of the above-referenced note and with the understanding that all parties are relying hereon regarding such note sale.

_____

Note Seller's First & Last Name **Purchase Date**

Read and hereby accepted **Purchase Date**

_____**Your Name Here**

Pay Me Now Letter

This letter is one of my favorites! It's called the "The Pay Me Now" letter or The Notice of Transfer of Loan To New Payee. This let's the Payor know that from now on they will send the payments to you and where to make those payments. You want to send this letter, or have your escrow agent, send it to the Payor once the transaction has been completed.

Additionally, with the Pay Me Now letter that you send - you may also write a letter saying "Would you like to pay off this note early?" You buy it at a discount and have them pay you off the next day! Not bad, right? You can find this and many other documents on our web site at www.notenetwork.com/helptips - On the following page you will find an example of the "Pay Me Now Letter.

Note Seller's Name
Street Address
City, State & Zip Code
Telephone #

and

Your Name Here
Street Address
City, State & Zip Code
Purchase Date

Note Payor's Name
Street Address
City, State & Zip Code
Telephone #

NOTICE OF TRANSFER OF LOAN AND NEW PAYEE

Dear **Note Payor's First Name**:

This letter is to inform you that the $___**Face Value**___ second trust deed loan on your property located at **Property Street Address, City, State & Zip Code** has been transferred to a new owner: **Your Name Here**.

A copy of the legal document confirming this transfer is attached herewith.

The only change that affects you is that you no longer send your payments to **Note Seller's First & Last Name**.

Starting on **Purchase Date**, mail your payments to:
Your Name Here
Street Address
City, State & Zip Code
Refer to our Loan Number: _____

If you have any questions or need to contact us, please call **Your Name Here**, Loan Supervisor, at **Your Telephone #**.

Yours, **Your Name Here**, Loan Supervisor

Selecting The Best Real Estate Paper

Here are some ideas on how to select the very best real estate paper. You are going to learn how to determine whether you have a good secured note or not. If it's a good secured note and you were selling it then you can, of course, sell it for more money and make a larger referral fee, right?!

Perhaps you have heard about mortgage companies or trustee companies selling trust deeds or mortgages that are guaranteed. Have you ever heard of a guaranteed note? Sure, some of you have. I want to say that those guarantees are about as good as the company is. There have been too many of these companies to go out of business. The word "guaranteed" doesn't mean very much if buying it from a company!

The guarantee that I am going to show you here is the one that you want to consider. Let's figure out what is the best guarantee – a guarantee that you are going to get paid.

Number one, when analyzing a note, look at the security of the note. First let's look at the property value. We can determine the value of a property from an actual arm lengths transaction where that property really sold in the recent times or by an expert appraisal from an appraiser. Or, perhaps you have personal knowledge of property value in that neighborhood. We start out determining the value of the property that secures the note. Personally, I like to value the property using the prior sale price, this makes it easy and gives you the "real" price the property is worth.

You've got to remember sometimes people will jack up the sales price of a property just to have a phony price, or they'll put extra tax stamps on the deed indicating that they paid more tax and had a higher sales price for the property. Tax stamps and so forth may give you an indicator of value but you have to verify it with other documented knowledge. The best indicator of the value of the property is the price it sold for. It could appraise at $230,000 but it sold at $200,000. What price are you going to use? The price it sold for, $200,000. The selling price is always the real value of the property. Also, if you have an appraiser you want to make sure it is one you choose!

Starting with the property value we then look at the loans of record on the property. Let's say you find out the values of loan 1, loan 2 and loan 3, that's the same old $50,000 first, $20,000 second and $10,000 third. So we've got $80,000 worth of loans on that property. We want to determine what the equity is. Price minus loans equals equity. Take $100,000 minus $80,000 worth of loans to learn that behind loan 3 there is $20,000 equity in the property. Each of the loans has a different equity because they are all in different positions.

Let's talk about a factor called the loan to value ratio. The loan to value ratio is your lien plus any senior liens on the property divided by the total property value.

The protective equity on a property, or gross equity cushion, and the loan to value ratio are what you look at to see how secure a particular loan is. Protective equity is equal to the property value minus your loan plus any senior loans.

What about the protective equity, or a gross equity cushion, for all three loans on that property? Obviously each of these loans has a different range of security doesn't it?

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If you were the owner of the first loan of $50,000 and the property is worth $100,000 how much equity cushion and/or protective equity would you have for that loan? $50,000. You take $100,000 minus the $50,000 of your loan and that leave $50,000. Now let's take a look at the loan to value ratio for loan 1. $50,000 loan divided by $100,000 value gives us 50% loan to value ratio.

Now on loan 2, which is $20,000, we have the same $100,000 property however, this time $100,000 minus $70,000 of total loans, yours and the senior loan, leaves a $30,000 protected equity.

When we take $70,000 total loan, that's your loan plus the senior, divided by $100,000 property value you see the loan to value ratio went up to 70%. So loan 2 isn't quite as secure as loan 1.

Further, let's look at loan 3. Again starting with the $100,000 property value we find that your loan, in this case loan 3 plus the two senior loans adds up to a total of $80,000. $100,000 minus $80,000 means $20,000 protective equity. $80,000 total loan divided by the $100,000 property gives an 80% loan to value ratio, which is even higher and not as safe.

Now when you go to a bank or other institutional lender, they consider 80% loan to value ratio as about as high as they want to go. Anything beyond that may be considered too risky. You are going to decide in your dealings what kind of a loan to value ratio you are happy with and what kind of a protective equity you feel comfortable with. I recommend in the beginning not to go above 80% Loan to Value or LTV. But here's another consideration – something called Investment To Value.

Investment to Value is simply all the loans on the property plus your investment divided by the value of the property. So, let's take the above example of $100,000.00 property. You have a $50,000.00 1st loan along with a $20,000.00 second + your investment. Let's say you purchased the $10,000.00 third for $5000.00. Your investment to value is 75%. You have the 50,000 1st, the $20,000.00 second and your investment at $5000.00 which totals $75,000.00. Divide $75,000.00 into $100,000.00 and you get an investment to value ratio of 75%.

Even though you have a high loan to value ratio, you can still reduce your risk when you look at your investment to value ratio. The higher the loan to value or investment to value the more risk you take on because you have less protective equity. The lower loan to value ratio the better for the person holding the note and the more money you will make to refer the note.

Now in our example, with all things being equal, all three of these loans are probably pretty well secured. Loan 1 is most secure, loan 2 a little less and loan 3 even a little less. But, they are all probably within the range of safety.

Remember, any of these liens can foreclose. The first to foreclose is in the driver's seat. They will have the edge, in terms of controlling the foreclosure. If the property owner is in default on the first, second or third, they are in default on all the loans, called "cross defaulting".

What kind of document do we record to protect our interest on the note? That's right a Request For Notice Of Default. You get the sample forms for the Request For Notice Of Default from you title

insurance company, your attorney or stationary store. Recording is your proof that you requested notice. Be sure that your mailing address is correct and file a new request for notice if your mailing address changes. They are only going to mail to the address that you put on the request. Also communicate directly with other lien holders to make sure that in the event that there is ever a default on their lien, they call you up, to catch them up, and you foreclose. In the back of the manual I have a letter you can send directly to the senior lien holders.

Also, many people are confused about whether a holder of a third note can foreclose if they don't get their payments? Most have heard, "If the holder of the first files foreclosure they get paid off in full and all the rest of the loans are wiped out".

Maybe you've heard that one also. That's not exactly true. You see you can foreclose whether you have a first, second, third or even maybe a seventh lien on the property. You have the right to foreclosure to protect your interest. It gets a little more complicated the further down the chain you happen to be, but you definitely have the right to foreclose. That's why you have the trust deed or mortgage in the first place. When you know what you are doing and do it as outlined in **Winning In The Cash Flow Business** you will foreclose and you either get paid off in full at the foreclosure auction or you'll get the property with a substantial equity in it. You'll always win

What about the due on sale clauses on the senior liens? Let's say that you hold the third and the first and second loans have due on sale clauses and then you end up foreclosing. First of all however, if the first were an FHA or VA loan or a private party loan there is a good chance that it might not have a due on sale clause so that's the very first thing that you do, check. That's one way that it could go, so there wouldn't be any problem in taking over the property in that case when you foreclose on your third.

Otherwise, let's say that the first is a federal lender and somebody who can enforce a "due on sale clause" and you think that you might have a problem there if you get the property back at the sale by foreclosing on your third. You feel that they might say, "Well, this was a sale of the property and you are going to have to renegotiate the loan with them." Well, you probably won't have to. Because foreclosing on a property is generally all right in terms of getting around the due on sale clause. This is a good way to get a property without having to qualify for it.

Summary Of Key Points

Remember protective equity is the main factor in determining the security of a note. You can measure your protective equity by the Loan to Value ratio, which is your gross equity cushion. This is how much equity there is beyond your loan when it's added to all the senior loans. If there is a first and a second and you have a second, you add the first and second loan together then subtract that total from the value of the property. This number is your protective equity or gross equity cushion.

Another thing to keep in mind is that senior liens are generally more secure than junior liens. Also, a senior lien holder always has the same amount of protective equity regardless of how many junior liens are stacked below it.

This is something people have many questions about. They ask that if they own a property and it has a $50,000 loan – can they put a $20,000 second on it without asking the holder of the first? What do you think? Do you need to ask them for permission? No! And the reason you don't have to ask is because, you could put a second, third, fourth, fifth, anything behind that loan and the first lien holder would still have the same exact protective equity and same loan to value ratio. Does this make sense?

If you are a junior lien holder you will file a notice of default or have your escrow company do it for you. You will also send a letter to the senior lender telling them that you'd be happy to make up any late payments if they will inform you (that letter is in the Appendix).

Remember, any lien holder can foreclose. Most people don't know this information that you are learning. I am so excited for you because I know this information will change your life, just like it has done for me.

Note Selection Or Rejection Criteria

Note selection or rejection criteria are very important points to remember. There is a $20,000 property with a $10,000 note against it, that you are considering buying. It is in first position, so how do you feel about that? Is it a good note? I forgot to tell you something: The property is barren land, it has no water and it's 100 miles from civilization. Now, it doesn't sound so interesting does it? The point of this story is, never take a note unless you wouldn't mind owning the security subject to any existing senior liens on the property. So, unless you want to take over the property and the loans on that property don't ever consider buying the note. Don't buy a note on a property unless you wouldn't mind owning it.

Always do your homework and check out all the notes that you are considering and you'll always win. Don't skip any steps, no matter how confident you get. Also, if you are going to refer the note for a quick cash profit of $2000 to $5,000 it's good to know this information. Why? Well let's say you didn't know any of this information, you'd probably only receive $2000 for the same amount of work that you could have received $5000 for. You could be spending your valuable time putting the deal together only to find out later that you've wasted your time! Knowing this information just saved you at least 5 hours of work and made you and extra $3000.

The Order Of Business For Note Purchase

As you will notice, I've enclosed "The Order of Business for a Note Purchase". This is the exact order in which you should process your note purchase. For your convenience, the Appendix contains a complete listing of all the documents mentioned on the following pages. It also contains other letters, forms and checklists, which will help you manage your business.

Order Of Business For Note Purchase

The following is the order in which to facilitate a note purchase along with the Corresponding documents.

1. Receive Copies of Documents

2. Make Database (see document: Note Record – Everything You Need To Know About This Note)

3. Order 104.1 Endorsement and Get Verbal of Clear Title 4 (see document: Order For 104.1 Title Policy Endorsement)

4. Check To See Senior Loan is Current

5. Order Drive-By Appraisal

6. Photo of Property

7. Escrow Instructions Document

7. a. Prepare documents:

- ☐ Bill of Sale, 2 x copies (see document: Bill of Sale)
- ☐ Seller Memo if not meeting Seller (see document: Trust Deed Sale Papers)
- ☐ Note Seller's Offset Statement, 2 x copies (see document: Note Sellers Offset Statement)
- ☐ Pay Me Now Letter, 2 x copies (see document: Transfer of Loan to New Payee)
- ☐ Note Payor's Offset Statement, 2 x copies
- ☐ Assignment, Deed Of Trust
- ☐ Elonge attaches to Note which endorses it, (see document: Assignment of Note)

10. Express mail documents to Seller and include return express envelope

11. Receive back signed documents and originals

12. Express mail to Title Company: Assignment, Title Doc. (see document: Order For 104.1 Title Policy Endorsement), and fees

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13. Express mail to Payor;

- ☐ Transfer of Loan to New Payee Letter
- ☐ Assignment of Note Document
- ☐ Request for Insurance Information Document
- ☐ Request for Social Security Number (see Document: Request for Tax Form 1098)
- ☐ Payment Labels and Letter (see Document: Loan Payment Mailing Labels)
- ☐ Return Envelope for Receiving Back The Above
- ☐ Certification to Receive Customer Information Letter

14. Letter to Senior Lender (see Document: Hello To Senior) and copy of Assignment

15. Hazard Insurance Policy Endorsement Document (see Document: Request for Insurance Information) and copy of Assignment to Payor.

16. Submission of Documents for Recording Letter to County Recorder Office

Bill Of Sale

Seller's First & Last Name (Note Seller(s)) herein transfer(s), sell(s), assign(s) and convey(s) all monies due and to become due, with interest and all rights to accrue under the note and trust deed in the original amount of $**Face Value of Note** secured by **Property Street, Property City, State & Zip Code** and dated _____ and recorded _____ to **Your Name Here**.

AS AN INVESTMENT

for the following consideration: $**Amount Buying the Note For**

The current note balance as of **Purchase Date** is $**Note Balance**.

The **Month & Spelled Out Date**, **20__** payment shall go to **Your Name Here**.

Executed **Purchase Date** at **City, State Where Executed**.

_____

Seller's First & Last Name

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Your Name Here
Street Address
City, State & Zip Code
Telephone #
Purchase Date

Note Seller's Name
Street Address
City, State & Zip Code
Telephone #

TRUST DEED SALE PAPERS

Dear **Note Seller's First Name**:

I am enclosing the following items for you to sign and return regarding the sale of your trust deed:

1) Assignment of Deed of Trust and Request for Special Notice (Long beige form)
   This form must be signed by all note owners and signed by a notary.
2) Note Seller's Offset Statement
3) Bill of sale
4) Payment transfer letter

Please sign all of the above forms and return to me with the original note and the original trust deed. Sign the original note on the back.

Please include your check for $_____ payable to **Title Company** for the title work.
As soon as these documents are received and the Title Company processes the transfer, I will mail your cashier's check by Federal Express.

Yours,

Your Name Here

Street Address
City, State & Zip Code
Telephone #

and

Your Name Here
Street Address
City, State & Zip Code
Purchase Date

Note Payor's Name
Street Address
City, State & Zip Code
Telephone #

NOTICE OF TRANSFER OF LOAN AND NEW PAYEE

Dear **Note Payor's First Name**:

This letter is to inform you that the $___**Face Value**___ second trust deed loan on your property located at **Property Street Address, City, State & Zip Code** has been transferred to a new owner: **Your Name Here**.

A copy of the legal document confirming this transfer is attached herewith.

The only change that affects you is that you no longer send your payments to **Note Seller's First & Last Name**.

Starting on **Purchase Date**, mail your payments to:
Your Name Here
Street Address
City, State & Zip Code
Refer to our Loan Number: _____

If you have any questions or need to contact us, please call **Your Name Here**, Loan Supervisor, at **Your Telephone #**.

Yours,

Your Name Here, Loan Supervisor

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Assignment Of Trust Deed

FOR VALUE RECEIVED, the undersigned grants, assigns and transfers to __(Your name)_____ all of its beneficial interest under that certain Deed of Trust dated ____Date_____, executed by ___(Buyers of the Property)____, as Trustor to _(Title Company as Stated in Trust Deed)__, as Trustee, and recorded as instrument No. __(see trust deed)___in Book __(see trust deed)__, Page __(see trust deed)__, of the official record in the County Recorder's Office of __(County of Property)____ County, ___(County of Property)____, together with note or notes therein described or referred to therein, the moneys due or to become due thereon with interest provided, and all rights accrued or to accrue under such Deed of Trust.

In Witness Whereof, I have set my hand and seal hereto this _____,day of _____,____.

_____

Seller

State of _____)

)ss

County of _____)

I, the undersigned, a Notary Public in and for the County and State aforesaid, do hereby certify that _____, whose name is signed to the foregoing, appeared before me this _____, day of _____, _____, and acknowledged that the foregoing is their true act and deed.

_____

Notary Public

_____

Commission Expiration

Assignment

FOR VALUE RECEIVED, THE UNDERSIGNED HEREBY GRANTS, ASSIGNS AND TRANSFERS THIS NOTE AND ALL MONEY DUE AND TO BECOME DUE THEREON WITH INTEREST, AND ALL RIGHTS TO ACCRUE UNDER SAID NOTE AND DEED OF TRUST TO:

_____ Name

_____ Date

This is good to place on the back of the trust deed or mortgage and on the note. I had this made into a rubber stamp to easily accomplish this task.

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Your Name Here
Street Address
City, State & Zip Code
Telephone #
Purchase Date

Title Company Name
Street Address
City, State & Zip Code
Telephone #

ORDER FOR 104.1 TITLE POLICY ENDORSEMENT

Policy Number: _____

Order Number: _____

Subject Property: **Property Street, City, State & Zip Code**

Per our conversation **Purchase Date**, your company is prepared to issue a 104.1 endorsement to the above policy showing that **Your Name Here** is the new owner of the $__**Face Value**___ second trust deed on the above referenced property and that no previous assignment nor reconveyance has been made.

We also understand that your records show no existing defaults or bankruptcies.

Please record the enclosed assignment immediately and mail the endorsement to:

Your Name Here
Street Address
City, State & Zip Code

A check for policy and recording fees is enclosed.

Yours,

Your Name Here, Loan Supervisor

Your Name Here
Street Address
City, State & Zip Code
Telephone #
Purchase Date

Note Payor's Name
Street Address
City, State & Zip Code
Telephone #

Loan Number: _____

REQUEST FOR INSURANCE INFORMATION

Dear **Note Payor's First Name**:

As the holder of the second trust deed loan on your property located at **Property Address, City, State & Zip Code**, it is required that I/we be named as additional insured on the fire and any other insurance policies on your property.

This feature doesn't cost you anything extra. There is some paperwork to handle, however. I will do that for you as soon as you give me the following information:

Insurance Company: _____

Address: _____

_____
City State Zip

Phone Number: ( ) _____

Agent's Name: _____

Policy Number: _____

Please fill in the above details and mail to: **Your Name Here, Address, City, State & Zip Code**.

I will handle any necessary paperwork directly with your insurance company. If you have any questions, please call me at **Your Telephone #**.

Yours,

Your Name Here, Loan Supervisor

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Your Name Here
Street Address
City, State & Zip Code
Telephone #
Purchase Date

Note Payor's Name
Street Address
City, State & Zip Code
Telephone #

Regarding: **Your Name Here**

Loan # _____

REQUEST FOR INFORMATION

Dear **Note Payor's First Name**:

According to IRS Regulations, we may need to give you a **Form 1098: Mortgage Interest Statement** regarding the interest you have paid on our loan during each calendar year.

This statement will help you in preparing your income tax returns.

In order for us to prepare this interest statement, we must have your Taxpayer Identification Number (Social Security Number).

Please write your I.D. Number(s) below and forward to us right away or call and leave a message at **Your Telephone #**.

Name _____I.D.#_____

Spouse/Partner Name _____I.D.#_____

Also, please furnish the information for the items checked below:

____ Daytime Phone #: (_____) _____

____ Home Phone #: (_____) _____

____ Your loan number for your loan with **Holder of First Note** _____

Thank you,

Your Name Here, Loan Supervisor

Your Name Here
Street Address
City, State & Zip Code
Telephone #
Purchase Date

I have found it helpful to send labels to the Payor to insure payment. You may want to consider doing this technique as well.

Note Payor's Name
Street Address
City, State & Zip Code

Loan # _____

Secured By: **Property Address, City, State & Zip Code**

LOAN PAYMENT MAILING LABELS

Dear **Note Payor's First Name**:

I am enclosing two sets of mailing labels for your use in mailing your loan payments:

1) Your Return Address Label, and
2) Our Mailing Address Label.

Please use both a return label with your name plus a mailing label with my name and address on your mailing envelope each month.

This should make it easier to keep track of your payments. You might even wish to label 12 envelopes at once and mark one for each month, January through December.

Then simply write a check for $ _____ (or more if you wish to save on interest and total payments) payable to **Your Name Here** and mail on or before the **Day Spelled Out** of each month.

For payments mailed after the **Late Payment Date**, add a late charge of $ _____.

Let me know when you run out of labels and I will send you a new supply.

If you have any questions, please call me at **Your Telephone #**.

Yours,

Your Name Here, Loan Supervisor

P.S. Please note that it is mandatory that you also pay on the first loan on your property in favor of **Holder of First Note**. Failure to do so is a default on our loan as well.

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Certificate Of Authority To Receive Customer Information

Loan Number: _____ Borrower Name: _____

PLEASE CHECK EITHER PART A OR PART B, WHICHEVER IS APPLICABLE AND COMPLETE PART C. ATTACH A COPY OF THE DOCUMENTS IDENTIFIED IN PART A OR PART B.

( ) Part A. Duly Authorized Agent

I am a duly authorized agent of the Borrower. My status as an agent is confirmed by either the signature of the Borrower appearing below, or by a copy of the documents attached to this Certification.

_____

Borrower's Signature/Date (only one signature required)

( ) Part B. Persons as to Whom the Customer has Affirmatively Authorized Disclosure of the Information.

I have been authorized by the Borrower to receive the requested information. I am attaching a copy of the Borrower's written authorization for disclosure of this information to me.

( ) Part C. Confidentiality Agreement

I agree that I will keep the information received confidential, and that I will limit my use of the information to:

_____(payoff)_____ other (explain) _____

I further agree to refrain from disclosing the information to third parties, except as required by law or as permitted by the rules of the OTS.

_____ Name of Company/Person

_____ Signature of Authorized Person

_____ Date

Your Name Here
Street Address
City, State & Zip Code
Telephone #
Purchase Date

Lender Name
Street Address
City, State & Zip Code
Attn: Loan Servicing and Collections Department
Telephone #

Re: Your Loan # _____

Payor: **Note Payor's First & Last Name**

Property Address: **Property Street, City, State & Zip Code**

REQUEST FOR NOTICE OF OVERDUE PAYMENTS

Please be advised that **Your Name Here** is the new owner of the second trust deed and note behind your first loan on the above-referenced property.

Therefore, I/we have a common interest with you in seeing that all payments on this property are made in a timely manner. We feel that our second loan actually enhances the safety and security of your first loan, since now two parties want to protect their equity (the property owner and our company).

We believe in a policy of cooperation amongst fellow lenders and we're sure that your company doesn't want any more foreclosures on its books than are absolutely necessary.

Therefore, we request that you notify us immediately in the event of any overdue payments on your loan. With that information, we can take prompt action to remedy the situation before it gets out of hand. WE USUALLY SEND YOU THE DELINQUENT PAYMENTS AND LATE CHARGES TO IMMEDIATELY CURE THE DELINQUENCY. This can be better for the public relations of your company as well as saving you time and money.

Please file this letter where it will be sure to be found in the event the property owner misses any payments on your loan. Please call me immediately at **Your Telephone #** in the event of any problems or questions.

Yours,

Your Name Here, Loan Supervisor
Enclosure: Copy of assignment document or title policy showing our interest in said trust deed

P.S. Please notify me in the event you sell this loan to another lender.

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Your Name Here
Street Address
City, State & Zip Code
Telephone #
Purchase Date

Insurance Company Name
Address
City, State & Zip Code
Attn:
Telephone #

Regarding Your Policy Number: _____
Insured: **Note Payor's First & Last Name**
Property Address: **Street, City, State & Zip Code**

REQUEST FOR INSURANCE POLICY ENDORSEMENT

Please change the coverage for additional loss payee (second lien holder) from **Note Seller's First & Last Name** to:

> **Your Name Here**
> Street
> City, State & Zip Code
> Loan # _____

That is the new owner of the second trust deed on the property located at **Property Street, City, State & Zip Code**.

You may refer any questions regarding this transfer to **Your Name Here** at **Telephone #**.

Thank you,

Your Name, Loan Supervisor

Your Name Here
Street Address
City, State & Zip Code
Telephone #
Date

County (Where Property is Located) Recorder's Office
Street Address
City, State & Zip Code
Telephone #

SUBMISSION OF DOCUMENT(S) FOR RECORDING

To Whom It May Concern:

I am enclosing the following documents for recording: SUBSTITUTION OF TRUSTEE AND FULL RECONVEYANCE.

Enclosed is my check for $ _____, representing $ ____ per page.

Yours,

Your Name Here, Loan Supervisor

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Note Purchase Checklist

1. Be sure the senior loans & taxes are current before closing!

2. What To Take To Title Company At Closing:
   - ☐ Original Assignment And Request For:
     - Notice
     - Cashier's Check
     - Bill Of Sale
     - Hazard Insurance Letter
     - Note Seller's Offset Statement
   - ☐ Pay Me Now Letter (see document: Transfer of Loan to New Payee)
   - ☐ Request For 104.1 Endorsement

3. What Note Seller Brings
   - ☐ Original Note
   - ☐ Original Trust Deed
   - ☐ Original Title Policy
   - ☐ Escrow Papers Note Created In
   - ☐ Hazard Insurance Papers
   - ☐ Loan Payment Book (If Available)
   - ☐ Checkbook For 104.1 Fee

4. What You Get
   - ☐ Original Note
   - ☐ Original Trust Deed
   - ☐ Loan Payment Book
   - ☐ Hazard Insurance Papers
   - ☐ Original Title Policy
   - ☐ Escrow Instructions/
   - ☐ Escrow Closing Statement
   - ☐ 10 Copies Of Assignment
   - ☐ Seller's Offset Statement
   - ☐ Bill Of Sale

5. Title Company Gets
   - ☐ Original Assignment
   - ☐ Request For 104.1
   - ☐ Check For 104.1

6. Note Seller Gets
   - ☐ Copies Of Everything
   - ☐ Cashier's Check

7. Items To Follow:
   - ☐ Next Payment From Property Owner
   - ☐ 104.1 Endorsement Or New Title Policy
   - ☐ Hazard Insurance Endorsement
   - ☐ Original Assignment From Recorder's Office
   - ☐ Major Headings (Clips In Note Folder)

8. Property
   - ☐ Photos
   - ☐ Escrow Papers Note Created In
   - ☐ Termite Report (Optional)
   - ☐ Confirmation Of Property Value (Appraisal)

9. Title
   - ☐ Title Policy
   - ☐ 104.1 Endorsement
   - ☐ Profile Optional

10. Note Seller
    - ☐ Bill Of Sale
    - ☐ Copy Of Cashier's Check
    - ☐ Note Seller's Offset Statement

11. Note Facts
    - ☐ Copy Of Note
    - ☐ Copy Of Trust Deed
    - ☐ Copy Of Assignment
    - ☐ Copy Of Request For Notice Of Default

12. Senior Loans
    - ☐ Information On Senior Notes
    - ☐ Senior Hello Letter

13. Property Owner
    - ☐ Pay Me Now Letter
    - ☐ Property Owner's Offset Statement (Technically Correct, Can Cause Bypass)
    - ☐ W-9

14. Hazard Insurance
    - ☐ Request For Endorsement
    - ☐ Endorsement

15. Tax Service
    - ☐ Request For Tax Service
    - ☐ Return Acknowledgment

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16. Collections

- ☐ Loan Amortization Schedule
- ☐ Old Loan Payment Book
- ☐ Collection Letters
- ☐ Refi Letter
- ☐ Pay More Letters

17. Items To Follow After Purchase

- ☐ Acquisition Date: ____**Purchase Date**_____
- ☐ Transfer of Loan to New Payee Return Receipt Received: _____
- ☐ First Loan Payment Due: ___**Day Spelled Out**_____
- ☐ Received: _____
- ☐ 104.1 Title Endorsement: _____
- ☐ Fire Insurance Endorsement: _____
- ☐ Original Assignment From Recorder's Office: _____
- ☐ Refinance Suggestion Letter: _____
- ☐ Pay More To Reduce Interest Payments Letter: _____
- ☐ W-9 TIN Received: _____
- ☐ Other: _____

Here are some additional documents for your convenience. There are all the documents necessary to purchase a note. However, if you would like a more complete set to manage your real estate note go to our webs site at: www.notenetwork.com/helptips.

Your Name Here
Street Address
City, State & Zip Code
Telephone #
Date

Note Payor's Name
Street Address
City, State & Zip Code
Telephone #

Regarding: **Your Name Here**

Loan #: _____

LOAN REDUCTION OFFER

Dear **Note Payor's First Name**:

Under the terms of the $ ___**Face Value**__ loan on your property, and according to **Your State** law, you may:

1) Pay more than the scheduled monthly payment of $ _____ any months you choose, and;

2) Pay off the entire remaining balance without prepayment penalty, anytime you choose.

All such additional payments will go entirely to principal reduction and may greatly reduce the total amount you will pay overall.

Example

A $10,000 loan at 10% interest for 5 years, with monthly interest payments of $83.33 would have a balloon payment at the end of 5 years of $10,083 and total payments of $15,000. In the event the debtor couldn't come up with the $10,083 balloon at the end, s/he could lose their home.

Here's what they could do to save money and lessen the balloon:

Monthly Payment	Time Period	Total Payment	Balloon Payment
$100	5 years	$14,709	$8,809
$125	5 years	$14,290	$6,923
$150	5 years	$13,838	$4,988
$175	5 years	$13,402	$3,077
$200	5 years	$12,966	$1,166

(cont'd)

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Monthly Payment	Time Period	Total Payment	Balloon Payment
$212	5 years	$12,720	None
$253	4 years	$12,144	None
$322	3 years	$11,592	None
$461	2 years	$11,064	None
$879	1 year	$10,548	None

These figures show you the kind of savings you may obtain on your loan by increasing your payments by whatever amount makes sense to you. You need no approval to do so. Any time you wish, you may send any additional amount you wish. The lender must reduce your principal balance by that amount and cease to charge interest on the principal so paid.

You may pay extra one month, pay the normal amount another month, and vary by any additional amount any month you wish. Some people look on this additional payment as putting money in savings at the loan interest rate. In the above example, it's like saving at 10%.

WHAT TO DO

In order to take advantage of this MORTGAGE REDUCTION OFFER simply decide what extra amount you can afford and send it in with your normal payment next month.

You will receive a receipt showing how much of your payment went to interest and how much went to principal. The following month, interest will only be charged on the new lower principal balance.

Yours,

Your Name Here, Loan Supervisor

Your Name Here
Street
City, State & Zip Code
Telephone Number
Date

Prospect's Name
Prospect's Street
City, State & Zip Code

Telephone Number

TRUST DEED SALES

Dear **Prospect's First Name**:

I'm writing to say hello and to remind you that I purchase trust deeds for cash.

In the event that you have a trust deed for sale, or one of your friends or clients needs to sell a trust deed they own, please give me a call at **Your Telephone Number**.

I buy both existing Seller carry back trust deeds and new trust deeds being created in the sale of property straight out of escrow.

Since I am a private party acting as principal, I can give your transaction personal attention.

Feel free to give my name and phone number to any of your associates that need to sell a trust deed also.

Yours,

Your Name Here

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Foreclosure Policy

Default On *Our Loan Only* (Senior is O.K.):

1. Late Payment Notice: 1 Day Late

2. Phone Call: 10 days late "grace period"

3. Foreclosure Warning Letter: 15 days late

4. File Notice Of Default (NOD): 30 days late

Default On Senior Only Or Default On Senior *And* Our Loan

1. Phone Call To Senior Loan Holder immediately upon discovery (What's going on?, What it takes to cure?, When they plan to foreclose?)

2. Reinstate Senior Loan if necessary

3. a) Phone Call To Payor (What's going on? Demand for immediate payment with cashier's check by Express Mail in my P.O. Box my noon on third business day)

   b) Prepare Foreclosure Papers, Forward To Trustee

   c) Federal Express Foreclosure Warning Letter to Payor with noon third business day deadline for cashier's check in my post office box.

4. Call Trustee With Instructions To Proceed/Cancel Foreclosure after noon of third business day

Cardinal Rules For Handling Delinquencies

- Don't let senior lenders start foreclosure before you do

- Don't delay starting your foreclosure for excuses or broken promises. The foreclosure period gives the Payor the legal time period to handle their problems.

- Don't give concessions without getting something in return.

Foreclosure Possibilities

☐ Owner Gives Deed In Lieu

☐ We Receive Property Subject To First Loan

☐ We Dispose Of Note

☐ We Foreclose On Note

☐ Owner Reinstates Loan, Continues Paying

☐ Owner Refinances Property, Pays Off Loan

☐ Property Goes To Sale

☐ We Get Paid Off

☐ We Get Property & Live In Property

☐ Rent Property For $_____

☐ Resell Property — Price: $_____

Sale Costs: $_____

Net Sale Proceeds: $_____

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Foreclosure Plan

Borrower: **Note Payor's First & Last Name**

Property Address: **Property Street, City, State & Zip Code**

Phone: **Note Payor's Phone #**

Loan # _____

Facts

Delinquency Discovered: _____

Our Basis in Note: $ _____

Minus Payments Received: $_____

Plus Advances to Senior: $_____

Plus Current Delinquencies on Senior: $_____

Net Investment in Note: $_____

Equity In Property: $_____

Foreclosure Warning Letter To Payor: _____

Foreclosure Papers Mailed To Trustee: _____

Notice Of Default Date: _____

File #: _____ Computer Ref #: _____

Three Month Date: _____ Trustee's Sale Date: _____

Our Loan Status: _____ Balance prior to advances: _____

Interest Paid To: _____ Interest Rate: _____%

Late Charge: $ _____ Refused Payments: _____

Senior Loan Information:

Senior Loan Status: _____

Senior Loan Face: $ _____

Senior Lender Name: _____

Address: _____

City, State & Zip Code: _____

Attn: _____

Phone: _____

Senior Loan #: _____

Payment Due Date: _____ Payment Amount: $ _____

Late Charges: $ _____ Payment Late Date: _____

Total Payment (With Late Charge): $_____

Delinquent Payments

Amount	For	Amount Advanced	Date
$			
$			
$			

Results

Reinstated Date: _____ Proceeds: _____

Payoff Date: _____ Proceeds: _____

Deed Received Date: _____

Other: _____

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Foreclosure Forms

- ☐ Reminder Of Payment Due
- ☐ Reminder Of Balloon Due (#1 & #2)
- ☐ Bounced Check — Demand For Replacement Of Bad Check
- ☐ Foreclosure Warning — Our Loan
- ☐ Foreclosure Warning — Senior Loan
- ☐ Foreclosure Warning — Our Balloon
- ☐ Foreclosure Warning — Hazard Insurance
- ☐ Notice To Pay Hazard Insurance Bill
- ☐ Hazard Insurance — Advance
- ☐ Request For Reimbursement of Hazard Insurance Advance
- ☐ Advance To Senior Lender #1
- ☐ Advance To Senior Lender #2
- ☐ Loan Plus Amortization Schedule For All Payments To Date Including Our Advances
- ☐ Default Preparation Request (to Trustee To Start Foreclosure)Foreclosure Notice And ☐ How To Get Out (To Property Owner)
- ☐ Foreclosure — Notice of Refused Payment (From Property Owner After Foreclosure Has Begun)

Your Name Here
Street Address
City State Zip

Phone Number

Date
Note Payor's Name
City, State & Zip Code
Telephone #

Re: $Face Value of Note Second Trust Deed Loan secured by Payor's Address, Payor's City, Payor's State, Payor's Zip Code. Our Loan #: _____.

NOTICE OF BALLOON PAYMENT DUE

Dear Payor's First Name:

You are being notified that on date balloon payment due, the final payment for the remaining principal balance on your loan will be due. Payment in full must be received by that date and there is no grace period.

In the event payment is not received by that date, foreclosure will be initiated immediately. Provided that all normal payments have been made as of date balloon payment due, the amount of the final payment will be approximately: $_____.

This payment should be made in the form of a Cashier's Check payable to: **Your Name Here.** The payment should be sent by U.S. Postal Service Express Mail to:

Your Address Here

Please contact me prior to sending your Cashier's Check so that we may verify the exact amount due.

If you have any further questions, please call me at Your Phone Number Here.

Yours,

Your Name Here, Loan Supervisor

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Appendix

Court House Leads

Today's Date:_____

Document number:_____

You Want The Person Receiving The Payments – The Mortgagee's Information

(This is the person you will mail or call.)

Name:_____

Address:_____

The Person Making The Payments – The Payor's Information

(In the event you'd like to refer to this information when talking to the note Seller.)

Name:_____

Address:_____

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Telephone Scripts

In this section of the course, I have provided you with several highly effective scripts that will be applicable to any situation you encounter. Please read through them and get familiar and comfortable with them. Also, feel free to mix and match the scripts to whatever feels comfortable for you. In addition, you will find many more telephone tips and tricks on our web site. Go to the web site www.notenetwork.com - and then click on the “how to reports” link.

SCRIPT: Getting Information on a Note for Sale

Hello, I'm calling about the Trust Deed (Mortgage, Land Contract) for sale.

Have you sold it yet?

In order for me to decide whether I might be interested in your note, I'1l need to get some information. May I ask you a few questions?

What is the property address?

What is the note secured by? (Type of Property)

What is the property worth?

How was that value established? By sale or by appraisal?

Do the Buyers live there?

What was the date of the sale (appraisal)?

Is your note a first or second (what position is it in)?

What is the principal balance on the first loan?

Who is the lender on the first?

What is the interest rate on the first?

What are the monthly payments on the first?

What is the due date on the first?

Is the first a FHA or VA loan?

Repeat questions for all senior loans.

What was the original face amount of your note?

What was the date of your note (when it started)?

What is the interest rate?

What are the monthly payments?

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What is the due date (when the note ends)?

Is there a balloon payment at the end?

How much is the balloon payment?

SCRIPT: Getting Information on a Note for Sale (Continued)

Are all the payments paid up to date?

What is the loan balance right now?

What is the last payment that has been made (month)?

What is the person who owes the money like?

What does he do for a living?

Why are you selling the note?

When do you need to sell by?

How much are you asking for the note?

Be sure to ask other questions that came up from the above questioning,

Such as: What clauses does the note have? Have you had any offers? Why didn't you take that offer?, etc.

If they don't have certain items of information, ask them to get them for you. Also, ask when they can have that information ready for you.

Mr. Note Seller, I'll need a little time to digest this information to determine whether I'd be interested in this note or not. I have to be sure I'm not taking too many chances. I'll call you back in a little while to discuss it further.
(At your leisure, fill out the rest of the paper analysis worksheet and list it on America's Note Network).

Issues to consider: Total loans/protective equity/Loan To Value Ratio (80% Or Less)? Is it a property you wouldn't mind owning? Could you handle the underlying loans if you foreclosed? How do the plus and minus features balance out?

Plus features: Single family residence, owner occupied, low loan to value ratio, desirable first loan (assumable, low interest, low payments), property owner has good payment record and good likelihood of continuing that way, size of note is $20,000 or less (easier to resell at profit), high interest, high

payments, short-term due date, motivated note Seller, possibility of renegotiating note terms for higher monthly payments by property owner, possibility of foreclosing and making even more money, large discount from note Seller.

SCRIPT: Getting Information on a Note for Sale (Continued)

Minus features: Secured by a property you wouldn't want to own, high Loan To Value Ratio, high interest, high payment first loan, delinquent with a large amount of money owed on back payments on first and second, size of note would make it hard to resell, bad personality of property owner or note Seller, note has low or no interest, no or low payments, long-term due date, note Seller not motivated or wants unrealistically small discount.

(Decide whether you'd care to pursue this note or not)

Points To Remember:

The note Seller doesn't know that you are new.

Whether you have money or not – it doesn't matter at this time.

Don't be overly enthusiastic – be a don't wanter

SCRIPT: Calls on Postcards You Sent to Note Holders

Always send yourself a postcard whenever you do a mailing. By doing this, you can experience receiving one of your postcards.

Strategy:

You mail out about 100 postcards at a time.

Then the calls start coming in, often out of curiosity.

At first, let your answering machine take the calls and ask the callers to leave their names and telephone numbers.

You return the calls when you are ready and organized (have your paper analysis worksheets handy).

As you return the calls, run through the questions provided in Script #2.

Remember:

Some people are calling out of curiosity.

Out of town or even out of state owners can be the most fun.

Front:

Your Name
Street
City, State, Zip

First
Class
Stamp

Note Holder's Name

I have been trying to contact you about the trust deed you own.

Please call me at 1-303-499-7064

Thank you, Russ Dalbey

Note: A computer-generated mailing label is okay, but the more personalized you can make it the better.

I have been trying to contact you about trust Deeds & Mortgages –

I have a free report on getting the most on your note – It's a $29, value Free!

Call 1-303-499-7064

and we'll rush it right out to you!

Thank you, Russ Dalbey

The above example is something you can send professionals and Note Holders to get deals. You can use your own variation on the concept and I deal above. I always like a "direct response", which means to get the person that you are sending the post card to – to actually do something. Give a way a free report or a newsletter or some article that you create. This example is to get you thinking!

SCRIPT: Handling Calls on Postcards You Sent to Note Owners

You: Mr. (Note Holder Name), this is (Your Name) returning your call. I'm the one who sent you the postcard in the mail. Do you still own your trust deed (mortgage, land contract)?

Note Holder: How did you know about my trust deed?

You: Oh, that! I was just browsing around the county recorder's office (courthouse, registry of deeds, etc.) the other day and I saw it in the public records. They are all public information, you know. No big deal.

Note Holder: Oh, I see. What do you want with my trust deed?

You: I am a private party trust deed investor, and I sometimes buy trust deeds like yours. So far, I don't even have enough information to know whether I'd be interested in buying your trust deeds or not, but I thought at least we could chat and see whether we might work out something that suits is both well.

Did you originally plan to get a trust deed when you sold your house or was that sort of an accident? Did the Buyer make you an offer you couldn't refuse?

Note Holder: I guess you could say, they made us an offer we couldn't refuse.

You: Are the people who bought your old home making the payments as agreed every month?

Note Holder: Yes, but that's not enough to suit me.

You: I understand. Let me explain what we might do. First I'11 need to get the facts about your trust deed to find out whether I'd care to by it.

Then, in the event it meets my requirements of safety and so forth, we can discuss a cash offer.

Should we agree on that? You could have quite a large sum of cash in about 3 weeks and I'11 hold on to the trust deed and collect the remaining payments as they trickle in.

You: Do you have your note and trust deed handy so you can give me some rough information about them?

Note Holder: No, but I can remember most of it now and get the rest later if you need it.

You: (Ask the questions on the paper analysis worksheet, see SCRIPT #1)

Mr. Note Holder, I'11 need a little time to digest this information to determine whether I'd be interested in this note or not. I need to be sure that I'm not taking too many chances. I'11 call you back in a little while, probably tomorrow to discuss this further.

Note Holder: O.K., I'll talk to you tomorrow.

You: Mr. Note Holder, based on what you've told me, here is my analysis of your note: 1) It doesn't necessarily have the terms I would have wanted, but it did help you to sell your house, 2) I'm not really sure the property securing the note is worth as much today as when you sold it, so the security for the note could be less than we think, 3) I'm not sure the property owner can come up with that large balloon payment at the end, either.

However, I might be willing to take a chance and buy the note and take those risks off your hands if the price is right. You can imagine how I feel putting up hard cash now and having to wait to get it back over a period of (Term of Note).

Supposing I could give you cash in 3 weeks, that's how long the sale paperwork would take, would that help you (Note Holder's reason for selling from paper analysis worksheet)?

Note Holder: It sure would. How much do you think my note is worth?

You: Considering the risks and all, I could give you $6,000 cash in 2 weeks. (Stop talking)

Note Holder: But my real estate agent said it would be worth $8,000.

You: I can believe they said that, but will your real estate agent buy the note for $8,000?

Note Holder: No, they won't buy it at all, I don't think they have the money and they are too busy trying to list and sell properties.

You: Well, I guess the answer is obvious. I could send you a letter stating my purchase price and the paperwork I'd need to purchase your note. Should I go ahead and send that to you?

Note Holder: Okay, what do you need from me.

You: (Tell him the information needed from the "Information Request Form" so he can have it ready for Federal Express the next day).

Miscellaneous Questions:

Note Holder: Do you have the cash right now?

You: When do you need the cash?

Note Holder: 2 weeks would be nice.

You: O.K., I think that can be arranged provided we can work out the rest of the details.

Note Holder: What discount do you want (what price will you pay?)

You: That depends on the note, as a matter of fact, I need to carefully evaluate the note to see if I'd even consider buying it at all. Not all notes are good and I have to be careful of what I buy. You understand, don't you?

You: Are you the only owner? If not, who else owns the note with you? Are they agreeable to selling?

(Talk to all owners at one time or else risk double negotiations wherein the first negotiator whittles you down and then takes the offer to his partners who then proceed to whittle you down even further.)

SCRIPT: Establishing Contact With Real Estate Agents

You: Hello, this is (**Your Name**). I am a potential client of yours. May I ask you a couple of questions?

Agent: Sure.

You: Do you ever sell a property where the Seller carries back part of the financing?

Agent: Yes.

You: Is it ever necessary to sell that paper in order to help close the deal?

Agent: Yes that happens.

You: Maybe I can help you make more sales. I buy trust deeds on 3-week notice. Next time you or anyone in your office knows of a good trust deed for sale, give me a call. I can help you make your property sale commission easier and faster.

Here's my name and phone number. Please put it in your personal telephone directory under "Trust Deeds."

By the way, what do you think is a fair discount for your Sellers to sell their trust deeds at?

SCRIPT: Establishing Contact with Escrow Agents

You: Hello, this is (**Your Name**). I'm calling about the possibility of closing some escrows through you. I'11 bet most of your escrows are for the sale of real estate?

Escrow Officer: Yes.

You: The escrows I may be bringing to you will be for the sale of trust deeds. Can you process this type of Transaction?

Escrow Officer: I'd have to study up on it.

You: That's O.K., I can show you a sample transaction, including the detailed requirements I need, and we can work it out together from there.

By the way, do you have many simultaneous closings (double escrows)?

Escrow Officer: Yes, we close loans and property sales concurrently, and real estate exchanges also involve simultaneous closing.

You: Good.

I'd like to stop by soon and meet you. Would tomorrow morning at 9:00 A.M. be O.K.?

Escrow Officer: I'11 put on a fresh pot of coffee.

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SCRIPT: Establishing Contact with Title Insurance Companies

You: Hello, this is (**Your Name**). May I have "Customer Service" please?

Customer Service, this is (**Your Name**) and I'd like to get a property profile (or listing package) on (**Your Residence Address**).

Customer Service: Fine, we'll mail that out today.

You: Thanks. I'd also be interested in a tour of your title plant.

Customer Service: Fine, you can come by any time and we'll be glad to show you around.

You: Thanks. I'll see you soon.

SCRIPT: Establishing Contact with Builders Who May Have Paper to Sell

You: Hello, is (**Builder's Name**) in?

Mr. Builder, My name is (**Your Name**). I've been able to help other builders get their hands on cash when they need it, without borrowing. I'd like to show you how this might help you, also.

When you build a project, sometimes you carry part of the financing when you sell it. That paper is nice to hold for the income, but sometimes you could accomplish more if you had a bigger chunk of cash right now, do you know what I mean?

Builder: Sure. I need to balance out my cash flow.

You: Of course. Sometimes I buy paper with hard cash. If that would ever help you, please give me a call. My name is (**Your Name**). You can reach me at (**Your Number**). Why don't you put my name and number in your personal telephone directory under "Trust Deeds", so you can find it when you need it.

By the way, do you have any trust deeds that you'd like to cash out right now?

Builder: I've got a couple.

You: Tell me about them (use the paper analysis worksheet and previous scripts).

Also, do you know anyone else that might want to sell some trust deeds at this time? I will keep our personal conversations and transactions confidential, of course.

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SCRIPT: Following Up with Professionals Once You've Mailed Them

I encourage you to follow up with the professionals that you sent your postcards, brochures or newsletters to. Just make a quick, simple phone call to them. This can be fun and exciting because you will be developing a relationship with them. That's it! You will not be selling them anything which they will greatly appreciate. This will help them to remember you and you will definitely get any notes that come across their desk in the future.

Your follow up call can be as simple as:

"Hi this is (Y**our Name**) and I'm just following up to see if you received my recent newsletter, Update on Real Estate, and to see if you have any questions that I might be able to answer. Do you have any clients I might be able to help at this time?"

Wait for their answer and at the end of the conversation just close with:

"Well, feel free to give me a call if any questions come up, I'd love to be of service, and I'll follow up next quarter to see if any questions may have come up."

Isn't that simple?

This closing will let them know that you're interested in establishing a relationship with them, this will peak their interest and create a desire in them to keep their ears and eyes open for opportunities for both of you.

It's very important to understand that as you do this, you are building your pipeline and you will be guaranteed, in the future, to have professionals calling you with their clients' notes that need liquidating. You will be setting yourself up with a business in which all you'll need to do is be available to answer your phone calls. This is the real key to building your business. Just implement these simple steps and you will be changing your life forever.

This is your chance to author your own life! It makes me very happy to support you all the way through this process; to watch you realize your dreams of being your own boss, being able to pay your bills and have time to yourself. You should be able to take those vacations whenever you want and still set yourself up for a comfortable retirement. This is what brings me satisfaction. My staff and I will be here to support you all the way!

End of Scripts

I have given you many ways in which you can contact people to make deals. I've also shown you how you can use your answering machine to get the names and phone numbers of Note Holders who will be calling you. You will see just how easy it is to have a consistent supply of real estate notes coming across your desk. It will take some work and it will take some time, but after 60 to 90 days you will have a pipeline filled with deals.

A Blueprint for Your Note Business

I find that people often get so excited about the incredible opportunities available to them through the discounted note business, that they often neglect to first sit down and define their marketing plan which will shape their business. In fact only 5% of business owners in the U.S. actually sit down and closely analyze their business philosophy and style. Isn't that remarkable? That's probably the reason so many businesses fail.

As a small business owner, you need to assess how you will work the business, how you will find customers and how you will interact with these customers to help meet their needs as well as your own. Remember, gaining referrals through your target market is your number one goal!

Every business could use a careful evaluation from time to time. In order to help facilitate this evaluation process, I have included "Steps to Success: A Blueprint for Your Note Business". It provides the tools to help you refine your marketing plan. Think of this report as a building block, which you can use to create a fully functioning, highly successful business that is both rewarding and fulfilling.

The set of questions are designed specifically to give you an outline for thinking more critically about how you'll begin your new real estate note business. Take the time to fill it out completely, you will find the insights you gain will be worth their weight in gold!

Think carefully and deeply about your answers, honestly assessing the realities of your business practices. If you've listened to the course, you will know the answers and will have an excellent quick start for your new business

One of my goals is to help you become the best real estate note professional that you can be - one who is successful and full of integrity. By spending the necessary time to complete this report, you'll be giving yourself the best opportunity for a quick start and on going success!

Steps to Success

1. Describe the goals for your business for the next:
   6 months_____
   1 year_____
   3-5 years_____
   10 years_____

2. What is your target market?
   _____
   _____
   _____

3. Describe how you will find notes and how to quickly sell them.

_____
_____
_____
_____

4. Describe how much prospecting mail you will send out each month and to whom you will send it. Why will you send it to this particular group?

_____
_____
_____
_____

5. What will your rate of return be on your mailing investment?

_____
_____

6. Will you use telemarketing as a way to follow up with your prospects?

_____
_____

7. What do your customers really want from you?

_____
_____
_____
_____

8. Will you solicit referral business from your customers?

_____
_____
_____
_____

9. Once you have a customer, will you solicit the customer's testimonials? How will you use these testimonials to expand your marketing efforts?

_____
_____
_____
_____

10. Describe your customers' needs and how you will addresses those needs.

_____
_____

11. What specific aspects of this business would you like more help with?

_____
_____
_____
_____

12. What additional aspects of this business are you interested in learning about, I.e. mobile home notes, business notes or other cash flows?

_____
_____
_____
_____

Congratulations!

You are one of the few business professionals who have taken the time to thoroughly evaluate their business. You are now in position to use this information to rev up your business!

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Private Note Grading & Pricing Guidelines

The discounted private real estate mortgage marketplace operates very much like the traditional, institutional lending industry. There are many different kinds of players, many different kinds of buying programs, new programs come and go and pricing and credit underwriting change almost daily.

Most borrowers do not understand this, nor do most note Sellers or inexperienced Creative Real Estate practitioners understand this. Obviously, it is difficult for both loan brokers and note brokers to keep up with every single possible program/rate/credit guideline at any given time.

As in the lending industry, it is possible to work from a matrix of benchmark guidelines, for safely evaluating an individual note package, and carefully setting a reasonable window for grading and pricing options. Keep in mind, whenever quoting a note price, the price is determined by yield requirements, not on any preset "discount" as a percentage of the remaining balance on a given note.

Also, bear in mind that while Loan To Value is an important element in discounted note pricing; unlike lending, the equity factor is given more weight in relation to Investment to Value, I.e. the Note Buyer's total dollars at risk as a percentage of the market value of the underlying collateral real estate.

NOTE RATING

Equity Factor (30% of final grade)

Equity Range*		Score
Lower	Upper	
0.0%	5.0%	5
5.1%	12.0%	4
12.1%	20.0%	3
20.1%	30.0%	2
30.0%	50.0%	1
50.0%	100.0%	0

Weighted Equity Score:_____

*Equity is calculated using note balance due as percentage of lower of sales price or appraisal. If note has one year of seasoning and property value is rising, equity is calculated as average of sales price and new appraisal.

For partial purchases, use note's equivalent balance, calculated by using present value of payments purchased as percentage of actual note balance.

Credit Rating Factor (40%)

Primary Repository Score*		Score
Lower	Upper	
0	500	6
501	550	5
no history	no history	4
551	600	3
601	650	2
651	700	1
700	1,000	0

Weighted Credit Score:_____

*Fico/Empirica/Beacon depending on primary repository for Payor's zip code.

Credit profile ratings dependent on different investors weighting preferences for account aging, collections/charge offs, proportion of debt to available credit, late payment history, bankruptcy, repossessions, foreclosures, liens or judgments appearing on Payor's credit report.

Generally, as many as 4 additional points could be assessed against the credit score for problems in a Payor's credit profile. For example, Payor scores 644 on Fico. But we see that in the past 18 months, he has had two different minor accounts go to collection, and he was late on a car payment 6 months ago. On investigation, we discover that the collection accounts are now resolved, but they were paid off on a modified payment plan. If we determine that these problems were due to a temporary cash crunch from job change or illness, we might add only 1 point to score. However, if it appears Payor is stretched too tightly, and the problems indicate long term debt load pressure, we may add 2 to 4 points, if it appears likely that we may see future lates on this Payor.

Note Payment Factor (10%)

Late Payment Record	Score
90 days and up (12 mos.)	15
90 days and up (24 mos.)	14
60 days (2 in 12 mos.)	14
60 days (3 in 24 mos.)	12
No Verifiable History	11
60 days (1 in 12 mos.)	10
30 days (3 in 12 mos.)	10
30 days (2 in 12 mos.)	8
30 days (1 in last 90 days)	6
30 days (1 in 12 mos.)	3
Notes less than 6 months old	3
Current 12 months	2
Current 12 to 30 months	1
Current 30 months or longer	0

Weighted Note History Score:_____

Seasoning Factor (20%)

Months of Seasoning		Score
Lower	Upper	
0	3	5
4	6	4
7	12	3
13	24	2
25	36	1
36	or more	0

Weighted Seasoning Score:_____

To calculate the Final Note Rating, we add up the weighted scores from each of the four factors. The sum is then matched to the Grade in the Final Note Rating Chart below. For example, we are looking at a 4 month old note, Payor has 15% equity, 650 Credit Score, and less than six months seasoning. Referring to the appropriate charts above, we would calculate the weighted score for each factor as follows:

Equity Factor	3 points x .30 weight	=	.90
Credit Rating Factor	2 points x .40 weight	=	.80
Note Payment Factor	3 points x .10 weight	=	.30
Seasoning Factor	4 points x .20 weight	=	.80
Total Weighted Score:		2.80	

We then compare this score to the Final Note Rating Chart below to assign the Grade for this particular note. As we can see, with a weighted score of 2.80, this note is assigned a Grade of A.

Final Note Rating

Weighted Note Score		**Grade**
Lower	Upper	
0.0	1.4	AAA
1.5	2.4	AA
2.5	3.4	A
3.5	4.4	AB
4.5	5.0	B
5.1	5.5	C
5.6	6.0	D

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Once the Final Note Rating has been established and the Paper Grade is determined, take the Paper Grade and apply it to the Property Type and Category charts below to establish maximum Investment to Value and Wholesale Yield Pricing for specific Note Grade/Property Categories. This will give you the approximate market yield demanded by institutional investors. (private investors' yield requirements vary widely, but generally they run approx. 1.5% to 2% above institutional investor yield requirements). The yield will change according to changes in the financial markets, and be adjusted from time to time to reflect such changes in yield requirements.

Residential Property/Category

1	2	3	4
O/O SFR's on fewer than 10 acres; O/O townhomes	O/O SFR's on 10+ acres O/O modulars, DW mobiles on 1-15 acres, or in MH subdivisions NOO townhomes, O/O 2-4 units 2nd homes	O/O condos, modulars, DW mobiles on less than 1 ac. or 15+ acres; NOO SFR's & NOO 2-4 units	NOO condos: NOO modulars & DW mobiles; SW mobiles, all 2nd liens (3) x

Maximum Investment to Property Value

Note Rating	1	2	3	4	Wholesale Yields (4)
AAA	90% (1)	85% (1)	80% (2)	75% (2)	9.00% - 12.00%
AA	85% (1)	80% (1)	75% (2)	70% (2)	9.50% - 12.50%
A	80% (1) 7	5%	70% (2)	67% (2) 1	0.00% - 13.00%
AB	75%	70%	67% (2)	65% (2)	11.00% - 14.00%
B	70%	65%	65% (2)	63% (2)	12.00% - 15.00%
C	65%	65% (2)	60% (2)	60% (2)	14.00% - 17.00%
D	60%	60% (2)	60% (2)	55% (2)	16.00% - 20.00%

1. Min.10% Payor equity required
2. Max ITV reduced 1% for 1% if less than 10% Payor equity
3. Add 1.5% - 2.0% on 2nds; lower ITV on Grade by 5% (ITV includes balance due on underlying financing)
4. For approximate private investor yields, add 1.5% to 3%

Residential Mobile homes In Parks(5)

1	2	3	4	5
O/O DW in 5 star or 4 star park,less than 5 years old, 1,150 sq ft or more	O/O DW in 5 star or 4 star park, 5.1 - 10.0 years old, 1,150 sq ft or more; or less than 5 years old in 3 star park	O/O DW in 5 star or 4 star park, 10.1 -15.0 years old; or 5.1-10.0 years old in 3 star park; or less than 1,150 sq ft	O/O DW in 5 star or 4 star park, 15.1 - 20.0 years old; or 10.1 - 15 years old in 3 star park; or less than 1,150 sq ft	O/O DW in 5 star or 4 star park, 20 + years old; or 15.1 - 20.0 years old in 3 star park; or less than 1,150 sq. ft

Maximum Investment to Wholesale Property Value (7)

Note Rating (3)	1	2	3	4	5	Wholesale Yields (4)(5)(6)
AAA	80%(1)	78%(2)	75%(2)	72%(2)	70%(2)	14% - 17%
AA	75%(1)	75%(2)	72%(2)	70%(2)	67%(2)	15% - 18%
A	75%(2)	72%(2)	70%(2)	67%(2)	63%(2)	16% - 20%
AB	70%(2)	68%(2)	65%(2)	63%(2)	60%(2)	18% - 23%
B	68%(2)	65%(2)	63%(2)	60%(2)	57%(2)	20% - 26%
C	65%(2)	63%(2)	60%(2)	58%(2)	54%(2)	23% - 30%
D	62%(2)	60%(2)	58%(2)	55%(2)	50%(2)	30% - 37%

1. Min.10% Payor equity required
2. Max ITV reduced 1% for 1% if less than 10% Payor equity
3. Add 3% < 24mos, 1% < 36 mos. for seasoning discount
4. Singlewide mobiles start Category 3, 2.0% to wholesale yield requirements
5. For NOO add 2.0% to wholesale yield requirements
6. **For approximate private investor yields, add 2.0% to 3.0%**
7. Refer to current NADA Mobile home Appraisal Guide for approximate valuation

*Note that the wholesale pricing indicates approximately what an investor would expect to earn on the investment. If you are brokering the note, you will need to calculate a higher yield spread in order to make your profit. And you will need to stay up on your markets as well. The rates used in this sheet are what were effective during the time this manual was published.

The Note Broker Resource Kit

Enclosed you will find 6 valuable resources that you may print and use over and over. Please note, that neither America's Note Network nor its employees are giving legal advice or recommending you use these documents. These sample documents are provided to you for educational purposes only. Please have all forms reviewed by your attorney before using.

1. Telephone Script
2. Paper Analysis Worksheet
3. Commitment letter – Contract with the Note Seller
4. Cover Letter to the Commitment Letter
5. Information Needed From Note Seller – Information Request Form
6. Non-Circumvent Agreement – Contract With Your Buyer

#1

The telephone Script is designed to give you an idea of what to say to your prospective note Seller. Remember that you want to be comfortable with what you are saying and not come across as someone reading a script. Once you have obtained the information required, you can then post that information on the America's Note Network web site for an immediate sale. The web address is: www.notenetwork.com - or you may fax or mail us the information

Telephone Script

Note Seller's Name _____ Date_____

Address _____ Your Name_____

Phone # _____

SCRIPT FOR CALLING

Their (**their name**), this is (**your name**) (speak with excitement). I'm calling because I have an interest in the property you sold in (**state**). Do you remember? The Buyers weren't able to pay you off in full so you had to carry back a promissory note, right?

I would like to cash you out of what you're owed.

Did you know that you have a right to sell your contract and get cash now? YES NO

Would you be interested in finding out today's value of your note?
YES go on / NO stop.

(Paper Analysis Worksheet Questions)
1. What is the property address? _____

2. What kind of property is it? _____

3. Do the Buyers live there? _____

4. What is the property worth? _____

5. How much did you sell it for? _____

5. a. What are the loans on the property?

a. 1st Loan $_____ Mo PMT $_____ NEW or ASSUMABLE LOAN

Lender?_____

b. 2nd Loan $_____ Mo PMT $_____ NEW or ASSM

Lender?_____

d. What was the Down PMT$_____

6. What is the original amount of your note? _____

7. What is the interest rate on your note? _____

8. What is the monthly payment amount you receive? _____

9. What is the original length of time on the note? _____

10. When did you receive your first payment? (Mo & YR)_____

11. What day of the month is your payment due? _____

12. How many payments have you received? _____

13. Have all of your payments been received on time? YES / NO

(if no) number of months late?_____

14. What does the Payor do for a living? _____

15. If we were to agree upon a price, how soon would you need the cash? _____

Ok, let me analyze your information and I'll call you back in a few minutes with an exact price.

(Now post this information on America's Note Network's web site at www.notenetwork.com - By posting this information you will gain an immediate idea of what the note is worth to the end Buyer. Once you know what a Buyer will pay for the note simply deduct $2000 to $5000 from that price and offer it to the Seller. The amount you deduct will be the amount you earn for your efforts. Be sure to check with the Buyer to be sure that the price offered is total price you will receive. Some Buyer will make you pay from $500 to $800 in closing costs, which will come out of your check, so be sure to ask the Buyer what your "net price" is. One more point is to ask for two different prices – a price for the full sale of the note and a price for a partial sale or some of the payments from the notes.

Also, if you don't have Internet access, you can fill out the "Paper Analysis Worksheet", which you will find in the next section. Transfer information from script to Paper Analysis Work sheet. Once the Paper Analysis Worksheet and then you can either mail or fax us the information.

What to Say When You Call Back the Note Seller

Hi, Bob this is _____. I have a purchase price for your note. Do you have a piece of paper and a pencil handy? You never know when I might say something important.

Have you ever sold a note before? Let me just briefly explain to you how this process works and how we determine the cash value of your note.

We are analyzing each monthly payment you receive and calculating its value into the future. In other words, dollars today will buy more than dollars in the future. If it is okay with you, I would like to give you a couple examples of what I'm talking about.

Looking back 15 to 20 years ago, we could go to the movies for what? About $.50, right! And gasoline was about $.65 a gallon? Now look at what we pay. This is what I mean when I say dollars today are worth more than dollars in the future. So we have to factor that into the price.

I have another example: Suppose I have $10 in my left hand and $5 in my right. Which bill would you like? The $10 in my left hand, right? But now, let's add this to the equation: you have to wait (the remaining number of monthly payments on their note, lets say 96) 8 years to get the $10 or you can have the $5 now. Which one would you rather have? Of course the $5 now, right?

So, let me give you some numbers, now that you understand how we determine the cash value of your note.

There are two ways you can sell a note. The first way is through a partial sale of your note, which is the most profitable way for you. You can sell a portion of the remaining payments. For example, you sell me the next 60 of your 96 remaining monthly payments you are owed. At the end of the 60 months, the note payments revert back to you, and you would receive the remaining 36 payments. At that time, the balance will still be $_____.

So, you are getting a lump sum of cash now and you still have $_____ coming to you in 5 years. With this option you are still in the deal. If the Payor doesn't pay, I'm going to come back to you and say, "Bob, I gave you all that money, so you need to keep me whole by keeping those payments current. They sound as if they are good Payors from what you described, so I'm sure there shouldn't be any problem.

The Second option is to cash you out in full. So, if the Payor's don't pay or if the property burns down or blows away, you don't care because you are out of the deal. I will give you $_____ for the full sale of your note.

Which one of these options sounds the best to you? (Be quiet and listen in order to solve their problem).

If they say, "I need to think about it". You can say, ok, I can understand that. Bob, let me

explain just one other thing to you. I want you to understand how the papers are actually transferred and how you are guaranteed to get paid.

When you decide to go ahead with this sale, I will send you out a Commitment Letter, which states my obligation to you, along with a list of copied documents I will need back from you.

Then I'll deposit a check in the amount of $_____ (purchase price) into an escrow account at a title or escrow company of your choice. They'll close the transaction and make sure you get the right amount of money and that I get the right paper work. This way you are guaranteed to get paid - Sounds pretty good, doesn't it?

Would you like me to send you this information package today? If yes: Ok, you should receive it in the next _____days. Would it be ok if I called you back on that day to go over it with you and answer any questions you may have. (Set an appointment or don't send it out).

If No: Ok, when should I call you back? Incidentally, I haven't said anything to offend you have I?

(Be quiet! They'll tell you their problem and what you need to do to solve it).
If the Seller says yes, you will send him a Commitment Letter, A Cover Letter and an Information Request Form all of which you will find in this section.

Additionally, to save you time you might log on to our web site, www.notenetwork.com - click on the "How-to Reports section and then go to "The Note Brokers Resource Kit". Once you are there, you'll be able to copy and paste this information into a word document and save time by not having to retype these documents. Please note: only copy the information on the site that has a statement indicating that it is okay to copy. Never copy anything that states our copyright, which is 99.9% of our web site. We take copyright violations very seriously and will prosecute to the fullest extent of the law.

#2

The Paper Analysis Worksheet

The Paper Analysis Worksheet must always be completed before anyone can make a determination of what the note is worth. Please make sure that you gather all the information on this worksheet. If you follow the script above you will have all the information necessary to list the paper on www.notenetwork.com

America's Note Network Paper Work Sheet

Name Of Note Seller: _____ Date:_____

Address: _____

Phone #: _____

Property Information
Property Address: _____

Type Of Property: _____ Owner Occupied: _____

Property Value: $_____ Established By - Sale/Other:_____ Date: _____

1st loan Amount: $_____ Monthly Pmt: $_____ New / Assumed

2nd loan Amount: $_____ Monthly Pmt: $_____ New / Assumed

Down Pmt Amount: $_____ LTV: _____% ITV: _____% (internal use)

Note Information

Original Amount $_____ Balance $_____ As of -Date: _____

Interest Rate: _____% Payment Amount: $_____ Date of 1st Pmt: _____
(internal use)
Original Length: _____ mos. Type: Amortized, Interest Only, Other_____

Number of Payments Made: _____ Number Remaining:_____

Are the payments on time: _____ What day of the month are they due:_____

Balloon Payment if any: $_____ Balloon Payment Date: _____

Are there any Clauses: _____

Seller Information
Note Seller's Motivation: _____

When Does H/She Need To Close: _____ Received other Offers: $_____

What does the Payor do for a living: _____

Is there anything else I should know about this note: _____

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#3
Commitment letter

The Commitment letter is a letter that you will send to the Seller of the note as soon you have an agreed upon price. This letter will tie up the note and take it off the market. If the Seller cancels the agreement, then you will receive $125 minimum for your efforts (if you choose, you could even replace the $125 with a flat rate percentage of the note, I.e. 10% of the note balance. If for any reason you or your Buyer cancel the agreement you may also cancel your agreement with the Seller without penalty.

COMMITMENT LETTER

THIS COMMITMENT TO PURCHASE, is made _____ by and between you, (their name), the undersigned (Seller), and (your name) , (Purchaser), and/or its successors and assigns, whose address is your address.

This commitment is made in (your county), subject to and contingent upon (your name), and/or its investor's inspection and approval of the property and all documents including, but not limited to, credit, appraisal and title work.

Seller agrees to sell and convey to Purchaser, and Purchaser agrees to buy, upon the terms and conditions set herein, that certain (Trust deed / Mortgage / Land Contract - the name of the instrument), wherein the Payor owes a current principal balance of ($balance amount) as of this month, carrying interest on the principal balance at the rate of (interest rate %) per annum, and requiring a monthly principal and interest payment of (payment amount).

The agreed purchase price is the sum of ($purchase price) provided there are no underlying problems. If the contract has to be renegotiated a verbal commitment from the Seller will be binding.

The subject property is located in (county) and is legally described as follows;

Property Address

_____

ADDITIONAL LEGAL DESCRIPTION TO BE PROVIDED AND VERIFIED BEFORE CLOSING

Seller warrants that:
1. There are no prior liens or encumbrances on the property subject to the Instrument except as stated below:

SUBJECT TO: NO OTHER LIENS OR ENCUMBRANCES

2. It has full power, authority and legal right to execute, deliver, and perform, its obligation under this letter;

3. This Letter and the Instrument are legally valid and binding, and enforceable in accordance with their terms, and there are no claims or defenses, personal or otherwise, or offsets whatsoever to the enforceability or validity of the Instrument;
4. There are no lawsuits or legal proceedings pending, or to the best of Seller's knowledge, threaten regarding encumbrances on, or the ownership, use or possession of, the property or the Instrument;

5. No brokerage or other commission is due and unpaid in connection with the Instrument; and,

6. Seller has, as of the date of this Letter, and will have as of the date of the closing, good, marketable title to the Instrument.

During our processing period any additional payments made to Seller on the Instrument which cause a reduction in the principal balance below $100 will also cause a minor adjustment in the purchase price at closing. Seller agrees to return any payments received after the closing of this Instrument.

Seller understands that (your name), is not acting as an advisor for Seller in connection with this transaction, nor as Seller's agent, but rather is dealing with Seller at arms length, at all times. Seller acknowledges that it has sought and received whatever independent legal, tax, accounting or other advice it desires concerning this transaction. Further, Seller is not relying on (your name), in entering into this transaction, but is acting on its own best judgment.

Seller agrees to execute all necessary documents to effect the assignment and conveyance to Purchaser of its interest in the Instrument. Seller agrees to furnish any and all documents in its possession necessary to consummate this transaction. If, after closing, it is discovered that errors, omissions, or loss of documents has occurred, Seller agrees to cooperate with the Purchaser to correct any and all errors, omissions, or losses with in ten (10) days of receipt of notice from Purchaser.

Upon our receipt of all the necessary closing documents related to this transaction, we should be able to close within 21 to 30 days.

All normal closing cost will be the responsibility of the Purchaser with the exception of any additional, or unexpected, legal cost necessary to clear or perfect title.

Should the Seller fail to close, after signing this agreement, Seller shall be obligated to reimburse Purchaser for all out-of-pocket expenses incurred related to this transaction, up to the time of cancellation. These expenses should normally be limited to title and/or appraisal fees, plus the processing fee of 10% of the remaining balance of the note as of today's date.

Purchaser hereby gives Seller a specific period of ten days to complete, and return, this Commitment Letter, and agrees to keep this offer open for that period of time. If Seller is unable to complete, and return this agreement within the allotted time, this agreement shall be canceled. Purchaser may extend the time period, upon conditions it deems acceptable.

By_____
Your Name & Signature

ACCEPTED:

_____ _____
Sellers Signature

Social Security Number of Seller

SSN: _____ SSN: _____

DATE: _____

#4
Cover To The Commitment Letter

Date

Seller's Name
Seller's Street
Seller's City, State, Zip

Dear First Name:

Thank you for the opportunity to be of service to you. We will do everything possible to expedite your closing once you return the enclosed "Information Request Form" and copies of the requested documents.

The cash you will receive is (dollar amount) for the full sale of your interest, or (dollar amount for partial sale) for the next _____ number of payments.

A typical transaction takes 21 to 30 days to process provided there are no unusual circumstances, which may arise. The normal closing process includes a credit evaluation on the Buyer, a drive-by appraisal and a title insurance review. We pay for the normal closing costs.

Occasionally, purchases have to be renegotiated or canceled if the review process reveals underlying problems that cannot be corrected. Thankfully, this situation doesn't happen very often! If it does, you retain the right to cancel the transaction without any obligation on your part.

Also find enclosed a formal "Commitment Letter" which begins the closing process and states our obligation to you. Please sign it and return it with the above requested documents. If you have any questions please call me at (1-XXX-XXX-XXXX). Thank you.

Warmly,

Your Name

#5

Information Request Form

The Information Request Form indicates the documents and information that you will want the note Seller to send to you. You may want to send this form to the Seller along with the Commitment Letter and the Commitment Cover Letter.

INFORMATION FOR YOUR CONTRACT SALE

The sale of your real estate contract CAN ONLY be processed when you follow these requirements. The information you provide on the front and back of this sheet is necessary to process your contract sale.

We will need a copy of the documents listed below:

____ Copy of Note

____ Copy of Trust Deed, Mortgage or Land Contract

____ Payment History – Payment Book or Bank Deposits

____ Escrow instructions from real estate sale in which the "Contract" was created

____ Escrow closing statement from real estate sale in which the "Contract" was created

____ Title insurance policy which insures the "Contract"

____ Fire insurance information on the property which secures the "Contract" (Insurance Company, Policy Number, Agent's Name and Address)

____ Loan Payment Record

____ Please provide two (2) pictures of subject property

____ Copy of street or city map showing property location

____ Plans, surveys or other documents in your possession

Your signature is required for us to confirm balances, payment history and to obtain copies from your title or escrow company in the event we need further information. Thank you.

_____	_____	_____
Sellers' Signature	Title / Escrow Company	Police Number

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#6
Non-Circumvent Agreement

The Non-Circumvent Agreement is designed to protect your interest when you are brokering a note to an investor or the end Buyer. You will have a commission due you for referring the note to the end Buyer. This document will protect you. Please have your attorney review this sample agreement that is used as an example and for educational purposes only.

NON-CIRCUMVENTION, NON-DISCLOSURE AND CONFIDENTIALITY AGREEMENT

THIS AGREEMENT entered into on this _____ day of _____, 20___ is for the Professional Association and arrangement of Non-Circumvention, Non-Disclosure and Confidentiality between _____whose office is at_____ _____ and _____ whose principal place of business is at _____ hereinafter, called the "The Parties."

The Parties with this agree to respect the integrity and tangible value of this agreement between them.

THIS AGREEMENT is a perpetuating guarantee for five (5) years from the date of execution and is to be applied to any and all transactions present and future, of the introducing party, including subsequent follow-up, repeat, extended, renegotiated, and new transactions regardless of the success of the project.

Because of THIS AGREEMENT, the Parties involved in this transaction may learn from one another, or from principals, the names and telephone numbers of investors, borrowers, lenders, agents, brokers, banks, lending corporations, individuals and/or trusts, or Buyers and Sellers hereinafter called contacts. The Parties with this acknowledge, accept and agree that the identities of the contacts will be recognized by the other Party as exclusive and valuable contacts of the introducing Party and will remain so for the duration of this agreement.

The Parties agree to keep confidential the names of any contacts introduced or revealed to the other party and that their firm, company, associates, corporations, joint ventures, partnerships, divisions, subsidiaries, employees, agents, heirs, assigns, designees, or consultants will not contact, deal with, negotiate or participate in any transactions with any of the contacts without first entering a written agreement with the Party who provided such contact unless that Party gives prior written permission. Such confidentiality will include any names, addresses, telephone, telex, facsimile numbers, and/or other pertinent information disclosed or revealed to either Party.

The Parties agree not to disclose, reveal or make use of any information during discussion or observation regarding methods, concepts, ideas, product/services, or proposed new products or services, nor to do business with any of the revealed contacts without the written consent of the introducing party or parties.

The Parties agree that due to the many variables surrounding each Business Financial Transaction that will occur because of this agreement, the commission to be paid and/or the fee structure between the Parties can vary. A separate fee/commission agreement will outline compensation for each Business/Financial Transaction. The fee or commission agreement must be drafted and acknowledged by signature before all Business/Financial Transactions.

In case of circumvention, the Parties agree and guarantee that they will pay a legal monetary penalty that is equal to the commission or fee the circumvented Party should have realized in such transactions, by the person(s) engaged on the circumvention for each occurrence. If either party commences legal proceedings to interpret or enforce the terms of THIS AGREEMENT, the prevailing Party will be entitled to recover court costs and reasonable attorney fees.

The parties will construe THIS AGREEMENT in accordance with the laws of the State of Oklahoma, County of Oklahoma. If any provision of this agreement is found to be void by any court of competent jurisdiction, the remaining provisions will remain in force and effect.

THIS AGREEMENT contains the entire understanding between the Parties and any waiver, amendment or modification to THIS AGREEMENT will be subject to the above conditions and must be attached hereto.

Upon execution of THIS AGREEMENT by signature below, the Parties agree that any individual, firm company, associates, corporations, joint ventures, partnerships, divisions, subsidiaries, employees, agents, heirs, assigns, designees or consultants of which the signee is an agent, officer, heir, successor, assign or designee is bound by the terms of THIS AGREEMENT.

A facsimile copy of this Non-Circumvention, Non-Disclosure and Confidentiality Agreement shall constitute a legal and binding instrument. By setting forth my hand below I warrant that I have complete authority to enter into THIS AGREEMENT.

For: Company Name Here

_____ _____

Buyer's Signature Date

Although it is not necessary, if you would like a more complete list of documents for closing and managing your own personal transactions, I recommend that you go to the link below for more information: www.notenetwork.com/helptips - The documents enclosed in this section of the course are all you need.

Ten Special Custom Cash Clauses That Can Make You Thousands Of Dollars

Add Or Delete These Clauses Depending On What You Want To Accomplish When Creating A Note

1. Special Protection Clause In Offers, Contracts, Escrow Instructions — This is an arm's length transaction and both parties have entered this agreement of their own free will. Both parties fully understand this contract and have obtained the review and approval of their attorneys and tax advisors. Seller is aware that Buyer intends to make a profit on this transaction.

2. Additional Special Clause For Real Estate Agents — Seller is aware that Buyer is a Real Estate Licensee (Broker Or Salesperson) and any listings, oral, written, or implied, are hereby cancelled. there is no commission involved. Buyer is acting solely as a Principal and has no fiduciary duty to Seller. Seller has not relied on any representations of Buyer in making this transaction.

3. Seller's Contingency Clause — This offer is accepted subject to the written disapproval of Seller's (Attorney — for legal reasons; Accountant — for tax reasons) no later than (Time, Date). Such written disapproval shall be deemed waived if not delivered to (Closing Agent) by the time stated.

4. Right Of First Refusal — The maker of this note reserves the right of first refusal to purchase this note back at a discount at the price a third party would pay, in the event holder decides to sell at a discount. Factors to include: Holder shall deliver written notice of such proposed sale to maker by certified mail at (address). Maker shall have (number) working days from delivery of said notice to buy the note at the discount offered to the third party. Holder shall pay maker's legal fees in the event maker has to sue because of violation of this provision.

5. Exculpatory Clause — The Real Property collateral shall be the sole security for this note and the beneficiary and future holders shall have no recourse other than the property. This clause eliminates any personal liability against you on any notes you sign.

6. Assumption Of Liability Clause — The Property Buyer takes title subject to and agrees to pay the existing Second Loan in the amount of $____ in favor of (beneficiary). (This clause binds the Buyer to pay the $____ note instead of you.)

7. Bursting Balloons Forever (or How To Make Time Fly) — People with short-term balloons payable are surprised how time flies. The Solution: Use the following Balloon Payment Rollover Clause — In the event that acceptable financing is not available to refinance this note when due, Maker at his/her option reserves the right to make a (amount) payment on the principal amount owed and extend the due date for an additional (number) years.

8. Due On Sale Clauses — When you sell a property, notes that have Due On Sale Clauses can be called by the Lenders. Enforceable: Recent court decisions have ruled that due on sale clauses are

enforceable, even in notes carried by private parties. The Solution: Use the following Right Of Assumption Clause in notes you sign. This note is fully assumable without further qualification by subsequent owners of the security property. Another Idea: In the event the property owner demands a Due On Sale Clause, ask for the right to a discount on payoff proportionate to the shortening of the original term of the loan.

9. Locked-In Discount — You do this when negotiating a note you are borrowing on. How To Have No Interest For 3 Years. Example: A $10,000 note with no payments for 7 years, 10% simple interest, 30% discount for payoff within 3 years. Accumulated interest, 3 years = $3,000, discount = $3,000! Unless you ask, you'll never find out whether you can get this one. Even if you lose, you still precondition the holder to a possible discount later on. Use the following Prepayment Discount Clause: In the event this note is paid off (within the first 3 years of its term), Maker is entitled to a (percentage) discount from the (original Face) (remaining principal) amount.

10. The Tantalizing Discount — The New Twist On The Check Is In The Mail — You use this to tantalize the holder into giving you a deep discount on a note you owe on. Two Checks! You send two checks when your monthly payment is due on a note. One check is for the regular monthly payment, the other payment in full at discount. Example: $20,000 Note, Due In 4 More Years, Payable $200/Month. You mail one check for $200 and one for $10,000. On the $10,000 check you write: By cashing or depositing this check, the note-holder agrees to discharge the entire amount of the obligation dated (date), secured by (property) in the amount of (amount).

62 Different Ways You Can Earn Money Referring & Purchasing Cash Flows

More Than $4,000,000,000.00 In Cash Flows & Growing Annually

Accounts Receivable	Land Contacts
Aircraft	Lawsuit Insurance Settlements
Annuities	Lawyer's Fee Notes
Automobile Notes	Lease Purchase Agreement
Business Invoices / Receivables	Letters of Credit
Cash Prizes and Awards	Lottery Winnings
Casino Winnings	Marine
Charitable Remainder Trusts	Mechanic's Liens
Church Bonds	Medical Receivables
Class Action Awards	Military Pensions
Collection Accounts	Mobile Home Notes
Commercial Deficiency Portfolios	Partnership Agreements
Commercial Leases	Pensions
Commission Notes	Property Lease
Consumer Installment Paper	Purchase Orders
Consumer Receivables	Real Estate Joint Ventures / Exchanges
Court Judgments	Real Estate Notes
Credit Card Accounts	Royalty Payments
Defaulted & Sub-Performing	RV Paper
Deferred Settlements	Sports Contracts
Disability Payments	Standard Full Purchase
Divorce Settlements	Structured Settlements
Equipment, Gas, Oil & Mineral Leases	Sweepstakes
Farm Subsidies	Tax Certificates
Funeral Purchase Agreements	Tax Shelters
Government Contract	Time Share Notes
Home Improvement Notes	VA Compensation
Inheritances & Probates	Viaticals Settlements - Life Insurance
International Opportunities	Vocational School Paper
Investment Opportunities	Voluntary Separation Incentives
Invoices	Worker's Compensation

GLOSSARY

Accrued Interest: The amount of interest earned on a note, but not yet received in payment. An example would be a straight note (no payments). At the end of the first year the balance owed would be the original principal plus one year's accrued interest.

Add-On Interest: The interest rate is applied to the loan amount to get yearly interest. This is multiplied by the number of years. This total interest is added on to the loan balance. The monthly payment is calculated by dividing this number (principal plus add-on interest) by the number of payments. This method contrasts with charging interest on the remaining principal balance.

Adjustable Rate Mortgage (ARM): A mortgage or other real estate loan wherein the interest rate and payments that correspond to the interest are adjustable from year to year according to some index such as the rate paid by the government on Treasury Bills.

Algebraic Logic: The calculator logic of putting the operation sign (plus, minus, times or divided by) before the number is entered.

All-Inclusive Deed of Trust: A note secured by deed of trust that "Wraps Around" a smaller senior loan. The debtor pays the holder of the wrap who in turn pays the included senior lien. See also "Wraparound Mortgage".

Amendment Of A Note: Changing the interest, payment schedule, or due date on an existing note without writing a new note.

Amortization: The payments on an amortized loan are established to contain both principal and interest so that the loan will be paid off in full by the end of the amortization period.

Annual Percentage Rate (APR): The true cost of a loan to a borrower as required by the Truth in Lending Laws.

Arrears: 1) Behind in making payments, as in "The payments were 3 months in arrears." 2) Later than earned, as in "Loan interest is paid in arrears. The interest for May is paid in the June payment."

Assignee: The person acquiring a note from a previous holder. Assignment: Transfer of the rights of a note from one holder to another. Assignor: The person giving up ownership of a note to a new holder. Balloon Payment: A large payment on a note, usually due at the end of the payment schedule. There can also be partial balloon payments during the note term.

Beneficiary: The person entitled to receive the payments on a note.

Blended Rate: The overall interest rate when two or more loans are on a property. It is higher than the rate on the lowest rate loan and lower then the rate on the highest interest loan. Also called Overall Rate(OAR).

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Buy Down: In order to reduce the interest and payments on a loan for the Buyer, the property Seller may pay the lender some money up front to "buy down" the interest and payments for a certain period of time. Example: The Seller buys down a 30-year loan at 14% interest so that the Buyer of the property only pays 11% interest for the first 2 years.

Calculator: An electronic machine, programmed to perform specific computations. It has a "mind of its own" which was developed by the programmer and manufacturer. Different calculators are designed for performing different jobs.

"Carry Paper": For a property Seller to take part or all of the sale price of the property in the form of a secured note. Example: The Seller carried $20,000 in paper to facilitate the sale of his property.

Cash Flow Diagram: A graphic representation of a series of cash flows, in or out or both, showing how much and their timing.

Clear: Remove previous instructions and data from the calculator so they will not interfere with the next calculations. You can clear the program, the financial registers, the storage registers, and the display.

Closing: Completion of a transaction, including details like preparation and recording of legal documents, procurement of applicable insurance coverage, and transfer of funds.

Closing Costs: The various fees and charges involved in closing a transaction.

Collateral: Property pledged as security for performance of an obligation.

Collection Service: A neutral third party, other than the borrower or lender. The collection agency or collection service collects the payments due on a note and forwards the proceeds to the proper recipients.

Compounding: The situation where interest accrues and then gathers interest. Example: A 310,000 straight note (no payments) with 12% compound interest earns 12% interest the first year (91,200). Adding that to the original principal gives the next year starting balance of 811,200. This sum will earn 12% interest. The process repeats each year. Compound Interest: See Compounding.

Constant (Loan Constant): The yearly payment on a loan divided by the remaining principal balance. As amortized loans are paid down, the Loan Constant increases.

Contract For Deed: A form of security instrument and debt contract wherein the owner of the property gives the Buyer legal title only after the obligation has been paid in full. See Land Contract.

Courthouse: Place where deeds and real estate paper are recorded. See also Recorder's Office and Registrar of Deeds.

Credit Report: The report on a person's credit standing issued by a credit information bureau such as T.R.W. It shows what credit a person has been granted and what their payment record is.

Creditor: The person to whom money is owed.

Current: Payments are current when they are up to date.

Current Principal Balance: The balance currently owed on a note, which may be smaller or larger than the original principal balance.

Dead Equity: Equity in property, not earning interest, not being used to acquire more property.

Debt: An obligation owed by a borrower to a creditor.

Debtor: One who owes money to another.

Debt Service: The monthly payments required to keep the loans on a property current.

Decimal: The period between numbers designating the difference between whole numbers and parts thereof. Example: 1.1, wherein the first 1 is a whole number and the second 1 represents l/10th. In this case there is one number to the right of the decimal.

Deed Of Trust: A security instrument, which utilizes a neutral third party, called a Trustee to foreclosure in the event of default. This makes it generally faster and easier to foreclose on a Deed of Trust than on a Mortgage.

Default: Violation of the terms and/or conditions of a note and security instrument.

Delinquent: When payments are overdue, they are said to be delinquent.

Delta: A Greek symbol shaped like a triangle, which stands for change between two numbers. Example: Delta % from 100 to 125 is 25% increase.

Discount: A price less than the remaining principal balance of a note.

Discounted Paper: Real Estate Paper bought or sold at a price less than the principal balance.

Discounting: The practice of adjusting the price of a note to compensate for other factors such as term, payments, interest rate, security, and needs of the Seller, The discount raises the yield to the Buyer.

Discount Points: A point is one percent of the principal amount.

Double Escrow: Two separate but related escrows or closings, each contingent or dependent on the other. Example: You are buying a note and reselling it immediately for profit. The buy and resale escrows are contingent on each other and close at the exact same time. See Simultaneous Closing.

Effective Interest Rate: The overall yield earned on an investment, taking into account the discount and all existing loan terms.

Enter: Putting a number or other information into the calculator. An entry starts in the display and then is entered into the calculator inner workings for use.

Equity: The amount left over after subtracting the loans from the value of the property.

Equity Cushion: The margin of safety over and above a specific loan on a property. A $100,000 property with $65,000 in loans would have a $35,000 equity cushion to protect the loans.

Escalation: Rising loan payments as time goes on.

Escrow: A neutral third party stakeholder that receives the instruments, contracts, documents and funds in a transaction as needed from both parties. Escrow sees that the terms and conditions of the contract are fulfilled according to the escrow instructions.

Escrow Instructions: Written instructions to an escrow officer, signed by both parties to a transaction. This tells the escrow officer exactly what to do to complete the transaction.

Escrow Officer: The person responsible for administration of the transactions in an escrow office.

Execution: The legal signing of a document. In order to record an instrument, a Notary Public must witness its execution.

Existing Financing: The financing on a property before making any changes. Example: When looking for a property to buy you are first interested in the existing financing. See also Proposed Financing.

Extension Agreement: A written agreement giving a debtor more time to pay on an obligation.

Face Amount: The original principal balance appearing on the face of the note. Be sure to check the current principal balance of a seasoned note because it may be drastically different than the face amount.

Financial Calculator: A calculator designed for dealing in computations involving money, loans, payments, and time.

First Loan: (Note, Mortgage, Trust Deed): The first loan to be recorded as a lien against a specific property. (First in time and seniority).

Foreclosure: A judicial foreclosure is the means of enforcing one's right to payment under a Mortgage. The judge orders the property to be sold at auction and the proceeds used to pay the creditor. A Trust Deed can be foreclosed by having the Trustee auction the property via Trustee's Sale.

Free And Clear: Property that has no loans on it whatsoever is free and clear.

Fully Amortized: A loan whose payments include both interest and principal and will eventually be paid in full during its term with no balloon payment.

FV: Future Value. The balloon payment of a loan or the loan balance as of some future date.

Green Note: A note that is created in the sale of property for the specific purpose of immediate resale to a prearranged investor. In this case it might be construed to be a direct loan of money from the investor to the property Seller; and therefore subject to usury and truth in lending laws. See also Usury and Truth In Lending.

Hard Money: New money loaned against a property without a change in ownership. Example: A property owner puts a new second loan on the property to get cash. This is a hard money loan. Hard money loans generally involve personal liability in addition to the lien on the property. See also Purchase Money.

Hard Paper: Paper that has good strong terms and commands a good resale value in the paper marketplace. It would sell for a relatively small discount.

Holder: The current owner of a note.

Hypothecation: Pledging assets for a loan. In the case of a real estate loan, the property is pledged or hypothecated as security for the loan. When you borrow against a note you own, you assign the note to the lender as, security for the money you are borrowing. The income from the note you assigned pays the payments on the money you borrowed. When the lender is paid in full, the note is assigned back to you.

I: The interest rate or yield on a note.

Imputed Interest: In Seller Carry back Financing, when the interest is below a certain rate determined by the IRS, the IRS imputes or charges the property Seller tax on the higher rate of interest. (See your tax advisor on this).

Imputed Principal: In Seller Carry back Financing, when the Buyer of the property gets an interest rate below a certain rate specified by the IRS, the IRS may impute or declare that the actual property sales price was lower than stated in the purchase contract. (See your tax advisor on this).

Installment: One of a series of payments on a note.

Installment Note: A note that is payable in several individual payments called installments.

Instrument: The legal document used as evidence of debt, title, lien, etc.

Interest: "Rent" paid on a debt. See also Add-On Interest, Compound Interest, and Simple Interest.

Interest Extra: The loan payment terms wherein the payment goes to principal and not to interest.

Interest Included: The loan payment terms wherein the payment goes to interest first and any surplus goes to reducing the principal.

Interest Only: The loan payment terms wherein the payment is exactly equal to the monthly interest, not more and not less.

Internal Rate Of Return (IRR): The yield or rate of return, used when working with a series of uneven cash flows; as contrasted to regular uniform payments.

Junior: Recorded at a later date (than the senior loans). The security instrument recorded next after the first loan would be a second. It is junior to the first

K Factor: The Loan Constant. See Constant.

Land Contract: A security instrument wherein the Seller (Vendor) gives the Buyer (Vendee) possession of the property, but retains legal title (the deed) as security for a loan until specific payment has been made. The Buyer of the property gets "equitable title" and the right to use and enjoy the property and tax benefits prior to actually receiving the deed.

Late Charges: Fees or penalties owed to a lender when payments are late.

Less Than Interest Only: The loan payment terms wherein the payments are less than the monthly interest. This means the total debt grows with time.

Level Payments: The loan payment terms wherein payments stay the same each period, neither increasing nor decreasing with time.

Leverage: Buying property with Other People's Money (OPM). This allows one to acquire much more property by putting as little down payment on each piece as possible. High leverage means low equity.

Liabilities: Debts and obligations owed on.
Lien: An encumbrance or charge recorded against a property. Recorded loans are liens.

Line of Credit: A prearranged loan from a lender wherein when you want the money, all you have to do is write a check. The check is deposited with the lender and becomes a loan at that time. Instant loan!

Liquidate: Go out of title, or turn into cash.

Loan: The granting of the use of money or equity in return for payment. The loan includes the right of one party to collect from another according to the loan agreement or note. There are existing loans (already there) and new loans (ones just being created).

Loan Constant: See Constant

Loan To Value Ratio (LTV): The measure of the security of a given loan. It is calculated by taking the amount of the loan and any senior loans and dividing that by the property value. The standard "safe" ratio is 80%.

Loan Value: The maximum of loans that most lenders would lend on a property. Assuming an 80% loan to value ratio, the Loan Value on a $100,000 property would be $80,000.

Long Term: In private party carry back notes, long-term depends on the viewpoint of the parties, but generally, long-term would be over 3 years for discount paper.

Maker: The person who signs a note, agreeing to pay it.

Marketable: A note is marketable when there are a large number of potential Buyers for it, based on note size, security, yield, and terms.

Market Value: What a normal Buyer would pay and a normal Seller would sell for in terms of price.

Maturity: The time when an obligation becomes due and payable in full.

Moratorium: A suspension of payments and possibly interest.

Mortgage: A security instrument, which pledges a property to insure payment of a note. In case of default, it is foreclosed in the courts.

Mortgage Broker: A party who joins borrowers and lenders for loans, earning a placement fee. Also, an intermediary who buys and sells secured notes.

Mortgage Deed: See Deed of Trust.

Mortgagee: The party who is the beneficiary of a mortgage.

Mortgage Release: A release of a mortgage by the lender when the loan has been paid in full.

Mortgagor: The party who has pledged the property as security for the mortgage and note.

Negative Amortization: A loan payment that is less than interest only. This means the obligation grows with time.

Negative Cash Flow: Cash going out, outflow of money.

Negotiable Instrument: A document such as a personal check or note. It must meet certain legal requirements that allow it to be transferred (negotiated) from one holder to another.

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Net Present Value (NPV): The value of a series of uneven cash flows discounted to a present value figure.

Nominal Interest Rate: The interest rate stated in a note. This may be quite different from the yield to an investor who buys the note at discount.

N: The number of payments or compounding periods on a loan.

Note: A written promise to pay, with all the terms and conditions of the obligation, signed, and in the proper legal format. A note can be secured or unsecured.

Note Holder: The person currently in ownership and possession of a note and entitled to collect all its remaining payments. The holder might not be the original beneficiary.

Note Owner: See Note Holder.

Note Payment Book (Record): A simple record of all payments made on a note showing how much was paid each payment. It breaks each payment down to principal and interest, and shows the current principal balance.

Nothing Down: Acquiring property with no cash out of pocket by the Buyer. This does not mean that the Seller and/or real estate agent did not receive cash. Cash comes from more places than just the Buyer.

Notice of Default: A written legal notice to junior lien holders from a senior lien holder, notifying them that the senior lien is foreclosing.

Notice of Trustee's Sale: Notice published in the newspaper, stating that a property in foreclosure is to be sold at auction.

Novation: Rewriting an old document and replacing it with the new one.

Obligee: The person to whom payments are owed according to the terms of a note.

Obligor: The person obligated to make the payments on a note.

Offset Statement: A written statement by a lender or borrower concerning the current status of a loan. It includes the current principal balance, whether payments are current or not, and terms and conditions of the loan.

Option: The right to buy something for a stated price and terms within a certain time period. Something must be paid for this right. This is called option consideration. The option will either be exercised (used) or abandoned (not used).

Optionee: The person who has the right to buy under an option.

Optionor: The person who has agreed to sell property under an option.

Original Principal Balance: The principal owed on a note the day it started. This is contrasted to the current principal balance, which may be different.

Origination: The creation of something, in this case a note and security instrument.

"Or More" Clause: A clause in a note stating that the monthly payments are to be so many dollars "Or More." This eliminates any kind of prepayment penalty.

Or Order: A clause in a note, such as "Pay to Joe Jones or order." The "or order" would be an assignee or future owner of the note.

Overall Rate (OAR): See Blended Rates.

Owner: The person having title to something such as property or a note.

Owner Financing: When the Seller of a property takes a note secured by the property as part of the payment.

Paper: In our usage, a promissory note secured by real estate.

Partial Amortization: Loan payments that cover principal and interest for a certain period of time, but then the remaining balance is due in a balloon payment at the stop date.

Pause: In running a program, the calculator will pause at certain points so you can write down the answer before it resumes processing.

Payee: The person to whom payments are due on a note.

payment: The amount of money paid in each installment on a note.

Payment Book: See Note Payment Book.

payment Schedule: The specifics of how much each payment is and when each payment is due.

Payor: The person obligated ~to make the payments on a note.

Percentage: A fraction expressed in one-hundredths. This is used for interest rates. .09 is 9X. 9% interest on $l00,000 is $9,000 per year.

Personal Note: An unsecured note. The maker has personal liability on a personal note.

PITI: Principal, Interest, Taxes and Insurance. On an amortized loan that has an impound or escrow account for taxes and insurance, the monthly payment consists of Principal, Interest, Taxes and Insurance (PITI).

PMT: The payment on a loan.

Points: A point is 1% of the principal. See also Discount Points.

Positive Cash Flow: Cash coming in, inflow of money.

Prepayment: Paying on a loan before the payment is due, especially paying the loan off in full before its due date.

Prepayment Penalty (PPP): A penalty in a certain amount of money charged by a lender in the event of early payoff of a loan. See also "Or More" Clause.

Present Valve (PV): Money has a time value. Money now is worth more than money later. The worth of a future amount of money is less than having that same amount of money now. Example: You might only be willing to pay $2,500 now in order to receive $10,000 payable in 10 years. The Present Value of that $10,000 is $2,500 in your mind.

Principal: The amount of money loaned out or carried hack on property sale. The principal amount of the note is at first equal to the face amount. It then may vary according to how payments are made.

Principal Balance: The remaining amount of principal due on a note as of a certain date. This may be more or less than the original face amount of the note. See also Amortization, Negative Amortization, and Interest Only.

Private Party: The normal "guy next door" that sold his property and carried back paper to make the sale. Not a loan broker or real estate agent dealing in notes for profit.

Private Party Financing: See Seller Carry back Financing.

Program: As a noun it means the detailed instructions given to a computer or calculator telling it what steps to do and in what order to do them. As a verb it means to tell the calculator what steps to do.

Promissory Note: A legal written promise to pay a certain amount according to its terms and conditions. See also Secured Loan, Unsecured Loan.

Property Owner: The person who owns the property that is the security for a note. The property owner is the one who owes and pays on the note.

Proposed Financing: How we intend to have the financing look after we are done with our current transaction. See also Existing Financing.

Protective Equity: The excess "equity cushion" left over after subtracting the loan we are considering and any senior loans from the property value. Example: A $100,000 property with $65,000 in loans against it would have a $35,000 protective equity over and above the loans.

Purchase Money: Money that is loaned for the purchase of real property. This can be in the form of Seller carry back financing or a new bank loan. It is contrasted to Refinance Money or Hard Money. In certain cases it may carry no personal liability and may not be subject to deficiency judgments.

PV: Present Value or current principal balance on a loan. Present value can be the worth of a stream of future payments discounted to today's dollars or to an amount of money today.

Rate of Return: See Yield.

Real Estate Paper: Notes secured by real estate and held by private parties; not banks, professional loan brokers, or real estate agents in the business of dealing in notes far profit. Real Estate Paper can include: Mortgages, Deeds of Trust, Security Deeds, and Land Contracts.

Recall: Retrieving data stored in the calculator memory. Recast: To decide new terms for an existing loan. This may be associated with the situation wherein a debtor cannot pay according to the original terms, but can pay some other way

Reconvey: When a trust deed is paid off, the trustee reconveys his title back to the property owner and releases the lien from the property. It means to convey title back to the owner of the property.

Reconveyance: See Reconvey.

Recordation: The formal recording (filing) of a legal document such as a security instrument. Recordation with the County Recorder's Office or other appropriate governmental office serves constructive notice to the world that the document exists.

Recorder's Office: The local governmental agency responsible for maintaining official records of documents filed therein, such as deeds and security instruments (real estate paper). See Courthouse, Registrar of Deeds.

Recourse: When signing (endorsing) a note from one party to another, you do so either with or without recourse. With recourse means that you still have contingent liability to the Buyer of the note. In the event the maker doesn't pay as promised, you have to pay. See Without Recourse.

Redemption: In a foreclosure situation, redemption means the right to pay off the loan in full plus foreclosure fees and either stop the foreclosure while it is in progress or get the property back after it has been sold. See Redemption Period.

Redemption Period: The period of time during a foreclosure when the debtor has the right to make payment in full and stop the proceedings. Also a period after the property has been sold through foreclosure in which the foreclosed owner can pay the loan amount plus applicable charges and get the property back. This varies according to state law.

Refinance: Paying off an old loan on the property by putting a new, usually larger loan on it. Any remaining funds go to the property owner. See also Hard Money, Personal Liability.

Registers: Storage Pockets in the calculator memory. You can store information in the appropriate register and then recall it later.

Registrar of Deeds: See Recorder's Office, Courthouse.

Reinstatement: In the beginning of a foreclosure, the debtor has the right to catch up the payments plus foreclosure fees and reinstate the loan. This means to make it current and stop the foreclosure, just as it was before. During reinstatement it is not necessary to pay the loan in full unless the loan was due anyway.

Reinstatement Period: The period specified by local law, within which the debtor has the right to catch up the payments plus foreclosure fees and stop foreclosure.

Release of Liability: The appropriate documentation from a creditor to a debtor, releasing the debt and any liens associated with it.

Release of Mortgage: A written instrument releasing a mortgage lien from a property. Also called a Certificate of Discharge.

Renegotiate: To change the terms and conditions of an existing note by mutual agreement of Payor and payee. Either party can ask the other to renegotiate. Asking for a discount for early payoff is a form of renegotiation.

Request for Reconveyance: An instrument executed by a trust deed holder, directing the trustee to convey his title lien on the property back to the Trustor (Property owner). The Request for Reconveyance is usually printed on the back of the trust deed.

Reverse Polish Notation: Calculator logic or way of thinking in which the number is entered before the operation (plus, minus, times, divided by).

Risk: A determination of how safe or dangerous something is. An unsecured note generally involves more risk than a well-secured note.

Rollover Note: A relatively short-term (5 year) note that renews each time at some new interest rate pegged to the cost of money at that time.

Rule of 72: A banker's interest computation invention that allows for greater than normal interest in the early part of the loan. Also a rule of thumb for determining how long it takes to double your money at a certain interest rate. Divide 72 by the interest rate and this is close to the number of years it will take to double the money.

Satisfaction of Mortgage: Completion of the terms of repayment and release from liability on a mortgage.

Seasoned Note: A note that has been in existence for awhile and has a proven record of satisfactory payments being made.

Second: The lien immediately junior to the First. Recorded second in time.

Secured Loan: A loan (note), which has specific collateral, pledged to secure its payment. In the event payment is not made, the collateral will be sold to provide funds to pay the note.

Security Deed: See Deed of Trust

Security Instrument: The official legal document which, when properly recorded, places a lien on the property to secure the payment on a note. The most common security instruments are mortgages and trust deeds.

Seller Carry back Financing: When the Seller of a property takes a note secured by the property as part of the payment. See also Owner Financing.

Seniority: The order in time in which documents are recorded. The first lien recorded is the "First," the next is the "Second," etc. Recording, not when notes were created, is what counts. In the event of foreclosure, the lien foreclosing is paid first and the leftover funds, if any, go to the juniors. Senior liens are more secure than junior liens.

Senior Lien: A lien recorded before others. A lien can be senior to some and junior to others. Example: A second is a senior to a third but junior to a first.

Short-Term: In private financing, a note having 3 years or less remaining. Sign: The plus or minus sign before a number as used in mathematics of addition or subtraction. Also indicating whether a cash flow is positive (in) or negative (out).

Signature Loan: An unsecured personal loan from a bank or credit union.

Simple Interest: Interest based on the principal balance of the loan only. It doesn't add on to the principal. It does not compound. It is less than compound interest.

Simultaneous Closing: Two transactions or two parts of a transaction that are completed at the same time. Such transactions are often dependent and contingent upon each other. One cannot happen without the other. See Double Escrow.

Soft Paper: Paper with low interest, a long term, low or no payments, and perhaps questionable security. It has little or no marketability for cash and is used mainly in trade. One would like to borrow on soft paper and sell on hard paper.

Stop Date: The date of the last payment on a note. It may be fully amortized or there may be a balloon payment. Also referred to as Call Date.

Storage: Placing a number in a register or memory unit of the calculator for later recall and use.

Straight Note: A note having no payments during its term, with a balloon payment at the end. It may

have either simple or compound interest. Term: The length of time a loan runs. Example: A 5-year term. Terms: The main features of a loan: Principal Amount, Interest Rate, Payment Schedule, and Due Date.

Trust Deed: Or deed of trust. A deed given by the borrower to a trustee to be held tending fulfillment of an obligation. This is the security instrument, which pledges the property to insure payment on the note.

Truth in Lending Laws: Legislation that pertains to fair dealing and full disclosure in making new loans. It does not apply to the sale of existing notes.

Uneven Payments: The payments of a loan vary from time to time, they are said to be "uneven" payments. Example: $100/month the first year, then $200/month the second year, and then $300/month thereafter. See IRR.

Unmarketable Note: A note which has such soft terms that it cannot be sold for cash. It might be used in trade as part of the down payment on real estate however.

Unsecured Loan: An unsecured note or personal note. It is secured only by the maker's written promise to pay. No specific security has been pledged to back up the promise to pay.

Unsecured Note: See Unsecured Loan.

Usury: There are "Usury" laws, which specify the minimum rate private parties can charge each other on loans. Above that rate, it is "Usury" and the loan would be "Usurious." This involves stiff legal penalties. There is absolutely no limit however as to how much yield a person can get when they buy a note at discount.

Value: What one party is willing to pay for something. There are as many values for something as there are parties considering owning it. When there is widespread agreement of value, we have a market value (generally agreed-upon price such as the price of gasoline). On the other hand, notes have a less well-defined market. Therefore, negotiation has a large part in determining value or price.

WAC: Weighted Average Coupon - this formula is used to weigh the average yield on a portfolio of two or more notes. To calculate WAC multiply each note's coupon (interest) rate by its individual remaining balance; add the products; then divide the result by the total remaining balance. That gives you the approximate existing yield for a package of notes with varied interest rates.

WAM: Weighted Average Maturity - Allows you to calculate the overall maturity rate of a note portfolio, reflecting a truer measure of where the weight falls on a time line. More accurate than an average maturity calculation when dealing with many notes or where you have the bigger notes for longer terms and a couple of smaller notes on real short terms. A simple average would be extremely distorted in bias toward the low side in remaining months to maturity.

Walking Backwards: A note whose payments are less than Interest Only. This means the amount owed increases with time. See also Negative Amortization, Straight Note.

Without Recourse: The way of endorsing a note to an assignee. This protects the assignor from any further liability on the sale, even in the event the Maker fails to pay on the note. This is the way to sell a note to protect yourself. See also Recourse.

Wraparound Contract: A Land Contract that wraps around earlier existing financing. See Wraparound mortgage.

Wraparound Mortgage: A larger Mortgage that "Wraps Around' a smaller senior lien. The debtor pays to the holder of the "Wraparound" and the holder of the "Wrap" pays on the included senior lien.

Yield: The true rate of return on investment on a note bought at discount, taking into account the actual amount invested and the remaining payments and their timing. The yield is often ·far greater than the interest rate specified in the note itself when the note is bought at discount.

State By State Guide To Real Estate Practices

State	Main Security Instru.	Dominant Foreclosure Method
Alabama	Mortgage	Power of Sale
Alaska	Trust Deed	Power of Sale
Arizona	Mortgage	Judicial
Arkansas	Mortgage	Power of Sale
California	Trust Deed	Power of Sale
Colorado	Trust Deed	Power of Sale
Connecticut	Mortgage	Strict Foreclosure
Delaware	Mortgage	Judicial
District of Columbia	Trust Deed	Power of Sale
Florida	Mortgage	Judicial
Georgia	Security Deed*	Power of Sale
Hawaii	Trust Deed	Power of Sale
Idaho	Trust Deed	Power of Sale
Illinois	Mortgage	Judicial
Indiana	Mortgage	Judicial
Iowa	Mortgage	Judicial
Kansas	Mortgage	Judicial
Kentucky	Mortgage	Judicial
Louisiana	Mortgage	Judicial
Maine	Mortgage	Entry & Possession
Maryland	Mortgage	Power of Sale
Massachusetts	Mortgage	Power of Sale
Michigan	Mortgage	Power of Sale
Minnesota	Mortgage	Power of Sale
Mississippi	Trust Deed	Power of Sale
Missouri	Trust Deed	Power of Sale
Montana	Mortgage	Judicial
Nebraska	Mortgage	Judicial
Nevada	Mortgage	Power of Sale
New Hampshire	Mortgage	Power of Sale
New Jersey	Mortgage	Judicial
New Mexico	Mortgage	Judicial
New York	Mortgage	Judicial
North Carolina	Trust Deed	Power of Sale
North Dakota	Mortgage	Judicial
Ohio	Mortgage	Judicial
Oklahoma	Mortgage	Judicial
Oregon	Trust Deed	Power of Sale
Pennsylvania	Mortgage	Judicial
Rhode Island	Mortgage	Power of Sale
South Carolina	Mortgage	Judicial
South Dakota	Mortgage	Power of Sale
Tennessee	Trust Deed	Power of Sale
Texas	Trust Deed	Power of Sale
Utah	Mortgage	Judicial
Vermont	Mortgage	Strict Foreclosure
Virginia	Trust Deed	Power of Sale
Washington	Mortgage	Judicial
West Virginia	Trust Deed	Power of Sale
Wisconsin	Mortgage	Power of Sale
Wyoming	Mortgage	Power of Sale

* Georgia's Security Deed functions like a Trust Deed.

Note: State laws change. Please consult your attorney for the latest information.

Cardens Capitol Solutions
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Phone/Fax 205-819-1694/734-661-2743
For Sale by Owner Real Estate Financing Specialists
E-mail cashoutfunds@charter.net

Greetings Prospective Real Estate Investor!

As we all know the late night TV infomercials get all us excited about the real estate riches that could be yours if you buy this course or that course! I have bought most of them and have learned some good things but mostly I never really was able to get to the level of comfort that seems to happen to some people who bought these courses!

I think most buy the course and then it seems to end up on the shelf collecting dust! ☺

Here in these pages is what I feel is the most practical way to invest in real estate! Your cost is minimal except for some news ads to advertise for home sellers and homebuyers. Also some business cards, brochures and of course your time to work the deals! A computer and fax machine would also facilitate the deals faster for you. Keep a log of all the costs to you so that for tax purposes you will be able to claim these as business expenses if you are set up as a business, which you should be! Please consult with a tax professional, attorney and CPA for your options concerning these matters. You have entered the fascinating world of mortgage notes and the market that exists for these financial instruments! You should also form a trust or better yet an LLC to do business in! I do not have to tell you how litigious America is! Also the booklet How to Sell your Home in 14 Days is a great booklet to reproduce at Kinkos or other printers with a yellow cover and leave this booklet with your card attached on FSBO home sellers in your area. Copy down the address and call them several days later and ask them if the information was helpful that you left on their door? We might just have a deal for either flipping or seller assisting them, as you will read in the pages below. Always be professional and polite even when something the people say does not sit right with you! ☺ Saves heart attacks!

eBusiness Help Center

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With Your New Or Existing Online Business

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- **Free E-book Compilers**
- **Free HTML Editors**
- **Free FTP Software**
- **Free Email Auto-Responders**
- **Free Bulk Email Software**
- **Free Up-to-Date 75 Million Opt-In Email Lists**
- **Free Web Positioning Tips**
- **Free Ready to Go Turnkey Websites**
- **Free Replicate Any Website**
- **Free How-to Tutorials for Everything**

Small membership fee then everything is

FREE!!!

You can make money in four different ways with my company:

1. **The first is to simply refer our services to help a FSBO (For Sale by Owner) home seller offer Owner Will Finance terms under on program. This is simply a referral from you to my company and of course if we close a deal you get a 50/50 split of the profits I make!**

2. **The second way is to close and flip properties in your name keeping your profits minus the discount I charge for using my funding sources. Here you get to keep 90 to 95% of the profits depending on the financing!**

3. **The other way is for us to split the profit 50/50 in the actual flip or resell of the home, we close the deal in my corporate name and your half of the profit is paid to you when we close. Some investors prefer this method as they appreciate the idea that their name is not on the deal. However use of my company name does not mean that you are an agent or represent Carden's Capitol Solutions in anyway! Hence you cannot bind my company in the process of real estate investment. It simply means that I will close a deal that you find if it is acceptable to my company guidelines, in my company name. Then I will instruct the title company in your transaction how I want the profit checks split 50/50 at closing!**

4. **We also purchase various payment streams such as existing 1st mortgages, lotteries, business notes, annuities, personal injury awards etc. You make referral fees from submitting these types of notes that you come across in your daily business! We have letters you can use in the marketing section of this manual that you can put on your letterhead and send them to the various professionals in your area! Please go to the Forms section to read how to transact a possible note purchase deal with us.**

In all cases you are the main contact for the entire deal! You learn by doing and since I cannot "clone" myself at this time you are the main person as they say. This means that you interact with sellers, finding deals, working with real estate brokers, title companies and occasionally attorneys. This business, contrary to what the get rich quick courses tout, is plain and simple…HARD WORK! But the rewards are great and the satisfaction of closing your deal is very satisfying.

The nice thing is that with proper effort and constant learning you can achieve your financial goals. After all, people need to live in something and Donald Trump certainly found real estate to be a great hobby! ☺

I try to mentor everyone in the proper way to conduct this business as far as paperwork and logistics but your style will come across, as you want to present yourself to buyers and sellers and this is something you want to develop. You are selling yourself and what we can do to effectuate a deal!

I hate to say it but first impressions count. When you walk up the drive to a perspective seller to transact business with, you can be sure they are checking out your car, what you wear and how you handle yourself in front of them! If they do not like you in the first 30 seconds I guarantee that you will have trouble closing a deal! I am sorry to say this but image counts here in America as you probably know! ☺

Again please remember that even though you will see my company name on paperwork that you choose to close deals with, you represent yourself and not as my agent in the deals and cannot bind my company in any way to any deal. I reserve the right to have the final say as to whether the real estate transaction is prudent for all interests involved. (Please note this only applies if you want to do a 50/50 split deal using my corporate name to close the deal in.) if you choose to deal directly in your company name then you keep most of the profits except the

discount I charge to use our financing sources. Please consider very carefully how you want to be involved in the transactions!

Other than the above I want to welcome you to our company and hope we can build a prosperous real estate business that will benefit you and I in the process. I am very up front with everyone and expect the same from you. In this business fraud is so rampant that many lenders will not fund investor flips or so called table funding deals where the party selling the home has not been on the title for at least 12 months of duration. My investor group at this time is not concerned with this issue and thus we enjoy some benefits not available to others at this time! However, this is why I am so adamant of maintaining high integrity and honesty in all the real estate transactions. Not only does it let us all sleep well at night but also, I happen to live my life by these standards!

Lastly I have tried to keep the process simple and understandable. However it still will take effort and a willingness to learn to make a successful transition into this investment field. But you have my company behind you to help push the learning curve a little faster! ☺

God Bless
James Carden
Member/Manager
Carden's Capitol Solutions

Please note the following:

If at anytime during a deal you need help please fax, e-mail or phone me for help. The best way is to fax me with the problem and I will reply as soon as I can. As I add new communication modes I will make you aware of them! For now here are the contact numbers.
Are: voice 205-819-1694 E-fax 734-661-2743
Also on the forms where you see my company name on them if you are doing a deal in your company name just change the wording to your company name on the forms! I left my company name on the documents to show you where the names go and also if you decide to close deals in my company name as stated in this manual.

Phone/Fax 205-819-1694/734-661-2743 24/7 access

E-mail cashoutfunds@charter.net

Postal Address
Carden's Capitol Solutions
PO Box 663
Cottondale, AL 35453

If you come across any suggestions or errors in this manual please let me know, as we are a constant work in progress! ☺ I have tried to keep everything simple but real estate is still shrouded in much tradition and local custom. So you must always be learning and patient in this endeavor of yours.

It is best to view this manual in Microsoft Word 97 as it contains helpful hyperlinks to move quickly throughout the document! Just click on the blue areas to go to the area you want!

Example of two very common offers we make in flipping a home.

1) 80% of appraisal all cash offer to seller!
We then resell to end buyer for 100% of appraisal.

2) 88% of appraisal broken down this way:
78% of appraisal all cash with 10% second note assumable one time! Of course we resell to end buyer at 100% of appraised value! The spread is our profit in both deals.

With these two simple offers, we can move quite a bit of property. If the seller still does not like these offers then recommend using our Seller Assist program to them where we can assist them in offering seller will finance terms on their home. We do not make, as much in this type deal but a half of pie, is better than none! ☺

Business Plan for Carden's Capitol Solutions

General Theory of Operation
The key to my system is that we are funding buyers from a private investor fund for buys seller created mortgage notes. In the enclosed sheet you will see the guidelines we have set up to fund different types of buyers.

My system allows for "Owner Will Finance" terms to be placed on properties. Whether we are helping a FSBO seller sell their home or for us when we "flip a home to an end buyer. Most home buyers respond to ad's for homes that feature this financing as they do not want to go through the mortgage company process or they have been turned down by these sources.

- **Please note! We do not originate loans! What we do is create a mortgage and note and sell this note to our investor group or buy existing 1st lien notes.** These buyers believe that the "Owner will Finance" home seller is the last resort to own a home. Most people do not even realize that the "paper" business exists to buy and sell mortgage notes or any promissory note for that matter! My company also buys lottery winnings, personal injury awards, land contracts, and commercial notes such as business notes. All these notes are known as payment streams evidenced by the note and mortgage documents recorded in the counties where the property is located. It is much like the stock market paper that exists today but the paper is backed by real estate…a much stronger backed security than stocks in my opinion.
- **No need to be an expert on this subject but just know that you most likely will handle this type of paper in your new "hobby" with us that can be most profitable!**

Here are the steps that if followed carefully will result in a successful home sale.

We do two types of investments

1. Buy a home at 75 to 88% of appraised value and then simultaneously sell it to an end buyer offering Seller Will Finance terms (Profits are in the 5K to 20K range) This is known as a flip transaction or simultaneous close. This is a program that makes millionaires over time! The resell to our end buyer of course is 100% of appraisal!
2. Do seller assists with our end buyer (Profits are smaller with this plan but less work is involved) (Profits are in the 1k to 3K range) this program is great to generate "pocket change" with minimal involvement in the real estate deal. We simply help FSBO (For Sale by Owner) home sellers offer Owner will Finance terms on their property to sell it quickly and at full appraised value. This is also the program that I use to assist you, the real estate investor to sell properties that you may have under contract or own and want to sell fast!

Here are the steps that we take to close a deal whether "Assisting or Flipping"

1. Place an ad to find buyers (Please see sample ads below) and get them qualified through my office. I feel it is better to have several qualified buyers ready to go, as most real estate agents want proof that you have the capability to close deals! With a ready and willing buyer, it makes it easier to make offers on property. Remember we are using the buyer's funds that come from my investors to purchase property for profit! We can use fax documents for initial qualifications and overnight mail for the original hard copy. We have a mortgage qualification sheet (Form 101) that can quickly weed out the people who simply cannot qualify even under our program. **Do not be afraid** to get into the buyer's personal financial history as relates to the home buying process. You also want to use the mortgage qualification sheet to find out how much home and monthly payment the buyer can afford. Even before we begin the process we must pre-qualify the buyer using our mortgage pre-qualification worksheet. This is to avoid wasting your time with a buyer who simply will not qualify under our program guidelines. Most people think they can afford the bigger house but quickly find the payments make them house poor! As a result they are more at risk for foreclosure. Our goal is to make a satisfying transaction for everyone concerned that will at least have a good chance of lasting for the buyer! My goal is to make **Carden's Capitol Solutions** a company that people equate with quality deals and high ethics. Of course you want to meet the buyers first so pick either your office or

a suitable coffee shop! You will also fill out the 1003 Standard Loan application form. Get the form from me by fax or your local mortgage lender, bank etc. You might also consider buying a BAII Financial calculator from Texas instruments. This will allow you to figure mortgage payment amounts and other great uses for this calculator in our industry. I of course will fax you over the terms of the mortgage if you wish but I make this suggestion to teach you the value of using this wonderful machine.

To summarize here are the steps and forms to fill out to pre-qualify the buyer:

1) Fill out Form 101 Buyer pre-qualification worksheet
2) Fill out 1003 Loan application (Do not forget to have this formed signed by buyer!)
3) Fill out Form 102 Non-Circumvent Agreement buyer
4) Give buyer Form 104 Preliminary Good Faith Estimate – New Note
5) Fill out Form 103 also.
6) Collect $25 cash or money order for credit report fee if you do not have a credit reporting service where you could pull the credit yourself! A friend in the mortgage business or real estate agent may be able to do this for you! if you decide to do this yourself please get a tri-merged credit report with credit scores! If you have the credit report then you can fax everything over to our office for processing. However if you do not, then you will need to send it all by mail to my office!
7) Fax or mail the 1003 loan application, Form 101, Form 102, Form 103 and the credit report or fee for the credit report if you want my office to pull this for you!

2. If they come back qualified from our investors, I will give you a fax or e-mail with the details of the financing structure.

3. You then find homes for sale by owners yourself or through realtors, and the buyer also finds some homes based on what they are qualified at for financing. We are looking for homes to purchase in the 80 to 90% of appraisal price range to flip! If we also have some homes under contract we can show them these homes also. The best way is to take what the buyer is looking for and give these criteria to a realtor and let them print out a list of homes that the buyer can visit. Let the realtor show the homes to the buyers and have the buyers and realtor do the legwork for you. Make sure that the buyers narrow the list down to 4 homes. Remember you must control the deal as best as you can! Also if you own property yourself or have some under contract you also use our program to get the buyer into the property. **Note: if you can buy lower than 80 to 90% of appraised value so be it! More profit to you and I!**

4. If the buyer visits the homes either themselves or through a realtor, and then call and tell us they like the home they looked out and wish to buy it we then enter into step 5. It might be a good idea to accompany the buyer when you visit the homes and get their impression firsthand!

5. If then buyer indicates they like the home and are interested in buying it, we approach the seller and try to negotiate to buy the home for 80 to 88% of appraisal. Please see example offers in Form 114 to see what a typical offer looks like that I use daily. If an offer cannot be negotiated by the Associate Investor at the 80 to 88% of appraisal area, we can then offer to assign our buyer over to the seller for a seller assist transaction by executing an assignment using Form 105. This assignment of course, is only used if the buyer expresses the desire to purchase the property. If the seller wants to sell to us for an all cash offer of 82 to 88% of appraisal we have the seller enter into a seller non-circumvent agreement Form 106 and put an Agreement to Purchase Contract Form 107 on the property. This contract allows us to show and advertise the home even if the buyer does not close on this home. It also is an option type contract that obligates neither the seller to sell nor us to buy respectively. If a realtor is involved we have the realtor place the offer via this option type contract and inform the parties that we have a buyer and we will be offering owner financing once we pay cash for the home if we can swing a deal. We also need a property disclosure Form 108 filled out, and if the home has been built before 1978, a pre-1978 lead disclosure Form 109. Also to protect

everyone involved in the transaction I now require a disclosure form that is to be signed by both seller and buyer. This form discloses how we flip a home to our end buyer! Fill out Form 110 Disclosure and have the seller sign this form at this time.

6. If you have decided that a Seller Assist is the only way we can help the seller, then at this point besides the Assigning over our buyer if possible, which in most cases will not happen (seller has to find their own buyer but with owner will finance terms we provide they will find them fast!), you will simply tell the seller you can help them by consulting with the seller on how to structure an owner will finance deal that my company will cash out at closing! When you consult with this type of seller and deal you can give out the booklet "How to Sell your Home in Two Weeks" Form 111 and also the 22-step plan of action Form 112 to get them started. Again you are the main person involved in your area so you will have to e-mail me or fax me if you need further details at anytime to help you get this type of transaction closed. I prefer e-mail or fax for general questions to save both of our long distance charges and only phone if you really need to speak to me right now! ☺ you will also need to leave a few 1003 loan applications for the sellers use and explain the need to collect a credit report fee from their buyers. Have them read the booklet How to Sell your Home in Two Weeks. You may want to read this booklet yourself to familuarze yourself with a seller assist deal.

7. We then have the buyer decide again about the home and if they want it we have them enter into an agreement to purchase contract Form 113, with us for the full appraised value if we are flipping the property to them or we assign our buyer over to the seller for an assist transaction. At this point regardless of which contract we use with the buyer they will need to put down 1% of the appraised resell value of the home. This check should be made out to the title company you are using in your area. **Never take an earnest money check in your name!** If the buyers want to sign a formal purchase contract at this time by all means do so if we are going to flip the home to them! **(Note: the informal contract gives the buyer time to think about the deal over a few days time!)** For an assist there is no need to sign a formal purchase agreement as the buyer and sellers will sign their own formal purchase contract together. If we are flipping the property to the buyer after they think about the deal and have previously signed the Agreement to Purchase contract they will need to sign a formal purchase agreement. At this point another check from the buyer for the appraisal amount of $350 should be made out to the seller you are buying the home from. The reason you are doing this is we told the seller they would be reimbursed for the appraisal when they order it! At this point we can now go into a formal purchase contract with the seller because the buyer has committed to us by signing the formal purchase contract, submitting an earnest money deposit and a check for the appraisal. Remember that earnest money checks are usually for 1% of the sale price with the balance of the down payment to be presented at closing by cashier's check from buyer. Additional forms to fill out with buyer at this time are the property disclosure Form 108, pre –1978 lead disclosure (If the home was built before 1978) Form 109, and the Disclosure for Flips (This form was originally signed when you met with the seller and now just requires the buyers signature) Form 110.

8. Seller or you order appraisal at this time, which can be paid by COD. Please see appraisal for details on how to order.

9. All forms and documents that we use to complete the transaction are signed and turned into the title company for closing. We also need the following for final processing from our investors; 1) A fully completed Note Purchase Information Sheet Form 118 2) All documents listed on Form 119 Submission Requirements New-Note 3) Completed Mortgage Purchase Agreement Form 120. After final approval by our funding sources and due diligence, closing can occur 14 days later.

Here is a sample of the ad's we place to find buyers and motivated sellers Note: Insert your name and telephone number in the ads!

I BUY HOMES Paying up to 90% of Appraisal Sam 555-1212	**Need to Sell Your home?** Have my written offer in 24 hours John 555-1212

Owner Financing
Homes in all areas. Small down.
Problem credit OK.
Paul 333-8989

Turned Down for a Mortgage?
Private investor can help.
Credit/Income solutions
Dr. Sam 444-8989

Selling Your Home Yourself?
Exclusive Financing System
Nets 100% of Appraisal
Sammy 555-1212

Need a Fast Home Sale?
Net 100% of Appraisal at Closing
Sue 444-5678

Buyer qualification General Guidelines to use the Owner Finance Program for Home Ownership.

Series 2000 Mortgage Note Purchase Program

(Please note! Our main business is purchasing mortgage notes that the seller is creating on the property being sold. **We do not originate loans!** There has been some confusion as to this aspect of our business. We do offer an origination type program called the Series 4000 but this is for hard to finance people and it requires a full documentation compared to the requirements for simple note purchases. ***Never make any promises to buyers or sellers as to whether they will qualify for our financing! If you do I promise that it will come back to haunt you from an irate seller or buyer! Just be honest and tell them always exactly how it is! If you must use a third party to blame it on, then blame our investors who are sooooo picky…get the idea?***

The following guidelines must be met for our investors to consider a mortgage note purchase. There are **no exceptions** to these requirements. Please follow the guidelines for the best chances for us to fund your deals!

- **We will only look at sales prices from $50K to $500K**
- **This program will work in all states and cities except Alaska, Hawaii, Baltimore, Philadelphia, and St. Louis**
- Credit scores 520 to 720+ may qualify for Series 2000 consideration
- Charitable gift funds are allowed for the entire down payment (Proof is needed)
- Borrower may use gift funds, or credit card funds, or loans for the down payment
- Income to debt ratios 50 to 55%
- Income for buyer must be at least $1,500 per month. Some require VOE and some only are stated income, the credit scores determine this requirement.
- All programs require a VOR if the buyer is renting a home, **no exemptions!**
- On the job for 12 months, same line of work for 1 year (exceptions can be made)
- Seller may pay all closing costs
- Credit report must show at least 2 paying accounts
- Down payment and closing costs equal 8% of selling price (5% down payment, 3% closing costs) except when the credit score allows no money down deals!
- Are free of judgments and tax liens
- Bankruptcy discharged at least 2 years with a minimum of 3 years on other programs
- $32.00 for credit reports, **payable in cash or money order only**! (If buyer does not have their own! If buyer has their own it must have the three tri-merged credit scores on it. **No exceptions!)**
- Signed 1003 loan application required on all applications

- An appraisal with full interior photos will be required on all homes under consideration for purchase. (Please see appraisal requirements below. There are **no exceptions** to this requirement)
- Co-borrowers accepted

Series 4000 Loan Origination Guidelines Credit Scores 520+

(Full documentation will be required from buyer, **no exceptions!**. To flip property under this program will require a special technique that is proprietary information to **Carden's Capitol Solutions** and only will be shared if a 50/50 profit split agreement is in place with investor and agreement to not reveal this information to others is signed by Associate Investor.

- 12 months seasoning of ownership required to resale property under this program
- Seller must agree to pay 6 points of the sales price towards buyers loan origination if needed!
- Seller will always pay to Carden's Capitol Solutions a 2% discount on 1st lien note to use this program
- Buyer can also pay 4 of the 6 points of the sellers origination points
- Seller can contribute an additional 6% towards closing fees
- ***Some cases could result in no down payment for better credit scores***
- Copy of most recent bank statement showing down payment and closing funds
- Copy of last two years W-2 forms or last two years signed tax returns if self employed and business profit and loss statement last two years
- Pay stubs covering most recent 30 days employment or verification of employment (N/A for self employed)
- Completed 1003 credit application including property address
- Copy of buyers last 12 months rent cancelled checks front and back
- Credit scores in **the 530 area** will most likely qualify for the 85/10/5 or 85/5/10 program
- Credit scores in **the 550 area** most likely will qualify for the 85/10/5 or 85/15/0 program (notice that this last program could qualify for a no money down deal!)

Non-Owner Occupied Guidelines

1 to 4 unit Non-Owner Occupied Guidelines

- Credit score 650+ may qualify for the 85/10/5 program
- Credit score 595 to 649 may qualify for the 80/15/5 program

Commercial Transactions

5-100 units and mixed use

- Credit score 700+ 70/25/5 program
- Credit score 640 to 699 65/30/5 program
- Credit score 600 to 639 60/35/5 program
- Credit score 550 to 599 55/35/10 program

Note all programs can be tailored either for the better or the worse depending on other factors such as income, credit scores, co-borrowers, gift funds, etc. All qualifications are based on our investors underwriting criteria and all pre-qualifications are on a case by case basis.

Most of our loan products do not require the following that most conventional mortgages do!

- **No written income verification**
- **No verification of assets**
- **No verification of rents**
- **No written employment verification**
- **No PITI reserve requirements**
- **No private mortgage insurance (PMI)**
- **No survey**
- **No termite policy**

- **No points to buyer**
- **No down payment seasoning**
- **Debt ratios up to 50-55%**

All submissions must include the following to start the pre-qualification process:

1. **Completely filled out 1003 loan application with signatures**
2. **Tri-merged credit report ($32-$64 cash or money order if buyer has no access to credit report)**
3. **Fax to 313-892-0328**

If buyer qualifies under our investor guidelines, a letter of intent indicating the LTV, Terms and interest rate will be issued. In addition requested documents will accompany this letter that must be included in the final package to processing for a closing to be scheduled.

If buyer does not qualify under the Series 2000 program then additional documents will be needed to send in to underwriting to try and qualify the buyer under the Series 4000 program.

Series 2000 Note Purchase Rates

(Note Sale) Effective 12/20/01

1. Three file merged credit report with all three risk scores required for pre-approval.
2. No Mobile homes
3. The Fair Isaac/Experian Score is used for this program.
4. Notes amortized for 360 months
5. Closings in 5 Days.
6. Funds arrive same day Seller closes.
7. No pre-payment penalties
8. Sales range 50K to 500K
9. Program not available in Alaska, Hawaii, Baltimore, Philadelphia and St. Louis
10. Property Type SFR - O/O

FICO Score	1st Lien	2nd Lien	Down Payment	Rate	Conditions
(A+)720 +	90%	5%	5%	09.50%	Stated and VOR - 0x30x12
	85%	10%	5%	10.00%	Stated and VOR - 0x30x12
(A) 650-719	90%	5%	5%	10.50%	Stated and VOR - 0x30x12
	85%	10%	5%	10.00%	Stated and VOR - 0x30x12
(A-) 600-649	85%	10%	5%	11.00%	Stated and VOR - 0x30x12
	80%	15%	5%	10.50%	Stated and VOR - 0x30x12
(B) 560-599	80%	15%	5%	12.00%	Light Doc/VOE/VOR - 1x30x12
	75%	20%	5%	11.50%	Light Doc/VOE/VOR - 1x30x12
(C) 520-559	70%	25%	5%	12.50%	Full Doc/VOE/VOI/VOR - 2x30x12

	65%	30%	5%	12.00%	Full Doc/VOE/VOI/VOR - 2x30x12

- Owner Occupied 2-4 Units, Condos and Town homes subtract 5% from above LTV's.

Non-Owner Occupied SFR, 2 to 10 Units, Condo's and Town homes

720 +	85%	10%	5%	10.50%	Stated and VOR or VOM - 0x30x12
	80%	15%	5%	10.00%	Stated and VOR or VOM - 0x30x12
650-719	85%	10%	5%	12.00%	Stated and VOR or VOM - 0x30x12
	80%	15%	5%	11.50%	Stated and VOR or VOM - 0x30x12
600-649	80%	15%	5%	12.00%	Stated and VOR or VOM - 0x30x12
	75%	20%	5%	11.50%	Stated and VOR or VOM - 0x30x12

- Debt to income ratio max. 40%. Provide copy of most recent bank statement
  (3 months reserves required)

- **Cash Out Percentages for Associate Investors**
- A+, A and A- products are cashed out at 95% with minimum discount of $3000
- B and C products are cashed out at 90% with a minimum discount of $3,500
- Non Owner Occupied products are cashed out at 90% with a minimum discount of $3000

Job Time Requirements and Bankruptcy Discharges

- A+ and A products require minimum 1 year same job. Minimum 3 years, bankruptcy discharged.
- A- products require minimum 2 years-same job. Minimum 2 years bankruptcy discharge.
- B products require minimum 2 years-same job. Minimum 2 years bankruptcy discharge.
- C products require minimum 3 years-same job. Minimum 2 years bankruptcy discharge.

All full appraisals must include interior photos!

Appraisals

State Certified Appraisals are now acceptable with a BPO (Broker Price Opinion Appraisal). The BPO provides a value range for your subject property. The middle range of value on the BPO **must be within 10% of the sale price** of your subject property. This solidifies the value of the subject, which is critical to all RE transactions. (You may still use the national companies we've been using for years, but a BPO will still be necessary.)

You may use any reputable appraisal firm when ordering appraisals. Be sure the appraiser is state certified and licensed. In addition to the appraisal you must also have a BPO. **Order the BPO directly from TD Services at 314-605-3254. We do not accept BPO's from any other company.** (BPO typical cost is $100 or less) If you would like **Carden's Capitol Solutions** to order the BPO, include a $100 money order or cashier's check when submitting your package

Another option is to order your original appraisal through the same company that will be doing the BPO! This will almost assure the BPO will support the value of the appraisal!

The national company to use is: TD Services: 314-605-3454.

New Note Appraisals

Appraisals for new notes are to be full appraisals with interior and comparable photos.
Appraisal when completed can be sent directly to **Carden's Capitol Solutions**, seller or you.

- Appraisal is ordered in the name of the seller who is the lender for the transaction.
- When ordering appraisal indicate you need an appraisal to determine current market value.

Please Note, Very Important!
It is extremely important not to let the appraiser know how much you're purchasing the property for if you're flipping it. This is a question the appraiser will most likely ask you. In many cases an appraiser will use the sale price of a property as a strong indicator of market value. If you're purchasing the property at a discount due to a distress situation, you don't want your low purchase price to influence the appraiser. **Simply tell the appraiser the reason for the appraisal is to determine the current market value**, which will most likely end up being the sale price! This is the absolute truth as you're resale price will be the full appraisal value in most cases.

Existing Note Appraisals

- Appraisals for existing notes are to be Drive-By Appraisals with comparable photos.
- Appraisal when completed can be sent directly to, seller or you.
- Appraisal is ordered in the name of the seller who is selling the existing note.
- When ordering appraisal indicate you need an appraisal to determine current market value.

Buyers information sheet on the points you want to cover with your buyers

- We are private investors that arrange to pay cash for the home of your choice and owner finance it back to you. Because we pay cash we can negotiate the seller down off the asking price and make a small profit in the process.
- After the paperwork is filled out, we will send this information to our investors and determine what they will fund for you.
- You will need to purchase a title policy, a hazard insurance policy, when you are settled on a home.
- When you find a home that you like either from our list of homes or the ones you find yourself, I will then have you sign an informal purchase agreement for the home. This contract can be cancelled before the formal contract is drawn up which will allow you to sleep on it before you make your final decision. If the home is not for you we simply cancel the contract and move on to the next one.
- We may have to carry a second note on the property because the investors might not want to risk all the price of a home on someone with credit problems. But that is what I do, do this is not a problem. It is just something to be aware of.
- Once we go into a formal contract either with us or with the seller for the home, you will need to make out 2 checks, one for the appraisal ($350), and an earnest money deposit of ($1,000). The earnest money check is made out to the title company, and the appraisal check is made out to the seller.
- At closing you will bring in the rest of the down payment. You will also have to purchase a hazard insurance policy on the property.
- A 1003 credit application and non-circumvent agreement will be filled out also. The non-circumvent basically prevents you from going around us, and dealing directly with the seller. Unfortunately we have had sellers try to do this and we have to now protect ourselves from this problem.

Information Sheet for FSBO Seller Meeting (This form will refresh you as to the points you want to cover with your seller)

- Explain to seller we buy homes and then owner finance them to our pre-approved buyers.
- Our buyers are past credit problem people that have been turned down for regular mortgages but they make great credit risks for our investors. Our investor group provides the cash to my company to buy your home, and as security for this money we assign the owner carried financing with them as security.
- We are not real estate agents so to show a home to my buyers we must have some type of agreement to purchase the home in place with you. We use a Purchase Agreement that basically allows us to agree on a set price for the property subject to a more formal contract being drawn up. The agreement does allow you to cancel it at anytime if you find a buyer before we do.
- The purchase agreement does not tie either you or us to consummate the transaction until a formal one is drawn up. But the agreement does allow us to show the home to our buyers and to buy the home at a set, agreed upon purchase price should we find a good buyer for the home.
- If our buyer wants the home we will then enter a formal purchase agreement with you as we have already entered a formal purchase contract with our buyer.
- We usually receive $1,000 in earnest money from our buyers and this amount will be placed at the title company used for closing the transaction.
- At this point after the formal contract is signed, you will then order an appraisal on the property but our buyer will pay for this appraisal. (**Under our special seller assist program if you are using this program to sell your home, we would assign our buyer over to you and then you and the buyer would proceed to a formal contract between the buyer and you).**
- At closing the investment group will wire funds to the title company and you are cashed out.

Remember, if you have a mortgage payment, everyday that you hold onto the property you have to pay to keep the mortgage current. Also if you use a real estate broker you will pay 6% commission plus 2% closing fees and 1% in ad costs you will net about the same as we are offering you right now to close your home sale. 60% of For Sale by Owner homes end up listing with real estate agents. Now you can

avoid this problem by going with the offer you have from us. We encourage the use of an attorney to oversee what we are offering you if you so desire!

- We encourage that when we arrange a showing to our buyers that you remain in the home for security reasons and answer any questions they may have about the home. However, we ask that you do not discuss any financing arrangements that you have with us. **(Note if this is a seller assist transaction then you will be answering questions about the financing!)**

Remember we never offer the suggestion of a second note on the first offer, build up to it as rapport is established with the seller. We really only need a second note if we cannot find a buyer that qualifies for our 90/10 program. (90% first lien, 10% cash down) Remember that building rapport with the seller is very important and first impressions count! The seller will be more receptive to a second note offer after some time has passed!

The interesting thing about the informal purchase agreement in place on the sellers home is that it allows advertising and showing buyers the home until the sellers sell the home. We also tell the seller if they decide to list with an agent to keep us off the name on the contract with the broker so that if our offer is better than what the agent brings in, they can sell to us and save the 6% commission.

Closing the Transaction

After the purchase contracts are turned into the title company and all forms, disclosures and documents are turned into processing for examination by our investors, 14 to 20 days later the transaction will be finished.

Note: all assignments should be notarized.

The Forms and Paperwork Section

Forms used to pre-qualify buyers (Click on blue hyperlinks to go to the form!)

1. Fully filled out 1003 Loan Application (I have a filled in example for all Associate Investors. Also this form can be downloaded from my website at www.FsboFinancingSolutions.com)
2. Form 101 Buyer Worksheet
3. Form 102 Buyer Non-Circumvent Agreement
4. Form 103 Proposed Deal Cover Sheet
5. Form 104 Good Faith Estimate for Buyer

Forms used after pre-qualification approval

1. Form 105 Assignment Form (Used to assign buyer over to seller if we do an assist)
2. Form 106 Seller Non-Circumvent Agreement
3. Form 107 Agreement to Purchase from Seller
4. Form 108 Residential Real Estate Disclosure Worksheet
5. Form 109 Pre-1978 built Lead Disclosure Form
6. Form 110 Disclosure Form for Flips
7. Form 111 How To Sell Your home in 2 Weeks Booklet
8. Form 112 Seller Assist 22 Step Plan of Action Handout
9. Form 113 Agreement to Purchase Real Estate from Buyer
10. Form 114 Example Offers
11. Form 117 Option Agreement for Sellers that will allow us to tie up their home for a period of time
12. Form 118 Note Purchase information Cover Sheet
13. Form 119 Submission Requirements New Note
14. Form 120 Mortgage Purchase Agreement New Note

Forms used to purchase existing notes

1. Form 121 Quote Worksheet Existing Note
2. Form 122 Mortgage Purchase Agreement-Existing Note
3. Form 123 Submission Requirements Existing Note
4. Form 124 Mortgage Estoppel Certificate
5. Form 125 Payment History Verification Form
6. Form 126 Lottery Winnings and Annuity Worksheet
7. Form 127 Closing Cost Estimate-Existing Note
8. From 132 Letter to Quote Bid to Note Seller

How to Purchase Existing Mortgage Notes

1. An existing mortgage note is created when a seller sells a property and provides owner financing to the buyer. The transaction will have already closed and the seller will have begun to receive the monthly payments as outlined in the mortgage note.

2. Mortgage notes having less than seven payments made are considered to be a new note. When dealing with this type of mortgage note, we must have credit scores on the buyer above 595 to be able to

bid on the note. After the seventh payment is made credit becomes less of an issue and we can bid on the note with scores down to 520. The note is considered seasoned after the seventh payment is made.
3. To learn how much you can purchase an existing mortgage note for is very simple. You must obtain the terms and conditions of the sale and note from the note seller. Have a quote worksheet Form 121 in front of yourself when speaking to the potential note seller. Ask the seller all the questions that are on the quote worksheet. Flow from one question to the next. This will give the impression to the note seller they are speaking to someone that knows their business. When you have all the information requested on the quote worksheet, fax it to our office. You may also submit via e-mail.
4. **Carden's Capitol solutions** will then fax or E-mail to you a pay price based upon the information provided. The pay price figure is a wholesale quote to you. This is the amount we will pay for the existing note. (Wholesale means the seller is responsible for closing fees, not you or us.
5. You can verbally quote the seller, fax the information or mail it. If seller is happy with the quote and wants to proceed you will need to document the quote. Use Form 132 to present this quote to seller!
6. Your final quote figure must be put onto the Mortgage Purchase Agreement – Existing Note Form 122 and signed by my company as the as the Purchaser. This agreement tells the note seller exactly how much you are going to pay for the note. (The note seller must notarize the form.

6. Provide the note seller with the Mortgage Note Purchase Agreement- Existing Note Form 122 for execution along with:

- Closing Costs Estimate Existing Note Form 127
- The Mortgage Estoppel Certificate – Form 124 (requires notary)
- The Payment History Verification – Form 125 (requires notary)
- The Submission Requirements Existing Note – Form 123

8. The seller must provide you with all the requested items on the Submission Requirements Form 123. After receiving all items, **send two copies** of all documents to Carden's Capitol solutions. When your complete package is received processing will begin. Closings on existing notes generally take approximately 10 business days from receipt of complete package. If any additional information is needed you will be contacted by us.
9. Upon processing's final approval, closing will be scheduled with the closing agent for the seller. At closing the seller turns over all original documentation (Note and Mortgage or Deed of Trust) to closing agent. Funds are then wired to the closing agent's bank and upon arrival are dispersed to the note seller.
10. The closing agent sends the original documents to our underwriters. Upon their receipt your commission check is sent to us and we will send your half of the profit to you. This generally occurs within 72 hours of disbursement.

How to Purchase Lottery Winnings and Annuities

Lotteries: When someone wins a lottery they have an opportunity to receive a lump sum payment or receive payments over a period of 20 to 30 years in most cases from the State. When the winner chooses to receive a lump sum the State discounts the winning amount by 50% in most States. This puts the winner in a position to make a tough decision. When the decision is to receive the annual payments, the winner has the option of selling off some or all of the future annual payments to raise enough cash for whatever their needs are. You are in a position to purchase these future payments. The amount that can be paid for this type of cash flow is regulated in most States. Purchase yields will depend upon the number of payments being sold and the State the winnings are in. Your job with an opportunity like this is to complete the Lottery Winnings and Annuity Worksheet Form 126 and fax to our office. Upon receipt, our underwriting department will contact the seller to verify intent. After that you will receive a call from underwriting to inform you of the sellers intent. From that point underwriting will complete the negotiations with the seller. If seller agrees to the offered purchase price a closing will then be scheduled. You will receive your commission check from Carden's Capitol solutions after we receive the entire original closing documents back from the closing agent. Typically this takes approximately 2-3 days after closing occurs.
Annuities: When a person wins a lawsuit for injuries sustained in an accident the winnings are many times paid out over a period of time. The losers insurance company creates an annuity for the value of the victim's winnings. The future payment stream created for the victim can possibly be sold by the annuitant to raise a lump sum of cash rather than waiting for the scheduled payments. Purchasing

annuities is highly regulated from state to state and before a quote can be generated underwriting must interview the annuitant and examine the annuity documents. The procedure for you is the same as the procedure for lottery winnings. Complete the Lottery Winnings and Annuity Worksheet Form 126 and fax to our office. The annuitant will be contacted first and then you. The closing procedure and issuance of your commission check is also the same as the lottery procedure.

Marketing Forms

1. Form 116 Realtors Brochure (to use our Seller Assist system for their listings and investors)
2. Form 115 Mortgage Brokers Brochure (to use our funding for those hard to fund buyers)
3. Form 111 FSBO Sellers (use this booklet on FSBO doors to solicit seller assist business)
4. Form 128 Letter to Real Estate Attorneys
5. Form 129 Letter to Personal Injury Attorneys
6. Form 130 Letter to Accountants
7. Form 131 Letter to Title Companies
8. Form 132 Letter to Present Bid to Note Seller

Market our services to your local professionals above for increased profits! Use the forms on your letterhead to give yourself an increased presence in your area. Remember the more people that use our service the more you make!

Carden's Capitol Solutions
PO Box 663
Phone/Fax 205-819-1694/734-661-2743
For Sale by Owner Real Estate Financing Specialists
E-mail cashoutfunds@charter.net

Form 101

We offer Owner Will Finance terms. What we do is purchase the home of your choice with our investor funds and owner finance it to you with a 30-year mortgage. As a result we need you to answer the following questions so we can qualify you to our investors who ultimately fund your home purchase. All questions asked will be kept in strict confidence and will not be shared with anyone except our investors for qualification determination.

Borrower: _____ **Co-Borrower:**_____

Age: _____ **S/S#**_____ **Age:** _____ **S/S#**_____

Current Address:_____ **Current Address:**_____

City/State/Zip:_____ **City/State/Zip:**_____

Phone Number:_____ **Phone Number:**_____

Borrower Work #:_____ **Co-Borrower Work #:**_____

Are Borrowers Married? Yes_____ No_____ (Unmarried buyers must have individual credit pulled, $32 each)

(Previous address if you have lived at the present address less than two years)

Address:_____ **Address:**_____

City/State/Zip:_____ **City/State/Zip:**_____

Borrowers Employer:_____ **Co-Borrowers Employer:**_____

Length of Employment:_____ **Length of Employment:**_____

Employment Position:_____ **Employment Position:**_____

Monthly Income:_____ Monthly Income:_____
_____

(Previous employment if less than two years at present employment)

Borrower:_____ Co-Borrower:_____
_____

From/To:_____ From/To:_____
_____

Income:_____ Income:_____
_____

We understand and work with credit problems. However we expect to receive payments on time and will check you credit history. Please answer the following to the best of your knowledge.

_____Excellent _____Good _____Fair _____Bad

Collection accounts must be closed and settled, no pending repossessions, bankruptcies settled one year, no pending foreclosures and judgments against you or co-borrower. If you have any of these problems they must be settled before we can process your loan request. If you are sure that none of the above exist then proceed filling out this application. (*Note: that we now have some programs that work with judgments and some low collection accounts; these are determined on a case by case basis).*

How much money have you saved for the down payment?_____
_____
How much can you raise before closing?_____
_____

Other sources of income _____
_____

Total monthly bills per credit report _____
_____

Number of children _____ Pets _____

Other sources for down payment: Relatives, employer loan, 401k plan, credit cards, assets that can be sold, whole life insurance policy to borrow from.

If your credit is good we do have programs that might allow you to enter home ownership with grant funds or no down payment. However if your credit is bad and you have no down payment, then please answer the following questions.

1. **Do you have friends or relatives that will give you the money? Yes___ No____**
2. **Can you sell something to get the money? Yes___ No____**
3. **Can you use your credit cards for the down payment? Yes___ No____**
4. **Can you borrow from your 401K plan at work? Yes___ No____**
5. **Do you have an insurance policy you can borrow on? Yes___ No____**

What is the most you can afford in a monthly house payment?_____

When would you like to move into a home?_____

What area of the state would you like to move into?_____

How many bedrooms?_____ **Bathrooms?**_____

What other rooms or features do you need?_____

What area of the city must you live in? _____

What is the price range that you are looking for? _____

Do you have a home selected? _____

How soon would you like to move? _____

Please note that the following must exist to even consider a person for a home:

- **We will only look at sales prices from $50K to $500K**
- **This program will work in all states except Alaska, Hawaii, Baltimore, Philadelphia, and St. Louis**
- Credit scores 520 to 720+ may qualify for Series 2000 consideration
- Charitable gift funds are allowed for the entire down payment (Proof is needed)
- Borrower may use gift funds, or credit card funds, or loans for the down payment
- Income to debt ratios 50 to 55%
- Income for buyer must be at least $1,500 per month. Some require VOE and some only are stated income, the credit scores determine this requirement.
- All programs require a VOR if the buyer is renting a home, **no exemptions!**
- On the job for 12 months, same line of work for 1 year (exceptions can be made)
- Seller may pay all closing costs
- Credit report must show at least 2 paying accounts
- Down payment and closing costs equal 8% of selling price (5% down payment, 3% closing costs) except when the credit score allows no money down deal!
- Are of free judgments and tax liens
- Bankruptcy discharged at least 2 years with a minimum of 3 years on other programs
- $32.00 for credit reports, **payable in cash or money order only**! (If buyer does not have their own! If buyer has there own it must have the three tri-merged credit scores on it. **No exceptions!)**
- Signed 1003 loan application required on all applications
- An appraisal with full interior photos will be required on all homes under consideration for purchase. (Please sees appraisal requirements below. There are **no exceptions** to this requirement)
- Co-borrowers accepted

Formula to determine maximum home price. (Note: you will figure this out as shown by example)

MB/MGI = ? - .50 = ? x (-MGI) = PITI (amount of PITI that the buyer can afford).

Example 500/4000 = .13 - .50 = -.38 x (-4,000) = 1,500

PITI -TI2 = MP x 100 = the home price buyer can afford

Example 1,500 - 300 = 1,200 x 100 = $120,000 in this example

MB = monthly bills **MGI = monthly gross income** **PITI = principal, interest, taxes and insurance**
MP = monthly payment **TI = taxes and insurance** **TI2 = TI + 2nd lien amount**

We will need you to fill out a formal 1003 loan application and collect from you $32/$64 (cash or money order) for the credit report(s). It takes 72 hours for a determination and then we will know either way if you qualify for any of our programs.

We make no promises to you that you will qualify for any of our programs, but we will try our best to get you into a home if possible. The credit report fees are non-refundable should you be denied a loan from us. By signing below you agree to all the terms and conditions in this application.

_____ Borrower

_____ Co-Borrower

_____ Date

FORM 102

NON-CIRCUMVENT AGREEMENT
(BUYER)

THIS AGREEMENT is made and entered into on _____, by and between

_____ (1st Party) and

_____ (2nd Party).

WHEREAS, 1st Party has certain homes under contract to purchase and will show the home to 2nd Party for possible purchase from the 1st Party.
WHEREAS, the 1st Party has expended expense, time and effort into both finding and negotiation of said homes and in finding the 2nd Party.

NOW THEREFORE, the 2nd Party agrees not to circumvent the 1st Party by entering into any agreement with the owner of title of any homes currently under contract by the 1st Party for a period of 24 months without written agreement from the 1st Party.

PENALTY FOR BREACH If this agreement is breached by the 2nd Party, and not corrected to the satisfaction of the 1st Party, it is agreed that an amount of the profit loss suffered by the 1st Party shall be paid by the 2nd Party to the 1st Party.
Signed this_____ day, month of _____, 20_____

_____1st Party

_____1st Party

SS number _____ Phone number_____

_____2nd Party

_____2nd Party

SS number _____ Phone number_____

CARDEN'S CAPITOL SOLUTIONS
Form 103

PO Box 663 Cottondale, AL 35453
Phone/Fax205-819-1694/734-661-2743
For Sale by Owner Real Estate Financing Specialists
E-mail cashoutfunds@charter.net

Fax this completed form along with tri-merged credit report with credit scores or money order for us to pull credit and 1003 loan application to: 313-892-0328 for fast pre-qualification of your buyer. Please allow 72 hours for determination!

Buyer Pre-Qualification Worksheet

Name **Carden's Capitol Solutions** **Date**_____

Phone 205-819-1694 Fax 734-661-2743

Are you working with: _____Seller _____Buyer _____Flipping

Where did you find: Seller_____ Buyer_____

If working with buyer: Buyer has home selected? _____ Yes _____ No

Is buyer in contract? _____ Yes _____ No

If flipping: Have you located willing seller? _____ Yes _____ No

Are you in contact to purchase? _____ Yes _____ No

If flipping purchase price $_____

Buyer's purchase price $_____

Down payment buyer is working with $_____

Property type: _____ SFR _____ Duplex _____ 3-4 Unit _____ Condo/Townhouse _____

Doublewide Mobile _____ Non-Owner Occupied

Will the property be: _____ Owner Occupied _____ Non Owner Occupied

Buyers Name _____

Buyers source of down payment _____

Comments:

Form 104

Preliminary Good Faith Estimate – New Note

The information provided below reflects charges you will incur at the settlement of your real estate purchase. The fees in section one are set fees unless otherwise indicated. Other charges that may apply are in section two. Exact charges for Section II items can be obtained from Title Company/Attorney closing the transaction. At closing you will be issued a HUD-1 Settlement Statement indicating the actual costs for the transaction.

Section I:

Document Preparation - first lien only	
Tax Certificate - ordering, retrieval and review	
Agent Certification - ordering, retrieval and review	
Insured Protection Letters - ordering, retrieval and review	
Title Commitment - ordering, retrieval and review	
RESPA Doc's - if required	$550.00
Flood Certification	$ 35.00
Processing Fee	$275.00
Courier Fee	$ 50.00
Wire Fee's	$ 50.00
Total Fixed Charges	$960.00

* If Real Estate Annual Tax Verification service is necessary add $60.00 (you will be notified if applicable)

Section II

Appraisal	$300.00 (varies depending upon property location)
Hazard Insurance (1yr. pre-paid)	$300.00 (varies depending upon property value)
Mortgage Assignment Fees	$ 30.00
Mortgagees Title Insurance Policy	$300.00 (varies depending on mortgage amount)

Misc. Title Co. Charges	$ 50.00 (varies)
Recording Fees	$ 35.00 (varies)
City/County/State Tax Stamps	$200.00 (varies upon respective tax rates)

* *If property is in Flood Zone, Flood Insurance will be required
This is a preliminary estimate and is provide for Buyer(s) information with regards to possible costs in a real estate transaction. These costs are based upon an owner financed note sale transaction with the Seller providing originating financing for the Buyer(s).

Form 105

ASSIGNMENT

For consideration of $10.00, cash paid in hand, I, _____ (Grantor) hereby grants, bargains, sells, assigns, transfers and sets over all rights that Grantor holds in the following described property

To wit:
Physical address:

_____

Legal Description :

_____and
further rights and obligations between myself and

_____
Whose address

is_____,

to Grantee
_____
whose address is

_____.

Signed this _____ day of _____, _____

_____
Grantor

_____
Grantor

State of

County of

On _____, _____ personally appeared before me
_____to
me known to be the individual(s) described in and who executed the foregoing instrument, signing same as his/her free and voluntary act and deed, for the uses and purposes therein mentioned. Witness may hand and seal hereto affixed the day and year first above written.

_____

Notary Public in and for the State of _____

My commission expires _____

Form 106

SELLERS NON-CIRCUMVENT AGREEMENT

THIS AGREEMENT is made and entered into on _____, by and between

_____ (1st Party) and

_____ (2nd Party).

WHEREAS, 1st Party has placed the home owned by 2nd Party under contract to purchase and will show the home to 3rd Parties for possible purchase from the 1st party. WHEREAS, the 1st Party has expended expense, time effort into both finding and negotiation of said homes and in finding the 3rd Parties.

NOW THEREFORE, the 2nd Party agrees not to circumvent the 1st Party by entering into any agreement with the owner of title of any homes currently under contract by the 1st Party for a period of 24 months without written agreement from the 1st Party.

PENALTY FOR BREACH If this agreement is breached by the 2nd Party, and not corrected to the satisfaction of the 1st Party, it is agreed that an amount of the profit loss suffered by the 1st Party shall be paid by the 2nd Party to the 1st Party.

Signed this_____ day, month of _____, 20_____

_____1st Party

_____1st Party

SS number _____ Phone number_____

_____2nd Party

_____2nd Party

SS number _____ Phone number_____

Form 107 TPFS

AGREEMENT TO PURCHASE
REAL ESTATE PROPERTY

In exchange for mutual promises between Buyer and Seller, both agree to the following terms and conditions.
DATE:

BUYER:
ADDRESS:

AGREES TO PURCHASE FROM

SELLER:
ADDRESS:

WHO AGREES TO SELL TO BUYER, THE PROPERTY LOCATED AT:

SALES PRICES $
PAYMENT OF THE PURCHASE PRICE IS AS FOLLOWS:

DOWN PAYMENT $
SELLER CARRIED 1ST LIEN NOTE AND MORTGAGE $

AT AN INTEREST RATE OF_____FOR A TERM OF _____ PAYMENT OF _____

SELLER CARRIED 2ND LIEN NOTE AND MORTGAGE $

AT AN INTEREST RATE OF_____FOR A TERM OF _____ PAYMENT OF _____

CONTIGNENCY: Seller must be able and allowed to sell 1st lien note at closing for $

EARNEST MONEY IN THE AMOUNT OF $
TO BE DEPOSITED WITH SELLER APPROVED TITLE COMPANY OR ATTORNEY UPON A SIGNED CONTRACT FOR SALE BEING DRAWN BETWEEN THE PARTIES.

THE CLOSING DATE SHALL BE ON OR BEFORE:

OTHER TERMS:
BUYER OR SELLER MAY CANCEL THIS AGREEMENT PRIOR TO A MORE DETAILED CONTRACT FOR SALE BEING AGREED UPON IN WRITING; BY GIVING WRITTEN NOTICE TO THE OTHER PARTY OF SUCH CANCELLATION. THIS AGREEMENT TO PURCHASE FORM DOES NOT REPRESENT A BINDING PURCHASE CONTRACT ON EITHER BUYER OR SELLER. BUYER MAY ASSIGN THIS AGREEMENT. ANY SUCH ASSIGNMENTS WILL RELEASE ORIGINAL BUYER FROM LIABILITY AND SUBSTITUTE ASSIGNEE IN HIS/HER OR ITS PLACE. SELLER AGREES TO PAY 1% (ONE PERCENT) TOWARD CLOSING COST, AND BUYER AGREES TO PAY ALL OTHER CLOSING COSTS.

_____ _____
SELLER DATE

_____ _____
BUYER DATE

Form 108

RESIDENTIAL REAL ESTATE SALES DISCLOSURE

THE PROSPECTIVE BUYER AND THE OWNER MAY WISH TO OBTAIN PROFESSIONAL ADVICE OR INSPECTIONS OF THE PROPERTY AND PROVIDE FOR APPROPRIATE PROVISIONS IN A CONTRACT BETWEEN THEM CONCERNING ANY ADVICE, INSPECTIONS, DEFECTS, OR WARRANTIES OBTAINED ON THE PROPERTY. THE REPRESENTATIONS IN THIS FORM ARE REPRESENTATIONS OF THE OWNER AND ARE NOT REPRESENTATIONS OF THE AGENT, IF ANY. THIS INFORMATION IS FOR DISCLOSURE ONLY AND IS NOT INTENDED TO BE A PART OF THE CONTRACT BETWEEN THE BUYER AND OWNER.

Seller states that the information contained in this Disclosure is correct as of the above date, to the best of the Seller's current actual knowledge.

PROPERTY ADDRESS:

The condition of the following property is:

1. FOUNDATION & STRUCTURE .....Yes____ No____ Don't Know____

a) Are there any problems with the foundation? Yes____ No____ Don't Know____

b) Are there any structural problems with the building? Yes____ No____ Don't Know____

c) Have any substantial additions or alterations been made without a required a building permit? Yes____ No____ Don't Know____

d) Are there any violations of zoning, building codes or restrictive covenants? Yes____ No____ Don't Know____

e) Are there moisture or water problems? Yes____ No____ Don't Know____

f) Is there termite, rodent or insect damage? Yes____ No____ Don't Know____

g) Is there damage due to wind or flood? Yes____ No____ Don't Know____

h) Is the property in a flood plain? Yes____ No____ Don't Know____

i) Is the property located within 1 (one) nautical mile of an airport? Yes____ No____ Don't Know____

j) Is there any threat of or pending litigation regarding the property? Yes____ No____ Don't Know____

k) Are the furnace, wood stove, and chimney/ flue in working order? Yes____ No____ Don't Know____

2. ELECTRICAL SYSTEM

a) Air filtration system Yes____ No____ Condition_____ Don't Know____

b) Burglar alarm Yes____ No____ Condition_____ Don't Know____

c) Cable TV wiring and connections Yes____ No____ Condition_____ Don't Know____

d) Ceiling fans Yes____ No____ Condition_____ Don't Know____

e) Garage door opener Yes____ No____ Condition_____ Don't Know____

f) Inside telephone wiring and jacks Yes____ No____ Condition_____ Don't Know____

g) Intercom Yes____ No____ Condition_____ Don't Know____

h) Kitchen range hood Yes____ No____ Condition_____ Don't Know____

i) Light fixtures Yes____ No____ Condition_____ Don't Know____

j) Sauna Yes____ No____ Condition_____ Don't Know____

k) Smoke/fire alarm Yes____ No____ Condition_____ Don't Know____

l) Switches and outlets Yes____ No____ Condition_____ Don't Know____

m) Amp services Yes____ No____ Condition_____ Don't Know____

n) Other Yes____ No____ Condition_____ Don't Know____

3. HEATING AND COOLING

a) Attic fan Yes____ No____ Condition_____ Don't Know____

b) Central air conditioning Yes____ No____ Condition_____ Don't Know____

c) Hot Water Heater Yes____ No____ Condition_____ Don't Know____

d) Furnace heater-gas, electric, oil, solar Yes____ No____ Condition_____ Don't Know____
e) Fireplace Yes____ No____ Condition_____ Don't Know____
f) Humidifier Yes____ No____ Condition_____ Don't Know____
g) Propane tank Yes____ No____ Condition_____ Don't Know____ Owned___ Leased___
h) Other Yes____ No____ Condition_____ Don't Know____
4. APPLIANCES
a) Vacuum system (built-in) Yes____ No____ Condition_____ Don't Know____
b) Clothes washing machine Yes____ No____ Condition_____ Don't Know____
c) Clothes dryer Yes____ No____ Condition_____ Don't Know____ Gas ___ Electric___
d) Trash Compactor Yes____ No____ Condition_____ Don't Know____
e) Convection oven Yes____ No____ Condition_____ Don't Know____ Gas___ Electric___
f) Dishwasher Yes____ No____ Condition_____ Don't Know____
g) Freezer Yes____ No____ Condition_____ Don't Know____
h) Garbage disposal Yes____ No____ Condition_____ Don't Know____
i) Gas Grill Yes____ No____ Condition_____ Don't Know____
j) Microwave oven Yes____ No____ Condition_____ Don't Know____
k) Oven Yes____ No____ Condition_____ Don't Know____ Gas___ Electric___
l) Range Yes____ No____ Condition_____ Don't Know____ Gas___ Electric ___
m) Refrigerator Yes____ No____ Condition_____ Don't Know____
n) TV antenna/Dish Yes____ No____ Condition_____ Don't Know____
o) Other
5. WATER & SEWER SYSTEM
a) Cistern Yes____ No____ Condition_____ Don't Know____
b) Septic Field/Bed Yes____ No____ Condition_____ Don't Know____
c) Hot tub Yes____ No____ Condition_____ Don't Know____
d) Plumbing Yes____ No____ Condition_____ Don't Know____
e) Aerator system Yes____ No____ Condition_____ Don't Know____
f) Sump Pump Yes____ No____ Condition_____ Don't Know____
g) Sprinkler/irrigation system Yes____ No____ Condition_____ Don't Know____
h) Water Heater-Gas, electric, solar Yes____ No____ Condition_____ Don't Know____
i) Water filtration system Yes____ No____ Condition_____ Don't Know____
j) Water softener Yes____ No____ Condition_____ Don't Know____ Type _____
k) Well Yes____ No____ Condition_____ Don't Know____
l) Public water system? Yes____ No____ Don't Know____
m) Public sewer system? Yes____ No____ Don't Know____
n) Private/community water system Yes____ No____ Don't Know____
o) Private/community sewer system Yes____ No____ Don't Know____
p) Other systems Yes____ No____ Don't Know____
6. ROOF
Age in year's _____
Are there any current leaks? Yes____ No____ Don't Know____
Is roof currently damaged? Yes____ No____ Don't Know____
Is there more than one roof on the structure? Yes____ No____ Don't Know____
If so, how many? _____
7. HAZARDOUS CONDITIONS
Are there any existing hazardous conditions on the property such as methane gas, radioactive material, radon or lead paint in house or well, or expansive soil, toxic materials, asbestos insulation, landfill, mineshaft or PCBs? If so, explain:
8. Additional comments or explanations:
Seller and Buyer hereby acknowledge receipt of this Disclosure Form by signing below:
Seller's Signature _____Date_____
Buyer's Signature_____ Date_____
Seller's Name_____ Buyer's Name _____

Form 109

LEAD DISCLOSURE STATEMENT

FOR SALE OF RESIDENTIAL PROPERTY

LEAD WARNING STATEMENT: Every purchaser of any interest in residential real property on which a residential dwelling was built prior to 1978 is notified that such property may present exposure to lead from lead-based paint that may place young children at risk of developing lead poisoning. Lead poisoning in young children may produce permanent neurological damage, including learning disabilities, reduced intelligence quotient, behavioral problems, and impaired memory. Lead poisoning also poses a particular risk to pregnant women. The seller of any interest in residential real property is required to provide the buyer with any information on lead-based paint hazards from risk assessments or inspections in the seller's possession and notify the buyer of any known lead-based paint hazards. A risk assessment or inspection for possible lead-based paint hazards is recommended prior to purchase.

SELLER'S DISCLOSURE (initial)_____
(a) Presence of lead-based paint and/or lead-based paint.
(i) Known lead-based paint and/or lead-based paint hazards are present in the housing (explain).
_____
____
(ii) Seller has no knowledge of lead-based paint and/or lead-based paint hazards in the housing.
(b) Records and reports available to the seller
(check (i) or (ii) below):
(i) Seller has provided the purchaser with all available records and reports pertaining to lead-based paint and/or lead-based paint hazards in the housing (list documents below).
_____
____
(ii) Seller has no reports or records pertaining to lead-based paint and/or lead-based paint hazards in the housing.

PURCHASER'S ACKNOWLEDGMENT (initial)_____
(c) Purchaser has received copies of all information listed above.
(d) Purchaser has received the pamphlet "Protect Your Family from Lead in Your Home."
(e) Purchaser has (check (i) or (ii) below):
(i) received a 10-day opportunity (or mutually agreed upon period) to conduct a risk assessment or inspection for the presence of lead-based paint and/or lead-based paint hazards; or
(ii) waived the opportunity to conduct a risk assessment or inspection for the presence of lead-based paint
and/or lead-based paint hazards.

AGENT'S ACKNOWLEDGMENT (initial)_____
(f) Agent has informed the seller of the seller's obligations under 42 U.S.C. 4852d and is aware of his/her responsibility to ensure compliance.

CERTIFICATION OF ACCURACY
The following parties have reviewed the information above and certify, to the best of their knowledge, that the information they have provided is true and accurate.
Seller Date Seller Date
Purchaser Date Purchaser Date
Agent Date Agent Date

GENERAL LEAD DISCLOSURE INFORMATION
(1) Lead-based paint hazards
The regulations effective October 28, 1995 shall require that, before the purchaser or lessee is obligated under any

contract to purchase or lease the housing, the seller or lessor shall--
(A) Provide the purchaser or lessee with a lead hazard information pamphlet, as prescribed by the Administrator of the
Environmental Protection Agency under section 406 of the Toxic Substances Control Act [15 U.S.C.A. s 2686];
(B) Disclose to the purchaser or lessee the presence of any known lead-based paint, or any known lead-based paint hazards, in such housing and provide to the purchaser or lessee any lead hazard evaluation report available to the seller or lessor; and
(C) Permit the purchaser a 10-day period (unless the parties mutually agree upon a different period of time) to conduct a risk assessment or inspection for the presence of lead-based paint hazards.
(2) Contract for purchase and sale Regulations promulgated under this section shall provide that every contract for the purchase and sale of any interest in target housing shall contain a Lead Warning Statement and a statement signed by the purchaser that the purchaser has--
(A) Read the Lead Warning Statement and understands its contents;
(B) Received a lead hazard information pamphlet; and
(C) Had a 10-day opportunity (unless the parties mutually agreed upon a different period of time) before becoming obligated under the contract to purchase the housing to conduct a risk assessment or inspection for the presence of lead-based paint hazards.
(3) Compliance assurance
Whenever a seller or lessor has entered into a contract with an agent for the purpose of selling or leasing a unit of target
housing, the regulations promulgated under this section shall require the agent, on behalf of the seller or lessor, to ensure
compliance with the requirements of this section. (4) Penalties for violations Penalties shall include monetary penalties, action by the Secretary of State, civil liability equal to three times the amount of damages, costs and attorney and expert witness fees.
(5) Validity of contracts and liens Nothing in this section shall affect the validity or enforceability of any sale or contract for the purchase and sale or lease of any interest in residential real property or any loan, loan agreement, mortgage, or lien made or arising in connection with a mortgage loan, nor shall anything in this section create a defect in title.

Form 110 **Disclosure Form**

1. I _____ (**Hereinafter Vendor**) and _____ (**Hereinafter Sub Vendee**) acknowledge and agree that **Carden's Capitol Solutions, its president and/or assigns (Hereinafter Vendee)** is a private real estate Investor and is buying and reselling property listed below for investment purposes. Vendor acknowledges that Vendee may rent out or resell property listed below at a later date for a profit.

2. Vendor, Sub Vendee further agrees and understands that Vendee and/or assigns do not represent any party to the transaction. All parties agree that they are acting independently and with full understanding of the real estate transaction pending. Vendor, Sub Vendee understand that the Vendee operates by placing credit report challenged, self employed, employed, or any type of entity or person that cannot qualify for a conventional, FHA, or Veterans mortgage, into homes by using Vendees access to private Vendee monies. The system used to transact business by Vendee is called a "Simultaneous Close" or "Double Escrow". In other words, Vendee enters into an option to purchase contract and/or formal purchase contract with Vendor at one price, and in turn, will assign its contract with Vendor and/or sell Vendees equitable title interest via the option and/or purchase contract to the property with the Vendor to Sub Vendee at the same and/or higher price under the same Equitable Title theory, all in one transaction at closing. Vendor, and Sub Vendee fully acknowledge that Vendee is not the owner of record in this property listed below and is selling and/or assigning to Sub Vendee, Vendees equitable title interest in a home under an option contract and/or formal purchase contract to buy with Vendor. The legal theory that Vendee is operating under is called Equitable Title and is based on the option to purchase type contract and/or formal purchase contract that Vendee has entered into with the Vendor who holds bare legal title. Vendee may also assign any contract that Vendee may have with Sub Vendee to purchase, to Vendor.

3. If Vendor, and/or Sub Vendee should default, back out of the transaction, rescind for other cause, no liability shall be imposed on Vendee in any way. Vendor and/or Sub Vendee or any party involved in the real estate transaction hereby holds harmless Vendee from any claims past, present or future that may arise from this real estate transaction. If a dispute should arise parties agree to arbitration as the sole source of dispute resolution as set forth in the formal real estate contract(s) between the Vendee, Vendor and Sub Vendee.

4. Vendor, Sub Vendee acknowledges that Vendee suggested, that an attorney should be consulted by Vendor, and Sub Vendee to oversee the entire transaction and its components.

5. Any assignments of any contract entered into by Vendee with either Vendor or Sub Vendee is without recourse to Vendee after assignment. Vendor and Sub Vendee agree to hold Vendee harmless from any further liability or obligation under the assignment(s).

_____ _____

Date Vendor

Date	Vendor
Property Address	Sub Vendee

Form 111

$29.95

How to Sell Your Home in 2 Weeks!

Have up to 5 signed offers in the next 2 weeks!

More Home Showings! More Signed Offers!

Net 95 to 100% of Appraised Price, Selling your Home Yourself!

Best program in the Nation! No mortgage brokers or real estate agents involved!

Carden's Capitol Solutions

E-mail cashoutfunds@charter.net

205-819-1694 Alabama

Services Nationwide

HOW TO SELL YOUR HOME IN TWO WEEKS

Chances are you have already encountered some of the many pitfalls in selling your home. Perhaps the first problem you encountered was listing your home with a local Real Estate agency. The agent probably had a few showings and maybe he even presented you with an offer. But it was so low you were shocked.

Three to six months later you started wondering if you weren't wasting time allowing someone to control the selling of your home without a personal and unique plan. You then realized it was time to take things into your own hands and **sell the house yourself!** It was that, or settle for a figure way below what you deserved to receive for your home.

You probably ran an ad in the local newspaper, posted a sign in the yard, and waited. There may have been a few seemingly interested responses, a few people who said they'd check into financing and get back in touch with you. Never heard from them again. You tried an open house, but only had one or two couples show up. You still have no offers!

Now what?

If this story sounds too hideously familiar, you're not alone. Thousands of people have walked this dead end path. They finally put an end to the frustration by dropping the price of their home by far too much—just to get it sold.

There is a better way! A professional real estate investor has perfected the methods presented in this booklet over many years. His extensive experience and proven techniques will make the selling of your home a **quick and painless process!**

Inside these pages is a step-by-step method to sell your home:

- **In as little as two weeks**
- **At your price**
- **Using a unique plan, just for you**
- **Using the least amount of paperwork**
- **With a company specializing in owner sold properties to assist you at every step**
- **With NO low-ball offers from buyers**
- **With up to five offers in the first week**
- **With YOU getting to select who buys your home**
- **With no showings at odd times—in fact, only two showings per week**
- **With no expensive fix-up costs.**

We help you in creating a **Seller-Financed Sale** of your home. We then step in at closing and simultaneously buy that financing from you at the closing. **We pay you cash for the owner financing you offered the buyer; and you get an easy, quick sale. You never have to collect one payment. We cash you out at closing.** We have bought Millions of dollars in owner financing in all 50 States. We will show you how to structure the note; then contract to buy that note from you at the closing

Preparing the Home

Our basic concept is: **If it can't be done for less than $500 total, don't fix or replace it!** With seller financing being offered, you will get the full-appraised value with minimal fix-up.

Just give it a good cleaning instead. We suggest you hire a professional cleaning service to give the home a good cleaning for about $100. After the cleaning decide about touch up paint or having it painted. The most important thing to have looking good outside is a clean, cut yard, and on the inside, clean and nice looking walls and ceilings. Floors and carpet don't count.

Old carpet that may be discolored and worn over time should **not** be replaced. The new carpet may not be a color or pattern that matches the buyer's furniture. In this way, **the old carpet actually becomes a selling point.** Say something like this when showing the house: "This carpet will probably need to be replaced later on. I can't replace it without passing the cost on to you. To keep your payment low it's best if you replace it yourself at a later time. That way, too, you choose a color that matches your furniture and have it done for a whole lot less than I can." Use this same approach for any problem that needs fixing or replacing. **It works!!!**

The respondents to your ad will be a totally different type of buyer than the traditional homebuyer coming in with mortgage money. They will not mind the small stuff, fix-ups, etc. They are only too glad that you will finance them.

- **Place an Owner Will Finance sign with a phone number in front of your home. Although it sometimes will, we don't depend on this sign to generate buyers, but it will help people find your home.**

- **During the showings, replace all the light bulbs in your home with 75-watt bulbs and turn them on. This gives more light in the house. Light brightens an otherwise dull looking home. Open all curtains, too. The more light the better. A darkened home looks dingy, boring, and small.**

Placing the Newspaper Ad

Our ad has pulled over 100 calls in a single week! Although the response varies, it will pull enough calls to work this system. No other ad gets this kind of response. The reason is that there is a large pool of buyers, in any city at any time, which are looking for an individual homeowner to finance them. They cannot get a regular mortgage from a bank or mortgage company for a number of reasons.

The bottom line is, **they cannot get a home without YOUR help.** Ask yourself this question: If you brought $100,000 in cash to a seller's home that you wanted to buy, could you negotiate the price down? Could you ask that everything about the house be fixed or replaced? Could **you** control the negotiations? AND, if you didn't get exactly what you wanted, couldn't you go somewhere else with your money? **Yes,** of course you could do all those things. That is why we don't want anyone who could be qualified by a mortgage company. That person has the cash, and he can do those things to you.

Now let's look at the buyers who will be answering our ad. They don't have the credit or income or time on the job or any of the many different requirements to qualify for a mortgage. **They are cash rich but credit poor**. They are coming to you for a loan and for assistance in establishing credit. They have been turned down everywhere else. They have no other choice. **You** are their only chance at getting the home they desire.

So, now it's not important that your home be the best looking house in the neighborhood. It's not important that it needs painting or fixing-up. Even the price you're asking isn't too important. They are happy just to have the opportunity to buy a home. They don't mind paying what you're asking. Although you could, you shouldn't ask for more than the appraisal value.

Now you understand why you must keep control. By screening the callers on the phone, you will only see this type of buyer at the showing.

Here Is the Hardest Hitting Ad You Can Place (Example Only)

Owner Will Carry
Small down. Problem credit, okay. 4bd, 2bth,
2,000 sq. ft. stucco home. Big kitchen, fenced,
near Grosse Pointe. $671 monthly. Owner 555-5555

We can adjust this model ad to your home. Keep the first line the same, **Owner Will Finance.** This is the attention grabber. Have this printed in bold. It filters out the buyers who have mortgage money and other time wasters. It brings only those calls we can continue to process. Leave the words "Small down. Problem credit okay" as they are.

Next, replace the noted information, i.e., bedrooms, etc., with numbers applicable to your home. Stucco was mentioned because it was a nice feature of that home. You should include the best features of your property in this part of the ad, such things as a fireplace, sunken living room, Jacuzzi, wrap around porch, vaulted ceilings, wood floors, and other desirable features. Include three or four of your home's best features.

Remember, women buy homes, not men. In your description, appeal to what a woman would be looking for. Always mention fencing, if the property has it. Mothers like to know their children will be safe while playing outside. Dog owners, too, appreciate a fenced in yard.

Mention a well-known area landmark. A significant crossroads or popular street can be substituted. For example, near Main and Third.

Place the monthly payment that we will give you. This is an amount for the first lien only. You may or may not have a second lien amount. That will not be known until later.

End the ad with the word "Owner" and your phone number. This shows that you are truly an individual homeowner and not a Realtor or sales company. Run the ad in the Sunday edition only or for a full week or for ten days. The latter will give you the best exposure for the money.

Try to answer all calls coming in on Sunday morning or any morning that the ad appears. The most motivated buyers are up early looking for a home and tend to have the whole day to go out looking at them.

Have an answering machine take your messages when you're out or tired of answering calls. Make a special note of anyone calling more than once. This is a motivated buyer.

Place your ad with the newspaper with the largest circulation in your area.

First Phone Contact with the Buyer

There are two rules to remember in conversations with buyers:

- **The person who calls has more control.** So, if you are answering the phone, ask for a name and phone number and tell the caller you will call them right back. Then return the call promptly.

- **The person who asks the questions is in control.** Of course, the buyer will start out asking questions about the house, putting him or her in control. Answer all their questions as best you can. However, once you **feel** they have gotten enough information to make an appointment, you must immediately take over

You do this by using a series of questions and statements. This also starts qualifying them for financing. The questions/statements are:

1) **Will you be living in the property, or do you plan on renting it out?**
2) **How many people will be living in the home?**
3) **Where are you living now? How much are you paying per month?**
4) **Credit is not something I'm really concerned about. What is important is the amount of down payment you can make. How much can you put down right now? (If it's five percent or more of the sales price, respond: "Great! I'm sure I can work with that.")**
5) **Are you sure you can afford $_____ per month? Depending on your down payment, I might be carrying a second note for a little more than that.**
6) **You sound like someone I'd like to work with on this.**
7) **I can show you the home tomorrow afternoon at ____. Will that work for you? Be sure to bring a check in case you like what you see and want to hold the house.**

Refer back to these questions and statements as we analyze what each conveys and achieves.

Have these questions and statements written down and keep them near the phone so you will be ready once the buyer's questions have been answered.

Question #1: This tells us if we need to waste anymore time with this person. If he/she plans on renting out the property, you are talking to an investor, and our program will not work with him/her—unless you are selling a duplex or 3-4 unit building. In that case, the buyer can live in one unit and rent out the rest.

The bottom line is we must be talking with someone who will live in the property. If the buyer is an investor don't waste anymore time with him. Tell her thanks for calling but that you cannot finance an investor.

Question #2: This is just a good general question of interest.

Question #3: This helps round out the picture of their current circumstances. The second part is the real question here. It shows what they have been paying on a monthly basis and whether they can afford your payments.

Question #4: Although credit is important in the final selection of who you will choose to buy your home, you don't want them to feel defeated in that area at this point in the process. You must downplay credit as a factor. It lets them know they have a good chance at getting owner financing. The second part of this question is a great psychological question that makes buyers want to prove to you they can afford your home. This question also lets the buyer know that you want as much down as he/she can afford.

Question #5: Get a **"yes"** here. They may want to convince you they can make the payment, etc. Let them! In the next part, just casually mention there may be a second lien (this second lien is only if you want to hold one!). This is to clear the air for a possible additional payment amount later. Follow through immediately with, "That depends on your down payment." Then immediately go on to the next item.

Statement #6: You must now reassure the buyer they have a good chance by telling them everything sounds great. If you don't do this, the qualifying questions will work against you after the phone call is over. The buyer will get discouraged, thinking he/she won't qualify, etc. Then, he/she will not show up at the scheduled time.

Statement #7: This is the **most important statement** you will make. If you don't include it, you will reduce your chances of a sale from 85 percent to 2 percent. That's how important it is. If you have done everything correctly thus far, you should have 80 to 90 percent of the prospects show up and fill out the contract and credit application.

Some prospects will ask to drive by first to see the home from the outside or to check out the neighborhood. Let them know that will be fine with you.

Arrange a day and time for them to meet you at the home. Let them know that you will have to take off from work or miss some other obligation to spend time with them and show them the house. Tell them you would appreciate being called if for any reason they can't keep the appointment. This alone will cut down on no shows. Don't let them know you will be showing the house to others at that same time, as that will discourage them before they show up.

Arrange to have people show up every 15 minutes or all at the same time. Set up as many showings as you want. We suggest a minimum of two showings per week: Wednesday at 6 PM during the summer, 4 PM during the winter (avoid showing at night) and Saturday at 2 PM. Schedule four to six buyers per showing. Make sure both the husband and wife can come to the showing **together.**

Setup Before the Showing

Have a table and chairs set up in one of the side areas such as the dining room. This will allow you to answer the front door without disturbing the prospective buyers who may be filling out forms.

Have plenty of forms and pens on the table. Have them out in the open, not in an envelope.
Have a radio playing classical music **softly** in the master bedroom.
Spray the home with a room freshener or have incense burning.

Buyer Arrival

Greet the buyer at the door and shake hands. Have a clipboard or index card close by to immediately write down their names. You will have many people coming in and out, and you can confuse names if you don't have some type of reference. Also, you can compare the name with notes you made about them while on the phone. This helps you remember the situation.

After the introduction, invite them to look around and tell them if they have any questions you'll be glad to help. Avoid going every step of the way with them. Go back to the table and sit down. Use this time to review paperwork and so forth. However, you should accompany them if the house is not yet vacant and personal items are still around for security reasons.

After they have seen the home, both inside and out, they will gravitate back to wherever you are. They will have some questions. Now is the time to emphasize the qualities of the home you would like for them to know about. Talk about such things as extra insulation, extra padding under the carpets, storm windows, local schools, quiet neighborhoods, etc.

Getting the Forms Filled Out

You may ask them this one simple question: Do you like the home? Wait for an answer. If they raise questions or concerns about fixing or replacing, use our stock answer as previously discussed. Other concerns may be financial. In any case, the answers here will always bring you to this step—discussion of your finance terms. You should say, "Have a seat and I'll tell you what I'm looking at as far as financing is concerned."

Instruct them that you are taking solid offers only this week and will decide which party you will sell to at the end of the week. Tell them, "To consider you as a candidate, I need you to fill out a **purchase contract and a credit application**.

You need to leave a deposit with the contract to show me you're serious." Ask them for a check for $500, as earnest money. Let them know you will not be cashing the check unless they are accepted (Note; the check should be made out to the title or escrow company).

Have them fill out the credit application first. Make sure they sign it. Any information they don't have can be filled in later.

You should already have the earnest money contract filled out with the price you wish to sell for. You will need to go over each paragraph with them before asking for a signature.

THIS NEXT POINT IS VERY IMPORTANT!!! Stress that you are not so concerned with how much they earn or what their credit looks like, but that you want someone in the home who can really appreciate it and take care of it. This is important because it helps them to stay motivated over the possibility of being selected for the purchase of your home. It also keeps them from being discouraged when they see others filling out your paperwork.

Find something you like about the person or couple and let them know you like that about them. This helps them feel they have a very good chance of being selected. If you have already received an offer or two, you should let them know you are looking at other offers. Allow competition to work for you.

Sometime during your first showing, the next appointment will show up. If you are talking with your first buyers, excuse yourself by telling them you had some other people who wanted to come by today. This starts the competitive fear in the first prospective buyers. They will begin to see that others want your house so they better get that contract signed. This is the strongest motivation for buyers to sit down and get started on the paperwork.

Start the next appointment on the same process of seeing the home on their own, or let your spouse or someone else show the home if it still contains personal possessions.

Finish up with the first couple and start on the paperwork with the second. We often have two couples filling out paperwork at the same time. One couple will stay in one room filling out their paperwork, and the other will fill it out in another room. Be sure to let the new people know that just because the other couple is filling out paperwork doesn't mean you have agreed to sell them the home. **(Note: you will also be dealing with single buyers too!)**

Closing Costs

We will go over the closing costs with you.

Let's break down what will be involved:

1) **A one-year paid up fire insurance premium (from buyer).**
2) **The homeowner's Title policy.**
3) **Prorated property tax.**
4) **Sale closing costs such as title company fee and legal documents.**
5) **Appraisal (may be passed on to buyer).**
6) **Other typical closing costs we will detail for you.**

You will explain these to the applicant with financial numbers appropriate to your closing. Have the buyers sign the agreement and exchange general conversation about the home and/or their situation. Remember, the more you know about them and their current circumstances, the better off you are in later negotiations. Walk them to the door and let them know you will be getting back to them as soon as possible, probably within a few days.

The Counteroffer

By the end of the week, you should have several offers. We will instruct you in getting the existing offers improved or getting a total cash-out situation.

Our Purchase of the Seller Financing

We'll confirm in writing the amount we will pay for that note at closing. You then sign the contract you decide to go with, then take it to a local title company. We will follow up with additional instructions. We will contact the title company for a closing date as soon as possible. We will wire your funds directly to the title company.

Common Questions from Sellers

Q. Where do I get the credit application and earnest money contract?
A. We will provide you with the credit application. The earnest money (Common Real Estate Sales Contract) contract can be bought at Staples, Office Max, Office Depot, or most office supplies stores. An attorney can provide you a better version. In some states you can obtain a free copy from a title company. Just stop in and ask the person at the front desk. We can also supply you with one.

Q. Are there any up front fees or hidden charges?
A. We have no up front fees that are paid to us. There will be normal costs associated with the closing of your home sale that will be the responsibility of you and the buyer, e.g., an appraisal, title policy, legal fees for drawing up documents from the title company. Almost all these fees can be taken from the funds at closing, including our discount amount. This allows you to avoid having to pay anything up front. Appraisal costs, along with credit fees, can be passed on to the buyer. We will go over these fees with you.

Q. Will this program work if I still owe money on the home I'm selling?
A. Yes, we will make sure your mortgage is paid off at closing (out of the money we are paying you). We will need a payoff statement before closing on that mortgage. We will instruct you on obtaining a payoff statement from your current mortgage holder.

Q. Once I find a qualified buyer to sell to, how long does it take for closing?
A. Each transaction is different. Although there is not a set time, most transactions close within two to four weeks of submitting all paperwork. Having the appraisal done before you start the selling process can accelerate this time period. We will cover the appraisal and closing process with you. You must use one of our approved national appraisal services.

We will gladly answer any additional questions you may have and go over the procedures with you. We look forward to talking with you and can instruct you further on how you can sell your home in the next 2 weeks.

Call James at 205-819-1694 for the details on this exciting way to sell your home fast!

Carden's Capitol Solutions
PO Box 663 Phone/fax 205-819-1694/734-661-2743
Cottondale, AL 35453
E-mail cashoutfunds@charter.net

Associate Investor _____

Form 112

Seller Assist Home Sell Program 22 Step Plan of Action!

1. Order an appraisal now if possible.
2. Reread the little booklet and supporting documents received in your home seller's package. Design an ad like the one in the little booklet changing the information as pertains to your home.
3. Place ad in your local newspaper (Detroit News is great!), for minimum of 10 days.
4. Add, "owner will finance" to any yard sign in front of property.
5. Make copies of 1003 loan application, pre-approval document, and loan information sheet, note sale funding disclosure, sales contract, and other property disclosure forms. Use carbon paper to give buyer a copy of the contract and disclosure forms or use a copy machine if you have one available.
6. Have us consult with you about writing up a note structure for your home.
7. Take all calls live if possible, follow the little booklet qualifications questions and commitment statements to the letter. **Do not make the number one mistake many sellers make by changing the techniques in the booklet**. This is the best way of selling your home, it works and has been proven over and over. We have had over 500,000 copies of the booklet distributed so far. It may look "silly" but the methods in this book work!
8. Arrange to have a person in each 30-minute segment of the evening of the next day, starting at 5:00 PM to 6:00 PM. Schedule appointments until 8:00 PM. Once those slots have been filled, start doubling the appointments but with a 15 minute difference from the original appointment.
9. Arrange a showing every other day or so depending on the number of calls coming in. **Always insist that both husband and wife come together.**
10. After buyer has seen the home and starts asking questions about the monthly payments or down payment, ask the buyer to be seated so you can go over the numbers with them. Have two chairs ready for the husband and wife. You should be facing them and have all the paperwork on the table in front of you. Go over the numbers and immediately ask them to each fill out a credit application. While they fill

out the credit application, you start filling out the real estate contract. (We have a sample filled out contract you can follow as a guideline). When you get to the earnest money section of the contract, ask them how much they can put down tonight as earnest money. Whatever they reply with, try to get more. You can say "I usually ask for $1500 or more, how close to that can you come"? At this point you are simply assuming the sale. You must assume the sale on everyone no matter what they may be saying. Keep on writing until you have finished filling out the contract. Go over the credit application visually to make sure all blanks are filled in. Ask them to make the check out to you or the title company. Next, go over the contract with them. Paraphrase each clause. Get initials as you go. Have them sign it at the bottom. **You do not sign the contract at this time! This now represents an offer to you to decide whether you will accept them or not.**

11. Sign on all disclosure forms, explain that funding and possession will take 2-3 days after the closing at the title company. This time is needed to make sure all documents were executed correctly from the title company.
12. You will now give them a copy of everything and tell them you will run the credit check and get back to them within a few days.
13. If during the time of filling out the paperwork with one buyer, and another potential buyer is in the home, excuse yourself and let them know that you have not sold the home yet but they are just filling out an offer. You will not make your final decision yet for another few days. This keeps them interested in also filling out an offer and so on with the other buyers.
14. Phase 1 begins. The morning after the showing, deposit any credit report checks, and get the 1003 credit application with the $30 to pull credit into us as soon as possible.
15. Within 24 hours and many times within 1 hour, you will have a letter of intent to purchase the note to be created with the buyer. It will contain the description of the terms that will maximize the purchase amount of the note to you. If the buyer does not qualify on any of our programs a decline will be sent/phoned back.
16. You of course can take as much time as you need to find the very best buyer for your home!

17. **Any buyer that has been declined as a note purchase transaction will require that you refund their earnest money minus the credit report fee.**
18. All other buyers still in the running as having some kind of acceptance from us will not have their earnest money refunded until you make a decision as to which one you will accept. Once that has been done, you must return all the other earnest money deposits.
19. **This brings to a close of phase 1. You turn in the sales contract and earnest money to your local title company and request a title commitment be prepared. Let the title company know that you will be using Cash Out $ervices and give them the phone number and address.**
20. **In phase 2, you will collect any required documents from the buyer as determined by the letter of intent.**
21. **In phase 3, the title company will contact you to arrange the day and time of closing. We suggest that the closing be done as early as possible in the day to speed up our document examination time, 9:00 AM is preferred.**
22. **Try arranging the closing day to be as close to the last day of the month as possible**. But allow yourself and the appraisal company and any other parties enough time to complete their tasks. It is advised that you have your closing no less than 45 days from the time you start the showings. Remember you can always close before the stated time on the contract if everyone has completed his or her tasks ahead of schedule.

Form 113 TSTB

AGREEMENT TO PURCHASE
REAL ESTATE PROPERTY

In exchange for mutual promises between Buyer and Seller, both agree to the following terms and conditions.
DATE:

BUYER:
ADDRESS:

AGREES TO PURCHASE FROM

SELLER:
ADDRESS:

WHO AGREES TO SELL TO BUYER, THE PROPERTY LOCATED AT:

SALES PRICES $
PAYMENT OF THE PURCHASE PRICE IS AS FOLLOWS:

DOWN PAYMENT $
SELLER CARRIED 1ST LIEN NOTE AND MORTGAGE $

AT AN INTEREST RATE OF_____FOR A TERM OF _____ PAYMENT OF _____

SELLER CARRIED 2ND LIEN NOTE AND MORTGAGE $

AT AN INTEREST RATE OF_____FOR A TERM OF _____ PAYMENT OF _____

CONTINGENCY: Seller must be able and allowed to sell 1st lien note at closing for $

EARNEST MONEY IN THE AMOUNT OF $
TO BE DEPOSITED WITH SELLER APPROVED TITLE COMPANY OR ATTORNEY UPON A SIGNED CONTRACT FOR SALE BEING DRAWN BETWEEN THE PARTIES.

THE CLOSING DATE SHALL BE ON OR BEFORE:

OTHER TERMS:
BUYER OR SELLER MAY CANCEL THIS AGREEMENT PRIOR TO A MORE DETAILED CONTRACT FOR SALE BEING AGREED UPON IN WRITING; BY GIVING WRITTEN NOTICE TO THE OTHER PARTY OF SUCH CANCELLATION. THIS AGREEMENT TO PURCHASE FORM DOES NOT REPRESENT A BINDING PURCHASE CONTRACT ON EITHER BUYER OR SELLER. SELLER MAY ASSIGN THIS AGREEMENT. ANY SUCH ASSIGNMENTS WILL RELEASE ORIGINAL SELLER FROM LIABILITY AND SUBSTITUTE ASSIGNEE IN HIS/HER OR ITS PLACE. SELLER AGREES TO PAY 1% (ONE PERCENT) TOWARD CLOSING COST, AND BUYER AGREES TO PAY ALL OTHER CLOSING COSTS.

SELLER DATE

BUYER DATE

Form 114

Example of Offers on Real Estate

Please note: We never offer the suggestion to the seller of carrying a 2nd lien on the property we are interested in as it will always be refused initially. However, after the seller has spent some time negotiating with us and still does not like the lower all cash offer we have presented, they will become more receptive to entertain other offers from us which of course includes the 2nd lien suggestion. The key is time invested and developing rapport which are priceless as it is in any sales presentation.

Buyers usually qualify under two LTV structures:

85/10/5

85% 1st lien
10% 2nd lien
5% Cash down

We assume a 100K appraised price

$88,300 cash from buyer in this deal
we offer 80% of appraised value or $80,000 Cash

Total profit to you is $8,300 in cash – ($3,400 my company discount for using our funding sources) or $4,900 cash and a 2nd lien note of $10,000 you would hold.

If seller does not go for the first offer above, we can then offer 88% of appraisal.

$78,000 cash and a $10,000 2nd lien note assumable one time by our buyer. Here the cash profit is $10,300 - $3,400 = $6,900 profit to you!

What if the buyer qualifies for the 90/0/10 structure?

Here these type buyers are the best, as it becomes an all cash deal for everyone concerned! We do not get too many of these type buyers but when you do it means extra profits.

Here we are working with $98,200 on the table from the buyer. You can offer up to 90% of appraisal and still make an $8,200 profit. Now what if the seller accepts an 80% of appraisal offer? Here $18,200 dollar profits await you! On the low end you make $5,000

cash and roughly $14,700 profit on the high end after we subtract the discounts on the notes we finance for you!

Of course if we close any deals in my company name than the usual 50/50 profit split is place on all deals you submit to me!

Do you have mortgage applicants that you have turned down!

Form 115

We have private investor funds available!

Over 2 million dollars in private investor funds available daily.

Before you say NO to your mortgage applicants try us!

Wholesale Owner Finance Program

For Mortgage Brokers and their Loan Officers

- No PMI Requirement
- No termite or other inspections needed
- No seasoning of down payment funds
- Gift funds can be used for the down payment and closing fees
- Seller can pay the entire closing costs
- No processing fees or points
- Charitable grants can be used on all transactions
- 50-55% income to debt ratios
- Works with residential properties in all 50 states
- Non - Conforming Properties accepted too
- Flip Properties without using your own money or credit
- No 12 Month "Seasoning" Requirements to "flip" property!

☺ Please note that we do not compete with your regular source of funds!

Call 313-892-0328 and ask for a fax with our current rates and requirements!

We are an additional source of funds for you!☺

Carden's Capitol Solutions are nationwide mortgage note buyers that have probably closed more simultaneous transactions than any other company in the nation. As leader in the mortgage note industry, **Carden's Capitol Solutions** has invested 10 years developing a program exclusively for Mortgage Brokers and Loan Officers **– we call it…The Owner Finance Option.**

Would your company benefit from using our private investor funds?

☺ Offer your Loan Officers a tool that gives them a competitive advantage

We can possibly turn a mortgage turn down into a deal that will be funded by our investors, as we do not follow the conventional secondary mortgage buying guidelines for origination loans! Remember, we do not originate loans but purchase mortgage notes

☺ Train investors on how to buy and sell properties simultaneously

Our relaxed credit standards and no limit to how many simultaneous transactions they can do, one per Month, one per Week, one per Day makes for a great investment opportunity!

☺ Increase profits via discount spreads, flipping property, more revenue to you

Learn how to increase revenue over and above commissions – Earn extra revenue! Purchase and resell property without using your own money or credit – and no seasoning issues to deal with!

Learn how to use our source of private mortgage funds to increase your closed deals!

Call Carden's Capitol solutions today or email us at cashoutfunds@charter.net

- **Carden's Capitol Solutions** provides unlimited support for your agents and you! Phone **205-819-1694** Fax**734-661-2743**; E-mail **cashoutfunds@charter.net.**

If you do not wish to receive any further fax information from Carden's Capitol Solutions, please fax this page back with your fax number here _____to be removed from our list. Thank you. However before you do, please consider what we can offer your mortgage turndowns as an additional marketing tool!

Form 116 Listings that offer *Owner Financing* *Increase* the potential marketplace of *buyers by at least 60%*

--- Statistic from the National Association of Realtors

Now All Your Listings Can Offer Owner Financing And Still Receive CASH For The Sale!

Call 205-819-1694 and request our current guideline rate sheet for the latest mortgage note programs!

Wholesale Owner Finance Program

For Real Estate Brokers and their Agents

- More Showings - More Signed Offers - Faster Sales
- No More Price Reductions – Buyers Pay Full Appraised Value
- Agents' Commissions based on "Full Value" Sale Prices
- Works with residential properties in all 50 states
- Non - Conforming Properties accepted too
- Flip Properties without using your own money or credit
- No 12 Month "Seasoning" Requirements to "flip" property!

Carden's Capitol Solutions are nationwide mortgage note buyers that have probably closed more simultaneous transactions than any other company in the nation. As leader in the mortgage note industry, **Carden's Capitol Solutions** has invested 10 years developing a program exclusively for Real Estate Professionals **– we call it…The Owner Finance Option.**

Would your company benefit from using our private investor funds?

☺ Offer your agents a tool that gives them a competitive advantage

Their listings can offer owner financing to the buyers while receiving cash for their sale, even with underlying mortgages and liens against the sellers property. Easier Sales – Commissions at Full Value!

☺ Train investors on how to buy and sell properties simultaneously

Credit scores are relaxed and there's no limit to how many simultaneous transactions they can do – one per Month, one per Week, one per Day!

☺ Increase profits via discount spreads, flipping property, more sold listings

Learn how to increase revenue over and above commissions – Earn Bonuses! Purchase and resell property without using your own money or credit – and no seasoning issues to deal with! Eliminate expired listings - use the Owner Finance Option and turn them into cash!

Learn how to use our source of private mortgage funds to increase your $old listings!

- ***Begin using the Owner Finance Option on all your listings immediately!***
- Carden's Capitol Solutions, provides unlimited support for your agents and you! Phone205-819-1694; Fax 734-661-2743 E-mailcashoutfunds@charter.net.

If you do not wish to receive any further fax information from Carden's Capitol Solutions, please fax this page back with your fax number here _____to be removed from our list. Thank you. However before you do, please consider what we can offer your listings as an additional marketing tool!

Form 117

OPTION TO PURCHASE REAL ESTATE

This option to purchase real estate (hereinafter referred to as the Option) is made this ____ day of _____ 20___, by and between the following parties:

_____

Residing at _____

(Hereinafter referred to as the Buyer);

And _____

Residing at _____

(Hereinafter referred to as the Seller).

For $10.00 and other consideration from the Buyer, the parties hereby agree as follows:

1. **DESCRIPTION:** The seller agrees to option, and the Buyer agrees to option the real property and improvements, hereinafter called property, located at:

_____

_____

2. TERM: The term of this Option shall be for a period of _____months commencing on _____, 20__, and ending on _____, 20__.
Buyer may extend the term of this Option for _____ additional renewal periods of ____ months, following the expiration of the initial term. The Buyer shall give notice to the Seller of its intent to extend the term of this Option as herein provided, by mailing a written notice to the last provided address of the Seller at least Ten (10) days in advance of the expiration of the then current term.

3. OPTION TO PURCHASE: The Buyer, as part of the consideration herein, is hereby granted the **exclusive** right, option and privilege of purchasing property at any time during the term of this Option agreement or any extension thereof. The Buyer shall notify the Seller in writing of the exercise of this option at least five (5) days prior to the expiration of the initial term of this Option or the expiration of any extension thereof, by mail to the last provided address of Seller.

4. COSTS: In the event the Buyer exercises the option to purchase set forth in paragraph (3) above, and through no fault of the Buyer, the Seller fails to convey said property to Buyer in accordance with the terms of this Option, the Buyer in addition to any other rights which Buyer may have in law or equity for the enforcement of Buyer's option to purchase shall be entitled to reimbursement for the cost of all repairs, maintenance and improvements and advertisement costs.

5. FURTHER ENCUMBRANCES: The Seller hereby warrants that the total of the options, mortgages, liens, and any other encumbrances against the property, whether of public record or not, are as follows:

A. First mortgage in favor of Principal in the approximate amount of $ _____.

B. Current taxes due for _____ in the amount of $ _____.

C. _____

_____

The Seller agrees not to lease to another party, nor to assign, sell, option, transfer, pledge, or otherwise to convey any or all rights or interests had by Seller in the property or in this Option agreement, nor to further encumber the property nor allow the same to occur. All third parties are hereby put on notice that any leases, assignments by the Seller, liens, options, mortgages, or and other conveyances or transfers occurring subsequent to the date of this Option are hereby declared by the Seller to be null and void and of no force and effect. The Seller further agrees to keep all mortgages, liens, taxes, or other encumbrances on the property, current and in good standing; Buyer shall have the right to make payments on same in the event that Seller becomes non-current or otherwise defaults thereon.

6. RIGHT OF ASSIGNMENT: The Buyer shall have the unqualified right to assign, sell, transfer, pledge or otherwise convey any or all rights or interests which the Buyer may have in the property or in this Option Agreement. Any such assignments will release original Buyer from liability and substitute assignee in his/her or its place.

7. MAINTENANCE AND REPAIRS: The Seller shall henceforth be responsible for all maintenance and repair upon said property, both interior and exterior. The Seller shall have the right to make such repairs, maintenance, add improvements, as Seller shall deem necessary, proper or desirable. The Seller shall be solely liable for payment for said improvements and shall hold the Buyer harmless therefrom, and that any electric, plumbing, heating or cooling system that is out of order at the commencement of this option or within 60 days thereafter will be repaired by the Seller at his/her expense. If the Seller can not or will not make the repairs necessary the Buyer will have the option of either voiding this agreement by written notice to the Seller or making such repairs and or receiving a credit against the purchase price plus interest at 10% per annum from date of payment.

8. BINDING AGREEMENTS: The parties hereto agree that this Option comprises the entire agreement of the parties and that no other representation or agreements have been made or relied upon, and that this Option agreement shall inure to the benefit of and shall be binding upon the parties, their heirs, executors, administrators, personal representatives, successors or assigns.

9. SPECIAL PROVISIONS:

A. A Title search will be ordered by the Buyer. This cost will be borne by the Buyer unless it is discovered that Seller has unmarketable title in which case the Seller will reimburse Buyer the cost of the search. If the title is unmarketable the Buyer will then have the option to void this agreement or proceed as agreed herewith.

OPTION PURCHASE TERMS

10. PRICE AND TERMS: The Buyer agrees to pay for said property the sum of _____, Less any sums for which the Buyer is entitled to claim reimbursement or offset in accordance with this agreement. Terms will be negotiated upon the execution of Buyer's Purchase Agreement and may include a 2nd Lien of $_____ to be held by Seller.

11. INCLUDED IN THE PURCHASE: The property shall also include all land, together with all improvements thereon, all appurtenant rights, privileges, easements, buildings, fixtures, heating , electrical, plumbing and air conditioning fixtures and facilities, window shades, venetian or mini blinds, awnings, curtain rods, screens, storm windows and doors, affixed mirrors, wall to wall carpeting, stair carpeting, built in kitchen appliances, bathroom fixtures, radio and television aerials, landscaping and shrubbery, water softeners, garage door openers and operating devices, and all utility or storage buildings or sheds. The property shall also include the following items:

_____

_____

12. TITLE: The Seller shall convey marketable title to the property with the above described inclusions, by good and sufficient General Warranty Deed in fee simple absolute, on or before closing; said title to be free, clear, and unencumbered except existing mortgages restrictions and easements of record shown in paragraph (5). Title to be conveyed to the Buyer and or assigns.

13. CLOSING: The deed shall be delivered and the purchase money shall be paid at the lending institutions, or other office, of Buyer's choice, at closing if this option is exercised.

14. COST AND PRORATIONS:

The Seller will pay for: Revenue stamps (State, county and local); Title commitment in the amount of the purchase price from a title insurance company/or title attorney to be selected by Buyer in the County of the Property location, Lender required repairs, Title abstract; Satisfaction of mortgage and recording fee.

The Buyer will pay for: Recording fees, prepaid insurance, prepaid taxes, prepaid interest, termite Inspection, appraisal fee, survey, fees associated with the procurement of financing, Buyer's repair costs, Property inspection

Prorated Items: All rents, water taxes or charges, taxes, assessments, monthly mortgage insurance premiums

from the insurance proceeds. Upon closing, the Buyer shall be responsible for fire and extended coverage from that date forward.

16. If Seller wishes to sell to another party after acceptance of this option, Buyer may agree to a release upon an agreed amount of consideration by both parties.

17. In the event this agreement is placed in the hands of an attorney for enforcement the prevailing party shall be entitled to recover court cost and attorney fees.

IN WITNESS WHEREOF, the parties hereto, have set their hands to this Option Agreement on this _____ day of _____ 20___.

WITNESS:_____

_____
SELLER

_____
SELLER

_____
BUYER

_____
BUYER
State of

County of

On _____, _____ personally appeared before me

_____to me known to be the individual(s) described in and who executed the foregoing instrument, signing same as his/her free and voluntary act and deed, for the uses and purposes therein mentioned. Witness may hand and seal hereto affixed the day and year first above written.

_____

Notary Public in and for the State of _____

My commission expires _____

Form 118

Note Purchase Information Sheet
(Please print neatly)

Seller Information:

Name_____

Address_____

City_____ State_____ Zip_____

Phone_____ Fax_____

Borrower Information:

Name_____

Current Address_____

City_____ State_____ Zip_____

Social Security #_____

Subject Property Address_____

(If additional buyers please attach another 118 Form with that buyers information only)

Closing Agent/Title Company/Attorney Information:

Organization Name_____ Contact_____

Address_____

City_____ State_____ Zip_____

Phone_____ Fax_____

Wiring Instructions: (we will be wiring funds to closing agents account)

Wire To_____ ABA #_____

Further Credit To_____ Account #_____

Hazard Insurance Company Information:

Company Name_____ Agent_____

Address_____

City_____ State_____ Zip_____

Phone_____ Fax_____

Note Information:

Sales Price $_____ Down Payment $_____

First Lien Amount $_____ Interest %_____

Second Lien Amount $_____ Interest %_____

Down Payment Amount $_____

Please print neatly

Form 119

Submission Requirements (New Note)
Incomplete packages are not processed

Checklist for 85% LTV and higher

_____ Note Purchase Information Sheet (Form 118)
_____ Full Appraisal with comparable photos and interior inspection (see appraisal section)
_____ Copy of executed sales contract (both contracts if Direct Resale Program)
_____ Mortgage Purchase Agreement (Form 120)
_____ Copy of Buyer Photo I.D.
_____ Copy of Buyer Social Security Card. (if no card W-9 to be completed at closing)
_____ Copy of earnest money deposit check.

Additional items needed if 80% LTV or lower

____ Most recent pay stub with year to date earnings indicated. If buyer does not receive pay stubs, W-2's or Verification of Employment Form is necessary.
*If buyer is self employed previous year tax return or copy of business license

Title Company Procedure:
Present executed sales contract and earnest money deposit to Title Company. Request title commitment be prepared with OFI and or assigns as proposed insured with insurance amount equal to first lien or greater. OFI will contact title company and obtain commitment, tax certificate, insured closing letter and agent certification upon your package submission.

From The Hazard Insurance Company:
Buyers must provide a one year pre-paid Hazard Insurance Policy naming OFI and or assigns as loss payee. Amount of insurance must be equal to or greater than new first lien amount.

Please submit 2 copies of entire package with one original appraisal and one copy. Incomplete packages are not processed. Packages that do not have two copies will not be processed. Send completed packages overnight to:

Carden's Capitol Solutions
PO Box 663
Cottondale, AL 35453

Form 120

Mortgage Purchase Agreement –New Note

THIS AGREEMENT made and entered into this _____ day of _____
20 _____, by and between:

_____ (Seller(s))

And
Carden's Capitol Solutions and or assigns (Purchaser)
WHERAS SELLER will transfer said Deed and assign said Note upon terms and conditions stated in executed Contract Of Sale between:

_____SELLER(S) and
_____BUYER(S)

NOW THERFORE, for and in consideration of the value to be paid, mutual benefits derived, the Seller(s) agree to the following:
1. Seller(s) warrant and represents the balance due on the above mentioned Note, as of closing will be $_____
2. Seller(s) shall receive at closing the discounted sum of $_____ in consideration for terms and conditions set forth in above Note.
3. Seller(s) shall receive any secondary financing terms and down payment monies as set forth in executed Contract of Sale between Seller(s) and Buyer(s).
4. Costs: Seller(s) and or Buyer(s) are responsible for all closing costs associated with transaction.
5. If any of the above mentioned conditions of sale are found unacceptable to Purchaser, the
Purchaser shall notify Seller(s) and this agreement shall become null and void.

_____ **Carden's Capitol Solutions**
SELLER PURCHASER

_____
SELLER

FORM 121

Quote Worksheet—Existing Note

Direct Agency **Carden's Capitol Solutions**
Phone 205-819-1694
Quote Return Fax 734-661-2743

Subject Address_____City_____
State_____

Credit of Payor: Excellent_____ Good_____ Bad_____ Unknown_____

Is there an underlying mortgage? If yes, how much? $_____

Is this a: First Lien_____ Second Lien_____ Wrap-Around_____

Note Structure:

Sale Price
$_____

Down Payment
$_____

Note Original Balance
$_____

Terms in Months
_____

Interest Rate
_____%

Payment Amount
$_____

Current Balance
$_____

Balloon Date
_____

Date of First Payment_____

Number of Payments Made
_____

Number of Remaining Payments_____

Next Payment Due Date_____

Property Type

Single Family _____

2-4 Unit _____

Condo _____

Town House _____

Mobile DBL_____

Mobile SWD_____

Balloon Amount
$_____

Other_____
_____

Current Value of Subject Property $_____

Is Seller interested in a partial note sale yes_____ No_____

How much is Seller trying to raise $_____

Comments:_____
_

Fax this completed form to: 313-892-0328

FORM 122

Mortgage Purchase Agreement –Existing Note

THIS AGREEMENT made and entered into this _____ day of _____20 _____, by and between:
_____ (Seller)
And
_____ and or assigns (Purchaser)
WHEREAS SELLER is the owner of a certain deed (Deed) which secures a certain promissory note (Note).
The property address is _____
Legal Description if no physical address:_____
WHEREAS SELLER will transfer said DEED and assign said NOTE, all upon the following terms and conditions set forth herein:
NOW THEREFORE, for and in consideration of the value to be paid, mutual benefits derived, the Seller agrees to grant PURCHASER and /or Assigns the exclusive right to purchase the note and security instrument, and the parties hereto agree as follows:
1. PURCHASE PRICE: SELLER warrants and represents that the balance due on the above mentioned NOTE, as of _____ is the sum of $_____. There are _____ payments remaining, plus a final balloon payment of $_____ . Said balloon payment is due on _____. PURCHASER shall pay to SELLER the sum of $_____ for the next _____ payments, plus any balloon amount and additional payment in the following form:
_____
_____
2. COSTS: SELLER will pay for cost of title insurance update and appraisal. If no mortgagee title policy exists SELLER will provide one at SELLER"S expense.
3. SELLER warrants that all real property taxes, that are due and payable, have been paid. In the event, at time of closing, there are real property due and payable then PURCHASER shall pay said taxes and deduct the amount paid from SELLER'S proceeds.
4. SELLER shall escrow his original DEED and NOTE to PURCHASER'S attorney/title agent at the time of closing. In the event SELLER refuses to transfer DEED or endorse NOTE to PURCHASER at time of closing or SELLER can't produce the original DEED and NOTE then PURCHASER may terminate this agreement and SELLER agrees to pay to PURCHASER liquidated damages equal to 10% (ten percent) of outstanding note balance, plus all fees, legal and otherwise, associated with collection. as PURCHASER"S sole and exclusive remedy.
5. CONTINGENT: This purchase shall be contingent upon the following conditions:

A. The real property securing the above described DEED & NOTE shall be of sufficient value to secure the investment. The determination of sufficient value shall be the sole discretion of the PURCHASER.

B. PURCHASER shall have 30 days to fully examine the SELLER'S title and interest, the original note and mortgage, the mortgaged property, payment history, credit status and financial status of the payors, and to cancel this agreement if any of the same is found to be unsatisfactory to him.

6. If any of the above mentioned conditions of sale are found unacceptable to the PURCHASER, SELLER shall be notified and this contract shall become null and void.
7. SELLER shall keep any mortgage payments that are paid during processing of this agreement and said payment shall be deducted from SELLER'S proceeds at closing.
8. This agreement shall be in full force and effect for a period of 30 days from the date of PURCHASER receiving the documentation requested below and thereafter, until the SELLER gives PURCHASER TEN DAYS written notice via certified mail of the intent to terminate this agreement.

Items needed from Seller:

A. Copy of the recorded security instrument and/or Note, Deed of Trust and any underlying instrument
B. Title Insurance Policy
C. Hazard -Fire Insurance Policy
D. Verification of outstanding balance if subject mortgage has underlying balance
E. Buyer's name, address, phone number, Social Security #(s), employment address/phone
F. SELLER'S name, address, phone and Social Security #(s)
G. Payment history of buyer… canceled checks, deposit receipts, servicing records
H. Current tax statement if SELLER held escrow and tax assessor's phone number
I. Drive-By Appraisal with comparable photos of subject property from approved firm

SELLER _____ SELLER _____

PURCHASER **Carden's Capitol Solutions**

Form 123

Submission Requirements-Existing Note

Incomplete packages are not processed

Checklist:

_____ Note Purchase Information Sheet (Form 118)
_____ Drive By Appraisal with comparable photos (see appraisal section of Manuel)
_____ Copy of Recorded Mortgage or Deed of Trust
_____ Copy of Note
_____ Copy of Settlement Statement from sale when note was created
_____ Completed Mortgage Estoppel from Seller (Form 124)
_____ Completed Pay History Verification Form (Form 125)
_____ Copy of Hazard Insurance Policy
_____ Copy of Mortgagee's Title Policy (if none exists, we will order at Seller expense)

Please submit 2 copies of entire package with one original appraisal and one copy.

Incomplete packages are not processed.

Packages that do not have two copies will not be processed.

Send completed packages overnight to:

Carden's Capitol solutions
PO Box 663
Cottondale, AL 35453

Form 124

Mortgage Estoppel Certificate

DATE:_____

STATE OF:_____

COUNTY OF:_____

KNOW ALL THESE PRESENTS:
BEFORE THE UNDERSIGNED NOTARY PUBLIC, ON THIS DAY PERSONALLY APPEARED THE INDIVIDUALS IDENTIFIED BELOW WHO, UPON OATH, AFTER BEING DULY WORN, DID DEPOSE AND STATE THE FOLLOWING:
1.) This Estoppel Certificate is given to Owner Finance Inc. (OFI) _____(date). OFI is to purchase all of the Seller's right, title and interest in the certain Promissory Note or equivalent ("note") in the original amount of $_____, Dated_____, and executed by_____ and is currently payable to the order of the Seller.
2.) The Seller is the legal and equitable owner and holder of the Note and all of the liens arising under that certain Deed of Trust or Mortgage ("Mortgage") dated_____, and recorded with the County Clerk of_____ County, under recording #_____, Book#_____, page _____, executed by_____ ("Maker"), TO ("Payee") securing the Note.
3.) None of the terms or provisions of the Note or Mortgage have been modified, amended or waived, except as disclosed by a Modification, Rider, Warranty Deed or other collateral document made part of this transaction.
4.) There have been no undisclosed prepayments, unpaid late charges, no offsets on amounts due on the note, the maturity has not been accelerated, no event of default or even which could constitute an event of default, has occurred on the Note or Mortgage.
5.) As of the date of this Certificate, the below information is accurate and was arrived at by adherence to all the terms of the Note and Mortgage:

Unpaid Principle Balance	$_____
Next Payment Due Date	$_____
Escrow Balance	$_____
Principle and Interest Payment	$_____
Total Monthly Payment (with escrow)	$_____

6.) All payments to escrow have been applied properly, and disbursements have been made properly. All escrow items have been handled in a manner that meets all Federal and State Laws. As of the date of this Certificate, no escrow disbursements items are due and payable.
7.) There is no indebtedness owing to the Seller or any related party which is secured by the Mortgage other than the indebtedness evidence by the Note, and the Seller has

made no agreement to extend any further credit to be secured by the Mortgage or any other lien upon the property described in the Mortgage.
8.) There are no outstanding liens, encumbrances, security interests or claims of any kind against or in the respect of the note.
9.) The Seller has the full power and legal authority to execute this affidavit on behalf of Seller and to transfer, reassign and convey the Note and liens arising under the Mortgage to Cash Out $ervices Inc.
10.) We acknowledge that the Purchaser is relying upon this Estoppel Certificate in connection with its purchase of the Note and would not purchase the Note without this Certificate, or the information contained herein.

_____ _____
SELLER SELLER

SUBSCRIBED AND SWORN TO BEFORE ME, THE UNDERSIGNED AUTHORITY, ON THIS THE

_____ DAY OF _____ YEAR _____

NOTARY PUBLIC, STATE OF _____

_____
PRINTED NAME OF NOTARY

Form 125

Payment History Verification Form

Borrower:_____ Date: _____

Subject Property Address:_____

City:_____ Sate:_____ Zip:_____

Payment Due Date	Date Received	Payment Amt.	Principle Balance	Escrow Balance
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____
_____	_____	_____	_____	_____

I/We the undersigned do hereby state on oath the above information to be true and accurate to the best of my/our knowledge.

_____ _____
SELLER SELLER

State of _____ County of _____

Subscribed and sworn before me, the above named _____ and acknowledged the foregoing. Witness my hand and official seal this _____ day of _____ year of 200____

My Commission expires on: _____

_____
Notary Public

Form 126

Lottery Winnings and Annuity Worksheet

Direct Agency Name: Carden's Capitol Solutions

Phone: 205-819-1694

Fax: 734-661-2743

Name of Winner/Annuitant: _____

Phone: _____ Best time to call: _____

Lottery Winnings State of: _____

Amount of Winnings: $_____ Date of Winning: _____

Amount of each scheduled payment: _____Next payment due: _____

List lump sum amounts and due dates if different than above.

Annuity Settlement State of: _____

Name of Insurance Company: _____

Current Balance of Annuity: $_____ Next payment due: _____

Amount of next payment due: $_____

List lump sum amounts and due dates of remaining payments due.

Fax to 313-892-0328

Form 127

Closing Costs – Existing Note

There are generally only three charges associated with the purchase of an existing mortgage note. They are:

Drive By Appraisal	$300.00
Title Update	$150.00
Recording Assignment	$ 50.00

Appraisal cost will vary due to property location. Call approved appraisal firms for quote and turn around time.

Title update cost will vary depending upon property location. If no existing mortgagee's title policy exists then one will need to be ordered at expense of seller. This will increase cost of title closing fees. Call Title Company local to property for a cost estimate.

These costs are the responsibility of the note seller. The appraisal costs are paid up front. The remainders of costs are paid from closing proceeds.

Investor Associate can pay for these expenses.

Caution: If transaction doesn't close the appraisal fee will be a loss to you, as it must be paid up front.

Form 128

This introduction letter is to be addressed to Real Estate Attorneys.
Put this on your own stationary. Use quality paper.
You only get one chance to make a good impression

Dear [[Recipient]]:

My name is _____. I'm an Associate Investor for **Carden's Capitol Solutions** a nationwide company that purchases mortgage notes, annuities and lottery winnings. I'd like to take this opportunity to tell you about our service and how we can possibly help your clients.

Have you ever had;
• A client that financed a real estate transaction that needs cash now?
• A client that lost they're financing at the last moment due to unexpected problems?
• A client needing to sell a property quickly?

These problems and many other difficult real estate situations as well, can be solved with our service.

We purchase new and existing mortgage notes, providing your clients with immediate cash. We specialize in simultaneous closings and can close transactions in all 50 states in as little as 5 days. Our purchase prices are tops in the industry and our closing are extremely fast! Our various programs typically sell a property in two weeks time!

We also purchase annuities and lottery winnings. It would be our pleasure to provide any of your clients with a no obligation quote.

Please don't hesitate to call if we can be of service in any way. We welcome the opportunity to explain our service further and to show you how we can help your clients and possibly yourself.

Sincerely,

Form 129

This introduction letter is to be addressed to Personal Injury Attorneys.
Put on your own letterhead. Use quality paper.
You only get one chance to make a good impression.

Dear [[Recipient]]:

Are any of your clients in need of a lump sum of cash today, instead of collecting monthly payments on their annuities?

My name is _____. I'm an Associate Investor for **Carden's Capitol Solutions** a nationwide company that purchases annuities, lottery winnings and mortgage notes. I'd like to take this opportunity to tell you about our service and how we can possibly help your clients.

We provide cash to annuitants that would like to sell part or their entire future monthly payment stream. We can customize the purchase to your client's exact needs in a quick efficient manor.

We also purchase new and existing mortgage notes, providing your clients with immediate cash. We specialize in simultaneous closings and can close transactions in all 50 states in as little as 5 days. Our purchase prices are tops in the industry and our closing are extremely fast! Our various programs typically sell a property in two weeks time!

Please don't hesitate to call if we can be of service in any way. We welcome the opportunity to discuss our service and to show you how we can help your clients and possibly yourself.

Sincerely,

Form 130
This introduction letter is to be addressed to Accountants.
Put this on your own stationary. Use quality paper.
You only get one chance to make a good impression

Dear [[Recipient]]:

My name is _____. I'm an Associate Investor for **Carden's Capitol solutions** a nationwide company that purchases mortgage notes, annuities and lottery winnings. I'd like to take this opportunity to tell you about our service and how we can possibly help your clients.

Have you ever had;
• A client that financed a real estate transaction that needs cash now?
• A client that lost they're financing at the last moment due to unexpected problems?
• A client needing to sell a property quickly?

These problems and many other difficult real estate situations as well, can be solved with our service.

We purchase new and existing mortgage notes, providing your clients with immediate cash. We specialize in simultaneous closings and can close transactions in all 50 states in as little as 5 days. Our purchase prices are tops in the industry and our closing are extremely fast! Our various programs typically sell a property in two weeks time!

• Do you have a client collecting monthly payments from an annuity but needing a lump sum of cash today?

We also purchase annuities and lottery winnings. It would be our pleasure to provide any of your clients with a no obligation quote.

We provide referral bonuses to anyone recommending a client that closes a transaction.

Please don't hesitate to call if we can be of service in any way. We welcome the opportunity to explain our service further and to show you how we can help your clients and possibly yourself.

Sincerely,

Form 131

This introduction letter is to be addressed to Title Companies Form
Put this on your own stationary. Use quality paper.
You only get one chance to make a good impression

Dear [[Recipient]]:

My name is _____. I'm an Associate Investor for **Carden's Capitol Solutions** a nationwide company that purchases mortgage notes, annuities and lottery winnings. I'd like to take this opportunity to tell you about our service and how we can possibly help your customers.

Have you ever had a closing fall apart at the table due to unexpected problems? When this occurs, it's a nightmare for the seller and buyer and a lost revenue opportunity for your company.

We can possibly help to resurrect these tough situations.

We specialize in simultaneous closings and can close transactions in all 50 states in as little as 5 days. Many of the reasons for transactions falling apart are not issues for us.

Simply give us a call when a deal falls apart and we'll show you what we can do.

We provide referral bonuses to any title company that recommends a transaction to us which closes.

We also purchase annuities and lottery winnings. It would be our pleasure to provide any of your customers with a no obligation quote.

Please don't hesitate to call if we can be of service in any way. We welcome the opportunity to explain our service and how it can benefit you and your customers.

Sincerely,

Form 132

This letter is to present a bid to a note seller.
Place on your own stationary.

Dear _____

It was a pleasure to speak with you.

Enclosed is our proposed purchase price for a first lien mortgage note. The purchase price is based upon the information provided to us.

As we understand it:

The current balance is: $_____

There are _____ payments remaining.

The interest rate on the note is _____%

We will pay a one-time cash sum in the amount of $_____ for the note based upon the above supplied information.

This offer is good for the next _____ days.

Should you decide to move forward with the note sale, please sign the enclosed Mortgage Purchase Agreement and other documentation supplied and return to me as quickly as possible.

If I can be of any assistance or answer any questions please don't hesitate to call.

Sincerely,

Your signature

FOURTH EDITION

THE COMPLETE BOOK OF HOME INSPECTION

Professional inspection worksheets with checklists in every chapter

Hundreds of photos and drawings

Based on the author's 35 years' experience as a home inspector

Updated with new material, including Chinese wallboard, engineered lumber, freestanding decks, geothermal heating, laminate flooring, alternative septic systems, and much more

NORMAN BECKER, P.E.

NOW WITH HOME INSPECTOR REQUIREMENTS

The
Complete Book of Home Inspection

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The Complete Book of Home Inspection

Fourth Edition

Norman Becker, P.E.

New York Chicago San Francisco Lisbon London Madrid
Mexico City Milan New Dehli San Juan Seoul
Singapore Sydney Toronto

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For Renée, Jeffrey, Piper, Ana Maria, Sharon, Mia, and Eli

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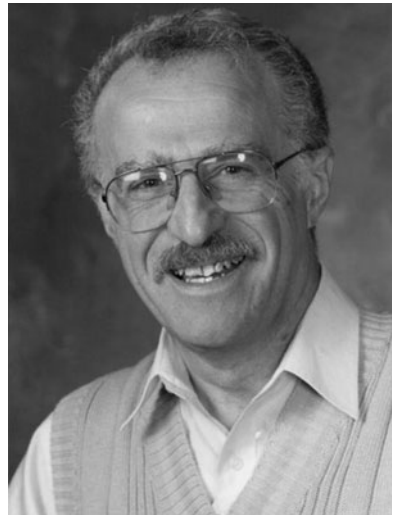
About the Author

Norman Becker, P.E. (Hamburg, New Jersey), has more than 35 years' experience in home inspection. He has inspected homes of all ages, from newly constructed to prerevolutionary, from vacation homes to stately mansions. He is one of the founders of the American Society of Home Inspectors (ASHI) and has been qualified in court as an expert witness on the subject of home inspection. He also wrote the widely read "Homeowners Clinic" column for *Popular Mechanics* magazine for 24 years and is the author of the Popular Mechanics book *500 Simple Home Repair Solutions*. Mr. Becker is a licensed professional engineer in New York, New Jersey, and Florida.



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Contents

Acknowledgments **xvii**

Introduction **xix**

1 Tools and procedure **1**

Tools needed 1
Inspection procedure 2
Exterior inspection 2
Interior inspection 3
Electromechanical systems 4
Final inspection 5

EXTERIOR INSPECTION

2 Roofs **6**

Pitched roofs 6
Shingles 8
Flat roofs 16
Built-up roofs (BURs) 17
Single-ply membrane 19
Roll roofing 19
Metal roofing 19
Checkpoint summary 20

3 Roof-mounted structures and projections 22

Chimneys 22
Vent stacks 26
Roof vents 27
Roof hatch 28
Skylights 28
TV antennas 28
Lightning protection 29
Gutters and downspouts 29
  Built-in gutters 30
  Exterior-mounted gutters 30
  Downspouts 32
Checkpoint summary 34

4 Paved areas around the structure 36

Sidewalks 36
Street-level/driveway-level steps 36
Front and side paths 37
Entry steps 37
Patio 38
Driveway 39
Checkpoint summary 41

5 Walls, windows, and doors 42

Exterior walls 43
  Exterior siding 44
  Masonry wall 51
Trim 52
Windows 53
  Inspection 55
Exterior doors 56
Storm windows, screens, and storm doors 58
  Storm windows 58
  Screens 58
  Storm doors 59
  Inspection 59
Caulking 59
Checkpoint summary 60

6 Lot and landscaping 62

Drainage 62
  Groundwater, water table 65
  Inspection 67
Retaining walls 70
  Inspection 71

Landscaping 74
Lawn 74
Shrubs 75
Trees 76
Decks 76
Free-standing decks 79
Composite decks 79
Fences 80
Checkpoint summary 81

7 Garage 84
Attached garage 84
Fire and health hazards 84
Plumbing check 86
Flood potential 88
Doors 88
General considerations 89
Detached garage 90
Exterior 90
Interior 91
Heat and electricity 92
Checkpoint summary 93

8 Wood-destroying insects and rot 95
Termites 95
Subterranean termites 98
Dry-wood termites 105
Formosan termites 106
Other wood-destroying insects 106
Carpenter ants 106
Powder-post beetles 108
Rot 109
Inspection 110
Checkpoint summary 112

INTERIOR INSPECTION

9 Attic 114
Insulation 115
Violations 116
Leakage 117
Fire hazards 117
Ventilation 118
Attic fan 120
Whole house fans 120
Structural 121
Checkpoint summary 123

10 Interior rooms 124

Walls and ceilings 125
Mold-resistant drywall 126
Chinese drywall 128
Floors 128
Heat 131
Windows 131
Electrical outlets 132
Fireplace 134
Gas-fired fireplace 136
Bedrooms 136
Bathrooms 137
Water pressure and flow 138
Kitchen 141
Hallway and staircase 142
Checkpoint summary 143

11 Basement and crawl space 147

Foundation 147
Settlement 148
Inspection 149
Dampness 154
Water seepage—causes and control 155
High groundwater level 155
Hydrostatic pressure—walls 156
Inspection 158
Furnace room 163
Ventilation 165
Crawl space 165
Conditioned crawl space 167
Checkpoint summary 168

ELECTROMECHANICALS

12 Electrical system 170

Inlet electrical service 170
Electrical capacity 171
Fuses and circuit breakers 174
Inlet service panel box 175
Panel-box interior 176
Aluminum wiring 176
Grounding 177
Improper ground connections 177
Interior electrical inspection 178
Electrical outlets 178

Knob-and-tube wiring 180
Low-voltage switching systems 180
Violations 181
Checkpoint summary 181

13 Plumbing 183

Water supply and distribution 184
Fixtures 185
Drainage system 185
Waste-disposal system 186
Cesspool 187
Septic system 187
Exterior inspection 191
Vent stack 191
Fresh-air vent 192
Lawn sprinkler systems 192
Septic system 193
Interior inspection 193
Fixtures 193
Cross-connection 193
Water pressure, flow 194
Plumbing wall hatch 194
Pipes 195
Basement inspection 197
Water-supply pipes 197
Distribution piping 198
Drainage pipes 199
Well-pumping systems 202
Wells 202
Well pumps 203
Accessory equipment 205
General considerations 206
Checkpoint summary 207

14 Heating systems I 209

Central heating systems 210
Heating outlets: registers and radiators 211
Thermostat and master shutoff 211
Warm-air systems 212
Advantages 213
Disadvantages 213
Gravity warm air 213
Forced warm air 215
Heat pump 218
Geothermal heating/cooling 218

Hot-water systems 219
Gravity hot water 219
Forced hot water 221
Steam heating systems 227
Distribution piping 228
Controls 229
Domestic water heater 231
Advantages and disadvantages 231
Hybrid heating systems 231
Steam–hot water 231
Hydro-air 231

15 Heating systems II 233
Oil-fired systems 233
Gas-fired systems 235
Electrical systems 236
Area heaters 236
Gas-fired units 237
Electrical units 237
Heating system inspection procedure 237
Warm-air systems 239
Hot-water systems 241
Steam systems 242
Oil burners 243
Gas burners 244
Checkpoint summary 244

16 Domestic water heaters 247
Tank water heaters 248
Reversed connection 248
Relief valve 249
Rumbling noise 251
Exhaust stack 252
Operational inspection 252
Water heater replacement 254
Water heater capacity and recovery 255
Tankless (coil) water heaters 256
Inspection procedure 258
Tankless (wall-mounted) water heaters 259
Indirect-fired storage water heaters 260
Checkpoint summary 261

17 Air-conditioning 262
Air-conditioning capacity 263
Air-conditioning systems 264
Integral system 264

Split system 264
Heat pump 272
Evaporative cooler 273
Checkpoint summary 273

18 Swimming pools 275

Concrete pools 275
Vinyl-lined pools 276
Preformed fiberglass pools 277
Pool equipment 278
Pool accessories 280
Inspection procedure 280
Checkpoint summary 282

OTHER ISSUES

19 Energy considerations 283

Energy audit 283
Insulation 284
Attic ventilation 287
Storm windows 288
Caulking and weatherstripping 289
Fireplaces and wood-burning stoves 289
Heating and air-conditioning systems 290

20 Environmental concerns 292

Radon 292
Asbestos 295
Drinking water 297
Lead 298
Formaldehyde 300
Leaky oil tanks 300
Electromagnetic fields 301
Mold 302

21 Green home technology 304

Roof 307
Roof-mounted structures 307
Paved areas around the structure 307
Exterior walls—siding (cladding) 308
Deck 308
Windows 308
Structural framing 309
Heating, ventilation, and air-conditioning (HVAC) 309
Water heating 310

22 Conclusion **312**
Professional home inspection 312
Home inspection limitations 312
Real estate warranty program 313
Private home inspection warranty programs 314
Manufacturers' warranties 314
Contract 314

Appendix **316**
Home inspector requirements 316
Quiz based on *The Complete Book of Home Inspection* 319
Quiz answers 334
ASHI Standards of Practice 335
ASHI Code of Ethics 343
ASHI membership categories and requirements 344

Glossary **345**

Inspection worksheets **348**

Index **355**

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Introduction

Over the years various new products and systems become available for house construction that are of interest to home buyers and owners as well as to home inspectors who have to examine and evaluate them. With each new edition of this book, I have tried to include those products and systems as well as items that may have inadvertently been omitted in the previous edition.

In this fourth edition, most of the chapters have been expanded to include additional items that should be checked during an inspection. Some of these topics are metal shingles, synthetic slate, fiber-cement siding, composite decking, free-standing decks, Superior Walls, conditioned space, Chinese wallboard, mold-resistant drywall, engineered lumber, laminate flooring, engineered hardwood flooring, bamboo flooring, air admittance valves, loop vents for island kitchens, hydro-air, geothermal heating and cooling, electronic low-water cutoffs, alternative septic systems (mound systems and alternating drainfields systems), PEX piping, recirculating hot water systems, tankless water heaters, and arc fault circuit interrupters. In addition, there is a new chapter titled "Green Home Technology" and an appendix that includes home inspector requirements.

By following the procedures outlined in this book, a home buyer will be able to look beyond the cosmetic and have a good idea as to the true condition of the house. The book is also helpful to an owner, who can use it to determine problems or potential problems in the house. There could be problems caused by deterioration as a result of aging or there could be safety or fire hazards. Very often the problems could be quite minor and could be corrected at little or no cost; however, if left unattended they could be quite costly to correct.

The section on home inspector requirements was included because I felt it was

important to inform the public about the demanding requirements and the training needed to become a professional home inspector. It will also be of interest to the many engineers, architects, and contractors who would like to work as home inspectors. The book should also be quite helpful to a buyer who wants to hire the services of a home inspector to check the condition of a prospective home.

Norman Becker, P.E.

The
Complete Book of Home Inspection

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1

Tools and procedure

Tools needed 1
Inspection procedure 2
Exterior inspection 2
Interior inspection 3
Electromechanical systems 4
Final inspection 5

The inspection procedure outlined in this book is similar to the one that I use when inspecting residential structures. Because the various components of homes are basically the same, this procedure is valid regardless of the geographic location of the structure. It has been used on homes of all ages, from newly constructed to pre-Revolutionary, from vacation homes to stately mansions.

Tools needed

To inspect the house properly, you will need the following tools: a flashlight, to see in dark places (and you'll be surprised what you might find); a magnet, to determine whether plumbing pipes are iron; a marble, to note whether the floors are relatively level; an ice pick or screwdriver, to aid in looking for wood rot and termite infestation; a 6-foot stepladder, for those houses that do not provide direct access (built-in or pull-down steps) to the attic; an electrical tester, for checking the electrical ground connection and the electrical polarity, particularly in the kitchen and bathroom outlet receptacles; binoculars, to get a closer look at the roof and roof-mounted structures; a thermometer to check the temperature of the domestic hot water; and a compass, to determine the building's exposure. Knowledge of the exposure is helpful in evaluating the condition of various structural elements and components.

Since the first edition was published, a number of electronic tools have come on the market that are being used by professional home inspectors. The one tool that I would recommend for homeowners and home buyers is a battery-operated moisture meter that checks for water leaks without damaging the surface being tested. One manufacturer of moisture meters is Delmhorst Instrument Co. They can be reached at (800) 222–0638 for information on purchasing a meter. You may have read about infrared cameras that can be used for thermal imaging of a house. The cameras are used for detecting heat loss, insulation deficiencies, and specific areas of air infiltration, and for locating moisture problems. Handling of these cameras, which are quite expensive, requires special training so that the images can be accurately interpreted. Infrared

cameras are not normally used during a home inspection. Most professional home inspectors do not have the camera, and those who do charge an additional fee for the service.

When performing the inspection, you should wear old clothes. Areas such as unfinished attics, basements, and crawl spaces are often quite dusty. The last items you need for inspection are a pencil and inspection worksheets. The worksheets are provided in the back of this book and should be completed as you perform the inspection. Later, you can use these worksheets to evaluate the true condition of the house and base your decision on facts rather than emotion.

Inspection procedure

A house, no matter how large or imposing, can be easily inspected if it is divided into its component parts, such as the exterior, interior, and electromechanical systems. The exterior and interior portions can be further subdivided. By approaching the inspection in a systematic order and using the worksheets provided as a guide, all the items of any consequence will be checked.

When driving up to the house, take a moment to notice the overall topography or shape of the land. Often, the topography in the immediate vicinity of the house is level; however, the overall topography might be inclined. Consequently, the possibility exists of subsurface water movement in the direction of the house. When you see inclined topography in the general area of the house, you should be alerted to the possibility of some water seepage into the lower level of the structure.

The exterior of the building should be inspected before the interior. This order is important because it provides you with an overall view of the structure that in turn can reveal the cause for some interior problems. Specifically, water seepage into a lower level can be the result of faulty gutters or downspouts, or improper grading (the ground immediately adjacent to the house slopes toward the house rather than away). A faulty roof can manifest itself in water stains one or two levels below the roof. Cracked and open exterior joints can allow the entry of water, which you will note as cosmetic damage to interior portions of the structure.

Exterior inspection

Before you start the exterior inspection, stand in front of the house and take a compass reading. The exposure for all four sides of the building should be marked on the worksheet (i.e., Front exposure—southerly; Right exposure—easterly, etc.). The exterior inspection is performed while walking around the house twice. The first time, you should look at the roof, gutters, chimney, vent stack, and anything else that is roof-mounted. The details of what to look for and how to inspect the various components of the house are discussed in the chapters that follow. During this first pass around the house, use binoculars so that you can get a closer view of the items on the upper portion of the structure. The binoculars should not have a magnification greater than 8X (eight times actual size). A more powerful pair of binoculars will tend to exaggerate hand movement, making it difficult to see details. The slightest hand movement will cause a blurred image. This problem, however, can be eliminated if you have a (more expensive) pair of 10X power binoculars with image stabilization.

After the first pass, the condition of those items inspected should be noted on the worksheet. If your first pass around the house is in the winter just after a snow, be careful where you walk. There may be a swimming pool behind the house that is covered over with snow. If you are concentrating on the

house, the pool may not be that obvious and you might step right into it. (See FIG. 1-1.)

During the second pass, you look for many types of problems. Start at the front of the house and look at all the items that are either on the front of the structure or in the front yard. Examples of these items are paths, entry steps, exterior wall siding, windows, doors, decks, landscaping, fence, and so on. All of the items normally encountered during an inspection are discussed in detail in the following chapters. You should be concerned only with those items that apply to the house you are inspecting.

After inspecting the front of the house, apply the same technique to the left side, the rear, and the right side of the building. If any items of a suspicious nature require further investigation on the interior of the structure, make a note on the worksheet as a reminder. For example, if an elbow is missing from one of the downspouts and no splash plate on the ground deflects the effluent from the downspout away from the building, you should check for water seepage from that area into the lower level of the structure. Noting this fact on your worksheet helps you remember to check the interior wall opposite the downspout for signs of water seepage.

After going around the building the second time, you should be finished with the exterior inspection. Double-check your worksheet to see if you've recorded the condition of all the items inspected. At this point, you should inspect the garage. After the garage inspection, you are ready for the inside of the house.

Interior inspection

Enter the house through the front door. Try the doorbell to make sure it is operational. It's important to remember that you are looking at a house you are interested in buying. If all goes well, this will be your home, so don't be shy or feel embarrassed about doing things that any homeowner would do. As part of the inspection, you should open and close faucets on sinks, tubs, and showers; flush toilets; open and shut doors and windows; turn on the heating system and air-conditioning system by means of the thermostats; feel the airflow from heat/cooling registers; see if radiators

Fig. 1-1. *Snow blanketing a swimming pool cover at the rear of a house.*

get warm; and turn switches controlling lights and fans on and off.

Start the interior inspection at the uppermost portion of the building. If the house has an attic, that's where you start. To inspect the attic, you might need your ladder—check with the owner. Some homes don't have an attic, so begin this portion of the inspection with the rooms directly below the roof.

After the attic inspection, check all of the rooms on the level directly below. In some large homes you can easily miss a room. To avoid overlooking any rooms or items, begin your inspection at the entry to that level. If you start at the entry and walk either clockwise or counterclockwise, looking at each room in order, you will return to your starting point and will have inspected all of the rooms. However, if you jump around from one side to another, you can easily overlook a room or two. Again, there is no substitute for good procedure.

After all the rooms on one level have been checked, proceed to the next lower level, inspecting the connecting staircase along the way. Check all the rooms on this level in the same manner. After all the finished rooms have been checked, inspect any unfinished areas such as the basement and crawl space. This is the end of the interior inspection. At this point, all the rooms, halls, and staircases throughout the house have been checked. To complete the home inspection, you must now check the electromechanical systems.

Electromechanical systems

The systems and associated equipment included in this category are electrical, plumbing, domestic water heater, heating, air-conditioning, and swimming pool. The condition, operation, and adequacy of each system in your house must be checked as described in its respective chapter and recorded on the worksheet.

This final check concludes your home inspection. You have now looked at every item in the house of any consequence and should have recorded on the worksheets all problems and deficiencies. Some of the problems you uncover might require the services of a professional for further investigation. All situations requiring the services of a professional are indicated in the chapters that follow.

Also, after the physical inspection, you might want to have certain tests performed to determine whether the house has environmental problems, such as a high radon concentration, contaminated well water, a leaking buried fuel-oil tank, lead paint, or a mold buildup.

Look at your worksheet and test results and try to evaluate the major problems. Do not expect a perfect house. You will always find minor problems, and the costs for correcting these problems should not concern you. However, if you find many minor problems, the costs for correction can be significant.

Of main concern from a cost point of view are major problems, some of which are defined as follows:

- The need for structural rehabilitation to the foundation
- The need for re-siding the exterior walls
- Water penetration into the basement or lower level
- A malfunctioning or obsolete heating system
- The need for repiping the plumbing system
- The need for a new roof
- A malfunctioning air-conditioning system
- Inadequate electrical service
- Termite infestation
- The need for complete rehabilitation to:
  —paved areas

—deck
—detached garage
—retaining walls

- Environmental problems

If you find a major problem, have a contractor look at it and give you a written estimate on the cost for correction. At this point, you should be able to determine the true cost of buying the house—the purchase price plus the costs for upgrading substandard, deteriorated, or malfunctioning components.

Final inspection

On the day of, but prior to, the contract closing, you should take one final walk through the house and look at the walls, windows, doors, and plumbing fixtures for cracked and broken sections. Sometimes damage occurs when the seller's furniture is being moved out or through vandalism when the house is left vacant for a period of time. Specifically, look for physical changes that occurred between the time of the contract signing and the closing.

During your walk-through, check the operation of the electrical, plumbing, and heating systems. The central air-conditioning system and swimming pool equipment should also be checked if the weather permits. Check the operation of all the appliances that are considered part of the purchase. If any appliances or electromechanical systems are malfunctioning, list them on a sheet of paper, along with any items that have been badly damaged since the contract signing. This list should be taken to the closing and discussed with the seller. Very often, dollar adjustments are made to compensate for the cost of repairs.

2

Roofs

Pitched roofs 6
Shingles 8
Asphalt shingles 10
Wood shingles and shakes 12
Asbestos-cement shingles 13
Slate shingles 13
Clay tiles 14
Metal shingles 15
Flat roofs 16
Built-up roofs (BURs) 17
Single-ply membrane 19
Roll roofing 19
Metal roofing 19
Checkpoint summary 20

Every roof has two basic elements—the *deck* and the weather-resistant *covering*. The deck (also called *roof sheathing*) serves as a base for supporting the roof covering that protects the structure from the weather. A proper roof inspection includes an evaluation of both the roof covering and the deck. Even though a covering might be in good condition, the deck underneath might be soft, spongy, and structurally unsound. This condition can be caused by rot or delamination and is not necessarily noticeable in an exterior inspection.

Pitched roofs

The technique used for inspecting the roof differs depending on whether the roof is pitched or flat. Pitched roofs are checked during your initial pass around the house. Because of the hazards involved, I do not recommend that you climb onto a pitched roof. Begin your inspection by stepping far enough away from the house so that you are able to see all exposed sections of the roof as you circle the structure. The use of binoculars is recommended for this inspection to get a close-up view of the roof.

As you walk around the structure looking at the roof, make note of any uneven, sagging, or damaged sections. Unevenness in the roof might be the result of warped sections of deck or a poor installation of a second layer of shingles. This condition is usually not a problem. However, shingles in uneven areas are more vulnerable to damage and water intrusion. Make a note on your worksheet of

the approximate locations of the uneven areas. During the attic inspection, you should check these areas for signs of leakage and to verify the cause of the unevenness.

Sagging sections in the roof, on the other hand, might be symptomatic of a structural problem or might reflect a problem that has been corrected. A sagging ridge beam or roof deck could indicate a structural failure, inadequate bracing, or inadequate spacing of wood-frame support members. The condition causing the sagging might have stabilized, so that no further corrective action is necessary. If you see a sagging ridge beam or sagging section of deck during your first pass around the house, have this condition evaluated by a professional.

Damaged sections can occur from falling tree limbs or swaying tree branches that overhang the roof. If you see a damaged section, record its location on your worksheet, since it must be repaired. Usually, patching the damaged area is all that is required.

Ventilation of the area directly below the roof deck is very important, especially in newer buildings where the deck is constructed of plywood panels rather than tongue-and-groove boards. If the area is inadequately ventilated, a moisture buildup can eventually cause the plywood sheathing to delaminate. This moisture problem is particularly acute in homes that have cathedral ceilings constructed in the following manner: The ceiling is plasterboard or an equivalent type of panel nailed directly to the roof rafters. Above the ceiling is insulation, and above this is the roof deck. Often there is a small air space between the insulation and the deck. When the moisture normally generated in the house by cooking, bathing, and so on reaches the area of the deck, there must be vent openings through which it can escape. Otherwise, rot and delamination can occur. A high percentage of the homes built with this type of cathedral ceiling have inadequately ventilated roof structures. Vent openings are needed near the top of each channel formed by the roof rafters and the ceiling and are also needed around the soffit. Often, only the soffit vents are installed. Vent openings for the top portion of the rafter channel can be provided through individual roof vents or a ridge vent. (See FIG. 2-1.) When the cathedral ceiling is the exposed roof-deck planks or panels, there is usually a rigid insulation on the top side between the deck and covering. This type of construction will not result in a deck having a problem with moisture accumulation, and therefore venting is not necessary.

If your house has a cathedral ceiling with no vent openings near the ridge, anticipate problems with the roof deck. You can tell if you have a deck problem by walking on the roof. If sections of the deck yield with each step and feel soft and spongy beneath your

Fig. 2-1. *Ridge vent. Note the ridge vent along the top of the roof. This low-profile ventilator helps circulate air through the area below the roof deck.*

feet, there are problems. Note that you should not attempt to walk on the roof if the pitch is steep or the shingles are a type that can easily be damaged, such as tile or slate. Also, if the roof is not readily accessible from a deck or an intermediate-level area, it is best to leave this part of the inspection to a professional. Even if the roof deck shows no signs of a problem, if the area is not adequately ventilated near the top of the roof, the installation of a ridge vent should be considered to prevent future problems.

Shingles

Pitched roofs are usually covered with shingles applied in an overlapping fashion. The shingles are not intended to be watertight; they protect the structure from rain intrusion by shedding water. The more common types of shingles are made of asphaltic material, wood, asbestos-cement, slate, and clay tiles. When inspecting the roof, pay particular attention to a slope that has a southerly or southwesterly exposure. These slopes receive a maximum sun exposure, and it is the sun's rays that cause the shingles to become brittle and age prematurely. Consequently, the shingles on these exposures will deteriorate more rapidly than the shingles on the other exposures. (See FIG. 2-2.)

Since shingles are intended only to shed water, any water that gets under them will leak into the interior of the structure. Shingles that are lifting, cracked, or broken are vulnerable to this type of water leakage. If you see this problem, it is an indication that some maintenance is needed. In areas where the winter temperature drops below freezing, roof leakage can occur as a result of an ice dam. Because of heat loss through the roof and heat from the sun, snow on a roof can start melting, even in freezing weather. As the water reaches the roof overhang, it often refreezes, forming an ice dam and blocking the melting snow from draining. As the snow continues to melt, the water backs up under the shingles and leaks into the interior. (See FIG. 2-3.)

Fig. 2-2. *The orientation of the house can affect the projected life of the roof shingles. The deteriorated shingles on the right slope have a southerly exposure, while the shingles on the left slope have a northerly exposure.*

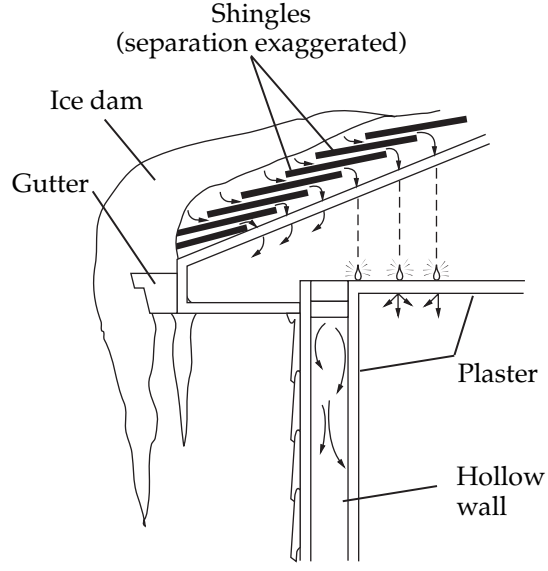


Fig. 2-3. *Ice dam at roof eaves. Because of the ice dam, water from melting snow backs up under the shingles and leaks into the house.*

Water leakage from this type of problem is not an indication of a faulty roof and should not be interpreted as a sign that roof repairs are necessary. It is an indication that adequate precautionary measures were not taken during the installation of the covering to eliminate or minimize the effects of an ice dam. The condition could have been reduced by the installation of eaves flashing. On existing roofs, the condition can be avoided by installing deicing cables along the edge of the roof and in the gutters and downspouts. This may not solve the problem completely, but it is somewhat effective. The deicing cables reduce the ice dam buildup by creating heated channels that allow water to drain into gutters and downspouts. The best method for minimizing an ice dam problem is to maintain what's called a *cold roof*. By overinsulating the attic floor and ventilating the attic profusely, the roof deck temperature will be lowered to the point where the snow won't melt.

When looking at a roof after all the snow has melted, you would never know whether there had been an ice dam and water leakage. Sometimes, however, you can see indications of a past problem—stained or warped sections of soffit trim or water stains on the ceilings of the rooms below, near the exterior walls. I have seen water stains on the ceilings of rooms two levels below the roof that were the result of water leakage because of an ice dam. Ice-dam problems will not necessarily occur every year; they depend on the severity of winter weather conditions.

Portions of the roof particularly vulnerable to leakage are the joints between the roof and roof-mounted structures, such as the chimney; the joint between the roof and a vertical sidewall; and the joint where two sloping sections of the roof intersect. The latter joint is commonly referred to as a *valley*. To protect the joints from water intrusion, they are normally covered with strips of a thin, impervious material called *flashing*. Sheet metal is usually used as a flashing material, with copper flashing as the top of the line; however, roll roofing strips are also used. Valley or sidewall flashing might not be visible, which depends on the type of joint construction. There are three basic types of valley construction: open, closed-cut, and woven valley. (See FIG. 2-4.)

When inspecting the roof, check the condition of the exposed flashing at the various joints. Loose, cracked, and deteriorated sections must be repaired. If there is leakage through any of these joints, it will usually be noted by water stains on the wood framing or roof sheathing in the

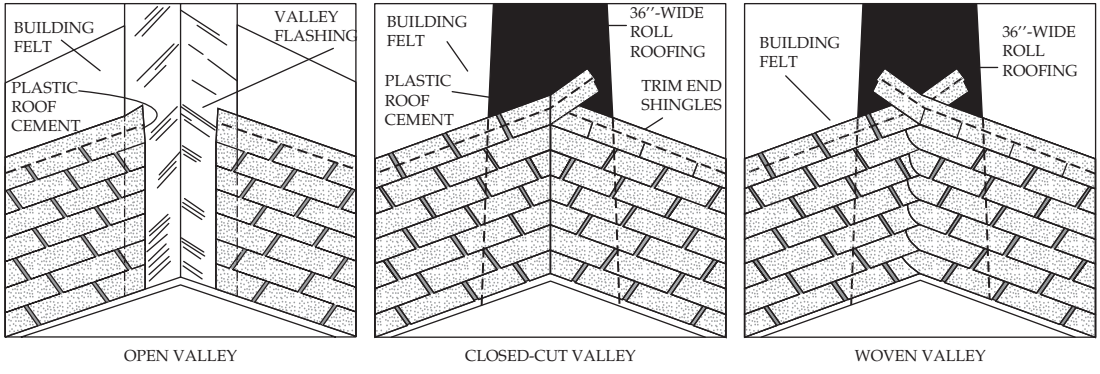


Fig. 2-4. *The three basic types of roof valley construction.*

attic or by stains in the ceilings of the interior rooms. Faulty joints are often resealed with an asphaltic cement rather than reflashed. The cement, however, is not as durable a seal as sheet-metal flashing, and the joint will often require periodic resealing.

Also check to see if the roof needs cleaning. Most pitched roofs need an occasional cleaning to remove an accumulation of debris—seed pods, twigs, pine needles, and leaves. Accumulated debris must be removed, especially from the spaces between the shingle tabs. If the debris is allowed to remain on the roof, it will retain moisture and promote the growth of moss and fungi, which is detrimental to the roofing. In addition, the litter can impede the runoff of rainwater, resulting in leaks.

Some asphalt shingle roofs develop a discoloration or what appear to be dirty streaks. The condition is often caused by wind-borne microscopic algae or mildew spores, which do not degrade or affect the performance of the shingles. It does, however, detract from the overall aesthetic appearance of the roof. The condition can usually be controlled by installing copper or zinc strips across the length of the roof and every few feet down the roof's slope.

Asphalt shingles The most common type of roof shingle used in this country is asphalt shingle, made by impregnating mats of fiberglass or organic felt materials such as rags, paper, and wood pulp, with asphalt and covering one surface with mineral granules. The *mat* is the vehicle for supporting the asphalt, which is a water-resistant material. The granules protect the shingle from damaging sun rays and provide color. When inspecting asphalt shingles, look for loss of granules, missing and torn sections with erosion of the mat. (See FIG. 2-5.) Some fiberglass-mat shingles have failed prematurely because of cracking, which can take the form of horizontal, vertical, and diagonal cracks across the shingles.

A particularly vulnerable location for leakage is the area between the shingle tabs. The granules in this area tend to come loose before those in other sections, exposing the mat to the weather. Although most roofs have a double and triple layer of shingles, a small section of the area between the shingle tabs has only one-shingle coverage. Thus, an eroded mat in this area is very vulnerable to water leakage. Loss of granules and erosion of the mat between shingle tabs is a deficiency that usually occurs on the roof slope with a

Fig. 2-5. *Deteriorating asphalt roof shingles. Note torn, missing, and brittle shingles with a loss of the granule covering, exposing the roofing mat.*

southerly or southwesterly exposure before other slopes. The condition is usually visible from the ground and can be clearly seen with the aid of your binoculars. When you see such a problem, you should anticipate early replacement of the roof shingles.

Most homes are designed to take three separate layers of shingles, although in some communities only two are allowed. When a new covering is needed on a structure that already has the maximum layers allowed, it is necessary to remove all the layers before installing the new shingles. When reroofing, it is more costly to remove existing layers of shingles than to install a new layer over existing shingles. Therefore, you should try to determine the number of layers. When the roof has an exposed edge, as in the case of a gable roof, look at the thickness of the layers. If you see two to three overlapping shingles, the roof covering is the first layer. In a hip type of roof, since there are no exposed edges, this type of determination cannot be made. In this case, try to find out the age of the house. Asphalt shingles have a projected life of seventeen to twenty-two years. The actual life span of the shingles will depend on the weight of the shingles, the type of mat, and the exposure. Asphalt shingles are classified by weight (pounds per roofing square); a roofing *square* is 100 square feet. Lightweight shingles, the least costly, weigh about 215 pounds per roofing square. Heavyweight shingles weigh about 350 pounds per square and have a longer life expectancy than lightweight ones.

If the covering is over seventeen years old, extended life for the shingles should not be anticipated. Even though the shingles might look all right (lying flat with no noticeable loss of granules or erosion), they are becoming brittle and vulnerable to wind damage. Also, these shingles will be more vulnerable to damage from someone walking on the roof when cleaning the gutters, installing a TV dish antenna, and so on. Often, these shingles will show signs of aging such as curling, cupping, cracking, and pitting. (See FIG. 2-6.) Such shingles are vulnerable to damage and will deteriorate rapidly. An exact estimate of the usable years or months remaining for the shingles is difficult. Some people do not replace an aging roof until there is a leakage problem. Others will replace it before any leakage occurs thus avoiding the cosmetic damage caused by leakage. The life span of an aging roof can be extended by patching and coating exposed cracks and eroded areas. However, even if you see no signs of leakage, the shingles on a roof that can take a second layer should be replaced before they become brittle, curl excessively, crack, and chip, as shown in FIG. 2-7. Because of the physical condition of these shingles, the surface of a second layer of shingles will be uneven, lumpy and aesthetically unattractive. In this case, for a nice even appearance the old shingles need to be stripped off the roof deck before the new shingles are installed.

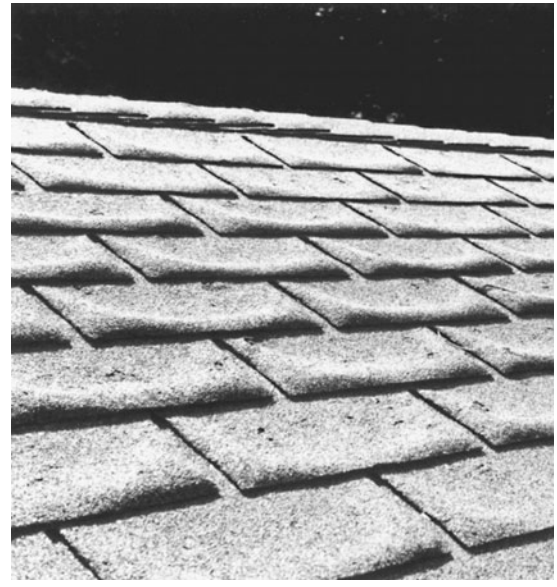


Fig. 2-6. *Aging asphalt roof shingles. Note curling of the edges, with some pitting.*

Fig. 2-7. *These old, weathered asphalt roof shingles are dry, brittle, cracked, chipped, and excessively curled.*

If more than approximately one-third of the roof shingles show signs of advanced aging, I recommend reroofing. At this point, attempts to extend the life of the shingles are usually not economically justifiable.

Wood shingles and shakes In many parts of the country, wood shingles and wood shakes are used as a roof covering. The basic differences between the two are appearance and thickness. During the manufacturing process, shingles are sawed; shakes are split. Consequently, wood shingles have a relatively smooth surface, and shakes have a textured surface.

Because of the need for resistance to decay, most wood shingles and shakes (hereafter referred to as shingles) are made from cedar. They are also made from redwood and southern cypress. The shingles, although resistant to decay, are not immune to decay and will rot after prolonged exposure to moisture. (Rot-producing fungi are discussed in chapter 8.) The projected life expectancy for a wood-shingle roof is twenty-five to thirty years. As a wood-shingle roof ages, the shingles dry, crack, curl, and rot. As you walk around the house looking at the roof, be aware of aging shingles. Rotting shingles should be replaced. If you notice loose, damaged, or missing sections, repair is needed, even if you see no signs of water leakage. When approximately one-third of the shingles on a slope show signs of excessive aging (rotting, chipped, cracked, loose, missing, or curling), all the shingles on that slope should be replaced.

On the northern slope or on portions of the roof that are usually shaded, you might see moss growing in clusters between the joints of the shingles. It should be removed. The moss functions like a wick; the root system provides a direct path for water entry. In addition, as the moss cluster builds up, it might lift the shingles slightly, making them more vulnerable to water penetration, particularly during a driving rain.

Wood shingles have traditionally been installed on spaced sheathing, as opposed to solid sheathing, which acts as nailing strips.

This enables air to circulate on the underside of the shingles so that they can dry from both sides. The shingles are spaced between ⅛ and ¼ inch apart to allow for swelling during damp weather. Because of this space and the irregularities of some of the shingles (due to thickness and texture), daylight might be visible through portions of the roof from the attic. If during your inspection of the attic you see daylight through a wood-shingle roof, don't think that roof maintenance is necessary. If daylight is visible through the roof by means of an indirect path, maintenance is not required. On the other hand, if daylight is visible via a direct path, such as a crack, some maintenance is needed. Depending on the pitch of the roof, the shingles are two-, three-, or four-ply and are installed so that the joints between the shingles for the various plies do not line up. When daylight is visible via a direct path, cracks in the shingles line up with the joints. In this case, water can penetrate the roof, and maintenance is needed. On newer construction, you may find the roof deck consisting of solid sheathing. This is not a problem. In such a case, in order to provide the needed air circulation on the underside of the shingles, a product called Cedar Breather is probably installed between the shingles and the roof deck. Cedar Breather is a three-dimensional nylon matrix that is stiff enough to resist crushing, thereby allowing air movement to the underside of the shingles.

Asbestos-cement shingles Asbestos-cement shingles were manufactured by combining asbestos fibers with Portland cement under high pressure. Although the shingles are no longer manufactured, they can be found on many homes. Because of the asbestos ban in the mid-1970s, similar-type shingles are now manufactured using nonasbestos man-made fibers and cement. The shingles possess properties that make them highly suitable for exterior use. They are immune to rot, unaffected by exposure to salt air, and fireproof. One drawback is that they are weak in their resistance to impact and thus are vulnerable to cracking and chipping.

As you walk around the exterior of the building during the roof inspection, look for cracked, loose, chipped, and missing shingles. Note on your worksheet the areas that will require maintenance. Although asbestos-cement shingles individually last many years, an asbestos-cement-shingle roof should not be considered maintenance-free, and periodic repairs should be anticipated. Occasionally, as with a wood-shingle roof, clusters of moss might be found on the northern slope or slopes shaded by trees. If you see this condition, note it on your worksheet. The moss is a potential problem and should be removed.

Slate shingles Of all roof coverings, slate shingles are the most durable. If they are of good quality, they can last indefinitely (at least in excess of one hundred years). The slate roof over the Saxon Chapel at Stratford-on-Avon in England is over eleven hundred years old and, according to the Vermont Structural Slate Company, is in good condition. A slate roof, however, does not remain maintenance-free, even though the slates are of good quality. I have seen very few slate roofs that did not have some cracked, loose, chipped, or missing slates, a condition that requires some repair. These repairs are considered minor roof maintenance and should be anticipated on a periodic basis. Slate roofs are often patched with asphalt cement, which has a tendency to dry and crack and requires periodic application. When inspecting this type of roof from the exterior, look for cracked, loose, chipped, or missing shingles. If you find any, make a note on your worksheet.

Repairs to a slate roof, even minor ones, can be somewhat costly. Several roofers have told me that their fee reflects additional work above and beyond the required repair because they always anticipate accidental cracking

Fig. 2-8. *Slate roof shingles. The ribbon slate is of inferior quality. Cracking often occurs along the ribbon after only 10 years.*

of some of the slates during the repair. One difficulty you should be aware of is that when replacing a slate shingle, the roofer might not be able to match the color of the new slate to the existing weathered shingles.

Sometimes a poor-quality slate, *ribbon slate*, is used as a roof covering. (See FIG. 2-8.) The ribbons within the individual shingles are softer than the normal slate and will cause the shingles to crack along the ribbon. Often, cracking occurs along the ribbon after only ten years. Repairs to these shingles must then be made as needed.

When inspecting the roof, flaking slates may also be noted. Surface flaking is of no concern, since the shingles are at least 3⁄16 inch thick and are basically impervious to water. However, if any of the shingles are deteriorating as a result of excessive splitting and flaking (a condition brought about by winter freeze-thaw cycles), they should be replaced.

There are a number of synthetic slate look-alikes that are now on the market. These products have the durability, texture, and appearance of natural slate and are lighter in weight. The materials used for synthetic slates are quite varied. One product called FlexShake is made from recycled steel-reinforced rubber automobile tire treads. Others are made from recycled postindustrial rubber and plastic waste. There is also a synthetic slate made from ground natural slate, resin, and fiberglass, bonded under high pressure. Although synthetic slates are too new to comment on their life span, manufacturers estimate it at 40 to 60 years or more.

If the house you are inspecting is in the northern part of the country where snow might accumulate, look for snow guards on the lower portion of the roof. (See FIG. 2-9.) In particular, they should be located above doorways, sidewalks, or other areas where people will pass or gather. Snow guards are needed to prevent sliding masses of snow and ice from falling off the roof and damaging the gutters. It might interest you to know that the slate roofs on the buildings of the Harriman estate in New York had 35,000 copper-wire snow guards.

Clay tiles Clay tiles are available in many patterns. The most common are *Spanish*

Fig. 2-9. *Snow guards along the edge of the roof will help keep the snow from sliding off.*

and *Mission*. These tiles are made by shaping moist clay in molds and firing the various shapes. They are hard, durable, and fireproof. However, they are also brittle and can be easily damaged by falling tree limbs or climbing on the roof to make repairs. As with slate shingles, repair or replacement of individual tiles is more difficult and costly than that of asphalt shingles. Also, matching new tiles to the weathered tiles is usually a problem. When inspecting this type of roof, look for loose, broken, chipped, cracked, or missing tiles. If any of these conditions is found, it should be noted on the worksheet, as repairs are needed. Tiles can also deteriorate as a result of freeze-thaw cycles. You might find some cracked areas that have been sealed with asphalt cement. This condition is usually an indication of past problems. Since asphalt cement does dry and crack, periodic reapplication should be anticipated.

Check the joint (valley) between two sloping sections of the roof. (See FIG. 2-10.) If it's filled with asphalt cement, it's an indication of a problem condition that has been temporarily corrected. The flashing in that joint should be replaced. As with slate roofs, repairs, even minor ones, can be somewhat costly. This item should be noted on your worksheet.

Metal shingles Metal shingles are becoming more popular for residential roofing. They are available in several different shapes and are primarily made from painted or coated aluminum or steel panels although they are also made from copper. The panels are approximately 4 feet wide by 1 foot high and are formed to resemble wood shakes, slate, or Spanish, Roman, and Mediterranean tiles. The shingles are durable, lightweight, and fire resistant. Some have embedded stone chips for additional texture.

When inspecting the roof look for loose nails or loose shingle panels, both of which can result in leakage. Check to see if any of the joints between panels and valley sections are covered with roofing cement, which indicates

Fig. 2-10. *Valley joint filled with a heavy layer of asphalt cement is an indication of a problem condition.*

past and potential problems. From a cosmetic point of view, is the finish on the shingles fading or chalking? Record your findings on the worksheets.

In addition to shingles, flat sheet metal roofing has also been gaining in popularity for residential pitched roofs. Metal roof panels that come in widths of 12, 16, 18, and 36 inches are installed so that they run down the slope of the roof, essentially from ridge to eave. The joints between the panels are overlapped and interlocked to provide weathertightness. Do not climb up to the roof for an inspection. Metal roofs are slippery when wet, and depending on how the panels are supported they could be dented. The roof should be inspected from the ground with binoculars. If there are any doubts about its condition, have it inspected by a professional roofer.

Flat roofs

A roof that is perfectly level or slightly pitched is referred to as a *flat roof*. Since this type of roof is not visible from the ground, the inspection must be made from the roof itself. As with a pitched roof, a flat roof should be the first item inspected. Safe access to the roof is of prime importance. If the building is higher than one story, the roof should be accessible from the interior. Anything other than an interior means of access is a potential hazard and is considered a deficiency in the structure's design. If the roof you are inspecting is flat and is more than one story high with no interior access, it is best to have it inspected by a professional roofer.

Ventilation of the area directly below the roof deck is needed to minimize the moisture buildup in this area. An excessive moisture condition can result in deterioration of the roof deck, a lowering of the thermal resistance of the insulation, and, eventually, damage to the interior of the structure. During the cooler months, the moisture trapped in the area between the roof and the upper-level ceiling will condense, drip onto the insulation, and cause random water stains on the ceiling. Adequate ventilation of this area is also important in reducing the summer heat load on the rooms located immediately below the roof.

All too often, provisions for ventilation have been omitted by the builder. Therefore, when inspecting a flat roof, be sure to look for ventilation openings. The openings might be in the form of roof vents (vertical pipes protruding through the roof deck) or open areas in the side of the building just below the roof. Roof vents are often shielded from the rain by a cover and should not be confused with the plumbing vent stacks, which also protrude through the roof deck. The plumbing vent stack is connected to the house sewer line and is easily identified by the odor of the discharging gases. If no ventilation openings are noted, that fact should be marked on your work-sheet, and installation of ventilation openings should be considered.

A flat roof must have a watertight covering, rather than one that merely sheds water, to protect the area below the roof from water intrusion. The most common types of flat-roof coverings are built-up, single-ply, roll roofing, and metal. When inspecting a flat roof, look for ponded water. Unless the roof was specifically designed to hold standing water as an energy conservation measure, to reduce the heat load during the warm or hot months, its presence is considered a potential problem. Ponded water can become a breeding place for insects and can promote the growth of vegetation and fungi. The roots of plants growing on the roof can puncture an asphalt covering. The freezing of ponded water that has penetrated into the layers of a built-up roof can delaminate the roof covering. The temperature difference of the wet and dry areas on a randomly ponded roof results in differential expansion that might cause warping and cracking of the roof cover. If you see ponded water or signs of past ponding on the roof during your inspection, note the location on your worksheet as an area that should be drained.

A properly designed roof should have provisions for drainage. Two basic drainage designs are used in a flat roof—the perimeter system and the interior drainage system. In the perimeter system, water that drains from the interior portions of the roof collects in gutters or scuppers (openings in a parapet wall) located along the perimeter and then flows into downspouts or merely drips off the roof. In the interior drainage system, drains are located in the roof itself and are connected to downspouts that run through the interior of the structure. Look for one of these drainage systems as you walk around the roof. The interior roof drains are often clogged with debris and are sometimes set higher than the surrounding area, a condition that results in ponding. Look for cracks around the joints between the roof drain and the roof covering.

When inspecting a flat roof, you should also inspect all roof-mounted structures and projections such as skylights, hatch covers, chimneys, vent stacks, and so on. These items are discussed in chapter 3.

Built-up roofs (BURs)

This type of roof consists of bitumen (asphalt or coal-tar pitch) sandwiched between two to five layers of roofing felts and is usually covered with a mineral aggregate embedded in the top surface. The bitumen is the waterproofing agent, stabilized and reinforced by the roofing felts. The felts restrain the bitumen from flowing in hot weather and help resist cracking in cold weather. The aggregate surfacing generally consists of gravel, slag, or crushed rock. Its purpose is to protect the bitumen from the damaging effects of the sun's infrared and ultraviolet rays. These rays, through a combination of heat and photochemical oxidation, accelerate the aging of bitumen, resulting in premature brittleness and cracking. Depending on the number of layers in the builtup roof and the quality of construction, the projected life can vary from ten to twenty years.

An aggregate-covered built-up roof is difficult to inspect, principally because of the

mineral-aggregate topping. Nevertheless, look for telltale signs of past, current, and potential problems. Walk around the roof systematically so that you cover the entire roof area. Look for patched areas, cracking, blistering, surface erosion, alligatoring, and wrinkling. In particular, look for cracks at the joints of roof projections and roof-mounted structures.

Usually, this type of roof has a flanged metallic strip along the perimeter, a *gravel stop*. It provides a finished edge for the built-up roofing and also prevents loose aggregates from washing off the roof. Look for cracks in the joint between the gravel stop and the roof. All cracks in the roof cover should be sealed. Record the location of any cracked or patched areas on your worksheet so that you can check the ceiling of the rooms below these areas for water stains.

Not all builtup roofs have a top surface covered with aggregates. A smooth-surface roof treatment has a weathering surface that is an asphalt-saturated roofing felt. Since the top surface is exposed, defective or deteriorated sections are visible. To maintain the weathering surface in reasonably good condition, the surface should be covered with a protective coating such as an asphalt-based emulsion every three to six years. Excessive application of the emulsion will result in alligator-type surface cracking, which is a potential problem. (See FIG. 2-11.)

Fig. 2-11. *Roof surface with alligator-type cracks.*

Incidentally, when walking on the roof, be careful not to step on any *blisters*—weak spots in the roof covering, usually the result of air or water vapor being trapped between the layers of roofing felts. Depending on a blister's brittleness, the weight of someone walking on the blister might cause the roofing felt to crack.

Single-ply membrane

In the 1970s, the notion that a single ply of rubber, plastic, or modified bitumen material could provide the same weather protection as a built-up roof gained acceptance. Initially, single-ply membranes were used on commercial and apartment buildings; today, they are also used on residential structures with flat roof decks.

Several methods are used for installing a single-ply membrane. The membrane can be loose-laid over the roof deck and attached only at the perimeters. It is then held in place everywhere else by the weight of gravel or concrete pavers placed on top. Another method is to adhere the membrane to the roof deck fully with a self-adhesive or an adhesive applied at the jobsite. Single-plies can also be installed as a partially adhered system by using mechanical fasteners or applying an adhesive at predetermined intervals.

When inspecting a single-ply roof membrane, look specifically for open joints at seams that are not properly adhered; check for membrane erosion and punctures; and look for cracks, splits, and open sections around the perimeter walls and roof projections. As with a BUR, if the membrane is covered with gravel or paving blocks, a visual inspection of the weathering surface is not practical. In this case, pay particular attention to the condition of the ceilings in the rooms directly below the roof.

Roll roofing

This type of covering is often found on older structures in urban areas and over porch roofs. It is also found on pitched roofs of low-cost homes and outbuildings. It consists basically of an asphalt-saturated roofing felt applied directly over the roof deck and provides only single- or two-ply coverage. Quite often, the outer surface is coated with hot tar to seal joints and small cracks. Roll roofing should be inspected for blistered, cracked, eroded, weathered, torn, and aging sections. (See FIG. 2-12.) Be careful not to walk on blistered sections. Sometimes the lapped joints between the strips curl and lift, making the joints vulnerable to water seepage. Check the joints between the roof and the parapet wall and other roof projections. These joints are vulnerable to cracking and periodically require resealing. (See FIG. 2-13.) If any of the above items are noted, they should be recorded on your worksheet, since they indicate the need for some maintenance.

Metal roofing

In older homes, the roof that covers porches, garages, or an exterior side projection such as a sunroom is usually made of galvanized iron (sheet iron coated with zinc), *terne* metal (steel-coated with a mixture of lead and tin), or copper. A galvanized roof with a heavy zinc coating will last many years without painting. However, a lightly galvanized roof will rust and must be kept well painted. A terne metal roof, if kept well painted, can last for over forty years. A copper roof will also last for many years and does not require painting. Occasionally, a sheet-metal roof covering might be found on the main roof of a Victorian structure. When you are inspecting a sheet-metal roof, look for cracks or open joints at the soldered seams; because of the large amount of expansion that

Fig. 2-12. *Weathered, cracked, and aging roof membrane.*

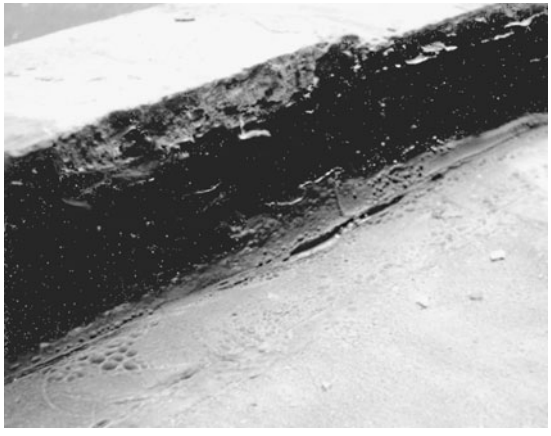


Fig. 2-13. *Cracked and open joint between the roof and the parapet wall.*

takes place, the seam is a vulnerable joint for leakage. Also, look for exposed corroding sections of metal; they must be scraped and coated with paint or a bituminous compound such as asphalt cement. In some cases, problem conditions that have occurred over the years have necessitated coating the entire roof with a bituminous compound as a means of sealing corroded areas. Be aware that this type of roof coating requires periodic maintenance.

Checkpoint summary

Pitched roofs

- ❍ Visually inspect all portions (slopes) of the roof.
- ❍ Note any sagging, uneven, damaged, or patched sections.
- ❍ Look for overhanging tree limbs or branches that can cause damage.
- ❍ Is the area directly below the roof deck ventilated?
- ❍ Is the roof in need of a cleaning?

Asphalt shingles

- ❍ Look for curling, cracked, torn, or missing shingles.

- ❍ Are shingles losing their stone granules?
- ❍ Look for eroded sections in the slot between the shingle tabs.
- ❍ Pay particular attention to slopes with a southerly or southwesterly exposure.
- ❍ How old are the roof shingles?
- ❍ How many layers of shingles?
- ❍ If roof has been recently reshingled, is a guarantee/warranty available?

Wood shingles, shakes

- ❍ Look for rotting, loose, cracked, chipped, or missing sections.
- ❍ Pay particular attention to the slopes with heavy shade.
- ❍ Any signs of moss?

Slate, asbestos-cement, clay tiles

- ❍ Look for missing, cracked, chipped, flaking, or loose sections.
- ❍ Sections patched with asphalt cement?
- ❍ Are there snow guards along the lower edge of the tile roof?
- ❍ Are the valley joints filled with asphalt cement?

Metal shingles

- ❍ Check for loose nails and loose shingle panels.
- ❍ Are any joints or valley sections covered with roofing cement?
- ❍ Are there any chalking, faded, or dented sections?

Flat roofs

- ❍ Safe access available?
- ❍ Cracked, blistered, eroded, split, punctured, or torn sections?
- ❍ Look for open joints and seams.
- ❍ Areas of ponding water or low points where water will accumulate?
- ❍ Drainage system functional?
- ❍ Area below the roof deck adequately ventilated?

Built-up roofs (BURs)

- ❍ Are there areas with missing aggregate?
- ❍ Look for blisters in the membrane.
- ❍ Look for patched areas, surface erosion, and alligatoring.
- ❍ During the interior inspection, check the ceilings of the upper-level rooms for water stains.

Roll roofing (tar paper)

- ❍ Sections drying, eroding, or blistered?
- ❍ Look for open seams.

3

Roof-mounted structures and projections

Chimneys 22
Vent stacks 26
Roof vents 27
Roof hatch 28
Skylights 28
TV antennas 28
Lightning protection 29
Gutters and downspouts 29
Built-in gutters 30
Exterior-mounted gutters 30
Downspouts 32
Checkpoint summary 34

When inspecting a roof, you should also inspect all roof-mounted structures and projections. Specifically, look at chimneys, plumbing vent stacks, roof vents, roof hatch, skylights, TV antennas, and gutters and downspouts. Except for the last two items, an area of concern is the joint between the item and the roof. This joint, although normally sealed with flashing, is vulnerable to water leakage. With years of weathering, the flashing can develop cracks, pinholes, or breaks, resulting in periodic leaks. To correct this type of water leakage, rather than reflashing the joints, the homeowner might often seal the joints with asphalt cement. While this is an effective correction, the asphalt cement will eventually become brittle and crack, and the joints will require periodic resealing.

Chimneys

Chimneys are used to vent smoke and combustion gases from heating units and fireplaces. If, during your exterior inspection, you do not find a chimney, it does not necessarily mean that the house lacks a heating system. In all probability, the house is heated electrically.

Chimneys are normally constructed of masonry (brick, concrete, stone) or are prefabricated from metal or a cement-asbestos material. Masonry chimneys are usually supported by their own footings, which in northern communities extend below the frost line. These chimneys are not dependent on the main structure for support. When inspecting a

masonry chimney that extends up the side of a building, if you see open joints between the chimney and the sidewall, it is an indication of some settlement and is often not a problem. (See FIG. 3-1.) However, the open areas should be sealed to prevent water intrusion. On the other hand, if the chimney is no longer vertical, it indicates excessive settlement because of the lack of a footing, or one that's improperly designed, and it should be checked by a professional. Depending on the degree of settlement, the flashing at the joint between the chimney and the roof might need repair. The movement of the chimney could result in open and loose sections of flashing. (See FIG. 3-2.)

Fig. 3-2. *Open and loose sections of flashing caused by movement of the chimney.*

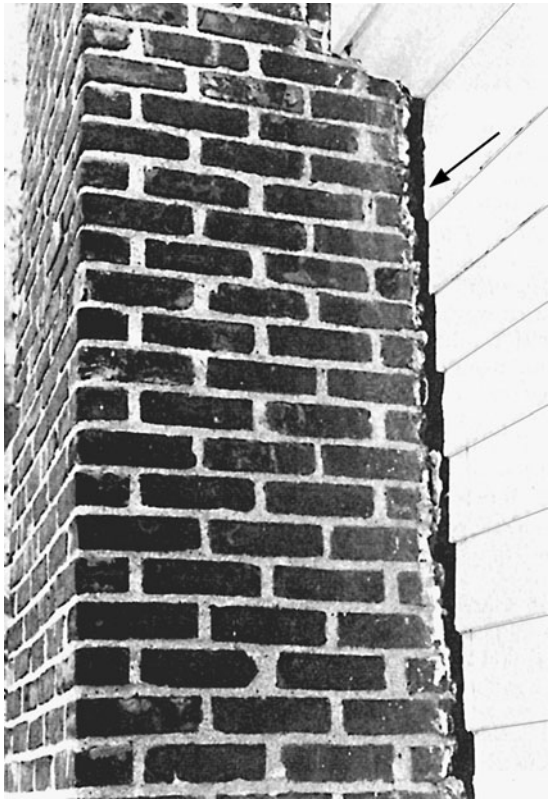


Fig. 3-1. *Uneven settlement of chimney. Note the open joint between the chimney and the sidewall.*

If your house has a brick chimney, look at the area above the roofline to see that it is vertical. Over the years, the mortar joints can weaken on one side and cause the chimney to lean. (See FIG. 3-3.) A leaning chimney represents a potential safety hazard and should be checked by a professional mason to determine whether or not corrective measures are needed, such as either bracing or rebuilding from the roofline up. If you ask the owner about the chimney, you'll probably learn that it has been in that condition for at least fifteen years. That fact does not mean that corrective action is not needed. A leaning chimney is an indication of weakening mortar joints and should be considered of questionable structural integrity.

Sometimes brick chimneys on relatively new houses might be coated with white mineral deposits called *efflorescence*, a condition often caused by the absorption of water by the bricks. The minerals in the bricks dissolve in the water and then surface when the water

Fig. 3-3. *The portion of the chimney that extends above the roof is leaning, a potentially hazardous condition.*

evaporates. Although efflorescence is quite common in new brickwork, it can easily be scrubbed or washed off with a dilute solution of muriatic acid. Recurrence can usually be controlled by covering the bricks with a vapor permeable water repellant. Efflorescence on a brick chimney that has been up for many years usually means that water is getting inside the chimney, through cracks in the joints on top of the chimney or cracks in the bricks or mortar joints. If you see heavy efflorescence on an older chimney, make a note on your worksheet. The top of a masonry chimney should have a cement finish that slopes from the flue to the edge of the chimney. The purpose of this finish is to deflect rain and protect the joints between the flue and the chimney. This cement finish is vulnerable to cracking, and periodic resealing of this area should be anticipated.

The top of the chimney must extend above the roofline to prevent downdrafts caused by the turbulence of the wind as it sweeps past nearby obstructions or over sloping roofs. The top of the chimney should extend at least 3 feet past the highest point where it passes through the roof, and 2 feet higher than any roof part within 10 feet measured horizontally (FIG. 3-4). When a chimney is 10 horizontal feet beyond a roof ridge, builders often terminate the top of the chimney below the ridge. This is not quality construction, but it satisfies the code. In this case, downdrafts can still occur as a result of air currents formed when the wind hits the side of the building. The downdrafts can affect the efficiency of the heating system or result in backsmoking of the fireplace. This type of problem can usually be controlled by installing a concrete or stone cap about 8 inches above the top of the flue.

Older homes very often have unlined chimney flues. Although these chimneys might operate satisfactorily, they are a potential hazard. Over the years, the corrosive gases can have a deteriorating effect on the mortar joints. (See FIG. 3-5.) If an unlined chimney in your house is connected to a fireplace, and if you intend to use the fireplace, you should have a flue liner installed down the existing flue. This

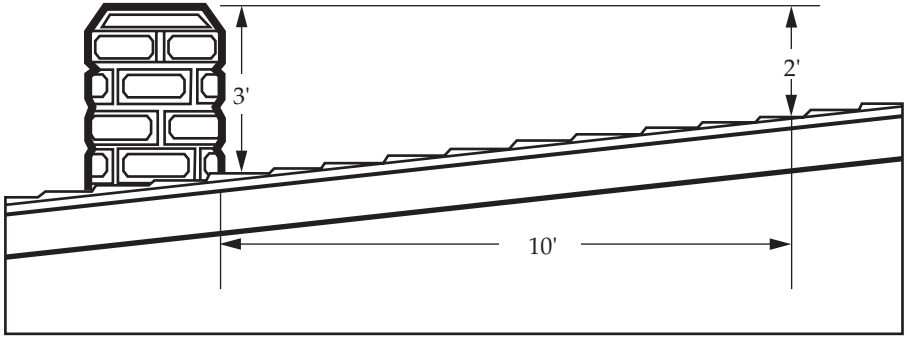


Fig. 3-4. *Chimneys should extend at least 3 feet past the highest point where they pass through the roof, and 2 feet higher than any roof part within 10 feet measured horizontally.*

Fig. 3-5. *Deteriorated chimney with no flue liner. Chimney should be rebuilt and flue should be lined.*

is an important fire safety measure and should be recorded on your worksheet.

In many homes when the flue damper in the firebox has deteriorated, it is replaced with a chimney-top damper. (See FIG. 3-6.) This spring-loaded damper is mounted over the flue opening at the top of the chimney. The device has a stainless-steel wire that runs from the damper down the flue into the opening of the fireplace. If you see a chimney-top damper during your inspection, don't forget to check its operation when inspecting the fireplace.

All masonry chimneys should be inspected for cracked, loose, chipped, deteriorating, and missing sections of brick and mortar joints. Some masonry chimneys have a stucco finish. In this case, look for cracked, chipped,

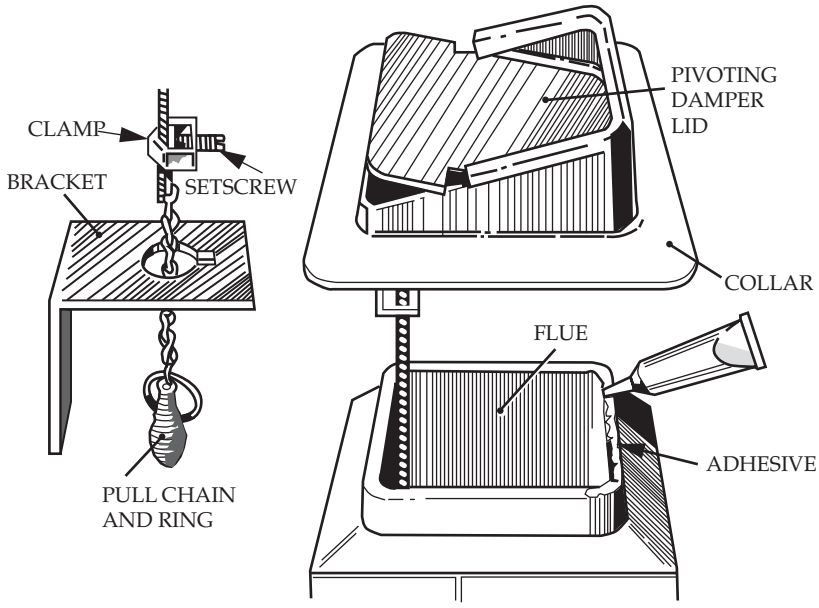


Fig. 3-6. *Spring-loaded chimney-top damper covers flue opening at top of chimney.*

and loose sections of stucco. Brick chimneys on older homes are sometimes covered with an asphalt-type coating, especially above the roofline. This technique is often used to prolong the life of the chimney when there are many cracked mortar joints and deteriorating bricks. It is considered makeshift. If you see any of the above items, they should be recorded on your worksheet.

Is there a *cricket* (also known as a *saddle*) behind the chimney? (See FIG. 3-7.) There should be one if the chimney is located along the slope of a roof and is more than 2 feet wide. The cricket prevents debris or snow and ice from piling up behind the chimney. This can cause rain or melting snow to back up under the shingles and leak into the house. The cricket also deflects water running down the roof around the chimney.

For the most part, very little maintenance is needed for prefabricated chimneys. Metal chimneys have a tendency to rust and should be checked for corrosion holes. If a metal chimney has no rain cover, note it on the worksheet; a cover is recommended.

Vent stacks

The vent stack is part of the plumbing system. Its purpose is to permit adequate circulation of air in all parts of the sanitary drainage system and to allow a means for sewer gas to vent harmlessly to the atmosphere. All homes should have at least one vent stack. (See discussion of air admittance valves in the Violations section of chapter 9.) The absence of a vent stack usually indicates that the plumbing system is not properly vented, almost always a violation of the plumbing code. As you inspect the roof, look for a pipe that projects through the roof and terminates about 8 inches above the roofline. In newer homes, the vent stack is usually fairly obvious. In older homes, however, the vent stack might be missing or at least not visible when looking at the roof. On occasion, I have found vent stacks that terminate in the attic. This condition is a violation of the

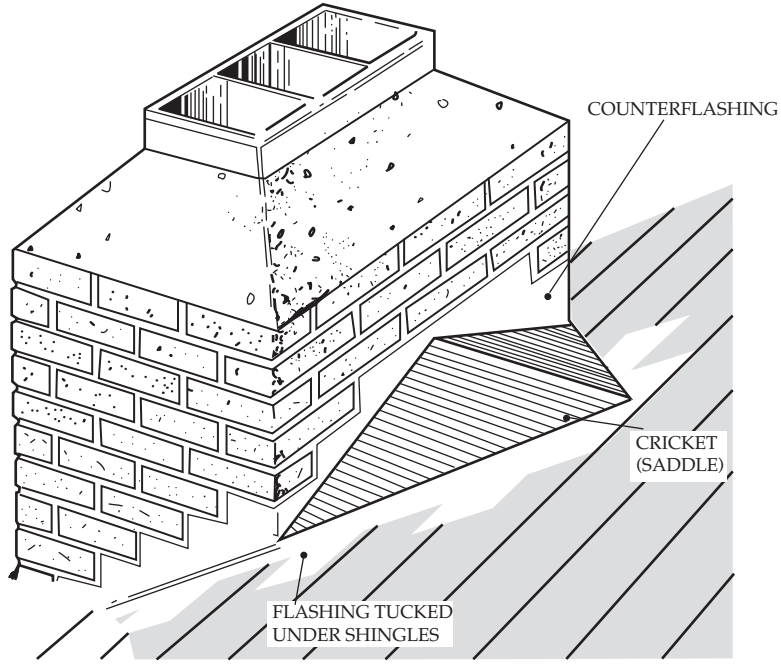


Fig. 3-7. *Cricket (saddle) prevents debris, snow, and ice from accumulating behind the chimney, causing roof leaks.*

plumbing code; the vent stack must extend above the roofline so that the escaping gases can discharge to the outside.

In some older homes, when kitchens or bathrooms are renovated, vent stacks are often run up along the outside of the building to a point above the roofline. (See FIG. 3-8.) If these homes are located in the northern part of the United States, this type of installation is undesirable. Because of the moisture in the escaping gas, during cold weather it could freeze over and eventually block the pipe. Sometimes you find vent stacks that terminate near a window. (See FIG. 3-9.) This installation is also undesirable because the discharging sewer gas might seep into the house when the window is open.

For vent stacks that terminate above the roof, very often you'll see a black ring at the base of the stack adjacent to the flashing. This black ring is asphalt cement that has been used to seal the joint. This joint is vulnerable to leakage and should be periodically checked. On one inspection, I found water dripping from a ceiling tile in a suspended ceiling located two levels below the roof. When I lifted the tile, water came cascading down. After the initial shock and after all the water had spilled away, it became obvious that the water was not caused by a leak in the above laundry room but had collected during the previous day's driving rain when water had leaked into the structure through the small crack between the vent stack and the flashing. This area should be periodically checked and sealed as needed.

Roof vents

These vents can be found on pitched and flat roofs and are available in both round and square hood styles. Normally, there are no problems with these types of vents. However, the joint between the vent and the roof is vulnerable to water leakage. Even though the joint might look okay from the roof side, it is

Fig. 3-8. *Exterior-mounted plumbing vent stack.*

best to check the vent openings from the attic periodically. If there is leakage, it will be noted by water stains on the roof deck in those areas. Water leakage around the joints can be easily corrected with asphalt cement or a suitable caulking.

Roof hatch

Access to a flat roof from the interior is provided through a roof hatch. Don't be surprised if you find a roof hatch on a house with a pitched roof. In some older and larger structures, they were installed as a means of easy access. Roof-hatch covers should be checked to determine whether they are operational; they should be. I have found that in about 30 percent of the cases, the hatch covers could not be opened. In all probability, during reroofing or maintenance, asphalt cement accidentally or intentionally sealed the hatch-cover frame. If this condition exists, it should be corrected. Usually, the hatch cover is constructed of wood and is covered with either sheet-metal or asphalt roll-roofing. Of particular concern is the integrity of the waterproofing cover. There should not be any cracked or open joints. The wood framing should not have any cracked or broken sections.

Skylights

Skylights are installed on a structure to provide daylighting and in some cases ventilation. The newer styles are prefabricated, with aluminum frames and plastic or glass panels or domes. Skylights can be found on pitched or flat roofs. These units should be checked for cracked or broken panes and signs of leakage. The leakage can be checked by inspecting the interior area below the skylight. If there are leaks around the skylight, you'll note water stains on the wall or finished ceiling in those areas. The skylights found on older flat-roof homes should be carefully checked for corroding frames and cracked and broken panes. Quite often the frames have corroded through and provide no support for the panes. This condition should be marked on your worksheet, because these skylights require complete rehabilitation.

TV antennas

Although roof-mounted TV antennas were quite common when the first edition of this book was written, for the most part they have been replaced by cable television or dish antennas. Nevertheless, they can still be found on many houses. Some TV antennas are strapped to the chimney for support. This means of

Fig. 3-9. *Plumbing vent stack terminating near window. If the window is open, the discharging sewer gases can be blown into the house.*

bracing the antenna is undesirable because repeated twisting action on the antenna from strong winds can cause stresses on the chimney that can in turn result in cracked mortar joints. When you see a TV antenna strapped to the chimney, look carefully at the joints. Sometimes the antenna is supported on the roof by means of guy wires anchored to the roof deck. When inspecting the roof, check the area around the anchors for deterioration of the roof covering. Sometimes the guy wires are strapped to vent stacks. This practice is undesirable because in a strong wind the movement of the antenna can cause the joint at the base of the vent stack to crack. I have also run into a situation where a homeowner inserted the TV antenna mast down into a vent stack to secure the antenna. If you see this situation, make a note of it so that you can remove the antenna after you take possession of the house. Finally, look for a ground wire that connects the antenna to a metal rod embedded in the ground. According to the National Electrical Code, this wire should not have any intervening splices or connections. The TV ground wire does not protect the house from lightning. Its purpose is to protect the television set in the event of a lightning surge.

Lightning protection

Although there are about 90 million lightning strikes each year in the United States, most homes don't have a lightning protection system. If a house has one, you will notice pointed metal rods projecting up above the high points of the building. These rods are connected to stranded cables, which are then connected to at least two grounded conductors. Of particular concern is whether the connections are properly bonded and if the system is properly grounded. Because of the destructive power of a lightning strike, the integrity of the system should be checked by a company specializing in lightning protection.

Gutters and downspouts

Gutters and downspouts are installed on a structure to control and direct rain runoff

from the roof. The absence of gutters might result in water seepage into the basement or crawl space, rotting sections of wood trim, damage to foundation plantings, and the erosion of topsoil. Whether they are masonry-constructed or have long overhanging eaves, most residential structures that are not in the snowbelt would benefit from gutters. In the snowbelt, gutters are considered more an inconvenience than a help because the snow and ice often tear them from the supports and maintenance is constantly necessary. If you do not see gutters on the structure during your inspection, indicate their absence on your worksheet. There are basically two types of gutters, built-in and exterior-mounted.

Built-in gutters

These gutters are essentially extensions of the roof framing with waterways built into the roof surface over the edges. The gutter channel might be lined with asphalt roll-roofing or some other type of impermeable material. These channels require periodic maintenance, such as applications of an asphalt-type cement. Leakage through these channels can often be detected by water stains in the soffit below the leaks or by water stains in the interior. Leaks in this type of gutter often result in rotting sections of trim. If stains or rotting sections are noted, they should be indicated on the worksheet. Built-in gutters are seldom used on modern residential structures.

Exterior-mounted gutters

These gutters can be made from copper, galvanized iron, wood, plastic, or, most commonly, aluminum. Copper gutters are considered the top of the line. They are expensive, virtually corrosion-resistant, and have a projected life in excess of forty years. However, as these gutters age, they corrode and develop tiny holes in the bottom portion of the gutter channel. Depending on the gutters' height, the holes might not be visible to the naked eye from the ground. However, by standing directly below the gutters and looking straight up, the sky is often visible through any corrosion holes.

The joints on copper gutters are always soldered. In some parts of the country, the joints on galvanized gutters are also soldered rather than clipped. When the gutters are painted, you can tell the difference between them by using a magnet. The magnet will not stick to a copper gutter. Sometimes leaks develop around the soldered joints. For the most part, because of their cost, copper gutters and downspouts are no longer used when replacing faulty gutters and downspouts. A number of years ago I inspected a church in Ossining, New York, that had a wet basement. It turned out that most of the copper gutters and downspouts had been stolen from the structure by someone in search of a quick dollar because there was a copper shortage at that time.

Galvanized gutters have been used on many homes because of their low initial cost. However, they rust easily and require periodic maintenance such as patching corrosion holes and repainting. The inside portion of the gutter channel should also be painted. This area is often overlooked by the homeowner.

Aluminum gutters are quite popular because they do not have the corrosion problems of galvanized gutters. Older aluminum gutters on occasion leak around the seam, a condition requiring resealing. Leakage from seams can be noted by discoloration at the joint or some water stains or erosion on the area directly below the joint. Aluminum gutters can now be manufactured to almost any length, producing *seamless gutters*. Leaks in this type of gutter usually occur at corner joints or the joint around the downspout.

Wood gutters are usually made of Douglas fir or red cedar and have a tendency to crack and rot at the various end joints and seams along their length. (See FIG. 3-10.) The joints around the end sections, particularly those where the connection is made to the downspout, deteriorate more rapidly than other portions and should be checked for rot and cracking. Wood gutters should be painted every few years and the inside channel coated with an asphalt-type roof paint.

Fig. 3-10. *Wood gutters. Note the cracked and rotting corner joint.*

Plastic gutters, although relatively maintenance-free, have not received wide acceptance. They are found occasionally, but not necessarily, on homes with vinyl siding.

When inspecting the roof with binoculars, you should check the gutters to see if there are any loose support straps or spikes that should be resecured. (See FIG. 3-11.) In addition, an overall view will show whether any gutters are pitched incorrectly or are sagging and should be reset. Sagging is a condition occasionally found on those homes with slate roofs that do not have snow guards. All types of gutters have a tendency to become cluttered with leaves, twigs, seed pods, and mineral granules from roof shingles. They should be cleaned

Fig. 3-11. *Loose gutter spike. Should be reset and resecured.*

Fig. 3-12. Gutters must be cleaned periodically to be effective. Note the weeds growing out of this gutter.

at least twice a year—once in the spring after the trees have bloomed and once in the fall after the leaves have fallen. Gutter screens are available to help prevent larger items, such as leaves and twigs, from cluttering the gutter channel. However, often a homeowner installs the screens and then forgets about cleaning the gutters. The gutters still require cleaning, although at less frequent intervals. Sometimes you can tell from the ground whether a gutter channel requires cleaning. Figure 3-12 shows weeds growing out of the gutter. Obviously, this gutter has not been cleaned for some time.

Downspouts

Downspouts are normally constructed of aluminum, copper, or galvanized iron. Copper and galvanized downspouts that have aged often have corrosion holes in the elbow sections. In some cases, the copper corrodes so that cracked sections are paper thin and can be stripped away easily. If you see this condition, it indicates that those sections should be replaced. Some downspouts have loose and

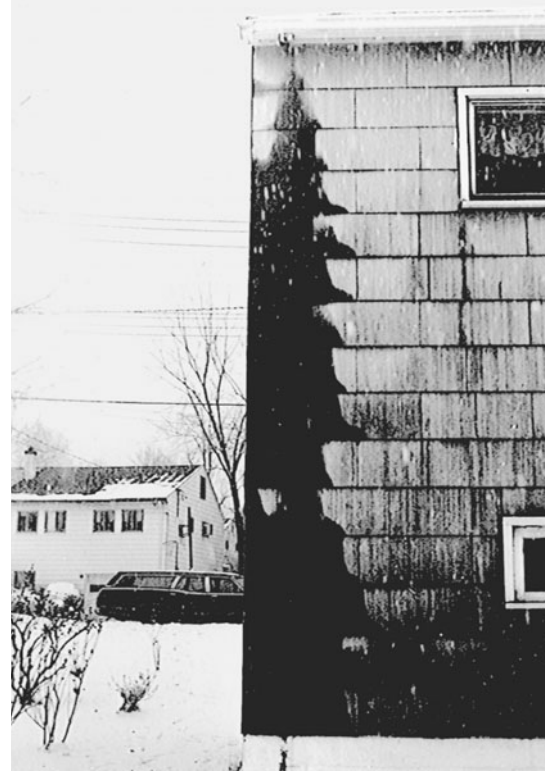


Fig. 3-13. Water stains on the exterior siding are the result of a missing downspout.

open seams along their length that interfere with their effectiveness.

If you do not specifically look for the downspouts, you might not realize that some of them are missing. Figure 3-13 shows water stains on the asbestos-cement shingles, the result of a missing downspout. In this case, it is obvious that a downspout is missing; however, if the house is inspected during dry weather, you might not see any stains, and this item can be easily overlooked. Check the assembly of the downspout at the various joints. The lower portion of the downspout should be outside the upper portion. Otherwise, water will leak around the joint. Figure 3-14 shows an incorrect downspout assembly. On occasion some downspouts come loose from their connection to the gutters and should be resecured. Loose support straps around downspouts should be resecured.

The water from downspouts must go somewhere; it can be piped away underground to suitable drainage or discharged onto the ground at the base. Any water discharging from the base of the downspouts must be directed away from the structure. Otherwise, it can accumulate around the foundation and can eventually enter the lower level. To help deflect this water away from the structure, there should be an elbow at the base of the downspout and a splash plate below on the ground. Effluent discharging around the foundation should be indicated on your worksheet.

Sometimes the downspouts terminate directly into the ground. It is usually not possible during an inspection to determine whether the downspouts are connected to free-flowing drain tiles or to dry wells. Free-flowing tiles are more desirable; dry wells can become clogged (see FIG. 3-15) or will become

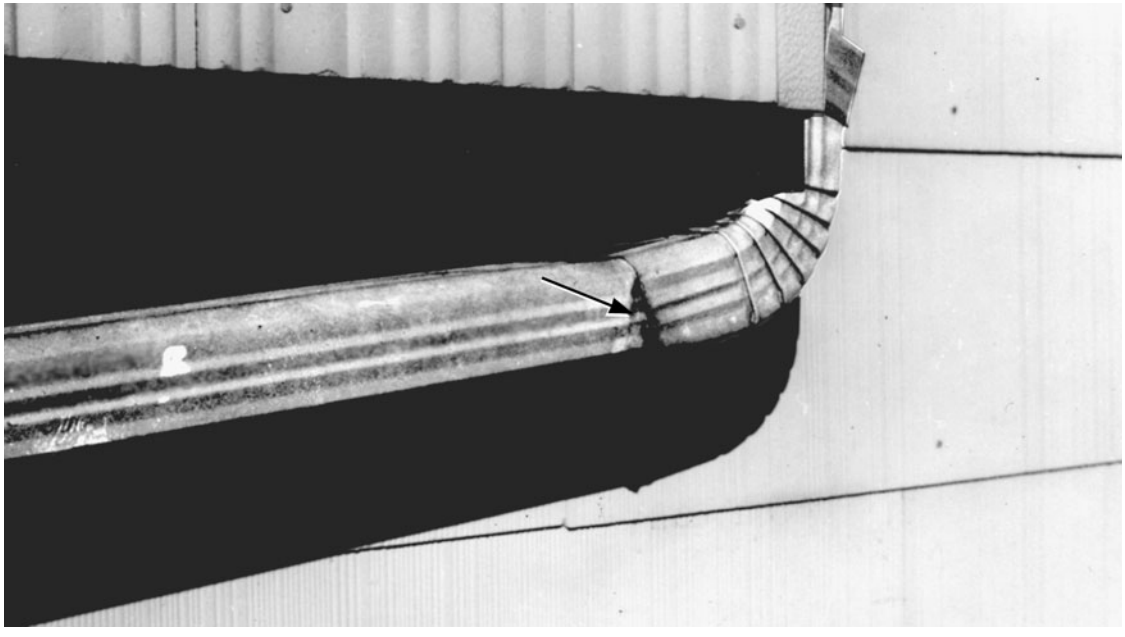


Fig. 3-14. *Incorrectly assembled downspout joint; the lower section is inside the upper section. It should be reversed; otherwise, water will leak out of the joint.*

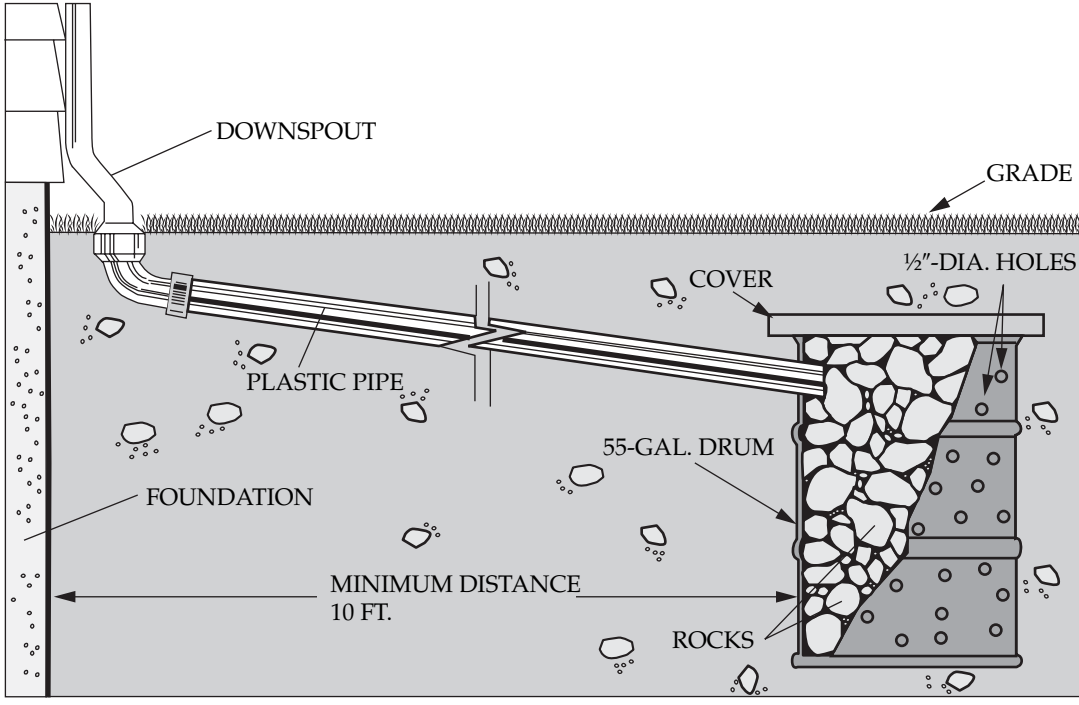


Fig. 3-15. *Over the years dry wells can become clogged, causing rainwater in the downspout to back up.*

ineffective if the level of the subsurface groundwater (water table) is high. Occasionally, some free-flowing tiles are visible at the street curb. If there are outlets at the curb, they must be kept clear.

Checkpoint summary

Chimneys

Masonry type (brick, stone, concrete block)

- ❍ Inspect for cracked, loose, chipped, eroding, or missing sections of masonry.
- ❍ Check mortar joints for cracked, loose, and deteriorating sections.
- ❍ For stucco-finished chimneys, cracked, chipped, missing, or loose sections of stucco?
- ❍ Chimney vertical?
- ❍ Open joints between the chimney and the sidewall?
- ❍ If the roof is flat, does the chimney extend 3 feet above the roofline?
- ❍ If the roof is pitched, does the chimney extend 2 feet above the roof ridge?
- ❍ If possible, check for cracked or missing sections of the chimney cap.
- ❍ If possible, check the chimney flashing for holes, tears, or loose sections. Check these vulnerable areas for leakage again during your attic inspection.
- ❍ If possible, check to see if the chimney flue is lined.
- ❍ Is there a chimney top damper?
- ❍ Is there a cricket (saddle) behind the chimney?

Metal type (prefabricated)

- ❍ Check for corrosion holes, rusting, or missing sections.
- ❍ Rain cover present?
- ❍ Note condition of flashing.

Vent stacks

- ❍ Plumbing vent stacks visible? (Their absence can be verified during attic inspection.)
- ❍ Black rings (asphalt cement) at the base joint of the vent stacks?
- ❍ Note any questionable roof joints and check further during attic inspection.
- ❍ Note vent stacks that
  —terminate near windows
  —run up an exterior side of the house (in northern climates)
  —have TV antennas strapped to them.

Roof vents, hatches, skylights, TV antennas, dish antennas, lightning protection

- ❍ Check all roof joints associated with vents, hatches, and skylights.
- ❍ Note questionable sections and verify tightness of joints during attic inspection.
- ❍ Does structure contain a roof hatch?
- ❍ Can you open it?
- ❍ Cracks or open joints in the cover?
- ❍ Check skylights for corroding frames and cracked or broken panes.
- ❍ Inspect ceiling area below for signs of leakage.
- ❍ Check TV antenna mast and guy wire connections to roof.
- ❍ Is antenna adequately grounded?
- ❍ Are lightning rods secure?

Gutters and downspouts

Exterior-mounted gutters

- ❍ Check for missing sections of gutters.
- ❍ Note type of material: copper, aluminum, galvanized iron, wood.
- ❍ Note gutter sections incorrectly pitched.
- ❍ Check metal gutters for corrosion holes, sagging sections, loose support straps or spikes, and leaking sections.
- ❍ Check wood gutters for cracked sections and areas of rot, particularly at connections and end sections.

Built-in gutters

- ❍ Check for areas with rotting trim.
- ❍ Check for signs of leakage.
- ❍ Note signs of seepage (stains) in soffit trim below gutters.
- ❍ Wherever possible, check the condition of the gutter channel.

Downspouts

- ❍ Note type of material: copper, aluminum, galvanized iron.
- ❍ Check for missing sections and improper joining.
- ❍ Inspect for loose straps, open seams, and corrosion holes at elbows.
- ❍ Do downspouts have elbows at base and extensions and splash plates (where required) to direct roof rain runoff away from the house?
- ❍ If downspouts terminate in the ground, try to find out whether they are connected to dry wells or to free-flowing outlets.

4

Paved areas around the structure

Sidewalks 36
Street-level/driveway-level steps 36
Front and side paths 37
Entry steps 37
Patio 38
Driveway 39
Checkpoint summary 41

As you walk around the house on the second pass, inspect the paths, steps, patio, and driveway. The problems normally encountered with these items usually do not require immediate correction. Nevertheless, a tripping hazard might exist, cosmetic maintenance might be needed, or a condition might make the lower level vulnerable to water penetration. If you see problems in these areas, record them on your worksheet for early correction.

Sidewalks

Sidewalks are usually constructed of concrete, asphalt, or stone embedded in the ground. Not all communities have sidewalks. If a sidewalk is in front of or on the sides of the house, look for cracked or uneven sections because they are a potential tripping hazard. Even though the sidewalk might be on property owned by the town, its maintenance is usually the homeowner's responsibility. If someone should be hurt because of a cracked or uneven section, you would be vulnerable to a lawsuit. Very often uneven sections are caused by the roots of trees growing nearby. Correcting the condition would require chopping that section of root away and resetting the sidewalk. You should be aware of the fact that trees adjacent to the sidewalk are often the property of the local municipality, and prior to altering the roots, permission should be obtained.

Street-level/ driveway-level steps

Steps might lead from the sidewalk or driveway to the front path. These steps should be inspected for cracked, chipped, broken, or uneven sections. Look specifically for dimensional variations in the step risers. The riser (vertical distance) for the top step or the bottom step is often a different size than those for the other steps. This difference is a tripping

hazard because it interrupts the natural rhythm of ascending and descending the steps. If there are more than two steps, there should be a handrail as a safety precaution.

Front and side paths

Two general types of paths are used with residential structures. One is a ribbon type, generally constructed of concrete or asphalt; the other is a sectional type, generally inlaid with material such as stones, bricks, sections of tree trunks, or precast concrete blocks. The sectional type normally requires periodic maintenance because of the tendency toward uneven settlement and weed growth between the sections. Sometimes the sections are loose and uneven and present a tripping hazard. Occasionally, the sections are set in mortar. Look for loose, cracked, and chipped mortar joints that require repointing. When inspecting the ribbon-type path, look for cracked, uneven, and broken sections. Very often damage occurs because the base below the path was not properly prepared during construction. Look particularly for settled sections that are sloping toward the house. These areas will direct rain runoff toward the house, so that water accumulates around the foundation. This water can enter the lower level. In this case, the path should be repositioned so that it slopes away from the structure or is completely rehabilitated.

While inspecting the paths, look for small, abrupt changes in the elevation. Occasionally, I have found a single step in the middle of a path. This step is a potential tripping hazard because it often goes unnoticed. A single step in a path, except at an entrance, should be avoided. If a slight elevation change is necessary and there is a step, it should be converted to a ramp, or shrubs should be planted at the step to call attention to the elevation change. An outdoor light should also be placed here. (See FIG. 4-1.) You might find a path partially blocked by overgrown shrubs; consequently it is no longer functional. In this case, if a path is needed, the shrubs should be pruned or the path repositioned.

Entry steps

Entry steps can be made of stone, concrete, brick, metal, or wood. As a safety precaution, when more than two steps are necessary, at least one handrail should be installed especially if the house is located in an area where the temperature drops below freezing.

Fig. 4-1. *A single step in the middle of a path is a potential hazard. The shrubs on both sides of this path call attention to the step. However, there should also be an outdoor light in the area.*

In those areas, the steps can be coated with a layer of ice after a freezing rain. (See FIG. 4-2.) Look specifically for differences in the vertical distance between the steps (risers). (See FIG. 4-3.) Any dimensional variations in the risers are potential tripping hazards. Some steps are designed so that the vertical distance between the treads is open (open risers). Although this might be aesthetically pleasing, it is a potential tripping hazard.

If the entry door opens onto the entry steps, a landing platform rather than a step tread is necessary at the doorway. The turnaround area of a single step tread is not considered adequate to operate a door safely. The platform should provide sufficient space to allow adequate standing room while opening the door, which swings over the landing. (See FIG. 4-4.)

When inspecting the steps, look specifically for cracked, broken, rotting, chipped, and loose sections. The treads should be level.

Fig. 4-2. *Handrail is needed for steps, especially when they could be covered with ice.*

Fig. 4-3. *Note that the vertical distances between the steps vary. These steps are a potential tripping hazard. The bottom riser needs masonry repair.*

Uneven sections are a tripping hazard. If the steps are masonry-constructed, look at the step foundation walls for cracked, broken, and chipped sections. Any wood *stringers* (the side portions of the steps that support the treads) should be resting on a concrete pad rather than on the soil. Check the base of wooden stringers for rot by probing the area with a screwdriver. If the screwdriver penetrates the wood easily, the stringer should be replaced. Metal handrails are often used with exterior steps. Very often, these handrails are corroding and have deep pockets of rust. In this case, the handrails should be scraped, primed, and repainted.

Patio

There are probably as many types and styles of patios as there are houses. The more common types are concrete slab, stone set in mortar, and brick or paving blocks set in the ground. In all cases, a particular concern is whether any tripping hazards can result

Fig. 4-4. *The turnaround area of the top step is too narrow to operate the door safely.*

from cracked, broken, or uneven sections. Some patios have a grid pattern consisting of wood embedded in the ground around sections of brick or concrete. This wood should be pressure-treated to protect it from rot. However, often the wood is not pressure-treated, so that after a few years it rots and requires replacement. Concrete-slab patios should have expansion joints and control joints for cracking. Very often these items are omitted, and the patio cracks in a random fashion that is aesthetically undesirable. Look at the patio for signs of uneven settlement. If a patio is adjacent to the house and has settled so that it is sloping toward the house, water can accumulate around the joint between the patio and the foundation wall. This water will eventually accumulate around the foundation and if the house has a basement or crawl space, it could enter those areas. This condition should be indicated on your worksheet for later correction and as a reminder for you to check the area of the basement adjacent to the patio.

Driveway

Driveways are normally constructed of asphalt, concrete, gravel, and, more recently, individual paving blocks. They also might just be a clearing with no covering. The latter is not particularly desirable from a cosmetic point of view and because of the ease with which ruts can develop. Gravel driveways on occasion also develop ruts and require periodic replacement of the gravel. Concrete and asphalt driveways should be inspected for cracked, broken, or settled areas that require rehabilitation. Extensive cracking, such as alligator cracks, is usually an indication of poor

Fig. 4-5. *Extensively cracked and deteriorating driveway.*

drainage of the subbase or poor construction. (See FIG. 4-5.) In this case, the cracks cannot be sealed effectively. The entire area should be patched. If a large portion of the driveway has this type of cracking, resurfacing is required.

If the base below a paving block driveway has not been prepared properly, sections will settle causing water to pond during a rain. (See FIG. 4-6.) Although the water will drain into the joints between the blocks, this item should be recorded on your worksheet so that it can be corrected at a later date.

Sometimes the driveway is on an incline, so that subsurface water flows below the driveway, undermining the subbase. In this case, prior to resurfacing, adequate provision for drainage of the subbase should be made.

When standing at the front of the driveway, look to see if it pitches directly down toward the house. If it does, the garage and any other portion of the lower level are vulnerable to flooding unless a large operational drain at the base of the driveway intercepts the surface water. Usually a channel drain that runs across the width of the driveway is needed to control such water runoff. The drain, however, should have a free-flowing outlet. If the drain is connected to a dry well, it might be ineffective during those months when there is a high water table; one corrective procedure would be

Fig. 4-6. *Water ponding on a paving block driveway.*

to connect the drain to a sump pit and remove the water by means of a sump pump.

When a house is located on a street that is inclined, the curb cut for the driveway should not be feathered into the street. Instead there should be a small ridge on the driveway at the joint between the driveway and the street. This ridge will prevent water that normally accumulates around the curb from flowing onto the driveway. This is normally not a problem in newer structures. However, in older houses the ridge tends to deteriorate, allowing water to overflow. This condition should be corrected.

In some northern areas, raised and inclined driveways have scratch marks that are caused by studded snow tires. This indicates that those driveways will be difficult to negotiate during some winter months; 100 pounds of salt and sand should be stored in the garage or near the driveway.

The minimum width for a driveway is 8 feet, although 9 feet is preferred. If the driveway is used both as an areaway for the car and a walkway in place of a path, it should be at least 10 feet. Anything less will make walking quite difficult when a car is parked in the driveway. Note whether the driveway discharges into a heavily trafficked street. If it does, an area in the driveway should function as a turnaround to allow a driver to head onto the street rather than back out onto the street. Also, look for overgrown trees and shrubs at the end of the driveway that might obstruct the driver's view when entering the street.

Checkpoint summary

Sidewalks, paths

- ❍ Inspect for cracked, missing, eroding, and uneven sections.
- ❍ Check for areas that might present a tripping hazard.
- ❍ Check slope of all paved paths adjacent to the house for improperly pitched sections.

Street-level/driveway-level steps

- ❍ Inspect for cracked, chipped, broken, or uneven sections.
- ❍ Check for missing handrails or railings.

Entry steps (masonry, wood)

- ❍ Inspect for cracked, broken, loose, or deteriorating sections.
- ❍ Note potential tripping hazards such as variations in riser heights and narrow treads.
- ❍ Check (probe) for rot in wood stringers, step treads, and handrails.
- ❍ Are wood stringers supported on concrete pads, or are they resting on the earth?
- ❍ Check for handrails.
- ❍ Inspect metal handrails for rusting, loose, and broken sections.
- ❍ Inspect wooden handrails for cracked, broken, loose, and rotting sections.
- ❍ Does entry door open onto a step or landing?

Patio

- ❍ Check for cracked, broken, eroding, and uneven areas.
- ❍ Inspect for uneven and settled sections adjacent to the house that can allow water to accumulate around the house foundation.
- ❍ Check for rot and insect damage to embedded wood sections.

Driveway

- ❍ Inspect for cracked, broken, eroding, or settled areas. Note extensively cracked and deteriorated areas for future rehabilitation.
- ❍ Check slope of driveway: level, raised, or inclined?
- ❍ For an inclined driveway, is there an adequate drain at the base?
- ❍ Does drain discharge to a drywall or to a free-flowing outlet?
- ❍ Is driveway width adequate (8 feet minimum, 9 feet preferred)?

5

Walls, windows, and doors

Exterior walls 43
Exterior siding 44
Wood siding 44
Aluminum siding 46
Vinyl siding 47
Asbestos-cement shingles 47
Fiber-cement siding 48
Asphalt siding 48
Stucco 49
Synthetic stucco 49
Veneer wall 50
Masonry wall 51
Trim 52
Windows 53
Inspection 55
Exterior doors 56
Storm windows, screens, and storm doors 58
Storm windows 58
Screens 58
Storm doors 59
Inspection 59
Caulking 59
Checkpoint summary 60

As you walk around the house inspecting the paved areas, you should also inspect the exterior walls, windows, trim, and doors. Before actually inspecting these items, however, look at the overall wall area for indications of past or current structural problems. Are the window and door lines square? Are any portions of the walls sagging or bulging? Are the walls and corner sections vertical? A problem condition should be recorded on your worksheet for further investigation. If by the end of the house inspection you cannot determine the cause, you should have the condition checked by a professional.

While inspecting the exterior walls, also note for further investigation any pipe or hood projecting through a wall or basement window. These items are usually not problem conditions, but it is useful to understand their function. The hood is often covering the

discharge end of an exhaust fan or clothes-dryer duct, and the pipe may be the discharge line for a sump pump or condensate line from an air-conditioning system. If the pipe is connected to a sump pump, it might indicate a past or current water-seepage problem. Sump pumps and water seepage are discussed in detail in chapter 11.

Exterior walls

The exterior walls in most residential structures will be either wood frame or masonry, sometimes a combination of the two. The latter is commonly called a *veneer wall*. The exterior walls rest directly on the foundation and are *bearing* (load-supporting) walls. They support the roof, floors, and vertical loads imposed by other building components. The outer covering of the exterior walls provides protection from the weather and, if properly installed, minimizes the flow of air, moisture, and heat into or out of the structure.

When the walls are wood frame, the vertical framing members (*studs*) support all the vertical loads, and the outer finish covering (generally called *siding*) provides weather protection. Insulation is normally located in the spaces between the studs. In masonry walls, the masonry (clay tile, brick, stone, concrete block, etc.) provides both the structural support and the weather barrier. A masonry-veneer wall is a wood-frame wall with masonry used in place of the siding. Although the masonry in a veneer wall is not used for supporting the vertical loads, it does support its own weight.

Basically, a wood-frame exterior wall consists of 2-by-4-inch or 2-by-6-inch studs covered on the interior side by materials such as plaster, Sheetrock, plasterboard, wood, or hardboard panels (as described in chapter 10) and on the exterior side by sheathing, sheathing paper, and the finish siding. (See FIG. 5-1.) In some parts of the country where rot and termite activity are problems, metal studs are now being used in place of wood studs.

Sheathing is installed over the studs to provide bracing and minimize air infiltration. Depending on the type of sheathing, it can also be used to form a surface onto which the exterior finish can be nailed. Wood boards, plywood, fiberboard, and plasterboard are often used for wall sheathing. Fiberboard sheathing adds a small amount of insulation to the overall exterior wall; however, it should not be used as a nailing base for the direct attachment of the exterior siding. Rather, the siding should be nailed either to the studding through the sheathing or to wood nailing strips that have been attached to the sheathing. In many communities, when the exterior siding is capable of supplying adequate bracing and weather protection (as with exterior plywood panels), the sheathing is often omitted.

The purpose of the sheathing paper is to resist the direct entry of water during a driving

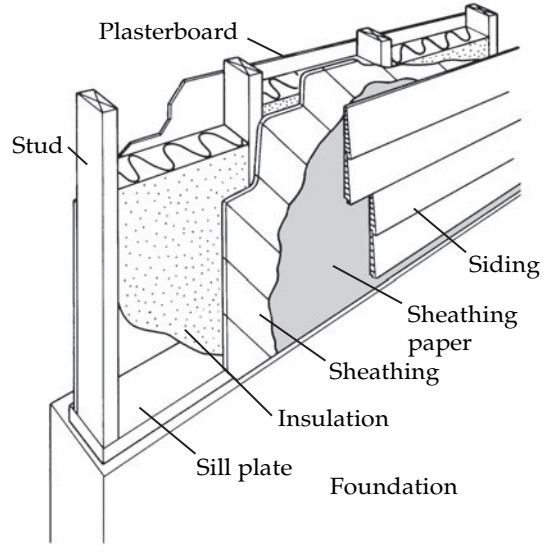


Fig. 5-1. *Components of a wood-framed exterior wall.*

rain. Sheathing paper (an asphalt-saturated felt) is water-resistant but not vapor-resistant and allows water vapor (which often builds up in the voids of the frame wall) to escape rather than condense and cause problems. Sheathing paper can also be very effective in reducing air infiltration.

Exterior siding

There are many types of exterior siding. If the siding is of good quality and has been maintained, it could last as long as the house. Normally, the type of maintenance required (other than painting) is the repair of cracked, broken, loose, rotting, or missing sections. When maintenance is needed, it is usually on a small section rather than the entire wall. However, some homeowners neglect the siding and allow it to deteriorate to a point where complete re-siding is necessary. Several clients have asked me about the condition of the old siding on a house that had been re-sided. Actually, the degree of deterioration of the old siding does not matter as long as the new siding is properly installed and provides the needed weather protection.

When inspecting the siding, pay particular attention to the sections that are facing south or southwesterly. These areas receive the maximum exposure to the sun and are more vulnerable to weather deterioration. The bottom of exterior siding should not be close to, or in contact with, the ground. Because of the dampness associated with the ground, the bottom of the siding should be at least 8 inches above the finished grade. Otherwise, the wood siding or the wood nailing boards for nonwood siding will be vulnerable to rot and termite infestation.

On occasion I have found vines growing up an exterior wall, in some cases reaching the roof. Although this might be aesthetically pleasing, the vines are undesirable. They can cover a multitude of problems and can cause problems. The vines can conceal termite shelter tubes (see chapter 8) or cracked portions of the siding. They can widen cracks, damage mortar joints, and loosen shingles. In addition, the dampness associated with the vines can promote rot and cause paint to blister and peel. If you find vines growing up an exterior wall, you should consider removing them.

Wood siding Wood siding is a broad classification that includes shingles, shakes, boards (applied vertically and horizontally), plywood panels, and hardboard. When inspecting wood siding, pay particular attention to exterior corner joints and the joints between the siding and window frames and doorframes. In addition, the area where the siding joins a dissimilar material (such as masonry or metal) is vulnerable to water penetration during a driving rain. These areas should be checked for weathertightness and rot.

On wood siding you might find dark, blotchy sections. This condition is generally caused by spores of fungi or mildew and often occurs in shaded areas. It is not a concern because it does not cause the siding to decay. However, it is unsightly. On painted surfaces, it can often be removed by washing with bleach and water. New paint on such areas should contain a mildew-inhibitor additive. On unpainted wood surfaces, this condition can usually be controlled by coating the siding with a penetrating preservative containing a mildewcide. You might also find brown and black discolorations on the siding (FIG. 5-2). This staining is caused by rusting of the nails used to secure the siding. The discolorations could have been avoided if aluminum or galvanized (rust-resistant) nails had been used. Eliminating this condition is somewhat difficult and usually not cost-justified.

Wood shingles/shakes Most shingles and shakes (hereafter referred to as shingles) used

for exterior sidewall application are made from cedar or redwood. They are basically the same ones that are used for roofing (as described in chapter 2). However, their application is somewhat different. Because vertical walls present fewer water-penetration problems than roofs, the shingles on walls can be installed with a greater weather exposure than those on roofs. In addition, roofs generally have a three-ply layer of shingles, whereas exterior walls have only a two-ply layer. For full weather protection, the butt joints between the wall shingles for the upper ply should not line up with the vertical joints for the lower ply. Otherwise, water can penetrate the wall during a driving rain.

Since the shingles are decay-resistant, they do not have to be painted for weather protection. However, new shingles that replace deteriorated unpainted weathered shingles will not match the remaining shingles. Many shingles are painted to achieve a color decor. After a number of years, the paint begins to peel and flake. Consequently, once the shingles are painted, they will require periodic repainting for cosmetic purposes.

When inspecting the shingles, look for cracked, loose, chipped, rotting, and missing sections. Check for open joints around window and door trim. (See FIG. 5-3.) Open joints allow water penetration during a rain. Inspect for warped shingles; they generally will be on the sidewall with the southerly or southwesterly exposure. Also look at the quality of the shingles. You might find that the top portions of some are paper thin and can crack or chip very easily. These shingles are of a lower quality and are intended for use as an undercourse or installation with less shingle-length exposure. This type of shingled sidewall has a short projected life, and periodic repairs, with eventual residing, should be anticipated. Try to lift a few shingles gently. They should not lift up. If they do, it is an indication that they were improperly nailed. Shingles that are nailed directly to fiberboard sheathing rather than to wooden nailing strips (attached to the sheathing) will lift up under gentle pressure. Any of the above conditions should be recorded on your worksheet for future correction.

Wood boards Wood-board siding can be applied horizontally or vertically. Horizontal siding tends to make a house appear lower and longer; vertical siding tends to make a house appear taller (and is popular on one-story houses). The wood used for board siding should be free of knots. Otherwise, over a period of time, shrinkage can cause the knotty

Fig. 5-2. *Discolorations of wood shingles caused by rust stains from iron nails.*

Fig. 5-3. *Open shingle joints allow rainwater penetration.*

cores to drop out, leaving the siding with holes that are vulnerable to water penetration.

With the exception of redwood and cedar boards, most wood siding is painted for protection against weathering and decay. When inspecting the siding, look at the condition of the paint. Are there any bare, peeling, flaking, or blistered sections? If there are, paint touchup or repainting may be needed. Blistered and peeling paint is often caused by moisture in the painted wood, although it can also result from a poor paint job. Determination of the exact cause for blistering and peeling paint cannot be made during a single inspection. Nevertheless, this condition should not affect your thinking about the house. If it is caused by moisture in the wood, it can be corrected after you move in, and usually at minimal expense.

Wood-board siding should be inspected for cracked, loose, and rotting sections. In addition, look for loose or missing knots. All holes should be patched with a wood filler. In vertical siding, check the joints between the vertical sections for weathertightness. In both vertical and horizontal siding, pay particular attention to the outside corner joints. These joints are vulnerable to water penetration during a rain, and any open joints must be sealed.

Plywood panels Plywood panels are also used for siding. They are made from exterior-type plywood in which the veneer layers are bonded together with a waterproof glue. The exterior facing of the panel comes in a variety of surface textures and grooves. The panels are 4 feet wide by 8, 9, or 10 feet long. The thickness of the panel will depend on the depth of the grooves and will generally vary between ⅜ and ⅝ inch. Plywood panels are usually installed in a vertical position with the vertical joints over studs. This minimizes the number of horizontal joints, which is desirable since plywood panels are often applied directly to the studs rather than over sheathing. Because of their vulnerability to water penetration, any horizontal joints should be shiplapped (not visible to the inspector) or protected by metal flashing (visible). When inspecting plywood siding, look for loose, warped, cracked, delaminated, and rotting sections. Also check for open and nonweathertight joints. If the panel siding is painted, check the finish for peeling and flaking paint and blistered sections.

Hardboard siding Hardboard siding is made by bonding (under heat and pressure) wood fibers that have been ground almost to a pulp. The siding is dense and tough, and has a fairly good dimensional stability, although not as good as that of plywood. Hardboard, like plywood, is available in a wide range of textures and surface treatments. It is available in 4-foot-wide panels and 9- and 12-inch-wide planks. When inspecting hardboard siding, look for cracked, chipped, broken, deteriorated, and loose sections. Also check horizontal and vertical joints for weathertightness.

Aluminum siding Aluminum siding is often used in new construction and is often used when re-siding the exterior walls. The siding comes in planks that are either smooth or embossed with a wood-grain texture (to resemble painted wood boards), also as shingles and vertical panels. Aluminum siding is relatively maintenance-free. It is noncorrosive and termite-proof, and will not rot. The siding surface is generally covered with a baked enamel-paint finish that can stand up for many years before it fades, becomes dull, and needs a coat of paint. If the siding is scratched, bare aluminum is exposed. However, since the aluminum does not corrode, the scratch is only of cosmetic concern and can easily be corrected with touch-up paint. One problem with the siding is that it can be dented if struck hard enough—as with a baseball or stone thrown from a power mower. Many communities

require that aluminum siding be grounded electrically as a precaution against electrical shock.

Aluminum siding is available with or without insulation backer boards. The insulation is generally a rigid foam (such as polystyrene) or fiberboard. Although the backer boards are only about ⅜ inch thick, they are quite effective as an insulator for a house that has no insulation in the exterior walls. Because of increasing energy costs, even a house with insulation in the exterior walls benefits from the additional insulation. The backer boards reduce heat loss in the winter and heat gain in the summer. They also increase the strength and rigidity of the siding. However, insulation-backed siding (and tight siding jobs) can cause moisture to accumulate within the exterior walls of houses that have no vapor barriers on the inside surface. (Insulation and vapor barriers are discussed in chapter 19.) You can usually tell whether the aluminum siding has an insulation backer board by pressing on it. If the siding is relatively firm, it has a backer board, but if it yields and bends under the pressure, it has no insulation board. Another method is to tap the siding. If it has no insulation, you will get a hollow sound.

When inspecting aluminum siding, look for loose, missing, and dented sections. Check the exterior joints for open sections and weathertightness. In those areas where electrical grounding of the siding is required, you should look for an electrical ground connection, a wire that runs from the siding to the inlet water pipe or a rod or pipe that has been driven into the ground. (See chapter 12.) You can find out whether an electrical ground connection is required by checking with the local municipal building department.

Vinyl siding Vinyl siding is very much like aluminum siding in size, shape, application, and appearance. Quite often close examination of the siding is needed to tell the difference between the two. The coloring in vinyl siding is embedded in the material and is the same throughout its thickness. Since the coloring in aluminum siding is only on the surface, an end cut or scratch in the aluminum reveals the silvery color of the bare metal. To tell whether the siding is vinyl or aluminum, look at an end cut or joint.

Vinyl siding is usually installed with an insulation backer board behind each sheet. In addition to insulation value, the board adds rigidity and strength. Vinyl siding normally does not dent from impact; it merely flexes and springs back to its original shape. However, during very cold weather, the siding becomes brittle, and a hard blow could crack or shatter it. When inspecting vinyl siding, check for cracked and broken sections and loose and sagging sections with open joints.

Vinyl siding expands and contracts as the temperature changes. When the siding is improperly nailed, this movement usually results in waviness and blisters in the vinyl panels. If you see this type of unevenness in the vinyl panels, record the fact on your worksheets for future correction.

Asbestos-cement shingles As with roofing shingles, asbestos-cement siding shingles were manufactured by combining asbestos fibers with Portland cement under pressure. These shingles are currently called *mineral-fiber shingles*. Although the shingles are no longer manufactured, they can be found on many homes in a variety of textures and colors. Since the shingles are unaffected by the weather and are immune to rot and termite activity, they require very little maintenance. However, the shingles are brittle and can be damaged and cracked by impact. The lower courses of the shingles are most vulnerable to damage. Usually damaged shingles are replaced rather than repaired. Depending on the weathered condition of the existing

shingles, the new shingles may not match the older ones. (See FIG. 5-4.) When inspecting asbestos shingle siding, look for cracked, chipped, broken, loose, and missing shingles. Shingles that have slipped out of place were usually improperly nailed, or the nails were not rust-resistant and deteriorated. If the condition is caused by the latter, additional shingles will slip out of place in the future, and maintenance should be anticipated.

Asbestos-cement shingles were generally installed with sheathing-paper-backer strips behind the vertical shingle joints. These backer strips provided additional protection against water penetration. You might find sections of backer strips that have slipped out of place or are hanging loose between the shingles. Since the shingles were normally installed over sheathing paper, which is waterproof, replacing the loose backer strips is usually not necessary.

Fig. 5-4. *Missing and patched (mismatched) asbestos-cement shingles.*

Fiber-cement siding Fiber-cement siding is made from a mixture of cement, sand, cellulose fibers, and other components such as water, waxes, and resins. The material then goes through a multistep high-pressure curing process in which the mixture is subjected to highly pressurized steam that presses the material into a variety of siding patterns. There are several companies that manufacture fiber-cement siding; the most popular is James Hardie Building Products. Hardie fiber-cement siding products that you will find on houses are HardiePlank lap siding, shingles, and vertical siding.

Fiber-cement siding is popular because it is fire-resistant and will not rot, warp, or delaminate. It is also resistant to termites, and because it is normally manufactured into a much thicker and more durable product than its vinyl counterparts (according to Hardie, its siding is 5 times thicker than vinyl siding and weighs about 1.5 times as much as wood), it resists cracking and impact damage. The main concern with fiber-cement siding is not the product, but improper installation, which can result in skewed trim, exposed nails, and cracked, chipped, loose, or damaged sections. If you see any problems, record them on your worksheets for future correction.

Asphalt siding Asphalt siding is made by impregnating an organic felt material or glass-fiber mat with asphalt. The siding is available as shingles or as a roll. The exterior surface of the roll material is coated and embossed so that from a distance it looks like bricks. As the siding ages, it becomes dry and brittle, and cracks easily. For the most part, asphalt materials are no longer used for siding or residing residential structures. However,

they can be found on existing buildings. When inspecting asphalt siding look for cracked, chipped, and eroded sections. Also check for open and lifting joints and loose, torn, and missing sections. If you find any areas in need of repair or replacement, record them on your worksheet.

Stucco A stucco finish on an exterior wall is basically a concrete sheet that has been built up in layers. It is usually made from a mixture of cement, lime, sand, and water. Stucco is weather-resistant, immune to termite and fungus attack, rigid, and durable—qualities that are desirable for an exterior wall finish. In addition, it can be applied to curved or irregularly shaped surfaces and to wood-frame walls that have been prepared with backing (sheathing) paper and metal lath. The backing paper is needed to resist water penetration through open joints or cracks that might develop in the stucco. The metal lath provides the means for bonding the stucco mix.

Stucco is generally applied in two coats on a masonry wall and three coats on a wood-frame wall. The minimum thickness for a three-coat wall is ⅞ inch; for a two-coat wall, ⅝ inch. The top layer of stucco is the finish coat and can be relatively smooth or have a rough texture. It can be prepared in a wide range of colors or painted.

Because stucco is a rigid material, cracks can develop as a result of a slight movement of the house. (See FIG. 5-5.) Movement occurs from foundation settlement and from wind forces. You generally find more cracks in stucco on a wood-frame house than on a solid masonry house. Shrinkage of the wood-framing members creates stresses in the stucco that often result in cracks. Once a crack develops, water can penetrate into the wall during a driving rain and can cause problems. In time, the portion of the metal lath around the crack rusts and deteriorates, and, depending on the condition of the backing paper, the wood

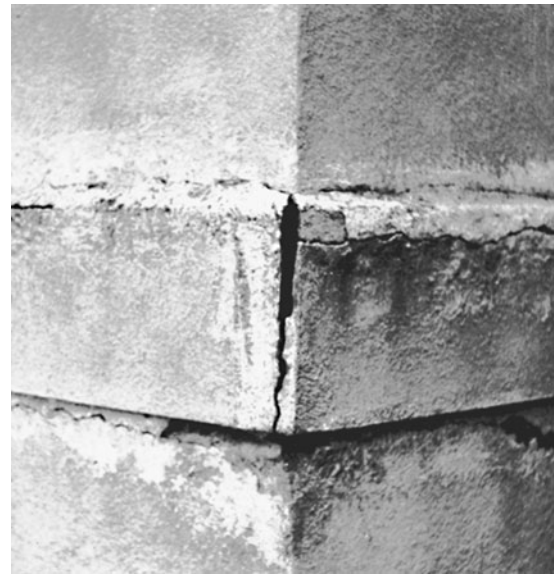


Fig. 5-5. *Cracked stucco wall. If wall was covered with vines, these cracks would be concealed.*

framing and sheathing might rot. In addition, in cold climates, accumulated water behind the stucco can freeze, causing further deterioration as a result of frost action.

All cracks should be sealed. Hairline cracks and cracks up to 1⁄16 inch generally can be sealed by coating them with a cement-based paint. The only difficulty is in matching the color of the wall. Larger cracks can be sealed by filling them with a mortar mix. Broken and loose sections of stucco must be rehabilitated by a skilled craftsman. When inspecting a stucco wall, look for chipped, cracked, loose, and broken sections. If you find areas in need of repair, record their location on your worksheet. Stucco does not require painting. But if it has been painted, check the condition of the paint. Once a stucco wall has been painted, periodic repainting will be required for cosmetic purposes, although at less frequent intervals than wood.

Synthetic stucco Synthetic stucco, commonly known as an exterior insulation

and finish system (EIFS), is an exterior wall siding that consists of four primary components:

- Foam insulation boards attached to the exterior wall sheathing
- A base coat that is applied to the insulation board
- A fiberglass reinforcing mesh embedded in the base coat
- A finish coat applied over the fiber glass mesh

Although the EIFS may resemble stucco in appearance, the two siding systems are quite different, especially with regard to controlling water intrusion. The traditional stucco system anticipates eventual water penetration through open joints and cracks. To prevent rot and deterioration of the wood framing and sheathing in the exterior walls, it uses a housewrap or building paper behind the stucco surface to carry any water that accumulates in that area down and out the bottom of the wall.

The EIFS, on the other hand, was not designed for water intrusion. It was considered a surface barrier system because it resisted water penetration at its outer surface. It was assumed that moisture would not penetrate the surface and reach the wall sheathing and/or framing. The system was not originally intended to drain water that got behind the EIFS cladding. In practice, however, water did penetrate the wall, not through the surface but through jambs and sills of window frames, and at the joints between the exterior walls and door, window, deck, and roof intersections. Water that penetrated the wall could not easily escape. It was trapped between the EIFS cladding and the sheathing.

Over a period of time the water was absorbed by the sheathing and framing, which increased their moisture content to a level above saturation, causing rot and structural damage. Depending on weather conditions and the quality of construction, significant damage due to moisture intrusion could occur. Damage from water intrusion has been found in the exterior walls of houses that are only 3 to 5 years old.

The industry, recognizing the problems that resulted because of the lack of drainage in the wall, modified the system to include the installation of drainage channels and building paper between the foam insulation and the sheathing. In appearance the new system is similar to the old one, and with a visual inspection you cannot tell the difference between the drainable and nondrainable EIFS. Not only is the location of water entry often difficult to see, but moisture damage to the sheathing and framing behind the exterior wall cladding cannot be readily detected by visual inspection.

If the exterior wall cladding is an EIFS, you can do a preliminary inspection by checking for cracked and open joints at the interfaces between the EIFS and dissimilar materials such as windows, doors, and wall penetrations. If any are found that require caulking, record their location on your worksheet. Also, if you have a noninvasive moisture meter, check those areas for water intrusion. However, because of the nature of the potential problems and the high cost for correction, it is recommended that you have the exterior walls inspected and evaluated by a professional.

Veneer wall A veneer wall is a wood-frame wall with an attached masonry facing. Unlike exterior siding, which is held in position by being fastened to the sheathing or studs, the masonry rests on top of the foundation wall and supports its own weight. It is attached to the wood backing by corrosion-resistant metal ties. The ties are considered the weakest point in this type of construction. If the ties have deteriorated or are not properly attached, the

masonry facing can pull away from the wood frame.

The masonry—usually clay brick, concrete brick, or split stone—is normally positioned so that there is a 1-inch air space between the veneer wall and the wood backing. (See FIG. 5-6.) Small holes (*weep holes*) are usually installed at the base of a veneer wall. These holes allow water that might accumulate in the air space to drain. When the masonry facing is brick, the weep holes are generally formed by eliminating the mortar in a vertical joint.

Some bricks absorb more water than others. Bricks with high absorption should not be used for the exterior facing of walls, especially in colder climates. Unfortunately, they are used occasionally. Alternate freezing and thawing of bricks that have absorbed water will cause them to deteriorate. Depending on how much water has been absorbed, the interior walls might become damp, a condition that can usually be detected during the interior inspection. This condition can often be controlled by coating the bricks with a silicone sealant.

When inspecting a veneer wall, look for chipped, cracked, loose, deteriorating, and missing bricks or stones. In addition, check for cracked, chipped, and deteriorating mortar joints. Pay particular attention to the mortar joints. Occasionally, because of excessive shrinkage of the wood framing or slight foundation settlement, you might find large open cracks, especially around window frames and doorframes. Also look for loose and bulging sections of veneer wall. If you find any of the above items, record their location on your worksheet for later correction.

Masonry wall

Unlike a wood-frame wall where the structural support and weather barrier are provided by two separate components, studs and siding, the masonry units in a masonry wall (clay tile, brick, stone, or concrete block) provide both the support and the weather protection. Because of the low thermal resistance of masonry, a masonry wall allows greater heat loss than a wood-frame wall.

To reduce the heat loss, insulation can be added by applying a rigid foam insulation board to the interior side. In addition to providing insulation, the board can also be

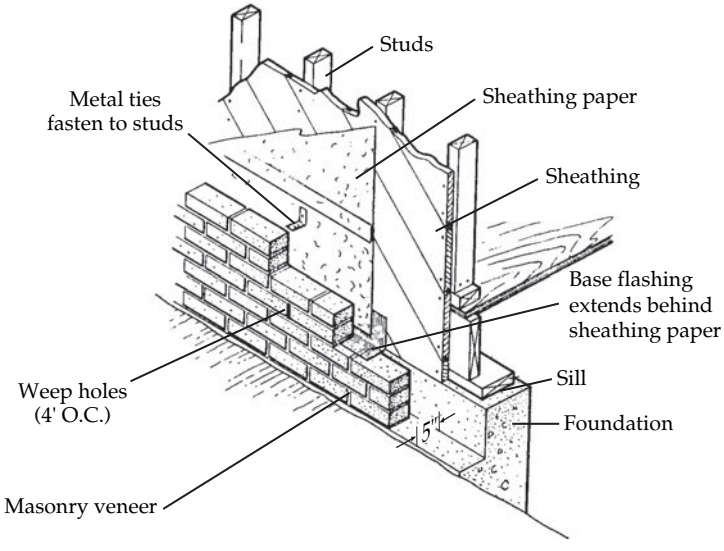


Fig. 5-6. *Components of a brick-veneered exterior wall.*

used as a base for plastering. Another approach is to apply furring strips to the inside wall; the furring strips create an airspace into which insulation can be placed prior to installing the finishing wall panel. In some cases, however, the interior side of the masonry wall is left completely exposed and serves as a decorative element or a base for direct plastering. This is quite wasteful from an energy-conservation point of view.

Because of the rigidity of masonry walls, differential movement within the wall might cause serious cracking. Wall movement might be the result of unequal foundation settlement, or expansion and contraction from temperature and humidity changes. Many cracks are not of structural concern, although they should be sealed to eliminate the possibility of water penetration. If you have any doubt about the severity of a crack, have the condition checked by a professional.

A common problem with masonry walls is *efflorescence* on the exterior surface. Efflorescence is a deposit of soluble salts that were originally within the masonry, usually brought to the surface by water in the wall. When the water evaporates, the salts are deposited on the surface. Efflorescence generally can be removed by scrubbing with a stiff brush or washing with a dilute solution of muriatic acid. However, if the condition is a recurring problem, it is an indication that water is penetrating the wall through cracks or faulty joints or flashing.

When inspecting a masonry wall, pay particular attention to the joints around window and doorframes. All joints should be weathertight. Are there any cracks around the corners of window or door openings? These are areas of high stress concentration and are vulnerable to cracking. Cracked and chipped mortar joints and deteriorated masonry should be indicated on your worksheet for later repair. If you notice bulging sections in the exterior walls or large cracked sections, have the condition checked professionally, since it might indicate structural problems.

Trim

All portions of the exterior finish, other than the wall covering, are generally classified as exterior trim. This includes the moldings and sills around windows and doors, fascia boards, soffits, louvers, shutters, and decorative columns. (See FIG. 5-7.) Trim does not serve a structural function. It is used as finishing around openings and to protect joints, edges, and ends. Most exterior trim is made of wood or wood products, although aluminum and vinyl trim have become quite popular. Many older, traditionally designed homes have decorative sheet-metal cornices, which are considered part of the trim. The problem with sheet-metal trim is that if it is not maintained and kept adequately painted, it will rust and deteriorate.

Wood trim that is exposed to the weather should be decay-resistant so that it does not rot. (See the section on rot in chapter 8.) Some types of preformed trim are factory-treated with a water-repellent preservative to make them water- and decay-resistant. When the trim is cut to size during construction, the ends or miter joints must be treated to make them water-resistant. All too often they are not treated, and the joints, which readily absorb water, begin to rot. When inspecting wood trim, pay particular attention to the joints that are vulnerable to decay. A house with a wide roof overhang at the eaves and gables provides greater weather protection of the sidewalls and trim than one with no roof projection beyond the walls. All nontreated wood continually exposed to moisture is prone to decay. The trim around the edge of the roof is particularly vulnerable. Although the Asphalt Roofing Manufacturers Association recommends the installation of a metal drip edge along the eaves of a roof deck,

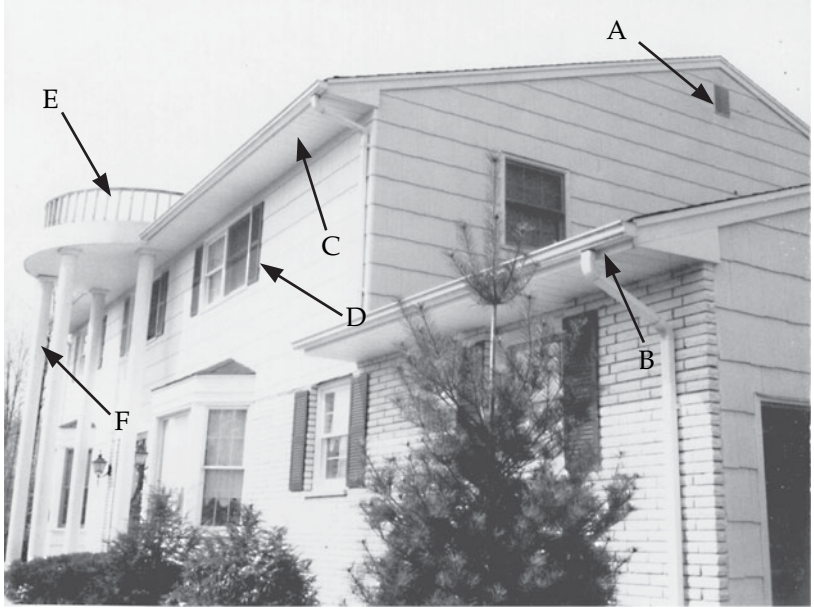


Fig. 5-7. *Exterior trim on a house: A—gable louvers, B—fascia, C— soffit, D—shutters, E— widow's walk balustrade, F—decorative columns.*

in practice it is often omitted. The drip edge is designed to allow water runoff to drip free of the underlying trim. Without it, water tends to curl back under the shingles, wetting the edge of the roof sheathing and trim.

Wood trim should be inspected for cracked, loose, missing, and rotting sections. If the trim is painted, is the paint peeling and flaking in sections? Does the trim need repainting for weather protection? In older Tudor-style houses with timbers embedded in the stucco siding, inspect the timbers at the stucco joints for decay, especially if the joint is horizontal. Over the years, the joints tend to open slightly, allowing water to penetrate. With nonwood trim, check for loose, missing, and deteriorated sections.

Windows

The windows should be checked during the exterior and the interior inspections. The overall condition of the windows should be checked during the exterior inspection; the operation of the windows should be checked during the interior inspection. (See the section on windows in chapter 10.)

Many types of windows are used in residential structures. The most common types, as shown in FIG. 5-8, are double-hung, horizontal sliding, casement, awning, jalousie, and fixed-pane.

The *double-hung window* is the most common window unit in older and newer homes. It consists of upper and lower sashes that slide vertically past each other. The sashes are held in a fixed position within the window frame by a friction fit, counterweights, or spring balances. In some windows, the sashes are removable for ease of maintenance such as cleaning or painting. One variation of the double-hung window is the single-hung window; the upper sash is fixed, and the lower sash is movable.

The sashes in a *horizontal sliding window* slide horizontally on separate tracks. The most

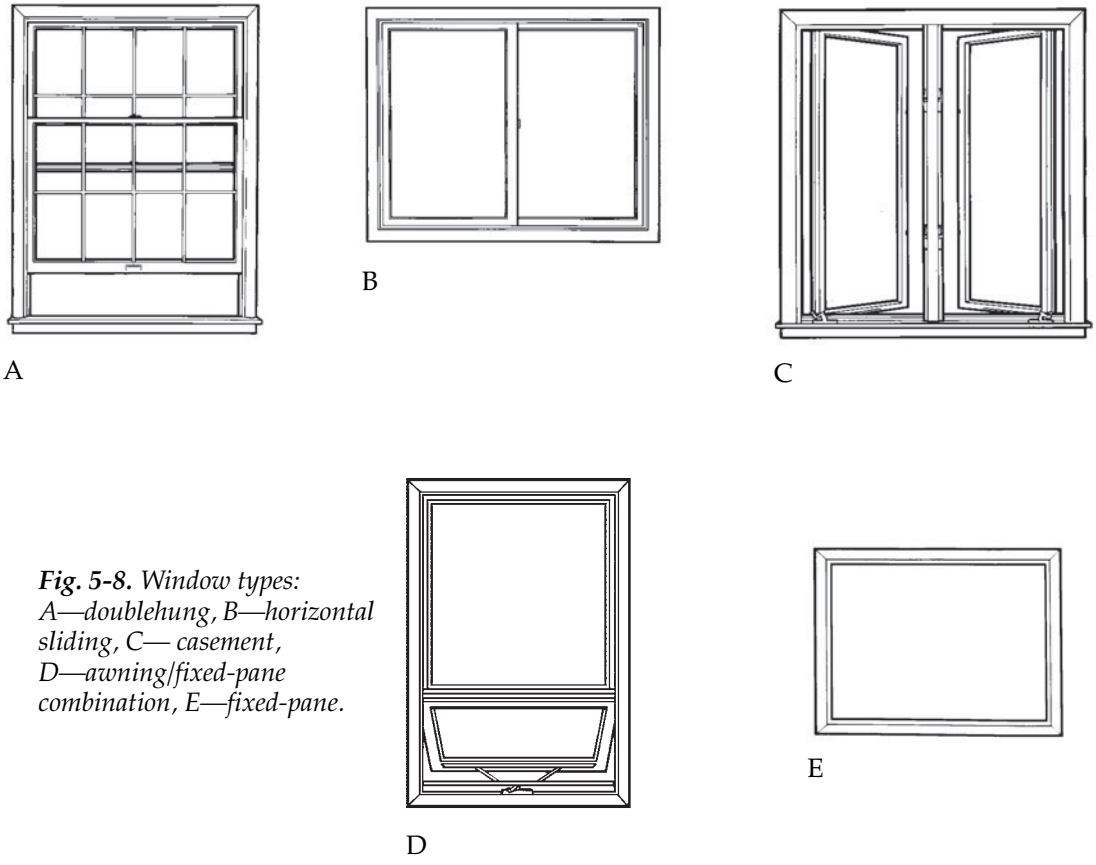


Fig. 5-8. *Window types: A—doublehung, B—horizontal sliding, C— casement, D—awning/fixed-pane combination, E—fixed-pane.*

common design consists of two sashes, both of which are movable. However, sometimes one sash is fixed. In most of these windows, the sash can be removed for cleaning.

Casement windows consist of two or more sashes hinged at the side and mounted so that they swing outward. The sashes are opened and closed by a cranking mechanism, a push bar mounted on the frame, or a handle fastened to the sash. Because the sash opens outward, a storm sash or screen must be attached to the inside of the window.

Awning windows have one or more sashes hinged at the top and mounted so that they swing out at the bottom. They are opened by push bars or cranking mechanisms similar to those on casement windows. As with casement windows, screens and storm sashes are mounted on the inside.

Jalousie windows are basically adjustable louvers. The louvers are glass slats (several inches wide) held by an aluminum frame at each end. The frames are interconnected by levers so that the slats open and close in unison, like venetian blinds. Jalousie windows are crank-operated and provide good ventilation. However, because of the many glass slats, they are troublesome to wash and are not weathertight. Even with a storm sash, cold-air leakage occurs around the windows. In

northern climates, jalousies are usually limited to use on porches and breezeways.

Unlike the preceding windows, which are movable and provide ventilation, *fixed-pane windows* are stationary and are used only to provide daylight and outdoor views. They can be used alone or in combination with sliding, double-hung, or swinging windows to achieve a custom design.

With the exception of the jalousie windows, available only in aluminum, all of the windows are available in wood, metal (steel or aluminum), and vinyl-clad frames. If you are not sure whether the metal window frames are steel or aluminum, you can always tell the difference by using a magnet. A magnet sticks to a steel frame but not to an aluminum one.

Metal frames get quite cold during the winter months. Consequently, some of the water vapor in the air inside the house tends to condense on the frames. To reduce this condensation, several manufacturers produce metal-framed windows with a thermal barrier that prevents the outside frame from touching the inside frame. This substantially reduces the condensation but does not eliminate it. Since wood has a greater thermal resistance than metal, wood window frames normally do not get cold enough for condensation to form on their inside surface.

Although wood windows provide a better insulation than metal windows, they do have a tendency to swell or shrink with changes in moisture. A wood sash that absorbs moisture will expand and bind in the frame, so that it does not operate freely. Wood windows should be treated (by the manufacturer) with a water-repellent preservative to resist decay and moisture absorption. In the past, not all windows were so treated; thus rotting sections and binding sashes are occasionally found.

The glass used in windows must be of sufficiently high quality to minimize distortion. Years ago, because of the difficulty of manufacturing large distortion-free panes, window glass was available only in small sheets. Consequently, to fill a large opening such as a window sash, small panes of glass were used and held in position by framing strips called *muntins*. Today, even though large windowpanes are available, muntins are still used to create a special architectural effect. Some window manufacturers provide preassembled wood or plastic dividers that simulate muntins. The dividers merely overlay the large windowpane and snap in and out of the sash. Some companies also install muntins between the panes of double-glazed windows during the manufacturing process.

Windowpanes are also available with single and double glazing. A double-glazed window, a thermal (or insulated) pane, reduces heat loss or gain through an equivalently sized single-pane window by about 50 percent. It also reduces condensation on the inside surface. With some windows, triple glazing is also available. See the section on windows in chapter 10 for a discussion of insulated windows and associated problems.

Inspection

When inspecting windows, look for cracked, broken, and missing panes. Check the joints between the sash and the window frames to see whether they are filled with paint. If they are, the windows might not open, and minor maintenance will be needed. The condition of the joints between the glass pane and the sash should be inspected. Are any panes loose? Most windowpanes are secured to the sash by bedding and sealing with a glazing compound such as putty. If putty is used, are any sections cracked, loose, chipped, or missing? Some panes are secured to the sash by wood strips (trim). Check the strips for cracked, loose, and missing sections. Note

any of the above items on your worksheet for later correction.

Look at the overall condition of the window frames and sash. Windows exposed to the elements are vulnerable to weathering deterioration. Are any wood sections cracked and rotted? Steel windows can rust. Depending on the extent of the deterioration, some windows require simple repair; others, replacement. All the windows generally are not visible or accessible during your exterior inspection, especially the windows on upper levels. The exteriors of those windows, and their operation, should be checked during your interior inspection.

Exterior doors

The two basic types of exterior wood doors are flush doors and stile-and-rail doors. Flush doors are made by bonding face panels to solid or hollow cores. Stile-and-rail doors (also referred to as *panel* doors) are solid doors that consist of vertical and horizontal members (called *stiles* and *rails*, respectively) that enclose wood or glass inserts. (See FIG. 5-9.)

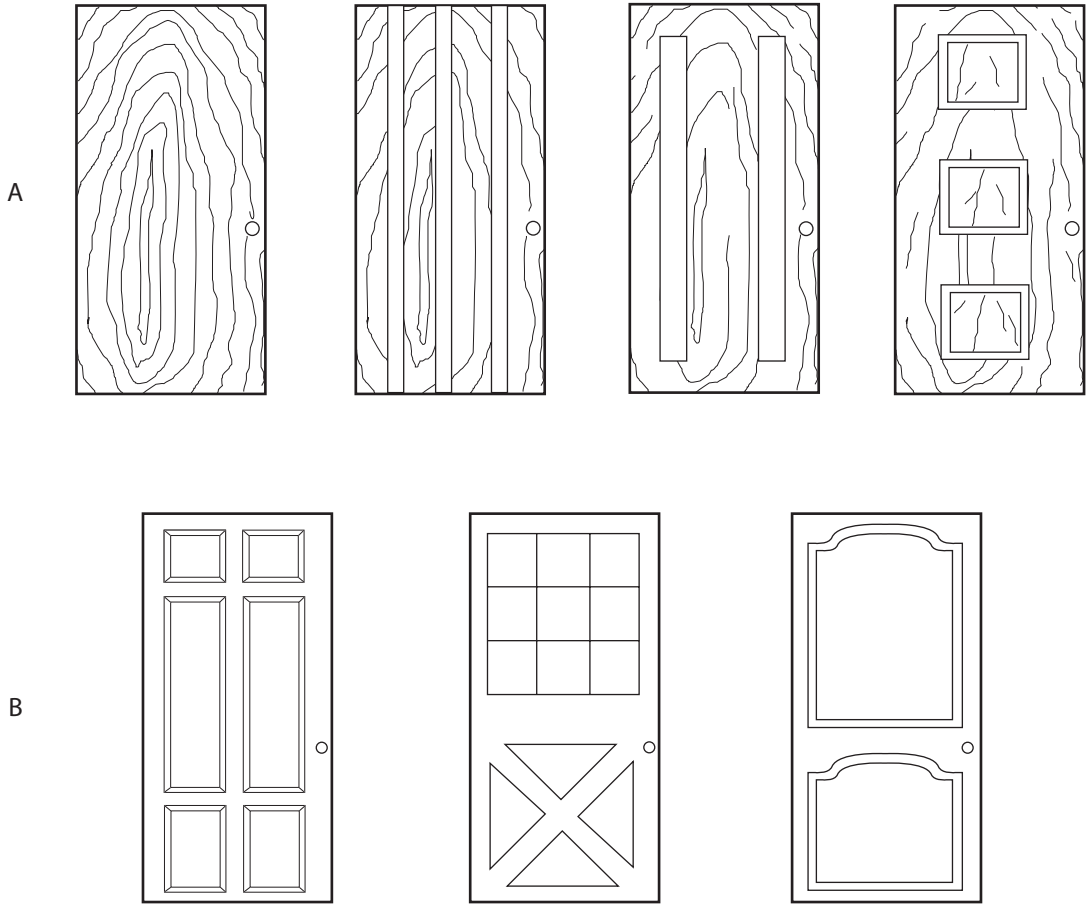


Fig. 5-9. *Exterior doors.*

Most *flush doors* have hardwood veneer face panels, although hardboard and softwood panels are also available. Some doors are made with cutouts for windows or louvers. Flush doors are used as interior and exterior doors. As exterior doors, they should be made with waterproof adhesives rather than water-resistant adhesives. You can often tell whether the proper adhesive was used by looking at the top edge. In many quality doors, you will find a small red plastic plug in the edge. This indicates that the door was bonded with a waterproof adhesive that is suitable for exterior use. When an improper adhesive is used, the exterior face panel eventually begins to delaminate and peel.

A solid-core flush door provides greater heat and sound insulation, fire resistance, and dimensional stability than a hollow-core door. The solid core of a flush door might be made of wood blocks or a composition material that has been formed into a rigid slab. A hollow core is generally made of wood or wood derivatives (cardboard) that have been formed into a honeycomb or parallel strips. When resistance to heat, sound, and fire are not important factors, the hollow-core flush door is sometimes used as an exterior door. This is not considered quality construction. When used on the exterior, the door should be treated with a water-repellent preservative and bonded with a waterproof adhesive. Unfortunately, this is not always the case.

One variation of the flush door is the metal-clad insulated entrance door. This door is available in a selection of surface styles and is becoming more popular. Basically the door consists of metal face panels with an insulating core. Some doors are provided with a thermal break to separate the interior parts of the frame and door panel from the exterior parts, thereby minimizing condensation during the winter months. Because of the insulating characteristics of this type of door, the need for a storm door is essentially eliminated.

Although *stile-and-rail doors* are not used as commonly as flush doors, they are available in a greater variety of designs. In addition to wood, the stile-and-rail doors are available in steel and fiberglass. Because of the number of panels and joints, the stile-and-rail door is not as effective an insulator as a flush door. Also, one or more panels in a wood door might crack as a result of shrinkage. If you stand inside of the house looking at the door, cracked sections are very noticeable. Daylight is visible through the cracks.

Some exterior doors are not considered secure because of the location of the glass panes relative to the door lock. If the door lock can be reached by breaking a glass pane in the door or in side panels, an auxiliary lock is recommended. This lock should be positioned where it is not accessible from the outside. Since you normally do not know whether you were given all the keys to the exterior door locks, it is recommended that after you take possession of the house, you replace all of the door locks or at least have the locks rekeyed.

The condition of the exterior doors should be checked during your exterior inspection, and the operation of the doors should be checked during your interior inspection. Outside, inspect a wood door for cracked, chipped, and delaminating sections. Inside, check the doors for cracks (visible daylight) and ease of operation. Check a steel door for dents and scratches, which will rust if not painted. A fiberglass door can crack under severe impact and should be checked. Does the door open and close easily, or does it bind? Also check for weatherstripping around the exterior joints. Weatherstripping is desirable, since it minimizes air infiltration. If you find any problems with the doors, record them on your worksheet.

Storm windows, screens, and storm doors

Storm windows

Windows are a major source of heat loss. On a per-square-foot basis, more heat is lost through windows than any other area. In fact, the heat lost through a single-pane window is approximately fourteen times greater than that lost through a well-insulated wall of comparable size. However, with storm windows, the heat loss can be reduced by about 50 percent. There are three basic types of storm windows: storm sashes, storm panels, and combination units.

A *storm sash* is a removable sash, usually made of wood, containing a fixed-pane window. The storm sash fits over the window on the outside or inside, depending on how the window opens. Storm sashes are most commonly found on the outside of older double-hung windows. They are not desirable for year-round use because they cannot be opened to admit breezes during the warmer months. Storm windows are generally taken off in early spring and reinstalled in late fall, a task that can be somewhat awkward and time-consuming.

A *storm panel* looks like a storm sash, but it is usually mounted in a narrow metal frame and is attached to the movable window sash rather than being fitted over the entire window opening. Since storm panels are attached directly to the movable sash, they do not interfere with the operation of the window and need not be removed during the warmer months.

Combination units refer to storm and screen sashes combined in a single frame. The unit is mounted over the outside of the window and is therefore effective in reducing air infiltration around the window joints in addition to reducing heat loss. Combination storm and screen windows are available in two- and three-track units. With two-track units, the outside track contains the storm sash in the upper half and a screen sash in the lower half. With the screen in position, the upper storm sash cannot move. The inside track contains the lower storm sash, which can slide up and down. In a triple-track unit, there is a separate track for each of the two storm panes and for the screen. Combination storm and screen units are generally found on double-hung and horizontal sliding windows. Since these units do not interfere with the operation of the movable sash and can also be opened to provide ventilation, they are not normally removed once installed.

Combination units are available in aluminum, steel, or solid vinyl. The aluminum frame with a baked enamel finish looks like a vinyl frame. You can tell the difference by looking at an edge or joint. The aluminum edge will have a silvery color; the vinyl edge will be the same color as the frame. Over the years, many aluminum frames with a mill finish (plain aluminum) show the effects of weathering, such as pitting, corrosion, and a degraded appearance. An anodized or baked enamel finish will offer greater protection against weathering. Combination storm and screen windows made of steel have a tendency to rust and require periodic painting.

Screens

Most window screens for residential structures are either mounted on a wood sash or rimmed with a metal or plastic frame. The wood-framed screen is usually used in conjunction with a storm sash; the metal- or plastic-framed screen is used in the combination storm and screen unit. Metal- or plastic-framed screens are also used for casement and awning-type windows. However, for these windows, the screen must be equipped with panels that provide access to the cranks or push bars.

Another type of screen (not very common) is the roll-up screen. This screen is mounted on the inside of the window and is similar in operation to a roll-up shade. When the screen is not being used, it can be rolled up and hidden from view. The sides of the screen move in metal tracks to prevent insects from flying in around the edges. As the screen ages, the joint between the screen and the track tends to open and become less effective.

Storm doors

In colder climates, unless the exterior doors are insulated, they are often used with storm doors to reduce heat loss and cold-air infiltration around the joints. Storm doors are generally lightly constructed wood or metal stile-and-rail-type–doors with a glass-panel insert. On many of these doors, the glass insert is interchangeable with a screen panel so that they can function as both storm and screen doors. Because storm doors are constantly being opened, they are not as effective as storm windows in reducing heat loss. Nevertheless, they are effective from an overall energy-conservation point of view.

Inspection

When inspecting the house, look for storm windows. If you do not see any or the inspection is being performed during warmer weather when storm sashes are normally not installed, ask the owner whether the house has storm sashes for all the fixed and movable windows. If no storm windows or only a few are available, record the fact on your worksheet. Installing a complete set of storm windows can be quite costly.

Storm windows should be inspected for cracked, broken, and missing panes. When the storm sash is wood, check for cracked, broken, and rotting sections. On combination units, look specifically at the corner joints. These joints should be tight so that no cold air leaks into the unit. Check the overall condition of the frames. Are any sections loose, broken, rusted, or corroded? Are any of the panes loose in the sash? Look for torn sections and holes. In metal- and plastic-rimmed screens, the screening is normally held in position by a spline that has been forced into a groove around the frame. Periodically, I find splines hanging loose within the frame of the combination unit. Loose splines are an indication that the joints in the associated screens must be resecured.

Storm doors should be checked for ease of operation and overall condition. Are sections cracked, broken, loose, rotted, or corroded? Is the glass panel loose, cracked, broken, or missing? If you find any problems with the storm windows, screens, or storm doors, record them on your worksheet as a reminder for later correction.

Caulking

As you walk around the house inspecting the walls, windows, trim, and doors, look for cracked and open joints. All exterior joints should be caulked (sealed) so that they are watertight and airtight. If they are not adequately caulked, wind-driven rain can enter and cause wood members to rot, metal ties to rust, and masonry sections to crack and chip. In addition, cold air can infiltrate the house, resulting in higher heating costs. A vulnerable joint for cracking is one that joins two dissimilar materials; for example, the joint between a brick facing and a non-masonry sidewall. Dissimilar materials usually have different expansion and contraction characteristics, often causing the joints between them to crack and open. These joints should be sealed with a non-shrinking flexible caulking compound.

There are several types of caulking compounds. The four most popular types are oil base, acrylic latex base, butyl-rubber

base, and silicone base. *Oil base* caulking compounds are the cheapest and will readily bond to most surfaces—wood, masonry, and metal. However, they are not very durable; they tend to dry and crack after a short time. Joints sealed with this type of caulk require periodic inspection and maintenance. *Acrylic latex* caulking compounds are medium-priced, durable, and flexible, and should last for many years. *Butyl-rubber* caulks are medium-priced, durable, and paintable; however, they exhibit high shrinkage, a characteristic that is acceptable when caulking narrow cracks and inside corners. *Silicone-base* caulks are the most expensive. They are very pliable and are good for sealing joints subject to movement. No one caulking compound is ideally suited for every application. However, based on cost, durability, and ease of application, acrylic-latex caulks are considered by many to be the best choice.

When inspecting the exterior joints, check the condition of the caulking. Look for cracked, chipped, crumbly, and missing caulking compound. The location of joints that need recaulking should be recorded on your worksheet. Recaulking is a relatively simple task and can be done after you move into the house.

Checkpoint summary

General considerations

- ❍ Inspect exterior walls for sagging, bulging sections, and for corners that are not vertical.
- ❍ Check for window frames and door frames that are not square.
- ❍ Structural problems whose cause cannot be determined should be evaluated by a professional.
- ❍ Note wall locations that have pipe or hood projections.
- ❍ Determine their usage (i.e., sump-pump discharge, condensate line, dryer vent, etc.).
- ❍ Check for vines growing up the exterior walls.

Exterior walls

Wood siding (shingles, shakes, boards, plywood panels, hardboard)

- ❍ Check bottom course of siding for sections in contact with, or in close proximity to, the ground (less than 8 inches).
- ❍ Check wood shingles/shakes for open joints, cracked, chipped, loose, or missing sections.
- ❍ Note areas of rot or discolorations.
- ❍ Check for peeling and flaking paint and warped shingles, particularly on sidewalls with a southerly or southwesterly exposure.
- ❍ Inspect for poor-quality shingles and shingles that have been improperly nailed.
- ❍ Check wood boards for open joints, cracked and rotting sections, loose or missing knots, peeling paint, and blistered sections.
- ❍ Inspect plywood panels for open joints, loose, warped, cracked, delaminated, or rotting sections.
- ❍ Check hardboard siding for cracked, deteriorated, or loose sections.

Aluminum/vinyl siding

- ❍ Check aluminum siding for loose, missing, torn, or dented sections.
- ❍ Check joints for open sections and weathertightness.
- ❍ Does siding contain insulation backer boards?
- ❍ Check siding for an electrical ground connection. (This requirement can be verified with the local building department.)
- ❍ Check vinyl siding for open joints, loose, cracked, or sagging sections.
- ❍ Check vinyl panels for waviness and blisters.

Asbestos-cement shingles/asphalt siding

- ❍ Check asbestos-cement shingles for loose or missing sections; cracked, chipped, and broken areas.
- ❍ Inspect asphalt siding for open or lifting joints; missing, loose, torn, cracked, chipped, or eroding sections.

Fiber-cement siding

- ❍ Check for skewed trim, exposed nails, and cracked, chipped, loose, or damaged sections.

Stucco-cement–finished walls

- ❍ Check for bulging, missing, loose, cracked, or chipped sections. Note areas in need of rehabilitation.
- ❍ If stucco is painted, check condition.

Synthetic stucco (EIFS)

- ❍ Check for cracked and open joints at the interface between the EIFS and windows, doors, wall penetrations, and so on.
- ❍ Are there indications of moisture in those areas?

Veneer and masonry walls

- ❍ Inspect for loose or bulging sections and large open cracks, particularly around door and window frames.
- ❍ Check for cracked, chipped, or missing sections of brick or stone.
- ❍ Inspect mortar joints for deterioration, cracked or loose sections.
- ❍ Check exterior surfaces on masonry walls for signs of water seepage (efflorescence).

Trim

- ❍ Check trim for cracked, loose, missing, or rotting sections.
- ❍ Inspect for areas of bare wood, blistered and peeling paint.
- ❍ Check nonwood trim for cracked, torn, missing, or loose sections.

Windows

- ❍ Check for cracked, broken, or missing panes.
- ❍ Are any of the windows painted shut?
- ❍ Are the panes properly secured to the sashes?
- ❍ Check the condition of the window frames and sashes.

Exterior doors

- ❍ Check wood door for cracked, chipped, or delaminating sections.
- ❍ Check metal door for dents or scratches.
- ❍ Check fiberglass door for cracks.
- ❍ Check for weatherstripping around exterior joints.

Storm windows, screens, and storm doors

- ❍ Check for missing units and/or partial installations.
- ❍ Inspect storm windows for loose, cracked, broken, or missing panes.
- ❍ Inspect wood units for cracked, broken, or rotting sections.
- ❍ Inspect combination units for loose, broken, rusting, or corroded sections.
- ❍ Inspect screens for torn sections and holes.
- ❍ Inspect doors for ease of operation; missing glass; cracked, broken, rotting, or corroded sections.

Caulking

- ❍ Check joints for cracked, chipped, crumbly, missing, or loose areas of caulking compound.

6

Lot and landscaping

Drainage 62
Groundwater, water table 65
Inspection 67
Retaining walls 70
Inspection 71
Landscaping 74
Lawn 74
Shrubs 75
Trees 76
Decks 76
Free-standing decks 79
Composite decks 79
Fences 80
Checkpoint summary 81

In addition to all of the items mentioned in the previous chapters, you should inspect the drainage around the house and the landscaping. Any retaining walls, decks, or fences also should be inspected.

Drainage

As housing developments and shopping centers sprout up in the countryside, they affect the drainage characteristics of the surrounding areas. Normally, in undeveloped areas most of the water falling to the earth soaks into the ground. The remainder flows over the surface into lakes, rivers, and streams, or accumulates in low-level areas, forming ponds. In built-up areas, thousands of acres that had been soaking up rain have been rendered impervious to water because of buildings and paved areas. The surface-water runoff in these areas might be two to ten times more than it was when the land was undeveloped.

In built-up areas, surface water usually flows into storm drains (catch basins) that in turn discharge into rivers and streams. In some cases established housing developments have been inundated with surface water after a heavy rain because their storm-drainage facilities were not adequate for the increased water flow resulting from adjacent new housing developments. In most cases, the increased runoff results in the rivers and streams swelling, although they are usually contained within their banks. However, after a heavy prolonged rain, a river or stream can overflow its banks and flood the surrounding

area. Many people do not realize that even a small creek, which might be a trickle when they see it, can become a raging, destructive torrent following an excessively heavy rain.

The area normally flooded when a river or stream overflows its banks is called a *flood plain*. Between 5 and 10 percent of the land in the United States is in a flood plain. Much of this land is level and from outward appearances seems to be desirable. As land in urban and suburban areas became more and more scarce, builders constructed homes directly on the flood plains of streams and other waterways. These homes are all vulnerable to flooding. (See FIG. 6-1.) In many parts of the country, some owners do not realize that their homes were built in a flood-prone area, and they probably will not realize it until it is too late.

If you have doubts about whether the house is located in a flood plain, you should check with the local town or county engineer. If the engineer is not available, often the local highway superintendent can tell you whether the area periodically floods. In many communities, federal flood insurance is available for those homes located in a flood plain. If you are considering such a home, you should consider purchasing flood insurance.

Surface runoff is of concern to the homeowner because it can result in soil erosion, ponded water, and water in the basement or crawl space. Soil erosion occurs whenever water flows over bare earth. Soil particles are loosened and are carried away by the flow. Water seeks its own level and will therefore flow from a higher elevation to a lower elevation. The paths the water takes

Fig. 6-1. *Backyard flooding of a house located in a flood plain.*

when flowing to a lower level are called *natural drainageways*. Areas particularly vulnerable to erosion are steep banks and drainageways. (See FIG. 6-2.)

The basic principle for preventing or minimizing erosion is to have the ground covered as much as possible with growing vegetation such as grass, trees, bushes, shrubs, and even weeds. If the vegetation does not root and keeps washing out, a substitute cover such as gravel, stones, or mulch can be used. This cover is not as effective, but it does reduce the erosion. Sometimes the banks are too steep for a ground cover of any kind; they must be stabilized by terracing or retaining walls.

In addition to a ground cover, erosion can be reduced by slowing down the water flow. For example, if there is a concentrated surface runoff along a natural drainageway, the water can be diverted to a man-made channel or ridge that follows a level contour. This spreads out the water and slows the flow so that the water does not scour and erode the soil.

The effects of surface runoff can be minimized by reshaping the ground surface. This can be done by terracing and/or regrading the lot into gentle slopes with diversionary ridges and swales. A *swale* is a depression in the ground that like a ridge will intercept surface runoff and redirect it to an area where the water will not cause damage. When a house is located on a sloping lot, a swale or ridge should be in the portion of the lot that slopes toward the house. This type of a diversion will prevent surface water from accumulating around the house. Otherwise, the surface runoff might seep into the basement or crawl space. (See chapter 11.)

Many building lots have low, level areas that will tend to accumulate water after a rain or from surface runoff. When the soil is slow-draining, as with clay and silt, the water will

Fig. 6-2. *Bank erosion on a steep slope. Correcting this condition will require a retaining wall with adequate drainage.*

pond rather than soak into the ground. The ponded areas retain the water until it evaporates or eventually seeps into the ground.

Depending on the location of the pond, the accumulated water might not be a problem. If the pond is over the leaching field of a septic system or is in an area that normally has a lot of foot traffic or is used by children, corrective action is necessary. The problem can often be corrected by bringing in fill and regrading the area. When regrading is not practical, the area can be drained by laying a line of perforated drainpipe through the affected area and directing one end of the pipe to a low spot. The pipe is generally encased in a bed of gravel or broken stones. If conditions warrant it, a concrete-block catch basin with radial spokes of perforated pipe can be installed at the low point. (See FIG. 6-3.) Water collected in the pipes and catch basin can then be directed to another area. If there are no other low areas to which the ponded water can be redirected using a pipe with gravity flow, the water can be directed to a sump pit and pumped to the desired location.

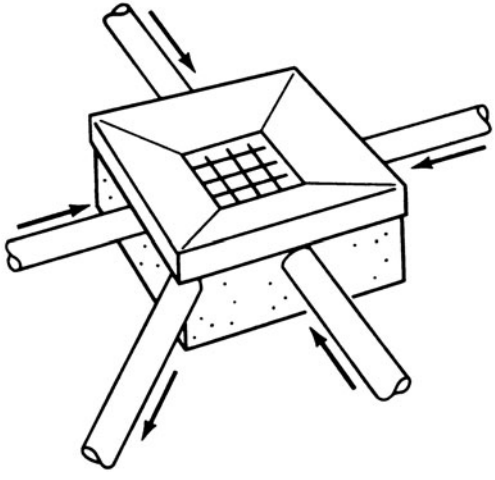


Fig. 6-3. *Concrete block catch basin with several perforated inlet pipes and a solid outlet pipe that drains to a suitable location. Basins of this type are used to drain low-level lawns that are collection ponds for rainwater.*

Groundwater, water table

Water that soaks into the ground eventually percolates downward under the influence of gravity until it reaches an impervious layer it cannot penetrate. After the water reaches the impervious layer, it begins to move in a lateral direction. This underground flow is known as *groundwater*, the top surface of which is commonly called the *water table*. The level of the water table will vary with the amount of rainfall. Consequently, the water table might be several feet higher after a prolonged rainy period than during a prolonged spell of dry weather.

A high water table can result in a flooded basement or failure of the septic system's leaching field. In many parts of the United States, the seasonal high water table is only 2 to 5 feet below the surface. In those areas, houses should be built on a slab or over a crawl space rather than over a full basement. Unfortunately, houses with full basements have been built in areas where the water table (during the wet season) is above the level of the basement floor. This invariably results in water penetration into the basement. Depending on the soil, even when the water table is several feet below the basement floor, some water might seep into the area as a result of the capillary rise of groundwater. (See chapter 11.)

Homes located in areas where the seasonal high water table is only a few feet below the ground surface should not have septic systems for waste disposal. Ideally, they should be connected to a sewer system. For proper operation of a septic system, the water table during the wet season should be at least 4 feet below the bottom of the leaching field or seepage pit. The operation of a septic system is explained in chapter 13.

Basically, the top surface of flowing streams, rivers, lakes, and oceans is the water table. Consequently, the terrain that gradually slopes into the waterway has a high water table. Homes built in these areas are not only vulnerable to problems associated with a high water table but are also vulnerable to flooding. The water table tends to follow the general contour of the land and in some areas might intersect the ground surface, thus forming marshy wetlands. To a homeowner, these wetlands are quite undesirable, because not only are they costly to drain, but they are also a breeding place for insects.

Excessive grading or reshaping of the ground surface (such as cutting out the side of a hill to locate a house, FIG. 6-4) can change the natural drainage patterns and cause groundwater to seep to the surface. I have inspected many such houses and have found (in the early spring or after an excessively heavy rain) water oozing out of the cut side of the hill. This water, if not redirected away from the house, can work its way into the basement or crawl space.

In areas with a seasonal high water table, if the topography is such that the land slopes toward one side of the house, in addition to surface-water runoff, subsurface water will flow toward the house. This water, if allowed to accumulate around the foundation, can seep into the basement or crawl space. This condition can usually be controlled by installing a *curtain drain* in the hillside parallel to the house to divert the water away from the house.

A curtain drain consists of a perforated drainpipe installed in a trench that is filled with gravel and covered with soil. The trench normally extends several feet beyond the house, with one end leading to a suitable disposal area. Incidentally, the perforations in the pipe should be facing downward, not upward as is popularly believed. As the subsurface water level rises, it enters the holes along the length of the pipe. Since water always takes the path of least resistance, once

Fig. 6-4. *House located on the cutout side of a hill. The building site requires special provisions to minimize erosion and drainage problems.*

inside the pipe it flows to the outlet, which must be located away from the house and must be unobstructed. The outlet, however, should have an animal screen to prevent a small animal (such as a rabbit) from entering, becoming lodged, and blocking the flow.

In areas with a seasonal high water table or a potential for surface water to accumulate around the foundation, it is advisable to have foundation footing drains (perforated drain-pipes) installed parallel and adjacent to the foundation footing. (See FIG. 6-5.) As with curtain drains, footing drains are installed with the holes facing downward. The purpose of the footing drain is to channel the water that accumulates around the foundation to another location. Footing and curtain drains either must have a free-flowing outlet or discharge into a sump pit where the accumulated water can be pumped to the desired location.

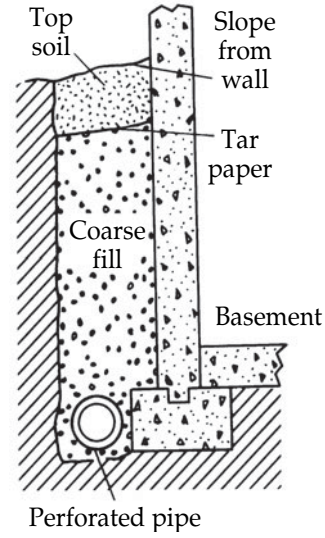


Fig. 6-5. *Foundation footing drain, used for channeling water that accumulates around the foundation to another location.*

Inspection

The drainage inspection should begin as you are driving to the house. When you approach the house, notice the overall topography. Is it level or inclined? If it is inclined, is it a gentle slope or a steep slope? With inclined topography, you should be concerned about the possibility of surface and subsurface water movement toward the house. If the house is located near the bottom of an inclined street, is a storm drain (catch basin) in the street at the low point? There should be, especially if the street is paved. Otherwise, after a rain or a snowmelt, water accumulates at the low area and depending on the amount, can flood the adjacent yards and driveways. Did you notice a waterway (stream, brook, etc.) on the street as you approached the house? If you did, the house might be located in a flood plain.

When you arrive at the house, notice whether the land between the house and the street is above or below the street level. If the land slopes downward from the street to the house, the house is vulnerable to drainage problems. The surface water, if not properly controlled, can accumulate around the foundation or can pond on the lawn or over the entry path. If the house is inspected when it is not raining, you might not see any problems. However, based on the slope and overall grading of the land around the house, you can at least determine the potential for a problem.

As you walk around the house, notice whether the ground immediately adjacent is graded so that it slopes away from the house on all sides. It should be. Otherwise, surface water can run directly to the foundation (see FIG. 6-6), seep down along the foundation walls, and accumulate at the lower section. This usually results in water seepage into the basement or crawl space. A rule of thumb for grading this area is a drop of about 1 inch per foot. The lawn should slope away from the house for at least 10 feet and should be pitched so that there is approximately a 10-inch drop over that distance. (See FIG. 6-7.)

Fig. 6-6. *Improper grading of the land adjacent to the house. The lawn pitches toward the door, resulting in surface water ponding in front of the entry area.*

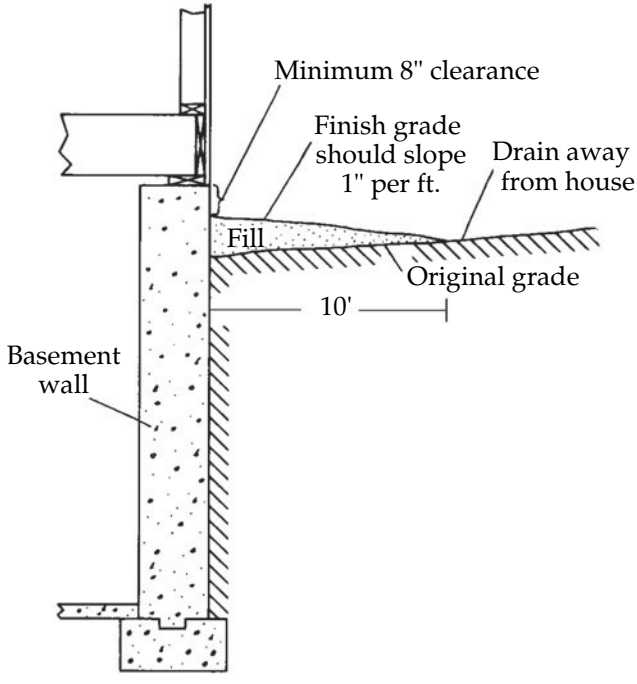


Fig. 6-7. *Finish grade of the ground adjacent to the foundation, sloped for proper drainage.*

Because of normal soil settlement and compaction, clogged gutter or faulty downspout, and foot traffic (especially when the ground is wet), the slope of the ground adjacent to the house usually changes with time. Consequently, the area around the foundation should be periodically checked for proper grading.

When checking the grading around the foundation, you might occasionally see a pipe protruding through the foundation wall or from a basement window. Record the fact on your worksheet for further investigation when you inspect the basement. Usually, this pipe is connected to a sump pump and is used for discharging the water that accumulates in the sump pit. The end of the pipe should be extended away from the house so that the water does not accumulate around the foundation. Sometimes the pipe terminates just beyond the foundation wall, which negates the advantage of a sump pump. The discharging water accumulates around and under the foundation and reenters the sump pit, only to be pumped out again. (See FIG. 6-8.)

If you find a stream on the property, you should realize the potential for flooding. As discussed previously, flooding can occur because of increased surface runoff resulting from a prolonged heavy rain. In addition, if the stream channel is blocked by fallen trees, tree limbs, sediment, or trash, flooding can result. Depending on the location of the stream relative to the house, occasional overflowing of the stream banks might or might not be a problem.

As you walk around, look at the overall landscape. If the topography is sloping, does a natural drainageway direct surface runoff away from the house, or does the lot need a swale or ridge? If there is an abrupt change in the grading, is there a need for a retaining wall? Are any areas eroding to the extent that corrective action is necessary? Are low or level areas vulnerable to ponding? Ponded water on the lawn does not necessarily indicate a drainage problem. It might be caused by a malfunctioning septic system, a faulty sewer hookup, or a break in the main water-supply pipe. If you find ponded water during your inspection, try to determine the cause.

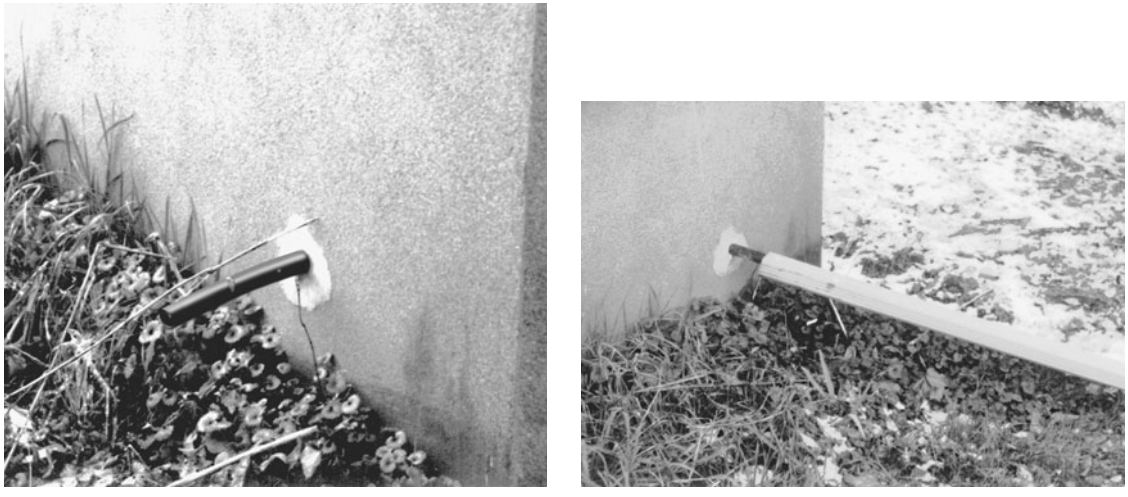


Fig. 6-8. *Sump pump discharge pipes. Left—The pipe terminates just beyond the foundation wall. Right—The discharge pipe has been extended so that effluent discharges away from the foundation.*

If there are footing drains around the foundation or curtain drains in a hillside, they will not be visible during your inspection. For these drains to function properly, they must have a free-flowing outlet. (See FIG. 6-9.) Ask the seller if there are drains, and if so, ask for the location of the outlets. Unfortunately, most homeowners do not know whether there are footing or curtain drains. When a house is sold, this type of information is usually not discussed, although it should be. Consequently, the location of the drain outlet is lost for all future owners. If you are lucky enough to have a seller who knows the location of the drain outlet, you should inspect the opening to make sure that it is not obstructed. If the footing drain discharges into a stream channel, an overflowing stream could be a problem. It all depends on the elevation of the footing drain relative to the level when the stream is running full. If the stream is above the level of the footing drain, then water will back up into the drain around the foundation and could cause a water seepage problem. Look for evidence of seepage when inspecting the basement or crawl space. In new homes, the drain outlet is sometimes inadvertently blocked when the lawn is landscaped. If you are buying a new house, ask the builder to show you the location of the drain outlet.

Fig. 6-9. *Free-flowing outlet of curtain drain. Note water discharging from pipe.*

Retaining walls

Retaining walls are mostly used for stabilizing and controlling erosion on steep banks. In some cases, they are used in conjunction with terracing of rear or side yards to provide a level area for recreation. In either case, they must be designed to withstand the lateral pressures being exerted on them by the soil.

Retaining walls are normally built with construction timbers, railroad ties, stone, concrete, or concrete blocks. Some concrete and concrete-block walls have stone or brick veneer facing. On occasion, you might find a *gabion* retaining wall—steel baskets filled with stones. (See FIG. 6-10.) As gabions age, the steel baskets tend to corrode and deteriorate, especially on the side facing the embankment. Over the years, however, soil sediment usually fills the voids between the stones and tends to hold the wall in place.

Stone retaining walls are often referred to as dry or wet, according to whether mortar

Fig. 6-10. *Gabion retaining wall.*

was used between the stones. A *dry* retaining wall is one that has been constructed without mortar. It depends on the weight and friction of one stone upon another for stability. Frost heaving is not a problem with this type of wall. The stones are not bonded together and will therefore be raised and lowered together by the frost. Consequently, the bottom course of the wall is usually only about 6 inches below grade rather than below the frost line.

A *wet* wall is one with mortar between the stones. The mortar secures one stone to another and thereby achieves a monolithic wall with greater stability. Because this wall is integral, frost heaving will cause cracking. To prevent frost heaving, the bottom of the wall must be below the frost line. A wet wall offers greater solidity, and therefore loose soil will not wash out or run through the voids. Also, a wet wall is less of a hazard because no loose stones can be kicked out of place or fall off the top.

When constructing a retaining wall, provisions must be made for draining the water that normally accumulates behind the wall. Otherwise, a hydrostatic pressure buildup can cause structural failure of the wall. Drainage should be provided by installing a continuous perforated drainpipe at the lower portion of the wall and backfilling the area with broken stones or gravel. The pipe should be directed so that the effluent flows to a suitable location away from the wall. In many monolithic retaining walls, the perforated pipe is replaced by *weep holes*, holes in the wall that run from the front to the gravel backfill. The weep holes allow the water that accumulates in the gravel to drain out through the wall. Weep holes should be placed at a 5- to 10-foot spacing and should be 4 inches in diameter (the same diameter as the drainpipes).

Unfortunately, retaining walls are often built without adequate drainage provisions. The gravel backfill and drainpipe might be omitted, or the weep holes might be too few or too small to be effective. The weep holes must be kept clear so that the water behind the wall can be adequately drained.

A retaining wall built with construction timbers or railroad ties should be anchored into the hillside to provide the resistance to overcome the lateral forces exerted on it. If the wall is not tied back into the earth, it can bow, buckle, or heave and eventually collapse. Anchoring of the wall is achieved by using *tiebacks* and *dead men*. A tieback is a construction timber that has been placed perpendicular to the wall. The front end is flush with the wall and fastened to it with large spikes. The rear end is fastened to a dead man, a small section of timber perpendicular to the tieback and parallel to the wall. (See FIG. 6-11.) When the area around the wall anchor is backfilled with soil, a force is developed on the anchor that resists the lateral force on the wall. Because of the open joints between the railroad ties, weep holes are not needed.

Many railroad-tie or timber retaining walls are not constructed with anchors. You can tell whether anchors were used by looking at the wall. If tiebacks were used, end sections will be visible in the face of the wall. (See FIG. 6-12.) However, from a visual inspection, you cannot tell the length of the tiebacks or whether dead men have been installed. Your inspection, therefore, should concern itself with the condition of the wall rather than its construction, unless it is a new wall. If it is newly constructed, you should inquire about a guarantee.

Inspection

When inspecting a retaining wall, look at its overall condition. With a dry stone wall, look for missing and loose stones and crumbled sections. This type of wall is relatively easy to repair and generally does require periodic maintenance. With a wet stone wall, check

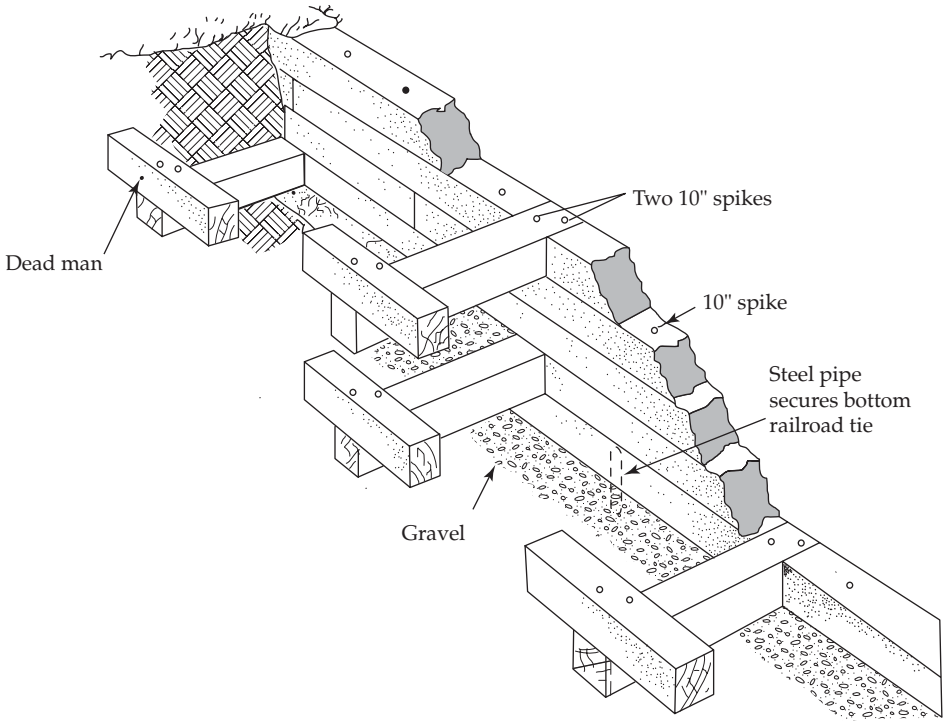


Fig. 6-11. *Construction timber/railroad tie retaining wall.*

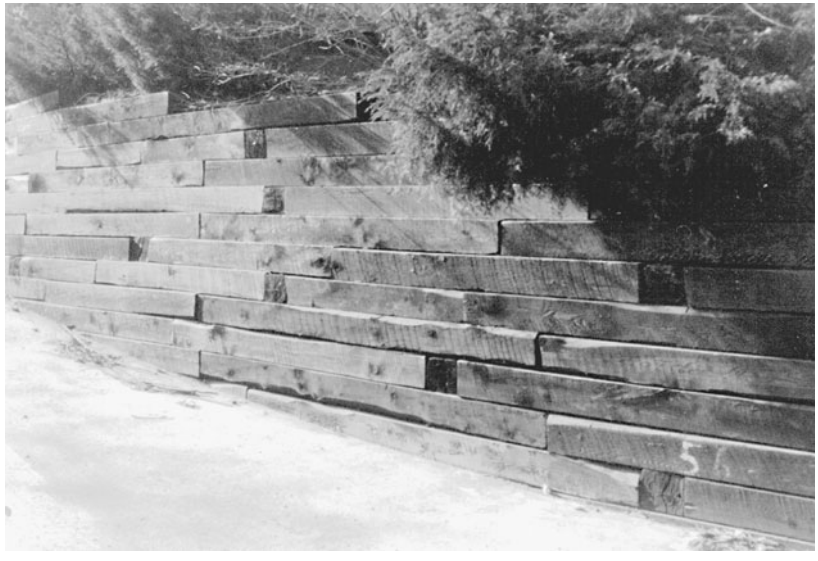


Fig. 6-12. *Timber retaining wall. Note the end sections, indicating tiebacks used for anchoring the wall.*

the mortar joints for cracked, loose, and deteriorated sections. Are there weep holes in the wall? If so, are they adequately sized and unobstructed? Concrete and concrete-block walls should also have weep holes. Are there any cracked and heaved sections? Wood-constructed retaining walls should be checked for cracked, rotting, loose, and heaved sections. Some retaining walls are completely covered with vines. Try to push the vines aside so that you can inspect the wall. Quite often I have found cracked sections in the wall through which the vines were growing. While inspecting the wall, look for loose, heaved, and deteriorated sections.

All retaining walls should be vertical or inclined slightly toward the embankment. They should not be leaning forward. When they are, it is an indication that they could not withstand the lateral forces being exerted on them by the terraced or sloped earth behind. Once a wall cracks and heaves, the pressure that caused the condition is relieved, and the wall might stay in the leaning position for many years. (See FIG. 6-13.) However, additional forces might cause the wall to continue to heave and eventually to collapse. If the heaving is excessive or by the wall's collapsing someone can get hurt, the wall must be rehabilitated or braced. If you have any questions about what is excessive heaving, have the wall inspected by a professional.

In recent years, manufactured concrete blocks have been used for retaining walls for residential construction (see FIG. 6-14). The blocks come in different sizes and shapes depending on the manufacturer. Often these walls are 5 feet high or higher, and many are constructed in tiers. In most states, if the retaining wall is taller than 4 feet, it must be designed or approved by a qualified, licensed professional engineer. In order to prevent failure and to reduce the earth's pressure behind the retaining walls, they are reinforced with horizontal layers of a geosynthetic polymer mesh, which extends back into the

Fig. 6-13. *Cracked and heaved retaining wall.*

Fig. 6-14. *Concrete block retaining wall.*

embankment. Since the length of the mesh will not be visible, from an inspection point of view all you can do is to check the wall for tilting, cracking, or bowing. If any are noted, it should be recorded on your worksheet for later inspection by a professional engineer.

Landscaping

As you walk around the house, inspect the landscaping in the front, rear, and side yards. Specifically, look at the lawn, shrubs, and trees. A nicely landscaped area greatly enhances the beauty and value of the house. However, do not jump to a hasty conclusion about the house based on the landscaping. I have seen many neglected houses with beautiful landscaping and many well-maintained houses with poor landscaping.

Lawn

A lawn serves two purposes. It adds to the aesthetic beauty of the property, and, more important, it prevents erosion and washout of the topsoil. If you find that a large portion of the lawn consists of crabgrass and other weeds, do not be distressed. With a planned program of weed control, seeding, and fertilizing, you can upgrade the lawn so that it can be the "showcase of the neighborhood" within a few years, and at not too great an expense.

If you find holes or sunken sections in the lawn, they should be filled in, since they represent a potential tripping hazard. Occasionally, sunken sections are caused by the collapse of rotted, decayed, or deteriorated construction debris buried on the site years before. In new homes, all construction debris should be removed from the site rather than buried there.

In some parts of the country, moles are a problem in lawn maintenance. They burrow in the ground near the surface in search of food (grubs, caterpillars, and insects) and in the process create soft ridges (mole hills) that spoil the lawn's appearance. If you see ridges over portions of the lawn and they feel soft when you walk over them, suspect moles. This condition can generally be controlled through soil treatment and should be discussed with the proprietor of a local nursery.

Some lawns have steep sloping areas that from a maintenance point of view are quite difficult to mow, even when mowing across

the slope. Because of the danger involved, sit-down riding mowers should not be used when cutting the grass on a steep slope. These mowers have been known to topple over and severely or fatally injure the driver. In some homes, the steep sections of the lawn have been replaced by terraced areas with steps that lead from one level to another. If there are terrace steps on the lawn, you should inspect them for cracked, loose, missing, and deteriorated sections. Also, check for uneven treads and dimensional variations in the risers (a tripping hazard). In addition, if there are more than two steps, a handrail is recommended.

If you are planning to buy a newly constructed house, find out whether it will be your responsibility or the builder's to establish a new lawn. If it is yours, it can be quite expensive, depending on the size of the lawn and whether topsoil needs to be added. Over 100 tons of topsoil is needed to cover an area one-third of an acre to a depth of 2 inches.

Shrubs

When new homes are landscaped, the shrubs are often intentionally planted very close to one another to produce an immediately pleasing effect. Many homeowners do not plant shrubs with the future appearance in mind. Consequently, as the shrubs grow and fill out, they tend to crowd one another, losing their individuality. Eventually, they become unsightly, with portions dying off due to lack of sunlight. In addition, the growing shrubs often block walkways and produce so much shade that the area around the house is always damp, a condition conducive to the growth of decay fungi and mildew. By extensive pruning of the shrubs and transplanting others (if you want to save them), the area can often be completely rejuvenated and restored to its original beauty. For some people, their dream house is one that is covered with ivy. (See FIG. 6-15.) Actually, vines of any type growing up the outside walls of a house are quite undesirable. As vines grow they can cause problems. They can lift wall

Fig. 6-15. *Vines growing up and partially covering exterior shingle wall.*

shingles and roof shingles. They can also grow into mortar joints and crush downspouts. (See FIG. 6-16.) If you see vines on the house, you should consider their removal.

Trees

If there are trees on the property, they should be checked to see if any are dead or have any large dead branches. All dead trees should be taken down. Because they are vulnerable to insect damage and decay, they are a potential hazard, especially if they are located near the house. Large dead branches are also a hazard. On a windy day, they can break off the trees and fall to the ground or, worse, onto the house.

After a deciduous tree has lost its leaves, it can be somewhat difficult to determine whether it is dead or has any dead branches. However, if you see any limbs with the bark peeled off, you can assume that those branches are dead. (See FIG. 6-17.) If you have any doubt, after you move into the house, you should have the trees checked by a professional, or wait until spring and summer when all the trees are in full bloom.

Fig. 6-16. *Downspout crushed by vines.*

If you find any dead trees or dead branches, record their location on your worksheet for later removal. Depending on the size and location of the dead tree, its removal can be somewhat costly. This type of work should be performed only by a professional who is insured in the event that the tree causes damage when it falls to the ground. In addition to dead branches, all limbs that are overhanging or resting on the roof should be pruned back. Otherwise, they might eventually damage the roof.

If you are buying a newly constructed house with trees on the property, you should be aware that the roots of some of the trees might have been damaged during construction. This could occur as a result of heavy equipment (tractors or trucks) being driven too close to the tree. Trees that have had root damage during construction do not necessarily show any immediate effects. However, within a year or two and depending on the degree of damage, the trees may die. If care is taken during construction, this problem can be avoided. Your best bet is to buy a house from a quality builder.

Decks

There are many types and styles of decks. However, from an inspection point of view, your main concern should be safety rather than appearance. When inspecting a deck, unless it is a rooftop or cantilever type, you should begin with the supports on the underside. If the deck is more than a few feet above the ground, it will generally be supported by wood or metal columns (posts). Unless wood

Fig. 6-17. *Large, dead branches are a potential safety hazard and should be removed.*

posts have been pressure-treated, they should not be in direct contact with the soil. Untreated wood in contact with the ground is vulnerable to rot and termite activity. Also, the dampness normally associated with the soil can promote rust deterioration of a metal post or connector.

Each post should rest on a concrete pad that has a footing below the frost line. Otherwise, the footing is subject to frost heave. Probe the base sections of the posts with a screwdriver to determine whether there is deterioration. If the screwdriver can penetrate the post beyond the surface, a problem exists that should be corrected. In some cases, the post might require replacement. Push the post to see if it moves. It should not. Occasionally I find columns that are loose and not adequately supporting the deck. (See FIG. 6-18.) The condition usually results from uneven settlement of the support footings and inadequate fastening at the top or bottom of the column. A loose post is a potential hazard and must be resecured as soon as possible.

When the deck is less than a few feet above the ground, it is usually supported by masonry piers. Inspect the piers for cracked, broken, loose, or deteriorated sections. They must be repaired. With some "ground-hugging" decks, usually less than a foot above the ground, this inspection might not be possible. Most of the support piers are not visible.

When one side of the deck is attached to the house, there are usually no support posts below that section. Consequently, if the joint between the house and the deck should weaken, there is a potential for the deck to collapse. Check the joint between the deck and the house to see if it is securely fastened. Is it pulling away from the house? It shouldn't be. This is a potential problem and should be called out on your worksheet for additional bracing. In some cases, the deck is fastened to the house with undersized or too few nails. I know of one community where this type of installation resulted in two decks collapsing. Because of these failures, the town passed an ordinance that requires using lag bolts rather than nails to secure the deck to the house. (See FIG. 6-19.)

Next, check the joist supports at the portion of the deck attached to the house. Since there are no posts, there will not be a girder to support the joists. In this case, the joists should be supported by metal brackets fastened to the

Fig. 6-18. *Inadequately supported deck. Column is loose and can easily be knocked over.*

header or by being toenailed into the header with a ledger below them. The former method is preferred because the ledger used is often skimpy. I have seen many decks where the joists were toenailed into the header but the ledger was never installed. If you find this type of installation, you should install angle brackets to support the joists or at the very least install a ledger as a precautionary measure. Check the condition of any and all metal brackets, connectors, nails, and screws. Over time they can corrode and rust, either because of the weather or because of the chemicals used in the deck's pressure-treated wood.

In addition, depending on the size of the deck, there might be a need for diagonal bracing. This provides additional rigidity to the deck and can be achieved by placing a 2-inch-by-6-inch board between two diagonal corners and nailing it to the underside of each joist.

When deck planks are installed, there should be a space of about ¼ inch between them. This space allows rainwater and melting snow to drain. In some cases, the planks are butted up against one another so that there is virtually no space between them other than the crack of the joint. Water entering this crack does not readily drain and instead promotes decay. If you can reach the underside of the deck planks and the top portion of the joists, probe them for rot. If there are rotting sections and the decay is advanced, you might see the fruiting bodies

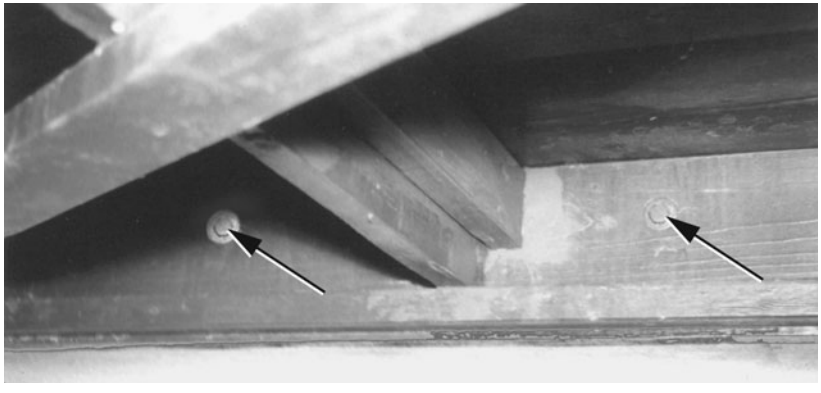


Fig. 6-19. *Lag bolts are used to secure the deck to the house. Note that joist is resting on a ledger board for support.*

of the decay fungi. (This is discussed in detail in the section on rot in chapter 8.) If steps lead to the deck, the treads, stringers, and handrails should be inspected for decay. As with the deck support posts, the stringers should rest on a concrete pad rather than soil.

After inspecting the underside of the deck and the steps, you should inspect the top portion. When the deck is more than 30 inches above the ground, there should be a guardrail around the perimeter as a safety precaution. Naturally, the higher the deck, the greater the need for a rail. Issues such as wobbly railings, loose stairs, and ledgers that appear to be pulling away from the home are all causes for concern. Metal connectors, nails, and screws can corrode over time. Look for rust and other signs of corrosion that can weaken the structure of your deck. Check the rail to see if it is loose and wobbly. If it is, record it on your worksheet to be resecured. If the deck is to be used by small children, additional protection is needed to block the open area between the railing, railing posts, and deck planks. When balusters are used for this purpose, they should be spaced 4 to 5 inches apart.

The guardrails and deck planks should be inspected for cracked, rotting, and loose sections. (See FIG. 6-20.) Depending on the quality of the wood and the upkeep, a deck need not deteriorate to a point where it requires complete rehabilitation. Repairs or replacement of deteriorated sections should be performed as needed. If you find sections of the deck that are in need of repair, you should indicate those areas on your worksheet.

Fig. 6-20. *Cracked and rotting deck planks. Planks should be replaced as needed.*

Free-standing decks

Free-standing decks are independent self-supporting structures. If constructed properly they are as safe and secure as attached decks and in some cases more secure. A number of attached decks have collapsed because the joint between the deck and the house has pulled away, because either it was improperly or inadequately secured or it has rotted. Depending on the size of the free-standing deck, it will require an additional beam and two or more posts situated next to the house. The posts should be mounted on footings that extend below the frost line. In order to be able to resist lateral and horizontal movement, diagonal bracing between the posts and the beams must be provided. (See FIG. 6-21.) As with attached decks, these decks should be checked for cracked, broken, loose, or rotting sections.

Composite decks

Most residential decks are constructed entirely of wood. However, the use of composite lumber for the visible portions of the deck, such as the deck planks, handrails, and trim has become very popular. Its popularity stems from the fact that it does not require waterproofing and resists damage from weather and insects. It is nevertheless not maintenance-free. The composites, which are generally made of recycled plastics and waste wood fibers, are

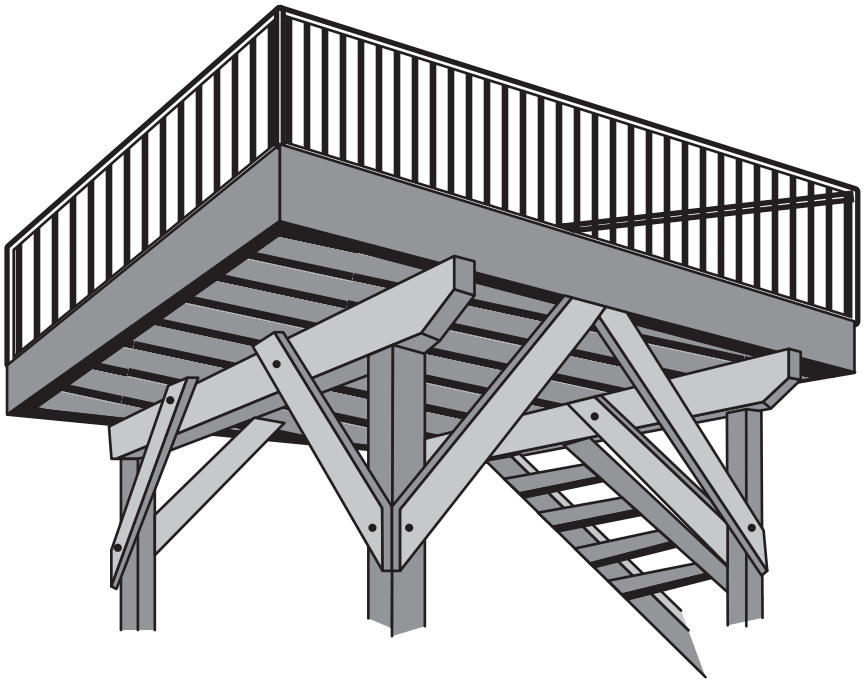


Fig. 6-21. *Diagonal bracing on free-standing deck.*

not intended for structural use. The structural support for those decks that use composite lumber (the joists, beams, and posts) will still be made of wood and should be inspected as previously discussed.

Trex and Timber Tech are the leading brands of composite lumber for decks, although there are a number of companies that also make composite lumber. Not all composite decks are made with the same quality ingredients. Because the material expands and contracts with temperature, proper spacing during installation is critical. Cupping deck planks and joints that don't line up have been noted. In addition, some of the other problems that have been noted, which should be recorded on your worksheet, are cracks, scratches, staining, mold (mildew) blotches, and fading.

One last point: If the deck was not built when the house was constructed or the deck is a complete replacement of a previously deteriorated one, check with the seller to see if a certificate of occupancy (CO) was issued by the local building department at the completion of construction. A CO is required by most municipalities. If one was not issued, record that fact on your worksheet for future discussion with your attorney.

Fences

If there is a fence on the property that you are inspecting, you should check its overall condition. The problems encountered with fences are normally not major and are usually not costly to correct. However, you might find a fence that has deteriorated to a point where it needs complete rehabilitation or replacement.

Wood fences should be inspected for cracked, broken, loose, and missing sections. In addition, they should be checked for deterioration from rot and termite infestation.

(Termites and rot are discussed in chapter 8.) The gates for the fence should also be checked for cracked, loose, or broken sections and ease of operation. Wooden gates often sag as they age and require periodic maintenance.

Metal fences should be inspected for rusting, loose, and deteriorated sections. Rusting sections should be scraped, primed, and painted. Chain link fences are generally constructed of galvanized steel. Galvanizing (zinc coating) protects the steel against rusting and is usually applied by hot dipping or electroplating. The hot-dipped process produces a heavy zinc coating that is very effective, in contrast to the thin coating produced by electroplating. Chain link fences that have been galvanized by electroplating have a tendency to rust and require periodic maintenance. Some chain link fences have a vinyl coating that protects against rust. The vinyl coating is quite effective and lasts for many years.

If there is an in-ground swimming pool on the property, there should be a fence around the pool area. Most communities have an ordinance requiring a fence of a specific height as a protective barrier. If you do not see a fence around a pool area, you should check the requirements with the municipal building department; otherwise, you might find after buying the house that you are legally obliged to install one.

Checkpoint summary

Drainage

- ❍ When approaching the house, take note of the overall topography.
- ❍ Is it level or inclined?
- ❍ Are there gently or steeply sloped areas?
- ❍ Is the house located near or at the bottom of an inclined street?
- ❍ Note whether there is a storm drain (catch basin) nearby.
- ❍ Are there nearby streams or brooks?
- ❍ Are you able to determine if the house is located in a flood plain or flood-prone area?
- ❍ Is the ground immediately adjacent to the house graded so that it slopes away on all sides of the structure?
- ❍ Are there natural drainageways to direct surface water away from the house?
- ❍ Are there low or level areas that are vulnerable to water ponding?
- ❍ Are there areas of ponded water on the lot?
- ❍ Are you able to determine whether the house has footing drains?
- ❍ Can you locate the outlet for these and any other drainage pipes?

Retaining walls

Timber, railroad tie, dry stone wall, gabion

- ❍ Inspect for missing, loose, and crumbling sections of stone.
- ❍ Check timber and railroad-tie walls for cracked, loose, rotting, and heaved sections.
- ❍ Are the wood-constructed walls properly anchored (tiebacks)?

Concrete, concrete block, wet stone wall

- ❍ Inspect for cracked and heaved sections.
- ❍ Check for loose, deteriorated, and missing mortar joints.
- ❍ Is the wall vertical, or does it lean?
- ❍ Are portions of the wall heavily covered with vines?
- ❍ Did you inspect these areas for cracked and heaved sections?
- ❍ Try to determine whether the area behind the retaining wall is adequately drained.
- ❍ Are there weep holes at the base of the wall?
- ❍ Are they blocked?
- ❍ Are the weep holes adequately sized and spaced?

Landscaping

Lawn

- ❍ Inspect for holes, sunken sections, bald spots, and eroding areas.
- ❍ Estimate areas that will require recultivation.
- ❍ Note soft sections or ridges (possibly due to moles).
- ❍ Inspect terrace steps for cracked, loose, rotting, or missing sections. Check steps for handrails, uneven treads, and variations in riser heights.

Shrubs

- ❍ Inspect shrubbery for overcrowding, dying sections, blocked walkways, steps.
- ❍ Note areas in need of pruning, transplanting, or removal.
- ❍ Note areas of the house that are covered with vines.

Trees

- ❍ Check for dead trees and limbs, especially those close to the house.
- ❍ Note tree limbs that are overhanging or resting on the roof.
- ❍ Note for future professional evaluation any trees that show evidence of rot, split sections, or insect infestation.

Decks

- ❍ Check and inspect the various deck components for safety rather than for appearance.
- ❍ Check concrete or brick piers for cracked, loose, and deteriorated sections.
- ❍ Inspect wood columns for rot and termite activity.
- ❍ Inspect metal columns for rust deterioration.
- ❍ Are columns supported on concrete pads, or are they in contact with the ground?
- ❍ Note any loose columns.
- ❍ Check for open and weakened joints between the deck and the house.
- ❍ Is the deck attached to the house with nails or lag bolts? (Lag bolts are preferred.)
- ❍ If the deck was not built at the time the house was constructed, does it have a certificate of occupancy (CO)?
- ❍ Inspect deck-joist supports at the portion of the deck attached to the house.
- ❍ Are deck joists supported by metal brackets (preferred), or are they toenailed into a header beam with a ledger board below the joist?
- ❍ Where the joists have been toenailed, check for missing ledger boards.
- ❍ Does deck contain diagonal bracings?
- ❍ Inspect the underside of deck (girders, joists, floor planks) for missing, cracked, and rotting members.
- ❍ Inspect wood step treads, stringers, and handrails for cracked, loose, missing, and rotting sections.
- ❍ Are the stringers supported on a concrete pad, or are they in contact with the ground?
- ❍ Check top portion of deck for cracked, loose, missing, and rotting sections of deck planks, railings, and railing posts.
- ❍ On free-standing decks, check for diagonal bracing, as well as for cracked, loose, and rotting members.
- ❍ On composite decks, inspect the wood structural support members. Check the composite decking, handrails, and trim for cracks, scratches, staining, mold (mildew) blotches, fading, and joints that don't line up.

Fences

- ❍ Inspect wood fences for cracked, broken, loose, and missing sections.
- ❍ Check for areas of rot and insect damage.

- ❍ Inspect metal fencing for loose, missing, and rusting sections.
- ❍ Check gates (metal and wood) for sag, missing hardware, and cracked, loose, broken, and missing sections.
- ❍ If property contains an in-ground pool, is the area around the pool adequately fenced off? (It might be a legal requirement.)

7

Garage

Attached garage 84
Fire and health hazards 84
Plumbing check 86
Flood potential 88
Doors 88
General considerations 89
Detached garage 90
Exterior 90
Interior 91
Heat and electricity 92
Checkpoint summary 93

The garage should be inspected after the exterior inspection has been completed. There are two basic types of garages: attached and detached. An attached garage is a part of the main building. It might be located below a habitable portion of the structure or connected to the side of the building. A detached garage is a separate structure, not part of the main building. There might be a connecting breezeway or porch between the two structures.

Attached garage

Since the principal use of the garage is car storage, the possibility of dripping oil and gasoline presents a potential fire hazard. Because the attached garage is connected to the main structure, certain precautionary measures should be taken during construction to minimize the hazards. Look around the garage to see if there are any potential problems.

Fire and health hazards

Is there an interior door between the garage and the house? If there is, is there at least one step leading up to the door? There should be. (See FIG. 7-1.) It is surprising how often I find that the garage floor slab is at the same or a higher level than the adjacent living area. (See FIG. 7-2.) The living area should be above the level of the garage floor to prevent toxic exhaust gases and gasoline vapors, which are heavier than air, from entering the house whenever the interior door is opened. As a precautionary measure, the interior door should have a tight seal around the joints to prevent seepage. This door should be fire-resistant, such as metal-clad, solid wood, or hollow core, with a sheet-metal covering on the *garage side*. As a safety feature, the interior

Fig. 7-1. *Steps connecting the garage floor slab to the adjacent living area, which is at a higher level.*

Fig. 7-2. *Garage floor slab at a higher level than the adjacent living area—a potential hazard.*

door should also be self-closing. In most homes it is not. It seems that homeowners have found self-closing doors inconvenient, especially when carrying in packages from the local supermarket. Nevertheless, safety should not be sacrificed for convenience.

Next, look at the walls that separate the garage from the living area. Are there exposed wood-frame members? There should not be. Exposed wood framing in this area is considered a fire hazard and should be covered with a fire-resistant material such as plaster or stucco on lath or ⅝-inch plasterboard. This wall should be insulated to reduce heat loss. If there is a living area above the garage, the ceiling should be insulated and have a fire-retardant covering.

In some garages an access hatch to the attic is located in the ceiling. Occasionally the hatch cover for this opening is missing or open. (See FIG. 7-3.) This is a fire hazard. If a fire should start in the garage, the open area in the ceiling could act as a flue and draw the flames up into the attic where they would quickly engulf the house. The attic hatch cover must be in place at all times.

Some homes have a garage in the basement. The garage is at the basement level with no partition walls separating the garage area from the basement area. This is a fire and health hazard in addition to being inefficient from an energy-conservation point of view. When the garage doors are opened, there will be a loss (from the basement) of warm air in the winter and cool air in the summer.

Occasionally the heating plant (furnace or boiler) is located in the garage. (See FIG. 7-4.) This is perhaps the least desirable location for a heating unit. There is always the possibility that a leak could develop in the gasoline tank or fuel line of an automobile. If the garage is inadequately ventilated, the resultant flammable vapors could be ignited by the flame in the heating system. Of course, this

Fig. 7-3. *Open attic-access hatch in the garage ceiling.*

Fig. 7-4. *Furnace located in the garage. Note that the ceiling should have been covered with fire-rated gypsum board.*

risk can be minimized by locating the heating unit on a platform or by building a low wall around the heating system (see FIG. 7-5) (since gasoline vapors are heavier than air and will accumulate at ground level) or by enclosing the heating unit in a room with a tight seal on the door. If the heating unit is enclosed, the area must be vented to provide outside air for combustion. Another problem with a water-heating system located in the garage is that the pipes are more vulnerable to freezing should the system malfunction or run out of fuel oil.

Plumbing check

While looking at the walls and ceiling of the garage, look for signs of plumbing leaks. Check the ceiling for water-leakage stains. If the garage has an overhead door, be sure to close the door and then look at the ceiling. In the open position, the overhead door will block about 25 percent of the ceiling; if there are leakage stains in that section, you might not see them. Ceiling stains are often caused by leakage from a bathroom above the area. (See FIG. 7-6.) When you do the interior inspection of the house, all the plumbing fixtures (sinks, bowls, and tub-shower) should be operated. After that portion of the inspection is completed, if the garage ceiling showed signs of past problems, you should reinspect it for indications of current leakage.

In some cases there are exposed drainpipes or water pipes in the garage. If your home is located in the northern part of the United States, the water pipes should be insulated as a precautionary measure against freezing.

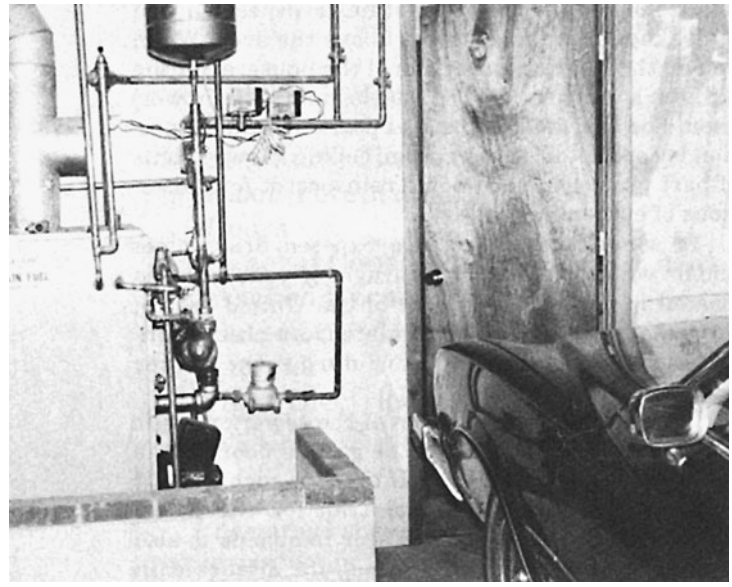


Fig. 7-5. *Heating system (oilfired, forced hot water) boiler located in the garage.*

Fig. 7-6. *Plumbing leak caused water-damaged ceiling in garage.*

Depending on the location of the sewer or septic tank, there might be a pit in the garage floor covered with a metal plate. It might contain a cleanout and trap for the house waste line. Sometimes the water inlet pipe is also located in this pit. (These items are discussed in detail in chapter 13.) Lift the cover and look inside the pit. Often the builder neglects to remove the wood framing around the sides of the pit (used as a form when constructing

the open area). Because of the dampness in the pit, a wood liner will eventually rot and might be termite-infested. (This is an area where termites are often found; see chapter 8 to learn how to determine their presence.) If there is wood in the pit, it should be removed, regardless of its condition.

Flood potential

The bottom of the pit should be relatively dry in all but very wet weather. If the bottom contains water, it is an indication that the level of the subsurface water (water table) in the overall area of the home is high. When this condition exists, there is a possibility that during rainy periods the water level can rise and seep into the garage through the pit or through cracks in the floor slab. (Water seepage into this area is discussed in detail in chapter 11.)

Cracks in the floor slab can be caused by shrinkage or differential settlement and are usually not a concerning factor. They should, however, be sealed because they can allow water to seep into the garage. An extensively cracked or heaved floor slab is of concern because it may indicate a water problem. Heaving and extensive cracking are very often caused by water pressure being exerted on the underside of the floor slab. This condition should be evaluated by a professional.

Note whether there is a drain in the floor slab. The floor should be pitched toward that drain. If there is no drain, the floor should have a slight pitch toward the automobile entry door. This will allow water from melting snow to drain to the exterior rather than puddle on the floor. Also, the floor slab should be slightly above the level of the driveway to reduce the possibility of water entry. It should be noted that a garage at the base of an inclined driveway is *always* vulnerable to water penetration. (This condition is discussed in the driveway section of chapter 4.)

Doors

When you inspect the garage, you should always check the operation of the exterior door or doors. If the door(s) does not have an automatic control, open and close each door and note whether it operates relatively easily. The most common type of door for an attached garage is the sectional overhead type. This door has the advantage of not taking up usable space when open. Look for obvious deficiencies such as broken or missing springs or guide wheels, loose and misaligned tracks, and so on. Check the door's operation. If it is difficult to lift, stuck in a fixed position, out of plumb, or does not stay in the up position, some minor maintenance is needed. When closing the door, give it a start and let it come down by itself. If the door closes rapidly and heavily, it is a hazard, especially for small children. Adjustment is needed to the spring tension, or a new spring should be installed. Check to see if there is a restraining cable that runs through the center of the spring. (See FIG. 7-7.) The cable is a safety feature that prevents the spring from whipping around and injuring a person or damaging a car in the event that the spring breaks. When the door is closed, use the lock mechanism. You might find that the lock bars need to be reset.

Many overhead doors are opened by an automatic control. Operate the control. The doors should open and close smoothly without binding in the tracks. Check to see if the control unit has a reversing feature. This is very important from a safety point of view. When the door is closing, exert a force in the upward direction at the bottom of the door. The door should stop and then reverse its downward travel. If it doesn't, record that fact on your worksheet. Repair or replacement of the control unit is recommended because it is a potential safety hazard. The newer garage door opener assemblies include a photoelectric

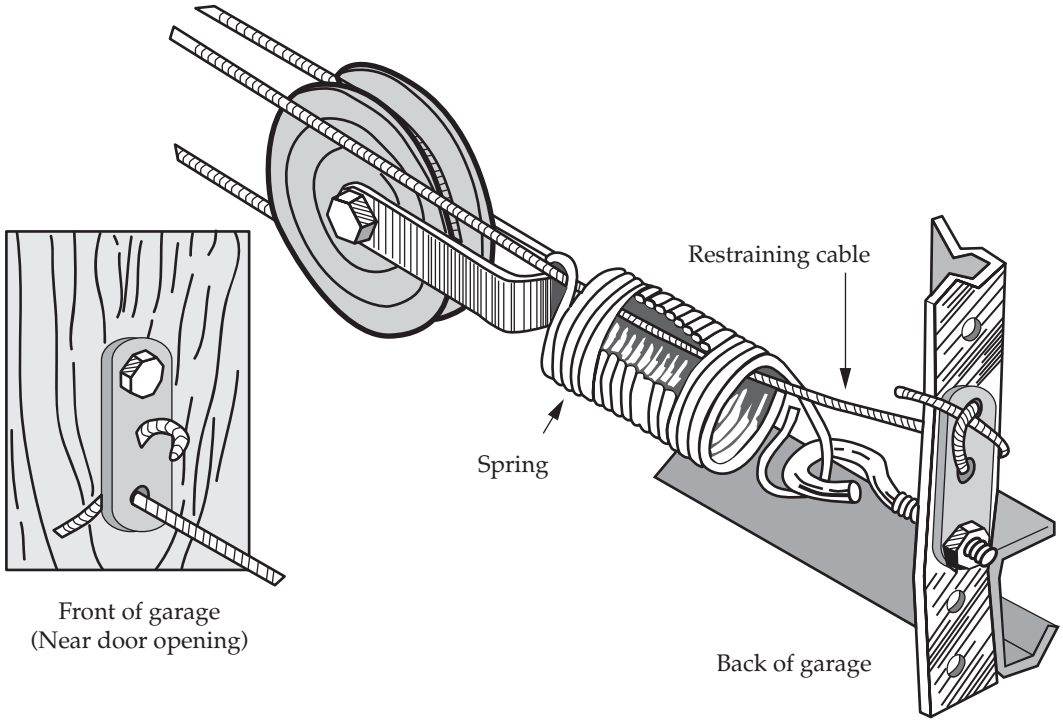


Fig. 7-7. *A restraining cable through the garage door spring prevents the spring from whipping around if it breaks.*

sensor that is mounted on both side tracks, about 12 inches above the floor. The sensor activates the controller, which will reverse the door when it is closing if a person or animal breaks the beam by passing through the opening. If the door does not reverse, it is very often because the sensor is misaligned causing the electronic beam to not contact the receiver's "bulls eye." This can be easily corrected by repositioning the sensor. Make certain that the radio controllers work. Ask the owner to demonstrate that they exist and work.

Some overhead doors are the one-piece, swing-up type rather than the sectional, roll-up type. These doors often require additional efforts to open, particularly during periods of snow and wind. Other doors found on a garage are the sliding and folding types. Sliding doors usually hang from overhead tracks. One disadvantage of such doors is that they take up valuable wall space when open. Also, small pieces of debris on the ground can interfere with their operation. Fold-out doors often sag, have loose hinges, and drag on the ground, making opening and closing quite difficult. In general, they require more frequent maintenance. These conditions can and should be corrected.

General considerations

Look around the garage for an electrical outlet. There should be at least one three-prong convenience outlet. Also, there should be overhead lights controlled by a switch near

the interior door and the exterior door. Two desirable features, although not necessary, are windows that provide daylight and ventilation and a service door that can be used as access to the garage without opening the automobile entry doors.

Depending on the location of the house, the garage might be heated. Heat is usually provided by extending the central heating system (hot water, steam, or warm air) into the garage area. The radiators or heat registers providing the heat should be checked as part of the overall heating-system inspection. If there are warm air ducts in the garage, look for return grilles. There shouldn't be any because through them poisonous exhaust fumes could be brought back into the system and circulated throughout the house. When a garage is used solely for storage of automobiles, it is necessary (and not even always) to bring the temperature only above freezing. Heating the garage above that temperature is wasteful of energy.

Last, when inspecting an attached garage, look for termites in any exposed wood-frame members. The area most vulnerable to termite infestation (aside from wood found in a sewer cleanout pit) is the wood framing around the base of the exterior door.

Detached garage

If your house has a detached garage, you need not be as concerned with the fire and health hazards mentioned with the attached garage. True, the area is still considered a potential fire hazard; however, since the structure is physically apart from the main building, a fire would not usually result in the loss of life. The main concern with this type of garage is its structural integrity.

Exterior

The exterior of the detached garage is checked the same way you inspect the main house. Walk around the outside of the building twice. The first time, look at the roof and gutters. Do any of the roof beams appear to be sagging? If so, additional bracing might be needed. Have a professional make this determination. Do not assume that the roof over the garage and the roof over the house are in the same condition. Although the roof covering on the main house might be in good condition, the covering of the garage roof might be badly worn and require replacement. (Inspecting roofs is discussed in chapter 2.) Are there gutters all around the base of the roofs? If not, make sure you check all wood siding and trim for rot. The rain runoff from the roof can promote rot. A wood-frame garage with a pitched roof should have gutters. If there are long overhanging eaves or the garage is masonry-constructed, gutters are not a necessary feature, although they are often desirable. If there are gutters and downspouts, see if they need repair. (These items are discussed in chapter 3.)

After looking at the roof and gutters, walk around the building once more. This time look at the walls, windows, and doors. If the exterior walls are covered with wood siding, does the base of the siding extend to the ground? It should end about 8 inches above the ground. If the siding is in contact with the ground, it should be checked for termites and rot. Pay particular attention to the rear wall. You might see a wall that is bowed. This is usually caused by a car that did not stop in time. The wall stopped the car, and in the process, the supporting studs were broken. If such is the case, the wall is in need of rehabilitation. Also, you might sometimes see a wall that is offset; the bottom section of the wall extends about 3 feet beyond the upper section. This is done to accommodate longer cars than those for which the garage was constructed.

Finally, check the base of the wood framing and trim around the garage doors. This area

is particularly vulnerable to rot and termite activity. (See FIG. 7-8.)

Interior

When entering the garage, check the doors first. Look for broken and cracked sections of wood framing and glass panes. Open and close the doors; they should operate smoothly and have all necessary hardware (see page 88).

Depending on the location of the garage, at times the entire roof is not visible from the outside. After you enter the garage, look up at the underside of the roof. If you can see daylight through a hole or crack, there is a problem with the roof. Look for signs of past water-leakage stains on the wood framing. These stains appear as dark-streaked discolorations on the wood. Leakage stains do not necessarily indicate a current leak—the problem might have been corrected. If you see stains on the wood framing, ask the homeowner whether repairs to the garage roof have been performed. Next, look at the walls. If the garage is located on an incline, look at those sections of walls that are below grade. These walls are usually constructed of brick, concrete, or rubble and also function as retaining walls. If proper drainage provisions have not been made, the walls will tend to crack and heave. (See FIG. 7-9.) If you see cracked and heaved walls, you should have a professional make a determination whether rehabilitation is required. Often the walls are covered with a stucco or plaster finish, and the wood-framing members that form the walls are not visible. However, any exposed studs and bottom plates should be checked for cracked and broken sections, rot, and termite activity.

To reduce the vulnerability of the bottom plate of a wood-frame wall to rot and termite infestation, the plate should be resting on a foundation wall that is at least 4 inches above the garage floor. In many older detached garages, this plate is found directly on the

Fig. 7-8. *Termite infestation and rot at base of garage door frame.*

Fig. 7-9. *Heaving garage wall. Section of wall was located below grade level.*

floor or in contact with the ground. If this is the case, look carefully at the plate and probe it with a screwdriver or ice pick. If it can be penetrated, there is probably rot, termite, or carpenter-ant activity.

Look at the condition of the floor. If there are cracked, broken, and settled sections, often found in older detached garages, rehabilitation is in order. This condition usually does not indicate an undermining of the structural integrity of the garage but a poor installation of the floor slab. In some garages, you will find a dirt floor rather than concrete or asphalt. This is not desirable because the dampness associated with this type of floor promotes rot in the wood-framing members and premature rusting of items stored in the garage.

Heat and electricity

Most detached garages are not heated. However, when they are, heat is usually provided by a space heater rather than by extending the central heating system. The heater should be checked to see if it is operational by turning up the thermostat. The thermostat will be wall-mounted or mounted directly on the unit. Most nonelectric heaters must be vented to the outside and should not have wood framing in contact with the exhaust stack, a fire hazard. If the heater is not vented to the outside, ask the owner to show you proof that the unit has been specifically approved for installation without a flue connection.

In new detached garages, the electrical service and wiring is usually not a problem. There should be an overhead light controlled by a wall switch and at least one three-prong outlet receptacle. If the garage is a distance from the house, a desirable feature would be to have either spotlights or row lights along the path between the two structures. The lights should be controlled by two three-way switches, one at the garage and one at the house. In many

older garages, the electrical wiring and service is often makeshift and nonoperational. Look around. If you see loose and hanging wires, exposed junction boxes and wire splices, you are looking at electrical violations. In some cases, the service wire from the main house to the detached garage is interior wire, not exterior. This is a potential hazard and must be corrected. If electrical problems are found during the garage inspection, you should require that the seller provide you at closing with a certificate of approval for the electrical system. The approval should be made by the municipal electrical inspection agency. (See chapter 12.)

Checkpoint summary

Attached garage

Inspecting for fire and health hazards

- ❍ Are the garage and basement area combined into one open area?
- ❍ Is the interior garage door located at least one step above the garage floor?
- ❍ Does this door have a tight seal? Is it self-closing?
- ❍ Is this door fire-resistant, or does it have a sheet-metal covering on the garage side?
- ❍ Is the boiler/furnace unit located in the garage?
- ❍ Has it been placed on a raised slab?
- ❍ Inspect garage ceiling and walls for exposed wood-frame members.
- ❍ Check ceiling area for open or missing attic access hatch.
- ❍ Check for return grilles in warm-air heating systems.

General considerations

- ❍ Inspect ceiling area for signs of plumbing leaks, stains, and patched sections.
- ❍ If garage is unheated, are there uninsulated water pipes that are vulnerable to freezing?
- ❍ Inspect floor for extensively cracked, settled, and heaved sections.
- ❍ Check these areas for evidence of water seepage and silt deposits.
- ❍ Does driveway incline make garage vulnerable to flooding?
- ❍ Is there a drain protecting the garage entry? Is it adequate?
- ❍ Does garage floor contain a drain?
- ❍ Inspect exterior doors and trim for cracked, missing, rotting, and insect-damaged sections.
- ❍ Operate doors. Note broken and missing springs, guide wheels, locks, and misaligned tracks.
- ❍ Is there a restraining cable running through the spring?
- ❍ If the overhead door is electrically controlled, does it reverse its downward travel when an upward force is exerted on the door?
- ❍ Check overhead lights, wall switches, and convenience outlets.

Detached garage

Exterior

- ❍ Inspect walls/siding for bulging, cracked, loose, missing, and rotting sections.
- ❍ Note broken windows and patched sections.
- ❍ Check roof beams for cracked, rotting, and sagging members.
- ❍ Inspect roof shingles (as outlined in chapter 2 checkpoint summary).
- ❍ Check type and condition of gutters and downspouts. Note their absence.
- ❍ Inspect and probe wood framing and trim around doors (particularly doors that are in contact with, or in close proximity to, the ground).

Interior

- ❍ Check garage doors for broken, cracked, and rotting sections.

- ❍ Inspect doors for operation, sagging sections, missing hardware, and broken glass panes.
- ❍ Inspect underside of roof for damaged sheathing and signs of leakage.
- ❍ Inspect foundation/retaining walls for cracked, bowed, and heaved areas.
- ❍ Concrete, asphalt, or dirt floor?
- ❍ Check concrete or asphalt floor for cracked, broken, and heaved sections.
- ❍ Probe wood sills for insect-infestation damage (particularly if these members are in contact with the ground).
- ❍ Inspect for loose and hanging electrical wires, exposed junction boxes, wire splices, extension-cord wiring, and makeshift wiring.
- ❍ Is there a space heater? Check operation.
- ❍ Is unit properly vented?
- ❍ Are wood-frame members in contact with the exhaust stack?

8

Wood-destroying insects and rot

Termites 95
Subterranean termites 98
Inspection 101
Dry-wood termites 105
Control 105
Inspection 105
Formosan termites 106
Other wood-destroying insects 106
Carpenter ants 106
Powder-post beetles 108
Inspection 108
Rot 109
Inspection 110
Checkpoint summary 112

There are many types of wood-destroying insects—subterranean and dry-wood termites; carpenter ants; and powder-post beetles. The one that causes the most damage to residential structures in the United States is the subterranean termite.

Termites

Home buyers generally overreact after discovering a termite condition and on occasion lose interest in the house. Actually, the discovery of termite infestation should not be cause for alarm—concern, maybe, but certainly not alarm.

Termites work very slowly. It takes many years for termites to do serious damage to a house. A mature colony of 60,000 termites eats the equivalent of 2 to 4 feet of 2-by-4-inch board in one year. Some well-established termite colonies have been estimated to contain more than 2 million termites. A termite condition can be controlled through the application of chemical insecticides by constructing a chemical barrier in the soil around and beneath the house. Thus termites attempting to go through the termiticide-treated soil to reach the house are either killed or repelled.

Prior to the mid 1980s, the chemical most often used for termite treatment was *chlordane*. It had an effective life that often exceeded twenty-five years. However, because chlordane

is considered a potential risk to human health, it was withdrawn from the U.S. market. Currently several different chemical termiticides are available for use by pest control operators for controlling a termite infestation. All of the chemicals are considered safe and have been found to be effective in the soil for periods of approximately 5 to 10 years.

Around 1995 the termite bait system came on the market for termite control. This system is an option for homeowners that don't want to use a chemical barrier treatment for termite control. Termite baits are considerably less toxic than most liquid termiticides, which are introduced into the soil by the hundreds of gallons in order to effectively control a termite condition in a house. Baits, on the other hand, deliver very small amounts of termiticides over a long period of time.

A bait system for termite control consists of installing plastic tubes or boxes in the ground at various locations around the house. Inside the tubes and boxes is a slow-acting poison combined with a termite food material such as paper or cardboard. Termite control depends on foraging termites finding the bait stations during their random search for a new food source, feeding on it, and carrying it back to the colony where the poisoned food is shared with other termites in the colony.

The length of time for termites to find the bait stations will vary considerably and depends on whether the stations are installed in the southern or northern states. It also seems to depend on whether the bait stations are installed in the spring or late summer. The time to locate the bait has been found to vary from as little as a day to as long as a year or more. Baiting to control a termite problem is a slow long-term solution, and it is not the recommended method to control a heavy infestation problem in a house.

In real estate transactions, if the house has a termite problem, a barrier treatment is the preferred control method rather than baiting. Successful control by baiting is a long-term commitment to frequent inspections and monitoring of the bait stations and rebaiting. In contrast, when necessary, a single application of a barrier treatment can be expected to last from 5 to 10 years after which retreatment may or may not be necessary.

A number of states have regulations requiring a termite inspection by a professional prior to, or as a condition of, the purchase agreement. The cost of this inspection is almost always paid by the seller. If your state has such a requirement, you should ask the seller or real estate agent to have the house inspected by a professional and have a report of the results sent to you. In many states (even in some that do not have a prepurchase termite inspection requirement), if a termite condition is found prior to the sale, the cost for correcting the condition (chemical treatment) is borne by the seller.

When termites are discovered, they should be exterminated professionally. However, because termites work slowly, termite-proofing the house need not be done immediately upon learning of an active infestation. Take your time and get two or three cost estimates from established termite-exterminating firms. After treating a house, most companies provide a one-year guarantee against reinfestation. The guarantee can often be extended annually for a fee, which covers inspection and retreatment if necessary. If the house had been treated previously for termites, find out if the owner has a guarantee and whether it can be transferred to you.

During an inspection, all exposed wood-framing members should be checked for structural deterioration from termite activity. There are very few houses on record that have been damaged by termites to a point where they are considered unsafe. Quite often the damage caused by termites (by the time

termite activity is discovered) is minor, and repair or replacement of the infested wood members is not necessary. Even with a heavy infestation, usually only a portion of the house is affected. And even then, only a portion of the wood framing might be damaged to a point where it has lost its structural value. In this case, only the affected members require repair or replacement. If you are in doubt about the structural integrity of any of the affected members, you should consult a professional.

Termites play an important role in the natural ecological cycle. They feed on cellulose, the principal ingredient of wood, and help to break down dead trees in forests and other wooded areas, thus enriching the soil. Termites began attacking houses when the wooded areas were cleared for building construction and there was no other available source of food near their nest. Subterranean termites are found in every state except Alaska. Their overall distribution within the continental United States is shown in FIG. 8-1. As their name implies, subterranean termites live in a colony (nest) that is usually located in the ground below the frost line. Even when a house is infested with termites, they usually do not have a nest in the house. They are there only to gather food. The only condition under which a nest might exist in a house (a rare occurrence) is a constant source of moisture

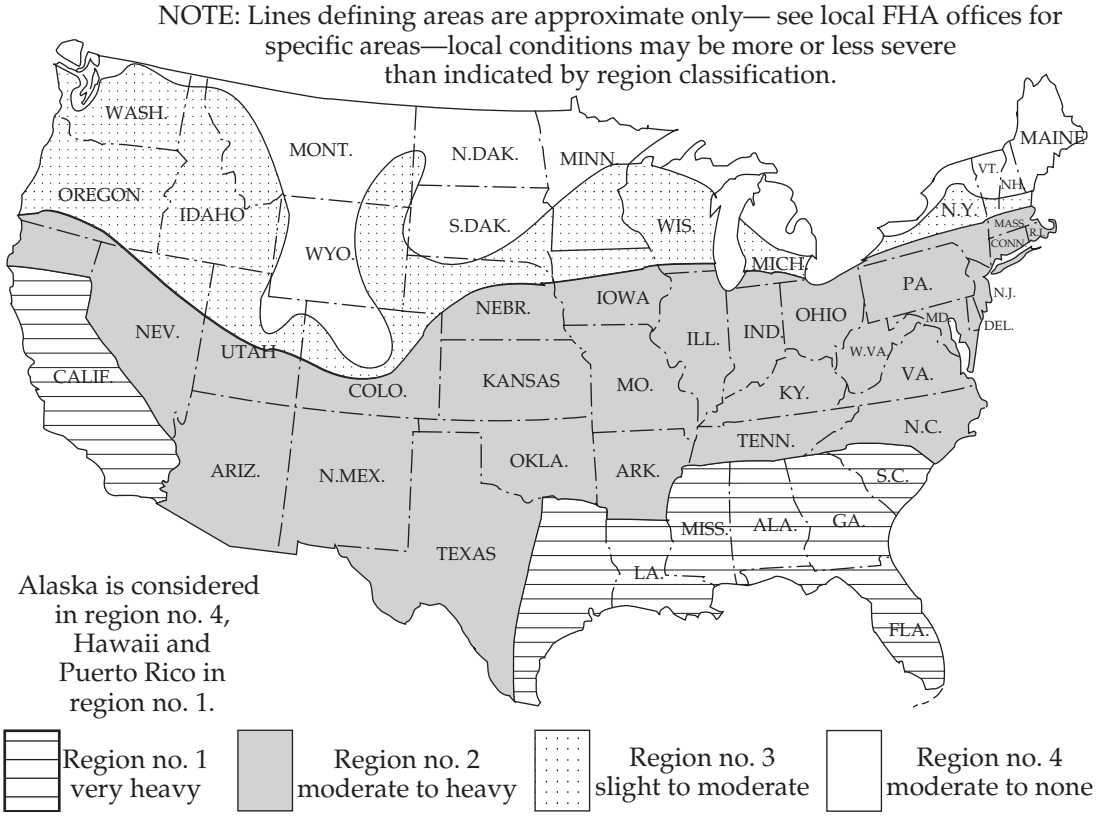


Fig. 8-1. *Subterranean termite distribution in the United States.*

such as a leaky waterpipe or drainpipe that wets the surrounding area.

Termites are social insects. Within each colony, there is a rigid caste system consisting of a queen and king, workers, soldiers, and reproductives. Each member of the colony instinctively performs its special task. The function of the queen and king is to propagate the colony. The fertilized queen lays the eggs and might live for as long as twenty-five years. The workers care for the eggs, feed the young and the queen, and generally maintain the colony. They also forage from the nest to the wood supply and return with food. The soldiers defend the colony against attack by other insects, mostly ants. The average worker and soldier live only two or three years. The function of the reproductives is to replace the queen and king in the event of their injury or death. They also lay eggs that rapidly increase the termite population.

When a colony matures, reproductives leave the nest (swarm) to set up a new colony. Although thousands of reproductives leave the nest, only a handful survive to establish a new colony. The remainder die because of adverse conditions in the soil or attacks by other insects. Reproductive termites sprout wings for the swarm. With their wings, they are only about ½ inch long. They are considered poor fliers and generally flutter around before falling to the ground. Some, however, might be picked up in the wind and carried great distances. Once the reproductives land, they shed their wings, pair off in couples, and return to the soil in search of a suitable place to build a nest.

In most parts of the country, swarming generally occurs in the spring, sometimes in the fall. However, swarming termites have been found in January in some heated houses. In the warm, humid parts of the country, swarming can occur at any time. Even if there are no other outward signs of termite activity, termite swarming in a house is an indication that there is a healthy established colony nearby from which worker termites are coming in their search for food.

Swarming termites do not attack wood. Their only function is to start a new colony. Even if a swarm is in your house, you might not see it. A swarm might last from fifteen minutes to one hour, and if you are not in the right place at the right time, it can be over by the time you enter the room. However, if there was a swarm, you can tell by the discarded wings. They are often found on windowsills and light fixtures, and beneath doors. Do not confuse swarming termites with swarming ants. To the untrained eye, they appear similar, but there are distinctive differences. (See FIG. 8-2.) The most obvious difference is that termites have a thick waist and ants have a pinched (hourglass) waist.

Subterranean termites

Subterranean termites require a dark, damp environment. In their search for food, worker termites build shelter tubes (tunnels) that help conserve moisture and shield the termites

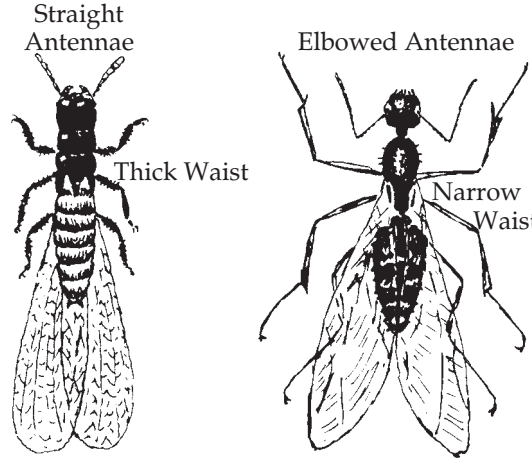


Fig. 8-2. *The difference between swarming ant (right) and swarming termite (actual size ½ inch).*

from the light. (See FIG. 8-3.) The tubes are about ¼- to ½-inch wide and provide a passageway between the ground and the food supply (wood member). They can be built at the rate of several inches per day and are mainly composed of soil, wood particles, and termite excreta. Shelter tubes, which might be noted on foundation walls, on the outside of wood framing, or even freestanding between the ground and an overhead pipe or beam, are visible evidence of termite infestation. If the tube is active, worker termites will be busy using it to go between the nest and the house. By breaking the tube, you can see the workers, who will try to repair the break. They are about ¼-inch long and have a whitish cream coloring.

Some tubes might be abandoned. If you find an inactive shelter tube, it does not mean that termites are no longer in the house. It might, if the house has been termite-proofed. However, if it has not, even an abandoned shelter tube, no matter how small, is sufficient evidence to consider termite treatment. Many shelter tubes emanate from a nest. There might be an active tube inside the voids of a concrete block wall that would not be visible during an inspection.

Whether a new building will be attacked by termites depends on the surrounding area and to a large extent the builder. Certain construction practices tend to increase the probability of termite attack. (See FIG. 8-4.) Some builders have been known to bury tree stumps and wood debris near the foundation or below the basement-floor slab. All stumps and debris should be removed from the building site. All form boards and scrap lumber should be removed before the excavated area around the foundation walls is backfilled. There should be no buried wood around the house. Otherwise, it can provide a source of food for a new termite colony that when it becomes large enough, will attack the house.

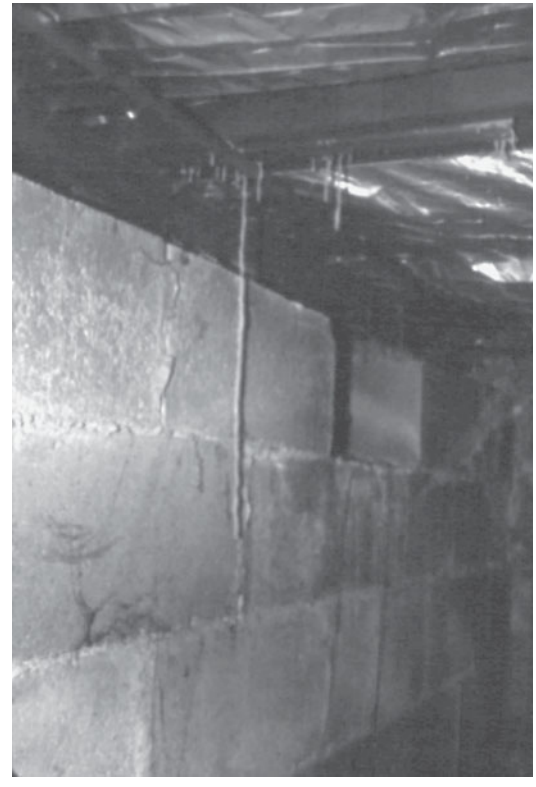


Fig. 8-3. *Termite shelter tubes: on foundation wall, header, and subflooring (top); hanging tubes in crawl space (bottom).*

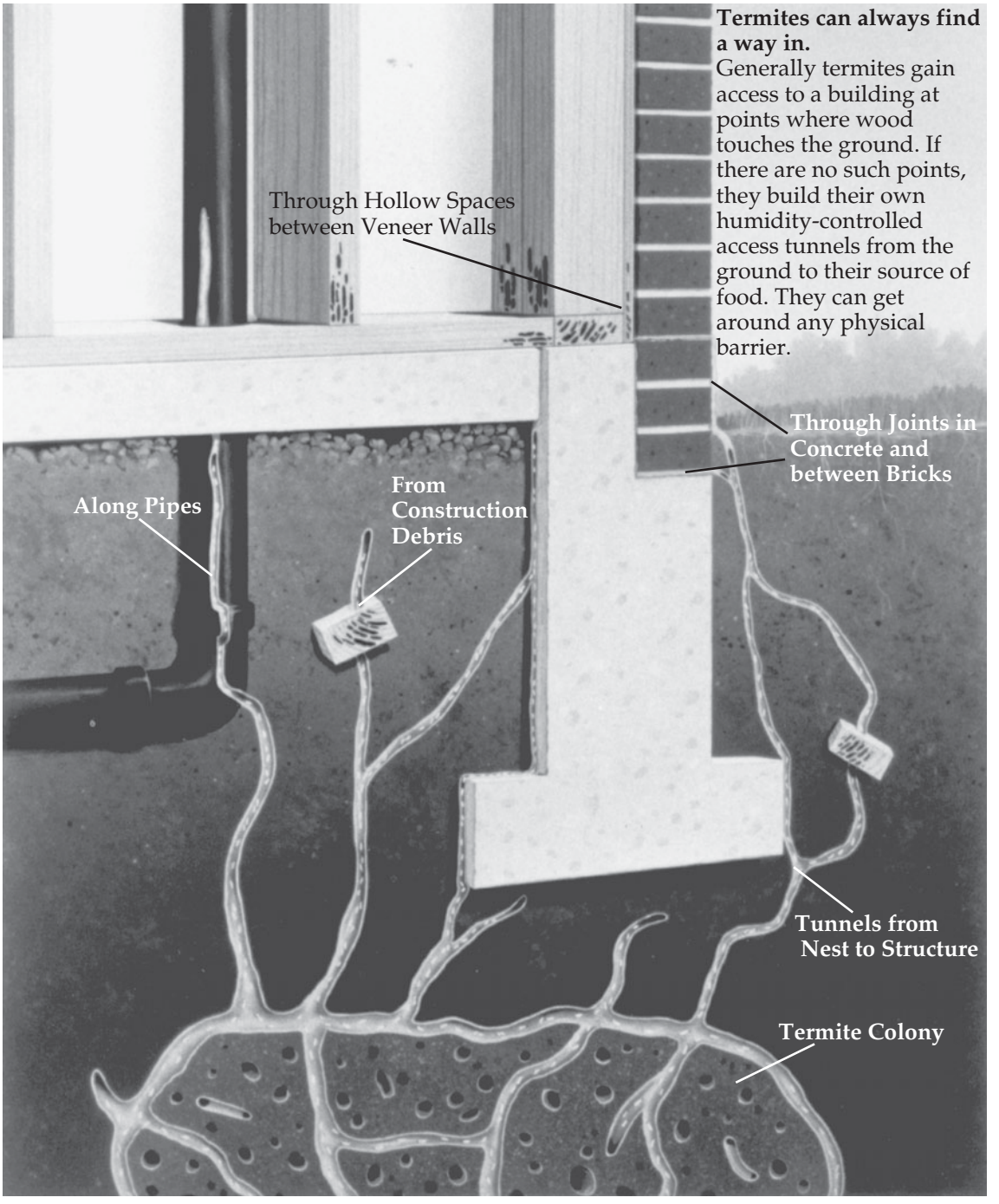


Fig. 8-4. *Termite entry points into a house.*

Most often termites enter a house by eating their way through untreated wood members that are in direct contact with the ground. Some of the more common points of entry are garage door frames, basement windowsills, wooden steps and supports, wood sills, and headers and studs on foundation walls that are located at or below grade. A particular area of attack is the wood framing adjacent to a concrete-covered, earth-filled porch, patio, or entrance slab. (See FIG. 8-5.) If there is no earth or wood contact, termites can build shelter tubes to provide passageways from the nest to the wood framing in the structure.

Some homes have a strip of metal (termite shield) between the foundation wall and the sill plate, that rests on top of the foundation wall. The purpose of the termite shield is to act as a barrier between the nest and the food supply. In most cases, the termite shield gives the homeowner a false sense of security. The shield does not prevent infestation. It only deters an attack. The problem is that the termite shield is rarely installed properly. An opening at a seam or a hole as small as 1/32 inch is large enough for termites to pass through. All seams should be soldered, and any holes around bolts and pipes should be filled with coal-tar pitch. Even if you see a termite shield, you should look for termite infestation.

Inspection A complete subterranean termite inspection consists of an interior and exterior check of that portion of the house that is close to, or in contact with, the

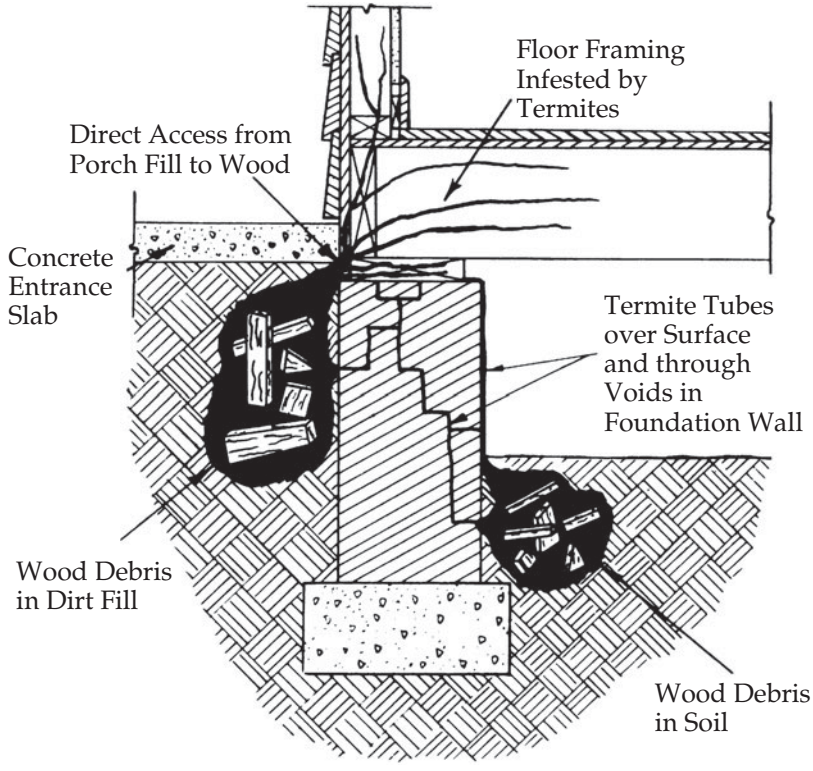


Fig. 8-5. *Termite colonies can develop in buried wood debris and gain entrance into a building, particularly at earth-filled concrete entrance slabs or patios.*

ground. The exterior termite inspection can be performed concurrently with the normal exterior inspection as described in chapter 1. As you walk around the outside of the house, look for termite shelter tubes along the outside foundation walls. (See FIG. 8-6.) In many homes, this area is covered or partially blocked by shrubbery. Part the shrubbery so that you can see the wall. This is especially important for areas just below a garden-hose spigot.

In some cases the base of the exterior wood siding is in contact with the ground, so that the foundation wall is not visible. This is a poor construction practice but unfortunately is fairly common and usually occurs during final grading and landscaping. The base of the wood siding should terminate at least 6 inches above the finished grade. Redwood or cedar exterior siding is often used. Both types of siding are resistant to termite attack and rot. However, it is important to understand that they are not immune to attack and might eventually succumb. If the base of the siding is in contact with the ground, probe it with an ice pick or a screwdriver. If the wood has not been attacked by rot, termites, or other wood-destroying insects, your probe will not penetrate much beyond the surface. If the probe penetrates the wood deeply, the wood has been attacked. To determine the cause for the deterioration, it is necessary to break open a section and look at the condition of the wood. Caution: Do not proceed beyond the probing without consent of the homeowner; in fact, it would be wise to obtain the homeowner's consent for the probing.

A section of termite-damaged wood reveals *galleries* (channels) that run parallel with the grain. (See FIG. 8-7.) Termites attack the softer portion of the wood grown during the spring and not the denser summer wood. The channels will not look polished, as they do with carpenter ants. Portions will be lined with grayish specks that consist of excrement and earth. Deteriorated wood could be the result of a combination of causes such as rot, termites, and carpenter ants. You should become familiar with the telltale signs. If you

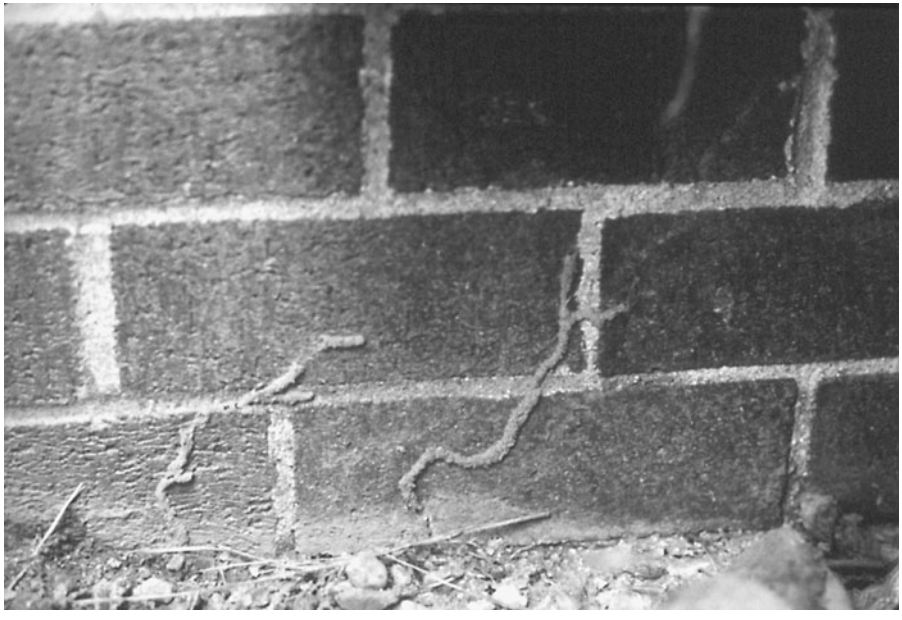


Fig. 8-6. *Termite shelter tubes at base of exterior wall.*

Fig. 8-7. *Termite-damaged wood. Note galleries that run parallel with the grain.*

are not certain of the cause, have the wood evaluated by a professional. The appearance of wood damaged by carpenter ants, powder-post beetles, and rot will be discussed in their respective sections.

As you walk around the outside of the house, probe the attached wood trim, posts, and framing members that are on or close to the ground. Specifically probe garage door frames, basement or lower-level window frames, step stringers, deck posts, and the entry-door riser. Termite activity is of concern only when it is found in the house or in an attached structure such as a garage or deck. If you find termite damage or shelter tubes on a fence post in the yard (FIG. 8-8) or in a piece of wood debris on the ground in the yard, all that means is that those pieces of wood have had termite infestation. It does not mean that the house is infested with termites and should be treated.

Fig. 8-8. *Termite shelter tubes on a fence post.*

After checking the outside of the house, the next place to look is in the crawl space beneath the house or porch. (Not all houses have a crawl space, in which case this step is omitted.) If the access to the crawl space is from the interior, it should be checked as part of the interior termite inspection. In the crawl space, probe the sills and headers for termite damage. Also check the first 15 inches of each

joist that rests on the sill or foundation. As you move around in the crawl space, look for termite shelter tubes on the foundation walls and piers. Sometimes the shelter tubes can be spotted between *double joists* (two joists nailed together, used to provide additional support for a heavy load). While in the crawl space, note any items of wood storage, remembering that they are vulnerable to infestation.

The interior inspection for subterranean termites is generally conducted in the basement and crawl space. If the basement is finished so that there are no exposed sections of foundation wall or wood framing, a thorough inspection cannot be performed, even by a professional. There are, however, some sections more vulnerable to termite attack than others, such as sill plates, headers, and joists below grade or adjacent to a dirt-filled, cement-covered patio. If the ceiling is covered with suspended tiles, the tiles can be lifted or moved to expose the wood framing. If there are no accessible areas, termite activity will have to be determined by a swarm or exterior inspection. In areas where termite infestation is heavy, such as the South and Southwest, a termite inspection should be performed every year. In other areas, an inspection every two year is adequate.

When the basement is unfinished, the wood framing (sill plate) on top of the foundation wall should be inspected by probing as described for the exterior crawl space. (See FIG. 8-9.) Also look for termite shelter tubes. You might find a tube that appears to start in the center of the foundation wall. Actually, the tube is connected to the earth through a small crack in the wall at that point. As previously mentioned, termites can work their way through cracks as small as 1/32 inch. While in the basement, pay particular attention to the area around the furnace/boiler and pipes through the foundation or floor slab. Often activity is discovered in these areas.

Homes built on a slab without a basement or crawl space are also vulnerable to attack by termites. Because there are generally no areas with exposed beams or foundation, detecting termites is quite difficult unless the infestation has advanced to the point where shelter tubes are

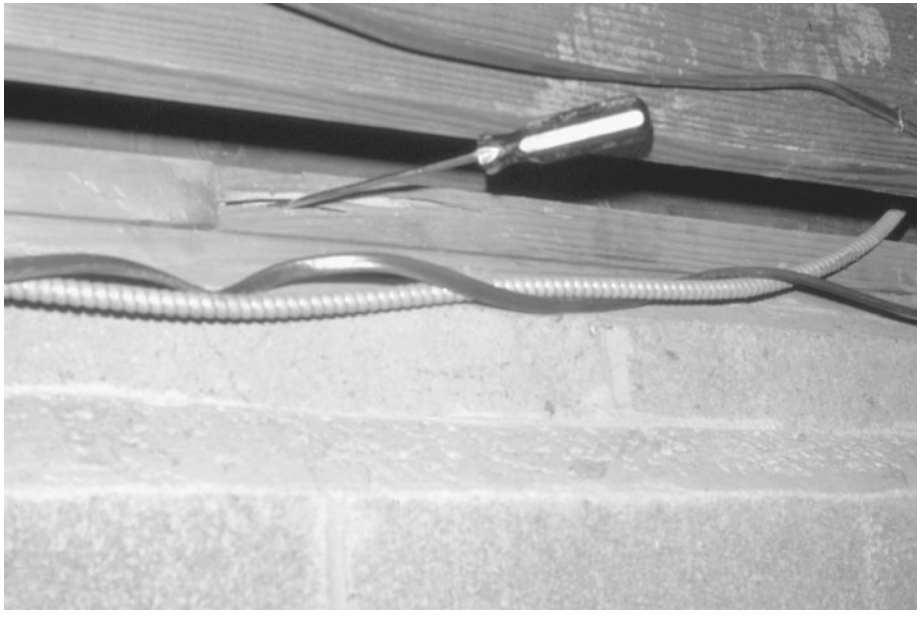


Fig. 8-9. *Termite-damaged sill plate found by probing with a screwdriver.*

visible in the finished rooms. When inspecting a slab house, look for soft spots in the baseboard trim along the exterior wall. Also check for shelter tubes around openings in the floor slab, such as around plumbing or heating pipes.

Dry-wood termites

Homes in the South and Southwest are vulnerable to attack by dry-wood termites as well as subterranean termites. Dry-wood termites cannot live outdoors in northern climates and have not established themselves in those areas. Isolated cases of dry-wood termite infestation have been found in homes located as far north as New York and Ohio, but those are rare.

Dry-wood termites are so called because they build their nest in perfectly good wood that is not decayed and not in contact with the ground. In fact, in many cases they establish a colony in the wood-framing members of the attic. As with subterranean termites, reproductive dry-wood termites swarm from the nest periodically in an attempt to establish a new colony. The swarming termites often do not fly more than a few feet before settling down. However, if aided by air currents, they can fly more than a mile. Once paired, the king and queen seek cracks or checks in nearby wood, whether a roof or lumber pile, and set up housekeeping. In homes, dry-wood termites can be found in rafters, studs, joists, sheathing, floorboards, window frames, door frames, and exterior trim.

Once a colony is established, it feeds on the wood around the nest. Dry-wood termites are general feeders and eat spring- and summer-grown wood. The galleries thus formed will cut *across* the grain. The cavities contain pellets of partially digested wood. These pellets are tiny, seedlike, and usually straw-colored. On occasion, some of the pellets are pushed through openings in the wood surface. If there is not much accumulation, the pellets can easily be overlooked. They are, however, often the first sign of infestation.

The maximum population of a fully established dry-wood termite colony is estimated to be about 3,000. This is considerably less than the typical number of subterranean termites in an established colony, which is estimated to be between 60,000 and 250,000. Consequently, it takes a longer period of time for serious damage to occur with dry-wood termites than with subterranean termites.

Control Since dry-wood termites do not nest in the ground, they must be chemically treated at the source of infestation. This is usually done by injecting insecticide into the galleries, a procedure that should be performed by a professional. To reach the galleries, holes are drilled in the infested wood members. The insecticide will be a liquid or a dust. When the wood is dry, dusting can be effective as far as 15 feet from the point of application. However, when the wood is wet, dusting usually is not effective because the dust tends to cake in the moist galleries. If dry-wood infestation is found in a fence or pole on the property, those wood members should be treated since the termites represent a potential source of infestation for the house.

For severe infestation, treatment is usually by fumigation. The entire house, including the roof, is wrapped with a plastic covering. After all the openings are sealed, a poisonous fumigant is introduced. The house should remain under fumigation for at least forty-eight hours. Since the insecticide is poisonous to humans, fumigation should be undertaken only by experienced fumigators.

Inspection Since dry-wood termites do not leave their nest in search of food, there are no telltale signs of infestation such as shelter tubes. They can be detected, however, by their pellets, which tend to accumulate in a small pile after being pushed from the wood by

the termites or falling through a crack in the infested wood. An infestation in the house can also be detected by the presence of a swarm if you happen to be in the room during an occurrence. Since dry-wood termites can attack wood located anywhere in the house, from the attic to the crawl space, all the exposed wood should be checked for signs of infestation. The wood should be gently probed, so as not to break the surface. Infested wood has hollow sections and if heavily probed, can break open, spilling the seedlike pellets. Dry-wood termites often consume wood up to the paint itself, forming what appears to be a paint blister. If the slightest pressure is applied to the blister, it can break. Care should be exercised to maintain the integrity of the wood surface; a broken gallery is difficult to treat with insecticide.

Formosan termites

The Formosan termite is a subterranean termite native to the Far East. It was first discovered in the United States in a Houston, Texas, shipyard in 1965 and has since spread to a number of southern coastal and Gulf states. All indications are that Formosan termites might eventually establish nests in some northern states as long as the temperature and moisture conditions are satisfactory.

An established Formosan termite colony, which can have more than a million termites, is extremely destructive. They can destroy wood six times faster than our native species. Formosan termites have been known to penetrate lead, plastic, rubber, mortar, and plaster to get to their food—wood. They are able to penetrate the above materials by secreting an acid substance from their frontal glands. In at least one recorded case, they have caused short circuits by damaging electric cables.

Identifying the worker Formosan termite is difficult because there are no obvious characteristics distinguishing them from our native species. However, in the latter colony, only 2 percent of the population are soldiers; whereas with the Formosan's, 25 percent are soldiers. As a result, if an active Formosan termite shelter tube is broken or an infested section of framing is examined, many more soldiers would be visible than if it was from our native species.

Native subterranean termites ordinarily have a ground connection and live partly in ground and partly in wood. However, the Formosan termite can live without a ground connection if there is a suitably located constant source of moisture. This characteristic is what makes the control of Formosan termites so difficult. For example, because of a plumbing leak, the termites might have a nest in an exterior wall. Consequently, chemical treatment of the soil around the house, which is the control procedure for native subterranean termites, will not exterminate the termites in the wall. Fumigation is needed.

Since the location of a termite nest is normally not known—it can be in the ground or in a wall—to control an infestation, it would be necessary to treat the soil around the house chemically and fumigate. With a single detached building, this combination of control procedures is possible; however, in urban areas with row houses and attached structures, fumigation is not a viable procedure. Unfortunately for these buildings, the condition cannot be corrected.

Other wood-destroying insects

Carpenter ants

Carpenter ants are also social insects. They live in colonies with a rigid caste system consisting of a queen, workers, and reproductives (sexually mature males and females that periodically swarm and set up new colonies).

Although worker ants can live four to seven years and the queen for as long as fifteen, colonies have been known to last for thirty to forty years. When the queen dies or is accidentally killed, specially fed workers take over the egg-laying function.

Carpenter ants differ from termites in that they do not eat wood. They merely excavate it to build a nest. The nest consists of irregularly shaped galleries that generally follow the grain. The small fragments of shredded wood that are generated during the excavation are removed from the galleries and deposited on the outside. Consequently, the galleries do not have the earthy appearance of the termite galleries. Rather, they have a polished or sandpapered appearance.

A carpenter-ant colony can be located on the ground in a decaying log or tree trunk or in the roof framing of a house. The ants also nest high in trees and can fly from there to set up new colonies in a house. They build their nests in a variety of locations, preferring wood that is moist or softened by decay. However, they will also build their nests in wood that is perfectly dry and sound.

When inspecting for carpenter ants, look specifically at sections of wood that have begun to decay as a result of a past or current moisture condition. Even though the source of the moisture might have been eliminated (as by correcting a leak), an ant colony might have been established already. Typical locations to inspect are portions of the wood framing, siding, or trim that are in contact with the ground; wood that has been dampened by the overflow from defective roof gutters; the area around a damaged section of siding or flashing; the base of hollow porch posts and columns, and areas with large open joints as might occasionally be found around exterior windows and doors. These areas should be probed with a screwdriver or an ice pick. If the wood yields, breaks, or cracks and ants come crawling out, there is a good chance that you have located a nest.

Consider yourself lucky if you do, because a carpenter ant nest is usually quite difficult to locate; it is often established in an inaccessible location in the wall or roof assembly. One indication of the existence of a colony is unexplained piles of sawdust. (See FIG. 8-10.) Some people, however, think that piles of sawdust are an indication of termites. They are not. Subterranean termites completely devour the wood that they are attacking and leave absolutely no trace of wood particles. Drywood termites also eat the wood completely. However, they do drop tiny, well-formed seedlike pellets. If the pellets are observed

Fig. 8-10. *Sawdust is an indication of carpenter ant activity in window trim.*

closely, they can be differentiated easily from irregularly shaped particles of sawdust.

When a house is infested with carpenter ants, there is little likelihood that the people living there are unaware of the condition. Numerous worker ants will be seen walking around the rooms as if they live there—which indeed they do, with free room and board. These ants feed on sweets, crumbs, and other foodstuffs normally found or spilled on a kitchen counter or floor. Carpenter ants are easy to recognize. They are among the largest ants in the United States, worker ants varying in size between ¼ to ½ inch long. They are black or black with a reddish brown midsection.

While the first sign of infestation is usually the presence of carpenter ants in the house, the fact that they are there does not mean that the nest is inside the house. It might be outdoors, and the ants may have entered the house foraging for food. A carpenter-ant infestation can be controlled only by destroying the nest, either directly or indirectly. Nests can sometimes be located by watching the ant traffic. Ants continually entering and leaving an area are generally an indication of the nest location. If the nest is found, it can be treated directly with insecticide. If not, dusts or sprays can be used where the ants are commonly seen. The latter might not eliminate the infestation, but it should reduce it.

Powder-post beetles

There are many types of wood-boring beetles. The ones whose larvae or grubs feed on seasoned wood and break it down to a powdery residue are commonly called powder-post beetles. These beetles exist all over the United States, although the greatest concentration will be found in those states with a warm, humid climate. The two principal varieties of powder-post beetles are the lyctid and the anobiid beetles. The lyctid beetle attacks only hardwoods; the anobiid beetle attacks both soft and hardwood timbers.

For the most part, powder-post beetles are usually brought into the house via the wood that had been used in its construction. Building materials might become infested while being stockpiled in the lumberyard. The insects might also be brought into the house in finished wood products such as oak flooring, paneling, and furniture.

The beetles lay eggs in the open pores, cracks, and crevices in the surface of unfinished wood. After the eggs hatch, the larvae feed and tunnel their way through the wood, reducing it to a powder. Depending on the temperature and moisture content of the wood, the larval stage can be as short as a few months or as long as a few years. Just prior to emerging, the newly formed adults chew small round exit holes in the wood surface (1/32 to ⅛ inch). In the process of emerging, finely powdered wood called *frass* is usually pushed out in front of the body. This is often the first external sign of infestation. Shortly after emerging, the beetles mate and lay eggs. They occasionally deposit the eggs in the mouth of an old exit hole, thereby reinfesting the same piece of wood. Some wood members have shown signs of extensive damage as a result of infestation by several generations of beetles. (See FIG. 8-11.)

On occasion the homeowner might be the one responsible for the powder-post beetle infestation in the house. Under natural conditions, the beetles breed in dead branches and limbs of trees. When gathering wood for the fireplace, it is possible to pick up infested pieces and store them in the basement or under the stairs for later use. If wood is left in storage through the following spring and summer, the emerging beetles might attack unfinished lumber such as girders, joists, studs, sill plates, and subflooring.

Inspection Inspection for powder-post beetles should be performed along with the

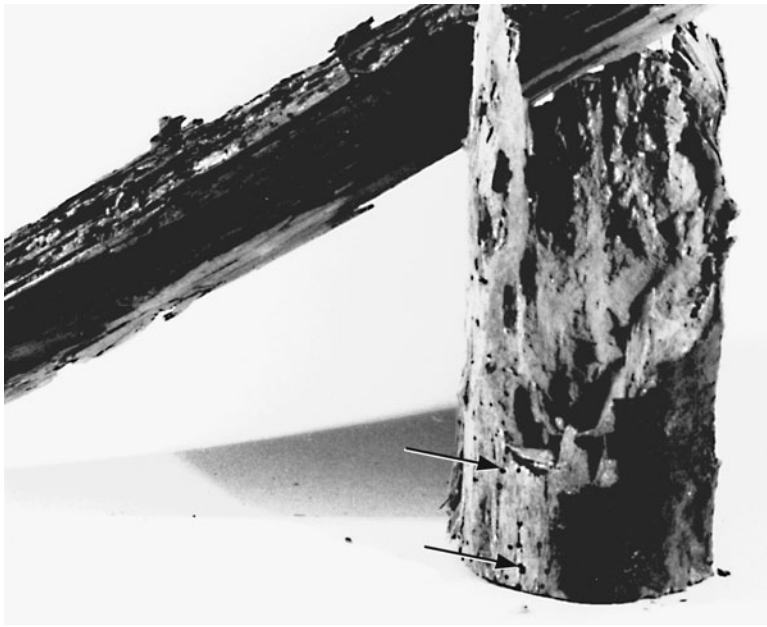


Fig. 8-11. *Wood post with extensive deterioration caused by powder-post beetle infestation. Note beetle exit holes at the lower section of the post.*

inspection for termites. When probing the exposed wood-framing members, look for the small round emergence holes of the beetles. Since it is possible for the beetles to emerge without reinfesting the wood, the fact that there are emergence holes does not mean that the wood member is currently infested. Newly formed flight holes are light and clean in appearance, like a fresh saw cut; older holes are darker in color. If the infestation is well established, there will usually be more than thirty exit holes per square foot of surface. Even though the wood might no longer be infested, small amounts of larvae frass might continue to sift through the holes for many years as a result of normal vibrations of the wood. Look at the frass. If the infestation is no longer active, it will have a yellowish appearance or will be caked.

If there is any doubt about whether the infestation is active, call a professional pest-control operator for an evaluation. An infestation in a single wood-framing member can often be controlled by replacing that piece of wood or coating it with an appropriate insecticide. However, if the infestation is widespread, chemical treatment by a professional is necessary.

Rot

Wood products used in construction are susceptible to decay (rot). However, if properly maintained, they can easily last for hundreds of years. There are three basic types of fungi that attack wood: *stain*, *mold*, and *decay*. Wood rot is caused by an attack of the decay fungi. Stain and mold fungi mainly grow on the wood surface, causing discoloration. By themselves, they do not weaken the wood; but their presence does indicate a moisture problem and should serve as a warning of conditions favorable to the growth of the decay fungi. The decay fungi are microscopic threadlike plants that grow in the wood and attack its thick cell walls. They break down the walls and feed on the contents of the cells. With the destruction

of the cells, the wood disintegrates, and decay becomes evident.

In the early stages, it is difficult to recognize that a section of wood has been attacked by the decay fungus. The wood might merely be discolored. However, the advanced stages of decay are easily recognizable because the wood undergoes changes in properties and appearance. The affected wood might be brownish and crumbly or white and spongy. In either case, the decay greatly reduces the strength and structural value of the wood member. The brown, crumbly rotted sections readily break into small cubes and in the final stage of deterioration are often quite dry. Most people when seeing this condition refer to it as "dry rot." This is really a misnomer. The actual decay occurred when the wood was wet since decay fungi cannot survive in dry wood.

Sometimes the physical changes in the wood are not apparent on the surface. They can be detected easily, however, by probing the wood with an ice pick or a screwdriver. If the wood is in good condition, the probe will not penetrate much beyond the surface. However, if the wood has deteriorated, the probe will easily penetrate into the wood. The conditions that promote the growth of the decay fungi also promote subterranean-termite and carpenter-ant activity. Consequently, when probing wood-framing members, you might find deteriorated sections that are caused by a combination of insect damage and decay. Under suitable conditions of temperature and humidity, the decay fungus gives rise to a fruiting body that contains enormous numbers of microscopic spores. The spores are the seeds of a new generation of decay fungi and are readily distributed by air currents. The spores are always present in the air and under normal conditions cannot be kept away from wood. The presence of decay-fungi spores on wood is of no concern unless the moisture content of the wood and the temperature are such that the spores will germinate and grow. Figure 8-12 shows the decay hazard zones in the United States.

Decay fungi will grow and develop only when the moisture content of the wood is in excess of 20 percent and the temperature is in a range from 40° F to 115° F. Temperatures above the upper limit kill the decay fungi; temperatures below the lower limit cause the fungi to become dormant. The latter is a condition that readily occurs in the northern states during the winter months. In the spring, when the temperature rises, the decay fungi in infested lumber resumes growth, assuming the moisture content of the wood has not changed. The moisture content of wood is defined as the weight of water in the wood expressed as a percentage of the weight of the wood when oven-dry. The decay fungi thrive when the moisture content is about 25 percent. However, when the wood is saturated with moisture, the decay fungi are inhibited from growing because of the lack of oxygen.

The moisture content of green lumber can be as high as 200 percent; after the lumber is kiln-dried, its moisture content may be as low as 7 to 10 percent. Wood in a house that has been properly constructed and maintained will seldom have a moisture content over 15 percent. However, once the moisture content exceeds 20 percent, the wood becomes vulnerable to deterioration by the decay fungi. If the building design is such that some of the wood must be subjected to damp or wet conditions, those sections should be treated with toxic chemicals to prevent decay or be made from the heartwood of certain species (cypress, cedar, or redwood) that are resistant to rot.

Inspection

As with the inspection for wood-destroying insects, the inspection for rot should be conducted on the exterior and interior of the

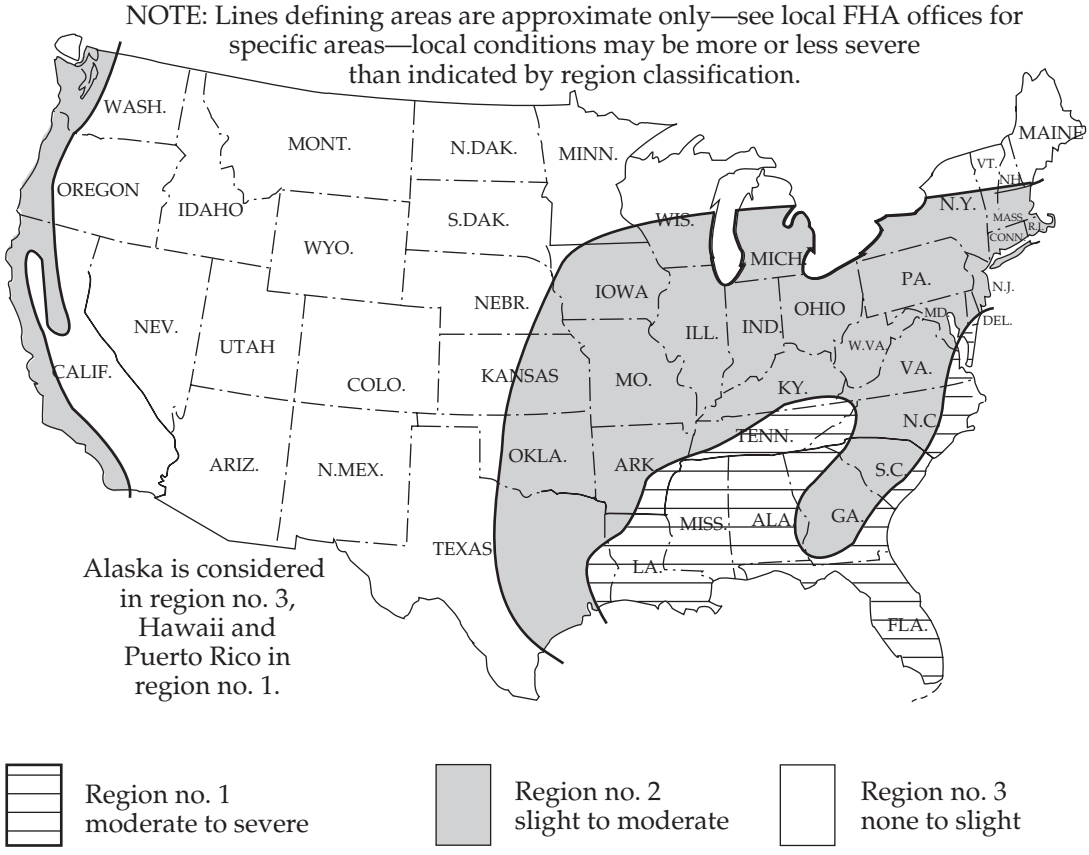


Fig. 8-12. *Decay hazard regions in the United States.*

structure. It can be performed concurrently with the inspection for termites. Areas that are vulnerable to attack by subterranean termites or carpenter ants are also conducive to the growth of the decay fungi. During the exterior inspection, in addition to probing the wood that is located near, or is in contact with, the ground, you should check wood members having cracks and open joints that are subjected to periodic wetting from rain. One area particularly vulnerable to decay is the end cut of exterior wood framing, trim, or siding. An exposed end cut (across the grain) absorbs water much more readily than a section that has been cut parallel with the grain.

During the interior inspection, you should check the unfinished attic and basement or crawl space for evidence of rot. In the attic the wood members can rot as a result of water intrusion through the roof because of a faulty roof covering or leakage around the joints of roof projections. Conditions conducive to rot can also result from condensation due to inadequate attic ventilation. In the basement or crawl space, the decay fungi thrives in the wood members if the humidity is constantly high. Check the overhead wood framing and subflooring for signs of rot. Probe the wood members above and around the top of the foundation wall

and base of wood posts. Vulnerable locations for decay are the wood members through which plumbing pipes pass—because of the possibility of leakage or condensation. Probe the joists and subflooring below kitchen or bathroom fixtures.

When inspecting for rot, note on your worksheet all wood-framing members that have decayed to a point where they can no longer provide structural support. These sections should be replaced or rehabilitated. If in doubt, consult a professional. If natural decay-resistant wood or preservative-treated wood is not used for the replacement of rotted sections and the source of the moisture has not been eliminated, then it will only be a matter of time before the new sections begin to decay. Rotted wood trim that serves no structural function need not be replaced except for cosmetic reasons. Once the infected wood has been dried out and the source of the wetting has been eliminated, the decay is permanently arrested.

Checkpoint summary

Subterranean termites

Exterior inspection

- ❍ Check all exterior areas of the structure that have wood in contact with, or close proximity to, the ground.
- ❍ Note any termite shelter tubes on the foundation walls.
- ❍ Probe vulnerable areas such as garage door frames, basement windowsills and frames, deck posts, step stringers, and entry-door risers.
- ❍ Probe wood-frame members adjacent to concrete-covered, earth-filled porches.
- ❍ Inspect crawl areas under steps, porches, and so on.
- ❍ Probe sills and headers.
- ❍ Check wood fencing, dead tree stumps, wood debris, or stored firewood in close proximity to the house for infestation and rot.

Interior inspection

- ❍ Inspect for shelter tubes on foundation walls and piers and around all plumbing pipes that pass through the foundation.
- ❍ Pay particular attention to areas around the heating system.
- ❍ Probe exposed sill plates, headers, joists, and girders.
- ❍ Inspect wood support posts for infestation and rot.
- ❍ If the house is built on a slab, note any soft spots in the baseboard trim.

Dry-wood termites

- ❍ Inspect property fencing for infestation.
- ❍ Probe exposed wood framing throughout the house, from attic to crawl space.

Carpenter ants

- ❍ Look for small piles of sawdust below or around wood members.
- ❍ Did you see any ants walking around in the rooms, particularly the kitchen?
- ❍ Probe the sections of wood framing, siding, and trim that show evidence of decay or past wetting.

Powder-post beetles

- ❍ Inspect wood framing for clusters of small round holes.
- ❍ Newly formed holes are the color of a fresh saw cut and indicate an active infestation.
- ❍ Probe these wood sections for deterioration.

Rot

- ❍ Probe vulnerable areas such as wood members that are subject to periodic wetting from rain or garden sprinklers.
- ❍ Inspect roof sheathing from the attic for decaying sections around chimney, vents, and so on.
- ❍ Check subflooring and support joists below kitchen and bathroom fixtures and around plumbing pipes.
- ❍ Probe sill plates, headers, and the ends of joists and girders.

9

Attic

Insulation 115
Violations 116
Leakage 117
Fire hazards 117
Ventilation 118
Attic fan 120
Whole house fan 120
Structural 121
Checkpoint summary 123

Once you are inside the house, if there is an accessible attic, it should be the first area inspected. There are basically two types of attic: full and crawl.

A *full* attic is one in which a person can easily walk around. Usually there is a floor in this type of attic, although the walls and ceilings are unfinished. There might be partition walls forming finished rooms with sloping or horizontal ceilings. Access to a full attic is usually through a finished staircase.

In a *crawl* attic, which is completely unfinished, the roof is sufficiently close to the floor so that to get around it is necessary to crawl or stoop over. The crawl attic usually does not have a structural floor. The ceiling joists from the level below are exposed. When getting around in this type of attic, be careful to walk only on the exposed joists. If you accidentally step between the joists, you will probably frighten the pants off of anyone in the room below because your foot will go right through the ceiling. Access to a crawl attic is usually through a ceiling hatch located in a closet or hallway or through hidden folding or sliding steps.

Inspecting an attic can reveal problems of which most homeowners are not aware, some of which might be potentially dangerous or costly to repair. It is not uncommon for a homeowner to say that he has lived in his house for over twenty years and has never gone into the attic. Incidentally, if the homeowner does say this, you can be sure that at the very least, the attic is inadequately insulated by current energy standards.

Insulation and roof leakage are probably the only items most people consider when thinking about the attic. However, there are other items of importance and concern, such as ventilation and its associated problems, fire hazards, electrical and plumbing violations, improperly discharging vents, and open duct joints.

Insulation

The attic area should be adequately insulated to minimize heat loss. The insulation needed in the attic will of course depend on the geographic location of the structure. (See chapter 19 to determine the proper insulation for your area and for a general description of the various types of insulation.) In both crawl and unfinished full attics, the insulation should be located in the floor (between the floor joists) and not between the roof rafters. (See FIG. 9-1.) Otherwise, heat from the rooms below will escape into the attic.

The insulation should be installed with a vapor barrier facing the heated portion of the structure and not the unfinished attic area. A *vapor barrier* is aluminum foil, a plastic sheet, or an asphalt-impregnated paper that prevents moisture movement from the heated portion of the house into the unfinished attic area. If the vapor barrier is incorrectly positioned (facing up into the unheated, unfinished attic), condensation problems can develop during cool weather. Moisture rising from the heated areas below condenses upon contacting the cool vapor barrier. Depending on the amount of vapor, the resulting condensation buildup can reduce the effectiveness of the insulation and cause peeling and flaking of the painted ceilings and walls in the rooms below.

Fig. 9-1. *The proper installation of insulation in the attic, between the floor joists and not the roof rafters. Note plumbing vent stack terminating in the attic—a violation of the plumbing code.*

If there are heating or air-conditioning ducts in the attic, check to see whether they are insulated. Metal ducts often have insulation in the inside, so tap the duct with your flashlight. If you hear a hollow sound, there is no insulation. If there is a dull thud, insulation is present. The more insulation on a duct, the less the heat loss during the winter and, in air-conditioning ducts, the less the heat gain during the summer. Generally, a minimum of 3 inches of insulation wrapped around the outside of the duct will substitute for missing insulation. If the duct is used for air-conditioning, the insulation should be covered with a vapor barrier to prevent condensation from forming.

In the northern sections of the country, when there is a furnace in the attic, insulation between the roof rafters as well as in the attic floor is recommended. To ensure proper ventilation and avoid condensation problems between the rafters, it is important to leave a ventilated air space between the top of the insulation and the underside of the roof deck. The insulation and the associated air space will help keep the roof deck cool. If the insulation is not between the rafters, heat from the furnace will warm the roof deck and melt

the bottom layer of snow that has accumulated on the roof. This often results in an ice dam (see chapter 2).

Often, a homeowner adds additional insulation to the attic to bring the total insulation up to current energy standards. The insulation added should not have a vapor barrier if the existing insulation has one. All too often the homeowner adds insulation with a vapor barrier, which can then cause condensation problems. Look at the insulation in the floor. If there are two layers of insulation and both have vapor barriers, the upper barrier should be slit with a razor blade to allow moisture movement.

If there is a full attic with partition walls forming rooms, the insulation should be located on the unfinished sides of the partition walls and on the ceilings of the rooms. Occasionally, insulation is placed between the roof rafters and not between the floor joists and the partition walls. This installation is inefficient because the heat will escape into the unfinished areas.

Violations

When inspecting the attic, look for vent stacks that terminate in the attic area. (See FIG. 9-1.) This is a violation of the plumbing code, a condition that should be corrected. The vent stack should extend through the roof so that the sewer gases can discharge to the outside. In the past, according to code, every vent stack in the attic terminated above the roof. This requirement can now be modified if the local municipality approves it. With the advent of air admittance valves (AAVs), at least one vent stack must terminate above the roof, as long as all the other vent stacks in the attic are capped with an AAV. This valve is a pressure-actuated one-way mechanical vent that is designed to maintain a plumbing fixture's trap seal and also prevent sewer gases from discharging into the attic. The AAV (see FIG. 9-2) opens only under negative pressure, which is created when a toilet is flushed or when water is flowing down the drain. The valve closes by gravity

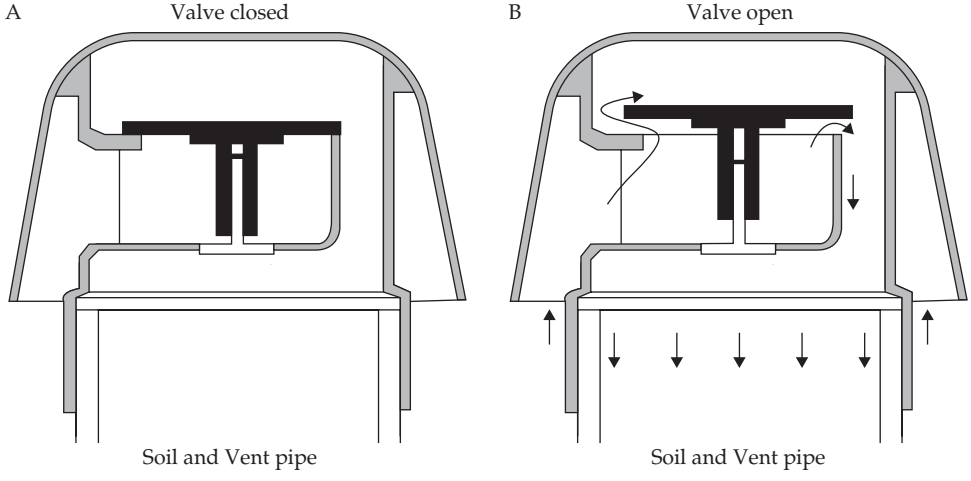


Fig. 9-2. *Air admittance valve (AAV). A—During times of nonactivity in the drainage system, the diaphragm forms a tight seal to close the valve. B—When a toilet is flushed, a negative pressure develops in the pipe, which causes the diaphragm seal to open and air to enter the vent pipe.*

or slight spring pressure to form a tight seal when the water flow stops, or when there is a positive pressure, which would be the result of a blockage in the drain. AAVs come in various designs; however, they all operate under the same principle.

While in the attic, also look for ducts. Whether they are air-conditioning ducts or ducts from an exhaust fan, they should not have any open joints. (See FIG. 9-3.) All open joints should be resecured. Sometimes the exhaust fan from a bathroom discharges its moisture-laden air into the attic. This is undesirable because the moisture can cause condensation problems. The duct from such an exhaust fan should be extended above the roofline so that the exhaust is discharged into the atmosphere. Also look for open electrical junction boxes and makeshift electrical wiring such as extension-cord wiring and "pigtailed" hanging light fixtures. These are electrical violations that should be corrected.

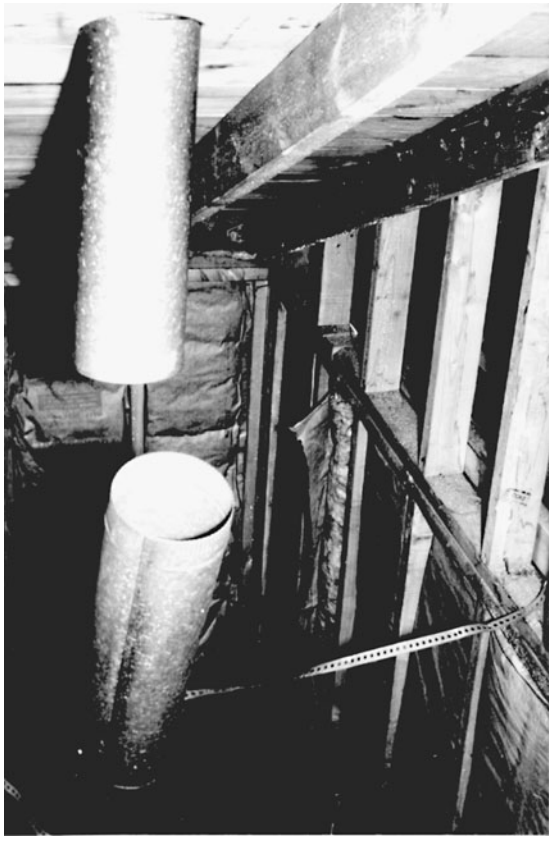


Fig. 9-3. *Open joint in duct from kitchen exhaust fan.*

Leakage

It is important to check the underside of the roof for signs of past water leakage and, if the structure is inspected during a rain, current water leakage. Water stains can show up on the sheathing or roof rafters and appear as dark-streaked discolorations on the wood. Sometimes there is a separate masonry chimney for the fireplace and a prefabricated chimney for the heating system. Joints vulnerable to water leakage are those between the chimney and the roof and between vent stacks and the roof. These joints should be checked for leakage. Water leakage through joints is a relatively minor problem and can usually be corrected by sealing the joints with an asphalt cement.

Fire hazards

Of particular concern is the joint between a prefabricated chimney and the attic floor. (See FIG. 9-4.) According to building codes, there should be 2 inches minimum clearance between the chimney and adjacent wood framing. The clearance is a fire safety measure because wood, which normally burns at temperatures between 400 and 600°F, can ignite spontaneously at a reduced temperature of about 200°F if it has been exposed over the years to temperatures between 150 and 250°F.

If your house has a prefabricated chimney, check the clearance between it and adjacent wood framing. While the clearance space around the chimney prevents a problem, it also creates one because the open space around the chimney generally runs from the

Fig. 9-4. *Open joint between chimney and attic floor—a potential fire hazard.*

boiler/furnace room to the attic. If a fire should develop in the boiler/furnace room, the open area around the chimney will act as a flue and draw the flames up into the attic where they can very rapidly consume the structure. Fortunately, the condition can easily and inexpensively be corrected by blocking (fire-stopping) the opening with a noncombustible material such as sheet metal.

If the house has a fireplace or wood-burning stove, check the section of the chimney that is exposed in the attic. Look for soot or a creosote buildup around the joints. This indicates cracked or open joints through which the exhaust smoke is seeping into the attic. This problem exists more often with chimneys that have unlined flues than those with lined flues. This condition is a potential fire hazard that must be corrected. Record this fact on your worksheet.

Ventilation

Ventilation in an attic is very important. It allows moisture that accumulates in the area to dissipate and also helps to reduce the heat buildup that normally develops during the summer months. Some of the moisture generated in the structure by bathing and cooking works its way up into the attic. If the area is inadequately ventilated, this moisture can eventually cause problems such as delaminating roof sheathing, water streaks on interior walls, peeling and flaking paint, and in severe cases some rotting of the wood framing. When walking around the attic, make sure that all vents are completely unblocked. Sometimes the homeowner blocks a vent opening (see FIG. 9-5) to cut down on the cold air entering the attic and reduce the heat loss through that opening. What he doesn't realize is that he is creating a problem. If the attic is properly insulated, the heat loss through the vent openings is minimal. Of greater importance is the need for vent openings so that moisture can escape. Look around; you'll be able to tell whether the attic is adequately ventilated.

Look at the roofing nails projecting through the sheathing. If you happen to be in the attic on a winter day when the temperature is around 20° F and the area is inadequately

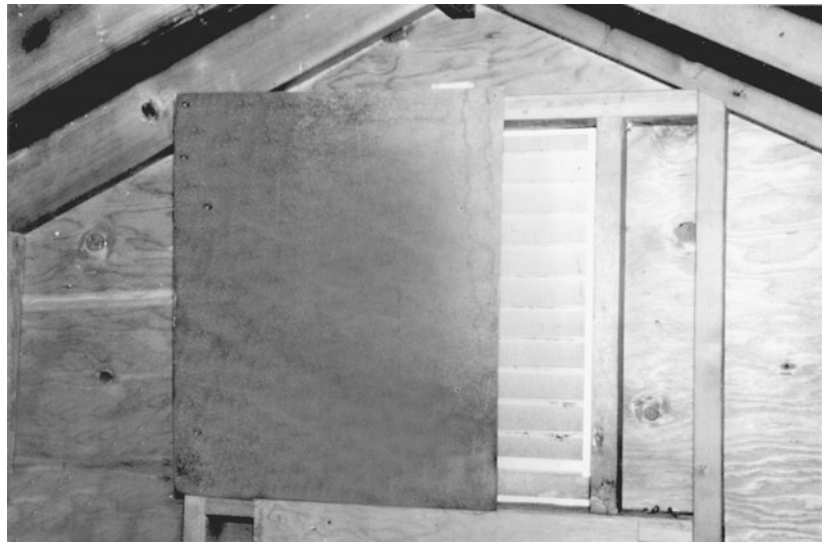


Fig. 9-5. *Partially blocked gable louvers. Louvers are used to ventilate the attic.*

Fig. 9-6. *Frost on roofing nails due to inadequate attic ventilation.*

ventilated, you will find frost on the roofing nails. (See FIG. 9-6.) The frost that forms on the nails melts and drips onto the floor during the warmer periods of the day. Many droplets of water show up as circular stains on the floorboards and on top of the insulation. (See FIG. 9-7.) If you are in the attic during the warmer months, you'll find rust stains and mildew on the sheathing near the nails. (See FIG. 9-8.)

When inspecting the attic, pay particular attention to the north slope of the roof. If the area is inadequately ventilated and plywood is used for the roof sheathing, delamination of the sheathing might be a problem. The northerly slope begins to delaminate before the southerly slope. Figure 9-9 shows an advanced stage of delamination as a result of moisture buildup in the attic. At this stage the entire roof sheathing and shingles must be replaced. The condition could have been avoided if the attic area had been adequately ventilated. Correcting an inadequately ventilated attic is relatively easy. All that is required is to increase the size of the existing vent openings (if there are any) or to provide additional openings such as roof vents, ridge vents, soffit vents, or a power ventilator. These vent openings can be used individually or in combination. The exact number of vent openings needed should be determined by a professional.

Fig. 9-7. *Water-droplet stains on catwalk in attic due to condensation on protruding roofing nails because of inadequate attic ventilation.*

Attic fan

If there is a fan in the attic, it is considered a desirable feature. (See FIG. 9-10.) Because of trapped air, an attic area can reach 150° F on a hot summer day. An attic fan that is thermostatically controlled greatly reduces the heat load on the building. Usually the thermostat is set to activate the fan when the attic temperature is about 100° F. Along with a thermostatic control, some attic fans also have an additional humidistat control. The humidistat turns the fan on and off regardless of temperature whenever the relative humidity is too high in the attic. The fan provides two additional benefits regarding air conditioning. By reducing the heat load on the structure, less electrical energy is required for air-conditioning units. And for those homes with a central air-conditioning blower coil located in the attic, the unit operates more efficiently at lower surrounding temperatures.

The attic fan should normally be operating during the warm days of summer. If it isn't, either the unit is malfunctioning or the thermostat is improperly set. On many units the thermostat is exposed and can be manually adjusted. But if the thermostat is factory set and not accessible, the unit will require professional maintenance. On cool but not cold days, you can usually check the attic fan, assuming the thermostat is exposed, by lowering the temperature control setting until the fan is activated.

Whole house fans

Some structures have whole house fans, which draw outside air in through screened windows and doors and blow it out through the opening around the fan or movable louvered vents. Check the fan before you go into the attic. If the fan is turned on while you are in the attic, be careful when walking around. In some homes, the area of the vent openings for the fan is too small for the size of the fan; consequently, the air that is moved by the fan is partially blocked from leaving the structure. As a result, pressure is built up in the attic, which decreases the efficiency of the fan. If the fan is turned on before you go into the attic, put your hand over any electrical outlet box located on the level just below the attic. If you feel air rushing onto your hand, the attic vent openings are inadequate and should be increased. Some fans are controlled by manual snap switches. From a convenience point of view, this is not as desirable as a timer switch or a thermostat switch. If this is the case, consider its replacement.

Whole house fans are mounted either in the attic floor or on the exterior sidewall of the attic.

Fig. 9-8. *Mildew on underside of roofing deck.*

Fig. 9-9. *Delamination of roof sheathing resulting from inadequate ventilation of attic.*

They have movable louvers that open when the fan is activated and remain closed when the fan is off. This operation creates a potential problem. During the winter months and during portions of the summer months when the fan is not operating, the louvers will be in a closed position and will thereby completely close off the vent opening, causing the attic to be inadequately ventilated. This problem can be avoided by adjusting the louvers so that even when the fan is not operating, they remain in a partly open position.

Some houses have no access to the attic area. If such is the case in your home, the probability is very great that the area is inadequately insulated by current energy standards. The amount of ventilation in the area is also questionable. Installing an access hatch to the attic is recommended.

Structural

While in the attic, be sure to inspect the roof framing. Check the rafters and trusses for cracked, broken, and sagging sections. (See FIG. 9-11.) Are the rafters spreading apart near the ridge? Although these problems are uncommon, they indicate a structural defect that should be evaluated by a professional. Look at the floor

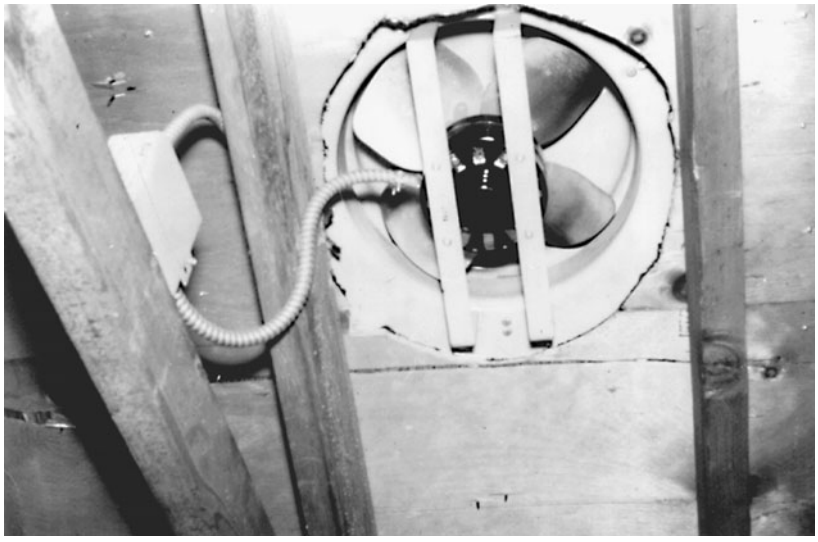


Fig. 9-10. *Thermostatically controlled attic fan mounted between the roof rafters.*

Fig. 9-11. *Cracked and broken roof rafters.*

joists. If they've been cut to accommodate an opening for an attic fan or pull-down stairs, have the cut ends been properly secured to a header? They should be. If not, record that fact on your worksheet for future correction.

When trusses have been used for roof framing, check to see if any of the webs or chords have been removed. Homeowners have been known to cut and remove them to accommodate storage items. This affects the structural integrity

of the truss and should also be recorded on your worksheet for needed repairs.

Checkpoint summary

- ❍ Is attic insulated?
- ❍ Is additional insulation needed?
- ❍ Does existing insulation contain a vapor barrier?
- ❍ Is insulation properly installed?
- ❍ Is ventilation provided?
- ❍ Are vent openings blocked?
- ❍ Check operation of attic fan.
- ❍ If attic is poorly ventilated, look particularly at northerly slope for delaminating plywood or warped roofing boards.
- ❍ Look for signs of past or current roof leakage.
- ❍ Pay particular attention to area around the chimney and plumbing vent stacks.
- ❍ Are air-conditioning and heating ducts insulated?
- ❍ Look for open joints in the duct work.
- ❍ Do any plumbing vent stacks terminate in the attic? If so, are they capped with AAVs?
- ❍ Are kitchen or bathroom exhaust fans discharging into the attic?
- ❍ Are there open electrical junction boxes or makeshift electrical wiring?
- ❍ If house has a prefabricated chimney, is there a need for fire-stopping around the joint between the chimney and the attic floor?
- ❍ Are there any cracked, broken or sagging sections of rafters or truss members?

10
Interior rooms

Walls and ceilings 125
Mold-resistant drywall 126
Chinese drywall 128
Floors 128
Heat 131
Windows 131
Electrical outlets 132
Fireplace 134
Gas-fired fireplace 136
Bedrooms 136
Bathrooms 137
Water pressure and flow 138
Kitchen 141
Hallway and staircase 142
Checkpoint summary 143

After inspecting the attic, you should inspect every room and closet in the house. Don't pass a door without opening it and looking inside. If a door is open, close it to see if it operates properly. All *pocket doors* should be checked to see if they slide open and close easily (pocket doors are doors that when open are housed within the wall cavity). If there is a problem, it generally requires opening a section of wall to provide access to the tracks for repair.

Start your inspection of the rooms at the upper level and work your way down to the basement. As you walk from one floor to another, inspect the hallways and connecting staircase.

The problems normally encountered during an interior room inspection are usually of a cosmetic nature and are not costly to correct. Occasionally you might see cracks or uneven floors or walls that are symptomatic of structural problems, but that is rare. Usually cracks and uneven floors are caused by shrinkage, warpage, or slight movement of the house. Slight movement is considered quite normal. Few people realize that a house is constantly in motion. As the outdoor temperature and humidity vary with the season and the time of day, they cause differential expansion, swelling, and contraction of the various structural and nonstructural elements. This movement, although slight, is very often enough to cause cracks at points of stress concentration, such as over windows or doors.

When you walk into a room, try to look beyond the cosmetics. Don't dwell on the position of the furniture or the pictures on the walls. Look at the walls, the floor, ceiling, and trim, but do not be concerned about minor cosmetic problems. Hairline cracks, small holes, chipped sections, dirty and marked-up areas can all be corrected easily by spackle, wood filler, paint, or stain, depending on the finished surface.

Walls and ceilings

The materials most often used for covering walls and ceilings are plaster and plasterboard, also referred to as gypsum wallboard, drywall, or Sheetrock, which is a trademark of the U.S. Gypsum Company. Plaster—usually made from a mixture of gypsum (a common mineral), sand, and water—has qualities that are very desirable for a wall finish: structural rigidity, durability, resistance to sound transmissions, and high fire resistance. In addition, it can readily be applied to curved or irregularly shaped surfaces. A plaster wall is usually applied in two or three coats to a backing called lath. Depending on the type of lath, the thickness of the plaster usually varies between ½ and ¾ inch.

Plasterboard is a sheet material that basically consists of a gypsum mixture surfaced with a treated paper. Depending on the application, the thickness of the plasterboard can range from ¼ to ⅝ inch. The sheets are usually 4 feet wide and are available in lengths up to 12 feet. When constructing walls using this material, the plasterboard is fastened directly to the studs, and the joints are covered with tape. The edges of the plasterboard are recessed slightly so that when the tape is applied, it is level with the surface. This type of construction requires that the wood framing be perfectly straight and true. Otherwise, the wall surface will be uneven, and there will be visible joint lines. If the moisture content of the wood used in construction is not very nearly that which will be attained in service, there might be nail pops and joint cracks. Popping nails is a condition most often found with plasterboard construction. It can be corrected easily. It often does, however, indicate low-quality installation.

In houses where the roof framing consists of trusses rather than rafters, you might see cracks at the wall-ceiling intersection in the interior rooms below the attic. The cracks are usually the result of truss uplift, which causes the ceiling to move up and down in the course of a yearly weather cycle. The size of the cracks can vary from a hairline to an actual opening of an inch or more. This condition is a cosmetic problem rather than structural. The easiest cosmetic repair is to cover the crack with decorative molding that is nailed to the ceiling and not to the wall. As long as the molding is wide enough, it will cover the crack as the ceiling moves up.

When you inspect a room, look specifically for areas that need major cosmetic rehabilitation, such as broken walls or ceiling, loose and bulging sections of plaster, and disintegrating plaster. Sagging or bulging sections in a plaster ceiling are a safety concern because of the possibility of collapse. This problem, if it exists, is usually found in older homes. Plaster is applied over a wood, metal, or gypsum lath. The sagging condition results from broken plaster keys, which no longer lock the plaster layers to the supporting lath. (See FIG. 10-1.) The condition occurs over a period of time and is usually caused by vibration and wetting from roof and plumbing leaks, which weaken and crack the keys. If there are sagging sections of the ceiling, record this problem on your worksheet for future repair.

Very often, major cosmetic damage is the result of a water condition. As you look at these areas, also look for water stains. Stains

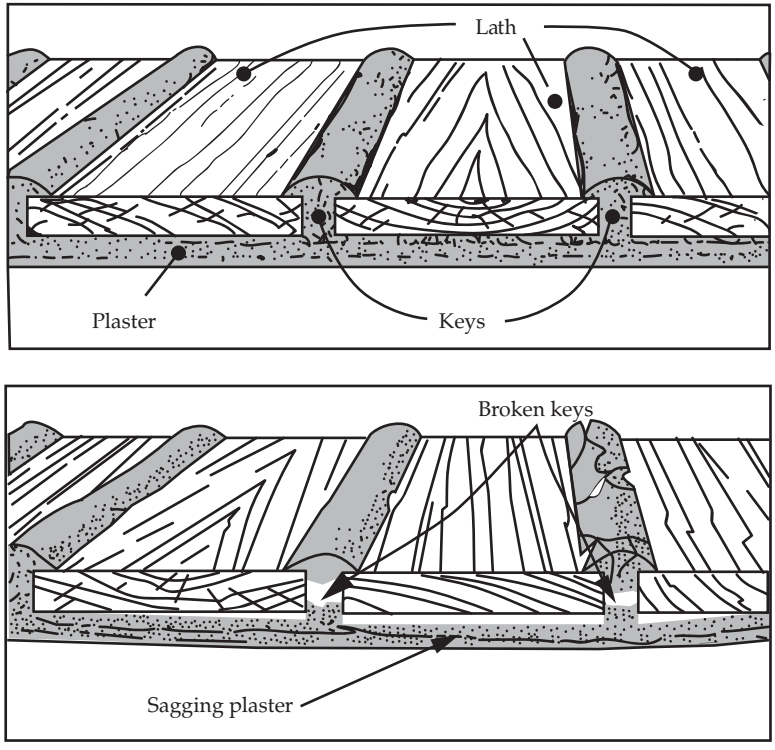


Fig. 10-1. *Ceiling plaster can sag down from lath when keys securing base coat give way.*

often show up as discolorations circled by a light brownish ring. If you see water stains, try to determine the source of the water. All stains do not indicate a current problem condition. You might be looking at the results of a problem that has been corrected. If you have a moisture meter, you should check all water stains to determine whether or not the leakage condition causing the stain is active. If it is, record it on your worksheet.

Mold-resistant drywall

Because of the concern in recent years about mold developing on wet or damp drywall, manufacturers have developed and are now supplying a mold-resistant gypsum wallboard. Mold growth requires moisture and a food source. When traditional drywall gets wet, the paper becomes the food source. With mold-resistant wallboard, either the paper has been chemically treated to resist or minimize the absorption of water or the paper has been replaced with a fiberglass mat facing. Mold-resistant wallboard will reduce the chances of mold developing. However, it does not mean that mold cannot grow. The installation of mold-resistant wallboard is exactly the same as for traditional wallboard.

Water stains on a ceiling can be caused by several types of problems, such as water leaking between the tile joints around a shower or tub located in a bathroom above the ceiling, an ice dam on the roof, an open joint between a plumbing vent stack or chimney and the roof, leaky plumbing, or condensation on cold-water pipes located above the ceiling. Sometimes the cause is obvious, such as a faulty roof. However, you should be aware that leaks that originate in the roof can stain ceilings two or more levels

below. The stains are not limited to ceilings just beneath the roof.

Sometimes the source of a stain cannot be explained by any of the above. On one inspection, I noticed that the ceiling of one room had several stains that were still damp. I knew that there were no plumbing pipes above the ceiling and that the roof was in good shape. Frankly, I couldn't figure out why the ceiling was damp. All of a sudden, I noticed that water was dripping from one section of the ceiling. I then went upstairs to the room above and found what was causing the leak. Apparently, the owner kept a puppy that was not housebroken in the room. Whenever the puppy missed the newspapers that were placed there for training purposes, the urine seeped through the floor joints, wetting the ceiling below.

Ceilings can also be covered with composition tiles. These tiles are generally made from asbestos, glass fiber, or fiberboard. They can be applied directly over plaster or plasterboard ceilings or over furring strips and are usually interconnected with tongue-and-groove joints. If you are inspecting an older home with plaster walls and ceilings and find yourself in a room that has a tile ceiling, the tiles were probably installed to cover broken and cracked sections in the original ceiling. It is becoming increasingly difficult to find a good plasterer. Consequently, when renovating an older home, many people cover a ceiling with tiles or plasterboard rather than have it replastered. Look specifically for loose and sagging sections. These sections must be resecured; otherwise, they can cause adjacent tiles to loosen, which can eventually result in a "domino" effect, causing most of the tiles to come down. (See FIG. 10-2.) I inspected a house the day after two-thirds of the ceiling tiles in one room came thundering down. The owner told me that there always had been a few loose tiles.

Water stains on walls facing the exterior might be an indication of water seepage through open joints in the exterior siding. In particular, this condition has been found in older homes with an exterior brick or stone siding and is usually caused by wind-driven rain penetrating cracked and deteriorating mortar joints. When water stains and peeling and flaking paint are found on walls just below windows, it is usually an indication of

Fig. 10-2. *Ceiling that had been covered with tiles, which came loose and fell down. Note that the tiles had been installed to cover a cracked, broken, and peeling ceiling.*

leakage through open exterior joints around the window.

Cracks in walls are normally merely of cosmetic concern. However, when walls are cracked and the windows and door frames in that room are not level, the condition might be indicative of a structural problem and should be evaluated by a professional.

When the walls are covered with wood or hardboard panels, cracks will not be visible. In quality homes, panels are normally installed over a plasterboard wall. This type of backing provides added rigidity and, when applied on exterior walls, added insulation. If the room you are inspecting has a panel wall, push on the panel at a point between the studs (the studs are usually located 16 inches apart, in some houses 24 inches apart). If the wall panel yields under your push, there is no plasterboard backing. I inspected a new house just after construction and prior to occupancy. The buyer specifically asked me to check the plasterboard because he was paying extra for ⅝-inch rather than ½-inch plasterboard. The builder did install the thicker plasterboard, but in those rooms that were paneled, the builder completely omitted the plasterboard behind the panels because it was not visible to the buyer.

The trim around the various joints in the room should be inspected and checked for missing, loose, cracked, and broken sections. Although a minor element, trim in this condition is an indication of shoddy workmanship in new construction and neglect in a resale.

Chinese drywall

Between 2004 and 2006, because of the housing boom and the need to rebuild the homes destroyed by Hurricane Katrina, many millions of pounds of drywall was imported from China. It is estimated that enough material was imported to build about 100,000 homes. Shortly thereafter, problems began to develop in some of the houses in the southern states where the interior walls were built using drywall made in China. Chinese drywall emits higher levels of sulfuric and organic compounds than drywall made in the United States. The sulfur fumes emitted caused air-conditioner coils, copper plumbing, and electrical wiring to corrode, as well as producing a foul odor such as that of a burning match or rotten eggs. The fumes have also been associated with respiratory and sinus problems in some residents. So far, most of the drywall problems have been limited to the southern states, where a warm, humid climate encourages the emission of sulfur fumes. If the drywall was also used in other parts of the country where it is dryer and cooler, it could be years before homeowners begin seeing the problems associated with the material. Correcting the problem would require stripping and removing all the drywall. There are also indications that it may be necessary to replace some of the material in the house such as carpeting and furniture.

Floors

When walking around the house, you might notice that the floor squeaks on one or more sections. This condition is found in both new and older homes and indicates slightly loose floorboards. It is usually difficult to eliminate. One corrective procedure is to wedge the floor from below. However, the underside is usually not accessible. If a hardwood floor is nailed from above, the nail holes can ruin the finish. With regard to the structural integrity of the house, squeaking floors are not a concern, although if excessive, they can be annoying.

If the floors in a portion of the house are finished hardwood and the remaining floors (other than those in the bathrooms and kitchen) are covered with wall-to-wall carpet, do not assume that there is a hardwood floor below the carpeting. There might be, but quite often

there isn't. It is not uncommon for a builder to give a buyer the option of hardwood floors or carpeting. When the buyer selects carpeting, it is laid over a plywood floor. If you are inspecting a room and see a hardwood floor in a closet, though the floor in the main portion of the room is carpeted, do not assume that there is a hardwood floor beneath the carpeting. If you cannot see it, you really cannot be sure. If a hardwood floor is important to you, get a representation in writing from the owner that the floors beneath the carpets are hardwood.

Just because the floor looks like a hardwood floor, it may not be, in the classic sense; that is, solid wood from top to bottom. It may be an engineered hardwood floor or a laminate floor. An engineered hardwood floor is made up of three to 10 thin layers of wood with a core of hardwood, plywood, or high-density fiber. The top layer is a hardwood veneer that is glued on the top surface of the core and is available in almost any hardwood species. It is less expensive than hardwood, and due to its multi-ply structure, engineered wood is much more stable than solid wood and is less susceptible to shrinking and expanding with changes in temperatures and humidity. It can be installed on any grade level, directly over concrete and can also be installed below ground level, whereas solid hardwood should only be installed above grade. Unlike engineered wood, moisture and extreme temperature changes can cause solid wood to shrink and expand, potentially causing gaps between boards during colder or drier seasons. If there is excessive moisture on the underside of the solid hardwood floor, it will cause the top surface to cup, that is, to form a concave surface with the edges raised.

Laminate flooring is the least expensive between solid hardwood and engineered flooring. Although it looks like wood flooring, there is actually no solid wood used in its construction. Laminate floors are made up of several materials bonded together under high pressure. Most laminate flooring consists of a moisture-resistant layer under a layer of HDF (high-density fiberboard). This is topped with a high resolution photographic image of natural hardwood flooring, which accurately reproduces the grain and color of natural hardwood. To protect the laminate, it is then finished with an extremely hard, durable clear coating made from special resin. Laminate flooring can be installed above or below grade and over virtually any other flooring surface. It is usually laid as a floating floor. It is not nailed or glued to the subfloor.

If the wall-to-wall carpet covering the hardwood floors is brand new, ask the seller for a representation in writing that the surfaces of the hardwood floors are in good condition. Several years ago I inspected a split-level house with hardwood floors. All the floors were covered with new wall-to-wall carpet. Lifting a corner of the carpet in each room did not reveal a problem. However, after the buyer moved in, he removed the carpet from all the hardwood floors and was dismayed by what he saw. Every one of the floors was very badly stained by cat or dog urine and had to be refinished.

Another type of hardwood floor is a bamboo floor. The flooring is typically made by slicing bamboo poles into strips. To prevent potential mold, fungus, or insect problems, these strips are boiled and then sent to a drying kiln to reduce moisture levels. The strips are then glued and assembled under extremely high pressure and heat either face up for horizontal flooring or side by side for vertical flooring. Although vertical flooring results in a smooth uniform appearance, horizontal flooring has a more natural look. The pressure and heat applied assure a strong, stable bond. After milling, the bamboo is given an aluminum oxide coating to increase its strength and endurance, and to protect it from stains. Direct sunlight can cause some

types of bamboo floor to become discolored. It may happen if the floor is exposed to highly concentrated sun rays for long periods. Bamboo flooring needs to be kept free of dust, dirt, and grit. Even the tiniest particles of dirt can cause minute scratches on its surface. It is like any wood floor—it is damaged by dents, scratches, and shoes with high heels.

If you walk into a room and notice that the floor is not level, do not be alarmed. In all probability, it is a condition caused by past shrinkage, warpage, and settlement of the wood framing and is not a concern. If the floor is sagging in one section, it might indicate that that portion of the floor is or was improperly supported. Go down to the level below to check the ceiling to see if it too is sagging. If it is, have a professional evaluate the condition. Occasionally this condition occurs in a kitchen floor when the refrigerator is placed in a location other than that intended by the builder.

Depending on the moisture content in the wood used for framing, you might see a large open joint between the floor and the partition walls. The joint might be open as much as 1 inch and might run the entire length of the partition wall. When you see this condition for the first time, it is quite unnerving. The trim that normally covers the joint between the floor and the wall is about an inch above the floor, and the joint is wide open. The condition is caused by excessive shrinkage of the wood framing and is only a cosmetic problem. By covering the open joint with trim or lowering the existing trim, the room will look almost as good as new.

The floor on the lower level of bilevels is a concrete slab. Depending on the quality of construction, the concrete floor slab could settle to a point where there is also a large open joint between the floor and the walls. (See FIG. 10-3.) During construction, if the ground below the floor slab is not properly compacted, the slab might eventually settle, resulting in open joints. The foundation walls all have support footings and are normally independent of the floor slab. Consequently, settlement of the floor slab usually does not indicate a problem with the main structure. Nevertheless, the wall above the open joint should be shimmed; otherwise, the floor above might sag. If the settlement of the concrete floor slab is accompanied by cracked and settled sections of the foundation wall, a severe problem does exist and should be evaluated by a professional.

Sometimes the concrete floor slab has a raised wood floor that might be covered with carpeting or resilient floor tiling. When walking on this floor, test for soft or spongy

Fig. 10-3. *Settled concrete floor slab. Note open joint between floor and partition walls.*

sections. This condition can be caused by inadequate spacing of the wood framing. However, more often than not, it is caused by rotting wood. If water seeps into the area between the wood floor and the concrete slab, it eventually causes the framing to rot and the subflooring to delaminate. (See FIG. 10-4.) See chapter 11 for a discussion of water seepage into the basement level.

Heat

With the exception of homes in the sunbelt, all the finished rooms in the house should have provisions for heating. Depending on the type of heating (see chapter 14), look for a radiator or heat register. If you don't see any, ask the owner how the room is heated. It might be heated by radiant panels in the floor, walls, or ceiling that would not be visible. If there is no source of heat, record the fact on your worksheet. Adding heat to a room by extending the existing heating system can be costly. If there is a means of heat supply, is it properly located? For maximum efficiency, radiators and heat-supply registers should be located on an exterior wall, preferably below a window. This allows the heat to mix with the cooler outside air that normally infiltrates the interior from around the windows.

Windows

Although the condition of most of the windows is checked during the exterior inspection (see chapter 5), the condition of the windows on the upper levels and the operation of the windows should be checked during an interior inspection. Also, if the windows are the casement or awning type, the storms and screens are often not visible from the exterior and should be looked for during the interior room inspection.

The cost of repairing a broken window frame or replacing a broken pane is usually not high on an individual basis unless the window is one of unusual design or a large thermal pane (double or triple glazing). Keep track of the number of windows that need repair or rehabilitation. It is surprising how fast the dollars add up when you multiply the

Fig. 10-4. *Rotting and delaminating section of raised wood floor in finished basement. Condition is caused by constant wetting from water seepage into the basement.*

cost for one repair by the number of windows that are faulty.

Specifically, check the windows for cracked and broken panes that require replacement. BB holes or small cracks in the corner of a pane can be overlooked, providing that the window is covered by a storm pane. Is the putty around the pane cracked, dry, chipped, or missing? If so, the window joints must be reputtied. Look at wood window frames and exterior sills for cracked and rotting sections. Some windows have metal frames. Metal frames get quite cold during the winter in the northern part of the United States and have a tendency toward excessive condensation. This can cause peeling and flaking paint or disintegrating sections of plaster near the window frame.

Pay particular attention to steel casement windows. These windows are usually a problem. They rust easily and must be painted every few years to prevent deterioration. In many cases, they do not close properly, a condition often caused by a sprung frame or excessive layers of paint around the joints. Also, almost invariably you will find cracked panes. Usually casement windows are crank-operated. Check the hardware. Sometimes the cranking mechanism is not operational.

Open and close the windows. They should operate relatively easily without sticking or binding. Double-hung windows should not rattle in the channel and should stay in a fixed position when opened fully or partially. Many older double-hung windows use a counterweight to hold the sash in a fixed open position. The weight is usually tied to a sash by a cord or a chain. If a cord is used, check to see if it is broken. Broken cords are not uncommon and should be replaced. If the cord is frayed, you can anticipate its early replacement.

When looking at the windows, check to see if the glazing is a single pane or a thermal pane, that is, two pieces of glass separated by a sealed air space. You can tell by looking at the thickness of the joint between the pane and the frame. A single pane is usually no more than 3⁄16 inch thick; a thermal pane is about 3⁄8 inch to 1 inch thick. You can also tell by looking very closely at the pane. Usually, you can see dust or dirty spots on the opposite side that reveal the thickness of the pane. Sometimes fixed-pane windows and sliding glass doors have thermal panes, even though the openable windows throughout the house have only a single pane. One of the well-known names for thermal glass is Thermopane. It is also referred to as insulated glazing. Each manufacturer has its own term for it. You can usually find the manufacturer's name in the corner of the window pane.

Thermal-pane windows are fabricated by hermetically sealing dry air or an inert gas between the panes. This is done to eliminate the possibility of future condensation problems between the panes. (See FIG. 10-5.) When the seal breaks, accidentally or otherwise, water vapor can enter the space between the panes. Look at the windows for signs of a faulty seal. If a portion of the window appears cloudy (FIG. 10-6) or there are water droplets between the panes, the seal has been broken. Although the insulating characteristics of a thermal-pane window with a faulty seal are at least as good as a storm window, the pane is not desirable from a visibility and a cosmetic point of view. If you see a thermal-pane window with a faulty seal, record it on your worksheet. The window requires replacement. The better window manufacturers offer a 20-year warranty on the seal of these windows.

Electrical outlets

While inspecting the interior rooms, look for electrical hazards and violations and whether there are an adequate number of electrical outlets on the walls. These items are discussed in chapter 12. According to the electrical code,

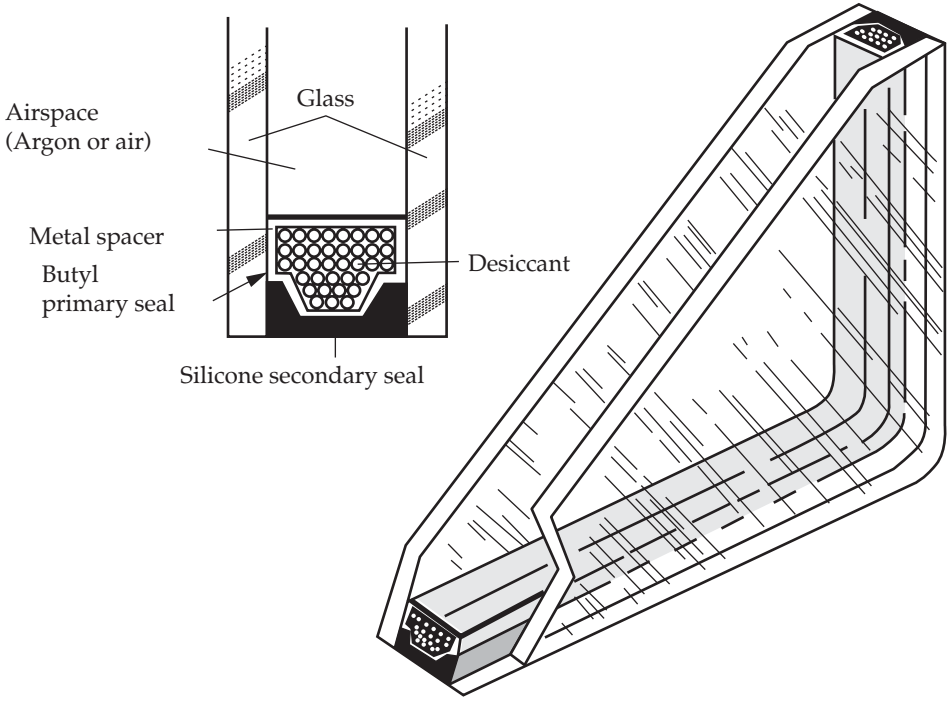


Fig. 10-5. *With an insulated glass pane, if there is a defective seal, moisture will condense between the panes.*

Fig. 10-6. *Faulty seal in thermal-pane windows adjacent to a sliding glass door. Restricted visibility is caused by condensation between the glass panes.*

the outlets in a new house must be located such that no point on the wall is more than 6 feet horizontally from an outlet. However, the actual number of outlets needed for a specific room depends on the room's usage and the position of the furniture.

Look at the electrical outlets. In new homes and in recently rewired older homes, the receptacles have three slots rather than two. The third slot is a ground connection that is used in conjunction with the three-prong plugs found on most modern appliances. It is a safety feature and is used for grounding the casing of electrical appliances and equipment. Should an internal short develop between the wiring and the equipment or appliance casing, the ground connection directs the leakage current harmlessly to the ground rather than through the user.

In homes built after 2008, check to see if the outlet receptacles are tamper resistant. If they are, the letters "TR" will be marked on the face of the receptacle. In 2008, the National Electrical Code (NEC) mandated the use of tamper-resistant receptacles in new or renovated construction. Tamper-resistant receptacles have a shutter mechanism that in most instances will block access to the electrical contacts from anything but an electrical plug. Although a worthwhile safety feature, not all municipalities have adopted the new code. Check with your local Building Department.

Not all electrical appliances and equipment have a grounding wire (three-prong plug). Some are made with double-insulated plastic cases that prevent the user from touching anything electrically charged, even if an internal short should develop. This type of equipment does not require a ground connection and can therefore be used with the older two-slot receptacles. As a safety precaution, you should use only electrical appliances and equipment that have been approved by Underwriters Laboratories, Inc., or some other nationally recognized testing agency.

The two-slot outlet receptacles can be used for the grounding of appliances with three-prong plugs. Adapters are available at hardware and electrical supply stores to enable two-slot receptacles to accept the three-prong plugs. To complete the ground connection when using the adapter, remember that the small wire (pigtail) must be secured to the center screw on the receptacle cover plate.

Check the receptacles (two- and three-slot) to determine if they are electrically hot, whether the receptacles have reverse polarity, and whether they are properly grounded. This can be done using a simple plug-in tester available at all electrical supply stores.

Reverse polarity is a problem because it indicates that the hot and neutral wires are connected to the wrong terminals in the receptacle. This is important because the switch on an appliance should disconnect the hot wire. This keeps everything beyond the switch inside the appliance from being electrically hot when the switch is off. With reverse polarity the switch disconnects the neutral wire so that everything beyond the switch will be hot, which could result in an electrical shock. The diagrams in FIG. 10-7 show how a polarized circuit can protect you from a shock hazard.

It is particularly important to check the receptacles in the bathroom and kitchen to see if they have ground-fault circuit protection. Receptacles that are not properly protected for ground faults are potential hazards. See chapter 12 for discussion of ground-fault circuit interrupters (GFCIs).

Fireplace

If a house has a fireplace, it is most often located in the living room or family room, although

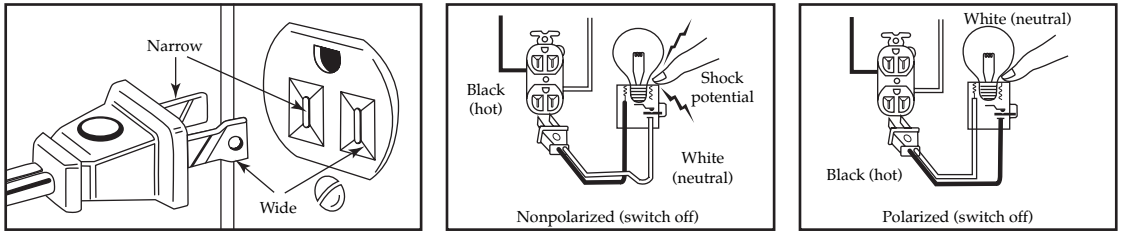


Fig. 10-7. *How a polarized circuit can protect you from a shock hazard.*

you might find a fireplace in a bedroom or kitchen. When inspecting the fireplace, look at the front face just above the firebox. If this area has a blackish tint or color, it is usually an indication of a smoky fireplace and is the result of a buildup over the years of layers of soot and creosote. This problem can usually be corrected.

A smoky fireplace might be the result of too small a flue for the size of the firebox opening. If this is the case, reducing the size of the opening by raising the hearth or installing a canopy on the top portion of the opening very often corrects the problem. However, determining the amount to raise the hearth or the size and shape of canopy to use requires experimentation. Sometimes the soot buildup is caused by backsmoking as a result of downdrafts. This is the result of wind currents bouncing off the side of the building or tall trees and then down the chimney. If the smoking is caused by downdrafts, the problem can usually be corrected by installing a concrete, stone, or metal cap on top of the chimney. Another possible reason for poor draft or backsmoking is that the chimney is undersized. A rule of thumb for the minimum height of the chimney states that the total height from the firebox floor to the top of the chimney should never be less than 15 feet.

Backsmoking can also be caused by a negative pressure condition within the house. This is a fairly common phenomenon in newer houses. To conserve energy, newer homes are better caulked, weatherstripped, and tighter than older homes. The negative pressure results when more air in the house exhausts to the outside from fans, heating-system chimney, and so on than flows in from infiltration. Because of the negative pressure, when a fire is first lit in the fireplace and the damper is opened, there is an onrush of incoming air down the flue. This condition can be eliminated by slightly opening a window or in newer fireplaces opening the fresh-air vent associated with the fireplace.

Look inside the firebox for a damper. The damper is used to close the flue when the fireplace is not in use. It prevents heat loss through the flue in the winter and also prevents small animals such as squirrels and racoons from entering the room through the flue. Check the operation of the damper. On many older fireplaces, dampers were omitted. If the fireplace does not have a damper, or if the damper is defective, record that fact on your worksheet. A damper or equivalent is considered necessary, and one should be installed. If there is a chimney-top damper, check its operation. See chapter 3, page 25.

The bricks or stones lining the firebox should be checked for cracked, chipped, broken, and disintegrating sections. Are the mortar joints intact, or are they in need of repointing? Cracked or open sections inside the firebox are a potential fire hazard and must be repaired.

Look up at the flue from inside the firebox. Normally this area will be coated with a layer of soot and creosote. If the layer is thick, have the chimney cleaned to minimize the possibility of a chimney fire. If the creosote layer is powdery, the flue can be cleaned by a chimney sweep with a brush. However, if the creosote buildup is of a tar consistency or a hard glaze, it cannot be brushed out by conventional means. It must be removed by chemical or mechanical means. Is there an obstruction in the flue, such as a bird's nest? If the flue has a slight offset and you can see daylight, there is no obstruction. When the flue is offset so that you cannot see straight up, determining whether there is an obstruction is difficult without lighting a fire. One trick is to blow up at the flue to dislodge fine particles of soot. If the flue is not obstructed, they will float up the chimney.

In some homes you might find a prefabricated wood-burning fireplace. These units are usually available with chimneys and have a specially insulated firebox shell. They are light in weight, do not require a special foundation, and can be wall-mounted or freestanding. The fireplace can be located in practically any part of a house, depending on local codes. If you find such a fireplace, check to see if it has been approved by Underwriters Laboratories, or some other nationally recognized testing agency.

Gas-fired fireplace

There are two basic types of gas fireplaces. They are either vent-free or have a direct vent. With direct vent fireplaces, the combustion gases are vented to the outside by a two-layer pipe that runs through a hole in the wall behind the unit. The outer pipe draws air in from the outside, which is needed for proper combustion of the gas. The inner pipe channels the gaseous products of combustion to the outside, or up a chimney. If a chimney is used, the local building codes may require the damper in your chimney to be permanently set to an open position because of the gas pilot light.

With a vent-free fireplace there is no need for a damper. These appliances have a thermal sensor located near the top of the fireplace opening. This is a safety device that in a properly operating fireplace would never be triggered. The sensor cannot be reset. It comes with the unit and is set in the factory. Vent-free fireplaces also have an oxygen depletion sensor. If the fire takes too much oxygen out of the room's air and is not replaced, the sensor is designed to turn off the gas before carbon monoxide reaches a dangerous level in the room.

Bedrooms

Every habitable room in the house must have at least one openable window. Sometimes do-it-yourself homeowners finish off an area in the basement or attic for use as an extra bedroom even though there is no window in the room. If you find such a room, be advised that it is a potential fire hazard.

When a room is used as a bedroom, certain items are necessary as fire-safety measures. As a means of escaping in the event of a fire, each bedroom should have at least one outside window whose sill height is not more than 44 inches above the floor. The window should also have a minimum net clear openable area of 5.7 square feet with no dimension less than 20 inches in width and 24 inches in height. If a bedroom is located two stories above the ground, a rope ladder or equivalent device should be provided in the room to enable the inhabitants to escape once they climb through the window. Some municipalities have local ordinances against converting a third-level attic into bedrooms without adequate fire protection. If you find bedrooms in a converted attic, you should check with the local building department to see if a certificate of occupancy had been issued for those rooms.

Last, from a fire-safety point of view, every bedroom must have an entry door. This door should be closed when the occupant goes to sleep. A closed door reduces drafts, thus reducing flame-spread time, and drastically reduces smoke infiltration. Check to see if there is a smoke detector on the wall or ceiling. There should be. In new construction most states require that all of the smoke detectors in the house be hard wired and interconnected. Check the operation of the detector. If it's interconnected with the others, hold your ears. The alarm noise is quite loud.

Don't forget to look for a closet. Is there a ceiling light fixture in the closet? More often than not the light fixture is a porcelain base with an exposed incandescent bulb. Check to see if the bulb is relatively close to the closet shelf. If it is, it's a potential fire hazard. If

clothing or other fabrics come in contact with a bulb that has been inadvertently left on for an extended period of time, they could ignite and start a fire. In some homes where bedrooms have been added, closets are omitted in the renovation. There should be a closet in every bedroom. If there isn't one, record that fact on your worksheet.

Bathrooms

Because of the nature of the room, the bathroom must be well ventilated. Ventilation can be provided naturally through an openable window or mechanically by an exhaust fan. If there is an exhaust fan, try to determine where it discharges. The air drawn through the fan should discharge into the atmosphere. This can be accomplished through the use of a duct that terminates on the side of the building or one that extends up through the attic and terminates on the roof. When the bathroom is located on the level just beneath the attic, the exhaust fan very often discharges directly into the attic. This is undesirable because the moisture-laden air can cause condensation problems in the attic. From a convenience point of view, many builders often connect the exhaust fan to the lighting circuit so that both are controlled by one switch. This is not an energy-efficient installation, since the exhaust fan is not always needed. If you see such a setup, you might want to consider rewiring the fan so that it can be controlled by a separate switch.

A recurring problem in bathrooms is water leakage through cracked and open tile joints around the tub or shower. This condition requires periodic maintenance and if neglected can cause considerable cosmetic damage. Check the tiles for cracked and open joints. Lean over the tub or go into the shower and press on the tiles, particularly at the lower portion of the walls. Loose tiles will move slightly or might even come out. If the tiles yield, it is usually an indication that the plaster or plasterboard backing has suffered some deterioration from water seepage. Depending on the severity of the deterioration, it might be necessary to rehabilitate that portion of the wall. Sometimes the cracks are not readily visible but will nevertheless allow water to seep through and wet the wall behind the tiles. You can check for leakage by using your moisture meter on the tile wall.

If the walls around the tub and shower are not kept watertight, water can leak around open areas, wet the ceiling below, and eventually rot the wood framing and cause the ceiling to deteriorate. Missing tiles must be replaced; loose tiles must be resecured; and cracked and open joints must be regrouted or caulked. Caulking is the procedure most often used for making repairs. A tube of caulking compound is available at any hardware store.

If the walls around the tub or shower have a panel finish rather than tile, check the joints for cracked or open sections. Sometimes the tub or shower and its associated walls are an integral unit made of molded plastic. In this case, leaks through open joints are not a problem. Many homes have showers and tubs with doors to prevent water from splashing onto the floor. The doors must be made with safety glass or plastic and should be checked for cracked panes and ease of operation.

When the shower base is covered with ceramic tiles rather than molded plastic or is terrazzo-constructed, there is the potential for a problem because of a faulty shower pan. A large lead or plastic sheet is normally installed below the tiles at the base of the shower to collect water that seeps through cracked and open tile joints. If the shower pan is intact, it will direct the water down the drain without incident. However, as the shower pan ages, the joints very often deteriorate, resulting in water leakage through those joints. If you notice

large water stains on or damage to the ceiling of an area below the shower, you should suspect a shower-pan problem. (See FIG. 10-8.)

If you have the seller's permission, you can test for a faulty shower pan by covering the shower drain and filling the shower base with about an inch of water. Let the water stand in the base for about forty-five minutes. If the shower pan is faulty and there are cracks in the base tile joints, water will seep through and wet the ceiling below. When the tile joints at the base of the shower are all sealed, even if the lead pan is faulty, there will be no leakage. Instead of replacing a faulty shower pan, many homeowners simply recaulk the tile joints at the base of the shower. This is considered a makeshift fix. If you find a heavy layer of caulking in the shower base, even if you do not find water stains on the ceiling below (the ceiling could have been repainted after the makeshift fix), you should suspect shower-pan problems.

Water pressure and flow

The water pressure in a house is an item of concern to most home buyers, and rightly so. However, water pressure per se is not usually the problem. If you see water trickling out of a faucet, it does not necessarily mean that the pressure is low. It means that the water flow is low. Low water flow can be caused by low pressure. However, more often than not, low flow is caused by a constriction in the supply pipes. The constriction can be the result of mineral or corrosive deposits on the inside diameter of the pipes, a kink in the pipe, or small-diameter piping. Quite often low flow at a fixture is caused by a partially clogged faucet aerator, which requires only cleaning. Water flow is measured in gallons per minute, and a sink faucet should be able to deliver 4 to 5 gallons per minute.

The water pressure available to a house at the meter varies, but it is usually in a range of 20 to 60 pounds per square inch (psi). I inspected

Fig. 10-8. *Water stains on ceilings caused by leaks from radiator in room above.*

a house that had a pressure gauge on the house side of the water meter. (A pressure gauge in the plumbing system is desirable but is not very common.) The gauge indicated that the available water pressure was 110 psi. Yet when three faucets were turned on at the same time, the water flow from each faucet was just a trickle. Regardless of how high the pressure is, if a constriction in the water pipes limits the water flow, the amount of water discharging from the faucet will be noticeably low. In this case, the pipes were made of galvanized iron. Over the years, corrosion and deposits had coated the inside of the distribution piping to a point where the pipes required replacement.

When you inspect the bathroom, check the water flow by simultaneously turning on the faucets in the sink and tub and flushing the bowl. There will usually be a drop in flow when the second faucet is turned on. If it is not very noticeable, do not worry about it—it is normal. You can trust your eye. If the water flow from the faucets looks good, then for all practical purposes, it is good. If the flow is noticeably low, record it on your worksheet. The condition requires correction. If there is a shower in the tub, check the operation of the shower diverter valve. When the shower is on, there should be very little or no water leaking out of the tub spout. If there is, the diverter valve is defective and will require replacement. Record this on your worksheet.

Check the flow for both the hot water and the cold water, but not at the same time. It is possible for the cold-water flow to be good and the hot-water flow fair or poor. Occasionally, when the domestic hot water is generated through the heating system, deposits form in the tankless coil, restricting the flow. If the hot-water flow is poor, you probably need to replace the tankless coil. (See chapter 16.)

Open and close the faucets rapidly. Do you hear a hammering and vibrating noise? You should not, but if you do, you are hearing *water hammer*, which occurs when the water flowing in the pipe comes to an abrupt stop. It introduces hydraulic shock and vibrations that can in extreme cases damage the pipe or fittings. The condition can be corrected easily by installing an air chamber or antiknock coil. These units provide a cushion of air to absorb the shock when the water flow stops.

While you are checking the water flow, look for water leakage around the faucets, and the drainage trap below the sink. If you notice that a portion of the trap is taped over, it is usually a makeshift correction for a leak. The drainage trap is not installed below the sink to catch rings or other valuables that fall down the drain, although very often this happens. The purpose of the trap is to provide a water seal that blocks noxious gases from seeping back into the room. If a sink trap is not properly vented, it can lose its seal from a siphoning action when the water is draining. (See FIG. 10-9.)

Usually the P-type sink trap is vented properly. However, the S-type trap is often not vented properly. You can tell by making the following test, although it is not foolproof. Fill the sink until the water is almost at the rim; then let the water drain. When most of the water has drained, if you hear a sucking and gurgling noise, the trap is not vented, and the water seal has been lost. When all the water has drained, if you let the water run freely for about five seconds, you will reestablish the water seal. If the main plumbing waste line has a house trap, the problem is minimized.

Check the drainage in the sink, tub, and bowl. Wrinkle up some toilet paper into a ball and throw it into the bowl. When the bowl is flushed, the paper should be carried down the drain. If the water in the bowl starts to rise to the top and then settles down without flushing, there is a blockage in the drain line that must be checked further and corrected. If the house has a septic system, this condition might indicate a problem with the septic

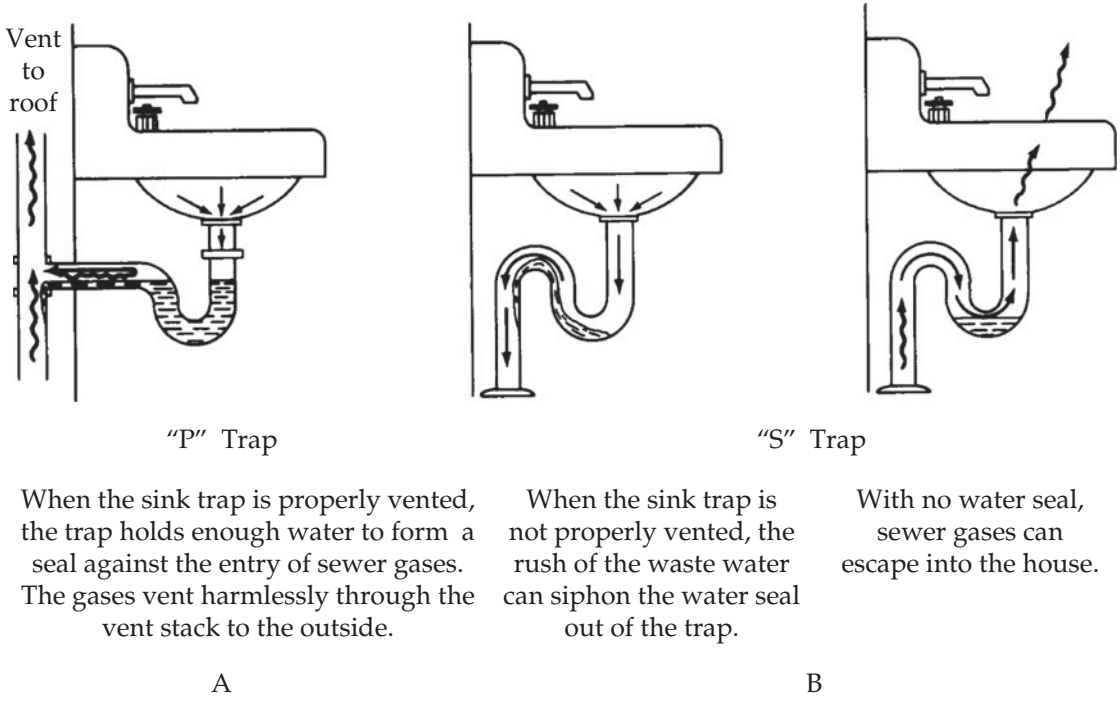


Fig. 10-9. *Sink traps: A—Properly vented P-type trap; B—S-type trap, usually not properly vented.*

system. If the water in the sink and tub does not readily drain away or drains sluggishly, there is a blockage in those drains that must also be corrected. In this case, the correction might be as simple as removing hair that has accumulated around the pop-up drain plug.

Look at the sink and tub faucets. When the tub and sink are filled to the flood rim, there should be an air gap between the top of the water and the bottom of the faucet spout. (See FIG. 10-10.) If there isn't, the faucet is vulnerable to back siphonage (the flowing back of dirty water from the sink or tub into the potable water supply because of a negative pressure in the line). This condition is a violation of the plumbing code and is found periodically in old homes. However, it is not limited to old homes. The "do-it-yourself" homeowner could have installed the faucet without being aware that it is a potential problem. Are there shutoff valves below the sink and bowl for the supply pipes? Although not a necessary feature, they are very convenient when making minor repairs.

If the tub is equipped with a whirlpool bath, check its operation. Fill the tub to a level above the jet ports before turning on the bath's pump. Record any problems on your worksheet. For health reasons, before the whirlpool bath is used, it should be professionally cleaned to remove bath residue and scale deposits because no inspection method is available to ensure that proper maintenance procedures were previously followed. Also check to see if there is an access hatch for the pump motor. This is occasionally overlooked during the installation, and it is helpful in the event that maintenance is required.

After you flush the bowl, if the toilet is the tank type, lift the tank lid and look inside. If the lid has a cloth cover, be careful when lifting

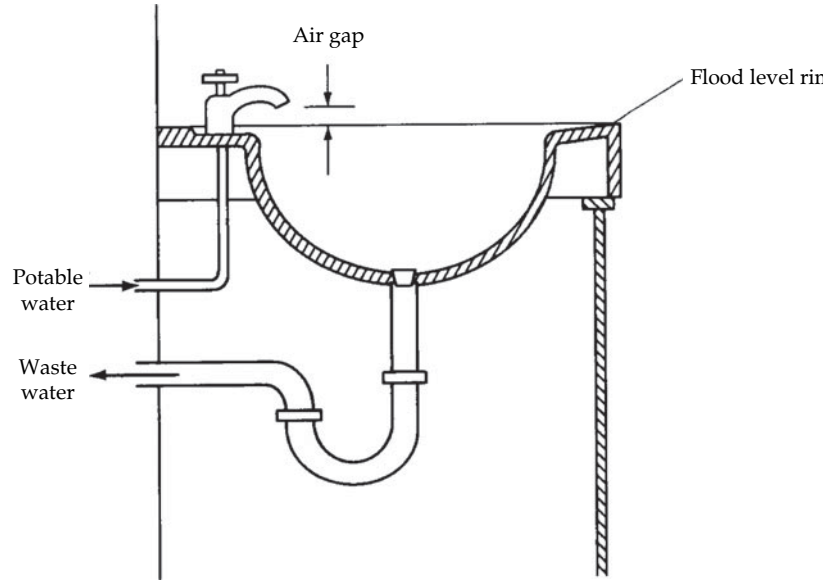


Fig. 10-10. *Air gap between bottom of faucet spout and flood rim of sink prevents the backflow of nonpotable water into the potable water supply.*

it. It might be cracked or chipped. If water is spurting out of the fill valve, maintenance is needed. You might even find the trip lever connected to the flush valve by a string rather than a metal chain or strip. Repair or replacement of the flushing mechanism is not costly.

Occasionally the seller, not being the original owner, inadvertently misrepresents the age of the house. Depending on the manufacturer of the toilet bowl, you might be able to verify the house's age by looking on the underside of the tank lid. There might be a date stamped on the underside that can be a clue, assuming the toilet is the original and was not installed during a later renovation. The date is the date of manufacture, usually within a few months of installation.

Kitchen

When inspecting the kitchen, in addition to the plumbing items mentioned above, the condition of the cabinets and counters should be checked. The appliances, although important, need not be inspected at this time. Because appliances can break down at any time, it is recommended that on the day of, but prior to, the contract closing, you come back to the house and operationally check every appliance included in the purchase. If an appliance is not operational, you can have your attorney request an adjustment at the closing for the cost of repairs.

Cabinets should be inspected for missing, cracked, and loose-fitting doors and drawers. Missing hardware for doors and drawers should be noted. The shelves should be checked to see if they are adequately supported. The counters should be inspected for cracked, burned, blistered, and loose sections. If there is a cutting board or hotplate on the counter, lift it up or move it aside. You might find that it is concealing a damaged section of the counter.

When inspecting the sink, in addition to checking water flow and drainage, look for a sprayer. If there is one, see if it is operational. I have seen many sprayers with a disconnected hose mounted in the sink fitting. The sprayers

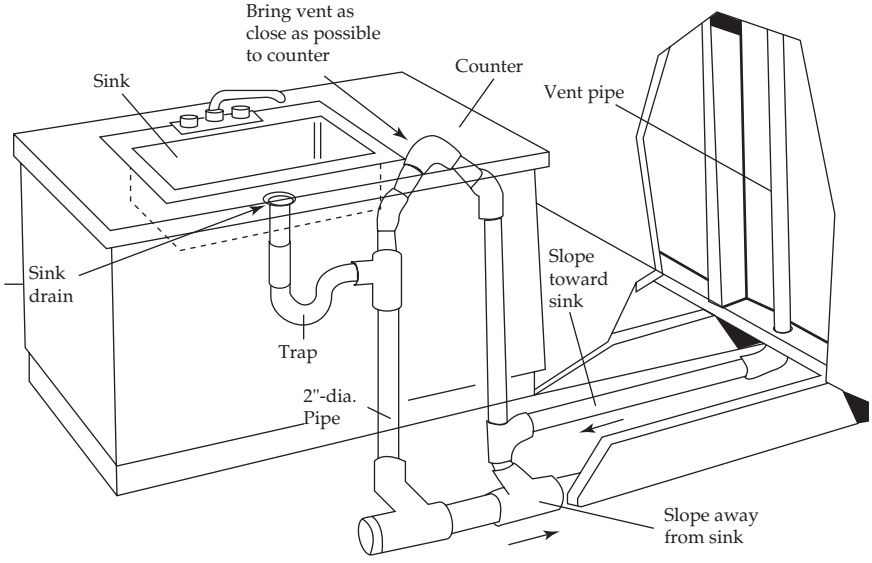


Fig. 10-11. *Loop vent—venting of an island sink.*

were not functional and served only as a decoration to cover the opening in the sink. Is there a sink in a central island cabinet? If there is, check the drain piping. Island sinks are notorious for being improperly vented. If the sink drain has an S-type trap rather than a P-type trap, it is not properly vented. Record this item on your worksheet. If approved by local codes, this condition can be corrected with a minor plumbing change by connecting an air admittance valve (AAV) to the drain. Another way of venting an island sink is with a "loop vent" (see FIG. 10-11), which is usually, but not always, installed during the construction phase of the house.

Is there a garbage-disposal unit connected to the sink drain? If there is and the house has a septic tank, there might be a problem. A garbage-disposal unit introduces solid wastes into the septic system at a greater rate than normal. To avoid overloading the system, some states have a design criterion calling for a larger-capacity septic tank when there is a garbage-disposal unit. Other states recommend that the tank be cleaned at more frequent intervals. (See chapter 13 for a discussion of septic systems.)

If the disposal unit was added after the house was constructed and provisions were not made for a larger septic tank or more frequent cleaning, the disposal unit might have been overloading the septic system. This can result in premature failure of the system. If the house has a garbage-disposal unit and a septic system, check with the local municipal building department to determine if the system was designed to accommodate the wastes from the disposal unit. Also, check with the owner to find out when the septic tank was last cleaned. If it was not cleaned or at least inspected for sludge buildup within the last three years, record the fact on your worksheet. The tank should be cleaned after you move in.

Hallway and staircase

The remaining rooms in the house should be checked as described previously. In addition,

the connecting hallway should be inspected as you walk from one part of the house to another. The hallway should be treated as an interior room, and its walls, floor, ceiling, and trim should be inspected. Look for an overhead light in the hall. Is it controlled by three-way switches located at both ends of the hall? It should be. As a fire-safety measure, a smoke detector or equivalent should be mounted on the ceiling of the hallway leading to the bedrooms. If there is a smoke detector, is it properly located? The corners of a hallway where the walls and ceiling meet is considered dead-air space. This means that even though smoke will circulate and accumulate near the ceiling, it will not penetrate into those corners until the hall is completely filled with smoke. According to the National Fire Code: "Spot-type smoke detectors shall be located on the ceiling not less than six inches from a side wall, or if on the side wall, between six to twelve inches from the ceiling." Neither wall- nor ceiling-mounted detectors should be placed near a light fixture or a ventilation grille that could block smoke from reaching the detector. If you see an incorrectly located smoke detector, you should alert the seller and record it on your worksheet.

As you proceed from one level to another, check the connecting staircase. Squeaky treads, as with squeaky floors, indicate loose sections. They are not a concerning factor, but if excessive, they are annoying. Correcting the problem is often difficult because the underside is usually concealed. The steps should be uniformly spaced without any dimensional variation. It is not uncommon to find basement steps with uneven risers for the bottom and top steps. This condition is a potential hazard, since someone can easily trip.

As a safety precaution, all steps should have handrails. Check to see if both ends of the handrail have a return to the wall. Rails with returned ends will prevent clothing from catching on the end, which could result in a fall. Loose handrails must be resecured. Sometimes the handrail is secured in such a manner that allows little finger room. This is a hazardous condition, especially for children. Is there a window at the base of the staircase or on the landing? If there is, its sill should be at least 36 inches above the floor. This will prevent someone from falling through the window in the event of a fall down the stairs. If the sill is less than 36 inches high, a window guard should be installed as a precautionary measure.

Lighting the stairway is essential, especially for areas that are often neglected, such as basement steps. The location of the light fixture is unimportant as long as the light provides sufficient illumination for the entire staircase. The light should be controlled by three-way switches, one at the top and the other at the bottom of the staircase.

Checkpoint summary

Walls and ceilings

- ❍ Do not be concerned with minor cosmetic problems. Specifically check for:
  - — broken walls and ceilings;
  - — loose, missing, and bulging areas of plaster or plasterboard;
  - — missing, loose, and sagging sections of ceiling tile;
  - — sagging sections of plaster;
  - — truss uplift cracks (at wall-ceiling intersection);
  - — water stains on ceilings, particularly below roofs, bathrooms, and kitchens;
  - — disintegrating plaster, peeling and flaking paint, and water stains on walls facing the exterior (usually caused by open or exposed exterior joints).
- ❍ If there is a sulfur-based odor in the house, suspect Chinese drywall, especially if the copper plumbing and electrical wiring show signs of corrosion.

- ❍ Note rooms that have cracked walls in which the windows and door frames are not level (professional evaluation is recommended).
- ❍ Check paneled walls for plasterboard backing (often omitted).
- ❍ Check trim for missing, loose, cracked, or broken sections.

Floors

- ❍ Inspect for floors that are not level, have loose floorboards, or have sagging areas. Sagging floors that are also noted in the ceilings below should be evaluated by a professional.
- ❍ Inspect for large open joints between floor and partition walls (usually caused by excessive shrinkage).
- ❍ Note floors that have wall-to-wall carpeting. Do not assume that there is a hardwood floor beneath the carpeting. Request that owner make this representation in writing.
- ❍ Inspect concrete floor slabs for cracked and settled areas. Note areas that have large open joints between the floor slab and the walls.
- ❍ Check raised wood floors over concrete slabs for soft, spongy, and delaminated sections. Often these conditions are a result of water seepage with associated rot in wood framing.

Heat

- ❍ Check interior rooms for missing radiators or heat registers.
- ❍ If rooms are heated by other means (radiant panels), verify this with the owner.
- ❍ Are radiators and heat-supply registers efficiently located (preferably on an exterior wall and below a window)?

Windows

- ❍ Check windows for ease of operation.
- ❍ Inspect for cracked and broken panes; chipped, cracked, and missing putty.
- ❍ Check exterior sills for cracked and rotting sections.
- ❍ Inspect double-hung windows for broken or missing sash cords, loose or binding sashes, and missing hardware.
- ❍ Inspect steel-casement windows for cracked panes, rusting and sprung frames, loose, missing, or inoperative hardware.
- ❍ Check thermal-pane windows for faulty seals (water droplets or cloudy areas between the glass panes).
- ❍ Check casement and awning windows for interior storm windows and screens.

Electrical outlets

- ❍ Inspect rooms, stairways, and hallways for electrical hazards and violations (see chapter 12 summary).
- ❍ Note all rooms in which there are insufficient outlets and outlets that are loose or have missing cover plates.
- ❍ Check whether outlets are electrically "hot" and properly grounded. Do any have reverse polarity?
- ❍ Are the kitchen and bathroom receptacles GFI protected?

Fireplace

- ❍ Inspect brick or stone firebox lining for cracked, chipped, broken, or deteriorating sections.
- ❍ Check for cracked, loose, or disintegrating mortar joints.
- ❍ Check top of firebox for an operational damper.
- ❍ Is there a chimney top damper?
- ❍ Inspect area for obstructions.
- ❍ Is the chimney flue lined?
- ❍ Check for heavy layers of soot and creosote (heavy layers indicate the need for chimney cleaning).

Bedrooms

- ❍ Check that all bedrooms have at least one openable window with the following criteria:
  - — sill height not *more* than 44 inches above the floor;
  - — minimum openable area of 5.7 square feet with no dimension less than 20 inches.
- ❍ Do all bedrooms have entry doors and closets?
- ❍ Is there a smoke detector on the wall or ceiling?
- ❍ If a portion of the attic or basement has been converted to a bedroom, is there a certificate of occupancy for the room?

Bathrooms

- ❍ Check bathrooms for adequate ventilation.
- ❍ If there is an exhaust fan
  - — is it operational?
  - — does it have a separate on-off switch?
  - — can you determine where the fan exhaust discharges?
- ❍ Inspect tiled areas, particularly around the tub or shower, for open joints, cracked, loose, and missing tiles.
- ❍ Note wall areas in the tub or shower that show evidence of deterioration (spongy or loose sections).
- ❍ Check shower doors for cracked panes (should be safety glass) and ease of operation.
- ❍ Check sinks, bowl, and tub or shower for cracked, chipped, and stained areas. Check that sinks and bowls are properly secured.
- ❍ Inspect sink and tub faucets for proper air gap (potential back siphonage).
- ❍ Check fixtures for individual shutoff valves.
- ❍ Inspect fixture plumbing for leaks, kinked lines, patched and makeshift corrections (taped joints and rubber-hose connections).
- ❍ Inspect sink drain lines for improper venting (S-type traps).
- ❍ Does shower diverter valve in the tub leak?
- ❍ Check operation of whirlpool bath.
- ❍ Is there an access hatch for the pump motor for the whirlpool bath?

Water pressure, flow

- ❍ Check cold-water flow by simultaneously turning on the faucets in the sink and tub or shower and flushing the bowl.
- ❍ Perform a similar check for hot-water flow.
- ❍ Check for water hammer when faucets are opened and closed rapidly.

Kitchen

- ❍ Check sink for low water flow and proper drainage.
- ❍ If there is an island sink, is the drain vented properly?
- ❍ If sink contains a sprayer, check operation (often this unit is disconnected).
- ❍ If sink drain contains a garbage-disposal unit and house has a septic tank, you should determine the following:
  - — Was disposal unit added after the house was constructed? (Septic tank might be undersized.)
  - — When was septic tank last cleaned? (If over three years, the tank should be cleaned.)
- ❍ Inspect cabinets for missing, cracked, or loose-fitting doors and drawers.
- ❍ Check for missing hardware on cabinet doors and drawers.
- ❍ Check shelving for adequate support, cracked, warped, or missing sections.
- ❍ Inspect counter and countertops for cracked, burned, blistered, or loose sections.
- ❍ Check all appliances for operational integrity on the day of, but prior to, contract closing.

Hallway and staircase

- ❍ Check for properly located smoke detectors in hallway areas leading to the bedrooms.
- ❍ Check hallways and staircases for adequate lighting. Are three-way switches located at both ends of the hallway?
- ❍ Check walls, floor, ceiling, trim, and so on as you would for interior rooms.
- ❍ Inspect stairways for uneven risers, loose treads, missing handrails, and handrails with tight finger room. Do the ends of the handrail have a return to the wall?
- ❍ If there is a window at the base of the stairway or landing, is the sill less than 36 inches above the floor? (If this condition exists, you should install a window guard.)

11
Basement and crawl space

Foundation 147
Settlement 148
Inspection 149
Cracks 149
Superior Walls 150
Structural support framing 151
Engineered lumber 153
Dampness 154
Water seepage—causes and control 155
High groundwater level 155
Hydrostatic pressure—walls 156
Inspection 158
Seepage indications in an unfinished basement 159
Seepage indications in a finished basement 163
Walls 160
Floors and floor joints 160
Furnace room 163
Ventilation 165
Crawl space 165
Conditioned crawl space 167
Checkpoint summary 168

Problems in a basement or crawl space are often among the most costly to correct. Look specifically for signs of water penetration, structural deterioration of the wood support members, and structural deficiencies of the foundation wall.

Foundation

The purpose of the foundation is to support the main portion of the house and transmit its load to the ground. The foundation of most residential structures consists of walls that rest on an enlarged base called a *footing*. The footing spreads the transmitted load directly to the supporting soil and is usually resting on undisturbed earth. Where there are freezing temperatures, the footings must be located below the frost line. Otherwise, the footings become vulnerable to frost heaving resulting from the freezing of soil moisture. Pilasters, piers, and columns are also used to support the main structure. (See FIG. 11-1.)

Foundation walls are normally designed to support the vertical loads from the house and to resist the horizontal forces resulting

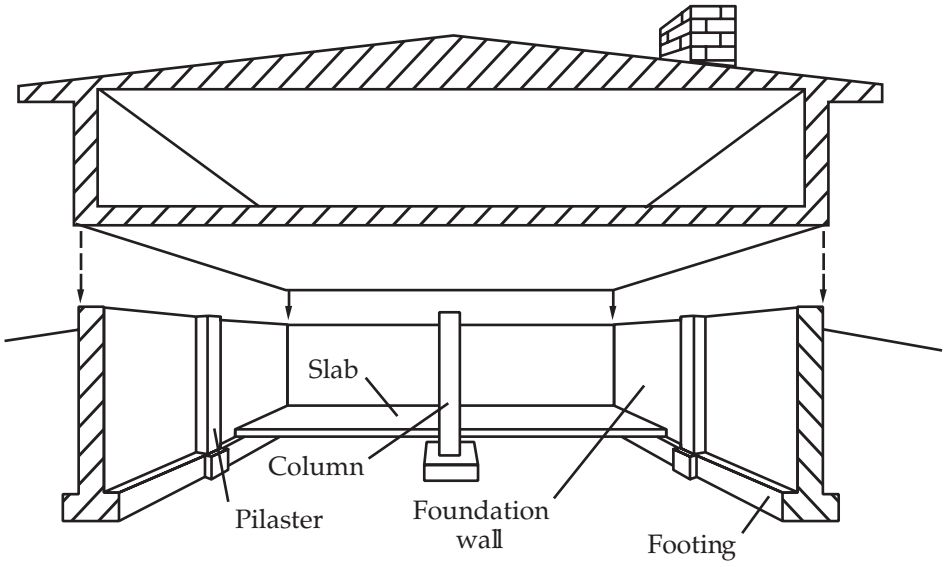


Fig. 11-1. *Elements of a foundation.*

from the earth's pressure. In most parts of the country, the house must be anchored to the foundation to provide resistance to wind and/or earthquake forces. High wind forces or rapid ground movement can cause a structure that is not properly anchored to lift, shift, or rotate slightly. When the house is properly anchored, the resistance to this movement produces stresses that are within the foundation wall. Consequently, the foundation wall must be designed to withstand these forces. In some cases, the combined vertical and horizontal forces acting on the foundation wall is great enough to require additional bracing and stiffening of the walls. In these cases, pilasters are often used to provide the additional support.

Settlement

All soils compress to some extent, and if the footing is not resting on bedrock, the foundation is subject to settlement. When the settlement is slight or uniform, or was anticipated in the design, it is of little concern. However, when the foundation settles unevenly (*differential* settlement), there is generally some cause for concern. Differential settlement introduces stresses that might seriously weaken the building. It often causes cracks in the foundation walls, unsightly cracks in the finished walls and ceilings, sloping floors and windows, and doors that bind. When the differential settlement is excessive, it can result in a structural failure of a portion of the foundation wall, a condition that can be quite costly to correct.

The principal cause of foundation settlement is a reduction of the volume of the voids in the soil supporting the foundation. The voids are the spaces between the soil particles and contain air and water. Sandy soil contains large granular particles with a relatively small volume of voids; clay soil contains fine-grained particles with a large volume of voids. The settlement of foundations built on a sandy soil tends to be quick and slight, whereas the settlement of foundations built on a clay soil tends to be greater and might occur over many years.

Usually you do not have to worry about foundation settlement in older homes because by the time you are considering buying the house, the settlement has already occurred, along with any accompanying problems. And what you see is what you get. However, if what you see is a house out of plumb, with sagging sections, it might have structural problems, and as a precautionary measure, you should have the house evaluated by a professional.

Some soils are considered poor for building-construction purposes. Homes built on a highly organic soil are vulnerable to excessive settlement when the soil dries out. Organic soil acts like a sponge, and as the soil dries, the organic matter shrinks. Depending on the amount of organic matter in the soil, the condition can cause differential foundation settlement.

Some soils on steep hillsides are subject to severe slippage. When the amount of buildable soil above an impervious subsoil layer is shallow, if the soil becomes saturated (because of an extended heavy rain), the entire upper layer of the hillside can slip to the bottom, along with any houses built on the side of the hill.

Some soils with a high clay content can swell or shrink up to 50 percent between wet and dry conditions. These soils are considered unstable, and unless special provisions are made during construction, the condition can cause excessive differential settlement cracks in the foundation.

If you have any questions about the soil the house is built on, you can usually get them answered at the local office of the U.S. Department of Agriculture, Soil Conservation Service, or at the office of the local county soil and water conservation district.

Inspection

Most houses built in the last seventy years have foundation walls of poured concrete, concrete blocks, or cinder blocks, whereas older homes generally have stone or brick foundation walls. When inspecting stone or brick foundations, especially in homes built before or around 1900, pay particular attention to the mortar joints. I have found that in homes of this vintage, many of the mortar joints in the foundation walls have deteriorated to a point where they are no longer functional. Some of the joints might have holes, and some may be filled with soft, crumbling mortar that can easily be raked out. In some cases, the joints between the foundation stones might have been filled with earth or mud rather than mortar.

Deteriorated mortar joints in foundation walls should be repointed, not so much because they represent a weakened structural condition (they do, but this is usually not a severe problem) but because they can allow water to penetrate into the basement (see FIG. 11-2) and enable mice and other pests to enter the area.

In some older homes with brick foundation walls, you might find soft, crumbled, and flaking bricks so badly deteriorated that they should be replaced. This condition is usually the result of using underburned bricks in the construction of the wall. Bricks that are underburned during the manufacturing process are softer and absorb water more readily. If you see this condition, it should be recorded on your worksheet, since masonry rehabilitation is needed.

Cracks Cracks in poured concrete or concrete-block foundation walls can result from shrinkage, differential settlement, lateral pressure on the wall by the soil, or poor-quality workmanship. It is not uncommon to find short cracks in foundation walls. These cracks might be vertical, horizontal, inclined, stepped, smooth, or irregular and are usually of no structural concern. All cracks, however, should be sealed as a precautionary measure

Fig. 11-2. *Deteriorated mortar joints in fieldstone foundation wall. Note water seeping through the wall at base.*

against water penetration into the basement. Otherwise, if there should be a hydrostatic pressure buildup in the soil against the foundation, water will seep through the cracks.

If there are long narrow cracks in the wall and both sides of the cracks line up so that there is no noticeable differential settlement, it is usually not a serious condition and can be controlled by sealing the cracks. However, when both sides of the cracks do not line up or there are long open cracks, a more serious condition of differential settlement exists. Since it is not possible to determine from a single inspection whether the differential settlement is active or dormant, the wall should be checked for incremental movement over a period of time, usually several months. In most cases, after some time, the differential settlement stabilizes with little effect on the house other than functional annoyances such as binding windows or a floor that might not be level. However, because of excessive settlement, an unstable condition can occur either in the foundation wall or the wood framing being supported by the wall. If there is any doubt in your mind about the condition of the foundation wall, you should have it checked by a professional.

Another type of crack of concern is a long, open horizontal crack in the foundation wall, especially if the wall shows signs of bowing. This condition is principally caused by an excessive horizontal pressure being exerted on the foundation wall by the earth backfill and indicates that the wall cannot adequately withstand these external lateral forces. Structurally the wall has failed; this condition should be recorded on your worksheet as a condition that requires further investigation and depending on the extent of bowing, reinforcement, or replacement.

Superior Walls In the 1980s, insulated, precast, ribbed concrete wall panels called *Superior Walls* were introduced to the market to be used for building foundations. (See FIG. 11-3.) The panels can be installed in a fraction of the time that it would take for poured concrete

Fig. 11-3. *Installing precast concrete "Superior Walls."*

foundations and traditional exterior walls. According to the manufacturer, when panels are delivered to the site, they are often erected in three or four hours. When installing a foundation, the Superior Walls are bolted together at the top and the bottom of each panel, and the joints between the panels are sealed with a polyurethane sealant. When inspecting the foundation, check for open joints and signs of wall tilt, and as with other foundations, check for cracks and signs of water penetration.

Structural support framing Because of the vulnerability to deterioration from rot and wood-destroying insects, all exposed wooden support members (girders, joists, posts, and sill plates) should be checked for structural integrity. Steel beams and columns, on the other hand, need be checked only for degree of rust or corrosion. Usually the rusting is only a surface defect that can be corrected by scraping, priming, and painting.

Wooden support members should be probed with a screwdriver or an ice pick, as described in chapter 8. If the wood is in good condition, the probe will not penetrate much below the surface. The portions of the joists and girders that are most vulnerable to deterioration are those resting on or adjacent to the foundation wall. While probing these areas, you should also check the sill plate (which is anchored to the top of the foundation) for structural integrity. Many older houses have wood support posts rather than steel columns. If there are wood posts, check their bases for decay. The base has a tendency to rot because of periodic dampness or seepage through the floor. A post with a rotted base should be replaced. Joists with deteriorated end sections, however, need not be replaced. They can be rehabilitated. In most cases, all that is needed is to place a similar size wood member alongside the affected joist and secure it to the portion of the joist that has not deteriorated.

Girders (the main support beams) are often supported at both ends by the foundation wall. If the girder is wood-constructed, the notch in the foundation wall in which the girder rests should be large enough to allow the sides and end of the girder to be ventilated. Otherwise, there can be a moisture buildup, which will

promote decay. There should normally be at least a ½-inch clearance around the sides and end of the girder. For adequate support, there should be a minimum of a 3-inch end bearing in the foundation notch. (See FIG. 11-4.)

If you find that the end of the girder has deteriorated so that it is no longer providing adequate support, do not be overly concerned. The condition can be corrected at a reasonable cost without replacing the girder. In many cases, all that is needed is to support the girder by a column or pier located near the foundation wall. This repair, however, should be performed by a professional, since the column or pier must have an adequate size footing to spread the load.

When girders or joists have sagging sections, these are usually noticeable on the floors above. During your interior inspection, if you find floors that are not level, you should be alerted to the possibility of sagging support beams. Sagging sections can be braced with adjustable screw-type columns to prevent further sag. The adjustable columns can be used for releveling sagging sections. This procedure, however, should be approached with caution. The leveling process introduces new stresses that in turn can cause cracking.

During the wood-framing inspection, you might find joists or girders that have been notched at the top or bottom to accommodate the passage of pipes. Notching a beam at the

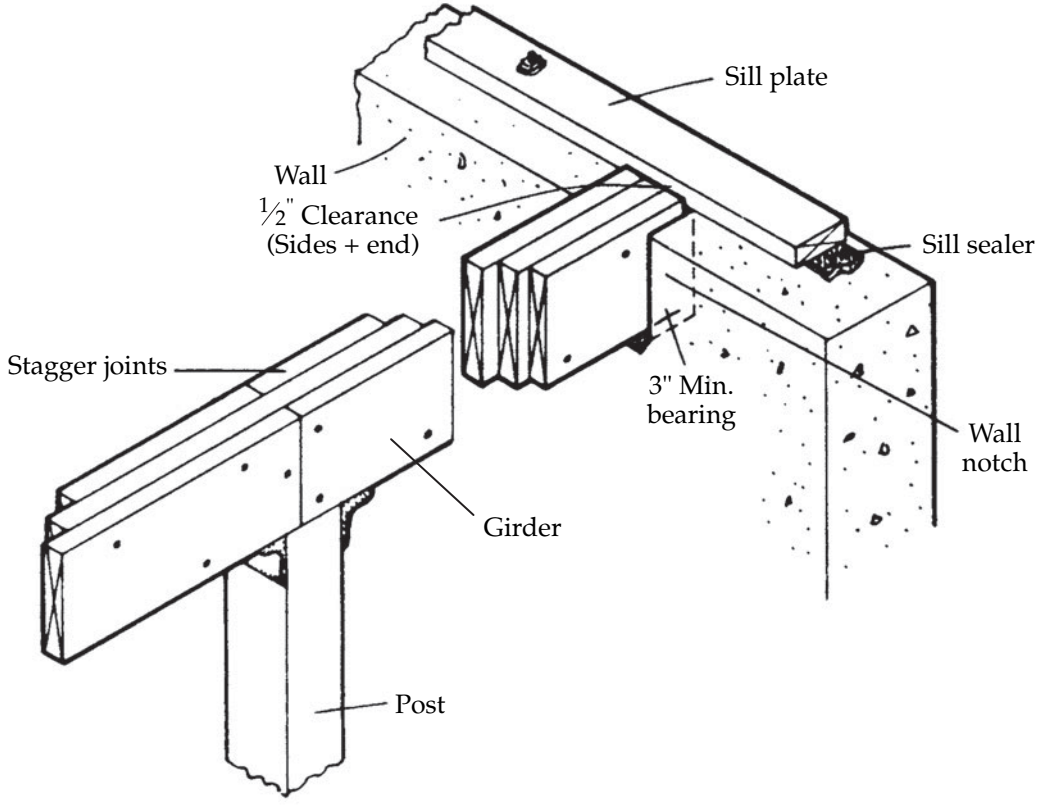


Fig. 11-4. *Notch at top of foundation wall to support the girder.*

top or bottom will reduce its strength. Just as a chain is as strong as its weakest link, a beam is as strong as its narrowest section. For example, if a 2-by-8-inch joist is notched to a depth of 2 inches, its strength will be reduced to that of a 2-by-6-inch joist. When a beam deflects, the top of the beam is in compression and the bottom is in tension. At a point approximately midway between the depth, the stresses change from one to the other so that at this point there is no compression or tension. Consequently, if a hole is cut midway between the top and bottom of a beam (as long as the hole is less than one-fourth the depth), there will be no effective reduction in strength. (See FIG. 11-5.) Using the above example, if a 2-by-8-inch joist has a 2-inch hole in its center, it will still be as strong as it was without the hole. If you find any notched beams, look specifically for signs of excessive deflection. This is an indication that reinforcement or bracing of the beam is necessary.

Fig. 11-5. *Hole in center of beam width does not effectively reduce beam strength.*

Engineered lumber Engineered lumber has replaced solid-sawn lumber as the framing and structural support member of choice by builders in many newer homes and in homes that are currently being built. The decision is based on the fact that although the lumber is initially more expensive, the total installed costs are less than that of dimensional lumber. The following products fall in the category of engineered lumber: glued laminated (GLULAM) beams, laminated veneer lumber (LVL), I-joists, and open web truss-joists. The advantage of engineered lumber is that it is stronger, stiffer, and more dimensionally stable than solid-sawn dimensional lumber. GLULAM beams and wood I-joists can carry greater loads over longer spans than is possible with solid-sawn lumber of the same size. Because of their "I" cross-sectional shape, wood I-joists weigh up to 60 percent less than solid lumber joists, making them easier to handle. They generally do not shrink, warp, cup, crown, or twist.

When inspecting the floor framing I-joists, look specifically for problem conditions such as notches in the flanges or holes in the webs that are larger than manufacturer's recommendations. Holes less than 1.5 inches in diameter are generally okay as long as they're not on or into the flange. In certain applications where joists line up under a load-bearing partition, depending on the load, there may be web stiffeners between the flanges of the I-joists. Web stiffeners are used to prevent problem conditions such as the web buckling out of plane or "knifing" through the flange. Also squash blocks are used in situations where there is a load-bearing wall above that is stacked over the wall below. The squash blocks transfer the load from the wall above to the wall below without relying on the joists for this support. (See FIG. 11-6.)

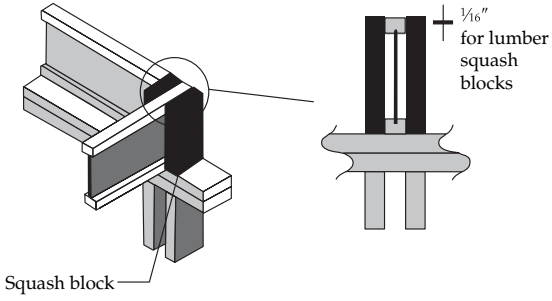


Fig. 11-6. *Squash block installation.*

Check to see if the rim boards are solid lumber or engineered lumber. Only engineered lumber should be used with I-joists. Solid lumber typically has a higher moisture content than engineered lumber, and if used as rim boards, the shrinkage can cause the I-joists to carry the wall load, which could cause web failure.

Most building codes require cross or solid bridging between the floor joists. (See FIG. 11-7.) The purpose of bridging is to hold the joists in a vertical position and to transfer the floor load from one joist to another. Cross bridging consists of pieces of wood or preformed metal set in a diagonal position between the joists to form an X. Solid bridging consists of solid blocks set between the joists. While inspecting the overhead floor joists for rot, insect damage, notching, and sagging sections, you should also check for the presence of bridging. If it is missing, record the fact on your worksheet for later installation.

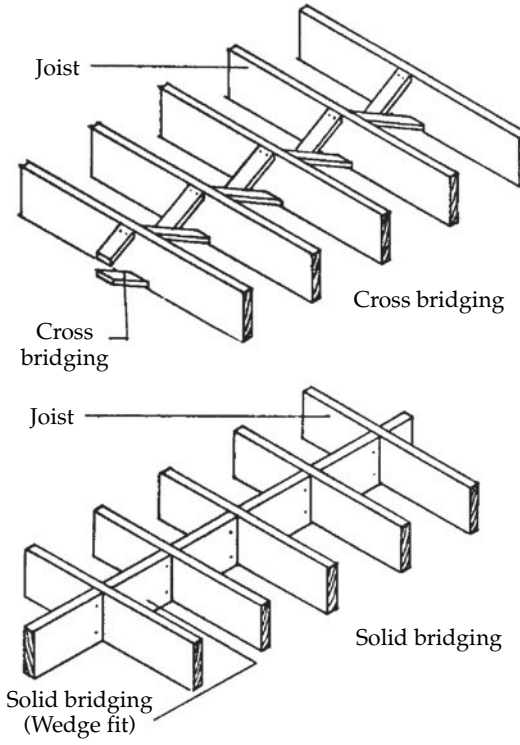


Fig. 11-7. *Bridging. Cross and solid bridging between floor joists. Cross bridging can be wood or metal.*

Dampness

In many parts of the country, the basement or lower level might be damp during portions of the late spring and summer. Dampness in a basement is a normal phenomenon that occurs because cool air cannot hold as much moisture as warm air. It does not necessarily indicate that the basement has a water problem. The temperature of the air in the basement or crawl space during the late spring and summer is always cooler than the outside air. Consequently, when outside air infiltrates into the basement through open windows, doors, cracks, or joints, the temperature of that air drops. This cooler air cannot hold as much moisture and results in a higher relative humidity of the air that entered the basement. Depending on the temperature and the amount of moisture present in the air, some moisture might condense on cool surfaces such as foundation walls and cold-water pipes.

Sometimes water droplets on the foundation wall caused by condensation are erroneously diagnosed as caused by seepage through the wall. If you see a damp-wet foundation wall, you can easily check whether the condition is

caused by seepage or condensation. Simply fasten a small piece (4 by 8 inches) of aluminum foil to the foundation wall. Using wide strips of an adhesive tape, seal all the edges of the foil to the wall. After the foil has been on the wall for at least twenty-four hours, examine its surface. If it is moist, the condition is caused by condensation. However, if the foil surface is dry and the area behind the foil is damp, the condition is caused by moisture seeping through the foundation wall from the outside. Of course, it is possible for both the foil and the wall to be damp, indicating both seepage and condensation.

Dampness in a basement or crawl space should be controlled. It can produce conditions conducive to the growth of mold and decay fungi. Dampness can often be detected by musty odors or a clammy, close feeling. In the drier portions of the country, normal dampness (not caused by seepage) in the basement can be controlled by opening the windows and ventilating the area. However, in areas where the climate is hot and humid during the summer, the benefit gained by ventilating the area is lost by the introduction of moist air into the basement. In these areas, the dampness in the lower level can be controlled with one or more electric dehumidifiers. Most of these units have a humidity control that automatically shuts the dehumidifier off when the moisture content in the air reaches a preset level. Depending on the weather and the size of the dehumidifier, the unit might have to run for many hours during each day in order to wring out sufficient moisture from the air so that it is not uncomfortably damp.

Water seepage—causes and control

Depending on the topography, drainage conditions of the soil, and groundwater level (water table), the basement or crawl space might be vulnerable to water seepage. *Water seepage*, as used herein, is a general term that refers to water intrusion into the lower level of the structure. It might manifest itself as a small wet area, a puddle, or layer of water completely covering the floor. If the ground under and around the house is wet, water can seep into the basement through cracks and open joints in the foundation walls or floor slab. Since water seepage can be caused by a number of factors and water can leak into the basement at any number of locations, it is important to determine the cause and source of the seepage so that the proper corrective action can be taken.

For example, if water is entering the basement through the foundation walls, installing a sump pit and pump below the floor slab will not correct the problem. Similarly, if water is seeping into the basement through the floor slab, sealing the walls will not correct the water-infiltration problem. All too often the unsuspecting homeowner is talked into a full waterproofing job, which can cost several thousand dollars, when all that might be needed is to redirect the water discharging from the roof drainage system (gutters and downspouts) so that the water does not accumulate around the foundation.

High groundwater level

Water entering the basement through the floor slab is an indication that water pressure is being exerted on the underside of the floor. When the level of the water below the house is sufficiently high (due to a seasonal high water table or improper drainage) so that it pushes on the underside of the floor slab, it seeps into the basement through cracks, open joints, or porous sections of the slab. If the pressure is great enough, it can cause the floor to crack and heave.

If the seepage is minor, it can often be controlled by sealing cracks and open joints

with a hydraulic cement and coating any porous areas of the slab with a cement-base or epoxy sealant. However, a better solution would be to lower the level of the water below the floor slab. This can be done by installing a sump pump below the slab. Subsurface water then flows into the sump pit in the manner of water flowing into a hole dug at the seashore. The water is then removed by the pump and discharged either into a storm drain or at a point sufficiently far from the house so that it will not be absorbed by the ground and flow back under the basement floor slab.

Depending on how the floor slab was constructed, a single sump pump might or might not be adequate to lower the level of the subsurface water. In areas with a seasonal high water table, a concrete floor slab should be installed over a gravel base. Water that accumulates below the slab can then flow through the voids between the gravel and drain away or flow into a sump pit. However, in many houses the floor slab has been installed directly over soil with poor drainage characteristics or over an inadequate gravel bed. In this case, water in the saturated area below the slab will not readily flow into a sump pit, and to control the water buildup, it is necessary to install a series of perforated drainpipes below the floor slab that terminate in the sump pit. Caution should be observed when lowering the level of the groundwater below the basement floor. With some slow-draining soils such as silts and clays, some soil can wash out from around the foundation footing. This can result in unequal settlement, which could crack the walls. Whether a sump pump or drainpipes are needed below the floor slab is an evaluation that should be determined by a professional.

If the house is located in an area with a high incidence of power failures, you should not depend solely on an electrically driven sump pump to control groundwater seepage. It is possible for the power to be knocked out when the water level below the floor slab is rising. As a precautionary measure, there should be an auxiliary backup sump pump in the sump pit. A backup system is particularly helpful in vacation homes where the house will be vacant for extended periods. One type of backup pump is a water-actuated (non-electrical) ejector pump. The Zoeller Pump Company, Louisville, Kentucky, manufactures this type of pump. The pump is connected to the house water supply and is activated by a float control. However, it will be of no help if the water to the house is supplied by an electrically driven well pump. If you install a water-actuated sump pump, it's important that you include a backflow preventer on the water supply because of the potential for contamination as a result of the cross connection. Another type of backup system is a battery-operated sump pump. This system will take over automatically to protect against flood damage when the power fails. The Zoeller Pump Company also manufactures this type of system.

Hydrostatic pressure—walls

Water seeping or leaking through the foundation walls into the basement is due to a hydrostatic pressure being exerted on the walls by saturated soil. This condition is the result of water accumulation around the foundation. The best way to control this type of problem is to minimize the amount of water that accumulates around the foundation. The following are some of the more common causes of water accumulation around the foundation, which can easily be detected and corrected by the homeowner.

- *Missing or defective gutters and downspouts to handle the rain runoff from the roof.* The downspouts must discharge the water

away from the structure. All too often, an elbow or splash plate at the base of a downspout is missing, so that the water is discharged directly around the foundation.

- *Improper grading.* The ground immediately adjacent to the structure should be pitched so that it slopes away from the building. Around many homes this area is incorrectly pitched, resulting in surface water (rain or melting snow) collecting around the foundation.
- *Unprotected basement-window wells.* The area around basement windows, if not shielded from rain or serviced with a drain, can easily accumulate water that can leak through window joints or seep down around the foundation.
- *Uneven settlement of walkways or patio.* Occasionally I find that the walkways around the house or the patio have settled and are sloping toward the house. As with improper grading, this condition can cause surface water to collect around the foundation.
- *Leaky garden spigots.* Most homes have exterior-mounted spigots for connection to a garden hose. If the valve is faulty or is not tightened properly, water will drip or leak around the foundation. Water dripping at a rate that fills 1 cup per minute results in 90 gallons of water per day accumulating around the foundation. This water enters the basement through cracks or open joints in the foundation wall.

When the house is located on an inclined lot, surface and subsurface water flows toward the house from the higher portions of the lot. In this case, depending on the incline and the amount of water involved, water-flow control measures will include grading the lot on the high side, so that there is a swale to collect and redirect surface water around the house, and installing a French drain (curtain drain) below the ground to intercept subsurface water and direct it away from the house.

If the amount of water that accumulates around the foundation walls is not excessive, it can be prevented from penetrating into the interior by sealing cracks and open joints on the inside walls with a hydraulic cement and then coating the walls with a cement-base or epoxy sealant. Coating the wall is particularly helpful when the wall is porous, like a cinderblock wall. However, when an excessive amount of water accumulates around the foundation wall, as with a poorly drained soil such as clay, waterproofing the exterior surface of the basement walls might be more effective than treating the interior surface. In addition, a perforated drainpipe is normally installed near and parallel with the foundation footing. (See FIG. 6-5.) The purpose of this footing drain is to carry away water that is accumulating around the foundation and thereby reduce the hydrostatic pressure.

For the footing drain to operate properly, it must have a free-flowing outlet. I know of several cases where builders installed faulty footing drains around houses during construction. The problem was that the drains completely encircled the houses like a doughnut and had no free-flowing outlets. These footing drains were of absolutely no value. Even though initially a footing drain might function properly, over the years it can malfunction because the perforations in the drainpipe or the outlet become clogged. Also, many a footing drain has been damaged during a later modification of or addition to the structure. If the house has a footing drain, you should ask the owner to show you the location of the outlet. The drain outlet should be kept clear and should be checked occasionally during a heavy rain to ensure that it is operating properly.

Even though waterproofing the exterior surface of the foundation wall is more effective than treating the interior surface, quite often an interior treatment is chosen because of the costs involved in excavating around the foundation and temporarily relocating trees and shrubbery. For excessive water accumulation around the foundation, an interior treatment includes sealing the cracks and coating the walls to make them watertight and installing a drainpipe along the foundation footing below the floor slab that discharges into a sump pit.

Just a word about waterproofing the exterior surface of the foundation wall using a pressure-pumping process that requires no digging or relocation of plantings: *Caution*. In this process, a sealant, pumped through tubes that are inserted into the ground, is supposed to coat the wall and render it watertight. The effectiveness of this treatment depends on the condition and porosity of the ground around the foundation. Since contractors doing this work do not always take test borings and analyze the soil, the process is usually not effective, and additional measures are invariably necessary.

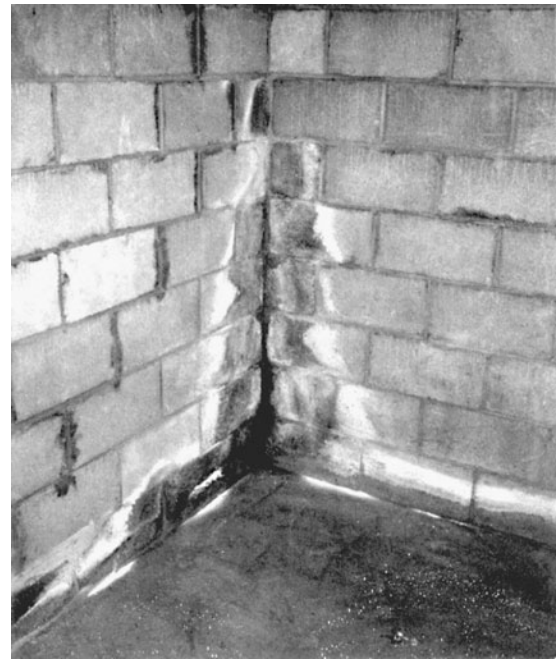


Fig. 11-8. *Water stains and mineral deposits (efflorescence) in the corner of a foundation wall.*

Inspection

The inspection for water seepage into the basement or crawl space should begin during your exterior inspection. As you walk around the house, record on your worksheet the location of those conditions that can cause water to accumulate around the foundation: faulty gutters and downspouts, improper grading, settlement of walkways, and so on. When you go into the basement, if there are problem conditions on the exterior, the walls and floor opposite those areas should be checked first for signs of water penetration. Figure 11-8 shows water stains and deposits in the corner of a foundation wall as a result of a faulty downspout. Even if there are no indications of past or current water seepage, the exterior problem conditions should be corrected.

A basement can have a water-seepage problem and be dry when you look at it. Many clients have told me that there were no seepage problems in the basement. After all, they looked at the basement during a heavy rain and found it "bone dry." So how could there be a problem? Well, as previously discussed, there are many causes for water seepage, and depending on the cause, a single rain might not result in seepage. For example, if water penetrates into the basement through the floor slab as a result of a seasonally high water table and the basement is inspected when the water table is 1 or 2 feet below the high level, a heavy rain will not raise the groundwater level sufficiently to cause water to seep through the floor slab. It takes time for rainwater to percolate into the ground and raise the water table.

Water puddles or flooded areas in the basement are obvious signs of a water problem. In most cases, however, you will not see standing water, and you must then make an evaluation of whether there is a condition of water intrusion based on other, more subtle signs. Water-seepage signs indicate only that water has seeped into the basement in the past. They do not indicate the frequency of the seepage or its extent. Consequently, if you see indications of water seepage, you should not engage a contractor to waterproof the house immediately upon taking possession. If you do, it could prove quite costly.

First talk with the homeowner about the condition. It is possible that whatever it was that caused the past seepage has already been corrected. (If the problem was corrected by installing buried drainpipes or coating the outside surface of the foundation wall, the correction would not be visible.) If the homeowner indicates that the problem has been corrected, you should ask to see a copy of the paid bill. Or get the name of the contractor so that you can call to find out exactly what corrective steps were taken. Quite often a contractor provides a guarantee against water seepage. If there is such a guarantee, you should find out whether it is transferable.

The possibility exists that even though there are signs of water seepage, the actual seepage might occur very infrequently—such as only after an excessively heavy rain as might occur every few years. In this case, depending on the extent of the seepage and the projected usage of the basement, costly waterproofing measures might not be justified. The best approach when considering the correction of water seepage is to correct immediately any obvious problem conditions such as faulty gutters and downspouts, improper grading, cracks through which water is actively leaking, and so on. However, before undertaking any major water-seepage control measures, such as excavating and coating the exterior surface of the foundation wall, inserting perforated drainpipes below the floor slab, or trenching and installing buried drainpipes in the yard, you should live in the house for at least one full year. This will enable you to evaluate the degree and extent of the seepage over a full weather cycle. If it turns out that the year is particularly dry so that there is no seepage, well and good. Wait another year. By not taking a "shotgun" approach and waterproofing everything, as recommended by many contractors, you might be able to resolve the problem at a cost that truly reflects the work needed to stop the seepage.

Seepage indications in an unfinished basement When looking for indications of water seepage, you should check the walls, the floor, the joint between the walls and the floor, and the bases of all the items stored or standing on the floor. Specifically, look for white powdery deposits on masonry foundation walls and floor. (See FIG. 11-9.) The

Fig. 11-9. *Efflorescence and water stains on foundation wall.*

deposits, called *efflorescence*, are mineral salts in the masonry that dissolve in the water as it passes through the walls or floor. When the water evaporates from the surface of the walls or floor, it deposits these salts. A thick layer of efflorescence is usually an indication of considerable seepage.

Walls Look for efflorescence, peeling and flaking paint, and scaling sections (surface deterioration) on the foundation wall. Any one of these items can indicate some degree of seepage. Porous walls, such as those made of cinder blocks, may have damp spots. Masonry-block walls are constructed with interior voids. When the hydrostatic pressure on the exterior portion of the wall is high, the voids often fill with water. As a result, the wall might be quite wet to the touch. (Caution: This might also be caused by condensation.) Vulnerable areas for seepage are cracks and the joints around pipes passing through the wall, such as the inlet water pipe and the drainpipe leading to the sewer. Look closely at these areas for water streak stains and efflorescence.

A poured concrete foundation wall is supposed to be more watertight than a concrete-block wall. This, however, assumes that the poured concrete wall is properly constructed. Quite often, it isn't. If the entire wall is not constructed with a single pouring, the joints between the sections constructed with each pour are vulnerable to water leakage. I inspected a new house just after construction was completed. The inspection was performed during a heavy rain, which was opportune, although not planned. While inspecting the basement, I found water leaking out of the joint at the seam between the individually poured sections of the foundation wall. The builder's mason apparently had not properly prepared the joint for a new pour, and consequently a cold joint with a poor bond was formed.

Look for seepage in a poured concrete wall around the tie-rod holes—holes in the concrete wall around the small-diameter metal rods that are used to hold (tie) the forms together when the wall is being poured. More often than not, these holes have been patched over. Also, these tie rods can corrode away over a period of time and when below grade are vulnerable areas for water intrusion. Sometimes you see efflorescence and water streaks just under the hole or patched sections. Occasionally I find these holes plugged with corks. This is not considered a permanent patch, and if seepage should develop, they should be plugged with hydraulic cement.

Floors and floor joints A vulnerable place for water seepage is the joint between the foundation wall and the floor. Look closely at this joint as you walk around the entire basement. Water stains and efflorescence are an indication of seepage. (See FIG. 11-10.) You might find silt deposits at the joint. This is also an indication of some degree of seepage. The fine silt is in suspension in the water as the water seeps in from the exterior. When the water evaporates, the silt is deposited. If you find evidence of water seepage through the joint between the floor slab and the foundation wall, you should record it on your worksheet for later correction. The joint should be sealed with either hot tar or a hydraulic cement.

Cracks tend to develop in the floor slab near the base of metal columns. Look for these cracks and any other cracks in the floor slab. Specifically, look for water stains, efflorescence, and silt deposits. Cracks in basement floors are a common phenomenon and are generally caused by slight settlement or shrinkage in the concrete. Usually they are of no concern other than the fact that water can seep through them. Therefore, they should be sealed. However, if the cracks are extremely wide or show evidence of heaving, they are of concern and should be checked further. In all

Fig. 11-10. *Signs of water seepage at joint between floor slab and foundation wall.*

probability, a cracked and heaved floor slab is the result of water pressure being exerted on the underside of the slab by a high water table.

Some homes have a cleanout and trap for the house waste line located in a pit below the basement floor slab. The bottom of the pit should be dry. If it is wet, it is an indication of a high groundwater level or a crack in the drain line. Occasionally I find that the top of the cleanout is open. (See FIG. 11-11.) It should normally be plugged. Some homeowners remove the plug so that the open cleanout can function as a drain if the basement becomes flooded. This is definitely not the way to eliminate the water in a flooded basement. If the basement periodically floods and there is no drain in the floor, a sump pump can be installed in the lowest section of the floor. The water can then be pumped out of the basement.

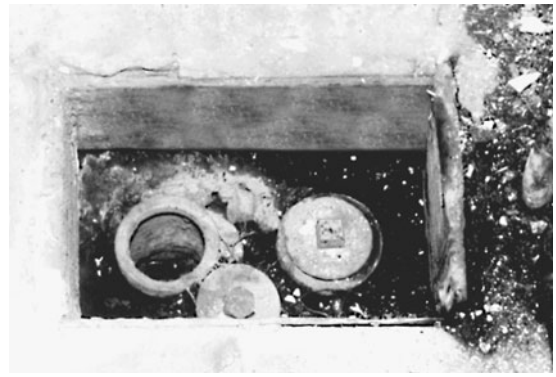


Fig. 11-11. *If the cleanout plug is removed, sewage can flood the basement.*

With the cleanout plug removed from the top of the house trap, the possibility exists that if the sewer line becomes overloaded (as is the case in some communities), sewage can back up and flood the basement. I know of several homes where this has happened. It was quite unpleasant.

Some people lose interest in a house when they find a sump pump in the basement. They think that the house has water problems. That is not necessarily so. There might have been periodic problems resulting from a seasonal high water table, but the sump pump might have controlled the water level. Or the pump might have been installed when the house was built in order to prevent a problem. To determine whether there still are problems, you must look beyond the sump pump. Look for signs of water seepage.

If the house has a sump pump, look down into the pit. If there is water in the pit and you are inspecting it during the dry season (the water table is usually highest during the spring), the sump pump will probably be operating continuously during the spring. Try to check the sump-pump operation. However, do not actuate a pump unless there is water in the pit. To check the operation of the pump and motor when there is no water in the pit, fill

the pit using a garden hose or gently tip in a couple of large buckets of water. If you notice that the water is disappearing into the ground or under the slab before the pump has a chance to activate, wrap a plastic sheet around the wall of the pit. You may have to line the pit bottom with plastic as well. When you actuate the pump, watch the water level to see if it drops. You might find that the motor that drives the pump is operational but the coupling between the pump and the motor is broken. In this case, it will sound as if the pump is working, but it is not, and the water level will not drop. A sump pump is relatively inexpensive and can be repaired or replaced easily.

Although a sump pump is sometimes located in the low section of the floor (when it is being used to collect surface water), it should not be located where it will present a tripping hazard. (See FIG. 11-12.) The pump can be placed in a corner where it will not take up valuable floor space and can be connected to the low spot in the floor by a drainpipe placed below the floor slab that discharges into the sump pit.

Check to see where the sump pump effluent discharges. It should not discharge into the house drain, which in turn discharges into the sanitary sewer or, if there is one, the septic system. As discussed in chapter 6, the sump pump should discharge onto the lawn sufficiently far away from the foundation so as not to seep back into the house.

After inspecting the walls and the floor for signs of water seepage, you should check the bases of items stored or standing on the floor for water stains and rust. You might find that the walls and the floor of the basement appear to be freshly painted. If you see this, you should be suspicious because the new layer of paint will cover almost all the signs of a water-seepage problem. There are some areas, however, that are often omitted when painting the basement. These should be checked for water stains and rust. Specifically, look at the base of the steps leading to the basement and in particular the back of the bottom step. Also look at the base of columns. Wood columns might have stains or may be rotting, and metal columns might be rusting. The base of the inside portion of a

Fig. 11-12. *Sump pit in center of basement floor—a tripping hazard.*

furnace sheet-metal casing is often overlooked when painting. Look inside. Is there extensive rust? If there is, it might have been caused by a past flood. However, it could also have been caused by a faulty humidifier, so do not jump to a quick conclusion.

Seepage indications in a finished basement Usually the finished walls in a basement are a few inches or more away from the foundation walls. Therefore, seepage indications on the foundation wall will not be reflected in the middle and upper portions of the finished wall. Look at the bottom portion of the wall for signs of water intrusion. If the wall is paneled, look for rotted and warped sections and water stains. Sometimes there are grayish mold spots or mold fungi on the walls, a condition caused by excessive dampness. With a plasterboard wall, look for water stains and blackened areas and spots. The latter is mold and mildew. In some cases, the lower portion of the plasterboard wall might have deteriorated.

Next, look at the floor. If the floor is raised above the level of the concrete floor slab, the wood flooring and the wood-framing members used to raise the floor are vulnerable to rot in the event of seepage. The wood framing below the floor should be pressure-treated but often is not. Try to walk all over the floor, especially around the perimeter. If there are any rotting sections, they will feel soft and spongy beneath your feet. If the floor is covered with resilient tiles, the rotting sections might be visible, since the dampness in the wood tends to loosen the tiles. (See FIG. 10-4.)

An area that is particularly vulnerable to water seepage is the portion of the basement that faces a yard where the overall topography is inclined toward the house. Even if the ground adjacent to the house is graded properly, there will still be subsurface water moving toward the house. The walls and the floor of the vulnerable section should always be checked for signs of seepage. Sometimes this is quite difficult; some homeowners might inadvertently (or intentionally) block the area with furniture. If the area is blocked, ask the homeowner if it is all right to move the furniture.

If the floor slab is covered with resilient tiles and there is a problem with heavy seepage through the floor, it is usually noticeable by looking at the tiles. The joints between the tiles become swollen and filled with a white crusting of mineral deposits (efflorescence). Some tiles become loose, and efflorescence is noted below them. Occasionally the tiles are covered with wall-to-wall carpeting. In this case, the tiles cannot be examined for signs of seepage. However, some checking for seepage can be done. Ask the homeowner for permission to lift the edge of the carpet off the tacking strip along a section of the exterior wall. If there is seepage in this area, the tacks will be rusted and the wood strips water stained or rotted.

If the basement is heated with baseboard convectors mounted on an exterior wall, another place to look for signs of seepage is below the convector. If there is some seepage in that area (the joint between the floor slab and the wall), the base of the convector will be rusted.

On occasion a portion of the basement might become flooded as a result of faulty plumbing, an overflowing sink or tub, a malfunctioning water heater, and so on. Flooding from the above is basically a one-time affair and will not cause the type of damage that results from repeated wetting. There will be water stains, but there usually will not be rot, peeling or flaking paint, efflorescence, or heavy rusting.

Furnace room

The heating plant in a house is normally a furnace or a boiler. (See chapter 14.) In this

chapter, the heating plant is called a furnace and the room in which it is located is called the furnace room.

In most homes, the furnace is located in the basement or lower level. It can be located in a large open area or confined in a relatively small room. In either case, the area around the furnace is considered a potential fire hazard. Consequently, there should not be any exposed wood framing in the ceiling or partition walls that are in close proximity to the heating plant. (See FIG. 11-13.) Exposed overhead floor joists or wall studs that are near the furnace should be covered with Type X fire-code plasterboard as a safety precaution. Sometimes I find that wood paneling has been installed around the furnace to make the area more attractive. However, it also makes the area more of a fire hazard, especially the portion of the wall around the chimney. (See FIG. 11-14.) If you find wood paneling near the furnace, you might consider covering it with fire-code plasterboard. There should be a minimum 2-inch clearance between the chimney and any wood framing or paneling. Note that the area around the furnace should not be used for storage. On many occasions I have seen combustible items actually stored against the furnace. Fortunately for the families involved, the items never ignited, but they could have!

Many heating systems have prefabricated chimneys that extend from the furnace room up through the interior portion of the structure, terminating above the roof. If the house has such a chimney, look at the joint between the chimney and the ceiling of the furnace room. If there are large openings, they represent a potential fire hazard and should be covered with a noncombustible material such as sheet metal. The open area around the chimney, if not properly blocked, can act as a flue and in the event of a fire in the furnace room, will draw the flames up to the attic.

While in the furnace room, also check for asbestos insulation around the furnace and heating pipes. (Asbestos as a health hazard is discussed in chapter 20.) The door to the furnace may be a louvered door. Depending on

Fig. 11-13. *Exposed wood joists above heating-system boiler—a potential fire hazard—should be covered with fire-code plasterboard.*

Fig. 11-14. *Wood paneling near furnace—a potential fire hazard.*

the local fire code requirements, louvered doors may not be permitted between the living space and the furnace room. The code may require that the door be fire rated. In this case check the adequacy of the ventilation; see below.

Ventilation

All fuel-burning heating systems must have adequate ventilation for proper operation. If the furnace is located in an unconfined space, the normal air infiltration into the area provides ventilation. However, when the furnace is located in a confined space such as a small room, inlet and outlet ventilation openings must be provided. The vent openings can lead directly to the outside or to a large unconfined area within the structure. The size of the openings depends on the total input (Btu/hour) rating of all the fuel-burning equipment in the enclosure. For most residential structures, an unobstructed inlet and outlet opening of 15 inches by 15 inches is sufficient.

If you would like to calculate the size of the vent openings needed, a safe formula to use is 1 square inch per 1,000 Btu/hour of input rating for both the inlet and outlet vents. The input rating will usually be found on a data plate mounted directly on the equipment. If the vent opening is covered by louvers, remember that metal louvers reduce the effective opening by about 25 percent and wood louvers by about 50 percent. An insect screen covering the louvers reduces the effective opening by another 25 percent.

Some homes have louvered entry doors to the furnace room, which provide the means for ventilation. Occasionally I find that for decorative reasons, the louvers have been covered over, blocking the effective ventilation opening. If the louvers have been covered, look for additional vent openings.

Crawl space

The foundation walls, piers, posts, and wood-support framing in a crawl space should be inspected (as described in the section on the unfinished basement) for deterioration, structural deficiencies, and evidence of water seepage. Pay particular attention to the wood-framing members that are very vulnerable to decay and termite infestation. (See FIG. 11-15.)

Many homes, however, have crawl spaces that are inaccessible and cannot be inspected. These homes were built in accordance with the Federal Housing Administration (FHA) Minimum Property Standards, which permit the ground level to be 18 inches below the bottom of the floor joists and 12 inches below the bottom of the girders. Even if there is an access opening to the area (see FIG. 11-16), the

Fig. 11-15. *Cracked and rotting wood-frame members in crawl space.*

Fig. 11-16. *Access hatch to crawl area.*

clearance in the crawl space is too low for a person to maneuver around easily and perform a detailed inspection. However, you should look into the area from the access opening (using your flashlight) to discover any obvious problems or problem conditions.

In most parts of the country, the crawl space will be quite damp, even though there are no problems with water seepage. The dampness is the result of the capillary rise of ground moisture. Unlike a basement where the ground is usually covered with a concrete floor slab, the floor in a crawl space is often bare earth. Even though the soil might appear dry and dusty, moisture can be present. In some soils, the capillary rise is more than 11 feet above the water table.

Dampness associated with capillary moisture can be effectively reduced by covering the ground with a vapor barrier, such as 4- to 6-mil polyethylene. Roll roofing is also a good vapor barrier, but it tends to deteriorate from fungi. If you do not notice a vapor-barrier ground cover, you should consider its installation.

To help minimize the dampness, the crawl space must be ventilated. There should be at least two vent openings on opposite sides

of the foundation with a total free area of 1 square foot for each 1,500 square feet of crawl space area, providing there is a ground cover. When no vapor barrier is used, there should be at least four vent openings (one on each side) with ten times the total free area. Look for vent openings. If you do not see any or they have been permanently blocked, put a note on your worksheet to that effect.

Crawl spaces are usually not heated. Consequently, unless there is some insulation between the floor joists, there will be heat loss between the heated room above and the unheated crawl area. Since moisture from the house can travel down through the floor, the insulation should have a vapor barrier on one side to reduce further moisture entry into the crawl space. The vapor barrier should be located above the insulation, facing the heated room (rather than below, facing the crawl area). If this vapor barrier is located below the insulation, the vapor will condense on its surface during cool weather. Depending on the amount of vapor, the resulting condensation buildup can reduce the effectiveness of the insulation. Look for insulation. You might find missing, loose, or hanging sections, which should be replaced or resecured. (See FIG. 11-17.) If you find uninsulated heating ducts or pipes in the crawl space, record this fact on your worksheet as a reminder to insulate the exposed sections.

Some homes are constructed with both a basement and a crawl space. In this case, the crawl space need not be vented to the outside but can be vented to the basement. Look for evidence of water seepage in the crawl space. Even though there might be no signs of seepage in the basement, there might be some in the crawl area. I recently inspected a home that had a combination basement–crawl space. The basement had been painted, and there were no visible signs of a past water condition. The crawl space was separated from the basement by plywood doors that were painted on the basement side and looked good. However, when I inspected the crawl space, I found evidence of a previous water condition. Apparently, the backside of the plywood doors (facing the crawl area) had not been painted over. There were water stains on the lower section. (See FIG. 11-18.) While in the crawl space, check subflooring and support joists below kitchen and bathroom fixtures for evidence of decay and plumbing leaks.

Fig. 11-17. *Loose, hanging insulation in crawl space.*

Conditioned crawl space

During your crawl space inspection, you may notice that the foundation walls are insulated, the wall vents are all closed, the dirt floor is covered with large plastic sheets, and the area is heated or air-conditioned. Basically the area is dry and comfortable. In this case the traditional crawl space has been converted to a conditioned crawl space. In the past few years, the concept of a conditioned crawl space has gotten some traction in the building

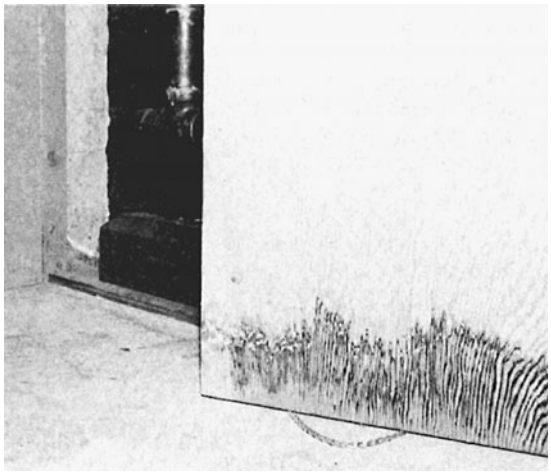


Fig. 11-18. Water stains on back side of entry door to a crawl area.

industry. Limited research has shown that a conditioned crawl space is more energy efficient than the traditional vented crawl space and will eliminate some of its problems. With a vented crawl space, warm, moist summer air will enter the cool crawl space and condense. This could lead to a buildup of mold and wood rot and is conducive to termite activity. During the winter months, the cold air could contribute to heat loss and freezing pipes. With a few minor changes, the traditional vented crawl space can be retrofitted and upgraded to a conditioned crawl space. The main concern is that the area must be kept dry. Prior to upgrading, all possible sources of water penetration into the crawl space must be corrected.

Checkpoint summary

Foundation

- ❍ Note foundation-wall construction type: poured concrete, precast concrete panels, concrete block, brick, stone, and so on.
- ❍ Check for cracked areas of concrete; crumbled and flaking bricks; cracked, loose, missing, and eroding mortar joints.
- ❍ Check for long open cracks that do not line up and have shifted sections.
- ❍ Note long, open, horizontal cracks and signs of bowing in the foundation wall.
- ❍ Are sections of the structure sagging and no longer vertical? (Consult a professional.)

Wood-support framing

- ❍ Inspect all vulnerable wood-support members (sill plates, girders, joists) resting on the foundation wall for rot and insect damage.
- ❍ Note floor joists or girders that sag or have notched sections.
- ❍ Is there bridging or blocking between the floor joists?
- ❍ Inspect wood columns, support joists, and subflooring for cracked sections and evidence of rot.
- ❍ Are there any notches in the flanges of I-joists? Any holes in the webs larger than 1.5 inches in diameter?

Water seepage

- ❍ Is the ground adjacent to the house pitched so that it slopes away from the structure?
- ❍ Are there concrete patios and paths that are improperly pitched (toward the house)?
- ❍ Are there basement windows or stairwells that are vulnerable to flooding?
- ❍ Do downspouts
  —have extensions?
  —discharge against the foundation?
  —terminate in the ground?
- ❍ Is there a sump pump?
- ❍ Is there water in the sump pit?
- ❍ Is the sump pump operational? Does the sump pump discharge into the house drain?
- ❍ Is the water being discharged away from the house or to a dry well?
- ❍ If the structure has been waterproofed, is there a guarantee or warranty available? Did you request a copy?

Basement walls

- ❍ Check for areas of scaling, peeling and flaking paint, damp spots, and signs of efflorescence.
- ❍ Check construction joints, tie-rod holes, and pipe openings for signs of seepage.
- ❍ Inspect wall paneling and base trim for stains, warped sections, and rot.
- ❍ Check underside of basement steps for water marks.
- ❍ Note areas of rust at base of metal columns and sheet-metal furnace casing.
- ❍ Check for dampness, noting musty odors and signs of mildew.

Basement floors

- ❍ Check for extensively cracked and heaved floor sections (usually the result of a high water table).
- ❍ Record all areas of active seepage and puddling.
- ❍ Check joint between foundation wall and floor slab for silt deposits.
- ❍ Check for porous areas and signs of efflorescence on floor and around perimeter.
- ❍ If floor is covered with tiles, are there swollen floor-tile joints?
- ❍ Is there efflorescence between joints?
- ❍ Inspect the house trap pit. Is it dry? Is the cleanout plug secure or loose?

Furnace room

- ❍ Check for exposed wood-frame members (wall studs, ceiling joists) that are in close proximity to the boiler or furnace.
- ❍ Check for large openings between the ceiling and the chimney.
- ❍ Is the room adequately ventilated?
- ❍ Check for asbestos insulation around the furnace and heating pipes.

Crawl space

- ❍ Inspect foundation walls, posts, and wood-support framing for deterioration and signs of water seepage.
- ❍ Check overhead subflooring and support joists for insect damage and/or rot.
- ❍ Check for adequate ventilation.
- ❍ Is this area damp?
- ❍ Is there a dirt floor? Is it covered with a vapor barrier?
- ❍ Is area insulated? Is insulation loose or incorrectly placed?
- ❍ Are there water-supply pipes that are vulnerable to freezing?
- ❍ Are there heat-supply ducts or pipes that should be insulated?
- ❍ Is the area conditioned crawl space?

12
Electrical system

Inlet electrical service 170
Electrical capacity 171
Fuses and circuit breakers 174
Inlet service panel box 175
Panel-box interior 176
Subpanel 176
Aluminum wiring 176
Grounding 177
Improper ground connections 177
Interior electrical inspection 178
Electrical outlets 178
Knob-and-tube wiring 180
Low-voltage switching systems 180
Violations 181
Checkpoint summary 181

The electrical system of a house can be compared to the nervous system of the human body. Just as every part of the body is supplied by nerves connected to the brain, every part of a house is (or at least should be) supplied by electrical wires connected to the inlet service panel box. These wires are called *branch circuits*. A proper electrical system is essential for a healthy house.

Inlet electrical service

The electrical service is provided through overhead wires or underground cables. If there are overhead wires, they can be seen around the outside of the house. These wires usually run from a utility pole to the house and are fastened to the structure at a point at least 10 feet above ground level. Count the number of wires coming into the house. If there are two wires (FIG. 12-1), the electrical service for the house is inadequate. Two-wire service provides only 110 volts, not 110/220 volts. There should be three wires coming into the house from the electrical service entry. (See FIG. 12-2.) Notice in FIG. 12-2 that the wires loop down before entering the weather-head. This is called a drip loop. It causes water that travels along the wires during a rain to drip down off the wire, thereby preventing it from entering the weather-head and flowing into the service entrance cable. Three-wire service provides 110/220 volts. In some cases, there might be four wires. Four-wire service also provides 110/220 volts but is

Fig. 12-1. *Two-wire inlet service provides 110 volts.*

Fig. 12-2. *Three-wire inlet service provides 110/220 volts.*

unusual in a residential structure. That service is three-phase and provides additional capacity, so that you may find it on some very large homes. It is usually found on a structure with heavy electrical demands such as an industrial or commercial building. The inlet service voltage might vary slightly so that in some areas it might be 120/240 rather than 110/220 volts. The difference is of no concern to the homeowner.

Before going into the house, look to see if any tree branches overhang or hit the inlet service wires. They should be pruned. Otherwise, the wire's outer insulation can be worn away, exposing the electrically hot conductors. This could be potentially dangerous if that section of conductors is within reach, as from an upper-level porch, or if it contacts a metal gutter.

While looking at the inlet service wires, check to see if they are securely fastened to the house and whether there are any frayed sections of the outer insulation. In many communities, the inlet service wire (from the attachment to the house to the electrical meter) is the responsibility of the homeowner, not the utility company. Service-entry wires that are badly frayed should be replaced because they can eventually result in a hazardous condition.

The inlet service wires, whether they are overhead or underground, terminate at the electrical meter, which can be mounted on the exterior or interior of the structure. The wires then run from the meter to a panel box, sometimes called the *service switch*. The panel box is basically a distribution center. The branch circuits throughout the house terminate in this box. See FIG. 12-3 for a generalized residential wiring diagram.

Electrical capacity

The unit of electrical power is called a *watt*. Watts are equivalent to volts times amps ($W = V \times A$). The electrical service that I have

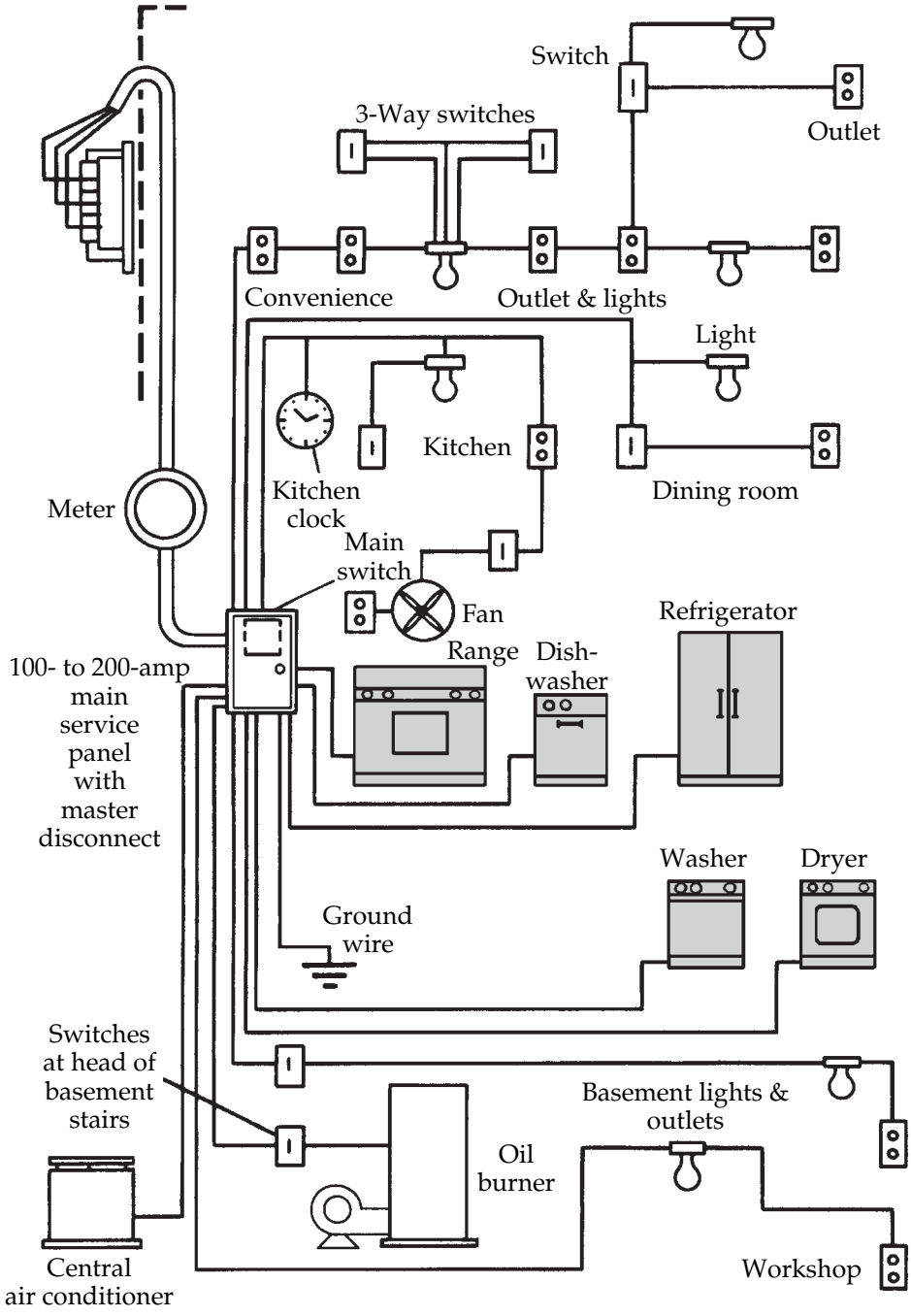


Fig. 12-3. *Generalized wiring diagram for a residential structure.*

found in houses and the corresponding equivalent power capacity is shown in TABLE 12-1.

In older houses, unless the electrical service has been upgraded, you are likely to find 30 and 60 amps at 110 or 110/220 volts. Any service less than 60 amps at 110/220 volts is considered inadequate. Homeowners with such electrical service might indicate that they have lived in the house for over forty years and have found the service totally acceptable. That might be true—for them—because they have adjusted to the lower electrical capacity by not using any major electrical appliances. Nevertheless, if you buy a house with low electrical service, you will probably have to upgrade the service after you move in.

The capacity of the electrical service should be great enough to satisfy the power requirements of the various electrical appliances to be used. Table 12-2 shows some typical

Table 12-1. Power capacity.

Amps	Volts	Watts	Evaluation
30	110	3,300	Inadequate
30	110/220	6,600	Inadequate
60	110	6,600	Inadequate
60	110/220	13,200	Marginal (small house only; no major appliances)
100	110/220	22,000	Minimum
150	110/220	33,000	Good
200	110/220	44,000	Very good

Table 12-2. Power requirements of appliances.

Appliance	Power requirement (watts)
Attic fan	400
Central air conditioning	6,000
Clothes dryer	4,500
Computer	200–400
Copy machine	1,300
Dishwasher	1,500
Fax machine	65
Forced-air furnace (electric heat)	28,000
Freezer	575
Garbage disposal	900
Hand iron	1,000
Instant hot water dispenser	1,000
Lamp (each bulb)	25–150
Microwave oven	500
Range, electric	8,000
Portable room heater	1,600
Printer	23
Room air conditioner	1,100
Sauna	8,000
Steam bath generator	7,500
Television (color)	150–450
Water heater	2,500–4,500

electrical appliances and their associated power requirements.

Considering the many electrical appliances that are available to the homeowner, the minimum electrical service is 100 amps at 110/220 volts. However, if the house is small and the intention is not to use many electrical appliances, 60 amps at 110/220 volts will probably suffice. When a house is equipped with an electric water heater, electric range, electric clothes dryer, and a central air-conditioning system, it should have at least 150-amp service. If electric heat is used in addition to the above appliances, the house should have 200-amp service.

Fuses and circuit breakers

The panel box contains either circuit breakers or fuses to protect individual branch circuits from an overload. Overloaded circuits are one of the chief causes of home electrical fires, and proper protection of branch circuits is essential. FIG. 12-4 shows a circuit-breaker panel box, and FIG. 12-5 shows a fuse panel box. Circuit breakers are more convenient than fuses. Once they have been tripped, they can be reset like a switch, whereas once a fuse has blown, it must be replaced. On the other hand, circuit breakers are somewhat less reliable than fuses. Circuit breakers have been known to "freeze" in the *on* position and should be manually tripped periodically to ensure operational integrity.

Is the panel box a Federal Pacific Electric (FPE) service panel? There have been numerous reports questioning the safety of this panel box and its Stab Lok circuit breakers. Some of the breakers have failed to shut off, or "trip," in response to an overload and arcing has occurred in the panel box. As a safety precaution, replacing the panel box is recommended.

It is important that the capacity of a fuse be matched with the current-carrying capacity of a branch circuit. When a fuse has been blown,

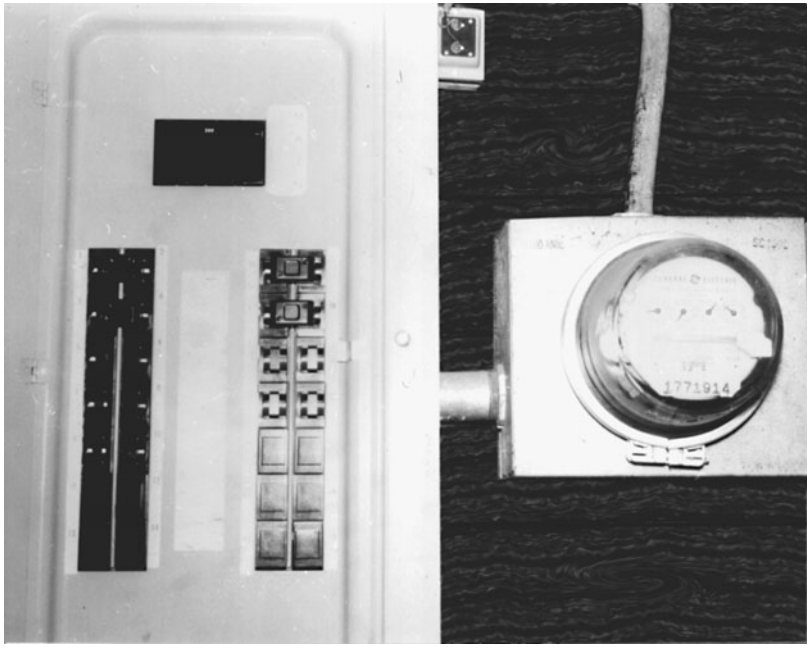


Fig. 12-4. *Circuit-breaker panel box with master disconnect.*

Fig. 12-5. Fuse panel box with master disconnect.

it must be replaced by a new fuse with the same current-carrying capacity. Too often, a homeowner replaces a 15-amp fuse with a 20- or 30-amp fuse, not realizing that all three are physically but not electrically interchangeable. In this case, if there is an overload on that branch circuit, the fuse will not blow, but the wires will become excessively hot and possibly cause a fire. This type of problem can be circumvented by replacing the fuse with a Fustat. (See FIG. 12-6.) A Fustat is basically a fuse with an adapter that fits into the fuse holder in the panel box. Once the adapter is inserted, it usually cannot be removed. The adapters are sized so that they accept only fuses of a specific current capacity and are not interchangeable.

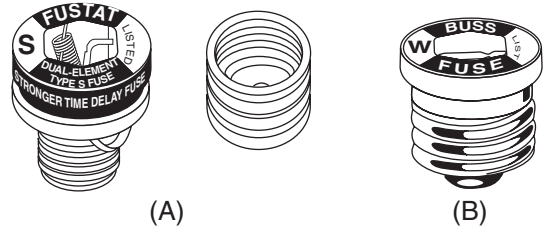


Fig. 12-6. A—Fustat with adapter; B—plug fuse. Bussman Mfg.

Fig. 12-7. Minibreaker/circuit breaker fuse.

There are also fuses that act like circuit breakers. (See FIG. 12-7.) Cooper-Bussmann manufactures 15- and 20-amp mini-circuit-breaker plug fuses that fit into any standard fuse socket. The minibreakers have a little push button that pops out when the circuit is overloaded. To reset the circuit breaker/fuse, simply push the button back in. The minibreakers are also designed for time delay to handle temporary starting loads so they do not trip unnecessarily when motors or appliances start up.

Inlet service panel box

Some panel-box covers have a door. If there is a door on the panel box, lift or swing it open. Warning: Do not remove the panel cover. The cover should be removed only by a professional inspector or electrician because of the danger involved with exposed electrically hot wires. Some homeowners remove the panel cover when doing home wiring and then forget to replace it. Others remove the cover and then

cover the panel box with a picture. They think this provides easy access. It does—for children too—and is very dangerous. Panel-box covers should be mounted and securely in place at all times.

When looking at the panel-box cover, note whether any knockout plates or fuses are missing. They represent a potential hazard; it is possible for a child to stick his or her finger in these openings and be electrocuted. If there are openings, they must be permanently blocked off. Check the size and number of the fuses or circuit breakers. There should be at least two 20-amp appliance circuits and one 15-amp lighting circuit for each 500 square feet of floor area. Anything less than this is not considered adequate. Also, if the branch circuits are protected by fuses, note if there are many blown fuses in the area indicating that one or more of the circuits might often be overloaded, a condition that might require installing additional branch circuits.

Panel-box interior

Because of the hazards involved, certain items should not be checked by the home buyer-owner, specifically those items found inside the main panel box. A professional home inspector or licensed electrical contractor checking the interior of the panel box can tell you whether the fuses or circuit breakers are properly sized for their respective branch circuits. Improperly protected branch circuits are found fairly often.

Once the panel cover has been removed, the actual inlet service capacity can be determined. It depends on the size of the inlet service wire only, not on the rated capacity of the panel box or the size of the fuse or circuit breaker used for the master disconnect, if there is one. Some municipalities require that the main electrical disconnect be located on the exterior of the house. Figure 12-4 shows a circuit-breaker panel box with a 200-amp master disconnect. A home buyer seeing this would normally believe that the house is supplied with 200-amp electrical service, and rightly so. In this case, however, the inlet service wire is too small to supply 200 amps. When the cover was removed, it was determined that the inlet service was 100 amps and that the master disconnect circuit breaker did not provide the overload protection.

Subpanel When finishing a basement or constructing an addition on a house, a subpanel is generally used to provide the needed branch circuits, rather than running those circuits from the main panel. During your inspection, you might see a subpanel. As with the main panel, because of the potential hazard, the home buyer-owner should not remove the subpanel cover. A professional home inspector or licensed electrician should check the interior to determine whether or not the grounding wire and the neutral are bonded together as in the main panel. They should definitely **not** be bonded in the subpanel. If you bond the neutral and ground on the same bus or ground bar at the subpanel, you create a parallel neutral current path that could energize all metal parts of the electrical installation. Whereas, by isolating the neutral from ground at the subpanel, any current would then go back to the main panel and go to the service ground.

Aluminum wiring

Inspecting the interior of the panel box also reveals whether aluminum wiring was used for the branch circuits rather than copper wiring. Aluminum wiring is considered a potential fire hazard. Between 1965 and 1973, about 1.5 million homes were wired with aluminum, which at the time was approved by the National Electrical Code. It was later found that dangerous overheating occurred at some of the connections in the 15- and 20-amp branch circuits, which resulted in fires.

If aluminum wiring was used, the electrical connections to the receptacles, switches, and

light fixtures throughout the structure should be checked by a competent electrical contractor to determine if they have been properly made or show evidence of problems. If the house does have aluminum branch circuits, you should be aware of the following trouble signs:

- Unusually warm cover plates on switches and outlet receptacles
- A distinctive or strange odor in the vicinity of a receptacle or switch
- Sparks or arcing at switches and outlets
- Periodic flickering of lights (sometimes traceable to faulty appliances or fixtures)

Correcting the problem does not require rewiring the house. Switches and outlet receptacles that are unmarked or marked AL/CU should be replaced with devices that are marked CO/ALR. Or existing switches and outlets can be used, provided short copper pigtails are attached to the ends of the aluminum wires and the devices. It's also necessary to connect light fixtures with copper pigtails. The home buyer-owner should not attempt to correct this condition.

Grounding

The electrical system must be grounded as a safety precaution. This means that a portion of the wiring in the main panel box must be deliberately connected to the ground. This is done by connecting the wiring to a grounding wire that in turn is clamped to a metallic inlet water pipe or to a rod driven into the ground.

Check to see if the electrical ground has been properly connected. There should be a wire coming out of the main panel box that runs to the inlet water pipe. Sometimes the wire is not visible, so go directly to the inlet water pipe. This pipe is located by the water meter (if there is one) and usually protrudes through the foundation wall or lower-level floor slab. The electrical ground wire should be clamped to the water pipe on the street side of the water meter. (See FIG. 12-8.) It might also be connected on the house side, but in such cases there must be a jumper cable running around the meter to the street side.

Improper ground connections

It is surprising how many houses have loose clamps on the water pipes, resulting in an improperly grounded electrical system. Many homeowners do not realize that the wire clamped to the water pipe is a grounding wire for the electrical system, and they loosen the clamp when making a repair or finishing the basement, often forgetting to reclamp the wire because nothing "apparent" happened when it was disconnected.

Look at the clamp. Is it loose? If it is, it must be resecured. This can usually be done with a screwdriver. Sometimes the clamp or screws have corroded and must be replaced. If there is no clamp or ground wire visible, you should question the integrity of the ground system. Sometimes the ground wire is clamped to a water pipe other than the inlet pipe. This procedure provides a false sense of security because a section of the pipe

Fig. 12-8. *Ground wire clamped to inlet water pipe.*

can be removed, causing an open circuit in the electrical ground. Some states require a jumper wire between the hot- and cold-water pipes that are connected to the tank-type water heater. This provides electrical bonding between the two pipes and prevents an interrupt in the ground circuit during that period in which the water heater is being replaced. These states may also require a jumper wire around the water meter (if there is one) and also around a plastic water filter in the main water line (if there is one). These requirements can be checked with the local authorities.

The inlet pipe to which the electrical ground is connected must be a functioning water pipe. This ensures that the pipe extends a considerable distance into the ground. According to the electrical code, the pipe should extend at least 10 feet into the ground. If a new inlet water pipe has been installed, the ground wire should be moved to the new pipe. Otherwise, there is no way of knowing how far the old pipe extends into the ground. Often, when replacing an old water pipe, the portion outside the structure is cut off at the foundation wall. This cannot be determined when looking at the pipe from inside the house.

When the inlet water pipe is plastic, as is often the case with a well, the electrical system is grounded by connecting the grounding wire to a rod driven into the ground. If this is the case, check the clamp connection and the rod. If either the clamp or rod is loose, the integrity of the electrical ground should be questioned.

Interior electrical inspection

Now that the basic system has been checked, walk around the interior portion of the house and determine the adequacy of the electrical distribution and possible violations.

Electrical outlets

Check each room for electrical outlets. You might feel that the number of outlets in each room is not very important. This is not so. If there are an insufficient number of outlets, the homeowner will tend to use extension cords. Most extension cords have a lower electrical current capacity than the outlet; and an overload on the extension cord can result in a fire rather than a blown fuse. Figure 12-9 shows one arrangement that is a potential hazard. The convenience outlet in the kitchen is capable of carrying 20 amps, whereas the extension cord can safely carry only 10 amps. Kitchens should ideally have 20-amp appliance outlets that are conveniently located (about every 24 inches) above a working counter.

The number of outlets needed for each room depends on the room's usage and the position of the furniture. Generally speaking, one receptacle outlet per wall for an average-size room (10 feet by 12 feet) is adequate. The outlets in larger rooms should be spaced so that no point along the wall is more than 6 feet (measured horizontally) from an outlet.

In addition to checking whether there are a sufficient number of outlets in each room, you should inspect the outlets to determine if they are functional and whether they are grounded properly. You can check the outlets with a simple plug-in tester available at electrical supply stores. Do the outlet receptacles have two or three slots? Newer outlets have three slots and are intended for use with appliances that have three-prong plugs, although two-prong plugs can also be used. The third slot is a grounding connection for grounding appliances. This is particularly important for appliances that are not double-insulated or have a metal casing. (See the discussion on electrical outlets in chapter 10.) Even though an appliance has a three-prong plug and requires grounding, it can be used with a properly grounded two-slot receptacle

Fig. 12-9. *The home wiring "octopus"—a potential fire hazard.*

with an adapter. There are, however, many electrical appliances that are double-insulated against shock hazards and thus do not require a grounding connection. These appliances can be safely used with outlets that have only two slots.

Bathrooms should have at least one, preferably two, outlets that are readily accessible. Often there is only a single outlet in the wall-mounted light fixture located above the medicine chest, which usually cannot be conveniently reached by anyone less than 6 feet tall. As a safety feature, the outlets and switches in the bathroom must not be reachable from the tub or shower.

According to the National Electrical Code, receptacle outlets in bathrooms, kitchens, garages, crawl spaces, and unfinished basements of new construction must have ground-fault circuit protection. The protection can be achieved by using a special receptacle or a circuit breaker that has been equipped with a ground-fault interrupter (GFI). A GFI is an electronic device that trips (opens) the circuit when it senses a potentially hazardous condition. It is very sensitive and operates very quickly. The GFI interrupts the power in less than 1/40 second if it senses an imbalance in the electrical current of as little as 0.005 amps. The quick response time in interrupting the power is fast enough to prevent injury to anyone in normal health. Ground-fault protection, however, is not a retroactive requirement and thus will probably not be found in most homes. If there is a GFI circuit breaker or receptacle, it should be tested to see if the fault-sensing function is operational. These units are equipped with manually operated test buttons that trip the circuit when they are operating properly. The GFI should then be reset. Underwriter's Laboratories, Inc., recommends that all GFIs be tested monthly.

In addition to circuit breakers that protect against ground faults, there is a new circuit breaker that protects against electrical arcing conditions, referred to as arc faults. Arc faults are considered one of the major causes of fires in the home. The circuit breaker is an arc fault

circuit interrupter (AFCI). It is designed to detect unexpected arcing in electrical wiring and disconnect the power before the arc generates a high temperature that can ignite nearby combustibles such as wood, paper, and carpets. Arc faults can occur in wiring or electrical cords where the insulation has become brittle or cracked, or where it has been punctured by staples or nails. It can also occur at a loose connection where wires are attached to switches and outlets, and where furniture has been pushed up against plugs. As with a GFCI, the unit is equipped with manually operated test button that will trip the circuit when the unit is operating properly. It is recommended that all AFCIs be tested monthly.

When walking through the hallways, rooms, and up and down steps, it should be possible to light the path ahead and to turn off the light without retracing one's steps. This can be done with three-way switches. Also, there should be a convenience outlet in hall areas for nightlights and cleaning equipment.

Knob-and-tube wiring

Knob-and-tube wiring is no longer used in new construction. However, since you might be considering an older house, the building might have knob-and-tube wiring throughout or in portions of the structure. A knob-and-tube wiring system uses porcelain insulating knobs, tubes, and flexible nonmetallic tubing for the protection and support of single-insulated conductors. (See FIG. 12-10.)

Obviously you cannot see the type of wiring behind the walls. However, very often there are exposed wires in the unfinished attic or basement. If there are exposed sections of knob-and-tube wiring, the outer insulation covering should be checked for broken and open sections. The insulation is often dry and brittle and chips easily. If there are exposed conductors, the exposed areas must be covered with electrical tape as a safety measure. Knob-and-tube wiring, although obsolete, is considered safe, providing that no modifications are made to that portion of the electrical system. If any changes or extensions are made, rewiring of that branch circuit might be necessary. All modifications to knob-and-tube wiring must be made by a licensed electrician. In addition, the outlet receptacles of a knob-and-tube-wired system are not grounded. Consequently, as a precautionary measure, they should be used only with appliances that do not require grounding.

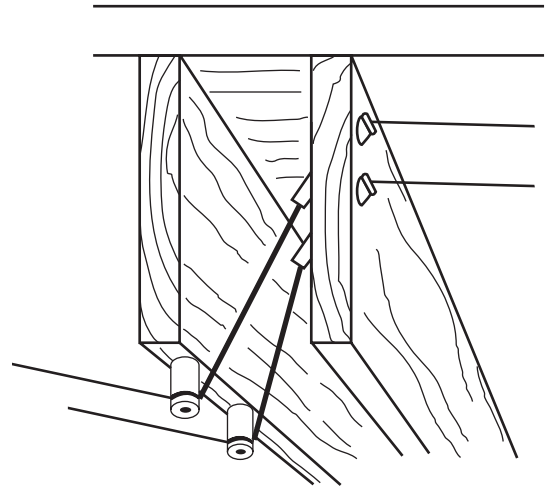


Fig. 12-10. *Knob-and-tube wiring, which is obsolete.*

Low-voltage switching systems

Light fixtures are normally controlled by switches that interrupt the electrical flow in a 110-volt circuit. However, in some houses, the light switches operate at about 24 volts. This type of wiring is generally installed so that the lights can be controlled from three or more locations. With this system, it is possible to control all the lights in the house from a master panel located anywhere in the house. The circuit for a low-voltage system includes a transformer

and an electrically operated switch (relay) that is usually mounted near the fixture. If your house has this type of system, make sure that there are replacement relays. Many electrical-supply houses do not stock these relays, and they would have to be specially ordered from the supplier. If you do not have replacement relays and a relay breaks down, you might be without light from that fixture for several weeks before the condition can be repaired.

Violations

Electrical violations should concern the home buyer-owner because they represent potential safety or fire hazards. As you walk around the interior and exterior of the structure, keep in mind those items that are considered common electrical violations. If there is an outside pole lamp, are the wires leading to the lamp buried? They should be. If a portion of the wire is exposed, is it stamped *UF—Sunlight Resistant*? This indicates that it can be used as exterior wire. Many times, homeowners unknowingly use interior-type wire as exterior wire. This is quite dangerous because sun, rain, or soil conditions can cause the insulation covering the wire to deteriorate, exposing the conductors. Incidentally, if there is an outside pole lamp, it should be turned on to see whether it is operational. If it is not, the problem may be as simple to correct as changing the bulb or replacing the switch. However, there might be faulty underground wiring. Do all of the outside electrical outlets have exterior-type covers that provide protection against water penetration? Although not a retroactive requirement, it is recommended that all outside lights and outlets be protected with ground-fault interrupters.

Inside the house, particularly in the basement, look for open junction boxes, loose wires, and exposed wiring and splices (unless the wires are low voltage). Recently, an inspection of a four-story multifamily brownstone walkup in New York City revealed several violations in one circuit located in the basement. The wire coming from the panel box was rated at 15 amps, but it was protected in the panel box by a 30-amp fuse. The wire was hanging in loops from the basement ceiling and had open splices with exposed conductors (splices in a branch circuit should be contained in a closed junction box). One of the hanging loops with exposed conductors was resting on the inlet water pipe leading to the heating-system boiler, and the floor below the pipe was wet. You seldom run into a more dangerous condition. Yet there were ten families living in that house.

If the wiring looks makeshift or appears to have been modified by a nonprofessional, you should request that the seller provide you at contract closing with the Board of Fire Underwriters' certificate of approval for the electrical wiring currently in the house. In your area, the Board of Fire Underwriters might be called by a different name, or a private commercial service might be used.

Finally, when walking through the house, see if all of the receptacle outlets and switches have cover plates. They should. Also, when using an extension cord, the homeowner sometimes runs the cord through the inside of a partition wall. This is a violation of the electrical code. If an outlet is needed, a permanent one should be installed.

Checkpoint summary

Exterior

- ❍ Is electrical service provided by underground cables or overhead wires?
- ❍ Are overhead service wires securely fastened to the house?
- ❍ Count the number of service wires. Note that a two-wire service provides only 110 volts, not 220 volts.

- ❍ Inspect inlet service wires for cracked, missing, and frayed sections of insulation.
- ❍ Note overhanging dead tree limbs or branches in contact with service wires.
- ❍ Inspect for exterior-mounted main panel boxes. (Replacement on the interior is recommended.)
- ❍ Check outside electrical outlets for weather protection.
- ❍ Inspect exterior wiring for proper type. It should be marked *UF—Sunlight Resistant*.
- ❍ Inspect exterior lights and outlets for operation.
- ❍ Note inoperative fixtures or fixtures that are missing, loose, or hanging by wires.

Interior

- ❍ Inspect main panel box. Is it a fuse or circuit-breaker type?
- ❍ Are the GFCIs operational, and are there any AFCIs?
- ❍ Is it a Federal Pacific Electric service panel box?
- ❍ Does system contain a main disconnect?
- ❍ Note the following (do not remove the panel cover):
  - — Loose or missing cover.
  - — Missing knockout plates or fuses.
  - — Are there at least two 20-amp appliance circuits?
  - — Is there at least one 15-amp lighting circuit for each 500 square feet of floor area?
  - — Are there many spare or burned-out fuses present?
- ❍ If panel-box cover is removed by an electrician or an inspector, he should inform you of
  - — the amount of service;
  - — circuits that are improperly protected (overfused);
  - — circuits that have aluminum wiring;
  - — evidence of water leakage or corrosion deposits.

Grounding

- ❍ Inspect electrical system for proper ground protection.
- ❍ If there is a municipal water supply, is the ground wire from the main panel box fastened on the street side of the water meter?
- ❍ Inspect the connection for tightness of fit and corrosion.
- ❍ If the inlet water pipe is plastic (often in a well-pumping system), check on the exterior for a rod or pipe to which the ground wire should be clamped.
- ❍ Note whether the ground wire is missing or has a loose or corroding section.

Interior wiring, outlets/switches, violations

- ❍ Does house contain old or obsolete wiring (i.e., knob-and-tube-type wiring)?
- ❍ Inspect for cracked and open sections of insulation.
- ❍ Inspect wiring in basement and attic areas for
  - — loose and hanging sections;
  - — extension-cord-type outlets;
  - — open junction boxes;
  - — exposed splices;
  - — makeshift or nonprofessional alterations.
- ❍ Inspect each room for electrical outlets
  - — at least one outlet in the bathroom.
  - — at least one outlet per wall for an average size room (10 by 12 feet).
- ❍ Are outlets functioning (electrically hot)?
- ❍ Check for loose outlets, switches, and missing cover plates.
- ❍ Are stairways and hallways adequately lit?
- ❍ Are there three-way switches?
- ❍ Are there outlets in the hallways for nightlights and cleaning equipment?
- ❍ Note violations such as
  - — open splices;
  - — fixtures hanging by wires;
  - — extension-cord wiring that passes through partitions or around door openings.

13
Plumbing

Water supply and distribution 184
Fixtures 185
Drainage system 185
Waste-disposal system 186
  Cesspool 187
  Septic system 187
    Alternating drainfields septic system 190
    Mound septic system 191
Exterior inspection 191
  Vent stack 191
  Fresh-air vent 192
  Lawn sprinkler systems 192
  Septic system 193
Interior inspection 193
  Fixtures 193
  Cross-connection 193
  Water pressure, flow 194
  Plumbing wall hatch 194
  Pipes 195
    PEX (plastic) pipe 195
    Polybutylene pipe 196
Basement inspection 197
  Water-supply pipes 197
  Distribution piping 198
  Drainage pipes 199
Well-pumping systems 202
  Wells 202
  Well pumps 203
    Piston pump 203
    Jet pump 203
    Submersible pump 204
  Accessory equipment 205
    Storage tanks 205
    Pressure switch, gauge, and relief valve 206
General considerations 206
Checkpoint summary 207

As with the electrical system, the major portion of the plumbing system is concealed behind the walls and below the floors. Nevertheless, the part of the plumbing system that is accessible for inspection permits you to make a meaningful evaluation of its condition. A basic plumbing system consists of a water-supply source, distribution piping, fixtures, drainage piping, and a waste-disposal system. Figure 13-1 shows the layout of a plumbing system for a typical one-family, two-story house.

Water supply and distribution

Water is supplied to the property line from the street water mains of the local utility company. At the property line, there is a shutoff valve called a *curb valve* that can be used to control the water supply to the

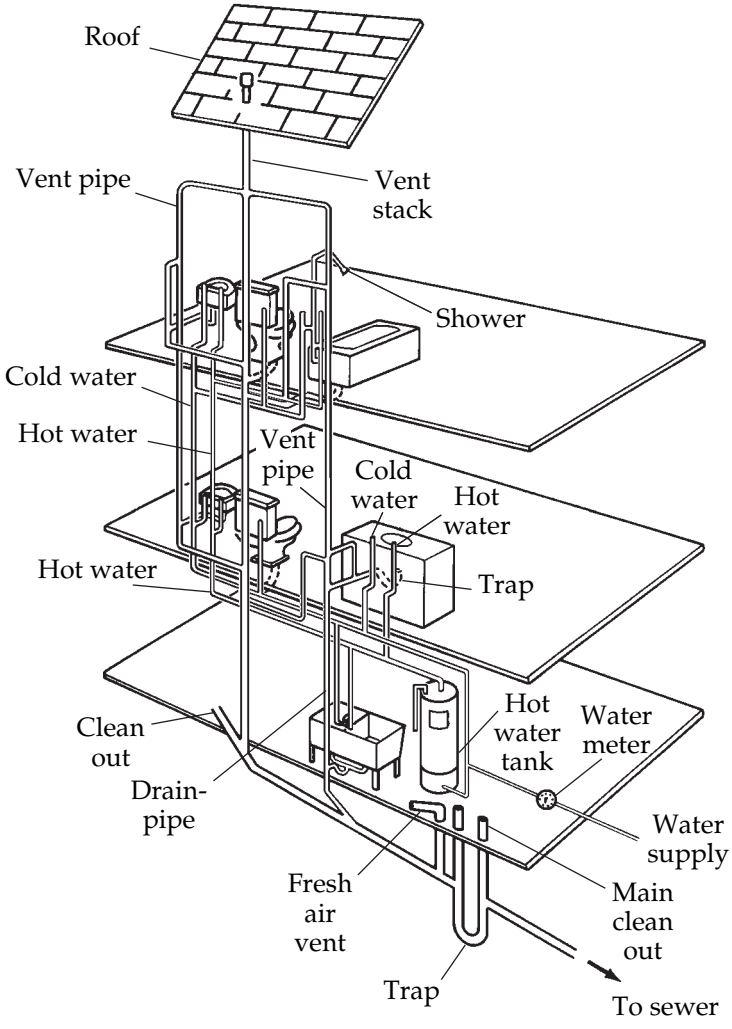


Fig. 13-1. *Plumbing system layout, showing water supply, drain and vent pipes for a typical one-family, two-story house.*

house. If you do not pay your water bill on time, the water company can close this valve. The pipe that actually delivers the water to the house, the *house service main*, runs from the curb valve to just inside the house and is the responsibility of the homeowner. Should this pipe need repair or replacement, it is at the homeowner's expense. If water is not supplied by a utility company, it will be supplied by a well-pumping system.

Inside the house, the cold water is distributed to the various fixtures located throughout the house. At the house inlet, there is a shutoff valve that the homeowner can use to close the water supply for the entire house. If there is a water meter in the system, it will usually be located inside the house near the inlet before any branch connections. Sometimes it is located near the curb valve. The cold-water pipe has a branch connection (usually near the inlet) that directs a portion of the water to a heater for generating the domestic hot water. The water heater can be a separate stand-alone unit or part of the heating system and is discussed in chapter 16. Distribution piping for the hot water will run from the heater to the various fixtures. The hot-water pipes are very often near and parallel to the cold-water pipes. However, they should be at least 6 inches apart so that the heat from the hot-water pipes does not affect the temperature of the cold-water system.

Fixtures

Plumbing fixtures are located at the end of the water supply and the beginning of the drainage system. They provide a means by which the water brought into the house can be used. Depending on their purposes, the fixtures have either hot water, cold water, or both. They also have a drain for the removal of the waste water. This waste water is channeled away from the fixtures through drainpipes to a sanitary sewer or a private sewage-disposal system such as a septic tank or cesspool.

Drainage system

The drainage system is more complex than the water distribution system, since it consists of three parts—traps, drainpipes, and vents. The drainage system begins just below the fixture with a water-filled trap. The trap is generally U-shaped and should have water at the bottom portion. The water in the trap forms a seal to prevent sewer gases usually in the drain line from entering the room.

The wastes flow from the fixture trap down the drain line and out to the sewer or private sewage-disposal system. Unlike the water distribution system, where the flow is under pressure, the drainage-system flow is entirely by gravity. Consequently, the drainpipes are larger in diameter than the water pipes, varying from 1½ inches to 4 inches, compared to ⅜ inch to 1 inch for the water pipes. In some communities, the house drain line leading to the sewer must have a house trap. The trap is usually located inside the house near the foundation wall. Its purpose is to provide a seal and prevent the gases that occur in the sanitary sewer from circulating back through the plumbing system. When there is a house trap, there should also be a fresh-air inlet pipe connected to the main drain. This air inlet pipe is located on the house side of the drain approximately 1 foot from the trap. (See FIG. 13-2.) In cold climates, it is located about 5 feet from the house trap to prevent the water seal from freezing during the winter. When the outer end of the fresh-air inlet terminates on the outside of the foundation wall, it should be covered with a perforated metal plate that admits the air and prevents obstruction. When it is freestanding, it should be covered with a cowl or gooseneck. (See FIG. 13-3.) The

Fig. 13-2. *House trap on main drain line leading to a sewer. Fresh-air inlet pipe on house side of the trap terminates on the outside of the foundation wall.*

function of the fresh-air inlet is to maintain atmospheric pressure at the house trap and to ensure complete air movement within the drainage system. With a private sewage system (septic tank), a house trap on the drain line is not needed. The gases that are generated in septic tanks are usually discharged to the atmosphere through the house drainage-vent system.

Venting is needed in the drainage system, since it provides a means to discharge to the atmosphere gases that develop in the system. It equalizes the air pressure in the drainage system by allowing air to flow into and out of the drainpipes. This free air movement maintains atmospheric pressure at the various fixture traps, which prevents the waste water from siphoning the water seal out of the drain trap. (See discussion on fixture traps in chapter 10, page 140.) Venting in the drainage system is achieved by vent pipes connected to the drain line near each fixture trap and to a pipe that terminates above the roof line. This pipe, called the *vent stack*, is visible from the outside. Vent pipes must be unobstructed. They carry no water or wastes.

Waste-disposal system

Waste disposal from a residential structure will be either through sewers connected to a community waste-treatment plant or through a private disposal system such as a septic tank or cesspool. When all other items are equal, a house with a sewer is more desirable than one with a private disposal system. Sewers are relatively maintenance-free. On occasion, there might be a blockage, which can usually be cleared at low cost by using a drain auger ("plumber's snake"). Maintaining a private disposal system, on the other hand, can be quite costly.

Whether the house is serviced by a sewer or is connected to a septic tank usually cannot be determined during an inspection. The house drain line passing through the foundation wall is the same regardless of whether there is an exterior connection to a sewer or to a septic tank. Since not all municipalities require a house trap on the main drain, the absence of a trap does not mean that there are no sewers. And just because there is a sanitary sewer in the street, it should not be assumed that the house is connected to the sewer line. Tying into the sanitary sewer (if the connection is permitted) is at the homeowner's expense. I know of several instances where homeowners elected to stay with their septic systems rather than go to the expense of tying into the sewer. In some communities, however, once a sewer

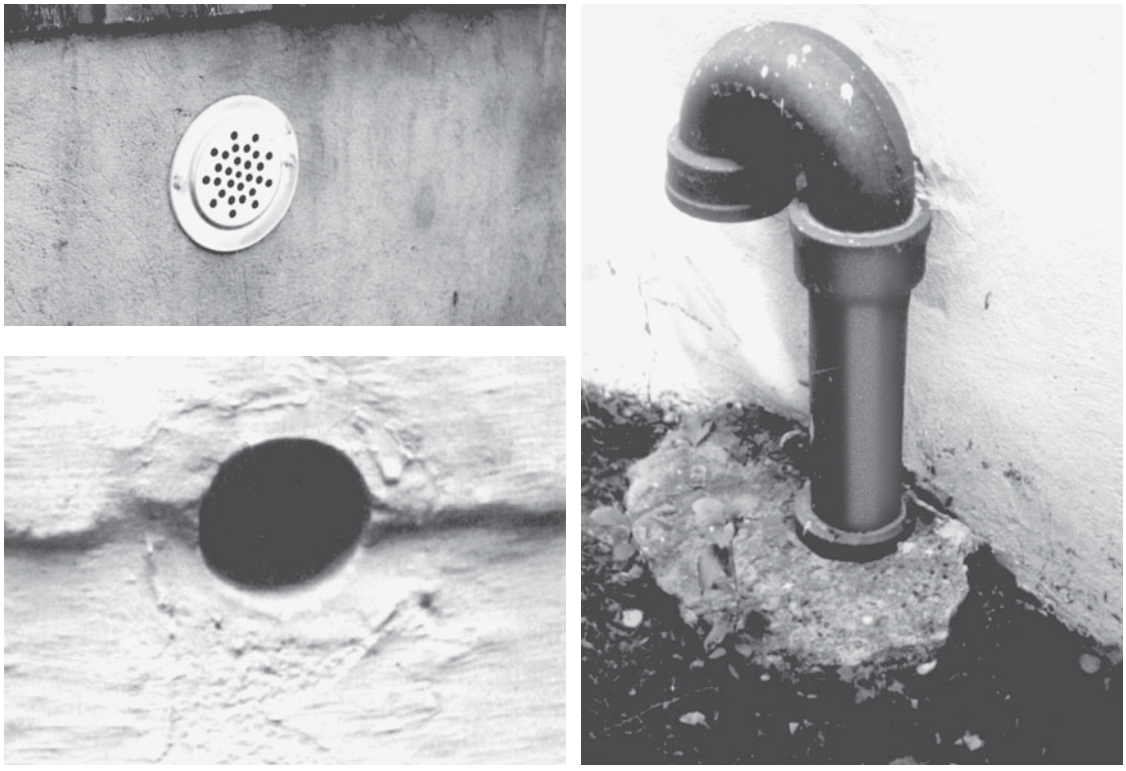


Fig. 13-3. *Terminations of fresh air vent: top left—perforated plate covers opening in foundation wall; bottom left—perforated cover plate for vent opening is missing, a common condition; right—a freestanding "gooseneck" cover.*

line is installed, all the homes on that street are legally obliged to connect. Your best bet is to contact the local municipal building department and ask them if this house is connected to the sanitary sewer system. It might save you a lot of aggravation later on.

Cesspool

A cesspool is basically a hole in the ground that has been lined with stone, brick, or some other material. It is constructed to allow raw contaminated liquid sewage to leach into the soil while retaining the organic matter and solids. Because of environmental and health considerations, most communities no longer allow cesspools in new construction. The older homes that have cesspool disposal systems are not required to upgrade them to septic systems as long as they are functioning properly. However, when problems develop, the homeowner is often legally obligated to replace the cesspool with a septic system rather than repair it. Depending on soil conditions, topography, and available space, the installation of a new septic system may cost over ten thousand dollars.

Septic system

The conventional septic system described below is the most common method of on-site waste water treatment and disposal in the

United States. It consists of a watertight container that functions as a detention tank for sewage sludge and a disposal field for the absorption of the liquid wastes. A septic tank is usually made of concrete but might be made of steel or fiberglass. Raw sewage from the house is discharged into the septic tank through the house drain line. (See FIG. 13-4.) After the sewage settles, the solids are decomposed by bacterial action and are converted into a liquid and a sludge that accumulates at the bottom of the tank. Several types of gases are by-products of the decomposition process, the most common of which is methane, an odorless and highly inflammable gas. The gases generated in the septic tank usually flow back through the house drain and are discharged harmlessly to the atmosphere at the roof-mounted vent stack.

When the level of the liquid (*effluent*) in the septic tank rises to the outlet port, the effluent flows through the outlet pipe to a drainage field. The drainage field, also called the *leaching field*, consists of a series of perforated pipes set into a bed of gravel. As the effluent flows through these pipes, it trickles through the perforations and is absorbed into the ground. The rate at which the ground absorbs the effluent (*percolation rate*) determines the size of the leaching field. When the topography changes abruptly or the area available for a leaching field is too small for adequate absorption, a seepage pit is used. It is basically a covered pit with an open jointed or perforated lining through which the effluent will seep or leach into the surrounding soil.

To determine the size of the leaching area needed for a house, percolation tests are taken in the area of the proposed sewage-disposal system. The rate of water absorption will depend upon, among other things, the type of soil and the level of the water table in that area. If the percolation tests are taken during a drought or when the water table is low (the

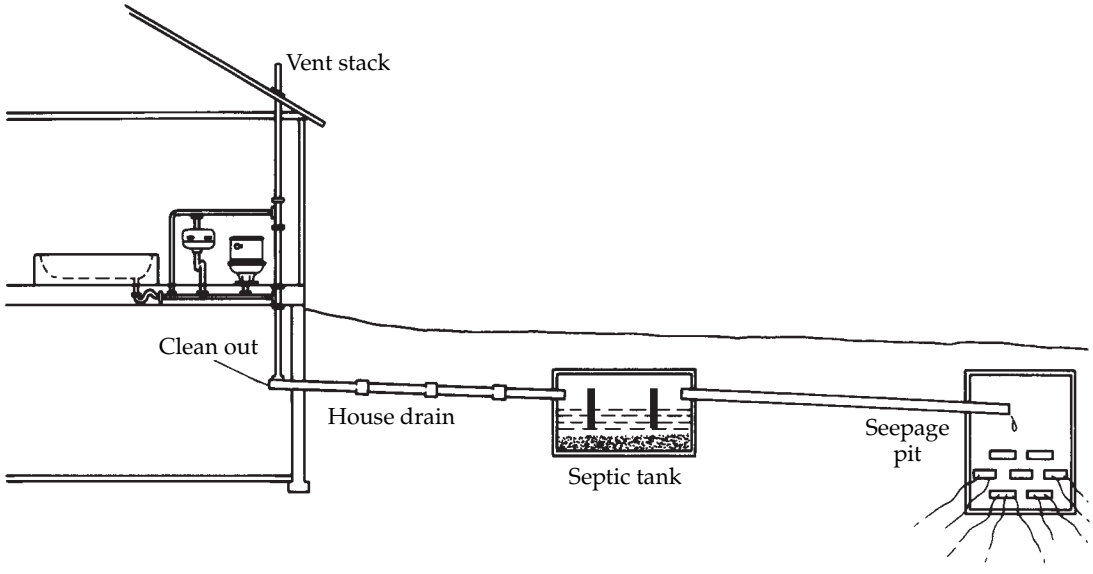


Fig. 13-4. *Typical septic system with seepage pit. Depending on the topography and amount of available land, the pit may be replaced by a leaching field.*

water table rises and drops during the year), the concluding data might result in designing an undersized leaching field that will cause premature failure of the septic system. I know of a village just northwest of New York City where the septic systems in hundreds of homes failed within eight years of installation, some of them within two years. A properly designed and maintained septic system should last between twenty and thirty years; indeed, fifty or more years is not uncommon.

Failure of the septic system will usually show up in the area of the leaching field and not necessarily over the septic tank, although there might be indications in both areas. Look for wet spots or a lush growth of grass. Both can be accompanied by an objectionable odor. When the ground in the seepage field becomes saturated and can no longer absorb the effluent, the liquid will build up and accumulate on the surface. The effluent contains nitrogen and other compounds that are natural fertilizers. When the effluent surfaces, it causes vegetation in the area, particularly grass, to thrive and have a lush green color. However, a healthy-looking patch of green grass over the leaching field is not necessarily an indication of a septic failure. During dry weather, when grass is apt to grow very slowly and turn brownish, the ground over the leaching field (depending on the depth of the field) often contains sufficient moisture to promote the growth of the grass and maintain the green color.

For the leaching field to function properly, there must be sufficient voids in the soil so that the effluent will be absorbed by the ground. Over the years, the voids can be filled with suspended solids, reducing the rate at which the effluent is absorbed into the soil to the point where the effluent surfaces. When this occurs, it is necessary to install a new leaching field. Aside from the cost, a serious problem can arise concerning how to handle the effluent when there is no more room on the property for a new leaching field or seepage pit. If the house has a septic system, find out if there is sufficient room for expansion of the leaching field should it be necessary at a later date.

Premature failure of the septic system can also occur as a result of neglect and abuse by the homeowner. A septic tank should be cleaned or at least inspected for sludge buildup every two to four years. If the tank is not cleaned periodically, the sludge will build up to such a level that the solids are carried out of the tank and into the leaching field. Eventually these solids will clog the voids in the soil or the perforations in the leaching-field pipes, blocking the normal flow of effluent. When this happens, the leaching field requires replacement. This type of problem can be avoided. Unfortunately, many homeowners neglect to inspect and clean the septic tank periodically.

On many occasions I have been told by an owner that the septic tank has never been cleaned. The owner knew from "experience" that if the septic system functioned properly, it was best not to disturb it. After all, his neighbor across the street had had his septic tank cleaned after fifteen years, and two weeks later the system failed and had to be replaced. If he had not touched the system, it would have been all right, wouldn't it? No! That system apparently had been on the verge of failure before the cleaning. The cleaning had nothing to do with the failure.

Occasionally septic systems can operate satisfactorily for many years without the tank being cleaned. In those cases, the tank might have been grossly oversized for the number of people living in the house, or, perhaps the house was used as a vacation home and occupied only part of the time. One method of extending the life of a septic system is to reduce the volume of water that passes through the tank and leaching field. This is

often done by installing a separate drain line for the waste water from fixtures such as the washing machine and connecting it to a dry well or seepage pit that is located away from the leaching field.

Sometimes the homeowner indicates that he has not cleaned the septic tank because he has been using a chemical compound or septic-tank cleaner that he pours down the drain. This cleaner is supposed to improve bacterial activity and eliminate the need for periodic cleaning. The advertising claims for these cleaners are not well founded; there will always be a sludge buildup that must be removed. In addition, some of the cleaners might contain compounds that will actually reduce the bacterial process and can cause the system to fail.

To reduce the possibility of premature failure of the septic system, some homes are equipped with a grease trap in the waste-disposal system. The trap separates grease from the kitchen waste line, thus preventing it from entering the septic system. A buildup of grease in the system can result in clogging or reducing the porosity of the leaching field and can also affect the bacterial action in the septic tank. If there is a grease trap in the waste-disposal system of the house, you should be advised that for maximum effectiveness, it should be frequently cleaned or at least inspected for grease buildup.

Discharging large volumes of water into the septic tank, such as rain runoff from roof gutters or storm drains can over a period of time adversely affect the tank's operation. Large volumes of water can flood the tank, forcing suspended solids into the leaching field where they can eventually block the perforations in the pipes and clog the voids in the soil.

Depending on the soil condition, a water softener can be detrimental to a septic system. If the seepage field consists of a clay-type soil, the waste water from the water-softener regeneration process must not be discharged into the septic tank. The salt brine in the water-softener waste water is not broken down by bacterial action as it passes through the septic tank to the leaching field and can clog the voids in the fine-textured clay soil.

Even though a septic system might be faulty, there might not be any visual indications of a problem when you inspect the house. Whether there is a water (effluent) accumulation over the leaching area or septic tank will depend upon the dryness of the season, the usage of the plumbing system prior to the inspection, and the degree of deterioration of the septic system. One way to check the operation of the system is to "push" it by turning on the water in the tub and letting it run for about one hour. (Before you do this test, ask the owner for permission.) The tub drain must be open so that the water will flow into the septic tank. Assuming an adequate water supply, this pushing should introduce about 275 gallons into the septic system, which very often is enough to cause the effluent in a faulty system to surface and be visible when you reinspect the areas over the tank and leaching field. This test, however, can be misleading if the homeowner had the tank pumped out a few weeks prior to your inspection.

In addition to the conventional septic system described above, there are alternative septic systems available, which are installed when warranted by specific soil conditions, topography, and available space. Alternative septic systems are more complex and costly than conventional systems because of the use of pumps, alarms, and diverter valves. Two such systems are the alternating drainfields septic system and the mound septic system.

Alternating drainfields septic system This system is similar to the conventional septic system's drainfield design. However, as a result of alternating the drainfields, the overall system can be designed so that it takes up less

space than a conventional system. Because many municipalities have a requirement that there must be room for a 100-percent drainfield expansion, a smaller drainfield area is a desirable feature, since it will allow construction on small pieces of property, which were considered unusable.

When the drainfield is unsaturated, the treatment of septic effluent is enhanced. As the effluent passes into and through the soil of an unsaturated field, the aerobic bacteria digest the organics in the waste stream and form a filtering layer (a bio-mat) at the soil/gravel edge. On the other hand, saturated conditions and excessive amounts of organics in the effluent reduce the treatment capacity of the system. Excessive amounts of organics escaping from the septic tank can result in a bio-mat growing so thick it will actually prevent adequate water flow into the soil. Consequently, depending on the wastewater flow and the load of suspended solids, some drainfields become clogged and less effective, and in some cases, the fields fail. The alternating drainfields septic system resolves this problem by having two or more drainfields. This system is used primarily to overcome soils with restrictive percolation rates, such as clay. By switching from one field to the other every six months to a year, each drainfield can alternately be used and rested. The resting period causes the bio-mat, which eventually clogs the field, to deteriorate due to lack of nourishment, and allows the drainfield to completely drain, thus renewing the field. Switching from one drainfield to the other is done through a diverter valve, which is housed in a valve box on the effluent line from the septic tank. The valve provides for independent flow to one drainfield or the other, but not both. It must have a watertight lid or cover, which permits unobstructed access for maintenance, inspection, and operation.

Mound septic system Mound systems are used when there are problems with the site for the drainfield, such as a high water table, inadequate percolation rates, and a shallow soil cover over creviced or porous bedrock. This system consists of a septic tank, a dosing chamber or tank with a pump and a high water alarm, and a drainage field constructed in a mound that is raised above the natural grade to maintain a proper distance from the water table or bedrock. (See FIG. 13-5.) The dosing tank is placed between the septic tank and the mound and accumulates septic tank effluent. Float-type control switches inside the tank turn the pump on and off. Once the accumulated effluent in the tank reaches a predetermined volume, the pump delivers a "dose" of effluent to the laterals in the mound by an electrical control system. The mound can be 3 to 5 feet at its highest.

An adequate evaluation of the plumbing system requires an interior and an exterior inspection. Although most of the plumbing inspection is performed in the interior, an exterior inspection can reveal venting problems, violations, and septic-system problems.

Exterior inspection

Vent stack

As you walk around the house looking at the roof, look for a plumbing vent stack. If you do not see one, it indicates either that the plumbing system is not properly vented or that the vent stack terminates in the attic. Both possibilities are violations of the plumbing code. If the construction of the roof is such that there are sections that are not visible from the ground, a vent stack should be looked for during the attic inspection. If there is a vent stack, you will see a pipe coming up from the floor and going out through the roof. Sometimes it is

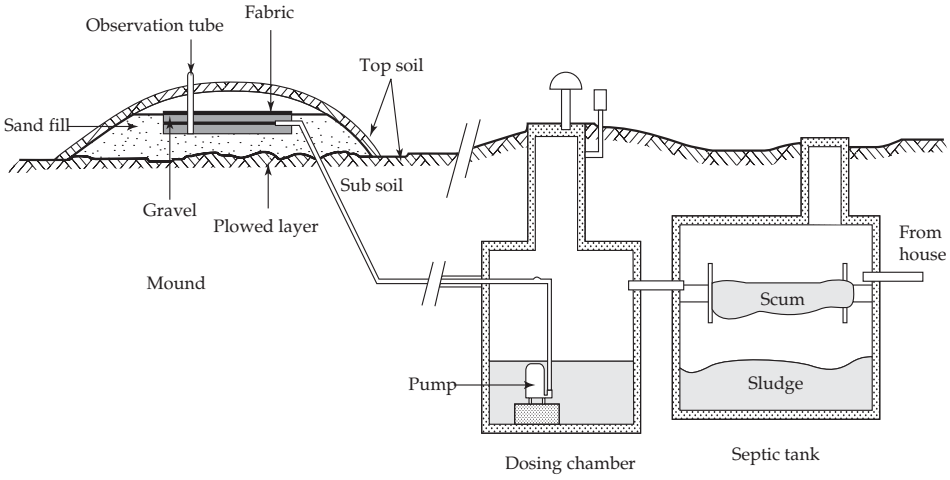


Fig. 13-5. *Schematic of a typical mound septic system.*

difficult to check for the vent stack in the attic because of the restricted space and the lack of adequate lighting.

The vent stack should terminate above the roof. If you see one that terminates near a window or one that runs up along the side of the building (in the northern portion of the country), it is in violation of the National Plumbing Code (as explained in chapter 3).

Fresh-air vent

When there is a fresh-air vent for the house trap, if the outer end terminates on the outside of the foundation wall, the opening should be covered with a screen or perforated metal plate. The covering is needed to prevent children from stuffing toys, balls, or other objects into the opening and blocking air movement. Technically, an unprotected fresh-air vent opening is also a violation of the plumbing code. If you do not see a cover over the fresh-air inlet vent, record the fact on your worksheet as a reminder for later installation. You should also use your flashlight to determine if there is any blockage.

Lawn sprinkler systems

Does the house have an underground lawn sprinkler system? If it does, look specifically for a vacuum breaker (antisiphon device) on the water-supply line for each zone. When the piping arrangement is such that the water is supplied to each zone through a manifold, the vacuum breaker should be on the pipe supplying water to the manifold.

A vacuum breaker is recommended to prevent dirty water or foreign matter that normally accumulates around pop-up spray heads from flowing back into the potable water supply as a result of a negative pressure in the line. It is a relatively simple device and is usually no larger than a few inches in diameter and a few inches high. (See FIG. 13-6.) The vacuum breaker has an atmospheric vent that is sealed when water is flowing to the spray heads. When the water pressure drops to below atmospheric pressure (vacuum) because of a problem in the supply line, a mechanical float drops, opening the atmospheric vent. This allows air to enter the piping system upstream of the spray heads

Fig. 13-6. Typical atmospheric vacuum breaker used in lawn irrigation systems. Rain Bird Sprinkle Mfg. Corp.

and thereby prevents dirty water at the spray head from being siphoned back into the supply piping.

Vacuum breakers must be located at least 6 inches above the level of the highest sprinkler head. Look for them near the foundation wall. Sometimes the piping is located in a well adjacent to the foundation, similar to a basement window well. Usually, the vacuum breakers and the electric solenoid valves that control the water flow to the various zones are in the same general area.

Septic system

If the house has a septic system, find out the location of the tank and the leaching area. As you walk around the house performing the general exterior inspection, look specifically for puddles over the leaching area and septic tank. If the puddles have a film on top and there is a foul odor in the area, you can be sure that there is a septic problem. If the puddle is a clear liquid and there is no odor, there might still be a septic problem. The best way to find out whether the liquid is septic effluent or surface water as a result of rain is to collect a sample and have it analyzed. If no puddles are noted during your initial exterior inspection, reinspect the area after "pushing" the septic system as described above.

Interior inspection

Fixtures

Since you will start your general interior inspection at the attic level and work your way down to the basement, the interior plumbing inspection will begin in the first room that has fixtures. (See the "Bathroom" section of chapter 10 for further discussion of plumbing.) The fixtures should be checked for general condition—cracked, chipped, and stained sections—and for operation. Do the faucets function properly, or are there leaks around the handles or spout? Is there an air gap between the spout and the top level of the water when the sink or tub is filled? There should be a gap to prevent back siphonage. Is the sink drain leaking or show signs of past leakage? Occasionally, you might find a pot below the drainage trap to catch dripping water. Sometimes you might find rubber-hose-type connections on the drain or a drain that has been taped up. These are makeshift corrections and require proper attention. Are there individual shutoff valves for the water supply to the various fixtures? Shutoff valves are not necessary but are desirable when making repairs or replacing the faucet. When you open and close the faucet rapidly, do you hear a "water hammer" noise? You shouldn't. But if you do, it can usually be corrected with an antiknock coil or air chamber. Are the toilet bowl flushing and fill valves operating properly? If you hear a whistling noise while the bowl is filling up, the fill valve needs adjustment. After the water closet (tank) has been filled, do you still hear water running? If you do, minor maintenance is needed.

Cross–connection

A cross-connection is where the potable water supply can become contaminated because it is connected to another source of water, which

may be nonpotable. Look for situations that could result in a cross-connection. Occasionally, in old homes I find that the faucet spout on the laundry sink extends below the sink's flood rim. This is a contamination problem waiting to happen. If the sink is filled with waste water from a washing machine discharge or some other source, and at the same time a partial vacuum is created in the municipal water supply, the waste water will be drawn back into the potable water, contaminating it. A vacuum can be created because of a number of reasons, such as when a work crew opens a water main to make repairs or when water is drawn from a fire hydrant to fight a fire. If you see this condition, recommend that the faucet be replaced with one where the spout is above the flood rim. The new faucet would create an air gap between the spout and any water in the sink, thereby preventing a cross-connection.

Water pressure, flow

After inspecting the fixtures, faucets, and associated valves, pay particular attention to the water flow and drainage. When there is a considerable flow of water from a faucet, most people say the pressure is good, and when the flow is merely a trickle, they say the pressure is bad. This is a popular misuse of the word *pressure*. It is true that if the pressure is low, the water flow will be low. However, a low-flow condition is not usually caused by low pressure. It is caused by a constriction in the inside of the supply pipes. Depending on the quality of the water, mineral or corrosion deposits can form along the inside of a pipe, reducing the effective pipe opening to that of a straw. In this case, even when the source pressure is good, the flow will be less than minimal.

Check the cold- and the hot-water flow separately by opening two faucets and flushing the bowl at the same time. If the flow appears to be less than adequate, record the fact on your worksheet as a reminder to check further. The low flow might be caused by a kink in the supply pipe, small-diameter distribution piping, or low water pressure at the service entry. However, the probability is greatest that the low flow is caused by a decrease in the inside diameter of one or more sections of pipe supplying the fixtures.

Old galvanized iron piping is particularly bad for water flow. In addition to mineral deposits, there is often a buildup of rust that further constricts the flow. If you find low water flow, especially in an older house, look for galvanized piping. You might find that the house has been partially repiped. Some iron sections might have been replaced with copper or brass. Mixing iron in a copper plumbing system is not desirable, for two reasons. First, just as a chain is as strong as its weakest link, a plumbing system is as good as the weakest section of pipe. Even a small section of iron pipe whose inside diameter has been reduced by a buildup of rust and mineral deposits will lower the flow of water discharging from a faucet. Second, when ferrous (iron) and nonferrous (copper) metals are in contact with each other, a galvanic action takes place between the metals that accelerates the corrosion of the plumbing system at the point of contact.

On occasion, in those homes that have water supplied by a well-pumping system rather than a local utility, you might find that the water discharging from the faucet has a pulsating flow. This condition is caused by a rapidly fluctuating water pressure and is the result of a waterlogged pressure tank. The condition, relatively easy to correct, is discussed on page 205.

Plumbing wall hatch

In many older homes, an opening in the wall of a hallway provides access to the plumbing pipes for the tub. The opening is usually no larger than 2 feet by 3 feet and often has a

wooden cover that has been painted like the rest of the wall so that it is not very noticeable. Sometimes this access hatch is in a closet or bedroom. If there is such a hatch, remove the cover. You should be able to see the water-supply pipes, the overflow, and the drainpipes. (See FIG. 13-7.) In newer homes a wall hatch that covers plumbing could also indicate modular construction.

Pipes

Water-distribution pipes can be made of copper, brass, galvanized iron, and more recently plastic (PEX). PEX piping will be discussed separately. Once you become familiar with the types of metal pipe, you will be able to differentiate between them very easily. Here are some pointers. Brass and galvanized pipe have threaded joints; copper joints are soldered. So if the pipe joints are threaded, you will know that they are not copper pipes. Do not try to determine whether the pipe is brass or galvanized by its color. There might be a dirt film on the pipe, or it might be painted. The easiest and most foolproof method is to use your magnet. If the pipe is made of galvanized iron, it will attract the magnet; if it is made of brass, it will not.

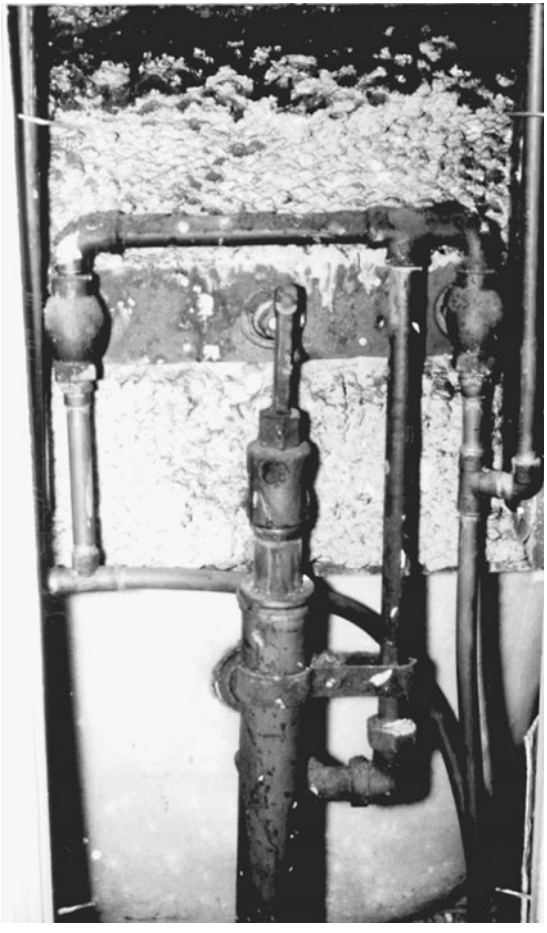


Fig. 13-7. *Wall hatch in hallway provides access to pipes for bathtub.*

Now look to see if the piping is a mixture of copper, brass, and galvanized sections. Even if there is no noticeable drop in water flow, mixed plumbing is not desirable because the resultant galvanic corrosion at the joints will eventually cause leakage. Figure 13-8 shows such a joint. The white encrustations on the pipe are mineral deposits left when the water oozing out of the fitting evaporated. Although deposits on this joint self-sealed past leakage, it is only a temporary correction, for the deposits can come loose at any time. Properly correcting this condition requires replacing the iron section with pipe of copper or brass.

PEX (plastic) pipe PEX piping (tubing) is made from cross-linked high-density polyethylene. Cross-linking is a chemical reaction that permanently links together polymer chains of the polyethylene. PEX was introduced in the United States in the 1980s, but was slow to catch on in the industry. It is now accepted by most municipalities and can be used for all potable water-supply lines, both hot and cold. It has a number of advantages over metal pipe. It is flexible, won't corrode or develop pin holes, has fewer connections and fittings, and is easier and faster to install. Because of its flexibility it is very freeze-break

Fig. 13-8. Mixed plumbing as seen from a hallway wall hatch. Some of the fittings are deteriorating (note the rust and mineral deposits).

resistant, and a 90-degree corner bend can be made without the need for elbow fittings. Also, PEX is considerably less expensive than copper pipe. PEX comes in three colors: standard white (unpigmented), red, and blue. The red and blue colors are used to help plumbers and homeowners distinguish between hot and cold water-supply lines. Unlike copper pipe, PEX piping does not require soldering at connection joints. There are two popular methods for making connections with PEX: one uses a crimping tool and a crimping ring to secure the tubing over a brass fitting, and the other uses an expansion tool, special expansion fittings, and plastic rings to secure the joints. As you walk around inspecting the pipes, check the exposed joints for signs of past or current leakage. If there is any doubt about the use of PEX tubing for plumbing applications in your house, contact the local authority with jurisdiction over plumbing to verify the acceptance.

Polybutylene pipe There is another plastic pipe that you should be aware of: polybutylene pipe. It's a gray plastic water-supply pipe that was used in the construction of millions of homes throughout the United States between 1978 and 1995. In the 1980s, complaints started to come in that leaks were developing around the fittings and in some cases the pipes were splitting. Some of the leaks were the result of improper installation such as overstressing the pipe at joints and fittings, and overbending the pipe into a tight curve. However, the majority of the leaks were caused by the deterioration of the pipe and/or the plastic fittings. It was determined that polybutylene pipe reacts with oxidants, such as chlorine, normally found in tap water. The reaction, which is internal to the pipe, causes it to scale, flake, and to become brittle, with micro fractures developing. As the pipe ages and reacts with water-soluble oxidants, the condition becomes more severe. Although from a visual inspection, assuming that there are no indications of leakage, the pipe may look to be in good condition. The problem is that since the deterioration is occurring within the pipe, it is very difficult to determine if the pipe is truly in good condition.

The best a home inspector can do if he/she finds polybutylene piping is to alert the buyer about its past history and to anticipate future problems.

Basement inspection

After inspecting all the fixtures, associated pipes, and fittings in the interior rooms, the rest of the plumbing inspection is carried out in the basement. Some homes are built on ground level and do not have a basement. In those cases, this portion of the inspection will be performed as part of the interior room inspection.

Water-supply pipes

Look for the entry of the water-supply pipe. It will be located near the foundation wall and will usually have a meter near the inlet. If you cannot find the water-service entry, ask the homeowner. Sometimes it is concealed behind boxes or storage shelves. The inlet service pipe will generally be made of copper, brass, or galvanized iron. However, in some older homes, you might find that the pipe is made of lead. A lead pipe can be detected by the type of joint between the sections. Lead pipes have wiped lead joints that appear in a horizontal section as a spherical bulge. (See FIG. 13-9.) There is usually a joint near the foundation wall. If you do not see a joint, you can gently scratch the surface of the pipe. If the pipe is made of lead, the surface will be relatively soft, and the scratch will expose an area with a silver-gray color.

Although a lead water pipe might be acceptable in a plumbing sense, it can be a potential health hazard. Depending on the quality of the water, some of the lead might dissolve out. Since the amount of lead that a person can safely absorb is limited and cumulative, by drinking this water over an extended period of time, the maximum tolerance level can be reached. If you find a lead inlet pipe, you should have the water analyzed for lead content. In many communities, the local health department will do the analysis free or for a very nominal charge. If the lead content is high, the pipe should be replaced. Again, remember that replacing the inlet pipe is not the responsibility of the water company; the cost must be borne by the homeowner.

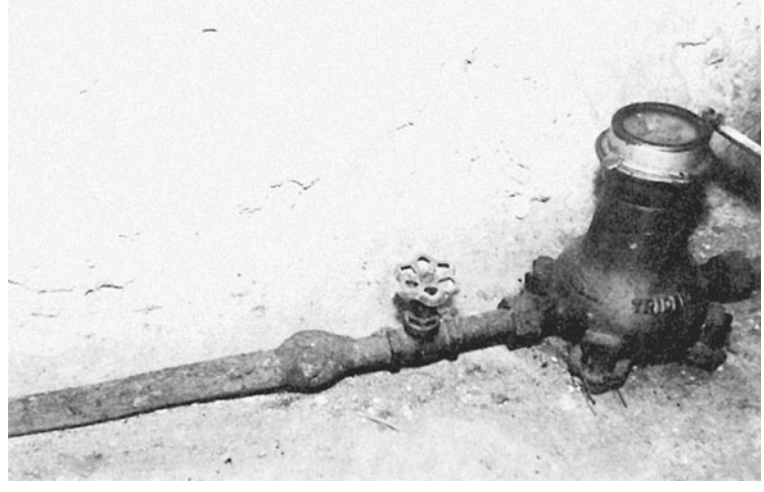


Fig. 13-9. *Lead inlet water pipe. Note wiped joint (bulge) near shutoff valve.*

During my inspections, I periodically find a lead inlet pipe. When I do, I always recommend to the prospective home buyer that as a precautionary measure the water should be analyzed. In one home, located in White Plains, New York, an analysis of the water revealed that it had seven times the allowable concentration of lead. Needless to say, that pipe was replaced.

If the water flow from the plumbing fixtures is low and the piping in the house is good (all copper or brass pipes and fittings with no leaks), the problem will be a constriction in the inlet water supply or low pressure at the street main. On several occasions, I have inspected houses where the old water pipes were completely replaced with new copper pipes and still the water flow was low. Further inspection revealed that even though the house had been repiped, the old galvanized inlet pipe had not been replaced. Under normal soil and water conditions, this pipe should last about forty years. As these pipes age, rust deposits build up on the inside, restricting the flow. Also, a galvanized iron pipe will eventually corrode from the outside and leak. Replacement can cost anywhere from several hundred to several thousand dollars, depending on the length of the line and ground conditions.

When domestic water is supplied by a utility company, the inlet pipe will lead directly to the house distribution piping. In some areas, depending on the quality of the water, there might be a water softener or a filter between the supply and distribution piping. Normally, however, you will not find a storage tank (similar to that needed in a well-pumping system) between the supply and distribution piping. If you do find such a tank, you should suspect a low-pressure condition at the street main. When the water pressure in the street main is low and there are simultaneous demands for water by the houses on the street, the flow to each house may be inadequate. To compensate for this condition, a storage tank is often installed to provide a reservoir to supply water during these periods. Water drawn from the tank is then replaced when the plumbing fixtures in that house are not being used. If you see such a tank between the inlet supply and distribution piping, record the fact on your worksheet.

When domestic water is not supplied by a utility company, it will be supplied by a well-pumping system. Such systems are discussed in the last section of this chapter.

At the house inlet side of the water-supply pipe, there will be a master shutoff valve that can close the water supply to the entire house. Sometimes there are two valves, one on each side of the water meter. See whether the valve is operational. Close and open it. Over the years, because of lack of use, the valve often freezes in the open position.

Distribution piping

Water is supplied to the various fixtures throughout the house by distribution piping. The distribution system begins by the inlet supply pipe just after the water meter and consists of two components: supply mains and fixture risers. The supply mains are usually suspended from the basement ceiling and can be readily inspected in an unfinished basement. The fixture risers run between the supply mains and the fixtures and are usually concealed behind the walls. For the most part, the risers cannot be inspected.

In addition to copper, brass, and galvanized iron pipes, most communities also allow the use of plastic (PEX) pipes for both hot- and cold-water distribution. Trace and inspect all of the exposed water pipes in the basement. You will find that there will be a branch takeoff pipe that leads to the domestic water heater, and if the house is heated by steam or hot water, there will be a cold or hot takeoff

leading to the boiler. As a point of interest, over the years, cold-water copper and brass pipes take on a darker color than the hot-water pipes. Sometimes you might find sections of cold piping "sweating" profusely. This is not a problem condition. It is merely condensation and can easily be eliminated by insulating the pipes or reducing the amount of moisture in the air with a dehumidifier.

Faulty plumbing does not necessarily mean that there is a steady stream of water leaking from a pipe or fitting, although if that is the case, immediate correction is necessary. Of particular concern are indications of aging and deterioration. Look specifically for signs of past and current leakage around fittings and valves. Look for mineral deposits, corrosion, and patched sections. The presence of galvanized iron pipes and fittings in a copper and brass plumbing system is a potential problem, as discussed previously. If you see iron pipes, you should make an estimate of the amount and anticipate their replacement. Copper pipes often take on a greenish cast, particularly around the fittings. Although this condition looks as if it could have been caused by water leaking from the joint, it is not. It is usually caused by the soldering flux. A leak, on the other hand, usually shows up as an encrustation of mineral deposits around the joint.

Brass pipes found in residential structures will usually be "red brass" or "yellow brass." You can often tell the difference by the color. Red brass, however, is not really red but a yellowish brown. Yellow-brass water pipes are more vulnerable to corrosion and dezincification (zinc leaching out of the brass into the water) than red-brass pipes. The projected life for yellow-brass pipes is about forty years; seventy-five years for red brass is not uncommon. The weakest part of a brass pipe is the threaded joint. With some older yellow-brass pipes, the threads are paper thin. If force is applied to one of the pipes (with a wrench during a repair or even by leaning on the pipe), the joint could easily rupture. Usually weak joints can be detected by a slight encrustation of mineral deposits. If you find encrusted joints on brass pipes, you should anticipate repair or replacement of those sections.

When the distribution pipes are brass, look along the length of the pipes for signs of leaks. Brass pipes are vulnerable to pinhole leaks along their length. Depending on its chemical quality, the water in the pipes can cause some of the zinc in the brass to dissolve. When this occurs, pinhole openings can be seen along the length of the pipe. Because of the small size of the openings, water drips from the holes very slowly. In many instances, the water will evaporate before it drips, leaving whitish mineral deposits around the opening. (See FIG. 13-10.) Eventually the deposits can self-seal the leak, although the pinhole openings will get larger.

I once inspected a house that had this problem. The owners had moved out in the beginning of the winter before they found a buyer. As a precautionary measure, water was drained from all of the pipes to keep them from freezing over the winter. My inspection took place the following spring when the water was turned on. The sudden surge of pressure in the pipes was enough to loosen all of the deposits, and water started to leak out all along the pipes so that it looked like a sprinkler system. If you see brass pipes with mineral encrustations along their length, even though there might not be any current leakage, those pipes should be replaced.

Drainage pipes

The wastes discharging from toilets and sinks flow from the fixtures down to the sewer or septic tank by means of drainage pipes. As with the distribution piping, only the portion

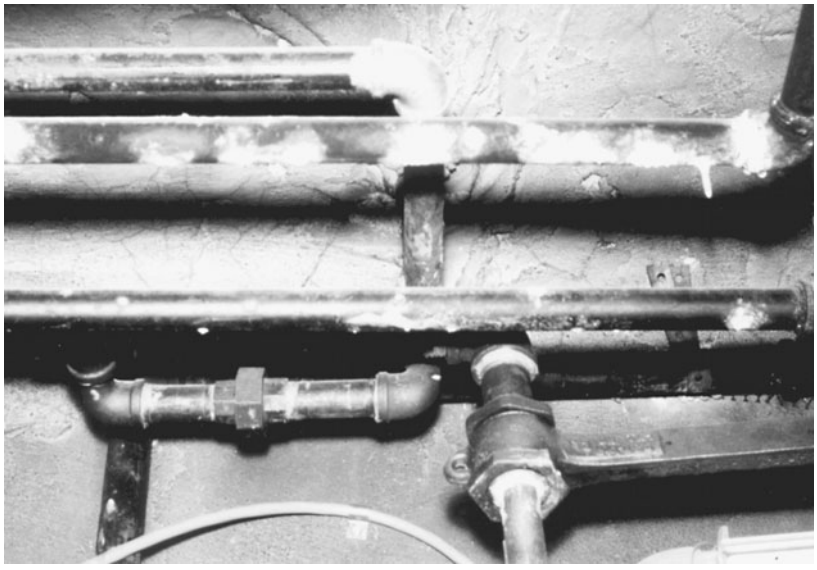


Fig. 13-10. *Brass water pipe with pinhole leaks, a condition caused by leaching zinc. Note mineral deposits on underside of pipe.*

of the drain line that is in the basement will be visible for inspection. In those houses built on ground level or those with finished basements, the drainpipes will probably not be visible and cannot be inspected.

Drainpipes are generally made of cast iron, galvanized iron, copper, lead, or plastic. Very often the drainage system will consist of a combination of the different types of pipes. This is acceptable. The problems encountered in the distribution system when using iron and copper pipes together or lead pipes do not exist in the drainage system.

For most of the day, the drainpipes are empty. The wastes flow down the drain by means of gravity. Consequently, the main house drain in the basement must have a steady downward pitch leading directly to the sewer or septic tank. Look at the drain line. If there is a low point along the length of the pipe, there is a problem. (See FIG. 13-11.) The low point in the pipe will allow grease and sewage

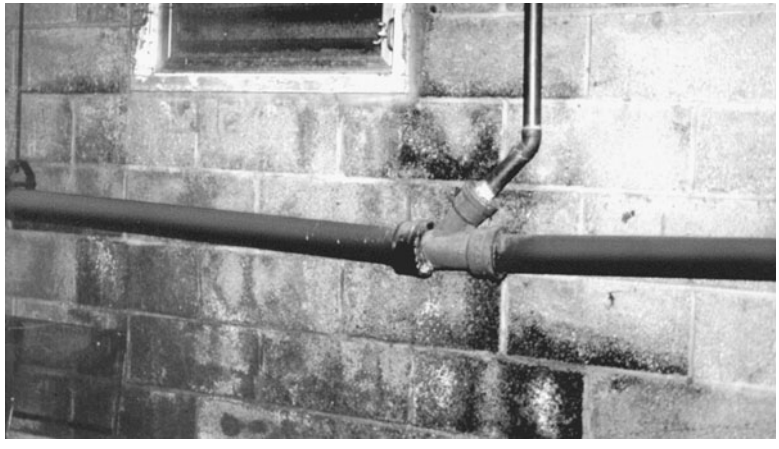


Fig. 13-11. *Low point in drainpipe can cause solid wastes to build up and block the flow.*

solids to settle and eventually block the pipe. This condition is a violation of the plumbing code and must be corrected. When inspecting the drainpipes, look for signs of current and past problems such as cracked and patched sections, improper pitch, and leakage.

One question that I am asked fairly often by prospective buyers is "Can we put a bathroom in the basement?" The only difficulty in installing a bathroom is how to handle the drainage, which must flow by gravity. If the house drain is connected to the sewer at a level above the basement floor, the wastes from the fixtures will have to be pumped up to the house drain so that they can flow out to the sewer. If there is a bathroom in the basement, check to see if the wastewater drainage discharges into a sewer ejector tank. The tank is normally located in an unfinished area of the basement. Since the tank is installed below the floor slab, the only portions visible are the top cover and the associated discharge and vent pipes. (See FIG. 13-12.) The cover should be gasketed and

Fig. 13-12. *Sewage ejector pumping system below the floor slab.*

tightly secured to the tank, and there should be adequate seals around the pipe penetrations. There should also be a gate valve and a check valve on the discharge line. A float switch controls the ejector pump. You can check the operation of the pump by flushing the toilet and then letting water run in the sink until the pump is activated. Another approach, although one that is not approved by most building codes, is to use a specially designed toilet that can lift the wastes about 10 feet without the use of a pump. It uses water pressure. This toilet is moderately priced. However, it is quite sensitive and if used for anything other than human wastes and toilet paper, it can become clogged. If only a sink is desired in the basement, a simple, inexpensive lift pump can be used to lift the waste water to the house drain.

When the house drain is located below the basement floor slab, connecting the fixture drains to the house drain will require breaking up sections of the floor. To minimize the installation cost, the proposed bathroom should be located near the existing drain line. In some cases, when the drain line is at or just below the basement floor surface, the toilet is located on a platform to facilitate the connection.

Well-pumping systems

When domestic water is not supplied by a utility company, it will be supplied by a private well-pumping system that includes a well pump, storage tank, and pressure switch.

Wells

As explained in chapter 6, part of the water hitting the surface of the earth as rain, snow, hail, or sleet seeps into the ground and percolates down until it hits an impermeable rock strata through which it cannot penetrate. The water then flows along the strata until it eventually reaches the ocean or a river, which can be more than a thousand miles away. The underground flow is not like a running stream but more like a turtle climbing a rock pile. The water flows through the pores and cracks of rock formations, sometimes surfacing along the way as a river or lake. The water composing this underground flow is *groundwater*, the top surface of which is commonly called the *water table*.

Subsurface rock formations that readily yield the groundwater to wells are *aquifers*. There are two types of wells—shallow and deep wells. A well that draws from an aquifer located less than 25 feet below the earth's surface is a shallow well. When the aquifer is more than 25 feet below the earth's surface, the well is a deep well. Wells over 500 feet deep are not uncommon.

Because of the proximity of the surface, shallow wells are vulnerable to contamination from cesspools, malfunctioning septic systems, barnyard manure, and industrial waste disposal. Deep wells, although less vulnerable to contamination, can also become polluted. Bacterial and chemical pollutants move downward in the soil until they reach the water table and then flow with the groundwater. To a large extent, the soil acts as a natural water purifier for bacterial contamination by filtering small suspended solids and allowing large pollutant particles to settle out. In addition, bacterial pollutants tend to die after a period of time; their life spans are usually short in the unfavorable conditions found in the soil.

Chemical pollution of the water source, however, can persist for years. I recently read a newspaper article about a toxic chemical solvent, trichlorethylene (TCE), that was contaminating the water supply of seventeen private wells. The solvent, which is used for thinning paint or removing grease, can cause neurological problems if inhaled or ingested

in high concentrations. The source for the contamination could not be determined. The local health commissioner, however, indicated that he thought it was the result of TCE being dumped in the area many years ago, prior to the homes being built.

Water that has a foul taste or odor and appears dirty may be completely potable, whereas water that is very clear and has a good taste may be polluted. You cannot tell by looking at it or tasting it whether the water is contaminated. As a precautionary measure, well water should be analyzed once a year for both bacterial and chemical pollutants. If the house has a well, have the water analyzed prior to contract closing.

Well pumps

The purpose of the pump is to draw water from the well and push it through the distribution piping with sufficient force that the water overcomes the frictional resistance of the pipes and provides an adequate flow at fixtures.

There are three basic types of well pumps used for residential structures: *submersible*, *jet*, and *piston*. All three can be used for shallow or deep wells. The submersible pump, however, is most frequently used for deep wells. In shallow wells, the jet or piston pumping mechanism is not located in the water. It is located on top of the well. The water is drawn up to the pump by a suction action, not unlike drinking through a straw. A suction will result in a pipe immersed in a body of water when the pressure inside the pipe is reduced below atmospheric pressure (vacuum). Under ideal conditions, the maximum suction lift is 34 feet. However, because of pump inefficiencies and frictional resistance of the pipe walls, the practical limit of suction lift is 25 feet, which is used in defining a shallow well. A deep well, therefore, is one in which water is pumped from a depth that exceeds 25 feet.

Well pumps and their accessory equipment are usually very reliable. Nevertheless, all well-pumping systems require occasional repair or replacement. The projected life expectancy of a pump is seven to ten years, although many pumps run without trouble for twenty to thirty years.

Piston pump These pumps are no longer in general use, although they might be found in older homes. Basically, they are motorized versions of the old hand pump. A motor drives the piston that alternately sucks water into the cylinder and then discharges it on every other stroke. In a shallow well, the pump (motor-piston assembly) is above the ground. In a deep well, the motor is above the ground, and the piston assembly is located in the well. Usually the motor is connected to the piston assembly by a belt and pulley. Inspect the belt for partially torn and frayed sections and adequate tension. Look for signs of leakage around casing joints and the piston rod. There should be none. An overall evaluation of any pumping system must include an inspection of the accessory equipment, which is discussed later in this chapter.

Jet pump The jet pump consists of a jet assembly and a centrifugal pump. The centrifugal pump can be thought of as a small paddle wheel driven by a motor. As the wheel turns, it imparts energy to the water, increasing its velocity and pressure. A portion of the water discharging from the centrifugal pump is diverted to the jet assembly, which has no moving parts. However, it uses this recirculated water to perform two functions. It creates a suction that draws well water into the assembly and pushes this water back up to the centrifugal pump. After passing through the pump, some of the water is again rediverted to the jet assembly and the remainder directed to the plumbing system for distribution.

You can tell whether the pump is a shallow-well or deep-well jet pump by the

number of pipes extending into the well. The basic difference between the two pumps is the location of the jet assembly. In a shallow-well jet pump, the jet assembly is built into the centrifugal pump casing and has only one pipe extending into the well. In a deep-well jet pump, the jet assembly must be located within the well (so that the suction lift does not exceed 25 feet). In this case, there are two pipes extending into the well. (See FIG. 13-13.) In areas where the temperature drops below freezing, proper weather protection of jet pumps is important. According to Gould Pumps, Inc., frozen pumps represent one of the most common reasons for pump replacement.

Submersible pump A submersible pump consists of an electrically driven centrifugal pump designed so that both the electric motor and the pump can operate under water. This pump is intended for placement directly in the well and is used primarily for deep wells. However, it can also be used for shallow wells. Water is drawn into the unit through screened openings located between the motor and the pump. A single discharge pipe is connected to the top of the pump and runs to the storage tank, which is usually found in the lower level of the house. When inspecting the pumping system, you will not see the pump, only the accessory equipment. (See FIG. 13-14.)

Because the electric motor is located in the well, in those areas where electrical storms are frequent, it is advisable to have a lightning arrester at the motor power supply. This will conduct high-voltage surges from the line to the ground before they enter and damage the motor. Submersible pumps have the advantage of quiet, dependable operation. They are relatively maintenance-free and are more efficient than jet or piston pumps. However, if a problem develops with the pump or motor, the entire unit must be withdrawn from the well.

Fig. 13-13. *Jet pumps: left—shallow-well jet pump, one pipe extending into well; right—deep-well jet pump, two pipes extending into well. Gould Pumps, Inc.*

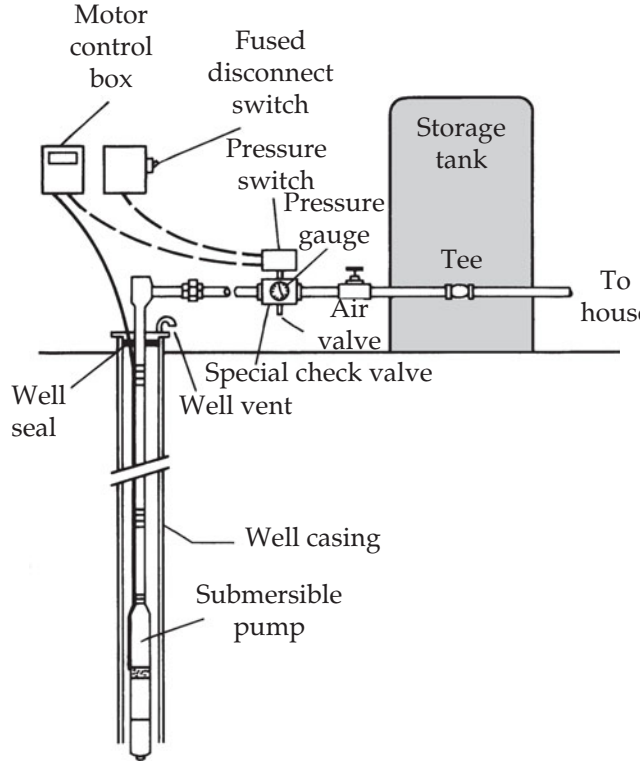


Fig. 13-14. *Typical submersible pump installation. Only the controls and storage tank are visible, since the pump is located in the well.*

Accessory equipment

For a private well-pumping system to provide water service comparable to that offered by a utility company, accessory equipment is needed.

Storage tanks The pump discharge line must be connected to a storage tank. The tank, also called a *pressure tank*, is generally located on the lower level of the house but might also be located in an outside pump house. Water from the tank is forced into the house supply pipe whenever there is a demand at one of the plumbing fixtures. A properly functioning tank provides a water reservoir that balances the capacity of the pump against the usage demand. It prevents excessive short-cycling (too rapid starting and stopping), which can cause switch and motor trouble.

The water in the storage tank is under pressure. Since water cannot be compressed, the tank must be partially filled with air to function properly. Over time, the water in the tank absorbs the air, so that the tank eventually becomes completely filled with water. The tank is then "waterlogged," and the pump performs as if no tank were used. Any small request for water, such as filling a glass, will cause the pump to cycle rapidly. This in turn will cause premature wear on the pump, motor, and switch.

The pressure range normally used for well-pumping systems is between 20 to 40 or 30 to 50 pounds per square inch (psi). If a waterlogged condition exists and there is a demand for water, you will hear the pump starting and stopping rapidly if the pump is the

jet or piston type. However, when a submersible pump is used, you will not hear the pump. In this case, you can tell that a waterlogged condition exists because the pressure switch will be clicking on and off. Also, the pointer on the pressure gauge will be fluctuating between the high- and low-pressure limits. If you find a waterlogged tank during your inspection, record it on your worksheet. The condition can be easily corrected by draining and then injecting air into the tank.

Some pumping systems have an air-charger apparatus that introduces air into the tank with each cycle to avoid waterlogging. Some prepressurized tanks claim to achieve a permanent separation of air and water by means of a plastic or rubber diaphragm or bag. These tanks should also be checked to determine whether they are waterlogged. I have found that on occasion they are, a condition that indicates a faulty diaphragm or bag.

In most areas of the country, the storage tank should be insulated to prevent condensation during the summer. Some tanks show signs of deterioration because of excessive rusting, a condition brought about over the years by moisture condensation on the tank. Depending on the degree of deterioration, the tank might have to be replaced or scraped, repainted, and insulated.

Pressure switch, gauge, and relief valve All systems must have a pressure switch and pressure gauge. The switch automatically starts and stops the pump at predetermined pressures. The pressure differential between start and stop is usually about 20 psi. The normal pressure range, as mentioned earlier, is 20–40 psi or 30–50 psi, sometimes 40–60 psi. Pressure in excess of 65 psi is abnormal and should be checked out by a pump service company. It might be caused by a faulty pressure switch.

The switch can easily be checked by turning on a faucet. Look at the pressure gauge and watch the pressure drop until the pump is activated by the low limit. Have someone turn off the faucet while you watch the pressure building up on the pressure gauge. When the upper limit is reached, the pump should stop. If it does not or it cuts out at too high a pressure, there is a problem. If the pressure gauge is broken, this test cannot be performed. All too often, I have found inoperative pressure gauges. If you find one, it should be replaced.

Standard tanks are normally rated for a maximum pressure of 75 psi. As a precautionary measure, there should be an automatic pressure relief valve on the storage tank or associated piping. In many jurisdictions it is a code requirement. The relief valve will prevent problems associated with excessive pressure buildup if the pressure switch malfunctions and allows the pump to continue running.

Look at the pressure gauge to see if the system will hold pressure when the pump is not running and no water is being used. If the pointer on the gauge drops, it indicates a leak. If no signs of leaks were noted during the plumbing inspection, the leak is probably between the storage tank and the well. Note this item on your worksheet, for it must be corrected.

General considerations

When the yield of a well is less than 5 gallons per minute (gpm), some municipalities require an auxiliary storage tank from which water can be drawn during periods of peak demand. The rate at which water will be used in a home can vary from 1 gpm (rinsing hands) to a peak rate of 12 gpm or more, depending on personal habits and plumbing fixtures available. The approximate rates at which the various home fixtures use water is shown in TABLE 13-1. This assumes adequate-size distribution piping.

Table 13-1. Water use rates (gpm).

Bathroom sink (lavatory) faucet	3
Water closet (toilet)	4
Bathtub	5
Shower	5
Dishwasher	2
Washing machine (laundry)	5
Garden hose	3
Lawn sprinkler	2

Table 13-2 shows the approximate water-supply requirements of home fixtures.

Obviously, all of the fixtures will not be in operation at the same time. Nevertheless, for a home with two full bathrooms, the pumping system should be designed so that it can supply a peak of about 10 gpm, even if this is greater than the yield of the well. If you find an auxiliary storage tank or the controls for a storage tank (the tank might be buried), you should try to find out the design criteria for the well-pumping system. You might find that the water flow at the design peak demand is less than you require. The design criteria might be known by the seller or might be available through local health department records or the company that installed the system.

Table 13-2. Water supply requirements.

Filling bathroom sink (lavatory)	2 gallons
Filling average bathtub	30 gallons
Each shower	Up to 60 gallons
Older water closet (toilet)	4–5 gallons per flush
Newer toilets	1.6 gallons per flush
Dishwater	3 gallons per load
Washing machine (laundry)	Up to 50 gallons per load

*This figure will, of course, vary with each individual. Also, shower heads are available that will reduce the flow rate.

Checkpoint summary

Exterior inspection

- ❍ Did you note any vent stacks that
  - — terminate near windows?
  - — run up an exterior side of the house (in northern climates)?
  - — have TV antennas and so on strapped to them?
- ❍ Is the drainage system connected to a municipal sewer, a septic tank, or a cesspool?
- ❍ Do you know where the septic system or cesspool is located?
- ❍ If house is connected to a septic tank, has the tank ever been cleaned? When?
- ❍ Did you note any wet spots or any foul odors in the area of the septic system?
- ❍ Are there any areas where liquids are oozing from the ground?
- ❍ Does property contain a lawn sprinkler system?
- ❍ Is sprinkler water-supply line protected by a vacuum breaker?

Interior inspection

Fixtures (operation and condition)

- ❍ Check all plumbing fixtures for operation.
- ❍ Note cracked, chipped, or stained areas.
- ❍ Are sinks or bowls loose?
- ❍ Do faucets leak around handles or spouts?
- ❍ Do sinks, bowls, tubs, and showers drain properly, or are they sluggish?
- ❍ Do sink and tub drains open and close properly?
- ❍ Are there any missing or inoperative "pop-up" units?
- ❍ Does toilet bowl fill and shut off properly?
- ❍ Do any fixture drain lines leak, have makeshift patches or missing traps?
- ❍ Do fixtures have individual shutoff valves on supply lines?

Water pressure, flow

- ❍ Check individual fixtures for low hot- or cold-water flow.
- ❍ Is water flow adequate?
- ❍ Note if there are knocks (water hammer) when faucets are opened and closed rapidly.
- ❍ Note any fixtures with galvanized iron piping or kinked lines (copper).

Piping

Inlet service

- ❍ If water is supplied by a utility company, locate the inlet pipe and the water meter if any.
- ❍ Is the inlet pipe made of iron, brass, copper, or lead?
- ❍ If inlet pipe is lead, take a water sample for analysis.
- ❍ Is there a master shutoff valve? Check its operation.

Distribution piping (supply mains, fixture risers)

- ❍ Are these pipes copper, brass, galvanized iron, plastic, or a combination?
- ❍ Are there signs of leakage, patched or corroding pipe sections or valves?
- ❍ If system is basically brass, note any mineral deposits along the undersides of pipes or around threaded joints.
- ❍ Pipes located in an unheated area such as a crawl space, garage, and so on may be vulnerable to freezing and should be insulated.
- ❍ Are any pipes sweating?
- ❍ Are any pipes improperly supported?
- ❍ Are hot- and cold-water lines adequately spaced apart?

Drainage pipes

- ❍ These pipes are generally made out of cast iron, galvanized iron, copper, lead, or plastic.
- ❍ Look for low points or sagging sections where solid wastes can accumulate.
- ❍ Are any visible drainage lines improperly pitched?
- ❍ Note any signs of leaking, cracked or patched sections.
- ❍ Is there a sewage ejector tank?
- ❍ If there is, is it operational?

Well-pumping systems

- ❍ Have a water sample analyzed for contamination.
- ❍ Is there a deep- or shallow-type well?
- ❍ Is well pump a piston, jet, or submersible type?
- ❍ Do you know the design criteria (gallons/minute) of the system?
- ❍ Are installation records and recorded flow available?

Accessory equipment

- ❍ Is storage tank insulated?
- ❍ Are there signs of rust or corroding areas?
- ❍ Does tank contain a pressure-relief valve?
- ❍ Is pressure gauge operational?
- ❍ When system is active (pumping), note the pressure differential.
- ❍ Does the pressure exceed 65 psi?
- ❍ Does gauge fluctuate rapidly, or does pump cycle on and off?
- ❍ Does system hold its pressure when all faucets are shut and there are no interior plumbing leaks?

14

Heating systems I

Central heating systems 210
Heating outlets: registers and radiators 211
Thermostat and master shutoff 211
Warm-air systems 212
- **Advantages 213**
- **Disadvantages 213**
- **Gravity warm air 213**
- **Forced warm air 215**
  - **Controls 215**
  - **Distribution systems 216**
  - **Supply registers and return grille 216**
- **Heat pump 218**
- **Geothermal heating/cooling 218**

Hot-water systems 219
- **Gravity hot water 219**
- **Forced hot water 221**
  - **Boilers 221**
  - **Advantages and disadvantages 223**
  - **Distribution piping 223**
  - **Radiators 224**
  - **Panel heating 224**
  - **Controls 225**
  - **Low water cutoff 227**

Steam heating systems 227
- **Distribution piping 228**
- **Controls 229**
- **Domestic water heater 231**
- **Advantages and disadvantages 231**

Hybrid heating systems 231
- **Steam–hot water 231**
- **Hydro-air 231**

Heating systems fall into two principal categories—central heating and area heaters. In a central heating system, warm air, hot water, or steam is generated in one location of the house and is distributed through ducts or pipes to heat other portions of the house. An area heater is basically a space heater and is used to provide warmth to the room in which it is located, as with a fireplace or potbellied stove. The area heaters of today, however, are much more sophisticated and are equipped with temperature and safety controls.

The principal energy sources used in heating systems are gas, oil, and electricity. To some extent, coal, wood, and solar energy are also used for heating residential structures.

Central heating systems

Most of the homes in the United States have central heating systems. The basic components of these systems are

- A burner for converting gas or oil to heat or a resistance coil for converting electrical energy to heat.
- A heat exchanger for transferring this heat to the air or water. When the heat exchanger is used to produce warm air, it is a *furnace*. When it produces hot water or steam, it is a *boiler*. Because many people have unknowingly been calling a boiler a furnace, the term *furnace* is pretty much the generic name for the heat exchanger.
- A distribution system, consisting of ducts or pipes for conveying the warm air, hot water, or steam to the various parts of the house.
- Heat outlets such as registers (vents) or radiators for transferring heat into the room.
- Automatic safety and temperature controls.

A central heating system provides heat to the rooms throughout the house and in some cases to the nonhabitable areas such as the garage or unfinished basement. In many cases, the system can be extended to provide heat to additions or modifications to the house such as a finished attic or a new dormer. Whether the heating system can be extended depends on its heating capacity and the configuration of the distribution system. If you are thinking about extending the heating system of the house, you should consult a professional to determine its feasibility.

One advantage of central heating is that the distribution system can be designed so that the house is divided into separate heating areas, *zones*. A multizoned house is more economical and more efficient to heat. Zoning is used to maintain the same or different temperatures in various parts of the house. Only those rooms that require it need be heated. Zone control is automatic. Each zone has a thermostat control that opens and closes valves for hot-water and steam systems or dampers for a warm-air system. If the house was originally designed with only one heating zone and you are considering converting it to a multizone system, have the conversion plans checked out by a professional. The configuration of the distribution system might be such that conversion to a multizone system is not economically justifiable. Reaching the break-even point on your investment (cost versus fuel savings) can take many years.

One of the problems of a central heating system is distributing the heat evenly to all parts of the house. The larger the house, the more difficult it is to obtain an even distribution. Often the registers or radiators farthest from the furnace or boiler do not supply as much heat as those that are closest. Minimizing this problem is called "balancing the heating system" and requires the use of dampers for warm-air systems, throttling

valves for hot-water systems, and certain types of air valves for steam systems. Balancing the heating system to your family's requirements is best performed after living in the house for a while. It might be that the system is already properly balanced for your needs and requires no further adjustment. Balancing is discussed in this chapter in the sections pertaining to the various systems.

Heating outlets: registers and radiators

The most effective location in a room for forced-warm-air registers and hot-water and steam radiators is along the exterior wall near windows or doors. This enables the heated air to mix with the cold air that very often infiltrates into the interior through the joints around windows and doors. Of course, if the joints are properly caulked and weatherstripped, the air infiltration on a cold, windy day will be minimized. Most homes, however, are not adequately caulked and weatherstripped. (See the section on caulking and weatherstripping in chapter 19.) The mixing of warm air with the cold air around the exterior walls will eliminate cold spots, reduce drafts, and produce a more uniform heat distribution in the room. If the registers or radiators are not located along the exterior walls in any of the rooms, the overall heat distribution in those rooms might be less than what you consider desirable.

All central heating systems have advantages and limitations. If you feel that the type of heating system is crucial to your decision on whether to buy the house, these advantages and limitations are important. Your decision, however, should be based on fact and not hearsay. I have had many clients tell me that they would consider only a house heated with a hot-water system because a warm-air system is "too dry." Well, all heating systems are "too dry" unless the air is intentionally humidified. I have been in homes heated with a hot-water system where the humidity was less than 10 percent, and I have been in homes heated with warm humidified air where the humidity was over 30 percent. Since a hot-water system does not have ducts, the house cannot be humidified from a central location as with a warm-air system. The advantages and limitations of various heating systems are discussed later in this chapter.

Thermostat and master shutoff

There are many types of controls for heating systems. The ones most familiar to homeowners are the thermostat and the master shutoff. The thermostat is used to turn on or shut down the heating system on an as-needed basis automatically. It is a temperature-sensitive switch that normally operates at low voltage (24 volts), although some operate at line voltage (110 volts). As the temperature drops below the thermostat setting, contacts within the thermostat close, activating the heating system. When the temperature in the room containing the thermostat rises above the setting, the contacts open, shutting down the heating system.

In some thermostats, the contacts are exposed to air and dust and should be cleaned periodically. Otherwise, a dust layer can form on the contacts that prevents them from operating properly. Over the years, the contacts in some thermostats become worn because of cleaning and no longer close properly. These thermostats require replacement. In newer thermostats, the contacts are encased in a glass enclosure or have been replaced by a sealed mercury switch.

In a house with a multizoned heating system, each zone will be controlled by a thermostat. The placement of the thermostat is quite important. Since the thermostat senses

only the temperature in the surrounding area, the placement of the thermostat must be such that the temperature in that area is representative of the temperature for the entire house or for that zone. The thermostat must never be placed in a draft or in an area where air circulation is blocked.

Research has indicated that by lowering the thermostat setting 5 to 10 degrees prior to going to sleep and resetting it in the morning, you can save 5 to 15 percent of your fuel bill, depending on your geographical location. If you want to take advantage of these savings but feel that you might forget to lower the thermostat setting each night, you can replace the regular thermostat with a clock thermostat. A clock thermostat will automatically lower the temperature setting each night and raise it each morning. From a convenience point of view, a clock thermostat is very worthwhile. If the house does not have a clock thermostat, you should consider its installation. Some units allow for a double setback, which is useful in houses that are empty during the day.

Every heating system should have at least one master shutoff switch. Usually, the switch is located near the furnace or boiler. Sometimes the switch is located at the top of the stairs that lead to the basement. In the event of a problem with the heating system, this switch can be used as an emergency shutoff for the burner. The switch is also used by a repairman when servicing the system. By turning the master switch off, no one can inadvertently turn the heating system on by raising the thermostat.

Warm-air systems

Air heated in a furnace travels via supply ducts to the rooms. The warm air enters the rooms and is discharged through wall or floor registers or ceiling diffusers. The cooler air in the room, being displaced by the heated air, travels through return ducts back to the furnace where it is reheated and recirculated. If the system does not have cold-air return ducts, the cold air travels back to the furnace via gravity. Usually the stairway allows the cold air to travel to the first floor, and grilles in the floor of the first level then allow it to recirculate to the furnace. Of course, doors must be open to permit the air movement. Where doors are closed, the heat rises in a very restricted manner.

The air in a warm-air system can be supplied to the furnace by recirculating heated air through ducts or by drawing in cool air from the basement. The latter method is no longer used in modern warm-air systems because of the potential danger of exposure to poisonous gas and because of the heating inefficiency. If the chimney is clogged, the exhaust gas, which contains poisonous carbon monoxide, backs up into the basement. It is then drawn into the furnace and distributed throughout the house. Also, since the temperature of the basement air is lower than the temperature of the recirculated air, more fuel will be required to heat it to the desired temperature. Although this method of supplying air to the system is for the most part no longer used, it will still be found in many older systems. You can easily spot it. Look for a large opening in the furnace casing.

There is only one condition under which a furnace or its heat exchanger must be replaced: when the walls in the heat exchanger that separate the circulating air from the hot exhaust gases deteriorate because of age, premature corrosion, or cracks and thus allow the exhaust gases to mix with the circulating air. Included in the exhaust gases is carbon monoxide which is poisonous. The mixture of air and exhaust gases circulating around the house is quite dangerous. The "life expectancy" of a furnace refers to the average number of years of usage that can be expected before the walls of the heat exchanger deteriorate. For many modern

furnaces, the projected life is between fifteen and twenty years, although some older ones have been safely operational for well over thirty years. A number of manufacturers are now providing replacement heat exchangers so that the overall life expectancy of the furnace can be extended indefinitely.

Advantages

Warm-air systems have an advantage over other types of heating systems in that the air in the house can be cleaned (dust particles removed by filtering) and humidified. Most systems use either inexpensive disposable filters or permanent-type filters that require periodic washing. Some systems utilize an electronic filter, which is very effective in removing dust and pollen from the air.

Not all warm-air furnaces are equipped with a humidifier for adding moisture to the circulating air. If you do not see one, you should consider installing one. The humidifier may be mounted in the main return or supply duct and is usually located near the furnace. Humidifiers such as the evaporative-plate or wick type add some moisture to the circulating air. However, they are not totally effective. A more positive introduction of moisture into the airstream can be achieved with a power spray humidifier that is controlled by a humidity-sensing device.

Additional advantages of a warm-air system:

- Adaptability to a central air-conditioning system. (See chapter 17.) The distribution ducts and the furnace blower can be used to circulate the cool air. This results in considerable cost savings when installing a central cooling system.
- There are no distribution pipes to freeze and burst. Consequently, if the heating system is not operational for several days during the winter, as would be the case in the event of an extended power failure, there would be no need to worry about the distribution system freezing (a condition that can occur with a hot-water heating system). Of course, regardless of the type of heating system, during an extended power failure, the domestic water pipes are vulnerable to freezing.
- The replacement cost for a new warm-air furnace is less than the replacement cost for a new hot-water or steam boiler.

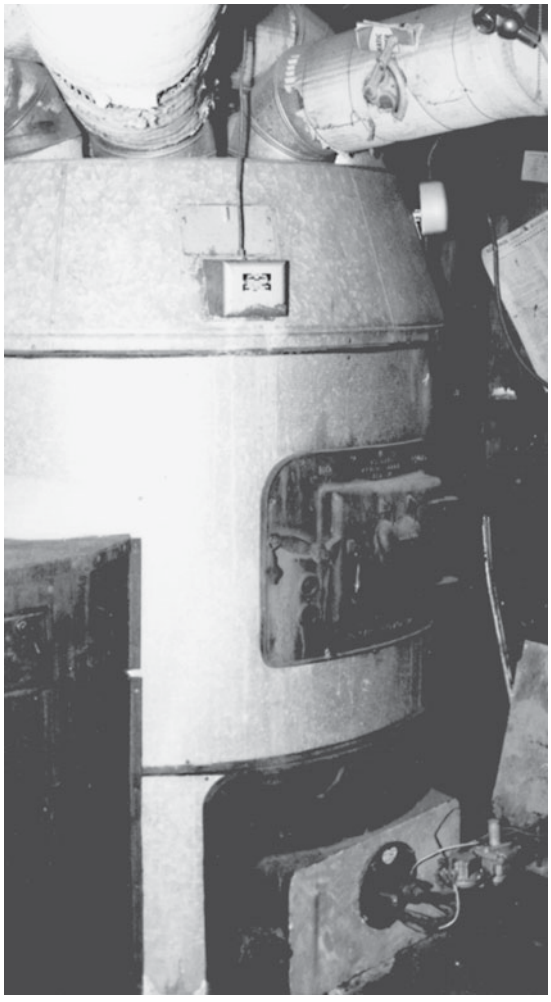
Disadvantages

The major disadvantage of a warm-air system is that in the event of a faulty heat exchanger, the exhaust gases will mix with the circulating air and be distributed around the house.

In a multizoned warm-air heating system, the zones are not totally independent of one another. The zones are controlled by motorized dampers located in the ducts. When the dampers are closed, they block the airflow in their respective ducts, preventing that portion of the house from being heated. However, some air will always flow around the closed damper, decreasing the overall efficiency of operation. In quality-constructed homes, zone control is often obtained by using two separate furnaces with separate distribution systems rather than by using motorized dampers.

Gravity warm air

A gravity warm-air system is a very simple system that is often found in older homes. Generally, the furnace is quite large and often looks like a mechanical "octopus" with many ducts sticking out of the upper portion. (See FIG. 14-1.) There are no moving parts, motors, or electrical connections other than those required for the thermostat and burner control. The basic principle of operation is the fact that warm air rises and as it does



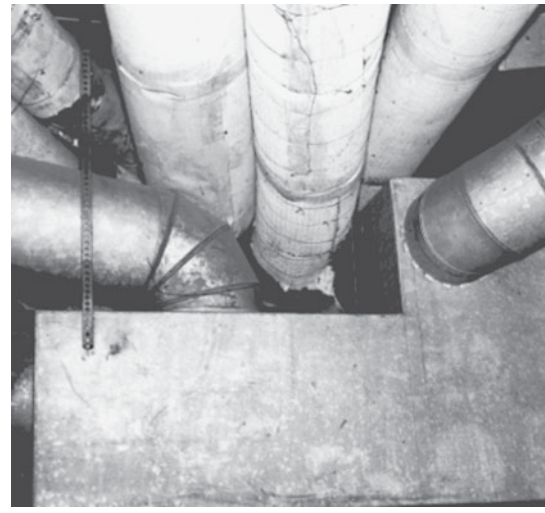


Fig. 14-1. *Left—Old "octopus" warm-air furnace; system was converted from gravity to forced warm air by installing a blower unit, which is located in the black casing on left side; right—Heat-supply ducts at top portion of "octopus" furnace.*

displaces the cool air, which in turn results in air circulation.

The heat distribution in a house heated by a gravity system is often less than desirable. To obtain a uniform heat distribution, there must be good air circulation. And in order to have good circulation, there must be a considerable temperature difference between the warm air entering the room and the cooler air in the room. As the room begins to warm, the temperature difference decreases, thereby reducing the air circulation.

The cooler air returning to the furnace is drawn into the return duct by a natural draft that is the result of thermal air currents. The moving air does not have much force. Consequently, there will usually not be a filter in this system for cleaning the air. The

resistance offered by a filter (especially a dirty one) is often enough to block the airflow.

Although a gravity system is considered obsolete, it can be updated to a forced warm-air system by installing a blower unit (fan and motor assembly). For the most part, the old gravity systems are quite rugged and can last for many years. I have seen many units that are over fifty years old. They are usually made of heavy-gauge cast iron or steel and can probably be used for many more years, assuming that efficiency of operation is not a consideration. As mentioned earlier, the only time a furnace must be replaced is when there is a crack in the heat exchanger that allows the exhaust gases to mix with the circulating air.

Forced warm air

Because it is economical to install and is versatile, the forced warm-air heating system is found in more homes than any other central heating system. The basic difference between this system and the gravity warm-air system is a blower in the heat exchanger that circulates the warm air. Since the warm air is distributed under a draft, comfort heating can be achieved at lower furnace temperatures with lower fuel consumption. In addition, the supply and return ducts need not be as large as those of a gravity system.

Controls There are three basic controls for this system: a thermostat, a fan control, and a high-temperature limit control. The thermostat has been discussed earlier in this chapter. The purpose of the fan control is to prevent the fan from circulating cool air around the house. The fan control is a temperature-sensitive switch that turns the blower on and off at preset air temperatures. It is independent of the thermostat. When the thermostat calls for heat, only the burners should fire. The fan should not begin to operate. If it does, the fan control is either faulty or in need of adjustment. After the heat exchanger warms up to a temperature of about 110° F to 120° F, the fan should begin to operate. When the temperature setting on the thermostat is satisfied, the thermostat will shut off the burner but not the fan. The fan will continue to operate until the temperature in the heat exchanger drops to about 85° F.

If the heat exchanger gets too hot, the high-temperature limit control will shut off the burner. The limit control is usually set at about 175° F. For proper operation, the fan should begin to operate before the burners are shut off by the limit control. Otherwise, the temperature of the air discharging from the registers will be too high for comfort heating.

Condensing furnaces Because of the need to conserve energy and the escalating cost of fuel after the energy crunch of the 1970s, the heating industry developed a new generation of gas-fired forced-warm-air furnaces. These furnaces have been able to achieve an overall operating efficiency of 90 to 97 percent, whereas many of the conventional furnaces found in most homes today have an overall operating efficiency of around 60 to 65 percent. Because the U.S. Department of Energy set a standard in 1992 that requires furnaces to have an overall efficiency in the 80 percent range, conventional furnaces are no longer installed in new homes or as replacement units.

The new furnaces are called *condensing furnaces*. The increase in efficiency is the result of the installation of a secondary heat exchanger that extracts heat from the exhaust gases that normally flow up the chimney with conventional furnaces. During this process, the temperature of the exhaust gases drops to a point where the water vapor in the exhaust gases condenses, thereby releasing additional heat. With the conventional furnace the temperature of the flue gases is about 450–550° F. With the high-efficiency units, it's about 120–130° F.

To achieve the increased efficiency, it was necessary to incorporate additional

components into the overall furnace package. Included with the furnace are a power vent fan (also called an *induced draft blower*), plastic piping to vent the flue gases through a side wall or the roof, condensate drainage piping, and an intake air duct for those units that have a sealed combustion system using outside air.

A power vent fan is needed to overcome the additional resistance to the flow of the exhaust gases caused by the secondary heat exchanger. Also, with the low temperature of the exhaust gases, it is not necessary to use the conventional chimney.

Pulse-combustion furnace Another type of high-efficiency furnace is the pulse-combustion furnace. As with the condensing furnaces, the high efficiency of a pulse unit results from the extraction of heat from the exhaust gases until the associated water vapor condenses. However, the combustion process is completely different. Whereas the heat in a condensing furnace results from a continuous burning of fuel, in a pulse combustion furnace, it results from sixty to seventy tiny explosions of a gas-air mixture per second in the combustion chamber.

Distribution systems There are two basic configurations used for the distribution of a forced-warm-air heating system—the *extended-plenum* and the *radial* configuration. (See FIG. 14-2.) Regardless of the configuration, there should always be a physical separation from the furnace at the beginning of the duct. The separate sections are usually connected by a heavy canvas fabric. (See FIG. 14-3.) The separation is intended to isolate the distribution system from the furnace so that blower noise will not be transmitted throughout the house. The isolation fabric in many older homes contains asbestos. If you suspect the fabric contains asbestos, recommend that it be tested and replaced if necessary. (See chapter 20, Environmental concerns.)

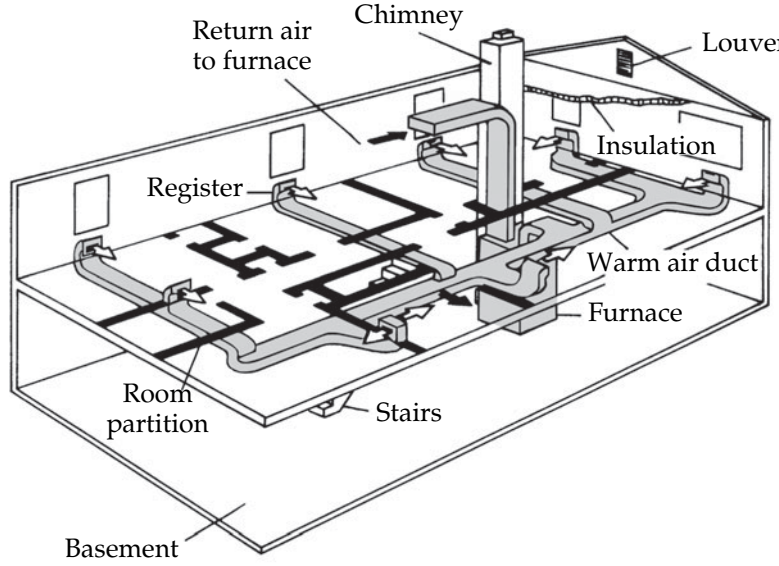
In the extended-plenum configuration, a large rectangular supply duct extends in a straight line from the plenum mounted on the furnace. From this main duct, branch ducts supply warm air to the various rooms. The large supply duct results in less resistance to airflow and produces a more effective heat distribution for those rooms farthest from the furnace.

In the radial configuration, there is no main supply duct. Each branch duct takes off directly from the plenum and runs to the individual room registers. This system is usually found in smaller houses. A variation on the radial configuration is the perimeter-loop-duct arrangement, which is intended for houses built on a slab. This configuration uses a duct that encircles the perimeter of the floor slab and is connected to the furnace by feeder ducts. (See FIG. 14-4.)

The branch ducts for both the extended-plenum and the radial configuration will be either rectangular or round. The round ducts are usually relatively small in diameter (4 to 6 inches), have a higher resistance to airflow, and are normally not used for air-conditioning. (Do not confuse these ducts with the insulated flexible ducts used in many central air-conditioning systems.)

The return duct for both configurations is usually made of sheet metal and has a rectangular cross section. However, in some homes with basements, you might find that a portion of the return duct has been formed using a section of the overhead wood framing. This is done by covering the channel that is formed by adjacent joists with sheet metal. (See FIG. 14-5.)

Supply registers and return grille As discussed earlier, the most effective location for the warm-air supply registers is along the outside walls. If the supply register is not located along the outside wall, and often it is not, the



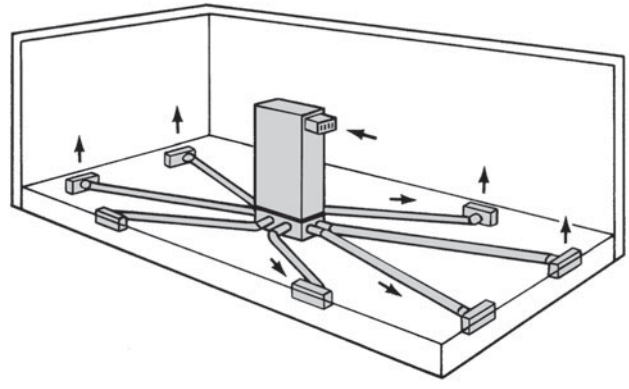


Fig. 14-2. *Warm-air distribution systems. Top—extended plenum. Bottom—radial.*

location of the return grille will be important for developing a uniform heat distribution. For optimum distribution, warm air entering the room from the supply register circulates around the room and then leaves through the return grille. If the return grille is located on the same wall as or a wall adjacent to the supply register, there will be a short cycle of the air circulation, which reduces its effectiveness. In this case, warm air discharging from the supply register can be drawn into the return grille before it has a chance to circulate.

You should look for separate return grilles for each room or a centrally located return grille for each floor. When each room has a separate return, the grille should be located on the wall opposite the supply register. If there is a centrally located return, the supply register should be located on the wall farthest from the door. This will provide a better

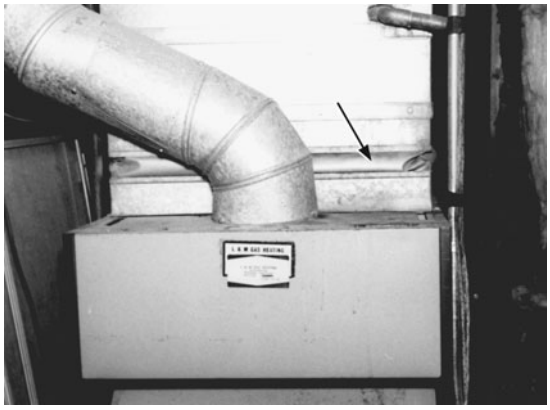


Fig. 14-3. Canvas fabric cover over the separation between the furnace and the main duct. The separation isolates the distribution system from noises and vibrations that may develop in the furnace.

circulation, since the air will flow through the door opening. Also, about 1 inch should be cut off the bottom of the door to allow for air movement while the door is closed.

Balancing the warm-air flow for your personal needs can best be accomplished after you move into the house. The various supply ducts will have dampers that can vary the airflow. By reducing the flow to the registers closest to the furnace, more warm air will flow to the registers farthest from the furnace. In addition, each register will have dampers that can be used for further restricting and "fine-tuning" the airflow.

Heat pump

Central heating using a heat pump is basically the same as a forced-warm-air system. However, the means by which the furnace is heated differs. The heating element is not a gas or oil burner but a component of a reversed-cycle air-conditioning system. The heat-pump system is discussed in detail in chapter 17.

Geothermal heating/cooling

A geothermal heating/cooling system is basically a modified heat pump system. It is often referred to as a ground source heat pump. Unlike an air source heat pump where the compressor/condenser is located on the outside of the house, the geothermal heat pump is generally located in the basement or utility room. It is packaged in a single cabinet that includes the compressor, refrigerant heat exchanger, and various controls. The system uses the earth as a heat source and a heat sink. It takes advantage of the earth's relatively constant temperature, at depths below 4 feet, of 40 to 55 degrees year round. The system circulates a water/antifreeze solution through a

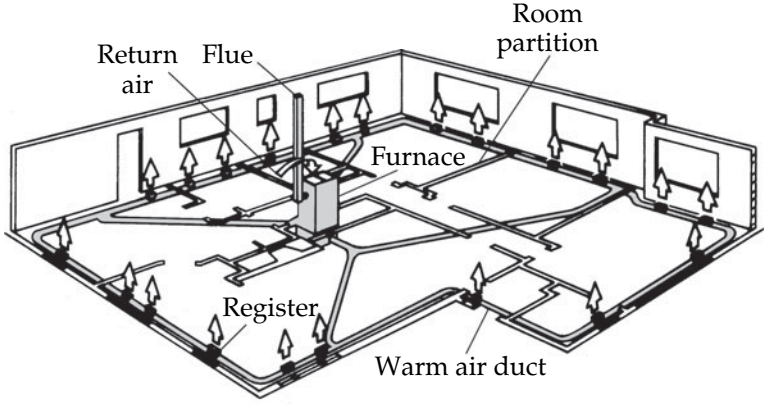


Fig. 14-4. Perimeter-loop duct arrangement, a variation on the radial configuration.

Fig. 14-5. *Return duct for warm-air heating system. The duct was made by enclosing the channel formed by adjacent ceiling joists with a sheetmetal covering. Usually found in older systems.*

closed loop of polyethylene pipe that is buried in the ground or set beneath the water. Depending on which cycle the system is operating under (heating or cooling), the solution adds or extracts heat from the heat exchanger in the heat pump cabinet. Geothermal heating/cooling is discussed in chapter 21.

Hot-water systems

This system operates on the principle of circulation and recirculation. Water heated in a boiler is transmitted through pipes to radiators located throughout the house. At the radiators, the hot water gives up some of its heat. The cooler water then continues to flow back to the boiler where it is reheated and recirculated.

In this system, the boiler, distribution piping, and all the radiators are completely filled with water. When heated, water expands, increasing its overall volume. Consequently, all hot-water heating systems must be equipped with an expansion tank to store the increased water volume temporarily. When the system is shut and the circulating water cools, the volume decreases, drawing the water back from the expansion tank. Without such a tank, excessive pressures could be built up in the system that could rupture the distribution pipes and fittings.

The water circulating within the heating system operates under a pressure that normally ranges from 12 to 22 psi. Although the water is constantly recirculating and there is no need for additional water, an automatic water-feed device is provided with all systems as a precautionary measure. The automatic water-feed device is a pressure-reducing valve. The water supply to the boiler is taken from the house water supply. Since the house supply pressure is normally in a range from 30 to 60 psi, it must be reduced before being introduced into the boiler. The reducing valve is usually preset by the manufacturer to 12 psi.

There are two basic types of hot-water heating systems—gravity and forced. They are classified according to the means by which the water within the system circulates.

Gravity hot water

As with the gravity warm-air heating system, the gravity hot-water system is inefficient, not very responsive to changing demands for heat, and no longer installed in new construction. However, it might be found in many older homes. The principle of operation is similar to that of a gravity warm-air system: As the water is heated, it becomes lighter than the cooler water and tends to rise. Since the system is filled with water, as the hot water rises, it displaces the cooler water, forcing it to return to the boiler for reheating, and thus induces circulation. To keep the resistance to flow at a

minimum, the size of the distribution piping is relatively large—about 3 inches in diameter—compared to the distribution piping in a forced system—about 1 inch in diameter.

Gravity systems might also be classified by whether they are *open* or *closed*. In an open system, the expansion tank has an overflow pipe that is open to the atmosphere. The expansion tank must be located above the highest radiator to ensure that the radiator will be filled with water. It is usually found in the attic with the overflow pipe extending through the roof or side of the building. (See FIG. 14-6.) If the attic has been partitioned off into rooms, the expansion tank might be found in a closet or corner. When the tank is located in an unfinished, unheated area, it must be insulated to minimize heat loss and to protect against freezing should the system malfunction.

Hot-water and steam systems are normally equipped with automatic pressure-relief valves that discharge when the pressure exceeds 30 psi and 15 psi, respectively. A relief valve, however, is not needed in an open gravity hot-water system because if the pressure should build up to a point where it exceeds the design pressure, the water will simply discharge through the overflow pipe in the expansion tank.

In the closed system, no portion of the expansion tank is open to the atmosphere. In this case, the expansion tank can be located anywhere in the system, usually near the boiler. Because the system is closed, it can operate at higher pressures, and therefore higher temperatures, without turning to steam. The higher temperatures permit the use of smaller radiators.

There are two types of expansion tanks used in closed systems—air cushion and diaphragm. In the air-cushion type, air is initially trapped in the tank to provide a cushion, which is compressed as the water in the system expands and enters the tank. Over the years, the air in the tank can be absorbed by the water resulting in a "waterlogged" expansion tank. In this case, when the heating system is turned on, since there is no room for expansion, the pressure will increase rapidly until the relief valve discharges. When this happens, the expansion tank must be flushed and the air cushion reinstalled.

Fig. 14-6. *Expansion tank for "open" gravity hotwater system—located in attic.*

To eliminate waterlogging, the diaphragm expansion tank was developed. This tank

uses a rubberized diaphragm to separate the air cushion from the water. For the most part, the diaphragm does eliminate waterlogging. However, where the diaphragm is faulty, waterlogging does occur.

If the heating system is gravity hot water, do not fret. It can be converted into a forced-hot-water system by installing a centrifugal pump with the associated controls to circulate the water through the distribution pipes and radiators. If the system is the open type, the expansion tank will have to be replaced with a closed tank.

Forced hot water

Quite often my clients comment on the small size of the boiler for the forced-hot-water system. They apparently are used to seeing a boiler originally designed for use in a gravity system or one that was converted from coal-fired to oil- or gas-fired, both of which are considerably larger—two to six times as large, depending on the manufacturer. Regardless of the size, you can easily recognize a forced-hot-water system by the presence of a circulating pump in the distribution return pipe just before the connection to the boiler. (See FIG. 14-7.)

Boilers The boilers used in these systems will be made of either cast iron or steel. Cast-iron boilers are more resistant to corrosion than steel boilers and thus have a longer projected life. The projected life span of a modern cast-iron boiler is about twenty-five to thirty years. However, many of the boiler manufacturers will provide only a twenty-year warranty. The older gravity-type boilers were probably made with a heavier-gauge metal. I have inspected many that were over fifty years old and still going strong. (See FIG. 14-8.) Steel boilers, being vulnerable to corrosion, have a shorter projected life, usually about twenty years. I have seen steel boilers that required replacement after fifteen years.

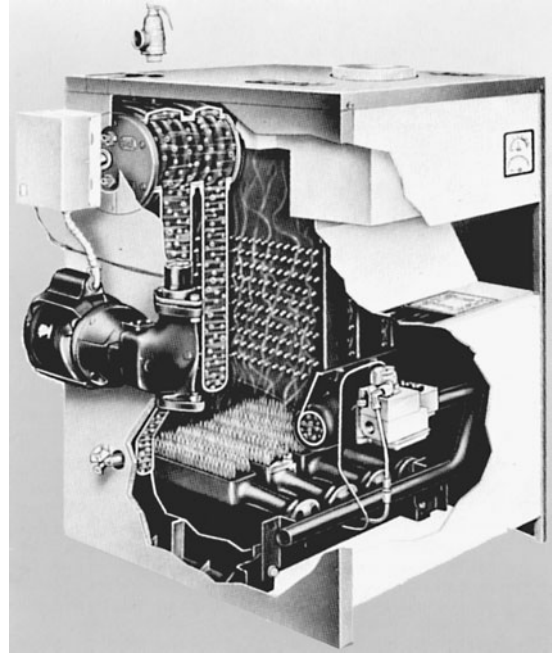


Fig. 14-7. *Boiler for forced-hot-water heating system. Note the circulating pump.*

Other than for reasons of efficiency and economy, the only time a boiler must be replaced is when a leak has developed that cannot be effectively patched. Sometimes, just after firing a boiler that has not been operational for a day or more, you might see a slight amount of water dripping into the firebox (assuming that the firebox is accessible for visual inspection). This is often the result of condensation caused by cold water circulating into the boiler or some slight joint movement. As the boiler heats up, the various sections tend to move slightly. In some cases, this results in a slightly open joint that allows water to drip out. However, as the sections continue to heat up, they expand, compressing the joint and sealing the leak. Although this condition is usually not a problem, if you see water dripping into the firebox, it would be best to have the condition checked by a professional.

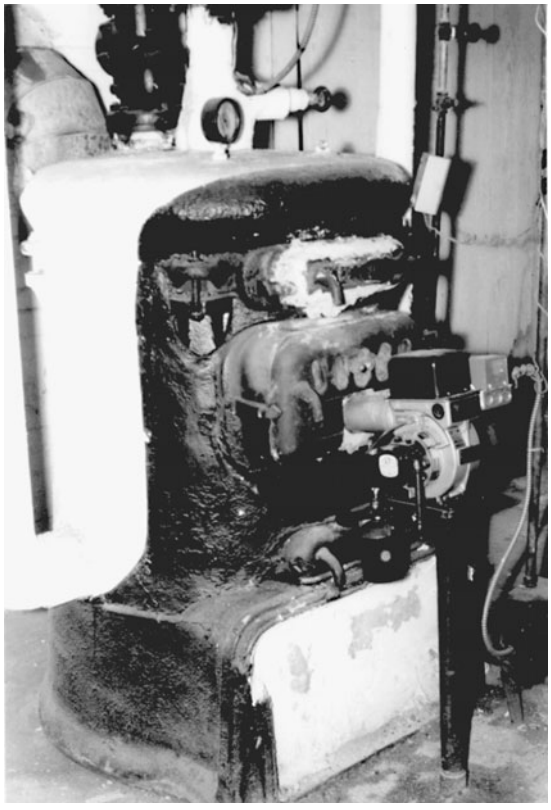


Fig. 14-8. *Old cast-iron boiler with new oil burner. Boiler was converted from a coal burner.*

On occasion, I have found a regular tank-type domestic water heater (of the type described in chapter 16) being used in the heating system in place of a boiler. From a safety point of view, this is acceptable because there is a high-temperature and pressure control along with a thermocouple control for the gas valve. However, water heaters have a projected life of seven to ten years and are often guaranteed by the manufacturer for only five years. In addition, with the exception of those homes located in the sunbelt, the Btu (heat) output of these units per hour is less than that needed to heat most homes adequately. This type of setup may be effective for heating an addition to a house where the existing heating system cannot be extended. The only drawback is the short projected life of the water heater.

Condensing boilers In addition to developing high-efficiency condensing furnaces, some manufacturers also developed high-efficiency boilers. As with the furnaces, the increase in efficiency results from extracting the heat from the exhaust gases that normally flow up the chimney with conventional boilers. By redesigning the heat exchanger within the high-efficiency boiler, more of the heat extracted from the exhaust (flue) gases is transferred to the water. In the process, the temperature of the flue gases drops to a point where the water vapor in the gases condenses, thereby giving up more heat. This process raises the overall operating efficiency of the boiler to about 87 percent, compared to about 60 percent for the conventional boiler.

Although boilers heat water and furnaces heat air, there are many similarities between high-efficiency boilers and furnaces. Neither requires a chimney for venting hot exhaust gases. They can vent the relatively cool flue gases through a side wall using a plastic pipe. Both require an intake air duct for those units that use outside air for combustion. Both require an induced draft blower (power vent). Both also require provisions for condensate drainage.

Pulse boiler Another type of high-efficiency boiler is the gas-fired Hydro-Pulse boiler. Its overall operating efficiency is about 90 percent. As with the boiler discussed above, the high operating efficiency is the result of extracting so much heat from the exhaust gases that the water vapor contained within condenses. However, the combustion process differs. With the gas-fired high-efficiency boiler, as well as the conventional boiler, heat is generated as a result of a continuous burning of the gas-air mixture, whereas with the Pulse boiler, heat is generated as a result of sixty to seventy mini explosions of the gas-air mixture per

second. This results in a noisier operation than with a conventional or high-efficiency boiler. Consequently, vibration isolators are usually installed between the boiler and connecting pipes to minimize noise transmission.

Advantages and disadvantages Because the forced-hot-water system operates under pressure with the water being circulated by a pump, it is very flexible. It can be used to heat an area below the level of the boiler. Additional, completely independent heating zones can be readily installed. Because the hot water remains in the pipes after the boiler is no longer being heated, there is less heat fluctuation and a more even temperature distribution. Also, the operation of this system is relatively quiet.

One of the disadvantages of this system is that with water in the pipes, the distribution system is vulnerable to freezing temperatures. In the event of an extended power failure or if an oil-fired boiler runs out of oil for several days during a cold spell, the pipes can freeze and burst. I know of several cases where antifreeze was introduced into the circulating water to prevent that type of a problem. In addition, this system is not adaptable to central conditioning of the air such as cooling, humidifying, and filtering.

Distribution piping There are three basic types of distribution piping arrangements for forced-hot-water systems: series loop, one pipe, and two pipe. The specific distribution system installed usually depends on the size and cost of the house.

Series loop This is the simplest and least expensive piping arrangement to install. It is usually used in smaller homes where room-by-room radiator adjustments are not needed for balancing the heat distribution. In a series loop, the radiators, usually baseboard convectors, are an integral part of the supply piping. (See FIG. 14-9.) If a radiator is shut off, the flow throughout the system is stopped. In this arrangement, the temperature of the water entering the last radiator will be considerably less than it was when it entered the first radiator. To minimize the difference in temperature and produce a more uniform heat distribution, the heating system for larger homes is often designed so that the house is divided into two or more heating zones. Each zone has a separate piping configuration and either has a separate circulating pump or shares a common circulating pump with the other zones, but has a separate thermostatically controlled valve in the main supply pipe.

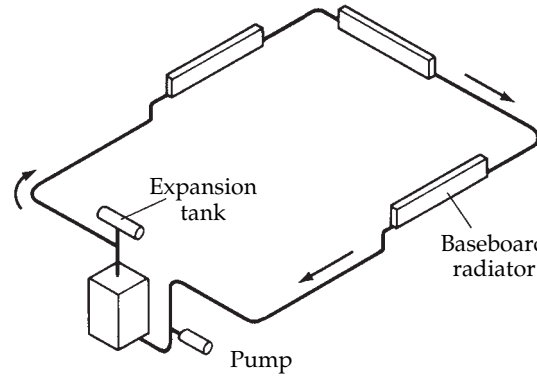


Fig. 14-9. *Series-loop piping configuration for forced-hot-water heating system.*

One pipe In a one-pipe distribution configuration, as with the series loop, a single pipe makes a complete circuit from the boiler and back again, serving as both the supply and the return. In this case, however, rather than the radiators being integral with the supply pipe, they are attached to it by two risers, one connected to each end of the radiator. (See FIG. 14-10.) Each radiator will also have a shutoff valve located at the inlet riser. Each radiator can be shut without affecting the water flow in the supply main. Consequently, this system can provide room-by-room heat control. However, as with the series loop, there is a considerable temperature difference between the water entering the first and last radiators. To compensate for the cooler water entering

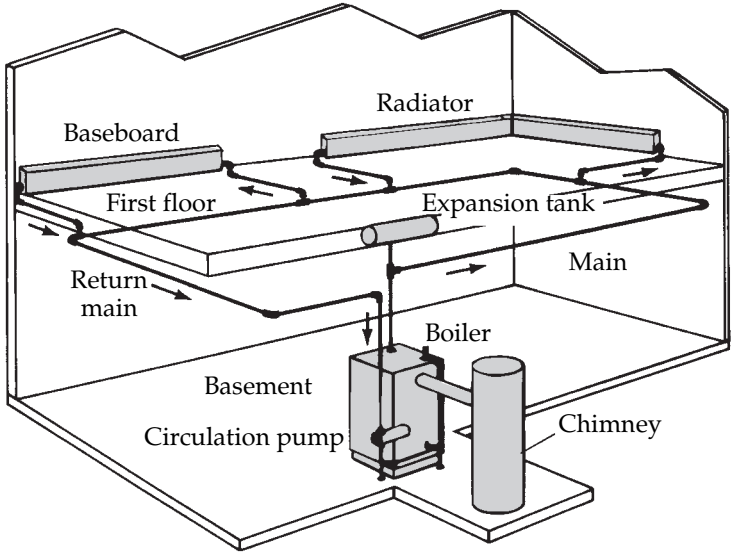


Fig. 14-10. *One-pipe distribution configuration for forced-hotwater heating system.*

the radiators downstream, larger radiators are often installed. They emit heat comparable to the smaller ones closer to the boiler.

Two pipe The two-pipe distribution configuration is the most costly to install, but it overcomes the deficiencies of the other configurations. There are two main pipes, one for the supply and the other for the return. The inlet and outlet ports of the radiators are attached to the mains by risers. (See FIG. 14-11.) The cool water leaving the radiator does not mix with the hot water flowing through the supply main, so the temperature difference between the water entering the first and last radiator is small.

Even though both the one- and two-pipe configurations will provide heat control for individual rooms if the radiator shutoff valve is manually closed or partially closed, the configurations are also often used in homes with zone heating. Zone heating is automatic. All that has to be done is to set the thermostat to the desired temperature for that portion of the house.

Radiators As discussed previously, the optimum location for a radiator is along an outside wall, preferably near or under a window. There are three basic types of radiators found in hot-water heating systems: freestanding cast iron, freestanding convector, and baseboard convector. Freestanding cast-iron radiators are found mostly in older homes. Unless an old home is being restored, a freestanding radiator is usually considered undesirable. Many clients have asked whether the radiators can be replaced with the newer finned-tube baseboard radiators. Yes, they can. Baseboard convector radiators are usually preferred because they distribute the heat better than cast-iron or freestanding convector radiators and are less conspicuous. They achieve an even temperature throughout the room because they distribute the heat near the floor. Natural convection causes the heated air to rise and warm the outside wall.

Panel heating Another method of heating using a forced-hot-water system is to embed the distribution piping into the walls, floors, or ceilings and let those areas (panels) function as radiators. (See FIG. 14-12.) The heat from the distribution piping is conducted to

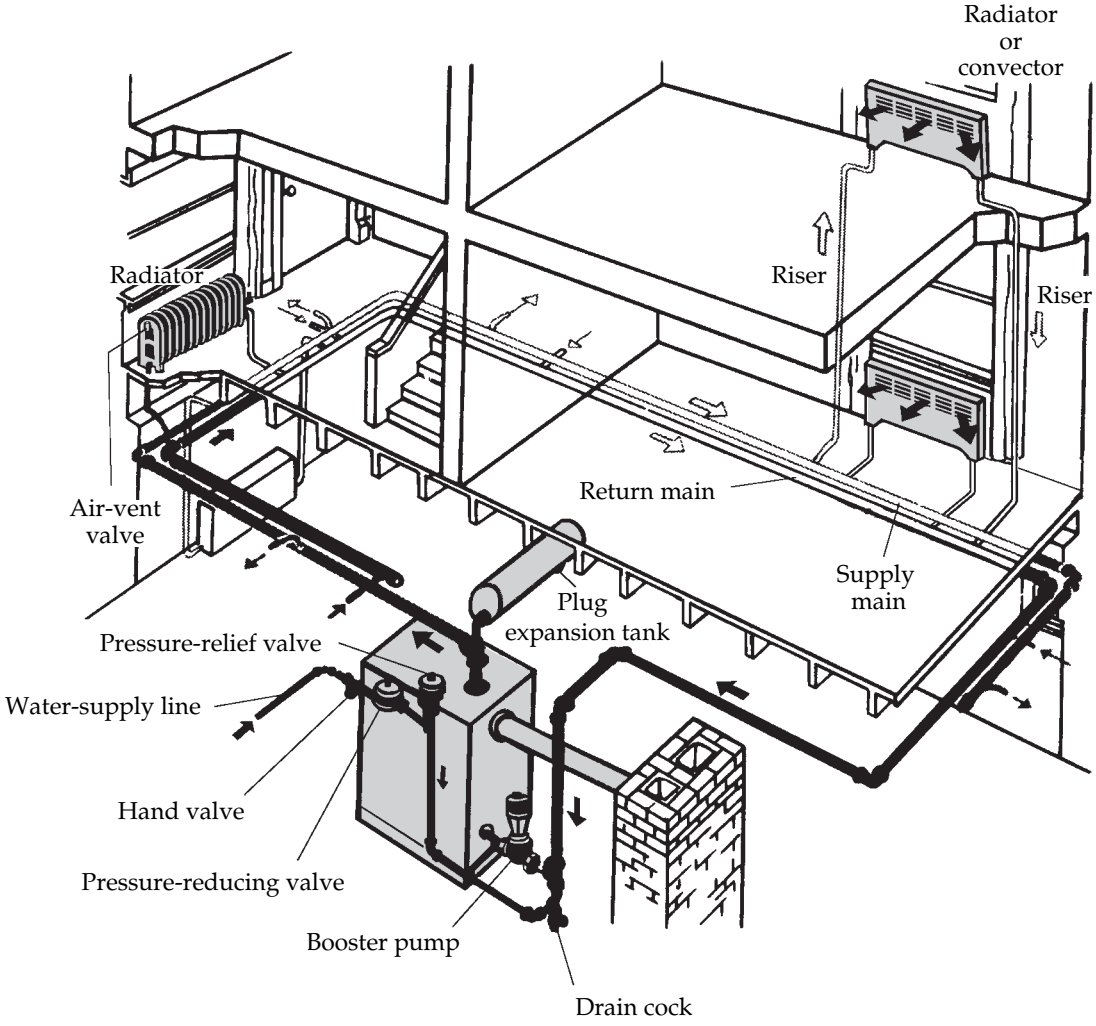


Fig. 14-11. *Two-pipe distribution configuration for forced-hot-water heating system.*

the surface of the panels; which in turn heats the room by radiation and convection. This system produces a very uniform temperature distribution and is particularly effective when the heating panel is the floor slab in a basementless house.

Controls In addition to the thermostat, hot-water systems have safety and operational controls. In a simple forced-hot-water system without individual zones, there is a high-temperature limit control that prevents the boiler water from exceeding a preset temperature and a controller for the circulating pump. Depending on the system design, the circulating pump can operate in any one of three modes: constant-running circulator, aquastat-controlled circulator, and relay-controlled circulator.

In the constant-running circulator, the pump is energized by a manual power switch

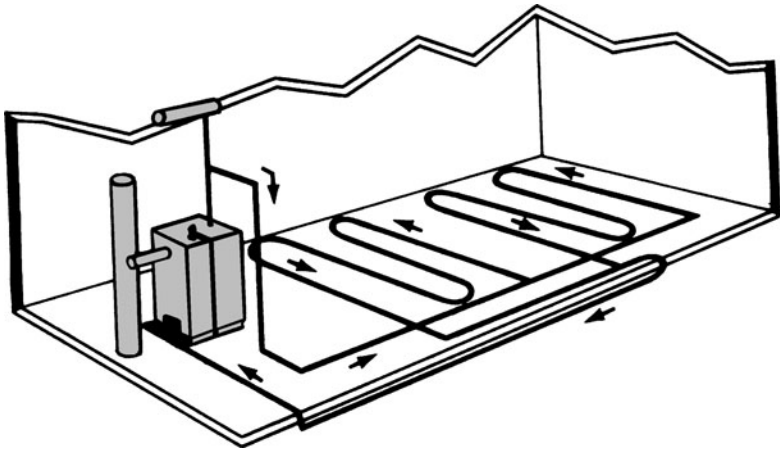


Fig. 14-12. Forced-hot-water radiant heating panels.

and operates continuously during the heating season. When the thermostat calls for heat, it fires the burner that heats the boiler. When the heating season is over, the circulating pump must be manually shut off. Sometimes the homeowner forgets to shut the pump, and the pump runs all summer. This type of operation is somewhat wasteful of electrical energy. However, this wastefulness must be weighed against the fact that intermittently operated circulating pumps tend to break down sooner than continuously operated pumps. The constant starting and stopping causes the bearings to wear out sooner. A constant-operating circulating pump is the least expensive to install because there is no relay or temperature controller. It can be converted to either—aquastat-controlled or relay-controlled.

In the aquastat-controlled circulator mode, as with the constant-running circulator, the thermostat will control only the burner. When the boiler water reaches a preset temperature (approximately 120° F), the circulator pump begins to operate. After the thermostat is satisfied and shuts off the burner, the circulator continues to operate until the water temperature drops below the temperature setting of the circulator control. In the relay-controlled mode, the thermostat simultaneously activates the burner and the circulating pump. When the thermostat is satisfied, it will simultaneously shut off the burner and the circulating pump.

Zone control Heating zones in a forced-hot-water system can have a separate circulating pump for each zone or a single circulating pump that services all the zones. When there is a single pump, each zone is controlled by an electrically activated valve that is in turn controlled by a thermostat. When one of the zone thermostats calls for heat, it opens the respective zone valve, fires the burner that heats the boiler water, and starts the circulating pump. After the system is operational, if another zone thermostat calls for heat, it merely opens the zone valve. This allows the hot water to circulate through that zone.

When there are separate circulating pumps for each zone, the first thermostat calling for heat will fire the burner and activate the pump. Thereafter, as long as the system is operational, other thermostats calling for heat will merely activate their respective circulating pumps.

Domestic water heater Most boilers used in hot-water systems can be equipped so that

they will also heat the domestic water (water used for washing and bathing). This is discussed in detail in chapter 16. When a heating-system boiler produces domestic hot water, the associated burner must fire all year long and not just for the heating season. In this case, the thermostat does not control the burner. It controls only the circulating pump. The burner is activated by an aquastat that controls the boiler water temperature.

Since the boiler will have hot water during those periods when heat is not required, a flow-control valve must be installed on the supply main. This valve prevents the hot water from rising into the distribution piping and heating the house like a gravity hot-water system. When heat is required, the circulating pump produces sufficient force to lift the flow-control valve and circulate the hot water. In a multizoned system, if zone valves are used, flow-control valves are not needed. When the zone valves are closed, water will not circulate in the distribution piping.

Relief valve Every forced-hot-water heating system must be equipped with an automatic pressure-relief valve as a safety control. To help ensure its effectiveness, the relief valve should be mounted directly on the boiler. Many systems have a relief valve that is mounted in the boiler feed line several feet away from the boiler. This is an improper location because over the years the relief valve can become isolated from the boiler as a result of a lime or scale buildup in the feed line. If this should happen, the valve would be completely ineffective in the event of a pressure buildup. If the heating system does not have a boiler-mounted relief valve, you should have one installed.

Pressure, temperature gauge Although not safety or operational controls, all forced-hot-water systems should have a pressure and a temperature gauge. Newer systems have a combination gauge that measures both pressure and temperature. In older systems, you probably will find a separate pressure gauge and a pencil-type thermometer attached to the boiler. The combination gauge often has two pressure scales, one in pounds per square inch (psi) and the other in altitude (feet of a column of water). (The altitude scale can basically be ignored, although for your information, one psi is equivalent to a column of water measuring 2.31 feet high.) The normal fill pressure of the boiler is 12 psi. This, then, is equivalent to an altitude of 27.7 feet. If the highest radiator in your house is more than 27.7 feet above the boiler, then a higher boiler-water pressure will be needed. Some pressure gauges have two points—one fixed and one movable. The fixed pointer is usually positioned over the normal altitude setting for that house. The movable pointer shows the actual working pressure of the heating system. If this pressure exceeds 30 psi, the relief valve will discharge.

Low water cutoff An automatic water feed valve is normally installed with a hot water boiler. It provides make up water in the event of a low water condition caused by a leak in the system or a discharging relief valve. Over the years these valves can become clogged with sediment and become ineffective. Electronic low water cutoffs are now being installed on new boilers to counter this potential problem. These units have a probe that projects into the water. As long as the water is covering the probe, an electronic circuit is maintained. If the water level drops below the probe, the circuit is broken, which automatically shuts off the burner and prevents damage to the boiler.

Steam heating systems

For the most part, steam heating systems are no longer used in new residential construction, but you will find them in older homes. In fact, in some of these homes, the boiler and its associated controls may be relatively new.

The boiler used in this system is basically the same as that used in a hot-water system. It will be made of either cast iron or steel. (See the discussion on boilers on pages 221–223. You can tell whether a boiler is being used for a steam system or a hot-water system by the type of controls and gauges used. A quick indication is a water-level gauge. (See FIG. 14-15.) If you see such a gauge, the boiler is being used to generate steam.

Unlike the hot-water system that is completely filled with water, the steam boiler is only partially (about three-quarters) filled with water, depending on the size and make. The remaining portion of the boiler, the distribution piping, and the radiators will be filled with air. After the system is fired, the water heats up until it boils, as in a tea kettle. The steam thus formed rises in the pipes of its own accord, without the aid of a fan or pump, pushing the air ahead of it as it moves along. The air from the pipes and radiators is then dissipated into the rooms through air-vent valves that, depending on the piping configuration, are located on the radiator or near the end of the steam main.

When the steam comes into contact with the cool radiator surface, it condenses back into water and in the process gives up its heat. The resulting water then flows back to the boiler for reheating. If because of a blockage in an air vent (often the result of painting the vent) the air cannot be evacuated from a radiator, a pressure will be built up within the radiator that will prevent the steam from entering. In this case, the radiator will be ineffective because it will not heat up. This condition can be easily corrected by replacing the air vent.

Distribution piping

There are two basic distribution piping configurations used with steam heating systems: one pipe and two pipe. You can easily tell which configuration is being used by the number of pipes connected to the radiator. In a one-pipe configuration, there is only one pipe connected to the radiator; in a two-pipe configuration, there are two.

In a one-pipe arrangement, the steam is distributed to the various radiators through the same pipe that carries the condensate back to the boiler. (See FIG. 14-13.) The radiators used in this system must be pitched so that the condensate flows back through the supply valve. Otherwise, the condensate can accumulate and block the steam flow. Each radiator has a manually operated supply valve and an air vent. Some radiators are equipped with an air-vent valve that has an adjustable opening. This opening can be increased or decreased in size, thus allowing the air in the radiators to be evacuated at a faster or slower rate. Adjustable air vents are often found in larger homes and are used as a means of providing a uniform steam supply to all of the radiators. Radiators closest to the boiler will receive steam before those that are farther away. In some cases, depending on the distance apart and the size of the radiator, those closest to the boiler can be fully heated before those farthest away receive any steam. By decreasing the vent opening on those radiators closest to the boiler and increasing the opening on those farthest away, it is possible for all of the radiators to receive steam at about the same time.

In a two-pipe configuration, the steam is supplied to the radiator by one pipe and the condensate returned to the boiler through another. The radiators in this system are not equipped with individual air-vent valves. They have a steam trap on the condensate return pipe. A steam trap allows the air bound in the radiator and the condensate to flow in the return pipe but closes on steam contact and does not allow the passage of steam. The air in the return line is then vented by a main vent. A two-pipe steam system can be converted to a forced-hot-water system. This cannot be done

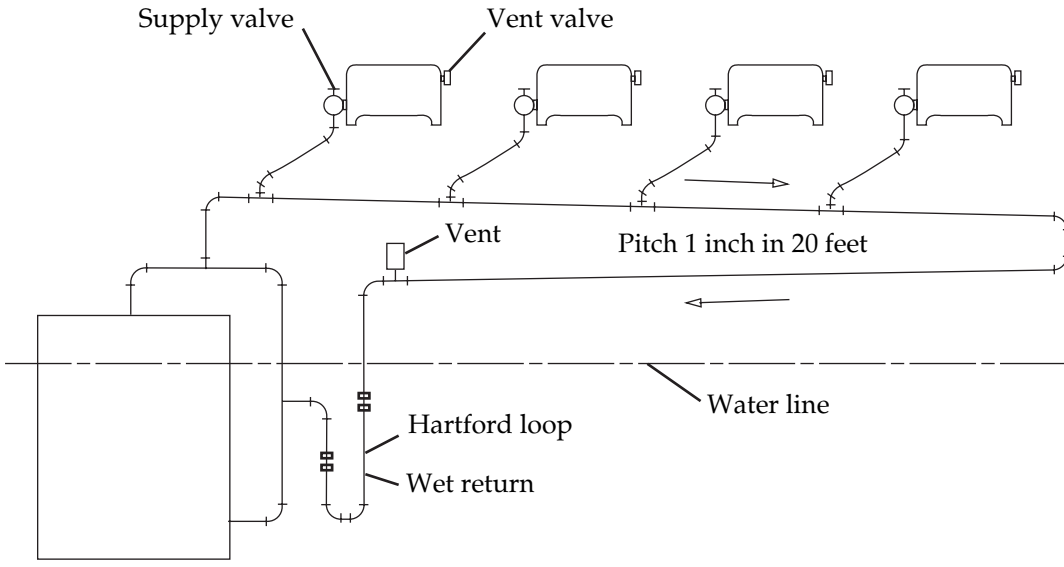


Fig. 14-13. *One-pipe distribution configuration for steam heating system.*

with a one-pipe steam system. In both one- and two-pipe systems, when the condensate is returned to the boiler, if the return line in the boiler room is above the boiler-water level, it is called a *dry return*. If the return line is below the boiler water level, it is called a *wet return*. When the system has a wet return, there should be a special piping arrangement at the boiler, a *Hartford loop*. (See FIG. 14-14.) The purpose of the Hartford loop is to prevent water from draining out of the boiler in the event of a leak in the wet-return piping. If a leak occurs in the return line, boiler water will drain down only until it reaches the top of the Hartford loop. There will still be sufficient water to prevent damage to the boiler if it continues to fire. If the heating system has a wet return, look for a Hartford loop. If you do not see one, you should consider its installation.

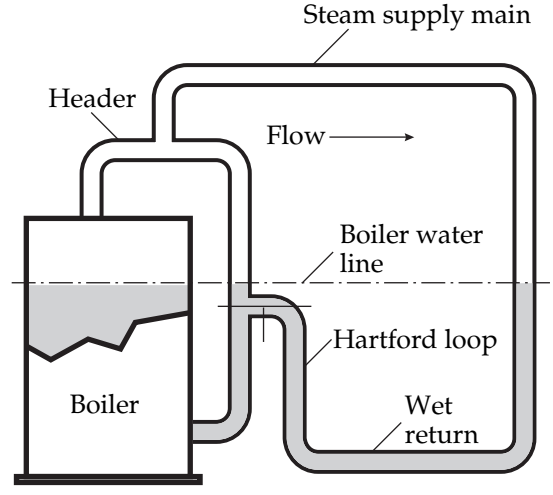


Fig. 14-14. *"Hartford loop" in the condensate return line of a steam heating system. The Hartford loop prevents water from draining out of the boiler in the event of a leak in the wet-return piping.*

Controls

In addition to the thermostat, every steam system should have a high-pressure limit switch, a low-water cutoff, and an automatic pressure-relief valve. Also, to determine whether the boiler is operating properly, there should be a water-level gauge and a pressure

gauge. (See FIG. 14-15.) The high-pressure limit switch is connected electrically to the burner control. When the steam pressure exceeds a predetermined setting, the limit switch will shut down the burner, thereby preventing the pressure from building up further. The limit control should be physically connected to the boiler with a pipe that has a curl that looks like a pigtail. The pigtail has water in the bottom of the loop, which prevents the corrosive action of the steam from affecting the control.

The low-water cutoff is a control that shuts down the burner when the level of the water in the boiler drops below the design level. There are two types of low-water controls—one mounted inside of the boiler and one externally mounted. The latter is preferred because it provides a convenient means for testing its operation. This unit has a blow-off valve that when opened drops the water level in the control, causing it to operate. In the past, manufacturers recommended that the low water cutoff be opened and blown down once every month to prevent sludge accumulation, which can affect its operation. They are currently recommending that it should be blown down once a week. All too often, homeowners neglect to perform this simple operation. I have checked many a unit that apparently had not been flushed in years; when I opened the blow-off valve, either nothing flowed out or there was a thick dark-brown sludge oozing out. The low water cutoff units that are mounted in the boiler have an electronic probe that projects into the water. As long as the water covers the probe, an electronic circuit is maintained. If the water level drops below the probe, the circuit is broken, which automatically shuts off the burner and prevents damage to the boiler.

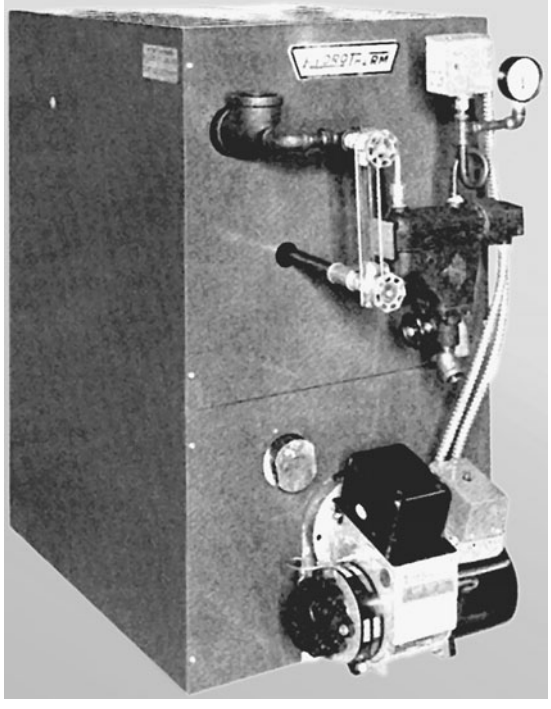


Fig. 14-15. *Oil-fired steam boiler, showing the level gauge, low-water cutoff, high-pressure limit switch, and pressure gauge.*

The water-level gauge provides a convenient means for determining the level of the water in the boiler. It is usually mounted on the side of the boiler; when there is an exterior-mounted low-water cutoff, it is often part of that assembly. The water level should be at the midpoint or two-thirds up the glass gauge. The exact position is not important. What is important is that you are able to see the water level. If the entire level gauge is filled with water, there is too much water in the system. In fact, the system can be flooded. If too much water is introduced into the boiler, the water level will rise until it fills the entire distribution system and radiators. If any of the radiator valves or fittings are not watertight, and sometimes they are not, the water will leak out all over the room.

When there is no water visible in the gauge, water must be introduced into the boiler. This can be done by manually opening the fill valve in the water-supply line. Some systems have an automatic boiler-water feeder that introduces

water to the required level as needed. This is a desirable feature, but occasionally such units malfunction. Often level gauges are coated with sediment so that the water level is not visible. In this case, the glass gauge must be cleaned and all the accumulated sediment removed.

The relief valve is a safety valve that automatically discharges when the operating pressure exceeds the design pressure. For a residential steam system, the relief valve is set to discharge at 15 psi, although the normal operating pressure is considerably less, usually about 1 to 2 psi. Some large systems may even operate at a negative pressure (vacuum).

Domestic water heater

As with hot-water boilers, steam boilers can also be equipped for generating domestic hot water. When it produces domestic hot water, the boiler must be fired all year long. When heat is not required, the boiler-water temperature is controlled by an aquastat. The aquastat activates the burner when the boiler-water temperature drops below a preset figure and shuts off the burner when the boiler-water temperature rises to about 200° F. When steam heat is required, the burner is activated by the thermostat. In this case, the thermostat overrides the aquastat control so that steam is produced.

In a forced-hot-water heating system that also produces domestic hot water, a flow-control valve is needed to prevent the boiler water from circulating as a gravity system during those months when heat is not required. In a comparable steam system, no flow-control valve or equivalent is necessary because the boiler water is not heated sufficiently to produce steam.

Advantages and disadvantages

The advantages of a steam heating system can be appreciated more in a large building than in a residential structure. It is a relatively simple system that does not require a pump or fan for circulation of the steam. Since there is no water in the pipes when the system is not operating, there is no problem of the pipes freezing and bursting. If a repair or replacement is needed to a section of pipe or a fitting, it is not necessary to drain the system. Also, a steam leak would result in very little water accumulation.

On the other hand, a steam system is slow in responding to an initial rapid change in heat demand because the boiler-water temperature must be brought up to 212° F before steam circulation begins. Unless the condensate is returned to the boiler by means of a pump, the boiler must be located below the radiator in the lowest rooms.

Hybrid heating systems

Depending on the extent to which the heating system has been modified or expanded, you may find a hybrid heating system. A hybrid system is composed of two separate heating systems working together.

Steam–hot water

I found the following in an old house. The system functioned as a two-zone system. The main portion of the house was heated by a steam system, and the remaining portion of the house (the lower sections) was heated by a forced-hot-water system. The distribution pipe for the hot-water system was tapped directly off the portion of the steam boiler that was below the water level, and a pump was used to circulate the hot water. The thermostat for this zone controlled the pump and the burner. There was also an aquastat temperature control for the boiler water to keep it from generating steam when the main zone was not calling for heat.

Hydro-air

Hydro-air is basically a hot water–warm air system. It is becoming more popular,

especially in larger homes. The system essentially consists of an air handler, which looks like the blower compartment of a furnace, a hot water boiler, and a duct system. Hot water from the boiler is pumped through a series of tubular coils that are mounted above the fan in the blower compartment. As air flows over the coil, it is heated and blown through the duct system to various areas of the house. There are a number of advantages to this system. You can easily add a number of separate zones to the boiler piping; one zone to an indirect fired water heater, another zone to a room that is a new addition and that is heated with baseboard, and a third to another air handler. Another advantage to hydro-air is that the same duct system can be used for the air-conditioning. Also, since no combustion takes place inside the air handler, there is no possibility of combustion gases being distributed throughout the house because of a cracked heat exchanger.

In large homes with more than one air handler, at least one air handler is usually located in the attic. In the event of a prolonged power failure, the water in the coils is subjected to freezing. If the home you are considering has a unit in the attic, as a precaution you should check to determine whether antifreeze has been added to the system either by a tag or a marking on the boiler or by asking the seller.

15

Heating systems II

Oil-fired systems 233
Gas-fired systems 235
Electrical systems 236
Area heaters 236
  Gas-fired units 237
  Electrical units 237
Heating system inspection procedure 237
  Warm-air systems 239
  Hot-water systems 241
  Steam systems 242
  Oil burners 243
  Gas burners 244
Checkpoint summary 244

The boilers and furnaces found in most homes today are heated with oil or gas burners or electrical resistance coils. In many older homes, you will find a boiler or furnace that was originally designed to burn coal but was converted to oil or gas for reasons of economy and convenience. The accessories associated with each heating element are described below.

Oil-fired systems

The most common type of oil burner used in residential heating is the high-pressure or gun-type burner. This unit has a pump that forces oil through a nozzle and produces an oil mist. It also has a fan that mixes the oil mist with a measured amount of air. The resulting flammable mixture is then ignited by an electric spark and burns in a refractory-lined firebox. If the mixture fails to ignite, a safety control will shut off the oil-pump motor. This control is located either in the exhaust stack as a heat-sensitive switch or in the burner as a light-detecting photocell.

The oil burner normally associated with the heating system will generally be either an older conventional unit or a high-efficiency flame-retention burner. Although both burners look somewhat the same to the untrained eye, there is a considerable difference in the flame pattern and overall efficiency. The flammable mixture of oil and air that is produced with a conventional burner is inconsistent. Some parts of the mixture will be fuel-rich and others fuel-lean. Consequently, these burners draw in a large quantity of air so that the fuel-rich portion of the flammable mixture will burn completely and thereby reduce the level of smoke produced.

The large quantity of air and the irregular flame pattern results in inefficient operation of the conventional burner. The flame-retention burner is more efficient. Because of its design, it produces a more uniform mixture of oil and air, requiring a smaller amount of air for complete combustion. This in turn produces a smaller, more compact flame that is hotter. A flame-retention burner gets more Btu out of a gallon of oil than a conventional burner. In fact, a new flame-retention burner is about 16–20 percent more efficient than a new, well-adjusted conventional burner. You can check with the company that services the oil burner to determine whether it is a conventional unit or a flame-retention burner.

The proper draft over the firebox is very important for efficient operation of the oil burner. To ensure the proper draft, most oil burners have a draft regulator mounted in the exhaust stack near the boiler or furnace. The regulator is basically a small swinging damper that can be adjusted to open an inch or two when the burner is firing. (See FIG. 16-7.) I have seen many draft regulators that have been made inoperative by someone cementing shut the opening. This can affect the efficiency of operation and result in greater fuel consumption. Also, to ensure the proper draft, the section of the exhaust stack between the boiler or furnace and the chimney must have an upward pitch.

Another type of oil burner occasionally found in central heating systems is the pot-type vaporizing burner. It contains few moving parts and therefore operates quietly. Basically, the unit consists of a pot containing a pool of oil and a control for regulating the oil flow to the pot. Air needed to produce a flammable mixture is introduced by a small fan. Once the mixture starts burning, the heat produced vaporizes the oil mixed with the air, thus maintaining the burning operation. The initial cost for this burner is less than that for a high-pressure gun burner. However, for efficient operation, it requires a more costly high-grade oil that vaporizes easily.

Oil for the burner is stored in a tank that is either buried in the ground just outside the house or located in the house not too far from the burner. The interior tank should be at least 7 feet from any flame and should have an outside fill connection. These tanks will generally have a 275-gallon capacity; buried tanks generally have a 550-, 1,000-, or 1,500-gallon capacity. Most municipalities allow a maximum of two 275-gallon tanks to be stored in the structure. Oil tanks have a projected life of about thirty years. After that time, pitting and corrosion holes tend to form on the bottom of the tank. This condition is the result of an accumulation of water and corrosive acids that settle on the bottom of the tank. Check to see if the bottom of the tank is at least 6 inches off the ground and whether the tank is at least 2 inches away from the walls. In many municipalities this is a code requirement. Run your hand across the bottom of the tank. If your hand has an oily film, the tank is leaking, even if it is not dripping oil. Recommend that the tank be replaced. Be advised that if there is a buried oil tank that is leaking, it is the homeowner's responsibility to clean it up, including removal of contaminated soil. See "Leaky oil tanks" in chapter 20.

All oil burners require periodic inspection, cleaning, lubrication, and adjustment to ensure an efficient soot- and odor-free operation. During the inspection, which should be performed at least once a year, the exhaust gas should be analyzed to determine whether the burner is operating at maximum efficiency. Preventive maintenance to the oil burner is usually provided by the company that supplies the oil. For an additional fee, oil companies usually issue a maintenance contract in which they agree to maintain and tune the system and provide emergency service. If you enter into a

maintenance contract with your oil company, make sure you know exactly what will be maintained. Some companies will inspect and maintain only the oil burner and not any of the peripheral equipment or controls.

I inspected a house one summer that had an oil-fired forced-hot-water heating system that also generated the domestic hot water. The burner, of course, had to fire during the summer to produce the domestic hot water. The circulating pump, however, had not operated for a few months because heat was not needed. When I turned on the heating system (by turning up the thermostat), the circulating pump started to smoke, and I smelled insulation burning. The homeowner, who was with me at the time, said, "How can this be? The oil company just serviced the system two days ago." I called the oil company to find out what kind of maintenance was performed. They informed me that they maintained the oil burner only. They did not even look at the circulating pump. Do not let a maintenance contract lull you into a false sense of security, thinking that your entire heating system is being maintained. It might be. But it must state so in the contract.

Gas-fired systems

If you are given an option and the fixed costs are comparable, a gas burner is preferred to an oil burner. It does not require annual maintenance and is less costly to install. Gas burners have a cleaner, quieter operation, and the supply of gas is not dependent on the weather. In addition, replacement costs are lower.

In this system, gas is supplied at low pressure to the burner through an automatic gas valve. The valve in turn is controlled by the thermostat or aquastat (if the system generates domestic hot water). At the burner, the gas that is mixed with air is ignited by a pilot light. Associated with the pilot light is a safety control, a *thermocouple*. The thermocouple closes the gas valve when the pilot light goes out. Basically, the thermocouple converts heat (from the pilot light) into a small electric current that keeps an electrically operated valve in the main gas line open. When the pilot light goes out, the current ceases, and the valve closes. If the thermocouple is faulty, the pilot will not light. Rather than have a pilot light that is constantly lit, many new boilers use an electronic ignition to fire up the burner.

Some gas-fired systems are equipped with a self-energizing control unit (Powerpile) that enables them to operate in the event of an electrical power outage. This is a particularly desirable feature, especially for those areas prone to power failures. The control unit basically consists of a special pilot-thermocouple assembly, gas valve, and thermostat. It can be used on steam, hot-water, and warm-air systems. With a self-energizing control unit during a power failure, a steam system will operate normally and a forced-hot-water or warm-air system will function as a gravity system.

As with oil burners, gas burners require a small but steady draft. However, rather than using a draft regulator, gas-burning equipment uses a draft diverter-hood. (See FIG. 16-7.) The hood is usually located on the exhaust stack above a boiler and is often built into the sheet-metal casing of a furnace. A draft-diverter hood is completely open on the underside and thus prevents air currents in the chimney (resulting from downdrafts) from blowing out the pilot-light flame.

All gas-burning equipment should have the American Gas Association's seal of approval. This indicates that a similar unit has been tested for safety. Look for the seal as you inspect the equipment. It is usually located on a plate mounted on the front of the boiler or furnace.

What type of pipe is used to supply gas to the furnace or boiler? It should be a rigid black iron pipe rather than a flexible pipe or a copper pipe. Many utility companies buy their gas from the cheapest supplier, and therefore, the gas can contain impurities that will react with copper. Although most municipalities allow flexible gas pipe for movable appliances such as clothes dryers and stoves, they generally require a rigid gas-supply pipe for stationary equipment such as a boiler, furnace, or domestic water heater. If the gas-supply pipe to the heating system is other than a black iron pipe, check with your local utility company for their requirements.

Check the gas meter to see if it is adequately sized to supply gas to the heating system and domestic water heater during peak periods. An inadequately sized gas meter might be found in a house that originally had a gas-fired water heater and an oil-fired heating system. Sometimes when the oil-fired system is converted to or replaced by a gas-fired system, the installer does not notify the utility company to replace the meter, which was sized to supply gas for only the water heater and kitchen stove.

A gas meter is rated in cubic feet per hour, and one cubic foot of natural gas is approximately equal to 1,000 Btu. Therefore, a meter rated at 250 cubic feet per hour can supply gas that is approximately equivalent to 250,000 Btu per hour. You can check to see if the gas meter is adequately sized by adding up the input Btu/hour requirements for the boiler or furnace and the water heater, and comparing the total with the meter. The input Btu will generally be found on the data plate that is mounted on the outer casing of the appliance. (The gas requirement for the kitchen stove is considered negligible for this comparison). The Btu capacity of the meter should be equal to or greater than the sum of the input Btu requirements for the heating system and water heater. If it isn't, make a note on your worksheet to notify the utility company.

Electrical systems

For the most part, electrical resistance heating is used for area heaters such as panel or baseboard heaters. It is also used, although less often, for central heating. The heating mechanism in a boiler or furnace is very simple. Electrical resistance coils are immersed directly into the water (for a boiler) or airstream (for a furnace). As the electrical current passes through the coils, they get hot and directly transmit their heat to the air or water. Unlike oil and gas energy, the conversion of electrical energy to heat is 100 percent. There is no heat lost to the exhaust gas because there are no exhaust gases. There is no fuel combustion with this system. Consequently, there is no need for a chimney.

From an installation point of view, electrical resistance coils are less expensive than oil or gas burners. However, for most parts of the country, they are more expensive to operate. To keep the operating expense from becoming excessive, electrically heated homes must be well insulated. In evaluating the cost of heating a house, do not depend on the owner's assurance ("Oh, it only costs a few hundred dollars to heat the house"). Insist upon seeing the most current year's bills.

Area heaters

These units are self-contained space heaters that are used to provide warmth to a single room. Sometimes they warm up two or three adjacent rooms if the doors between the rooms are kept open. The heat distribution is not very desirable from a comfort point of view. Other than a fireplace or stove, most area heaters of today will be gas-fired or electric.

Gas-fired units

Gas-fired space heaters are basically small warm-air furnaces and can operate either as gravity or forced-air units. Some of the smaller gravity heaters have an open combustion area exposing the flames. This is a potential fire hazard and is particularly undesirable when there are small children in the house. The exhaust gases from all gas-fired space heaters must be vented to the outside. In addition, the units should have the American Gas Association seal of approval. These units are controlled either automatically by a wall-mounted thermostat or manually by a calibrated knob on the gas valve. They are inexpensive to install, relatively maintenance-free, and require only periodic cleaning and adjustment.

Electrical units

Electrical space heaters have an advantage over central heating systems in that each room is usually individually wired, so there are as many independent heating zones as there are rooms. There are three general types of electrical area heaters: panel, baseboard, and wall. *Panel* heating, sometimes called *radiant heating*, is similar in concept to forced-hot-water panel (radiant) heating, as described in chapter 14. However, instead of hot-water pipes being embedded in the walls or ceiling, electrical resistance cables are installed with each room having a separate control. Similarly, *baseboard* heaters are like baseboard convectors (see chapter 14) but they contain electrical resistance coils rather than circulating hot water. They are very popular because of the ease of installation and low initial cost. They also produce a uniform heat distribution. Some baseboard heaters have a thermostat mounted directly on the unit rather than on the wall. This is not a desirable thermostat location because in many cases it will be necessary to move furniture every time a temperature change is desired. *Wall heaters* are compact units mounted on or recessed into a wall. Most heaters operate in conjunction with a fan that blows the warm air into the surrounding area. They are usually used to provide heat in nonhabitable areas such as a garage or workshop and are sometimes used to supplement a central heating system. These heaters do not produce a uniform heat distribution but are very responsive to a call for heat. They are usually manually controlled rather than automatically controlled.

Heating system inspection procedure

A full heating system inspection consists of an evaluation of the operation of the boiler or furnace, the burner, the condition of the distribution system (wherever visible), and heat outlets—radiators or registers. During your interior inspection, each room should be checked to determine whether there is a heat outlet and if there is, whether it is properly located for maximum effectiveness. The area below the radiators should be checked for signs of leakage, and the dampers in registers should be checked for ease of operation. Distribution piping or ducts, which are often visible in the basement, crawl space, attic, and garage, should be checked for leaky joints and the need for insulation. Also, the thermostats should be checked for location (should not be in a draft), condition, and type. An automatic clock-type thermostat is more convenient and if used properly, will result in fuel savings. A broken thermostat must be replaced, and one that is loosely mounted must be resecured.

The boiler or furnace and the associated burner are inspected after completing the interior inspection. By the time you are ready to perform this inspection, you should know whether the house is heated by warm air, hot

water, or steam. You can tell by the type of heat outlets—registers for warm air or radiators for hot water and steam. A radiator with one pipe attached is a steam radiator. When there are two pipes, it might be difficult to tell whether the radiator is used for hot water or steam. In this case, you should look at the boiler.

At first glance, two or more thermostats can lead to a false conclusion—that the house has a multizoned heating system. A house with a multizoned heating system will have more than one thermostat. However, a house with more than one thermostat need not have a multizoned heating system. The number of heating zones should be verified when you inspect the boiler or furnace. In a hot-water system, the zones are controlled by electrically operated valves, circulating pumps, or a combination of the two. For a warm-air system, the zones are controlled by electrically operated damper motors. Usually the number of thermostats indicates the number of independent heating zones. However, you might find more thermostats than zone controllers. I have inspected homes that had a one-zone heating system that was activated by two separate thermostats. When either thermostat called for heat, the entire house would be heated. Also, in older homes you might find an old nonfunctioning thermostat on a wall.

When you are ready to inspect the boiler or furnace, stand where you can see the burner, about 3 feet away. Have someone turn up the thermostat and activate the burner. It is important to be near the unit when the burner ignites to determine if there is a problem condition. A puffback with an oil burner, or flames licking back under the cover plate with a gas burner, is an abnormal condition and a potential hazard that must be corrected. Record it on your worksheet. If the unit does not fire, check the master switch. If the switch is on and there is an oil burner, push the *reset* button once. If the burner does not fire, there is a problem condition that must be corrected. If the gas burner does not fire and the pilot is lit, there is also a problem.

Once the unit is firing, check the overall condition. Is the boiler or furnace an aging unit? Do the burner and boiler or furnace appear to have been neglected? Are there signs of excessive corrosion (rust), dust, and flakes? Are there mineral deposits, indicating a past or current water leakage? If there is more than one heating zone, check each zone independently. This can be done by waiting until the burner or circulating pump (if a forced-hot-water system) shuts down and then activating the thermostat that controls the zone being checked. The thermostat should activate the burner or circulating pump, depending on the system (as described in chapter 14). Sometimes there is a time delay of about one minute or so between engaging the thermostat and activating the burner or circulating pump. This occurs because of the time that it takes to open the zone valve or damper physically. Also, some gas valves have a built-in time delay. However, if after five minutes nothing happens, there is a problem with the controls.

Check the condition of the smoke pipe. This is the horizontal section of sheet-metal pipe that connects the boiler or furnace to the chimney. In some cases, the boiler or furnace is connected directly to a prefabricated metal chimney, and there is no horizontal run. When there is, however, the pipe must have a slight upward pitch from the boiler or furnace to the chimney. If the pipe is long, it should be supported to prevent sagging sections. The pipe should not have corrosion holes, and the joints between sections should be tight. This pipe gets very hot and should not be within several inches of combustible material.

In recent years, *direct-vent appliances* (appliances that vent exhaust gas through a sidewall) have become more common. During your exterior inspection, if you see a

direct-vent terminal below a window, check the distance between the top of the vent and the bottom of the window. If the terminal is too close and the window is open, flue gases could enter the house. The recommended distance for an appliance with an input of 50,000 Btu per hour is a minimum of 9 inches, and for an appliance with an input of over 50,000 Btu per hour, the vent terminal clearance is at least 12 inches. Also the bottom of the vent terminal should be at least 12 inches above the ground.

The various types of heating systems have specific items that should be checked during an inspection. Each is discussed below. At the conclusion of the heating system inspection, remember to turn the thermostat back to its original setting.

Of particular concern is whether there is an adequate supply of air for ventilation and combustion for the heating equipment. When the heating system is located in an unconfined space such as an unfinished basement, there is generally sufficient infiltration so that the air supply is usually not a problem. However, if the system is located in a confined space such as a small furnace room, provisions must be made for an adequate air supply.

To provide the needed air supply, openings must be made within 12 inches of the top and 12 inches of the bottom in one of the walls of the enclosure. Each opening should have a *net free area* of at least 1 square inch per 1,000 Btu of total input rating of the equipment in the enclosed space. The size of the opening can be reduced if the air supplied to the furnace room comes from the outdoors rather than from inside the building. If the adequacy of the air supply is a concern, you should have it checked by a professional.

Warm-air systems

This system will be either gravity or forced. You can determine which by whether there is a fan. In some of the old "octopus"-type furnaces, the fan might be difficult to locate. It might be on top of the unit 5½ feet off the ground, or there might be fans in return ducts.

After the burner has fired, wait until the fan begins to operate. It should begin before the burner is shut down by the high-temperature limit control. If it begins after the burners are shut off, the fan controller is either faulty or out of adjustment. Also, if there is a canvas connection between the furnace and the main supply duct, check its condition. Torn or open sections should be patched. The canvas connection is used to isolate the supply ducts from the vibrations and sounds that develop within the furnace.

Be advised that with some older systems, the fabric connector may contain asbestos. Since warm air is constantly flowing across the fabric when the heating system is operating, the presence of asbestos would be considered a potential health hazard. See "Asbestos" in chapter 20.

When the fan is operating, is there excessive noise or vibration? There should be none. If there is a power humidifier, it is usually wired so that it will operate only when the fan is running. Turn the humidifier on by turning the humidity control up. If there are portholes in the unit, see if the fan or drum is rotating. If there are no portholes, listen to hear if the motor goes on and shuts off when the humidity control is lowered. Very often the humidifier is in need of a tune-up. This is usually indicated by excessive mineral deposits around the humidifier and the duct to which it is attached.

When the system is operational, check the flow and temperature of the air discharging from the various heat-supply registers. Put your hand in front of the register. A weak flow can be the result of air leakage in the distribution ducts, a dirty air filter, a loose fan belt, or the need for rebalancing. When the temperature of

the discharging air in one room is lower than in other rooms, it is probably caused by a heat loss in the branch duct leading to that room. The return register can be checked by placing a tissue on the grille. Because the return duct draws air in, the tissue should stay in place without falling down.

The item of main concern is the heat exchanger. When this portion of the heating system breaks down, the furnace or its heat exchanger must be replaced. When the furnace is aging or excessive corrosion is noted, the condition of the heat exchanger should be suspect. Also, if the flames in a gas-fired furnace are unstable and appear to be dancing, this often indicates a crack in the heat exchanger. It is recommended that prior to the contract closing, the furnace and associated equipment be tuned by a competent service organization. At that time, the serviceman can check the condition of the heat exchanger. Checking the heat exchanger usually requires the use of sprays, propane torches, and mirrors or disassembling a portion of the furnace and should be performed by a professional.

If the furnace is the high-efficiency condensing type, check the unit and associated piping for corrosion. Corrosion is a major concern in these furnaces because of the acidic nature of the condensate. Sulfur in the fuel oil or natural gas can combine with the flue-gas condensate to form sulfuric acid. Also, when indoor air is used for combustion, if the air contains chlorides, the chlorides can combine with the water vapor in the flue gas to form a corrosive condensate containing hydrochloric acid. Chlorides in the air can come from laundry bleach, household cleaners, even chlorinated tap water. To counter these problems, most condensing furnaces use outdoor air for combustion. They also generally use a plastic pipe for the exhaust stack and condensate drain.

Check the condensate drainpipe for blockage and loose sections. The condensate pipe should discharge into a floor drain that is connected to the house sewer. If the floor drain is not lower than the condensate drain or there is no floor drain, a condensate pump should be used. It is not good practice to have the condensate discharge into a hole in the floor slab.

The air supply should also be checked for blockage. If the supply pipe is run through the roof, the exposed end should be shaped like an inverted U with the open end facing down. This keeps the rain out, and since the supply and exhaust pipes are generally near each other, it prevents exhaust gases from being drawn into the supply pipe.

With a condensing furnace, the exhaust vent should not be combined with the exhaust from another appliance such as a water heater. The exhaust gases can be vented through a side wall, the roof, or a masonry chimney. However, if connected to a chimney, the plastic pipe should run up to the top of the chimney where the exhaust gas can vent to the atmosphere. If the exhaust pipe terminates at the base of the chimney, the corrosive condensate that forms will attack the masonry.

If the exhaust pipe has horizontal sections, see if any low spots or sagging sections could trap condensate and thereby block the exhaust gas from venting. Horizontal sections should have a slight pitch back to the furnace. This is especially important if the section is near the termination by a side wall or attic. If the exhaust pipe is sloped away from the furnace, the condensing water vapor in the exhaust gas could freeze and eventually block the opening in the pipe.

Condensing furnaces are noisier than conventional furnaces. They have a higher airflow, which is needed to absorb the additional heat resulting from the added heat exchanger. The higher airflow produces more sound and vibration. There is also a draft-inducing blower that is needed to overcome

the increased resistance to the flowing exhaust gases. Although the operation of a condensing furnace is noisier than that of a conventional furnace, it is generally not considered annoying. If you find it bothersome, record that fact on your worksheet. The system is in need of a tune-up and adjustment by a competent heating contractor.

Condensation of water vapor in the exhaust gases also occurs in a pulse-combustion furnace. Consequently, the overall concerns of exhaust-gas venting and condensate removal, as discussed previously for condensing furnaces, apply. Because of the nature of the combustion process in a pulse furnace, the sound of sixty to seventy tiny explosions per second can be heard outdoors at the side-wall terminations of the air-supply and exhaust-vent piping. In those cases, where the sound is considered objectionable, mufflers can be installed on the supply and exhaust pipes to reduce the sound level.

Hot-water systems

When inspecting a hot-water heating system, you should first determine whether it is a gravity or forced system. Sometimes an open expansion tank is found in the attic during the interior inspection. This would normally indicate a gravity system. Often, however, the expansion tank is no longer functional and was replaced by a closed expansion tank when the system was converted to forced circulation. You can easily tell whether a system has forced or gravity circulation by checking the equipment associated with the boiler. A forced system will have a circulating pump in the return line near the boiler. Record the type of system on your worksheet.

Next, look at the pressure gauge and record the operating pressure. The normal operating pressure should be between 12 and 22 psi. Since the water-makeup valve (pressure-reducing valve) is set to introduce water into the system when the pressure drops below 12 psi, any pressure below that value indicates either a malfunctioning valve or the need for adjustment. A low-pressure reading is fairly common.

If the pressure gauge indicates an operating pressure of 30 psi, the relief valve should be discharging. Sometimes the relief valve has already discharged and lowered the pressure to about 28 psi. In this case, the exposed end of the relief valve will have water dripping from it, and there will be a pool of water on the floor. A high-pressure condition that results in the relief valve discharging will usually be caused by a waterlogged or undersized expansion tank. If domestic hot water is generated through the heating system, another possible cause for a high-pressure condition is pinholes in the coils of the water heater. Regardless of the cause of the high pressure, the condition must be corrected.

Locate the relief valve. From a safety point of view, it should be boiler-mounted. If there is no boiler-mounted relief valve (and often there is not), the installation of one should be considered. Do not check the valve to determine whether it is operational. Bits of corroded material, sediment, or mineral deposits may prevent the valve from reseating properly and shutting off. Your best bet is to check the valve after you move into the house. At that time, if it does not reseat properly, it should be replaced. A relief valve is inexpensive. These valves should be checked at least once a year by pulling the lever and allowing a small quantity of water to flow. This action flushes any sediment that tends to build up before it has a chance to clog the valve. Some relief valves do not have levers for testing the unit. If you have such a relief valve on your boiler, you should consider replacing it.

As the various zones are being checked, inspect the zone valves for dripping water and deposits. Even though the valves might

be working during your inspection, if water is dripping from the valves, they should be replaced. The dripping water results in a mineral-deposit buildup that can eventually cause the valve to "freeze" in an open or closed position. This might happen, and usually does, on the coldest night of the year. Zone valves are perhaps the weakest link in the heating system, and their occasional replacement should be anticipated.

Is the circulating pump operating properly? Just because you can hear the pump operating or feel its vibration does not mean that it is functioning properly. The coupler between the pump and the motor may be broken, and the noise that you hear or the vibration that you feel may be only the motor turning, not the pump. You can be sure the pump is operating by putting your hand on the return pipe associated with that pump. After a while, the pipe will get hot if the pump is operational. Check the gasket between the pump and the motor for signs of current or past leakage. This is a vulnerable joint for leakage.

Is the circulating pump emitting any unusual or loud sounds? If it is, the noises might indicate faulty bearings, and the condition should be checked by a service organization. If you see smoke coming from the circulating pump or smell electrical insulation burning, the entire system must be shut down immediately and the condition corrected. One last check of the circulating pump is to determine whether it operates continuously or intermittently. If the circulating pump continues to run long after the thermostat is not calling for heat, it is in continuous-mode operation. This mode, discussed in chapter 14, can be modified to an intermittent operation.

If the heating system is used for generating domestic hot water, the thermostat will not control the burner, only the circulating pump. In this case, check the temperature of the boiler water (look at the temperature gauge). If the temperature drops below 150° F and the burner does not fire, it will indicate a faulty or improperly set aquastat. In most cases, the burner will be activated when the temperature drops below 180° F.

In addition to the above, with high-efficiency condensing and pulse boilers, look at the piping associated with the inlet air supply, exhaust gas vent, and condensate drain. Check to see that there are no loose sections, that there is no blockage at the pipe terminations, that the exhaust pipe is not combined with the exhaust from the water heater, and that the horizontal portions of the exhaust pipe slope back to the boiler. Also check that the condensate pipe discharges into a floor drain or condensate pump rather than a hole in the floor slab.

Steam systems

In this system, a water line showing the level of water in the boiler should be visible in the level gauge. Look for the gauge. If it is dirty, it must be cleaned. A gauge that is completely filled with water indicates too much water in the system, and an empty gauge indicates an insufficient amount of water in the boiler. When the water level in the gauge is unsteady (rising and dropping), it indicates a problem condition that might reflect an excessive grease and dirt buildup in the boiler or that the boiler is operating at an excessive output. In either case, it should be corrected.

Check the heating unit to determine whether it has all the required safety controls. A steam system should have a low-water cutoff, a high-pressure limit switch, and a relief valve. If any of these items are missing, record the fact on your worksheet. Look for the low-water cutoff. Is it the built-in type or externally mounted? If it is externally mounted, you should test its operation. This is a normal procedure that the manufacturer recommends

the homeowner perform periodically. If the relief valve is old, then as a precautionary measure it should be replaced after you take possession of the house.

Look for the condensate return line to the boiler. Is it a wet or dry return? If it is a wet return, it should be connected to the boiler by means of a special piping arrangement, a *Hartford loop*. Is there one? If not, the installation of a loop should be considered.

Oil burners

When the heating system is oil-fired, the first thing you should note is whether the top portion of the chimney (as seen during your exterior inspection) is covered with soot. This is an indication that the oil burner has not been operating efficiently. When you are inspecting the heating unit, look for a card or tag near or on the unit that contains the maintenance service record. Whenever a serviceperson performs any type of maintenance, even a tune-up, he or she records the date on this card. This will at least give you an idea of whether the burner has been maintained or neglected. The burner should be tuned up and checked for combustion efficiency at least once a year.

Other telltale signs indicate the need for oil-burner maintenance. Is there a smoke odor in the furnace room? When the oil burner first fired, was there a puffback of smoke and fire? At startup, while running, or at shutdown, do you feel pulsations in the boiler room? Are there particles of soot on the furnace or around the burner? Is the oil burner emitting an abnormal noise during operation? If any of the above questions are answered yes, oil-burner maintenance is needed. There are also tests that can be made, such as sampling the exhaust gas for combustion efficiency. This analysis, however, should be performed by a competent serviceperson.

The proper draft over the firebox for an oil-fired system is critical to efficient operation. Therefore, there must not be any cracks or open joints that will allow excess air to infiltrate into the combustion chamber or smoke pipe. Look for cracks and open joints at the front of the boiler near the burner, especially around the air tube, mounting plate, and front boiler doors. If you can see the flame through the cracks or open joints, the open areas should be sealed with a refractory cement. A vulnerable joint for air leakage is the joint between the smoke pipe and the chimney. If this joint is cracked, it must be sealed. Also, to ensure a proper draft, there should be a functioning draft regulator on or near the smoke pipe. Look for one. If it is missing or inoperative, record the fact on your worksheet.

If you see a small hole in the flue stack about ¼ inch in diameter, don't be concerned. It is a test hole that is used by the oil-burner serviceperson for measuring operational parameters such as draft, percentage of carbon dioxide, and stack temperature.

Next, look inside the firebox. The refractory lining of the fire chamber should be intact. There should not be any broken sections or holes in the lining. If there are, maintenance is needed. While looking inside the firebox, if the heating unit is a boiler rather than a furnace, look for water dripping or seeping around the top or sides. As discussed earlier, this condition might be caused by joint movement as a result of thermal expansion. Nevertheless, as a precautionary measure, since it can also be caused by a cracked boiler, it should be checked by a professional.

The oil burner receives its oil through a feed line that runs to the oil storage tank. The feed line is usually a small-diameter copper tube that can easily be damaged and must be protected. Look for the line. It should not run exposed over the floor. (See FIG. 15-1.) Someone could accidentally step on and damage the feed line, restricting the

Fig. 15-1. *Oil-fired forced-hot-water boiler with an exposed oil-feed line. The feed line is a small-diameter copper tube that can easily be damaged. It should be protected. Usually the feed line is located below the floor slab and emerges near the oil burner.*

flow to the burner and causing oil to leak on the floor. If the storage tank is the interior type, the underside of the bottom section should be checked for oil leakage. Run your hand along the underside of the tank. If your hand has a slight or heavy film of oil, the unit may be deteriorating, in which case patching repairs would be in order. The average projected life for these tanks is about twenty years.

Gas burners

Gas burners do not require as much preventive maintenance as oil burners. All that is normally needed is periodic cleaning and adjustment. Look at the gas burners. In neglected units, they are covered with excessive corrosion (rust) dust. Quite often some of the gas ports are clogged by the rust particles and are no longer effective. This condition requires a professional cleaning. The quality of the flames on the gas burner is important. The flame should be primarily bluish in color, with little or no yellow. If the flame is lifting off the burner head, it is an indication that too much air is being introduced into the mixture.

A yellow tip in the flame will result in a soot layer building up in the flue passage of a boiler. After some years, the soot buildup can completely block the flue passage. I found this condition in a boiler that was only seven years old. A blocked flue passage is a potentially dangerous condition because it prevents the exhaust gas from rising up to the chimney. Instead, the gas, which contains poisonous carbon monoxide, seeps into the house. Fortunately, this condition can be easily corrected. Clean the boiler flue passages with a long stiff brush to remove the soot buildup and adjust the air intake to the burner.

Another safety check that should be made is to test the draft in the chimney. After the heating unit has been operational for a few minutes, put your hand near the draft diverter (located on the exhaust stack above a boiler and built into the sheet-metal casing of a furnace). There should be no outward flow of hot exhaust gas toward your hand. If you do feel a flow on your hand, a potentially dangerous condition exists that should be checked by a professional.

Checkpoint summary

General considerations

- ❍ How old is the heating system?
- ❍ Is the boiler or furnace an obsolete unit (i.e., a converted coal-fired boiler or an "octopus" warm-air furnace)?

- ❍ Check each room for heat-supply registers or radiators.
- ❍ Are supply registers or radiators located on or near exterior walls (preferably under the windows or next to exterior door openings)?
- ❍ Check supply-register dampers for ease of operation.
- ❍ Are there separate return grilles for each room or centrally located returns for each floor?
- ❍ Check radiators for broken shutoff valves and blocked air vents (steam systems).
- ❍ Inspect area below radiators for signs of leakage.
- ❍ Check visible portions of ductwork and piping (basement, attic, garage, etc.) for open or leaking joints and uninsulated sections.
- ❍ Are the thermostats properly located (no drafts)?
- ❍ Note whether the thermostats are manual or automatic clock units.
- ❍ Is the clock functional?
- ❍ Check each heating zone and thermostat control independently.
- ❍ Is there an adequate air supply for the heating system?
- ❍ If the heating unit has a direct vent, is it properly located?

Boiler or furnace

- ❍ Check boiler or furnace during startup. Note any puffback with an oil burner or a licking back of flames on a gas burner.
- ❍ Is the boiler a steel or cast-iron unit? Is it aging? Is it neglected?
- ❍ Check for signs of excessive corrosion (rust), dust, flaking metal, and mineral deposits indicating past or current leakage.
- ❍ Inspect firebox, if accessible, for water seepage through joints and dripping water. Have this condition checked by a professional.
- ❍ Check smoke pipe for corrosion holes, open joints, sagging sections, and adequate clearance.
- ❍ If furnace or boiler is the condensing type, check for corrosion, signs of condensate leakage, blockage in the supply and vent pipes, and horizontal vent pipe sections sloping back to the furnace or boiler.
- ❍ Check master shutoff switches for proper operation.

Warm-air systems

- ❍ Check furnace, burner area, and sheet-metal casing for excessive corrosion, rust, and flaking metal.
- ❍ Check for unstable or dancing flames (gas-fired furnace). If these conditions are noted, have the heat exchanger checked by a professional.
- ❍ If there is a canvas connection between furnace and main supply duct, check it for torn and open sections. This material may contain asbestos.
- ❍ Check fan controller during furnace operation. If fan starts after the burners shut off, controller is either faulty or out of adjustment.
- ❍ Check fan operation for excessive noise or vibrations.
- ❍ If system contains a power humidifier, check for operation, signs of leakage, and excessive mineral deposits.
- ❍ During furnace operation, check airflow and temperature in room supply registers.
- ❍ Check return grilles for proper air circulation (tissue test).

Hot-water systems

- ❍ Check whether system is forced or gravity circulation.
- ❍ During operation, check pressure gauge. System pressure should generally be between 12 and 22 psi.

- ❍ Inspect for relief valve, which should be boiler-mounted. Do not check valve operation.
- ❍ Check circulating pumps for proper operation (motor and pump both functioning). Note any unusual loud sounds.
- ❍ Inspect pumps for leaking fittings or gaskets.
- ❍ Check each zone valve independently. Inspect valves for dripping water and deposits.
- ❍ If boiler also generates domestic hot water, check temperature gauge to determine whether aquastat is faulty or improperly set.

Steam systems

- ❍ Check water-level gauge for proper level, accumulated sediment, and fluctuations (rising and dropping).
- ❍ Is the water supply to the boiler a manual or an automatic feed?
- ❍ Check boiler for required safety controls: a low-water cutoff, a high-pressure limit switch, and an automatic relief valve.
- ❍ If low-water cutoff is an external type, check operation by flushing the unit.
- ❍ Inspect boiler relief valve. *Do not operate*. If valve is old, consider replacement.
- ❍ Inspect the condensate return line. Is it a wet or dry return? If a wet return, is there a Hartford loop?

Oil burners

- ❍ During exterior inspection, check top portion of the chimney for accumulated soot.
- ❍ Has oil burner been maintained or neglected? Look for a dated maintenance service card.
- ❍ During operation, note any smoke odors or soot particles in the furnace room.
- ❍ Are any abnormal noises or pulsations emitted from the oil burner during operation?
- ❍ Check for cracks and open joints near the burner, particularly around the air tube, mounting plate, and front boiler doors.
- ❍ Check for air leakage at the joint between the smoke pipe and the chimney.
- ❍ Check exhaust stack for an operational draft control.
- ❍ Check refractory lining of the fire chamber for cracked and deteriorating sections.
- ❍ Check oil-burner feed lines (copper tubing). Are there kinked or exposed sections vulnerable to damage?
- ❍ Check underside of oil storage tank (interior type) for leakage.

Gas burners

- ❍ Check gas burners for corrosion dust and clogged gas ports.
- ❍ Check flame pattern for safe and efficient operation.
- ❍ Check draft diverter on the exhaust stack for backflow of exhaust gases.
- ❍ Is the gas meter adequately sized?

16
Domestic water heaters

Tank water heaters 248
Reversed connection 248
Relief valve 249
Rumbling noise 251
Exhaust stack 252
Operational inspection 252
Water heater replacement 254
Water heater capacity and recovery 255
Tankless (coil) water heaters 256
Inspection procedure 258
Tankless (wall-mounted) water heaters 259
Indirect-fired storage water heaters 260
Checkpoint summary 261

Hot water for bathing and washing (domestic hot water) is produced through a separate tank-type water heater, through the heating-system boiler (steam or hot water) by a tankless coil, or through an indirect-fired storage water heater. Domestic hot water is considered by manufacturers as cold water whose temperature has been raised 100° F. An important consideration in the design of water heaters is the ability of the unit to raise the temperature of 1 gallon of water 100° F. This criterion is used in evaluating the recovery rate for tank heaters and the water-flow rate for tankless coil heaters. These items will be discussed in the sections that follow.

The temperature of domestic hot water is important for energy conservation and safety. The operating temperature range for most water heaters is between 120° and 160° F, although in some cases it is possible to achieve temperatures of 180° F. Normally, a thermostat setting that produces a water temperature of 140° F will be adequate for household chores, including the use of automatic clotheswashers and dishwashers. However, for washing dishes by hand or bathing, temperatures of 120° F are more than adequate. In fact, 120° F water is above the tolerance level of most people and will have to be mixed with cold water. Setting the thermostat so that the water temperature exceeds 140° F is wasteful of energy and will shorten the life of the water heater. In addition, a water temperature in excess of 160° F is a potential hazard because of the possibility of being scalded while showering (if the mixing valve should be faulty).

Tank water heaters

Most tank water heaters are located near the heating system or in a utility room, sometimes in the kitchen or a closet. These heaters basically consist of a lined steel tank that is covered with an insulated sheet-metal jacket to reduce heat loss. The lining in the tank is usually vitreous enamel (glass) but can be concrete (stone) or copper. To minimize tank corrosion, most heaters are equipped with a "sacrificial" magnesium anode rod that is suspended inside the tank. The electrochemical action causing corrosion takes place between the water and the anode rather than between the water and the tank, thereby extending the life of the tank. Some tanks are constructed so that the magnesium anode can be inspected and replaced if necessary. Tank water heaters are gas- or oil-fired or electric. (See FIG. 16-1.)

Reversed connection

Many water heaters have at the top of the tank hot-water outlet and cold-water inlet fittings that are clearly marked HOT and COLD, respectively. Yet it is surprising how many times I have found heaters with a reversed water-line installation. You can tell whether the installation is reversed by touching a pipe about 4 feet away from the unit and comparing it with the HOT outlet fitting on top of the tank. A reversed connection results in an inefficient operation of the heater. Even though there is a cold-water inlet tap at the top, the cold water does not enter the tank at the top. There is a pipe (dip tube) inside the tank connected to the inlet fitting that carries the cold water to the bottom of the tank. Because the hot water tends to rise above the cold water, the hot water is normally at the top of the tank where it flows through the outlet fitting. When the inlet-outlet

Fig. 16-1. *Tank water heaters. Left—gas-fired. Center—oil-fired. Right—electric. Rheem Mfg. Corp.*

connection is reversed, the cold water enters the tank at the top and mixes with the hot water as it settles to the bottom near the outlet fitting. Consequently, for the same thermostat setting, the temperature of the hot water is lower than it would otherwise have been. To compensate for the lower temperature, homeowners usually turn the thermostat to the high setting, thereby increasing the fuel cost and decreasing the life of the water heater. Some heaters have interchangeable cold- and hot-water fittings. In these units, the dip tube can be shifted from one side to the other.

Relief valve

All water heaters must have a relief valve that is both temperature- and pressure-sensitive. A relief valve that responds to pressure only will not offer adequate protection for the homeowner. An excessively high pressure alone can cause the tank to rupture. Though this will cause water damage, it is not necessarily dangerous. However, if the tank should rupture as a result of a high-temperature failure, the superheated water contained therein will flash into steam, instantaneously releasing high energy in an explosion. A relief valve that is sensitive to both temperature and pressure can avoid this problem.

The relief valve should have an extension that will allow it to discharge into a bucket on the floor. Sometimes, a relief valve is found without this extension. (See FIG. 16-2.) This is a potential hazard because a person standing near the water heater when the relief valve discharges could be scalded. I have also found an extension on the relief valve that leads to a sink or floor drain located near the water heater or in the next room. (See FIG. 16-3.) This type of piping arrangement is usually installed to eliminate water damage if the relief valve discharges. Water discharging from the valve will flow directly down the drain rather than

Fig. 16-2. *If this relief valve discharges, someone standing nearby could be scalded. The relief valve should have an extension that discharges into a bucket located on the floor.*

Fig. 16-3. *The relief valve has an extension that leads to a sink in the adjacent room. This is undesirable because the effluent will go down the drain, and the homeowner will not be aware of a discharge condition.*

accumulate on the floor. The disadvantage of this installation is that the homeowner might never know a discharge condition had occurred. A discharging relief valve indicates an abnormal condition of some type that should be checked out. Obviously, if the homeowner does not know that there is a problem, he or she will not have it corrected. By having the relief valve discharge into a bucket, water damage can be eliminated, and the presence of a problem condition will be indicated.

If you notice that the relief valve is dripping and the temperature of the hot water is not excessive, the problem will be either a defective relief valve or the result of thermal expansion. Many municipalities require a backflow preventer or a nonbypass pressure regulator on the inlet water service. This creates a closed system when a faucet is not drawing water. When the water is heated and expands, the resulting pressure buildup causes the relief valve to drip. Installing an expansion tank on the cold-water inlet to the water heater can control this condition. (See FIG. 16-4.) Record a dripping relief valve on your worksheet for later correction.

It's also important that the Btu capacity of the relief valve exceed the Btu input of the water heater. If the capacity is less, the relief valve will not be able to discharge the overheated water at the same rate that it's produced, resulting in an unsafe condition or possible explosion. Check the capacity of the relief valve by looking at the nameplate mounted on the valve. Specifically look for the AGA (American Gas Association) rating given in Btu/hour (see FIG. 16-5). This rating must exceed the Btu input to the water heater listed on the data plate mounted on the side or top of the tank casing. You can also check the Btu rating of electric water heaters even though they are rated in watts rather than Btu/hour. You can determine the electrical energy input to the heater by converting the total wattage of the heater, which is listed on the data plate, to Btu/hour. 1 watt = 3.413 Btu/hour.

To be effective, the relief valve should be located so that its sensing element is immersed

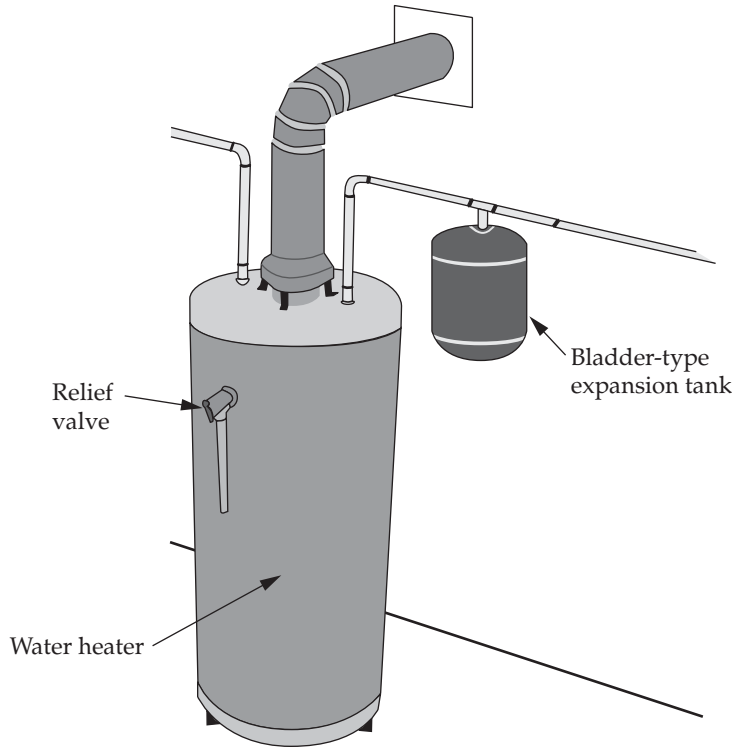


Fig. 16-4. *Bladder-type expansion tank installed to prevent relief valve from leaking due to thermal expansion of the water in the domestic water heater tank.*

in the top 6 inches of water in the tank rather than in the hot-water outlet pipe. This is important because there is a temperature difference between the tank and the hot-water outlet pipe. For instance, when the relief valve is installed in the hot-water outlet pipe 5 inches away from the tank, the water in the tank could be raised to 250° F before the temperature at the valve reaches 210° F.

During my inspections, I have often found the relief valve located on the cold-water inlet pipe. This location negates the effectiveness of the valve. If you find a relief valve on the cold-water inlet pipe, you should notify the homeowner of the potential hazard and have it relocated after you take possession of the house.

It is important that the diameter of the relief-valve extension pipe be the same as the outlet opening of the relief valve. If the extension pipe has a smaller diameter, it reduces the discharge capability of the valve and reduces its effectiveness as a safety device.

Rumbling noise

Over the years, sediment scale and mineral deposits tend to build up at the base of the tank. Manufacturers suggest that a few quarts of water be periodically drained from the water heater to help remove these deposits. However, this practice is not always effective, and if sufficient deposits accumulate, a rumbling or pounding sound can be heard when the unit is firing. If you hear a rumbling noise while inspecting the water heater, do not be alarmed. It is not a dangerous condition, although the noise can be annoying. In addition to their annoyance value, accumulated deposits at the

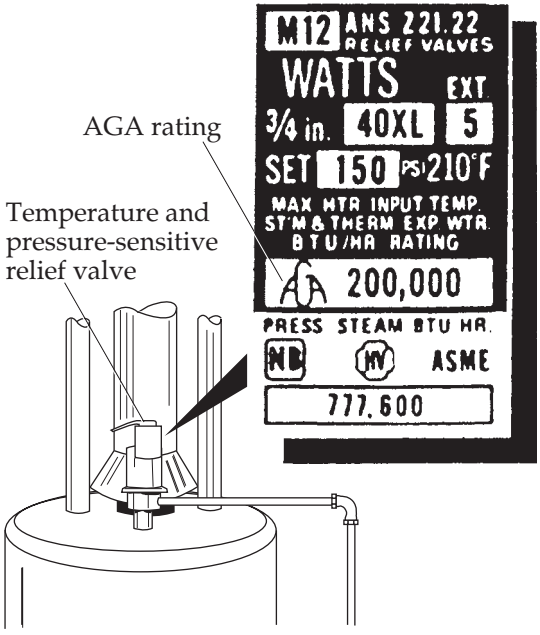


Fig. 16-5. Look for the AGA rating on the plate hanging from the relief valve. The rating must exceed the Btu input to the water heater.

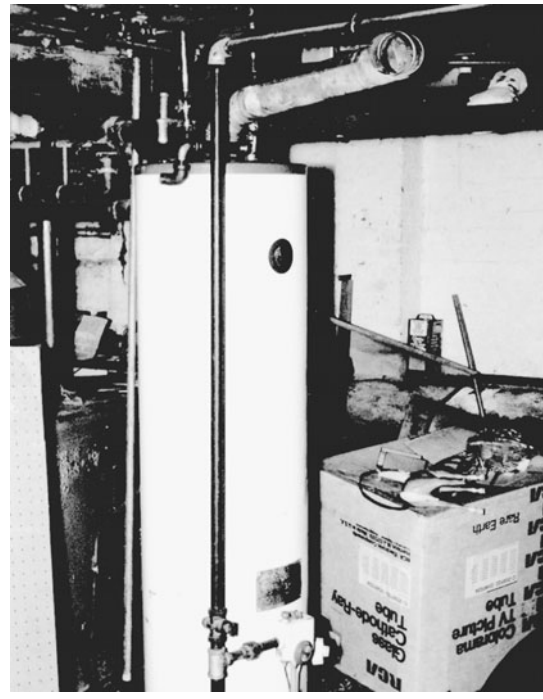


Fig. 16-6. Disconnected exhaust stack. Exhaust gases from this gas-fired water heater discharge into the basement rather than a chimney—a potentially dangerous condition.

base of the tank can act as an insulator between the water and the flame, decreasing the overall efficiency of operation.

Exhaust stack

All oil- and gas-fired water heaters must have an exhaust stack to vent the products of combustion to the outside. If you find an exhaust stack that is loose or broken, so that the exhaust gases are discharging directly into the house (see FIG. 16-6), you should notify the homeowner of this potentially dangerous condition. As with a heating system, the exhaust pipe should have an upward pitch from the heater to the chimney connection. The exhaust pipe gets quite hot and therefore should not be in contact with combustible material.

Operational inspection

The water heater should be inspected while the burner is operational. This can be achieved by opening the hot-water faucet at a nearby sink. Within a few minutes, depending on the size of the tank and the water flow at the sink, the burner should fire. (This assumes that the pilot is lit for a gas burner or that the electronic ignition is operational for an oil burner, and that there is oil in the storage tank.) If the burner fails to fire, there is a problem condition that should be checked. Oil and gas burners and their controls are discussed in detail in chapter 15.

To provide an adequate draft for combustion gases, oil-fired units should have a draft regulator, and gas-fired units should have a draft diverter. (See FIG. 16-7.) After the unit has been firing for several minutes, check the draft in a gas-fired unit. Put your hand near the draft diverter. If you feel a flow of hot gases on your hand, there is either a blockage in

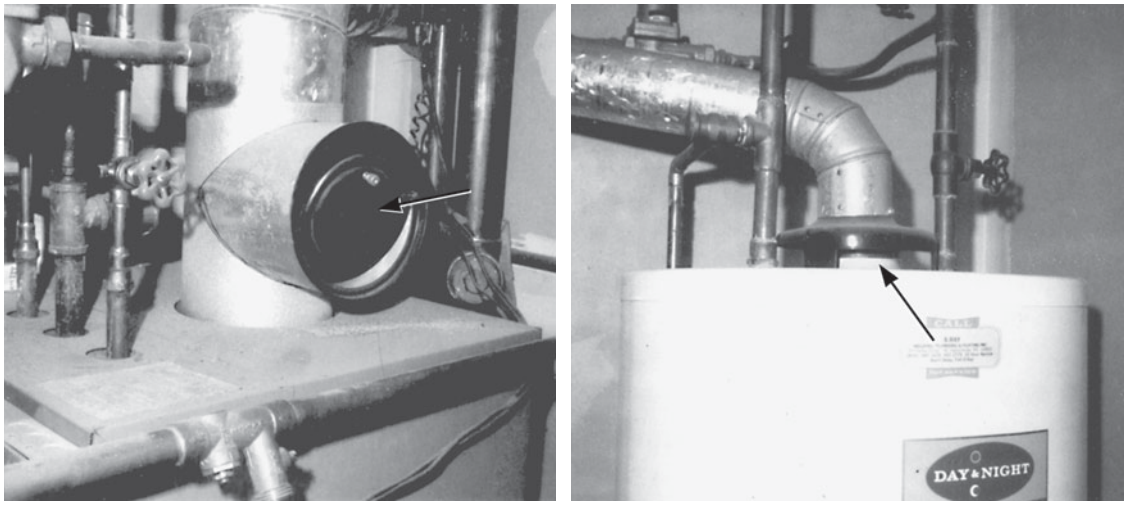


Fig. 16-7. *Draft regulator (left) for an oil-fired water heater; draft diverter (right) for a gas-fired water heater.*

the flue passage or there is a negative pressure in the house. This is a condition that must be corrected because the exhaust gas contains carbon monoxide. This colorless, odorless gas is poisonous and can cause asphyxiation.

Another check for faulty venting of the exhaust gases is to hold a lit match at the draft diverter opening. If the exhaust gases spill out into the room, they will blow out the flame. If the venting system is functioning properly, the flame will be sucked into the draft diverter hood. As a safety feature, some water heaters have a spill switch sensor mounted on the draft diverter. (See FIG. 16-8.) When combustion gases spill out of the draft diverter, the spill switches sense the heat from the exhaust gases. This causes the spillage sensor circuit to open, which shuts the pilot, causing the burner to shut down.

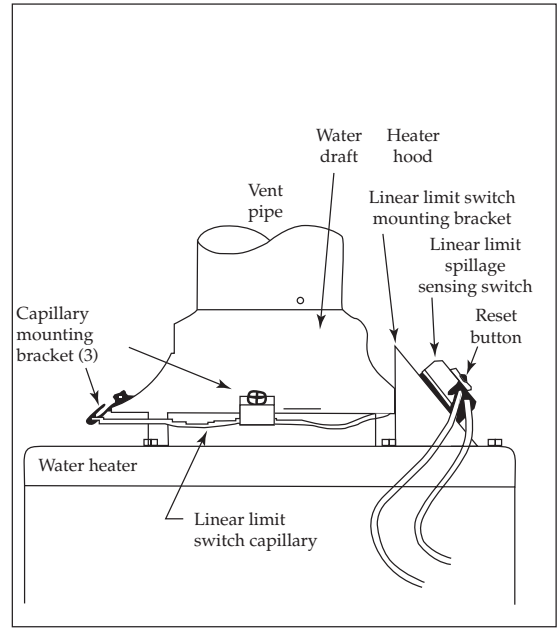


Fig. 16-8. *Exhaust gas spill switch sensor. Courtesy of: Tjernlund Product, Inc.*

Whenever there is a heavy draw of water, if the temperature of the inlet water is low, condensation can form on the tank. If this should occur, you might see some water beneath the heater; in a gas-fired unit, you may hear sizzling or pinging sounds caused by water droplets falling on the burner. Consequently, if you see a little water on the floor or hear the pinging noise of droplets, do not assume that the water

heater is leaking; it may be condensation. If it is, the condition will disappear after the water in the heater becomes heated. If the condition does not disappear, a leak should be suspected, and the unit may require replacement.

If you notice a water pipe connected to the drain fitting at the bottom of the tank, it is probably a hot-water return line. (See FIG. 16-9.) This is the typical connection for providing "instant" hot water at the bathroom fixture that is farthest from the water heater. It is more often found in large pricey houses than in more modest homes. You can check out the effectiveness of the instant hot-water system during the interior inspection of the bathrooms.

As with a gas-fired heating system, the pipe supplying gas to a domestic water heater should be rigid black iron and not a copper pipe or a flexible pipe. If the pipe is not black iron, check with the utility company for its requirements.

Some gas-fired water heaters use bottled gas (propane) because natural gas is not available. In that case, a copper gas-supply pipe is usually acceptable because the supplier provides a quality control over the impurities in the gas. All impurities that would react with the copper are removed.

Water heater replacement

A water heater requires replacement only when the tank is leaking. If there are problems with any of the controls, they can be replaced individually as needed. You cannot tell by looking at a unit when it will start leaking. The projected life for an oil- or gas-fired water heater is from seven to ten years, although units have been known to last over fifteen years. Electrical units have a longer projected life than oil- and

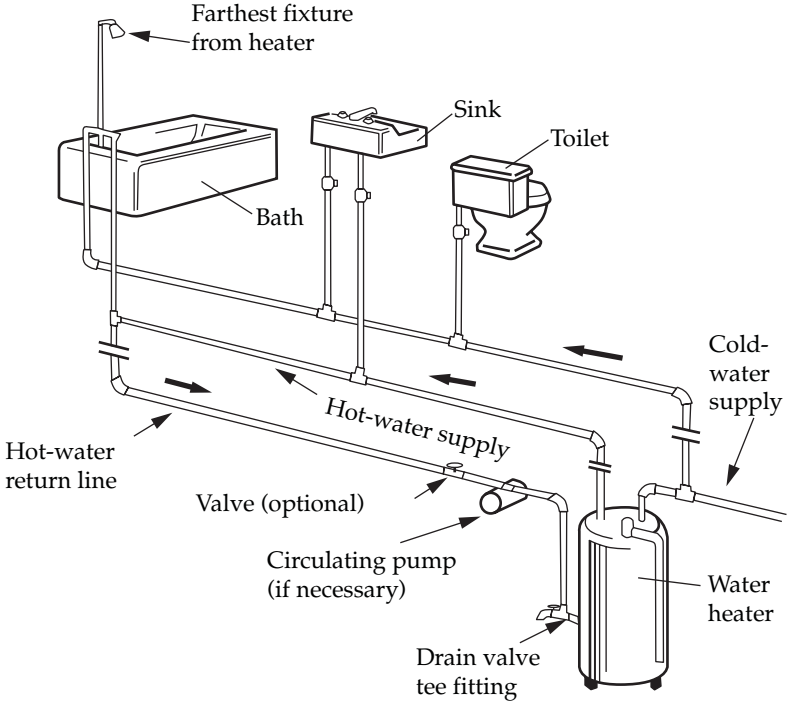


Fig. 16-9. *Hot-water return line supplies "instant" hot water to a fixture. This results from the constant recirculation of the water back to the water heater.*

gas-fired heaters. This is because the electrical heating element is immersed in the water, imparting its heat directly to the water and not to the tank, whereas in an oil- or gas-fired heater the flame imparts its heat directly to the base of the tank. The intense heat results in expansion and contraction stresses that effectively shorten the life of the tank. Look at the temperature control knob (thermostat) on the tank. If it is at the maximum setting, the unit has been operating at a high temperature, and a shorter life span should be anticipated.

The age of a tank water heater can generally be determined from the serial number found on the tank's data plate. The numbering system, however, varies by manufacturer. For example, for Rheem or Rudd water heaters, the first four numbers of the serial number indicate the month and year of production (thus 0286 would indicate that the heater was manufactured in February 1986). Usually a water heater is installed within several months of its manufacture.

With newer A. O. Smith water heaters, the date of manufacture is listed on the data plate. However, with older A. O. Smith water heaters, the date can be found by checking the serial number. For example, in serial number 800-A-89-12345, the letter stands for the month of manufacture (January in this case); and the middle number (89) stands for the year of manufacture, 1989. The letter code for month of manufacture is

A—January	G—July
B—February	H—August
C—March	J—September
D—April	K—October
E—May	L—November
F—June	M—December

If you determine that the water heater is over ten years old, you should not anticipate an extended life for the unit, even though it might look relatively new (shiny and clean on the outside).

I have been asked by clients whether it is necessary to replace a gas-fired water heater that has been in a flooded basement. It is not necessary to replace the unit. The tank is designed to hold water and therefore cannot be damaged by it. However, the burner assembly and controls (pilot, thermocouple, and thermostat) can be damaged and should be checked by a competent serviceman. If any of the controls are malfunctioning, they should be replaced as needed. Also, when the insulation between the tank and the jacket gets wet to the extent that it becomes thoroughly soaked, it can sag and be less effective as an insulator. If this should occur, you will feel "hot spots" on the jacket. This condition can easily be remedied. Insulation jackets are available that fit over water heaters to reduce heat loss.

Water heater capacity and recovery

The amount of hot water that your family requires depends on the number of people, their bathing and washing habits, and the number of tubs and showers available for simultaneous use. Do not judge whether a water heater is adequate by the capacity of the tank alone. Equally as important is its recovery rate—the volume of water that will have its temperature raised by 100° F in one hour. The capacity of residential water heaters typically varies between 30 and 82 gallons. The following example, although somewhat exaggerated, illustrates the point.

Let us take an average home. Assuming normal water pressure and flow, the typical faucet delivers about 5 gallons of water per minute. Let us further assume that there is approximately a sixty-minute demand for hot water flowing at the rate of 2 gallons per minute. This hot water will usually be mixed

with cold water for washing and bathing. If the home is equipped with an electric water heater that has a 60-gallon capacity and a 10-gallon recovery rate, after about thirty minutes there would be no more hot water. The low recovery rate of 0.17 gallons per minute is less than 10 percent of that required and would be totally ineffective in satisfying the hot-water demand. On the other hand, if the home had been equipped with an oil-fired water heater that had a capacity of only 30 gallons (half the capacity of the electric heater) and a 120-gallon recovery rate, the hot water would never run out, and the demand would be completely satisfied.

What is the capacity and the recovery rate of the water heater that you are inspecting? The capacity of all water heaters will usually be stamped on the data plate. Gas-fired units might also have the recovery rate on the plate. If yours doesn't, you can get an approximate value by dividing the number of input Btu (on the data plate) by 1,000 and multiplying the results by 0.85. Oil-fired water heaters might not indicate their recovery rate. This should be of little concern because oil-fired units have a high recovery rate, often on the order of 120 gallons per hour. Electric units will not have their recovery rate on the data plate. However, the wattage of the upper heating element, the lower heating element, and the total wattage will usually be stamped on the plate. You can easily compute the approximate recovery rate for an electric water heater by using the following formula: Each 250 watts heats about 1 gallon of water 100° F in one hour. Thus a water heater rated at 4,500 watts has a recovery rate of only 18 gallons per hour. This is a typical recovery rate for an electric water heater and is quite low in comparison to a gas- or oil-fired unit. To compensate for the low recovery rate, electric units should, and often do, have large-capacity tanks.

I have found the following rule of thumb effective in determining the adequacy of a water heater for a house, regardless of whether the unit is gas- or oil-fired or electric: For a house with one full bathroom (sink, bowl, and shower-tub), the sum of the capacity plus the recovery rate should total about 70. For two full bathrooms, the total should be about 90; for three full bathrooms, about 105; and for four full bathrooms, about 115. This also assumes that there is a washing machine in the house that might be operating while all the showers-tubs are being used. Of course, your requirements might be different. If you buy a house with three full bathrooms and there are only two people in your family, you obviously do not need a water heater whose capacity and recovery rate total 105.

From an energy-conservation point of view, a small tank with a high recovery rate would be better than a large tank with a low recovery rate. In addition, it is more costly to maintain a large tank of hot water, especially during periods when there is no hot-water demand.

Tankless (coil) water heaters

Tankless water heaters, sometimes called "instantaneous water heaters," should not be confused with tankless (wall-mounted) water heaters, which will be discussed in the next section. Tankless coil-type water heaters are used in conjunction with steam and hot-water boilers. Most tankless heaters consist of a small-diameter pipe shaped in the form of a coil that is located inside of the boiler (internal generator). (See FIG. 16-10.) The coil might also be located in a casing outside, but connected to, the boiler (external generator). The coil is surrounded by hot boiler water that gives up its heat to the water flowing in the coil. Cold water enters the coil and leaves as hot water with its temperature increased by 100° F. These units are designed for a specific

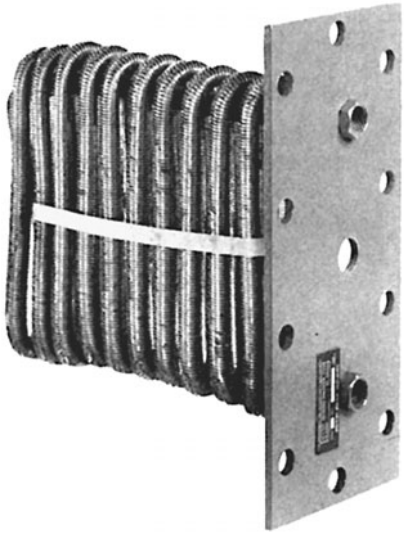


Fig. 16-10. *Tankless water heater. Unit is mounted inside a boiler. Triangle Tube and Specialty Co., Inc.*

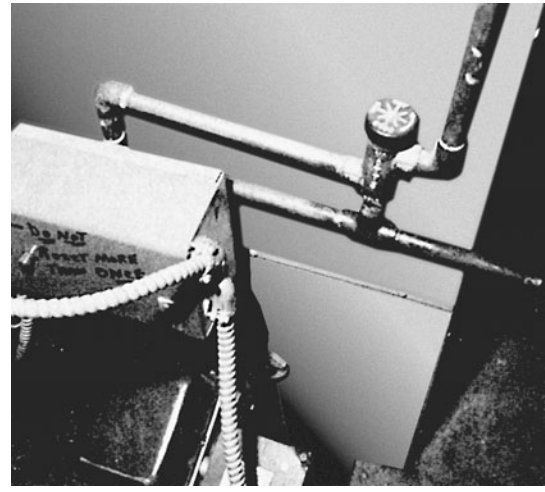


Fig. 16-11. *Mixing valve for tankless water heater.*

water-flow rate (gallons/minute) through the coil to achieve the desired increase in temperature.

If water flows through the coil at a greater rate, less heat will be transferred to each gallon, resulting in a lower outlet temperature. Consequently, many units have a flow-regulating valve installed in the cold-water supply pipe to the tankless heater to limit the water flow to the capacity of the heater. The design flow through these heaters is usually about 3 to 4 gallons per minute. Assuming a normal water supply to the house, the typical cold-water flow will be between 4 to 8 gallons per minute.

To regulate the temperature of the hot water being distributed throughout the house, there should be a mixing valve between the cold-water inlet and the hot-water outlet pipe. (See FIG. 16-11.) A mixing valve is considered a necessary feature to eliminate the possibility of scalding. Over the years, mineral deposits tend to build up inside the heater coil, especially in hard-water areas. This in turn further reduces the water flow through the heater and results in a higher water temperature at the outlet. The high-temperature water, which is a potential hazard, can be cooled to the design temperature by mixing it with cold water in the mixing valve. This water can then be distributed to the plumbing fixtures throughout the house.

As mineral deposits form inside the heater coil, they restrict the water flow. It is possible for the deposits to build up to such a point that the hot water flow becomes a trickle when two or more faucets are turned on at the same time. The hot-water flow should be checked during your interior inspection, as discussed in chapter 10. A low hot-water flow that is caused by a blockage in the tankless coil can often be corrected by chemically flushing the unit and dissolving the deposits. However, when the flow becomes a trickle, the heater coil should be replaced.

A tankless (coil) has virtually no storage capacity. Consequently, if there is a hot-water demand that exceeds the design flow (and it often does), there will not be enough hot water. To provide additional hot water,

some installations are equipped with a storage tank. Water heated in the tankless coil will be circulated to the tank by gravity flow or a pump. The pipe that distributes hot water to the plumbing fixtures will be connected to the storage tank rather than the tankless heater. When the hot-water flow between the tankless heater and the storage tank is by gravity, the storage tank must be located above the boiler. When the flow is induced by a circulating pump, the tank can be located alongside the boiler. (See FIG. 16-12.)

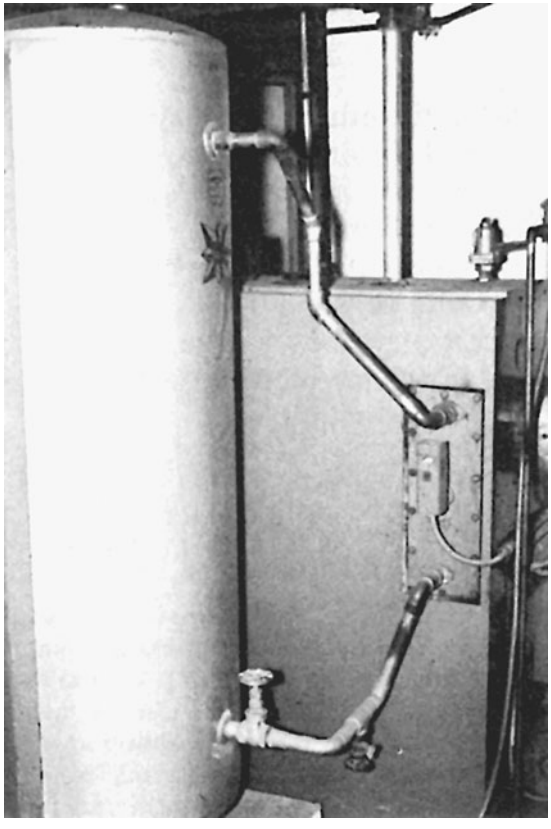


Fig. 16-12. *Storage tank connected to tankless water heater. The hot water circulates between the tank and the coil to maintain high temperature. The tank increases the overall volume of available hot water.*

From an energy-conservation point of view, a tankless (coil-type) water heater is not desirable. It is inefficient and wasteful of energy. To produce domestic hot water, there must be a double heat transfer. The boiler water will first be heated with oil or gas, and it will then transfer its heat to the water in the tankless coil. To produce domestic hot water, the boiler must be heated all year long, winter and summer. As discussed in chapter 14, controls associated with the heating system prevent steam or hot water from being distributed throughout the house when heat is not required. Nevertheless, the heated boiler water during those months does represent wasted energy. It also introduces an additional heat load on the house at a time when heat is not desired. If you should decide to replace a tankless coil with a tank-type water heater, it can be done at a reasonable cost. An oil-fired water heater, however, is more expensive than a gas-fired or an electric unit.

Inspection procedure

The first portion of the tankless water heater inspection is performed in the bathroom. Turn on the hot water at the sink and the tub simultaneously and look at the flow. If the flow appears to be low, mineral deposits might have built up in the tankless coil, and maintenance might be needed. On the other hand, the low flow might reflect a constriction in the distribution piping. Record the fact that there is a low flow on your worksheet as a reminder that the condition must be corrected regardless of the cause.

At the boiler, look at the joints around the tankless heater mounting plate. This is a vulnerable area for leakage. If there are water stains and deposits around the joint, even if you do not see water dripping, maintenance is needed. The deposits tend to self-seal the leak, but this is not a permanent fix. Any movement

or vibration of the boiler can cause the deposits to loosen, reactivating the leak. Often, all that is needed is tightening of the mounting bolts around the joint or replacing the gasket around the joint. Look at the inlet and outlet pipes to the heater and the mixing valve (if there is one) for signs of past or current leakage.

The temperature of the boiler water that heats the domestic hot water is controlled by an aquastat. You can check the operation of the aquastat by opening one of the hot-water faucets. After a while, the temperature of the boiler water will drop to a point where the aquastat will cause the oil or gas burner to fire. Tankless coils are designed to operate with a boiler-water temperature of about 200° F. Look at the boiler-mounted thermometer when the burner fires. If the boiler-water temperature is less than 180° F, the aquastat may be in need of adjustment. In some homes, the aquastat is intentionally set lower. This, of course, will result in a lower hot-water temperature.

Look for a temperature-pressure relief valve on the hot-water outlet line of the tankless coil. If there is a storage tank associated with the tankless coil, the relief valve might be located on the tank. A temperature-sensitive relief valve is a necessary safety control and is normally factory-set to discharge when the domestic hot water reaches a scalding temperature. If you do not find a relief valve, record the fact on your worksheet as a reminder to have one installed after you move in.

Tankless (wall-mounted) water heaters

A tankless (wall-mounted) water heater, also sometimes called an "instantaneous water heater," is an appliance that heats water as the water is used. It's about the size of a medium-capacity suitcase. Operating a hot-water faucet activates either a burner (natural gas or propane) or an electrical resistance heater that transfers thermal energy to a heat exchanger. As cold water flows through the heat exchanger, it is heated to a preset temperature, which is normally 120° F. However, for most units there is a temperature controller within the unit, which is accessible by removing the cover, that can adjust the temperature setting from 100° to 140° F. Some units have a remote control option for the homeowner to control the temperature. Tankless water heaters are designed for a maximum flow rate through the heat exchanger; exceeding the flow rate results in a cooler water outlet temperature. However, for high-demand applications, two or more tankless units can be connected together to operate as one. Closing the hot water faucet deactivates the heating mechanism.

One advantage of this water heater is that because of its compact size it can be placed close to the point of use so that very little of the water's heat is lost between where the water is heated and where it is used. However, if a gas-fired unit is installed as a retrofit, as opposed to an electric unit, it must be located in an area where the exhaust gases can be vented to the outside. One item of concern with a retro fit is the size of the gas line. It's important that the gas pipe being used meets the requirements of the new gas-fired tankless water heater. The gas requirement of the tankless unit often exceeds that of the existing tank-style water heater. If the water heater is a retrofit, you should check with the owner to determine whether the installation was approved by the local municipal building department. If the house is located in an area where there are exceptionally hard-water conditions, the heat exchanger inside the unit may require periodic flushing by a plumber to remove built-up scale. To minimize this problem, a water softener or a descaling device should be installed in the water line before the heater.

Indirect-fired storage water heaters

In the mid-1970s, a new type of water heater, an *indirect-fired storage water heater*, was developed. The unit is called indirect-fired because the medium used for heating the domestic water is boiler water, which itself is heated in a separate boiler used for either central heating or space heating. The boiler water circulates through a heat exchanger that is located either within the heater tank or in an external compartment. Figure 16-13 shows one type of indirect-fired storage water heater. This unit has a specially designed heat-exchanger coil mounted in the base of the tank. Hot boiler water flows through the coil, which is surrounded by domestic water. The design of the heat exchanger, which consists of an inner core surrounded by an outer helical coil, is such that it results in a relatively high recovery rate.

Fig. 16-13. *Indirect-fired storage water heater.*

The typical capacity of this residential indirect-fired water heater is about 40 gallons. With water heaters, whether there is an adequate supply will depend not only on the capacity but also on the recovery rate of the unit. The actual rate will depend on the Btu rating of the boiler that feeds the heat exchanger. For a typical house with a boiler that has an output rating of about 100,000 Btu per hour, the recovery rate is about 90 gallons per hour.

The indirect-fired storage water heater works off the heating system as a separate zone, utilizing its own circulator pump. According to manufacturers, 15–20 gallons of domestic hot water is removed before the zone aquastat calls for hot water from the boiler. Consequently, with the high recovery rate, the boiler firings are kept to a minimum.

In checking the unit, either raise the thermostat setting to HOT or let the hot water run until the boiler fires. You can tell if the pump is operating by touching the water supply to the heater before and after the boiler fires. The pipe should get hot. Look for signs of leakage around the base of the unit. Also, make sure that there is a pressure-temperature relief valve mounted directly on the tank casing. If you adjust the thermostat to activate the boiler and circulator pump, don't forget to reset it.

In hard-water areas, it is possible that even though the boiler is functioning properly, the domestic water does not get very hot. This is caused by a lime buildup on the heat exchanger, which acts as an insulator and inhibits the heat transfer. In this case, the coil is in need of a cleaning, although it may require replacement.

Checkpoint summary

- ❍ Is hot water supplied by a separate-tank type of water heater, a tankless coil, or by a wall-mounted tankless heater?
- ❍ If you have a tank-type heater, record the capacity (gallons), the recovery rate (gallons per hour), and the age (from serial number).
- ❍ Are exhaust gases spilling out of the draft diverter?
- ❍ Is tank-type heater adequate for house? (See table.)

Full bathrooms	Sum of tank capacity plus recovery rate
1	70
2	90
3	105
4	115

- ❍ Is hot-water flow adequate when two fixtures are turned on?
- ❍ Are hot and cold supply lines incorrectly installed (reversed)?
- ❍ Does water heater contain a properly installed temperature-pressure relief valve?
- ❍ Is the relief valve dripping?
- ❍ Is there an expansion tank on the cold water line?
- ❍ Look for signs of corrosion or past leakage:
  - — Tank type (gas-fired unit): corrosion dust and flaking metal in burner area.
  - — Tankless coil: rust and deposits around fittings and gasket.
- ❍ Is there an "instant" hot-water return line?

17
Air-conditioning

Air-conditioning capacity 263
Air-conditioning systems 264
Integral system 264
Split system 264
Inspection procedure 265
Heat pump 272
Evaporative cooler 273
Checkpoint summary 273

Before outlining the procedure for inspecting a central air-conditioning system, let me discuss the components of a typical residential system and their functions. Central air-conditioning systems provide comfort cooling by lowering the air temperature and removing excess moisture. This is achieved by recirculating air from the house across a cooling coil. As the air flows across the coil, its temperature drops, causing some of the moisture in the air to condense out on the coil. The cool, dehumidified air is then distributed throughout the house, and the moisture is disposed of through a drain.

The basic components of an air-conditioning system are the compressor, condenser, expansion device, and evaporator. The evaporator is the cooling coil mentioned above. The other components simply provide the means for the evaporator coil to cool the circulating air. This is done using a cooling medium, a *refrigerant*, that cycles between the components. (See FIG. 17-1.) The refrigerant is normally a gas at atmospheric pressure and temperature. By (1) applying pressure to the refrigerant and (2) removing absorbed heat, the refrigerant will change from a gas to a liquid. At this point, the refrigerant exists as a high-pressure liquid. When the pressure on the liquid refrigerant is released, the refrigerant (3) expands and changes back to a gas. In the process of changing from a liquid to a gas, the refrigerant (4) absorbs heat from its surroundings, thus cooling the air passing over the coil.

An air-conditioning system is a closed system, and theoretically there should never be a need for additional refrigerant. However, in practice the various fittings on the connecting pipes can loosen or develop hairline cracks that can allow some of the refrigerant gas to escape. Usually, when a system is low in refrigerant, the practice is to introduce additional refrigerant and not to look for the openings in the system that allowed the refrigerant to escape. However, if the air-conditioning system cannot hold a refrigerant charge for at least one season, the

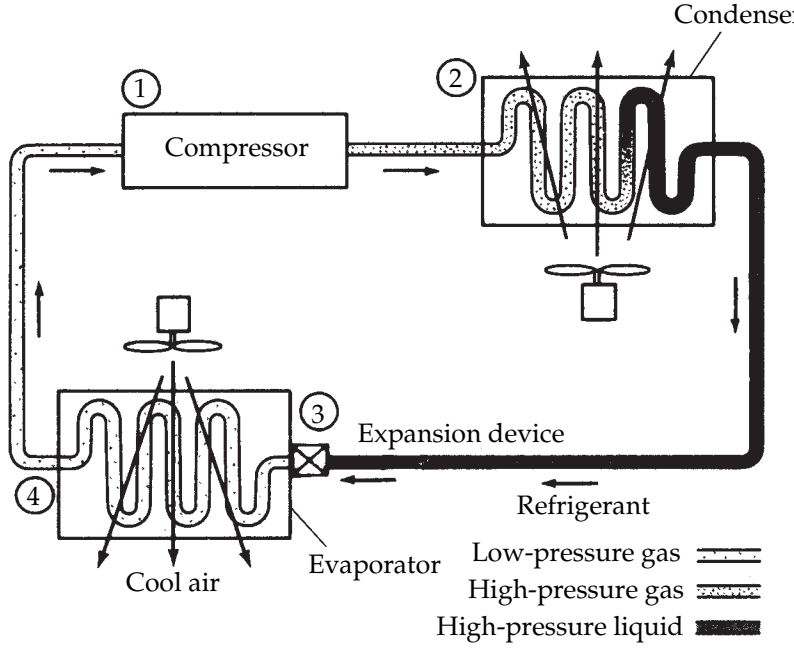


Fig. 17-1. *Basic air-conditioning cycle. Normally the compressor and condenser are contained in a single housing.*

leaks in the pipes or fittings should be located and corrected.

Air-conditioning capacity

The overall cooling capacity of an air-conditioning system is usually measured in Btus (British thermal units) or tonnage. One Btu is the heat required to raise the temperature of 1 pound of water 1° F. A rating in Btus per hour indicates the amount of heat that the unit will remove in that time. A *ton* of air-conditioning, historically, represented the cooling effect achieved by melting 1 ton of ice in twenty-four hours. An air-conditioning system that is rated at 1 ton will provide 12,000 Btus of cooling in an hour.

The cooling needed for a house depends on several variables, such as size of the rooms, whether there are cathedral ceilings, the number and type of windows, the amount of insulation in the walls and ceilings, and whether shading is provided by trees. The following rule of thumb can be used to determine the size of the air-conditioning system needed to cool the house that you are inspecting. One ton of cooling capacity (12,000 Btu) is needed for every 550 square feet in the structure. Therefore, if you are inspecting a house with 1,800 square feet, you will require an air-conditioning system rated at 3 tons. More recently, because newer homes are tighter and are better insulated, a figure of 700 square feet per ton has been used. The exact requirement can be determined by a professional. However, the rule of thumb is quite effective in determining whether the unit servicing the house is grossly oversized or undersized. Calculate your cooling requirements and then ask the homeowner the capacity of the air-conditioning system.

You can check the capacity yourself by looking at the data plate on the compressor-condenser. Even though most manufacturers donot put the system's capacity on the data plate,

it can be approximated. The model number of the compressor on most air-conditioning systems contains digits that represent the approximate number of thousands of Btu of cooling capacity. See TABLE 17-1.

Another figure on the data plate that can be used for determining the cooling capacity is the full load amperage (FLA) or rated load amps (RLA). There are approximately 7 amps per ton of cooling. The FLA for the Tappan compressor in TABLE 17-1 is 27.1. When this figure is divided by 7, you get approximately 4 tons, which verifies the figure indicated by the model number.

An air-conditioning system should be properly sized or slightly undersized, but it should not be oversized. A unit that is too large operates intermittently. It quickly chills the air and then shuts down. When the system is shut off, moisture in the air does not condense, and the system does not dehumidify the air. For the system to remove enough moisture to make the air comfortably dry, the evaporator coil must be kept cold. This means that the compressor should run almost continuously for maximum comfort. Even though a system that is too small will run continuously, its cooling capacity is not adequate to remove enough heat to cool the room to a comfortable level.

Air-conditioning systems

There are basically two types of central air-conditioning systems used in residential structures—the *integral* system and the *split* system.

Integral system

This system, sometimes referred to as a *single-package unit*, is self-contained. That is, all the components—compressor, condenser, expansion device, and evaporator, plus the electrical controls and fans—are contained in a single housing. This system, which must be vibration-mounted, is often installed in the attic or a crawl space with ducts projecting through the exterior wall or roof to provide air for cooling the condenser. The integral system is less expensive than the split system. However, the noise level from the compressor makes an interior installation less desirable.

Split system

In this system, the compressor-condenser is physically apart from the evaporator coil. To eliminate the interior noise and provide outside air for cooling the condenser, the compressor and condenser are housed in a unit located outside the structure, usually at the rear or side. The evaporator coil, on the other hand, is located in the house, either in the attic or inside the heating system. The specific location often depends on the type of heating system. When the house is heated by forced warm air, the evaporator coil is usually located in the furnace plenum and utilizes the furnace blower to move the air through the coil. When the house is heated by steam or hot water, the evaporator coil is usually located in the attic with a separate blower (fan) to move the air through the coil and distribute it throughout the house. When there

Table 17-1. Air conditioner capacity.

Manufacturer	Model number	Btu/hour	Tons
General Electric	BTB390A	30,000	2½
Bryant	567CO36RCU	36,000	3
Carrier	38CC042-1	42,000	3½
Tappan Company	CM48-42C	48,000	4

is no attic, the evaporator unit can be located in a closet or the basement.

The compressor-condenser is connected to the evaporator coil by two copper pipes that contain the refrigerant that cycles between the two units. (See FIG. 17-2.) The diameters of the two pipes are different—one pipe is the size of a pencil, the other the size of a broom handle. The small pipe (pencil size) is the liquid line; it carries the high-pressure liquid refrigerant from the condenser to the expansion valve. The larger pipe (broom-handle size) is the suction line; it carries low-pressure refrigerant gas from the evaporator coil to the compressor. The suction line should be insulated. Usually it is covered with black foam-rubber type of insulation.

Inspection procedure Whether the air-conditioning system can be checked operationally depends on the outside air temperature. Most manufacturers do not recommend turning on the system at temperatures below 60° F because of the possibility of damage to the compressor. If the outside temperature is below 60° F during your inspection, do not start up the air conditioner. If the system cannot be checked prior to purchasing the house, the seller should provide you with a guarantee of its operational integrity. If the temperature is above 60° F during your inspection, walk over to the compressor and have someone turn down the thermostat that controls the air conditioner so that the system will begin to operate.

Compressor The compressor is the most important part of any air-conditioning system and the most costly to replace. Its projected life is about eight to ten years, although units have been known to last over fifteen years. In areas of the sunbelt with long air-conditioning seasons,

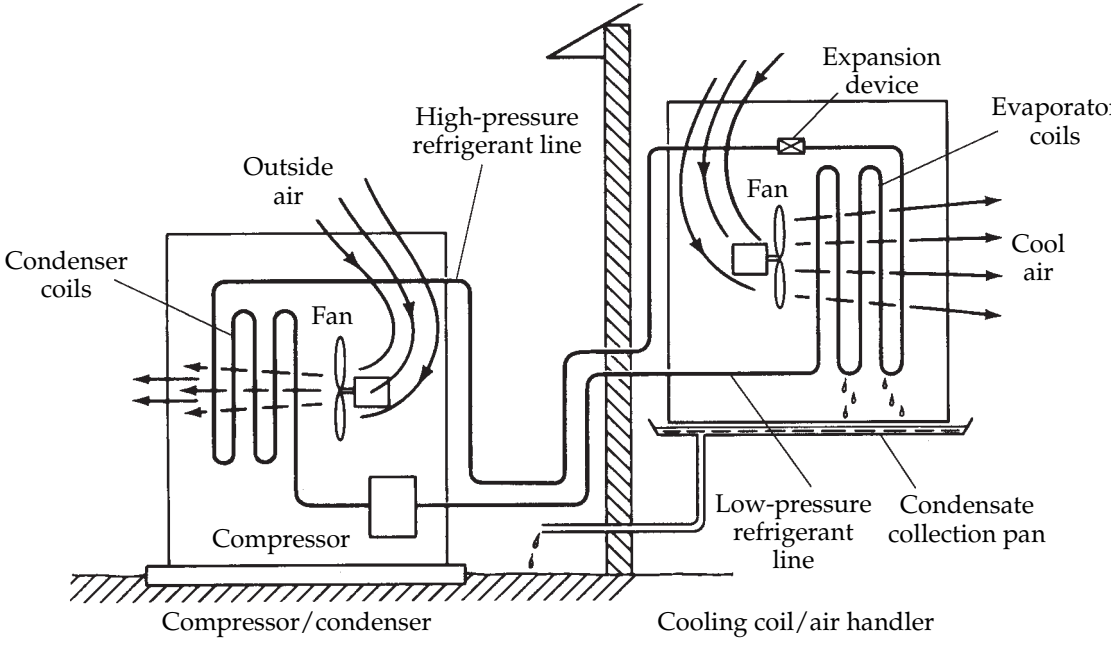


Fig. 17-2. *Schematic diagram of a split air-conditioning system. The compressor-condenser is located outside the house, and the cooling coil is inside the house (usually in the furnace plenum or attic).*

the projected life will be somewhat less. After the system has been turned on, listen for any unusual sounds. The compressor should start up smoothly. A straining, grunting, groaning, or squealing noise indicates a problem condition that should be checked and corrected by a competent service organization. Shut the unit off and note the condition on your worksheet. Once the compressor starts up smoothly, it should then operate continuously without any noise (except a low hum) or squeaks. The compressor should not operate in short cycles (on and off repeatedly). If this occurs, there is a problem condition and the unit should be shut down.

When the air-conditioning system is turned on, the fan associated with the condenser should begin to operate at the same time as the compressor. Look inside the unit to see if the fan is turning. If the interior portion is not visible and you cannot see whether the fan is operating, place your hand over the unit. Air rushing over your hand is an indication that it is operating. After the system has been operational for about fifteen minutes, the air being discharged through the condensing coil should be warm. This air is removing the heat that has been generated during the compression of the refrigerant. Air that is not warm is usually an indication that the compressor is not operating properly, a condition that should also be checked by a competent service company.

After the system has been operational for about fifteen minutes, look at the low-pressure refrigerant line (the pipe about the size of a broom handle). Usually the pipe is covered with insulation. If a section of the pipe is exposed, grab it with your hand. If the compressor is working properly and there is an adequate refrigerant charge, the pipe will be quite cool to the touch. On many occasions, the pipe and end fittings will be "sweating" as a result of condensation. This is a normal operating condition. However, a low-pressure line covered with frost usually indicates a deficiency in refrigerant. Even though cooling can be obtained with an air-conditioning system that is deficient in refrigerant, the efficiency of the system is greatly reduced.

Occasionally you will find a sight glass on the small-diameter refrigerant line. The sight glass is a small device installed directly into the high-pressure liquid refrigerant line that allows the homeowner to see whether there is a problem with the flow of the liquid refrigerant. The refrigerant is colorless, and if the system is operating properly, nothing unusual will be noted when looking at the sight glass. However, when the system is low in refrigerant, bubbles will show up in the liquid as it passes under the glass. Record it on your worksheet.

The location of the compressor-condenser is important for efficient operation. (See FIG. 17-3.) The compressor should be located where it will receive a minimum of direct sunlight, since the cooler the air flowing across the condenser, the more efficient the cycle. See if the compressor is positioned so that the condenser air intake is at least 12 inches away from any obstruction

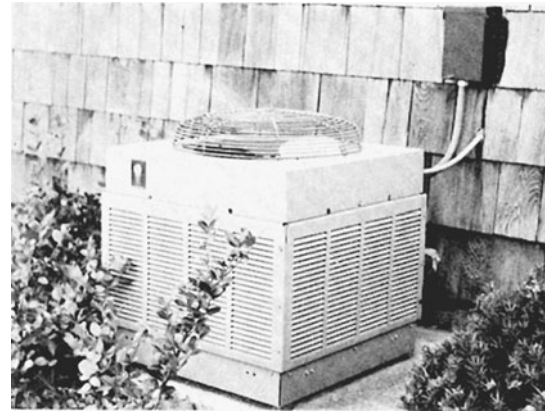


Fig. 17-3. *Typical compressor-condenser for a split air-conditioning system. Airflow through unit must be unobstructed.*

or dense shrubbery. If it isn't, there will not be an adequate airflow for condenser cooling.

The compressor-condenser can be a noisy piece of equipment and should be vibration-mounted on a concrete slab or precast concrete blocks that will not settle. The unit should be level. Excessive uneven settlement can cause fractures in refrigerant-line fittings and thereby allow the refrigerant to escape.

Look for an electrical disconnect switch on the exterior wall near the compressor. The purpose of this switch is to allow the maintenance man to disconnect the unit so that if someone in the house unknowingly turns the thermostat down, the unit will not be activated while he is making repairs. The absence of a disconnect switch should be recorded on your worksheet. The overall compressor-condenser unit should be checked to see whether it is in need of a cleaning. These units require periodic cleaning because leaves, seed pods, twigs, and dust tend to clog the condenser, thus restricting the airflow. The condenser has fins like an automobile radiator's, which can clog easily.

The condenser discussed above is air-cooled. On occasion, you might see a condenser that is water-cooled. A water-cooled unit can be located inside the structure since it does not require outside air. These condensers are generally not used for residential structures because they are quite wasteful and costly to operate. To cool the condenser adequately, cold water flows through a jacket around the coils absorbing heat and is then directed into a sink or floor drain. If the central air-conditioning system operates for twelve hours a day, this type of system can waste several thousand gallons of water a day. If you find this type of condenser in the air-conditioning system, you should consider its replacement.

In large air-conditioning systems such as those found in apartment buildings, water-cooled condensers are not wasteful or costly to operate because the cooling water is recirculated. After the water absorbs heat in the condenser, it is pumped up to a cooling tower, often located on the roof, where it loses its heat and is then recirculated to the condenser.

Evaporator After checking the compressor-condenser, you should inspect the evaporator unit, commonly called the cooling coil. The evaporator will usually be located in the attic or the basement. When the unit is located in the attic, you will often find the refrigerant lines from the compressor running up along the outside of the structure and entering the building at the attic level. When the evaporator coil is located in the basement, either as a separate unit or in the furnace plenum, the refrigerant lines from the compressor are short and run directly into the structure. If possible, the evaporator coil should be observed after the unit has been operational for about thirty minutes. The coil might not always be accessible because it may be covered with a sheet-metal casing that cannot be easily disassembled. If the evaporator is accessible, look at the coil and the associated refrigerant tubing. The evaporator is used to cool and dehumidify the circulating air. If you notice a frosting condition (a buildup of ice) on portions of the coil and refrigerant tubing rather than dripping water, the system is not operating properly. The frosting is usually the result of an insufficient airflow through the evaporator coil or an inadequate amount of refrigerant in the system. This condition should be indicated on your worksheet.

Furnace-mounted evaporator When the house is heated by forced warm air, the most common location for the evaporator is in the *furnace* plenum. A furnace-mounted unit takes advantage of the ducts that have been installed for heating the house and also uses the heating-system blower to circulate the cool air.

You can tell if the evaporator coil is located inside the furnace plenum by whether there are refrigerant lines entering the sheet-metal casing of the plenum. The refrigerant lines

inside the casing are connected directly to the evaporator coil. The most common type of coil that is found in a furnace plenum is a two-section design, an *A-coil* (because of its shape). Sometimes an inclined or horizontal coil is used. (See FIG. 17-4.)

Below the evaporator coil is a pan that collects the water condensing out of the circulating air. The water is then removed by means of a plastic drain line that will be visible when looking at the furnace plenum. Look for it. Depending on the location of the furnace, the condensate drain line will run to a nearby sink where the condensate drips down the drain or will run through the foundation wall, where the condensate drips on the outside. When the condensate drain line is extended through the foundation wall, there should be a splash plate below the end of the pipe so that the dripping water can be directed away from the foundation.

Fig. 17-4. *Evaporator (cooling) coil mounted in furnace plenum.*

Sometimes the condensate drain line runs from the furnace down to a small hole in the floor slab. The condensate trickling out of the drain line accumulates below the slab. This method of removing the condensate is not very desirable in those areas where the water will not readily drain because of a high water table or a high clay content in the soil. Even though the amount of water discharging from the condensate drain is small, the introduction of additional water could aggravate a condition that makes the lower level of the structure vulnerable to water seepage.

The condensate drain line should terminate at the plenum with a U-shaped trap. Since the condensate drain line is an open pipe leading directly into the cooling coil, the trap, which is on the negative side of the blower, prevents the blower from sucking air up through the drain line. This would inhibit the condensate from flowing out and could cause a flooding problem. Look for a trap. If it is missing, record that on your worksheet.

Occasionally the condensate drain discharges into a small rectangular box located near the furnace. This box is the reservoir for a lift pump. The purpose of the pump is to lift the condensate to a level where it can then flow to any desired location. Without a pump, it is often necessary to position the drain line so that it blocks a portion of the room or interferes with foot traffic. Check the pump's operation. These pumps have a float control that is activated when the water reaches a preset level. If there is only a small amount of water in the reservoir, the pump can be checked by pouring water from a glass into the reservoir. A malfunctioning pump should be recorded on your worksheet.

Now look at the overall furnace plenum around the evaporator coil. Rust and mineral deposits indicate a past or present problem in condensate removal. Water overflowing the condensate drain pan can damage the heat

exchanger below. If you see this condition, you should have the furnace heat exchanger checked by a heating contractor for signs of deterioration. (See chapter 14.)

When the evaporator coil is located inside the furnace plenum, the blower for the heating system is also used as the blower for circulating the cool air. Because cool air is heavier than warm air, when the blower is used for air-conditioning, it should operate at a higher speed. Most often, however, the furnace is equipped with a one-speed motor. Consequently, the air-conditioning system is often not as effective as it might be. A pair of double- or triple-sheaved hubs can be installed to allow multispeed operation. When the blower is turned off by the master switch, check the tension in the fan belt. There should be no excessive slack. Press the belt midway between the pulleys. If the belt gives more than ¾ inch to an inch, it is too loose, and adjustment is needed. When the blower is operating, listen for any unusual noises or vibrations. They should be recorded on your worksheet. You might also ask the owner when the unit was last serviced—there is no substitute for periodic maintenance.

Blower coil When the evaporator coil is housed in a separate casing that contains a blower for circulating the cool air, the coil is commonly referred to as a *blower coil*. Most often, the blower coil is located in the attic. However, it can be located in a closet or in the basement. The blower coil should be vibration-mounted to prevent the noise of the blower unit from being transmitted into the living area. Vibration mounting can be achieved by placing the unit on rubber, cork, or styrofoam pads. (See FIG. 17-5.) The vibrations might also be isolated in the attic by suspending the unit from the roof rafters.

The base of the blower coil is basically a condensate collection pan. The accumulated condensate is removed by means of a drain line that will extend through the exterior wall, terminating on the outside, or extend through the lower portion of the roof, terminating in the gutter. Sometimes the condensate drain line terminates in the plumbing vent stack located in the attic. (See FIG. 17-6.) In many communities, this type of termination is not permitted because it is not in compliance with the plumbing code. If the drain terminates in the vent stack, record that on your worksheet. The legality of this type of connection should then be verified with the local building department.

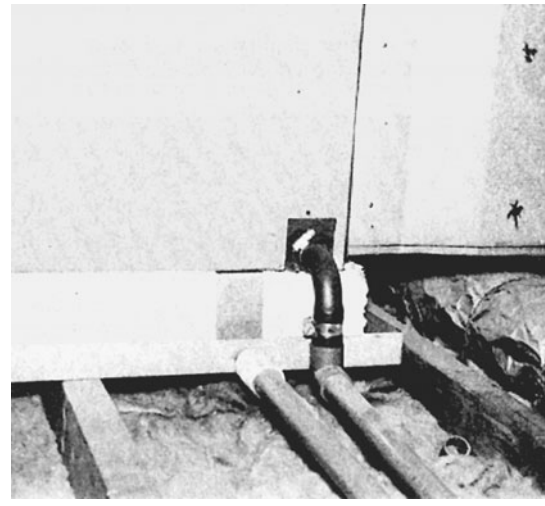


Fig. 17-5. *Attic-mounted blower coil. Unit is resting on a styrofoam pad to minimize vibrations. Below the unit is an auxiliary condensate drain pan and associated drain line. Note that the main condensate drain line does not have a U-shaped trap.*

The purpose of the vent stack is to channel sewer gases in the plumbing system to the outside. If the condensate drain line is connected to the vent stack and there is no trap on the drain line, the sewer gases may back up into the condensate drain line, enter the blower coil, and be circulated throughout the house. An additional concern is bacterial growth developing in the air handler. The condensate drain line should have a U-shaped trap near

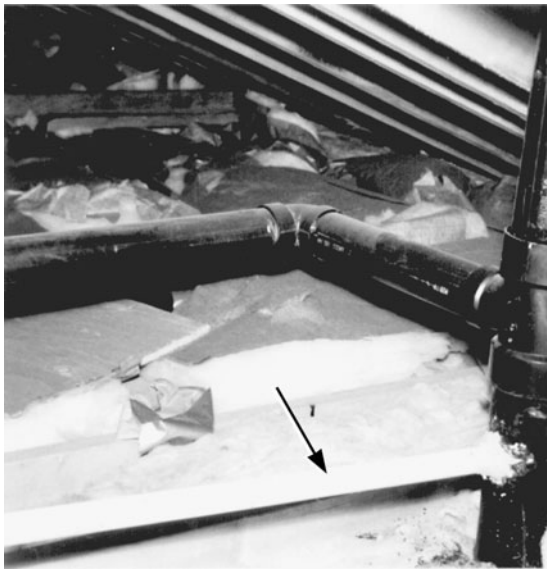


Fig. 17-6. *Air-conditioning condensate drain line terminating in plumbing vent stack. In many communities, this type of termination does not comply with the plumbing code.*

its connection to the blower-coil housing. On many installations, this trap is omitted. Look for it. If it is missing, one should be installed.

When the blower coil is located in the attic, certain steps must be taken to prevent cosmetic damage to the ceiling below in the event of a blockage in the main condensate drain line. Some blower-coil housings have a fitting for an auxiliary drain line that is located just above the main condensate drain fitting. If the main drain becomes clogged, the level of the condensate will rise and be drawn off by the auxiliary drain.

For those blower coils that do not have a fitting in the housing for an auxiliary drain line, there should be an auxiliary drain pan below the unit. The auxiliary pan will collect any condensate that overflows from the main pan when there is a blockage in the main drain line. Look for an auxiliary drain pan. In some parts of the country auxiliary drain pans are installed when the blower coil is located over any furred space, even when the blower housing has an auxiliary drain fitting. Record the absence of one on your worksheet. Unfortunately, many air-conditioning contractors do not install the auxiliary drain or drain pan. Because rising costs make it difficult to remain competitive, they cut costs wherever they can.

The auxiliary drain pan must have a separate drain line that discharges to the outside. It should not be connected to the main drain line. (See FIG. 17-7.) If it is, it reflects poor-quality workmanship; if the main drain line becomes clogged near the discharge end, the auxiliary drain line will also not function.

If the evaporator coil is accessible, it should be inspected for frost buildup. From an efficiency point of view, the attic is the least desirable area for locating the blower coil because of the high temperatures, easily reaching the 140° to 150° F that normally occur during the summer. Even though the blower coil is insulated, there will be a heat gain because of this high temperature. The overall attic temperature, however, can be lowered by increasing the number or size of the attic vent openings. A ridge vent is quite effective, as is a thermostatically controlled power ventilator.

Ducts After the air-conditioning system has been operational for about fifteen minutes, the air discharging from the registers should be felt to determine whether it is relatively cool. The temperature of the air discharging from the supply registers should be about 15 degrees lower than the temperature in the room. If the air does not have a slight chill, it might be because there is a heat gain along the duct leading to that register as a result of inadequate insulation, or the system may be undersized or low in refrigerant.

While checking the temperature of the air leaving the supply registers, also check the airflow. If the air discharging from the registers has a low flow and appears to be

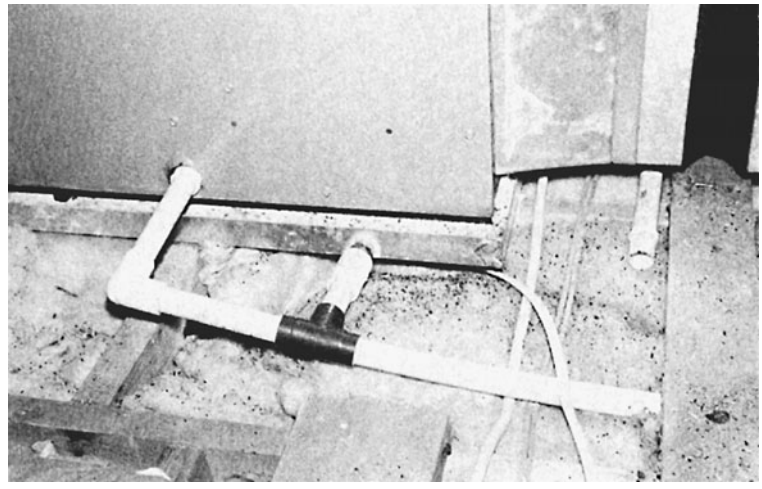


Fig. 17-7. *Auxiliary condensate drain line connected to main condensate line. This negates the use of an auxiliary drain and reflects poor-quality workmanship. If the main drain becomes clogged near the discharge end, the auxiliary drain will not function. Note that the U-shaped trap is missing.*

sluggish, it might indicate that there is an obstruction within the system caused by dirty filters or icing on the evaporator coils. Sometimes the condition is caused by an undersized fan or the need for balancing the airflow between the registers. In any case, the condition is abnormal and should be recorded on your worksheet.

As with a heating system, the location of the supply registers is important for effective air-conditioning. Since cool air is heavier than warm air, the cool air will tend to accumulate near the lower portion of the room and the warm air near the top. As a result, there is usually a temperature difference between the ceiling and floor. This stratification of heat layers can be minimized by adequate circulation in the room. Adequate circulation can be achieved by locating the supply registers on the opposite side of the room from the return grille. When the return grille is near the supply register, the air discharging from the supply is drawn in by the return grille and does not have a chance to circulate adequately around the room. In many houses, the rooms do not have individual return grilles. Instead there might be a large central return located in the hall. In these cases, the supply registers should be located on a wall that will allow the supply air to circulate completely prior to being drawn off and returned to the central grille. Also, the doors to the individual rooms must be undercut so that when they are closed, the supply air will be able to flow to the return grille.

Ideally, air-conditioning supply registers should be located in or near the ceiling. To minimize air-conditioning installation costs, rather than install new ducts many new homes use the ducts and registers provided with a forced-air heating system. These registers are usually located near or at the floor level and are quite effective for heating purposes. However, when they are used for air-conditioning, they are less effective and tend to increase the stratification effect. Some houses that have forced-warm-air heating have what are called *high-low registers*. The duct supplying the heat register is extended vertically to a point near the ceiling level where it terminates at another register. When the system is used for heating, the damper controlling the upper register is manually closed, and the lower register is opened. When the system is used for cooling, the damper controlling the lower register is

closed, and the upper register is opened. This type of arrangement is very desirable and is often found in high-quality construction.

The presence of a central air-conditioning system does not mean that the entire house is air-conditioned. Look specifically for registers as you walk through the house. In many raised ranches, I have found that the upper level is air-conditioned and the lower level is not. If you have any questions, check each room while the air-conditioning system is operating.

There are two basic types of ducts used in residential structures—sheet metal and glass fiber. While checking the distribution portion of the air-conditioning system, look for exposed ducts. The glass-fiber type of duct is by its very nature insulated. However, the metal duct may or may not be insulated. The fact that there is exposed metal on the outside does not mean that the duct is not insulated. The insulation might be located inside the duct. Whether the metal duct is insulated can be determined by feeling the duct when the system is operating (if no insulation, the duct will be quite cool) or by striking the duct with your fingernail. If there is no insulation, you will hear a ringing sound, and if there is insulation, you will hear a dull thud. All ducts that lead through unfinished areas such as crawl spaces and attics must be insulated so that the cool air flowing through the ducts will not absorb heat from its surroundings. Pay particular attention to the joints for indications of air leakage. Any open joints should be sealed with inexpensive duct tape. Also, whether the evaporator coil is located inside the furnace plenum or in the attic, check the joints around the housing for air leakage. Very often, there are open joints that must be sealed.

Heat pump

A heat pump is a year-round air-conditioning system that provides warm air during the winter and cool air during the summer. It is basically a compressor-cycle air-conditioning system (similar to the one described previously) that can operate in reverse. During the reverse operation, the condenser functions as an evaporator, and the evaporator functions as the condenser. The overall refrigerant cycle, however, remains the same. (See page 262 and FIG. 17-1 for the operational flow details.)

When the system is operating, the condenser (which is located in the house) is cooled by the air that is circulated around the house. As this air passes over the condenser, it absorbs heat that is used for heating the house. For the cycle to operate properly, the evaporator (which is located on the outside) must absorb heat from the outside air. Even when the outside temperature drops to as low as 20° F. the evaporator can absorb heat because the refrigerant within the evaporator is at a lower temperature. However, as the temperature of the outside air drops, the ability of the evaporator to absorb heat decreases, decreasing the effectiveness of the heat pump. Even though a heat pump may be operational at temperatures as low as 20° F, the Btu output is sufficiently reduced so that auxiliary heaters are usually required.

A heat pump should be sized for the air-conditioning load and not the heating load. Otherwise, the air conditioner will be oversized. Except for a small section of the Deep South, the heating load on a house will always be greater than the cooling load. A heat pump will produce approximately 20 percent more Btus per hour for heating than it does for cooling. Consequently, in most parts of the country, when a house is heated by a heat pump, auxiliary heat will also be needed. For example, in the New York area, a typical eight-room house would require a furnace that could produce about 100,000 Btus per hour for winter heating and also a 3½ ton (42,000 Btu/hour) air-conditioning unit for summer cooling. If a properly sized heat pump was used for heating,

it would produce only 50,400 Btu/hour. The remaining 49,600 Btu/hour would have to be provided by auxiliary heaters, which are usually electrical resistance heaters.

The auxiliary heaters in heat pumps are automatically activated when the pump cannot supply sufficient heat to keep up with the heat loss of the structure during the winter. In northern communities where there is a considerable amount of moisture and low temperatures during the winter, there is a tendency toward an ice buildup on the metal fins of the outdoor evaporator coil. An excessive ice buildup could cut off air circulation across the coil and result in a loss of heating capacity. With some heat pumps, this icing condition is automatically controlled by a defrost cycle that reverses the flow of the refrigerant for a short time. The hot refrigerant heats the outdoor coil and melts the ice. During the defrost cycle, the auxiliary heaters are usually energized to offset the cycle's cooling effect on the indoor circulating air.

A heat pump can operate in either the heating or air-conditioning mode. Most manufacturers suggest that the unit be operated in the air-conditioning mode when the outdoor air temperature is above 65° F (unlike a regular air conditioner, where the recommended temperature is 60° F) and in the heating mode when the temperature is below 65° F. Operating a heat pump in the wrong mode can result in damage to the compressor.

The components and problems of heat pumps are basically similar to those of air-conditioning systems. Consequently, the overall inspection procedure outlined earlier in this chapter for air conditioners should be used when inspecting heat pumps. However, you should not check both modes of operation. As long as the unit is functioning properly in the mode tested, it is an indication that the major and most costly components (compressor, fans, and coils) are operational. The system should then also function in the opposite mode. If it doesn't, a faulty reversing valve is usually the cause.

Evaporative cooler

One of the benefits of air conditioning is the dehumidification of the circulating air. This benefit is not without cost. Cooling and dehumidifying the air is more costly than cooling alone. In the southwestern part of the United States, the outdoor air is relatively dry, and dehumidification is not necessary. In this area, cooling can be achieved by means of an evaporative cooler. Because of the low humidity, water readily evaporates. In the evaporation process, the water absorbs heat from its surroundings and lowers the temperature.

The typical evaporative cooler consists of a sheet-metal and plastic casing containing a fan, pads, filter, and a water source. The pads, which hold the water, can be wetted by a spray, by a trickling stream, or by passing through a reservoir on a rotating drum. In some units, the wetted pads also function as air filters. As the air passes over or through the pads, it is cooled by the evaporating water and then distributed throughout the house.

When inspecting an evaporative cooler, turn the unit on and listen for any unusual sounds or vibrations in the blower compartment. Also look for signs of water leaks and check the pads for deposits and crusting. For efficient operation, the pads may require cleaning or replacement.

Checkpoint summary

General considerations

- ❍ How old is the air-conditioning system?
- ❍ When was the unit last serviced?
- ❍ Do not turn system on if the outside air temperature is below 60° F.

Compressor-condenser

- ❍ Check compressor during startup. Listen for any unusual sounds, such as straining, groaning, or squealing.
- ❍ Does compressor operate smoothly without short-cycling (repeated startup and shutdown)?
- ❍ Is condenser fan operating properly?
- ❍ Does compressor appear to be functioning properly? (Warm air should be discharging from unit.)
- ❍ Are there indications that the system is low in refrigerant (frosting on low-pressure refrigerant line or air bubbles in sight glass)?
- ❍ Is compressor-condenser located properly for maximum effectiveness (minimum sun exposure and unrestricted airflow)?
- ❍ Is unit in need of a cleaning (clogged with leaves, twigs, dust, etc.)?
- ❍ Check that unit is level and adequately supported by a concrete pad or blocks.
- ❍ For safety and maintenance, check for a main electrical disconnect for the compressor located near the unit.

Evaporator (cooling coil)

- ❍ During operation if possible, check cooling coil for frosting (ice buildup), usually the result of an insufficient airflow or lack of refrigerant.

Furnace-mounted evaporators (installed in the furnace plenum)

- ❍ Check for signs of leakage, mineral deposits, and areas of rust and corrosion.
- ❍ Note method of condensate discharge. Is it
  —to a nearby sink?
  —to the exterior?
  —to a floor drain?
  —to a hole in the floor slab (less desirable)?
- ❍ If condensate discharges into a reservoir lift pump (small rectangular box), check operation of pump.
- ❍ Check blower motor for unusual noises and vibrations. Is blower a single- or two-speed unit?

Blower coil (housed in a separate casing and most often located in the attic)

- ❍ Is unit vibration-mounted?
- ❍ If access is available, inspect evaporator coil for frost buildup.
- ❍ Check for a condensate drain line.
- ❍ Does this drain line discharge the condensate to a nearby roof gutter or directly into a plumbing vent stack? (The latter type of connection is usually not permitted and should be verified with the local building department.)
- ❍ Check blower-coil casing for auxiliary drain-line fitting; if not present, check for auxiliary drain pan below the unit. The auxiliary pan should contain an independent drain line that is *not* connected to the main drain line.
- ❍ If blower coil is located in attic, is the attic adequately ventilated?
- ❍ Is ventilation provided by ridge vent or thermostatically controlled power ventilator?

Ducts or registers

- ❍ Check airflow and temperature after fifteen minutes of operation.
- ❍ Note type of supply registers—ceiling units, combined type (heating and air conditioning), or high-low registers.
- ❍ Check whether all rooms are air-conditioned.
- ❍ Are supply registers and return grilles efficiently located?
- ❍ If rooms do not have individual return grilles, check for a large central return grille (often located in the hall).
- ❍ Are doors to the rooms undercut to permit proper air circulation?
- ❍ Check ductwork for open joints, signs of air leakage, and uninsulated ducts (particularly in the attic and crawl spaces).

18
Swimming pools

Concrete pools 275
Vinyl-lined pools 276
Preformed fiberglass pools 277
Pool equipment 278
Pool accessories 280
Inspection procedure 280
Checkpoint summary 282

Swimming pools, like central air-conditioning systems, are no longer considered a luxury that only a privileged few can afford. New construction methods and materials have considerably lowered the cost of construction. Swimming pools can be installed either in-ground or aboveground. You will find them with various sizes and shapes that can fit into almost every budget. Because the shape of an in-ground pool can be freeform, the shapes available are limitless. On the other hand, the shape of aboveground pools is basically limited to circular, rectangular, or oval. There are three types of construction for the shell of an in-ground pool: concrete, vinyl lined with sidewall supports, and preformed fiberglass. These items as well as the pool's associated equipment and accessories will be discussed below.

Concrete pools

Concrete pools can be constructed using any of four methods: shotcrete, gunite, poured concrete, and concrete block. Both shotcrete and gunite are applied and sprayed from a hose that is directed behind, over, and above previously installed reinforcing rods (re-bars). (See FIG. 18-1.) Shotcrete is premixed wet concrete, and gunite is a dry mix, which combines with water as it discharges from the hose. The spraying of the concrete mix allows complete freedom of size and shape because it can follow the contours of any excavated shape. Poured concrete and concrete block walls are more restrictive with regard to the shape of the pool. Whichever method is used to construct the shell, an interior finish must be applied to provide a waterproof surface.

The most common finish used on a concrete pool is plaster. It gives a smooth finish to the pool and also provides a nonskid walking surface. (See FIG. 18-2.) The projected life of a plaster finish is about 7 to 10 years depending on how well the pool and water quality has been maintained over the years. In many homes where the pool and the chemistry of the water have been diligently maintained, the plaster finish has lasted considerably longer.

Fig. 18-1. *Gunite being sprayed around reinforcing rods for a concrete swimming pool.*

Fig. 18-2. *Plaster finish being applied to a concrete pool.*

Other finishes are paint, fiberglass coating, and ceramic tile. Tile is by far the most expensive; so most homeowners opt for a decorative ribbon of tile above the water line. The top edge of the pool shell is covered with coping, which prevents water from getting behind the shell. It can also serve as a handhold for swimmers and as a shove-off point into the water. The coping can be in the form of precast coping stones, flagstones, or brick, or it can even be the extension of a concrete deck over the edge of the pool shell.

Vinyl-lined pools

The advent of vinyl-lined pools brought the ownership of swimming pools to within the reach of many families. Construction of the

pool shell consists of two phases: building of the perimeter frame or sidewalls and installing the liner. The most common sidewall panels are galvanized steel or aluminum. The frame must be structurally adequate to support the various forces exerted on the pool. After the sidewalls are bolted together, the bracing is installed. (See FIG. 18-3.) Then the area around the bracing is backfilled so that it is flush with the surrounding terrain. The sidewalls must have a smooth surface so as not to abrade the vinyl. They also don't have to be waterproof since the vinyl lining is. Prior to installing the liner, the base must be prepared. The bottom of the liner generally rests on a 2- to 3-inch sand base, and the top is secured with a special coping. The life of a vinyl liner is affected by the sun's ultraviolet light and the chemistry of the water. Manufacturers generally guarantee a liner against defective workmanship for 10 years. As vinyl pool liners age, the material becomes less supple and more prone to leaks from cracks or damage. It is possible to patch a small hole in a vinyl pool with a similar vinyl sheet material and a waterproof adhesive. Patching, if done correctly, can be effective, but once a liner has reached the age when several patches are needed, it is worth considering replacing the liner.

Aboveground pools are also vinyl lined. They are considered portable pools in that they can be dismantled and moved to a new location; however, many pools are partially or fully surrounded by a deck and are more permanent. The walls of the pool must be self-supporting and capable of withstanding the pressure being exerted on them by the water. The walls are usually galvanized steel, plastic, or aluminum and are 48 or 52 inches high. Because of the height of the walls, most municipalities do not require a safety fence surrounding the pool.

Preformed fiberglass pools

There are a number of advantages to a preformed fiberglass pool. The major advantage is its durability; the pool can flex and not get damaged. Also time is not lost in constructing the pool shell. After the site is excavated and prepared, the pool shell, which is brought to the site by truck, is lifted by a crane and placed into the excavation. (See FIG. 18-4.) Another advantage is the low maintenance. It is difficult for algae to cling to the sides of the pool because of its very smooth surface. As a result, the walls are very easy to clean. The main drawback of preformed pools is that

Fig. 18-3. *Steel bracing for the shell of a vinyl-lined pool.*

Fig. 18-4. *Preformed fiberglass pool shell being installed in excavated area.*

they are limited in size and shape. However, once the installation of the pool is complete, you cannot readily tell the difference between it and an on-site constructed pool.

Pool equipment

The standard equipment associated with circulating the water in a swimming pool are the pump and motor, filter, heater, and surface skimmer. The water circulation system is a closed system. The pump, which is driven by the motor, is normally located on the intake side of the filter. It draws water from the pool and forces it through the filter where dirt particles are removed. The water then flows to the heater and then back to the pool. To prevent the pump from getting clogged, there is a strainer basket on the water inlet side of the pump, which catches hair, lint, and other debris.

There are three basic types of filters available for swimming pools: sand filters, cartridge filters, and diatomaceous earth (DE) filters. The filters have no moving parts, and any one of the three will provide effective filtration. No matter which filter is used, the filtering medium will require periodic cleaning. The process used to clean DE and sand filters is backwashing, which is sending water backward through the filter, thereby flushing the debris onto the lawn, into the street, or to an approved drain line or sewer. Cartridge filters are not cleaned by backwashing; the cartridge is simply removed from the casing and washed. Most filters have a pressure gauge that is mounted on the top of the casing. The normal operating pressure is usually around 10 to 12 psi, although for some of the newer filters, it may be between 5 and 7 psi. As the filtering medium becomes dirty and clogged, it takes more pressure for the water to flow. It is generally time to clean the filter when the filter pressure increases approximately 10 psi above the normal operating range.

A swimming pool heater is not mandatory, but most houses with pools have one for comfort and because the heater can extend the swimming season. Most swimming pools are heated with a gas-fired heater, although they can also be heated with an electric heater and to a limited extent with solar heating or a heat pump. The ignition system in gas-fired heaters will be either a pilot light or electronic spark ignition. Either natural gas or propane gas (LP) can be used as the fuel for firing the

heater. However, a heater that is designed for natural gas should not be used with propane gas and vice versa, because it will not operate properly. Keeping the pool water in the proper chemical balance is very important not only for health reasons and maintaining the quality of the water but also to extend the life of the pool heater. Water that is out of balance will result in a scale buildup within the heater, which if not corrected will cause a blockage of water circulation.

Most swimming pool shells have at least one to two built-in surface skimmers with skimmer baskets that are tied into the water's circulation system. When the pump is operating, dirt, leaves, oils from lotions, algae, and other debris that float on the water's surface are drawn into the skimmer by floating over the entrance weir. (See FIG. 18-5.) The baskets trap and collect the larger debris, and the oils and dirt particles circulate back to the filter where they are removed from the water. Some pools have skimmers that are also connected to a pipe located below the water level. This pipe prevents air from being sucked into the circulation system when the water level is down. Otherwise, when the pool water level is below the bottom of the weir, air will be drawn into the circulation system, which could damage the pump. The pump is not designed to run dry. Running a pump with air in the system or running it dry can

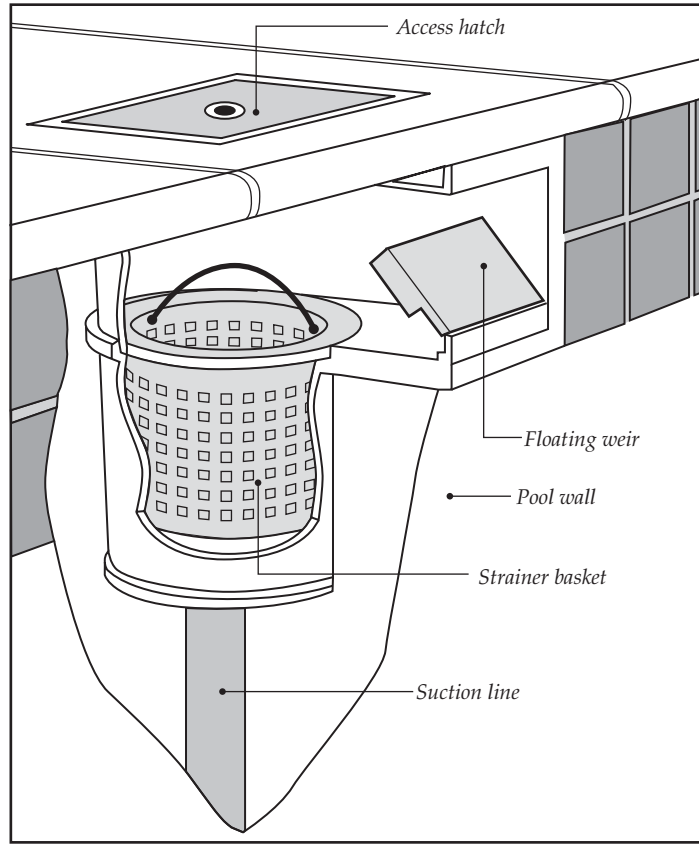


Fig. 18-5. *Cutaway view of a typical surface skimmer for a concrete pool.*

cause overheating and seriously damage both the pump and the motor.

Pool accessories

There are a number of accessories associated with a swimming pool, but the ones of concern from an inspection point of view are the pool cover, diving board, ladder, slide, and grab rails.

The main use for a pool cover is to keep debris out of the pool. It is mostly used when the pool will not be used for an extended period of time, such as during the winter months. (See FIG. 18-6.) However, depending on the material and design, the covers are also used by some homeowners during the swimming season to minimize heat loss and maximize heat gain. There are also safety covers that prevent small children or animals from falling into the pool. These covers are reinforced mesh with spring-loaded straps that hook onto the deck. There is also a "thermal or solar" cover available for a pool. It is essentially a sheet of vinyl bubble wrap that floats on the water. One puts it over the pool during swimming season because it allows the sun to heat the water and because it provides a barrier against evaporation.

Diving boards are available in spring-assisted and simple platform models. They are covered with fiberglass to make them waterproof and topped with a nonslip coating. Because of the danger of injury, some homes have jump boards rather than diving boards. Jump boards are shorter and are considered safer than diving boards. The concern about ladders, slides, and grab rails is whether they are adequately anchored to the deck.

Inspection procedure

In most municipalities a swimming pool is considered to be an auxiliary structure, and, as such, a building permit is required prior to construction. After completion, depending on the municipality, a Final Inspection Certificate, a Certificate of Compliance, or a Certificate of Occupancy is normally issued. If the house that you are inspecting has a swimming pool, check to see if there is a completion certificate for the pool.

There are certain limitations in a home inspection with regard to a swimming pool that you should be aware of. With no splashing, the average water loss in one week from evaporation is less than 1 inch. There

Fig. 18-6. *Pool cover keeps debris out when pool is not in use for extended period of time.*

could be a leak in the underground piping that causes the water level to drop more than what would be expected over a 24-hour period. This is a major problem to correct, but it will never be picked up during a home inspection. Pools lose water continuously through evaporation, splashing, and on the bodies of swimmers as they get out of the water. This is normal. However, a steady drop in the water line even when the pool is not being used may indicate a leak. This item should be discussed with the seller. In addition, the chemical composition of the water is generally not checked as part of a home inspection because it is considered to be normal ongoing maintenance.

As you walk around the house during your exterior inspection, check to see if there is a fence that encloses the swimming pool. This is important from a safety point of view. The fence should provide limited access to the pool. The gate(s) must be self-closing and self-latching. Check the condition of the fence and the operation of the gate. If maintenance is needed, record it on your worksheet for later correction.

The swimming pool and equipment can be inspected either before or after the inspection of the house, whichever is convenient. Check the condition of the deck that surrounds the pool. With an in-ground pool the deck is often concrete, although it could be stone, tile, or brick. Specifically look for cracked, chipped, or settled sections. Uneven joints between the sections are considered tripping hazards. If there are any open joints, particularly between the deck and the coping, they must be sealed. While on the deck if there is a grab rail, ladder, and slide, check to see if they are adequately anchored to the deck. If there is a diving board, look for cracks. If there are any, the board should be replaced. Is the board topped with a nonslip coating? Many older pools with diving boards do not meet new diving board standards. The safety upgrades outlined in the standards are mandatory. Check with a local pool company for the latest standards. With an aboveground pool the deck is generally wood constructed. Check the decking and railing for cracked, broken, or rotting sections. If there is access to the area below the deck, inspect the support framing.

After the deck inspection check the condition of the pool's sidewalls. With a vinyl-lined pool, look for staining, discolorations, or tears in the lining. Faded liners are more likely to tear. Has any portion of the lining pulled out of the edge retainer? If there are stains in the liner at the bottom of the pool that don't continue up the sides, it may indicate a fungal growth in the sand below the liner. With tile-lined concrete walls, look for cracked, loose, chipped, or missing tiles. If the walls are finished with plaster, check for spalling (flaking or chipped) or cracked sections. With painted walls, look for flaking or faded paint and cracks. As you walk around the pool looking at the sidewalls, check the skimmer. Does the weir move freely? Is it broken or missing? Is the strainer basket in place? Is it damaged?

Before you inspect the pump, filter, and heater, look closely at the pool water. If it is turbid, it would indicate that the filter is in need of a cleaning. If there are tiny bubbles discharging at the water-supply outlet, it would indicate that air is getting into the system. This condition must be corrected to prevent possible damage to the pump. Check the cover to the pump's hair and lint strainer. Most covers are transparent. If bubbles are visible, it would normally indicate that the cover is not tightly secured or that the gasket needs replacement. However, if there are no bubbles, you should suspect a leak in the water circulation system. In this case, further investigation is required by a pool service company.

When inspecting the pump, listen for any abnormal sounds. If it is noisy, there may be impeller damage or worn bearings. A pump that is very hot to the touch is also a problem

condition. It could indicate that the pump is running dry. If there is water dripping around the pump, it may indicate leakage around the shaft because of worn seals or because the hair and lint strainer cap is not tightly secured. Check the pressure gauge on the filter. Is it inoperative? Is the pressure excessively high? If the heater is not on, turn it on. If it doesn't fire up, record it on your worksheet. If the heater cycles on and off, it may indicate low water flow, a condition that must be corrected. To whatever extent the burner area is visible, look for a scale buildup with rust flakes and dust. Is water dripping in that area? If it is, you should suspect pin-hole leaks. If this condition exists, have the heater inspected by a pool service company. If there is an underwater pool light, check to see if it is operational. Also if there are electrical outlets nearby, check to see if they are GFI protected.

If the pool is not being used and is covered over, check the condition of the cover. Is it worn, are there any torn or damaged sections? If the cover is held in place with straps, are any straps missing? Since the operation of the pool equipment and the condition of the pool shell cannot be checked at this time, you should contact the company that has been servicing the pool and ask them for a copy of their service record. If the record is not available, have the seller include a clause in the contract to guarantee that the pool shell and equipment are in good operating condition.

Checkpoint summary

General considerations

- ❍ Has a Certificate of Occupancy been issued for the pool?
- ❍ Is there a fence that encloses the swimming pool?
- ❍ Are fence gate(s) self-closing and self-latching?

Deck

- ❍ Are there any cracked, chipped, or settled sections?
- ❍ Look for uneven joints between sections.
- ❍ Cracked or open joints should be sealed.
- ❍ Are grab rails, ladder, and slide adequately anchored to deck?
- ❍ Is diving board cracked or warped?

Vinyl-lined pool

- ❍ Is lining stained, discolored, or torn?
- ❍ Has lining pulled out of edge retainer?
- ❍ Is bottom of liner stained?

Concrete pool

- ❍ Are there cracked, chipped, loose, or missing tiles?
- ❍ Does the plaster finish have flaking, chipped, or discolored sections?
- ❍ Are any cracks visible in the sidewalls?
- ❍ Is the painted surface flaking or faded?
- ❍ Check the skimmer weir and strainer basket.

Pool equipment

- ❍ Is pool water turbid?
- ❍ Are tiny bubbles discharging into pool?
- ❍ Is the pump noisy? Is it very hot to the touch?
- ❍ Check for water dripping around the pump.
- ❍ Is the pressure gauge on the filter operative?
- ❍ Does heater cycle on and off?
- ❍ Look for scale buildup with rust flakes and dust around heater.
- ❍ Is water dripping under or around the heater?
- ❍ Does pool cover have torn or damaged sections?
- ❍ Check the operation of underwater pool light(s).
- ❍ Are electrical outlets GFI protected?

19
Energy considerations

Energy audit 283
Insulation 284
Attic ventilation 287
Storm windows 288
Caulking and weatherstripping 289
Fireplaces and wood-burning stoves 289
Heating and air-conditioning systems 290

Many states have enacted an energy conservation construction code to supplement their building codes. The purpose of the energy conservation code is to provide a construction standard that will minimize energy consumption in a building while maintaining the necessary comfort factors. The conservation code applies to new construction, renovations, and additions to buildings. The code is not retroactive and therefore does not apply to buildings constructed prior to its enactment. You can check with the local building department to determine whether there is an energy conservation construction code in your state and if so, whether it was in effect prior to the construction of the house you are planning to buy.

If you are considering the purchase of an existing building, there is a high probability that the house is not as energy efficient as it could be. Although the energy-deficient items are usually found during a prepurchase home inspection, they are often not upgraded until the buyer takes possession of the house. Consequently, after you move into the house, you should perform an energy audit to bring back into focus those items that are needed for conservation improvements.

Having an energy-efficient house is not only good citizenship; it is also good for your pocketbook, resulting in reduced utility bills. The actual dollar savings will of course depend on the gas, oil, and electricity rates in your area; the climate; and the extent to which your house is already energy efficient. You can often determine the projected savings and payback period for the costs involved in making your home energy efficient by contacting your local utility company. For a nominal fee, many utility companies will analyze your energy-conserving improvements, taking into account current and projected energy costs, and will estimate your dollar savings per year.

Energy audit

An energy audit is an inspection of the house to determine the extent of deficiencies that result in energy being wasted. The decision

whether to upgrade deficiencies is usually based on economics. Are the dollars spent in making energy-conservation improvements a wise investment? Will the improvements save you enough money on heating and cooling to pay for themselves? For most homes, the answer is yes, especially with ever-increasing costs for fuel.

One cause for wasted energy in a house, especially an older one, is the lack of adequate insulation. Insulation is a basic energy saver and should be used in all houses regardless of location. In colder climates, it reduces heat loss and thereby reduces fuel costs. In warmer climates, the insulation reduces heat gain and consequently reduces cooling costs (electricity is used for running most residential air-conditioning units). During your energy audit, you should determine whether your house is adequately insulated.

Insulation

Insulation is available in a variety of forms and materials. The three most common forms are flexible insulation, loose-fill insulation, and rigid insulation. *Flexible* insulation is manufactured in two types, batts and blankets. Both are made of fibrous materials such as glass fibers, rock wool, wood fibers, or cotton. Organic fibers are treated chemically to make them resistant to fire and decay. Batts are precut in 4- or 8-foot lengths and are available in thicknesses between 2 and 6 inches. Blankets are furnished in continuous rolls and are available in thicknesses between 1½ and 3 inches. Both batts and blankets are manufactured in 15- and 23-inch widths so that they can be readily used in homes that have been constructed with joist and stud spacing of 16 or 24 inches.

Loose-fill insulation is generally made from rock wool, glass fibers, vermiculite, pearlite, cellulose, granulated cork, shredded redwood bark, sawdust, or wood shavings. It is normally supplied in bags or bales and can be poured, blown, or placed by hand. Loose-fill insulation is suited for use in the sidewalls of homes that were not insulated during construction or between the floor joists of unheated attics. However, if there is no floor covering, it is not recommended for use between the floor joists when an attic fan could blow the loose material around.

Rigid insulation is generally made from extruded polystyrene, polystyrene bead board, urethane, fiberglass, or wood fiberboard. It is often used to insulate masonry walls and comes in widths of 24 and 48 inches. Most rigid insulation boards are not fire resistant and should be covered with at least ½-inch gypsum wallboard to ensure fire safety. Rigid insulation boards are also used as backer boards for aluminum and vinyl exterior siding.

Another type of insulation that was popular in the late 1970s was *foamed-in-place* insulation. It was made from urea formaldehyde. In many homes, the foam ingredients were improperly mixed and installed. This resulted in excessive formaldehyde vapor being released into the house, causing adverse health effects. Urea formaldehyde foam insulation (UFFI) is no longer being installed; however, many homes have UFFI in their walls. This is no longer considered a problem. See "Formaldehyde" in chapter 20.

One measure of the effectiveness of insulation is its resistance to heat flow, the *R-number*. The higher the R-number, the greater the resistance to winter heat loss or summer heat gain. Table 19-1 shows typical R-numbers for various types and thicknesses of insulation.

R-numbers are additive. You can add an insulation rated R-11 to one that is rated R-19 to achieve a resistance value of R-30. The thermal resistance of an area covered with loose-fill or flexible insulation can change over the years. The insulation value depends not only on the

Table 19-1. Insulation ratings.

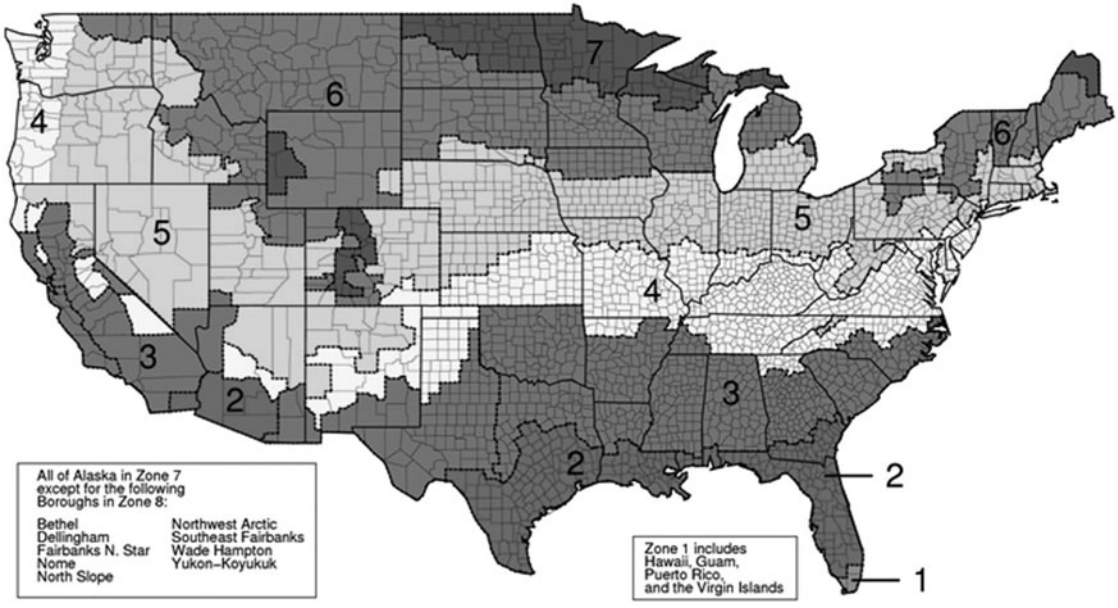
	R-number					
Insulation type	**11**	**13**	**19**	**22**	**30**	**38**
Batts/blankets						
Fiberglass	3½″	4″	6″	7″	9½″	12″
Rock wool	3″	4″	5½″	6″	8½″	11″
Loose-fill						
Fiberglass	5″	5½″	8½″	10″	13½″	17″
Rock wool	4″	4½″	6½″	8″	10½″	13″
Cellulose	3″	3½″	5½″	6″	8½″	11″
Vermiculite	5″	6″	9″	10″	14″	18″
Rigid board						
Polystyrene (extruded)	3″	3½″	5″	5½″	7½″	9½″
Polystyrene (bead board)	3″	3½″	5½″	6″	8½″	10½″
Urethane	2″	2″	3″	3½″	5″	6″
Fiberglass	3″	3½″	5″	5½″	7½″	9½″

material but also on the amount of trapped air contained within the material. If the loose fill is disturbed or the flexible insulation crushed (because of items being stored on top of it), it will no longer be as thick as when it was installed. Consequently, its effective R-number will be reduced. To determine the current R-number of the insulation in your home, you should measure its thickness.

The insulation recommended for your house can be determined from the map in FIG. 19-1. You might be surprised to learn how much insulation is recommended. The R-numbers, however, are based on current and projected fuel costs. If your house is already insulated, once you determine the amount of existing insulation, you can add the difference. Remember, the R-numbers are additive. In some homes, it might not be economically justifiable to increase the insulation to the recommended value.

In determining whether your house is adequately insulated, you should check the exterior walls and the ceilings and floors that face unheated areas, such as the attic and crawl space. (See FIG. 19-2.) In unfinished areas where the insulation is exposed (often in the floor of an attic or ceiling of a crawl space), the thickness can easily be measured. If the attic floor is covered, you can pry up one board and look for insulation. Determining the amount of insulation in a finished exterior wall is more difficult. However, you can make a quick determination whether the wall is inadequately insulated or has no insulation by feeling the inside surface during the heating season. If the wall feels cold to the touch, insulation is needed.

Sometimes you can determine the amount of insulation by removing the cover to a light switch and peering into the wall space, using a flashlight. Caution should be observed, since the switch is electrically hot. Because of the small amount of open space between the wall and switch box, this method is usually not effective. Also, it is possible that the electrician who installed the wiring might have pulled the insulation away from the switch and outlet boxes to facilitate installation. In this case, you might think that there is no insulation in the wall. The only way to determine positively how



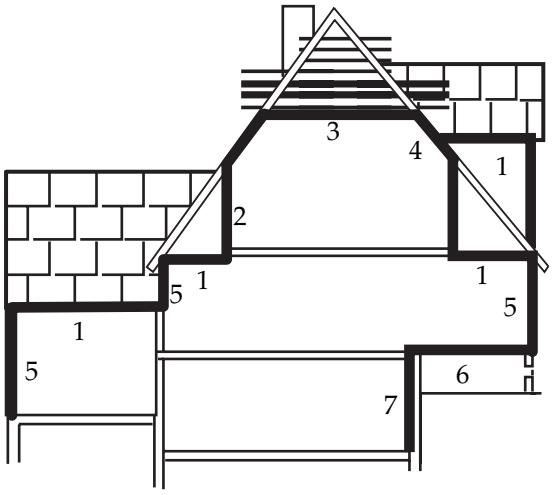
Zone	Add Insulation to Attic		Floor
	Uninsulated Attic	Existing 3–4 Inches of Insulation	
1	R30 to R49	R25 to R30	R13
2	R30 to R60	R25 to R38	R13 to R19
3	R30 to R60	R25 to R38	R19 to R25
4	R38 to R60	R38	R25 to R30
5 to 8	R49 to R60	R38 to R49	R25 to R30

Fig. 19-1. *Recommended insulation levels for retrofitting existing wood-framed buildings. Courtesy of: Energy Star (U.S. Dept. of Energy and EPA)*

much insulation there is in a finished exterior wall is to make a small hole in the wall (in a nonobvious location such as a closet) and measure it. The hole can then be patched.

While you are determining the amount of insulation, you should also determine whether there is a *vapor barrier* associated with the insulation. A vapor barrier is a thin sheet material such as polyethylene film, aluminum foil, or an asphalt-impregnated kraft paper through which water vapor cannot readily pass. Many insulation materials are produced with a vapor barrier applied on one side. If the insulation does not have a vapor barrier, a separate one can be installed. The purpose of a vapor barrier is to prevent moisture problems in exterior walls and ceilings, and floors that face unheated areas, due to condensation of water vapor (normal in a house) that passes through those surfaces. To be effective, the vapor barrier must be facing the heated room rather than the cool, unheated area. (See FIG. 19-3.)

In addition to the need for insulation of the building shell (exterior walls, ceilings, and floors), all hot-water pipes and heating and cooling ducts that pass through unheated



1. Ceilings below an unheated area.
2. "Knee" walls of a finished attic level room.
3. Floor of a crawl attic.
4. The sloping portion of the roof in a finished attic. Leave an airspace between insulation and roof.
5. Exterior walls.
6. Floors above cold crawl spaces. Floors above a porch or an unheated garage.
7. Walls of a heated basement.

Fig. 19-2. *Where to insulate.*

portions of the house (such as a crawl space, garage, or unfinished attic) must be insulated. Most houses usually have no more than 1 or 2 inches of insulation wrapped around ducts in unheated areas. Because of increasing fuel costs, this is considered minimal for most areas, and additional insulation can usually be justified. Check the condition of the insulation. Are there any loose, torn, or missing sections? Also, if there are any exposed duct joints, check them to see if they are sealed tightly. When the ducts are used exclusively for air conditioning or serve a dual function (such as heating and air-conditioning), the outside of the insulation should be covered with a vapor barrier to prevent condensation. A vapor barrier, however, is not needed on ducts used only for heating. If there is a vapor barrier on the ducts, check its condition. Look for torn and missing sections. All vapor-barrier joints must be tightly sealed.

If the domestic hot water is produced in a tank-type water heater located in an unheated area, the tank should be covered with an insulation jacket. These jackets can be purchased in most building-supply or hardware stores. Although tank-type water heaters are normally insulated by the manufacturer, by installing an outer insulation jacket, you will further reduce heat loss and thereby minimize the energy needed to maintain the desired water temperature. The temperature of the hot water should not exceed 140° F. (See chapter 16.) Temperatures in excess of 140° F are not only wasteful of energy but will also shorten the life of the water heater.

Attic ventilation

While in the attic checking the insulation, see if the area is adequately ventilated. As discussed in chapter 9, attic ventilation is necessary not only to prevent condensation problems during the winter months but also from an energy-conservation point of view to reduce the heat load on the structure during the summer. Because of trapped air, attic areas can become excessively hot during the summer, reaching temperatures of about 150° F. If there is an air-conditioning blower coil located in the attic, the high temperature will tend to lessen its efficiency of operation.

Ventilation in an attic should be provided by at least two vent openings located so that air can flow in one opening and out of the other. Vents in the eaves and at gable ends are better than gable vents alone. One of the most effective methods for ventilating the attic is a combination of vents in the eaves and a continuous ridge vent. Remember, the attic must also be adequately

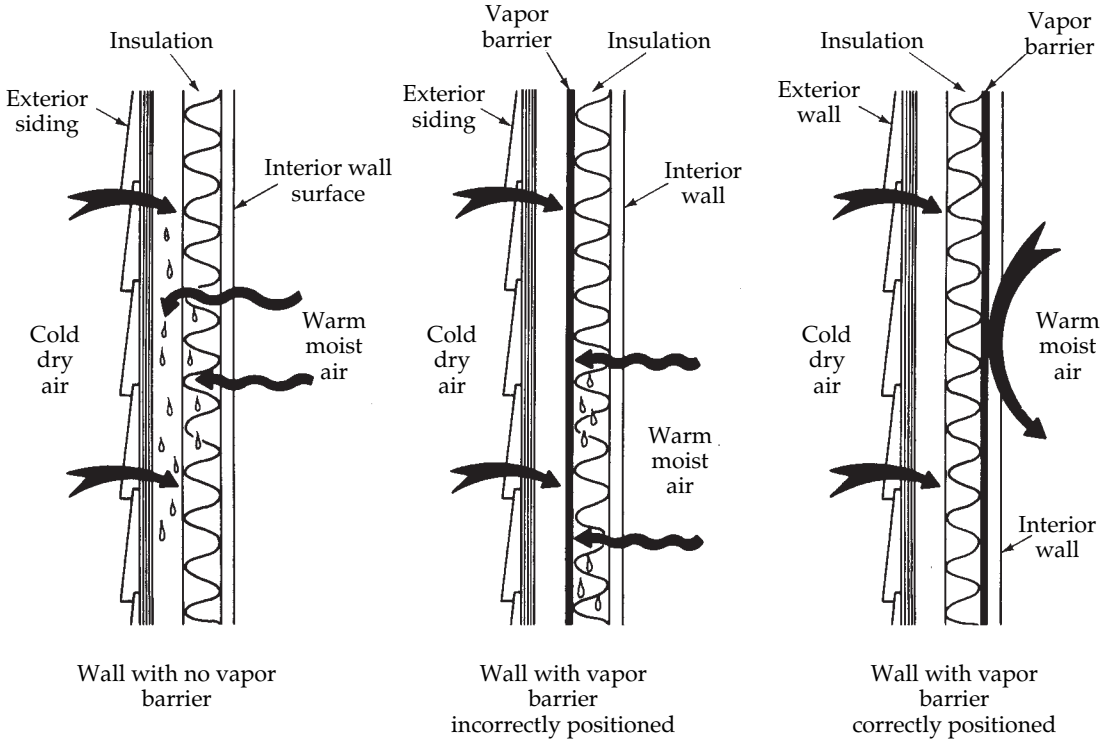


Fig. 19-3. *How a correctly positioned vapor barrier prevents condensation in the exterior wall.*

ventilated during the winter. As long as the attic is adequately insulated, the benefits of ventilation greatly exceed any fuel savings that might result from blocking the vent openings.

Storm windows

Most homes with single-pane windows will benefit by the installation of storm windows. (See chapter 5.) A storm window, whether a storm sash, panel, or combination unit, reduces the heat loss through a single-glazed window by about 50 percent. In cold climates, it also adds to physical comfort by reducing an apparent draft. Body heat radiates toward a cold surface. Also, warm air hitting a cold surface loses its heat, becomes dense, and falls to the floor. This combined effect creates what appears to be a draft to someone sitting or standing near the cold surface (window). If the storm window is a sash or combination unit (both of which cover the window frame), it also helps reduce cold-air infiltration through the movable and fixed joints around the window.

Basically, a storm window is effective because it traps a layer of air between itself and the window. This dead air space acts as an insulator and thus reduces heat loss. If installing storm windows is not economically justified because you are planning to move or your budget does not presently permit the purchase of storm windows, you can still make your windows energy efficient. Simply cover them with plastic sheets and secure the edges with tacks, molding strips, and caulking. Although temporary, these inexpensive

homemade storm windows are an effective approach to reducing heat loss. They will more than pay for themselves in fuel savings in the first year.

Caulking and weatherstripping

In a well-insulated house with thermal-pane or storm windows, air leakage is the greatest source of heat loss. To conserve energy further by reducing the cold-air infiltration during the winter and the loss of air-conditioned air in the summer, the movable joints (such as those around windows and doors) should be weatherstripped, and the fixed exterior joints should be caulked. (See chapter 5 for types of caulking compounds.)

Check windows and doors for weatherstripping and tightness of fit. Loose-fitting windows and doors not only lose heat but result in uncomfortable drafts. All window sashes, exterior doors, and interior doors or hatches leading to unheated areas (such as an attic, basement, or crawl space) should be weatherstripped on their sides, tops, and bottoms. Periodically check the condition of the weatherstripping. Over the years, some types of weatherstripping will wear, tear, crack, and generally deteriorate so that replacement is required.

The condition of the caulking on the exterior joints should be checked during your energy audit. Specifically, look at the joints (1) between the exterior siding and the window and door frames, (2) at the inside and outside corners formed by the exterior siding, (3) just under the bottom side of the exterior siding and the foundation wall, (4) between dissimilar siding materials (such as a masonry-and-shingle wall), (5) where the chimney meets the siding, and (6) where storm windows meet the window frame (except for drain holes at the windowsill). If the caulking is old, brittle, broken, or missing, the joints should be recaulked. Good home maintenance includes an annual check of all exterior joints, particularly in view of rising fuel costs.

Fireplaces and wood-burning stoves

Most fireplaces are used for creating a relaxed, cozy atmosphere rather than heating. Usually their use as an auxiliary source of heat cannot be economically justified, since they are very inefficient. A fireplace requires a large volume of air for combustion. Normally this air is drawn from the heated air in the house. Since the combustion air flows up the chimney, all the fuel that had been used in heating the air is wasted. To minimize this problem, a fireplace should have dampered air vents that provide combustion air from the outdoors. Although newer fireplace installations have provisions for outside air, most existing fireplaces do not have this feature and therefore waste more heat than they generate. In fact, in terms of the total heating value of the wood being burned, a fireplace does not generate much heat at all. Only about 10 to 15 percent of the available Btus actually find their way out into the room, while much more warm air disappears up the chimney.

Even when a fireplace is not being used, it is a potential source of heat loss. If the flue is not blocked, heat in the house will be drawn up the chimney. This condition can normally be minimized by closing the damper. Check the fireplace to see whether there is a damper and if so, whether it properly seals the flue opening. Fireplaces in many older houses do not have dampers. If a movable damper is too costly to install, you can always block the flue with a piece of sheet metal supported by guides on the sidewalls. It can be inserted and removed on an as-needed basis.

Some fireplaces have built-in convection ducts around the firebox that function as a

heat exchanger. Cool air entering the bottom of the ducts is heated as it circulates around the firebox. The warm air rises and flows out into the room through openings in the upper section of the ducts. This type of fireplace has a greater heating efficiency than the conventional open-faced masonry fireplace. Nevertheless, a much more efficient way to heat the house is by using a wood-burning stove. A good-quality stove will allow only the air needed for combustion into the unit. Consequently, heated room air is not lost up the chimney. If you control the airflow through the stove, a log will produce more heat by burning for a longer period of time. In addition, since the stove is physically located in the room that it is intended to heat, the entire surface of the unit will heat up and warm the room by convection and radiation.

The cost-effectiveness of a wood-burning stove for heating will depend on the cost of the wood being burned. In those areas where wood is inexpensive, a stove is an economically viable method for providing auxiliary heat and reducing your overall heating bill. Even in those areas where wood is more costly, as utility rates increase, the use of a wood-burning stove becomes more attractive. Different woods have different burning characteristics. For example, wood from conifer trees (softwood) such as pine, spruce, and fir burns more quickly and gives less heat than wood from deciduous trees (hardwood) such as maple, oak, and beech. To aid you in making a proper selection for your fireplace or stove, TABLE 19-2, prepared by the Maine Bureau of Forestry, shows the various characteristics of wood.

Heating and air-conditioning systems

During your energy audit, you have been mainly concerned with those items needed to reduce heat loss. Another item of concern is maximizing the Btu output of your heating system. As you walk around the house, check the radiators or heat registers to see that they are unobstructed. If your house is heated with a warm-air furnace, check the filter to see if it needs replacement. If the oil or gas burner for the heating system was not cleaned and tuned up prior to your energy audit, it should be done as soon as possible. A heating system out of adjustment results in

Table 19-2. Characteristics of woods for use in a fireplace or stove.

Species	Ease of starting	Ember generation	Sparks	Fragrance	Heating value
Apple	Poor	Excellent	Few	Excellent	Good
Ash	Fair	Good	Few	Slight	Good
Beech	Poor	Good	Few	Slight	Excellent
Birch (white)	Good	Good	Moderate	Slight	Good
Cherry	Poor	Excellent	Few	Excellent	Good
Cedar	Excellent	Poor	Many	Good	Fair
Elm	Fair	Good	Very few	Fair	Good
Hemlock	Good	Low	Many	Good	Fair
Hickory	Fair	Excellent	Moderate	Slight	Excellent
Locust (black)	Poor	Excellent	Very few	Slight	Excellent
Maple (sugar)	Poor	Excellent	Few	Good	Excellent
Oak (red)	Poor	Excellent	Few	Fair	Excellent
Pine (white)	Excellent	Poor	Moderate	Good	Fair

greater fuel consumption, which can be quite costly. Heating systems require a periodic tune-up for efficient operation.

Various devices on the market to be fitted on or around the chimney flue are supposed to cut fuel consumption and conserve heat. Many of these furnace attachments, however, do not live up to the manufacturers' claims of saving significant energy.

One device of concern from a safety point of view is the *automatic flue damper*. This device is designed to close the furnace chimney after the burner turns off. The intention is to conserve heat by preventing room air from being drawn up the chimney. However, if the automatic flue damper fails to open when the burner fires, poisonous carbon monoxide fumes will vent into the house. If your furnace has such a device, you should find out whether it has been approved by a nationally recognized testing agency and by your local utility company. If it has not been approved, you should consider its removal or replacement as a precautionary measure.

Table 19-3. Energy savings for lowering thermostat.

	Percent of energy savings for an 8-hour temperature setback	
Degree days	**5° F**	**10° F**
5,000	8.1	12.1
6,000	7.2	10.8
7,000	6.1	9.6
8,000	5.2	8.5
8,500	4.6	7.8

By lowering the thermostat setting 5 to 10 degrees each night before going to bed and raising it in the morning, you will reduce fuel consumption and save dollars. The amount of the savings will depend on the duration of the setback, the climate, and the fuel costs in your area. See TABLE 19-3.

The *degree day* is a unit that expresses the severity of the climate in an area. The reference temperature for evaluating degree days is 65° F. Degree days are the number of degrees that the average (of the high and low temperatures for a 24-hour period) is less than 65° F. For example, if for a twenty-four-hour period (during the heating season), the high and low temperatures are 50° F and 30° F, respectively, the average temperature would be 40° F. The degree-day number for that day is then 65–40, or 25. The total number of degree days for an area, therefore, is simply the sum of the degree-day numbers during the heating season. You can check with the local utility company to find the total number of degree days for your area.

From a convenience point of view, if your heating system is controlled by a manual thermostat, you should consider replacing it with an automatic-lock thermostat. With this type of thermostat, you can regulate the amount of the setback and its duration. Depending on your requirements, thermostats with double setbacks are also available.

If there is a central air-conditioning system in your house, it must also be cleaned and tuned up to maximize the efficiency of operation. Prior to the cooling season, have the system checked to see if it needs a refrigerant charge. The system will cool even if it is low in refrigerant; however, it will operate inefficiently. Check the location of the compressor to see if it is in the shade and whether the airflow into and out of the unit is unobstructed. If the compressor is in the midday and afternoon sun, it will not perform efficiently. You should build a sunscreen to shade the unit if necessary. Be careful, however, not to obstruct the airflow.

20
Environmental concerns

Radon 292
Asbestos 295
Drinking water 297
Lead 298
Formaldehyde 300
Leaky oil tanks 300
Electromagnetic fields 301
Mold 302

In the past, whenever people bought a home, their main concern was the physical house; that is, the structural integrity of the building; the condition of the mechanical equipment such as the heating system, plumbing, water heater; the adequacy of the electrical system; the condition of the roof; whether the basement was dry; and whether there was a termite condition. In recent years, another factor has entered into the decision process—environmental problems. Some of these problems, such as a high radon concentration or deteriorating asbestos insulation, are potential health hazards. Others, like a leaky buried oil tank, can contaminate the soil and eventually the aquifer (water table). In all cases, it costs money to correct the problems. This cost should be added to the overall sale price of the house to determine the true cost of purchasing the house.

In this chapter, I will discuss environmental problems that are or should be of concern to the home buyer or homeowner. There is no doubt that in the future, as technology improves and more statistical health information becomes available, additional items will be added to the list of environmental problems.

Radon

Although the health risks associated with exposure to high concentrations of radon have been known for decades because of experience with uranium miners, it wasn't until December 1984 that it was realized that people in homes can also be exposed to high concentrations of radon resulting from uranium deposits in the soil on which the houses are built. A worker in a nuclear generating plant passed through a radiation detection monitor as he entered the plant. It turned out that his home had twenty times more radiation than is allowed in a uranium mine.

Radon is a gas present in varying quantities in the atmosphere and soils around the world. It is colorless, odorless, and tasteless, and is produced by the natural radioactive decay of uranium deposits in the earth. Prolonged exposure to high concentrations

of radon can cause cancer. According to the U.S. Environmental Protection Agency (EPA), scientists estimate that between 5,000 and 20,000 lung-cancer deaths a year in the United States can be attributed to radon.

The concentration of radon in the air is measured in units of *picocuries* per liter of air (pCi/l). Based on currently available information, the EPA has set guidelines for radon levels in residential structures. (See TABLE 20-1.) Their "action level" is 4 pCi/l; that is, no action is needed if the radon concentration is below 4 pCi/l. The EPA acknowledges that even the action level is not risk free because exposure to an annual radon level of 4 pCi/l is equivalent to the risk of smoking ten cigarettes a day or having two-hundred chest X-rays a year. The action level was set at 4 pCi/l because in some cases reduction below that level might be difficult or impossible to achieve.

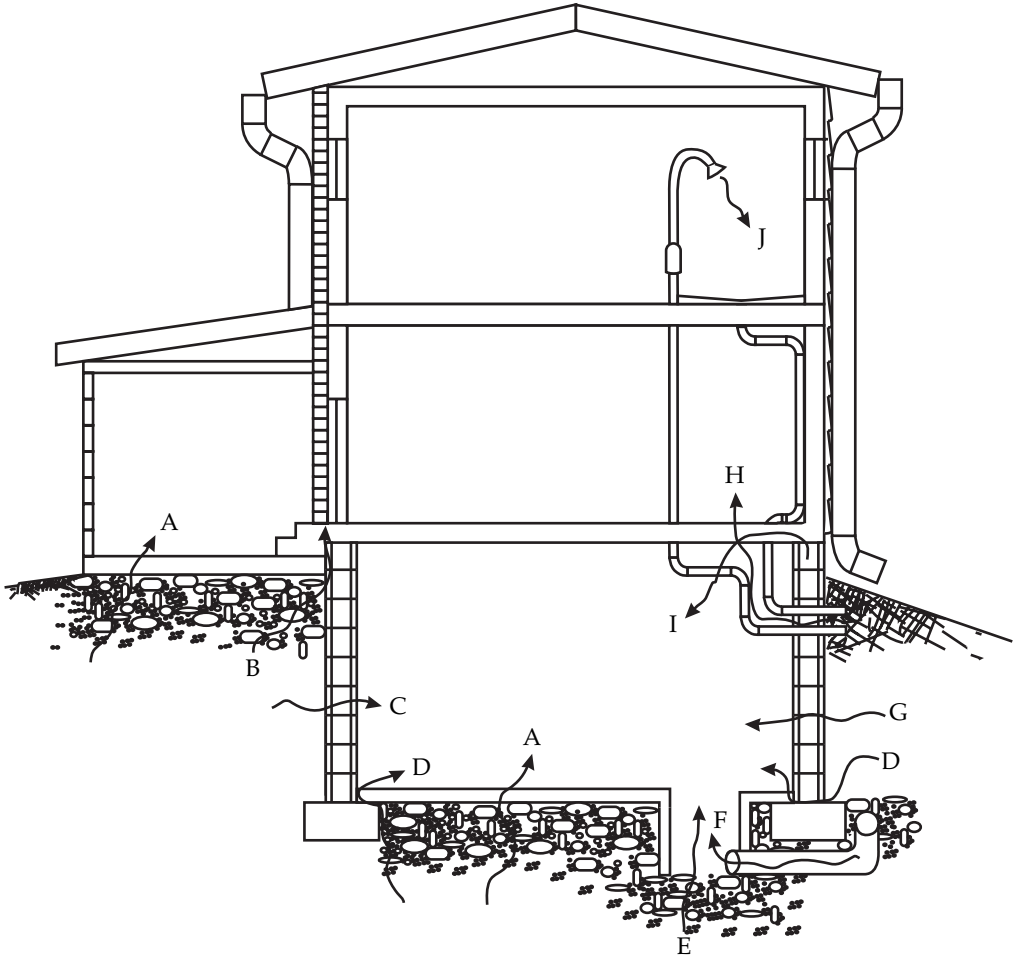
Table 20-1.
U.S. EPA guidelines for residential radon.

Annual average Radon level	Recommended action
Over 200 pCi/l	Take action to reduce levels within several weeks.
Between 20 and 200 pCi/l	Take action to reduce levels within several months
Between 4 and 20 pCi/1	Exposures in this range are considered above average You should take action to reduce levels to about 4 pCi/l or below within a few years (sooner if levels are at the upper end of this range).
Below 4 pCi/l	Exposures in this range are considered average or slightly above average. Although exposures in this range do present some increased risk of lung cancer, reductions of levels this low may be difficult, and sometimes impossible, to achieve.
Below 1.0 pCi/l	These are average first-floor residential levels.

Although radon gas is present in varying quantities in soils around the world, not every house has a problem with high radon levels. It is possible for one house to have a very low radon concentration while an adjacent house has a very high level. It depends on the construction of the house, the uranium-radium content in the soil, and geological formation below the house. The only way to know if a house has a radon problem is to test it. The radon concentration in a house varies with time. It is affected by a number of environmental factors such as rain, snow, barometric pressure, and direction of wind relative to open windows, and by induced negative pressures caused by periodic use of exhaust fans, attic fans, fireplaces, and heating systems. Consequently, the most accurate method of determining the average annual radon concentration is a long-term test. However, since time is usually limited in real estate transactions, a long-term test is not practical, and consequently a charcoal canister with a test period of three to seven days is generally used.

Canisters can be purchased in hardware stores and home centers. Also, in many areas professional home-inspection companies offer radon-testing services. If you intend to place the radon-detection canister yourself, make sure that you follow the directions carefully; otherwise, the results might be inaccurate.

Since radon is a gas, it can seep into the lower level of a house through dirt floors, cracks in concrete floors and walls, floor drains, sump pits, open joints and tiny cracks or pores in hollow block walls. (See FIG. 20-1.) If after a house is tested it is determined that it has a high radon concentration, don't panic. The condition can be corrected at a reasonable cost.



A. Cracks in concrete slabs
B. Spaces behind brick veneer walls that rest on uncapped hollow-block foundation
C. Pores and cracks in concrete blocks
D. Floor-wall joints
E. Exposed soil, as in a sump
F. Weeping (drain) tile, if drained to open sump
G. Mortar joints
H. Loose fitting pipe penetrations
I. Open tops of block walls
J. Shower

Fig. 20-1. *Major radon entry routes.*

A number of methods have been successful in reducing radon concentration levels in buildings to a point below the "action level." A typical mitigation procedure that is very effective is to use a 4-inch plastic pipe with an in-line fan that vents the radon gas from below the floor slab to above the roof. Correcting the problem is not a do-it-yourself task. It should be done by a radon-mitigation contractor that has completed the requirements for listing under the U.S. EPA's Radon Contractor Proficiency Program.

Radon can also enter the house through the domestic water supplied by a private well. It can be transferred into the air during a shower or when water is running in a sink. However, it takes relatively high levels of waterborne radon to produce a significantly elevated level of radon in a house; the large volume of air inside a house dilutes the radon being transferred to the air from the relatively small volume of water. It is estimated that the normal use of a water supply containing 10,000 pCi/l will produce a concentration of 1 pCi/l of radon in the air. It therefore takes a waterborne radon level of 40,000 pCi/l to reach the EPA's action level of 4 pCi/l.

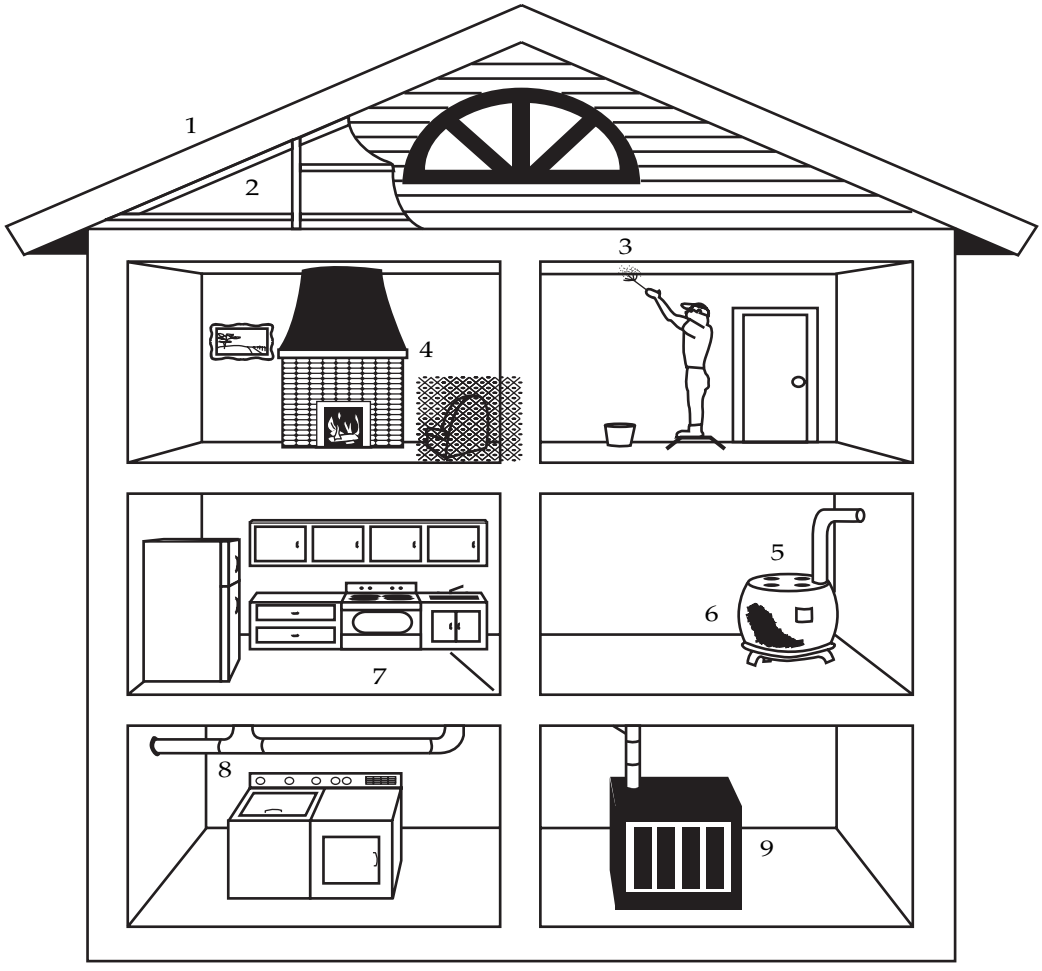
In most parts of the country, radon gas emanating from the soil is the major contributor to indoor airborne radon. As a result, the water from a private well is normally not tested for radon during the initial screening test. However, in some areas of the United States, waterborne radon significantly contributes to the total radon concentration. You can check with your local health department to find out if testing the water is recommended for your area. As of this writing, the EPA has not set a maximum level for radon in drinking water. Nevertheless, if the radon level is greater than 10,000 pCi/l, water-supply mitigation should be considered. There are water-treatment methods available that can be used for removing radon at the point of entry. The specific method should be discussed with the radon-mitigation contractor. Incidentally, do not worry about drinking the water. The health effect of drinking waterborne radon is relatively insignificant compared to that associated with breathing in airborne radon.

Asbestos

A common concern of many home buyers is whether there is any asbestos in the house, and if there is, is it in a condition that would be considered a health hazard? Asbestos, which has been identified as a carcinogen, is a naturally occurring fibrous mineral found in certain types of rock formations throughout the world. Asbestos fibers are strong, won't burn, resist corrosion, and insulate well. These physical properties have made it a staple in architectural and construction applications. When the fibers are mixed during processing with a material which binds them together, they can be used in many construction products such as cement siding and roof shingles, vinyl floor tiles, ceiling tiles, textured paints or coatings, blown-in insulation, flexible fabric connections in ductwork, spackling compounds, boiler insulation, pipe insulation, caulking, putties, door gaskets on wood-burning stoves, and so on. (See FIG. 20-2.) The amount of asbestos in these products varies considerably, from approximately 1 percent to 75 percent.

Asbestos-containing material in the home doesn't necessarily pose a health risk. Asbestos materials become hazardous only when due to damage, disturbance, or deterioration over time, they release fibers into the air. Airborne asbestos fibers can be inhaled through the nose and mouth and lodge in the lungs. According to estimates by the EPA, every year 3,300–12,000 people die from cancer caused by exposure to asbestos. Of particular concern is asbestos-containing material that is sprayed or troweled or that has become friable. (Friable material can be crumbled, pulverized, or reduced to powder by hand pressure.) As long as the asbestos-containing material is intact, it does not pose a health hazard. If the asbestos material is not likely to be disturbed or is in an area where renovations will not occur, the EPA suggests that it is best left alone.

Many houses have old boilers that are insulated with asbestos. The insulation looks like a white plaster coating over the boiler shell. When the boiler is eventually replaced, it is



1. Some roofing and siding shingles are made of asbestos cement.
2. Houses built between 1930 and 1950 may have asbestos as insulation.
3. Asbestos may be present in textured paint and in patching compounds used on wall and ceiling joints. Their use was banned in 1977.
4. Artificial ashes and embers sold for use in gas-fired fireplaces may contain asbestos.
5. Older products such as stove-top pads may have some asbestos compounds.
6. Walls and floors around woodburning stoves may be protected with asbestos paper, millboard, or cement sheets.
7. Asbestos is found in some vinyl floor tiles and the backing on vinyl sheet flooring and adhesives.
8. Hot water and steam pipes in older houses may be coated with an asbestos material or covered with an asbestos blanket or tape.
9. Oil and coal furnaces and door gaskets may have asbestos insulation.

Fig. 20-2. *Locations of possible asbestos hazards in the home.*

necessary first to remove the asbestos insulation, even if the insulation is in good condition, before disassembling the boiler. Most heating contractors are not certified in asbestos removal. The job must be done by a qualified asbestos-removal contractor that has been trained and certified. Once removed, the asbestos cannot be thrown out like ordinary household garbage. A licensed industrial-waste hauler must take it, properly identified and contained, to a landfill that accepts asbestos.

Removal of damaged or deteriorating asbestos materials is not always necessary. In fact, it is the least desirable alternative because in the process it creates a considerable amount of airborne asbestos fibers that must be contained and removed. Depending on its condition, the asbestos material can be encapsulated by coating it with a sealant so that the fibers cannot be easily released. It can also be enclosed in airtight walls or ceilings that completely isolate and contain any fibers that become airborne. The decision whether to remove, encapsulate, or enclose deteriorating or damaged asbestos material, as well as the repair of damaged sections, should be made only by a certified trained professional.

Although most of the asbestos materials that had been used in construction are no longer being manufactured, various items can be found in many homes built prior to 1978. Identifying the more common types of asbestos material can generally be done in a visual inspection by home inspectors, asbestos-abatement personnel, or tradespeople who have frequently worked with asbestos material, and even by you. For example, in many older homes, the heating pipes in the basement or crawl spaces are covered with insulation that contains asbestos. The insulation on the straight sections of pipe, when viewed from an end, looks like corrugated cardboard. The angle fittings on the heating pipes are covered with an insulation coating that looks like plaster and is shaped around the fitting. If you see this type of insulation, look for torn, loose, crushed, or otherwise damaged sections. In many cases, it is not readily apparent whether building products and insulation materials contain asbestos. In those cases, positive identification of asbestos can be made by a qualified laboratory after analyzing representative samples of the material.

Drinking water

Domestic water is generally supplied to homes through private wells or public water companies. Water supplied by public water companies is usually safe to drink and does not pose a health risk. The quality of the water supplied by these companies is periodically checked because it must comply with rigid standards set by the U.S. EPA. Nevertheless, the EPA has indicated that some 40 million people have been using drinking water containing potentially hazardous levels of lead. The problem does not originate with the water supply but with distribution piping, solder used at the pipe fittings, and fixtures in the house. In some older homes, the inlet water pipe is made of lead; the solder used on pipe fittings in homes built before 1988 contained lead; and lead is contained in the metal alloy used in the manufacture of many faucets.

The most important factor causing a high concentration of lead in water is the contact time between the water and the lead. Water that is slightly acidic or soft (water that makes soapsuds easily) is corrosive and reacts with lead. When the water stands in pipes or faucets that contain lead for several hours without use, there is a potential for lead to leach, or dissolve, into the water. Also, hot water dissolves lead more quickly than cold water.

Dissolved lead in water has no odor and cannot be seen or tasted. Testing by an approved laboratory is the only way to determine if the drinking water has high levels of dissolved

lead. The test is generally conducted in two parts, A "first draw" sample is collected—water that has been sitting in the pipes overnight or at least four hours. Then a "fully purged" sample is collected; the water is turned on and allowed to flow for at least one full minute before a sample is collected. According to preliminary studies at the University of North Carolina, about 30 percent of homes have a high lead concentration in the first draw, but purging corrects the problem more than 90 percent of the time. The current federal standards limit the amount of lead in water to 15 parts per billion (ppb), which is equivalent to 0.015 milligrams per liter (mg/l).

Another domestic water problem is excessive sodium. This condition is the result of using a water softener in the water supply. The softener replaces the calcium in the water with sodium. When the sodium concentration in the water is greater than 28 mg/l, people with high blood pressure and those with low-salt diets should be warned. When using a water softener, the sodium content is usually 100 mg/l or more. The problem can be corrected by having the pipe that supplies water to the kitchen sink bypass the water softener. All drinking and cooking water should then be taken only from the kitchen sink.

In addition to the possibility of high concentrations of lead and sodium, domestic water supplied by a private well can be contaminated by harmful bacteria resulting from faulty septic tanks, chemicals from a toxic spill that occurred years before, leaking underground storage tanks, or pesticides and fertilizers. The only way to tell whether the water is potable is to have it tested. The tests for pesticides and other chemicals are more complex and costly than the routine tests for bacteria or minerals. If you are concerned about pesticide and chemical contamination of your well, first contact your county officials and find out whether contamination problems have been reported in the area. As a precautionary measure, the water from a private well should be analyzed once a year for coliform bacteria to ensure that it is potable.

Lead

Lead poisoning is considered by many public-health officials the number-one environmental threat to children. It dwarfs radon and asbestos. High concentrations of lead in the body can cause permanent brain damage, even death. Low concentrations can result in reading disorders and hyperactivity and can affect a child's ability to perform in school. The government is estimating that one out of every nine children under the age of six has enough lead in his blood to place him at risk. The sad truth is that lead poisoning is entirely preventable.

Lead poisoning occurs in the home. It is not confined to children of low-income families living in the inner-city ghettos but has also been found in children of well-to-do families living in the suburbs. According to the EPA, about two-thirds of the homes built before 1940 and one-third to one-half of the homes built between 1940 and 1960 contain heavily leaded paint. A smaller percentage of homes built between 1960 and 1980 also had surfaces coated with lead-based paint. In 1978, the U.S. Consumer Product Safety Commission (CPSC) lowered the legal maximum lead content in most kinds of paint to trace amounts (0.06%), so houses built after 1978 should be relatively free of lead paint.

It has been known for years that children have been poisoned by eating chips of lead-based paint. However, it was only recently documented that they are also at risk of poisoning from exposure to lead dust in household air. Lead dust particles can become airborne when surfaces covered with lead-based paint are scraped, sanded, or heated

with an open flame during paint stripping. Lead dust can also be created by the rubbing and sliding of lead-base-painted window sashes as they open and close.

Lead dust can be inhaled when airborne. When the dust settles on the floor, windowsills, or furniture, it can be ingested by children through their normal hand-to-mouth behavior. Also, settled lead dust particles can become airborne as a result of household cleaning. The particles, which are very fine, can penetrate the filter system of home vacuums and are recirculated in the exhaust airstream. Cleaning of lead dust should be done by a professional who specializes in lead abatement.

The only way to tell whether the paint in a home contains lead is to have samples from different areas tested, such as windowsills, door trim, radiators, banisters, and walls where the paint may be peeling and flaking. Testing by a qualified laboratory is considerably more accurate than using a do-it-yourself kit. Many of these kits aren't very precise, since other metals can cause false-positive results. They are not sensitive to low levels of lead, so that a sample might test negative and still be considered hazardous. Also, the kits cannot tell *how much* lead is in the paint. According to the U.S. Department of Housing and Urban Development (HUD), action should be taken to reduce exposure to lead when the lead content in the paint exceeds 0.5 percent. Measures to reduce exposure to lead are particularly important when the paint is deteriorating or when infants, young children, or pregnant women are present.

If you are planning on buying a house that has lead-painted walls and trim, you have several options not unlike those for asbestos. If it is in good condition and there is little possibility that it will be eaten by children, then leave it undisturbed. If there are damaged or deteriorating sections of paint on the walls or ceilings, you can have those areas covered over with gypsum wallboard or some other building material.

You can also have the lead-based paint removed. This task, however, must be done by professionals trained in removing lead-based paint, since each of the paint-removal methods (sanding, scraping, chemical paint stripping, and heat guns) can produce lead dust or fumes. If not done properly, this option will create a greater health hazard than the original one. In some cases, complete removal and replacement of items such as windows, doors, and wall and door trim might be the best approach because of the cost or difficulty of removing the paint. This task should also be done by professionals, who will control, contain, and remove the lead dust.

If a surface that has been painted with a lead-based paint is intact, painting it with a nonleaded paint is considered a viable method of reducing the hazard associated with lead paint. However, painting the surface is not considered a permanent or long-term solution because the lead-based paint below the top coat might eventually loosen and create lead flakes and dust. Before undertaking any abatement procedures, you should have a qualified lead inspector do a *lead hazard risk analysis* and have him develop an abatement strategy that considers all the options.

Because awareness of the pervasive nature of the lead-dust problem is relatively recent, there is currently a lack of qualified lead inspectors and abatement contractors. However, a number of states are in the process of implementing certification, licensing, or training requirements for abatement contractors. Also, HUD has prepared and published guidelines for identification and abatement of lead-based paint hazards. To find a qualified lead inspector or abatement contractor, check with your state department of health or environmental agency. In those states that have not implemented certification procedures, you might still be

able to find qualified inspectors and contractors. Certified lead-abatement training courses are available in Massachusetts and Maryland. A number of companies, including asbestos-abatement contractors from other states, have taken these courses and listed their companies in the telephone yellow pages under the overall heading of "Lead Paint" with subheadings "Inspection" and "Abatement."

Formaldehyde

Although formaldehyde gas had been known for many years to be a powerful irritant that can contaminate the air in a house, it wasn't until the installation of urea formaldehyde foam insulation (UFFI) in houses that state and federal agencies began to focus their attention on it. Exposure to formaldehyde vapor can cause eye, nose, and throat irritation; coughing; skin rashes; headaches; dizziness; and nausea. It has been shown to cause cancer in laboratory animals.

After the oil embargo of 1973, many homeowners, realizing the need for energy conservation, had insulation or additional insulation installed in the exterior walls of their houses. It is estimated that about 500,000 homes were insulated with UFFI, most of which was done in the 1970s. With UFFI, the quality of formulation and installation determines the amount of formaldehyde released. The amount also increases under hot and humid conditions. By the end of 1980, the CPSC received more than 1,500 complaints of adverse health effects associated with the release of formaldehyde gas from UFFI. In 1982, the CPSC banned the use of UFFI in homes; however, in 1983, the ban was overturned by a U.S. court of appeals. By that time, most of the installation contractors were out of business.

At this time, the UFFI is not considered a major source of formaldehyde air contamination. Formaldehyde levels decline rapidly to below 0.1 parts per million (ppm) within the first year of the installation of UFFI. Although people vary in their susceptibility to formaldehyde, most healthy adults do not experience ill effects from exposure below 0.1 ppm. Also, since the UFFI was installed years ago, any vapors from the insulation would probably be negligible.

Notwithstanding the above, there might still be a high formaldehyde vapor concentration in the air. Formaldehyde is found widely in many household and construction products such as plywood, particle board, chipboard, plastic laminates, cosmetics, cleaners, paper products, drapes, carpets, and even tobacco smoke. Symptoms of exposure to formaldehyde generally resemble those associated with a cold or allergies; however, the symptoms usually cease once exposure is discontinued. If you are concerned about excessive formaldehyde concentration in the house, have the air analyzed by a private qualified testing laboratory.

Leaky oil tanks

Out of sight, out of mind. That's exactly how homeowners with oil-fired heating systems think about the buried tank that holds the heating oil. They could be in for a rude awakening. Most homeowners do not know that they are responsible if their oil tank leaks. If a tank leaks and contaminates the surrounding soil, the cost for the cleanup, which includes excavating around the tank, scooping up the oil-saturated soil, and carting it away by a licensed carter, must be paid by the homeowner. This effort can cost thousands of dollars. If the oil leak contaminates an aquifer or a stream, the cost for cleanup can run into tens of thousands.

Most of the buried tanks used to store home heating oil are steel and have a projected life of about twenty years, although the actual

life depends on the extent to which water has been accumulating within the tank and on soil conditions. If the oil tank for the house that you want to purchase is that age or older, you have three options. You can ask the seller to provide you with a certification on the integrity of the tank; you can have the tank tested for leaks at your expense; or as a preventive measure you can replace the tank—the most expensive option.

Some homes have buried oil tanks that are no longer in use because their heating system has been converted from oil to gas. If this is the case, ask the seller if the tank has been properly put out of service. If it hasn't, it should be; otherwise, safety and environmental problems can develop. In many communities, properly putting a tank out of service is a legal requirement. An abandoned tank that has not been properly prepared will eventually deteriorate because of corrosion resulting in leakage, collapse, or both. Leakage, of course, contaminates the soil.

To put a tank out of service properly, the residual oil or sludge at the bottom of the tank must be pumped out and disposed of, using a licensed carter. The tank should then be removed entirely or filled with an approved filler such as sand. If the soil below the tank is contaminated, it must be removed. The exact abandonment procedure may vary depending on the municipality. Check with your local department of environmental conservation or health department for the approved method.

Electromagnetic fields

More and more attention by the news media is currently being devoted to electromagnetic fields. Whenever electricity is present, there are both electric fields and magnetic fields. These fields, when taken together, are referred to as electromagnetic fields, or EMF. They exist around electrical transmission lines, transformers on poles, house wiring, appliances, electronic equipment, and so on. An epidemiological study published in 1979 concluded that children living in Denver near certain power lines that were exposed to electromagnetic fields with a magnetic field strength of 2–3 milligauss (mG) were twice as likely to develop leukemia than children living in houses without such exposure. The conclusions of the above study were not universally accepted by the scientific community; some researchers felt that the study was flawed and not scientifically sound. In the early 1980s, the scientific community began looking extensively into whether exposure to electromagnetic fields is dangerous to a person's health. The complexity of the problem is compounded by the fact that the results vary according to the characteristics of the electromagnetic field, such as frequency, intensity, field orientation, period of exposure, and whether the field is continuous or pulsed.

The studies to date have not resulted in definite conclusions. They have shown that there is a statistical association between electromagnetic fields and cancer. However, they have not shown that the fields are involved in causing cancer. Based on all available information, many scientists have concluded that more research is needed before they can understand how EMF interacts with the human body to cause health effects and whether there is indeed a risk from exposure to EMF. Also, since not enough is known about which elements of the exposure are important to health, a safe exposure level has not been established. Both electric fields and magnetic fields are being studied. However, more attention is being focused on magnetic fields because they can penetrate through common objects as thick as concrete walls without losing their strength whereas electric fields can be shielded by materials like wood, aluminum, or insulation around the wires.

How does all of the above affect a person contemplating purchasing a home near power lines or an electrical substation? You can have measurements taken to determine the magnetic-field intensity in and around the house to see if the readings are within typical background levels. A few home inspectors provide this service. Unfortunately, as of this writing, no government regulation or scientific recommendation helps answer the question. Until the research is complete, it is premature to recommend any course of action. Nevertheless, prudent avoidance should be considered, because until the cloud of uncertainty is removed, this problem can affect the resale value of these homes.

Mold

Mold growth in a house is the latest environmental concern. *Mold* is the common name for simple plants or fungi, usually microscopic in size, which are naturally occurring and produce spores that can be found everywhere indoors and outdoors. It has been estimated that there are at least 40,000 known species of fungi. Molds thrive on materials such as cotton, wool, paper, leather, and wood. As a result mold, which will grow anywhere indoors where there is moisture, is quite a common occurrence in buildings. The moisture may be in the host material, on its surface, or in the form of humidity in the air. Although there have been known health problems associated with mold, the one problem that brought it to the attention of the media and therefore the public is a house in Austin, Texas. Because of a series of water leaks in the house, a toxic buildup of mold developed.

It is not unusual for a water leak in a house to cause the mold buildup. However, in this case the mold was the toxic species *Stachybotrys chartarum* (atra), which is black in color and produces airborne toxins. The spores of other molds can appear as black, brown, blue, orange, or white specks although they are not always visible to the naked eye. Because of the airborne toxins, the family living in the house suffered a number of very serious health problems, and the house was deemed uninhabitable.

In order not to overreact to finding a mold buildup in the house, it's important to separate the hype from reality. Fortunately, extensive *Stachybotrys* mold is relatively rare, and the molds usually found in homes are the less toxic species. Exposure to mold spores in a house does not always present a health problem. The testing for mold during a home inspection is not considered necessary even though there are a number of companies selling kits that test for mold. According to the U.S. Center for Disease Control, "It is not necessary to determine what type of mold you may have. All molds should be treated the same with respect to potential health risks and removal."

If there is a mold condition in the house that you are inspecting and you are allergic or otherwise sensitive to mold, you will usually know it because you may experience symptoms such as nasal stuffiness, eye irritation, or wheezing. During your inspection of the interior, check all the rooms, especially a basement, for indications of a possible mold buildup. In this effort your eyes and nose are the best tools. Large mold infestations can usually be seen or smelled. If you see a moldy buildup on a wall or ceiling, record the location on your worksheets for either cleanup or replacement. In most cases you can easily remove the mold by a thorough cleaning with bleach and water. *(Never combine bleach and ammonia because the mixture produces a toxic gas.)* However, if there is an extensive amount of mold, you may want to engage the services of a professional with experience in cleaning mold in homes. Eliminating the mold problem may include

discarding moldy items and replacing sections of walls and/or ceilings.

Mold odors can be masked intentionally or unintentionally by a seller. If the house that you are inspecting has an odor because of incense burning, cinnamon water boiling on the stove, or some other pleasant odor, ask the seller if you can return for an additional inspection when there are no extraneous odors.

If you detect a moldy odor in a room, look for water stains, even those stains that are dry to the touch. It is possible that there is mold buildup on the backside of the drywall or paneling. In this case further investigation is required. However, this type of investigation is beyond the scope of a home inspection and should be performed by a company or consultant that specializes in "sick houses." Also, in those carpeted rooms that are vulnerable to occasional or more frequent flooding such as a bathroom or finished basement, if there is a moldy odor, the carpet should be suspect as the source of the mold buildup. If there is mold, the typical solution is to replace the carpet. The hidden dust in fibers and the underside of a wetted carpet are ideal locations for mold growth. In addition to the carpet, it is also possible that there is mold buildup behind the walls.

Since basements are below ground and are therefore vulnerable to water penetration, pay particular attention for any signs of past water problems because mold growth is almost always due to excessive moisture. A moldy odor in the basement during the warmer months is not uncommon and is the result of condensation because of high relative humidity.

The condition can be easily corrected with a dehumidifier. If the dehumidifier doesn't correct the problem, further investigation will be necessary.

21

Green home technology

Roof 307
Roof-mounted structures 307
Paved areas around the structure 307
Exterior walls—siding (cladding) 308
Deck 308
Windows 308
Structural framing 309
Heating, ventilation, and air-conditioning (HVAC) 309
Water heating 310

In the residential real estate market, a "green" home is the latest buzz word. But what does green really mean? There is no single fixed definition. It is interpreted in many different ways. A green home encompasses a myriad of factors such as

- Its impact on the environment
- The site the house is located on
- The actual building design
- The material used for construction
- The use of nontoxic and renewable material for decorating
- The efficient use of energy, which includes heating and air conditioning equipment, appliances, and lighting
- The efficient use of water and its associated fixtures
- The quality of the indoor air
- Whether the project has a global impact

In order for a house to be certified as a green home, it must satisfy certain criteria. There are several shades of "green" depending on the extent to which the criteria have been satisfied. There are a number of organizations that provide guidelines for a green building certification program. However, the two main organizations that certify homes are the U.S. Green Building Council, which issues the Leadership in Energy and Environmental Design (LEED) for Homes certification, and the National Association of Home Builders (NAHB), which issues the National Green Building certification. In 2008, the American National Standards Institute (ANSI) approved the National Green Building Standard, which is used as part of the NAHB National Green Building program.

Each of the above items is subdivided into great detail, and each subitem is assigned a number of points. Based on the total number of points received, houses are certified at one of four levels of green. The green certification levels and the number of points required to achieve that level vary depending on the group that is doing the certifying. The LEED certification

levels are Certified (45–59 points), Silver (60–74 points), Gold (75–89 points), and Platinum (90–136 points). The NAHB certification levels are Bronze (237 points), Silver (311 points), and Gold (395 points).

The following checklist is from the U.S. Green Building Council's *The Green Home Guide*. It lists those items in general terms that a person should look for and be aware of when looking for a green home.

- *Location*. New green homes and neighborhoods must not be built on environmentally sensitive sites like prime farmland, wetlands, and endangered species habitats. The greenest development sites are "in-fill" properties like former parking lots, rail yards, shopping malls, and factories. Look for compact development where the average housing density is at least six units per acre. The home should also be within easy walking distance of public transportation—like bus lines, light rail, and subway systems—so that you can leave your car at home. A green home should also be within walking distance of parks, schools, and stores.
- *Size.* No matter how many green building elements go into the home, a 5,000-square-foot green home still consumes many more natural resources than a 2,000-square-foot green home. The larger home will also require more heating, air conditioning, and lighting. If you really want a sustainable home, choose a smaller size.
- *Building design.* The home should be oriented on its site to bring abundant natural daylight into the interior to reduce lighting requirements and to take advantage of any prevailing breezes. Windows, clerestories, skylights, light monitors, light shelves, and other strategies should be used to bring daylight to the interior of the house. The exterior should have shading devices (sunshades, canopies, green screens, and—best of all—trees), particularly on the southern and western facades and over windows and doors, to block the hot summer sun. Dual-glaze windows reduce heat gain in summer and heat loss during cold winter months. The roof should be a light-colored, heat-reflecting Energy Star® roof, or a green (landscaped) roof, to reduce heat absorption.
- *Green building materials*. A green home will have been constructed or renovated with healthy, nontoxic building materials and furnishings, like low and zero volatile organic compound (VOC) paints and sealants and nontoxic materials like strawboard for the subflooring. Wood-based features should come from rapidly renewable sources like bamboo, but if tropical hardwoods are used, they must be certified by the Forest Stewardship Council. A green home uses salvaged materials like kitchen tiles and materials with significant recycled content.
- *Insulation*. A nontoxic insulation, derived from materials like soybean or cotton, with a high R (heat resistance) factor in a home's walls and roof will help prevent cool air leakage in the summer and warm air leakage in the winter.
- *Windows and doors.* Windows and exterior doors should have Energy Star ratings and they should seal their openings tightly to avoid heat gain in summer and heat loss in winter.
- *Energy efficiency.* A green home has energy-efficient lighting, heating,

cooling, and water-heating systems. Appliances should have Energy Star ratings.

- *Renewable energy.* The home should generate some of its own energy with technologies like photovoltaic (PV) systems.
- *Water efficiency.* A green home has a water-conserving irrigation system and water-efficient kitchen and bathroom fixtures. Look for a rainwater collection and storage system, particularly in drier regions where water is increasingly scarce and expensive.
- *Indoor environmental quality.* Natural daylight should reach at least 75 percent of the home's interior. Natural ventilation (via building orientation, operable windows, fans, wind chimneys, and other strategies) should bring plentiful fresh air inside the house. The heating, ventilation, and air conditioning (HVAC) system should filter all incoming air and vent stale air outside. The garage should not have any air handling equipment or return ducts, and it should have an exhaust fan.
- *Landscaping*. Vine-covered green screens, large canopy trees, and other landscaping should shade exterior walls, the driveway, patios, and other paved areas to minimize heat islands. Yards should be landscaped with drought-tolerant plants rather than water-guzzling plants and grass in most regions.

Along with green certification, homes are often rated by Energy Star, the government-backed symbol for superior energy efficiency. Products that can earn the Energy Star include windows, heating and cooling equipment, lighting, and appliances. Energy Star is a joint program of the U.S. Environmental Protection Agency (EPA) and the U.S. Department of Energy. To earn the Energy Star, a home must meet guidelines for energy efficiency set by the U.S. EPA. These homes are at least 15 percent more energy efficient than homes built to the 2004 International Residential Code (IRC), and include additional energy-saving features that typically make them 20 to 30 percent more efficient than standard homes.

Typical features to look for in Energy Star–qualified homes include

- An efficient home envelope, with effective levels of wall, floor, and attic insulation properly installed, comprehensive air barrier details, and high-performance windows
- Efficient air distribution, where ducts are effectively insulated
- Efficient equipment for heating, cooling, and water heating
- Efficient lighting, including fixtures that earn the Energy Star
- Efficient appliances, including Energy Star–qualified dishwashers, refrigerators, and clothes washers

In addition to the above, a green home is one that is environmentally sustainable. That is, the material used for the construction and the utilization of energy during the building's lifecycle will not compromise the health of the occupants or the ability of future generations to meet their own needs. Although a green home may be the ideal, in all probability you are more likely to find a home that is partially green than one that is certified green.

Every year there are millions of homes where one or more of the home's major components is being replaced or upgraded, or a new room addition to the house is being planned or constructed. To a large extent the degree to which these items will conform

to green principles will depend on the homeowner's budget and finances.

During the construction phase of an addition, and in upgrading various home components, there are usually a number of different techniques, devices, materials, and equipment that can be used to comply with green principles. Discussing all of them is beyond the scope of this chapter. However, presented here is a sampling of some of the items that are used to green-up an existing house that you are likely to encounter when house hunting.

Roof

Asphalt shingles are the most common type of roof covering. Typically their lifespan has been between 15 to 25 years. When replacing a roof there are a number of "green" options. There are synthetic slate look-alikes that are now on the market. These products have the durability, texture, and appearance of natural slate and are lighter in weight. The materials used for synthetic slates are quite varied. One product is made from recycled steel reinforced rubber automobile tire treads. Others are made from recycled postindustrial rubber and plastic waste. There is also a synthetic slate made from ground natural slate, resin, and fiberglass, bonded under high pressure. Although synthetic slates are too new to comment on their life span, manufacturers estimate it at 40 to 60 years or more.

Metal shingles are becoming more popular for residential roofing. They are available in several different shapes and are primarily made from painted or coated aluminum or steel panels although they are also made from copper. The panels are formed to resemble wood shakes, slate or Spanish, Roman, and Mediterranean tile. The shingles are durable, lightweight, and fire-resistant. Some have embedded stone chips for additional texture. In addition to shingles, flat sheet metal roofing has also been gaining in popularity for residential pitched roofs.

Also, shake-like shingles have been made from 100 percent recycled vinyl and cellulose fibers, and reclaimed wood can be reformed into shakes, or wooden shingles. Photovoltaic (PV) roof shingles are also used. They are most effective when the roof slope faces a southern or southwestern exposure. These shingles convert sunlight into electricity.

Roof-mounted structures

Some homes have thermostatically controlled roof-mounted attic fans, which are wired to the household electrical system (see discussion on attic fans in chapter 9). These units are being replaced with PV solar-powered attic fans, which can be mounted on a roof pitch of 3/12 to 12/12. The PV panel on the unit can be adjusted from laying flat to a 45 degree angle. This unit qualifies for federal tax credits in the Solar Energy Systems category under Photovoltaic Systems as defined in the Energy Improvement and Extension Act of 2008.

Gutters and downspouts can be an important part in water conservation. A simple rainwater collection system can be made by connecting the base of the downspout to a barrel. The water in the barrel can then be used to water plants and shrubs, thereby saving the equivalent amount of potable water.

Paved areas around the structure

The driveways, walkways, and the patios in many homes have a surface area that is impervious to water. As a result, rain washing over those areas picks up contaminants, pollutants, and oils that dripped from the underside of the family auto and carry them to the storm drain where they flow to the local water supply. Some homes have minimized

this problem with the use of permeable paving. With permeable paving, water drains naturally through the voids into the ground, where it helps to recharge the groundwater. For the most part, porous paving materials appear nearly indistinguishable from nonporous materials. Permeable paving can be made from asphalt, paving stones, bricks, or concrete. Even though the pavement may appear to be the same as traditional pavement, it is manufactured without the "fine" materials used in traditional pavement, and instead incorporates void spaces that allow for drainage.

Exterior walls—siding (cladding)

For hundreds of years wood, in the form of cedar shingles, shakes, and clapboard, had been the popular choice for siding a house. It was readily available, reasonably priced, and attractive. However, old growth forests have been depleted or are being depleted at a rapid rate, and as a result wood siding is no longer as readily available. Wood siding is still being used on houses, however; for a green house, the wood should be certified by the Forest Stewardship Council (FSC). This indicates that the siding came from a forest that was managed and harvested with sustainable methods. In fact, in addition to siding, all the lumber used for framing a green house should be FSC-certified.

Fiber-cement siding is a popular cladding for green homes. It is made from a mixture of cement, sand, cellulose fibers, and other components. The siding is popular because unlike wood siding it is fire-resistant and will not burn. It will not rot, warp, or delaminate, and is resistant to termites. It is also warranted to last 50 years. Fiber-cement siding can be textured to look like wood lap siding, shingles, and vertical siding.

Vinyl siding, which is commonly used throughout the country because of its low cost and low maintenance, does not have the blessings of many in the green building industry. Because of environmental concerns in the processing, manufacturing, and disposal of vinyl siding, there is controversy concerning its use. Dioxin, an environmental toxin, is a by-product of the manufacturing process. Also, in the event of a fire, when vinyl siding burns, it can release toxic fumes into the atmosphere.

Deck

In the past most residential decks were constructed entirely of wood, and to a large extent many still are. Wood is a renewable resource and can easily be recycled. In addition to using domestic wood for decking, exotic South American hardwoods such as Ipe, Cambara, and Meranti, normally used for furniture, are now also being used for decking. The hardwoods are beautiful, durable, and rot- and insect-resistant. Bamboo is also being used for decking. Of course, all wood decking should be FSC-certified.

In the last 20 years, composite decking has been displacing wood as the decking material of choice. Its popularity stems from the fact that it does not require waterproofing and resists damage from weather and insects, and is splinter-free. They are available in different colors and textures, which give the appearance of wood. The composites are generally made of recycled plastics such as shopping bags and wastewood fibers from reclaimed wood and sawdust. They are not intended for structural use. The structural support for those decks that use composite lumber, the joists, beams, and posts, will still be made of wood.

Windows

A big percentage of the heat loss in a house occurs at the windows. Most of the homes built before 1985 were erected with single glazed

window panes. No doubt many windows have already been replaced, with many more due for replacement. A minimum replacement window for a green home is one that is wood framed and double glazed. A better window is one where the void between the panes is filled with an inert gas such as argon or krypton, which are better insulators than air. The best window is one where the glazing has a low-emissivity (low-e) coating. Depending on the climate that the house is located in, the low-e coating can be used to reflect the heat back into the house during the winter and reflect the sun's rays away during the summer.

Vinyl frame windows have also been used in green homes. The downside, however, is that vinyl manufacturing and incineration create dioxin, a highly carcinogenic chemical. Fiberglass frames are also energy-efficient but are more expensive than vinyl. Regardless of which windows are used they should have the Energy Star label indicating that they are high-performance windows.

Structural framing

Most existing homes were built with traditional 2 × 4″, 16″ on-center framing. With green homes the recommended framing is 2 × 6″, 24″ on-center. This will not only save wood, but the additional depth of the wall allows for increased insulation, which in turn reduces heat loss and saves on fuel. Instead of stick-built exterior walls, some green homes have walls built with structural insulated panels (SIPs). These panels consist of a foam core of expanded polystyrene (EPS) sandwiched between two layers of oriented strand board (OSB). Typically, panels are 4 to 24 feet wide, 8 or 9 feet high, and made in thicknesses of 4½ or 6½ inches. SIPs are 35 percent more energy-efficient than stick frame walls and are approximately 50 percent stronger than standard construction.

Framing of the interior portion of the house can be done with conventional lumber; however, engineered lumber has replaced solid-sawn lumber as the framing and structural support members of choice by builders in many newer homes and in homes that are currently being built. The decision is based on the fact that engineered lumber can be ordered to specific dimensions so that there is less wasted wood. Also, the lumber can be made from small-diameter, fast-growing trees that are grown in tree farms. The advantage of engineered lumber is that it is stronger, stiffer, and more dimensionally stable than solid-sawn dimensional lumber. Although the lumber is initially more expensive, the total installed costs are less than that of conventional lumber. The following products fall in the category of engineered lumber: Glued laminated beams (glulam), laminated veneer lumber (LVL), I-joists, and open web truss-joists. Glulam and wood I-joists can carry greater loads over longer spans than is possible with solid-sawn lumber of the same size. Because of their "I" cross-sectional shape, wood I-joists weigh up to 60 percent less than lumber joists, making them easier to handle. They generally do not shrink, warp, cup, crown, or twist. As with all green homes, the wood used for framing should have the Forest Stewardship Council certification.

Heating, ventilation, and air-conditioning (HVAC)

The heating and cooling equipment in a house provides a comfortable environment, but it is also a major consumer of energy. In homes that have been "greened up," the heating unit (furnace or boiler) is often replaced with a unit that has the Energy Star label. That is, the conventional heating unit, which had an operating efficiency of about 60 to 65 percent,

has been replaced with a condensing boiler or furnace with an operating efficiency of about 90 percent. The increase in efficiency results from a redesign of the heat exchanger, which extracts the heat from the exhaust gases that normally flow up the chimney. During this process, the temperature of the exhaust gases drops to a point where the water vapor in the exhaust gases condenses, thereby releasing additional heat. With the conventional furnace, the temperature of the flue gases is about 450–550° F. With the high-efficiency units, it's about 120–130° F.

An HVAC system that you are more likely to find in new construction than in existing homes is a geothermal heating and cooling system. This system is basically a modified heat pump system. It is often referred to as a *ground source heat pump*. Unlike an air source heat pump where the compressor/condenser is located on the outside of the house, the geothermal heat pump is generally located in the basement or utility room. It is packaged in a single cabinet that includes the compressor, refrigerant heat exchanger, and various controls. The system uses the earth as a heat source in the winter, and heat sink in the summer. It takes advantage of the earth's relatively constant temperature, at depths below the frost line, of 40° to 55° F year round. The system circulates a water/antifreeze solution through a loop of high-density polyethylene pipe that is buried in the ground. There are two basic types of loops used with this system: closed and open. The simplest, but less common, open loop system circulates a constant source of ground water through the heat pump's heat exchanger, and discharges it back to the same aquifer. However, the supply and return lines must be placed far enough apart to ensure thermal recharge of the source. The open loop can also work with a stream, well, or pond, although in some areas this creates environmental concerns.

In a closed loop system, depending on the ground conditions and available space, the polyethylene pipe can be laid out vertically in holes 75 to 500 feet deep or horizontally in trenches dug below the frost line. Where there is a pond or stream that is deep enough and with enough flow, closed loop coils can be placed on the bottom of the pond or stream. Depending on which cycle the system is operating under (heating or cooling), the water/antifreeze solution circulating through the heat exchanger in the heat pump cabinet adds or extracts heat. It has been estimated that a homeowner may save anywhere from 20 to 60 percent annually on utilities by switching from an ordinary system to a ground source system.

Water heating

Many geothermal systems installed today are equipped with desuperheaters, which provide domestic hot water when the system is providing heat or air conditioning. A desuperheater is a small auxiliary heat-recovery system at the compressor outlet that uses superheated gases from the heat pump's compressor to heat water, which then circulates through a pipe to the home's water heater tank. In the summer, when the air conditioning runs frequently, a desuperheater can provide all the hot water needed by a household virtually for free. However, it provides less hot water during the winter months, and none during the spring and fall months if the system is not operating. The home's conventional water heater is then used to meet household hot water needs in winter if the desuperheater isn't producing enough hot water and in spring and fall when the geothermal heating and cooling system may not be operating at all.

As discussed above, there is no single fixed definition of a green home. It is interpreted

in many different ways. It encompasses environmentally sustainable construction, which is the responsible use of natural resources, and how it affects the quality of life for both present and future generations. It's more than energy conservation; it includes the impact on the environment, the site the house is located on, the material used for construction, the use of nontoxic and renewable material for decorating, the efficient use of water and its associated fixtures, the quality of the indoor air, and whether the project has a global impact. At the present time, from a home inspection point of view, you are more likely to find an existing home that has been "greened up" than a home that has been certified as a green home.

22

Conclusion

Professional home inspection 312
Home inspection limitations 312
Real estate warranty program 313
Private home inspection warranty programs 314
Manufacturers' warranties 314
Contract 314

For most families, the purchase of a home is an emotionally charged event filled with anxiety, hopeful dreams, and sometimes disappointments after moving in. The disappointment, however, can be avoided or at least minimized if you know the true condition of the house that you are buying. Prior to purchasing the house, you or a professional should perform a home inspection.

Professional home inspection

The purpose of this book is to provide sufficient background material and an overall procedure, so that you can perform a technical inspection of the house you are considering buying or the one you are currently living in. As previously pointed out, at times the services of a professional home inspector are necessary. A professional inspector, however, will not inspect in as detailed a fashion as suggested in this book. He or she will normally not operate every window; check every light switch; check the temperature of every radiator; indicate every cracked wall, floor, or ceiling (unless the crack represents a structural problem); check the caulking at every joint; and so on.

The main concerns of an inspector are the major problems or deficiencies, ones that will be costly to correct and ones that pose a health, safety, or fire hazard. Because of the inspector's training and experience, he or she is better able than a layperson to pick up problems through a more cursory inspection and relate problem conditions in one area to difficulties in another.

When selecting a professional home inspector, choose one whose sole endeavor is inspection. It is advisable not to use an inspector who is affiliated with an exterminating company, a real estate broker, or a contractor (plumber, electrician, roofer, and so on). The inspector must be completely unbiased and must not have a vested interest in finding problem conditions. Licensed professional engineers who specialize in home inspections have an advantage (because of their training) in that they can evaluate certain problems in depth.

Home inspection limitations

A home inspection is not perfect and will not necessarily reveal every problem, but it is the best thing available. A home inspection

is basically a visual inspection as well as an operational check of the various visible elements and components of the house. If performed in the manner suggested herein, you should have a fairly good picture of the condition of the house at the time of the inspection. By taking into account the age and present condition of various items, predictions can usually be made about future problems.

However, a home inspection cannot reveal a deficiency or problem if the conditions causing it are not visible. The following are just a few examples of such possible situations:

- A house with a concrete block foundation may have termite infestation in the voids of the foundation walls. This condition would not be visible during an inspection. Nevertheless, a week later there may be visible termite shelter tubes or a swarm.
- A basement or crawl space can be "bone dry" for the first three years and then flood in the fourth year because of a new building development nearby.
- The operation of a septic system depends on the condition (porosity and degree of saturation) of the subsoil in the leaching field, an item that is not readily apparent during an inspection. Depending on the weather, the level of the water table, and the usage prior to the inspection, it is possible for a malfunctioning septic system to appear to operate properly during the time it takes to perform an inspection.
- If there is an inadequately insulated water pipe in an exterior wall, it can freeze and burst during a severe cold spell. Since the pipe would not be visible during an inspection, the condition would not be detected.

Even with such limitations, a proper home inspection will reveal considerable information about the house that very often even the owner does not know.

Real estate warranty program

Many homes throughout the United States are being sold with a warranty protection plan for the buyer. The warranty usually covers the following components:

- Electrical system
- Heating system
- Water heater
- Plumbing system
- Central air-conditioning system
- Built-in appliances

It is in effect for the first year that the buyer owns the house. The warranties are usually made available to the buyer through the real estate broker. Not all brokers, however, are affiliated with companies that offer home warranties.

The home warranties that are currently available when you buy a house are very limited in scope and should not be considered a replacement for a home inspection. The warranty is basically an insurance plan that will protect the new homeowner against defects or malfunctions in the covered components, and nothing more. When you are planning on buying a house, many questions about the house should be answered so that you can make an intelligent decision. These questions concern items that are not covered by the warranty, and their answers can have a significant impact on the true cost of buying the house. Remember, the true cost of a house is the purchase price plus the costs for upgrading substandard, deteriorated, or malfunctioning components.

For example, the electrical system is covered against defects under the warranty. The fact that the electrical service in the house might be totally inadequate (110 volts at

30 amps) and would have to be upgraded at a considerable expense is not covered by the warranty. Also not covered by the warranty but costly to correct are basements that are subjected to periodic water penetration, structural damage to the foundation and wood framing, termite infestation and deterioration, roof replacement, and improvements needed for energy conservation. In addition, items of concern are general and latent defects such as an inadequately ventilated attic. A home warranty is definitely of value as long as you realize that it is not the answer to all of your questions or potential problems.

Private home inspection warranty programs

For an additional fee, some private home inspection companies offer a warranty protection plan after they inspect the house. The warranty applies for a twelve-month period and is usually effective from the day of the inspection or the transfer of title. The warranty plan is basically an insurance program. In fact, in some states, inspection companies have been forced to drop their warranty programs because they were not licensed by the state insurance commission to sell insurance.

As with all types of insurance, you should know exactly what you are buying before you put your money down. The warranty plan protects the buyer against defects in most of the major housing components, providing that the components are in reasonably good condition to begin with. If during the inspection any covered component is judged to be in less than satisfactory condition, it is excluded from coverage, although this is not reflected in the warranty fee. Also, for an item such as the roof, there is usually a prorated repair schedule that is a function of age. For example, in one plan if the roof is nine years old (which is not considered old or even aging), only 30 percent of the repair or replacement costs are covered. If the deductible (which might be $250 or $500) is subtracted, there might not be any coverage.

The warranty agreement should be read very carefully. In addition to items excluded because of condition or age, many components that are costly to correct are often not included in the plan. As with real estate warranty plans, these warranties can also be of value as long as you know exactly what you are buying and understand the limitations.

Manufacturers' warranties

Many of the components and items in a house have the manufacturer's guarantee or warranty against defects for a specific number of years. Items that are usually covered are the furnace, water heater, roof shingles, well pump, air-conditioning compressor, and electrical appliances. If you are purchasing a relatively new house or are in an older house any of the above components are relatively new (because of replacement), you should obtain the warranties or bills of sale. Many warranties are transferable to a new owner. Also, if the house has been termite-proofed, do not forget to get a copy of the guarantee if it is still in effect.

Contract

Many lawyers indicate that the best time to inspect a house you are considering buying is *before* signing the contract. This avoids the problems that can develop if the contract has already been signed and the subsequent inspection reveals major deficiencies in the house. Often the buyer wants a price adjustment or wants to back out of the deal. By inspecting the house before signing the contract, the correction of problems and deficiencies can be written into the contract.

In a seller's market, however, the buyer might feel pressured into signing the contract prior to the inspection in fear of having the house sold to another buyer before the inspection has been performed.

If you do sign a contract before the house has been inspected, for your protection, the contract should include an "inspection contingency" clause.

It is important that the clause be broad enough to include all the major problems that can occur in a house. Otherwise, there might be legal problems in backing out of the deal because of a major defect that was not covered in the contract. For example, many years ago I received a telephone call from a buyer for whom I had done a home inspection. The buyer indicated that his contract had an inspection clause that provided him with the option of declaring the contract null and void if there were *structural* deficiencies. That was basically the extent of the clause; it was very limited. My inspection had revealed that the electrical service was inadequate, that the heating system had to be replaced, and that there was evidence of water penetration into the basement. After the inspection, the buyer decided that he no longer wanted to buy the house. He called to find out if the problem items were considered structural deficiencies. No, they were not, and unfortunately, because of the wording in the contract, the buyer lost part of his deposit.

One contingency clause that has been used states that the sales agreement is contingent upon having a home inspection within *n* days of the signing. The inspection is defined to include a physical check of the exterior and interior components of the house (including the structural integrity of the building) and the condition of the electrical and mechanical equipment. If the inspection reveals any defects for which the cost exceeds $*n*, the buyer should have the following options: have defects corrected by the seller; negotiate the cost of the corrections with the seller; or declare the sales agreement null and void. The limitation of this clause is in defining the means by which the costs for correcting the defects are determined.

To avoid this type of problem, one attorney I know uses the following clause:

> *This contract is contingent upon the Purchaser's making, or having made on his behalf by another, a physical inspection of the entire premises. If such inspection reveals any condition or state of facts unsatisfactory to the Purchaser, in his sole discretion, the Purchaser shall receive back all monies paid hereunder. Upon receipt of said monies, this agreement shall be null and void, and neither party under any obligation whatsoever to the other.*

This clause might not be valid in your state. To avoid any legal entanglement, your best bet is to consult an attorney.

As mentioned in chapter 1, just before the contract closing you should perform a final "walk-through" inspection of the house. Although most sellers will not deny you the right to make this inspection, it is not ensured. Consequently, the right to a final walk-through inspection should be made part of the contract.

No two houses are alike. Just as a person changes with age, so does a house. Regardless of whether you are a home buyer or a homeowner, it is important to know the true condition of the house. With this book, you are now prepared to find out. Try doing the inspection yourself. It's really a lot of fun. Worksheets are provided on which you can record your observations. Good luck!

Appendix

Home inspector requirements

In a little over 30 years, home inspection as a service to home buyers has morphed from a part-time activity, by a number of individuals working in and around large metropolitan areas, into a mature profession that has been accepted and recommended by government agencies. When I started my home inspection company in 1971 there were no specific requirements covering the items in a house to be inspected, and there were no specific qualifications to be an inspector. At that time anyone could hang out a shingle claiming to be a home inspector. Things started to change when we formed the American Society of Home Inspectors (ASHI). In January 1976 a small group of independent inspectors met and discussed the need to form a nonprofit professional organization. We recognized that in order for inspectors to be accepted by the public as professionals, it would be necessary to establish an organization that has a set of standards regarding those items to be inspected, a code of ethics, and membership requirements.

Today, ASHI is the largest national professional organization of home inspectors with 88 local ASHI chapters servicing thousands of members throughout the United States and Canada. ASHI's Standards of Practice, Code of Ethics, and membership requirements are included at the end of this appendix. As the profession of home inspection matured, additional national organizations were formed to promote excellence and professionalism by also providing a set of standards and a code of ethics and providing educational opportunities such as technical seminars, continuing education courses, and monthly meetings at which there are relevant speakers and where members can exchange ideas and network.

National home inspection organizations and their date of establishment are

- American Society of Home Inspectors (ASHI)—1976
- National Association of Home Inspectors (NAHI)—1987
- National Association of Building Inspection Engineers (NABIE)—1989
- Housing Inspection Foundation (HIF)—1989
- National Association of Certified Home Inspectors (NACHI)—1990
- Canadian Association of Home & Property Inspectors (CAHPI)—1994
- National Society of Home Inspectors (NSHI)—2003

In addition to the national home inspection organizations above, there is also a number of independent state home inspection associations as listed below:

- California Real Estate Inspection Association (CREIA)—1976
- Texas Association of Real Estate Inspectors (TAREI)—1977
- Minnesota Society of Home Inspectors (MSHI)—1979

- Georgia Association of Home Inspectors (GAHI)—1989
- Connecticut Association of Home Inspectors (CAHI)—1992
- Kentucky Real Estate Inspection Association, Inc. (KREIA)—1992
- Arkansas Association of Real Estate Inspectors (AAREI)—1993
- Wisconsin Association of Home Inspectors, Incorporated (WAHI)—1995
- North Carolina Licensed Home Inspector Association (NCLHIA)—1997
- Southern Nevada Association of Professional Property Inspectors (SNAPPI)—1998

As of this writing, 32 states have enacted legislation that requires individuals performing home inspections to become licensed. This further ensures professionalism and provides consumer protection by preventing anyone who is not licensed by the state from holding oneself out as a home inspector, or from performing a home inspection. Although licensing requirements vary from state to state, most require the candidate to take the National Home Inspection Examination or equivalent, as a means of assessing their competence. Some states also require the candidate to successfully complete an exam of ASHI standards and ethics. The national examination is administered by Pearson VUE at more than 215 proctored test center locations throughout the United States, Canada, and Puerto Rico. In addition to the exam, depending on the state, there are requirements that the candidate must successfully complete 60 to 180 hours of classroom instruction, approved by the state, with some states also requiring 40 hours of field-based instruction; moreover, the candidate must have both liability insurance and errors and omission insurance, and must have completed 100 to 200 fee-paid inspections under the supervision of a licensed home inspector.

Included in this appendix is a 128-question quiz along with the answers. The quiz is based on the inspection information that is presented in this book. It is not intended as a study guide for the National Home Inspection Examination. However, it is a good check on your understanding of some of the basics of home inspection. If you are interested in taking the national exam, the national organizations or their local chapters can provide you with information on schools that provide training for the exam.

Once the candidate is approved for licensing, he or she must abide by the rules and regulations set out by the legislation. An example of an item that is included in the legislation of one state is the preinspection agreement. There is a requirement that the home inspector must send a preinspection agreement to the client no later than one business day after the appointment for the home inspection is made. The agreement must contain, among other things, the fee and a description of the systems and components that will be inspected, as well as those items that are not part of the home inspection. The preinspection agreement is also required to contain a description of any and all services not part of the home inspection for which the client is charged an additional fee. The agreement must be executed prior to the start of the home inspection.

In some states, these two areas of concern are not part of a home inspection and require the inspector to have a separate license in order to evaluate them: the presence of wood-destroying organisms and the condition of the septic system. A seperate license is also needed to perform a test or collect samples to check for environmental hazards, such as a high radon concentration in the house and the presence of mold, asbestos, and lead in the water or paint. Those tests or samples must then be analyzed by a certified laboratory.

Depending on the state, the licensing legislation may also contain a standards of practice section, which outlines in considerable detail those systems and components in a house that must be inspected, as well as those items that must be included in a written report to the client. The licensing law can be quite specific. One state, New Jersey, has included in its legislation a mandatory tools and equipment requirement. It states that all home inspectors during the performance of an inspection must be equipped with the following minimum tools and equipment; the inspector, however, is not limited to that list and can use additional tools and equipment.

1. A ladder, minimum 11 feet in length.
2. A flashlight, or another equivalent light source, with a minimum 15,000 candlepower illumination.
3. A flame inspection mirror.
4. An electrical outlet tester with ground fault circuit interrupter (GFCI) test ability.
5. Tools necessary to remove common fasteners on covers or panels that are required to be removed for inspection.
6. A measuring tape.
7. A probe.
8. Thermometers for testing air-conditioning.
9. Binoculars with a magnification between 8 × 42 and 10 × 50.
10. A moisture meter.
11. Combustible gas leak detection equipment.
12. A voltage detector.

Depending on the state requirements, when renewing the home inspection license, the inspector must attest or provide information showing successful completion of 10 to 40 hours of continuing education units (CEUs) per renewal period.

In most of those states that do not license home inspectors, there is usually a statute concerning the field of home inspection. In the statute there is a requirement that the inspector must be a member of a national or a state home inspection organization. This has helped the profession to be self-regulating. When there is a new inspector in town the more-experienced inspectors will check to determine whether or not the new inspector is a member of a national or state inspection organization. They check because the new inspector is more competition for them. If he or she is not a member of a national or state home inspection organization, which have strict membership requirements, the new inspector is encouraged to join one of the organizations.

Quiz based on *The Complete Book of Home Inspection*

1. A home inspection should begin on the
   a) exterior
   b) roof
   c) crawlspace
   d) interior
   e) electrical system

2. Roof sheathing is another term for
   a) wood shingles
   b) the roof deck
   c) thatched roofs
   d) roof runoff
   e) rain gutters

3. The most common form of roof shingle used in this country is
   a) wood shingles
   b) asphalt shingles
   c) concrete tile
   d) synthetic shakes
   e) tar and gravel

4. On a 17-year-old asphalt shingle roof, you would expect to find the shingles on the _____ slope more weathered than the shingles on the other slopes.
   a) easterly
   b) northerly
   c) southerly
   d) westerly
   e) none of the above

5. A Cedar Breather is
   a) a beetle found in cedar shingles
   b) a nylon matrix underlayment for cedar shingles
   c) a finish coating on cedar shingles
   d) used for regenerating the odor in a cedar closet
   e) a device for removing moss from cedar shingles

6. The most durable roof covering is
   a) modified bitumen
   b) treated shakes
   c) tile
   d) 40-year dimensional asphalt shingles
   e) slate

7. Ponded water on a flat roof that was not designed to hold standing water
   a) is desirable because it can reduce the heat load in summer
   b) is especially valuable in freezing weather
   c) must be maintained by hosing the roof in summer
   d) has more disadvantages than advantages and should be avoided
   e) is acceptable only on metal roofs

8. Single-ply membranes
   a) are used as an underlayment below shingle roofs
   b) are used on steeply sloped tile roofs
   c) can only be found on commercial roofs
   d) are vulnerable to leakage at seams
   e) cannot be covered with gravel

9. If the owner says the chimney has been leaning for 15 years
   a) it has withstood the test of time and is presumed safe
   b) corrective action is still needed
   c) it is because of uniform deterioration of the mortar on all sides of the chimney
   d) the chimney is not a potential hazard
   e) the owner probably removed an antenna from the chimney

10. A chimney cricket is
    a) an insect that nests in the chimney
    b) also known as a saddle
    c) found on every chimney

d) a code requirement
e) able to prevent downdrafts

11. Vent stacks
a) are parts of the plumbing system that project through the roof surface
b) should not go all the way through the roof
c) are self-sealing and not vulnerable to roof leakage
d) need not be checked unless doing a smoke bomb test of the septic tank
e) should end below the eaves

12. The absence of rain gutters
a) is a design defect, especially in snow country
b) indicates that the soils are not expansive
c) should be noted on your worksheet
d) is normal in houses with eaves having sufficient overhang
e) shows that the owner removed them rather than repaint them

13. Rain gutters without seams
a) are always copper
b) can be aluminum
c) are not subject to corrosion
d) do not require painting
e) are an impossibility

14. The acceptable difference in height between stair risers
a) should be less than one inch
b) can be any amount when the steps are not level
c) should be zero to avoid potential tripping hazards
d) can be any amount as long as there is a handrail
e) can be ½ inch

15. Sheathing on exterior walls
a) is inappropriate and belongs only on the roof
b) is installed to provide bracing and minimize air infiltration
c) cannot also be the exterior siding material
d) must be made of solid material, not fiberboard or gypsum
e) is always used as the nailing base for exterior siding

16. When inspecting siding, it is important to pay special attention to
a) the areas facing the north
b) the area facing the prevailing winds
c) the second story
d) the areas facing east
e) the sections that face south or southwesterly

17. If you find vines growing up an exterior wall
a) you should consider removing them
b) you are not responsible for inspecting the siding in that area
c) the vines provide extra insulating value
d) there is no problem as long as this is on a south-facing wall
e) the paint is being protected from sunlight and will be OK

18. Aluminum siding
a) is sometimes required to be grounded
b) never needs repainting
c) is durable and resistant to mechanical damage from impact
d) is never used in new construction
e) cannot incorporate insulation due to condensation problems

19. Stucco siding
a) is a concrete sheet that is poured first then applied to a wall
b) is made of recycled marble
c) can be applied to curved or irregular-shaped surfaces

d) adheres directly to sheathing material
e) is built up in five or six coats

20. EIFS is the acronym for
a) Exterior Interior Flame Safety
b) Easily Installed Flue Shutoff
c) Exterior Insulation Finish System
d) Exterior Interior Final Siding
e) Every Interrupt Fault System

21. Fiber-cement wall shingles are popular because they
a) will not rot
b) will not warp
c) will not delaminate
d) are resistant to termites
e) all of the above

22. In a brick veneer wall, the weakest point is
a) the space between the bricks and the foundation
b) the metal ties to the wall frame
c) the mortar between the bricks
d) the weep holes
e) the area over window or door openings

23. Exterior trim
a) includes all portions of the exterior finish other than the siding
b) serves a structural function
c) is installed in addition to the protection for joints and edges
d) refers only to wood and not to metal
e) cannot be exposed to the weather

24. The most common type of window in older homes is
a) awning window
b) horizontal sliding window
c) casement style
d) Craftsman style
e) double-hung

25. Jalousie refers to a style or type of
a) soffit
b) window
c) porch
d) cornice
e) tango

26. A swale is a
a) measuring stick to determine the water table
b) type of marine mammal
c) leach field for a septic tank system
d) junction box for an underground drainage system
e) depression in the ground to intercept and redirect surface runoff

27. A high water table
a) is especially good when there is a septic tank
b) has nothing to do with local rainfall
c) can be lowered by puncturing the ground
d) will likely lead to flooding in basements
e) is never within 20 feet of the ground surface

28. A dry retaining wall is one constructed
a) without weep holes to let water out
b) only in areas where the soils percolate moisture readily
c) without mortar
d) with the footing at least two feet below the frost line
e) in one piece

29. A retaining wall must be designed or approved by a licensed engineer if it is taller than
a) 3 feet
b) 4 feet
c) 5 feet
d) 6 feet
e) 7 feet

30. Where deck joists attach to a house, they should be secured by
    a) being toe-nailed into a header
    b) toe-nails and a ledger, or by metal brackets
    c) notches in the siding material
    d) diagonal braces
    e) posts set into the siding

31. Wood decks
    a) that show any signs of deterioration should be replaced completely
    b) should have proper drainage slope on the surface
    c) do not require guardrails except on second stories and balconies
    d) should have repairs or replacement of deteriorated planks as needed
    e) must always be constructed with pressure-treated pine

32. Composite decks
    a) are constructed entirely of wood
    b) are maintenance free
    c) do not expand and contract with temperature changes
    d) can be used for structural members
    e) use wood for the structural support members

33. Free-standing decks
    a) require two or more additional posts
    b) are as safe and secure as attached decks
    c) need diagonal bracing between the posts and the beams
    d) all of the above
    e) have posts that do not extend below the frost line

34. A door between the house and the garage
    a) should have a metal surface on the house side
    b) must not be on a higher elevation than the garage floor
    c) should be self-closing
    d) cannot have a tight seal
    e) may not be solid wood

35. A wall between the garage and the house
    a) may not have the attic entrance hatch, even if covered
    b) should have vents to the crawlspace or basement
    c) need not be inspected if covered with storage shelving
    d) may have exposed wood framing if the rest of the garage is also open
    e) must be covered with plaster, stucco, or other fire-resistant material

36. Garage doors with automatic openers
    a) should be checked for automatic reversal of the door
    b) need not be tested if the garage is detached from the main house
    c) should be tested only by disconnecting them from the automatic opener
    d) should only be tested by operating the remote control
    e) cannot be single-piece doors

37. Garage door restraining cables are used to
    a) prevent the door from closing too fast
    b) prevent the spring from whipping around in the event it breaks
    c) prevent the rollers from slipping out of the channels
    d) prevent fingers from getting crushed in door sections
    e) prevent the door from reversing automatically

38. The insect that causes the most damage to houses in the United States is the
    a) powder post beetle
    b) subterranean termite
    c) drywood termite

d) carpenter ant
e) dampwood termite

39. In general, subterranean termites
a) are very fast working and immediately destructive
b) are likely to colonize within the home near the heating plant
c) can be permanently eradicated by pesticides and termite barriers
d) are social insects with a rigid caste structure
e) are rare in California and the Southeast

40. Termite baits are
a) considerably less toxic that most liquid termiticides
b) slow-acting poisons combined with a termite food material
c) usually installed in plastic tubes or boxes
d) used by pest control operators
e) all of the above

41. Fiberglass batt insulation in an unfinished attic
a) should be placed between rafters with the foil side showing
b) should be placed between joists with the foil facing toward the attic
c) is not necessary in warm climates such as California
d) should be placed between joists with the foil facing toward the heated portion of the structure
e) should be slit to allow water vapor to escape

42. Attic ventilation
a) is not necessary in climates with no snowfall
b) is very difficult to upgrade
c) is important in both summer and winter
d) should not be provided by openings in gable walls
e) is typically provided by ducts from the kitchen range hood

43. An air admittance valve (AAV)
a) is a pressure-actuated one-way mechanical vent
b) is a code requirement
c) allows sewer gases to vent to the attic
d) negates the need for vent stacks
e) is only effective on rainy days

44. Defective Chinese drywall
a) is a gypsum wallboard made in China
b) produces a rotten egg odor
c) causes air-conditioning coils to corrode
d) causes copper plumbing and electrical wiring to corrode
e) all of the above

45. Squeaks in flooring
a) indicate a significant structural defect
b) are generally difficult to eliminate
c) can be easily repaired, especially on the second floor
d) indicate problems with water vapor
e) can be corrected by carpeting

46. Roof truss uplift causes
a) cracks in door frames
b) cracks in joint between floor and walls
c) cracks in joint between walls and ceiling
d) cracks in window frames
e) permanent sag in roof ridge

47. If a thermal pane window appears cloudy
a) it indicates poor housekeeping on the part of the owner
b) the hermetic seal should be repaired
c) water has leaked into the window from the exterior

d) there is no insulating value to the window
e) the window requires replacement

48. Poor water flow is typically caused by
a) too many fixtures on the second floor
b) poor water pressure
c) constriction in the supply pipes
d) inadequate meter sizing
e) clogged aerators

49. S-type traps are
a) used only in second floor bathrooms
b) required in two-pipe steam systems
c) installed on a/c condensate lines
d) not permitted by most plumbing codes
e) installed on water heaters

50. Improper venting at sink traps
a) can be determined by filling the sink with water and listening as it drains
b) is not an important enough problem to be worth fixing
c) is the term for lack of siphoning in a drain trap
d) can be seen by tape on the drain trap
e) will cause water hammer in the drain pipes

51. A rule of thumb for the minimum height of the chimney above the fireplace floor is
a) 8 feet
b) 10 feet
c) 12 feet
d) 15 feet
e) 18 feet

52. The best location for a smoke detector is
a) in the return air duct of the heating system
b) over the stove, since most fires start there
c) on the ceiling of the hallway leading to the bedroom
d) on a hallway wall but no closer than 6 inches from the ceiling
e) in the upper corners of each bedroom

53. Soils with a high clay content can swell or shrink up to
a) 10 percent
b) 20 percent
c) 30 percent
d) 40 percent
e) 50 percent

54. Deteriorated mortar joints in foundation walls
a) do not represent a weakened structural condition
b) should be repointed to improve the appearance of the foundation
c) should be repointed to restore load-bearing capacity
d) should be repointed to prevent basement water entry
e) can be painted to prevent further deterioration

55. Superior walls are
a) walls made from superior materials
b) less likely to crack under pressure
c) insulated, precast, ribbed concrete wall panels
d) made from a mix of concrete and fiber
e) concrete blocks with insulation in the voids

56. Engineered lumber
a) can only be used for roof framing
b) is termite-resistant
c) is stronger and more dimensionally stable than solid-sawn lumber
d) will prevent squeaks in flooring
e) is most effective when installed in cold weather

57. The inspection for water seepage into a basement or crawlspace begins
    a) after you see standing water in the crawlspace
    b) on the roof
    c) on the exterior
    d) by consulting maps available from the U.S. Geological Survey (USGS)
    e) by smelling damp conditions

58. Efflorescence is
    a) a significant structural defect
    b) an enthusiastic spontaneous response from realtors reading a favorable inspection report
    c) a chalky residue of sand and dissolved concrete created by the action of acidic soils
    d) an indication of effective damp proofing
    e) an accumulation of mineral salts created by moisture in masonry or concrete

59. The minimum FHA standards for crawlspace clearance are
    a) 24 inches between any wood and soil
    b) 18 inches soil-to-joist, 12 inches soil-to-girder
    c) 18 inches between any wood and soil
    d) 12 inches between the subfloor and soil
    e) any distance if pressure-treated lumber is used

60. In a conditioned crawl space
    a) the foundation walls are insulated
    b) wall vents are closed
    c) a dirt floor, if there is one, is covered with large plastic sheets
    d) the area is heated or air-conditioned
    e) all of the above

61. 110-volt electrical services
    a) are adequate for all modern appliances
    b) are adequate in most cases
    c) will suffice for all houses except those with air-conditioning
    d) are inadequate by current standards
    e) require that you use a gas refrigerator

62. Circuit breakers
    a) are an inconvenience when compared to fuses
    b) are more reliable than fuses and always provide greater safety
    c) cannot be used to provide overcurrent protection
    d) prevent overloading by allowing just enough voltage to pass through to meet demand
    e) are somewhat less reliable than fuses

63. The capacity of a branch circuit fuse
    a) can be increased by inserting a penny behind it
    b) should be as large as possible for added safety
    c) should match the current-carrying capacity of the branch circuit
    d) is electrically interchangeable with any other Edison fuse
    e) is increased by replacing the fuse with a fusestat

64. Removal of the interior cover of an electrical panel box
    a) is necessary to locate the main circuit breaker
    b) cannot be done without an electrical permit
    c) will enable determination of the true electrical capacity
    d) is not necessary when determining proper sizing of circuit breakers
    e) should be part of routine homeowner maintenance

65. If a house is wired with aluminum
    a) it is normal and acceptable for switches and outlets to be warm to the touch

b) the wiring is unsafe and should be completely replaced
c) there is no problem provided that outlets marked AL/CU were used
d) you should scan all the walls with an infrared heat detector to check for bad wiring
e) the connections should all be checked by a qualified electrical contractor

66. A ground fault circuit interrupter (GFCI) is an electronic device that
a) can be used instead of a fuse
b) is retroactively required for all bathroom receptacles
c) will not work properly if the main grounding is faulty
d) opens the circuit when it senses a potentially hazardous condition
e) can be reached when touching another ground source such as a shower head

67. An arc fault circuit interrupter (AFCI) is an electronic device that
a) is a backup if the GFI fails to operate
b) does not require periodic testing
c) disconnects the power if it detects arcing in electrical wiring
d) is an important part of a fire alarm system
e) is a retroactive building code requirement

68. Knob-and-tube wiring is
a) obsolete but usually safe if unmodified
b) acceptable when it includes grounding conductors
c) dangerous because the wires are not insulated
d) exposed and readily accessible in walls and ceilings
e) found only in Canada, Europe, and the East Coast

69. Systems with light fixture switches operating at 24 volts
a) indicate a significant loss of current and waste of electricity
b) can be operated from only one location, and do not work for three-way switches
c) can be repaired by removing the transformer
d) should be provided with spare replacement relays
e) are borrowed from automobile wiring systems

70. The house service main water pipe
a) is maintained by the water company
b) must always be at least 1 inch in diameter
c) would be the homeowners' expense if in need of repair or replacement
d) must not be made of metal or a dangerous electrical ground would result
e) should be fully visible and accessible to inspection

71. Hot water piping
a) should be no further than 4 inches from the parallel cold water piping
b) cannot be a part of the heating system of the house
c) is not visually accessible due to insulation
d) is required for all plumbing fixtures
e) should be separated from cold water piping by at least 6 inches

72. Drainage systems
a) are simpler than supply systems
b) consist of horizontal runs of piping
c) include traps, drainpipes, and vents
d) cannot operate properly by gravity alone
e) must be the same diameter as supply pipes

73. The gases that are generated in a septic tank are usually
   a) explosive and must be kept out of the house drainage-vent system
   b) must be dissipated through a fresh air inlet at the house trap
   c) dissipated into the earth through the leach field
   d) dissipated to the atmosphere through the house drainage-vent system
   e) an indication that the septic tank is sterilized and not functioning

74. A mound septic system
   a) is most effective in areas with hard water
   b) is normally found on top of a mountain ridge
   c) is used when the drainfield has a problem such as inadequate percolation rates
   d) can have a mound 6 to 8 feet high
   e) uses gravity to move the effluent

75. Vent pipes in drainage systems
   a) allow air to flow in and out of drain systems
   b) are not necessary when connected to a public sewer
   c) carry water and wastes
   d) should not connect near fixtures
   e) are not allowed to discharge into the atmosphere

76. The presence of a septic tank
   a) cannot always be determined during an inspection
   b) can be determined by whether or not there is a house trap
   c) can be ruled out if there are sewers for other houses on the street
   d) cannot be determined from the building department or other public records
   e) is a significant defect that must always be reported

77. The appropriate size for a septic leaching field is determined by
   a) the number of seepage pits
   b) the size of the water supply piping
   c) the elevation above sea level
   d) whether or not a garbage disposer is installed
   e) the percolation rate of the ground

78. Septic tank leaching field
   a) must be supplied with fresh leaches each year
   b) works best in clay soils
   c) will receive nitrogen and other natural fertilizers from the septic effluent
   d) definitely failed if the vegetation over them is lush and green
   e) are a less likely area for failure to be visible as compared to the area over the tank

79. An atmospheric vacuum breaker
   a) cannot be used in residential plumbing without the approval of the Department of Air Quality
   b) is required for all lawn sprinkler systems
   c) may not be more than 6 inches above grade
   d) is required at each sprinkler head
   e) prevents dirty water from backing up from the drains

80. A wall hatch providing access to the fixture side of a tub
   a) is a violation of most plumbing codes
   b) indicates that leakage occurred requiring the wall to be opened for repairs
   c) must be distinctly noticeable and not blocked by furniture
   d) is common in many older homes
   e) should never be found above the first floor

81. Inlet service pipes made of lead
   a) can sometimes be identified by a large bulge around a wiped joint
   b) are still installed in modern homes
   c) pose no hazard after prolonged use as interior corrosion prevents direct water contact with lead
   d) are the responsibility of the water supply company not the homeowner
   e) are common, but testing of the effects on water is very expensive and usually unnecessary

82. PEX piping (tubing)
   a) should only be used for cold water
   b) should only be used for hot water
   c) is flexible, and won't corrode or develop pin holes
   d) uses a special adhesive to seal the joints
   e) reacts with water-soluble oxidants

83. Leaching zinc is the cause of
   a) encrustation around fittings of copper pipe
   b) pinhole leaks in brass pipe
   c) rusting in galvanized pipe
   d) galvanic corrosion
   e) a green color at copper pipe fittings

84. A pressure tank
   a) can be located near a well pump house or in a basement
   b) is an indication that the well pump is inadequate
   c) compensates for lack of water in the well
   d) is illegal in most building jurisdictions
   e) is only needed for wells that yield less than 5 gallons per minute

85. Central heating
   a) can be easily extended to room additions
   b) always includes the basement
   c) has fewer moving parts than area heaters
   d) can usually be designed to provide distribution to separate zones
   e) automatically balances itself

86. Every heating system should have
   a) a humidistat
   b) a setback thermostat with timer
   c) multiple zones
   d) a master shutoff switch
   e) a filter

87. A condition under which a furnace must be replaced is
   a) a cracked heat exchanger
   b) introduction of carbon monoxide into the air return
   c) blocking of the chimney
   d) being older than the anticipated service life of the furnace
   e) being over 30 years old

88. Examples of a warm air heating system are
   a) single-pipe steam systems
   b) forced-air heating systems with ducts
   c) two-pipe steam heating system
   d) electric baseboard heating system
   e) all of the above

89. A multizoned forced-air heating system
   a) provides truly independent operation of one zone from another
   b) can only be controlled by a single thermostat
   c) requires motorized duct dampers
   d) bypasses potential dangers of failed heat exchangers
   e) has no moving parts

90. An "octopus" heating system
   a) is another term for a system that smells like dead fish
   b) requires air filters to function properly

c) will not work in thin atmospheres above 1,000 feet
d) requires frequent lubrication of the blower motor
e) is another term for a large gravity warm air central furnace

91. Condensing furnaces are
a) furnaces with reduced clearances that fit into a condensed space
b) the new generation of high efficiency furnaces
c) furnaces that extract the heat from a refrigeration system
d) furnaces without internal air-conditioning coils
e) types with a single heat exchanger cell

92. An extended plenum is
a) a type of warm air distribution system
b) the same as a radial duct system
c) a platform to provide clearance above a garage or basement floor
d) a vibration damper in a duct system
e) always composed of square or rectangular ducts

93. The optimum location for heating registers is
a) high on the wall or on the ceiling opposite from windows
b) in the center of each room's ceiling
c) along the outside walls and below windows
d) as close as possible to the return air inlet
e) where it will produce a "short cycle"

94. All hot water heating systems must be supplied with
a) a pump
b) an expansion tank
c) radiators
d) storage-tank boilers
e) an oil filter

95. Older coal-fired gravity-type boilers
a) cannot be converted to oil or gas
b) should be replaced with domestic water heaters
c) are typically cast iron and very large
d) produce condensation and require drain piping
e) operate at pressures in excess of 100 PSI

96. A gravity hot water heating system does not need an expansion tank
a) True
b) False

97. An advantage of a forced hot-water heating system is
a) immunity from problems with freezing
b) easy adaptability to air-conditioning
c) lack of any moving parts requiring maintenance
d) the absence of a need for any other energy source other than water pressure
e) less heat fluctuation and adaptability to be multiple zones

98. When a boiler is also used to provide heat for domestic hot water, it requires a
a) flow-control valve
b) second pressure relief valve
c) seasonal setting on the thermostat
d) sight glass
e) supplementary circulating pump

99. A pressure-temperature gauge is
a) a necessary safety control on a hot-water heating system
b) an operational control
c) illegal, as there must be separate gauges for each function
d) only necessary on steam heating
e) sometimes provided with a scale in altitude

100. A quick means to determine whether a boiler is for steam or hot water is
   a) whether the system was installed before 1900
   b) if it is hooked up to the municipal steam supply
   c) if it includes a water-level gauge (sight glass)
   d) if the tank has welded pressure boiler plates
   e) the presence of a steam whistle

101. A Hartford loop can be found on
   a) gas-fired water heaters
   b) steam boilers
   c) hot water boilers
   d) oil-fired water heaters
   e) air-conditioning piping

102. The purpose of a Hartford loop is to
   a) provide a more efficient balancing of steam to the radiators
   b) prime the system and prevent freezing
   c) allow expansion and contraction of piping with changes in temperature
   d) prevent water from draining out of the boiler in the event of a leak
   e) qualify the house for insurance by a certain company in Connecticut

103. A blow-off valve is
   a) an automatically self-cleaning valve
   b) a part of the fuel delivery system in an oil burner
   c) part of an externally mounted low water cutoff valve
   d) a phrase to be used when disclaiming any knowledge about steam heating
   e) a type of pressure relief valve

104. A one-pipe steam heating system can be easily converted to an induced hot-water heating system by changing the radiators and adding a circulator pump and expansion tank.
   a) True
   b) False

105. Oil burners
   a) burn cleaner than gas burners
   b) do not require maintenance
   c) must bear an approval stamp from the American Gas Association
   d) are often maintained by the companies that supply the fuel oil
   e) do not require a source of combustion air

106. Condensing furnaces
   a) can be vented into masonry chimneys
   b) are noisier than conventional furnaces
   c) have less air flow than conventional furnaces
   d) must have vertical or near-vertical exhaust piping
   e) can be combined with vents from a gas-fired water heater

107. Gas burners
   a) should have a blue flame with little or no yellow
   b) should have a flame that lifts well above the burner
   c) should have an orange flame
   d) will normally vary in height depending on the barometric pressure
   e) do not produce soot or water vapor when functioning properly

108. A water heater temperature and pressure relief valve
   a) is not required for modern efficient water heaters
   b) can be placed in either the cold or hot water piping near the tank
   c) must always be placed in the lower third of the tank

d) should connect to the inlet with the dip tube
e) should be provided with a discharge pipe ending in a visible location

109. A rumbling noise from a water heater tank
a) is an indication of imminent explosion
b) means that the pressure-relief valve is blocked
c) is a result of loose gas or oil burners
d) results from accumulated sediment
e) means that the water heater will leak soon

110. A dripping water heater relief valve could be an indication of
a) excessive high pressure
b) defective valve
c) thermal expansion
d) all of the above
e) none of the above

111. Recovery rate most often refers to
a) air-conditioning compressor
b) warm air furnace capacity
c) tank-type water heaters
d) hot water heating systems
e) water pressure reducing valves

112. A water heater should be replaced when
a) the burners malfunction
b) the flue is worn out
c) the sacrificial anode contains magnesium
d) it is more than 10 years old
e) it leaks

113. Electric water heaters
a) are usually instantaneous, with no storage tank
b) use much more energy and are not allowed by most cities for energy conservation reasons
c) have lower recovery rates than gas- or oil-fired water heaters
d) have higher recovery rates than gas, so the tanks are usually smaller
e) always require a mixing valve to prevent scalding

114. One ton of cooling capacity
a) means that the air conditioner will produce one ton of ice per hour
b) is needed for approximately every 700 square feet of living space
c) is a measure of pressure in an average size compressor
d) is the weight of the air cooled by a one-ton air conditioner each hour
e) is equal to 2,000 Btu of cooling capacity

115. An air-conditioning condenser
a) draws approximately 7 amps per ton of cooling capacity
b) must be provided with a condensate drain pipe
c) should be located in a basement or furnace room
d) must be protected from rainfall
e) will weigh approximately one ton for each ton of cooling capacity

116. An evaporator coil is
a) part of a hydronic heating system used for cooling interior air
b) a ring on the outside of an air-conditioning compressor
c) an adaptation often found on air-conditioning when distilling spirits
d) located on the building exterior
e) the place where coolant changes state from a liquid to a gas

117. An electrical disconnect switch
a) is needed to deactivate the evaporator coils

b) must be turned on to energize the condensing coils
c) is not needed except for the circuit breaker controlling the furnace
d) is required for a light near the condenser
e) should be found near the portion of the air-conditioning system containing the compressor

118. A condensate trap in air-conditioning
a) is to prevent any condensate from escaping
b) means that the system has trapped too much cold air
c) prevents the blower from sucking air up through the drain line
d) must be vented to dissipate sewer gases
e) recycles the coolant to the condenser

119. When a split-system air conditioner is also part of a heating system
a) the blower should have at least two speeds
b) there should be a separate set of smaller ducts for the air conditioner
c) the split should be healed before operating the heating system
d) the coolant can be run through the furnace heat exchanger
e) the compressor should be next to the furnace plenum

120. The temperature of air discharging from the registers during the cooling cycle
a) should be 10 to 20 degrees lower than the outside air
b) should be 15 degrees lower than the temperature during the heating cycle
c) should be no more than 60 degrees
d) should be about 15 degrees lower than the temperature of the air in the room
e) should be at least 20 degrees lower than the temperature of the return air

121. A heat pump should
a) not ever need supplementary electric-resistance heating
b) be sized based upon the cooling load, not the heating load
c) be tested in both the cooling and heating modes to ensure that the compressor works
d) be located entirely within the building
e) not be tested when the outside air temperature is 40 degrees

122. Evaporative coolers are most effective where?
a) East Coast
b) Florida
c) Southwest
d) California
e) Washington and Oregon

123. If attic insulation does not have a vapor barrier
a) one should be laid over the top of it in an attic
b) one cannot be added to it or the manufacturer's warranty is void
c) one can be laid under the insulation so that it is adjacent to the heated ceiling
d) one can be added to the underside of the roof deck
e) it is because a vapor barrier is never necessary

124. The average water loss in one week in a swimming pool due to evaporation is
a) less than 1 inch
b) 1 inch
c) 1½ inches
d) 2 inches
e) 2½ inches

125. Radon gas
   a) is one of the most significant forms of manmade pollution
   b) is odorless, tasteless, invisible, and formed by natural uranium deposits
   c) is a result of high frequency radio waves generated for communications lines
   d) can be prevented from forming when a house is properly insulated
   e) most often enters a home through shower heads

126. Asbestos
   a) kills thousands of people annually from asbestos-related cancers
   b) must always be removed prior to sale of a home
   c) should never be encapsulated, as this only increases its dangers
   d) can be removed only by a licensed heating or insulating contractor
   e) in any level is a health risk within a home

127. Mold growth in a house thrives on moisture and
   a) cotton
   b) wool
   c) paper
   d) wood
   e) all of the above

128. A desuperheater
   a) is used to steam clean clothing
   b) eliminates static electricity in a house
   c) is a device on a geothermal system that is used to heat water
   d) uses gas as an energy source
   e) is a device on newly designed oil burners

Quiz answers

1. a
2. b
3. b
4. c
5. b
6. e
7. d
8. d
9. b
10. b
11. a
12. c
13. b
14. c
15. b
16. e
17. a
18. a
19. c
20. c
21. e
22. b
23. a
24. e
25. b
26. e
27. d
28. c
29. b
30. b
31. d
32. e
33. d
34. c
35. e
36. a
37. b
38. b
39. d
40. e
41. d
42. c
43. a
44. e
45. b
46. c
47. e
48. c
49. d
50. a
51. d
52. c
53. e
54. d
55. c
56. c
57. c
58. e
59. b
60. e
61. d
62. e
63. c
64. c
65. e
66. d
67. c
68. a
69. d
70. c
71. e
72. c
73. d
74. c
75. a
76. a
77. e
78. c
79. b
80. d
81. a
82. c
83. b
84. a
85. d
86. d
87. a
88. b
89. c
90. e
91. b
92. a
93. c
94. b
95. c
96. b
97. e
98. a
99. e
100. c
101. b
102. d
103. c
104. b
105. d
106. b
107. a
108. e
109. d
110. d
111. c
112. e
113. c
114. b
115. a
116. e
117. e
118. c
119. a
120. d
121. b
122. c
123. c
124. a
125. b
126. a
127. e
128. c

ASHI Standards of Practice

1. INTRODUCTION

The American Society of Home Inspectors®, Inc. (ASHI®) is a not-for-profit professional society established in 1976. Membership in ASHI is voluntary and its members are private home *inspectors.* ASHI's objectives include promotion of excellence within the profession and continual improvement of its members' inspection services to the public.

2. PURPOSE AND SCOPE

2.1 The purpose of the Standards of Practice is to establish a minimum and uniform standard for home *inspectors* who subscribe to these Standards of Practice. *Home inspections* performed to these Standards of Practice are intended to provide the client with objective information regarding the condition of the *systems* and *components* of the home as *inspected* at the time of the *home inspection.* Redundancy in the description of the requirements, limitations, and exclusions regarding the scope of the *home inspection* is provided for emphasis only.

2.2 Inspectors shall:

A. adhere to the Code of Ethics of the American Society of Home Inspectors.

B. *inspect readily accessible,* visually observable, *installed systems* and *components* listed in these Standards of Practice.

C. report:

1. those *systems* and *components inspected* that, in the professional judgment of the *inspector,* are not functioning properly, significantly deficient, *unsafe*, or are near the end of their service lives.
2. recommendations to correct, or monitor for future correction, the deficiencies *reported* in 2.2.C.1, or items needing *further evaluation*. (*Per* Exclusion 13.2.A.5 *inspectors* are NOT required to determine methods, materials, or costs of corrections.)
3. reasoning or explanation as to the nature of the deficiencies *reported* in 2.2.C.1, that are not self-evident.
4. *systems* and *components* designated for inspection in these Standards of Practice that were present at the time of the *home inspection* but were not *inspected* and the reason(s) they were not *inspected.*

2.3 These Standards of Practice are not intended to limit *inspectors* from:

A. including other inspection services or *systems* and *components* in addition to those required in Section 2.2.B.

B. designing or specifying repairs, provided the *inspector* is appropriately qualified and willing to do so.

C. excluding *systems* and *components* from the inspection if requested by the client.

3. STRUCTURAL COMPONENTS

3.1 The *inspector* shall:

A. *inspect*:

1. *structural components* including the foundation and framing.
2. by probing a *representative number* of *structural components* where deterioration is suspected or where clear indications of possible deterioration exist. Probing is NOT required when probing would damage any finished surface or where no deterioration is visible or presumed to exist.

B. *describe:*
1. the methods used to *inspect underfloor crawl spaces* and attics.
2. the foundation.
3. the floor structure.
4. the wall structure.
5. the ceiling structure.
6. the roof structure.

3.2 The inspector is NOT required to:

A. provide any *engineering* or architectural services or analysis.

B. offer an opinion as to the adequacy of any *structural system* or *component*

4. EXTERIOR

4.1 The inspector shall:

A. *inspect:*
1. *siding,* flashing and trim.
2. all exterior doors.
3. attached or adjacent decks, balconies, stoops, steps, porches, and their associated railings.
4. eaves, soffits, and fascias where accessible from the ground level.
5. vegetation, grading, surface drainage, and retaining walls that are likely to adversely affect the building.
6. adjacent or entryway walkways, patios, and driveways.

B. *describe:*
1. *siding.*

4.2 The *inspector* is NOT required to *inspect*

A. screening, shutters, awnings, and similar seasonal accessories.

B. fences.

C. geological and/or soil conditions.

D. *recreational facilities*.

E. outbuildings other than garages and carports.

F. seawalls, break-walls, and docks.

G. erosion control and earth stabilization measures.

5. ROOFING

5.1 The inspector shall:

A. *inspect:*
1. roofing materials.
2. *roof drainage systems*.
3. flashing.
4. skylights, chimneys, and roof penetrations.

B. *describe:*
1. roofing materials.
2. methods used to *inspect* the roofing.

5.2 The inspector is NOT required to inspect:

A. antennae.

B. interiors of flues or chimneys that are not *readily accessible*.

C. other *installed accessories*.

6. PLUMBING

6.1 The inspector shall:

A. *inspect:*
1. interior water supply and distribution *systems* including all fixtures and faucets.
2. drain, waste, and vent *systems* including all fixtures.
3. water heating equipment and hot water supply system.
4. vent *systems*, flues, and chimneys.
5. fuel storage and fuel distribution *systems*.
6. drainage sumps, sump pumps, and related piping.

B. *describe:*
1. water supply, drain, waste, and vent piping materials.
2. water heating equipment including energy source(s).
3. location of main water and fuel shut-off valves.

6.2 The Inspector is NOT required to:

A. *inspect:*

1. clothes washing machine connections.
2. interiors of flues or chimneys that are not *readily accessible*.
3. wells, well pumps, or water storage related equipment.
4. water conditioning *systems*.
5. solar water heating *systems*.
6. fire and lawn sprinkler *systems*.
7. private waste disposal *systems*.

B. determine:

1. whether water supply and waste disposal *systems* are public or private.
2. water supply quantity or quality.

C. operate *automatic safety controls* or manual stop valves.

7. ELECTRICAL

7.1 The inspector shall:

A. *inspect*:

1. service drop.
2. service entrance conductors, cables, and raceways.
3. service equipment and main disconnects.
4. service grounding.
5. interior *components* of service panels and sub panels.
6. conductors.
7. overcurrent protection devices.
8. a *representative number* of *installed* lighting fixtures, switches, and receptacles.
9. ground fault circuit interrupters.

B. *describe:*

1. amperage and voltage rating of the service.
2. location of main disconnect(s) and sub panels.
3. presence of solid conductor aluminum branch circuit wiring.
4. presence or absence of smoke detectors.
5. *wiring methods.*

7.2 The inspector is NOT required to:

A. *inspect:*

1. remote control devices.
2. *alarm systems* and *components*.
3. low voltage wiring *systems and components*.
4. ancillary wiring *systems* and *components* that are not a part of the primary electrical power distribution *system.*

B. measure amperage, voltage, or impedance.

8. HEATING

8.1 The inspector shall:

A. open *readily openable access panels.*

B. *inspect:*

1. *installed* heating equipment.
2. vent *systems,* flues, and chimneys.

C. *describe:*

1. energy source(s).
2. heating *systems.*

8.2 The inspector is NOT required to:

A. *inspect:*

1. interiors of flues or chimneys that are not *readily accessible*.
2. heat exchangers.
3. humidifiers or dehumidifiers.
4. electronic air filters
5. solar space heating *systems.*

B. determine heat supply adequacy or distribution balance.

9. AIR CONDITIONING

9.1 The inspector shall:

A. open *readily openable access panels.*

B. *inspect:*

1. central and through-wall equipment.
2. distribution *systems*

C. *describe:*

1. energy source(s).
2. cooling *systems.*

9.2 The inspector is NOT required to:

A. *inspect* electronic air filters.

B. determine cooling supply adequacy or distribution balance.

C. *inspect* window air conditioning units.

10. INTERIORS

10.1 The *inspector* shall *inspect:*

A. walls, ceilings, and floors.

B. steps, stairways, and railings.

C. countertops and a *representative number* of *installed* cabinets.

D. a *representative number* of doors and windows.

E. garage doors and garage door operators.

10.2 The *inspector* is NOT required to *inspect:*

A. paint, wallpaper, and other finish treatments.

B. carpeting.

C. window treatments.

D. central vacuum *systems.*

E. *household appliances.*

F. *recreational facilities.*

11. INSULATION & VENTILATION

11.1 The inspector shall:

A. *inspect:*

1. insulation and vapor retarders in unfinished spaces.
2. ventilation of attics and foundation areas.
3. mechanical ventilation *systems.*

B. *describe:*

1. insulation and vapor retarders in unfinished spaces.
2. absence of insulation in unfinished spaces at conditioned surfaces.

11.2 The *inspector* is NOT required to disturb insulation.

See 13.2.A.11 and 13.2.A.12.

12. FIREPLACES AND SOLID FUEL BURNING APPLIANCES

12.1 The *inspector* shall:

A. *inspect:*

1. *system components.*
2. chimney and vents.

B. *describe:*

1. fireplaces and *solid fuel burning appli*ances.
2. chimneys.

12.2 The inspector is NOT required to:

A. *inspect:*

1. interiors of flues or chimneys.
2. fire-screens and doors.
3. seals and gaskets.
4. automatic fuel feed devices.
5. mantles and fireplace surrounds.
6. combustion make-up air devices.
7. heat distribution assists (gravity fed and fan assisted).

B. ignite or extinguish fires.

C. determine draft characteristics.

D. move fireplace inserts and stoves or firebox contents.

13. GENERAL LIMITATIONS AND EXCLUSIONS

13.1 General limitations:

A. The *inspector is* NOT required to perform any action or make any determination not specifically stated in these Standards of Practice.

B. Inspections performed in accordance with these Standards of Practice:

1. are not *technically exhaustive.*
2. are not required to identify concealed. conditions, latent defects, or consequential damage(s).

C. These Standards of Practice are applicable to buildings with four or fewer dwelling units and their garages or carports.

13.2 General exclusions:

A. *Inspectors* are NOT required to determine:

1. conditions of *systems* or *components* that are not *readily accessible.*
2. remaining life expectancy of any *system* or *component.*
3. strength, adequacy, effectiveness, or efficiency of any *system* or *component.*
4. the causes of any condition or deficiency.
5. methods, materials, or costs of corrections.
6. future conditions including but not limited to failure of *systems* and *components.*
7. the suitability of the property for any specialized use.
8. compliance with regulatory requirements (codes, regulations, laws, ordinances, etc.).
9. market value of the property or its marketability.
10. the advisability of purchase of the property.
11. the presence of potentially hazardous plants or animals including, but not limited to, wood destroying organisms or diseases harmful to humans including molds or mold-like substances.
12. the presence of any environmental hazards including, but not limited to, toxins, carcinogens, noise, and contaminants in soil, water, and air.
13. the effectiveness of any *system installed* or method utilized to control or remove suspected hazardous substances.
14. operating costs of *systems* or *components.*
15. acoustical properties of any *system* or *component.*
16. soil conditions relating to geotechnical or hydrologic specialties.

B. *Inspectors* are NOT required to offer:

1. or perform any act or service contrary to law.
2. or perform *engineering* services.
3. or perform any trade or any professional service other than *home inspection.*
4. warranties or guarantees of any kind.

C. *Inspectors* are NOT required to operate:

1. any *system* or *component* that is *shut dow*n or otherwise inoperable.
2. any *system* or *component* that does not respond to *normal operating controls*.
3. shut-off valves or manual stop valves.

D. *Inspectors* are NOT required to enter:

1. any area that will, in the opinion of the *inspector,* likely be dangerous to the *inspector* or other persons or damage the property or its *systems* or *components.*
2. *under-floor crawl spaces* or attics that are not *readily accessible.*

E. *Inspectors* are NOT required to inspect:

1. underground items including but not limited to underground storage tanks or other underground indications of their presence, whether abandoned or active.
2. items that are not *installed.*
3. *installed decorative* items.
4. items in areas that are not entered in accordance with 13.2.D.
5. detached structures other than garages and carports.

6. common elements or common areas in multi-unit housing, such as condominium properties or cooperative housing.

F. *Inspectors* are NOT required to:

1. perform any procedure or operation that will, in the opinion of the *inspector*, likely be dangerous to the *inspector* or other persons or damage the property or its *systems* or *components*.
2. describe or report on any *system* or *component* that is not included in these Standards and was not *inspected*.
3. move personal property, furniture, equipment, plants, soil, snow, ice, or debris.
4. *dismantle* any *system* or *component*, *except* as explicitly required by these Standards of Practice.

ASHI Standards of Practice glossary of italicized terms

Alarm Systems
Warning devices *installed* or free-standing including but not limited to smoke detectors, carbon monoxide detectors, flue gas, and other spillage detectors, and security equipment

Automatic Safety Controls
Devices designed and *installed* to protect *systems* and *components* from unsafe conditions

Component
A part of a *system*

Decorative
Ornamental; not required for the proper operation of the essential *systems* and *components* of a home

Describe
To identify (in writing) a *system* or *component* by its type or other distinguishing characteristics

Dismantle
To take apart or remove any *component*, device, or piece of equipment that would not be taken apart or removed by a homeowner in the course of normal maintenance

Engineering
The application of scientific knowledge for the design, control, or use of building structures, equipment, or apparatus

Further Evaluation
Examination and analysis by a qualified professional, tradesman, or service technician beyond that provided by the *home inspection*

Home Inspection
The process by which an inspector visually examines the *readily accessible systems* and *components* of a home and which *describes* those *systems* and *components* in accordance with these Standards of Practice

Household Appliances
Kitchen, laundry, and similar appliances, whether *installed* or free-standing

Inspect
To examine any *system* or *component* of a building in accordance with these Standards of Practice, using *normal operating controls* and opening *readily openable access panels*

Inspector
A person hired to examine any *system* or *component* of a building in accordance with these Standards of Practice

Installed
Attached such that removal requires tools

Normal Operating Controls
Devices such as thermostats, switches, or valves intended to be operated by the homeowner

Readily Accessible
Available for visual inspection without requiring moving of personal property, *dismantling*, destructive measures, or any action that will likely involve risk to persons or property

Readily Openable Access Panel
A panel provided for homeowner inspection and maintenance that is *readily accessible*, within normal reach, can be removed by one person, and is not sealed in place

Recreational Facilities
Spas, saunas, steam baths, swimming pools, exercise, entertainment, athletic playground or other similar equipment, and associated accessories

Report
Communicate in writing

Representative Number
One *component* per room for multiple similar interior *components* such as windows, and electric receptacles; one *component* on each side of the building for multiple similar exterior *components*

Root Drainage Systems
Components used to carry water off a roof and away from a building

Shut Down
A state in which a *system* or *component* cannot be operated by *normal operating controls*

Siding
Exterior wall covering and cladding; such as: aluminum, asphalt, brick, cement/asbestos, EIFS, stone, stucco, veneer, vinyl, wood, etc.

Solid Fuel Burning Appliances
A hearth and fire chamber or similar prepared place in which a fire may be built and that is built in conjunction with a chimney; or a listed assembly of a fire chamber, its chimney, and related factory-made parts designed for unit assembly without requiring field construction

Structural Component
A *component* that supports non-variable forces or weights (dead loads) and variable forces or weights (live loads)

System
A combination of interacting or interdependent *components,* assembled to carry out one or more functions.

Technically Exhaustive
An investigation that involves *dismantling,* the extensive use of advanced techniques, measurements, instruments, testing, calculations, or other means

Under-floor Crawl Space
The area within the confines of the foundation and between the ground and the underside of the floor

Unsafe
A condition in a *readily accessible, installed system* or *component* that is judged to be a significant risk of bodily injury during normal, day-to-day use; the risk may be due to damage, deterioration, improper installation, or a change in accepted residential construction standards

Wiring Methods
Identification of electrical conductors or wires by their general type, such as non-metallic sheathed cable, armored cable, or knob and tube, etc.

ASHI Code of Ethics

For the home inspection profession

Integrity, honesty, and objectivity are fundamental principles embodied by this Code, which sets forth obligations of ethical conduct for the home inspection profession. The Membership of ASHI has adopted this Code to provide high ethical standards to safeguard the public and the profession.

Inspectors shall comply with this Code, shall avoid association with any enterprise whose practices violate this Code, and shall strive to uphold, maintain, and improve the integrity, reputation, and practice of the home inspection profession.

1. **Inspectors shall avoid conflicts of interest or activities that compromise, or appear to compromise, professional independence, objectivity, or inspection integrity.**

   A. Inspectors shall not inspect properties for compensation in which they have, or expect to have, a financial interest.

   B. Inspectors shall not inspect properties under contingent arrangements whereby any compensation or future referrals are dependent on reported findings or on the sale of a property.

   C. Inspectors shall not directly or indirectly compensate realty agents, or other parties having a financial interest in closing or settlement of real estate transactions, for the referral of inspections or for inclusion on a list of recommended inspectors, preferred providers, or similar arrangements.

   D. Inspectors shall not receive compensation for an inspection from more than one party unless agreed to by the client(s).

   E. Inspectors shall not accept compensation, directly or indirectly, for recommending contractors, services, or products to inspection clients or other parties having an interest in inspected properties.

   F. Inspectors shall not repair, replace, or upgrade, for compensation, systems or components covered by ASHI Standards of Practice, for one year after the inspection.

2. **Inspectors shall act in good faith toward each client and other interested parties.**

   A. Inspectors shall perform services and express opinions based on genuine conviction and only within their areas of education, training, or experience.

   B. Inspectors shall be objective in their reporting and not knowingly understate or overstate the significance of reported conditions.

   C. Inspectors shall not disclose inspection results or client information without client approval. Inspectors, at their discretion, may disclose observed immediate safety hazards to occupants exposed to such hazards, when feasible.

3. **Inspectors shall avoid activities that may harm the public, discredit themselves, or reduce public confidence in the profession.**

   A. Advertising, marketing, and promotion of inspectors' services or qualifications shall not be fraudulent, false, deceptive, or misleading.

   B. Inspectors shall report substantive and willful violations of this Code to the Society.

ASHI membership categories and requirements

All ASHI members are required to abide by the ASHI Code of Ethics, which specifically forbids home inspectors from active brokerage or sale of real estate, or performing repairs on homes that they inspect. ASHI members also agree to perform and report inspections in accordance with the ASHI Standards of Practice. Not only is the ASHI logo widely regarded as the mark of a professional home inspector, its use by the ASHI membership is also carefully controlled.

There are three designations of active professional home inspector membership in ASHI. These ASHI membership categories are as follows:

ASHI Certified Inspectors—Inspectors in this category have:

- Passed the National Home Inspector Examination and ASHI's Standards and Ethics module.
- Had inspection reports successfully verified for compliance with ASHI's Standards of Practice.
- Submitted valid proof of performance of at least 250 fee-paid home inspections that meet or exceed the ASHI Standards of Practice.

ASHI Associates w/ Logo—Inspectors in this category have:

- Passed the National Home Inspector Examination and ASHI's Standards and Ethics module.
- ASHI has verified performance of 50 fee-paid inspections in substantial compliance with the Standards of Practice.
- Had inspection reports successfully verified for compliance with ASHI's Standards of Practice.

ASHI Associates—Inspectors in this category have:

- Just joined ASHI and may be new to the inspection profession or may be a seasoned inspector who has not yet completed ASHI's requirements to move up in membership and logo use.

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Glossary

alligatoring Extensive surface cracking in a pattern that resembles the hide of an alligator.

areaway An open subsurface space around a basement window or doorway; provides light, ventilation, and access.

backfill The gravel or earth replaced in the space around a building wall after the foundation is in place.

bottom plate The bottom horizontal member of a frame wall.

Btu (British thermal unit) The amount of heat required to raise the temperature of 1 pound of water by 1 degree Fahrenheit.

cantilever A structural member that projects beyond its supporting wall or column.

Cedar Breather A three-dimensional nylon matrix that is stiff enough to resist crushing, thereby allowing air movement to the underside of wood shingles and shakes.

Conditioned crawl space A crawl area that has insulated foundation walls, closed vents, is heated and/or air conditioned and has a dirt floor that is covered over with large plastic sheets or cement. Basically an area that is dry and comfortable all year long.

control joint A groove that is formed, sawed, or tooled in a concrete or masonry structure to regulate the location and amount of cracking.

cornice Horizontal projection at the top of a wall or under the overhanging portion of the roof.

cross connection A direct arrangement of a piping line that allows the potable water supply to be connected to a line that contains a contaminant.

cupping An inward-curling distortion at the exposed corners of asphalt shingles.

downdraft A downward current of air in a chimney, often carrying smoke with it.

dry well A covered pit, either with open-jointed lining or filled with coarse aggregate, through which drainage from downspouts or foundation footing drains may seep into the surrounding soil.

eaves The lower edge of a roof that projects beyond the building wall.

efflorescence A white powdery substance appearing on masonry wall surfaces, composed of soluble salts that have been brought to the surface by water or moisture movement.

fascia (or facia) A horizontal board nailed vertically to the ends of roof rafters; sometimes supports a gutter.

feathering The tapering of one surface into another.

flashing Sheet-metal or other thin, impervious material used around roof and wall junctions to protect joints from water penetration.

flue A passageway in a chimney for conveying smoke, gases, or fumes to the outside air.

frost line The depth of frost penetration in soil; varies in different parts of the country.

gable roof A double-sloped roof from the ridge to the eaves; the end section appears as an inverted V.

girder The main structural support beam in a wood-framed floor; a girder supports one end of each joist.

glulam (glued laminated lumber) An engineered structural timber product composed of several layers of dimensioned timber glued together.

By laminating several smaller pieces of timber, a single large, strong, structural member is manufactured.

grade The ground level at the outside walls of a building or elsewhere on a building site.

header A framing member that crosses and supports the ends of joists.

hip roof A roof that slopes upward from all four sides of a building.

hydro-air Basically a hot water/warm air system, which essentially consists of an air handler that looks like the blower compartment of a furnace, a hot water boiler, and a duct system.

joist One of a series of parallel beams used to support floor and ceiling loads, supported in turn by larger beams (*girders*) or bearing walls.

knee wall A wall that acts as a brace by supporting roof rafters at an intermediate position along their length.

Lally column A steel tube, filled with concrete, used to support girders and other floor beams.

lath A building material of wood, metal, gypsum, or insulating board fastened to the frame of a building to act as a plaster base.

lintel A horizontal structural member that supports the load over an opening such as a door or window.

nosing The rounded edge of a stair tread that projects over the riser.

parapet wall The part of a wall that extends above the roofline.

pier A masonry column, usually rectangular in horizontal cross section, used to support other structural members.

pigtail (1) A flexible conductor attached to a light fixture that provides a means of connecting the fixture to a circuit. (2) A short length of copper conductor that is attached to the end of an aluminum branch circuit by a special fastener, then fastened to the terminal of a switch or outlet.

pilaster A pier-type projection of the foundation wall used to support a floor girder or stiffen the wall.

plenum A chamber or large duct above a furnace that serves as a distribution area.

ply A sheet in a layered construction, such as plywood, roofing.

pointing (repointing) Filling open mortar joints; removing deteriorated mortar between joints of masonry units and replacing it with new mortar.

rafter One of a series of inclined structural roof members spanning from an exterior wall to a center ridge beam or ridge board.

refractory A material, usually nonmetallic, used to withstand high temperatures, as in the combustion chamber of an oil-fired heating system.

relay An electromechanical switch; a device in which changes in the current flow in one circuit are used to open or close electrical contacts in a second circuit.

resilient tile A manufactured interior floor covering that is resilient, such as vinyl or vinyl-asbestos tile.

ridge beam The beam or board placed on edge at the ridge (top) of the roof into which the upper ends of the rafters are fastened.

riser The vertical height of a stair step; also the vertical boards that close the space between the treads of a stairway.

sheathing The structural covering, usually wood boards or plywood, over a building's exterior studs or rafters.

sheave A wheel with a grooved rim (pulley).

shelter-tube Mud-type tube (tunnel) built by termites as a passageway between the ground and the source of food (wood).

sill plate The lowest member of the house framing resting on top of the foundation wall. Also called *mud sill*.

soffit The visible underside of a roof overhang or eaves.

stringer (step) One of the enclosed sides of a stair supporting the treads and risers.

stud One of a series of slender wood or metal vertical structural members placed as supporting elements in walls and partitions.

subfloor Boards or plywood laid on joists, over which a finished floor is to be laid.

swale A shallow depression in the ground to form a channel for storm-water drainage.

thermocouple A device consisting of two junctions of dissimilar metals; when the two junctions are at different temperatures, a voltage is generated. Used in controlling gas valves.

toenail Driving a nail at an angle into the corner of one wood-frame member to penetrate into a second member.

tread The horizontal board in a stairway on which feet are placed.

truss A combination of structural members usually arranged in triangular units to form a rigid framework for spanning between load-bearing walls.

weep hole A small opening at the bottom of a retaining wall or the lower section of a masonry veneer facing on a wood-frame exterior wall, that permits water to drain.

Inspection worksheets

Address:_____

EXTERIOR

Front Exposure: N E S W

Condition

1. **Sidewalks:** none_____ concrete_____ asphalt_____ stone_____ cracked_____ uneven_____ _____
2. **Exterior walls:** brick_____ stucco_____ stone_____ wood siding_____ fiber-cement siding_____
   wood/asbestos shingle_____ aluminum/vinyl siding_____ other_____ vines growing_____ _____
3. **Trim:** cracked_____ rotting_____ broken_____ loose_____ needs paint touch-up_____ _____
4. **Paths:** concrete_____ stone_____ brick_____ asphalt_____ cracked_____ settled_____
   overgrown_____ _____
5. **Steps:** concrete_____ stone_____ brick_____ wood_____ need repair_____
   Handrail:_____ _____
6. **Porch:** front/rear/left/right: cracked_____ rotting_____ chipped_____ loose_____ _____
7. **Windows:** wood_____ aluminum_____ cracked_____ broken_____ reputty_____
   broken cords_____ needs lubrication/adjustment_____ do not close properly_____
   corroding/rotting frames_____ thermal panes_____ faulty seals_____ _____
8. **Storms/screens:** none_____ partial_____ full_____ cracked_____ broken_____
   torn screens_____ _____
9. **Roof:** asphalt_____ wood_____ slate_____ tile_____ roll roofing_____ other_____
   Shingles: missing_____ loose_____ cracked_____ aging_____ eroded_____ _____
10. **Gutters/downspouts:** none_____ partial_____ full_____ built-in_____ aluminum_____
    copper_____ galvanized_____ wood_____ loose/sagging_____ open joints_____
    need splash plates/elbows_____ need cleaning_____ _____
11. **Chimney:** brick_____ masonry_____ prefabricated_____ needs repair_____ _____

Condition

12. **Garage:** none_____ attached_____ detached_____ car occupancy_____

    Doors: operational_____ need lubrication/adjustment_____ automatic opener_____ _____

13. **Driveway:** cracked_____ uneven_____ broken_____ heaving_____ drain_____ _____

14. **Patio:** yes_____ no_____ concrete_____ stone_____ brick_____ needs repair_____

    cracked_____ settled_____ _____

15. **Deck:** attached_____ free-standing_____ composite decking_____ wood_____

    cracked_____ rotting_____ broken_____ needs additional bracing_____

    loose railings/handrails_____ loose steps_____ loose posts_____ needs CO_____ _____

16. **Landscaping:** grass needs recultivation_____ shrubs need pruning_____

    Trees_____ overhanging roof_____ need pruning_____ dead/dying_____ _____

17. **Retaining walls:** brick_____ stone_____ concrete block_____ wood_____ need repair_____ _____

18. **Fencing:** wood/metal_____ broken_____ rotting/rusting_____ needs painting_____ _____

19. **Drainage/grading:** satisfactory_____ poor_____ low spots_____ needs regrading_____

    stairwell_____ window well_____ _____

20. **Termites:** no visible evidence:_____ visible evidence_____ where_____ _____

21. **Caulking:** needed around exterior joints: yes_____ no_____ _____

    Comments: _____

    _____

ATTIC AREA

- ❍ **Type:** full_____ crawl_____ finished_____ unfinished_____
- ❍ **Accessible:** yes_____ no_____ **Evidence of condensation:** yes_____ no_____
- ❍ **Insulation:** floor_____ roof_____ walls_____ partial_____ adequate_____ inadequate_____

  none visible_____ loose sections_____ improperly installed_____

  Vapor barrier: yes_____ no_____
- ❍ **Ventilation:** adequate_____ inadequate_____ none_____ need roof/gable vents_____ ridge vent_____

  power ventilator_____ Attic fan: _____ operational: yes_____ no_____
- ❍ **Past leakage:** chimney_____ plumbing vent stacks_____ rafters_____ other_____
- ❍ **Firestopping:** needed around chimney and attic floor: yes_____ no_____

CRAWL SPACE (BASEMENT LEVEL)

- ❍ **None:** _____ **Accessible:** yes_____ no_____ Conditioned space: yes_____ no_____
- ❍ **Floor:** dirt_____ cement_____ asphalt_____ other_____

  Vapor barrier needed for floor: yes_____ no_____

  Past water seepage: yes_____ no_____
- ❍ **Insulation needed:** yes_____ no_____ loose section(s)_____
- ❍ **Ventilation:** adequate_____ inadequate_____ Dehumidifier needed: yes_____ no_____
- ❍ **Termites:** evidence of_____ no visible evidence_____ conditions conducive to activity_____

  Comments: _____

  _____

BASEMENT AND/OR UTILITY ROOM(S)

- ❍ **Evidence of water seepage:** yes_____ no_____

  water stains_____ efflorescence: on walls_____ on floor_____

  swelled floor tiles/joints_____

  peeling and flaking paint on walls_____ corrosion below radiators_____

  Seepage condition extensive: yes_____ no_____

  Sump pump: yes_____ no_____ Dehumidifier needed: yes_____ no_____

	Condition
❍ **Foundation walls:** concrete_____ block_____ stone_____ brick_____ other_____ cracked_____ reseal_____ cracked or loose mortar joints_____ repoint_____	_____
❍ **Girders:** wood_____ steel_____ none_____ not visible_____	_____
❍ **Joists:** (partially) covered_____ sagging_____	_____
❍ **Columns:** wood_____ steel_____ screw-jack type_____	_____
❍ **Mold:** evidence of: yes_____ no_____	_____

Comments: _____

_____

ELECTROMECHANICALS

❍ **Electricity**_____ amps 110-120 volts circuit breakers_____ fuses_____

Service: adequate_____ marginal_____ inadequate_____

Wiring/outlets: adequate_____ marginal_____ inadequate_____ knob-and-tube wiring_____

aluminum branch circuits_____

❍ **Heating system:** forced_____ gravity_____; hot water_____ hot air_____ steam_____

high-efficiency condensing type_____ hydro-air_____ geothermal_____

oil_____ gas_____ electric_____; zones_____

Condition: good_____ fair_____ aging_____ poor_____

Buried oil tank_____ Gas meter adequately sized_____

Furnace room ventilation: adequate_____ inadequate_____

Fire-code plasterboard needed: yes_____ no_____

Asbestos insulation on heating pipes and/or boiler_____

❍ **Domestic hot water:** tankless coil thru heating system_____ tankless wall unit_____

separate tank unit_____ capacity_____ recovery_____ age_____

oil_____ gas_____ electric_____

Capacity: adequate_____ marginal_____ inadequate_____ recirculating system_____

Relief valve adequately sized_____

Indirect fired storage type_____

Condition: good_____ fair_____ aging_____ poor_____

❍ **Plumbing:** Pipes and fittings: copper_____ brass_____ iron_____ PEX_____ other_____

Water flow: adequate_____ low_____

Drain lines: cast iron_____ galvanized_____ copper_____ lead_____ plastic_____

Condition: good_____ fair_____ aging_____ poor_____; leakage_____ corrosion_____

Water inlet: copper_____ iron_____ lead_____ plastic_____ inaccessible_____

Septic system: yes_____ no_____

❍ **Well pump:** none_____ jet_____ submersible_____ other_____

Storage tank: yes_____ no_____ Insulation needed: yes_____ no_____

Relief valve needed: yes_____ no_____

Condition: good_____ fair_____ aging_____ poor_____

SWIMMING POOL

In-ground _____ Aboveground _____

- ❍ **Safety fence:** Y___ N___

  Needs repair: Y___ N___ Gate self-closing and self-latching: Y___ N___

- ❍ **Masonry deck:** cracked___ chipped___ uneven joints___ open joints___

  Grab rail___ adequately secured___ Ladder___ adequately secured___

  Slide___ adequately secured___ Diving board___ cracked___ warped___

- ❍ **Wood deck:** cracked___ rotting___ broken___ Handrail: Y___ N___ condition___

- ❍ **Vinyl lined pool:**

- ❍ **Lining:** stained___ tears___ discolored___

  Lining pulled out of edge retainer: Y___ N___ Replacement recommended: Y___ N___

- ❍ **Concrete pool side walls:**

  Tiles___ cracked___ loose___ chipped___ missing___ Plaster___ flaking___ chipped___ cracked___

  Paint___ faded___ flaking___ cracked___

- ❍ **Skimmer:** Weir: moves freely___ broken___ missing___ Strainer basket: damaged___ missing___

- ❍ **Pump:** noisy___ hot to the touch___ water dripping around pump___

  Strainer basket: needs cleaning___

- ❍ **Heater:** operational Y___ N___ Cycles on/off: Y___ N___

  Rust dust and flakes around base of heater: Y___ N___

- ❍ **Filter:** Pressure gauge operational: Y___ N___ Filter needs cleaning: Y___ N___

- ❍ **Cover:** worn___ torn___ damaged___ Repairs needed___ Replacement recommended___

  Comments:_____

  _____

Room_____

Condition

1. **Ceiling/walls:** plaster_____ sheetrock_____ Chinese wallboard_____
   Cracked: yes_____ no_____ Broken: yes_____ no_____
   Evidence of past leakage: wall_____ ceiling_____ peeling and flaking paint/paper_____
   old layers of paint_____ lead-based paint_____ _____
2. **Floor:** wood_____ bamboo_____ laminate_____ tile_____ concrete_____ carpet_____
   other_____squeaks_____ slopes_____ sagging_____ refinish_____ torn/chipped_____
   loose_____ _____
3. **Trim:** cracked_____ chipped_____ missing_____ lead-based paint_____ _____
4. **Electrical outlets:** not observable_____ number_____ should have_____ _____
5. **Doors:** Exterior:_____ weatherstripped: yes_____ no_____ sliding glass_____
   Interior:_____ cracked_____ chipped_____ broken_____ pocket door_____ _____
6. **Hardware** (locks, hinges, knobs, handles): missing_____ needs repair_____ _____
7. **Closets:** yes_____ no_____ number_____ _____
8. **Heating:** radiators_____ baseboard_____ air registers_____ convectors_____
   radiation panels_____ none_____ _____
9. **Fireplace:** yes_____ no_____ cracked/chipped mortar joints_____ needs cleaning_____
   Damper: missing: yes_____ no_____ needs repair: yes_____ no_____
   indication of backsmoking_____ _____
10. **Cabinets/counter:** none_____ kitchen_____ medicine/vanity_____
    cracked_____ chipped_____ loose_____ _____
11. **Plumbing fixtures:** yes_____ no_____ leaks_____ Operational: yes_____ no_____
    Water flow: adequate_____ low_____ Drainage: adequate_____ blockage_____
    Regrouting/caulking needed at tub/shower joints: yes_____ no_____ _____
12. **Exhaust fan:** yes_____ no_____ operational_____ _____

Comments:_____

_____

Room_____

Condition

1. **Ceiling/walls:** plaster_____ sheetrock_____ Chinese wallboard_____
   Cracked: yes_____ no_____ Broken: yes_____ no_____
   Evidence of past leakage: wall_____ ceiling_____ peeling and flaking paint/paper_____
   old layers of paint_____ lead-based paint_____ _____
2. **Floor:** wood_____ bamboo_____ laminate_____ tile_____ concrete_____ carpet_____
   other_____squeaks_____ slopes_____ sagging_____ refinish_____ torn/chipped_____
   loose_____ _____
3. **Trim:** cracked_____ chipped_____ missing_____ lead-based paint_____ _____
4. **Electrical outlets:** not observable_____ number_____ should have_____ _____
5. **Doors:** Exterior:_____ weatherstripped: yes_____ no_____ sliding glass_____
   Interior:_____ cracked_____ chipped_____ broken_____ pocket door_____ _____
6. **Hardware** (locks, hinges, knobs, handles): missing_____ needs repair_____ _____
7. **Closets:** yes_____ no_____ number_____ _____
8. **Heating:** radiators_____ baseboard_____ air registers_____ convectors_____
   radiation panels_____ none_____ _____
9. **Fireplace:** yes_____ no_____ cracked/chipped mortar joints_____ needs cleaning_____
   Damper: missing: yes_____ no_____ needs repair: yes_____ no_____
   indication of backsmoking_____ _____
10. **Cabinets/counter:** none_____ kitchen_____ medicine/vanity_____
    cracked_____ chipped_____ loose_____ _____
11. **Plumbing fixtures:** yes_____ no_____ leaks_____ Operational: yes_____ no_____
    Water flow: adequate_____ low_____ Drainage: adequate_____ blockage_____
    Regrouting/caulking needed at tub/shower joints: yes_____ no_____ _____
12. **Exhaust fan:** yes_____ no_____ operational_____ _____

Comments:_____

_____

Index

A

air admittance valves (AAVs), 116–117
air-conditioning systems, 262–274
  basic components of, 262
  central, 264–272
  cooling capacity, 263–264
  energy considerations, 290–291
  evaporative cooler, 273
  geothermal heating/cooling, 218–219
  heat pump, 272–273
  inspection checklist, 273–274
antennas, 28–29
  inspection checklist, 35
arc fault circuit interrupter (AFCI), 179–180
American Society of Home Inspectors (ASHI)
  Code of Ethics, 343
  glossary of italicized terms, 341–342
  membership categories and requirements, 344
  Standards of Practice, 335–340
asbestos, 295–297
  shingles, 13, 47–48
attic, 114–123
  crawl, 114
  fans, 120
  fire hazards, 117–118
  full, 114
  heating system located, 115
  inspection checklist, 123
  insulation, 115–116, 284–287
  structure, 121–123
  truss, 122–123, 125
  ventilation, 118–119, 287–288
  violations, 116
  water leakage, 117

B

basement, 147–169
  dampness, 154–155
  floors and floor joints, 160–162
  foundation, 147–151
  furnace room, 163–165
  inspection checklist, 168–169
  plumbing, 197–202
  sump pump, 155–156, 161–162
  walls, 159–160
  water seepage, 155–163
bathrooms, 137–141
  electrical outlets, 179
bathrooms *continued*
  inspection checklist, 143–146
  shower diverter, 139
  water pressure and flow, 138–141
  whirlpool tub, 140
bedrooms, 136–137
  closet, 136–137
  inspection checklist, 145
  smoke detectors, 136
Board of Fire Underwriters, 181
boilers, 210, 221–223
  inspection checklist, 245

C

carpenter ants, 106–108
  inspection checklist, 112
caulking, 59–60
  acrylic latex, 60
  butyl-rubber, 60
  inspection checklist, 61
  oil-base, 60
  silicone-base, 60
  windows and weather-stripping, 289
ceilings, 125–128
  inspection checklist, 143–144
  sagging plaster, 125–126

ceilings *continued*
tile, 127–128
water stains, 126
central air, 264–272
blower coil, 269–270
compressor, 265–267
condensate drain line, 268–270
condenser, 267
drain pan, 270–271
ducts, 270–272
evaporator, 267–269
inspection procedure, 273–274
integral system, 264
split system, 264–265
types of, 264
vent stack, 269
cesspool, 187
chimneys, 22–26
chimney-top damper, 25, 135
cricket, 26–27
inspection checklist, 34
saddle (*see* cricket *above*)
chlordane, 95–96
circuit breakers, 174
contracts, 314–315
crawl space, 165–168
conditioned crawl space, 167–168
FHA standards, 165
inspection checklist, 169

D

decks, 76–80
bracing, 78
column support, 77
composite deck, 79–80
free-standing deck, 79
guardrails, 79
inspection checklist, 82
joist supports, 77–78
spacing between planks, 78
domestic water heaters, 247–261 (*see also* water heaters)
doors
exterior, 56–57
flush, 57
inspection checklist for exterior, 61
metal-clad insulated, 57
pocket, 124
solid-core flush, 57
stile-and-rail, 57
storm, 59
drainage, 62–70
curtain drain, 66–67
flood plain, 63
groundwater/water table, 65–67
inspection checklist, 81
plumbing system, 185–186
surface runoff, 63–65
driveways, 39–41
inspection checklist, 41
dry well, 33–34
drywall (*see* plasterboard)

E

efflorescence, 52, 158–160
EIFS (synthetic stucco), 49–50
electrical heating systems, 236–237
space heaters, 237
electrical outlets, 132–134
inspection checklist, 144
electrical system, 170–182
aluminum wiring, 176–177
appliance power requirements, 173
arc fault circuit interrupter (AFCI), 179–180
capacity, 171–173
fuses and circuit breakers, 174–175
ground-fault interrupter (GFI), 179
grounding, 177–178
inlet electrical service, 170–171
inlet service panel box, 175–176
inspection checklist, 181–182
knob-and-tube wiring, 180
low-voltage switching systems, 180–181
outlets (receptacles), 134, 178–180
service switch, 171
tamper-resistant receptacles, 134
violations, 181
electromagnetic fields (EMF), 301–302
energy considerations, 283–291
engineered lumber, 153–154
environmental concerns, 292–303
asbestos, 295–297
environmental concerns *continued*
electromagnetic fields (EMF), 301–302
formaldehyde, 300
lead poisoning, 298–300
leaky oil tanks, 300–301
radon, 292–295
water contamination, 297–298

F

Federal Housing Administration (FHA), crawl space standards, 165
fences, 80–81
inspection checklist, 82
fireplaces, 134–136, 289–290
chimney-top damper, 25–26, 135
creosote, 135
gas-fired, 136
inspection checklist, 144
recommended types of wood, 290
soot (*see* creosote *above*)
vent-free, 136
flood plain, 63
floors, 128–131
bamboo flooring, 129–130
carpet-covered (new), 129
engineered hardwood floor, 129
inspection checklist, 144
laminate flooring, 129
forced hot-water heating systems, 221–227
advantages/disadvantages, 223
controls, 225–227
distribution piping, 223–224
domestic water heater, 226–227
panel, 224–225
pressure/temperature gauge, 227
radiators, 224
relief valve, 227
zone control, 226
forced warm-air heating systems, 215–218
air distribution systems 216–218
supply registers and return grille, 216–218

formaldehyde, 300
foundation, 147–151
bridging, 154
cracks, 149–150
girders, 151–152
inspection checklist, 168
settlement, 148–149
structural support framing, 151–154
Superior Walls, 150–151
furnaces, 210
condensing, 215–216
furnace room, 163–165, 169
inspection checklist, 245
pulse-combustion, 216
fuses, 174–175

G

garages, 84–94
attached, 84–90
detached, 90–93
door photoelectric eye, 88–89
door restraining cable, 88–89
doors, 88–89
electricity, 89, 92–93
exterior of detached, 90–91
fire and health hazards, 84–85
flood potential, 88
general considerations, 89–90
heat, 92
inspection checklist, 93–94
interior of detached, 91–92
plumbing problems, 86–88
gas burner heating systems, 235–236, 244
inspection checklist, 246
geothermal heating/cooling, 218–219
gravity hot-water heating systems, 219–221
expansion tanks, 220
gravity warm-air heating systems, 213–215
green home technology, 307–311
groundwater, 65–67, 202
high level, 155–156
gutters and downspouts, 29–34
built-in, 30
exterior-mounted, 30–32
inspection checklist, 35
types of material, 30–31
gypsum board (*see* plasterboard)

H

hallway, 142–143
inspection checklist, 146
heat pump, 218, 272–273
heating systems, 209–246
central, 210–211
combustion air, 239
direct venting, 238–239
electrical, 236–237
energy considerations, 290–291
forced hot-water, 221
forced warm-air, 215
gas burners, 244
geothermal heating/cooling 218–219
gravity hot-water, 219–221
gravity warm-air, 213–215
heat pump, 218, 272–273
hot-water, 219–227
hybrid, 231
hydro-air, 231–232
inspection checklist, 244–246
inspection procedures, 237–244
low-water cutoff, 227, 230
oil burners, 243–244
registers and radiators, 211
space heaters, 236–237
steam, 227–231
thermostat and master shut-off, 211–212
venting, 238–239
warm-air, 212–219
home inspection
contracts, 314–315
electromechanical systems, 4
exterior, 2–3
final, 4
interior, 3–4
limitations, 312–313
procedures, 1–4
professional, 312
quiz, 319–333
quiz answers, 334
warranties (*see* warranties)
worksheets, 348–354
home inspector requirements, 316–318
hot-water heating systems, 219–227
inspection checklist, 245–246
inspection procedures, 241–242
hybrid heating systems, 231
steam–hot water, 231

I

insects
carpenter ants, 106–108
inspection checklist, 112–113
powder-post beetles, 108–109
termites, 95–106
wood-destroying, 95–109
instantaneous water heaters, 254, 259
insulation, 284–287
attic, 115–116
determining amount of, 285–286
flexible, 284
foamed-in-place, 284
jacket for water heaters, 287
loose-fill, 284
R-value, 285
recommended amounts of, 286
types of, 284
urea formaldehyde foam (UFFI), 284, 300
vapor barrier, 286–287
interior rooms, 124–143
bathrooms, 137–141
bedrooms, 136–137
cracks (truss uplift), 125
electrical outlets, 132–134
floors, 128–131
hallway, 142–143
inspection checklist, 143–146
kitchen, 141–142
kitchen island sink, 142
staircase, 143
walls and ceilings, 125–128

K

kitchen, 141–142
inspection checklist, 145
loop vent, 142

L

landscaping, 74–76
decks, 76–80
drainage, 62–65
fences, 80–81
foundation settlement, 148–149
inspection checklist, 81–83
lawn, 74–76

landscaping *continued*
lawn sprinkler systems, 192–193
retaining walls, 70–74
shrubs, 75–76
trees, 76
lead poisoning, 298–300
lightning protection, 29

M

moisture meter, 1, 126
mold, 302–303

O

oil burner heating systems, 233–235
inspection procedures, 243–244
oil tanks
buried, 300–301
interior location, 234
leaking, 300–301

P

patios, 38–39
inspection checklist, 41
plasterboard, 125
plumbing, 184–207
basement, 197–198
brass pipes, 199
curb valve, 184
distribution piping, 198–199
drainage pipes, 199–202
drainage system, 185–186
fixtures, 185, 193–194
fresh air vent, 185–187, 192
house service main, 185
inspection checklist, 145, 207–208
island sink vent, 142
lawn sprinkler systems, 192–193
PEX, 195–196
pipes, 195–199
polybutylene, 196–197
problems in garages, 86–87
septic systems, 193, 187–192
sewage ejector pump, 201–202
shower diverter, 139
sink trap, 139–140
sump pumps, 156, 161–162
vent stack, 26–27, 116–117, 191–192
plumbing *continued*
wall hatch, 194–195
waste disposal system, 186–192
water pressure and flow, 138–139, 194
water supply and distribution, 184–185
water-supply pipes in basement, 197–198
well-pumping systems, 202–207
powder-post beetles, 108–109
inspection checklist, 112

R

radon, 292–295
EPA guidelines for residential, 293
water supply contamination, 297–298
retaining walls, 70–74
inspection checklist, 81
types of, 70
roofs, 6–20
built-up (BUR), 17–19
discolored, 10
flat, 16–20
hatch, 28
ice dam, 8
inspection checklist, 20–21, 34–35
metal, 15–16, 19–20
pitched, 6–8
roll roofing, 19
shingles (*see* shingles)
single-ply membrane, 19
structures and projections, 22–34
valley construction, 9
vents, 27–28

S

screens, 58–59
septic tank, 187–192
alternating drainfields, 190–191
bacterial cleaner, 190
cleaning, 190
mound systems, 191–192
water softeners, 190
sewage ejector pump, 201–202
sheathing paper, 43–44
shingles, 8
asbestos-cement, 13, 47–48
asphalt, 10–12
clay tiles, 14–15
life span of, 11
on pitched roofs, 6–8
slate, 13–14
synthetic slate, 14
wood, 44–45
wood and shakes, 12–13
sidewalks, 36
front and side pathways, 37
inspection checklist, 41
siding, 44–49
aluminum, 46–47
asbestos-cement shingles, 47–48
asphalt, 48–49
EIFS (synthetic stucco), 49–50
exterior, 44–49
fiber-cement siding, 48
hardboard, 46
inspection checklist, 60–61
masonry veneer, 50–52
mineral-fiber shingles, 47–48
plywood panels, 46
stucco, 49
synthetic stucco (EIFS), 49–50
vinyl, 47
wood, 44–46
wood boards, 45–46
wood shingles/shakes, 44–45
skylights, 28
smoke detectors, 136, 143
soil erosion, 63–64
space heaters, 236–237
electric, 237
gas, 237
staircase, 143
steam heating systems, 227–231
advantages/disadvantages, 231
controls, 229–231
distribution piping, 228–229
domestic water heater, 231
inspection checklist, 246
inspection procedures, 242–243
steps
entry, 37–39
inspection checklist, 41
interior staircase, 143
stucco, 49
sump pumps, 156, 161–162

swimming pools, 275–282
accessories, 280
concrete, 275–276
equipment, 278–279
inspection checklist, 282
inspection procedure, 280–282
preformed fiberglass, 277–278
vinyl-lined, 276–277
synthetic stucco, 49–50

T

termites, 95–106
bait, 83
dry-wood, 105
Formosan, 106
inspection checklist, 112
subterranean, 98–105
wood damaged by, 102
trim
exterior, 52–53
interior, 128

V

vents
air admittance valves (AAVs), 116–117
condensate drain line connected to, 269–270
loop vents, 142
stacks, 26–27, 115–117, 191–192

W

walls
basement, 159–160
Chinese dry wall, 128
exterior, 43–52
interior, 125–128
load-bearing, 43
masonry, 51–52
mold-resistant drywall, 126
siding (*see* siding)
studs, 43
Superior Walls, 150–151
veneer, 43, 50–51
water stains, 125–128
wood-framed exterior, 43–44
warm-air heating systems, 212–218
advantages, 213
disadvantages, 213
inspection procedures, 239–241
warranties
manufacturers', 314
private home inspection, 314
real estate, 313–314
waste disposal system, 186–191
cesspool, 187
leaching field, 188
septic tank, 187–188
water
contamination of, 297–298
ground, 65–67, 202–203
high groundwater level, 155–156
leaking into attic, 117
pressure and flow, 138–141
seepage inspection checklist, 168–169
seeping into basement, 155–156
seeping through foundation walls, 156–158
stains on ceilings, 125–126
supply requirements, 207
table, 65
usage rates, 207
water heaters
capacity and recovery, 255–256
determining age of, 255
domestic, 247–260
exhaust stack, 252
expansion tank, 250–251
indirect-fired storage, 260
inspection checklist, 261
instantaneous, 259
insulation jacket for, 287
operational inspection, 252–254
pressure/temperature-relief valve, 249–251
recirculation, 254
relief valve, 249–251
replacement, 254–255
water heaters *continued*
reversed connection, 248–249
rumbling noise, 251–252
spill switch, 253
tank, 248–256
tankless (coil), 256–258
tankless (coil) inspection procedures, 258–259
tankless (wall-mounted) heater, 259
weep holes, 51
well pumps, 202–206
jet, 203–204
piston, 203
submersible, 204
wells, 202
general considerations, 206–207
inspection checklist, 207
pressure switch and gauge, 206
storage (pressure) tanks, 205–206
windows, 53–56, 131–132
awning, 54
casement, 54
caulking and weather-stripping, 289
double-hung, 53
fixed-pane, 55
frames, 55
glass used in, 55
horizontal sliding, 53
inspection checklist, 61, 144
jalousie, 54
repairing broken, 131–132
screens, 58–59
storm, 58, 288–289
thermal-pane, 132–133
wood
insects that destroy, 95–109
rotting, 109–112
wood-burning stoves, 289–290
recommended types of wood, 290
(*see also* fireplaces)

Y

yard (*see* landscaping)

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CONTENTS

	Acknowledgments	v
	Introduction	1
CHAPTER 1	Review of Math Skills	7
CHAPTER 2	Fractions, Decimals, and Percentages	20
CHAPTER 3	Commissions, Growth Rates, and Net Proceeds	32
CHAPTER 4	Legal Descriptions and Lot Size	45
CHAPTER 5	Real Estate Taxes	56
CHAPTER 6	Time Value of Money (TVM)	64

CHAPTER 7	Mortgage Calculations Using TVM	87
CHAPTER 8	Appreciation and Depreciation	114
CHAPTER 9	The Closing and Closing Statements	129
CHAPTER 10	Real Estate Appraisal	145
CHAPTER 11	Real Estate Investment Analysis	174
CHAPTER 12	Risk in Real Estate	202
CHAPTER 13	Leases	223
	Final Exam	235
	Glossary	251
	Quiz Answers	265
	Final Exam Answers	272
	Index	275

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Introduction

Real estate math is scary for some people. This does not have to be the case. In this book we revert back to some math principles we mastered in elementary school. In addition we brush up on some calculations we performed in junior high school and high school. Finally we address some topics that are usually discovered in college-level real estate courses. This book is not designed for people who have already taken those college-level courses; it is designed for the students who have forgotten some (or most) of the math they took as a student in the past, but are sincere in their desire to be able to analyze real estate from all the different viewpoints. This includes the viewpoint of the buyer, the seller, the lender, the appraiser, and the investor. I would certainly not discourage those who have taken college-level courses from reading the book, however. It will be an excellent review of some topics and may well introduce a couple of new ones to you.

This book is targeted at a broad group of readers. It will certainly be beneficial for those who are interested in obtaining their real estate broker's or salesperson's license. The individual investor would also be well advised to read this book.

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Real estate students at the community college and university level would also profit from reading this book. Since I have been all of these people myself—a real estate salesperson and broker, a real estate investor, and a real estate student—I understand the needs of each of these groups of people. Now, as a real estate professor, I see the need for a book such as this to benefit the groups of people that I have belonged to.

There is much that is exciting about real estate analysis, and much of it is dependent on a firm math background. If you don't have that background right now, don't worry. You will have it by the time you finish this book. I have attacked this book not from the standpoint of a math expert. I am very much a practitioner when it comes to math, not a theory guy. In order for math to make sense to me, I have to be able to use it for something. If you are interested in math theory, you'd better find another book. If you are interested in how math can help you analyze real estate investments, find a quiet place, some paper, a pencil, and a financial calculator. Then hang on; it's going to be wild ride.

Review

You will find that this book is divided into 13 chapters that range from simple review to challenging new material. The first chapter is a review of math skills and addresses such concepts as equations and units of measure. We discuss what makes an equation an equation and also some relevant units of measure that are used in real estate. We close the chapter with a brief discussion of the financial calculator and how that will be used in future chapters.

Parts of a Whole

The second chapter addresses the concepts of fractions, decimals, and percentages. The manipulation of fractions, including the addition, subtraction, multiplication and division of those fractions is discussed in detail. This includes the manipulation of proper fractions, improper fractions, and mixed numbers. Later in the chapter we look at converting those fractions to decimals and percentages. These percentages are important since much of real estate math is dealing with commission rates, rates of return, interest rates, and discount rates, all of which are percentages.

Commissions

In Chapter 3 the topics of commission and growth rates are studied. This is an extension of the percentage discussion that begins at the end of Chapter 2. In addition to commission rates, which are of importance to buyers, sellers, brokers, and salespeople, growth rates are discussed. Both average growth rates and compound growth rates are analyzed. If you don't know the difference between average and compound growth rates, you need me; buy the book. If you do know the difference between the two but you don't know how to calculate them, you need me; buy the book.

Big Backyard?

The fourth chapter is called "Legal Descriptions and Lot Size: Does This Drawing Make My Backyard Look Big?" There are three types of legal descriptions that are the most commonly used in the United States. They are the metes and bounds system, the government survey system, and the subdivision plat system. The first one dates back to medieval England; the second, back to the days of the Louisiana Purchase; and the third, to relatively more recent times. In addition to these systems of describing land, we use some of the tools from the first chapter to calculate the area of a lot and the volume of a structure.

Real Estate Taxes

Chapter 5 is all about real estate taxes and covers such topics as ad valorem taxes, assessed value, estimated market values, mill rates, and state deed taxes. We address the concept of how value is determined for tax purposes. We look at the three approaches for appraising property, although in a much more cursory way than in Chapter 10 on real estate appraisal. Three different types of tax rates are analyzed—the nominal tax rate, the average tax rate, and the effective tax rate.

Time Value of Money

In Chapter 6, "Time Value of Money," we start to hit the mother lode of the book. As I tell my students, this stuff isn't important. It's critical! Once you understand

time value of money, you understand finance, you understand investments, you understand appraisal, and you understand life. We will learn, mark, and inwardly digest the concepts of present value, future value, ordinary annuity, annuity due, net present value, internal rate of return, sinking fund payment, and payment to amortize. Your financial calculator will get its initial workout in this chapter. Don't worry if you don't understand your financial calculator yet. By the time you are done with this book, you will be playing that instrument like Johann Sebastian Bach played the organ.

Mortgages

We continue using the time value of money techniques when we move into the mortgage calculations in Chapter 7. Mortgage payment calculations and principal balance calculations will become second nature after you finish reading this chapter and working the associated problems. The impact of discount points and other prepaid items on loan yields are focused on. Those yields are important both from the lender's point of view and from the borrower's point of view. Loan-to-value ratios are discussed, and homeowner's equity is calculated. Finally, borrower qualifications and mortgage underwriting problems are tackled.

Appreciation and Depreciation

Chapter 8 is "Appreciation and Depreciation: You Win Some, and You Lose Some." The increase in property value over time is what we refer to as appreciation. The impact of appreciation on the cost of owning is one of the major factors leading over 67 percent of the population in the United States to own rather than rent their personal residence. We will look at estimating the value of a residence given a certain rate of appreciation. On the other end of changes in value is the concept of depreciation. Depreciation in two forms are addressed in the chapter. First of all the depreciation as it relates to real estate appraisal is discussed. This form of depreciation is a loss in value due to any cause, and it comes into play in the cost approach of the appraisal process. The second form of depreciation that we look at is the depreciation for tax purposes that is an important element in real estate investment analysis.

Closing Statements

The ninth chapter is about closings and closing statements. The closing statement is the actual accounting of the purchase/sales transaction. It tracks the expenses and the prepayments associated with the transaction. As much as it gives me the willies to talk about accounting (my wife is an accounting professor), in the closing statements we track both the buyer's and the seller's debits and credits. The bottom line in the buyer's closing statement is how much additional cash they have to bring to the closing. The corresponding line on the seller's statement will tell the seller how much money he or she will be taking home from the closing. Topics de jour include expenses, prepaid items, accrued items, and prorated items.

Appraisal

Real estate appraisal is the next topic in the book, and it appears in Chapter 10. The math portion of the sales comparison approach and the cost approach are pretty much a function of adding and subtracting. I feel confident you didn't buy this book in order to review adding and subtracting whole numbers and dollars and cents. That being the case, I focus most of my time and energies in this chapter on the different forms of the income approach. These include the gross rent multiplier, the income capitalization, and the discounted cash flow methods. Within the discussion of the income capitalization method are methods of calculating the capitalization rate in two different ways. One is through market extraction, and the other is called the band of investment method. Hopefully, when we finish up on the band of investment method, you will respond the same way I did when I first saw it. Wow! That is what I said, and that is what my students say, well the bright ones, anyway.

Real Estate Investment

An investor will only pay the present value of all cash flows to be received, discounted at the required rate of return. This is pretty much the heart of Chapter 11. It draws extensively upon Chapter 6, "Time Value of Money," and Chapter 10, "Real Estate Appraisal." The topics focused on are cash flow estimation, net present value, and internal rate of return as they apply to

real estate investment. Once you have completed this chapter, you will be able to use these tools to analyze a student rental investment, a single-family home rental, a 4-unit building, a 5,000-unit apartment complex, or the Mall of America. The same concepts and analyses apply to all types of property.

Risk

Risk is, in effect, the probability of achieving an undesired outcome. From an investor's viewpoint that would be achieving a rate of return that is lower than the expected rate of return. For some reason investors don't mind achieving a rate of return higher than was expected. Rather, it is the downside risk they are concerned with. In Chapter 12 we take a close look at the impact that risk has on the investor, the appraiser, and the lender. We also look at the impact of risk on interest rates. Expected inflation is built into short-term and long-term interest rates, so we also look at the method of extracting expected inflation rates from those interest rates.

Leases

The chapter on leases gives the reader a picture of the importance of the lease in a real estate investment. Different types of rent are discussed including gross rent, net rent, percentage rent, overage rent, average rent, and effective rent. The final two that are listed, average rent and effective rent, are calculated in different lease scenarios. There are differences in how the rent is charged in residential property, office property, warehouse property, and retail property. The concepts and calculations of leasehold value and leased fee value are also addressed. You have no real estate investment until you have tenants sign a lease and start paying rent, so although this chapter is the last in the book, it could very easily be the first chapter.

The Financial Calculator

From Chapter 6 through to the end of the book, we are very dependent on the use of the financial calculator. When I tell my students in class that the world revolves around the time value of money, they question my sanity. As you will see from the latter half of the book, much of what goes on in the finance and real estate worlds is closely tied to this concept. Don't worry if you are uncomfortable with the calculator now. You will be close friends with it soon.

CHAPTER 1

Review of Math Skills

Math? I Took Math Once

Operations

As a quick review of your very first math course, there are four basic operations in math calculations: addition, subtraction, multiplication, and division. The author is confident that you are familiar with these processes, which are used repeatedly in this book. Knowing when to add, subtract, multiply, and divide is one of the keys to successful real estate math calculations.

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Units of Measure

The units of measure used in real estate math calculations can be varied. Lot sizes and building sizes use feet, or more precisely, square feet as a basic unit of measure. If we take a storage shed measuring 6 feet by 6 feet, its area would be 6 feet × 6 feet = 36 feet^2 or 36 square feet. Notice that both the 6 is squared and the unit of measure, or feet, is squared. You will see both lot sizes and building sizes described in number of square feet, which is a measure of size for the area of a lot or building.

Some basic units of measure that are used in real estate include:

1 foot = 12 inches
1 yard = 3 feet
1 acre = 43,560 square feet
1 section = 640 acres = 1 square mile
1 township = 36 sections
1 mile = 5,280 feet
1 mile = 8 furlongs

As a subset of feet, we may look at inches, for smaller-sized objects. Surface area calculations result in answers with units of measure stated in square feet, square yards, or square inches. In the case of a rectangle you take the length times the width to get the area. If you are measuring the area of a square, as in the previous paragraph, you also take the length times the width, it just so happens these lengths are both the same. By definition the length and the width are the same in the case of a square.

When measuring volume, the unit of measure is not square feet, square inches, or square yards, but rather it is cubic feet, cubic inches, or cubic yards. That is because in order to calculate the volume of a three-dimensional object, you take the length times the width times the height. If our cube is 6 inches by 6 inches by 6 inches, the calculation becomes 6 inches × 6 inches × 6 inches = 216 inches^3 or 216 cubic inches.

Other units of measure that we may come across in real estate would include acres. One acre is equal to 43,560 square feet. Regarding the government survey system of legal descriptions, one township is made up of 36 sections of land. One section is 1 square mile and is made up of 640 acres of land. If that is the case, how many square feet are there in one section?

Equation 1.1

$$640 \times 43{,}560 \text{ square feet} = 27{,}878{,}400 \text{ square feet}$$

So there are 27,878,400 square feet in one section of land. Then how many square feet are there in a township?

Equation 1.2

$$36 \times 640 \times 43{,}560 \text{ square feet} = 1{,}003{,}622{,}400 \text{ square feet}$$

It appears that there are over 1 billion square feet in one township.

Equations

An *equation* is a mathematical statement that includes an equal sign. The values on either side of the equal sign must be equivalent to each other. If they are not equivalent, then the statement is not true. The following statement is not true: $35 = 5 \times 6$. That is, 35 is not the same as 5×6. When you take 5×6, you do not get an answer of 35; you get an answer of 30. In order to make the statement true, you would need to write $30 = 5 \times 6$, or you could write $35 = 5 \times 7$. In either case, the statement being made is true, so they are both valid equations. Thirty is equivalent to 5×6 and 35 is equivalent to 5×7.

Equations are the tools that are used to solve problems. The problem may be a long complex word problem, or it could be a short straightforward calculation. In either case an equation can be used to solve the question at hand.

In algebra we learned that an equation can be altered, and as long as we do the same thing to both sides of the equation, it will still be an equation. If we are using the equation from the first part of this section:

Equation 1.3

$$35 = 5 \times 7$$

and we divide both sides of the equation by 5, the result is:

Equation 1.4

$$35/5 = (5 \times 7)/5, \text{ which says, } 7 = 7$$

so our equation is still a true statement.

Some of these types of problems are addressed in this book. If *algebra* scares you, don't worry. That word will not be mentioned again … too much.

ORDER OF OPERATIONS

When there is a problem that requires more than one calculation, the order of operations can be dictated through the use of parentheses. The calculation within

the parentheses is performed first, before the other(s). In the statement below:

Equation 1.5

$$(7 \times 5) + 5 = 40$$

there is a multiplication process called for as well as an addition process. Since the multiplication process is within the parentheses, that is the calculation that is made first. Thus make the 7×5 calculation and get an answer of 35, and then add the 5 for an answer of 40. If the statement did not have the parentheses and looked like this:

Equation 1.6

$$7 \times 5 + 5 = 70$$

the calculation may progress in a different manner. If we add the $5 + 5$ first, we get 10. And if we then take the 10×7, we get an answer of 70. As you can see, the parentheses are very important because they indicate which process, or calculation, should be performed first. Without the parentheses a completely different answer would result (in the example, 40 instead of 70).

EQUATIONS FOR AREA AND VOLUME

The calculations of area and volume are referred to earlier in the chapter. There are specific equations to use in the calculation of each of these items. The equation for finding the area of a rectangle or square is shown in Equation 1.7.

Equation 1.7

$$\text{Area} = \text{L} \times \text{W}$$

In Equation 1.7, L represents the length of one side of the rectangle, and W represents the width of the rectangle. To obtain the area of the rectangle, simply multiply the length times the width. (See Figure 1.1.) As mentioned previously, if we are finding the area of a square, the length and width are the same, so the area can be obtained by taking one side times itself, or the side squared. If the unit of measure of our rectangle or square is feet, then the answer to our calculation is given in square feet. If a lot measures 40 feet by 150 feet, the area of that lot is shown in Equation 1.8.

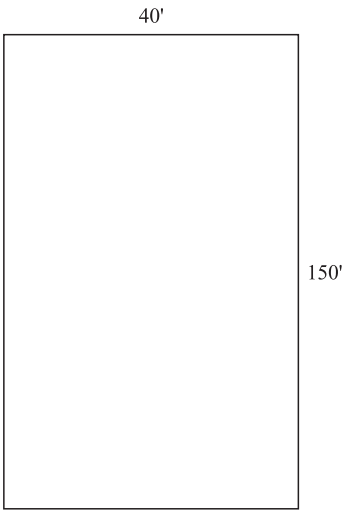

Figure 1.1 Rectangle

Equation 1.8

$$\text{Area} = 40 \text{ feet} \times 150 \text{ feet} = 6{,}000 \text{ square feet}$$

The volume of a rectangular box, or cube, is found by multiplying the length times the width times the height, as shown in Equation 1.9.

Equation 1.9

$$\text{Volume} = \text{L} \times \text{W} \times \text{H}$$

If the unit of measure in our calculation is feet, then our answer is given in cubic feet. If a shed is square in shape and is a single floor with measurements of 6 feet by 6 feet and it has a 6-foot-high ceiling, the volume calculation would look like Equation 1.10 (see Figure 1.2.)

Equation 1.10

$$\text{Volume} = 6 \text{ feet} \times 6 \text{ feet} \times 6 \text{ feet} = 216 \text{ cubic feet}$$

The area of a circle is only somewhat more complex in that we must use a number called pi, or the Greek symbol π. Pi (π) is equal to approximately 3.14. The area of a circle is as follows:

Equation 1.11

$$\text{Area} = \pi(r^2)$$

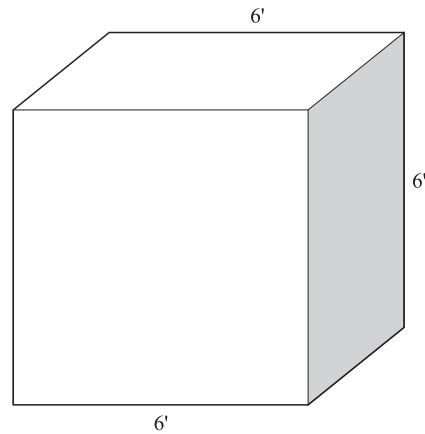

Figure 1.2 Cube

where r is equal to the radius of the circle and π, or pi, is equal to 3.14 rounded to two decimal places. (See Figure 1.3.) The radius is the distance from the center of the circle to the outside of the circle itself, or one half of the diameter of the circle. If we wanted to find the area of a circle that has a radius of 20 feet, the calculation would be as follows.

Equation 1.12

$$\text{Area} = 3.14(20^2) = 3.14(400) = 1{,}256 \text{ square feet}$$

The area of a circle does not come up too often in real estate, but it may arise in an agricultural setting where the square footage covered by an irrigation system must be found.

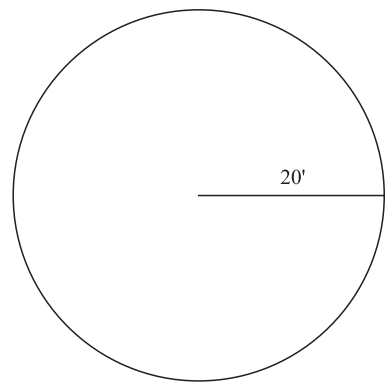

Figure 1.3 Circle

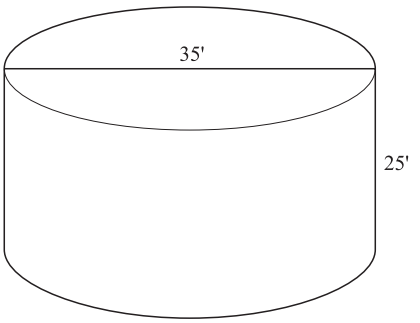

Figure 1.4 Cylinder

The volume of a cylindrical tube, like a silo, would be the area of the base times the height. (See Figure 1.4.) The calculation would look like this:

Equation 1.13

$$\text{Volume} = \pi(r^2) \times \text{H}$$

It is simply the area of the circular base times the height. If a silo is 35 feet from side to side (diameter = 35 feet) and stands 25 feet tall, what would its volume be? The calculation would look like this:

Equation 1.14

$$\text{Volume} = 3.14(35/2)^2 \times 25 = 3.14(17.5)^2 \times 25 = 3.14 \times 306.25 \times 25$$
$$= 24{,}040.63 \text{ cubic feet}$$

Recall that the calculation of the area of a circle calls for the radius squared times π, and in the preceding problem we were given the diameter. As a result, in Equation 1.14 we needed to take the diameter, 35, and divide it by 2 to get the radius of 17.5.

A trapezoid is a four-sided figure in which the corners are not all right angles (90 degrees) and the bases are not the same length but they are parallel to each other (see Figure 1.5). The calculation for the area of a trapezoid is as follows.

Equation 1.15

$$\text{Area} = {}^1\!/_2\,(\text{sum of the bases}) \times \text{H}$$

The H in this case is the perpendicular distance between the bases, not the length of the shorter sides. The area of a trapezoid (see Figure 1.5) that has bases of

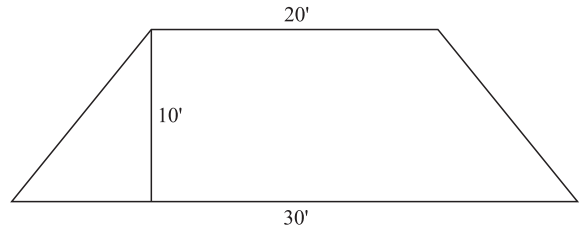

Figure 1.5 Trapezoid

20 feet and 30 feet and a height of 10 feet would be:

Equation 1.16

$$\text{Area} = 1/2\,(20 + 30) \times 10 = 1/2 \times 50 \times 10 = 250 \text{ square feet}$$

The Financial Calculator

Starting with Chapter 6, "Time Value of Money," this book depends strongly on the use of the financial calculator. This time-saving device has replaced the cumbersome time value of money tables that had been used in the past. In real estate, the tables were referred to as the *six functions of a dollar*. The subtitle of Chapter 6 makes reference to the equations that made use of the tables, "Six Equations That Will Change Your Life." The calculator solutions that are used in the book have reduced the dependence on the equations. However, for someone who truly wants to understand time value of money, understanding the equations is a prerequisite.

THE TI BUSINESS ANALYST II PLUS CALCULATOR

A number of the calculations that are addressed in this book are simplified through the use of a financial calculator. Chapter 6 depends extensively on this calculator. Subsequent chapters also make much use of the financial calculator. While the calculations can be made using a standard four-function calculator and a set of present value/future value tables, the financial calculator makes the job much easier. In those chapters that make use of the financial calculator, you will see the solutions to the problems spelled out in calculator keystrokes. The calculator that is used is the Texas Instruments Business Analyst II Plus financial calculator. It is probably the most cost-effective financial calculator in use today. It is readily

available in office supply stores and college bookstores. Some of the important keys for us are described in the following section.

IMPORTANT CALCULATOR KEYS

The BA II Plus calculator has many abilities that we do not address in this book. The ones we primarily focus on are the time value of money keys and the cash flow keys. The time value of money keys are in the third row from the top of the calculator and are as follows: [N] [I/Y] [PV] [PMT] [FV]. The [N] key stands for the number of compounding periods in the calculation. The [I/Y] key is the interest

Figure 1.6 The Texas Instruments BA II Plus calculator

Texas Instruments BA II Plus™ image used with permission

rate per year. The [PV] represents the present value in a problem. The [PMT] is the payment in an annuity calculation, and finally the [FV] is the future value calculation. These keys are put into context in the time value of money (TVM) discussion in Chapter 6.

Other keys that we make use of are in the first row. These include the [cpt] key, which tells the calculator to compute a value. The [enter] key is used to enter a value. The up and down arrow are used to move up and down within a cash flow worksheet that we use in the real estate investment chapter (Chapter 11). The [on/off] key is fairly self-explanatory.

The second row of keys is also used in the investment chapter as well as others. The [2nd] key moves us up to the second level of many of the keys. You will notice in the photo of the calculator in Figure 1.6 that the second level of the [FV] key says CLR TVM. If we hit the [2nd] key followed by the [FV] key, that clears out the TVM registers. In other words that process puts zeros in those TVM registers so that we can start from scratch on a new problem. If you don't clear out those registers and you move from one type of problem to another, an old number from the previous problem will try and work its way into the new problem and end up giving you a bogus answer. The [CF] key stands for cash flows, and we use that key to get into the cash flow worksheet in our investment analysis. The [NPV] key is used for calculating the net present value of a series of cash flows. The [IRR] is used when we want to calculate the internal rate of return of a series of cash flows. (The terms *NPV* and *IRR* are defined further in Chapter 11.)

The worksheet can be cleared after an NPV problem or an IRR problem by hitting the [2nd] key followed by the [CLR WORK] key in the lower left-hand corner of the calculator. Additional keys are described as their use becomes necessary.

Quiz for Chapter 1

1. The home you are selling has a rectangular lot with dimensions of 75 feet by 150 feet. What is the area of the lot?
   a. 10,750 square feet
   b. 12,000 square feet
   c. 11,250 square feet
   d. 11,750 square feet

2. Your driveway is 20 feet by 20 feet. How many square feet of pavement will you have if you have the driveway tarred?
   a. 400 square feet
   b. 4,000 square feet
   c. 600 square feet
   d. 400 cubic feet

3. If your garage has a flat roof, what is its volume if its dimensions are 22 feet by 24 feet and it stands 8 feet tall?
   a. 528 square feet
   b. 528 cubic feet
   c. 4,224 square feet
   d. 4,224 cubic feet

4. What is the answer to the following calculation? $7 + (3 \times 2) - 4 = ?$
   a. 16
   b. 9
   c. 10
   d. 14

5. Your neighbor's lot is trapezoidal in shape. The two bases are 50 feet and 80 feet in length. The perpendicular distance between the bases is 100 feet. What is the area, in square feet, of your neighbor's lot?
   a. 400,000 square feet
   b. 13,000 square feet
   c. 6,500 square feet
   d. 13,000 cubic feet

6. You are planning to make a skating rink in your back yard. You put a stake in the center of the yard and by using a rope you measure a circle

with a 15-foot radius. What will be the area of your skating rink in square feet?
a. 225 square feet
b. 706.5 square feet
c. 225 cubic feet
d. 94.2 square feet

7. A farmer is building a new storage bin for grain storage. The base of the bin will be a circle with a 28-foot diameter. If the bin is 30 feet tall, what will its volume be?
a. 2,461.8 cubic feet
b. 615.4 cubic feet
c. 18,463.2 cubic feet
d. 615.4 square feet

8. The floor plan on your new house looks like the one pictured below in Figure 1.7. What is the square footage of the first floor?
a. 1,300 square feet
b. 1,200 square feet
c. 1,600 square feet
d. 1,500 square feet

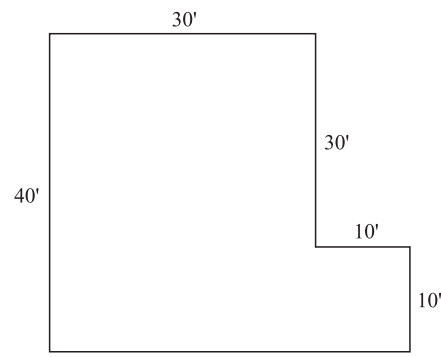

Figure 1.7

9. Your son and daughter are coming home from Iraq this weekend, and you would like to tie a yellow ribbon around the entire house shown in Figure 1.7. How much ribbon do you need to buy if you think you will need an extra 6 feet to tie the bow?
a. 1,306 feet
b. 156 feet

c. 166 feet
d. 126 feet

10. The lot you recently sold had a sale price of $65,000. The lot had a front footage of 80 feet and a depth of 165 feet. What was the price per square foot it sold for and the price per front foot?
a. $4.92 and $393.94
b. $393.94 and $812.50
c. $80.00 and $393.94
d. $4.92 and $812.50

2

CHAPTER

Fractions, Decimals, and Percentages

Which One of These Is Not Like the Others?

A large portion of math is involved with calculating and manipulating parts of a whole. These parts may be fractions, they may be decimals, or they may be percentages. Real estate is no different. You may be dealing with 1/2 of an acre, or an operating expense ratio of 0.35, or calculating 6 percent of the sale price. In each case we are dealing with a part of a whole something. The greater

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your ease in moving from one measuring unit to another, the greater is your chance of success in working in real estate.

Fractions

There are a couple of different ways to look at a fraction, and the best way for you to look at a fraction is the way that makes the most sense to you. The first way to look at a simple fraction (a fraction with a value of less than 1) is by analyzing both the numerator (top number) and the denominator (bottom or "down" number). The denominator tells us how many parts our whole is divided into. If the fraction is $3/4$, that tells us that our whole item is divided into four parts. The numerator tells us how many of those parts we are actually dealing with. Again if our fraction is $3/4$, the numerator of 3 tells us that we are only dealing with 3 of those 4 parts that the whole is divided into. If the fraction is $1/2$, it says that our whole item is divided into 2 parts and that we are currently looking at only 1 of those parts. If the fraction is $2/2$, then the item is divided into two parts, and we are looking at both of them. So if the fraction is $2/2$ we are looking at 2 of 2 parts, in other words we are looking at the whole item, so $2/2 = 1$. Whenever the numerator and denominator are the same, the value of the fraction is the whole number 1. Thus, the value of each of these fractions is 1: $2/2$, $3/3$, $5/5$ and $1{,}000/1{,}000$.

MIXED NUMBERS

Another way to look at a fraction is that a fraction is a division problem waiting to happen. If the numerator is greater than the denominator (or the value is greater than 1), the solution or answer to the division problem will be a mixed number. By performing the operation that is called for, we are beginning to manipulate a fraction. In Equation 2.1,

Equation 2.1

$$5/4 = 5 \div 4 = 1\,1/4$$

you divide the 5 by 4, and a you get the whole number 1, plus a remainder of 1 which becomes the numerator, and 4 is your denominator, so the answer is $1\,1/4$. This is referred to as a *mixed number,* because there is a whole number and a fraction. If we want to convert this back to a fraction, we take the denominator, 4,

times the whole number, 1, and add the numerator 1 and we get $5/4$. If we take the fraction $7/2$, we could convert that to a mixed number by dividing 7 by 2 and get the answer 3 plus a remainder of 1 (which becomes the numerator over the denominator of 2) to give us the mixed number $3\,1/2$. That $3\,1/2$ in turn could be converted to a mixed number by taking the denominator of 2 times the number 3 to get 6, plus the numerator of 1 gives us $7/2$.

REDUCING FRACTIONS

A fraction can be reduced to simpler form. The fraction $4/8$ can be reduced to $2/4$, and $2/4$ can be reduced to $1/2$. For the fraction $4/8$ divide the numerator by 2 and the denominator by 2, and that yields an answer of $2/4$. Do the same to $2/4$, that is, divide both the numerator and denominator by 2 and get the answer $1/2$. Alternatively, just dividing the numerator and denominator of $4/8$ by 4 will also give the answer of $1/2$. This is called *reducing a fraction to its simplest form.*

MANIPULATING FRACTIONS

Adding fractions is just like adding whole numbers. In order to add $1/4$ plus $3/4$, simply add the numerators, $1 + 3 = 4$, and put the answer back over the denominator, $4/4$. In like fashion $3/8 + 7/8 = (3 + 7)/8 = 10/8$. That answer could be converted to the mixed number $1\,2/8$, which can be reduced to $11/4$. In similar fashion $3/4$ minus $1/4$ would result in an answer of $2/4$, or $1/2$.

The requirement that must be met before adding or subtracting fractions is that they must first have the same denominator. If there are fractions with different denominators, they can still be added or subtracted, but they must first be converted to a *common denominator*. A common denominator is a denominator that the two fractions would have in common with each other, given a little manipulation. The simplest way to find a common denominator would be to multiply together the two denominators. For example, to add the two fractions $1/4 + 1/3$, multiply the 4 times the 3 and get a common denominator of 12. In effect we multiply each fraction by 1. In the case of the fraction $1/4$, we will multiply it by $3/3$ to get an answer of $3/12$. We multiply the $1/3$ by $4/4$ to get an answer of $4/12$. The result is $1/4 + 1/3 = 3/12 + 4/12 = 7/12$.

Following the steps from the previous paragraph, take a minute and add the fractions $1/2 + 3/7$. Let's see what you might have done.

Equation 2.2

$$1/2 + 3/7 = (7/7 \times 1/2) + (2/2 \times 3/7) = 7/14 + 6/14 = 13/14$$

The common denominator for the two fractions would be $2 \times 7 = 14$. Multiply the $1/2$ by $7/7$ and get $7/14$. Then multiply $3/7$ by $2/2$ and get $6/14$. Now add the $7/14 + 6/14$ and get $13/14$ as an answer. By multiplying $1/2$ by $7/7$ and $3/7$ by $2/2$, we multiplied each fraction by 1 and any number multiplied by 1 gives us the same number. Just like $1 \times 5 = 5$, $1/2 \times 7/7 = 1/2$, only this time we are calling $1/2$ by the name $7/14$ so that we can add it to $6/14$.

If this didn't make sense when you read it the first time, read it over again and jot down the fractions on a sheet of paper as you go. There is no penalty associated with reading some material twice.

Converting Fractions to Decimals

The division problem that is being called for in a fraction might not deal with a remainder, as in the explanation of Equation 2.1 above. Rather, it may make use of a decimal point, and the answer may be in decimal form. Let's look at the fraction $3/4$ again. The fraction asks us to divide 3 by 4. If we were to do this in long division, or more likely today, punch the numbers into a calculator, $3 \div 4$, the answer to the calculation is 0.75. Thus 0.75 is the decimal equivalent of $3/4$, or $3/4 = 0.75$. (See Chapter 1 for the calculator key strokes for the TI Professional Business Analyst calculator.)

Your calculator key strokes should look like this for the TI calculator:

Equation 2.3

$$3\,[\div]\,4\,[=]\,0.75$$

This is the type of answer you will get when the fraction is a simple fraction with a numerator that is less than the denominator; in other words it has a value of less than 1. The answer will begin with a decimal point, again indicating a value of less than 1. If the division problem has a numerator that is greater than the denominator, then the answer will begin with a whole number with a decimal point

somewhere in the middle of the number with additional zeros or numbers to the right of the decimal point. If the fraction is 5/4, the TI calculator key strokes would look like this:

Equation 2.4

$$5\,[\div]\,4\,[=]\,1.25$$

The decimal equivalent then of 5/4 is one point two five (1.25). You will recall the mixed fraction answer to this problem was 1 1/4. The decimal equivalent of 1/4 is in fact 0.25 or 25 one-hundredths. The first place to the right of the decimal point is tenths, the second is hundredths, the third is thousands, the fourth is ten thousandths, and so on.

If Equation 2.1 is true and Equation 2.4 is true, then it must be true that:

Equation 2.5

$$5/4 = 1\,1/4 = 1.25$$

To verify that, take 1/4 and punch it into your calculator, 1 [÷] 4 [=] 0.25 plus 4/4 which is equal to 1, so $1 + 0.25 = 1.25$. So Equation 2.5 is indeed an equation because the elements on either side of the equal sign, in this case two equals signs, are indeed equivalent to each other.

We have discovered two ways to find the decimal equivalent of 5/4. Either take 5 [÷] 4 = 1.25 or take 1 [÷] 4 [=] 0.25 and add it to the 1 to get 1.25.

As practice, find the decimal equivalents of each of the fractions in Table 2.1. Cover up the right-hand column as you calculate the decimal equivalent of each of the following fractions.

Table 2.1 Fractions to decimals

Fractions	Decimals
1/2	0.50
1 3/4	1.75
2 2/3	2.67
3/5	0.60
20 4/10	20.4
10 65/100	10.65
5 1/4	5.25

Converting Decimals to Percentages and Back

The second decimal place to the right of the decimal point represents hundredths. A percentage is a statement in hundredths of a whole, or 1 hundredth = 1 percent = 0.01. Sixty-five hundredths stated as a decimal is = 0.65. To convert that decimal value to a percent, simply move the decimal point two places to the right and add a percent sign, so 0.65 = 65%. This is again an equation because the value to the left of the equal sign is equivalent to the value to the right of the equal sign. The decimal value may be stated in thousandths rather than hundredths. It doesn't matter; we still move the decimal places two places to the right to get the percentage value. That being the case, a decimal value of 0.855 is equivalent to 85.5%.

The need to convert decimals to percentages arises all the time in different real estate settings. For example, your taxes went up from $3,000 per year to $3,500 per year, and you want to know what percent increase that was. The taxes started at $3,000, and they went up to $3,500. The ending value of $3,500 minus the beginning value of $3,000 gives us an increase of $500 per year. Taking the $500 increase and dividing it by the $3,000 beginning value gives us an increase of 0.167 ($500 ÷ $3,000 = 0.167). Now convert that to a percentage by moving the decimal point two places to the right and adding a percent sign, and we see that your taxes went up by 16.7%. Alternatively we could take the ending value ($3,500) divided by the beginning value ($3,000), $3,500 ÷ $3,000 = 1.167. We then subtract the 1, shift our decimal point two places to the right, add the percent sign, and we get 16.7%. Either method is acceptable.

Another situation may involve an investor. She has purchased a duplex for $285,000 and the assessor has told her that the land value is $57,000. She would like to know what percentage of the total purchase price is represented by the land value. She should take the land value and divide it by the total purchase price, $57,000 ÷ $285,000 = 0.20 and then move the decimal point two places to the right and add a percent sign. This answer indicates that the land value represents 20% of the total purchase price.

Maybe your city planner tells you that the maximum coverage your new building can have on your lot is 55% according to the city building requirements. You know that your lot is a rectangle of 125 feet by 150 feet. The building you are planning to put up has a footprint, or a first floor square footage, of 9,750 square feet. Do you fit within the city's requirements? First find the area of the lot. Take 125 feet × 150 feet and get 18,750 square feet as the area of the lot. Then take the square footage of the first floor of the building and divide it by the area of the lot; 9,750 ÷ 18,750 = 0.52 = 52%. Your building will cover 52% of the lot, so you are within the city code for area coverage.

Table 2.2 Decimal to percent

Decimal	Percent
0.75	75%
0.22	22%
35.9	35.9%
1.255	125.5%
0.999	99.9%
0.01	1%
2.02	202%

Cover up the right hand column of Table 2.2 and convert the decimal values to percentages. Uncover the right-hand column to check your answers.

Just as frequently in real estate transactions there is a need to convert percentages to their decimal equivalents to facilitate, or make easier, a calculation. You are a broker and have just sold a house for a seller; the sale price was $355,000. You told the seller he would have to pay you a 6% commission. What is the dollar value of the gross commission? Take the 6% and shift the decimal point two places to the left and drop the percent sign and get 0.06. Now take the 0.06 × $355,000 and find the gross commission value which is $21,300.

Maybe you are working as a property manager and your boss told you that you are being given a lot more responsibility and you will now be managing four buildings instead of the three that you have been working on in the past. As a result you will receive a raise of 8%. You are currently making $42,000 per year. How much will your raise be? How much will you be making next year? Take the 8% and shift the decimal point two places to the left, drop the percent sign and get 0.08. Now take the 0.08 × $42,000, and your raise is $3,360. Add that $3,360 to the $42,000 to find you will be making $45,360 next year. As an alternate method take the $42,000 and multiply it times 1.08. You also get $45,360 as your next year's salary.

In Table 2.3, cover up the right-hand column and calculate the decimal equivalents of the percentages that are given. Once you have finished, uncover the right-hand column, and the correct answers will again magically appear.

Part, Percent, Whole

Many real estate situations call on the use of the part, percent, whole concept. It is an example of simple algebra, but don't let that word scare you. Look at Figure 2.1.

Table 2.3 Percent to decimal

Percents	Decimals
6.5%	0.065
20%	0.02
135%	1.35
15%	0.15
55.5%	0.555
110%	1.10
7%	0.07

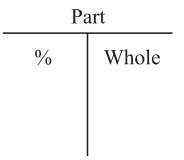

Figure 2.1 Part, percent, whole

You will notice that the part is above the horizontal line and the percent and whole are below the horizontal line. Think of that horizontal line as the line in a fraction. In effect we are creating two different fractions and one multiplication problem. The first fraction illustrated is part/whole. To make this an equation, we simply plug in the percent, as shown in Equation 2.6.

Equation 2.6

$$\text{Part/whole} = \text{Percent}$$

This tells us that if we take a part of the whole and divide by the total whole, it will give us the percentage of the whole that the part represents. Let's say that we have a whole sale price of $125,000 and we know that the commission that is being paid on the transaction is $7,500. The question is, what was the commission rate on the deal? We simply plug our number into Equation 2.6 and get $7,500/$125,000 and get 0.06 or 6%.

The second equation that Figure 2.1 is begging us to create is Equation 2.7.

Equation 2.7

$$\text{Part/percent} = \text{Whole}$$

This equation tells us that if we take the part and divide it by the percentage that it represents, the resulting answer will be the whole that we are dealing with. If our net proceeds from the sale are $134,850 and that is after paying

a 7% commission, then the net proceeds actually represent 93% of the whole, so we take \$134,850/0.93 and get a whole sale price of \$145,000. If, on the other hand, we had been given the commission amount of \$10,150 and had been told that it was 7% of the sale price, we would have taken \$10,150/0.07 and gotten the same whole sale price of \$145,000.

The third equation that is being called for in Figure 2.1 is multiplying the two items below the line to get the value above the line.

Equation 2.8

$$\text{Percent} \times \text{whole} = \text{Part}$$

This calculation is probably used more often than the other two. This time we can take our commission rate times our sale price and get the dollar amount of the commission. Given a sale price of \$325,000 and a commission rate of 6%, this should result in a commission value of \$325,000 × 0.06 = \$19,500.

You will find a variation on the part, percent, whole equations used extensively in Chapter 10 on real estate appraisal. The equations in appraisal are referred to as the IRV formula, where I is equal to the NOI (income) of the property, R is the capitalization rate and V is the value of the property. The resulting equations are I/R = V, or income over rate equals value; I/V = R, or income over value equals rate; and R × V = I, or rate times value equals income.

Percentages and Mortgages

Mortgage amounts are typically stated in terms of loan-to-value ratios. A *ratio* is one number divided by another. In the loan-to-value ratio, the loan or mortgage amount is divided by the value of the property, like this—(loan ÷ value) or (loan/value)—and the answer is given as a percent. If we are purchasing a home for \$100,000 and we are getting an \$80,000 mortgage, our loan-to-value ratio is \$80,000/\$100,000 = 0.80 = 80%. In similar fashion only this time working in the other direction, if we are purchasing a home for \$145,000 and we are getting a 75% loan to value mortgage, \$145,000 × 0.75 = \$108,750, we will be borrowing \$108,750 in the form of a mortgage loan.

One minus the loan-to-value ratio is the equity-to-value ratio. If you think of the total value of the home as 1, or 100%, and your loan to value ratio is 80%, then your equity-to-value ratio must be 20%, 100% – 80% = 20%. This emphasizes the concept that the market value of the property is made up of equity and debt, where debt is the mortgage on the home. The difference between the market value of the home and the mortgage balance is your equity, as stated in Equation 2.9.

When you just purchase the home, your equity is the same as your down payment, and your mortgage balance is the amount you just borrowed from the bank in the form of a home mortgage.

Equation 2.9

$$\text{Equity} = \text{Market value} - \text{mortgage balance}$$

As time goes by, your equity increases because of two changes (see Equation 2.10). First of all, your equity increases because of any appreciation that takes place in the value of your home. This increase in market value gives you more equity. Second, your equity increases because the principal balance on your mortgage decreases over time because the principal is reduced each time you make a mortgage payment. (See Chapter 7.)

Equation 2.10

$$\uparrow \text{Equity} = \uparrow \text{Market value} - \downarrow \text{mortgage balance}$$

Equation 2.10 states that an increase in equity can come about as a result of an increase in market value and/or a decrease in mortgage balance. As long as your housing market experiences no housing price bubble, the first caveat will be true. And as long as you have an amortized mortgage and you continue to make your mortgage payments, the second caveat will be true.

Quiz for Chapter 2

1. Add the following sets of fractions. Where necessary, find the common denominators before adding. Reduce the answers to their simplest form where necessary.
   a. $1/4 + 3/4 = ?$
   b. $2/3 + 2/3 = ?$
   c. $1/5 + 3/5 = ?$
   d. $3/8 + 1/4 = ?$
   e. $5/4 + 1/3 = ?$
   f. $1/2 + 4/6 = ?$

2. Following the instructions from question 1, perform the following subtraction calculations.
   a. $3/4 - 1/4 = ?$
   b. $2/3 - 1/2 = ?$
   c. $6/7 - 3/4 = ?$
   d. $3/8 - 1/4 = ?$

3. Perform the indicated multiplication calculations.
   a. $3/4 \times 1/4 = ?$
   b. $2/3 \times 2/3 = ?$
   c. $3/8 \times 1/4 = ?$
   d. $5/4 \times 1/3 = ?$

4. Perform the indicated division calculations.
   a. $3/4 \div 1/4 = ?$
   b. $2/3 \div 2/3 = ?$
   c. $1/5 \div 3/5 = ?$
   d. $3/8 \div 1/4 = ?$
   e. $5/4 \div 1/3 = ?$
   f. $1/2 \div 4/6 = ?$

5. List the decimal equivalent of the following fractions and mixed numbers.
   a. $3/4 = ?$
   b. $2/3 = ?$
   c. $1/5 = ?$
   d. $1\ 1/2 = ?$

e. $2\,1/4 = ?$
f. $4\,3/4 = ?$

6. List the percentages represented by those same fractions and mixed numbers in question 5.

7. Sylvia purchased a home earlier this year for $167,750 and took out a mortgage for $142,375 at 8% for 30 years. What was the loan-to-value ratio on the mortgage, and what was her down payment as a percentage of the purchase price?
   a. 75%, 25%
   b. 85%, 15%
   c. 90%, 10%
   d. 85%, 10%

8. How much equity did Sylvia have in her home on the day of closing in question 7?
   a. $142,375
   b. $167,750
   c. $25,375
   d. $16,775

9. Your brother Jake just sold his house for $220,000 and netted $206,800 on the sale. What was the commission rate that he paid his broker?
   a. 5%
   b. 6%
   c. 7%
   d. 7.5%

10. Jake, in question 9, had purchased his house only one year earlier. He purchased the house for $215,686. What rate of appreciation had he earned in that one year?
   a. 5%
   b. 4%
   c. 3%
   d. 2%

3

CHAPTER

Commissions, Growth Rates, and Net Proceeds

Every Seller Has a Price

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Commissions, growth rates, and net proceeds all have one thing in common. They either begin with or end with some sort of percentage. A percentage is a value given in an amount per hundred. One percent is 1 of 100 parts. Five percent is 5 of 100 parts. Fifty percent of a candy bar is 50/100ths, or 1/2 of the candy bar. A 7% commission is 7/100ths of the selling price of the house. In this chapter you will become familiar with decimals and percentages (including commissions and growth rates) and with calculating the net proceeds from a sale.

Broker/Salesperson's Commissions

The classic percentage calculation that most people can relate to, whether you are a broker, salesperson, buyer, or seller, is the commission. The sales commission is generally a percentage of the sale or exchange price of a piece of real estate. The commission could also be a percentage of the monthly or annual rental rate of a piece of property in the case of a property manager.

To facilitate the commission calculation, it helps to convert the commission percentage to its decimal equivalent.

PERCENTAGE TO DECIMAL

A percentage can be converted to its decimal equivalent, as explained in Chapter 2, by taking the decimal point and shifting it two places to the left and dropping the percent sign, as shown in Equation 3.1.

Equation 3.1

$$6.5\% = 0.065$$

Once the percentage has been converted to its decimal equivalent, you can begin to calculate the dollar value of the commission, given a certain sale price.

MULTIPLICATION USING DECIMALS

To calculate the dollar value of the commission, you simply multiply the decimal equivalent of the commission times the sale price, as illustrated in Equation 3.2.

Equation 3.2

$$\text{Commission rate} \times \text{sale price} = \text{Commission amount}$$

If the sale price of a home is $175,000 and the commission rate is 7%, convert the commission to the decimal equivalent, 7% = 0.07 and multiply the decimal equivalent times the sale price as shown in Equation 3.3. Use Equation 2.8 (from Chapter 2):

Equation 3.3

$$\text{Percent} \times \text{whole} = \text{Part}$$

$$0.07 \times \$175{,}000 = \$12{,}250 = \text{Gross commission}$$

Given a commission rate of 7% and a sale price of $175,000, the resulting commission is equal to $12,250.

NET PROCEEDS

To arrive at the net proceeds (before mortgage payoff and other expenses) that the seller would receive after the commission is paid, simply subtract the commission amount from the sale price, as illustrated in Equation 3.4.

Equation 3.4

$$\text{Sale price} - \text{commission amount} = \text{Net proceeds}$$

Using the dollar amounts and commission rate that were used in Equation 3.3, the net proceeds are stated in Equation 3.5.

Equation 3.5

$$\$175{,}000 - \$12{,}250 = \$162{,}750$$

Given a sale price of $175,000 and a commission rate of 7%, we have illustrated that the commission amount would be $12,250 and the net proceeds to the seller after the commission has been paid would be $162,750.

SHORTCUT TO NET PROCEEDS

A second method of calculating the net proceeds from the sale is to take 1 minus the commission rate and multiply that resulting percentage, or decimal equivalent, by the sale price. Again, using the sale price and commission rate used above, the shortcut calculation of the net proceeds is illustrated in Equation 3.6.

Equation 3.6

$$(1 - 0.07) \times \$175{,}000 = 0.93 \times \$175{,}000 = \$162{,}750$$

As the equation states, take 1 minus 7%, or $1 - 0.07$, and multiply that resulting 0.93 by the sale price of $175,000, and you get exactly the same net proceeds of $162,750 that you calculated in Equations 3.3 and 3.5. In effect, the multiplication problem from Equation 3.3 and the subtraction problem from Equation 3.5 have been combined into the single Equation 3.6.

Commission Splits

When real estate brokers and salespersons have a cooperating sale with another brokerage firm, the commission is typically split between the two firms. That split may be 50-50, with 50% of the commission going to each firm, or it may be 55-45 with 55% going to one firm (usually the listing firm) and 45% going to the other (or selling) firm. The commission split arrangements can vary depending on local custom.

If you had a cooperative sale with a $195,000 sale price and a 6% gross commission, and the firms were on a 55-45 split, the commission would look like this. Multiply the sale price of $195,000 by the commission rate of 6% and get a gross commission of $11,700, as shown in Equation 3.7

Equation 3.7

$$\$195{,}000 \times 0.06 = \$11{,}700 = \text{Gross commission}$$

As shown in Equation 3.8, the listing firm would receive 55% of that, or $6,435.

Equation 3.8

$$\$11{,}700 \times 0.55 = \$6{,}435$$

The selling firm would get 45% of the gross commission, or $5,265. This amount may be obtained by multiplying the gross commission by 0.45 or simply subtracting the listing firm's commission from the gross commission. Both calculations are illustrated in Equation 3.9.

Equation 3.9

$$\$11{,}700 \times 0.45 = \$5{,}265 = \$11{,}700 - \$6{,}435$$

The commission split does not affect the homeowner typically. The brokers would work out those details.

Let's try a practice problem. You have just received your real estate salesperson's license, and your first day on the job you sell a small house for $125,000. The house was listed by a broker across town at a 6% commission rate. Brokers in your community are on a 50-50% commission split arrangement on cooperative sales. Your broker pays you 60% of all commission dollars you bring into the shop. How much will you earn from this transaction? First you find the gross commission amount by multiplying the sale price by the commission rate, $125,000 × 0.06 = $7,500. Then you multiply the gross commission by the 50% for the split with the listing broker, $7,500 × 0.50 = $3,750. You then multiply that amount by the 60% that your broker has agreed to pay you, $3,750 × 0.60 = $2,250. So you have earned $2,250 from this particular transaction.

Graduated Commissions

For transactions involving larger property values, the commission will sometimes be calculated on a graduated scale; this is sometimes called a *tiered commission*. That is, the first so many dollars of sale price will have a commission rate of X%, and for additional sale price over and above that amount the commission rate may be Y%. There may even be three or more different tiers of commission rates used for properties with very large values. The average commission rate would then be the total gross commission divided by the sale price.

Let's look at a small office property with a sale price of $950,000. The broker and seller have agreed that the commission rate will be 7% on the first $300,000 of sale price, 6% on the next $600,000 of sale price, and 5% on any sale price in excess of $900,000. If the building sells for $925,000 what will be the amount of the commission?

The solution is summarized in Equation 3.10.

Equation 3.10

$$\text{Commission} = (\$300{,}000 \times 0.07) + (\$600{,}000 \times 0.06) + (\$25{,}000 \times 0.05)$$

$$\text{Commission} = \$21{,}000 + \$36{,}000 + \$1{,}250 = \$58{,}250$$

The gross commission on the sale of the property for $925,000 with the graduated commission as stated would be $58,250. The average commission rate would be the total gross commission divided by the sale price in the transaction. The average commission rate on the transaction would be 6.3%, as is illustrated in Equation 3.11:

$$\text{Average commission} = \text{Total gross commission/sale price.}$$

This results in Equation 3.11.

Equation 3.11

$$\text{Average commission} = \$58{,}250/\$925{,}000 = 0.063 = 6.3\%$$

Average Growth Rates

Two types of growth rates are addressed in this chapter: average growth rates and compound growth rates. Average growth rates are just that; they are the result of a simple arithmetic average. This rate does not take into consideration any compounding effect. Before looking at a multiyear growth rate, we should first address the single-period or single-year growth rate.

SINGLE-YEAR GROWTH RATES

To calculate a growth rate for a single period or single year, take the ending value minus the beginning value and divide that result by the beginning value. It may help to think in terms of prices. Let's call the beginning price P_0, meaning the price at time period 0 or the price today, and the ending price we'll call P_1, or the price at the end of the first period. The growth rate calculation is shown in Equation 3.12.

Equation 3.12

$$(P_1 - P_0)/P_0 = \text{Growth rate}$$

This is the calculation for a one-period growth rate, say a one-year rate. If you are looking for the growth rate in the value of your home and we know that last year at this time that the home was worth $185,000 and today it is worth $192,400, the calculation of the one-year growth rate would look like Equation 3.13.

Equation 3.13

$$(\$192{,}400 - \$185{,}000)/\$185{,}000 = \$7{,}400/\$185{,}000 = 0.04 \text{ or } 4\%$$

You see that the single-year growth rate in value for a beginning value of $185,000 and an ending value of $192,400 is 4%. Try this additional example on your own, and then come back to check your answer.

Your neighbor purchased her home one year ago for $167,500, and today it is worth $175,000. What has been her one-year growth rate in value,

sometimes referred to as a one-year appreciation rate? You'll find the solution in Equation 3.14.

Equation 3.14

$$(\$175{,}000 - \$167{,}500)/\$167{,}500 = \$7{,}500/\$167{,}500 = 0.045 = 4.5\%$$

SHORTCUT TO ONE-YEAR GROWTH RATE

A shortcut to a one-year growth rate looks like Equation 3.15. Take the ending price, P_1, and divide it by the beginning price, P_0. The resulting answer is equal to 1 plus the growth rate. So if we subtract the 1 from the right-hand side of the equation and then convert the decimal in the resulting answer to its percentage equivalent, we have the growth rate.

Equation 3.15

$$P_1/P_0 = 1 + \text{growth rate}$$

If you plug the dollar values from the previous calculation into Equation 3.15, this results in Equation 3.16.

Equation 3.16

$$\$175{,}000/\$167{,}500 = 1.045, \text{ then}$$

$$1.045 - 1 = .045 = 4.5\%$$

By using the shortcut method, we were able to arrive at exactly the same answer that was obtained in Equation 3.14. (Additional quiz problems can be found at the end of the chapter.)

MULTIYEAR GROWTH RATES

Multiyear average growth-rate calculations start out the same as the single-year calculation. Take the ending value (P_2) divided by the beginning value (P_0) and divide the answer by the beginning value, P_0. If it is a two-year growth period, simply divide the answer by 2 to get the annual growth rate. Take a home that sold today for $205,000 and was purchased two years ago for $195,000. What is the average annual growth rate in value? Refer to Equation 3.17 for the solution.

Equation 3.17

$$(\$205{,}000 - \$195{,}000)/\$195{,}000 = \$10{,}000/\$195{,}000 = 0.0513, \text{ then}$$

$$0.0513/2 = 0.0257 = 2.57\%$$

Using the shortcut method from Equation 3.15, the calculation looks like Equation 3.18.

Equation 3.18

$$\$205{,}000/\$195{,}000 = 1.0513, \text{ then}$$

$$1.0513 - 1 = 0.0513, \text{ then}$$

$$0.0513/2 = 0.0257 = 2.57\%$$

Both methods indicate that the average annual growth rate was 2.57% per year. Use the method that feels most comfortable to you.

COMPOUND GROWTH RATES

Compound growth-rate calculations depend on the use of time value of money (TVM) calculations. (Since this is the case and TVM is not covered until Chapter 6, compound growth rates are addressed in Chapter 8.)

Selling Price and Required Net Proceeds

The seller of a home is interested with how much money he or she will have left after paying the broker's commission. This amount is often referred to as the *net proceeds from the sale.* In Chapter 8, you will see that another way to describe net proceeds includes the deduction of selling expenses and mortgage payoff. However, in this chapter, we define net proceeds as the amount the seller has after paying just the commission. If the seller has a specific net proceeds amount in mind, it is possible to calculate the needed sale price which will result in that specific net proceeds amount from a home sale. To arrive at this value, we make use of one of the part, percent, whole equations from Chapter 2.

Specifically, use Equation 2.7 which stated that part/percent = whole. In this case the net proceeds are equal to the part, the percent is equal to the quantity (1 minus the commission rate), and the sale price is equal to the whole. The reason that we divide by the quantity (1 minus the commission rate), rather than the commission rate itself, is that the part in this case is what is left over *after*

we've paid the commission. Thus, we take the net proceeds divided by the quantity (1 minus the commission rate), and the resulting answer is equal to the sale price. This process is illustrated in Equation 3.19.

Equation 3.19

$$\text{Net proceeds}/(1 - \text{commission rate}) = \text{Sale price}$$

Let's say that a seller wants to net $150,000 from a sale, before mortgage payoff and other expenses, and that he is going to have to pay a 6% brokerage commission. If that is the case, simply plug the numbers into Equation 3.19, which results in Equation 3.20. Once again, notice that Equation 3.19 is a variation on a theme of the part, percent, whole Figure 2.1 from Chapter 2 and the accompanying Equation 2.7.

Equation 3.20

$$\$150{,}000/(1 - 0.06) = \$150{,}000/0.94 = \$159{,}574.47$$

In order for the seller to net at least $150,000 from the sale, the home must sell for at least $159,574.47. Intuition might tell a person that we should just take the $150,000 times 6%, and that amount added to the $150,000 should give us the necessary sale price. Let's try that and see what we get. $150,000 × 0.06 = $9,000. That added to the $150,000 gives us a projected sale price of $159,000.

Take that sale price and calculate the commission due by multiplying it by 6% ($159,000 × 0.06 = $9,540). If we subtract that commission from the sale price we get a net proceeds ($159,000 − $9,540 = $149,460) which is less than the required $150,000. However, if you take the $159,574.47 × 0.06, you get a commission of $9,574.47. If you subtract that from the $159,574.47, you do, in fact, end up with net proceeds of $150,000.

The list price of the property will depend on many market and marketing factors that the broker and seller will have to take into consideration. All we know for sure is that the property must sell for at least $159,574.47 if the seller is to net $150,000 after paying the 6% commission.

Let's try an additional problem of this type. A coworker of yours has told her broker that she needs to achieve net proceeds from the sale of her house of $110,000 before mortgage payoff and other expenses. The broker and seller decide on a 7% commission for the sale of her home. The minimum selling price that is needed for her to net at least $110,000 is illustrated in Equation 3.21.

Equation 3.21

$$\$110{,}000/(1 - 0.07) = \$110{,}000/0.93 = \$118{,}279.57$$

You know that the $110,000 needs to be at least 93% of the sale price because she needs the $110,000 after the 7% commission has been paid. Equation 3.21 tells us that the home must sell for at least $118,279.57 in order for your coworker to net her required amount of $110,000 before mortgage payoff and other expenses.

Quiz for Chapter 3

1. John decided to sell his condo in Honolulu and contacted a broker to determine what it might be worth in today's market and how large a commission he might have to pay. The broker did a market analysis of the condo and determined that it would probably sell for about $475,000. The broker and John agreed on a 6% commission to be paid upon a successful closing on the condo sale. How many dollars will John have to pay the broker at the closing if the condo sells for $475,000?
   a. $33,250
   b. $28,500
   c. $23,750
   d. $30,875

2. What will John's net proceeds be after the commission has been paid on the transaction in question 1?
   a. $28,500
   b. $441,750
   c. $446,500
   d. $451,250

3. Tara recently obtained her real estate salesperson's license. She sold her first house for $225,000. The seller had agreed to pay a 7% commission on the sale. The house was listed with a cooperating broker, and the custom in that market is that commissions are split 50-50 between the listing and selling brokers. Tara is on a 50-50 split with her broker. How much does Tara take home as compensation for her first real estate sale?
   a. $15,750
   b. $7,875
   c. $3,937.50
   d. $3,375

4. After Tara's first sale her broker tells her that in the future her split will be 60-40 because she is doing such a good job. Her next sale is for a sale price of $195,000, and she is both the listing agent and the selling agent. The seller paid a 6% commission. What is the amount of this pay check?
   a. $7,020
   b. $3,510
   c. $2,925
   d. $8,190

5. Tony is a commercial real estate broker. He just sold a small office building for $1.5 million. He is told that the commission is 6% on the first $500,000, 4% on the next $500,000 and 2% on the last $500,000. What is Tony's commission in dollars if he is to receive the total amount?
   a. $90,000
   b. $30,000
   c. $50,000
   d. $60,000

6. What is the average commission rate on the transaction in question 5?
   a. 6%
   b. 5%
   c. 4%
   d. 3.3%

7. Stef bought her house exactly one year ago for $164,500. She had an appraisal done, and the appraiser told her that the home is currently worth $171,000. What was the annual growth rate in value, or the annual appreciation rate, rounded to the nearest percent?
   a. 3%
   b. 4%
   c. 5%
   d. 6%

8. Stef, from question 7, finds out that next year her house will be worth $179,700. What is the average annual appreciation rate that her home will experience, rounded to the nearest 1/10 of a percent?
   a. 4.0%
   b. 4.6%
   c. 4.8%
   d. 5.0%

9. Tom, a local real estate broker, goes out to a listing presentation with a seller and finds that the seller would like to receive net proceeds of $144,000 from the sale of his house after the commission has been paid. If Tom intends to charge the seller a 5% commission, what is the minimum price the home must sell for in order for the seller to achieve the desired net proceeds?
   a. $151,200
   b. $144,000
   c. $153,191
   d. $151,578

10. On Tom's next listing presentation he finds that the seller needs to net $175,000 after paying a 5.5% commission. What is the minimum sale price the home must bring in order to meet the seller's needs?
    a. $185,185
    b. $184,625
    c. $183,750
    d. $184,210

CHAPTER 4

Legal Descriptions and Lot Size

Does This Drawing Make My Backyard Look Big?

Land is defined as the earth's surface, everything above, and everything below (to the center of the earth), and everything put on the earth's surface by nature. (See Figure 4.1.)

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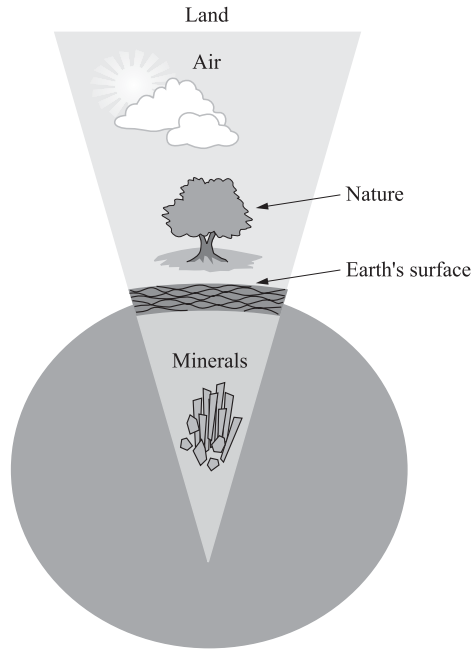

Figure 4.1 Land illustrated

Legal Descriptions

A *legal description* is a precise way of describing a parcel of land that would be upheld in a court of law. There are three basic forms of legal descriptions that are commonly used in the United States. They are metes and bounds, the government (or rectangular) survey system, and the subdivision plat system.

Metes and Bounds

The metes and bounds system is the oldest form of legal description used in the United States and was brought over by the European settlers. It makes use of a system of measurements and boundaries to describe a parcel of land. If you squint your eyes just right, it looks like "measurements and boundaries" doesn't it? (I like to think it is old English for measurements and boundaries.)

The description first measures distance and direction away from some monument. That monument may be something as precise as a surveyor's monument put in the earth's surface or something as imprecise as the old oak tree, the large block of granite, or the intersection of two roads. The nonsurveyor's monuments can be imprecise and can change over time. The old oak tree can be hit by lightening and decay away over the years. The intersection can change when roads are widened. Surveyor's monuments are of course preferred, but other monuments do indeed show up in metes and bounds descriptions.

Once you have a monument, you then measure distance and direction away from this monument to establish a beginning point. From that point of beginning you again use distance and direction to describe the perimeter of the parcel of land. When the method was created, it was described as a plan for a walk around the perimeter of the parcel. This form of legal description can be quite lengthy and occasionally inaccurate. I have seen metes and bounds descriptions that are in excess of two pages in length. The source of the inaccuracy is the nonpermanent nature of some types of monuments. If the monument in question is the old oak tree, the large block of granite, or the intersection of two roads, as mentioned previously, these monuments could change over time. As the location of these monuments change over time, so would the accuracy of the legal description.

EXAMPLE 4.1

Figure 4.1 illustrates a parcel of land that you have purchased. You have decided to place a split-rail fence around it, and the farm supply store has quoted you a cost of \$4.50 per lineal foot for the materials. What is the price of the materials if you intend to enclose the entire lot in fencing? I'm thinking that the appearance of the sides may not be to scale in Figure 4.2, so focus on the linear feet as they are stated. There are two dimensions you need to fill in, but you do not have enough information to do that.

Equation 4.1

$$\text{Cost} = (60 + 30 + 20 + 30 + 80 + 60) \times \$4.50 = 280 \times \$4.50 = \$1{,}260$$

Beginning at the top dimension and going clockwise, the dimensions are 60 feet by 30 feet by 20 feet by 30 feet by 80 feet by 60 feet for a total perimeter lineal footage of 280 feet. If you take 280 feet times the \$4.50 per lineal foot cost, you get a total cost of \$1,260. Now what is the square footage of the lot in Figure 4.2? The solution is in Equation 4.2.

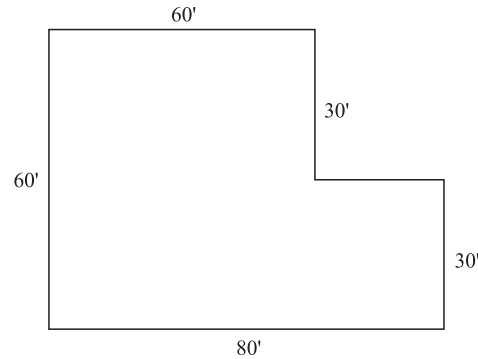

Figure 4.2 Lot size 1

Equation 4.2

$$\text{Area} = (60 \times 60) + [(80 - 60) \times 30] = 3{,}600 + (20 \times 30) = 3{,}600 + 600$$
$$= 4{,}200 \text{ square feet}$$

We have basically two shapes, a 60 × 60 square and a rectangle that is 20 by 30. This results in a total square footage of 4,200 square feet.

EXAMPLE 4.2

Your metes and bounds description reads like the following:

> Beginning at a point formed by the intersection of the northerly side of Georgia Avenue and the easterly side of 27th St., thence east 100 feet, thence north at a 90 degree angle for 50 feet, thence west at a 90 degree angle for 75 feet, thence back to the point of beginning in a straight line.

The parcel is illustrated in Figure 4.3. What is its square footage?

Equation 4.3

$$\text{Area} = (75 \times 50) + (50 \times 25)1/2 = 3{,}750 + 625 = 4{,}375$$

Once again, divide the parcel into two shapes. This time you have a rectangle and a triangle. The rectangle is 50 feet by 75 feet, and the triangle has

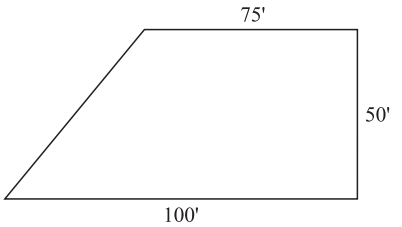

Figure 4.3 Lot size 2

a 25-foot base and a height of 50 feet. The total square footage of the parcel is 4,375 square feet.

EXAMPLE 4.3

Kate purchased the lot next to the little palace she lives in which is shown in Figure 4.4. As a favor to her husband, she decided to build a tennis court on it. If she needs to cover the entire lot with a six-inch layer of concrete, how many cubic feet of concrete will she need to complete the tennis court?

Equation 4.4

$$\text{Concrete needed} = 125 \times 95 \times 0.5 = 5{,}937.5 \text{ cubic feet}$$

If you take the depth of the lot times the width of the lot times 0.5, or one-half of a foot, you find that Kate will need 5,937.5 cubic feet of concrete. How many cubic yards will she need? (Concrete is typically sold in cubic yards.)

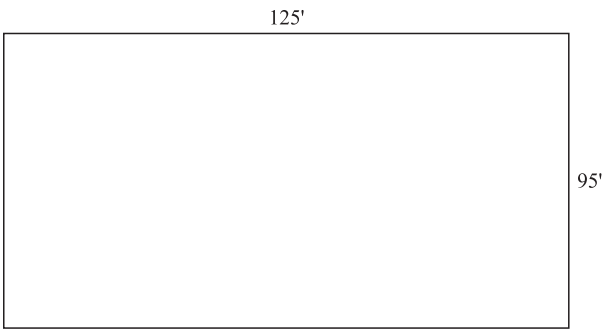

Figure 4.4 Tennis court

Government Survey System

The *government survey system* was developed by Thomas Jefferson around the time of the Louisiana Purchase. This system (also known as the *rectangular survey system* or the *township and range system*) is based on a set of imaginary lines put on the earth's surface, much like the lines of longitude and latitude, only these are referred to as principal meridians and base lines. Principal meridians run in a north-south direction, and base lines run east-west, as shown in Figure 4.5

The map in Figure 4.5 indicates the location of the principal meridians and baselines that are used for measurement in the government survey system. You will note that those states that appear without shading in the map are not covered by this system. Those include basically the original 13 colonies plus a few more, including Texas. These states were basically fully described using the metes and bounds system before the government survey system was developed.

The government survey system makes use of these lines by measuring distance and direction away from these lines to describe our property's location. The principal meridians are spaced 6 miles apart. The baselines are also spaced 6 miles apart,

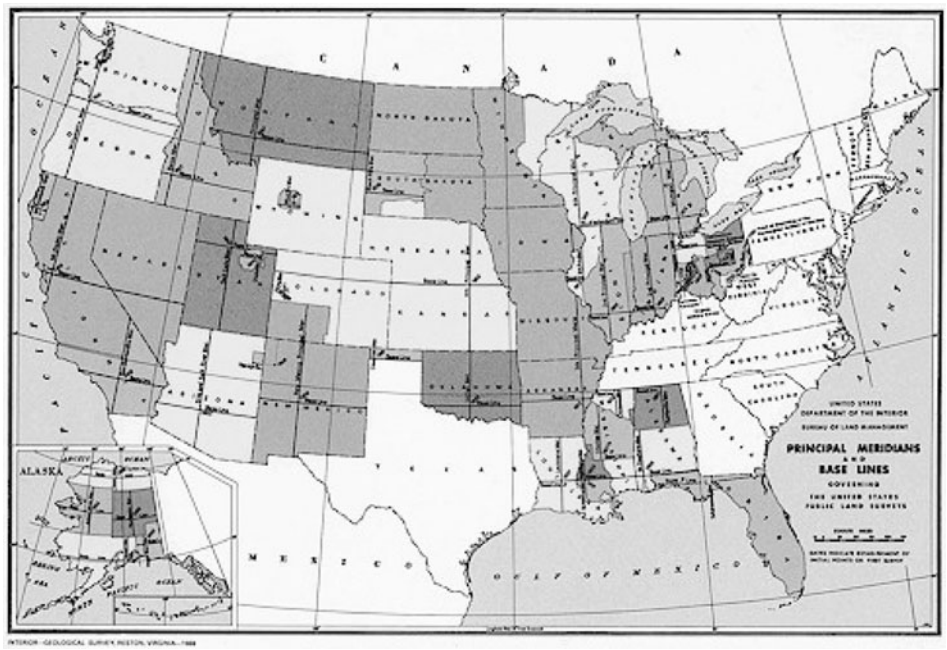

Figure 4.5 Principal meridians and baselines

Source of map: U.S. Bureau of Land Management, http://www.blm.gov/cadastral/meridians/meridians.htm

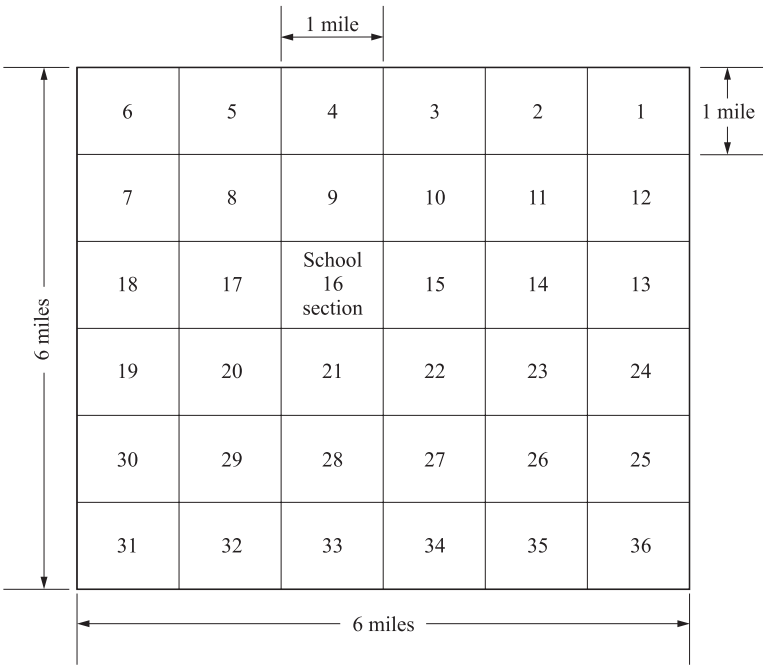

Figure 4.6 Sections in a township

thus creating parcels of land that are 6 miles by 6 miles, or 36 square miles in size. These 36-square-mile parcels are referred to as townships.

These townships are divided into 1-square-mile parcels of land referred to as sections. Thus, there are 36 sections in a township, as illustrated in Figure 4.6. The sections are always numbered in the same way with section number 1 located in the northeast corner of the township and section number 36 in the southeast corner of the township. Historically, section 16 was set aside for school purposes.

The section may be divided into quarters and halves to describe parcels of land smaller than 1 square mile. A section contains 640 acres of land, hence a quarter section contains 160 acres, and a quarter of a quarter section contains 40 acres. (Figure 4.7 contains a sample section which has been divided into quarter sections and smaller divisions.)

Relevant measures to keep in mind relative to the government survey system, as well as legal descriptions in general, include the following:

1 mile = 5,280 feet
1 acre = 43,560 square feet
1 furlong = 1/8 of a mile
1 section = 1 square mile = 640 acres
1 township = 36 sections

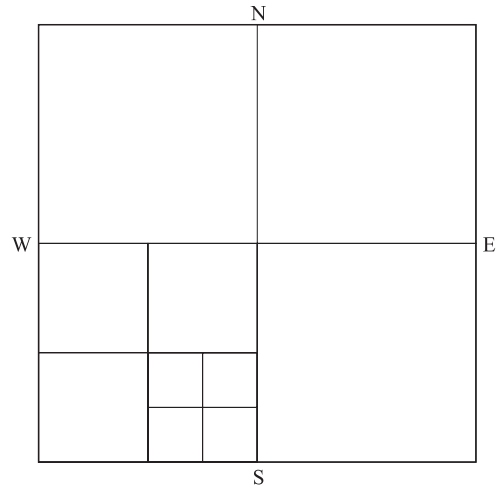

Figure 4.7 Section divided into quarters

EXAMPLE 4.4

Locate on Figure 4.7 the following tract of land—the SE 1/4 of the SE 1/4 of the SW 1/4. How many acres are in the tract of land? It contains 640 × 1/4 × 1/4 × 1/4 = 10 acres of land. Locate the N 1/2 of the SW 1/4 in Figure 4.7. How many acres does it contain? It contains 640 × 1/4 × 1/2 = 80 acres.

Subdivision Plat System

The *subdivision plat system* is also called the *lot and block system*. Within an urban area, it would become unwieldy to continue breaking the description of a 75-foot by 150-foot lot down using the SW 1/4 of the SE 1/4 of the SE 1/4 and so on, until we get down to this lot size. As a result the subdivision plat system was developed. When subdividers or developers create a residential or commercial development, they must follow a series of steps to establish the subdivision. They must have the land surveyed by a licensed surveyor who provides for the creation of a subdivision plat drawing, or subdivision plan. The drawing will contain the lot dimensions, the street widths, the setbacks, and other dimensions within the subdivision.

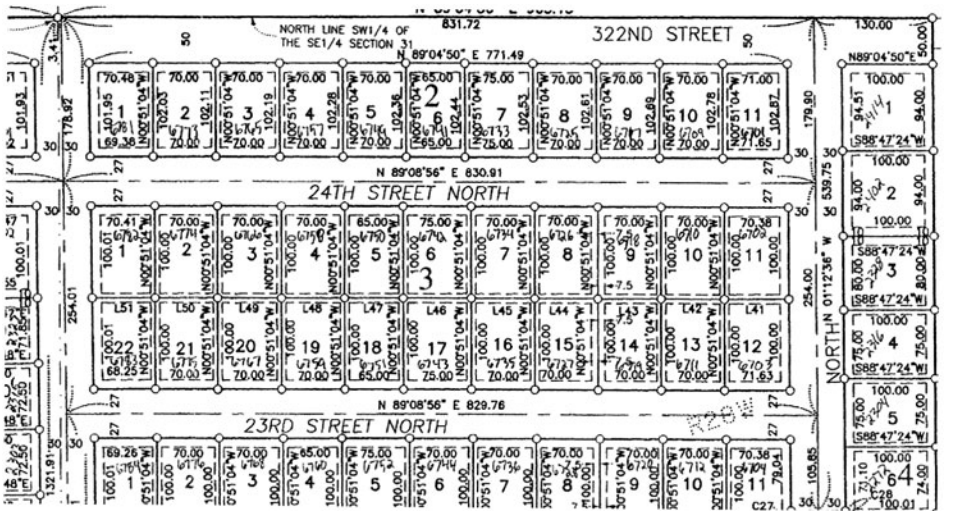

Figure 4.8 Plat drawing

Source: St. Cloud, MN, assessor's office

In order to be recorded, the plat drawing (see Figure 4.8) must be approved by the city, town, or village in which the land is located, to verify that the lot sizes, setbacks, and street widths are within the standards for the municipality. The developer must then verify that there are no outstanding real estate taxes or special assessments against any of the property in question. As a final step, the plat drawing has to be notarized. This finally allows the developer to record the subdivision plat drawing at the county recorder's office, thus informing the world that the subdivision exists. The land is divided into lots and blocks. The blocks are the larger division of land, containing approximately 8–40 different lots for residential or commercial development.

An example of a lot and block description would be: "Lot 1, Block 3, Park Manor Addition, Your County, MN, in the S 1/2 of the NW 1/4 of the SW 1/4 of section 12, Township 25 North Range 10 West of the 4th Principal Meridian." While this is the complete description, the description that is typically used would be "Lot 1, Block 3, Park Manor Addition in Your County, Your State." The county recorder is not going to allow you to record a plat with the name Park Manor Addition if there is already a Park Manor Addition recorded in the county because that would obviously cause confusion. Since that is the case, the government survey system information is no longer necessary.

Quiz for Chapter 4

1. Given the information in Figure 4.8, what is the square footage of Lot 1, Block 3?
   a. 6,500
   b. 7,000
   c. 7,500
   d. 7,041

2. If all of the lots in Block 3 sell for the same price of $35,000, which lot sells for the highest price per square foot?
   a. 1
   b. 5
   c. 6
   d. 7

3. How many lots are contained in Block 3 in Figure 4.8?
   a. 6
   b. 11
   c. 22
   d. 4

4. In Figure 4.7, locate the NE 1/4 of the SE 1/4 of the SW 1/4 of the section. How many acres does the parcel contain?
   a. 640
   b. 160
   c. 40
   d. 10

5. Again looking at Figure 4.7, how many acres are contained in the NW 1/4 of the SW 1/4 and the S 1/2 of the NW 1/4?
   a. 40
   b. 120
   c. 160
   d. 80

6. Describe the dimensions of the parcel of land detailed in question 5 above, starting with the northern side of the parcel.
   a. 2,640 feet × 1,320 feet × 1,320 feet × 1,320 feet × 2,640 feet
   b. 5,280 feet × 2,640 feet × 2,640 feet × 2,640 feet × 5,280 feet

c. 2 furlongs × 1 furlong × 1 furlong × 1 furlong × 2 furlongs
d. 80 acres × 40 acres × 40 acres × 40 acres × 80 acres

7. Li has just purchased sections 1, 2, 11, and 12 of the township illustrated in Figure 4.5. How many acres of land did she purchase?
   a. 640 acres
   b. 1,280 acres
   c. 2,560 acres
   d. 5,120 acres

8. If Li purchased the land in question 7 with a 40% cash down payment, how large was the loan she took out from the bank, if she bought the land for $2,000 per acre?
   a. Less than $1 million
   b. Between $1 million and $2 million
   c. Between $2 million and $3 million
   d. More than $3 million

9. Given the dimensions in Figure 4.9, shown below, what is the area of the lot in the diagram?
   a. 6,000 square feet
   b. 11,200 square feet
   c. 7,200 square feet
   d. 8,400 square feet

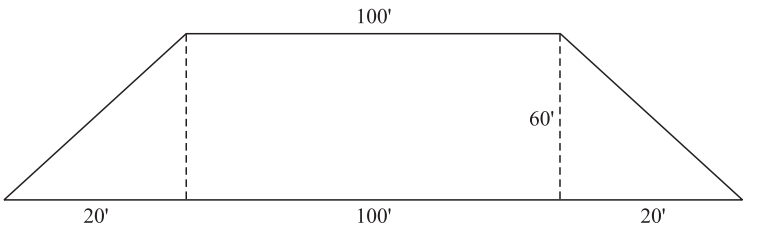

Figure 4.9 Lot size 3

10. If we were to make a bingo card out of the sections in a township in Figure 4.6 and put section 1 in the NE corner of the bingo card, which section would be the "free" space?
    a. 15
    b. 16
    c. 21
    d. 22

5

CHAPTER

Real Estate Taxes

Hold On to Your Wallets!

There are basically two types of real estate taxes that are covered in this chapter. These are the property taxes and the taxes associated with real estate transactions. The taxes associated with real estate transactions are the state deed tax, sometimes called the real estate transfer tax, and the mortgage registration tax.

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Property Tax

Property taxes are referred to as ad valorem taxes, that is to say they are based on value. The tax levy, or the total amount of revenue that needs to be generated, is spread over the taxpayers based on the value of their individual property. The property tax is the method that local government uses to raise revenue to pay for schools, roads, police and fire protection, parks, libraries, and other local services.

Property taxes are based on two factors. The first of these is the annual budget of the taxing authority. That budget can be made up for many different services that need funding. This budget amount is called the *property tax levy*, or the total amount of revenue to be raised from property taxes.

Table 5.1 contains the items listed on a property tax statement for taxes payable in 2007. This indicates where the tax dollars of this particular taxpayer are going. While not a taxing authority budget as such, it does give a clear picture of where the county and local government dollars are being spent. All these items do not have dollar values listed on any one statement, and they may vary from county to county; and they certainly may vary in your state. However, the table does convey the magnitude of establishing the annual budget for the taxing authority.

The second factor in estimating tax liability is the assessed value of the property within the taxing authority's assessment area. The type of value that may show up on the property tax statement may vary. The type of value may be called appraised

Table 5.1 Sample tax statement

Budget item	$ Amount
County	$562.66
City or town	$130.28
State general tax	$0.00
School district	
1. Voter-approved levies	$188.94
2. Other local levies	$190.90
Special taxing districts	
1. Metropolitan special tax	$27.56
2. Other special tax districts	$4.00
3. Tax increment	$0.00
4. Fiscal disparity	$0.00
Nonschool voter-approved levies	$0.00
Total property tax before special assessments	$1,104.34
Special assessments added	
City street curbing	$30.00
Total property tax + special assessments	$1,134.34

value, assessed value, market value, estimated market value, limited market value, or taxable market value. All these won't show up on a single tax statement but a couple of them might. I will use a Minnesota tax statement as an example in this chapter. Currently, on the Minnesota tax statement we have estimated market value and taxable market value. The two values are very often the same. If they are not the same, the estimated market value would be larger than the taxable market value, sometimes called the *limited market value*. The reason the estimated market value may be greater than the taxable market value is that value increases were capped at a certain percentage for a number of years, and there may have been increases in the estimated market value that didn't find their way into the taxable market value.

The individuals who estimate market values and assessed values for city and county government taxing authorities are called *assessors.* Assessors are simply appraisers working for a governmental entity. There are often separate parallel licensing processes for public assessors and private appraisers.

While the paragraph relating to the second factor in estimating tax liability may sound a little confusing, it is just the tip of the iceberg when it comes to understanding property taxes as a whole. Maybe property taxes in Minnesota are more confusing than taxes in your state.

TAX RATE AND MILL RATE

Let's move on to what is referred to as the *tax rate*. The tax rate can be stated a number of different ways. Some states refer to it in a percentage format, or dollars per hundred. Other states use the term *mill rate*. One mill equals $^{1}/_{1,000}$ of a dollar, or a tenth of a cent per dollar. Still other states use measure of dollars per thousand. In order to obtain the tax rate or mill rate, we need the aforementioned tax levy and the total assessed value within the taxing district.

Equation 5.1

$$\text{Tax rate} = \text{Budgeted revenue} \div \text{total assessed value of all property}$$

Let's try an example. Given a revenue budget for the city and county of \$50 million and total assessed value for property in the taxing district of \$400 million, what is the implied tax rate for the district?

Equation 5.2

$$\text{Tax rate} = \$10{,}000{,}000 \div \$400{,}000{,}000 = 0.025 = 2.5\%$$

In many states we would then just take that tax rate times the assessed value of the individual property, and that would result in the tax liability. If we have

a property that has an assessed value of $175,000, the tax liability falls out in Equation 5.3. If this example was stated in mills, we would have 25 mills times $175,000/1,000 or 25 × $175 = $4,375. The answer is the same whether your state uses the term mill rate or it uses a tax rate in percentage form.

Equation 5.3

$$\text{Tax liability} = \$175{,}000 \times 0.025 = \$4{,}375$$

If a community wanted to reduce the tax rate, it could encourage development to increase the denominator or the total assessed value. That would result in a lower tax rate. Of course more developed land will result in greater budgetary requirements, so it wouldn't be a direct reduction in the rate. As an example, if the city encouraged and received another $50 million in assessed value through additional development, the tax rate would go down to 2.2% if there was no increase in the budget.

Equation 5.4

$$\text{Tax rate} = \$10{,}000{,}000 \div \$450{,}000{,}000 = 0.022 = 2.2\%$$

This would bring the tax liability of our $175,000 house down to $3,850. That would be a decrease of 12%.

Equation 5.5

$$\text{Tax liability} = \$175{,}000 \times 0.022 = \$3{,}850$$

$$\text{Reduction} = \$4{,}375 - \$3{,}850 = \$525/\$4{,}375 = 0.12 = 12\%$$

Taxpayers often assume that if their assessed value goes up, their tax will automatically go up also. That is not the case as long as everybody's assessed value goes up. If all property values go up, then the tax rate will go down to compensate for that increase. There are only two ways for your property taxes to go up. Either your assessed value has to increase faster than everybody else's in your tax district, or your local and country governments are spending more money. So, either the numerator goes up in Equation 5.3, or your assessed value goes up and all other values stay the same so that the tax rate is virtually unchanged but it is multiplied against your higher assessed value to give you a greater tax liability.

MINNESOTA EXAMPLE

The example here is neither advocating the Minnesota property tax system nor is it an endorsement or request for you to move to Minnesota. It is just another

Table 5.2 Home tax liability

Tax inputs	Values
Taxable market value	$250,000
× Tax capacity %	×0.01
Tax capacity	$2,500
× Tax rate	×1.02268
Base tax	$2,556.70
− Homestead exemption	− $147.40
Tax liability	$2,409.30

example of how property taxes may be determined. Table 5.2 contains the relevant calculations of the tax liability for a $250,000 home.

First the assessed value is multiplied by the tax capacity percentage. In the case of this home in St. Cloud, the tax capacity percentage is 1% or 0.01. That results in a tax capacity of $2,500. That is now multiplied by the tax rate of 1.02268 which results in a base tax of $2,556.70. Minnesota has a homestead credit if you own and occupy your own personal residence. The maximum homestead credit is $304 per year on a home with a value of $76,000 and then begins to be reduced beyond that value. The calculation for the homestead credit for this home is contained in Equation 5.6.

Equation 5.6

$$\text{Homestead credit reduction} = (\$250{,}000 - \$76{,}000) \times 0.0009 = \$156.60$$

$$\text{Homestead credit} = \$304 - \$156.60 = \$147.40$$

The homestead credit is then deducted from the base tax to give the final tax liability of $2,409.30. There are several other tax credits and adjustments that apply to special interest situations but this will suffice for now.

Transaction Taxes

As mentioned at the beginning of this chapter there are taxes associated with the transfer of real estate—the state deed tax and the mortgage registration tax.

STATE DEED TAX

The state deed tax is the seller's expense in Minnesota. This tax is sometimes referred to as the state deed tax stamps because stamps are actually affixed to the

deed based on the value of the transaction. The rate is currently \$3.30 per \$1,000 of the sale price. If you wanted to know how much a seller paid for a piece of property, you could go to the county recorder's office, look at a copy of the deed that was filed, and add up the value of the stamps.

Your brother has recently sold his home, and the closing will take place in two weeks. The house was listed for \$220,000 for a five-week period, and then the price was reduced to \$210,000 and was finally sold for \$205,000. The buyer was taking out a \$160,000 mortgage at 7% for 30 years. How much state deed tax will your brother have to pay at the closing in St. Paul?

Equation 5.7

$$\text{State deed tax} = 205 \times \$3.30 = \$676.50$$

The state deed tax on the transaction described above would be \$676.50.

MORTGAGE REGISTRATION TAX

Whenever a new mortgage is recorded in Minnesota, a mortgage registration tax must be paid. The rate for the mortgage registration tax is \$2.30 per \$1,000 of new mortgage amount. The tax need not be paid in the case of a mortgage assumption because the tax has already been paid on that mortgage. How much mortgage registration tax has to be paid on the transaction mentioned in the paragraph directly preceding Equation 5.7? It is the buyer's expense to record the mortgage, and it is the buyer's expense to pay the mortgage registration tax.

Equation 5.8

$$\text{Mortgage registration tax} = \$2.30 \times 160 = \$368.00$$

Dave had been trying to sell his home in Minnesota for some time. His original listing price was \$195,500. After three months he decided to reduce the asking price to \$190,500. Three days later he had an offer for \$193,700 which he accepted. The buyer was to take out an FHA mortgage for \$175,500 to complete the purchase. The closing is this afternoon and Dave is wondering who pays the state deed tax and how much it will be, and who pays the mortgage registration tax and how much that will be. Punch some buttons and see what you come up with. Then look at Equations 5.9 for the solution.

Equation 5.9

$$\text{State deed tax} = 193.7 \times \$3.30 = \$639.21\text{, seller's expense}$$

$$\text{Mortgage registration tax} = 175.5 \times \$2.30 = \$403.65\text{, buyer's expense}$$

Quiz for Chapter 5

1. There are two major factors in determining the property tax rate. Which of the following items is one of those factors?
   a. Annual budget of the taxing authority
   b. State deed tax rate
   c. Mortgage registration tax rate
   d. The state annual budget

2. Which of the following is the second factor in determining property tax rates?
   a. The total limited market value of homes on your block
   b. The total assessed value of homes on your block
   c. The total assessed value of property in your taxing authority area
   d. The total assessed value of homes plus investment properties on your block

3. Budgeted revenue ÷ Total assessed value of all property is the formula for:
   a. Assessed value
   b. Tax rate
   c. Estimated market value
   d. Tax liability

4. You are buying a townhouse. The list price was $142,900, and you made an offer of $140,000 which the seller accepted. The mortgage you are taking out is for $138,000 to be amortized over 30 years at a 6.25% rate, and closing costs will come to $3,600. How much mortgage registration tax will you have to pay at the closing?
   a. $328.67
   b. $322.00
   c. $317.40
   d. $455.40

5. In the transaction described in question 4, how much state deed tax will the seller have to pay at the closing?
   a. $471.57
   b. $462.00
   c. $455.40
   d. $322.00

6. The authorized budget for your city and county for next year comes to $8.5 million. The total assessed value for the taxing authority area is $365 million. Your home has an assessed value of $163,000. What is the tax rate in your area for the coming year?
   a. 1.92%
   b. 2.33%
   c. 4.0%
   d. 2.43%

7. In question 6, what will your tax liability be?
   a. $3,129
   b. $3,797
   c. $6,520
   d. $3,960

8. Using the same criteria that are detailed above in the Minnesota example that is summarized in Table 5.2, what would the tax liability be on a home with an assessed value of $325,000? Use the same tax capacity and tax rate that you find in Table 5.2.
   a. $3,250
   b. $3,323.71
   c. $3,243.81
   d. $224.10

9. Using the same information from question 8, what is the amount of the homestead exemption?
   a. $304.00
   b. $79.90
   c. $224.10
   d. $76,000

10. Why is mortgage registration tax paid only when new mortgages are recorded and not for mortgage assumptions?
    a. Just because
    b. New mortgages are for larger dollar amounts than are mortgage assumptions
    c. It's Minnesota, for gosh sake
    d. Someone has already paid mortgage registration tax on an existing mortgage

6

CHAPTER

Time Value of Money (TVM)

Six Equations That Will Change Your Life

Money has differing values over time. A dollar we receive today is not worth the same as a dollar that we receive five years from today. Since most people are thought to fit the definition of wealth-maximizing individuals, a dollar received today should have a greater value than a dollar we are to receive in five years. One explanation for this is that if we had the dollar today, we could set it aside in an

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interest-bearing account so that it could grow in value for that five-year period and have a much greater value at the end of the five years.

This chapter addresses the value of money over time and will enable you to calculate the value of money over time so that you can use these tools to analyze a mortgage, analyze a real estate investment opportunity, and analyze your retirement portfolio so that you can make the necessary allocations to maximize your retirement income. Stated quite simply, we look at *six equations that will change your life!* They will change your life because if you understand them, they give you command over financial calculations that banks make, that real estate brokers use, and that investors need to understand in order to adequately analyze investment opportunities.

Four Major Premises

The concept of time value of money is driven home by remembering four separate major premises. These major premises are referred to several times throughout this chapter as well as in other parts of the book; if you can master these four time value of money concepts, the financial world will be yours to work with and profit from.

1. The higher the discount rate, the lower the present value.
2. The sooner you get the money, the more its worth.
3. The principal balance at any point in time is equal to the present value of the remaining payments.
4. An investor will pay only the present value of all cash flows to be received, discounted at the required rate of return.

Future Value

The first of the six equations is the calculation of what is called the future value (FV) of a lump some, or single amount. Future value is either the amount that a sum today, which is called a present value (PV) will grow to in the future, or the value of some amount of money that is to be received in the future. Equation 6.1 is the mathematical calculation for converting a PV into a FV, or taking an amount of money today and compounding it forward to achieve its corresponding future value.

Equation 6.1

$$FV = PV\ (1 + r)^n$$

This equation says that we take the present value and multiply it by 1 plus the rate of interest, raised to the nth power based on the number of compounding periods. If it compounded for two periods, we square the (1 + r); if it's three periods we cube it, and so on.

If raising values to a power makes you nervous, you can use Equation 6.2 because all of the values for the FVIF (future value interest factor) can be calculated using your financial calculator.

Equation 6.2

$$FV = PV\ (FVIF)$$

The FVIF can be calculated by putting a –1 in your financial calculator as the [PV], 5 as your [i/y], 3 [n] and then hitting [cpt] [FV]. You can use any interest rate and any number of periods. The calculator in fact renders the equations obsolete, but I have found that the students who understand the equations have a more complete understanding of the time value of money concept.

As an example, if you took $100 today and put it in a 5% account for three years and wanted to know what the value of the account would be at the end of those three years, your calculation would look like Equation 6.3.

Equation 6.3

$$FV = PV\ (FVIF_{3n,5\%}) = \$100(1.1576) = \$115.76$$

The future value is equal to the present value times the future value interest factor for 5% interest for 3 periods, or 3n. If you put 1 [+/−] [PV], 3 [n], 5 [i/y] in your financial calculator and [cpt] [FV], you will get a value of 1.1576; plugging that into the equation results in a future value of $115.76. Notice that the calculator operates in terms of cash inflows and cash outflows. The present value must be entered as a negative number for your future value to come out as a positive number. In order to make the present value negative, you must hit the [+/−] key after entering the amount that you want as a present value. If it doesn't bother you when you get a negative sign in your answer, then don't worry about using the [+/−] key on your input. However, when you input both the present value and the future value on a problem, you must have one positive and the other negative. Otherwise the calculator will give you an error message.

The same calculation can be made using a financial calculator. The keystrokes for the TI Business Analyst II Plus calculator would be as follows.

Solution 6.1

100 [+/−] [PV]
3 [n]
5 [i/y] .>
[cpt] [FV] 115.76

Prior to making the above calculation with your Texas Instruments financial calculator, you should make sure that the calculator is set on one compounding period per year. To do that, hit the [2nd] key followed by the [i/y] key. Your screen should look like this, P/Y = 1.00. The calculator is telling you it will use one compounding period per year. The alternative that could show up on the screen is P/Y = 12.00 which would be 12 compounding periods per year. While it seems that this setting would work well for monthly compounding problems, we work with a method that won't require us to change back and forth from 1 compounding period per year to 12 compounding periods per year, because invariably we forget to make the technical change and end up getting a bogus answer.

In order to change the calculator to one compounding period per year hit the [2nd] key again followed by the [enter] key, followed by 1, followed by the [enter] key again. Now the calculator is set to one compounding period per year. I have found it most convenient to always have the calculator set to one compounding period per year and to just make the needed adjustments when more compounding periods are required. All the calculator solutions in this book assume you have the calculator set to one compounding period per year.

If you did not get an answer of 115.76 the first time because you had the incorrect number of compounding periods set on your calculator, make the changes mentioned in the previous paragraph and try the problem again.

Let's look at my all-time favorite future problem. It may be your favorite problem too when we get done with it. Let's look at the best real estate deal ever struck in the United States. When I bring this up in class, it's usually the third one mentioned, and by "usually" I mean 95% of the time. The first one mentioned is usually the Louisiana Purchase. I say that it was a good deal, but not the best deal. Then Seward's Icebox, Alaska, is mentioned. Again, this is a good deal but not the best deal. The best real estate deal ever struck in the United States has to be the purchase of Manhattan by the Dutch. The supposed purchase price was $24 worth of beads. For those of you who doubt that it was the best deal, I worked it out on a cost per acre basis, and it was in fact the lowest purchase price. The assumption has always been that the Native Americans got robbed by the Dutch and were taken advantage of. Now, let's look at the transaction a little closer and see who got robbed. We can analyze the transaction from a time value of money standpoint and see how everyone did.

First of all, the deal took place in the year 1628, some 379 years ago. Let's take the $24 and compound it forward 379 years and see if the indicated value makes sense. The question is what rate of annual appreciation has taken place since the year 1628? Experts indicate that the average home in the United States has gone up by 4% per year over the last 50 years or so. I tend to think that Manhattan Island may appreciate faster than the average home. Let's use 8% for our calculation. The calculator keystrokes should look like this.

Solution 6.2

24 [+/−] [PV]

378 [n]

8 [i/y]

[cpt] [FV] 1.116386 14

The answer is in scientific notation. That 14 floating out to the right-hand side of the display means that we have to shift the decimal point 14 places to the right. That gives us an answer of $111,638,600,000,000. That reads about 111 trillion dollars! Does it seem reasonable that the land of Manhattan Island would be worth 111 trillion dollars? No, I don't think so either. The total U.S. land area is about 852.6 million acres. About half of that is farmed, and most of the rest is in forest, plains, and park lands.

If we use an optimistic $5,000 per acre, which is nearly twice the value of the most productive farmland, and apply that value to the entire 852.6 million acres, the total U.S. land value would only be $4.26 trillion. The logical conclusion then is that the Dutch overpaid for the property. What do you think it was worth? $11? Maybe $11.50 tops? If indeed there is anything wrong with the calculation, maybe it is the 8% appreciation rate that was used. Maybe from 1628 to 1629 it didn't go up by 8% in value. If we just reduce the appreciation rate from 8% to 4%, the ending value goes from $111 trillion down to $68.5 million!

Here is one final item in my favorite FV problem. When looking at the original answer of $111 trillion, how much of that is interest? That's right. Everything except for the $24 is interest. That's why, when someone asked Albert Einstein what the most powerful force in the world was, he didn't answer nuclear fission, he didn't answer nuclear fusion, he answered compound interest. If it's good enough for Al, it's good enough for me.

Present Value

The future value calculation tends to be the easiest for people to understand since most of us have put money into a savings account and watched it grow over time.

Somewhat less intuitive is the present value of a lump sum calculation. Rather than pushing money forward over time, as we do in the future value calculation, in the present value calculation we are bringing money back over time. While the future value calculation is called *compounding*, the present value calculation is referred to as *discounting*.

Let's say my grandmother offers me $115.76 in three years or some money today. Which should I take? Well, it depends on how much she is going to give me today. The equation for the calculation of a present value looks like Equation 6.4.

Equation 6.4

$$PV = FV/(1 = r)^n = FV\ (PVIF)$$

Hopefully you can see then that the PVIF is simply the reciprocal of the FVIF, or 1/FVIF. This means that both the compounding of FV calculations and the discounting of PV calculations are based on the same compound interest concept. In fact, all six equations that will change your life are based on the same compound interest basis.

Plugging our numbers into Equation 6.4, we get $100.00. The PVIF can be calculated by inputting a 1 [FV], 3 [n], 5 [i/y] and then hitting [cpt] [PV] which results in a value of 0.8615. To set the number of decimal places displayed, use the keystrokes [2nd] [Format] and then put in the number of decimal places you want displayed, followed by the [Enter] key. To get four decimal places, use [2nd] [Format] 4 [Enter].

Equation 6.5

$$PV = FV\ (PVIF) = \$115.76\ (0.8639) = \$100.00$$

The calculator keystrokes for the calculation give us the same answer.

Solution 6.3

115.76 [FV]

3 [n]

5 [i/y]

[cpt] [PV] −100.00

Again we have shown that I would be indifferent to either $115.76 in three years or $100.00 today, if my required rate of return was 5%.

Let's try that same problem with one change. This time let's say that our required rate of return, or our discount rate, is 7%. In that case the calculator solution looks like this.

Solution 6.4

115.76 [FV]

3 [n]

7 [i/y]

[cpt] [PV] −94.49

This illustrates the first major premise mentioned at the beginning of the chapter. The higher the discount rate, the lower the present value. This is important because it is just the reverse of the future value calculation. In a future value calculation a higher interest rate will get you a larger future value. Well, it's just the other way around in a present value calculation. The higher the discount rate the lower the present value. In this case increasing the discount rate from 5% to 7% reduces the present value from $100 to $94.49.

The second major premise—the sooner you get the money, the more it's worth—can also be illustrated with a slight change in Equation 6.5 using the original 5% discount rate. Let's say that instead of waiting for three years to get our money, we have to wait for five years. Solution 6.5 illustrates the new calculation.

Solution 6.5

$115.76 [FV]

5 [n]

5 [i/y]

[cpt] [PV] −90.70

Instead of the $115.76 having a present value of $100, if we have to wait five years, the present value goes down to $90.70. In other words, the sooner we get the money, the more its worth.

Let's say that an investor has an opportunity to purchase the right to receive a $10,000 cash payment, but it won't be received for 10 years. If he needs an 8% return on his investment, how much should he pay today for the right to receive the $10,000 in 10 years? As you recall from the fourth major premise at the beginning of this chapter, an investor will pay only the present value of all cash flows to be received, discounted at the required rate of return. The resulting calculator keystrokes are shown in Solution 6.6.

Solution 6.6

10000 [FV]

10 [n]

8 [i/y]

[cpt] [PV] −4631.93

If the investor needs an 8% return on his investment, he will pay $4,631.93 today for the right to receive $10,000 at the end of 10 years. Stated in another way, if the investor pays $4,631.39 today and receives $10,000 as a result in 10 years, he will receive an 8% rate of return.

Future Value of an Annuity

Before discussing the future value of an annuity, we should address the concept of an annuity. An *annuity* is a series of equal payments that come at regular intervals. Mortgage payments are considered an annuity; they are typically paid on a monthly basis. Lease payments also follow a regular monthly pattern.

There are two types of annuities; the ordinary annuity and the annuity due. The payments in an ordinary annuity come at the end of the period as shown in Figure 6.1. Mortgage payments are ordinary annuity payments. They are considered end-of-the-month payments because they accrue interest until the end of the month. When you make that monthly payment, you are paying interest for the previous month.

Rent payments on the other hand are considered annuity due payments which come at the beginning of the period as shown in Figure 6.2. Rental payments are made at the beginning of the month to cover rent for the space during that same month. Whenever the annuity payments come at the beginning of the period, they are considered an annuity due.

Now, let's get back to the future value of an annuity. Let's say that my grandmother says she will give me $100 at the end of each year for the next three years, or an amount of money at the end of the three-year period, whichever I prefer. If I knew what the future value of that three-period annuity was going to be, I could

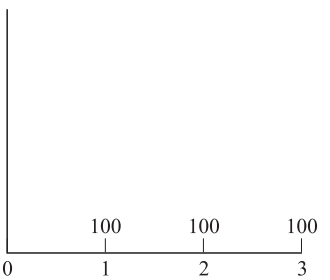

Figure 6.1 Ordinary annuity

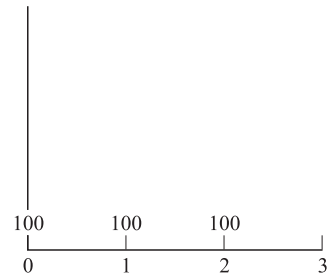

Figure 6.2 Annuity due

make an informed decision about the payment plan that I would prefer. The cash flows are diagramed in Figure 6.1, and we assume that my interest rate is 5%.

To find the future value of this annuity, we could take each payment individually and calculate its future value, that is, take the first payment and compound it forward to the end of period three, take the second payment and compound it forward, and then take the third payment with no compounding since it is already at the end of period three, and then we could add those three values to get our future value. The solution looks like the following:

100 [+/−] [PV]	100 [+/−] [PV]	100 [+/−] [PV]
2 [n]	1 [n]	0 [n]
5 [i/y]	5 [i/y]	5 [i/y]
[cpt] [FV] 110.25	[cpt] [FV] 110.00	[cpt] [FV] 100.00

When the three future values are added, 110.25 + 110.00 + 100.00 = 315.25, the total future value of $315.25 is achieved. That is almost doable when you have only three payments. If you had a series of 300 payments to compound forward, it would take forever.

Equation 6.6 illustrates how the future value of an annuity is calculated using time value of money tables, or the mathematically calculated Future Value Interest Factor of an Annuity (FVIFA). It allows us to use a single TVM equation, or calculation, rather than the three calculations used above. The FVIFA can be calculated with these keystrokes; 1 [+/−] [pmt], 3 [n], 5 [i/y], [cpt] [FV], 3.1525.

Equation 6.6

$$FV_A = \text{pmt (FVIFA)} = 100\ (3.1525) = \$315.25$$

The calculator keystrokes are shown in Solution 6.7.

Solution 6.7

100 [+/−] [pmt]
3 [n]
5 [i/y]
[cpt] [FV] 315.25

The future value of this three-period annuity of $100 per year is $315.25. It appears I would be indifferent between receiving the $100 payment at the end of each year for three years or a lump sum payment of $315.25 at the end of the three-year period. Both payment plans are worth the same to me, assuming my interest rate or required rate of return is 5%. Thus I would tell my grandmother that I will take either $100 at the end of each year or I would take $315.25 at the end of the three-year period. Notice that the payment value in the calculator keystrokes is entered as a negative number. Since the calculator operates in terms of cash inflows and cash outflows, we have to tell it that the payments are cash outflows, which will give us a positive number for the future value or cash inflow.

If the cash flows were to be received at the beginning of the year rather than the end of the year, the diagram of cash flows would appear as shown in Figure 6.2.

The future value of the annuity due will always be greater than the future value of an ordinary annuity of the same payment amount, number of payments, and interest rate because you are earning more interest. One way to look at it is that the final payment in the ordinary annuity has been shifted from the end of period 3 back to time period 0, or today. It will earn three periods' worth of interest by the time we want its value at the end of period three. Alternatively, you could think of it as picking up all three payments and shifting them one period to the left. In that case we are earning one more period's worth of interest on each of the three payments. Regardless of whether we earn three more period's worth of interest on one payment or one more period's worth of interest on three payments, the result is the same.

The calculation for the future value of an annuity due is to simply take the future value of the ordinary annuity times the quantity (1 plus the rate of interest), as shown in Equation 6.7. The annuity due will always have a greater value than the ordinary annuity because we will be receiving one more period's worth of interest on all of our payments. By multiplying the value of the ordinary annuity ($315.25) by the quantity (1 plus the rate of interest), we are taking that ordinary annuity value and adding on one more period of interest.

Equation 6.7

$$FV_{A\text{-Due}} = FV_A\ (1 + r) = \$315.25\ (1 + 0.05) = \$315.25\ (1.05) = \$331.01$$

If you decide to use the [beg] key on your calculator, that is what the calculator is doing, multiplying the value of the ordinary annuity by the quantity (1 plus the rate of interest).

Another future value of an annuity problem might look like this. You plan on setting $100 aside at the end of each month for the next 40 years. You plan to put this into a mutual fund which has on average earned 10% per year over the last several decades, and you expect that rate of return to continue for the next 40 years. How much will you have in your mutual fund account after those 40 years? The financial calculator keystrokes look like those presented in Solution 6.8.

Solution 6.8

100 [+/−] [pmt]

40 × 12 = [n]

10 ÷ 12 = [i/y]

[cpt] [FV] 632407.96

Setting aside $100 per month in a 10% account each month for 40 years will result in an accumulation of $632,407.96! In this case the 10% interest is an annual rate. Interest rates are typically annual rates unless stated otherwise. Since the payments are monthly, the rate of interest is converted to the monthly rate by dividing it by 12. For the same reason, the number of years is multiplied by 12 to arrive at the number of monthly payments. In all time value of money calculations the interest rate and the number of payments have to be compatible with each other. If we have monthly payments, we need the interest rate stated put in the calculator as a monthly rate. If we have quarterly payments, we need a quarterly rate of interest. If we have annual compounding, we need an annual rate of interest and we use the number of years as our "n."

Present Value of an Annuity

Similar to the present value calculation we did earlier in the chapter, the present value of an annuity calculation is a discounting process rather than a compounding one, as in the future value calculations. In other words, we bring the value of the money back to today's value, or present value.

Once again, look at the cash flows as pictured in Figure 6.1, but this time, my grandmother asks if I want the $100 payments or an amount of money today. We are really asking what the present value of this annuity is.

The Present Value Interest Factor of an Annuity (PVIFA) uses these keystrokes from our calculator; 1 [+/−] [pmt], 3 [n], 5 [i/y], [cpt] [PV] 2.7232. The present value of an annuity equation is shown in Equation 6.8.

Equation 6.8

$$PV_A = \text{pmt (PVIFA)} = 100\ (2.7232) = \$272.32$$

The calculation using the financial calculator will follow in Solution 6.9. Note that from this point on I will assume that you know that when I use a negative payment or negative present value, you will know to use the [+/−] key.

Solution 6.9

−100 [pmt]
3 [n]
5 [i/y]
[cpt] [pv] 272.32

The conclusion this time is that we would either take the $100 payments at the end of each year for three years or we would take the lump sum of $272.32 today. We are indifferent between the two plans because they have exactly the same value to us. Now, if Grandma says that she will either give us the annual payments or $275 today, we jump all over that. That is because the payments have a value of $272.32, and she is offering us $275, which is a higher present value.

The present value of an annuity calculation can be used to find the principal balance on a loan, such as a mortgage. If we look back to the four major premises at the beginning of the chapter, specifically premise 3, we see that the principal balance at any point in time is equal to the PV of the remaining payments. Let's work with a $175,000 mortgage amortized over 30 years at a 7% rate of interest. The keystrokes are shown in Solution 6.10.

Solution 6.10

175000 [PV]
30 × 12 = [n]
7 ÷ 12 = [i/y]
[cpt] [pmt] 1164.28

This results in a monthly payment of $1,164.28. If the question is to determine the principal balance of the mortgage after 5 years, we simply take the present value of the remaining payments as is indicated in major premise 3. This can be

accomplished by first hitting the recall key, [rcl] followed by the number of payments key, [n]. The number of months, 360, will show up in the screen. Simply subtract 60 from the 360 (since 5 years, or 60 months are gone) and get an answer of 300; there are 300 payments remaining. Put the 300 in [n] without changing anything else on the calculator, and now compute the new present value, [cpt] [PV], and get $164,730.28. All of those keystrokes are shown in Solution 6.11.

Solution 6.11

175000 [PV]

360 [n]

7 ÷ 12 = [n]

[cpt] [pmt] 1164.28

[rcl] [n] −60 = [n]

[cpt] [PV] 164730.28

Note that this time I just put 360 directly into [n] without multiplying 30 × 12. It was a shortcut because I already knew that 30 × 12 is equal to 360. I didn't take a shortcut with the interest rate however. First of all I can't do that one in my head, and second if I just put in 0.58 which is the two decimal place answer to that division problem, I would be leaving off nine other decimal places worth of information that the calculator actually has "behind" the display screen. Your calculator calculates answers to 11 decimal places and displays only what you ask it to. You can change the number of decimal places you display by hitting [2nd] [Format] followed by the number of decimal places you would like displayed, say 2 or 4, followed by the [enter] key. For that same reason, if we were to put the payment of 1,164.28 directly into the calculator, with 300 [n] and the interest rate as 7 ÷ 12 and then calculated the present value, we would get a slightly different answer (164,730.37) because we put in a truncated, or chopped off, payment, with only two decimal places, as is illustrated in Solution 6.12.

When we did the calculation above, the payment had some additional decimal places hiding behind the display. If the calculator is asked to display four decimal places, the payment becomes 1,164.2794. So, by plugging a payment of 1,164.28 into the calculator we are losing some precision.

Solution 6.12

1164.28 [pmt]

300 [n]

7 ÷ 12 = [i/y]

[cpt] [PV] 164730.37

The answer is different from that in Solution 6.11 by 9 cents. The first calculation in Solution 6.11 is more precise, and that is the number the bank will come up with. The second method in Solution 6.12 is certainly acceptable in most cases, unless of course it is your money, in which case you will want to be as accurate as possible!

The present value of an annuity due works in similar fashion to the future value of an annuity due. The third payment in Figure 6.1 gets shifted to the front end, or time period 0 in Figure 6.2. This means that instead of being discounted for three periods, there is no discounting at all because it is received today. Once again, the present value of the annuity due must be greater than the present value of the ordinary annuity. The present value of the annuity due is equal to the present value of the ordinary annuity times 1 plus the rate of interest. So using the ordinary annuity in Equation 6.8, the value of the annuity due is shown in Equation 6.9.

Equation 6.9

$$PV_{A\text{-Due}} = PV_A\ (1 + r) = \$272.32\ (1 + 0.05) = \$272.32\ (1.05) = \$285.94$$

The value of the annuity due becomes \$285.94 because the cash flows are earning one more period's worth of interest, via discounting, since the payments are all received one period sooner. Going back to the second major premise, the sooner we get the money, the more it's worth.

Sinking Fund Payment

There are two types of payments that come out of the time value of money. The first of these is called a *sinking fund payment*. For the sinking fund payment there is a target future value that an investor is shooting for. The sinking fund payment is the size of the payment needed to set aside at regular intervals that will accumulate the desired future value.

This is an example I like to use with my college students, who are typically juniors and seniors. Assume that you want to go on a vacation, say in three years, and you decide you will need \$5,000 for that vacation. If you set aside some money at the end of each year in a 5% account, how large should the payments be that you are placing in the account? The calculation in Equation 6.10 makes use of the time value of money table values, or the calculated factor.

Equation 6.10

$$Pmt = FV_A/FVIFA = \$5{,}000/3.1525 = \$1{,}586.04$$

The future value of the annuity is the amount of money we want to accumulate in the future, in this case $5,000. The FVIFA, or the future value of an annuity interest factor, is for 3n and 5% interest. The calculation tells us that the students will need to set aside $1,586.04 at the end of each year in a 5% account in order to accumulate the $5,000 needed for their vacation. The calculator keystrokes are shown in Solution 6.13.

Solution 6.13

5000 [FV]

3 [n]

5 [i/y]

[cpt] [pmt] 1586.04

Another situation that this calculation may be used in would be when your neighbor has a balloon payment due in five years on her contract for deed. The balloon payment is going to be $10,000, and she wants to set aside some money each month in her 5% account to accumulate the $10,000 in five years.

In order to do the calculator calculation, make sure to set your [i/y] key to 1 payment per period. Do that by hitting [2nd] [i/y] 1 [enter]. Now hit the [CE/C] twice, and you're set to go. See if you can come up with the answer. Your keystrokes should look like those in Solution 6.14.

Solution 6.14

10000 [FV]

5 ÷ 12 = [i/y]

5 × 12 = [n]

[cpt] [pmt] 147.05

You will note that when using the financial calculator for TVM calculations, the interest rate and the number of periods have to be compatible with each other. When the calculator is in its default setting, one compounding period per year, it is set to do annual problems. When we do something other than annual compounding, we have to tell the calculator what we plan to do. In this problem, since we have monthly payments, we tell the calculator that we need the interest rate per month, so we divide the 5% by 12 and put that in the [i/y] key. We also take the 5 years and multiply that by 12 and put that in the [n] key. Now we have payments per month and interest rate per month, so the number of periods and interest rate are compatible with each other.

The keystrokes above tell us that if we set aside $147.05 at the end of each month for 5 years, or 60 months, in a 5% account, we will accumulate $10,000.

Also note that the calculator assumes that the annuity problems are ordinary annuities, with the payments at the end of the period, unless you tell it otherwise. You can do that with the [BGN] key, but it is not necessary. Just take the PV or the FV of an ordinary annuity and multiply that answer by 1 plus the rate of interest to get the PV or the FV on an annuity due, as mentioned earlier in this chapter.

Payment to Amortize

The final equation of the six equations that will change your life (has it started to happen yet?) is the calculation of the payment to amortize. The payment to amortize is the payment needed to repay a debt over a certain period of time at a certain rate of interest. You have probably used the payment to amortize whether it was a car loan repayment, a student loan repayment, or a mortgage loan repayment. The variables in this calculation are the loan amount, or present value, the interest rate, and the repayment period, usually in numbers of months.

If you borrow $20,000 to buy a car and the credit union says that you can repay it monthly over a five-year period at 6% interest, what would your loan payment be? The calculation looks like Solution 6.15.

Solution 6.15

20000 [PV]

6 ÷ 12 = [i/y]

5 × 12 = [n]

[cpt] [pmt] 386.66

Your monthly payment would be $386.66. If you did not get this answer, there are two possible explanations. First check your number of payments per year by hitting [2nd] [p/y] key. If a 1 is not in the screen, hit 1 followed by [enter] and then [CE/C] key twice. If that was already set at 1, then you may need to clear your TVM memory registers. This can be done by hitting [2nd] [CLR TVM]. If you don't clear the memory registers between problems, the calculator will try to pick up a number from a previous problem and plug it into the new problem, thus giving a bogus answer to the new problem. So try and make it a practice to clear the memory registers after each problem.

Let's try another one, this time a mortgage loan. Your favorite mortgage lender says that you may obtain a $165,000 mortgage at 6.5% interest amortized

over 30 years. What will your mortgage payment be on this loan? The keystrokes are shown in Solution 6.16.

Solution 6.16

165000 [PV]
30 × 12 = 360 [n]
6.5 ÷ 12 = [i/y]
[cpt] [pmt] 1042.91

The payment on the $165,000 mortgage amortized over 30 years at a 6.5% rate of interest comes out to be $1,042.91 per month. In the next chapter, we do some additional payment calculations in addition to calculating mortgage balances and the breakdown between principal and interest on a monthly payment.

Compound Growth Rates

A compound growth rate takes into consideration the compounding effect that results from the time value of money as opposed to an average growth rate which simply takes the total growth rate divided by the number of years. If a home experienced a 4% average growth rate over say three years, that would result in a value increase of 12% over the three-year period, or 4% × 3 = 12%.

A 4% compound growth rate would take into consideration that the 4% increase in year two is going to be on top of the 4% for year one, so in year two we would receive the appreciation not only on the beginning value but also on the 4% appreciation from year one. The 4% compound appreciation is illustrated in Solution 6.17.

Solution 6.17

−1 [PV]
3 [n]
4 [i/y]
[cpt] [FV] 1.1249

Solution 6.17 states that we start with $1 as a PV and we grow it at the 4% rate compounded over three years resulting in a total future value of $1.1249. When we subtract our initial $1 we are left with 0.1249, or an increase of 12.49%. The average growth rate that we learned about in Chapter 3 would be 12% for

this problem (3 × 4%) = 12%. The extra 0.49% in appreciation comes from the compounding effect, or the interest on interest that results from compounding.

Net Present Value

There are two more TVM concepts that are presented as they come up again in Chapter 11, "Real Estate Investment Analysis." The first of these is net present value, or NPV. The NPV of an investment is the difference between the PV of the cash inflows and the PV of the cash outflows. The cash outflow is typically the cash investment at the front end, or time period zero. If there are additional cash outflows during the holding period of the investment, those are also discounted to PV. The cash investment at time period zero does not need to be discounted because it is already at time period zero. In the NPV calculation then, the total PV of the cash inflows is net out against the PV of the cash outflows. Let's do a small example using Table 6.1.

Illustrated in Table 6.1 is a $5,000 investment that generates annual cash inflows over a three-year period of $1,000 at the end of year 1, $2,000 at the end of year 2, and $3,000 at the end of year 3. The question we are asking is, given a discount rate of 10%, what is the net present value of this set of cash flows. The first step is a simple PV calculation, 1000 [FV], 1 [n], and 10 [i/y], [cpt] [PV], and the result is $909.09. The second step is 2000 [FV], 2 [n], 10 [i/y], [cpt] [PV], and the result is $1,652.89. The third step is 3000 [FV], 3 [n], 10 [i/y], [cpt] [PV], and the answer is $2,253.94. We then sum those present values to get the total PV of $4,815.92. We then net that against the cash outflow, $4,815.92 − $5,000 = −$184.08, which is the NPV of these cash flows given a 10% discount rate.

The same calculation can be done with the financial calculator with a little more ease and fewer keystrokes. Solution 6.18 contains the keystrokes to find the NPV of the cash flows for the problem we analyzed in Table 6.1.

Table 6.1 NPV of cash flows

Time period	Cash flow	PV at 10%
0	−$5,000	−$5,000
1	$1,000	$909.09
2	$2,000	$1,652.89
3	$3,000	$2,253.94
Total PV		$4,815.92
NPV		−$184.08

Solution 6.18

[CF] 5000 [+/−] [enter]
[↓] 1000 [enter] [↓]
[↓] 2000 [enter] [↓]
[↓] 3000 [enter] [↓]
[↓] [NPV] 10 [enter]
[↓] [cpt] 184.07

Notice that the answer from the cash flows keys is $.01 different from the answer in Table 6.1. This is caused by the rounding of the answer. The calculator has 13 decimal places in its answers, but we are looking at only 2 of them. If we had stored the answers to the PV problems in the storage registers of the calculator and recalled them and summed them up, we would have gotten the same answer as the one achieved using the cash flow keys. Check your calculator manual on the storage keys.

After hitting the down arrow key following the enter key, you will notice that you receive an F01 in the screen. The calculator is asking for the frequency of C01, or the frequency of cash flow 1. In other words, how many cash flows of this same amount will there be? The default value is 1, so that is why we just hit the down arrow key again, and the worksheet goes on to the next cash flow.

While the keystrokes for the cash flow keys may appear to be daunting at first glance, once you have done a few problems using them, they become very familiar and their use can save a large amount of work. They also can bring more accuracy to your calculations because you don't have to worry about inverting numbers as you write them down.

Internal Rate of Return

The final TVM calculation of this chapter is the internal rate of return, or IRR. This is a cousin of the NPV calculation, and you will notice the resemblance in the definition. The *IRR* is the discount rate that makes the PV of the cash inflows equal to the PV of the cash outflows. Now, if these two PVs become equal to each other, what will the NPV be? Zero, you are absolutely correct. Another definition for the IRR is that it is the discount rate that makes the NPV = 0. The IRR is a compound rate of return calculation, because the IRR assumes that the

cash flows can be reinvested at the same rate of return. In Chapter 11 we look at a straightforward method of estimating IRR. Right now we look at how the calculation can be made with the cash flow keys of our calculator.

The keystrokes are illustrated in Solution 6.19. Note that the only difference between Solution 6.18 and Solution 6.19 is the last line. After we have calculated the NPV, we just have to hit two additional keys, [IRR] and [cpt], and the IRR comes up on the screen.

Solution 6.19

[CF] 5000 [+/−] [enter]
[↓] 1000 [enter] [↓]
[↓] 2000 [enter] [↓]
[↓] 3000 [enter] [↓]
[↓] [NPV] 10 [enter]
[↓] [cpt] 184.07
[IRR] [cpt] 8.21

So the IRR of this investment with this set of cash flows is 8.21%.

We again discuss the NPV and IRR calculations in both the mortgage chapter and the investment chapter, later in this book.

Summary

This chapter addresses what some finance books refer to as six functions of a dollar, or what I like to call six equations that will change your life. The six equations, or calculations, allow you to calculate the future value of a lump sum, the present value of a lump sum, the future value of an annuity, the present value of an annuity, a sinking fund payment, and finally the payment to amortize.

To maximize our understanding of the six calculations, we looked at the four major premises association with time value of money. These major premises are:

1. The higher the discount rate the lower the present value.
2. The sooner we get the money the more it's worth.
3. The principal balance at any point in time is equal to the present value of the remaining payments.

4. An investor will pay only the present value of all cash flows to be received, discounted at the required rate of return.

These major premises also come up in the investment chapter later in the book. Please don't just look at these premises and say, "Oh, that's nice." Study them and remember them and you will achieve an understanding of time value of money.

Quiz for Chapter 6

1. Savings institutions in your neighborhood are advertising certificates of deposit of $10,000 that have a three-year maturity and pay 5.5% interest. What will be the value of the CD at the end of three years?
   a. $11,576
   b. $11,592
   c. $11,742
   d. $10,000

2. You are participating in a company savings plan and will be depositing $150 at the end of each month for the next 20 years. If the plan earns annual interest of 8%, how much money should you expect to be in your account at the end of the 20-year period?
   a. $6,864
   b. $88,353
   c. $61,655
   d. $65,344

3. You need to accumulate $75,000 in 12 years. How much should you put in your 10% account at the end of each year to accumulate the necessary funds?
   a. $3,507
   b. $4,273
   c. $4,705
   d. $3,107

4. You would like to provide an annual scholarship of $1,000 each year for the next 25 years. The first scholarship will be awarded one year from today. If you deposit an amount of money in an 8% account, how much should you deposit today so that there will be sufficient funds for the 25 scholarships?
   a. $73,105
   b. $3,650
   c. $10,674
   d. $3,328

5. If your starting salary is $35,000 and you receive 4% raises each year for 15 years, how much will your salary be after 15 years?
   a. $56,000
   b. $63,033

c. $85,000
d. $65.075

6. Your neighbor just took out a mortgage for $95,000 at a 6% rate for 30 years. What is her monthly payment?
   a. $569.57
   b. $6,901.65
   c. $575.14
   d. $475.00

7. Given the mortgage in question 6, what is the mortgage balance after 10 years, assuming that all payments have been made on time?
   a. $88,401
   b. $79,501
   c. $38,000
   d. $103,518

8. What is the current principal balance of a mortgage with a monthly payment of $659.00, a 7% interest rate, and 20 years remaining?
   a. $85,000
   b. $158,160
   c. $99,053
   d. $112,971

9. An investor is purchasing a note that will pay him $45,000 at the end of five years. If his required return is 8%, how much should he pay for the note today?
   a. $62,253
   b. $30,457
   c. $30,626
   d. $66,485

10. You have decided to go back to school, and you feel that you will need $5,000 for tuition for each of the four years you intend to be there. If you intend to enroll exactly one year from today, how much should you deposit in your 5% account so that you will have enough money for your four tuition payments?
    a. $21,000
    b. $18,616
    c. $19,000
    d. $17,729

CHAPTER 7

Mortgage Calculations Using TVM

I Will Gladly Give You a Dollar Tomorrow for the Dollar You Give Me Today

This chapter is an extension of Chapter 6 in that we use the tools that we learned in that chapter to make some standard mortgage calculations that will be useful

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to the real estate broker or salesperson, the real estate appraiser, the real estate lender, and the real estate investor. In this chapter we address calculations of mortgage payments and principal balances. We analyze the impact of discounts points on a mortgage APR and effective rate of return. Finally, loan-to-value ratios, homeowner's equity, and borrower qualifications are explored.

If you have not already read Chapter 6 and tried out the problems in that chapter, I strongly suggest that you do so before you attempt to read Chapter 7. The chapters were in fact put in this order for a reason.

Mortgage Payment

The mortgage payment on a constant payment mortgage is the payment to amortize that we refer to in Chapter 6 as one of those equations, or calculations, that would change your life. As a review of the financial calculator key strokes that are required for this calculation, the mortgage amount gets plugged in as [PV], the mortgage term in months is plugged into [n], the interest rate per month is plugged into [i/y], and then we [cpt] [pmt] to come up with the monthly payment. Remember to take the number of years the mortgage is being amortized over times 12 to get the number of months in the mortgage term, or [n]. Since the interest rate and the term have to be compatible with each other, you must now take the annual interest rate and divide that by 12 to get the monthly rate of interest, and that is what gets placed in [i/y]. If you were to compute an annual payment using the number of years for [n] and the annual interest rate for [i/y], it would be less meaningful because most mortgages today have monthly payments. What we could not do is calculate the annual payment and divide that by 12 and expect to get the correct monthly payment. That would not work because it would not allow for the principal reduction that takes place each month when we make our monthly payment.

If we borrow $142,500 in the form of a home mortgage amortized monthly over 25 years at an annual rate of 6.5%, our mortgage payment calculation would look like Solution 7.1 below.

Solution 7.1

142,500 [PV]

$25 \times 12 =$ [n]

$6.5 \div 12 =$ [i/y]

[cpt] [pmt] −962.17

Our monthly mortgage payment on that $142,500 mortgage amortized monthly over a 25-year period at 6.5% interest comes in at $962.17. This mortgage payment is made up of both principal and interest, sometimes referred to as P & I. One way to break that payment down into the principal portion of the payment and the interest portion is to multiply the principal amount of $142,500 by the decimal equivalent of the interest rate and divide that by 12 to get the monthly interest due on the mortgage, as shown in Equation 7.1.

Equation 7.1

$$\text{Monthly interest} = \$142{,}500 \times 0.065 = \$9{,}265.50 \div 12 = \$771.88$$

Since the payment is made up of principal plus interest, to get the principal portion of the payment, simply take the monthly payment minus the monthly interest and that will leave the principal portion of the payment, also referred to as the principal reduction, as shown in Equation 7.2.

Equation 7.2

$$\text{Principal portion of the payment} = \$962.17 - \$771.88 = \$190.29$$

The principal balance after the first payment has been made would then be $142,500 − $190.10 = $142,309.71.

Table 7.1 is an amortization schedule containing the payment breakdown between principal and interest for the first year of the mortgage described in Solution 7.1. It shows the payment number, the total principal plus interest payment, the principal portion of the payment as well as the interest portion of each payment, and finally the principal balance after the given payment is made. You will notice how the principal portion of each payment increases as the interest portion of each payment decreases. This takes place thanks to the principal reduction. As the outstanding principal balance goes down, the interest portion of the payment declines. This type of table can be created using an Excel spreadsheet or you could create one with your financial calculator.

The interest due in the second month would be the principal balance at the end of the first month, $142,309.71 × 0.065 = $9,250.13/12 = $770.84. The total payment of $962.17 minus the interest of $770.84 equals the principal portion of $191.33. That deducted from the previous principal balance equals the new principal balance of $142,118.38.

A 1/2% increase in the rate of interest can have a significant impact on the mortgage payment. As the interest rate goes up, keeping the mortgage amount and the term constant, our mortgage payment will go up. Try the same calculation at 7%.

Table 7.1 Amortization schedule

Mortgage amount	$142,500.00
Mortgage term	25
Interest rate	6.50%

Payment number	Payment	Principal	Interest	Principal balance
				$142,500.00
1	−$962.17	$190.29	$771.88	$142,309.71
2	−$962.17	$191.33	$770.84	$142,118.38
3	−$962.17	$192.36	$769.81	$141,926.02
4	−$962.17	$193.40	$768.77	$141,732.61
5	−$962.17	$194.45	$767.72	$141,538.16
6	−$962.17	$195.51	$766.67	$141,342.66
7	−$962.17	$196.56	$765.61	$141,146.09
8	−$962.17	$197.63	$764.54	$140,948.46
9	−$962.17	$198.70	$763.47	$140,749.76
10	−$962.17	$199.78	$762.39	$140,549.99
11	−$962.17	$200.86	$761.31	$140,349.13
12	−$962.17	$201.95	$760.22	$140,147.18

Solution 7.2

142500 [PV]

$25 \times 12 =$ [n]

$7 \div 12 =$ [i/y]

[cpt] [pmt] −1007.06

As the interest rate goes from 6.5% to 7% the monthly mortgage payment goes from $962.17 to $1,007.06. Thus an increase in the rate of interest will result in an increase in the monthly payment. Why don't you fill in the first five months worth of payments on the amortization schedule in Table 7.2 using the $142,500

Table 7.2 Amortization schedule

Mortgage amount	$142,500.00
Mortgage term	25
Interest rate	7.00%

Payment number	Payment	Principal	Interest	Principal balance
1				
2				
3				
4				
5				

principal amount, the 25-year term, and the 7% rate of interest. Once you have completed the table, you can check the solution table (Table 7.3) at the end of this chapter.

We can find another interesting calculation by looking at the original mortgage of $142,500 at 6.5% interest amortized over 25 years. This time let's keep the mortgage payment constant when we change the interest rate. By doing this, the principal balance, or the PV of the mortgage, will change when the interest rate goes up, as in the scenario that follows. If you are a home buyer and, while you are searching for a home, market rates of interest go up from 6.5% to 7% and you wanted to keep your anticipated mortgage payment constant at $962.17, you would find that you couldn't borrow the same amount of money. Solution 7.3 illustrates the calculation starting from the initial mortgage payment calculation at 6.5% interest followed by changing the interest rate to 7% and then calculating the new PV, or mortgage amount.

Solution 7.3

142500 [PV]
25 × 12 = [n]
6.5 ÷ 12 = [i/y]
[cpt] [pmt] −962.17
7.0 ÷ 12 = [i/y]
[cpt] [PV] 136134.45

As you see, if rather than keeping the [PV] constant, as we did in Solution 7.2, we keep the [pmt] constant, the [PV], or the mortgage amount, decreases from $142,500 to $136,134.45. In order to keep the payment constant, we couldn't borrow as much money at the higher rate of interest. This is a reflection of major premise 1 from Chapter 6 which states that the higher the discount rate, the lower the present value. It also gives you a hint about why housing price bubbles take place in times of increasing interest rates. When interest rates go up, people can't afford to pay as much for a home because they can't afford to borrow as much mortgage money.

Let's try another of these problems. Your brother goes to the bank and is told that he can borrow $175,000 at 6% interest amortized over 30 years. From that he calculates that his monthly payment will be $1,049.21.

Solution 7.4

175000 [PV]
30 × 12 = [n]

6 ÷ 12 = [i/y]

[cpt] [pmt] −1049.21

One week later he calls the bank and is told that rates have gone up to 6.75% on 30-year loans. If he still borrows $175,000, what will his mortgage payment be?

Solution 7.5

175000 [PV]

30 × 12 = [n]

7 ÷ 12 = [i/y]

[cpt] [pmt] −1164.28

Thus the monthly payment increases from $1,049.21 to $1,164.28 when the interest rate increases from 6% to 6.75% on a $175,000 mortgage. If your brother told the bank that he couldn't afford the new payment and wanted to keep the payments constant at $1,049.21 how much mortgage money could the lender give him at the 6.75% interest rate?

Solution 7.6

175000

30 × 12 = [n]

6 ÷ 12 = [i/y]

[cpt] [pmt] −1049.21

7 ÷ 12 = [i/y]

[cpt] [PV] 157704.72

Biweekly Mortgages

As the name implies, in a biweekly mortgage the payments are made every two weeks rather than once a month. When calculating the size of the payment in a biweekly mortgage rather than multiplying the number of years by 12 to get the level of [n], we would multiply the number of years by 26, since there are 26 biweekly periods in a year. We would then divide the annual interest rate by 26 to get the biweekly interest rate. Let's calculate the biweekly payment on the problem we analyzed in Solution 7.1. The calculations are shown in Solution 7.7.

Solution 7.7

142500 [PV]
25 × 26 = [n]
6.5 ÷ 26 = [i/y]
[cpt] [pmt] −443.82

This biweekly payment would pay off the loan in 25 years, just as the monthly payment from Solution 7.1 would pay off the loan in 25 years. What lenders will sometimes do is take the monthly payment and divide it by 2 and make that the biweekly payment. The monthly payment divided by 2 in this case would be $481.09. You will notice it is larger than the calculated biweekly payment by $37.27. That additional money would go to pay off the principal balance faster than the biweekly amortized payment in Solution 7.4. That results in a shorter payoff term for the loan, and this is sometimes attractive to the borrower. In this case, the $481.09 payment would pay off the $142,500 mortgage at 6.5% annual interest in 20.81 years, as shown in Solution 7.8.

Solution 7.8

142500 [PV]
6.5 ÷ 26 = [i/y]
−481.09 [pmt]
[cpt] [n] 541
541 ÷ 26 = 20.81

Principal Balance

As stated in major premise 3 in Chapter 6, the principal balance at any point in time is equal to the present value of the remaining payments. Just as the principal balance at the beginning of the loan is equal to the present value of the total number of payments, at any point along the timeline the principal balance is equal to the present value of the number of payments left on the loan. This is true whether there are 300 payments left or 3 payments left.

If five years ago you took out a mortgage for $150,000 to be amortized over 30 years at an interest rate of 7% and you wanted to know the current mortgage balance, or principal balance, you would follow the steps shown in Solution 7.9. First you calculate the monthly payment, and then you tell the calculator that your [n] is no longer 360, but it is now 300, because 60 months (or 5 years) are gone.

Then you ask the calculator what the new present value of the payments is. You do that because the principal balance at any point in time is equal to the present value of the remaining payments.

Solution 7.9

150000 [PV]

$30 \times 12 = 360$ [n]

$7 \div 12 =$ [i/y]

[cpt] [pmt] 997.95

[rcl] [n] $-60 = 300$ [n]

[cpt] [PV] 141197.38

Thus the principal balance after five years on the mortgage would have decreased from the original $150,000 down to $141,197.38.

Your parents have decided to sell their home, and they ask you what their current mortgage balance is. They took out a $125,000 mortgage 15 years ago. The mortgage had an original term of 25 years and carried an interest rate of 8%. Following the same steps you used in the previous problem, (1) first calculate the monthly payment, (2) next change the [n] to the number of remaining payments, and (3) finally calculate the new present value, as shown in Solution 7.10.

Solution 7.10

125000 [PV]

$25 \times 12 = 300$ [n]

$8 \div 12 =$ [i/y]

[cpt] [pmt] -964.77

[rcl] [n] $-180 = 120$ [n]

[cpt] [PV] 79517.79

The monthly payment comes in at $964.77 per month. Since the mortgage was originally amortized over 25 years and 15 years have passed, there are 10 years of payments remaining. By hitting [rcl] [n], the original 300 appears in the screen and then we can subtract 180 (or 15×12) from that original 300 and find there are 120 [n] remaining. After plugging the new 120 [n] into the calculator, we can now solve for the new [PV] and find that the principal balance is $79,517.79.

Interest Paid

Calculating the amount of interest paid on a loan is quite straightforward once we have learned how to calculate principal balance. One key to keep in mind is that the payment is made up of principal plus interest, or P + I.

Let's take the mortgage analyzed in Solution 7.10 and ask the question, how much interest would have been paid on that mortgage had your parents let the mortgage run for it's full course of 25 years? Assuming that all payments were made in a timely manner, we would first take the monthly payment and multiply it by 300. That would give us the total principal plus interest paid over the life of the loan, or 300 × \$964.77 = \$289,431.08. We know that \$125,000 of that amount is principal because that is the original amount that was borrowed. The final calculation is simply to take the total (P + I) − P = I, so \$289,431.08 − \$125,000 = \$164,431.08 is the total interest paid over the life of the loan as shown in Equation 7.3.

Equation 7.3

$$300 \times \$964.77 = \$289{,}431.08 = P + I$$

$$(P + I) - P = I$$

$$\$289{,}431.08 - \$125{,}000 = \$164{,}431.08$$

To calculate the amount of interest paid over a term shorter than the entire mortgage term, the calculation is similar to the one in Equation 7.3. If we wanted the interest paid for the same mortgage, but just during the 15 years that your parents were making payments on the mortgage, we again would need to multiply the monthly payment by the number of payments that were made. In this case the number would be 180, because they made payments over 15 years. So the total P+I paid over the 15 years would be 180 × \$964.77 = \$173,658.65. From that amount we have to subtract the principal reduction that took place over the 15-year period. That principal reduction is equal to the beginning principal amount minus the principal balance at the end of year 15. This comes to \$125, 000 − \$79,517.79 = \$45,482.21.

You will recall that the \$79,517.79 was the principal balance that we calculated in Solution 7.10 above. The difference between the original principal amount and the principal balance at the end of year 15 is \$45,482.21. So once again we take the total P + I and subtract the P (or principal reduction) to get the amount of

interest paid over the first 15 years of the mortgage. A summary of this calculation is shown in Solution 7.11.

Solution 7.11

125000 [PV]
$25 \times 12 = 300$ [n]
$8 \div 12 =$ [i/y]
[cpt] [pmt] 964.77
[rcl] [n] $- 180 = 120$ [n]
[cpt] [PV] 79517.79
$125{,}000 - 79{,}517.79 = 45{,}482.21 = P$
$\$964.77 \times 180 = \$173658.65 = P + I$
$(P + I) - P = I$
$\$173658.65 - \$45482.21 = \$128176.44$

Thus the total interest paid over the first 15 year of the loan is $128,176.44.

Annual Percentage Rate

The annual percentage rate, or APR, is the effective cost of mortgage money that the borrower is paying once all (in fact, most) of the up-front costs associated with the loan are factored into the calculation. It is considered a yield to maturity, which assumes the loan will run the full term and not be prepaid. The APR is the discount rate that makes the present value of the mortgage payments equal to the net proceeds that the borrower receives at the time of closing after deducting the additional finance charges, such as points paid by the borrower, origination fees, and mortgage insurance if there is any. Lenders will typically round off the APR to the nearest 1/8 of a percent.

Let's say you have recently applied for a mortgage of $212,000 at a 6.75% rate of interest to be amortized over 30 years. The lender says that in addition to the rate of interest you will have to pay a 2% origination fee. What is your APR on the loan if you expect the mortgage to be in place for the full 30 years? First you would calculate the monthly payment on the mortgage, as shown in Solution 7.12.

Solution 7.12

212000 [PV]
$30 \times 12 = 360$ [n]

6.75/12 = [i/y]

[cpt] [pmt] 1375.03

Next we have to reduce the net proceeds that the borrower is actually receiving from the loan. The borrower receives $212,000 from the bank but then turns right around and pays the bank the 2% origination fee, so the net proceeds the borrow gets from the loan is actually $212,000 × 0.98 = $207,760. Leaving the previous calculation in the calculator, this amount now gets placed in the [PV], and we solve for the new rate of interest, as shown in Solution 7.13.

Solution 7.13

207760 [PV]

[cpt] [i/y] 0.58 × 12 = 6.95

The APR is rounded to the nearest 1/8% which would make that 7.0%.

Effective Rate of Return

The effective rate of return or the effective rate of interest is to the lender as the APR is to the borrower. It is the total rate of return on a loan taking interest and additional financing charges into consideration. The effective rate is calculated by first calculating the payment on the mortgage at the stated interest rate over the stated term. The points and/or other prepaid items are then deducted from the mortgage amount. That new value is then input as the new present value, and then the new [i/y] is calculated. The result is the effective rate of return or the effective rate of interest the lender is receiving. If the points and other prepaid items are being paid by the borrower to the lender, the effective rate of return to the lender will be the same as the annual percentage rate paid by the borrower. If a third party is paying the points, such as the seller, the APR and the effective rate will not be the same.

Discount Points and Prepaid Items

Discount points and prepaid items have an effect on the annual percentage rate that the borrower is paying and on the effective interest rate that the lender is receiving. Discount points, or just points, function like prepaid interest. It is an amount of up-front money paid at the time of closing, and the impact of the

points is to increase the yield to the lender. If they are paid by the buyer, they also increase the annual percentage rate that the buyer is paying on the loan. It is possible that the points could be paid by the seller, usually in a buyer's market, and in that case they would again increase the yield to the lender, but they would have no impact on the annual percentage rate that the borrower would be paying.

To determine how much the buyer or seller would have to pay in points, 1 point is equal to 1 percent of the mortgage amount. If the buyer was taking out a \$170,000 mortgage and the lender said that the loan would be at a 7% interest rate plus 1 1/2 points, the buyer would have to pay \$170,000 × 0.015 = \$2,550 cash at the closing to cover the points. Given a mortgage of \$200,000 with 3 points, the buyer would have to pay \$200,000 × 0.03 = \$6,000 in order to get the mortgage.

A rough estimate, or rule of thumb, of the impact that points have on the yield of the mortgage to the lender is that 1 point will increase the yield to the lender by approximately 1/8 of a percent. The accuracy of that estimate will vary depending on the general level of interest rates.

EFFECTIVE RATE ON A FULLY AMORTIZED MORTGAGE

Let's analyze the mortgage mentioned above. If that \$200,000 mortgage was at a stated rate of interest of 7% and was to be amortized over 30 years, the payment calculation would look like Solution 7.14.

Solution 7.14

200000 [PV]

30 × 12 = [n]

7 ÷ 12 = [i/y]

[cpt] [pmt] −1330.60

In other words, the net proceeds to the borrower would be \$200,000 and would result in monthly payments of \$1,330.60. If the borrower had to pay 3 points in order to get the loan, the net proceeds from the loan would not be \$200,000. Rather, the net proceeds from the loan would be the \$200,000 minus the \$6,000 they would have to pay in points, or a net of \$194,000. The borrower would, however, still be making payments on the mortgage amount of \$200,000. Thus, the payment calculation would still look like Solution 7.14; however, the yield to the lender and the annual percentage rate to the borrower would be calculated as shown in Solution 7.15.

Solution 7.15

200000 − 6000 = 194000 [PV]

30 × 12 = [n]

−1330.60 [pmt]

[cpt] [i/y] 0.61 × 12 = 7.3

If the borrower had to pay 3 points to get this $200,000 mortgage, the yield to the lender would be 7.3%. If the borrower paid the points, the annual percentage rate that the borrower would be paying would also be that same 7.3%. You can think of the mortgage amount in terms of money the borrower borrows or the amount of money the lender invests in the transaction. When the points are paid by the borrower, it reduces the net proceeds from the loan thus increasing the cost of borrowing. From the lender's perspective the points decrease the amount of money invested in the transaction by $6,000, but since the payments are based on the mortgage amount of $200,000, it increases the yield, or effective rate of return, to 7.3%.

You will notice that the increase in yield is less than predicted by the rule of thumb. The rule of thumb indicated approximately a 3/8% increase in yield, and the actual increase is only 3/10%. Still, that is not a bad estimate.

Let's try another problem of this type from beginning to end. We have a mortgage amount of $154,000 at an 8% interest rate amortized over 25 years. If the borrower has to pay 2 points to get the loan, what is the effective interest rate on the loan? The entire solution is contained in Solution 7.16 below.

Solution 7.16

154000 [PV]

25 × 12 = [n]

8 ÷ 12 = [i/y]

[cpt] [pmt] −1188.60

154000 × 0.02 = 3080

154000 − 3080 = 150920 [PV] or 154000 × 0.98 = 150920

[cpt] [i/y] 0.69 × 12 = 8.24%

To summarize Solution 7.16, first the monthly payment on the mortgage is calculated. The $154,000 mortgage amount, 25-year term, and 8% interest rate result in a monthly payment of $1,188.60. To calculate the value of the points, multiply the mortgage amount by 0.02, or 2% of the mortgage amount. This results in the cash value of the points being equal to $3,080. The cash amount of the points is then deducted from the mortgage amount to result in net proceeds

of the loan of $150,920. That net proceeds are then keyed into the present value key, and then we solve for [i/y] and get 0.69 (plus the unseen decimal values inside the calculator). That value is a monthly effective rate so we take that times 12 and get the annual effective rate of 8.24%.

Other prepaid charges or expenses can have a similar impact on the effective rate of interest that a borrower is paying. If the charge is linked to the mortgage, then the annual percentage rate being paid will increase. Let's say a borrower is obtaining a $100,000 mortgage at 7% interest amortized over 30 years. As part of the mortgage costs, the borrower has to pay an origination fee of $500 associated with obtaining the mortgage. The monthly payment would be calculated, and then the prepaid charges would be deducted from the mortgage amount. The resulting net proceeds would be put into present value, and the [i/y] would then be calculated as shown in Solution 7.17.

Solution 7.17

100000 [PV]

$30 \times 12 =$ [n]

$7 \div 12 =$ [i/y]

[cpt] [pmt] −665.30

$100000 - 500 = 99500$ [PV]

[cpt] [i/y] $0.59 \times 12 = 7.05\%$

The impact on the cost of the mortgage money to the borrower is that the rate goes from 7% to 7.05%. Keep in mind that while your calculator is showing 0.59 when you compute your [i/y], that value is rounded and your calculator actually has 11 more decimal places that are unseen. That means you can't just take the truncated, or chopped off, value of 0.59 times 12 and get the same answer. In fact, the four decimal place value in the [i/y] key is 0.5875, and your calculator is just showing you 0.59 when you have your decimal places set to two places. Whenever possible, keep the value in your calculator and don't truncate it.

EFFECTIVE RATE ON A PARTIALLY AMORTIZED LOAN

The impact of points and other prepaid costs will be much greater on a partially amortized mortgage than they are on a fully amortized mortgage. If you pay off your mortgage after five years, which is what we mean by a partially amortized mortgage, and you pay points as an example, you will be paying a disproportionately greater portion of your interest on the loan at the front end. As an example,

if you were to pay $2,000 in points and your loan ran the full 30 years, you would be spreading the cost of the points over 30 years when you calculate your effective rate. If you pay your loan off after five years, you would be spreading the $2,000 cost over only 5 years so your annual percentage rate would be affected much more because of the shorter term.

Let's take a look at the problem from Solution 7.15. This time we assume that the loan will be paid off after five years. The first thing we have to do is calculate what the cash flows from the mortgage are going to be. First of all there will be five years of monthly payments, and those will be followed with the cash flow from the principal balance that will be paid off. Thus we need to calculate the monthly mortgage payment, or the payment to amortize. That step is identical to Solution 7.15, and we get a payment of $1,330.60. The second step to the problem is to calculate the principal balance at the end of five years. Recall that the principal balance at any point in time is equal to the present value of the remaining payments. The payment and principal balance calculations are found in Solution 7.18.

Solution 7.18

200000 [PV]

$30 \times 12 =$ [n]

$7 \div 12 =$ [i/y]

[cpt] [pmt] −1330.60

[rcl] [n] $- 60 =$ [n]

[cpt] [PV] 188263.18

We now have all the cash flows associated with the mortgage. We do not have the net proceeds to the borrower however. You will recall that the borrower had to pay 3 points in order to get the mortgage, which means that the borrower had to pay $6,000 at the closing. This results in a net proceeds to the borrower of $\$200,000 - \$6,000 = \$194,000$. Now we can plug the cash flows into the calculator and solve for the new [i/y] which will be the effective rate the borrower is paying and the lender is receiving.

Solution 7.19

194000 [PV]

−1330.60 [pmt]

−188263.18 [FV]

60 [n]

[cpt] [i/y] $0.65 \times 12 = 7.74\%$

The answer you get when you compute [i/y] is a monthly rate of 0.65% which you then must multiply by 12 to get the annual rate of 7.74%. You will notice that I have the cash flows set up from the borrower's perspective. The $196,000 is a cash inflow to the borrower so it has a positive sign. The monthly payment is a cash outflow to the borrower so it has a negative sign. The mortgage payoff, or future value, is a cash outflow to the borrower so it also has a negative sign. The signs must be correct to obtain the correct answer because your calculator operates in terms of cash inflows and cash outflows.

Had we wanted to look at the loan from the lender's perspective, we would just change each of the signs around and get the same answer. The net proceeds for the borrower would be a cash outflow to the lender so it would have a negative sign, the monthly payment would be a cash inflow to the lender so it would have a positive sign, and the principal payoff would be a cash inflow to the lender with a positive sign. The resulting effective rate to the lender would still be 7.74%. The only time the effective rate to the lender would be different from the effective cost to the borrower is when the prepaid costs are not paid to the lender, but to a third party, such as an appraiser. An appraisal fee would affect the effective cost to the borrower because the borrower pays the cost of the appraisal. The appraisal fee would not affect the effective rate to the lender because the lender does not get to keep the appraisal fee so it has no impact on the lender's return. While the appraisal fee would increase the effective cost of the mortgage, technically it does not go into the APR calculation for the borrower according to current disclosure regulations.

As Solution 7.19 indicates, the annual percentage rate that the borrower is paying because of the 3 points and the expected five-year payoff of the loan is 7.74% as opposed to the 7.3% if the loan were to go full term. So, shortening the term with the same number of points increases the effective cost of the mortgage money because of a disproportionate share of the interest being paid up front. If you expect to stay in a home for a short period of time, you would prefer not to pay any points and you may in fact be better off with a slightly higher rate of interest and no points than with a lower rate of interest with points. You now know how to do the analysis and the calculations that will show you which is the better deal or lower effective rate.

Let's try one more problem with a partially amortized mortgage. Your brother-in-law is taking out a new mortgage of $215,000 amortized over 30 years at a 7.25% interest rate with 2 points being charged, and he believes he will sell the house and pay off the mortgage in seven years. He asks you, since you have read this book and now fully understand effective rates, what the effective cost of his mortgage will be. You state, "That will be no problem," and you start by coming up with the cash flows found in Solution 7.20.

Solution 7.20

215000 [PV]
30 × 12 = [n]
7.25 ÷ 12 = [i/y]
[cpt] [pmt] −1466.68
[rcl] [n] − 84 = 276 [n]
[cpt] [PV] 196716.86

Now that you have your cash flows, you just need to calculate the net proceeds that your brother-in-law will receive from the mortgage. So you multiply the $215,000 mortgage amount by 0.02, and you find that the points will come to $4,300 which you then deduct from the $215,000 to get the net proceeds of $210,700. Now the cash flows can be analyzed just as they were in Solution 7.19. Verify your calculations by comparing them to Solution 7.21.

Solution 7.21

210700 [PV]
−196716.86 [FV]
−1466.68 [pmt]
84 [n]
[cpt] [i/y] 0.64 × 12 = 7.63%

As the solution indicates, the annual percentage rate to the borrower, or the effective rate of return earned by the lender, in this case increases from the stated rate of interest of 7.25% to 7.63% when the up-front cost of the points is factored into the calculation.

Adjustable Rate Mortgage

An *adjustable rate mortgage* (ARM) is a mortgage that shifts the interest rate risk from the lender to the borrower (see Chapter 12). Suffice it to say that when a lender makes fixed interest rate mortgage loans and the market rate of interest goes up, the value of the lender's mortgage portfolio goes down. This reflects perfectly the TVM major premise—the higher the discount rate, the lower the present value. To protect the lender from this loss in value, the ARM was developed, so that when the market rate of interest goes up, the interest rate on the mortgage

goes up. This protects the lender from an erosion in the value of the mortgage portfolio resulting from increases in market interest rates. There are certain key terms associated with an ARM, and they are listed here:

- Margin
- Index
- Initial mortgage interest rate
- Composite rate
- Adjustment interval
- Caps/floors
- Negative amortization

In an ARM the mortgage will start with an initial mortgage interest rate. This initial interest rate is typically set slightly below the rate on a fixed-rate mortgage so that it looks attractive to a borrower. Hence, this initial rate is sometimes called a *teaser rate*. After the adjustment interval or adjustment period the rate will be adjusted based on the interest rate movement of the index. The index may be the index of one-year treasury securities, five-year treasuries, the average of conventional mortgage interest rates for the previous thirty days, or some other similar interest rate benchmark index. As the index moves, so would the interest rate on our ARM. At the adjustment time the new index rate plus the margin would be the new mortgage interest rate, or composite rate, on the ARM.

If there are no payment caps, or limitation on the payment increase that can be passed on to the borrower, then the new mortgage payment would be calculated using the new composite rate, the number of payments remaining, and the principal balance at the time the interest rate changes. There could also be payment floors which are limitations on the amount of payment decrease that could be passed on to the borrower. Let's try an example. Your neighbor took out an adjustable rate mortgage with an initial rate of 5.5% for $130,000. After one year, which was the adjustment interval, the index rate is at 5%, and there is a 2% margin. Those values are added together to give a composite rate of 7%. What happens to your neighbor's monthly payment if the original term was 30 years?

Solution 7.22

130000 [PV]

360 [n]

5.5/12 = [i/y]

[cpt] [pmt] −738.13

[rcl] [n] − 12 = [n]

[cpt] [PV] 128248.78

7/12 = [i/y]

[cpt] [pmt] −862.00

The payment increases over $123 per month to $862 per month from $738.13 per month. That is what is sometimes called payment shock when discussing adjustable rate mortgages. If the borrower is not expecting that, it can have tremendous negative impact on the household budget. It can also lead to foreclosure if the borrower is not prepared.

If there is a payment cap associated with the ARM, that means that the entire payment increase might not be able to be passed on to the borrower. In the case when all the interest due per month cannot be passed on, the amount that is not passed on to the borrower gets added to the principal balance. This phenomenon is referred to as *negative amortization*. Instead of a decreasing principal balance, the loan can result in an increasing principal balance. This is another characteristic that the borrower should not be thrilled with. In order to get the low teaser rate and some degree of payment protection, this is one of the risks that the borrower may have to take on.

The Shared Appreciation Mortgage

The *shared appreciation mortgage* (SAM) is one of the alternative mortgage instruments developed in the late 1970s–early 1980s time period. Many of these alternative mortgages were developed to help borrowers cope with the high market rates of interest that were in effect at that time. The shared appreciation mortgage allowed the borrower a lower rate of interest in exchange for a piece of the appreciation that the borrower was expected to gain as a result of home ownership. The lender would say, "I'll give you an X% reduction in your mortgage interest rate in exchange for X% of the appreciation you experience in the first five years of home ownership."

Let's try an example with a SAM. The bank says that the interest rate on the $150,000 30-year fixed-rate mortgage is 14% on the home you expect to purchase for $175,000. You can't qualify for a fixed-rate loan at 14%, so the lender says it will reduce your interest rate by 25% in exchange for 25% of the appreciation (see Chapter 8) you receive in your first five years of ownership. What is the mortgage payment you would have had at 14%? What is your new interest rate? What is your new payment? What is the effective interest rate you end up paying over the first five years if your home goes up in value by 4% per year compounded annually?

First we look at what the payment would have been at 14% interest.

Solution 7.23

150000 [PV]

360 [n]

14/12 = [i/y]

[cpt] [pmt] −$1777.31

The monthly payment would have been a very healthy $1,777.31 per month. The second question is, what is the new interest rate on the SAM?

Equation 7.4

$$\text{New interest rate} = 14\% \ (1 - 0.25) = 14\% \ (0.75) = 10.5\%$$

So the new interest rate on the SAM would be 10.5% or a 25% reduction from the previously quoted 14%. What is the new payment on the SAM?

Solution 7.24

150000 [PV]

360 [n]

10.5/12 = [i/y]

[cpt] [pmt] −1372.11

The final question, what is the effective rate on the loan if your home goes up in value by 4% per year compounded annually, is a little more challenging. We first must establish what the cash flows are that the lender is receiving. We have already established that the lender will receive $1,372.11 per month for 60 months. The lender will also receive the principal balance at the end of five years. Finally, the lender will receive 25% of the appreciation that takes place in the first five years. The principal balance is found in Solution 7.25.

Solution 7.25

150000 [PV]

360 [n]

10.5/12 = [i/y]

[cpt] [pmt] −1372.11

[rcl] [n] −60 = [n]

[cpt] [PV] −145322.55

To estimate the appreciation, we need to know what the value of the property is after five years. That is found by taking the purchase price of $175,000 and

calling that a PV, compounding it forward five periods, at a 4% growth rate. We find that future value by executing the keystrokes in Solution 7.26.

Solution 7.26

−175000 [PV]
5 [n]
4 [i/y]
[cpt] [FV] −212914.26

Thus the appreciation would be \$212,914.26 − \$175,000 = \$37,914.26. Now the agreement says that 25% of that amount will go to the lender in exchange for the interest rate reduction. The amount of the appreciation going to the lender is \$37,914.26 × 0.25 = \$9,478.56. The cash flows going to the lender along with the effective rate calculation are indicated in Solution 7.27.

Solution 7.27

−150000 [PV]
1372.11 [pmt]
60 [n]
145322.55 + 9478.56 = 154801.11 [FV]
[cpt] [i/y] 0.95 × 12 = 11.45%

The effective return to the lender, which happens to be the same as the effective cost to the borrower, for this loan is 11.45%. Now many borrowers were terribly upset with the prospect of sharing their appreciation with the lender. However, when the choices were to share the appreciation or not get the mortgage because the interest rate was too high, this was in fact a viable option for the borrower. In this example the total cost of the loan turned out to be only 11.45% versus the market rate of 14%, so it was a good deal for the borrower. The catch is, if market rates were 14%, then the appreciation rate probably would have exceeded the 4% per year used in the example.

Reverse Annuity Mortgage

The *reverse annuity mortgage* (RAM) was developed around the time of the SAM, but it appears to have greater staying power in the marketplace because it is still used today. Its use is limited to specific situations. The mortgage is designed to allow senior citizens to stay in their homes longer by turning their equity into

a cash flow stream. Seniors are often on a fixed income and get caught in a squeeze. When the real estate taxes and the maintenance costs continue to escalate, they are often forced from their homes. The RAM allows them to get some of their equity out of their home on a monthly basis so that they can afford to stay in the house for a prolonged period of time.

Let's say that a senior couple owns their home and that it is currently worth $170,000. The bank says it will enter into a RAM at 7% interest for 15 years up to 80% of the home's current value. In other words, the most the loan balance could grow to over 15 years would be $170,000 × 0.80 = $136,000. The payments that the couple could receive over the next 15 years are indicated in Solution 7.28.

Solution 7.28

136000 [FV]

15 × 12 = 180 [n]

7/12 = [i/y]

[cpt] [pmt] −429.07

So the couple could receive monthly payments over the next 15 years of $429.07. At the end of the 15 years the couple would either have to refinance into a standard mortgage and start repaying the $136,000 debt, or they would have to sell their home. In either case they were able to stay in the house an extra 15 years beyond the time they thought they would.

Loan-to-Value Ratio

The *loan-to-value ratio* is the ratio of mortgage amount divided by the property value. If you are dealing with a property that has a market value of $200,000 and you are taking out a $160,000 mortgage to purchase the property, your loan to value ratio is as indicated in Equation 7.5.

Equation 7.5

$$\text{Loan-to-value ratio} = \$160{,}000/\$200{,}000 = 0.80 = 80\%$$

The equity-to-value ratio is 1 minus the loan-to-value ratio, which for the above situation, would be Equation 7.6.

Equation 7.6

$$\text{Equity-to-value ratio} = 1 - 0.80 = 0.20 = 20\% = \$40{,}000/\$200{,}000$$

As you can see in Equation 7.6, this value may also be determined by dividing the equity investment, or down payment, by the property value. The lesson to be learned here is that the total property value is made up of equity plus debt, or equity plus the mortgage amount. This is summarized in Equation 7.7.

Equation 7.7

$$\text{Property value} = \text{Equity} + \text{mortgage amount}$$

Homeowner's Equity

One of the glorious features of real estate is that the equity that homeowners have in their property tends to increase over time. This equity increase comes from two different sources. If we take Equation 7.7 and manipulate it a little by subtracting mortgage amount from both sides of the equation, we end up with Equation 7.8.

Equation 7.8

$$\text{Property value} - \text{mortgage amount} = \text{Equity} + \text{mortgage amount}$$

$$-\text{mortgage amount}$$

$$\text{Equity} = \text{Property value} - \text{mortgage amount}$$

Once the mortgage amount has been subtracted from both sides, Equation 7.8 states that the equity is equal to the property value minus the mortgage amount. You will notice that Equation 7.8 is identical to Equation 2.5 from Chapter 2. The terms used are slightly different, but synonymous. In Equation 2.5 we use the terms *market value* instead of *property value* and *mortgage balance* instead of *mortgage amount*. The terms *market value* and *mortgage balance* are actually preferable because they refer to the changes that can take place over time. Over time the property value can change, and the term that we use to refer to that new value is market value. In addition, as payments are made on the mortgage, the principal gets paid down, and we refer to the new mortgage amount as the principal balance. See Table 7.3.

These two actions then, the appreciation in the home's market value and the principal reduction on the mortgage can both result in an increase in the homeowner's equity. This is reflected in Equation 2.6, which is replicated below in Equation 7.9.

Table 7.3 Amortization schedule solution

Mortgage amount	$142,500.00
Mortgage term	25
Interest rate	7.00%

Payment number	Payment	Principal	Interest	Principal balance
				$142,500.00
1	−$1,007.16	$175.91	$831.25	$142,324.09
2	−$1,007.16	$176.94	$830.22	$142,147.15
3	−$1,007.16	$177.97	$829.19	$141,969.18
4	−$1,007.16	$179.01	$828.15	$141,790.18
5	−$1,007.16	$180.05	$827.11	$141,610.13

Equation 7.9

$$\uparrow \text{Equity} = \uparrow \text{Market value} - \downarrow \text{mortgage balance}$$

Equation 7.9 says that an increase in equity can result from two sources. If market value increases, then the homeowner's equity will increase. Second, if the mortgage balance decreases, the homeowner's equity will increase. This is indeed one of the major benefits of home ownership. It is the primary source of wealth for the average individual in the United States.

Quiz for Chapter 7

1. Sara recently purchased a house for $187,500 and took out a mortgage for $150,000 at a 6.5% annual interest rate amortized over 30 years to finance the purchase. What is the monthly payment on her mortgage?
   a. $11,486.62
   b. $957.22
   c. $948.10
   d. $812.50

2. Five years later Sara (from problem 1) is considering refinancing her mortgage. What is the mortgage balance, or principal balance, on Sara's original mortgage?
   a. $93,114.00
   b. $140,416.47
   c. $150,000.00
   d. $140,112.33

3. Your cousin Michael is purchasing a home in a new subdivision. The purchase price of the home is $225,000, and he is taking out a $170,000 mortgage at 7% interest amortized over 25 years. One of the requirements of the mortgage is that he pay 3 discount points and a 1% origination fee to the lender in order to get the loan. What annual percentage rate (rounded to two decimal places) is Michael paying on the loan if it is expected to run the full 25 years? (Use your financial calculator.)
   a. 7.00%
   b. 7.20%
   c. 7.37%
   d. 7.46%

4. If Michael (in problem 3) knows he is going to stay in this house for only five years and then plans to sell the house, what will his APR be rounded to two decimal places?
   a. 8.01%
   b. 7.46%
   c. 7.00%
   d. 7.37%

5. XYZ Federal Savings Bank is considering making a mortgage loan to Jennifer to assist her with her new home purchase. She is asking for a

loan of $145,000 to be amortized over 30 years at a 7.5% rate of interest. If the lending officer tells Jennifer she will have to pay 2 points to get the loan, what is the effective rate of interest that XYZ Federal will be earning on the loan, assuming the loan will run for the full 30-year term?

a. 7.5%
b. 7.71%
c. 7.81%
d. 8.01%

6. Aaron is buying a new house with a purchase price of $162,500. The bank has told him it will give him a mortgage of $130,000 at 7% interest amortized over 30 years. What is the loan-to-value ratio for this particular mortgage?

a. 125%
b. 80%
c. 75%
d. 7%

7. Using the information in question 6, if Aaron's house goes up by 2% in value each year for the next three years and he makes all his mortgage payments on time, how much equity will he have in his home at the end of three years? In order to get this answer, you will need to answer four questions in total. They are: (a) What is the monthly mortgage payment? (b) What is the principal balance at the end of year 3? (c) What is the market value of the home after three years? (d) How much equity does Aaron have at the end of year 3? Check the quiz solutions for the answers.

a.
b.
c.
d.

8. Ashley is taking out a $215,000 mortgage to purchase a new home. The mortgage will have a 30-year term and a stated rate of interest of 6%. The lender is charging Ashley 1.5 discount points for her to get the loan. If Ashley believes that she will pay off the loan within five years, either because she will move or refinance, what is the annual percentage rate she will be paying on the loan?

a. 6%
b. 6.36%

c. 6.5%
d. 6.76%

9. Chase is buying a new home with a purchase price of $195,000. He is taking out a 75% loan-to-value mortgage amortized over 25 years with a 6.25% rate of interest. What is Chase's principal balance at the end of three years if he makes all his payments on time?
   a. $146,250
   b. $140,770
   c. $111,518
   d. $138,232

10. Ashley's grandparents are considering a reverse annuity mortgage to generate some extra cash flow during their retirement since their original mortgage was paid off eight years ago. The lender says they can accumulate debt to a maximum of 75% of their home's current value of $220,000. Given a 15-year term and an interest rate of 7.25%, how large a monthly payment can they expect to receive?
    a. $679.13
    b. $1,506.22
    c. $2,008.30
    d. $509.35

8

CHAPTER

Appreciation and Depreciation

You Win Some and You Lose Some

Value Increase Caused by Appreciation

Real estate tends to go up in value over time, which is a phenomenon referred to as *appreciation.* A prime cause of this is general inflation in the economy, but it is also the result of other market-driven factors such as amount of competing

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property on the market, number of buyers in the market, demographics of those buyers, and other factors. A historic average of single-family home appreciation over the last 50 years in the United States is about 4% per year. This value can vary dramatically however.

It is important to note the difference between average, or nominal rate of appreciation, and the compound rate of appreciation. The methods of calculating these two different types of appreciation are spelled out a little later in the chapter. Suffice it to say at this point that the compound rate takes into consideration the phenomenon of compounding and the average rate does not. The result is that the average rate will sound greater than the compound rate.

According to the U.S. Census Bureau, the median value of a home in the United States from 2002–2005 averaged a compound annual increase of 6.9%. Appreciation rates can vary by time and by market area. Over the same time period listed above the median home values in New Mexico increased by only 2.6% per year while the median home value in California increased at a compound rate of 20.1% per year. Appreciation rates are much more volatile over shorter time periods, and the rates tend to be much smoother over longer time periods. Home buyers and investors are interested in the rate of appreciation the properties in their market area have experienced. It gives them a clue about the sort of appreciation they might earn on their property in the future, even though past appreciation rates are no guarantee of what future rates of appreciation may be earned.

DOLLAR AMOUNT OF APPRECIATION

If that 4% rate over the last 50 years is accurate and a homeowner purchased a home four years ago for $175,000, then that home may be worth $204,725 today if the rate of appreciation over the past four years has been at the average rate. There are two ways to get to that answer. Multiplying the purchase price by 1 plus the growth rate four times will get us there as shown in Equation 8.1. Each multiplication means that the homeowner will end up with the beginning value plus the additional 4%. After year one that means the homeowner will be earning appreciation on the previous appreciation in addition to appreciation on the initial home value. This is the compounding process at work.

Equation 8.1

$$\$175{,}000 \times (1.04) \times (1.04) \times (1.04) \times (1.04) = \$204{,}725$$

The reason we can't just multiply the $175,000 by 1.16, which is four years of 4% growth, is because we must capture the compounding effect of the 4% growth each year. As you can see in Equation 8.2, multiplying the purchase price by

1 plus 16%, or 1.16, yields a future value of only $203,000. This method misses the additional $1,725 in value growth from the compounding.

Equation 8.2

$$\$175{,}000 \times (1.16) = \$203{,}000$$

The second method of finding the value after four years of 4% annual growth involves the following financial calculator keystrokes which also yield the answer of $204,725.

Solution 8.1

−175000 [PV]

4 [n]

4 [i/y]

[cpt] [FV] 204725

Using the financial calculator to determine our future value takes into consideration the compounding effect of our 4% growth rate and gives us the correct answer.

Given the purchase price of $175,000 and the current value of $204,725, you have experienced appreciation of $204,725 − $175,000 = $29,725. Another way this appreciation can be exhibited is by looking at the equity that the homeowner has in the property. As mentioned in other chapters, equity is defined as shown in Equation 8.3.

Equation 8.3

$$\text{Equity} = \text{Market value} - \text{mortgage balance}$$

As you can see, if market value goes up, so does the equity that we have in the property. So if we saw the market value go from $175,000 to $204,725, we have seen our equity increase by $29,725 regardless of what happened to our mortgage balance. Fortunately, if we have been making our mortgage payments on time, the mortgage balance has also gone down. That decrease in mortgage balance has only added to our equity, because as mortgage balance goes down, our equity also goes up. An increase in our equity results in an increase in our net worth, but that's a topic for another day.

Let's look at another example. If you purchased your home two years ago for $189,000 and have been told that your market experienced appreciation two years ago of 4% and 6% last year, what is your home currently worth? See Equation 8.4.

Equation 8.4

$$\text{Home value} = \$189{,}000 \times 1.04 \times 1.06 = \$208{,}353.60$$

Based on the appreciation rates of 4% the first year you owned the home and 6% the second year you owned the home, the current value should be approximately $208,353. The answer can be found using the financial calculator as well. However, this time it will take two separate calculations because of the two different growth rates. The keystrokes are contained in Solution 8.2.

Solution 8.2

−189000 [PV]
1 [n]
4 [i/y]
[pt] [FV] 196560

And then,

−196560 [PV]
1 [n]
6 [i/y]
[cpt] [FV] 208353.60

In this case, it is almost easier to use Equation 8.4 rather than the financial calculator because of the requirement of entering two separate future value calculations at two different growth rates.

COMPOUND ANNUAL GROWTH RATE

Some situations require you to figure out what growth rate caused the value to move from an initial value to a greater value. In that case we are trying to solve for the rate of interest, or the growth rate. In this type of calculation the financial calculator is a tremendous asset.

Look at a case where a homeowner purchased her home for $125,000 five years ago, and she has it appraised and finds that the current value is $153,000. She would like to know what annual rate of appreciation she has earned over the five-year period. Using the following financial calculator keystrokes will get her the answer.

Solution 8.3

−125000 [PV]
5 [n]

153000 [FV]

[cpt] [i/y] 4.13%

Her annual compound rate of appreciation has been 4.13%. This means that it went up in value by 4.13% the first year, then by 4.13% the second year, and so on. It is a compound growth rate.

Let's assume that you are selling a piece of investment property that you purchased 10 years ago for $275,000. One of the tenants would like to purchase the building and has made an offer of $435,000. You have told the tenant that you wouldn't sell unless you have earned a compounded annual rate of appreciation of at least 4.5%. Should you sell the property? Go ahead and push some buttons. If you were paying attention when we went through the last problem, you probably went back to check Equation 8.3 and did something similar to what is shown in Solution 8.4.

Solution 8.4

−275000 [PV]

435000 [FV]

10 [n]

[cpt] [i/y] 4.69%

Your decision, of course, would be to sell the property because you are earning in excess of your required appreciation rate of 4.5%. In fact you are earning a compound rate of 4.69%.

AVERAGE OR NOMINAL APPRECIATION

The owner's average, or nominal, noncompounded annual rate of appreciation is calculated using $(P_1 - P_0)/P_0$ as follows. The total change in value over the five-year period is $28,000, and that figure divided by the initial value results in 22.4% of the initial value. That 22.4% divided by five years gives us an average growth rate of 4.5% per year as shown in Equation 8.5.

Equation 8.5

$$(\$153{,}000 - \$125{,}000)/\$125{,}000 = \$28{,}000/\$125{,}000 = 0.224/5 = 0.045 = 4.5\%$$

This average rate is not compounded, which is why it is higher than the compounded rate. The compounded rate takes into consideration that the owner is receiving interest on interest in the compounding process. The average growth rate

has the advantage of being much easier to calculate. We don't need a financial calculator to find the average growth rate. We can solve Equation 8.5 with a standard four-function calculator.

While the average growth rate is much easier to calculate, it also gives us a somewhat distorted picture of the actual growth rate because it tends to overstate the rate of growth. The compound growth rate requires the use of a financial calculator, but it gives us a truer picture of how the growth rate works. Each year we go up in value, that value increase is based on the value of what has happened in the past. Property values truly do increase at a compounded rate of growth.

TOTAL APPRECIATION OVER A NUMBER OF YEARS

If the total amount of appreciation is the percentage that is desired, it can also be determined in a couple of different ways. Let's say that a homeowner purchased a home for $120,000 and it is currently worth $150,000. The total amount of appreciation can be determined in a few different ways. The first of these is by dividing the current value by the purchase price, subtract 1 and convert the decimal to a percentage.

Equation 8.6

$$\$150{,}000/\$120{,}000 = 1.25 - 1 = 0.25 \text{ or } 25.0\%$$

In Equation 8.6 we have taken the current, or ending, value and divided it by the purchase price, or beginning value. Then we took the answer of 1.25 and subtracted the 1 so we are left with 0.25 or 25%. Over the holding period, however long it was, this property increased in value by 25%.

Alternatively the calculation can be made again using the $(P_1 - P_0)/P_0$ format, and the same value is achieved as follows.

Equation 8.7

$$(\$150{,}000 - \$120{,}000)/\$120{,}000 = 0.25 \text{ or } 25.0\%$$

What we have done in Equation 8.7 is taken P_1, or $150,000, and subtracted P_0, or $120,000, and divided that quantity by P_0, which again is $120,000. The result of the calculation is once again 0.25 or 25%. This illustrates that the home has experienced appreciation of 25%.

A third way to get the total amount of appreciation is by using the financial calculator. This time the (n) value will not be a number of years; it will simply represent the entire holding period, so it is given a value of 1.

Solution 8.5

−120000 [PV]

150000 [FV]

1 [n]

[cpt] [i/y] 0.25 = 25%

All three calculations result in the same answer for total appreciation, which is 25%.

If an investor purchased a building for $375,000 and has been told that the building has appreciated by 25% in value, what would that building be worth today?

Equation 8.8

$$\$375{,}000 \times (1 + 0.25) = \$375{,}000 \times (1.25) = \$468{,}750$$

The ending value based on a total appreciation rate could also be found using the financial calculator. Solution 8.6 shows the required keystrokes. Make note that since we are using a total amount of appreciation rather than an annual amount, the [n] we use is simply 1. It is not 25% per year; it is 25% over the total holding period. Think of it as one holding period.

Solution 8.6

−375000 [PV]

1 [n]

25 [i/y]

[cpt] [FV] 465750

Today that building would be worth $468,750 if it had indeed appreciated 25% in value. Equation 8.8 and Solution 8.6 take us to the same place.

If the question went a step further and asked, what was the compound annual rate of appreciation that took the value from $375,000 to $468,750 over the five-year period, the solution on the financial calculator would look like this.

Solution 8.7

−375000 [PV]

468750 [FV]

5 [n]

[cpt] [i/y] 4.56% per year

The compound annual rate of appreciation is 4.56%. This rate is again lower than the average rate of appreciation of 5%, or 25%/5 = 5%. The lower compound rate is lower because of the compounding effect.

Depreciation in Appraisal

According to the *Dictionary of Real Estate Appraisal*, published by the Appraisal Institute, *depreciation* is a loss in value due to any cause. This depreciation is applied to the replacement cost of the improvements in the cost approach as you will see in Chapter 10 on real estate appraisal.

The depreciation can come in three forms: physical deterioration, functional obsolescence, and economic or locational obsolescence. The first of these, physical deterioration, is probably what comes to mind when most people think of depreciation. This is the physical wearing out of the improvements. It is the chipped paint, the cracked plaster, or the missing roof shingles. When this form of depreciation is valued separately, it is usually based on the cost to cure. How much would it cost to repaint the rooms? How much would it cost to repair the plaster? Or how much would it cost to replace the roof?

The second form of depreciation may escape casual observers. They may not recognize it as depreciation, but they may respond that, "There is something funny about that house." That something funny is functional obsolescence. This is either something that doesn't function the way it should or something that is no longer desirable in the marketplace. It may be a dysfunctional floor plan, such as a bedroom off of the living room. It may be a stairway coming directly into a room rather than into a hallway. I think of my grandmother's kitchen when I think of functional obsolescence. She had these very large cupboard doors that were about four feet tall, reaching up to the high ceiling. Nobody could ever get anything down from the top two shelves. There were linoleum countertops in the kitchen, in a red swirl pattern as I recall, with a little aluminum band around the edge where all of the "gunk" got caught. Other examples of functional obsolescence would include shag carpet, avocado colored appliances, a gravity furnace, or a single-car garage.

A dollar value is a little more difficult to establish for this type of depreciation. The concept of curable versus incurable depreciation comes into play with functional obsolescence as well as for physical deterioration. The basic test is economic viability. If the change is not economically viable, the depreciation is incurable; if it makes economic sense, it's curable. It is pretty difficult to change a floor plan deficiency, which makes that incurable. Replacing shag carpeting makes economic sense.

The third form of depreciation is locational, or economic, obsolescence. Let's say you own a house in Hibbing, Minnesota, and the taconite plants are closed down. Suddenly there are scores of unemployed workers who decide they have to move to another town for employment. They all put their houses on the market at the same time. This tremendous increase in the supply of housing without a corresponding increase in demand will cause values to go down. This loss in value is simply the result of where the home is located—in Hibbing. This value loss, or depreciation, is pretty much incurable.

An appraiser will be asked to determine the loss in value that has resulted from these three forms of depreciation on the property. Some of the valuation service companies such as Marshall & Swift publish tables that have combined the different forms of depreciation into depreciation tables. Depreciation tables give a percentage of depreciation that should be taken based on the age of the structure and the original quality of construction. If a house has a construction cost of $200,000 new, and the depreciation tables recommend taking depreciation of 20%, then the house would have a depreciated cost as stated in Equation 8.9.

Equation 8.9

$$\$200{,}000 \times 0.20 = \$40{,}000 \text{ and then } \$200{,}000 - \$40{,}000 = \$160{,}000$$

The depreciated cost of the improvements is equal to the cost times 1 minus the depreciation rate. This is the same calculation as shown in Equation 8.10.

Equation 8.10

$$\$200{,}000 \times (1 - 0.20) = \$200{,}000 \times (0.80) = \$160{,}000$$

The question may be worded in reverse fashion. A house is currently worth $140,000 and has depreciated by 15% since it was purchased. What was its original value? The calculation then becomes Equation 8.11.

Equation 8.11

$$\$140{,}000/(1 - 0.15) = \$140{,}000/0.85 = \$164{,}705.88$$

Rather than multiplying by 1 minus the rate as we did in Equation 8.9, you simply divide by 1 minus the rate of depreciation. Dividing the $140,000 by 0.85 gives us the value of $164,705.88. To check your answer, now multiply the $164,705.88 by 1 minus the rate, or $164,705.88 × (1 − 0.15), which is the same as $164,705.88 × 0.85, and get the correct value of $140,000.

Depreciation in Investment Property

Depreciation in an investment property scenario is quite a different thing from depreciation in appraisal. In the previous section it was stated that depreciation is a loss in value due to any cause. For investment property, depreciation is a theoretical wearing out of the property that is deducted from income for taxation purposes. Uncle Sam, the IRS, says that investors can deduct the value of this depreciation from their income so that the investors' tax liability will be reduced. Uncle Sam is saying that investors can have a larger cash flow from operations because of this depreciation. The purpose of depreciation is to allow investors to recapture this wearing out of the asset so that they could theoretically replace it once it wears out. In effect, depreciation is another expense that can be deducted from investors' operating income. However, it is called a noncash expense since the investor doesn't actually write out a check to depreciation.

Current tax law states that real property wears out in one of two ways. It either wears out over 27.5 years in the case of residential property, or it wears out over 39 years in the case of nonresidential property. *Residential property* is defined as someplace where you can live. This depreciation may be taken over what is referred to as a straight line. That means that the same amount of depreciation expense is taken each year until the asset is fully depreciated, when the basis equals zero. Adjusted basis is equal to the acquisition cost minus depreciation that has been taken. To calculate the amount of depreciation expense that can be taken, subtract the land value from the acquisition cost to obtain the value of the improvements. Then divide the value of the improvements by either 27.5 for residential property or by 39 for nonresidential property.

Equation 8.12

$$\text{Depreciation expense} = (\text{Acquisition cost} - \text{land value})/27.5 \text{ (or 39)}$$

THE IMPACT OF DEPRECIATION ON TAXABLE INCOME

The impact of depreciation on taxable income is illustrated in Table 8.1. The top portion of the table, calculating net operating income (NOI) and before-tax cash flow (BTCF), is addressed in Chapter 10, "Real Estate Appraisal." The bottom portion of the table, calculating after-tax cash flow (ATCF) is covered in Chapter 11, "Real Estate Investment Analysis."

By looking at depreciation in the left-hand column of Table 8.1, one can see that interest expense and depreciation are deducted from net operating income. The result of this deduction is called taxable income if the number is positive and taxable loss if the number is negative. As we will see in Chapter 11, the investor

Table 8.1 After-tax cash flow

Potential gross income	
− Vacancy and rent loss	
Effective gross income	
− Operating expenses	
Net operating income	
− Debt service	
Before-tax cash flow	
Net operating income	$32,490
− Interest	−$26,129
− Depreciation	−$14,545
Tax income (loss)	−$8,185
× − Marginal tax rate	× − 0.28
Tax liability (savings)	$2,292
Before-tax cash flow	
−/+ Tax liability or savings	
After-tax cash flow	

does not mind if this number is negative, or a tax loss. In any event, you can see that more depreciation expense means we end up with either a lower taxable income or a larger tax loss. When the taxable income is lower, this means that we will have a lower tax liability. When we have a larger tax loss, this means that we will have a larger tax savings. Both of these possibilities are good things as far as the investor is concerned.

If the marginal tax rate (MTR) is plugged into the table as a negative number, the product of the tax rate times the taxable income or loss has the correct sign, from a cash flow standpoint. Note in Table 8.1, that the tax loss of −$8,185 is multiplied by the −28% tax rate to get a +$2,292 tax savings. This tax savings of $2,292 increases the after-tax cash flow by that same amount. These calculations are expanded upon in Chapter 11.

As an example of how depreciation is calculated, consider an investor who purchases an apartment building for $500,000 which includes land value of $100,000. Her annual depreciation calculation is shown in Equation 8.13.

Equation 8.13

$$(\$500{,}000 - \$100{,}000)/27.5 = \$14{,}545.45$$

The investor could deduct $14,545.45 in depreciation expense from the net income on her building for tax purposes. See Chapter 11 to see how this tax benefit can result in greater cash flow to the investor. Additional IRS regulations, Accelerated Cost Recovery System, or ACRS, state that the entire $14,545.45 cannot be taken the first year the property is put in service, but that is another

story entirely. It is referred to as the half-year convention. Please consult your tax accountant to determine how much depreciation expense you may deduct from the income of your own investment property.

If the investor purchases a warehouse to rent out to a tenant, the calculation follows the same process. The only difference is that a 39-year life is used for nonresidential property. If the purchase price is $750,000 and the land value represents 20% of the value, or $150,000, the depreciation calculation would look like Equation 8.14.

Equation 8.14

$$(\$750{,}000 - \$150{,}000)/39 = \$15{,}384.62$$

ACCELERATED DEPRECIATION

In past years depreciation other than straight line was allowed for real property. As recently as 1986 the IRS permitted the use of 175% declining balance depreciation. At the time a 19-year life was used. This means that the investor could take much more depreciation expense under those provisions. Equation 8.15 illustrates that calculation for depreciation using a 19-year life and a 175% declining balance.

Equation 8.15

$$175\%/19 = 0.0921 = 9.21\% \text{ per year}$$

The investor could take 9.21% of the value of the improvement per year as depreciation. Let's say we had a piece of property with an improvement value of $100,000. We would take that times the 0.0921 and get depreciation expense in the first year of $9,210. The declining balance tells us to take $100,000 − $9,210 and get an adjusted basis of $90,079. In year 2 we would take $90,079 × 0.0921 and get a depreciation expense of $8,361.76. This would again be deducted from the previous adjusted basis, and so on until the basis is down to zero, hence the term declining balance. Under current IRS regulations, that same property would receive a depreciation deduction of only $2,560. We can get that by taking 100%/39 = 2.56% and then taking 2.56% of the $100,000 improvement value. Hopefully you can see the magnitude of this change that took place under the 1986 Tax Reform Act. Using this small piece of property as an example, the difference in taxable income between these two different tax regulations would be $6,650 per year. This is not a small change in income. You can see why property values did not increase significantly directly after the 1986 Tax Reform Act took effect.

Quiz for Chapter 8

1. A seller signs a purchase agreement to sell her home for $225,000. She purchased the home several years ago for $162,900. What was the total appreciation percentage that she experienced?
   a. 23.4%
   b. 17.9%
   c. 38.1%
   d. 27.6%

2. An appraiser estimates that the current construction costs for a subject property are $185,000. The appropriate depreciation rate for the age of the building is 15%. What is the depreciated cost of the building?
   a. $185,000
   b. $212,750
   c. $160,869
   d. $157,250

3. You purchased your home six years ago for $194,500, and you have been told that homes have been appreciating at the rate of 3% per year in your neighborhood. What is your home worth today based on annual compounding?
   a. $229,510
   b. $232,243
   c. $217,842
   d. $231,652

4. An investor just purchased a warehouse for $345,000 to be rented out at market rental rates. The assessor's office tells him that the land value is $70,000. How much depreciation expense can he take using straight line depreciation?
   a. $7,051
   b. $1,794
   c. $10,000
   d. $2,545

5. Your brother finds out that you are a real estate math wiz and asks you how much depreciation expense he can take on his newly acquired rental house in Florida. The home was purchased for $220,000, of

which $44,000 was the value of the land. What amount of straight line depreciation can your brother take per year to offset income?

a. $8,000

b. $5,641

c. $6,400

d. $4,512

6. Your boss tells you that he purchased his home 19 years ago for $120,000. He goes to the bank and is told that his home is currently worth $455,000. What has been his annual compound rate of appreciation?

a. 7.3%

b. 4.5%

c. 20%

d. 3.9%

7. A homeowner purchased her home four years ago for $137,900 and sold it today for $163,500. What was her average annual rate of appreciation (not compounded)?

a. 4.6%

b. 18.6%

c. 3.6%

d. 9.7%

8. A house recently sold for $133,000. It had depreciated by 15% since it was originally purchased. What was the original purchase price?

a. $19,950

b. $152,950

c. $145,000

d. $156,470

9. Your parents are selling their home, and they ask you how much total appreciation they have experienced since they bought their home. The sale price is $175,000, and they purchased the home for $123,900. Their total appreciation rate is:

a. 8.5%

b. 29.2%

c. 41.2%

d. 43.1%

10. The purchase price of your home was $245,000 five years ago, and homes in your market have been appreciating by 4% per year. Given the compound rate of appreciation, what is the current value of your home?
    a. $298,080
    b. $254,800
    c. $294,000
    d. $294,080

CHAPTER 9

The Closing and Closing Statements

In Summation, Your Honor

The *closing* can be defined as a gathering of interested parties at which the promises made in the purchase agreement are executed. Who are the interested parties? First of all, the two parties associated with the purchase agreement, the vendor and the vendee, or the seller and the buyer. Other interested parties may include the salesperson(s), the broker(s), an attorney, a representative of the title

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insurance company, a representative of the mortgage lender, other lien holders (i.e., contract for deed holders), and the person referred to as the closing agent. The closing agent is the person who will calculate and create the closing statements. The closing agent may be a real estate broker, a representative of the title insurance company or mortgage lender, or an attorney. The closing agent may be someone who is licensed solely to act as a closing agent.

The closing statement is used to sort out the expenses and prepayments associated with a real estate closing. In other words, the debits and the credits of the transaction are accounted for in the closing statements. There are two separate closing statements that appear at the closing—the buyer's closing statement and the seller's closing statement. The bottom line of the buyer's closing statement tells the buyer how much additional cash must be brought to the closing. The seller's closing statement tells the seller what the net proceeds will be from the transaction, or how much cash he or she will have when they go home.

The debits on the closing statement are a charge to the debited party, or an amount of money this person owes. When you cover up the i in the word debit, you are left with the word *debt*, which is another nice explanation of a debit. The credits on the closing statement are either an amount of money the credited party has coming in or an amount of money this person has already paid and wants to get credit for having paid it.

Expenses

The types of expenses that may show up on the closing statement include sales commissions, title opinions, title insurance fees, appraisal fees, origination fees, recording fees, mortgage registration tax, state deed tax, real estate taxes, insurance premiums, discount points, credit report, document preparation, abstract extension, home warranty fee, and others. Some of these expenses typically fall under the buyer's responsibility to pay, and some typically fall under the seller's responsibility. There are by no means hard-and-fast rules and could vary depending upon the state in which the closing is taking place.

Expenses that are typically paid by the buyer would include those costs associated with the buyer's new mortgage. This would include the origination fee, the appraisal fee, the discount points, the mortgage registration tax, the recording fee associated with the new mortgage and the deed, and in some states the title insurance premium. This is not to imply that the seller might not pick up these expenses in a buyer's market, but they are most often paid by the buyer.

Those expenses that are typically paid by the seller include the sales commission to the broker, title clearing costs including recording fees for any documents

needed in clearing the title, abstract extension, attorney's fees, recording of the mortgage satisfaction, and in some states the title insurance premium. The title insurance cost is kind of a variable. In some states the title insurance cost falls on the buyer since it is protecting the buyer's interest. In other states however, the title insurance cost falls on the seller, since that is the way the seller can assure the buyer that the seller is providing clear title to the property. It turns out to be whatever is the customary practice in an individual market.

PREPAID EXPENSES

Expenses can be classified as either prepaid or accrued. Expenses that are prepaid have been paid for, but not fully used up. Let's look at real estate taxes that can be prepaid in certain instances. In Minnesota real estate taxes are paid twice a year. The first half of the real estate taxes is due on May 15 of the year. This payment covers the taxes for the first half of the year, from January 1 through June 30. If the closing is to take place on May 30 of the year, the first half of the real estate taxes will already have been paid by the seller on May 15. In this situation the real estate taxes will be prepaid as far as the seller is concerned. This means that the seller will have already paid the taxes for the use of the property from January 1 through June 30, but the seller is not going to be on the property for the month of June; the buyer will be using the property then. As a result, the buyer will have to pay the seller for the real estate taxes for the month of June at the closing. The seller is said to own the property up to and including the day of closing and pays the expenses for the day of closing, so the buyer starts paying the real estate taxes as of June 1.

The real estate tax payment would show up on the seller's closing statement as a credit for the month of June. The same amount would show up on the buyer's closing statement as a debit. These expenses that are split between the seller and the buyer are referred to as *prorated items.* They are the only items that appear on both the seller's statement and the buyer's statement as the same amount.

ACCRUED EXPENSES

Accrued expenses are those expenses that have been earned but not yet paid. An example of an accrued expense can again be real estate taxes. If in the previous example the closing was to take place on March 30, the taxes would indeed be an accrued expense to the seller. The seller would have been in the property for all of January, February, and March and would not have paid any taxes for that time period. It would be the buyer that is in the property on May 15 when the check would have to be written for the taxes. The result is that the seller would have to

pay the buyer at the closing for the taxes that he or she had earned, or used up, during the months of January–March. That amount would appear as a debit on the seller's closing statement, and the same amount would appear as a credit on the buyer's statement.

Prorated Items

As mentioned previously, prorated items are expenses that are split between the buyer and the seller. Real estate taxes are one area in which we see the prorating process used. Another area would be in the interest due on an assumed mortgage.

INTEREST ON AN ASSUMED MORTGAGE

Let's say that we are having a closing and the buyer is assuming the seller's mortgage. The mortgage will have a principal balance of $95,500 on March 12, the day of closing. The mortgage carries a 7% rate of interest. Mortgage payments are due on the first of the month, and they require interest to be paid in arrears. This means that we don't have to pay for using the money until we have already used it. As a result the March 1 mortgage payment contained the interest paid for the use of the money during the month of February. The next payment will be due on April 1, and that will contain the interest for the use of the money during the month of March. The seller will be using the mortgage money for twelve days, from March 1 through March 12. The buyer will be making the mortgage payment on April 1, so the buyer needs to collect from the seller the interest that the seller has accrued from the first through the twelfth. Equation 9.1 contains the calculation for the annual interest on the mortgage.

Equation 9.1

$$\text{Annual interest} = \text{Principal amount} \times \text{interest rate} = \$95{,}500 \times 0.07 = \$6{,}685$$

That amount is now divided by twelve to get the monthly amount of interest as shown in Equation 9.2.

Equation 9.2

$$\text{Monthly interest} = \text{Annual interest} \div 12 = \$6{,}685 \div 12 = \$557.08$$

To get the daily amount of interest, we divide the monthly interest by the number of days in the month of closing, in this case 31. The result is shown in Equation 9.3.

Equation 9.3

$$\text{Daily interest} = \text{Monthly interest} \div 31 = \$557.08 \div 31 = \$17.97$$

Now we can calculate the amount of interest that the seller owes to the buyer by multiplying the daily amount of interest due on the mortgage by 12, as shown in Equation 9.4.

Equation 9.4

$$\text{Interest due from March 1 through March 12} = \$17.97 \times 12 = \$215.64$$

Thus the amount of interest due from the seller to the buyer at the closing would be $215.64, which would appear as a debit on the seller's statement and a credit on the buyer's statement. Now when the buyer makes the mortgage payment on April 1, he or she will have the total amount of interest that is owed on the mortgage for the use of the money during the month of March. The buyer will have the amount of interest for the use of the money from the first through the twelfth that the seller has paid and the amount of interest from the thirteenth through the thirty-first that is owed as a result of being in the property during that time period.

REAL ESTATE TAXES

Real estate taxes can also be prorated between the seller and the buyer. Assume we are having a closing on April 14 and the real estate taxes are to be prorated between the seller and the buyer. Annual real estate taxes are $1,000, and the first half of those taxes are due and payable on May 15. In other words someone has to pay $500 for those taxes on May 15. In order to calculate the prorated amount, start by taking the $500 and divide it by 6 to get the monthly amount, as shown in Equation 9.5. The same value could be obtained by taking the annual amount of $1,000 and dividing it by 12.

Equation 9.5

$$\text{Monthly amount} = \$500 \div 6 = \$83.33 \text{ or } \$1{,}000 \div 12 = \$83.33$$

Next, to get the daily amount, divide the monthly amount by 30, since there are 30 days in April. Occasionally closing agents and banks will use a statutory

year, which has 360 days and 30 days per month. At other times they will use a calendar year that has 365 days and the actual number of days per month.

Equation 9.6

$$\text{Daily amount} = \$83.33 \div 30 = \$2.78$$

To get the amount to be prorated, multiply the daily amount by 14. Since we are closing on the fourteenth and the seller owns the property up to and including the day of closing, the seller will be accruing taxes for the first through the fourteenth.

Equation 9.7

$$\begin{aligned}\text{Prorated amount} &= (\$2.78 \times 14) + (3 \times \$83.33)\\ &= \$38.89 + \$249.99 = \$288.88\end{aligned}$$

The total amount to be prorated would be 14 times the daily rate for the April value plus 3 times the monthly rate for January, February, and March. That total amount comes to $288.88, which would be the amount debited to the seller and credited to the buyer.

Buyer's Statement

The buyer's closing statement is designed to inform the buyer, or buyers, how much additional cash they need to bring to the closing. A typical blank buyer's closing statement is illustrated in Table 9.1 below. Before moving on to the next paragraph, look at the blank statement and try and determine which line items would show up as debits on the buyer's statement and which items would show up as credits on the buyer's statement. A little later in the chapter we use Table 9.1 in a closing statement case problem.

It is important that we have an understanding of the terminology used in the buyer's closing statement. The *purchase price* is in fact the price paid for the property. This same amount will appear as the *sale price* on the seller's closing statement. *Earnest money* is the amount of money that the buyer puts down at the time the offer is made. Earnest money serves two purposes. First it indicates that the buyer is sincere, or earnest, in his or her desire to purchase the property and should discourage the buyer from defaulting prior to the closing. Second it serves as compensation to the seller in the event a default takes place. The earnest money was put down at the time the purchase agreement was signed and thus would show up as a credit on the buyer's statement. The buyer wants to receive credit for already having paid it.

Table 9.1 Buyer's closing statement

	Debits	Credits
Purchase price		
Earnest money		
Mortgage		
– Principal		
– Interest		
Real estate taxes		
Insurance		
Title insurance		
Origination fee		
Appraisal fee		
Credit report		
Recording		
– New mortgage		
– Deed		
– Mortgage satisfaction		
Mortgage registration tax		
Subtotals		
Due from buyer		
Totals		

The *mortgage principal and interest* that show up on the buyer's statement are the new mortgage being used to finance the purchase of the property. The mortgage principal is the amount being borrowed, and it will appear as a credit on the buyer's statement. It appears as a credit because it is an amount of money the buyer has coming from the bank, and it is a part of the purchase price that the buyer won't have to bring in cash to the closing. The interest referred to is the amount of interest that would accrue from the day of closing through the end of the month of closing.

Since the first mortgage payment will not made until one full calendar month's worth of interest has accrued, the interest for the month of closing has to be paid at the closing. It was stated earlier that the seller owns the property on the day of closing, and this is true. However, the buyer receives the mortgage money from the lender on the day of closing, and as a result starts paying interest from the day of closing. If the closing is on April 14, the first mortgage payment will not be made until June 1. That is because one full calendar month's worth of interest will not accrue until then. That being the case, the buyer will have to pay for the use of the mortgage money during the month of April on the day of closing. In this case the buyer would have to pay for 17 days' worth of interest at the closing for the fourteenth through the thirtieth.

If the buyer is not taking out a new mortgage but is assuming the seller's old mortgage, then the principal amount is the principal amount of the old mortgage being assumed. This principal amount also would show up as a credit on the buyer's statement, just as the principal amount of the new mortgage shows up as a credit. It is a part of the purchase price that the buyer does not have to bring to closing in the form of cash. The interest shows up as the amount of interest that the seller has accrued from the first of the month through the date of closing, and that amount appears as a credit on the buyer's statement. It appears as a credit because the seller has to pay it to the buyer so the buyer can afford to make the next mortgage payment which is due on the first of the following month.

The *real estate taxes* show up on the buyer's closing statement because they are commonly prorated between the buyer and the seller. Depending on the common practice in a given market and the time of year that the taxes are due in that market, those taxes may appear as either a debit or a credit on the buyer's statement. Insurance may show up on the buyer's statement in regard to a homeowner's insurance policy. That amount may show up as a debit if the buyer has yet to order a homeowner's policy, or it may show up as a credit if the buyer has already prepaid a one-year policy. The mortgage lender is going to require that a one-year policy be in place to protect the lender's interest in the event of a protected catastrophe occurring during the term of the mortgage. The *title insurance* item may appear on the buyer's statement, as it does here, or it may show up on the seller's statement depending on local market practices. As mentioned earlier, in Minnesota it will appear on the buyer's statement, and in Texas it will appear on the seller's statement. In both cases it would appear as a debit on the closing statement.

The *origination fee*, the *appraisal fee*, and the *credit report* costs are all associated with the new mortgage and as a result will all appear as debits on the buyer's closing statement. Any other fees associated with the new mortgage would be the buyer's expense and thus show up as debits on the buyer's statement.

The *recording fees* appear as debits for the person who is responsible for paying them. The person paying the fees is the person whose interest is being protected by the recording of the document. The recording of the new mortgage is the buyer's expense since the new mortgage is associated with the buyer and not the seller and because recording that document protects the buyer's, as well as the lender's, interest. The recording of the deed also protects the buyer's interest. Since the recording of these two documents protects the buyer's interest, the buyer pays to record them, and they show up as debits on the buyer's closing statement. The *mortgage satisfaction* is a document issued by the mortgage lender of the seller's mortgage which tells the world the seller has paid off the mortgage. Recording this document protects the seller's interest so it is the seller's expense to record it.

This means that it will show up as a debit on the seller's closing statement and will not appear on the buyer's closing statement.

The final item on the statement in Table 9.1 is the *mortgage registration tax*. This is a tax paid by the buyer at the time the mortgage is recorded in the county courthouse and shows up on the buyer's statement as a debit.

Once all values are recorded on the buyer's closing statement, both the debit column and the credit column are summed and the resulting values are recorded in the subtotals row. The debits will no doubt exceed the credits on the buyer's statement. I tell my students that if they are reluctant to purchase a property where the credits exceed the debits, they should give me a call and I will buy that property! The next step is to subtract the subtotal of the credits from the subtotal of the debits, and that difference is the amount still due from the buyer. It gets recorded in the line below the subtotal of the credits. Now that value is added to the subtotal of the credits and gets recorded on the totals line in the credits column. The subtotal of the debits column is now brought down to the totals line in the debits column, and the buyer's closing statement is complete.

Seller's Statement

The seller's closing statement is designed to tell the seller how much cash he or she will end with after the closing. A seller's closing statement is illustrated in Table 9.2. Before moving to the next paragraph, take a look at each item on the seller's closing statement and try to determine which items will appear as debits and which items will appear as credits. This table is used a little later in the chapter in a case study.

Table 9.2 Seller's closing statement

	Debit	Credit
Sale price		
Mortgage		
– Principal		
– Interest		
Real estate taxes		
Insurance		
Recording fee		
Commission		
State deed tax		
Subtotals		
Amount due seller		
Totals		

The *sale price* that is mentioned in the seller's statement is the same amount as the purchase price that appears in the buyer's closing statement. The *mortgage principal and interest* that appear in the seller's statement are the amounts associated with the seller's old mortgage that is either being paid off or assumed. The principal amount is the mortgage balance that is either being paid off by the seller from the proceeds of the sale, or it is the amount being assumed by the buyer in the case of a mortgage assumption. In either case the principal amount will appear as a debit on the seller's statement. The interest amount that appears on the seller's statement is the amount of interest accrued from the first of the month until the day of closing, as was described previously when addressing the mortgage assumption for the buyer's statement. It is the interest expense that the seller is accruing during the month of closing while the seller is in the property. This time the amount will appear as a debit on the seller's statement. The seller has to pay the buyer for the interest accrued so that the buyer will be able to make the mortgage payment on the first of the following month.

The *real estate taxes* appear on the seller's statement because they are often prorated. If they are prorated, the amount that appears on the seller's statement will be the same amount that appears on the buyer's statement, only in the opposite column. If they are a debit on the buyer's statement, they will be a credit on the seller's statement, and vice versa. If it is a buyer's market, the parties may agree that the seller will pay all the taxes due in the year of sale. In that case they would not appear on the buyer's statement, but only on the seller's. On the other hand if it is a seller's market, the buyer may pay the full year's taxes. In that case they would not appear on the seller's statement, but only on the buyer's. Real estate taxes are very often a negotiable item. Insurance is typically an item that does not appear on the seller's statement because it is usually the buyer's expense. In certain strange circumstances the annual insurance premium may be prorated and would then appear on both statements.

The *recording fee* that appears on the seller's statement is for recording the mortgage satisfaction. Recording this document tells the world that the seller no longer owes money against this property. Since it protects the seller's interest, it is the seller's expense to record it, and thus it appears as a debit on the seller's statement.

The selling commission is typically paid by the seller and thus shows up as a debit on the seller's closing statement. Finally, the state deed tax, or a tax of similar name and purpose, is paid by the seller and shows up as a debit on the seller's statement.

Once again the subtotals of the columns are calculated and recorded. In the seller's case the credit column will usually exceed the debit column, although it is not quite as cut and dried as the buyer's statement. If the seller is in a market that has experienced price reductions resulting from rising interest rates or some other

market shock, the debits may in fact exceed the credits. It is in these markets that we tend to see a dramatic increase in the number of mortgage foreclosures. If we are in a normal market under normal conditions, the total credits will typically exceed the total debits. Taking the difference between those two values, we find the amount that is due the seller. That amount is then added to the total debits, and the resulting figures balance in the totals row.

The following case study can be completed by using the blank statements in Table 9.1 and 9.2 which appeared earlier in this chapter. Using those tables, and the information provided in this chapter, complete the case study that follows. The completed closing statements will be found on the following pages, but don't look at them until you have completed Table 9.1 and Table 9.2 on your own. Helpful hint: You may want to use pencil on this.

Case Study

Given the following information, calculate both the buyer's closing statement and the seller's closing statement for the transaction described with a closing date of September 15, 20—.

- Sale price—$123,000
- New mortgage of $90,000, 7% interest rate, 30 years
- Old mortgage with $45,000 balance, 10% interest rate
- Earnest money—$3,000
- Insurance premium—$400 payable at closing
- Real estate taxes $1,680 per year, payable May 15 and October 15
- Sales commission of 6%
- State deed tax—$3.30 per $1,000 of the sales price
- Mortgage registration tax—$2.30 per $1,000 of new mortgage amount
- Recording fees of $15 per document; new mortgage, mortgage satisfaction, deed
- Title insurance—$500
- Origination fee for the new mortgage of 1% of the mortgage amount
- Credit report—$75
- Appraisal fee—$350

CASE STUDY SOLUTION

As is indicated in the completed buyer's closing statement (Table 9.3), the buyer would be required to bring another $32,392 to the closing. That amount of $32,392 represents the balance of the down payment plus the net of the expenses and prorations. The balance of the down payment, $33,000 − $3,000 = $30,000, would

Table 9.3 Buyer's closing statement

	Debits	Credits
Purchase price	$123,000	
Earnest money		$3,000
Mortgage		
– Principal		$90,000
– Interest 9/15 – 9/30	$280	
Real estate taxes		$350
Insurance	$400	
Title Insurance	$500	
Origination fee	$900	
Appraisal fee	$350	
Credit report	$75	
Recording		
– New mortgage	$15	
– Deed	$15	
– Mortgage satisfaction		
Mortgage registration tax	$207	
Subtotals	$125,742	$93,350
Amount due from buyer		$32,392
Totals	$125,742	$125,472

have to be in cash or certified funds. A personal check could be used for the difference.

CALCULATIONS

Mortgage interest:

$$\$90{,}000 \times 0.07 = 6{,}300 \div 12 = 525 \div 30 = 17.50$$

$$\$17.50 \times 16 = \$280$$

Sixteen days' worth of interest due at closing:

$$9/15 - 9/30 = 16 \text{ days}$$

which includes the fifteenth, the first day we get the money.
Real estate taxes: $\$1{,}680 \div 2 = \$840$ for six months, first six months already paid on May 15.

$$\$840 \div 6 = \$140 \times 2.5 = \$350$$

Taxes of $140 per month for 2.5 months, which is a credit to the buyer.

Origination fee:

$$\$90{,}000 \times 0.01 = \$900$$

Mortgage registration tax:

$$\$90{,}000 \div 1{,}000 = 90 \times \$2.30 = \$207$$

Amount due from buyer:

$$\$125{,}742 - \$93{,}350 = \$32{,}392$$

As stated previously, the seller's closing statement will inform the seller of the net proceeds to expect as a result of the sale. In Table 9.4 that figure is represented by the amount due to the seller.

CALCULATIONS

Interest:

$$\$45{,}000 \times .10 = \$4{,}500 \div 12 = \$375 \div 30 = \$12.50 \times 15 = \$187.50$$

Twelve days of interest at $12.50 per day. Real estate taxes: The same amount that is a credit to the buyer is a debit to the seller. See the calculation under the buyer's statement.

Table 9.4 Seller's closing statement

	Debit	Credit
Sale price		$123,000
Mortgage		
– Principal	$45,000.00	
– Interest 9/1 – 9/15	$187.50	
Real estate taxes	$350.00	
Insurance		
Recording	$15.00	
Commission	$7,380.00	
State deed tax	$405.90	
Subtotals	$53,338.40	$123,000
Amount due seller	$69,661.60	
Totals	$123,000.00	$123,000

Commission:

$$\$123{,}000 - 0.06 = \$7{,}380$$

State deed tax:

$$\$123{,}000 \div \$1{,}000 = 123 - \$3.30 = \$405.90$$

Amount due seller:

$$\$123{,}000 - \$53{,}338.40 = \$69{,}661.60$$

Quiz for Chapter 9

1. Which of the following is true of real estate closings?
   a. Closings are generally conducted by real estate salespeople.
   b. The buyer usually receives rent for the day of closing.
   c. The buyer must reimburse the seller for any title evidence provided by the seller.
   d. The seller usually pays the expenses for the day of closing.

2. The earnest money deposited in the broker's trust account would show up on the closing statements as:
   a. A debit to the seller.
   b. A debit to the buyer.
   c. A credit to the seller.
   d. A credit to the buyer.

3. The buyer's new mortgage amount shows up on the closing statements as:
   a. A debit to the seller.
   b. A debit to the buyer.
   c. A credit to the seller.
   d. A credit to the buyer.

4. The subtotals on the buyer's closing statement look like this: subtotal of debits = $175,000, and subtotal of credits = $54,700. What amount will appear in both the total of the debits column and the total of the credits column?
   a. $175,000
   b. $54,700
   c. $120,300
   d. None of the above

5. In the scenario stated in Question 4, how much additional cash is due from the buyer at the closing?
   a. $175,000
   b. $54,700
   c. $120,300
   d. None of the above

6. When an expense has accrued to a seller, it appears on the seller's closing statement as:
   a. A debit to the seller.
   b. A debit to the buyer.
   c. A credit to the seller.
   d. It doesn't appear on the seller's statement.

7. The interest due for the month of closing on the new mortgage appears as what on the seller's closing statement?
   a. A debit to the buyer.
   b. A credit to the buyer.
   c. A debit to the seller.
   d. It doesn't appear on the seller's statement.

8. When the seller's old mortgage is being assumed,
   a. The principal balance appears as a debit on the seller's statement.
   b. The principal balance appears as a credit on the seller's statement.
   c. The principal balance appears as a debit on the buyer's statement.
   d. The principal balance appears on neither statement.

9. If the buyer's new mortgage is $115,000 at a 7% interest rate and the closing in on the May 13, how much interest expense will be debited to the buyer at the closing?
   a. $380.10
   b. $357.80
   c. $402.50
   d. $670.80

10. If the mortgage registration tax is calculated at the rate of $3.30 per $1,000 of new mortgage amount and the buyer purchased the house for $225,000 with a new mortgage of $180,000 at 6.5% interest, what is the amount of mortgage registration tax due at the closing?
    a. $594.00
    b. $742.50
    c. $975.00
    d. $3,300.00

CHAPTER 10

Real Estate Appraisal

We Value Your Opinion

Introduction

An *appraisal* is an informed estimate or opinion of value. It can also be referred to as the process of estimating the value of real property. The type of value that the appraiser is called on to determine is most often the fair market value of a piece of property. A fair market value definition can be summarized as the most probable price a property could bring if exposed to the market for a reasonable period of time. It is assumed that the buyer and seller are under no duress and are well informed, the property is exposed to the market for a reasonable period of time, and payment is made in cash or its equivalent.

Another type of value that a property may have is called *investment value*. Investment value is the value that a property may have for a specific individual investor. One investor may have a different investment objective than the typical

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investor in the marketplace. The investor may require a 12% return on equity rather than a 14% return that may be typical in the market. Obviously these returns will vary by property type and individual market characteristics.

The Three Approaches

The appraisal process incorporates three different approaches for estimating property value. These are the cost approach, the sales comparison approach, and the income approach. Each of the three approaches makes use of different mathematical calculations. These three approaches are described in some detail, and typical calculations for each approach are reviewed and practiced.

THE COST APPROACH

The first of the three approaches is the *cost approach* which is based on an appraisal principle called the *principle of substitution*. This principle states that nobody will pay more for a property than it would reasonably cost to construct a new substitute for that property. As a result the value of existing housing tends to be tied to the cost of new construction. If the two types of property were not relatively similar in value, one type of property would sell and the other would not.

The cost approach can be broken down into five steps. They are:

1. Estimate the value of the land (site) the building is sitting on.
2. Estimate the current construction costs.
   - They may be reproduction costs, replacing everything exactly as it is today, brick for brick.
   - They may be replacement costs, replacing the building with one of similar size and similar utility.
   - Replacement costs are generally used unless reproduction costs are specified.
3. Estimate the accrued depreciation that has taken place since the building was constructed. The depreciation may be one of three types: physical deterioration, functional obsolescence, or economic/locational obsolescence.
4. Deduct the accrued depreciation from the construction costs to get the depreciated construction costs.
5. Add the depreciated construction costs to the value of the land to get the value estimate using the cost approach.

The equation for the value of a property using the cost approach would look like Equation 10.1, which is in fact a summary of steps 1–5 above.

Equation 10.1

$$\text{Value} = (\text{Construction costs} - \text{depreciation}) + \text{land value}$$

In summarizing the tasks involved in the five steps listed above, the land value estimate, which is the fourth step in the appraisal process, usually shows up in the cost approach portion of the appraisal report. The land value is typically estimated by comparing the subject site with similar sites that have recently been sold. I like to refer to this as a mini sales comparison approach. The complete explanation of a sales comparison appears in the next section of this chapter.

The second step of estimating current construction costs is accomplished by researching a reference such as the *Marshall and Swift Current Construction Cost Guide*. This, and other similar publications, contains square-foot construction cost estimates for different sized houses of five different construction and material qualities. There are also multipliers used for materials in different parts of the country. Using these costs produces very reasonable construction cost estimates.

If we had a subject property of 1,550 square feet and the construction cost manual suggested a replacement cost per square foot of \$67.50 per square foot and based on the home's age the appropriate depreciation was 20% of the construction costs, what would the depreciated cost of the improvements be? We would simply follow the steps in Equation 10.1 and Equation 10.2.

Equation 10.2

Depreciated cost of the improvements

$$= (1{,}550 \times \$67.50) - 0.20(1{,}550 \times \$67.50) = \$104{,}625 - \$20{,}925$$

$$= \$83{,}700$$

Thus the depreciated cost of the improvements would be equal to \$83,700. The same value could have been obtained by taking the construction costs times $(1 - 0.20)$ or $\$104{,}625 \times 0.80 = \$83{,}700$.

The third step in the cost approach involves the estimation of the depreciation that the subject property has experienced since the home was constructed. *Depreciation* is defined as a loss in value due to any cause. The depreciation can take one of three different forms: physical deterioration, functional obsolescence, and economic (or locational) obsolescence. Calculating the value of the depreciation can be the most challenging part of the cost approach, particularly in older properties. There is a table used for estimating depreciation in the Marshall and Swift cost guide based on the remaining economic life of a property.

Step 4 is a straightforward subtraction problem, and step 5 is an addition problem; they are both self-explanatory.

The cost approach should establish the upper limit of value since nobody should pay more for a home than it would cost them to rebuild that home. This approach works best on new construction and special purpose type properties. It works well on new construction because there hasn't been much depreciation when the property is new or nearly new. The depreciation estimate is the most difficult part of the cost approach, so by reducing the magnitude of that calculation, the appraiser can be more confident in the value estimate that results from the cost approach. The cost approach is useful for appraising special purpose properties because they don't sell very often, making the sales comparison approach difficult to use, and they don't generate any income so the income approach is not very useful.

THE SALES COMPARISON APPROACH

The second of the three approaches is the *sales comparison approach*. The sales comparison is the best approach to use in valuing single-family residential property. The approach is based on the principle of substitution. Someone will not pay substantially more for a house today than a similar house sold for yesterday. The subject property is compared to a number of houses that sold recently, which are referred to as comparable sales, or comps. The houses are compared based on a number of different factors, called *elements of comparison*. These elements of comparison include;

- Lot size
- Square footage of the improvements
- Conditions of sale
- Architectural style
- Type of heating
- Air-conditioning
- Fireplaces
- Garages
- Outbuildings
- Quality of materials
- Condition of the improvements
- Age of improvements
- Location
- Date of sale
- Financing used

- Number of bedrooms
- Number of baths

Every time there is a difference between the subject and the comparable, an adjustment must be made. The adjustments are made to the sale price of the comparable as follows:

- Deduct the value of the features that are in the comparable but not in the subject.
- Add the value of those features that are in the subject but not in the comparable.
- Adjust the comparable to make it equal to the subject property.

To come up with an adjusted sale price for the comparable, simply net out the adjustments against the sale price. Those comparables that require the fewest adjustments are in fact the best comparables. The adjusted sale price of the comparable would be the sale price minus the net value of the total adjustments.

Problem 10.1

Your subject property is a three-bedroom rambler with 1,000 square feet of improved living area with a single bathroom and a two-car garage. You found a comparable sale of similar type house with three bedrooms, 1,000 square feet of space, a single bathroom and a two-car garage. The only difference between the subject property and the comparable is that the comparable has a fireplace and the subject property does not. The comparable sold for $150,000. You have determined that the fireplace has a market value of $5,000. This may have been done by analyzing market sales, or it may be some depreciated cost calculation. If this is the one and only difference between the two properties, then the first bullet above says that we deduct the value of those features that are in the comparable but not in the subject. Thus, Equation 10.3 contains the appropriate calculation.

Equation 10.3

$$\text{Value of subject} = \text{Sale price of the comparable} - \text{value of the fireplace}$$

$$\$145{,}000 = \$150{,}000 - \$5{,}000$$

The sale price of the comparable in this problem would reflect the value of a home with a fireplace. Since our subject does not have a fireplace, we would have to deduct the value of the fireplace from the sale price of the comparable to reflect the value of a home without a fireplace. Thus the value of our subject property in this example would be $145,000 if the fireplace was the only difference between the subject and the comparable.

Problem 10.2

If the subject property used in the previous problem had the fireplace and the comparable did not have one, the calculation of the subject's value would look like Equation 10.4. The value of the subject would be equal to the value of the comparable plus the value of the fireplace. This is because in this case the sale price of the comparable would reflect the value of a home without a fireplace, so we would have to add its value into the sale price to reflect the value of a home with a fireplace.

Equation 10.4

$$\text{Value of the subject} = \text{Sale price of the comparable} + \text{value of the fireplace}$$

$$\$155{,}000 = \$150{,}000 + \$5{,}000$$

THE INCOME APPROACH

There are several forms of the income approach. These include the gross rent multiplier (GRM), income capitalization, and discounted cash flow. The gross rent multiplier is the most effective form of the income approach for valuing single-family residences. The gross rent multiplier is calculated, or extracted, from a comparable sale. The comparable should have been rented at the time of the sale to be the best comparable. The GRM is equal to the sale price of the comp divided by the gross monthly rent of the comp, as shown in Equation 10.5.

Equation 10.5

$$\text{GRM} = \text{Sale price}_c/\text{gross monthly rent}_c$$

The GRM is then applied to the market rent of the subject as shown in Equation 10.6.

Equation 10.6

$$\text{GRM} \times \text{market rent}_s = \text{Value}_s$$

The value of the subject is equal to the GRM times the market rent of the subject. The market rent is the monthly rent that could be generated by the subject property if it were exposed to the rental market. You should notice that there are no adjustments made to the comparables as there were in the sales comparison approach. This is because the market should have already factored in property difference through the rental rates. Renters know the value of additional square footage or a fireplace since they have looked at other units in the marketplace.

As a result we don't see the adjustments made in the income approach like those that appeared in the sales comparison approach.

Problem 10.3

You are called on to appraise a single-family home in your neighborhood that is a 1,000 square foot rambler (ranch) that has three bedrooms. You find a number of comparables in the neighborhood that have recently sold. The best comparable sold for $165,000 and was generating rent of $1,450 per month. In conducting your market research, you have determined that the market rent of your subject property would be $1,275 per month. What is the value of your subject property using the GRM form of the income approach using your best comparable? First you would make use of Equation 10.5 to estimate your GRM, as shown in Equation 10.7.

Equation 10.7

$$\text{GRM} = \$165{,}000 \div \$1{,}450 = 113.79$$

You would then use Equation 10.6 to estimate the value of the subject property by taking the product of the GRM that you have just calculated times the market rent of the subject property, getting a value of just over $145,000. This calculation is illustrated in Equation 10.8.

Equation 10.8

$$\text{Value of subject} = 113.79 \times \$1{,}275 = \$145{,}082$$

The income capitalization form of the income approach is an effective valuation technique when applied to income-producing properties. These may be residential properties, such as apartment buildings, or commercial buildings like office buildings, warehouses, or retail centers. This form of the income approach can be broken down to five steps.

1. Estimate the potential gross income (PGI) the building could generate in a 12-month period, assuming tenants always paid their rent and the building were occupied 100% of the time. For an apartment building this would be the number of units times the rent per unit, plus any garage income that may be generated during the year, plus any extraneous income such as laundry income. The PGI for a four-unit apartment building with each unit renting for $950 per month would be $4 \times \$950 \times 12 = \$45{,}600$. The PGI for an office building would be the number of rentable square feet in the building times the rent per square foot per year. The PGI for

a 5,000 square foot office building renting for \$14 per square foot would be 5,000 × \$14 = \$70,000.

2. Deduct a vacancy and rent loss allowance from the potential gross income to get the effective gross income (EGI) for the property. Effectively this is the amount of income the owner will actually see.
3. Then deduct the annual operating expenses for the property from the effective gross income to get the net operating income (NOI). These expenses will include snow removal, accounting expenses, management fees, real estate taxes, and any other operating expenses for the year. This will not include financing charges. This NOI is the income that the investor is buying and the income that the appraiser is valuing.
4. Next a capitalization rate, or cap rate, is estimated. Two methods of estimating a cap rate are market extraction and band of investment. To estimate the cap rate using market extraction, you need a comparable sale. Take the NOI of the comparable and divide it by the sale price of the comparable using the IRV (income rate value) formula in Equation 10.9.

Equation 10.9

$$\text{IRV: } I_c/V_c = R$$

where I = NOI, R = cap rate, and V = value. So IRV tells us to take the NOI of the comparable for the coming period and divide it by the value, or the sale price, of the comparable, and that will give us our cap rate.

5. The final step in the income capitalization form of the income approach is to again use IRV, this time dividing the subject property's NOI for the coming period by the cap rate just extracted from the comparable sale, and that will result in the value estimate, as is illustrated in Equation 10.10.

Equation 10.10

$$I_s/R = V_s$$

The five steps mentioned above are summarized in Table 10.1.

Table 10.1 NOI estimation

PGI
– Vacancies
EGI
– Operating expenses
NOI

Note that IRV is simply a variation on the part, percent, whole format that is mentioned in Chapter 1 of this book. The income, or NOI, is a part, the R, or capitalization rate, is a percent, and the value is the whole.

Problem 10.4

You are called on to appraise a six-unit apartment building in which all apartments are rented for $1,100 per month. The building and local market for similar buildings are both experiencing a 6% vacancy rate. Operating expenses for the coming year are expected to be $27,000. A similar building in the subject property's neighborhood sold recently for $650,000 and was generating $52,000 in NOI at the time it was sold.

The PGI calculation is contained in Equation 10.11. Since this is an apartment building, we multiply the rent per unit by the number of units by 12 months to get the potential gross income. In this instance there is no income other than that received for the apartment rent.

Equation 10.11

$$\text{PGI} = \$1{,}100 \times 6 \times 12 = \$79{,}200$$

The EGI calculation follows in Equation 10.12, with the PGI minus the vacancy allowance. In this case the PGI is multiplied by 1 minus the vacancy rate which accomplishes the same goal. The vacancy allowance in this problem is equal to 6% of the PGI.

Equation 10.12

$$\text{EGI} = \text{PGI} - \text{vacancy allowance} = \$79{,}200 - \$4{,}752 = \$77{,}448$$

An algebraic shortcut to this calculation appears in Equation 10.13. Algebraically what is happening is that by extending the equation, we are multiplying the PGI by 1 and the PGI by the negative of the vacancy rate which yields the answer of the PGI minus the vacancy rate. Whichever method is more comfortable to you is the one you should use. Both methods lead to the same answer.

Equation 10.13

$$\text{EGI} = \text{PGI}\,(1 - \text{vacancy rate}) = \$79{,}200\,(1 - 0.06) = \$79{,}200 \times 0.94 = \$77{,}448$$

By plugging the numbers into the equation, we can obtain the resulting EGI of $77,448.

Table 10.2 NOI estimation solution

PGI	$79,200
– Vacancies	–$4,752
EGI	$77,448
– Operating expenses	–$27,000
NOI	$47,448

The NOI of the building for the coming year is obtained by deducting the annual operating expenses from the EGI and is summarized in Equation 10.14.

Equation 10.14

$$\text{NOI} = \text{EGI} - \text{operating expenses} = \$77{,}448 - \$27{,}000 = \$47{,}448$$

The NOI estimation is also summarized in Table 10.2.

Now that the NOI is in place, we need to estimate the capitalization rate (R), which is simply the NOI/value, or sale price, of the comparable. The cap rate estimate is illustrated in Equation 10.15.

Equation 10.15

$$\text{R} = \text{NOI}/\text{Value} = \$52{,}000/\$650{,}000 = 0.08$$

The final step is the value estimate itself. This again depends on the IRV formula which indicates that the value is equal to the NOI divided by the cap rate, as found in Equation 10.16.

Equation 10.16

$$\text{Value} = \text{NOI}/\text{R} = \$47{,}448/0.08 = \$593{,}100$$

Thus the value of our six-unit building with each unit renting for $1,100 per month is $593,100.

Referring back to step 4 of the income capitalization form of the income approach mentioned previously, the second method of estimating the cap rate is called the band of investment method. The band of investment provides a method of estimating a cap rate, such that the resulting value estimate ensures that the property will generate sufficient NOI to provide an adequate return to the debt holder and an adequate return to the equity holder. Stated another way, the lenders will achieve their required rate of return and the investors will achieve their rate of return.

The equation for estimating the cap rate using the band of investment is contained in Equation 10.17. The equation says that the cap rate is equal to the

loan-to-value ratio (L/V) times the annual mortgage constant (MC), plus the equity to value ratio (E/V) times the investor's required return on equity (ROE).

Equation 10.17

$$R = (L/V \times MC) + (E/V \times ROE)$$

The L/V ratio, or loan-to-value ratio, is the mortgage amount divided by the value of the property, typically stated as a percentage or its decimal equivalent. The annual mortgage constant is taken from the payment to amortize time value of money calculation. It is actually the payment necessary to amortize the debt of one dollar per month multiplied by 12 to annualize it. If we wanted to calculate the annual mortgage constant for a 75% L/V mortgage amortized over 30 years at 7% interest, we would use the calculator keystrokes shown in Solution 10.1. Computing the monthly payment to amortize results in a value of 0.006653, which we multiply by 12 to get a rounded annual mortgage constant of 0.0798.

Solution 10.1

1 [PV]
360 [n]
7/12 = [i/y]
[cpt] [pmt] 0.006653 × 12 = −0.0798

The third variable in Equation 10.17 is the equity-to-value ratio, or E/V. This is simply 1 minus the loan-to-value ratio. At the time of purchase the E/V ratio is the percentage of the purchase price represented by the down payment. The final variable in Equation 10.17 is the investor's required return on equity. This return is stated by the investor and is based on his or her risk tolerance, investment goals, and so on.

Problem 10.5

You are called on to estimate a capitalization rate to value a property, and you are told it should be derived using the band of investment technique. The parameters you are given include an 80% L/V mortgage amortized over 30 years at 6.5% interest and an investor's required rate on equity of 12%. What is the implied cap rate?

First of all, refer to Solutions 10.1 and 10.2 to estimate the annual mortgage constant. Next, plug your values into Equation 10.17, and you will end up with Equation 10.18.

Solution 10.2

1 [PV]
360 [n]
6.5/12 = [i/y]
[cpt] [pmt] 0.0063 × 12 = −0.0758

Equation 10.18

$$R = (0.80 \times 0.0758) + (0.20 \times 0.12) = 0.0607 + 0.024 = 0.0847$$

Notice that the 12% required return on equity has been converted to the decimal equivalent in order to be consistent with the format of the mortgage constant. Thus the cap rate indicated by the band of investment technique is equal to 0.0847 or 8.47% given the information provided.

Problem 10.6

Let's try a more comprehensive problem. An investor has called on you to estimate the value of a 10-unit apartment building. All of the units are the same size and are currently renting for $1,200 per month. There is a 5% vacancy rate for this property and others like it, and operating expenses for the coming year are expected to be $54,720. The investor is contemplating a 75% L/V mortgage amortized over 25 years at a 7% rate of interest. Her required return on equity is 14%. Given this information, what is the building's value using income capitalization and the band of investment technique for estimating the cap rate?

First we need to estimate the expected NOI, and then we need to estimate the appropriate capitalization rate. Potential gross income is found in Equation 10.19.

Equation 10.19

$$PGI = \$1{,}200 \times 10 \times 12 = \$144{,}000$$

The effective gross income is equal to the PGI minus the vacancy allowance, as shown in Equation 10.20.

Equation 10.20

$$EGI = \$144{,}000\ (1 - 0.05) = \$144{,}000 \times 0.95 = \$136{,}800$$

Finally, the NOI is equal to the EGI minus the annual operating expenses, as shown in Equation 10.21.

Table 10.3 NOI estimation

PGI	\$144,000
– Vacancies	−\$7,200
EGI	\$136,800
– Operating expenses	−\$54,720
NOI	\$82,080

Equation 10.21

$$\text{NOI} = \$136{,}800 - \$54{,}720 = \$82{,}080$$

The NOI calculation is also summarized in Table 10.3.

In order to estimate our cap rate, we again refer to Equation 10.17 and plug in the needed numbers to get Equation 10.22. First we need to get our annual mortgage constant using the TVM keys of our financial calculator as shown in Solution 10.3.

Solution 10.3

1 [PV]

$25 \times 12 = 300$ [n]

$7/12 =$ [i/y]

[cpt] [pmt] $0.0071 \times 12 = -0.0848$

Equation 10.22

$$R = (0.75 \times 0.0848) + (0.25 \times 0.14) = 0.0636 + 0.035 = 0.0986 = 9.86\%$$

The cap rate of 0.0986 can now be applied to the NOI of \$82,080 using IRV as can be seen in Equation 10.23.

Equation 10.23

$$\text{Value} = \text{I/R} = \$82{,}080/0.0986 = \$832{,}454$$

So the value of our 10-unit building is the NOI of \$82,080 divided by the cap rate of 0.0986 which is \$832,454 given the financing and investment assumptions that were stated above. An interesting exercise, and when I make this statement to my students, they hear the words, "This is going to be hard to do." Now check to see if this value *estimate results in there being adequate NOI to satisfy both the debt holder and the equity holder* as we said it would at the beginning of this band of investment section, just two paragraphs prior to Equation 10.17. It really won't be that hard to do, and it usually results in a "wow" moment.

First we will need to examine the return on equity (ROE) calculation. The general equation is Equation 10.24.

Equation 10.24

$$\text{ROE} = \text{BTCF}/\text{equity}$$

The BTCF is the before-tax cash flow, and it is calculated by deducting the annual debt service, which is the sum of the year's monthly mortgage payments, from the net operating income. Thus we multiply the monthly mortgage payment by 12, and that is the annual debt service. When we deduct that amount from the NOI, we are left with before-tax cash flow. Equity at the time of purchase is equal to the investor's down payment. Calculating equity at any time during the holding period is shown in Equation 10.25.

Equation 10.25

$$\text{Equity} = \text{Market value} - \text{mortgage balance}$$

Now that we know how to come up with ROE, let's see if we did Problem 10.6 correctly.

The value estimate that we arrived at is $832,454. Our financing plans called for a 75% L/V mortgage amortized over 25 years at a 7% rate of interest. The mortgage amount is $832,454 × 0.75 which is equal to $624,340.50. The monthly payment for that mortgage is found in Solution 10.4 below.

Solution 10.4

624340.50 (PV)

25 × 12 = 300 [n]

7/12 = [i/y]

[cpt] [pmt] −4412.37

The annual debt service is equal to 12 × $4,412.37 or $52,952.51. That amount is deducted from the NOI as illustrated in Table 10.4 to get the before-tax cash flow.

Now, to determine whether there is sufficient NOI to satisfy both the debt holder and the equity holder, we can first look at the debt holder. The lender is earning the required rate of return because the payment was calculated using the 7% return needed by the lender. As we see in Table 10.4, the lender will receive the debt service of $52,952 and be happy with that 7% return. That will leave another $29,127 of the NOI that will go to the investor in the form of BTCF. In order to see whether that satisfies the investor's requirement, we calculate the return on

Table 10.4 Before-tax cash flow

PGI	$144,000
– Vacancies	−$7,200
EGI	$136,800
– Operating expenses	−$54,720
NOI	$82,080
– Debt service	−$52,952
BTCF	$29,127

equity, or ROE. In Equation 10.26 we divide the BTCF by the investor's equity investment, which in this case is the 25% of the purchase price, or value. We are doing that because the E/V ratio is equal to 1 – L/V, and $1 - 0.75 = 0.25$. Thus, equity is equal to $832,454 × 0.25 or $208,113.50.

Equation 10.26

$$\text{ROE} = \text{BTCF}/\text{Equity} = \$29{,}127/\$208{,}113.50 = 0.14 = 14\%$$

As you can see in Equation 10.26, the ROE received by this investor will in fact be 14%, which is exactly the same value we indicated that the investor needed to receive at the beginning of this problem. What we have done then is, we have *created a cap rate such that the resulting value estimate ensured sufficient NOI to satisfy both the debt holder and the equity holder*. Wow!

DISCOUNTED CASH FLOW

The final form of the income approach to be addressed is called *discounted cash flow*. One of the potential drawbacks of the income capitalization form of the income approach is the result of the mathematical form that it takes. The IRV formula for the value calculation is I/R = V. This is in fact a present value calculation. It is the present value of a particular annuity. You will recall that an annuity is a series of equal payments that come at regular intervals. This type of an annuity is called a *perpetuity*, because it is a perpetual annuity. The payments are assumed to come forever, or in perpetuity. Some people say, and with some degree of validity, that this is an unreasonable expectation for a depreciating asset. As a result, another form of valuing income property has been developed that eliminates the perpetual concept, and we look at a property over a finite holding period. In the discounted cash flow (DCF) analysis we take the present value of a finite number of NOIs generated by the property and add to that the present value of a future sale price, or reversion. As you may recall from Chapter 6, on the time

value of money, an investor will only pay the present value of all cash flows to be received, discounted at the required rate of return. The process follows financial theory that states that the value of a share of stock is equal to the present value of the expected dividends over a projected holding period plus the present value of the future sale price of that share of stock.

Not only does DCF overcome the problem of valuing one single year's NOI and the implicit assumption of that income being constant forever, but it allows the inputting of new assumptions regarding variability of rent levels, changes in vacancy rates, and changes in operating expenses in addition to assumptions about market conditions affecting property values during the projected holding period.

Problem 10.7

To get a feeling for how DCF works, let's take a look at a sample problem. An investor is considering the purchase of a 12-unit apartment building where each unit is currently renting for $1,250 per month. Rents are expected to increase by 3% per year. The building has a vacancy rate of 5%, and that is expected to remain constant over the near future. The operating expenses for the coming year are expected to be $68,400, and they are expected to increase at the rate of 2% per year. In five years the anticipated going out cap rate, which is the cap rate expected in the market in five years when the building is expected to be sold, will be 8.5%. The investor's required rate of return on investment is 12%. Given this information and using DCF, what is the value of this building?

Given the assumptions stated in the paragraph above, the NOI calculations for a six-year period are as stated in Table 10.5.

A sixth year of NOI is included in Table 10.5 for the calculation of the reversion, or sale price at the end of the five-year holding period. You may recall that in the initial discussion of IRV we said that we take the coming year's NOI and divide it by the cap rate. In other words, to get the value at time period 0, which is today, we divide the cap rate into the NOI for time period 1, or the coming period.

Table 10.5 Six years of NOI

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
GPI	$180,000	$185,400	$190,962	$196,691	$202,592	$208,669
–Vacancies	9,000	9,270	9,548	9,835	10,130	10,433
EGI	171,000	176,130	181,414	186,856	192,462	198,236
–Operating expenses	68,400	69,768	71,163	72,587	74,038	75,518
NOI	$102,600	$106,362	$110,251	$114,270	$118,424	$122,718

Table 10.6 Total present value

Year	NOI (+rev in year 5)	Present value @ 12%
1	$102,600	$91,607
2	106,362	84,791
3	110,251	78,474
4	114,270	72,620
5	118,424 + 1,443,741	886,414
Total value		$1,213,906

So, if $V_0 = I_1/R$ that should tell us that for calculating V_5 we will need the NOI for period 6, since $V_5 = I_6/R$. Armed with this information, the reversion value calculation in Equation 10.27 should make sense. We divide the NOI for year 6 by the going out cap rate of 8.5%, or 0.085, and get the reversion value of $1,443,741.

Equation 10.27

$$V_6 = \$122{,}718/0.085 = \$1{,}443{,}741 = \text{Reversion value}$$

Now, using the values from Table 10.5 and the reversion value from Equation 10.27, we can calculate the value of the subject property using the DCF method. The calculation is summarized in Table 10.6. For the first four years' worth of NOI, we simply take the PV of that amount discounted at the 12% required rate of return. In year 5 we take the PV of the sum of the final NOI + the reversion value (rev), since both those cash flows are assumed to come at the end of year 5. We then add the present values and get the final value estimate of $1,213,906. Please be advised that most appraisers and investors do not think they can estimate the value of a $1 million plus building down to the nearest dollar, so an appraiser would probably state the value as about $1,214,000 rather than $1,213,906.

The value may also be calculated using the cash flow keys of your calculator. See Solution 10.5 for the keystrokes.

Solution 10.5

[CF] 0 [enter]

[↓] 102600 [enter][↓]

[↓] 106362 [enter][↓]

[↓] 110251 [enter][↓]

[↓] 114270 [enter][↓]

[↓] 1562165 [enter][↓]
[↓][NPV] I = 12 [enter] [↓]
NPV = [cpt] 1213907.79

The calculator display is indicated where there are no [ ] (brackets) around the letters. You will notice a slight difference between the value in Table 10.6 and the value in Solution 10.5. This is the result of the rounding that was done in the table. You will notice that we don't use cents in the present value calculation and that the calculator is accurate to 13 decimal places. The cash flow key solution is the more accurate.

By using the DCF method of the income approach, we are able to input some market assumptions that we could not have used in the income capitalization method. We are able to use a growth rate in the rents, we use a growth rate in the operating expenses that was different from the growth rate in rents, and we are able to make an assumption about the property value increase during the holding period. These are some of the benefits of using the DCF method. Keep in mind, however, that the benefit of the method can also be its downfall if one makes wild unsupportable assumptions.

CASH EQUIVALENCY

When a seller is willing to finance the sale of his or her property with a below-market rate of interest contract for deed or when the buyer assumes the seller's below-market rate of interest mortgage, the buyer is getting an advantage. Whenever property is bought using a below-market interest rate, the buyer is getting the property as well as the benefit of the below-market financing. That sale price will represent the value of the property plus the value of the financing. The technique used to separate the value of the financing from the value of the property is called *cash equivalency*. Let's take a look at the process of finding the value of below-market financing.

The first step involves calculating the monthly payment at the contract rate of interest. Second, discount those payments at the market rate of interest. The resulting value will be the present value of the financing. That discounted present value of the financing plus the cash down payment will result in the cash equivalent value, or the adjusted sale price. The difference between the cash equivalent value and the actual sale price would be the value of the beneficial financing.

Let's take a look at an example. Eileen is appraising a house, and she found a comparable sale that went for $175,000. The purchase price was made up of a $50,000 cash down payment and $125,000 in the form of a contract for deed at 6% interest amortized over 25 years. The market rate of interest at the time of the

sale was 7.25%. What was the cash equivalent value, and what was the value of the beneficial financing?

First Eileen must find the payment at the contract rate. See Solution 10.6 for the calculation of the payment.

Solution 10.6

125000 [PV]

$25 \times 12 = 300$ [n]

6/12 = [i/y]

[cpt] [pmt] −805.38

Now that monthly payment has to be discounted at the market rate, in this case 7.25%. Simply change the discount rate to 7.25/12 and solve for the new present value, as shown in Solution 10.7.

Solution 10.7

125000 [PV]

300 [n]

6/12 = [i/y]

[cpt] [pmt] −805.38

7.25/12 = [i/y]

[cpt] [PV] 111423.51

The value of the financing has dropped from $125,000 to $111,423.51. What the appraiser has done is first ask what the payment would be in a 6% market. Once Eileen had the payment, she asked how much money that payment of $805.38 would buy in a 7.25% market? The answer is $111,423.51, which is the present value of the financing. Now Eileen adds the cash down payment of $50,000 to the present value of the financing and finds the cash equivalent value, $111,423.51 + $50,000 = $161,423.51. That would make the value of the beneficial financing $175,000 − $161,423.51 = $13,576.49. So the buyer paid $161,423.51 for the real estate and $13,576.49 for the financing.

This calculation assumes that the buyer would pay for the full 25 years' worth of beneficial financing. In reality buyers won't pay for the full 25 years' worth of financing. They will probably pay for something less than that since they will either sell the property and pay off the loan before the end of the term, or they will refinance and pay off the loan. Appraisers will usually choose some shorter time period, say between five and nine years, and find the value of the financing over that time period. Let's use the same example as above, only this time we'll

say that the market is only paying for five years' worth of beneficial financing. Again, what is the cash equivalent value of the real estate, and what is the value of the beneficial financing?

The steps in the process given a truncated, chopped off, holding period are as follows.

- Calculate the monthly payment at the contract rate.
- Find the principal balance after five years at the contract rate.
- Find the present value of the five years' worth of payments at the market rate.
- Find the present value of the principal balance at the market rate.
- Add the PV of the payments to the PV of the principal balance and to the cash down payment. This equals the cash equivalent value or adjusted sale price.
- The contract sale price minus the cash equivalent value equals the value of the beneficial financing.

Just as the appraiser did in the previous example, we must first find the monthly payment at the contract rate. See the first four steps of Solution 10.8 for that calculation. Next we have to find the principal balance after five years since the market is paying for only five years of beneficial financing. That calculation is found in the final two steps of Solution 10.8. Keep in mind that the principal balance at any point in time is equal to the PV of the remaining payments.

Solution 10.8

125000 [PV]

$25 \times 12 = 300$ [n]

$6/12 =$ [i/y]

[cpt] [pmt] −805.38

[rcl] [n] $-60 =$ [n]

[cpt] [PV] 112415.11

The principal balance at the end of five years is equal to $112,415.11. The third step listed above is to find the present value of the monthly payments discounted at the market rate, as shown in Solution 10.9.

Solution 10.9

−805.38 [pmt]

60 [n]

$7.25/12 =$ [i/y]

[cpt] [PV] 40432.02

The fourth step is to find the present value of the principal balance discounted at the market rate, and we find that calculation in Solution 10.10.

Solution 10.10

112415.11 [FV]
60 [n]
7.25/12 = [i/y]
[cpt] [PV] −78318.91

Those two previous steps could be reduced to one calculation by calling the principal balance the future value, using your payment of 805.38 and the market rate of interest as the discount rate, and solving for present value as shown in Solution 10.11.

Solution 10.11

112415.11 [FV]
805.38 [pmt]
60 [n]
7.25/12 = [i/y]
[cpt] [PV] −118750.92

Notice that the answer in Solution 10.11 is the sum of the answers in Solutions 10.9 and 10.10, \$78,318.91+\$40,432.02 = \$118,750.93 with one penny difference resulting from rounding. We take that value and add it to the cash down payment and get the cash equivalent value, or the adjusted sale price of \$118,750.93 + \$50,000 = \$168,750.93. The value of the beneficial financing is \$175,000 − \$168,750.93 = \$6,249.07. The financing is worth less because we are only valuing five years' worth of beneficial financing versus the entire 25 years in the previous calculation.

As you can see, cash equivalency gives us a method of finding the value of beneficial, or below-market rate, financing used in a transaction. This beneficial financing may result from a below-market rate contract for a deed being used or by the assumption of a below-market rate mortgage.

Problem 10.8

Joe is appraising a single-family house and has come up with an excellent comparable sale. The sale price of the comp is \$235,000, and the sale was financed with a mortgage assumption of \$185,000 at 6% interest and 20 years remaining on the loan. The balance of \$50,000 was in the form of a cash down payment.

The market rate of interest at the time of the sale was 7%. What is the cash equivalent value or adjusted sale price if the market is currently paying for seven years of below-market financing? What is the value of the beneficial financing?

The steps in the process that appeared above just prior to Solution 10.8 suggest that the first thing to do is to calculate the payment at the contract rate of interest as in Solution 10.12.

Solution 10.12

185000 [PV]
$20 \times 12 = 24 =$ [n]
$6/12 =$ [i/y]
[cpt] [pmt] −1325.40

The next step is to find the principal balance at the end of seven years, again at the contract rate of interest.

Solution 10.13

185000 [PV]
$20 \times 12 = 24 =$ [n]
$6/12 =$ [i/y]
[cpt] [pmt] −1325.40
[rcl] [n] − 84 = [n]
[cpt] [PV] 143329.06

Next we will use the combined method of finding the present value of the payments and the present value of the principal balance which is found in Solution 10.11. Both of these sets of cash flows are discounted back 84 periods at the market rate of interest of 7%. This calculation is illustrated in Solution 10.14.

Solution 10.14

143329.06 [FV]
1325.40 [pmt]
84 [n]
$7/12 =$ [i/y]
[cpt] [PV] −175749.67

The financing has a present value of $175,749.61, which, when added to the cash down payment, results in the cash equivalent value of $225,749.67. When the

cash equivalent value of $225,749.67 is deducted from the sale price of $235,000, we find that the value of the beneficial financing is $9,250.33.

RECONCILIATION

Several times throughout the appraisal, the appraiser will be called on to take three different value estimates and convert them into a single value estimate. The most obvious situation comes about as a result of the three approaches to value. The appraiser will come up with one value estimate from the cost approach, one from the sales comparison approach, and yet another one from the income approach. At the end of the appraisal, the appraiser will have to take those three different values and convert them into a single value. The uninitiated would suggest adding them and dividing by three to get the final value estimate. An appraiser would take offense at that idea since even a third-grader can calculate an average. The reconciliation process allows appraisers to input their knowledge of the appraisal process as well as their knowledge of the quality of the data used in the appraisal into the final value estimate.

The appraiser will first consider the type of property being appraised and which of the three approaches is the more valid approach for the subject property being appraised. If the property is a single-family residence, the sales comparison approach would be the most appropriate approach. If the subject is an income-producing piece of commercial property, the most valid approach is probably the income approach. Finally, if the subject is a special-purpose property, then the best approach is probably going to be the cost approach. Once the best approach has been determined, the appraiser will analyze the quality of the data that went into each approach. Given these inputs, the appraiser will assign weights to each of the value estimates, and these weights will be applied to each of the three approaches, with the general equation in Equation 10.28. The weights assigned to the three approaches must add up to 1.

Equation 10.28

$$\text{Value} = (\text{wt}_1 \times \text{approach}_1) + (\text{wt}_2 \times \text{approach}_2) + (\text{wt}_3 \times \text{approach}_3)$$

The reconciled value is in fact a weighted average calculation. This results in a value estimate that contains information from each of the three approaches, but in fact it contains more information from the most valid approach and more information from the data that were deemed to be of the highest quality by the appraiser. Because of this process, appraisers are allowed to input their understanding of the appraisal process and their understanding of the market data into the final value estimate.

Problem 10.9

You are working on an appraisal of a one-year-old three-bedroom rambler on a half-acre lot in a neighborhood with very few rental properties. Let's say your cost approach indicates a value of $175,000. Your sales comparison approach gives you a value estimate of $168,500. Finally, your income approach indicates a value for the subject property of $159,000. Given this information, you need to come up with a single value estimate for the subject property.

The weights that you assign to the approaches in the reconciliation may be determined like this. First, you know that the subject is a single-family house and that the sales comparison approach is the best approach for this type of property if we have an adequate number of comparables to draw from. You feel that you had some pretty good comparables and, given these kinds of data, you decide to assign a weight of 0.50 to the sales comparison approach. Next, looking at the cost approach, you know that this approach works well on newly constructed property because the depreciation calculation can be relatively accurate for these new properties. Since the subject is only one year old, you decide to weight the cost approach the second most heavily, and you assign a weight of 0.40 to it. Since the income approach is going to be least reliable for this type of property and with the data quality present, you assign this approach a weighting of 0.10. Your weights sum up to 1, so you have not made an error in the weighting process: $0.50 + 0.40 + 0.10 = 1$.

The reconciled value estimate is illustrated in Equation 10.29.

Equation 10.29

$$\text{Reconciled value} = (0.50 \times \$168{,}500) + (0.40 \times \$175{,}000) + (0.10 \times \$159{,}000)$$

$$= \$84{,}250 + \$70{,}000 + \$15{,}900 = \$170{,}150$$

The reconciled value in Equation 10.29, which is based on the value estimates from our cost, sales comparison, and income approaches, is $170,150.

This final reconciliation is really only one of four reconciliations that is required throughout the whole appraisal. The first reconciliation to be done is in the cost approach, specifically in the land or site valuation. In this section of the appraisal the appraiser will do a mini sales comparison approach to estimate the land value. Three comparable sales will be analyzed and adjusted to find out what the subject's land value is. Those three comps will most likely yield three different adjusted sale prices that the appraiser will need to reconcile down into a single value estimate.

The sales comparison approach itself will result in three different adjusted sale prices which will also have to be reconciled to a single value estimate. Finally, the income approach will include three comparables used to determine the gross rent multiplier that is to be used. These three gross rent multipliers will be reconciled

into a single gross rent multiplier, or the three GRMs will be multiplied by the market rent of the subject, and then those three values will be reconciled into a single value estimate. Thus, there may well be four different reconciliations in a single appraisal.

Summary

The appraisal chapter is filled with challenging mathematical concepts based on number of previous chapters. The simplest of the three approaches to determining value is the cost approach. In this approach the appraiser performs a mini sales comparison approach to determine land value and then adds the depreciated current construction costs to that to obtain the value estimate. In the sales comparison approach the appraiser finds sales of comparable properties that are similar to the subject property. Adjustments are made to the comparables for any differences between the comparable and the subject. Those dollar value adjustments result in an adjusted sale price for the comparable which will be an indication of the value of the subject property. The income approach establishes a value estimate for the subject property based on the amount of income the subject property could generate. For single-family residential property this is accomplished through the use of a gross rent multiplier. In the case of income-producing commercial property this will more likely be done through the use of income capitalization. Finally, the results of these three approaches to value are reconciled down from three value estimates to a single value estimate based on the quality of the data used in the three approaches and the appraisers understanding of the appraisal process.

Quiz for Chapter 10

1. An appraiser is working on the cost approach for Tom's house. The house is a 1,200-square-foot rambler that was built in 1979. The cost manual suggests that a home of this quality should have a replacement cost of $65.75 per square foot. The manual also suggests a depreciation of 19% of the construction costs. What is the depreciated cost of the house?
   a. $78,900
   b. $14,991
   c. $63,909
   d. $93,891

2. In conducting the sales comparison approach portion of the appraisal of Tom's house from question 1 above, a comparable was found in the same neighborhood that sold for $145,000. This comparable has 1,450 square feet of improved area, or about 250 square feet more than the subject property. If the appraiser concludes that the market is paying an additional $55 for each additional square foot of space over 1,200 square feet, what is the adjusted sale price of the comparable?
   a. $79,750
   b. $131,250
   c. $66,000
   d. $158,750

3. You have been called on to estimate the value of a single-family home using the gross rent multiplier (GRM) form of the income approach. The subject property you are appraising is a 1,300-square-foot home with three bedrooms, a living room, a family room, two bathrooms, and a two-car garage. You feel if it were put on the rental market, it would draw $1,400 per month in rent. A comparable that was recently sold for $162,500 was renting for $1,500 per month when it was sold. Using the GRM, what is the indicated value of the subject property?
   a. $151,600
   b. $174,100
   c. $162,500
   d. $175,000

4. In appraising a single-family home, you have found the following comparables and you have assigned the corresponding weights to these

comps based on their degree of comparability to the subject property. What is the reconciled GRM given the following information?

Sale price	Monthly rent	Weight	GRM
$179,000	$1,650	50%	
$149,750	$1,300	15%	
$187,500	$1,700	35%	

a. 112.10
b. 101.32
c. 102.10
d. 110.12

5. A 12-unit apartment building, with half the units renting for $1,050 per month and the other half of the units renting for $1,100 per month, is being appraised. The building is experiencing a 7% vacancy rate, and the operating expenses are expected to be $57,600 for the coming year. Using the table provided, calculate the building's net operating income (NOI).

PGI
–Vacancies
EGI
–Operating expenses
NOI

6. You are appraising a 4,000-square-foot office building which is currently renting for $12.50 per square foot. Given a 9% vacancy rate and operating expenses of $17,300 for the coming year, what is the expected NOI for next year?
   a. $50,000
   b. $45,500
   c. $28,200
   d. $32,700

7. Given the sales of office buildings listed in the table below and their associated NOIs and weights, what is the reconciled cap rate that you should use in estimating the value of the building in question 6?

Sale price	NOI	R	Weight
$370,000	$33,300		45%
$300,000	$24,000		35%
$280,000	$23,100		20%

a. 8.6%
b. 8.25%
c. 8.9%
d. 8.0%

8. You have decided to refinance your eight-unit apartment building, and the appraiser has decided to use the band of investment method to estimate the cap rate in her income approach. You have applied for an 80% L/V mortgage to be amortized over 30 years at a 6.5% rate of interest. Investors in today's market are expecting a return on equity of 16%. What is the cap rate the appraiser should be using in her appraisal given this information and the band of investment method?
   a. 6.5%
   b. 7.58%
   c. 10%
   d. 9.27%

9. The apartments in the eight-unit building mentioned in question 8 are each renting for $1,300 per month. The vacancy rate is running at 8%. Operating expenses for the coming year are expected to be $44,800. If the value of the building turns out to be $755,300, what is the building's before-tax cash flow (BTCF)? Use the information in both questions 8 and 9, and use the table provided.

PGI
–Vacancies
EGI
–Operating expenses
NOI
–DS
BTCF

10. If a building is generating NOI as listed below and is expected to sell after five years for the amount listed and if the appropriate discount rate is 11%, what is the indicated value of the property using the discounted cash flow (DCF) form of the income approach?

Year	NOI	Reversion
1	$5,000	
2	$5,500	
3	$5,575	
4	$6,120	
5	$6,150	$95,000

a. $45,454
b. $56,377
c. $77,103
d. $95,000

11

CHAPTER

Real Estate Investment Analysis

The PV of All Cash Flows to be Received

Cash Flow Estimation

When investors purchase investment property, they do so for reasons that are different from those of homeowners who purchase single-family homes. Homeowners purchase in order to house their families over the coming years. They spend a great deal of time in their homes raising families, playing with pets, and generally living life. As a result, buying a house is a very emotional decision for

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many people. They often take a great deal of time looking at potential homes, both new and existing.

Investment property on the other hand is not an emotional decision typically. An investor is making a financial decision. The investor is buying a series of cash flows, and the largest question is how much to pay for those cash flows. Before that purchase price can be addressed, however, the make up of the cash flows must be determined. In the Chapter 10, "Real Estate Appraisal," we look at the net operating income (NOI) calculation. Chapter 8 on depreciation looks at the taxable income calculation. In this chapter we put all the cash flow calculations together and see how each of the elements is dependent on the others. The investor is interested in cash flows on a before-tax basis and an after-tax basis; the investor is also interested in both cash flows from operations and cash flows from the sale of the property.

Potential Gross Income

The cash flow analysis begins with the cash flows from operations. Investors will typically analyze the cash flows over their projected holding period for the property. That may be three years, five years, ten years, or more. (Later in the chapter we look at cash flow from the sale of the property.) The cash flow from operations estimate begins with the potential gross income (PGI) of a piece of investment property. This is the amount of income that the property could generate in one year, given two hypothetical situations. These hypotheticals are that the building is occupied 100% of the time and that all tenants always pay their rent—two things that don't always happen. This is the optimal amount of income the building could generate.

In the case of an apartment building, this would be the number of apartment units times the rent per unit plus any garage income that may be generated plus an estimate of the laundry income if there are laundry facilities. If the property is an office building or a warehouse facility, we would multiply the number of rentable square feet by the rent per square foot. This rent is typically stated as rent per square foot per year.

Effective Gross Income

We next deduct a vacancy and credit loss allowance from the PGI to obtain the effective gross income, because this is effectively the amount of money we are going to have to work with. It could also be called the "realistic" gross income

because it is a more realistic number than is the potential gross income. This vacancy allowance should reflect what is going on in the investor's market for this type of property. If the market vacancy rate for this type of property is 8% and the seller says that the vacancy for the building is only 2% and that is what should be used, the seller may be indicating that rents are well below the market. The market should indicate what the appropriate vacancy rate to use is. Investors function in the market, and they should pay attention to what the market is telling them.

Net Operating Income

The net operating income (NOI) is equal to the effective gross income (EGI) minus the annual operating expenses. These operating expenses could include lawn service, snow removal, garbage pickup, accounting services, legal services, real estate taxes, and so on—whatever it costs to operate the building for one year. Operating expenses will not include finance charges. They are a completely different category, and they will be addressed shortly.

Before-Tax Cash Flow

The before-tax cash flow is where financing charges come into play. The annual debt service is the monthly mortgage payment times 12 plus any other financing payments such as contract for deed (land contract) payments. This annual debt service is deducted from the property's NOI resulting in the before-tax cash flow (BTCF). This is, in effect, the amount of money that is left in the checkbook after all the rents have been deposited and after all the expenses and the lender have been paid.

EXAMPLE 11.1

Let's use a single example to illustrate the cash flow analysis in the chapter. I refer to this single example, or problem, throughout the entire chapter. Our ultimate goal in this analysis is to calculate the after-tax cash flow from operations. Let's take a nine-unit apartment building with each unit renting for $1,175 per month. The building and the market are both experiencing a 7% vacancy rate. Operating expenses are expected to be $47,000 next year. The building can be purchased for $835,500 with an 80% L/V mortgage amortized over 20 years at a 7% interest rate

mortgage. The land value of the property is $165,000. We expect rents to grow at a rate of 3% per year, operating expenses are to grow at 2% per year, and property values are expected to grow at a 3% rate per year. The investor expects to pay a 5% commission when he sells the building at the end of the holding period. The potential gross income from operations calculation is contained in the Equation 11.1.

Equation 11.1

$$\text{PGI} = \$1{,}175 \times 9 \times 12 = \$126{,}900$$

The effective gross income is illustrated in Equation 11.2.

Equation 11.2

$$\text{EGI} = \$126{,}900\ (1 - 0.07) = \$126{,}900\ (0.93) = \$118{,}017$$

The net operating income is the EGI minus the annual operating expenses as is shown in Equation 11.3. So the NOI of the building is $71,017.

Equation 11.3

$$\text{NOI} = \$118{,}017 - \$47{,}000 = \$71{,}017$$

Next we have to calculate the monthly mortgage payment, and then we'll multiply that by 12 to get the annual debt service. The mortgage amount is $\$835{,}500 \times 0.80 = \$668{,}400$.

Solution 11.1

668400 [PV]

$20 \times 12 = 240$ [n]

$7/12 =$ [i/y]

[cpt] [pmt] 5182.10

The annual debt service is then $\$5{,}182.10 \times 12 = \$62{,}185.18$. The before-tax cash flow from operations becomes Equation 11.4.

Equation 11.4

$$\text{BTCF} = \$71{,}017 - \$62{,}185.18 = \$8{,}831.82$$

The BTCF calculation is summarized in Table 11.1. You will notice in this table that the dollar values are rounded. These amounts are just fine for type B people. Type A people will, of course, want to use cents.

Table 11.1 Before-tax cash flow

PGI	$126,900
–Vacancies	8,883
EGI	118,017
–Operating expenses	47,000
NOI	71,017
–DS	62,185
BTCF	$8,832

Taxable Income or Loss

We next have to assess the impact of the IRS, or Uncle Sam, on the cash flows generated by the property. The first thing we do is look once again at the net operating income the building is generating. The question that needs to be answered is, how much of that NOI is the IRS going to want to take? Uncle Sam says that we don't have to pay taxes on the interest we pay on our financing. So we deduct our annual interest expense from the NOI.

The interest expense calculation requires us to go back to Solution 11.1. Reenter the Solution 11.1 keystrokes in your calculator. We now have our monthly payment of $5,182.10. Now calculate the principal balance at the end of year 1. Those keystrokes are in Solution 11.2.

Solution 11.2

668400 [PV]

$20 \times 12 = 240$ [n]

$7/12 =$ [i/y]

[cpt] [pmt] 5182.10

[rcl] [n] $- 12 =$ [n]

[cpt] [PV] 652499.10

Given this information, we can determine the interest paid in the first year of the mortgage. The total principal plus interest paid in year 1 is $5,182.10 × 12 = $62,185.20. Principal reduction in year 1 is $668,400 − $652,499.10 = $15,900.90. That means that the total interest paid is equal to $62,185.20 − $15,900.90 = $46,284.30. These calculations are summarized in Equation 11.5.

Equation 11.5

$$\text{Total principal} + \text{interest} = \$5{,}182.10 \times 12 = \$62{,}182.20$$

$$\text{Principal reduction} = \$668{,}400 - \$652{,}499.10 = \$15{,}900.90$$

$$\text{Interest paid} = \$62{,}182.20 - 15{,}900.90 = \$46{,}284.30$$

$$(\mathrm{P} + \mathrm{I}) - \mathrm{P} = \mathrm{I}$$

The payment to amortize is made up of principal plus interest. The total principal plus interest for the year minus the principal reduction for the year is equal to the interest paid for the year.

In addition to not paying tax on our interest expense, we also do not need to pay taxes on the depreciation expense that we are allowed to take. Since that is the case, we also deduct depreciation expense from the NOI. As is discussed in Chapter 8 on appreciation and depreciation, current IRS code allows real property to be depreciated over one of two lifetimes. If the property is residential in nature, meaning you can live in it, it can then be depreciated over a 27.5-year life. If the property is commercial, it requires a 39-year life. In either case the depreciation is to be straight line, which means that exactly the same amount of depreciation is taken each year over the life of the improvement.

Equation 11.6 contains the calculation for depreciation expense. The only portion of the property's value that can be depreciated is the value of the improvements. The land cannot be depreciated, land is forever. The building and other improvements do wear out over time and can be depreciated. In effect, Uncle Sam is letting us recoup the cost of the improvements so that they can be replaced when they have worn out completely.

Equation 11.6

$$\text{Depreciation expense} = (\text{Acquisition cost} - \text{land value})/27.5 \text{ (or 39)}$$

$$\text{Depreciation expense} = (\$835{,}500 - \$165{,}000)/27.5 = \$24{,}381$$

So what we are doing in Equation 11.6 is taking the acquisition cost and deducting the land value, leaving the value of the improvements. They are then divided by the useful life to get the depreciation expense that can be used per year. Tax code says you cannot use one full year of depreciation expense the year you put the building in service, but that is treading very close to an accountant's territory, and I don't want to go there.

Prior to the 1986 Tax Reform Act, investment property could be depreciated over a 19-year life using a 175% declining balance. What this means is that the investor could take 175% and divide it by 19 to see what percentage

of the improvements could be deducted as depreciation expense each year. Today by using straight-line depreciation, we are taking 100% of the value of the improvements and dividing by 27.5, in the case of residential property, to get that percentage. Prior to 1986 the percentage would have been 175% ÷ 19 = 9.21% of the value of the undepreciated value each year. So the depreciation in year 1 for the problem we are working on would be equal to (\$835,500 − \$165,000) = \$670,500 × 0.0921 = \$61,753 rather than the \$24,381 calculated in Equation 11.6. In year 2 the depreciation expense would have been (\$670,500 − \$61,753) × 0.0921 = \$608,747 × 0.0921 = \$56,065. That is why the method is called *declining balance*, because each year the depreciation expense was calculated on a balance that was reduced by the previous year's depreciation expense.

By deducting the interest expense and the depreciation expense from the NOI, we end up with the taxable income or taxable loss. It is considered taxable income if the result is a positive number, and it is considered a taxable loss if the result is a negative number.

Tax Liability or Tax Savings

Tax liability (or savings) is found by multiplying the taxable income or loss by the marginal tax rate (MTR) of the investor. If the property earned a positive taxable income, the result of multiplying that by the MTR will be a tax liability for the investor. If the property earned a tax loss, the result of the multiplication will be a tax savings. I find that if I make the MTR a negative number, I get the correct sign on my tax. If it is a positive taxable income multiplied by a negative tax rate, the answer is a tax liability with a negative sign. That tells me it is a cash outflow. If it is a taxable loss multiplied by the negative MTR (the product of two negative numbers) the resulting tax savings has a positive sign, a cash inflow. This is just a hint that might help you. The tax liability or tax savings calculation is summarized in Table 11.2.

Table 11.2 Tax liability

NOI	71,017
–Interest	46,284
–Depreciation	24,382
Tax income	351
–MTR	−0.28
Tax liability	−98

For this property we have a tax liability of $98 in the first year of operation. We could just as easily have had a tax savings if we would have had a negative taxable income, sometimes referred to as a *tax loss*.

In order to take advantage of any tax savings, investors must be considered small investors. That is, their annual income must be $100,000 or less. In that case they can use up to $25,000 in tax savings to offset ordinary income. For each dollar they make over $100,000, they lose $1 in tax savings benefit so that by the time they earn $150,000 in income, they have lost all deductibility of tax savings. Second, they must be considered actively involved in the management of the property. That is to say, they must be actively making some of the decisions about the property, such as when to increase rents, and so forth.

After-Tax Cash Flow

The final calculation in the cash flows from operations is the calculation of the after-tax cash flow (ATCF). We already have both the elements that go into this calculation. The BTCF minus the tax liability (or plus the tax savings) will give us the ATCF. This is illustrated in Table 11.3.

Ratio Analysis

The cash flows from operations for year one have now been estimated, but what do we do with them? Just looking at the raw numbers of $71,017 for NOI, $8,832 for BTCF, and $8,734 for the ATCF doesn't really give us an indication of whether this is a good investment or not. What we do next is exactly what financial analysts do when they analyze the stock of a company. We are going to calculate some financial ratios that we can then compare with other similar buildings to determine if this particular investment is one that we want to undertake or one that we should pass on.

Table 11.3 After-tax cash flow

BTCF	8,832
+/− Tax liability	−98
ATCF	8,734

Debt Coverage Ratio

The first of these ratios is called the *debt coverage ratio* (DCR). This ratio is of great concern to the lender who is providing the mortgage money for the transaction. This ratio tells the investor and the lender whether the NOI is adequate to cover the annual debt service. The ratio is the NOI divided by the annual debt service. The lender will typically want this ratio to be at least 1.2. In the case of riskier investments, such as new construction, the lender may want the DCR to be at least 1.25. You may ask why new construction would be riskier than an existing building. It is considered riskier because we start out with no tenants, and we don't know for sure when it will be fully occupied. The lender will want a larger cushion to cover any shortfalls in rent that may occur.

Equation 11.7

$$\text{DCR} = \text{NOI/debt service} = \$71{,}017/\$62{,}185 = 1.14$$

When we present this investment plan to a financial institution, it would probably decline our mortgage application given the low DCR in this example. We can look closely at Table 11.1 and try to determine how we could modify our analysis to increase our DCR. It is apparent there are only two ways we can increase this ratio. We either have to increase the NOI, or we have to decrease the debt service (DS). There are three possible changes we can make to increase NOI. We can increase rents, decrease vacancies, or decrease operating expenses. Any one of these changes will increase our NOI if everything else is held constant. The problem is that everything else will not remain constant. Let's look at the impact of each of these changes. If our rents are already at the market rate, what will happen to vacancies if we increase the rents? That's correct, vacancies will increase, because tenants will shop around and find better rent levels at the market rate. How do we reduce vacancy rates? We can either reduce rents, or we can offer better services. Those better services will increase our operating expenses, which may once again be counterproductive with respect to its impact on NOI. As we see, increasing NOI is not as easy as it sounds.

Rather than increasing NOI, we could also decrease the DS payment, and that would increase our DCR. There are a number of ways we could decrease the DS payment, and these changes are not as likely to affect other areas of our cash flow analysis as the changes to NOI would. We could negotiate a lower interest rate which would reduce our mortgage payment. Second, we could increase our down payment, which would decrease the mortgage amount, thus decreasing the mortgage payment. We could also use some alternative financing method other than a fixed rate mortgage. We could use a graduated payment mortgage (GPM), an adjustable rate mortgage (ARM), or even an interest-only mortgage. All these

mortgages have additional risks for the borrower which he or she would have to take into consideration when thinking about the alternative financing methods. Their use may in fact increase the DCR enough to make the plan acceptable to the lender.

Breakeven Occupancy Rate

The *breakeven occupancy rate* is the occupancy level at which the property's income will just cover the bills. The bills that must be covered are the debt service and the operating expenses. The ratio appears in Equation 11.8.

Equation 11.8

$$\text{Breakeven occupancy} = (\text{DS} + \text{Op Exp})/\text{PGI}$$
$$= (\$62{,}185 + \$47{,}000)/\$126{,}900 = 0.86 = 86\%$$

This tells the investor that the building needs a vacancy rate of 14% or less in order for the before-tax cash flow to be positive because if the vacancy is greater than 14%, the investor won't have enough NOI to cover the debt service and the operating expense. There is no magic number for breakeven occupancy; however, the lower this ratio is, the sooner the bills will be covered and the higher the vacancy rate that the building will be able to absorb.

Operating Expense Ratio

The operating expense ratio is the amount of annual operating expense divided by the effective gross income. This ratio simply gives us a value that we can use to compare the subject property with other similar properties. As far as what level is desirable for this ratio, lower is preferable to higher. Professional organizations like the Building Owners and Manager Association (BOMA) and the Institute of Real Estate Management (IREM) collect data from members and aggregate those data for members to access. In this way members can compare the operating expense ratio and other ratios of their properties with similar properties to determine if they are managing their buildings effectively and efficiently. If the operating expense ratio of their subject property is much less than the operating expense ratio of similar properties, it may help explain why their vacancy rate is higher than the comparable properties, because they may not be providing similar

levels of maintenance and upkeep. If the ratio is much greater than that of comparable properties, it may indicate that they are providing levels of service that are greater than what the market is demanding.

Equation 11.9

$$\text{Operating expense ratio} = \text{Operating expenses/effective gross income}$$
$$= \$47{,}000/\$118{,}017 = 0.398 = 39.8\%$$

Return on Investment

The next two ratios are return ratios that give investors a picture of the rate of return which is being made on their total investment as well as the return being made on their equity investment. Investors would prefer these ratios to be higher rather than lower. The first of these is called the *return on investment* (ROI), meaning the return on their total investment, or purchase price. The ratio is the net operating income divided by the total investment.

Equation 11.10

$$\text{Return on investment} = \text{NOI/investment} = \$71{,}017/\$835{,}500$$
$$= 0.08499 = 8.5\%$$

Look very carefully at Equation 11.10 for a minute and think about where you have seen it before. It's IRV, from Chapter 10. Specifically, it is R = I/V. The ROI is the same as the cap rate from IRV. The only difference is that in appraisal we called the denominator *value* rather than *investment*. At different times in real estate we refer to that dollar amount as value, as purchase price, as sale price, or as the total investment. They are all proxies, or substitutes, for one another.

Return on Equity

The second return calculation, and the final ratio we look at, is the return on equity, or ROE. This numerator of this ratio, rather than being the NOI, is the before-tax cash flow, and the denominator is the equity the investor has in the property. At the time of purchase, that equity can also be referred to as the *down payment*. For this reason this ratio is sometimes called the cash on cash return.

It is the cash return on the cash investment. It is also sometimes called the *equity dividend rate*. Again, as a return type of ratio, the investor would prefer this to be higher rather than lower.

Equation 11.11

$$\text{ROE} = \text{BTCF/equity} = \$8{,}832/\$167{,}100 = 0.053 = 5.3\%$$

The equity in the ROE equation comes from the purchase price minus the mortgage amount indicated in the problem, or \$835,500 − \$668,400 = \$167,100.

As is mentioned at the beginning of the chapter, the investor will usually look at the cash flows from operations for a holding period of some number of years. To calculate these ratios, we typically use the values from the cash flow analysis in year 1 of the projected holding period. We do this for two reasons. First, the year 1 values in the cash flow analysis are likely the most accurate since the farther out years are based on some assumptions about growth in rents and operating expenses. Hopefully we make valid assumptions about those growth rates, but they are subject to changes in the market and the economy. The second reason we use year 1 ratios is that some of the values change over time, such as the equity the investor has in the property, and this makes the year 1 ratios more meaningful.

Estimating Cash Flows after Year 1

The cash flows and ratios calculated for year 1 give the investor a nice snapshot of how the property is expected to perform in year 1 of the holding period. The investor's time horizon is typically greater than one year. This is particularly the result of the high transaction costs associated with buying and selling real property. It is hard to recoup the commission expense associated with selling investment property after owning it for only a single year. Also, while the ratios we calculated are very useful for comparing properties, they are missing some important elements of the cash flows that the investor is to receive. Let's look at the ROI, and we'll see what information is lacking from this ratio. The ratio itself, as stated in Equation 11.10, is ROI = NOI/investment. This means that all the cash flow values that come below NOI are left out of consideration. Look at Tables 11.1 and 11.2 to see what information doesn't work itself into the ROI. The impact of financing is missing, because debt service comes after NOI in Table 11.1. All depreciation and tax benefits are left out of ROI because they come after NOI in Table 11.2. Any appreciation, or value increase, is left out of ROI because we are looking only at cash flows from operations.

As you can see, there is a lot of important information that is missing from the ROI.

Similarly, there is much information that is missing from ROE. If you look at Equation 11.11, you will note that the ROE = BTCF/equity. This return calculation does take financing into consideration because BTCF = NOI − DS; however, it is still missing information on tax benefits, rent increases over time, operating expense increases over time, and any appreciation that may take place. For these reasons investors like to take a look at the investment over a longer holding period than one year, and they also like another return type of calculation that captures cash flows for the entire holding period plus this missing information that was just mentioned.

Growth Rates

The investor will make an assumption about the growth in rents over the projected holding period. You will notice in Table 11.4 that we have increased rents at a 3% rate each year over the five-year holding period. In similar fashion the operating expenses have been increased at a 2% annual growth rate. Table 11.4 uses values rounded to even dollars.

Table 11.4 Five years of cash flows

	Year 1	Year 2	Year 3	Year 4	Year 5
PGI	126,900	130,707	134,628	138,667	142,827
–Vacancies	8,883	9,149	9,424	9,707	9,998
EGI	118,017	121,558	125,204	128,960	132,829
–Operating expenses	47,000	47,940	48,899	49,877	50,874
NOI	71,017	73,618	76,305	79,084	81,955
–DS	−62,185	−62,185	−62,185	−62,185	−62,185
BTCF	8,832	11,432	14,120	16,898	19,770
NOI	71,017	73,618	76,305	79,084	81,955
–Interest	46,284	45,135	43,902	42,581	41,163
–Depreciation	24,382	24,382	24,382	24,382	24,382
Tax inc.	351	4,101	8,021	12,121	16,410
–MTR	−0.28	−0.28	−0.28	−0.28	−0.28
Tax liability	−98	−1,148	−2,246	−3,394	−4,595
BTCF	8,832	11,432	14,120	16,898	19,770
+/− Tax liability	−98	−1,148	−2,246	−3,394	−4,595
ATCF	8,734	10,284	11,874	13,504	15,175

Year 2 Cash Flows

As indicated above, the PGI for year 1 is multiplied by 1.03 (3% growth) to obtain the year 2 value of $130,707. The vacancy in year 2 is once again the PGI times the 7% vacancy rate, resulting in a vacancy allowance of $9,149. That value deducted from the PGI leaves an EGI of $121,558 in year 2. Multiplying the first year's operating expenses by 1.02 (1 + 2% growth) results in operating expenses in year 2 of $47,940, and that value deducted from the EGI leaves an NOI of $73,618. The debt service is constant since we are using a fixed-rate constant payment mortgage, so the $62,185 deducted from the NOI leaves a BTCF of $11,432 for year 2.

Now we return to the NOI to see how much of that the investor has to share with the IRS. The interest expense in year 2 can be calculated after we have calculated the mortgage balance at the end of year 2. You will recall that the principal balance at the end of year 1 was $652,499 (see Solution 11.2), which represented the PV of the remaining 228 monthly payments (240 − 12 = 228). The principal balance at the end of year 2 is the PV of 216 monthly payments (228 − 12 = 216), as indicated in Solution 11.3.

Solution 11.3

5182.10 [pmt]
216 [n]
7/12 = [i/y]
[cpt] [PV] 635448.79

If we now take the principal balance at the end of year 1 minus the principal balance at the end of year 2, that will give us the principal reduction in year 2. The total debt service for the year (which is p + i) minus the principal reduction for the year will give us the total interest paid in year 2.

Equations 11.12

$$\$652{,}499 - \$635{,}449 = \$17{,}050 = \text{Principal reduction}$$

$$\$62{,}185 - \$17{,}050 = \$45{,}135 = \text{Interest paid in year 2}$$

The depreciation expense in year 2 is the same as that for year 1 since we are using straight line depreciation. Once again this is a math book, not a tax book, but remember that the first year you put a building in service you can take only one-half the allowed depreciation expense. I am using the same amount in year 1 as in the other years for simplification purposes only. Check with your accountant or tax attorney for your particular case.

Beyond this point the after-tax cash flow calculation will work the same as it did in year 1. Now that we have seen how the year 2 cash flows are calculated, years 3, 4, and 5 follow exactly the same pattern. You may want to verify the numbers in Table 11.4, and that would be a very useful exercise.

After-Tax Cash Flow from the Sale

At the end of the projected holding period, we factor in a sale price for the property, or what we call a *reversion* in Chapter 10. This future sale price may be calculated in a couple of different ways. We could do an income capitalization at the end of year 5, and that is often the way the reversion is estimated. This would involve IRV, or V = I/R. Since the value at time period zero is equal to the NOI for period one divided by R, the value at the end of time period five would be the NOI for period six divided by R. The cap rate used to estimate the value at the end of the holding period is called the *going out cap rate*. This is as opposed to the cap rate involved at the front end of the investment which is referred to as the *going in cap rate*. Another method of estimating the value at the end of the holding period, and the one used in this example, is to take the original purchase price and increase that value at a certain growth rate over the holding period. We estimated the sale price in this example by taking the purchase price of $835,500 and grew that at a 3% growth rate compounded for five years.

Solution 11.4

835500 [PV]

5 [n]

3 [i/y]

[cpt] [FV] 968753

Hence, a sale price of $968,753 appears under sale price in our cash flow analysis. The next value on the analysis is the mortgage balance. The mortgage balance at any point in time is equal to the PV of the remaining payments. We started with a 20-year, or 240-month, mortgage. Five years are now gone, so 15 years are remaining. The principal balance is the PV of 15 years' worth of payments, or $576,539 in our example.

Solution 11.5

5182.10 [pmt]

$15 \times 12 = 180$ [n]

7/12 = [i/y]

[cpt] [PV] 576539

The selling expenses are figured at 5% of the selling price, or $968,573 × 0.05 = $48,429. The mortgage balance and the selling expenses are both deducted from the sale price to leave the before-tax cash flow from the sale (BTCF).

The next step is to go back to the sale price and to deduct the adjusted basis from that value. The *adjusted basis* is defined as the acquisition cost minus any depreciation that has been taken. In this case our acquisition cost was $835,500 and we took depreciation of $24,382 five times, or 5 × $24,382 = $121,910. Our adjusted basis calculation is illustrated in Equation 11.13.

Equation 11.13

$$\text{Adjusted basis} = \$835{,}500 - \$121{,}910 = \$713{,}591$$

Now, as in Table 11.5, we take the sale price minus the adjusted basis and also minus the selling expenses again to arrive at the gain on the sale. The reason we once again subtract selling expenses is that we are now attempting to figure out how much of this BTCF we have to share with the IRS. Uncle Sam says that we don't have to pay tax on our selling expenses, so we get to deduct them before we calculate our tax liability. This gain on the sale is in fact a capital gain and as such receives some preferential treatment as far as the tax rate is concerned. Rather than paying the same rate that we pay on the income from operations, we are permitted to use a 15% rate and a 25% rate. That portion of the gain that comes from the appreciation of property value is taxed at the 15% rate.

Table 11.5 After-tax cash flow from the sale

Sale price	$968,573
–Mortgage balance	−$576,539
–Selling expenses	−$48,429
BTCF(s)	$343,606
Sale price	$968,573
–Adjusted basis	−$713,591
–Selling expenses	−$48,429
Gain on sale	$206,554
× − Gain tax rate × Appreciation + 2nd gain tax rate	$20,055
× Excess appreciation	+$18,371
Tax liability	$38,425
BTCF(s)	$343,606
–Tax liability	−$38,425
ATCF(s)	$305,181

Any additional or excess gain that has resulted from the depreciation is taxed at the 25% rate. In this case we had a total gain of $206,554. The portion that came from appreciation was $968,573 − $835,500 = $133,073. That amount is taxed at the 15% rate. The excess gain over and above that from appreciation was $206,554 − $133,703 = $73,481 and is taxed at the 25% rate.

Equation 11.14

$$\text{Tax from sale} = \$133{,}703 \times 0.15 = \$20{,}055 \text{ and } \$73{,}481 \times 0.25 = \$18{,}370$$

$$\text{Or } \$20{,}055 + \$18{,}370 = \$38{,}425$$

Deducting the tax liability of $38,425 from the BTCF leaves an ATCF of $305,181.

Net Present Value and Internal Rate of Return

The cash flows are now in place for calculating a rate of return that will take into consideration the elements that are missing from the ROI and ROE ratios. By calculating the ATCF from operations over a five-year period and the ATCF from the sale of the building at the end of the holding period, we have brought much more information into the analysis. We now use these cash flows and come up with a much more complete measure of the investor's return. The return that we use is called the *internal rate of return* (IRR). (This calculation is discussed in Chapter 6.) The cash flows that will be used for the IRR calculation are the ATCF from operations for years 1–5 and the ATCFs at the end of the holding period. The cash outflow at time period zero will be the cash down payment. See Table 11.6.

There are two ways you can calculate the internal rate of return that is present in a set of cash flows. One method is to use the cash flow keys of your financial

Table 11.6 IRR cash flows

Year	ATCF
0	–$167,100
1	$8,734
2	$10,284
3	$11,874
4	$13,504
5	$15,175 + $305,181

calculator as illustrated in Chapter 6. The second method is to do some present value calculations, a little addition and a little subtraction. We look at both methods in this chapter. While the cash flow key method is the fastest once you become accustomed to it, the second method gives the investor the clearest picture concerning what the IRR calculation is really doing and really means.

Let's look at the second method first. The first step is to choose some discount rate to begin with, and it doesn't matter what it is. I like to use the interest rate on the mortgage simply because it is there. So what we do is find the present value of each of the cash flows from our property discounted at the 7% discount rate.

Table 11.7 started out the same as Table 11.6 with the year in column one and the ATCF in column two. The only difference is the year 5 after-tax cash flows were added together so that we have to deal with only a single cash flow. So, $15,175 was added to $305,181, and the result of $320,356 was placed in that cell in the table for the column two year 5 value. Next we calculated the PV of each of the after-tax cash flows and placed them in column three. The $8,734 was called an FV, for one period, a 7% discount rate, and we solved for PV, which turned out to be $8,163. Next the $10,284 was discounted back two periods at the 7% rate for a PV of $9,693. The other three cash flows were treated in a similar manner. The five present values were then added together to get the total present value of the cash inflows. Finally, the net present value (NPV) was calculated. The NPV is the difference between the PV of the cash inflows and the PV of the cash outflows. The NPV calculation is illustrated in Equation 11.15.

Equation 11.15

$$\text{NPV} = \$265{,}549 - \$167{,}100 = +\$98{,}449$$

The PV of the cash outflow is in fact the down payment which takes place at time period zero, so it is already in PV form. The NPV of these cash flows is +$98,449,

Table 11.7 NPV at 7% discount rate

Year	ATCF	PV @ 7%
0	−$167,100	−$167,100
1	$8,734	$8,163
2	$10,284	$8,982
3	$11,874	$9,693
4	$13,504	$10,302
5	$320,356	$228,409
Total PV		$265,549
NPV		+$98,449

Table 11.8 NPV at 7% and 20%

Year	ATCF	PV @ 7%	PV @ 20%
0	−$167,100	−$167,100	−$167,100
1	$8,734	$8,163	$7,278
2	$10,284	$8,982	$7,142
3	$11,874	$9,693	$6,872
4	$13,504	$10,302	$6,512
5	$320,356	$228,409	$128,744
Total PV		$265,549	$156,578
NPV		+$98,449	−$10,522

and one of the key elements is that the NPV is positive. The positive NPV means that we are earning more than the discount rate we used, in this case 7%. What we want to do next is to choose another discount rate that will give us a net present value that is negative. Recalling one of our major premises regarding TVM—the higher the discount rate, the lower the PV—we need to choose a higher discount rate to get a lower PV and hence a lower NPV. Let's try a 20% discount rate. Now look at Table 11.7 and calculate the PV of each of the cash flows, this time using a 20% discount rate. (The results are found in Table 11.8.)

You will recall from Chapter 6 that the IRR is the discount rate that makes the NPV equal to zero. If you look at Table 11.8, you see that we have calculated NPVs of +$98,449 and −$10,522, which means that the zero is in between those two values. Given a linear relationship between the NPV and the discount rate, we can then assume that the IRR is somewhere between the two discount rates, 7% and 20%. Given the distances between the two NPVs and zero, it would appear that the IRR is closer to 20% than it is to 7%.

Now that we have 1 + NPV and 1 − NPV, we can use what I call the simple five-step method to estimate the internal rate of return. The steps are listed below:

1. Find the total range in net present values. That is, how far apart are they on the number line? This may be obtained by adding together their absolute values.
2. Divide the +NPV by the total range in net present values.
3. Find the total range in discount rates.
4. Multiply answer 2 by answer 3.
5. Add answer 4 to the discount rate associated with the +NPV, and the resulting answer is the estimate of the IRR.

The five steps used to find the IRR using the data in Table 11.8 are contained in Table 11.9.

Using the five-step method, the estimate of the IRR of these cash flows is 18.74%. Keep in mind that this is an estimate. The farther apart the two discount

Table 11.9 Five-step method of IRR

Step	Calculation
1. Find the total range in NPVs	98,449 + 10,522 = 108,971
2. Divide the +NPV by the total range	98,449/108,971 = 0.9034
3. Find the total range in discount rates	20% − 7% = 13%
4. Answer 2 × answer 3	0.9034 × 13% = 11.74%
5. Add answer 4 to the discount rate associated with +NPV	11.74% + 7% = 18.74% = IRR

rates are that we use in the calculation, the greater our margin of error. Since we used discount rates that are fairly far apart, a range of 13%, we might expect our margin of error to be fairly large.

We next use the financial calculator to calculate the IRR as is illustrated in Chapter 6. Using the cash flow keys will allow us to see how far away from the actual IRR our estimate is. The steps are shown in Solution 11.6.

Solution 11.6

[CF] 167100 [+/−] [enter]

[↓] 8734 [enter][↓]

[↓] 10284 [enter][↓]

[↓] 11874 [enter][↓]

[↓] 13504 [enter][↓]

[↓] 320356 [enter][↓]

[↓][IRR] [cpt] 18.29%

As we have just shown, the IRR of the after-tax cash flows for this investment property using the cash flow keys of the financial calculator is 18.29%. If you look at Table 11.9, you can see that the five-step method gives us a very reasonable estimate of the IRR at 18.74%. This is in spite of our using a fairly wide range in discount rates in our estimate.

The IRR calculation suffers from two problems. One is called the *multiple rate of return problem*, and one is called the *reinvestment assumption*. When the cash flows in an IRR calculation have multiple sign changes, where the cash flows go from negative to positive to negative, there can actually be two discount rates that will make the NPV equal to zero. In other words there are two IRRs. The investor must be aware that the potential for such a problem exists.

The second problem, the reinvestment assumption, comes about because the IRR calculation is a compound interest calculation. The IRR calculation assumes that the cash flows are immediately reinvested at the same IRR. This may be an

overly optimistic assumption. In the previous problem the process assumes that the $8,734 ATCF in year 1 can be reinvested and earn the same 18.29% rate of return that we earn from the $167,100 initial investment. The reality may be that we can't find another investment that will pay us 18.29% for the much smaller amount of $8,734. Once again, as long as investors are aware of the potential problems that can arise from the limitation of the calculation, they should be able to deal with it.

Before-Tax Equivalent Rate of Return

The IRR we just calculated is an after-tax rate of return because we used after-tax cash flows to estimate it. We can also determine the before-tax rate of return that we would have to earn in order for our return to be equivalent to this after-tax rate of return. To obtain the before-tax equivalent rate of return of an after-tax rate of return, simply divide the after-tax rate of return by 1 minus the tax rate that the investor pays. In the case of our example, divide the 18.29% by (1 − 0.28) as shown in Equation 11.16.

Equation 11.16

$$\text{BT equivalent} = \text{AT rate}/(1-\text{T}) = 18.29\%/(1-0.28) = 18.29\%/0.72 = 25.4\%$$

As you can see, in order to earn the same return as our 18.29% after-tax rate of return, you would need to earn a before-tax return of 25.4%. Most returns that you see advertised are before-tax rates of return, because you have to pay tax on the earnings. This gives you a method of comparing one with the other. If you want to go in the other direction, that is, you have a before-tax rate of return and you would like to know what the equivalent after tax-rate of return is going to be, just take the before-tax rate of return and multiply it by 1 minus the tax rate as shown in Equation 11.17.

Equation 11.17

$$\text{AT return} = \text{BT return } (1 - \text{T}) = 25.4\% \ (1 - 0.28) = 25.4\%(0.72) = 18.29\%$$

Modified Internal Rate of Return

The goal of the modified internal rate of return (MIRR) is to compensate for the drawback of the IRR that assumes the cash flows can immediately be reinvested

at the same IRR. The MIRR reinvests those cash flows at a more reasonable rate. Some analysts will use the firm's cost of capital, if we are dealing with a corporate finance department, or the cash flows may be reinvested at the risk free rate of interest. In our example we reinvest them at the same interest rate that the lender is earning—the mortgage interest rate. The investor should be able to earn at least that much and certainly more since he or she taking considerably more risk than is the lender.

Let's go back to the cash flows in Table 11.6. The MIRR asks us to take the cash inflows and compound them forward to the end of the holding period, compounding at a safe rate of interest that we choose. The mortgage interest rate that we used for this problem was 7%, so we compound our cash inflows forward at a 7% rate. Those future values are given in Table 11.10.

Now that we have the total future value of the cash inflows, we simply ask the question, what interest rate takes us from a present value of $167,000 to a future value of $372,446 in five years, as in Solution 11.7.

Solution 11.7

−167000 [PV]

372446 [FV]

5 [n]

[cpt] [i/y] 17.4

The MIRR is 17.4%, and we have worked around one of the major gripes about the IRR—that the cash flow is assumed to be reinvested at the IRR. In this case we have made the assumption that the cash flows are reinvested at a realistic 7%. If there had been other cash outflows during the holding period, those would have been discounted back to present value to be added to the cash outflow at time period zero. Then we would solve in the same way by finding the interest rate that makes the present value of the inflows equal to the future value of the inflows.

Table 11.10 Future value of cash flows

Year	ATCF	Future value
0	−$167,000	—
1	$8,734	$11,448
2	$10,284	$12,598
3	$11,874	$13,595
4	$13,504	$14,449
5	$320,356	$320,356
Total		$372,446

Leverage

Leverage can be defined as the use of borrowed money to finance an investment and the borrowed money's impact on the investment's rate of return. In the example that we look at throughout this chapter, we assume that the investor is going to use an 80% L/V mortgage to finance the purchase. We could just have easily assumed the investor was going to pay cash for the investment. Let's take another look at the investment assuming that the investor would pay cash for the investment and see what the impact on the rate of return is.

To accomplish this, we go back to Table 11.4 and take out anything that has to do with the mortgage. The debt service will go to zero as will the interest expense. The new amounts appear in Table 11.11. The cash flow from sale calculation from Table 11.5 is also affected, and those new values appear in Table 11.11.

You will notice that the before-tax cash flows from operations are approximately $62,000 greater than the before-tax cash flows from Table 11.4. They are greater by the amount of the annual debt service payment that is not being paid in Table 11.10 because we are now free from debt. The after-tax cash flows in Table 11.4 are not greater than those in Table 11.10 by the exact amount of the debt service payment. This is because by using all cash, we have lost the tax benefit of the interest expense deduction. As a result the after-tax cash flows in Table 11.10 are greater by $49,000–$50,000.

Table 11.11 After-tax cash flow with no debt

	Year 1	Year 2	Year 3	Year 4	Year 5
PGI	126,900	130,707	134,628	138,667	142,827
–Vacancies	8,883	9,149	9,424	9,707	9,998
EGI	118,017	121,558	125,204	128,960	132,829
–Operating expenses	47,000	47,940	48,899	49,877	50,874
NOI	71,017	73,618	76,305	79,084	81,955
–Debt service	0	0	0	0	0
BTCF	71,017	73,618	76,305	79,084	81,955
NOI	71,017	73,618	76,305	79,084	81,955
–Interest	0	0	0	0	0
–Depreciation	24,382	24,382	24,382	24,382	24,382
Taxable income	46,635	49,236	51,924	54,702	57,573
x–MTR	−0.28	−0.28	−0.28	−0.28	−0.28
Tax liability	−13,058	−13,786	−14,539	−15,316	−16,120
BTCF	71,017	73,618	76,305	79,084	81,955
+/−Tax liability	−13,058	−13,786	−14,539	−15,316	−16,120
ATCF	57,959	59,832	61,767	63,767	65,834

Table 11.12 Cash flows from sale with no debt

Sale price	968,573
–Mortgage balance	0
–Selling expense	48,429
BTCF(s)	920,145
Sale price	968,573
–Adjusted basis	713,591
–Selling expense	48,429
Gain on sale	206,554
–Gain tax rate	
Tax liability	−38,425
BTCF(s)	920,145
–Tax liability	−38,425
ATCF(s)	881,720

The after-tax cash flow from the sale is also larger using no debt because, of course, we have no mortgage payoff at the end of the holding period. See Table 11.12 for that calculation.

Given that the after-tax cash flows are so much greater than they were using debt, you might assume that the IRR using the after-tax cash flows (IRR-AT) would also be greater. Surprisingly, that is not the case. This is because our cash outflow at time period zero is no longer the cash down payment of $167,100 that we used earlier, but rather it is the entire purchase price of $835,500 since we are using all cash. The IRR calculator calculation is detailed in Solution 11.8.

Solution 11.8

[CF] 835500 [+/−] [enter]

[↓] 57959 [enter][↓]

[↓] 59832 [enter][↓]

[↓] 61767 [enter][↓]

[↓] 63767 [enter][↓]

[↓] 947554 [enter][↓]

[↓][IRR] [cpt] 8.30%

Note that the cash flow used for year 5 is the ATCF from operations of $65,834 plus the cash flow from sale of $881,720 for a total of $947,554. The IRR-AT for this property using all cash is only 8.30%. The same value using the 80% loan-to-value mortgage amortized over 20 years at a 7% rate of interest was 18.29%. This illustrates the use of positive leverage. In this example the IRR has been magnified by using borrowed funds. As long as the after-tax cost of debt is less

than the IRR-AT using no debt, the IRR-AT using debt will be magnified. In this case even the before-tax cost of debt, or 7%, was less than the IRR-AT using no debt, or 8.3%. As a result our IRR-AT of 18.29% was magnified, or was greater than the rate using no debt, or 8.3%. Once again, this is called *positive leverage*.

Summary

Is the property that we just looked like a good investment? It is a good investment if we can get over one hurdle, and that is the debt coverage ratio. That ratio is sitting at a paltry 1.14, and most lenders are going to want that ratio to be at least 1.2 or higher.

This cash flow analysis can be used to analyze a single-family house, a four-unit apartment building, a 5,000-unit apartment complex, or a 50-story office building. The analysis does not change. The cash flows become a little more challenging, but the analysis is the same. The entire analysis may be put into an Excel spreadsheet, and the amount of work and the number of calculations that must be done by hand are both greatly reduced. There are also canned software packages that can be purchased to streamline the process. Once you understand what is happening in this chapter, your ability to choose good investment properties should improve dramatically. The level of sophistication that you choose to use in your analysis is entirely your decision. You can use a pad of paper and a financial calculator, you can create an Excel spreadsheet, or you can invest in expensive software programs. In any event you will need to know the difference between before-tax cash flows and after-tax cash flows, between adjusted basis and an adjustable mortgage, and between cash inflows and cash outflows. Hopefully this chapter has brought you to that level.

Quiz for Chapter 11

1. An investor is considering the purchase of an 18-unit apartment building. The building contains six one-bedroom units, six two-bedroom units, and six three-bedroom units. The one-bedroom units rent for $800 per month; the two-bedroom units rent for $950 per month; and the three-bedroom units rent for $1,100 per month. What is the potential gross income of the building? (See Table 11.13.)
   a. $57,600
   b. $237,600
   c. $205,200
   d. $172,800

Table 11.13

PGI	$205,200
–Vacancies	–$10,260
EGI	$194,940
–Operating expenses	–$75,000
NOI	$119,940
–Debt Service	–$99,058
BTCF	$20,882

2. Given the information in Table 11.13, what is the debt coverage ratio of the building being analyzed?
   a. 1.21
   b. 84.8
   c. 38.5
   d. 8
   e. 5.6

3. Given the information in Table 11.13, what is the operating expense ratio?
   a. 1.21
   b. 84.8
   c. 38.5
   d. 8
   e. 5.6

4. Given the information in Table 11.13, what is the breakeven occupancy of the property?
   a. 1.21%
   b. 84.8%
   c. 38.5%
   d. 8%
   e. 5.6%

5. Given the information in Table 11.14 (below), and the fact that the property in question is an apartment building, what is the cost of the improvements?
   a. $1,500,000
   b. $1,200,000
   c. $1,125,000
   d. $119,940

Table 11.14

NOI	$119,940
–Interest	–$89,660
–Depreciation	–$43,636
Taxable income	–$13,357
× –0.28	× –0.28
Tax liability (saving)	$3,740

6. Does the building described in Table 11.14 experience a tax liability or a tax savings?
   a. Tax liability
   b. Tax savings
   c. Both of the above
   d. Neither of the above

7. Given the information in Table 11.15 (below), what is the commission rate (selling expense) as a percentage of the sale price?
   a. 9.8%
   b. 32.5%
   c. 5%
   d. 6%

Table 11.15

Sale price	$1,738,911
–Mortgage balance	–$1,069,536
–Selling expense	–$104,335
BTCF(s)	$565,041

8. Given the information in Table 11.15 and the fact that the purchase price of the property is $1,500,000, what annual value growth rate was used to get the sale price if there was a five-year holding period?
   a. 2%
   b. 3%
   c. 4%
   d. 5%

9. Given the information in Tables 11.13 and 11.14, what is the ATCF from operations?
   a. $17,142
   b. $24,622
   c. $20,882
   d. $3,740

10. Using the after-tax cash flows from operations and the after-tax cash flow from the sale represented in Table 11.16 (below), and given a cash down payment of $150,000 at time period zero, what is the IRR of this investment?
   a. 11.73%
   b. 12.73%
   c. 13.73%
   d. 14.73%

Table 11.16

End of year	Cash flows
1	$10,000
2	$20,000
3	$30,000 + $155,000

12

CHAPTER

Risk in Real Estate

The Probability of Achieving an Undesired Outcome

Risk can be defined in a number of different ways. One way of defining risk is that it is the probability of achieving an undesired outcome—that is, the chance that an investor will achieve a rate of return that is different from the expected rate of return. Carrying this thought a little further, the definition of risk could be variability of returns. In this chapter we address risk and its impact on mortgages, both from the lender's perspective and the borrower's perspective. We also see

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what the impact of risk is on capitalization rates and hence property values. Finally, we address the different types of risk that affect real estate investors.

Interest Rates and Risk

Interest is a charge for the use of money. Lenders are sometimes referred to as investors because they are investing money in a transaction. Investors, or lenders, want to earn fair compensation, or a fair return, for the money they have invested. This return includes compensation for any risk they are undertaking in their investment.

RISK-FREE RATES

Interest rates are made up of a number of different elements. Risk-free rates of interest, such as those earned on U.S. Treasury instruments such as treasury bills and treasury bonds are said to be made up of two elements. These elements are a real rate of return plus an inflation premium. Let's say we are going to invest in a one-year treasury security. The expected rate of return, or risk-free rate, is summarized in Equation 12.1.

Equation 12.1

$$\text{Risk free rate, } R_f = \text{real rate} + E\ (\text{inflation premium})$$

The real rate of return is simply to compensate the lender for not having his or her money for the coming year. Historically, the real rate of return has been in the 1% to 2% neighborhood on U.S. treasuries. The treasury securities are considered risk free because the federal government will always pay the investor back. If the government doesn't have enough from tax revenue to pay back investors, it will simply borrow more money (issue new treasury securities) to pay them back.

The inflation premium in Equation 12.1 is preceded by the letter E because we are referring to the *e*xpected inflation for the coming year. We are not considering the CPI (consumer price index) for the previous year because that is history as far as financial markets are concerned. Investors are loaning their money to the government for the coming year so they are interested in the expected inflation during the coming year. When their money is paid back at the end of the year, they will want compensation for the increase in the prices of goods and services that took place during the year they didn't have their money.

THE YIELD CURVE

The *yield curve* is the graphic representation of what is called the *term structure of interest rates*. The term structure of interest rates is the relationship between interest rates and time. When the yield curve is in its normal position, as in Figure 12.1, long-term rates tend to be higher than short term rates. There are a couple of explanations for this. One of these explanations is referred to as *market segmentation*, which says that there is a market for all types of loans. By and large lenders prefer to lend short term because there is less time for the borrower to default. Since lenders would like to get their money back sooner, they have to be encouraged to loan money long term, by the borrower paying a higher rate of interest. Borrowers on the other hand would prefer to borrow long term. It puts off their having to repay the debt until a later date, postponing what is sometimes called *crisis at maturity*, or a default on the borrower's part caused by the borrower's lack of ability to repay the loan. In order to borrow long term, borrowers are willing to pay a higher rate of interest. In both these situations the long-term rates end up higher than the short-term rates.

Occasionally the yield curve assumes an inverted position, as shown in Figure 12.2. This happens when short-term rates are higher than long-term rates. This typically is the result of higher rates of inflation. When inflation is high in the short term, this gets factored into short-term rates. The markets will then predict a reduction in inflation rates in the long term so that short-term rates end up higher than long-term rates.

A second explanation for the yield curve is called *perfect expectations*. This theory holds that the interest rate markets reflect what is going to happen in the future. Long-term interest rates are the geometric average of the intermittent short-term rates. What this is saying is that long-term rates have short-term rates built right into them. That would mean that the expected inflation in coming years is somehow built in to the long-term interest rates and if we just know the

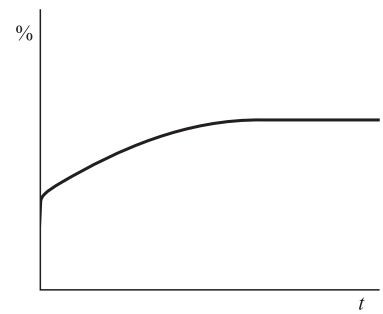

Figure 12.1 Yield curve in normal position

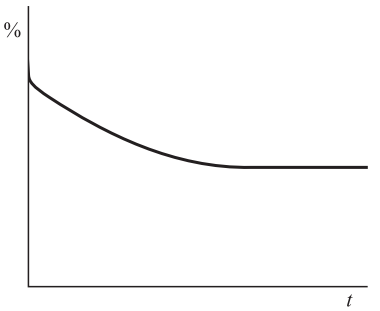

Figure 12.2 Yield curve in inverted position

right tools, we could get the future inflation expectations from these long-term rates. Fortunately, we do know what the tool is, and it is a time value of money calculation, which means that we can solve it with our financial calculator.

SPOT RATES AND FORWARD RATES

In order to find the expected inflation rate, you can reference a source of U.S. treasury yields, such as in the *Wall Street Journal*. In Table 12.1 you will find the yields on one-, two-, and three-year treasuries as of October 5, 2006. You will notice that the one-year rate is 4.78%, the two-year rate is 4.58% and the three-year rate is 4.51%. Given this information, we can see that the yield curve is inverted with short-term rates higher than long-term rates. The current one-period spot rate of 4.78% could be broken down between the real rate of interest and the expected inflation. If the real rate is 1%, then the expected inflation rate would be $4.78\% - 1\% = 3.78\%$.

Table 12.1 Spot rates

Maturity	Yield
1 year	4.78%
2 year	4.58%
3 year	4.51%

These rates are referred to as spot rates, because we are standing at time period zero, that is today, and looking at the one-year rate, the two-year rate, and the three-year rate. If we purchased these treasury securities, we would earn 4.78% for one year, or 4.58% each year for two years, or 4.51% each year for three years depending on which security we invested in. One-period forward rates will contain the expected inflation premiums that we are interested in. The one-period

forward rate would be the interest rate that the markets predict will be in effect from the end of period one to the end of period two and from the end of period two until the end of period three. Standing at time period zero, we can't purchase a security that will give us a return from the end of period one until the end of period two because that rate will depend on market factors when we get to that time period. The perfect expectations theory states that those future spot rates, or short-term (ST) rates, are already built into the existing long-term (LT) rates.

To calculate those forward rates, we start with $1 and compound it forward given the spot rates in Table 12.1. The calculations are shown in Solutions 12.1, 12.2, and 12.3.

Solution 12.1

−1 [PV]
1 [n]
4.78 [i/y]
[cpt] [FV] 1.0478

Solution 12.2

−1 [PV]
2 [n]
4.58 [i/y]
[cpt] [FV] 1.0937

Solution 12.3

−1 [PV]
3 [n]
4.51 [i/y]
[cpt] [FV] 1.1415

To estimate the forward rate from the end of period one to the end of period two, we ask the question, what interest rate will take us from a present value of –1.0478 to a future value of 1.0937 in one period? That answer is found in Solution 12.4.

Solution 12.4

−1.0478 [PV]
1.0937 [FV]

Table 12.2 Spot rates, forward rates, and expected inflation

Year	Spot rate	Forward rate	Expected inflation
1	4.78%		3.78%
2	4.58%	4.38%	3.38%
3	4.51%	4.37%	3.37%

1 [n]

[cpt] [i/y] 4.38%

The forward rate that is expected by the financial markets from the end of period one to the end of period two is 4.38%. That illustrates to us that the markets expect the rate of inflation to go down. If the real rate is again 1%, then the expected inflation from the end of period one to the end of period two would be 4.38% − 1% = 3.38%, or a reduction of 4.78% − 4.38% = 0.4%.

The one-year forward rate from the end of period two to the end of period three can be estimated in similar fashion using Solution 12.5. We ask what rate will take us from a present value of –1.0937 to a future value of 1.1415 in one period.

Solution 12.5

−1.0937 [PV]

1.1415 [FV]

1 [n]

[cpt] [i/y] 4.37%

The financial markets believe the inflation will decline ever so slightly in year three to 3.37%, 4.37% − 1% = 3.37%, assuming a real rate of return of 1% again.

Based on one-year, two-year, and three-year treasury securities, Table 12.2 contains the spot rates, forward rates, and inflation premiums that are expected in the market today, or as of October 5, 2006. The expected inflation premiums are based on an assumption of a 1% real rate of return.

Mortgage Interest Rates

While a treasury security earns a risk-free rate of return, a mortgage will earn a risky rate of return. The federal government will always pay the investor back, and the mortgage borrower isn't always a sure thing. There are two major types of risk that the lender assumes in generating a mortgage loan. The first of these is default risk and the second is interest rate risk.

DEFAULT RISK

As the name implies, *default risk* is the risk that the borrower may in fact not repay the debt as agreed to in the mortgage note and mortgage document, but rather default on the mortgage before the full debt has been repaid. The interest rate on a mortgage, or risky loan, is summarized in Equation 12.2. We generally use a lowercase r to designate a risky rate of interest as opposed to the upper case R_f which is used to designate the risk free rate of interest.

Equation 12.2

$$r = \text{Real rate} + E\ (\text{inflation premium}) + \text{default premium}$$

or:

$$r = R_f + E\ (\text{inflation premium})$$

Both statements in Equation 12.2 say the same thing, since Equation 12.1 states that R_f = real rate + E (inflation premium). That default premium is sometimes referred to as the risk premium. The term *default premium* is used here because we refer to many types of risk, and hence risk premiums, throughout the chapter.

If we check the current mortgage interest rate on a 30-year conventional mortgage, we find that it is about 6.13%. If we compare that with a 25- or 30-year treasury security which is listed as 4.78%, we can extract a default premium of 6.13% − 4.78% = 1.35% on a 30-year mortgage. So mortgage lenders are earning about a 1.35% default premium on their 30-year mortgages to compensate them for the additional risk of default. Naturally, lenders try to manage that risk through effective underwriting programs that allow them to eliminate borrowers who are most likely to default on their mortgage loans.

INTEREST RATE RISK

The second major risk from the lender's viewpoint is referred to as *interest rate risk*. This is the risk that market rates of interest will increase while the lender has fixed interest rate mortgages outstanding. This increase in market rates of interest, if they cannot be passed on to the borrowers, will result in the value of the lender's mortgage portfolio (the lender's assets) decreasing. If the value of these assets decreases while the value of the liabilities remains the same, there is a technical term for that, *bankruptcy*. This is the one of the major problems that hit the savings and loan industry in the 1970s and 1980s.

Let's take a look at an example of what interest rate risk means to the value of a mortgage portfolio. XYZ Mortgage Company has a portfolio of 100 mortgages

of $100,000 each for a total value of $10,000,000. That portfolio has an average interest rate of 6.5%. Suddenly, or over time (it doesn't make much difference), market rates of interest go up to 8%. The average remaining term on the mortgages is 25 years. What has happened to the portfolio's value? We can analyze this situation by looking at one mortgage, the average mortgage, in the portfolio that is for $100,000 at a 6.5% rate with 20 years remaining. The payment calculation is in Solution 12.6. After calculating the payment we change the interest rate to 8% and solve for the new present value.

Solution 12.6

100000 [PV]
$20 \times 12 = 240$ [n]
$6.5/12 =$ [i/y]
[cpt] [pmt] 745.57
$8/12 =$ [i/y]
[cpt] [PV] 89136.47

We see that the payments are now discounted at the new market rate of 8%, and that reduces the present value of the mortgage from $100,000 to $89,136.47 which reduces the value of the portfolio from $10,000,000 to $8,913,646. One fact that might reduce the size of that value change would be that a mortgage today generally doesn't have an expected life of 20 years. Most mortgages today are expected to be paid off in seven to nine years, either because the property will be sold or because the loan will be refinanced. However, the size of the interest rate shift that lenders saw in the 1970s was greater than the 1.5% shift we use in our example. Lenders saw the mortgage market shift from 8.5% to in excess of 14% in a very short period of time. This increase in market rates had a tremendous impact on the value of savings and loan mortgage portfolios. In times of increasing rates you don't see much refinancing either, so mortgages tend to run for longer periods of time, exacerberating the problem.

Lenders have attempted to create situations where they are not required to bear the full brunt of interest rate risk in the mortgage market. The adjustable rate mortgage (ARM) has been the most useful tool for these purposes over the years. The ARM ties its interest rate to an index, and as that index moves, so does the interest rate on the borrower's mortgage. As the index goes up, the interest rate on the mortgage goes up. As the interest rate goes up, the payments go up. This same tool that protects the lender against market rate increases passes the interest rate risk on to the borrower. Many borrowers have been hit hard by payment increases that were not budgeted for, and these changes have resulted in large numbers of foreclosures.

Appraisal Cap Rates and Risk

Risk also affects appraisal capitalization rates and, as a result, real estate values. The risk associated with commercial/investment property valuation can be found in the capitalization rate used in the appraisal process. Two major types of risk affect the cap rate choice, and they are the lack of liquidity associated with a real estate investment that is not present in a common stock investment and the potential for changing markets associated with a real estate investment. The two types are in fact closely associated with each other. It is the lack of liquidity, or the inability to quickly get out of a real estate investment, that subjects the investor to the potential for changing markets. If the investment was more liquid, investors would not have to worry as much about changing markets because they could simply sell the investment and get out of it.

These changing markets could affect both the NOI of the property as well as the potential selling price of the real estate at the end of the holding period. These two risk factors are present in the cap rate used by an appraiser. While they are most likely not separated out and/or separately calculated, they are present in the rate. Other risks, such as tenant quality, can also come up in appraising one property in comparison with the entire local market for investment properties.

MARKET EXTRACTED CAP RATES

Let's say we are appraising a single-tenant building in an office/warehouse market. The comparables that you have used as an appraiser to come up with your market-extracted cap rate have been of different types. A market-extracted cap rate, you will recall, is one that is extracted from a comparable sale using IRV. Using IRV, the cap rate is calculated as shown in Equation 12.3.

Equation 12.3

$$R = I/V$$

Two of the comps in your analysis are single-tenant buildings, but the third has several tenants. The one with several tenants is probably deemed less risky because of the investor's eggs not all being in one basket, so to speak. If that building is less risky to an investor, should its cap rate be the same as those derived from single-tenant buildings by the appraiser? It should probably be lower than the other two because of the reduction of risk resulting from multiple tenants. Not only would the number of tenants be relevant, but the quality of those tenants is also important. Those tenants with a higher credit rating should certainly be

reflected in a lower cap rate. Maybe the tenant of one of the comps is the U.S. Postal Service which has signed a 30-year lease. In that case the income is almost like the income on a treasury security. Rather than saying our cap rate should reflect default or some other type of risk, maybe we should be using a risk-free cap rate.

Hopefully you are getting the feeling of how capitalization rates can be risk-adjusted rates and how different types of risk are applicable to different types of tenants. Riskier properties should be valued using cap rates that reflect those elevated levels of risk. The higher cap rates will result in lower values.

BAND OF INVESTMENT CAP RATES

You will recall from Chapter 10 that the band of investment method of estimating a cap rate uses both the mortgage information and the required rate of return on equity for the investor in building the cap rate. As the expected inflation premium and the default premium associated with the mortgage increase, the mortgage constant will increase, both leading to a higher cap rate. As the required return on equity for a given investor increases, so will the cap rate using the band of investment. Increased risk finds its way into the cap rate both through the mortgage terms and through the return on equity for the investor. It is probably easier to see these risk factors affecting the cap rate in the band of investment method of estimating the cap rate than it is in the market extraction method. At least it is easier to isolate and quantify them. The equation for calculating the cap rate using the band of investment technique is replicated from Chapter 10 in Equation 12.4.

Equation 12.4

$$R = (L/V \times MC) + (E/V \times ROE)$$

As a review, it says that the cap rate is calculated by multiplying the loan-to-value ratio on the mortgage by the annual mortgage constant, plus the equity-to-value ratio times the required return on equity for the typical investor in this type of property. Risk is built into this cap rate in two places. First of all it is built into the mortgage information. We have already discussed how the risk of default premium and the expected inflation premium are built into mortgage interest rates. If that is the case, then those same premiums are built into the mortgage constant. Second, risk factors are built into an investor's required return on equity. Investors certainly will not be happy earning a risk-free rate of return given the types of risk that they are exposing themselves to by investing in the real estate market.

What does the presence of risk premiums in cap rates do to property values? If those risk premiums increase the cap rate, then the obvious impact on property values is that the values will go down. To quote a major premise, the higher the discount rate, the lower the present value. Increases in risk premium will convert to increases in cap rates which will convert to decreases in property value.

Problem 12.1

Let's look at a situation in which a lender has mortgage applications on two different four-unit apartment buildings, property A′ and property B′, that are right next to each other. They were built in the same year by the same builder. The units within the buildings are the same size, and they generate the same amount of rent per month. The lender finds the credit score and hence the creditworthiness of borrower A to be better than that of borrower B. The lender decides that the risk of default is greater for borrower B than it is for borrower and A, and as a result will charge a 1/2% greater interest rate on the mortgage to compensate for the additional risk. The mortgage to be obtained is an 80% L/V mortgage amortized over 30 years. Borrower A will get the mortgage at a 7.5% rate of interest, and borrower B will pay 8% interest. Both buildings will generate $26,000 of NOI next year, and investors in this type of building are expecting a 12% ROE. What is the impact of the additional default risk on the value of property B versus the value of property A?

We use the band of investment technique for estimating the cap rate in this problem. First we must calculate the mortgage constant. This is done in Solution 12.7 for investor A.

Solution12.7: Mortgage Constant for Investor A

1 [PV]
360 [n]
7.5/12 = [i/y]
[cpt] [pmt] 0.0070 × 12 = 0.0839

The same calculation for investor B is made in Solution 12.8.

Solution12.8: Mortgage Constant for Investor B

1 [PV]
360 [n]
8/12 = [i/y]
[cpt] [pmt] 0.0073 × 12 = 0.0881

These mortgage constants are then inserted into Equation 12.4 to result in the cap rates indicated in Equations 12.5.

Equations 12.5

$$R_A = (0.80 \times 0.0839) + (0.20 \times 0.12) = 0.0671 + 0.024 = 0.0911 = 9.11\%$$

$$R_B = (0.80 \times 0.0881) = (0.20 \times 0.12) = 0.0705 + 0.024 = 0.0945 = 9.45\%$$

The additional default risk resulted in an increase in the cap rate from 9.11% for investor A to 9.45% for investor B. How does the increase in default risk affect the value of the property? This is illustrated in Equations 12.6.

Equations 12.6

$$V_A = I/R_A = \$26{,}000/0.0911 = \$285{,}400$$

$$V_B = I/R_B = \$26{,}000/0.0945 = \$275{,}132$$

In this case the additional default risk that was present in the increased rate of interest charged to investor B resulted in a property value decline of approximately $10,000, from $285,400 to $275,132. What this really means to investor B is that in order to buy the property, this investor will have to come up with an additional $10,000 in down payment. The seller isn't really going to care if investor B has to pay a higher rate of interest on the mortgage; that is the investor's problem. The seller is still going to want the same $285,400 that building A is selling for because it is an identical building. The additional risk results in the investor having to make a larger cash investment on the property.

Problem 12.1 illustrates how risk that finds its way into capitalization rates can have a detrimental effect on property values.

Standard Deviation of Returns

One method of measuring the risk associated with a real estate investment is to analyze that investment given different economic scenarios and see how the investment returns vary. This is typically measured using the standard deviation of returns. As an example, an investor is looking at a building and determines through economic analysis that the economy could go in one of three directions. The economy could be super duper, it could be okay, or it could be really rotten. These are technical economic terms that you might not be familiar with. Through the cash flow analysis the investor has calculated the IRR associated with each of those projected economic conditions. Table 12.3 contains the economic conditions, the

Table 12.3 Investment A

Economic condition	Probability	IRR
1. Super duper	0.30	18%
2. Okay	0.40	11%
3. Really rotten	0.30	7%

probability of those conditions, and the IRRs associated with each economic scenario. This example is referred to as investment A.

The information contained in Table 12.3 is now used to calculate the expected return and the standard deviation of returns. First we calculate the expected return using Equation 12.7. (Before you look at the equation, don't panic. The terms are explained below.)

Equation 12.7

$$\text{Expected return, } E(R) = \sum (R_j \times P_j)$$

$$E(R) = (18\% \times 0.30) + (11\% \times 0.40) + (7\% \times 0.30)$$

$$= 5.4\% + 4.4\% + 2.1\% = 11.9\%$$

The Greek letter sigma ($\sum$) stands for *summation*, so we multiply the return by the probability associated with that return, and we add them all up. The j in the equation refers to return 1, or return 2, or return 3 and probability 1, probability 2, and probability 3. So the j is just standing in for 1, 2, or 3. In the case of the data in Table 12.3, the expected value, given the three different economic scenarios and the returns associated with those scenarios, is 11.9%. Now that we have the expected value, we can calculate the variance of returns and then the ultimate goal which is the standard deviation of returns.

Equation 12.8

$$\text{Variance} = \sum [R_j - E(R)]^2 \times P_j$$

To calculate the variance, you start in the middle, between the brackets. Take the actual return (R_j) minus the expected (or average) return, and square that difference. Then multiply the result by the probability associated with that return. Then the sigma tells us to sum up all of those values. The variance calculation for this investment is illustrated in Equation 12.9.

Equation 12.9

$$\begin{aligned}\text{Variance} &= (18 - 11.9)^2 \times 0.30 + (11 - 11.9)^2 \times 0.40 + (7 - 11.9)^2 \times 0.30 \\ &= (37.21)\ 0.30 + (0.81)\ 0.40 + (24.01)\ 0.30 = 11.16 + 0.32 + 7.2 \\ &= 18.68\end{aligned}$$

The variance itself doesn't tell us a whole lot about the investment. Rather it is the standard deviation that gives us some information. The calculation of the variance allows us to get to the standard deviation because the standard deviation is the square root of the variance.

Equation 12.10

$$\text{Standard deviation} = \sqrt{18.68} = 4.32\%$$

What this says is that the expected return given the three economic scenarios has a standard deviation of 4.32%. The standard deviation is a measure of variability of returns or a measure of risk. The standard deviation in this form is best used in comparing investment alternatives. If we were to analyze the standard deviations of two similar investments that we are considering and if they have similar expected returns, an investor would select the investment with the lower standard deviation in order to avoid the additional risk.

Let's analyze a second investment option and compare it with our original investment from Table 12.3. This time we have the same potential economic scenarios and the same probabilities of each of them taking place, but the expected IRRs associated with the scenarios are 15% given a super duper economy, 11% given an okay economy, and 8% given a really rotten economy. Calculate the standard deviation of returns for this investment, which we refer to as investment B.

Equation 12.11

$$\begin{aligned}E(R) &= (15\% \times 0.30) + (11\% \times 0.40) + (8\% \times 0.30) \\ &= 4.5\% + 4.4\% + 2.4\% = 11.3\%\end{aligned}$$

As shown in Equation 12.11, the expected return of investment B is 11.3%. We can now move on to the variance and standard deviation calculations.

Equation 12.12

$$\begin{aligned}\text{Variance} &= (15 - 11.3)^2 \times 0.30 + (11 - 11.3)^2 \times 0.40 + (8 - 11.3)^2 \times 0.30 \\ &= 13.69 + 0.09 + 10.89 \\ &= (13.69)\ 0.30 + (0.09)\ 0.40 + (10.89)\ 0.30 \\ &= 4.11 + 0.036 + 3.27 \\ &= 7.42\end{aligned}$$

The variance of returns for investment B is 7.42. Once again, the square root of the variance is equal to the standard deviation.

Equation 12.13

$$\text{Standard deviation} = \sqrt{7.42} = 2.72\%$$

Now the standard deviation for investment A can be compared with the standard deviation for investment B, as shown in Table 12.4.

In looking at Table 12.4 it is apparent that investment A has the higher expected rate of return, which would make it more attractive to an investor. It also has the higher standard deviation which would signal greater risk to the investor. Both of these pieces of information are important to the investor, but they each may lead the investor to a different conclusion.

COEFFICIENT OF VARIATION

There is one more measure of risk that can clear up problems of weighing rate of return versus standard deviation, and that is called the *coefficient of variation*. What it does is that it gives us a measure of risk per percentage point rate of return.

Table 12.4 Comparison of standard deviations of investments A and B

Investment	E(R) Expected return	Standard deviation
A	11.9%	4.32%
B	11.3%	2.72%

Equation 12.14

$$\text{Coefficient of variation} = \text{Standard deviation/E(R)}$$

$$\text{Coefficient of variation}_{\text{A}} = 4.32/11.9 = 0.36$$

$$\text{Coefficient of variation}_{\text{B}} = 2.72/11.3 = 0.24$$

Since investment A has a higher coefficient of variation, it is considered riskier than investment B because it has a higher measure of risk per percentage point rate of return.

Partitioning of IRR

Another way we can measure the risk of an investment is to partition the IRR into two parts. We are interested in seeing how much the IRR is dependent on the cash flows from operations and how much of the IRR is dependent on the cash flow from the sale of the building. When a larger portion of the IRR comes from the cash flow from the sale, that would be considered a riskier investment than one in which a larger percentage of the IRR comes from the cash flows from operations. The cash flows from operations are received sooner by the investor than the cash flow from the sale, and as a result they are considered less risky. There is less time until the cash flows are received for changes in market and economic conditions to take place so these cash flow estimates are more certain than that coming from the sale which is more uncertain.

Table 12.5 is the summary of cash flows contained in Table 11.6 (in Chapter 11). You may recall that the IRR of these cash flows was 18.29%. Let's partition this rate of return to determine what percentage is coming from the cash flows from operations and what percentage is coming from the cash flow from the sale. We need to find the present value of the cash flows from operations using the IRR as the discount rate.

Table 12.5 After-tax cash flows

Year	ATCF
0	−$167,100
1	$8,734
2	$10,284
3	$11,874
4	$13,504
5	$15,175 + $305,181

This calculation is found in Solution 12.9.

Solution 12.9

[CF] 0 [enter]
[↓] 8734 [enter][↓]
[↓] 10284 [enter][↓]
[↓] 11874 [enter][↓]
[↓] 13504 [enter][↓]
[↓] 15175 [enter][↓]
[↓][NPV] I = 18.29 [enter] [↓]
[NPV] [cpt] 35356.43

Now we find the present value of the cash flow from the sale discounted at the IRR, which is summarized in Solution 12.10.

Solution 12.10

305181 {FV]
5 [n]
18.29 [i/y]
[cpt] [PV] 131770.24

The present value of the cash flow from operations and the present value of the cash flow from the sale of the property are now added together as shown in Equation 12.15.

Equation 12.15

$$\text{Total PV of cash flows} = \$35{,}356.43 + \$131{,}770.24 = \$167{,}126.67$$

To get the percentage of the IRR coming from the cash flow from operations, simply divide the present value of the cash flows from operations by the total present value of all of the cash flows as shown in Equation 12.16.

Equation 12.16

$$\%\ \text{of IRR from operations} = \$35{,}356.43/\$167{,}126.67 = 0.212 = 21.2\%$$

To obtain the percentage of the IRR coming from the sale of the property divide the present value of the sale price of the property as calculated in Solution 12.10, by the total present value of the cash flows that was calculated in Equation 12.15.

This operation is illustrated in Equation 12.17. Alternatively, we can simply take 1 minus the result of Equation 12.16. In both cases we obtain 78.8%.

Equation 12.17

$$\% \text{ of IRR from sale} = \$131{,}770.24/\$167{,}126.67 = 0.788 = 78.8\%$$

This measure can also be used in comparing one investment with another to determine which investment is more dependent on sale cash flow. Those investments receiving a greater percentage of their return from the sale are considered riskier, as stated previously.

Quiz for Chapter 12

1. If the real rate of return is 1%, what are the expected rates of inflation and the default premium associated with the following securities? The one-year treasury rate = 4.6%, and the one-year corporate bond rate = 6.1%.
   a. Inflation premium = 3.6%; default premium = 2%
   b. Default premium = 2%; inflation premium = 3.6%
   c. Inflation premium = 3.6%; default premium = 1.5%
   d. Default premium = 1.5%; inflation premium = 3.6%

2. XYZ Federal Savings has a mortgage portfolio containing mortgages with a face value of $1,500,000. They earn an average interest rate of 7% and an average term of 25 years and are payable monthly. If the mortgages are expected to be paid off in the full 25 years (that is, no prepayments), and the market rate of interest goes to 7.5%, what is the new value of the portfolio?
   a. $1,500,000
   b. $65,383
   c. $1,750,000
   d. $1,434,616

3. Li has just taken out an adjustable rate mortgage (ARM) from her favorite lender for an amount of $140,000 amortized over 30 years at a 6.25% rate of interest. At the end of the first year her interest rate went up to 6.5%. What is her monthly payment in the second year of the loan, assuming no payment caps and no negative amortization?
   a. $862.00
   b. $884.41
   c. $884.90
   d. $862.48

4. Kate is appraising your apartment building, and she tells you that she is going to use the band of investment method of estimating a capitalization rate. You have told her that you are refinancing the building and that you are applying for a 75% loan-to-value mortgage with a 7% rate and a 30-year amortization. She finds most investors in this type of building are expecting a return on equity of 14%. What cap rate will Kate be using in her income capitalization approach if she uses the band of investment technique to estimate her cap rate?

a. 9.49%
b. 7%
c. 8.75%
d. 10%

5. You are looking into an investment with the following potential internal rates of return (IRR) and the given probabilities that they will occur. What is the expected IRR given the probabilities?

IRR	Probability
10%	20%
14%	30%
16%	30%
18%	20%

a. 14.5%
b. 14.6%
c. 14.0%
d. 15.0%

6. What is the variance of the returns in question 5?
a. 8.61
b. 4.23
c. 2.31
d. 1.96

7. What is the standard deviation of the returns from question 5?
a. 1.4%
b. 2.41%
c. 2.06%
d. 2.93%

8. Bill is analyzing two real estate investment opportunities that have come his way. The first one has an expected return of 16% and has a standard deviation of returns of 3.5%. The second investment has an expected rate of return of 14% and has a standard deviation of 2.8%. If Bill is using rate of return as his benchmark, he chooses the first investment because it has a higher rate of return. If Bill's decision rule is based on standard deviation, he chooses the second investment because it is less risky. If Bill uses the coefficient of correlation as his decision rule, which investment does he choose?

a. First investment since it has less risk per percentage point rate of return
b. Second investment since it has less risk per percentage point rate of return
c. Either one would be acceptable to Bill
d. Neither one would be acceptable to Bill

9. Dave is analyzing a real estate investment with the cash flows found in Table 12.6. He has found that the IRR of the after-tax cash flows is 13.73%. He has decided that in order to do an effective risk analysis, he should partition the IRR and determine what percentage of the IRR comes from the cash flows from operations. What percentage of the IRR is coming from the cash flows from operations?

Table 12.6

Year	Cash flows
0	(150,000)
1	$10,000
2	$20,000
3	$30,000 + $155,000

a. 29.8%
b. 28.9%
c. 70.2%
d. 71.1%

10. In question 9, what percentage of the IRR is coming from the cash flow from the sale of the property?
a. 29.8%
b. 28.9%
c. 70.2%
d. 71.1%

CHAPTER 13

Leases

This Is the Lease of Your Problems

A *lease* is the contract between the landlord, or building owner, and the tenant. It establishes the rights and responsibilities of both parties to the agreement. The primary items of interest in the lease are the term, or how long the lease is in effect, and the rental rate, or how much rent the tenant is obligated to pay. The lease will also indicate whether the rental payments will be gross rental payments or net rental payments. Since the lease is a contract, it must contain the essential elements of a valid contract. These essential elements are offer and acceptance, competent parties, legality of object, and consideration. Since it is a real estate

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contract, there are two additional elements. First the contract must be written, and second it must contain a description of the property in question.

Appraisers and investors are interested in the information contained in the lease because the information will be the primary indicator of the market value and the investment value of the property. Both of these values are dependent on the duration of the lease, the quality of the tenant, and the amount of rent to be generated by the property.

Gross Rent and Net Rent

Gross rent is the gross amount that the landlord or owner of the building will be receiving. When landlords receive the gross amount, that indicates that they will have to pay the operating expenses out of that rental amount. If the rent they receive is the net amount, that means that the tenant will be paying the operating expenses because this is already the landlord's net amount. To keep these straight, think back to the cash flow analysis in Chapter 11. In order to obtain the net operating income, we had to deduct vacancy and rent loss from the potential gross income, and we also had to deduct operating expenses, as shown in Table 13.1. If the landlord were to receive a net rental payment, that would imply that he or she does not have to pay operating expenses, but of course someone has to pay them. In the case of net rental payments being made to the landlord, the tenant must pay the operating expenses.

Residential Rent

Residential rent is typically stated as a monthly rental amount. The apartment can be rented for $1,000 per month. Rent is also usually due at the beginning of the month. If we refer back to Chapter 6, we see the lease payments as an annuity

Table 13.1 Before-tax cash flow

PGI	$126,900
–Vacancies	$8,883
EGI	$118,017
–Operating expenses	$47,000
NOI	$71,017
–Debt Service	–$62,185
BTCF	$8,832

due, since the payments are made at the beginning of the month. By analyzing the value of the rental payments, we can see why the landlord would be upset if we, as the tenants, were consistently late with our rent payments. If we were to look at the value of a one-year lease with payments of $1,000 per month and using a discount rate of 10%, we can find that value in Solution 13.1.

Solution 13.1

–1000 [pmt]

12 [n]

10/12 = [i/y]

[cpt] [PV] 11374.51 × 1.0083 = $11,469.30

The lease has a value of $11,469.30. When we compute the PV of the annuity, the calculator assumes it is an ordinary annuity unless we tell the calculator that we are going to use the beginning of the period payments. In Solution 13.1, I didn't tell the calculator that, so the value of $11,374.51 must be multiplied by 1 plus the rate of interest for one period, in this case 1 plus (10/12 = 0.83%) or 1.0083. There is also a [BGN] key on your calculator that will move the payment from the end of the period to the beginning of the period, but I will let you read your manual about that. I prefer to simply multiply the present value of the ordinary annuity by 1 plus the rate of interest for one period. The resulting value is the present value of the annuity due, or the present value of the lease.

Notice that if our payments were consistently late by one month during the term of the lease, then we would have an ordinary annuity, with payments at the end of the month. What would be the value of the lease then? It would be worth $11,374.51. That is why the landlord insists that we make our lease payments in a timely manner. If we don't, the landlord is losing value or wealth.

OFFICE AND WAREHOUSE RENT

Office and warehouse rent is typically quoted in price per square foot per year. If the stated office rental rate is $14 per square foot and the space to be rented is 1,500 square feet, that would equal the value stated in Equation 13.1. First the annual rental amount is calculated followed by the monthly amount.

Equation 13.1

$$\text{Annual rent} = \$14 \times 1{,}500 = \$21{,}000 \text{ per year}$$

$$\text{Monthly rent} = \$21{,}000/12 = \$1{,}750 \text{ per month}$$

This rental rate may be a gross figure, or it may be a net figure. If it is a gross rental amount, the landlord would be responsible for paying the operating expenses as explained previously. If it is a net rental amount, the tenant would be responsible for paying the operating expenses.

RETAIL RENT

Retail rent can work differently from either of the others already mentioned. In retail leases we may have something referred to as *percentage rent*. In a rental situation with percentage rent the tenant first customarily pays what is called *base rent*. This would simply be the rent needed to open up the shop. Then there may be percentage rent that is added on top of the base rent. That percentage is generally a percentage of sales volume during the month. In that way the more successful the store is, the more successful the landlord is also. The percentage will vary depending on the business enterprise that the tenant is involved in. The range of percentages is most often in the 5–10% of sales range. The difference between the base rent and the total rent paid is referred to as *overage rent*.

STEPS

A tenant may sign a multiyear lease with the annual rental rates established at the time the lease is signed. The rental rates may very well increase at different times during the lease, maybe every year, maybe less often. These increases, or steps, may be in the form of dollars per square foot, or they may be tied to the consumer price index (CPI).

Leased Fee Value versus Leasehold Value

If the landlord entered into a long-term lease without steps, then the tenant may be able to obtain value for his leasehold interest. This value gain for the leasehold interest would be in direct proportion to the value loss that would be experienced by the leased fee (landlord's) interest. Let's look at an example in which the landlord may lose value. Look at the formula for the value of the leased fee estate, Equation 13.2, and then, the value of the leasehold estate, in Equation 13.3.

Equation 13.2

$$\text{Value of leased fee} = \text{PV of NOI}_j + \text{PV of reversion}$$

In simple terms, the value of the leased fee estate, the landlord's interest, is equal to the present value of the NOI for j periods, plus the present value of the reversion, or selling price, at the end of the holding period.

Equation 13.3

$$\text{Value of the leasehold} = \text{PV of any rent savings}$$

The value of the leasehold estate, or the tenant's interest, is equal to the present value of any rent savings (versus the market rent) that may be earned.

Let's say that the tenant signs a five-year lease. The contract net rent is $14 per square foot for 1,500 total rentable square feet. There are no steps in the lease. After the first two years the market goes through a small change, and the market rent is now $16 per square foot. What happens to the leasehold interest? If we assume a 10% discount rate, the value of the leasehold interest is contained in Solution 13.2.

Solution 13.2

–3000 [pmt]
3 [n]
10 [i/y]
[cpt] [PV] 7460.56

The leasehold interest has a value of $7,460.56. Since the tenant is locked in at the $14 rate for five years, after two years if the market rate goes to $16 per square foot, the tenant will be experiencing a rent savings of $2 per square foot for the last three years of the lease. That $2 per square foot × 1,500 square feet results in a rent savings of $3,000 per year. The present value of the rent savings is the value of the leasehold interest.

The value gain that accrues to the tenant because of the fixed-rent long-term lease is identical to the value loss experienced by the landlord as a result of the lease. The contract rent which is $2 per square foot lower than what the market rent is means that the leased fee interest is going to have a lower present value than it would have if the contract rent was at the market level. The present value of that rent loss is equal to the same $7,460.56. The value that one party to the lease gains is the same value that the other party to the lease loses.

Problem 13.1

Let's look at a comprehensive problem illustrating the value loss and value gain associated with a long-term lease. This time the subject property is a small office

building of 5,000 square feet. The lease is a five-year lease with a contract rental rate of $12.50 per square foot for the entire five-year period. After three years the market rent climbs to $14 per square foot. Using a 10% discount rate and a going out cap rate of 8%, calculate the value of the leasehold interest, the value of the leased fee interest, and finally the value of the leased fee interest if the rental rate was at the market level at the end of year 3. All three value estimates are to be calculated at the end of year 3.

Solution 13.3

–7500 [pmt]

2 [n]

10 [i/y]

[cpt] [PV] 13016.53

As indicated in Solution 13.3, the leasehold interest has a value at the end of year 3 of $13,016.53. There is a rent savings in each of the last two years of $1.50 × 5,000 = $7,500. Discounted at the 10% discount rate gives the rent savings a present value of $13,016.

In order to calculate the value of the leased fee interest we have to calculate the present value of the NOI for the two-year period plus the present value of the reversion at the end of period two. The reversion value, or projected sale price, can be calculated using IRV. You will recall from Chapter 10 that $V_0 = I_1/R$. The value at time period zero is equal to the NOI for period 1, the coming period, divided by the cap rate. We want to estimate the value at the end of period three, so we will need to use the NOI for period four, the coming period. The NOI = 5,000 × $12.50 = $62,500. If the rent was at the market rate, the NOI would be $14 × 5,000 = $70,000. The market rent is typically used to estimate the value of the reversion, so V = 70,000/0.08 = $875,000. The value of the leased fee interest then is contained in Solution 13.4.

Solution 13.4

875000 [FV]

62500 [pmt]

2 [n]

10 [i/y]

[cpt] [PV] − 831611.57

The value of the leased fee interest comes in at $831,611. If the rent was at the market rate, the value of the leased fee interest would be as shown in Solution 3.5.

Solution 13.5

875000 [FV]
70000 [pmt]
2 [n]
10 [i/y]
[cpt] [PV] − 844,628.10

If the rent was at the market rate of $14 per square foot rather than the lower contract rate of $12.50 per square foot, the value of the leased fee interest would be $844,628. That represents a value difference of $844,628 − $831,611 = $13,016, which just happens to be the value of the leasehold interest. Is that another wow moment? I think so.

Average Rent and Effective Rent

If a lease has contract rent of $10 per square foot in year 1 and then contains steps of a $1.50 increase each year over the remaining four years of the five-year lease, the rents would appear as shown in Table 13.2. Average rent is a simple arithmetic average of each of the annual rental rates, and for this lease, the calculation would look like Equation 13.4.

Equation 13.4

$$\text{Average rent} = (10 + 11.50 + 13 + 14.50 + 16)/5 = 13$$

Given the rental values based on the beginning contract rent of $10 per square foot and annual steps of $1.50 per foot, the average rental rate for the lease is $13 per square foot.

The effective rent takes into consideration the time value of money. The calculation involves finding the present value of each of the rental rates and then taking

Table 13.2 Rent per square foot

Year	Rent per square foot
1	$10.00
2	$11.50
3	$13.00
4	$14.50
5	$16.00

the total present value and amortizing it over the lease term. Using the rental rates from Table 13.1, we would discount $10 back one period, $11.50 back two periods, $13 back three periods, $14.50 back four periods, and $16 back five periods. Let's use a 9% discount rate for our calculations. To simplify the calculation we can use the cash flow keys on the calculator as shown in Solution 13.6.

Solution 13.6

[cf]
10 [enter] [↓][↓]
11.50 [enter] [↓][↓]
13 [enter] [↓][↓]
14.50 [enter] [↓][↓]
16 [enter] [↓][↓]
[NPV] I = 10 [enter]
[↓] NPV [cpt] 48.20

Remember, the values not in [ ] above show up in the display. The [characters] are your keystrokes. The rental amounts have a total present value of $48.20. That amount is now called a *present value*, and we calculate the payment to amortize to obtain the effective rent as shown in Solution 13.7.

Solution 13.7

48.20 [PV]
5 [n]
10 [i/y]
[cpt] [pmt] − 12.72

The effective rent of this series of rental amounts is $12.72 versus the average rent of $13. The rental amounts in years 1 and 2 have a greater impact on the present value than do the rents for years 4 and 5, which is why the effective rent is lower than the average rent.

Problem 13.2

Let's look at another five-year lease situation with net rents of $13, $15, $15.75, $16.60, and $17.50 in years 1 through 5 of the lease. Calculate both the average rent and the effective rent for the rental amounts stated.

Equation 13.5

$$\text{Average rent} = (13 + 15 + 15.75 + 16.60 + 17.50)/5 = \$15.57$$

The effective rent is calculated in Solution 13.8 and Solution 13.9.

Solution 13.8

[cf]
13 [enter] [↓][↓]
15 [enter] [↓][↓]
15.75 [enter] [↓][↓]
16.60 [enter] [↓][↓]
17.50 [enter] [↓][↓]
[NPV] I = 10 [enter]
[↓] NPV [cpt] 58.25

Solution 13.9

58.25 [PV]
5 [n]
10 [i/y]
[cpt] [pmt] − 15.37

The effective rent of this second series of rental amounts is $15.37 per square foot per year.

Quiz for Chapter 13

1. Dan is managing a small office building, and the lease states that the rent can be payable monthly, at the rate of $2,500 per month and that it covers a period of two years. Given a discount rate of 10%, what is the current value of the lease?
   a. $60,000
   b. $54,177
   c. $54,626
   d. $22,461

2. Bev has purchased a warehouse, and the building has a five-year lease with rent payments constant for all five years at $10,000 per year. At the end of year 3 the market rent increases to $12,000 per year. Given a discount rate of 10%, what is the value of the leasehold interest at the end of year 3?
   a. $3,471
   b. $4,000
   c. $20,826
   d. $20,280

3. In question 2, what is the value of the leased fee interest today, at time period zero if we assume the reversion is zero?
   a. $40,000
   b. $37.907
   c. $45,489
   d. $35,907

4. The net rent per square foot on your office building for the next three years is $10.25 per square foot, $11 per square foot, and $12.50 per square foot. What is the average rent per square foot?
   a. $11.00
   b. $11.25
   c. $11.50
   d. $11.75

5. What is the effective rent for the next three years on the office building in question 4 given a 10% discount rate?

a. $11.00
b. $11.25
c. $11.35
d. $11.18

6. The local drug store asks you to analyze its new lease with the strip center that it rents space from. The base rent is $7 per square foot of the 1,500-square-foot store, plus there is percentage rent at the rate of 4% of annual sales. The store has averaged annual sales of about $500,000 per year. How much rent can it expect to pay for the coming year based on the lease requirements?
   a. $10,500
   b. $20,000
   c. $30,500
   d. $35,000

7. How much of the annual rent in question 6 is overage rent?
   a. $10,500
   b. $20,000
   c. $30,500
   d. $35,000

8. The lease for your office space is a five-year lease, and it quotes annual per square foot rental rates of $13, $13.75, $14.25, $15, and $16.50 for years 1 through 5, respectively. What is the average rent per square foot?
   a. $14.00
   b. $14.25
   c. $14.50
   d. $14.75

9. What is the effective rent per square foot of the lease described in question 8 using a discount rate of 10%?
   a. $14.25
   b. $14.34
   c. $14.44
   d. $14.54

10. If you are renting 1,500 square feet of space in question 8, what is the present value of the lease if your discount rate is 10%?
    a. $81,567
    b. $75,767
    c. $72,987
    d. $67,777

Final Exam

1. Tony had his 22nd birthday this week, and he has decided he'd like to be a millionaire by the time he retires at age 65. If Tony can set aside equal amounts each month until he retires in a 10% account, how large would his monthly payments have to be to have $1 million by the time he retires?
   a. $8,450.05
   b. $116.72
   c. $1,937.98
   d. $516.00

2. I want to be a millionaire when I retire at 65 and I've just had my 57th birthday. How much do I have to set aside each month until I retire in my 10% account to have my $1 million?
   a. $8,450.05
   b. $516.00
   c. $6,840.83
   d. $15,174.00

3. If you borrow $120,000 in the form of a 25-year mortgage amortized monthly at the 7% annual rate, what is your monthly payment?

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a. $848,14
b. $798.36
c. $719.46
d. $773.16

4. What is the principal balance after two years on the mortgage described in question 3?
   a. $117,473
   b. $112,896
   c. $116,195
   d. $100,839

5. If I deposit $4,000 today in an investment paying 10% annual interest and I withdraw $800 per year, how many withdrawals will I be able to make, if those withdrawals are made at the end of the year?
   a. 5
   b. 5.27
   c. 7
   d. 7.27

6. You've decided to go to graduate school, and you've calculated that you will need $8,500 per year for each of the three years you expect to be there. If you intend to enroll five years from today, given an interest rate of 9%, how much money should you set aside today?
   a. $21,516
   b. $13,983
   c. $25,500
   d. $16,573

7. Your driveway is 30 feet by 42 feet. If you cover it with a three-inch layer of concrete, how many cubic feet of concrete will you need?
   a. 630 cubic feet
   b. 1,260 cubic feet
   c. 415 cubic feet
   d. 315 cubic feet

8. Sylvia purchased a home earlier this year for $167,750 and took out a mortgage for $142,375 at 8% for 30 years. What was the loan-to-value ratio on the mortgage, and what is her down payment as a percentage of the purchase price?

a. 75%, 25%
b. 85%, 15%
c. 90%, 10%
d. 85%, 10%

9. Your cousin Kara recently purchased a new home for $179,500. The lot is worth $36,000 according to the appraiser. The lot size is 75 feet × 140 feet. What is the cost per square foot of the lot?
   a. $12.76
   b. $3.20
   c. $3.43
   d. $4.99

10. Ghulam purchased his home a year ago for $275,000 and has been told by an appraiser that it is currently worth $297,000. What has been the rate of appreciation the home has experienced over the last year?
    a. 6.5%
    b. 7%
    c. 7.5%
    d. 8%

11. Dennis has an opportunity to purchase a duplex for $325,000. He intends to finance the purchase with an 80% loan-to-value mortgage amortized over 30 years at a 7% rate of interest. If he buys the duplex and the value remains at $325,000 for one year, how much equity will Dennis have in the duplex at the end of the first year?
    a. $65,000
    b. $256,596
    c. $72,089
    d. $67,641

12. When Adrienne sold her home, she paid a 6% commission of $14,700. What was the sale price of Adrienne's home?
    a. $235,000
    b. $245,000
    c. $255,000
    d. $265,000

13. Dennis, from question 11, sold his duplex three years after he purchased it for $382,550. What was the compound annual appreciation that Dennis earned during his three-year holding period?

a. 3.6%
b. 4.6%
c. 5.6%
d. 6.6%

14. Karen asked a local real estate broker to come out and do a market analysis on her house because she was thinking of selling. The broker told her that the home should be listed for $235,900 and that he would be charging a 5% commission on the sale. If the home sells for 95% of the listing price, how much will Karen have to pay the broker for the commission?
    a. $11,795
    b. $11,205
    c. $13,446
    d. $10,615

15. Jason just signed a purchase agreement to sell his condo for $215,000. He bought it three years ago for $185,000. What was his annual average rate of appreciation over the three years?
    a. 5.4%
    b. 5.0%
    c. 16.2%
    d. 4.0%

16. Frances is selling her home after being transferred to another city for her job. She would like to net $175,000 from the sale of her home after paying a 6% commission to the broker. What sale price does the home have to sell for in order for Frances to receive her desired net proceeds?
    a. $185,500
    b. $186,170
    c. $186,500
    d. $185,170

17. Partha is selling a manufacturing building that has been in his family for years. The broker informed him that the commission would be 5% on the first $500,000 in sale price, 4% on the second $500,000 in sale price, and 2% on anything in excess of $1,000,000. If the building sells for a sale price of $1,250,000 how much commission does Partha have to pay?
    a. $50,000
    b. $45,000
    c. $25,000
    d. $47,500

18. The service station located two blocks from your home is installing a new fuel tank. The tank is 15 feet long and has a diameter of 6 feet. How many cubic feet of fuel does the tank hold?
    a. 282.6 cubic feet
    b. 423.9 cubic feet
    c. 141.3 cubic feet
    d. 372.6 cubic feet

19. Elise recently purchased the NW 1/4 of section 12 to house her horses and set up a training ring. She paid $475,000 for the land. How much did Elise pay per acre?
    a. $2,968
    b. $11,875
    c. $5,937
    d. $3,958

20. A half-acre lot on the outskirts of the city is listed for $8 per square foot. The commission on the listing contract is 7% of the sale price. If the lot sells for 85% of the listing price, what is the amount of the gross commission on the sale?
    a. $20,734
    b. $12,196
    c. $17,624
    d. $10,367

21. Denny took a listing on a four-unit apartment building with a list price of $425,000. The property sold for 95% of the list price. The net proceeds to the seller were $375,487 after the commission was paid. What was the commission rate charged on the sale of the four-unit building?
    a. 5%
    b. 6%
    c. 7%
    d. 8%

22. Tim is hoping to purchase a condo for $225,000, and he intends to get a mortgage of $157,500 at a 7% interest rate amortized over 25 years. What is the loan-to-value ratio on the mortgage?
    a. 60%
    b. 70%
    c. 80%
    d. 90%

23. A sum of $50,000 is invested today to provide a man with an annual income for 20 years; the first payment is to be received in one year. Given an interest rate of 5%, how much will the annual payments be?
    a. $1,512
    b. $2,500
    c. $3,500
    d. $4,012

24. How much money do you have to invest today in order to be able to spend $500 in two years and $700 in four years if you can earn 10% on your investment?
    a. $413.22
    b. $341.51
    c. $478.11
    d. $891.33

25. If your starting salary is $37,000 and you receive a 5% raise each year for the next 20 years, what will your salary be in year 20?
    a. $74,000
    b. $98,172
    c. $89,172
    d. $79,821

26. Kate is buying a condo; the purchase price is $315,000, and she is taking out a 90% loan-to-value mortgage to finance the purchase. The interest rate on the loan will be 7.25%, and it will be amortized over 30 years. What are Kate's monthly principal and interest payments on the mortgage going to be if it is a fixed-rate mortgage?
    a. $1,933.97
    b. $2,148.86
    c. $23,422.66
    d. $1,951.89

27. Five years from now Kate decides to sell her condo from question 26. If the property has gone up in value by 3% per year compounded annually, what is the expected sale price of the condo?
    a. $362,250
    b. $324,450
    c. $365,171
    d. $364,651

28. What is the mortgage balance when Kate sells her condo in question 27?
    a. $283,500.00
    b. $167,461.81
    c. $267,563.83
    d. $274,908.99

29. What is Kate's total equity in her condo when she sells it in question 27?
    a. $50,171
    b. $81,671
    c. $97,607
    d. $31,501

30. Pat bought a new house and closed on it last week for the price of $345,000. He took out a 75% loan-to-value 30-year mortgage to finance the purchase. He will be making payments of $1,635.48 for principal and interest each month on the loan. What is the rate of interest Pat is paying on the mortgage?
    a. 5.0%
    b. 5.5%
    c. 6.0%
    d. 6.5%

31. If Pat decides to sell the house in question 30 after 10 years, what will be the amount of his mortgage payoff?
    a. $258,750
    b. $219,358
    c. $242,218
    d. $238,219

32. The home that Maxine bought a couple of years ago cost $169,500 at the time of her purchase. She obtained a mortgage of $135,600 amortized over 25 years at a 5.5% rate of interest. What is the amount of her monthly mortgage payment?
    a. $823.70
    b. $832.70
    c. $827.30
    d. $837.20

33. What is the loan-to-value ratio on Maxine's mortgage in question 32?
    a. 125%
    b. 90%

c. 80%

d. 75%

34. Four years ago the country club took out a mortgage to finance the construction of a new club house. The total amount financed came to $2,500,000, and it had a 20-year term and an interest rate of 7%. What is the current principal balance on the mortgage?
    a. $19,382
    b. $2,457,638
    c. $2,235,043
    d. $2,480,634

35. What portion of the country club's (question 34) next payment, payment 49, will go toward principal reduction?
    a. $19,382
    b. $13,037
    c. $6,344
    d. $15,286

36. Dale took out an ARM three years ago for $179,500 at a 6% rate of interest with a 30-year amortization. His interest rate readjustment is coming up later this month, when the mortgage will be exactly three years old. He has been told that the treasury bond index, which is the index against which his mortgage is benchmarked, will be 4.5%. The margin on his loan is 2%. What will the new mortgage payment on his loan be after the interest rate is readjusted assuming that there are no payment caps on the mortgage?
    a. $1,130.64
    b. $1,058.21
    c. $1,076.19
    d. $920.51

37. Mary Jo recently bought a townhouse in a new development in town. When she went to the bank to apply for a mortgage, she found out that the bank had recently introduced biweekly mortgages. She thought that sounded interesting, so she asked what the payment would be on such a mortgage for $180,000 at 6% interest with a 30-year amortization. What will the biweekly payment be?
    a. $497.85
    b. $549.36

c. $1,079.19
d. $539.60

38. Gina has just finished her first year in the real estate brokerage business. She has sold $3,750,000 worth of real estate. Her broker told her at the beginning of the year that she would get 50% of the commission on her first $1,500,000 in real estate sales and 60% on all sales thereafter. If her sales were at an average commission rate of 3% of the sale prices, how much did Gina make in her first year?
a. $63,000
b. $56,250
c. $67.500
d. $112,500

39. Which of the following is not an equation?
a. $100 = 4 \times 25$
b. $100 = 1{,}000 \div 10$
c. $100 = 1{,}010 - 10$
d. $100 = 90 + 10$

40. Your cousin Kara recently purchased a home for $179,500. The lot is worth $36,000 according to the appraiser. The lot size is 75 feet × 150 feet. What is the square footage of the lot?
a. 75 square feet
b. 11,250 square feet
c. 150 square feet
d. 15.96 square feet

41. Laura is paying her broker a 7% commission to sell her house. How would you express Laura's expected net proceeds after her commission is paid?
a. Sale price × (1 + 0.07)
b. Sale price/(1 + 0.07)
c. Sale price × (1 − 0.07)
d. Sale price/(1 − 0.07)

42. Sharon purchased a new home for the price of $322,500 and took out a 25-year 6.5% interest rate mortgage for $258,000 to finance the purchase. She will have to pay loan costs that total $5,000 to take out the mortgage. What is the APR that the lender will have to disclose to Sharon at the closing?

a. 6.71%
b. 6.675%
c. 6.75%
d. 6.875%

43. What is the loan-to-value ratio of the mortgage in question 42?
a. 60%
b. 75%
c. 80%
d. 90%

44. Equity is equal to _____ – mortgage balance.
a. Principal balance
b. Market value
c. Down payment
d. Total interest

45. The mortgage you took out this morning to purchase a new home required you to make a down payment of $45,000. If you took out an 80% loan-to-value mortgage, what was the purchase price of your home?
a. $56,250
b. $180,000
c. $450,000
d. $225,000

46. What was the amount of your mortgage in question 45?
a. $56,250
b. $180,000
c. $450,000
d. $225,000

47. The type of mortgage that starts at a certain rate of interest but can have the interest rate and the payments increase at different points in time is referred to as:
a. A shared appreciation mortgage
b. An adjustable rate mortgage
c. A constant payment mortgage
d. A reverse annuity mortgage

48. Your sister purchased a home five years ago for the price of $199,500. Today the assessor told her that the property was worth $254,618. What has been her annual compound rate of appreciation on the home?

a. 3%
b. 4%
c. 5%
d. 6%

49. When Kent took out his shared appreciation mortgage, the bank reduced his interest rate by 25% in exchange for 25% of the appreciation that would take place over the next five years. If Kent paid $275,500 for the home and after five years its value has increased to $325,000, how much must Kent pay to the lender to meet the terms of the mortgage?
a. $49,500
b. $12,500
c. $12,225
d. $12,375

50. If the market rate of interest when the loan was originated in question 49 was 12% and the mortgage had a loan-to-value ratio of 80% amortized over 30 years, what was Kent's monthly payment during the first year of the loan?
a. $1,773.39
b. $2,267.06
c. $1,617.22
d. $2,615.02

51. Kristi's mortgage was originated five years ago for $176,600 to be amortized over 30 years at 5.75% interest. If Kristi makes regular payments on the loan until it is satisfied, how much total interest will Kristi pay on the loan?
a. $176,600
b. $371,012
c. $304,635
d. $194,412

52. Given the mortgage in question 51, what portion of payment number 3 is principal?
a. $1,030.59
b. $844.44
c. $186.15
d. $195.16

53. Given the mortgage in question 51, how much principal will Kristi pay over the life of the loan?

a. $176,600
b. $371,012
c. $304,635
d. $194,412

54. If you take out a mortgage for $217,900 amortized over 25 years at a 6% rate of interest and the lender charges you 2 points plus a 1% origination fee, what is the lender's effective rate of return?
a. 6.25%
b. 6.375%
c. 6.32%
d. 6.5%

55. What is the APR that must be disclosed to the borrower in the mortgage described in question 54?
a. 6.25%
b. 6.375%
c. 6.32%
d. 6.5%

56. In the cost approach to determining value, the depreciated cost of the improvements is added to the value of the _____ in order to obtain the value estimate.
a. The total construction cost of the improvements
b. The historical construction cost of the improvements
c. The depreciated cost of the improvements
d. The cost of the land

57. Betty is appraising a 2,000-square-foot colonial style house that has four bedrooms. One of the comparables that Betty chose to use in her sales comparison approach was another colonial with similar square footage, four bedrooms. The property was otherwise very similar to the subject property, but it had a swimming pool in the backyard, and the subject did not have a pool. The comparable sold for $245,000, and the appraiser thinks the market value of the pool is about $25,000. What is the indicated value of the subject property?
a. $245,000
b. $270,000
c. $220,000
d. $232,500

58. Ben, your boss at the appraisal firm, has just given you an assignment to appraise a single-family home, and he wants you to use the gross rent multiplier to get its value. The subject should bring in about $1,450 per month if it were to be rented out. The very best comparable you can find was rented for $1,350 when it sold earlier this month for a price of $165,000. What is the indicated value of the subject property using the GRM form of the income approach and the given comparable?
    a. $122.22
    b. $177,219
    c. $164,900
    d. $153,620

59. Which of the following is critical in the value estimate using the income approach and IRV?
    a. Net investment income
    b. Investment value
    c. Discount rate
    d. Capitalization rate

60. The appraiser is going to use the band of investment method of estimating a cap rate. He is going to use the mortgage constant for a 75% loan-to-value mortgage amortized for 25 years at a 6% interest rate and a required return on equity for the investor of 13%. What is the annual mortgage constant that should be used in the formula for estimating the cap rate?
    a. 0.0064
    b. 0.0325
    c. 0.0773
    d. 0.0880

61. The potential gross income minus the vacancy and rent loss allowance is called what?
    a. NOI
    b. PGI
    c. BTCF
    d. EGI

62. The amount of cash flow that the investor earns in a year after all operating expenses, debt service, and income taxes have been paid is called what?
    a. NOI
    b. BTCF

c. ATCF
d. IOU

63. Amanda has invested $150,000 in a small office building, and it is generating after-tax cash flows of $5,000 in year 1, $6,000 in year 2, $7,000 in year 3, $8,000 in year 4, and $9,000 in year 5 plus a $225,000 reversion, or sale price, at the end of year 5. Given Amanda's required rate of return of 10%, what is the net present value of the cash flows of the building?
a. $14,523
b. $15,523
c. $16,523
d. $17,523

64. You are analyzing a potential investment in an office building, and you notice that the before-tax cash flow is positive. What does that tell you about the debt coverage ratio?
a. It is greater than 1
b. It is less than 1
c. It is equal to 1
d. Nothing

65. If the one-year spot rate for treasuries is 4.5% and the two-year spot rate is 4.25%, what is the indicated forward rate from the end of period one to the end of period two?
a. 4.75%
b. 4.25%
c. 4.0%
d. 3.75%

66. An investment opportunity has three potential outcomes. It could earn a return of 22% if the economy does really well, and you think there is a 25% probability of that happening. If the economy is just average, the return should be 15%, and the probability of that is 40%. If the economy does very poorly, you will earn only a 4% return, and there is a 35% probability of that taking place. What is your expected return?
a. 11.5%
b. 12.9%
c. 13.3%
d. 10.5%

67. Given the expected return you calculated from the information in question 66, what is the standard deviation of the returns from the same question?

a. 4.5%
b. 5.2%
c. 6.3%
d. 7.1%

68. You were talking about this book around the office, and your boss suggested that you help her solve a problem she had been working on. A property your company is considering investing in has an IRR of 18%. The cash flows from operations have a present value of $425,000, and the cash flow from the sale of the property will be $975,000. What percentage of the IRR comes from operations, and what percentage comes from the sale?
a. 30.3% from the sale and 69.7% from operations
b. 43.6% from the sale and 56.4% from operations
c. 69.7% from the sale and 30.3% from operations
d. 56.4% from the sale and 43.6% from operations

69. Fred purchased a small office building that has a potential gross income of $145,500, a 6% vacancy rate, and net income of $24,700. What are the operating expenses in year 1?
a. $115,800
b. $112,070
c. $151,800
d. $121,070

70. Blair just took a listing on a 4,000-square-foot retail building and is putting together a cash flow analysis. The lease states that the store has a base rent of $8 per square foot and a percentage rent of 4% of annual sales revenue. If the store has sales revenue of $1 million, what is the total rent for the next year?
a. $32,000
b. $52,000
c. $72,000
d. $92,000

71. Lauren's company is looking for new office space. She is looking at a building that is in a good location for her needs, and the lease terms include rent for the first five years of $10.50, $10.50, $12.00, $13.75, and $14.25, respectively, per square foot. What is the average rent per square foot per year?
a. $10.50
b. $11.40

c. $13.10
d. $12.20

72. What is the effective rent on the building that Lauren is considering in question 71, given a 10% discount rate?
a. $45.48
b. $12.00
c. $12.20
d. $10.50

73. How much overage rent is there in the lease in question 70?
a. All of it
b. $40,000
c. $32,000
d. $72,000

74. You are measuring a home for a listing, and the main body of the house is a rectangle that is 35 feet × 45 feet, and there is a year-round porch off the back that is 10 feet × 14 feet. What is the square footage of the main floor?
a. 1,575 square feet
b. 140 square feet
c. 1,435 square feet
d. 1,715 square feet

75. The state deed transfer tax rate in your state is $3.30 per $1,000 of sale price, and you just closed on the purchase of your first home, for which you paid $265,900. You paid $53,180 in cash and the balance with a 30-year mortgage at 6%. What amount of state deed tax did you pay at closing?
a. $701.90
b. $175.56
c. $877.47
d. $656.27

Glossary

accelerated depreciation Depreciation in excess of straight line depreciation for tax purposes, not currently allowed for real property.

accrued expense An expense that has been earned, but not fully used up.

acquisition cost The same as the purchase price of property.

acre A unit of measure of land made up of 43,560 square feet.

adjustable rate mortgage (ARM) A mortgage that has an interest rate that is adjusted to the market rate of interest periodically. It shifts some of the interest rate risk to the borrower.

adjusted basis A term in investment property that refers to acquisition cost minus any depreciation that has been taken.

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adjustment interval The time period between interest rate adjustments in an ARM.

after-tax cash flow (ATCF) Either the cash flow from operations or the cash flow from the sale of a building. It is the amount of the cash flow available to the investor after paying all expenses and all taxes.

amortization schedule A breakdown and summary of the principal and interest payments on a mortgage as well as the principal balance over time.

annual compounding One of the compounding periods over which time value of money calculations can be calculated. Others include quarterly, monthly, and daily compounding.

annual percentage rate (APR) The effective cost of money to the borrower after all loan fees and interest paid to the lender have been accounted for.

annuity A series of equal payments that comes at regular intervals.

annuity due An annuity in which the payments come at the beginning of a period.

appraisal An informed estimate or opinion of value. It is also the process of valuing property.

appreciation The increase in property value resulting from inflation in the market.

area The surface size of a plane, it can be in square feet, square inches, or acres.

baseline The horizontal line from which government rectangular survey legal descriptions are measured; similar in concept to the lines of latitude.

before-tax cash flow (BTCF) The cash flow available to the investor after paying operating expenses and debt service, but before settling taxes.

beneficial financing Mortgage or contract for deed financing that has an interest rate that is lower than the current mortgage interest rate. It could be a below-market rate contract for deed or a below-market interest rate mortgage assumption.

biweekly mortgage Rather than having monthly mortgage payments, biweekly mortgages have payments due every two weeks.

breakeven occupancy The percentage of occupancy needed in an investment property so that there is sufficient income to cover just the mortgage payments and the operating expenses.

capital gain A gain on one's capital investment. In the case of investment property it comes from a combination of property value appreciation and depreciation taken for tax purposes.

capital gain tax rate The tax rate that applies to capital gain income. Current tax law applies a 15% rate to gains coming from appreciation and 25% to gains in excess of appreciation.

capitalization rate The rate that is divided into the net income of a piece of property. It results in a value estimate in the income approach to appraisal.

cash equivalency The process of adjusting a comparable sale for the presence of below-market-rate financing in the appraisal process.

cash flow from sale The one-time cash flow from the sale of property which comes at the end of the holding period.

cash flows from operations Cash flows that come each year of a real estate investment from the operations of the building. They are assumed to come at the end of the year.

closing A gathering of interested parties at which the promises made in the purchase agreement are executed.

closing agent The person who conducts the proceedings of the closing and calculates the closing statements.

closing statement The document that sorts out the expenses and prepayments associated with a real estate transaction.

coefficient of variation A statistical measure that puts the standard deviation, or variation in cash flows, in a per unit of rate of return format. It is a measure of risk.

commission The form of compensation that a broker or salesperson receives in exchange for the service provided to buyers and sellers. It is typically a percentage of the sale or exchange price of a piece of property.

common denominator To facilitate the addition or subtraction of fractions, a common denominator is required. It is most easily established by multiplying the two denominators together.

composite rate In an ARM this is the combined value of the index rate and the margin.

compound growth rate A rate of increase per year or per month that, when multiplied by a beginning value, will yield a new value. The value increases at a greater rate than a nominal rate because of the interest that is earned on both the beginning value and the interest that is earned on the previously earned interest.

compound interest See *compound growth rate*.

contract for deed A sales and financing agreement in which the buyer of property makes payments directly to the seller with no lending institution involved. In some states this is called a *land contract*.

contract rate The contract rate of interest is the rate that is stated in the contract. The contract may be a contract for deed, or it may be a mortgage contract.

cost approach One of the three approaches for determining value in a real estate appraisal.

credits The values in a closing statement that are either prepaid and the payer wants credit for having paid them or is money that is coming to either the buyer or the seller.

debits Values in a closing statement that the person being debited owes or is responsible for paying.

debt coverage ratio (DCR) Gives an indication of how much cushion there is in NOI over and above the debt service. Lenders typically want a DCR of 1.2 or greater.

decimal equivalent This is achieved by dividing the numerator into the denominator in a fraction, or by shifting the decimal point two places to the left in

a percentage. The decimal equivalent of 1/2 is 0.5, and the decimal equivalent of 25% is 0.25.

default risk The risk that the borrower may default on loan payments prior to the debt being satisfied.

depreciation There are two types of depreciation, one that is used in appraisal and one that is used for investment property. In appraisal it is a loss in value resulting from any cause. In investment property it is the theoretical wearing out of the property over time. It reduces an investor's taxable income. Currently straight line depreciation is used. The useful life for residential property is 27.5 years, and for commercial property it is 39 years.

discount points One discount point is equal to 1% of the mortgage amount. Discount points are cash paid at the time of closing, and their impact is that they increase the yield to the lender.

discount rate The rate used to calculate a present value. The higher the discount rate, the lower the present value.

discounted cash flow (DCF) A form of the income approach used by an appraiser to estimate the value of income-producing property. The value is equal to the present value of the property's NOI plus the present value of the reversion. Both types of cash flows are discounted over the projected holding period.

effective gross income (EGI) The amount equal to the potential gross income minus the vacancy and rent loss allowance in the cash flow analysis of investment property.

effective rate of interest The rate that the borrower is paying once all loan fees have been factored into the cost.

equation States a relationship between numbers or values using an equal sign. The values on each side of the equal sign are equivalent to each other.

equity The market value of a property minus the mortgage balance.

equity-to-value ratio One minus the loan-to-value ratio. If the loan-to-value ratio is 80%, then the equity-to-value ratio is 20%. This ratio is used in the band of investment method of estimating a capitalization rate.

expected return The weighted average return on an investment using the probability of different market conditions taking place.

financial calculator A calculator programmed to make time value of money calculations given financial inputs. Those inputs can be present value, future value, payment, term, and interest rate.

fixed-rate mortgage A mortgage that has the same interest rate over the entire term of the mortgage.

floors In an adjustable rate mortgage, the lowest interest rate level that the loan could have.

forward rate An interest rate that may be changed in the future, such as the one-year rate in effect from the end of period one to the end of period two, or the end of period two to the end of period three.

fraction A part of a whole. The denominator states how many parts are in the whole, and the numerator states how many of those parts we are dealing with. The fraction 1/4 says we are looking at a whole with four parts, but we are dealing with only one of those parts.

functional obsolescence A form of appraisal depreciation that can result from a poor floor plan, from a feature that no longer serves the same purpose it once did, or from a feature that is no long desired in the marketplace, such as a shag carpet or an oil-fired furnace.

future value (FV) One of the inputs in a time value of money calculation. It is the value of an amount of money at some point in the future.

government survey system A form of legal description that describes land using a grid system of principal meridians and baselines. Land is divided into townships and sections.

gross lease A lease in which the rent that is paid is the gross amount to the landlord, and the landlord is responsible for paying the operating expenses out of that rent.

gross rent multiplier (GRM) A form of the income approach in which the GRM is extracted from a comparable sale by taking the sale price and dividing it by

the gross rent. The rent is usually monthly in the case of single-family residential property and annual rent for other property types.

growth rate The rate at which cash flow items, such as rents or operating expenses, are growing.

highest and best use Referring to a parcel of land, the most economically profitable way to use the property or the use that generates the highest dollar return for the land.

holding period The period of time that an investor expects to hold, or own, a piece of property.

improvements Improvements to land include buildings, access, and utilities.

income approach One of three approaches to determining property value. The other two are the sales comparison approach and the cost approach.

income capitalization One form of the income approach. It makes use of the IRV formula, in that V = I/R. This says that the value of the property is equal to the property's NOI divided by the capitalization rate.

index An interest rate series against which the interest rate on a mortgage is measured.

inflation premium A premium built into interest rates because investors want to be compensated for any inflation in the cost of goods and services that takes place while their investment is outstanding.

interest rate risk The risk long-term lenders take that the market rates of interest will go up and that they will be locked into the lower rate. The increase in market rates will have a negative impact on the value of the mortgage.

investment property Property that is used in a trade or business or held for the production of income.

IRV (income rate value) The appraisal method that is often used in the income approach. It spawns two equations, I/V = R and I/R = V, where I = NOI, R = cap rate, and V = value.

land The earth's surface, everything above the earth's surface and everything below the earth's surface to the center of the earth. Air rights are limited to 1,000 feet in an urban area and 500 feet in a rural area.

lease A contract between the landlord and the tenant in which the landlord conveys to the tenant the right of possession of a piece of property.

legal description A precise method of describing a parcel of land that would be upheld in a court of law.

loan-to-value ratio The mortgage amount divided by the property value.

locational (economic) obsolescence The loss in value that results simply from the location of a property. If a major employer in a small town were to close and many people had to put their homes on the market at the same time, they would all lose value due to locational, or economic, obsolescence.

lot and block A form of legal description used in urban areas, sometimes referred to as a subdivision plat.

lot size The surface area of the lot typically stated in square feet.

margin Used in an ARM and added to the index to get the composite rate, or the new interest rate, on the mortgage.

marginal tax rate (MTR) The tax rate on the next dollar earned by an investor.

market value The price of a property that a reasonable buyer would be willing to pay and a reasonable seller would be willing to accept.

measurement and boundaries See *metes and bounds*.

metes and bounds A form of legal description in which a parcel of land's entire perimeter is detailed starting at a point of beginning. This point is referenced to some monument, which may be as precise as a surveyor's monument placed in the earth's surface or something as imprecise as a old oak tree or a large block of granite.

mixed number A number containing both a whole number and a fraction.

monthly compounding Uses the interest rate on a monthly basis and in a time value of money problem.

monument See *metes and bounds*.

mortgage A loan secured from a lender that uses property as security for the debt. The borrower will typically make payments over a 20-, 25-, or 30-year period.

mortgage balance The unpaid principal amount on a loan.

mortgage constant The payment necessary to repay the debt of one dollar over time. It is calculated just like a mortgage payment, only rather than using the mortgage amount as the present value, you use 1 as the present value. It is used in the band of investment method of estimating a capitalization rate.

mortgage registration tax The tax charged by the state to register a new mortgage document.

negative amortization Results from a payment that is not sufficient to cover the interest due on a mortgage. The unpaid interest gets added on to the principal balance.

net lease Provides the net amount to the landlord so any operating expenses will be paid by the tenant.

net operating income (NOI) The the income available to the investor after both vacancy and operating expenses have been deducted. It is the income that an appraiser is going to value.

net present value (NPV) The difference between the present value of the cash inflows and the present value of the cash outflows.

net proceeds The net amount that the borrower receives after any loan fees are deducted from the total loan amount.

nominal rate The same as the stated rate or the contract rate.

operating expense ratio Calculated by taking the operating expenses divided by the effective gross income as a cash flow analysis.

operating expenses The expenses needed to operate a building for one year.

ordinary annuity An annuity in which the payments come at the end of the period.

origination fee A fee paid by the borrower to the lender to cover the paperwork costs associated with the loan application. It has the effect of increasing the effective rate on the loan.

part, percent, whole Explains the relationship between these three elements algebraically. The following equations are inferred; part/whole = %, part/% = whole, and % × whole = part.

partially amortized loan A loan that is not fully paid off with the monthly payments, but currently has a principal balance yet to be paid.

payment cap In an ARM a payment cap would establish an upper limit beyond which the monthly payment could not go. The impact on the loan may be negative amortization.

payment to amortize In a TVM problem the payment to amortize would be the payment needed to repay a debt over time. The payment is made up of both principal and interest.

percentage Refers to a whole that is divided into 100 parts, and we are just referring to a portion of those parts. Example: 25%—the whole has 100 parts, and we are looking at 25 of them.

percentage rent Often charged in a retail lease and refers to a percentage of sales a store makes that would be paid to the landlord as part of the rent.

physical deterioration A form of appraisal depreciation that refers to the chipped paint and cracked plaster on a property.

point of beginning In a metes and bounds legal description, this is the point where the description of the perimeter of the parcel of land begins and ends.

points See *discount points*.

potential gross income (PGI) The amount of income that the investment property could generate given two assumptions: The building is occupied 100% of the time, and tenants always pay their rent.

prepaid expense An expense that has already been paid but the good or service has not been fully used up. Prepaid expenses appear on transaction closing statements.

prepaid interest A term sometimes applied to the concept of discount points.

present value (PV) One of the variables in a time value of money calculation. It refers to the value of an amount of money today at time period zero.

principal balance The unpaid principal amount on a loan at a point in time. The initial principal balance is the amount borrowed. The principal balance at any point in time is equal to the present value of the remaining payments.

principal meridian The north/south line in the government survey system.

principal plus interest (P+I) The payment to amortize is made up of principal plus interest. A mortgage payment is an example of a principal plus interest payment.

principal reduction Every time a mortgage payment is made, the principal portion of the payment goes to reducing the principal balance. This is principal reduction.

prorated items Expenses that are split between the buyer and the seller in a closing statement.

quarter section The government survey system divides land into sections, which contain 640 acres of land. A quarter section contains $640 \times 1/4 = 160$ acres.

real estate Land plus improvements.

real property Refers to the rights of ownership, sometimes called the bundle of rights, which include the right to use and enjoy, the right to possess, the right to mortgage, the right to lease, and the right to convey.

real rate of return The market rate of interest on a risk-free security minus the expected rate of inflation. It represents the compensation that investors require for just not having their money.

reconciliation The process of converting three value estimates to a single value estimate in an appraisal. It is usually a weighted average calculation.

rectangle A geometric shape with four sides, 90-degree angles at the corners, and two parallel sides that are longer than the other two parallel sides.

rectangular survey system See *government survey system*.

replacement cost In the cost approach of the appraisal process the replacement costs are the construction costs associated with replacing the building with one of similar size and similar utility.

reproduction cost In the cost approach of the appraisal process the reproduction costs are the construction costs associated with replacing the building with one that is exactly the way the first building is today.

return on equity (ROE) Sometimes called the cash-on-cash return or the cash return on the cash investment. ROE is the before-tax cash flow divided by the equity investment.

return on investment (ROI) The return on the investor's total investment and equal to the NOI divided by the investment, or purchase price.

reverse annuity mortgage (RAM) A mortgage arrangement that allows the borrower to convert equity into a cash flow stream. Designed for retirees, it provides a series of payments from the lender to the borrower.

reversion Refers to the sale price of a real estate investment at the end of the projected holding period.

risk The probability of achieving an undesired outcome or the variability of returns.

sales comparison approach One of the three approaches for determining value in the appraisal process. The subject property is compared to similar properties that have already been sold to estimate the subject's value.

scientific notation A method of stating a number in relation to a power of 10. The number 2,000 would be 20×10^2.

section In the government survey system, consists of 640 acres. There are 36 sections in a township.

shared appreciation mortgage (SAM) The borrower gives up part of the equity over a period of years in exchange for an interest rate reduction at the outset of the loan.

sinking fund payment One of the time value of money calculations, it is the payment needed to accumulate some amount of money in the future.

spot rate An interest rate that could be obtained today for a one-year, two-year, three-year loan or investment.

standard deviation A statistical measure of risk. Approximately 68% of the observations should be within 1 standard deviation of the expected value in a normal distribution.

state deed tax Tax levied against grantees when they record the deed to their property.

straight line depreciation The same amount of depreciation expense each year. Simply divide the value of the improvements by the useful life.

subdivision plat See *lot and block*.

teaser rate The interest rate for the first year of an ARM. Generally a little lower than the rate on a fixed-rate mortgage in order to tease, or attract, borrowers.

term Referring to a mortgage, the period of time over which the payments will be made.

time value of money (TVM) The concept that money has differing values over time. The variables used in TVM calculations are present value, future value, number of periods, interest rate or discount rate, and payment.

title insurance Protects a buyer from undisclosed title defects that may arise.

township The government survey system divides land into six-mile by six-mile parcels of land called townships. These are divided into 36 one-square-mile sections.

township and range system See *government survey system*.

trapezoid A four-sided object with two parallel sides.

vacancy rate The percentage of units in the building that are not occupied.

volume The amount of interior space within a fully enclosed cube, box, or cylinder.

yield curve The graphical representation of the relationship between interest rates and time. The yield curve can either be in its normal position, in its inverted position, or it may be flat, in which case the one-year rate, two-year rate, three-year rate, and so on are all equal.

Quiz Answers

Chapter 1

1. c. $75 \times 150 = 11{,}250$ square feet
2. a. $20 \times 20 = 400$ square feet
3. d. $22 \times 24 \times 8 = 4{,}224$ cubic feet
4. b. $7 + 6 - 4 = 9$
5. c. $(50 + 80) \times 1/2 \times 100 = 6{,}500$ square feet
6. b. $(15 \times 15) \times 3.14 = 706.5$ square feet
7. c. $(14 \times 14) \times 3.14 \times 30 = 18{,}463.2$ cubic feet
8. a. $(30 \times 40) + (10 \times 10) = 1{,}200 + 100 = 1{,}300$ square feet
9. c. $30 + 30 + 10 + 10 + 40 + 40 = 166$ feet
10. d. $80 \times 165 = 13{,}200$; \$65,000 ÷ 13,200 = \$4.92; \$65,000 ÷ 80 = \$812.50

Chapter 2

1. $4/4 = 1$, $4/3 = 1\ 1/3$, $4/5$, $5/8$, $16/12 = 1\ 4/12 = 1\ 1/3$, $7/6 = 1\ 1/6$
2. $2/4 = 1/2$, $1/6$, $3/28$, $1/8$

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3. $3/16$, $4/9$, $3/32$, $5/12$
4. $12/4 = 3$, $6/6 = 1$, $5/15 = 1/3$, $12/8 = 1\ 4/8 = 1\ 1/2$, $15/4 = 3\ 3/4$, $6/8 = 3/4$
5. 0.75, 0.67, 0.20, 1.5, 2.25, 4.75
6. 75%, 67%, 20%, 150%, 225%, 475%
7. b. 142375/167750 = 0.85 = 85% L/V; 1 − 0.85 = 0.15 = 15% down payment
8. c. 167750 − 142375 = 25375
9. b. 220000 − 206800 = 13200/220000 = 0.06 = 6% or 206800/220000 = 0.94 and 1 − 0.94 = 0.06 = 6%
10. d. 220000 − 215686 = 4314/220000 = 0.02 = 2% or 220000/215686 = 1.02 − 1 = 0.02 = 2%

Chapter 3

1. b. \$475,000 × 0.06 = \$28,500
2. c. \$475,000 − \$28,500 = \$446,500
3. c. \$225,000 × 0.07 = \$15,750 v 0.50 = \$7,875 × 0.50 = \$3,937.50
4. a. \$195,000 × 0.06 = \$11,700.60 = \$7,020
5. d. \$500,000 × 0.06 = \$30,000; \$500,000 × 0.04 = \$20,000; \$500,000 × 0.02 = \$10,000; \$30,000 + \$20,000 + \$10,000 = \$60,000
6. c. \$60,000/\$1,500,000 = 0.04 = 4%
7. b. \$171,000 − \$164,500 = \$6,500/\$164,500 = 0.04 = 4%, or \$171,000/\$164,500 = 1.04 − 1 = 0.04 = 4%
8. b. \$179,700 − \$164,500 = \$15,200/\$164,500 = 0.092/2 = 0.046 = 4.6%
9. d. \$144,000/(1 − 0.05) = \$144,000/0.95 = \$151,578
10. a. \$175,000/(1 − 0.055) = \$175,000/0.945 = \$185,185

Chapter 4

1. d. 70.41 × 100 = 7,041
2. b. \$35,000/7041 = \$4.97, \$35,000/6500 = \$5.38, \$35,000/7500 = \$4.67, \$35,000/7000 = \$5.00
3. c. 22
4. d. $640 \times 1/4 \times 1/4 \times 1/4 = 10$
5. b. $640 \times 1/4 \times 1/4 = 40$, $640 \times 1/4 \times 1/4 = 80$, $40 + 80 = 120$
6. a.
7. c. 640 × 4 = 2,560 acres
8. d. 2,560 × \$2,000 = \$5,120,000 × 0.60 = \$3,072,000
9. b. 100 × 100 = 10, 000, (60 × 20) × 1/2 = 600, 10, 000 + 600 + 600 = 11, 200 square feet.
10. a. 15

Chapter 5

1. a.
2. c.
3. b.
4. c. \$138,000 ÷ 1,000 = 138; 138 × \$2.30 = \$317.40
5. b. \$140,000 ÷ 1,000 = 140; 140 × \$3.30 = \$462.00
6. b. \$8,500,000 ÷ \$365,000,000 = 0.023 = 2.3%
7. b. \$163,000 × 0.0233 = \$3,797
8. b. \$325,000 × 0.01 = 3,250; 3,250 × 1.02268 = 3,323.71
9. c. \$325,000 − \$76,000 = \$249,000; \$249,000 × 0.0009 = 224.10; 304 − 224.10 = 79.90
10. d.

Chapter 6

1. c. −10000 [PV], 3 [n], 5.5 [i/y], [cpt] [FV] 11,742.41
2. b. −150 [pmt], 20 × 12 = [n], 8/12 = [i/y], [cpt] [FV] 88,353.06
3. d. 75,000 [FV], 12 [n], 10 [i/y], [cpt] [pmt] 3,507.25
4. c. −1,000 [pmt], 25 [n], 8 [i/y], [cpt] [PV] 10,674.78
5. b. 35,000 [PV], 15 [n], 4 [i/y], [cpt] [FV] 63,033.02
6. a. 95,000 [PV], 30 × 12 = [n], 6/12 = [i/y], [cpt] [pmt] 569.57
7. b. 95,000 [PV], 30 × 12 = [n], 6/12 = [i/y], [cpt] [pmt] 569.57, [rcl] [n] − 120 = [n] [cpt] [PV] 79,501.44
8. a. −659 [pmt], 7/12 = [i/y], 240 [n], [cpt] [PV] 84,999.47
9. c. 45,000 [FV], 5 [n], 8 [i/y], [cpt] [PV] 30,626.24
10. d. −5,000 [pmt], 4 [n], 5 [i/y], [cpt] [PV] 17,729.75

Chapter 7

1. c. 150,000 [PV], 360 [n], 6.5/12 = [i/y], [cpt] [pmt] 948.10
2. b. 150,000 [PV], 360 [n], 6.5/12 = [i/y], [cpt] [pmt] [rcl] [n] − 60 = [n] [cpt] [PV] 140,416.47
3. d. 170,000 [PV], 300 [n], 7/12 = [i/y], [cpt] [pmt] 1,201.52 [rcl] [PV] 170,000 × 0.96 = 163,200 [PV] [cpt] [i/y] 0.62 × 12 = 7.46
4. a. 170,000 [PV], 300 [n], 7/12 = [i/y], [cpt] [pmt] 1,201.52 [rcl] [n] − 60 = [n] [cpt] [PV] 154,975.66; [2nd] [CLR TVM], 154,975.66 [FV] 1,201.52 [pmt] − 163,200 [PV] 60 [n] [cpt] [i/y] 0.67 × 12 = 8.01
5. b. 145,000 [PV], 360 [n], 7.5/12 = [i/y], [cpt] [pmt] 1,013.86 [rcl] [PV] × 0.98 = [PV] [cpt] [i/y] 0.64 × 12 = 7.71
6. b. 130,000/162,500 = 0.80 = 80%
7. a. 864.89, b. 125,745.05, c. 172,446.30, d. 46,701.25

8. b. 215,000 [PV], 360 [n], 6/12 = [i/y], [cpt] [pmt] 1,289.03; [rcl] [n] − 60 = [n] [cpt] [PV] 200,066.87; [2nd] [CLR TVM] 200,066.87 [FV], 1,289.03 [pmt], −215,000 × 0.985 = −211,775 [PV], 60 [n], [cpt] [i/y] 0.53 × 12 = 6.36
9. d. 195,000 × 0.75 = 146,250 [PV], 25 × 12 = 300 [n], 6.25/12 = [i/y], [cpt] [pmt] 964.77, [rcl] [n] − 36 = [n] [cpt] [PV] 138,232.96
10. d. 220,000 × 0.75 = 165,000 [FV], 15 × 12 = [n], 7.25/12 = [i/y], [cpt] [pmt] 509.35

Chapter 8

1. c. 225,000/162,00 = 1.381; 1.381 − 1 = 0.381 = 38.1%
2. d. 185,000 × (1 − 0.15) = 185,000 × 0.85 = 157,250
3. b. −194,500 [PV], 6 [n], 3 [i/y], [cpt] [FV] 232,243.17
4. a. (345,000 − 70,000)/39 = 275,000/39 = 7,051.28
5. c. (220,000 − 44,000)/27.5 = 176,000/27.5 = 6,400
6. a. −122,000 [PV], 455,000 [FV], 19 [n], [cpt] [i/y] 7.27
7. a. 163,500/137,900 = (1.186 −1)/4 = 0.186/4 = 0.046 = 4.6%
8. d. 133,000/(1 − 0.15) = 133,000/0.85 = 156,470.59
9. c. 175,000/123,900 = 1.412; 1.412 − 1 = 0.412 = 41.2%
10. a. 245,000 [PV], 5 [n], 4 [i/y], [cpt] [FV] 298,079.96

Chapter 9

1. d
2. d
3. d
4. a
5. c
6. a
7. a
8. a
9. c
10. a

Chapter 10

1. c. 1,200 × $65.75 = $78,900 × (1 − 0.19) = $78,900 × 0.81 = $63,909
2. b. $55 × 250 = $13,750; $145,000 − $13,570 = $131,250
3. a. $162,500/$1,500 = 108.33; 108.33 × $1,400 = $151,667

4. d. 179,000/1,650 = 108.79 × 0.50 = 54.44; 149,750/1300 = 115.19 × 0.15 = 17.28; 187500/1,700 = 110.29 × 0.35 = 38.6; 54.44 + 17.28 + 38.6 = 110.12
5.

PGI	$154,800
–Vacancies	–$10,836
EGI	$143,964
–Operating expenses	–$57,600
NOI	$86,364

6. c. 4,000 × $12,50 = $50,000 × (1 − 0.09) = $50,000 × 0.91 = $45,500 − $17,300 = $28,200
7. a. 33,300/370,000 = 0.09; 24,000/300,000 = 0.08; 23,100/280,000 = 0.083; 0.09 × 0.45 = 0.041; 0.08 × 0.35 = 0.028; 0.083 × 0.20 = 0.017; 0.041 + 0.028 + 0.017 = 0.086
8. d. R = (0.80 × 0.0758) + (0.20 × 0.16) = 0.0607 + 0.032 = 0.0927 = 9.27%
9.

PGI	$124,800
–Vacancies	–$9,984
EGI	$114,816
–Operating expenses	–$44,800
NOI	$70,016
–DS	–$45,830
BTCF	$24,185

755,300 × 0.80 = 604,240 [PV]

360 [n]

6.5/12 = [i/y]

[cpt] [pmt] 3,819.21 × 12 = 45,830

10. c. [CF] 0 [enter]

[↓] 5,000 [enter][↓]

[↓] 5,500 [enter][↓]

[↓] 5,575 [enter][↓]

[↓] 6,120 [enter][↓]

[↓] 101,150 [enter][↓]

[↓][NPV] I = 1 [enter] [↓]

NPV = [cpt] 77,103.86

Chapter 11

1. c. [(6 × $800) + (6 × $950) + (6 × $1,100)] × 12 = $205,200
2. a. $119,940/$99,058 = 1.211

3. c. \$75,000/\$194,940 = 0.385 = 38.5%
4. b. (\$99,058 + \$75,000)/\$205,200 = 0.848 = 84.8%
5. b. \$43,636 × 27.5 = \$1,199,990
6. b.
7. d. \$104,335/\$1,738,911 = 0.06 = 6%
8. b. −1,500,000 [PV], 1,738,911 [FV], 5 [n], [cpt] [i/y] 3.0
9. b. 20,882 + 3,740 = 24,622
10. c. [CF] 150,000 [+/−] [enter] [↓]
    10000 [enter] [↓][↓]
    20000 [enter] [↓][↓]
    185000 [enter] [↓][↓]
    [IRR] [cpt] 13.73

Chapter 12

1. c. 4.6% − 1% = 3.6% E(inflation); 6.1% − 1% − 3.6% = 2% Default premium
2. d. 1,500,000 [PV], 300 [n], 7/12 = [i/y], [cpt] [pmt] 10,601.69 7/5/12 = [i/y] [cpt] [PV] 1,434,616
3. b. 14,000 [PV], 360 [n], 6.25/12 = [i/y], [cpt] [pmt] 862.00, [rcl] [n] − 12 = [n] [cpt] [PV] 138,359.49 6.5/12 = [i/y] [cpt] [pmt] 884.41
4. a. 1 [PV], 7/12 = [i/y], 360 [n], [cpt] [pmt] 0.0067 × 12 = 0.0798 = MC; R = (L/V × MC) + (E/V × ROE); R = (0.75 × 0.0798) + (0.25 × 0.14) = 0.0949
5. b. 0.20(10) + 0.30(14) + 0.30(16) + 0.20(20) = 15.0%
6. a. $(10 - 14.6)^2\ 0.20 + (14 - 14.6)^2\ 0.30 + (16 - 14.6)^2\ 0.30 + (18 - 14.6)^2\ 0.20 = 8.61$
7. d. $\sqrt{8.61} = 2.93$
8. b. 3.5/16 = 0.2188, 2.8/14 = 0.20
9. a. [cf] 0 [enter] [↓] 10,000 [enter] [↓][↓] 20,000 [enter] [↓][↓] 30,000 [enter] [↓][↓] [NPV] I = 13.73 [enter] [↓] npv = [cpt] 44,648.97 ÷ 150,000 = 0.298
10. c. 155,000 [FV], 3 [n], 13.73 [i/y], [cpt] [PV] 105,367/150,000 = 0.702

Year	Cash flows
0	(150,000)
1	\$10,000
2	\$20,000
3	\$30,000 + \$155,000

Chapter 13

1. b. −2500 [pmt], 24 [n], 10/12 = [n], [cpt] [PV] 54,177.14
2. a. −2000 [pmt], 2 [n], 10 [i/y], [cpt] [PV] 3,471.07
3. b. −10000 [pmt], 5 [n], 10 [i/y], [cpt] [PV] 37,907.87
4. b. 10.25 + 11.00 + 12.50 = 33.75, 33.75 ÷ 3 = 11.25
5. d. 10.25 [FV], 1 [n], 10 [i/y], [cpt] [PV] 9.32; 11 [FV], 2 [n], 10 [i/y], [cpt] [PV] 9.09; 12.50 [FV], 3 [n], 10 [i/y], [cpt] [PV] 9.39; 9.32 + 9.09 + 9.39 = 27.80; 27.80 [PV], 3 [n], 10 [i/y], [cpt] [pmt] 11.18
6. c. 7 × 1,500 = 10,500; 500000 × 0.04 = 20,000; 10500 + 20000 = 30,500
7. b.
8. c. 13.00 + 13.75 + 14.25 + 15.00 + 16.50 = 72.50; 72.50 ÷ 5 = 14.50
9. b. C[F][↓] 13 [enter][↓][↓] 13.75 [enter][↓][↓] 14.25 [enter][↓][↓] 15 [enter][↓][↓] 16.50 [enter][↓][↓] [NPV] I 10 [enter][↓] NPV [cpt] 54.38; [2nd][CLR TVM] 54.38 [PV], 5 [n], 10 [i/y], [cpt][pmt] 14.345
10. a. 13 × 1500 = 19,500; 13.75 × 1500 = 20,625; 14.25 × 1500 = 21,375; 15 × 1500 = 22,500; 16.50 × 1500 = 24,750;
    C[F][↓] 19500 [enter][↓][↓] 20625 [enter][↓][↓] 21375 [enter][↓][↓] 22500 [enter][↓][↓] 24750 [enter][↓][↓] [NPV] I 10 [enter][↓] NPV [cpt] 81,567.69

Final Exam Answers

1. b. 1,000,000 [FV], 12 × 43 = [n], 10/12 = [i/y], [cpt] [pmt] −116.72
2. c. 1,000,000 [FV], 8 × 12 = [n], 10/12 = [i/y], [cpt] [pmt] −6,840.83
3. a. 120,000 [PV], 25 × 12 = [n], 7/12 = [i/y], [cpt] [pmt] −848.14
4. c. Continuing on from the keystrokes in answer 3, [RCL] [n] − 24 [=] [n], [cpt] [pv] 116,195
5. d. 4,000 [PV] −800 [pmt] 10 [i/y] [cpt] [n] 7.27
6. b. −8,500 [pmt] 3 [n] 9 [i/y] [cpt] [pv] 21,516
   21,516 [fv] 5 [n] 9 [i/y] [cpt] [pv] 13,983
7. d. [30 × 42 x 25] = 315
8. b. 142,375/167,750 = 0.85; 1 − 0.85 = 0.15; 85%, 15%
9. c. 75 × 140 = 10,500; 35,000/10,500 = 3.43
10. d. 297,000/275,000 = 1.08 − 1 = 0.08 = 8%
11. d. 260,000 [pv], 25 × 12 = [n], 7/12 = [i/y] [cpt] [pmt] [rcl] [n] − 12 = [n], [cpt] [pv]; 257,828; 325,000 − 257,828 = 67,641
12. b. 14,700/0.06 = 245,000
13. c. −325,000 [pv] 382,550 [fv] 3 [n] [cpt] [i/y] 5.58
14. b. 235,900 × 0.95 = 224,105 × 0.05 = 11,205
15. a. 215,000 − 185,000 = 30,000; 30,000/3 = 10,000; 10,000/185,000 = 5.4
16. b. 175,000/0.94 = 186,170
17. a. 0.05 × 500,000 = 25,000; 0.04 × 500,000 = 20,000; 0.02 × 250,000 = 5,000; 25,000 + 20,000 + 5,000 = 50,000
18. b. $3.14 \times 3^2 \times 15 = 423.9$
19. a. 475,000/160 = 2968.75

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20. d. 43,560/2 = 21,780; 21,870 × 8 = 174,240; 174,240 × 0.85 = 148,104; 148,104 × 0.07 = 10,367
21. c. 425,000 × 0.95 = 403,750; 375,487/403,750 = 0.93; 1 − 0.93 = 0.07 = 7%
22. b. 157,500/225,000 = 0.70
23. d. 50,000 [pv], 20 [n], 5 [i/y] [cpt] [pmt] 4012.13
24. d. 500 [fv], 2 [n], 10 [i/y] [cpt] [pv], 413.22; 700 [fv], 4 [n] 10 [i/y] [cpt] [pv] 478.11; 413.22 + 478.11 = 891.33
25. b. −37,000 [pv] 5 [i/y] 20 [n] [cpt] [fv] 98,172
26. a. 315,000 × 0.90 = 283,500 [pv] 30 × 12 = [n] 7.25/12 = [i/y], [cpt] [pmt] 1,933.97
27. c. −315,000 [pv] 3 [i/y] 5 [n] [cpt] [fv] 365,171
28. c. Continuing on from answer 26 keystrokes, [rcl] [n] − 60 = [n] [cpt] [cpv] 267,563.83
29. c. 365,171 − 267,563 = 97,607
30. d. 345,000 × 0.75 = 258,750 [pv] 360 [n] − 1635.48 [pmt] [cpt] [i/y] 0.54 × 12 = 6.5
31. b. [rcl] [n] − 120 = [n] [cpt] [pv] 219,358
32. b. 135,600 [pv] 300 [n], 5.5/12 = [i/y] [cpt] [pmt] 832.70
33. c. 135,600/169,500 = 0.80
34. c. 2,500,000 [pv] 240 [n] 7/12 = [i/y] [cpt] [pmt] 19,392.47 [rcl] [n] − 48 = [n] [cpt] [pv] 2,235,043.14
35. c. 2,235,043.14 × 0.07 = 156,453.02; 156,453.02/12 = 13,037.75 = interest; 19,382.47 − 13,037.75 = 6,344.72; (P + I) − I = P
36. a. 179,500 [pv], 6/12 = [i/y] 360 [n] [cpt] [pmt] [rcl] [n] − 36 = [n] [cpt] [pv] 172,470.01; 6.5/12 = [i/y] [cpt] [pmt]
37. a. 180,000 [pv] 30 × 26 = [n]; 6/26 = [i/y] [cpt] [pmt] 497.85
38. a. 1,500,000 × 0.03 = 45,000; 45,000 × 0.50 = 22,500; (3,750,000 − 1,500,000) = 2,250,000; 2,250,000 × 0.03 = 67,500; 67,500 × 0.60 = 40,500; 22,500 + 40,500 = 63,000
39. c.
40. b. 75 × 150 = 11,250
41. c.
42. c. 258,000 [pv] 300 [n] 6.5/12 = [i/y] [cpt] [pmt] 1,742.03; [rcl] [pv] − 5,000 = [pv] [cpt] [i/y] 0.56 × 12 = 6.71, 6.75%
43. c. 258,000/322,500 = 0.80
44. b. market value
45. d. 45,000/0.20 = 225,000
46. b. 225.000 × 0.80 = 180,000
47. b. an adjustable rate mortgage
48. c. −199,500 [pv], 254,618 [fv], 5 [n], [cpt] [i/y] 5%

49. d. 325,000 − 275,500 = 49,500 × 0.25 = 12,375
50. a. 275,500 × 0.80 = 220,400 [pv] 360 [n] 9/12 = [i/y] [cpt] [pmt] 1,773.39
51. d. 176,600 [pv], 360 [n], 5.75/12 = [i/y], [cpt] [pmt] 1,030.59; 1,030.59 × 360 = 371,012; 371,012 − 176,600 = 194,412
52. c. Continuing on from the payment calculation in answer 51, [rcl] [n] − 2 = [n] [cpt] [pv] 176,230.35; 176,230.56 × 0.0575 = 10,133.25; 10,133.25/12 = 844.44; 1,030.59 − 844.44 = 186.15
53. a. 176,600
54. c. 217,900 [pv] 300 [n], 6/12 = [i/y], [cpt] [pmt] 1,403.90 [rcl] [pv] × 0.97 = 211,363 [pv] [i/y] 0.53 × 12 = 6.32
55. b. 6.375
56. d. The cost of the land
57. c. 245,000 − 25,000 = 220,000
58. b. 165,000/1,350 = 122.22 × 1,450 = 177,219
59. d. capitalization rate
60. c. 1 [pv], 300 [n], 6/12 = [i/y], [cpt] [pmt] 0.0064 × 12 = 0.0773
61. d. EGI
62. c. ATCF
63. b. [cf] 150,000 [+/−] [enter] [↓] 5000 [enter] [↓][↓] 6000 [enter] [↓][↓] 7000[enter] [↓][↓] 8000 [enter] [↓][↓] 234000 [enter] [↓][↓] [NPV] I 10 [enter][↓] [cpt] 15,523
64. a.
65. c. −1.045 [pv], 1.0868 [fv] 1 [n] [cpt] [i/y] 4.0%
66. b. (22 × 0.25) + (15 × 0.40) + (4 × 0.35) = 12.9%
67. d. = $(22 - 12.9)^2$ 0.25 + $(15 - 12.9)^2$ 0.40 = $(4 - 12.9)^2$ 0.35, = 20.7 + 1.76 + 27.72, = 50.19; $\sqrt{50.19} = 7.1$
68. c. 425,000 + 975,000 = 1,400,000; 425,000/1,400,000 = 0.303 op; 10 0.303 = 0.697 sale
69. b. 145,500 × 0.94 = 136,770; 136,770 − 24,700 = 112,070
70. c. 8 × 4,000 = 32,000, 1,000,000 × 0.04 = 40,000; 32,000 + 40,000 = 72,000
71. d. (10.50 + 10.50 + 12 + 13.75 + 14.75)/5 = 12.20
72. b. [cf] 0 [+/−] [enter] [↓] 10.50 [enter] [↓][↓] 10.50 [enter] [↓][↓] 12.00 [enter] [↓][↓] 13.75 [enter] [↓][↓] 14.25 [enter] [↓][↓] [NPV] I 10 [enter] [↓] [cpt] 45.48; NPV = 45.48; 45.48 [pv] 5 [n] 10 [i/y] [pmt] 12
73. b. 40,000
74. d. 35 × 45 = 1575, 10 × 14 = 140, 1,575 + 140 = 1,715
75. c. 265,900/1,000 = 265.9; 265.9 × 3.30 = 877.47

INDEX

Accelerated Cost Recovery System (ACRS), 124
Accelerated depreciation, 125, 251
Accrued expenses, 131–132, 251
Acquisition cost, 251
Acre, 251
ACRS. *See* Accelerated Cost Recovery System
Adjustable rate mortgages (ARM), 103–105, 182, 209, 251
Adjusted basis, 251
Adjustment interval, 104, 252
After-tax cash flow (ATCF), 123–124, 181, 188–190, 196–197, 217, 252
Amortization schedule, 90, 110, 252
Amortized loan, 100–103
Amortizing payment
  defining, 260
  from TVM, 79–80
Annual compounding, 252
Annual growth, 116
Annual percentage rate (APR), 96–97, 252
Annuities
  defining, 252
  future value of, 71–74
  ordinary, 260
  present value of, 74–77
Annuity due, 252
Apartment building, 153–155
Appraisals
  apartment building, 153–155
  approaches of, 146–159
  cap rates of, 210–213
  cost approach of, 146–148, 167, 254
  defining, 252
  depreciation in, 121–122
  discounted cash flow in, 159–162
  fee, 136
  income approach of, 150–159, 167, 169, 257
  as informed value estimate, 145–146
  Institute, 121
  reconciliation in, 167–169
  sales comparison approach of, 148–150, 167–169, 262
  of single-family home, 151
  of three-bedroom rambler, 149
Appreciation, 114–121
  average/nominal, 118–119
  calculating, 115–117, 119–121
  compound annual, 117–118
  defining, 252
  shared, mortgage, 105–107, 263
APR. *See* Annual percentage rate
Area, 252
Area calculations, 8, 10–14
ARM. *See* Adjustable rate mortgages
Assessors, 58
ATCF. *See* After-tax cash flow
Average appreciation, 118–119
Average growth rates, 37–39
Average rent, 229–231

Band of investment, 152, 154–155, 211–213
Band of investment cap rates, 211–213
Baseline, 252
Before-tax cash flow (BTCF), 123, 158–159, 189, 224
  calculations for, 187
  defining, 252
  income minus expense for, 176–178

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Before-tax equivalent rate of return, 194–195
Below-market financing, 162–167
Beneficial financing, 163–165, 252
Biweekly mortgages, 92–93, 253
BOMA. *See* Building Owners and Manager Association
Breakeven occupancy rate, 183, 253
Brokers, 33–34
BTCF. *See* Before-tax cash flow
Building Owners and Manager Association (BOMA), 183
Building value, 161–162
Buyers statement
  in closing, 134–137, 140
  sellers statement and, 139

Calculators
  decimal places in, 100
  important keys on, 15–16
  Texas Instruments Business Analyst, 14–16
Capital gain, 253
Capital gain tax rate, 253
Capitalization rate (Cap rate), 152, 154–157, 188
  appraisals and, 210–213
  band of investment, 211–213
  defining, 253
  market extracted, 210–211
Cash equivalency
  below-market financing and, 162–167
  defining, 253
Cash flow, 77, 186
  after-tax, 123–124, 181, 188–190, 196–197, 217, 252
  analysis, 188, 196, 197
  before-tax, 123, 158–159, 176–178, 187, 189, 224, 252
  discounted, 159–162, 255
  IRR, 190–194
  keys, 162
  mortgages and, 101
  net present value of, 81–82
  from operations, 253
  from sale, 253
Cash flow estimations
  investment properties using, 174–175, 185–188
  after one year, 185–186
  after two years, 187–188
Circles, equations for, 11–12
Closing, 129–130, 253
  agents, 253
  buyers statement in, 134–137, 140
  expenses of, 130–131
  sellers statement in, 137–139
  statement equations, 140–142
  statements, 130, 137, 141, 253
Coefficient of variation
  defining, 253
  in risk, 216–217
Commission, 254
Commission rates
  calculating, 26–28
  equations for, 33–37
  graduated, 36–37
  percentages used in, 33–34
  sales price and, 39–41
  splitting, 35–36
  tiered, 36
Common denominator, 22–23, 254
Comparable sale, 149, 151
Composite rate, 104, 254
Compound annual appreciation, 117–118
Compound annual growth rates, 117–118
Compound growth rates, 39–41, 80–81, 115–116, 254
Compounding periods, 67
Compound interest, 254
Compound rate of return, 82–83
Consumer price index (CPI), 203
Contract for deed, 254
Contract rate, 164, 254
Cost approach, appraisals, 146–148, 167, 254
Cost of improvements, 147
CPI. *See* Consumer price index
Credit report, 136
Credits, 254
Crisis at maturity, 204
Cylindrical tube, 13

DCF. *See* Discounted cash flow
DCR. *See* Debt coverage ratio
Debits, 254
Debt, 130
Debt coverage ratio (DCR)
  defining, 254
  investment properties using, 182–183

Debt service (DS), 182
Decimals
in calculators, 100
equivalents of, 24, 254–255
fractions converted to, 23–24
percentages from, 25–26
Declining balance depreciation, 125, 180
Default premium, 208
Default risk, 208, 255
Denominators, 22–23. *See also* Common denominator
Depreciation, 121–125
accelerated, 125, 251
in appraisals, 121–122
cost of improvements with, 147
declining balance, 125, 180
defining, 255
equations, 122–123
expense, 179
of investment property, 123–125
straight-line, 180, 263
taxable income influenced by, 123–125
Developments, 52–53
Dictionary of Real Estate Appraisal (Appraisal Institute), 121
Discounted cash flow (DCF), 159–162, 255
Discounting, 69, 77
Discount points, 97–98, 255
Discount rate, 70, 91, 255
DS. *See* Debt service

Earnest money, 134
Economic obsolescence. *See* Locational (economic) obsolescence
Effective gross income (EGI), 152, 156
defining, 255
investment properties using, 175–176
Effective rate of interest, 255
Effective rate of return, 97–103
Effective rent, 229–231
EGI. *See* Effective gross income
Elements of comparison, 148–149
Equations
adjustable rate mortgage, 103–105
amortizing payment, 79–80
appreciation, 115–117, 119–121
area/volume calculated with, 8, 10–14
average rent, 229–231
band of investment, 211–213
before-tax cash flow, 176–178
before-tax equivalency, 194–195
breakeven occupancy, 183
closing statement, 140–142
commission rate, 33–37
comparable sale, 149
compounding growth rate, 80–81
debt coverage ratio, 182–183
default risk, 208
defining, 255
depreciation, 122–123
equity, 109–110
future value, 65–68
future value interest factor of annuity, 72–74
gross rent multiplier, 150, 151
growth rate, 37–41
income rate value, 210
interest paid, 95–96, 132–133
internal rate of return partitioning, 217–219
leased fee, 226–227
lease payment, 225
as mathematical statement, 9
metes and bounds, 46–49
mortgage payment, 88–92
net present value, 191–192
part percent whole, 26–28
point payment, 99–100
potential gross income, 153, 156–157, 177
present value, 68–71, 94
present value interest factor of annuity, 75–77
principal balance, 93–94
real estate tax, 132–134
reconciliation, 167–169
rectangle, 10–11
return on investment, 184
reverse annuity mortgage, 107–108
shared appreciation mortgage, 105–107
sinking fund payment, 77–79
standard deviation of returns, 213–216
for volume calculations, 10–14
Equity, 29
defining, 255
market value in, 116
from mortgages, 109–110
return on, 158, 184–185, 262
Equity dividend rate, 185
Equity-to-value ratio, 108–109, 255

Expected return, 256
Expenses. *See also* Accrued expenses; Operating expenses; Prepaid expenses; Prorated expenses
  accrued, 131–132, 251
  before-tax cash flow and, 176–178
  closing, 130–131
  depreciation, 179
  income minus, 176–178
  operating, 260
  operating ratio of, 183–184, 259
  prepaid, 131, 261
  prorated, 132–134

Financial calculator, 256
Financing, 162–167
Financing value, 162–165
Fixed-rate mortgage, 256
Floors, 256
Foreclosures, 139
Forward rates, 205–207, 256
Fractions, 21, 256
  decimals from, 23–24
  manipulating, 22–23
  mixed numbers with, 21–22
  reducing, 22
Fully amortized mortgages, 98–100
Functional obsolescence, 121, 256
Future sale calculations, 188–190
Future value (FV), 65–68, 71–74, 256
Future value interest factor (FVIP), 66
Future value interest factor of annuity (FVIFA), 71–74
FV. *See* Future value
FVIFA. *See* Future value interest factor of annuity
FVIP. *See* Future value interest factor

Government survey system, 50–52, 256
GPM. *See* Graduated payment mortgage
Graduated commission rates, 36–37
Graduated payment mortgage (GPM), 182
GRM. *See* Gross rent multiplier
Gross lease, 256
Gross rent, 224
Gross rent multiplier (GRM), 150, 151, 256–257
Growth rates
  average, 37–39
  compound, 39–41, 80–81, 115–116, 254
  compound annual, 117–118
  defining, 257
  investment properties considering, 186
  multiyear, 38–39
  shortcut to one-year, 38
  single-year, 37–38

Highest and best use, 257
High market rates, 105
Holding period, 257
Homeowners
  appreciation calculated for, 119–121
  equity gained by, 109–110

Imaginary lines, 50–52
Improvements
  defining, 257
  depreciated cost of, 147
Income, 176–178. *See also* Effective gross income; Net operating income; Potential gross income; Taxable income
Income approach, appraisals, 150–159, 167, 169, 257
Income capitalization, 151–152, 154, 257
Income-producing properties, 151, 167
Income rate value (IRV), 152, 159
  calculations of, 210
  defining, 257
Index, 104, 257
Inflation premium, 257
Inflation rates, 203, 205–207, 207
Informed value estimate, 145–146
Institute of Real Estate Management (IREM), 183
Interest
  compound, 254
  effective rate of, 255
  equations, 95–96, 132–133
  mortgages calculations of, 140–142
  prepaid, 261
  principal plus, 135, 261
Interest paid, mortgages, 95–96, 132–133, 135
Interest rates
  changing, 91–92
  lenders risk of, 208–209
  of mortgages, 140–142, 207–209

risk and, 203–207, 257
with yield curve, 204–205
Internal rate of return (IRR), 82–83, 190–194
calculations of, 198
five step method of, 193
modified, 194–195
partitioning of, 217–219
Investment properties
cash flow analysis of, 196
cash flow estimations of, 174–175, 185–188
debt coverage ratio used for, 182–183
defining, 257
depreciation of, 123–125
effective gross income used for, 175–176
future sale calculations of, 188–190
growth rates considered in, 186
operating expense ratio used on, 183–184
potential gross income used for, 175
ratio analysis used for, 181
return on equity used on, 184–185
return on investment used on, 184
taxable income/loss of, 178–180
IREM. *See* Institute of Real Estate Management
IRR. *See* Internal rate of return
IRS regulations, 123–125
IRV. *See* Income rate value

Jefferson, Thomas, 50

Land, 258
Land value, 147
Lease(s), 223–224
defining, 258
gross, 256
payment equations, 225
Leased fee value, 226–229
Leasehold value, 226–229
Legal descriptions, 46–49, 258
Lenders
interest rate risk of, 208–209
rate of return for, 203
time and, 204
Leverage, 196–198
Levies, 57
Limited market value, 58
Loan-to-value ratio, 28–29, 108–109, 155, 258
Locational (economic) obsolescence, 122, 258
Long-term lease, 227–228
Long-term rates (LT), 206
Lot and block system, 52–53, 258
Lot size, 258
Louisiana Purchase, 50
LT. *See* Long-term rates

Margin, 258
Marginal tax rate (MTR), 124, 180
defining, 258
tax liability using, 180–181
Market extracted cap rates, 210–211
Market extraction, 152
Market segmentation, 204
Market value, 109, 116, 258
Mathematical statement, 9
MC. *See* Mortgage constant
Measurement and boundaries. *See* Metes and bounds system
Metes and bounds system, 46–49
Mill rates, 58–59
Minnesota tax example, 59–60
Mixed numbers, 21–22, 258
Monthly compounding, 259
Monthly payments, mortgage, 88
Monument. *See* Metes and bounds system
Mortgage balance, 259
Mortgage constant (MC), 155, 259
Mortgage registration tax, 61, 259
Mortgages
adjustable rate, 103–105, 182, 209, 251
annual percentage rate of, 96–97
biweekly, 92–93, 253
cash flow and, 101
defining, 259
effective rate of return on, 97–103
equity from, 109–110
fixed rate, 256
fully amortized, 98–100
interest paid in, 95–96, 132–133, 135
interest rates of, 140–142, 207–209
loan-to-value ratio in, 108–109
net proceeds from, 101–102
partially amortized, 100–103
payments calculations for, 88–92
percentages used in, 28–29
points/prepaid items in, 97–98
principal balance of, 93–94

Mortgages *(continued)*
principal/interest in, 135
registration tax for, 61, 137
reverse annuity, 107–108, 262
shared appreciation, 105–107, 263
MTR. *See* Marginal tax rate
Multiple rate of return problem, 193
Multiyear growth rates, 38–39

Negative amortization, 259
Net lease, 259
Net operating income (NOI), 123, 176
discounted cash flow and, 160–162
defining, 259
estimation of, 152, 154, 157
increasing, 182–183
Net present value (NPV), 81–82, 190–194, 259
Net proceeds, 34, 259
mortgage, 101–102
part percent whole used for, 39–41
shortcut calculation of, 34–35
Net rent, 224
NOI. *See* Net operating income
Nominal appreciation, 118–119
Nominal rate, 259
NPV. *See* Net present value

Office rent, 225–226
Operating expense ratio
defining, 259
investment properties using, 183–184
Operating expenses, 260
Operations, 253
Order of operation, 9–10
Ordinary annuity, 260
Origination fee, 136, 260

Parentheses, 9–10
Partially amortized loan, 260
Partially amortized mortgages, 100–103
Partitioning internal rate of return, 217–219
Part percent whole concept, 26–28, 39–41, 153, 260
Payment calculations, 88–92
Payment caps, 105, 260
Payment to amortize. *See* Amortizing payment
Percentages
commission rates using, 33–34
decimals converted to, 25–26
defining, 260
mortgage calculations using, 28–29
rent, 260
Perfect expectations, 204
Perpetuity, 159
PGI. *See* Potential gross income
Physical deterioration, 121, 260
Pi (π), 11
Point of beginning, 260
Points. *See* Discount points
Positive leverage, 198
Potential gross income (PGI), 151, 153, 156–157
calculations of, 177
defining, 261
investment properties using, 175
Prepaid expenses, 131, 261
Prepaid interest, 261
Prepaid items, 97–98
Present value (PV), 65, 230, 261
of annuities, 74–77
calculating, 68–71, 94
total, 161
Present value interest factor of annuity (PVIFA), 74–77
Principal, 135
Principal balance, 93–94, 261
Principal/interest, 135
Principal meridians, 50–52, 261
Principal plus interest (P + I), 261
Principal reduction, 95, 261
Principle of substitution, 146
Property taxes, 57–58
calculating, 58–60
levy on, 57
Property value, 109, 162–165
Prorated expenses, 132–134
Prorated items, 261
Purchase price, 134
PV. *See* Present value
PVIFA. *See* Present value interest factor of annuity

Quarter section, 261

Radius, 12
RAM. *See* Reverse annuity mortgages

Rate of return, 203
Ratio, 28–29
Ratio analysis, 181
Real estate, 261
Real estate taxes, 132–134, 136, 138
Real property, 261
Real rate of return, 262
Reconciled value, 167–168
Reconciliation
  in appraisals, 167–169
  defining, 262
Recording fee, 138
Rectangle
  defining, 262
  equation for, 10–11
Rectangular survey system. *See* Government survey system
Reducing fractions, 22
Registration tax, 61, 137
Reinvestment assumption, 193
Rent
  average/effective, 229–231
  gross/net, 224
  office/warehouse, 225–226
  payments, 71
  percentage, 260
  residential, 224–225
  retail, 226
Replacement cost, 262
Residential property, 123
Residential rent, 224–225
Retail rent, 226
Return on equity (ROE), 158, 184–185, 262
Return on investment (ROI), 184, 262
Reverse annuity mortgages (RAM), 107–108, 262
Reversion value, 161, 188, 262
Risk
  appraisal cap rates and, 210–213
  coefficient of variation in, 216–217
  defining, 262
  interest rates and, 203–207, 257
Risk-free rates, 203
ROE. *See* Return on equity
ROI. *See* Return on investment

Sale price, 39–41, 138
Sales comparison approach, appraisals, 148–150, 167–169, 262
Salesperson, 33–34
SAM. *See* Shared appreciation mortgages
Scientific notation, 263
Section, 263
Sellers statement
  buyers statement and, 139
  in closing, 137–139
Senior citizens, 107–108
Shared appreciation mortgages (SAM), 105–107, 263
Shortcut calculation, 34–35
Shortcut to one-year growth rates, 38
Short-term rates (ST), 206
Single-family home, 151, 165–167
Single-year growth rates, 37–38
Sinking fund payments
  defining, 263
  from time value of money, 77–79
Six-unit apartment building, 153–155
Special-purpose property, 167
Spot rates, 205–207, 263
Square, equation for, 10–11
Square feet equation, 8
ST. *See* Short-term rates
Standard deviation, 263
Standard deviation of returns, 213–216
State deed tax, 60–61, 263
Straight-line depreciation, 180, 263
Subdivision plat system, 52–53. *See also* Lot and block system
Subject property, 183–184
Substitution, principle of, 146
Surface area calculations, 8, 10–14

Tax
  codes, 179
  liability, 180–181
  loss, 181
  rates, 58–59
  statements, 57
Taxable income, 123–125, 178–180
Tax Reform Act, 179
Teaser rate, 104, 263
Term, 263

Texas Instruments (TI), 14
Three-bedroom rambler, 149, 168
TI. *See* Texas Instruments
TI Business Analyst II Plus calculator, 14–16
  adjustable rate mortgage calculations on, 103–105
  after-tax cash flow calculated on, 188–190
  appreciation calculations on, 115–117, 119–121
  average rent calculated on, 229–231
  before-tax cash flow calculated on, 176–178
  building value calculated on, 161–162
  cap rate calculated on, 154–157
  cash equivalency calculations on, 163–166
  compound growth rates on, 80–81
  depreciation, 122–123
  future value calculations on, 67, 68
  future value interest factor of annuity calculations on, 72–74
  interest paid calculations on, 95–96
  internal rate of return calculations on, 193, 198
  leased fee calculated on, 226–227
  lease payment calculated on, 225
  loan-to-value ratio calculated on, 155
  mortgage payments on, 88–92
  point payment calculations on, 99–100
  potential gross income calculated on, 177
  present value calculations on, 69–71
  present value interest factor of annuity calculations on, 75–77
  principal balance calculations on, 93–94
  reverse annuity mortgage calculations on, 107–108
  shared appreciation mortgage calculations on, 106–107
  sinking fund payment calculations on, 77–79
  spot rates calculated on, 206–207
Tiered commission, 36
Time, 204
Time value of money (TVM)
  adjustable rate mortgages and, 103–105
  amortizing payment from, 79–80
  defining, 263
  future value calculations in, 65–68
  major premises of, 65, 83–84, 192
  sinking fund payments from, 77–79
Title insurance, 136, 263
Total present value, 161
Township, 264
Township and range system. *See* Government survey system
Transaction taxes
  as mortgage registration tax, 61, 259
  as state deed tax, 60–61
Trapezoid, 13–14, 264
Treasury securities, 203
TVM. *See* Time value of money
12-unit apartment building, 160–162

Units of measure, 8
U.S. Treasury yields, 205, 207

Vacancy rate, 264
Value, 167
Volume calculations
  defining, 264
  equations for, 10–14

Warehouse rent, 225–226
Wealth, 110
Weighted average calculations, 167
Whole numbers, 21–22

Yield curve
  defining, 264
  interest rates with, 204–205

THE MATHEMATICS OF MONEY MANAGEMENT: RISK ANALYSIS TECHNIQUES FOR TRADERS

by Ralph Vince

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Preface and Dedication

The favorable reception of ***Portfolio Management Formulas*** exceeded even the greatest expectation I ever had for the book. I had written it to promote the concept of optimal f and begin to immerse readers in portfolio theory and its missing relationship with optimal f.

Besides finding friends out there, ***Portfolio Management Formulas*** was surprisingly met by quite an appetite for the math concerning money management. Hence this book. I am indebted to Karl Weber, Wendy Grau, and others at John Wiley & Sons who allowed me the necessary latitude this book required.

There are many others with whom I have corresponded in one sort or another, or who in one way or another have contributed to, helped me with, or influenced the material in this book. Among them are Florence Bobeck, Hugo Rourdssa, Joe Bristor, Simon Davis, Richard Firestone, Fred Gehm (whom I had the good fortune of working with for awhile), Monique Mason, Gordon Nichols, and Mike Pascaul. I also wish to thank Fran Bartlett of G & H Soho, whose masterful work has once again transformed my little mountain of chaos, my little truckload of kindling, into the finished product that you now hold in your hands.

This list is nowhere near complete as there are many others who, to varying degrees, influenced this book in one form or another.

This book has left me utterly drained, and I intend it to be my last.

Considering this, I'd like to dedicate it to the three people who have influenced me the most. To Rejeanne, my mother, for teaching me to appreciate a vivid imagination; to Larry, my father, for showing me at an early age how to squeeze numbers to make them jump; to Arlene, my wife, partner, and best friend. This book is for all three of you. Your influences resonate throughout it.

Chagrin Falls, Ohio ***R. V.***

March 1992

Index

Introduction....5
Scope of this book....5
Some prevalent misconceptions....6
Worst-case scenarios and stategy....6
Mathematics notation....7
Synthetic constructs in this text....7
Optimal trading quantities and optimal f....8
Chapter 1-The Empirical Techniques....9
Deciding on quantity....9
Basic concepts....9
The runs test....10
Serial correlation....11
Common dependency errors....12
Mathematical Expectation....13
To reinvest trading profits or not....14
Measuring a good system for reinvestment the Geometric Mean....14
How best to reinvest....15
Optimal fixed fractional trading....15
Kelly formulas....16
Finding the optimal f by the Geometric Mean....16
To summarize thus far....17
Geometric Average Trade....17
Why you must know your optimal f....18
The severity of drawdown....18
Modern portfolio theory....19
The Markovitz model....19
The Geometric Mean portfolio strategy....21
Daily procedures for using optimal portfolios....21
Allocations greater than 100%....22
How the dispersion of outcomes affects geometric growth....23
The Fundamental Equation of trading....24
Chapter 2 - Characteristics of Fixed Fractional Trading and Salutary Techniques....26
Optimal f for small traders just starting out....26
Threshold to geometric....26
One combined bankroll versus separate bankrolls....27
Threat each play as if infinitely repeated....28
Efficiency loss in simultaneous wagering or portfolio trading....28
Time required to reach a specified goal and the trouble with fractional f....29
Comparing trading systems....30
Too much sensivity to the biggest loss....30
Equalizing optimal f....31
Dollar averaging and share averaging ideas....32
The Arc Sine Laws and random walks....33
Time spent in a drawdown....34
Chapter 3 - Parametric Optimal f on the Normal Distribution....35
The basics of probability distributions....35
Descriptive measures of distributions....35
Moments of a distribution....36
The Normal Distribution....37
The Central Limit Theorem....38
Working with the Normal Distribution....38
Normal Probabilities....39
Further Derivatives of the Normal....41
The Lognormal Distribution....41
The parametric optimal f....42
The distribution of trade P&L's....43
Finding optimal f on the Normal Distribution....44
The mechanics of the procedure....45
Chapter 4 - Parametric Techniques on Other Distributions....49
The Kolmogorov-Smirnov (K-S) Test....49
Creating our own Characteristic Distribution Function....50
Fitting the Parameters of the distribution....52
Using the Parameters to find optimal f....54
Performing "What Ifs"....56
Equalizing f....56
Optimal f on other distributions and fitted curves....57
Scenario planning....57
Optimal f on binned data....60
Which is the best optimal f?....60
Chapter 5 - Introduction to Multiple Simultaneous Positions under the Parametric Approach....62
Estimating Volatility....62
Ruin, Risk and Reality....63
Option pricing models....63
A European options pricing model for all distributions....66
The single long option and optimal f....67
The single short option....70
The single position in The Underlying Instrument....71
Multiple simultaneous positions with a causal relationship....71
Multiple simultaneous positions with a random relationship....73
Chapter 6 - Correlative Relationships and the Derivation of the Efficient Frontier....74
Definition of The Problem....74
Solutions of Linear Systems using Row-Equivalent Matrices....77
Interpreting The Results....78
Chapter 7 - The Geometry of Portfolios....81
The Capital Market Lines (CMLs)....81
The Geometric Efficient Frontier....82
Unconstrained portfolios....84
How optimal f fits with optimal portfolios....85
Threshold to The Geometric for Portfolios....86
Completing The Loop....86
Chapter 8 - Risk Management....89
Asset Allocation....89
Reallocation: Four Methods....91
Why reallocate?....93
Portfolio Insurance – The Fourth Reallocation Technique....93
The Margin Constraint....96
Rotating Markets....97
To summarize....97
Application to Stock Trading....98
A Closing Comment....98
APPENDIX A - The Chi-Square Test....100
APPENDIX B - Other Common Distributions....101
The Uniform Distribution....101
The Bernouli Distribution....101
The Binomial Distribution....102
The Geometric Distribution....103
The Hypergeometric Distribution....104
The Poisson Distribution....104
The Exponential Distribution....105
The Chi-Square Distribution....105
The Student's Distribution....106
The Multinomial Distribution....107
The stable Paretian Distribution....107
APPENDIX C - Further on Dependency: The Turning Points and Phase Length Tests....109

Introduction

SCOPE OF THIS BOOK

I wrote in the first sentence of the Preface of ***Portfolio Management Formulas***, the forerunner to this book, that it was a book about mathematical tools.

This is a book about machines.

Here, we will take tools and build bigger, more elaborate, more powerful tools-machines, where the whole is greater than the sum of the parts. We will try to dissect machines that would otherwise be black boxes in such a way that we can understand them completely without having to cover all of the related subjects (which would have made this book impossible). For instance, a discourse on how to build a jet engine can be very detailed without having to teach you chemistry so that you know how jet fuel works. Likewise with this book, which relies quite heavily on many areas, particularly statistics, and touches on calculus. I am not trying to teach mathematics here, aside from that necessary to understand the text. However, I have tried to write this book so that if you understand calculus (or statistics) it will make sense and if you do not there will be little, if any, loss of continuity, and you will still be able to utilize and understand (for the most part) the material covered without feeling lost.

Certain mathematical functions are called upon from time to time in statistics. These functions-which include the gamma and incomplete gamma functions, as well as the beta and incomplete beta functions-are often called functions of mathematical physics and reside just beyond the perimeter of the material in this text. To cover them in the depth necessary to do the reader justice is beyond the scope, and away from the direction of, this book. This is a book about account management for traders, not mathematical physics, remember? For those truly interested in knowing the "chemistry of the jet fuel" I suggest Numerical Recipes, which is referred to in the Bibliography.

I have tried to cover my material as deeply as possible considering that you do not have to know calculus or functions of mathematical physics to be a good trader or money manager. It is my opinion that there isn't much correlation between intelligence and making money in the markets. By this I do not mean that the dumber you are the better I think your chances of success in the markets are. I mean that intelligence alone is but a very small input to the equation of what makes a good trader. In terms of what input makes a good trader, I think that mental toughness and discipline far outweigh intelligence. Every successful trader I have ever met or heard about has had at least one experience of a cataclysmic loss. The common denominator, it seems, the characteristic that separates a good trader from the others, is that the good trader picks up the phone and puts in the order when things are at their bleakest. This requires a lot more from an individual than calculus or statistics can teach a person.

In short, I have written this as a book to be utilized by traders in the real-world marketplace. I am not an academic. My interest is in real-world utility before academic pureness.

Furthermore, I have tried to supply the reader with more basic information than the text requires in hopes that the reader will pursue concepts farther than I have here.

One thing I have always been intrigued by is the architecture of music -music theory. I enjoy reading and learning about it. Yet I am not a musician. To be a musician requires a certain discipline that simply understanding the rudiments of music theory cannot bestow. Likewise with trading. Money management may be the core of a sound trading program, but simply understanding money management will not make you a successful trader.

This is a book about music theory, not a how-to book about playing an instrument. Likewise, this is not a book about beating the markets, and you won't find a single price chart in this book. Rather it is a book about mathematical concepts, taking that important step from theory to application, that you can employ. It will not bestow on you the ability to tolerate the emotional pain that trading inevitably has in store for you, win or lose.

This book is not a sequel to ***Portfolio Management Formulas***. Rather, ***Portfolio Management Formulas*** laid the foundations for what will be covered here.

Readers will find this book to be more abstruse than its forerunner. Hence, this is not a book for beginners. Many readers of this text will have read ***Portfolio Management Formulas***. For those who have not, Chapter 1 of this book summarizes, in broad strokes, the basic concepts from ***Portfolio Management Formulas***. Including these basic concepts allows this book to "stand alone" from ***Portfolio Management Formulas***.

Many of the ideas covered in this book are already in practice by professional money managers. However, the ideas that are widespread among professional money managers are not usually readily available to the investing public. Because money is involved, everyone seems to be very secretive about portfolio techniques. Finding out information in this regard is like trying to find out information about atom bombs. I am indebted to numerous librarians who helped me through many mazes of professional journals to fill in many of the gaps in putting this book together.

This book does not require that you utilize a mechanical, objective trading system in order to employ the tools to be described herein. In other words, someone who uses Elliott Wave for making trading decisions, for example, can now employ optimal f.

However, the techniques described in this book, like those in ***Portfolio Management Formulas***, require that the sum of your bets be a positive result. In other words, these techniques will do a lot for you, but they will not perform miracles. Shuffling money cannot turn losses into profits. You ***must*** have a winning approach to start with.

Most of the techniques advocated in this text are techniques that are advantageous to you in the long run. Throughout the text you will encounter the term "an asymptotic sense" to mean the eventual outcome of something performed an infinite number of times, whose probability approaches certainty as the number of trials continues. In other words, something we can be nearly certain of in the long run. The root of this expression is the mathematical term "asymptote," which is a straight line considered as a limit to a curved line in the sense that the distance between a moving point on the curved line and the straight line approaches zero as the point moves an infinite distance from the origin.

Trading is never an easy game. When people study these concepts, they often get a false feeling of power. I say false because people tend to get the impression that something very difficult to do is easy when they understand the mechanics of what they must do. As you go through this text, bear in mind that there is nothing in this text that will make you a better trader, nothing that will improve your timing of entry and exit from a given market, nothing that will improve your trade selection. These difficult exercises will still be difficult exercises even after you have finished and comprehended this book.

Since the publication of ***Portfolio Management Formulas*** I have been asked by some people why I chose to write a book in the first place. The argument usually has something to do with the marketplace being a competitive arena, and writing a book, in their view, is analogous to educating your adversaries.

The markets are vast. Very few people seem to realize how huge today's markets are. True, the markets are a zero sum game (at best), but as a result of their enormity you, the reader, are not my adversary.

Like most traders, I myself am most often my own biggest enemy. This is not only true in my endeavors in and around the markets, but in life in general. Other traders do not pose anywhere near the threat to me that I myself do. I do not think that I am alone in this. I think most traders, like myself, are their own worst enemies.

In the mid 1980s, as the microcomputer was fast becoming the primary tool for traders, there was an abundance of trading programs that entered a position on a stop order, and the placement of these entry stops was often a function of the current volatility in a given market. These systems worked beautifully for a time. Then, near the end of the decade, these types of systems seemed to collapse. At best, they were able to carve out only a small fraction of the profits that these systems had just a few years earlier. Most traders of such systems would later abandon them, claiming that if "everyone was trading them, how could they work anymore?"

Most of these systems traded the Treasury Bond futures market. Consider now the size of the cash market underlying this futures market. Arbitrageurs in these markets will come in when the prices of the cash and futures diverge by an appropriate amount (usually not more than a

few ticks), buying the less expensive of the two instruments and selling the more expensive. As a result, the divergence between the price of cash and futures will dissipate in short order. The only time that the relationship between cash and futures can really get out of line is when an exogenous shock, such as some sort of news event, drives prices to diverge farther than the arbitrage process ordinarily would allow for. Such disruptions are usually very short-lived and rather rare. An arbitrageur capitalizes on price discrepancies, one type of which is the relationship of a futures contract to its underlying cash instrument. As a result of this process, the Treasury Bond futures market is intrinsically tied to the enormous cash Treasury market. The futures market reflects, at least to within a few ticks, what's going on in the gigantic cash market. The cash market is not, and never has been, dominated by systems traders. Quite the contrary.

Returning now to our argument, it is rather inconceivable that the traders in the cash market all started trading the same types of systems as those who were making money in the futures market at that time! Nor is it any more conceivable that these cash participants decided to all gang up on those who were profiteering in the futures market, There is no valid reason why these systems should have stopped working, or stopped working as well as they had, simply because many futures traders were trading them. That argument would also suggest that a large participant in a very thin market be doomed to the same failure as traders of these systems in the bonds were. Likewise, it is silly to believe that all of the fat will be cut out of the markets just because I write a book on account management concepts.

Cutting the fat out of the market requires more than an understanding of money management concepts. It requires discipline to tolerate and endure emotional pain to a level that 19 out of 20 people cannot bear. This you will not learn in this book or any other. Anyone who claims to be intrigued by the "intellectual challenge of the markets" is not a trader. The markets are as intellectually challenging as a fistfight. In that light, the best advice I know of is to always cover your chin and jab on the run. Whether you win or lose, there are significant beatings along the way. But there is really very little to the markets in the way of an intellectual challenge. Ultimately, trading is an exercise in self-mastery and endurance. This book attempts to detail the strategy of the fistfight. As such, this book is of use only to someone who already possesses the necessary mental toughness.

SOME PREVALENT MISCONCEPTIONS

You will come face to face with many prevalent misconceptions in this text. Among these are:

– Potential gain to potential risk is a straight-line function. That is, the more you risk, the more you stand to gain.

– Where you are on the spectrum of risk depends on the type of vehicle you are trading in.

– Diversification reduces drawdowns (it can do this, but only to a very minor extent-much less than most traders realize).

– Price behaves in a rational manner.

The last of these misconceptions, that price behaves in a rational manner, is probably the least understood of all, considering how devastating its effects can be. By "rational manner" is meant that when a trade occurs at a certain price, you can be certain that price will proceed in an orderly fashion to the next tick, whether up or down-that is, if a price is making a move from one point to the next, it will trade at every point in between. Most people are vaguely aware that price does not behave this way, yet most people develop trading methodologies that assume that price does act in this orderly fashion.

But price is a synthetic perceived value, and therefore does not act in such a rational manner. Price can make very large leaps at times when proceeding from one price to the next, completely bypassing all prices in between. Price is capable of making gigantic leaps, and far more frequently than most traders believe. To be on the wrong side of such a move can be a devastating experience, completely wiping out a trader.

Why bring up this point here? Because the foundation of any effective gaming strategy (and money management is, in the final analysis, a gaming strategy) is to ***hope for the best but prepare for the worst***.

WORST-CASE SCENARIOS AND STATEGY

The "hope for the best" part is pretty easy to handle. Preparing for the worst is quite difficult and something most traders never do. Preparing for the worst, whether in trading or anything else, is something most of us put off indefinitely. This is particularly easy to do when we consider that worst-case scenarios usually have rather remote probabilities of occurrence. Yet preparing for the worst-case scenario is something we must do now. If we are to be prepared for the worst, we must do it as the starting point in our money management strategy.

You will see as you proceed through this text that we always build a strategy from a worst-case scenario. We always start with a worst case and incorporate it into a mathematical technique to take advantage of situations that include the realization of the worst case.

Finally, you must consider this next axiom. ***If you play a game with unlimited liability, you will go broke with a probability that approaches certainty as the length of the game approaches infinity.*** Not a very pleasant prospect. The situation can be better understood by saying that if you can only die by being struck by lightning, eventually you will die by being struck by lightning. Simple. If you trade a vehicle with unlimited liability (such as futures), you will eventually experience a loss of such magnitude as to lose everything you have.

Granted, the probabilities of being struck by lightning are extremely small for you today and extremely small for you for the next fifty years. However, the probability exists, and if you were to live long enough, eventually this microscopic probability would see realization. Likewise, the probability of experiencing a cataclysmic loss on a position today may be extremely small (but far greater than being struck by lightning today). Yet if you trade long enough, eventually this probability, too, would be realized.

There are three possible courses of action you can take. One is to trade only vehicles where the liability is limited (such as long options). The second is not to trade for an infinitely long period of time. Most traders will die before they see the cataclysmic loss manifest itself (or before they get hit by lightning). The probability of an enormous winning trade exists, too, and one of the nice things about winning in trading is that you don't have to have the gigantic winning trade. Many smaller wins will suffice. Therefore, if you aren't going to trade in limited liability vehicles and you aren't going to die, make up your mind that you are going to quit trading unlimited liability vehicles altogether if and when your account equity reaches some prespecified goal. If and when you achieve that goal, get out and don't ever come back.

We've been discussing worst-case scenarios and how to avoid, or at least reduce the probabilities of, their occurrence. However, this has not truly prepared us for their occurrence, and we must prepare for the worst. For now, consider that today you had that cataclysmic loss. Your account has been tapped out. The brokerage firm wants to know what you're going to do about that big fat debit in your account. You weren't expecting this to happen today. No one who ever experiences this ever does expect it.

Take some time and try to imagine how you are going to feel in such a situation. Next, try to determine what you will do in such an instance. Now write down on a sheet of paper exactly what you will do, who you can call for legal help, and so on. Make it as definitive as possible. Do it now so that if it happens you'll know what to do without having to think about these matters. Are there arrangements you can make now to protect yourself before this possible cataclysmic loss? Are you sure you wouldn't rather be trading a vehicle with limited liability? If you're going to trade a vehicle with unlimited liability, at what point on the upside will you stop? Write down what that level of profit is. Don't just read this and then keep plowing through the book. Close the book and think about these things for awhile. This is the point from which we will build.

The point here has not been to get you thinking in a fatalistic way. That would be counterproductive, because to trade the markets effectively will require a great deal of optimism on your part to make it through the inevitable prolonged losing streaks. The point here has been to get you to think about the worst-case scenario and to make contingency plans in case such a worst-case scenario occurs. Now, take that sheet of paper with your contingency plans (and with the amount at which point you will quit trading unlimited liability vehicles altogether written on it) and put it in the top drawer of your desk. Now, if the

worst-case scenario should develop you know you won't be jumping out of the window.

Hope for the best but prepare for the worst. If you haven't done these exercises, then close this book now and keep it closed. Nothing can help you if you do not have this foundation to build upon.

MATHEMATICS NOTATION

Since this book is infected with mathematical equations, I have tried to make the mathematical notation as easy to understand, and as easy to take from the text to the computer keyboard, as possible. Multiplication will always be denoted with an asterisk (*), and exponentiation will always be denoted with a raised caret (^). Therefore, the square root of a number will be denoted as ^(l/2). You will never have to encounter the radical sign. Division is expressed with a slash (/) in most cases. Since the radical sign and the means of expressing division with a horizontal line are also used as a grouping operator instead of parentheses, that confusion will be avoided by using these conventions for division and exponentiation. Parentheses will be the only grouping operator used, and they may be used to aid in the clarity of an expression even if they are not mathematically necessary. At certain special times, brackets ({ }) may also be used as a grouping operator.

Most of the mathematical functions used are quite straightforward (e.g., the absolute value function and the natural log function). One function that may not be familiar to all readers, however, is the exponential function, denoted in this text as EXP(). This is more commonly expressed mathematically as the constant e, equal to 2.7182818285, raised to the power of the function. Thus:

EXP(X) = e^X = 2.7182818285^X

The main reason I have opted to use the function notation EXP(X) is that most computer languages have this function in one form or another. Since much of the math in this book will end up transcribed into computer code, I find this notation more straightforward.

SYNTHETIC CONSTRUCTS IN THIS TEXT

As you proceed through the text, you will see that there is a certain geometry to this material. However, in order to get to this geometry we will have to create certain synthetic constructs. For one, we will convert trade profits and losses over to what will be referred to as ***holding period returns or HPRs*** for short. An HPR is simply 1 plus what you made or lost on the trade as a percentage. Therefore, a trade that made a 10% profit would be converted to an HPR of 1+.10 = 1.10. Similarly, a trade that lost 10% would have an HPR of 1+(-.10) = .90. Most texts, when referring to a holding period return, do not add 1 to the percentage gain or loss. However, throughout this text, whenever we refer to an HPR, it will always be 1 plus the gain or loss as a percentage.

Another synthetic construct we must use is that of a ***market system***. A market system is any given trading approach on any given market (the approach need not be a mechanical trading system, but often is). For example, say we are using two separate approaches to trading two separate markets, and say that one of our approaches is a simple moving average crossover system. The other approach takes trades based upon our Elliott Wave interpretation. Further, say we are trading two separate markets, say Treasury Bonds and heating oil. We therefore have a total of four different market systems. We have the moving average system on bonds, the Elliott Wave trades on bonds, the moving average system on heating oil, and the Elliott Wave trades on heating oil.

A market system can be further differentiated by other factors, one of which is dependency. For example, say that in our moving average system we discern (through methods discussed in this text) that winning trades beget losing trades and vice versa. We would, therefore, break our moving average system on any given market into two distinct market systems. One of the market systems would take trades only after a loss (because of the nature of this dependency, this is a more advantageous system), the other market system only after a profit. Referring back to our example of trading this moving average system in conjunction with Treasury Bonds and heating oil and using the Elliott Wave trades also, we now have six market systems: the moving average system after a loss on bonds, the moving average system after a win on bonds, the Elliott Wave trades on bonds, the moving average system after a win on heating oil, the moving average system after a loss on heating oil, and the Elliott Wave trades on heating oil.

Pyramiding (adding on contracts throughout the course of a trade) is viewed in a money management sense as separate, distinct market systems rather than as the original entry. For example, if you are using a trading technique that pyramids, you should treat the initial entry as one market system. Each add-on, each time you pyramid further, constitutes another market system. Suppose your trading technique calls for you to add on each time you have a $1,000 profit in a trade. If you catch a really big trade, you will be adding on more and more contracts as the trade progresses through these $1,000 levels of profit. Each separate add-on should be treated as a separate market system. There is a big benefit in doing this. The benefit is that the techniques discussed in this book will yield the optimal quantities to have on for a given market system as a function of the level of equity in your account. By treating each add-on as a separate market system, you will be able to use the techniques discussed in this book to know the optimal amount to add on for your current level of equity.

Another very important synthetic construct we will use is the concept of a ***unit***. The HPRs that you will be calculating for the separate market systems must be calculated on a "1 unit" basis. In other words, if they are futures or options contracts, each trade should be for 1 contract. If it is stocks you are trading, you must decide how big 1 unit is. It can be 100 shares or it can be 1 share. If you are trading cash markets or foreign exchange (forex), you must decide how big 1 unit is. By using results based upon trading 1 unit as input to the methods in this book, you will be able to get output results based upon 1 unit. That is, you will know how many units you should have on for a given trade. It doesn't matter what size you decide 1 unit to be, because it's just an hypothetical construct necessary in order to make the calculations. For each market system you must figure how big 1 unit is going to be. For example, if you are a forex trader, you may decide that 1 unit will be one million U.S. dollars. If you are a stock trader, you may opt for a size of 100 shares.

Finally, you must determine whether you can trade fractional units or not. For instance, if you are trading commodities and you define 1 unit as being 1 contract, then you cannot trade fractional units (i.e., a unit size less than 1), because the smallest denomination in which you can trade futures contracts in is 1 unit (you can possibly trade quasifractional units if you also trade minicontracts). If you are a stock trader and you define 1 unit as 1 share, then you cannot trade the fractional unit. However, if you define 1 unit as 100 shares, then you can trade the fractional unit, if you're willing to trade the odd lot.

If you are trading futures you may decide to have 1 unit be 1 minicontract, and not allow the fractional unit. Now, assuming that 2 minicontracts equal 1 regular contract, if you get an answer from the techniques in this book to trade 9 units, that would mean you should trade 9 minicontracts. Since 9 divided by 2 equals 4.5, you would optimally trade 4 regular contracts and 1 minicontract here.

Generally, it is very advantageous from a money management perspective to be able to trade the fractional unit, but this isn't always true. Consider two stock traders. One defines 1 unit as 1 share and cannot trade the fractional unit; the other defines 1 unit as 100 shares and can trade the fractional unit. Suppose the optimal quantity to trade in today for the first trader is to trade 61 units (i.e., 61 shares) and for the second trader for the same day it is to trade 0.61 units (again 61 shares).

I have been told by others that, in order to be a better teacher, I must bring the material to a level which the reader can understand. Often these other people's suggestions have to do with creating analogies between the concept I am trying to convey and something they already are familiar with. Therefore, for the sake of instruction you will find numerous analogies in this text. But I abhor analogies. Whereas analogies may be an effective tool for instruction as well as arguments, I don't like them because they take something foreign to people and (often quite deceptively) force fit it to a template of logic of something people already know is true. Here is an example:

The square root of 6 is 3 ***because*** the square root of 4 is 2 and 2+2 = 4. Therefore, since 3+3 = 6, then the square root of 6 ***must*** be 3.

Analogies explain, but they do not solve. Rather, an analogy makes the a priori assumption that something is true, and this "explanation" then masquerades as the proof. You have my apologies in advance for the use of the analogies in this text. I have opted for them only for the purpose of instruction.

OPTIMAL TRADING QUANTITIES AND OPTIMAL F

Modern portfolio theory, perhaps the pinnacle of money management concepts from the stock trading arena, has not been embraced by the rest of the trading world. Futures traders, whose technical trading ideas are usually adopted by their stock trading cousins, have been reluctant to accept ideas from the stock trading world. As a consequence, modern portfolio theory has never really been embraced by futures traders.

Whereas modern portfolio theory will determine optimal weightings of the components within a portfolio (so as to give the least variance to a prespecified return or vice versa), it does not address the notion of optimal quantities. That is, for a given market system, there is an optimal amount to trade in for a given level of account equity so as to maximize geometric growth. This we will refer to as the optimal f. This book proposes that modern portfolio theory can and should be used by traders in any markets, not just the stock markets. However, we must marry modern portfolio theory (which gives us optimal weights) with the notion of optimal quantity (optimal f) to arrive at a truly optimal portfolio. It is this truly optimal portfolio that can and should be used by traders in any markets, including the stock markets.

In a nonleveraged situation, such as a portfolio of stocks that are not on margin, weighting and quantity are synonymous, but in a leveraged situation, such as a portfolio of futures market systems, weighting and quantity are different indeed. In this book you will see an idea first roughly introduced in ***Portfolio Management Formulas***, that optimal quantities are what we seek to know, and that this is a function of optimal weightings.

Once we amend modern portfolio theory to separate the notions of weight and quantity, we can return to the stock trading arena with this now reworked tool. We will see how almost any nonleveraged portfolio of stocks can be improved dramatically by making it a leveraged portfolio, and marrying the portfolio with the risk-free asset. This will become intuitively obvious to you. The degree of risk (or conservativeness) is then dictated by the trader as a function of how much or how little leverage the trader wishes to apply to this portfolio. This implies that where a trader is on the spectrum of risk aversion is a function of the leverage used and not a function of the type of trading vehicle used.

In short, this book will teach you about ***risk management***. Very few traders have an inkling as to what constitutes risk management. It is not simply a matter of eliminating risk altogether. To do so is to eliminate return altogether. It isn't simply a matter of maximizing potential reward to potential risk either. Rather, ***risk management is about decision-making strategies that seek to maximize the ratio of potential reward to potential risk within a given acceptable level of risk***.

To learn this, we must first learn about optimal f, the optimal quantity component of the equation. Then we must learn about combining optimal f with the optimal portfolio weighting. Such a portfolio will maximize potential reward to potential risk. We will first cover these concepts from an empirical standpoint (as was introduced in ***Portfolio Management Formulas***), then study them from a more powerful standpoint, the parametric standpoint. In contrast to an empirical approach, which utilizes past data to come up with answers directly, a parametric approach utilizes past data to come up with ***parameters***. These are certain measurements about something. These parameters are then used in a model to come up with essentially the same answers that were derived from an empirical approach. The strong point about the parametric approach is that you can alter the values of the parameters to see the effect on the outcome from the model. This is something you cannot do with an empirical technique. However, empirical techniques have their strong points, too. The empirical techniques are generally more straightforward and less math intensive. Therefore they are easier to use and comprehend. For this reason, the empirical techniques are covered first.

Finally, we will see how to implement the concepts within a user-specified acceptable level of risk, and learn strategies to maximize this situation further.

There is a lot of material to be covered here. I have tried to make this text as concise as possible. Some of the material may not sit well with you, the reader, and perhaps may raise more questions than it answers. If that is the case, than I have succeeded in one facet of what I have attempted to do. Most books have a single "heart," a central concept that the entire text flows toward. This book is a little different in that it has many hearts. Thus, some people may find this book difficult when they go to read it if they are subconsciously searching for a single heart. I make no apologies for this; this does not weaken the logic of the text; rather, it enriches it. This book may take you more than one reading to discover many of its hearts, or just to be comfortable with it.

One of the many hearts of this book is the broader concept of ***decision making in environments characterized by geometric consequences***. An environment of geometric consequence is an environment where a quantity that you have to work with today is a function of prior outcomes. I think this covers most environments we live in! Optimal f is the regulator of growth in such environments, and the by-products of optimal f tell us a great deal of information about the growth rate of a given environment. In this text you will learn how to determine the optimal f and its by-products for any distributional form. This is a statistical tool that is directly applicable to many real-world environments in business and science. I hope that you will seek to apply the tools for finding the optimal f parametrically in other fields where there are such environments, for numerous different distributions, not just for trading the markets.

For years the trading community has discussed the broad concept of "money management." Yet by and large, money management has been characterized by a loose collection of rules of thumb, many of which were incorrect. Ultimately, I hope that this book will have provided traders with exactitude under the heading of money management.

Chapter 1-The Empirical Techniques

This chapter is a condensation of Portfolio Management Formulas. The purpose here is to bring those readers unfamiliar with these empirical techniques up to the same level of understanding as those who are.

DECIDING ON QUANTITY

Whenever you enter a trade, you have made two decisions: Not only have you decided whether to enter long or short, you have also decided upon the quantity to trade in. This decision regarding quantity is ***always*** a function of your account equity. If you have a $10,000 account, don't you think you would be leaning into the trade a little if you put on 100 gold contracts? Likewise, if you have a $10 million account, don't you think you'd be a little light if you only put on one gold contract ? Whether we acknowledge it or not, the decision of what quantity to have on for a given trade is inseparable from the level of equity in our account.

It is a very fortunate fact for us though that an account will grow the fastest when we trade a fraction of the account on each and every trade-in other words, when we trade a quantity relative to the size of our stake.

However, the quantity decision is not simply a function of the equity in our account, it is also a function of a few other things. It is a function of our perceived "worst-case" loss on the next trade. It is a function of the speed with which we wish to make the account grow. It is a function of dependency to past trades. More variables than these just mentioned may be associated with the quantity decision, yet we try to agglomerate all of these variables, including the account's level of equity, into a subjective decision regarding quantity: How many contracts or shares should we put on?

In this discussion, you will learn how to make the mathematically correct decision regarding quantity. You will no longer have to make this decision subjectively (and quite possibly erroneously). You will see that there is a steep price to be paid by not having on the correct quantity, and this price increases as time goes by.

Most traders gloss over this decision about quantity. They feel that it is somewhat arbitrary in that it doesn't much matter what quantity they have on. What matters is that they be right about the direction of the trade. Furthermore, they have the mistaken impression that there is a straight-line relationship between how many contracts they have on and how much they stand to make or lose in the long run.

This is not correct. As we shall see in a moment, the relationship between potential gain and quantity risked is not a straight line. It is curved. There is a peak to this curve, and it is at this peak that we maximize potential gain per quantity at risk. Furthermore, as you will see throughout this discussion, the decision regarding quantity for a given trade is as important as the decision to enter long or short in the first place. Contrary to most traders' misconception, whether you are right or wrong on the direction of the market when you enter a trade does not dominate whether or not you have the right quantity on. ***Ultimately, we have no control over whether the next trade will be profitable or not. Yet we do have control over the quantity we have on. Since one does not dominate the other, our resources are better spent concentrating on putting on the tight quantity***.

On any given trade, you have a perceived worst-case loss. You may not even be conscious of this, but whenever you enter a trade you have some idea in your mind, even if only subconsciously, of what can happen to this trade in the worst-case. This worst-case perception, along with the level of equity in your account, shapes your decision about how many contracts to trade.

Thus, we can now state that there is a divisor of this biggest perceived loss, a number between 0 and 1 that you will use in determining how many contracts to trade. For instance, if you have a $50,000 account, if you expect, in the worst case, to lose $5,000 per contract, and if you have on 5 contracts, your divisor is .5, since:

50,000/(5,000/.5) = 5

In other words, you have on 5 contracts for a $50,000 account, so you have 1 contract for every $10,000 in equity. You expect in the worst case to lose $5,000 per contract, thus your divisor here is .5. If you had on only 1 contract, your divisor in this case would be .1 since:

50,000/(5,000/.l) = 1

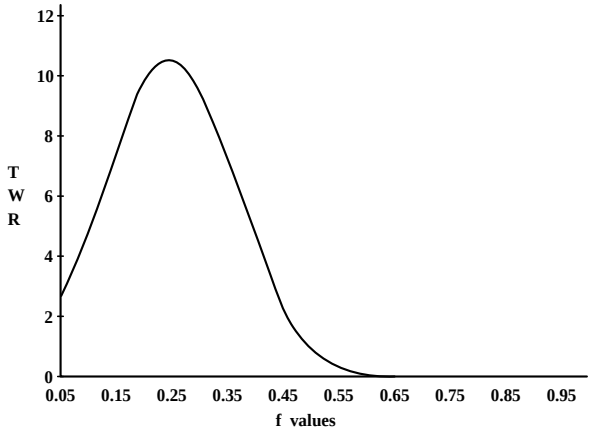

Figure 1-1 20 sequences of +2, -1.

This divisor we will call by its variable name f. Thus, whether consciously or subconsciously, on any given trade you are selecting a value for f when you decide how many contracts or shares to put on.

Refer now to Figure 1-1. This represents a game where you have a 50% chance of winning $2 versus a 50% chance of losing $1 on every play. Notice that here the optimal f is .25 when the TWR is 10.55 after 40 bets (20 sequences of +2, -1). TWR stands for Terminal Wealth Relative. It represents the return on your stake as a multiple. A TWR of 10.55 means you would have made 10.55 times your original stake, or 955% profit. Now look at what happens if you bet only 15% away from the optimal .25 f. At an f of .1 or .4 your TWR is 4.66. This is not even half of what it is at .25, yet you are only 15% away from the optimal and only 40 bets have elapsed!

How much are we talking about in terms of dollars? At f = .1, you would be making 1 bet for every $10 in your stake. At f = .4, you would be making I bet for every $2.50 in your stake. Both make the same amount with a TWR of 4.66. At f = .25, you are making 1 bet for every $4 in your stake. Notice that if you make 1 bet for every $4 in your stake, you will make more than twice as much after 40 bets as you would if you were making 1 bet for every $2.50 in your stake! Clearly it does not pay to overbet. At 1 bet per every $2.50 in your stake you make the same amount as if you had bet a quarter of that amount, 1 bet for every $10 in your stake! Notice that in a 50/50 game where you win twice the amount that you lose, at an f of .5 you are only breaking even! That means you are only breaking even if you made 1 bet for every $2 in your stake. At an f greater than .5 you are losing in this game, and it is simply a matter of time until you are completely tapped out! In other words, if your fin this 50/50, 2:1 game is .25 beyond what is optimal, you will go broke with a probability that approaches certainty as you continue to play. Our goal, then, is to objectively find the peak of the f curve for a given trading system.

In this discussion certain concepts will be illuminated in terms of gambling illustrations. The main difference between gambling and speculation is that gambling creates risk (and hence many people are opposed to it) whereas speculation is a transference of an already existing risk (supposedly) from one party to another. The gambling illustrations are used to illustrate the concepts as clearly and simply as possible. The mathematics of money management and the principles involved in trading and gambling are quite similar. The main difference is that in the math of gambling we are usually dealing with Bernoulli outcomes (only two possible outcomes), whereas in trading we are dealing with the entire probability distribution that the trade may take.

BASIC CONCEPTS

A ***probability statement*** is a number between 0 and 1 that specifies how probable an outcome is, with 0 being no probability whatsoever of the event in question occurring and 1 being that the event in question is certain to occur. An ***independent trials process (sampling with replacement)*** is a sequence of outcomes where the probability statement is constant from one event to the next. A coin toss is an example of just such a process. Each toss has a 50/50 probability regardless of the outcome of the prior toss. Even if the last 5 flips of a coin were heads, the probability of this flip being heads is unaffected and remains .5.

Naturally, the other type of random process is one in which the outcome of prior events ***does*** affect the probability statement, and naturally, the probability statement is not constant from one event to the next. These types of events are called ***dependent trials processes (sampling without replacement).*** Blackjack is an example of just such a process. Once a card is played, the composition of the deck changes. Suppose a new deck is shuffled and a card removed-say, the ace of diamonds. Prior to removing this card the probability of drawing an ace was 4/52 or .07692307692. Now that an ace has been drawn from the deck, and not replaced, the probability of drawing an ace on the next draw is 3/51 or .05882352941.

Try to think of the difference between independent and dependent trials processes as simply ***whether the probability statement is fixed (independent trials) or variable (dependent trials) from one event to the next based on prior outcomes.*** This is in fact the only difference.

THE RUNS TEST

When we do sampling without replacement from a deck of cards, we can determine by inspection that there is dependency. For certain events (such as the profit and loss stream of a system's trades) where dependency cannot be determined upon inspection, we have the runs test. The runs test will tell us if our system has more (or fewer) streaks of consecutive wins and losses than a random distribution.

The runs test is essentially a matter of obtaining the Z scores for the win and loss streaks of a system's trades. A Z score is how many standard deviations you are away from the mean of a distribution. Thus, a Z score of 2.00 is 2.00 standard deviations away from the mean (the expectation of a random distribution of streaks of wins and losses).

The Z score is simply the number of standard deviations the data is from the mean of the Normal Probability Distribution. For example, a Z score of 1.00 would mean that the data you arc testing is within 1 standard deviation from the mean. Incidentally, this is perfectly normal.

The Z score is then converted into a ***confidence limit,*** sometimes also called a ***degree of certainty.*** The area under the curve of the Normal Probability Function at 1 standard deviation on either side of the mean equals 68% of the total area under the curve. So we take our Z score and convert it to a confidence limit, the relationship being that the Z score is a number of standard deviations from the mean and the confidence limit is the percentage of area under the curve occupied at so many standard deviations.

Confidence Limit (%)	Z Score
99.73	3.00
99	2.58
98	2.33
97	2.17
96	2.05
95.45	2.00
95	1.96
90	1.64

With a minimum of 30 closed trades we can now compute our Z scores. What we are trying to answer is how many streaks of wins (losses) can we expect from a given system? Are the win (loss) streaks of the system we are testing in line with what we could expect? If not, is there a high enough confidence limit that we can assume dependency exists between trades -i.e., is the outcome of a trade dependent on the outcome of previous trades?

Here then is the equation for the runs test, the system's Z score:

(1.01) Z = (N*(R-.5)-X)/((X*(X-N))/(N-1))^(1/2)

where

N = The total number of trades in the sequence.

R = The total number of runs in the sequence.

X = 2*W*L

W = The total number of winning trades in the sequence.

L = The total number of losing trades in the sequence.

Here is how to perform this computation:

1. Compile the following data from your run of trades:

A. The total number of trades, hereafter called N.

B. The total number of winning trades and the total number of losing trades. Now compute what we will call X. X = 2*Total Number of Wins*Total Number of Losses.

C. The total number of runs in a sequence. We'll call this R.

2. Let's construct an example to follow along with. Assume the following trades:

-3 +2 +7 -4 +1 -1 +1 +6 -1 0 -2 +1

The net profit is +7. The total number of trades is 12, so N = 12, to keep the example simple. We are not now concerned with how big the wins and losses are, but rather how many wins and losses there are and how many streaks. Therefore, we can reduce our run of trades to a simple sequence of pluses and minuses. Note that a trade with a P&L of 0 is regarded as a loss. We now have:

- + + - + - + + - - - +

As can be seen, there are 6 profits and 6 losses; therefore, X = 2*6*6 = 72. As can also be seen, there are 8 runs in this sequence; therefore, R = 8. We ***define a run as anytime you encounter a sign change when reading the sequence as just shown from left to right*** (i.e., chronologically). Assume also that you start at 1.

1. You would thus count this sequence as follows:

-	+	+	-	+	-	+	+	-	-	-	+
1	2		3	4	5	6		7			8

2. Solve the expression:

N*(R-.5)-X

For our example this would be:

12*(8-5)-72
12*7.5-72
90-72
18

3. Solve the expression:

(X*(X-N))/(N-1)

For our example this would be:

(72*(72-12))/(12-1)
(72*60)/11
4320/11
392.727272

4. Take the square root of the answer in number 3. For our example this would be:

392.727272^(l/2) = 19.81734777

5. Divide the answer in number 2 by the answer in number 4. This is your Z score. For our example this would be:

18/19.81734777 = .9082951063

6. Now convert your Z score to a confidence limit. The distribution of runs is binomially distributed. However, when there are 30 or more trades involved, we can use the Normal Distribution to very closely approximate the binomial probabilities. Thus, if you are using 30 or more trades, you can simply convert your Z score to a confidence limit based upon Equation (3.22) for 2-tailed probabilities in the Normal Distribution.

The runs test will tell you if your sequence of wins and losses contains more or fewer streaks (of wins or losses) than would ordinarily be expected in a truly random sequence, one that has no dependence between trials. Since we are at such a relatively low confidence limit in our example, we can assume that there is no dependence between trials in this particular sequence.

If your Z score is negative, simply convert it to positive (take the absolute value) when finding your confidence limit. A negative Z score implies positive dependency, meaning fewer streaks than the Normal Probability Function would imply and hence that wins beget wins and losses beget losses. A positive Z score implies negative dependency, meaning more streaks than the Normal Probability Function would imply and hence that wins beget losses and losses beget wins.

What would an acceptable confidence limit be? Statisticians generally recommend selecting a confidence limit at least in the high nineties. Some statisticians recommend a confidence limit in excess of 99% in order to assume dependency, some recommend a less stringent minimum of 95.45% (2 standard deviations).

Rarely, if ever, will you find a system that shows confidence limits in excess of 95.45%. Most frequently the confidence limits encountered are less than 90%. Even if you find a system with a confidence limit between 90 and 95.45%, this is not exactly a nugget of gold. To assume that there is dependency involved that can be capitalized upon to make a substantial difference, you really need to exceed 95.45% as a bare minimum.

As long as the dependency is at an acceptable confidence limit, you can alter your behavior accordingly to make better trading decisions, even though you do not understand the underlying cause of the dependency. If you could know the cause, you could then better estimate when the dependency was in effect and when it was not, as well as when a change in the degree of dependency could be expected.

So far, we have only looked at dependency from the point of view of whether the last trade was a winner or a loser. We are trying to determine if the sequence of wins and losses exhibits dependency or not. The runs test for dependency automatically takes the percentage of wins and losses into account. However, in performing the runs test on runs of wins and losses, we have accounted for the ***sequence*** of wins and losses but not their size. In order to have true independence, not only must the sequence of the wins and losses be independent, the sizes of the wins and losses within the sequence must also be independent. It is possible for the wins and losses to be independent, yet their sizes to be dependent (or vice versa). One possible solution is to run the runs test on only the winning trades, segregating the runs in some way (such as those that are greater than the median win and those that are less), and then look for dependency among the size of the winning trades. Then do this for the losing trades.

SERIAL CORRELATION

There is a different, perhaps better, way to quantify this possible dependency between the size of the wins and losses. The technique to be discussed next looks at the sizes of wins and losses from an entirely different perspective mathematically than the does runs test, and hence, when used in conjunction with the runs test, measures the relationship of trades with more depth than the runs test alone could provide. This technique utilizes the linear correlation coefficient, r, sometimes called ***Pearson's*** r, to quantify the dependency/independency relationship.

Now look at Figure 1-2. It depicts two sequences that are perfectly correlated with each other. We call this effect ***positive correlation.***

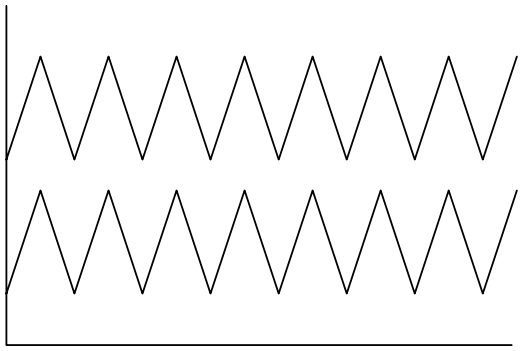

Figure 1-2 Positive correlation (r = +1.00).

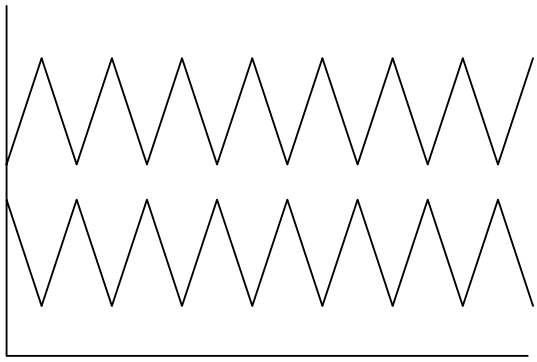

Figure 1-3 Negative correlation (r = -1 .00).

Now look at Figure 1-3. It shows two sequences that are perfectly negatively correlated with each other. When one line is zigging the other is zagging. We call this effect negative correlation.

The formula for finding the linear correlation coefficient, r, between two sequences, X and Y, is as follows (a bar over a variable means the arithmetic mean of the variable):

(1.02) $R = (\sum_a(X_a-X[])*(Y_a-Y[]))/((\sum_a(X_a-X[])^2)^{(1/2)}*(\sum_a(Y_a-Y[])^2)^{(1/2)})$

Here is how to perform the calculation:

7. Average the X's and the Y's (shown as X[] and Y[]).

8. For each period find the difference between each X and the average X and each Y and the average Y.

9. Now calculate the numerator. To do this, for each period multiply the answers from step 2-in other words, for each period multiply together the differences between that period's X and the average X and between that period's Y and the average Y.

10. Total up all of the answers to step 3 for all of the periods. This is the numerator.

11. Now find the denominator. To do this, take the answers to step 2 for each period, for both the X differences and the Y differences, and square them (they will now all be positive numbers).

12. Sum up the squared X differences for all periods into one final total. Do the same with the squared Y differences.

13. Take the square root to the sum of the squared X differences you just found in step 6. Now do the same with the Y's by taking the square root of the sum of the squared Y differences.

14. Multiply together the two answers you just found in step 1 - that is, multiply together the square root of the sum of the squared X differences by the square root of the sum of the squared Y differences. This product is your denominator.

15. Divide the numerator you found in step 4 by the denominator you found in step 8. This is your linear correlation coefficient, r.

The value for r will always be between +1.00 and -1.00. A value of 0 indicates no correlation whatsoever.

Now look at Figure 1-4. It represents the following sequence of 21 trades:

1, 2, 1, -1, 3, 2, -1, -2, -3, 1, -2, 3, 1, 1, 2, 3, 3, -1, 2, -1, 3

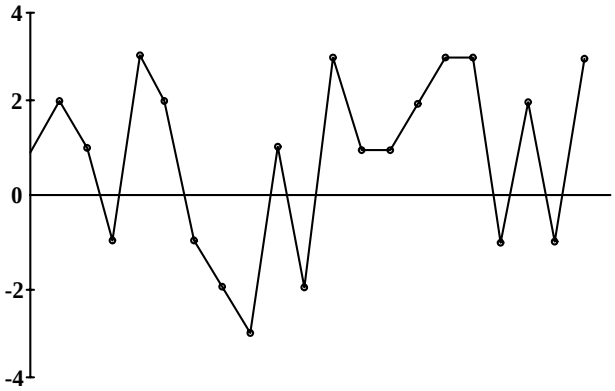

Figure 1-4 Individual outcomes of 21 trades.

We can use the linear correlation coefficient in the following manner to see if there is any correlation between the previous trade and the current trade. The idea here is to treat the trade P&L's as the X values in the formula for r. Superimposed over that we duplicate the same trade P&L's, only this time we skew them by 1 trade and use these as the Y values in the formula for r. In other words, the Y value is the previous X value. (See Figure 1-5.).

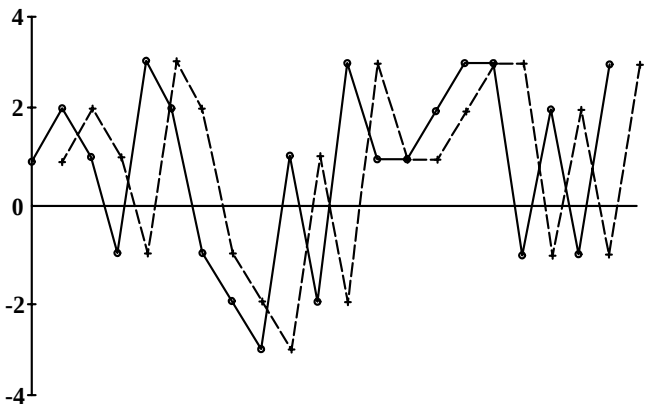

Figure 1-5 Individual outcomes of 21 trades skewed by 1 trade.

A(X)	B(X)	C(X-X[])	D(Y-Y[])	E(C*D)	F(C^2)	G(D^2)
1						
2	1	1.2	0.3	0.36	1.44	0.09
1	2	0.2	1.3	0.26	0.04	1.69

-1	1	-1.8	0.3	-0.54	3.24	0.09
3	-1	2.2	-1.7	-3.74	4.84	2.89
2	3	1.2	2.3	2.76	1.44	5.29
-1	2	-1.8	1.3	-2.34	3.24	1.69
-2	-1	-2.8	-1.7	4.76	7.84	2.89
-3	-2	-3.8	-2.7	10.26	14.44	7.29
1	-3	0.2	-3.7	-0.74	0.04	13.69
-2	1	-2.8	0.3	-0.84	7.84	0.09
3	-2	2.2	-2.7	-5.94	4.84	7.29
1	3	0.2	2.3	0.46	0.04	5.29
1	1	0.2	0.3	0.06	0.04	0.09
2	1	1.2	0.3	0.36	1.44	0.09
3	2	2.2	1.3	2.86	4.84	1.69
3	3	2.2	2.3	5.06	4.84	5.29
-1	3	-1.8	2.3	-4.14	3.24	5.29
2	-1	1.2	-1.7	-2.04	1.44	2.89
-1	2	-1.8	1.3	-2.34	3.24	1.69
3	-1	2.2	-1.7	-3.74	4.84	2.89
	3					
X[] = .8	Y[] = .7		Totals	0.8	73.2	68.2

The averages differ because you only average those X's and Y's that have a corresponding X or Y value (i.e., you average only ***those values*** that overlap), so the ***last Y value*** (3) is not figured in the Y average nor is the ***first X value*** (1) figured in the x average.

The numerator is ***the*** total of ***all entries in*** column E (0.8). To ***find the denominator***, we take ***the square root of the total*** in column F, ***which is 8.555699***, and we take ***the square root to the total in*** column G, which is 8.258329, and multiply them together to obtain a denominator of 70.65578. We now divide our numerator of 0.8 by our denominator of 70.65578 to obtain .011322. This is our linear correlation coefficient, r.

The linear correlation coefficient of .011322 in this case is hardly indicative of anything, but it is pretty much in the range you can expect for most trading systems. High ***positive correlation*** (at least .25) generally suggests that big wins are seldom followed by big losses and vice versa. Negative correlation readings (below -.25 to -.30) imply that big losses tend to be followed by big wins and vice versa. The correlation coefficients can be translated, by a technique known as ***Fisher's Z transformation,*** into a confidence level for a given number of trades. This topic is treated in Appendix C.

Negative correlation is just as helpful as positive correlation. For example, if there appears to be negative correlation and the system has just suffered a large loss, we can expect a large win and would therefore have more contracts on than we ordinarily would. If this trade proves to be a loss, it will most likely not be a large loss (due to the negative correlation).

Finally, in determining dependency you should also consider out-of-sample tests. That is, break your data segment into two or more parts. If you see dependency in the first part, then see if that dependency also exists in the second part, and so on. This will help eliminate cases where there appears to be dependency when in fact no dependency exists.

Using these two tools (the runs test and the linear correlation coefficient) can help answer many of these questions. However, they can only answer them if you have a high enough confidence limit and/or a high enough correlation coefficient. Most of the time these tools are of little help, because all too often the universe of futures system trades is dominated by independency. If you get readings indicating dependency, and you want to take advantage of it in your trading, you must go back and incorporate a rule in your trading logic to exploit the dependency. In other words, you must go back and change the trading system logic to account for this dependency (i.e., by passing certain trades or breaking up the system into two different systems, such as one for trades after wins and one for trades after losses). Thus, we can state that if dependency shows up in your trades, you haven't maximized your system. In other words, dependency, if found, should be exploited (by changing the rules of the system to take advantage of the dependency) until it no longer appears to exist. The first stage in money management is therefore ***to exploit, and hence remove, any dependency in trades***.

For more on dependency than was covered in ***Portfolio Management Formulas*** and reiterated here, see Appendix C, "Further on Dependency: The Turning Points and Phase Length Tests."

We have been discussing dependency in the stream of trade profits and losses. You can also look for dependency between an indicator and the subsequent trade, or between any two variables. For more on these concepts, the reader is referred to the section on statistical validation of a trading system under "The Binomial Distribution" in Appendix B.

COMMON DEPENDENCY ERRORS

As traders we must generally assume that dependency does not exist in the marketplace for the majority of market systems. That is, when trading a given market system, we will usually be operating in an environment where the outcome of the next trade is not predicated upon the outcome(s) of prior trade(s). That is not to say that there is never dependency between trades for some market systems (because for some market systems dependency does exist), only that we should act as though dependency does not exist unless there is very strong evidence to the contrary. Such would be the case if the Z score and the linear correlation coefficient indicated dependency, and the dependency held up across markets and across optimizable parameter values. If we act as though there is dependency when the evidence is not overwhelming, we may well just be fooling ourselves and causing more self-inflicted harm than good as a result. Even if a system showed dependency to a 95% confidence limit for all values of a parameter, it still is hardly a high enough confidence limit to assume that dependency does in fact exist between the trades of a given market or system.

A type I error is committed when we reject an hypothesis that should be accepted. If, however, we accept an hypothesis when it should be rejected, we have committed a type II error. Absent knowledge of whether an hypothesis is correct or not, we must decide on the penalties associated with a type I and type II error. Sometimes one type of error is more serious than the other, and in such cases we must decide whether to accept or reject an unproven hypothesis based on the lesser penalty.

Suppose you are considering using a certain trading system, yet you're not extremely sure that it will hold up when you go to trade it real-time. Here, the hypothesis is that the trading system will hold up real-time. You decide to accept the hypothesis and trade the system. If it does not hold up, you will have committed a type II error, and you will pay the penalty in terms of the losses you have incurred trading the system real-time. On the other hand, if you choose to not trade the system, and it is profitable, you will have committed a type I error. In this instance, the penalty you pay is in forgone profits.

Which is the lesser penalty to pay? Clearly it is the latter, the forgone profits of not trading the system. Although from this example you can conclude that if you're going to trade a system real-time it had better be profitable, there is an ulterior motive for using this example. If we assume there is dependency, when in fact there isn't, we will have committed a type 'II error. Again, the penalty we pay will not be in forgone profits, but in actual losses. However, if we assume there is not dependency when in fact there is, we will have committed a type I error and our penalty will be in forgone profits. Clearly, we are better off paying the penalty of forgone profits than undergoing actual losses. Therefore, unless there is absolutely overwhelming evidence of dependency, you are much better off assuming that the profits and losses in trading (whether with a mechanical system or not) are independent of prior outcomes.

There seems to be a paradox presented here. First, if there is dependency in the trades, then the system is 'suboptimal. Yet dependency can never be proven beyond a doubt. Now, if we assume and act as though there is dependency (when in fact there isn't), we have committed a more expensive error than if we assume and act as though dependency does not exist (when in fact it does). For instance, suppose we have a system with a history of 60 trades, and suppose we see dependency to a confidence level of 95% based on the runs test. We want our system to be optimal, so we adjust its rules accordingly to exploit this apparent dependency. After we have done so, say we are left with 40 trades, and dependency no longer is apparent. We are therefore satisfied that the system rules are optimal. These 40 trades will now have a higher optimal f than the entire 60 (more on optimal f later in this chapter).

If you go and trade this system with the new rules to exploit the dependency, and the higher concomitant optimal f, and if the dependency is not present, your performance will be closer to that of the 60 trades, rather than the superior 40 trades. Thus, the f you have chosen will be too far to the right, resulting in a big price to pay on your part for assuming dependency. If dependency is there, then you will be closer to the peak of the f curve by assuming that the dependency is there. Had you

decided not to assume it when in fact there was dependency, you would tend to be to the left of the peak of the f curve, and hence your performance would be suboptimal (but a lesser price to pay than being to the right of the peak).

In a nutshell, look for dependency. If it shows to a high enough degree across parameter values and markets for that system, then alter the system rules to capitalize on the dependency. Otherwise, in the absence of overwhelming statistical evidence of dependency, assume that it does not exist, (thus opting to pay the lesser penalty if in fact dependency does exist).

MATHEMATICAL EXPECTATION

By the same token, you are better off not to trade unless there is absolutely overwhelming evidence that the market system you are contemplating trading ***will be*** profitable-that is, unless you fully expect the market system in question to have a positive mathematical expectation when you trade it realtime.

Mathematical expectation is the amount you expect to make or lose, on average, each bet. In gambling parlance this is sometimes known as the player's edge (if positive to the player) or the ***house's advantage*** (if negative to the player):

(1.03) Mathematical Expectation = $\sum[i = 1,N](P_i*A_i)$

where

P = Probability of winning or losing.

A = Amount won or lost.

N = Number of possible outcomes.

The mathematical expectation is computed by multiplying each possible gain or loss by the probability of that gain or loss and then summing these products together.

Let's look at the mathematical expectation for a game where you have a 50% chance of winning $2 and a 50% chance of losing $1 under this formula:

Mathematical Expectation = (.5*2)+(.5*(-1)) = 1+(-5) = .5

In such an instance, of course, your mathematical expectation is to win 50 cents per toss on average.

Consider betting on one number in roulette, where your mathematical expectation is:

ME = ((1/38)*35)+((37/38)*(-1))

= (.02631578947*35)+(.9736842105*(-1))

= (9210526315)+(-.9736842105)

= -.05263157903

Here, if you bet $1 on one number in roulette (American double-zero) you would expect to lose, on average, 5.26 cents per roll. If you bet $5, you would expect to lose, on average, 26.3 cents per roll. Notice that ***different amounts bet have different mathematical expectations in terms of amounts, but the expectation as a percentage of the amount bet is always the same. The player's expectation for a series of bets is the total of the expectations for the individual bets***. So if you go play $1 on a number in roulette, then $10 on a number, then $5 on a number, your total expectation is:

ME = (-.0526*1)+(-.0526*10)+(-.0526*5) = -.0526-.526 .263 = -.8416

You would therefore expect to lose, on average, 84.16 cents.

This principle explains why systems that try to change the sizes of their bets relative to how many wins or losses have been seen (assuming an independent trials process) are doomed to fail. The summation of negative expectation bets is always a negative expectation!

The most fundamental point that you must understand in terms of money management is that ***in a negative expectation game, there is no money-management scheme that will make you a winner. If you continue to bet, regardless of how you manage your money, it is almost certain that you will be a loser, losing your entire stake no matter how large it was to start***.

This axiom is not only true of a negative expectation game, it is true of an even-money game as well. Therefore, the only game you have a chance at winning in the long run is a positive arithmetic expectation game. Then, you can only win if you either always bet the same constant bet size or bet with an f value less than the f value corresponding to the point where the geometric mean HPR is less than or equal to 1. (We will cover the second part of this, regarding the geometric mean HPR, later on in the text.)

This axiom is true only in the absence of an upper absorbing barrier. For example, let's assume a gambler who starts out with a $100 stake who will quit playing if his stake grows to $101. This upper target of $101 is called an absorbing barrier. Let's suppose our gambler is always betting $1 per play on red in roulette. Thus, he has a slight negative mathematical expectation. The gambler is far more likely to see his stake grow to $101 and quit than he is to see his stake go to zero and be forced to quit. If, however, he repeats this process over and over, he will find himself in a negative mathematical expectation. If he intends on playing this game like this only once, then the axiom of going broke with certainty, eventually, does not apply.

The difference between a negative expectation and a positive one is the difference between life and death. It doesn't matter so much how positive or how negative your expectation is; what matters is whether it is positive or negative. So before money management can even be considered, you must have a positive expectancy game. If you don't, all the money management in the world cannot save you[1]. On the other hand, if you have a positive expectation, you can, through proper money management, turn it into an exponential growth function. It doesn't even matter how marginally positive the expectation is!

In other words, it doesn't so much matter how profitable your trading system is on a 1 contract basis, so long as it is profitable, even if only marginally so. If you have a system that makes $10 per contract per trade (once commissions and slippage have been deducted), you can use money management to make it be far more profitable than a system that shows a $1,000 average trade (once commissions and slippage have been deducted). What matters, then, is not how profitable your system has been, but rather how certain is it that the system will show at least a marginal profit in the future. Therefore, the most important preparation a trader can do is to make as certain as possible that he has a positive mathematical expectation in the future.

The key to ensuring that you have a positive mathematical expectation in the future is to not restrict your system's degrees of freedom. You want to keep your system's degrees of freedom as high as possible to ensure the positive mathematical expectation in the future. This is accomplished not only by eliminating, or at least minimizing, the number of optimizable parameters, but also by eliminating, or at least minimizing, as many of the system rules as possible. Every parameter you add, every rule you add, every little adjustment and qualification you add to your system diminishes its degrees of freedom. Ideally, you will have a system that is very primitive and simple, and that continually grinds out marginal profits over time in almost all the different markets. Again, it is important that you realize that it really doesn't matter how profitable the system is, so long as it is profitable. The money you will make trading will be made by how effective the money management you employ is. The trading system is simply a vehicle to give you a positive mathematical expectation on which to use money management. Systems that work (show at least a marginal profit) on only one or a few markets, or have different rules or parameters for different markets, probably won't work real-time for very long. The problem with most technically oriented traders is that they spend too much time and effort hating the computer crank out run after run of different rules and parameter values for trading systems. This is the ultimate "woulda, shoulda, coulda" game. It is completely counterproductive. Rather than concentrating your efforts and computer time toward maximizing your trading system

[1] This rule is applicable to trading one market system only. When you begin trading more than one market system, you step into a strange environment where it is possible to include a market system with a negative mathematical expectation as one of the markets being traded and actually have a higher net mathematical expectation than the net mathematical expectation of the group before the inclusion of the negative expectation system! Further, it is possible that *the* net mathematical expectation for the group with the inclusion of the negative mathematical expectation market system can be higher than the mathematical expectation of any of the individual market systems! For the time being we will consider only one market system at a time, so we most have a positive mathematical expectation in order for the money-management techniques to work.

profits, direct the energy toward maximizing the certainty level of a marginal profit.

TO REINVEST TRADING PROFITS OR NOT

Let's call the following system "System A." In it we have 2 trades: the first making SO%, the second losing 40%. If we do not reinvest our returns, we make 10%. If we do reinvest, the same sequence of trades loses 10%.

System A

	No Reinvestment		With Reinvestment	
Trade No.	P&L	Cumulative	P&L	Cumulative
		100		100
1	50	150	50	150
2	-40	110	-60	90

Now let's look at System B, a gain of 15% and a loss of 5%, which also nets out 10% over 2 trades on a nonreinvestment basis, just like System A. But look at the results of System B with reinvestment: Unlike system A, it makes money.

System B

	No Reinvestment		With Reinvestment	
Trade No.	P&L	Cumulative	P&L	Cumulative
		100		100
1	15	115	15	115
2	-5	110	-5.75	109.25

An important characteristic of trading with reinvestment that must be realized is that ***reinvesting trading profits can turn a winning system into a losing system but not vice versa!*** A winning system is turned into a losing system in trading with reinvestment if the returns are not consistent enough.

Changing the order or sequence of trades does not affect the final outcome. This is not only true on a nonreinvestment basis, but also true on a reinvestment basis (contrary to most people's misconception).

System A

	No Reinvestment		With Reinvestment	
Trade No.	P&L	Cumulative	P&L	Cumulative
		100		100
1	40	60	40	60
2	50	110	30	90

System B

	No Reinvestment		With Reinvestment	
Trade No.	P&L	Cumulative	P&L	Cumulative
		100		100
1	-5	95	-5	95
2	15	110	14.25	109.25

As can obviously be seen, the sequence of trades has no bearing on the final outcome, whether viewed on a reinvestment or a nonreinvestment basis. (One side benefit to trading on a reinvestment basis is that the drawdowns tend to be buffered. As a system goes into and through a drawdown period, each losing trade is followed by a trade with fewer and fewer contracts.)

By inspection it would seem you are better off trading on a nonreinvestment basis than you are reinvesting because your probability of winning is greater. However, this is not a valid assumption, because in the real world we do not withdraw all of our profits and make up all of our losses by depositing new cash into an account. Further, the nature of investment or trading is predicated upon the effects of compounding. If we do away with compounding (as in the nonreinvestment basis), we can plan on doing little better in the future than we can today, no matter how successful our trading is between now and then. It is compounding that takes the linear function of account growth and makes it a geometric function.

If a system is good enough, the profits generated on a reinvestment basis will be far greater than those generated on a nonreinvestment basis, and that gap will widen as time goes by. If you have a system that can beat the market, it doesn't make any sense to trade it in any other way than to increase your amount wagered as your stake increases.

MEASURING A GOOD SYSTEM FOR REINVESTMENT THE GEOMETRIC MEAN

So far we have seen how a system can be sabotaged by not being consistent enough from trade to trade. Does this mean we should close up and put our money in the bank?

Let's go back to System A, with its first 2 trades. For the sake of illustration we are going to add two winners of 1 point each.

System A

	No Reinvestment		With Reinvestment	
Trade No.	P&L	Cumulative	P&L	Cumulative
		100		100
1	50	150	50	150
2	-40	110	-60	90
3	1	111	0.9	90.9
4	1	112	0.909	91.809
Percentage of Wins		75%	75%	
Avg. Trade		3	- 2.04775	
Risk/Rew.		1.3	0.86	
Std. Dev.		31.88	39.00	
Avg. Trade/Std. Dev.		0.09	-0.05	

Now let's take System B and add 2 more losers of 1 point each.

System B

	No Reinvestment		With Reinvestment	
Trade No.	P&L	Cumulative	P&L	Cumulative
		100		100
1	15	115	15	115
2	- 5	110	-5.75	109.25
3	-1	109	-1.0925	108.1575
4	- 1	108	-1.08157	107.0759
Percentage of Wins		25%	25%	
Avg. Trade		2	1.768981	
Risk/Rew.		2.14	1.89	
Std. Dev.		7.68	7.87	
Avg. Trade/Std. Dev.		0.26	0.22	

Now, if consistency is what we're really after, let's look at a bank account, the perfectly consistent vehicle (relative to trading), paying 1 point per period. We'll call this series System C.

System C

	No Reinvestment		With Reinvestment	
Trade No.	P&L	Cumulative	P&L	Cumulative
		100		100
1	1	101	1	101
2	1	102	1.01	102.01
3	1	103	1.0201	103.0301
4	1	104	1.030301	104.0604
Percentage of Wins		1.00	1 .00	
Avg. Trade		1	1.015100	
Risk/Rew.		Infinite	Infinite	
Std. Dev.		0.00	0.01	
Avg. Trade/Std. Dev.		Infinite	89.89	

Our aim is to maximize our profits under reinvestment trading. With that as the goal, we can see that our best reinvestment sequence comes from System B. How could we have known that, given only information regarding nonreinvestment trading? By percentage of winning trades? By total dollars? By average trade? The answer to these questions is "no," because answering "yes" would have us trading System A (but this is the solution most futures traders opt for). What if we opted for most consistency (i.e., highest ratio average trade/standard deviation or lowest standard deviation)? How about highest risk/reward or lowest drawdown? These are not the answers either. If they were, we should put our money in the bank and forget about trading.

System B has the tight mix of profitability and consistency. Systems A and C do not. That is why System B performs the best under reinvestment trading. What is the best way to measure this "right mix"? It turns out there is a formula that will do just that-the geometric mean. This is simply the Nth root of the Terminal Wealth Relative (TWR), where N is the number of periods (trades). The TWR is simply what we've been computing when we figure what the final cumulative amount is under reinvestment, In other words, the TWRs for the three systems we just saw are:

System	TWR
System A	.91809
System B	1.070759
System C	1.040604

Since there are 4 trades in each of these, we take the TWRs to the 4th root to obtain the geometric mean:

System	Geometric Mean
System A	0. 978861
System B	1.017238
System C	1.009999

(1.04) TWR = ∏[i = 1,N]HPR_i

(1.05) Geometric Mean = TWR^(1/N)

where

N = Total number of trades.

HPR = Holding period returns (equal to 1 plus the rate of return - e.g., an HPR of 1.10 means a 10% return over a given period, bet, or trade).

TWR = The number of dollars of value at the end of a run of periods/bets/trades per dollar of initial investment, assuming gains and losses are allowed to compound.

Here is another way of expressing these variables:

(1.06) TWR = Final Stake/Starting Stake

The geometric mean (G) equals your growth factor per play, or:

(1.07) G = (Final Stake/Starting Stake)^(I/Number of Plays)

Think of the geometric mean as the "growth factor per play" of your stake. The system or market with the highest geometric mean is the system or market that makes the most profit trading on a reinvestment of returns basis. A geometric mean less than one means that the system would have lost money if you were trading it on a reinvestment basis.

Investment performance is often measured with respect to the dispersion of returns. Measures such as the Sharpe ratio, Treynor measure, Jensen measure, Vami, and so on, attempt to relate investment performance to dispersion. The geometric mean here can be considered another of these types of measures. However, unlike the other measures, the geometric mean measures investment performance relative to dispersion in the same mathematical form as that in which the equity in your account is affected.

Equation (1.04) bears out another point. If you suffer an HPR of 0, you will be completely wiped out, because anything multiplied by zero equals zero. Any big losing trade will have a very adverse effect on the TWR, since it is a ***multiplicative*** rather than ***additive*** function. Thus we can state that ***in trading you are only as smart as your dumbest mistake.***

HOW BEST TO REINVEST

Thus far we have discussed reinvestment of returns in trading whereby we reinvest 100% of our stake on all occasions. Although we know that in order to maximize a potentially profitable situation we must use reinvestment, a 100% reinvestment is rarely the wisest thing to do.

Take the case of a fair bet (50/50) on a coin toss. Someone is willing to pay you $2 if you win the toss but will charge you $1 if you lose. Our mathematical expectation is .5. In other words, you would expect to make 50 cents per toss, on average. This is true of the first toss and all subsequent tosses, provided you do not step up the amount you are wagering. But in an independent trials process this is exactly what you should do. As you win you should commit more and more to each toss.

Suppose you begin with an initial stake of one dollar. Now suppose you win the first toss and are paid two dollars. Since you had your entire stake ($1) riding on the last bet, you bet your entire stake (now $3) on the next toss as well. However, this next toss is a loser and your entire $3 stake is gone. You have lost your original $1 plus the $2 you had won. If you had won the last toss, it would have paid you $6 since you had three $1 bets on it. The point is that if you are betting 100% of your stake, you'll be wiped out as soon as you encounter a losing wager, an inevitable event. If we were to replay the previous scenario and you had bet on a nonreinvestment basis (i.e., constant bet size) you would have made $2 on the first bet and lost $1 on the second. You would now be net ahead $1 and have a total stake of $2.

Somewhere between these two scenarios lies the optimal betting approach for a positive expectation. However, we should first discuss the optimal betting strategy for a negative expectation game. When you know that the game you are playing has a negative mathematical expectation, the best bet is no bet. Remember, there is no money-management strategy that can turn a losing game into a winner. 'However, if you must bet on a negative expectation game, the next best strategy is the ***maximum boldness strategy***. In other words, you want to bet on as few trials as possible (as opposed to a positive expectation game, where you want to bet on as many trials as possible). The more trials, the greater the likelihood that the positive expectation will be realized, and hence the greater the likelihood that betting on the negative expectation side will lose. Therefore, the negative expectation side has a lesser and lesser chance of losing as the length of the game is shortened - i.e., as the number of trials approaches 1. If you play a game whereby you have a 49% chance of winning $1 and a 51% of losing $1, you are best off betting on only 1 trial. The more trials you bet on, the greater the likelihood you will lose, with the probability of losing approaching certainty as the length of the game approaches infinity. That isn't to say that you are in a positive expectation for the 1 trial, but you have at least minimized the probabilities of being a loser by only playing 1 trial.

Return now to a positive expectation game. We determined at the outset of this discussion that on any given trade, the quantity that a trader puts on can be expressed as a factor, f, between 0 and 1, that represents the trader's quantity with respect to both the perceived loss on the next trade and the trader's total equity. If you know you have an edge over N bets but you do not know which of those N bets will be winners (and for how much), and which will be losers (and for how much), you are best off (in the long run) treating each bet exactly the same in terms of what percentage of your total stake is at risk. This method of always trading a fixed fraction of your stake has shown time and again to be the best staking system. If there is dependency in your trades, where winners beget winners and losers beget losers, or vice versa, you are still best off betting a fraction of your total stake on each bet, but that fraction is no longer fixed. In such a case, the fraction must reflect the effect of this dependency (that is, if you have not yet "flushed" the dependency out of your system by creating system rules to exploit it).

"Wait," you say. "Aren't staking systems foolish to begin with? Haven't we seen that they don't overcome the house advantage, they only increase our total action?" This is absolutely true for a situation with a negative mathematical expectation. For a positive mathematical expectation, it is a different story altogether. In a positive expectancy situation the trader/gambler is faced with the question of how best to exploit the positive expectation.

OPTIMAL FIXED FRACTIONAL TRADING

We have spent the course of this discussion laying the groundwork for this section. We have seen that in order to consider betting or trading a given situation or system you must first determine if a positive mathematical expectation exists. We have seen that what is seemingly a "good bet" on a mathematical expectation basis (i.e., the mathematical expectation is positive) may in fact not be such a good bet when you consider reinvestment of returns, if you are reinvesting too high a percentage of your winnings relative to the dispersion of outcomes of the system. Reinvesting returns never raises the mathematical expectation (as a percentage-although it can raise the mathematical expectation in terms of dollars, which it does geometrically, which is why we want to reinvest). If there is in fact a positive mathematical expectation, however small, the next step is to exploit this positive expectation to its fullest potential. For an independent trials process, this is achieved by reinvesting a fixed fraction of your total stake. [2]

And how do we find this optimal f? Much work has been done in recent decades on this topic in the gambling community, the most famous and accurate of which is known as the Kelly Betting System. This is actually an application of a mathematical idea developed in early 1956 by John L. Kelly, Jr.[3] The Kelly criterion states that we should bet that fixed fraction of our stake (f) which maximizes the growth function G(f):

(1.08) G(f) = P*ln(l+B*f)+(1 -P)*ln(l-f)

where

f = The optimal fixed fraction.

P = The probability of a winning bet or trade.

[2] For a dependent trials process, just as for an independent trials process, the idea of betting a proportion of your total stake also yields the greatest exploitation of a positive mathematical expectation. However, in a dependent trials process you optimally bet a variable fraction of your total stake, the exact fraction for each individual bet being determined by the probabilities and payoffs involved for each individual bet. This is analogous to trading a dependent trials process as two separate market systems.

[3] Kelly, J. L., Jr., A New Interpretation of Information Rate, Bell System Technical Journal, pp. 917-926, July, 1956.

B = The ratio of amount won on a winning bet to amount lost on a losing bet.

ln() = The natural logarithm function.

As it turns out, for an event with two possible outcomes, this optimal f[4] can be found quite easily with the Kelly formulas.

KELLY FORMULAS

Beginning around the late 1940s, Bell System engineers were working on the problem of data transmission over long-distance lines. The problem facing them was that the lines were subject to seemingly random, unavoidable "noise" that would interfere with the transmission. Some rather ingenious solutions were proposed by engineers at Bell Labs. Oddly enough, there are great similarities between this data communications problem and the problem of geometric growth as pertains to gambling money management (as both problems are the product of an environment of favorable uncertainty). One of the outgrowths of these solutions is the first Kelly formula. The first equation here is:

(1.09a) f = 2*P-l

or

(1.09b) f = P-Q

where

f = The optimal fixed fraction.

P = The probability of a winning bet or trade.

Q = The probability of a loss, (or the complement of P, equal to 1-P).

Both forms of Equation (1.09) are equivalent.

Equation (l.09a) or (1.09b) will yield the correct answer for optimal f provided the quantities are the same for both wins and losses. As an example, consider the following stream of bets:

-1, +1, +1,-1,-1, +1, +1, +1, +1,-1

There are 10 bets, 6 winners, hence:

f = (.6*2)-l = 1.2-1 = .2

If the winners and losers were not all the same size, then this formula would not yield the correct answer. Such a case would be our two-to-one coin-toss example, where all of the winners were for 2 units and all of the losers for 1 unit. For this situation the Kelly formula is:

(1.10a) f = ((B+1)*P-1)/B

where

f = The optimal fixed fraction.

P = The probability of a winning bet or trade.

B = The ratio of amount won on a winning bet to amount lost on a losing bet.

In our two-to-one coin-toss example:

f = ((2+ l).5-l)/2

= (3*.5-l)/2

= (1.5 -l)/2

= .5/2

= .25

This formula will yield the correct answer for optimal f provided all wins are always for the same amount and all losses are always for the same amount. If this is not so, then this formula will not yield the correct answer.

The Kelly formulas are applicable only to outcomes that have a Bernoulli distribution. A Bernoulli distribution is a distribution with two possible, discrete outcomes. Gambling games very often have a Bernoulli distribution. The two outcomes are how much you make when you win, and how much you lose when you lose. Trading, unfortunately, is not this simple. To apply the Kelly formulas to a non-Bernoulli distribution of outcomes (such as trading) is a mistake. The result will not be the true optimal f. For more on the Bernoulli distribution, consult Appendix B. Consider the following sequence of bets/trades:

+9, +18, +7, +1, +10, -5, -3, -17, -7

Since this is not a Bernoulli distribution (the wins and losses are of different amounts), the Kelly formula is not applicable. However, let's try it anyway and see what we get.

Since 5 of the 9 events are profitable, then P = .555. Now let's take averages of the wins and losses to calculate B (here is where so many traders go wrong). The average win is 9, and the average loss is 8. Therefore we say that B = 1.125. Plugging in the values we obtain:

f = ((1.125+1) .555-1)/1.125

= (2.125*.555-1)/1.125

= (1.179375-1)/1.125

= .179375/1.125

= .159444444

So we say f = .16. You will see later in this chapter that this is not the optimal f. The optimal f for this sequence of trades is .24. Applying the Kelly formula when all wins are not for the same amount and/or all losses are not for the same amount is a mistake, for it will not yield the optimal f.

Notice that the numerator in this formula equals the mathematical expectation for an event with two possible outcomes as defined earlier. Therefore, we can say that as long as all wins are for the same amount and all losses are for the same amount (whether or not the amount that can be won equals the amount that can be lost), the optimal f is:

(1.10b) f = Mathematical Expectation/B

where

f = The optimal fixed fraction.

B = The ratio of amount won on a winning bet to amount lost on a losing bet.

The mathematical expectation is defined in Equation (1.03), but since we must have a Bernoulli distribution of outcomes we must make certain in using Equation (1.10b) that we only have two possible outcomes.

Equation (l.l0a) is the most commonly seen of the forms of Equation (1.10) (which are all equivalent). However, the formula can be reduced to the following simpler form:

(1.10c) f = P-Q/B

where

f = The optimal fixed fraction.

P = The probability of a winning bet or trade.

Q = The probability of a loss (or the complement of P, equal to 1-P).

FINDING THE OPTIMAL F BY THE GEOMETRIC MEAN

In trading we can count on our wins being for varying amounts and our losses being for varying amounts. Therefore the Kelly formulas could not give us the correct optimal f. How then can we find our optimal f to know how many contracts to have on and have it be mathematically correct?

Here is the solution. To begin with, we must amend our formula for finding HPRs to incorporate f:

(1.11) HPR = 1+f*(-Trade/Biggest Loss)

where

f = The value we are using for f.

-Trade = The profit or loss on a trade (with the sign reversed so that losses are positive numbers and profits are negative).

Biggest Loss = The P&L that resulted in the biggest loss. (This should always be a negative number.)

And again, TWR is simply the geometric product of the HPRs and geometric mean (G) is simply the Nth root of the TWR.

(1.12) TWR = ∏[i = 1,N](1+f*(-$Trade_i$/Biggest Loss))

(1.13) G = (∏[i = 1,N](1+f*(-$Trade_i$/Biggest Loss))]^(1/N)

where

f = The value we are using for f.

-$Trade_i$ = The profit or loss on the ith trade (with the sign reversed so that losses are positive numbers and profits are negative).

Biggest Loss = The P&L that resulted in the biggest loss. (This should always be a negative number.)

N = The total number of trades.

[4] As used throughout the text, f is always lowercase and in roman type. It is not to be confused with the universal constant, F, equal to 4.669201609…, pertaining to bifurcations in chaotic systems.

G = The geometric mean of the HPRs.

By looping through all values for I between .01 and 1, we can find that value for f which results in the highest TWR. This is the value for f that would provide us with the maximum return on our money using fixed fraction. We can also state that the optimal f is the f that yields the highest geometric mean. It matters not whether we look for highest TWR or geometric mean, as both are maximized at the same value for f.

Doing this with a computer is easy, since both the TWR curve and the geometric mean curve are smooth with only one peak. You simply loop from f = .01 to f = 1.0 by .01. As soon as you get a TWR that is less than the previous TWR, you know that the f corresponding to the previous TWR is the optimal f. You can employ many other search algorithms to facilitate this process of finding the optimal f in the range of 0 to 1. One of the fastest ways is with the parabolic interpolation search procedure detailed in ***portfolio Management Formulas***.

TO SUMMARIZE THUS FAR

You have seen that a good system is the one with the highest geometric mean. Yet to find the geometric mean you must know f. You may find this confusing. Here now is a summary and clarification of the process:

Take the trade listing of a given market system.

1. Find the optimal f, either by testing various f values from 0 to 1 or through iteration. The optimal f is that which yields the highest TWR.
2. Once you have found f, you can take the Nth root of the TWR that corresponds to your f, where N is the total number of trades. This is your geometric mean for this market system. You can now use this geometric mean to make apples-to-apples comparisons with other market systems, as well as use the f to know how many contracts to trade for that particular market system.

Once the highest f is found, it can readily be turned into a dollar amount by dividing the biggest loss by the negative optimal f. For example, if our biggest loss is $100 and our optimal f is .25, then -$100/-.25 = $400. In other words, we should bet 1 unit for every $400 we have in our stake.

If you're having trouble with some of these concepts, try thinking in terms of betting in units, not dollars (e.g., one $5 chip or one futures contract or one 100-share unit of stock). The number of dollars you allocate to each unit is calculated by figuring your largest loss divided by the negative optimal f.

The optimal f is a result of the balance between a system's profit-making ability (on a constant 1-unit basis) and its risk (on a constant 1-unit basis).

Most people think that the optimal fixed fraction is that percentage of your total stake to bet, This is absolutely false. There is an interim step involved. Optimal f is not in itself the percentage of your total stake to bet, it is the divisor of your biggest loss. The quotient of this division is what you divide your total stake by to know how many bets to make or contracts to have on.

You will also notice that ***margin has nothing whatsoever to do with what is the mathematically optimal number of contracts to have on***. Margin doesn't matter because the sizes of individual profits and losses are not the product of the amount of money put up as margin (they would be the same whatever the size of the margin). Rather, the profits and losses are the product of the exposure of 1 unit (1 futures contract). The amount put up as margin is further made meaningless in a money-management sense, because the size of the loss is not limited to the margin.

Most people incorrectly believe that f is a straight-line function rising up and to the right. They believe this because they think it would mean that the more you are willing to risk the more you stand to make. People reason this way because they think that a positive mathematical expectancy is just the mirror image of a negative expectancy. They mistakenly believe that if increasing your total action in a negative expectancy game results in losing faster, then increasing your total action in a positive expectancy game will result in winning faster. This is not true. At some point in a positive expectancy situation, further increasing your total action works against you. That point is a function of both the system's profitability and its consistency (i.e., its geometric mean), since you are reinvesting the returns back into the system.

It is a mathematical fact that when two people face the same sequence of favorable betting or trading opportunities, if one uses the optimal f and the other uses any different money-management system, then the ratio of the optimal f bettor's stake to the other person's stake will increase as time goes on, with higher and higher probability. In the long run, the optimal f bettor will have infinitely greater wealth than any other money-management system bettor with a probability approaching 1. Furthermore, if a bettor has the goal of reaching a specified fortune and is facing a series of favorable betting or trading opportunities, the expected time to reach the fortune will be lower (faster) with optimal f than with any other betting system.

Let's go back and reconsider the following sequence of bets (trades):

+9, +18, +7, +1, +10, -5, -3, -17, -7

Recall that we determined earlier in this chapter that the Kelly formula was not applicable to this sequence, because the wins were not all for the same amount and neither were the losses. We also decided to average the wins and average the losses and take these averages as our values into the Kelly formula (as many traders mistakenly do). Doing this we arrived at an f value of .16. It was stated that this is an incorrect application of Kelly, that it would not yield the optimal f. The Kelly formula must be specific to a single bet. You cannot average your wins and losses from trading and obtain the true optimal fusing the Kelly formula.

Our highest TWR on this sequence of bets (trades) is obtained at .24, or betting $1 for every $71 in our stake. That is the optimal geometric growth you can squeeze out of this sequence of bets (trades) trading fixed fraction. Let's look at the TWRs at different points along 100 loops through this sequence of bets. At 1 loop through (9 bets or trades), the TWR for f = ,16 is 1.085, and for f = .24 it is 1.096. This means that for 1 pass through this sequence of bets an f = .16 made 99% of what an f = .24 would have made. To continue:

Passes Throe	Total Bets or Trades	TWR for f=.24	TWR for f=.16	Percentage Difference
1	9	1.096	1.085	1
10	90	2.494	2.261	9.4
40	360	38.694	26.132	32.5
100	900	9313.312	3490.761	62.5

As can be seen, using an f value that we mistakenly figured from Kelly only made 37.5% as much as did our optimal f of .24 after 900 bets or trades (100 cycles through the series of 9 outcomes). In other words, our optimal f of .24, which is only .08 different from .16 (50% beyond the optimal) made almost 267% the profit that f = .16 did after 900 bets!

Let's go another 11 cycles through this sequence of trades, so that we now have a total of 999 trades. Now our TWR for f = .16 is 8563.302 (not even what it was for f = .24 at 900 trades) and our TWR for f = .24 is 25,451.045. At 999 trades f = .16 is only 33.6% off = .24, or f = .24 is 297% off = .16!

As you see, using the optimal f does not appear to offer much advantage over the short run, but over the long run it becomes more and more important. The point is, you must give the program time when trading at the optimal f and not expect miracles in the short run. The more time (i.e., bets or trades) that elapses, the greater the difference between using the optimal f and any other money-management strategy.

GEOMETRIC AVERAGE TRADE

At this point the trader may be interested in figuring his or her geometric average trade-that is, what is the average garnered per contract per trade assuming profits are always reinvested and fractional contracts can be purchased. This is the mathematical expectation when you are trading on a fixed fractional basis. ***This figure shows you what effect there is by losers occurring when you have many contracts on and winners occurring when you have fewer contracts on. In effect, this approximates how a system would have fared per contract per trade doing fixed fraction.*** (Actually the geometric average trade is your mathematical expectation in dollars per contract per trade. The geometric mean minus 1 is your mathematical expectation per trade-a geometric mean of 1.025 represents a mathematical expectation of 2.5% per trade, irrespective of size.) Many traders look only at the average trade of a market system to see if it is high enough to justify trading the sys-

tem. However, they should be looking at the geometric average trade (GAT) in making their decision.

(1.14) GAT = G*(Biggest Loss/-f)

where

G = Geometric mean-1.

f = Optimal fixed fraction. (and, of course, our biggest loss is always a negative number).

For example, suppose a system has a ***geometric mean*** of 1.017238, the biggest loss is $8,000, and the optimal f is .31. Our geometric average trade would be:

GAT = (1.017238-1)*(-$8,000/-.31)

= .017238*$25,806.45

= $444.85

WHY YOU MUST KNOW YOUR OPTIMAL F

The graph in Figure 1-6 further demonstrates the importance of using optimal fin fixed fractional trading. Recall our f curve for a 2:1 coin-toss game, which was illustrated in Figure 1-1.

Let's increase the winning payout from 2 units to 5 units as is demonstrated in Figure 1-6. Here your optimal f is .4, or to bet $1 for every $2.50 in you stake. After 20 sequences of +5,-l (40 bets), your $2.50 stake has grown to $127,482, thanks to optimal f. Now look what happens in this extremely favorable situation if you miss the optimal f by 20%. At f values of .6 and .2 you don't make a tenth as much as you do at .4. This particular situation, a 50/50 bet paying 5 to 1, has a mathematical expectation of (5*.5)+(1*(-.5)) = 2, yet if you bet using an f value greater than .8 you lose money.

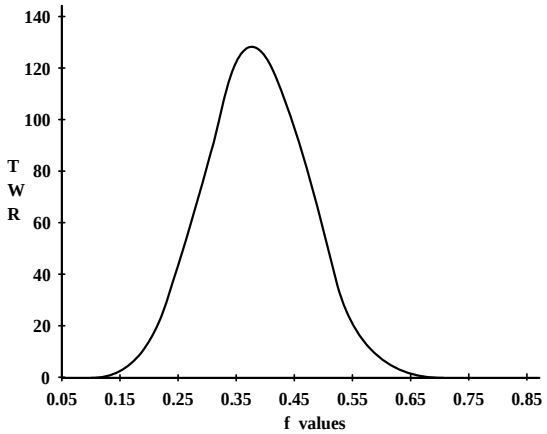

Figure 1-6 20 sequences of +5, -1.

Two points must be illuminated here. The first is that whenever we discuss a TWR, we assume that in arriving at that TWR we allowed fractional contracts along the way. In other words, the TWR assumes that you are able to trade 5.4789 contracts if that is called for at some point. It is because the TWR calculation allows for fractional contracts that the TWR will always be the same for a given set of trade outcomes regardless of their sequence. You may argue that in real life this is not the case. In real life you cannot trade fractional contracts. Your argument is correct. However, I am allowing the TWR to be calculated this way because in so doing we represent the average TWR for all possible starting stakes. If you require that all bets be for integer amounts, then the amount of the starting stake becomes important. However, if you were to average the TWRs from all possible starting stake

values using integer bets only, you would arrive at the same TWR value that we calculate by allowing the fractional bet. Therefore, the TWR value as calculated is more realistic than if we were to constrain it to integer bets only, in that it is representative of the universe of outcomes of different starting stakes.

Furthermore, the greater the equity in the account, the more trading on an integer contract basis will be the same as trading on a fractional contract basis. The limit here is an account with an infinite amount of capital where the integer bet and fractional bet are for the same amounts exactly.

This is interesting in that generally the closer you can stick to optimal f, the better. That is to say that the greater the capitalization of an account, the greater will be the effect of optimal f. Since optimal f will make an account grow at the fastest possible rate, we can state that optimal f will make itself work better and better for you at the fastest possible rate.

The graphs (Figures 1-1 and 1-6) bear out a few more interesting points. The first is that at ***no other fixed fraction will you make more money than you will at optimal f.*** In other words, it does not pay to bet $1 for every $2 in your stake in the earlier example of a 5:1 game. In such a case you would make more money if you bet $1 for every $2.50 in your stake. ***It does not pay to risk more than the optimal f-in fact, you pay a price to do so!***

Obviously, the greater the capitalization of an account the more accurately you can stick to optimal f, as the dollars per single contract required are a smaller percentage of the total equity. For example, suppose optimal f for a given market system dictates you trade 1 contract for every $5,000 in an account. If an account starts out with $10,000 in equity, it will need to gain (or lose) 50% before a quantity adjustment is necessary. Contrast this to a $500,000 account, where there would be a contract adjustment for every 1% change in equity. Clearly the larger account can better take advantage of the benefits provided by optimal f than can the smaller account. Theoretically, optimal f assumes you can trade in infinitely divisible quantities, which is not the case in real life, where the smallest quantity you can trade in is a single contract. In the asymptotic sense this does not matter. But in the real-life integer-bet scenario, a good case could be presented for trading a market system that requires as small a percentage of the account equity as possible, especially for smaller accounts. But there is a tradeoff here as well. Since we are striving to trade in markets that would require us to trade in greater multiples than other markets, we will be paying greater commissions, execution costs, and slippage. Bear in mind that the amount required per contract in real life is the greater of the initial margin requirement and the dollar amount per contract dictated by the optimal f.

The finer you can cut it (i.e., the more frequently you can adjust the size of the positions you are trading so as to align yourself with what the optimal f dictates), the better off you are. Most accounts would therefore be better off trading the smaller markets. Corn may not seem like a very exciting market to you compared to the S&P's. Yet for most people the corn market can get awfully exciting if they have a few hundred contracts on.

Those who trade stocks or forwards (such as forex traders) have a tremendous advantage here. Since you must calculate your optimal f based on the outcomes (the P&Ls) on a 1-contract (1 unit) basis, you must first decide what 1 unit is in stocks or forex. As a stock trader, say you decide that I unit will be 100 shares. You will use the P&L stream generated by trading 100 shares on each and every trade to determine your optimal f. When you go to trade this particular stock (and let's say your system calls for trading 2.39 contracts or units), you will be able to trade the fractional part (the .39 part) by putting on 239 shares. Thus, by being able to trade the fractional part of 1 unit, you are able to take more advantage of optimal f. Likewise for forex traders, who must first decide what 1 contract or unit is. For the forex trader, 1 unit may be one million U.S. dollars or one million Swiss francs.

THE SEVERITY OF DRAWDOWN

It is important to note at this point that the drawdown you can expect with fixed fractional trading, as a percentage retracement of your account equity, historically would have been at least as much as f percent. In other words if f is .55, then your drawdown would have been at least 55% of your equity (leaving you with 45% at one point). This is so because if you are trading at the optimal f, as soon as your biggest loss was hit, you would experience the drawdown equivalent to f. Again, assuming that f for a system is .55 and assuming that translates into trading 1 contract for every $10,000, this means that your biggest loss was $5,500. As should by now be obvious, when the biggest loss was encountered (again we're speaking historically what would have happened), you would have lost $5,500 for each contract you had on, and would have had 1 contract on for every $10,000 in the account. At that point, your drawdown is 55% of equity. Moreover, the drawdown might continue: The next trade or series of trades might draw your account down even more. Therefore, the better a system, the higher the f. The higher the f, generally the higher the drawdown, since the drawdown (in terms of a percentage) can never be any less than the f as a percentage. There is a paradox involved here in that if a system is good enough to

generate an optimal f that is a high percentage, then the drawdown for such a good system will also be quite high. Whereas optimal fallows you to experience the greatest geometric growth, it also gives you enough rope to hang yourself with.

Most traders harbor great illusions about the severity of drawdowns. Further, most people have fallacious ideas regarding the ratio of potential gains to dispersion of those gains.

We know that if we are using the optimal f when we are fixed fractional trading, we can expect substantial drawdowns in terms of percentage equity retracements. Optimal f is like plutonium. It gives you a tremendous amount of power, yet it is dreadfully dangerous. These substantial drawdowns are truly a problem, particularly for notices, in that trading at the optimal f level gives them the chance to experience a cataclysmic loss sooner than they ordinarily might have. Diversification can greatly buffer the drawdowns. This it does, but the reader is warned not to expect to eliminate drawdown. In fact, ***the real benefit of diversification is that it lets you get off many more trials, many more plays, in the same time period, thus increasing your total profit.*** Diversification, although usually the best means by which to buffer drawdowns, does not necessarily reduce drawdowns, and in some instances, may actually increase them!

Many people have the mistaken impression that drawdown can be completely eliminated if they diversify effectively enough. To an extent this is true, in that drawdowns can be buffered through effective diversification, but they can never be completely eliminated. ***Do not be deluded***. No matter how good the systems employed are, no matter how effectively you diversify, you will still encounter substantial drawdowns. The reason is that no matter of how uncorrelated your market systems are, there comes a period when most or all of the market systems in your portfolio zig in unison against you when they should be zagging. You will have enormous difficulty finding a portfolio with at least 5 years of historical data to it and all market systems employing the optimal f that has had any less than a 30% drawdown in terms of equity retracement! This is regardless of how many market systems you employ. If you want to be in this and do it mathematically correctly, you better expect to be nailed for 30% to 95% equity retracements. This takes enormous discipline, and very few people can emotionally handle this.

When you dilute f, although you reduce the drawdowns arithmetically, you also reduce the returns geometrically. Why commit funds to futures trading that aren't necessary simply to flatten out the equity curve at the expense of your bottom-line profits? ***You can diversify cheaply somewhere else.***

Any time a trader deviates from always trading the same constant contract size, he or she encounters the problem of what quantities to trade in. This is so whether the trader recognizes this problem or not. Constant contract trading is not the solution, as you can never experience geometric growth trading constant contract. So, like it or not, the question of what quantity to take on the next trade is inevitable for everyone. To simply select an arbitrary quantity is a costly mistake. Optimal f is factual; it is mathematically correct.

MODERN PORTFOLIO THEORY

Recall the paradox of the optimal f and a market system's drawdown. The better a market system is, the higher the value for f. Yet the drawdown (historically) if you are trading the optimal f can never be lower than f. Generally speaking, then, the better the market system is, the greater the drawdown will be as a percentage of account equity if you are trading optimal f. That is, if you want to have the greatest geometric growth in an account, then you can count on severe drawdowns along the way.

Effective diversification among other market systems is the most effective way in which this drawdown can be buffered and conquered while still staying close to the peak of the f curve (i.e., without hating to trim back to, say, f/2). When one market system goes into a drawdown, another one that is being traded in the account will come on strong, thus canceling the draw-down of the other. This also provides for a catalytic effect on the entire account. The market system that just experienced the drawdown (and now is getting back to performing well) will have no less funds to start with than it did when the drawdown began (thanks to the other market system canceling out the drawdown). Diversification won't hinder the upside of a system (quite the reverse-the upside is far greater, since after a drawdown you aren't starting back with fewer contracts), yet it will buffer the downside (but only to a very limited extent).

There exists a quantifiable, optimal portfolio mix given a group of market systems and their respective optimal fs. Although we cannot be certain that the optimal portfolio mix in the past will be optimal in the future, such is more likely than that the optimal system parameters of the past will be optimal or near optimal in the future. Whereas optimal system parameters change quite quickly from one time period to another, optimal portfolio mixes change very slowly (as do optimal f values). Generally, the correlations between market systems tend to remain constant. This is good news to a trader who has found the optimal portfolio mix, the optimal diversification among market systems.

THE MARKOVITZ MODEL

The basic concepts of modern portfolio theory emanate from a monograph written by Dr. Harry Markowitz.[5] Essentially, Markowitz proposed that portfolio management is one of composition, not individual stock selection as is more commonly practiced. Markowitz argued that diversification is effective only to the extent that the correlation coefficient between the markets involved is negative. If we have a portfolio composed of one stock, our best diversification is obtained if we choose another stock such that the correlation between the two stock prices is as low as possible. The net result would be that the portfolio, as a whole (composed of these two stocks with negative correlation), would have less variation in price than either one of the stocks alone.

Markowitz proposed that investors act in a rational manner and, given the choice, would opt for a similar portfolio with the same return as the one they have, but with less risk, or opt for a portfolio with a higher return than the one they have but with the same risk. Further, for a given level of risk there is an optimal portfolio with the highest yield, and likewise for a given yield there is an optimal portfolio with the lowest risk. An investor with a portfolio whose yield could be increased with no resultant increase in risk, or an investor with a portfolio whose risk could be lowered with no resultant decrease in yield, are said to have ***inefficient*** portfolios. Figure 1-7 shows all of the available portfolios under a given study. If you hold portfolio C, you would be better off with portfolio A, where you would have the same return with less risk, or portfolio B, where you would have more return with the same risk.

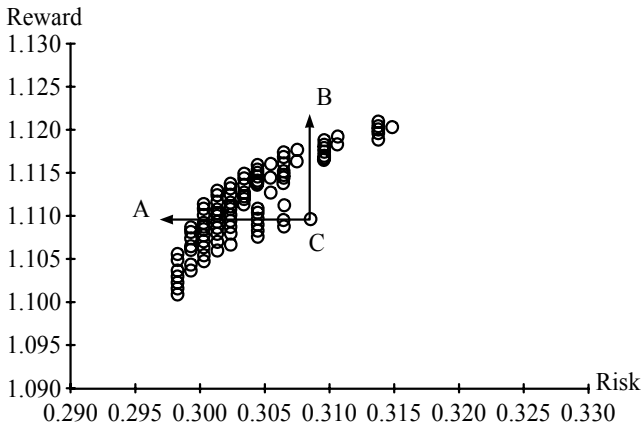

Figure 1-7 Modern portfolio theory.

In describing this, Markowitz described what is called the ***efficient frontier***. This is the set of portfolios that lie on the upper and left sides of the graph. These are portfolios whose yield can no longer be increased without increasing the risk and whose risk cannot be lowered without lowering the yield. Portfolios lying on the efficient frontier are said to be ***efficient*** portfolios. (See Figure 1-8.)

[5] Markowitz, H., Portfolio Selection—Efficient Diversification of Investments. Yale University Press, New Haven, Conn., 1959.

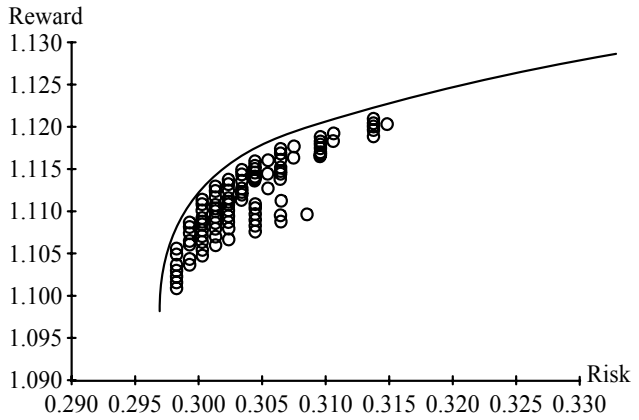

Figure 1-8 The efficient frontier

Those portfolios lying high and off to the right and low and to the left are generally not very well diversified among very many issues. Those portfolios lying in the middle of the efficient frontier are usually very well diversified. Which portfolio a particular investor chooses is a function of the investor's risk aversion-Ms or her willingness to assume risk. In the Markowitz model any portfolio that lies upon the efficient frontier is said to be a good portfolio choice, but where on the efficient frontier is a matter of personal preference (later on we'll see that there is an exact optimal spot on the efficient frontier for all investors).

The Markowitz model was originally introduced as applying to a portfolio of stocks that the investor would hold long. Therefore, the basic inputs were the expected returns on the stocks (defined as the expected appreciation in share price plus any dividends), the expected variation in those returns, and the correlations of the different returns among the different stocks. If we were to transport this concept to futures it would stand to reason (since futures don't pay any dividends) that we measure the expected price gains, variances, and correlations of the different futures.

The question arises, "If we are measuring the correlation of prices, what if we have two systems on the same market that are negatively correlated?" In other words, suppose we have systems A and B. There is a perfect negative correlation between the two. When A is in a drawdown, B is in a drawup and vice versa. Isn't this really an ideal diversification? What we really want to measure then is not the correlations of prices of the markets we're using. Rather, we want to ***measure the correlations of daily equity changes between the different market system***.

Yet this is still an apples-and-oranges comparison. Say that two of the market systems we are going to examine the correlations on are both trading the same market, yet one of the systems has an optimal f corresponding to I contract per every $2,000 in account equity and the other system has an optimal f corresponding to 1 contract per every $10,000 in account equity. To overcome this and incorporate the optimal fs of the various market systems under consideration, as well as to account for fixed fractional trading, we convert the daily equity changes for a given market system into daily HPRs. The HPR in this context is how much a particular market made or lost for a given day on a 1-contract basis relative to what the optimal f for that system is. Here is how this can be solved. Say the market system with an optimal f of $2,000 made $100 on a given day. The HPR then for that market system for that day is 1.05. To find the daily HPR, then:

(1.15) Daily HPR = (A/B)+1

where

A = Dollars made or lost that day.

B = Optimal fin dollars.

We begin by converting the daily dollar gains and losses for the market systems we are looking at into daily HPRs relative to the optimal fin dollars for a given market system. In so doing, we make quantity irrelevant. In the example just cited, where your daily HPR is 1.05, you made 5% that day on that money. This is 5% regardless of whether you had on 1 contract or 1,000 contracts.

Now you are ready to begin comparing different portfolios. The trick here is to compare every possible portfolio combination, from portfolios of 1 market system (for every market system under consideration) to portfolios of N market systems.

As an example, suppose you are looking at market systems A, B, and C. Every combination would be:

A
B
C
AB
AC
BC
ABC

But you do not stop there. For each combination you must figure each Percentage allocation as well. To do so you will need to have a minimum Percentage increment. The following example, continued from the portfolio A, B, C example, illustrates this with a minimum portfolio allocation of 10% (.10):

A	100%		
B	100%		
C	100%		
AB	90%	10%	
	80%	20%	
	70%	30%	
	60%	40%	
	50%	50%	
	40%	60%	
	30%	70%	
	20%	80%	
	10%	90%	
AC	90%	10%	
	80%	20%	
	70%	30%	
	60%	40%	
	50%	50%	
	40%	60%	
	30%	70%	
	20%	80%	
	10%	90%	
B C	90%	10%	
	80%	20%	
	70%	30%	
	60%	40%	
	50%	50%	
	40%	60%	
	30%	70%	
	20%	80%	
	10%	90%	
ABC	80%	10%	10%
	70%	20%	10%
	70%	10%	20%
	10%	30%	60%
	10%	20%	70%
	10%	10%	80%

Now for each CPA we go through each day and compute a net HPR for each day. The net HPR for a given day is the sum of each market system's HPR for that day times its percentage allocation. For example, suppose for systems A, B, and C we are looking at percentage allocations of 10%, 50%, 40% respectively. Further, suppose that the individual HPRs for those market systems for that day are .9, 1.4, and 1.05 respectively. Then the net HPR for this day is:

Net HPR = (.9*.1)+(1.4*.5)+(1.05*.4)

= .09+.7+.42

= 1.21

We must perform now two necessary tabulations. The first is that of the average daily net HPR for each CPA. This comprises the reward or Y axis of the Markowitz model. The second necessary tabulation is that of the standard deviation of the daily net HPRs for a given CPA-specifically, the population standard deviation. This measure corresponds to the risk or X axis of the Markowitz model.

Modern portfolio theory is often called E-V Theory, corresponding to the other names given the two axes. The vertical axis is often called E, for expected return, and the horizontal axis V, for variance in expected returns.

From these first two tabulations we can find our efficient frontier. We have effectively incorporated various markets, systems, and f fac-

tors, and we can now see ***quantitatively*** what our best CPAs are (i.e., which CPAs lie along the efficient frontier).

THE GEOMETRIC MEAN PORTFOLIO STRATEGY

Which particular point on the efficient frontier you decide to be on (i.e., which particular efficient CPA) is a function of your own risk-aversion preference, at least according to the Markowitz model. However, there is an optimal point to be at on the efficient frontier, and finding this point is mathematically solvable.

If you choose that CPA which shows the highest geometric mean of the HPRs, you will arrive at the optimal CPA! We can estimate the geometric mean from the arithmetic mean HPR and the population standard deviation of the HPRs (both of which are calculations we already have, as they are the X and Y axes for the Markowitz model!). Equations (1.16a) and (l.16b) give us the formula for the estimated geometric mean (EGM). This estimate is very close (usually within four or five decimal places) to the actual geometric mean, and it is acceptable to use the estimated geometric mean and the actual geometric mean interchangeably.

(1.16a) EGM = (AHPR^2-SD^2)^(1/2)

or

(l.16b) EGM = (AHPR^2-V)^(1/2)

where

EGM = The estimated geometric mean.

AHPR = The arithmetic average HPR, or the return coordinate of the portfolio.

SD = The standard deviation in HPRs, or the risk coordinate of the portfolio.

V = The variance in HPRs, equal to SD^2.

Both forms of Equation (1.16) are equivalent.

The CPA with the highest geometric mean is the CPA that will maximize the growth of the portfolio value over the long run; furthermore it will minimize the time required to reach a specified level of equity.

DAILY PROCEDURES FOR USING OPTIMAL PORTFOLIOS

At this point, there may be some question as to how you implement this portfolio approach on a day-to-day basis. Again an example will be used to illustrate. Suppose your optimal CPA calls for you to be in three different market systems. In this case, suppose the percentage allocations are 10%, 50%, and 40%. If you were looking at a $50,000 account, your account would be "subdivided" into three accounts of $5,000, $25,000, and $20,000 for each market system (A, B, and C) respectively. For each market system's subaccount balance you then figure how many contracts you could trade. Say the f factors dictated the following:

Market system A, 1 contract per $5,000 in account equity.

Market system B, 1 contract per $2,500 in account equity.

Market system C, l contract per $2,000 in account equity.

You would then be trading 1 contract for market system A ($5,000/$5,000), 10 contracts for market system B ($25,000/$2,500), and 10 contracts for market system C ($20,000/$2,000).

Each day, as the total equity in the account changes, all subaccounts are recapitalized. What is meant here is, suppose this $50,000 account dropped to $45,000 the next day. Since we recapitalize the subaccounts each day, we then have $4,500 for market system subaccount A, $22,500 for market system subaccount B, and $18,000 for market system subaccount C, from which we would trade zero contracts the next day on market system A ($4,500 7 $5,000 = .9, or, since we always floor to the integer, 0), 9 contracts for market system B ($22,500/$2,500), and 9 contracts for market system C ($18,000/$2,000). You always recapitalize the subaccounts each day regardless of whether there was a profit or a loss. Do not be confused. Subaccount, as used here, is a mental construct.

Another way of doing this that will give us the same answers and that is perhaps easier to understand is to divide a market system's optimal f amount by its percentage allocation. This gives us a dollar amount that we then divide the entire account equity by to know how many contracts to trade. Since the account equity changes daily, we recapitalize this daily to the new total account equity. In the example we have cited, market system A, at an f value of 1 contract per $5,000 in account equity and a percentage allocation of 10%, yields 1 contract per $50,000 in total account equity ($5,000/.10). Market system B, at an f value of 1 contract per $2,500 in account equity and a percentage allocation of 50%, yields 1 contract per $5,000 in total account equity ($2,500/.50). Market system C, at an f value of 1 contract per $2,000 in account equity and a percentage allocation of 40%, yields 1 contract per $5,000 in total account equity ($2,000/.40). Thus, if we had $50,000 in total account equity, we would trade 1 contract for market system A, 10 contracts for market system B, and 10 contracts for market system C.

Tomorrow we would do the same thing. Say our total account equity got up to $59,000. In this case, dividing $59,000 into $50,000 yields 1.18, which floored to the integer is 1, so we would trade 1 contract for market system A tomorrow. For market system B, we would trade 11 contracts ($59,000/$5,000 = 11.8, which floored to the integer = 11). For market system C we would also trade 11 contracts, since market system C also trades 1 contract for every $5,000 in total account equity.

Suppose we have a trade on from market system C yesterday and we are long 10 contracts. We do not need to go in and add another today to bring us up to 11 contracts. Rather the amounts we are calculating using the equity as of the most recent close mark-to-market is for new positions only. So for tomorrow, since we have 10 contracts on, if we get stopped out of this trade (or exit it on a profit target), we will be going 11 contracts on a new trade if one should occur. Determining our optimal portfolio using the daily HPRs means that we should go in and alter our positions on a day-by-day rather than a trade-by-trade basis, but this really isn't necessary unless you are trading a longer-term system, and then it may not be beneficial to adjust your position size on a day-by-day basis due to increased transaction costs. In a pure sense, you should adjust your positions on a day-by-day basis. In real life, you are usually almost as well off to alter them on a trade-by-trade basis, with little loss of accuracy.

This matter of implementing the correct daily positions is not such a problem. Recall that in finding the optimal portfolio we used the daily HPRs as input, We should therefore adjust our position size daily (if we could adjust each position at the price it closed at yesterday). In real life this becomes impractical, however, as transaction costs begin to outweigh the benefits of adjusting our positions daily and may actually cost us more than the benefit of adjusting daily. We are usually better off adjusting only at the end of each trade. The fact that the portfolio is temporarily out of balance after day 1 of a trade is a lesser price to pay than the cost of adjusting the portfolio daily.

On the other hand, if we take a position that we are going to hold for a year, we may want to adjust such a position daily rather than adjust it more than a year from now when we take another trade. Generally, though, on longer-term systems such as this we are better off adjusting the position each week, say, rather than each day. The reasoning here again is that the loss in efficiency by having the portfolio temporarily out of balance is less of a price to pay than the added transaction costs of a daily adjustment. You have to sit down and determine which is the lesser penalty for you to pay, based upon your trading strategy (i.e., how long you are typically in a trade) as well as the transaction costs involved.

How long a time period should you look at when calculating the optimal portfolios? Just like the question, "How long a time period should you look at to determine the optimal f for a given market system?" there is no definitive answer here. Generally, the more back data you use, the better should be your result (i.e., that the near optimal portfolios in the future will resemble what your study concluded were the near optimal portfolios). However, correlations do change, albeit slowly. One of the problems with using too long a time period is that there will be a tendency to use what were yesterday's hot markets. For instance, if you ran this program in 1983 over 5 years of back data you would most likely have one of the precious metals show very clearly as being a part of the optimal portfolio. However, the precious metals did very poorly for most trading systems for quite a few years after the 1980-1981 markets. So you see there is a tradeoff between using too much past history and too little in the determination of the optimal portfolio of the future.

Finally, the question arises as to how often you should rerun this entire procedure of finding the optimal portfolio. Ideally you should run

this on a continuous basis. However, rarely will the portfolio composition change. Realistically you should probably run this about every 3 months. Even by running this program every 3 months there is still a high likelihood that you will arrive at the same optimal portfolio composition, or one very similar to it, that you arrived at before.

ALLOCATIONS GREATER THAN 100%

Thus far, we have been restricting the sum of the percentage allocations to 100%. It is quite possible that the sum of the percentage allocations for the portfolio that would result in the greatest geometric growth would exceed 100%. Consider, for instance, two market systems, A and B, that are identical in every respect, except that there is a negative correlation (R<0) between them. Assume that the optimal f, in dollars, for each of these market systems is $5,000. Suppose the optimal portfolio (based on highest geomean) proves to be that portfolio that allocates 50% to each of the two market systems. This would mean that you should trade 1 contract for every $10,000 in equity for market system A and likewise for B. When there is negative correlation, however, it can be shown that the optimal account growth is actually obtained by trading 1 contract for an amount less than $10,000 in equity for market system A and/or market system B. In other words, when there is negative correlation, you can have the sum of percentage allocations exceed 100%. Further, it is possible, although not too likely, that the individual percentage allocations to the market systems may exceed 100% individually.

It is interesting to consider what happens when the correlation between two market systems approaches -1.00. When such an event occurs, the amount to finance trades by for the market systems tends to become infinitesimal. This is so because the portfolio, the net result of the market systems, tends to never suffer a losing day (since an amount lost by a market system on a given day is offset by the same amount being won by a different market system in the portfolio that day). Therefore, with diversification it is possible to have the optimal portfolio allocate a smaller f factor in dollars to a given market system than trading that market system alone would.

To accommodate this, you can divide the optimal f in dollars for each market system by the number of market systems you are running. In our example, rather than inputting $5,000 as the optimal f for market system A, we would input $2,500 (dividing $5,000, the optimal f, by 2, the number of market systems we are going to run), and likewise for market system B.

Now when we use this procedure to determine the optimal geomean portfolio as being the one that allocates 50% to A and 50% to B, it means that we should trade 1 contract for every $5,000 in equity for market system A ($2,500/.5) and likewise for B.

You must also make sure to use cash as another market system. This is non-interest-bearing cash, and it has an HPR of 1.00 for every day. Suppose in our previous example that the optimal growth is obtained at 50% in market system A and 40% in market system B. In other words, to trade 1 contract for every $5,000 in equity for market system A and 1 contract for every $6,250 for B ($2,500/.4). If we were using cash as another market system, this would be a possible combination (showing the optimal portfolio as having the remaining 10% in cash). If we were not using cash as another market system, this combination wouldn't be possible.

If your answer obtained by using this procedure does not include the non-interest-bearing cash as one of the output components, then you must raise the factor you are using to divide the optimal fs in dollars you are using as input. Returning to our example, suppose we used non-interest-bearing cash with the two market systems A and B. Further suppose that our resultant optimal portfolio did not include at least some percentage allocation to non-interest bearing cash. Instead, suppose that the optimal portfolio turned out to be 60% in market system A and 40% in market system B (or any other percentage combination, so long as they added up to 100% as a sum for the percentage allocations for the two market systems) and 0% allocated to non-interest-bearing cash. This would mean that even though we divided our optimal fs in dollars by two, that was not enough, We must instead divide them by a number higher than 2. So we will go back and divide our optimal fs in dollars by 3 or 4 until we get an optimal portfolio which includes a certain percentage allocation to non-interest-bearing cash. This will be the optimal portfolio. Of course, in real life this does not mean that we must actually allocate any of our trading capital to non-interest-bearing cash, Rather, the non-interest-bearing cash was used to derive the optimal amount of funds to allocate for 1 contract to each market system, when viewed in light of each market system's relationship to each other market system.

Be aware that the percentage allocations of the portfolio that would have resulted in the greatest geometric growth in the past can be in excess of 100% and usually are. This is accommodated for in this technique by dividing the optimal f in dollars for each market system by a specific integer (which usually is the number of market systems) and including non-interest-bearing cash (i.e., a market system with an HPR of 1.00 every day) as another market system. The correlations of the different market systems can have a profound effect on a portfolio. It is important that you realize that a portfolio can be greater than the sum of its parts (if the correlations of its component parts are low enough). It is also possible that a portfolio may be less than the sum of its parts (if the correlations are too high).

Consider again a coin-toss game, a game where you win $2 on heads and lose $1 on tails. Such a game has a mathematical expectation (arithmetic) of fifty cents. The optimal f is .25, or bet $1 for every $4 in your stake, and results in a geometric mean of 1.0607. Now consider a second game, one where the amount you can win on a coin toss is $.90 and the amount you can lose is $1.10. Such a game has a negative mathematical expectation of -$.10, thus, there is no optimal f, and therefore no geometric mean either.

Consider what happens when we play both games simultaneously. If the second game had a correlation coefficient of 1.0 to the first-that is, if we won on both games on heads or both coins always came up either both heads or both tails, then the two possible net outcomes would be that we win $2.90 on heads or lose $2.10 on tails. Such a game would have a mathematical expectation then of $.40, an optimal f of .14, and a geometric mean of 1.013. Obviously, this is an inferior approach to just trading the positive mathematical expectation game.

Now assume that the games are negatively correlated. That is, when the coin on the game with the positive mathematical expectation comes up heads, we lose the $1.10 of the negative expectation game and vice versa. Thus, the net of the two games is a win of $.90 if the coins come up heads and a loss of -$.10 if the coins come up tails. The mathematical expectation is still $.40, yet the optimal f is .44, which yields a geometric mean of 1.67. Recall that the geometric mean is the growth factor on your stake on average per play. This means that on average in this game we would expect to make more than 10 times as much per play as in the outright positive mathematical expectation game. Yet this result is obtained by taking that positive mathematical expectation game and combining it with a negative expectation game. The reason for the dramatic difference in results is due to the negative correlation between the two market systems. Here is an example where the portfolio is greater than the sum of its parts.

Yet it is also important to bear in mind that your drawdown, historically, would have been at least as high as f percent in terms of percentage of equity retraced. ***In real life***, you should expect that in the future it will be higher than this. This means that the combination of the two market systems, even though they are negatively correlated, would have resulted in at least a 44% equity retracement. This is higher than the outright positive mathematical expectation which resulted in an optimal f of .25, and therefore a minimum historical drawdown of at least 25% equity retracement. The moral is clear. ***Diversification, if done properly, is a technique that increases returns. It does not necessarily reduce worst-case drawdowns.*** This is absolutely contrary to the popular notion.

Diversification will buffer many of the little pullbacks from equity highs, but it does not reduce worst-case drawdowns. Further, as we have seen with optimal f, drawdowns are far greater than most people imagine. Therefore, even if you are very well diversified, you must still expect substantial equity retracements.

However, let's go back and look at the results if the correlation coefficient between the two games were 0. In such a game, whatever the results of one toss were would have no bearing on the results of the other toss. Thus, there are four possible outcomes:

Game 1		Game 2		Net	
Outcome	Amount	Outcome	Amount	Outcome	Amount
Win	$2.00	Win	$.90	Win	$2.90
Win	$2.00	Lose	-$1.10	Win	$.90

Game 1		Game 2		Net	
Outcome	Amount	Outcome	Amount	Outcome	Amount
Lose	-$1.00	Win	$.90	Lose	-S.10
Lose	-$1 .00	Lose	-$1.10	Lose	-$2.10

The mathematical expectation is thus:

ME = 2.9*.25+.9*.25-.1*.25-2.1*.25 = .725+.225-.025-.525 = .4

Once again, the mathematical expectation is $.40. The optimal f on this sequence is .26, or 1 bet for every $8.08 in account equity (since the biggest loss here is -$2.10). Thus, the least the historical drawdown may have been was 26% (about the same as with the outright positive expectation game). However, here is an example where there is buffering of the equity retracements. If we were simply playing the outright positive expectation game, the third sequence would have hit us for the maximum drawdown. Since we are combining the two systems, the third sequence is buffered. But that is the only benefit. The resultant geometric mean is 1.025, less than half the rate of growth of playing just the outright positive expectation game. We placed 4 bets in the same time as we would have placed 2 bets in the outright positive expectation game, but as you can see, still didn't make as much money:

1.0607^2 = 1.12508449 1.025^ 4 = 1.103812891

Clearly, when you diversify you ***must*** use market systems that have as low a correlation in returns to each other as possible and preferably a negative one. You must realize that your worst-case equity retracement will hardly be helped out by the diversification, although you may be able to buffer many of the other lesser equity retracements. ***The most important thing to realize about diversification is that its greatest benefit is in what it can do to improve your geometric mean.*** The technique for finding the optimal portfolio by looking at the net daily HPRs eliminates having to look at how many trades each market system accomplished in determining optimal portfolios. Using the technique allows you to look at the geometric mean alone, without regard to the frequency of trading. Thus, the geometric mean becomes the single statistic of how beneficial a portfolio is. There is no benefit to be obtained by diversifying into more market systems than that which results in the highest geometric mean. This may mean no diversification at all if a portfolio of one market system results in the highest geometric mean. It may also mean combining market systems that you would never want to trade by themselves.

HOW THE DISPERSION OF OUTCOMES AFFECTS GEOMETRIC GROWTH

Once we acknowledge the fact that whether we want to or not, whether consciously or not, we determine our quantities to trade in as a function of the level of equity in an account, we can look at HPRs instead of dollar amounts for trades. In so doing, we can give money management specificity and exactitude. We can examine our money-management strategies, draw rules, and make conclusions. One of the big conclusions, one that will no doubt spawn many others for us, regards the relationship of geometric growth and the dispersion of outcomes (HPRs).

This discussion will use a gambling illustration for the sake of simplicity. Consider two systems, System A, which wins 10% of the time and has a 28 to 1 win/loss ratio, and System B, which wins 70% of the time and has a 1 to 1 win/loss ratio. Our mathematical expectation, per unit bet, for A is 1.9 and for B is .4. We can therefore say that for every unit bet System A will return, on average, 4.75 times as much as System B. But let's examine this under fixed fractional trading. We can find our optimal fs here by dividing the mathematical expectations by the win/loss ratios. This gives us an optimal f of .0678 for A and .4 for B. The geometric means for each system at their optimal f levels are then:

A = 1.044176755

B = 1.0857629

System	% Wins	Win:Loss	ME	f	Geomean
A	10	28:1	1.9	.0678	1.0441768
B	70	1:1	.4	.4	1.0857629

As you can see, System B, although less than one quarter the mathematical expectation of A, makes almost twice as much per bet (returning 8.57629% of your entire stake per bet on average when you reinvest at the optimal f levels) as does A (which returns 4.4176755% of your entire stake per bet on average when you reinvest at the optimal f levels).

Now assuming a 50% drawdown on equity will require a 100% gain to recoup, then 1.044177 to the power of X is equal to 2.0 at approximately X equals 16.5, or more than 16 trades to recoup from a 50% drawdown for System A. Contrast this to System B, where 1.0857629 to the power of X is equal to 2.0 at approximately X equals 9, or 9 trades for System B to recoup from a 50% drawdown.

What's going on here? Is this because System B has a higher percentage of winning trades? The reason B is outperforming A has to do with the dispersion of outcomes and its effect on the growth function. Most people have the mistaken impression that the growth function, the TWR, is:

(1.17) TWR = (1+R)^N

where

R = The interest rate per period (e.g., 7% = .07).

N = The number of periods.

Since 1+R is the same thing as an HPR, we can say that most people have the mistaken impression that the growth function,[6] the TWR, is:

(1.18) TWR = HPR^N

This function is only true when the return (i.e., the HPR) is constant, which is not the case in trading.

The real growth function in trading (or any event where the HPR is not constant) is the multiplicative product of the HPRs. Assume we are trading coffee, our optimal f is 1 contract for every $21,000 in equity, and we have 2 trades, a loss of $210 and a gain of $210, for HPRs of .99 and 1.01 respectively. In this example our TWR would be:

TWR = 1.01*.99 = .9999

An insight can be gained by using the estimated geometric mean (EGM) for Equation (1.16a):

(1.16a) EGM = (AHPR^2-SD^2)^(1/2)

or

(1.16b) EGM = (AHPR^2-V)^(1/2)

Now we take Equation (1.16a) or (1.16b) to the power of N to estimate the TWR. This will very closely approximate the "multiplicative" growth function, the actual TWR:

(1.19a) Estimated TWR = ((AHPR^2-SD^2)^(1/2))^N

or

(1.19b) Estimated TWR = ((AHPR^2-V)^(1/2))^N

where

N = The number of periods.

AHPR = The arithmetic mean HPR.

SD = The population standard deviation in HPRs.

V = The population variance in HPRs.

The two equations in (1.19) are equivalent.

The insight gained is that we can see here, mathematically, the tradeoff between an increase in the arithmetic average trade (the HPR) and the variance in the HPRs, and hence the reason that the 70% 1:1 system did better than the 10% 28:1 system!

Our goal should be to maximize the coefficient of this function, to maximize:

(1.16b) EGM = (AHPR^2-V)^(1/2)

Expressed literally, ***our goal*** is ***"To maximize the square root of the quantity HPR squared minus the population variance in HPRs."***

The exponent of the estimated TWR, N, will take care of itself. That is to say that increasing N is not a problem, as we can increase the number of markets we are following, can trade more short-term types of systems, and so on.

However, these statistical measures of dispersion, variance, and standard deviation (V and SD respectively), are difficult for most non-statisticians to envision. What many people therefore use in lieu of these measures is known as the ***mean absolute deviation*** (which we'll call M).

[6] Many people mistakenly use the arithmetic average HPR in the equation for HPH^N. As is demonstrated here, this will not give the true TWR after N plays. What you must use is the geometric, rather than the arithmetic, average HPR^N. This will give you the true TWR. If the standard deviation in HPRs is 0, then the arithmetic average HPR and the geometric average HPR are equivalent, and it matters not which you use.

Essentially, to find M you simply take the average absolute value of the difference of each data point to an average of the data points.

(1.20) M = ∑ABS(Xi-X[])/N

In a bell-shaped distribution (as is almost always the case with the distribution of P&L's from a trading system) the mean absolute deviation equals about .8 of the standard deviation (in a Normal Distribution, it is .7979). Therefore, we can say:

(1.21) M = .8*SD

and

(1.22) SD = 1.25*M

We will denote the arithmetic average HPR with the variable A, and the geometric average HPR with the variable G. Using Equation (1.16b), we can express the estimated geometric mean as:

(1.16b) G = (A^2-V)^(1/2)

From this equation, we can obtain:

(1.23) G^2 = (A^2-V)

Now substituting the standard deviation squared for the variance [as in (1.16a)]:

(1.24) G^2 = A^2-SD^2

From this equation we can isolate each variable, as well as isolating zero to obtain the fundamental relationships between the arithmetic mean, geometric mean, and dispersion, expressed as SD ^ 2 here:

(1.25) A^2-C^2-SD^2 = 0

(1.26) G^2 = A^2-SD^2

(1.27) SD^2 = A^2-G^2

(1.28) A^2 = G^2+SD^2

In these equations, the value SD^2 can also be written as V or as (1.25*M)^2.

This brings us to the point now where we can envision exactly what the relationships are. Notice that the last of these equations is the familiar Pythagorean Theorem: The hypotenuse of a right angle triangle squared equals the sum of the squares of its sides! But here the hypotenuse is A, and we want to maximize one of the legs, G.

In maximizing G, any increase in D (the dispersion leg, equal to SD or V ^ (1/2) or 1.25*M) will require an increase in A to offset. When D equals zero, then A equals G, thus conforming to the misconstrued growth function TWR = (1+R)^N. Actually when D equals zero, then A equals G per Equation (1.26).

So, in terms of their relative effect on G, we can state that an increase in A ^ 2 is equal to a decrease of the same amount in (1.25*M)^2.

(1.29) ΔA^2 = -A((1.25*M)^2)

To see this, consider when A goes from 1.1 to 1.2:

A	SD	M	G	A^2	SD^2 = (1.25*M)^2
1.1	.1	.08	1.095445	1.21	.01
1.2	.4899	.39192	1.095445	1.44	.24
				.23	.23

When A = 1.1, we are given an SD of .1. When A = 1.2, to get an equivalent G, SD must equal .4899 per Equation (1.27). Since M = .8*SD, then M = .3919. If we square the values and take the difference, they are both equal to .23, as predicted by Equation (1.29).

Consider the following:

A	SD	M	G	A^2	SD^2 = (1.25*M)^2
1.1	.25	.2	1.071214	1.21	.0625
1.2	.5408	.4327	1.071214	1.44	.2925
				.23	.23

Notice that in the previous example, where we started with lower dispersion values (SD or M), how much proportionally greater an increase was required to yield the same G. Thus we can state that ***the more you reduce your dispersion, the better, with each reduction providing greater and greater benefit.*** It is an exponential function, with a limit at the dispersion equal to zero, where G is then equal to A.

A trader who is trading on a fixed fractional basis wants to maximize G, not necessarily A. In maximizing G, the trader should realize that the standard deviation, SD, affects G in the same proportion as does A, per the Pythagorean Theorem! Thus, when the trader reduces the standard deviation (SD) of his or her trades, it is equivalent to an equal increase in the arithmetic average HPR (A), and vice versa!

THE FUNDAMENTAL EQUATION OF TRADING

We can glean a lot more here than just how trimming the size of our losses improves our bottom line. We return now to equation (1.19a):

(1.19a) Estimated TWR = ((AHPR^2-SD^2)^(1/2))^N

We again replace AHPR with A, representing the arithmetic average HPR. Also, since (X^Y)^Z = X^(Y*Z), we can further simplify the exponents in the equation, thus obtaining:

(1.19c) Estimated TWR = (A^2-SD^2)^(N/2)

This last equation, the simplification for the estimated TWR, we call the ***fundamental equation for trading***, since it describes how the different factors, A, SD, and N affect our bottom line in trading.

A few things are readily apparent. The first of these is that if A is less than or equal to 1, then regardless of the other two variables, SD and N, our result can be no greater than 1. If A is less than 1, then as N approaches infinity, A approaches zero. This means that if A is less than or equal to 1 (mathematical expectation less than or equal to zero, since mathematical expectation = A-1), we do not stand a chance at making profits. In fact, if A is less than 1, it is simply a matter of time (i.e., as N increases) until we go broke.

Provided that A is greater than 1, we can see that increasing N increases our total profits. For each increase of 1 trade, the coefficient is further multiplied by its square root. For instance, suppose your system showed an arithmetic mean of 1.1, and a standard deviation of .25. Thus:

Estimated TWR = (1.1^2-.25^2)^(N/2) = (1.21-.0625)^(N/2) = 1.1475^(N/2)

Each time we can increase N by 1, we increase our TWR by a factor equivalent to the square root of the coefficient. In the case of our example, where we have a coefficient of 1.1475, then 1.1475^(1/2) = 1.071214264. Thus every trade increase, every 1-point increase in N, is the equivalent to multiplying our ***final stake*** by 1.071214264. Notice that this figure is the geometric mean. Each time a trade occurs, each time N is increased by 1, the coefficient is multiplied by the geometric mean. Herein is the real benefit of diversification expressed mathematically in the fundamental equation of trading. ***Diversification lets you get more N off in a given period of time.***

The other important point to note about the fundamental trading equation is that it shows that if you reduce your standard deviation more than you reduce your arithmetic average HPR, you are better off. It stands to reason, therefore, that cutting your losses short, if possible, benefits you. But the equation demonstrates that at some point you no longer benefit by cutting your losses short. That point is the point where you would be getting stopped out of too many trades with a small loss that later would have turned profitable, thus reducing your A to a greater extent than your SD.

Along these same lines, reducing big winning trades can help your program if it reduces your SD more than it reduces your A. In many cases, this can be accomplished by incorporating options into your trading program. Having an option position that goes against your position in the underlying (either by buying long an option or writing an option) can possibly help. For instance, if you are long a given stock (or commodity), buying a put option (or writing a call option) may reduce your SD on this net position more than it reduces your A. If you are profitable on the underlying, you will be unprofitable on the option, but profitable overall, only to a lesser extent than had you not had the option position. Hence, you have reduced both your SD and your A. If you are unprofitable on the underlying, you will have increased your A and decreased your SD. All told, you will tend to have reduced your SD to a greater extent than you have reduced your A. Of course, transaction costs are a large consideration in such a strategy, and they must always be taken into account. Your program may be too short-term oriented to take advantage of such a strategy, but it does point out the fact that different strategies, along with different trading rules, should be looked at relative to the fundamental trading equation. In doing so, we gain an insight into how these factors will affect the bottom line, and what specifically we can work on to improve our method.

Suppose, for instance, that our trading program was long-term enough that the aforementioned strategy of buying a put in conjunction with a long position in the underlying was feasible and resulted in a greater estimated TWR. Such a position, a long position in the underlying and a long put, is the equivalent to simply being outright long the

call. Hence, we are better off simply to be long the call, as it will result in considerably lower transaction costs'[7] than being both long the underlying and long the put option.

To demonstrate this, we'll use the extreme example of the stock indexes in 1987. Let's assume that we can actually buy the underlying OEX index. The system we will use is a simple 20-day channel breakout. Each day we calculate the highest high and lowest low of the last 20 days. Then, throughout the day if the market comes up and touches the high point, we enter long on a stop. If the system comes down and touches the low point, we go short on a stop. If the daily opens are through the entry points, we enter on the open. The system is always in the market:

Date	Position	Entry	P&L	Cumulative	Volatility
870106	L	24107	0	0	.1516987
870414	S	27654	35.47	35.47	.2082573
870507	L	29228	-15.74	19.73	.2182117
870904	S	31347	21.19	40.92	.1793583
871001	L	32067	-7.2	33.72	.1 848783
871012	S	30281	-17.86	15.86	.2076074
871221	L	24294	59.87	75.73	.3492674

If we were to determine the optimal f on this stream of trades, we would find its corresponding geometric mean, the growth factor on our stake per play, to be 1.12445.

Now we will take the exact same trades, only, using the Black-Scholes stock option pricing model from Chapter 5, we will convert the entry prices to theoretical option prices. The inputs into the pricing model are the historical volatility determined on a 20-day basis (the calculation for historical volatility is also given in Chapter 5), a risk-free rate of 6%, and a 260.8875-day year (this is the average number of weekdays in a year). Further, we will assume that we are buying options with exactly .5 of a year left till expiration (6 months) and that they are at-the-money. In other words, that there is a strike price corresponding to the exact entry price. Buying long a call when the system goes long the underlying, and buying long a put when the system goes short the underlying, using the parameters of the option pricing model mentioned, would have resulted in a trade stream as follows:

Date	Position	Entry	P&L	Cumulative	Underlying	Action
870106	L	9.623	0	0	24107	LONG CALL
870414	F	35.47	25.846	25.846	27654	
870414	L	15.428	0	25.846	27654	LONG PUT
870507	F	8.792	-6.637	19.21	29228	
870507	L	17.116	0	19.21	29228	LONG CALL
870904	F	21.242	4.126	23.336	31347	
870904	L	14.957	0	23.336	31347	LONG PUT
871001	F	10.844	-4.113	19.223	32067	
871001	L	15.797	0	19.223	32067	LONG CALL
871012	F	9.374	-6.423	12.8	30281	
871012	L	16.839	0	12.8	30281	LONG PUT
871221	F	61.013	44.173	56.974	24294	
871221	L	23	0	56.974	24294	LONG CALL

If we were to determine the optimal f on this stream of trades, we would find its corresponding geometric mean, the growth factor on our stake per play, to be 1.2166, which compares to the geometric mean at the optimal f for the underlying of 1.12445. This is an enormous difference. Since there are a total of 6 trades, we can raise each geometric mean to the power of 6 to determine the TWR on our stake at the end of the 6 trades. This returns a TWR on the underlying of 2.02 versus a TWR on the options of 3.24. Subtracting 1 from each TWR translates these results to percentage gains on our starting stake, or a 102% gain trading the underlying and a 224% gain making the same trades in the options. The options are clearly superior in this case, as the fundamental equation of trading testifies.

Trading long the options outright as in this example may not always be superior to being long the underlying instrument. This example is an extreme case, yet it does illuminate the fact that trading strategies (as well as what option series to buy) should be looked at in light of the fundamental equation for trading in order to be judged properly.

As you can see, the fundamental trading equation can be utilized to dictate many changes in our trading. These changes may be in the way of tightening (or loosening) our stops, setting targets, and so on. These changes are the results of inefficiencies in the way we are carrying out our trading as well as inefficiencies in our trading program or methodology.

I hope you will now begin to see that the computer has been terribly misused by most traders. Optimizing and searching for the systems and parameter values that made the most money over past data is, by and large a futile process. You only need something that will be marginally profitable in the future. By correct money management you can get an awful lot out of a system that is only marginally profitable. In general, then, the degree of profitability is determined by the money management you apply to the system more than by the system itself

Therefore, you should build your systems (or trading techniques, for those opposed to mechanical systems) around how certain you can be that they will be profitable (even if only marginally so) in the future. This is accomplished primarily by not restricting a system or technique's degrees of freedom. The second thing you should do regarding building your system or technique is to bear the fundamental equation of trading in mind It will guide you in the right direction regarding inefficiencies in your system or technique, and when it is used in conjunction with the principle of not restricting the degrees of freedom, you will have obtained a technique or system on which you can now employ the money-management techniques. Using these money-management techniques, whether empirical, as detailed in this chapter, or parametric (which we will delve into starting in Chapter 3), will determine the degree of profitability of your technique or system.

[7] There is another benefit here that is not readily apparent hut has enormous merit. That is that we know, in advance, what our worst-case loss is in advance. Considering how sensitive the optimal f equation is to what the biggest loss in the future is, such a strategy can have us be much closer to the peak of the f curve in the future by allowing US to predetermine what our largest loss can he with certainty. Second, the problem of a loss of 3 standard deviations or more having a much higher probability of occurrence than the Normal Distribution implies is eliminated. It is the gargantuan losses in excess of 3 standard deviations that kill most traders. An options strategy such as this can totally eliminate such terminal losses.

Chapter 2 - Characteristics of Fixed Fractional Trading and Salutary Techniques

We have seen that the optimal growth of an account is achieved through optimal f. This is true regardless of the underlying vehicle. Whether we are trading futures, stocks, or options, or managing a group of traders, we achieve optimal growth at the optimal f, and we reach a specified goal in the shortest time.

We have also seen how to combine various market systems at their optimal f levels into an optimal portfolio from an empirical standpoint. That is, we have seen how to combine optimal f and portfolio theory, not from a mathematical model standpoint, but from the standpoint of using the past data directly to determine the optimal quantities to trade in for the components of the optimal portfolio.

Certain important characteristics about fixed fractional trading still need to be mentioned. We now cover these characteristics.

OPTIMAL F FOR SMALL TRADERS JUST STARTING OUT

How does a very small account, an account that is going to start out trading 1 contract, use the optimal f approach? One suggestion is that such an account start out by trading 1 contract not for every optimal f amount in dollars (biggest loss/-f), but rather that the drawdown and margin must be considered in the initial phase. The amount of funds allocated towards the first contract should be the greater of the optimal f amount in dollars or the margin plus the maximum historic drawdown (on a 1-unit basis):

(2.01) A = MAX {(Biggest Loss/-f), (Margin+ABS(Drawdown))}

where

A = The dollar amount to allocate to the first contract.

f = The optimal f (0 to 1).

Margin = The initial speculative margin for the given contract.

Drawdown = The historic maximum drawdown.

MAX{} = The maximum value of the bracketed values.

ABS() = The absolute value function.

With this procedure an account can experience the maximum drawdown again and still have enough funds to cover the initial margin on another trade. Although we cannot expect the worst-case drawdown in the future not to exceed the worst-case drawdown historically, it is rather unlikely that we will start trading right at the beginning of a new historic drawdown.

A trader utilizing this idea will then subtract the amount in Equation (2.01) from his or her equity each day. With the remainder, he or she will then divide by (Biggest Loss/-f). The answer obtained will be rounded down to the integer, and 1 will be added. The result is how many contracts to trade.

An example may help clarify. Suppose we have a system where the optimal f is .4, the biggest historical loss is -$3,000, the maximum drawdown was -$6,000, and the margin is $2,500. Employing Equation (2.01) then:

A = MAX{(-$3,000/-.4), ($2,500+ABS(-$6,000))}

= MAX(($7,500), ($2,500+$6,000))

= MAX($7,500, $8,500)

= $8,500

We would thus allocate $8,500 for the first contract. Now suppose we are dealing with $22,500 in account equity. We therefore subtract this first contract allocation from the equity:

$22,500-$8,500 = $14,000

We then divide this amount by the optimal fin dollars:

$14,000/$7,500 = 1.867

Then we take this result down to the integer:

INT(1.867) = 1

and add 1 to the result (the 1 contract represented by the $8,500 we have subtracted from our equity):

1+1 = 2

We therefore would trade 2 contracts. If we were just trading at the optimal f level of 1 contract for every $7,500 in account equity, we would have traded 3 contracts ($22,500/$7,500). As you can see, this technique can be utilized no matter of how large an account's equity is (yet the larger the equity the closer the two answers will be). Further, the larger the equity, the less likely it is that we will eventually experience a drawdown that will have us eventually trading only 1 contract. For smaller accounts, or for accounts just starting out, this is a good idea to employ.

THRESHOLD TO GEOMETRIC

Here is another good idea for accounts just starting out, one that may not be possible if you are employing the technique just mentioned. This technique makes use of another by-product calculation of optimal f called the ***threshold to geometric***. The by-products of the optimal f calculation include calculations, such as the TWR, the geometric mean, and so on, that were derived in obtaining the optimal f, and that tell us something about the system. The threshold to the geometric is another of these by-product calculations. Essentially, ***the threshold to geometric tells us at what point we should switch over to fixed fractional trading, assuming we are starting out constant-contract trading***.

Refer back to the example of a coin toss where we win $2 if the toss comes up heads and we lose $1 if the toss comes up tails. We know that our optimal f is .25, or to make 1 bet for every $4 we have in account equity. If we are starting out trading on a constant-contract basis, we know we will average $.50 per unit per play. However, if we start trading on a fixed fractional basis, we can expect to make the geometric average trade of $.2428 per unit per play.

Assume we start out with an initial stake of $4, and therefore we are making 1 bet per play. Eventually, when we get to $8, the optimal f would have us step up to making 2 bets per play. However, 2 bets times the geometric average trade of $.2428 is $.4856. Wouldn't we be better off sticking with 1 bet at the equity level of $8, whereby our expectation per play would still be $.50? The answer is, "Yes." The reason that the optimal f is figured on the basis of contracts that are infinitely divisible, which may not be the case in real life.

We can find that point where we should move up to trading two contracts by the formula for the threshold to the geometric, T:

(2.02) T = AAT/GAT*Biggest Loss/-f

where

T = The threshold to the geometric.

AAT = The arithmetic average trade.

GAT s The geometric average trade,

f = The optimal f (0 to 1).

In our example of the 2-to-l coin toss:

T = .50/.2428*-1/-.25 = 8.24

Therefore, we are better off switching up to trading 2 contracts when our equity gets to $8.24 rather than $8.00. Figure 2-1 shows the threshold to the geometric for a game with a 50% chance of winning $2 and a 50% chance of losing $1.

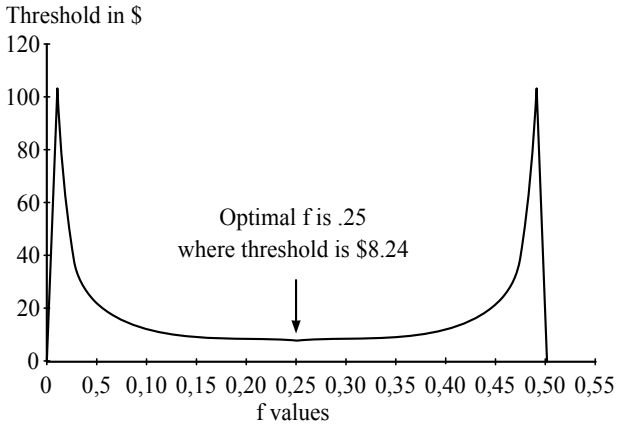

Figure 2-1 Threshold to the geometric for 2:1 coin toss.

Notice that the trough of the threshold to the geometric curve occurs at the optimal f. This means that since the threshold to the geometric is the optimal level of equity to go to trading 2 units, you go to 2 units at the lowest level of equity, optimally, when incorporating the threshold to the geometric at the optimal f.

Now the question is, "Can we use a similar approach to know when to go from 2 cars to 3 cars?" Also, 'Why can't the unit size be 100 cars starting out, assuming you are starting out with a large account, rather than simply a small account starting out with 1 car?" To answer the second question first, it is valid to use this technique when starting out with a unit size greater than 1. However, it is valid only if you do not trim back units on the downside before switching into the geometric mode. The reason is that before you switch into the geometric mode you are assumed to be trading in a constant-unit size.

Assume you start out with a stake of 400 units in our 2-to-l coin-toss game. Your optimal fin dollars is to trade 1 contract (make 1 bet) for every $4 in equity. Therefore, you will start out trading 100 contracts (making 100 bets) on the first trade. Your threshold to the geometric is at $8.24, and therefore you would start trading 101 contracts at an equity level of $404.24. You can convert your threshold to the geometric, which is computed on the basis of advancing from 1 contract to 2, as:

(2.03) Converted T = EQ+T-(Biggest Loss/-f)

where

EQ = The starting account equity level.

T = The threshold to the geometric for going from 1 car to 2.

f = The optimal f (0 to 1).

Therefore, since your starting account equity is $400, your T is $8.24, your biggest loss -$1, and your f is .25:

Converted T = 400+8.24-(-1/-.25)

= 400+8.24-4

= 404.24

Thus, you would progress to trading 101 contracts (making 101 bets) if and when your account equity reached $404.24. We will assume you are trading in a constant-contract mode until your account equity reaches $404.24, at which point you will begin the geometric mode. Therefore, until Your account equity reaches $404.24, you will trade 100 contracts on the next trade regardless of the remaining equity in your account. If, after you cross the geometric threshold (that is, after your account equity hits S404.24), you suffer a loss and your equity drops below $404.24, you will go back to trading on a constant 100-contract basis if and until you cross the geometric threshold again.

This inability to trim back contracts on the downside when you are below the geometric threshold is the drawback to using this procedure when you are at an equity level of trading more than 2 contacts. If you are only trading 1 contract, the geometric threshold is a very valid technique for determining at what equity level to start trading 2 contracts (since you cannot trim back any further than 1 contract should you experience an equity decline). However, it is not a valid technique for advancing from 2 contracts to 3, because the technique is predicated upon the fact that you are currently trading on a constant-contract basis. That is, if you are trading 2 contracts, unless you are willing not to trim back to 1 contract if you suffer an equity decline, the technique is not valid, and likewise if you start out trading 100 contracts. You could do just that (not trim back the number of contracts you are presently trading if you experience an equity decline), in which case the threshold to the geometric, or its converted version in Equation (2.03), would be the valid equity point to add the next contract. The problem with doing this (not trimming back on the downside) is that you will make less (your TWR will be less) in an asymptotic sense. You will not make as much as if you simply traded the full optimal f. Further, your drawdowns will be greater and your risk of ruin higher. Therefore, the threshold to the geometric is only beneficial if you are starting out in the lowest denomination of bet size (1 contract) and advancing to 2, and it is only a benefit if the arithmetic average trade is more than twice the size of the geometric average trade. Furthermore, it is beneficial to use only when you cannot trade fractional units.

ONE COMBINED BANKROLL VERSUS SEPARATE BANKROLLS

Some very important points regarding fixed fractional trading must be covered before we discuss the parametric techniques. First, when trading more than one market system simultaneously, you will generally do better in an asymptotic sense using only one combined bankroll from which to figure your contract sizes, rather than separate bankrolls for each.

It is for this reason that we "recapitalize" the subaccounts on a daily basis as the equity in an account fluctuates. What follows is a run of two similar systems, System A and System B. Both have a 50% chance of winning, and both have a payoff ratio of 2:1. Therefore, the optimal f dictates that we bet $1 for every S4 units in equity. The first run we see shows these two systems with positive correlation to each other. We start out with $100, splitting it into 2 subaccount units of $50 each. After a trade is registered, it only affects the cumulative column for that system, as each system has its own separate bankroll. The size of each system's separate bankroll is used to determine bet size on the subsequent play:

System A			System B		
Trade	P&L	Cumulative	Trade	P&L	Cumulative
		50.00			50.00
2	25.00	75.00	2	25.00	75.00
-1	-18.75	56.25	-1	-18.75	56.25
2	28.13	84 .38	2	28.13	84.38
-1	-21.09	63.28	-1	-21.09	63.28
2	31.64	94 .92	2	31.64	94 .92
-1	-23.73	71.19	-1	-23.73	71.19
		-50.00			-50.0
Net Profit 21.19140			21.19140		
Total net profit of the two banks = $42.38					

Now we will see the same thing, only this time we will operate from a combined bank starting at 100 units. Rather than betting $1 for every $4 in the combined stake for each system, we will bet $1 for every $8 in the combined bank. Each trade for either system affects the combined bank, and it is the combined bank that is used to determine bet size on the subsequent play:

System A		System B		
Trade	P&L	Trade	P&L	Combined Bank
				100.00
2	25.00	2	25.00	150.00
-1	-18.75	-1	-18.75	112.50
2	28.13	2	28.13	168.75
-1	-21.09	-1	-21.09	126.56
2	31.64	2	31.64	189.84
-1	-23.73	-1	-23.73	142.38
				-100.00
Total net profit of the combined bank =				$42.38

Notice that using either a combined bank or a separate bank in the preceding example shows a profit on the $100 of $42.38. Yet what was shown is the case where there is positive correlation between the two systems. Now we will look at negative correlation between the same two systems, first with both systems operating from their own separate bankrolls:

System A			System B		
Trade	P&L	Cumulative	Trade	P&L	Cumulative
		50.00			50.00
2	25.00	75.00	-1	-12.50	37.50
-1	-18.75	56.25	2	18.75	56.25
2	28.13	84.38	-1	-14.06	42.19
-1	-21.09	63.28	2	21.09	63.28
2	31.64	94.92	-1	-15.82	47.46
-1	-23.73	71.19	2	23.73	71.19
		-50.00			-50.00
Net Profit		21.19140			21.19140
Total net profit of the two banks =					$42.38

As you can see, when operating from separate bankrolls, both systems net out making the same amount regardless of correlation. However, with the combined bank:

System A		System B		
Trade	P&L	Trade	P&L	Combined Bank
				100.00
2	25.00	-1	-12.50	112.50
-1	-14.06	2	28.12	126.56
2	31.64	-1	-15.82	142.38
-1	-17.80	2	35.59	160.18
2	40.05	-1	-20.02	180.20
-1	-22.53	2	45.00	202.73
				-100.00
Total net profit of the combined bank =				$102.73

With the combined bank, the results are dramatically improved. ***When using fixed fractional trading you are best off operating from a single combined bank.***

THREAT EACH PLAY AS IF INFINITELY REPEATED

The next axiom of fixed fractional trading regards maximizing the current event as though it were to be performed an infinite number of times in the future. We have determined that for an independent trials process, you should always bet that f which is optimal (and constant) and likewise when there is dependency involved, only with dependency f is not constant.

Suppose we have a system where there is dependency in like begetting like, and suppose that this is one of those rare gems where the confidence limit is at an acceptable level for us, that we feel we can safely assume that there really is dependency here. For the sake of simplicity we will use a payoff ratio of 2:1. Our system has shown that, historically, if the last play was a win, then the next play has a 55% chance of being a tin. If the last play was a loss, our system has a 45% chance of the next play being a loss. Thus, if the last play was a win, then from the Kelly formula, Equation (1.10), for finding the optimal f (since the payoff ratio is Bernoulli distributed):

(1.10) f = ((2 +1)*.55-1)/2

= (3*.55-1)/2

= .65/2

= .325

After a losing play, our optimal f is:

f = ((2+ l)*.45-l)/2

= (3*.45- l)/2

= .35/2

= .175

Now dividing our biggest losses (-1) by these negative optimal fs dictates that we make 1 bet for every 3.076923077 units in our stake after a win, and make 1 bet for every 5.714285714 units in our stake after a loss. In so doing we will maximize the growth over the long run. Notice that we treat each individual play as though it were to be performed an infinite number of times.

Notice in this example that betting after both the wins and the losses still has a positive mathematical expectation individually. What if, after a loss, the probability of a win was .3? ***In such a case, the mathematical expectation is negative, hence there is no optimal f and as a result you shouldn't take this play:***

(1.03) ME = (.3*2)+ (.7*-1)

= .6-.7 = -.1

In such circumstances, you would bet the optimal amount only after a win, and you would not bet after a loss. If there is dependency present, you must segregate the trades of the market system based upon the dependency and treat the segregated trades as separate market systems.

The same principle, namely that ***asymptotic growth is maximized if each play is considered to be performed an infinite number of times into the future***, also applies to simultaneous wagering (or trading a portfolio). Consider two betting systems, A and B. Both have a 2:1 payoff ratio, and both win 50% of the time. We will assume that the correlation coefficient between the two systems is 0, but that is not relevant to the point being illuminated here. The optimal fs for both systems (if they were being traded alone, rather than simultaneously) are .25, or to make 1 bet for every 4 units in equity. The optimal fs for trading both systems simultaneously are .23, or 1 bet for every 4.347826087 units in account equity.[1] System B only trades two-thirds of the time, so some trades will be done when the two systems are not trading simultaneously. This first sequence is demonstrated with a starting combined bank of 1,000 units, and each bet for each system is performed with an optimal f of 1 bet per every 4.347826087 units:

A		B		Combined Bank
				1,000.00
-1	-230.00			770.00
2	354.20	-1	-177.10	947.10
-1	-217.83	2	435.67	1,164.93
2	535.87			1,700.80
-1	-391.18	-1	-391.18	918.43
2	422.48	2	422.48	1,763.39

Next we see the same exact thing, the only difference being that when A is betting alone (i.e., when B does not have a bet at the same time as A), we make 1 bet for every 4 units in the combined bank for System A, since that is the optimal f on the single, individual play. On the plays where the bets are simultaneous, we are still betting 1 unit for every 4.347826087 units in account equity for both A and B. Notice that in so doing we are taking each bet, whether it is individual or simultaneous, and applying that optimal f which would maximize the play as though it were to be performed an infinite number of times in the future.

A		B		Combined Bank
				1,000.00
- 1	-250.00			750.00
2	345.00	-1	-172.50	922.50
- 1	-212.17	2	424.35	1,134.67
2	567.34			1,702.01
- 1	-391.46	-1	-391.46	919.09
2	422.78	2	422.78	1,764.65

As can be seen, there is a slight gain to be obtained by doing this, and the more trades that elapse, the greater the gain. The same principle applies to trading a portfolio where not all components of the portfolio are in the market all the time. You should trade at the optimal levels for the combination of components (or single component) that results in the optimal growth as though that combination of components (or single component) were to be traded an infinite number of times in the future.

EFFICIENCY LOSS IN SIMULTANEOUS WAGERING OR PORTFOLIO TRADING

Let's again return to our 2:1 coin-toss game. Let's again assume that we are going to play two of these games, which we'll call System A and System B, simultaneously and that there is zero correlation between the outcomes of the two games. We can determine our optimal fs for such a case as betting 1 unit for every 4.347826 in account equity when the games are played simultaneously. When starting with a bank of 100 units, notice that we finish with a bank of 156.86 units:

	System A		System B		
	Trade	P&L	Trade	P&L	Bank
Optimal f is 1 unit for every 4.347826 in equity:					100.00
	-1	-23.00	-1	-23.00	54.00
	2	24.84	-1	-12.42	66.42
	-1	-15.28	2	30.55	81.70
	2	37.58	2	37.58	156.66
	System A		System B		
	Trade	P&L	Trade	P&L	Bank
Optimal f is 1 unit for every 8.00 in equity:					100.00
	-1	-12.50	-1	-12.50	75.00
	2	18.75	2	18.75	112.50
	-1	-14.06	-1	-14.06	84.38
	2	21.09	2	21.09	126.56

Now let's consider System C. This would be the same as Systems A and B, only we're going to play this game alone, without another game going simultaneously. We're also going to play it for 8 plays-as opposed to the previous endeavor, where we played 2 games for 4 simultaneous plays. Now our optimal f is to bet 1 unit for every 4 units in equity. What we have is the same 8 outcomes as before, but a different, better end result:

	System C		
	Trade	P&L	Bank
Optimal f is 1 unit f or every 4.00 in equity:			100.00
	-1	-25.00	75.00
	2	37.50	112.50
	-1	-28.13	84.38
	2	42.19	126.56
	2	63.28	189.84
	2	94.92	284.77
	-1	-71.19	213.57
	-1	-53.39	160.18

The end result here is better not because the optimal fs differ slightly (both are at their respective optimal levels), but because there is a small efficiency loss involved with simultaneous wagering. ***This inefficiency is the result of not being able to recapitalize your account after every single wager as you could betting only 1 market system.*** In

[1] The method We are using here to arrive at these optimal bet sizes is described in Chapters 6 and 7. We are, in effect, using 3 market systems, Systems A and B as described here, both with an arithmetic HPR of 1.125 and a stand and deviation in HPRs of .375, and null cash, with an HPR of 1.0 and a standard deviation of 0. The geometric average is thus maximized at approximately E = .23, where the weightings for A and B both are .92. Thus, the optimal fs for both A and B are transformed to 4.347826. Using such factors will maximize growth in this game.

the simultaneous 2-bet case, you can only recapitalize 3 times, whereas in the single B-bet case you recapitalize 7 times. Hence, the efficiency loss in simultaneous wagering (or in trading a portfolio of market systems).

We just witnessed the case where the simultaneous bets were not correlated. Let's look at what happens when we deal with positive (+1.00) correlation:

Notice that after 4 simultaneous plays where the correlation between the market systems employed is+1.00, the result is a gain of 126.56 on a starting stake of 100 units. This equates to a TWR of 1.2656, or a geometric mean, a growth factor per play (even though these are combined plays) of ***1.2656^(1/4) = 1.06066.***

Now refer back to the single-bet case. Notice here that after 4 plays, the outcome is 126.56, again on a starting stake of 100 units. Thus, the geometric mean of 1.06066. This demonstrates that the rate of growth is the same when trading at the optimal fractions for perfectly correlated markets. As soon as the correlation coefficient comes down below+1.00, the rate of growth increases. Thus, we can state that ***when combining market systems, your rate of growth will never be any less than with the single-bet case, no matter of how high the correlations are, provided that the market system being added has a positive arithmetic mathematical expectation.***

Recall the first example in this section, where there were 2 market systems that had a zero correlation coefficient between them. This market system made 156.86 on 100 units after 4 plays, for a geometric mean of (156.86/100)^(1/4) = 1.119. Let's now look at a case where the correlation coefficients are -1.00. Since there is never a losing play under the following scenario, the optimal amount to bet is an infinitely high amount (in other words, bet 1 unit for every infinitely small amount of account equity). But, rather than getting that greedy, we'll just make 1 bet for every 4 units in our stake so that we can make the illustration here:

	System A		System B		
	Trade	P&L	Trade	P&L	Bank
Optimal f is 1 unit for every 0.00 in equity (shown is 1 for every 4):					100.00
	-1	-12.50	2	25.00	112.50
	2	28.13	-1	-14.06	126.56
	-1	-15.82	2	31.64	142.38
	2	35.60	-1	-17.80	160.18

There are two main points to glean from this section. The first is that there is a small efficiency loss with simultaneous betting or portfolio trading, a loss caused by the inability to recapitalize after every individual play. The second point is that combining market systems, provided they have a positive mathematical expectation, and even if they have perfect positive correlation, never decreases your total growth per time period. However, as you continue to add more and more market systems, the efficiency loss becomes considerably greater. If you have, say, 10 market systems and they all suffer a loss simultaneously, that loss could be terminal to the account, since you have not been able to trim back size for each loss as you would have had the trades occurred sequentially.

Therefore, we can say that there is a gain from adding each new market system to the portfolio provided that the market system has a correlation coefficient less than 1 and a positive mathematical expectation, or a negative expectation but a low enough correlation to the other components in the portfolio to more than compensate for the negative expectation. There is a marginally decreasing benefit to the geometric mean for each market system added. That is, each new market system benefits the geometric mean to a lesser and lesser degree. Further, as you add each new market system, there is a greater and greater efficiency loss caused as a result of simultaneous rather than sequential outcomes. At some point, to add another market system will do more harm then good.

TIME REQUIRED TO REACH A SPECIFIED GOAL AND THE TROUBLE WITH FRACTIONAL F

Suppose we are given the arithmetic average HPR and the geometric average HPR for a given system. We can determine the standard deviation in HPRs from the formula for estimated geometric mean:

(1.19a) EGM = (AHPR^2-SD^2)^(1/2)

where

AHPR = The arithmetic mean HPR.

SD = The population standard deviation in HPRs.

Therefore, we can estimate the standard deviation, SD, as:

(2.04) SD^2 = AHPR^2-EGM^2

Returning to our 2:1 coin-toss game, we have a mathematical expectation of $.50, and an optimal f of betting $1 for every $4 in equity, which yields a geometric mean of 1.06066. We can use Equation (2.05) to determine our arithmetic average HPR:

(2.05) AHPR = l+(ME/f$)

where

AHPR = The arithmetic average HPR.

ME = The arithmetic mathematical expectation in units.

f$ = The biggest loss/-f. f = The optimal f (0 to 1).

Thus, we would have an arithmetic average HPR of:

AHPR = 1+(.5/(-1/ -.25))

= 1+(.5/4)

= 1+.125

= 1.125

Now, since we have our AHPR and our ECM, we can employ equation (2.04) to determine the estimated standard deviation in the HPRs:

(2.04) SD^2 = AHPR^2-EGM^2

= 1.125^2-1.06066^2

= 1.265625-1.124999636

= .140625364

Thus SD^2, which is the variance in HPRs, is .140625364. Taking the Square root of this yields a standard deviation in these HPRs of .140625364^(1/2) = .3750004853. You should note that this is the estimated standard deviation because it uses the estimated geometric mean as input. It is probably not completely exact, but it is close enough for our purposes.

However, suppose we want to convert these values for the standard deviation (or variance), arithmetic, and geometric mean HPRs to reflect trading at the fractional f. These conversions are now given:

(2.06) FAHPR = (AHPR-1)*FRAC+1

(2.07) FSD = SD*FRAC

(2.08) FGHPR = (FAHPR^2-FSD^2)^(1/2)

where

FRAC = The fraction of optimal f we are solving for.

AHPR = The arithmetic average HPR at the optimal f.

SD = The standard deviation in HPRs at the optimal f. FAHPR = The arithmetic average HPR at the fractional f.

FSD = The standard deviation in HPRs at the fractional f FGHPR = The geometric average HPR at the fractional f.

For example, suppose we want to see what values we would have for FAHPR, FGHPR, and FSD at half the optimal f (FRAC = .5) in our 2:1 coin-toss game. Here, we know our AHPR is 1.125 and our SD is .3750004853. Thus:

(2.06) FAHPR = (AHPR-1)*FRAC+1

= (1.125- 1)*.5+1

= .125*.5+1

= .0625+1

= 1.0625

(2.07) FSD = SD*FRAC

= ,3750004853*.5

= .1875002427

(2.08) FGHPR = (FAHPR^2-FSD^2)^(1/2)

= (1.0625^2-.1875002427^2)^(1/2)

= (1.12890625-.03515634101)^(1/2)

= 1.093749909^(1/2)

= 1.04582499

Thus, for an optimal f of .25, or making 1 bet for every $4 in equity, we have values of 1.125, 1.06066, and .3750004853 for the arithmetic average, geometric average, and standard deviation of HPRs respectively. Now we have solved for a fractional (.5) f of .125 or making 1

bet for every $8 in our stake, yielding values of 1.0625, 1.04582499, and .1875002427 for the arithmetic average, geometric average, and standard deviation of HPRs respectively.

We can now take a look at what happens when we practice a fractional f strategy. We have already determined that under fractional f we will make geometrically less money than under optimal f. Further, we have determined that the drawdowns and variance in returns will be less with fractional f. What about time required to reach a specific goal?

We can quantify the expected number of trades required to reach a specific goal. This is not the same thing as the expected time required to reach a specific goal, but since our measurement is in trades we will use the two notions of time and trades elapsed interchangeably here:

(2.09) N = ln(Goal)/ln(Geometric Mean)

where

N = The expected number of trades to reach a specific goal.

Goal = The goal in terms of a multiple on our starting stake, a TWR.

ln() = The natural logarithm function.

Returning to our 2:1 coin-toss example. At optimal f we have a geometric mean of 1.06066, and at half f this is 1.04582499. Now let's calculate the expected number of trades required to double our stake (goal = 2). At full f:

N = ln(2)/ln(1.06066) = .6931471/.05889134 = 11.76993

Thus, at the full f amount in this 2:1 coin-toss game, we anticipate it will take us 11.76993 plays (trades) to double our stake. Now, at the half f amount:

N = ln(2)/ln(1.04582499) = .6931471/.04480602 = 15.46996

Thus, at the half f amount, we anticipate it will take us 15.46996 trades to double our stake. In other words, trading half f in this case will take us 31.44% longer to reach our goal.

Well, that doesn't sound too bad. By being more patient, allowing 31.44% longer to reach our goal, we eliminate our drawdown by half and our variance in the trades by half. Half f is a seemingly attractive way to go. The smaller the fraction of optimal f that you use, the smoother the equity curve, and hence the less time you can expect to be in the worst-case drawdown.

Now, let's look at it in another light. Suppose you open two accounts, one to trade the full f and one to trade the half f. After 12 plays, your full f account will have more than doubled to 2.02728259 (1.06066^12) times your starting stake. After 12 trades your half f account will have grown to 1.712017427 (1.04582499^12) times your starting stake. This half f account will double at 16 trades to a multiple of 2.048067384 (1.04582499^16) times your starting stake. So, by waiting about one-third longer, you have achieved the same goal as with full optimal f, only with half the commotion. However, by trade 16 the full f account is now at a multiple of 2.565777865 (1.06066^16) times your starting stake. Full f will continue to pull out and away. By trade 100, your half f account should be at a multiple of 88.28796546 times your starting stake, but the full f will be at a multiple of 361.093016!

So anyone who claims that the only thing you sacrifice with trading at a fractional versus full f is time required to reach a specific goal is completely correct. Yet time is what it's all about. We can put our money in Treasury Bills and they will reach a specific goal in a certain time with an absolute minimum of drawdown and variance! Time truly is of the essence.

COMPARING TRADING SYSTEMS

We have seen that two trading systems can be compared on the basis of their geometric means at their respective optimal fs. Further, we can compare systems based on how high their optimal fs themselves are, with the higher optimal f being the riskier system. This is because the least the drawdown may have been is at least an f percent equity retracement. So, there are two basic measures for comparing systems, the geometric means at the optimal fs, with the higher geometric mean being the superior system, and the optimal fs themselves, with the lower optimal f being the superior system. Thus, rather than having a single, one-dimensional measure of system performance, we see that performance must be measured on a two-dimensional plane, one axis being the geometric mean, the other being the value for f itself. ***The higher the geometric mean at the optimal f, the better the system, Also, the lower the optimal f, the better the system.***

Geometric mean does not imply anything regarding drawdown. That is, a higher geometric mean does not mean a higher (or lower) drawdown. The geometric mean only pertains to return. The optimal f is the measure of minimum expected historical drawdown as a percentage of equity retracement. A higher optimal f does not mean a higher (or lower) return. We can also use these benchmarks to compare a given system at a fractional f value and another given system at its full optimal f value.

Therefore, when looking at systems, you should look at them in terms of how high their geometric means are and what their optimal fs are. For example, suppose we have System A, which has a 1.05 geometric mean and an optimal f of .8. Also, we have System B, which has a geometric mean of 1.025 and an optimal f of .4. System A at the half f level will have the same minimum historical worst-case equity retracement (drawdown) of 40%, just as System B's at full f, but System A's geometric mean at half f will still be higher than System B's at the full f amount. Therefore, System A is superior to System B.

"Wait a minute," you say, "I thought the only thing that mattered was that we had a geometric mean greater than 1, that the system need be only marginally profitable, that we can make all the money we want through money management!" That's still true. However, the rate at which you will make the money is still a function of the geometric mean at the f level you are employing. The expected variability will be a function of how high the f you are using is. So, although it's true that you ***must*** have a system with a geometric mean at the optimal f that is greater than 1 (i.e., a positive mathematical expectation) and that you can still make virtually an unlimited amount with such a system after enough trades, the rate of growth (the number of trades required to reach a specific goal) is dependent upon the geometric mean at the f value employed. The variability en route to that goal is also a function of the f value employed.

Yet these considerations, the degree of the geometric mean and the f employed, are secondary to the fact that you must have a positive mathematical expectation, although they are useful in comparing two systems or techniques that have positive mathematical expectations and an equal confidence of their working in the future.

TOO MUCH SENSIVITY TO THE BIGGEST LOSS

A recurring criticism with the entire approach of optimal f is that it is too dependent on the biggest losing trade. This seems to be rather disturbing to many traders. They argue that the amount of contracts you put on today should not be so much a function of a single bad trade in the past.

Numerous different algorithms have been worked up by people to alleviate this apparent oversensitivity to the largest loss. Many of these algorithms work by adjusting the largest loss upward or downward to make the largest loss be a function of the current volatility in the market. The relationship seems to be a quadratic one. That is, the absolute value of the largest loss seems to get bigger at a faster rate than the volatility. (Volatility is usually defined by these practitioners as the average daily range of the last few weeks, or average absolute value of the daily net change of the last few weeks, or any of the other conventional measures of volatility.) However, this is not a deterministic relationship. That is, just because the volatility is X today does not mean that our largest loss ***will*** be X^Y. It simply means that it usually is ***somewhere near X^Y.***

If we could determine in advance what the largest possible loss would be going into today, we could then have a much better handle on our money management.[2] Here again is a case where we must consider the worst-case scenario and build from there. The problem is that we do not know exactly what our largest loss can be going into today. An algo-

[2] This is where using options in a trading strategy is so useful. Either buying a put or call out right in opposition to the underlying position to limit the loss to the strike price of the options, or simply buying options outright in lieu of the underlying, gives you a floor, an absolute maximum loss. Knowing this is extremely handy from a money-management, particularly an optimal f, standpoint, Further, if you know what your maximum possible loss is n advance (e.g., a day trade), then you can always determine what the f is in dollars perfectly for any trade by the relation dollars at risk per unit/optima] f. For example, suppose a day trader knew her optimal 1 was .4. Her stop today, on a I-unit basis, is going to be $900. She will therefore optimally trade 1 unit for every $2,250 ($900/.4) in account equity.

rithm that can predict this is really not very useful to us because of the one time that it fails.

Consider for instance the possibility of an exogenous shock occurring in a market overnight. Suppose the volatility were quite low prior to this overnight shock, and the market then went locked-limit against you for the next few days. Or suppose that there were no price limits, and the market just opened an enormous amount against you the next day. These types of events are as old as commodity and stock trading itself. They can and do happen, ***and they are not always telegraphed in advance*** by increased volatility.

Generally then you are better off not to "shrink" your largest historical loss to reflect a current low-volatility marketplace. Furthermore, ***there Is the concrete possibility of experiencing a loss larger in the future than what was the historically largest*** loss. There is no mandate that the largest loss seen in the past is the largest loss you can experience today.[3] This is true regardless of the current volatility coming into today.

The problem is that, empirically, the f that has been optimal in the past is a function of the largest loss of the past. There's no getting around this. However, as you shall see when we get into the parametric techniques, you can budget for a greater loss in the future. In so doing, you will be prepared if the almost inevitable larger loss comes along. Rather than trying to adjust the largest loss to the current climate of a given market so that your empirical optimal f reflects the current climate, you will be much better off learning the parametric techniques.

The technique that follows is a possible solution to this problem, and it can be applied whether we are deriving our optimal f empirically or, as we shall learn later, parametrically.

EQUALIZING OPTIMAL F

Optimal f will yield the greatest geometric growth on a stream of outcomes. This is a mathematical fact. Consider the hypothetical stream of outcomes:

+2, -3, +10, -5

This is a stream from which we can determine our optimal f as .17, or to bet 1 unit for every $29.41 in equity. Doing so on such a stream will yield the greatest growth on our equity.

Consider for a moment that this stream represents the trade profits and losses on one share of stock. Optimally we should buy one share of stock for every $29.41 that we have in account equity, regardless of what the current stock price is. But suppose the current stock price is $100 per share. Further, suppose the stock was $20 per share when the first two trades occurred and was $50 per share when the last two trades occurred.

Recall that with optimal f we are using the stream of past trade P&L's as a proxy for the distribution of expected trade P&L's currently. Therefore, we can preprocess the trade P&L data to reflect this by converting the past trade P&L data to reflect a commensurate percentage gain or loss based upon the current price.

For our first two trades, which occurred at a stock price of $20 per share, the $2 gain corresponds to a 10% gain and the $3 loss corresponds to a 15% loss. For the last two trades, taken at a stock price of $50 per share, the $10 gain corresponds to a 20% gain and the $5 loss corresponds to a 10% loss.

The formulas to convert raw trade P&L's to percentage gains and losses for longs and shorts are as follows:

(2.10a) P&L% = Exit Price/Entry Price-1 (for longs)

(2.10b) P&L% = Entry Price/Exit Price-1 (for shorts)

or we can use the following formula to convert both longs and shorts:

(2.10c) P&L% = P&L in Points/Entry Price

Thus, for our 4 hypothetical trades, we now have the following stream of ***percentage*** gains and losses (assuming all trades are long trades):

+.l, -.15, +.2, -.1

We call this new stream of translated P&L's the ***equalized data***, because it is equalized to the price of the underlying instrument when the trade occurred.

To account for commissions and slippage, you must adjust the exit price downward in Equation (2.10a) for an amount commensurate with the amount of the commissions and slippage. Likewise, you should adjust the exit price upward in (2.10b). If you are using (2.10c), you must deduct the amount of the commissions and slippage (in points again) from the numerator P&L in Points.

Next we determine our optimal f on these percentage gains and losses. The f that is optimal is .09. We must now convert this optimal f of .09 into a dollar amount based upon the current stock price. This is accomplished by the following formula:

(2.11) f$ = Biggest % Loss*Current Price*$ per Point/-f

Thus, since our biggest percentage loss was -.15, the current price is $100 per share, and the number of dollars per full point is 1 (since we are only dealing with buying 1 share), we can determine our f$ as:

f$ = -.15*100*1/-.09 = -15/-.09 = 166.67

Thus, we would optimally buy 1 share for every $166.67 in account equity. If we used 100 shares as our unit size, the only variable affected would have been the number of dollars per full point, which would have been 100. The resulting f$ would have been $16,666.67 in equity for every 100 shares.

Suppose now that the stock went down to $3 per share. Our f$ equation would be exactly the same except for the current price variable which would now be 3. Thus, the amount to finance 1 share by becomes:

f$ = -.15*3*1/-.09 = -.45/-.09 = 5

We optimally would buy 1 share for every $5 we had in account equity.

Notice that the optimal f does not change with the current price of the stock. It remains at .09. However, the f$ changes continuously as the price of the stock changes. This doesn't mean that you must alter a position you are already in on a daily basis, but it does make it more likely to be beneficial that you do so. As an example, if you are long a given stock and it declines, the dollars that you should allocate to 1 unit (100 shares in this case) of this stock will decline as well, with the optimal f determined off of equalized data. If your optimal f is determined off of the raw trade P&L data, it will not decline. In both cases, your daily equity is declining. Using the equalized optimal f makes it more likely that adjusting your position size daily will be beneficial.

Equalizing the data for your optimal f necessitates changes in the by-products.[4] We have already seen that both the optimal f and the geometric mean (and hence the TWR) change. The arithmetic average trade changes because now it, too, must be based on the idea that all trades in the past must be adjusted as if they had occurred from the current price. Thus, in our hypothetical example of outcomes on 1 share of +2, -3,+10, and -5, we have an average trade of $1. When we take our percentage gains and losses of +.1, -15, +.2, and -.1, we have an average trade (in percent) of +.5. At $100 per share, this translates into an average trade of 100*.05 or $5 per trade. At $3 per share, the average trade becomes $.15 (3*.05).

The geometric average trade changes as well. Recall Equation (1.14) for the geometric average trade:

(1.14) GAT = G*(Biggest Loss/-f)

where

G = Geometric mean 1.

f = Optimal fixed fraction.

[3] Prudence requires that we USC a largest loss at least as big as the largest loss seen in the past. As the future unfolds and we obtain more and more data, we will derive longer runs of losses. For instance, if] flip a coin 100 times I might see it come up tails 12 times for a row at the longest run of tails. If I go and flip it 1,000 times, I most likely will see a longer run of tails. This same principle is at work when we trade. Not only should we expect longer streaks of losing trades in the future, we should also expect a bigger largest losing trade.

[4] Risk-of-ruin equations, although not directly addressed in this text, must also be adjusted to reflect equalized data when being used. Generally, risk-of-ruin equations use the raw trade P&L data as input. However, when you use equalized data, the new stream of percentage gains and losses must be multiplied by the current price of the underlying instrument and the resulting stream used. Thus, a stream of percentage gains and losses such as .1, -.15, .2, -.1 translates into a stream of 10, -15, 20, -10 for an underlying at a current price of $100. This new stream should then be used as the data for the risk-of-ruin equations.

(and, of course, our biggest loss is always a negative number).

This equation is the equivalent of:

GAT = (geometric mean-1)*f$

We have already obtained a new geometric mean by equalizing the past data. The f$ variable, which is constant when we do not equalize the past data, now changes continuously, as it is a function of the current underlying price. Hence our geometric average trade changes continuously as the price of the underlying instrument changes.

Our threshold to the geometric also must be changed to reflect the equalized data. Recall Equation (2.02) for the threshold to the geometric:

(2.02) T = AAT/GAT*Biggest Loss/-f

where

T = The threshold to the geometric.

AAT = The arithmetic average trade.

GAT = The geometric average trade.

f = The optimal f (0 to 1).

This equation can also be rewritten as: T = AAT/GAT*f$

Now, not only do the AAT and GAT variables change continuously as the price of the underlying changes, so too does the f$ variable.

Finally, when putting together a portfolio of market systems we must figure daily HPRs. These too are a function of f$:

(2.12) Daily HPR = D$/f$+1

where

D$ = The dollar gain or loss on 1 unit from the previous day. This is equal to (Tonight's Close-Last Night's Close)*Dollars per Point.

f$ = The current optimal fin dollars, calculated from Equation (2.11). Here, however, the current price variable is last night's close.

For example, suppose a stock tonight closed at $99 per share. Last night it was $102 per share. Our biggest percentage loss is -15. If our f is .09 then our f$ is:

f$ = -.15*102 *1/-.09

= -15.3/-.09

= 170

Since we are dealing with only 1 share, our dollars per point value is $1. We can now determine our daily HPR for today by Equation (2.12) as:

(2.12) Daily HPR = (99-102)*1/170+1 = -3/170+1 = -.01764705882+1 = .9823529412

Return now to what was said at the outset of this discussion. Given a stream of trade P&L's, the optimal f will make the greatest geometric growth on that stream (provided it has a positive arithmetic mathematical expectation). We use the stream of trade P&L's as a proxy for the distribution of possible outcomes on the next trade. Along this line of reasoning, it may be advantageous for us to equalize the stream of past trade profits and losses to be what they would be if they were performed at the current market price. In so doing, we may obtain a more realistic proxy of the distribution of potential trade profits and losses on the next trade. Therefore, we should figure our optimal f from this adjusted distribution of trade profits and losses.

This does not mean that we would have made more by using the optimal f off of the equalized data. We would not have, as the following demonstration shows:

	P&L	Percentage	Underlying Price	f$	Number of Shares	Cumulative
At f = .09, trading the equalized method:						$10,000
	+2	.1	20	$33.33	300	$10,600
	-3	-.15	20	$33.33	318	$9,646
	+10	.2	50	$83.33	115.752	$10,803.52
	-5	-.1	50	$83.33	129.642	$10,155.31
	P&L	Percentage	Underlying Price	f$	Number of Shares	Cumulative
At f = .17, trading the nonequalized method:						$10,000
	+2	.1	20	$29.41	340.02	$10,680.04
	-3	-.15	20	$29.41	363.14	$9,590.61
	+10	.2	50	$29.41	326.1	$12,851.61
	-5	-.1	50	$29.41	436.98	$10,666.71

However, if all of the trades were figured off of the current price (say $100 per share), the equalized optimal f would have made more than the raw optimal f.

Which then is the better to use? Should we equalize our data and determine our optimal f (and its by-products), or should we just run everything as it is? This is more a matter of your beliefs than it is mathematical fact. It is a matter of what is more pertinent in the item you are trading, percentage changes or absolute changes. Is a $2 move in a $20 stock the same as a $10 move in a $100 stock? What if we are discussing dollars and deutsche marks? Is a 30-point move at .4500 the same as a .40-point move at .6000?

My personal opinion is that you are probably better off with the equalized data. Often the matter is moot, in that if a stock has moved from $20 per share to $100 per share and we want to determine the optimal f, we want to use current data. The trades that occurred at $20 per share may not be representative of the way the stock is presently trading, regardless of whether they are equalized or not.

Generally, then, you are better off not using data where the underlying was at a dramatically different price than it presently is, as the characteristics of the way the item trades may have changed as well. In that sense, the optimal f off of the raw data and the optimal f off of the equalized data will be identical if all trades occurred at the same underlying price.

So we can state that if it does matter a great deal whether you equalize your data or not, then you're probably using too much data anyway. You've gone so far into the past that the trades generated back then probably are not very representative of the next trade. In short, we can say that it doesn't much matter whether you use equalized data or not, and if it does, there's probably a problem. If there isn't a problem, and there is a difference between using the equalized data and the raw data, you should opt for the equalized data. This does not mean that the optimal f figured off of the equalized data would have been optimal in the past. It would not have been. The optimal f figured off of the raw data would have been the optimal in the past. However, in terms of determining the as-yet-unknown answer to the question of what will be the optimal f (or closer to it tomorrow), the optimal f figured off of the equalized data makes better sense, as the equalized data is a fairer representation of the distribution of possible outcomes on the next trade.

Equations (2.10a) through (2.10c) will give different answers depending upon whether the trade was initiated as a long or a short. For example, if a stock is bought at 80 and sold at 100, the percentage gain is 25. However, if a stock is sold short at 100 and covered at 80, the gain is only 20%. In both cases, the stock was bought at 80 and sold at 100, but the sequence-the chronology of these transactions-must be accounted for. As the chronology of transactions affects the distribution of percentage gains and losses, we assume that the chronology of transactions in the future will be more like the chronology in the past than not. Thus, Equations (2.10a) through (2,10c) will give different answers for longs and shorts.

Of course, we could ignore the chronology of the trades (using 2.10c for longs and using the exit price in the denominator of 2.10c for shorts), but to do so would be to reduce the information content of the trade's history. Further, the risk involved with a trade is a function of the chronology of the trade, a fact we would be forced to ignore.

DOLLAR AVERAGING AND SHARE AVERAGING IDEAS

Here is an old, underused money-management technique that is an ideal tool for dealing with situations where you are absent knowledge.

Consider a hypothetical motorist, Joe Putzivakian, case number 286952343. Every week, he puts $20 of gasoline into his auto, regardless of the price of gasoline that week. He always gets $20 worth, and every week he uses the $20 worth no matter how much or how little that buys him. When the price for gasoline is higher, it forces him to be more austere in his driving.

As a result, Joe Putzivakian will have gone through life buying more gasoline when it is cheaper, and buying less when it was more expensive. He will have therefore gone through life paying a below average cost per gallon of gasoline. In other words, if you averaged the cost of a gallon of gasoline for all of the weeks of which Joe was a motorist, the average would have been higher than the average that Joe paid.

Now consider his hypothetical cousin, Cecil Putzivakian, case number 286952344. Whenever he needs gasoline, he just fills up his pickup and complains about the high price of gasoline. As a result, Cecil has used a consistent amount of gas each week, and has therefore paid the average price for it throughout his motoring lifetime.

Now let's suppose you are looking at a long-term investment program. You decide that you want to put money into a mutual fund to be used for your retirement many years down the road. You believe that when you retire the mutual fund will be at a much higher value than it is today. That is, you believe that in an asymptotic sense the mutual fund will be an investment that makes money (of course, in an asymptotic sense, lightning ***does*** strike twice). However, you do not know if it is going to go up or down over the next month, or the next year. You are absent knowledge about the nearer-term performance of the mutual fund.

To cope with this, you can dollar average into the mutual fund. Say you want to space your entry into the mutual fund over the course of two years. Further, say you have $36,000 to invest. Therefore, every month for the next 24 months you will invest $1,500 of this $36,000 into the fund, until after 24 months you will be completely invested. By so doing, you have obtained a below average cost into the fund. "Average" as it is used here refers to the average price of the fund over the 24-month period during which you are investing. It doesn't necessarily mean that you will get a price that is cheaper than if you put the full $36,000 into it today, nor does it guarantee that at the end of these 24 months of entering the fund you will show a profit on your $36,000. The amount you have in the fund at that time may be less than the $36,000. What it does mean is that if you simply entered arbitrarily at some point along the next 24 months with your full $36,000 in one shot, you would probably have ended up buying fewer mutual fund shares, and hence have paid a higher price than if you dollar averaged in.

The same is true when you go to exit a mutual fund, only the exit side works with share averaging rather than dollar averaging. Say it is now time for you to retire and you have a total of 1,000 shares in this mutual fund, You don't know if this is a good time for you to be getting out or not, so you decide to take 2 years (24 months), to average out of the fund. Here's how you do it. You take the total number of shares you have (1,000) and divide it by the number of periods you want to get out over (24 months). Therefore, since 1,000/24 = 41.67, you will sell 41.67 shares every month for the next 24 months. In so doing, you will have ended up selling your shares at a higher price than the average price over the next 24 months. Of course, this is no guarantee that you will have sold them for a higher price than you could have received for them today, nor does it guarantee that you will have sold your shares at a higher price than what you might get if you were to sell all of your shares 24 months from now. What you will get is a higher price than the average over the time period that you are averaging out over. That is guaranteed.

These same principles can be applied to a trading account. By dollar averaging money into a trading account as opposed to simply "taking the plunge" at some point during the time period you are averaging over, you will have gotten into the account at a better "average price." Absent knowledge of what the near-term equity changes in the account will be you are better off, on average, to dollar average into a trading program. Don't just rely on your gut and your nose, use the measures of dependency discussed in Chapter 1 on the monthly equity changes of a trading program. Try to see if there is dependency in the monthly equity changes. If there is dependency to a high enough confidence level so you can plunge in at a favorable point, then do so. However, if there isn't a high enough confidence in the dependency of the monthly equity changes, then dollar average into (and share average out of) a trading program. In so doing, you will be ahead in an asymptotic sense.

The same is true for withdrawing money from an account. The way to share average out of a trading program (when there aren't any shares, like a commodity account) is to decide upon a date to start averaging out, as well as how long a period of time to average out for. On the date when you are going to start averaging out, divide the equity in the account by 100. This gives you the value of "1 share." Now, divide 100 by the number of periods that you want to average out over. Say you want to average out of the account weekly over the next 20 weeks. That makes 20 periods. Dividing 100 by 20 gives 5. Therefore, you are going to average out of your account by 5 "shares" per week. Multiply the value you had figured for 1 share by 5, and that will tell you how much money to withdraw from your trading account this week. Now, going into next week, you must keep track of how many shares you have left. Since you got out of 5 shares last week, you are left with 95. When the time comes along for withdrawal number 2, divide the equity in your account by 95 and multiply by 5. This will give you the value of the 5 shares you are "cashing in" this week. You will keep on doing this until you have zero shares left, at which point no equity will be left in your account. By doing this, you have probably obtained a better average price for getting out of your account than you would have received had you gotten out of the account at some arbitrary point along this 20-week withdrawal period.

This principle of averaging in and out of a trading account is so simple, you have to wonder why no one ever does it. I always ask the accounts that I manage to do this. Yet I have never had anyone, to date, take me up on it. The reason is simple. The concept, although completely valid, requires discipline and time in order to work-exactly the same ingredients as those required to make the concept of optimal f work.

Just ask Joe Putzivakian. It's one thing to understand the concepts and believe in them. It's another thing to do it.

THE ARC SINE LAWS AND RANDOM WALKS

Now we turn the discussion toward drawdowns. First, however, we need to study a little bit of theory in the way of the first and second arc sine laws. These are principles that pertain to random walks. The stream of trade P&L's that you are dealing with may not be truly random. The degree to which the stream of P&L's you are using differs from being purely random is the degree to which this discussion will not pertain to your stream of profits and losses. Generally though, most streams of trade profits and losses are nearly random as determined by the runs test and the linear correlation coefficient (serial correlation).

Furthermore, not only do the arc sine laws assume that you know in advance what the amount that you can win or lose is, they also assume that the amount you can win is equal to the amount you can lose, and that this is always a constant amount. In our discussion, we will assume that the amount that you can win or lose is $1 on each play. The arc sine laws also assume that you have a 50% chance of winning and a 50% chance of losing. Thus, the arc sine laws assume a game where the mathematical expectation is 0.

These caveats make for a game that is considerably different, and considerably more simple, than trading is. However, the first and second arc sine laws are exact for the game just described. To the degree that trading differs from the game just described, the arc sine laws do not apply. For the sake of learning the theory, however, we will not let these differences concern us for the moment.

Imagine a truly random sequence such as coin tossing[5] where we win 1 unit when we win and we lose 1 unit when we lose. If we were to plot out our equity curve over X tosses, we could refer to a specific point (X,Y), where X represented the Xth toss and Y our cumulative gain or loss as of that toss.

We define ***positive territory*** as anytime the equity curve is above the X axis or on the X axis when the previous point was above the X axis. Likewise, we define ***negative territory*** as anytime the equity curve is below the X axis or on the X axis when the previous point was below the X axis. We would expect the total number of points in positive territory to be close to the total number of points in negative territory. But this is not the case.

If you were to toss the coin N times, your probability (Prob) of spending K of the events in positive territory is:

(2.13) Prob~l/(Pi*K^.5*(N-K)^.5)

where

Pi = 3.141592654.

The symbol ~ means that both sides tend to equality in the limit. In this case, as either K or (N-K) approaches infinity, the two sides of the equation will tend toward equality.

[5] Although empirical tests show that coin tossing is not a truly random sequence due to slight imperfections in the coin used, we will assume here, and elsewhere in the text when referring to coin tossing, that we are tossing an ideal coin with exactly a .5 chance of landing heads or tails.

Thus, if we were to toss a coin 10 times (N = 10) we would have the following probabilities of being in positive territory for K of the tosses:

K	Probability[6]
0	.14795
1	.1061
2	.0796
3	.0695
4	.065
5	.0637
6	.065
7	.0695
6	.0796
9	.1061
10	.14795

You would expect to be in positive territory for 5 of the 10 tosses, yet that is the least likely outcome! In fact, the most likely outcomes are that you will be in positive territory for all of the tosses or for none of them!

This principle is formally detailed in the ***first arc sine law*** which states:

For a Fixed A (0<A<1) and as N approaches infinity, the probability that K/N spent on the positive side is < A tends to:

(2.14) Prob{(K/N)<A} = 2/Pi*ARCSIN(A^.5)

where

Pi = 3.141592654.

Even with N as small as 20, you obtain a very close approximation for the probability.

Equation (2.14), the first arc sine law, tells us that with probability .1, we can expect to see 99.4% of the time spent on one side of the origin, and with probability .2, the equity curve will spend 97.6% of the time on the same side of the origin! With a probability of ***.5,*** we can expect the equity curve to spend in excess of 85.35% of the time on the same side of the origin. That is just how perverse the equity curve of a fair coin is!

Now here is the ***second arc sine law,*** which also uses Equation (2.14) and hence has the same probabilities as the first arc sine law, but applies to an altogether different incident, the maximum or minimum of the equity curve. The second arc sine law states that the maximum (or minimum) point of an equity curve will most likely occur at the endpoints, and least likely at the center. The distribution is exactly the same as the amount of time spent on one side of the origin!

If you were to toss the coin N times, your probability of achieving the maximum (or minimum) at point K in the equity curve is also given by Equation (2.13):

(2.13) Prob~l/(Pi*K^.5*(N-K)^.5)]where Pi = 3.141592654.

Thus, if you were to toss a coin 10 times (N = 10) you would have the following probabilities of the maximum (or minimum) occurring on the Kth toss:

K	Probability
0	.14795
1	.1061
2	.0796
3	.0695
4	.065
5	.0637
6	.065
7	.0695
8	.0796
9	.1061
10	.14795

In a nutshell, the second arc sine law states that the maximum or minimum are most likely to occur near the endpoints of the equity curve and least likely to occur in the center.

TIME SPENT IN A DRAWDOWN

Recall the caveats involved with the arc sine laws. That is, the arc sine laws assume a 50% chance of winning, and a 50% chance of losing. Further, they assume that you win or lose the exact same amounts and that the generating stream is purely random. Trading is considerably more complicated than this. Thus, the arc sine laws don't apply in a pure sense, but they do apply in spirit.

Consider that the arc sine laws worked on an arithmetic mathematical expectation of 0. Thus, with the first law, we can interpret the percentage of time on either side of the zero line as the percentage of time on either side of the arithmetic mathematical expectation. Likewise with the second law, where, rather than looking for an absolute maximum and minimum, we were looking for a maximum above the mathematical expectation and a minimum below it. The minimum below the mathematical expectation could be greater than the maximum above it if the minimum happened later and the arithmetic mathematical expectation was a rising line (as in trading) rather than a horizontal line at zero.

Thus, we can interpret the spirit of the arc sine laws as applying to trading in the following ways. (However, rather than imagining the important line as being a, horizontal line at zero, we should imagine a line that slopes upward at the rate of the arithmetic average trade (if we are constant-con-tract trading). If we are Axed fractional trading, the line will be one that curves upward, getting ever steeper, 'at such a rate that the next point equals the current point times the geometric mean.) We can interpret the first arc sine law as stating that we should expect to be on one side of the mathematical expectation line for far more trades than we spend on the other side of the mathematical expectation line. Regarding the second arc sine law, we should expect the maximum deviations from the mathematical expectation line, either above or below it, as being most likely to occur near the beginning or the end of the equity curve graph and least likely near the center of it.

You will notice another characteristic that happens when you are trading at the optimal f levels. This characteristic concerns the length of time you spend between two equity high points. If you are trading at the optimal f level, whether you are trading just 1 market system or a portfolio of market systems, the time of the longest drawdown[7] (not necessarily the worst, or deepest, drawdown) takes to elapse is usually 35 to 55% of the total time you are looking at. This seems to be true no matter how long or short a time period you are looking at! (Again, time in this sense is measured in trades.)

This is not a hard-and-fast rule. Rather, it is the effect of the spirit of the arc sine laws at work. It is perfectly natural, and ***should be expected***

This principle appears to hold true no matter how long or short a period we are looking at. This means that we can expect to be in the largest drawdown for approximately 35 to 55% of the trades over the life of a trading program we are employing! This is true whether we are trading 1 market system or an entire portfolio. Therefore, we must learn to expect to be within the maximum drawdown for 35 to 55% of the life of a program that we wish to trade. Knowing this before the fact allows us to be mentally prepared to trade through it.

Whether you are about to manage an account, about to have one managed by someone else, or about to trade your own account, you should bear in mind the spirit of the arc sine laws and how they work on your equity curve relative to the mathematical expectation line, along with the 35% to 55% rule. By so doing you will be tuned to reality regarding what to expect as the future unfolds.

We have now covered the empirical techniques entirely. Further, we have discussed many characteristics of fixed fractional trading and have introduced some salutary techniques, which will be used throughout the sequel. We have seen that by trading at the optimal levels of money management, not only can we expect substantial drawdowns, but the time spent between two equity highs can also be quite substantial. Now we turn our attention to studying the parametric techniques, the subject of the next chapter.

[6] Note that since neither K nor N may equal 0 in Equation (2.13) (as you would then be dividing by 0), we can discern the probabilities corresponding to K = 0 and K = N by summing the probabilities from K = l to K = N-l and subtracting this sum from 1. Dividing this difference by 2 will give us the probabilities associated with K = 0 and K = N.

[7] 7By longest drawdown here is meant the longest time, in terms of the number of elapsed trades, between one equity peak and the time (or number of elapsed trades) until that peak is equaled or exceeded.

Chapter 3 - Parametric Optimal f on the Normal Distribution

Now that we are finished with our discussion of the empirical techniques as well as the characteristics of fixed fractional trading, we enter the realm of the parametric techniques. Simply put, these techniques differ from the empirical in that they do not use the past history itself as the data to be operated on Bather, we observe the past history to develop a mathematical description of that distribution of that data This mathematical description is based upon what has happened in the past as well as what we expect to happen in the future. In the parametric techniques we operate on these mathematical descriptions rather than on the past history itself

The mathematical descriptions used in the parametric techniques are most often what are referred to as probability distributions. Therefore, if we are to study the parametric techniques, we must study probability distributions (in general) as a foundation We will then move on to studying a certain type of distribution, the Normal Distribution. Then we will see how to find the optimal f and its byproducts on the Normal Distribution.

THE BASICS OF PROBABILITY DISTRIBUTIONS

Imagine if you will that you are at a racetrack and you want to keep a log of the position in which the horses in a race finish. Specifically, you want to record whether the horse in the pole position came in first, second, and so on for each race of the day. You will only record ten places. If the horse came in worse than in tenth place, you will record it as a tenth-place finish. If you do this for a number of days, you will have gathered enough data to see the ***distribution*** of finishing positions for a horse starting out in the pole position. Now you take your data and plot it on a graph. The horizontal axis represents where the horse finished, with the far left being the worst finishing position (tenth) and the far right being a win. The vertical axis will record how many times the pole position horse finished in the position noted on the horizontal axis. You would begin to see a bell-shaped curve develop.

Under this scenario, there are ten possible finishing positions for each race. We say that there are ten ***bins*** in this distribution. What if, rather than using ten bins, we used five? The first bin would be for a first- or second-place finish, the second bin for a third-or fourth-place finish, and so on. What would have been the result?

Using fewer bins on the same set of data would have resulted in a probability distribution with the same profile as one determined on the same data with more bins. That is, they would look pretty much the same graphically. However, using fewer bins does reduce the information content of a distribution. Likewise, using more bins increases the information content of a distribution. If, rather than recording the finishing position of the pole position horse in each race, we record the time the horse ran in, rounded to the nearest second, we will get more than ten bins; and thus the information content of the distribution obtained will be greater.

If we recorded the exact finish time, rather than rounding finish times to use the nearest second, we would be creating what is called a continuous distribution. In a continuous distribution, there are no bins. Think of a continuous distribution as a series of infinitely thin bins (see Figure 3-1). A continuous distribution differs from a ***discrete*** distribution, the type we discussed first in that a discrete distribution is a binned distribution. Although binning does reduce the information content of a distribution, in real life it is often necessary to bin data. Therefore, in real life it is often necessary to lose some of the information content of a distribution, while keeping the profile of the distribution the same, so that you can process the distribution. Finally, you should know that it is possible to take a continuous distribution and make it discrete by binning it, but it is not possible to take a discrete distribution and make it continuous.

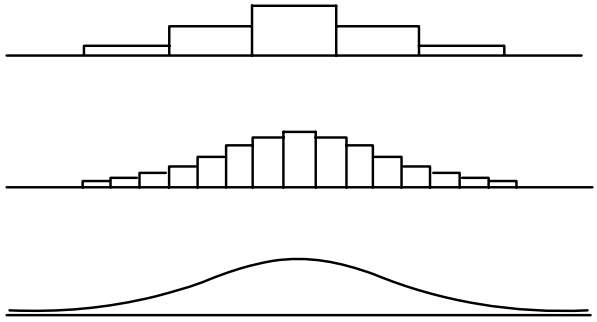

Figure 3-1 A continuous distribution is a series of infinitely thin bins

When we are discussing the profits and losses of trades, we are essentially discussing a continuous distribution. A trade can take a multitude of values (although we could say that the data is binned to the nearest cent). In order to work with such a distribution, you may find it necessary to bin the data into, for example, one-hundred-dollar-wide bins. Such a distribution would have a bin for trades that made nothing to $99.99, the next bin would be for trades that made $100 to $199.99, and so on. There is a loss of information content in binning this way, yet the profile of the distribution of the trade profits and losses remains relatively unchanged.

DESCRIPTIVE MEASURES OF DISTRIBUTIONS

Most people are familiar with the average, or more specifically the ***arithmetic mean***. This is simply the sum of the data points in a distribution divided by the number of data points:

(3.01) $A = (\sum[i = 1,N]\ X_i)/N$

where

A = The arithmetic mean.

X_i = The ith data point.

N = The total number of data points in the distribution.

The arithmetic mean is the most common of the types of measures of ***location***, or ***central tendency*** of a body of data, a distribution. However, you should be aware that the arithmetic mean is not the only available measure of central tendency and often it is not the best. The arithmetic mean tends to be a poor measure when a distribution has very broad tails. Suppose you randomly select data points from a distribution and calculate their mean. If you continue to do this you will find that the arithmetic means thus obtained converge poorly, if at all, when you are dealing with a distribution with very broad tails.

Another important measure of location of a distribution is the median. The median is described as the middle value when data are arranged in an array according to size. The median divides a probability distribution into two halves such that the area under the curve of one half is equal to the area under the curve of the other half. The median is frequently a better measure of central tendency than the arithmetic mean. Unlike the arithmetic mean, the median is not distorted by extreme outlier values. Further, the median can be calculated even for open-ended distributions. An open-ended distribution is a distribution in which all of the values in excess of a certain bin are thrown into one bin. An example of an open-ended distribution is the one we were compiling when we recorded the finishing position in horse racing for the horse starting out in the pole position. Any finishes worse than tenth place were recorded as a tenth place finish. Thus, we had an open distribution. The median is extensively used by the U.S. Bureau of the Census.

The third measure of central tendency is the mode-the most frequent occurrence. The mode is the peak of the distribution curve. In some distributions there is no mode and sometimes there is more than one mode. Like the median, the mode can often be regarded as a superior measure of central tendency. The mode is completely independent of extreme outlier values, and it is more readily obtained than the arithmetic mean or the median.

We have seen how the median divides the distribution into two equal areas. In the same way a distribution can be divided by three ***quartiles*** (to give four areas of equal size or probability), or nine ***deciles*** (to give ten areas of equal size or probability) or 99 ***percentiles*** (to give 100 areas of equal size or probability). The 50th percentile is the median, and along with the 25th and 75th percentiles give us the quartiles. Finally, another term you should become familiar with is that of a ***quan-***

tile. A quantile is any of the N-1 variate values that divide the total frequency into N equal parts.

We now return to the mean. We have discussed the arithmetic mean as a measure of central tendency of a distribution. You should be aware that there are other types of means as well. These other means are less common, but they do have significance in certain applications.

First is the ***geometric mean***, which we saw how to calculate in the first chapter. The geometric mean is simply the Nth root of all the data points multiplied together.

(3.02) $G = (\prod[i = 1,N]X_i)^{(1/N)}$

where

G = The geometric mean.

X_i = The ith data point.

N = The total number of data points in the distribution.

The geometric mean cannot be used if any of the variate-values is zero or negative.

We can state that the arithmetic mathematical expectation is the arithmetic average outcome of each play (on a constant I-unit basis) minus the bet size. Likewise, we can state that the geometric mathematical expectation is the geometric average outcome of each play (on a constant I-unit basis) minus the bet size.

Another type ***of mean is*** the ***harmonic mean.*** This is the reciprocal of the mean of the reciprocals of the data points.

(3.03) $1/\prod = 1/N \sum[i = 1,N]1/X_i$

where

H = The harmonic mean.

X_i = The ith data point.

N = The total number of data points in the distribution.

The final measure of central tendency ***is*** the ***quadratic mean*** or ***roof mean square.***

(3.04) $R^2 = 1/N\sum[i = 1,N]Xi^2$

where

R = The root mean square.

X_i = The ith data point.

N = The total number of data points in the distribution.

You should realize that the arithmetic mean (A) is always greater than or equal to the geometric mean (G), and the geometric mean is always greater than or equal to the harmonic mean (H):

(3.05) $H<=G<=A$

where

H = The harmonic mean.

G = The geometric mean.

A = The arithmetic mean.

MOMENTS OF A DISTRIBUTION

The central value or location of a distribution is often the first thing you want to know about a group of data, and often the next thing you want to know is the data's variability or "width" around that central value. We call the measures of a distributions central tendency the ***first moment*** of a distribution. The variability of the data points around this central tendency is called the ***second moment*** of a distribution. Hence the second moment measures a distribution's dispersion about the first moment.

As with the measure of central tendency, many measures of dispersion are available. We cover seven of them here, starting with the least common measures and ending with the most common.

The ***range*** of a distribution is simply the difference between the largest and smallest values in a distribution. Likewise, the ***10-90 percentile range*** is the difference between the 90th and 10th percentile points. These first two measures of dispersion measure the spread from one extreme to the other. The remaining five measures of dispersion measure the departure from the central tendency (and hence measure the half-spread).

The ***semi-interquartile range or quartile deviation*** equals one half of the distance between the first and third quartiles (the 25th and 75th per-centiles). This is similar to the 10-90 percentile range, except that with this measure the range is commonly divided by 2.

The ***half-width*** is an even more frequently used measure of dispersion. Here, we take the height of a distribution at its peak, the mode. If we find the point halfway up this vertical measure and run a horizontal line through it perpendicular to the vertical line, the horizontal line will touch the distribution at one point to the left and one point to the right. The distance between these two points is called the half-width.

Next, the ***mean absolute deviation or mean deviation*** is the arithmetic average of the absolute value of the difference between the data points and the arithmetic average of the data points. In other words, as its name implies, it is the average distance that a data point is from the mean. Expressed mathematically:

(3.06) $M = 1/N \sum[i = 1,N] ABS (X_i-A)$

where

M = The mean absolute deviation.

N = The total number of data points.

X_i = The ith data point.

A = The arithmetic average of the data points.

ABS() = The absolute value function.

Equation (3.06) gives us what is known as the ***population*** mean absolute deviation. You should know that the mean absolute deviation can also be calculated as what is known as the ***sample*** mean absolute deviation. To calculate the sample mean absolute deviation, replace the term 1/N in Equation (3.06) with 1/(N-1). You use the sample version when you are making judgments about the population based on a sample of that population.

The next two measures of dispersion, variance and standard deviation, are the two most commonly used. Both are used extensively, so we cannot say that one is more common than the other; suffice to say they are both the most common. Like the mean absolute deviation, they can be calculated two different ways, for a population as well as a sample. The population version is shown, and again it can readily be altered to the sample version by replacing the term 1/N with 1/(N-1).

The ***variance*** is the same thing as the mean absolute deviation except that we square each difference between a data point and the average of the data points. As a result, we do not need to take the absolute value of each difference, since multiplying each difference by itself makes the result positive whether the difference was positive or negative. Further, since each distance is squared, extreme outliers will have a stronger effect on the variance than they would on the mean absolute deviation. Mathematically expressed:

(3.07) $V = 1/N \sum[i = 1,N] ((X_i-A)^2)$

where V = The variance.

N = The total number of data points.

X_i = The ith data point.

A = The arithmetic average of the data points.

Finally, the ***standard deviation*** is related to the variance (and hence the mean absolute deviation) in that the ***standard deviation is simply the square root of the variance.***

The ***third moment*** of a distribution is called ***skewness,*** and it describes the extent of asymmetry about a distributions mean (Figure 3-2). Whereas the first two moments of a distribution have values that can be considered ***dimensional*** (i.e., having the same units as the measured quantities), skew-ness is defined in such a way as to make it ***nondimensional.*** It is a pure number that represents nothing more than the shape of the distribution.

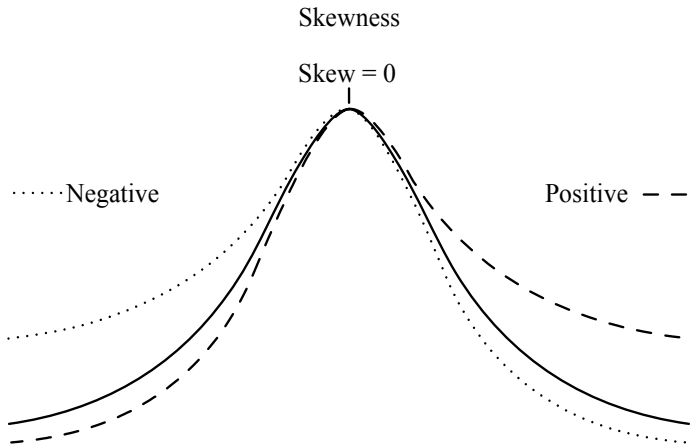

Figure 3-2 Skewness

A positive value for skewness means that the tails are thicker on the positive side of the distribution, and vice versa. A perfectly symmetrical distribution has a skewness of 0.

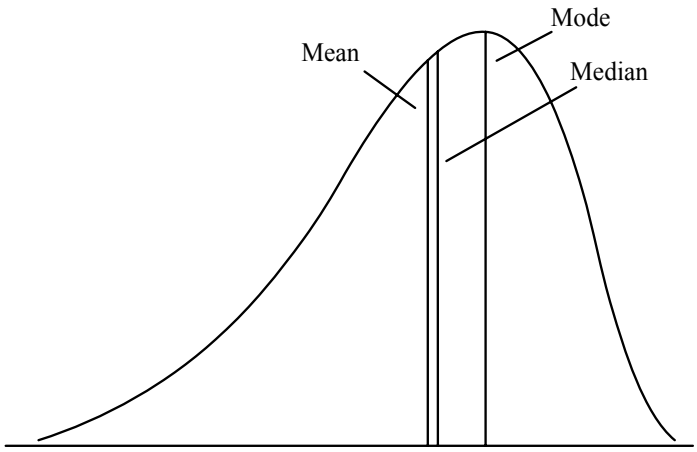

Figure 3-3 Skewness alters location.

In a symmetrical distribution the mean, median, and mode are all at the same value. However, when a distribution has a nonzero value for skewness, this changes as depicted in Figure 3-3. The relationship for a skewed distribution (any distribution with a nonzero skewness) is:

(3.08) Mean-Mode = 3*(Mean-Median)

As with the first two moments of a distribution, there are numerous measures for skewness, which most frequently will give different answers. These measures now follow:

(3.09) S = (Mean-Mode)/Standard Deviation

(3.10) S = (3*(Mean-Median))/Standard Deviation

These last two equations, (3.09) and (3.10), are often referred to as Pearson's first and second coefficients of skewness, respectively. Skewness is also commonly determined as:

(3.11) $S = 1/N \sum[i = 1,N] (((X_i-A)/D)^3)$

where

S = The skewness.

N = The total number of data points.

X_i = The ith data point.

A = The arithmetic average of the data points.

D = The population standard deviation of the data points.

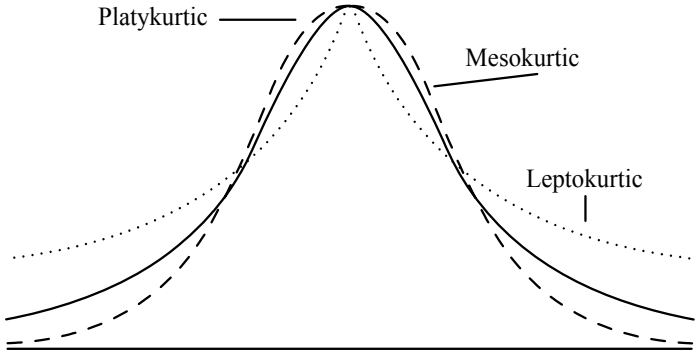

Figure 3-4 Kurtosis.

Finally, the ***fourth moment*** of a distribution, ***kurtosis*** (see Figure 34) measures the peakedness or flatness of a distribution (relative to the Normal Distribution). Like skewness, it is a nondimensional quantity. A curve less peaked than the Normal is said to be ***platykurtic*** (kurtosis will be negative), and a curve more peaked than the Normal is called ***leptokurtic*** (kurtosis will be positive). When the peak of the curve resembles the Normal Distribution curve, kurtosis equals zero, and we call this type of peak on a distribution ***mesokurtic.***

Like the preceding moments, kurtosis has more than one measure. The two most common are:

(3.12) K = Q/P

where

K = The kurtosis.

Q = The semi-interquartile range.

P = The 10-90 percentile range.

(3.13) $K = (1/N (\sum[i = 1,N] (((Xi-A)/D)^ 4)))-3$

where

K = The kurtosis.

N = The total number of data points.

X_i = The ith data point.

A = The arithmetic average of the data points.

D = The population standard deviation of the data points.

Finally, it should be pointed out there is a lot more "theory" behind the moments of a distribution than is covered here, For a more in-depth discussion you should consult one of the statistics books mentioned in the Bibliography. The depth of discussion about the moments of a distribution presented here will be more than adequate for our purposes throughout this text.

Thus far, we have covered data distributions in a general sense. Now we will cover the specific distribution called the Normal Distribution.

THE NORMAL DISTRIBUTION

Frequently the Normal Distribution is referred to as the Gaussian distribution, or de Moivre's distribution, after those who are believed to have discovered it-Karl Friedrich Gauss (1777-1855) and, about a century earlier and far more obscurely, Abraham de Moivre (1667-1754).

The Normal Distribution is considered to be the most useful distribution in modeling. This is due to the fact that the Normal Distribution accurately models many phenomena. Generally speaking, we can measure heights, weights, intelligence levels, and so on from a population, and these will very closely resemble the Normal Distribution.

Let's consider what is known as Galton's board (Figure 3-5). This is a vertically mounted board in the shape of an isosceles triangle. The board is studded with pegs, one on the top row, two on the second, and so on. Each row down has one more peg than the previous row. The pegs are arranged in a triangular fashion such that when a ball is dropped in, it has a 50/50 probability of going right or left with each peg it encounters. At the base of the board is a series of troughs to record the exit gate of each ball.

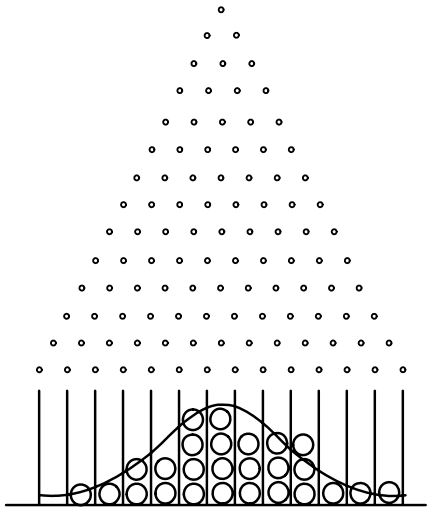

Figure 3-5 Galton's board.

The balls falling through Galton's board and arriving in the troughs will begin to form a Normal Distribution. The "deeper" the board is (i.e., the more rows it has) and the more balls are dropped through, the more closely the final result will resemble the Normal Distribution.

The Normal is useful in its own right, but also because it tends to be the limiting form of many other types of distributions. For example, if X is distributed binomially, then as N tends toward infinity, X tends to be Normally distributed. Further, the Normal Distribution is also the limiting form of a number of other useful probability distributions such as the Poisson, the Student's, or the T distribution. In other words, as the data (N) used in these other distributions increases, these distributions increasingly resemble the Normal Distribution.

THE CENTRAL LIMIT THEOREM

One of the most important applications for statistical purposes involving the Normal Distribution has to do with the distribution of averages. The averages of samples of a given size, taken such that each sampled item is selected independent of the others, will yield a distribution that is close to Normal. This is an extremely powerful fact, for it means that you can generalize about an actual random process from averages computed using sample data.

Thus, we can state that ***if N random samples are drawn from a population, then the sums (or averages) of the samples will be approximately Normally distributed, regardless of the distribution of the population from which the samples are drawn The closeness to the Normal Distribution improves as N (the number of samples) increases.***

As an example, consider the distribution of numbers from 1 to 100. This is what is known as a ***uniform distribution:*** all elements (numbers in this case) occur only once. The number 82 occurs once and only once, as does 19, and so on. Suppose now that we take a sample of five elements and we take the average of these five sampled elements (we can just as well take their sums). Now, we replace those five elements back into the population, and we take another sample and calculate the sample mean. If we keep on repeating this process, we will see that the sample means are Normally distributed, even though the population from which they are drawn is uniformly distributed.

Furthermore, this is true ***regardless*** of how the population is distributed! The Central Limit Theorem allows us to treat the distribution of sample means as being Normal without having to know the distribution of the population. This is an enormously convenient fact for many areas of study.

If the population itself happens to be Normally distributed, then the distribution of sample means will be exactly (not approximately) Normal. This is true because how quickly the distribution of the sample means approaches the Normal, as N increases, is a function of how close the population is to Normal. As a general rule of thumb, if a population has a ***unimodal*** distribution-any type of distribution where there is a concentration of frequency around a single mode, and diminishing frequencies on either side of the mode (i.e., it is convex)-or is uniformly distributed, using a value of 20 for N is considered sufficient, and a value of 10 for N is considered ***probably*** sufficient. However, if the population is distributed according to the Exponential Distribution (Figure 3-6), then it may be necessary to use an N of 100 or so.

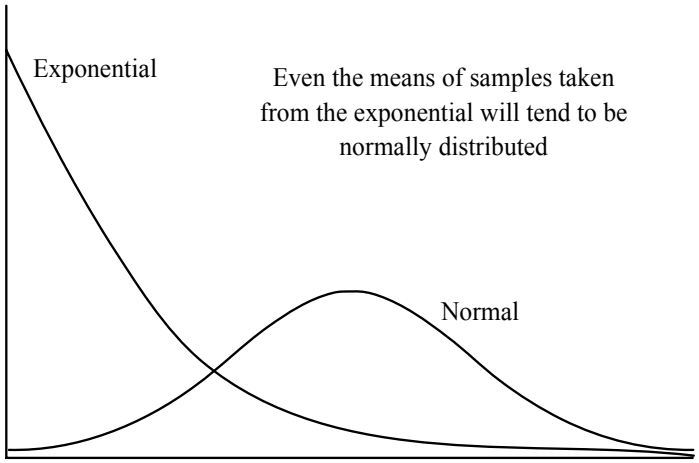

Figure 3-6 The Exponential Distribution and the Normal.

The Central Limit Theorem, this amazingly simple and beautiful fact, validates the importance of the Normal Distribution.

WORKING WITH THE NORMAL DISTRIBUTION

In using the Normal Distribution, we most frequently want to find the percentage of area under the curve at a given point along the curve. In the parlance of calculus this would be called the integral of the function for the curve itself. Likewise, we could call the function for the curve itself the derivative of the function for the area under the curve. Derivatives are often noted with a prime after the variable for the function. Therefore, if we have a function, N(X), that represents the percentage of area under the curve at a given point, X, we can say that the derivative of this function, N'(X) (called N prime of X), is the function for the curve itself at point X.

We will begin with the formula for the curve itself, N'(X). This function is represented as:

(3.14) N'(X) = 1/(S*(2*3.1415926536)^(1/2))*EXP(-((X-U)^2)/(2*S^2))

where

U = The mean of the data.

S = The standard deviation of the data.

X = The observed data point.

EXP() = The exponential function.

This formula will give us the Y axis value, or the height of the curve if you Will, at any given X axis value.

Often it is easier to refer to a point along the curve with reference to its X coordinate in terms of how many standard deviations it is away from the mean. Thus, a data point that was one standard deviation away from the mean would be said to be one ***standard unit*** from the mean.

Further, it is often easier to subtract the mean from all of the data points, which has the effect of shifting the distribution so that it is centered over zero rather than over the mean. Therefore, a data point that was one standard deviation to the right of the mean would now have a value of 1 on the X axis.

When we make these conversions, subtracting the mean from the data points, then dividing the difference by the standard deviation of the data points, we are converting the distribution to what is called the ***standardized normal,*** which is the Normal Distribution with mean = 0 and variance = 1. Now, N'(Z) will give us the Y axis value (the height of the curve) for any value of Z:

(3.15a) N'(Z) = 1/((2*3.1415926536)^(1/2))*EXP(-(Z^2/2)) = .398942*EXP(-(Z^2/2))

where

(3.16) Z = (X-U)/S

and U = The mean of the data.

S = The standard deviation of the data.

X = The observed data point.

EXP() = The exponential function.

Equation (3.16) gives us the number ***of standard units*** that the data point corresponds to-in other words, how many standard deviations away from the mean the data point is. When Equation (3.16) equals 1, it is called the ***standard normal deviate***. A standard deviation or a standard unit is sometimes referred to as a sigma. Thus, when someone speaks of an event being a "five sigma event," they are referring to an event whose probability of occurrence is the probability of being beyond five standard deviations.

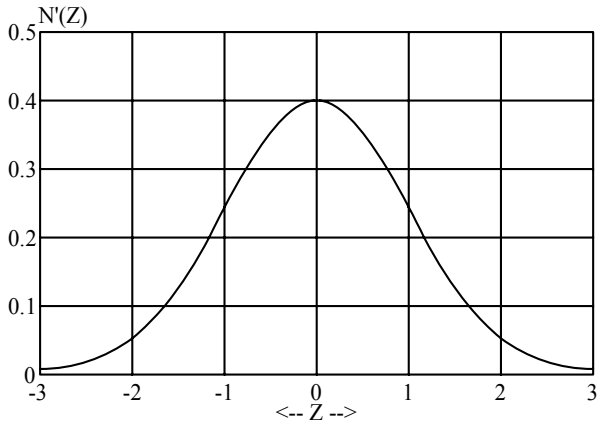

Figure 3-7 The Normal Probability density function.

Consider Figure 3-7, which shows this equation for the Normal curve. Notice that the height of the standard Normal curve is .39894. From Equation (3.15a), the height is:

(3.15a) N'(Z) = .398942*EXP(-(Z^2/2))

N'(0) = .398942*EXP(-(0^2/2))

N'(0) = .398942

Notice that the curve is continuous-that is, there are no "breaks" in the curve as it runs from minus infinity on the left to positive infinity on the right. Notice also that the curve is symmetrical, the side to the right of the peak being the mirror image of the side to the left of the peak.

Suppose we had a group of data where the mean of the data was 11 and the standard deviation of the group of data was 20. To see where a data point in that set would be located on the curve, we could first calculate it as a standard unit. Suppose the data point in question had a value of -9. To calculate how many standard units this is we first must subtract the mean from this data point:

-9 -11 = -20

Next we need to divide the result by the standard deviation:

-20/20 = -1

We can therefore say ***that*** the number of standard units is -1, when the data point equals -9, and the mean is 11, and the standard deviation is 20. In other words, we are one standard deviation away from the peak of the curve, the mean, and since this value is negative we know that it means we are one standard deviation to the left of the peak. To see where this places us on the curve itself (i.e., how high the curve is at one standard deviation left of center, or what the Y axis value of the curve is for a corresponding X axis ***value*** of -1), we need to now plug this into Equation (3.15a):

(3.15a) N'(Z) = .398942*EXP(-(Z^2/2))

= .398942*2.7182818285^(-(-1^2/2))

= .398942*2.7182818285^(-1/2)

= .398942*.6065307

= .2419705705

Thus we can say that the height of the curve at X = -1 is .2419705705. The function N'(Z) is also often expressed as:

(3.15b) N'(Z) = EXP(-(Z^2/2))/((8*ATN(1))^(1/2)
= EXP(-(Z^2/2))/((8*.7853983)^(1/2)
= EXP(-(Z^2/2))/2.506629

where

(3.16) Z = (X-U)/S

and

ATN() = The arctangent function.

U = The mean of the data.

S = The standard deviation of the data.

X = The observed data point.

EXP() = The exponential function.

Nonstatisticians often find the concept of the standard deviation (or its square, ***variance***) hard to envision. A remedy for this is to use what is known as the ***mean absolute deviation*** and convert it to and from the standard deviation in these equations. The ***mean absolute deviation*** is exactly what its name implies. The mean of the data is subtracted from each data point. The absolute values of each of these differences are then summed, and this sum is divided by the number of data points. What you end up with is the average distance each data point is away from the mean. The conversion for mean absolute deviation and standard deviation are given now:

(3.17) Mean Absolute Deviation = S*((2/3.1415926536)^(1/2)) = S*.7978845609

where

M = The mean absolute deviation.

S = The standard deviation.

Thus we can say that in the Normal Distribution, the mean absolute deviation equals the standard deviation times .7979. Likewise:

(3.18) S = M*1/.7978845609 = M*1.253314137

where

S = The standard deviation.

M = The mean absolute deviation.

So we can also say that in the Normal Distribution the standard deviation equals the mean absolute deviation times 1.2533. Since the variance is always the standard deviation squared (and standard deviation is always the square root of variance), we can make the conversion between variance and mean absolute deviation.

(3.19) M = V^(1/2)*((2/3.1415926536)^(1/2)) = V^(l/2)*.7978845609

where

M = The mean absolute deviation.

V = The variance.

(3.20) V = (M*1.253314137)^2

where

V = The variance.

M = The mean absolute deviation.

Since the standard deviation in the standard normal curve equals 1, we can state that the mean absolute deviation in the standard normal curve equals .7979.

Further, in a bell-shaped curve like the Normal, the semi-interquartile range equals approximately two-thirds of the standard deviation, and therefore the standard deviation equals about 1.5 times the semi-interquartile range. This is true of most bell-shaped distributions, not just the Normal, as are the conversions given for the mean absolute deviation and standard deviation.

NORMAL PROBABILITIES

We now know how to convert our raw data to standard units and how to form the curve N'(Z) itself (i.e., how to find the height of the curve, or Y coordinate for a given standard unit) as well as N'(X) (Equation (3.14), the curve itself without first converting to standard units). To really use the Normal Probability Distribution though, we want to know what the probabilities of a certain outcome happening arc. This is not given by the height of the curve. Rather, the probabilities correspond to the area under the curve. These areas are given by the integral of this N'(Z) function which we have thus far studied. We will now concern ourselves with N(Z), the integral . to N'(Z), to find the areas under the curve (the probabilities).[1]

(3.21) N(Z) = 1 -N'(Z)*((1.330274429*Y ^ 5)-
(1.821255978*Y^4)+(1.781477937*Y^3)-
(.356563782*Y^2)+(.31938153*Y))

If Z<0 then N(Z) = 1-N(Z)

(3.15a) N'(Z) = .398942*EXP(-(Z^2/2))

[1] The actual integral to the Normal probability density does not exist in closed form, but it can very closely be approximated by Equation (3.21).

where

Y = 1/(1+2316419*ABS(Z))

and

ABS() = The absolute value function.

EXP() = The exponential function.

We will always convert our data to standard units when finding probabilities under the curve. That is, we will not describe an N(X) function, but rather we will use the N(Z) function where:

(3.16) Z = (X-U)/S

and U = The mean of the data.

S = The standard deviation of the data.

X = The observed data point.

Refer now to Equation (3.21). Suppose we want to know what the probability is of an event not exceeding +2 standard units (Z = +2).

Y = 1/(1+2316419*ABS(+2))

= 1/1.4632838

= .68339443311

(3.15a) N'(Z) = .398942*EXP(-(+2^2/2))

= .398942*EXP(-2)

= .398942*.1353353

= .05399093525

Notice that this tells us the height of the curve at +2 standard units. Plugging these values for Y and N'(Z) into Equation (3.21) we can obtain the probability of an event not exceeding +2 standard units:

N(Z) = 1-N'(Z)*((1.330274429*Y^5)-(1.821255978*Y^4)+(1.781477937*Y^3)-(.356563782*Y^2)+(.31938153*Y))

= 1-.05399093525*((1.330274429*.68339443311^5)-(1.821255978*.68339443311^4+1.781477937*.68339443311^3)-(.356563782*.68339443311^2)+(.31938153*.68339443311))

= 1-.05399093525*((1.330274429*.1490587)-(1.821255978*.2181151+(1.781477937*.3191643)-(-356563782*.467028+.31938153*.68339443311))

= 1-.05399093525*(.198288977-.3972434298+.5685841587-.16652527+.2182635596)

= 1-.05399093525*.4213679955

= 1-.02275005216

= .9772499478

Thus we can say that we can expect 97.72% of the outcomes in a Normally distributed random process to fall shy of +2 standard units. This is depicted in Figure 3-8.

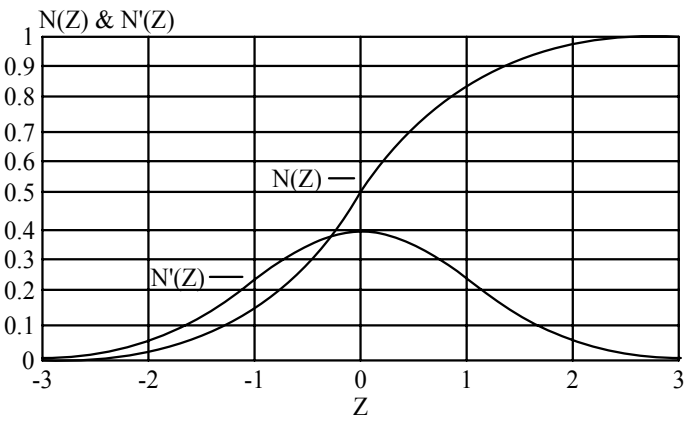

Figure 3-8 Equation (3.21) showing probability with Z = +2.

If we wanted to know what the probabilities were for an event equaling or exceeding a prescribed number of standard units (in this case +2), we would simply amend Equation (3.21), taking out the 1- in the beginning of the equation and doing away with the -Z provision (i.e., doing away with "If Z < 0 then N(Z) = 1-N(Z)"). Therefore, the second to last line in the last computation would be changed from

= 1-.02275005216

to simply

.02275005216

We would therefore say that there is about a 2.275% chance that an event in a Normally distributed random process would equal or exceed +2 standard units. This is shown in Figure 3-9.

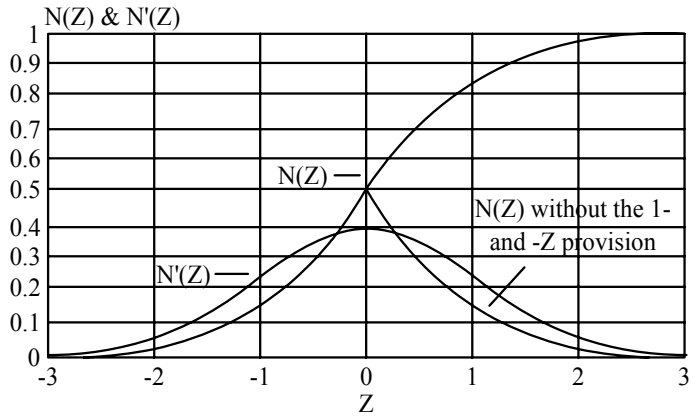

Figure 3-9 Doing away with the 1- and -Z provision in Equation (3.21).

Thus far we have looked at areas under the curve (probabilities) where we are only dealing with what are known as "1-tailed" probabilities. That is to say we have thus far looked to solve such questions as, "What are the probabilities of an event being less (more) than such-and-such standard units from the mean?" Suppose now we were to pose the question as, “What are the probabilities of an event being within so many standard units of the mean?" In other words, we wish to find out what the "e-tailed" probabilities are.

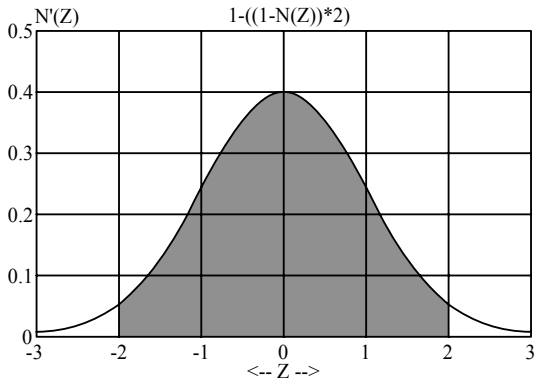

Figure 3-10 A two-tailed probability of an event being+or-2 sigma.

Consider Figure 3-10. This represents the probabilities of being within 2 standard units of the mean. Unlike Figure 3-8, this probability computation does not include the extreme left tail area, the area of less than -2 standard units. To calculate the probability of being within Z standard units of the mean, you must first calculate the I-tailed probability of the absolute value of Z with Equation (3.21). This will be your input to the next Equation, (3.22), which gives us the 2-tailed probabilities (i.e., the probabilities of being within ABS(Z) standard units of the mean):

(3.22) e-tailed probability = 1-((1-N(ABS(Z)))*2)

If we are considering what our probabilities of occurrence within 2 standard deviations are (Z = 2), then from Equation (3.21) we know that N(2) = .9772499478, and using this as input to Equation (3.22):

2-tailed probability = 1-((1-.9772499478)*2) = 1-(.02275005216* 2) = 1-.04550010432 = .9544998957

Thus we can state from this equation that the probability of an event in a Normally distributed random process falling within 2 standard units of the mean is about 95.45%.

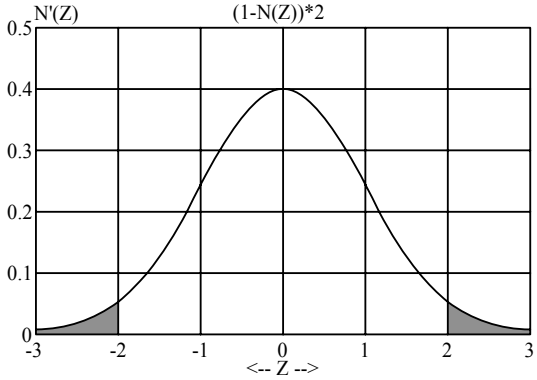

Figure 3-11 Two-tailed probability of an event being beyond 2 sigma.

Just as with Equation (3.21), we can eliminate the leading 1- in Equation (3.22) to obtain (1-N(ABS(Z)))*2, which represents the probabilities of an event falling outside of ABS(Z) standard units of the mean. This is depicted in Figure 3-11. For the example where Z = 2, we can state that the probabilities of an event in a Normally distributed random process falling outside of 2 standard units is:

2 tailed probability (outside) = (1-.9772499478)*2 = .02275005216*2 = .04550010432

Finally, we come to the case where we want to find what the probabilities (areas under the N'(Z) curve) are for two different values of Z.

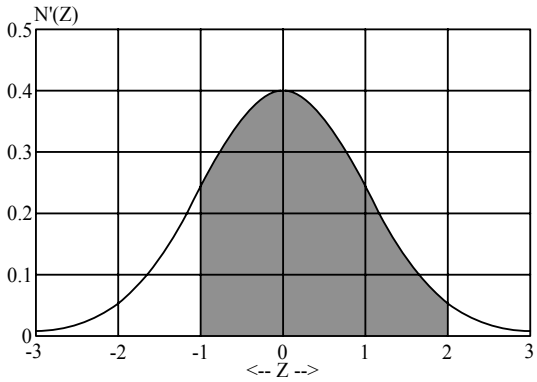

Figure 3-12 The area between -1 and +2 standard units.

Suppose we want to find the area under the N'(Z) curve between -1 standard unit and +2 standard units. There are a couple of ways to accomplish this. To begin with, we can compute the probability of not exceeding +2 standard units with Equation (3.21), and from this we can subtract the probability of not exceeding -1 standard units (see Figure 3-12). This would give us:

.9772499478-.1586552595 = .8185946883

Another way we could have performed this is to take the number 1, representing the entire area under the curve, and then subtract the sum of the probability of not exceeding -1 standard unit and the probability of exceeding 2 standard units:

= 1-(.022750052+.1586552595) = 1 .1814053117 = .8185946883

With the basic mathematical tools regarding the Normal Distribution thus far covered in this chapter, you can now use your powers of reasoning to figure any probabilities of occurrence for Normally distributed random variables.

FURTHER DERIVATIVES OF THE NORMAL

Sometimes you may want to know the second derivative of the N(Z) function. Since the N(Z) function gives us the area under the curve at Z, and the N'(Z) function gives us the height of the curve itself at Z, then the N"(Z) function gives us the ***instantaneous slope*** of the curve at a given Z:

(3.23) N"(Z) = -Z/2.506628274*EXP(-(Z^2/2)

where

EXP() = The exponential function.

To determine what the slope of the N'(Z) curve is at +2 standard units:

N"(Z) = -2/2.506628274*EXP(-(+2^2)/2)

= -212.506628274*EXP(-2)

= -2/2.506628274*.1353353

= -.1079968336

Therefore, we can state that the instantaneous rate of change in the N'(Z) function when Z = +2 is -.1079968336. This represents rise/run, so we can say that when Z = +2, the N'(Z) curve is rising -.1079968336 for ever) 1 unit run in Z. This is depicted in Figure 3-13.

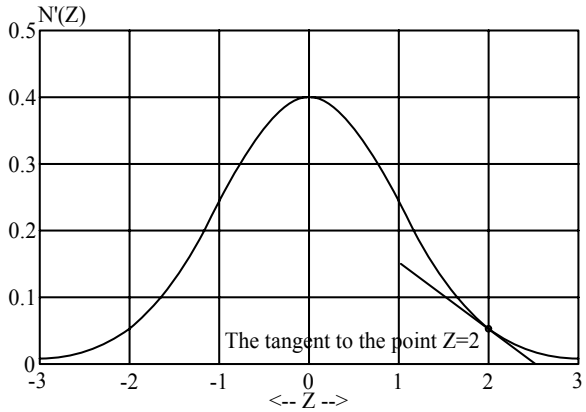

Figure 3-13 N"(Z) giving the slope of the line tangent tangent to N'(Z) at Z = +2.

For the reader's own reference, further derivatives are now given. These will not be needed throughout the remainder of this text, but arc provided for the sake of completeness:

(3.24) N'"(Z) = (Z^2-1)/2.506628274*EXP(-(Z^2)/2)

(3.25) N""(Z) = ((3*Z)-Z^3)/2.506628274*EXP(-(Z^2)/2)

(3.26) N"""(Z) = (Z^4-(6*Z^2)+3)/2.506628274*EXP(-(Z^2)/2)

As a final note regarding the Normal Distribution, you should be aware that the distribution is nowhere near as "peaked" as the graphic examples presented in this chapter imply. The real shape of the Normal Distribution is depicted in Figure 3-14.

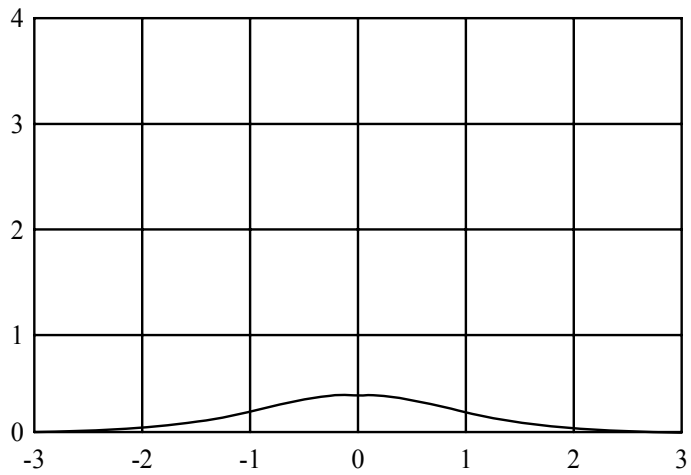

Figure 3-14 The real shape of the Normal Distribution.

Notice that here the scales of the two axes are the same, whereas in the other graphic examples they differ so as to exaggerate the shape of the distribution.

THE LOGNORMAL DISTRIBUTION

Many of the real-world applications in trading require a small but crucial modification to the Normal Distribution. This modification takes the Normal, and changes it to what is known as the Lognormal Distribution.

Consider that the price of any freely traded item has zero as a lower limit.2 Therefore, as the price of an item drops and approaches zero, it should in theory become progressively more difficult for the item to get lower. For example, consider the price of a hypothetical stock at $10 per share. If the stock were to drop $5, to $5 per share, a 50% loss, then according to the Normal Distribution it could just as easily drop from $5 to $0. However, under the Lognormal, a similar drop of 50% from a

price of $5 per share to $2.50 per share would be about as probable as a drop from $10 to $5 per share.

The Lognormal Distribution, Figure 3-15, works exactly like the Normal Distribution except that with the Lognormal we are dealing with percentage changes rather than absolute changes.

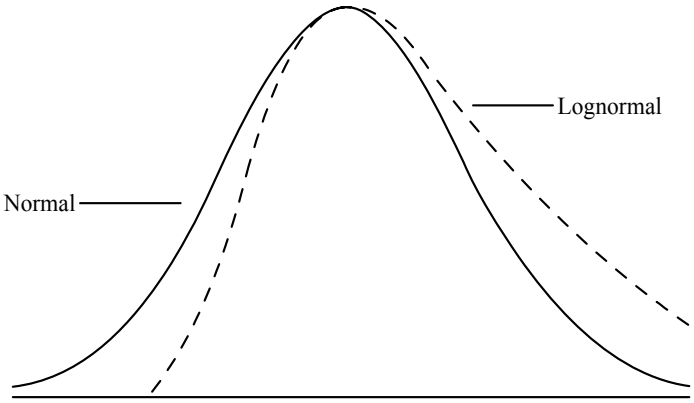

Figure 3-15 The Normal and Lognormal distributions.

Consider now the upside. According to the Lognormal, a move from $10 per share to $20 per share is about as likely as a move from $5 to $10 per share, as both moves represent a 100% gain.

That isn't to say that we won't be using the Normal Distribution. The purpose here is to introduce you to the Lognormal, show you its relationship to the Normal (the Lognormal uses percentage price changes rather than absolute price changes), and point out that it usually is used when talking about price moves, or anytime that the Normal would apply but be bounded on the low end at ***zero.***[2]

To use the Lognormal distribution, you simply convert the data you are working with to natural logarithms.[3] Now the converted data will be Normally distributed if the raw data was Lognormally distributed.

For instance, if we are discussing the distribution of price changes as

being Lognormal, we can use the Normal distribution on it. First, we must divide each closing price by the previous closing price. Suppose in this instance we are looking at the distribution of monthly closing prices (we could use any time period-hourly, daily, yearly, or whatever). Suppose we now see $10, $5, $10, $10, then $20 per share as our first five months closing prices. This would then equate to a loss of 50% going into the second month, a gain of 100% going into the third month, a gain of 0% going into the fourth month, and another gain of 100% into the fifth month. Respectively then, we have quotients of .5, 2, 1, and 2 for the monthly price changes of months 2 through 5. These are the same as HPRs from one month to the next in succession. We must now convert to natural logarithms in order to study their distribution under the math for the Normal Distribution. Thus, the natural log of .5 is -.6931473, of 2 it is .6931471, and of 1 it is 0. We are now able to apply the mathematics pertaining to the Normal distribution to this converted data.

[2] This idea that the lowest an item can trade for is zero is not always entirely true. For instance. during tile stock market crash of 1929 and the ensuing bear market, the shareholders of many failed banks were held liable to the depositors in those banks. Persons who owned stock in such banks not only lost their full investment, they also realized liability beyond the amount of their investment. The point here isn't to say that such an event can or cannot happen again. Rather, we cannot always say that zero is the absolute low end of what a freely traded item can be priced at, although it usually is.

[3] The distinction between common and natural logarithms is reiterated here. A common log is a log base 10, while a natural log is a log base e, where e = 2.7182818285. The common log of X is referred to mathematically as log(X) while the natural log is referred to as ln(X). The distinction gets blurred when we observe BASIC programming code, which often utilizes a function LOG(X) to return the natural log. This is diametrically opposed to mathematical convention. BASIC does not have a provision For common logs, but the natural log can be converted to the common log by multiplying the natural log by .4342917. likewise, we CM convert common logs to natural logs by multiplying the common log by 2.3026.

THE PARAMETRIC OPTIMAL F

Now that we have studied the mathematics of the Normal and Lognormal distributions, we will see how to determine an optimal f based on outcomes that are Normally distributed.

The Kelly formula is an example of a parametric optimal f in that the optimal f returned is a function of two parameters. In the Kelly formula the input parameters are the percentage of winning bets and the payoff ratio. However, the Kelly formula only gives you the optimal f when the possible outcomes have a Bernoulli distribution. In other words, the Kelly formula will only give the correct optimal f when there are only two possible outcomes. When the outcomes do not have a Bernoulli distribution, such as Normally distributed outcomes (which we arc about to study), the Kelly formula will not give you the correct optimal f.[4]

When they are applicable, parametric techniques are far more powerful than their empirical counterparts. Assume we have a situation that can be described completely by the Bernoulli distribution. We can derive our optimal f here by way of either the Kelly formula or the empirical technique detailed in ***Portfolio Management Formulas.*** Suppose in this instance we win 60% of the time. Say we are tossing a coin that is biased, that we know that in the long run 60% of the tosses will be heads. We are therefore going to bet that each toss will be heads, and the payoff is 1:1. The Kelly formula would tell us to bet a fraction of .2 of our stake on the next bet. Further suppose that of the last 20 tosses, 11 were heads and 9 were tails. If we were to use these last 20 trades as the input into the empirical techniques, the result would be that we should risk .1 of our stake on the next bet.

Which is correct, the .2 returned by the parametric technique (the Kelly formula in this Bernoulli distributed case) or the .1 returned empirically by the last 20 tosses? The correct answer is .2, the answer returned from the parametric technique. The reason is that the next toss has a 60% probability of being heads, not a 55% probability as the last 20 tosses would indicate. Although we are only discussing a 5% probability difference, 1 toss in 20, the effect on how much we should bet is dramatic. Generally, the parametric techniques are inherently more accurate in this regard than are their empirical counterparts (provided we know the distribution of the outcomes). This is the first advantage of the parametric to the empirical. This is also a critical proviso-that we must know what the distribution of outcomes is in the long run in order to use the parametric techniques. This is the biggest drawback to using the parametric techniques.

The second advantage is that the empirical technique ***requires*** a past history of outcomes whereas the parametric does not. Further, this past history needs to be rather extensive. In the example just cited, we can assume that if we had a history of 50 tosses we would have arrived at an empirical optimal f closer to .2. With a history of 1,000 tosses, it would be even closer according to the law of averages.

The fact that the empirical techniques require a rather lengthy stream of past data has almost restricted them to mechanical trading systems. Someone trading anything other than a mechanical trading system, be it by Elliott Wave or fundamentals, has almost been shut out from using the optimal f technique. With the parametric techniques this is no longer true. Someone who wishes to blindly follow some market guru, for instance, now has a way to employ the power of optimal f. Therein lies the third advantage of the parametric technique over the empirical-it can be used by any trader in any market.

There is a big assumption here, however, for someone not employing a mechanical trading system. The assumption is that the future distribution of profits and losses will resemble the distribution in the past (which is what we figure the optimal f on). This may be less likely than with a mechanical system.

This also sheds new light on the expected performance of any technique that is not purely mechanical. Even the best practitioners of such techniques, be it by fundamentals, Gann, Elliott Wave, and so on, are doomed to fail if they are too far beyond the peak of (to the right of) the f curve. If they are too far to the left of the peak, they are going to end

[4] We are speaking of the Kelly formulas here in a singular sense even though there are, in fact, two different Kelly formulas, one for when the payoff ration is 1:1, and the other for when the payoff is any ratio. In the examples of Kelly in this discussion we are assuming a payoff of 1:1, hence it doesn't matter which of the two Kelly formulas we are using.

up with geometrically lower profits than their expertise in their area should have made for them. Furthermore, practitioners of techniques that are not purely mechanical must realize that everything said about optimal f and the purely mechanical techniques applies. This should be considered when contemplating expected drawdowns of such techniques. Remember that the drawdowns Will be substantial, and this fact does not mean that the technique should be abandoned.

The fourth and perhaps the biggest advantage of the parametric over the empirical method of determining optimal f, is that the parametric method allows you to do 'What if' types of modeling. For example, suppose you are trading a market system that has been running very hot. You want to be prepared for when that market system stops performing so well, as you know it Inevitably will. With the parametric techniques, you can vary your input parameters to reflect this and thereby put yourself at what the optimal f will be when the market system cools down to the state that the parameters you Input reflect. The parametric techniques are therefore far more powerful than the empirical ones.

So why use the empirical techniques at all? The empirical techniques are more intuitively obvious than the parametric ones are. Hence, the empirical techniques are what one should learn first before moving on to the parametric. We have now covered the empirical techniques in detail and are therefore prepared to study the parametric techniques.

THE DISTRIBUTION OF TRADE P&L'S

Consider the following sequence of 232 trade profits and losses in points. It doesn't matter what the commodity is or what system generated this stream-it could be any system on any market.

Trade#	P&L	Trade#	P&L	Trade#	P&L	Trade#	P&L
1.	0.18	42.	-1.58	83.	-4.13	124.	-2.63
2.	-1.11	43.	-0.5	84.	-1.63	125.	-0.73
3.	0.42	44.	0.17	85.	-1.23	126.	-1.83
4.	-0.83	45.	0.17	86.	1.62	127.	0.32
5.	1.42	46.	-0.65	87.	0.27	128.	1.62
6.	0.42	47.	0.96	88.	1.97	130.	1.02
1.	-0.99	48.	-0.88	89.	-1.72	131.	-0.81
8.	0.87	49.	0.17	90.	1.47	132.	-0.74
9.	0.92	50.	-1.53	91.	-1.88	133.	1.09
10.	-0.4	51.	0.15	92.	1.72	134.	-1.13
11.	-1.48	52.	-0.93	93.	1.02	135.	0.52
12.	1.87	53.	0.42	94.	0.67	136.	0.18
13.	1.37	54.	2.77	95.	0.67	137.	0.18
14.	-1.48	55.	8.52	96.	-1.18	138.	1.47
15.	-0.21	56.	2.47	97.	3.22	139.	-1.07
16.	1.82	57.	-2.08	98.	-4.83	140.	-0.98
17.	0.15	58.	-1.88	99.	8.42	141.	1.07
18.	0.32	59.	-1.88	100.	-1.58	142.	-0.88
19.	-1.18	60.	1.67	101.	-1.88	143.	-0.51
20.	-0.43	61.	-1.88	102.	1.23	144.	0.57
21.	0.42	62.	3.72	103.	1.72	145.	2.07
22.	0.57	63.	2.87	104.	1.12	146.	0.55
23.	4.72	64.	2.17	105.	-0.97	147.	0.42
24.	12.42	65.	1.37	106.	-1.88	148.	1.42
25.	0.15	66.	1.62	107.	-1.88	149.	0.97
26.	0.15	67.	0.17	108.	1.27	150.	0.62
27.	-1.14	68.	0.62	109.	0.16	151.	0.32
28.	1.12	69.	0.92	110.	1.22	152.	0.67
29.	-1.88	70.	0.17	111.	-0.99	153.	0.77
30.	0.17	71.	1.52	112.	1.37	154.	0.67
31.	0.57	72.	-1.78	113.	0.18	155.	0.37
32.	0.47	73.	0.22	114.	0.18	156.	0.87
33.	-1.88	74.	0.92	115.	2.07	157.	1.32
34.	0.17	75.	0.32	116.	1.47	158.	0.16
35.	-1.93	76.	0.17	117.	4.87	159.	0.18
36.	0.92	77.	0.57	118.	-1.08	160.	0.52
37.	1.45	78.	0.17	119.	1.27	161.	-2.33
38.	0.17	79.	1.18	120.	0.62	162.	1.07
39.	1.87	80.	0.17	121.	-1.03	163.	1.32
40.	0.52	81.	0.72	122.	1.82	164.	1.42
41.	0.67	82.	-3.33	123.	0.42	165.	2.72
Trade#	P&L	Trade#	P&L	Trade#	P&L	Trade#	P&L
166.	1.37	183.	0.24	200.	-0.98	217.	-1.08
167.	-1.93	184.	0.57	201.	0.17	218.	0.25
168.	2.12	185.	0.35	202.	-0.96	219.	0.14
169.	0.62	186.	1.57	203.	0.35	220.	0.79
170.	0.57	187.	-1.73	204.	0.52	221.	-0.55
Trade#	P&L	Trade#	P&L	Trade#	P&L	Trade#	P&L
171.	0.42	188.	-0.83	205.	0.77	222.	0.32
172.	1.58	189.	-1.18	206.	1.10	223.	-1.30
173.	0.17	190.	-0.65	207.	-1.88	224.	0.37
174.	0.62	191.	-0.78	208.	0.35	225.	-0.51
175.	0.77	192.	-1.28	209.	0.92	226.	0.34
176.	0.37	193.	0.32	210.	1.55	227.	-1.28
177.	-1.33	194.	1.24	211.	1.17	228.	1.80
178.	-1.18	195.	2.05	212.	0.67	229.	2.12
179.	0.97	196.	0.75	213.	0.82	230.	0.77
180.	0.70	197.	0.17	214.	-0.98	231.	-1.33
181.	1.64	198.	0.67	215.	-0.85	232.	1.52
182.	0.57	199.	-0.56	216.	0.22		

If we wanted to determine an equalized parametric optimal f we would now convert these trade profits and losses to percentage gains and losses [based on Equations (2.10a) through (2.10c)]. Next, we would convert these percentage profits and losses by multiplying them by the current price of the underlying instrument. For example, P&L #1 is .18. Suppose that the entry price to this trade was 100.50. Thus, the percentage gain on this trade would be .18/100.50 = .001791044776. Now suppose that the current price of this underlying instrument is 112.00. Multiplying .001791044776 by 112.00 translates into an equalized P&L of .2005970149, If we were seeking to do this procedure on an equalized basis, we would perform this operation on all 232 trade profits and losses.

Whether or not we are going to perform our calculations on an equalized basis (in this chapter we will not operate on an equalized basis), we must now calculate the mean (arithmetic) and population standard deviation of these 232 individual trade profits and losses as .330129 and 1.743232 respectively (again, if we were doing things on an equalized basis, we would need to determine the mean and standard deviation on the equalized trade P&L's). With these two numbers we can use Equation (3.16) to translate each individual trade profit and loss into standard units.

(3.16) $Z = (X-U)/S$

where

U = The mean of the data.

S = The standard deviation of the data.

X = The observed data point.

Thus, to translate trade #1, a profit of .18, to standard units:

$Z = (.18-.330129)/1.743232 = -.150129/1.743232 = -.08612106708$

Likewise, the next three trades of -1.11, .42, and -.83 translate into -.8261258398, .05155423948, and -.6655046488 standard units respectively.

If we are using equalized data, we simply standardize by subtracting the mean of the data and dividing by the data's standard deviation.

Once we have converted all of our individual trade profits and losses over to standard units, we can bin the now standardized data. Recall that with binning there is a loss of information content about a particular distribution (in this case the distribution of the individual trades) but the character of the distribution remains unchanged.

Suppose we were to now take these 232 individual trades and place them into 10 bins. We are choosing arbitrarily here-we could have chosen 9 bins or 50 bins. In fact, one of the big arguments about binning data is that most frequently there is considerable arbitrariness as to how the bins should be chosen.

Whenever we bin something, we must decide on the ranges of the bins. We will therefore select a range of -2 to +2 sigmas, or standard deviations. This means we will have 10 equally spaced bins between -2 standard units to +2 standard units. Since there are 4 standard units in total between -2 and +2 standard units and we are dividing this space into 10 equal regions, we have 4/10 = -4 standard units as the size or "width" of each bin. Therefore, our first bin, the one "farthest to the left," will contain those trades that were within -2 to -1.6 standard units, the next one trades from -1.6 to -1.2, then -1.2 to -.8, and so on, until our final bin contains those trades that were 1.6 to 2 standard units. Those trades that are less than -2 standard units or greater than +2 standard units will not be binned in this exercise, and we will ignore them. If we so desired, we could have included them in the extreme bins, placing those data points less than -2 in the -2 to -1.6 bin, and likewise for those data points greater than 2. Of course, we could have chosen a wider range for binning, but since these trades are beyond the range of our

bins, we have chosen not to include them. In other words, we are eliminating from this exercise those trades with P&L's less than .330129-(1.743232*2) = -3.156335 or greater than .330129+(1.743232*2) = 3.816593.

What we have created now is a distribution of this system's trade P&L's. Our distribution contains 10 data points because we chose to work with 10

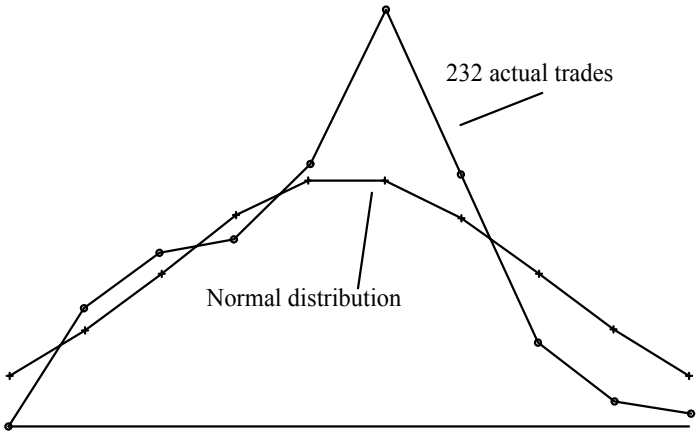

Figure 3-16 232 individual trades in 10 bins from -2 to +2 sigma versus the Normal Distribution.

bins. Each data point represents the number of trades that fell into that bin. Each trade could not fall into more than 1 bin, and if the trade was beyond 2 standard units either side of the mean (P&L's<-3.156335 or >3.816593), then it is not represented in this distribution. Figure 3-16 shows this distribution as we have just calculated it.

"Wait a minute," you say. "Shouldn't the distribution of a trading system's P&L's be skewed to the right because we are probably going to have a few large profits?"

This particular distribution of 232 trade P&L's happens to be from a system that very often takes small profits via a target. Many people have the mistaken impression that P&L distributions are going to be skewed to the right for all trading systems. This is not at all true, as Figure 3-16 attests. Different market systems will have different distributions, and you shouldn't expect them all to be the same.

Also in Figure 3-16, superimposed over the distribution we have just put together, is the Normal Distribution as it would look for 232 trade P&L's if they were Normally distributed. This was done so that you can compare, graphically, the trade P&L's as we have just calculated them to the Normal. The Normal Distribution here is calculated by first taking the boundaries of each bin. For the leftmost bin in our example this would be Z = -2 and Z = -1.6. Now we run these Z values through Equation (3.21) to convert these boundaries to a cumulative probability. In our example, this corresponds to .02275 for Z = -2 and .05479932 for Z = -1.6. Next, we take the absolute value of the difference between these two values, which gives us ABS(.02275-.05479932) = .03204932 for our example. Last, we multiply this answer by the number of data points, which in this case is 232 because there are 232 total trades (we still must use 232 even though some have been eliminated because they were beyond the range of our bins). Therefore, we can state that if the data were Normally distributed and placed into 10 bins of equal width between -2 and +2 sigmas, then the leftmost bin would contain .03204932*232 = 7.43544224 elements. If we were to calculate this for each of the 10 bins, we would calculate the Normal curve superimposed in Figure 3-16.

FINDING OPTIMAL F ON THE NORMAL DISTRIBUTION

Now we can construct a technique for finding the optimal f on Normally distributed data. Like the Kelly formula, this will be a ***parametric*** technique. However, this technique is far more powerful than the Kelly formula, because the Kelly formula allows for only two possible outcomes for an event whereas this technique allows for the full spectrum of the outcomes (provided that the outcomes are Normally distributed). The beauty of Normally distributed outcomes (aside from the fact that they so frequently occur, since they are the limit of many other distributions) is that they can be described by 2 parameters. The Kelly formulas will give you the optimal f for Bernoulli distributed outcomes by inputting the 2 parameters of the payoff ratio and the probability of winning. The technique about to be described likewise only needs two parameters as input, the average and the standard deviation of the outcomes, to return the optimal f.

Recall that the Normal Distribution is a continuous distribution, In order to use this technique we need to make this distribution be discrete. Further recall that the Normal Distribution is unbounded. That is, the distribution runs from minus infinity on the left to plus infinity on the right.

Therefore, the first two steps that we must take to find the optimal f on Normally distributed data is that we must determine (1) at how many sigmas from the mean of the distribution we truncate the distribution, and (2) into how many equally spaced data points will we divide the range between the two extremes determined in (1).

For instance, we know that 99.73% of all the data points will fall between plus and minus 3 sigmas of the mean, so we might decide to use 3 sigmas as our parameter for (1). In other words, we are deciding to consider the Normal Distribution only between minus 3 sigmas and plus 3 sigmas of the mean. In so doing, we will encompass 99.73% of all of the activity under the Normal Distribution. Generally we will want to use a value of 3 to 5 sigmas for this parameter.

Regarding step (2), the number of equally spaced data points, we will generally want to use a bare minimum of ten times the number of sigmas we are using in (1). If we select 3 sigmas for (1), then we should select at least 30 equally spaced data points for (2). This means that we are going to take the horizontal axis of the Normal Distribution, of which we are using the area from minus 3 sigmas to plus 3 sigmas from the mean, and divide that into 30 equally spaced points. Since there are 6 sigmas between minus 3 sigmas and plus 3 sigmas, and we want to divide this into 30 equally spaced points, we must divide 6 by 30-1, or 29. This gives us .2068965517. So, our first data point will be minus 3, and we will add .2068965517 to each previous point until we reach plus 3, at which point we will have created 30 equally spaced data points between minus 3 and plus 3. Therefore, our second data point will be -3+.2068965517 = -2.793103448, our third data point 2.79310344+.2068965517 = -2.586206896, and so on. In so doing, we will have determined the 30 horizontal input coordinates to this system.

The more data points you decide on, the better will be the resolution of the Normal curve. Using ten times the number of sigmas is a rough rule for determining the bare minimum number of data points you should use. Recall that the Normal distribution is a ***continuous*** distribution. However, we must make it ***discrete*** in order to find the optimal f on it. The greater the number of equally spaced data points we use, the closer our discrete model will be to the actual continuous distribution itself, with the limit of the number of equally spaced data points approaching infinity where the discrete model approaches the continuous exactly.

Why not use an extremely large number of data points? The more data points you use in the Normal curve, the more calculations will be required to find the optimal f on it. Even though you will usually be using a computer to solve for the optimal f, it will still be slower the more data points you use. Further, each data point added resolves the curve further to a lesser degree than the previous data point did. We will refer to these first two input parameters as the ***bounding parameters.***

Now, the third and fourth steps are to determine the arithmetic average trade and the population standard deviation for the market system we are working on. If you do not have a mechanical system, you can get these numbers from your brokerage statements or you can estimate them. That is the one of the real benefits of this technique-that you don't need to have a mechanical system, you don't even need brokerage statements or paper trading results to use this technique. The technique can be used by simply estimating these two inputs, the arithmetic mean average trade (in points or in dollars) and the population standard deviation of trades (in points or in dollars, so long as it's consistent with what you use for the arithmetic mean trade). Be forewarned, though, that your results will only be as accurate as your estimates.

If you are having difficulty estimating your population standard deviation, then simply try to estimate by how much, on average, a trade will differ from the average trade. By estimating the mean absolute deviation in this way, you can use Equation (3.18) to convert your estimated mean absolute deviation into an estimated standard deviation:

(3.18) S = M*1/.7978845609 = M*1.253314137

where

S = The standard deviation.

M = The mean absolute deviation.

We will refer to these two parameters, the arithmetic mean average trade and the standard deviation of the trades, as the ***actual*** input ***parameters.***

Now we want to take all of the equally spaced data points from step (2) and find their corresponding price values, based on the arithmetic mean and standard deviation. Recall that our equally spaced data points are expressed in terms of standard units. Now for each of these equally spaced data points we will find the corresponding price as:

(3.27) D = U+(S*E)

where

D = The price value corresponding to a standard unit value.

E = The standard unit value.

S = The population standard deviation.

U = The arithmetic mean.

Once we have determined all of the price values corresponding to each data point we have truly accomplished a great deal. We have now constructed the distribution that we expect the future data points to tend to.

However, this technique allows us to do a lot more than that. We can incorporate two more parameters that will allow us to perform "What if ' types of scenarios about the future. These parameters, which we will call' the ***"What if" parameters***, allow us to see the effect of a change in our average trade or a change in the dispersion (standard deviation) of our trades.

The first of these parameters, called ***shrink,*** affects the average trade. Shrink is simply a multiplier on our average trade. Recall that when we find the optimal f we also obtain other calculations, which are useful by-products of the optimal f. Such calculations include the geometric mean, TWR, and geometric average trade. Shrink is the factor by which we will multiply our average trade before we perform the optimal f technique on it. Hence, shrink lets us see what the optimal f would be if our average trade were affected by shrink as well as how the other by-product calculations would be affected.

For example, suppose you are trading a system that has been running very hot lately. You know from past experience that the system is likely to stop performing so well in the future. You would like to see what would happen if the average trade were cut in half. By using a shrink value of .5 (since shrink is a multiplier, the average trade times .5 equals the average trade cut in half) you can perform the optimal f technique to determine what your optimal f should be if the average trade were to be cut in half. Further, you can see how such changes affect your geometric average trade, and so on.

By using a shrink value of 2, you can also see the affect that a doubling of your average trade would have. In other words, the shrink parameter can also be used to increase (unshrink?) your average trade. What's more, it lets you take an unprofitable system (that is, a system with an average trade less than zero), and, by using a negative value for shrink, see what would happen if that system became profitable. For example, suppose you have a system that shows an average trade of -$100. If you use a shrink value of -.5, this will give you your optimal f for this distribution as if the average trade were $50, since -100*-.5 = 50. If we used a shrink factor of -2, we would obtain the distribution centered about an average trade of $200.

You must be careful in using these "What if" parameters, for they make it easy to mismanage performance. Mention was just made of how you can turn a system with a negative arithmetic average trade into a positive one. This can lead to problems if, for instance, in the future, you still have a negative expectation.

The other "What if" parameter is one called ***stretch.*** This is not, as its name would imply, the opposite of shrink. Rather, stretch is the multiplier to be used on the standard deviation. You can use this parameter to determine

the effect on f and its by-products by an increase or decrease in the dispersion. Also, unlike shrink, stretch must always be a positive number, whereas shrink can be positive or negative (so long as the average trade times shrink is positive). If you want to see what will happen if your standard deviation doubles, simply use a value of 2 for stretch. To see what Would happen if the dispersion quieted down, use a value less than 1.

You will notice in using this technique that lowering the stretch toward zero will tend to increase the by-product calculations, resulting in a more optimistic assessment of the future and vice versa. Shrink works in an opposite fashion, as lowering the shrink towards zero will result in more pessimistic assessments about the future and vice versa.

Once we have determined what values we want to use for stretch and shrink (and for the time being we will use values of 1 for both, which means to leave the actual parameters unaffected) we can amend Equation (3.27) to:

(3.28) D = (U*Shrink)+(S*E*Stretch)

where

D = The price value corresponding to a standard unit value.

E = The standard unit value.

S = The population standard deviation.

U = The arithmetic mean.

To summarize thus far, the first two steps are to determine the bounding parameters of the number of sigmas either side of the mean we are going to use, as well as how many equally spaced data points we are going to use within this range. The next two steps are the actual input parameters of the arithmetic average trade and population standard deviation. We can derive these parameters empirically by looking at the results of a given trading system or by using brokerage statements or paper trading results. We can also derive these figures by estimation, but remember that the results obtained will only be as accurate as your estimates. The fifth and sixth steps are to determine the factors to use for stretch and shrink if you are going to perform a "What if type of scenario. If you are not, simply use values of 1 for both stretch and shrink. Once you have completed these six steps, you can now use Equation (3.28) to perform the seventh step. The seventh step is to convert the equally spaced data points from standard values to an actual amount of either points or dollars (depending on whether you used points or dollars as input for your arithmetic average trade and population standard deviation).

Now the eighth step is to find the associated probability with each of the equally spaced data points. This probability is determined by using Equation (3.21):

(3.21) N(Z) = 1-N'(Z)*((1.330274429*Y^5)-
(1.821255978*Y^4)+(1.781477937*Y^3)-
(.356563782*Y^2)+(.31938153*Y))

If Z<0 then N(Z) = 1-N(Z)

where

Y = 1/(1+.2316419*ABS(Z))

ABS() = The absolute value function.

N'(Z) = .398942*EXP(-(Z^2/2))

EXP() = The exponential function.

However, we will use Equation (3.21) without its 1-as the first term in the equation and without the -Z provision (i.e., without the "If Z<0 then N(Z)-1-N(Z)"), since we want to know what the probabilities are for an event equaling or exceeding a prescribed amount of standard units.

So we go along through each of our equally spaced data points. Each point has a standard value, which we will use as the Z parameter in Equation (3.21), and a dollar or point amount. Now there will be another variable corresponding to each equally spaced data point-the associated probability.

THE MECHANICS OF THE PROCEDURE

The procedure will now be demonstrated on the trading example introduced earlier in this chapter. Since our 232 trades are currently in points, we should convert them to their dollar representations. However, since the market is a not specified, we will assign an arbitrary value of $1,000 per point. Thus, the average trade of .330129 now becomes .330129*$1000, or an average trade of $330.13. Likewise the population standard deviation of 1.743232 is also multiplied by $1,000 per point to give $1,743.23.

Now we construct the matrix. First, we must determine the range, in sigmas from the mean, that we want our calculations to encompass. For

our example we will choose 3 sigmas, so our range will go from minus 3 sigmas to plus 3 sigmas. Note that you should use the same amount to the left of the mean that you use to the right of the mean. That is, if you go 3 sigmas to the left (minus 3 sigmas) then you should not go only ***2 or 4*** sigmas to the right, but rather you should go 3 sigmas to the right as well (i.e., plus 3 sigmas from the mean).

Next we must determine how many equally spaced data points to divide this range into. Choosing 61 as our value gives a data point at every tenth of a standard unit-simple. Thus we can determine our column of standard values.

Now we must determine the arithmetic mean that we are going to use as input. We determine this empirically from the 232 trades as $330.13. Further, we must determine the population standard deviation, which we also determine empirically from the 232 trades as $1,743.23.

Now to determine the column of associated P&L's. That is, we must determine a P&L amount for each standard value. Before we can determine our associated P&L column, we must decide on values for stretch and shrink. Since we are not going to perform any "What if types of scenarios at this time, we will choose a value of 1 for both stretch and shrink.

Arithmetic mean = 330.13

Population Standard Deviation = 1743.23

Stretch = 1

Shrink = 1

Using Equation (3.28) we can calculate our associated P&L column. We do this by taking each standard value and using it as E in Equation (3.28) to get the column of associated P&L's:

(3.29) D = (U*Shrink)+(S*E*Stretch)

where

D = The price value corresponding to a standard unit value.

E = The standard unit value.

S = The population standard deviation.

U = The arithmetic mean.

For the -3 standard value, the associated P&L is:

D = (U*Shrink)+(S*E*Stretch)

= (330.129*1)+(1743.232*(-3)*1)

= 330.129+(-5229.696)

= 330.129-5229.696

= 4899.567

Thus, our associated P&L column at a standard value of -3 equals 4899.567. We now want to construct the associated P&L for the next standard value, which is -2.9, so we simply perform the same Equation, (3.29), again-only this time we use a value of -2.9 for E.

Now to determine the associated probability column. This is calculated using the standard value column as the Z input to Equation (3.21) without the preceding 1-and without the-Z provision (i.e, the "If Z < 0 then N(Z) = 1-N(Z)"). For the standard value of -3 (Z = -3), this is:

N(Z) = N'(Z)*((1.330274429*Y^5)-(1.821255978*Y^4)+(1.781477937*Y^3)-(.356563782*Y^2+(.31938153*Y))

If Z<0 then N(Z) = 1-N(Z)

where

Y = 1/(1+.2316419*ABS(Z))

ABS() = The absolute value function.

N'(Z) = .398942*EXP(-(Z^2/2))

EXP() = The exponential function.

Thus:

N'(3) = .398942*EXP(-((-3)^2/2)) = .398942*EXP(-(9/2)) = .398942*EXP(-4.5) = .398942*.011109 = .004431846678

Y = 1/(1+2316419*ABS(-3)) = 1/(1+2316419*3) = 1/(1+6949257) = 1/1.6949257 = .5899963639

N(-3) = .004431846678*((1.330274429*.5899963639^5)-(1.821255978*.5899963639^4)+(1.781477937*.5899963639^3)-(.356563782*.5899963639^2)+(.31938153*.5899963639))

= .004431846678*((1.330274429*.07149022693)-(1.821255978*.1211706)+(1.781477937*.2053752)-(.356563782*.3480957094)+(.31938153*.5899963639))

= .004431846678*(.09510162081-.2206826796+.3658713876-.1241183226+.1884339414)

= .004431846678*.3046059476 = .001349966857

Note that even though Z is negative (Z = -3), we do not adjust N(Z) here by making N(Z) = 1-N(Z). Since we are not using the-Z provision, we just let the answer be.

Now for each value in the standard value column there will be a corresponding entry in the associated P&L column and in the associated probability column. This is shown in the following table. Once you have these three columns established you are ready to begin the search for the optimal f and its by-products.

STD VALUE	ASSOCIATED P&L	ASSOCIATED PROBABILITY	ASSOCIATED HPR AT f=.01
-3.0	($4,899.57)	0.001350	0.9999864325
-2.9	($4,725.24)	0.001866	0.9999819179
-2.8	($4,550.92)	0.002555	0.9999761557
-2.7	($4,376.60)	0.003467	0.9999688918
-2.6	($4,202.27)	0.004661	0.9999598499
-2.5	($4,027.95)	0.006210	0.9999487404
-2.4	($3,853.63)	0.008198	0.9999352717
-2.3	($3,679.30)	0.010724	0.9999191675
-2.2	($3,504.98)	0.013903	0.9999001875
-2.1	($3,330.66)	0.017864	0.9998781535
-2.0	($3,156.33)	0.022750	0.9998529794
-1.9	($2,982.01)	0.028716	0.9998247051
-1.8	($2,807.69)	0.035930	0.9997935316
-1.7	($2,633.37)	0.044565	0.9997598578
-1.6	($2,459.04)	0.054799	0.9997243139
-1.5	($2,284.72)	0.066807	0.9996877915
-1.4	($2,110.40)	0.080757	0.9996514657
-1.3	($1,936.07)	0.096800	0.9996168071
-1.2	($1,761.75)	0.115070	0.9995855817
-1.1	($1,587.43)	0.135666	0.999559835
-1.0	($1,413.10)	0.158655	0.9995418607
-0.9	($1,238.78)	0.184060	0.9995341524
-6.8	($1,064.46)	0.211855	0.9995393392
-0.7	($890.13)	0.241963	0.999560108
-0.6	($715.81)	0.274253	0.9995991135
-0.5	($541.49)	0.308537	0.9996588827
-0.4	($367.16)	0.344578	09997417168
-0.3	($192.84)	0.382088	0.9998495968
-0.2	($18.52)	0.420740	0.9999840984
-0.1	$155.81	0.460172	1.0001463216
0.0	$330.13	0.500000	1.0003368389
0.1	$504.45	0.460172	1.0004736542
0.2	$678.78	0.420740	1.00058265
0.3	$853.10	0.382088	1.0006649234
0.4	$1,027.42	0.344578	1.0007220715
0.5	$1,201.75	0.308537	1.0007561259
0.6	$1,376.07	0.274253	1.0007694689
0.7	$1,550.39	0.241963	1.0007647383
0.8	$1,724.71	0.211855	1.0007447264
0.9	$1,899.04	0.184060	1.0007122776
1.0	$2,073.36	0.158655	1.0006701921
1.1	$2,247.68	0.135666	1.0006211392
1.2	$2,422.01	0.115070	.0005675842
1.3	$2,596.33	0.096800	.0005117319
1.4	$2,770.65	0.080757	.0004554875
1.5	$2,944.98	0.066807	1.0004004351
1.6	$3,119.30	0.054799	1.0003478328
1.7	$3,293.62	0.044565	.0002986228
1.8	$3,467.95	0.035930	.0002534528
1.9	$3,642.27	0.028716	1.0002127072
2.0	$3,816.59	0.022750	1.0001765438
2.1	$3,990.92	0.017864	.000144934
2.2	$4,165.24	0.013903	.0001177033
2.3	$4,339.56	0.010724	.0000945697
2.4	$4,513.89	0.008198	.0000751794
2.5	$4,688.21	0.006210	1.0000591373
2.6	$4,862.53	0.004661	1.0000460328
2.7	$5,036.86	0.003467	1.0000354603
2.8	$5,211.18	0.002555	1.0000270338
2.9	$5,385.50	0.001866	1.0000203976

STD VALUE	ASSOCIATED P&L	ASSOCIATED PROBABILITY	ASSOCIATED HPR AT f=.01
3.0	$5,559.83	0.001350	1.0000152327

By-products atf-.01:

TWR = 1.0053555695

Sum of the probabilities = 7.9791232176

Geomean = 1.0006696309 GAT = $328.09

Here is how you go about finding the optimal f. First, you must determine the search method for f. You can simply loop from 0 to 1 by a predetermined amount (e.g., .01), use an iterative technique, or use the technique of parabolic interpolation described in ***Portfolio Management formulas***. What you seek to find is what value for f (between 0 and 1) will result in the highest geometric mean.

Once you have decided upon a search technique, you must determine what the worst-case associated P&L is in your table. In our example it is the P&L corresponding to -3 standard units, 4899.57. You will need to use this particular value repeatedly throughout the calculations.

In order to find the geometric mean for a given f value, for each value of f that you are going to process in your search for the optimal, you must convert each associated P&L and probability to an HPR. Equation (3.30) shows the calculation for the HPR:

(3.30) HPR = (1+(L/(W/(-f))))^P

where

L = The associated P&L.

W = The worst-case associated P&L in the table (This will always be a negative value).

f = The tested value for f.

P = The associated probability.

Working through an example now where we use the value of .01 for the tested value for f, we will find the associated HPR at the standard value of -3. Here, our worst-case associated P&L is 4899.57, as is our associated P&L. Therefore, our HPR here is:

HPR = (1+(-4899.57/-4899.57/(-.01))))^.001349966857

= (1+(-4899.57/489957))^.001349966857

= (1+(-.01))^.001349966857

= .99^.001349966857

= .9999864325

Now we move down to our next standard value, of -2.9, where we have an associated P&L of -2866.72 and an associated probability of 0.001865. Our associated HPR here will be:

HPR = (-4725.24/(-4899.57/(-.01))))^.001866

= (1+(-4725.24/489957))^001866

= (1+(-4725.24/489957))^.001866

= (1+(-.009644193266))^.001866

= .990355807^.001866

= .9999819

Once we have calculated an associated HPR for each standard value for a given test value off (.01 in our example table), you are ready to calculate the TWR. The TWR is simply the product of all of the HPRs for a given f value multiplied together:

(3.31) TRW = (∏[i = 1,N]HPR_i)

where

N = The total number of equally spaced data points.

HPR_i = The HPR corresponding to the i'th data point, given by Equation (3.30).

So for our test value off = .01, the TWR will be:

TWR = .9999864325*.9999819179*...*1.0000152327 = 1.0053555695

We can readily convert a TWR into a geometric mean by taking the TWR to the power of 1 divided by the sum of all of the associated probabilities.

(3.32) G = TRW^(1/∑[i = 1,N] P_i)

where

N = The number of equally spaced data points.

P_i = The associated probability of the ith data point.

Note that if we sum the column that lists the 61 associated probabilities it equals 7.979105. Therefore, our geometric mean at f = .01 is:

G = 1.0053555695^(1/7.979105) = 1.0053555695^.1253273393 = 1.00066963

We can also calculate the geometric average trade (GAT). This is the amount you would have made, on average per contract per trade, if you were trading this distribution of outcomes at a specified f value.

(3.33) GAT = (G(f)-1)*(w/(-f))

where

G(f) = The geometric mean for a given f value.

f = The given f value.

W = The worst-case associated P&L.

In the case of our example, the f value is .01:

GAT = (1.00066963-1)*(-4899.57/(-.01))

= .00066963*489957

= 328.09

Therefore, we would expect to make, on average per contract per trade, $328.09.

Now we go to our next value for f that must be tested according to our chosen search procedure for the optimal f In the case of our example we are looping from 0 to 1 by .01 for f, so our next test value for f is .02. We will do the same thing again. We will calculate a new associated HPRs column, and calculate our TWR and geometric mean. The f value that results in the highest geometric mean is that value for f which is the optimal based on the input parameters we have used.

In our example, if we were to continue with our search for the optimal f, we would find the optimal at f = .744 (I am using a step increment of .001 in my search for the optimal f here.) This results in a geometric mean of 1.0265. Therefore, the corresponding geometric average trade is $174.45.

It is important to note that the TWR itself doesn't have any real meaning as a by-product. Rather, when we are calculating our geometric mean parametrically, as we are here, the TWR is simply an interim step in obtaining that geometric mean. Now, we can figure what our TWR would be after X trades by taking the geometric mean to the power of X. Therefore, if we want to calculate our TWR for 232 trades at a geometric mean of 1.0265, we would raise 1.0265 to the power of 232, obtaining 431.79. So we can state that trading at an optimal f of .744, we would expect to make 43,079% ((431.79-1)*100) on our stake after 232 trades.

Another by-product we will calculate is our threshold to geometric Equation (2.02):

Threshold to geometric = 330.13/174.45*-4899.57/-.744 = 12,462.32

Notice that the arithmetic average trade of $330.13 is not something that we have calculated with this technique, rather it is a given as it is one of the input parameters.

We can now convert our optimal f into how many contracts to trade by the equations:

(3.34) K = E/Q

where

K = The number of contracts to trade.

E = The current account equity.

(3.35) Q = W/(-f)

where

W = The worst-case associated P&L.

f = The optimal f value.

Note that this variable, Q, represents a number that you can divide your account equity by as your equity changes on a day-by-day basis to know how many contracts to trade.

Returning now to our example:

Q = -4,899.57/-.744 = $6,585.44

Therefore, we will trade 1 contract for every $6,585.44 in account equity. For a $25,000 account this means we would trade:

K = 25000/6585.44 = 3.796253553

Since we cannot trade in fractional contracts, we must round this figure of 3.796253553 down to the nearest integer. We would therefore trade 3 contracts for a $25,000 account. The reason we always round down rather than up is that the price extracted for being slightly below optimal is less than the price for being slightly beyond it.

Notice how sensitive the optimal number of contracts to trade is to the worst loss. This worst loss is solely a function of how many sigmas you have decided to go to the left of the mean. This bounding parameter, the range of sigmas, is very important in this calculation. We have chosen three sigmas in our calculation. This means that we are, in effect, budgeted for a three-Sigma loss. However, a loss greater than three sigmas can really hurt us, depending on how far beyond three sigmas it is. Therefore, you should be very careful what value you choose for this range bounding parameter. You'll have a lot riding on it.

Notice that for the sake of simplicity in illustration, we have not deducted commissions and slippage from these figures. If you wanted to incorporate commissions and slippage, you should deduct X dollars in commissions and slippage from each of the 232 trades at the outset of this exercise. You would calculate your arithmetic average trade and population standard deviation from this set of 232 adjusted trades, and then perform the exercise exactly as described.

We could now go back and perform a "What if type of scenario here. Suppose we want to see what will happen if the system begins to perform at only half the profitability it is now (shrink = .5). Further, assume that the market that the system we are looking at is in gets very volatile, and that as a consequence the dispersion among the trades increases by 60% (stretch = 1.6). By pumping these parameters through this system we can see what the optimal will be so that we can make adjustments to our trading before these changes become history. In so doing we find that the optimal f now becomes ,262, or to trade 1 contract for every $31,305.92 in account equity (since the worst-case associated P&L is strongly affected by changes in stretch and shrink). This is quite a change. This means that if these changes in the market system start to materialize, we are going to have to do some altering in our money management regarding that system. The geometric mean will drop to 1.0027, the geometric average trade will be cut to $83.02, and the TWR over 232 trades will be 1.869. This is not even close to what it presently would be. All of this is predicated upon a 50% decrease in average trade and a 60% increase in standard deviation. This quite possibly could happen. It is also quite possible that the future could work out ***more*** favorably than the past. We can test this out, too. Suppose we want to see what will happen if our average profit increases by only 10%. We can check this by inputting a shrink value of 1.1. These “What if” parameters, stretch and shrink, really give us a great deal of power in our money management.

The closer your distribution of trade P&L's is to Normal to begin with, the better the technique will work for you. The problem with almost any money management technique is that there is a certain amount of "slop" involved. Here, we can define slop as the difference between the Normal Distribution and the distribution we are actually using. The difference between the two is slop, and the more slop there is, the less effective the technique becomes.

To illustrate, recall that using this method we have determined that to trade 1 contract for every $6,585.44 in account equity is optimal. However, if we were to go over these trades and find our optimal f empirically, we would find that the optimal is to trade 1 contract for every $7,918.04 in account equity. As you can see, using the Normal Distribution technique here would have us slightly to the right of the f curve, trading slightly more contracts than the empirical would suggest.

However, as we shall see, there is a lot to be said for expecting the future distribution of prices to be Normally distributed. When someone buys or sells an option, the assumption that the future distribution of the log of price changes in the underlying instrument will be Normal is built into the price of the option. Along this same line of reasoning, someone who is entering a trade in a market and is not using a mechanical system can be said to be looking at the same possible future distribution.

The technique detailed in this chapter was shown using data that was not equalized. We can also use this very same technique on equalized data by incorporating the following changes:

Before the data is standardized, it should be equalized by first converting all of the trade profits and losses to percentage profits and losses per Equations (2.10a) through (2.10c). Then these percentage profits and losses should be translated into percentages of the current price by simply multiplying them by the current price.

1. When you go to standardize this data, standardize the now equalized data by using the mean and standard deviation of the equalized data.

2. The rest of the procedure is the same as written in this chapter in terms of determining the optimal f, geometric mean, and TWR. The geometric average trade, arithmetic average trade, and threshold to the geometric are only valid for the current price of the underlying instrument. When the price of the underlying instrument changes, the procedure must be done again, going back to step 1 and multiplying the percentage profits and losses by the new underlying price. When you go to redo the procedure with a different underlying price, you will obtain the same optimal f, geometric mean, and TWR. However, your arithmetic average trade, geometric average trade, and threshold to the geometric will differ, depending on the new price of the underlying instrument.

3. The number of contracts to trade as given in Equation (3.34) must be changed. The worst-case associated P&L, the W variable in Equation (3.34) [as subequation (3.35)] will be different as a result of the changes caused in the equalized data by a different current price.

In this chapter we have learned how to find the optimal f on a probability distribution. We have used the Normal Distribution because it shows up so frequently in many naturally occurring processes and because it is easier to work with than many other distributions, since its cumulative density function, Equation (3.21), exists.[5] ***Yet the Normal is often regarded as a poor model for the distribution of trade profits and losses. What then is a good model for our purposes? In the next chapter we will address this question and build upon the techniques we have learned in this chapter to work for any type of probability distribution, whether its cumulative density function is known or not.***

[5] Again, the cumulative density function to the Normal Distribution does not really exist, but rather is very closely approximated by Equation (3.21). However, the cumulative density of the Normal can at least be approximated by an equation, a luxury which not all distributions possess.

Chapter 4 - Parametric Techniques on Other Distributions

We have seen in the previous chapter how to find the optimal f and its by-products on the Normal Distribution. The same technique can be applied to any other distribution where the cumulative density function is known. Many of these more common distributions and their cumulative density functions are covered in Appendix B. Unfortunately, most distributions of trade P&L's do not fit neatly into the Normal or other common distribution functions. In this chapter we first treat this problem of the undefined nature of the distribution of trade P&L's and later look at the technique of scenario planning, a natural outgrowth of the notion of optimal f. This technique has many broad applications. This then leads into finding the optimal f on a binned distribution, which leads us to the next chapter regarding both options and multiple simultaneous positions.

Before we attempt to model the real distribution of trade P&L's, we must have a method for comparing two distributions.

THE KOLMOGOROV-SMIRNOV (K-S) TEST

The chi-square test is no doubt the most popular of all methods of comparing two distributions. Since many market-oriented applications other than the ones we perform in this chapter often use the chi-square test, it is discussed in Appendix A. However, the best test for our purposes may well be the K-S test. This very efficient test is applicable to ***unbinned*** distributions that are a function of a ***single*** independent variable (profit per trade in our case).

All cumulative density functions have a minimum value of 0 and a maximum value of 1. What goes on in between differentiates them. The K-S test measures a very simple variable, D, which is defined as the maximum absolute value of the difference between two distributions' cumulative density functions.

To perform the K-S test is relatively simple. N objects (trades in our case) are standardized (by subtracting the mean and dividing by the standard deviation) and sorted in ascending order. As we go through these sorted and standardized trades, the cumulative probability is however many trades we've gone through divided by N. When we get to our first trade in the sorted sequence, the trade with the lowest standard value, the cumulative density function (CDF) is equal to 1/N. With each standard value that we pass along the way up to our highest standard value, 1 is added to the numerator until, at the end of the sequence, our CDF is equal to N/N or 1.

For each standard value we can compute the theoretical distribution that we wish to compare to. Thus, we can compare our actual cumulative density to any theoretical cumulative density. The variable D, the K-S statistic, is equal to the greatest distance between any standard values of our actual cumulative density and the value of the theoretical distribution's CDF at that standard value. Whichever standard value results in the greatest difference is assigned to the variable D.

When comparing our actual CDF at a given standard value to the theoretical CDF at that standard value, we must also compare the previous standard value's actual CDF to the current standard value's actual CDF. The reason is that the actual CDF breaks upward instantaneously at the data points, and, if the actual is below the theoretical, the difference between the lines is greater the instant before the actual jumps up.

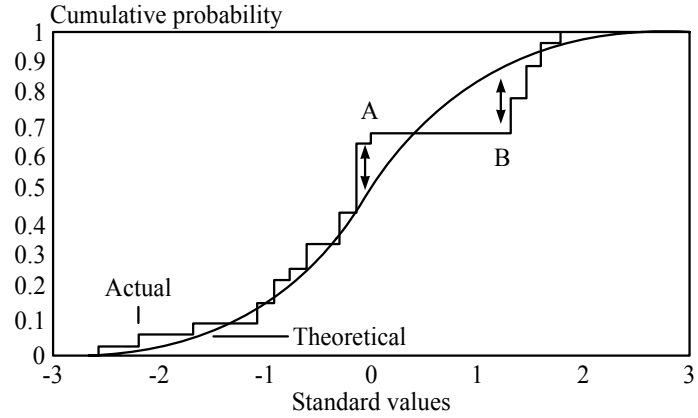

Figure 4-1 The K-S test.

To see this, look at Figure 4-1. Notice that at point A the actual line is above the theoretical. Therefore, we want to compare the current actual CDF value to the current theoretical value to find the greatest difference. Yet at point B, the actual line is below the theoretical. Therefore, we want to compare the previous actual value to the current theoretical value. The rationale is that we are measuring the greatest distance between the two lines. Since we are measuring at the instant the actual jumps up, we can consider using the previous value for the actual as the current value for the actual the instant before it jumps.

In summary, then, for each standard value, we want to take the absolute value of the difference between the current actual CDF value and the current theoretical CDF value. We also want to take the absolute value of the difference between the previous actual CDF value and the current theoretical CDF value. By doing this for all standard values, all points where the actual CDF jumps up by 1/N, and taking the greatest difference, we will have determined the variable D.

The lower the value of D, the more the two distributions are alike. We can readily convert the D value to a significance level by the following formula:

(4.01) SIG = ∑[j = 1, ∞] (j%2)*4-2*EXP(-2*j^2*(N^(1/2)*D)^2)

where

SIG = The significance level for a given D and N.

D = The K-S statistic.

N = The number of trades that the K-S statistic is determined over.

% = The modulus operator, the remainder from division. As it is used here, J % 2 yields the remainder when J is divided by 2.

EXP() = The exponential function.

There is no need to keep summing the values until J gets to infinity. The equation converges (in short order, usually) to a value. Once the convergence is obtained to a close enough user tolerance, there is no need to continue summing values.

To illustrate Equation (4.01) by example. Suppose we had 100 trades that yielded a K-S statistic of .04:

J_1 = (1%2)*4-2*EXP(-2*1^2*(100^(1/2)*.04)^2)

= 1*4-2*EXP(-2*1^2*(10*.04)^2)

= 2*EXP(-2*1^2*.4^2)

=2*EXP(-2*1*.16)

= 2*EXP(-.32)

= 2*.726149

= 1.452298

So our first value is 1.452298. Now to this we will add the next pass through the equation, and as such we must increment J by 1 so that J now equals J2:

J_2 = (2%2)*4-2*EXP(-2*2^2*(100^(1/2)*.04)^2)

= 0*4-2*EXP(-2*2^2*(10*.04)^2)

= -2*EXP(-2*2^2*.4^2)

= -2*EXP(-2*4*.16)

= -2*EXP(-1.28)

= -2*.2780373

= -.5560746

Adding this value of -.5560746 back into our running sum of 1.452298 gives us a new running sum of .8962234. We again increment J by 1, so it equals J3, and perform the equation. We take the resulting sum and add it to our running total of .8962234. We keep on doing this until we converge to a value within a close enough tolerance. For our example, this point of convergence will be right around .997, depending upon how many decimal places we want to be accurate to. This answer means that for 100 trades where the greatest value between the two distributions was .04, we can be 99.7% certain that the actual distribution was generated by the theoretical distribution function. In other words, we can be 99.7% certain that the theoretical distribution function represents the actual distribution. Incidentally, this is a very good significance level.

CREATING OUR OWN CHARACTERISTIC DISTRIBUTION FUNCTION

We have determined that the Normal Probability Distribution is generally not a very good model of the distribution of trade profits and losses. Further, none of the more common probability distributions are either. Therefore, we must create a function to model the distribution of our trade profits and losses ourselves.

The distribution of the logs of price changes is generally assumed to be of the stable Paretian variety (for a discussion of the stable Paretian distribution, refer to Appendix B). The distribution of trade P&L's can be regarded as ***a transformation*** of the distribution of prices. This transformation occurs as a result of trading techniques such as traders trying to cut their losses and let their profits run. Hence, the distribution of trade P&L's can also be regarded as of the stable Paretian variety. What we are about to study, however, is ***not*** the stable Paretian.

The stable Paretian, like all other distributional functions, models a specific probability phenomenon. The stable Paretian models the distribution of sums of independent, identically distributed random variables. The distributional function we arc about to study does not model a specific probability phenomenon. Rather, it models other unimodal distributional functions. As such, it can replicate the shape, and therefore the probability densities, of the stable Paretian as well as any other unimodal distribution.

Now we will create this function. To begin with, consider the following equation:

(4.02) Y = 1/(X^2+1)

This equation graphs as a general bell-shaped curve, symmetric about the X axis, as is shown in Figure 4-2.

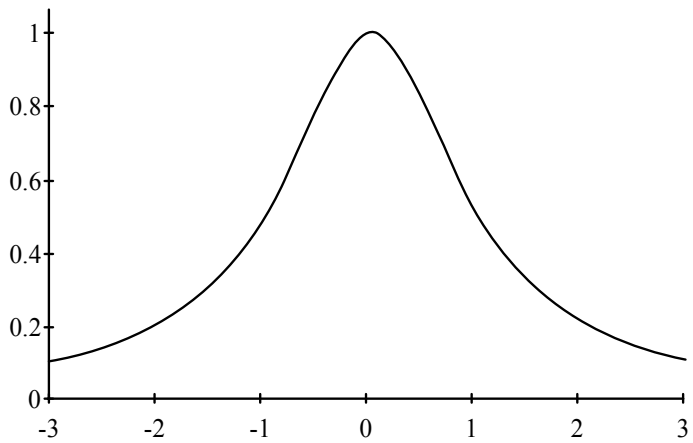

Figure 4-2 LOC = 0 SCALE = 1 SKEW = 0 KURT = 2.

We will thus build from this general equation. The variable X can be thought of as the number of standard units we are either side of the mean, or Y axis. We can affect the first moment of this "distribution," the location, by adding a value to represent a change in location to X. Thus, the equation becomes:

(4.03) Y = 1/((X-LOC)^2+1)

where

Y = The ordinate of the characteristic function.

X = The standard value amount.

LOC = A variable representing the location, the first moment of the distribution.

Thus, if we wanted to alter location by moving it to the left by 1/2 of a standard unit, we would set LOC to -.5. This would give us the graph depicted in Figure 4-3.

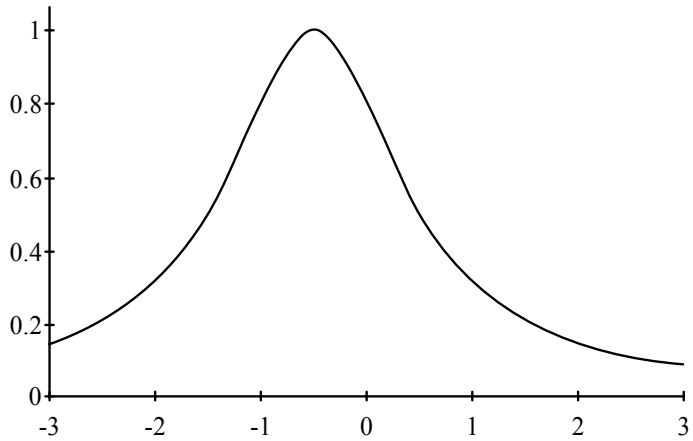

Figure 4-3 LOC =-.5 SCALE = 1 SKEW = 0 KURT = 2

Likewise, if we wanted to shift location to the right, we would use a positive value for the LOC variable. Keeping LOC at zero will result in no shift in location, as depicted in Figure 4-2.

The exponent in the denominator affects kurtosis. Thus far, we have seen the distribution with the kurtosis set to a value of 2, but we can control the kurtosis of the distribution by changing the value of the exponent. This alters our characteristic function, which now appears as:

(4.04) Y = 1/((X-LOC)^KURT+1)

where

Y = The ordinate of the characteristic function.

X = The standard value amount.

LOC = A variable representing the location, the first moment of the distribution.

KURT = A variable representing kurtosis, the fourth moment of the distribution.

Figures 4-4 and 4-5 demonstrate the effect of the kurtosis variable on our characteristic function. Note that the higher the exponent the more flat topped and thin-tailed the distribution (platykurtic), and the lower the exponent, the more pointed the peak and thicker the tails of the distribution (leptokurtic).

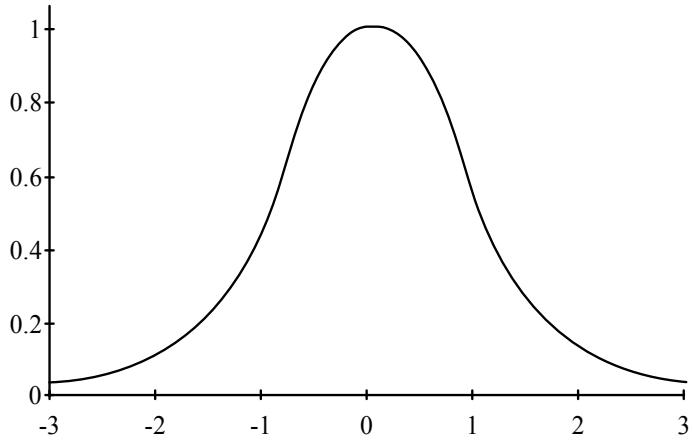

Figure 4-4 LOC = 0 SCALE = 1 SKEW =0 KURT = 3.

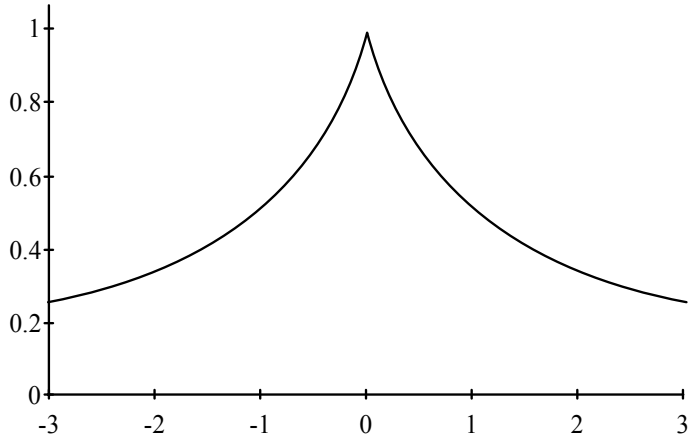

Figure 4-5 LOC = 0 SCALE = 1 SKEW = 0 KURT = 1

So that we do not run into problems with irrational numbers when KURT<1, we will use the absolute value of the coefficient in the denominator. This does not affect the shape of the curve. Thus, we can rewrite Equation (4.04) as:

(4.04) Y = 1/(ABS(X-LOC)^KURT+1)

We can put a multiplier on the coefficient in the denominator to allow us to control the scale, the second moment of the distribution. Thus, our characteristic function has now become:

(4.05) Y = 1/(ABS((X-LOC)*SCALE) ^ KURT+1)

where

Y = The ordinate of the characteristic function.

X = The standard value amount.

LOC = A variable representing the location, the first moment of the distribution.

SCALE = A variable representing the scale, the second moment of the distribution.

KURT = A variable representing kurtosis, the fourth moment of the distribution.

Figures 4-6 and 4-7 demonstrate the effect of the scale parameter. The effect of this parameter can be thought of as moving the horizontal axis up or down on the distribution. When the axis is moved up (by decreasing scale), the graph is also enlarged. This results in what we have in Figure 4-6. This has the effect of moving the horizontal axis up and enlarging the distribution curve. The result is as though we were looking at the "cap" of the distribution. Figure 4-7 does just the opposite. As is borne out in the figure, the effect is that the horizontal axis has been moved down and the distribution curve shrunken.

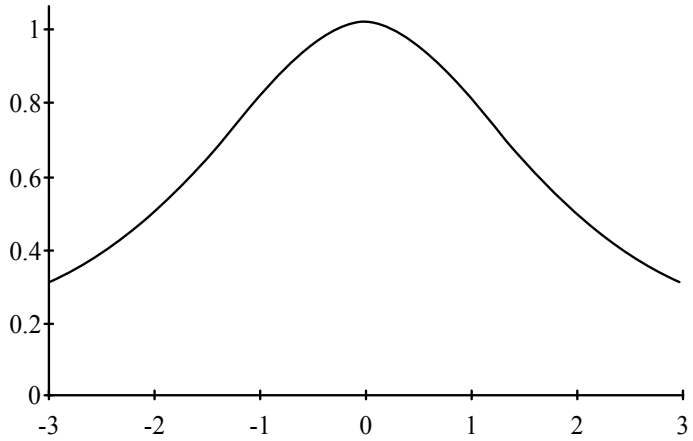

Figure 4-6 LOC = 0 SCALE = .5 SKEW = 0 KURT = 2.

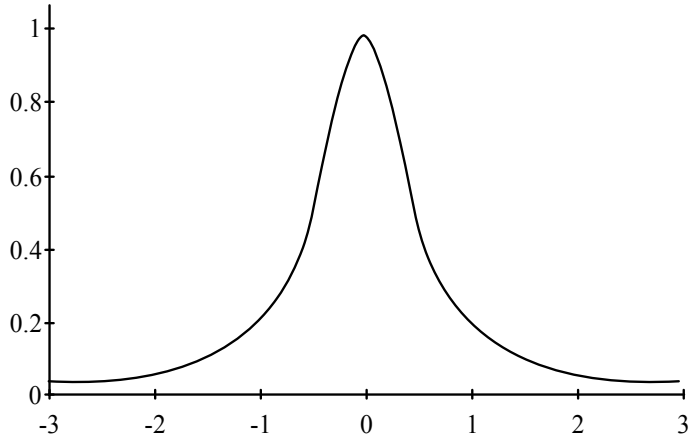

Figure 4-7 LOC = 0 SCALE = 2 SKEW = 0 KURT = 2.

We now have a characteristic function to a distribution whereby we have complete control over three of the first four moments of the distribution. Presently, the distribution is symmetric about the location. What we now need is to be able to incorporate a variable for skewness, the third moment of the distribution, into this function. To account for skewness, we must amend our function further. Our characteristic function has now evolved to:

(4.06) Y = (1/(ABS((X-LOC)*SCALE)^KURT+1))^C

where

C = The exponent for skewness, calculated as:

(4.07) C = (1+(ABS(SKEW)^ABS(1/(X-LOC))*sign(X)*-sign(SKEW)))^.5

Y = The ordinate of the characteristic function. X = The standard value amount.

LOC = A variable representing the location, the first moment of the distribution.

SCALE = A variable representing the scale, the second moment of the distribution.

SKEW = A variable representing the skewness, the third moment of the distribution.

KURT = A variable representing kurtosis, the fourth moment of the distribution.

sign() = The sign function, equal to 1 or -1. The sign of X is calculated as X/ABS(X) for X not equal to 0. If X is equal to zero, the sign should be regarded as positive.

Figures 4-8 and 4-9 demonstrate the effect of the skewness variable on our distribution.

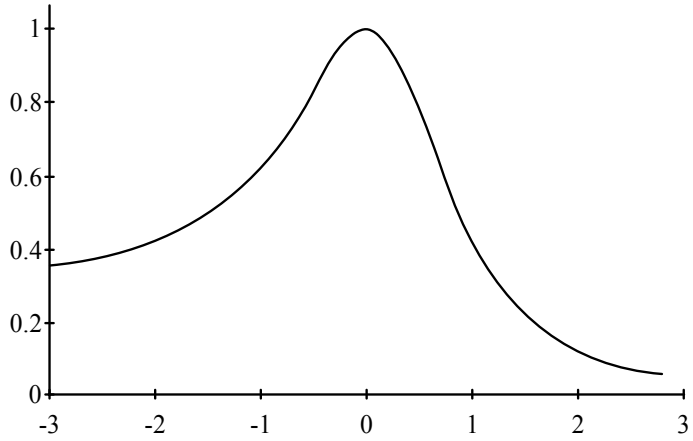

Figure 4-8 LOC = 0 SCALE = 1 SKEW = -.5 KURT = 2.

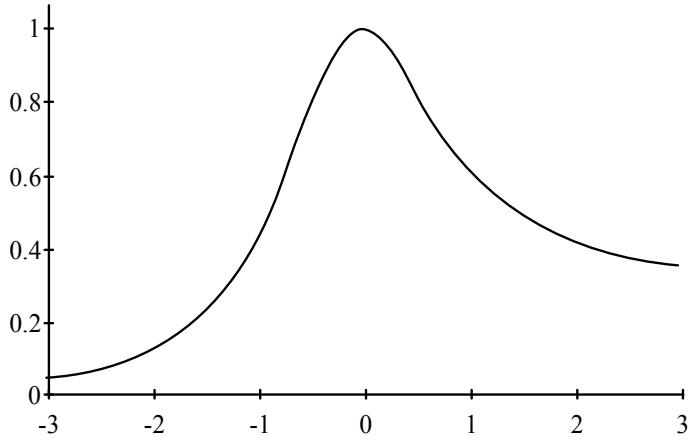

Figure 4-9 LOC = 0 SCALE = 1 SKEW = +.5 KURT = 2.

A few important notes on the four parameters LOC, SCALE, SKEW, and KURT. With the exception of the variable LOC (which is expressed as the number of standard values to offset the distribution by), the other three variables are ***nondimensional*** - that is, their values are pure numbers which have meaning only in a relative context, characterizing the shape of the distribution and are relevant only to this distribution.

Furthermore, the parameter values are not the same values you would get if you employed any of the standard measuring techniques detailed in "Descriptive Measures of Distributions" in Chapter 3. For instance, if you determined one of Pearson's coefficients of skewness on a set of data, it would not be the same value that you would use for the variable SKEW in the adjustable distributions here. The values for the four variables are unique to our distribution and have meaning only in a relative context.

Also of importance is the range that the variables can take. The SCALE. variable must always be positive with no upper bound, and likewise with KURT. In application, though, you will generally use values between .5 and 3, and in extreme cases between .05 and 5. However, you can use values beyond these extremes, so long as they are greater than zero.

The LOC variable can be positive, negative, or zero. The SKEW parameter must be greater than or equal to -1 and less than or equal to +1. When SKEW equals +1, the entire right side of the distribution (right of the peak) is equal to the peak, and vice versa when SKEW equals -1.

The ranges on the variables are summarized as:

(4.08) -infinity<LOC<+infinity

(4.09) SCALE>0

(4.10) -1<=SKEW<=+1

(4.11) KURT>0

Figures 4-2 through 4-9 demonstrate just how pliable our distribution is. We can fit these four parameters such that the resultant distribution can fit to just about any other distribution.

FITTING THE PARAMETERS OF THE DISTRIBUTION

Just as with the process described in Chapter 3 for finding our optimal f on the Normal Distribution, we must convert our raw trades data over to standard units. We do this by first subtracting the mean from each trade, then dividing by the population standard deviation. From this point forward, we will be working with the data in standard units rather than in its raw form. After we have our trades in standard values, we can sort them in ascending order. With our trades data arranged this way, we will be able to perform the K-S test on it.

Our objective now is to find what values for LOC, SCALE, SKEW, and KURT best fit our actual trades distribution. To determine this "best fit" we rely on the K-S test. We estimate the parameter values by employing the "twentieth-century brute force technique." We run every combination for KURT from 3 to .5 by -.1 (we could just as easily run it from .5 to 3 by .1, as it doesn't matter whether we ascend or descend through the values). We also run every combination for SCALE from 3 to .5 by -.1, For the time being we leave LOC and SKEW at 0. Thus, we are going to run the following combinations:

LOC	SCALE	SKEW	KURT
0	3	0	3
0	3	0	2.9
0	3	0	2.8
0	3	0	2.7
0	3	0	2.6
0	3	0	2.5
0	3	0	2.4
0	3	0	2.3
0	3	0	2.2
0	3	0	2.1
0	3	0	2
0	3	0	1.9
0	2.9	0	3
0	2.9	0	2.9
0	.5	0	.6
0	.5	0	.5

We perform the K-S test for each combination. The combination that results in the lowest K-S statistic we assume to be our optimal best-fitting Parameter values for SCALE and KURT (for the time being).

To perform the K-S test for each combination, we need both the actual distribution and the theoretical distribution (determined from the parameters for the adjustable distribution that we are testing). We already have seen how to construct the actual cumulative density as X/N, where N is the total number of trades and X is the ranking (between 1 and N) of a given trade. Now we need to calculate the CDF, (the function for what percentage of the area of the characteristic function a certain point constitutes) for our theoretical distribution for the given LOC, SCALE, SKEW, and KURT parameter values we are presently looping through.

We have the characteristic function for our adjustable distribution. This is Equation (4.06). To obtain a CDF from a distribution's characteristic function we must find the integral of the characteristic function. We define the integral, the percentage of area under the characteristic function at point X, as N(X). Thus, since Equation (4.06) gives us the first derivative to the integral, we define Equation (4.06) as N'(X).

Often you may not be able to derive the integral of a function, even if you are proficient in calculus. Therefore, rather than determining the integral to Equation (4.06), we are going to rely on a different technique, one that, although a bit more labor intensive, is hardier than the technique of finding the integral.

The respective probabilities can always be estimated for any point on the function's characteristic line by making the distribution be a series of many bars. Then, for any given bar on the distribution, you can calculate the probability associated at that bar by taking the sum of the areas of all those bars to the left of your bar, including your bar, and dividing it by the sum of the areas of all the bars in the distribution. The more bars you use, the more accurate your estimated probabilities will be. If you could use an infinite number of bars, your estimate would be exact.

We now discuss the procedure for finding the areas under our adjustable distribution by way of an example. Assume we wish to find probabilities associated with every .1 increment in standard values from -3 to +3 sigmas of our adjustable distribution. Notice that our table (p. 163) starts at -5 standard units and ends at +5 standard units, the reason being that you should begin and end 2 sigmas beyond the bounding parameters (-3 and +3 sigmas in this case) to get more accurate results. Therefore, we begin our table at -5 sigmas and end it at +5 sigmas.

Notice that X represents the number of standard units that we are away from the mean. This is then followed by the four parameter values. The next column is the N'(X) column, the height of the curve at point X given these parameter values. N'(X) is calculated as Equation (4.06).

We now work with Equation (4.06). Assume that we want to calculate N'(X) for X at -3, with the values for the parameters of .02, 2.76, 0, and 1.78 for LOC, SCALE, SKEW, and KURT respectively. First, we calculate the exponent of skewness, C in Equation (4.06)-given as Equation (4.07)-as:

x	LOC	SCALE	SKEW	KURT	N'(X)Eq.(4.06)	RUNNING-SUM	N(X)
-5.0	0.02	2.76	0	1.78	0.0092026741	0.0092026741	0.000388
-4.9	0.02	2.76	0	1.78	0.0095350519	0.018737726	0.001178
-4.8	0.02	2.76	0	1.78	0.0098865117	0.0286242377	0.001997
-4.7	0.02	2.76	0	1.78	0.01025857	0.0388828077	0.002847
-4.6	0.02	2.76	0	1.78	0.0106528988	0.0495357065	0.003729

x	LOC	SCALE	SKEW	KURT	N'(X)Eq.(4.06)	RUNNING-SUM	N(X)
-4.5	0.02	2.76	0	1.78	0.0110713449	0.0606070514	0.004645
-4.4	0.02	2.76	0	1.78	0.0115159524	0.0721230038	0.005598
-4.3	0.02	2.76	0	1.78	0.0119889887	0.0841I19925	0.006590
-4.2	0.02	2.76	0	1.78	0.0124929748	0.0966049673	0.007622
-4.1	0.02	2.76	0	1.78	0.0130307203	0.I096356876	0.008699
-4.0	0.02	2.76	0	1.78	0.0136053639	0.1232410515	0.009823
-3.9	0.02	2.76	0	1.78	0.0142204209	0.1374614724	0.010996
-3.8	0.02	2.76	0	1.78	0.0148798398	0.1523413122	0.012224
-3.7	0.02	2.76	0	1.78	0.0155880672	0.1679293795	0.013509
-3.6	0.02	2.76	0	1.78	0.0163501266	0.184279506	0.014856
-3.5	0.02	2.76	0	1.78	0.0171717099	0.2014512159	0.016270
-3.4	0.02	2.76	0	1.78	0.0180592883	0.2195105042	0.017756
-3.3	0.02	2.76	0	1.78	0.0190202443	0.2385307485	0.019320
-3.2	0.02	2.76	0	1.78	0.0200630301	0.2585937786	0.020969
-3.1	0.02	2.76	0	1.78	0.0211973606	0.2797911392	0.022709
-3.0	0.02	2.76	0	1.78	0.0224344468	0.302225586	0.024550
-2.9	0.02	2.76	0	1.78	0.0237872819	0.3260128679	0.026499
-2.8	0.02	2.76	0	1.78	0.0252709932	0.3512838612	0.028569
-2.7	0.02	2.76	0	1.78	0.0269032777	0.3781871389	0.030770
-2.6	0.02	2.76	0	1.78	0.0287049446	0.4068920835	0.033115
-2.5	0.02	2.76	0	1.78	0.0307005967	0.4375926802	0.035621
-2.4	0.02	2.76	0	1.78	0.032919491I	0.4705121713	0.038305
-2.3	0.02	2.76	0	1.78	0.0353966362	0.5059088075	0.041186
-2.2	0.02	2.76	0	1.78	0.0381742015	0.544083009	0.044290
-2.1	0.02	2.76	0	1.78	0.041303344	0.5853863529	0.047642
-2.0	0.02	2.76	0	1.78	0.0448465999	0.6302329529	0.051276
-1.9	0.02	2.76	0	1.78	0.0488810452	0.6791139981	0.055229
-1.8	0.02	2.76	0	1.78	0.0535025185	0.7326165166	0.059548
-1.7	0.02	2.76	0	1.78	0.0588313292	0.7914478458	0.064287
-1.6	0.02	2.76	0	1.78	0.0650200649	0.8564679107	0.06951I
-1.5	0.02	2.76	0	1.78	0.0722644105	0.9287323213	0.075302
-1.4	0.02	2.76	0	1.78	0.080818341	1.0095506622	0.081759
-1.3	0.02	2.76	0	1.78	0.0910157581	1.1005664203	0.089007
-1.2	0.02	2.76	0	1.78	0.1033017455	1.2038681658	0.097204
-1.1	0.02	2.76	0	1.78	0.I182783502	1.322146516	0.106550
-1.0	0.02	2.76	0	1.78	0.1367725028	1.4589190187	0.117308
-0.9	0.02	2.76	0	1.78	0.1599377464	1.6188567651	0.129824
-0.8	0.02	2.76	0	1.78	0.1894070001	1.8082637653	0.144560
-0.7	0.02	2.76	0	1.78	0.2275190511	2.0357828164	0.162146
-0.6	0.02	2.76	0	1.78	0.2776382822	2.3134210986	0.183455
-0.5	0.02	2.76	0	1.78	0.3445412618	2.6579623604	0.209699
-0.4	0.02	2.76	0	1.78	0.4346363128	3.0925986732	0.242566
-0.3	0.02	2.76	0	1.78	0.5550465747	3.6476452479	0.284312
-0.2	0.02	2.76	0	1.78	0.7084848615	4.3561301093	0.337609
-0.1	0.02	2.76	0	1.78	0.8772840491	5.2334141584	0.404499
0.0	0.02	2.76	0	1.78	1	6.2334141584	0.483685
0.1	0.02	2.76	0	1.78	0.9363557429	7.1697699013	0.565363
0.2	0.02	2.76	0	1.78	0.776473162	7.9462430634	0.637613
0.3	0.02	2.76	0	1.78	0.6127219404	8.5589650037	0.696211
0.4	0.02	2.76	0	1.78	0.4788099392	9.0377749429	0.742253
0.5	0.02	2.76	0	1.78	0.377388991	9.4151639339	0.778369
0.6	0.02	2.76	0	1.78	0.3020623672	9.7172263011	0.807029
0.7	0.02	2.76	0	1.78	0.2458941852	9.9631204863	0.830142
0.8	0.02	2.76	0	1.78	0.2034532796	10.1665737659	0.849096
0.9	0.02	2.76	0	1.78	0.1708567846	10.3374305505	0.864885
1.0	0.02	2.76	0	1.78	0.1453993995	10.48282995	0.878225
1.1	0.02	2.76	0	1.78	0.1251979811	10.6080279311	0.889639
1.2	0.02	2.76	0	1.78	0.1089291462	10.7169570773	0.899515
1.3	0.02	2.76	0	1.78	0.0956499316	10.8126070089	0.908145
1.4	0.02	2.76	0	1.78	0.0846780659	10.8972850748	0.915751
1.5	0.02	2.76	0	1.78	0.0755122067	10.9727972814	0.922508
1.6	0.02	2.76	0	1.78	0.0677784099	11.0405756913	0.928552
1.7	0.02	2.76	0	1.78	0.0611937787	11.10176947	0.933993
1.8	0.02	2.76	0	1.78	0.0555414402	11.1573109102	0.938917
1.9	0.02	2.76	0	1.78	0.0506530744	11.2079639847	0.943396
2.0	0.02	2.76	0	1.78	0.0463965419	11.2543605266	0.947490
2.1	0.02	2.76	0	1.78	0.0426670018	11.2970275284	0.951246
2.2	0.02	2.76	0	1.78	0.0393804519	11.3364079803	0.954707
2.3	0.02	2.76	0	1.78	0.0364689711	11.3728769515	0.957907
2.4	0.02	2.76	0	1.78	0.0338771754	11.4067541269	0.960874
2.5	0.02	2.76	0	1.78	0.0315595472	11.4383136741	0.963634
2.6	0.02	2.76	0	1.78	0.0294784036	11.4677920777	0.966209
2.7	0.02	2.76	0	1.78	0.0276023341	11.4953944118	0.968617
2.8	0.02	2.76	0	1.78	0.0259049892	11.5212994011	0.970874
2.9	0.02	2.76	0	1.78	0.0243641331	11.5456635342	0.972994
3.0	0.02	2.76	0	1.78	0.0229608959	11.5686244301	0.974990
3.1	0.02	2.76	0	1.78	0.0216791802	11.5903036102	0.976873
3.2	0.02	2.76	0	1.78	0.0205051855	11.6108087957	0.978653
3.3	0.02	2.76	0	1.78	0.0194270256	11.6302358213	0.980337
3.4	0.02	2.76	0	1.78	0.0184344179	11.6486702392	0.981934
3.5	0.02	2.76	0	1.78	0.0175184304	11.6661886696	0.983451
3.6	0.02	2.76	0	1.78	0.0166712734	11.682859943	0.984893
3.7	0.02	2.76	0	1.78	0.0158861285	11.6987460714	0.986266
3.8	0.02	2.76	0	1.78	0.0151570063	11.7139030777	0.987576
3.9	0.02	2.76	0	1.78	0.014478628	11.7283817056	0.988826
4.0	0.02	2.76	0	1.78	0.0138463263	11.742228032	0.990020
4.1	0.02	2.76	0	1.78	0.0132559621	11.7554839941	0.991164
4.2	0.02	2.76	0	1.78	0.012703854	11.7681878481	0.992259
4.3	0.02	2.76	0	1.78	0.0121867187	11.7803745668	0.993309
4.4	0.02	2.76	0	1.78	0.0117016203	11.7920761871	0.994316
4.5	0.02	2.76	0	1.78	0.0112459269	11.8033221139	0.995284
4.6	0.02	2.76	0	1.78	0.0108172734	11.8141393873	0.996215
4.7	0.02	2.76	0	1.78	0.0104135298	11.8245529171	0.997110
4.8	0.02	2.76	0	1.78	0.0100327732	11.8345856903	0.997973
4.9	0.02	2.76	0	1.78	0.0096732643	11.8442589547	0.998804
5.0	0.02	2.76	0	1.78	0.0093334265	11.8535923812	0.999606

(4.07) C = (1+(ABS(SKEW)^ABS(1/(X-LOC))*sign(X)*-sign(SKEW)))^.5

= (1+(ABS(0)^ABS(l/(-3-.02))*-1*-1))^5

= (1+0)^.5 = 1

Thus, substituting 1 for C in Equation (4.06):

(4.06) Y= (1/(ABS((X-LOC)*SCALE)^KUKT+1))^C

= (l/(ABS((-3-.02)*2.76)^1.78+1))^1

= (1/((3.02*2.76)^1.78+1))^1

= (1/(8.3352^1.78+1))^1

= (1/(43.57431058+1))^1

= (1/44.57431058)^1

= .02243444681^1

= .02243444681

Thus, at the point X = -3, the N'(X) value is .02243444681. (Notice that we calculate an N'(X) column, which corresponds to every value of X). The next step we must perform, the next column, is the running sum of the N'(X)'s as we advance up through the X's. This is straight forward enough. Now we calculate the N(X) column, the resultant probabilities associated with each value of X, for the given parameter values. To do this, we must perform Equation (4.12):

(4.12) N(C) = (∑[i = 1,C]N'(X_i)+∑[i = 1,C-1]N'(X_i))/2/ ∑[i = 1,M]N'(X_i)

where

C = The current X value.

M = The total count of X values.

Equation (4.12) says, literally, to add the running sum at the current value of X to the running sum at the previous value of X as we advance up through the X's. Now divide this sum by 2. Then take the new quotient and divide it by the last value in the column of the running sum of the N'(X)'s (the total of the N'(X) column). This gives us the resultant probabilities for a given value of X, for given parameter values.

Thus, for the value of -3 for X, the running sum of the N'(X)'s at -3 is .302225586, and the previous X, -3.1, has a running sum value of .2797911392. Summing these two running sums together gives us 5820167252. Dividing this by 2 gives us .2910083626. Then dividing this by the last value in the running sum column, the total of all of the N'(X)'s, 11.8535923812, gives us a quotient of .02455022522. This is the associated probability, N(X), at the standard value of X = -3.

Once we have constructed cumulative probabilities for each trade in the actual distribution and probabilities for each standard value increment in our adjustable distribution, we can perform the K-S test for the parameter values we are currently using. Before we do, however, we must make adjustments for a couple of other preliminary considerations.

In the example of the table of cumulative probabilities shown earlier for our adjustable distribution, we calculated probabilities at every .1 increment in standard values. This was for the sake of simplicity. In practice, you can obtain a greater degree of accuracy by using a smaller step increment. I find that using .01 standard values is a good step increment.

A word on how to determine your bounding parameters in actual practice-that is, how many sigmas either side of the mean you should go in determining your probabilities for our adjustable distribution. In our example we were using 3 sigmas either side of the mean, but in reality you must use the absolute value of the farthest point from the mean. For our 232-trade example, the extreme left (lowest) standard value is -2.96 standard units and the extreme right (highest) is 6.935321 standard units. Since 6.93 is greater than ABS(-2.96), we must take the 6.935321. Now, we add at least 2 sigmas to this value, for the sake of accuracy, and construct probabilities for a distribution from -8.94 to +8.94 sigmas. Since we want a good deal of accuracy, we will use a step increment of .01. Therefore, we will figure probabilities for standard values of:

-8.94

-8.93

-8.92

-8.91

+8.94

Now, the last thing we must do before we can actually perform our K-S statistic is to round the actual standard values of the sorted trades to the nearest .01 (since we are using .01 as our step value on the theoretical distribution). For example, the value 6.935321 will not have a corresponding theoretical probability associated with it, since it is in between the step values 6.93 and 6.94. Since 6.94 is closer to 6.935321, we round 6.935321 to 6.94. Before we can begin the procedure of optimizing our adjustable distribution parameters to the actual distribution by employing the K-S test, we must round our actual sorted standardized trades to the nearest step increment.

In lieu of rounding the standard values of the trades to the nearest Xth decimal place you can use linear interpolation on your table of cumulative probabilities to derive probabilities corresponding to the actual standard values of the trades. For more on linear interpolation, consult a good statistics book, such as some of the ones suggested in the bibliography or ***Commodity Market Money Management*** by Fred Gehm.

Thus far, we have been optimizing only for the best-fitting KURT and SCALE values. Logically, it would seem that if we standardized our data, as we have, then the LOC parameter should be kept at 0 and the SCALE parameter should be kept at 1. This is not necessarily true, as the true location of the distribution may not be the arithmetic mean, and the true optimal value for scale may not be at 1. The KURT and SCALE values have a very strong relationship to one another. Thus, we first try to isolate the -"neighborhood" of best-fitting parameter values for KURT and SCALE. For our 232 trades this occurs at SCALE equal to 2.7 and KURT equal to 1.9.

Now we progressively try to zero in on the best-fitting parameter values. This is a computer-time-intensive process. We run our next pass through, cycling the LOC parameter from .1 to -.1 by -.05, the SCALE parameter from 2.6 to 2.8 by .05, the SKEW parameter from .1 to -.1 by -.05, and the KURT parameter from 1.86 to 1.92 by .02. The results of this cycle through give the optimal (lowest K-S statistic) at LOC = 0, SCALE = 2.8, SKEW = 0, and KURT = 1.86.

Thus we perform a third cycle through. This time we run LOC from .04 to -.04 by -.02, SCALE from 2.76 to 2.82 by .02, SKEW from .04 to -.04 by -.02, and KURT from 1.8 to 1.9 by .02. The results of the third cycle through show optimal values at LOC = .02, SCALE = 2.76, SKEW = 0, and KURT = 1.8.

Now we have zeroed right in on the optimal neighborhood, the areas where the parameters make for the best fit of our adjustable characteristic function to the actual data. For our last cycle through we are going to run LOC from 0 to .03 by .01, SCALE from 2.76 to 2.73 by -.01, SKEW from ,01 to -.01 by -.01, and KURT from 1.8 to 1.75 by -.01. The results of this final pass show optimal parameters for our 232 trades at LOC = .02, SCALE = 2.76, SKEW = 0, and KURT = 1.78.

USING THE PARAMETERS TO FIND OPTIMAL F

Now that we have found the best-fitting parameter values, we can find the optimal f on this distribution. We can take the same procedure we used to find the optimal f on the Normal Distribution discussed in the last chapter. The only difference now is that the associated probabilities for each standard value (X value) are calculated per the procedure described for Equations (4.06) and (4.12). With the Normal Distribution, we find our associated probabilities column (probabilities corresponding to a certain standard value) by using Equation (3.21). Here, to find our associated probabilities, we must follow the procedure detailed previously:

1. For a given standard value, X, we figure its corresponding N'(X) by Equation (4.06).

2. For each standard value, we also have the interim step of keeping a running sum of the N'(X) 's corresponding to each value of X.

3. Now, to find N(X), the resultant probability for a given X, add together the running sum corresponding to the X value with the running sum corresponding to the previous X value. Divide this sum by 2. Then divide this quotient by the sum total of the N'(X)'s, the last entry in the column of running sums. This new quotient is the associated 1- tailed probability for a given X.

Since we now have a procedure to find the associated probabilities for a given standard value, X, for a given set of parameter values, we can find our optimal f. The procedure is exactly the same as that detailed for finding the optimal f on the Normal Distribution. The only difference is that we calculate the associated probabilities column differently.

In our 232-trade example, the parameter values that result in the lowest K-S statistic are .02, 2.76, 0, and 1.78 for LOC, SCALE, SKEW, and KURT respectively. We arrived at these parameter values by using the optimization procedure outlined in this chapter. This resulted in a K-S statistic of .0835529 (meaning that at its worst point, the two distributions were apart by 8.35529%), and a significance level of 7.8384%. Figure 4-10 shows the distribution function for those parameter values that best fit our 232 trades.

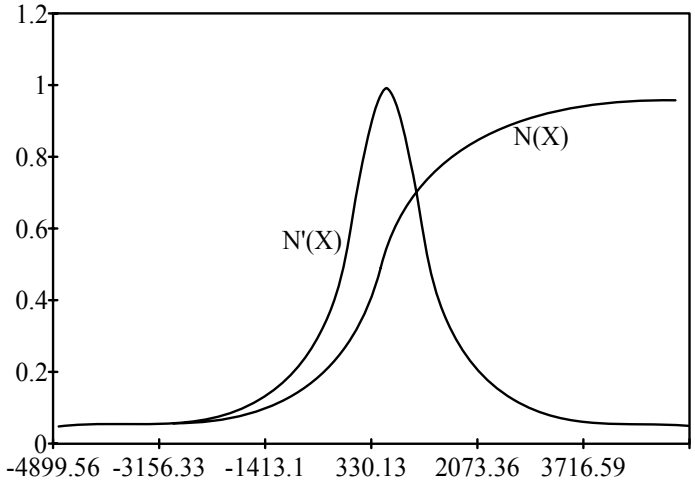

Figure 4-10 Adjustable distribution fit to the 232 trades.

If we take these parameters and find the optimal f on this distribution, bounding the distribution from +3 to -3 sigmas and using 100 equally spaced data points, we arrive at an optimal f value of .206, or 1 contract for every $23,783.17. Compare this to the empirical method, which showed that optimal growth is obtained at 1 contract for every $7,918.04 in account equity.

But that is the result we get if we bound the distribution at 3 sigmas either side of the mean. In reality, in the empirical stream of trades, we had a worst-case loss of 2.96 sigmas and a best-case gain of 6.94 sigmas. Now if we go back and bound our distribution at 2.96 sigmas on the left (negative side) of the mean and 6.94 on the right (and we'll use 300 equally spaced data points this time), we obtain an optimal f of .954 or 1 contract for every $5,062.71 in account equity. Why does this differ from the empirical optimal f of $7,918.04?

The difference is in the "roughness" of the actual distribution. Recall that the significance level of our best-fitting parameters was only 7.8384%. Let us take our 232-trade distribution and bin it into 12 bins from -3 to +3 sigmas.

	Bin	Number of Trades
-3.0	-2.5	2
-2.5	-2.0	1
-2.0	-1.5	2
-1.5	-1.0	24
-1.0	-0.5	39

-0.5	0.0	43
0.0	0.5	69
0.5	1.0	38
1.0	1.5	7
1.5	2.0	2
2.0	2.5	0
2.5	3.0	2

Notice that out on the tails of the distribution are gaps, areas or bins where there isn't any empirical data. These areas invariably get smoothed over when we fit our adjustable distribution to the data, and it is these smoothed-over areas that cause the difference between the parametric and the empirical optimal fs. Why doesn't our distribution fit the observed better, especially in light of how malleable it is? The reason has to do with the observed distribution having too many ***pointy of inflection.***

A parabola can be cupped upward or downward. Yet over the extent of a parabola, the direction of the cup, whether it points upward or downward, is unchanged. We define a point of inflection as any time the direction of the concavity changes from up to down. Therefore, a parabola has 0 points of inflection, since the direction of the concavity never changes. An object shaped like the letter S lying on its side has one point of inflection, one point where the concavity changes from up to down.

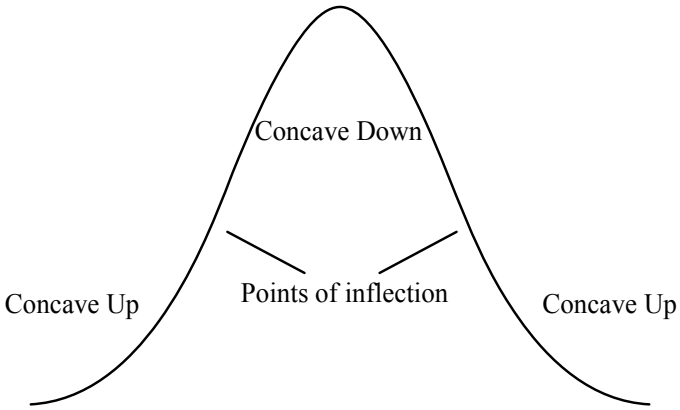

Figure 4-11 Points of inflection on a bell-shaped distribution.

Figure 4-11 shows the Normal Distribution. Notice there are ***two*** points of inflection in a bell-shaped curve such as the Normal Distribution. Depending on the value for SCALE, our adjustable distribution can have n zero points of inflection (if SCALE is very low) or two points of inflection. The reason our adjustable distribution does not fit the actual distribution of trades any better than it does is that the actual distribution has too many Points of inflection.

Does this mean that our fitted adjustable distribution is wrong? Probably not. If we were so inclined, we could create a distribution function that allowed for more than two points of inflection, which would better curve-fit to the actual observed distribution. If we created a distribution function that allowed for as many points of inflection as we desired, we could fit to the observed distribution perfectly. Our optimal f derived therefrom would • then be nearly the same as the empirical. However, the more points of inflection we were to add to our distribution function, the less robust it would be (i.e., it would probably be less representative of the trades in the future).

However, we are not trying to fit the parametric f to the observed exactly. We are trying to determine how the observed data is distributed so that we can determine with a fair degree of accuracy what the optimal fin the future will be if the data is distributed as it were in the past. When we look at the adjustable distribution that has been fit to our actual trades, the spu***rious points of inflection*** are removed.

An analogy may clarify this. Suppose we are using Galton's board. We know that asymptotically the distribution of the balls falling through the board will be Normal. However, we are only going to see 4 balls rolled through the board. Can we expect the outcomes of the 4 balls to be perfectly conformable to the Normal? How about 5 balls? 50 balls?

In an asymptotic sense, we expect the observed distribution to flesh out to the expected as the number of trades increases. Fitting our theoretical distribution to every point of inflection in the actual will not give us any greater degree of accuracy in the future. As more trades occur, we can expect the observed distribution to converge toward the expected, as we can expect the extraneous points of inflection to be filled in with trades as the number of trades approaches infinity. If the process generating the trades is accurately modeled by our parameters, the optimal f derived from the theoretical will be more accurate over the future sequence of trades than the optimal f derived empirically over the past trades.

In other words, if our 232 trades are a proxy of the distribution of the trades in the future, then we can expect the trades in the future to arrive in a distribution more like the theoretical one that we have fit than like the observed with its extraneous points of inflection and its roughness due to not having an infinite number of trades. In so doing, we can expect the optimal fin the future to be more like the optimal f obtained from the theoretical distribution than it is like the optimal f obtained empirically over the observed distribution.

So, we are better off in this case to use the parametric optimal f rather than the empirical. The situation is analogous to the 20-coin-toss discussion of the previous chapter. If we expect 60% wins at a 1:1 payoff, the optimal f is correctly .2. However, if we only had empirical data of the last 20 tosses, 11 of which were wins, our optimal f would show as .1, even though ,2 is what we should optimally bet on the next toss since it has a 60% chance of winning. We must assume that the parametric optimal f ($5,062.71 in this case) is correct because it is the optimal f on the ***generating*** function. As with the coin-toss game just mentioned, we must assume that the optimal f for the next trade is determined parametrically by the generating function, even though this may differ from the empirical optimal f.

Obviously, the bounding parameters have a very important effect on the optimal f. Where should you place the bounding parameters so as to obtain the best results? Look at what happens as we move the upper bound up. The following table is compiled by bounding the lower end at 3 sigmas, and using 100 equally spaced data points and the optimal parameters to our 232 trades:

Upper Bound	f	f$
3 Sigmas	.206	$23783.17
4 Sigmas	.588	$8,332.51
5 Sigmas	.784	$6,249.42
6 Sigmas	.887	$5,523.73
7 Sigmas	.938	$5,223.41
8 Sigmas	.963	$5,087.81
100 Sigmas	.999	$4,904.46

Notice that, keeping the lower bound constant, the higher up we move the higher bound, the more the optimal f approaches 1. Thus, the more we move the upper bound up, the more the optimal f in dollars will approach the lower bound (worst-case expected loss) exactly. In this case, where our lower bound is at -3 sigmas, the more we move the upper bound up, the more the optimal f in dollars will approach the lower bound as a limit-$330.13-(1743.23*3) = -$4,899.56.

Now observe what happens when we keep the upper bound constant (at 3), but move the lower bound lower. Very soon into this process the arithmetic mathematical expectation turns negative. This happens because more than 50% of the area under the characteristic function is to the left of the zero axis. Consequently, as we move the lower bounding parameter lower, the optimal f quickly goes to zero.

Now consider what happens when we move both bounding parameters out at the same rate. Here we are using the optimal parameter set of .02, 2.76, 0, and 1.78 on our distribution of 232 trades, and 100 equally spaced data points:

Upper and Lower Bound	f	f$
3 Sigmas	.206	$23,783.17
4 Sigmas	.158	$42,040.42
5 Sigmas	,126	$66,550.75
6 Sigmas	.104	$97,387.87
10 Sigmas	.053	$322,625.17

Notice that our optimal f approaches 0 as we move both bounding parameters out to plus and minus infinity. Furthermore, since our worst-case loss gets greater and greater, and gets divided by a smaller and smaller optimal f, our f$, the amount to finance 1 unit by, approaches infinity as well.

The problem of where the best place is to put the bounding parameters is best rephrased as, "Where, in the extreme case, do we expect the best and worst trades in the future (over the course of which we are going to trade this market system) to occur?" The tails of the distribution itself actually go to plus and minus infinity. To account for this we

would optimally finance each contract by an infinitely high amount (as in our last example, where we moved both bounds outward). If we were going to trade for an infinitely long time into the future, our optimal f in dollars would be infinite. But we're not going to trade this market system forever. The optimal f in the future over which we are going to trade this market system is a function of what the best and worst trades in that future are.

Recall that if we flip a coin 100 times and record what the longest streak of consecutive tails is, then flip the coin another 100 times, the longest streak of consecutive tails at the end of 200 flips will more than likely be greater than it was after only the first 100 flips. Similarly, if the worst-case loss seen over our 232-trade history was a 2.96-sigma loss (let's say a 3-sigma loss) then we should expect a loss of greater than 3 sigmas in the future over which we are going to trade this market system. Therefore, rather than bounding our distribution at what the bounds of the past history of trades were (-2.96 and +6.94 sigmas), we will bound it at -4 and +6.94 sigmas. We should perhaps expect the high-end bound to be violated in the future, much as we expect the low-end bound to be violated. However, we won't make this assumption for a couple of reasons. The first is that trading systems notoriously do not trade as well into the future, in general, as they have over historical data, even when there are no optimizable parameters involved. It gets back to the principle that mechanical trading systems seem to suffer from a ***continually deteriorating edge.*** Second, the fact that we pay a lesser penalty for erring in optimal f if we err to the left of the peak of the f curve than if we err to the right of it suggests that we should err on the conservative side in our prognostications about the future.

Therefore, we will determine our parametric optimal f by using the bounding parameters of -4 and +6.94 sigmas and use 300 equally spaced data points. However, in calculating the probabilities at each of the 300 equally spaced data points, it is important that we begin our distribution 2 sigmas before and after our selected bounding parameters. We therefore determine the associated probabilities by creating bars from -6 to +8.94 sigmas, even though we are only going to use the bars between -4 and +6.94 sigmas. In so doing, we have enhanced the accuracy of our results.

Using our optimal parameters of .02, 2.76, 0, and 1.78 now yields an optimal f of .837, or 1 contract per every $7,936.41.

So long as our selected bounding parameters are not violated, our model of reality is accurate in terms of the bounds selected. That is, so long as we do not see a loss greater than 4 sigmas-$330.13-(1743.23*4) = -$6,642.79-or a profit greater than 6.94 sigmas-$330.13+(1743.23*6.94) = $12,428.15-we have accurately modeled the bounds of the distribution of trades in the future.

The possible divergence between our model and reality is our blind spot. That is, the optimal f derived from our model (with our selected bounding parameters) is the optimal f for our model, not necessarily for reality. If our selected bounding parameters are violated in the future, our selected optimal f cannot then be the optimal. We would be smart to defend this blind spot with techniques, such as long options, that limit our liability to a prescribed amount.

While we are discussing weaknesses with the method, one final weakness should be pointed out. Once you have obtained your parametric optimal f, you should be aware that the actual distribution of trade profits and losses is one in which the parameters are constantly changing, albeit slowly. You should frequently run the technique on your trade profits and losses for each market system you are trading to monitor these dynamics of the distributions.

PERFORMING "WHAT IFS"

Once you have obtained your parametric optimal f, you can perform "What If types of scenarios on your distribution function by altering the parameters LOC, SCALE, SKEW, and KURT of the distribution function to replicate different expected outcomes in the near future (different distributions the future might take) and observe the effects. Just as we can tinker with stretch and shrink on the Normal distribution, so, too, can we tinker with the parameters LOC, SCALE, SKEW, and KURT of our adjustable distribution.

The "What if capabilities of the parametric technique are the strengths that help to offset the weaknesses of the actual distribution of trade P&L's moving around. The parametric techniques allow us to see the effects of changes in the distribution of actual trade profits and losses ***before*** they occur, and possibly to budget for them.

When tinkering with the parameters, a suggestion is in order. When finding the optimal f, rather than tinkering with the LOC, the location parameter, you are better off tinkering with the arithmetic average trade in dollars that you are using as input. The reason is illustrated in Figure 4-12.

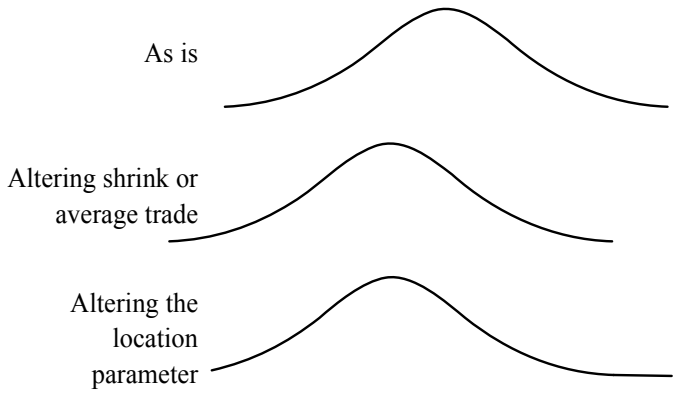

Figure 4-12 Altering location parameters.

Notice that in Figure 4-12, changing the location parameter LOC moves the distribution right or left in the "window" of the bounding parameters. But the bounding parameters do not move with the distribution. Thus, a change in the LOC parameter also affects how many equally spaced data points will be left of the mode and right of the mode of the distribution. By changing the actual arithmetic mean (or using the shrink variable in the Normal Distribution search for ***f),*** the window of the bounding parameters moves also. When you alter the arithmetic average trade as input, or alter the shrink variable in the Normal Distribution mechanism, you still have the same number of equally spaced data points to the right and left of the mode of the distribution that you had before the alteration.

EQUALIZING F

The technique detailed in this chapter was shown using data that was not equalized. We can also use this very same technique on equalized data. If we want to determine an equalized parametric optimal f, we would convert the raw trade profits and losses over to percentage gains and losses, based on Equations (2.10a) through (2.10c). Next, we would convert these percentage profits and losses by multiplying them by the current price of the underlying instrument. For example, P&L number 1 is .18. Suppose the entry price to this trade was 100.50. The percentage gain on this trade would be .18/100.50 = .001791044776. Now suppose that the current price of this underlying instrument is 112.00. Multiplying .001791044776 by 112.00 translates into an equalized P&L of .2005970149.

If we were seeking to do this procedure on an equalized basis, we would perform this operation on all 232 trade profits and losses. We would then calculate the arithmetic mean and population standard deviation on the equalized trades and would use Equation (3.16) to standardize the trades. Next, we could find the optimal parameter set for LOC, SCALE, SKEW, and KURT on the equalized data exactly as was shown in this chapter for nonequalized data.

The rest of the procedure is the same in this chapter in terms of determining the optimal f, geometric mean, and TWR. The by-products of the geometric average trade, arithmetic average trade, and threshold to the geometric are only valid for the current price of the underlying instrument. When the price of the underlying instrument changes, the procedure must be done again, going back to step one and multiplying the percentage profits and losses by the new underlying price. When you go to redo the procedure with a different underlying price, you will obtain the same optimal f, geometric mean, and TWR. However, your arithmetic average trade, geometric average trade, and threshold to the geometric will be different based upon the new price of the underlying instrument.

The number of contracts to trade as given in Equation (3.34) must be changed. The worst-case associated P&L, the W variable, Equation (3.35), will be different in Equation (3.34) as a result of the changes caused in the equalized data by a different current price.

OPTIMAL F ON OTHER DISTRIBUTIONS AND FITTED CURVES

At this point you should realize that there are many other ways you can determine your parametric optimal f. We have covered a procedure for finding the optimal f on Normally distributed data in the previous chapter. Thus we have a procedure that will give us the optimal f for any Normally distributed phenomenon. ***That same procedure can be used to find the optimal on data of any distribution, so long as the cumulative density function of the selected distribution is available*** (these functions arc given for many other common distributions in Appendix B). ***When the cumulative density function is not available, the optimal f can be found for any other function by the integration method used in this chapter to approximate the cumulative densities, the areas under the curve.***

I have elected in this chapter to model the actual distribution of trades by way of our adjustable distribution. This amounts to little more than finding a function and its appropriate values, which model the actual density function of the trade P&L's with a maximum of 2 points of inflection. You could use or create many other functions and methods to do this-such as polynomial interpolation and extrapolation, rational function (quotients of polynomials) interpolation and extrapolation, or using splines to fit a theoretical function to the actual. Once any theoretical function is found, the associated probabilities can be determined by the same method of integral estimation as was used in finding the associated probabilities of our adjustable distribution or by using integration techniques of calculus.

There is a problem with fitting any of these other functions. Part of the thrust of this book has been to allow users of systems that are not purely mechanical to have the same account management power that users of purely mechanical systems have. As such, the adjustable distribution route that I took only requires estimates for the parameters. These parameters pertain to the first four moments of the distribution. It is these moments -location, scale, skewness, and kurtosis-that describe the distribution. Thus, someone trading on some not purely mechanical basis-e.g., Elliott wave— could estimate the parameters and have access to optimal f and its by-product calculations. A past history of trades is not a prerequisite for estimating these parameters. If you were to use any of the other fitting techniques mentioned, you wouldn't necessarily need a past history of trades either, but the estimates for the parameters of those fitting techniques do not necessarily pertain to the moments of the distribution. What they pertain to is a function of the particular function you are using. These other techniques would not necessarily allow you to see what would happen if kurtosis increased or skewness changed or the scale were altered, and so on. Our adjustable distribution is the logical choice for a theoretical function to fit to the actual, since the parameters not only measure the moments of the distribution, they give us control over those moments when prognosticating about future changes to the distribution. Furthermore, estimating the parameters of our adjustable distribution is easier than with fitting any other function which I am aware of.

SCENARIO PLANNING

People who forecast for a living (economists, stock market forecasters, weathermen, government agencies, etc.) have a notorious history for incorrect forecasts, but most decisions anyone must make in life usually require making a ***forecast*** about the future.

A couple of pitfalls immediately crop up here. To begin with, people generally make assumptions about the future that are more optimistic than the actual probabilities. Most people feel that they arc far more likely to win the lottery this month than they are to die in an auto accident, even though the probabilities of the latter are greater. This is not only true on the level of the individual, it is even more pronounced at the level of the group. When people work together, they tend to see a favorable outcome as the most likely result (everyone else seems to, otherwise they wouldn't be working here), otherwise they would quit the project they are a part of (unless, of course, we have all become automatons mindlessly slaving away on sinking ships).

The second and more harmful pitfall is that people make straight-line forecasts into the future. People try to predict the price of a gallon of gas two years from now, predict what will happen with their jobs, who will be the next president, what the next styles will be, and on and on. Whenever we think of the future, we tend to think in terms of a ***single, most likely outcome.*** As a result, whenever we must make decisions, whether as an individual or a group, we tend to make these decisions based on what we think will be the single most likely outcome in the future. As a consequence, we are extremely vulnerable to unpleasant surprises.

Scenario planning is a partial solution to this problem. A scenario is simply a ***possible*** forecast, a story about one way that the future ***might*** unfold. Scenario planning is a collection of scenarios to cover the spectrum of possibilities. Of course, the complete spectrum can never be covered, but the scenario planner wants to cover as many possibilities as he or she can. By acting in this manner, as opposed to a straight-line forecast of the most likely outcome, the scenario planner can prepare for the future as it unfolds. Furthermore, scenario planning allows the planner to be prepared for what might otherwise be an unexpected event. Scenario planning is tuned to reality in that it recognizes that ***certainty is an illusion.***

Suppose you are involved in long-run planning for your company. Say you make a particular product. Bather than making a single-most-likely-outcome, straight-line forecast, you decide to exercise scenario planning. You Will need to sit down with the other planners and brainstorm for possible scenarios. What if you cannot get enough of the raw materials to make your product? What if one of your competitors fails? What if a new competitor emerges? What if you have severely underestimated demand for this product? What if a war breaks out on such-and-such a continent? What if it is a nuclear war? Because each scenario is only one of several, each scenario can be considered seriously. But what do you do once you have defined these scenarios?

To begin with, you must determine what goal you would like to achieve for each given scenario. Depending upon the scenario, the goal need not be a positive one. For instance, under a bleak scenario your goal may simply be damage control. Once you have defined a goal for a given scenario, you then need to draw up the contingency plans pertaining to that scenario to achieve the desired goal. For instance, in the rather unlikely bleak scenario where your goal is damage control, you need to have plans formulated so that you can minimize the damage. Above all else, scenario planning provides the planner with a course of action to take should a certain scenario develop. It forces you to make plans before the fact; it forces you to be prepared for the unexpected.

Scenario planning can do a lot more, however. There is a hand-in-glove fit between scenario planning and optimal f. Optimal fallows us to determine the optimal quantity to allocate to a given set of possible scenarios. We can exist in only one scenario at a time, even though we are planning for multiple futures (multiple scenarios). Scenario planning puts us in a position where we must make a decision regarding how much of a resource to allocate today given the possible scenarios of tomorrow. This is the true heart of scenario planning-quantifying it.

We can use another parametric method for optimal f to determine how much of a certain resource to allocate given a certain set of scenarios. This technique will maximize the utility obtained in an asymptotic geometric sense. First, we must define each unique scenario. Second, we must assign a number to the probability of that scenario's occurrence. Being a probability means that this number is between 0 and 1. Scenarios with a probability of 0 we need not consider any further. Note that these probabilities are not cumulative. In other words, the probability assigned to a given scenario is unique to that scenario. Suppose we are a decision maker for XYZ Manufacturing Corporation. Two of the many scenarios we have are as follows. In one scenario XYZ Manufacturing files for bankruptcy, with a probability of .15; in the other scenario XYZ is being put out of business by intense foreign competition, with a probability of .07. Now, we must ask if the first scenario, filing for bankruptcy, includes filing for bankruptcy due to the second scenario, intense foreign competition. If it does, then the probabilities in the first scenario have not taken the probabilities of the second scenario into account, and we must amend the probabilities of the first scenario to be .08 (.15-.07). Note also that just as important as the uniqueness of each probability to each scenario is that the sum of the probabilities of all of the scenarios we are considering must equal 1 exactly, not 1.01 nor .99, but 1.

For each scenario we now have assigned a probability of just that scenario occurring. We must also assign an outcome result. This is a numerical value. It can be dollars made or lost as a result of a scenario manifesting itself, it can be units of utility, medication, or anything. However, our output is going to be in the same units that we put in as

input. ***You must have at least one scenario with a negative outcome in order to use this technique.***

This is mandatory. Since we are trying to answer the question "How much of this resource should we allocate today given the possible scenarios of tomorrow?", if there is not a negative outcome scenario, then we should allocate 100% of this resource. Further, without a negative outcome scenario it is questionable how tuned to reality this set of scenarios really is.

A last prerequisite to using this technique is that the mathematical expectation, the sum of all of the outcome results times their respective probabilities, must be greater than zero.

(1.03) ME = ∑[i = 1,N] (P_i *A_i)

where

P_i = The probability associated with the ith scenario.

A_i = The result of the ith scenario.

N = The total number of scenarios under consideration.

If the mathematical expectation equals zero or is negative, the following technique cannot be used. That's not to say that scenario planning itself cannot be used. It can and should. However, optimal f can only be incorporated with scenario planning when there is a positive mathematical expectation. When the mathematical expectation is zero or negative, we ought not allocate any of this resource at this time.

Lastly, you must try to cover as much of the spectrum of outcomes as possible. In other words, you really want to account for 99% of the possible outcomes. This may sound nearly impossible, but many scenarios can be made broader so that you don't need 10,000 scenarios to cover 99% of the spectrum. In making your scenarios broader, you must avoid the common pitfall of three scenarios: an optimistic one, a pessimistic one, and a third where things remain the same. This is too simple, and the answers derived therefrom are often too crude to be of any value. Would you want to find your optimal f for a trading system based on only three trades?

So even though there may be an unknowably large number of scenarios covering the entire spectrum, we can cover what we believe to be about 99% of the spectrum of outcomes. If this makes for an unmanageably large number of scenarios, we can make the scenarios broader to trim down their number. However, by trimming down their number we lose a certain amount of information. When we trim down the number of scenarios (by broadening them) down to only three, a common pitfall, we have effectively eliminated so much information that this technique is severely hampered in its effectiveness.

What is a good number of scenarios to have then? As many as you can and still manage them. Here, a computer is a great asset. Assume again that we are decision making for XYZ. We are looking at marketing a new product of ours in a primitive, remote little country. We are looking at five possible scenarios (in reality you should have many more than this, but we'll use five for the sake of illustration). These five scenarios portray what we perceive as possible futures for this primitive remote country, their probabilities of occurrence, and the gain or loss of investing there.

Scenario	Probability	Result
War	.1	-$500,000
Trouble	.2	-$200,000
Stagnation	.2	0
Peace	.45	$500,000
Prosperity	.05	$1 ,000,000
	Sum 1.00	

The sum of our probabilities equals 1. We have at least 1 scenario with a negative result, and our mathematical expectation is positive:

(.1*-$500,000)+(.2*-$200,000)+.. = $185,000

We can therefore use the technique on this set of scenarios.

Notice first, however, that if we used the single most likely outcome method we would conclude that peace ***will*** be the future of this country, and we would then act as though peace was to occur, as though it were a certainty, only vaguely remaining aware of ***the other*** possibilities.

Returning to the technique, we must determine the optimal f. The optimal f is that value for f (between 0 and 1) which maximizes the geometric mean:

(4.13) Geometric mean = TWR^(1/∑[i = 1,N] Pi)

and

(4.14) TWR = ∏[i = 1,N] HPRi

and

(4.15) HPRi = (1+(Ai/(W/-f))) ^ Pi therefore

(4.16) Geometric mean = (∏[i = 1,N] (1+(Ai/(W/-f))) ^ Pi) ^ (1/∑[i = 1,N] Pi) Finally then, we can compute the real TWR as:

(4.17) TWR = Geometric Mean ^ X

where

N = The number of different scenarios.

TWR = The terminal wealth relative.

HPR_i = The holding period return of the ith scenario.

A_i = The outcome of the ith scenario.

P_i = The probability of the ith scenario.

W = The worst outcome of all N scenarios.

f = The value for f which we are testing.

X = However many times we want to "expand" this scenario out. That is, what we would expect to make if we invested f amount into these possible scenarios X times.

The TWR returned by Equation (4.14) is just an interim value we must have in order to obtain the geometric mean. Once we have this geometric mean, the real TWR can be obtained by Equation (4.17).

Here is how to perform these equations. To begin with, we must decide on an optimization scheme, a way of searching through the f values to find that f which maximizes our equation. Again, we can do this with a straight loop with f from .01 to 1, through iteration, or through parabolic interpolation. Next, we must determine what the worst possible result for a scenario is of all of the scenarios we are looking at, ***regardless of how small the probabilities of that scenario's occurrence are.*** In the example of XYZ Corporation this is -$500,000. Now for each possible scenario, we must first divide the worst possible outcome by negative f. In our XYZ Corporation example, we will assume that we are going to loop through f values from .01 to 1. Therefore we start out with an f value of .01. Now, if we divide the worst possible outcome of the scenarios under consideration by the negative value for f:

-$500,000/-.01 = $50,000,000

Negative values divided by negative values yield positive results, so our result in this case is positive. As we go through each scenario, we divide the outcome of the scenario by the result just obtained. Since the outcome to the first scenario is also the worst scenario, a loss of $500,000, we now have:

-$500,000/$50,000,000 = -.01

The next step is to add this value to 1. This gives us: l+(-.01) = .99

Lastly, we take this answer to the power of the probability of its occurrence, which in our example is .1:

.99^.1 = .9989954713

Next, we go to the next scenario labeled 'Trouble," where there is a .2 probability of a loss of $200,000. Our worst-case result is still -$500,000. The f value we are working on is still .01, so the value we want to divide this scenario's result by is still $50,000,000:

-$200,000/$50,000,000 = -.004

Working through the rest of the steps to obtain our HPR:

1+(-.004) = .996

.996^.2 = .9991987169

If we continue through the scenarios for this test value of .01 for f, we will find the 3 HPRs corresponding to the last 3 scenarios:

Stagnation	1.0
Peace	1.004467689
Prosperity	1.000990622

Once we have turned each scenario into an HPR for the given f value, we must multiply these HPRs together:

.9989954713*.9991987169*1.0*1.004487689*1.000990622 = 1.00366'7853

This gives us the interim TWR, which in this case is 1.003667853. Our next step is to take this to the power of 1 divided by the sum of the probabilities. Since the sum of the probabilities is 1, we can state that we must raise the TWR to the power of 1 to give us the geometric mean. Since anything raised to the power of 1 equals itself, we can say that our geometric mean equals the TWR in this case. We therefore have a geo-

metric mean of 1.003667853. If, however, we relaxed the constraint that each scenario must have a unique probability, then we could allow the sum of the probabilities of the scenarios to be greater than 1. In such a case, we would have to raise our TWR to the power of 1 divided by this sum of the probabilities in order to derive the geometric mean.

The answer we have just obtained in our example is our geometric mean corresponding to an f value of .01. Now we move on to an f value of .02, and repeat the whole process until we have found the geometric mean corresponding to an f value of .02. We keep on proceeding until we arrive at that value for f which yields the highest geometric mean.

In our example we find that the highest geometric mean is obtained at an f value of .57, which yields a geometric mean of 1.1106. Dividing our worst possible outcome to a scenario (-$500,000) by the negative optimal f yields a result of $877,192.35. In other words, if XYZ Corporation wants to commit to marketing this new product in this remote country, they will optimally commit this amount to this venture at ***this time.*** As time goes by and things develop, so do the scenarios, and as their resultant outcomes and •probabilities change, so does this f amount change. The more XYZ Corporation keeps abreast of these changing scenarios, and the more accurate the scenarios they develop as input are, the more accurate their decisions will be. Note that if XYZ Corporation cannot commit this $877,192.35 to this undertaking at this time, then they are too far beyond the peak of the f curve. It is the equivalent to the trader who has too many commodity contracts on with respect to what the optimal f says he or she should have on. If XYZ Corporation commits more than this amount to this project at this time, the situation would be analogous to a commodity trader with too few contracts on.

Furthermore, although the quantity discussed here is a quantity of money, it could be a quantity of anything and the technique would be just as valid. The approach can be used for any quantitative decision in an environment of favorable uncertainty.

If you create different scenarios for the stock market, the optimal f derived from this methodology will give you the correct percentage to be invested in the stock market at any given time. For instance, if the f returned is .65, then that means that 65% of your equity should be in the stock market with the remaining 35% in, say, cash. This approach will provide you with the greatest geometric growth of your capital in the long run. Of course, again, the output is only as accurate as the input you have provided the system with in terms of scenarios, their probabilities of occurrence, and resultant payoffs and costs. Furthermore, recall that everything said about optimal f applies here, and that also means that the expected drawdowns will approach a 100% equity retracement. If you exercise this scenario planning approach to asset allocation, you can expect close to 100% of the assets allocated to the endeavor in question to be depleted at any one time in the future. For example, suppose you arc using this technique to determine what percentage of investable funds should be in the stock market and what percentage should be in a risk-free asset. Assume that the answer is to have 65% invested in the stock market and the remaining 35% in the risk-free asset. You can expect the drawdowns in the future to approach 100% of the amount allocated to the stock market. In other words, you can expect to see, at some point in the future, almost 100% of your entire 65% allocated to the stock market to be gone. Yet this is how you will achieve maximum geometric growth.

This same process can be used as an alternative parametric technique for determining the optimal f for a given trade. Suppose you are making your trading decisions based on fundamentals. If you wanted to, you could outline the different scenarios that the trade may take. The more scenarios, and the more accurate the scenarios, the more accurate your results would be. Say you are looking to buy a municipal bond for income, but you're not planning on holding the bond to maturity. You could outline numerous different scenarios of how the future might unfold and use these scenarios to determine how much to invest in this particular bond issue.

This concept of using scenario planning to determine the optimal f can be used for everything from military strategies to deciding the optimal level to participate in an underwriting to the optimal down payment on a house.

For our purposes, this technique is perhaps the best technique, and certainly the easiest to employ for someone not using a mechanical means of entering and exiting the markets. Those who trade on fundamentals, weather patterns, Elliott waves, or any other approach that requires a degree of subjective judgment, can easily discern their optimal fs with this approach. This approach is easier than determining distributional parameter values.

The arithmetic average HPR of a group of scenarios can be computed as:

(4.18) $AHPR = (\sum[i = 1,N](1+(A_i/(W/-f)))*P_i)\sum[i = 1,N]P_i$

where

N = the number of scenarios.

f = the f value employed.

A_i = the outcome (gain or loss) associated with the ith scenario.

P_i = the probability associated with the ith scenario.

W = the most negative outcome of all the scenarios.

The AHPR will be important later in the text when we will need to discern the efficient frontier of numerous market systems. We will need to determine the expected return (arithmetic) of a given market system. This expected return is simply AHPR-1.

The technique need not be applied parametrically, as detailed here; it can also be applied empirically. In other words, we can take the trade listing of a given market system and use each of those trades as a scenario that might occur in the future, the profit or loss amount of the trade being the outcome result of the given scenario. Each scenario (trade) would have an equal probability of occurrence-1/N, where N is the total number of trades (scenarios). This will give us the optimal f empirically. This technique bridges the gap between the empirical and the parametric. There is not a fine line that delineates the two schools. As you can see, there is a gray area.

When we are presented with a decision where there is a different set of scenarios for each facet of the decision, selecting the scenario whose geometric mean corresponding to its optimal f is greatest will maximize our decision in an asymptotic sense. Often this flies in the face of conventional decision-making rules such as the Hutwicz rule, maximax, minimax, minimax regret, and greatest mathematical expectation.

For example, suppose we must decide between two possible choices. We could have many possible choices, but for the sake of simplicity we choose two, which we call "white" and "black." If we select the decision labeled "white," we determine that it will present the possible future scenarios to us:

White Decision

Scenario	Probability	Result
A	.3	-20
B	.4	0
C	.3	30

Mathematical expectation = $3.00
Optimal f = .17
Geometric mean = 1 .0123

It doesn't matter what these scenarios are, they can be anything, and to further illustrate this they will simply be assigned letters, A, B, C in this discussion. Further, it doesn't matter what the result is, it can be just about anything.

The Black decision will present the following scenarios:

Black Decision

Scenario	Probability	Result
A	.3	-10
B	.4	5
C	.15	6
D	.15	20

Mathematical expectation = $2.90
Optimal f = .31
Geometric mean = 1.0453

Many people would opt for the white decision, since it is the decision with the higher mathematical expectation. With the white decision you can expect, "on average," a $3.00 gain versus black's $2,90 gain. Yet the black decision is actually the correct decision, because it results in a greater geometric mean. With the black decision, you would expect to make 4.53% (1.0453-1) "on average" as opposed to white's 1.23% gain. When you Consider the effects of reinvestment, the black decision makes more than three times as much, on average, as does the white decision!

"Hold on, pal," you say. "We're not doing this thing over again, we're doing it only once. We're not reinvesting back into the same future scenarios here. Won't we come out ahead if we always select the highest

arithmetic mathematical expectation for each set of decisions that present themselves this way to us?"

The only time we want to be making decisions based on greatest arithmetic mathematical expectation is if we are planning on not reinvesting the money risked on the decision at hand. Since, in almost every case, the money risked on an event today will be risked again on a different event in the future, and money made or lost in the past affects what we have available to risk today (i.e., an environment of geometric consequences), we should decide based on geometric mean to maximize the long-run growth of our money. Even though the scenarios that present themselves tomorrow won't be the same as those of today, by always deciding based on greatest geometric mean we are maximizing our decisions. It is analogous to a dependent trials process such as a game of blackjack. Each hand the probabilities change, and therefore the optimal fraction to bet changes as well. By always betting what is optimal for that hand, however, we maximize our long-run growth. Remember that to maximize long-run growth, we ***must look at the current contest as one that expands infinitely into the future.*** In other words, we must look at each individual event ***as though we were to play it an infinite number of times over*** if we want to maximize growth over many plays of different contests.

As a generalization, whenever the outcome of an event has an effect on the outcome(s) of subsequent event(s) we are best off to maximize for greatest geometric expectation. In the rare cases where the outcome of an went has no effect on subsequent events, we are then best off to maximize for greatest arithmetic expectation. Mathematical expectation (arithmetic) does not take the variance between the outcomes of the different scenarios into account, and therefore can lead to incorrect decisions when reinvestment is considered, or in any environment of geometric consequences.

Using this method in scenario planning gets you quantitatively ***positioned*** with respect to the possible scenarios, their outcomes, and the likelihood of their occurrence. The method is inherently more ***conservative*** than positioning yourself per the greatest arithmetic mathematical expectation. equation (3.05) Allowed that the geometric mean is never greater than the arithmetic mean. Likewise, this method can never have you position yourself (have a greater commitment) than selecting by the greatest arithmetic mathematical expectation would. In the asymptotic sense, the long-run sense, this is not only a superior method of positioning yourself, as it achieves greatest geometric growth, it is also a more conservative one than positioning yourself per the greatest arithmetic mathematical expectation, which ***would invariably put you to the right of the peak*** of ***the f*** curve.

Since reinvestment is almost always a fact of life (except on the day before you retire[1]) - that is, you reuse the money that you are using today - we must make today's decision under the assumption that the same decision will present itself a thousand times over in order to maximize the results of our decision. We must make our decisions and position ourselves in order to maximize geometric expectation. Further, since the outcomes of most events do in fact have an effect on the outcomes of subsequent events, we should make our decisions and position ourselves based on maximum geometric expectation. This tends to lead to decisions and positions that arc not always apparently obvious.

OPTIMAL F ON BINNED DATA

Now we come to the case of finding the optimal f and its by-products on binned data. This approach is also something of a hybrid between the parametric and the empirical techniques. Essentially, the process is almost identical to the process of finding the optimal f on different scenarios, only rather than different payoffs for each bin (scenario), we use the midpoint of each bin. Therefore, for each bin we have an associated probability figured as the total number of elements (trades) in that bin divided by the total number of elements (trades) in all the bins. Further, for each bin we have an associated result of an element ending up in that bin. The associated results are calculated as the midpoint of each bin.

For example, suppose we have 3 bins of 10 trades. The first bin we will define as those trades where the P&L's were -$1,000 to -$100. Say there are 2 elements in this bin. The next bin, we say, is for those trades which are -$100 to $100. This bin has 5 trades in it. Lastly, the third bin has 3 trades in it and is for those trades that have P&L's of $100 to $1,000.

Bin	Bin	Trades	Associated Probability	Associated Result
-1,000	-100	2	.2	-550
- 100	100	5	.5	0
100	1,000	3	.3	550

Now it is simply a matter of solving for Equation (4.16), where each bin represents a different scenario. Thus, for the case of our S-bin example here, we find that our optimal f is at .2, or 1 contract for every $2,750 in equity (our worst-case loss being the midpoint of the first bin, or (-$1000+-$100)/2 = -$550).

This technique, though valid, is also very rough. To begin with, it assumes that the biggest loss is the midpoint of the worst bin. This is not always the case. Often it is helpful to make a single extra bin to hold the worst-case loss. As applied to our 3-bin example, suppose we had a trade that was a loss of $1,000. Such a trade would fall into the -$1,000 to -$100 bin, and would be recorded as -$550, the midpoint of the bin. Instead we can bin this same data as follows:

Bin	Bin	Trades	Associated Probability	Associated Result
-1,000	-1,000	1	.1	-1,000
-999	-100	1	.1	-550
-100	100	5	.5	0
100	1,000	3	.3	550

Now, the optimal f is .04, or 1 contract for every $25,000 in equity. Are you beginning to see how rough this technique is? So, although this technique ***will*** give us the optimal f for binned data, we can see that the loss of information involved in binning the data to begin with can make our results so inaccurate as to be useless. If we had more data points and more bins to start with, the technique would not be rough at all. In fact, if we had infinite data and an infinite number of bins, the technique would be exact. (Another way in which this method could be exact is if the data in each of the bins equaled the midpoints of their respective bins exactly.)

The other problem with this technique is that the average element in a bin is not necessarily the midpoint of the bin. In fact, the average of the elements in a bin will tend to be closer to the mode of the entire distribution than the midpoint of the bin is. Hence, the dispersion tends to be greater with this technique than is the real case. There are ways to correct for this, but these corrections themselves can often be incorrect, depending upon the shape of the distribution. Again, this problem would be alleviated and the results would be exact if we had an infinite number of elements (trades) and an infinite number of bins.

If you happen to have a large enough number of trades and a large enough number of bins, you can use this technique with a fair degree of accuracy if you so desire. You can do "What if" types of simulations by altering the number of elements in the various bins and get a fair approximation for the effects of such changes.

WHICH IS THE BEST OPTIMAL F?

We have now seen that we can find our optimal f from an empirical procedure as well as from a number of different parametric procedures for both binned and unbinned data. Further, we have seen that we can equalize the data as a means of preprocessing, to find what our optimal f should be if all trades occurred at the present underlying price. At this point you are probably asking for the real optimal f to please stand up. Which optimal f is really optimal?

For starters, the straight (nonequalized) empirical optimal f will give you the optimal f on past data. Using the empirical optimal f technique detailed in Chapter 1 and in ***Portfolio Management Formulas*** will yield the optimal f that would have realized the greatest geometric growth on a ***past*** stream of outcomes. However, we want to discern what the value for this optimal f will be in the future (specifically, over the next trade), considering that we are absent knowledge regarding the outcome of the

[1] There are certain tines when you will want to maximize for greatest arithmetic mathematical expectation instead of geometric, Such a case is when an entity is operating in a "constant-contract" kind or way and wants to switch over to a "fixed fractional" mode of operating at some favorable point in the future. This favorable point can be determined as the geometric threshold where the arithmetic average trade that is used as input is calculated as the arithmetic mathematical expectation (the sum of the outcome of each scenario times its probability of occurrence) divided by (he sum of the probabilities of all of the scenarios. Since the sum of the probabilities of all of the scenarios usually equals 1, we can state that the arithmetic average "trade" is equal to the arithmetic mathematical expectation.

next trade. We do not know whether it will be a profit, in which case the optimal f would be 1, or a loss, in which case the optimal f would be 0. Rather, we can only express the outcome of the next trade as an ***estimate of the probability distribution of outcomes for the next trade.*** That being said, our best estimate for traders employing a mechanical system, is most likely to be obtained by using the parametric technique on our adjustable distribution function as detailed in this chapter on either equalized or nonequalized data. If there is a material difference in using equalized versus nonequalized data, then there is most likely too much data, or not enough data at the present price level. For non-system traders, the scenario planning approach is the easiest to employ accurately. In my opinion, these techniques will result in the best estimate of the probability distribution of outcomes on the next trade.

You now have a good conception of both the empirical and parametric techniques, as well as some hybrid techniques for finding the optimal f. In the next chapter, we consider finding the optimal j (parametrically) when more than one position is running concurrently.

Chapter 5 - Introduction to Multiple Simultaneous Positions under the Parametric Approach

Mention has already been made in this text of the idea of using options, either by themselves or in conjunction with a position in the underlying, to improve returns. Buying a long put in conjunction with a long position in the underlying (or simply buying a call in lieu of both), or sometimes even writing (setting short) a call in conjunction with a long position in the underlying can increase asymptotic geometric growth. This happens as the result of incorporating the options into the position, which then often (but not always) reduces dispersion to a greater degree than it reduces arithmetic average return. Per the fundamental equation of trading, this then results in a greater estimated TWR.

Options can be used in a variety of ways, both among themselves and in conjunction with positions in the underlying, to manage risk. In the future, as traders concentrate more and more on risk management, options will very likely play an ever greater role.

Portfolio Management Formulas discussed the relationship of optimal j and options.[1] In this chapter we pick up on that discussion and Carry it further into an introduction of multiple simultaneous positions, especially with regard to options.

This chapter gives us another method for finding the optimal f s for positions that are not entered and exited by using a mechanical system. The parametric techniques discussed thus far could be utilized by someone not trading by means of a mechanical system, but aside from the scenario planning approach, they still have some rough edges. For example, someone not using a mechanical system who was using the technique described in Chapter 4 would need an estimate of the kurtosis of his or her trades. This may not be too easy to come by (at least, an accurate estimate of this may not be readily available). Therefore, this chapter is for those who are using purely nonmechanical means of entering and exiting their trades. Users of these techniques will not need parameter estimates for the distribution of trades. However, they will need parameter estimates for both the volatility of the underlying instrument and the trader's forecast for the price of the underlying instrument. For a trader not utilizing a mechanical, objective system, these parameters are for easier to come by than parameter estimates for the distribution of trades that have not yet occurred.

This discussion of optimal f and its by-products for those traders not utilizing a mechanical, objective system comes at a convenient stage in the book, as it is the perfect entree for multiple simultaneous positions. Does this mean that someone who is using a mechanical means to enter and exit trades cannot engage in multiple simultaneous positions? No. Chapter 6 will show us a method for finding optimal multiple simultaneous positions for traders whether they are using a mechanical system or not. This chapter introduces the concept of multiple simultaneous positions, but the standpoint is that of someone not using a mechanical system, and possibly using options as well as the underlying instruments.

ESTIMATING VOLATILITY

One important parameter a trader wishing to use the following concepts must input is volatility. We discuss two ways to determine volatility. The first is to use the estimate that has been determined by the marketplace. This is called ***implied volatility.*** The option valuation models introduced in this chapter use volatility as one of their inputs to derive the fair theoretical price of an option. Implied volatility is determined by assuming that the market price of an option is equivalent to its fair theoretical price. Solving for the volatility value that yields a fair theoretical price equal to the market price determines the implied volatility. This value for volatility is arrived at by iteration.

The second method of estimating volatility is to use what is known as ***historical volatility,*** which is determined by the actual price changes in the underlying instrument. Although volatility as input to the options pricing models is an annualized figure, a much shorter period of time, usually 10 to 20 days, is used when determining historical volatility and the resulting answer is annualized.

Here is how to calculate a 20-day annualized historical volatility.

Step 1 Divide tonight's close by the previous market day's close.

Step 2 Take the natural log of the quotient obtained in step 1. Thus, for the March 1991 Japanese yen on the night of 910225 (this is known as YYMMDD format for February 25, 1991), we take the close of 74.82 and divide it by the 910222 close of 75.52:

74.82/75.52 = .9907309322

We then take the natural log of this answer. Since the natural log of .9907309322 is -.009312258, our answer to step 2 is -.009312258.

Step 3 After 21 days of back data have elapsed, you will have 20 values for step 2. Now you can start running a 20-day moving average to the answers from step 2.

Step 4 You now want to run a 20-day sample variance for the data from step 2. For a 20-day variance you must first determine the moving average for the last 20 days. This was done in step 3. Then, for each day of the last 20 days, you take the difference between today's moving average, and that day's answer to step 2. In other words, for each of the last 20 days you will subtract the moving average from that day's answer to step 2. Now, you square this difference (multiply it by itself). In so doing, you convert all negative answers to positives so that all answers are now positive. Once that is done, you add up all of these positive differences for the last 20 days. Finally, you divide this sum by 19, and the result is your sample variance for the last 20 days.

The following spreadsheet will show how to find the 20-day sample variance for the March 1991 Japanese yen for a single day, 901226 (December 26, 1990):

A Date	B Close	C LN Change	D 20-Day Average	E Col C-(-.0029)	F Col E Squared	G Sum of Last20 Values of Col F	H Col G Divided by 19
901127	77.96						
901128	76.91	-9.0136		-0.0107	0.000113		
901129	74.93	-0.0261		-0.0232	0.000537		
901130	75.37	0.0059		0.0088	0.000076		
901203	74.18	-0.0159		-0.0130	0.000169		
901204	74.72	0.0073		0.0102	0.000103		
901205	74.57	-0.0020		0.0009	0.000000		
901206	75.42	0.0113		0.0142	0.000202		
901207	76.44	0.0134		0.0163	0.000266		
901210	75.54	-0.0118		-0.0089	0.000079		
901211	75.37	-0.0023		0.0006	0.000000		
901212	75.9	0.0070		0.0099	0.000098		
901213	75.57	-0.0044		-0.0015	0.000002		
901214	75.08	-0.0065		-0.0036	0.000012		
901217	75.11	0.0004		0.0033	0.000010		
901218	74.99	-0.0016		0.0013	0.000001		
901219	74.52	-0.0063		-0.0034	0.000011		
901220	74.06	-0.0062		-0.0033	0.000010		
901221	73.91	-0.0020		0.0009	0.000000		
901224	73.49	-0.0057		-0.0028	0.000007		
901226	73.5	0.0001	-.0029	0.0030	0.000009	.001716	.000090

As you can see, the 20-day sample variance for 901226 is .00009. You need to do this for every day so that you will have determined the 20-day sample variance for every single day.

Step 5 Once you have determined the 20-day sample variance for every single day, you must convert this into a 20-day sample standard deviation. This is easily accomplished by taking the square root of the variance for each day. Thus, for 901226, taking the square root of the variance (which was shown to be .00009) gives us a 20-day sample standard deviation of .009486832981.

Step 6 Now we must "annualize" the data. Since we are using daily data, and we'll suppose that there are 252 trading days in the yen per year (approximately), we must multiply the answers from step ***5*** by the square root of 252, or 15.87450787. Thus, for 901226, the 20-day sample standard deviation is ,009486832981, and multiplying by 15.87450787 gives us an answer of .1505988048. This answer is th***e*** historical volatility-in this case, 15.06%-and can be used as the volatility input to the Black-Scholes option pricing model.

[1] There were some minor formulative problems with the options material in Portfolio management Formulas, These have since been resolved, and the corrected formulations are presented here. My apologies for whatever confusion this may have caused.

The following spreadsheet shows how to go through the steps to get to this 20-day annualized historical volatility. You will notice that the interim steps in determining variance for a given day, which were detailed on the previous spreadsheet, are not on this one. This was done in order for you to see the whole process. Therefore, bear in mind that the variance column in this following spreadsheet is determined for each row exactly as in the previous spreadsheet.

A DATE	B CLOSE	C LN Change	D 20-Day Average	E 20-Day Variance	F 20-Day SD	G Annualized*15.8745 1
901127	77.96					
901128	76.91	-0.0136				
901129	74.93	-0.0261				
901130	75.37	0.0059				
961203	74.18	-0.0159				
901204	74.72	0.0073				
901205	74.57	-0.0020				
901206	75.42	0.0113				
901207	76.44	0.0134				
901210	75.54	-0.0118				
901211	75.37	-0.0023				
961212	75.9	0.0070				
961213	75.57	-0.0044				
901214	75.08	-0.0065				
961217	75.11	0.0004				
901218	74.99	-0.0016				
901219	74.52	-0.0063				
901220	74.06	-0.0062				
901221	73.91	-0.0020				
901224	73.49	-0.0057				
901226	73.5	0.0001	-0.0029	0.0001	0.0095	0.1508
901227	73.34	-0.0022	-0.0024	0.0001	0.0092	0.1460
901 228	74.07	0.0099	-0.0006	0.0001	0.0077	0.1222
901231	73.84	-0.0031	-0.0010	0.0001	0.0076	0.1206

RUIN, RISK AND REALITY

Recall the following axiom from the Introduction to this text: ***if you play a game with unlimited liability, you will go broke with a probability that approaches certainty as the length of the game approaches infinity***. What constitutes a game with unlimited liability? The answer is a distribution of outcomes where the left tail (the adverse outcomes) is unbounded and goes to minus infinity. Long option positions allow us to bound the adverse tail of the distribution of outcomes.

You may take issue with this axiom. It seems irreconcilable that the risk of ruin be less than 1 (i.e., ruin is not certain), yet I contend that in trading an instrument with unlimited liability on any given trade, ruin is certain. In other words, my contention here is that if you trade anything other than options and you are looking at trading for an ***infinite*** length of time, your real risk of ruin is 1. Ruin is certain under such conditions. This can be reconciled with risk-of-ruin equations in that equations used for risk of ruin use empirical data as input. That is, the input to risk-of-ruin equations comes from ***a finite sample*** of trades. My contention of certain ruin for playing an infinitely long game with unlimited liability on any given trade is derived from a parametric standpoint. The parametric standpoint encompasses the large losing trades, those trades way out on the left tail of the distribution, which have not yet occurred and are therefore not a part of the finite sample used as input into the risk-of-rum equations.

To picture this, assume for a moment a trading system being performed under constant-contract trading. Each trade taken is taken with only 1 contract. To plot out where we would expect the equity to be X trades into the future, we simply multiply X by the average trade. Thus, if our system has an average trade of $250, and we want to know where we can expect our equity to be, say, 7 trades into the future, we can determine this as $250*7 = $1,750. Notice that this line of arithmetic mathematical expectation is a straight-line function.

Now, on any given trade, a certain amount can be lost, thus dropping us down (temporarily) from this expected line. In this hypothetical situation we have a limit to what we can lose on any given trade. Since our line is always higher than the most we can lose on a given trade, we cannot be ruined on one trade. However, a prolonged losing streak could drop us far enough down from this line that we could not continue to trade, hence we would be "ruined." The probability of this diminishes as more trades elapse, as the line of expectation gets higher and higher. A risk-of-ruin equation can tell us what the probability of ruin is before we start out trading this system.

If we were trading this system on a fixed fractional basis, the line would curve upward, getting steeper and steeper with each elapsed trade. However, the amount we could drop off of this line is always commensurate with how high we are on the line. That is, the probability of ruin does not diminish as more and more trades elapse. In theory, though, the risk of ruin in fixed fractional trading is zero, because we can trade in infinitely divisible units. In real life this is not necessarily so. In real life, the risk of ruin in fixed fractional trading is always a little higher than in the same system under constant-contract trading.

In reality, there is no limit on how much you can lose on any given trade.

In reality, the equity expectation lines we are talking about can be retraced completely in one trade, regardless of how high they are. Thus, the risk of ruin, if we are to trade for an infinitely long period of time in an instrument with unlimited liability, regardless of whether we are trading on a constant-contract or a fixed fractional basis, is 1. Ruin is certain. The only way to defuse this is to be able to put a cap on the maximum loss. This can be accomplished by trading options where the position is initiated at a debit.[2]

OPTION PRICING MODELS

Imagine an underlying instrument (it can be a stock, bond, foreign currency, commodity, or anything else) that can trade up or down by 1 tick on the next trade. If, say, we measure where this stock will be 100 ticks down the road, and if we do this over and over, we will find that the distribution of outcomes is Normal. This, per Galton's board, is as we would expect it to be.

If we then figured the price of the option based on this principle such that you could not make a profit by buying these options, or by selling them short, we would have arrived at the ***Binomial Option Pricing Model*** (Binomial Model or Binomial). This is sometimes also called the ***Cox-Ross-Rubenstein model*** after those who devised it. Such an option price is based on its expected value (its arithmetic mathematical expectation), since you cannot make a profit by either buying these options repeatedly and holding them to expiration or selling them repeatedly and holding the position till expiration, losing on some and winning on others but netting out a profit in the end. Thus, the option is said to ***be fairly priced.***

We will not cover the specific mathematics of the Binomial Model. Rather, we till cover the mathematics of the Black-Scholes Stock Option Model and the Black Futures Option Model. You should be aware that, inside from these three models, there are other valid options pricing models which will not be covered here either, although the concepts discussed in this chapter apply to all options pricing models. Finally, the best reference I know of regarding the mathematics of options pricing models is ***Option Volatility and Pricing Strategies*** by Sheldon Natenberg. Natenberg's book covers the mathematics for many of the options pricing models (including the Binomial Model) in great detail. The math for the Black-Scholes Stock Option Model and the Black Futures Option Model, which we are about to discuss, comes from Natenberg. These topics take an entire text to discuss, more space than we have here. Those readers who want to pursue the concepts of optimal f and options are referred to Natenberg for foundational material regarding options.

We must cover pricing models on a level sufficient to work the optimal f techniques about to be discussed on option prices. Therefore, we will now discuss the Black-Scholes Stock Option Pricing Model (hereafter, Black-Scholes). This model is named after those who devised it, Fischer Black at the University of Chicago and Myron Scholes at M.I.T., and appeared in the May-June 1973 ***Journal of Political Economy.*** Black-Scholes is considered the limiting form of the Binomial Model (hereafter, Binomial). In other words, with the Binomial, you must determine how many up or down ticks you are going to use before

[2] We will see later in this chapter that underlying instruments are identical to call options with infinite time till expiration. Therefore, if we are long the underlying installment we can assume that our worst-case loss is the full value of the instrument. In many cases, this can be regarded in a loss of such magnitude as to be synonymous with a cataclysmic loss. However, being short the underlying instrument is analogous to being short a call option with infinite time remaining of expiration, and liability is truly unlimited in such a situation.

you record where the price might end up. The following little diagram shows the idea.

```
                    /
                   /\
                  /\/
                 /\/\
                /\/\/
               /\/\/\
Initial Price /\/\/\/\
              \/\/\/\/
               \/\/\/
                \/\/\
                 \/\/
                  \/\
                   \/
                    \
```

Here, you start out at an initial price, where price can branch off in 2 directions for the next period. The period after that, there are 4 directions that the price might end up. Ultimately, with the Binomial you must determine in advance how many periods in total you are going to use to figure the fair price of the option on.

Black-Scholes is considered the limiting form of the Binomial because it assumes an infinite number of periods (in theory). That is, Black-Scholes assumes that this little diagram will keep on branching out and to the right infinitely. If you determine an option's fair price via Black-Scholes, then you will tend toward the same answer with the Binomial as the number of periods used in the Binomial tends toward infinity. (The fact that Black-Scholes is the limiting form of the Binomial would imply that the Binomial Model appeared first. Oddly enough, the Black-Scholes model appeared first.)

The mathematics of Black-Scholes are quite straightforward. The fair value of a call on a stock option is given as:

(5.01) C = U*EXP(-R*T)*N(H)-E*EXP(-R*T)*N(H-V*T^(1/2))

and for a put:

(5.02) P = -U*EXP(-R*T)*N(-H)+E*EXP(-R*T)*N(V*T^(l/2)-H)

where

C = The fair value of a call option.

P = The fair value of a put option.

U = The price of the underlying instrument.

E = The exercise price of the option.

T = Decimal fraction of the year left to expiration.[3]

V = The annual volatility in percent.

R = The risk-free rate.

ln() = The natural logarithm function.

N() = The cumulative Normal density function, as given in Equation (3.21).

(5.03) H = ln(U/(E*EXP(-R*T)))/(V*T^(l/2))+(V*T^(l/2))/2

For stocks that pay dividends, you must adjust the variable U to reflect the current price of the underlying minus the present value of the expected dividends:

(5.04) U = U-∑[i = 1,N] D_i*EXP(-R*W_i)

where

D_i = The ith expected dividend payout.

W_i = The time (decimal fraction of a year) to the ith payout.

One of the very nice things about the Black-Scholes Model is the exact calculation of the delta, the first derivative of the price of the option. This is the option's instantaneous rate of change with respect to a change in U, the price of the underlying:

(5.05) Call Delta = N(H)

(5.06) Put Delta = -N(-H)

These deltas become quite important in Chapter 7, when we discuss portfolio insurance.

Black went on to make the model applicable to futures options, which have a stock-type settlement.[4] The Black futures option pricing model is the same as the Black-Scholes stock option pricing model except for the variable H:

(5.07) H = ln(U/E)/(V*T^(1/2))+(V*T^(l/2))/2

The only other difference in the futures model is the deltas, which are:

(5.08) Call Delta = EXP(-R*T)*N(H)

(5.09) Put Delta = -EXP(-R*T)*N(-H)

For example, suppose we are looking at a futures option that has a strike price of 600, a current market price of 575 on the underlying, and an annual volatility of 25%. We will use the commodity options model, a 252-day year, and a risk-free rate of 0 for simplicity. Further, we will assume that the expiration day of the options is September 15, 1991 (910915), and that the day on which we are observing these options is August 1, 1991 (910801).

To begin with, we will calculate the variable T, the decimal fraction of the year left to expiration. First, we must convert both 910801 and 910915 to their Julian day equivalents. To do this, we must use the following algorithm.

1. Set variable 1 equal to the year (1991), variable 2 equal to the month (8) and variable 3 equal to the day (1).
2. If variable 2 is less than 3 (i.e., the month is January or February) then set variable 1 equal to the year minus 1 and set variable 2 equal to the month plus 13.
3. If variable 2 is greater than 2 (i.e., the month is March or after) then set variable 2 equal to the month plus 1.
4. Set variable 4 equal to variable 3 plus 1720995 plus the integer of the quantity 365.25 times variable 1 plus the integer of the quantity 30.6001 times variable 2. Mathematically:

V4 = V3+1720995+INT(365.25*V1)+INT(30.6001*V2)

5. Set variable 5 equal to the integer of the quantity .01 times variable 1: Mathematically:

V5 = INT(.01*V1)

Now to obtain the Julian date as variable 4 plus 2 minus variable 5 plus the integer of the quantity .25 times variable 5. Mathematically:

JULIAN DATE = V4+2-V5+INT(.25*V5)

So to convert our date of 910801 to Julian:

Step 1 V1 = 1991, V2 = 8, V3 = 1

Step 2 Since it is later in the year than January or February, this step does not apply.

Step 3 Since it is later in the year than January or February, this step does apply. Therefore V2 = 8+1 = 9.

Step 4 Now we set V4 as:

V4 = V3+1720995+INT(365.25*V1)+INT(30.6001*V2)

= 1+1720995+INT(365.25*1991)+INT(30.6001*9)

= 1+1720995+INT(727212.75)+INT(275.4009)

= 1+1720995+727212+275

= 2448483

Step 5 Now we set V5 as:

V5 = INT(.01*V1)

= INT(.01*1991)

= INT(19.91)

= 19

Step 6 Now we obtain the Julian date as:

JULIAN DATE = V4+2-V5+INT(.25*V5)

[3] Most often, only market days are used in calculating the fraction of a year in options. The number of weekdays in a year (Gregorian) can be determined as 365.2425/7*5 = 260.8875 weekdays on average per year. Due to holidays, the actual number of trading days in a year is usually somewhere between 250 and 252. Therefore, if we are using a 252-trading-day year, and there are 50 trading days left to expiration, the decimal fraction of the year left to expiration, T, would be 50/252 = .1984126984.

[4] Futures-type settlement requires no initial cash payment, although the required margin must be posted. Additionally, all profits and losses are realized immediately, even if the position is not liquidated. These points are in direct contrast to stock-type settlement. In stock-type settlement, purchase requires full and immediate payment, and profits (or losses) are not realized until the position is liquidated.

= 2448483+2-19+INT(.25*19)

= 2448483+2-19+INT(4.75)

= 2448483+2-19+4

= 2448470

Thus, we can state that the Julian date for August 1, 1991, is 2448470. Now if we convert the expiration date of September 15, 1991 to Julian, we would obtain a Julian date of 2448515.

If we were using a 365 day year (or 365.2425, the Gregorian Calendar length), we could find the time left until expiration by simply taking the difference between these two Julian dates, subtracting 1 and dividing the sum by 365 (or 365.2425).

However, we are not using a 365 day year; rather we are using a 252-day year, as we are only counting days when the exchange is open (weekdays less holidays). Here is how we account for this. We must examine each day between the two Julian dates to see if it is a weekend. We can determine what day of the week a given Julian date is by adding 1 to the Julian date, dividing by 7, and taking the remainder (the modulus operation). The remainder will be a value of 0 through 6, corresponding to Sunday through Saturday. Thus, for August 1, 1991, where the Julian date is 2448470:

Day of week = ((2448470+l)/7) % 7

= 2448471/ % 7

= ((2448471/7)-INT(2448471/7))*7

= (349781.5714-349781)*7

= .5714*7

= 4

Since 4 corresponds to Thursday, we can state that August 1, 1991 is a Thursday.

We now proceed through each Julian date up to and including the expiration date. We count up all of the weekdays in between those two dates and find that there are 32 weekdays in between (and including) August 1, 1991 and September 15, 1991. From our final answer we must subtract 1, as we count day one when August 2, 1991 arrives. Therefore, we have 31 weekdays between 910801 and 910915.

Now we must subtract holidays, when the exchange is closed. Monday September 2, 1991, is Labor Day in the United States. Even though we may not live in the United States, the exchange where this particular option is traded on, being in the United States, will be closed on September 2, and therefore we must subtract 1 from our count of days. Therefore, we determine that we have 30 "tradeable" days before expiration.

Now we divide the number of tradeable days before expiration by the length of what we have determined the year to be. Since we are using a 252 day year, we divide 30 by 252 to obtain .119047619. This is the decimal fraction of the year left to expiration, the variable T.

Next, we must determine the variable H for the pricing model. Since we are using the futures model, we must calculate H as in Equation (5.07):

(5.07) H = ln(U/E)/(V*T^(1/2))+(V*T^(l/2))/2

= ln(575/600)/(.25*.119047619^(1/2))+(.25*.119047619 ^ (l/2))/2

= ln(575/600)/(.25*.119047619^.5)+(.25*.119047619^.5)/2

= ln(575/600)/(.25*.3450327796)+(.25*.3450327796)/2

= ln(575/600)/.0862581949+.0862581949/2

= ln(.9583333)/.0862581949+.0862581949/2

= .04255961442/.0862581949+.0862581949/2

= -.4933979255+.0862581949/2

= -.4933979255+.04312909745

= -.4502688281

In Equation (5.01) you will notice that we need to use Equation (3.21) on two occasions. The first is where we set the variable Z in Equation (3.01) to the variable H as we have just calculated it; the second is where we set it to the expression H-V*T^(1/2). We know that V*T^(1/2) is equal to .0862581949 from the last expression, so H-V*T^(1/2) equals -.4502688281-.0862581949 = -.536527023. We therefore must use Equation (3.21) with the input variable Z as -.4502688281 and -.536527023. Prom Equation (3.21), this yields .3262583 and .2957971 respectively (Equation (3.21) has been demonstrated in Chapter 3, so we need not repeat it here). Notice, however, that we have now obtained the delta, the instantaneous rate of change of the price of the option with respect to the price of the underlying. The delta is N(H), or the variable H pumped through as Z in Equation (3.21). Our delta for this option is there-fore .3262583.

We now have all of the inputs required to determine the theoretical option price. Plugging our values into Equation (5.01):

(5.01) C = U*EXP(-R*T)*N(H)-E*EXP(-R*T)*N(H-V *T^(1/2))

= 575*EXP(-0*.119047619)*N(-.4502688281)-600*EXP(-0*.119047619)*N(-.4502688281-.25*.119047619^(1/2))

= 575*EXP(-0*.119047619)*.3262583-600*EXP(-0*.119047619)*.2957971

= 575*EXP(0)*.3262583-600*EXP(0)*.2957971

= 575*1*.3262583-600*1*.2957971

= 575*.3262583-600*.2957971

= 187.5985225-177.47826

= 10.1202625

Thus, the fair price of the 600 call option that expires September 15, 1991, with the underlying at 575 on August 1, 1991, with volatility at 25%, and using a 252-day year and the Black futures model with R = 0, is 10.1202625.

It is interesting to note the relationship between options and their underlying instruments by using these pricing models. We know that 0 is the limiting downside price of an option, but on the upside the limiting price is the price of the underlying instrument itself. The models demonstrate this in that the theoretical fair price of an option approaches its upside limiting value of the value of the underlying, U, if any or all three of the variables T, R, or V are increased. This would mean, for instance, that if we increased T, the time till expiration of the option, to an infinitely high amount, then the price of the option would equal that of the underlying instrument. In this regard, we can state that ***all underlying instruments are really the same as options, only with infinite*** T. Thus, what follows in this discussion is not only true of options, it can likewise be said to be true of the underlying as though it were an option with infinite T.

Both the Black-Scholes stock option model and the Black futures model are based on certain assumptions. The developers of these models were aware of these assumptions and so should you be. Nonetheless, despite whatever shortcomings are involved in the assumptions, these models are still very accurate, and option prices will tend to these models' values.

The first of these assumptions is that the option cannot be exercised until the exercise date. This ***European style*** options settlement tends to underprice certain options as compared to the ***American style,*** where the options can be exercised at any time. Some of the other assumptions in this model are that we actually know the future volatility of the underlying instrument and that it will remain constant throughout the life of the option. Not only will this not happen (i.e., the volatility ***will*** change), but the distribution of volatility changes is lognormal, an issue that the models do not address.[5] Another issue that the models assume is that the risk-free interest rate will remain constant throughout the life of an option. This also Is unlikely. Furthermore, short-term rates appear to be lognormally distributed. Since the higher the short-term rates are the higher the resultant option prices will be, this assumption regarding short-term rates being constant may further undervalue the fair price of the option (the price returned by the models) relative to the expected value (its true arithmetic mathematical expectation).

Finally, another point (perhaps the most important point) that might undervalue the model-generated fair value of the option relative to the true expected value regards the assumption that the logs of price changes are normally distributed. If rather than having a time frame in which they expired, options had a given number of up and down ticks before they expired, and could only change by 1 tick at a time, and if each tick was statistically independent of the last tick, we could rightly make this assumption of Normality. The logs of price changes, however, do not have these clean characteristics.

[5] The fact that the distribution of volatility changes is lognormal is not a very widely considered fact. In light of how extremely sensitive option prices are to the volatility of the underlying instrument, this certainly makes the prospect of buying a long Option (put Or call) more appealing in terms of mathematical expectation.

All of these assumptions made by the pricing models aside, the theoretical fair prices returned by the models are monitored by professionals in the marketplace. Even though many are using models that differ from these detailed here, most models return similar theoretical fair prices. When actual prices diverge from the models to the extent that an arbitrageur has a profit opportunity, they will begin to again converge to what the models claim is the theoretical fair price. This fact, that we can predict with a fair degree of accuracy what the price of an option will be given the various inputs (time to expiration, price of the underlying instrument, etc.) allows us to perform the exercises regarding optimal f and its by-products on options and mixed positions. The reader should bear in mind that all of these techniques are based on the assumptions just noted about the options pricing models themselves.

A EUROPEAN OPTIONS PRICING MODEL FOR ALL DISTRIBUTIONS

We can create our own pricing model devoid of any assumptions regarding the distribution of price changes.

First, the term "theoretically fair" needs to be defined when referring to an options price. This definition is given as the ***arithmetic mathematical expectation of the option at expiration, expressed in terms of-its present worth,*** assuming no directional bias in the underlying. This is our options pricing model in literal terms. The frame of reference employed here is 'What is this option worth to me today as an options buyer?"

In mathematical terms, recall that the mathematical expectation (arithmetic) is defined as Equation (1.03):

(1.03) Mathematical expectation = $\sum[i = 1,N] (p_i*a_i)$

where

p = Probability of winning or losing the ith trial.

a = Amount won or lost on the ith trial.

N = Number of possible outcomes (trials).

The mathematical expectation is computed by multiplying each possible gain or loss by the probability of that gain or loss and then summing these products. When the sum of the probabilities, the pi terms, is greater than 1, Equation 1,03 must then be divided by the sum of the probabilities, the pi terms.

In a nutshell, our options pricing model will take all those discrete price increments that have a probability greater than or equal to .001 of occurring at expiration and determine an arithmetic mathematical expectation on them.

(5.10) $C = \sum(p_i*a_i)/\sum p_i$

where

C = The theoretically fair value of an option, or an arithmetic mathematical expectation.

p_i = The probability of being at price i on expiration.

a_i = The intrinsic value associated with the underlying instrument being at price i.

In using this model, we first begin at the current price and work up I tick at a time, summing the values in both the numerator and denominator until the price, i, has a probability, pi, less than .001 (you can use a value less than this, but I find .001 to be a good value to use; it implies finding a fair value assuming you are going to have 1,000 option trades in your lifetime). Then, starting at that value which is 1 tick below the current price, we work down 1 tick at a time, summing values for both the numerator and denominator until the price, i, results in a probability, pi, less than .001. Note that the probabilities we are using are 1-tailed probabilities, where if a probability is greater than .5, we are subtracting the probability from 1.

Of interest to note is that the pi terms, the probabilities, can be discerned by whatever distribution the user feels is applicable, not just the Normal. That is, the user can derive a theoretically fair value of an option for ***any*** distributional form! Thus, this model frees us to use the stable Paretian, Student's t, Poisson, our own adjustable distribution, or any other distribution we feel price conforms to in determining fair options values.

We still need to amend the model to express the arithmetic mathematical expectation at expiration as a present value:

(5.11) $C = (\sum (p_i*a_i)*EXP(-R*T))/ \sum p_i$

where

C = The theoretically fair value of an option, or the present value of the arithmetic mathematical expectation at time T.

p_i = The probability of being at price i on expiration.

a_i = The intrinsic value associated with the underlying instrument being at price i.

R = The current risk-free rate.

T = Decimal fraction of a year remaining till expiration.

Equation (5.11) is the options pricing model for all distributions, returning the present worth of the arithmetic mathematical expectation of the option at expiration.[6] Note that the model can be used for put values as well, the only difference being in discerning the intrinsic values, the a_i terms, at each price increment, i.

When dividends are involved, Equation (5.04) should be employed to adjust the current price of the underlying by. Then this adjusted current price is used in determining the probabilities associated with being at a given price, i, at expiration.

An example of using Equation (5.11) is as follows. Suppose we determine that the Student's t distribution is a good model of the distribution of the log of price changes[7] for a hypothetical commodity that we are considering buying options on. Now we use the K-S test to determine the best-fitting parameter value for the ***degrees of freedom*** parameter of the Student's t distribution. We will assume that 5 degrees of freedom provides for the best fit to the actual data per the K-S test.

We will assume that we are discerning the fair price for a call option on 911104 that expires 911220, where the price of the underlying is 100 and the strike price is 100. We will assume an annualized volatility of 20%, a risk-free rate of 5%, and a 260.8875-day year (the average number of weekdays in a year; we therefore ignore holidays that fall on a weekday, for example, Thanksgiving in the United States). Further, we will assume that the minimum tick that this hypothetical commodity can trade in is .10.

If we perform Equations (5.01) and (5.02) using (5.07) for the variable II, we obtain fair values of 2.861 for both the 100 call and 100 put. These options prices are thus the fair values according to the Black commodity options model, which assumes a lognormal distribution of prices. If, however, we use Equation (5.11), we must figure the p_i terms. These we obtain from the snippet of BASIC code in Appendix B. Note that the snippet of code requires a standard value, given the variable name Z, and the degrees of freedom, given the variable name DEGFDM. Before we call this snippet of code we can convert the price, i, to a standard value by the following formula:

(5.12) Z = ln(i/current underlying price)/(V*T^.5)

where

i = The price associated with the current status of the summation process.

V = The annualized volatility as a standard deviation.

T = Decimal fraction of a year remaining till expiration.

ln() = The natural logarithm function.

Equation (5.12) can be expressed in BASIC as:

```
Z = LOG(I/U)/(V*T^.5)
```

[6] Notice that Equation (5.11) does not differentiate stock from commodity options. Conventional thinking has it that, embedded in the price of a stock option, is the interest on a pure discount bond that matures at expiration with a face value equal to the strike price. Commodity options, it is believed, see an interest rate of 0 on this, so it is as if they do not have it. From our frame of reference-that is, "What is this option worth to me today as an options buyer?"-we disregard this. If both a stock and a commodity have exactly the same expected distribution of outcomes, their arithmetic mathematical expectations are the same, and the rational investor would opt for buying the less expensive. This situation is analogous to someone considering buying One of two identical houses where one is priced higher because the seller has paid a higher interest rate on the mortgage.

[7] The Student's t distribution is generally a poor model of the distribution of price changes. However, since the only other parameter, aside from volatility as an annualized standard deviation, which needs to be considered in using the Student's t distribution, is the degrees of freedom, and since the probabilities associated with the Student's t distribution are easily ascertained by the snippet of Basic code in Appendix B, we will use the Student's t distribution here for the sake of simplicity and demonstration.

The variable U represents the current underlying price (adjusted for dividends, if necessary).

Lastly, once we have obtained a probability from the Student's t distribution BASIC code snippet in Appendix B, the probability returned is a 2-tailed one. We need to make it a 1-tailed probability and express it as a probability of deviating from the current price (i.e., bound it between 0 and .5). These two procedures are performed by the following two lines of BASIC:

CF = 1-((1- CF)/2) IF CF >.5 then CF = 1-CF

Doing this with the option parameters we have specified, and 5 degrees of freedom, yields a fair call option value of 3.842 and a fair put value of 2.562. These values differ considerably from the more conventional models for a number of reasons.

First, the fatter tails of the Student's t distribution with 5 degrees of freedom will make for a higher fair call value. Generally, the thicker the tails of the distribution used, the greater the call value returned. Had we used 4 degrees of freedom, we would have obtained an even greater fair call value.

Second, the put value and the call value differ substantially, whereas with the more conventional model the put and call value were equivalent. This difference requires some discussion.

The fair value of a put can be determined from a call option with the same strike and expiration (or vice versa) by the put-call parity formula:

(5.13) P = C+(E-U)*EXP(-R*T)

where

P = The fair put value.

C = The fair call value.

E = The strike price.

U = The current price of the underlying instrument.

R = The risk-free rate.

T = Decimal fraction of a year remaining till expiration.

When Equation (5.13) is not true, an arbitrage opportunity exists. From (5.13) we can see that the conventional model's prices, being equivalent, would appear to be correct since the expression E-U is 0, and therefore P = c.

However, let's consider the variable U in Equation (5.13) as the expected price of the current underlying instrument at expiration. The expected value of the underlying can be discerned by (5.10) except the ai term simply equals i. For our example with DEGFDM = 5, the expected value for the underlying instrument = 101.288467. This happens as a result of the fact that the least a commodity can trade for in this model is 0, whereas there is no upside limit. A move from ***a*** price of 100 to a price of 50 is as likely as a move from a price of 100 to 200. Hence, call values will be priced greater than put values. It comes as no surprise then that the expected value of the underlying instrument at expiration should be greater than its current value. This seems to be consistent with our experience with inflation. When we replace the U in Equation (5.13), the current price of the underlying instrument, with its expected value at expiration, we can derive our fair put value from (5.13) as:

P = 3.842+(100-101.288467)*EXP(-.05*33/260.8875) = 3.842+-1.288467*EXP(-.006324565186) = 3.842+-1.288467*.9936954 = 3.842+-1.280343731 = 2.561656269

This value is consistent with the put value discerned by using Equation (5.11) for the current value of the arithmetic mathematical expectation of the put at expiration.

There's only one problem. If both the put and call options for the same strike and expiration are fairly priced per (5.11), then an arbitrage opportunity exists. In the real world the U in (5.13) is the current price of the underlying, not the expected value of the underlying, at expiration. In other words, if the current price is 100 and the December 100 call is 3.842 and the 100 put is 2.561656269, then an arbitrage opportunity exists per (5.13).

The absence of put-call parity would suggest, given our newly derived options prices, that rather than buy the call for 3.842 we instead obtain a* equivalent position by buying the put for 2.562 and buy the underlying.

The problem is resolved if we first calculate the expected value on the underlying, discerned by Equation (5.10) except the ai term simply equals i (for our example with DEGFDM = 5, the expected value for the underlying instrument equals 101.288467) and subtract the current price of the underlying from this value. This gives us 101.288467-100 = 1.288467. Now if we subtract this value from each ai term, each intrinsic value in (5.11) (and setting any resultant values less than 0 to 0), then Equation (5.11) will yield theoretical values that are consistent with (5.13). This procedure has the effect of forcing the arithmetic mathematical expectation on the underlying to equal the current price of the underlying. In the case of our example using the Student's t distribution with 5 degrees of freedom, we obtain a value for both the 100 put and call of 3.218. Thus our answer is consistent with Equation (5.13), and an arbitrage opportunity no longer exists between these two options and their underlying instrument.

Whenever we are using a distribution that results in an arithmetic mathematical expectation at expiration on the underlying which differs from the current value of the underlying, we must subtract the difference (expectation-current value) from the intrinsic value at expiration of the options and floor those resultant intrinsic values less than 0 to 0. In so doing, Equation (5.11) will give us, for any distributional form we care to use, ***the present worth of the arithmetic mathematical expectation of the option at expiration, given an arithmetic mathematical expectation on the underlying instrument equivalent to its current price*** (i.e., assuming no directional bias in the underlying instrument).

THE SINGLE LONG OPTION AND OPTIMAL F

Let us assume here that we are speaking about the simple outright purchase of a call option. Rather than taking a full history of option trades that a given market system produced and deriving our optimal f therefrom, we are going to take a look at all the possible outcomes of what this particular option might do throughout the term that we hold it. We are going to weight each outcome by the probability of its occurrence. This probability-weighted outcome will be derived as an HPR relative to the purchase price of the option. Finally, we will look at the full spectrum of outcomes (i.e., the geometric mean) for each value for f until we obtain the optimal value.

In almost all of the good options pricing models the input variables that have the most effect on the theoretical options price are (a) the time remaining till expiration, (b) the strike price, (c) the underlying price, and (d) the volatility. Different models have different input, but basically these four have the greatest bearing on the theoretical value returned.

Of the four basic inputs, two-the time remaining till expiration and the underlying price-are certain to change. One, volatility, may change, yet rarely to the extent of the underlying price or the time till expiration, and certainly not as definitely as these two. One, the strike price, is certain not to change.

Therefore, we must look at the theoretical price returned by our model for all of these different values of different underlying prices and different for all of these different values of different underlying prices and different times left till expiration. The HPR for an option is thus a function not only of the price of the underlying, but also of how much time is left on the option:

(5.14) HPR(T,U) = (1+f*(Z(T,U-Y)/S-1))^P(T,U)

where

HPR(T,U) = The HPR for a given test value for T and U.

f = The tested value for f.

S = The current price of the option.

Z(T,U-Y) = The theoretical option price if the underlying were at price U-Y with time T remaining till expiration. This can be discerned by whatever pricing model the user deems appropriate.

P(T,U) = The I-tailed probability of the underlying being at price U by time T remaining till expiration. This can discerned by whatever distributional form the user deems appropriate.

Y = The difference between the arithmetic mathematical expectation of the underlying at time T, given by Equation (5.10), and the current price.

This formula will give us the HPR (which is probability-weighted to the probability of the outcome) of one possible outcome for this option: that the underlying instrument will be at price U by time T.

In the preceding equation the variable T represents the decimal part of the year remaining until option expiration. Therefore, at expiration T

= 0. If 1 year is left to expiration, T = 1. The variable Z(T, U-Y) is found via whatever option model you are using. The only other variable you need to calculate is the variable P(T, U), the probability of the underlying being at price U with time T left in the life of the option.

If we are using the Black-Scholes model or the Black commodity model, we can calculate P(T, U) as:

if U < or = to Q:

(5.15a) P(T,U) = N((ln(U/Q))/(V*(L^(1/2))))

if U > Q:

(5.15b) P(T,U) = 1-N((ln(U/Q))/(V*(L^(1/2))))

where

U = The price in question.

Q = Current price of the underlying instrument.

V = The annual volatility of the underlying instrument.

L = Decimal fraction of the year elapsed since the option was put on.

N() = The Cumulative Normal Distribution Function. This is given as Equation (3.21).

ln() = The natural logarithm function.

Having performed these equations, we can derive a probability-weighted HPR for a particular outcome in the option. A broad range of outcomes are possible, but fortunately, these outcomes are not continuous. Take the time remaining till expiration. This is not a continuous function. Rather, a discrete number of days are left till expiration. The same is true for the price of the underlying. If a stock is at a price of, say, 35 and we want to know how many possible price outcomes there are between the possible prices of 30 and 40, and if the stock is traded in eighths, then we know that there are 81 possible price outcomes between 30 and 40 inclusive.

What we must now do is calculate all of the probability- weighted HPRs on the option for the expiration date or for some other mandated exit date prior to the expiration date. Say we know we will be out of the option no later than a week from today. In such a case we do not need to calculate HPRs for the expiration day, since that is immaterial to the question of how many of these options to buy, given all of the available information (time to expiration, time we expect to remain in the trade, price of the underlying instrument, price of the option, and volatility). If we do not have a set time when we will be out of the trade, then we must use the expiration day as the date on which to calculate probability-weighted HPRs.

Once we know how many days to calculate for (and we will assume here that we will calculate up to the expiration day), we must calculate the probability-weighted HPRs for all possible prices for that market day. Again, this is not as overwhelming as you might think. In the Normal Probability Distribution, 99.73% of all outcomes will fall within three standard deviations of the mean. The mean here is the current price of the underlying instrument. Therefore, we really only need to calculate the probability-weighted HPRs for a particular market day, for each discrete price between -3 and +3 standard deviations. This should get us quite accurately close to the correct answer. Of course if we wanted to we could go out to 4, 5, 6 or more standard deviations, but that would not be much more accurate. Likewise, if we wanted to, we could contract the price window in by only looking at 2 or 1 standard deviations. There is no gain in accuracy by doing this though. The point is that 3 standard deviations is not set in stone, but should provide for sufficient accuracy.

If we are using the Black-Scholes model or the Black futures option model, we can determine how much 1 standard deviation is above a given underlying price, U:

(5.16) Std. Dev. = U*EXP(V*(T^(1/2)))

where

U = Current price of the underlying instrument.

V = The annual volatility of the underlying instrument.

T = Decimal fraction of the year elapsed since the option was put on.

EXP() = The exponential function.

Notice that the standard deviation is a function of the time elapsed in the trade (i.e., you must know how much time has elapsed in order to know where the three standard deviation points are).

Building upon this equation, to determine that point that is X standard deviations above the current underlying price:

(5.17a) +X Std. Dev. = U*EXP(X*(V*T^(1/2)))

Likewise, X standard deviations below the current underlying price is found by:

(5.17b) -X Std. Dev. = U*EXP(-X*(V*T ^ (1/2))) where U = Current price of the underlying instrument.

V = The annual volatility of the underlying instrument.

T = Decimal fraction of the year elapsed since the option was put on.

EXP() = The exponential function.

X = The number of standard deviations away from the mean you are trying to discern probabilities on.

Remember, you must first determine how old the trade is, as a fraction of a year, before you can determine what price constitutes X standard deviations above or below a given price U.

Here, then, is a summary of the procedure for finding the optimal f for a given option.

Step 1 Determine if you will be out of the option by a definite date. If not, then use the expiration date.

Step 2 Counting the first day as day 1, determine how many days you will have been in the trade by the date in number 1. Now convert this number of days into a decimal fraction of a year.

Step 3 For the day in number 1, calculate those points that are within +3 and -3 standard deviations of the current underlying price.

Step 4 Convert these ranges of values of prices in step 3 to discrete values. In other words, using increments of 1 tick, determine all of the possible prices between and including those values in step 3 that bound the range.

Step 5 For each of these outcomes now calculate the Z(T, U-Y)'s and P(T, U)'s for the probability-weighted HPR equation. In other words, for each of these outcomes now calculate the resultant theoretical option price as well as the probability of the underlying instrument being at that price by the dates in question.

Step 6 After you have completed step ***5,*** you now have all of the input required to calculate the probability-weighted HPRs for all of the outcomes.

(5.14) HPR(T,U) = (1+f*(Z(T,U-Y)/S-1))^P(T,U)

where

f = The tested value for f.

S = The current price of the option.

Z(T,U-Y) = The theoretical option price if the underlying were at price U-Y with time T remaining till expiration. This can discerned by whatever pricing model the user deems appropriate.

P(T,U) = The 1-tailed probability of the underlying being at price U by time T remaining till expiration. This can be discerned by whatever distributional from the user deems appropriate.

Y = The difference between the arithmetic mathematical expectation of the underlying at time T, given by (5.10), and the current price.

You should note that the distributional form used for the variable P(T, U) need not be the same distributional form used by the pricing model employed to discern the values for Z(T, U-Y). For example, suppose you are using the Black-Scholes stock option model to discern the values for Z(T, U-Y). This model assumes a lognormal distribution of price changes. However, you can correctly use another distributional form to determine the corresponding P(T, U). Literally, this translates as follows: You know that if the underlying goes to price U, the option's price will tend to that value given by Black-Scholes. Yet the probability of the underlying going to price U from here is greater than the lognormal distribution would indicate.

Step 7 Now you can begin the process of finding the optimal f. Again you can do this by iteration, by looping through all of the possible f values between 0 and 1, by parabolic interpolation, or by any other one-dimensional search algorithm. By plugging the test values for f into the HPRs (and you have an HPR for each of the possible price increments between +3 and -3 standard deviations on the expiration date or mandated exit date) you can find your geometric mean for a given test value of f. The way you now obtain this geometric mean is to multiply

all Of these HPRs together and then take the resulting product to the power of 1 divided by the sum of the probabilities:

(5.18a) G(f,T) = {∏[U = -3SD,+3SD]HPR(T,U)}^(1/∑[U = -3SD,+3SD]P(T,U))

Therefore:

(5.18b) G(f,T) = {∏[U = -3SD,+3SD](l+f*(Z(T,U-Y)/S1))^P(T,U)}^(1/∑[U = -3SD,+3SD]P(T,U))

where

G(f, T) = The geometric mean HPR for a given test value for f and a given time remaining till expiration from a mandated exit date.

f = The tested value for f.

S = The current price of the option.

Z(T,U-Y) = The theoretical option price if the underlying were at price U -Y with time T remaining till expiration. This can be discerned by whatever pricing model the user deems appropriate.

P(T,U) = The probability of the underlying being at price U by time T remaining till expiration. This can be discerned by whatever distributional form the user deems appropriate.

Y = The difference between the arithmetic mathematical expectation of the underlying at time T, given by (5.10), and the current price.

The value for f that results in the greatest geometric mean is the value for f that is optimal.

We can optimize for the optimal mandated exit date as well. In other words, say we want to find what the optimal f is for a given option for each day between now and expiration. That is, we run this procedure over and lover, starting with tomorrow as the mandated exit date and finding the optimal f, then starting the whole process over again with the next day as the mandated exit date. We keep moving the mandated exit date forward until the mandated exit date is the expiration date. We record the optimal fs and geometric means for each mandated exit date. When we are through with this entire procedure, we can find the mandated exit date that results in the highest geometric mean. Now we know the date by which we must be out

of the option position by in order to have the highest mathematical expectation (i.e., the highest geometric mean). We also know how many contracts to buy by using the f value that corresponds to the highest-geometric mean. We now have a mathematical technique whereby we can blindly go out and buy an option and (as long as we are out of it by the mandated exit date that has the highest geometric mean-provided that it is greater than 1.0, of course-and buy the number of contracts indicated by the optimal f corresponding to that highest geometric mean) be in a positive mathematical expectation. Furthermore, these are ***geometric*** positive mathematical expectations. In other words, the geometric mean (minus 1.0) is the mathematical expectation when you are reinvesting returns. (The true arithmetic positive mathematical expectation would of course be higher than the geometric.) Once you know the optimal f for a given option, you can readily turn this into how many contracts to buy based on the following equation:

(5.19) K = INT(E/(S/f))

where

K = The optimal number of option contracts to buy.

f = The value for the optimal f (0 to 1).

S = the current price of the option.

E = The total account equity.

INT() = The integer function.

The answer derived from this equation must be "floored to the integer." In other words, for example, if the answer is to buy 4.53 contracts, you would buy 4 contracts. We can determine the TWR for the option trade. To do so we must know how many times we would perform this same trade over and over. In other words, if our geometric mean is 1.001 and we want to find the TWR that corresponds to make this same play over and over 100 times, our TWR would be 1.001 ^ 100 = 1.105115698. We would therefore expect to make 10.3115698% on our stake if we were to make this same options play 100 times over. The formula to convert from a geometric mean to a TWR was given as Equation (4.18):

(4.18) TWR = Geometric Mean^X

where

TWR = The terminal wealth relative.

X = However many times we want to "expand" this play out. That is, what we would expect to make if we invested f amount into these possible scenarios X times.

Further, we can determine our other by-products, such as the geometric mathematical expectation, as the geometric mean minus 1. If we take the biggest loss possible (the cost of the option itself), divide this by the optimal f, and multiply the result by the geometric mathematical expectation, the result will yield the geometric average trade. As you have seen, when applied to options positions such as this, the optimal f technique has the added by-product of discerning what the optimal exit date is.

We have discussed the options position in its pure form, devoid of any underlying bias we may have in the direction of the price of the underlying. For a mandated exit date, the points of 3 standard deviations above and below are calculated from the current price. This assumes that we know nothing of the future direction of the underlying. According to the mathematical pricing models, we should not be able to find positive arithmetic mathematical expectations if we were to hold these options to expiration. However, as we have seen, through the use of this technique it is possible to find positive geometric mathematical expectations if we put on a certain quantity and exit the position on a certain date.

If you have a bias toward the direction of the underlying, that can also be incorporated. Suppose we are looking at options on a particular underlying instrument, which is currently priced at 100. Further suppose that our bias, generated by our analysis of this market, suggests a price of 105 by the expiration date, which is 40 market days from now. We expect the price to rise by 5 points in 40 days. If we assume a straight-line basis for this advance, we can state that the price should rise, on average, .125 points per market day. Therefore, for the mandated exit day of tomorrow, we will figure a value of U of 100.125. For the next mandated exit date, U will be 100.25. Finally, by the time that the mandated exit date is the expiration date, U will be 105. If the underlying is a stock, you should subtract the dividends from this adjusted U via Equation (5.04). The bias is applied to the process by having a different value for U each day because of our forecast. Because they affect the outcomes of Equations (5.17a) and (5.17b), these different values for U will dramatically affect our optimal f and by-product calculations. Notice that because Equations (5.17a) and (5.17b) are affected by the new value for U each day, there is an automatic equalization of the data. Hence, the optimal f's we obtain are based on equalized data.

As you work with this optimal f idea and options, you will notice that each day the numbers change. Suppose you buy an option today at a certain price that has a given mandated exit date. Suppose the option has a different price after tomorrow. If you run the optimal f procedure again on this new option, it, too, may have a positive mathematical expectation and a different mandated exit date. What does this mean?

The situation is analogous to a horse race where you can still place bets after the race has begun, until the race is finished. The odds change continuously, and you can cash your ticket at any time, you need not wait until the ***race*** is over. Say you bet $2 on a horse before the race begins, based on a positive mathematical expectation that you have for that horse, and the horse is running next to last by the first turn. You make time stop (because you can do that in hypothetical situations) and now you look at the tote board. Your $2 ticket on this horse is now only worth S 1.50. You determine the mathematical expectation on your horse again, considering how much of the race is already finished, the current odds on your horse, and where it presently is in the field. You determine that the current price of that $1.50 ticket on your horse is 10% undervalued. Therefore, since you could cash your 82 ticket that you bought before the race for S 1.50 right now, taking a loss, and you could also purchase the $1.50 ticket on the horse right now with a positive mathematical expectation, you do nothing. The current situation is thus that you have a positive mathematical situation, but on the basis of a $l.50 ticket not a $2 ticket.

This same analogy holds for our option trade, which is now slightly underwater but has a positive mathematical expectation on the basis of the new price. You should use the new optimal f on the new price, adjusting your current position if necessary, and go with the new optimal exit date. In so doing, you will have incorporated the latest price information about the underlying instrument. Often, doing this may have you

take the position all the way into expiration. There are many inevitable losses along the way by following this technique of optimal f on options.

Why you should be able to find positive mathematical expectations in options that are theoretically fairly priced in the first place may seem like a paradox or simply quackery to you. However, there is a very valid reason why this is so: ***Inefficiencies are a function of your frame of reference.*** Let's start by stating that theoretical option prices as returned by the models do not give a positive mathematical expectation (arithmetic) to either the buyer or seller. In other words, the models are theoretically fair. The missing caveat here is "if held till expiration." It is this missing caveat that allows an option to be fairly priced per the models, yet have a positive expectation if not held till expiration.

Consider that options decay at the rate of the square root of the time remaining till expiration. Thus, the day with the least expected time premium decay will always be the first day you are in the option. Now consider Equations (5.17a) and (5.17b), the price corresponding to a move of X standard deviations after so much time has elapsed. Notice that each day the window returned by these formulas expands, but by less and less. The day of the greatest rate of expansion is the first day in the option.

Thus, for the first day in the option, the time premium will shrink the least, and the window of X standard deviations will expand the fastest. The less the time decay, the more likely we are to have a positive expectation in a long option. Further, the wider the window of X standard deviations, the more likely we are to have a positive expectation, as the downside is fixed with an option but the upside is not. There is a constant tug-of-war going on between the window of X standard deviations getting wider and wider with each passing day (at a slower and slower rate, though) and time decaying the premium faster and faster with each passing day.

What happens is that the first day sees the most positive mathematical expectation, although it may not be positive. In other words, the mathematical expectation (arithmetic and geometric) is greatest after you have been in the option 1 day (it's actually greatest the first instant you put on the option and decays gradually thereafter, but we are looking at this thing at discrete intervals-each day's close). Each day thereafter the expectation gets lower, but at a slower rate.

The following table depicts this decay of expectation of a long option. The table is derived from the option discussed earlier in this chapter. This is the 100 call option where the underlying is at 100, and it expires 911220. The volatility is 20% and it is now 911104. We are using the Black commodity option formula (H discerned as in Equation (5.07) and R = 5%) and a 260.8875-day year. We are using 8 standard deviations to calculate our optimal f's from, and we are using a minimum tick increment of .1 (which will be explained shortly).

Exit Date	AHPR	GHPR	f
Tue. 911105	1.000409	1.000195	.0806
Wed. 911106	1.000001	1 .000000	.0016
Thu. 911107	<1	<1	0

The AHPR column is the arithmetic average HPR (the calculation of which will be discussed later on in this chapter), and GHPR is the geometric mean HPR. The f column is the optimal f from which the AHPR and GHPR columns were derived. The arithmetic mathematical expectation, as a percentage, is simply the AHPR minus 1, and the geometric mathematical expectation, as a percentage, is the GHPR minus 1.

Notice that the greatest mathematical expectations occur on the day after we put the option on (although this example has a positive mathematical expectation, not all options will show a positive mathematical expectation). Each day thereafter the expectations themselves decay. The rate of decay also gets slower and slower each day. After 911106 the mathematical expectations (HPR-1) go negative.

Therefore, if we wanted to trade on this information, we could elect to enter today (911104) and exit on the close tomorrow (911105). The fair option price is 2.861. If we assume it is traded at a price of $100 per full point, the cost of the option is 2.861*$100 = $286.10. Dividing this price by the optimal f of .0806 tells us to buy one option for every $3,549.63 in equity. If we wanted to hold the option till the close of 911106, the last day that still has a positive mathematical expectation, we would have to initiate the position today using the f value corresponding to the optimal for an exit 911106 of .0016. We would therefore enter today (911104) with 1 contract for every $178,812.50 in account equity ($286.10/ .0016). Notice that to do so has a much lower expectation than if we entered with 1 contract for every 33,549.63 in account equity and exited on the close tomorrow, 911105.

The rate of change between the two functions, time premium decay and the expanding window of X standard deviations, may create a positive mathematical expectation for being long a, given option. This expectation is at its greatest the first instant in the position and declines at a decreasing rate from there. Thus, an option that is priced fairly to expiration based on the models can be found to have a positive expectation if exited early on in the premium decay.

The next table looks at this same 100 call option again, only this time we look at it using different-sized windows (different amounts of standard deviations):

Number of Standard Deviations					
	2	3	5	8	10
AHPR	1.000102	1.000379	1.000409	1.000409	1.000409
GHPR	1.000047	1.00018	1.000195	1.000195	1.000195
f	.043989	.0781	.0806	.0806	.0806
Cutoff	911105	911105	911106	911106	911106

The AHPR and GHPR pertain to the arithmetic and geometric HPRs at the optimal f values if you exit the trade on the close of 911105 (the most opportune date to exit, because it has the highest AHPR and GHPR). The f corresponds to the optimal f for 911105. The heading Cutoff pertains to the last date when a positive expectation (i.e., AHPR and GHPR both greater than 1) exists.

The interesting point to note is that the four values AHPR, GHPR, f, and Cutoff all converge to given points as we increase the number of standard deviations toward infinity. Beyond 5 standard deviations the values hardly change at all. Beyond 8 standard deviations they seem to stop changing. The tradeoff in using more standard deviations is that extra computer time is required. This seems a small price to pay, but as we get into multiple simultaneous positions in this chapter, you will notice that each additional leg of a multiple simultaneous position increases the time required exponentially. For one leg we can argue that using 8 standard deviations is ideal. However, for more than one leg simultaneously, we may find it necessary to trim back this number of standard deviations. Furthermore, this 8 standard deviation rule applies only when we assume Normality in the logs of price changes.

THE SINGLE SHORT OPTION

Everything stated about the single long option holds true for a single short option position. The only difference is in regard to Equation (5.14):

(5.14) HPR(T,U) = (1+f*(Z(T,U-Y)/S-1))^P(T,U)

where

HPR(T,U) = The HPR for a given test value for T and U.

f = The tested value for f.

S = The current price of the option.

Z(T,U-Y) = The theoretical option price if the underlying were at price U with time T remaining till expiration.

P(T,U) = The probability of the underlying being at price U by time T remaining till expiration.

Y = The difference between the arithmetic mathematical expectation of the underlying at time T, given by (5.10), and the current price.

For a single short option position this equation now becomes:

(5.20) HPR(T,U) = (1+f*(1-Z(T,U-Y)/S))^P(T,U)

where

HPR(T,U) = The HPR for a given test value for T and U.

f = The tested value for f.

S = The current price of the option.

Z(T,U-Y) = The theoretical option price if the underlying

were at price U with time T remaining till expiration.

P(T,U) = The probability of the underlying being at price U by time T remaining till expiration.

Y = The difference between the arithmetic mathematical expectation of the underlying at time T, given by (5.10), and the current price.

You will notice that the only difference between Equation (5.14), the equation for a single long option position, and Equation (5.20), the equation for a single short option position, is in the expression (Z(T,U-

Y)/S-1), which becomes (1-Z(T,U-Y)/S) for the single short option position. Aside from this change, everything else detailed about the single long option position holds for the single short option position.

THE SINGLE POSITION IN THE UNDERLYING INSTRUMENT

In Chapter 3 we detailed the math of finding the optimal f parametrically. Now we can use the same method as with a single long option, only our calculation of the HPR is taken from Equation (3.30).

(3.30) HPR(U) = (1+(L/(W/(-f))))^P

where

HPR(U) = The HPR for a given U.

L = The associated P&L.

W = The worst-case associated P&L in the table (this will always be a negative value).

f = The tested value for f.

P = The associated probability.

The variable L, the associated P&L, is discerned by taking the price of the underlying at a given price U, minus the price at which the trade was initiated, S, for a long position.

(5.21a) L for a long position = U-S

For a short position, the associated P&L is figured just the reverse:

(5.21b) L for a short position = S-U

where

S = The current price of the underlying instrument.

U = The price of the underlying instrument for this given HPR.

We could also figure the optimal f for a single position in the underlying instrument using Equation (5.14). When doing so we must realize that the optimal f returned can be greater than 1.

For example, consider an underlying instrument at a price of 100. We determine that the five following outcomes might occur:

Outcome	Probability	P&L
110	.15	10
105	.30	5
100	.50	0
95	.25	-5
90	.10	-10

Note that per Equation (5.10), our arithmetic mathematical expectation on the underlying is 100.5769230 77. This means that the variable Y in (5.14) is equal to .576923077 since 100.576923077-100 = .576923077.

If we were to figure the optimal f using the P&L column and the Equation (3.30) method, we derive an f of .19, or 1 unit for every $52.63 in equity.

If instead we used Equation (5.14) on the outcome column, whereby the variable S is therefore equal to 100, and ***we do not*** subtract the value of Y, the arithmetic mathematical expectation of the underlying minus its current value from U in discerning our Z(T, U -Y) variable, we find our optimal fat approximately 1.9. This translates again into 1 unit for every $52.63 in equity as 100/1.9 = 52.63.

On the other hand, if we subtract the value of Y, the arithmetic mathematical expectation on the underlying per Equation (5.10), in the Z(T, U-Y) term of (5.14) we end up with a mathematical expectation on the underlying equal to its current value, and therefore we do not have an optimal f. This is what we must do, subtract the value of Y in the Z(T, U-Y) term of Equation (5.14) in order to be consistent with the options calculations as well as the put/call parity formula.

If we are using the Equation (3.30) method instead of the Equation (5.14) method, then each value for U in (5.21a) and (5.21b) must have the arithmetic mathematical expectation of the underlying, Y, subtracted from it. That is, we must subtract the value of Y from each P&L. Doing so again yields a situation where there is not a positive mathematical expectation, and therefore there is no value for f that is optimal.

Literally, this means only that if we ***blindly*** go out and take a position in the underlying instrument, we do not get a positive mathematical expectation (as we do with some options), and therefore there is no f that is optimal in this case. We can have an optimal f only if we have a positive mathematical expectation. We can have this only if we hav***e*** a bias in the underlying.

Now we have a methodology that can be used to give us the optimal f (and its by-products) for options, whether long or short, as well as trades in the underlying instrument (from a number of different methods).

Note that the methods used in this chapter to discern the optimal fs and by-products for either options or the underlying instrument are predicated upon not necessarily using a mechanical system to enter your trades. For instance, the empirical method for finding optimal f used an empirical stream of trade P&L's generated by a mechanical system. In Chapter 3 we learned of a parametric technique to find the optimal f from data that was Normally distributed. This same technique can be used to find the optimal f from data of any distribution, so long as the distribution in question has a cumulative density function. In Chapter 4 we learned of a method to find the optimal f parametrically for distributions that do not have a cumulative density function, such as the distribution of trade P&L's (whether a mechanical system is used or not) or the scenario planning approach.

In this chapter we have learned of a method for finding the optimal f when not using a mechanical system. You will notice that all of the calculations thus far assume that you are, in effect, blindly entering a position at some point in time and exiting at some unknown future point. Usually the method is shown where there isn't a bias in the price of the underlying -that is, the method is shown devoid of any price forecast in the underlying. We have seen however, that we can incorporate our price forecast into the process simply by changing the value of the underlying used as input into the Equations (5.17a and 5.17b) each day as the trade progresses. Even a slight bias changes the expectation function dramatically. The optimal exit date may now very well ***not*** be the market day immediately after the entry day. In fact, the optimal exit date may well become the expiration day. In such a case, the option has a positive mathematical expectation even if held all expiration. Not only is the expectation function altered dramatically by even a slight bias in the price of the underlying, so, too, are the optimal fs, AHPRs, and GHPRs. For instance, the following table is once again derived from the option discussed earlier in this chapter. This is the 100 call option where the underlying is at 100, and it expires 911220. The volatility is 20% and it is now 911104. We are using the Black commodity option formula (H discerned as in Equation (5.07) and R = 5%) and a 260.8875-day year. We will again use 8 standard deviations to calculate our optimal fs from (to be consistent with the previous tables showing no bias in the underlying, or bias = 0), and we are using a minimum tick increment of .1. Here, however, we will assume a bias of .01 points (one tenth of one tick) upward per day in the price of the underlying:

Exit Date	AHPR	GHPR	f
Tue. 911105	1.000744	1.000357	.1081663
Wed. 911106	1.000149	1.000077	.0377557
Thu. 911107	1.000003	1.000003	.0040674
Fri. 911108	<1	<1	0

Notice how simply a tiny .01-point upward bias per day changes the results. Our optimal exit date is still 911105, and our optimal f is .1081663, which translates into 1 contract for every $2,645.00 in account equity (2.861*100/.1081663). Also notice that a positive expectation is obtained in this option all the way until the close of 911107. Had we had a stronger bias than simply .01 point upward per day, the results would be changed to an even more pronounced degree.

The last point that needs to be addressed is the cost of commissions. In the price of the option obtained with Equation (5.14), the variable Z(T, U-Y) must be adjusted downward to reflect the commissions involved in the transaction (if you are charged commissions on the entry side also, then you must adjust the variable S in Equation (5.14) ***upward*** by the amount of the commissions).

We have covered finding the optimal f and its by-products when we are not using a mechanical system. We can now begin to combine multiple positions.

MULTIPLE SIMULTANEOUS POSITIONS WITH A CAUSAL RELATIONSHIP

As we begin our discussion of multiple simultaneous positions, it is important to differentiate between causal relationships and correlative relationships. In the causal relationship, there is a factual, connective

explanation of the correlation between two or more items. That is, a causal relationship is one where there is correlation, and the correlation can be explained or accounted for in some logical, connective fashion. This is in contrast to a correlative relationship where there is, of course, correlation, but there is no causal, connective, explanation of the correlation.

As an example of a causal relationship, let's look at put options on IBM and call options on IBM. Certainly the correlation between the IBM puts and the IBM calls is -1 (or very close to it), but there is more to the relationship than simply correlation. We know for a fact that when there is upward pressure on IBM rah that there will be downward pressure on the puts (all else remaining constant, including volatility). This logical, connective relationship means that there is a causal relationship between IBM calls and IBM puts.

When there is correlation but no cause, we simply say that there is a correlative relationship (as opposed to a causal relationship). Usually, correlative relationships will not have correlation coefficients whose absolute values are close to 1. Usually, the absolute value of the correlation coefficient will be closer to 0. For example, corn and soybeans tend to move in tandem. Although their correlation coefficients are not exactly equal to 1, there is still a causal relationship because both markets are affected by things that affect the grains. If we look at IBM calls and Digital Equipment puts (or calls), we cannot say that the relationship is completely a causal relationship. Surely there is somewhat of a causal relationship, as both of the underlying stocks are members of the computer group, but just because IBM goes up (or down) is not an absolute mandate that Digital Equipment will also. As you can see, there is not a fine line that differentiates causal and correlative relationships.

This "clouding" of causal relationships and those that are simply correlative will make our work more difficult. For the time being, we will only deal with causal relationships, or what we believe are causal relationships. In the text chapter we will deal with correlative relationships, which encompass causal relationships as well. You should be aware right now that the techniques mentioned in the next chapter on correlative relationships arc also applicable to, or can be used in lieu of, the techniques for causal relationships about to be discussed. The reverse is not true. That is, it is erroneous to apply the following techniques on causal relationships to relationships that are simply correlative.

A causal relationship is one where the correlation coefficients between the prices of two items is 1 or -1. To simplify matters, a causal relationship almost always consists of any two tradeable items (stock, commodity, option, etc.) that have the same underlying instrument. This includes, but is not limited to, options spreads, straddles, strangles, and combinations, as well as covered writes or any other position where you are using the underlying in conjunction with one or more of its options, or one or more options on the same underlying instrument, ***even if you do not have a position in that underlying instrument.***

In its simplest form, multiple simultaneous positions consisting of only options (no position in the underlying), when the position is put on at a debit, can be solved for by using Equation (5.14). By ***solved for*** I mean that we can determine the optimal f for the entire position and its by-products (including the optimal exit date). The only differences are that the variable S will now represent the net of the legs of the position at the trade's inception. The variable Z(T, U-Y) will now represent the net of the legs at price U by time T remaining till expiration.

Likewise, multiple simultaneous positions consisting of only options (no position in the underlying), when the position is put on at a credit, can be solved for by using Equation (5.20). Again, we must alter the variables S and Z(T, U-Y) to reflect the net of the legs of the position. For example, suppose we are looking to put on a long option straddle, the purchase of a put and a call on the same underlying instrument with the same strike price and expiration date. Further suppose that the optimal f returned by this technique was 1 contract for every $2,000. This would mean that for every $2,000 in account equity we should buy 1 straddle; for every $2,000 in account equity we should buy 1 of the puts ***and*** 1 of the calls. The optimal f returned by this technique pertains to financing 1 unit of the ***entire*** position, no matter how large that position is. This fact will be true for all the multiple simultaneous techniques discussed throughout this chapter.

We can now devise an equation for multiple simultaneous positions involving whether a position in the underlying instrument is included or not. We can use this generalized form for multiple simultaneous positions with a causal relationship:

(5.22) $HPR(T,U) = (1+\sum[i = 1,N]C_i(T,U))^P(T,U)$

where

N = The number of legs in the position.

HPR(T,U) = The HPR for a given test value for T and U.

$C_i(T,U)$ = The coefficient of the ith kg at a given value for U, at a given time T remaining till expiration:

For an option leg put on at a debit or a long position in the underlying:

(5.23a) $C_i(T, U) = f*(Z(T, U-Y)/S-l)$

For an option leg put on at a credit or a short position in the underlying:

(5.23b) $C_i(T,U) = f*(1-Z(T,U-Y)/S)$

where

f = The tested value for f.

S = The current price of the option or underlying instrument.

Z(T,U-Y) = The theoretical option price if the underlying

were at price U with time T remaining till expiration.

P(T,U) = The probability of the underlying being at price U by time T remaining till expiration.

Y = The difference between the arithmetic mathematical expectation of the underlying at time T, given by (5.10), and the current price.

Equation (5.22) can be used if you are planning on putting these legs all on at once, one for one, and you only need to iterate for the optimal f and optimal exit date of the entire position (that is what is meant by "multiple simultaneous positions").

For each value of U you will have an HPR given by Equation (5.22). For each value for f you will have a geometric mean, composed of all of the HPRs per Equation (5.18a):

(5.18a) $G(f,T) = \{\prod[U = -8SD,8SD]HPR(T,U)\}^{(1/\sum[U = -8SD,8SD]P(T,U))}$

where

G(f,T) = The geometric mean HPR for a given test value for f and a given time remaining till expiration from a mandated exit date. Those values off and T (the values of the optimal f and mandated exit date) that result in the highest geometric means, are the ones that you should use on the net position of the legs.

To summarize the entire procedure. We want to find the optimal f for each day, using each market day between now and expiration as the mandated exit date. For each mandated exit date you will determine those discrete prices between plus and minus X standard deviations (ordinarily we will let X equal 8) from the base price of the underlying instrument. The base price can be the current price of the underlying instrument or it can be altered to reflect a particular bias you might have regarding that market's direction. You now need to find the value between 0 and 1 for f that results in the greatest geometric mean HPR, using an HPR for each of the discrete prices between plus and minus X standard deviations of the base price for that mandated exit date. Therefore, for each mandated exit date you will have an optimal f and a corresponding geometric mean. The mandated exit date that has the greatest geometric mean is the optimal exit date for the position, and the f corresponding to that geometric mean is the f that is optimal.

The "nesting" of the logic of this procedure is as follows:

For each mandated exit date (weekday) between now and expiration For each value off (until the optimal is found) For each market system For each tick between+and-8 std. devs. Determine the HPR

Finally, you should note that in this section we have been attempting, among other things, to discern the optimal exit date, which we have looked upon as a single date at which to close down all of the legs of the position. You can apply the same procedure to determine the optimal exit date for each leg in the position. This compounds the number of computations geometrically, but it can be accomplished. This would alter the logic to appear as:

For each market system

For each mandated exit date (weekday) between now and expiration

For each value off (until the optimal is found)

For each market system

For each tick between +8 and -8 std. devs.

Determine the HPR

We have thus covered multiple simultaneous positions with a causal relationship. Now we can move on to a similar situation where the relationship is random.

MULTIPLE SIMULTANEOUS POSITIONS WITH A RANDOM RELATIONSHIP

You should be aware that, as with the causal relationships already discussed, the techniques mentioned in the next chapter on correlative relationships are also applicable to, or can be used in lieu of, the techniques for random relationships about to be discussed. This is not true the other way around. That is, it is erroneous to apply the techniques on random relationships that follow in this chapter to relationships that are correlative (unless the correlation coefficients equal 0). A ***random relationship*** is one where the correlation coefficients between the ***prices*** of two items is 0.

A random relationship exists between any two tradeable items (stock, futures, options, etc.) whose ***prices*** are independent of one another, where the correlation coefficient between the two prices is zero, or is expected to be zero in an asymptotic sense.

When there is a correlation coefficient of 0 between every combination 062 legs in a multiple simultaneous position, the HPR for the net position is given as:

(5.24) HPR(T,U) = (1+∑[i = 1,N] C_i(T,U))^∏[i = 1,N] P_i(T,U)

where

N = The number of legs in the position.

HPR(T,U) = The HPR for a given test value for T and U.

C_i(T,U) = The coefficient of the ith leg at a given value for U, at a given time remaining till expiration of T:

For an option leg put on at a debit or a long position in the underlying instrument:

(5.23a) C_i(T,U) = f*(Z(T,U-Y)/S-1)

For an option leg put on at a credit or a short position in the underlying instrument:

(5.23b) C_i(T,U) = f*(l-Z(T,U-Y)/S)

where

f = The tested value for f.

S = The current price of the option.

Z(T,U-Y) = The theoretical option price if the underlying were at price U with time T remaining till expiration.

P_i(T,U) = The probability of the ith underlying being at price U by time remaining till expiration of T.

Y = The difference between the arithmetic mathematical expectation of the underlying at time T, given by (5.10), and the current price.

We can now figure the geometric mean for random relationship HPRs as:

(5.25) C(f,T) = {∏[U1 = -8SD,+ 8SD]...∏[UN = -8SD,+8SD]{(1+∑[i = 1,N]C_i(T,U))^∏[i = 1,N]P_i(T,U)}}^{1/(∑[U1 = -8SD,+ 8SD]...∑[UN = -8SD,+ 8SD]∏[i = 1,N]P_i(T,U))}

where

G(f, T) = The geometric mean HPR for a given test value for f and a given time remaining till expiration from a mandated exit date. Once again, the f and T that result in the greatest geometric mean are optimal.

The "nesting" of the logic of this procedure is exactly the same as with the causal relationships:

For each mandated exit date (weekday) between now and expiration

For each value off (until the optimal is found)

For each market system

For each tick between +8 and -8 std. devs.

Determine the HPR

The only difference between the procedure for solving for random relationships and that for causal relationships is that the exponent to each HPR in the random relationship is calculated by multiplying together the probabilities of all of the legs being at the given price of the particular HPR. Each of these probability sums used as exponents for each HPR are themselves summed so that when all of the HPRs are multiplied together to obtain the interim TWR, it can be raised to the power of 1 divided by the sum of the exponents used in the HPRs. And again, the outer loop of the logic could be mended to accommodate a search for the optimal exit date for each leg in the position.

Complicated as Equation (5.25) looks, it still does not address the problem of a linear correlation coefficient between the prices of any two components that is not 0. As you can see, solving for the optimal mixture of components is quite a task! In the next few chapters you will see how to find the right quantities for each leg in a multiple position-using stock, commodities, options, or any other tradeable item-regardless of the relationship (causal, random, or correlative). The inputs you will need for a given option position in the next chapter are (1) the correlation coefficient of its average daily HPR on a 1-contract basis to each of the other positions in the portfolio, and (2) its arithmetic average HPR and standard deviation in HPRs.

Equations (5.14) and (5.20) detailed how to find the HPR for long options and short options respectively. Equation (5.18) then showed how to turn this into a geometric mean. Now, we can also discern the arithmetic mean as:

For long options, options put on at a debit:

(5.26a) AHPR = {∑[U = -8SD,+ 8SD]((1+f*(Z(T, U-Y)/S-1))*P(T,U))}/∑[U1 = -8SD,+ 8SD]P(TU)

For short options, options put on at a credit:

(5.26b) AHPR = (∑[U = -8SD,+ 8SD]((1+f*(1-Z(T, U-Y)/S))*P(T,U))}/∑[U = -8SD,+ 8SD]P(T,U)

where

AHPR = The arithmetic average HPR.

f = The optimal f (0 to 1).

S = The current price of the option.

Z(T,U-Y) = The theoretical option price if the underlying were at price U with time T remaining till expiration.

P(T, U) = The probability of the underlying being at price U with time T remaining till expiration.

Y = The difference between the arithmetic mathematical expectation of the underlying at time T, given by (5.10), and the current price.

Once you have the geometric average HPR and the arithmetic average HPR, you can readily discern the standard deviation in HPRs:

(5.27) SD = (A^2-G^2)^(1/2)

where

A = The arithmetic average HPR.

G = The geometric average HPR.

SD = The standard deviation in HPRs.

In this chapter we have leaned of yet another way to calculate optimal f. The technique shown was for nonsystem traders and used the distribution of outcomes on the underlying instrument by a certain date in the future as input. As a side benefit, this approach allows us to find the optimal f on both options and for multiple simultaneous positions. However, one of the drawbacks of this technique is that the relationships between all of the positions must be random or causal

Does this mean we cannot use the techniques far finding the optimal f, discussed in earlier chapters, on multifile simultaneous positions or options? No-again, which method you choose is a matter of utility to you. The methods detailed in this chapter have certain drawbacks as well as benefits (such as the ability to discern optimal exit times). In the next chapter, we will begin to delve into optimal portfolio construction, which will later allow us to perform multiple simultaneous positions using the techniques detailed earlier.

There are many different directions of study we could head off into at this function. However, the goal in this text is to study portfolios of different markets, portfolios of different market systems, and different tradeable items. This being the case, we will part from the trail of theoretical option prices and head in the direction of optimal portfolio construction

Chapter 6 - Correlative Relationships and the Derivation of the Efficient Frontier

We have now covered finding the optimal quantities to trade for futures, stocks, and options, trading them either alone or in tandem with another item, when there is either a random or a causal relationship between the prices of the items. That is, we have defined the optimal set when the linear correlation coefficient between any two elements in the portfolio equals 1, ~1, or 0. Yet the relationships between any two elements in a portfolio, whether we look at the correlation of prices (in a nonmechanical means of trading) or equity changes (in a mechanical system), are rarely at such convenient values of the linear correlation coefficient.

In the last chapter we looked at trading these items from the standpoint of someone not using a mechanical trading system. Because a mechanical trading system was not employed, we were looking at the correlative relationship of the prices of the items.

This chapter provides a method for determining the efficient frontier of portfolios of market systems when the linear correlation coefficient between any two portfolio components under consideration is any value between -1 and 1 inclusive. Herein is the technique employed by professionals for determining optimal portfolios of stocks. In the next chapter we will adapt it for use with any tradeable instrument.

In this chapter, an important assumption is made regarding these techniques. The assumption is that the generating distributions (the distribution of returns) have finite variance. These techniques are effective only to the extent that the input data used, has finite variance. [1]

DEFINITION OF THE PROBLEM

For the moment we are dropping the entire idea of optimal f; it will catch up with us later. It is easier to understand the derivation of the efficient frontier parametrically if we begin from the assumption that we are discussing a portfolio of stocks. These stocks are in a cash account and are paid for completely. That is, they are not on margin.

Under such a circumstance, we derive the efficient frontier of portfolios. That is, for given stocks we want to find those with the lowest level of expected risk for a given level of expected gain, the given levels being determined by the particular investor's aversion to risk. Hence, this basic theory of Markowitz (aside from the general reference to it as Modern Portfolio Theory) is often referred to as ***E-V theory*** (Expected return-Variance of return). Note that the inputs are based on returns. That is, the inputs to the derivation of the efficient frontier are the returns we would expect on a given stock and the variance we would expect of those returns. Generally, returns on stocks can be defined as the dividends expected over a given period of time plus the capital appreciation (or minus depreciation) over that period of time, expressed as a percentage gain (or loss).

Consider four potential investments, three of which are stocks and one a savings account paying 8.5% per year. Notice that we are defining the length of a holding period, the period we measure returns and their variances, as 1 year in this example:

Investment	Expected Return	Expected Variance of Return
Toxico	9.5%	10%
Incubeast Corp.	13%	25%
LA Garb	21 %	40%
Savings Account	6.5%	0%

We can express expected returns as HPR's by adding 1 to them. Also, we can express expected variance of return as expected standard deviation of return by taking the square root of the variance. In so doing, we transform our table to:

Investment	Expected Return as an HPR	Expected Standard Deviation of Return
Toxico	1.095	.316227766
lncubeast Corp.	1.13	.5
LA Garb	1.21	.632455532
Savings Account	1.085	0

The time horizon involved is irrelevant so long as it is consistent for all components under consideration. That is, when we discuss expected return, it doesn't matter if we mean over the next year, quarter, 5 years, or day, as long as the expected returns and standard deviations for all of the components under consideration all have the same time frame. (That is, they must will be for the next year, or they must all be for the next day, and so on.) Expected return is synonymous with ***potential gains,*** while variance (or standard deviation) in those expected returns is synonymous with ***potential*** risk. Note that the model is two-dimensional. In other words, we can say that the model can be represented on the upper right quadrant of the Cartesian plane (see Figure 6-1) by placing expected return along one axis (generally the vertical or Y axis) and expected variance or standard deviation of returns along the other axis (generally the horizontal or X axis). There are other aspects to potential risk, such as potential risk of (probability of) a catastrophic loss, which E-V theory does not differentiate from variance of returns in regards to defining potential risk. While this may very well be true, we will not address this concept any further in this chapter so is to discuss E-V theory in its ***classic*** sense. However, Markowitz himself nearly stated that a portfolio derived from E-V theory is optimal only if the utility, the "satisfaction," of the investor is a function of expected return and variance in expected return only. Markowitz indicated that investor utility may very well encompass moments of the distribution higher than the first two (which are what E-V theory addresses), such as skewness and kurtosis of expected returns.

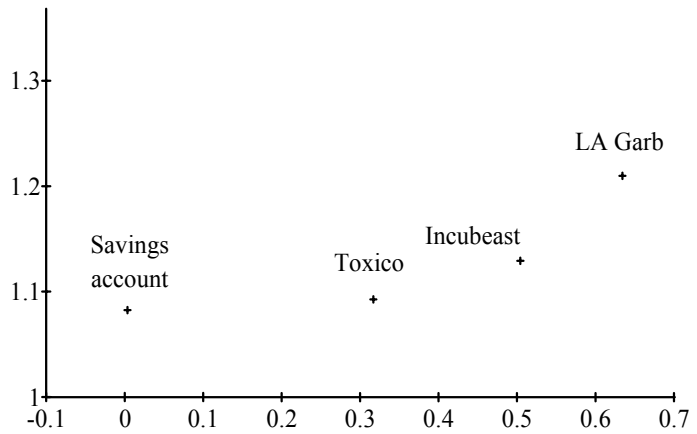

Figure 6-1 The upper-right quadrant of the Cartesian plane.

Potential risk is still a far broader and more nebulous thing than what we have tried to define it as. Whether potential risk is simply variance on a contrived sample, or is represented on a multidimensional hypercube, or incorporates further moments of the distribution, we try to define potential risk to account for our inability to really put our finger on it. That said, we will go forward defining potential risk as the variance in expected returns. However, we must not delude ourselves into thinking that risk is simply defined as such. Risk is far broader, and its definition far more elusive.

So the first step that an investor wishing to employ E-V theory must make is to quantify his or her beliefs regarding the expected returns and variance in returns of the securities under consideration for a certain time horizon (holding period) specified by the investor. These parameters can be, arrived at empirically. That is, the investor can examine the past history of the securities under consideration and calculate the returns and their variances over the specified holding periods. Again the term ***returns*** means not only the dividends in the underlying security, but any gains in the value of the security as well. This is then specified as a percentage. ***Variance*** is the statistical variance of the percentage returns. A user of this approach would often perform a linear regression on the past returns to determine the return (the expected return) in the next holding period. The variance portion of the input would then be determined by calculating the variance of each past data point from what would have been predicted for that past data point (and not from the regression line calculated to predict the next expected return). Rather than gathering these figures empirically, the investor can also simply

[1] For more on this, see Fama, Eugene F., "Portfolio Analysis in a Stable Paretian Market," Management Science 11, pp. 404-419, 1965. Fama has demonstrated techniques for finding the efficient frontier parametrically for stably distributed securities possessing the same characteristic exponent, A, when the returns of the components all depend upon a single underlying market index. Headers should be aware that other work has been done on determining the efficient frontier when there is infinite variance in the returns of the components in the portfolio. These techniques are not covered here other than to refer interested readers to pertinent articles. For more on the stable Paretian distribution, see Appendix B. For a discussion of infinite variance, see The Student's Distribution" in Appendix B.

estimate what he or she believes will be the future returns and variances[2] in those returns. Perhaps the best way to arrive at these parameters is to use a combination of the two. The investor should gather the information empirically, then, if need be, interject his or her beliefs about the future of those expected returns and their variances.

The next parameters the investor must gather in order to use this technique are the linear correlation coefficients of the returns. Again, these figures can be arrived at empirically, by estimation, or by a combination of the two.

In determining the correlation coefficients, it is important to use data points of the same time frame as was used to determine the expected returns and variance in returns. In other words, if you are using yearly data to determine the expected returns and variance in returns (on a yearly basis), then you should use yearly data in determining the correlation coefficients. If you are using daily data to determine the expected returns and Variance in returns (on a daily basis), then you should use daily data in determining the correlation coefficients,

It is also very important to realize that we are determining the correlation coefficients of ***returns*** (gains in the stock price plus dividends), not of the underlying price of the stocks in question.

Consider our example of four alternative investments-Toxico, Incubeast Corp., LA Garb, and a savings account. We designate these with the symbols T, I, L, and S respectively. Next we construct a grid of the linear correlation coefficients as follows:

	I	L	S
T	-.15	.05	0
I		.25	0
L			0

From the parameters the investor has input, we can calculate the ***covariance*** between any two securities as:

(6.01) $COV_{a,b} = R_{a,b}*S_a*S_b$

where

$COV_{a,b}$ = The covariance between the ath security and the bth one.

$R_{a,b}$ = The linear correlation coefficient between a and b.

S_a = The standard deviation of the ath security.

S_b = The standard deviation of the bth security.

The standard deviations, S_a and S_b, are obtained by taking the square root of the variances in expected returns for securities a and b.

Returning to our example, we can determine the covariance between Toxico (T) and Incubeast (I) as:

$COV_{T,I}$ = -.15*.10^(1/2)*.25^(1/2) = -.15*.316227766*.5 = -.02371708245

Thus, given a covariance and the comprising standard deviations, we can calculate the linear correlation coefficient as:

(6.02) $R_{a,b} = COV_{a,b}/(S_a*S_b)$

where

$COV_{a,b}$ = The covariance between the ath security and the bth one.

$R_{a,b}$ = The linear correlation coefficient between a and b.

S_a = The standard deviation of the ath security.

S_b = The standard deviation of the bth security.

Notice that the covariance of a security to itself is the variance, since the linear correlation coefficient of a security to itself is 1:

(6.03) $COV_{X,X} = 1*S_X*S_X = 1*S_X\text{^}2 = S_X\text{^}2 = V_X$

where

COVX,X = The covariance of a security to itself.

SX = The standard deviation of a security.

V_X = The variance of a security.

We can now create a table of covariances for our example of four investment alternatives:

	T	I	L	S
T	.1	-.0237	.01	0
I	-.0237	.25	.079	0
L	.01	.079	.4	0
s	0	0	0	0

We now have compiled the basic parametric information, and we can begin to state the basic problem formally. First, the sum of the weights of the securities comprising the portfolio must be equal to 1, since this is being done in a cash account and each security is paid for in full:

(6.04) $\sum[i = 1,N]X_i = 1$

where

N = The number of securities comprising the portfolio.

X_i = The percentage weighting of the ith security.

It is important to note that in Equation (6.04) each X_i must be non-negative. That is, each X_i must be zero or positive.

The next equation defining what we are trying to do regards the expected return of the entire portfolio. This is the E in E-V theory. Essentially what it says is that the expected return of the portfolio is the sum of the returns of its components times their respective weightings:

(6.05) $\sum[i = 1,N]U_i*X_i = E$

where

E = The expected return of the portfolio.

N = The number of securities comprising the portfolio.

X_i = The percentage weighting of the ith security.

U_i = The expected return of the ith security.

Finally, we come to the V portion of E-V theory, the variance in expected returns. This is the sum of the variances contributed by each security in the portfolio plus the sum of all the possible covariances in the portfolio.

(6.06a) $V = \sum[i = 1,N]\sum[j = 1,N]\ X_i*X_j*COV_{i,j}$

(6.06b) $V = \sum[i = 1,N]\sum[j = 1,N]X_i*X_j*R_{i,j}*S_i*S_j$

(6.06c) $V = (\sum[i = 1,N]X_i\text{^}2*S_i\ \text{^}\ 2)+2*\sum[i = 1,N]\sum[j = i+1,N]X_i*X_j*COV_{i,j}$

(6.06d) $V = (\sum[i = 1,N]X_i\text{^}2*S_i\text{^}2)+2*\sum[i = 1,N]\sum[j = i+1,N]X_i*X_j*R_{i,j}*S_i*S_j$

where

V = The variance in the expected returns of the portfolio.

N = The number of securities comprising the portfolio.

X_i = The percentage weighting of the ith security.

S_i = The standard deviation of expected returns of the ith security.

$COV_{i,j}$ = The covariance of expected returns between the ith security and the jth security.

$R_{i,j}$ = The linear correlation coefficient of expected returns between the ith security and the jth security.

All four forms of Equation (6.06) are equivalent. The final answer to Equation (6.06) is always expressed as a positive number.

We can now consider that our goal is to find those values of X_i, which when summed equal 1, that result in the lowest value of V for a given value of E. When confronted with a problem such as trying to maximize (or minimize) a function, H(X,Y), subject to another condition or constraint, such as G(X,Y), one approach is to use the method of Lagrange.

To do this, we must form the Lagrangian function, F(X,Y,L):

(6.07) F(X,Y,L) = H(X,Y)+L*G(X,Y)

Note the form of Equation (6.07). It states that the new function we have created, F(X,Y,L), is equal to the Lagrangian multiplier, L-a slack variable whose value is as yet undetermined-multiplied by the constraint function G(X,Y). This result is added to the original function H(X,Y), whose extreme we seek to find.

Now, the simultaneous solution to the three equations will yield those points (X_1,Y_1) of relative extreme:

$F_X(X,Y,L) = 0$

$F_Y(X,Y,L) = 0$

$F_L(X,Y,L) = 0$

For example, suppose we seek to maximize the product of two numbers, given that their sum is 20. We will let the variables X and Y be the two numbers. Therefore, H(X,Y) = X*Y is the function to be maximized given the constraining function G(X,Y) = X+Y-20 = 0. We must form the Lagrangian function:

[2] Again estimating variance can be quite tricky. An easier way is to estimate the mean absolute deviation, then multiply this by 1.25 to arrive at the standard deviation. Now multiplying this standard deviation by itself, squaring it, gives the estimated variance.

$F(X,Y,L) = X*Y+L*(X+Y-20)$ $F_X(X,Y,L) = Y+L$ $F_Y(X,Y,L) = X+L$ $F_L(X,Y,L) = X+Y-20$

Now we set $F_X(X,Y,L)$ and $F_Y(X,Y,L)$ both equal to zero and solve each for L:

$Y+L = 0$

$Y = -L$

and

$X+L = 0$

$X = -L$

Now setting $F_L(X,Y,L) = 0$ we obtain $X+Y-20 = 0$. Lastly, we replace X and Y by their equivalent expressions in terms of L:

$(-L)+(-L)-20 = 0$

$2*-L = 20$

$L = -10$

Since Y equals -L, we can state that Y equals 10, and likewise with X. The maximum product is 10*10 = 100.

The method of Lagrangian multipliers has been demonstrated here for two variables and one constraint function. The method can also be applied when there are more than two variables and more than one constraint function. For instance, the following is the form for finding the extreme when there are three variables and two constraint functions:

(6.08) $F(X,Y,Z,L_1,L_2) = H(X,Y,Z)+L_1*G_1(X,Y,Z)+L_2*G_2(X,Y,Z)$

In this case, you would have to find the simultaneous solution for five equations in five unknowns in order to solve for the points of relative extreme. We will cover how to do that a little later on.

We can restate the problem here as one where we must minimize V, the variance of the entire portfolio, subject to the two constraints that:

(6.09) $(\sum[i = 1,N]X_i*U_i)-E = 0$

and

(6.10) $(\sum[i = 1,N]X_i) -1 = 0$

where N = The number of securities comprising the portfolio. E = The expected return of the portfolio. X_i = The percentage weighting of the ith security. U_i = The expected return of the ith security.

The minimization of a restricted multivariable function can be handled by introducing these Lagrangian multipliers and differentiating partially with respect to each variable. Therefore, we express our problem in terms of a Lagrangian function, which we call T. Let:

(6.11) $T = V+ L_1*((\sum[i = 1,N]X_i*U_i) -E)+L2*((\sum[i = 1,N]X_i)-1)$

where

V = The variance in the expected returns of the portfolio, from Equation (6.06).

N = The number of securities comprising the portfolio.

E = The expected return of the portfolio.

X_i = The percentage weighting of the ith security.

U_i = The expected return of the ith security.

L_1 = The first Lagrangian multiplier.

L_2 = The second Lagrangian multiplier.

The minimum variance (risk) portfolio is found by setting the first-order partial derivatives of T with respect to all variables equal to zero.

Let us again assume that we are looking at four possible investment alternatives: Toxico, Incubeast Corp., LA Garb, and a savings account. If we take the first-order partial derivative of T with respect to X_1 we obtain:

(6.12) $\delta T/\delta X_1 = 2*X_1*COV_{1,1}+2*X_2*COV_{1,2}+2*X_3*COV_{1,2+}2*X_4*COV_{1,4}+L_1*U_1+L_2$

Setting this equation equal to zero and dividing both sides by 2 yields:

$X_1*COV_{1,1+}X_2*COV_{1,2}+X_3*COV_{1,3}+X_4*COV_{1,4}+.5*L_1*U_1+.5*L_2 = 0$

Likewise:

$\delta T/\delta X_2 = X_1*COV_{2,1}+X_2 +COV_{2,2}+X_3*COV_{2,3}+X_4*COV_{2,4}+.5*L_1*U_2+.5*L_2 = 0$

$\delta T/\delta X_3 = X_1*COV_{3,1}+X_2*COV_{3,2}+X_3*COV_{3,3}+X_4*COV_{3,4}+.5*L_1*U_3+.5*L_2 = 0$

$\delta T/\delta X_4 = X_1*COV_{4,1}+X_2*COV_{4,2}+X_3*COV_{4,3}+X_4*COV_{4,4}+.5 *L_1*U_4+ .5*L_2 = 0$

And we already have $\delta T/\delta L_1$ as Equation (6.09) and $\delta T/\delta L_2$ as Equation (6.10).

Thus, the problem of minimizing V for a given E can be expressed in the N-component case as N+2 equations involving N+2 unknowns. For the four-component case, the generalized form is:

$$
\begin{array}{llllllll}
X_1*U_1 & +X_2*U_2 & +X_3*U_3 & +X_4*U_4 & & & =E \\
X_1 & +X_2 & +X_3 & +X_4 & & & =1 \\
X_1*COV_{1,1} & +X_2*COV_{1,2} & +X_3*COV_{1,3} & +X_4*COV_{1,4} & +.5*L_1*U_1 & +.5*L_2 & =0 \\
X_1*COV_{2,1} & +X_2*COV_{2,2} & +X_3*COV_{2,3} & +X_4*COV_{2,4} & +.5*L_1*U_2 & +.5*L_2 & =0 \\
X_1*COV_{3,1} & +X_2*COV_{3,2} & +X_3*COV_{3,3} & +X_4*COV_{3,4} & +.5*L_1*U_3 & +.5*L_2 & =0 \\
X_1*COV_{4,1} & +X_2*COV_{4,2} & +X_3*COV_{4,3} & +X_4*COV_{4,4} & +.5*L_1*U_4 & +.5*L_2 & =0
\end{array}
$$

where

E = The expected return of the portfolio.

X_i = The percentage weighting of the ith security.

U_i = The expected return of the ith security.

$COV_{A,B}$ = The covariance between securities A and B.

L_1 = The first Lagrangian multiplier.

L_2 = The second Lagrangian multiplier.

This is the generalized form, and you use this basic form for any number of components. For example, if we were working with the case of three components (i.e., N = 3), the generalized form would be:

$$
\begin{array}{llllll}
X_1*U_1 & +X_2*U_2 & +X_3*U_3 & & & =E \\
X_1 & +X_2 & +X_3 & & & =1 \\
X_1*COV_{1,1} & +X_2*COV_{1,2} & +X_3*COV_{1,3} & +.5*L_1*U_1 & +.5*L_2 & =0 \\
X_1*COV_{2,1} & +X_2*COV_{2,2} & +X_3*COV_{2,3} & +.5*L_1*U_2 & +.5*L_2 & =0 \\
X_1*COV_{3,1} & +X_2*COV_{3,2} & +X_3*COV_{3,3} & +.5*L_1*U_3 & +.5*L_2 & =0
\end{array}
$$

You need to decide on a level of expected return (E) to solve for, and your solution will be that combination of weightings which yields that E with the least variance. Once you have decided on E, you now have all of the input variables needed to construct the coefficients matrix.

The E on the right-hand side of the first equation is the E you have decided you want to solve for (i.e., it is a given by you). The first line simply states that the sum of all of the expected returns times their weightings must equal the given E. The second line simply states that the sum of the weights must equal 1. Shown here is the matrix for a three-security case, but you can use the general form when solving for N securities. However, these first two lines are always the same. The next N lines then follow the prescribed form.

Now, using our expected returns and covariances (from the covariance table we constructed earlier), we plug the coefficients into the generalized form. We thus create a matrix that represents the coefficients of the generalized form. In our four-component case (N = 4), we thus have 6 rows (N+2):

X_1	X_2	X_3	X_4	L_2	L_2	Answer
.095	.13	.21	.085			=E
1	1	1	1			=1
.1	-.0237	.01	0	.095	1	=0
-.0237	.25	.079	0	.13	1	=0
.01	.079	.4	0	.21	1	=0
0	0	0	0	.085	1	=0

Note that the expected returns are not expressed in the matrix as HPR's, rather they are expressed in their "raw" decimal state.

Notice that we also have 6 columns of coefficients. Adding the answer portion of each equation onto the right, and separating it from the coefficients with a creates what is known as an ***augmented matrix,*** which is constructed by fusing the coefficients matrix and the answer column, which is also known as the ***right-hand side vector.***

Notice that the coefficients in the matrix correspond to our generalized form of the problem:

$$
\begin{array}{llllllll}
X_1*U_1 & +X_2*U_2 & +X_3*U_3 & +X_4*U_4 & & & =E \\
X_1 & +X_2 & +X_3 & +X4 & & & =1 \\
X_1*COV_{1,1} & +X_2*COV_{1,2} & +X_3*COV_{1,1} & +X_4*COV_{1,4} & +.5*L_1*U_1 & +.5*L_2 & =0 \\
X_1*COV_{2,1} & +X_2*COV_{2,2} & +X_3*COV_{2,3} & +X_4*COV_{2,4} & +.5*L_1*U_2 & +.5*L_2 & =0 \\
X_1*COV_{3,1} & +X_2*COV_{3,2} & +X_3*COV_{3,3} & +X_4*COV_{3,4} & +.5*L_1*U_3 & +.5*L_2 & =0 \\
X_1*COV_{4,1} & +X_2*COV_{4,2} & +X_3*COV_{4,3} & +X_4*COV_{4,4} & +.5*L_1*U_4 & +.5*L_2 & =0
\end{array}
$$

The matrix is simply a representation of these equations. To solve for the matrix, you must decide upon a level for E that you want to solve for. Once the matrix is solved, the resultant answers will be the optimal weightings required to minimize the variance in the portfolio as a whole for our specified level of E.

Suppose we wish to solve for E=.14, which represents an expected return of 14%.Plugging .14 into the matrix for E and putting in zeros for the variables L_1 and L_2 in the first two rows to complete the matrix gives us a matrix of:

X_1	X_2	X_3	X_4	L_1	L_2	Answer
.095	.13	.21	.085	0	0	=.14
1	1	1	1	0	0	=1
.1	-.0237	.01	0	.095	1	=0
-.0237	.25	.079	0	.13	1	=0
.01	.079	.4	0	.21	1	=0
0	0	0	0	.085	1	=0

By solving the matrix we will solve the N+2 unknowns in the N+2 equations.

SOLUTIONS OF LINEAR SYSTEMS USING ROW-EQUIVALENT MATRICES

A ***polynomial*** is an algebraic expression that is the sum of one or more terms. A polynomial with only one term is called a ***monomial;*** with two terms a ***binomial;*** with three terms a ***trinomial.*** Polynomials with more than three terms are simply called polynomials. The expression 4*A^3+A^2+A+2 is a polynomial having four terms. The terms are separated by a plus (+) sign.

Polynomials come in different ***degrees.*** The degree of a polynomial is the value of the highest degree of any of the terms. The degree of a term is the sum of the exponents on the variables contained in the term. Our example is a third-degree polynomial since the term 4*A^3 is raised to the power of 3, and that is a higher power than any of the other terms in the polynomial are raised to. If this term read 4*A^3*B^2*C, we would have a sixth-degree polynomial since the sum of the exponents of the variables (3+2+1) equals 6.

A first-degree polynomial is also called a ***linear equation,*** and it graphs as a straight line. A second-degree polynomial is called a ***quadratic,*** and it graphs as a parabola. Third-, fourth-, and fifth-degree polynomials are also called ***cubics, quartics,*** and ***quintics,*** respectively. Beyond that there aren't any special names for higher-degree polynomials. The graphs of polynomials greater than second degree are rather unpredictable. Polynomials can have any number of terms and can be of any degree. Fortunately, we will be working only with linear equations, first-degree polynomials here.

When we have more than one linear equation that must be solved simultaneously we can use what is called the ***method of row-equivalent matrices.*** This technique is also often referred to ***as*** the ***Gauss-Jordan procedure or*** the ***Gaussian elimination method.***

To perform the technique, we first create the augmented matrix of the problem by combining the coefficients matrix with the right-hand side vector as we have done. Next, we want to use what are called ***elementary transformations*** to obtain what is known as the ***identity matrix.*** An elementary transformation is a method of processing a matrix to obtain a different but equivalent matrix. Elementary transformations are accomplished by what are called ***row operations.*** (We will cover row operations in a moment.)

An identity matrix is a square coefficients matrix where all of the elements are zeros except for a diagonal line of ones starting in the upper left comer. For a six-by-six coefficients matrix such as we are using in our example, the identity matrix would appear as:

1	0	0	0	0	0
0	1	0	0	0	0
0	0	1	0	0	0
0	0	0	1	0	0
0	0	0	0	1	0
0	0	0	0	0	1

This type of matrix, where the number of rows is equal to the number of columns, is called a ***square matrix.*** Fortunately, due to the generalized form of our problem of minimizing V for a given E, we are always dealing with a square coefficients matrix.

Once an identity matrix is obtained through row operations, it can be regarded as equivalent to the starting coefficients matrix. The answers then are read from the right-hand-side vector. That is, in the first row of the identity matrix, the 1 corresponds to the variable X1, so the answer in the fight-hand side vector for the first row is the answer for X1. Likewise, the second row of the right-hand side vector contains the answer for X2, since the 1 in the second row corresponds to X2. By using row operations we can make elementary transformations to our original matrix until we obtain the identity matrix. From the identity matrix, we can discern the answers, the weights X_1, ..., X_N, for the components in a portfolio. These weights will produce the portfolio with the minimum variance, V, for a given level of expected return, E.[3]

Three types of row operations can be performed:

1. Any two rows may be interchanged.
2. Any row may be multiplied by any nonzero constant.
3. Any row may be multiplied by any nonzero constant and added to the corresponding entries of any other row.

Using these three operations, we seek to transform the coefficients matrix to an identity matrix, which we do in a very prescribed manner.

The first step, of course, is to simply start out by creating the augmented matrix. Next, we perform the first elementary transformation by invoking row operations rule 2. Here we take the value in the first row, first column, which is .095, and we want to convert it to the number 1. To do so, we multiply each value in the first row by the constant 1/.095. Since any number times 1 divided by that number yields 1, we have obtained a 1 in the first row, first column. We have also multiplied every entry in the first row by this constant, 1/.095, as specified by row operations rule 2. Thus, we have obtained elementary transformation number 1.

Our next step is to invoke row operations rule 3 for all rows except the one we have just used rule 2 on. Here, for each row, we take the value of that row corresponding to the column we just invoked rule 2 on. In elementary transformation number 2, for row 2, we will use the value of 1, since that is the value of row 2, column 1, and we just performed rule 2 on column 1. We now make this value negative (or positive if it is already negative). Since our value is 1, we make it -1. We now multiply by the corresponding entry (i.e., same column) of the row we just performed rule 2 on. Since we just performed rule 2 on row 1, we will multiply this -1 by the value of row 1, column 1, which is 1, thus obtaining -1. Now we add this value back to the value of the cell we are working on, which is 1, and obtain 0.

Now on row 2, column 2, we take the value of that row corresponding to the column we just invoked rule 2 on. Again we will use the value of 1, since that is the value of row 2, column 1, and we just performed rule 2 on column 1. We again make this value negative (or positive if it is already negative). Since our value is 1, we make it -1. Now multiply by the corresponding entry (i.e., same column) of the row we just performed rule 2 on. Since we just performed rule 2 on row 1, we will multiply this -1 by the value of row 1, column 2, which is 1.3684, thus obtaining -1.3684. Again, we add this value back to the value of the cell we are working on, row 2, column 2, which is 1, obtaining 1+(-1.3684) = -.3684. We proceed likewise for the value of every cell in row 2, including the value of the right-hand side vector of row 2. Then we do the same for all other rows until the column we are concerned with, column 1 here, is all zeros. Notice that we need not invoke row operations rule 3 for the last row, since that already has a value of zero for column 1.

When we are finished, we will have obtained elementary transformation number 2. Now the first column is already that of the identity matrix. Now we proceed with this pattern, and in elementary transformation 3 we invoke row operations rule 2 to convert the value in the second row, second column to a 1. In elementary transformation number 4, we invoke row operations rule 3 to convert the remainder of the rows to zeros for the column corresponding to the column we just invoked row operations rule 2 on.

We proceed likewise, converting the values along the diagonals to ones per row operations rule 2, then converting the remaining values in that column to zeros per row operations rule 3 until we have obtained the identity matrix on the left. The right-hand side vector will then be our. solution set.

X_1	X_2	X_3	X_4	L_1	L_2	Answer	Explanation
Starting Augmented Matrix							
.095	.13	.21	.085	0	0	.14	
1	1	1	1	0	0	1	
.1	-.023	.01	0	.095	1	0	

[3] That is, these weights will produce the portfolio with a minimum V for a given E only to the extent that our inputs of E and V for each component and the linear correlation coefficient of every possible pair of components are accurate and variance in returns is infinite.

X_1	X_2	X_3	X_4	L_1	L_2	Answer	Explanation
-.023	.25	.079	0	.13	1	0	
.01	.079	.4	0	.21	1	0	
0	0	0	0	.085	1	0	
Elementary Transformation Number 1							
1	1.3684	2.2105	.8947	0	0	1.47368	row1*(1/.095)
1	1	1	1	0	0	1	
0.1	-.023	.01	0	.095	1	0	
-.023	.25	.079	0	.13	1	0	
.01	.079	.4	0	.21	1	0	
0	0	0	0	.085	1	0	
Elementary Transformation Number 2							
1	1.3684	2.2105	.8947	0	0	1.47368	
0	-.368	-1.210	.1052	0	0	-.4736	row2+(-1*row1)
0	-.160	-.211	-.089	.095	1	-.1473	row3+(-.1*row1)
0	.2824	.1313	.0212	.13	1	.03492	row4+(.0237*row1)
0	.0653	.3778	-.008	.21	1	-.0147	row5+(-.01*row1)
0	0	0	0	.085	1	0	
Elementary Transformation Number 3							
1	1.3684	2.2105	.8947	0	0	1.47368	
0	1	3.2857	-.285	0	0	1.28571	row2*(1/-.36842)
0	-.160	-.211	-.089	.095	1	-.1473	
0	.2824	.1313	.0212	.13	1	.03492	
0	.0653	.3778	-.008	.21	1	-.0147	
0	0	0	0	.085	1	0	
Elementary Transformation Number 4							
1	0	-2.285	1.2857	0	0	-.2857	row1+(-1.368421*row2)
0	1	3.2857	-.285	0	0	1.28571	
0	0	.3164	-.135	.095	1	.05904	row3+(.16054*row2)
0	0	-.796	.1019	.13	1	-.3282	Сгрока4+(-.282431*row2)
0	0	.1632	.0097	.21	1	-.0987	row5+(-.065315*row2)
0	0	0	0	.085	1	0	
Elementary Transformation Number 5							
1	0	-2.285	1.2857	0	0	-.2857	
0	1	3.2857	-.285	0	0	1.28571	
0	0	1	-.427	.3002	3.1602	.18658	row3*(1/.31643)
0	0	-.796	.1019	.13	1	-.3282	
0	0	.1632	.0097	.21	1	-.0987	
0	0	0	0	.085	1	0	
Elementary Transformation Number 6							
1	0	0	.3080	.6862	7.2233	.14075	row1+(2.2857*row3)
0	1	0	1.1196	-.986	-1.38	.67265	row2+(-3.28571*row3)
0	0	1	-.427	.3002	3.1602	.18658	
0	0	0	-.238	.3691	3.5174	-.1795	row4+(.7966*row3)
0	0	0	.0795	.1609	.4839	-.1291	row5+(-.16328*row3)
0	0	0	0	.085	1	0	
Elementary Transformation Number 7							
1	0	0	.3080	.6862	7.2233	.14075	
0	1	0	1.1196	-.986	-1.38	.67265	
0	0	1	-.427	.3002	3.1602	.18658	
0	0	0	1	-1.545	-14.72	.75192	row4*(1/-.23881)
0	0	0	.0795	.1609	.4839	-.1291	
0	0	0	0	.085	1	0	
Elementary Transformation Number 8							
1	0	0	0	1.1624	11.760	-.0908	row1+(-.30806*row4)
0	1	0	0	.7443	6.1080	-.1692	row2+(-1.119669*row4)
0	0	1	0	-.360	-3.139	.50819	row3+(.42772*row4)
0	0	0	1	-1.545	-14.72	.75192	
0	0	0	0	.2839	1.6557	-.1889	row5+(-.079551*row4)
0	0	0	0	.085	1	0	
Elementary Transformation Number 9							
1	0	0	0	1.1624	11.761	-.0909	
0	1	0	0	.7445	6.1098	-.1693	
0	0	1	0	-.361	-3.140	.50823	
0	0	0	1	-1.545	-14.72	.75192	
0	0	0	0	1	5.8307	-.6655	row5*(1/.28396)
0	0	0	0	0.085	1	0	
Elementary Transformation Number 10							
1	0	0	0	0	4.9831	0.68280	row1+(-1.16248*row5)
0	1	0	0	0	1.7685	0.32620	row2+(-.74455*row5)
0	0	1	0	0	-1.035	0.26796	row3+(.3610*row5)
0	0	0	1	0	-5.715	-0.2769	row4+(1.5458trow5)
0	0	0	0	1	5.8312	-0.6655	
0	0	0	0	0	0.5043	0.05657	row6+(-.085*row5)
Elementary Transformation Number 11							
1	0	0	0	0	49826	0.68283	
0	1	0	0	0	1.7682	0.32622	
0	0	1	0	0	-1.035	0.26795	
0	0	0	1	0	-5.715	-0.2769	
0	0	0	0	1	5.8312	-0.6655	
0	0	0	0	0	1	0.11217	row6*(1/.50434)
Elementary Transformation Number 12							
1	0	0	0	0	0	0.12391	row1+(-4.98265*row6)
0	1	0	0	0	0	0.12787	row2+(-1.76821*row6)
0	0	1	0	0	0	0.38407	row3+(1.0352*row6)
0	0	0	1	0	0	0.36424	row4+(5.7158*row6)
0	0	0	0	1	0	-1.3197	row5+(-5.83123*row6)
0	0	0	0	0	1	0.11217	
Matrix Obtained							
1	0	0	0	0	0	0.12391	$=X_1$
0	1	0	0	0	0	0.12787	$=X_2$
0	0	1	0	0	0	0.38407	$=X_3$
0	0	0	1	0	0	0.36424	$=X_4$
0	0	0	0	1	0	-1.3197/.5	$=-2.6394=L_1$
0	0	0	0	0	1	0.11217/.5	$=.22434=L_2$

INTERPRETING THE RESULTS

Once we have obtained the identity matrix, we can interpret its meaning. Here, given the inputs of expected returns and expected variance in returns for all of the components under consideration, and given the linear correlation coefficients of each possible pair of components, for an expected yield of 14% this solution set is optimal. Optimal, as used here, means that this solution set will yield the lowest variance for a 14% yield. In a moment, we will determine the variance, but first we must interpret the results.

The first four values, the values for X_1 through X_4, tell us the weights (the percentages of investable funds) that should be allocated to these investments to achieve this optimal portfolio with a 14% expected return. Hence, we should invest 12.391% in Toxico, 12.787% in Incubeast, 38.407% in LA Garb, and 36.424% in the savings account. If we are looking at investing $50,000 per this portfolio mix:

Stock	Percentage	(*50,000 =) Dollars to Invest
Toxico	.12391	$6,195.50
Incubeast	.12787	$6,393.50
LA Garb	.38407	$19,203.50
Savings	.36424	$18,212.00

Thus, for Incubeast, we would invest $6,393.50. Now assume that Incubeast sells for $20 a share. We would ***optimally*** buy 319.675 shares (6393.5/20). However, in the real world we cannot run out and buy fractional shares, so we would say that optimally we would buy either 319 or 320 shares. Now, the odd lot, the 19 or 20 shares remaining after we purchased the first 300, we would have to pay up for. Odd lots are usually marked up a small fraction of a point, so we would have to pay extra for those 19 or 20 shares, which in turn would affect the expected return on our Incubeast holdings, which in turn would affect the optimal portfolio mix We are often better off to just buy the round lot-in this case, 300 shares. As you can see, more slop creeps into the mechanics of this. Whereas we can identify what the optimal portfolio is down to the fraction of a share, the real-life implementation requires again that we allow for slop.

Furthermore, the larger the equity you are employing, the more closely the real-life implementation of the approach will resemble the theoretical optimal. Suppose, rather than looking at $50,000 to invest, you were running a fund of $5 million. You would be looking to invest 12.787% in Incubeast (if we were only considering these four investment alternatives)? and would therefore be investing 5,000,000*.12787 = $639,350. Therefore, at $20 a share, you would buy 639,350/20 = 31,967.8 shares. Again, if you restricted it down to the round lot, you would buy 31,900 shares, deviating from the optimal number of shares by about 0.2%. Contrast this to the case "where you have $50,000 to invest and buy 300 shares versus the optimal of 319.675. There you are deviating from the optimal by about 6.5%.

The Lagrangian multipliers have an interesting interpretation. To begin with, the Lagrangians we are using here must be divided by .5 after the Identity matrix is obtained before we can interpret them. This is in accordance with the generalized form of our problem. The L_1 variable

equals $-\delta V/\delta E$. This means that L_1 represents the marginal variance in expected returns. In the case of our example, where $L_1 = -2.6394$, we can state that V is changing at a rate of $-L_1$, or -(-2.6394), or 2.6394 units for every unit in E instantaneously at E = .14.

To interpret the L_2 variable requires that the problem first be restated. Rather than having $\sum X_i = 1$, we will state that $\sum X_i = M$, where M equals the dollar amount of funds to be invested. Then $L_2 = \delta V/\delta M$. In other words, L_2 represents the marginal risk of increased or decreased investment.

Returning now to what the variance of the entire portfolio is, we can use Equation (6.06) to discern the variance. Although we could use any variation of Equation (6.06a) through (6.06d), here we will use variation a:

(6.06a) $V = \sum[i = 1,N]\sum[j = 1,N]\ X_i*X_j*COV_{i,j}$

Plugging in the values and performing Equation (6.06a) gives:

X_i	X_j	$COV_{i,j}$	
0.12391*	0.12391*	0.1	0.0015353688
0.12391*	0.12787*	-0.0237	=-0.0003755116
0.12391*	0.38407*	0.01	0.0004759011
0.12391*	0.36424*	0	0
0.12787*	0.12391*	-0.0237	=-0.0003755116
0.12787*	0.12787*	0.25	0.0040876842
0.12787*	0.38407*	0.079	0.0038797714
0.12787*	0.36424*	0	=0
0.38407*	0.12391*	0.01	=0.0004759011
0.38407*	0.12787*	0.079	=0.0038797714
0.38407*	0.38407*	0.4	=0.059003906
0.38407*	0.36424*	0	=0
0.36424*	0.12391*	0	=0
0.36424*	0.12787*	0	=0
0.36424*	0.38407*	0	=0
0.36424*	0.36424*	0	=0
			.0725872809

Thus, we see that at the value of E = .14, the lowest value for V is obtained at V = .0725872809.

Now suppose we decided to input a value of E = .18. Again, we begin with the augmented matrix, which is exactly the same as in the last example of E = .14, only the upper rightmost cell, that is the first cell in the right-hand side vector, is changed to reflect this new E of .18:

X_1	X_2	X_3	X_4	L_1	L_2	Answer
Starting Augmented Matrix						
.095	.13	.21	.085	0	0	.18
1	1	1	1	0	0	1
.1	-.023	0.01	0	.095	1	0
-.023	.25	.079	0	.13	1	0
.01	.079	.4	0	.21	1	0
0	0	0	0	.085	1	0

Through the use of row operations... the identity matrix is obtained:

1	0	0	0	0	0	0.21401=X_1
0	1	0	0	0	0	0.22106=X_2
0	0	1	0	0	0	0.66334=X_3
0	0	0	1	0	0	-.0981=X_4
0	0	0	0	1	0	-1.3197/.5=-2.639=L_1
0	0	0	0	0	1	0.11217/.5=.22434=L_2

We then go about solving the matrix exactly as before, only this time we get a negative answer in the fourth cell down of the right-hand side vector. Meaning, we should allocate a negative proportion, a disinvestment of 9.81% in the savings account.

To account for this, whenever we get a negative answer for any of the X_i's-which means if any of the first N rows of the right-hand side vector is less than or equal to zero-we must pull that row+2 and that column out of the starting augmented matrix, and solve for the new augmented matrix. If either of the last 2 rows of the right-hand side vector are less than or equal to zero, we don't need to do this. These last 2 entries in the right-hand side vector always pertain to the Lagrangians, no matter how many or how few components there are in total in the matrix. The Lagrangians are allowed to be negative.

Since the variable returning with the negative answer corresponds to the weighting of the fourth component, we pull out the fourth column and the sixth row from the starting augmented matrix. We then use row operations to perform elementary transformations until, again, the identity matrix is obtained:

X_1	X_2	X_3	L_1	L_2	Answer
Starting Augmented Matrix					
.095	.13	.21	0	0	.18
1	1	1	0	0	1
.1	-.023	0.01	.095	1	0
-.023	.25	.079	.13	1	0
.01	.079	.4	.21	1	0

Through the use of row operations... the identity matrix is obtained:

1	0	0	0	0	0.1283688	=X_1
0	1	0	0	0	0.1904699	=X_2
0	0	1	0	0	0.6811613	=X_3
0	0	0	1	0	-2.38/.5=-4.76	=L_1
0	0	0	0	1	0.210944/.5=.4219	=L_2

When you must pull out a row and column like this, it is important that you remember what rows correspond to what variables, especially when you have more than one row and column to pull. Again, using an example to illustrate, suppose we want to solve for E = .1965. The first identity matrix we arrive at will show negative values for the weighting of Toxico, X1, and the savings account, X4. Therefore, we return to our starting augmented matrix:

X_1	X_2	X_3	X_4	L_1	L_2	Answer	Pertains to
Starting Augmented Matrix							
.095	.13	.21	.085	0	0	.1965	Toxico
1	1	1	1	0	0	1	Incubeast
.1	-.023	.01	0	.095	1	0	LA Garb
-.023	.25	.079	0	.13	1	0	Savings
.01	.079	.4	0	.21	1	0	L_1
0	0	0	0	.085	1	0	L_2

Now we pull out row 3 and column 1, the ones that pertain to Toxico, and also pull row 6 and column 4, the ones that pertain to the savings account:

X_2	X_3	X_4	L_1	L_2	Answer	Pertains to
Starting Augmented Matrix						
.13	.21	.085	0	0	.1965	Incubeast
1	1	1	0	0	1	LA Garb
.25	.079	0	.13	1	0	L_1
.079	.4	0	.21	1	0	L_2

So we will be working with the following matrix:

X_2	X_3	X_4	L_1	L_2	Answer	Pertains to
Starting Augmented Matrix						
.13	.21	.085	0	0	.1965	Incubeast
1	1	1	0	0	1	LA Garb
.25	.079	0	.13	1	0	L_1
.079	.4	0	.21	1	0	L_2

Through the use of row operations ... the identity matrix is obtained:

1	0	0	0	.169	Incubeast
0	1	0	0	.831	LA Garb
0	0	1	0	-2.97/.5=-5.94	L_1
0	0	0	1	.2779695/.5=.555939	L_2

Another method we can use to solve for the matrix is to use the ***inverse*** of the coefficients matrix. An inverse matrix is a matrix that, when multiplied by the original matrix, yields the identity matrix. This technique will be explained without discussing the details of matrix multiplication.

In matrix algebra, a matrix is often denoted with a boldface capita] letter. For example, we can denote our coefficients matrix as C. The inverse to a matrix is denoted as superscripting -1 to it. The inverse matrix to C then is C^{-1}.

To use this method, we need to first discern the inverse matrix to our coefficients matrix. To do this, rather than start by augmenting the righthand-side vector onto the coefficients matrix, we augment the identity matrix itself onto the coefficients matrix. For our 4-stock example:

Starting Augmented Matrix											
X_1	X_2	X_3	X_4	L_1	L_2	Identity Matrix					
0.095	0.13	0.21	0.085	0	0	1	0	0	0	0	0
1	1	1	1	0	0	0	1	0	0	0	0
0.1	-0.023	0.01	0	0.095	1	0	0	1	0	0	0
-0.023	0.25	0.079	0	0.13	1	0	0	0	1	0	0
0.01	0.079	0.4	0	0.21	1	0	0	0	0	1	0
0	0	0	0	0.085	1	0	0	0	0	0	1

Now we proceed using row operations to transform the coefficients matrix to an identity matrix. In the process, since every row operation performed on the left is also performed on the right, we will have transformed the identity matrix on the right-hand side into the inverse matrix

C-r, of the coefficients matrix C. In our example, the result of the row operations yields:

C						C^{-1}					
1	0	0	0	0	0	2.2527	-0.1915	10.1049	0.9127	-1.1370	-9.8806
0	1	0	0	0	0	2.3248	-0.1976	0.9127	4.1654	-1.5726	-3.5056
0	0	1	0	0	0	6.9829	-0.5935	-1.1370	-1.5726	0.6571	2.0524
0	0	0	1	0	0	-11.5603	1.9826	-9.8806	-3.5056	2.0524	11.3337
0	0	0	0	1	0	-23.9957	2.0396	2.2526	2.3248	6.9829	-11.5603
0	0	0	0	0	1	2.0396	-0.1734	-0.1915	-0.1976	-0.5935	1.9826

Now we can take the inverse matrix, C-i, and multiply it by our original right-hand side vector. Recall that our right-hand side vector is:

E
S
0
0
0
0

Whenever we multiply a matrix by a columnar vector (such as this) we multiply all elements in the first column of the matrix by the first element in the vector, all elements in the second column of the matrix by the second element in the vector, and so on. If our vector were a row vector, we would multiply all elements in the first row of the matrix by the first element in the vector, all elements in the second row of the matrix by the second element in the vector, and so on. Since our vector is columnar, and since the last four elements are zeros, we need only multiply the first column of the inverse matrix by E (the expected return for the portfolio) and the second column of the inverse matrix by S, the sum of the weights. This yields the following set of equations, which we can plug values for E and S into and obtain the optimal weightings. In our example, this yields:

E*2.2527+S*-0.1915 = Optimal weight for first stock

E*2.3248+S*-0.1976 = Optimal weight for second stock

E*6.9829+S*-0.5935 = Optimal weight for third stock

E*-11.5603+S*1.9826 = Optimal weight for fourth stock

E*-23.9957+S*2.0396 = **.**5 of first Lagrangian

E*2.0396+S*-0.1734 = .5 of second Lagrangian

Thus, to solve for an expected return of 14% (E = .14) with the sum of the weights equal to 1:

.14*2.2527+1*-0.1915 = .315378-.1915 = .1239 Toxico

.14*2.3248+1*-0.1976 = .325472-.1976 = .1279 Incubeast

.14*6.9829+1*-0.5935 = .977606-.5935 = .3841 LA Garb

.14*-11.5603+1*1.9826 = -1.618442+1.9826 = .3641 Savings

.14*-23.9957+1*2.0396 = -3.359398+2.0396 = -1.319798*2 = -2.6395 L_1

.14*2.0396+1 *-0.1734 = .285544-.1734 = .1121144*2 = .2243L_2

Once you have obtained the inverse to the coefficients matrix, you can quickly solve for any value of E provided that your answers, the optimal weights, are all positive. If not, again you must create the coefficients matrix without that item, and obtain a new inverse matrix.

Thus far we have looked at investing in stocks from the long side only How can we consider short sale candidates in our analysis?

To begin with, you would be looking to sell short a stock if you expected it would decline. Recall that the term "returns" means not only the dividends in the underlying security, but any gains in the value of the security as well. This figure is then specified as a percentage. Thus, in determining the returns of a short position, you would have to estimate what percentage gain you would expect to make on the declining stock, and from that you ***would then*** need to ***subtract*** the dividend (however many dividends go ex-date over the holding period you are calculating your E and V on) as a percentage.[4] Lastly, any linear correlation coefficients of which the stock you are looking to short is a member must be multiplied by -1. Therefore, since the linear correlation coefficient between Toxico and Incubeast is -.15, if you were looking to short Toxico, you would multiply this by -1. In such a case you would use -.15*-1 = .15 as the linear correlation coefficient. If you linear looking to short both of these stocks, the linear correlation coefficient between the two would be -.15*-1*-1 = -.15. In other words, if you are looking to short both stocks, the linear correlation coefficient between them remains unchanged, as it would if you were looking to go long both stocks.

Thus far we have sought to obtain the optimal portfolio, and its variance V, when we know the expected return, E, that we seek. We can also solve for E when we know V. The simplest way to do this is by iteration using the techniques discussed thus far in this chapter.

There is much more to matrix algebra than is presented in this chapter. There are other matrix algebra techniques to solve systems of linear equations. Often you will encounter reference to techniques such as Cramer's Rule, the Simplex Method, or the Simplex Tableau. These are techniques similar to the ones described in this chapter, although more involved. There are a multitude of applications in business and science for matrix algebra, and the topic is considerably involved We have only etched the surface, just enough for what we need to accomplish. For a more detailed discussion of matrix algebra and its applications in business and science, the reader is referred to Sets, Matrices, and Linear Programming, by Robert L. Childness.

The next chapter covers utilizing the techniques detailed in this chapter for any tradeable instrument, as well as stocks, while incorporating optimal f, as well as a mechanical system.

[4] In this chapter we are assuming that all transactions are performed in a cash account. So, though a short position is required to be performed in a margin account as opposed to a cash account, we will not calculate interest on the margin.

Chapter 7 - The Geometry of Portfolios

We have now covered how to find the optimal fs for a given market system from a number of different standpoints. Also, we have seen how to derive the efficient frontier. In this chapter we show how to combine the two notions of optimal f and, the efficient frontier to obtain a truly efficient portfolio for which geometric growth is maximized. Furthermore, we will delve into an analytical study of the geometry of portfolio construction.

THE CAPITAL MARKET LINES (CMLS)

In the last chapter we saw how to determine the efficient frontier parametrically. We can improve upon the performance of any given portfolio by combining a certain percentage of the portfolio with cash. Figure 7-1 shows this relationship graphically.

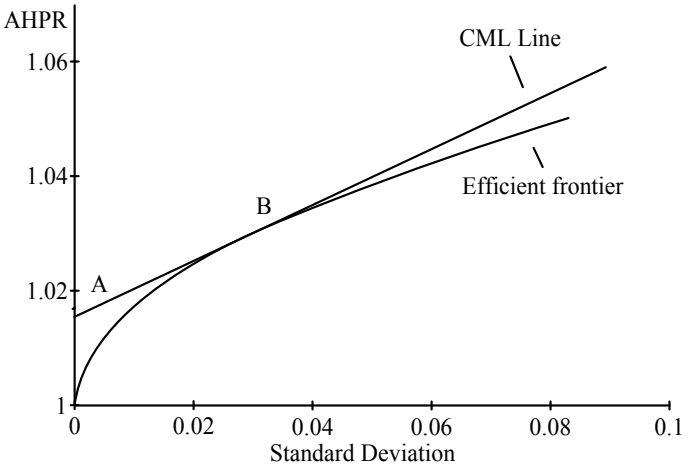

Figure 7-1 Enhancing returns with the risk-free asset.

In Figure 7-1, point A represents the return on the risk-free asset. This would usually be the return on 91-day Treasury Bills. Since the risk, the standard deviation in returns, is regarded as nonexistent, point A is at zero on the horizontal axis.

Point B represents the tangent portfolio. It is the only portfolio lying upon the efficient frontier that would be touched by a line drawn from the risk-free rate of return on the vertical axis and zero on the horizontal axis. Any point along line segment AB will be composed of the portfolio at point B and the risk-free asset. At point B, all of the assets would be in the portfolio, and at point A all of the assets would be in the risk-free asset. Anywhere in between points A and B represents having a portion of the assets in both the portfolio and the risk-free asset. Notice that any portfolio along line segment AB dominates any portfolio on the efficient frontier at the same risk level, since being on the line segment AB has a higher return for the same risk. Thus, an investor who wanted a portfolio less risky than portfolio B would be better off to put a portion of his or her investable funds in portfolio B and a portion in the risk-free asset, as opposed to owning 100% of a portfolio on the efficient frontier at a point less risky than portfolio B. The line emanating from point A, the risk-free rate on the vertical axis and zero on the horizontal axis, and emanating to the right, tangent to one point on the efficient frontier, is called the ***capital market line*** (CML). To the right of point B, the CML line represents portfolios where the investor has gone out and borrowed more money to invest further in portfolio B. Notice that an investor who wanted a portfolio with a greater return than portfolio B would be better off to do this, as being on the CML line right of point B dominates (has higher return than) those portfolios on the efficient frontier with the same level of risk.

Usually, point B will be a very well-diversified portfolio. Most portfolios high up and to the right and low down and to the left on the efficient frontier nave very few components. Those in the middle of the efficient frontier, where the tangent point to the risk-free rate is, usually are very well diversified.

It has traditionally been assumed that all rational investors will want to get the greatest return for a given risk and take on the lowest risk for a given return. Thus, all investors would want to be somewhere on the CML line. In other words, all investors would want to own the same portfolio, only with differing degrees of leverage. This distinction between the investment decision and the financing decision is known as the ***separation theorem.***[1]

We assume now that the vertical scale, the E in E-V theory, represents the arithmetic average HPR (AHPR) for the portfolios and the horizontal, or V, scale represents the standard deviation in the HPRs. For a given risk-free rate, we can determine where this tangent point portfolio on our efficient frontier is, as the coordinates (AHPR, V) that maximize the following function are:

(7.01a) Tangent Portfolio = MAX{(AHPR-(1+RFR))/SD}

where

MAX{} = The maximum value.

AHPR = The arithmetic average HPR. This is the E coordinate of a given portfolio on the efficient frontier.

SD = The standard deviation in HPRs. This is the V coordinate of a given portfolio on the efficient frontier.

RFR = The risk-free rate.

In Equation (7.0la), the formula inside the braces ({ }) is known as the Sharpe ratio, a measurement of risk-adjusted returns. Expressed literally, the Sharpe ratio for a portfolio is a measure of the ratio of the expected excess returns to the standard deviation. The portfolio with the highest Sharpe ratio, therefore, is the portfolio where the CML line is tangent to the efficient frontier for a given RFR.

The Sharpe ratio, when multiplied by the square root of the number of periods over which it was derived, equals the t statistic. From the resulting t statistic it is possible to obtain a confidence level that the AHPR exceeds the RFR by more than chance alone, assuming finite variance in the returns.

The following table shows how to use Equation (7.0la) and demonstrate the entire process discussed thus far. The first two columns represent the coordinates of different portfolios on the efficient frontier. The coordinates are given in (AHPR, SD) format, which corresponds to the Y and X axes of Figure 7-1. The third column is the answer obtained for Equation (7.01a) assuming a 1.5% risk-free rate (equating to an AHPR of 1.015. We assume that the HPRs here are quarterly HPRs, thus a 1.5% risk-free rate for the quarter equates to roughly a 6% risk-free rate for the year). Thus, to work out (7.0la) for the third set of coordinates (60013. 1.002):

(AHPR-(1+RFR))/SD = (1.002-(1+.015))/.00013 = (1.002-1.015)/.00013 = -.013/.00013 = -100

The process is completed for each point along the efficient frontier. Equation (7.01a) peaks out at .502265, which is at the coordinates (.02986, 1.03). These coordinates are the point where the CML line is tangent to the efficient frontier, corresponding to point B in Figure 7-1. This tangent point is a certain portfolio along the efficient frontier. The Sharpe ratio is the slope of the CML, with the steepest slope being the tangent line to the efficient frontier.

Efficient Frontier			CML line	
AHPR	SD	Eq.(7.01a)	Percentage	AHPR
		RFR=.015		
1.00000	0.00000	0	0.00%	1.0150
1.00100	0.00003	-421.902	0.11%	1.0150
1.00200	0.00013	-100.000	0.44%	1.0151
1.00300	0.00030	-40.1812	1.00%	1.0152
1.00400	0.00053	-20.7184	1.78%	1.0153
1.00500	0.00063	-12.0543	2.78%	1.0154
1.00600	0.00119	-7.53397	4.00%	1.0156
1.00700	0.00163	-4.92014	5.45%	1.0158
1.00600	0.00212	-3.29611	7.11%	1.0161
1.00900	0.00269	-2.23228	9.00%	1.0164
1.01000	0.00332	-1.50679	11.11%	1.0167
1.01100	0.00402	-0.99622	13.45%	1.0170
1.01200	0.00476	-0.62783	16.00%	1.0174
1.01300	0.00561	-0.35663	18.78%	1.0178
1.01400	0.00650	-0.15375	21.78%	1.0183
0.91500	0.00747	0	25.00%	1.0188
1.01600	0.00649	0.117718	28.45%	1.0193
1.01700	0.00959	0.208552	32.12%	1.0198
1.01800	0.01075	0.279036	36.01%	1.0204
1.01900	0.01198	0.333916	40.12%	1.0210
1.02000	0.01327	0.376698	44.45%	1.0217

[1] See Tobin, James, "Liquidity preference as Behavior Towards Risk," Review of Economic Studies 25, pp. 65-85, February 1958.

Efficient Frontier			CML line	
AHPR	SD	Eq.(7.01a)	Percentage	AHPR
1.02100	0.01463	0.410012	49.01%	1.0224
1.02200	0.01606	0.435850	53.79%	1.0231
1.02300	0.01755	0.455741	58.79%	1.0236
1.02400	0.01911	0.470073	64.01%	1.0246
1.02500	0.02074	0.482174	69.46%	1.0254
1.02600	0.02243	0.490377	75.12%	1.0263
1.02700	0.02419	0.496064	81.01%	1.0272
1.02800	0.02602	0.499702	87.12%	1.0281
1.02900	0.02791	0.501667	93.46%	1.0290
1.03000	0.02986	0.502265(peak)	100.02%	1.0300
1.03100	0.03189	0.501742	106.79%	1.0310
1.03200	0.03398	0.500303	113.80%	1.0321
1.03300	0.03614	0.498114	121.02%	1.0332
1.03400	0.03836	0.495313	128.46%	1.0343
1.03500	0.04065	0.492014	136.13%	1.0354
1.03600	0.04301	0.488313	144.02%	1.0366
1.03700	0.04543	0.484287	152.13%	1.0376
1.03800	0.04792	0.480004	160.47%	1.0391
1.03900	0.05047	0.475517	169.03%	1.0404
1.04000	0.05309	0.470873	177.81%	1.0417
1.04100	0.05578	0.466111	186.81%	1.0430
1.04200	0.05853	0.461264	196.03%	1.0444
1.04300	0.06136	0.456357	205.48%	1.0456
1.04400	0.06424	0.451416	215.14%	1.0473
1.04500	0.06720	0.446458	225.04%	1.0466
1.04600	0.07022	0.441499	235.15%	1.0503
1.04700	0.07330	0.436554	245.48%	1.0516
1.04800	0.07645	0.431634	256.04%	1.0534
1.04900	0.07967	0.426747	266.82%	1.0550
1.05000	0.08296	0.421902	277.82%	1.0567

The next column over, "percentage, "represents what percentage of your assets must be invested in the tangent portfolio if you are at the CML line for that standard deviation coordinate. In other words, for the last entry in the table, to be on the CML line at the .08296 standard deviation level, corresponds to having 277.82% of your assets in the tangent portfolio (i.e., being fully invested and borrowing another $1.7782 for every dollar already invested to invest further). This percentage value is calculated from the standard deviation of the tangent portfolio as:

(7.02) P = SX/ST

where

SX = The standard deviation coordinate for a particular point on the CML line.

ST = The standard deviation coordinate of the tangent portfolio.

P = The percentage of your assets that must be invested in the tangent portfolio to be on the CML line for a given SX.

Thus, the CML line at the standard deviation coordinate .08296, the last entry in the table, is divided by the standard deviation coordinate of the tangent portfolio, .02986, yielding 2.7782, or 277.82%.

The last column in the table, the CML line AHPR, is the AHPR of the CML line at the given standard deviation coordinate. This is figured as:

(7.03) ACML = (AT*P)+((1+RFR)*(1-P))

where

ACML = The AHPR of the CML line at a given risk coordinate, or a corresponding percentage figured from (7.02).

AT = The AHPR at the tangent point, figured from (7.01a).

P = The percentage in the tangent portfolio, figured from (7.02)

RFR = The risk-free rate.

On occasion you may want to know the standard deviation of a certain point on the CML line for a given AHPR. This linear relationship can be obtained as:

(7.04) SD = P*ST

where

SD = The standard deviation at a given point on the CML line corresponding to a certain percentage, P, corresponding to a certain AHPR.

P = The percentage in the tangent portfolio, figured from (7.02).

ST = The standard deviation coordinate of the tangent portfolio.

THE GEOMETRIC EFFICIENT FRONTIER

The problem with Figure 7-1 is that it shows the arithmetic average HPR. When we are reinvesting profits back into the program we must look at the geometric average HPR for the vertical axis of the efficient frontier. This changes things considerably. The formula to convert a point on the efficient frontier from an arithmetic HPR to a geometric is:

(7.05) GHPR = (AHPR^2-V)^(1/2)

where

GHPR = The geometric average HPR.

AHPR = The arithmetic average HPR.

V = The variance coordinate. (This is equal to the standard deviation coordinate squared.)

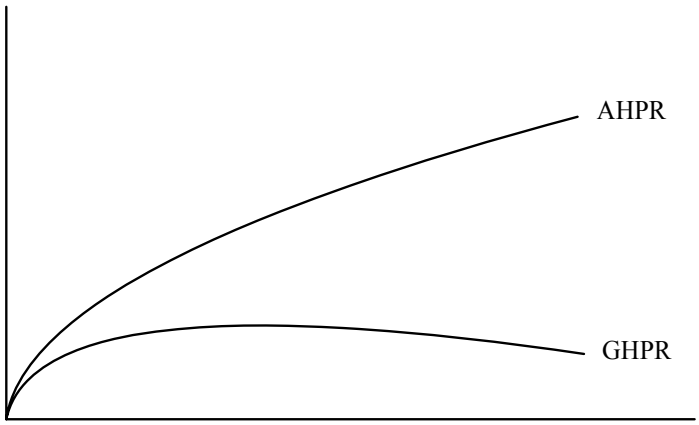

Figure 7-2 The efficient frontier with/without reinvestment

In Figure 7-2 you can see the efficient frontier corresponding to the arithmetic average HPRs as well as that corresponding to the geometric average HPRs. You can see what happens to the efficient frontier when reinvestment is involved.

By graphing your GHPR line, you can see which portfolio is the geometric optimal (the highest point on the GHPR line). You could also determine this portfolio by converting the AHPRs and Vs of each portfolio along the AHPR efficient frontier into GHPRs per Equation (7.05) and see which had the highest GHPR. Again, that would be the geometric optimal. However, given the AHPRs and the Vs of the portfolios lying along the AHPR efficient frontier, we can readily discern which portfolio would be geometric optimal- the one that solves the following equality:

(7.06a) AHPR-1-V = 0

where

AHPR = The arithmetic average HPRs. This is the E coordinate of a given portfolio on the efficient frontier.

V = The variance in HPR. This is the V coordinate of a given portfolio on the efficient frontier. This is equal to the standard deviation squared.

Equation (7.06a) can also be written as any one of the following three forms:

(7.06b) AHPR-1 = V

(7.06c) AHPR-V = 1

(7.06d) AHPR = V+1

A brief note on the geometric optimal portfolio is in order here. Variance in a portfolio is generally directly and positively correlated to drawdown in that higher variance is generally indicative of a portfolio with higher draw-down. Since the geometric optimal portfolio is that portfolio for which E and V are equal (with E = AHPR-1), then we can assume that the geometric optimal portfolio will see high drawdowns. In fact, the greater the GHPR of the geometric optimal portfolio-that is, the more the portfolio makes-the greater will be its drawdown in terms of equity retracements, since the GHPR is directly positively correlated with the AHPR. Here again is a paradox. We want to be at the geometric optimal portfolio. Yet, the higher the geometric mean of a portfolio, the greater will be the drawdowns in terms of percentage equity retracements generally. Hence, when we perform the exercise of diversification, we should view it as an exercise to obtain the highest geometric mean rather than the lowest drawdown, as the two tend to pull in oppo-

site directions! The geometrical optimal portfolio is one where a line drawn from (0,0), with slope 1, intersects the AHPR efficient frontier.

Figure 7-2 demonstrates the efficient frontiers on a one-trade basis. That is, its rows what you can expect on a one-trade basis. We can convert the geometric average HPR to a TWR by the equation:

(7.07) GTWR = GHPR^N

where

GTWR = The vertical axis corresponding to a given GHPR after N trades.

GHPR = The geometric average HPR.

N = The number of trades we desire to observe.

Thus, after 50 trades a GHPR of 1.0154 would be a GTWR of 1.0154 A 50 = 2.15. In other words, after 50 trades we would expect our stake to have grown by a multiple of 2.15.

We can likewise project the efficient frontier of the arithmetic average HPRs into ATWRs as:

(7.08) ATWR = 1+N*(AHPR-1)

where

ATWR = The vertical axis corresponding to a given AHPR after N trades.

AHPR = The arithmetic average HPR.

N = The number of trades we desire to observe.

Thus, after 50 trades, an arithmetic average HPR of 1.03 would have made 1+50*(1.03-1) = 1+50*.03 = 1+1.5 = 2.5 times our starting stake. Note that this shows what happens when we do not reinvest our winnings back into the trading program. Equation (7.08) is the TWR you can expect when constant-contract trading.

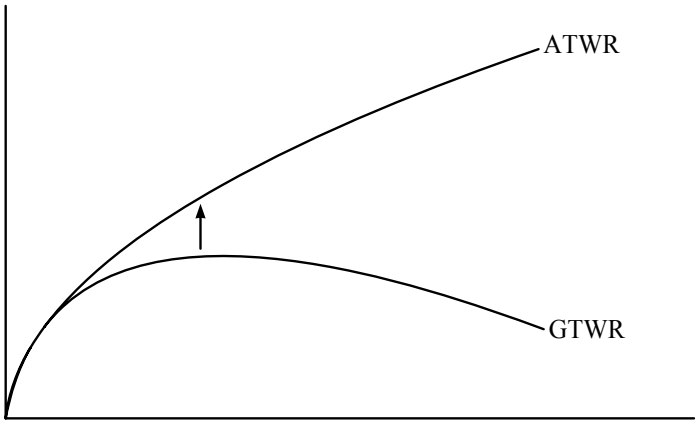

Figure 7-3 The efficient frontier with/without reinvestment

Just as Figure 7-2 shows the TWRs, both arithmetic and geometric, for one trade, Figure 7-3 shows them for a few trades later. Notice that the GTWR line is approaching the ATWR line. At some point for N, the geometric TWR will overtake the arithmetic TWR. Figure 7-4 shows the arithmetic and geometric TWRs after more trades have elapsed. Notice that the geometric has overtaken the arithmetic. If we were to continue with more and more trades, the geometric TWR would continue to outpace the arithmetic. Eventually, the geometric TWR becomes infinitely greater than the arithmetic.

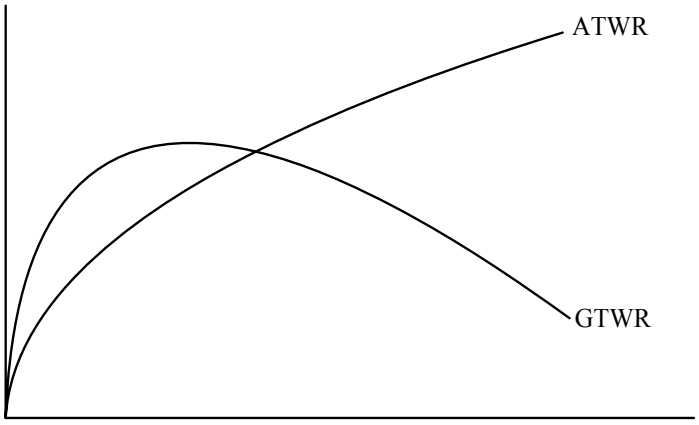

Figure 7-4 The efficient frontier with/without reinvestment.

The logical question is, “How many trades must elapse until the geometric TWR surpasses the arithmetic?” Recall Equation (2.09a), which tells us the number of trades required to reach a specific goal:

(2.09a) N = ln(Goal)/ln(Geometric Mean)

where

N = The expected number of trades to reach a specific goal.

Goal = The goal in terms of a multiple on our starting stake, a TWR.

ln() = The natural logarithm function.

We let the AHPR at the same V as our geometric optimal portfolio be our goal and use the geometric mean of our geometric optimal portfolio in the denominator of (2.09a). We can now discern how many trades are required to make our geometric optimal portfolio match one trade in the corresponding arithmetic portfolio. Thus:

N = ln(l.031)/ln(1.01542) = .035294/.0153023 = 1.995075

We would thus expect 1.995075, or roughly 2, trades for the optimal GHPR to be as high up as the corresponding (same V) AHPR after one trade.

The problem is that the ATWR needs to reflect the fact that two trades have elapsed. In other words, as the GTWR approaches the ATWR, the ATWR is also moving upward, albeit at a constant rate (compared to the GTWR, which is accelerating). We can relate this problem to Equations (7.07) and (7.08), the geometric and arithmetic TWRs respectively, and express it mathematically:

(7.09) GHPR^N => 1+N*(AHPR-1)

Since we know that when N = 1, G will be less than A, we can rephrase the question to "At how many N will G equal A?" Mathematically this is:

(7.10a) GHPR^N = 1+N*(AHPR-1)

which can be written as:

(7.10b) 1+N*(AHPR-1)-GHPR ^N = 0

or

(7.10c) 1+N*AHPR-N-GHPR^N = 0

or

(7.10d) N = (GHPR^N-1)/(AHPR -1)

The N that solves (7.10a) through (7.10d) is the N that is required for the geometric HPR to equal the arithmetic. All three equations are equivalent. The solution must be arrived at by iteration. Taking our geometric optimal portfolio of a GHPR of 1.01542 and a corresponding AHPR of 1.031, if we were to solve for any of Equations (7.10a) through (7.10d), we would find the solution to these equations at N = 83.49894. That is, at 83.49894 elapsed trades, the geometric TWR will overtake the arithmetic TWR for those TWRs corresponding to a variance coordinate of the geometric optimal portfolio.

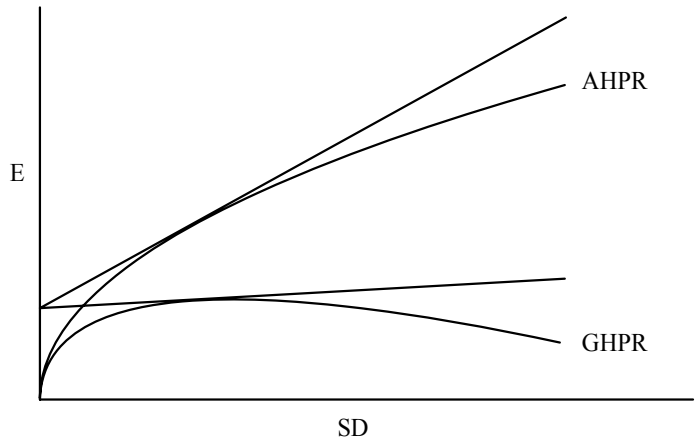

Figure 7-5 AHPR, GHPR, and their CML lines.

Just as the AHPR has a CML line, so too does the GHPR. Figure 7-5 shows both the AHPR and the GHPR with a CML line for both calculated from the same risk-free rate.

The CML for the GHPR is calculated from the CML for the AHPR by the following equation:

(7.11) CMLG = (CMLA^2-VT*P)^(1/2)

where

CMLG = The E coordinate (vertical) to the CML line to the GHPR for a given V coordinate corresponding to P.

CMLA = The E coordinate (vertical) to the CML line to the AHPR for a given V coordinate corresponding to P.

P = The percentage in the tangent portfolio, figured from (7.02).

VT = The variance coordinate of the tangent portfolio.

You should know that, for any given risk-free rate, the tangent portfolio and the geometric optimal portfolio are not necessarily (and usually are not) the same. The only time that these portfolios will be the same is when the following equation is satisfied:

(7.12) RFR = GHPROPT-1

where

RFR = The risk-free rate.

GHPROPT = The geometric average HPR of the geometric optimal portfolio. This is the E coordinate of the portfolio on the efficient frontier.

Only when the GHPR of the geometric optimal portfolio minus 1 is equal to the risk-free rate will the geometric optimal portfolio and the portfolio tangent to the CML line be the same. If RFR > GHPROPT-1, then the geometric optimal portfolio will be to the left of (have less variance than) the tangent portfolio. If RFR < GHPROPT-1, then the tangent portfolio will be to the left of (have less variance than) the geometric optimal portfolio. In all cases, though, the tangent portfolio will, of course, never have a higher GHPR than the geometric optimal portfolio.

Note also that the point of tangency for the CML to the GHPR and for the CML to the AHPR is at the same SD coordinate. We could use Equation (7.01a) to find the tangent portfolio of the GHPR line by substituting the AHPR in (7.01a) with GHPR. The resultant equation is:

(7.01b) Tangent Portfolio = MAX{(GHPR-(1+RFR))/SD}

where

MAX() = The maximum value.

GHPR = The geometric average HPRs. This is the E coordinate of a given portfolio on the efficient frontier.

SD = The standard deviation in HPRs. This is the SD coordinate of a given portfolio on the efficient frontier.

RFR = The risk-free rate.

UNCONSTRAINED PORTFOLIOS

Now we will see how to enhance returns beyond the GCML line by lifting the sum of the weights constraint. Let us return to geometric optimal portfolios. If we look for the geometric optimal portfolio among our four market systems-Toxico, Incubeast, LA Garb and a savings account-we find it at E equal to .1688965 and V equal to .1688965, thus conforming with Equations (7.06a) through (7.06d). The geometric mean of such a portfolio would therefore be 1.094268, and the portfolio's composition would be:

Toxico	18.89891%
Incubeast	19.50386%
LA Garb	58.58387%
Savings Account	.03014%

In using Equations (7.06a) through (7.06d), you must iterate to the solution. That is, you try a test value for E (halfway between the highest and the lowest AHPRs, -1 is a good starting point) and solve the matrix for that E. If your variance is higher than E, it means the tested for value of E was too high, and you should lower it for the next attempt. Conversely, if your variance is less than E, you should raise E for the next pass. You determine the variance for the portfolio by using one of Equations (6.06a) through (6.06d). You keep on repeating the process until whichever of Equations (7.06a) through (7.06d) you choose to use, is solved. Then you will have arrived at your geometric optimal portfolio. (Note that all of the portfolios discussed thus far, whether on the AHPR efficient frontier or the GHPR efficient frontier, are determined by constraining the sum of the percentages, the weights, to 100% or 1.00.)

Recall Equation (6.10), the equation used in the starting augmented matrix to find the optimal weights in a portfolio. This equation dictates that the sum of the weights equal 1:

(6.10) $(\sum[i = 1,N]X_i) -1 = 0$

where

N = The number of securities comprising the portfolio.

X_i = The percentage weighting of the ith security.

The equation can also be written as:

$(\sum[i = 1,N]X_i) = 1$

By allowing the left side of this equation to be greater than 1, we can find the unconstrained optimal portfolio. The easiest way to do this is to add another market system, called non-interest-bearing ***cash*** (NIC), into the Starting augmented matrix. This market system, NIC, will have an arithmetic average daily HPR of 1.0 and a population standard deviation (as well as variance and covariances) in those daily HPRs of 0. What this means is that each day the HPR for NIC will be 1.0. The correlation coefficients for NIC to any other market system are always 0.

Now we set the sum of the weights constraint to some arbitrarily high number, greater than I. A good initial value is 3 times the number of market systems (without NIC) that you are using. Since we have 4 market systems (when not counting NIC) we should set this sum of the weights constraint to 4*3 = 12. Note that we are not really lifting the constraint that the sum of the weights be below some number, we are just setting this constraint at an arbitrarily high value. The difference between this arbitrarily high value and what the sum of the weights actually comes out to be will be the weight assigned to NIC.

We are not going to really invest in NIC, though. It's just a null entry that we are pumping through the matrix to arrive at the unconstrained weights of our market systems. Now, let's take the parameters of our four market systems from Chapter 6 and add NIC as well:

Investment	Expected Return as an HPR	Expected Standard Deviation of Return
Toxico	1.095	.316227766
Incubeast Corp.	1.13	.5
LA Garb	1.21	.632455532
Savings Account	1.085	0
NIC	1.00	0

The covariances among the market systems, with NIC included, are as follows:

	T	I	L	S	N
T	.1	-.0237	.01	0	0
I	-.0237	.25	.079	0	0
L	.01	.079	.4	0	0
S	0	0	0	0	0
N	0	0	0	0	0

Thus, when we include NIC, we are now dealing with 5 market systems; therefore, the generalized form of the starting augmented matrix is:

$X_1*U_1+ X_2*U_2+ X_3*U_3+ X_4*U_4+ X_5*U_5 = E$

$X_1+ X_2+ X_3+ X_4+ X_5 = S$

$X_1*COV_{1,1}+X_2*COV_{1,2}+X_3*COV_{1,3}+X_4*COV_{1,4}+X_5*COV_{1,5}+.5*L_1*U_1 +.5*L_2 = 0$

$X_1*COV_{2,1}+X_2*COV_{2,2}+X_3*COV_{2,3}+X_4*COV_{2,4}+X_5*COV_{2,5}+.5*L_1*U_2 +.5*L_2 = 0$

$X_1*COV_{3,1}+X_2*COV_{3,2}+X_3*COV_{3,3}+X_4*COV_{3,4}+X_5*COV_{3,5}+.5*L_1*U_3 +.5*L_2 = 0$

$X_1*COV_{4,1}+X_2*COV_{4,2}+X_3*COV_{4,3}+X_4*COV_{4,4}+X_5*COV_{4,5}+.5*L_1*U_4 +.5*L_2 = 0$

$X_1*COV_{5,1}+X_2*COV_{5,2}+X_3*COV_{5,3}+X_4*COV_{5,4}+X_5*COV_{5,5}+.5*L_1*U_5 +.5*L_2 = 0$

where

E = The expected return of the portfolio.

S = The sum of the weights constraint.

$COV_{A,B}$ = The covariance between securities A and B.

X_i = The percentage weighting of the ith security.

U_i = The expected return of the ith security.

L_1 = The first Lagrangian multiplier.

L_2 = The second Lagrangian multiplier.

Thus, once we have included NIC, our starting augmented matrix appears as follows:

X_1	X_2	X_3	X_4	X_5	L_1	L_2	Answer
.095	.13	.21	.085	0			E
1	1	1	1	0			12
.1	-.0237	.01	0	0	.095	1	0

-.0237	.25	.079	0	0	.13	1	0
.01	.079	.4	0	0	.21	1	0
0	0	0	0	0	.085	1	0
0	0	0	0	0	0	1	0

Note that the answer column of the second row, the sum of the weights constraint, is 12, as we determined it to be by multiplying the number of market systems (not including NIC) by 3.

When you are using NIC, it is important that you include it as the last, the Nth market system of N market systems, in the starting augmented matrix.

Now, the object is to obtain the identity matrix by using row operations to produce elementary transformations, as was detailed in Chapter 6. You can now create an unconstrained AHPR efficient frontier and an unconstrained GHPR efficient frontier. The unconstrained AHPR efficient frontier represents using leverage but not reinvesting.

The GHPR efficient frontier represents using leverage and reinvesting the profits. Ideally, we want to find the unconstrained geometric optimal portfolio. This is the portfolio that will result in the greatest geometric growth for us. We can use Equations (7.06a) through (7.06d) to solve for which of the portfolios along the efficient frontier is geometric optimal. In so doing, we find that no matter what value we try to solve E for (the value in the answer column of the first row), we get the same portfolio-comprised of only the savings account levered up to give us whatever value for E we want. This results in giving us our answer; we get the lowest V (in this case zero) for any given E.

What we must do, then, is take the savings account out of the matrix and start over. This time we will try to solve for only four market systems -Toxico, Incubeast, LA Garb, and NIC-and we set our sum of the weights constraint to 9. Whenever you have a component in the matrix with zero variance and an AHPR greater than 1, you'll end up with the optimal portfolio as that component levered up to meet the required E.

Now, solving the matrix, we find Equations (7.06a) through (7.06d) satisfied at E equals .2457. Since this is the geometric optimal portfolio, V is also equal to .2457. The resultant geometric mean is 1.142833. The portfolio is:

Toxico	102.5982%
Incubeast	49.00558%
LA Garb	40.24979%
NIC	708.14643%

“Wait,” you say. "How can you invest over 100% in certain components?” We will return to this in a moment.

If NIC is not one of the components in the geometric optimal portfolio, then you must make your sum of the weights constraint, S, higher. You must keep on making it higher until NIC becomes one of the components of the geometric optimal portfolio. Recall that if there are only two components in a portfolio, if the correlation coefficient between them is -1, and if both have positive mathematical expectation, you will be required to finance an infinite number of contracts. This is so because such a portfolio would never have a losing day. Now, the lower the correlation coefficients are between the components in the portfolio, the higher the percentage required to be invested in those components is going to be. The difference between the percentages invested and the sum of the weights constraint, S, must be filled by NIC. If NIC doesn't show up in the percentage allocations for the geometric optimal portfolio, it means that the portfolio is running into a constraint at S and is therefore not the unconstrained geometric optimal. Since you are not going to be actually investing in NIC, it doesn't matter how high a percentage it commands, as long as it is listed as part of the geometric optimal portfolio.

HOW OPTIMAL F FITS WITH OPTIMAL PORTFOLIOS

In Chapter 6 we saw that we must determine an expected return (as a percentage) and an expected variance in returns for each component in a portfolio. Generally, the expected returns (and the variances) are determined from the current price of the stock. An optimal percentage (weighting) is then determined for each component. The equity of the account is then multiplied by a components weighting to determine the number of dollars to allocate to that component, and this dollar allocation is then divided by the current price per share to determine how many shares to have on. That generally is how portfolio strategies are currently practiced. But it is ***not*** optimal. Here lies one of this book's many hearts. Rather than determining the expected return and variance in expected return from the current price of the component, the expected return and variance in returns should be determined from the optimal f, in dollars, for the component. In other words, as input you should use the arithmetic average HPR and the variance in the HPRs. Here, the HPRs used should be not of trades, but of a fixed time length such as days, weeks, months, quarters, or years-as we did in Chapter 1 with Equation (1.15).

(1.15) Daily HPR = (A/B)+1

where

A = Dollars made or lost that day.

B = Optimal fin dollars.

We need not necessarily use days. We can use any time length we like so long as it is the same time length for all components in the portfolio (and the same time length is used for determining the correlation coefficients between these HPRs of the different components). Say the market system with an optimal f of $2,000 made $100 on a given day. Then the HPR for that market system for that day is 1.05.

If you are figuring your optimal f based on equalized data, you must use Equation (2.12) in order to obtain your daily HPRs:

(2.12) Daily HPR = D$/f$+1

where

D$ = The dollar gain or loss on 1 unit from the previous day. This is equal to (Tonight's Close-Last Night's Close)*Dollars per Point

f$ = The current optimal fin dollars, calculated from

Equation (2.11). Here, however, the current price variable is last night's close.

In other words, once you have determined the optimal fin dollars for 1 unit of a component, you then take the daily equity changes on a 1-unit basis and convert them to HPRs per Equation (1.15)-or, if you are using equalized data, you can use Equation (2.12). When you are combining market systems in a portfolio, all the market systems should be the same in terms of whether their data, and hence their optimal fs and by-products, has been equalized or not.

Then we take the arithmetic average of the HPRs. Subtracting 1 from the arithmetic average will give us the expected return to use for that component. Taking the variance of the daily (weekly, monthly, etc.) HPRs will give the variance input into the matrix. Lastly, we determine the correlation coefficients between the daily HPRs for each pair of market systems under consideration.

Now here is* the *critical point. Portfolios whose parameters (expected returns, variance in expected ret urns, and correlation coefficients of the expected returns) are selected based on the current price of the component will not yield truly optimal portfolios. To discern the truly optimal portfolio you must derive the input parameters based on trading 1 unit at the optimal f for each component. You cannot be more at the peak of the optimal f curve than optimal f itself: to base the parameters on the current market price of the component is to base your parameters arbitrarily-and, as a consequence, not necessarily optimally.

Now let's return to the question of how you can invest more than 100% in a certain component. One of the basic premises of this book is that weight and quantity are not the same thing. The weighting that you derive from solving for a geometric optimal portfolio must be reflected back into the optimal f's of the portfolio's components. The way to do this is to divide the optimal f's for each component by its corresponding weight. Assume we have the following optimal f's (in dollars):

Toxico	$2,500
Incubeast	$4,750
LA Garb	$5,000

(Note that, if you are equalizing your data, and hence obtaining an equalized optimal f and by-products, then your optimal fs in dollars will change each day based upon the previous day's closing price and Equation[2.11].)

We now divide these f's by their respective weightings:

Toxico	$2,500/1.025982 = $2,436.69
Incubeast	$4,750/.4900558 = $9,692.77
LA Garb	$5,000/.4024979 = $12,422.43

Thus, by trading in these new "adjusted" f values, we Witt be at the geometric optimal portfolio. In other words, suppose Toxico represents a certain market system. By trading 1 contract under this market system for every $2,436.69 in equity (and doing the same with the other market systems at their new adjusted f values) we will be at the geometric optimal unconstrained portfolio. Likewise if Toxico is a stock, and we regard 100 shares as "1 contract," we will trade 100 shares of Toxico for every l$2,436.69 in account equity. For the moment, disregard margin completely. Later in the next chapter we will address the potential problem of margin requirements.

"Wait a minute," you protest. "If you take an optimal portfolio and change it by using optimal f, you have to prove that it is still optimal. But if you treat the new values as a different portfolio, it must fall somewhere else on the return coordinate, not necessarily on the efficient frontier. In other words, if you keep reevaluating f, you cannot stay optimal, can you?"

We are not changing the f values. That is, our f values (the number of units put on for so many dollars in equity) are still the same. We are simply performing a shortcut through the calculations, which makes it appear as though we are "adjusting" our f values. We derive our optimal portfolios based on the expected returns and variance in returns of trading 1 unit of each of the components, as well as on the correlation coefficients. We thus derive optimal weights (optimal percentages of the account to trade each component with). Thus, if a market system had an optimal f of $2,000, and in optimal portfolio weight of .5, we would trade 50% of our account at the full optimal f level of $2,000 for this market system. This is exactly the same is if we said we will trade 100% of our account at the optimal f divided by the optimal weighting ($2,000/.5) of $4000. In other words, we are going to trade the optimal f of $2,000 per unit on 50% of our equity, which in turn is exactly the same as saying we are going to trade the adjusted f of $4,000 on 100% of our equity.

The AHPRs and SDs that you input into the matrix are determined from the optimal f values in dollars. If you are doing this on stocks, you can compute your values for AHPR, SD, and optimal f on a I-share or a 100-share basis (or any other basis you like). You dictate the size of one unit.

In a nonleveraged situation, such as a portfolio of stocks that are not on margin, weighting and quantity are synonymous. Yet in a leveraged situation, such as a portfolio of futures market systems, weighting and quantity arc different indeed. you can now see the idea first roughly introduced in ***Portfolio Management Formulas***: that optimal quantities are what we seek to know, and that this is ***a function*** of optimal weightings.

When we figure the correlation coefficients on the HPRs of two market systems, both with a positive arithmetic mathematical expectation, we find a slight tendency toward positive correlation. This is because the equity curves (the cumulative running sum of daily equity changes) both tend to rise up and to the right. This can be bothersome to some people. One solution is to determine a least squares regression line to each equity curve (before equalization, if employed) and then take the difference at each point in time on the equity curve and its regression line. Next, convert this now detrended equity curve back to simple daily equity changes (noncumulative, i.e., the daily change in the detrended equity curve). If you are equalizing the data, you would then do it at this point in the sequence of events. Lastly, you figure your correlations on this processed data.

This technique is valid so long as you are using the correlations of daily equity changes and not prices. If you use prices, you may do yourself more harm than good. Very often prices and daily equity changes are linked, as example would be a long-term moving average crossover system.

This detrending technique must always be used with caution. Also, the daily AHPR and standard deviation in HPRs must always be figured off of non-detrended data.

A final problem that happens when you detrend your data occurs with systems that trade infrequently. Imagine two day-trading systems that give one trade per week, both on different days. The correlation coefficient between them may be only slightly positive. Yet when we detrend their data, we get very high positive correlation. This mistakenly happens because their regression lines are rising a little each day. Yet on most days the equity change is zero. Therefore, the difference is negative. The preponderance , slightly negative days with both market systems, then mistakenly results in high positive correlation.

THRESHOLD TO THE GEOMETRIC FOR PORTFOLIOS

Now let's address the problem of incorporating the threshold to the geometric with the given optimal portfolio mix. This problem is readily handled simply by dividing the threshold to the geometric for each component by its weighting in the optimal portfolio. This is done in exactly the same way as the optimal fs of the components are divided by their respective weightings to obtain a new value representative of the optimal portfolio mix. For example, assume that the threshold to the geometric for Toxico is $5,100. Dividing this by its weighting in the optimal portfolio mix of 1.025982 gives us a new adjusted threshold to the geometric of:

Threshold = $5,100/1.025982 = $4,970.85

Since the weighting for Toxico is greater than 1, both its optimal f and its threshold to the geometric will be reduced, for they are divided by this weighting. In this case, if we cannot trade the fractional unit with Toxico, and if we are trading only 1 unit of Toxico, we will switch up to 2 units only when our equity gets up to $4,970.85.

Recall that our new adjusted f value in the optimal portfolio mix for Toxico is $2,436.69 ($2,500/1.025982). Since twice this amount equals $4,873.38, we would ordinarily move up to trading two contracts at that point. However, our threshold to the geometric, being greater than twice the f allocation in dollars, tells us there isn't any benefit to switching to trading 2 units before our equity reaches the threshold to the geometric of $4970.85.

Again, if you are equalizing your data, and hence obtaining an equalized optimal f and by-products, including the threshold to the geometric, then your optimal fs in dollars and your thresholds to the geometric will change each day, based upon the previous day's closing price and Equation (2.11).

COMPLETING THE LOOP

One thing you will readily notice about unconstrained portfolios (portfolios for which the sum of the weights is greater than 1 and NIC shows up as a market system in the portfolio) is that the portfolio is exactly the same for any given level of E-the only difference being the degree of leverage. This is not true for portfolios lying along the efficient frontier(s) when the sum of the weights is constrained). In other words, the ratios of the weightings of the different market systems to each other are always the same for any point along the unconstrained efficient frontiers (AHPR or GHPR).

For example, the ratios of the different weightings between the different market systems in the geometric optimal portfolio can be calculated. The ratio of Toxico to Incubeast is 102.5982% divided by 49.00558%, which equals 2.0936. We can thus determine the ratios of all the components in this portfolio to one another:

Toxico/Incubeast = 2.0936

Toxico/LA Garb = 2.5490

Incubeast/LA Garb = 1.2175

Now, we can go back to the unconstrained portfolio and solve for different values for E. What follows are the weightings for the components of the unconstrained portfolios that have the lowest variances for the given values of E. You will notice that the ratios of the weightings of the components are exactly the same:

	E = .1	E = .3
Toxico	.4175733	1.252726
Incubeast	.1 994545	.5983566
LA Garb	.1638171	.49145

Thus, we can state that ***the unconstrained efficient frontiers are the same portfolio at different levels of leverage***. This portfolio, the one that gets levered up and down with E when the sum of the weights constraint is lifted, is the portfolio that has a value of zero for the second Lagrangian multiplier when the sum of the weights equals 1.

Therefore, we can readily determine what our unconstrained geometric optimal portfolio will be. First, we find the portfolio that has a value of zero for the second Lagrangian multiplier when the sum of the weights is constrained to 1.00. One way to find this is through iteration. The resultant portfolio will be that portfolio which gets levered up (or down) to satisfy any given E in the unconstrained portfolio. That value

for E which satisfies any of Equations (7.06a) through (7.06d) will be the value for E that yields the unconstrained geometric optimal portfolio.

Another equation that we can use to solve for which portfolio along the unconstrained AHPR efficient frontier is geometric optimal is to use the first Lagrangian multiplier that results in determining a portfolio along any particular point on the unconstrained AHPR efficient frontier. Recall from Chapter 6 that one of the by-products in determining the composition of a portfolio by the method of row-equivalent matrices is the first Lagrangian multiplier. The first Lagrangian multiplier represents the instantaneous rate of change in variance with respect to expected return, sign reversed. A first Lagrangian multiplier equal to -2 means that at that point the variance was changing at that rate (-2) opposite the expected return, sign reversed. This would result in a portfolio that was geometric optimal.

(7.06e) $L_1 = -2$

where

L_1 = The first Lagrangian multiplier of a given portfolio along the unconstrained AHPR efficient frontier.[2]

Now it gets interesting as we tie these concepts together. The portfolio that gets levered up and down the unconstrained efficient frontiers (arithmetic or geometric) is the portfolio tangent to the CML line emanating from an RFR of 0 when the sum of the weights is constrained to 1.00 and NIC is not employed.

Therefore, we can also find the unconstrained geometric optimal portfolio by first finding the tangent portfolio to an RFR equal to 0 where the sum of the weights is constrained to 1.00, then levering this portfolio up to the point where it is the geometric optimal. But how can we determine how much to lever this constrained portfolio up to make it the equivalent of the unconstrained geometric optimal portfolio?

Recall that the tangent portfolio is found by taking the portfolio along the constrained efficient frontier (arithmetic or geometric) that has the highest Sharpe ratio, which is Equation (7.01). Now we lever this portfolio up, and we multiply the weights of each of its components by a variable named q, which can be approximated by:

(7.13) q = (E-RFR)/V

where

E = The expected return (arithmetic) of the tangent portfolio.

RFR = The risk-free rate at which we assume you can borrow or loan.

V = The variance in the tangent portfolio.

Equation (7.13) actually is a very close approximation for the actual optimal q.

An example may help illustrate the role of optimal q. Recall that our unconstrained geometric optimal portfolio is as follows:

Component	Weight
Toxico	1.025955
Incubeast	.4900436
LA Garb	.4024874

This portfolio, we found, has an AHPR of 1.245694 and variance of .2456941. Throughout the remainder of this discussion we will assume for simplicity's sake an RFR of 0. (Incidentally, the Sharpe ratio of this portfolio, (AHPR-(1+RFR))/SD, is .49568.)

Now, if we were to input the same returns, variances, and correlation coefficients of these components into the matrix and solve for which portfolio was tangent to an RFR of 0 when the sum of the weights is constrained to 1.00 and we do not include NIC, we would obtain the following portfolio:

Component	Weight
Toxico	.5344908
Incubeast	.2552975
LA Garb	.2102117

This particular portfolio has an AHPR of 1.128, a variance of .066683, and a Sharpe ratio of .49568. It is interesting to note that ***the Sharpe ratio of the tangent portfolio, a portfolio for which the sum of the weights is con strained to 1.00 and we do not include NIC, is exactly the same as the Sharpe ratio for our unconstrained geometric optimal portfolio.***

Subtracting 1 from our AHPRs gives us the arithmetic average return of the portfolio. Doing so we notice that in order to obtain the same return for the constrained tangent portfolio as for the unconstrained geometric optimal portfolio, we must multiply the former by 1.9195.

.245694/.128 = 1.9195

Now if we multiply each of the weights of the constrained tangent portfolio, the portfolio we obtain is virtually identical to the unconstrained geometric optimal portfolio:

Component	Weight	* 1.9195 = Weight
Toxico	.5344908	1.025955
Incubeast	.2552975	.4900436
LA Garb	.2102117	.4035013

The factor 1.9195 was arrived at by dividing the return on the unconstrained geometric optimal portfolio by the return on the constrained tangent portfolio. Usually, though, we will want to find the unconstrained geometric optimal portfolio knowing only the constrained tangent portfolio. This is where optimal q comes in.[3] If we assume an RFR of 0, we can determine the optimal q on our constrained tangent portfolio as:

(7.13) q = (E-RFR)/V = (. 128-0)7.066683 = 1.919529715

A few notes on the RFR. To begin with, we should always assume an RFR of 0 when we are dealing with futures contracts. Since we are not actually borrowing or lending funds to lever our portfolio up or down, there is effectively an RFR of 0. With stocks, however, it is a different story. The RFR you use should be determined with this fact in mind. Quite possibly, the leverage you employ does not require you to use an RFR other than 0.

You will often be using AHPRs and variances for portfolios that were determined by using daily HPRs of the components. In such cases, you must adjust the RFR from an annual rate to a daily one. This is quite easy to accomplish. First, you must be certain that this annual rate is what is called the ***effective mutual interest rate.*** Interest rates are typically stated as annual percentages, but frequently these annual percentages are what is referred to as the ***nominal annual interest rate***. When interest is compounded semiannually, quarterly, monthly, and so on, the interest earned during a year is greater than if compounded annually (the nominal rate is based on compounding annually). When interest is compounded more frequently than annually, an effective annual interest rate can be determined from the nominal interest rate. It is the effective annual interest rate that concerns us and that we will use in our calculations. To convert the nominal rate to an effective rate we can use:

(7.14) E = (1+R/M)^M-1

where

E = The effective annual interest rate.

R = The nominal annual interest rate.

M = The number of compounding periods per year.

Assume that the nominal annual interest rate is 9%, and suppose that it is compounded monthly. Therefore, the corresponding effective annual interest rate is:

(7.14) E = (1+.09/12)^12-1 = (1+.0075)^12-1 = 1.0075^12-1 = 1.093806898-1 = .093806898

Therefore, our effective annual interest rate is a little over 9.38%. Now if we figured our HPRs on the basis of weekdays, we can state that there are 365.2425/7*5 = 260.8875 weekdays, on average, in a year. Dividing .093806898 by 260.8875 gives us a daily RFR of .0003595683887.

If we determine that we are actually paying interest to lever our portfolio up, and we want to determine from the constrained tangent portfolio what the unconstrained geometric optimal portfolio is, we simply input the value for the RFR into the Sharpe ratio, Equation (7.01), and the optimal q, Equation (7.13).

Now to close the loop. Suppose you determine that the RFR for your portfolio is not 0, and you want to find the geometric optimal portfolio without first having to find the constrained portfolio tangent to your applicable RFR. Can you just go straight to the matrix, set the sum

[2] Thus, we can state that the geometric optimal portfolio is that portfolio which, when the sum of the weights is Constrained to 1, has a second Lagrangian multiplier equal to 0, and when unconstrained has a first Lagrangian multiplier of -2. Such a portfolio will also have a second Lagrangian multiplier equal to 0 when unconstrained.

[3] Latane, Henry, and Donald Tuttle, "Criteria for Portfolio Building," journal of Finance 22, September 1967, pp. 362363.

of the weights to some arbitrarily high number, include NIC, and find the unconstrained geometric optimal portfolio when the RFR is greater than 0? Yes, this is easily accomplished by subtracting the RFR from the expected returns of each of the components, but not from NIC (i.e., the expected return for NIC remains at 0, or an arithmetic average HPR of 1.00). Now, solving the matrix will yield the unconstrained geometric optimal portfolio when the RFR is greater than 0.

Since the unconstrained efficient frontier is the same portfolio at different levels of leverage, you cannot put a CML line on the unconstrained efficient frontier. You can only put CML lines on the AHPR or GHPR efficient frontiers if they are constrained (i.e., if the sum of the weights equals 1). It is not logical to put CML lines on the AHPR or GHPR unconstrained efficient frontiers.

We have seen numerous ways of arriving at the geometric optimal portfolio. For starters, we can find it empirically, as was detailed in Portfolio Management Formulas and recapped in Chapter 1 of this text. We have seen how to find it parametrically in this chapter, firm a number of different angles, for any value of the risk-free rate.

Now that we know how to find the geometric optimal portfolio we must learn how to use it in real life. The geometric optimal portfolio will give us the greatest possible geometric growth In the next chapter we will go into techniques to use this portfolio within given risk constraints.

Chapter 8 - Risk Management

We now know haw to find the optimal portfolios by numerous different methods. Further, we now have a thorough understanding of the geometry of portfolios and the relationship of optimal quantities and optimal weightings. We can now see that the best way to trade any portfolio of any underlying instrument is at the geometric optimal level Doing so on a reinvestment of returns basis will maximize the ratio of expected gain to expected risk

In this chapter we discuss how to use these geometric optimal portfolios within the risk constraints that we specify. Thus, whatever vehicles we are trading in, we can align ourselves anywhere we desire on the risk spectrum. In so doing, we will obtain the maximum rate of geometric growth for a given level of risk

ASSET ALLOCATION

You should be aware that the optimal portfolio obtained by this parametric technique will always be almost, if not exactly, the same as the portfolio that would be obtained by using an empirical technique such as the one detailed in the first chapter or in Portfolio Management Formulas.

As such, we can expect tremendous drawdowns on the entire portfolio in terms of equity retracement. Our only guard against this is to dilute the portfolio somewhat. What this amounts to is combining the geometric optimal portfolio with the risk-free asset in some fashion. This we call asset allocation. The degree of risk and safety for any investment is not a function of the investment itself, but rather a function of asset allocation.

Even portfolios of blue-chip stocks, if traded at their unconstrained geometric optimal portfolio levels, will show tremendous drawdowns. Yet these blue-chip stocks ***must*** be traded at these levels to maximize potential geometric gain relative to dispersion (risk) and also provide for attaining a goal in the least possible time. When viewed from such a perspective, trading blue-chip stocks is as risky as pork bellies, and pork bellies are no less conservative than blue-chip stocks. The same can be said of a portfolio of commodity trading systems and a portfolio of bonds.

The object now is to achieve the desired level of potential geometric gain to dispersion (risk) by combining the risk-free asset with whatever it is we are trading, be it a portfolio of blue-chip stocks, bonds, or commodity trading systems.

When you trade a portfolio at unconstrained fractional f, you are on the unconstrained GHPR efficient frontier, but to the left of the geometric optimal point-the point that satisfies any of Equations (7.06a) through (7.06e). Thus, you have less potential gain relative to the dispersion than you would if you were at the geometric optimal point. This is one way you can combine a portfolio with the risk-free asset.

Another way you can practice asset allocation is by splitting your equity into two subaccounts, an active subaccount and an inactive subaccount. These are not two separate accounts, rather they are a way of splitting a single account in theory. The technique works as follows. First, you must decide upon an initial fractional level. Suppose that, initially, you want to emulate an account at the half f level. Your initial fractional level is .5 (the initial fractional level must be greater than zero and less than 1). This means you will split your account, with half the equity in your account going into the inactive subaccount and half going into the active subaccount. Assume you are starting out with a $100,000 account. Initially, $50,000 is in the inactive subaccount and $50,000 is in the active subaccount. It is the equity in the active subaccount that you use to determine how many contracts to trade. These subaccounts are not real; they are a hypothetical construct you are creating in order to manage your money more effectively. You always use the full optimal fs with this technique. Any equity changes are reflected in the active portion of the account. Therefore, each day you must look at the account's total equity (closed equity plus open equity, marking open Positions to the market), and subtract the inactive amount (which will remain constant from day to day). The difference is your active equity, and it is on this difference that you will calculate how many contracts to trade at the full f levels. Now suppose that the optimal f for market system A is 'to trade 1 contract for every $2,500 in account equity. ***You*** come into the first day with $50,000 in active equity, and therefore you will look to trade 20 contracts. If you were using the straight half f strategy; you would end up with the same number of contracts on day one. At half f, you would trade 1 contract for every $5,000 in account equity ($2,500/.5), and you would use the full $100,000 account equity to figure how many contracts to trade. Therefore, under the half f strategy, you would trade 20 contracts on this day as well.

However, as soon as the equity in the accounts changes, the number of contracts you will trade changes as well. Assume now that you make $5,000 this next day, thus pushing the total equity in the account up to $105,000. Under the half f strategy, you will now be trading 21 contracts. However, with the split-equity technique, you must subtract the now-constant inactive amount of $50,000 from your total equity of $105,000. This leaves an active equity portion of $55,000, from which you will figure your contract size at the optimal f level of 1 contract for every $2,500 in equity. Therefore, with the split-equity technique, you will now look to trade 22 contracts.

The procedure works the same way on the downside of the equity curve, with the split-equity technique peeling off contracts at a faster rate than the fractional f strategy does. Suppose you lost $5,000 on the first day of trading, putting the total account equity at $95,000. With the fractional f strategy you would now look to trade 19 contracts ($95,000/$5,000). However, with the split-equity technique you are now left with $45,000 of active equity, and thus you will look to trade 18 contracts ($45,000/$2,500).

Notice that with the split-equity technique, the exact fraction of optimal f that we are using changes with the equity changes. We specify the fraction we want to start at. In our example we used an initial fraction of .5. When the equity increases, this fraction of the optimal f increases too, approaching 1 as a limit as the account equity approaches infinity. On the downside, this fraction approaches 0 as a limit at the level where the total equity in the account equals the inactive portion. The fact that portfolio insurance is built into the split-equity technique is a tremendous benefit and will be discussed at length later in this chapter. Because the split-equity technique has a fraction for f that moves, we refer to it as a dynamic fractional ŕ strategy, as opposed to the straight fractional f (***static fractional f***) strategy.

The static fractional f strategy puts you on the CML line somewhere to the left of the optimal portfolio if you are using a constrained portfolio. Throughout the life of the account, regardless of equity changes, the account will stay at that point on the CML line. If you are using an unconstrained portfolio (as you rightly should), you will be on the unconstrained efficient frontier (since there are no CML lines with unconstrained portfolios) at some point to the left of the optimal portfolio. As the equity in the account changes, you stay at the same point on the unconstrained efficient frontier.

With the dynamic fractional f technique, you start at these same points for the constrained and unconstrained portfolios. However, as the account equity increases, the portfolio moves up and to the right, and as the equity decreases, the portfolio moves down and to the left. The limits are at the peak of the curve to the right where the fraction of f equals 1, and on the left at the point where the fraction off equals 0.

With the static f method of asset allocation, the dispersion remains constant, since the fraction of optimal fused is constant. Unfortunately, this is not true with the dynamic fractional f technique. Here, as the account equity increases, so does the dispersion as the fraction of optimal f used increases. The upper limit to this dispersion is the dispersion at full f as the account equity approaches infinity. On the downside, the dispersion diminishes rapidly as the fraction of optimal f used approaches zero as the total account equity approaches the inactive subaccount equity. Here, the lower limit to the dispersion is zero.

Using the dynamic fractional f technique is analogous to trading an account full out at the optimal f levels, where the initial size of account is the active equity portion. So we see that there are two ways to dilute an account down from the full geometric optimal portfolio, two ways to exercise asset allocation. We can trade a static fractional or a dynamic fractional f. The dynamic fractional will also have dynamic variance, a slight negative, but it also provides for portfolio insurance (more on this later). Although the two techniques are related, you can also see that they differ. Which is best? Assume we have a system in which the average daily arithmetic HPR is 1.0265. The standard deviation in these daily HPRs is .1211, so the geometric mean is 1.019. Now, we look at

the numbers for a .2 static fractional f and a .1 static fractional f by using Equations (2.06) through (2.08):

(2.06) FAHPR = (AHPR-1)*FRAC+1

(2.07) FSD = SD*FRAC

(2.08) FGHPR = (FAHPR^2-FSD^2)^1/2

where

FRAC = The fraction of optimal f we are solving for

AHPR = The arithmetic average HPR at the optimal f,

SD = The standard deviation in HPRs at the optimal f.

FAHPR = The arithmetic average HPR at the fractional f.

FSD = The standard deviation in HPRs at the fractional f,

FGHPR = The geometric average HPR at the fractional f.

The results then are:

	Full f	.2 f	.1 f
AHPR	1.0265	1.0053	1.00265
SD	.1211	.02422	.01211
GHPR	1.01933	1.005	1.002577

Now recall Equation (2.09a), the time expected to reach a specific goal:

(2.09a) N = ln(Goal)/1n(Geometric Mean)

where

N = The expected number of trades to reach a specific goal.

Coal = The goal in terms of a multiple on our starting stake, a TWR. ln() = The natural logarithm function.

Now, we compare trading at the -2 static fractional f strategy, with a geometric mean of 1.005, to the .2 dynamic fractional f strategy (20% as initial active equity) with a daily geometric mean of 1.01933. The time (number of days since the geometric means are daily) required to double the static fractional f is given by Equation (2.09a) as:

ln(2)/ln(1.005) = 138.9751

To double the dynamic fractional f requires setting the goal to 6. This is because if you initially have 20% of the equity at work, and you start out with a $100,000 account, then you initially have $20,000 at work. The goal is to make the active equity equal $120,000. Since the inactive equity remains at $80,000, you will then have a total of $200,000 on your account. Thus, to make a $20,000 account grow to $120,000 means you need to achieve a TWR of 6. Therefore, the goal is 6 in order to double a .2 dynamic fractional f:

1n(6)/ln(1.01933) = 93.58634

Notice that it took 93 days for the dynamic fractional f versus 138 days for the static fractional f.

Now look at the .1 fraction. The number of days expected in order for the static technique to double is:

ln(2)/ln(1.002577) = 269.3404

Compare this to doubling a dynamic fractional f that is initially set to .1 active. You need to achieve a TWR of 11, so the number of days required for the comparative dynamic fractional f strategy is:

ln(11)/ln(1.01933) = 125.2458

To double the account equity at the .1 level of fractional f takes 269 days for our static example, as compared to 125 days for the dynamic. ***The lower the fraction for f, the faster the dynamic will outperform the static technique***.

Now take a look at tripling the .2 fractional f. The number of days expected by the static technique to triple is:

ln(3)/ln(1.005) = 220.2704

This compares to its dynamic counterpart, which requires: ln(11)/ln(1.01933) = 125.2458 days

To make 400% profit (i.e., a goal or TWR of 5) requires of the .2 static technique:

ln(5)/ln(1.005) = 322.6902 days

Which compares to its dynamic counterpart:

ln(21)/ln(1.01933) = 159.0201 days

The dynamic technique takes almost half as much time as the static to teach the goal of 400% in this example. However, if you look out in time 322.6902 days to where the static technique doubled, the dynamic technique would be at a TWR of:

TWR = .8+(1.01933^322.6902)*.2

= .8+482.0659576*.2

= 97.21319

This represents making over 9,600% in the time it took the static to make 100%

We can now amend Equation (2.09a) to accommodate both the static and fractional dynamic f strategies to determine the expected length required to achieve a specific goal as a TWR. To begin with, for the static fractional f, we can create Equation (2.09b):

(2.09b) N = ln(Goal)/ln(A)

where

N = The expected number of trades to reach a specific goal.

Goal = The goal in terms of a multiple on our starting stake, a TWR.

A = The adjusted geometric mean. This is the geometric mean, run through Equation (2.08 to determine the geometric mean for a given static fractional f.

ln() = The natural logarithm function. For a dynamic fractional f, we have Equation (2.09c):

(2.09c) N = ln(((Goal-1)/ACTV)+l)/ln(Geometric Mean)

where

N = The expected number of trades to reach a specific goal.

Goal = The goal in terms of a multiple on our starting stake, a TWR.

ACTV = The active equity percentage.

Geometric Mean = This is simply the raw geometric mean, there is no adjustment performed on it as there is in (2.09b).

ln() = The natural logarithm function.

To illustrate the use of (2.09c), suppose we want to determine how long it will take an account to double (i.e., TWR = 2) at .1 active equity and a geometric mean of 1.01933:

(2.09) N = ln(((Goal-1)/ACTV)+l)/ln(Geometric Mean)-ln(((2-1)/.l)+l)/ln(1.01933)

= ln((1/.1)+1)/ln(1.01933)

= ln(10+l)/ln(1.01933)

= ln(11)/ln(1.01933)

= 2.397895273/.01914554872

= 125.2455758

Thus, if our geometric mean is determined on a daily basis, we can expect to double in about 125% days. If our geometric mean is determined on a trade-by-trade basis, we can expect to double in about 125% trades. So long ***as you are dealing with an N great enough such that (2.09c) is less than (2.09b), then you are benefiting from dynamic fractional f trading.***

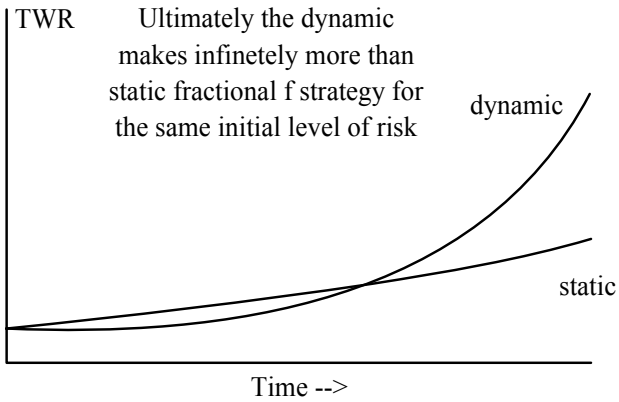

Figure 8-1 Static versus dynamic fractional f.

Figure 8-1 demonstrates the relationship between trading at a static versus a dynamic fractional f strategy over time. The more the time that elapses, the greater the difference between the static fractional f and the dynamic fractional f strategy. Asymptotically, the dynamic fractional f strategy provides infinitely greater wealth than its static counterpart.

In the long run you are better off to practice asset allocation in a dynamic fractional f technique. That is, you determine an initial level, a percentage, to allocate as active equity. The remainder is inactive equity. The day-to-day equity changes are reflected in the active portion only.

The inactive dollar amount remains constant. Therefore, each day you subtract the constant inactive dollar amount from your total account equity. This difference is the active portion, and it is on this active portion that you will figure your quantities to trade in based on the optimal f levels.

Eventually, if things go well for you, your active portion will dwarf your inactive portion, and you'll have the same problem of excessive variance and Potential drawdown that you would have had initially at the full optimal f level. We now discuss four ways to treat this "problem." There are no fine lines delineating these four methods, and it is possible to mix methods to meet your specific needs.

REALLOCATION: FOUR METHODS

First, a word about the risk-free asset. Throughout this chapter the risk-free asset has been treated as though it were simply cash, or near-cash equivalents such as Treasury Bills or money market funds (assuming that there is no risk in any of these).

The risk-free asset can also be any asset which the investor believes has no risk, or risk so negligible as to be nonexistent. This may include long-term government and corporate bonds. These can be coupon bonds or zeros. Holders may even write call options against these risk-free assets to further enhance their returns.

Many trading programs employ zero coupon bonds as the risk-free asset. For every dollar invested in such a program, a dollar's worth of face value zero coupon bonds is bought in the account. Such a bond, if it were to mature in, say, 5 years, would surely cost less than a dollar. The difference between the dollar face value of the bond and its actual cost is the return the bond will generate over its remaining life. This difference is then applied toward the trading program. If the program loses all of this money, the bonds will still mature at their full face value. At the time of the bond maturity, the investor is then paid an amount equal to his initial investment, although he would not have seen any return on that initial investment over the term that the money was in the program (5 years in the case of this example). Of course, this is predicated upon the managers of the program not losing an amount in excess of the difference between the face value of the bond and its market cost.

This same principle can be applied by any trader. Further, you need not use zero coupon bonds. Any kind of interest-generating vehicle can be used. The point is that the risk-free asset need not be simply "dead" cash. It can be an actual investment program, designed to provide a real yield, and this yield can be made to offset potential losses in the program. The main consideration is that the risk-free asset be regarded as risk-free (i.e., treated as though safety of principal were the primary concern).

Now on with our discussion of allocating between the risk-free asset, the "inactive" portion of the account, and the active, trading portion. The first, and perhaps the crudest, way to determine what the active/inactive percentage split will be initially, and when to reallocate back to this percentage, is the ***investor utility method***. This can also referred to as the ***gut feel method***. Here, we assume that the drawdowns to be seen will be equal to a complete retracement of active equity. Therefore, if we are willing to see a 50% drawdown, we initially allocate 50% to active equity. Likewise, if we are tilling to see a 10% drawdown, we initially split the account into 10% active, 90*inactive. Basically, with the investor utility method you are trying to allocate as high a percentage to active equity as you are willing to risk losing.

Now, it is possible that the active portion may be completely wiped out, at which point the trader no longer has any active portion of his account left with which to continue trading. At such a point, it will be necessary for the trader to decide whether to keep on trading, and if so, what percentage of the remaining funds in the account (the inactive subaccount) to allocate as new active equity. This new active equity can also be lost, so it is important that the trader bear in mind at the outset of this program that the initial active equity is ***not*** the maximum amount that can be lost. Furthermore, in any trading where there is unlimited liability on a given position (such as a futures trade) the entire account is at risk, and even the trader's assets outside of the account are at risk! The reader should not be deluded into thinking that he or she is immune from a string of locked limit days, or an enormous opening gap that could take the entire account into a deficit position, regardless of what the "active" equity portion of the account is.

This approach also makes a distinction between a drawdown in blood and a drawdown in diet cola. For instance, if a trader decides that a 25% equity retracement is the most that the trader would initially care to sit through, he or she should initially split the account into 75% inactive, 2.5% active. Suppose the trader is starting out with a $100,000 account. Initially, therefore, $25,000 is active and $75,000 is inactive. Now suppose that the account gets up to $200,000. The trader still has $75,000 inactive, but now the active portion is up to $125,000. Since he or she is trading at the full f amount on this $125,000, it is very possible to lose a good portion, if not all of this amount by going into an historically typical drawdown at this point. Such a drawdown would represent greater than a 25% equity retracement, even though the amount of the initial starting equity that would be lost would be 25% if the total account value plunged down to the inactive $75,000.

An account that starts out at a lower percentage of active equity will therefore be able to reallocate sooner than an account trading the same market systems starting out at a higher percentage of active equity. Therefore, not only does the account that starts out at a lower percentage of active equity have a lower potential drawdown on initial margin, but also since the trader can reallocate sooner he is less likely to get into awkward ratios of active to inactive equity (assuming an equity runup) than if he started out at a higher initial active equity percentage.

As a trader, you are also faced with the question of when to reallocate, whether you are using the crude investor utility method or one of the more sophisticated methods about to be described. You should decide in advance at what point in your equity, both on the upside and on the downside, you want to reallocate. For instance, you may decide that if you get a 100% return on your initial investment, it would be a good time to reallocate. Likewise, you should also decide in advance at what point on the downside you will reallocate. Usually this point is the point where there is either no active equity left or the active equity left doesn't allow for even 1 contract in any of the market systems you are using. You should decide, preferably in advance, whether to continue trading if this downside limit is hit, and if so, what percentage to reallocate to active equity to start anew.

Also, you may decide to reallocate with respect to time, particularly for professionally managed accounts. For example, you may decide to reallocate every quarter. This could be incorporated with the equity limits of real-location. You may decide that if the active portion is completely wiped out, you will stop trading altogether until the quarter is over. At the beginning of the next quarter, the account is reallocated with X% as active equity and 100-X% as inactive equity.

It is not beneficial to reallocate too frequently. Ideally, you will never reallocate. Ideally, you will let the fraction of optimal f you are using keep approaching 1 as your account equity grows. In reality, however, you most likely will reallocate at some point in time. It is to be hoped you will not reallocate so frequently that it becomes a problem.

Consider the case of reallocating after every trade or every day. Such is the case with static fractional f trading. Recall again Equation (2.09a), the time required to reach a specific goal.

Let's return to our system, which we are trading with a .2 active portion and a geometric mean of 1.01933. We will compare this to trading at the static fractional .2 f, where the resultant geometric mean is 1.005. If we start with a $100,000 account and we want to reallocate at $110,000 total equity, the number of days (since our geometric means here are on a per day basis) required by the static fractional .2 f is:

$\ln(1.1)/\ln(1.005) = 19.10956$

This compares to using $20,000 of the $100,000 total equity at the full f amount and trying to get the total account up to $110,000. This would represent a goal of 1.5 times the $20,000:

$\ln(1.5)/\ln(1.01933) = 21.17807$

At lower goals, the static fractional f strategy grows faster than its corresponding dynamic fractional f counterpart. As time elapses, the dynamic overtakes the static, until eventually the dynamic is infinitely farther ahead. Figure 8-1 displays this relationship between the static and dynamic fractional fs graphically.

If you reallocate too frequently you are only shooting yourself in the foot, as the technique would then be inferior to its static fractional f counterpart, Therefore, since you are best off in the long run to use the dynamic fractional f approach to asset allocation, you are also best off to reallocate funds between the active and inactive subaccounts as infre-

quently as possible. Ideally, you will make this division between active and inactive equity only once, at the outset of the program.

Generally, the dynamic fractional f will overtake its static counterpart faster the lower the portion of initial active equity. In other words, a portfolio with an initial active equity of .1 will overcome its static counterpart faster than a portfolio with an initial active equity allocation of .2 will overtake its static counterpart. At an initial active equity allocation of 100% (1.0), the dynamic never overtakes the static fractional f (rather they grow at the same rate). Also affecting the rate at which the dynamic fractional f overtakes its static counterpart is the geometric mean of the portfolio itself. The higher the geometric mean, the sooner the dynamic will overtake the static. At a geometric mean of 1.0, the dynamic never overtakes its static counterpart.

A second method for determining initial active equity amounts and real-location is the ***scenario planning method***. Under this method the amount allocated initially is determined mathematically as a function of the different scenarios, their outcomes, and their probabilities of occurrence, for the performance of the account. This exercise, too, can be performed at regular intervals. The technique involves the scenario planning method detailed in Chapter 4.

As an example, suppose you are pondering three possible scenarios for the next quarter:

Scenario	Probability	Result
Drawdown	50%	-100%
No gain	25%	0%
Good runup	25%	+300%

The result column pertains to the results on the account's active equity. Thus, there is a 50% chance here of a 100% loss of active equity, a 25% chance of the active equity remaining unchanged, and a 25% chance of a 360% gain on the active equity.

In reality you should consider more than three scenarios, but for simplicity, only three are used here. You input the three different scenarios, their probabilities of occurrence, and their results in units, where each unit represents a percentage point. The results are determined based on what you see happening for each scenario if you were trading at the full optimal f amount.

Inputting these three scenarios yields an optimal f of .11. Don't confuse this optimal f with the optimal fs of the components of the portfolio you are trading. They are different. Optimal f here pertains to the optimal f of the scenario planning exercise you just performed, which also told you the optimal amount to allocate as active equity for your given parameters. Therefore, given these three scenarios, you are best off in an asymptotic sense to allocate 11% to active equity and the remaining 89% to inactive. At the beginning of the next quarter, you perform this exercise again, and determine your new allocations at that time. Since the amount of funds you have to reallocate for a given quarter is a function of how you have allocated them for the previous quarter, you are best off to use this optimal f amount, as it will provide you with the greatest geometric growth in the long run. (Again, that's provided that your input-the scenarios, their probabilities, and the corresponding results-is accurate.)

This scenario planning method of asset allocation is also useful if you are trying to incorporate the opinion of more than one adviser. In our example, rather than pondering three possible scenarios for the next quarter, you might want to incorporate the opinions of three different advisers. The probability column corresponds to how much faith you have in each different adviser. So in our example, the first scenario, a 50% probability of a 100% loss on active equity, corresponds to a very bearish adviser whose opinion deserves twice the weight of the other two advisers.

Recall the share ***average method*** of pulling out of a program, which was examined in Chapter 2. We can incorporate this concept here as a reallocation method. In so doing, we will be creating a technique that systematically takes profits out of a program advantageously and also takes us out of a losing program.

The program calls for pulling out a regular periodic percentage of the total equity in the account (active equity + inactive equity). Therefore, each month, quarter, or whatever time period you are using, you will pull out X% of your equity. Remember though, that you want to get enough time in each period to make certain that you are benefiting, at least somewhat, by dynamic fractional f. Any value for N that is high enough to satisfy Equation (8.01) is a value for N that we can use and be certain that we are benefiting from dynamic fractional f:

(8.01) FG^N <= G^N*FRAC+1-FRAC

where

FG = The geometric mean for the fractional f, found by Equation (2.08).

N = The number of periods, with G and FG figured on the basis of 1 period.

G = The geometric mean at the optimal f level.

FRAC = The active equity percentage.

If we are using an active equity percentage of 20% (i.e., FRAC = .2), then FG must be figured on the basis of a .2 f. Thus, for the case where our geometric mean at full optimal f is 1.01933, and the .2 f (FG) is 1.005, we want a value for N that satisfies the following:

1.005^N <= 1.01933^N*.2+1-.2

We figured our geometric mean for optimal f(G) and therefore also our geometric mean for the fractional f (FG) on a daily basis, and we want to see if 1 quarter is enough time. Since there are about 63 trading days per quarter, we want to see if an N of 63 is enough time to benefit by dynamic fractional f. Therefore, we check Equation (8.01) at a value of 63 for N:

1.005^63 <= 1.01933^63*.2+1-.2

1.369184237 <= 3.340663933*.2+1-.2

1.369184237 <= .6681327866+1-.2

1.369184237 <= 1.6681327866-.2

1.369184237 <= 1.4681327866

The equation is satisfied, since the left side is less than or equal to the right side. Thus, we can reallocate on a quarterly basis under the given values here and be benefiting from using dynamic fractional f.

And where do you put this now pulled-out equity? Why, it goes right back into the account as inactive equity. Each period you will figure the total value of your account, and transfer that amount from active to inactive equity. Thus, there is reallocation. For example, again assume a $100,000 account where $20,000 is regarded as the active amount. Say you are share averaging out on a quarterly basis, and the quarterly percentage you pull out is 2%. Now assume that at the beginning of the following quarter the account still stands at $100,000 total equity, of which $20,000 is active equity. You now take out 2% of the total account equity of $100,000 and transfer that amount from active to inactive equity. Therefore, you transfer $2,000 from active to inactive equity, and your $100,000 account now has $18,000 active equity and $82,000 inactive.

We hope that the program will outpace the periodic percentage withdrawals to the upside. Suppose that in our last example, our $100,000 account goes to $110,000 at the end of the quarter. Now, when we go to reallocate 2%, $2,200, we debit our active equity amount of $30,000 and credit our inactive amount of $80,000. Thus, we have $27,800 active equity and $82,200 inactive. Since our active equity after the reallocation is still greater than it was at the beginning of the previous period, we can say that the program has outpaced the reallocation.

On the other hand, if the program loses money, or if the program goes nowhere (in which case you are risking money repeatedly, yet not making any upward progress on your equity), this technique has you eventually end up with the entire account equity as inactive equity. At that point, you have automatically ceased trading a losing program.

Naturally, two questions must now crop up. The first is, "What must this periodic percentage reduction be such that if the account equity were to stagnate after N periodic deductions from active equity, the program would automatically terminate (i.e., active equity equal to 0)?" The solution is given by Equation (8.02):

(8.02) P = 1-INACTIVE^(1/N)

where

P = The periodic percentage of the total account equity that should be transferred from active to inactive equity.

INACTIVE = The inactive percent of account equity.

N = The number of periods we want the program to terminate in if the equity stagnates.

Thus, if we were to make quarterly transfers of equity from active to inactive, and we were using an initial allocation of 80% as inactive equity, and we wanted the program to terminate in 2,5 years (10 quarters-i.e., N = 10), the quarterly percentage would be:

P = 1-.8^(1/10)

= 1-.8^.1

= 1-.9779327685

= .0220672315

Thus, we should pull out 2.20672315% of the total equity each quarter, and transfer that from active to inactive equity.

The second question to arise is, "If we are pulling out a certain given percentage, what must the number of periods be in order for the active equity to equal 0?" In other words, if we know we want to pull out P% each period (again we assume that the periods here are quarters) and if the account equity stagnates, over how many periods, N, must we make these equity transfers until the active equity equals 0. The solution is given by Equation (8.03):

(8.03) N = ln(INACTIVE)/ln(l-P)

where

P = The periodic percentage of the total account equity that will be transferred from active to inactive equity.

INACTIVE = The inactive percentage of account equity.

N = The number of periods it will take for the program to terminate if the equity stagnates.

Again, assume that the initial inactive equity is allocated as 80% and that you are pulling out 2.20672315% per quarter. Therefore, the number of periods, quarters in this case, required until the program terminates if the equity stagnates is:

N = ln(.8)/ln(l-.0220672315) = ln(.8)/ln(.9779327685) = -.223143/-.0223143 = 10

For the given values, it would thus take 10 periods for the program to terminate.

Share averaging will get us out of a portfolio over time at an above-average price, just as dollar averaging will get us into a portfolio over time at a below-average cost. Consider now that most people do just the opposite of this, hence they are getting into and out of a portfolio at prices worse than average. When someone opens an account to trade, they dump all the trading capital in and just start trading. When they want to add funds, they will almost always invariably add in single blocks of cash, unable to make equal dollar deposits over time.

A trader trying to live off trading profits will generally withdraw enough money from the account on a periodic basis to cover his living expenses, regardless of what percentage of his account this constitutes. This is exactly what he should not do. Suppose that the trader's living expenses are constant from one month to the next, SO he is withdrawing a constant dollar amount. By doing this he is accomplishing the exact opposite of share averaging in that he will be withdrawing a larger percentage of his funds when the account balance is lower, and a smaller percentage when the account balance is higher. In short, he is slowly getting out of the portfolio (or a portion of it) over time at a below-average price.

Rather, the trader should withdraw a constant percentage (of total account equity, active plus inactive) each month. The withdrawn funds can be put into a middle account, a simple demand deposit account. Then from this demand deposit account the trader can withdraw a constant dollar amount each month to meet his living expenses. If the trader were to bypass this middle account and withdraw a constant dollar amount directly from the trading account, it would cause the ideas of share averaging and dollar averaging to work against him.

Recall from Chapter 2 the observation that when you are trading at the optimal f levels you can expect to be in the worst-case drawdown 35 to 55% of the time period you are looking at. Generally, this doesn't sit well with most traders. Most traders want or need a much smoother equity curve, either to satisfy the needs of their living expenses or for other, more emotional, reasons. What trader wouldn't like to make a steady $X per day from trading? This 35 to 55% principle is true on a full optimal f basis, and therefore is true on a dynamic fractional f basis as well, but is not true on a static fractional f basis. Since the dynamic is asymptotically better than its static fractional f counterpart, we can expect this 35 to 55% principle to apply to us if we are going to trade our account in the mathematically optimal fashion-that is, at full optimal f for a given level of initial risk (our initial active equity).

The establishment of a buffer demand deposit account allows for the account to be traded in the mathematically optimal fashion (dynamic optimal 0 while it also allows the share averaging method of reallocation to work (i.e., cash is transferred to the buffer demand deposit account) and allows for a steady dollar outcome from the buffer demand deposit account, thus meeting the trader's needs. Thus, if a trader needs $X per day to meet his needs, be they living expenses or otherwise, these can be satisfied without sabotaging the mathematics in the account by establishing and administering a buffer demand deposit account, and share averaging funds on a periodic basis from the trading program to this buffer account. The trader then makes regular withdrawals of a constant dollar amount from this buffer account.

Of course, the regular dollar withdrawals must be for an amount less than the smallest amount transferred from the trading account to the buffer account. For example, if we are looking at a $500,000 account, we are withdrawing 1% per month, and we start out with 20% initial active equity, then we know that our smallest withdrawal from the trading account will be .01*500,000*(1-.2) = .01*500,000*.8 = $4,000. Therefore, our constant dollar withdrawal from the buffer account should be for an amount no greater than $4,000. The buffer account can also be the inactive subaccount.

Before we come to the fourth asset allocation technique, a certain confusion must be cleared up. With optimal fixed fractional trading, you can see that you add more and more contracts when your equity increases, and vice versa when it decreases. This technique makes the greatest geometric growth of your equity in the long run.

WHY REALLOCATE?

Reallocation seems to do just the opposite of what we want to do in that reallocation trims back after a runup in equity or adds more equity to the active portion after a period where the equity has been run down. Reallocation is a compromise between the theoretical ideal and the real-life implementation. These techniques allow us to make the most of this compromise.

Ideally, you would never reallocate. When your humble little $10,000 account grew to $10 million, it would never go through reallocation. Ideally, you would sit through the drawdown that took your account back down to $50,000 from the $10 million mark before it shot up to $20 million. Ideally, if your active equity were depleted down to 1 dollar, you would still be able to trade a fractional contract (a "micro-contract"?). In an ideal world, all of these things would be possible. In real life, you are going to reallocate at some point on the upside or the downside. Given that you are going to do this, you might as well do it in a systematic, beneficial way.

In reallocating, or compromising, you "reset" things back to a state you would be at if you were starting the program all over again, only at a different equity level. Then you let the outcome of the trading dictate where the fraction off used floats to by using a dynamic fractional fin between reallocations. Things can get levered up awfully fast, even when you start out with an active equity allocation of only 20%. Remember, you are using the full optimal f on this 20%, and if your program does modestly well, you'll be trading in substantial quantities relative to the total equity in the account in short order.

PORTFOLIO INSURANCE – THE FOURTH REALLOCATION TECHNIQUE

Assume for a moment that you are managing a stock fund. Figure 8-2 depicts a typical portfolio insurance strategy (also known as dynamic ***hedging***). The floor in this example is the current portfolio value of 100 (dollars per share). The typical portfolio follows the equity market 1 for 1. This is represented by the unbroken line. The insured portfolio is depicted here by the dotted line. Note that the dotted line is below the unbroken line when the portfolio is at or above its initial value (100). This difference represents the cost of the portfolio insurance. Otherwise, as the portfolio falls in value, portfolio insurance provides a floor on the value of the portfolio at a desired floor value (in this case the present value of 100) minus the cost of performing the strategy.

In a nutshell, portfolio insurance is akin to buying a put option on the portfolio. Suppose the fund you are managing consists of only 1

stock, which is currently priced at 100. Buying a put option on this stock, with a strike price of 100, at a cost of 10, would replicate the dotted line in Figure 8-2. The worst that could happen now to your portfolio of 1 stock and a put option on it is that you could exercise the put, which sells your stock at 100, and you lose the value of the put, 10. Thus, the worst that this portfolio can be worth is 90, no matter how far down the underlying stock goes.

In a nutshell, portfolio insurance is akin to buying a put option on the portfolio. Suppose the fund you are managing consists of only 1 stock, which is currently priced at 100. Buying a put option on this stock, with a strike price of 100, at a cost of 10, would replicate the dotted line in Figure 8-2. The worst that could happen now to your portfolio of 1 stock and a put option on it is that you could exercise the put, which sells your stock at 100, and you lose the value of the put, 10. Thus, the worst that this portfolio can be worth is 90, no matter how far down the underlying stock goes. On the upside, your insured portfolio suffers somewhat in that the value of the portfolio is always reduced by the cost of the put.

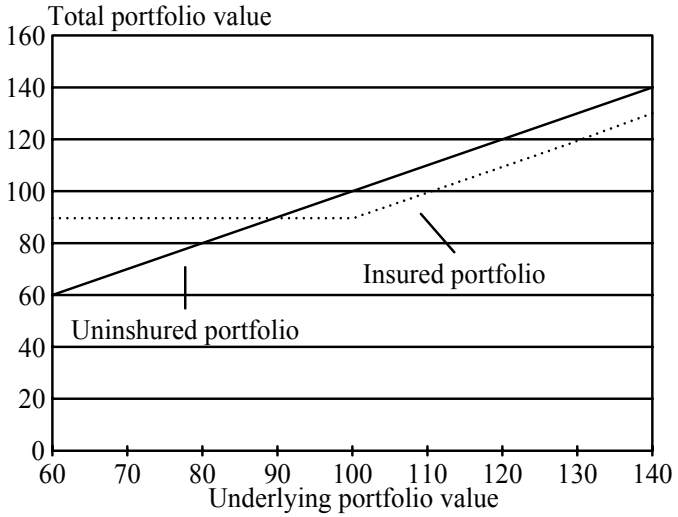

Figure 8-2 Portfolio insurance.

Clearly, looking at Figure 8-2 and considering the fundamental equation for trading, the estimated TWR of Equation (1.19c), you can intuitively see that an insured portfolio is superior to an uninsured portfolio in an asymptotic sense. In other words, if you're only as smart as your dumbest mistake, you have put a floor on that dumbest mistake by portfolio insurance.

Now consider that being long a call option will give you the same profile as being long the underlying and long a put option with the same strike price and expiration date as the call option. Here, when we speak of the same profile, we mean an equivalent position in terms of the risk/reward characteristics at different values for the underlying. Thus, the dotted line in Figure 8-2 can also represent a portfolio comprised of simply being long the 100 call option at expiration.

Here is how dynamic hedging works to provide portfolio insurance. Suppose you buy 100 shares of a single stock for your fund, at a price of $100 per share. You now replicate the call option by using this underlying stock. You do this by determining an initial floor for the stock. The floor you choose is, say, 100. You also determine an expiration date for the hypothetical option you are going to create. Say the expiration date you choose is the date on which this quarter ends.

Now you figure the delta for this 100 call option with the chosen expiration date. You can use Equation (5.05) to find the delta of a call option on a stock (you can use the delta for whatever option model you are using; we're using the Black-Scholes Stock Option Model here). Suppose the delta is .5. This means that you should be 50% invested in the given stock. You would thus have only 50 shares of stock on rather than the 100 shares you would have on if you were not practicing portfolio insurance. As the value of the stock increases, so will the delta, and likewise the number of shares you hold. The upside limit is a delta at 1, where you would be 100% invested. In our example, at a delta of 1 you would have on 100 shares. As the stock price decreases, so does the delta, and so does the size of your position in the stock. The downside limit is at a delta of 0 (where the put delta is-1), at which point you wouldn't have any position in the stock.

Operationally, stock fund managers have used ***noninvasive*** methods of dynamic hedging. Such a technique involves not having to trade the cash portfolio. Rather, the portfolio as a whole is adjusted to what the current delta should be as dictated by the model by using futures, and sometimes put options. One benefit of using futures is low transaction costs. Selling short futures against the portfolio is equivalent to selling off part of the portfolio and putting it into cash. As the portfolio falls, more futures are sold, and as it rises, these short positions are covered. The loss to the portfolio as it goes up and the short futures positions are covered is what accounts for the portfolio insurance cost, the cost of the replicated put options. Dynamic hedging, though, has the benefit of allowing us to closely estimate this cost at the outset. To managers trying to implement such a strategy, it allows the portfolio to remain untouched while the appropriate asset allocation shifts are performed through futures and/or options trades. This noninvasive technique of using futures and/or options permits the separation of asset allocation and active portfolio management.

To implement portfolio insurance, you must continuously adjust the portfolio to the appropriate delta. This means that, say each day, you must input into the option pricing model the current portfolio value, time of expiration, interest rate levels, and portfolio volatility to determine the delta of the put option you are trying to replicate. Adding this delta (which is a number between 0 and -1) to 1 will give you the corresponding call's delta. This is the hedge ratio, the percentage that you should be invested in the fund. You must make sure that you stay as close to this hedge ratio as possible.

Suppose your hedge ratio for the present moment is .46. Say that the size of the fund you are managing is the equivalent to 50 S&P futures contracts. Since you only want to be 46% invested, you want to be 54% dis-invested. Fifty-four percent of 50 contracts is 27 contracts. Therefore, at the present price level of the fund, at this point in time, for the given interest rate and volatility levels, the fund should be short 27 S&P contracts along with its long position in cash stocks. Because the delta needs to be recomputed on an ongoing basis, and portfolio adjustments constantly monitored, the strategy is called a dynamic hedging strategy.

One problem with using futures in the strategy is that the futures market does not exactly track the cash market. Further, the portfolio you are selling futures against may not exactly follow the cash index upon which the futures market is traded. These tracking errors can add to the expense of a portfolio insurance program. Furthermore, when the option being replicated gets very near to expiration and the portfolio value is near the strike price, the gamma of the replicated option goes up astronomically. Gamma is the instantaneous rate of change of the delta or hedge ratio. In other words, gamma is the delta of the delta. If the delta is changing very fast (i.e., if the replicated option has a high gamma), portfolio insurance becomes increasingly more cumbersome to perform. There are numerous ways to work around this problem, some of which are very sophisticated. One of the simplest involves not only trying to match the delta of the replicated option, but using futures and options together to match both the delta ***and*** gamma of the replicated option. Again, this high gamma usually becomes a problem only when expiration draws near and the portfolio value and the replicated option's strike price are very close.

There is a very interesting relationship between optimal f and portfolio insurance. When you enter a position, you can state that f percent of your funds are invested. For example, consider a gambling game in which your optimal f is .5, your biggest loss is -1, and your bankroll is $10,000. In such a case, you would bet $1 for every $2 in your stake, since -1, the biggest loss, divided by -.5, the negative optimal f, is 2. Dividing $10,000 by 2 yields $5,000. You would therefore bet $5,000 on the next bet, which is f percent, 50%, of your bankroll. Had you multiplied our bankroll of $10,000 by f, .5, you would have arrived at the same $5,000 result. Hence, you have bet f percent of our bankroll.

Likewise, if your biggest loss were $250 and everything else remained the same, you would be making 1 bet for every $500 in your bankroll (since -$250/-.5 = $500). Dividing $10,000 by $500 means that you would make 20 bets. Since the most you can lose on any one bet is $250, you have thus risked f percent, 50% of our stake, in risking $5,000 ($250*20). We can therefore state that f equals the percentage of our funds at risk, or f equals the hedge ratio. Since f is only applied on the active portion of our portfolio in a dynamic fractional f strategy, the hedge ratio of the portfolio is:

(8.04a) H = f*A/E

where

H = The hedge ratio of the portfolio.

f = The optimal f (0 to 1).

A = The active portion of funds in an account.

E = The total equity of the account.

Equation (8.04a) gives us the hedge ratio for a portfolio being traded on a dynamic fractional f strategy. Portfolio insurance is also at work in a static fractional f strategy, only the quotient A/E equals 1, and the value for f, the optimal f, is multiplied by whatever value we are using for the fraction off. Thus, in a static fractional f strategy the hedge ratio is:

(8.04b) H = f*FRAC

where

H = The hedge ratio of the portfolio.

f = The optimal f (0 to 1).

FRAC = The fraction of optimal f that you are using.

Since there is usually more than one market system working in an account, we must account for this. When this is the case, the variable fin Equation (8.04a) or (8.04b) must be calculated as:

(8.05) $f = \sum[i = 1,N]f_i*W_i$

where

f = The f (0 to 1) to be input in Equation (8.04a) or (8.04b).

N = The total number of market systems in the portfolio.

W_i = The weighting of the ith component in the portfolio (from the identity matrix).

f_i = The f factor (0 to 1) of the ith component in the portfolio.

We can state that in trading an account on a dynamic fractional f basis we are performing portfolio insurance. Here, the floor is equal to the initial inactive equity plus the cost of performing the insurance. However, it is often simpler to refer to the floor of a dynamic fractional f strategy as simply the initial inactive equity of an account.

We can state that Equation (8.04a) or (8.04b) equals the delta of the call option of the terms used in portfolio insurance. Further, we find that this delta changes much the way a call option that is deep out-of-the-money and very far from expiration changes. Thus, by using a constant inactive dollar amount, trading an account on a dynamic fractional f strategy is equivalent to owning a put option on the portfolio that is deep in-the-money and very far out in time. Equivalently, we can state that trading a dynamic fractional f strategy is the same as owning a call option on the portfolio that doesn't expire for a very long time and is very far out-of-the-money, rather than the portfolio itself. This quality, this relationship to portfolio insurance, is true for any dynamic fractional f strategy, whether we are using share averaging, scenario planning, or investor utility.

It is also possible to use portfolio insurance as a reallocation technique to "steer" performance somewhat. This steering may be analogous to trying to steer a tanker with a rowboat oar, but this is a valid reallocation technique. The method involves setting parameters for the program initially. First you must determine a floor value. Once this has been chosen, you must decide upon an expiration date, a volatility level, and other input parameters for the particular option model you intend to use. These inputs will give you the options delta at any given point in time. Once the delta is known, you can determine what your active equity should be. Since the delta for the account, the variable H in Equation (8.04a), must equal the delta for the call option being replicated, D, we can replace H in Equation (8.04a) with D:

D = f*A/E

Therefore:

(8.06) D/f = A/E if D < f (otherwise A/E = 1)

where

D = The hedge ratio of the call option being replicated.

f = The f (0 to 1) from Equation (8.05).

A = The active portion of funds in an account.

E = The total equity of the account.

Since A/E is equal to the percentage of active equity, we can state that the percentage of the total account equity funds that we should have in active equity is equal to the delta on the call option divided by the f determined in Equation (8.05). However, you will note that if D is greater than f, then it is suggesting that you allocate greater than 100% of an account's equity as active. Since this is not possible, there is an upper limit of 100% of the account's equity that can be used as active equity. You can use Equation (5.05) to find the delta of a call option on a stock, or Equation (5.08) to find the delta of a call option on a future.

The problem with implementing portfolio insurance as a reallocation technique, as detailed here, is that reallocation is taking place constantly. This detracts from the fact that a dynamic fractional f strategy will asymptotically dominate a static fractional f strategy. As a result, trying to steer performance by way of portfolio insurance as a dynamic fractional f reallocation strategy probably isn't such a good idea. However, any time you use dynamic fractional f, you are employing portfolio insurance.

We now cover an example of portfolio insurance. Recall our geometric optimal portfolio of Toxico, Incubeast, and LA Garb. We found the geometric optimal portfolio to exist at V = .2457. We must now convert this portfolio variance into the volatility input for the option pricing model. Recall that this input is described as the annualized standard deviation. Equation (8.07) allows us to convert between the portfolio variance and the volatility estimate for an option on the portfolio:

(8.07) OV = (V^.5)*ACTV*YEARDAYS^.5

where

OV = The option volatility input for an option on the portfolio.

V = The variance on the portfolio.

ACTV = The current active equity portion of the account.

YEARDAYS = The number of market days in a year.

If we assume a year of 251 market days and an active equity percentage of 100% (1.00) for the sake of simplicity:

OV = (.2457^.5)*1*251^.5 = .4956813493*15.84297952 = 7.853069464

This corresponds to a volatility of over 785%! Remember, this is the annualized volatility on the portfolio being traded at the optimal f level with 100% of the account designated as active equity. As a result, we are going to get very high volatility readings. Since we are going to demonstrate portfolio insurance as a reallocation technique, we must use 1.00 as the value for ACTV.

Equation (5.05) will give us the delta on a particular call option as:

(5.05) Call Delta = N(H)

The H term in (5.05) is given by (5.03) as:

(5.03) H = ln(U/(E*EXP(-R*T)))/(V*T^(1/2))+(V*T^(l/2))/2

U = The price of the underlying instrument.

E = The exercise price of the option.

T = Decimal fraction of the year to expiration.

V = The annual volatility in percent.

R = The risk-free rate.

ln() = The natural logarithm function.

N() = The cumulative Normal density function, as given in Equation (3.21).

Notice that we are using the stock option pricing model here. We now use our answer for OV as the volatility input, V, in Equation (5.03). If we assume the risk-free rate, R, to be 6% and the decimal fraction of the year left till expiration, T, to be .25, Equation (5.03) yields:

H = ln(100/(100*EXP(-.06*.25)))/(7.853069464*.25^.5)+(7.853069464*.25^.5)/ 2

= ln(100/(100*EXP(-.015)))/(7.853069464*.5)+(7.853069464*.5)/2

= ln(100/(100*.9851119396))/(7.853069464*.5)+(7.853069464*.5)/2

= ln(100/98.51119396)／3.926534732+3.926534732/2

= ln(1.015113065)／3.926534732+1.963267366

= .015 13.926534732+1.963267366

= .00382+1.963267366

= 1.967087528

This answer represents the H portion of (5.05). We must now run this through Equation (3.21) as the Z variable to obtain the actual call delta:

(3.21) N(Z) = 1-N'(Z)*((1.330274429*Y^5)-(1.821255978*Y^4)+(1.781477937*Y^3)-(.356563782*Y^2)+(.31938153*Y))

where

Y = 1/(1+.2316419*ABS(Z))

N'(Z) = .398942*EXP(-(Z^2/2))

Thus:

Y = 1/ (1+.2316419*ABS(1.967087528))

= 1/(1+ .4556598925)

= 1/1.4556598925

= .6869736574

Now solving for the term N'(1.967087528)

N'(1.967087528) = .398942*EXP(-(1.967087528 ^ 2/2))

= .398942*EXP(-(3.869433343/2))

= .398942*EXP(-1.934716672)

= .398942*.1444651941

= .05763323346

Now, plugging the values for Y and N' (1.967087528) into (3.21) to obtain the actual call delta as given by Equation (5.05):

N(Z) = 1-.05763323346*((1.330274429*.6869736574^5)-(1.821255978*.6869736574^4)+(1.781477937*.6869736574^3)-(.356563782*.6869736574^2)+(.31938153*.6869736574))

= 1-.05763323346*((1.330274429*.1530031)-(1.821255978*.2227205)+(1.781477937*.3242054)-(.356563782*.4719328)+(.31938153*.6869736))

= 1-.05763323346*(.2035361115-.405631042+-5775647672-.168274144+.2194066794)

= 1-.05763323346*.4266023721

= 1-.02458647411

= .9754135259

Thus, we have a delta of .9754135259 on our hypothetical call option for a portfolio trading at a price of 100%, with a strike price of 100%, with .25 of a year left to expiration, a risk-free rate of 6%, and a volatility on this portfolio of 785.3069464%.

Now recall that the sum of the weights on this geometric optimal portfolio consisting of Toxico, Incubeast, and LA Garb, per Equation (8.05), is 1.9185357. Thus, per Equation (8.06), we would reallocate to 50.84156244% (.9754135259/1.9185357) active equity if we were using portfolio insurance to reallocate.

"What is the cost of this insurance?" That depends upon the volatility that will actually be seen over the life of the replicated option. For instance, if the equity in the account were not to fluctuate at all over the life of the replicated option (volatility equal to 0), the replicated option, the insurance, would cost us nothing. This is a great benefit to portfolio insurance versus outright buying a put option (assuming one was available on our portfolio). We pay the actual theoretical price of the option for the volatility actually encountered, not the volatility perceived by the marketplace before the fact, as would be the case with actually buying the put option. Further, actually buying the put option (again assuming one was available) entails a bid-ask spread that is circumvented by replicating the option.

THE MARGIN CONSTRAINT

Here is a problem that continuously crops up when we take any of the fixed fractional trading techniques out of its theoretical context and apply it in the real world. We have seen that anytime an additional market system is added to the portfolio, so long as the linear correlation coefficient of daily equity changes between that market system and another market system in the portfolio is less than +1, the portfolio is improved. That is to say that the geometric mean of daily HPRs is increased. Thus, it stands to reason that you would want to have as many market systems as possible in a portfolio. Naturally, at some point, margin considerations become a problem.

Even if you are trading only 1 market system, margin considerations can often be a problem. Consider that the optimal fin dollars is very often less than the initial margin requirements for a given market. Now, depending on what fraction of f you are using at the moment, whether you are using a static or dynamic fractional f strategy, you will encounter a margin call if the fraction is too high.

When you trade a portfolio of market systems, the problem of a margin call becomes even more likely. With an unconstrained portfolio, the sum of the weights is often considerably greater than 1. When you trade only 1 market system, the weight is, de facto, 1. If the sum of the weights of a market system you are trading is, say, 3, then the likelihood of a margin call is 3 times as great as it would be if you were trading just 1 market.

What is needed is a way to reconcile how to create an optimal portfolio within the bounds of the margin requirements on the components in the portfolio. This can very easily be found. The way to accomplish this is to find what fraction off you can use ***as an upper limit***. This upper limit, U, is given by Equation (8.08) as:

(8.08) $U = \sum[i = 1,N]f_i\$/((\sum[i = 1,N]\ margin_i\$)*N)$

where

U = The upside fraction of J At this particular fraction off you are trading the optimal portfolio as aggressively as possible without incurring an initial margin call.

$f_i\$$ = The optimal fs in dollars for the ith market system.

$margin_i\$$ = The initial margin requirement of the ith market system.

N = The total number of market systems in the portfolio.

If U is greater than 1, then use 1 as the answer for U. For instance, suppose we have a portfolio with the three market systems as follows, with the following optimal fs in dollars for the three market systems and the following initial margin requirements. (***Note:*** the f$ are the optimal fs in dollars for each market system in the portfolio. This represents the market system's individual optimal f$ divided by its weighting in the portfolio):

Market System	f$	Initial Margin
A	$2,500	$2,000
B	$2,000	$2,000
C	$3,000	$2,000
Sums	$7,500	$6,000

Now, per Equation (8.08) we use the sum of the f$ column in the numerator, which is $7,500, and divide by the sum of the initial margin requirements, $6,000, times the number of markets, N, which is 3:

U = $7,500/($6,000*3) = 7500/18,000 = .4167

Therefore, we can determine that, as an upside limit, our fraction off cannot exceed 41.67% in this case (that is, if we are employing a dynamic fractional f strategy). Therefore, we must reallocate when our active equity divided by our total equity in the account equals or exceeds .4167.

If, however, you are still employing a static fractional f strategy (despite my protestations), then the highest you should set that fraction to is .4167. This will put you on the unconstrained geometric efficient frontier, to the left of the optimal portfolio, but as far to the right as possible without encountering a margin call.

To see this, suppose we have a $100,000 account. We set our fractional f values to a .4167 fraction of optimal. Therefore for each market system:

Market System	f$	1.4167 = New f$
A	$2,500	$6,000
B	$2,000	$4,600
C	$3,000	$7,200

For a $100,000 account, we will trade 16 contracts of market system A (100,000/6,000), 20 contracts of market system B (100,000/4,800), and 13 contracts of market system C (100,000/7,200). The resulting margin requirement for such a portfolio is:

16*$2,000 = $32,000 20*2,000 = 40,000 13*2,000 = 26,000

Initial margin requirement $96,000

Notice that using this formula (8.08) yields the highest fraction for f (without incurring an initial margin call) that gives you the same ratios of the different market systems to one another. Hence, Equation (8.08) returns the unconstrained optimal portfolio at its least diluted state without incurring an initial margin call.

Notice in the previously cited example that if you are trading a fractional f strategy, the value returned from Equation (8.08) is the maximum fraction for f you can get to without incurring an initial margin call. Again consider a $100,000 account. Assume that at one time, when

you opened this account, it had $70,000 in it. Further assume that of that initial $70,000 you allocated $58,330 as inactive equity. Thus, you initially started out at a roughly 83:17 percentage split between inactive and active equity. You have traded the active portion at the full optimal f values. Now your account stands at $100,000. You still have $58,330 as inactive equity, therefore your active equity is $41,670, which is .4167 of your total equity. This should now be the maximum fraction you can use, the maximum ratio of active to total equity, without incurring a margin call. Recall that you are trading at the full f levels. Therefore, you will trade 16 contracts of market system A (41,670/2,500), 20 contracts of market system B (41,670/2,000), and 13 contracts of market system C (41,670/3,000). The resultant margin requirement for such a portfolio is:

16*$2,000 = $32,000 20*2,000 = 40,000 13* 2,000 = 26,000

Initial margin requirement $96,000

Again we can see that this is pushing it as much as possible without incurring a margin call, since we have $100,000 total equity in the account.

Recall from Chapter 2 the fact that adding more and more market systems results in higher and higher geometric means for the portfolio as a whole. However, there is a tradeoff in that each market system adds marginally less benefit to the geometric mean, but marginally more detriment in the way of efficiency loss due to simultaneous rather than sequential outcomes. Therefore, you do not want to trade an infinite number of market systems. What's more, theoretically optimal portfolios run into the real-life application problem of margin constraints. In other words, you are better off to trade 3 market systems at the full optimal f levels than to trade 300 market systems at dramatically reduced levels as a result of Equation (8.08). Usually, you will find that the optimal number of market systems to trade in, particularly when you have many orders to place and the potential for mistakes, is but a handful.

If one or more market systems in the portfolio have optimal weightings greater than 1, a potential problem emerges. For example, assume a market system with an optimal f of .8 and a biggest loss of $4,000. Therefore, f$ is $5,000. Let's suppose the optimal weighting for this component of the portfolio is 1.25. Therefore you will trade one unit of this component for every $4,000 ($5,000/1.25) in account equity. As you can see, as soon as the component sees its largest loss, all of the active equity in the account will be wiped out (unless profits are sufficient in the other market systems to salvage some active equity).

This problem tends to crop up for systems that trade infrequently. For example, recall that if we could have two market systems with perfect negative correlation and a positive expectation, we would optimally have on an infinite number of contracts. When one of the components lost, the other would win an equal or greater amount. Thus, we would always have a net profit on each play. However, these market systems are always having a simultaneous play. The situation being discussed is analogous to this hypothetical situation when one of these components is not active on a certain play. Now there's only one market system active on a given play, and that market system has on an infinite number of contracts. A loss is catastrophic.

The solution is to divide 1 by the highest weighting of any of the components in the portfolio and use the answer as the upper limit on active equity if the answer is less than the answer to Equation (8.08). This ensures that if a loss is encountered in the future of the same magnitude as the largest loss over which f was derived, it will not wipe out the account. For example, suppose the highest weighting of any component in our portfolio is 1.25. Then if Equation (8.08) does not give us an answer less than .8 (1/1.25), we will use .8 as our upper limit on our active equity percentage.

This is unlikely to be a problem if you start with a low active equity percentage. However, a more aggressive trader may encounter this problem. An alternative solution is to set additional constraints in the portfolio matrix (such as constraints on the maximum weighting for each market system being set to 1, as well as constraints pertaining to margin). These additional linear programming constraints may be slightly beneficial to the aggressive trader, but the matrix solutions can be involved. Interested readers are again referred to Childress.

ROTATING MARKETS

Many traders use systems or techniques that have them monitoring many markets all the time, filtering for what they feel are the best markets for the systems at the moment. For example, some traders may prefer to monitor the volatility in all of the futures markets and trade only those markets whose volatility exceeds a certain amount. Sometimes they will be in many markets, sometimes they won't be in any. Further, the markets that they are in are constantly changing. This changing composition seems to be particularly a problem for stock fund managers. How can we manage such a thing and still be at the optimal portfolio?

The solution is really quite simple. Anytime a market is added or deleted from the portfolio, the new unconstrained geometric optimal portfolio is calculated as detailed in this chapter. Any adjustments to existing positions in terms of the quantity that should be on in light of the newly added or deleted market system ought to be made as well.

In a nutshell, it is alright to have a constantly changing portfolio in terms of components. The goal for the manager of such a portfolio, however, is to have the portfolio always be the unconstrained geometric optimal of the components involved and to keep the inactive equity amount constant. In so doing, a constantly changing portfolio composition can be managed in a manner that is asymptotically optimal.

There is a potential problem with this type of trading from a portfolio standpoint. An example may help illustrate. Imagine two highly correlated markets, such as gold and silver. Now imagine that your system trades so infrequently that you have never had a position in both of these markets on the same day. When you determine the correlation coefficients of the daily equity changes, it is quite possible that the correlation coefficient you will show between gold and silver is 0. However, if in the future you have a trade in both markets simultaneously, you can expect them to have a high positive correlation.

To solve this problem, it is helpful to edit your correlation coefficients with an eye toward this type of situation. In short, don't be afraid to edit the correlation coefficients upward. However, be wary of moving them lower. Suppose you show the correlation coefficient between Bonds and Soybeans as 0, but you feel it should be lower, say -.25. You really should not adjust correlation coefficients lower, as lower correlation coefficients tend to have you increase position size. In short, if you're going to err in the correlation coefficients, err by moving them upward rather than downward. Moving them upward will tend to move the portfolio to the left of the peak of the portfolio's f curve, while moving correlation coefficients lower will tend to move you to the right of the portfolio's f curve.

Often people try to filter trades in a manner as to have them in a particular market during certain times and out at others in an attempt to lower drawdown. If the filtering technique works, if it lowers drawdown on a one-unit basis, then the f that is optimal for the filtered trades will be higher (and f$ lower) than for the entire series of trades before filtering. If the trader applies the optimal f over the entire prefiltered series to the postfiltered series, she will find herself at a fractional f on the postfiltered series and hence cannot be obtaining a geometric optimal portfolio. On the other hand, if the trader applies the optimal f on the postfiltered series, she can obtain the geometric optimal portfolio, but she is right back to the problem of impending large drawdowns at optimal f. She seems to have defeated the purpose of her filter.

This illustrates the fallacy of filters from a money-management standpoint. ***Filters might work (reduce drawdown on a one-unit basis) only because they cause the trader to be at a fraction of the optimal f.***

Why filter at all? We could state that we benefit by filtering if our answer to the fundamental equation of trading on postfiltered trades at the prefiltered optimal f is greater than the answer to the fundamental equation of trading on prefiltered trades at the prefiltered optimal f. It is important to note when making such a comparison that the postfiltered trades are less in number (have lower N) than the prefiltered trades.

TO SUMMARIZE

We have seen that trading on a fixed fractional basis makes the most money in an asymptotic sense. It maximizes the ratio of potential gain to potential loss. Once we have an optimal f value we can convert our daily equity changes on a 1-unit basis to an HPR, we can determine the arithmetic average HPR and standard deviation in those HPRs, and we can calculate the correlation coefficient of the HPRs between any two market systems, We can then use these parameters as inputs in determining the optimal weightings for an optimal portfolio. (Since we are using leveraged vehicles, weighting and quantity are not synonymous, as they

would be if there was no leverage involved.) These weightings then are reflected back into the f values, the amount we should finance each contract by, as the f values are divided by their respective weightings. This gives us new f values, which result in the greatest geometric growth with respect to the intercorrelations of the other market systems and their weightings.

The greatest geometric growth is obtained by using that set of weightings whose sum is unconstrained and whose arithmetic average HPR minus its standard deviation in HPRs squared (its variance) equals 1 [Equation (7.06c)]. Rather than being diluted (which only puts you farther left on the unconstrained efficient frontier), as is the case with a static fractional f strategy, this portfolio is traded full out with only a fraction of the funds in the account. Such a technique is called a ***dynamic fractional f*** strategy. The remaining funds, the inactive equity, are left untouched by the activity that goes on in these active funds.

Since this active portion is being traded at the optimal levels, fluctuations in this active equity will be swift. As a result, at some point on the upside or downside in the equity fluctuations, or at some point in time, you will likely find it necessary, even if only from an emotional standpoint, to reallocate funds between the active and inactive portions. Four methods of doing so have been explained, although other, possibly better, methods may exist:

1. Investor Utility.
2. Scenario Planning.
3. Share Averaging.
4. Portfolio Insurance.

The fourth method, portfolio insurance or dynamic hedging, is inherent in any dynamic fractional f strategy, but it can also be utilized as a reallocation method.

We have further seen that to take the unconstrained geometric optimal portfolio and apply it in real time will most likely encounter a problem in terms of the initial margin requirements. This problem can be alleviated by determining an upper level limit for the ratio of active equity to total account equity.

APPLICATION TO STOCK TRADING

The techniques that have been described in this book apply not only to futures traders, but to traders in ***any*** market. Even someone trading a portfolio of only blue chip stocks is not immune from the principles and the consequences discussed in this book. You have seen that such a portfolio of blue chip stocks has an optimal level of leverage where the ratio of potential gains to potential losses in equity are maximized. At such a level, the drawdowns to be expected arc also quite severe, and therefore the portfolio ought to be diluted, preferably by way of a dynamic fractional f strategy.

The entire procedure can be performed exactly as though the stock being traded were a commodity market system. For instance, suppose Toxico were trading at $40 per share. The cost of 100 shares of Toxico would be $4,000. This 100-share block of Toxico can be treated as 1 contract of the Toxico market system. Thus, if we were operating in a cash account, we could replace the $\text{margin}_i\$$ variable in Equation (8.08) with the value of 100 shares of Toxico ($4,000 in this example). In so doing, we can determine the upper limit on the fraction of f to use such that we never have to even perform the procedure in a margin account. When you are doing this type of exercise, remember that you are replicating a leveraged situation, but there isn't really any borrowing or lending going on. Therefore, you should use an RFR of 0 in any calculations (such as the Sharpe ratio) that require an RFR.

On the other hand, if we perform the procedure in a margin account, and if initial margin levels are, say, 50%, then we would use a value of $2,000 for the $\text{margin}_i\$$ variable for Toxico in (8.08).

Traditionally, stock fund managers have used portfolios where the sum of the weights is constrained to 1. Then they opt for that portfolio composition which gives the lowest variance for a given level of arithmetic return. The resultant portfolio composition is expressed in the form of the weights, or percentages of the trading account, to apply to each component of the portfolio.

By lifting this sum of the weights constraint and opting for the single portfolio that is geometric optimal, we get the optimal leveraged portfolio. Here, the weights and quantities are completely different. We now divide the optimal amount to finance I unit of each component by its respective weighting; the result is the optimal leverage for each component in the portfolio. Now, we can dilute this portfolio down by marrying it to the risk-free asset. We can dilute the portfolio to the point where there really isn't any leverage involved. That is, we are leveraging the active equity portion of the portfolio but the active equity portion is actually borrowing its own money, interest-free, from the inactive equity portion. The result is a portfolio ***and*** a method of adding to and trimming back from positions as the equity in the account changes that will result in the greatest geometric growth. As such a method maximizes the potential geometric growth to the potential loss and allows for the maximum loss acceptable to be essentially specified at the outset, it can also be argued to be a superior means of managing a stock portfolio.

The current generally accepted procedure for determining the efficient frontier will not really yield the efficient frontier, much less the portfolio that is geometric optimal (the geometric optimal portfolio always lies on the efficient frontier). This can be derived only by incorporating the optimal f. Further, the generally accepted procedure yields a portfolio that gets traded on a static f basis rather than on a dynamic basis, the latter being asymptotically infinitely more powerful.

A CLOSING COMMENT

This is a very exciting time to be in this field, New concepts have been emerging nearly continuously since the mid 1950s. We have witnessed an avalanche of great ideas from the academic community building upon the E-V model. Among the ideas presented has been the E-S model. With the E-S model the measure of risk is semivariance in lieu of variance.[1] Semivariance is defined as the variation beneath some target level of return, which could be the expected return, zero return, or any other fixed level of return. When this target level of return equals the expected return and the distribution of returns is symmetrical (without skew), the E-S efficient frontier is the same as the E-V efficient frontier.

Other portfolio models have been presented using other measures for risk than variance in returns. Still other portfolio models have been presented using moments of the distribution of returns beyond the first two moments. Of particular interest in this regard have been the ***stochastic dominance approaches,*** which encompass the entire distribution of returns and hence can be considered the limiting case of multidimensional portfolio analysis as the number of moments incorporated approaches infinity.[2] This approach may be particularly useful when the variance in returns is infinite or undefined.

Again, I am not a so-called academic. This is neither a boast nor an apology. I am no more an academic than I am a ventriloquist or a TV wrestler. Academics want a model to explain how the markets work. As a nonacademic, I don't care how they work. For example, many people in the academic community argue that the efficient market hypothesis is flawed because there is no such thing as a rational investor. They argue that people do not behave rationally, and therefore conventional portfolio models, such as E-V theory (and its offshoots) and the Capital Asset Pricing model, are poor models of how the markets operate. While I agree that people certainly do not behave rationally, it does not mean that we shouldn't behave rationally or that we cannot benefit by behaving rationally. When variance in returns is finite, we can certainly benefit by being on the efficient frontier.

There has been much debate in recent years over the usefulness of current portfolio models in light of the fact that the distribution of the logs of price changes appear to be stable Paretian with infinite (or undefined) variance. Yet many studies demonstrate that the markets in recent years have seen a move toward Normality (therefore finite variance) and independence, which the portfolio models being criticized assume.[3]

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[1] Markowitz, Harry, Portfolio Selection: Efficient Diversification of Investments. New York: John Wiley, 1959.

[2] See Quirk, J, P., and R. Saposnik, "Admissibility and Measurable Utility Functions," Review of Economic Studies, 29(79):140-146, February 1962. Also see Reilly, Frank K, Investment Analysis and Portfolio Management. Hinsdale, IL: The Dryden Press, 1979.

[3] See Helms, Billy P., and Terrence F. Martell, "An Examination of the Distribution of Commodity Price Changes," Working Paper Series. New York: Columbia University Center for the Study of Futures Markets, CFSM-76, April 1984. Also see Hudson, Michael A., Raymond M. Leuthold, and Cboroton F. Sarassorro, "Commodity Futures Price Changes: Distribution, Market Efficiency, and Pricing

Further, the portfolio models use the distribution of returns as input, not the distribution of the logs of price changes. Whereas the distribution of returns is a ***transformed*** distribution of the logs of price changes (transformed by techniques such as cutting losses short and letting profits run), they are not necessarily the same distribution, and the distribution of returns may not be a member of the stable Paretian (which is why we modeled the distribution of trade P&L's in Chapter 4 with our adjustable distribution). Furthermore, there are derivative products such as options that have finite semivariance (if long) or finite variance altogether. For example, a vertical option spread put on at a debit guarantees finite variance in returns.

I'm not defending against the attacks on the current portfolio models. Rather, I am playing devil's advocate here. The current portfolio models can be employed provided we are aware of their shortcomings. We no doubt need better portfolio models. It is not my contention that the current portfolio models are adequate. Rather, it is my contention that the input to the portfolio models, current and future for whatever portfolio models we use, should be based on trading one unit at the optimal level-or what we believe will be the optimal level for that item in the future, as though we were trading only that item. For example, if we are employing E-V theory, the Markowitz model, the inputs are the expected return, variance in returns, and correlation of returns to other market systems. These inputs must be determined from trading one unit on each market system at the optimal f level. Portfolio models other than E-V may require different input parameters. These parameters must be discerned based on trading one unit of the market systems at their optimal f levels.

Portfolio models are but one facet of money management, but they are a facet where debate is certain to rage for quite some time. This book could not be definitive in that regard, as newer, better models are yet to be formulated. We most likely will never have a model we all agree upon as being adequate. That should make for a healthy and stimulating environment.

Commodity Options," Working Paper Series, New York: Columbia University Center for the Study of Futures Markets, CFSM-127, June 1986.

APPENDIX A - The Chi-Square Test

There exist a number of statistical tests designed to determine if two samples come from the same population. Essentially, we want to know if two distributions are different. Perhaps the most well known of these tests is the chi-square test, devised by Karl Pearson around 1900. It is perhaps the most popular of all statistical tests used to determine whether two distributions are different.

The chi-square statistic, X^2, is computed as:

(A.01) X^2 =>[i = 1,N](O_i-E_i)^2/E_i

where

N = The total number of bins.

O_i = The number of events observed in the ith bin.

E_i = The number of events expected in the ith bin.

A large value for the chi-square statistic indicates that it is unlikely that the two distributions are the same (i.e., the two samples are not drawn from the same population). Likewise, the smaller the value for the chi-square statistic, the more likely it is that the two distributions are the same (i.e., the two samples were drawn from the same population).

Note that the observed values, the O_i's, will always be integers. However, the expected values, the E_i's, can be nonintegers. Equation (A.01) gives the &i-square statistic when both the expected and observed values are integers. When the expected values, the Ei's, are permitted to be nonintegers, we must use a different equation, known as ***Yates' correction,*** to find the chi-square statistic:

(A.02) X^2 = ∑[i = 1,N] (ABS(O_i-E_i)-.5)^2/E_i

where

N = The total number of bins.

O_i = The number of events observed in the ith bin.

E_i = The number of events expected in the ith bin.

ABS()-The absolute value function.

If we are comparing the number of events observed in a bin to what the Normal Distribution dictates should be in that bin, we must employ Yates' correction. That is because the number of events expected,[1] the E_i's, are nonintegers.

We now work through an example of the chi-square statistic for the data corresponding to Figure 3-16. This is the 232 trades, converted to standard units, placed in 10 bins from -2 to +2 sigma, and plotted versus what the data would be if it were Normally distributed. Note that we must use Yates' correction:

Bin#	Observed	Expected	((ABS(O-E)-.5)^2)/E
1		7.435423	4.738029
2	17	13.98273	.4531787
3	25	22.45426	.1863813
4	27	30.79172	.3518931
5	38	36.05795	.05767105
6	61	36.078	16.56843
7	37	30.7917	1.058229
8	12	22.45426	4.41285
9	4	13.98273	6.430941
10	2	7.435423	3.275994
			X2=37.5336

We can convert a chi-square statistic such as 37.5336 to a ***significance level***. In the sense we are using here, a significance level is a number between 0, representing that the two distributions are different, and 1, meaning that the two distributions are the same. We can never be 100% certain that two distributions are the same (or different), but we can determine how alike or different two distributions are to a certain significance level. There are two ways in which we can find the significance level. This first and by far the simplest way is by using tables. The second way to convert a chi-square statistic to a significance level is to perform the math yourself (which is how the tables were drawn up in the first place). However, the math requires the use of incomplete gamma functions, which, as was mentioned in the Introduction, will not be treated in this text. Interested readers are referred to the Bibliography, in particular to ***Numerical Recipes.*** However, most readers who would want to know how to calculate a significance level from a given chi-square statistic would want to know this because tables are rather awkward to use from a programming standpoint. Therefore, what follows is a snippet of BASIC language code to convert from a given chi-square statistic to a significance level.

```
1000 REM INPUT NOBINS%, THE NUMBER OF BINS AND
CHISQ, THE CHI-SQUARE STATISTIC
1010 REM OUTPUT IS CONF, THE CONFIDENCE LEVEL FOR A
GIVEN NOBINS% AND CHISQ
1020 PRINT "CHI SQUARE STATISTIC AT"NOBINS%-
3"DEGREES FREEDOM IS"CHISQ
1030 REM HERE WE CONVERT FROM A GIVEN CHISQR TO A
SIGNIFICANCE LEVEL, CONF
1040 XI = 0:X2 = 0:X3# = 0:X4 = 0:X5 = 0:X6 = 0:CONF = 0
1050 IF CHISQ < 31 OR (NOBINS%-3) > 2 THEN X6 =
(NOBINS%-3)/2-1 :X1 = 1 ELSE CONF = 1 :GOTO 1110
1060 FOR X2 = 1 TO ((NOBINS%-3)/2-.5):X1 = XI*X6:X6 = X6-1:
NEXT
1070 IF (NOBINS%-3) MOD 2 <> 0 THEN X1 = X
1*1.77245374942627#
1080 X7 = 1:X4 = 1:X3# = ((CHISQ/2)*((NOBINS%-
3)/2))*2/(EXP(CHISQ/2)
* XI*(NOBINS%-3)):X5 = NOBINS% -3+2
1090 X4 = X4*CHISQ/X5:X7 = X7+X4:X5 = X5+2:IF X4> 0 THEN
1090
1100 CONF = 1-X3#*X7
1110 PRINT "FOR A SIGNIFICANCE LEVEL OF
";USING".#########";CONF
```

Whether you determine your significance levels via a table or calculate them yourself, you will need two parameters to determine a significance level. The first of these parameters is, of course, the chi-square statistic itself. The second is the number of ***degrees of freedom*** Generally, the number of degrees of freedom is equal to the number of bins minus 1 minus the number of population parameters that have to be estimated for the sample statistics. Since there are ten bins in our example and we must use the arithmetic mean and standard deviation of the sample to construct the Normal curve, we must therefore subtract 3 degrees of freedom. Hence, we have 7 degrees of freedom.

The significance level of a chi-square statistic of 37.5336 at 7 degrees of freedom is .000002419, Since this significance level is so much closer to zero than one, we can safely assume that our 232 trades from Chapter 3 are not Normally distributed. What follows is a small table for converting between chi-square values and degrees of freedom to significance levels. More elaborate tables may be found in many of the statistics books mentioned in the Bibliography:

VALUES OF X^2				
Degrees of Freedom	Significance Level			
	.20	.10	.05	.01
1	1.6	2.7	3.8	6.6
2	3.2	4.6	6.0	9.2
3	4.6	6.3	7.8	11.3
4	6.0	7.8	9.5	13.3
5	7.3	9.2	11.1	15.1
10	13.4	16.0	18.3	23.2
20	25.0	28.4	31.4	37.6

You should be aware that the chi-square test can do a lot more than is presented here. For instance, you can use the chi-square test on a 2 x 2 contingency table (actually on any N x M contingency table). If you are interested in learning more about the chi-square test on such a table, consult one of the statistics books mentioned in the Bibliography.

Finally, there is the problem of the arbitrary way we have chosen our bins as regards both their number and their range. Recall that binning data involves a certain loss of information about that data, but generally the profile of the distribution remains relatively the same. If we choose to work with only 3 bins, or if we choose to work with 30, we will likely get somewhat different results. It is often a helpful exercise to bin your data in several different ways when conducting statistical tests that rely on binned data. In so doing, you can be rather certain that the results obtained were not due solely to the arbitrary nature of how you chose your bins.

In a purely statistical sense, in order for our number of degrees of freedom to be valid, it is necessary that the number of elements in each

[1] As detailed in Chapter 3, this is determined by the Normal Distribution per Equation (3.21) for each boundary of the bin, taking the absolute value of the differences, and multiplying by the total number of events.

of the expected bins, the E_i's, be at least five. When there is a bin with less than five expected elements in it, theoretically the number of bins should be reduced until all of the bins have at least five expected elements in them. Often, when only the lowest and/or highest bin has less than 5 expected elements in it, the adjustment can be made by making these groups "all less than" and "all greater than" respectively.

APPENDIX B - Other Common Distributions

This appendix covers many of the other common distributions aside from the Normal. This text has shown how to find the optimal f and its by-products on any distribution. We have seen in Chapter 3 how to find the optimal f and its by-products on the Normal distribution. We can use the same technique to find the optimal f on any other distribution where the cumulative density function is known.

It matters not whether the distribution is continuous or discrete. When the distribution is discrete, the equally spaced data points are simply the discrete points along the cumulative density curve itself. When the distribution is continuous, we must contrive these equally spaced data points as we did with the Normal Distribution in Chapter 3.

Further, it matters not whether the tails of the distribution go out to plus and minus infinity or are bounded at some finite number. When the tails go to plus and minus infinity we must determine the bounding parameters (i.e., how far to the left extreme and right extreme we are going to operate on the distribution). The farther out we go, the more accurate our results. If the distribution is bounded on its tails at some finite point already, then these points become the bounding parameters.

Finally, in Chapter 4 we learned a technique to find the optimal f and its by-products for the area under any curve (not necessarily just our adjustable distribution) when we do not know the cumulative density function, so we can find the optimal f and it's by products for any process regardless of the distribution. The hardest part is determining what the distribution in question is for a particular process, what the cumulative density function is for that process, and what parameter value(s) are best for our application.

One of the many hearts of this book is the broader concept of decision making in environments characterized by geometric consequences. Optimal f is the regulator of growth in such environments, and the by-products of optimal f tell us a great deal about the growth rate of a given environment. You may seek to apply the tools for finding the optimal f parametrically to other fields where there are such environments. For this reason this appendix has been included.

THE UNIFORM DISTRIBUTION

The ***Uniform Distribution,*** sometimes referred to as the ***Rectangular Distribution*** from its shape, occurs when all items in a population have equal frequency. A good example is the 10 digits 0 through 9. If we were to randomly select one of these digits, each possible selection has an equal chance of occurrence. Thus, the Uniform Distribution is used to model truly random events. A particular type of uniform distribution where A = 0 and B = 1 is called the ***Standard Uniform Distribution,*** and it is used extensively in generating random numbers.

The Uniform Distribution is a ***continuous*** distribution. The probability density function, N'(X), is described as:

(B.01) N'(X) = 1/(B-A) for A<= X<= B else N'(X) = 0

where

B = The rightmost limit of the interval AB.

A = The leftmost limit of the interval AB.

The cumulative density of the Uniform is given by:

(B.02) N(X) = 0 for X<A else N(X) = (X-A)/(B-A) for A <= X<= B else N(X) = 1 for X>B

where

B = The rightmost limit of the interval AB.

A = The leftmost limit of the interval AB.

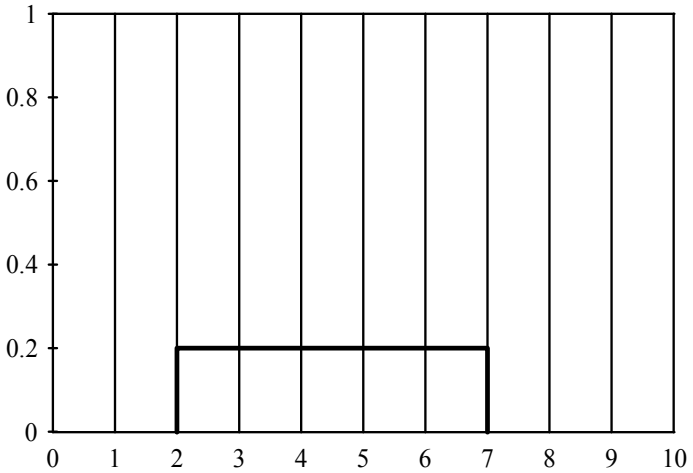


Figure B-1 Probability density functions for the Uniform Distribution (A = 2, B = 7).

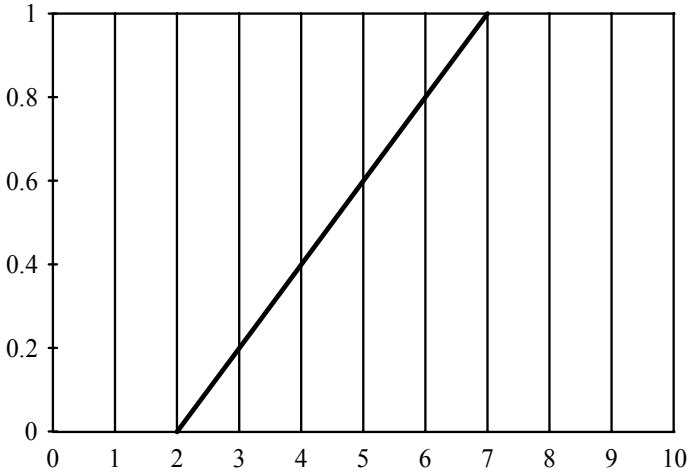


Figure B-2 Cumulative probability functions for the Uniform Distribution (A = 2, B = 7).

Figures B-1 and B-2 illustrate the probability density and cumulative probability (i.e., cdf) respectively of the Uniform Distribution. Other qualities of the Uniform Distribution are:

(B.03) Mean = (A+B)/2

(B.04) Variance = (B-A)^2/12

where

B = The rightmost limit of the interval AB.

A = The leftmost limit of the interval AB.

THE BERNOULI DISTRIBUTION

Another simple, common distribution is the ***Bernoulli Distribution.*** This is the distribution when the random variable can have only two possible values. Examples of this are heads and tails, defective and non-defective articles, success or failure, hit or miss, and so on. Hence, we say that the Bernoulli Distribution is a ***discrete distribution*** (as opposed to being a continuous distribution). The distribution is completely described by one parameter, P, which is the probability of the first event occurring. The variance in the Bernoulli is:

(B.05) Variance = P*Q

where

(B.06) Q = P-1

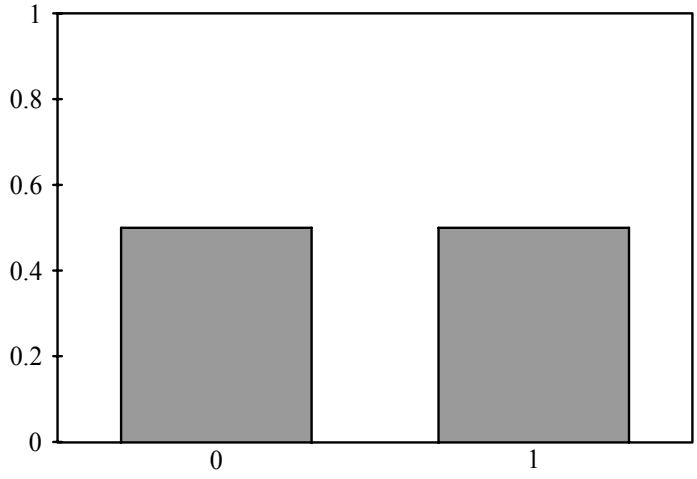


Figure B-3 Probability density functions for the Bernoulli Distribution (P = .5).

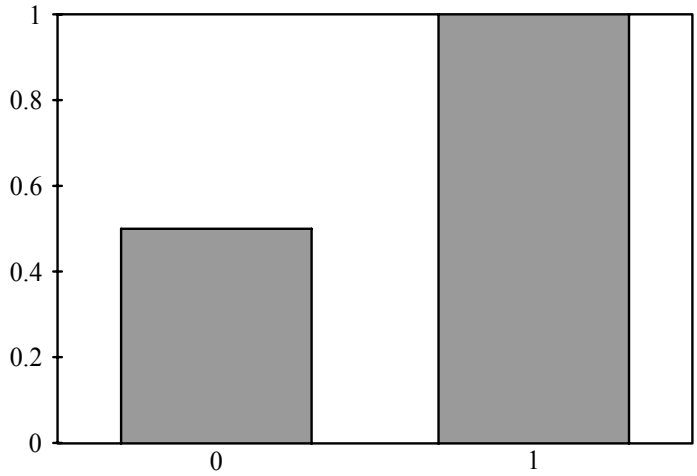


Figure B-4 Cumulative probability functions for the Bernoulli Distribution (P = .5).

Figures B-3 and B-4 illustrate the probability density and cumulative probability (i.e., cdf) respectively of the Bernoulli Distribution.

THE BINOMIAL DISTRIBUTION

The ***Binomial Distribution*** arises naturally when sampling from a Bernoulli Distribution. The probability density function, N'(X), of the Binomial (the probability of X successes in N trials or X defects in N items or X heads in N coin tosses, etc.) is:

(B.07) N'(X) = (N!/(X!*(N-X)!))*(P^X)*(Q^(N-X))

where

N = The number of trials.

X = The number of successes.

P = The probability of a success on a single trial.

Q = 1-P.

It should be noted here that the exclamation point after a variable denotes the factorial function:

(B.08a) X! = X*(X-l)*(X-2)*...*1

which can be also written as:

(B.08b) X! = ∏[J = 0,X-1]X-J

Further, by convention: (B.08c) 0! = 1

The cumulative density function for the Binomial is:

(B.09) N(X) = ∑[J = 0,X] (N!/(J!*(N-J)!))*(P^J)*(Q^(N -J))

where

N = The number of trials.

X = The number of successes.

P = The probability of a success on a single trial.

Q = 1-P.

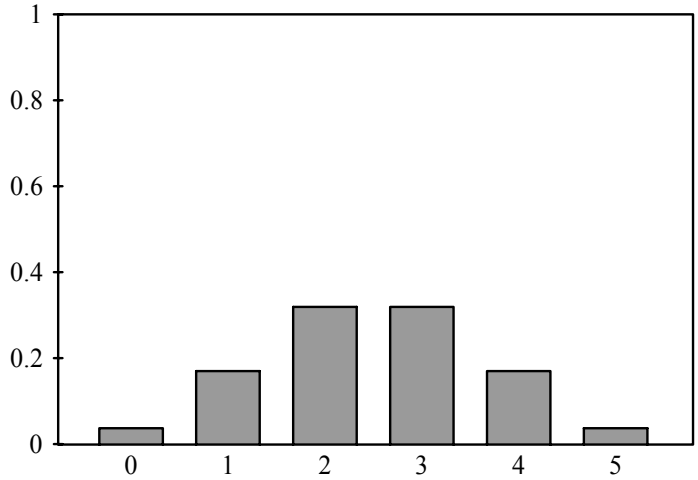


Figure B-5 Probability density functions for the Binomial Distribution (N = 5, P = .5).

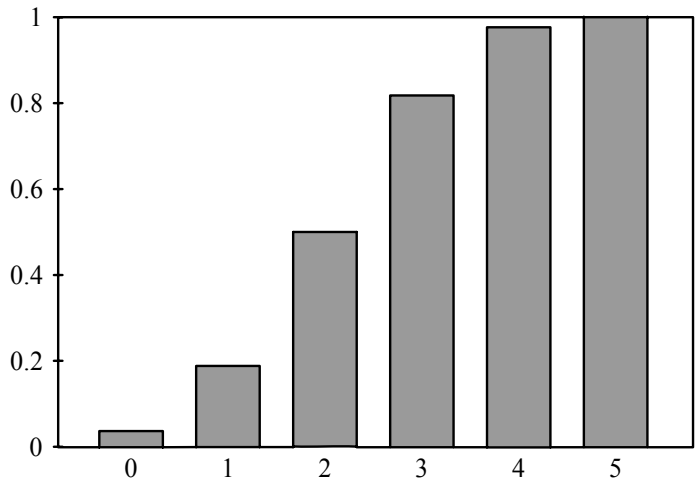


Figure B-6 Cumulative probability functions for the Binomial Distribution (N = 5, P = .5).

Figures B-5 and B-6 illustrate the probability density and cumulative probability (i.e., cdf) respectively of the Binomial Distribution.

The Binomial is also a discrete distribution. Other properties of the Binomial Distribution are:

(B.10) Mean = N*P

(B.11) Variance = N*P*Q where N = The number of trials.

P = The probability of a success on a single trial. Q = 1-P.

As N becomes large, the Binomial tends to the Normal Distribution, with the Normal being the limiting form of the Binomial. Generally, if N*P and N*Q are both greater than 5, you could use the Normal in lieu of the Binomial as an approximation.

The Binomial Distribution is often used to Statistically validate a gambling system. An example will illustrate. Suppose we have a gambling system that has won 51% Of the time. We want to determine what the winning percentage would be if it performs in the future at a level of 3 standard deviations worse. Thus, the variable of interest here, X, is equal to .51, the probability of a winning trade. The variable of interest need not always be for the probability of a win. It can be the probability of an event being in one of two mutually exclusive groups. We can now perform the first necessary equation in the test:

(B.12) L = P-Z*((P*(1-P))/(N-1))^.5

where

L = The lower boundary for P to be at Z standard deviations.

P = The variable of interest representing the probability of being in one of two mutually exclusive groups.

Z = The selected number of standard deviations. N = The total number of events in the sample.

Suppose our sample consisted of 100 plays. Thus:

L = .51-3*((.51*(1-.51))/(100-1))^.5

= .51-3*((.51*.49)/99)^.5

= .51-3*(.2499/99)^.5

= .51-3*.0025242424^.5

= .51-3*.05024183938

= .51-.1507255181

= .3592744819

Based on our history of 100 plays which generated a 51% win rate, we can state that it would take a 3-sigma event for the population of plays (the future if we play an infinite number of times into the future) to have less than 35.92744819 percent winners.

What kind of a confidence level does this represent? That is a function of N, the total number of plays in the sample. We can determine the confidence level of achieving 35 or 36 wins in 100 tosses by Equation (B.09). However, (B.09) is clumsy to work with as N gets large because of all of the factorial functions in (B.09). Fortunately, the Normal distribution, Equation (3.21) for 1-tailed probabilities, can be used as a very close approximation for the Binomial probabilities. In the case of our example, using Equation (3.21), 3 standard deviations translates into a 99.865% confidence. Thus, if we were to play this gambling system over an infinite number of times, we could be 99.865% sure that the percentage of wins would be greater than or equal to 35.92744819%.

This technique can also be used for statistical validation of trading systems. However, this method is only valid when the following assumptions are true. First, the N events (trades) are all independent and randomly selected. This can easily be verified for any trading system. Second, the N events (trades) can all be classified into two mutually exclusive groups (wins and losses, trades greater than or less than the median trade, etc.). This assumption, too, can easily be satisfied. The third assumption is that the probability of an event being classified into one of the two mutually exclusive groups is constant from one event to the next. This is not necessarily true in trading, and the technique becomes inaccurate to the degree that this assumption is false, Be that as it may, the technique still can have value for traders.

Not only can it be used to determine the confidence level for a certain method being profitable, the technique can also be used to determine the confidence level for a given market indicator. For instance, if you have an indicator that will forecast the direction of the next day's close, you then have two mutually exclusive groups: correct forecasts, and incorrect forecasts. You can now express the reliability of your indicator to a certain confidence level.

This technique can also be used to discern how many trials are necessary for a system to be profitable to a given confidence level. For example, suppose we have a gambling system that wins 51% of the time on a game that pays 1 to 1. We want to know how many trials we must observe to be certain to a given confidence level that the system will be profitable in an asymptotic sense. Thus we can restate the problem as, "If the system wins 51% of the time, how many trials must I witness, and have it show a 51% win rate, to know that it will be profitable to a given confidence level?"

Since the payoff is 1:1, the system must win in excess of 50% of the time to be considered profitable. Let's say we want the given confidence level to again be 99.865, or 3 standard deviations (although we are using 3 standard deviations in this discussion, we aren't restricted to that amount; we can use any number of standard deviations that we want). How many trials must we now witness to be 99.865% confident that at least 51% of the trials will be winners?

If .51-X = .5, then X = .01, Therefore, the right factors of Equation (B.12), Z*((P*(1-P))/(N-1))^.5, must equal .01. Since Z = 3 in this case, and .01/3 = .0033, then:

((P*(1-P))/(N-1))^.5 = .0033

We know that P equals .51, thus:

((.51*(1-.51))/(N-1))^.5 = .0033

Squaring both sides gives us:

((.51*(l-.51))/(N-1)) = .00001111

To continue:

(.51*.49)/(N-1) = .00001111 .2499/(N-1)

= .00001111 .2499/.00001111

= N-1 .2499/.00001111+1

= N 22,491+1 = N

N = 22,492

Thus, we need to witness a 51% win rate over 22,492 trials to be 99.865% certain that we will see at least 51% wins.

THE GEOMETRIC DISTRIBUTION

Like the Binomial, the ***Geometric Distribution***, also a discrete distribution, occurs as a result of N independent Bernoulli trials. The Geometric Distribution measures the number of trials before the first success (or failure). The probability density function, N'(X), is:

(B.13) N'(X) = Q ^ (X- 1)*P

where

P = The probability of success for a given trial.

Q = The probability of failure for a given trial.

In other words, N'(X) here measures the number of trials until the first success. The cumulative density function for the Geometric is therefore:

(B.14) N(X) = ∑[J = 1,X] Q^(J-1)*P

where

P = The probability of success for a given trial.

Q = The probability of failure for a given trial.

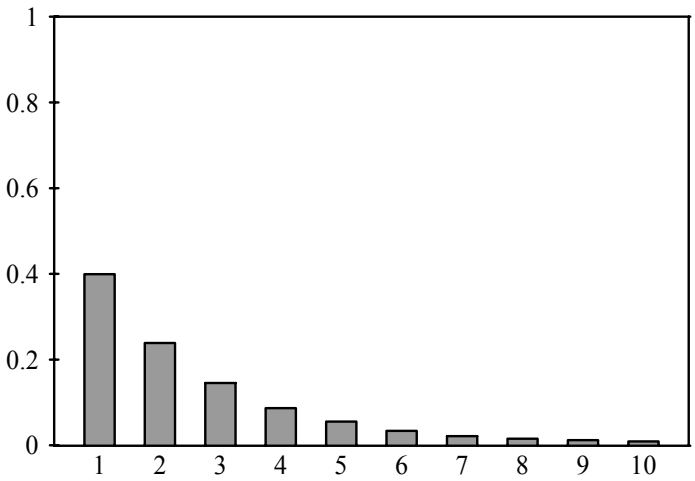


Figure B-7 Probability density functions for the Geometric Distribution (P = .6).

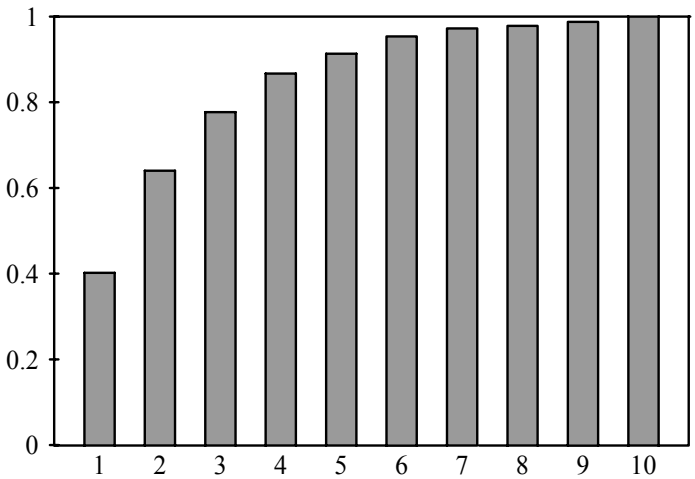


Figure B-8 Cumulative probability functions for the Geometric Distribution (P = .6).

Figures B-7 and B-8 illustrate the probability density and cumulative probability (i.e., cdf) respectively of the Geometric Distribution. Other properties of the Geometric are:

(B.15) Mean = 1/P (B.16) Variance = Q/P^2

where

P = The probability of success for a given trial.

Q = The probability of failure for a given trial.

Suppose we are discussing tossing a single die. If we are talking about having the outcome of 5, how many times will we have to toss the die, on average, to achieve this outcome? The mean of the Geometric Distribution tells us this. If we know the probability of throwing a 5 is 1/6 (.1667) then the mean is 1/.1667 = 6. Thus we would expect, on average, to toss a die six times in order to get a 5. If we kept repeating this process and recorded how many tosses it took until a 5 appeared, plotting these results would yield the Geometric Distribution function formulated in (B.13).

THE HYPERGEOMETRIC DISTRIBUTION

Another type of discrete distribution related to the preceding distributions is termed the ***Hypergeometric Distribution.*** Recall that in the Binomial Distribution it is assumed that each draw in succession from the population has the same probabilities. That is, suppose we have a deck of 52 cards. 26 of these cards are black and 26 are red. If we draw a card and record whether it is black or red, we then put the card back into the deck for the next draw. This "sampling with replacement" is what the Binomial Distribution assumes. Now for the next draw, there is still a .5 (26/52) probability of the next card being black (or red).

The Hypergeometric Distribution assumes almost the same thing, except there is no replacement after sampling. Suppose we draw the first card and it is red, and we ***do*** not replace it back into the deck. Now, the probability of the next draw being red is reduced to 25/51 or .4901960784. In the Hypergeometric Distribution there is ***dependency,*** in that the probabilities of the next event are dependent on the outcome(s) of the prior event(s). Contrast this to the Binomial Distribution, where an event is ***independent*** of the outcome(s) of the prior event(s).

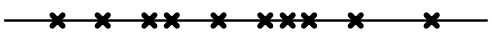
The basic functions N'(X) and N(X) of the Hypergeometric are the same as those for the Binomial, (B.07) and (B.09) respectively, except that with the Hypergeometric the variable P, the probability of success on a single trial, changes from one trial to the next.

It is interesting to note the relationship between the Hypergeometric and Binomial Distributions. As N becomes larger, the differences between the computed probabilities of the Hypergeometric and the Binomial draw closer to each other. Thus we can state that as N approaches infinity, the Hypergeometric approaches the Binomial as a limit.

If you want to use the Binomial probabilities as an approximation of the Hypergeometric, as the Binomial is far easier to compute, how big must the population be? It is not easy to state with any certainty, since the desired accuracy of the result will determine whether the approximation is successful or not. Generally, though, a population to sample size of 100 to 1 is usually sufficient to permit approximating the Hypergeometric with the Binomial.

THE POISSON DISTRIBUTION

The ***Poisson Distribution*** is another important discrete distribution. This distribution is used to model arrival distributions and other seemingly random events that occur repeatedly yet haphazardly. These events can occur at points in time or at points along a wire or line (one dimension), along a plane (two dimensions), or in any N-dimensional construct. Figure B-9 shows the arrival of events (the X's) along a line, or in time.



The Poisson Distribution was originally developed to model incoming telephone calls to a switchboard. Other typical situations that can be modeled by the Poisson are the breakdown of a piece of equipment, the completion of a repair job by a steadily working repairman, a typing error, the growth of a colony of bacteria on a Petri plate, a defect in a long ribbon or chain, and so on.

The main difference between the Poisson and the Binomial distributions is that the Binomial is not appropriate for events that can occur more than once within a given time frame. Such an example might be the probability of an automobile accident over the next 6 months. In the Binomial we would be working with two distinct cases: Either an accident occurs, with probability P, or it does not, with probability Q (i.e., 1-P). However, in the Poisson Distribution we can also account for the fact that more than one accident can occur in this time period.

The probability density function of the Poisson, N'(X), is given by:

(B.17) N'(X) = (L^X*EXP(-L))/X!

where

L = The parameter of the distribution.

EXP() = The exponential function.

Note that X must take discrete values.

Suppose that calls to a switchboard average four calls per minute (L = 4). The probability of three calls (X = 3) arriving in the next minute are:

N'(3) = (4^3*EXP(-4))/3!

= (64*EXP(-4))/(3*2)

= (64*.01831564)/6

= 1.17220096/6

= .1953668267

So we can say there is about a 19.5% chance of getting 3 calls in the next minute. Note that this is not cumulative-that is, this is not the probability of getting 3 calls or fewer, it is the probability of getting exactly 3 calls. If we wanted to know the probability of getting 3 calls or fewer we would have had to use the N(3) formula [which is given in (B.20)].

Other properties of the Poisson Distribution are:

(B.18) Mean = L (B.10) Variance = L

where

L = The parameter of the distribution.

In the Poisson Distribution, both the mean and the variance equal the parameter L. Therefore, in our example case we can say that the mean is 4 calls and the variance is 4 calls (or, the standard deviation is 2 calls-the square root of the variance, 4).

When this parameter, L, is small, the distribution is shaped like a reversed J, and when L is large, the distribution is not dissimilar to the Binomial. Actually, the Poisson is the limiting form of the Binomial as N approaches infinity and P approaches 0. Figures B-10 through B-13 show the Poisson Distribution with parameter values of .5 and 4.5.

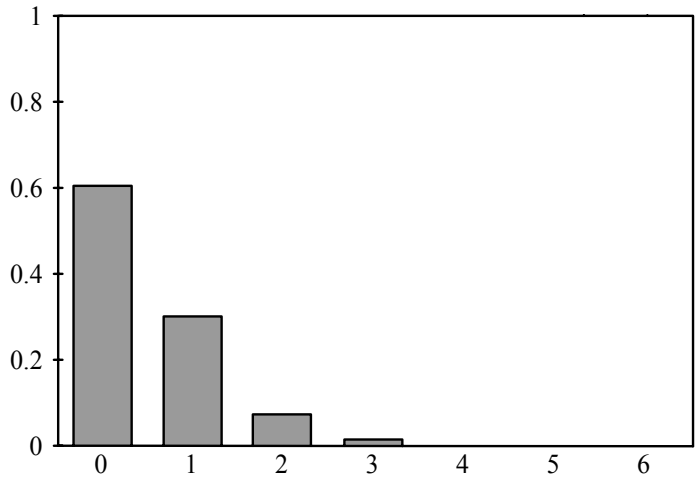


Figure B-10 Probability density functions for the Poisson Distribution (L = .5).

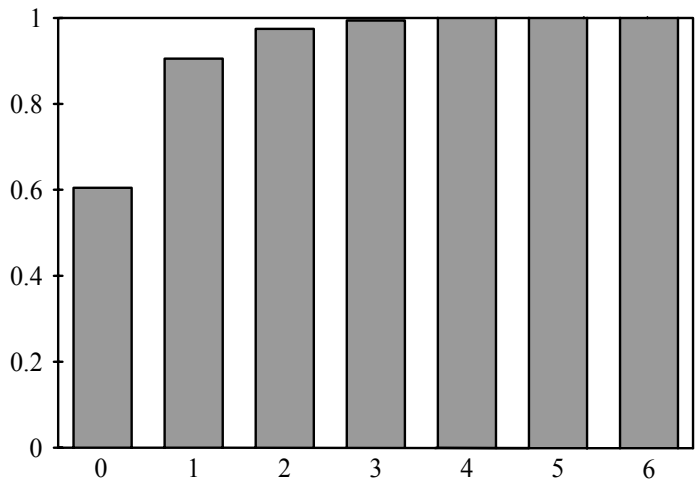


Figure B-11 Cumulative probability functions for the Poisson Distribution (L = .5).

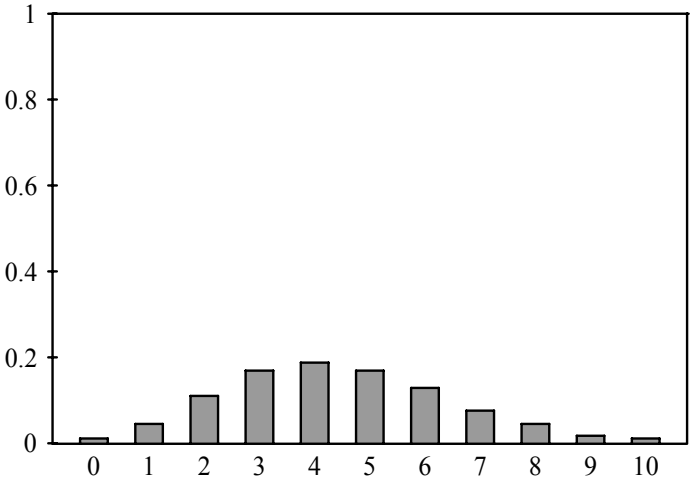


Figure B-12 Probability density functions for the Poisson Distribution (L = 4.5).

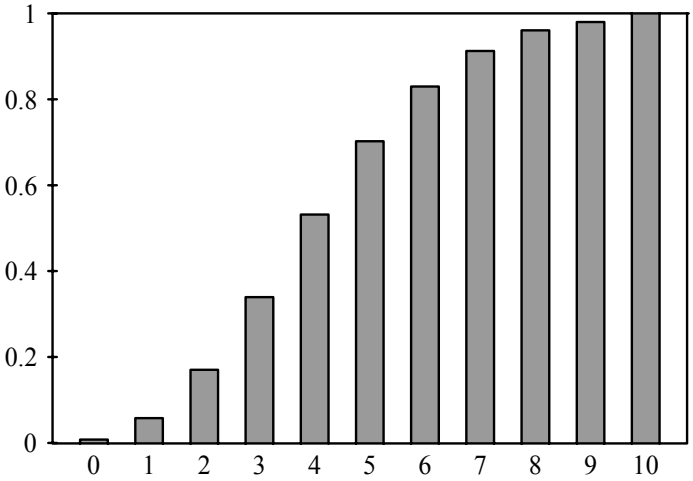


Figure B-13 Cumulative probability functions for the Poisson Distribution (L = 4.5).

The cumulative density function of the Poisson, N(X), is given by:

(B.20) N(X) = ∑[J = 0,X] (L^J*EXP(-L))/J!

where

L = The parameter of the distribution.

EXP() = The exponential function.

THE EXPONENTIAL DISTRIBUTION

Related to the Poisson Distribution is a continuous distribution with a wide utility called the ***Exponential Distribution,*** sometimes also referred to as the ***Negative Exponential Distribution.*** This distribution is used to model interarrival times in queuing systems, service times on equipment, and sudden, unexpected failures such as equipment failures due to manufacturing defects, light bulbs burning out, the time that it takes for a radioactive particle to decay, and so on. (There is a very interesting relationship between the Exponential and the Poisson distributions. The arrival of calls to a queuing system follows a Poisson Distribution, with arrival rate L. The interarrival distribution (the time between the arrivals) is Exponential with parameter 1/L.)

The probability density function N'(X) for the Exponential Distribution is given as:

(B.21) N'(X) = A*EXP(-A*X)

where

A = The single parametric input, equal to 1/L in the Poisson Distribution. A must be greater than 0.

EXP() = The exponential function.

The integral of (B.21), N(X), the cumulative density function for the Exponential Distribution is given as:

(B.22) N(X) = 1-EXP(-A*X)

where

A = The single parametric input, equal to 1/L in the Poisson Distribution. A must be greater than 0.

EXP() = The exponential function.

Figures B-14 and B-15 show the functions of the Exponential Distribution. Note that once you know A, the distribution is completely determined.

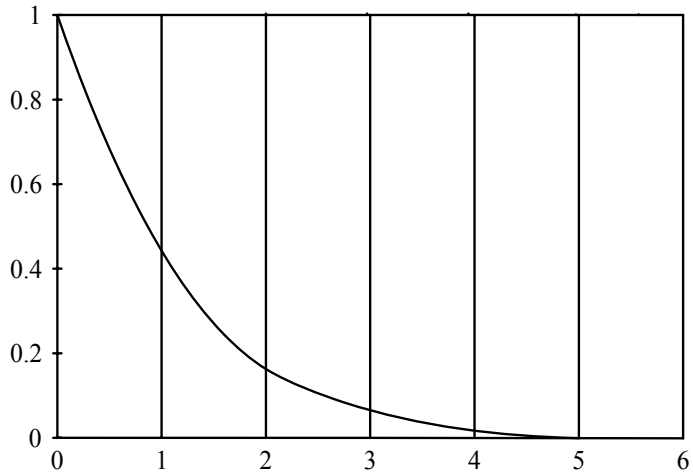


Figure B-14 Probability density functions for the Exponential Distribution (A = 1).

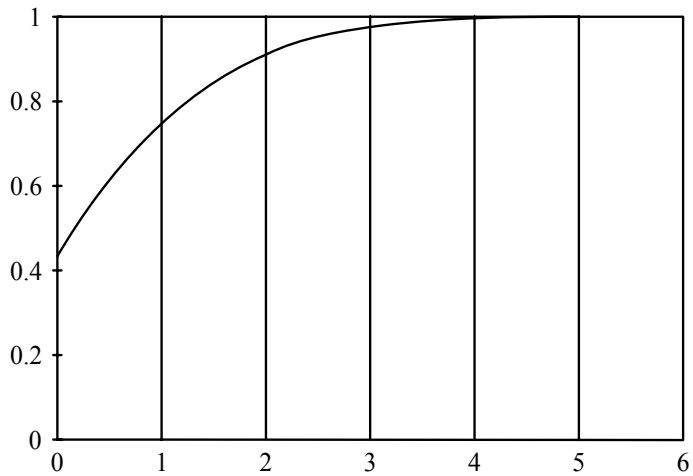


Figure B-15 Cumulative probability functions for the Exponential Distribution (A = 1).

The mean and variance of the Exponential Distribution are:

(B.23) Mean = 1/A (B.24) Variance = 1/A^2

Again A is the single parametric input, equal to 1/L in the Poisson Distribution, and must be greater than 0.

Another interesting quality about the Exponential Distribution is that it has what is known as the "forgetfulness property." In terms of a telephone switchboard, this property states that the probability of a call in a given time interval is not affected by the fact that no calls may have taken place in the preceding interval(s).

THE CHI-SQUARE DISTRIBUTION

A distribution that is used extensively in goodness-of-fit testing is the ***Chi-Square Distribution*** (pronounced ***ki square***, from the Greek letter X (chi) and hence often represented as the X^2 distribution). Appendix A shows how to perform the chi-square test to determine how alike or unalike two different distributions are.

Assume that K is a standard normal random variable (i.e., it has mean 0 and variance 1). If we say that K equals the square root of J (J = K^2), then we know that K will be a continuous random variable. However, we know that K will not be less than zero, so its density function will differ from the Normal. The Chi-Square Distribution gives us the density function of K:

(B.27) N'(K) = (K ^ ((V/2)-1)*EXP(-V/2))/(2 ^ (V/2)*GAM(V/2))

where

K = The chi-square variable X^2.

V = The number of degrees of freedom, which is the single input parameter.

EXP() = The exponential function. GAM() = The standard gamma function.

A few notes on the gamma function are in order. This function has the following properties:

5. GAM(0) = 1
6. GAM(1/2) = The square root of pi, or 1.772453851
7. GAM(N) = (N-1)*GAM(N-1); therefore, if N is an integer, GAM(N) = (N-1)!

Notice in Equation (B.25) that the only input parameter is V, the number of degrees of freedom. Suppose that rather than just taking one independent random variable squared (K^2), we take M independent random variables squared, and take their sum:

$J_M = K_1$^2+K_2^2 ... K_M^2

Now J_M is said to have the Chi-Square Distribution with M degrees of freedom. It is the number of degrees of freedom that determines the shape of a particular Chi-Square Distribution. When there is one degree of freedom, the distribution is severely asymmetric and resembles the Exponential Distribution (with A = 1). At two degrees of freedom the distribution begins to look like a straight line going down and to the right, with just a slight concavity to it. At three degrees of freedom, a convexity starts taking shape and we begin to have a unimodal-shaped distribution. As the number of degrees of freedom increases, the density function gradually becomes more and more symmetric. As the number of degrees of freedom becomes very large, the Chi-Square Distribution begins to resemble the Normal Distribution per The Central Limit Theorem.

THE STUDENT'S DISTRIBUTION

The ***Student's Distribution,*** sometimes called the ***t Distribution*** or ***Student's t,*** is another important distribution used in hypothesis testing that is related to the Normal Distribution. When you are working with less than 30 samples of a near-Normally distributed population, the Normal Distribution can no longer be accurately used. Instead, you must use the Student's Distribution. This is a symmetrical distribution with one parametric input, again the degrees of freedom. The degrees of freedom usually equals the number of elements in a sample minus one (N-1).

The shape of this distribution closely resembles the Normal except that the tails are thicker and the peak of the distribution is lower. As the number of degrees of freedom approaches infinity, this distribution approaches the Normal in that the tails lower and the peak increases to resemble the Normal Distribution. When there is one degree of freedom, the tails are at their thickest and the peak at its smallest. At this point, the distribution is called ***Cauchy***.

It is interesting that if there is only one degree of freedom, then the mean of this distribution is said not to exist. If there is more than one degree of freedom, then the mean does exist and is equal to zero, since the distribution is symmetrical about zero. The variance of the Student's Distribution is infinite if there are fewer than three degrees of freedom.

The concept of ***infinite variance*** is really quite simple. Suppose we measure the variance in daily closing prices for a particular stock for the last month. We record that value. Now we measure the variance in daily closing prices for that stock for the next year and record that value. Generally, it will be greater than our first value, of simply last month's variance. Now let's go back over the last 5 years and measure the variance in daily closing prices. Again, the variance has gotten larger. The farther back we go-that is, the more data we incorporate into our measurement of variance-the greater the variance becomes. Thus, the variance increases without bound as the size of the sample increases. This is infinite variance. The distribution of the log of daily price changes appears to have infinite variance, and thus the Student's Distribution is sometimes used to model the log of price changes. (That is, if C_0 is today's close and C_1 yesterday's close, then $\ln(C_0/C_1)$ will give us a value symmetrical about 0. The distribution of these values is sometimes modeled by the Student's distribution).

If there are three or more degrees of freedom, then the variance is finite and is equal to:

(B.26) Variance = V/ (V-2) for V>2

(B.27) Mean = 0 for V>1

where

V = The degrees of freedom.

Suppose we have two independent random variables. The first of these, Z, is standard normal (mean of 0 and variance of 1). The second of these, which we call J, is Chi-Square distributed with V degrees of freedom. We can now say that the variable T, equal to Z/(J/V), is distributed according to the Student's Distribution. We can also say that the variable T will follow the Student's Distribution with N-1 degrees of freedom if:

T = N^(1/2)*((X-U)/S)

where

X = A sample mean.

S = A sample standard deviation,

N = The size of a sample.

U = The population mean.

The probability density function for the Student's Distribution, N'(X), is given as:

(B.28) N'(X) =
(GAM((V+1)/2)/(((V*P)^(1/2))*GAM(V/2)))*((1+((X^2)/V))^(-(V+1)/2))

where

P = pi, or 3.1415926536.

V = The degrees of freedom.

GAM() = The standard gamma function.

The mathematics of the Student's Distribution are related to the incomplete beta function. Since we aren't going to plunge into functions of mathematical physics such as the incomplete beta function, we will leave the Student's Distribution at this point. Before we do, however, you still need to know how to calculate probabilities associated with the Student's Distribution for a given number of standard units (Z score) and degrees of freedom. You can use published tables to find these values. Yet, if you're as averse to tables as I am, you can simply use the following snippet of BASIC code to discern the probabilities. You'll note that as the degrees of freedom variable, DEGFDM, approaches infinity, the values returned, the probabilities, converge to the Normal as given by Equation (3.22):

```
1000 REM 2 TAIL PROBABILITIES ASSOCIATED WITH THE
STUDENT'S T DISTRIBUTION
1010 REM INPUT ZSCORE AND DEGFDM, OUTPUTS CF
1020 ST = ABS(ZSCORE):R8 = ATN(ST/SQR(DEGFDM)):RC8
 = COS(R8):X8 = 1:R28 = RC8*RC8:RS8 = SIN(R8)
1030 IF DEGFDM MOD 2 = 0 THEN 1080
1040 IF DEGFDM = 1 THEN Y8 = R8:GOTO 1070
1050 Y8 = RC8:FOR Z8 = 3 TO (DEGFDM-2) STEP 2:X8
 = X8*R28*(Z8-1)/Z8:Y8 = Y8+X8*RC8:NEXT
1060 Y8 = R8+RS8*Y8
1070 CF = Y8*.6366197723657157#:GOT01100
1080 Y8 = 1 :FOR Z8 = 2 TO (DEGFDM-2) STEP 2:X8 = X8* R28
* (Z8-1)/Z8:Y8 = Y8+X8:NEXT
1090 CF = Y8*RS8
1100 PRINT CF
```

Next we come to another distribution, related to the Chi-Square Distribution, that also has important uses in statistics. The ***F Distribution,*** sometimes referred to ***as Snedecor's Distribution*** or ***Snedecor's F***, is useful in hypothesis testing. Let A and B be independent chi-square random variables with degrees of freedom of M and N respectively. Now the random variable:

F = (A/M)/(B/N)

Can be said to have the F Distribution with M and N degrees of freedom. The density function, N'(X), of the F Distribution is given as:

(B.29) N'(X) =
(GAM((M+N)/2)*((M/N)^(M/2)))/(GAM(M/2)*GAM(N/2)*((1+M/N)^((M+N)/2)))

where

M = The number of degrees of freedom of the first parameter.

N = The number of degrees of freedom of the second parameter.

GAM() = The standard gamma function.

THE MULTINOMIAL DISTRIBUTION

The ***Multinomial Distribution*** is related to the Binomial, and likewise is a discrete distribution. Unlike the Binomial, which assumes two possible outcomes for an event, the Multinomial assumes that there are M different outcomes for each trial. The probability density function, N'(X), is given as:

(B.30) $N'(X) = (N!/(\prod[i = 1,M] N_i!))*\prod[i = 1,M] P_i^{N_i}$

where

N = The total number of trials.

N_i = The number of times the ith trial occurs.

P_i = The probability that outcome number i will be the result of any one trial. The summation of all P_i's equals 1.

M = The number of possible outcomes on each trial.

For example, consider a single die where there are 6 possible outcomes on any given roll (M = 6). What is the probability of rolling a 1 once, a 2 twice, and a 3 three times out of 10 rolls of a fair die? The probabilities of rolling a 1, a 2 or a 3 are each 1/6. We must consider a fourth alternative to keep the sum of the probabilities equal to 1, and that is the probability of not rolling a 1, 2, or 3, which is 3/6. Therefore, $P_1 = P_2 = P_3 = 1/6$, and $P_4 = 3/6$. Also, $N_1 = 1$, $N_2 = 2$, $N_3 = 3$, and $N_4 = 10 \bullet 3\text{-}2\text{-}1 = 4$. Therefore, Equation (B.30) can be worked through as:

N'(X) = (10!/(1!*2!*3!*4!))*(1/6)^1*(1/6)^2*(1/6)^3*(3/6) 4

= (3628800/(1*2*6*24))*.1667*.0278*.00463*.0625

= (3628800/288)*.000001341

= 12600*.000001341

= .0168966

Note that this is the probability of rolling exactly a 1 once, a 2 twice, and a 3 three times, not the cumulative density. This is a type of distribution that uses more than one random variable, hence its cumulative density cannot be drawn out nicely and neatly in two dimensions as you could with the other distributions discussed thus far. We will not be working with other distributions that have more than one random variable, but you should be aware that such distributions and their functions do exist.

THE STABLE PARETIAN DISTRIBUTION

The ***stable Paretian Distribution*** is actually an entire class of distributions, sometimes referred to as "Pareto-Levy" distributions. The probability density function N'(U) is given as:

(B.31) ln(N'(U)) = i*D*U-V*abs(U)^A*Z

where

U = The variable of the stable distribution.

A = The kurtosis parameter of the distribution.

B = The skewness parameter of the distribution.

D = The location parameter of the distribution.

V = This is also called the scale parameter, i = The imaginary unit, -1^(1/2)

Z = 1 -i*B*(U/ASS(U))*tan(A*3.1415926536/2) when A >< 1 and 1+i*B*(U/ASS(U))*2/3.1415926536*log(ABS(U)) when A = 1.

ABS() = The absolute value function. tan() = The tangent function. ln() = The natural logarithm function.

The limits on the parameters of Equation (B.31) are: (B.32) 0<A<= 2 (B.33) -1 <= B <= 1 (B.34) 0<= V

The four parameters of the distribution-A, B, D, and V-allow the distribution to assume a great many different shapes.

The variable A measures the height of the tails of the distribution. Thus, we can say that A represents the kurtosis variable of the distribution. A is also called the characteristic exponent of the distribution. When A equals 2, the distribution is Normal, and when A equals 1 the distribution is Cauchy. For values of A that are less than 2, the tails of the distribution are higher than with the Normal Distribution. The total probability in the tails increases as A decreases. When A is less than 2, the variance is infinite. The mean of the distribution exists only if A is greater than 1.

The variable B is the index of ***skewness.*** When B equals zero, the distribution is perfectly symmetrical. The degree of skewness is larger the larger the absolute value of B. Notice that when A equals 2, W(U,A) equals 0, hence B has no effect on the distribution. In this case, when A equals 2, no matter what B is we still have the perfectly symmetrical Normal Distribution. The ***scale parameter,*** V, is sometimes written as a function of A, in that V = C^A, therefore C = V^(1/A). When A equals 2, V is one-half the variance. When A equals 1, the Cauchy Distribution, V is equal to the semi-interquartile range. D is the ***locution parameter***. When A is equal to 2, the arithmetic mean is an unbiased estimator of D; when A is equal to 1, the median is.

The cumulative density functions for the stable Paretian are not known to exist in closed form. For this reason, evaluation of the parameters of this distribution is complex, and work with this distribution is made more difficult. It is interesting to note that the stable Paretian parameters A, B, C, and D correspond to the fourth, third, second, and first moments of the distribution respectively. This gives the stable Paretian the power to model many types of real-life distributions-in particular, those where the tails of the distribution are thicker than they would be in the Normal, or those with infinite variance (i.e., when A is less than 2). For these reasons, the stable Paretian is an extremely powerful distribution with applications in economics and the social sciences, where data distributions often have those characteristics (fatter tails and infinite variance) that the stable Paretian addresses.

This infinite variance characteristic makes the Central Limit Theorem inapplicable to data that is distributed per the stable Paretian distribution when A is less than 2. This is a very important fact if you plan on using the Central Limit Theorem.

One of the major characteristics of the stable Paretian is that it is invariant under addition. This means that the sum of independent stable variables with characteristic exponent A will be stable, with approximately the same characteristic exponent. Thus we have the Generalized Central Limit Theorem, which is essentially the Central Limit Theorem, except that the limiting form of the distribution is the stable Paretian rather than the Normal, and the theorem applies even when the data has infinite variance (i.e., A < 2), which is when the Central Limit Theorem does not apply. For example, the heights of people have finite variance. Thus we could model the heights of people with the Normal Distribution. The distribution of people's incomes, however, does not have finite variance and is therefore modeled by the stable Paretian distribution rather than the Normal Distribution.

It is because of this Generalized Central Limit Theorem that the stable Paretian Distribution is believed by many to be representative of the distribution of price changes.[1]

There are many more probability distributions that we could still cover (Negative Binomial Distribution, Gamma Distribution, Beta Distribution, etc.); however, they become increasingly more obscure as we continue from here. The distributions we have covered thus far are, by and large, the main common probability distributions.

Efforts have been made to catalogue the many known probability distributions. Undeniably, one of the better efforts in this regard has been done by Karl Pearson, but perhaps the most comprehensive work done on cataloguing the many known probability distributions has been presented by Frank Haight.[2] Haight's "Index" covers almost all of the known distributions on which information was published prior to January, 1958. Haight lists most of the mathematical functions associated with most of the distributions. More important, references to books and articles are given so that a user of the index can find what publications to consult for more in-depth matter on the particular distribution of interest. Haight's index categorizes distributions into ten basic types:

1. Normal
2. Type III
3. Binomial

[1] Do not confuse the stable Paretian Distribution with our adjustable distribution discussed in Chapter 4. The stable Paretian is a real distribution because it models a probability phenomenon. Our adjustable distribution does not. Rather, it models other (Z-dimensional) probability distributions, such as the stable Paretian.

[2] Haight, F. A., "Index to the Distributions of Mathematical Statistics," Journal of Research of the National Bureau of Standards-B. Mathematics and Mathematical Physics 65 B No. 1, pp. 23-60, Januaiy-March 1961.

4. Discrete
5. Distributions on (A, B)
6. Distributions on (0, infinity)
7. Distributions on (-infinity, infinity)
8. Miscellaneous Univariate
9. Miscellaneous Bivariate
10. Miscellaneous Multivariate

Of the distributions we have covered in this Appendix, the Chi-Square and Exponential (Negative Exponential) are categorized by Haight as Type III. The Binomial, Geometric, and Bernoulli are categorized as Binomial. The Poisson and Hypergeometric are categorized as Discrete. The Rectangular is under Distributions on (A, B), the F Distribution as well as the Pareto are under Distributions on (0, infinity), the Student's Distribution is regarded as a Distribution on (-infinity, infinity), and the

Multinomial as a Miscellaneous Multivariate. It should also be noted that not all distributions fit cleanly into one of these ten categories, as some distributions can actually be considered subclasses of others. For instance, the Student's distribution is catalogued as a Distribution on (-infinity, infinity), yet the Normal can be considered a subclass of the Student's, and the Normal is given its own category entirely. As you can see, there really isn't any "clean" way to categorize distributions. However, Haight's index is quite thorough. Readers interested in learning more about the different types of distributions should consult Haight as a starting point.

APPENDIX C - Further on Dependency: The Turning Points and Phase Length Tests

There exist statistical tests of dependence other than those mentioned in ***Portfolio Management Formulas*** and reiterated in Chapter 1. The ***turning points test*** is an altogether different test for dependency. Going through the stream of trades, a turning point is counted if a trade is for a greater P&L value than both the trade before it and the trade after it. A trade can also be counted as a turning point if it is for a lesser P&L value than both the trade before it and the trade after it. Notice that we are using the individual trades, not the equity curve (the cumulative values of the trades). The number of turning points is totaled up for the entire stream of trades. Note that we must start with the second trade and end with the next to last trade, as we need a trade on either side of the trade we are considering as a turning point.

Consider now three values (1, 2, 3) in a random series, whereby each of the six possible orderings are equally likely:

1, 2, 3 2, 3,1 1, 3, 2 3, 1,2 2, 1,3 3, 2, 1

Of these six, four will result in a turning point. Thus, for a random stream of trades, the expected number of turning points is given as:

(C.01) Expected number of turning points = 2/3*(N-2) where N = The total number of trades.

We can derive the variance in the number of turning points of a random series as:

(C.02) Variance = (16*N-29)/90

The standard deviation is the square root of the variance. Taking the difference between the actual number of turning points counted in the stream of trades and the expected number and then dividing the difference by the standard deviation will give us a Z score, which is then expressed as a confidence limit. The confidence limit is discerned from Equation (3.22) for 2-tailed Normal probabilities. Thus, if our stream of trades is very far away (very many standard deviations from the expected number), it is unlikely that our stream of trades is random; rather, dependency is present. If dependency appears to a high confidence limit (at least 95%) with the turning points test, you can determine from inspection whether like begets like (if there are fewer actual turning points than expected) or whether like begets unlike (if there are more actual turning points than-expected).

Another test for dependence is the ***phase length test***. This is a statistical test similar to the turning points test. Rather than counting up the number of turning points between (but not including) trade 1 and the last trade, the phase length test looks at how many trades have elapsed between turning points. A "phase" is the number of trades that elapse between a turning point high and a turning point low, or a turning point low and a turning point high. It doesn't matter which occurs first, the high turning point or the low turning point. Thus, if trade number 4 is a turning point (high or low) and trade number 5 is a turning point (high or low, so long as it's the opposite of what the last turning point was), then the phase length is 1, since the difference between 5 and 4 is 1.

With the phase length test you add up the number of phases of length 1, 2, and 3 or more. Therefore, you will have 3 categories: 1, 2, and 3+. Thus, phase lengths of 4 or 5, and so on, are all totaled under the group of 3+. It doesn't matter if a phase goes from a high turning point to a low turning point or from a low turning point to a high turning point; the only thing that matters is how many trades the phase is comprised of. To figure the phase length, simply take the trade number of the latter phase (what number it is in sequence from 1 to N, where N is the total number of trades) and subtract the trade number of the prior phase. For each of the three categories you will have the total number of complete phases that occurred between (but not including) the first and the last trades.

Each of these three categories also has an expected number of trades for that category. The expected number of trades-of phase length D is:

(C.03) E(D) = 2*(N-D-2)*(D^2*3*D+1)/(D+3)!

where

D = The length of the phase.

E(D) = The expected number of counts.

N = The total number of trades.

Once you have calculated the expected number of counts for the three categories of phase length (1, 2, and 3+), you can perform the chi-square test. According to Kendall and colleagues,[1] you should use 2.5 degrees of freedom here in determining the significance levels, as the lengths of the phases are not independent. Remember that the phase length test doesn't tell you about the dependence (like begetting like, etc.), but rather whether or not there is dependence or randomness.

Lastly, this discussion of dependence addresses converting a correlation coefficient to a confidence limit. The technique employs what is known as ***fisher's Z transformation,*** which converts/a correlation coefficient, r, to a Normally distributed variable:

(C.04) F = .5*ln((1+r)/(l-r))

where

F = The transformed variable, now Normally distributed.

r = The correlation coefficient of the sample.

ln() = The natural logarithm function.

The distribution of these transformed variables will have a variance of:

(C.05) V = 1/(N-3)

where

V = The variance of the transformed variables.

N = The number of elements in the sample.

The mean of the distribution of these transformed variables is discerned by Equation (C.04), only instead of being the correlation coefficient of the sample, r is the correlation coefficient of the population. Thus, since our population has a correlation coefficient of 0 (which we assume, since we are testing deviation from randomness) then Equation (C.04) gives us a value of 0 for the mean of the population.

Now we can determine how many standard deviations the adjusted variable is from the mean by dividing the adjusted variable by the square root of the variance, Equation (C.05). The result is the Z score associated with a given correlation coefficient and sample size. For example, suppose we had a correlation coefficient of .25, and this was discerned over 100 trades. Thus, we can find our Z score as Equation (C.04) divided by the square root of Equation (C.05), or:

(C.06) Z = (.5*ln((1+r)/(1-r)))/(l/(N-3))^.5

Which, for our example is:

Z = (.5*ln((l+.25)/(l-.25)))/(l/(100-3))^.5

= (.5*ln(1.25/.75))/(l/97)^.5

= (.5*ln(1.6667))/.010309^.5

= (.5*.51085)/.1015346165

= .25541275/.1015346165

= 2.515523856

Now we can translate this into a confidence limit by using Equation (3.22) for a Normal Distribution e-tailed confidence limit. For our example this works out to a confidence limit in excess of 98.8%. If we had had 30 trades or less, we would have had to discern our confidence limit by using the Student's Distribution with N-1 degrees of freedom.

[1] Kendall, M. G., A. Stuart, and J. K. Ord. The Advanced Theory of Statistics, Vol. III. New York: Hafner Publishing, 1983.

REAL ESTATE TERMINOLOGY

A Course Companion for Studying for The Real Estate Exam, for Real Estate Home Study Courses, for Real Estate Continuing Education Courses, for Real Estate Statutory Courses, and for Any Form of College Real Estate Course.

A

ABANDONMENT Failure to occupy and use property; may result in loss of rights.

ABATEMENT OF NUISANCE The act of ending or terminating a nuisance; a type of legal action brought to end a nuisance.

ABSENTEE OWNER A property holder who does not reside on the property and who usually relies on a property manager to supervise the investment.

ABSOLUTE OWNERSHIP SEE: *Fee Simple Estate*

ABSTRACT A brief summary.

ABSTRACTORS A person who, historically, searches out anything affecting the title to real property and summarizes the information in the findings.

ABSTRACT OF JUDGMENT A summary of money judgment. The summary is usually prepared so that it may be recorded, thereby creating a (judgement) lien on real estate owned by the judgment debtor.

ABSTRACT OF TITLE A summary of the instruments affecting title to a parcel of real property as shown by the public records.

ABSTRACTION A method of valuing land. The indicated value of the improvement is deducted from the sale price.

ABSTRACTION METHOD Method of appraising vacant land; allocation of the appraised total value or sale price of the property between land and building either on a ratio basis or by subtracting a figure representing building value or price from the total appraised value or price of the property. Also called Allocation Method.

ACCELERATE To make a note all due and payable at one time.

ACCREDITED MANAGEMENT ORGANIZATION (AMO) A professional designation awarded to qualified property management firms by the institute of Real Estate Management.

ACCREDITED RESIDENT MANAGER (ARM An individual who has completed IREM s educational program for resident managers of residential property.

ACCELERATED COST RECOVERY SYSTEM (ACRS) The system for figuring depreciation (cost recovery) for depreciable real property acquired and placed into service after January 1, 1981

ACCELERATED DEPRECIATION A method of cost write-off in which depreciation allowances are greater in the first few years of ownership than in subsequent years. This permits an earlier recovery of capital and a faster tax write-off of an asset.

ACCELERATION CLAUSE A clause in a deed of trust or mortgage giving the lender the right to call all sums owing him or her to be immediately due and payable upon the occurrence of a certain event. It is also a clause that permits a debtor to pay off a loan before the due date.

ACCEPTANCE 1. Agreeing to the terms of an offer to enter into a contract, thereby creating a binding contract. 2. Taking delivery of a deed. The act of agreeing or consenting to an offer.

ACCEPTANCE OF AN OFFER After acceptance of an offer, a broker may not return the buyer s deposit without authorization from the seller. An essential element of every contract, it is the consent to be bound by the offer. In deeds, it is the consent to accept a grant of real property.

ACCESSION The acquisition of title to additional property by its annexation to real estate already owned. An addition to property through the efforts of man or by natural forces.

ACCESS RIGHT The right of an owner to go into and out of his or her property.

ACCOMMODATION PARTY A person who, without receiving value, signs a promissory note to help another person borrow money or get credit.

ACCOMMODATOR An intermediary who holds funds in a delayed exchange.

ACCORD AND SATISFACTION An agreement to accept something different than (and usually less than) what the

original contract called for. The discharge of an existing contract by accepting the performance under a substitute contract. Generally, consideration under the new contract is different from and of lesser value than under the original contract, and satisfaction is the performance of that contract; the combination discharges the original contract.

ACCRETION A gradual addition to land from natural causes; for example, from gradual action of ocean or river waters.

ACCRUE To increase or accumulate; interest on loans is said to accrue daily.

ACCRUED DEPRECIATION The difference between the cost of replacement of a new building, as of the date of the appraisal and the present appraised value. Depreciation that has accumulated over a period of time. (1) The difference between the cost of replacement new as of the date of the appraisal and the present appraised value. (2) The accumulated losses in value that has affected the improvements on real property.

ACCRUED ITEMS OF EXPENSE Those incurred expenses which are not yet payable. The seller s accrued expenses are credited to the purchaser in a closing statement

ACCUSATION A written statement of rules violated, used in a property right healing.

ACKNOWLEDGMENT When a person who has signed a document formally declares to an authorized public official (usually a notary public) that he or she signed voluntarily. The official attests that the signature is voluntary and genuine. A formal declaration before a notary public or qualified officer that the person signing the document is doing so voluntarily and using his or her legal name and signature; called notarizing.

ACOUSTICAL TILE Blocks of fiber, mineral, or metal with small holes or a rough-textured surface to absorb sound, used as covering for interior walls and ceilings.

ACQUISITION The act or process by which a person procures property.

ACQUISITION COST Under FHA . A loan is based on acquisition cost, which is sale price or FHA value, whichever is lesser, plus nonrecurring closing costs the buyer is paying per FHA rules.

ACRE A measure of land equaling 160 square rods, 4840 square yards, 43,560 square feet, or a tract about 208.71 feet square.

ACT A statute

ACTUAL AUTHORITY Authority expressly given by the principal or given by the law and not denied by the principal.

ACTUAL EVICTION Forcible removal of a tenant from a property by an officer after a judgement decree of possession has been issued in favor of the owner.

ACTUAL FRAUD An act intended to deceive another, e.g., making a false statement, making a promise without intending to perform it, suppressing the truth.

ACTUAL NOTICE An individual may be conscious of the circumstances in which the owner received title to the property and is at the same time is aware that the owner has not recorded the deed nor is he in possession of the property. There is no constructive notice, only actual notice as to the owner of the property.

ADDENDUM An attachment to a purchase agreement or to escrow instructions. Used to modify or make changes.

ADJACENT Located next to or near an object or parcel of property.

ADJOINING Located so as to touch an object or share a common property line.

ADJUDICATION A judicial or court decision.

ADJUSTED COST BASIS The income tax cost basis of the property with certain additions, such as acquisition costs and the cost of improvements, and certain subtractions, such as depreciation in value.

ADJUSTMENT INTERVAL The time between permitted changes in the interest rate or monthly payments, typically six months to one year, depending on the indexused.

ADJUSTMENTS In appraising , a means by which characteristics of a residential property are regulated by dollar amount of percentage to conform to similar characteristics of another residential property.

ADJUSTABLE-RATE-MORTGAGE A mortgage or deed of trust with a variable interest rate (an interest rate that changes periodically. This mortgage tends to attract more people into the mortgage market.

ADJUDICATIVE METHODS The resolution of a dispute by mirroring the judicial process in that a third party decides the

controversy much as a judge does in court.

ADJUSTED BASIS The adjusted basis is equal to the purchase price plus buying.

ADJUSTABLE RATE MORTGAGE (ARM) A mortgage loan which bears interest at a rate subject to change during the term of the loan, predetermined or otherwise.

ADJUSTABLE RATE NOTE A note whose interest rate is tied to a flexible index.

ADMINISTRATIVE AGENCY A government agency that administrates a complex area of law, adopting an enforcing detailed regulations that have the force of law.

ADMINISTRATIVE LAW JUDGE A law judge that conducts hearings enforcing the detailed regulations that have the force of law, by a government agency. It is a complex area of law.

ADMINISTRATOR A person appointed by the probate court to manage and distribute the estate of a deceased person when no executor is named in the will or there is no will.

ADJUSTED COST BASIS For tax purposes it is the cost of the property plus improvements and minus depreciation, amortization, and depletion.

ADMINISTRATOR A person appointed by the probate court to administer the estate of a deceased person. His or her duties include making an inventory of the assets, managing the property, paying the debts and expenses, filing necessary reports and tax returns, and distributing the assets as ordered by the probate court.

AD VALOREM According to value

AD VALOREM LIEN Refers to General real estate tax.

AD VALOREM TAX A property tax based upon value.

ADVANCES Transfer of funds from a lender to a borrower in advance on a loan. Money advanced by a beneficiary under a trust deed to pay real estate taxes or other items to protect the lenders interest under the trust deed. Also refers to additional funds loaned under an open -end trust deed or mortgage.

ADVANCE FEE ACCOUNTS A verified copy of advance fee accounts must be sent to the owner of advance fee funds every quarter.

ADVANCE FEE AGREEMENTS. For DRE approval, an advance free agreement must state the total amount of advances fees to be paid. An advance fee agreement may not include a guarantee the transaction will be completed.

ADVANCE COMMITMENT The institutional investors prior agreement to provide long-term financing upon the completion of construction; also known as a take-out loan commitment.

ADVANCE FEES A fee paid in advance of any services rendered. Sometimes unlawfully charged in connection with that illegal practice of obtaining a fee in advance for the advertising of property or a business for sale., with no intent to obtain a buyer, by persons representing themselves as a real estate licensees, or representative of a licensed real estate firm.

ADVERSARY Opponent, a person or a group that opposes the other.

ADVERSE INTEREST A purpose in opposition to the interest of another party(as for example, with a buyer and a seller)

ADVERSE POSSESSION A method of acquiring property based on open and notorious possession, under a claim of right, color of title, continuous use for five years, and the payment of taxes. A method of acquiring property through continuous use of that property while paying taxes on it.

.**ADVERTISING (COSTS)** Purchased space in a newspaper, magazine or other medium used to attract public attention to a commodity for sale or lease. They should be based on projected vacancies, turnover market conditions. Where you advertise depends on who are the customers that you want to reach.

AFFIANT One who makes an affidavit or gives evidence.

AFFIDAVIT A statement or declaration reduced to writing, sworn to or affirmed before some officer who has authority to administer an oath or affirmation, such as a notary public or a commanding officer in the service.

AFFIDAVIT OF TITLE A statement in writing , made under oath by seller or grantor, acknowledged before a Notary Public in which the affiant identifies himself or herself and affiant s marital status certifying that since the examination of title on the contract date there are no judgements, bankruptcies or divorces, no unrecorded deeds, contracts, unpaid repairs or improvements, or defects of title known to the affiant and that affiant is in possession of the property.

AFFIRM To confirm, swear, ratifying, verity.

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AFFIRMATION A solemn declaration by an individual who is adverse to take an oath.

AFTER-TAX CASH FLOW (*See* cash flow)

AGE-LIFE METHOD OF DEPRECIATION SEE: Straight-line Method of Depreciation.

AGENCY A special relationship of trust by which one person (agent) is authorized to conduct business, sign papers, or otherwise act on behalf of another person (principal).

AGENCY AGREEMENT An agent must use reasonable care and skill in carrying out the tasks dictated by the agency agreement.

AGENCY CONFIRMATION STATEMENT The Agency Disclosure Addendum will always be used by the selling broker whenever Agency Confirmation Statement is required. An Agency Confirmation Statement is required in a transaction involving the lease of one-top-four unit residential property for more than one year.

AGENCY COUPLED WITH AN INTEREST When the agent has a personal interest in the subject of the agency; as when one co-owner has been authorized by the others to sell the property.

AGENCY DISCLOSURE ADDENDUM This required when a broker is involved in negotiating the sale of one-to-four unit residential property. This defines and explains, in general terms, the words and phrases used to express the agency relationship of brokers to the parties of the residential sale transaction. Refusals to sign the Agency Disclosure Addendum could occur when: owners refuse to list with the broker FSBO sellers refusal to accept an offer and when buyers refuse to sign a deposit receipt offer presented for consideration.

AGENT One who represents another called a principal and has authority to act for the principal in dealing with third parties. The relationship is referred to as an agency. Someone authorized to act for another (called the principal) in business matters.

AGENT, GENERAL An agent authorized to handle all of the principals affairs in one area or in a specified area.

AGENT, SPECIAL An agent authorized to do everything that can br lawfully delegated to a representative.

AGENT, UNIVERSAL An agent authorized to do everything that can be lawfully be delegated to a representative.

AGENTS OF PRODUCTION Four factors that are combined to produce income; labor, coordination, capital, and land.

AGREEMENT A mutual understanding or compact between parties. Although often used a synonymous with contract, technically it denotes mutual promises that fail as a contract for lack of consideration.

AGREED -UPON-COMPENSATION To receive this compensation you must be the procuring cause, must find a ready, willing and able buyer, and must be the one that initially brought the third party into the contract..

AGREEMENT FOR DEED (*See* contract for deed)

AGREEMENT OF SALE (1) A written contract between a buyer and seller setting out the terms of sale. (2) An installment sales contract covering real property, especially a long-term contract.

AGRICULTURE *(FLORIDA)* Defined in Chapter 475,F.S., to mean property zoned as such, consisting of more than 10 acres.

AIR LOT A parcel of property above the surface of the earth, not containing any land; for example , a condominium unit on the third floor.

AIR RIGHTS The rights in real property to the reasonable use of the air space above the surface of the land.

ALIENATE Conveys title to real property.

ALIENATION The transferring of property to another. Conveyance or transfer of title to real estate from one person to another person.

ALIENATION CLAUSE In a deed of trust or mortgage, a provision that if the secured property is sold or transferred, the lender has the option of accelerating the loan and declaring the entire unpaid balance immediately due and payable. Also called a "due-on-sale" clause.

ALIENATION, INVOLUNTARY Transfer of an interest in property against the will of the owner, or without the action of the owner, occurring through the operation of law, natural process, or adverse possession.

ALIENATION, VOLUNTARY When an owner voluntarily transfers an interest to someone else.

ALL-INCLUSIVE DEED OF TRUST A financing device

whereby a lender makes payments on the existing trust deeds of a borrower and takes from the borrower a junior trust deed with a face value in an amount equal to the amount outstanding on the old trust deeds and the additional amount of money borrowed.

ALLOCATION METHOD SEE: Abstraction Method.

ALLODIAL SYSTEM A theory of land ownership that individuals may own land free of the rights of an overlord.

ALLODIAL TENURE A real property ownership system where ownership may be complete except for those rights held by the government. Allodial is in contrast to feudal tenure.

ALLUVION (ALLUVIUM) Soil that has been deposited by accretion on the shore of a river or body of water and that increases the real property.

ALTA OWNERS POLICY (A.L.T.A.) An owner s extended coverage policy that provides buyers and owners the same protection the ALTA policy gives to lenders.

ALTA TITLE POLICY (American Land Title Association) A type of title insurance policy issued by title insurance companies which expands the risks normally insured against under the standard type policy to include unrecorded mechanic s liens; unrecorded physical easements; facts a physical survey would show,; water and mineral rights; and rights of parties in possession , such as tenants and buyers under unrecorded instruments.

ALTER EGO A doctrine which holds that a corporation is really owned by shareholders as their own property, and therefore it should not be considered as a separate entity. Usually used to try to hold shareholders liable for corporate debts.

ALTERNATIVE DISPUTE RESOLUTION (ADR) The resolution of disputes by negotiation, mediation, and arbitration.

ALTERNATIVE MORTGAGE INSTRUMENTS Nonstandardized financing loans.

AMBULATORY Capable of being changed or revoked. In wills, it refers to the concept that a will may be revoked or modified at any time up to the testator's death.

AMELIORATING WASTE Improvements to property that, while not damaging the value of the property, technically qualify as waste. For example, an apartment building constructed on property designated only for single-family structures is considered ameliorating waste.

AMENITIES As used in the real estate business, the features that make a piece of real property, especially a home, enjoyable.

AMENDMENT A change made to correct an error or to alter or augment part of an agreement without changing its principle idea or essence.

AMERICAN INSTITUTE OF ARCHITECTS (AIA) A professional association of registered architects that publishes construction contract forms as one of its activities.

AMERICAN SOCIETY O INDUSTRIAL SECURITY A professional association of industrial security personnel that provides training leading to the designation of Certified Protection Professional (CPP).

AMERICANS WITH DISABILITIES ACT This is the act that set forth the requirement that landlords must make facilities accessible to the handicapped to the extent readily achievable.

AMORTIZATION (1) The liquidation of a financial obligation on an installment basis, which includes both principal and interest. (2) Recovery of cost or value over a period of time. The method or plan for the payment of a debt, bond, deed of trust, etc., by installments or sinking fund.

AMORTIZE Pay off a debt in installments.

AMORTIZED LOAN (MORTGAGE) A loan to be repaid, interest and principal, by a series of regular payments that are equal or nearly equal, without any special balloon payment prior to maturity. Also called a Level Payment Loan

AMOUNT IN CONTROVERSY The amount of money at issue in a lawsuit; used as a limitation on the jurisdiction of some courts.

ANCHOR STORE The most important store in a shopping center, the store that has the largest draw of customers.

ANNEXATION Attaching personal property to land so that the law views it as part of the real property (a fixture). Annexation can be actual or constructive.

ANNEXATION, ACTUAL A physical attachment of personal property to land.

ANNEXATION, CONSTRUCTIVE When personal property is associated with real property in such a way that the law treats it as a fixture, even though it is not physically attached to the real property.

ANNIVERSARY DATE Recurring every year; the date an insurance policy must be renewed to continue in effect.

ANNUAL DEBT SERVICE The amount of money required each year for the payment of all mortgage interest and principal.

ANNUAL PERCENTAGE RATE (APR) The cost of credit as determined in accordance with Regulation Z of the Board of Governors of the Federal Reserve System for implementing the Federal Truth in Lending Act.

ANNUITY A sum of money received or paid yearly or at other fixed periods.

ANNUITY CAPITALIZATION An income capitalization method providing for annuity recapture of invested capital; also referred to as yield capitalization. Discounts future income to an estimate of present value.

ANSWER The document the defendant must file with the court in response to the plaintiffs s complaint.

ANTICIPATION, PRINCIPLE OF Affirms that value is created by the anticipated benefits to be derived in the future.

ANTICIPATORY BREACH Advance notice of intention to violate the terms of a contract.

ANTICIPATORY REPUDIATION When one party in a contract informs the other before the time set for performance that he or she does not intend to perform as agreed.

ANTI-DEFICIENCY RULES Laws that prevent a secured lender from suing the borrower for a deficiency judgement after foreclosure in certain circumstances.

ANTIDEFICIENCY LEGISLATION Legislation that prohibits a lender from obtaining a judgement for money against a defaulting borrower under a deed of trust when the value of property foreclosed upon is not adequate to satisfy the debt.

ANTI-DISCRIMINATION VIOLATIONS The following can sue in this matter, state attorney general, U.S. attorney general, and a tester.

APARTMENT OWNERS Are considered business establishments subject to the Unruh Civil Rights Act.

APPEAL The review or rehearing by a higher court of a low (inferior) court's decision.

APPELLANT The party appealing a court decision. Either party may appeal; hence, the appellant could have been either the plaintiff or the defendant in the trial court.

APPELLEE In an appeal, the party who did not file the appeal. Also known as the respondent.

APPLICANT A person who applies for something; a candidate.

APPRAISAL An estimate and opinion of value. An opinion or estimate of the fair market value of a property.

APPRAISAL CERTIFICATION There are two types of certification, general and residential.

APPRAISAL PLANT Copies of current statistics and publications kept by appraisers in their library or record room.

APPRAISAL REPORT Communication of a formal appraisal.

APPRAISED VALUE Estimated worth of a property determined by someone qualified in valiation.

APPRAISER One qualified by education, training, and experience, who is hired to estimate the value of real and personal property on the basis of experience, judgment, facts, and use of formal appraisal processes.

APPRECIATION Increase in the value of property.

APPROPRIATIVE RIGHT SEE: *Prior Appropriation*

APPROPRIATION OF WATER The taking, impounding or diversion of water flowing on the public domain from its natural course and the application of the water to some beneficial use personal and exclusive to the appropriators.

APPURTENANCE That which belongs to something, but not immemorially; all those rights, privileges and improvements which belong to and pass with the transfer of property, but which are not necessarily a part of the actual property. Appurtenances to real property pass with the real property to which they are appurtenant, unless a contrary intention is

manifested. Typical appurtenances are right-of way, easements, water rights, and any property improvements.

APPURTENANT Attached to or considered part of land, because of being considered necessary and incidental to the use of that land. Commonly applied to easements that are considered part of property.

APPURTENANT RIGHT A right that belongs to the owners of one property that gives them the right to use another property (which they do not own) in a specific way that benefits their property (e.g., an easement).

APPURTENANCE, INTANGIBLE An appurtenant right that does not involve ownership of physical objects; for example, an easement (as opposed to mineral rights).

APR See: ANNUAL PERCENTAGE RATE

ARBITRATION A neutral third party who listens to each party s position and makes a final binding decision.

ARBITRATOR A neutral third party who receives evidence and resolves the dispute.

ARCHITECTURAL STYLE Generally the appearance and character of a building s design and construction.

AREA MANAGEMENT BROKER (AMB) A property manager who works directly for the Federal Housing Administration managing subsidized housing under contract.

ARM An adjustable rate mortgage.

ARMS LENGTH TRANSACTION A transaction, such as the sale of property, in which all parties involved are acting in their own self-interest and are under no undue influence or pressure from the other parties.

ARREARS That which is behind; used when describing payment of past due interest and loan payments.

ARTICLES OF INCORPORATION An instrument setting forth the basic rules and purposes under which a private corporation is formed.

ARTIFICIAL PERSON A person created by law, as distinguished from a natural person, a human being; usually refers to a corporation.

ARM S LENGTH TRANSACTION May be used when the price paid for a comparable property is being used.

AS IS CLAUSE A provision in a deposit receipt stating that the buyer accepts the property in its present condition.

ASSEMBLAGE The process of combining two or more contiguous parcels into one larger parcel which makes the one parcel more valuable than the separate properties.

ASSESSED VALUE Value placed on property as a basis for taxation. A value used by the tax assessor before July 1978. It represented 25 percent of the assessor's fair market value. After deducting any exemptions from assessed value, one applied the tax rate to the net figure to determine annual property taxes.

ASSESSMENT The valuation of property for the purpose of levying a tax, or the amount of tax levied.

ASSESSMENT BOND An obligation to pay for costs of local improvements such as sidewalks, sewers, or street lighting.

ASSESSMENT OF REAL PROPERTY In a real estate transaction a sale of real property would create a new assessment of real property.

ASSESSMENT ROLL A list of all taxable property showing the assessed value of each parcel; establishes the tax base.

ASSETS Anything of real value owned by an individual or business.

ASSESSOR The official who has the responsibility of determining the assessed values.

ASSET MANAGEMENT The assembly, management and disposition of a portfolio of investment properties.

ASSIGN To transfer a right or an interest in property to another.

ASSIGNEE One to whom property is assigned or transferred.

ASSIGNMENT A transfer to another of any property or right. The transfer of one's entire interest in property. Generally, the term is limited to intangible personal property (that is, stocks, bonds, promissory notes) and to leasehold estates.

ASSIGNMENT OF RENTS An assignment of future rents form property as security for a debt.

ASSIGNMENT FOR RENTS CLAUSE A clause in a deed of

trust or mortgage, providing that in the event of default, all rents and income from the secured property will be paid to the lender to help reduce the outstanding loan balance.

ASSIGNMENT OF A DEED OF TRUST An instrument that transfers the beneficial interest under a deed of trust from one lender to another.

ASSIGNMENT OF RENT CLAUSE A clause in a trust deed that gives the beneficiary the right under limited circumstances to collect rents of the property if the borrower defaults.

ASSIGNOR One who assigns a right or an interest to another.

ASSIGNEES Those to whom property or interests therein shall have been transferred

ASSOCIATE Person working for a broker.

ASSOCIATION An organization of persons having a common interest.

ASSOCIATION AGREEMENT Set of private conditions, covenants, and restrictions applying to all properties in a planned unit development, condominium, or other community project.

ASSUMPTION Acceptance of personal liability for another's debt or obligation. In the case of the sale of real estate, the buyer personally accepts and promises to pay off the existing deed of trust.

ASSUMPTION FEE A lenders charge for changing over and processing new records for a new owner who is taking over an existing loan.

ASSUMPTION OF AGREEMENT A contract by which a person agrees to pay a debt or obligation owed by someone else.

ASSUMPTION OF MORTGAGE OR DEED OF TRUST The taking of title to property by a grantee in which he or she assumes liability for payment of existing note secured by a mortgage or deed of trust against the property.

ATTACHED HOUSE Shares one or more walls and often involves a party wall agreement.

ATTACHMENT Seizure of property by court order before judgment, usually done to have it available in the event a judgment is obtained in a pending law suit. The actual or constructive seizure of property by court order during a lawsuit. The usual purpose is to hold the assets as security for the satisfaction of a judgment.

ATTACHMENT LIEN A lien on property arising because of an attachment of that property.

ATTACHMENTS, MAN MADE SEE: *Fixture*

ATTACHMENTS, NATURAL Things growing on a piece of land, such as trees , shrubs or crops.

ATTEST (1) To affirm to be true or genuine. (2) An official act establishing authenticity.

ATTESTATION The act of witnessing the execution of an instrument (such as a deed or a will).

ATTORNEY-IN-FACT An agent authorized to perform certain acts for another under a power of attorney. (See Power of Attorney.)

AUTOMATIC EXTENSION CLAUSE a lease covenant providing that a lease will be renewed indefinitely until one of the parties gives notice of the intent to terminate at the end of the lease term.

AUTHORITY, ACTUAL Authority actually given to an agent by the principal, either expressly or by implication.

AUTHORITY, APPARENT SEE: *Agency, Apparent.*

AUTHORITY, IMPLIED An agents authority to do everything reasonably necessary to carry out the principals expressed orders.

AUTOMATED UNDERWRITING A service that enables lenders to obtain a credit risk classification using applications software in the loan underwriting process.

AVULSION The sudden tearing away or removal of land by the action of water flowing over or through it.

AWARD The decision of the arbitrator.

B

REAL ESTATE TERMINOLOGY

A Course Companion for Studying for The Real Estate Exam, for Real Estate Home Study Courses, for Real Estate Continuing Education Courses, for Real Estate Statutory Courses, and for Any Form of College Real Estate Course.

BACKFILL The replacement of excavated earth in a hole or against the side of a structure.

BAILMENT Personnel property is transferred in trust for an accomplishment of a specific purpose. A possessory interest in personal property.

BALANCE SHEET A financial statement showing a person's assets, liabilities, and net worth.

BALLOON PAYMENT When the final payment on a note is greater than the preceding normal installments, the final installment is termed a balloon payment. An installment promissory note providing for the last payment to be much larger than any previous payment. By statute, any payment more than twice the smallest payment is a balloon payment, although in practice generally the term refers only to the last payment.

BAND OF INVESTMENT Method of estimating interest and capitalization rates based on a weighted average of the mortgage interest rate (or other cost of borrowed funds) and the rate of return on equity required.

BANKER S MONTH 30 days

BANKER S YEAR 360 days

BARGAIN AND SALE DEED Any deed that recites a consideration and purports to convey real estate; a bargain and sale deed with a covenant against the grantor s act is one in which the grantor warrants that grantor has done nothing to harm or cloud title.

BASE COSTS Average or typical costs of similar buildings, usually obtained from published cost manuals; used in the comparative square foot method of estimating cost of construction.

BASE INDUSTRIES Businesses that attract outside money into the area, primary.

BASE LINE In the government survey system, a main east-west line from which township lines are established. Each principal meridian has one base line associated with it.

BASE RENT SEE: *Minimum Rent.*

BASE VALUE SEE: *Value, Base*

BASE AND MERIDIAN Imaginary lines used by surveyors from which they find, measure, and describe the location of lands.

BASEBOARD A board that goes around the room against the wall and next to the floor.

BASE MOLDING Molding used at the top of the baseboard.

BASIS (1) *Cost Basis* The dollar amount assigned to property at the time of acquisition under provisions of the Internal Revenue Code for the purpose of determining gain, loss and depreciation in calculating the income tax to be paid upon the sale or exchange of property. (2) *Adjusted Cost Basis* The cost basis after the application of certain conditions for improvements, etc., and deductions for depreciation.

BASE SHOW Molding used at junction of baseboard and floor, sometimes called a carpet strip.

BASIC MONEY SUPPLY This consists of cash, coins, and checking accounts.

BATNA Best Alternative To a Negotiated Agreement.

BATTEN Narrow strips of wood or metal used to cover joints on the interior or exterior of a building; they are also used for decorative effect.

BEAM A horizontal structural member supporting a load.

BEARING WALL OR PARTITION A wall or partition that supports any vertical load, in addition to its own weight.

BEFORE-TAX CASH FLOW (Btcf; Cash Throw off; Gross Spendable Income) The resulting amount when annual debt service is subtracted from net operating income.

BENCH MARKS A location indicated on a permanent marker by surveyors.

BENEFICIARY (1) One entitled to benefit from a trust. (2) The lender on the security of a note and deed of trust. The creditor (lender) under a deed of trust.

BENEFICIARY STATEMENT (See Offset Statement.)

BEQUEATH To leave by will.

BEQUEST Personal property that is given by the terms of a will. A gift of personal property by will.

BETTERMENT An improvement on real property that increases the value and is considered a capital asset.

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BILATERAL CONTRACT A contract in which the consideration given by each party is a promise: that is , a promise for a promise.

BILATERAL ESCROW INSTRUCTIONS A single set of escrow instructions signed by both the buyer and the seller ; often signed at the opening of escrow, not at the end.

BILATERAL EXECUTORY CONTRACT A contract between the seller of a home and a real estate broker, whereby the seller agrees to pay the broker a commission if he procures a buyer ready, willing and able to buy and the broker agrees to use due diligence.

BILATERAL EXECUTORY When a broker contracts to perform certain services for a principal and in exchange the principal and in exchange the principal agrees to pay the broker a specific fee, their agreement would bilateral executory.

BILL A proposed law, formally submited to a legislature for consideration.

BILL OF SALE A written instrument given by the seller to the buyer to pass title to personal property.

BINDER A written statement that binds the parties to an agreement until formal contracts can be drawn; an agreement to cover a down payment as evidence of good faith.

BINDING ARBITRATION The decision of the arbitrator is final and not review able by the courts.

BIWEEKLY PAYMENTS Real estate loan payments made every two weeks. A monthly payment is divided by two and paid 26 times per year.

BIENNIUM (biennial) A period of two tears.

BILATERAL CONTRACT An agreement wherein both parties are legally obligated to each other to perform.

BINDER A memorandum given subject to the writing of a formal contract for sale, usually acknowledging receipt of a portion of the down payment for purchase of real property.

BRACKETING When using the sales comparison approach, selection of market data so that the subject is contained within a range of data.

BLACKTOP Asphalt paving used in streets and driveways.

BLANKET DEED OF TRUST A deed of trust binding more than one parcel of property as security. It is frequently encountered in subdivisions, where every lot in the subdivision is bound by the same deed of trust. As the lots are sold, they are released from the deed of trust by a partial release provision.

BLANKET MORTGAGE (LOAN) One mortgage or deed of trust that covers more than one piece of real property.

BLENDE-RATE MORTGAGE The average trust deed or mortgage covering more than one parcel of land.

BLIGHTED AREA An area in which real property is declining in value because of destructive economic forces.

BLIGHT CORRECTION Rehabilitation of residential properties that have deteriorated significantly.

BLIND ADVERTISEMENT Advertisement that does not contain the name of the broker.

BLOCK In reference to platted property, a group of lots surrounded y streets or unimproved land.

BLOCK BUSTING The practice on the part of unscrupulous or real estate agents of inducing panic selling of homes at below market value, especially by exploiting the prejudices of property owners in neighborhoods in which the racial make-up is changing or appears to be on the verge of change.

BOARD FOOT A unit of measurement for lumber: one foot wide, one foot long, one inch thick (144 cubic inches).

BOMA CHART OF ACCOUNTS The standardized system of income and expenses accounting for office properties developed by the Building Owners and Managers Association International.

BONA FIDE In good faith; genuine

BONA FIDE PURCHASER (BFP) A purchaser who pays fair value for property in good faith, and without notice of adverse claims.

BOND An obligation under seal. Real estate bonds are issued on the security of a mortgage or deed of trust. A certificate representing a contract for the payment of money, often used to repay certain loans or held as security to ensure the performance of a stated act. The type of investment made by people looking for fixed returns and a little risk.

BOND COVERAGE Insurance protection individuals or firms against default in the performance of their duties.

BOOK VALUE An accounting term which is the difference between cost and the total amount of depreciation that has been taken.

BOOK OF ABSTRACTS A key set of books maintained by a title company.

BOOT In an exchange, any property that isn t treated as a like-kind for income tax purposes; for example, if a building is trade for a vacant lot and a yacht, the yacht is boot.

BORROWER (Debtor) The mortgagor; one who gives a mortgage as security for a debt.

BORROWER S STATEMENT TO LENDER Document prepared by the lender and signed by the borrower authorizing the lender to perform certain acts (complete a loan; etc.) Usually included in the loan package.

BOUNDARY The perimeter or border of a peice of land ; dividing line between one piece of property and another.

BOUNDS Boundaries

BRANCH OFFICE A business location other than the real estate broker s principal place of business.

BRACING Frame lumber nailed at an angle in order to provide stability to the structure.

BREACH The breaking of or failure of duty, either by omission or commission. The violation of or failure to perform an obligation.

BREACH OF CONTRACT. A violation of the terms of a legal agreement; default. Breach of contract allows the non-breaching party to rescind the contract, sue for damages, or sue for performance of the contract.

BREACH MATERIAL A breach of contract important enough so that bit excuses the nonbreaching party from preforming his or her contractual obligations.

BREAK-EVEN POINT Occupancy level at which gross income for a property equals the total fixed and variable operating costs.

BREEZE WAY A covered porch or passage, open on two ends, that connects the house and garage, or two parts of the house.

BRIDGE LOAN A loan that bridges the gap between two other loans, usually for a short time.

BRIDGING Wood or metal pieces used to brace floor joists.

BROKER An agent who earns income by arranging sales and other contracts. A real estate broker is an individual licensed by the state of California to arrange the sale or transfer of interests in real property for compensation.

BROKER , ASSOCIATE One who is licensed as a real estate broker but works for another broker.

BROKERAGE A broker s business

BROKER S COMMISSION Agreement between the client and the broker. This charged to the seller and not the buyer.

BROKER FEE Mere payment of the buyer s broker fee by the seller does not make the cooperating buyer s broker a dual agent.

BROKER S LICENSE When a person is granted a broker s license it is valid for four years, unless suspended or revoked.

BROKERS LOAN STATEMENT A statement signed and received by the borrower at the time of a loan transaction, indicating the costs, deductions, including commissions, of a loan negotiated by a real estate licensee.

BROKER S PRINCIPAL. In a real estate transaction the broker s principal can be a: seller, buyer, or landlord.

BROKER-SALESPERSON RELATIONSHIP AGREEMENT A written agreement required by regulations of the Real Estate Commissioner setting forth the material aspects of the relationship between a real estate broker and each salesperson and broker performing licensed activities in the name of the supervising broker.

BROWNFIELDS Area where soil is contaminated.

B.T.U. British thermal unit. The quantity of heat required to raise the temperature of one pound of water one degree Fahrenheit.

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BUFFER ZONE A strip of land separating one type of land use from another.

BUILDING CODE A set of rules establishing minimum standards for construction methods and materials,

BUILDING EXPENSES A good source to find out a buildings expenses is the utility company.

BUILDING LINE Often called a setback line, a building line is a line running a certain distance from the street, in front of which an owner cannot build. These lines are set by law.

BUILDING OWNERS AND MANAGERS ASSOCIATION INTERNATIONAL (BOMA) An international organization of office building owners and managers, which fosters professionalism through its educational programs, forums and publications.

BUILDING OWNERS AND MANAGERS INSTITUTE INTERNATIONAL (BOMI). An independent educational organization supported by BOMA. Its courses lead to the designations Real Property Administrator (RPA), Systems Maintenance Technician (SMT), Systems Maintenance Administrator (SMA), and Facilities management Administrator (FMA).

BUILDING PAPER A heavy waterproofed paper used as sheathing in exterior walls, or in roof construction as insulation and protection against moisture.

BUILDING RELATED ILLNESS A clinically diagnosed condition that is caused by toxic substances or pathogens, that persists when an occupant leaves the building. Symptoms include hypersensitivity, pneumonitis, asthma and certain allergic reactions.

BUILDING RESIDUAL TECHNIQUE Technique of income capitalization; the net income to the building (after deducting the income required for the land) is capitalized into an estimated value for the building.

BUILDING STANDARD The specific set of amenities and alterations a landlord is willing to make free of charge for an incoming commercial tenant.

BULK PURCHASING A method of cutting operating costs for a property in which supplies are purchased in large quantities and stored for later use. Also called volume buying.

BULK SALE The sale by a business of a major portion of its stock-in-trade to someone other than customers.

BUILT-INS Cabinets and other features built in as a part of the house.

BUMP CLAUSE A provision in a deposit receipt that allows the seller to keep the property on the market until a condition in the contract is fulfilled.

BUNDLE OF RIGHTS The rights that accompany the ownership of real estate. Each stick is a right

BURDEN OF PROOF SEE: Proof, Burden of.

BUNDLE OF RIGHTS An ownership concept that describes real property by the legal rights associated with owning the property. It specifies right such as the rights to sell, lease, use, occupy, mortgage, and trade the property, among others. These rights are typically purchased by the buyer in a sales transaction unless specifically noted or limited in the sale.

BUSINESS BROKER Real estate licensees who engage in the sale, purchase or lease of a business.

BUSINESS BROKERAGE The sale, purchase, or lease of businesses that provide goods and services.

BUSINESS COMPULSION SEE: Duress

BUSINESS CYCLE A wavelike movement of increasing and decreasing economic prosperity consisting of four phases; expansion, recession, contraction and revival.

BUSINESS OPPORTUNITY BROKERAGE The real estate activity dealing in the sale, purchase or lease of a business.

BUSINESS PARK A development or subdivision allocated to office-warehouse or similar use. Also known as an office park. An outgrowth of industrial parks.

BUSINESS AND PROFESSIONS CODE One of the 25 California codes containing the laws passed by the state legislature. It contains the statutes regulating the conduct of real estate brokers and establishes the Department of Real Estate.

BUSINESS OPPORTUNITY A term used to describe a business including its stock-in-trade, fixtures, and goodwill.

BUSINESS TRUST *(See Syndicate)*

BUYDOWN *(See Subsidy Buydown)*

BUYER If the buyer in a real estate transaction, (such as lease contract) needs assistance in deciding how to take option, he should consult his attorney.

BUYER BROKERAGE AGREEMENT An employment contract with a purchase.

BUYERS MARKET The supply of available properties exceeds the demand.

BYLAWS Rules for the conduct of the internal affairs of corporations and other organizations.

C

CALL PROVISION SEE: *Acceleration Clause*

CAL-VET FINANCING The State of California holds the titles under Cal-Vet financing.

CANCEL ESCROW To terminate escrow bu mutual written instructions.

CAL-VET LOAN PROGRAM (CALIFORNIA VETERANS LOAN)
A program administered by the State Department of Veterans Affairs for the direct financing of farms and homes for veterans who qualify.

CANCELED A license ceases to exist, effective as of the date approved by the Commission , and does not involve disciplinary action.

CANCELLATION Termination of a contract without undoing acts that have already been performed under contract. COMPARE; Rescission.

CANCELLATION OPTION A lease clause granting the tenant the option to cancel at the end of a predetermined term.``````

CAP A ceiling on interest rate increases.

CAPACITY Legal ability to perform some act, such as enter into a contractor execute a deed or will.

CAPITAL An agent of production; construction and equipment costs; investment money.

CAPITAL ASSETS Assets of a permanent nature used in the production of income. Examples would include land, buildings, and equipment.

CAPITAL-DEFICIT AREA A region where the total amount of savings is not sufficient to finance economic development already underway in that area.

CAPITAL GAIN The gain recognized for federal and state income tax purposes when a taxpayer disposes of a capital asset.

CAPITAL EXPENDITURE Money expended on repairs and improvements and repair or prolong its life; not deductible. COMPARE: Deduction, Repair

CAPITALIZATION In appraising, a method of determining value of property by considering net income and a reasonable percentage of return on the investment.

CAPITALIZED INCOME APPROACH SEE: Income Approach.

CAPITALIZED INCOME METHOD OF DEPRECIATION
Method for estimating depreciation by comparing the subject s capitalized value to its replacement cost new.

CAPITALIZATION RATE The percentage rate or rate of interest considered a reasonable return on the investment. It is used in the capitalization method of determining value based upon net return.

CAP RATE See *LIFE OF LOAN CAP*

C.A.R. Abbreviation for the California Association of Realtors.

CARET California Association of Real Estate Teachers; a division of the California Association of Realtors.

CARPET STRIP See *Base Shoe*

CARRYBACK LOAN SEE: *Loan, Carryback*

CARRYOVER CLAUSE SEE: Extender Clause

CASE LAW Rules of law developed in court decisions, as opposed to constitutional law, statutory law, or administrative regulations. Also called decisional law.

CASH-ON-CASH Investment return based on actual cash invested; cash flow as a percentage or ratio to equity.

CASH RETURN TO EQUITY Equity dividend; cash flow.

CASE OR CONTROVERSY REQUIREMENT A provision in the U.S. Constitution That limits judicial power to deciding actual, active conflict (as opposed to hypothetical questions).
Declaratory relief is an exception to this rule.

CASEMENT WINDOW Windows set in frames of wood or metal that swing outward.

CASH FLOW (After tax cash flow) The new amount of cash a property produces when all cash income and other cash generated are added together and all cash expenses and other cash payments are deducted.

CASH FLOW STATEMENT A yearly financial report showing the bottom-line return after taxes.

CAUCUS Occurs when the mediator meets with each party separately.

CAUSE OF ACTION A legal right; facts giving rise to an enforceable claim.

CAVEAT EMPTOR A Latin phrase meaning " let the buyer beware"; the legal maxim stating that the buyer must examine the goods or property and buy at his or her own risk.

CCIM Certified Commercial Investment Member

C.C. & R s Abbreviation for covenants, conditions, and restrictions. Often used synonymously with general plan restrictions on a subdivision.

CEASE AND DESIST ORDER An action by a government agency to require a person business to stop an illegal or unfair practice.

CENTRAL TOWN A town that performs a variety of services for the surrounding area.

CENSURE An official act of disapproval.

CERTIFICATE OF CLEARANCE The State Board of Equalization issues that the seller has paid sales tax.

CERTIFICATE OF ELIGIBILITY Issued by the Department of Veterans Affairs - evidence of individual s eligibility to obtain a VA loan

CERTIFICATE OF OCCUPANCY A statement issued by a local government verifying that a newly constructed building is in compliance with all codes and maybe occupied.

CERTIFICATE OF SALE The document given to the purchaser of a mortgage foreclosure sale, instead of the deed; replaced with a sheriffs deed only after the redemption period expires.

CERTIFICATE OF REASONABLE VALUE (CRV) The Veterans Administrations's written appraisal of the value of a property.

CERTIFICATE OF TAXES DUE A written statement of guaranty of the condition of the taxes on a certain property made by the County Treasurer of the county wherein the property is located. Any loss resulting to any person from an error in a tax certificate shall be paid by the county which such treasurer represents.

CERTIFICATE OF TITLE A written opinion by an attorney that ownership of the particular parcel of land is as stated in the certificate.

CERTIFICATE OF TITLE OPNION (Opinion of Title) A document signed by a title examiner (attorney or title company agent) stating the judgement that, based on an examination of the public records, the seller has good title to the property being conveyed to the buyer (not to be confused with title insurance)

CERTIFIED APARTMENT MANAGER (CAM); CERTIFIED APARTMENT PROPERTY SUPERVISOR (CAPS); CERTIFIED APARTMENT MAINTENANCE TECHNICIAN (CAMT). Designations awarded by the National Apartment Association (NAA) for appropriate courses of study.

CERTIFIED APPRAISER *(See State Certified appraiser)*

CERTIFIED ASSOCIATION MANAGER (CAM) A designation awarded by the Community Association Institute for courses of study in the professional management community associations.

CERTIFIED PLANT ENGINEER (CPE) A designation awarded for qualification in plant engineering facilities management by the American Institute of Plant Engineers (AIPE)

CERTIFIED PROPERTY MANAGER (CPM) A property manager who has fulfilled the Institute of Real Estate Management s requirements for this professional designation.

CERTIFIED SHOPPING CENTER MANAGER (CSM);

CERTIFIED MARKETING DIRECTOR (CMD). Designations granted to qualified shopping center managers and marketing directors who have satisfied the requirements and educational programs of the International Council of Shopping Centers.

CERTIORARI, WRIT OF The Supreme Court order indicating that the court has decided to exercise its discretion and accept a case offered on appeal. The court reviews only those select cases that it deems worthy of review.

CHAIN A unit of measurement used by surveyors. A chain consists of a hundred links equal to 66 feet.

CHAIN OF TITLE A series of conveyances, encumbrances, and other instruments affecting the title from the time original patent was granted, or as far back as records are available. A history of the recorded ownership of real estate and claims against title to real estate.

CHATTEL The old name for personal property.

CHATTEL MORTGAGE A personal-property mortgage. (See Security Agreement.)

CHATTEL REAL In real estate, an estate less than a freehold estate, such as a lease.

CHATTELS (1) Personal property. (2) This term is sometimes used in a law to describe any interest in real or personal property other than a freehold.

CHECK A square measuring 24 miles on each side and representing the largest unit of measure in the government survey system.

CHOICE-OF AGENCY After a broker has confirmed his choice-of-agency, the choice cannot be corrected or modified at any time.

CHOSE IN ACTION A personal right to something not presently in owners , but recoverable by a legal action for possession.

CHOSE IN POSSESSION Something in possession rather than the right of possession.

CIRCUIT BREAKER An electrical device that automatically interrupts an electrical circuit when an overload occurs. Circuit breakers can be reset and today are used instead of fuses.

CITATIONS Statements of alleged violations and the penalties imposed.

CITY GROWTH PATTERNS The following people have done work on this subject, Von Thunen, Burgess, Babcock and Hoyt.

CIVIL CODE One of the 25 California codes containing the statutes passed by the state legislature. The most important code relating to contracts and real estate, the Civil Code defines the nature and requirements for contracts and real estate transactions, among its many other provisions.

CIVIL LAW A system of jurisprudence, sometimes called Roman law, wherein all the laws are set forth in advance to regulate conduct (as opposed to common law, where the principles of law develop on a case-by-case basis). In California the term also refers to the law relating to and between individuals, as opposed to criminal law.

CIVIL RIGHTS Fundamental rights guaranteed to all persons by the law. The term is primarily used in reference to constitutional and statutory protections against discrimination based on race, religion, sex, or national origin.

CIVIL RIGHTS ACT OF 1866 A federal law that guarantees that citizens of all races have the same rights as white citizens to inherit, purchase, lease, sell, hold and convey real and personnel property.

CIVIL RIGHTS ACT OF 1968 Violations of this act should be reported to HUD.

CLAPBOARD Boards that are used for siding and that are usually thicker at one edge.

CLAUSE A distinct provision in a written document.

CLIENT A person represented by a broker or an attorney.

CLOSE OF ESCROW (COE) The date when documents are recorded and title passes from seller to buyer; on this date buyer becomes legal owner and title insurance becomes effective.

CLOSING (1) Process by which all the parties to a real estate transaction conclude the details to a sale or mortgage. The process includes the signing and transfer of documents and distribution of funds. (2) Condition in description of real property by courses and distances at the boundary lines where the lines meet to include all the tract of land.

CLOSING COSTS The miscellaneous expenses buyers and sellers normally incur in the transfer of ownership of real property over and above the cost of the property.

CLOSING STATEMENT An accounting of funds made to the buyer and seller separately. Required by law to be made at the completion of every real estate transaction.

CLOUD ON TITLE A claim or document that affects title to real estate. The actual cloud may ultimately prove invalid, but its existence mars the title.

CLTA POLICY The title insurance policy issued to homeowners and noninstitutional lenders. The initials stand for the California Land Title Association, an organization that regulates and standardizes the provisions within title policies.

CODE OF CIVIL PROCEDURE One of the 25 California codes that contain the statutes passed by the state legislature. It contains most of the procedural requirements for enforcing rights granted by other codes, including the procedures for evictions, foreclosures, and lawsuits.

CODE OF ETHICS A set of rules and principles expressing a standard of accepted conduct for a proffessio9nal group and governing the relationship of members to each other and to the organization

CODICIL An amendment to a will.

CODIFICATION Collection and organization of piecemeal laws into a comprehensive code.

COINSURANCE CLAUSE A common provision in property insurance policies that limits the liability of the insurance company to that proportion of the loss that amount of insurance bears to a percentage of the value of the property.

COLLAR BEAM A beam that connects the pairs of opposite roof rafters above the attic floor.

COLLATERAL Property subject to a security interest; property used as security for a debt. (See Security Agreement.) Another word for security. This held until the money has been paid back.

COLLATERALLY Refers to liens secured by other liens.

COLLATERALIZATION The hypothecating of property, usually personal, as security for a loan.

COLLATERAL SECURITY The transfer of property of other valuables to ensure the performance of a principal agreement; an obligation attached to a contract to guarantee its performance.

COLLECTIBLE INCOME Gross income from property minus the vacancy and other types of rent loss. Also called gross adjusted income.

COLLUSION A secret agreement between two or more persons wishing to defraud another for a wrongful purpose or to obtain an object forbidden by law.

COLOR OF TITLE That which appears to be a good title but, in fact, is not; for example, a forged deed. A document that appears to convey title, but in fact is ineffective, conveying no title at all. It is one of the requirements for adverse possession and easement by prescription.

COMBED PLYWOOD A grooved building material used primarily for interior finish.

COMMERCIAL ACRE A term applied to the remainder of an acre of land after the area devoted to streets, sidewalks, curbs, and so on has been deducted from the acre.

COMMERCIAL BANK A financial institution chartered by the state or federal government to receive, lend and safeguard money and other items of value. They tend to loan money for construction loans, home improvement loans, and consumer loans.

COMMERCIAL LOAN A personal loan from a commercial bank, usually unsecured and short term, for other than mortgage purposes.

COMMERCIAL PAPER Negotiable instruments used in business.

COMMERCIAL PROPERTY A classification of real estate that includes income producing properties. When appraising a commercial property, the appraiser is most concerned with the sale price of comparable properties. Commercial property usually must be zoned for business purposes.

COMMERCIAL TENANT Reasons for rejecting a commercial tenant may be any one of the following; insufficient profit margin to maintain long-term rent, incompatible mix with existing tenants, and a large amount of physical alteration would be required to accommodate the tenant.

COMMINGLING The mixing of different funds so that they can no longer be distinguished. In domestic law it refers to the combination of separate property and community property, so that the separate property and community funds can no longer be distinguished; in such cases all property is considered community property. For brokers it refers to the mixing o clients' money with the broker's separate bank accounts.

COMMISSION An agent's compensation for performing the duties of his or her agency agreement. In the real estate business, it is usually a percentage of the selling price or a percentage of the lease or rents, for example. Demanding a commission or a discount based on your status as a licensee after the terms of an agreement have been struck are unethical.

COMMISSION SPLIT The previously agreed upon division of money between a broker and a sales-associate when the broker has been paid a commission from a sale made by the associate.

COMMISSIONER S FINAL REPORT Maybe used in its entirety by a subdivider in his advertisement of his subdivision.

COMMITMENT A pledge or a promise; a firm agreement.

COMMITMENT OF TITLE Similar to a preliminary title report; guarantees that the title company will issue title insurance.

COMMON AREA An entire common interest subdivision except the separate interests therein.

COMMON ELEMENTS The parts of multiple-ownership property not included in the units; those parts in which each individual owner holds an undivided interest.

COMMON GRANTOR A person who owned two or more adjacent properties and then sold them to different buyers.

COMMON INTEREST SUBDIVISION Subdivided lands which include a separate interest in real property combined with an interest in common with other owners. The interest in common may be through a membership in an association. Examples are condominiums and stock cooperatives.

COMMON LAW The body of law that grew from customs and practices developed and used in England. A body of unwritten law that developed in England from the general customs and usage. It was adopted in the United States and exercised by court decisions following the ancient English principles and the recodified law of a state.

COMMON LAW REMEDY Money awarded to a plaintiff in a civil lawsuit; damages. COMPARE: Equitable Remedy

COMMON STOCK That class of corporate stock to which there is ordinarily attached no preference with respect to the receipt of dividends or the distribution of assets on corporate dissolution.

COMMUNITY ASSOCIATIONS INSTITUTE (CAI). A professional organization offering educational programs for persons involved in homeowners, condominium, and cooperative associations

COMMUNITY CENTER A shopping center of about 100,000 to 250,000 square feet (20to70 retail spaces) supported by more than 5,000 families.

COMMUNITY LAND-USE Political factors should be incorporated into the management plan because of this.

COMMUNITY PROPERTY All property acquired by a husband and wife living together, except separate property. (See Separate Property.) Property owned in common by a husband and wife as a kind of marital partnership.

COMMUNITY REINVESTMENT ACT Federal law requiring financial institutions to lend in communities served, including low and moderate-income areas, consistent with considerations of safety and soundness.

CO-MORTGAGOR a person who signs a note or trust deed in addition to the borrower to give extra security to the loan. The co-mortgagor is jointly liable for the repayment of the loan.

COMBINATION LOAN A combined construction loan and permanent take-out loan after construction is completed.

COMPACTION Packing or consolidation of soil. When soil is added to a lot to fill in low places or to raise the level of the lot, it is often too loose to sustain the weight of buildings. Therefore, it is necessary to compact the added soil so that it will carry the weight of the building without danger of settling or cracking.

COMPARABLE PROPERTY SALES Sales which have similar characteristics as the subject property and are used for analysis in the appraisal process. Commonly called Comparables , they are recent selling prices of properties

similarly situated in a similar market.

COMPARATIVE INCOME AND EXPENSE ANALYSIS A financial study of the projected income from a property in as-is condition versus financial returns from that property if suggested capital improvements were implemented. Property managers use the analysis to demonstrate to owners the return on proposed capital expenditures.

COMPARATIVE MARKET ANALYSIS (CMA) One of three methods in the appraisal process. A means of comparing similar type properties, which have recently sold, to the subject property.

COMPARATIVE SQUARE FOOT METHOD Method of estimating construction costs using typical square foot costs for the type of construction being estimated.

COMPARISON APPROACH A real estate comparison method which compares a given property with a similar or comparable surrounding properties; also called market comparison.

COMPENSATION Anything of value or a valuable consideration, directly or indirectly paid, promised or expected to be paid or received.

COMPENSATING FACTORS Positive factors that are considered by lenders to approve loans to otherwise marginal borrowers.

COMPETENT Legally qualified or capable.

COMPETITION, PRINCIPLE OF Holds that profits tend to breed competition and excess profits tend to breed ruinous completion.

COMPETITIVE BIDS Work estimates submitted to the property manager by service contractors, suppliers, trades people or construction contractors.

COMPLAINANT A person who makes an allegation or a charge against another (the respondent).

COMPLAINT A document a plaintiff files with the court to start a lawsuit. A formal allegation or charge.

COMPOUND INTEREST Interest paid on the original principal and also on the accrued and unpaid interest that has accumulated as the debt matures.

COMPREHENSIVE PLAN (Master Plan) A statement of policies for the future physical development of an area (e.g., city, county, region).

COMPREHENSIVE ENVIRONMENTAL RESPONSE COMPENSATION AND LIABILITY ACT (CERCLA) A 1980 federal law created to impose liability on people or organizations responsible for environmental damage and to facilitate the financing of asbestos cleanup projects and property damage claims.

COMPUTERIZED LOAN ORIGINATIONS (CLOs) Accessing lender loan programs via computer.

CONCEALMENT The act of keeping from site or keeping secret.

CONCESSION A negotiable point in a lease, decide in the prospective tenant s favor.

CONCIERGE SERVICES A trend in the property management field that provides personal , secretarial, catering or other services to the occupants of office or residential buildings.

CONCLUSION The final estimate of value, realized from the facts, data, experience and judgement, set out in an appraisal. Appraisers certified conclusion.

CONCLUSIVE PRESUMPTION A legal assumption that cannot be rebutted, and is therefore accepted as true and binding on the courts.

CONCURRENT ESCROW A real estate transaction procedure in which the closing of one escrow is dependent upon the closing of another one; also called a double escrow; commonly used in exchanges and in instances where the buyer depends on funds he expects to get from the sale of another property.

CONCURRENTLY Occurring simultaneously, at the same time; real estate exchanges often must be recorded concurrently.

CONCURRENT OWNERSHIP Any form of ownership in which two or more people share title to piece of property, holding undivided interests . Also called cotenancy.

CONDEMNATION (1) The act of taking private property for public use by a political subdivision. (2) A declaration by proper governmental authorities that a structure is unfit for use. The taking of private property for public use through th exercise of the power of eminent domain.

CONDITION A provision in a contract stating that the contract will not go into effect or that it will terminate upon the occurrence of some specified future event. (1) A restriction added to a conveyance that, upon the occurrence or nonoccurrence of a some act or event, causes the estate to be defeated. (2) A contractual provision that upon the occurrence or nonoccurrence of a stated act or event, an obligation is created , destroyed, or defeated.

CONDITIONS, COVENANTS, AND RESTRICTIONS Recorded deed restrictions that run with the land, usually initiated by the original subdivider.

CONDITION PRECEDENT A condition that must occur before an estate is created or enlarged, or before some other right or obligation occurs.

CONDITION SUBSEQUENT A condition that, upon its failure or nonperformance, causes the defeat or extinguishment of an estate, right, or obligation.

CONDITIONAL COMMITMENT A loan commitment for a definite amount under certain terms and conditions. It is subject to an unknown purchaser's satisfactory credit rating.

CONDITIONAL ESTATE Usually called, in California , Fee Simple defeasible. An estate that is granted subject to a condition subsequent. The estate is terminable on happening of the condition.

CONDITIONAL FEE SEE: Fee Conditional

CONDITIONAL SALE CONTRACT A contract for the sale of property whereby the seller retains legal title until the conditions of the contract have been fulfilled. The buyer has an equitable interest in the property. (See Security Agreement.) A contract for the sale of property by which possession is delivered to the buyer, but title remains with the seller until full payment or the satisfaction of other stated conditions.

CONDITIONAL USE PERMIT An exception to or relief from the application of a zoning ordinance, because of special authorization granted by the zoning authorities. The issuance rests on public policy benefits and prior authorization in the zoning ordinance.

CONDOMINIUM A system of individual ownership of units in a multifamily structure, combined with joint ownership of common areas of the structure and the land. The ownership of an individual unit in a multi-unit structure, combined with joint ownership of common walkways, land, and other portions of the property. Each condominium is owned separately in a fee simple estate. They generally offer more amenities than other types of residential rentals or ownership. Owners can obtain secondary financing and cash out his or her equity, can sell at a higher price than paid, getting benefit from increased value or can obtain financing.

CONDOMINIUM ASSOCIATION The organization that manages the operation of a condominium, imposing assessments and arranging for the maintenance of the common areas. The association members are the unit owners., and they usually elect a board of directors.

CONDOMINIUM DECLARATION The document which establishes a condominium and describes the property rights of the unit owners.

CONDUIT Usually a metal pipe in which electrical wiring is installed.

CONFESSION OF JUDGMENT Any entry of judgment upon the debtor's voluntary admission or confession.

CONFIRMATION OF SALE A court approval of the sale of property by an executor, administrator, guardian, or conservator.

CONFLICTING DEMANDS When different parties each make claims that are inconsistent with one another.

CONFORMING LOAN A loan that does not exceed Fannie Mae/Freddie Mac limits. This limit changes annually.

CONSERVATION Minor repair, renovation and restoration of residential buildings that have substantial economic use remaining. Also called blight prevention.

CONSIDERATION Anything of value, or that is legally sufficient, given to induce someone to enter into a contract. The inducement for entering into a contract; usually money, services, or a promise, although it may consist of a legal benefit to the promisor or any legal detriment to the promisee.

CONSIDERATION, ADEQUATE Consideration that is comparable in value to the consideration of the other party to the contract is giving. A contract is enforceable even if the consideration is inadequate, but a court can not order specific performance in that case.

CONSTANT A factor representing twelve times the monthly payment expressed as a percentage of the original loan amount. A short-cut to providing annual debt service.

CONSTITUTION A fundamental document that establishes a governments structure and sets limits on power.

CONSTITUTIONAL 1. Pertaining to or based on a constitution. 2. Not in violation of the U.S. constitution or a state constitution.

CONSTRUCTION The interpretation of an ambiguous term or provision in a statute or agreement.

CONSTRUCTION CLASSIFICATION Type of construction; a system that rates the basic frame, walls, and roof of a structure as to their relative fire resistance (e.g., Class A, B, C, or D construction, Class A being the most fireproof).

CONSTRUCTION LOAN A temporary loan to a home buyer by the lender to pay the building contractor, either in installments or in one lump sum at the end of construction.

CONSTRUCTIVE A fiction imputed by law.

CONSTRUCTIVE EVICTION A breach of the landlord's warranty of quiet enjoyment. Any acts by the landlord that substantially interfere with the tenant's use and enjoyment of the premises.

CONSTRUCTIVE NOTICE Notice given by the public records; that which is considered equivalent to acutal notice even though there is not actual notice. (1) Notice given by a recorded document. (2) Notice imputed by a law because a person could have discovered certain facts upon reasonable investigation, and a "reasonable man" in the same situation would have conducted such an investigation.

CONSTRUCTIVE RECEIPT Control of the cash proceeds in a delayed exchange without the actual physical possession by the exchanger or his or her agent.

CONSUMMATE To complete.

CONSUMER CREDIT PROTECTION ACT A federal law that includes the truth-in-Leading Law.

CONSUMER GOODS Goods sold or purchased primarily for personal, family, or household purposes.

CONTIGUOUS Adjoining or touching upon , such as properties touching each other.

CONTEMPLATING AUCTIONING HOMES A homebuilder should consider the ability to quickly liquidate developments after the initial sales momentum has worn off.

CONTINGENT Conditional, uncertain, conditioned upon the occurrence or nonoccurrence of some uncertain future event.

CONTINGENCY A condition that must be met or an event that must happen before a purchase contract becomes binding between the parties.

CONTINGENCY CLAUSE SEE: Condition

CONTINUATION STATEMENT A statement filed to extend the time limit on a financing statement that had been filed earlier.

CONTRACT. An agreement to do or not to do a certain thing. It must have four essential elements: capable parties, mutual consent, a lawful object, and consideration. A contract of real estate must also be in writing and signed by the party or parties to be charged with performance.

CONTRACT, BILATERAL A contract in which each party promises to do something. COMPARE: Contract, Unilateral.

CONTRACT, EXECUTED A contract in which both parties have completely performed their contractual obligations.

CONTRACT, EXECUTORY A contract in which one or both parties have not yet completed performance of their obligations.

CONTRACT, EXPRESS A contract that has been put into words, either spoken or written.

CONTRACT, INSTALLMENT LAND SEE: Contract, Land

CONTRACT, LAND A contract for the sale of property in which the buyer pays in property immediately, but not taking title until the purchase price has been paid in full. Also called an installment land contract, installment sales contract, land sales contract, real estate contract, and other names.

CONTRACT, ORAL A spoken agreement, as opposed to a written one.

CONTRACT OF SALE (See Conditional Sale Contract.)

CONTRACT RATE Average rate charged on ARM loans or fixed-rate loans by savings institutions nationally.

CONTRACT RENT Amount of rent being paid under contractual commitments binding owners and tenants.

CONTRACT SERVICES Maintenance tasks performed by outside laborers on a regular basis for a specified fee.

CONTRACT, UNENFORCEABLE an agreement that a court would refuse to enforce; for example, it may be unenforceable because it isn t in writing, or because the statute of limitations has run out.

CONTRACT, UNILATERAL When one party promises to do something if the other party performs a certain an, but the other party does not promise to perform it; the contract if formed only if the other party does perform the requested act.
COMPARE: *Contract, Bilateral.*

CONTRACT, VALID A binding, legally enforceable contract.

CONTRACT, VOID An agreement that isn t an enforceable
contract because it lacks a required element or is defenseve in some other respect.

CONTRACTION A phase of the business cycle characterized by decreasing production.

CONTRACT, VOIDABLE A contract that one of the parties can disaffirm without liability, because of lake of capacity or a negative factor such as fraud or duress.

CONVENTIONAL MORTGAGE LOAN A loan that is made that is not federally insured or guaranteed.

CONVERSION The wrongful appropriation of another's goods to one's own use; to change from one character or use to another. (1) In tort, an unauthorized claim of ownership over another's personal property. (2) In property, the change of character of property from real to personal , or vice versa.

COOPERATIVE The main difference in this type of ownership and a condominium is that a cooperative has a blanket mortgage over the whole building.

CONVERTIBLE- RATE LOAN (Mortgage) A loan that starts out as a adjustable-rate loan, then, at the option of the borrower during a designated period , is switched to a fixed-rate loan.

CONVEYANCE (1) The transfer of the title of real property from one to another. (2) An instrument that transfers an interest in real property from one person to another. The transfer of title to real estate from one person to another.

COOPERATIVE A building owned by a corporation, where the residents are shareholders in the corporation; each shareholder receives a proprietary lease on an individual unit and the right to use the common areas.

COORDINATOR An agent of production; management.

CO-OWNERSHIP(Concurrent or multiple ownership) Title to real property held by two or more persons at the same time.

CORRESPONDENT An abbreviated term meaning mortgage loan correspondent. A mortgage banker who services loans as an agent for the owner of the mortgage. Also applies when a mortgage company originates a loan.

CORNER LOT Lot with frontage on two intersecting streets.

CORNER INFLUENCE The increase in value of a property because it is located on a corner lot.

CORPORATE COOPERATIVE Cooperative in which legal ownership of a building is being held by a corporation created for that purpose.

CORPORATION An association organized under strict rules, in which individuals purchase ownership shares; regarded by law as an artificial person, separate from individual shareholders.

CORPORATION NOT FOR PROFIT An artificial or fictitious person formed to conduct specified types of business activities.

CORPORATION, DOMESTIC A corporation doing business in the state where it was created.

CORPORATION , FOREIGN A corporation doing business in one state, but created in another state.

CORPORATION SOLE An artificial or fictitious person formed by an ecclesiastical body.

CORRECTIVE MAINTENANCE Actual repairs necessary to keep a property in good condition and operating smoothly.

CORRECTION LINES Adjustment lines used in the government survey system to compensate for the curvature of the earth. They occur at 24-mile intervals (every fourth township line), where the distance between range lines is corrected to 6 miles.

CORRELATION SEE: *Reconciliation*

REAL ESTATE TERMINOLOGY

A Course Companion for Studying for The Real Estate Exam, for Real Estate Home Study Courses, for Real Estate Continuing Education Courses, for Real Estate Statutory Courses, and for Any Form of College Real Estate Course.

COST The expenditure of monies necessary for the creation of improvements on a property.

COST APPROACH TO VALUE (Cost-depreciation Approach) A method in which the value of the property is derived by estimating the replacement cost of the improvements, then deducting the estimated depreciation, then adding the market value of the land. This is most efficient when used estimating the cost of a new building. The information used in this approach is called Cost Data

COST OF FUNDS The cost to the lender, expressed as a percentage, to obtain funds for lending,. Includes interest paid to depositors, cost of borrowing, advertising, giveaways and other sales costs, administrative and overhead costs, reserves, etc.

CO-TENANT Anyone who shares ownership of a piece of property with another; may be a joint tenant, a tenant in common, a tenant in partnership, or a spouse owning community property.

CO-TENANCY Any form of joint ownership.

COUNTER OFFER Rejection of an offer to buy or sell, with a simultaneous substitute offer.

COUNTY RECORDS A system for recording documents in permanent books at the county court house; maintained by each county and provided for by law; open to public examination

COUNTY TAX RATE. The county tax rate is set annually by the County Treasurer.

COURSE A direction, stated in terms of a compass bearing, in metes and bounds description of property.

COURT-ANNEXED A court mandated arbitration.

COOPERATIVE APARTMENT A form of ownership in which each individual apartment owner shares in a cooperative venture that entitles the owner to use, rent, or sell a specific apartment unit.

CORPORATION A group or a body of persons recognized by law as an individual person with rights and liabilities distinct from those of the persons comprising it. Since the corporation is created by law, it may continue for any length of time that the law prescribes. An artificial entity given authority to conduct business and possess many of the rights of natural persons. One of the key characteristics is that of perpetual existence.

COST SEE: *Replacement Cost, Reproduction Cost.*

COST APPROACH One of the three classic approaches to value. It involves estimating the replacement cost new of the improvements, deducting the estimated accrued depreciation, and then adding the market value of the land. This is called the Summation Method.

COST BASIS See *Adjusted Cost Basis*.

COST MULTIPLIER Factor used in adjusting published construction cost figures to estimate current and local costs.

COST-PLUS A method of paying construction contractors in which the contractor furnishes a preliminary estimate for the proposed job and is paid the actual cost of the work plus a percentage of profit.

COST-TO0CURE METHOD OF DEPRECIATION Method of estimating accrued depreciation (loss in value) based on the cost to cure or repair observed building defects.

COUNTER FLASHING Flashing used on chimneys at roof-line to cover shingle flashing and prevent moisture entry.

COUNTER-OFFER The rejection of an offer by the submission of another offer, different in terms from the original offer. Any purported acceptance of an offer that introduces new terms is a rejection of that offer, and amounts to a counter-offer.

COURT-ANNEXED ARBITRATION This may be ordered by the superior court when the sum at stake is less than $50,000 dollars.

COURT PAPERS These papers cannot be served by the property owner or manager.

COURTYARD HOME SEE *Zero-Lot-Line Home*.

COVENANT An agreement or a promise to do or not to do a particular act. Covenant: A contractual agreement whereby one of the parties promises to perform or to refrain from doing certain acts.

COVENANT OF QUITE ENJOYMENT A promise that buyer or tenants possession will not be disturbed by the previous owner, the lessor, or anyone else claiming an interest in the property.

CPI (CERTITFIED PROPERTY INDEX) This index is commonly used for rent increases in office buildings

CPM Certified Property Manager; a member of the Institute of Real Estate Property management of the National Association of Realtors.

CRAWL HOLE Exterior or interior opening permitting access underneath a building, as building codes may require

CREATIVE FINANCING Any financing out of the ordinary, such as seller carrybacks and wrap-arounds.

CREDIT A payment receivable as opposed to a debi, which is a payment due.

CREDIT APPLICATION A statement provided by the borrower for a prospective lender in order to establish or exhibit financial stability.

CREDIT BID When a lien holder purchasing the security property at a foreclosure sale is allowed to apply the amount the borrower owes him or her to the purchase, rather than having to pay the full amount of the bid in cash.

CREDIT REPORT Credit history of a person or business issued by a company in the credit reporting business, used to help determine creditworthiness.

CREDITOR One who is owed a debt.

CREDITOR, SECURED A creditor with a lien on specific property, which enables him or her to foreclose or collect the debt from the sale proceeds if it is not otherwise paid.

CRIMINAL LAW The body of law concerned with crimes, an individuals action against society.

CUL-DE-SAC A dead end street.

CUL-DE-SAC LOT Lot located at or near the end of a dead-end street.

CURABLE DEPRECIATION Items of physical deterioration or functional obsolescence that if repaired would add at least as much of the market value of the property as the cost of repairs.

CURE To remedy a default, by paying money that is overdue or fulfilling other obligations.

CURB APPEAL The impression gained, good or poor, of a property when it is first seen, usually from the street while driving, hence curb appeal.

CURBSTONE APPRAISAL A slang phrase, implying an informal valuation of a property based on observation and experience.

CURTAIL SCHEDULE A list of the due dates and amounts by which the principal sum of an obligation will be reduced by partial payments.

CUSTOMER A prospective property buyer.

CYCLICAL FLUCTUATION See *business cycle*

D

DAMAGES The indemnity recoverable by a person who has sustained an injury to either his or her person, property, or rights through the act or default of another. Compensation ordered by the courts for the loss of or injury to one's person or property.

DAMAGES, ACTUAL Compensatory damages.

DAMAGES, COMPENSATORY Damages intended to compensate the plaintiff for harm caused by the defendants an or failure to, including personal injuries (physical and mental), property damage and financial loss.

DAMAGES, CONSEQUENTIAL Damages compensating for loses that where not the direct result of the defendants wrongful act, but which were foreseeable consequence of it.

DAMAGES, EXEMPLARY Punitive damages

DAMAGES, LIQUIDATED A sum that the parties to a contract agree in advance (at the time of entering into the contract) will serve as compensation in the event of a breach.

DAMAGES, PUNITIVE An award added to compensatory damages , to punish the defendant for malicious or outrageous conduct and discourage others from similar acts.

DATA PLANT An appraisers file of information on real estate.

DATUM An artificial horizontal plane of elevation, established in reference to sea level, used by surveyors as a reference point in determining elevation.

DEALER A person who holds property primarily for sale

to his or her customers in the ordinary course of his or her business.

DEALER PROPERTY Property held for sale to customers rather than as a long-term investment; a developers inventory of subdivision lots, for example.

DEATH OCCURRING ON THE PROPERTY A broker listing a property for sale must disclose a death accruing on the property within three years before the sale.

DEBENTURE Bonds issued without security, an obligation not secured by a specific lien on property.

DEBIT A bookkeeping entry on the left side of an account, recording the creation of or addition to an asset or expense, or reduction or elimination of a liability or item of equity or revenue.

DEBT COVERAGE RATIO (DCR) Net operating income divided by annual debt service. Used by lenders when analyzing income property loans.

DEBT-TO-INCOME RATIO Borrowers monthly payment obligations as a percentage of their income.

DEBTOR (1) A party who "owns" the property that is subject to a security interest. (2) A person who owes a debt.

DEBT SERVICE The sum of money needed each payment period to amortize the loan or loans.

DECEDENT A person who has died.

DECIDUOUS Trees which shed their leaves at seasonal intervals.

DECISIONAL LAW SEE: Case Law

DECK Usually an open porch on the roof or another part of the structure.

DECLARATION The legal document that the developer of a condominium must file and record in order to create a condominium under state law.

DECLARATION OF ABANDONMENT A document recorded by an owner that voluntarily releases a property from homestead protection.

DECLARATION OF RESTRICTIONS SEE: CC&Rs

DECLARATION OF HOMESTEAD A single-family dwelling; a house situated on a two-acre parcel; a fourplex.

DECLARATION OF TRUST A formal instrument filed by a business trust with the Department of State as a prerequisite for creating the trust.

DECLARATORY JUDGEMENT A course of action declaring rights claimed under a contract or statute intended to prevent loss or guide performance by the party or parties affected.

DECLARATORY RELIEF A court's decision on the rights of the parties in a question of law, without ordering anything to be done.

DECLINE PHASE Third phase in the cycle of a neighborhood, generally marked by delayed repairs and deterioration of buildings.

DECLINING BALANCE DEPRECIATION A method of accelerated depreciation allowed by the IRS in certain circumstances. Double Declining Balance Depreciation is its most common form and is computed by using the rate used for straight line deprecation

DECREE OF FORECLOSURE Decree by a court ordering the sale of mortgaged property and the payment of debt owing to the lender out of the proceeds.

DEDICATION An appropriation of land by its owner for some public use and accepted for such use by authorized public officials on behalf of the public. A gift of privately owned land to the public or for public use. It may be voluntary or involuntary.

DEDICATION, IMPLIED Involuntary dedication, resulting from an owners acquiescence to public use of his or her property for at least 5 years. Also called common law dedication.

DEDICATION, STATUTORY A dedication required by law; for example , dedication of property for streets and sidewalks as a prerequisite to subdivision approval.

DEDUCTION An amount a taxpayer is allowed to subtract from his or her income before calculating the tax on the income.

DEDUCTION, COST RECOVERY An income tax reduction that allows the taxpayer to recover the cost of depreciable property used for the production of income or used in trade or business. Formerly called a deprecation deduction.

DEDUCTION, REPAIR An income tax deduction allowed for expenditure made to keep property in ordinary, efficient operating condition, not allowed for a principal residence or personal use property.

DEED A written instrument that when properly executed and delivered conveys title.

DEED CORRECTION A deed used to correct minor mistakes in an earlier deed, such as misspelled names or errors in the legal description.

DEED, GENERAL WARRANTY A deed in which the grantor warrants the title against defects that might have arisen before or during his or her period of ownership. COMPARE: Deed, Special Warranty.

DEED, GIFT A deed that is not supported by a valuable consideration; often lists love and affection as the consideration.

DEED, GRANT Any deed that uses the word grant in its
words of conveyance; carries two implied warranties and conveys after-acquired title. The most commonly used deed in California. COMPARE: Deed, Quitclaim.

DEED, QUITCLAIM A deed that conveys any interest in a
piece of real property the grantor has at the time deed is executed. Often used to clear up a cloud on the title. It contains no warranties of any kind, and does not convey after-acquired title. COMPARE Deed. Grant.

DEED IN LIEU OF A FORECLOSURE To prevent a foreclosure from happening an owner may give the mortgagor the deed to the property to stop the foreclosure proceedings.

DEED OF RECONVEYANCE A legal instrument that conveys title from a trustee back to the borrower under a mortgage once the mortgage has been paid out,

DEED OF TRUST A security instrument transferring title to property to a third person (trustee) as security for a debt or other obligation.

DEED OF TRUST, BLANKET 1. A trust deed that covers more than one parcel of real estate. 2. A trust deed that covers an entire building or development, rather than an individual building or lot.

DEED OF TRUST, FICTITIOUS A blank trust deed form filed for record to save recording costs on real deeds of trust.

DEED OF TRUST, JUNIOR A second (or third, etc.) Deed of trust , with lower lien priority than the first trust deed.

DEED OF TRUST, SENIOR A deed of trust with higher priority than another deed of trust on a property.

DEED RESTRICTION A restrictive covenant in a deed.

DEEMER PERIOD Refers to the way this state regulates rate fillings by title companies, in other words, how approval is obtained for rate fillings by the regulatory authorities.

DEFAULT (1) Failure to fulfill a duty or promise or to discharge an obligation. (2) Omission or failure to perform any act. Failure to perform a legal duty or to discharge a promise.

DEFAULT JUDGMENT A judgment obtained because the defendant failed to appear and defend his case.

DEFEASIBLE FEE Sometimes called a base fee or qualified fee; a fee simple absolute interest in land that is capable of being defeated or terminated upon the happening if a specified event.

DEFEASANCE CLAUSE The clause in a mortgage or deed of trust that gives the borrower the right to redeem his or her property upon the payment of his or her property upon the payment of his or her obligations to the lender.

DEFEASIBLE Capable of being defeated. A defeasible estate is one that has a condition attached to the title, which if broken causes the termination of that estate.

DEFECT *(See Cloud on Title)*

DEFENDANT The party being sued in a lawsuit; the party against whom an action is filed.

DEFERMENT A right to defer payment of an obligation (such as paying taxes) until a later date.

DEFERRED INTEREST See *Negative amortization*

DEFERRED MAINTENANCE Maintenance and accumulated repairs that have been postponed to later dates

DEFERRED PAYMENT OPTIONS The privilege of deferring income payments to take advantage of statutes affording tax benefits.

DEFICIENCY JUDGEMENT(Decree) A judgment given for

the unpaid balance of a debt remaining after the surety is sold. A court decree holding a debtor personally liable for the shortage or insufficiency realized on the sale of secured property. The debtor owes the difference between the sale price of the property and the amount of the secured debt.

DEFINE THE PROBLEM The first step in the appraisal process.

DELAYED SELLING Most inventories of real estate are held back because the owners expect the interest rates to drop.

DELEGATION OF POWERS The conferring upon by an agent upon another of all or certain of the powers that have been conferred upon the agent by the principal.

DELINQUENCY Failure to make timely payments on a loan.

DELIVERY (OF A DEED) The unconditional, irrevocable intent of a grantor immediately to divest (give up) an interest in real estate by a deed or other instrument.

DEMAND The desire to possess, plus the ability to buy; an essential element of value.

DEMAND DEPOSIT Checking accounts or transaction deposit withdrawable upon demand, as opposed to time deposit.

DEMINIMUS VALUE Transactions with a value less than a certain minimum amount.

DEMISE A transfer of an estate to another person for a specified period of years, for life, or at will.

DENIAL A refusal or rejection.

DENSITY The number of homes or lots per acre.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT (HUD) A government agency authorized to construct and provide financial assistance to housing development for low income tenants.

DEPARTMENT OF VETERANS AFFAIRS (DVA) A government agency that guarantees approved lenders against foreclosure loss on loans made to eligible veterans.

DEPOSIT (MONEY) Money given to another as security to ensure the performance of a contract. The money is usually intended to be applied toward the purchase price of property, or forfeited on failure to complete the contract. The claim of the tenant to this money comes before any creditors of the landlord. The landlord must furnish a written statement showing the amount received and the amount disbursed to the tenant. All unused deposit money must be returned to the tenant with proper accounting within two weeks after vacating premises.

DEPOSITION The formal, out of court testimony of a winess in a lawsuit, taken before the trial; used as part of the discovery process, to determine the fans of the case, or if or if the witness will not be able to attend the trial. A transcript of a deposition can be introduced as evidence in a trial.

DEPOSIT RECEIPT The document used for a prospective real estate buyers offer to a seller, which also serves as the buyer s receipt for deposit. If the seller accepts the receipt it becomes their contract; also called an earnest money agreement or purchase and sale agreement.

DEPRECIATE To decline in value.

DEPRECIATED COST METHOD Method for adjusting comparable sales; adjustments are calculated from an analysis of the depreciated replacement cost for each differentiating feature.

DEPRECIATION A loss in value from any cause. This loss in value to real property may be caused by age or physical deterioration, or by functional or economic obsolescence.

DEPRECIABLE PROPERTY Property that s eligible for depreciation (cost recovery) deduction because it will wear out and have to be replaced.

DEPTH Distance from the frontage of a lot to the rear lot line.

DEPTH TABLES Depth tables are used by appraisers when determining value of business property that varies in depth.

DESCENT The passage of title to real property upon the death of the owner to his or her legal descendants.

DESCRIPTION A reference to certain maps, plats, and other instruments that are recorded with the county and serve to make a positive property identification.

DESK COST The total of rent, telephone, utilities, advertising and other expenses divided by the number of desks found in a real estate office.

DESIGN TYPE Classification of buildings based on the use for which a structure is designed.

DEREGULATION An easing and relaxing of rules and regulations for lenders.

DESIGNATED SALES ASSOCIATES(FL) Two real estate licensees designated to represent the buyer and the seller as single agents in a nonresidential transaction. The buyer and seller must have assets of more than $1 million or more and sign disclosures stating their assets meet the required threshold.

DESIST AND REFRAIN ORDER An order that the Real Estate Commissioner is empowered by law and refrain from committing an act in violation of the Real Estate Law.

DETERIORATION The process of gradual worsening or depreciation.

DETERMINABLE FEE An estate which may end on the happening of an event that may or may not occur.

DETRIMENTAL RELIANCE SEE: Estoppel, Promissory

DEVELOPMENT PHASE First phase in the life cycle of a neighborhood, consisting of the initial construction of improvements on vacant land.

DEVELOPMENT STAGE The first stage in a development cycle.

DEVELOPMENT METHOD (LAND DEVELOPMENT METHOD) Method of vacant land valuation; development costs are subtracted from estimated gross sales, and finally, developers profits are accounted for. The results are an estimate of raw land value.

DEVELOPMENT OF REGIONAL IMPACT(DRI) A large project affecting more than one county.

DEVELOPER WHO PLANS WELL To be one of these a developer must anticipate risks and profits, survey the market and measure present needs.

DEVISE A gift of real property by deed.

DEVISEE One who receives real property under a will.

DEVISOR One who disposes of real property by will.

DICTU A written observation, remark, or opinion by a judge to illustrate or suggest an argument or rule of law not incidental to the case at hand, and which, therefore, although persuasive, is not binding on the judge.

DIMINISHED UTILITY SEE: Accrued Depreciation.

DIRECT CAPITALIZATION METHOD Income capitalization technique; value is estimated by dividing net operating income by the overall capitalization rate.

DIRECT COSTS All of the costs that are directly involved with the physical construction of the structure, including labor, materials and equipment, design and engineering, and subcontractors fees.

DIRECT MANAGEMENT COURSE Expenses that can be attributed directly to the operation of a management firm or department.

DIRECT MARKET COMPARISON APPROACH SEE: Sales Comparison Approach.

DIRECT MARKET METHOD Method of adjusting comparable sales; two or more comparable properties with one differing feature are used to estimate the amount of the adjustment for that feature. (Also called the matched pair method.)

DIRECTIONAL GROWTH The direction in which the residential sections of a city seem destined or determined to grow.

DISABLED PERSONS A hotel or lodging house need not be designed to accommodate disabled persons if it contains fewer than 25 rooms.

DISABLED TENANT A landlord may not charge an additional security deposit for a disabled tenant s guide dog. A landlord may modify residential rental property to accommodate the needs of disabled tenants.

DISABILITY Any physical or mental impairment that substantially limits one or more of an individual s major life activities, including carin for oneself, performing manual tasks, walking, seeing, hearing, speaking and working.

DISAFFIRM To ask a court to terminate a voidable contract.

DISBURSEMENT The release of monies held in an escrow account; usually on the day that escrow closes.

DISCLOSURE REQUIREMENT If a real estate licencee or seller willfully or negligently fails to comply with the disclosure requirements he or she will be liable for any actual damages suffered by a buyer.

DISCLOSURE STATEMENT A statement that the Truth-in-Lending Law requires a creditor to give a debtor showing the finance charge, annual percentage rate, and other required information.

DISCOUNT To sell a promissory note before maturity at a price less than the outstanding principal balance of the note at the time of sale. It may also be the amount deducted in advance by the lender from the face of the note.

DISCOUNT DEPARTMENT STORES A specialized type of shopping center or a large single store with emphasis on lower prices as a merchandising technique. The closed door discount house is open only to qualifying members; the open discount house is open to the general public.

DISCOUNT POINTS A fee charged by the lender when making an FHA or VA loan to offset the lower interest rate the lender will receive compared with conventional loan interest rates. One point is equal to 1 percent.

DISCOUNT RATE The interest rate that is charged on money borrowed by banks from the Federal Reserve System.

DISCOUNT TABLES Tables used by lenders and investors to show how much a given value is, called the discounted value, based upon various interest rates and terms of maturity.

DISCRETIONARY POWERS OF AGENCY Those powers conferred upon an agent by the principal which empower the agent in certain circumstances to make decisions based on the agent s own judgement.

DISCRIMINATION Failure to advertise real estate for sale in non-English publications does not constitute unlawful discrimination if the property offered is in an area with a significant non-English speaking population.

DISCOUNTED CASH FLOW (DCF) Technique of income capitalization; estimated future investment returns are discounted to a present value.

DISCRIMINATORY BUSINESS PRACTICES A broker engaging in discriminatory business practices is subject to DRE discipline.

DISCRIMINATORY PREFERENCE Use of the words Restricted , Exclusive and Private , in real estate advertising should be avoided as they indicate discriminatory preferences.

DISINTERMEDIATION The sudden withdrawal of substantial sums of money savers have deposited with savings and loan associations, commercial banks, and mutual savings banks. This term can also be considered to include life insurance policy purchasers borrowing against the value of their policies. The essence of this phenomenon is financial intermediaries losing within a short period of time billions of dollars as owners of funds held by those institutional lenders exercise their prerogative of taking them out of the hands of these financial institutions.

DISPOSABLE INCOME The after-tax income a household receives to spend on personal consumption.

DISPOSSESS To deprive one of the use of real estate.

DISPOSSESS PROCEEDINGS A suit brought by a landlord to evict a tenant for defaulting in the terms of the lease. Also known as unlawful detainer actions.

DISSOLUTION OF MARRIAGE A divorce.

District A neighborhood that contains only one kind of land use.

DISTRICT COURT The main trial court in the federal court system and the lowest federal court. It has jurisdiction in civil cases where the plaintiffs and defendants are from different states (diversity of citizenship) and the amount in controversy is over $10,000, and in cases involving a federal question.

DIVESTMENT The elimination or removal of a right or title, usually applied to the cancellation of an estate in land.

DIVIDED AGENCY When a broker or an agent acts on behalf of both parties he is considered a divided agent See *dual agent*

DOCTRINE OF CORRELATIVE USERS An owner may use only a reasonable amount of the total underground water supply for his or her beneficial use.

DOCUMENTARY TRANSFER TAX A state enabling act allows a county to adopt a documentary transfer tax to apply to

all transfers of real property located in the county. Notice of payment is entered on the face of the deed or on a separate paper filed with the deed.

DOCUMENTARY (DOC) STAMPS Tax applicable to property transfers and affixed to the grant deed; varies from county to county, city to city; sometimes called a transfer tax

DOCUMENTARY STAMP TAX ON DEEDS, STATE Tax required on all deeds or other documents used as conveyances. The charge is based on the total purchase price.

DOCUMENTARY STAMP TAX ON NOTES, STATE Tax required on all promissory notes. The cost is based on the face value of the note.

DEVELOPMENT PHASE First phase in the life cycle of a neighborhood, consisting of the initial construction of improvements on vacant land.

DOCUMENTS Legal instruments such as mortgages, contracts, deeds, options, wills, bills of sale, etc.

DOMICILE A person's permanent residence.

DOMINANT TENEMENT The tenement obtaining the benefit of an easement appurtenant. That parcel of land that benefits from an easement across another parcel of property (servient tenement).

DONEE The person to whom a gift is made.

DONOR The person who makes a gift.

DORMER A projection built out over the slope of a roof, used to house windows on the upper floor to provide additional light and ventilation.

DOUBLE DECLINING BALANCE DEPRECIATION (See *DECLINING BALANCE DEPRECIATION*)

DOUBLE ESCROW An escrow that will close only upon the condition that a prior escrow is consummated. The second escrow is contingent upon and tied to the first escrow. While double escrow is not illegal, unless there is full and fair disclosure of the second escrow, there may be a possibility of fraud or other actionable conduct by the parties.

DOUBLE-HUNG A window consisting of two sashes that move up and down in a pair of channels and are held open by tension springs.

DOWER The right that a wife has in her husband's estate at his death. Dower has been abolished in California.

DOWN PAYMENT The difference between the sale price of the property and the loan amount.

DRE Ethics Regulations Do not compel a broker to cooperate with other brokers by sharing property information.

DRAW Usually applies to construction loans when disbursement of a portion of the mortgage is made in advance, as improvements to the property are made.

DUAL AGENCY Representing both principals in a transaction. (Not a legal agency relationship in the state of Florida)

DUAL AGENT Even if the buyer s broker does not intend to be a dual agent by of his conduct, the seller s deposit receipt agreement to employ him makes the seller his principal and client in addition to the buyer. Before a broker acting as a dual agent on the sale of one-to-four unit residential property may relay confidential pricing information to the party, the broker must have written authority to release it.

DUE-ON-ENCUMBRANCE CLAUSE A clause in a deed of trust or mortgage that provides that upon the execution of additional deeds of trust or other encumbrances against a secured parcel of property, the lender may declare the entire unpaid balance of principal and interest due and owing.

DUE-ON-SALE CLAUSE An acceleration clause that grants the lender the right to demand full payment of the mortgage or deed of trust upon sale of the property. A clause in a deed of trust or mortgage that provides that if the secured property is sold or transferred, the lender may declare the entire unpaid balance immediately due and payable. Its use has been severely limited by recent court decisions. Also called an alienation clause.

DUN & BRADSTREET A credit-reporting agency that publishes credit ratings for many corporations and businesses.

DUE PROCESS OF LAW A constitutional guarantee that the government will not interfere with a person's private property rights without following procedural safeguards prescribed by law.

DURESS Unlawful constraint by force or fear.

DURESS, ECONOMIC Threatening to take some action that will be financially harmful to a person, to force him or her to sign a document; for example, threatening to breach a

contract. Also called business compulsion.

DUTIES OF AN AGENT A special relationship of trust by which one person (agent) is authorized to conduct business, sign papers or otherwise act.

DVA Department of Veteran Affairs, established on March 15, 1989 to succeed the Veterans Administration.

E

EARNEST MONEY DEPOSIT A deposit of money paid by a buyer for real property as evidence of good faith.

EARNEST MONEY AGREEMENT SEE: Deposit Receipt

EASEMENT A right, privilege, or interest that one party has to use the land of another. Example: A right of way. A legal right to use another's land for one's benefit or the benefit of one's property (right-of-way).

EASEMENT APPURTENANT An easement created for the benefit of a particular parcel of property. There is both a dominant and a servient estate. The easement is annexed to and part of the dominant property.

EASEMENT, IMPLIED SEE: Easement by Implication.

EASEMENT, NEGATIVE An easement that prevents the servient tenant from using his or her own land in certain way (instead of allowing the dominant tenant to use it). Essentially the same thing as a restrictive covenant.

EASEMENT, POSITIVE An easement that allows the dominant tenant to use the servient tenement in a particular way.

EASEMENT BY PRESCRIPTION This brought about by open and notorious use over a long period of time.

EASEMENT, PRESCRIPTIVE An easement acquired by prescription.

EASEMENT BY EXPRESS GRANT An easement granted to another in a deed or other document.

EASEMENT BY EXPRESS RESERVATION An easement created in a deed when a landowner is dividing the property, transferring the servient tenement but retaining the dominant tenement.

EASEMENT BY IMPLICATION An easement created by law (not by express grant) when a parcel of land is divided, it there is a long-standing, apparent use that is reasonably necessary for the enjoyment of implied easement. COMPARE: Easement by Necessity.

EASEMENT BY NECESSITY A special type of implied easement; when the dominant tenement would be completely useless without an easement, an easement exists even if it isn t a long-standing, apparent use.

EASEMENT IN GROSS An easement that benefits a particular individual, not a parcel of property. Involves only a servient estate. A public utility easement is an example.

EASY MONEY Loose money policy of the federal reserve board.

EAVES The lower projecting edge of a roof over the wall.

ECONOMIC BASE STUDIES An analysis of employment in the primary industries of the region.

ECONOMIC LIFE The remaining useful life of an improvement or structure; that period during which an improvement will yield a return on the investment.

ECONOMIC OBSOLESCENCE The loss in value to property due to external causes such as zoning or a deteriorating neighborhood. It is also referred to as social obsolescence.

ECONOMIC OVERSUPPLY A market condition in which available rental space is priced beyond the financial capabilities of potential tenants.

ECONOMIC RENT The reasonable rental expectancy if the property were available for renting at the time of its valuation.

ECONOMIC TREND Pattern of related changes in some aspect of the economy.

EER Means Energy Efficient Ratio

EFFECT A SALE A provision in a listing contract requiring the broker to obtain a signed contract from a ready; willing and able buyer on the terms specified.

EFFECTIVE AGE OF IMPROVEMENT The number of years of age that is indicated by the condition of the structure, distinct from chronological age.

EFFECTIVE DATE OF VALUE (APPRAISAL) The specific day the conclusion of value applies.

EFFECTIVE GROSS RENT Gross rent, minus an allowance for vacancy and credit losses.

EFFECTIVE INTEREST RATE The percentage of interest that is actually being paid by the borrower for the use of the money, distinct from chronological age.

EFFECTIVE GROSS INCOME The amount of net income that remains after the deduction from gross income of bad debt vacancy factor and credit losses.

EGRESS Exit; the act or avenue or leaving property.

EIGHTEEN YEARS The legal age for getting a real estate license

E.I.R. Abbreviation for Environmental Impact Report.

ELECTIVE SHARE An estate defined as consisting of 30 percent of the decedents s personal property and Florida real property, except homestead exempt property claims.

ELEMENTS OF COMPARISON Four categories of information about sales: terms of sale, time of sale, location elements, and physical elements.

ELEMENTS OF VALUE Four prerequisites that must be present for an object to have value: utility, scarcity, demand, and transferability.

ELECTRONIC DATA PROCESSING The use of a computer to compile and process information.

ELLWOOD TECHNIQUE A mortgage/equity method of capitalization.

ELEVATION SHEET Drawings of the front and side views of the finished homes.

EMBEZZLED FUNDS Are reportable as income for tax purposes.

EMBLEMENTS Things that grow on the land require annual planting and cultivation.

EMINENT DOMAIN The right of the government and certain others, such as public utilities, to acquire property for public or quasi-public use by condemnation, upon payment of just compensation to the owner. The constitutional or inherent right of a government to take private property for public good upon the payment of just compensation.

EMPLOYEE Someone who works under the direction and control of another. COMPARE: Independent Contractor.

EMPLOYMENT AGREEMENT An agreement between broker and salesman must be kept by both broker and salesman for three years from date of termination.

EMPLOYER The individual who hires the services of another.

EMPTY NESTER Older parents whose housing needs change after their children have moved away.

ENCROACHMENT The projection of a structure onto the land of an adjoining owner. A structure or natural object that unlawfully extends into another's property.

ENCUMBRANCE (CLAUSE) Any claim, interest, or right in property possessed by another that may diminish the true owner's rights or value in the estate. Examples include mortgages, easements, or restrictions of any kind. A claim, lien, or charge on property.

ENDORSEMENT See Indorsement.

ENJOIN To prohibit an an, or command performance of an an, by court order; to issue an injunction.

EQA The California Environmental Quality Act.

ENVIRONMENTAL IMPACT REPORT A report that must be prepared whenever any agency or individual considers a project that may have a significant impact on the environment, as directed by the California Environmental Quality Act.

ENVIRONMENTAL PROTECTION AGENCY (EPA) A federal organization created by The National Environmental Policy Act. The EPA s purpose is to centralize governments s environmental responsibilities.

EQUAL CREDIT OPPORTUNITY Federal law prohibiting discrimination in the extension of credit.

EQUAL PROTECTION The Fourteenth Amendment to the U.S. Constitution and similar provisions in the California Constitution require each citizen to receive equal protection of the laws. There are no minimum standards of protection; all equally situated individuals must simply be treated equally. (The due process clause of the Constitution imposes certain minimum standards of protection.)

EQUILIBRIUM When supply equals demand.

EQUITABLE REMEDY A judgment granted to a plaintiff that is something other than an award of money (damages);
an injunction, quiet title, rescission, and specific performance are examples. COMPARE: common Law Remedy.

EQUITABLE TITLE SEE: Title, Equitable.

EQUITY (1) The interest or value that on owner has in real property over and above the liens against it. (2) A part of our justice system by which courts seek to supplement the strict terms of the law to fairness under the circumstances, rather than on fixed legal principles or statutes. (3) Ownership in property, determined by calculating the fair market value less the amount of liens and encumbrances.

EQUITY BUILD-UP The increase of the owner's equity due to mortgage principal reduction and value appreciation.

EQUITY CAPITALIZATION RATE Factor used to estimate the value of the equity in the equity-residual technique of capitalization and other mortgage and equity techniques; the equity cash flow divided by the equity value.

EQUITY FINANCING Lender finances high-ratio loan in exchange for a percentage of ownership and the right to share in the property s cash flow.

EQUITY PARTICIPATION A mortgage transaction in which the lender, in addition to receiving a fixed rate of on the loan acquires an interest in the borrowers real property, and shares in the profits derived from the property.

EQUITY OF REDEMPTION The right to redeem property during the foreclosure period. In California the mortgagor has the right to redeem within 12 months after the foreclosure sale.

EQUITY RESIDUAL TECHNIQUE Technique of income capitalization; The net income remaining to the equity position (after mortgage payments) is capitalized into an estimate of the value of the equity.

EROSION The wearing away of the surface of the land by the action of wind, water, and glaciers, for example.

ERROR, HARMLESS A mistake by a trial judge that did not affect the final judgment in the case.

ERROR, PREJUDICIAL a mistake by a trial judge that may have affected the final judgment in the case. Also called reversible error (because it s grounds for reversing the trial court s decision).

ESCALATION The right reserved by the lender to increase the amount of the payments and/or interest upon the happening of a certain event.

ESCALATION CLAUSE A lease clause providing that rental rate will increase or decrease according to selected index of economic conditions, such as the consumer price index.

ESCALATOR CLAUSE A clause in a contract that provides for the upward or downward adjustment of certain items to cover the specific contingencies set forth. A clause in a promissory note, lease, or other document that provides that upon the passage of a specified time or the happening of a stated event, the interest rate shall increase.

ESCHEAT The reversion of property to the state when there are no devisees or heirs capable of inheritance. Reversion of property to the state upon the death of an owner who has no heirs able to inherit.

ESCROW (ACCOUNT) The deposit of instruments and funds with a third neutral party with instructions to carry out the provisions of an agreement or contract. A complete or perfect escrow is one in which everything has been deposited to enable carrying out the instructions. The neutral third party (stakeholder) who holds deeds or other documents pursuant to instructions for delivery upon completion or occurrence of certain conditions.

ESCROW AGENT The neutral third party holding funds or something of value in trust for another or others.

ESCROW COMPANY When an escrow company acts as escrow, it must be licensed by the Commissioner of Corporations.

ESCROW DISBURSEMENT ORDER (EDO) A course of action for determining the disposition of a contested deposit.

ESCROW HOLDERS Lending institutions and attorneys can act as escrow, as can brokers. Brokers can act only as escrow holders in a transaction if he charges the fees provided by law.

ESCROW INSTRUCTIONS The document that authorizes

an escrow agent to deliver items deposited in escrow once the parties have complied with specified conditions.

ESCROW MEMO The escrow memo contains the names of the buyer and the seller. It also contains information, is a form, and helps with the escrow instructions.

ESCROW NUMBER The file number assigned to an escrow by the escrow officer for identification purposes.

ESCROW OFFICER Also known as an escrow agent, someone qualified to perform all the steps necessary to prepare and carry out escrow instructions.

ESTATE The degree, quantity, nature, and extent of the interest that a person has in real property. (1) Ownership interest in real estate. (2) The quality and quantity of rights in property.

ESTATE AT SUFFERANCE An estate arising when the tenant wrongfully holds over after expiration of the term. The landlord has the choice of evicting the tenant as a trespasser or accepting such tenant for a similar term and under the condition of the tenant's previous holding. Also called a tenancy at sufferance.

ESTATE AT WILL The occupation of real property by a tenant for an indefinite period. It may be terminated at will by one or both parties. A leasehold tenancy, which at common law could be terminated by either party at any time, without advance notice. Thirty days' notice are now required to terminate this type of estate in California.

ESTATE BY THE ENTIRETIES A tenancy created by the husband and wife jointly owning real property with instant and complete right of survivorship.

ESTATE FOR LIFE A freehold estate whose duration is measured by and limited to the life or lives of one or more persons.

ESTATE FROM PERIOD TO PERIOD A leasehold tenancy that continues indefinitely for successive periods of time, until terminated by proper notice. When the periods are one month in duration, it is often called a month-to-month tenancy.

ESTATE TAXES These are a form of taxes that are paid off by the estate of the deceased.

ESTATE FOR YEARS A lease that will expire at a definite time or date. A leasehold tenancy of a fixed duration, being a definite and ascertainable period of a year or any fraction of multiple thereof. It has a definite beginning and ending date, and hence a known and definite duration.

ESTATE IN FEE SIMPLE SEE: *Fee Simple*.

ESTATE IN REMAINDER SEE: *Remainder.*

ESTATE IN REVERSION SEE: *Reversion.*

ESTATE IN SOLE Real property owned by a corporation.

ESTATE OF INHERITANCE An estate that may go to the heirs of the deceased. All freehold estates are estates of inheritance, except life estates.

ESTIMATE A preliminary opnion of value. Appraise, set a value.

ESTIMATED REMAINING LIFE The period of time (years) it takes for the improvements to become useless.

ESTOP To ban, stop, or impede.

ESTOP NOTICE a notice served on the owner of property or custodian of funds. It requests, with certain penalties for noncompliance, that any funds due to a general contractor be paid to the claimant, laborer, or materialman.

ESTOPPEL A doctrine whereby one is forbidden to contradict or deny his or her own previous statement, act, or position. The doctrine that prevents a person from exercising a legal right, because that person previously acted in an inconsistent manner, so that a third person detrimentally relied on the earlier acts.

ESTOPPEL CERTIFICATE A written statement that bars the signer from making a claim inconsistent with the instrument (commonly used with a mortgage assumption).

ESTOPPEL, PROMISSORY A doctrine applied when someone has made a technically unenforceable promise to another, and the other person has acted in reasonable reliance on the promise. If the person who relied on the promise will suffer harm unless it is enforced, a court may enforce it. Also called the doctrine of detrimental reliance.

ET AL Abbreviation meaning and others (other person).

ETHICS A standard of conduct that all members of a given profession owe to the public, clients or patrons, and to other members of that profession

ET UX Abbreviation meaning and wife.

EVICTION Dispossession by legal process, as in the termination of a tenant's right to possession through re-entry or other legal proceedings.

EVICTION, ACTUAL Physically forcing someone off of property (or preventing them from reentering), or using the legal process to make someone leave. COMPARE: Eviction, Constructive.

EVICTION, CONSTRUCTIVE When a landlord s an (or failure to an) interferes with the tenant s quiet enjoyment of the property, or makes the property unfit for its intended use, to such an extent that the tenant is forced to move out.

EVICTION NOTICE A landlord s legal notice to a tenant explaining the tenant s default under the terms of the lease and informing him or her of a pending eviction suit.

EVICTION, RETALIATORY When a landlord evicts a tenant in retaliation for requesting repairs, filing a complaint against the landlord, or organizing or participating in a tenants rights group.

EVICTION, SELF-HELP When a landlord uses physical force, a lockout, or a utility shutoff to get rid of a tenant, instead of using the legal process.

EVICTION, WRONGFUL When a landlord evicts a tenant in violation of the tenant s rights.

EVIDENCE All relevant information, facts, and exhibits admissible in a trial.

EXCEPTIONS Conditional items listed on a preliminary title report and effecting the title,; would be excluded from coverage by the title insurance company.

EXCESS RENT The amount by which the total contract rent exceeds market rent.

EXCESS LAND Land above and beyond what is needed for the highest and best use of the site.

EXCHANGE A reciprocal transfer of properties between two or more parties.

EXCLUSION General affecting title to real property excluded from coverage of a title insurance policy.

EXCLUSIVE AGENCY A contract hiring the broker as the exclusive agent for the seller. If anyone, except the seller, finds a buyer, the broker has earned the commission.

EXCLUSIVE AGENCY LISTING A written agreement giving one agent the exclusive right to sell property for a specified period of time, but reserving the right of the owner to sell the property himself or herself without liability for the payment of a commission.

EXCLUSIVE-RIGHT-TO-SELL LISTING A written agreement giving one agent the exclusive right to sell property for a specified period of time. The agent may collect a commission if the property is sold by anyone, including the owner, during the term of the listing agreement. An exclusive right to sell listing can best be identified as an Executory Unilateral Contract.

EXCLUSIVE AGENCY AGREEMENT When a broker receives an exclusive agency agreement from the seller, he owes a fiduciary relationship to the seller.

EXCLUSIVE RIGHT TO SELL AGENCY A contract hiring the broker as the only person authorized to sell property. If anyone, including the seller, finds a buyer, the broker earns the commissions.

EXCULPATORY CLAUSE A provision in leases and other instruments seeking to relieve one party of liability for his negligence and other acts. In residential leases such clauses are invalid, and in other leases the courts have limited the landlord's ability to escape liability for intentional acts, and for acts of affirmative negligence.

EXECUTE To complete, make, perform, do or to follow out. To sign a document, intending to make it a binding instrument. The term is also used to indicate the performance of a contract.

EXECUTED CONTRACT Completed and fully performed by both parties.

EXECUTION The legal process in which a court orders an official (such as a sheriff) to seize and sell the property of a judgment debtor to satisfy a judgment lien

EXECUTION LIEN A lien arising because of an execution on property. A judgment is not self-executing; however, when a writ of execution has been obtained, the sheriff will levy (seize) property, which creates a lien on the property.

EXECUTIVE The head of a government, such as president, governor, or mayor.

EXECUTIVE POWER (FREC)(FL) Duties related to the education of the licensees, the regulating of professional

practices, and the publishing of materials.

EXECUTOR A person named by the testator of a will to carry out its provisions as to the disposition of the estate. A personal representative appointed in a will to administer a decedent's estate.

EXECUTOR/EXECUTRIX A person named in a will to carry out its provisions. If it s a man, he s an executor; if it s a woman, she s an executrix. COMPARE: administrator.

EXECUTORY CONTRAC A contract that is yet to be preformed.

EXEMPT PROPERTY Property that has been decreed to be excluded from taxation or claim by others.

EXEMPTION A provision holding that a law or rule doesn t apply to a particular person or group. For example, a person entitled to a property tax exemption is not required to pay property taxes. An exemption can be full or partial.

EXHIBIT 1. Documentary or physical evidence submitted in a trial. 2. An attachment to a document.

EX PARTE By only one party or side. For example, an injunction obtained by evidence presented by only one side, without notice to the other parties.

EXPANDIBLE HOUSE A home designed for expansion and additions in the future.

EXPANSION A phase of the business cycle characterized by increasing production.

EXPANSION JOINT A fiber strip used to separate units of concrete to prevent cracking due to expansion as a result of temperature changes.

EXPANSION OPTION A lease clause granting a tenant an option to lease additional adjacent space after a specified period of time.

EXPEDIENTES The right to use another s land for a specific purpose , sometimes known as the right -of-way.

EXPENSES Certain items which appear on a closing statement in connection with a real estate sale.

EXPERIENCE EXCHANGE REPORT An annual **BOMA** publication containing income and expense statistics for office properties classified by type of building, area and such

EXPORT PRODUCTION Goods and services produced for sale or use outside the town or area in which they ar produced.

EXPRESS Stated in words, spoken or written. COMPARE: Implied.

EXPRESS CONTRACT A contract whose elements are stated either orally or in writing.

EXPROPRIATION To take by public authority through the power of eminent domain.

EXTENDED POLICY An extended insurance policy.

EXTENDER CLAUSE A clause in a listing agreement providing that for a specified period after the listing expires, the broker will still be entitled to a commission if the property is sold to someone the broker dealt with during the listing term. Also called a carryover clause or safety clause.

F

FACADE The face of a building, especially the front face.

FACILITY MANAGEMENT ADMINISTRATOR (FMA) A designation awarded by BOMI based on the curriculum for commercial property specialists who are responsible for real property as a corporate asset.

FACSIMILE (FAX) An exact copy.

FACTOR MARKET A resource pool representing the four major elements of production that are bought and sold.

FACTORS OF VALUE The least important factor in figuring present value is the original cost.

FAILURE OF PURPOSE When the intended purpose of an agreement or arrangement can no longer be achieved; in most cased, this releases the parties from their obligations.

FAIR HOUSING ACT (TITLE VIII OF THE CIVIL RIGHTS ACT 1968) A federal law that prohibits discrimination in the sale, rental or financing of housing based on race, color, religion, sex, handicap, familial status or national origin. One of the regulations of this act is that hallways, doorways and common areas are accessible for the width of wheel chairs.

FAIR MARKET VALUE The amount of money that would be paid for a property offered on the open market for a reasonable length of time with both the buyer and the seller knowing all uses to which the property could be put and with neither party being under pressure to buy or sell. See market Value.

FAMILIAL STATUS For the purposes of fair housing laws is not synonymous with marital status.

FANNIE MAE The Federal National Mortgage Association (FNMA). Does conforming loans.

FARM AREA A selected and limited geographical area to which a sales associate devotes special attention and study; to farm an area neighborhood.

FARMERS HOME ADMINISTRATION An agency of the Department of Agriculture. Primary responsibility is to provide financial assistance for farmers and others living in rural areas where financing is not available on reasonable terms from private sources.

FASTTRACK CONSTRUCTION A method under which construction of a building begins under a negotiated contract before all plans and specifications have become final. Construction proceeds as plans come off drawing board.

FEASIBILITY STUDY A report on the potential profitability of a propose real estate project. It includes considerations such as land area, physical features of the land, requirements of the project and estimated cost.

FEDERAL DEPOSIT INSURANCE CORPORATION A federal corporation that insures deposits in commercial banks (FDIC).

FEDERAL FAIR HOUSING LAWS Are not enforced by the Department of Justice

FEDERAL HOME LOAN BANK (FHLB) A district bank of the Federal Home Loan Bank System that lends only to savings and loan associations who are members.

FEDERAL HOME LOAN MORTGAGE CORPORATION (FHLMC) A federal corporation that provides savings and loan associations with a secondary mortgage money market for loans. It is also known as Freddy Mac.

FEDERAL HOUSING ADMINISTRATION (FHA) An agency of the federal government that insures mortgage loans.

FEDERAL HOUSING FINANCE BOARD Federal agency that regulates the 12 Federal Home Loan Banks.

FEDERAL INSURANCE CONTRIBUTIONS ACT (FICA) A federal regulation requiring employers to pay retirement fund taxes (social security) for employees.

FEDERAL LAND BANK SYSTEM Federal government agency making long term loans to farmers.

FEDERAL NATIONAL MORTGAGE ASSOCIATION (FNMA) A federal corporation that provides lenders with a secondary mortgage money market.

FEDERAL QUESTION A legal issue involving the U.S. constitution, a treaty, or a federal statute. Federal courts have jurisdiction to hear federal question cases, but they may also be decided in state court.

FEDERAL RESERVE SYSTEM The federal banking system of the United States under the control of a central board of governors (Federal Reserve Board). It involves a central bank in each of 12 geographical districts, with broad powers in controlling credit and the amount of money in circulation. They are the primary government regulator in monetary policy activities.

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION (FSLIC) A federal corporation that insures deposits in savings and loan associations.

FEDERAL STATUTES Bankruptcy proceedings are initiated under Federal statutes.

FEDERAL TRADE COMMISSION (FTC) A federal agency that investigates and eliminates unfair deceptive trade practices.

FEDERAL UNEMPLOYMENT TAX ACT (FUTA) A regulation requiring employers to file federal unemployment tax returns for employees.

FEDERALLY RELATED TRANSACTIONS Any sale transaction that ultimately involves a federal agency in either the primary or secondary mortgage market. Under FIRREA, state certified or state licensed appraisers must be used for certain loans in federally related transactions.

FEE An estate of inheritance in real property for life.

FEE ABSOLUTE SEE: *Fee Simple.*

FEE, CONDITIONAL Title that may be terminated by a former owner if conditions stated in the deed are not met. The only type of defeasible fee that s recognized in California now. Also called fee simple subject to a condition subsequent. SEE: Power of termination.

FEE SIMPLE An estate in real property by which the owner has the greatest possible power over the title. In modern use it expressly establishes the title of real property with the owner without limitation or end. He or she may dispose of it by sale, trade, or will, as he or she chooses. In modern estates the terms "Fee" and "Fee Simple" are substantially synonymous.

FEE SIMPLE ABSOLUTE The highest estate known at law. A freehold estate of indefinite duration, incapable of being defeated by conditions or limitations. Sometimes simply called fee or fee estate.

FEE SIMPLE DEFEASIBLE (QUALIFIED) A fee simple estate to which certain conditions or limitations attach, such that the estate may be defeated or terminated upon the happening of an act or event. Also called a fee simple subject to a condition subsequent estates.

FEE SIMPLE DETERMINABLE A defeasible fee that is terminated automatically if certain conditions occur. No longer recognized in California; now treated as a conditional fee.

FEE SIMPLE ESTATE The greatest interest that one can have in real property. An estate is unqualified of indefinite duration, freely transferable and inheritable.

FEE SIMPLE SUBJECT TO A CONDITION SUBSEQUENT A fee simple defeasible estate that requires the holder of the future interest to act promptly to terminate the present interest, in order for that interest to be terminated.

FEUDAL TENURE A real property ownership system in which ownership rests with a sovereign who may grant lesser interests in return for service or loyalty. This is in contrast to allodial tenure.

FHA Federal Housing Administration.

FHLMC Federal Home Loan Mortgage Corporation; also known as Freddie Mac. SEE: Secondary Marketing.

FICTITIOUS DEED OF TRUST A recorded deed of trust that discloses all the terms of the trust deed but does not relate to a specific transaction and is used for reference only.

FIDELITY BOND A security posted for the discharge of an obligation of personal services.

FIDUCIARY A person in a position of trust and confidence, as between principal and broker. A fiduciary may not make a profit from his or her position without first disclosing it to the beneficiary.

FIDUCIARY DUTY That duty owed by an agent to act in the highest good faith toward the principal and not to obtain any advantage over the latter by the slightest misrepresentation, concealment, duress or pressure.

FIDUCIARY RELATIONSHIP a relationship of trust and confidence, where one party owes the other (or both parties owe each other) loyalty and a higher standard of good faith than they owe to third parties. For example, an agent is a fiduciary in relation to the principal; husband and wife are fiduciaries in relation to each other.

FILE AND USE Title insurers in most states file rate schedules, policy forms, and endorsement forms with the state insurance department; they may then use those rates and forms after a specified waiting interval; rates so filed are mandatory.

FILTERING DOWN The process whereby higher-priced properties become available to lower income buyers.

FINAL ORDER A decision made by FREC.

FINANCE CHARGE Any charge a borrower is assessed, directly or indirectly, in connection with the loan.

FINANCIAL INSTITUTIONS REFORM , RECOVERY, AND ENFORCEMENT ACT OF 1989 (FIRREA) Federal legislation to liquidate, consolidate, and recover the assets of troubled savings and loan organizations.

FINANCIAL INTERMEDIARY Financial institutions such as banks, savings and loan associations, mutual savings banks and life insurance companies which receive relatively small sums of money from the public and invest them in the form of large sums. A considerable portion of these funds are loaned on real estate.

FINANCING PROCESS The systematic 5 step procedure followed by major institutional lenders in analyzing a proposed loan, which includes ---- filing of application by a borrower ;lenders analysis of borrower and property; processing of loan documentation; closing (paying) the loan; and servicing

(collection and record keeping).

FINANCING CONTINGENCY The buyer must use reasonably diligent efforts to secure financing.

FINANCING STATEMENT The instrument filed to perfect the security agreement and give constructive notice of the security interest, thereby protecting the interest of the secured parties. (See Security Agreement; Security Interest; and Secured Party.) The security interest in personal property. It is analogous to a mortgage on real property, except that it secures personal property. Under the UCC, it may be filed in Sacramento with the secretary of state.

FINANCING REAL ESTATE Securing a loan by giving real property as collateral for payment of the debt.

FIND A PURCHASER A provision in a listing contract requiring a broker to produce a ready, willing and able buyer or offer on the terms specified.

FINDER'S FEE Money paid to a person for finding someone interested in selling or buying property. To conduct any negotiations of sale terms, the finder must be a licensed broker or he violates the law.

FINISH FLOOR The final covering on the floor, such as wood, linoleum, cork, or carpet.

FIRE INSURANCE REQUIREMENT FORM A form included in loan papers that a borrower must sign, in which the borrower agrees to obtain fire insurance coverage to protect the property and insure the lender.

FIRST CHOICE Anybody may bid on a piece of property, there are no priorities.

FIRE SAFETY Smoke detectors and fire extinguishers are required by law, but most insurance companies also require them.

FIRE STOP A solid, tight closure of a concealed space placed to prevent the spread of fire and smoke through the space.

FIRST DEED OF TRUST The loan of first priority; it takes precedence over junior loans and encumbrances. Also called senior primary lien.

FIRST TIME HOME BUYERS Generally buy homes with two or less bedrooms.

FIRM COMMITMENT The amount lenders agree to lend on a specified property to a specified borrower for a certain length of time.

FIRST AMENDMENT The constitutional amendment guaranteeing freedom of speech, press, assembly, and religion.

FIRST LIEN POSITION The spot held by the deed of trust with highest lien priority, when there s more than one deed of trust on the property. SEE: Deed of Trust, First.

FIRST MORTGAGE A legal document pledging collateral for a loan (See mortgage) that has first priority over all other claims against the property except taxes and bonded indebtedness. That mortgage is superior to any other.

FIRST TRUST DEED The deed with the highest position of being collected first.

FISCAL POLICY Programs by the federal government that are intended to influence economic activity by making changes in government expenditures and taxation implemented by the U.S. Treasurey.

FIVE YEARS Commissioners Final Public Report Expiration date.

FIVE-YEAR FORECAST A long-term. projection of estimated income and expense for a property based on predictable changes.

FIXED EXPENSES An expense item in a property s operating budget that does not fluctuate with rental income.

FIXED (INTEREST) RATE MORTGAGE A mortgage with an interest rate that does not change over the life of the loan.

FIXED TERM A period of time with a definite ending date.

FISCAL POLICY Programs by the federal government that are intended to influence economic activity by making changes in government expenditures and taxation.

FIXED EXPENSES Operating costs that are more or less permanent and that vary little from year to year.

FIXITY OF LOCATION The physical characteristic of real estate that subjects it to the influence of its surroundings.

FIXTURE An item of personal property that has been so attached to real property as to be considered part of that real property.

FIXTURES Items that were originally personal property but

that have become part of the real property, usually because they are attached to the real property more or less permanently. Examples: Store fixtures built into the property and plumbing fixtures.

FLAG LOT Rear lot, behind other houses or lots, with a long, narrow access road (like a flagpole).

FLASHING Sheet metal or similar material used to protect a building form water seepage.

FLAT FEE A property management fee expressed as a dollar amount per year or month.

FLAT LEASE SEE: *Straight Lease*.

FLEA MARKET A large building or open area in which space is sold to individuals for the sale of merchandise, usually used or of a collectible nature.

FLOOR AREA RATIO METHOD A Flexible method of limiting the size of a building in relation to the size of a lot; used in some zoning ordinances as an alternative to strict size and coverage limits.

FNMA Federal National Mortgage association; also known as Fannie Mae. SEE: Secondary Marketing.

FOOTING The base or bottom of a foundation wall, pier. or column.

FOOTLOOSE A term describing industries that are capable of being located almost anywhere.

FOLLOW-UP What a sales associate does after a sale to maintain customer contact and goodwill.

FORCIBLE DETAINER Wrongful retention of property by actual or constructive force.

FORCIBLE ENTRY Entry into property without the consent of the owner, by acts that constitute more than mere trespass.

FORBEARANCE Any arrangement that delays foreclosure action.

FORECASTING Taking the past asa guide to the future, together with judgements from the projections of the future.

FORECLOSURE A legal proceeding to enforce a lien on such as a mortgage or deed of trust. The process by which secured property is seized and sold to satisfy a debt. A mortgage or involuntary lien must be sold by a court-ordered sale; a sale under a deed of trust may be either by court action or through a private trustee's sale.

FORECLOSURE, JUDICIAL A lawsuit filed by a mortgagee or deed of trust beneficiary to foreclose on the security property when the borrower has defaulted.

FORECLOSE, NONJUDICIAL Foreclosure by a trustee under the power of sale clause in a deed of trust.

FOREIGN TRADE ZONE (FTZ) An area designated under federal law that permits manufacturing, shipping or storage of goods duty-free.

FORFEITURE Loss of a legal right, interest, or title by default.

FORM REPORT Written appraisal report presented on a standardized form or checklist.

FORMAL APPRAISAL An estimate of value that is reached by the collection and analysis of relevant data. A formal appraisal is usually reported in writing.

FORMAL COMPLAINT An outline of charges against a licensee that must be answered within the statutory time limit.

FORMAL CONTRACT Any agreement that contains all the essentials of a contract, including that it is in writing and under seal; a contract dependent on a particular form.

FORMAL HEARING *(See Hearing)*

FORMAL WILL A will signed by the testator in the presence of two or more witnesses, who must themselves sign the will.

FOUR UNITIES SEE: Unities, Four.

FOUNDATION That part of a structure or wall wholly or partly below the surface of the ground that is the base or support, including the footings.

FOURTEENTH AMENDMENT The constitutional amendment that directs that no state can deprive a person of life, liberty ,or property without due process or equal protection of the law.

FRANCHISE A specified privilege awarded by a government or business firm which awards an exclusive dealership.

FRAUD Deception that deprives another person of his her rights or injures him or her. False representation or concealment of material facts that induces another justifiably to rely on it to his detriment.

FRAUD, ACTIONABLE Fraud that meets certain criteria, so that the victim can successfully sue. The victim/plaintiff usually must prove that the defendant concealed a material fan or made a false statement (intentionally negligently) with the intent to induce the victim to enter a transaction, and that the victim was harmed because he or she relied on the misrepresentation.

FRAUD, ACTUAL Intentional misrepresentation or concealment, or negligent misrepresentation, which is making a false statement without reasonable grounds for believing it is true.

FRAUD, CONSTRUCTIVE A breach of duty that misleads the person the duty was owed to, without an intention to deceive.

FREDDIE MAC (See FEDERAL HOME LOAN MORTGAGE CORPORATION.)

FREE AND CLEAR Title to property that is absolute and unencumbered.

FREEHOLD An estate of fee. An estate in real property that is either a life estate or an estate in fee.

FREEHOLD ESTATE An estate of indeterminable duration, e.g., fee simple or life estate.

FRONT-END RATIO The ratio used by lenders to qualify a borrower for a loan, determined by adding the principal, interest, taxes, insurance, and mortgage insurance on the new loan and by diving by the borrower s gross monthly income.

FRONT FOOTAGE Property measurement for sale or valuation purposes. The property measurement is along the street line, and each front foot extends to the depth of the lot. It is usually used in connection with commercial property.

FRONTAGE A term used to describe or identify that part of a parcel of land or an improvement on the land that faces the street or a body of water. The term is also used to refer to the lineal extent of the land or the improvement that is parallel to and facing the street, e.g., a 75 foot frontage.

FRONT MONEY The minimum amount of money necessary to initiate a real estate venture, to get the transaction underway.

FROST LINE The depth of frost penetration in the soil.

FRUCTOSE Fruits, crops, and other plants. If the vegetation is produced by human labor, such as crops, it is called fructus industrials; vegetation growing naturally is called fructus naturales.

FRUCTUS INDUSTRIALES Plants planted and cultivated by people, such as crops (fruits of industry).

FRUCTUS NATURALES Naturally occurring plants (fruits of nature).

FRUITS AND NUTS Usually bring the highest monetary return per acre.

FSBO (For Sale BY Owner) Property offered for sale typically without the use of a real estate broker.

FULL CASH VALUE SEE: Value, Full Cash.

FULLY INDEXED NOTE RATE As related to adjustable rate mortgages, the index value at the time of application plus the gross margin states in the note.

FUNCTIONAL OBSOLESCENCE A loss value due to adverse factors from within the structure which affect the utility of the structure, value and marketability.

FUNCTIONAL UTILITY The combination of the usefulness and attractiveness of a property.

FUNDING The release of loan funds from a lending institution to the escrow company, generally on the closing day of escrow or recordation.

FUNDING LETTER Written request to a lender for the release of loan funds; also called *request for loan proceeds.*

FURTHER ASSURANCE A provision in a deed containing a covenant or warranty to perform any further acts the grantee (buyer) might require to perfect title to the property.

FURRING Strips of wood or metal fastened to wall to even it, form air space, or to give the wall greater thickness.

FUTURE ADVANCES Future (additional) loans made by a lender and secured under the original deed of trust. The advances may be either optional or obligatory, but the deed of trust or mortgage must provide in the security instrument that it will cover any such future advances.

FUTURE APPRECIATION This appreciation is referred to as savings value.

FUTURE BENEFITS The anticipated benefits the present owner will receive from the property in the future.

FUTURE INTEREST An estate that does not or may entitle one to possession or enjoyment until a future time.

FUTURE VALUE The estimated lump-sum value of money or property at a date in the future.

G

GABLE ROOF Pitched roof with sloping sides.

GAIN A profit, benefit, or value gain

GAIN, CAPITAL A gain realized on the sale of a capital asset. Real estate is considered a capital asset if it is income property, or property used in a trade or business.

GAMBREL ROOF A curb roof, having a steep lower slope with a flatter upper slope above.

GARNISHMENT A legal process to seize a debtor's property or money in the possession of a third party.

GUARANTEE OF TITLE An assurance of clear title.

GENERAL AGENT A representative authorized by the principal to perform only acts related to a business or to employment of a particular nature.

GENERAL LIEN A lien on all the property of the debtor.

GENERAL PARTNERSHIP An association of two or more persons for the purpose of jointly conducting a business, each being responsible for all the debts incurred in the conducting of that business.

GENERAL PLAN A long-term, comprehensive plan for the development of a city or county, used as a guide in preparing zoning ordinances.

GENERAL PLAN RESTRICTIONS Covenants, conditions, and restrictions placed on a subdivision or other large tract of land, designed to benefit and burden each lot in the tract.

GENERAL WARRANTY DEED A deed in which the grantor warrants the title against defects might that might have arisen before or during his or her period of ownership.

G.I. LOANS Common term for loans guaranteed by the department of veterans Affairs for qualified veterans. Also known as DVA loans.

GIFT A voluntary transfer of property without consideration.

GIFT DEED A deed for which there is no material consideration.

GINNIE MAE The GNMA.

GIRDER A beam used to support other beams, joists, and partitions.

GOING CONCERN VALUE The worth of a business, including real estate, goodwill and earning capacity.

GOLF COURSES One of the major things that builders like to build close to or around.

GOOD FAITH A party s honest intent to transact business; free from any intent to defraud the other party, each part s faithfulness to one s duty or obligations set forth by contract.

GOOD FAITH IMPROVER Someone who makes an improvement on land in the mistaken belief that he or she owns the land. Also called an innocent improver

GOODWILL An intangible but salable asset of a business derived from the expectation of continued public patronage.

GOVERNMENT LOT A parcel of land that can t be divided into a regular section in the government survey, because of the convergence of range lines, or because of a body of water or some other obstacle or irregularity.

GOVERNMENT NATIONAL MORTGAGE ASSOCIATION (GNMA) A federal corporation that assists in financing special assistance programs for federally aided housing. The corporation is also known as Ginny Mae.

GOVERNMENT SPONSORED ENTERPRISE (GSE) Collective title for the secondary market consisting of the FNMA, FHLMC; and GNMA.

GOVERNMENT SECURITIES In order to combat inflation the Federal Reserve will buy government securities on the open market.

GOVERNMENT SURVEY A method of specifying the location of a parcel of land using prime meridians , base line, standard parallels, guide meridians, townships and sections.

GRADE Ground level at the foundation.

GRADUATED LEASE Usually a long-term lease that provides for adjustments in the rental rate on the basis of some future determination. For example, the rent may be based upon the result of appraisals to be made at predetermined times in the future.

GRADUATED PAYMENT MORTGAGE (GPM) A land loan for which periodic payments increase at a stated period of time and then level off for the remainder of the term of the loan.

GRANT (1) To transfer. (2) A deed. (3) When used in a deed, a technical term implying certain warranties. A transfer or conveyance of real estate.

GRANT DEED In California, a deed in which the word grant is used as a work of conveyance and therefore by law implies certain warrantees, deed used to transfer property in California. By statute it impliedly contains only two limited warranties.

GRANTEE The buyer; a person to whom a grant is made.

GRANTING CLAUSE Words in a deed that indicate the grantor s intent to transfer an interest in property.

GRANTOR The seller; one who signs a deed. The seller or person who executes a grant.

GRANTOR/GRANTEE INDEXES Indexes of recorded documents, with each document listed in alphabetical order according to the last name of the grantor (in the grantor/grantee index) and grantee (in the grantee/grantor index). The recording number of each document is given, so that they can be located in the public record. COMPARE: Tract Index.

GRATUITOUS AGENT A person not paid by the principal for services on behalf of the principal, who cannot be forced to act as an agent, but who becomes bound to act as an agent, but who becomes bound to act in good faith and obey the principal s instructions once he or she undertakes to act as an agent.

GREAT DEPRESSION During this period one of the facts is that even though the economy slumped the population grew.

GREENBELT LAW (FL) Legislation that authorizes county property appraisers to assess land used for agricultural purposes according to its current value as agricultural land.

GRID A chart used in rating the borrower, property, and neighborhood.

GROSS FLOOR AREA A method of measuring industrial space in which the area is the total of all floor space within the exterior walls of the building, with no allowance made for structural projections and with a required minimum ceiling height of 7½ feet.

GROSS INCOME Total income before expenses are deducted.

GROSS INCOME MULTIPLIER (GIM) The ratio of the selling price (or appraisal value) to the gross income of a property. May be multiplied by the gross income of a property to produce an estimate of the property s value. Also known as the gross rent multiplier (GRM).

GROSS LEASE A common residential lease under which the tenant pays a fixed rental and the landlord pays all operating expenses for the property.

GROSS MARGIN With regard to an adjustable rate mortgage, an amount expressed as percentage points, stated in the note which is added to the current index value on the rate adjustment date to establish the new note rate.

GROSS NATIONAL PRODUCT The total value of all goods and services produced in an economy during a given period of time.

GROSS RENT MUTIPLIER A number that reflects the ratio between the sales price of a property and its gross monthly rents. It is used in the income approach of appraising property.

GROSS SALES The total sales made by a retail tenant at a leased premises. A proportion of gross sales is charged as rental consideration under a percentage lease.

GROSS SCHEDULED INCOME Total income from investment property before deducting any expenses.

GROUND LEASE An agreement leasing land only, without improvements, ordinarily with the understanding that improvements will be placed on the land by the tenant.

GROUND RENT (1) Earnings from the ground only. (2) Earnings of improved property after an allowance is made for earnings of improvements. (3) A perpetual rent that a grantor in some states may reserve to himself or herself and his or her heirs when he or she conveys real property.

GROUP LICENSE A right granted a sales associate or broker associate to work various properties owned by affiliated entities under one owner developer.

GROWING EQUITY MORTGAGE Loan with fixed interest rate and scheduled annual increases in monthly payments, resulting in shorter maturity.

GUARDIAN A person appointed by a court to administer the affairs of a minor or an incompetent person.

GUIDE MERIDIANS SEE: Meridians, Guide.

H

HARD MONEY LOAN Loan usually from a private lender . Actual money loaned and secured by a trust deed as opposed to a loan carried back by a seller, in which no money passes.

HABENDUM CLAUSE The to have and hold clause which may be found in a deed.

HANDICAP STATUS As defined in the Fair Housing Act, a physical or mental impairment that substantially limits one or more major life activities.

HAZARD COMMUNICATION STANDARD PLAN An OSHA-mandated plan to be compiled by property managers detailing protective measures to be implemented when handling hazardous chemicals. See *Occupational Safety and Health Administration*

HAZARD INSURANCE Insurance that protects the owner and lender against physical hazards to property such as fire and windstorm damage.

HEADER A beam placed perpendicularly to joists and to which joists are nailed in the framing of openings such as windows, doors, and stairways.

HEARING A session in which testimony and arguments are presented, especially before an official.

HEIRS Persons who succeed to the estate of someone who dies intestate (without a will). It sometimes indicates anyone who is entitled to inherit a decedent's property.

HEREDITAMENT A term usually referring to real estate and all that goes with it as being incidental.

HIGHER LAND COSTS This generally leads to the lot sizes of the homes being decreased.

HIGHEST AND BEST USE An appraisal phrase that means that use of real property that is most likely to produce the greatest net return on land or buildings, or both, over a given period of time. Qualifies as the highest and best use.

HIGH FARM LAND COSTS To be able to come out at the end of the year with a profitable statement some cattlemen have had to plant fruits and vegetables.

HIGH LOCAL UNEMPLOYMENT The type of area that will except businesses that have high employment, but create noise and dust.

HIP ROOF A pitched roof with sloping sides and ends.

HISTORIC COST Cost of a property at the time it was constructed or purchased.

HIV Persons afflicted with HIV are not protected under federal fair housing laws.

HOLDER IN DUE COURSE One who has taken a negotiable note, check, or bill of exchange in due course (1) before it was past due; (2) in good faith; (3) without knowledge that it has been previously dishonored and without notice of any defect at the time it was negotiated to him or her; (4) for value. Someone who acquires a negotiable instrument in good faith and without any actual or constructive notice of defect. The acquisition must occur before the note's maturity. Such a holder takes the note free from any personal defenses (such as failure of consideration, fraud in the inducement) that may be available against the maker.

HOLOGRAPHIC WILL A will that is entirely written, dated, and signed by the testator in the testator's handwriting. No witnesses are needed.

HOLDOVER TENANT Tenant who remains in possession of leased property after the expiration date of the lease.

HOME EQUITY LOANS Due to the Tax Reform Act of 1986 these loans have become very popular due to their tax advantages.

HOMEOWNER S ASSOCIATION A nonprofit association made up of homeowners in a subdivision responsible for enforcing the subdivision s CC&Rs and managing other community affairs.

HOMEOWNERS ENDORSEMENT An addition to a policy of title insurance that extends the normal policy to cover items other than those stated in the standard policy; may include such items as mineral rights and mechanics liens.

HOMEOWNER'S EXEMPTION An exemption or reduction in real property taxes available to those who reside on their property as of March 1. The current amount is $70 off the normal tax bill otherwise due.

HOME PURCHASE LOAN The leader in home purchase lending is saving institutions.

HOMESTEAD (1) A home upon which the owner or owners have recorded a Declaration of Homestead, as provided by California statutes, that protects the home against judgments up to a specified amount. (2) A probate homestead is a similarly protected home property set aside by a California probate court for a widow or minor children. A special, limited exemption against certain judgments available to qualified homeowners.

HOTEL MANAGEMENT Property managers usually attend a college course which is part of a major in hotel-restaurant management.

HOMESTEAD EXEMPTION In some jurisdictions, a reduction in the assessed value allowed for ones principal residence.

HOUSEHOLD One individual , or a group of individuals, living in dwelling unit.

HOUSING AND URBAN DEVELOPMENT (HUD) DEPARTMENT. A U.S. government agency established to implement certain federal housing and community development programs. This federal agency attempts to assure decent, safe, and sanitary housing for all Americans, and investigates complaints of discrimination in housing.

HOUSING FINANCIAL DISCRIMINATION ACT (1977) Prevents discrimination in the purchase, construction, rehabilitation, improvement of housing accommodations because of conditions, characteristics, or trends in the neighborhood.

HUD The department of housing And Urban development which is responsible for the implementation and administration of U.S. government housing and urban development programs.

HUD FORM A final accounting of closing costs, itemizing the buyers and sellers closing costs separately; a consumer protection form.

HUNDRED PERCENT LOCATION A retail business location considered the best available for attracting business.

HYPOTHECATE (HYPOTHECATION) To give something as security without giving up possession of it. To pledge property; to pledge a security interest in property without the transfer of possession.
An example is a trust deed.

I

ILLUSORY CONTRACT An agreement that gives the appearance of a contract, but in fact is not a contract because it lacks one of the essential elements.

IMMIGRATION REFORM AND CONTROL ACT OF1986 The act must be adhered to by all American employers.

IMMUNE Real property that is owned by a unit of government and is not subject to taxation.

IMPERFECT REAL ESTATE MARKET The following three factors help to make the real estate market imperfect, (1) Imperfect knowledge, (2) Production time for new units, and (3) Must sell and will sell sellers.

IMPLIED Not expressed by words, but presumed from facts, acts, or circumstances.

IMPLIED BY LAW Required by law to be part of an agreement; read into an agreement even if it contradicts the express terms the parties agreed to.

IMPLIED CONTRACT An agreement that has not been put into words, but is implied by the actions of the parties.

IMPLIED LISTING An employment contract that arises from the conduct of the broker and the seller and may be enforceable even though not clearly spelled out in words.

IMPLIED WARRANTY SEE: Warranty, Implied.

IMPLIED WARRANTY OF HABITABILITY A warranty implied by law in every residential lease, that the property is safe and fit for habitation.

IMPOUND (ACCOUNT) A trust account established by the lender to pay property taxes and hazard insurance.

IMPROVEMENTS Man-made additions to real property. Generally increasing the value of the property.

INCOME Amount earned or gained, not return of capital.

INCOME AND EXPENSE REPORT A monthly financial report showing the income from property, operating expenses and the amount remitted to the owner.

INCOME APPROACH (**Income Approach to value**) An appraisal technique used on income producing properties. Also known as the **Capitalization Approach**.

INCOME FORECAST Gross or net income estimate.

INCOME (PRODUCING) PROPERTY Property that generates rent (or other income) for the owner, such as an apartment building. Most of this property is owned by individuals.

INCOME RATIO The monthly payment on a loan (including principal, interest, taxes and hazard insurance) divided by thr borrowers monthly gross income.

INCOME STATEMENT A summary of all income and expenses of a business for a stated period of time.

INCOME STREAM Actual or estimated flow of net earnings over time.

INCOMPETENT Someone incapable of managing his or her own affairs by reason of age, disease, weakness of mind, or any other cause.
Any increase. (1) A term frequently used to refer to

INCREMENT the increased value of land because of population growth and increased wealth in the community.

INCUBATOR SPACE A building located in an industrial park and divided into small units of varying sizes to accommodate young, growing companies that want to combine office and industrial space at one location.

INCURABLE DEPRECIATION Building defects or problems that would cost more to repair than the anticipated value increase from such repair.

INDEBTEDNESS A debt or obligation.(2) "Unearned increment" is used in this connection since the values increased without effort on the part of the owner.

INEFFECTIVE Status of a license when it is inactive or has been suspended.

INDEMNIFY To make a payment for a loss.

INDEMNIFICATION Compensation to a person who has already sustained a loss. For example, insurance payment for a loss under policy.

INDEMNITY a guarantee against loss; a building contractor may , for example, give a title company an indemnity agreement that renders the title company harmless against any liens that may arise due to the contractors failure to pay his or her bills.

INDEPENDENT CONTRACTOR A person who contracts to do a job for another but maintains control over how he or she will carry out the task, rather than following detailed instructions. COMPARE: Employee.

INDEX a number used by a lender to measure interest rate changes over time; used as a guide for resetting rates of adjustable rate loans.

INDEX LEASE A lease containing an escalation clause.

INDEX METHOD Method for estimating construction costs; adjusts original costs to the current cost level by a multiplier obtained from a published cost index.

INDICATED VALUE Value estimate calculated/produced by an appraisal approach.

INDIRECT COSTS All of the time and money costs involved in a construction project that are not directly involved with construction itself. Examples are loan fees, interest, legal fees, and marketing costs.

INDIRECT LIGHTING A method of illumination in which the light is reflected from the ceiling or other object outside the fixture.

INDIRECT MANAGEMENT COSTS Expenses in the budget of a real estate agency or parent company that are partially attributable to the operation of the management department.

INDIVIDUAL BUSINESS OWNER When an individual owner rents office space both the husband and the wife should sign.

INDIVIDUAL LENDER Seller, third party, or real estate **agent ;** any person or group of persons other than institutional lenders.

INDORSEMENT (1) The act of signing one's name on the back of a check or a note, with or without further qualification. (2) The signature described above. The title insurance policy usually has on e of these.

INDUSTRIAL PARK A suburban industrial subdivision designed to offer comparatively small firms land in outlying areas with good accessability to transportation now often called a business park.

INDUSTRIAL LEASE The following should be contained in this type of lease; what happens if a industrial tenant violates pollution laws, what happens if there is a strike and picket lines block other tenants access and is the storage of hazardous materials allowed on the premises.

INDUSTRIAL REAL ESTATE Properties that include (1) sites in industrial parks or subdivisions, (2) redeveloped industrial parcels in central areas, (3) industrial acreage. It is commonly owned by the company occupying it.

INFLATION Increase in prices for goods and services resulting from too much money in circulation or rising costs of services and material.

INFLATION ENDORSEMENT Coverage that may be added to the standard owner s policy of title insurance; it adjusts the amount of coverage according to cost-of-living index.

INFORMAL APPRAISAL An estimate of value that is reached by using intuition, past experience, and general knowledge.

INFORMAL HEARING A respondent who does not dispute allegations of material fact in the administrative complaint may request an informal hearing before the FREC for the final action complaint.

INFORMATION SUPERHIGHWAY A system of fiber optic cables that will allow rapid transfer of electronic data of all different types(text, voice, video, etc.).

INFRASTRUCTURE The man-made physical features of urban area, such as roads, highways, sewage and drainage systems and utility facilities necessary to support a concentration of population.

INGRESS The act of or avenue for entering property.

INHERIT To take property through a deceased's estate.

INITIAL MOVE-IN FEES This fee should be paid by money order or certified check.

INJUNCTION An order issued by a court to restrain one or more parties to a suit or proceeding from performing an act deemed inequitable or unjust in regard to the rights of some other party or parties in the suit or proceeding.

IN-MIGRATION Movement into a community or region by new residents.

INNOCENT IMPROVER SEE: *Good Faith Improver.*

INQUIRY NOTICE SEE: *Notice, Inquiry.*

INSTALLMENT A partial payment of a debt due in a series of payments.

INSTALLMENT NOTE A note that provides that payments of a certain sum or amount be paid in more than one payment on the dates specified in the instrument.

INSTALLMENT-SALE(Method) A method of reporting capital gains by installments for successive tax years to minimize the impact of capital gains tax in the year of the sale.

INSTALLMENT SALES CONTRACT Also known as an agreement of sale or a land contract.

INSTITUTE OF REAL ESTATE MANAGEMENT (IREM) A subsidiary group of the National Association of Realtors, founded in 1933 to encourage professionalism in the field of property management.

INSTITUTIONAL LENDER Lenders who make a substantial number of real estate loans, such as banks, savings and loan associations, and insurance companies.

INSTITUTIONAL PROPERTY Office buildings owned and occupied by the same corporation.

INSTRUMENT A written legal document created to affect the rights of the parties. A document that transfers title, creates a lien, or gives a right to payment, such as a deed, deed of trust, or contract. *(SEE: Negotiable Instrument.)*

INSURABLE TITLE A property title that a title insurance company is willing to insure.

INSURANCE CLAUSE A provision in a mortgage that requires the mortgagor to obtain and keep current a hazard

insurance policy.

INSURANCE COMPANIES Are the most conservative income property owners. They make the policies payable to the insured and the lender.

INSURANCE, HOMEOWNER S Insurance against damage to the real property and the homeowner s personal property.

INSURANCE, TITLE, EXTENDED COVERAGE Title insurance that covers problems that should be discovered by an inspection of the property (such as encroachments and adverse possession) in addition to the problems covered by standard coverage policies.

INSURANCE, TITLE, STANDARD COVERAGE Title insurance that protects against latent title defects (such as forged deeds) and undiscovered recorded encumbrances, but does not protect against problems that would only be discovered by an inspection of the property.

INTANGIBLE ASSET Something of value lacking physical substance; existing only in connection with something else(e.g., the goodwill of a business).

INTANGIBLE PROPERTY Rights to something other than tangible or physical property.

INTANGIBLE TAX ON MORTGAGES, STATE Tax required prior to a mortgage being recorded. The costs is based on the value of the mortgage.

INTEGRATION CLAUSE A provision in a contract document stating that the document contains the entire agreement between the parties.

INTEGRATIVE NEGOTIATION Goals of the parties are mutual gain, win-win

INTENSITY The concentration of activity (pedestrian and vehicular traffic) used as a means of designating land for commercial zones.

INTENT, OBJECTIVE A person s manifested intention; what he or she appears to intend, whether or not that is what he or she actually intends.

INTENT, SUBJECTIVE What a person actually intends, whether or not that is apparent to others.

INTEREST 1. A right or share in something (such as a piece of real estate). 2. A charge a borrower pays to a lender for the use of the lender s money. COMPARE: Principal.

INTEREST, FUTURE An interest in property that will or may become possessatory at some point in the future. SEE: Remainder; Reversion.

INTEREST-ONLY LOAN A straight non-amortizing loan, in which only interest is paid. Interest can be paid periodically or at maturity , when principal is paid in a lump sum.

INTEREST, PREPAID Interest on a new loan that must be paid at the time of closing; covers the interest due for the first month of the loan term. Also called interim interest.

INTEREST RATE The percentage of a sum of money charged for its use.

INTEREST, UNDIVIDED A co-tenant s interest, giving him or her the right to possession of the whole property, rather than to a particular section of it. SEE: Unity of Possession.

INTERIM FINANCING Any short-term financing, such as a Swing Loan or a loan used to finance construction, due at the completion of the construction. Usually paid off with h the proceeds of a Take-out loan

INTERIM OCCUPANCY When title and possession do not transfer at the same time, the real estate licensee should prepare an interim occupancy.

INTERIOR LOT Lot with frontage on only one street.

INTERMEDIARY Financial institution that acts as a go-between for savers, depositors, and investors.

INTERMEDIATION The process whereby financial middleman consolidate many small savings accounts belonging to individual depositors and invest those funds in large, diversified projects.

INTERMEDIATE-TERM LOANS Temporary short-term loans, ordinarily three to ten years, that include home improvement loans, consumer loans or loans for the purpose of permitting a developer to delay long-term financing until more favorable loan conditions.

INTERMEDIATE THEORY STATE A state in which the security of the mortgage is based on the title theory or deed of trust; but requires the lender to foreclose to obtain legal title.

INTERMINGLE *See Commingle*

INTERNAL RATE OF RETURN The rate of return generated by an investment over the holding period; considers all future

benefits, discounting them to equal the present value.

INTERNATIONAL COUNCIL OF SHOPPING CENTERS (ICSC) An organization of shopping center owners, managers and major tenants that function as a medium for the interchange of information about shopping center operations.

INTERNATIONAL FACILITY MANAGEMENT ASSOCIATION (IFMA) An association created in 1980 to provide support to facility management professionals through career development, education and research programs.

INTERPLEADER A course of action when two contesting parties cannot reach an arbitrated agreement, A legal proceeding whereby the broker, having no financial interest in the disputed funds, deposits with the court the disputed escrow deposit so that the court can determine who is the rightful claimant. A court proceeding initiated by a stakeholder, such as a broker or escrow agent.

INTERROGATORIES Written questions submitted to the opposing party in a lawsuit during discovery, which he or she is required to answer in writing and under oath.

INTERVAL OWNERSHIP Fee simple possession , for the limited time purchased (one or more weeks), of a time-share unit, complete with deed, title and equity.

INTER VIVOS TRUST A living trust; inter vivos is a Latin expression meaning among the living .

INTERVAL OWNERSHIP See time sharing

INTESTATE A person who dies without a will.

INTESTATE SUCCESSION Distribution of the property of a person who died intestate to his or her heirs.

INVERSE CONDEMNATION ACTION A court action by a private landowner against the government, seeking compensation for damage to property that resulted from government action.

INVERTED PYRAMID A way of visualizing ownership of real property; theoretically, a property owner owns all the earth, water, and air enclosed by a pyramid that has its tip at the center of the earth and extends up through the property boundaries out into the sky.

INVESTING The two main reasons for investing are income and profit.

INVESTMENT The outlay of money in the anticipation of income or profit; the sum risked or the property purchase.

INVESTMENT CONTRACT A type of security using the sale of real property as the investment.

INVESTMENT PROPERTY Unimproved property held as an investment because it is appreciating in value.

INVESTMENT VALUE The worth of a property to a particular investor based on his or her desired rate of return, risk tolerance, etc.

INVESTOR A person who holds property primarily for future appreciation in value for federal and state income tax purposes.

INVITEE A person who enters another's land because of an express or implied social invitation, such as a social guest. The term also covers certain government workers who enter someone's land, such as police officers and firefighters. Classification of such status was revoked by a recent court case.

INVOLUNTARY ALIENATION Title to real property may be acquired or transferred by operation of law or court order.

INVOLUNTARY CONVERSION The loss of real property due to destruction, seizure, condemnation, foreclosure sale, or tax sale.

INVOLUNTARY INACTIVE The license status that results when a license is not renewed at the end of the license period.

INVOLUNTARY LIEN Any lien imposed on property without the consent of the owner.

IRREVOCABLE Incapable of being recalled or revoked; unchangeable.

IRRIGATION DISTRICTS Quasi-political districts created under special laws to provide for water services to property-owners in the district.

IREM CODE OF ETHICS A set of guidelines on good business conduct for professional property managers.

IRS Internal Revenue Service.

ISSUE A person s direct descendants: children, grandchildren, great-grandchildren, and so on.

J

JALOUSIE A screen or shutter consisting of overlapping horizontal slats that is used on the exterior to keep out sun and rain while admitting light and air.

JAMB The side post or lining of a doorway, window, or other opening.

JOINDER REQUIREMENTS The rules requiring both husband and wife to consent to and sign agreements and conveyances concerning community property.

JOINT The space between the adjacent surfaces of two components joined and held together by nails, glue, or cement, for example.

JOINT NOTE A note signed by two or more persons who have equal liability for payment.

JOINT PROTECTION POLICY A title insurance policy insuring the interest of both owner and lender.

JOINT TENANCY Joint ownership by two or more persons with right of survivorship. Four unities must be present: time, title, interest, and possession. Property held by two or more people with right of survivorship.

JOINT TENANCY DEED A deed that gives title to grantee as joint tenants.

JOINT TRUSTEESHIP A trust created jointly by husband and wife.

JOINT VENTURE In legal effect it is a partnership for a limited, specific business project.

JOISTS One of a series of parallel beams to which the boards of floor and ceiling laths or plaster boards are nailed and supported in turn by larger beams, girders, or bearing walls.

JUDGMENT A court of competent jurisdiction's final determination of a matter presented to it. The final decision by a court in a lawsuit, motion, or other matter.

JUDGMENT AFFIRMED A decision by an appellate court reaffirming, approving, and agreeing with an inferior court's decision.

JUDGMENT CREDITOR A person who is owed money as a result of a judgment in a lawsuit.

JUDGMENT DEBTOR A person who has an unsatisfied money judgment levied against him or her.

JUDGMENT LIEN A money judgment that, because it has been recorded, has become a lien against the judgment debtor's real property.

JUDGMENT REVERSED A decision by an appellate court disagreeing with an inferior court's decision and modifying tha decision to conform with its findings.

JUDICIAL FORECLOSURE SEE: Foreclosure, Judicial.

JUDICIAL REVIEW When a court considers whether or not a statute or regulation is constitutional.

JUDICIAL SALE A sale of property by court proceedings to satisfy a lien.

JUMBO LOAN Amount of loan exceeding the maximum purchased by FNMA and FHLMC. Also called a *Nonconforming Loan.*

JUNIOR LIEN A lien lower in priority or rank than another or other liens.

JUNIOR MORTGAGE A mortgage second in lien to a previous mortgage.

JUNIOR TRUST DEED Any trust deed which is not a forst trust deed.

JURAT Certificate f an officer, such as notary public or magistrate, who has witnessed someone s signature to a sworn document; also, that part of an affidavit stating by whom, where, when, and before whom it was sworn.

JURISDICTION The authority of a court to hear and decide a particular type of case. The power of a court to hear and decide a case or issue.

JURISDICTION, APPELLATE The authority to hear an appeal (as opposed to conducting a trial). Compare: Jurisdiction, Original.

JURISDICTION, DIVERSITY The federal courts power to hear cases in which a citizen of one state sues a citizen of another state (or country).

JURISDICTION, GENERAL When a court s jurisdiction is not limited to specific types of cases.

JURISDICTION, ORIGINAL The authority to conduct a trial (as opposed to hearing an appeal). COMPARE: Jurisdiction, Appellate.

JURISDICTION, PERSONAL A court s authority over a particular individual; usually obtained by service of process

JURISDICTION, SUBJECT MATTER The types of cases a particular court has authority to hear. COMPARE: Jurisdiction General.

JUST COMPENSATION SEE: Eminent Domain.

JUST VALUE The fair market value.

K

KEY LOT Lot that has several other lots backing onto its sideyard.

KEY TENANT A major department store in a shopping center. Also called anchor store.

KICKBACK Payment of money from someone other than the buyer or seller associated with the real estate business.

KIOSK A small sales stall in a shopping mall.

KITING Also known as ballooning, an unethical and fraudulent act in which dual contracts are made, one at the true purchase price and the second at a higher price, with the hope of duping the lender into granting a higher loan

L

LABOR An agent of production; cost of all operating expenses and wages except management.

LABOR-EXTENSIVE INDUSTRY A business with a low concentration of employees per acre.

LABOR-INTENSIVE INDUSTRY A business with a high concentration of employees per acre.

LABOR-ORIENTED INDUSTRY a business that tends to locate near a low-cost labor pool.

LACHES Unreasonable delay in asserting one's legal rights.

LAFCO Local Agency Formation Commission.

LAISSEZ-FAIRE Allow to act; noninterference by government in trade, industry, and individual action generally.

LAND The surface, the soil and rocks beneath, and the airspace above that the landowner can reasonably use and enjoy.

LAND CONTRACT(of sale) A contract used in the sale of real property when the seller wishes to retain legal title until all or a certain part of the purchase price is paid by the buyer. It is also referred to as an installment sales contract or an agreement of sale.

LAND DESCRIPTION (LEGAL DESCRIPTION) A definite and positive written identification of a specific parcel of land and its location without additional oral testimony.

LANDLOCKED Property totally surrounded by other property with no means of ingress or egress.

LANDLORD The person who leases property; the owner of the property.

LAND SALES CONTRACT Contract for Deed) A contract for the sale of property, by which possession is delivered to the buyer, but title remains with the seller until full payment or the satisfaction of other stated conditions.

LAND RESIDUAL TECHNIQUE Technique of income capitalization; the net income remaining to the land (after income attributable to the building has been deducted) is capitalized into an estimate of value for the land.

LANDS, TENEMENTS, AND HEREDITAMENT Inheritable lands or interest.

LARGE PARCEL Total parcel of property from which a governmental body is acquiring only a portion through condemnation.

LATE CHARGE A charge made by a lender against a

borrower who fails to make loan installments when due.

LATE SUPPORT The support that the soil of an adjoining owner gives to his or her neighbor's land.

LATENT DEFECTS Defens that are not visible or apparent; hidden defects.

LATERAL SUPPORT SEE: Support, Lateral.

LATH A building material of wood, metal gypsum, or insulating board fastened to the frame of a building to act as a plaster base.

LAUNDRY ROOM The building owner may own and service the machines, outside vendors may own and handle the machines themselves or the machines may be operated on a card instead of a coin.

LAWFUL OBJECT A legal purpose.

LAW OF FIXTURES Five tests to determine whether an object is a fixture or personal property.

LAY MEMBER One not belonging to or connected with a particular profession.

LEASE A contract between owner and tenant, setting forth conditions upon which the tenant may occupy and use the property and the term of the occupancy.

LEASE ASSUMPTION A transaction whereby a proerty owner agrees to take over the balance of payments on a prospective tenants current lease if he or she rents space in the owner s property.

LEASED FEE Property owner s interest in leased property.

LEASE, FIXED A lease in which the rent is set at a fixed amount, and the landlord pays most or all of the operating expenses (such as taxes, insurance, and repair costs). Also called a flat lease, gross lease, or straight lease.

LEASE, GRADUATED A lease in which it is agreed that the rental payments will increase at intervals by an agreed amount or according to an agreed formula.

LEASEHOLD ESTATE The estate of a tenant under a lease. (See Estate for Years.)

LEASE, NET A lease requiring the tenant to pay all the costs of maintaining the property (such as taxes, insurance, and repairs), in addition to the rent paid to the landlord.

LEASE OPTION A lease in which the lessee is given the option to purchase the property at a specific price and under the terms set out in the lease option agreement..

LEGACY A gift of money by will.

LEGAL ADVICE Legal advice is not something that a real estate agent gives. Refer the client to a lawyer.

LEGAL DOCUMENT SERVICE The process server must br at least 18 years of age and the person receiving the service must be at least 18 years of age.

LEGAL DESCRIPTION A description recognized by law; a description by which property can be definitely located by reference to government surveys or approved recorded maps.

LEGALLY SUFFICIENT (FL) A complaint that contains facts indicating that a violation has occurred of a Florida statue, a DBPR rule, or a FREC rule.

LEGATEE Someone who receives personal property (a legacy) under a will.

LEGISLATURE The arm of a government that has primary responsibility for making new laws.

LENDER A lender with assets of more than $10,000,000 per year must not disclose to the public the race, sex and income of the loan applicants , the amount of loans requested , and the action taken by the lender on the loan application.

LENDERS ESCROW INSTRUCTIONS A lenders instruction to an escrow company giving specific conditions that must be met before escrow can close or the deed of trust can be recorded.

LENDER S TITLE INSURANCE Title insurance issued for the unpaid mortgage amount to protect the lender against title defects.

LESSEE A tenant; the person who is entitled to possession of property under a lease.

LESSOR A landlord; the property owner who executes a lease.

LESS-THAN-FREEHOLD ESTATE A leasehold estate.

LET The temporary use of property to be rented.

LETTER OF CREDIT Letter from a bank asking that the holder be allowed to withdraw money from the recipient bank or agency that will be charged back to the first bank.

LETTER OF INTENT An expression of intent to invest, develop, or purchase without creating any firm legal obligation to do so.

LETTER REPORT One-to five-page written report summarizing the appraisal and its conclusions.

LEVEL Used in finance to express the payment where the monthly sum of principal and interest is always the same.

LEVEL-PAYMENT PLAN A method of amortizing a mortgage whereby the borrower pays the same amount each month.

LEVERAGE Use of borrowed funds to purchase property, with the expectation of increasing the rate of return to equity; sometimes called trading on the equity. An example of using maximum credit.

LEVY To execute upon; to seize and sell property to obtain money to satisfy a judgment.

LIABILITY The claim of creditors against a business.

LIABILITIES Debts or claims that creditors have against assets.

LIABILITY INSURANCE Insurance protecting a property owner or manger in case of damage to the person or property of another due to the owner s or manager s negligence.

LICENSE Personal, nonassignable authorization to enter and perform certain acts on another's land.

LICENSEE Under the law before 1968, which classified persons who entered upon others' land, a licensee was someone who entered upon land with the owner's express or implied permission for a business purpose. Referring to real estate licensee he may be given disciplinary action for being incompetent.

LICENSURE Certification as a licensee; the granting by the state of a license to practice real estate.

LICENSE, RESTRICTED A real estate broker s or salesperson s license that includes limitations on the licensee s right to do business; usually issued after a suspended or revoked license has been reinstated.

LIEN A lien makes the debtor's property security for the payment of a dept or the discharge of an obligation. A charge or claim against property as security for payment of a debt or obligation.

LIENEE One whose property is subject to a claim or charge by another.

LIEN EQUITABLE A lien arising as a matter of fairness, rather than by agreement or by operation of law.

LIEN, MATERIALMAN S Similar to a mechanic s lien, but based on a debt owed to someone who supplied materials (as opposed to labor) for a project.

LIENOR One who has a claim or charge on the property of another.

LIEN PRIORITY The order in which liens are paid off out of the proceeds of a foreclosure sale.

LIEN, PROPERTY TAX A specific lien on property to secure payment of the property taxes.

LIEN, SPECIFIC A lien that attaches only to a particular piece of property (as opposed to a general lien, which attaches to all of the debtor s property).

LIEN, TAX A lien on property to secure the payment of taxes.

LIEN THEORY STATES States in which the mortgagor (borrower) retains legal title to the property; lender (mortgagee) has a lien on the property asa security for the debt.

LIFE ESTATE An estate in real property that continues for the life of a particular person. The life involved may be that of the owner or that of some other person. An estate in property whose duration is limited to and measured by the life of a natural person or persons.

LIFE-ESTATE PUR AUTRE VIE A life estate for the life of another , where the measuring life is someone other than the life tenant.

LIFE INSURANCE COMPANY A business that collects a person s savings by selling contracts (policies) often paid through periodic premiums to provide cash payment upon death.

LIFE SAFETY AND SECURITY A trend in property management that provides for the management of the total physical protection of tenants. A typical life safety and security

program consists of prevention, detection, containment and counteraction.

LIFE SAFETY CONTROL CENTER A security center found most often in large complexes, responsible for handling various emergencies impacting complex workers.

LIFE TENANT Someone who owns a life estate; the person entitled to possession of the property during the measuring life.

LIFETIME CAP Ceiling for rate increases over life of an ARM, expressed as a particular percentage rate or as so many points over or under the initial rate.

LITTORAL RIGHTS Rights to shoreline property on a large body of water, such as an ocean or lake.

LIMITED APPRAISAL REPORT When exercising the departure provision you are usually working under this provision.

LIMITED LIABILITY COMPANY A business entity where each owner has the limited liability of a corporate shareholder and the tax advantages of a partner.

LIMITED LIABILITY PARTNERSHIP A partnership composed of some partners whose contribution and liability are limited. There must always be one or more general partners with unlimited liability and one or more limited partners with limited liability. A special partnership composed of limited and general partners. The general partners have unlimited liability and total management, whereas the limited partners have to voice in the management and their only financial exposure is to the extent of their investment. In some ways the limited partners' interest is similar to that of stockholders in a corporation.

LINEAL The line of ancestry or a straight line

LINEAR FOOT A measurement meaning one foot or 12 inches in length as contrasted to a square foot or a cubic foot.

LINEAR REGRESSION Statistical technique for calculating sales adjustment; line of best fit for two variables.

LINK Each deed or other instrument transferring title in *the chain of title*, the history of ownership of a parcel of real estate.

LINEAL Descended in a direct family line; relating to or derived from ancestors.

LINTEL A horizontal board that supports the load over an opening such as a door or window.

LIQUIDATED DAMAGES CLAUSE An agreement between the parties that in the event of a breach, the amount of damages shall be liquidated (set or fixed). The amount is set before the breach, usually at the time of making the contract, on the assumption that the exact amount of damages is difficult to determine because of the nature of the contract.

LIQUIDATION The process of determining liabilities and apportioning the assets in order to discharge the indebtedness of a business to be sold.

LIQUIDITY The ease with which property can be converted into cash.

LIQUIDITY OF INVESTMENT The ease in which investments can be quickly turned into cash.

LIS PENDENS A notice of pending litigation recorded to give constructive notice of a suit that has been filed. A recorded notice that a lawsuit is pending, the outcome of which may affect title to property.

LISTING An employment contract between a broker and his principal (client).

LISTING AGREEMENT An employment contract authorizing a broker to sell, lease, or exchange an owner's property.

LITIGANT A party to a lawsuit; a plaintiff or defendant.

LITIGATION A civil lawsuit; a judicial controversy.

LITTORAL Legal rights related to land abutting an ocean, sea, or lake, usually extending to the high-water mark.

LOAD FACTOR The ratio of rentable space to usable space on a multiple-tenancy floor of an office building.

LOAN APPLICATION A lender s initial source of information on a borrower/applicant and the collateral involved; stipulates the amount of money requested and the repayment terms.

LOAN APPLICANT S AGE A lender may consider a loan applicant s age when making a determination of the applicant s credit worthiness.

LOAN ASSUMPTION In a loan assumption setup the seller

and buyer are liable under the loan.

LOAN ASSUMPTION FEE A fee a lender charges a buyer in return for granting the buyer permission to assume an existing loan.

LOAN CLOSING When all conditions of the loan have been met , the loan officer authorizes the recording of the trust deed and disbursement of funds.

LOAN COMMITTEE The committee in a lending institution that reviews and approves or disapproves the loan applications recommended by a loan officer.

LOAN COMMITMENT A lender s agreement to lend a specified amount of money; must be exercised within a certain time limit.

LOAN, CONSTRUCTION A loan made to cover the cost of construction of a building, usually arranged so that the money is advanced in installments as the work progresses.

LOAN, CONVENTIONAL Loan with only the property as security, without the government insuring (FHA) or guaranteeing (VA) the loan.

LOAN CORRESPONDENT A loan agent usually used by distant lenders to help the lender make real estate loans.

LOAN FEE A loan origination fee.

LOAN, GUARANTEED A loan in which someone (the VA, for example) guarantees repayment; so that if the borrower defaults, the guarantor reimburses the lender for some or all of the loss.

LOAN ORIGINATION Steps involved in the loan process, from application to close of escrow.

LOAN ORIGINATION FEE A fee a lender charges a borrower in exchange for issuing a loan; also called a loan fee.

LOAN PACKAGE A group of documents prepared along with a loan application to give the prospective lender complete details about the proposed loan.

LOAN, PURCHASE MONEY 1. A loan the borrower uses to buy the security property (as opposed to a loan secured by property the borrower already owns). 2. A carryback loan.

LOAN-TO-VALUE-RATIO (LTV) Percentage of a loan to a property s appraised value; expressed in terms as to how much the lender will lend.

LOAN TRUST FUND ACCOUNT (See Impound Account.)

LOAN UNDERWRITING The process of approving or disapproving loan applications.

LOAN VALUE The lender's appraised value of the property.

LOCAL ACCESS NETWORK A method of linking together personal computers within the same office to allow communication between the computers.

LOCAL PRODUCTION Goods and services produced for sale or use in the town or area in which they are produced.

LOCK-IN CLAUSE A clause in a promissory note or land contract that prohibits prepayment before a specified date, or prohibits it altogether.

LOCK-IN RATE Formal commitment to lend a specific amount or at a specific rate, guaranteed for a specific time period.

LOFT A low-rent , multistory building located in the central business district, originally used for a combination of manufacturing, office and storage space.

LONG-LIVED, INCURABLE PHYSICAL DETERIORATION Loss in value attributable to the major components of a building, when age is the major contributing factor and the cost of repair would exceed the value that would be added to the structure by the repair.

LOSS, CAPITAL A loss taken on the sale of a capital asset. Real estate is considered a capital asset if it s income property, investment property, or property used in a trade or business.

LOSS FACTOR The ratio of rentable space to usable space on a single-tenancy floor of an office building.

LOSS, PASSIVE A loss taken in connection with income property. SEE: Passive Income.

LOT A parcel of land; especially, a parcel in subdivision.

LOT AND BLOCK DESCRIPTION The type of legal description used for platted property. The description states only the property s lot number and block number in a particular subdivision. To find out the exact location of the property s

boundaries you consult the plat map for that subdivision at the county recorders office.

LOT BOOK REPORT A short title company report providing the property owners name, the vesting, the property s legal description, and a plat map.

LOUVER An opening with a series of horizontal slats set at an angle to permit ventilation without admitting rain, sunlight, or vision.

LUMP SUM Payment of the entire principal amount due at maturity on a straight note.

LUMP-SUM DOLLAR ADJUSTMENT Type of sales adjustment; specific dollar amount is added or subtracted for each differing feature.

M

MAI A term that designates a person who is a member of the American Institute of Appraisers of the National Association of Realtors.

MAILBOX RULE An acceptance of a contract offer is effective as of the moment it is mailed, even though the other party hasn t received it yet.

MAINTENANCE CLAUSE A provision in a mortgage agreement that requires mortgagors (borrowers) to maintain mortgaged property in good condition.

MAINTENANCE STAFF OR PERSONNEL May be either employees or independent contractors. They should report the number of people living in a residential unit, the use of extension chords and the storage of flammable products.

MAJORITY, AGE OF The age at which a person gains legal capacity; in California, 18 years old. COMPARE: *Minor.*

MAKER A person who signs a promissory note; the borrower who promises to repay the debt.

MLS Mere membership in an MLS by a broker creates a dual agency with the principals of other broker members of the MLS. (Multiple Listing Service)

MALFEASANCE The committing of an unlawful act, especially by a public official.

MANAGEMENT CONFIRMATION LETTER This letter contains: where the owner has moved to, why he or she did not sell and his or her current goal in renting the property.

MANAGEMENT PLAN The financial and operational strategy for the ongoing management of a property. It is based on the market analyses, a property analyses and the owners goals and consists of an operating budget, a five year forecast and sometimes a comparative income and expense analysis. Future data very important.

MANAGEMENT PRICING WORKSHEET A method of computing management fees by itemizing management activities, calculating the direct cost to the firm and adding a percentage for profit.

MANDAMUS,WRIT OF A court decree ordering a lower court judge, public official, or corporate officer to perform an act acquired of that office.

MANDATE Directive from higher authority to a lower body.

MARGINAL LAND Land which barely pays the cost of working or using it.

MARGIN The amount added to the index rate determined a borrowers adjusted interest rate on a adjustable loan.

MARGIN OF SECURITY The difference between the amount of secured loan(s) on a property and its appraised value.

MARKET APPROACH (to value) SEE: *Sales Comparison Approach.*

MARKET ANALYSES A regional and neighborhood studies of economic. Demographic and other information made by the property manager to determine the supply and demand, market trends and other factors important in leasing and operating a specific property.

MARKET-ORIENTED INDUSTRY A business that tends to locate near industrial users and consumers of its products.

MARKET DATA APPROACH (See Comparative Market Analysis.)

MARKET EXPOSURE Making a reasonable number of potential buyers of a property is available for sale.

MARKET METHOD OF DEPRECIATION SEE: Sales Data Method of Depreciation.

MARKET PRICE The price paid regardless of

pressures, motives, or intelligence.

MARKET RENT The rental income the property could command if placed for rent on the open market as of the effective date of the appraisal.

MARKET TREND DATA Two forces the tend to affect value in this outlook are social and economic, and governmental and environmental.

MARKET VALUE (1) The price at which a willing seller would sell and a willing buyer would buy, neither being under abnormal pressure. (2) As defined by the courts, it is the highest price estimated in terms of money that a property will bring if exposed for sale in the open market, allowing a reasonable time to find a purchaser with knowledge of the property's use and capabilities for use.

MARKETABLE TITLE Title free and clear of reasonable objections and doubts; also called merchantable title.

MASTER IN CHANCERY An appointed assistant to the court.

MATERIAL FACT A fact that would be likely to affect a person's decision in determining whether to enter into a particular transaction.

MATERIALMAN Someone who supplies materials for a construction project. SEE: Lien, Materialmans. COMPARE: Mechanic.

MATURE PHASE SEE: Stable Phase.

MATURITY DATE The date by which a loan is supposed to be paid off in full.

MAXIMUM PERCENTAGE LEASE A type of percentage lease that sets a ceiling on the amount of rent to be paid.

MEASURING LIFE SEE: Life Estate.

MECHANIC Someone who performs work (construction, improvement, or repairs) on real property. SEE: Lien, Mechanics. COMPARE: Materialman.

MECHANIC'S LIEN A lien given by statute to persons supplying labor, materials, or other services to improve real property. Whenever a contractor, laborer, or materialman provides labor or materials to improve real property and is not paid, that person is entitled to a lien against the property as a means of securing payment. Certain statutory steps must be taken to file, record, and foreclose the lien. Memo to set: A document filed in a lawsuit which asks to be placed on the waiting list ("docket") for the next available court date.

MEDIATION The act of having a third party attemprt to reconcile a dispute between two parties.

MEDIATION CLAUSE A clause in a contract requiring mediation in the even of a dispute.

MEDIATOR A person who helps the parties reach a voluntary agreement.

MEETING OF MINDS *SEE: Mutual Consent.*

MEGALOPOLIS A heavily populated urban area which includes many cities.

MENACE A threat to use duress. (See Duress.)

MERCHANTABLE TITLE (See Marketable Title.)

MERCHANTS ASSOCIATION An organization of shopping centers tenants intended to facilitate joint advertising, promotion and other activities beneficial to the center.

MERGER Uniting two or more separate properties by transferring ownership of all of them to one person.

MERGER OF TITLE The combination of two estates. Also refers to the joining of one estate burdened by an encumbrance and another estate benefitted by the encumbrance. Whenever a benefit and a burden are merged, the encumbrance is extinguished.

MERIDIANS Imaginary north-south lines that intersect base lines to form a starting point for the measurement of land.

MERIDIAN, PRINCIPAL In the government survey system, the main north-south line in a particular grid, used as the starting point in numbering the ranges. California has the Humboldt Meridian, the Mt. Diablo Meridian, and the San Bernardino Meridian.

METES Measurements.

METES AND BOUNDS DESCRIPTION Terms used to describe the boundary lines of land, setting forth all the boundary lines together with their terminal points and angles. Metes means measurements Bounds means boundaries.

MIDDLEMAN An intermediary who merely brings two parties together.

MILL A taxation measurement equal to one tenth of one percent ($.001).

MILLAGE A tax expressed as the number of mills to be applied.

MINERAL RIGHTS Rights to the minerals located beneath the surface of a piece of property.

MINIMUM-GUARANTEED PERCENTAGE LEASE A type of percentage lease that requires the tenant to pay either a fixed minimum rental or a percentage of gross sales, whichever is greater.

MINIMUM RENT Base rent that is the fixed minimum amount paid under a percentage lease.

MINIRESORT A budget motel that has been transformed into a desirable weekend vacation spot by capitalizing on local recreational areas and points of interest.

MINISTORAGE Small, secure storage units rented to individuals and small businesses. Rent is usually established after surveying similar spaces to determine market rents.

MINOR (1) A person under the age of majority. (2) In California all persons under eighteen years of age - the age of majority in California. Someone under age 18.

MINOR, EMANCIPATED A minor who is or has been married, is on active duty in the armed forces, or has a declaration of emancipation from a court. An emancipated minor has legal capacity to contract.

MINUS CASH FLOW An event that takes place when there is not enough cash to cover expenses and service the mortgage debt.

MISDEMEANOR Any crime punishable by fine or imprisonment other than a penitentiary.

MISFEASANCE A lawful act done in a negligent or unlawful manner.

MISPLACED IMPROVEMENT A building that is functionally obsolete because it is the wrong type or use for its location; an example of functional obsolescence.

MISREPRESENTATION An intentional or negligent suggestion or statement of a material fact in a false manner with the intent of deceiving someone into taking a course of action he would not otherwise normally pursue.

MISTAKE, MUTUAL When both parties to a contract were mistaken about a fan or a law.

MISTAKE, UNILATERAL When only one of the parties to a contract was mistaken about a fan or a law.

MITIGATION Facts or circumstances that tend to justify or excuse an act or course of conduct.

MIS Mortgage Information System

MIXED CAPITALISM The U.S. economic system is a prime example. Many different types of businesses abound in the U.S. giving it strength economically.

MIXED-USE DEVELOPMENT (MXD) A development in the use of property combining retail, office-residential or industrial-office residential development.

MOBILE HOME PARK The property manager of thid type of rental must offer a one-year lease to all tenants.

MODULAR HOME Building composed of modules constructed on an assembly line in a factory.

MONETARY POLICY Programs by the Federal Reserve System that increase or decrease the supply of or demand for money in an effort to achieve designated economic goals.

MONTH-TO-MONTH TENANCY A lease of property for a month at a time, under a periodic tenancy that continues for successive months until terminated by proper notice, usually 30 days.

MONTHLY MORTGAGE PAYMENTS A specified amount of money that is paid every month to reduce the amount of the mortgage.

MOBILE HOME A stationary, nonmotorized vehicle designed and equipped for human habitation. It may be transported to a homesite by special equipment.

MOLDING Usually patterned strips used to provide ornamental variation of outline or contour, such as cornices, bases, window and door jambs.

MONUMENT A fixed object and point established by surveyors or others to establish land locations.

MORAL TURPITUDE An act of corruption, vileness, or

moral depravity; a disgraceful action or deed.

MORATORIUM The temporary suspension, usually by stature, of the enforcement of liability for debt.

MORTGAGE An instrument by which property is hypothecated to secure the payment of a debt or obligation.

MORTGAGE-BACKED SECURITIES Investment securities similar to bonds representing an interest in a pool of mortgages.

MORTGAGE BANKERS Use their own funds to make loans, sell loans to investors and service loans that they have made.

MORTGAGE BROKERS Differ from mortgage bankers in that they invest no capital; their prime function is to bring together borrowers and lenders, for this they are paid a fee.

MORTGAGE COMPANY A mortgage loan company that originates, services, and sells loans to investors.

MORTGAGE/EQUITY ANALYSIS A technique used to analyze the debt and equity return requirements of an investment.

MORTGAGE INSURANCE PREMIUM (MIP) FHA insures lenders against loss on FHA loans;. The premium can be paid up front or financed as part of the loan.

MORTGAGE LOAN DISCLOSURE STATEMENT A statement that informs the buyer of all charges and expenses related to a particular loan.

MORTGAGE, SATISFACTION OF The document a mortgagee gives the mortgagor when the mortgage debt has been paid in full, acknowledging that the debt has been paid and the mortgage is no longer a lien against the property. COMPARE: reconveyance.

MORTGAGEE One to whom a mortgagor gives a mortgage to secure a loan or performance of an obligation: the lender under a mortgage. (See Secured Party.) A creditor (lender) under a mortgage. A lender who holds a mortgage on a specific property as security for the money loaned to the borrower.

MORTGAGE GUARANTY INSURANCE Insurance against financial loss available to mortgage lenders from the Mortgage Guaranty Insurance Corporation, a private company organized in 1956.

MORTGAGE YIELD The rate of return for a buyer of an exiting loan that takes into consideration the interest rate, discount rate, loan servicing fees and the term of the loan.

MORTGAGOR One who gives a mortgage on his or her property to secure a loan or assure performance of an obligation; the borrower under a mortgage. (See Debtor.) A borrower (property owner) of money under a mortgage.

MOTELS AND HOTELS Access from freeways or highways is a very important factor of doing business.

MULTIMEDIA A computer system or program that utilizes data in several different forms (i.e., text, voice , music and video)

MULTIPLE LICENSES Licenses held by a broker in two or more real estate firms.

MULTIPLE LISTING A listing, usually an exclusive-right-to-sell, taken by a member of an organization composed of real estate brokers with the provisions that all members will have the opportunity to find an interested client; a cooperative listing. A listing taken by a broker and shared with other brokers through a specialized distribution service, usually provided by the local real estate board. Generally, such listings are exclusive right to sell listings.

MULTIPLE REGRESSION Statistical technique for calculating sales adjustments for more than one feature.

MUNICIPAL COURT An inferior trial court having jurisdiction in cases involving up to $15,000 in money damages and in unlawful detainer actions in which the rental value is under $1,000 per month.

MUTUAL ASSENT An agreement between the parties in a contract. The offer and acceptance of a contract.

MUTUAL CONSENT When all parties freely agree to the terms of a contract, without fraud, undue influence, duress, menace, or mistake. Mutual consent is achieved through offer and acceptance; it can be referred to as a meeting of the minds.

MUTUAL MISTAKE SEE: *Mistake, Mutual.*

MUTUAL SAVINGS BANK A savings bank originated in the New England states in which depositors place their savings with the right to borrow money for home loans. There are no

mutual saving banks in California.

MUTUAL WATER COMPANY A water company organized by or for water-users in a given district, with the object of securing an ample water supply at a reasonable rate. Stock is issued to users.

N

NAR National Association of Realtors.

NAREB National Association of Real Estate Boards. This trade organization is now known as the National Association of Realtors.

NARRATIVE REPORT A detailed formal written report of the appraisal and the value conclusion.

NATIONAL ASSOCIATION OF INDUSTRIAL AND OFFICE PARKS (NAIOP) A professional association for developers, owners and managers of office/business/industrial parks.

NATIONAL ASSOCIATION OF REALTORS (NAR) Has a professional organization of property managers called the Institute of Real Estate Management.

NATIONAL ENVIRONMENTAL POLICY ACT (NEPA) A federal act passed in 1970 that requires the processing of environmental impact disclosures for major federal action affecting the environment.

NATURAL PERSON A human being, an individual (as opposed to an artificial person, such as a corporation).

NEGATIVE AMORTIZATION Occurs when normal payments on a loan are insufficient to cover all interest then due, so that unpaid interest is added ro principal. Thus, even though payments are timely made, the principal grows with each payment.

NEGLIGENCE Either the failure to act as a reasonable, prudent person, or the performance of an act that would not be done by a reasonable, prudent person.

NEGOTIABLE Capable of being assigned or transferred by endorsement; checks, drafts and notes are all negotiable.

NEGOTIABLE INSTRUMENT (NOTE) A check or promissory note that meets specified statutory requirements and is therefore easily transferable in somewhat the same manner as money. The negotiable instrument can be passed by endorsement and delivery (or in some cases by mere delivery), and the transferee takes title free of certain real defenses (such as failure of consideration, fraud in the inducement) that might exist against the original maker of the negotiable instrument. You are not responsible dor this if it has been forged or altered

NEGOTIABILITY Loan is capable of being sold on the secondary mortgage market.

NEIGHBORHOOD An area whose occupants and users share some common ties or characteristics.

NEIGHBORHOOD CENTER A shopping center of about 30.000 to 100.000 square feet (15 to 20 retail spaces) catering to 1,000 families or more.

NEIGHBORHOOD CYCLE The process of neighborhood change, involving four phases of change: development, maturity, decline, and renaissance. (SEE: Principle of Change.)

NEPA Abbreviation for the National Environmental Protection Act, a federal statute requiring all federal agencies to prepare an Environmental Impact Statement and meet other requirements whenever a major federal action is anticipated that could significantly affect the environment.

NET This type of adjustment is the net sum of positive and negative adjustments.

NET AREA *SEE: Useful Area.*

NET INCOME Gross annual income less income lost due to vacancies and uncollectible rents, less all operating expenses.

NET INCOME RATIO Net income divided by gross income.

NET LEASE Lease under which the lessee pays all property expenses.

NET OPERATING INCOME (NOI) The resulting amount when all operating expenses are subtracted from effective gross income.

NET LISTING A listing that provides that the agent may retain as compensation for his or her services all sums received over and above a stated net price to the owner. An employment agreement that entitles the broker to a commission only in the amount, if any, that the sales price of the property exceeds the listing price. No implied or expressed warranties.

NET PRESENT VALUE This the discounted cash flow approach to capital budgeting.

NET SPENDABLE INCOME Net operating income less vacancies, uncollectible rents, and other operating expenses.

NEUTRAL DEPOSITORY An escrow business conducted by someone who is a licensed escrow holder.

NEW CAR DEALERS The best location fora new car dealer is with other different new car dealers.

NOLO CONTENDERE A pleading of no contest by a defendant; a plea in a criminal action not admitting guilt but subjecting the defendant to punishment as if it were a guilty plea.

NOMINAL INTEREST RATE A state (or contract) rate of interest. May not correspond to the true or effective annual percentage rate (e.g., when payments are made monthly).

NONBINDING ARBITRATION The decision of the arbitrator is review able by the court.

NONCOMPETING TENANT RESTRICTIONS A lease clause granting a retail tenant an exclusive right to operate without competition on the property.

NON-CONFORMING LOAN A loan for an amount that exceeds the Fannie Mae/Freddie Mac guide lines for a *conforming loan.* The limit is adjusted annually. Also known as a *jumbo loan.*

NONCONFORMING USE A property use that doesn t conform to current zoning requirements, but is allowed because the property was being used in that way before the present zoning ordinance was enacted.

NONFIDUCIARY LENDER Loan sources such as individuals who owe no agency duty, because they lend their own funds rather than invest on behalf of other lenders.

NONFREEHOLD ESTATE A lease tenancy. (See under Estates for the four types of leasehold estates.)

NONINSTITUTIONAL LENDER Lenders on real estate loans other than banks, insurance companies, and savings and loan associations.

NONJUDICIAL FORECLOSURE Foreclosure and sale of property without resort to court action, by private sale. For deeds of trust the foreclosure provisions are outlined by the statutes and the requirements in the security instrument, which include a notice of default, right to reinstate, publication of sale, and trustee's sale.

NONPOSSESSORY INTEREST An interest in property that does not include the right to possess and occupy the property; an encumbrance, such as a lien or an easement.

NON-RECURRING CLOSING COSTS Fees and costs that are paid only once usually at closing, such as title insurance or points.

NONRECURRING VARIABLE EXPENSE A type of variable property expense (e.g.; capital improvements) that occurs only once.

NONRECOGNITION PROVISION A provision in the income tax law that allows a taxpayer to defer recognition and taxation of a gain until a later time or later transaction.

NOTARY PUBLIC An individual licensed by the state to charge a fee for acknowledging signatures on instruments.

NOTE A signed written instrument promising payment of a stated sum of money . Shortened name for a promissory note. A note may contain all the following clauses, request for notice, prepayment penalty and late charges.

NOTE, DEMAND A promissory note that is due when-ever the holder of the note demands payment.

NOTICE, ACTUAL Actual knowledge of a fan, as opposed to knowledge imputed by law.

NOTICE OF COMPLETION A notice recorded after termination of work on improvements, limiting the time in which mechanic's liens can be filed against the property.

NOTICE OF CESSATION A notice recorded by a property owner when construction on the property has ceased, although the project hasn t been completed; it limits the period in which laborers and suppliers can file mechanics liens.

NOTICE OF CHANGE OF TERMS OF TENANCY This notice may be used for rent increases, to notify tenant of new property manager and to notify tenants that they must begin to pay for certain utilities,

NOTICE OF DEFAULT A notice that is recorded in the county recorder's office stating that a trust deed is in default and that the holder has chosen to have the property sold. The trustor (property owner) has three months after the date of recording to reinstate the loan . Recorded notice that a trustor has defaulted on his secured debt. The correct name for this is request for notice .

NOTICE, INQUIRY When there were circumstances that should have alerted someone to a possible problem and caused him or her to investigate further, he or she may be held to have had notice of the problem.

NOTICE OF INTENTION To sell under bulk transfer law would be recorded in the county where the business is located.

NOTICE OF LEVY A notice recorded by the receiver after a court has issued a decree of foreclosure.

NOTICE OF NONCOMPLIANCE (FL) Issued by the DBPR in the case of a minor rule violation that does not endanger the public health, safety and welfare.

NOTICE OF NONRESPONSIBILITY A notice provided by law designed to relieve a property owner from responsibility for the cost of work done on the property or materials furnished for it when the work or materials were ordered by a person in possession. Notice relieving an owner from possession. Notice relieving an owner from mechanic's liens for work on property not ordered by that owner.

NOTICE TO PAY RENT OR QUIT A notice to a tenant to vacate rented property. Also called a three-day notice. Notice given to a tenant in default of his lease terms or on his rent, which directs him either to cure the default or to vacate the premises. This should only be used when there is an existing lease.

NOTICE OF SALE A notice issued by a trustee (or by the receiver after a decree of foreclosure) setting the date for the foreclosure sale.

NOVATION The acceptance of a new contract in substitution for the old contract, with the intent that the new contract will extinguish the original contract. Sometimes encountered in transfers of deeds of trust, where the new owner assumes the debt and the lender, through novation, releases the former owner from any liability under the original promissory note and deed of trust.

***NOW* ACCOUNTS** Negotiable order of withdrawal, an interest bearing checking account permitted for the first time by savings and loan associations and banks as of 1982.

NUISANCE Anything that is injurious to health or indecent or offensive to the senses, or any obstruction to the free use of property so as to interfere with the comfortable enjoyment of life or property or unlawfully obstructs the free passage or use, in the customary manner, of any navigable lake or river, bay, stream, canal, or basin, or any public park, square, street, or highway. A legal wrong arising from acts or use of one's property in a way that unreasonably interferes with another's use of his property.

NUISANCE RENT RAISE The amount of money a property manager can raise current rents without causing a vacancy based on the theory that the tenant will pay rather than suffer the trouble and expense of moving.

O

OBJECTIVE INTENT SEE: Intent. Objective.

OBLIGATORY ADVANCES Disbursements of money that the lender is required to make, under terms of the loan, over the period of the construction loan.

OBLIGEE A promisor; a person to whom another is bound by a promise or another obligation.

OBLIGOR A borrower or mortgagor.

OBSERVED CONDITION METHOD OF DEPRECIATION SEE: *Cost-to-Cure Method of Depreciation.*

OBSOLESCENCE Loss in value due to reduced desirability and usefulness of a structure because its design and construction become obsolete; loss because of becoming old-fashioned and not in keeping with modern needs.

OCCUPATIONAL SAFETY AND HEATH ADMINISTRATION (OSHA) a federal organization empowered to prescribe and legislate the use of potentially toxic chemicals and compounds, and other safety rules for the workplace.

OFFER A proposal to create a contract, which signifies the present intent of the offeror to be legally bound by his proposal.

OFFERS TO PURCHASE Any offer to purchase received prior to the closing of a sale must be presented by the broker unless instructions stating otherwise are received from the seller.

OFFEREE A person to whom an offer is made.

OFFEROR A person who makes an offer.

OFFICE BUILDINGS Have had a national vacancy rate of about 11%.

OFFICE OF THRIFT SUPERVISORS (OTS) A branch of the United States Treasury Department that replaced the Federal Home Loan Bank Board as regulator of the thrift industry.

OFFICE PARK See *business park*

OFFICE POLICY MANUAL This contains objectives of the business enterprise, employee and personnel policies and safety regulations, and job descriptions and benefits.

OFFICIAL RECORDS A master set of books kept by the county recorder in which copies of all recorded documents in that county are stored; may be microfilmed.

OFF-PRICE CENTER A specialized type of shopping center recognized by the Urban Land Institute; a variation on the discount department store concept.

OFFSET STATEMENT Statement by owner of a deed of trust or mortgage against the property, setting forth the present status of the debt and lien. Also called a beneficiary statement.

OIL COMPANIES Because they have large tracks of land and are ample funded these companies are suited to develop large tracts of land.

ON-SITE JOB PROGRAM Employment of tenants occupying low-cost residential buildings to perform maintenance work in these buildings.

OPEN-END MORTGAGE OR DEED OF TRUST (CLAUSE) A mortgage containing a clause that permits the mortgagor or trustor to borrow additional money without rewriting the mortgage or deed of trust.

OPEN MARKET TRANSACTION Transaction in which both buyer and seller act willingly, with full knowledge of all details of the property and transaction, and under no pressure.

OPEN LISTING An authorization given by a property-owner to a real estate agent in which the agent is given the nonexclusive right to secure a purchaser. Open listings may be given to any number of agents without liability to compensate any except the one who first secures a buyer ready, willing, and able to meet the terms of the listing or who secures the acceptance by the seller of a satisfactory offer.

OPERATING BUDGET A projection of income and expense for the operation of a property over a one-year period.

OPERATING EXPENSES Expenses required to run a property. Includes fixed, variable, and reserves for replacement.

OPERATING STATEMENT Written record of a property s gross income, expenses, and resultant net income for a given period of time.

OPINION An agent s opinion is not a sueable matter.

OPINION, JUDICIAL A judge s Written statement of a decision in a court case, outlining the fans of the case and explaining the legal basis for the decision.

OPINION OF TITLE An attorney s written evaluation of the condition of title to a real property, based upon careful examination of the abstract of title.

OPINION OF VALUE An estimate of a property s worth given by a licensee for the purpose of a prospective sale.

OPTION CONTRACT A right to have an act performed in the future; a right given for a consideration to purchase or lease a property upon specified terms within a specified time; a contract to keep an offer open for a particular period of time. The right of a person to buy or lease property at a set price at any time during the life of a contract.

OPTION TO RENEW A lease provision giving the tenant the right to extend the lease for an additional period of time on specified terms.

OPTIONEE The person to whom an option is given.

OPTIONOR The person who gives an option.

OPTION LISTING A listing that also includes an option, permitting the broker to buy the property at the stated price at any time during the listing period.

OPTION ON PROPERTY Allows the buyer to buy within certain restrictions but does not make buyer obligated to buy.

OPTION TO PURCHASE An option giving the optionee the right to buy property owned by the optionor at an agreed price during a specified period.

ORAL CONTRACT A verbal agreement, one not reduced to writing.

ORDINANCE A law passed by a political subdivision of the state (such as a town, city, or county).

ORIENTATION Placement of a house on its lot with regard to its exposure to the rays of the sun, prevailing winds, privacy from the street, and protection from outside noises.

ORIGINATION FEE Fee paid to the lender for originating and closing the loan; typically 1% of the loan amount.

OR-MORE CLAUSE A simple prepayment clause that permits the borrower to make a normal payment or any larger amount, up to and including the entire outstanding balance, without a prepayment penalty.

OSTENSIBLE That authority which a person reasonably believe an agent possesses because of the acts or omissions of the principal.

OSTENSIBLE AGENCY An agency implied by law because the principals intentionally or inadvertently caused a third person to believe someone to be his agent, and that third person acted as if that other person was in fact the principal's agent.

OSTENSIBLE PARTNERSHIP One or more parties cause a third party to be deceived into believing that a business relationship exists when no such relationship exists.

OTS Took over the responsibilities of the disbanded Federal Home Loan Bank Board.

OUSTER One co-tenant refuses to allow occupancy by the other co-tenant.

OUTLAW The Statue of Limitations has expired.

OVERBUILDING Two things caused by overbuilding are lower rents and increased vacancy factor.

OVERAGE A percentage of gross sales over a certain amount paid to an owner in addition to a minimum base rent; often required in percentage leases.

OVERAGE RENT Amounts paid over and above the base rent, under a percentage lease.

OVERALL CAPITALIZATION RATE (OAR) The relationship between net income and value for the total property. Used to capitalize income.

OVERHANG The part of the roof that extends beyond the walls and that shades buildings and covers walks.

OVER IMPROVEMENT An improvement that is not the highest and best use for the site on which it is placed, by reason of excessive size or cost.

OVERAGES Unexplained overages in trust accounts may not be used to offset shortages.

OVERLAPPING TRUST DEED See *Blanket Deed of Trust or Mortgage*

OWNER OF THE FUNDS All profits earned by a broker through misuse of trust belong to the owner of the funds.

OWNERSHIP The right of a person to use and possess property to the exclusion of others.

OWNERSHIP IN SEVERALTY Ownership by a single individual. COMPARE: Concurrent Ownership.

OWNER S TITLE INSURANCE Title insurance issued for the total purchase price of the property to protect the new homeowner against unexpected risks.

P

PACKAGE LOAN (MORTGAGE) Loan secured both by real and personal property, usually appliances and other fixtures.

PACKAGE TRUST DEED OR MORTGAGE A trust deed secured by both real property and personal property. (Appliances, furniture etc.)

PAPER Notes in lieu of cash.

PANIC SELLING SEE: Bllockbusting.

PAR The face amount of a loan with no premium or discount.

PARCEL A lot or piece of real estate, particularly a specified part of a larger tract.

PAROL Oral or verbal.

PAROL CONTRACT An oral or verbal contract.

PAROL EVIDENCE RULE A rule of courtroom evidence that once the parties make a written contract, they may not then introduce oral agreements or statements to modify the terms of that written agreement. An exception exists for fraud or mistake, which will permit the parties to offer evidence to vary the terms of the writing.

PARQUET FLOOR Hardwood flooring laid in squares or patterns.

PARTIAL EVICTION A situation in which the landlord s

negligence renders all or part of the premises unusable to the tenant for the purposes intended in the lease.

PARTIAL RECONVEYANCE (DEED) In a deed of trust or mortgage, a clause that permits release of a parcel or part of a parcel from the effects and lien of that security instrument. The release usually occurs upon the payment of a specified sum of money.

PARTIAL RELEASE CLAUSE A clause in a trust deed that provides for the release of pert of the property from the lien of the trust deed upon payment of a specific portion of the debt.

PARTIAL TAKING Governmental agency acquiring only a portion of a property through condemnation.

PARTICIPATION When a lending institution sells a part interest in a block of loans to another institution or agency.

PARTICIPATION CERTIFICATE Proof of membership in a trust cooperative granted in a particular amount , usually with right to occupy a unit in property owned by trust.

PARTITION ACTION A legal action by which co-owners seek to sever their joint ownership. The physical division of property between co-owners, usually through court action.

PARTITION, JUDICIAL A court action to divide up a property among its co-owners, so that each owns part of it in severalty, or (if it s not practical to divide the property physically) each gets a share of the sale proceeds.

PARTITION, VALUNTARY When co-owners agree to terminate their co-ownership, dividing up the property so that each owns a piece of it in severalty.

PARTNER, GENERAL A partner who has the authority to manage and contract for a general or limited partnership, and who is personally liable for the partnership s debts.

PARTNER, LIMITED A partner in a limited partnership who is primarily an investor and does not participate in the management of the business, and who is not personally liable for the partnership s debts.

PARTNERSHIP An association of two or more persons to unite their property, labor or skill, or any one or combination thereof, in prosecution of some joint business, and to share the profits in certain proportions. An agreement of two or more individuals jointly to undertake a business enterprise. If it is a general partnership, all partners have unlimited liability and, absent other agreements, share equally in the management and profits of the business.

PARTNERSHIP, GENERAL A partnership in which each member has an equal right to manage the business and share in the profits, as well as an equal responsibility for the partnership s debts. All of the partners are general partners.

PARTNERSHIP, LIMITED A partnership made up of one or more general partners and one or more limited partners.

PARTNERSHIP PROPERTY All property that partners bring into their business at the outset or later acquire for their business; property owned as tenants in partnership. SEE: Tenancy in partnership

PARITY WALL A wall erected on the line between two adjoining properties that are under different ownership for the use of both owners.

PASSIVE INCOME Income (rents) received from income property, as opposed to wages, salaries, interest, dividends, or royalties. An IRS term.

PASS-THROUGH SECURITIES Certificates pledging a group (pool) of existing government-backed mortgages used for the purpose of channeling funds into housing markets.

PATENTS (1) Conveyance of title to government land. (2) An ambiguous legal description. Deeds used by the U.S. government when confirming or transferring ownership to private parties.

PATIO HOME SEE: Zero-Lot-Line Home.

PAYEE The person entitled to payment under a promissory note.

PAYMENT CLAUSE A provision in a promissory note, deed of trust, or mortgage, permitting the debtor to pay off the obligation before maturity.

PAYOFF CHECK Final disbursement check to a lender to pay off a loan in full.

PAYOR Person who pays the sum on a note due to a payee.

PENALTY CLAUSE A provision in a mortgage that requires that requires the buyer to pay a penalty in money if the mortgage payments are made in advance of the normal due date or if the mortgage is paid in full ahead of the due date.

PENNY The term, as applied to nails, that serves as a measure of nail length and is abbreviated by the letter d .

PERCENTAGE ADJUSTMENT Type of sales adjustment; the estimated difference between the comparable sale and the subject is first calculated as a percentage of the sale price of the comparable, and then applied as an upward or downward adjustment to the price.

PER-UNIT-COST-METHOD A method of computing management fees based on the management firm s capabilities and the direct cost of managing a specific number of units.

PERCENTAGE FEE A property management fee expressed as a percentage of the gross collectible income from a property.

PERCENTAGE LEASE A lease on property, the rental for which is determined by the amount of business done by the tenant, usually a percentage of gross receipts from the business, with provision for a minimum rental.

PERCOLATION The ability of the soil to absorb water.

PER DIEM By the day; an allowance for daily expenses.

PERFORMANCE Point when a party or parties to a contract fulfill the promises or obligations in the contract.

PERFORMANCE BOND A bond furnished to guarantee that a builder will perform in accordance with the contract terms and that the property at completion will be free of mechanic s liens.

PERIMETER HEATING Baseboard heating or any system in which the heat registers are located along the outside walls of a room, especially under the windows.

PERIODIC COST A type of fixed property expenses that occurs on a regular but infrequent basis.

PERIODIC TENANCY A leasehold estate that continues indefinitely for successive periods of time, until terminated by proper notice. When the periods are one month in duration, it is often called a month-to-month lease.

PERMANENT FINANCING See *Take-out Loan*

PERSONAL INJURY A term commonly used in tort (e.g. negligence cases) indicating an injury to one's being or body (for example, cuts or broken bones) as opposed to injury to his property.

PERSONAL PROPERTY Any property that is not real property. (See Real Property.) Property that is movable, as opposed to real property, which is immovable; also includes intangible property and leasehold estates.

PERSONAL REPRESENTATIVE Administrator for a deceased person s estate.

PERSONALTY Personal property.

PERSONAL USE PROPERTY Property that a taxpayer owns for his or her own use (or family use), as opposed to income property, investment property, dealer property, or property used in a trade or business.

PETITION TO CONFIRM Filed with the court when a party refuses to comply with the arbitration award.

PETITION TO REVIEW A request to a court of appeal asking to examine the record of the proceedings in a specific case.

PETITIONER A person who petitions the court on a special proceeding or a motion.

PHYSICAL CONDITION OF PROPERTY When evaluating the physical condition of a building it is also important to note the number and size of the units and the staff size.

PHYSICAL DETERIORATION OR DETERIORATION The loss of value from all causes of age and action of the elements. Loss in value brought about by wear and tear, disintegration, use and actions of the elements.

PIER A column of masonry used to support other structural members.

PITCH The incline or rise of a roof.

PITI The monthly payments necessary to cover principal, interest, taxes, and insurance.

PLAINTIFF The party who initiates a lawsuit; the person who sues another.

PLANNED UNIT DEVELOPMENT(PUD) A development (usually residential) with small, clustered lots designed to leave more open space than traditional subdivisions have. Each individual lot is substandard, has inadequate parking, and has equity that often increases at a faster pace than other association housing.

PLANNING Devising ways and means for achieving desired goals.

PLANNING COMMISSION A local government agency responsible for preparing the community s general plan for

development. SEE: General Plan.

PLANS AND SPECIFICATIONS Architectural and engineering drawings and specifications for construction of a building , including description of materials and manner in which they are to be applied.

PLANT DEPARTMENT Department in a title company where research materials and copies of official documents are kept.

PLATE BOOK A large book containing subdivision plats, kept at the county recorder s office.

PLATE A horizontal board placed on a wall or supported on posts or studs to carry the trusses of a roof or rafters directly; a shoe or base member, as of a partition or other frame; a small flat board placed on or in a wall to support girders and rafters, for example.

PLAT MAP Map of land subdivision or housing development.

PLEDGE Deposition of personal property by a debtor with a creditor as security for a debt or engagement.

PLEDGEE One who is given a pledge as security. (See Security Party)

PLEDGOR One who gives a pledge as security. (See Debtor)

PLOTTAGE or ASSEMBLAGE INCREMENT (VALUE) The appreciation in unit value created by joining smaller ownerships into one large single ownership.

PLYWOOD (1) Laminated wood made up in panels. (2) Several thicknesses of wood glued together with grains at different angles for strength.

PMI Private mortgage insurance. See mortgage insurance.

POINT OF BEGINNING (POB) The starting point in a metes and bounds description; described by reference to a monument.

POINT In the context of a loan, a point is equal to 1% of the loan amount and would be included in the loan costs.

POINTS (See Discount Points)

POINT ESTIMATE The final estimate stated in a single dollar amount.

POINT OF BEGINNING (POB) The starting (and ending) place in a land survey using the metes-and-bounds method of property description.

POINT OF CONTACT INFORMATION Any means by which to contact the brokerage firm or individual licensee including mailing address, physical street address, e-mail address, telephone numbers, and fax machine numbers.

POLICE POWER The right of the state to enact laws and regulations and its right to enforce them for the order, safety, health, morals, and general welfare of the public. The power of the state to prohibit acts that adversely affect the public health, welfare, safety, or morals. (Zoning and building codes are examples of exercise of the police power.)

POLICY MANUAL The notebook of written rules and regulations that set desired standards and procedures in an office.

POORER NEIGHBORHOODS These neighborhoods suffer the most during a recession.

PORTFOLIO LENDER A lender that keeps loans for its own portfolio, rather than selling the loan on the secondary market to Freddie Mac or Fannie Mae.

POST AND BEAM This type of framing is larger-sized lumber used so that the framing members can be spaced farther apart.

POSSESSION 1. The holding and enjoyment of property. 2. Actual physical occupation of real property.

POSSESSION DATE Day when the buyer actually moves on to the property; may be different from the close of escrow or recording date.

POSSESSORY INTEREST An interest in property that includes the right to possess and occupy the property; not necessarily ownership.

POTABLE Water suitable for drinking.

POTENTIAL GROSS INCOME The total annual income a property would produce with 100% occupancy and no collection or vacancy losses.

POWER OF ATTORNEY An instrument authorizing a person to act as the agent of the person granting it. A special power of attorney limits the agent to a particular or specific act, as a landowner may grant an agent special power of attorney to convey a single and specific parcel of property. Under a general power of attorney, the agent may do almost anything for the principal that the principal could do himself or herself. A document authorizing a person (an attorney-in-fact) to act as

an agent.

POWER OF SALE CLAUSE A clause in a deed of trust giving the trustee the right to foreclose nonjudicially (sell the debtor s property without a court action) if the borrower defaults.

POWER OF TERMINATION The future interest created whenever there is a grant of a fee simple subject to a condition subsequent estate. The future interest matures into a present interest estate only if the holder timely and properly exercises his right upon a breach by the current holder of the fee estate.

PRECEDENT A published judicial opinion that serves as authority for determining a similar issue in a later case. SEE: Stare Decisis

PRECEDENT, BINDING A precedent that a particular court is required to follow.

PREDICTIONS An agent s predictions are not asueable matter.

PREEMPTION SEE: *Right of Preemption.*

PREFABRICATED HOUSE A house manufactured, and sometimes partly assembled, before delivery to the building site.

PREJUDGEMENT ATTACHMENT An attachment of property made before the trial, with the intent of holding that property as security, to have an asset to sell if the court judgment is favorable to the attaching party.

PRELIMINARY REPORT A report showing the current status of a property and the condition under which a title company is willing to insure title as of a specific date.

PREMISES SECTION (*See Granting Clause)*

PREMIUM An amount, usually measured in points, in excess of the loan balance owing, paid for the purchase of a note and a trust deed.

PREPAID ITEMS Expenses paid by borrower-buyer at closing, such as taxes, insurance, and interest.

PREPAYMENT Paying off part or all of a loan before payment is due.

PREPAYMENT CLAUSE A provision in a mortgage that allows the mortgagor to pay the mortgage debt ahead of schedule without penalty.

PREPAYMENT PENALTY Penalty for the payment of a note before it actually becomes due. A fee or charge imposed upon a debtor who desires to pay off his loan before its maturity. Not all prepayment clauses provide for a penalty, and in many real estate transactions the law regulates the amount of penalty that may be changed.

PREPAYMENT PRIVILEGE Allows borrower to make extra payments on the principal payment without penalty.

PRESCRIPTION, EASEMENT BY Securing of an easement by open, notorious, and uninterrupted use, adverse to the owner of the land for the period required by statute, which, in California, is five years. A method of obtaining an easement by adverse use over a prescribed period of time.

PRESENT INTEREST An estate in land that gives the owner the right to occupy his property immediately; as opposed to a future interest, which grants only the right to occupy the premises at some future date.

PRESENT VALUE Current value or the discounted value of some future income or benefits.

PRESUMPTION That which may be assumed without proof. A conclusion or assumption that is binding in the absence of sufficient proof to the contrary.

PRE-TAX CASH FLOW The amount of income available to the owner after the mortgage lender has been paid its portion of the net operating income.

PREVENTIVE MAINTENANCE A program of regularly scheduled maintenance activities and routine inspections of the interior and exterior of the buildings, equipment and grounds. Its objective is to preserve the physical integrity of the property, eliminate corrective maintenance costs and ensure uninterrupted service to the tenants.

PRICE The amount of money or other consideration given for a property; agreed upon between buyer and seller; also called *purchase price* or *sales price.*

PRICE LEVEL ADJUSTED MORTGAGE (PLAM) Interest rate is fixed, but outstanding loan balance and monthly payments vary according to changes in some price index.

PRIMA FACIE (1) Presumptive on its face. (2) Assumed correct until overcome by further proof. Facts, evidence, or documents that are taken at face value and presumed to be as they appear (unless proven otherwise).

PRIME CONTRACTOR A construction supervisor who contracts with the property manager to oversee a job and then sublets the work to various skilled trades people.

PRIMARY LENDER Financial institution that makes

mortgage loans directly to borrower.

PRIMARY MARKET A source for the purchase of a mortgage by a borrower.

PRIMARY MORTGAGE MARKET The market in which loans are made directly to the borrowers.

PRIME RATE Interest rate banks charge preferred customers.

PRINCIPAL The employer of an agent. Someone who hires an agent to act on his behalf. The term also refers to the amount of an outstanding loan (exclusive of interest).

PRINCIPAL MERIDIANS Imaginary lines running north and south and crossing a base line at a definite point; used by surveyors for reference in locating and describing land under the government survey system.

PRINCIPLE OF ANTICIPATION Value is the present worth of future benefits, both income and intangible amenities.

PRINCIPLE OF CHANGE Real estate values are constantly changed by social, economic, and political forces in society. (SEE: Neighborhood Cycle.)

PRINCIPLE OF COMPETITION Market demand generates profits and profits generate competition; competition stabilizes profits.

PRINCIPLE OF CONFORMITY Maximum value results when properties in a neighborhood are relatively similar in size, style, quality, use and/or type.

PRINCIPLE OF CONSISTENT USE Both land and improvements must be appraised for the same use.

PRINCIPLE OF HIGHEST AND BEST USE Maximum market value of a given parcel of land, vacant or improved, is created by development or utilization at its highest and best use.

PRINCIPLE OF INCREASING AND DECREASING RETURNS Income and other benefits available from real estate may be increased by adding capital improvements only up to the point of balance in the agents of production, beyond which the increase in value tends to be less than the increase in costs.

PRINCIPLE OF PROGRESSION AND REGRESSION Lower-valued properties generally benefit from close proximity to many properties of higher value and higher-valued properties tend to suffer when placed in close proximity with lower-valued properties.

PRINCIPLE OF SUBSTITUTION When a property can be easily replaced by another, the value of such property tends to be set by the cost of acquiring an equally desirable substitute property.

PRINCIPLE OF SUPPLY AND DEMAND Prices and rent levels tend to increase when demand is greater than supply and tend to decrease when supply exceeds demand.

PRINCIPLE OF SURPLUS PRODUCTIVITY, BALANCE AND CONTRIBUTION Income that is available to land, after the other economic agents have been paid for, is known as the surplus of productivity; a proper balance of the agents maximizes the income available to land; the value of any agent is determined by its contribution to the whole.

PRINCIPAL RESIDENCE PROPERTY Real property that is the owner s home, his or her main dwelling. A person can only have one principal residence at a time. The term is most often used in connection with the income tax laws.

PRIOR APPROPRIATION A system of allocating water rights. Under this system, a person who wants to use water from a particular lake or river is required to apply for an appropriation permit. It is not necessary to own property beside the body of water in order to acquire an appropriative right. COMPARE: Riparian Rights.

PRIORITY That which comes first in point of time or right. superior, higher, or preferred rank or position.
Private restrictions Are normally found in the CC&R .

PRIVATE MORTGAGE INSURANCE *See Mortgage Insurance*

PRIVATE SECTOR When there is a federal deficit, the treasury covers the short fall by issuing interest-bearing securities to investors, in doing so, the government is actually borrowing money from the private sector.

PRIVITY Closeness or mutuality of a contractual relationship.

PROBABLE CAUSE Reasonable grounds or justification for prosecuting.

PROBATE Court supervision of the collection and distribution of a deceased person's estate.

PROBATE COURT A court that oversees the distribution of property under a will or by intestate succession.

PROBATION A suspended sentence during good behavior, usually under supervision.

PROCEDURAL LAW The law of how to present and proceed with legal rights (for example, laws of evidence, enforcement of judgments). It is the opposite of substantiative law.

PROCESSING Preparation of loan application and supporting documents for consideration for by a lender or an insurer.

PROCURING CAUSE That event originating from another series of events that, without a break in continuity, results in an agent's producing a final buyer.

PROFESSIONAL ASSOCIATION (PA) A business corporation consisting of one or more individuals engaged in a primary business that provides a professional service.

PROFIT The amount one makes over and above one s cosy.

PROFIT AND LOSS STATEMENT A n annual financial report of a property s actual net profit before taxes.

PRO FORMA STATEMENT An estimate of the economic results of a proposed project; a projected income statement.

PROGRESSION The principle that states the value of an inferior property is enhanced by its association with superior properties of the same type.

PROMISEE Someone who has been promised something; someone who is supposed to receive the benefit of a contractual promise.

PROMISOR Someone who has made a contractual promise to another.

PROMISSORY ESTOPPEL SEE: Estoppel, Promissory.

PROMISSORY NOTE See *Note*

PROOF, BURDEN OF The responsibility for proving or disproving a particular issue in a lawsuit. In most cases, the plaintiff has the burden of proof.

PROOF, STANDARD OF The extent to which the plaintiff or prosecutor must have convinced the jury or judge in order to win the case. In most civil suits, a preponderance of the evidence must support the plaintiff s case. In a criminal action, the prosecutor s case must be proven beyond a reasonable doubt.

PROPERTY. Everything capable of being owned and acquired lawfully. The rights of ownership. The right to use, possess, enjoy, and dispose of a thing in every legal way and to exclude everyone else from interfering with these rights.
Property is classified into two groups, personal property and real estate.

PROPERTY ANALYSIS A study made to familiarize a property manager with the nature and condition of a building, its position relative to comparable properties and its estimated income and operating expenses.

PROPERTY HELD FOR PRODUCTION OF INCOME SEE: *Income Property.*

PROPERTY INCOME One way to increase property income in a large metropolitan area is to rent garages and storage space separately.

PROPERTY INSURANCE *(See Hazard Insurance)*

PROPERTY MANAGEMENT A branch of the real estate profession that seeks to preserve or increase the value of an investment property while generating income for its owners. The portion of the real estate business involving the operations, maintenance and marketing of income-reducing property

PROPERTY MANAGEMENT FEES For many real estate offices property management fees are a more steady source of income than commissions.

PROPERTY MANAGER A broker acting as a property manager may not legally refuse to rent an apartment to an unmarried couple. The property manager must make sure the property management contract gives him or her the specific right to display signs on the property. Some of hid duties are ; preparing a tweleve month statement, forecasting projected monthly dues and creating budgets and handling expenses.

PROPERTY PROFILE Shows the way title was taken.

PROPERTY TAX SEE: *Tax, Property*.

PROPERTY USED IN A TRADE OR BUSINESS Property such as business sites and factories used in one s trade or business.

PROPOSITION 13 The initiative measure passed in 1978 that led to major revisions in California s property tax laws.

PROPOSITION 90 Allows a senior citizen to purchase a new house in a different county and keep his or her old tax bill.

PRORATION The process of dividing something (especially a sum of money or an expense) proportionately. The bankers

rule. (360 days)

PROPRIETARY LEASE The right of a member of a cooperative to occupy a unit in the building subject to certain conditions.

PROFIT A PRENDRE An easement coupled with a power to consume resources on the burdened property.

PROMISSORY NOTE A written promise to pay a designated sum of money at a future date.

PROPERTY Anything that may be owned. Anything of value in which the law permits ownership.

PRORATE To divide or assess proportionate shares of charges and credits between buyer and seller according to their individual period of ownership.

PRORATIONS Adjustments of interest, taxes, and insurance, etc., on a pro rated basis as of the closing or agreed upon date based on a 30 day month.

PRORATION OF TAXES Division of the taxes equally or proportionately between buyer and seller on the basis of time of ownership.

PROVISIONAL TITLE A condition in a deed makes the title provisional.

PROXIMATE CAUSE That cause of an event which, in a natural and continuous sequence unbroken by a new cause, produced that event, and without which the event would not have happened. Also, the procuring cause. A broker is the procuring cause of a sale if his or her efforts set in motion an unbroken chain of events that resulted in the sale.

PUBLIC ACCOMMODATIONS Places of public accommodations constructed for first occupancy before August 26, 1990 are required to remove architectural barriers which limit access by disabled persons.

PUBLIC RECORDS Records which by law impart constructive notice of matters relating to land.

PUBLIC TRUSTEE The county official whose offices has been created by the statute to whom title to real property in certain states, e.e, Colorado, is conveyed by trust deed for the use and benefit of the beneficiary, who usually is the lender.

PUBLICITY Editorial space in a newspaper, magazine or other medium that is not paid for but serves to attract public attention to an individual, firm or commodity.

PUD A form of development that contains a mixture of building types and land use.

PUFFING Superlative statements about a property that shouldn t be considered assertions of fact. The best buy in town, or It s a fabulous location are examples of puffing. Puffing is not a sueable matter.

PUNITIVE DAMAGES Money awarded by the court for the sole purpose of punishing the wrongdoer, and not designed to compensate the injured party for his damages.

PUR AUTRE VIE SEE: Life Estate *Pur Autre Vie*.

PURCHASE AND INSTALLMENT SALEBACK Involves purchase of the property upon completion of construction and immediate saleback on a long-term installment contract.

PURCHASE OF LAND , LEASEBACK AND LEASEHOLD MORTGAGES An arrangement whereby land is purchased by the lender and leased back to the developer with a mortgage negotiated on the resulting leasehold of the income property constructed. The lender receives an annual ground rent, plus a percentage of income from the property.

PURCHASE AND LEASEBACK Involves the purchase of property by the buyer and immediate leaseback to seller.

PURCHASE MONEY INSTRUMENT A mortgage or deed of trust that does not permit a deficiency judgment in the event of foreclosure and sale of the secured property for less than the amount due on the promissory note. It is called purchase money since the deed of trust and mortgage was used to buy all or part of the property.

PURCHASE-MONEY MORTGAGE OR PURCHASE-MONEY DEED OF TRUST (PMM) A mortgage or deed of trust given as part or all of the consideration for the purchase of property or given as security for a loan to obtain money for all or part of the purchase price.

PURCHASE AND SALE AGREEMENT A contract in which a seller promises to convey title to real property to a buyer in exchange for the purchase price. Usually called a deposit receipt in California. SEE: Deposit receipt.

PURCHASE PRICE See *price*

Q

QUADRANT Quarter; any of the four quarters into which something is divided.

QUALIFICATION The process of reviewing prior to the approval (of a buyers housing needs and financial abilities, of a borrowers mortgage loan application, or of an application for licensure.(Underwriting)

QUALITY OF CONSTRUCTION Classification or rating based on basic structural integrity, materials, finishes, and special features.

QUANTITY SURVEY A highly technical process in arriving at a cost estimate of new construction and sometimes To in the building trade as the price take-off method. It involves a detailed estimate of the quantities of raw material. Used as well as the current price of the material and installation costs. These factors are all added together to arrive at the cost of a structure. It is usually used by contractors and experienced estimators.

QUARTER ROUND A molding whose profile resembles a quarter of a circle.

QUASI Almost as if it were.

QUASI-CONTRACT A contract implied by law; that is, the law will imply and consider certain relationships as if they were a contract.

QUASI-LEGISLATIVE (FL) Powers delegated to the FREC to enact rules and regulations, decide questions of practice, and validate records. (imprint with FREC s seal).

QUASI- JUDICIAL (FL) Powers delegated to the FREC to discipline real estate licensees for violations of of real estate license law and FREC administrative rules.

QUASI PARTNERSHIP *(See Ostensible Partnership)*

QUESTION OF FACT In a lawsuit, a question about what actually occurred, as opposed to a question about the legal consequences of what occurred (a question of law).

QUESTION OF LAW In a lawsuit, a question about what the law is on a particular point; what the legal rights and duties of the parties were.

QUIET ENJOYMENT The right of an owner to the use of property without interference with his or her possession or use.

QUITE TITLE A court action brought to establish title and to remove a cloud from the title.

QUIET TITLE ACTION A lawsuit designed to remove any clouds on a title to property. It forces the claimant of an adverse interest in property to prove his right to title; otherwise he will be forever barred from asserting it.

QUITCLAIM DEED A deed to relinquish any interest in property that the grantor may have, but implying no warranties. A deed that transfers only whatever right, title, or interest, if any, the grantor owns, without implying any warranties.

QUORUM The minimum number of persons who may lawfully transact the business of a meeting.

R

RACE/NOTICE RULE When the same property has been sold to two different buyers, it the second buyer records his or her deed before the first buyer, the second buyer has good title to the property - as long as he or she did not have notice of the first buyer s interest.

RADIANT HEATING A method of heating, usually consisting of coils or pipes placed in the floor, wall, or ceiling.

RAFTER One of a series of boards of a roof designed to support roof loads.

RANGE A strip of land six miles wide, determined by a government survey, running in a north-south direction.

RANGE LINES (SUBMERIDIANS) A series of government survey lines running north and south at six-mile intervals staring with the principal meridian and forming the east and west boundaries of town ships.

RANGE VALUE The appraiser s estimate of the range in which the property s value is most likely to be.

RATE ADJUSTMENT DATE With respect to an adjustable rate mortgage, the date the borrower s note range may change.

RATIFICATION The adoption or approval of an act performed on behalf of a person without previous authorization. Approval and confirmation of a prior act performed on one's behalf by another person without previous authority.

RATIFIED Approved

RATIO The relationship in quantity, size or amount between two things; proportions.

REAL ESTATE TERMINOLOGY

A Course Companion for Studying for The Real Estate Exam, for Real Estate Home Study Courses, for Real Estate Continuing Education Courses, for Real Estate Statutory Courses, and for Any Form of College Real Estate Course.

REAL ESTATE (See Real Property)

REAL ESTATE SALES ASSOCIATE The same as a real estate salesperson, holding a real estate license and employed by a broker.

REAL ESTATE DEBT Real estate debt has been rapidly increasing over the past two decades.

REAL ESTATE CYCLE A sequence of strengths and weaknesses that occurs in the real estate segment of the general business economy; phases of the cycle are influenced by, but are not identical to, those of the business cycle.

REAL ESTATE SETTLEMENT PROCEDURES ACT (RESPA) A federal law requiring the disclosure to borrowers of settlement (closing) procedures and costs by means of a pamphlet and forms prescribed by the United States Department of Housing and Urban Development.

REAL ESTATE SYNDICATE An organization of investors usually in the form of a limited partnership who have joined together for the purpose of pooling capital for the acquisition of real property interests.

READY, WILLING, AND ABLE BUYER A purchaser of property, who is willing to buy on terms acceptable to the seller, and who further possesses the financial ability to consummate the sale. Producing such a buyer sometimes earns the broker a commission, even though a sale is not forthcoming.

REAL ESTATE Land, including the air above and the earth below, plus any permanent improvements affecting the utility of the of the land; real property; property that is not personal property.

REAL ESTATE ADVERTISING All references to age in real estate advertising are prohibited.

REAL ESTATE AGENT A real estate agent is required to use diligence, care and skill in the performance of
his duties.

REAL ESTATE BUSINESS A commercial activity in which the sale, purchase, leasing rental or exchange or management of real property is conducted by qualified and licensed parties acting either for themselves or for compensation.

REAL ESTATE BOARD An organization whose members consist primarily of real estate brokers and salespersons.

REAL ESTATE CONTRACT 1. A purchase and sale agreement. 2. A land contract. 3. Any contract having to do with real property.

REAL ESTATE CYCLE Periodic pattern of changes in the amount of construction and volume of sales in the real estate market.

REAL ESTATE INVESTMENT TRUST(REIT) A specialized form of holding title to property that enables investors to pool their resources and purchase property, while still receiving considerable tax advantages, without being taxed as a corporation. Also known as REIT.

REAL ESTATE LICENCE The commissioner has the right to suspend a real estate a real estate licence when a licensee : makes a secret profit, acts for more than one party without the consent of each and is derelict in his duty. A license is not required when an owner rents or manages his or her own property.

REAL ESTATE LICENSEE MALFEASANCE (CA) The special fund established by the legislature to help compensate victims of real estate licensee malfeasance a Recovery Account Fund.

REAL ESTATE PROFESSION A profession requiring knowledge of real estate values, experience in dealing with the public, plus exceptional personal integrity and character as qualifications to act as advisors and agents for members of the public.

REAL ESTATE RECOVERY ACCOUNT (CA) Awards of attorneys fees, and punitive damages, may be recovered from the Real Estate Recovery Account.
An individuals recovery from the Real Estate Recovery Account is not limited to $50,000 per transaction.

REAL ESTATE SALESPERSON Is the agent of the employing broker. A real estate salesperson is the special agent. In California a real estate salesperson must be licenced by the Department of Real Estate. (DRE)

REAL ESTATE SERVICES Real estate activities involving compensation for performing the activities for another.

REAL ESTATE TRUST A special arrangement under federal and state law whereby investors may pool funds for investments in real estate and mortgages and yet escape corporation taxes.

REAL ESTATE TERMINOLOGY

A Course Companion for Studying for The Real Estate Exam, for Real Estate Home Study Courses, for Real Estate Continuing Education Courses, for Real Estate Statutory Courses, and for Any Form of College Real Estate Course.

REAL PROPERTY Land and anything affixed, incidental, or appurtenant to it, and anything considered immovable under the law. Land, buildings, and other immovable property permanently attached thereto.

REAL ESTATE PURCHASE CONTRACT Must be made by parties with legal capacity to do so, must be an offer made on definite terms and with a lawful objective, and must include acceptance of the terms by all parties and some form of consideration.

REAL PROPERTY ADMINISTRATOR (RPA) A property manager who has successfully completed BOMI s educational program and fulfilled other requirements for this professional designation.

REAL PROPERTY LOAN LAW Article 7 of Chapter 3 of the Real Estate Law under which a real estate licensee negotiating loan s secured by real proerty within a specified range is required to give the borrower a statement disclosing the costs and terms and which also limits the amount of expenses and charges that a bborrower may pay with respect to the loan.

REAL PROPERTY SALES CONTRACT An agreement to convey title to real property upon satisfaction of specified conditions which does not require conveyance within one year of formation of the contract. The buyer does not take title.

REAL PROPERTY TAXES. Unpaid real property taxes constitute a lien prior to a mortgage lien.

REASONABLE TIME In the real estate business 30 days is considered a reasonable time .

REALIZATION The point at which a gain or profit is actually obtained; for example, the value of a piece of property has been increasing steadily, but the owner s profit won t be realized until she sells the property.

REALTOR A real estate broker holding active membership in a real estate board affiliated with the National Association of Realtors. Membership in a trade organization for brokers or salespeople is optional.

REALTY Real property.

REASONABLE TIME A variable period of time, which may be affected by market conditions, desires of the owner, supply and demand, fluctuations of values, or an official decision.

REBUTTABLE PRESUMPTION A presumption that is not conclusive and that may be contradicted by evidence. A presumption that applies unless proven inapplicable by the introduction of contradictory evidence.

RECAPTURE (1) The rate of interest necessary to provide for the return of an investment. (2) A provision in tax laws that reduces certain benefits from claiming depreciation.

RECAPTURE CLAUSE A provision in a percentage lease that grants the landlord the right to terminate the lease at the end of a certain period if gross sales have not reached the level anticipated during negotiations.

RECAPTURE PROVISION A clause within an assignment and subletting lease clause giving the landlord the right to recover any space that the tenant is unable to occupy or sublease.

RECEIVER A neutral third party, appointed by the court to collect the rents and profits from property, and distribute them as ordered by the court. Often used as a remedy when mere damages are inadequate.

RECEIVERSHIP CLAUSE A provision in a mortgage, related to income producing property, that is designed to require that income derived shall be used to make mortgage payments in the event the mortgagor (borrower) defaults.

RECESSION The peak in the business cycle; the point at which the supply equals and begins to surpass demand.

RECIPROCAL When you divide a number into one, the result is a reciprocal.

RECIPROCAL OF THE CAPITALIZATION RATE Multiplier and factor are the reciprocals.

RECOMMENDED ORDER A determination by an administrative judge that includes findings and conclusions as well as other information required by law or agency rule to be a final order.

RECOGNITION The point at which a gain is taxed (which is ordinarily in the year it was realized, but may be later if a nonrecognition provision applies).

RECONCILIATION The process by which the appraiser reviews and considers the indicated values developed by the applied approaches to arrive at a final value conclusion.

RECONSIDERATION A request by the Department of Real Estate or the respondent made before the effective day of the hearing decision.

RECONVEYANCE (DEED OF) A conveyance to the landowner of the legal title held by a trustee under a deed of trust. The transfer of property back from a lender who holds an interest as security for the payment of a debt. In a deed of

trust, the beneficiary reconveys property upon satisfaction of the promissory note.

RECONVEYANCE DEED Conveys title from trustor to trustee.

RECONVEYANCE, PARTIAL A reconveyance that releases some parcels from the lien of a blanket deed of trust, usually recorded when the borrower has paid off a certain amount of the debt.

RECORDATION (RECORD) Filing of instruments for record in the office of the county recorder. The act of having a document filed for record in the county recorder's office. Once recorded, the instrument gives constructive notice to the world.

RECORDED LOT, BLOCK AND TRACT Legal description of a parcel of land by means of reference to a recorded plat of a subdivision.

RECORDING The process of placing a document on file with a designated public official for public notice.

RECORDING NUMBER The numbers stamped on documents when they re recorded, used to identify and locate the documents in the public record. (Each page is stamped with a consecutive number, but an entire document is often referred to by the number on the first page.)

RECOVERING ADDICTS Are considered handicapped persons and are protected under the Federal Fair Housing Act

RECOVERY FUND. Generally administered by the Real Estate Commission. Requires licensees to contribute, then reimburses aggrieved persons who are unable to collect from brokers for wrongdoings.
Real Estate Commissioner. The public official charged with enforcing the real estate laws as they apply to licensees, subdivisions, and real estate related activities.

RECOVERY PERIOD The assigned time over which property is depreciated for tax purposes.

RECTANGULAR SURVEY SYSTEM System for legal description of property based on principal meridians, baselines, and a grid system.

RECURRING COSTS Any item that requires an impound account.

RECURRING CLOSING COSTS Costs and fees that will br paid monthly or annually such as fire, insurance, interest, property taxes and mortgage insurance.

RECURRING VARIABLE EXPENSE A type of variable property expense (e.g., redecorating costs) that occurs repeatedly on an irregular basis.

REDEEM To buy back; repurchase; recover.

REDEMPTION Buying back one's property after a judicial sale. The repurchasing of one's property after a judicial sale.

REDEMPTION, EQUITABLE RIGHT OF The right of a borrower to redeem property prior to the foreclosure sale.

REDEMPTION PERIOD Period of time in which the borrower may redeem his or her property.

REDEMPTION, STATUTORY RIGHT OF The right of a mortgagor to redeem property after a foreclosure sale.

REDEVELOPMENT Existing structures are destroyed anew ones are built immediately.

REDLINING Is the failure or refusal by the lender to provide financing in certain communities. Redlining does not include any consideration of the market value of the real estate intended to secure the loan. A licensee is required to report any institution that he knows that is taking part in this activity.

REFINANCING The paying-off of an existing obligation ans assuming a new obligation in its place. To finance anew, or extend or renew existing financing.

REFORMATION A legal action to correct a mistake in a deed or other document.

REGIONAL CENTER A large shopping center containing from 70 to 225 stores and more than 400,000 square feet of leasable area.

REGIONAL MAIL For this type of mail to be successful it must encompass a surrounding population of over150,000 people within a 15-mile radius.

REGISTRATION Authorization by the state to place an applicant on the register (record) of officially recognized individuals or businesses.

REGRESSION The principle that states that the value of a superior property is adversely affected by its association with an inferior property of the same type.

REGULARLY RECURRING COSTS A type of fixed property expense (e.g. cleaning costs) that occurs consistently each month.

REGULATION 1. A rule adopted by an administrative agency. 2. Any governmental order having the force of law.

REGULATION Z The Federal Reserve Board s regulation that implements the Truth in Lending Act. An estimated breakdown of costs that will be incurred in obtaining a loan; given to the borrower by an institutional lender before the loan is taken out; a consumer protection form.

REINSTATE To cure adefault under a note secured by a trust deed.

REIT A method of pooling investment money using the trust form ownership.

RELATION BACK A legal doctrine that allows a court to rule that a party acquired title at some point before he or she actually received the deed. Applied in cases involving escrow or the exercise of an option to purchase.

RELIGIOUS ORGANIZATIONS May limit sales or rentals of dwellings for noncommercial purposes to members of the same religion.

REINSTATEMENT A right available to anyone under an accelerated promissory note secured by a deed of trust or mortgage on property. If a deed of trust is foreclosed by trustee's sale, the debtor may have up to three months from the recording of the notice of default to pay the amount in arrears plus interest and costs, thereby completely curing the default (reinstating) without penalty.

REGIONAL ANALYSIS Includes economic conditions, physical attributes and population growth.

REHABILITATION The restoration of property to satisfactory condition without drastically changing the plan, form or style of architecture.

REINTERMEDIATION Return of savings to thrift institutions from previously higher paying investment outlets.

REIT A Real Estate Investment Trust is a business trust which deals principally with interest in land ---- generally organized to conform to the Internal Revenue Code.

REJECTION Refusal to accept an offer. Repudiation of an offer automatically terminates the offer.

RELATIVE COMPARISON ANALYSIS The adjustment terms are expressed in terms of value (superior, inferior, etc.).

RELEASE To give up or abandon a right. The release of rights may be voluntary, as when one voluntarily discharges an obligation under a contract. The release may be involuntary, by operation of the law; for example, one's wrongful conduct may bar him from asserting his rights. In deeds of trust a partial release clause frees certain property from the security of the deed of trust upon the payment of specified sums of money.

RELEASE CLAUSE A stipulation in a deed of trust or mortgage that upon the payment of a specific sum of money to the holder of the deed of trust or mortgage, a particular lot or area shall be removed from the blanket lien on the whole area involved.

RELEASE DEED An instrument executed by the mortgagee or the trustee reconveying to the mortgagor or trustor the real estate which secured the loan after the debt has been paid in full.

RELEASE OF LIABILITY An agreement by the lender to terminate the personal obligation of the buyer.

RELICTION The gradual lowering of water from the usual watermark.

REMAINDER An estate that vests after the termination of the prior estate, such as after a life estate. Example: A life estate may be granted to Adams, with the remainder granted to Baker. Most commonly, an estate (future interest) that arises in favor of a third person after a life estate.

REMAINDER DEPRECIATION The possible future loss in a value of an improvement to real property.

REMAINDERMAN The person who has an estate in remainder.

REMAINDER PARCEL The portion of a property left to the owner when there has been a partial taking by eminent domain.

REMAND To send back to a lower court for further action.

REMEDY The means by which a right is enforced, preserved, or compensated. Some of the more common remedies are damages, injunctions, rescission, and specific performance.

REMODELING To change the floor plan or architectural style of the improvements.

RENAISSANCE Fourth phase in the cycle of a neighborhood, the transition to a new cycle through the demolition, relocation, or major renovation of existing buildings.

RENEGOTIABLE RATE MORTGAGE A loan secured by a long term mortgage which provides for renegotiation, at pre-determined intervals, of the interest rate (for aa maximum variation of five percent over the life of the mortgage).

RENT The consideration paid by a tenant for possession of property under a lease.

RENTABLE SPACE According to BOMA. The floor area of an office building minus allowances for stairs, elevator shaft, duct work and other areas not available to the tenant.

RENTAL AGREEMENT This agreement should be a bilateral, executory contract. All parties should get a signed copy.

RENTAL HOUSING The demand for rental housing are produced by , the price of the home, the volume of sales and the future housing supply.

RENTAL PROPERTY ADS These adds that give phone numbers should have a recorded message so that there is no doubt about what they hears.

RENUNCIATION When someone who has been granted something or has accepted something later gives it up or rejects it; as when an agent withdraws from the agency relationship. COMPARE: Revocation.

RENT CONTROL Rent control of rental property will usually decrease investing in rental property. Places the government s burden of supporting the poor on the shoulders of private property owners.

RENT MULTIPLIER SEE: Gross Income Multiplier.

RENT ROLL Total of all scheduled rental amounts for tenant space, services and parking.

RENTAL LOSS METHOD OF DEPRECIATION SEE: Capitalized Income Method of Depreciation.

RENUNCIATION To abandon an acquired right without transferring that right to another.

REPLACEMENT COST METHOD The cost to replace a structure with one having utility equivalent to that being appraised, but constructed with modern materials and according to current standards, design and layout. This method uses the three following items; the square foot method, the unit -in-place method and the quantity survey method.

REPRIMAND An official act of oral and/or written criticism with a formal warning included.

REPRODUCTION COST The cost of replacing the subject improvement with one that is the exact replica, having the same quality of workmanship, design and layout, or cost to duplicate the asset.

REQUEST FOR NOTICE OF DEFAULT AND NOTICE OF SALE A recorded notice made by anyone requesting that he or she be notified in the event that a Notice of Default is recorded.

RESCIND To annul, cancel. Repeal or terminate.

RESCISSION The unmaking of a contract, and the restoring of each party to the same position each held before the contract arose.

RESCISSION OF CONTRACT The cancelling of a contract by either mutual consent of the parties or legal action.

RESERVATION A right or interest retained by a grantor when conveying property; also called an exception.

RESERVE ACCOUNT SEE: Impound account.

RESERVES (1) In a common interest subdivisions, an accumulation of funds collected from the owners for future replacement and major maintenance of the common area facilities. (2) With regard to mortgage loans, an accumulation of funds, collected from the borrower by the lender as part of each monthly mortgage payment , an amount allocated to pay property taxes and insurance when they are due.

RESERVES FOR REPLACEMENT Annual allowances set up for replacement of building components and equipment.

RESIDENTIAL PROPERTY There are more square feet of this type of property to be managed than any other type. The type of property that people live in or rent.

RESIDENTIAL REAL ESTATE The majority of loans from savings and loans are used for this type of real estate.

RESIDENTIAL SALE The sale of improved residential property of four or fewer units, the sale of unimproved residential property intended for use as four or fewer units, or the sale of agricultural property of ten or fewer acres.

RESIDUAL TECHNIQUES OF CAPITALIZATION Income approach to valuation methods that separate income attributed to components of the property, such as land or building , or debt or equity, for purposes of analysis.

RESIDUE That portion of a person's estate that has not been specifically devised.

RES JUDICATA The legal doctrine holding that once a lawsuit between two parties has been tried and a final judgment has been issued, neither one can sue the other over the same dispute again.

RESOLUTION OF A CONTRACT Three methods of resolving a contract are negotiation and compromise, arbitration and default. The end result of contract negotiations.

RESPA (See Real Estate Settlement Procedures Act)

RESPONDEAT SUPERIOR This Latin phrase, "let the master answer," means that an employer is liable for the tortuous acts of an employee, and a principal is liable for the acts of an agent. To be liable, the acts must be within the "course and scope" of the agency or employment. For example, an employer would not be liable for the acts of an employee while at home and not doing work for the employer.

RESPONDENT The person against whom an appeal is taken; the opposite of an appellant.

RESTITUTION Restoring something to a person that he or she was unjustly deprived of.

RESTRICTED REPORT This report may only be used by the client and for one particular purpose.

RESTRICTION A limitation on the use of real property arising from a contract or a recorded instrument. An encumbrance on property that limits the use of it; usually a covenant or condition.

RESTRICTION, DEED A restrictive covenant in a deed.

RESTRICTION, PRIVATE A restriction imposed on property by a previous owner, or the subdivision developer;
a restriction covenant or a condition in a deed.

RESTRICTION, PUBLIC A law or regulation limiting or regulating the use of real property.

RESTRICTIVE COVENANT A promise to do or not do an act relating to real property; usually an owner s promise to not use property in a particular way. May or may not run with the land. Sometimes between the owner and the neighboring owner.

RESTRICTED LICENSE A license with restrictions attached.

RETALIATORY EVICTION A landlord's attempt to evict a tenant from a lease because the tenant has used the remedies available under the warranty of habitability.

RETROSPECTIVE VALUE The value of the property as of a previous date.

RETURN Profit from an investment; the yeild

RETURN ON INVESTMENT General rule of return on investment and risk, is the greater the return on the investment the greater the risk.

REVENUE STAMPS SEE: Tax, Documentary Transfer.

REVERSE To overturn a lower court s decision on appeal, ruling in favor of the appellant. COMPARE: Affirm.

REVERSE ANNUITY MORTGAGE Stream of monthly payments provided to homeowners through an annuity purchased by a loan against the owner s accumulated equity in their home.

REVERSION The right a grantor keeps when he or she grants someone an estate that will or may end in the future. Examples: The interest remaining with a landlord after he or she grants a lease, or the interest an owner of land has after he or she grants someone a life estate. Any future interest (estate) left in the grantor. The residue of an estate left in the grantor after the termination of a lesser estate.

REVERSIONARY INTEREST The interest which a person has in lands or other property, upon the termination of the preceding estate. A future interest.

REVOCATION Withdrawal of an offer or other right, thereby voiding and destroying that offer or right. It is a recall with intent to rescind.

REZONE An amendment to a zoning ordinance, usually changing the uses allowed in a particular zone. Requires the approval of the local legislative body. Also called a zoning amendment. COMPARE: Zoning, Spot.

RIDER An addition ti a document.

RIDGE The horizontal line at the junction of the top edges of two sloping roof surfaces. (The rafters at both slopes are nailed at the ridge.)

RIDGE BOARD The board placed on edge at the ridge of the roof to support the upper ends of the rafters; also called roof tree, ridge piece, ridge plate, or ridgepole.

RIGHT OF FIRST REFUSAL A right of preemption.

RIGHT OF PREEMPTION A right to have the first chance to buy or lease property if the owner decides to put it up for sale or make it available. Also called a right of first refusal. COMPARE: *Option.*

RIGHT OF SURVIVORSHIP The right to acquire the interest of a deceased joint-owner. It is the distinguishing feature of a joint tenancy.

RIGHT TRIANGLE A right triangle in which two of the sides meet at a right angle.

RIGHT OF RESCISSION A borrowers s right to cancel a credit contract within three business days from the day he or she entered into the loan contract.

RIGHT OF WAY The right to pass over a piece of real property or to have pipes, electrical lines, or the like go across it. An easement granting a person the right to pass across another's property.

RIGHT, TITLE AND INTEREST A term used in deeds to denote that the grantor is conveying all of that to which grantor held claim .

RIGHT-TO-USE A lease hold interest in a time-share unit based on a limited time (one or more weeks) specified in the agreement.

RIPARIAN RIGHTS The right of a landowner with regard to a stream crossing or adjoining his or her property.

RISER (1) The upright board at the back of each step of a stairway. (2) In heating, a riser is a duct slanted upward to carry hot air from the furnace to the room above.

RISK The chance of loss of all or a part of an investment; the uncertainty of financial loss.

RISK ANALYSIS A study made, usually by a lender, of the various factors that might affect the repayment loan.

RISK RATING A process used by the lender to decide on the soundness of making a loan and to reduce all the various factors affecting the repayment of the loan to a qualified rating of some kind.

ROLLOVER When a taxpayer sells his or her principal residence and reinvests the sale proceeds in another home, deferring recognition of the gain on the sale.

ROUNDED To reflect the input numbers with the highest degree of precision, answers should be rounded.

ROW HOUSE SEE: *Townhouse.*

RULE AGAINST PERPETUITIES A complex set of laws designed to prevent excessive restrictions on the transferability of property. The rule holds that "no interest is good unless it must vest, if at all, not later than 21 years after some life in being at the creation of the interest."

RULES-OF AGENCY DISCLOSURE Can be given with a sellers listing. The exact wording of the Rules-of-Agency Disclosure is not dictated by statute.
Transactions involving the sale of nonresidential property requires the statutory Rules-of Agency Disclosure be given to the buyer.

RULE OF CAPTURE A legal principle that grants a landowner the right to all oil and gas produced from wells on his or her land, even belonging to someone else.

RUNNING WITH THE LAND Binding or benefiting the successive owners of a piece of property, rather than terminating when a particular owner transfers his or her interest. Usually said in reference to an easement or a restrictive covenant.

RURAL HOUSING SERVICES ADMINISTRATION (FL) An agency of the Department of Agriculture that offers assistance to rural residents and communities.

R-VALUE A special rating or method of judging the insulating effectiveness of insulation products.

S

SAFETY CLAUSE In a listing agreement, a provision that if anyone found by the broker during his listing period purchases the property within a specified time after the expiration of the listing, the broker receives his full commission.

SALES PRICE See *Price*

SALES COMPARISON APPROACH TO VALUE See *Market Approach to Value*

SATISFACTION OF MORTGAGE SEE: Mortgage, Satisfaction of.

SALE- LEASEBACK A situation in which the owner of a piece of property sells it and retains occupancy be leasing it from the buyer.

SALE- LEASEBACK-BUY-BACK A sale and leaseback transaction in which the leaseholder has the option to buy back

the original property after specified period of time.

SALE OF RENTAL PROPERTY In the sale of rental property an agency agreement requires a written contract.

SALES ANALYSIS GRID Table of relevant data on comparable properties.

SALES ASSOCIATE A licensed individual who, for compensation, is employed by an owner-developer or by a broker.

SALES COMPARISON (APPROACH) One of the three classic approaches to value. It involves comparing similar properties, that have recently sold, to the subject property This method is considered the most important one..

SALES CONTRACT A contract between buyer and seller setting out the terms of sale.

SALES DATA METHOD OF DEPRECIATION Method of estimating depreciation wherein building values abstracted from sales are compared to current costs new.

SALESPERSON An individual licensed to sell property, but who must at all times be under the supervision and direction of a broker.

SALVAGE VALUE In computing deprecation for tax purposes, the reasonably anticipated fair market value of the property at the end of its useful life and must be considered with all but the declining balance methods of depreciation.

SANDWICH LEASE A leasehold interest that lies between the primary lease and the operating lease. Example: A leases to B; B subleases to C; C subleases to D. C's lease is a sandwich lease.

SASH A wood or metal frame containing one or more windowpanes.

SATISFACTION OF MORTGAGE Discharge of a mortgage or deed of trust lien from the records upon payment of the secured debt. Discharge of an obligation or indebtedness by paying what is due.

SATISFACTION OF JUDGEMENT This paying off judgement. It must be recorded to clear title

SATISFACTION PIECE An instrument for recording and acknowledging payment of an indebtedness secured with a mortgage.

SAVINGS ASSOCIATION INSURANCE FUND (SAIF) Administered by the FDIC to insure deposits at savings and loans and federal savings banks.

SAVINGS AND LOAN ASSOCIATIONS Deposit-type savings institutions that are major lenders in the residential field.

SAVINGS BANKS Savings and loan associations using newly-permitted designations.

SCARCITY In relatively short supply.

SCRIBING Fitting woodwork to an irregular surface.

SEAL An impression mark or stamp made to attest to the execution of an instrument.

SEASONAL VARIATIONS Changes in the economy that recur at least once a year.

SECRET PROFIT A financial benefit that an agent takes from a transaction without informing the principal; usually the result of self-dealing.

SECOND FLOOR One disadvantage of adding a second floor is that an additional set of stairs may be required or a fire scape may have to be added.

SECOND MORTGAGE (SECONDARY FINANCING) A loan that is junior or subordinate to a first mortgage, normally taken out when the borrower needs more money.

SECONDARY FINANCING A loan secured by a second mortgage or a second deed of trust.

SECONDARY LENDER Agency or financial institution that buys mortgage loans previously made by primary lenders.

SECONDARY MARKETING Buying and selling existing mortgage and trust deed loans. The primary market is the one in which lenders loan money to borrowers; the secondary market is the one in which the lenders sell their loans to the large secondary marketing agencies (FNMA, FHLMC, and GNMA) or to other investors.

SECONDARY MORTGAGE MARKET The purchasing and selling of existing mortgages and notes secured by a deed of trust. This market is dominated by Fannie Mae, Freddie Mac and Ginnie Mae.

SECRET PROFIT OR COMMISSION *(See Overage)*

SECTION A square mile of land, as established by government survey, containing 640 acres.

SECTION OF TOWNSHIP A section of township consists of 640 acres.

SECTOR THEORY A development method that resembles a pie chart.

SECURITY Property pledged to ensure payment of debt; collateral.

SECURED DEBT An obligation that includes property held as security for the payment of that debt; upon default, the property may be sold to satisfy the debt.

SECURED PARTY The party having the security interest in personal property. The mortgagee, conditional seller, or pledgee is referred to as the secured party.

SECURITY AGREEMENT An agreement between the secured party and the debtor that creates a security interest in personal property. It replaced such terms as chattel mortgage, pledge, trust receipt, chattel trust, equipment trust, conditional sale, and inventory lien.

SECURITY DEPOSIT A deposit made to assure performance of an obligation, usually by a tenant. A sum of cash given as collateral to ensure faithful performance of specified obligations. A landlord has three weeks in which to return the unused portion of the tenant s security deposit.

SECURITY INTEREST A term designating the interest of a secured creditor in the personal property of the debtor.

SECURITIZATION Debt issuance backed by mortgage portfolio

SEIZIN The possession of land under a claim of freehold.

SELF-DEALING When a real estate agent buys the principal s property him or herself (or sells it to a relative, friend, or associate, or to a business he or she has an interest in), without disclosing that fan to the principal, and in violation of his or her fiduciary duties to the principal.

SELF-EXECUTING ARBITRATION CLAUSE The parties do not need to use the court to compel arbitration.

SELLER The owner of the property now being sold. Most trust deeds and notes are held by the seller.

SELLER FINANCING When a seller extends credit to a buyer to finance the purchase of the property; as opposed to having the buyer obtain a loan from a third party, such as an institutional lender. SEE: Loan, Carryback.

SELLER S MARKET The market condition which exists when a seller is in a more commanding position as to price and terms because demand exceeds supply.

SELLING OFFICE (SO) In MLS printouts, the selling broker is noted as the selling office.

SEMIFIDUCIARY LENDER Noninstitutional source of real estate lending, such as through a mortgage broker, involving greater risks than funding through fiduciary lenders.

SENIOR CITIZEN HOUSING To qualify as senior citizen housing, a project must not limit residency to persons over the age of 62.

SENIOR LIEN A lien that is superior to or has priority over another lien. Also, the first deed of trust or lein on a property.

SEPARATE PROPERTY Property that is owned by a husband or wife and that is not community property. It is property acquired by either spouse prior to marriage or by gift or inheritance after marriage; also, in California, it is the income from separate property after marriage. Property held by a married person that is not community property; it includes property owned before marriage and property acquired after marriage by gift or inheritance.

SEPTIC TANK An underground tank in which sewage from the house is reduced to liquid by bacterial action and drained off.

SERVICE OF PROCESS Delivery of a legal document (especially a summons) to a person in accordance with the rules prescribed by statute, so that he or she is held to have received it (whether or not he or she actually did).

SERVICE INDUSTRIES Businesses that attract local money (e.g., grocery stores, retail shops).

SERVICING LOANS Supervising and administering a loan after it has been made. This involves such things as collecting payments, keeping accounting records, computing on interest and principal, foreclosure of defaulted loans, and so on.

SERVIENT ESTATE That parcel of property which is burdened by and encumbered with an easement.

SERVIENT TENEMENT An estate burdened by an easement.

SETBACK The minimum distance a building or other improvement must stand from the property lines; in accord with local zoning ordinances or deed restrictions.

SET-BACK ORDINANCE An ordinance prohibiting the erection of a building or structure between the curb and the set-back line. (see Building Line)

SETTLEMENT 1. An agreement between the parties to a civil lawsuit, in which the plaintiff agrees to drop the suit in exchange for money or the defendant s promise to do or refrain from doing something. 2. Closing.

SETTLEMENT STATEMENT A document that presents a final, detailed accounting for a real estate transaction, listing each party s debits and credits and the amount each will receive or be required to pay at closing. Also called a closing statement.

SETTLOR One who creates an inter vivos or living trust.

SEVERABLE When one provision in a law or a contract can be held unenforceable, without making the entire law or contract unenforceable.

SEVERALTY Sole ownership of property. Ownership by one person.

SEVERALTY OWNERSHIP Ownership by only one person; sole ownership.

SEVERANCE Termination of a joint tenancy, turning it into a tenancy in common.

SEVERANCE DAMAGE Damage to the value of the remainder parcel as a result of a partial taking by eminent domain.

SHAKE A hand-split shingle, usually edge-grained.

SHARED APPRECIATION MORTGAGE A loan having a fixed rate of interest set below the market rate for the term of the loan which also provides for contingent interest to be paid to the lender on a certain percentage of appreciation in the value of the property against which the loan is secured upon transfer of sale of the property or the repayment of the loan.

SHEATHING Structural covering, such as boards, plywood, or wallboard, placed over the exterior studding or rafters of a house. The skin that covers the house.

SHERIFF'S DEED A deed given by court order in connection with the sale of property to satisfy a judgement.

SHERIFF S SALE A foreclosure sale held after a judicial foreclosure. Sometimes called an execution sale.

SHOPPING CENTER A shopping center can be a complicated management problem as it may contain the following problems, security patrols, unchaperoned minors, and large parking lots.

SHORT PAYOFF Lender agreement to compromise adebt. Also called short sale.

SHORT PLATTING Subdividing a parcel of land into two, three, or four lots.

SHORT (TERM) RATE A reduced rate for title insurance applicable in cases where the owner of a property has been insured previously or where any lender has been insured somewhat recently on the property.

SICK BUILDING SYNDROME A physical condition caused by substances within a building that causes symptoms that disappear when occupant leaves the building.

SIDE YARD The area between a building and one of the side boundaries of the lot it s located on.

SIGHT DEPOSIT See *Demand Deposit*

SIGNED INSTRUMENT It is unlawful to modify without the consent and knowledge of the party related to the instrument

SIGNS The property manager must make sure the property management contract gives him or her the specific right to display signs on the property.

SILL The board or piece of metal forming the lower side of an opening, such as a door sill or window sill.

SIMPLE CONTRACT Essentials of a simple contract are lawful object, mutual consent, and capable parties.

SIMPLE INTEREST Interest computed on the principal; amount of a loan only as distinguished from compound interest.

SINGLE AGENT A broker who represents the seller or the buyer but not both.

SINGLE BATH HOMES There are very few of these homes being built now as buyers generally demand two bathrooms.

SINGLE-HUNG A window characterized by a movable lower sash.

SINKING FUND (1) A fund set aside from the income from property that, with accrued interest, will eventually pay for replacement of the improvements. (2) A similar fund set aside to pay a debt.

SITE PLAN A document that indicates the improvements details for a project of greater-than-average-size.

SITUS Relationships and influences created by location of a property that affect value (e.g.; accessibility, personal preference).

SIXTY-TWO-OR-OVER SENIOR CITIZEN HOUSING If a housing project qualifies as 62-or-over senior citizen housing, all persons under the age of 62 are excluded, including spouses under the age of 62.

SLAB-ON-GRADE Concrete foundation poured directly on the ground.

SLANDER OF TITLE A false and malicious statements disparaging an owner s title to property and resulting in actual pecuniary damage to the owner.

SLUM CLEARANCE The razing of substandard and unsalvageable residential buildings for redevelopment.

SMALL CLAIMS COURT A branch of the Municipal Court. The rules of this court forbid parties to be assisted by attorneys, dispense with most formal rules of evidence, and have all trials heard by judges. The monetary limit of cases before the court is $1,500.

SOCIETY OF INDUSTRIAL AND OFFICE REALTORS (SIOR) An association of Realtor specializing in leasing and selling industrial and office property.

SOIL PIPE Pipe carrying waste from the house to the main sewer line.

SOLD TO THE STATE A bookkeeping entry on the county tax rolls indicating that the property taxes are delinquent. The entry begins the five-year redemption period, after which the property may be physically sold to the public for back taxes.

SOLE OR SOLE PLATE A structural member, usually two-by-four, on which wall and partition studs rest.

SOLE PROPRIETOR A sole proprietor may have a trade name and may or may not have employees.

SPAN The distance between structural supports, such as walls, columns, piers, beams, and girders.

SPECIAL AGENT One authorized by a principal to perform a particular act or transaction, without contemplation of continuity of service as with a general agent.

SPECIAL ASSESSMENT Legal charge against real estate by a public authority to pay the cost of public improvement, as distinguished from taxes levied for the general support of government.

SPECIAL-FUNCTION A town whose employment concentrates on one special service or purpose.

SPECIAL EXCEPTION PERMIT SEE: Conditional Use Permit.

SPECIAL POWER OF ATTORNEY A written instrument whereby a principal confers limited authority upon an agent to perform certain prescribed acts on behalf of the principal.

SPECIAL PURPOSE PROPERTY Hotels, resorts, nursing homes, theaters, schools, places of worship and other business or organizations whose special needs dictate design and operation of the building.

SPECIAL TAX ASSESSMENTS Special tax assessments differ from annual tax assessments because special assessments provide for local improvement.

SPECIAL WARRANTY DEED A deed in which the grantor warrants or guarantees the title only against defects arising during grantor s ownership of the property and not against defects existing before the time of grantor s ownership.

SPECIFIC CYCLE A wavelike movement, similar to the business cycle, that occurs in certain sectors of the general economy.

SPECIFIC LIENS Claims that affect only the property designated in the lien instruments or agreements.

SPECIFIC PERFORMANCE A legal action to compel performance of a contract; for example a contract for the sale of land. A contract remedy by which one party is ordered by the court to comply with the terms of the agreement.

SPOT ZONING SEE: Zoning, Spot.

SPOUSE A person's husband or wife.

SREA The Society of Real Estate Appraiser

STABLE PHASE Second phase in the cycle of a neighborhood, marked by stability of the existing buildings and occupants.

STABILIZED BUDGET Part of a five -year projected budget, arrived at by averaging income and expense items over a five-year period.

STANDARD DEPTH Generally the most typical lot depth in the neighborhood.

STANDARD FIRE INSURANCE A basic form of insurance protecting a property against direct loss or damage.

STANDARD OF PROOF SEE: Proof. Standard of.

STANDBY COMMITMENT The mortgage banker frequently protects a builder by a standby agreement, under which the banker agrees to make the mortgage loans at an agreed price for many months into the future. The builder deposits a standby fee with the mortgage banker for this service. Frequently, the mortgage broker protects self by securing a standby from a long term investor for the same period of time, paying a fee for this privilege.

STARE DECISIS a fundamental principle of law, which holds that courts should follow prior decisions on a point of law. A proper decision is a binding precedent on equal or lower courts having the same facts in controversy.

STARKER A taxpayer who won an important U.S. Court of Appeals case in 1979 (T.J. Starker v. U.S.) Dealing with delayed exchange and whose name is synonymous with the those exchanges; the Sterker ruling has since been modified in IRS Code Section 1031

STATE ACTION In constitutional law, action by a government (federal, state, or local) rather than by a private party.

STATE BOARD OF EQUALIZATION. Is responsible for collecting state taxes.

STATE COURT Cases that involve the U.S. government are not heard in state court.

STATEMENT OF ISSUES A written allegation by the commissioner identifying the issues and listing the rules violated, used in a non property right hearing.

STATUTE A written law.

STATUTE OF FRAUDS The state law that provides that certain contracts must be in writing in order to be enforceable in the courts. Examples: real property leased for more than one year or an agent's authorization to sell real estate. A law that requires certain contracts (including most real estate contracts) to be in writing to be enforceable.

STATEMENT OF IDENTITY Form often required by the title company from buyer and seller to ensure that items found in the title search apply to the individuals in question.

STATUTE OF LIMITATIONS A statute that requires lawsuits to be brought within a certain time to be enforceable. The basic periods are one year for personal injury, two years for oral contracts, three years for damages to real or personal property, four years for written contracts, and three years from date of discovery for fraud.

STATUTORY CONSTRUCTION When a judge interprets and applies a statute in the course of resolving a lawsuit.

STATUTORY LAW Laws adopted by a legislative body (congress, a state legislature, or a county or city council), as opposed to constitutional law, case law, or administrative regulations.

STATUTORY WARRANTY DEED A short term warranty deed which warrants by inference that the seller is the undisputed owner, has the right to convey the property, and will defend the title if necessary. This type of deed protects the purchaser in that the conveyor covenants to defend all claims against the property. If conveyor fails to do so, the new owner can defend said claims and sur former owner.

STAY Delay temporarily; stop for a limited time.

STEERING Channeling prospective buyers or tenants to particular neighborhoods based on their race, religion, national origin, or ancestry.

STEPPED-UP BASIS a higher, increased tax value of property given as the result of most sales or taxable transfers. The tax basis is used in computing capital gains and losses on the transfer of property.

STEP-UP LEASE (STEP-UP CLAUSE) Lease agreement that establishes progressively higher rental amounts for different segments of the lease term; graduated lease.

STOCK The ownership element in a corporation usually divided into shares and represented by transferable certificates (may be divided into two or more classes of differing rights and stated values).

STOCK COOPERATIVE SEE: Cooperative.

STRAIGHT LEASE Lease agreement in which rent is a fixed amount that stays the some over the entire lease term.

STRAIGHT-LINE DEPRECIATION an accounting procedure that sets the rate of depreciation as a fixed percentage of the amount to be depreciated; the percentage stays the same each year.

STRAIGHT-LINE METHOD OF DEPRECIATION Method of computing depreciation in which the loss in value of a building is assumed to be the ratio of its age (or effective age) to its total useful or economic life.

STRAIGHT MORTGAGE OR DEED OF TRUST a mortgage or deed of trust in which there is no reduction of the principal during the term of the instrument. Payments to interest are usually made on an annual, semiannual, or quarterly basis.

STRAIGHT NOTE A promissory note that is unamortized. The principal is paid at the end of the term of the note.

STRAIGHT PERCENTAGE LEASE A type of percentage lease that bases rental rate solely on gross sales.

STRICT LIABILITY When someone is held legally responsible for an injury to another, even though he or she did not an negligently. COMPARE: *Negligence.*

STRIKE LIST An arbitration service sends a list of arbitrators to each party and the parties strike the names that are unacceptable.

STRING, STRINGER (1) a timber or other support for cross-members. (2) in stairs, the support on which the stair treads rest.

STRIP CENTER A small shopping center of about 10,000 to 30,000 square feet (four to ten retail spaces) located at the edge of an urban area or in a suburb.

STRUCTURAL DENSITY The ratio of the total ground floor area of a building to the total land area on the site on which it is built.

STUDS OR STUDDING Vertical supporting timbers in walls and partitions.

SUB-ACCOUNTS Sub-acounts within a trust account must be reconciled within the general account.

SUBAGENTS. Subagents are also called selling agents. A licensed salesperson cannot be a subagent of the seller.

SUBBASELINES (See Township Lines)

SUBCHAPTER-S CORPORATION A corporation that, for federal tax purposes only, is taxed similarly to a partnership. The corporate entity is disregarded for most federal tax purposes, and the shareholders are generally taxed as individual partners.

SUBDIVIDE To segment large, acquired tracts of real property in order to create small tracts for the purpose of resale.

SUBDIVIDED LANDS ACT The right of the state to regulate for the purpose of promoting health, safety, welfare and morality.

SUBDIVISION A legal definition of those divisions of real property for the purpose of sale, lease or financing which are regulated by law.

SUBDIVISION PLAT SEE: Plat.

SUBDIVISION REGULATIONS State and local laws that must be complied with before land can be subdivided.

SUBJECT PROPERTY The real property under discussion or appraisal.

SUBJACENT SUPPORT Support that the soil below the surface gives to the surface of the land.

SUBJECT TO (1) Burdened by and liable for an obligation. (2) A method of taking over a loan without becoming personally liable for its payment.

SUBJECT TO" MORTGAGE OR DEED OF TRUST When a grantee takes a title to real property subject to a mortgage or deed of trust, he or she is not responsible to the holder of the promissory note for the payment of any portion of the amount due. The most that he or she can lose in the event of a foreclosure is his or her equity in the property. In neither case is the original maker of the note released from his or her responsibility. (See also Assumption of Mortgage or Deed of Trust.)

SUBLEASE A lease given by a tenant.

SUBLETTING Partial transfer of a tenants right in arental property to a third party.

SUBMERIDIANS *(See Range Lines)*

SUBORDINATE To make subject or junior to.

SUBORDINATION Made subject to or subservient to; assignment to a lesser roll or position.

SUBORDINATION (AGREEMENT) In a mortgage or deed of trust, a provision that a later lien shall have a priority interest over the existing lien. It makes the existing lien inferior to a later lien, in effect exchanging priorities with that later lien.

SUBORDINATION CLAUSE Senior lien that makes it inferior to what would otherwise be a junior lien.

SUBPOENA A legal order to cause a witness to appear and give testimony.

SUBPOENA DUCES TECUM An order to produce books, records or other documents.

SUBROGATE To substitute one person for another's legal rights to a claim or debt.

SUBROGATION The substitution of another person in place of the creditor with regard to an obligation.

SUBSIDIZED HOUSING Residential development for low-income families that are insured or (indirectly) financed in part by a government agency.

SUBSIDY BUYDOWN Funds provided usually by the builder or seller to temporarily reduce the borrower s monthly principal and interest payment.

SUBSTANTATIVE LAW The laws describing rights and duties. Differs from procedural law, which only describes how to enforce and protect rights.

SUBSTANTIAL PERFORMANCE When a promisor doesn t perform all of his or her contractual obligations, but does enough so that the promisee is required to fulfill his or her side of the bargain. COMPARE: Breach, Material

SUBSTITUTION, PRINCIPLE OF Affirms that the maximum value of a property tends to be set by the cost of acquiring an equally desirable and valuable substitute property, assuming no costly delay is encountered in making the substitution.

SUB-STRUCTURE DATA Includes information about basement or crawl area, parts of the building as is also known as foundation data.

SUBURBAN DEVELOPMENT This was greatly aided by the railroads enabling people easy access to the nearby cities.

SUCCESSION The inheritance of property.

SUCCESSOR IN INTEREST The next succeeding owner of an interest in property. The transferee or recipient of a property interest.

SUCCESSOR S LIABILITY The liability of the next successive owner of the real estate.

SUIT An act of suing; an action in court of law for the recovery of a right or claim.

SUMMARY SUSPENSION Emergency or immediate action against a license to protect the public.

SUMMATION APPROACH SEE: Cost Approach.

SUMMONS A document informing a defendant that a lawsuit has been filed against him or her, and ordering the defendant to file an answer to the plaintiff s complaint with the court.

SUM-OF-THE-YEARS S-DIGITS DEPRECIATION An accelerated depreciation method. Accomplished by multiplying the remaining years of the property s economic life by the property s remaining value and then dividing by the sum of all the years in the remaining economic life of the property.

SUPERFUND AMENDMENTS AND REAUTHORIZATION ACT OF 1986 (SARA) The umbrella title given to various amendments to CERCLA.. Amendments limit pesticide liability and provide the government reclamation of contaminated property.

SUPPLY AND DEMAND, PRINCIPLE OF In appraising, a valuation principle stating that market value is affected by intersection of supply and demand forces in the market as of the appraisal date.

SUPERIOR COURT The principal trial court of the state; a court of unlimited monetary and subject matter jurisdiction, and an appeal court for decisions of municipal courts and small claims courts.

SUPERSEDEAS, WRIT OF A stay of enforcement; temporary stop in a legal proceeding; restraining order.

SUPPORT, LATERAL The Support that a piece of land receives from the land adjacent to it.

SUPPORT, SUBJACENT The support that the surface of a piece of land receives from the land beneath it.

SUPPORT RIGHTS The right to have one s land supported by the land adjacent to it and beneath it.

SUPPLY The quantity of goods or services offered for sale to the consumers.

SUPREME COURT The highest court in the California and the federal court structure. This court is almost exclusively an appeals court, accepting (by certiorari) only those cases that, in the court's desecration, involve issues of significant magnitude and social importance.

SURETY One who guarantees the performance by another, a guarantor.

SURPLUS PRODUCTIVITY, PRINCIPLE OF The net income that remains after the proper costs of labor, organization and capital have been paid, which surplus is imputable to the land and tends to fix the value thereof.

SURRENDER Giving up an estate (such as a life estate or leasehold) before it has expired.

SURVEY The process by which a parcel of land is located on the ground and measured.

SURVIVORSHIP SEE: Right of Survivorship.

SUSPENSION When a real estate agent s license is temporarily withdrawn.

SUSPENSION, SUMMARY License suspension before a hearing has been held.

SWING LOAN A short term loan to bridge the gap between the purchase of a new home and the subsequent sale of an old one.

SYNDICATE An association formed to operate an investment business. A syndicate is not a recognized legal entity; it can be organized as a corporation, partnership, or trust.

SYNDICATION A group of individuals pooling their resources to purchase property through the holding vehicle of a partnership, corporation, or other association. Each individual owns share in the legal entity formed to acquire and hold title to the property.

SYSTEM MAINTENANCE ADMINISTRATOR (SMA); SYSTEMS MAINTENANCE TECHNICIAN
Designations awarded to building engineers and maintenance personnel by the Building Owners and Managers Institute International (BOMI) for completion of courses in building systems operation and maintenance.

T

TACKING When successive periods of use or possession by more than one person are added together to make up the five years required for prescription or adverse possession.

TAKING When the government acquires private property for public use by condemnation, it s called a taking. The term is also used in inverse condemnation lawsuits, when a government action has made private property useless.

TAKE-OUT LOAN The loan arranged by the owner or builder developer for a buyer. The construction loan made for construction of the improvements is usually paid in full from the proceeds of this more permanent mortgage loan.

TANGIBLE ASSET Anything of substance; personal and real property.

TANDEM PLAN This is the name of the plan used by GNMA and FNMA for buying loans at par, which is less than market value.

TAX A compulsory charge on property or individuals, the payment of which supports a government.

TAXABLE INCOME Gross income minus tax deductions; net operating income plus reserve for replacements minus financing costs and allowable deductions.

TAXABLE VALUE The assessed value less allowable exemptions resulting in an amount to which the tax rate is applied to determine property taxes due.

TAX BASIS The tax value of property to the taxpayer. It is a figure used to compute capital gains and losses.

TAX CERTIFICATE A document sold by a local tax authority granting the certificate buyer the right to receive delinquent taxes plus interest when paid by the legal property owner.

TAX CLAUSE A provision in a mortgage that requires the borrower to pay all legitimate property taxes.

TAX DEED Deed issued to the purchaser at a tax sale.

TAX-DEFERRED EXCHANGE A method of postponing capital gains when disposing of real property by trading one property for another of like kind.

TAX DISTRICT An authority, such as a city, county, school board or special levy area(e.g., water district) with power to assess property owners annually in order to meet its expenditures for the public good.

TAX-FREE EXCHANGE The trade or exchange of one real property for another without the need to pay income taxes on the gain at the time of trade.

TAX, GENERAL REAL ESTATE Property taxes.

TAX LIEN A claim against real property arising out of non-payment of the property taxes.

TAX PARTICIPATION CLAUSE A lease provision requiring the tenant to pay a pro-rata share of any increase in real estate taxes or assessments in addition to the basic rental.

TAX, PROPERTY An annual ad valorem tax levied on real and personal property.

TAX SALE Sale of property after a period of nonpayment of taxes.

TAX RATE The percentage of value that is used to determine the amount of tax to be levied against each individual unit of property; ad valorem (according to value).

TAX SALE NUMBER A number assigned to a property when property taxes are not paid on time; identifies that property on the delinquent tax roll.

TAX SERVICE A reporting service that notifies the lender in the event the borrower does not keep the property taxes current.

TAX SHELTER An investment that shields items of income or gain from payment of income taxes; a term used to describe some tax advantages of owning real property (or other investments), including postponement or even elimination of certain taxes.

TAX WRITE-OFF When a purchaser buys an older building for this purpose only the building is depreciable not the land.

TECHNICAL OVERSUPPLY A market condition in which available rental space exceeds tenant demand.

TENANCY A leasehold estate. (For specific types of leases see Estates.)

TENANCY AT SUFFERANCE A rental situation in which a tenant who originally obtained possession of the remises legally continues to occupy the property after the expiration of the leasehold interest and without the consent of the owner.

TENANCY AT WILL When a tenant is in possession with the owner s permission, but there s no definite lease term; as when a landlord allows a holdover tenant to remain on the premises until another tenant is found.

TENANCY BY THE ENTIRETIES An estate created by husband and wife jointly owning real property with instant and complete right of survivorship.

TENANCY-IN-COMMON Ownership by two or more persons who hold an undivided interest in real property, without right of survivorship; the interests need not be equal.

TENANCY, TERM SEE: *Estate for Years.*

TENANCY IN PARTNERSHIP The form of concurrent ownership in which general partners own partnership property, whether or not title to the property is in the partnership s name. Each partner has an equal undivided interest, but no right to transfer the interest to someone outside the partnership.

TENANT One who leases real property from the owner.

TENANT ALTERATION COSTS Construction, remodeling and alteration expenses for work needed to make the premises usable by the tenant. These costs are assumed by the tenant or the owner or both and are a major point of negotiations.

TENANTS BY THE ENTIRETIES Under certain state laws, ownership of property acquired by a husband and wife during marriage, which property is jointly and equally owned. Upon death of one spouse it becomes the property of the survivor.

TENANT, HOLDOVER A lessee who remains in possession of the property after the lease term has expired.

TENANT, LIFE Someone who owns a life estate.

TENANT MIX The combination of retail tenants occupying a shopping center; must be considered carefully to achieve maximum profit for each merchant of the center.

TENANT UNION A local organization of residential tenants working for their common interests and rights.

TENANT WARDENS Employees of tenant companies who are schooled in emergency procedures by the building staff to direct their fellow employees during routine drills and actual emergencies.

TENDER An unconditional offer by one of parties to a contract to perform his or her part of the agreement; made when the offeror believes the other party is breaching, it establishes the offeror s right to sue if the other party doesn t accept it. Also called a tender offer.

TENEMENTS All rights in real property that pass with a conveyance of it.

TENTATIVE MAP The Subdivision Map Act requires

subdividers initially to submit a tentative map of their tract to the local planning commission for study. The approval or disapproval of the planning commission is noted on the map. Thereafter, the planning commission requests a final map of the tract embodying any changes.

TENURE IN LAND The manner in which land is held.

TERM A prescribed period of time; especially, the length of time a borrower has in which to pay off a loan, or the duration of a lease.

TERM LOAN A loan made for a specific period of time.

TERM MORTGAGE A nonamortizing loan that normally calls for repayment of the principal in full at the end of the loan term.

TERMS Refers to the amount of each installment payment, interest rate , due dates, and number of years.

TERMITES Antlike insects that feed on wood.

TERMITE SHIELD A shield, usually of noncorrodible metal, placed on top of the foundation wall or around pipes to prevent passage of termites.

TESTAMENT The written declaration of one's last will.

TESTAMENTARY DISPOSITION A gift passing by will.

TESTATE Describes a person who dies leaving a will.

TESTATOR A person who makes a will. Technically, a testator is a male and a testatrix is a female, although in common use testator refers to anyone who makes a will.

TESTATRIX A woman who makes a will.

TESTER A person working with a fair housing organization, who pretends to be interested in buying or renting property from someone suspected of unlawful discrimination.

THEFT As related to real estate, it includes entering and removing part of the realty, defrauding by misrepresentation, and taking away part of the security for a trust deed with the intent to defraud the beneficiary.

THIRD PARTY Persons who are not parties to a contract which affects an interest they have in the object of the contract.

THIRTY-DAY NOTICE A notice terminating a periodic tenancy without cause, by ending a tenancy thirty days from date of service.

THREE-DAY NOTICE A notice giving a tenant three days in which to cure a default or quit the premises. It is the first step in an unlawful detainer action, as the means of terminating a lease for cause. When rent is delinquent, it is sometimes called a notice to quit or pay rent.

THREE-QUARTER BATH This bath contains a shower, a sink and a toilet.

THRESHOLD A strip of wood or metal beveled on each edge and used above the finished floor under outside doors.

TIDELANDS Lands that are covered and uncovered by the ebb and flow of the tide.

TIER An east west row of townships (as used in the government survey method of land descriptions).

TIGHT MONEY MARKET A market in which the demand for money exceeds the supply, causing interest rates to increase and borrower qualifications to be tightened.

TIME DEPOSIT Savings account with a fixed maturity, as opposed to a demand deposit.

"TIME IS OF THE ESSENCE" These words, when placed in an agreement, make it necessary that all time limitations and requirements be strictly observed.

TIME-SHARE ESTATE A right of occupancy in a time share project (subdivision) which is coupled with an estate in the real property.

TIME-SHARE CONDOMINIUM Ownership in vacation area residential property for an assigned period, usually two weeks. Also called interval ownership.

TIME-SHARE PROJECT A form of subdivision of real property into rights to the recurrent, exclusive use or occupancy of a lot, parcel, unit or a segment of real property, on an annual or some other period basis, for a specified period of time.

TIME-SHARE USE A license or contractual or membership right of occupancy in a timeshare project which is not coupled with an estate in the real property.

T-INTERSECTION LOT Lot facing the dead-end street at the T-intersection.

REAL ESTATE TERMINOLOGY

A Course Companion for Studying for The Real Estate Exam, for Real Estate Home Study Courses, for Real Estate Continuing Education Courses, for Real Estate Statutory Courses, and for Any Form of College Real Estate Course.

TITLE Evidence of the owner's right or interest in property. (1) The right of ownership. (2) The evidence of a person's ownership or interest in property.

TITLE, AFTER-ACQUIRED Title acquired by a grantor after he or she attempted to convey property he or she didn t own.

TITLE, CLEAR Title that is free of encumbrances or defects: marketable title.

TITLE COMPANY Company authorized to sell title insurance, as well as to serve escrow needs.

TITLE, EQUITABLE The vendee s interest in property under a land contract. Also called an equitable interest. COMPARE: Title, Legal.

TITLE INSURANCE Insurance protecting a property owner against losses resulting from an imperfect title.

TITLE, LEGAL The vendor s interest in property under a land contract. COMPARE: Title, Equitable.

TITLE, MARKETABLE Tile free and clear of objectionable liens, encumbrances, or defects, so that a reasonable prudent person with full knowledge of the fans would not hesitate to purchase the property..

TITLE PLANT A duplicate (usually microfilmed) of a county s public record, maintained by a title company at its offices for use in title searches

TITLE REPORT A report which discloses condition of title , made by a title company preliminary to issuance of title insurance policy. A duplicate (usually microfilmed) of a county s public record, maintained by a title company at its offices for use in title searches.

TITLE THEORY A mortgage arrangement whereby title to mortgaged real property vests in the lender. Some states give greater protection to mortgage lenders and assume lenders have title interest, Distinguished from the Lien Theory States

TITLE THEORY STATE A state in which the borrower assigns title to the lender, typically in a deed of trust.

TITLE SEARCH An inspection of the public record to determine all

TIME PERIODS Time periods for various lawsuits are specified in the Statute of Frauds.

TITLE INSURANCE Insurance written by a title company to protect a property-owner against loss if title is defective or not marketable. A special policy of insurance issued by a title company, insuring the owner against loss of or defect in title to the insured property. The policy may be either a CLTA policy, issued to the property owner and to noninstitutional lenders, or an ALTA policy, issued to institutional lenders.

TITLE POLICIES An ALTA lender s policy is the Title Policy usually required by the lender.

TOPOGRAPHY Nature of the surface of the land. Topography may be level, rolling, or mountainous.

TORRENS SYSTEM A governmental title registration system that uses certificates of title issued by a public official (the registrar of title) as evidence of title.

TORRENS TITLE A title included in a state-insured title system no longer used in California.

TORT (1) A wrongful act. (2) A wrong or injury. (3) Violation of a legal right. A civil wrong, not arising from a breach of contract. Most torts lie in negligence, although they could also be intentional torts (such as assault and battery, trespass) or strict liability torts.

TORTFEASOR A person who commits a tort.

TORTIOUS Conduct which amounts to a tort.

TOWNHOUSE One of a row of houses usually of the same or similar design with common side walls or with a very narrow space between adjacent side walls.

TOWNSHIP A territorial subdivision that is six miles long and six miles wide and that contains 36 sections, each one mile square.

TOWNSHIP LINES Lines running east-west, spaced six miles apart, in the government survey system.

TOWNSHIP TIER In the government survey system, a strip of land running east-west, six miles wide and bounded on the north and south by township lines.

TOWNHOUSE A residential unit connected to similar units. Describes a style of architecture , with title to the unit and its lot invested in the individual buyer with an undivided interest in the common area.

TRACS An on-line computer system being developed by HUD to help administer subsidized housing.

TRACT 1. A piece of land of undefined size. 2. In the government survey system, an area made up of 16 townships; 24 miles on each side.

TRACT INDEX An index of the public record, grouping together all recorded documents that carry a particular legal description. COMPARE: Grantor/grantee Indexes.

TRADE ASSOCIATION A voluntary nonprofit organization of independent and competing business units engaged in the same industry or trade, formed to help solve industry problems, promote progress and enhance service.

TRADE FIXTURES Articles of personal property that are annexed to real property but that are necessary to the carrying on of a trade and are removable by the owner. Fixtures installed to further one's trade, business, or profession. They are an exception to the general rule that fixtures are part of a building. Such fixtures installed by a tenant may be removed before the expiration of the tenancy.

TRADE-IN Method of guaranteeing an owner a minimum amount of cash on the sale of his or her present property to permit him or her to purchase another. If the property is not sold within a specified time at the listed price, the broker agrees to arrange financing to purchase the property at an agreed-upon discount.

TRADE NAME Any adopted or fictitious name used to designate a business concern.

TRANSACTIONAL BROKER A real estate agent representing both buyer and seller in a transaction; also referred to as a dual *agent.*

TRANSACTION ACCOUNTS Accounts used to make payments or transfers to others, such as a checking account

TRANSFER Conveyance; passage of title.

TRANSFERABILITY The ability to will, lease, give or sell a property.

TRANSFER FEE A charge made by alending institution holding or collecting on a real estate mortgage to change its records to reflect different ownership.

TRANSFER TAX See *DOCUMENTARY STAMPS*

TRANSFER TAX STAMPS In a real estate sale, the transfer tax stamps are the prime responsibility of the seller.

TRANSFEREE The person to whom a transfer is made.

TRANSFEROR The person who makes a transfer.

TRANSMUTATION AGREEMENT A contract in which co-owners agree to change their form of ownership; usually one in which husband and wife agree to change community property to separate property.

TREADS Horizontal boards of a stairway.

TREND A series of related changes brought about by a chain of causes and effects.

TRESPASS An invasion of an owner's rights in his or her property. (1) Unauthorized entry onto another's land. (2) Invasion of another's rights or property.

TRESPASSER One who trespasses. The importance of this classification of individuals on property is created by the methods for removal and the liability of the property owner if the trespasser is injured on his property.

TRIAL The fundamental court proceeding in a lawsuit, in which a judge (and in some cases, a jury) hears evidence presented by both parties and issues a judgment. COMPARE: Appeal.

TRIER OF FACT The one who decides questions of fact in a lawsuit. In a jury trial, its the jury; in a non-jury trial, its the judge. (Questions of law are always decided by the judge.)

TRIGGERING TERMS The Truth-in-Lending Act requires creditors to disclose certain information if certain credit terms, are included in the advertisement. Triggering terms include the amount or percentage of down payment, number of payments, period (term) of repayment, amount of any payment, and the amount of any finance charges.

TRIM The finish materials in a building, such as moldings applied around openings (window trim, door trim) or at the floor and ceiling (baseboard, cornice, picture molding).

TRUST A right of property, real or personal, held by one party called the trustee for the benefit of another party called the beneficiary. Arrangement whereby one person holds property for the benefit of another under fiduciary (special confidential) relationship.

TRUST ACCOUNT An account separate and apart and physically segregated from brokers own funds, in which broker is required by law to deposit all funds collected for client.

TRUST COOPERATIVE A cooperative in which legal ownership of a building is held by a trust company.

TRUST DEED Deed given by a borrower to a trustee to be held pending fulfillment of an obligation, which is usually repayment of a loan to a beneficiary. A deed of trust. It may contain all the following clauses, request for notice, prepayment penalty and late charges.

TRUST FUNDS. Trust funds accepted by a broker may not be placed in the broker s business account, or his personal account. Trust fund handling requirements do not apply to advance fees. A broker must place trust funds in an interest-bearing account if requested by the owner of the funds. The broker must keep records of trust funds deposited in a trust account. A broker must retain records of trust funds for three years after the closing or cancellation of the transaction involving the funds. If a broker is found to be mishandling trust funds, the broker, the broker s business may be handed over to a receiver. Criminal penalties apply to mishandling of trust funds.

TRUSTEE The person who holds property in trust for another. In a deed of trust, the person who holds bare legal title in trust. After a deed has been paid off , the deed reconveying title to the trustor will be signed by the trustee.

TRUSTEE'S DEED The deed issued by the beneficiary after the foreclosure and sale under a deed of trust.

TRUSTEE'S SALE The private sale of property held by a trustee under a deed of trust as part of the foreclosure proceedings.

TRUSTOR (1) One who conveys his or her property to a trustee. (2) The borrower or debtor under a deed of trust.

TRUTH IN LENDING LAW (TIL) A complex set of federal statutes designed to provide a borrower with a means of discovering and comparing the true costs of credit. Under Regulation Z of the act, certain borrowers of property have three days after accepting a loan to rescind without cost or liability.

TWO-STEP MORTGAGE Loan with lower initial fixed interest rate, increasing after conversion period.

TURNOVER The frequency in which new tenants move in and out of a unit.

U

UNCONSTITUTIONAL Violating a provision of the U.S. Constitution or a state constitution.

UNDERIMPROVEMENT An improvement which, because of its deficiency in size or in cost, is not the highest and best use of the site.

UNDERWRITING Insuring something against loss; guaranteeing financially.

UNDIVIDED INTERESTS SEE : *Interest, Undivided*

UNDUE INFLUENCE Taking any fraudulent or unfair advantage of another's necessity or weakness of mind. Using a position of trust and confidence improperly to persuade a person to take a course of action. By relying on the trusted confidant, the decision maker fails to exercise his free will and independent judgment.

UNEARNED INCREMENT An increase in value of real estate due to no effort on the part of the owner, often due to an increase in population.

UNENFORCEABLE CONTRACT Incapable of being enforced at law. An example of an unenforceable contract is an oral listing agreement to pay a broker a commission.

UNETHICAL CONDUCT An owner/ broker submits a listing to a multiple listing service, and another broker sells his property, however the owner/broker does not disclose that he is a broker would constitute unethical conduct under DRE regulation.

UNIFORM COMMERCIAL CODE A group of statutes establishing a unified and comprehensive scheme for regulation of security transactions in personal property and other commercial matters, superseding the existing statutes on chattel mortgages, conditional sales, trust receipts, assignment of accounts receivable, and other similar matters.

UNIFORM RESIDENTIAL LANDLORD AND TENANT ACT, A model law drafted in 1972 by the National Conference of Commissioners on Uniform State Laws. It serves as a model statue for standardization and regulation of the residential landlord-tenant relationship.

UNIFORM SETTLEMENT STATEMENT A closing statement required for any transaction involving a loan that s subject to the Real Estate Settlement Procedures An (RESPA).

UNIFORM STANDARDS OF PROFESSIONAL APPRAISAL PRACTICE These standards are developed, interpreted and amended by The Appraisal Standards Board.

UNILATERAL (CONTRACT) One-sided, ex parte.

UNILATERAL ESCROW INSTRUCTIONS Separate sets of escrow instructions, one for the buyer and one for the seller; normally drawn up after all the information is in and escrow is ready to close.

UNILATERAL MISTAKE SEE: Mistake, Unilateral.

UNLAWFUL DISCRIMINATION A bank refuses to loan money to a buyer because of his religion.

UNINCORPORATED ASSOCIATION The legal designation for an organization that has recorded a statement listing the names of those who are authorized to execute conveyances on its behalf, which makes possible for title to be held in the association s name.

UNITIES, FOUR The unities of time, title, interest, and possession, required for a joint tenancy.

UNIT-IN-PLACE METHOD The cost of erecting a building by estimating the cost of each separate component.

UNITY OF INTEREST When each co-owner has an equal interest (equal share of ownership) in a piece of property.

UNITY OF POSSESSION When each co-owner is equally entitled to possession of the entire property, because the ownership interests are undivided.

UNITY OF TIME When each co-owner acquired title at the same time.

UNITY OF TITLE When each co-owner acquired title through the same instrument (deed, will, or court order).

UNIVERSAL AGENT A representative authorized by the principal to perform all acts that the principal can personally perform and that may be lawfully delegated to another.

UNJUST ENRICHMENT A legal doctrine that prevents a person from inequitably benefitting from another's mistake, poor judgment, or loss. In a land sales contract the vender may no longer keep both the property and the buyer's excess payments (over his damages) in the event of breach, because to do so would unjustly enrich him at the buyer's expense.

UNLAWFUL Illegal.

UNLAWFUL CONDUCT A licensee solicits a listing by selling a prospective home seller and the property has a high market value when there is no reasonable basis to the representation. It would be unlawful conduct.

UNLAWFUL DETAINER An action to recover possession of real property. A lawsuit designed to evict a defaulting tenant, or anyone unlawfully in possession of property, from premises. It is summary in nature, entitled to a priority court trial, and litigates only the right to possession of property (and damages resulting therefrom).

UNLAWFUL DISCRIMINATION A person fined with this act may be fined as high as $10,000 for a first violation.

UNLIQUIDATED DAMAGES The amount of valuable consideration awarded by a court to an injured party as a result of a default.

UNSECURED DEBT A debt not backed by specific property to satisfy the indebtedness in case of default.

UNSECURED NOTE (LOAN) A loan granted solely on the strength of a borrower s signature; no security is pledged, and no deed of trust recorded.

UNTENANTABLE Not fit for occupancy.

UPC Identification number for a specific property; also called assessor s tax parcel number, account number or folio number.

URBAN LAND INSTITUTE (ULI) A nonprofit organization founded in 1936 to improve the quality of land-use planning and development.

URBAN PROPERTY City property; closely settled property.

URBAN RENEWAL Renovation, rehabilitation and redevelopment of substandard urban residential properties.

USABLE SPACE Floor area of an office building that can be used for tenant office space.

USE VARIANCE SEE: *Variance, Use.*

USPAP Stands for Uniform standards of Professional Appraisal.

USURY OR USURIOUS INTEREST Claiming a rate of interest greater than permitted by law. Charging a greater rate of interest on loans than the rate allowed by law (10 percent in many cases).

UNTENABLE PROPERTY The penalty for any landlord who collects or demands rent when his property has become untenable is ; actual damages up to $10,000, the tenant s court

costs and fees, and possible punitive damages imposed by a judge.

UTILITIES Refers to services rendered by public utility companies, such as --– water, gas, electricity or telephone.

UTILITY The ability to give satisfaction and/or excite a desire for possession. An element of value.

UTILITY VALUE The usefulness of property.

V

VA Veterans Administration.

VACANCY AND COLLECTION LOSSES A deduction from potential gross income for (1) current or future space not rented due to tenant turnover and (2) loss from uncollected rent due from delinquent tenants.

VACANCY RATE The percentage of rental units that are not occupied.

VACATE To set aside, cancel, or annul; to leave emoty.

VALID The legal classification of a contract that is binding and enforceable in a court of law.

VALUABLE CONSIDERATION SEE: Consideration.

VALID CONTRACT (1) Legally sufficient and authorized by law. (2) Having force or binding force. Fully effective at law; legally sufficient.

VALID DEED All legal essential legal elements are present. One that is binding and enforceable in a court of law.

VALID ESCROW It is a necessary requirement in a valid escrow for the transfer of title to real property for: a binding contract for the sale of real property and a conditional delivery of instructions to escrow

V A LOAN A loan made to qualified veterans for the purchase of real property wherein the Department of Veterans Affairs guarantees the lender payment of the mortgage.

VALLEY The internal angle formed by the junction of two sloping sides of a roof.

VALUATION (1) Estimated worth or price. (2) The act of valuing by appraisal.

VALUATION SEE: Appraisal.

VALUE Present worth of future benefits arising out of ownership to typical users/investors. The monetary worth of property, goods or services to buyers. When net operating income is divided by the capitalization rate you get value.

VALUE, BASE Under Proposition 13, the initial assessed value of a piece of property, used in calculating a particular owner s property taxes; this figure is later adjusted to reflect inflation and improvements.

VALUE, FULL CASH Under Proposition 13, the assessed value of newly transferred property; it s the purchase price of the property, unless it can be shown that the property wouldn t have been sold at that price on the open market.

VARIABLE COSTS RATIO A method of expressing variable costs for a property as a percentage of total rental income.

VARIABLE EXPENSE An expense item in a property s operating budget that increases or decreases with the occupancy level of the building.

VARIABLE INTEREST RATE An interest rate that fluctuates in a set proportion to changes in an economic index, such as the cost of money. Extensive regulations cover use of VIRs in loans on residential property.

VARIABLE SCALE PERCENTAGE LEASE A type of percentage lease in which the percentage rental rate increases or decreases according to the volume of business done by the tenant.

VARIANCE An exception or departure from the general rule. An exception granted to a property owner, relieving him from obeying certain aspects of a zoning ordinance. Its granting is discretionary with the zoning authorities and is based on undue hardship suffered by the property owner because of unique circumstances affecting his property.

VARIANCE, USE A variance that permits an owner to use the property in a way that isn t ordinarily allowed in that zone; for example, a commercial use in a residential zone.

VENDEE Purchaser or buyer or real property.

VENDOR Seller of real property.

VENDOR S LIEN A claim against property giving the seller

the right to hold the property as security for any unpaid purchase money.

VENEER Thin sheets of wood placed over another material.

VENT A pipe installed to provide a flow of air to or from a drainage system or to provide a circulation of air within such system to protect trap seals from siphon age and back pressure.

VENUE The location in which a cause of action occurs; it determines the court having jurisdiction to hear and decide the case. For real estate, the court having proper venue is one in the county in which the property is located.

VERIFICATION A sworn statement before a duly qualified officer as to the correctness of the contents of an instrument. Written certification under oath and/or penalty of perjury, confirming the truth of the facts in a document.

VERSUS Against (abbreviated v. or vs.). Used in case names, with the plaintiff's name given first.

VEST To confer or bestow upon, as in the expression, Title shall vest in.....

VESTED Bestowed upon someone, such as title to property. Absolute, not contingent or subject to being defeated.

VESTEE Current recorded owner.

VESTING The manner in which title is held.

VETERANS ADMINISTRATION Federal agency succeeded as of March 15' 1989 by the Department of Veterans Affairs.

VETERAN'S EXEMPTION A deduction from the annual property tax allowed to a qualified veteran residing on residential property. Since July 1978, it has amounted to $40 off the normal tax bill.

VETO When the president or governor formally rejects a bill that Congress or the legislature has passed. The bill won t become law unless the legislative body votes to override the veto.

VOD Verification of Deposit form sent to borrower s financial institutions to verify funds for the down payment and closing costs.

VOE Verification of employment form sent to prospective borrower s employer to verify employment status, salary, and length of employment.

VOID Having no legal force or effect.

VOID CONTRACT To have no legal force or effect; that which is unenforceable. Unenforceable, null, having no legal effect.

VOIDABLE CONTRACT An instrument that appears to be valid and enforceable on its face but is, in fact, lacking some essential requirement. May be declared void, but is valid unless and until declared void.

VOIDABLE CONTRACT A title that is valid until voided by the party who has a right to nullify it.

VOLUME BUYING *See Bulk Purchasing*

VOLUNTARILY INACTIVE The license status that results when a licensee has met all the requirements for licensure, yet the licensee chooses not to engage in the real estate business, and has requested his or her license be placed in this status.

VOLUNTARY LIEN Any lien placed on property with the consent of the owner or as a result of the voluntary act of the owner.

VRM Variable Rate Mortgages. See *Adjustable-Rate Mortgages*

W

WAINSCOTING Wood lining of an interior wall, lower section of a wall when finished differently from the upper part.

WAIVE To give up a right.

WAIVER Giving up of certain rights or privileges. The relinquishment may be voluntary and knowing, or it may occur involuntarily through action of the parties. The action resulting in the waiver is unilateral, and requires no action or reliance by the other party.

WALK-UP An apartment building with two or more floors without an elevator.

WAREHOUSES Rent is usually established after surveying similar spaces to determine market rents.

WAREHOUSING Temporary retention of loans pending

sales to investors.

WARRANT A guarantee or covenant, as in a warranty deed.

WARRANTY An absolute undertaking or promise that certain facts are as represented. Occasionally used interchangeably with guarantee.

WARRANTY DEED A deed that is used to convey real property and that contains warranties of title and quiet possession; the grantor thus agrees to defend the premises against the lawful claims of third persons. It is commonly used in other states, but in California the grant deed has replaced it. Used predominantly in states that do not have title insurance companies. This deed contains six full warranties of protection to the buyer, including warranties that the seller owns the property, that it is unencumbered, and that the seller will defend title against any defects.

WARRANTY OF AUTHORITY A representation by an agent to third persons that the agent is acting within the scope of authority conferred by his or her principal.

WARRANTY FOREVER A provision in a deed gaurantee ing that the seller will for all time defend title and possession for the buyer.

WARRANTY, IMPLIED In the sale of property, a guarantee created by operation of law, whether or not the seller intended to offer it.

WARRANTY OF HABITABILITY Implied warranty in residential leases. The landlord covenants by implication that the premises are suitable for human occupancy. The implied warranties are found in the statutes and implied by common law.

WASTE The destruction, or material alteration of or injury to premises by a tenant-for-life, or tenant, or tenant-for-years. Example: a tenant cutting down trees or mining coal. The destruction, injury, material alteration, or abusive use of property by a person rightfully in possession, but who does not own the fee or entire estate (for example, by a lessee or life tenant).

WATER RIGHTS SEE: Prior Appropriation; Riparian Rights

WATER TABLE Distance from the surface of the ground to a depth at which natural ground water is found.

WEAR AND TEAR Deprecation of an asset due to ordinary usage.

WELFARE OR SOCIAL SECURITY A lender may not legally deny a loan application based on the applicants receipt of income from a public assistance program such as Welfare or Social Security.

WILD DEED A deed that will not be discovered using the grantor-grantee indexes., because of a break in the chain of title. A deed of trust or other document can be wild.

WILL A written, legal document that directs the disposition of one's property after death.

WILL, NUNCUPATIVE An oral will made on the testator or testatrix s death bed. No longer recognized in California.

WILL, STATUTORY A formal will prepared on the statutory will form provided in California s Probate Code.

WIRELESS COMMUNICATION Electronic communication that is sent via satellite, thus eliminating the need to use telephone lines.

WITNESS A person who gives testimony ; one who observers and attests to the signing or executing of a document.

WITNESSED WILL A formal will, signed by the testator in the presence of two or more witnesses, each of whom must also sign the will.

WORK WEEK (REGULAR) This type of may include holidays, Sundays and weekdays.

WORKERS COMPENSATION INSURANCE Provides coverage for employees injured or killed in the course of the job.

WRAP AROUND MORTGAGE (DEED OF TRUST) (See All-Inclusive Deed of Trust.)

WRAP-AROUND DEED OF TRUST A sophisticated financing package that permits the seller to sell his property without paying off the outstanding deed of trust. The buyer's larger loan, which is used to purchase the property, includes provisions for paying off the seller's existing loan.

WRAPAROUND LOAN A loan that is really a combination of loans, the existing loan(s) and a new second loan.

WRIT A court order directing a party to do a specific act, usually to appear in or report to a court of law.
S
WRIT OF POSSESSION A process of the court under which property may be seized. An order from the court to the sheriff or other law enforcement officer directing and authorizing a specific act.

WRIT OF ATTACHMENT A writ authorizing and directing the physical attachment (seizure) of property.

WRIT OF EXECUTION An order directing the sheriff to seize property to satisfy a judgment.

WRIT OF IMMEDIATE POSSESSION An order authorizing a landlord to obtain immediate possession of a tenant's premises, pending the outcome of an unlawful retainer action or other court proceeding.

WRIT OF POSSESSION A court order issued after an unlawful detainer action, informing a tenant that he or she must vacate the landlord s property within a specified period or be forcibly removed by the sheriff.

X

X An individual who cannot write may execute a legal document by affixing an X (his/her mark) where the signature normally goes. Beneath the mark a witness than writes the person s name and signs his or her name as the witness.

WRITTEN OFFER Submitting all written offers is a beneficial practice.

Y

YARD A unit of measurement 3 feet long.

YIELD The interest earned by an investor on an investment (or by a bank on the money it has loaned). Also, called return.

YIELD RATE The yield expressed as a percentage of the total investment. Also called the rate of return.

Z

ZONE The area set off by the proper authorities in which the real property can be used for only specific purposes.

ZONING ORDINANCES Act of city or county authorities specifying the type of use to which property may be put in specific areas. A government's division of a city or other geographic area into districts, and the regulation of property uses within each district. A use that is legally nonconforming is allowed to continue in this zone.

ZONING AMENDMENT SEE: Rezone.

ZONING, EXCLUSIONARY A zoning law that has the effect of preventing certain groups (such as minorities or poor people) from living in a community.

ZONING, SPOT An illegal rezone that favors (or restricts) a particular property owner (or a small group of owners) without justification.

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Preface

This dictionary provides the user with the main vocabulary currently being used in British and American law. The areas covered include criminal, civil, commercial and international law, as well as interactions with the police and legal advisers, and the procedures of the courts and prisons. Common words used in reading or writing reports, articles or guidelines are also included.

The dictionary is designed for anyone who needs to check the meaning or pronunciation of legal terms, but especially for those who need some knowledge of legal terms in their work but who may not be legal professionals, or for those for whom English is an additional language. Each headword is explained in a clear, straightforward way. Pronunciations, uncommon plurals and uncommon verb forms are provided.

Many people have helped or advised on the compilation and checking of the dictionary in its various editions. In particular, thanks are due to Coral Hill, Senior Lecturer at the College of Law of England and Wales, for her helpful comments and advice on this fourth edition.

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Pronunciation

The following symbols have been used to show the pronunciation of the main words in the dictionary.

Stress is indicated by a main stress mark (') and a secondary stress mark (ˌ). Note that these are only guides, as the stress of the word changes according to its position in the sentence.

Vowels		*Consonants*	
æ	b**a**ck	b	**b**uck
ɑː	h**ar**m	d	**d**ead
ɒ	st**o**p	ð	o**th**er
aɪ	t**y**pe	dʒ	**j**ump
aʊ	h**ow**	f	**f**are
aɪə	h**ire**	g	**g**old
aʊə	**hour**	h	**h**ead
ɔː	c**our**se	j	**y**ellow
ɔɪ	ann**oy**	k	**c**ab
e	h**ea**d	l	**l**eave
eə	f**air**	m	**m**ix
eɪ	m**a**ke	n	**n**il
eʊ	g**o**	ŋ	si**ng**
ɜː	w**or**d	p	**p**rint
iː	k**ee**p	r	**r**est
i	happ**y**	s	**s**ave
ə	**a**bout	ʃ	**sh**op
ɪ	f**i**t	t	**t**ake
ɪə	n**ear**	tʃ	**ch**ange
u	ann**u**al	θ	**th**eft
uː	p**oo**l	v	**v**alue
ʊ	b**oo**k	w	**w**ork
ʊə	t**our**	x	lo**ch**
ʌ	sh**u**t	ʒ	mea**s**ure
		z	**z**one

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A.B.A. *abbreviation US* American Bar Association

abandon /ə'bændən/ *verb* **1.** to stop doing something ○ *The company has decided to abandon the project.* ○ *We have abandoned the idea of taking the family to court.* □ **to abandon an action** to stop pursuing a legal action □ **to abandon a legal right *or* claim** to accept that a right or claim cannot be legally enforced **2.** to leave someone or something without help ○ *He abandoned his family and went abroad.* ○ *The crew had to abandon the sinking ship.*

abandonment /ə'bændənmənt/ *noun* **1.** the act of giving something up voluntarily such as the right to a property **2.** the act of giving up either the whole or part of a claim put forward during civil litigation **3.** the act of a parent or guardian leaving a child on their own in circumstances covered by the Children and Young Persons Act 1933

abate /ə'beɪt/ *verb* **1.** to remove or stop a nuisance **2.** to reduce a legacy **3.** to be reduced **4.** (*of a legacy*) to be reduced because there is not enough money in the estate to pay it in full

abatement /ə'beɪtmənt/ *noun* **1.** the legal right to remove or stop a nuisance once a reasonable period of notice has been given to the wrongdoer **2.** the reduction of a legacy when the deceased person has not left enough money to pay it in full **3.** the reduction or removal of a debt when a person has failed to leave enough money to cover a legacy in full. ◊ **tax abatement**

ABC *abbreviation* Acceptable Behaviour Contract

abduct /æb'dʌkt/ *verb* to take someone away against their will, usually by force ○ *The bank manager was abducted at gunpoint.* ○ *The robbers abducted the heiress and held her to ransom.*

COMMENT: The Child Abduction Act 1984 provides for specific offences to cover the abduction of a child either by a person connected with the child or by other persons. Abduction of an adult may result in prosecutions for kidnapping and/or false imprisonment.

abduction /æb'dʌkʃən/ *noun* the notifiable offence of taking someone away against their will, usually by force

abductor /æb'dʌktə/ *noun* a person who takes someone away against their will

abeyance /ə'beɪəns/ *noun* **1.** □ **in abeyance** not being used or enforced at present ○ *This law is in abeyance.* □ **to fall into abeyance** to stop being used or enforced ○ *The practice was common but has fallen into abeyance.* **2.** a situation where there is no owner of a piece of land

ABH *abbreviation* actual bodily harm

abide by /ə'baɪd baɪ/ *verb* to accept a rule or follow a custom ○ *He promised to abide by the decision of the court.* ○ *She did not abide by the terms of the agreement.* □ **to abide by a promise** to carry out a promise that has been made

ab initio /ˌæb ɪ'nɪʃiəʊ/ *phrase* a Latin phrase meaning 'from the beginning'

abjuration /ˌæbdʒʊə'reɪʃ(ə)n/ *noun* the act of taking back a statement made on oath

abjure /əb'dʒʊə/ *verb* **1.** to make a public promise not to do something **2.** *US* to swear not to bear allegiance to another country

abode /ə'bəʊd/ *noun* the place where someone lives. ◊ **right of abode** □ **of no fixed abode** with no permanent address

mainp - softvnn.com

Law.fm Page 2 Friday, June 11, 2004 2:08 PM

abolish /ə'bɒlɪʃ/ *verb* to cancel or remove something such as a law or rule ○ *The Chancellor of the Exchequer refused to ask Parliament to abolish the tax on alcohol.* ○ *The Senate voted to abolish the death penalty.*

abolition /ˌæbə'lɪʃ(ə)n/ *noun* the act of abolishing something ○ *campaigning for the abolition of the death penalty*

abortion /ə'bɔːʃ(ə)n/ *noun* the ending of a pregnancy before its natural term (NOTE: Illegal abortion is a notifiable offence.)

abrogate /'æbrəgeɪt/ *verb* to end something such as a law or treaty

abrogation /ˌæbrə'geɪʃ(ə)n/ *noun* an act of ending something such as a law or treaty

abscond /əb'skɒnd/ *verb* **1.** to leave somewhere suddenly and without permission ○ *He was charged with absconding from lawful custody.* **2.** not to return to the court after being released on bail **3.** to escape from prison

absent /'æbsənt/ *adjective* not present when you expected to be at something such as a meeting or hearing, or your place of work

absentee /ˌæbsən'tiː/ *noun* a person who is not present at something such as court proceedings even though they are expected to be there

absolute discharge /ˌæbsəluːt 'dɪstʃɑːdʒ/ *noun* the release of a convicted person without any punishment

absolute majority /ˌæbsəluːt mə 'dʒɒrɪti/ *noun* a majority over all the others counted together

absolute monopoly /ˌæbsəluːt mə 'nɒpəli/ *noun* a situation where only one producer or supplier produces or supplies something

absolute privilege /ˌæbsəluːt 'prɪvɪlɪdʒ/ *noun* a rule which protects a person from being sued for defamation in specific circumstances such as when a judge or lawyer makes a statement during judicial proceedings, or when an MP speaks in the House of Commons

absolute right /ˌæbsəluːt 'raɪt/ *noun* in the European Convention on Human Rights, a right that under no circumstances may legally be interfered with (NOTE: Examples are the freedoms of thought, conscience, and religion and the prohibitions on torture.)

absolute title /ˌæbsəluːt 'taɪt(ə)l/ *noun* land registered with the Land Registry, where the owner has a guaranteed title to the land (NOTE: Absolute title also exists to leasehold land, giving the proprietor a guaranteed valid lease.)

absolutism /'æbsəluːˌtɪz(ə)m/ *noun* the political theory that any legitimate government should have absolute power

absolutist /ˌæbsə'luːtɪst/ *adjective* **1.** believing in absolutism **2.** referring to a political system where the government has absolute power ■ *noun* a person who believes in absolutism

abstain /əb'steɪn/ *verb* to refrain from doing something, especially voting

abstention /əb'stenʃən/ *noun* **1.** the act of refraining from doing something, especially voting ○ *The motion was carried by 200 votes to 150, with 60 abstentions.* **2.** *US* a situation where a federal court may refuse to hear a case and passes it to a state court which then becomes competent to decide on the federal constitutional issues raised

abstract /'æbstrækt/ *noun* a short summary of a report or document ○ *to make an abstract of the deeds of a property* ■ *verb* to make a summary

abstract of title /æbˌstrækt əv 'taɪt(ə)l/ *noun* a summary of the details of the ownership of a property which has not been registered

abuse *noun* /ə'bjuːs/ **1.** the use of something in a way in which it was not intended to be used **2.** rude or insulting language ○ *The prisoner shouted abuse at the judge.* **3.** very bad treatment of a person, usually physical or sexual ○ *child abuse* ○ *sexual abuse of children* **4.** a harmful or illegal practice ■ *verb* /ə 'bjuːz/ **1.** to use something wrongly □ **to abuse one's authority** to use authority in an illegal or harmful way **2.** to say rude words about someone ○ *He abused the police before being taken to the cells.* **3.** to treat someone very badly, usually physically or sexually ○ *He had abused small children.*

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Law.fm Page 3 Friday, June 11, 2004 2:08 PM

abuse of power /əˌbjuːs əv ˈpaʊə/ *noun* the use of legal powers in an illegal or harmful way

abuse of process /əˌbjuːz əv prəʊ ˈses/ *noun* the use of a legal process without proper justification or for malicious reasons

abut /əˈbʌt/**, abut on** /əˈbʌt ɒn/ *verb* (*of a piece of land*) to touch another property (NOTE: **abutting – abutted**)

abuttal /əˈbʌt(ə)l/ *noun* the boundaries of a piece of land in relation to land that is adjoining

ACAS /ˈeɪkæs/ *abbreviation* Advisory Conciliation and Arbitration Service

ACC *abbreviation* Assistant Chief Constable

acceptable /əkˈseptəb(ə)l/ *adjective* good enough to be accepted, although not particularly good ○ *The offer is not acceptable to both parties.*

Acceptable Behaviour Contract /əkˌseptəb(ə)l bɪˈheɪvjə ˌkɒntrækt/ *noun* a formal written agreement in written form made between an individual and either parent or guardian or another party that the individual will not act in an antisocial manner in future. Abbreviation **ABC**. ◊ **Antisocial Behaviour Order** (NOTE: ABCs normally last for a period of 6 months.)

acceptance /əkˈseptəns/ *noun* **1.** one of the main conditions of a contract, where one party agrees to what is proposed by the other party □ **acceptance of an offer** an agreement to accept an offer and therefore to enter into a contract **2.** the act of signing a bill of exchange to show that you agree to pay it

acceptor /əkˈseptə/**, accepter** *noun* somebody who accepts an offer

access /ˈækses/ *noun* **1.** the right of the owner of a piece of land to use a public road which is next to the land ○ *He complained that he was being denied access to the main road.* **2.** □ **to have access to something** to be able to obtain or reach something □ **to gain access to something** to reach or to get hold of something ○ *Access to the courts should be open to all citizens.* ○ *The burglar gained access through the window.* **3.** the right of a child to see a parent regularly, or of a parent or grandparent to see a child regularly, where the child is in the care of someone else **4.** □ **right of access to a solicitor** in the EU, the right of anyone who is in police custody to see a solicitor in private to ask advice

accession /əkˈseʃ(ə)n/ *noun* **1.** the act of becoming a member of something by signing a formal agreement **2.** the act of taking up an official position □ **accession to the throne** becoming King or Queen

access order /ˌækses ˈɔːdə/ *noun* formerly, a court order allowing a parent to see a child where the child is in the care of someone else, such as the other parent in the case of a divorced couple (NOTE: Access orders have been replaced by contact orders.)

accessory /əkˈsesəri/ *noun* a person who helps or advises someone who commits a crime □ **accessory after the fact** formerly, a person who helps a criminal after a crime had been committed □ **accessory before the fact** a person who helps a criminal before a crime is committed

accident /ˈæksɪd(ə)nt/ *noun* something unpleasant which happens suddenly, often as the result of a mistake, such as the crash of a vehicle or plane or other event resulting in injury or death or damage to something

accidental /ˌæksɪˈdent(ə)l/ *adjective* happening as an accident, or without being planned ○ *a case of accidental death*

accident insurance /ˌæksɪd(ə)nt ɪn ˈʃʊərəns/ *noun* insurance which pays money if an accident takes place

accident policy /ˌæksɪd(ə)nt ˈpɒlɪsi/ *noun* an insurance policy which pays money if an accident takes place

accommodation /əˌkɒməˈdeɪʃ(ə)n/ *noun* a place to live or somewhere to stay for a short time (NOTE: In British English, **accommodation** has no plural.)

accommodation address /əˌkɒmə ˈdeɪʃ(ə)n əˌdres/ *noun* an address used for receiving messages that is not the address of the company's offices

accomplice /əˈkʌmplɪs/ *noun* somebody who helps another to commit a

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Law.fm Page 4 Friday, June 11, 2004 2:08 PM

crime or who commits a crime with another person

accordance /ə'kɔːd(ə)ns/ *noun* □ **in accordance with** in a way that agrees with something that has been suggested or decided ○ *In accordance with your instructions we have deposited the money in your current account.* ○ *I am submitting the claim for damages in accordance with the advice of our legal advisers.*

accord and satisfaction /ə,kɔːd ən sætɪs'fækʃən/ *noun* **1.** the payment by a debtor of a debt or part of a debt **2.** the performing by a debtor of some act or service which is accepted by the creditor in full settlement, so that the debtor is no longer liable under the contract

accordingly /ə'kɔːdɪŋli/ *adverb* in agreement with what has been decided ○ *We have received your letter and have altered the contract accordingly.*

according to /ə'kɔːdɪŋ tuː/ *preposition* **1.** as someone says or writes ○ *According to the witness, the accused carried the body on the back seat of his car.* ○ *The payments were made according to the maintenance order.* **2.** in agreement with a rule or system **3.** in relation to

account /ə'kaʊnt/ *noun* **1.** a record of money paid or owed ○ *please send me your account* or *a detailed* or *an itemised account* □ **action for an account** court action to establish how much money is owed by one party to another **2.** an arrangement which a customer has with a shop or supplier to buy goods and pay for them at a later date, usually the end of the month **3.** a customer who does a large amount of business with a firm and has a credit account with that firm **4.** a notice or attention □ **to take account of the age of the accused**, **to take the accused's age into account when passing sentence** to pass a (lighter) sentence because the accused is very old or very young ■ *plural noun* **accounts** a detailed record of a company's financial affairs ■ *verb* □ **to account for** to explain and record a money deal ○ *to account for a loss* or *a discrepancy*

accountability /ə,kaʊntə'bɪlɪti/ *noun* the fact of being responsible for something

accountable /ə'kaʊntəb(ə)l/ *adjective* being responsible for what takes place and needing to be able to explain why it has happened ○ *If money is lost, the person at the cash desk is held accountable.* ○ *The group leader will be held accountable for the actions of the group.*

account of profit /ə,kaʊnt əv 'prɒfɪt/ *noun* in copyright law, an assessment showing how much profit has been made on the sales of goods which infringe a copyright or patent, because the plaintiff claims the profit made by the defendant

accounts payable /ə,kaʊnts 'peɪəb(ə)l/ *noun* money owed to creditors

accounts receivable /ə,kaʊnts rɪ 'siːvəb(ə)l/ *noun* money owed by debtors

accredited /ə'kredɪtɪd/ *adjective* (*of an agent*) appointed by a company to act on its behalf (NOTE: A person is accredited **to** an organisation.)

accusation /,ækjuː'zeɪʃ(ə)n/ *noun* the act of saying that someone has committed a crime

accusatorial procedure /ə ,kjuːzətɔːriəl prə'siːdʒə/ *noun* a procedure in countries using common law procedures, where the parties to a case have to find the evidence themselves. Compare **inquisitorial procedure**. ◊ **burden of proof**

accuse /ə'kjuːz/ *verb* **1.** to say that someone has committed a crime ○ *She was accused of stealing £25 from her boss.* ○ *He was accused of murder.* ○ *Of what has she been accused?* or *What has she been accused of?* (NOTE: You accuse someone **of** a crime.) **2.** to charge someone with a crime

accused /ə'kjuːzd/ *noun* □ **the accused** the person or persons charged with a crime ○ *All the accused pleaded not guilty.* ○ *The police brought the accused, a young man, into the court.*

acknowledge /ək'nɒlɪdʒ/ *verb* **1.** to accept that something is true **2.** to admit that a debt is owing **3.** to confirm that a letter has been received □ **to acknowledge service** to confirm that a legal doc-

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Law.fm Page 5 Friday, June 11, 2004 2:08 PM

ument such as a claim form has been received

acknowledged and agreed /ək ˌnɒlɪdʒd ən əˈgriːd/ *phrase* words written on an agreement to show that it has been read and approved

acknowledgement of service /ək ˌnɒlɪdʒmənt əv ˈsɜːvɪs/ *noun* a document whereby a defendant confirms that a claim form or other legal document has been received and that he or she intends to contest the claim

acquiescence /ˌækwiˈes(ə)ns/ *noun* consent which is either given directly or is implied (NOTE: There is a distinction between mere knowledge of a situation and positive consent to it. The latter is required in order to constitute acquiescence.)

acquit /əˈkwɪt/ *verb* to set a person free because he or she has been found not guilty ○ *He was acquitted of the crime.* ○ *The court acquitted two of the accused.* (NOTE: **acquitting – acquitted**. Note also that you acquit someone **of** a crime.)

acquittal /əˈkwɪt(ə)l/ *noun* the act of acquitting someone of a crime ○ *After his acquittal he left the court smiling.*

COMMENT: There is no appeal against an acquittal, and a person who has been acquitted of a crime cannot be charged with the same crime again.

act /ækt/ *noun* a statute which has been approved by a law-making body (NOTE: Before an Act becomes law, it is presented to Parliament in the form of a Bill. See notes at **bill**.)

acte clair /ˌækt ˈkleə/ *noun* (*in the EU*) French legal term meaning that a legal question is clear and there can be no doubt about it

action /ˈækʃən/ *noun* **1.** a proceeding heard in the civil court allowing an individual to pursue a legal right □ **action in personam** a court case in which one party claims that the other should do some act or should pay damages □ **action in rem** a court case in which one party claims property or goods in the possession of the other □ **action in tort** a court case brought by a claimant who alleges he or she has suffered damage or harm caused by the defendant □ **to take legal action** to begin a legal case, e.g. to instruct a solicitor or to sue someone **2.** something that is done, or the doing of something ○ *action to prevent the information becoming public* □ **to take action** to do something ○ *They should have taken immediate action to prevent a similar accident happening.*

actionable /ˈækʃənəb(ə)l/ *adjective* referring to writing, speech or an act which could provide the grounds for bringing a legal case against someone □ **torts which are actionable per se** torts which are in themselves sufficient grounds for bringing an action without the need to prove that damage has been suffered

actionable per se /ˌækʃənəb(ə)l pɜː ˈsaɪ/ *adjective* being in itself sufficient grounds for bringing an action

active partner /ˌæktɪv ˈpɑːtnə/ *noun* a partner who works in a partnership

activist /ˈæktɪvɪst/ *noun* a person who works actively for a political party, usually a person who is in disagreement with the main policies of the party or whose views are more extreme than those of the mainstream of the party ○ *The meeting was disrupted by an argument between the chairman and left-wing activists.* ○ *Party activists have urged the central committee to adopt a more radical approach to the problems of unemployment.*

act of God /ˌækt əv ˈgɒd/ *noun* a natural disaster which you do not expect to happen, and which cannot be avoided, e.g. a storm or a flood. ◊ **force majeure** (NOTE: Acts of God are usually not covered by an insurance policy.)

Act of Parliament /ˌækt əv ˈpɑːləmənt/ *noun* a decision which has been approved by Parliament and so becomes law

actual bodily harm /ˌæktʃuəl ˈbɒdɪli hɑːm/ *noun* the offence of causing injury to an individual by attacking them. The injury does not have to be serious or permanent but it must be more than just a scratch. Abbreviation **ABH**

actual loss /ˌæktʃuəl ˈlɒs/ *noun* real loss or damage which can be shown to have been suffered

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Law.fm Page 6 Friday, June 11, 2004 2:08 PM

actual notice /ˌæktʃuəl 'nəʊtɪs/ *noun* real knowledge which someone has of something

actual possession /ˌæktʃuəl pə 'zeʃ(ə)n/ *noun* the situation of occupying and controlling land and buildings

actual total loss /ˌæktʃuəl 'təʊt(ə)l lɒs/ *noun* a loss where the item insured has been destroyed or damaged beyond repair and can no longer be used for its intended purpose

actual value /ˌæktʃuəl 'vælju:/ *noun* the real value of something if sold on the open market

actuarial /ˌæktʃu'eəriəl/ *adjective* calculated by an actuary ○ *The premiums are worked out according to actuarial calculations.*

actuary /'æktʃuəri/ *noun* a person employed by an insurance company to calculate premiums

actus reus /ˌæktəs 'reɪəs/ *phrase* a Latin phrase meaning 'guilty act': an act which is forbidden by the criminal law, one of the two elements of a crime. Compare **mens rea**. ◊ **crime**

addicted /ə'dɪktɪd/ *adjective* unable to stop doing something □ **addicted to alcohol** or **drugs** being unable to live without taking alcohol or drugs regularly

address /ə'dres/ *noun* **1.** the details of number, street and town where an office is or where a person lives □ **address for service** an address where court documents such as pleadings can be sent to a party in a case **2.** a formal speech ○ *In his address to the meeting, the mayor spoke of the problems facing the town.* □ **address of thanks** a formal speech, thanking someone for doing something, e.g. thanking a VIP for opening a new building, thanking the Queen for reading the Queen's Speech ■ *verb* **1.** to write the details of an address on an envelope ○ *an incorrectly addressed package* **2.** to speak to someone ○ *The defendant asked permission to address the court.* ○ *The chairman addressed the meeting.* **3.** to speak about a particular issue ○ *He then addressed the question of the late arrival of notification.* □ **to address oneself to a problem** to deal with a particular problem ○ *The government will have to address itself to problems of international trade.*

address list /ə'dres lɪst/ *noun* a list of names and addresses of people and companies

adduce /ə'dju:s/ *verb* to offer something as a reason or proof □ **to adduce evidence** to bring evidence before a court

adeem /ə'di:m/ *verb* to remove a legacy from a will because the item mentioned no longer exists, e.g. in the case when the person who made the will sold the item before they died)

ademption /ə'dempʃ(ə)n/ *noun* the act of removing a legacy from a will, because the item concerned no longer exists

ad hoc /ˌæd 'hɒk/ *phrase* a Latin phrase meaning 'for this particular purpose' □ **an ad hoc committee** a committee set up to study a particular problem. ◊ **standing**

ad idem /ˌæd 'aɪdem/ *phrase* a Latin phrase meaning 'in agreement'

adjective law /'ædʒɪktɪv lɔ:/ *noun* an area of law which deals with practices and procedures in the courts

adjoin /ə'dʒɔɪn/ *verb* (*of a property*) to touch another property ○ *The developers acquired the old post office and two adjoining properties.* ○ *The fire spread to the adjoining property.*

adjoining /ə'dʒɔɪnɪŋ/ *adjective* next to and touching something else ○ *adjoining properties*

adjourn /ə'dʒɜ:n/ *verb* **1.** to stop a meeting for a period ○ *to adjourn a meeting* ○ *The meeting adjourned at midday.* □ **to adjourn sine die** to adjourn without saying when the next meeting will be ○ *The hearing was adjourned sine die.* **2.** to put off a legal hearing to a later date ○ *The chairman adjourned the tribunal until three o'clock.* ○ *The appeal was adjourned for affidavits to be obtained.*

adjournment /ə'dʒɜ:nmənt/ *noun* **1.** an act of adjourning ○ *The adjournment lasted two hours.* ○ *The defendant has applied for an adjournment.* □ **adjournment sine die** adjournment without fixing a date for the next meeting (used in the US Congress to end a session) **2.** the

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Law.fm Page 7 Friday, June 11, 2004 2:08 PM

period during which a meeting has been adjourned

adjudicate /ə'dʒuːdɪkeɪt/ *verb* to give a judgment between two parties in law ○ *to adjudicate a claim* ○ *to adjudicate in a dispute* ○ *Magistrates may be paid expenses when adjudicating.* □ **he was adjudicated bankrupt** he was declared legally bankrupt

adjudication /əˌdʒuːdɪ'keɪʃ(ə)n/ *noun* the act of giving a judgment or of deciding a legal problem

adjudication order /əˌdʒuːdɪ 'keɪʃ(ə)n ˌɔːdə/ *noun* an order by a court making someone bankrupt

adjudication tribunal /əˌdʒuːdɪ 'keɪʃ(ə)n traɪˌbjuːn(ə)l/ *noun* a group which adjudicates in industrial disputes

adjudicator /ə'dʒuːdɪkeɪtə/ *noun* somebody who gives a decision on a problem ○ *an adjudicator in an industrial dispute*

adjust /ə'dʒʌst/ *verb* to change something to fit new conditions, especially to calculate and settle an insurance claim

adjuster /ə'dʒʌstə/**, adjustor** *noun* somebody who calculates losses for an insurance company

adjustment /ə'dʒʌstmənt/ *noun* **1.** an act of adjusting **2.** a slight change

adjustor /ə'dʒʌstə/ *noun* same as **adjuster**

ad litem /ˌæd 'liːtəm/ *phrase* a Latin phrase meaning 'referring to the case at law'

administer /əd'mɪnɪstə/ *verb* **1.** to be responsible for providing, organising or managing something □ **to administer justice** to provide justice □ **to administer an oath** to make someone swear an oath **2.** to give someone a medicine, drug or medical treatment ○ *She was accused of administering a poison to the old lady.*

administration /ədˌmɪnɪ'streɪʃ(ə)n/ *noun* the organisation, control or management of something such as of the affairs of someone who has died, e.g. payment of liabilities, collection of assets or distributing property to the rightful people shown in the will □ **the administration of justice** providing justice

administration bond /ədˌmɪnɪ 'streɪʃ(ə)n bɒnd/ *noun* an oath sworn by an administrator that he or she will pay the state twice the value of the estate being administered, if it is not administered in accordance with the law

administration order /ədˌmɪnɪ 'streɪʃ(ə)n ˌɔːdə/ *noun* an order by a court, appointing someone to administer the estate of someone who is not able to meet the obligations of a court order

administrative /əd'mɪnɪstrətɪv/ *adjective* referring to administration

administrative law /əd'mɪnɪstrətɪv lɔː/ *noun* law relating to how government organisations affect the lives and property of individuals

administrative tribunal /əd ˌmɪnɪstrətɪv traɪ'bjuːn(ə)l/ *noun* a tribunal which decides in cases where government regulations affect and harm the lives and property of individuals

administrator /əd'mɪnɪstreɪtə/ *noun* **1.** somebody who arranges the work of other employees in a business so that the business functions well **2.** a person appointed by a court to represent a person who has died without making a will or without naming executors, and who is recognised in law as able to manage the estate

administratrix /əd'mɪnɪstrətrɪks/ *noun* a woman appointed by a court to administer the estate of a person who has died

Admiralty /'ædm(ə)rəlti/ *noun* the British government office which is in charge of the Navy

Admiralty Court /'ædm(ə)rəlti kɔːt/ *noun* a court, part of the Queen's Bench Division, which decides in disputes involving ships

Admiralty law /'ædm(ə)rəlti lɔːw/ *noun* law relating to ships and sailors, and actions at sea

admissibility /ədˌmɪsə'bɪlɪti/ *noun* the fact of being admissible ○ *The court will decide on the admissibility of the evidence.*

admissible /əd'mɪsəb(ə)l/ *adjective* referring to evidence which a court will allow to be used ○ *The documents were not considered relevant to the case and were therefore not admissible.*

mainp - softvnn.com

Law.fm Page 8 Friday, June 11, 2004 2:08 PM

admission /əd'mɪʃ(ə)n/ *noun* **1.** permission for someone to go in ○ *free admission on Sundays* ○ *There is a £1 admission charge.* ○ *Admission is free on presentation of this card.* **2.** making a statement that you agree that some facts are correct, saying that something really happened **3.** (*in civil cases*) a statement by a defendant that a claim or part of a claim by the claimant is true ○ *When a party has made an admission in writing, the other party can apply for judgment on that admission.*

admission charge /əd'mɪʃ(ə)n tʃɑːdʒ/ *noun* the price to be paid before going into an exhibition, etc.

admit /əd'mɪt/ *verb* **1.** to allow someone to go in ○ *Children are not admitted to the bank.* ○ *Old age pensioners are admitted at half price.* **2.** to allow someone to practise as a solicitor ○ *She was admitted in 1989.* **3.** to allow evidence to be used in court ○ *The court agreed to admit the photographs as evidence.* **4.** to agree that an allegation is correct ○ *She admitted having stolen the car.* ○ *He admitted to being in the house when the murder took place.* (NOTE: **admitted – admitting**. Note also that you admit **to** something, or admit **having done** something.) **5.** to say that something really happened ○ *He admitted his mistake* or *his liability.*

adopt /ə'dɒpt/ *verb* **1.** to become the legal parent of a child who was born to other parents **2.** to accept something so that it becomes law ○ *to adopt a resolution* ○ *The proposals were adopted unanimously.*

adoption /ə'dɒpʃən/ *noun* **1.** the act of becoming the legal parent of a child which is not your own **2.** the act of agreeing to something so that it becomes legal ○ *He moved the adoption of the resolution.*

adoption order /əˌdɒpʃən 'ɔːdə/ *noun* an order by a court which legally transfers the rights of the natural parents to the adoptive parents

adoption proceedings /əˌdɒpʃən prə'siːdɪŋz/ *plural noun* court action to adopt someone

adoptive /ə'dɒptɪv/ *adjective* resulting from the process of adoption, or from choice ○ *his adoptive country*

adoptive child /ə'dɒptɪv tʃaɪld/ *noun* a child who has been adopted

adoptive parent /əˌdɒptɪv 'peərənt/ *noun* a person who has adopted a child. Compare **biological parent** (NOTE: If a child's parents divorce, or if one parent dies, the child may be adopted by a step-father or step-mother.)

ADR *noun* same as **alternative dispute resolution**

adult /'ædʌlt, ə'dʌlt/ *noun* a person who is eighteen years old or older

adulteration /əˌdʌltə'reɪʃ(ə)n/ *noun* the addition of material to food for sale, which makes it dangerous to eat or drink

adulterous /ə'dʌlt(ə)rəs/ *adjective* referring to adultery ○ *He had an adulterous relationship with Miss X.*

adultery /ə'dʌlt(ə)ri/ *noun* sexual intercourse by consent between a married person and someone of the opposite sex who is not that person's spouse ○ *His wife accused him of committing adultery with Miss X.*

ad valorem /ˌæd və'lɔːrəm/ *phrase* a Latin phrase meaning 'according to value'

ad valorem duty /ˌæd və'lɔːrəm ˌdjuːti/ *noun* a tax calculated according to the value of the goods taxed

advance /əd'vɑːns/ *noun* □ **in advance** before something happens ○ *to pay in advance* ○ *freight payable in advance* ■ *adjective* early ○ *advance booking* ○ *advance payment* ○ *You must give seven days' advance notice of withdrawals from the account.*

advancement /əd'vɑːnsmənt/ *noun* money or goods given by a parent to a child which the child would inherit in any case if the parent died

advantage /əd'vɑːntɪdʒ/ *noun* something useful which may help you to be successful □ **to learn something to your advantage** to hear news which is helpful to you, especially to hear that you have been left a legacy □ **obtaining a pecuniary advantage by deception** the offence of deceiving someone so as to derive a financial benefit

mainp - softvnn.com

Law.fm Page 9 Friday, June 11, 2004 2:08 PM

adversarial /ˌædvɜːˈseəriəl/ *adjective* based on people opposing each other

adversarial procedure /ˌædvɜːˌseəriəl ˈpɒlɪtɪks/ *noun* same as **accusatorial procedure**

adversary /ˈædvəs(ə)ri/ *noun* an opponent in a court case ■ *adjective* □ **adversary procedure** same as **accusatorial procedure**

adverse /ˈædvɜːs/ *adjective* contrary, which goes against one party

adverse outcome /ˌædvɜːs ˈaʊtkʌm/ *noun* a result which was unexpected and unwanted

adverse party /ˌædvɜːs ˈpɑːtɪ/ *noun* the opponent in a court case

adverse possession /ˌædvɜːs pə ˈzeʃ(ə)n/ *noun* an occupation of property by squatters or others that is contrary to the rights of the real owner

adverse witness /ˌædvɜːs ˈwɪtnəs/ *noun* a witness called by one party in a court case whose evidence goes unexpectedly against that party. Such a witness can then be cross-examined as if the evidence were being given for the other party in the case.

advert /ˈædvɜːt/ *verb* to refer to ○ *This case was not adverted to in Smith v. Jones Machines Ltd.*

advice /ədˈvaɪs/ *noun* an opinion as to what action should be taken □ **as per advice** according to what is written on an advice note □ **counsel's advice** the opinion of a barrister about a case ○ *we sent the documents to the police on the advice of the solicitor* or *we took the solicitor's advice and sent the documents to the police* □ **to take legal advice** to ask a lawyer to advise about a problem in law

advice note /ədˈvaɪs nəʊt/ *noun* a written notice to a customer giving details of goods ordered and shipped but not yet delivered

advise /ədˈvaɪz/ *verb* **1.** to give a professional legal opinion on something such as the strengths and weaknesses of a case **2.** to suggest to someone what should be done ○ *We are advised to take the shipping company to court.* ○ *The solicitor advised us to send the documents to the police.* □ **to advise against something** to suggest that something should not be done ○ *The bank manager advised against closing the account.* ○ *Our lawyers have advised against suing the landlord.*

advisement /ədˈvaɪzmənt/ *noun* □ **to take something under advisement** to consider something in order to make a judgment

adviser /ədˈvaɪzə/**, advisor** *noun* somebody who suggests what should be done ○ *He is consulting the company's legal adviser.*

advisory /ədˈvaɪz(ə)ri/ *adjective* as an adviser ○ *She is acting in an advisory capacity.*

advisory board /ədˈvaɪz(ə)ri ˌbɔːd/ *noun* a group of advisers

Advisory Conciliation and Arbitration Service /ədˌvaɪz(ə)ri kən ˌsɪliˌeɪʃ(ə)n ən ˌɑːbɪˌtreɪʃ(ə)n ˈsɜːvɪs/ *noun* a government body which assists in furthering industrial relations and settling industrial and employment disputes. Abbreviation **ACAS**

advocacy /ˈædvəkəsi/ *noun* **1.** the skill of pleading a case orally before a court ○ *his advocacy of the right of these illegal immigrants to remain in the country* **2.** support for a cause

advocate *noun* /əˈbjuːs/ **1.** a person, usually a barrister or solicitor, with right of audience (i.e. the right to speak in open court) as the representative of a party in a case ○ *Fast track trial costs include the cost of a party's advocate in preparing the case and appearing in court.* (NOTE: Solicitors who take additional exams may qualify as solicitor-advocates and have the same rights of audience as barristers.) **2.** *US* a legal practitioner **3.** a barrister or solicitor who may argue a case for their client during legal proceedings. Both barristers and solicitors can acquire rights of audience (i.e. the right to speak in open court), but a solicitor's right of audience is limited to the magistrates and county courts. ■ *verb* /ˈædvəkeɪt/ to suggest a course of action

Advocate General /ˌædvəkət ˈdʒen(ə)rəl/ *noun* **1.** one of the two Law Officers for Scotland (NOTE: The position of the Advocates General is equal to that of the fifteen judges in the Euro-

mainp - softvnn.com

Law.fm Page 10 Friday, June 11, 2004 2:08 PM

pean Court of Justice; their role is to give careful advice on legal matters.) **2.** one of eight independent members forming part of the European Court of Justice together with 15 judges, who summarises and presents a case to the judges to assist them in coming to a decision (NOTE: The plural is **Advocates General**.)

advowson /əd'vaʊz(ə)n/ *noun* the right to nominate a person to be a parish priest

affair /ə'feə/ *noun* **1.** something which is relevant to one person or group of people only ○ *Are you involved in the copyright affair?* ○ *It's an affair for the police.* **2.** a sexual relationship where one party or both parties are married to someone else □ **to have an affair with someone** to commit adultery ■ *plural noun* **affairs** situations or activities relating to public or private life ○ *His affairs were so difficult to understand that the lawyers had to ask accountants for advice.*

affidavit /ˌæfɪ'deɪvɪt/ *noun* a written statement which is signed and sworn before a solicitor, judge, JP, commissioner for oaths or other official and which can then be used as evidence in court hearings

affiliation order /əˌfɪli'eɪʃ(ə)n ˌɔːdə/ *noun* formerly, a court order which made the father of an illegitimate child contribute towards the cost of the child's upbringing (NOTE: It is now replaced by the provisions of the Family Law Reform Act 1987.)

affiliation proceedings /əˌfɪli 'eɪʃ(ə)n prəˌsiːdɪŋz/ *plural noun* formerly, the proceedings needed to order the father of an illegitimate child to provide for the child's maintenance (NOTE: They are now replaced by the provisions in the Family Law Reform Act 1987.)

affirm /ə'fɜːm/ *verb* **1.** to state that you will tell the truth, though without swearing an oath **2.** to confirm that something is correct

affirmation /ˌæfə'meɪʃ(ə)n/ *noun* **1.** a statement in court that you will tell the truth, though without swearing an oath (NOTE: It is similar to an affidavit, but is not sworn on oath.) **2.** a written statement which is affirmed as true by the person making it **3.** a statement by an MP of his or her allegiance to the Queen when not wishing to take the Oath of Allegiance on religious or other grounds

affirmative action /əˌfɜːmətɪv 'ækʃən/ *noun US* a policy of positive discrimination to help groups in society who have a disadvantage (NOTE: The British equivalent is **equal opportunity**.)

affirmative easement /əˌfɜːmətɪv 'iːzmənt/ *noun US* an easement where the servient owner allows the dominant owner to do something

affix /ə'fɪks/ *verb* to attach something such as a signature to a document

affray /ə'freɪ/ *noun* the offence of intentionally acting in a threatening way towards someone in public

COMMENT: A person is guilty of affray if he uses or threatens to use unlawful violence towards another, and his conduct is such that a reasonable person who happened to be present might fear for his safety.

AFO *abbreviation* assault on a federal officer

aforementioned /ə'fɔːmenʃənd/ *adjective* having been mentioned earlier ○ *the aforementioned company*

aforesaid /ə'fɔːsed/ *adjective* said earlier □ **as aforesaid** as was stated earlier

aforethought /ə'fɔːθɔːt/ *adjective* □ **with malice aforethought** with the intention of committing a crime, especially murder

a fortiori /ˌeɪ ˌfɔːti'ɔːraɪ/ *phrase* a Latin phrase meaning 'for a stronger reason' ○ *If the witness was present at the scene of the crime, then a fortiori he must have heard the shot.*

after the event /ˌɑːftə ðə ɪ'vent/ *adjective* □ **after the event insurance policy** a policy to cover the recovery of costs in case of failure in a case where a conditional fee arrangement is applied

age /eɪdʒ/ *noun* the number of years someone has lived. ◊ **age of consent, age of criminal responsibility**

age discrimination /'eɪdʒ dɪskrɪmɪ ˌneɪʃ(ə)n/ *noun US* the unfair treatment of people because of their age

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Law.fm Page 11 Friday, June 11, 2004 2:08 PM

age limit /'eɪdʒ ˌlɪmɪt/ *noun* the top age at which you are permitted to do something

agency /'eɪdʒənsi/ *noun* **1.** an arrangement where one person or company acts on behalf of another person in contractual matters ○ *They signed an agency agreement* or *an agency contract.* **2.** the office or job of representing another company in an area **3.** a branch of government ○ *the Atomic Energy Agency* ○ *a counter-intelligence agency*

agent /'eɪdʒənt/ *noun* **1.** somebody who represents a company or another person in matters relating to contracts **2.** the person in charge of an agency ○ *advertising agent* ○ *estate agent* ○ *travel agent* **3.** somebody who works for a government agency, especially in secret

agent provocateur /ˌæʒɒn prə ˌvɒkə'tɜːr/ *noun* a person who provokes others to commit a crime, often by taking part in it personally, in order to find out who is not reliable or in order to have his or her victim arrested

age of consent /ˌeɪdʒ əv kən'sent/ *noun* the age at which a girl can legally consent to sexual intercourse. The age of consent is 16.

age of criminal responsibility /ˌeɪdʒ əv ˌkrɪmɪn(ə)l rɪˌspɒnsɪ'bɪlɪti/ *noun* the age at which a person is considered to be capable of committing a crime

aggravated /'ægrəveɪtɪd/ *adjective* made worse

aggravated assault /ˌægrəveɪtɪd ə 'sɒlt/ *noun* assault causing serious injury or carried out in connection with another serious crime

aggravated burglary /ˌægrəveɪtɪd 'bɜːgləri/ *noun* burglary where guns or other offensive weapons are carried or used

aggravated damages /ˌægrəveɪtɪd 'dæmɪdʒɪz/ *plural noun* damages awarded by a court against a defendant who has behaved maliciously or wilfully

aggravating circumstances /ˌægrəveɪtɪŋ 'sɜːkəmstænsɪz/ *noun* circumstances which make a crime worse

aggravation /ˌægrə'veɪʃ(ə)n/ *noun* an action, especially the carrying of a weapon, which makes a crime more serious

aggrieved /ə'griːvd/ *adjective* injured or harmed by the actions of a defendant ○ *the aggrieved party*

AGM *abbreviation* Annual General Meeting

agree /ə'griː/ *verb* **1.** to approve or accept something ○ *The figures were agreed between the two parties.* ○ *Terms of the contract are still to be agreed.* **2.** □ **to agree to do something** to say that you will do something □ **to agree with someone** to say that your opinions are the same as someone else's □ **to agree with something** to be the same as something else ○ *The witness' statement does not agree with that of the accused.*

agreed /ə'griːd/ *adjective* having been accepted by everyone ○ *an agreed amount* ○ *on agreed terms* or *on terms which have been agreed upon*

agreed price /əˌgriːd 'praɪs/ *noun* the price which has been accepted by both the buyer and seller

agreement /ə'griːmənt/ *noun* **1.** a contract between two people or groups where one party makes an offer, and the other party accepts it ○ *written agreement* ○ *unwritten* or *oral agreement* ○ *to break an agreement* ○ *to reach an agreement* or *to come to an agreement on prices* or *salaries* ○ *an international agreement on trade* ○ *collective wage agreement* ○ *an agency agreement* ○ *a marketing agreement* ◊ **gentleman's agreement** □ **agreement in principle** agreement with the basic conditions of a proposal **2.** a document setting out the contractual terms agreed between two parties, ○ *to witness an agreement* ○ *to draw up* or *to draft an agreement* ○ *Both companies signed the agreement.*

aid /eɪd/ *noun* help □ **to pray in aid** to rely on something when pleading a case ○ *I pray in aid the Statute of Frauds in support of the defendant's case* ■ *verb* to help □ **to aid and abet** to help and encourage someone to commit a crime

aiding and abetting /ˌeɪdɪŋ ənd ə 'betɪŋ/ *noun* the act of helping and encouraging someone to commit a crime such as driving a car to help a criminal escape from the scene of a crime or keep-

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Law.fm Page 12 Friday, June 11, 2004 2:08 PM

ing watch while a crime is committed. ◊ **accessory**

air rage /'eə reɪdʒ/ *noun* a violent attack by a passenger on a member of the crew of an aircraft, caused by drink, tiredness or annoyance at something

a. k. a. *abbreviation* also known as

al. ◆ **et al.**

aleatory /ˌæli'eɪtəri/ *adjective* **1.** not certain **2.** carrying a risk

aleatory contract /ˌælieɪtəri 'kɒntrækt/ *noun* an agreement such as a wager where what is done by one party depends on something happening which is not certain to happen

alia ◆ **et al., inter alia**

alias /'eɪliəs/ *noun* a name which you use to hide your real name ○ *The confidence trickster used several aliases.* ■ *adverb* using the name of ○ *John Smith, alias Reginald Jones*

alibi /'ælɪbaɪ/ *noun* a plea that a person charged with a crime was somewhere else when the crime was committed

alien /'eɪliən/ *noun* a person who is not a citizen of a country (NOTE: In the UK, an alien is a person who is not a UK citizen, not a citizen of a Commonwealth country and not a citizen of the Republic of Ireland.)

alien absconder /ˌeɪliən əb'skɒndə/ *noun* an illegal foreign visitor to the United States who has been told to leave the country but has not done so

alienation /ˌeɪliə'neɪʃ(ə)n/ *noun* the transfer of property, usually land, to someone else

alienation of affection /ˌeɪliəneɪʃ(ə)n əv ə'fekʃən/ *noun US* the loss of affection by one of the partners in a marriage for the other

alieni juris /eɪliˌenaɪ 'dʒuːrɪs/ *phrase* a Latin phrase meaning 'of another's right': a person such as a minor who has a right under the authority of a guardian. Compare **sui generis**

alimony /'ælɪməni/ *noun* the money that a court orders a husband to pay regularly to his separated or divorced wife (NOTE: It can occasionally be applied to a wife who is ordered to support her divorced husband.) □ **alimony pending suit**, **alimony pendente lite** money paid by a husband to his wife while their divorce case is being prepared. ◊ **palimony**

allegation /ˌælə'geɪʃ(ə)n/ *noun* a statement, usually given in evidence, that something has happened or is true

allege /ə'ledʒ/ *verb* to state, usually in giving evidence, that something has happened or is true ○ *The prosecution alleged that the accused was in the house when the crime was committed.*

allegiance /ə'liːdʒ(ə)ns/ *noun* obedience to the State or the Crown. ◊ **oath of allegiance**

All England Law Reports /ˌɔːl ˌɪŋlənd 'lɔː rɪˌpɔːts/ *plural noun* reports of cases in the higher courts. Abbreviation **All E.R.**

allocate /'æləˌkeɪt/ *verb* to share something between several people, or decide officially how something is to be divided between different possibilities □ **to allocate a case to a track** (*of a court*) to decide which track a case should follow ○ *The court may allocate a case to a track of a higher financial value.*

allocation /ˌælə'keɪʃ(ə)n/ *noun* **1.** the division of a sum of money in various ways ○ *allocation of funds to research into crime* **2.** the act of deciding which of three systems of processing (small claims, fast track or multi-track) a case should follow, depending on the monetary value of the claim ○ *The allocation of a case to a particular track has implications for the speed with which the case will be processed.*

allocation hearing /ˌælə'keɪʃ(ə)n ˌhɪərɪŋ/ *noun* a court hearing to consider statements from the parties to a case and decide which system of processing (small claims, fast track or multi-track) a case should follow when an allocation questionnaire has not been submitted

allocation questionnaire /ˌælə 'keɪʃ(ə)n ˌkwestʃəneə/ *noun* a form to be filled in by each party to a claim, to give the court enough information to allow it to allocate the case to one of three systems of processing (small claims, fast track or multi-track)

allocatur /ˌælɒkeɪ'tuːə/ *phrase* a Latin word meaning 'it is allowed': a court document confirming the amount of

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Law.fm Page 13 Friday, June 11, 2004 2:08 PM

costs to be paid by one party to another after a court action

allocution /ˌæləˈkjuːʃ(ə)n/ *noun US* a request by the judge to a person who has been found guilty, asking if they wants to say anything on their own behalf before sentence is passed

allow /əˈlaʊ/ *verb* **1.** to say that someone can do something ○ *The law does not allow you to drive on the wrong side of the road.* ○ *Begging is not allowed in the station.* ○ *Visitors are not allowed into the prisoners' cells.* **2.** to give someone time or a privilege ○ *The court adjourned to allow the prosecution time to find the missing witness.* ○ *You are allowed thirty days to pay the fine.* **3.** to approve or accept something legally ○ *to allow a claim* or *an appeal* **4.** □ **allow for** to consider something when making a decision about something else ○ *In coming to our conclusion, we allowed for his poor knowledge of the language.*

allowable /əˈlaʊəb(ə)l/ *adjective* legally accepted

allowable expenses /əˌlaʊəb(ə)l ɪk ˈspensɪz/ *plural noun* expenses which can be claimed against tax

all-points bulletin /ˌɔːl ˈpɔːɪnts ˌbʊlətɪn/ *noun* an urgent message broadcast to all police in an area

alteram /ˈɔːltərəm/ ◗ **audi alteram partem**

alteration /ˌɔːltəˈreɪʃ(ə)n/ *noun* a change made to a legal document such as a will, which usually has the effect of making it invalid

alternative /ɔːlˈtɜːnətɪv/ *noun* something which takes the place of something else ○ *They argued that they had offered a similar car as an alternative.* □ **pleading in the alternative**, **alternative pleading** *US* the practice of making two or more pleadings which are mutually exclusive. ◗ **service by an alternative method** ■ *adjective* able to take the place of something else ○ *an alternative solution to the problem*

alternative dispute resolution /ɔːl ˌtɜːnətɪv dɪˈspjuːt ˌrezəluːʃ(ə)n/ *noun* any of various methods which can be used to settle a dispute without going to trial. Abbreviation **ADR**

ambassador /æmˈbæsədə/ *noun* somebody who is the highest level of diplomat representing his or her country in another country ○ *our ambassador in France* ○ *She is the wife of the Spanish Ambassador.* ○ *The government has recalled its ambassador for consultations.*

ambassadorial /ˌæmbæsəˈdɔːriəl/ *adjective* referring to an ambassador

ambassadress /æmˈbæsədres/ *noun* an ambassador's wife

Amber alert /ˌæmbə əˈlɜːt/ *noun* a system of bulletins issued by police to the media, and in the USA sometimes also on electronic road signs, seeking information leading to the rapid return of a kidnapped child

ambiguity /ˌæmbɪˈgjuːɪti/ *noun* **1.** the fact of being unclear because it can be understood in different ways **2.** something which is unclear because it can be understood in different ways. ◗ **latent ambiguity**

ambiguous /æmˈbɪgjuəs/ *adjective* meaning two or more things and therefore possibly misleading ○ *The wording of the clause is ambiguous and needs clarification.*

ambulatory /ˌæmbjuˈleɪt(ə)ri/ *adjective* (*of a will*) only taking effect after the death of the person who made it

COMMENT: Writing a will does not bind you to do what you say you are going to do in it. If in your will you leave your car to your son, and then sell the car before you die, your son has no claim on the will for the value of the car.

amend /əˈmend/ *verb* to change something ○ *Please amend your copy of the contract accordingly.*

amendment /əˈmen(d)mənt/ *noun* **1.** a change made in a document ○ *to propose an amendment to the draft agreement* ○ *to make amendments to a contract* **2.** a change made to a statement of case, which in civil law can be done before the details of a claim are served **3.** a change proposed to a Bill which is being discussed in Parliament

amends /əˈmendz/ *plural noun* □ **to make amends** to do something to compensate for damage or harm done □ **offer of amends** an offer by a libeller to write an apology

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Law.fm Page 14 Friday, June 11, 2004 2:08 PM

American Bar Association /ə ˌmerɪkən 'bɑː əˌsəʊsieɪʃ(ə)n/ *noun US* an association of lawyers practising in the USA. Abbreviation **ABA**

amicus curiae /əˌmaɪkəs 'kjʊəriaɪ/ *phrase* a Latin phrase meaning 'friend of the court': a lawyer who does not represent a party in a case but who is called upon to address the court to help clear up a difficult legal point or to explain something which is in the public interest

amnesty /'æmnəsti/ *noun* a pardon, often for political crimes, given to several people at the same time ■ *verb* to grant convicted persons a pardon ○ *They were amnestied by the president.*

anarchic /ə'nɑːkɪk/, **anarchical** /ə 'nɑːkɪkl/ *adjective* with no law or order ○ *the anarchic state of the country districts after the coup*

anarchism /'ænəkɪz(ə)m/ *noun* the belief that there should be no government or control of people by the state

anarchist /'ænəkɪst/ *noun* somebody who believes in anarchism

COMMENT: Anarchism flourished in the latter part of the 19th and early part of the 20th century. Anarchists believe that there should be no government, no army, no civil service, no courts, no laws, and that people should be free to live without anyone to rule them.

anarchy /'ænəki/ *noun* absence of law and order, because a government has lost control or because there is no government ○ *When the president was assassinated, the country fell into anarchy.*

ancestor /'ænsestə/ *noun* a person living many years ago from whom someone is descended □ **common ancestor** a person from whom two or more people are descended ○ *Mr Smith and the Queen have a common ancestor in King Charles II*

ancient lights /ˌeɪnʃənt 'laɪts/ *plural noun* a claim by the owner of a property that he or she has the right to enjoy light in his windows and not have it blocked by a neighbour's buildings

ancillary /æn'sɪləri/ *adjective* giving help or support

ancillary relief /ænˌsɪləri rɪ'liːf/ *noun* financial provision or adjustment of property rights ordered by a court for a spouse or child in divorce proceedings

animus /'ænɪməs/ *noun* intention

animus cancellandi /ˌænɪməs ˌkænsəl'ændaɪ/ *noun* the intention to cancel

animus furandi /ˌænɪməs ˌfjʊə 'rændaɪ/ *noun* the intention to steal

animus manendi /ˌænɪməs mæn 'nendaɪ/ *noun* the intention to stay in a place

animus revocandi /ˌænɪməs ˌrevə 'kændaɪ/ *noun* the intention to revoke a will

COMMENT: With all these terms, when the phrase is 'with the intention of', **animo** is used: e.g. *animo revocandi* 'with the intention of revoking a will'.

annexation /ˌænek'seɪʃ(ə)n/ *noun* the act of annexing a territory

annexe, annex *noun* a document added or attached to a contract ■ *verb* **1.** to attach a document to something **2.** to take possession of a territory which belongs to another state and attach it to your country, so taking full sovereignty over the territory ○ *The island was annexed by the neighbouring republic.* ○ *The war was caused by a dispute over the annexing of a strip of land.*

annual /'ænjuəl/ *adjective* for one year □ **on an annual basis** each year

Annual General Meeting /ˌænjuəl ˌdʒen(ə)rəl 'miːtɪŋ/ *noun* a meeting of the shareholders of a company which takes place once a year to approve the accounts. Abbreviation **AGM**

annually /'ænjuəli/ *adverb* each year ○ *The figures are revised annually.*

annual return /ˌænjuəl rɪ'tɜːn/ *noun* a form to be completed by each company once a year, giving details of the directors and the financial state of the company

annuitant /ə'njuːɪtənt/ *noun* somebody who receives an annuity

annuity /ə'njuːɪti/ *noun* money paid each year to a person, usually as the result of an investment ○ *to buy* or *to take out an annuity* ○ *He has a government annuity* or *an annuity from the government.*

mainp - softvnn.com

Law.fm Page 15 Friday, June 11, 2004 2:08 PM

annul /ə'nʌl/ *verb* **1.** to stop something having any legal effect ○ *The contract was annulled by the court.* **2.** to declare that something never existed or that something never had legal effect ○ *Their marriage has been annulled.* (NOTE: [all senses] **annulling – annulled**)

annullable /ə'nʌləb(ə)l/ *adjective* able to be cancelled

annulling /ə'nʌlɪŋ/ *adjective* cancelling ○ *annulling clause* ■ *noun* the act of cancelling ○ *the annulling of a contract*

annulment /ə'nʌlmənt/ *noun* the act of cancelling

annulment of adjudication /ə ˌnʌlmənt əv əˌdʒuːdɪ'keɪʃ(ə)n/ *noun* the cancelling of an order making someone bankrupt

annulment of marriage /əˌnʌlmənt əv 'mærɪdʒ/ *noun* the act of ending a marriage by saying that it was never valid

annum /'ænəm/ ◗ **per annum**

answer /'ɑːnsə/ *noun* **1.** a spoken or written reply ○ *my letter got no answer* or *there was no answer to my letter* ○ *I am writing in answer to your letter of October 6th.* ○ *I tried to phone his office but there was no answer.* **2.** a formal reply to an allegation made in court, especially a defence made by a respondent to a divorce petition ■ *verb* **1.** to speak or write after someone has spoken or written to you □ **to answer a letter** to write a letter in reply to a letter which you have received □ **to answer the telephone** to lift the telephone when it rings and listen to what the caller is saying **2.** to reply formally to an allegation made in court □ **to answer charges** to plead guilty or not guilty to a charge □ **the judge ruled there was no case to answer** the judge ruled that the prosecution or the claimant had not shown that the accused or the defendant had done anything wrong

answerable /'ɑːns(ə)rəb(ə)l/ *adjective* being responsible for one's actions and having to explain why actions have been taken ○ *He is answerable to the Police Commissioner for the conduct of the officers in his force.* ○ *She refused to be held answerable for the consequences of the police committee's decision.* (NOTE: You are answerable **to** someone **for** an action.)

ante /'ænti/ *Latin adverb meaning* 'which has taken place earlier' or 'before'

antecedents /ˌæntɪ'siːd(ə)nts/ *plural noun* details of the background of a convicted person given to a court before sentence is passed

antedate /ˌæntɪ'deɪt/ *verb* to put an earlier date on a document ○ *The invoice was antedated to January 1st.*

anti- /ænti/ *prefix* against ○ *an anti-drug campaign* ○ *the anti-terrorist squad*

anticipatory /æn'tɪsɪpət(ə)ri/ *adjective* done before it is due

anticipatory breach /æn ˌtɪsɪpət(ə)ri 'briːtʃ/ *noun* a refusal by a party to a contract to perform his or her obligations under the contract at a time before they were due to be performed

antisocial behaviour /ˌæntisəʊʃ(ə)l bɪ'heɪvjə/ *noun* bad or unpleasant behaviour in public

Antisocial Behaviour Order /ˌæntisəʊʃ(ə)l bɪ'heɪvjə ˌɔːdə/ *noun* an order that can be applied for by the police against any individual over the age of 10 years old who is causing someone distress, harm or harassment, in order to restrict their behaviour. Abbreviation **ASBO**. ◗ **Acceptable Behaviour Contract** (NOTE: ASBOs are a provision of the Crime and Disorder Act 1998.)

anti-trust /ˌænti 'trʌst/ *adjective* attacking monopolies and encouraging competition ○ *anti-trust laws* or *legislation*

Anton Piller order /ˌæntɒn 'pɪlər ˌɔːdə/ *noun* in a civil case, an order by a court allowing a party to inspect and remove a defendant's documents, especially where the defendant might destroy evidence (NOTE: So called after the case of *Anton Piller K.G. v. Manufacturing Processes Ltd.* Since the introduction of the new Civil Procedure Rules in April 1999, this term has been replaced by **search order**.)

any other business /ˌeni ˌʌðə 'bɪznɪs/ *noun* an item at the end of an agenda, where any matter not already on

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Law.fm Page 16 Friday, June 11, 2004 2:08 PM

the agenda can be raised. Abbreviation **AOB**

apology /ə'pɒlədʒi/ *noun* a defence made to an action of defamation where the defendant argues that the offending statement was either made innocently or unintentionally (NOTE: Even if an apology is not accepted, the offer in itself will always be capable of reducing the amount of compensation awarded to the plaintiff.)

a posteriori /ˌeɪ pɒsteri'ɔːri/ *phrase* a Latin phrase meaning 'from what has been concluded afterwards' □ **a posteriori argument** an argument based on observation

apparent /ə'pærənt/ *adjective* easily visible, or obvious □ **apparent defect** a defect which can be easily seen

appeal /ə'piːl/ *noun* **1.** the act of asking a higher court to change a decision of a lower court ○ *the appeal from the court order* or *the appeal against the planning decision will be heard next month* ○ *He lost his appeal for damages against the company.* □ **to win a case on appeal** to lose a case in the first court, but to have the decision changed by an appeal court □ **appeal against conviction** the act of asking a higher court to change the decision of a lower court that a person is guilty □ **appeal against sentence** the act of asking a higher court to reduce a sentence imposed by a lower court **2.** the act of asking a government department to change a decision ■ *verb* to ask a government department to change its decision or a high law court to change a sentence ○ *The company appealed against the decision of the planning officers.* ○ *He has appealed to the Supreme Court.* (NOTE: You appeal **to** a court or **against** a decision, an appeal is **heard** and either **allowed** or **dismissed**.)

Appeal Court /ə'piːl kɔːt/ *noun* ➧ **Court of Appeal**

appear /ə'pɪə/ *verb* **1.** to seem ○ *The witness appeared to have difficulty in remembering what had happened.* **2.** (*of a party in a case*) to come to court **3.** (*of a barrister or solicitor*) to come to court to represent a client ○ *Mr A. Clark QC is appearing on behalf of the defendant.*

appearance /ə'pɪərəns/ *noun* the act of coming to court to defend or prosecute a case □ **to enter an appearance** to register with a court that a defendant intends to defend an action

appellant /ə'pelənt/ *noun* a person who goes to a higher court to ask it to change a decision or a sentence imposed by a lower court

appellate /ə'pelət/ *adjective* referring to appeal

appellate committee /ə'pelət kə ˌmɪti/ *noun* the upper house of the British Parliament, which is responsible for analysing legislation and hearing cases which have been referred to it by lower courts

appellate court /ə'pelət kɔːt/ *noun* ➧ **Court of Appeal**

appellate jurisdiction /əˌpelət ˌdʒʊərɪs'dɪkʃ(ə)n/ *noun* the power of a judge to hear appeals from a previous decision made by a lower court ○ *If the ECJ tries to decide if a national court's decision to refer a case to it is correct, then the ECJ is exercising a form of appellate jurisdiction.*

appendix /ə'pendɪks/ *noun* an additional piece of text at the end of a document ○ *The markets covered by the agency agreement are listed in the Appendix.* ○ *See Appendix B for the clear-up rates of notifiable offences.* (NOTE: The plural is **appendices**.)

applicant /'æplɪkənt/ *noun* **1.** somebody who applies for something ○ *an applicant for a job* or *a job applicant* ○ *There were thousands of applicants for shares in the new company.* **2.** somebody who applies for a court order

application /ˌæplɪ'keɪʃ(ə)n/ *noun* **1.** the act or process of asking for something, usually in writing ○ *application for shares* ○ *shares payable on application* ○ *application for a job* or *job application* **2.** the act of asking the Court to make an order ○ *His application for an injunction was refused.* ○ *Solicitors acting for the wife made an application for a maintenance order.*

COMMENT: Applications can now be dealt with by telephone (a 'telephone hearing'); urgent applications can be

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Law.fm Page 17 Friday, June 11, 2004 2:08 PM

made without making an application notice.

application form /ˌæplɪˈkeɪʃ(ə)n ˌfɔːm/ *noun* a form to be filled in when applying ○ *to fill in an application form for a job* or *a job application form*

application notice /ˌæplɪˈkeɪʃ(ə)n ˌnəʊtɪs/ *noun* a document by which an applicant applies for a court order. The notice must state what type of order is being sought and the reasons for seeking it. (NOTE: The phrase **applications made without notice being served on the other party** is now used instead of **ex parte applications**.)

apply /əˈplaɪ/ *verb* **1.** to ask for something, usually in writing ○ *to apply for a job* ○ *to apply for shares* ○ *to apply in writing* ○ *to apply in person* ○ *My client wishes to apply for Legal Aid.* ○ *He applied for judicial review* or *for compensation* or *for an adjournment.* □ **to apply to the Court** to ask the court to make an order ○ *he applied to the Court for an injunction* **2.** to affect or be relevant to something or someone ○ *This clause applies only to deals outside the EU.* ○ *The legal precedent applies to cases where the parents of the child are divorced.*

appoint /əˈpɔɪnt/ *verb* to choose someone for a job ○ *to appoint James Smith to the post of manager* ○ *The government has appointed a QC to head the inquiry.* ○ *The court appointed a receiver.* (NOTE: You appoint a person **to** a job or **to do** a job.)

appointee /əpɔɪnˈtiː/ *noun* somebody who is appointed to a job

appointment /əˈpɔɪntmənt/ *noun* **1.** an arrangement to meet someone ○ *to make* or *to fix an appointment for two o'clock* ○ *to make an appointment with someone for two o'clock* ○ *He was late for his appointment.* ○ *She had to cancel her appointment.* **2.** the act of appointing someone or being appointed to a job □ **on his appointment as magistrate** when he was made a magistrate **3.** a job □ **legal appointments vacant** list in a newspaper of legal jobs which are vacant

appointments book /əˈpɔɪntmənts bʊk/ *noun* a desk diary in which appointments are noted

apportion /əˈpɔːʃ(ə)n/ *verb* to share out something such as property, rights or liabilities in appropriate proportions ○ *Costs are apportioned according to planned revenue.*

apportionment /əˈpɔːʃ(ə)nmənt/ *noun* the act of sharing out such as property, rights or liabilities in appropriate proportions

appraise /əˈpreɪz/ *verb* to make an estimate of the value of something

appraiser /əˈpreɪzə/ *noun* somebody who appraises something

apprehend /ˌæprɪˈhend/ *verb* (*formal*) **1.** to understand ○ *I apprehend that you say your client has a reference.* **2.** to arrest and take into police custody ○ *The suspect was apprehended at the scene of the crime.*

apprehension /ˌæprɪˈhenʃ(ə)n/ *noun* the act of arresting someone (*formal*)

appropriate *adjective* /əˈprəʊpriət/ suitable for a particular purpose ○ *Is a fine an appropriate punishment for sex offences?* ■ *verb* /əˈprəʊprieɪt/ **1.** to take control of something illegally **2.** to take something for a particular use, e.g. taking funds from an estate to pay legacies to beneficiaries

appropriation /əˌprəʊpriˈeɪʃ(ə)n/ *noun* the allocation of money for a particular purpose such as distributing parts of an estate to beneficiaries

approval /əˈpruːv(ə)l/ *noun* **1.** permission to do something given by someone with authority ○ *to submit a budget for approval* **2.** □ **on approval** a sale where the buyer pays for goods only if they are satisfactory

approve /əˈpruːv/ *verb* to agree to something officially ○ *to approve the terms of a contract* ○ *The proposal was approved by the board.* ○ *The motion was approved by the committee.* □ **to approve of** to think something is good

approved school /əˈpruːvd skuːl/ *noun* formerly, a school for young delinquents

appurtenances /əˈpɜːrtɪnənsɪz/ *plural noun* land or buildings attached to or belonging to a property

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Law.fm Page 18 Friday, June 11, 2004 2:08 PM

appurtenant /ə'pɜːrtɪnənt/ *adjective* relevant to

a priori /ˌeɪ praɪ'ɔːri/ *phrase* a Latin phrase meaning 'from the first': using logic and reason to draw conclusions from what is already known □ **a priori argument** reasoning based on ideas or assumptions, not on real examples

arbitrate /'ɑːbɪtreɪt/ *verb* (*usually used in building, shipping or employment disputes*) to settle a dispute between parties by referring it to an arbitrator instead of going to court ○ *to arbitrate in a dispute*

arbitration /ˌɑːbɪ'treɪʃ(ə)n/ *noun* the settling of a dispute by an outside person or persons agreed on by both sides ○ *to submit a dispute to arbitration* ○ *to refer a question to arbitration* ○ *to take a dispute to arbitration* ○ *to go to arbitration*

arbitration agreement /ˌɑːbɪ 'treɪʃ(ə)n əˌgriːmənt/ *noun* an agreement by two parties to submit a dispute to arbitration

arbitration award /ˌɑːbɪ'treɪʃ(ə)n əˌwɔːd/ *noun* a ruling given by an arbitrator

arbitration board /ˌɑːbɪ'treɪʃ(ə)n bɔːd/ *noun* a group which arbitrates

arbitration clause /ˌɑːbɪ'treɪʃ(ə)n klɔːz/ *noun* a written term in a contract, usually a commercial contracts, requiring anyone who is party to the contract to agree to refer any contractual disputes to arbitration

arbitrator /'ɑːbɪtreɪtə/ *noun* a person not concerned with a dispute who is chosen by both sides to try to settle it ○ *an industrial arbitrator* ○ *to accept* or *to reject the arbitrator's ruling*

argue /'ɑːgjuː/ *verb* **1.** to discuss something about which there is disagreement ○ *They argued over* or *about the price.* ○ *Counsel spent hours arguing about the precise meaning of the clause.* **2.** to give reasons for something ○ *Prosecuting counsel argued that the accused should be given exemplary sentences.* ○ *The police solicitor argued against granting bail.* (NOTE: You argue **with** someone **about** *or* **over** something.)

argument /'ɑːgjʊmənt/ *noun* **1.** the discussion of something without agreement ○ *They got into an argument with the judge over the relevance of the documents to the case.* ○ *He sacked his solicitor after an argument over costs.* **2.** a speech giving reasons for something ○ *The judge found the defence arguments difficult to follow.* ○ *Counsel presented the argument for the prosecution.* ○ *The Court of Appeal was concerned that the judge at first instance had delivered judgment without proper argument.* (NOTE: can be used without **the**)

arise /ə'raɪz/ *verb* to happen as a result of something ○ *The situation has arisen because neither party is capable of paying the costs of the case.* ○ *The problem arises from the difficulty in understanding the regulations.*

armed neutrality /ˌɑːmd njuː 'trælətɪ/ *noun* the condition of a country which is neutral during a war, but maintains armed forces to defend itself

armourer /'ɑːmərə/ *noun* a criminal who supplies guns to other criminals (*slang*)

arm's length /ˌɑːmz 'leŋθ/ *noun* □ **at arm's length** not closely connected □ **to deal with someone at arm's length** to deal as if there were no connection between the parties, e.g. when a company buys a service from one of its own subsidiaries ○ *The directors were required to deal with the receiver at arm's length.*

arraign /ə'reɪn/ *verb* to make an accused person appear in the court and read the indictment to him or her

arraignment /ə'reɪnmənt/ *noun* the act of reading of an indictment to the accused and hearing his or her plea

arrangement /ə'reɪndʒmənt/ *noun* **1.** a way in which something is organised ○ *The company secretary is making all the arrangements for the AGM.* **2.** the settling of a financial dispute, especially by proposing a plan for repaying creditors ○ *to come to an arrangement with the creditors*

arrears /ə'rɪəz/ *plural noun* money which has not been paid at the time when it was due ○ *to allow the payments to fall into arrears* □ **in arrears** owing money which should have been paid earlier ○ *The payments are six months in arrears.* ○ *He is six weeks in arrears with his rent.*

mainp - softvnn.com

Law.fm Page 19 Friday, June 11, 2004 2:08 PM

arrest /ə'rest/ *noun* an act of taking and keeping someone in custody legally, so that he or she can be questioned and perhaps charged with a crime □ **a warrant is out for his arrest** a magistrate has signed a warrant, giving the police the power to arrest someone for a crime □ **under arrest** kept and held by the police ○ *Six of the gang are in the police station under arrest.* ■ *verb* **1.** to hold someone legally so as to keep him or her in custody and charge them with a crime ○ *Two of the strikers were arrested.* ○ *The constable stopped the car and arrested the driver.* **2.** to seize a ship or its cargo **3.** to stop something from continuing

arrestable offence /ə,restəbl ə 'fens/ *noun* a crime for which someone can be arrested without a warrant, usually an offence which carries a penalty of at least five years' imprisonment

arrest of judgment /ə,rest əv 'dʒʌdʒmənt/ *noun* a situation where a judgment is held back because there appears to be an error in the documentation

arrest warrant /ə,rest 'wɒrənt/ *noun* a warrant signed by a magistrate which gives the police the power to arrest someone for a crime. ◊ **citizen's arrest**

COMMENT: Any citizen may arrest a person who is committing a serious offence, though members of the police force have wider powers, in particular the power to arrest persons on suspicion of a serious crime or in cases where an arrest warrant has been granted. Generally a policeman is not entitled to arrest someone without a warrant if the person does not know or is not told the reason for his arrest.

arson /'ɑːs(ə)n/ *noun* the notifiable offence of setting fire to a building ○ *He was charged with arson.* ○ *During the riot there were ten cases of looting and two of arson.* ○ *The police who are investigating the fire suspect arson.* □ **an arson attack on a house** setting fire to a house

arsonist /'ɑːs(ə)nɪst/ *noun* somebody who commits arson

article /'ɑːtɪk(ə)l/ *noun* **1.** a product or thing for sale ○ *a black market in imported articles of clothing* **2.** a section of a legal agreement ○ *See article 8 of the contract.* **3.** □ **articles of association**, **articles of incorporation** *US* document which regulates the way in which a company's affairs are managed **4.** □ **to serve articles** to work as an articled clerk in a solicitor's office

Article 81 /,ɑːtɪk(ə)l ,eɪti 'wʌn/ *noun* a provision contained in the Treaty of Rome designed to prevent agreements that aim to or effectively restrict, prevent or manipulate competition in the European Union (NOTE: Formerly known as Article 85.)

Article 82 /,ɑːtɪk(ə)l ,eɪti 'tuː/ *noun* a provision contained in the Treaty of Rome designed to prevent businesses abusing their position of dominance within the European Union

articled clerk /,ɑːtɪk(ə)ld 'klɑːk/ *noun* formerly, a trainee who is bound by a contract to work in a solicitor's office for some years to learn the law (NOTE: Now called **trainee solicitor**.)

articles /'ɑːtɪk(ə)lz/ *noun* formerly, the period during which someone is working in a solicitor's office to learn the law (NOTE: Now called **traineeship**.)

articles of association /,ɑːtɪk(ə)lz əv ə,səʊsi'eɪʃ(ə)n/ *noun* a document which regulates the way in which a company's affairs such as the appointment of directors or rights of shareholders are managed. Also called **articles of incorporation**

articles of impeachment /,ɑːtɪk(ə)lz əv ɪm'piːtʃmənt/ *noun US* a statement of the grounds on which a public official is to be impeached

articles of incorporation /,ɑːtɪk(ə)lz əv ɪn,kɔːpə'reɪʃ(ə)n/ *noun* same as **articles of association**

articles of partnership /,ɑːtɪk(ə)lz əv 'pɑːtnəʃɪp/ *noun* a document which sets up the legal conditions of a partnership ○ *She is a director appointed under the articles of the company.* ○ *This procedure is not allowed under the articles of association of the company.*

artificial person /,ɑːtɪfɪʃ(ə)l 'pɜːs(ə)n/ *noun* a body such as a company which is regarded as a person in law

ASBO *abbreviation* Antisocial Behaviour Order

mainp - softvnn.com

Law.fm Page 20 Friday, June 11, 2004 2:08 PM

ascendant /ə'sendənt/ *noun* the parent or grandparent of a person (NOTE: The opposite, the children or grandchildren of a person, are **descendants**.)

ask /ɑːsk/ *verb* **1.** to put a question to someone ○ *Prosecuting counsel asked the accused to explain why the can of petrol was in his car.* **2.** to tell someone to do something ○ *The police officers asked the marchers to go home.* ○ *She asked her secretary to fetch a file from the managing director's office.* ○ *The customs officials asked him to open his case.* ○ *The judge asked the witness to write the name on a piece of paper.* **3.** □ **to ask for something** to say that you want or need something ○ *He asked for the file on 1992 debtors.* ○ *Counsel asked for more time to consult with his colleagues.* ○ *There is a man on the phone asking for Mr Smith.* □ **to ask for bail to be granted** to ask a court to allow a prisoner to be remanded on bail

assassin /ə'sæsɪn/ *noun* someone who murders a well-known person

assassinate /ə'sæsɪneɪt/ *verb* to murder a well-known person

assassination /ə,sæsɪ'neɪʃ(ə)n/ *noun* the murder of a well-known person

assault /ə'sɔːlt/ *verb* the crime or tort of acting in such a way that someone is afraid he or she will be attacked and hurt ○ *She was assaulted by two muggers.* ◊ **battery** ■ *noun* the offence of acting intentionally to make someone afraid that they will be attacked and hurt ○ *He was sent to prison for assault.* ○ *The number of cases of assault* or *the number of assaults on policemen is increasing.* (NOTE: As a crime or tort, assault has no plural. When it has a plural it means 'cases of assault'.)

COMMENT: Assault should be distinguished from battery, in that assault is the threat of violence, whereas battery is actual violence. However, because the two are so closely connected, the term 'assault' is frequently used as a general term for violence to a person. 'Aggravated assault' is assault causing serious injury or carried out in connection with another serious crime. The term 'common assault' is frequently used for any assault which is not an aggravated assault.

assaulter /ə'sɔːltə/ *noun* **1.** a member of a police hostage rescue team **2.** someone who attacks another person physically or verbally in a violent way

assay /'æseɪ, ə'seɪ/ *noun* a test of a precious metal such as gold or silver to see if it is of the right quality

assay mark /'æseɪ mɑːk/ *noun* a mark put on gold or silver items to show that the metal is of correct quality. Also called **hallmark**

assemble /ə'semb(ə)l/ *verb* **1.** to come together or to gather ○ *The crowd assembled in front of the police station.* **2.** to put something together from various parts ○ *The police are still assembling all the evidence.*

assembly /ə'semblɪ/ *noun* the action of people meeting together in a group. ◊ **freedom of assembly, unlawful assembly**

assemblyman /ə'semblimən/ *noun* a member of an assembly

Assembly of the European Community /ə,sembli əv θə ˌjʊərəpiən kə'mjuːnɪti/ *noun* the European Parliament

assent /ə'sent/ *noun* **1.** agreement to or approval of something **2.** notification by a personal representative that part of an estate is not needed for the administration of the estate and can be passed to the beneficiary named in the will (NOTE: The assent can be given verbally or in writing and applies to personal property and real estate.) ■ *verb* to agree to something ○ *The executor assented to the vesting of the property to the beneficiary.*

assent procedure /ə,sent prə'siːdʒə/ *noun* a procedure by which the approval of the European Parliament is necessary before legislation can be put into law

assess /ə'ses/ *verb* to calculate the value of something, especially for tax or insurance purposes ○ *to assess damages at £1,000* ○ *to assess a property for the purposes of insurance*

assessment /ə'sesmənt/ *noun* a calculation of value ○ *assessment of damages* ○ *assessment of property* ○ *tax assessment*

mainp - softvnn.com

Law.fm Page 21 Friday, June 11, 2004 2:08 PM

assessment of costs /əˌsesmənt əv ˈkɒsts/ *noun* an assessment of the costs of a legal action by the costs judge (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has replaced **taxation of costs**.)

assessor /əˈsesə/ *noun* an expert who helps the court when a case requires specialised technical knowledge

asset /ˈæset/ *noun* something which belongs to company or person and which has a specific value ○ *He has an excess of assets over liabilities.* ○ *Her assets are only £640 as against liabilities of £24,000.*

asset value /ˌæset ˈvæljuː/ *noun* the value of a company calculated by adding together all its assets

assign /əˈsaɪn/ *verb* **1.** to give or transfer something ○ *to assign a right to someone* ○ *to assign shares to someone* ○ *to assign a debt to someone* **2.** to give someone a piece of work to do ○ *He was assigned the job of checking the numbers of stolen cars.* ○ *Three detectives have been assigned to the case.* ■ *noun* same as **assignee**

assignee /ˌæsaɪˈniː/ *noun* somebody who receives something which has been assigned

assignment /əˈsaɪnmənt/ *noun* **1.** the legal transfer of a property or of a right ○ *assignment of a patent* or *of a copyright* ○ *assignment of a lease* **2.** a document by which something is assigned **3.** a particular task to be completed ○ *We have put six constables on that particular assignment.*

assignor /ˌæsaɪˈnɔː/ *noun* somebody who assigns something to someone

assigns /əˈsaɪnz/ *plural noun* people to whom property has been assigned □ **his heirs and assigns** people who have inherited property and have had it transferred to them

assist /əˈsɪst/ *verb* to help ○ *The accused had to be assisted into the dock.* ○ *She has been assisting us with our inquiries.*

Assistant Chief Constable /əˌsɪst(ə)nt tʃiːf ˈkʌnstəb(ə)l/ *noun* a rank in the police force below Chief Constable

assisted person /əˌsɪstɪd ˈpɜːs(ə)n/ *noun* somebody who is receiving Legal Aid

Assizes, Assize Courts *plural noun* formerly, the Crown Court

associate /əˈsəʊsieɪt/ *adjective* joined together with something ■ *noun* somebody who works in the same business as someone ○ *In his testimony he named six associates.* ■ *verb* to mix with or to meet people □ **she associated with criminals** she was frequently in the company of criminals

associate company /əˌsəʊsiət ˈkʌmp(ə)ni/ *noun* a company which is partly owned or controlled by another

associated /əˈsəʊsieɪtɪd/ *adjective* joined to or controlled by ○ *Smith Ltd and its associated company, Jones Brothers.*

associate director /əˌsəʊsiət daɪ ˈrektə/ *noun* a director who attends board meetings, but does not have the full powers of a director

associated person /əˌsəʊsieɪtɪd ˈpɜːs(ə)n/ *noun* a concept widened by the Family Law Act 1996, allowing any person who falls under this category the right to apply for a protection order. ◊ **non-molestation order, occupation order**

Associate Justice /əˌsəʊsiət ˈdʒʌstɪs/ *noun US* a member of the Supreme Court who is not the Chief Justice

associate of the Crown Office /əˌsəʊsieɪt əv ðɪ kraʊn ˈɒfɪs/ *noun* an official who is responsible for the clerical and administrative work of a court

association /əˌsəʊsiˈeɪʃ(ə)n/ *noun* **1.** a group of people or of companies with the same interest ○ *trade association* ○ *employers' association* **2.** (*in prison*) the time when prisoners can move about and meet other prisoners

assure /əˈʃʊə/ *verb* to have an agreement with an insurance company that in return for regular payment, the company will pay compensation for injury or loss of life □ **the assured** the person whose interests are assured, who is entitled to the benefit in an insurance policy

assured shorthold tenancy /əˌʃʊəd ˌʃɔːthəʊld ˈtenənsi/ *noun* a ten-

mainp - softvnn.com

Law.fm Page 22 Friday, June 11, 2004 2:08 PM

ancy allowing a landlord to bypass the usual grounds for regaining possession of an assured tenancy. The Housing Act 1996 states that from the 28th February 1997, a landlord will no longer be required to give notice to the tenant and as of this date all new tenancies will automatically be classified as assured shorthold tenancies unless otherwise specified in the contract.

assured tenancy /əˌʃʊəd 'tenənsi/ *noun* in England and Wales, a lease under the Housing Act 1988 that gives a tenant limited security of tenure and allows a landlord a specific means of terminating a lease

assurer /ə'ʃʊərə/, **assuror** *noun* a company which provides insurance

COMMENT: **assure** and **assurance** are used in Britain for insurance policies relating to something which will certainly happen (such as death or the end of a given period of time); for other types of policy use **insure** and **insurance**.

asylum /ə'saɪləm/ *noun* refuge in a country granted to a person who is subject to extradition by a foreign government ▫ **to ask for political asylum** to ask to be allowed to remain in a foreign country because it would be dangerous to return to the home country for political reasons

at issue /ət 'ɪʃuː/ ◆ **issue**

at large /ət 'lɑːdʒ/ *adjective* not in prison ○ *Three prisoners escaped – two were recaptured, but one is still at large.*

attach /ə'tætʃ/ *verb* **1.** to fasten something to something else ○ *I am attaching a copy of my previous letter.* ○ *Attached is a copy of my letter of June 24th.* **2.** to arrest a person or take property

attaché /ə'tæʃeɪ/ *noun* a person who does specialised work in an embassy abroad ○ *a military attaché* ○ *The government ordered the commercial attaché to return home.*

attachment /ə'tætʃmənt/ *noun* a court order preventing a debtor's property from being sold until debts are paid

attachment of earnings /əˌtætʃmənt əv 'ɜːnɪŋz/ *noun* a legal power to take money from a person's salary to pay money which is owed to the courts

attachment of earnings order /əˌtætʃmənt əv 'ɜːnɪŋz ˌɔːdə/ *noun* a court order to make an employer pay part of an employee's salary to the court to pay off debts

attack /ə'tæk/ *verb* **1.** to try to hurt or harm someone ○ *The security guard was attacked by three men carrying guns.* **2.** to criticise ○ *The newspaper attacked the government for not spending enough money on the police.* ■ *noun* **1.** the act of trying to hurt or harm someone ○ *There has been an increase in attacks on police* or *in terrorist attacks on planes.* **2.** criticism ○ *The newspaper published an attack on the government.* (NOTE: You attack someone, but make an attack **on** someone.)

attacker /ə'tækə/ *noun* somebody who attacks ○ *She recognised her attacker and gave his description to the police.*

attempt /ə'tempt/ *noun* **1.** an act of trying to do something ○ *The company made an attempt to break into the American market.* ○ *The takeover attempt was turned down by the board.* ○ *All his attempts to get a job have failed.* **2.** an act of trying to do something illegal (NOTE: Attempt is a crime even if the attempted offence has not been committed.)

attempted murder /əˌtemptɪd 'mɜːdə/ *noun* the notifiable offence of trying to murder someone

attend /ə'tend/ *verb* to be present at ○ *The witnesses were summoned to attend the trial.*

attendance /ə'tendəns/ *noun* the fact of being present

attendance centre /əˌtendəns 'sentə/ *noun* a place where a young person may be sent by a court to take part in various activities or do hard work as a punishment. This applies to people between the ages of 17 and 21 and is on the condition that they have not had a custodial sentence before.

attest /ə'test/ *verb* to sign a document such as a will in the presence of a witness who also signs the document to confirm that the signature is genuine

mainp - softvnn.com

Law.fm Page 23 Friday, June 11, 2004 2:08 PM

attestation /ˌæte'steɪʃ(ə)n/ *noun* the act of signing a document such as a will in the presence of a witness to show that the signature is genuine

attestation clause /ˌæte'steɪʃ(ə)n klɔːz/ *noun* a clause showing that the signature of the person signing a legal document has been witnessed (NOTE: The attestation clause is usually written: 'signed sealed and delivered by … in the presence of …'.)

attorn /ə'tɔːn/ *verb* to transfer

attorney /ə'tɜːni/ *noun* **1.** somebody who is legally allowed to act on behalf of someone else **2.** *US* a lawyer

attorney-at-law /əˌtɜːni ət 'lɔː/ *noun* formerly, a barrister

Attorney-General /əˌtɜːni 'dʒen(ə)rəl/ *noun* **1.** in the UK, one of the Law Officers, a Member of Parliament, who prosecutes for the Crown in some court cases, advises government departments on legal problems and decides if major criminal offences should be tried **2.** in a US state or in the federal government, the head of legal affairs (NOTE: In the US Federal Government, the Attorney-General is in charge of the Justice Department.)

attributable /ə'trɪbjʊtəb(ə)l/ *adjective* being able to be attributed

attribute /ə'trɪbjuːt/ *verb* to suggest that something came from a source ○ *remarks attributed to the Chief Constable*

audi alteram partem /ˌaʊdi ˌælterəm 'pɑːtəm/ *phrase* a Latin phrase meaning 'hear the other side': a rule in natural justice that everyone has the right to speak in his or her own defence and to have the case against them explained clearly

audit /'ɔːdɪt/ *noun* **1.** an examination of the books and accounts of a company ○ *to carry out an annual audit* **2.** a careful review of the effectiveness of something ○ *an audit of safety procedures* ■ *verb* **1.** to examine the books and accounts of a company ○ *to audit the accounts* ○ *The books have not yet been audited.* **2.** to review something carefully

Audit Commission /ˌɔːdɪt kə 'mɪʃ(ə)n/ *noun* an independent body which examines the accounts of local authorities, ensures that money is spent legally and wisely, and checks for possible fraud and corruption

auditor /'ɔːdɪtə/ *noun* somebody who audits ○ *The AGM appoints the company's auditors.*

audit trail /'ɔːdɪt treɪl/ *noun* a record in the form of computer or printed documents that shows how something happened

autarchy /'ɔːtɑːki/ *noun* a situation where a state rules itself without outside interference and has full power over its own affairs

autarky /'ɔːtɑːki/ *noun* a situation where a state is self-sufficient and can provide for all its needs without outside help

authenticate /ɔː'θentɪˌkeɪt/ *verb* to show that something is true

authenticity /ˌɔːθen'tɪsɪti/ *noun* the state of being genuine ○ *The police are checking the authenticity of the letter.* ○ *An electronic signature confirms the authenticity of the text.*

authorisation /ˌɔːθəraɪ'zeɪʃ(ə)n/, **authorization** *noun* **1.** official permission or power to do something ○ *Do you have authorisation for this expenditure?* ○ *He has no authorisation to act on our behalf.* **2.** a document showing that someone has official permission to do something ○ *He showed the bank his authorisation to inspect the contents of the safe.*

authorise /'ɔːθəˌraɪz/, **authorize** /'ɔːθəraɪz/ *verb* **1.** to give official permission for something to be done ○ *to authorise payment of £10,000* **2.** to give someone the authority to do something ○ *to authorise someone to act on your behalf*

authorised /'ɔːθəraɪzd/, **authorized** *adjective* permitted

authorised capital /ˌɔːθəraɪzd 'kæpɪt(ə)l/ *noun* the amount of capital which a company is allowed to have, according to its memorandum of association

authorised dealer /ˌɔːθəraɪzd 'diːlə/ *noun* a person or company such as a bank which is allowed to buy and sell foreign currency

mainp - softvnn.com

Law.fm Page 24 Friday, June 11, 2004 2:08 PM

authoritarian /ɔːˌθɒrɪˈteərɪən/ *adjective* acting because of having power

authoritarianism /ɔːˌθɒrɪˈteərɪən[[ðɪʃç]]ˌɪz(ə)m/ *noun* a theory that a regime must rule its people strictly in order to be efficient

authoritarian regime /ɔːˌθɒrɪteərɪən reɪˈʒiːm/ *noun* a government which rules its people strictly and does not allow anyone to oppose its decisions

authoritative /ɔːˈθɒrɪtətɪv/ *adjective* **1.** having the force of law ○ *Courts in Member States cannot give authoritative rulings on how Community law should be interpreted.* **2.** based on the best reliable information ○ *an authoritative opinion on likely trends*

authority /ɔːˈθɒrəti/ *noun* **1.** official power given to someone to do something ○ *He has no authority to act on our behalf.* ○ *She was acting on the authority of the court.* ○ *On whose authority was the charge brought?* **2.** □ **the authorities** the government, police or official organisations with legal powers to control things

automatism /ɔːˈtɒmətɪz(ə)m/ *noun* a defence to a criminal charge whereby the accused states he or she acted involuntarily

autonomous /ɔːˈtɒnəməs/ *adjective* governing itself ○ *an autonomous regional government*

autonomy /ɔːˈtɒnəmi/ *noun* self-government, or freedom from outside control ○ *The separatists are demanding full autonomy for their state.* ○ *The government has granted the region a limited autonomy.*

autopsy /ˈɔːtɒpsi/ *noun* an examination of a dead person to see what was the cause of death

autrefois acquit /ˌəʊtrəfwæ əˈkiː/ *phrase* a French phrase meaning 'previously acquitted': a plea that an accused person has already been acquitted of the crime with which he or she is charged

COMMENT: There is no appeal against an acquittal, and a person who has been acquitted of a crime cannot be charged with the same crime again.

autrefois convict /ˌəʊtrəfwæ kɒn ˈvɪkt/ *phrase* a French phrase meaning 'previously convicted': a plea that an accused person has already been convicted of the crime with which he or she is now charged

available /əˈveɪləb(ə)l/ *adjective* able to be used ○ *The right of self-defence is only available against unlawful attack.*

aver /əˈvɜː/ *verb* to make a statement or an allegation in pleadings (NOTE: **averring – averred**)

average /ˈæv(ə)rɪdʒ/ *noun* **1.** a number calculated by adding together several figures and dividing by the number of figures added ○ *sales average* or *average of sales* ○ *The average for the last three months* or *the last three months' average.* □ **on average** in general ○ *On average, £15 worth of goods are stolen every day.* **2.** the sharing of the cost of damage or loss of a ship between the insurers and the owners ■ *adjective* **1.** calculated by adding together several figures and dividing by the number of figures added ○ *the average cost of expenses per employee* ○ *the average figures for the last three months* ○ *the average increase in prices* **2.** ordinary or typical ○ *The company's performance has been only average.* ○ *He is an average worker.* □ **above *or* below average** more or less than is usual or typical ■ *verb* to produce as an average figure ○ *Price increases have averaged 10% per annum.* ○ *Days lost through sickness have averaged twenty-two over the last four years.*

average adjuster /ˌæv(ə)rɪdʒ əˈdʒʌstə/ *noun* somebody who calculates how much is due to the insured when he or she makes a claim under his or her policy

average adjustment /ˌæv(ə)rɪdʒ əˈdʒʌstmənt/ *noun* a calculation of the share of cost of damage or loss of a ship

average income per capita /ˌæv(ə)rɪdʒ ˌɪnkʌm pə ˈkæpɪtə/ *noun* the average income of one person

averment /əˈvɜːmənt/ *noun* a statement or allegation made in pleadings

avoid /əˈvɔɪd/ *verb* **1.** to try not to do something ○ *The company is trying to avoid bankruptcy.* ○ *My aim is to avoid paying too much tax.* ○ *We want to avoid direct competition with Smith Ltd.* □ **to avoid creditors** to make sure that credi-

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Law.fm Page 25 Friday, June 11, 2004 2:08 PM

tors cannot find you so as not to pay them **2.** to make something void ○ *to avoid a contract* **3.** to quash a sentence

avoidance /ə'vɔɪd(ə)ns/ *noun* **1.** a plan or deliberate policy to avoid something or someone ○ *avoidance of an agreement* or *of a contract* **2.** a confession to a charge, but suggesting it should be cancelled

award /ə'wɔːd/ *noun* a decision which settles a dispute ○ *an award made by an industrial tribunal* ○ *The arbitrator's award was set aside on appeal.* ■ *verb* to decide the amount of money to be given to someone ○ *to award someone a salary increase* ○ *to award damages* ○ *The judge awarded costs to the defendant.* □ **to award a contract to a company** to decide that a company will have the contract to do work for you

AWOL /'eɪwɒl/ *abbreviation* absent without leave

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B

backdate /bæk'deɪt/ *verb* to put an earlier date on a cheque or an invoice ○ *Backdate your invoice to April 1st.* ○ *The pay increase is backdated to January 1st.*

background /'bækgraʊnd/ *noun* **1.** the previous experience, cultural background or family connections that someone has ○ *The accused is from a good background.* ○ *Can you tell us something of the girl's family background?* **2.** general facts about a situation including relevant information about what happened in the past ○ *He explained the background to the claim.* ○ *The court asked for details of the background to the case.* ○ *I know the contractual situation as it stands now, but can you fill in the background details?*

back interest /ˌbæk 'ɪntrəst/ *noun* interest which has not yet been paid

back orders /'bæk ˌɔːdəz/ *noun* orders received in the past and not yet supplied

back pay /'bæk peɪ/ *noun* salary which has not been paid

back payment /'bæk ˌpeɪmənt/ *noun* the payment of money which is owed

back rent /'bæk rent/ *noun* rent which has not been paid

backsheet /'bækʃiːt/ *noun* the last sheet of paper in a legal document which, when folded, becomes the outside sheet and carries the endorsement

back taxes /'bæk ˌtæksɪz/ *plural noun* taxes which have not been paid

back wages /ˌbæk 'weɪdʒɪz/ *plural noun* wages which have not been paid to a worker

bad debt /ˌbæd 'det/ *noun* money owed which will never be paid back

baggage check /'bægɪdʒ tʃek/ *noun* an examination of passengers' baggage to see if it contains bombs

bail /beɪl/ *noun* **1.** the release of an arrested person from custody after payment has been made to a court on condition that the person will return to face trial ○ *to stand bail of £3,000 for someone* (NOTE: The US term is **pretrial release**.) **2.** payment made to a court to release an arrested person ○ *He was granted bail on his own recognizance of £1,000.* ○ *The police opposed bail on the grounds that the accused might try to leave the country.* (NOTE: The US term is **pretrial release**.) □ **he was remanded on bail of £3,000** he was released on payment of £3,000 as a guarantee that he would return to the court to face trial □ **to jump bail** not to appear in court after having been released on bail ■ *verb* □ **to bail someone out** to pay a debt on behalf of someone ○ *She paid £3,000 to bail him out.*

bail bandit /'beɪl ˌbændɪt/ *noun* an accused person who commits a crime while on bail awaiting trial for another offence, or who fails to appear in court on the date agreed

bail bond /'beɪl bɒnd/ *noun* a signed document which is given to the court as security for payment of a judgment

bail bondsperson /ˌbeɪl 'bɒndzpɜːs(ə)n/ *noun* someone who provides bail money or acts as surety for an accused person

bailee /ˌbeɪ'liː/ *noun* somebody who receives property by way of bailment

Bailey ➧ **Old Bailey**

bailiff /'beɪlɪf/ *noun* **1.** a person employed by the court whose responsibility is to see that documents such as sum-

mainp - softvnn.com

Law.fm Page 27 Friday, June 11, 2004 2:08 PM

monses are served and that court orders are obeyed ○ *The court ordered the bailiffs to seize his property because he had not paid his fine.* (NOTE: The US equivalent is a **marshal**.) **2.** *US* the deputy to a sheriff

bailment /'beɪlmənt/ *noun* a transfer of goods by one person (the bailor) to another (the bailee) who then holds them until they have to be returned to the bailor. The process is that of leaving a coat in a cloakroom or at the cleaner's.

bailor /ˌbeɪ'lɔː/ *noun* somebody who transfers property by way of bailment

Bakke decision /'bækiː dɪˌsɪʒ(ə)n/ *noun* a US Supreme Court ruling that made the reservation of a specific number of places for students from minority groups unlawful because it prevented applicants not from those groups from competing for the reserved places

balance /'bæləns/ *noun* □ **balance of mind** mental state

ballot-rigging /'bælət ˌrɪgɪŋ/ *noun* an illegal attempt to manipulate the votes in an election so that a specific candidate or party wins

ban /bæn/ *noun* an order which forbids someone from doing something or which makes an activity illegal ○ *a government ban on the sale of weapons* ○ *a ban on the copying of computer software* □ **to impose a ban on smoking** to make an order which forbids smoking □ **to lift the ban on smoking** to allow people to smoke ■ *verb* to forbid something or make it illegal ○ *The government has banned the sale of alcohol.* ○ *The sale of pirated records has been banned.*

bank /bæŋk/ *noun* a business which holds money for its clients, lends money at interest, and trades generally in money ■ *verb* to deposit money into a bank or to have an account with a bank

bankable paper /ˌbæŋkəb(ə)l 'peɪpə/ *noun* a document which a bank will accept as security for a loan

bank account /'bæŋk əˌkaʊnt/ *noun* an arrangement which you make with a bank to keep your money safely until you want it

bank borrowings /'bæŋk ˌbɒrəʊɪŋz/ *plural noun* loans made by banks

bank charter /ˌbæŋk 'tʃɑːtə/ *noun* an official government document allowing the establishment of a bank

bank draft /'bæŋk drɑːft/ *noun* a cheque payable by a bank

banker's order /'bæŋkəz ˌɔːdə/ *noun* an order written by a customer asking a bank to make a regular payment to someone else

bank loan /'bæŋk ləʊn/ *noun* money lent by a bank

bank mandate /'bæŋk ˌmændeɪt/ *noun* a written order allowing someone to sign cheques on behalf of a company

bank note /'bæŋk nəʊt/**, banknote** *noun* a piece of printed paper money (NOTE: The US term is **bill**.)

bank reserves /ˌbæŋk rɪ'zɜːvz/ *plural noun* cash and securities held by a bank to cover deposits

bankrupt /'bæŋkrʌpt/ *adjective* declared by a court not capable of paying debts ○ *a bankrupt property developer* ○ *He was adjudicated* or *declared bankrupt.* ○ *He went bankrupt after two years in business.* ■ *noun* someone who has been declared by a court to be not capable of paying debts and whose affairs have been put into the hands of a trustee ■ *verb* to make someone become bankrupt ○ *The recession bankrupted my father.*

COMMENT: A bankrupt cannot serve as a Member of Parliament, a Justice of the Peace, a director of a limited company, and cannot sign a contract or borrow money.

bankruptcy /'bæŋkrʌptsi/ *noun* the state of being bankrupt ○ *The recession has caused thousands of bankruptcies.* (NOTE: The term bankruptcy is applied to individuals or partners, but not to companies. For companies, the term to use is 'insolvency'.) □ **adjudication of bankruptcy**, **declaration of bankruptcy** legal order making someone bankrupt ◇ **to file a petition in bankruptcy 1.** to apply to the Court to be made bankrupt **2.** to ask for someone else to be made bankrupt

mainp - softvnn.com

Law.fm Page 28 Friday, June 11, 2004 2:08 PM

Bankruptcy Court /ˈbæŋkrʌptsi kɔːt/ *noun* a court which deals with bankruptcies

bankruptcy notice /ˌbæŋkrʌptsi ˈnəʊtɪs/ *noun* a notice warning someone that they face bankruptcy if they fail to pay money which they owe

bankruptcy petition /ˌbæŋkrʌptsi pəˈtɪʃ(ə)n/ *noun* an application to a court asking for an order making someone bankrupt

bankruptcy proceedings /ˌbæŋkrʌptsi prəˈsiːdɪŋz/ *plural noun* a court case to make someone bankrupt

bank transfer /ˈbæŋk ˌtrænsfɜː/ *noun* the movement of money from a bank account to an account in another country

banning order /ˈbænɪŋ ˌɔːdə/ *noun* a court order to stop someone from going to a specific place (NOTE: **banning – banned**)

banns /bænz/ *plural noun* a declaration in church that a couple intend to get married ○ *to publish the banns of marriage between Anne Smith and John Jones*

bar /bɑː/ *noun* the set of rails in a court behind which the lawyers and public stand or sit □ **to be called to the bar** to pass examinations and fulfil specific requirements to become a barrister □ **prisoner at the bar** a prisoner being tried in court ■ *verb* to forbid something, or make something illegal ○ *He was barred from attending the meeting.* ○ *The police commissioner barred the use of firearms.* ◇ **the Bar 1.** the profession of barrister **2.** all barristers or lawyers

Bar Council /ˈbɑː ˌkaʊns(ə)l/ *noun* the ruling body of English and Welsh barristers

bareboat charter /ˈbeəbəʊt ˌtʃɑːtə/ *noun* a charter of a ship where the owner provides only the ship and not the crew, fuel or insurance

bargain /ˈbɑːgɪn/ *noun* an agreement between two people or groups to do something ■ *verb* to discuss something with someone in order to make an improvement for yourself

bargaining /ˈbɑːgɪnɪŋ/ *noun* the act of discussing something in order too reach an agreement that everyone is happy with. ◊ **plea bargaining**

bargaining position /ˈbɑːgɪnɪŋ pə ˌzɪʃ(ə)n/ *noun* a statement of position by one group during negotiations

bargaining power /ˈbɑːgɪnɪŋ ˌpaʊə/ *noun* the relative strength of one person or group when several people or groups are discussing prices, wages or contracts

baron /ˈbærən/ *noun* a prisoner who has power over other prisoners because he or she runs various rackets in a prison (*slang*)

barratry /ˈbærətri/ *noun* **1.** a criminal offence by which the master or crew of a ship damage the ship **2.** *US* an offence of starting a lawsuit with no grounds for doing so

barrister /ˈbærɪstə/ *noun* especially in England and Wales, a lawyer who can plead or argue a case in one of the higher courts

COMMENT: In England and Wales, a barrister is a member of one of the Inns of Court; he or she has passed examinations and spent one year in pupillage before being called to the bar. Barristers have right of audience in all courts in England and Wales, that is to say they have the right to speak in court, but they do not have that right exclusively. Note also that barristers were formerly instructed only by solicitors and never by members of the public.; now they can take instruction from professional people such as accountants. Barristers are now allowed to advertise their services. A barrister or a group of barristers is referred to as 'counsel'.

base /beɪs/ *noun* **1.** the lowest or first position **2.** the place where a company has its main office or factory, or the place where a businessperson has their office ○ *The company has its base in London and branches in all European countries.* ○ *He has an office in Madrid which he uses as a base while he is travelling in Southern Europe.* ■ *verb* **1.** to start to calculate or to negotiate from a position ○ *We based our calculations on last year's turnover.* **2.** to set up a company or a person in a place ○ *a London-based sales executive* ○ *The European manager is based in our London office.* ○ *Our foreign branch is based in the Bahamas.*

mainp - softvnn.com

Law.fm Page 29 Friday, June 11, 2004 2:08 PM

base costs /ˈbeɪs kɒsts/ *noun* the general costs of a case which apply before any percentage increase is assessed

based on /ˈbeɪst ɒn/ *noun* calculating from

base year /ˈbeɪs jɪə/ *noun* the first year of an index, against which later years' changes are measured

basic award /ˈbeɪsɪk əˌwɔːd/ *noun* a minimum award, which is the first stage of assessing compensation

basic rate tax /ˈbeɪsɪk reɪt ˌtæks/ *noun* the lowest rate of income tax

basics /ˈbeɪsɪks/ *plural noun* simple and important facts □ **to get back to basics** to start discussing the basic facts again

basis /ˈbeɪsɪs/ *noun* **1.** a point or number from which calculations are made ○ *We have calculated the turnover on the basis of a 6% price increase.* **2.** the general facts on which something is based ○ *We have three people working on a freelance basis.* □ **on a short-term, long-term basis** for a short or long period ○ *He has been appointed on a short-term basis.*

bastard /ˈbɑːstəd/ *noun* an illegitimate child, born to an unmarried mother (NOTE: The child now has some rights to the property of its parents.)

baton /ˈbætɒn/ *noun* a large stick used by the police for defence and to hit people with ○ *The crowd was stopped by a row of policemen carrying batons.*

baton charge /ˈbætɒn tʃɑːdʒ/ *noun* a charge by police using batons against a mob

baton round /ˈbætɒn raʊnd/ *noun* a thick bullet made of plastic fired from a special gun, used by the police only in self-defence. Also called **plastic bullet**

batter /ˈbætə/ *verb* to hit someone or something hard ○ *The dead man had been battered to death with a hammer.* ○ *Police were battering on the door of the flat.*

battered /ˈbætəd/ *adjective* frequently beaten as a punishment or act of cruelty □ **battered child, battered wife** a child who is frequently beaten by one of its parents, or a wife who is frequently beaten by her husband

battery /ˈbæt(ə)ri/ *noun* the crime or tort of using force against another person. Compare **assault**

beak /biːk/ *noun* a magistrate (*slang*)

bear /beə/ *verb* **1.** (*of costs*) to pay ○ *The company bore the legal costs of both parties.* **2.** □ **to bear on** to refer to or have an effect on ○ *The decision of the court bears on future cases where immigration procedures are disputed.*

bearing /ˈbeərɪŋ/ *noun* an influence or effect □ **to have a bearing on** to refer to or have an effect on ○ *The decision of the court has a bearing on future cases where immigration procedures are disputed.*

beat /biːt/ *noun* an area which a policeman patrols regularly □ **the constable on the beat** the ordinary policeman on foot patrol ■ *verb* □ **to beat a ban** to do something which is going to be forbidden by doing it rapidly before the ban is enforced

Beddoe order /ˈbedəʊ ˌɔːdə/ *noun* a court order allowing a trustee to bring or defend an action and to recover any resulting costs from the trust property

behalf /bɪˈhɑːf/ *noun* □ **on behalf of** acting for someone or a company ○ *solicitors acting on behalf of the American company* ○ *I am writing on behalf of the minority shareholders.* ○ *She is acting on my behalf.*

belli ➧ **casus belli**

bellman /ˈbelmən/ *noun* a criminal who specialises in stopping burglar alarms and other security devices (*slang*)

bench /bentʃ/ *noun* a place where judges or magistrates sit in court □ **to be up before the bench** to be in a magistrates' court, accused of a crime □ **he is on the bench** he is a magistrate

Bencher /ˈbentʃə/ *noun* one of the senior members of an Inn of Court

bench of magistrates /bentʃ əv ˈmædʒɪˌstreɪts/ *noun* a group of magistrates in an area

bench warrant /ˈbentʃ ˌwɒrənt/ *noun* a warrant issued by a court for the arrest of an accused person who has not appeared to answer charges

mainp - softvnn.com

Law.fm Page 30 Friday, June 11, 2004 2:08 PM

benefactor /'benɪfæktə/ *noun* somebody who gives property or money to others, especially in a will

beneficial interest /ˌbenɪfɪʃ(ə)l 'ɪntrəst/ *noun* the interest of the beneficiary of a property, shares or trust, which allows someone to occupy or receive rent from a property, while the property is owned by a trustee

beneficial occupier /ˌbenɪfɪʃ(ə)l 'ɒkjʊpaɪə/ *noun* somebody who occupies a property but does not own it

beneficial owner /ˌbenɪfɪʃ(ə)l 'əʊnə/ *noun* the true or ultimate owner whose interest may be concealed by a nominee

beneficial use /ˌbenɪ'fɪʃ(ə)l juːs/ *noun* the right to use, occupy or receive rent from a property which is owned by a trustee

beneficiary /ˌbenɪ'fɪʃəri/ *noun* **1.** somebody who is left property in a will ○ *The main beneficiaries of the will are the deceased's family.* **2.** somebody whose property is administered by a trustee

COMMENT: In a trust, the trustee is the legal owner of the property, while the beneficiary is the equitable owner who receives the real benefit of the trust.

benefit /'benɪfɪt/ *noun* **1.** money or advantage gained from something ○ *The estate was left to the benefit of the owner's grandsons.* **2.** payment which is made to someone under a national or private insurance scheme ○ *She receives £52 a week as unemployment benefit.* ○ *The sickness benefit is paid monthly.* ○ *The insurance office sends out benefit cheques each week.* ■ *verb* □ **to benefit from, by something** to be improved by something, to gain more money because of something

Benjamin order /'bendʒəmɪn ˌɔːdə/ *noun* an order from a court to a personal representative, which directs how someone's estate should be distributed

bent /bent/ *adjective* corrupt, stolen or illegal (*slang*) □ **bent copper** a corrupt policeman □ **bent job** an illegal deal

bequeath /bɪ'kwiːð/ *verb* to leave property, but not freehold land, to someone in a will ○ *He bequeathed his shares to his daughter.*

bequest /bɪ'kwest/ *noun* money or property, but not freehold land, given to someone in a will ○ *He made several bequests to his staff.*

COMMENT: Freehold land given in a will is a **devise**.

Berne Convention /'bɜːn kən ˌvenʃ(ə)n/ *noun* an international agreement on the regulations governing copyright, signed in Berne in 1886. ◊ **copyright**

COMMENT: Under the Berne Convention, any book which is copyrighted in a country which has signed the convention is automatically copyrighted in the other countries. Some countries (notably the USA) did not sign the Convention, and the UCC (Universal Copyright Convention) was signed in Geneva in 1952, under the auspices of the United Nations, to try to bring together all countries under a uniform copyright agreement.

best evidence rule /ˌbest 'evɪd(ə)ns ˌruːl/ *noun* the rule that the best evidence possible should be produced, so an original document is preferred to a copy

bestiality /ˌbesti'ælɪti/ *noun* buggery with an animal

betray /bɪ'treɪ/ *verb* to give away a secret ○ *He betrayed the secret to the enemy.* □ **to betray your country, a friend** to give away your country's or your friend's secrets to an enemy

betrayal /bɪ'treɪəl/ *noun* an act of betraying someone or something

betrayal of trust /bɪˌtreɪəl əv 'trʌst/ *noun* an act against someone who trusts you

betting duty /ˌbetɪŋ 'djuːti/ *noun* a tax levied on the activity of placing bets on horse and dog races, etc.

BFP *abbreviation US* bona fide purchaser

bi- /baɪ/ *prefix* twice

bias /'baɪəs/ *noun* unfairly different treatment of a person or group as compared with others □ **likelihood of bias** a possibility that bias will occur because of a connection between a member of the court and a party in the case

biased /'baɪəst/ *adjective* unfairly favouring a person or group as compared with others

mainp - softvnn.com

Law.fm Page 31 Friday, June 11, 2004 2:08 PM

bigamist /'bɪgəmɪst/ *noun* somebody who is married to two people at the same time

bigamous /'bɪgəməs/ *adjective* referring to bigamy ○ *They went through a bigamous marriage ceremony.*

bigamy /'bɪgəmi/ *noun* the notifiable offence of going through a ceremony of marriage to someone when you are still married to someone else. Compare **monogamy, polygamy**

bilateral /baɪ'læt(ə)rəl/ *adjective* (*of an agreement*) between two parties or countries ○ *The minister signed a bilateral trade agreement.*

bilateral contract /baɪˌlæt(ə)rəl kən 'trækt/ *noun* a contract where the two parties each have duties to the other

bilateral discharge /ˌbaɪlætər(ə)l 'dɪstʃɑːdʒ/ *noun* an agreement by two parties to bring a contract to an end by releasing each other from their existing obligations

bilaterally /ˌbaɪ'lætər(ə)li/ *adverb* between two parties or countries ○ *The agreement was reached bilaterally.*

bilking /'baɪkɪŋ/ *noun* the offence of removing goods without paying for them, or of refusing to pay a bill

bill /bɪl/ *noun* **1.** a written list of charges to be paid ○ *The salesman wrote out the bill.* ○ *Does the bill include VAT?* ○ *The bill is made out to Smith Ltd.* ○ *The builder sent in his bill.* ○ *He left the country without paying his bills.* □ **to foot the bill** to pay the costs **2.** a list of charges in a restaurant ○ *Can I have the bill please?* ○ *The bill comes to £20 including service.* ○ *Does the bill include service?* ○ *The waiter has added 10% to the bill for service.* **3.** a written paper promising to pay money **4.** *US* a piece of paper money **5.** a draft of a new law to be discussed by a legislature ○ *The house is discussing the Noise Prevention Bill.* ○ *The Finance Bill had its second reading yesterday.* ■ *verb* to present a bill to someone so that it can be paid ○ *The builders billed him for the repairs to his neighbour's house.*

COMMENT: In the UK, a Bill passes through the following stages in Parliament: **First Reading, Second Reading, Committee Stage, Report Stage** and **Third Reading.** The Bill goes through these stages first in the House of Commons and then in the House of Lords. When all the stages have been passed the Bill is given the Royal Assent and becomes law as an Act of Parliament. In the USA, a Bill is introduced either in the House or in the Senate, is referred to an appropriate committee with public hearings, then to general debate in the full House. The Bill is debated section by section and after being passed by both House and Senate is engrossed and sent to the President as a **joint resolution** for signature or veto.

bill of attainder /ˌbɪl əv ə'teɪndə/ *noun* formerly, a way of punishing a person legally without holding a trial, by passing a law to convict and sentence him

bill of exchange /ˌbɪl əv ɪks 'tʃeɪndʒ/ *noun* a document ordering the person to whom it is directed to pay a person money on demand or at a specified date

bill of health /ˌbɪl əv 'helθ/ *noun* a document given to the master of a ship showing that the ship is free of disease

bill of indictment /ˌbɪl əv ɪn 'daɪtmənt/ *noun US* **1.** a draft of an indictment which is examined by the court, and when signed becomes an indictment **2.** a list of charges given to a grand jury, asking them to indict the accused

bill of lading /ˌbɪl əv 'leɪdɪŋ/ *noun* a list of goods being shipped, which the shipper gives to the person sending the goods to show that they have been loaded

Bill of Rights /ˌbɪl əv 'raɪts/ *noun US* those sections (i.e. the first ten amendments) of the constitution of the United States which refer to the rights and privileges of an individual

bill of sale /ˌbɪl əv 'seɪl/ *noun* **1.** a document which the seller gives to the buyer to show that the sale has taken place **2.** a document given to a lender by a borrower to show that the lender owns the property as security for the loan

bills for collection /ˌbɪlz fə kə 'lekʃən/ *noun* bills where payment is due

bills payable /ˌbɪlz 'peɪəb(ə)l/ *noun* bills which a debtor will have to pay

mainp - softvnn.com

Law.fm Page 32 Friday, June 11, 2004 2:08 PM

bind /baɪnd/ *verb* to make someone obey a rule or keep a promise ○ *The company is bound by its articles of association.* ○ *He does not consider himself bound by the agreement which was signed by his predecessor.* ○ *High Court judges are bound by the decisions of the House of Lords.*

binder /'baɪndə/ *noun US* a temporary acknowledgement of a contract of insurance sent before the insurance policy is issued (NOTE: The British English term is **cover note**.)

binding /'baɪndɪŋ/ *adjective* having the ability to force someone to do something ○ *This document is legally binding* or *it is a legally binding document.* □ **the agreement is binding on all parties** all parties signing it must do what is agreed

binding precedent /ˌbaɪndɪŋ 'presɪd(ə)nt/ *noun* a decision of a higher court which has to be followed by a judge in a lower court

bind over /ˌbaɪnd 'əʊvə/ *verb* **1.** to make someone promise to behave well and not commit another offence, or to return to court at a later date to face charges ○ *He was bound over (to keep the peace* or *to be of good behaviour) for six months.* **2.** *US* to order a defendant to be kept in custody while a criminal case is being prepared

bind-over order /ˌbaɪnd 'əʊvə ˌɔːdə/ *noun* a court order which binds someone over ○ *The applicant sought judicial review to quash the bind-over order.*

biological parent /ˌbaɪəˌlɒdʒɪk(ə)l 'peərəmt/ *noun* the mother or father to whom a child is born. Compare **adoptive parent, stepparent, foster parent**

birth /bɜːθ/ *noun* the occasion of being born, or the social position relating to the circumstances of it. ◊ **concealment of birth** □ **by birth** according to where or to what family someone was born ○ *He's English by birth.* □ **date and place of birth** the day of the year when someone was born and the town where he or she was born

birth certificate /'bɜːθ səˌtɪfɪkət/ *noun* a document giving details of a person's date and place of birth

black /blæk/ *adjective* □ **to pay black market prices** to pay high prices to get items which are not easily available

black economy /ˌblæk ɪ'kɒnəmi/ *noun* the system by which work is paid for in cash or goods and not declared to the tax authorities

black letter law /ˌblæk 'letə ˌlɔː/ *noun* emphasis on the fundamental principles of law, as opposed to discussion of possible changes to the legal system to make it more perfect (*informal*)

black list /'blæk lɪst/ *noun* a list of goods, people or companies which have been blacked

blacklist /'blæklɪst/ *verb* to put goods, people or a company on a black list ○ *His firm was blacklisted by the government.*

blackmail /'blækmeɪl/ *noun* the notifiable offence of getting money from someone by threatening to make public information which he or she does not want revealed or by threatening violence ○ *He was charged with blackmail.* ○ *They got £25,000 from the managing director by blackmail.* ○ *She was sent to prison for blackmail.* ■ *verb* to threaten someone that you will make public information which he or she does not want revealed or to threaten an act of violence unless he or she pays you money ○ *He was blackmailed by his former secretary.*

blackmailer /'blækmeɪlə/ *noun* somebody who blackmails someone

black market /ˌblæk 'mɑːkɪt/ *noun* the illegal buying and selling goods that are not easily available or in order to avoid taxes ○ *There is a lucrative black market in spare parts for cars.* ○ *You can buy gold coins on the black market.* ○ *They lived well on black-market goods.*

black marketeer /ˌblæk ˌmɑːkə'tiːə/ *noun* somebody who sells goods on the black market

blag /blæg/ *noun* a robbery by an armed gang (*slang*)

blanche ➧ **carte blanche**

blank /blæŋk/ *adjective* with nothing written ■ *noun* a space on a form which has to be completed ○ *Fill in the blanks in block capitals.*

blank cheque /ˌblæŋk 'tʃek/ *noun* a cheque with the amount of money and

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Law.fm Page 33 Friday, June 11, 2004 2:08 PM

the payee left blank, but signed by the drawer

blanket agreement /ˌblæŋkɪt ə ˈgriːmənt/ *noun* an agreement which covers many different items

blanket insurance policy /ˌblæŋkɪt ɪnˈʃʊərəns ˌpɒlɪsi/ *noun* a policy covering several items

blaspheme /blæsˈfiːm/ *verb* to ridicule or deny God or the Christian religion

blasphemy /ˈblæsfəmi/ *noun* formerly, the crime of ridiculing or denying God or the Christian religion in a scandalous way

block /blɒk/ *noun* **1.** a series of items grouped together ○ *He bought a block of 6,000 shares.* **2.** a series of buildings forming a square with streets on all sides **3.** a building in a prison ○ *a cell block* ○ *a hospital block* ■ *verb* to stop something taking place ○ *He used his casting vote to block the motion.* ○ *The planning committee blocked the plan to build a motorway through the middle of the town.*

blocked currency /ˌblɒkt ˈkʌrənsi/ *noun* a currency which cannot be taken out of a country because of exchange controls

block exemption /ˌblɒk ɪg ˈzempʃ(ə)n/ *noun* an exemption granted to a large business or group of businesses exempting them from some obligations under competition law

blood relationship /ˌblʌd rɪ ˈleɪʃ(ə)nʃɪp/ *noun* a relationship between people who have a common ancestor

blood sample /ˈblʌd ˌsɑːmpəl/ *noun* a small amount of blood taken from someone for a blood test in order to establish something such as the alcohol content of the blood

blood test /ˈblʌd test/ *noun* a test to establish the paternity of a child

blotter /ˈblɒtə/ *noun US* a book in which arrests are recorded at a police station

blue bag /ˈbluː bæg/ *noun* the blue bag in which a junior barrister carries his or her gown. ◊ **red bag**

Blue Book /ˌbluː ˈbʊk/ *noun* an official report of a Royal Commission, bound in blue covers

blue laws /ˈbluː lɔːz/ *plural noun US* laws relating to what can or cannot be done on a Sunday

blue sky laws /ˌbluː ˈskaɪ ˌlɔːz/ *plural noun US* state laws to protect investors against fraudulent traders in securities

board meeting /ˈbɔːd ˌmiːtɪŋ/ *noun* a meeting of the directors of a company

board of directors /ˌbɔːd əv daɪ ˈrektəz/ *noun* a group of directors elected by the shareholders to run a company ○ *The bank has two representatives on the board.* ○ *He sits on the board as a representative of the bank.* ○ *Two directors were removed from the board at the AGM.*

board of visitors /ˌbɔːd əv ˈvɪzɪtəs/ *noun* in the UK, a group of people appointed by the Home Secretary to visit and inspect the conditions in prisons

bobby /ˈbɒbi/ *noun* a policeman (*informal*)

bodily /ˈbɒdɪli/ *adjective* affecting someone's body ○ *Fortunately no bodily harm had been caused.* ■ *adverb* **1.** in a way that has an effect on the body ○ *The police lifted the protester bodily and removed him from the street.* **2.** in person ○ *She had not been bodily present when the fight had started.*

body /ˈbɒdi/ *noun* **1.** the whole of a person or animal **2.** an organisation or group of people who work together ○ *Parliament is an elected body.* ○ *The governing body of the university has to approve the plan to give the President a honorary degree.* **3.** a large group or amount ○ *a body of evidence* □ **body of opinion** a group of people who have the same view about something ○ *there is a considerable body of opinion which believes that capital punishment should be reintroduced*

bodyguard /ˈbɒdigɑːd/ *noun* somebody who protects someone ○ *The minister was followed by his three bodyguards.*

bogus caller /ˌbəʊgəs ˈkɔːlə/ *noun* someone who claims to be an official in

mainp - softvnn.com

Law.fm Page 34 Friday, June 11, 2004 2:08 PM

order to be allowed to enter a home in order to steal from it

boilerplate /ˈbɔɪləpleɪt/ *noun US* a standard form of agreement or contract with blank spaces to be filled in

bomb hoax /ˈbɒm həʊks/ *noun* the act of placing an imitation bomb in a public place or making a phone call to report a bomb which does not exist

bona fide purchaser /ˌbəʊnə ˌfaɪdi ˈpɜːtʃəsə/ *noun* a purchaser who buys something in good faith

bona fides /ˌbəʊnə ˈfaɪdiːz/**, bona fide** /ˌbəʊnə ˈfaɪdi/ *phrase* a Latin phrase meaning 'good faith' or 'in good faith' ○ *He acted bona fide.* ○ *The respondent was not acting bona fides.* □ **a bona fide offer** an offer which is made honestly, which can be trusted

bona vacantia /ˌbəʊnə vəˈkæntiə/ *noun* property with no owner, or which does not have an obvious owner, and which usually passes to the Crown, as in the case of the estate of a person without living relatives dying without having made a will

bond /bɒnd/ *noun* **1.** a contract document promising to repay money borrowed by a company or by the government ○ *government bonds* or *treasury bonds* **2.** a contract document promising to repay money borrowed by a person **3.** a signed legal document which binds one or more parties to do or not to do something □ **goods (held) in bond** goods held by the customs until duty has been paid □ **entry of goods under bond** bringing goods into a country in bond □ **to take goods out of bond** to pay duty on goods so that they can be released by the customs

bonded /ˈbɒndɪd/ *adjective* held in bond

bonded goods /ˈbɒndɪd gʊdz/ *plural noun* goods which are held by the customs under a bond until duty has been paid

bondholder /ˈbɒndhəʊldə/ *noun* somebody who holds government bonds

bondsman /ˈbɒndzmən/**, bondsperson** *noun* somebody who has stood surety for another person

book /bʊk/ *noun* □ **to bring someone to book** to find a suspect and charge him with a crime □ **to throw the book at someone** to charge someone with every possible crime (*informal*) ○ *If ever we get the gang in the police station, we'll throw the book at them.* ■ *verb* **1.** to order or to reserve something ○ *to book a room in a hotel* or *a table at a restaurant* or *a ticket on a plane* ○ *I booked a table for 7.45.* ○ *He booked a ticket through to Cairo.* □ **to book someone into a hotel, onto a flight** to order a room or a plane ticket for someone **2.** to charge someone with a crime (*informal*) ○ *He was booked for driving on the wrong side of the road.*

book value /ˈbʊk vælju:/ *noun* the value of a company's assets as shown in the company accounts

boot camp /ˈbuːt kæmp/ *noun US* a camp providing a form of treatment for young offenders where they are subjected to harsh discipline for a short period

bootleg /ˈbuːtleg/ *adjective* (*of alcohol*) illegally produced and sold

bootlegger /ˈbuːtlegə/ *noun* somebody who makes or supplies illicit alcohol

bootlegging /ˈbuːtlegɪŋ/ *noun* **1.** the production of illicit alcohol **2.** the production of illegal records or tapes from live concerts

borrow /ˈbɒrəʊ/ *verb* **1.** to take money from someone for a time, possibly paying interest for it, and repaying it at the end of the period ○ *He borrowed £1,000 from the bank.* ○ *The company had to borrow heavily to repay its debts.* ○ *They borrowed £25,000 against the security of the factory.* **2.** to steal (*slang*)

borrower /ˈbɒrəʊə/ *noun* somebody who borrows ○ *Borrowers from the bank pay 12% interest.*

borrowing /ˈbɒrəʊɪŋ/ *noun* the action of borrowing money ○ *The new factory was financed by bank borrowing.*

borrowing power /ˈbɒrəʊɪŋ ˌpaʊə/ *noun* the amount of money which a company can borrow

borrowings /ˈbɒrəʊɪŋz/ *plural noun* money borrowed ○ *The company's borrowings have doubled.*

mainp - softvnn.com

Law.fm Page 35 Friday, June 11, 2004 2:08 PM

borstal /'bɔːst(ə)l/ *noun* formerly, a centre where a young offender was sent for training after committing a crime which would normally be punishable by a prison sentence (NOTE: Now replaced by **Young Offender Institutions**.)

boss /bɒs/ *noun* the head of a Mafia family or other criminal gang

bottomry /'bɒtəmri/ *noun* the mortgage of a ship or cargo

bottomry bond /'bɒtəmri bɒnd/ *noun* a bond which secures a ship or cargo against a loan

bounce /baʊns/ *verb* to be returned to the person who has tried to cash it, because there is not enough money in the payer's account to pay it (*informal*) ○ *He paid for the car with a cheque that bounced.*

bound /baʊnd/ ➧ **duty bound**

boundary /'baʊnd(ə)ri/, **boundary line** /'baʊnd(ə)ri laɪn/ *noun* a line marking the edge of a piece of land owned by someone ○ *The boundary dispute dragged through the courts for years.*

Boundary Commission /ˌbaʊnd(ə)ri kə'mɪʃ(ə)n/ *noun* a committee which examines the area and population of constituencies for the House of Commons and recommends changes to ensure that each Member of Parliament represents approximately the same number of people

bounty /'baʊnti/ *noun* a payment made by government to someone who has saved lives or found treasure

box /bɒks/ *noun* ➧ **witness box**

box file /'bɒks faɪl/ *noun* a cardboard box for holding documents

bracelets /'breɪsləts/ *plural noun* handcuffs (*slang*)

branch /brɑːntʃ/ *noun* **1.** a local office of a bank or large business ○ *The bank* or *the store has branches in most towns in the south of the country.* ○ *The insurance company has closed its branches in South America.* ○ *He is the manager of our local branch of Lloyds bank.* ○ *We have decided to open a branch office in Chicago.* ○ *The manager of our branch in Lagos* or *of our Lagos branch.* **2.** a local shop of a large chain of shops **3.** a part or separate section of a area of knowledge or study such as the law ○ *The Law of Contract and the Law of Tort are branches of civil law.* **4.** ➧ **Special Branch**

branded goods /ˌbrændɪd 'gʊdz/ *plural noun* goods sold under brand names

brand name /'brænd neɪm/ *noun* the name of a particular make of product

breach /briːtʃ/ *noun* **1.** failure to carry out the terms of an agreement ○ *They alleged that a breach of international obligations had been committed.* □ **in breach of** failing to do something which was agreed, not acting according to ○ *We are in breach of Community law.* ○ *The defendant is in breach of his statutory duty.* **2.** failure to obey the law ○ *The soldier was charged with a serious breach of discipline.*

COMMENT: Anyone can arrest a person who is committing a breach of peace; a policeman can arrest someone who is committing a breach of the peace without charging him.

breach of confidence /ˌbriːtʃ əv 'kɒnfɪd(ə)ns/ *noun* the release of confidential information without permission

breach of contract /ˌbriːtʃ əv 'kɒntrækt/ *noun* an act of breaking the terms of a contract □ **the company is in breach of contract** the company has failed to carry out what was agreed in the contract

breach of promise /ˌbriːtʃ əv 'prɒmɪs/ *noun* formerly, a complaint in court that someone had promised to marry the claimant and then had not done so

breach of the peace /ˌbriːtʃ əv ðə 'piːs/ *noun* the act of creating a disturbance which is likely to annoy or frighten people

breach of trust /ˌbriːtʃ əv 'trʌst/ *noun* a failure on the part of a trustee to act properly in regard to a trust

breach of warranty /ˌbriːtʃ əv 'wɒrənti/ *noun* a failure to supply goods which not meet the standards of the warranty applied to them

break /breɪk/ *noun* a short space of time when you can rest ○ *The court adjourned for a ten-minute break.* ■ *verb* **1.** □ **to break the law** to do something

mainp - softvnn.com

Law.fm Page 36 Friday, June 11, 2004 2:08 PM

which is against the law ○ *If you hit a policeman you will be breaking the law.* ○ *He is breaking the law by parking on the pavement.* ○ *The company broke section 26 of the Companies Act.* **2.** ○ *The company has broken the contract* or *the agreement.* □ **to break a contract** to fail to carry out the duties of a contract ○ *The company has broken the contract* or *the agreement.* □ **to break an engagement to do something** not to do what has been agreed

breakages /'breɪkɪdʒɪz/ *plural noun* items that have been broken ○ *Customers are expected to pay for breakages.*

break down /ˌbreɪk 'daʊn/ *verb* **1.** to stop working because of mechanical failure ○ *The two-way radio has broken down.* ○ *What do you do when your squad car breaks down?* **2.** to stop ○ *negotiations broke down after six hours* ○ *Their marriage broke down and they separated.* **3.** to show all the items in a total list ○ *We broke the crime figures down into crimes against the person and crimes against property.* ○ *Can you break down this invoice into spare parts and labour?*

breakdown /'breɪkˌdaʊn/ *noun* **1.** an occasion of stopping work because of mechanical failure ○ *We cannot communicate with our squad car because of the breakdown of the radio link.* **2.** a situation in which something such as discussions or negotiations fail or begin to fail ○ *a breakdown in talks* **3.** □ **irretrievable breakdown of a marriage** situation where the two spouses can no longer live together, where the marriage cannot be saved and therefore divorce proceedings can be started **4.** the process of showing details item by item ○ *Give me a breakdown of the latest clear-up figures.*

break in /ˌbreɪk 'ɪn/ *verb* to go into a building by force in order to steal ○ *Burglars broke in through a window at the back of the house.*

break-in /'breɪk ɪn/ *noun* the crime of breaking into a house (*informal*) ○ *There have been three break-ins in our street in one week.*

breaking and entering /ˌbreɪkɪŋ ənd 'entərɪŋ/ *noun* the crime of going into a building by force and stealing things ○ *He was charged with breaking and entering.* ◊ **housebreaking**

break into /ˌbreɪk 'ɪntə/ *verb* to go into a building by force to steal things ○ *Their house was broken into while they were on holiday.* ○ *Looters broke into the supermarket.*

break off /ˌbreɪk 'ɒf/ *verb* to stop ○ *We broke off the discussion at midnight.* ○ *Management broke off negotiations with the union.*

break up /ˌbreɪk 'ʌp/ *verb* **1.** to split something large into small sections ○ *The company was broken up and separate divisions sold off.* **2.** to come to an end, or make something come to an end ○ *The meeting broke up at 12.30.* ○ *The police broke up the protest meeting.*

breathalyse /'breθəlaɪz/ *verb* to test someone's breath using a breathalyser

breathalyser /'breθəlaɪzə/ *noun* a device for testing the amount of alcohol a person has drunk by testing his or her breath

breath test /'breθ test/ *noun* a test where a person's breath is sampled to establish the amount of alcohol he or she has drunk

bribe /braɪb/ *noun* money offered corruptly to someone to get him to do something to help you ○ *The police sergeant was dismissed for taking bribes.* ■ *verb* to give someone a bribe ○ *He bribed the police sergeant to get the charges dropped.*

bribery /'braɪb(ə)ri/ *noun* the crime of giving someone a bribe ○ *Bribery in the security warehouse is impossible to stamp out.*

bridewell /'braɪwel/ *noun* the cells in a police station (*slang*)

brief /briːf/ *noun* **1.** details of a client's case, prepared by a solicitor and given to the barrister who is going to argue the case in court **2.** a lawyer or barrister (*slang*) ■ *verb* to explain something to someone in detail ○ *The superintendent briefed the press on the progress of the investigation.* □ **to brief a barrister** to give a barrister all the details of the case which he or she will argue in court

briefing /'briːfɪŋ/ *noun* an occasion when someone is given details about

mainp - softvnn.com

Law.fm Page 37 Friday, June 11, 2004 2:08 PM

something that is going to happen ○ *All the detectives on the case attended a briefing given by the commander.*

bring forward /ˌbrɪŋ ˈfɔːwəd/ *verb* to make earlier ○ *to bring forward the date of repayment* ○ *The date of the hearing has been brought forward to March.*

bring in /ˌbrɪŋ ˈɪn/ *verb* to decide a verdict ○ *The jury brought in a verdict of not guilty.*

bring up /ˌbrɪŋ ˈʌp/ *verb* to refer to something for the first time ○ *The chairman brought up the question of corruption in the police force.*

brothel /ˈbrɒθ(ə)l/ *noun* a house where sexual intercourse is offered for money

bug /bʌg/ *noun* a small device which can record conversations secretly and send them to a secret radio receiver ○ *The cleaners planted a bug under the lawyer's desk.* Also called **bugging device, surveillance device** ■ *verb* to place a secret device in a place so that conversations can be heard and recorded secretly ○ *The agents bugged the President's office.*

buggery /ˈbʌgəri/ *noun* a notifiable offence of sexual intercourse with animals, or rectal intercourse with man or woman

bugging device /ˈbʌgɪŋ dɪˌvaɪs/ *noun* same as **bug** ○ *Police found a bugging device under the lawyer's desk.*

building permit /ˈbɪldɪŋ ˌpɜːmɪt/ *noun* an official document which allows someone to build on a piece of land

Bullock order /ˈbʊlək ˌɔːdə/ *noun* in civil proceedings where the claimant has succeeded in establishing a claim against one defendant but has failed in relation to the second defendant, an order that requires the claimant to pay the successful defendant's costs but allows the money which will come from the unsuccessful defendant to be included

bumping /ˈbʌmpɪŋ/ *noun* **1.** a series of movements of staff between jobs which results in the final person in the chain being made redundant **2.** *US* a situation where a senior employee takes the place of a junior employee

bunco /ˈbʌŋkəʊ/ *noun* a dishonest act of cheating someone out of money, usually at cards (*slang*)

bundle /ˈbʌnd(ə)l/ *noun* ➧ **trial bundle**

burden of proof /ˌbɜːd(ə)n əv ˈpruːf/ *noun* the duty to prove that something which has been alleged in court is true □ **to discharge a burden of proof** to prove something which has been alleged in court □ **the burden of proof is on the prosecution** the prosecution must prove that what it alleges is true

bureau /ˈbjʊərəʊ/ *noun* an office which specialises in particular work

burglar /ˈbɜːglə/ *noun* a person who steals or tries to steal goods from property, or who enters property intending to commit a crime

burglar alarm /ˈbɜːglər əˌlɑːm/ *noun* a bell which is set to ring when someone tries to break into a house or shop ○ *As he put his hand through the window he set off the burglar alarm.*

burglarise, burglarize *verb US* to steal goods from property (*informal*)

burglary /ˈbɜːgləri/ *noun* the crime of going into a building at night, usually by force, and stealing things ○ *He was charged with burglary.* ○ *There has been a series of burglaries in our street.*

burgle /ˈbɜːg(ə)l/ *verb* to steal goods from property ○ *The school was burgled when the caretaker was on holiday.*

burn /bɜːn/ *verb* to destroy by fire ○ *The chief accountant burned the documents before the police arrived.* (NOTE: **burning – burned** *or* **burnt**)

burn down /ˌbɜːn ˈdaʊn/ *verb* to destroy completely in a fire

business /ˈbɪznɪs/ *noun* **1.** the work of buying or selling □ **on business** on commercial work **2.** a commercial company ○ *He owns a small car repair business.* ○ *She runs a business from her home.* ○ *He set up in business as an insurance broker.* **3.** something that has to be discussed or dealt with ○ *The main business of the meeting was finished by 3 p.m.* □ **any other business** an item at the end of an agenda, where any matter can be raised. Abbreviation **AOB** □ **move the business forward** go on to the next item on the agenda

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Law.fm Page 38 Friday, June 11, 2004 2:08 PM

business call /ˈbɪznɪs kɔːl/ *noun* a visit to talk to someone on business

business day /ˈbɪznɪs deɪ/ *noun* any day except Saturdays, Sundays or bank holidays

business expenses /ˈbɪznɪs ɪk ˌspensɪz/ *plural noun* money spent on running a business, not on stock or assets

business hours /ˈbɪznɪs ˌaʊəz/ *plural noun* the period, usually between 9 a.m. and 5–6 p.m., when a business is staffed and open to the public

business letter /ˈbɪznɪs ˌletə/ *noun* a letter which deals with business matters

business name /ˈbɪznɪs neɪm/ *noun* the name under which a firm or company trades

business practices /ˈbɪznɪs ˌpræktɪsɪz/ *plural noun* ways of managing or working in business, industry or trade

business premises /ˈbɪznɪs ˌpremɪsɪz/ *plural noun* a building or set of buildings and land used for the purpose of carrying out a business activity

business transaction /ˈbɪznɪs træn ˌzækʃən/ *noun* the activity or an act of buying or selling something

bust /bʌst/ *verb* to catch and punish someone for doing something that is illegal

bylaw /ˈbaɪlɔː/**, byelaw, by-law, byelaw** *noun* **1.** a rule governing an aspect of the internal running of a corporation, club or association such as number of meetings or election of officers **2.** a rule or law made by a local authority or public body and not by central government ○ *The bylaws forbid playing ball in the public gardens.* ○ *According to the local bylaws, noise must be limited in the town centre.*

COMMENT: Bylaws must be made by bodies which have been authorized by Parliament before they can become legally effective.

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C

© the copyright symbol

COMMENT: The symbol adopted by the Universal Copyright Convention in Geneva in 1952. Publications bearing the symbol are automatically covered by the convention. The copyright line in a book should give the © followed by the name of the copyright holder and the date.

CAB *abbreviation* Citizens' Advice Bureau

cadaver /kə'dævə/ *noun US* a dead human body (NOTE: The British term is **corpse**.)

cadet /kə'det/ *noun* a trainee police officer ○ *He has entered the police cadet college.* ○ *She joined the police force as a cadet.*

calendar /'kælɪndə/ *noun* a book or set of sheets of paper showing all the days and months in a year ○ *a desk calendar*

calendar month /'kælɪndə mʌnθ/ *noun* a whole month as on a calendar, from the 1st to the 28th, 30th or 31st

calendar year /ˌkælɪndə 'jɪə/ *noun* one year from the 1st January to 31st December

call /kɔːl/ *noun* **1.** a conversation on the telephone **2.** a demand for repayment of a loan by a lender **3.** a demand by a company to pay for shares **4.** the admission of a barrister to the bar **5.** a particular number of years a barrister has practised at the bar □ **he is ten years' call** he has been practising for ten years **6.** a visit ○ *The doctor makes six calls a day.* ■ *verb* **1.** to telephone to someone ○ *I shall call you at your office tomorrow.* **2.** to admit someone to the bar to practise as a barrister ○ *He was called (to the bar) in 1989.*

call in /ˌkɔːl 'ɪn/ *verb* **1.** to ask someone to come to help ○ *The local police decided to call in the CID to help in the murder hunt.* **2.** to ask for plans to be sent to the ministry for examination ○ *The minister has called in the plans for the new supermarket.*

camera /'kæm(ə)rə/ ◗ **in camera**

campaign /kæm'peɪn/ *noun* a planned method of working ○ *The government has launched a campaign against drunken drivers.* ■ *verb* to try to change something by writing about it, organising protest meetings or lobbying Members of Parliament ○ *They are campaigning for the abolition of the death penalty* or *they are campaigning against the death penalty.* ○ *She is campaigning for the re-introduction of the death penalty.* ○ *He is campaigning for a revision of the Official Secrets Act.*

campaigner /kæm'peɪnə/ *noun* a person who is working actively to support an issue or organisation ○ *He is an experienced political campaigner.* ○ *She is a campaigner for women's rights.*

cancel /'kænsəl/ *verb* **1.** to stop something which has been agreed or planned ○ *to cancel an appointment* or *a meeting* ○ *to cancel a contract* **2.** □ **to cancel a cheque** to stop payment of a cheque which you have signed

cancellandi ◗ **animus cancellandi**

cancellation /ˌkænsə'leɪʃ(ə)n/ *noun* the act of stopping something which has been agreed or planned ○ *cancellation of an appointment* ○ *cancellation of an agreement*

cancellation clause /ˌkænsə 'leɪʃ(ə)n klɔːz/ *noun* a clause in a contract which states the terms on which the contract may be cancelled

candidacy /'kændɪdəsi/, **candidature** /'kændɪdətʃə/ *noun* the state of be-

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Law.fm Page 40 Friday, June 11, 2004 2:08 PM

ing a candidate ○ *The Senator has announced his candidacy for the Presidential election.*

candidate /'kændɪdeɪt/ *noun* **1.** somebody who applies for a job ○ *There are six candidates for the post of security guard.* ○ *We interviewed ten candidates for the job.* **2.** somebody who puts themselves forward for election ○ *Which candidate are you voting for?*

canon law /ˌkænən 'lɔː/ *noun* law applied by the Anglican and Roman Catholic churches to priests (NOTE: Formerly it was also applied to other members of the church in cases of marriage, legitimacy and personal property.)

capacity /kə'pæsɪti/ *noun* **1.** the amount of something which can be produced or contained **2.** the amount of space that exists somewhere **3.** ability ○ *He has a particular capacity for hard work.* **4.** the ability to enter into a legally binding agreement, which is one of the essential elements of a contract □ **person of full age and capacity** person who is over eighteen years of age and of sound mind, and therefore able to enter into a contract **5.** a role or job □ **in his capacity as chairman** acting as chairman □ **speaking in an official capacity** speaking officially

capax ◆ **doli capax**

capias /'kæpiæs/ *phrase* a Latin word meaning 'that you take': used in phrases to indicate that several writs have been issued together

capias ad respondendum /ˌkæpiæs æd ˌrespɒn'dendəm/ *noun* a writ for the arrest of a defendant and an order to attend court

capita /'kæpɪtə/ ◆ **per capita**

capital /'kæpɪt(ə)l/ *noun* **1.** the money, property and assets used in a business □ **to make political capital out of something** to use something to give you an advantage in politics ○ *The Opposition made a lot of capital out of the Minister's mistake on TV.* ◇ **expenditure 2.** a town or city where the government of a province or country is situated ○ *London is the capital of England and Washington is the capital of the USA.*

capital allowance /ˌkæpɪt(əl ə 'laʊəns/ *noun* a variable tax reduction resulting from the expenditure on items such as plant and machinery used in connection with the business

capital assets /ˌkæpɪt(ə)l 'æsets/ *plural noun* property or machinery which a company owns and uses in its business

capital crime /ˌkæpɪt(ə)l 'kraɪm/ *noun* a crime for which the punishment is death (NOTE: In the UK the only capital crime is now treason.)

capital expenditure /ˌkæpɪt(ə)l ɪk 'spendɪtʃə/ *noun* **1.** money spent on assets such as property or machinery **2.** the major costs of a council or central government, such as schools, roads, hospitals, etc.

capital gains /ˌkæpɪt(ə)l 'geɪnz/ *plural noun* money made by selling a fixed asset or by selling shares at a profit

capital gains tax /ˌkæpɪt(ə)l 'geɪnz ˌtæks/ *noun* the tax payable where an asset has increased in value during the period of ownership. Abbreviation **CGT**

capital goods /'kæpɪt(ə)l gʊdz/ *plural noun* machinery, buildings and raw materials which are used in the production of goods

capital letters /ˌkæpɪt(ə)l 'letəz/ *plural noun* letters written as A, B, C, D, etc., and not as a, b, c, d, etc. ○ *Write your name in block capitals at the top of the form.*

capital levy /ˌkæpɪt(ə)l 'levi/ *noun* a tax on the value of a person's property and possessions

capital loss /ˌkæpɪt(ə)l 'lɒs/ *noun* a loss made by selling assets

capital punishment /ˌkæpɪt(ə)l 'pʌnɪʃmən(ə)t/ *noun* punishment of a criminal by execution

capital transfer tax /ˌkæpɪt(ə)l 'trænsfɜː ˌtæks/ *noun* a tax paid on the transfer of capital or assets from one person to another. Abbreviation **CTT**

Capitol /'kæpɪt(ə)l/ *noun US* the building in Washington, D.C. where the US Senate and House of Representatives meet

Capitol Hill /ˌkæpɪt(ə)l 'hɪl/ *noun US* the hill on which the Capitol building

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Law.fm Page 41 Friday, June 11, 2004 2:08 PM

stands, together with other important government buildings

caption /'kæpʃən/ *noun* a formal heading for an indictment, affidavit or other court document, giving details such as the names of the parties, the court which is hearing the case, and relevant reference numbers

card file /'kɑːd faɪl/ *noun* information kept in alphabetical order on small cards

card holder /'kɑːd ˌhəʊldə/ *noun* a frame which protects a card or a message

card sharper /'kɑːd ˌʃɑːpə/ *noun* somebody who makes a living by cheating at cards

care /keə/ *noun* **1.** the act of looking after someone ○ *The children were put in the care of the social services department.* **2.** the activity of making sure that someone is not harmed

care and control /ˌkeə ən kən'trəʊl/ *noun* responsibility for day-to-day decisions relating to the welfare of a child

careless /'keələs/ *adjective* without paying attention to other people □ **careless driving** driving without due care and attention □ **causing death by careless driving** the offence committed by an individual who is unfit to drive as a result drink or drugs, causing the death of another person

care order /'keə ˌɔːdə/ *noun* a court order placing a child under the care of a local authority, granted when the child is suffering or likely to suffer significant harm if it continues to remain under its parents care

care proceedings /'keə prəˌsiːdɪŋz/ *plural noun* court proceedings to determine whether a child should be made the subject of a care order. ◊ **care order**

car insurance /'kɑːr ɪnˌʃʊərəns/ *noun* insuring a car, the driver and passengers in case of accident

carriageway /'kærɪdʒweɪ/ *noun* a public way where people have a right to go in vehicles

carrier /'kæriə/ *noun* a person or company which takes goods from one place to another

carrier's lien /ˌkæriəz 'liːən/ *noun* the right of a carrier to hold goods until he or she has been paid for carrying them

carry /'kæri/ *verb* **1.** to take from one place to another ○ *The train was carrying a consignment of cars.* □ **carrying offensive weapons** the offence of holding a weapon or something such as a bottle which could be used as a weapon **2.** to vote to approve □ **the motion was carried** the motion was accepted after a vote **3.** to be punishable by ○ *The offence carries a maximum sentence of two years' imprisonment.*

carte blanche /ˌkɑːt 'blɑːntʃ/ *phrase* permission given by someone to another person, allowing him or her to act in any way necessary to achieve something ○ *He has carte blanche to act on behalf of the company* or *the company has given him carte blanche to act on its behalf.*

case /keɪs/ *noun* **1.** a possible crime and its investigation by the police ○ *We have three detectives working on the case.* ○ *The police are treating the case as murder* or *are treating it as a murder case.* ○ *We had six cases of looting during the night.* **2.** □ **the case is being heard next week** the case is coming to court **3.** a set of arguments or facts put forward by one side in legal proceedings ○ *Defence counsel put his case.* ○ *There is a strong case against the accused.* □ **the case rests** all the arguments for one side have been put forward □ **no case to answer** submission by the defence (after the prosecution has put its case) that the case should be dismissed ■ *verb* □ **to case a joint** to look at a building carefully before deciding how to break into it (*slang*)

COMMENT: A case is referred to by the names of the parties, the date and the reference source where details of it can be found: *Smith v. Jones 1985 2 W.L.R. 250* This shows that the case involved Smith as plaintiff and Jones as defendant, it was heard in 1985, and is reported in the second volume of the Weekly Law Reports for that year on page 250.

case law /'keɪs lɔː/ *noun* law established by precedents, that is by the decisions of courts in earlier similar cases

case management conference /keɪs ˌmænɪdʒmənt 'kɒnf(ə)rəns/ *noun* a court hearing fixed when a case is

mainp - softvnn.com

Law.fm Page 42 Friday, June 11, 2004 2:08 PM

allocated to the fast track, when the parties involved and their legal representatives are asked about their preparations for the case and the court decides on matters such as the disclosure of documents and expert evidence

case stated /ˌkeɪs 'steɪtɪd/ *noun* a statement of the facts of a case which has been heard in a lower court such as a Magistrates' Court, drawn up so that a higher court such as the High Court can decide on an appeal ○ *She appealed by way of case stated.* ○ *The Appeal Court dismissed the appeal by way of case stated.*

case summary /ˌkeɪs 'sʌməri/ *noun* a short document of not more than 500 words prepared by a claimant to help the court understand what the case is about

cash items /'kæʃ ˌaɪtəmz/ *plural noun* goods sold for cash

cash offer /'kæʃ ˌɒfə/ *noun* an offer to pay in cash

cash on delivery /ˌkæʃ ɒn dɪ 'lɪv(ə)ri/ *noun* payment in cash when the goods are delivered

cash reserves /'kæʃ rɪˌzɜːvz/ *plural noun* a company's reserves in cash deposits or bills kept in case of urgent need

cash settlement /ˌkæʃ 'set(ə)lmənt/ *noun* the payment of an invoice in cash, not by cheque

cash terms /'kæʃ tɜːmz/ *plural noun* lower terms which apply if the customer pays cash

cash transaction /'kæʃ trænˌzækʃən/ *noun* a transaction paid for in cash

cast /kɑːst/ *verb* □ **to cast a vote** to vote ○ *The number of votes cast in the election was 125,458.*

casting vote /ˌkɑːstɪŋ 'vəʊt/ *noun* a vote used by the chair in a case where the votes for and against a proposal are equal ○ *The chairman has a casting vote.* ○ *He used his casting vote to block the motion.* (NOTE: **casting – cast – has cast**)

casual /'kæʒuəl/ *adjective* not permanent or not regular ○ *a casual employee*

casual labour /ˌkæʒuəl 'leɪbə/ *noun* people who are hired to work for a short period

casual work /'kæʒuəl wɜːk/ *noun* work where people are hired for a short period

casus belli /ˌkɑːzəs 'beliː/ *phrase* a Latin phrase meaning 'case for war': a reason which is used to justify a declaration of war

category /'kætɪg(ə)ri/ *noun* a type of item ○ *The theft comes into the category of petty crime.*

category A prisoner /ˌkætɪg(ə)ri eɪ 'prɪz(ə)nə/ *noun* a prisoner who is regarded as a danger to the public and must be closely guarded to prevent escape

category B prisoner /ˌkætɪg(ə)ri biː 'prɪz(ə)nə/ *noun* a prisoner who is less dangerous than a category A prisoner but who still has to be guarded carefully to prevent escape

category C prisoner /ˌkætɪg(ə)ri siː 'prɪz(ə)nə/ *noun* a prisoner who is not likely to try to escape, but who cannot be kept in an open prison

category D prisoner /ˌkætɪg(ə)ri diː 'prɪz(ə)nə/ *noun* a reliable prisoner who can be kept in an open prison

causa ➧ **donatio mortis causa**

cause /kɔːz/ *noun* **1.** something which makes something happen □ **to show cause** to appear before a court to show why an order nisi should not be made absolute ○ *The judgment debtor was given fourteen days in which to show cause why the charging order should not be made absolute.* **2.** legal proceedings ■ *verb* to make something happen ○ *The recession caused hundreds of bankruptcies.*

cause list /'kɔːz lɪst/ *noun* a list of cases which are to be heard by a court

cause of action /ˌkɔːz əv 'ækʃən/ *noun* the reasons that entitle someone to start legal proceedings

caution /'kɔːʃ(ə)n/ *noun* **1.** a warning from a police officer, telling someone not to repeat a minor crime ○ *The boys were let off with a caution.* **2.** a warning by a police officer to someone who is to be charged with a crime that what he or she says may be used as evidence in a trial ○ *He typed his confession under caution.* **3.** a document lodged at the Land Registry to prevent land or property being sold

mainp - softvnn.com

Law.fm Page 43 Friday, June 11, 2004 2:08 PM

without notice to the cautioner (NOTE: In senses 2 and 3 **caution** can be used without **the** or **a**: *to lodge caution.*) ■ *verb* **1.** to warn someone that what he or she has done is wrong and should not be repeated ○ *The policeman cautioned the boys after he caught them stealing fruit.* **2.** to warn someone who is to be charged with a crime that what he or she says may be used as evidence in a trial ○ *The accused was arrested by the detectives and cautioned.*

cautioner /ˈkɔːʃ(ə)nə/ *noun* somebody who lodges caution at the Land Registry

caveat /ˈkæviæt/ *noun* a warning □ **to enter a caveat** to warn legally that you have an interest in a case or a grant of probate, and that no steps can be taken without notice to you

caveat emptor /ˌkæviæt ˈemptɔː/ *phrase* 'let the buyer beware': used to show that the buyer is personally responsible for checking that what he or she buys is in good order

caveator /ˈkæviætə/ *noun* somebody who warns the court not to give probate without asking his or her consent

CB *abbreviation* confined to barracks

CC *abbreviation* Chief Constable

CCR *abbreviation* County Court Rules

CD *abbreviation* certificate of deposit

CDS *abbreviation* Criminal Defence Service

cease and desist order /siːs ən dɪ ˌzɪst ˈɔːdə/ *noun US* a court order telling someone to stop doing something

cell /sel/ *noun* a small room in a prison or police station where a criminal can be kept locked up ○ *She was put in a small cell for the night.* ○ *He shares a cell with two other prisoners.*

cellmate /ˈselmeɪt/ *noun* somebody who shares a prison cell with someone else

censor /ˈsensə/ *noun* an official whose job is to say whether books, films or TV programmes, etc., are acceptable and can be published or shown to the public ○ *The film was cut* or *was banned* or *was passed by the censor.* ■ *verb* to say that a book, film or TV programme, etc., cannot be shown or published because it is not considered right to do so ○ *All press reports are censored by the government.* ○ *The news of the riots was censored.* ○ *The TV report has been censored and only parts of it can be shown.*

censorship /ˈsensəʃɪp/ *noun* the act of censoring ○ *TV reporters complained of government censorship.* ○ *The government has imposed strict press censorship* or *censorship of the press.*

censure /ˈsenʃə/ *noun* a criticism ■ *verb* to criticise

Central Criminal Court /ˌsentrəl ˈkrɪmɪn(ə)l kɔːt/ *noun* the Crown Court in central London. Also called **Old Bailey**

central government /ˌsentrəl ˈgʌv(ə)nmənt/ *noun* the main organisation dealing with the affairs of the whole country

central office /ˌsentrəl ˈɒfɪs/ *noun* the main office which controls all smaller offices

centre /ˈsentə/ *noun* an office or building where people can go for information and advice. ◊ **Legal Aid Centre** (NOTE: The US spelling is **center**.)

certificate /səˈtɪfɪkət/ *noun* an official document which shows that something is true

certificated bankrupt /səˌtɪfɪkeɪtɪd ˈbæŋkrʌpt/ *noun* a bankrupt who has been discharged from bankruptcy with a certificate to show that he or she was not at fault

certificate of approval /səˌtɪfɪkət əv əˈpruːv(ə)l/ *noun* a document showing that an item has been officially approved

certificate of deposit /səˌtɪfɪkət əv dɪˈpɒzɪt/ *noun* a document from a bank showing that money has been deposited. Abbreviation **CD**

certificate of incorporation /sə ˌtɪfɪkət əv ɪnˌkɔːpəˈreɪʃ(ə)n/ *noun* a certificate issued by the Registrar of Companies showing that a company has been officially incorporated and the date at which it came into existence

certificate of judgment /səˌtɪfɪkət əv ˈdʒʌdʒmənt/ *noun* an official document showing the decision of a court

mainp - softvnn.com

Law.fm Page 44 Friday, June 11, 2004 2:08 PM

certificate of origin /sə,tɪfɪkət əv 'ɒrɪdʒɪn/ *noun* a document showing where goods were made or produced

certificate of registration /sə ,tɪfɪkət əv ,redʒɪ'streɪʃ(ə)n/ *noun* a document showing that an item has been registered

certificate of registry /sə,tɪfɪkət əv 'redʒɪstri/ *noun* a document showing that a ship has been officially registered

certificate of service /sə,tɪfɪkət əv 'sɜːvɪs/ *noun* a certificate by which a court proves that a document was sent and is deemed to have been served

certified accountant /,sɜːtɪfaɪd ə 'kaʊntənt/ *noun* an accountant who has passed the professional examinations and is a member of the Chartered Association of Certified Accountants

certified cheque /,sɜːtɪfaɪd 'tʃek/ *noun* a cheque which a bank says is good and will be paid out of money put aside from the bank account

certified copy /,sɜːtɪfaɪd 'kɒpi/ *noun* a document which is certified as being exactly the same in content as the original

certify /'sɜːtɪ,faɪ/ *verb* to make an official declaration in writing ○ *I certify that this is a true copy.* ○ *The document is certified as a true copy.*

certiorari /,sɜːtiə'rɑːri/ *phrase* a Latin word meaning 'to be informed'

cessate grant /'sesеɪt ,grɑːnt/ *noun* a special grant of probate made because of the incapacity of an executor, or a grant made to renew a grant which has expired

cesser /'sesə/ *noun* (*of a mortgage, charter, etc.*) the ending

cession /'seʃ(ə)n/ *noun* the act of giving up property to someone, especially a creditor

CFI *abbreviation* Court of First Instance

CGT *abbreviation* capital gains tax

chair /tʃeə/ *noun* the role of chairperson presiding over a meeting ○ *to be in the chair* ○ *She was voted into the chair.* ○ *She is Chair of the Finance Committee.* ○ *This can be done by Chair's action and confirmed later.* □ **Mr Jones took the chair** Mr Jones presided over the meeting □ **to address the chair** in a meeting, to speak to the chairman and not directly to the rest of the people at the meeting □ **to ask a question through the chair** to ask someone a question directly, by speaking to him or her through the chairman ○ *May I ask the councillor through the chair why he did not declare his interest in the matter?* ■ *verb* to preside over a meeting ○ *The meeting was chaired by Mrs Smith.*

chairman /'tʃeəmən/ *noun* **1.** a person who is in charge of a meeting and holds the casting vote ○ *chairman of the magistrates* or *of the bench* ○ *Mr Howard was chairman* or *acted as chairman.* □ **Mr Chairman**, **Madam Chairman** way of speaking to the chairman **2.** a person who presides over meetings of a Committee of the House of Commons or of a local council **3.** somebody who presides over the board meetings of a company ○ *the chairman of the board* or *the company chairman*

chairman and managing director /,tʃeəmən ən ,mænɪdʒɪŋ daɪ'rektə/ *noun* a managing director who is also chairman of the board of directors

chairman of the justices /,tʃeəmən əv ðɪ 'dʒʌstɪss/ *noun* the chief magistrate in a magistrates' court

chairmanship /'tʃeəmənʃɪp/ *noun* the role of being a chairman □ **the committee met under the chairmanship of Mr Jones** Mr Jones chaired the meeting of the committee

chairperson /'tʃeəpɜːs(ə)n/ *noun* a person who is in charge of a meeting and holds the casting vote

chairwoman /'tʃeəwʊmən/ *noun* a woman who is in charge of a meeting and holds the casting vote

challenge /'tʃælɪndʒ/ *noun* the act of objecting to a decision and asking for it to be set aside ■ *verb* to refuse to accept a juror or piece of evidence ○ *to challenge a sentence passed by magistrates by appeal to the Crown Court*

challenge for cause /,tʃælɪndʒ fə 'kɔːz/ *noun US* an objection to a proposed juror, stating the reasons for the objection

challenge without cause /,tʃælɪndʒ wɪ'ðaʊt kɔːz/ *noun US* an

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Law.fm Page 45 Friday, June 11, 2004 2:08 PM

objection to a proposed juror, not stating the reasons for the objection

chamber /'tʃeɪmbə/ *noun* a room where a committee or legislature meets ○ *The meeting will be held in the council chamber.*

chambers /'tʃeɪmbəz/ *plural noun* **1.** the offices of a group of barristers who work together and share the same staff (NOTE: actually called 'a set of chambers') **2.** the office of a judge □ **the judge heard the case in chambers** in private rooms, without the public being present and not in open court

champerty /'tʃæmpəti/ *noun* formerly, financial help given to a person starting a proceedings against a party, where the person giving help has a share in the damages to be recovered

Chancellor /'tʃɑːns(ə)lə/ *noun* **1.** ◗ **Lord Chancellor 2.** *US* a judge who presides over a court of equity

Chancellor of the Duchy of Lancaster /ˌtʃɑːnsələ əv ðiː 'dʌtʃi/ *noun* a member of the British government with no specific responsibilities

Chancellor of the Exchequer /ˌtʃɑːnsələr əv ðiː ɪks'tʃekə/ *noun* the chief finance minister in the British government

Chancery Bar /'tʃɑːnsəri bɑː/ *noun* the group of barristers who specialise in the Chancery Division

Chancery business /ˌtʃɑːnsəri 'bɪznɪs/ *noun* the range of legal cases relating to the sale of land, mortgages, trusts, estates, bankruptcies, partnerships, patents and copyrights, probate, and cases involving companies

Chancery Court /'tʃɑːnsəri kɔːt/ *noun* formerly, the court presided over by the Lord Chancellor, which established case law or equity

Chancery Division /ˌtʃɑːnsəri dɪ 'vɪʒ(ə)n/ *noun* one of the three divisions of the High Court, dealing with matters such as wills, partnerships and companies, taxation and bankruptcies

change of use /ˌtʃeɪndʒ əv 'juːs/ *noun* an order allowing a property to be used in a different way, e.g. a house to be used as a business office, or a shop to be used as a factory

channel /'tʃæn(ə)l/ *noun* the way in which information or goods are passed from one place to another □ **to go through the official channels** to deal with government officials, especially when making a request □ **to open up new channels of communication** to find new ways of communicating with someone

chapter /'tʃæptə/ *noun* **1.** an official term for an Act of Parliament **2.** *US* a section of an Act of Congress

Chapter 7 /ˌtʃæptə 'sevən/ *noun US* a section of the US Bankruptcy Reform Act 1978 which sets out the rules for the liquidation of an incorporated company

Chapter 11 /ˌtʃæptə 'ten/ *noun US* a section of the US Bankruptcy Reform Act 1978, which allows a corporation to be protected from demands made by its creditors for a period of time, while it is reorganised with a view to paying its debts. The officers of the corporation will negotiate with its creditors as to the best way of reorganising the business.

Chapter 13 /ˌtʃæptə θɜːr'tiːn/ *noun US* a section of the Bankruptcy Reform Act 1978 which allows a business to continue trading and to pay off its creditors by regular monthly payments over a period of time

character /'kærɪktə/ *noun* the general qualities of a person which make him or her different from others □ **he is a man of good character** he is an honest, hard-working or decent man □ **to give someone a character reference** to say that someone has good qualities □ **to introduce character evidence** to produce witnesses to say that a person is of good or bad character

charge /tʃɑːdʒ/ *noun* **1.** money which must be paid as the price of a service ○ *to make no charge for delivery* ○ *to make a small charge for rental* ○ *There is no charge for service* or *no charge is made for service.* **2.** □ **charge on land**, **charge over property** a mortgage or liability on a property which has been used as security for a loan □ **charge by way of legal mortgage** a way of borrowing money on the security of a property, where the mortgagor signs a deed which gives the mortgagee an interest in the property **3.**

mainp - softvnn.com

Law.fm Page 46 Friday, June 11, 2004 2:08 PM

an official statement in a court accusing someone of having committed a crime ○ *He appeared in court on a charge of embezzling* or *on an embezzlement charge.* ○ *The clerk of the court read out the charges.* □ **to answer charges** to plead guilty or not guilty to a charge □ **the charges against him were withdrawn, dropped** the prosecution decided not to continue with the trial □ **to press charges against someone** to say formally that someone has committed a crime ○ *He was very angry when his neighbour's son set fire to his car, but decided not to press charges.* **4.** a set of instructions given by a judge to a jury, summing up the evidence and giving advice on the points of law which have to be considered ■ *verb* **1.** to ask someone to pay for services ○ *to charge £5 for delivery* ○ *How much does he charge?* □ **he charges £9 an hour** he asks to be paid £9 for an hour's work **2.** (*in a court*) to accuse someone formally of having committed a crime ○ *He was charged with embezzling his clients' money.* ○ *They were charged with murder.* (NOTE: You charge someone **with** a crime.)

chargeable /ˈtʃɑːdʒəb(ə)l/ *adjective* being able to be charged

chargee /tʃɑːˈdʒiː/ *noun* somebody who holds a charge over a property

charge sheet /ˈtʃɑːdʒ ʃiːt/ *noun* a document listing the charges which a magistrate will hear, listing the charges against the accused together with details of the crime committed

charging order /ˈtʃɑːdʒɪŋ ˌɔːdə/ *noun* a court order made in favour of a judgment creditor granting them a charge over a debtor's property

charitable trust /ˈtʃærɪtəb(ə)l trʌst/, **charitable corporation** *US* /ˌtʃærɪtəb(ə)l ˌkɔːpəˈreɪʃ(ə)n/ *noun* a trust which benefits the public as a whole, by promoting education or religion, helping the poor or doing other useful work

Charity Commissioners /ˈtʃærɪtɪ kəˌmɪʃ(ə)nəz/ *plural noun* a UK body which governs charities and sees that they follow the law and use their funds for the purposes intended

charter /ˈtʃɑːtə/ *noun* **1.** a document from the Crown establishing a town, a corporation, a university or a company **2.** the hire of transport for a special purpose □ **on charter to** hired by ○ *a boat on charter to Mr Smith*

chartered /ˈtʃɑːtəd/ *adjective* **1.** (*of a company*) set up by royal charter and not registered as a company **2.** □ **chartered ship, bus, plane** ship or bus or plane which has been hired for a special purpose

Chartered Accountant /ˌtʃɑːtəd ə ˈkaʊntənt/ *noun* an accountant who has passed the professional examinations and is a member of the Institute of Chartered Accountants

charterer /ˈtʃɑːtərə/ *noun* a person who hires a ship, plane or train for a special purpose

chartering /ˈtʃɑːtərɪŋ/ *noun* the act of hiring a ship, plane or train for a special purpose

charterparty /ˈtʃɑːtəpɑːti/ *noun* a contract where the owner of a ship charters it to someone for carrying goods

chattel mortgage /ˈtʃæt(ə)l ˌmɔːgɪdʒ/ *noun US* a mortgage using personal property as security

chattels personal /ˌtʃæt(ə)lz ˈpɜːs(ə)n(ə)l/ *noun* any property that is not real property

chattels real /ˌtʃæt(ə)lz ˈrɪəl/ *noun* leaseholds

cheap labour /ˌtʃiːp ˈleɪbə/ *noun* workers who do not earn much money

cheap money /ˌtʃiːp ˈmʌni/ *noun* money which can be borrowed at a low rate of interest

check /tʃek/ *noun* **1.** a sudden stop □ **to put a check on the sale of firearms** to stop some firearms being sold **2.** an investigation or examination ○ *a routine check of the fire equipment* ○ *The auditors carried out checks on the petty cash book.* ■ *verb* **1.** to stop or delay something ○ *to check the entry of contraband into the country* **2.** to examine or to investigate ○ *to check that an invoice is correct* ○ *to check and sign for goods* □ **he checked the computer printout against the invoices** he examined the

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Law.fm Page 47 Friday, June 11, 2004 2:08 PM

printout and the invoices to see if the figures were the same

check sample /'tʃek ˌsɑːmp(ə)l/ *noun* a sample to be used to see if a consignment is acceptable

cheque /tʃek/**, check** *US* /tʃek/ *noun* **1.** an order to a bank to pay money from your account to the person whose name is written on it **2.** □ **to endorse a cheque** to sign a cheque on the back to make it payable to someone else □ **to make out a cheque to someone** to write out a cheque to someone □ **to pay by cheque** to pay by writing a cheque, and not by using cash or a credit card □ **to pay a cheque into your account** to deposit a cheque □ **to bounce a cheque** to refuse to pay a cheque because there is not enough money in the account to pay it (*informal*) □ **the bank referred the cheque to drawer** the bank returned the cheque to person who wrote it because there was not enough money in the account to pay it □ **to sign a cheque** to sign on the front of a cheque to show that you authorise the bank to pay the money from your account □ **to stop a cheque** to ask a bank not to pay a cheque which you have written

cheque account /'tʃek əˌkaʊnt/ *noun* a bank account which allows the customer to write cheques

chief /tʃiːf/ *adjective* □ **in chief** in person

Chief Constable /ˌtʃiːf 'kʌnstəb(ə)l/ *noun* the person in charge of a police force

Chief Inspector /ˌtʃiːf ɪn'spektə/ *noun* a rank in the police force above Inspector or Superintendent

Chief Inspector of Prisons /ˌtʃiːf ɪnˌspektə əv 'prɪzənz/ *noun* a government official who is the head of the Inspectorate of Prisons, and whose job is to inspect prisons to see that they are being run correctly and efficiently

Chief Justice /ˌtʃiːf 'dʒʌstɪs/ *noun* **1.** *US* a senior judge in a court **2.** the presiding justice of the US Supreme Court

child /tʃaɪld/ *noun* a person under the age of 18

COMMENT: In Great Britain a child does not have full legal status until the age of eighteen. A contract is not binding on a child, and a child cannot own land, cannot make a will, cannot vote, cannot drive a car (under the age of seventeen). A child cannot marry before the age of sixteen, and can only marry between the ages of 16 and 18 with written permission of his or her parents. A child who is less than ten years old is not considered capable of committing a crime; a child between ten and fourteen years of age may be considered capable of committing a crime if there is evidence of malice or knowledge, and so children of these ages can in certain circumstances be convicted. In criminal law the term 'child' is used for children between the ages of 10 and 14; for children between 14 and 17, the term 'young person' is used; all children are termed 'juveniles'.

child benefit /ˌtʃaɪld 'benɪfɪt/ *noun* money paid by the state to the person who is responsible for a child under 16 years of age, or 19 if the child is in full-time education

child destruction /ˌtʃaɪld dɪ 'strʌkʃən/ *noun* the notifiable offence of killing an unborn child capable of being born alive

child in care /ˌtʃaɪld ɪn 'keə/ *noun* a child who is the subject of a care order and is therefore in the care of the local social services department

child stealing /'tʃaɪld ˌstiːlɪŋ/ *noun* *US* the notifiable offence of taking away a child from its parents or guardian

child support /'tʃaɪld səˌpɔːt/ *noun* *US* money paid as part of a divorce settlement, to help maintain a child of divorced parents

Child Support Agency /ˌtʃaɪld sə 'pɔːt ˌeɪdʒənsi/ *noun* an agency of the Department for Work and Pensions, created by the Child Support Act 1991, which has responsibility for the assessment, review, collection and enforcement of maintenance for children, which was previously supervised by the courts. Abbreviation **CSA**

chose /tʃəʊz/ *French word meaning* 'item' or 'thing' □ **chose in action** a personal right which can be enforced or claimed as if it were property (such as a patent, copyright, debt or cheque) □ **chose in possession** a physical thing

mainp - softvnn.com

Law.fm Page 48 Friday, June 11, 2004 2:08 PM

which can be owned such as a piece of furniture

Christmas Day /ˌkrɪsməs 'deɪ/ *noun* 25th December, one of the four quarter days when rent is payable on land

CID *abbreviation* Criminal Investigation department

circuit /'sɜːkɪt/ *noun* one of six divisions of England and Wales for legal purposes ○ *He is a judge on the Welsh Circuit.*

COMMENT: The six circuits are: Northern, North-Eastern, Midland and Oxford, Wales and Chester, South-Eastern, and Western.

circuit judge /'sɜːkɪt dʒʌdʒ/ *noun* a judge in the Crown Court or a County Court

circular letter /ˌsɜːkjʊlə 'letə/ *noun* a letter sent to many people

circulation /ˌsɜːkjʊ'leɪʃ(ə)n/ *noun* □ **to put money into circulation** to issue new notes to business and the public

circumstances /'sɜːkəmstænsɪz/ *plural noun* the situation as it is when something happens ○ *The police inspector described the circumstances leading to the riot.* ◊ **extenuating circumstances**

circumstantial /ˌsɜːkəm'stænʃ(ə)l/ *adjective* allowing someone to infer facts

circumstantial evidence /ˌsɜːkəmstænʃ(ə)l 'evɪd(ə)ns/ *noun* evidence which suggests that something must have happened, but does not give firm proof of it

citation /saɪ'teɪʃ(ə)n/ *noun* **1.** an official request asking someone to appear in court (NOTE: used mainly in the Scottish and American courts) **2.** the quoting of a legal case, authority or precedent **3.** a set of words used in giving someone an award or honour, explaining why the award is being made

citation clause /saɪ'teɪʃ(ə)n klɔːz/ *noun* a clause in a Bill which gives the short title by which it should be known when it becomes an Act

cite /saɪt/ *verb* **1.** to summon someone to appear in court **2.** to refer to something ○ *The judge cited several previous cases in his summing up.* **3.** to refer to an Act of Parliament using the short title ○ *This Act may be cited as the Electronic Communications Act 1999.*

citizen /'sɪtɪz(ə)n/ *noun* **1.** somebody who lives in a city **2.** somebody who has the nationality of a specific country ○ *He is a French citizen by birth.*

Citizens' Advice Bureau /ˌsɪtɪzənz əd'vaɪs ˌbjʊərəʊ/ *noun* an office where people can go to get free advice on legal and administrative problems. Abbreviation **CAB**

citizen's arrest /ˌsɪtɪz(ə)nz ə'rest/ *noun* a right of a private person to arrest without a warrant someone suspected of committing a crime

Citizen's Charter /ˌsɪtɪzənz 'tʃɑːtə/ *noun* a promise by the government that people must be fairly dealt with, in particular by government departments and state-controlled bodies

citizenship /'sɪtɪz(ə)nʃɪp/ *noun* the right of being a citizen of a country ○ *The Treaty has established European citizenship for everyone who is a citizen of the Member State of the EU.*

COMMENT: A person has British citizenship if he is born in the UK and his father or mother is a British citizen, or if his father or mother has settled in the UK, or if he is adopted in the UK by a British citizen; British citizenship can also be granted to wives of British citizens.

civic /'sɪvɪk/ *adjective* referring to a city or the official business of running a city ○ *Their civic pride showed in the beautiful gardens to be found everywhere in the city.*

civic centre /ˌsɪvɪk 'sentə/ *noun* the main offices of a city council

civic dignitaries /ˌsɪvɪk 'dɪgnɪt(ə)riz/ *plural noun* the mayor and other senior officials of a city or town

civil /'sɪv(ə)l/ *adjective* **1.** referring to the rights and duties of private persons or corporate bodies, as opposed to criminal, military or ecclesiastical bodies **2.** referring to the public in general

civil action /ˌsɪv(ə)l 'ækʃən/ *noun* a court case brought by a person or a company (the claimant) against someone who is alleged to have done them wrong (the defendant)

mainp - softvnn.com

Law.fm Page 49 Friday, June 11, 2004 2:08 PM

civil court /ˌsɪv(ə)l ˈkɔːt/ *noun* a court where civil actions are heard

civil disobedience /ˌsɪv(ə)l dɪsə ˈbiːdiəns/ *noun US* the activity of disobeying the orders of the civil authorities such as the police as an act of protest ○ *The group planned a campaign of civil disobedience as a protest against restrictions on immigrants.*

civil disorder /ˌsɪv(ə)l dɪsˈɔːdə/ *noun US* riots or fighting in public places

civilian /səˈvɪliən/ *adjective* referring to people who are not in the armed forces ○ *Civilian rule was restored after several years of military dictatorship.* ○ *The military leaders called general elections and gave way to a democratically elected civilian government.* ■ *noun* someone who is not a member of the armed forces ○ *The head of the military junta has appointed several civilians to the Cabinet.*

civil law /ˌsɪv(ə)l ˈlɔː/ *noun* laws relating to people's rights and to agreements between individuals. Compare **criminal law**

civil liberties /ˌsɪv(ə)l ˈlɪbətiz/ *plural noun* freedom for people to work or write or speak as they want, providing they keep within the law

Civil List /ˌsɪv(ə)l ˈlɪst/ *noun* money appropriated from the Consolidated Fund for paying the Royal Family and their expenses

Civil Procedure Rules /ˌsɪv(ə)l prə ˈsiːdʒə ˌruːlz/ *plural noun* rules setting out how civil cases are to be brought to court and heard. Abbreviation **CPR**

civil rights /ˌsɪv(ə)l ˈraɪts/ *plural noun* rights and privileges of each individual according to the law

civil strife /ˌsɪv(ə)l ˈstraɪf/ *noun* trouble occurring when groups of people fight each other, usually over matters of principle

Civil Trial Centre /ˌsɪv(ə)l ˈtraɪəl ˌsentə/ *noun* a court which deals with multi-track claims

CJ *abbreviation* Chief Justice

claim /kleɪm/ *noun* **1.** an assertion of a legal right **2.** a document used in the County Court to start a legal action □ **claim for personal injuries** a claim where the claimant claims damages for disease or physical or mental disablement **3.** a statement that someone has a right to property held by another person **4.** a request for money that you believe you should have ○ *an insurance claim* ○ *a wage claim* **5.** □ **no claims bonus** reduction of premiums to be paid because no claims have been made against the insurance policy □ **to put in a claim** to ask the insurance company officially to pay for damage or loss ○ *She put in a claim for repairs to the car.* □ **to settle a claim** to agree to pay what is asked for ■ *verb* **1.** to state a grievance in court **2.** to ask for money ○ *He claimed £100,000 damages against the cleaning firm.* ○ *She claimed for repairs to the car against her insurance.* **3.** to say that you have a right to property held by someone else ○ *He is claiming possession of the house.* ○ *No one claimed the umbrella found in my office.* **4.** to state that something is a fact ○ *He claims he never received the goods.* ○ *She claims that the shares are her property.* **5.** to attack someone in prison (*slang*) **6.** to arrest someone (*slang*)

claimant /ˈkleɪmənt/ *noun* **1.** a person who claims something **2.** somebody who makes a claim against someone in the civil courts. Compare **defendant** (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has replaced **plaintiff**.)

claim back /ˌkleɪm ˈbæk/ *verb* to ask for money to be paid back

claim form /ˈkleɪm fɔːm/ *noun* **1.** a form which has to be completed when making an insurance claim ○ *He filled in the claim form and sent it to the insurance company.* **2.** a form issued by a court when requested by a claimant, containing the particulars of claim and a statement of value. ◊ **Production Centre** (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has replaced the **writ of summons**.)

COMMENT: The claim form must be served on the defendant within four months of being issued. If a claim form has been issued but not served, the defendant can ask for it to be served, and if the claimant does not do so, the claim may be dismissed.

mainp - softvnn.com

Law.fm Page 50 Friday, June 11, 2004 2:08 PM

class /klɑːs/ *verb* to put something into a category ○ *The magazine was classed as an obscene publication.*

COMMENT: In the UK the population is classified into social classes for statistical purposes. These are: **Class A:** higher managers, administrators and professionals; **Class B:** intermediate managers, administrators and professionals; **Class C1:** supervisors, clerical workers and junior managers; **Class C2:** skilled manual workers; **Class D:** semi-skilled or unskilled manual workers; **Class E:** pensioners, casual workers, long-term unemployed.

class action /ˌklɑːs ˈækʃən/ *noun US* a legal action brought on behalf of a group of people

Class A drug /ˌklɑːs eɪ ˈdrʌg/ *noun* a strong and dangerous drug such as cocaine, heroin, crack, or LSD

Class B drug /ˌklɑːs biː ˈdrʌg/ *noun* a drug such as the amphetamines, cannabis or codeine

Class C drug /ˌklɑːs siː ˈdrʌg/ *noun* a drug which is related to the amphetamines, e.g. benzphetamine

Class F charge /ˌklɑːs ˈef ˌtʃɑːdʒ/ *noun* a charge on a property registered by a spouse who is not the owner, claiming a right to live in the property

class gift /ˈklɑːs gɪft/ *noun US* a gift to a defined group of people

classified information /ˌklæsɪfaɪd ˌɪnfəˈmeɪʃ(ə)n/ *noun* information which is secret and can be told only to specified people

classify /ˈklæsɪfaɪ/ *verb* **1.** to put into groups or categories **2.** to make information secret

clause /klɔːz/ *noun* a section of a contract or of a constitution ○ *There are ten clauses in the contract.* ○ *According to clause six, payment will not be due until next year.*

claw back /ˌklɔː ˈbæk/ *verb* **1.** to take back money which has been allocated ○ *Income tax claws back 25% of pensions paid out by the government.* **2.** (*of the Inland Revenue*) to take back tax relief which was previously granted ○ *Of the £1m allocated to the development of the system, the government clawed back £100,000 in taxes.*

clawback /ˈklɔːbæk/ *noun* **1.** money taken back **2.** the loss of tax relief previously granted

clean hands /ˌkliːn ˈhænds/ *plural noun* □ **the plaintiff or claimant must have clean hands** the claimant cannot claim successfully if his or her motives or actions are dishonest, or if his or her own obligations to the defendant have not been discharged

clear /klɪə/ *adjective* **1.** easily understood ○ *He made it clear that he wanted the manager to resign.* ○ *There was no clear evidence* or *clear proof that he was in the house at the time of the murder.* **2.** □ **to have a clear title to something** to have a right to something with no limitations or charges **3.** □ **three clear days** a period of time, calculated without including the first day when the period starts and the last day when it finishes, that includes three full days ○ *Allow three clear days for the cheque to be paid into your account.* ■ *verb* **1.** □ **to clear goods through the customs** to have all documentation passed by the customs so that goods can leave the country **2.** □ **to clear 10%, $5,000 on the deal** to make 10% *or* $5,000 clear profit □ **we cleared only our expenses** the sales revenue paid only for the costs and expenses without making any profit **3.** □ **to clear a cheque** to pass a cheque through the banking system, so that the money is transferred from the payer's account to another account ○ *The cheque took ten days to clear* or *the bank took ten days to clear the cheque.* **4.** □ **to clear someone of charges** to find that someone is not guilty of the charges against him or her ○ *He was cleared of all charges* or *he was cleared on all counts.* **5.** □ **to clear a debt** to pay all of a debt

clearance certificate /ˈklɪərəns sə ˌtɪfɪkət/ *noun* a document which shows that goods have been passed by customs

clearing /ˈklɪərɪŋ/ *noun* **1.** □ **clearing of goods through the customs** the passing of goods through customs **2.** □ **clearing of a debt** the payment of all of a debt

clearing bank /ˈklɪərɪŋ bæŋk/ *noun* a bank which clears cheques by transferring money from the payer's account to another account

mainp - softvnn.com

Law.fm Page 51 Friday, June 11, 2004 2:08 PM

clearing house /'klɪərɪŋ haʊs/ *noun* a central office where clearing banks exchange cheques

clear profit /ˌklɪə 'prɒfɪt/ *noun* the profit made after all expenses have been paid ○ *We made $6,000 clear profit on the sale.*

clear up /ˌklɪər 'ʌp/ *verb* to discover who has committed a crime and arrest them ○ *Half the crimes committed are never cleared up.*

COMMENT: Clear up can be divided into two categories: **primary clear up,** when a crime is solved by arresting the suspect, and **secondary clear up,** where a person charged with one crime then confesses to another which had not previously been solved.

clear-up rate /'klɪə ʌp ˌreɪt/ *noun* the number of crimes solved, as a percentage of all crimes committed

clemency /'klemənsi/ *noun* pardon or mercy ○ *As an act of clemency, the president granted an amnesty to all political prisoners.*

clerical /'klerɪk(ə)l/ *adjective* related to the type of work done in an office

clerical error /ˌklerɪk(ə)l 'erə/ *noun* a mistake made in an office

clerical staff /'klerɪk(ə)l stɑːf/ *noun* the staff of an office

clerical work /'klerɪk(ə)l wɜːk/ *noun* paperwork done in an office

clerical worker /'klerɪk(ə)l ˌwɜːkə/ *noun* somebody who works in an office

clerk /klɑːk/ *noun* somebody who works in an office ○ *accounts clerk* ○ *sales clerk* ○ *wages clerk*

clerk of works /ˌklɑːk əv 'wɜːks/ *noun* an official who superintends the construction of a building

clerkship /'klɜːkʃɪp/ *noun US* the time when a student lawyer is working in the office of a lawyer before being admitted to the bar (NOTE: The British term is **traineeship**.)

click-wrap agreement /'klɪk ræp ə ˌgriːmənt/ *noun* a contract entered into when purchasing an item on the Internet, where no paper documentation exists and the agreement to purchase is made by clicking on the appropriate button

client /'klaɪənt/ *noun* **1.** a person who pays for a service carried out by a professional person such as an accountant or a solicitor **2.** somebody who is represented by a lawyer ○ *The solicitor paid the fine on behalf of his client.*

clientele /ˌkliːɒn'tel/ *noun* all the clients of a business such as a shop, restaurant or hotel

close /kləʊz/ *adjective* □ **close to** very near, almost ○ *The company was close to bankruptcy.* ○ *We are close to solving the crime.* ■ *verb* □ **to close the accounts** to come to the end of an accounting period and make up the profit and loss account ◇ **to close an account 1.** to stop supplying a customer on credit **2.** to take all the money out of a bank account and stop the account

close company /ˌkləʊs 'kʌmp(ə)ni/**, close corporation** *US* /kləʊz ˌkɔːpə 'reɪʃ(ə)n/**, closed corporation** /kləʊzd ˌkɔːpə'reɪʃ(ə)n/ *noun* a privately owned company where the public may own a small number of shares

close down /ˌkləʊz 'daʊn/ *verb* to shut a shop or factory for a long period or for ever ○ *The company is closing down its London office.*

closed session /ˌkləʊzd 'seʃ(ə)n/ *noun* a meeting which is not open to the public or to journalists ○ *The town council met in closed session to discuss staff problems in the Education Department.* ○ *The public gallery was cleared when the meeting went into closed session.*

close protection officer /ˌkləʊs prə'tekʃ(ə)n ˌɒfɪsə/ *noun* someone who is employed to protect a celebrity or public figure from attack

closing /'kləʊzɪŋ/ *adjective* coming at the end of something

closing speeches /ˌkləʊsɪŋ 'spiːtʃəz/ *plural noun* final speeches for and against a motion in a debate, or for prosecution and defence at the end of a trial

closing stock /ˌkləʊzɪŋ 'stɒk/ *noun* the value of stock at the end of an accounting period

closing time /'kləʊzɪŋ taɪm/ *noun* the time when a shop or office stops work

mainp - softvnn.com

Law.fm Page 52 Friday, June 11, 2004 2:08 PM

closure /'kləʊʒə/ *noun* **1.** the act of closing **2.** (*in the House of Commons*) the ending of a debate

COMMENT: When an MP wishes to end the debate on a motion, he says 'I move that the question be now put' and the Speaker immediately puts the motion to the vote.

closure motion /ˌkləʊʒə 'məʊʃ(ə)n/ *noun* a proposal to end a debate

CLS *abbreviation* Community Legal Service

clue /kluː/ *noun* something which helps someone solve a crime ○ *The police have searched the room for clues.* ○ *The police have several clues to the identity of the murdered.*

Co *abbreviation* company ○ *J. Smith & Co Ltd*

co- /kəʊ/ *prefix* working or acting together

c/o *abbreviation* care of

co-creditor /ˌkəʊ 'kredɪtə/ *noun* somebody who is a creditor of the same company as you are

c.o.d. *abbreviation US* cash on delivery

code /kəʊd/ *noun* **1.** an official set of laws or regulations. ◊ **Highway Code, penal code 2.** the set of laws of a country □ **the Louisiana Code** *US* the laws of the state of Louisiana **3.** a set of semi-official rules **4.** a system of signs, numbers or letters which mean something ○ *The spy sent his message in code.* ■ *verb* to write a message using secret signs ○ *We received coded instructions from our agent in New York.*

co-decision procedure /ˌkəʊ dɪ 'sɪʒ(ə)n prəˌsiːdʒə/ *noun* (*in the EU*) a procedure by which the Commission sends proposed legislation to both the Council of the European Union and the European Parliament for approval

co-defendant /ˌkəʊ dɪ'fendənt/ *noun* somebody who appears in a case with another defendant

Code Napoleon /ˌkəʊd nə'pəʊliən/ *noun* the civil laws of France, introduced by Napoleon

code of conduct /ˌkəʊd əv 'kɒndʌkt/ *noun* a set of rules of behaviour by which a group of people work

code of practice /ˌkəʊd əv 'præktɪs/ *noun* **1.** rules to be followed when applying a law ○ *the Code of Practice on Picketing has been issued by the Secretary of State* **2.** a set of rules drawn up by an association which the members must follow in their work

codicil /'kəʊdɪsɪl/ *noun* a document executed in the same way as a will, making additions or changes to an existing will

codification /kəʊdɪfɪ'keɪʃ(ə)n/ *noun* **1.** the act of bringing all laws together into a formal legal code **2.** the act of bringing together all statutes and case law relating to a specific issue, to make a single Act of Parliament. ◊ **consolidation**

codify /'kəʊdɪfaɪ/ *verb* to put different laws together to form a code

coding /'kəʊdɪŋ/ *noun* the act of putting a code on something to identify or classify it ○ *the coding of invoices*

co-director /'kəʊ daɪˌrektə/ *noun* a person who is a director of the same company as another person

coercion /kəʊ'ɜːʃ(ə)n/ *noun* the use of force to make someone commit a crime or do some act

cohabit /kəʊ'hæbɪt/ *verb* (*of a man and a woman*) to live together as husband and wife

cohabitant /kəʊ'hæbɪtənt/ *noun* same as **cohabiter**

cohabitation /kəʊˌhæbɪ'teɪʃ(ə)n/ *noun* the practice of living together as husband and wife whether legally married or not

cohabiter /kəʊ'hæbɪtə/, **cohabitee** /kəʊˌhæbɪ'tiː/ *noun* a person who lives with another as husband or wife but is not legally married

co-heir /kəʊ 'eə/ *noun* somebody who is an heir with others

co-insurance /ˌkəʊ ɪn'ʃʊərəns/ *noun* insurance where the risk is shared among several insurers

collaborative divorce /kəˌlæb(ə)rətɪv dɪ'vɔːs/ *noun* a divorce of which the terms are agreed by both spouses and their solicitors before presenting the final agreement to a judge without a trial

mainp - softvnn.com

Law.fm Page 53 Friday, June 11, 2004 2:08 PM

collateral /kə'læt(ə)rəl/ *noun* security used to provide a guarantee for a loan ○ *collateral security* ■ *adjective* providing security for a loan

collateral contract /kəˌlæt(ə)rəl 'kɒntrækt/ *noun* a contract which induces a person to enter into a more important contract

collateral issue /kəˌlæt(ə)rəl 'ɪʃuː/ *noun* an issue which arises from a plea in a criminal court

collation /kə'leɪʃ(ə)n/ *noun* the comparison of a copy with the original to see if it is perfect

collect /kə'lekt/ *verb* **1.** to make someone pay money which is owed □ **to collect a debt** to go and make someone pay a debt **2.** to take goods away from a place ○ *We have to collect the stock from the warehouse.* ○ *Can you collect my letters from the typing pool?* □ **letters are collected twice a day** the post office employees take them from the letter box to the post office so that they can be sent off

collection /kə'lekʃən/ *noun* **1.** the activity of making someone pay money which is owed **2.** the act of fetching goods ○ *The stock is in the warehouse awaiting collection.* □ **to hand something in for collection** to leave something for someone to come and collect **3.** the taking of letters from a letter box or mail room to the post office to be sent off ○ *There are six collections a day from the letter box.*

collection charges /kə'lekʃənˌtʃɑːdʒɪz/ *plural noun* charges which have to be paid for collecting something

collections /kə'lekʃənz/ *plural noun* money which has been collected

collective /kə'lektɪv/ *adjective* working together

collective ownership /kəˌlektɪv 'əʊnəʃɪp/ *noun* ownership of a business by the employees who work in it

collective responsibility /kəˌlektɪv rɪˌspɒnsɪ'bɪlɪti/ *noun* a doctrine that all members of a group are responsible together for the actions of that group

collector /kə'lektə/ *noun* somebody who makes people pay money which is owed ○ *collector of taxes* or *tax collector* ○ *debt collector*

collusion /kə'luːʒ(ə)n/ *noun* illicit co-operation between people in order to cheat another party or to defraud another party of a right ○ *He was suspected of collusion with the owner of the property.* □ **to act in collusion with** to co-operate with someone in a way that is not allowed in order to cheat or defraud another party ○ *They had acted in collusion with a former employee.*

collusive action /kəˌluːsɪv 'ækʃən/ *noun* an action which is taken in collusion with another party

comity /'kɒmɪti/ *noun US* the custom by which courts in one state defer to the jurisdiction of courts in other states or to federal courts

comity of nations /ˌkɒmɪti əv 'neɪʃ(ə)nz/ *noun* the custom whereby the courts of one country acknowledge and apply the laws of another country

command /kə'mɑːnd/ *noun* an order □ **by Royal Command** by order of the Queen or King

commander /kə'mɑːndə/ *noun* a high rank in the Metropolitan Police force, equivalent to Assistant Chief Constable

commencement /kə'mensmənt/ *noun* the beginning □ **commencement of proceedings** the start of proceedings in a County Court □ **date of commencement** the date when an Act of Parliament takes effect

comment /'kɒment/ *noun* a remark giving a spoken or written opinion ○ *The judge made a comment on the evidence presented by the defence.* ○ *The newspaper has some short comments about the trial.*

commentary /'kɒmənt(ə)ri/ *noun* **1.** a textbook which comments on the law **2.** brief notes which comment on the main points of a judgment

Commercial Court /kə'mɜːʃ(ə)l kɔːt/ *noun* a court in the Queen's Bench Division which hears cases relating to business disputes

commercial law /kəˌmɜːʃ(ə)l 'lɔː/ *noun* law regarding the conduct of businesses

commercial lawyer /kəˌmɜːʃ(ə)l 'lɔːjə/ *noun US* someone who specialis-

mainp - softvnn.com

Law.fm Page 54 Friday, June 11, 2004 2:08 PM

es in company law or who advises companies on legal problems

commercial premises /kəˌmɜːʃ(ə)l ˈpremisɪz/ *plural noun* same as **business premises**

commission /kəˈmɪʃ(ə)n/ *noun* **1.** a group of people officially appointed to examine or be in charge of something ○ *The government has appointed a commission of inquiry to look into the problems of prison overcrowding.* ○ *He is the chairman of the government commission on football violence.* ◊ **Law Commission, Royal Commission 2.** a request to someone such as an artist or architect to do a piece of work for which they will be paid **3.** a payment, usually a percentage of turnover, made to an agent ○ *She has an agent's commission of 15% of sales.* **4.** an official position of being an officer in the army **5.** the act of committing a crime

commission agent /kəˈmɪʃ(ə)n ˌeɪdʒənt/ *noun* an agent who is paid by commission, not by fee

commissioner /kəˈmɪʃ(ə)nə/ *noun* a person who has an official commission

commissioner for oaths /kəˌmɪʃ(ə)nə fər ˈəʊðs/ *noun* a solicitor appointed by the Lord Chancellor to administer affidavits which may be used in court

commissioner of police /kəˌmɪʃ(ə)nər əv pəˈliːs/ *noun* the highest rank in a police force

Commissioners of Inland Revenue /kəˌmɪʃ(ə)nəz əv ˌɪnlənd ˈrevənjuː/ *noun* the Board of Inland Revenue

Commission for Racial Equality /kəˌmɪʃ(ə)n fə ˌreɪʃ(ə)l ɪˈkwɒlɪti/ *noun* in the UK, an official committee set up to deal with issues relating to equal treatment of ethnic groups. Abbreviation **CRE**

Commission of the European Community *noun* the main executive body of the EC, one of the four bodies which form the basis of the European Community, made up of members from each state

COMMENT: The Commission is formed of 20 members or Commissioners who are appointed by the governments of the Member States. The larger Member States (France, Germany, Italy, Spain and the UK) have two Commissioners each and the other smaller countries appoint one each. Each Commissioner is appointed for a five-year renewable term, and all the appointments end together, so the Commission is either changed or renewed every five years. Member States cannot dismiss the Commission, but can refuse to renew the term of appointment. The European Parliament can force the entire Commission to resign, but cannot dismiss an individual Commissioner. The European Court of Justice can force a Commissioner to retire on grounds of misconduct. The Commission is headed by the President of the European Commission, with two Vice-Presidents. The Commissioners are not supposed to be the representatives of their respective governments but must take the interests of the Community as a whole into account. Each commissioner has his or her own private office or Cabinet, headed by a Chef de Cabinet. The Commission has 23 departments called Directorates General, each headed by a Director-General, the Directorates General are subdivided into Directorates, and these are subdivided into Divisions. Each Directorate General is responsible to one of the Commissioners. The Commission represents all the Member States in negotiations with other parties, for example in trade negotiations with the USA. The Commission proposes laws for the European Community, and the Council of Ministers makes decisions accordingly. The Commission can make proposals regarding some legal matters and some matters concerning the internal security of Member States, but its main role is that of a watchdog, seeing that treaty obligations are carried out by Member States.

commit /kəˈmɪt/ *verb* **1.** to send someone to prison or to a court ○ *He was committed for trial in the Central Criminal Court.* ○ *The magistrates committed her for trial at the Crown Court.* **2.** to carry out a crime ○ *The gang committed six robberies before they were caught.* (NOTE: **committing – committed**)

commitment /kəˈmɪtmənt/ *noun* an order for sending someone to prison

commitments /kəˈmɪtmənts/ *plural noun* things which have to be done □ **fi-**

mainp - softvnn.com

Law.fm Page 55 Friday, June 11, 2004 2:08 PM

nancial commitments debts which have to be paid ▫ **to honour your commitments** to do what you are obliged to do

committal /kə'mɪt(ə)l/ *noun* the act of sending someone to a court or to prison ▫ **committal for trial** the act of sending someone to be tried in a higher court following committal proceedings in a magistrates' court ▫ **committal for sentence** the act of sending someone who has been convicted in a magistrates court to be sentenced in a higher court

committal order /kəˌmɪt(ə)l 'ɔːdə/ *noun* an order sending someone to prison for a contempt of court offence such as perjury

committal proceedings /kəˌmɪt(ə)l prə'siːdɪŋz/ *plural noun* the preliminary hearing of a case in a magistrates' court, to decide if it is serious enough to be tried before a jury in a higher court

committal warrant /kəˌmɪt(ə)l 'wɒrənt/ *noun* an order sending someone to serve a prison sentence

committee /kə'mɪti/ *noun* **1.** an official group of people who organise or plan for a larger group ○ *to be a member of a committee* or *to sit on a committee* ○ *He was elected to the Finance Committee* ○ *The new plans have to be approved by the committee members.* ○ *She is attending a committee meeting.* ○ *He is the chairman of the Planning Committee.* ○ *She is the secretary of the Housing Committee.* ▫ **to chair a committee** to be the chairman of a committee **2.** a section of a legislature which considers bills passed to it by the main chamber **3.** a person to whom something such as the charge of someone who is incapable of looking after himself or herself is officially given

Committee of Privileges /kəˌmɪti əv 'prɪvɪlɪdʒɪz/ *noun* a special committee of the House of Commons which examines cases of breach of privilege

Committee of the Parliamentary Commission /kəˌmɪti əv ðə ˌpɑːlə 'ment(ə)ri kəˌmɪʃ(ə)n/ *noun* a committee which examines reports by the Ombudsman

Committee of Ways and Means /kəˌmɪti əv ˌweɪz ən 'miːnz/ *noun* a committee of the whole House of Commons which examines a Supply Bill

Committee Stage /kə'mɪti steɪdʒ/ *noun* one of the stages in the discussion of a Bill, where each clause is examined in detail ○ *The Bill is at Committee Stage and will not become law for several months.*

common /'kɒmən/ *adjective* **1.** which happens very often ○ *Putting the headed paper into the photocopier upside down is a common mistake.* ○ *Being caught by the customs is very common these days.* **2.** referring to or belonging to several different people or to everyone **3.** ▫ **in common** together or jointly. ◊ **tenancy in common**

common ancestor /ˌkɒmən 'ænsestə/ *noun* a person from whom two or more people are descended

common assault /ˌkɒmən ə'sɔːlt/ *noun* the crime or tort of acting in such a way that another person is afraid he or she will be attacked and hurt

common carrier /ˌkɒmən 'kæriə/ *noun* a firm which carries goods or passengers, which cannot usually refuse to do so, and which can be used by anyone

common land /ˌkɒmən 'lænd/ *noun* an area of land to which the public has access for walking

common law /ˌkɒmən 'lɔː/ *noun* **1.** a law established on the basis of decisions by the courts, rather than by statute **2.** a general system of laws which formerly were the only laws existing in England, but which in some cases have been superseded by statute (NOTE: You say **at common law** when referring to something happening according to the principles of common law.)

common-law /'kɒmən lɔː/ *adjective* according to the old unwritten system of law ▫ **common-law marriage** situation where two people live together as husband and wife without being married ▫ **common-law spouse**, **wife** somebody who has lived or is living with another as husband or wife, although they have not been legally married

common ownership /ˌkɒmən 'əʊnəʃɪp/ *noun* ownership of a company

mainp - softvnn.com

Law.fm Page 56 Friday, June 11, 2004 2:08 PM

or of a property by a group of people who each own a part

common position /ˌkɒmən pə ˈzɪʃ(ə)n/ *noun* a position taken by the Council of the European Union on proposed legislation, which is then passed to the European Parliament for approval. It can be adopted or rejected by the Parliament, and the Parliament may propose changes to the proposed common position.

common pricing /ˌkɒmən ˈpraɪsɪŋ/ *noun* the illegal fixing of prices by several businesses so that they all charge the same price

Commons /ˈkɒmənz/ *plural noun* same as **House of Commons** ○ *The Commons voted against the Bill.* ○ *The majority of the Commons are in favour of law reform.*

common seal /ˌkɒmən ˈsiːl/ *noun* a metal stamp which every company must possess, used to stamp documents with the name of the company to show they have been approved officially ○ *to attach the company's seal to a document*

Common Serjeant /ˌkɒmən ˈsɑːdʒənt/ *noun* a senior barrister who sits as a judge in the City of London and acts as adviser to the City of London Corporation

commorientes /kəʊˌmɒriˈentiːz/ *plural noun* people who die at the same time, e.g. a husband and wife who both die in the same accident

COMMENT: In such cases, the law assumes that the younger person has died after the older one; this rule also applies to testators and beneficiaries who die at the same time.

commune /ˈkɒmjuːn/ *noun* a group of people who live and work together, and share their possessions

communicate /kəˈmjuːnɪˌkeɪt/ *verb* to pass information to someone ○ *The members of the jury must not communicate with the witnesses.*

communication /kəˌmjuːnɪˈkeɪʃ(ə)n/ *noun* **1.** the passing of information between different people □ **to enter into communication with someone** to start discussing something with someone, usually in writing ○ *We have entered into communication with the relevant government department.* **2.** an official message ○ *We have had a communication from the local tax inspector.*

communications /kəˌmjuːnɪˈkeɪʃ(ə)nz/ *plural noun* the ways people use to give information or express their thoughts and feelings to each other ○ *After the flood all communications with the outside world were broken.*

community /kəˈmjuːnɪti/ *noun* **1.** a group of people living or working in the same place □ **the local business community** the business people living and working in the area **2.** same as **European Community** □ **the Community finance ministers** the finance ministers of all the countries of the European Community

Community act /kəˈmjuːnɪti ækt/ *noun* a legal act of the European Union which has the force of law

community charge /kəˈmjuːnɪti tʃɑːdʒ/ *noun* a local tax levied on each eligible taxpayer. Also known as **poll tax**

community home /kəˈmjuːnɪti həʊm/ *noun* a house which belongs to a local authority, where children in care can live

Community Legal Service /kəˌmjuːnəti ˌliːg(ə)l ˈsɜːvɪs/ *noun* a system that consolidates previous features of the legal aid scheme, which it replaced in April 2000, in a re-structured form, outlining strict financial criteria for eligibility. It is administered by the Legal Services Commission who ensure that public funds are made available to those individuals in need of it most. Legal assistance is broken down into six differing levels of assistance: (1) legal help (2) help at court; (3) investigative help; (4) full representation (5) support funding; (6) specific directions.

Community legislation /kəˌmjuːnɪti ledʒɪˈsleɪʃ(ə)n/**, Community law** *noun* **1.** regulations or directives issued by the EC Council of Ministers or the EC Commission **2.** laws created by the European Community which are binding on Member States and their citizens

community policing /kəˌmjuːnɪti pəˈliːsɪŋ/ *noun* a way of policing a section of a town, where the members of the

mainp - softvnn.com

Law.fm Page 57 Friday, June 11, 2004 2:08 PM

local community and the local police force act together to prevent crime and disorder, with policemen on foot patrol rather than in patrol cars

community property /kəˌmjuːnɪti ˈprɒpəti/ *noun* in the USA, Canada, France and many other countries, a situation where a husband and wife jointly own any property which they acquire during the course of their marriage. Compare **separate property**

community service /kəˌmjuːnɪti ˈsɜːvɪs/ *noun* work that someone has to do in their spare time as punishment for some offences instead of going to prison

community service order /kəˌmjuːnɪti ˈsɜːvɪs ˌɔːdə/ *noun* a punishment where a convicted person is sentenced to do unpaid work in the local community. Abbreviation **CSO**

community support officer /kəˌmjuːnɪti səˈpɔːt ˌɒfɪsə/ *noun* ▸ **Police Community Support Officer**

commutation /ˌkɒmjʊˈteɪʃ(ə)n/ *noun* the reduction of a punishment to one that is less severe

commute /kəˈmjuːt/ *verb* **1.** to travel to work from home each day ○ *He commutes from the country to his office in the centre of town.* **2.** to change a right into cash **3.** to reduce a harsh sentence to a lesser one ○ *The death sentence was commuted to life imprisonment.*

compact /ˈkɒmpækt/ *noun* an agreement

Companies Act /ˈkʌmp(ə)niz ækt/ *noun* in the UK, an Act which states the legal limits within which a company may do business

Companies House /ˌkʌmpəniz ˈhaʊs/ *noun* in the UK, an office which keeps details of incorporated companies

companies' register /ˌkʌmpəniz ˈredʒɪstə/ *noun* a list of companies showing their directors and registered addresses, and statutory information kept at Companies House for public inspection

company /ˈkʌmp(ə)ni/ *noun* **1.** a group of people organised to buy, sell or provide a service **2.** a group of people organised to buy or sell or provide a service which has been legally incorporated, and so is a legal entity separate from its individual members □ **a tractor *or* aircraft *or* chocolate company** a company which makes tractors or aircraft or chocolate □ **a company of good standing** a very reputable company □ **to put a company into liquidation** to close a company by selling its assets to pay its creditors □ **to set up a company** to start a company legally **3.** □ **companies' register**, **register of companies** list of companies showing details of their directors and registered addresses **4.** an organisation in the City of London which does mainly charitable work and is derived from one of the former trade associations ○ *the Drapers' Company* ○ *the Grocers' Company*

company director /ˌkʌmp(ə)ni daɪˈrektə/ *noun* a person appointed by the shareholders to run a company

company flat /ˌkʌmp(ə)ni ˈflæt/ *noun* a flat owned by a company and used by members of staff from time to time (NOTE: The US term is **apartment**.)

company law /ˌkʌmp(ə)ni ˈlɔː/ *noun* law relating to the way companies may operate

company member /ˌkʌmp(ə)ni ˈmembə/ *noun* a shareholder in a company

company promoter /ˌkʌmp(ə)ni prəˈməʊtə/ *noun* a person who organises the setting up of a new company

company rules /ˈkʌmp(ə)ni ruːlz/, **company rules and regulations** /ˌkʌmp(ə)ni ruːlz ən ˌregjʊˈleɪʃ(ə)nz/ *plural noun* the general way of working in a company

company secretary /ˌkʌmp(ə)ni ˈsekrɪt(ə)ri/ *noun* somebody who is responsible for a company's legal and financial affairs

comparative law /kəmˈpærətɪv lɔː/ *noun* a study which compares the legal systems of different countries

compel /kəmˈpel/ *verb* to force someone to do something ○ *The Act compels all drivers to have adequate insurance.* (NOTE: **compelling – compelled**)

compellability /kəmˌpeləˈbɪlɪti/ *noun* the fact of being compellable

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Law.fm Page 58 Friday, June 11, 2004 2:08 PM

compellable /kəm'peləb(ə)l/ *adjective* able to be forced to do something ○ *a compellable witness*

compensate /'kɒmpənseɪt/ *verb* to pay for damage done ○ *to compensate a manager for loss of commission*

compensation /ˌkɒmpən'seɪʃ(ə)n/ *noun* **1.** payment made by someone to cover the cost of damage or hardship which he or she has caused ○ *Unlimited compensation may be awarded in the Crown Court.* □ **compensation for damage** payment for damage done □ **compensation for loss of office** payment to a director who is asked to leave a company before his or her contract ends □ **compensation for loss of earnings** payment to someone who has stopped earning money or who is not able to earn money **2.** *US* a payment made to someone for work which has been done

compensation fund /ˌkɒmpən 'seɪʃ(ə)n fʌnd/ *noun* a special fund set up by the Law Society to compensate clients for loss suffered because of the actions of solicitors

compensation order /ˌkɒmpən 'seɪʃ(ə)n ˌɔːdə/ *noun* an order made by a criminal court which forces a criminal to pay compensation to his or her victim

compensation package /ˌkɒmpən 'seɪʃ(ə)n ˌpækɪdʒ/ *noun* the salary, pension and other benefits offered with a job

compensatory damages /ˌkɒmpənseɪt(ə)ri 'dæmɪdʒɪz/ *plural noun* damages which compensate for loss or harm suffered

compete /kəm'piːt/ *verb* □ **to compete with someone or with a company** to try to do better than another person or another company

competence /'kɒmpɪt(ə)ns/**, competency** /'kɒmpɪt(ə)nsi/ *noun* **1.** the ability to do something effectively **2.** the fact of being able to give evidence (NOTE: Anyone is able to give evidence, except the sovereign, persons who are mentally ill, and spouses when the other spouse is being prosecuted.) **3.** □ **the case falls within the competence of the court** the court is legally able to deal with the case

competent /'kɒmpɪt(ə)nt/ *adjective* **1.** able to do something ○ *She is a competent secretary* or *a competent manager.* **2.** efficient **3.** legally able to do something ○ *Most people are competent to give evidence.* □ **the court is not competent to deal with this case** the court is not legally able to deal with the case

competition /ˌkɒmpə'tɪʃ(ə)n/ *noun* the process of attempting to do better and be more successful than another company

competitor /kəm'petɪtə/ *noun* a person or company which competes ○ *Two German firms are our main competitors.* ○ *The contract of employment forbids members of staff from leaving to go to work for competitors.*

complainant /kəm'pleɪnənt/ *noun* somebody who makes a complaint or who starts proceedings against someone

complaint /kəm'pleɪnt/ *noun* **1.** a statement that you feel something is wrong ○ *When making a complaint, always quote the reference number.* ○ *She sent her letter of complaint to the managing director.* □ **to make** or **lodge a complaint against someone** to write and send an official complaint to someone's superior **2.** a document signed to start proceedings in a Magistrates' Court **3.** a statement of the case made by the claimant at the beginning of a civil action

complaints procedure /kəm 'pleɪnts prəˌsiːdʒə/ *noun* an agreed way of presenting complaints formally, e.g. from an employee to the management of a company

complete /kəm'pliːt/ *adjective* whole, with nothing missing ○ *The order is complete and ready for sending.* ○ *The order should be delivered only if it is complete.* ■ *verb* **1.** to finish ○ *The factory completed the order in two weeks.* ○ *How long will it take you to complete the job?* **2.** □ **to complete a conveyance** to convey a property to a purchaser, when the purchaser pays the purchase price and the vendor hands over the signed conveyance and the deeds of the property

completion /kəm'pliːʃ(ə)n/ *noun* **1.** the act of finishing something **2.** the last stage in the sale of a property when the solicitors for the two parties meet, when

mainp - softvnn.com

Law.fm Page 59 Friday, June 11, 2004 2:08 PM

the purchaser pays and the vendor passes the conveyance and the deeds to the purchaser

completion date /kəm'pliːʃ(ə)n deɪt/ *noun* the date when something will be finished

completion statement /kəm ˌpliːʃ(ə)n 'steɪtmənt/ *noun* a statement of account from a solicitor to a client showing all the costs of the sale or purchase of a property

compliance /kəm'plaɪəns/ *noun* willingness to do what is ordered ○ *The documents have been drawn up in compliance with the provisions of the Act.*

compliant /kəm'plaɪənt/ *adjective* agreeing with something □ **not compliant with** not in agreement with ○ *The settlement is not compliant with the earlier order of the court.*

compliments slip /'kɒmplɪmənts slɪp/ *noun* a piece of paper with the name of a company printed on it, sent with documents, gifts, etc., instead of a letter

comply /kəm'plaɪ/ *verb* □ **to comply with** to obey ○ *The company has complied with the court order.* ○ *She refused to comply with the injunction.*

composition /ˌkɒmpə'zɪʃ(ə)n/ *noun* an agreement between a debtor and creditors to settle a debt immediately by repaying only part of it

compos mentis /ˌkɒmpɒs 'mentɪs/ *phrase* a Latin phrase meaning 'of sound mind' or 'sane'

compound /kəm'paʊnd/ *verb* **1.** to agree with creditors to settle a debt by paying part of what is owed **2.** □ **to compound an offence** to agree (in return for payment) not to prosecute someone who has committed an offence

comprehensive /ˌkɒmprɪ'hensɪv/ *adjective* including everything

comprehensive insurance /ˌkɒmprɪhensɪv ɪn'ʃʊərəns/ *noun* insurance which covers you against a large number of possible risks

comprehensive policy /ˌkɒmprɪhensɪv 'pɒlɪsi/ *noun* an insurance policy which covers risks of any kind, with no exclusions

compromise /'kɒmprəmaɪz/ *noun* an agreement between two sides, where each side gives way a little in order to reach a settlement ○ *After some discussion a compromise solution was reached.* ■ *verb* **1.** to reach an agreement by giving way a little ○ *He asked £15 for it, I offered £7 and we compromised on £10.* **2.** to involve someone in something which makes his or her reputation less good ○ *The minister was compromised in the bribery case.*

comptroller /kən'trəʊlə/ *noun* the person in charge, especially referring to accounts

Comptroller and Auditor-General /kənˌtrəʊlə ən ˌɔːdɪtə 'dʒen(ə)rəl/ *noun* an official whose duty is to examine the accounts of ministries and government departments and who heads the National Audit Office

compulsory /kəm'pʌlsəri/ *adjective* being forced or ordered

compulsory liquidation /kəm ˌpʌlsəri ˌlɪkwɪ'deɪʃ(ə)n/ *noun* liquidation which is ordered by a court

compulsory purchase /kəm ˌpʌlsəri 'pɜːtʃɪs/ *noun* the buying of a property by the local council or the government even if the owner does not want to sell

compulsory purchase order /kəm ˌpʌlsəri 'pɜːtʃɪs ˌɔːdə/ *noun* an official order from a local authority or from the government ordering an owner to sell his or her property

compulsory winding up order /kəmˌpʌlsəri ˌwaɪndɪŋ 'ʌp ˌɔːdə/ *noun* an order from a court saying that a company must be wound up (stop trading)

computer error /kəmˌpjuːtər 'erə/ *noun* a mistake made by a computer

computer fraud /kəm'pjuːtə frɔːd/ *noun* fraud committed by using data stored on computer

computerise /kəm'pjuːtəraɪz/, **computerize** *verb* to change from a manual system to one using computers ○ *The police criminal records have been completely computerised.*

computer language /kəm'pjuːtə ˌlæŋgwɪdʒ/ *noun* a system of signs, let-

mainp - softvnn.com

Law.fm Page 60 Friday, June 11, 2004 2:08 PM

ters and words used to instruct a computer

computer program /kəm'pjuːtə ˌprəʊgræm/ *noun* a set of instructions to a computer, telling it to do a particular piece of work

computer time /kəm'pjuːtə taɪm/ *noun* the time when a computer is being used (paid for at an hourly rate)

con /kɒn/ *noun* **1.** a trick done to try to get money from someone (*informal*) ○ *Trying to get us to pay him for ten hours' overtime was just a con.* **2.** same as **convict** (*slang*) **3.** same as **conviction** (*slang*) ■ *verb* to trick someone to try to get money (*informal*) ○ *They conned the bank into lending them £25,000 with no security.* ○ *He conned the finance company out of £100,000.* (NOTE: **conning – conned**. Note also you con someone **into** doing something.)

conceal /kən'siːl/ *verb* to hide ○ *She was accused of concealing information.* ○ *The accused had a gun concealed under his coat.*

concealment /kən'siːlmənt/ *noun* the act hiding something for criminal purposes □ **concealment of assets** the act of hiding assets so that creditors do not know they exist □ **concealment of birth** a notifiable offence of hiding the fact that a child has been born

concede /kən'siːd/ *verb* to admit that an opposing party is right ○ *Counsel conceded that his client owed the money.* ○ *The witness conceded under questioning that he had never been near the house.* □ **to concede defeat** to admit that you have lost

concern /kən'sɜːn/ *noun* a business or company □ **his business is a going concern** the company is working (and making a profit) □ **sold as a going concern** sold as an actively trading company ■ *verb* to deal with, to be connected with ○ *The court is not concerned with the value of the items stolen.* ○ *The report does not concern itself with the impartiality of the judge.* ○ *He has been asked to give evidence to the commission of inquiry concerning the breakdown of law and order.* ○ *The contract was drawn up with the agreement of all parties concerned.*

concert party /'kɒnsət ˌpɑːti/ *noun* an arrangement by which several people or companies act together in secret to take over a company

concession /kən'seʃ(ə)n/ *noun* **1.** the right to use someone else's property for business purposes **2.** the right to be the only seller of a product in a place ○ *She runs a jewellery concession in a department store.* **3.** an allowance **4.** an act of accepting defeat

concessionaire /kənˌseʃə'neə/ *noun* somebody who has the right to be the only seller of a product in a place

conciliation /kənˌsɪli'eɪʃ(ə)n/ *noun* the activity of bringing together the parties in a dispute so that the dispute can be settled

Conciliation Service /kənˌsɪli 'eɪʃ(ə)n ˌsɜːvɪs/ *noun* same as **Advisory Conciliation and Arbitration Service**

conclude /kən'kluːd/ *verb* **1.** to complete successfully ○ *to conclude an agreement with someone* **2.** to believe from evidence ○ *The police concluded that the thief had got into the building through the main entrance.*

conclusion /kən'kluːʒ(ə)n/ *noun* **1.** an opinion which is reached after careful thought and examination of the evidence ○ *The police have come to the conclusion* or *have reached the conclusion that the bomb was set off by radio control.* **2.** □ **conclusion of fact** *US* a statement of a decision by a judge, based on facts □ **conclusion of law** a statement of a decision by a judge, based on rules of law **3.** the final completion ○ *the conclusion of the defence counsel's address* □ **in conclusion** finally, at the end ○ *In conclusion, the judge thanked the jury for their long and patient service.*

conclusive /kən'kluːsɪv/ *adjective* proving something ○ *The fingerprints on the gun were conclusive evidence that the accused was guilty.*

conclusively /kən'kluːsɪvli/ *adverb* in a way which proves a fact ○ *The evidence of the eye witness proved conclusively that the accused was in the town at the time the robbery was committed.*

mainp - softvnn.com

Law.fm Page 61 Friday, June 11, 2004 2:08 PM

concordat /kən'kɔːdæt/ *noun* agreement between the Roman Catholic Church and a government, which allows the Church specific rights and privileges

concur /kən'kɜː/ *verb* to agree ○ *Smith LJ dismissed the appeal, Jones and White LJJ concurring.*

concurrence /kən'kʌrəns/ *noun* agreement between different people ○ *In concurrence with the other judges, Smith LJ dismissed the appeal.*

concurrent /kən'kʌrənt/ *adjective* taking place at the same time. ◊ **consecutive**

concurrently /kən'kʌrəntli/ *adverb* taking place at the same time ○ *He was sentenced to two periods of two years in prison, the sentences to run concurrently.* ◊ **consecutively**

concurrent power /kən,kʌrənt 'paʊə/ *noun* a power which is held concurrently by a Member State and by the community, where the Member State can exercise the power up to the point at which the community exercises its rights. If the community acts, the power becomes exclusive to the community and the Member State can no longer act.

concurrent sentence /kən,kʌrənt 'sentəns/ *noun* a sentence which takes place at the same time as another ○ *He was given two concurrent jail sentences of six months.*

condemn /kən'dem/ *verb* **1.** to sentence someone to be punished ○ *The prisoners were condemned to death.* **2.** to say that a dwelling is not fit for people to live in

condemnation /,kɒndem'neɪʃ(ə)n/ *noun* **1.** the act of sentencing of someone to a particular severe punishment **2.** the forfeit of a piece of property when it has been legally seized

condemned cell /kən'demd sel/ *noun US* a cell where a prisoner is kept who has been sentenced to death

condition /kən'dɪʃ(ə)n/ *noun* **1.** a term of a contract or duty which has to be carried out as part of a contract, or something which has to be agreed before a contract becomes valid □ **on condition that** provided that ○ *They were granted the lease on condition that they paid the legal costs.* **2.** a general state ○ *item sold in good condition* ○ *What was the condition of the car when it was sold?*

conditional /kən'dɪʃ(ə)n(ə)l/ *adjective* only able to happen if something else happens first □ **to give a conditional acceptance** to accept, provided that specific things happen or terms apply □ **the offer is conditional on the board's acceptance** the offer will only go through if the board accepts it □ **he made a conditional offer** he offered to buy, provided that specific terms applied

conditional discharge /kən ,dɪʃ(ə)n(ə)l dɪs'tʃɑːdʒ/ *noun* an act of allowing an offender to be set free without any immediate punishment on condition that he or she does not commit an offence during the following period

conditional fee /kən'dɪʃ(ə)n(ə)l fiː/ *noun* a fee which is paid only if the case is won. Also called **contingent fee, success fee**

COMMENT: Conditional fee agreements originally covered a limited range of cases, but are now applied to insolvency, defamation, civil liberties, intellectual property, employment and many other areas of action. These agreements allow clients to agree with their lawyers that the lawyers will not receive all or part of the usual fees or expenses if the case is lost; if the case is won, on the other hand, the client agrees to pay an extra fee in addition to the normal fee. Insurance policies are available to people contemplating legal action to cover the costs of the other party and the client's own fees if the case is lost.

conditional fee agreement /kən ,dɪʃ(ə)n(ə)l fiː ə'griːmənt/ *noun* an agreement between a client and their representation that the legal fees will only be paid if the case is successful. Also known as **no win no fee**

conditionally /kən'dɪʃ(ə)n(ə)li/ *adverb* provided some things take place □ **to accept an offer conditionally** to accept provided some conditions are fulfilled

conditional will /kən'dɪʃ(ə)n(ə)l wɪl/ *noun* a will which takes effect when the person dies, but only if specific conditions apply

mainp - softvnn.com

Law.fm Page 62 Friday, June 11, 2004 2:08 PM

condition precedent /kənˌdɪʃ(ə)n 'presɪd(ə)nt/ *noun* a condition which says that a right will not be granted until something is done

conditions of employment /kənˌdɪʃ(ə)nz əv ɪm'plɔɪmənt/ *plural noun* the terms of a contract of employment, which must be supplied in writing to an employee within two months of the start of employment

conditions of sale /kənˌdɪʃ(ə)nz əv 'seɪl/ *plural noun* a list of the terms such as discounts and credit terms under which a sale takes place

condition subsequent /kənˌdɪʃ(ə)n 'sʌbsɪkwənt/ *noun* a condition which says that a contract will be modified or annulled if something is not done

condominium /ˌkɒndə'mɪniəm/ *noun US* a system of ownership, where a person owns an individual apartment in a building, together with a share of the land and common parts such as stairs and roof

condonation /ˌkɒndə'neɪʃ(ə)n/ *noun* the forgiving by one spouse of an act, especially adultery, of the other

condone /kən'dəʊn/ *verb* to fail to criticise bad or criminal behaviour ○ *The court cannot condone your treatment of your children.*

conducive /kən'djuːsɪv/ *adjective* likely to lead to or produce ○ *The threat of legal action is not conducive to an easy solution to the dispute.*

conduct /kən'dʌkt/ *noun* a way of behaving ○ *She was arrested for disorderly conduct in the street.* □ **conduct conducive to a breach of the peace** a way of behaving, using rude or threatening language in speech or writing, which seems likely to cause a breach of the peace ■ *verb* to carry out an activity ○ *to conduct discussions* or *negotiations* ○ *The chairman conducted the proceedings very efficiently.*

confederation /kənˌfedə'reɪʃ(ə)n/, **confederacy** /kən'fed(ə)rəsi/ *noun* a group of organisations working together for common aims ○ *a loose confederation of local businesses*

confer /kən'fɜː/ *verb* **1.** to give power or responsibility to someone ○ *the discretionary powers conferred on the tribunal by statute* **2.** to discuss ○ *The Chief Constable conferred with the Superintendent in charge of the case.*

conference /'kɒnf(ə)rəns/ *noun* a meeting of a group of people to discuss something ○ *The Police Federation is holding its annual conference this week.* ○ *The Labour Party Annual Conference was held in Brighton this year.* ○ *He presented a motion to the conference.* ○ *The conference passed a motion in favour of unilateral nuclear disarmament.*

conference agenda /ˌkɒnf(ə)rəns ə'dʒendə/ *noun* the business which is to be discussed at a conference

conference papers /ˌkɒnf(ə)rəns 'peɪpəs/ *plural noun* copies of lectures given at a conference, printed and published after the conference has ended

conference proceedings /'kɒnf(ə)rəns prəˌsiːdɪŋz/ *plural noun* written report of what has been discussed at a conference

conference table /ˌkɒnf(ə)rəns 'teɪb(ə)l/ *noun* a table around which people sit to negotiate

confess /kən'fes/ *verb* to admit that you have committed a crime ○ *After six hours' questioning by the police the accused man confessed.*

confession /kən'feʃ(ə)n/ *noun* **1.** a statement by a defendant that they have committed a crime ○ *The police sergeant asked him to sign his confession.* **2.** a document in which you admit that you have committed a crime ○ *The accused typed his own confession statement.* ○ *The confession was not admitted in court, because the accused claimed it had been extorted.*

confession and avoidance /kənˌfeʃ(ə)n ən ə'vɔɪd(ə)ns/ *noun* an admission by a party of the allegations made against him or her, but at the same time bringing forward new pleadings which make the allegations void

confidence /'kɒnfɪd(ə)ns/ *noun* **1.** feeling sure about something or having trust in someone ○ *The sales teams do not have much confidence in their manager.* ○ *The board has total confidence in the managing director.* **2.** the ability to

mainp - softvnn.com

Law.fm Page 63 Friday, June 11, 2004 2:08 PM

trust someone with a secret ▫ **in confidence** in secret ○ *I will show you the report in confidence.*

confidence trick /'kɒnfɪd(ə)ns ˌtrɪk/, **confidence game** *US* /'kɒnfɪd(ə)ns geɪm/ *noun* a business deal where someone gains another person's confidence and then tricks him or her

confidence trickster /'kɒnfɪd(ə)ns ˌtrɪkstə/, **confidence man** *US* /'kɒnfɪd(ə)ns mæn/ *noun* somebody who carries out confidence tricks on people

confidence vote /'kɒnfɪd(ə)ns vəʊt/ *noun* a vote to show that a person or group is or is not trusted ○ *He proposed a vote of confidence in the government.* ○ *The chairman resigned after the motion of no confidence was passed at the AGM.*

confidential /ˌkɒnfɪ'denʃəl/ *adjective* secret between two persons or a small group of people ○ *the letter was marked 'Private and Confidential'*

confidential information /ˌkɒnfɪdenʃəl ˌɪnfə'meɪʃ(ə)n/ *noun* information which is secret, and which must not be passed on to other people ○ *He was accused of passing on confidential information.* ○ *The knowledge which an employee has of the working of the firm for which he works can be seen to be confidential information which he must not pass on to another firm.*

confidentiality /ˌkɒnfɪdenʃi'ælɪti/ *noun* an understanding between two or more parties that specified information remains secret

confidential report /ˌkɒnfɪdenʃəl rɪ 'pɔːt/ *noun* a secret document which must not be shown to other than a few named persons

confine /kən'faɪn/ *verb* to keep a criminal in a room or restricted area

confined to barracks /kənˌfaɪnd tə 'bærəks/ *adjective* (*of a soldier*) sentenced to stay in the barracks for a set period of time and not to go outside. Abbreviation **CB**

confinement /kən'faɪnmənt/ *noun* the situation of being kept in a place without being free to leave, especially as a punishment

confirm /kən'fɜːm/ *verb* to say that something is certain or is correct ○ *The Court of Appeal has confirmed the judge's decision.* ○ *His secretary phoned to confirm the hotel room* or *the ticket* or *the agreement* or *the booking.* ▫ **to confirm someone in a job** to say that someone is now permanently in a particular job

confiscate /'kɒnfɪskeɪt/ *verb* to take away private property into the possession of the state ○ *The court ordered the drugs to be confiscated.*

confiscation /ˌkɒnfɪs'keɪʃ(ə)n/ *noun* the act of confiscating

conflict *noun* /'kɒnflɪkt/ disagreement ▫ **to be in *or* come into conflict with** to disagree with someone over something ■ *verb* /kən'flɪkt/ not to agree ○ *The evidence of the wife conflicts with that of her husband.* ○ *The UK legislation conflicts with the directives of the EC.*

conflicting evidence /ˌkɒnflɪktɪŋ 'evɪd(ə)ns/ *noun* evidence from different witnesses which does not agree ○ *The jury has to decide who to believe among a mass of conflicting evidence.*

conflict of interest /ˌkɒnflɪkt əv 'ɪntrəst/, **conflict of interests** /ˌkɒnflɪkt əv 'ɪntrəsts/ *noun* a situation where a person may profit personally from decisions which he or she takes in their official capacity, or may not be able to act independently because of connections with other people or organisations

conflict of laws /ˌkɒnflɪkt əv 'lɔːz/ *noun* a section in a country's statutes which deals with disputes between that country's laws and those of another country

conform /kən'fɔːm/ *verb* to act in accordance with something ○ *The proposed Bill conforms to the recommendations of the Royal Commission.*

conformance /kən'fɔːməns/ *noun* behaviour in accordance with a rule ○ *in conformance with the directives of the Commission* ○ *He was criticised for non-conformance with the regulations.*

mainp - softvnn.com

Law.fm Page 64 Friday, June 11, 2004 2:08 PM

conformity /kən'fɔːmɪti/ *noun* □ **in conformity with** agreeing with ○ *He has acted in conformity with the regulations.*

Congress /'kɒŋgres/ *noun US* the elected federal legislative body in many countries, especially in the USA where it is formed of the House of Representatives and the Senate ○ *The President is counting on a Democrat majority in Congress.* ○ *He was first elected to Congress in 1988.* ○ *At a joint session of Congress, the President called for support for his plan.* (NOTE: often used without **the** except when referring to a particular legislature: *The US Congress met in emergency session*; *The Republicans had a majority in both houses of the 1974 Congress.*)

Congressional /kən'greʃ(ə)n(ə)l/ *adjective US* referring to Congress ○ *a Congressional subcommittee*

conjugal /'kɒndʒʊg(ə)l/ *adjective* referring to marriage

conjugal rights /ˌkɒndʒʊg(ə)l 'raɪts/ *plural noun* rights of a husband and wife in relation to each other

conman /'kɒnmæn/ *noun* same as **confidence trickster** (*informal*)

connected persons /kəˌnektɪd 'pɜːs(ə)ns/ *plural noun* people who are closely related to, or have a close business association with, a company director

connection /kə'nekʃən/ *noun* something which joins one person or thing to another ○ *Is there a connection between the loss of the documents and the death of the lawyer?* □ **in connection with** referring to ○ *the police want to interview the man in connection with burglaries committed last November*

connivance /kə'naɪvəns/ *noun* the act of not reporting a crime that you know is being or is about to be committed ○ *With the connivance of the customs officers, he managed to bring the goods into the country.*

connive /kə'naɪv/ *verb* □ **to connive at something** to shut one's eyes to wrongdoing, to know that a crime is being committed, but not to report it

consecutive /kən'sekjʊtɪv/ *adjective* following. ◊ **concurrent** □ **consecutive sentences** two or more sentences which follow one after the other

consecutively /kə'sekjʊtɪvli/ *adverb* following ○ *He was sentenced to two periods of two years in jail, the sentences to run consecutively.* ◊ **concurrently**

consensual /kən'sensjʊəl/ *adjective* happening by agreement

consensual acts /kənˌsensjʊəl 'ækts/ *plural noun* sexual acts which both parties agree should take place

consensus /kən'sensəs/ *noun* general agreement ○ *There was a consensus between all parties as to the next steps to be taken.* ○ *In the absence of a consensus, no decisions could be reached.*

consensus ad idem /kənˌsensəs æd 'aɪdem/ *phrase* a Latin phrase meaning 'agreement to this same thing': a real agreement to a contract by both parties

consent /kən'sent/ *noun* agreement or permission that something should happen ○ *He borrowed the car without the owner's consent.* □ **age of consent** sixteen years old, when a girl can agree to have sexual intercourse ■ *verb* to agree that something should be done ○ *The judge consented to the request of the prosecution counsel.*

consent judgment /kənˌsent 'dʒʌdʒmənt/ *noun* an agreement of the parties in a lawsuit to a judgment which then becomes the settlement

consent order /kənˌsent 'ɔːdə/ *noun* a court order that someone must not do something without the agreement of another party

consequential /ˌkɒnsɪ'kwenʃəl/ *adjective* following as a result of

consequential damages /ˌkɒnsɪkwenʃəl 'dæmɪdʒɪz/ *plural noun* damages suffered as a consequence of using a piece of equipment, software, etc., e.g. the stoppage of business activities because of computer or software failure

consequent on /'kɒnsɪkwənt ɒn/, **upon** /ʌ'pɒn/ *adjective* following as a result of ○ *The manufacturer is not liable for injuries consequent on the use of this apparatus.*

mainp - softvnn.com

Law.fm Page 65 Friday, June 11, 2004 2:08 PM

consider /kən'sɪdə/ *verb* **1.** to think seriously about something □ **to consider the terms of a contract** to examine and discuss if the terms are acceptable □ **the judge asked the jury to consider their verdict** he asked the jury to discuss the evidence they had heard and decide if the accused was guilty or not **2.** to believe ○ *He is considered to be one of the leading divorce lawyers.* ○ *The law on libel is considered too lenient.*

consideration /kənˌsɪdə'reɪʃ(ə)n/ *noun* **1.** serious thought ○ *We are giving consideration to moving the head office to Scotland.* □ **to take something into consideration** to think about something when deciding what to do ○ *Having taken the age of the accused into consideration, the court has decided to give him a suspended sentence.* □ **to ask for other offences to be taken into consideration** to confess to other offences after being accused or convicted of one offence, so that the sentence can cover all of them ○ *The accused admitted six other offences, and asked for them to be taken into consideration.* **2.** the price, in money, goods, or some other reward, paid by one person in exchange for another person promising to do something, which is an essential element in the formation of a contract □ **for a small consideration** for a small fee or payment

consign /kən'saɪn/ *verb* □ **to consign goods to someone** to send goods to someone for him to use or to sell for you

consignation /ˌkɒnsaɪ'neɪʃ(ə)n/ *noun* the act of consigning

consignee /ˌkɒnsaɪ'niː/ *noun* somebody who receives goods from someone for his or her own use or to sell for the person who sends them

consignment /kən'saɪnmənt/ *noun* the sending of goods to someone who will hold them for you and sell them on your behalf □ **goods on consignment** goods kept for another company to be sold on their behalf for a commission

consignment note /kən'saɪnmənt nəʊt/ *noun* a note saying that goods have been sent

consignor /kən'saɪnə/ *noun* somebody who consigns goods to someone

COMMENT: The goods remain the property of the consignor until the consignee sells them.

consistent /kən'sɪstənt/ *adjective* agreeing with and not contradicting something ○ *The sentence is consistent with government policy on the treatment of young offenders.*

consolidate /kən'sɒlɪˌdeɪt/ *verb* **1.** to bring several Acts of Parliament together into one act ○ *The judge ordered the actions to be consolidated.* **2.** to hear several sets of proceedings together

Consolidated Fund /kənˌsɒlɪdeɪtɪd 'fʌnd/ *noun* a fund of money formed of all taxes and other government revenues. ◊ **Exchequer**

consolidated shipment /kənˌsɒlɪdeɪtɪd 'ʃɪpmənt/ *noun* goods from different companies grouped together into a single shipment

Consolidating Act /kən'sɒlɪdeɪtɪŋˌækt/ *noun* an Act of Parliament which brings together several previous Acts which relate to the same subject. ◊ **codification**

consolidation /kənˌsɒlɪ'deɪʃ(ə)n/ *noun* **1.** the act of bringing together various Acts of Parliament which deal with one subject into one single Act **2.** a procedure whereby several sets of proceedings are heard together by the court

consortium /kən'sɔːtiəm/ *noun* **1.** a group of different companies which work together on one project **2.** the right of a husband and wife to the love and support of the other

conspiracy /kən'spɪrəsi/ *noun* a plan made with another person or other people to commit a crime or tort (NOTE: Conspiracy to commit a crime is itself a crime.)

conspire /kən'spaɪə/ *verb* to agree with another person or other people to commit a crime or tort

constitute /'kɒnstɪˌtjuːt/ *verb* to make or to form ○ *The documents constitute primary evidence.* ○ *This Act constitutes a major change in government policy.* ○ *Conduct tending to interfere with the course of justice constitutes contempt of court.*

constitution /ˌkɒnstɪ'tjuːʃ(ə)n/ *noun* **1.** the set of laws, usually written

mainp - softvnn.com

Law.fm Page 66 Friday, June 11, 2004 2:08 PM

down, under which a country is ruled ○ *The freedom of the individual is guaranteed by the country's constitution.* ○ *The new president asked the assembly to draft a new constitution.* **2.** the written rules of a society, association or club ○ *Under the society's constitution, the chairman is elected for a two-year period.* ○ *Payments to officers of the association are not allowed by the constitution.*

COMMENT: Most countries have written constitutions, usually drafted by lawyers, which can be amended by an Act of the country's legislative body. The United States constitution was drawn up by Thomas Jefferson after the country became independent, and has numerous amendments (the first ten amendments being the Bill of Rights). Great Britain is unusual in that it has no written constitution, and relies on precedent and the body of laws passed over the years to act as a safeguard of the rights of the citizens and the legality of government.

constitutional /ˌkɒnstɪ'tjuːʃ(ə)nəl/ *adjective* **1.** referring to a country's constitution ○ *Censorship of the press is not constitutional.* **2.** according to a constitution ○ *The re-election of the chairman for a second term is not constitutional.* ◊ **unconstitutional**

constitutional law /ˌkɒnstɪ 'tjuːʃ(ə)n(ə)l lɔː/ *noun* the set of laws relating to government and its function under which a country is ruled

constitutional lawyer /ˌkɒnstɪtjuːʃ(ə)n(ə)l 'lɔːjə/ *noun* a lawyer who specialises in drafting or interpreting constitutions

constitutional right /ˌkɒnstɪ 'tjuːʃ(ə)n(ə)l raɪt/ *noun* a right which is guaranteed by the constitution of a country

construction /kən'strʌkʃən/ *noun* an interpretation of the meaning of words ▫ **to put a construction on words** to suggest a meaning for words which is not immediately obvious

construction company /kən 'strʌkʃ(ə)n ˌkʌmp(ə)ni/ *noun* a company which specialises in building

constructive /kən'strʌktɪv/ *adjective* helping in the making of something ○ *She made some constructive suggestions for improving employer-employee relations.* ○ *We had a constructive proposal from a shipping company in Italy.*

constructive dismissal /kən ˌstrʌktɪv dɪs'mɪs(ə)l/ *noun* a situation when a worker leaves his or her job voluntarily, but because of unreasonable pressure from the management

constructive knowledge /kən ˌstrʌktɪv 'nɒlɪdʒ/ *noun* knowledge of a fact or matter which the law says a person has available to them, whether or not that person actually has it

constructive notice /kənˌstrʌktɪv 'nəʊtɪs/ *noun* knowledge which the law says a person has of something, whether or not the person actually has it, because the information is available if reasonable inquiry is made

constructive total loss /kən ˌstrʌktɪv 'təʊt(ə)l lɒs/ *noun* a loss where the item insured has been thrown away as it is likely to be irreplaceable

constructive trust /kən'strʌktɪv trʌst/ *noun* trust arising by reason of a person's behaviour

construe /kən'struː/ *verb* to interpret the meaning of words or of a document ○ *The court construed the words to mean that there was a contract between the parties.* ○ *Written opinion is not admissible as evidence for the purposes of construing a deed of settlement.*

consult /kən'sʌlt/ *verb* to ask an expert for advice ○ *He consulted his solicitor about the letter.*

consultancy /kən'sʌltənsi/ *noun* the act of giving specialist advice ○ *a consultancy firm* ○ *He offers a consultancy service.*

consultant /kən'sʌltənt/ *noun* a specialist who gives advice ○ *engineering consultant* ○ *management consultant* ○ *tax consultant*

consultation /ˌkɒnsəl'teɪʃ(ə)n/ *noun* **1.** a meeting with someone who can give specialist advice **2.** a meeting between a client and a professional adviser such as a solicitor or QC

consultation document /ˌkɒnsəl 'teɪʃ(ə)n ˌdɒkjʊmənt/ *noun* a paper which is issued by a government department to people who are asked to com-

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Law.fm Page 67 Friday, June 11, 2004 2:08 PM

ment and make suggestions for improvement

consultative /kən'sʌltətɪv/ *adjective* being asked to give advice ○ *the report of a consultative body* ○ *She is acting in a consultative capacity.*

consultative document /kən ˌsʌltətɪv 'dɒkjʊmənt/ *noun* same as **consultation document**

consulting /kən'sʌltɪŋ/ *adjective* person who gives specialist advice ○ *consulting engineer*

consumer /kən'sjuːmə/ *noun* a person or company which buys and uses goods and services ○ *Gas consumers are protesting at the increase in prices.* ○ *The factory is a heavy consumer of water.*

consumer council /kənˌsjuːmə 'kaʊns(ə)l/ *noun* a group representing the interests of consumers

consumer credit /kənˌsjuːmə 'kredɪt/ *noun* the provision of loans by finance companies to help people buy goods

consumer goods /kənˌsjuːmə 'gʊdz/ *plural noun* goods bought by the general public and not by businesses

consumer legislation /kənˌsjuːmə ˌledʒɪ'sleɪʃ(ə)n/ *noun* law which gives rights to people who buy goods or who pay for services

consumer protection /kənˌsjuːmə prə'tekʃən/ *noun* the activity of protecting consumers from unfair or illegal business practices

consummation /ˌkɒnsə'meɪʃ(ə)n/ *noun* the act of having sexual intercourse for the first time after the marriage ceremony

contact /'kɒntækt/ *noun* **1.** a person you know who can give you help such as finding work or advice and information ○ *He has many contacts in the city.* ○ *Who is your contact in the Ministry?* **2.** the act of getting in touch with someone □ **I have lost contact with them** I do not communicate with them any longer □ **he put me in contact with a good lawyer** he told me how to get in touch with a good lawyer

contact order /'kɒntækt ˌɔːdə/ *noun* a court order allowing a parent to see a child where the child is in the care of someone else, such as the other parent in the case of a divorced couple. Former name **access order**

contemnor /kən'temnə/ *noun* somebody who commits a contempt of court

contempt /kən'tempt/ *noun* the act of showing a lack of respect to a court or Parliament □ **to be in contempt** to have shown disrespect to a court, especially by disobeying a court order □ **to purge one's contempt** to apologise, to do something to show that you are sorry for the lack of respect shown

contempt of court /kənˌtempt əv 'kɔːt/ *noun* the act of showing a lack of respect to a court, by bad behaviour in court or by refusing to carry out a court order ○ *At common law, conduct tending to interfere with the course of justice in particular legal proceedings constitutes criminal contempt.*

content /'kɒntent/ *noun* the subject matter of a letter or other document □ **the content of the letter** the real meaning of the letter

contentious /kən'tenʃəs/ *adjective*, *noun* (*of legal business*) where there is a dispute

contents /'kɒntents/ *plural noun* things contained in something ○ *The contents of the bottle poured out onto the floor.* ○ *The customs officials inspected the contents of the box.* □ **the contents of the envelope** the things in the envelope

contest /kən'test/ *noun* a situation in which people or groups try to gain an advantage ■ *verb* **1.** to argue that a decision or a ruling is wrong ○ *I wish to contest the statement made by the witness.* **2.** to compete to be successful in something such as an election

contested takeover /kənˌtestɪd 'teɪkəʊvə/ *noun* a takeover where the directors of the company being bought do not recommend the bid and try to fight it

context /'kɒntekst/ *noun* **1.** other words which surround a word or phrase ○ *The words can only be understood in the context of the phrase in which they occur.* □ **the words were quoted out of context** the words were quoted without the rest of the surrounding text, so as to

mainp - softvnn.com

Law.fm Page 68 Friday, June 11, 2004 2:08 PM

give them a different meaning **2.** the general situation in which something happens ○ *The action of the police has to be seen in the context of the riots against the government.*

contingency /kən'tɪndʒənsi/ *noun* a possible state of emergency when decisions will have to be taken quickly

contingency fund /kən'tɪndʒənsi fʌnd/ *noun* money set aside in case it is needed urgently

contingency plan /kən'tɪndʒənsi plæn/ *noun* a plan which will be put into action if something happens which is expected to happen

contingent expenses /kən ˌtɪndʒənt ɪk'spensɪz/ *plural noun* expenses which will be incurred only if something happens

contingent fee /kən'tɪndʒənt fiː/ *noun US* a fee paid to a legal practitioner which is a proportion of the damages recovered in the case

contingent interest /kənˌtɪndʒənt 'ɪntrəst/ *noun US* an interest in property which may or may not exist in the future

contingent policy /kənˌtɪndʒənt 'pɒlɪsi/ *noun* a policy which pays out only if something happens, e.g. if the person named in the policy dies before the person who is to benefit from it

contingent remainder /kən ˌtɪndʒənt rɪ'meɪndə/ *noun* a remainder which is contingent upon something happening in the future

contra /'kɒntrə/ *prefix* against, opposite, or contrasting

contract /kən'trækt/ *noun* **1.** a legal agreement between two or more parties ○ *to draw up a contract* ○ *to draft a contract* ○ *to sign a contract* □ **the contract is binding on both parties** both parties signing the contract must do what is agreed □ **by private contract** by private legal agreement □ **under contract** bound by the terms of a contract ○ *The firm is under contract to deliver the goods by November.* □ **to void a contract** to make a contract invalid **2.** □ **contract for services** an agreement for the supply of a service or goods ○ *contract for the supply of spare parts* ○ *to enter into a contract to supply spare parts* ○ *to sign a contract for #10,000 worth of spare parts* □ **to put work out to contract** to decide that work should be done by another company on a contract, rather than employing members of staff to do it □ **to award a contract to a company**, **to place a contract with a company** to decide that a company shall have the contract to do work for you □ **to tender for a contract** to put forward an estimate of cost for work to be carried out under contract □ **the company is in breach of contract** the company has failed to do what was agreed in the contract **3.** an agreement to kill someone for a payment (*slang*) □ **there is a contract out for him** someone has offered money for him to be killed ■ *verb* to agree to do something on the basis of a contract ○ *to contract to supply spare parts* or *to contract for the supply of spare parts* □ **the supply of spare parts was contracted out to Smith Ltd** Smith Ltd was given the contract for supplying spare parts □ **to contract out of an agreement** to withdraw from an agreement with written permission of the other party

COMMENT: A contract is an agreement between two or more parties to create legal obligations between them. Some contracts are made 'under seal', i.e. they are signed and sealed by the parties; most contracts are made orally or in writing. The essential elements of a contract are: (a) that an offer made by one party should be accepted by the other; (b) consideration; (c) the intention to create legal relations. The terms of a contract may be express or implied. A breach of contract by one party entitles the other party to sue for damages or in some cases to seek specific performance.

contracting party /kənˌtræktɪŋ 'pɑːti/ *noun* the person or company that signs a contract

contract killer /ˌkɒntrækt 'kɪlə/ *noun* somebody who will kill someone if paid to do so

contract law /'kɒntrækt lɔː/ *noun* law relating to agreements

contract note /'kɒntrækt nəʊt/ *noun* a note showing that shares have been bought or sold but not yet paid for

contract of employment /ˌkɒntrækt əv ɪm'plɔɪmənt/, **contract**

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Law.fm Page 69 Friday, June 11, 2004 2:08 PM

of service *noun* a contract between an employer and an employee showing all the conditions of work

contractor /kən'trækt ə/ *noun* a person who enters into a contract, especially a person or company that does work according to a written agreement

contractual /kən'trækt ʃʊəl/ *adjective* according to a contract ▫ **to fulfil your contractual obligations** to do what you have agreed to do in a contract ▫ **he is under no contractual obligation to buy** he has signed no agreement to buy

contractual liability /kən,trækt ʃuəl ,laɪə'bɪlɪti/ *noun* a legal responsibility for something as stated in a contract

contractually /kən'trækt juəli/ *adverb* according to a contract ○ *The company is contractually bound to pay his expenses.*

contract under seal /,kɒntrækt 'ʌndə siːl/ *noun* a contract which has been signed and legally approved with the seal of the company or the person entering into it. Compare **simple contract**

contract work /'kɒntrækt wɜːk/ *noun* work done according to a written agreement

contradict /,kɒntrə'dɪkt/ *verb* **1.** to say exactly the opposite of something ○ *The witness contradicted himself several times.* **2.** to disagree in various details with another statement, story or report, so that both cannot be true ○ *The statement contradicts the report in the newspapers.*

contradiction /,kɒntrə'dɪkʃən/ *noun* a statement which contradicts ○ *The witness' evidence was a mass of contradictions.* ○ *There is a contradiction between the Minister's statement in the House of Commons and the reports published in the newspapers.*

contradictory /,kɒntrə'dɪkt(ə)ri/ *adjective* not agreeing ○ *a mass of contradictory evidence*

contra entry /'kɒntrə ,entri/ *noun* an entry made in the opposite side of an account to make an earlier entry worthless, i.e. a debit against a credit

contra proferentem /,kɒntrə ,prɒfə 'rentem/ *phrase* a Latin phrase meaning 'against the one making the point': rule that an ambiguity in a document is construed against the party who drafted it

contrary /'kɒntrəri/ *noun* the opposite ○ *Information suggests that the contrary is true.* ▫ **on the contrary** used for emphasising an opposite statement ○ *Counsel was not annoyed with the witness – on the contrary, she praised him.* ▫ **quite the contrary** used for emphasising an opposite statement ○ *I don't dislike his manner of working -quite the contrary – I think it's very effective.* ▫ **to the contrary** suggesting that the opposite is true or should happen ○ *You should continue to do it this way, unless you receive instructions to the contrary.*

contravene /,kɒntrə'viːn/ *verb* to do something that is not allowed by rules or regulations ○ *The workshop has contravened the employment regulations.* ○ *The fire department can close a restaurant if it contravenes the safety regulations.*

contravention /,kɒntrə'venʃən/ *noun* the act of breaking a regulation ▫ **in contravention of** contravening, going against ○ *The restaurant is in contravention of the safety regulations.* ○ *The management of the cinema locked the fire exits in contravention of the fire regulations.*

contribute /kən'trɪbjuːt/ *verb* ▫ **to contribute to** to help something ○ *The public response to the request for information contributed to the capture of the gang.*

contribution /,kɒntrɪ'bjuːʃ(ə)n/ *noun* **1.** money paid to add to a sum **2.** (*in civil cases*) the right of someone to get money from a third party to cover the amount which he or she personally has to pay

contributor of capital /kən ,trɪbjʊtər əv 'kæpɪt(ə)l/ *noun* somebody who contributes capital to a company

contributory /kən'trɪbjʊt(ə)ri/ *noun* a shareholder who is liable in respect of partly paid shares to a company being wound up

contributory causes /kən ,trɪbjʊt(ə)ri 'kɔːzɪz/ *plural noun* causes which help something to take place ○ *The report listed bad community rela-*

mainp - softvnn.com

Law.fm Page 70 Friday, June 11, 2004 2:08 PM

tions as one of the contributory causes to the riot.

contributory factor /kən ˌtrɪbjʊt(ə)ri ˈfæktə/ *noun* something which contributes to a result

contributory negligence /kən ˌtrɪbjʊt(ə)ri ˈneglɪdʒəns/ *noun* negligence partly caused by the claimant and partly by the defendant, resulting in harm done to the claimant

con trick /ˈkɒn trɪk/ *noun* same as **confidence trick** (*informal*)

control /kənˈtrəʊl/ *noun* the fact of keeping someone or something in order or being able to direct them ○ *The company is under the control of three shareholders.* ○ *The family lost control of its business.* □ **to gain control of a business** to buy more than 50% of the shares so that you can direct the business □ **to lose control of a business** to find that you have less than 50% of the shares in a company, and so are not longer able to direct it ■ *verb* **1.** to have the power to decide what should happen to someone or something **2.** to make sure that something is restricted or kept at the correct level ○ *The government is fighting to control inflation* or *to control the rise in the cost of living.*

controlled /kənˈtrəʊld/ *adjective* **1.** limited by law ○ *controlled chemicals* **2.** carried out in a way that will give accurate results and information ○ *controlled trials* **3.** able to show no emotion when you are angry or upset ○ *There were tears in her eyes as she replied but her voice was controlled.*

controlled drug /kənˌtrəʊld ˈdrʌg/, **controlled substance** /kənˌtrəʊld ˈsʌbstəns/ *noun* a drug or other substance which is restricted by law and of which possession may be an offence

controlling /kənˈtrəʊlɪŋ/ *adjective* □ **to have a controlling interest in a company** to own more than 50% of the shares so that you can direct how the company is run

control systems /kənˈtrəʊl ˌsɪstəmz/ *plural noun* systems used to check that a computer system is working correctly

control test /kənˈtrəʊl test/ *noun* a test to decide if someone is an employee or is self-employed, used for purposes of tax assessment

convene /kənˈviːn/ *verb* to ask people to come together ○ *to convene a meeting of shareholders*

convenience /kənˈviːniəns/ *noun* □ **at your earliest convenience** as soon as you find it possible □ **ship sailing under a flag of convenience** ship flying the flag of a country which may have no ships of its own but allows ships of other countries to be registered in its ports

convenor /kənˈviːnə/ *noun* a person who calls other people together for a meeting

convention /kənˈvenʃən/ *noun* **1.** a way in which something is usually done, accepted as the normal way to do it ○ *It is the convention for American lawyers to designate themselves 'Esquire'.* **2.** a meeting or series of meetings held to discuss and decide important matters **3.** an international treaty ○ *the Geneva Convention on Human Rights* ○ *The three countries are all signatories of the convention.*

conversion /kənˈvɜːʃ(ə)n/ *noun* the tort of dealing with a person's property in a way which is not consistent with that person's rights over it

conversion of funds /kənˌvɜːʃ(ə)n əv ˈfʌndz/ *noun* the use of money which does not belong to you for a purpose for which it is not supposed to be used

convert /kənˈvɜːt/ *verb* **1.** to change property into another form such as cash **2.** □ **to convert funds to one's own use** to use someone else's money for yourself

convey /kənˈveɪ/ *verb* **1.** to carry goods from one place to another **2.** □ **to convey a property to a purchaser** to pass the ownership of the property to the purchaser

conveyance /kənˈveɪəns/ *noun* a legal document which transfers the ownership of land from the seller to the buyer

conveyancer /kənˈveɪənsə/ *noun* somebody who draws up a conveyance

conveyancing /kənˈveɪənsɪŋ/ *noun* **1.** drawing up the document which legally transfers a property from a seller to a

mainp - softvnn.com

Law.fm Page 71 Friday, June 11, 2004 2:08 PM

buyer **2.** law and procedure relating to the purchase and sale of property

convict /kən'vɪkt/ *noun* somebody who is kept in prison as a punishment for a crime ■ *verb* □ **to convict someone of a crime** to find that someone is guilty of a crime ○ *He was convicted of manslaughter and sent to prison.*

convicted criminal /kənˌvɪktɪd 'krɪmɪn(ə)l/ *noun* a criminal who has been found guilty and sentenced

conviction /kən'vɪkʃən/ *noun* **1.** the feeling of being sure that something is true ○ *It is his conviction that the claimant has brought the case maliciously.* **2.** a decision that a person accused of a crime is guilty ○ *He has had ten convictions for burglary.* ◊ **spent conviction**. Compare **sentence**

convict settlement /kənˌvɪkt 'set(ə)lmənt/ *noun US* a prison camp where convicts are sent

cooling off period /ˌkuːlɪŋ 'ɒf ˌpɪəriəd/, **cooling time** *US* /'kuːlɪŋ taɪm/ *noun* **1.** during an industrial dispute, a period when negotiations have to be carried on and no action can be taken by either side **2.** a period when a person is allowed to think about something which he or she has agreed to buy on hire-purchase and possibly return the item

co-operation procedure /kəʊ ˌɒpə 'reɪʃ(ə)n prəˌsiːdʒə/ *noun* (*in the EU*) a procedure introduced by the Single European Act which gives the European Parliament a more important role than before in considering European legislation. ◊ **common position**

COMMENT: Originally the co-operation procedure was restricted to measures concerning the internal market (free movement of people within the union, no discrimination on grounds of nationality, harmonisation of health and safety in the workplace, etc.). It is now also used in connection with European transport policy, training, environmental issues, etc. The co-operation procedure implies that at the end of a discussion period the Council will adopt a **common position** which must then be approved by the European Parliament.

co-operative /kəʊ'ɒp(ə)rətɪv/ *noun* a business run by a group of workers who are the owners and who share the profits ○ *industrial co-operative* ○ *to set up a workers' co-operative*

co-opt /ˌkəʊ 'ɒpt/ *verb* □ **to co-opt someone onto a committee** to ask someone to join a committee without being elected

co-owner /ˌkəʊ 'əʊnə/ *noun* somebody who owns something jointly with another person or persons ○ *The two sisters are co-owners of the property.*

co-ownership /ˌkəʊ 'əʊnəʃɪp/ *noun* **1.** an arrangement where two or more persons own a property **2.** an arrangement where partners or employees have shares in a company

cop /kɒp/ *noun* **1.** a policeman (*informal*) **2.** an arrest (*informal*) □ **it's a fair cop** you have caught me ■ *verb* **1.** to catch or arrest someone (*slang*) **2.** to get or to receive something (*slang*) □ **to cop a plea** to plead guilty to a lesser charge and so hope the court will give a shorter sentence to save the time of a full trial

co-partner /kəʊ 'pɑːtnə/ *noun* somebody who is a partner in a business with another person

co-partnership /kəʊ 'pɑːtnəʃɪp/ *noun* an arrangement where partners or employees have shares in the company

copper /'kɒpə/ *noun* a policeman (*informal*)

copper-bottomed /ˌkɒpə 'bɒtəmɪd/ *adjective* (*of a guarantee or promise*) able to be completely trusted

co-property /kəʊ 'prɒpəti/ *noun* ownership of property by two or more people together

co-proprietor /ˌkəʊ prə'praɪətə/ *noun* somebody who owns a property with another person or several other people

copy /'kɒpɪ/ *noun* **1.** a document which looks the same as another **2.** anything which copies information in a document, by whatever means, including electronic copies, recordings, etc. ○ *an illegal copy* **3.** any document ■ *verb* **1.** to make a second item which is like the first ○ *He copied the company report at night and took it home.* **2.** to make something which is similar to something else ○ *She simply copied the design from another fashion*

mainp - softvnn.com

Law.fm Page 72 Friday, June 11, 2004 2:08 PM

designer. ○ *He is successful because he copies good ideas from other businesses.*

copyright /'kɒpiraɪt/ *noun* an author's legal right to publish his or her own work and not to have it copied, which lasts 50 years after the author's death under the Berne Convention, or a similar right of an artist, film maker or musician □ **work which is out of copyright** work by a writer, etc., who has been dead for fifty years, and which anyone can publish □ **work still in copyright** work by a living writer, or by a writer who has not been dead for fifty years ■ *verb* to confirm the copyright of a written work by printing a copyright notice and publishing the work ■ *adjective* covered by the laws of copyright ○ *It is illegal to take copies of a copyright work.*

COMMENT: Copyright exists in original written works, in works of art and works of music; it covers films, broadcasts, recordings, etc.; it also covers the layout of books, newspapers and magazines. Copyright only exists if the work is created by a person who is qualified to hold a copyright, and is published in a country which is qualified to hold a copyright. There is no copyright in ideas, items of news, historical events, items of information, or in titles of artistic works. When a copyright is established, the owner of the copyright can copy his work himself, sell copies of it to the public, perform his work or exhibit it in public, broadcast his work, or adapt it in some way. No other person has the right to do any of these things. Copyright lasts for 50 years after the author's death according to the Berne Convention, and for 25 years according to the Universal Copyright Convention. In the USA, copyright is for 50 years after the death of an author for books published after January 1st, 1978. For books published before that date, the original copyright was for 28 years after the death of the author, and this can be extended for a further 28 year period up to a maximum of 75 years. In 1995, the European Union adopted a copyright term of 70 years after the death of the author. The copyright holder has the right to refuse or to grant permission to copy copyright material, though under the Paris agreement of 1971, the original publishers (representing the author or copyright holder) must, under certain circumstances, grant licences to reprint copyright material. The copyright notice has to include the symbol ©, the name of the copyright holder and the date of the copyright (which is usually the date of first publication). The notice must be printed in the book and usually appears on the reverse of the title page. A copyright notice is also printed on other forms of printed material such as posters.

Copyright Act /'kɒpiˌraɪt ækt/ *noun* an Act of Parliament such as the Copyright Acts 1911, 1956 or 1988 making copyright legal and controlling the copying of copyright material

copyright deposit /ˌkɒpiraɪt dɪ 'pɒzɪt/ *noun* the act of placing a copy of a published work in a copyright library, usually the main national library, which is part of the formal process of copyrighting printed material

copyrighted /'kɒpiraɪtɪd/ *adjective* protected by a valid copyright

copyright holder /ˌkɒpiraɪt 'həʊldə/ *noun* somebody who owns the copyright in a work

copyright law /'kɒpiraɪt lɔː/ *noun* law dealing with the protection of copyright

copyright notice /ˌkɒpiraɪt 'nəʊtɪs/ *noun* a note in a book showing who owns the copyright and the date of ownership

cordon /'kɔːd(ə)n/ *noun* □ **a police cordon** barriers and policemen put round an area to prevent anyone getting near it ■ *verb* □ **to cordon off** to put barriers and policemen round (an area) so that no one can get near it ○ *The street was cordoned off after the bomb was discovered.*

co-respondent /ˌkəʊ rɪ'spɒndənt/ *noun* a party to divorce proceedings who has committed adultery with another person (NOTE: Do not confuse with **correspondent**.)

coroner /'kɒrənə/ *noun* a public official, either a doctor or a lawyer, who investigates sudden violent deaths

COMMENT: Coroners investigate deaths which are violent or unexpected, deaths which may be murder or manslaughter, deaths of prisoners and deaths involving the police.

coroner's court /'kɒrənəz kɔːt/ *noun* a court presided over by a coroner

mainp - softvnn.com

Law.fm Page 73 Friday, June 11, 2004 2:08 PM

coroner's inquest /ˌkɒrənəz ˈɪnkwest/ *noun* an inquest carried out by a coroner into a death, or into a case of treasure trove

corporal punishment /ˌkɔːp(ə)rəl ˈpʌnɪʃmənt/ *noun* the physical punishment of someone by beating him or her

corporate /ˈkɔːp(ə)rət/ *adjective* referring to a company

corporate killing /ˌkɔːp(ə)rət ˈkɪlɪŋ/ *noun* a proposed criminal offence under which companies and similar organisations would be held responsible for any deaths occurring as a result of the company's negligence

corporate manslaughter /ˌkɔːp(ə)rət ˈmænslɔːtə/ *noun* the killing of someone by a limited company, as in a fatal train accident where the railway company is held responsible

corporate name /ˌkɔːp(ə)rət ˈneɪm/ *noun* the name of a large corporation

corporate personality /ˌkɔːp(ə)rət ˌpɜːsəˈnælɪti/ *noun* the legal status of a company, so that it can be treated as a person

corporate planning /ˌkɔːp(ə)rət ˈplænɪŋ/ *noun* the activity of planning the future work of a whole company

corporate profits /ˌkɔːp(ə)rət ˈprɒfɪts/ *noun* the profits of a corporation

corporation /ˌkɔːpəˈreɪʃ(ə)n/ *noun* **1.** a legal body such as a limited company or town council which has been incorporated **2.** *US* a company which is incorporated in the United States **3.** any large company

corporeal hereditaments /kɔːˌpɔːriəl herɪˈdɪtəmənts/ *plural noun* rights of property which physically exists, e.g. houses or furniture

corpse /kɔːps/ *noun* the body of a dead person (NOTE: The US term is **cadaver**.)

corpus /ˈkɔːpəs/ *noun* a body of laws. ◊ **habeas corpus** (NOTE: The plural is **corpora**.)

corpus delicti /ˌkɔːpəs dɪˈlɪktaɪ/ *phrase* a Latin phrase meaning 'the body of the crime': the real proof that a crime has been committed

corpus legis /ˌkɔːpəs ˈledʒɪs/ *phrase* a Latin phrase meaning 'body of laws': books containing Roman civil law

correctional institution /kəˌrekʃn(ə)l ˌɪnstɪˈtjuːʃ(ə)n/ *noun US* a prison

corrective /kəˈrektɪv/ *adjective* treating someone in such a way that he or she improves their behaviour or attitude ○ *He was sent to the detention centre for corrective training.*

correspondent /ˌkɒrɪˈspɒndənt/ *noun* **1.** somebody who writes letters **2.** a journalist who writes articles for a newspaper on specialist subjects ○ *The Times' legal correspondent* □ **a court correspondent** journalist who reports on the activities of a king or queen and the royal family □ **a lobby correspondent** journalist from a newspaper who is part of the lobby which gets private briefings from government ministers

corrigendum /ˌkɒrɪˈgendəm/ *noun* an item which has been corrected (NOTE: The plural is **corrigenda**.)

corroborate /kəˈrɒbəreɪt/ *verb* to prove evidence which has already been given ○ *The witness corroborated the accused's alibi, saying that at the time of the murder she had seen him in Brighton.*

corroboration /kəˌrɒbəˈreɪʃ(ə)n/ *noun* evidence which confirms and supports other evidence ○ *The witness was unable to provide corroboration of what he had told the police.*

corroborative /kəˈrɒbərətɪv/ *adjective* adding support to something such as a statement or evidence ○ *The letter provides corroborative evidence, showing that the accused did know that the victim lived alone.*

corrupt /kəˈrʌpt/ *adjective* willing to take bribes ■ *verb* □ **to corrupt someone's morals** to make someone behave in a way which goes against the normal standard of behaviour

corruption /kəˈrʌpʃən/ *noun* dishonest behaviour such as paying or accepting money or giving a favour to make sure that something is done ○ *The government is keen to stamp out corruption in the police force.* ○ *Bribery and corruption are difficult to control.*

mainp - softvnn.com

Law.fm Page 74 Friday, June 11, 2004 2:08 PM

corruptly /kə'rʌptli/ *adverb* in a corrupt way ○ *He corruptly offered the officer money to get the charges dropped.*

Cosa Nostra /ˌkəʊzə 'nɒstrə/ *noun* same as **Mafia**

cosponsor /'kəʊˌspɒnsə/ *noun* somebody who sponsors something with someone else ○ *the three cosponsors of the bill*

cost /kɒst/ *noun* **1.** the amount of money which has to be paid for something ○ *Computer costs are falling each year.* ○ *We cannot afford the cost of two telephone lines.* □ **to cover costs** to produce enough money in sales to pay for the costs of production **2.** □ **to pay costs** to pay the costs of a court case ■ *verb* **1.** to have a price ○ *How much does the machine cost?* ○ *Rent of the room will cost £50 a day.* **2.** □ **to cost something** to calculate how much money will be needed to make or do something

cost of living /ˌkɒst əv 'lɪvɪŋ/ *noun* money which has to be paid for essential items such as food, accommodation or heating

cost-of-living allowance /ˌkɒst əv 'lɪvɪŋ əˌlaʊəns/ *noun* an addition to a standard salary to cover increases in the cost of living

cost-of-living increase /ˌkɒst əv 'lɪvɪŋ ˌɪnkriːs/ *noun* an increase in salary to allow it to keep up with the increased cost of living

cost-of-living index /ˌkɒst əv 'lɪvɪŋ ˌɪndeks/ *noun* a way of measuring the cost of living which is shown as a percentage increase on the figure for the previous year

costs /kɒsts/ *plural noun* the expenses involved in a court case, including the fees, expenses and charges levied by the court itself, which can be awarded by the judge to the party which wins, so that the losing side pays the expenses of both sides ○ *The judge awarded costs to the defendant.* ○ *Costs of the case will be borne by the prosecution.* ○ *The court awarded the claimant £2,000 in damages, with costs.*

costs draftsman /'kɒsts ˌdrɑːftsmən/ *noun* someone who draws up a bill of costs for assessment by the costs judge

costs judge /'kɒsts dʒʌdʒ/ *noun* an official of the Supreme Court who assesses the costs of a court action (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has in some cases replaced **Taxing Master**.)

costs order /'kɒsts ˌɔːdə/ *noun* a court order requiring someone to pay costs

coterminous /kəʊ'tɜːmɪnəs/ *adjective* referring to two things which end at the same time ○ *The leases are coterminous.*

council /'kaʊnsəl/ *noun* **1.** an official group chosen to run something or to advise on a problem **2.** same as **Privy Council**

Council of Ministers /ˌkaʊns(ə)l əv 'mɪnɪstəz/ *noun* ➧ **Council of the European Union**

Council of the European Union /ˌkaʊns(ə)l əv ðə ˌjʊərəpiːən 'juːnjən/ *noun* one of the four bodies which form the basis of the European Community (NOTE: not to be confused with the **European Council**. Formerly the Council of the European Union was called the **Council of Ministers** and it is still sometimes called this.)

COMMENT: The Council does not have fixed members, but the Member States are each represented by the relevant government minister. The Council is headed by a President, and the Presidency rotates among the Member States in alphabetical order, each serving for a six-month period. In practice this means that each Member State can control the agenda of the Council, and therefore that of the European Union, for a period of six months, and can try to get as many of its proposals put into legislation as it can during that period. When meeting to discuss general matters the Council is formed of the foreign ministers of the Member States, but when it discusses specialised problems it is formed of the relevant government ministers: so when discussing agriculture, for example, it is formed of the Agriculture Ministers of the Member States.

counsel /'kaʊnsəl/ *noun* a barrister or barristers acting for one of the parties in

mainp - softvnn.com

Law.fm Page 75 Friday, June 11, 2004 2:08 PM

a legal action ○ *defence counsel* ○ *prosecution counsel* ○ *The claimant appeared in court with his solicitor and two counsel.*

counsellor /'kaʊnsələ/ *noun* **1.** a trained person who gives advice or help ○ *They went to see a marriage guidance counsellor.* **2.** *US* a legal practitioner who advises a person in a case

counsel's advice /ˌkaʊnsəlz əd 'vaɪs/ *noun* a barrister's written advice about a case ○ *We sent the documents to the police on the advice of the solicitor* or *we took the solicitor's advice and sent the documents to the police.*

counsel's opinion /ˌkaʊnsəlz ə 'pɪnjən/ *noun* same as **counsel's advice**

count /kaʊnt/ *noun* a separate charge against an accused person read out in court in the indictment ○ *He was found guilty on all four counts.*

counter /'kaʊntə/ *noun* a long flat surface in a shop for displaying and selling goods □ **over the counter** legally □ **goods sold over the counter** retail sales of goods in shops □ **under the counter** illegally □ **under-the-counter sales** black market sales ■ *adjective*, *adverb* opposite, or with an opposite effect

counter- /kaʊntə/ *prefix* opposing

counterclaim /'kaʊntəklaɪm/ *noun* **1.** in a court, a claim by a defendant against whom a claimant is bringing a claim. The counterclaim is included in the same proceedings and statement of case as the original claim. Also called **Part 20 claim 2.** a claim for damages made in reply to a previous claim ○ *Jones claimed £25,000 in damages against Smith, and Smith entered a counterclaim of £50,000 for loss of office.* ■ *verb* to put in a counterclaim ○ *Jones claimed £25,000 in damages and Smith counterclaimed £50,000 for loss of office.*

counterfeit /'kaʊntəfɪt/ *adjective* (*especially of money or objects of value*) false or imitation ○ *He was charged with passing counterfeit notes in shops.* ○ *She was selling counterfeit Rolex watches.* ■ *verb* to make imitation money or other objects of value

counterfeiting /'kaʊntəˌfɪtɪŋ/ *noun* the crime of making imitation money or other objects of value

counter-intelligence /ˌkaʊntə ɪn 'telɪdʒəns/ *noun* an organisation of secret agents whose job is to work against the secret agents of another country ○ *The offices were bugged by counter-intelligence agents.*

countermand /ˌkaʊntə'mɑːnd/ *verb* □ **to countermand an order** to say that an order must not be carried out

counteroffer /'kaʊntərˌɒfə/ *noun* an offer made in reply to another offer

counterpart /'kaʊntəpɑːt/ *noun* **1.** a copy of a lease **2.** somebody who has a similar job in another company □ **John is my counterpart in Smith's** he has a similar post at Smith's as I have here

counter-promise /ˌkaʊntə 'prɒmɪs/ *noun* a promise made in reply to a promise

countersign /'kaʊntəsaɪn/ *verb* to sign a document which has already been signed by someone else ○ *The payment has to be countersigned by the mortgagor.*

counter to /'kaʊntə tə/ *noun* against, opposite ○ *The decision of the court runs counter to the advice of the clerk to the justices.*

country of origin /ˌkʌntri əv 'ɒrɪdʒɪn/ *noun* a country where someone was born or from where someone has come, or where goods were produced ○ *There is a space on the form for 'country of origin'.*

County Court /ˌkaʊnti 'kɔːt/ *noun* one of the types of court in England and Wales which hears local civil cases

COMMENT: There are about 270 County Courts in England and Wales. County Courts are presided over by either district judges or circuit judges. They deal mainly with claims regarding money, but also deal with family matters, bankruptcies and claims concerning land. A district judge will hear most civil cases up to a value of £50,000, and circuit judge will deal with more serious cases.

County Court Rules /ˌkaʊnti kɔːt 'ruːlz/ *noun* a book of procedural rules for County Courts. Abbreviation **CCR**

mainp - softvnn.com

Law.fm Page 76 Friday, June 11, 2004 2:08 PM

coup /kuː/**, coup d'état** /ˈkuː deɪˈtæ/ *noun* a rapid change of government which removes one government by force and replaces it by another ○ *After the coup, groups of students attacked the police stations.*

COMMENT: A coup is usually carried out by a small number of people, who already have some power (such as army officers), while a revolution is a general uprising of a large number of ordinary people. A coup changes the members of a government, but a revolution changes the whole social system.

court /kɔːt/ *noun* **1.** a place where a trial is held □ **to take someone to court** to start legal proceedings against someone □ **in court** present during a trial ○ *The defendant was in court for three hours.* □ **in open court** in a courtroom with members of the public present □ **a settlement was reached out of court**, **the two parties reached an out-of-court settlement** the dispute was settled between the two parties privately without continuing the court case **2.** □ **Criminal Court**, **Civil Court** a court where criminal or civil cases are heard **3.** the judges or magistrates in a court ○ *The court will retire for thirty minutes.*

COMMENT: In England and Wales the main courts are: **the Magistrates' Court:** trying minor criminal offences such as petty crime; adoption; affiliation; maintenance and domestic violence; licensing; **the County Court:** most civil actions up to a value of £50,000; **the High Court:** most civil claims where the value exceeds £50,000; **the Crown Court:** major crime; **the Court of Appeal:** appeals from lower courts, such as the High Court; **the House of Lords:** the highest court of appeal in the country; **the Privy Council:** appeals on certain matters from England and Wales, and appeals from certain Commonwealth countries; **the European Court of Justice:** appeals where EU legislation is involved. Other courts include **employment tribunals:** employment disputes; **courts-martial:** military matters.

court action /ˈkɔːt ˌækʃən/ *noun* a civil case in a law court where a person files a claim against another person (NOTE: In general, **action** has now been replaced by **claim**.)

court case /ˈkɔːt keɪs/ *noun* same as **court action**

courthouse /ˈkɔːthaʊs/ *noun especially US* a building in which trials take place ○ *There was police cordon round the courthouse.*

court-martial /ˌkɔːt ˈmɑːʃ(ə)l/ *noun* **1.** a court which tries someone serving in the armed forces for offences against military discipline ○ *He was found guilty by the court-martial and sentenced to imprisonment.* **2.** the trial of someone serving in the armed forces by the armed forces authorities ○ *The court-martial was held in the army headquarters.* (NOTE: The plural is **courts-martial**.) ■ *verb* to try someone who is serving in the armed forces (NOTE: **court-martialled**)

Court of Appeal /kɔːt əv əˈpiːl/**, Court of Appeals** /kɔːt əv/ *noun* a civil or criminal court to which a person may go to ask for an award or a sentence to be changed. Also called **Appeal Court**

COMMENT: In the majority of cases in English law, decisions of lower courts and of the High Court can be appealed to the Court of Appeal. The Court of Appeal is divided into the Civil Division and the Criminal Division. The Civil Division hears appeals from the County Court and the High Court; the Criminal Division hears appeals from the Crown Court. From the Court of Appeal, appeal lies to the House of Lords. When the remedies available under English law are exhausted, it is in some cases possible to appeal to the European Court of Justice. For many countries, especially Commonwealth countries, appeals from the highest court of these countries may be heard by the Privy Council.

court officer /ˌkɔːt ˈɒfɪsə/ *noun* a member of the staff of a court, especially a County Court

court of first instance /ˌkɔːt əv fɜːst ˈɪnstəns/ *noun* a court where a case is heard first

COMMENT: The CFI hears cases concerning the staff of the EU, cases concerning the coal and steel industries and cases regarding competition. The court is formed of 15 judges, and its judgements can be appealed to the ECJ.

Court of First Instance /ˌkɔːt əv fɜːst ˈɪnstəns/ *noun* a court set up under

mainp - softvnn.com

Law.fm Page 77 Friday, June 11, 2004 2:08 PM

the Single European Act, formed of 15 judges, whose judgments can be appealed to the European Court of Justice. Abbreviation **CFI**

COMMENT: The Court of First Instance initially heard only cases concerning the staff of the EU, cases concerning the coal and steel industries and cases regarding competition. As a result of provisions of the Treaty of European Union, the CFI now has all of the European Court's jurisdiction except for Article 234 references and cases involving infringement proceedings against Member States.

Court of Justice of the European Communities *noun* ➧ **European Court of Justice**

court of last resort /ˌkɔːt əv lɑːst rɪ ˈzɔːt/ *noun US* the highest court from which no appeals can be made

court of law /ˌkɔːt əv ˈlɔː/ *noun* same as **court** ○ *The law courts are in the centre of the town.* ○ *She works in the law courts as an usher.*

Court of Protection /ˌkɔːt əv prə ˈtekʃ(ə)n/ *noun* a court appointed to protect the interests of people who are incapable of dealing with their own affairs, such as patients who are mentally ill

Court of Session /ˌkɔːt əv ˈseʃ(ə)n/ *noun* the highest civil court in Scotland

court order /ˌkɔːt ˈɔːdə/ *noun* a legal order made by a court, telling someone to do or not to do something ○ *The court made an order for maintenance* or *made a maintenance order.* ○ *He refused to obey the court order and was sent to prison for contempt.*

court or tribunal /ˌkɔːt ɔː traɪ ˈbjuːn(ə)l/ *noun* any body which has official status and which has the power to give binding rulings on legal rights and obligation, although it may not have the actual title of 'court' (NOTE: The Deputy High Bailiff's Court in the Isle of Man and the Dutch Appeals Committee for General Medicine have each been held to be a 'court or tribunal' according to European Union law.)

courtroom /ˈkɔːtruːm/ *noun* a room where a judge presides over a trial

covenant /ˈkʌvənənt/ *noun* an agreement or undertaking to do something or not to do something, contained in a deed or contract ○ *He signed a covenant against underletting the premises.* ■ *verb* to agree to pay a sum of money each year by contract ○ *to covenant to pay £10 per annum to a charity*

COMMENT: Examples of restrictive covenants could be a clause in a contract of employment which prevents the employee from going to work for a competitor, or a clause in a contract for the sale of a property which prevents the purchaser from altering the building. There is a tax advantage to the recipient of covenanted money; a charity pays no tax, so it can reclaim tax at the standard rate on the money covenanted to it.

covenant marriage /ˈkʌvənənt ˌmærɪdʒ/ *noun* in the USA, a form of marriage contract with stricter than usual conditions for couples wishing to marry or get divorced, including counselling before marriage and a two-year separation before a divorce

covenant to repair /ˌkʌvənənt tə rɪ ˈpeə/ *noun* an agreement by a landlord or tenant to keep a rented property in good repair

cover /ˈkʌvə/ *noun* **1.** □ **to operate without adequate cover** without being protected by insurance □ **to ask for additional cover** to ask the insurance company to increase the amount for which you are insured **2.** □ **to send something under separate cover** in a separate envelope □ **to send a document under plain cover** in an ordinary envelope with no company name printed on it ■ *verb* **1.** to include and deal with something ○ *The agreement covers all agencies.* ○ *The newspapers have covered the murder trial.* ○ *The fraud case has been covered by the consumer protection legislation.* **2.** □ **to cover a risk** to be protected by insurance against a risk □ **to be fully covered** to have insurance against all risks **3.** *US* to purchase goods from another supplier to replace those which have not been delivered according to contract **4.** to have enough money to pay □ **the damage was covered by the insurance** the insurance company paid for the damage □ **to cover a position** to have enough money to pay for a forward purchase **5.** to ask for security against a loan which you are making **6.** to earn enough money to pay for costs,

mainp - softvnn.com

Law.fm Page 78 Friday, June 11, 2004 2:08 PM

expenses, etc. ○ *We do not make enough sales to cover the expense of running the shop.* ○ *We hope to reach the point soon when sales will cover all costs.*

coverage /ˈkʌv(ə)rɪdʒ/ *noun* **1.** ➧ **press coverage 2.** *US* protection guaranteed by insurance ○ *Do you have coverage against fire damage?*

covering letter /ˌkʌvərɪŋ ˈletə/, **covering note** *noun* a letter or note sent with documents to say why you are sending them

cover note /ˈkʌvə nəʊt/ *noun* a letter from an insurance company giving basic details of an insurance policy and confirming that the policy exists

covert /ˈkəʊvət, ˈkʌvət/ *adjective* secret

covert action /ˌkəʊvət ˈækʃən/ *noun* an action which is carried out secretly

coverture /ˈkʌvətʃʊə/ *noun* (*of a woman*) a state of being married

CPR *abbreviation* Civil Procedure Rules

CPS *abbreviation* Crown Prosecution Service

cracksman /ˈkræksmən/ *noun* a criminal who specialises in breaking safes (*slang*)

credere /ˈkreɪdəri/ ➧ **del credere agent**

credit /ˈkredɪt/ *verb* to note money received in an account

credit account /ˈkredɪt əˌkaʊnt/ *noun* an account which a customer has with a shop which allows them to buy goods and pay for them later

credit agency /ˈkredɪt ˌeɪdʒənsi/ *noun* a company which reports on the ability of customers to pay their debts and shows whether they should be allowed credit

credit balance /ˈkredɪt ˌbæləns/ *noun* the balance on an account showing that more money is owed or has been paid by someone than is due or has been received by them

credit bank /ˈkredɪt bæŋk/ *noun* a bank which lends money

credit card /ˈkredɪt kɑːd/ *noun* a plastic card which allows the owner to buy goods without paying for them immediately

credit card holder /ˈkredɪt kɑːd ˌhəʊldə/ *noun* somebody who has a credit card

credit facilities /ˈkredɪt fəˌsɪlɪtiz/ *plural noun* arrangement with a bank or supplier to have credit so as to buy goods

credit limit /ˈkredɪt ˌlɪmɪt/ *noun* a fixed amount of money which is the most a client can owe

credit note /ˈkredɪt nəʊt/ *noun* a note showing that money is owed to a customer

creditor /ˈkredɪtə/ *noun* somebody who is owed money. ◊ **secured creditor, unsecured creditor**

creditors' meeting /ˈkredɪtəz ˌmiːtɪŋ/ *noun* a meeting of all persons to whom a company in receivership owes money

credit rating /ˈkredɪt ˌreɪtɪŋ/ *noun* the amount which a credit agency feels a customer should be allowed to borrow

credit transfer /ˈkredɪt ˌtrænsfɜː/ *noun* the movement of money from one account to another

crime /kraɪm/ *noun* **1.** an act which is against the law and which is punishable by law ○ *There has been a 50% increase in crimes of violence.* **2.** illegal acts in general ○ *crime is on the increase* ○ *There has been an increase in violent crime.*

COMMENT: A crime is an illegal act which may result in prosecution and punishment by the state if the accused is convicted. Generally, in order to be convicted of a crime, the accused must be shown to have committed an unlawful act (**actus reus**) with a criminal state of mind (**mens rea**). The main types of crime are: **1. crimes against the person**: murder; manslaughter; assault, battery, wounding; grievous bodily harm; abduction; **2. crimes against property**: theft; robbery; burglary; obtaining property or services or pecuniary advantage by deception; blackmail; handling stolen goods; going equipped to steal; criminal damage; possessing something with intent to damage or destroy property; forgery; **3. sexual offences**: rape; buggery; bigamy; indecency; **4. political offences**: treason; terrorism; sedition; breach of the Official Secrets

mainp - softvnn.com

Law.fm Page 79 Friday, June 11, 2004 2:08 PM

Act; **5. offences against justice**: assisting an offender; conspiracy; perjury; contempt of court; perverting the course of justice; **6. public order offences**: obstruction of the police; unlawful assembly; obscenity; possessing weapons; misuse of drugs; breach of the peace; **7. road traffic offences**: careless or reckless driving; drunken driving; driving without a licence or insurance. Most minor crime is tried before the Magistrates' Courts; more serious crime is tried at the Crown Court which has greater powers to sentence offenders. Most crimes are prosecuted by the police or the Crown Prosecutors, though private prosecutions brought by individuals are possible.

crime rate /ˈkraɪm reɪt/ *noun* the number of crimes committed in a specific period, shown as a percentage of the total population

crime scene /ˈkraɪm siːn/ *noun* the place where a crime has been committed

crime scene tape /ˈkraɪm siːn ˌteɪp/ *noun* tape that is used to cordon off an area and warn people of a crime scene (NOTE: The British term is incident tape.)

crime wave /ˈkraɪm weɪv/ *noun* a sudden increase in crime

criminal /ˈkrɪmɪn(ə)l/ *adjective* **1.** illegal ○ *Misappropriation of funds is a criminal act.* **2.** referring to crime □ **the criminal population** all people who have committed crimes ■ *noun* a person who has committed a crime or who often commits crimes ○ *The police have contacted known criminals to get leads on the gangland murder.* □ **a hardened criminal** a person who has committed many crimes

criminal action /ˌkrɪmɪn(ə)l ˈækʃən/ *noun* a case brought usually by the state against someone who is charged with a crime

criminal bankruptcy /ˌkrɪmɪn(ə)l ˈbæŋkrʌptsi/ *noun* bankruptcy of a criminal in the Crown Court as a result of crimes of which he or she has been convicted

criminal bankruptcy order /ˌkrɪmɪn(ə)l ˈbæŋkrʌptsi ˌɔːdə/ *noun* an order made against someone who has been convicted in the Crown Court of an offence which has resulted in damage above a specific sum to other identified parties

criminal court /ˈkrɪmɪn(ə)l kɔːt/ *noun* a court such as a Crown Court which deals with criminal cases

criminal damage /ˌkrɪmɪn(ə)l ˈdæmɪdʒ/ *noun* the notifiable offence of causing serious damage

Criminal Defence Service /ˌkrɪmɪn(ə)l dɪˈfens ˌsɜːvɪs/ *noun* the British government service which provides legal advice and assistance in each community to people with very little money who are suspected of criminal offences or are facing criminal proceedings. Abbreviation **CDS**

COMMENT: The service replaces part of the Legal Aid scheme (the Community Legal Service deals with civil and family cases).

Criminal Injuries Compensation Board /ˌkrɪmɪn(ə)l ˌɪndʒəriz ˌkɒmpənˈseɪʃ(ə)n ˌbɔːd/ *noun* a committee which administers the awarding of compensation to victims of crime

Criminal Investigation department /ˌkrɪmɪn(ə)l ɪnˌvestɪˈgeɪʃ(ə)n dɪ ˌpɑːtmənt/ *noun* a section of the British police which investigates serious crimes. Abbreviation **CID**

criminal law /ˌkrɪmɪn(ə)l ˈlɔː/ *noun* law relating to acts committed against the laws of the land and which are punishable by the state

criminal libel /ˌkrɪmɪn(ə)l ˈlaɪb(ə)l/ *noun* a serious libel which might cause a breach of the peace

criminal negligence /ˌkrɪmɪn(ə)l ˈneglɪdʒəns/ *noun* the offence of acting recklessly with the result that harm is done to other people

criminal offence /ˌkrɪmɪn(ə)l ə ˈfens/ *noun* an action which is against the law

criminal record /ˌkrɪmɪn(ə)l ˈrekɔːd/ *noun* a note of previous crimes for which someone has been convicted ○ *The accused had no criminal record.* ○ *He has a criminal record going back to the time when he was still at school.*

criminal responsibility /ˌkrɪmɪn(ə)l rɪˌspɒnsɪˈbɪlɪti/ *noun* the fact of being responsible for a crime that has been committed (NOTE: The age of

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Law.fm Page 80 Friday, June 11, 2004 2:08 PM

criminal responsibility is ten years. Children under ten years old cannot be charged with a crime.)

criminology /ˌkrɪmɪˈnɒlədʒi/ *noun* the academic study of crime

criterion /kraɪˈtɪəriən/ *noun* the standard by which something can be judged ○ *Using the criterion of the ratio of cases solved to cases reported, the police force is becoming more efficient.* (NOTE: The plural is **criteria**.)

criticise /ˈkrɪtɪsaɪz/, **criticize** *verb* to say that someone or something is bad or wrong ○ *The procedures were severely criticised as being discriminatory.* (NOTE: **criticised – criticising**)

criticism /ˈkrɪtɪsɪz(ə)m/ *noun* **1.** a comment ○ *If you have any constructive criticisms to make, I shall be glad to hear them.* **2.** an unfavourable comment or series of comments ○ *There was a lot of criticism of the proposed changes.* ○ *My detailed criticisms relate to section 3 of the report.*

crook /krʊk/ *noun* a person who has committed a crime, especially a crime involving deceit (*slang*)

cross /krɒs/ *verb* □ **to cross a cheque** to write two lines across a cheque to show that it has to be paid into a bank

crossed cheque /ˌkrɒst ˈtʃek/ *noun* a cheque with two lines across it showing that it can only be deposited at a bank and not exchanged for cash

cross-examination /ˌkrɒs ɪgzæmɪˈneɪʃ(ə)n/ *noun* the questioning of a witness called by the opposing side in a case. Opposite **evidence in chief** (NOTE: The opposite is **evidence in chief**.)

cross-examine /ˌkrɒs ɪgˈzæmɪn/ *verb* to question witnesses called by the other side in a case, in the hope that you can discredit or weaken their evidence

cross holdings /ˈkrɒs ˌhəʊldɪŋz/ *plural noun* situation where two companies own shares in each other in order to stop each from being taken over ○ *The two companies have protected themselves from takeover by a system of cross holdings.*

cross off /ˌkrɒs ˈɒf/ *verb* to remove something from a list ○ *He crossed my name off his list.* ○ *You can cross him off our mailing list.*

cross out /ˌkrɒs ˈaʊt/ *verb* to put a line through something which has been written ○ *She crossed out £250 and put in £500.*

Crown /kraʊn/ *noun* □ **the Crown** the King or Queen as representing the State ○ *Mr Smith is appearing for the Crown.* ○ *The Crown submitted that the maximum sentence should be applied in this case.* ○ *The Crown case* or *the case for the Crown was that the defendants were guilty of espionage.*

Crown copyright /ˌkraʊn ˈkɒpiraɪt/ *noun* copyright in government publications

Crown Court /ˌkraʊn ˈkɔːt/ *noun* a court, above the level of the magistrates' courts, which is based on the six circuits in England and Wales and which hears criminal cases

COMMENT: A Crown Court is formed of a circuit judge and jury, and hears major criminal cases.

Crown Lands /ˌkraʊn ˈlɑːndz/ *plural noun* land or property belonging to the King or Queen

Crown privilege /ˌkraʊn ˈprɪvɪlɪdʒ/ *noun* the right of the Crown or the government not to have to produce documents to a court by reason of the interest of the state

Crown Prosecution Service /ˌkraʊn ˌprɒsɪˈkjuːʃ(ə)n ˌsɜːvɪs/ *noun* a government department, headed by the Director of Public Prosecutions, which is responsible for the conduct of all criminal cases instituted by the police in England and Wales, except for those prosecuted by the Serious Fraud Office. Abbreviation **CPS**

Crown prosecutor /ˌkraʊn ˈprɒsɪkjuːtə/ *noun* an official of the Crown Prosecution Service who is responsible for prosecuting criminals in one of 13 areas in England Wales

cruelty /ˈkruːəlti/ *noun* **1.** behaviour which causes pain or injury to a person or animal **2.** cruel behaviour towards a spouse

cryptographic /ˌkrɪptəˈgræfɪk/ *adjective* referring to cryptography

mainp - softvnn.com

Law.fm Page 81 Friday, June 11, 2004 2:08 PM

cryptography /ˌkrɪp'tɒgrəfi/ *noun* the science of codes which allow ordinary text to be encrypted so that it cannot be read without a key

cryptography support service /ˌkrɪptɒgrəfi sə'pɔːt ˌsɜːvɪs/ *noun* a service which helps senders or receivers of encrypted electronic messages to read those messages

CS gas /ˌsiː es 'gæs/ *noun* gas given off by solid crystals of $C_6H_4(Cl)CH$, used by police as a method of crowd control

CSO *abbreviation* community service order

CTT *abbreviation* capital transfer tax

culpability /ˌkʌlpə'bɪlɪti/ *noun* the fact of being culpable

culpable /'kʌlpəb(ə)l/ *adjective* being likely to attract blame

culpable homicide /ˌkʌlpəb(ə)l 'hɒmɪsaɪd/ *noun US* murder or manslaughter

culpable negligence /ˌkʌlpəb(ə)l 'neglɪdʒəns/ *noun US* negligence which is so bad that it amounts to an offence

culprit /'kʌlprɪt/ *noun* somebody who is responsible for a crime or for something which has gone wrong

curiam ◗ **per curiam**

currency /'kʌrənsɪ/ *noun* money in coins and notes which is used in a particular country

current account /'kʌrənt əˌkaʊnt/ *noun* an ordinary account in a bank into which money can be deposited and on which cheques can be drawn

current assets /ˌkʌrənt 'æsets/ *plural noun* assets used by a company in its ordinary work, e.g. materials, finished goods, cash

current liabilities /ˌkʌrənt laɪə 'bɪlɪtiz/ *plural noun* debts which a company has to pay within the next accounting period

curriculum vitae /kəˌrɪkjʊləm 'viːtaɪ/ *noun* a summary of a person's life story showing details of education and work experience ○ *Candidates should send a letter of application with a curriculum vitae to the administrative office.* Abbreviation **CV** (NOTE: The US term is **résumé**.)

curtilage /'kɜːtɪlɪdʒ/ *noun* land round a house

custodial establishment /kʌˌstəʊdiəl ɪ'stæblɪʃmənt/ *noun* a prison or other institution where criminals are kept

custodial sentence /kʌˌstəʊdiəl 'sentəns/ *noun* a sentence which involves sending someone to prison

custodian /kʌ'stəʊdiən/ *noun* somebody who protects, guards or looks after something or someone

custody /'kʌstədi/ *noun* **1.** the condition of being kept in prison or in a cell □ **in police custody** held by the police, but not actually arrested, while helping the police with their inquiries ○ *The young men were kept in police custody overnight.* **2.** the legal right of a parent to keep and bring up a child after a divorce ○ *Custody of the children was awarded to the mother.* ○ *The court granted the mother custody of both children.* **3.** the control and care of something by someone ○ *The files are in the custody of my lawyer or in my lawyer's custody.*

custom /'kʌstəm/ *noun* **1.** unwritten rules which lay down how things are usually done and have been done for a long time ○ *It is the custom that everyone stands up when the magistrates enter the courtroom.* Also called **customary law** □ **the customs of the trade** general way of working in a trade **2.** the use of a shop by regular shoppers □ **to lose someone's custom** to do something which makes a regular customer go to another shop

customs /'kʌstəmz/ *plural noun* **1.** same as **Customs and Excise** □ **to go through customs** to pass through the area of a port or airport where customs officials examine goods **2.** office of this department at a port or airport

Customs and Excise /ˌkʌstəmz ən 'eksaɪz/ *noun* a government department which deals with VAT and with taxes on imports and on taxable products such as alcohol produced in the country

customs barrier /'kʌstəmz ˌbæriə/ *noun* the existence of customs duty intended to prevent imports

mainp - softvnn.com

Law.fm Page 82 Friday, June 11, 2004 2:08 PM

customs clearance /ˈkʌstəmz ˌklɪərəns/ *noun* the act of clearing goods through customs

customs declaration /ˈkʌstəmz dekləˌreɪʃ(ə)n/ *noun* a statement declaring goods brought into a country on which customs duty may be paid

customs duty /ˈkʌstəmz ˌdjuːti/ *noun* a tax on goods imported into a country

customs examination /ˈkʌstəmz ɪgˌzæmɪneɪʃ(ə)n/ *noun* the examination of goods or baggage by customs officials

customs formalities /ˈkʌstəmz fɔː ˌmælɪtiz/ *plural noun* declaration of goods by the shipper and examination of them by the customs

customs officer /ˈkʌstəmz ˌɒfɪsə/, **customs official** *noun* somebody working for the customs

customs seal /ˈkʌstəmz siːl/ *noun* a seal attached by customs officers to a box to show that the contents have passed through the customs

customs tariffs /ˌkʌstəmz ˈtærɪfs/ *plural noun* tax to be paid for importing or exporting goods

customs union /ˈkʌstəmz ˌjuːnjən/ *noun* an agreement between several countries that goods can travel between them without paying duty, while goods from other countries have to pay special duties

cut in on /ˌkʌt ˈɪn ˌɒn/ *verb* □ **to cut someone in on** to offer someone part of the profits of a deal

CV /ˌsiː ˈviː/ *abbreviation* curriculum vitae ○ *Please apply in writing, enclosing a current CV.*

cyberlaw /ˈsaɪbəlɔː/ *noun* law dealing with use of the Internet, especially commercial law relating to commercial transactions, copyright law on information, or defamation law regarding statements made public

cy-près /ˌsiː ˈpreɪ/ *adjective*, *adverb* as near as possible

cy-près doctrine /ˌsiː ˈpreɪ ˌdɒktrɪn/ *noun* a rule that if a charity cannot apply its funds to the purposes for which they were intended, a court can apply the funds to a purpose which is as close as possible to the original intention

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D

DA *abbreviation US* district attorney

dabs /dæbz/ *plural noun* fingerprints (*slang*)

Dáil /dɔɪl/, **Dáil Éireann** /ˌdɔɪl 'eər(ə)n/ *noun* the lower house of the parliament in the Republic of Ireland ○ *The Foreign Minister reported on the meeting to the Dáil.* (NOTE: The members of the Dáil are called **Teachta Dala (TD)**.)

damage /'dæmɪdʒ/ *noun* harm done to things □ **to suffer damage** to be harmed □ **to cause damage** to harm something □ **causing criminal damage** notifiable offence where serious damage is caused ■ *verb* to harm ○ *The storm damaged the cargo.* ○ *Stock which has been damaged by water.* ○ *He alleged that the newspaper article was damaging to the company's reputation.*

damaged /'dæmɪdʒd/ *adjective* having suffered damage or which has been harmed

damage feasant /ˌdæmɪdʒ 'fiːzənt/ *noun* a situation where the animals of one person damage the property of another person

damages /'dæmɪdʒɪz/ *plural noun* **1.** money claimed by a claimant from a defendant as compensation for harm done ○ *to claim £1,000 in damages* **2.** money awarded by a court as compensation to a claimant ○ *to be liable for* or *in damages* ○ *to pay £25,000 in damages* □ **to bring an action for damages against someone** to take someone to court and claim damages

danger /'deɪndʒə/ *noun* **1.** the possibility of being harmed or killed ○ *There is danger to the employees in using old machinery.* **2.** likelihood or possibility □ **there is no danger of the case being heard early** it is not likely that the case will be heard early □ **in danger of** being easily able to happen ○ *He is in danger to being in contempt of court.*

dangerous /'deɪndʒərəs/ *adjective* being possibly harmful □ **dangerous animals** animals, such as some breeds of dog and some wild animals, which may attack people and have to be kept under strict conditions, or for which a licence has to be held □ **dangerous job** a job where employees may be killed or hurt □ **dangerous weapon** a device or weapon which can hurt someone

dangerous driving /ˌdeɪndʒərəs 'draɪvɪŋ/ *noun* formerly, an offence of driving dangerously (NOTE: Now called 'reckless driving'.) □ **causing death by dangerous driving** the offence committed by a driver causing the death of another person

dark /dɑːk/ *adjective* not being used for hearings, trials, or other proceedings

data protection /'deɪtə prəˌtekʃən/ *noun* protecting information such as records of individuals stored in a computer from being copied or used wrongly (NOTE: **data** is usually singular: *the data is easily available*)

date of commencement /ˌdeɪt əv kə'mensmənt/ *noun* the date when an Act of Parliament takes effect

date stamp /'deɪt stæmp/ *noun* a stamp with rubber figures which can be changed, used for marking the date on documents

day training centre /deɪ ˌtreɪnɪŋ 'sentə/ *noun* a centre where young offenders attend courses as a condition of being on probation

DC *abbreviation* detective constable

mainp - softvnn.com

Law.fm Page 84 Friday, June 11, 2004 2:08 PM

DCC *abbreviation* Deputy Chief Constable

dead /ded/ *adjective* **1.** not alive ○ *Six people were dead as a result of the accident.* ○ *We inherited the house from my dead grandfather.* **2.** not working

dead account /ˌded əˈkaʊnt/ *noun* an account which is no longer used

dead letter /ˌded ˈletə/ *noun US* a regulation which is no longer valid ○ *This law has become a dead letter.*

dead loss /ˌded ˈlɒs/ *noun US* a complete loss ○ *The car was written off as a dead loss.*

dealings /ˈdiːlɪŋz/ *plural noun* □ **to have dealings with someone** to do business with someone

death /deθ/ *noun* the act of dying or the state of being dead □ **to put someone to death** to execute someone

death benefit /ˈdeθ ˌbenɪfɪt/ *noun* money paid to the family of someone who dies in an accident at work

death certificate /ˈdeθ səˌtɪfɪkət/ *noun* an official certificate signed by a doctor, stating that a person has died and giving details of the person

death grant /ˈdeθ grɑːnt/ *noun US* a government grant to the family of a person who has died, which is supposed to contribute to the funeral expenses

death in service /ˌdeθ ɪn ˈsɜːvɪs/ *noun* insurance benefit or pension paid when someone dies while employed by a company

death penalty /ˈdeθ ˌpen(ə)lti/ *noun* a sentence ordering a criminal to be executed

debate /dɪˈbeɪt/ *noun* a discussion about a subject, especially a formal discussion leading to a vote ○ *The Bill passed its Second Reading after a short debate.* ○ *The debate continued until 3 a.m.* ■ *verb* to discuss a subject, especially in a formal way that leads to a vote

debenture /dɪˈbentʃə/ *noun* a document whereby a company acknowledges it owes a debt and gives the company's assets as security □ **debenture register, register of debentures** list of debenture holders of a company

debenture bond /dɪˈbentʃə bɒnd/ *noun* a certificate showing that a debenture has been issued

debenture capital /dɪˈbentʃə ˌkæpɪt(ə)l/ *noun* capital borrowed by a company using its fixed assets as security

debenture holder /dɪˈbentʃə ˌhəʊldə/ *noun* somebody who holds a debenture for money lent

debenture issue /dɪˈbentʃə ˌɪʃuː/ *noun* borrowing money against the security of the company's assets

debit /ˈdebɪt/ *verb* □ **to debit an account** to charge an account with a cost ○ *His account was debited with the sum of £25.*

debit and credit /ˌdebɪt ən ˈkredɪt/ *noun* the money that a company owes and which it is entitled to receive

debit balance /ˈdebɪt ˌbæləns/ *noun* the balance in an account showing that more money is owed to or has been received by someone than is owed or has been paid by them

debit note /ˈdebɪt nəʊt/ *noun* a note showing that a customer owes money

debt /det/ *noun* money owed for goods or services ○ *The company stopped trading with debts of over £1 million.* □ **to be in debt** to owe money □ **to get into debt** to start to borrow more money than you can pay back □ **to be out of debt** not to owe money any more □ **to pay back a debt** to pay all the money owed □ **to pay off a debt** to finish paying money owed □ **to service a debt** to pay interest on a debt

debt collection /ˈdet kəˌlekʃən/ *noun* the act of collecting money which is owed

debt collection agency /ˈdet kə ˌlekʃən ˌeɪdʒənsi/ *noun* a company which collects debts for other companies for a commission

debt collector /ˈdet kəˌlektə/ *noun* somebody who collects debts

debt factor /ˈdet ˌfæktə/ *noun* a person who buys debts at a discount and enforces them for himself, or a person who enforces debts for a commission

debtor /ˈdetə/ *noun* somebody who owes money

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Law.fm Page 85 Friday, June 11, 2004 2:08 PM

decease /dɪ'siːs/ *noun* death (*formal*) ○ *On his decease all his property will go to his widow.*

deceased /dɪ'siːst/ *adjective* (*of people*) recently dead ○ *The deceased left all his property to his widow.* ○ *She inherited the estate of a deceased aunt.* ■ *noun* a person who has died recently, or people who have died recently

deceit /dɪ'siːt/ *noun* dishonest behaviour intended to trick someone into paying money or doing something ○ *He built up a career based on lies and deceit over several years.*

deception /dɪ'sepʃən/ *noun* an act of tricking someone into believing or doing something ○ *He obtained her key by deception.* □ **obtaining a pecuniary advantage by deception** the offence of deceiving someone so as to derive a financial benefit □ **obtaining property by deception** the offence of tricking someone into handing over possession of property

decide /dɪ'saɪd/ *verb* **1.** to give a judgment in a civil case ○ *The judge decided in favour of the claimant.* **2.** to make up your mind to do something ○ *We have decided to take our neighbours to court.* ○ *The tribunal decided against awarding any damages.*

decided case /dɪ'saɪdɪd ˌkeɪs/ *noun* a case where a court has made a decision and that decision then becomes a precedent

decidendi ➧ **ratio decidendi**

deciding factor /dɪˌsaɪdɪŋ 'fæktə/ *noun* the most important factor which influences a decision

decision /dɪ'sɪʒ(ə)n/ *noun* **1.** a judgment in a civil court □ **the decision of the House of Lords is final** there is no appeal against a decision of the House of Lords **2.** the process of deciding to do something ○ *to come to a decision* or *to reach a decision* **3.** □ **decisions** (*in the EU*) legally binding acts of the European Community which apply to individual Member States of the EU or to groups of people or individual citizens of those states

decision maker /dɪ'sɪʒ(ə)n ˌmeɪkə/ *noun* somebody who has to decide

decision making /dɪˌsɪʒ(ə)n 'meɪkɪŋ/ *noun* the act of coming to a decision □ **the decision-making processes** the ways in which decisions are reached

decisis ➧ **stare decisis**

declaration /ˌdeklə'reɪʃ(ə)n/ *noun* an official statement

declaration of association /ˌdekləreɪʃ(ə)n əv əˌsəʊsi'eɪʃ(ə)n/ *noun* a statement in the articles of association of a company, saying that the members have agreed to form the company and buy shares in it

declaration of compliance /ˌdekləreɪʃ(ə)n əv kəm'plaɪəns/ *noun* a declaration made by a person forming a limited company, that the requirements of the Companies' Act have been met

declaration of income /ˌdekləreɪʃ(ə)n əv 'ɪnkʌm/ *noun* a statement declaring income to the tax office

declaratory judgment /dɪˌklærət(ə)ri 'dʒʌdʒmənt/ *noun* a judgment where a court states what the legal position of the various parties is

declare /dɪ'kleə/ *verb* to make an official statement ○ *to declare someone bankrupt* ○ *to declare a dividend of 10%* □ **to declare goods to customs** to state that you are importing goods which are liable to duty □ **to declare an interest** to state in public that you own shares in a company being investigated, that you are related to someone who can benefit from your contacts, etc.

declared /dɪ'kleəd/ *adjective* having been made public or officially stated

declared value /dɪˌkleəd 'vælju:/ *noun* the value of goods entered on a customs declaration

declassification /diːˌklæsɪfɪ 'keɪʃ(ə)n/ *noun* the act of making something no longer secret

declassify /diː'klæsɪfaɪ/ *verb* to make a secret document or piece of information available to the public ○ *The government papers relating to the war have recently been declassified.*

decontrol /diːkən'trəʊl/ *verb* to stop or remove controls from something □ **to decontrol the price of petrol** to stop

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Law.fm Page 86 Friday, June 11, 2004 2:08 PM

controlling the price of petrol so that a free market price can be reached

decree /dɪ'kriː/ *noun* **1.** an order made by a head of state or government which is not approved by a parliament □ **to govern by decree** to rule a country by issuing orders without having them debated and voted in a parliament **2.** an order made by a court ■ *verb* to make an order ○ *The President decreed that June 1st (his birthday) should be a National Holiday.*

decree absolute /dɪˌkriː 'æbsəluːt/ *noun* an order from a court which ends a marriage finally

decree nisi /dɪˌkriː 'naɪsaɪ/ *noun* an order from a court which ends a marriage subject to a decree absolute at a later time

decriminalise /diː'krɪmɪnəlaɪz/**, decriminalize** *verb* to make the possession or use of something no longer a crime ○ *There are plans to decriminalise some soft drugs.*

decrypt /diː'krɪpt/ *verb* to read an encrypted text by using a special key

decryption /diː'krɪpʃ(ə)n/ *noun* the action of reading encrypted text using a special key

deducing title /dɪ'djuːsɪŋ ˌtaɪt(ə)l/ *noun* the act of a vendor proving a valid right to the property being sold

deduction /dɪ'dʌkʃən/ *noun* **1.** a conclusion which is reached by observing something ○ *By deduction, the detective came to the conclusion that the dead person had not been murdered.* **2.** the removal of money from a total, or money removed from a total ○ *Net salary is salary after deduction of tax and social security contributions.* □ **deduction from salary**, **salary deduction, deduction at source** money which a company removes from a salary to give to the government as tax, national insurance contributions, fines etc.

deed /diːd/ *noun* a legal document which has been signed and delivered by the person making it in the presence of two witnesses

deed of arrangement /ˌdiːd əv ə 'reɪndʒmənt/ *noun* an agreement made between a debtor and his or her creditors whereby the creditors accept an agreed sum in settlement of their claim rather than make the debtor bankrupt

deed of assignment /ˌdiːd əv ə 'saɪnmənt/ *noun* an agreement which legally transfers a property from a debtor to a creditor

deed of covenant /ˌdiːd əv 'kʌvənənt/ *noun* an officially signed agreement to do something such as to pay someone a sum of money each year

deed of partnership /ˌdiːd əv 'pɑːtnəʃɪp/ *noun* an agreement which sets up a partnership

deed of transfer /ˌdiːd əv 'trænsfɜː/ *noun* an agreement which transfers the ownership of shares

deed poll /'diːd pəʊl/ *noun* a written legal instrument to which there is only one party, e.g. the validation of a change of name □ **to change one's name by deed poll** to sign a legal document by which you change your name

deem /diːm/ *verb* to believe or to consider ○ *The judge deemed it necessary to order the court to be cleared.* ○ *If no payment is made, the party shall be deemed to have defaulted.*

deeming provision /ˌdiːmɪŋ prə 'vɪʒ(ə)n/ *noun* a service of documents which is assumed to have taken place, e.g. if using first-class post, service is deemed to have taken place on the second day after the documents were posted

de facto /ˌdeɪ 'fæktəʊ/ *phrase* a Latin phrase meaning taken as a matter of fact, even though the legal status may not be certain ○ *He is the de facto owner of the property.* ○ *The de facto government has been recognised.*

de facto authority /ˌdeɪ ˌfæktəʊ ɔː 'θɒrɪti/ *noun* the authority or rule of a country by a group because it is actually ruling

defalcation /ˌdiːfæl'keɪʃ(ə)n/ *noun* the illegal use of money by someone who is not the owner but who has been trusted to look after it

defamation of character /ˌdefəmeɪʃ(ə)n əv 'kærɪktə/ *noun* the act of injuring someone's reputation by maliciously saying or writing things about him or her

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Law.fm Page 87 Friday, June 11, 2004 2:08 PM

defamatory statement /dɪ ˌfæmət(ə)ri ˈsteɪtmənt/ *noun* an untrue statement which is capable of lowering the reputation of the stated individual in the eyes of right-thinking people in the community

defame /dɪˈfeɪm/ *verb* to say or write things about the character of someone so as to damage his or her reputation

default /dɪˈfɔːlt/ *noun* a failure to do something which is required by law, such as a failure to carry out the terms of a contract, especially a failure to pay back a debt □ **in default of payment** if no payment is made □ **to be in default** not to do or not to have done something which is required by law □ **the company is in default** the company has failed to carry out the terms of the contract □ **by default** because no one else will act □ **he was elected by default** he was elected because all the other candidates withdrew, because there were no other candidates ■ *verb* to fail to carry out the terms of a contract, especially to fail to pay back a debt □ **to default on payments** not to make payments which are due under the terms of a contract

default action /dɪˌfɔːlt ˈækʃən/ *noun* a County Court action to get back money owed

defaulter /dɪˈfɒltə/ *noun* somebody who defaults

default summons /dɪˌfɔːlt ˈsʌmənz/ *noun* a County Court summons to someone to pay what is owed

defeasance /dɪˈfiːz(ə)ns/ *noun* in a collateral deed, a clause which says that a contract, bond or recognisance will be revoked if something happens or if some act is performed

defeat /dɪˈfiːt/ *verb* to revoke or render invalid an agreement, contract or bond

defect /dɪˈfekt/ *noun* a fault ■ *verb* (*of a spy, agent or government employee*) to leave your country and go to work for an enemy country

defective /dɪˈfektɪv/ *adjective* **1.** not working properly ○ *The machine broke down because of a defective cooling system.* **2.** not legally valid ○ *His title to the property is defective.*

defence /dɪˈfens/ *noun* **1.** the party in a legal case that is being sued by the claimant **2.** the party in a criminal case that is being prosecuted **3.** the legal team representing a party being sued or prosecuted **4.** the arguments used when fighting a case ○ *His defence was that he did not know the property was stolen.* **5.** a document or statement setting out a defendant's case ○ *A defence must say which parts of a claim are denied or admitted, and which must be proved by the claimant.* □ **to file a defence** to state that you wish to defend a case, and outline the reasons for doing so **6.** the protection of someone or something against attack (NOTE: [all senses] The US spelling is **defense**.)

defence before claim /dɪˌfens bɪ ˈfɔː kleɪm/ *noun* a defence that the defendant offered the claimant the amount of money claimed before the claimant started proceedings against him or her. Also called **tender before claim**

defence counsel /dɪˈfens ˌkaʊnsəl/ *noun* a solicitor who represents the defendant or the accused

Defence Secretary /ˌsekrətri əv steɪt fə dɪˈfens/ *noun* same as **Secretary of State for Defence** (NOTE: The US spelling is **Defense Secretary**.)

defence statement /dɪˈfens ˌsteɪtmənt/ *noun* a document used in criminal proceedings that sets out the accused's defence before going to trial

defence witness /dɪˌfens ˈwɪtnəs/ *noun* somebody who is called to court to give evidence which helps the case of the defendant or of the accused

defend /dɪˈfend/ *verb* **1.** to fight to protect someone or something which is being attacked ○ *The company is defending itself against the takeover bid.* **2.** to speak on behalf of someone who has been charged with a crime ○ *He hired the best lawyers to defend him against the tax authorities.* □ **to defend an action** to appear in court to state your case when accused of something

defendant /dɪˈfendənt/ *noun* **1.** somebody who is sued in a civil case. Compare **claimant, plaintiff 2.** somebody who is accused of a crime in a crim-

mainp - softvnn.com

Law.fm Page 88 Friday, June 11, 2004 2:08 PM

inal case (NOTE: usually called the **accused**)

defer /dɪ'fɜː/ *verb* to arrange a meeting or activity for a later date than originally planned ○ *to defer judgment* ○ *The decision has been deferred until the next meeting.* (NOTE: **deferring – deferred**)

deferment /dɪ'fɜːmənt/ *noun* the act of arranging a meeting or activity for a later date than originally planned ○ *deferment of payment* ○ *deferment of a decision*

deferment of sentence /dɪ ˌfɜːmənt əv 'sentəns/ *noun* a decision to delay sentencing a convicted criminal for up to six months to assess their behaviour in that period

deferred /dɪ'fɜːd/ *adjective* delayed until a later date

deferred creditor /dɪˌfɜːd 'kredɪtə/ *noun* somebody who is owed money by a bankrupt but who is paid only after all other creditors

deferred payment /dɪˌfɜːd 'peɪmənt/ *noun* payment for goods by instalments over a long period

deficiency /dɪ'fɪʃ(ə)nsi/ *noun US* the amount of tax owing by a taxpayer after he or she has submitted a tax return which is too low

deforce /diː'fɔːs/ *verb* to take wrongfully and hold land which belongs to someone else

deforcement /diː'fɔːsmənt/ *noun* the wrongful taking and holding of another person's land

defraud /dɪ'frɔːd/ *verb* to trick someone so as to obtain money illegally ○ *He defrauded the Inland Revenue of thousands of pounds.* (NOTE: You defraud someone **of** something.)

defray /dɪ'freɪ/ *verb* to provide money to pay the cost of something ○ *The company agreed to defray the costs of the prosecution.*

degrading treatment or punishment /dɪˌgreɪdɪŋ ˌtriːtmənt ɔː 'pʌnɪʃmənt/ *noun* an absolute right prohibiting an individual from being subjected to a feeling of fear, anguish and inferiority which has the possible effect of humiliating the victim, as such treatment can never be justified as being in the public interest (NOTE: It is found in Article 3 of the European Convention of Human Rights and was introduced into UK law by the Human Rights Act 1998.)

degree /dɪ'griː/ *noun* **1.** a level or measure of a relationship **2.** *US* a system for classifying murders

COMMENT: In the US, the penalty for first degree murder can be death.

de jure /ˌdeɪ 'dʒʊəri/ *phrase* a Latin phrase meaning 'as a matter of law', where the legal title is clear ○ *He is the de jure owner of the property.* ◊ **de facto**

del credere agent /del 'kreɪdərɪ ˌeɪdʒənt/ *noun* an agent who receives a high commission because he or she guarantees payment by customers to his or her principal

delegate *noun* /'delɪgət/ somebody who is elected by others to put their case at a meeting ○ *The company sent a delegate to the conference in Hong Kong* ■ *verb* /'deləˌgeɪt/ to pass authority or responsibility to someone else

delegated legislation /ˌdeləgeɪtɪd ˌledʒɪ'sleɪʃ(ə)n/ *noun* **1.** (*in the UK*) legislation which has the power of an Act of Parliament but which is passed by a minister to whom Parliament has delegated its authority **2.** (*in the EU*) legislation which is proposed by the Commission and implemented by the Council of Ministers

delegatus non potest delegare /ˌdelɪgɑːtəs nɒn pɒˌtest ˌdelɪ'gɑːreɪ/ *phrase* a Latin phrase meaning 'the delegate cannot delegate to someone else'

deliberate *adjective* /dɪ'lɪb(ə)rət/ done on purpose ○ *The police suggest that the letter was a deliberate attempt to encourage disorder.* ■ *verb* /dɪ'lɪbəreɪt/ to consider or to discuss a problem ○ *The committee deliberated for several hours before reaching a decision.*

deliberations /dɪˌlɪbə'reɪʃ(ə)nz/ *plural noun* discussions ○ *The result of the committee's deliberations was passed to the newspapers.*

delicti ◆ **corpus delicti**

delicto ◆ **in flagrante delicto**

delinquency /dɪ'lɪŋkwənsi/ *noun* the act of committing crime, usually minor crime

mainp - softvnn.com

Law.fm Page 89 Friday, June 11, 2004 2:08 PM

delinquent /dɪ'lɪŋkwənt/ *adjective* **1.** *US* (*of a debt*) overdue **2.** (*of behaviour*) antisocial or criminal ■ *noun* someone, especially a young person, who has acted in an antisocial way or broken the law □ **a juvenile delinquent**, **a delinquent** *US* young criminal who commits minor crimes, especially crimes against property

delivery /dɪ'lɪv(ə)ri/ *noun* **1.** □ **delivery of goods** transport of goods to a customer's address □ **to take delivery of goods** to accept goods when they are delivered **2.** goods being transferred from the possession of person to another ○ *We take in three deliveries a day.* ○ *There were four items missing in the last delivery.* **3.** the transfer of a bill of exchange **4.** a formal act whereby a deed becomes effective ○ *Deeds take effect only from the time of delivery.*

delivery note /dɪ'lɪv(ə)ri nəʊt/ *noun* a list of goods being delivered which is given to the customer with the goods

delivery order /dɪ'lɪv(ə)ri ˌɔːdə/ *noun* an instruction for goods to be delivered given by the customer to the person holding the goods

delivery up /dɪ'lɪv(ə)ri ʌp/ *noun* the action of delivering goods which have been made in infringement of a copyright or patent to the claimant, so that they can be destroyed (*infringement of copyright*)

demagogue /'deməgɒg/ *noun* (*usually as criticism*) a leader who is able to get the support of the people by exciting their lowest feelings and prejudices

demagogy, demagoguery *noun* the activity of appealing to feelings such as fear, greed or hatred of the mass of the people

demand bill /dɪ'mɑːnd bɪl/ *noun* a bill of exchange which must be paid when payment is asked for

demanding with menaces /dɪ ˌmɑːndɪŋ wɪð 'menəss/ *noun* the offence of attempting to make someone give you something by threatening them with violence

de minimis non curat lex /ˌdeɪ ˌmɪnɪmis nɒn ˌkjʊərət 'leks/ *phrase* a Latin phrase meaning 'the law does not deal with trivial things'

demise /dɪ'maɪz/ *noun* **1.** death ○ *On his demise the estate passed to his daughter.* **2.** the granting of property on a lease

demise charter /dɪˌmaɪz 'tʃɑːtə/ *noun* the charter of a ship without the crew

demise of the Crown /dɪˌmaɪz əv ðə 'kraʊn/ *noun* the death of a king or queen

democracy /dɪ'mɒkrəsi/ *noun* **1.** a theory or system of government by freely elected representatives of the people ○ *After the coup, democracy was replaced by a military dictatorship.* **2.** the right to fair government, free election of representatives and equality in voting **3.** a country ruled in this way ○ *The pact was welcomed by western democracies.*

democratic /ˌdemə'krætɪk/ *adjective* **1.** referring to a democracy ○ *After the coup the democratic processes of government were replaced by government by decree.* **2.** free and fair, reflecting the views of the majority ○ *The resolution was passed by a democratic vote of the council.* ○ *The action of the leader is against the wishes of the party as expressed in a democratic vote at the party conference.*

demonstrative legacy /dɪ ˌmɒnstrətɪv 'legəsi/ *noun* a gift in a will which is ordered to be paid out of a special account

demur /dɪ'mɜː/ *noun* an objection ○ *Counsel made no demur to the proposal.* ■ *verb* **1.** not to agree ○ *Counsel stated that there was no case to answer, but the judge demurred.* **2.** to make a formal objection that the facts as alleged are not sufficient to warrant the civil action (NOTE: **demurring – demurred**)

demurrage /dɪ'mʌrɪdʒ/ *noun* money paid to the owner of a cargo when a ship is delayed in a port

demurrer /dɪ'mɜːrə/ *noun* in a civil action, a plea that although the facts of the case are correct, they are not sufficient to warrant the action

denial /dɪ'naɪəl/ *noun* **1.** the act of not allowing something **2.** the act of stating

mainp - softvnn.com

Law.fm Page 90 Friday, June 11, 2004 2:08 PM

that you have not done something ○ *In spite of his denials he was found guilty.*

denial of human rights /dɪˌnaɪəl əv ˈhjuːmən raɪts/ *noun* the act of refusing someone a generally accepted right

denial of justice /dɪˌnaɪəl əv ˈdʒʌstɪs/ *noun* a situation where justice appears not to have been done

denial-of-service attack /dɪˌnaɪəl əv ˈsɜːvɪs əˌtæk/ *noun* an illegal attempt to cause a computer system to crash by sending it data from many sources simultaneously

de novo /ˌdeɪ ˈnəʊvəʊ/ *phrase* a Latin phrase meaning 'starting again'

deny /dɪˈnaɪ/ *verb* **1.** not to allow something ○ *She was denied the right to see her lawyer.* **2.** to say that you have not done something ○ *He denied being in the house at the time of the murder.* (NOTE: You deny someone something *or* deny doing *or* having done something.)

depart /dɪˈpɑːt/ *verb* □ **to depart from normal practice** to act in a different way from the normal practice

Department of Justice /dɪ ˌpɑːtmənt əv ˈdʒʌstɪs/ *noun US* the department of the US government responsible for federal legal cases, headed by the Attorney-General

Department of Justice Canada /dɪˌpɑːtmənt əv ˌdʒʌstɪs ˈkænədə/ *noun* the Canadian government department that is responsible for developing policies affecting the justice system and providing legal services to the federal government

Department of State /dɪˌpɑːtmənt əv ˌsəʊʃ(ə)l ˈsteɪt/ *noun* **1.** a major section of the British government headed by a Secretary of State ○ *the Department of Trade and Industry* **2.** a major section of the US government headed by a Secretary ○ *the Lord Chancellor's Department*

departure /dɪˈpɑːtʃə frəm/ *noun* □ **a departure from the usual practice** different from what usually happens ○ *This forms a departure from established practice.* ○ *Any departure from the terms and conditions of the contract must be advised in writing.*

dependant /dɪˈpendənt/ *noun* **1.** somebody who is supported financially by someone else ○ *He has to provide for his family and dependants out of a very small salary.* **2.** a person who is a member of the family of someone who works in the European Union, even if not a EU citizen

COMMENT: For the purposes of EU law, dependants are classified as the spouse of a EU citizen, the children and parents of a EU citizen, the grandchildren and grandparents of a EU citizen (in the case of children and grandchildren, they count as dependants up to the age of 21).

dependent /dɪˈpendənt/ *adjective* **1.** being supported financially by someone else ○ *Tax relief is allowed for dependent relatives.* **2.** referring to a dependant

dependent rights /dɪˈpendənt raɪts/ *plural noun* the rights of a dependant to enter a EU country along with a parent or other close relative

deponent /dɪˈpəʊnənt/ *noun* somebody who makes a statement under oath, by affirmation or by affidavit

deport /dɪˈpɔːt/ *verb* to send someone away from a country permanently ○ *The illegal immigrants were deported.*

deportation /ˌdiːpɔːˈteɪʃ(ə)n/ *noun* the sending of someone away from a country ○ *The convicts were sentenced to deportation.*

deportation order /ˌdiːpɔːˈteɪʃ(ə)n ˌɔːdə/ *noun* an official order to send someone away from a country ○ *The minister signed the deportation order.*

depose /dɪˈpəʊz/ *verb* **1.** to state under oath **2.** to remove a monarch from the throne

deposit /dɪˈpɒzɪt/ *noun* **1.** money placed in a bank for safe keeping or to earn interest **2.** money given in advance so that the thing which you want to buy will not be sold to someone else ○ *to leave £10 as deposit* □ **to forfeit a deposit** to lose a deposit because you have decided not to buy the item ■ *verb* **1.** to put documents somewhere for safe keeping ○ *We have deposited the deeds of the house with the bank.* ○ *He deposited his will with his solicitor.* **2.** to put money into a bank account ○ *to deposit £100 in a current account*

mainp - softvnn.com

Law.fm Page 91 Friday, June 11, 2004 2:08 PM

deposit account /dɪ'pɒzɪt ə,kaʊnt/ *noun* a bank account which pays interest but on which notice has to be given to withdraw money

depositary /dɪ'pɒzɪtəri/ *noun US* a person or corporation that can place money or documents for safekeeping with a depository (NOTE: Do not confuse with **depository**.)

deposition /,depə'zɪʃ(ə)n/ *noun* a written statement of evidence from a witness

depositor /dɪ'pɒzɪtə/ *noun* somebody who deposits money in a bank

depository /dɪ'pɒzɪt(ə)ri/ *noun* a person or company with whom money or documents can be deposited (NOTE: Do not confuse with **depositary**.)

deprave /dɪ'preɪv/ *verb* to make someone's character bad ○ *Such TV programmes which may deprave the minds of children who watch them.*

deputise /'depjʊtaɪz/, **deputize** *verb* □ **to deputise for someone** to take the place of someone who is absent □ **to deputise someone** to appoint someone as a deputy

deputy /'depjʊti/ *noun* **1.** somebody who takes the place of a higher official, who assists a higher official ○ *He acted as deputy for the chairman* or *he acted as the chairman's deputy.* **2.** *US* somebody who acts for or assists a sheriff

derelict /'derɪlɪkt/ *noun* an abandoned floating boat

dereliction of duty /derɪ,lɪkʃən əv 'djuːti/ *noun* failure to do what you ought to do ○ *She was found guilty of gross dereliction of duty.*

derivative action /dɪ,rɪvətɪv 'ækʃən/ *noun* an action started by a shareholder or a group of shareholders which is derived from the company's rights but which the company itself does not want to proceed with

derogate /'derəgeɪt/ *verb* □ **to derogate from something which has been agreed** to act to prevent something which has been agreed from being fully implemented

derogation /,derə'geɪʃ(ə)n/ *noun* **1.** the act of avoiding or destroying something **2.** (*in the EU*) an action by which an EC directive is not applied

COMMENT: Derogations from the principle of equality of access to employment may be where the job can only be done by someone of one particular sex, such as a person modelling men's clothes.

derogation of responsibility /,derəgeɪʃ(ə)n əv rɪ,spɒnsɪ'bɪlɪti/ *noun* the avoidance of doing something that should be done

descendant /dɪ'sendənt/ *noun* (*in the EU*) a child or grandchild of a person (NOTE: The opposite, the parents or grandparents of a person, are **ascendants**.)

descent /dɪ'sent/ *noun* **1.** family ties of inheritance between parents and children □ **he is British by descent**, **he is of British descent** one (or both) of his parents is British **2.** □ **by descent** way of inheriting property by an heir, where there is no will

desegregate /diː'segrɪgeɪt/ *verb* to end a policy of segregation

desegregation /,diːsegrɪ'geɪʃ(ə)n/ *noun* the ending of segregation

deselect /,diːsɪ'lekt/ *verb* to decide that a person who had been selected by a political party as a candidate for a constituency is no longer the candidate

deselection /,diːsɪ'lekʃ(ə)n/ *noun* the act of deselecting ○ *Some factions in the local party have proposed the deselection of the candidate.*

desert /dɪ'zɜːt/ *verb* **1.** to leave the armed forces without permission ○ *He deserted and went to live in South America.* **2.** to leave a family or spouse ○ *The two children have been deserted by their father.*

deserter /dɪ'zɜːtə/ *noun* somebody who has left the armed forces without permission

desertion /dɪ'zɜːʃ(ə)n/ *noun* **1.** the act of leaving the armed forces without permission **2.** the act of leaving a spouse ○ *He divorced his wife because of her desertion.*

despatch /dɪ'spætʃ/ *verb* to send ○ *The letters about the rates were despatched yesterday.* ○ *The Defence Minis-*

mainp - softvnn.com

Law.fm Page 92 Friday, June 11, 2004 2:08 PM

ter was despatched to take charge of the operation.

despatch box /dɪ'spætʃ bɒks/ *noun* **1.** a red box in which government papers are sent to ministers **2.** one of two boxes on the centre table in the House of Commons at which a Minister or member of the Opposition Front Bench stands to speak □ **to be at the despatch box** (*of a minister*) to be speaking in parliament

destruction /dɪ'strʌkʃən/ *noun* the action of killing someone, or of ending the existence of something completely ○ *The destruction of the evidence in the fire at the police station made it difficult to prosecute.*

detain /dɪ'teɪn/ *verb* to hold a person so that he or she cannot leave ○ *The suspects were detained by the police for questioning.*

detainee /ˌdiːteɪ'niː/ *noun* somebody who has been detained

detainer /dɪ'teɪnə/ *noun* the act of holding a person

detect /dɪ'tekt/ *verb* to notice or discover something which is hidden or difficult to see ○ *The machine can detect explosives.*

detection /dɪ'tekʃən/ *noun* the process of discovering something, especially discovering who has committed a crime or how a crime has been committed

detection rate /dɪ'tekʃ(ə)n reɪt/ *noun* the number of crimes which are solved, as a percentage of all crimes

detective /dɪ'tektɪv/ *noun* somebody, usually a policeman, who tries to solve a crime

COMMENT: The ranks of detectives in the British Police Force are Detective Constable, Detective Sergeant, Detective Inspector, Detective Chief Inspector, Detective Superintendent, and Detective Chief Superintendent.

detective agency /dɪˌtektɪv 'eɪdʒənsi/ *noun* an office which hires out the services of private detectives

detention /dɪ'tenʃən/ *noun* **1.** the act of keeping someone so that he or she cannot escape ○ *The suspects were placed in detention.* **2.** wrongfully holding goods which belong to someone else

detention centre /dɪ'tenʃən ˌsentə/ *noun* a place where young offenders aged between 14 and 21 can be kept for corrective training, instead of being sent to prison, if they are convicted of crimes which would usually carry a sentence of three months' imprisonment or more

detention order /dɪˌtenʃən 'ɔːdə/ *noun* a court order asking for someone to be kept in detention

determine /dɪ'tɜːmɪn/ *verb* **1.** to control what will happen or what something will be like ○ *Their attitudes have been determined by their experiences.* **2.** to discover something ○ *We need to determine what the long-term effects of this decision might be.*

deterrence /dɪ'terəns/ *noun* the idea that the harsh punishment of one criminal will deter other people from committing crimes

deterrent /dɪ'terənt/ *noun* a punishment which is strong enough to stop people from committing a crime ○ *A long prison sentence will act as a deterrent to other possible criminals.*

deterrent sentence /dɪˌterənt 'sentəns/ *noun* a harsh sentence which the judge hopes will deter other people from committing crimes

detinue /'detɪnjuː/ *noun* the tort of wrongfully holding goods which belong to someone else □ **action in detinue** action formerly brought to regain possession of goods which were wrongfully held by someone

detriment /'detrɪmənt/ *noun* damage or harm □ **without detriment to his claim** without harming his claim □ **his action was to the detriment of the claimant** his action harmed the claimant

detrimental /ˌdetrɪ'ment(ə)l/ *adjective* harmful ○ *Action detrimental to the maintenance of public order.*

developer /dɪ'veləpə/ *noun* □ **a property developer** person who plans and builds a group of new houses or new factories

development area /dɪ'veləpmənt ˌeəriə/ *noun* an area which has been given special help from a government to encourage businesses and factories to be set up there

devil /'dev(ə)l/ *noun* a barrister to whom another barrister passes work be-

mainp - softvnn.com

Law.fm Page 93 Friday, June 11, 2004 2:08 PM

cause he or she is too busy ■ *verb* to pass instruction to another barrister because you are too busy to deal with the case yourself □ **to devil for someone** to do unpleasant or boring work for someone

devise /dɪ'vaɪz/ *noun* a gift of freehold land to someone in a will ■ *verb* to give freehold property to someone in a will

COMMENT: Giving of other types of property is a **bequest**.

devisee /dɪvaɪ'ziː/ *noun* somebody who receives freehold property in a will

devolve /dɪ'vɒlv/ *verb* to pass to someone under the terms of a will

dictum /'dɪktəm/ *noun* a statement made by a judge

die /daɪ/ *verb* to stop living. ◊ **death** (NOTE: **dying – died**)

digest /'daɪdʒest/ *noun* a book which collects summaries of court decisions together, used for reference purposes by legal practitioners

dilapidation /dɪˌlæpɪ'deɪʃ(ə)n/ *noun* damage arising through neglect

dilatory /'dɪlət(ə)ri/ *adjective* too slow

dilatory motion /ˌdɪlət(ə)ri 'məʊʃ(ə)n/ *noun* a motion in the House of Commons to delay the debate on a proposal

dilatory plea /'dɪlət(ə)ri pliː/ *noun* a plea by a defendant relating to the jurisdiction of the court, which has the effect of delaying the action

diminished responsibility /dɪ ˌmɪnɪʃt rɪˌspɒnsɪ'bɪlɪti/ *noun* a mental state of a criminal, either inherited or caused by illness or injury, which means that he or she cannot be held responsible for the crime which has been committed

DInsp *abbreviation* detective inspector

dip /dɪp/ *noun* a pickpocket (*slang*)

diplomat /'dɪpləmæt/, **diplomatist** /dɪ'pləʊmətɪst/ *noun* a person such as an ambassador who is an official representative of his country in another country

diplomatic agent /ˌdɪpləmætɪk 'eɪdʒənt/ *noun* a person officially employed by the embassy of a foreign country

diplomatic channels /ˌdɪpləmætɪk 'tʃæn(ə)lz/ *plural noun* communicating between countries through their diplomats ○ *The message was delivered by diplomatic channels.* ○ *They are working to restore diplomatic channels between the two countries.*

diplomatic corps /ˌdɪplə'mætɪk kɔː/ *plural noun* all foreign diplomats in a city or country

diplomatic immunity /ˌdɪpləmætɪk ɪ'mjuːnɪti/ *noun* not subject to the laws of a country because of being a foreign diplomat ○ *He claimed diplomatic immunity to avoid being arrested.*

direct /daɪ'rekt/ *verb* to give an order to someone ○ *The judge directed the jury to acquit all the defendants.* ○ *The Crown Court directed the justices to rehear the case.*

direct discrimination /daɪˌrekt dɪ ˌskrɪmɪ'neɪʃ(ə)n/ *noun* illegal discrimination where similar cases are treated differently or where different cases are treated in the same way

direct effect /daɪˌrekt ɪ'fekt/ *noun* the effect of a legal decision of the European Union which creates rights for citizens. ◊ **supremacy**

COMMENT: Direct effect applies vertically, from the state giving a right to the citizen, and from the citizen who has an obligation to the state. It can also apply horizontally between individual citizens who have rights and obligations to each other.

direct evidence /daɪˌrekt 'evɪd(ə)ns/ *noun* first-hand evidence such as the testimony of an eye witness or the production of original documents

direct examination /daɪˌrekt ɪg ˌzæmɪ'neɪʃ(ə)n/ *noun* the questioning of a witness by his or her own lawyers as a means of oral evidence by the witness to be given in court

direction /daɪ'rekʃən/ ◇ **directions** **1.** order which explains how something should be done ○ *the court is not able to give directions to the local authority* **2.** instructions from a judge to a jury **3.** orders given by a judge concerning the general way of proceeding with a case

directive /daɪ'rektɪv/ *noun* **1.** an order or command to someone to do something **2.** (*in the EU*) a legally binding act of the European Community which is binding

mainp - softvnn.com

Law.fm Page 94 Friday, June 11, 2004 2:08 PM

on the Member States of the EU but not on individuals until it has been made part of national law ○ *The Commission issued a directive on food prices.* Compare **regulations**

COMMENT: A directive is binding in the result which is to be achieved. Directives do not have a direct effect before any time limit for their implementation has expired, and they do not have any horizontal direct effect (i.e. an effect between citizens).

Director-General /daɪˌrektə ˈdʒen(ə)rəl/ *noun* (*in the EU*) the head of the Directorates General in the Commission (NOTE: The plural is **Directors-General**.)

Director-General of Fair Trading /daɪˌrektə ˌdʒen(ə)rəl əv ˌfeə ˈtreɪdɪŋ/ *noun* an official in charge of the Office of Fair Trading, dealing with consumers and the law

Director of Public Prosecutions /daɪˌrektə əv ˌpʌblɪk ˌprɒsɪ ˈkjuːʃ(ə)nz/ *noun* a government official in charge of the Crown Prosecution Service, working under the Attorney-General, who can prosecute in important cases and advises other government departments if prosecutions should be started ○ *The papers in the fraud case have been sent to the Director of Public Prosecutions.* Abbreviation **DPP**

direct selling /daɪˌrekt ˈselɪŋ/ *noun* the activity of selling a product direct to the customer without going through a shop

direct sexual discrimination /daɪˌrekt ˌsekʃuəl dɪˌskrɪmɪˈneɪʃ(ə)n/ *noun* an instance of sexual discrimination that is overt, e.g. failure to pay one sex the same wage as the other in an equivalent job. ◊ **indirect sexual discrimination**

direct taxation /daɪˌrekt tæk ˈseɪʃ(ə)n/ *noun* a tax such as income tax which is paid direct to the government

disability /ˌdɪsəˈbɪlɪti/ *noun* **1.** the condition of being unable to use a part of the body properly **2.** a lack of legal capacity to act in your own right because of age or mental state □ **person under a disability** person who is not capable to taking legal action for himself

Disability Rights Commission /ˌdɪsəbɪlɪti ˈraɪts kəˌmɪʃ(ə)n/ *noun* an official committee set up to deal with issues relating to discrimination against people with disabilities. Abbreviation **DRC**

disabled person /dɪsˌeɪb(ə)ld ˈpɜːs(ə)n/ *noun* a person with physical disabilities

disallow /ˌdɪsəˈlaʊ/ *verb* not to accept something ○ *The judge disallowed the defence evidence.* ○ *He claimed £2000 for fire damage, but the claim was disallowed.*

disapproval /ˌdɪsəˈpruːv(ə)l/ *noun* the act of disapproving a decision made by a lower court

disapprove /ˌdɪsəˈpruːv/ *verb* **1.** to show doubt about a decision made by a lower court, but not to reverse or overrule it ○ *The Appeal Court disapproved the County Court decision.* **2.** □ **to disapprove of something** to show that you do not approve of something, that you do not think something is good ○ *The judge openly disapproves of juries.*

disbar /dɪsˈbɑː/ *verb* to stop a barrister from practising (NOTE: **disbarring – disbarred**)

disburse /dɪsˈbɜːs/ *verb* to pay money

disbursement /dɪsˈbɜːsmənt/ *noun* an amount of money paid from a fund held for a particular purpose, or the process of making such a payment

discharge *noun* /ˈdɪstʃɑːdʒ/ **1.** the ending of a contract by performing all the conditions of the contract, releasing a party from the terms of the contract, or being in breach of contract **2.** payment of debt □ **in full discharge of a debt** paying a debt completely, paying less than the total amount owed, by agreement **3.** release from prison or from military service **4.** □ **in discharge of his duties as director** carrying out his duties ■ *verb* /dɪsˈtʃɑːdʒ/ **1.** to let someone go free ○ *The prisoners were discharged by the judge.* □ **the judge discharged the jury** the judge told the jury that they were no longer needed **2.** □ **to discharge a bankrupt** to release someone from bankruptcy (as when a person has paid his or her debts) **3.** □ **to discharge a debt**, **to discharge one's liabilities** to pay a debt or

mainp - softvnn.com

Law.fm Page 95 Friday, June 11, 2004 2:08 PM

one's liabilities in full **4.** to dismiss someone from a job or position ○ *to discharge an employee*

discharge by agreement /ˌdɪstʃɑːdʒ baɪ əˈgriːmənt/ *noun* a situation where both parties agree to end a contract

discharge by performance /dɪsˌtʃɑːdʒ baɪ pəˈfɔːməns/ *noun* a situation where the terms of a contract have been fulfilled

discharged bankrupt /dɪsˌtʃɑːdʒd ˈbæŋkrʌpt/ *noun* somebody who has been released from being bankrupt

discharge in bankruptcy /ˌdɪstʃɑːdʒ ɪn ˈbæŋkrʌptsi/ *noun* an order of a court to release someone from bankruptcy

disciplinary /ˌdɪsɪˈplɪnəri/ *adjective* □ **to take disciplinary action against someone** to punish someone

disciplinary procedure /ˌdɪsɪˈplɪnəri prəˌsiːdʒə/ *noun* a way of warning an employee officially that he or she is breaking rules or that their standard of work is unacceptable

discipline /ˈdɪsɪplɪn/ *verb* to punish someone ○ *The clerk was disciplined for leaking the report to the newspapers.*

disclaim /dɪsˈkleɪm/ *verb* **1.** to refuse to admit ○ *He disclaimed all knowledge of the bomb.* ○ *The management disclaims all responsibility for customers' property.* **2.** to refuse to accept a legacy or devise made to you under someone's will

disclaimer /dɪsˈkleɪmə/ *noun* **1.** a legal refusal to accept responsibility or to accept a right **2.** a clause in a contract where a party disclaims responsibility for something **3.** a refusal to accept property bequeathed under someone's will

disclose /dɪsˈkləʊz/ *verb* **1.** to tell details ○ *The bank has no right to disclose details of my account to the tax office.* **2.** (*in civil cases*) to say that a document exists ○ *Parties to a case are required to disclose relevant documents.*

disclosure /dɪsˈkləʊʒə/ *noun* **1.** the act of telling details or of publishing a secret ○ *The disclosure of the takeover bid raised the price of the shares.* ○ *The defendant's case was made stronger by the disclosure that the claimant was an undischarged bankrupt.* ◊ **non-disclosure** **2.** stating that documents exist or have existed before a hearing starts in the civil courts, usually done by preparing a list of documents. Parties to whom documents have been disclosed have the right to inspect them. (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has in some contexts replaced **discovery**.)

discontinuance /ˌdɪskənˈtɪnjuəns/ *noun* the action of discontinuing a claim or action ○ *The claimant has served notice of discontinuance.*

discontinue /ˌdɪskənˈtɪnjuː/ *verb* to stop a claim which has been issued or an action which has started ○ *A claimant may need to seek permission of the court to discontinue a claim.*

discovery of documents /dɪˌskʌv(ə)ri əv ˈdɒkjʊmənts/ *noun* disclosure of each party's documents to the other before a hearing starts in the civil courts (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has in some contexts been replaced by **disclosure**.)

discredit /dɪsˈkredɪt/ *verb* to show that a person is not reliable ○ *The prosecution counsel tried to discredit the defence witnesses.*

discretion /dɪˈskreʃ(ə)n/ *noun* the ability to decide correctly what should be done ○ *Magistrates have a discretion to allow an accused person to change his election from a summary trial to a jury trial.* ○ *The judge refused the application, on the ground that he had a judicial discretion to examine inadmissible evidence.* □ **to exercise one's discretion** to decide which of several possible ways to act □ **the court exercised its discretion** the court decided what should be done □ **I leave it to your discretion** I leave it for you to decide what to do □ **at the discretion of someone** if someone decides ○ *Membership is at the discretion of the committee.* ○ *Sentencing is at the discretion of the judge.* ○ *The granting of an injunction is at the discretion of the court.*

discretionary /dɪˈskreʃ(ə)n(ə)ri/ *adjective* being possible if someone wants □ **the minister's discretionary powers**

mainp - softvnn.com

Law.fm Page 96 Friday, June 11, 2004 2:08 PM

powers which the minister could use if he or she thought it suitable □ **the tribunal has wide discretionary power** the tribunal can decide on many different courses of action

discretionary trust /dɪˌskreʃ(ə)n(ə)ri ˈtrʌst/ *noun* a trust where the trustees decide how to invest the income and when and how much income should be paid to the beneficiaries

discriminate /dɪˈskrɪmɪneɪt/ *verb* to note differences between things and act accordingly ○ *The planning committee finds it difficult to discriminate between applications which improve the community, and those which are purely commercial.* □ **to discriminate against someone** to treat someone unequally ○ *The council was accused of discriminating against women in its recruitment policy.* ○ *He claimed he had been discriminated against because of his colour.*

discrimination /dɪˌskrɪmɪˈneɪʃ(ə)n/ *noun* **1.** the unfair treatment of someone because of their colour, class, language, race, religion, sex or a disability ○ *Racial discrimination is against the law.* ○ *She accused the council of sexual discrimination in their recruitment policy.* ○ *There should be no discrimination on the grounds of disability.* **2.** the ability to notice the differences between things ○ *The tests are designed to give clear discrimination between the three categories.* **3.** good judgement and decision-making ○ *The committee showed discrimination in its choice of advisers for the project.*

COMMENT: The UK is gradually introducing the necessary legislation to comply with the European Council Directive on Equal Treatment in Employment and Occupation (2000/78/EC). This will result in a consistency of approach between the various types of unlawful discrimination and introduce some new types of unlawful discrimination. In particular, the Equality (Religion or Belief) Regulations 2003 and the Employment Equality (Sexual Orientation) Regulations 2003 are now both in force and legislation against dismissal on the grounds of age is intended by 2006.

disenfranchise /ˌdɪsɪnˈfræntʃaɪz/, **disfranchise** *verb* to take away someone's right to vote ○ *The company has tried to disenfranchise the ordinary shareholders.*

dishonour /dɪsˈɒnə/ *verb* to refuse to pay a cheque or bill of exchange because there is not enough money in the account to pay it ○ *The bank dishonoured his cheque.* ■ *noun* the act of dishonouring a cheque ○ *The dishonour of the cheque brought her business to a stop.*

disinherit /ˌdɪsɪnˈherɪt/ *verb* to make a will which prevents someone from inheriting ○ *He was disinherited by his father.*

diskette /dɪˈsket/ *noun* a very small floppy disk

dismiss /dɪsˈmɪs/ *verb* **1.** □ **to dismiss an employee** to remove an employee from a job ○ *He was dismissed for being late.* **2.** to refuse to accept ○ *The court dismissed the appeal* or *the application* or *the action.* ○ *The justices dismissed the witness' evidence out of hand.*

dismissal /dɪsˈmɪs(ə)l/ *noun* **1.** the removal of an employee from a job, especially as a result of something they have done wrong. ◊ **wrongful dismissal, unfair dismissal 2.** an unwillingness to accept that something might be true ○ *the company's public dismissal of the allegation of fraud* **3.** an order telling someone to leave a place, or to stop carrying out a role ○ *the dismissal of jurors* **4.** a judge's decision that a court case should not continue

dismissal procedure /dɪsˌmɪs(ə)l prəˈsiːdʒə/ *noun* the process of dismissing an employee, following the rules in the contract of employment

disobedience /ˌdɪsəˈbiːdiəns/ *noun* bad behaviour which ignores rules or requests to do something ○ *The prisoners were put in solitary confinement as punishment for their disobedience of the governor's orders.*

disorder /dɪsˈɔːdə/ *noun* a lack of order or of control

disorderly /dɪsˈɔːdəli/ *adjective* badly behaved ○ *She was charged with disorderly conduct* or *with being drunk and disorderly.*

dispensation /ˌdɪspenˈseɪʃ(ə)n/ *noun* **1.** the act of giving out justice **2.** special permission to do something

mainp - softvnn.com

Law.fm Page 97 Friday, June 11, 2004 2:08 PM

which is normally not allowed or is against the law

dispense /dɪ'spens/ *verb* **1.** to provide something, especially officially ○ *to dispense justice* **2.** □ **to dispense with something** not to use something, to do without something ○ *The chairman of the tribunal dispensed with the formality of taking minutes.* ○ *The accused decided to dispense with the services of a lawyer.*

displaced person /dɪsˌpleɪsd 'pɜːs(ə)n/ *noun* a man or woman who has been forced to leave home and move to another country because of war

dispose /dɪ'spəʊz/ *verb* □ **to dispose of** to get rid of, to sell cheaply ○ *to dispose of excess stock* ○ *to dispose of one's business*

disposition /ˌdɪspə'zɪʃ(ə)n/ *noun* the act of passing property in the form of land or goods to another person, especially in a will ○ *to make testamentary dispositions*

dispossess /ˌdɪspə'zes/ *verb* to deprive someone wrongfully of his or her possession of land

dispossession /ˌdɪspə'zeʃ(ə)n/ *noun* the act of wrongfully depriving someone of possession of land

dispute /dɪ'spjuːt, 'dɪspjuːt/ *noun* a disagreement or argument between parties □ **to adjudicate, to mediate in a dispute** to try to settle a dispute between other parties ■ *verb* to argue against something □ **the defendant disputed the claim** the defendant argued that the claim was not correct □ **she disputed the policeman's version of events** she said that the policeman's story of what had happened was wrong □ **to dispute the jurisdiction of a court** to argue that a court has no jurisdiction over a case

disqualification /dɪsˌkwɒlɪfɪ 'keɪʃ(ə)n/ *noun* **1.** a situation in which someone is legally prevented from doing something **2.** the fact of being legally prevented from driving a car

disqualification from office /dɪsˌkwɒlɪfɪkeɪʃ(ə)n frəm 'ɒfɪs/ *noun* a rule which forces a director to be removed from a directorship if he or she does not fulfil the conditions

disqualify /dɪs'kwɒlɪfaɪ/ *verb* not to allow someone to do something, because they have done something which is not allowed or have committed a legal offence ○ *Being a judge disqualifies him from being a Member of Parliament.* ○ *After the accident she was fined £1000 and disqualified from driving for two years.* ○ *He was convicted of driving a motor vehicle while disqualified.*

disrepute /ˌdɪsrɪ'pjuːt/ *noun* a situation where something is not regarded very highly □ **to bring something into disrepute** to give something a bad reputation ○ *He was accused of bringing the club into disrepute by his bad behaviour.*

disseisin /dɪs'siːzɪn/ *noun* illegally depriving someone of possession of land

dissemination /dɪˌsemɪ'neɪʃ(ə)n/ *noun* the act of passing information, slanderous or libellous statements to other members of the public

dissent /dɪ'sent/ *noun* disagreement with the majority of other people or with the authorities ○ *The opposition showed its dissent by voting against the Bill.* ■ *verb* to disagree in writing with a majority opinion in a court judgment ○ *One of the appeal judges dissented.*

dissenting judgment /dɪˌsentɪŋ 'dʒʌdʒmənt/ *noun* the judgment of a judge, showing that he or she disagrees with other judges in a case which has been heard by several judges

dissolve /dɪ'zɒlv/ *verb* to bring to an end ○ *to dissolve a marriage* or *a partnership or a company* □ **to dissolve Parliament** to end a session of Parliament, and so force a general election

distrain /dɪ'streɪn/ *verb* to seize goods to pay for debts

distress /dɪ'stres/ *noun* the taking of someone's goods to pay for debts

distress sale /dɪ'stres seɪl/ *noun* the selling of someone's goods to pay his or her debts

distribution /ˌdɪstrɪ'bjuːʃ(ə)n/ *noun* sharing out property in an estate

distribution of assets /ˌdɪstrɪbjuːʃ(ə)n əv 'æsets/ *noun* sharing the assets of a company among the shareholders

mainp - softvnn.com

Law.fm Page 98 Friday, June 11, 2004 2:08 PM

district /'dɪstrɪkt/ *noun* a section of a town or of a country

district attorney /ˌdɪstrɪkt ə'tɜːni/ *noun US* **1.** a prosecuting attorney in a federal district **2.** the state prosecuting attorney ▸ abbreviation **DA**

district court /'dɪstrɪkt kɔːt/ *noun US* a court in a federal district

district registrar /ˌdɪstrɪkt ˌredʒɪ 'strɑː/ *noun* an official who registers births, marriages and deaths in a specific area

district registry /ˌdɪstrɪkt 'redʒɪstri/ *noun* an office where records of births, marriages and deaths are kept

disturb /dɪ'stɜːb/ *verb* □ **to disturb the peace** to make a noise which annoys people in the area

disturbance /dɪ'stɜːbəns/ *noun* a noise or movement of people which annoys other people ○ *Street disturbances forced the government to resign.* ○ *He was accused of making a disturbance in the public library.*

disturbed balance of mind /dɪ ˌstɜːbd 'bæləns əv maɪnd/ *noun US* a state of mind when someone is temporarily incapable of rational action because of depression or mental distress ○ *The verdict of the coroner's court was suicide while the balance of mind was disturbed.*

division /dɪ'vɪʒ(ə)n/ *noun* **1.** one section of something which is divided into several sections ○ *Smith's is now a division of the Brown group of companies.* **2.** a separate section of the High Court, e.g. the Queen's Bench Division, the Family Division or the Chancery Division, or a separate section of the Appeal Court, e.g. the Civil Division or the Criminal Division **3.** the act of dividing or of being divided □ **to have a division of opinion** to disagree **4.** (*in the EU*) one of the subdivisions of a Directorate in the Commission, with a Head of Division at its head

divisional court /dɪ'vɪʒ(ə)n(ə)l kɔːt/ *noun* one of courts of the High Court

divisional judge /dɪ'vɪʒ(ə)n(ə)l dʒʌdʒ/ *noun* a judge in a division of the High Court

division of responsibility /dɪ ˌvɪʒ(ə)n əv rɪˌspɒnsɪ'bɪlɪti/ *noun* the act of splitting the responsibility for something between several people

divorce /dɪ'vɔːs/ *noun* the legal ending of a marriage ■ *verb* to legally end a marriage to someone ○ *He divorced his wife and married his secretary.*

COMMENT: Under English law, the only basis of divorce is the irretrievable breakdown of marriage. This is proved by one of five grounds: (a) adultery; (b) unreasonable behaviour; (c) one of the parties has deserted the other for a period of two years; (d) the parties have lived apart for two years and agree to a divorce; (e) the parties have lived apart for five years. In the context of divorce proceedings the court has wide powers to make orders regarding residence and contact orders for children, and ancillary relief. Divorce proceedings are normally dealt with by the County Court, or in London at the Divorce Registry. Where divorce proceedings are defended, they are transferred to the High Court, but this is rare and most divorce cases are now conducted by what is called the 'special procedure'.

divorcee /dɪvɔː'siː/ *noun* someone who is divorced

divorce petition /dɪˌvɔːs pə'tɪʃ(ə)n/ *noun* an official request to a court to end a marriage ○ *She was granted a divorce on the grounds of unreasonable behaviour by her husband.*

Divorce Registry /dɪˌvɔːs 'redʒɪstri/ *noun* a court which deals with divorce cases in London

DMC *abbreviation* donatio mortis causa

dock /dɒk/ *noun* the part of a court where an accused prisoner stands □ **the prisoner in the dock** the prisoner who is being tried for a crime

dock brief /'dɒk briːf/ *noun* a former system where an accused person could choose a barrister from those present in court to represent them for a small fee

dock dues /'dɒk djuːz/ *noun* the payment which a ship makes to the harbour authorities for the right to use the harbour

docket /'dɒkɪt/ *noun* **1.** a list of contents of a package which is being sent **2.** *US* a list of cases for trial

doctrine /'dɒktrɪn/ *noun* a general principle of law

mainp - softvnn.com

Law.fm Page 99 Friday, June 11, 2004 2:08 PM

document /ˈdɒkjʊmənt/ *noun* **1.** a paper or set of papers, printed or handwritten, which contains information ○ *Deeds, contracts and wills are all legal documents.* **2.** anything in which information is recorded, e.g. maps, designs, computer files, databases **3.** an official paper from a government department ■ *verb* to put in a published paper ○ *The cases of unparliamentary language are well documented in Hansard.*

documentary /ˌdɒkjʊˈment(ə)ri/ *adjective* in the form of documents ○ *documentary evidence* ○ *documentary proof*

documentary evidence /ˌdɒkjʊment(ə)ri ˈevɪd(ə)ns/ *noun* evidence in the form of documents

documentary proof /ˌdɒkjʊment(ə)ri ˈpruːf/ *noun* proof in the form of a document

documentation /ˌdɒkjʊmen ˈteɪʃ(ə)n/ *noun* all documents referring to something ○ *Please send me the complete documentation concerning the sale.*

document exchange /ˌdɒkjʊmənt ɪksˈtʃeɪndʒ/ *noun* a bureau which receives documents for clients and holds them securely in numbered boxes. Abbreviation **DX** (NOTE: Service can be effected through a document exchange in cases where this is given as the address for service.)

Doe ➧ **John Doe**

do-it-yourself conveyancing /ˌduː ɪt jəˌself kənˈveɪənsɪŋ/ *noun* drawing up a legal conveyance without the help of a lawyer

doli capax, doli incapax *phrase* Latin phrases meaning 'capable of crime' or 'incapable of crime'

COMMENT: Children under ten years of age are doli incapax and cannot be prosecuted for criminal offences; children aged between 10 and 14 are presumed to be doli incapax but the presumption can be reversed if there is evidence of malice or knowledge.

dollar stocks /ˌdɒlə ˈstɒks/ *plural noun* shares in American companies

Domesday Book /ˈduːmzdeɪ bʊk/ *noun* a record made for King William I in 1086, which recorded all the land in England and the owners and inhabitants for tax purposes

domestic /dəˈmestɪk/ *adjective* **1.** referring to a family **2.** referring to the market of the country where a business is situated

domestic consumption /dəˌmestɪk kənˈsʌmpʃən/ *noun* consumption on the home market

domestic court /dəˈmestɪk kɔːt/ *noun US* a court which covers the district in which a defendant lives or has his or her address for service (NOTE: The British term is **home court**.)

domestic premises /dəˌmestɪk ˈpremɪsɪz/ *plural noun* house, flat, or other unit used for private accommodation

domestic proceedings /dəˌmestɪk prəˈsiːdɪŋz/ *plural noun* a court case which involves a husband and wife, or parents and children

domestic production /dəˌmestɪk prəˈdʌkʃən/ *noun* a production of goods in the home country

domestic sales /dəˈmestɪk seɪlz/ *plural noun* sales in the home market

domicile /ˈdɒmɪsaɪl/ *noun* a country where someone is deemed to live permanently, or where a company's office is registered, especially for tax purposes ■ *verb* to live in a place officially ○ *The defendant is domiciled in Scotland.* □ **bills domiciled in France** bills of exchange which have to be paid in France

domiciled /ˈdɒmɪsaɪld/ *adjective* living in a particular place

domicile of choice /ˌdɒmɪsaɪl əv ˈtʃɔɪs/ *noun* a country where someone has chosen to live, which is not the domicile of origin

domicile of origin /ˌdɒmɪsaɪl əv ˈɒrɪdʒɪn/ *noun* a domicile which a person has from birth, usually the domicile of the father

dominant owner /ˌdɒmɪnənt ˈəʊnə/ *noun* someone who has the right to use someone else's property

dominant tenement /ˌdɒmɪnənt ˈtenəmənt/ *noun* land which has been granted an easement over another property (NOTE: also called 'dominant estate' in the USA)

mainp - softvnn.com

Law.fm Page 100 Friday, June 11, 2004 2:08 PM

dominion /dəˈmɪnjən/ *noun* □ **a Dominion** an independent state, part of the British Commonwealth ○ *the Dominion of Canada*

donatio mortis causa /dəˌnɑːtiəʊ ˌmɔːtɪs ˈkəʊzə/ *phrase* a Latin phrase meaning 'gift because of death': transfer of property made when death is imminent

donee /ˌdəʊˈniː/ *noun* somebody who receives a gift from a donor

donor /ˈdəʊnə/ *noun* somebody who gives property to another

dormant account /ˌdɔːmənt əˈkaʊnt/ *noun* a bank account which is not used

double /ˈdʌb(ə)l/ *verb* to make something twice as big

double jeopardy /ˌdʌb(ə)l ˈdʒepədi/ *noun US* the possibility that a citizen may be tried twice for the same crime, prohibited in most legal systems

double taxation agreement /ˌdʌb(ə)l tækˈseɪʃ(ə)n əˌgriːmənt/, **double taxation treaty** /ˌdʌb(ə)l tækˈseɪʃ(ə)n ˌtriːti/, **double tax treaty** *noun* an agreement between two countries that a person living in one country shall not be taxed in both countries on the income earned in the other country

doubt /daʊt/ *noun* a feeling of not being sure that something is correct □ **beyond reasonable doubt**, **beyond a reasonable doubt** *US* to a degree of certainty that is considered acceptable in convicting a person in a criminal case □ **open to doubt** not certain and even unlikely ○ *Her ability to recognise him after so long is open to doubt.*

doveish /ˈdʌvɪʃ/ *adjective* like a dove ○ *He was accused of having doveish tendencies.*

down payment /ˌdaʊn ˈpeɪmənt/ *noun* part of a total payment made in advance

dowry /ˈdaʊri/ *noun* money or property brought by a wife to her husband when she marries him

DPP *abbreviation* Director of Public Prosecutions

draft /drɑːft/ *noun* **1.** an order for money to be paid by a bank □ **to make a draft on a bank** to ask a bank to pay money for you **2.** the first rough plan of a document which has not been finished ○ *He drew up the draft agreement on the back of an envelope.* ○ *The first draft of the contract was corrected by the managing director.* ○ *The draft Bill is with the House of Commons lawyers.* ■ *verb* to make a first rough plan of a document ○ *to draft a contract* or *a document* or *a bill* ○ *The contract is still being drafted* or *is still in the drafting stage.*

drafter /ˈdrɑːftə/ *noun* somebody who makes a draft

drafting /ˈdrɑːftɪŋ/ *noun* the act of preparing the draft of a document ○ *The drafting of the contract took six weeks.* ○ *The drafting stage of a parliamentary Bill.*

draftsman /ˈdrɑːftsmən/ *noun* somebody who drafts documents

drawee /drɔːˈiː/ *noun* a person or bank asked to make a payment by a drawer

drawings /ˈdrɔːɪŋz/ *plural noun* money taken out of a partnership by a partner as his or her salary

draw up /ˌdrɔː ˈʌp/ *verb* to write a legal document ○ *to draw up a contract* or *an agreement* ○ *to draw up a company's articles of association*

drive /draɪv/ *verb* □ **he drives a hard bargain** he is a difficult negotiator

driving licence /ˈdraɪvɪŋ ˌlaɪs(ə)ns/ *noun* a document which shows that you have passed a driving test and can legally drive a car, truck, etc. ○ *Applicants for the police force should hold a valid driving licence.*

driving without due care and attention /ˌdraɪvɪŋ wɪˌðaʊt djuː ˌkeə ən əˈtenʃən/ *noun* the offence of driving a car in a careless way, so that other people are in danger

drop /drɒp/ *noun* a fall ○ *drop in sales* ○ *sales show a drop of 10%* ○ *a drop in prices* ■ *verb* **1.** to fall ○ *Sales have dropped by 10%* or *have dropped 10%.* ○ *The pound dropped three points against the dollar.* **2.** to stop a case ○ *The prosecution dropped all charges against the accused.* ○ *The claimant decided to drop the case against his neighbour.* (NOTE: **dropping – dropped**)

mainp - softvnn.com

Law.fm Page 101 Friday, June 11, 2004 2:08 PM

drop ship /ˌdrɒp ˈʃɪp/ *verb* to deliver a large order direct to a customer

drop shipment /ˈdrɒp ˌʃɪpmənt/ *noun* a delivery of a large order from the factory direct to a customer's shop or warehouse without going through an agent or wholesaler

drug /drʌg/ *noun* **1.** an illegal substance which can be harmful if taken regularly **2.** a medicine given by a doctor to treat a medical problem **3.** to give a substance to someone or put it in their food or drink, especially secretly, to make them go to sleep or become unconscious

COMMENT: There are three classes of controlled drugs: **Class 'A' drugs:** (cocaine, heroin, crack, LSD, etc.); **Class 'B' drugs:** (amphetamines, cannabis, codeine, etc.); and **Class 'C' drugs:** (drugs which are related to the amphetamines, such as benzphetamine). The drugs are covered by five schedules under the Misuse of Drugs Regulations: **Schedule 1:** drugs which are not used medicinally, such as cannabis and LSD, for which possession and supply are prohibited; **Schedule 2:** drugs which can be used medicinally, such as heroin, morphine, cocaine, and amphetamines: these are fully controlled as regards prescriptions by doctors, safe custody in pharmacies, registering of sales, etc. **Schedule 3:** barbiturates, which are controlled as regards prescriptions, but need not be kept in safe custody; **Schedule 4:** benzodiazepines, which are controlled as regards registers of purchasers; **Schedule 5:** other substances for which invoices showing purchase must be kept.

drug abuse /ˈdrʌg əˌbjuːs/ *noun* the regular use of drugs for non-medical reasons

drug addict /ˈdrʌg ˌædɪkt/ *noun* somebody who is physically and mentally dependent on taking drugs regularly

drug addiction /ˈdrʌg əˌdɪkʃən/ *noun* mental and physical dependence on taking a drug regularly

drug baron /ˈdrʌg ˌbærən/ *noun* a person with an important position in an organisation that sells illegal drugs

drug czar /ˈdrʌg sɑː/ *noun* a person employed by a government to lead a campaign against the sale and use of illegal drugs

drug runner /ˈdrʌg ˌrʌnə/ *noun* a person who takes or makes someone else take drugs illegally from one country to another

Drug Squad /ˈdrʌg skwɒd/ *noun* a section of the police force which investigates crime related to drugs

drug trafficking /ˈdrʌg ˌtræfɪkɪŋ/ *noun* the activity of buying and selling drugs illegally

drunk /drʌŋk/ *adjective* incapable because of having drunk too much alcohol

drunk and disorderly /ˌdrʌŋk ən dɪsˈɔːdəli/ *adjective* incapable and behaving in a wild way because of having drunk too much alcohol

drunk and incapable /ˌdrʌŋk ən ɪn ˈkeɪpəb(ə)l/ *noun* the offence of having drunk so much alcohol that you are not able to act normally

drunkard /ˈdrʌŋkəd/ *noun* somebody who is frequently drunk. ◊ **habitual**

drunken driving /ˌdrʌŋkən ˈdraɪvɪŋ/ *noun* an offence of driving a car when under the influence of alcohol. Also called **driving with alcohol concentrations above a certain limit**

DSgt *abbreviation* detective sergeant

dud /dʌd/ *adjective*, *noun* (*of a coin, banknote or cheque*) worth nothing because it is false (*informal*) ○ *The £50 note was a dud.*

dud cheque /ˌdʌd ˈtʃek/ *noun* a cheque which the bank refuses to pay because the person writing it has not enough money in his or her account to pay it

due /djuː/ *adjective* **1.** owed □ **to fall due**, **to become due** to be ready for payment □ **bill due on May 1st** bill which has to be paid on May 1st □ **balance due to us** amount owed to us which should be paid **2.** expected to arrive ○ *The plane is due to arrive at 10.30* or *is due at 10.30.* **3.** according to what is expected as usual or correct □ **in due form** written in the correct legal form ○ *receipt in due form* ○ *contract drawn up in due form* □ **after due consideration of the problem** after thinking seriously about the problem □ **the due process of the law** the formal work of a fair legal action

mainp - softvnn.com

Law.fm Page 102 Friday, June 11, 2004 2:08 PM

due date /ˈdjuː deɪt/ *noun* the date on which a debt has to be paid

due diligence /ˌdjuː ˈdɪlɪdʒəns/ *noun* the carrying out of your duty as efficiently as is necessary ○ *The executor acted with due diligence to pay the liabilities of the estate.*

due execution of a will /djuː ˌeksɪ ˈkjuːʃ(ə)n əv eɪ wɪl/ *noun* the act of making a will in the correct way. A will must be written (handwritten, printed, or written on a standard form, etc.), signed by the testator and witnessed by two witnesses in the presence of the testator.

due process /ˌdjuː ˈprəʊses/ *noun* a rule that the forms of law must be followed correctly

duly /ˈdjuːli/ *adverb* **1.** properly ○ *duly authorised representative* **2.** as was expected ○ *We duly received his letter of 21st October.*

dungeon /ˈdʌndʒən/ *noun* an underground prison (often in a castle)

duplicating paper /ˈdjuːplɪkeɪtɪŋ ˌpeɪpə/ *noun* a special paper to be used in a duplicating machine

duress /djʊˈres/ *noun* an illegal threat to use force on someone to make him or her do something ○ *Duress provides no defence to a charge of murder.* □ **under duress** being forced to do something ○ *They alleged they had committed the crime under duress from another defendant.* □ **he signed the confession under duress** he signed the confession because he was threatened

dutiable goods /ˌdjuːtiəb(ə)l ˈgʊdz/ *plural noun* goods on which a customs or excise duty has to be paid

duty /ˈdjuːti/ *noun* **1.** work which a person has to do ○ *It is the duty of every citizen to serve on a jury if called.* ○ *The government has a duty to protect the citizens from criminals.* **2.** official work which you have to do in a job □ **to be on duty** to be doing official work at a special time **3.** a tax which has to be paid ○ *to take the duty off alcohol* ○ *to put a duty on cigarettes* □ **goods which are liable to duty** goods on which customs or excise tax has to be paid □ **duty-paid goods** goods where the duty has been paid

duty bound /ˈdjuːti baʊnd/ *adjective* bound to do something because it is your duty ○ *Witnesses under oath are duty bound to tell the truth.*

duty-free /ˌdjuːti ˈfriː/ *adjective*, *adverb* sold with no duty to be paid ○ *He bought a duty-free watch at the airport* or *he bought the watch duty-free.* □ **duty-free shop** shop at an airport or on a ship where goods can be bought without paying duty

duty of care /ˌdjuːti əv ˈkeə/ *noun* a legal obligation which imposes a duty on individuals not to act negligently

duty sergeant /ˌdjuːti ˈsɑːdʒənt/ *noun* a police sergeant who is on duty at a particular time

duty solicitor /ˌdjuːti səˈlɪsɪtə/ *noun* a solicitor who is on duty at a magistrates' court and can be contacted at any time by a party who is appearing in that court or by a party who has been taken to a police station under arrest or for questioning

dwelling /ˈdwelɪŋ/ *noun* a place where someone lives such as a house or flat ○ *The tax on dwellings has been raised.*

DWI *abbreviation US* driving while intoxicated

DX *abbreviation* document exchange

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E

e. & o.e. *abbreviation* errors and omissions excepted

earmark /ˈɪəˌmɑːk/ *verb* to reserve for a special purpose ○ *to earmark funds for a project* ○ *The grant is earmarked for computer systems development.*

earn /ɜːn/ *verb* **1.** to be paid money for working ○ *to earn £150 a week* ○ *Our agent in Paris certainly does not earn his commission.* **2.** to produce interest or dividends ○ *account which earns interest at 10%* ○ *What level of dividend do these shares earn?*

earnest /ˈɜːnɪst/ *noun* money paid as a down payment to show one's serious intention to proceed with a contract ○ *He deposited £1,000 with the solicitor as earnest of his intention to purchase.*

earning power /ˈɜːnɪŋ ˌpaʊə/ *noun* the amount of money someone should be able to earn

earnings /ˈɜːnɪŋz/ *plural noun* **1.** the salary or wages, profits and dividends or interest received by an individual **2.** profits of a business

earnings per share /ˌɜːnɪŋz pə ˈʃeə/ *noun* the money earned in profit per share

earnings-related pension /ˌɜːnɪŋz rɪˌleɪtɪd ˈpenʃən/ *noun* a pension which is linked to the size of the salary

easement /ˈiːzmənt/ *noun* a right which someone (the dominant owner) has to make use of land belonging to someone else (the servient owner) for a purpose such as a path

Easter /ˈiːstə/ *noun* **1.** one of the four sittings of the Law Courts **2.** one of the four law terms

EC *abbreviation* European Community ○ *EC ministers met today in Brussels.* ○ *The USA is increasing its trade with the EC.*

ECB *abbreviation* European Central Bank

ecclesiastical /ɪˌkliːziˈæstɪk(ə)l/ *adjective* referring to the church

ecclesiastical court /ɪˌkliːzi ˈæstɪk(ə)l kɔːt/ *noun* a court which hears matters referring to the church

ECJ *abbreviation* European Court of Justice

economic activity /ˌiːkənɒmɪk æk ˈtɪvɪti/ *noun* work

economically /ˌiːkəˈnɒmɪkli/ *adverb* ▫ **economically active** (*in the EU*) being an active worker ○ *Economically active persons have the right to move freely from one EU country to another with their families.*

economic planning /ˌiːkənɒmɪk ˈplænɪŋ/ *noun* the activity of planning the future financial state of the country for the government

economic sanctions /ˌiːkənɒmɪk ˈsæŋkʃ(ə)ns/ *plural noun* restrictions on trade with a country in order to influence its political situation or in order to make its government change its policy

e-conveyancing /ˈiː kənˌveɪənsɪŋ/ *noun* ➧ **electronic transfer**

ecoterrorist /ˈiːkəʊˌterərɪst/ *noun* somebody who attacks things for ecological reasons ○ *Ecoterrorists attacked several fields of crops.*

edict /ˈiːdɪkt/ *noun* the public announcement of a law

editorial /ˌedɪˈtɔːriəl/ *adjective* referring to an editor

editorial board /edɪˌtɔːriəl ˈbɔːd/ *noun* a group of editors (on a newspaper, etc.)

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Law.fm Page 104 Friday, June 11, 2004 2:08 PM

education welfare officer /ˌedjʊkeɪʃ(ə)n ˈwelfeə ˌɒfɪsə/ *noun* a social worker who looks after schoolchildren, and deals with attendance and family problems

EEC *abbreviation* European Economic Community

effective date /ɪˈfektɪv deɪt/ *noun* the date on which a rule or a contract starts to be applied

effective date of termination /ɪˌfektɪv deɪt əv ˌtɜːmɪˈneɪʃ(ə)n/ *noun* the date on which a contract of employment expires

E-FIT™ a trademark for software that produces an image of the face of a police suspect on the basis of what a witness can remember

e.g. /ˈiːˈdʒiː/ *abbreviation* e.g.

egalitarian /ɪˌgælɪˈteərɪən/ *noun* somebody who supports egalitarianism

EGM *abbreviation* Extraordinary General Meeting

eject /ɪˈdʒekt/ *verb* to make someone leave a property which he or she is occupying illegally

ejection /ɪˈdʒekʃən/ *noun* the action of making someone leave a property which he or she is occupying illegally

COMMENT: The ejection of someone who is legally occupying a property is an **ouster,** while removing a tenant is **eviction**.

ejectment /ɪˈdʒektmənt/ *noun* □ **action of ejectment** a court action to force someone to leave a property which he or she is occupying illegally

ejusdem generis /iːˌdʒʊsdem ˈdʒenərɪs/**, eiusdem generis** /eɪˌjuːsdem ˈdʒenərɪs/ *phrase* a Latin phrase meaning 'of the same kind': a rule of legal interpretation, that when a word or phrase follows two or more other words or phrases, it is construed to be of the same type as the words or phrases which precede it

COMMENT: In the phrase **houses, flats and other buildings** other buildings can mean only other dwellings, and would not include, for example, a church.

elapse /ɪˈlæps/ *verb* (*of time*) to pass ○ *Six weeks elapsed before the court order was put into effect.* ○ *We must allow sufficient time to elapse before making a complaint.*

elect /ɪˈlekt/ *verb* **1.** to choose someone by a vote ○ *A vote to elect the officers of an association.* ○ *She was elected chair of the committee.* ○ *He was first elected for this constituency in 1992.* **2.** to choose to do something ○ *He elected to stand trial by jury.*

election /ɪˈlekʃən/ *noun* **1.** the act of electing ○ *His election as president of the society.* **2.** the act of electing a representative or representatives **3.** the act of choosing a course of action ○ *The accused made his election for jury trial.* **4.** a choice by a legatee to take a benefit under a will and relinquish a claim to the estate at the same time

COMMENT: In Britain, a Parliament can only last for a maximum of five years, and a dissolution is usually called by the Prime Minister before the end of that period. The Lord Chancellor then issues a writ for the election of MPs. All British subjects (including Commonwealth and Irish citizens), are eligible to vote in British elections provided they are on the electoral register, are over 18 years of age, are sane, are not members of the House of Lords and are not serving prison sentences for serious crime. In the USA, members of the House of Representatives are elected for a two-year period. Senators are elected for six-year terms, one third of the Senate being elected every two years. The President of the USA is elected by an electoral college made up of people elected by voters in each of the states of the USA. Each state elects the same number of electors to the electoral college as it has Congressmen, plus two. This guarantees that the college is broadly representative of voters across the country. The presidential candidate with an overall majority in the college is elected president. A presidential term of office is four years, and a president can stand for re-election once.

electoral reform /ɪˌlekt(ə)rəl rɪˈfɔːm/ *noun* the activity of changing the electoral system to make it fairer

electric chair /ɪˌlektrɪk ˈtʃeə/ *noun* a chair attached to a powerful electric current, used in some states of the USA for executing criminals

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Law.fm Page 105 Friday, June 11, 2004 2:08 PM

electronic communication /ˌelektrɒnɪk kəˌmjuːnɪˈkeɪʃ(ə)n/ *noun* a message which is sent from one person to another by telephone or by other electronic means

electronic conveyancing /ˌelektrɒnɪkː kənˈveɪənsɪŋ/ *noun* ♦ **electronic transfer**

electronic signature /ˌelektrɒnɪk ˈsɪgnɪtʃə/ *noun* electronic text or symbols attached to a document sent by email which acts in a similar way to a handwritten signature, in that they prove the authenticity of the document

electronic surveillance /ˌelektrɒnɪk səˈveɪləns/ *noun* surveillance using hidden microphones, cameras, etc.

electronic transfer /ˌelektrɒnɪk ˈtrænsfɜː/ *noun* the transfer of interests in land by electronic methods rather than paper documents

eleemosynary /ˌeliːˈmɒzɪnəri/ *adjective* referring to charity

eligible /ˈelɪdʒɪb(ə)l/ *adjective* person who can be chosen ○ *She is eligible for re-election.*

E list /ˈiː lɪst/ *noun* a list of the names of prisoners who frequently try to escape from prison

embargo /ɪmˈbɑːgəʊ/ *noun* a government order which stops a type of trade □ **to lay, put an embargo on trade with a country** to say that trade with a country must not take place □ **to lift an embargo** to allow trade to start again □ **to be under an embargo** to be forbidden ■ *verb* not to allow something to take place ○ *The government has embargoed trade with the Eastern countries.* □ **the press release was embargoed until 1st January** the information in the release could not be published until 1st January

embezzle /ɪmˈbez(ə)l/ *verb* to use illegally or steal money which you are responsible for as part of your work ○ *He was sent to prison for six months for embezzling his clients' money.*

embezzlement /ɪmˈbez(ə)lmənt/ *noun* the act of embezzling ○ *He was sent to prison for six months for embezzlement.*

embezzler /ɪmˈbez(ə)lə/ *noun* somebody who embezzles

emblements /ˈembləmənts/ *plural noun* vegetable products which come from farming

embracery /ɪmˈbreɪs(ə)ri/ *noun* the offence of corruptly seeking to influence jurors

emergency powers /ɪˌmɜːdʒənsi ˈpaʊəs/ *plural noun* special powers granted by law to a government or to a minister to deal with an emergency, usually without going through the usual democratic processes

emergency protection order /ɪˌmɜːdʒənsi prəˈtekʃ(ə)n ˌɔːdə/ *noun* a court order, established under the Children's Act 1989, which gives a local authority or the National Society for the Prevention of Cruelty to Children (NSPCC) the right to remove a child from the care of its parents for a period of eight days, with the right to apply for a seven-day extension. An order will only be granted if the court is satisfied that there is reasonable cause to believe that the child is suffering or likely to suffer significant harm unless the order is made. ◊ **parental responsibility** (NOTE: Such an order gives the local authority parental responsibility for the child, allowing decisions to be made in relation to its welfare.)

emergency services /ɪˈmɜːdʒənsi ˌsɜːvɪsɪz/ *plural noun* police, fire and ambulance services, which are ready for action if an emergency arises

emigrant /ˈemɪgrənt/ *noun* somebody who emigrates. Compare **immigrant**

emigrate /ˈemɪgreɪt/ *verb* to go to another country to live permanently. Compare **immigrate**

emigration /ˌemɪˈgreɪʃ(ə)n/ *noun* the act of leaving a country to go to live permanently in another country. Compare **immigration**

eminent domain /ˌemɪnənt dəʊ ˈmeɪn/ *noun* the right of the state to appropriate private property for public use

emoluments /ɪˈmɒljʊmənts/ *plural noun* wages, salaries, fees or any monetary benefit from an employment (*formal or humorous, not technical*)

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Law.fm Page 106 Friday, June 11, 2004 2:08 PM

empanel /ɪm'pæn(ə)l/ *verb* □ **to empanel a jury** to choose and swear in jurors

employed advocate /ɪmˌplɔɪd 'ædvəkət/ *noun* a person employed to plead in court such as a Crown Prosecutor

employee /ɪm'plɔɪiː/ *noun* a person who is employed by someone else ○ *Employees of the firm are eligible to join a profit-sharing scheme.* ○ *Relations between management and employees have improved.* ○ *The company has decided to take on new employees.*

employer /ɪm'plɔɪə/ *noun* a person or company which has employees and pays them

employer's contribution /ɪm ˌplɔɪəz ˌkɒntrɪ'bjuːʃ(ə)n/ *noun* money paid by the employer towards an employee's pension

employer's liability /ɪmˌplɔɪəz laɪə 'bɪlɪti/ *noun* the legal responsibility of an employer when employees are subject to accidents due to negligence on the part of the employer

employers' organisation /ɪm 'plɔɪəz ˌɔːgənaɪzeɪʃ(ə)n/ *noun US* a group of employers with similar interests

employment /ɪm'plɔɪmənt/ *noun* a contractual relationship between an employer and his or her employees

Employment Appeal Tribunal /ɪm ˌplɔɪmənt ə'piːl traɪˌbjuːn(ə)l/ *noun* a court which hears appeals from employment tribunals

employment bureau /ɪm'plɔɪmənt ˌbjʊərəʊ/ *noun* an office which finds jobs for people

employment law /ɪm'plɔɪmənt ˌbjʊərəʊ/ *noun* law referring to the rights and responsibilities of employers and employees

employment office /ɪm'plɔɪmənt ˌɒfɪs/ *noun* an office which finds jobs for people

employment tribunal /ɪm'plɔɪmənt traɪˌbjuːnəl/ *noun* a body responsible for hearing work-related complaints as specified by statute. The panel hearing each case consists of a legally qualified chairperson and two independent lay people who have experience of employment issues. Decisions need to be enforced by a separate application to the court. Former name **industrial tribunal**

empower /ɪm'paʊə/ *verb* to give someone the power to do something ○ *The agent is empowered to sell the property.* ○ *She was empowered by the company to sign the contract.* ○ *A constable is empowered to arrest a person whom he suspects of having committed an offence.*

emptor /'emptə/ ♦ **caveat emptor**

enact /ɪn'ækt/ *verb* to make a law

enacting clause /ɪn'æktɪŋ klɔːz/ *noun* the first clause in a bill or act, starting with the words 'be it enacted that', which makes the act lawful

enactment /ɪ'næktmənt/ *noun* **1.** the action of making a law **2.** an Act of Parliament

enclosure /ɪn'kləʊʒə/ *noun* **1.** a document enclosed with a letter **2.** the act of removing land from common use by putting fences round it

encroachment /ɪn'krəʊtʃmənt/ *noun* illegally taking over someone's property little by little

encrypt /ɪn'krɪpt/ *verb* to take ordinary text and convert it to a series of figures or letters which make it unable to be read without a special key

encryption /ɪn'krɪpʃən/ *noun* the action of encrypting text

encumbrance /ɪn'kʌmbrəns/ *noun* a liability such as a mortgage or charge which is attached usually to a property or piece of land

endanger /ɪn'deɪndʒə/ *verb* to put someone in danger of being killed or hurt □ **endangering railway passengers**, **endangering life at sea, criminal damage endangering life** notifiable offences where human life is put at risk

endorse /ɪn'dɔːs/ *verb* **1.** to agree with ○ *The court endorsed counsel's view.* **2.** □ **to endorse a bill**, **a cheque** to sign a bill or a cheque on the back to make it payable to someone else **3.** to make a note on a driving licence that the holder has been convicted of a traffic offence **4.** to write a summary of the contents of a legal document on the outside of the folded document

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Law.fm Page 107 Friday, June 11, 2004 2:08 PM

endorsee /ˌendɔːˈsiː/ *noun* a person in whose favour a bill or a cheque is endorsed

endorsement /ɪnˈdɔːsmənt/ *noun* **1.** the act of endorsing **2.** a signature on a document which endorses it **3.** a summary of a legal document noted on the outside of the folded document **4.** a note on an insurance policy which adds conditions to the policy **5.** a note on a driving licence to show that the holder has been convicted of a traffic offence. ◊ **totting up**

endorser /ɪnˈdɔːsə/ *noun* somebody who endorses a bill or cheque

endowment /ɪnˈdaʊmənt/ *noun* a gift of money to provide a regular income

endowment assurance /ɪnˈdaʊmənt əˌʃʊərəns/ *noun* an assurance policy where a sum of money is paid to the insured person on a specific date, or to the heirs if he or she dies

endowment mortgage /ɪnˈdaʊmənt ˌmɔːgɪdʒ/ *noun* a mortgage backed by an endowment policy

end user /ˌend ˈjuːzə/ *noun* somebody who actually uses a product

enforce /ɪnˈfɔːs/ *verb* to make sure something is done or is obeyed ○ *to enforce the terms of a contract* □ **to enforce a debt** to make sure a debt is paid

enforceable /ɪnˈfɔːsəb(ə)l/ *adjective* being possible to enforce

enforcement /ɪnˈfɔːsmənt/ *noun* **1.** the process of making sure that something is obeyed ○ *Enforcement of the terms of a contract.* **2.** (*in the EU*) the power to force someone to comply with the law

enforcement notice /ɪnˈfɔːsmənt ˌnəʊtɪs/ *noun* a notice issued by a local planning authority which outlines the steps that need to be taken within a specified time to stop or repair a breach of planning control

enforcement proceedings /ɪnˌfɔːsmənt prəˈsiːdɪŋz/ *plural noun* legal proceedings used by the Commission for ensure that Member States fulfil their treaty obligations

enfranchisement /ɪnˈfrəntʃaɪzmənt/ *noun* the action of giving someone a vote

engage /ɪnˈgeɪdʒ/ *verb* **1.** □ **to engage someone to do something** to bind someone contractually to do something ○ *The contract engages the company to purchase minimum annual quantities of goods.* **2.** □ **to be engaged in** to be busy with ○ *He is engaged in work on computers.* ○ *The company is engaged in trade with Africa.*

engross /ɪnˈgrəʊs/ *verb* to draw up a legal document in its final form ready for signature

engrossment /ɪnˈgrəʊsmənt/ *noun* **1.** drawing up of a legal document in its final form **2.** a legal document in its final form

engrossment paper /ɪnˈgrəʊsmənt ˌpeɪpə/ *noun* a thick heavy paper on which court documents are engrossed

enjoin /ɪnˈdʒɔɪn/ *verb* to order someone to do something

enjoyment /ɪnˈdʒɔɪmənt/ *noun* □ **quiet enjoyment of land** right of an occupier to occupy a property under a tenancy without anyone interfering with that right

enquire /ɪŋˈkwaɪə/**, enquiry** another spelling of **inquire**

entail /ɪnˈteɪl/ *noun* an interest in land where the land is given to another person and the heirs of his or her body, but reverts to the donor when the donee and heirs have all died. ◊ **fee tail**

entente /ɒnˈtɒnt/ *noun* an agreement between two countries or groups, used especially of the 'Entente Cordiale' between Britain and France in 1904

enter /ˈentə/ ◇ **to enter into 1.** to begin to do something ○ *to enter into relations with someone* **2.** to agree to do something ○ *to enter into negotiations with a foreign government* ○ *to enter into a partnership with a friend* ○ *to enter into an agreement* or *a contract*

entering /ˈentərɪŋ/ *noun* the act of writing items in a record

entering of appearance /ˌentərɪŋ əv əˈpɪərəns/ *noun* same as **entry of appearance**

entertain /ˌentəˈteɪn/ *verb* to be ready to consider a proposal ○ *The judge will not entertain any proposal from the prosecution to delay the start of the hearing.*

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Law.fm Page 108 Friday, June 11, 2004 2:08 PM

entertainment expenses /ˌentə ˈteɪnmənt ɪkˌspensɪz/ *plural noun* money spent on giving meals to business visitors

entice /ɪnˈtaɪs/ *verb* to try to persuade someone to do something by offering money ○ *They tried to entice the managers to join the new company.*

enticement /ɪnˈtaɪsmənt/ *noun* the act of trying to persuade someone to do something, especially trying to persuade an employee to leave a job or a wife to leave her husband

entitle /ɪnˈtaɪt(ə)l/ *verb* to give someone the right to something □ **he is entitled to four weeks' holiday** he has the right to take four weeks' holiday

entitlement /ɪnˈtaɪt(ə)lmənt/ *noun* something to which you are entitled

entity /ˈentɪti/ *noun* something which exists in law ○ *His private company is a separate entity.*

entrapment /ɪnˈtræpmənt/ *noun* the act of enticing someone to commit a crime so as to be able to arrest him or her, by someone in authority such as a police officer (NOTE: It is not a defence in British law, but exists in US law.)

entrenched /ɪnˈtrentʃt/ *adjective* (*of ideas and practices*) existing in the same way for a long time and very difficult to change ○ *The government's entrenched position on employees' rights.*

entrenched clause /ɪnˈtrentʃt klɔːz/ *noun* a clause in a constitution which stipulates that it cannot be amended except by an extraordinary process

entryism /ˈentriˌɪz(ə)m/ *noun* a way of taking control of a political party or elected body, where extremists join or are elected and are then able to take control because they are more numerous or more active than other members

entryist /ˈentriɪst/ *adjective* referring to entryism ○ *The party leader condemned entryist techniques.*

entry of appearance /ˌentri əv ə ˈpɪərəns/ *noun* the lodging of a document in court by the defendant to confirm his or her intention to defend an action

entry of judgment /ˌentri əv ˈdʒʌdʒmənt/ *noun* the act of recording the judgment of a court in the official records

entry permit /ˌentri pəˈmɪt/ *noun* a document allowing someone to enter a country

entry visa /ˈentri ˌviːzə/ *noun* a visa allowing someone to enter a country

environmental health /ɪnˌvaɪrənment(ə)l ˈhelθ/ *noun* the health of the public as a whole

environmental pollution /ɪnˌvaɪrənment(ə)l pəˈluːʃ(ə)n/ *noun* the polluting of the environment

equalise /ˈiːkwəˌlaɪz/, **equalize** /ˈiːkwəlaɪz/ *verb* to make equal ○ *to equalise dividends*

equality /ɪˈkwɒlɪti/ *noun* the condition where all citizens are equal, have equal rights and are treated equally by the state

equality of access /ɪˌkwɒlɪti əv ˈækses/ *noun* a situation in which everyone must be given the same opportunities for education, employment and other activities

equality of opportunity /ɪˌkwɒlɪti əv ɒpəˈtjuːnɪti/ *noun* a situation in which everyone has the same opportunities to receive education, employment, election, etc.

equality of treatment /ɪˌkwɒlɪti əv ˈtriːtmənt/ *noun* **1.** a situation in which everyone receives the same fair treatment in education, at work and in the community **2.** a right of workers who are nationals of other Member States of the European Union to be treated equally to nationals of the country where they work

Equal Opportunities Commission /ˌiːkwəl ɒpəˈtjuːnɪtiz kəˌmɪʃ(ə)n/ *noun* an official committee set up to make sure that men and women have equal chances of employment and to remove discrimination between the sexes (NOTE: The US term is **Equal Employment Opportunity Commission**.)

equal opportunities programme /ˌiːkwəl ɒpəˈtjuːnɪtiz ˌprəʊgræm/ *noun* a programme to avoid discrimination in employment (NOTE: The US term is **affirmative action program**.)

equal pay /ˌiːkwəl ˈpeɪ/ *noun* the situation in which the same salary is paid for the same type of work regardless of

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Law.fm Page 109 Friday, June 11, 2004 2:08 PM

whether it is done by, e.g., men or women

equitable /'ekwɪtəb(ə)l/ *adjective* **1.** fair and just **2.** referring to equity

equitable interests /ˌekwɪtəb(ə)l 'ɪntrəsts/ *plural noun* interests in property which are recognised separately from rights given by law

equitable jurisdiction /ˌekwɪtəb(ə)l ˌdʒʊərɪs'dɪkʃən/ *noun* the power of a court to enforce a person's rights

equitable lien /ˌekwɪtəb(ə)l 'liːən/ *noun* a right of someone to hold property which legally he or she does not own until the owner pays money due

equitable mortgage /ˌekwɪtəb(ə)l 'mɔːgɪdʒ/ *noun* a mortgage which does not give the mortgagee a legal estate in the land mortgaged

equity /'ekwɪti/ *noun* **1.** a system of British law which developed in parallel with the common law to make the common law fairer, summarised in the maxim 'equity does not suffer a wrong to be without a remedy' **2.** the right to receive dividends as part of the profit of a company in which you own shares

equity of redemption /ˌekwɪti əv rɪ 'dempʃən/ *noun* the right of a mortgagor to redeem the estate by paying off the principal and interest

equivocal /ɪ'kwɪvək(ə)l/ *adjective* not clearly expressed, or ambiguous ○ *The court took the view that the defendant's plea was equivocal.*

error /'erə/ *noun* a mistake ○ *He made an error in calculating the total.* ○ *The secretary must have made a typing error.* □ **errors and omissions excepted** words written on an invoice to show that the company has no responsibility for mistakes in the invoice. Abbreviation **e. & o.e.**

error rate /'erə reɪt/ *noun* the number of mistakes per thousand entries or per page

escalate /'eskəleɪt/ *verb* to increase at a constant rate

escalation of prices /ˌeskə'leɪʃ(ə)n əv praɪss/ *noun US* a constant increase in prices

escalator clause /'eskəleɪtə klɔːz/ *noun* a clause in a contract allowing for regular price increases because of increased costs

escape /ɪ'skeɪp/ *verb* **1.** to get away from a place of detention ○ *Three prisoners escaped by climbing over the wall.* **2.** to avoid something that is unpleasant ○ *He escaped with a reprimand.* ○ *They narrowly escaped prosecution.* ○ *We escaped the need to reveal sensitive details publicly.* ■ *noun* an act of getting away from a place of detention □ **to make your escape** to leave or escape from somewhere

escape clause /ɪ'skeɪp klɔːz/ *noun* a clause in a contract which allows one of the parties to avoid carrying out the terms of the contract under some conditions without penalty

escrow /'eskrəʊ/ *noun* a deed which the parties to it deliver to an independent person who hands it over only when specific conditions have been fulfilled □ **in escrow** held in safe keeping by a third party □ **document held in escrow** document given to a third party to keep and to pass on to someone when, e.g., money has been paid

escrow account /'eskrəʊ əˌkaʊnt/ *noun US* an account where money is held until something happens such as a contract being signed or goods being delivered

espionage /'espiənɑːʒ/ *noun* the activity of spying

Esq. *noun* **1.** sometimes written after the name of a man instead of using 'Mr' **2.** *US* sometimes written after the name of a male or female lawyer ▸ full form **Esquire**

essence of contract /ˌes(ə)ns əv 'kɒntrækt/ *noun* a fundamental term of a contract. Also called **condition of contract**

establish /ɪ'stæblɪʃ/ *verb* **1.** to set up, to make or to open something ○ *The company has established a branch in Australia.* ○ *The business was established in Scotland in 1823.* □ **to establish oneself in business** to become successful in a new business **2.** to decide what is correct or true ○ *The police are trying to establish his movements on the night of the*

mainp - softvnn.com

Law.fm Page 110 Friday, June 11, 2004 2:08 PM

murder. ○ *It is an established fact that the car could not have been used because it was out of petrol.*

established post /ɪˈstæblɪʃt pəʊst/ *noun* a permanent post in the civil service or similar organisation

established use /ɪˈstæblɪʃt juːz/ *noun* the use of land for a specific purpose which is recognised by a local authority because the land has been used for this purpose for some time

establishment /ɪˈstæblɪʃmənt/ *noun* □ **the Establishment** powerful and important people who run the country and its government

establishment charges /ɪˈstæblɪʃmənt ˌtʃɑːdʒɪz/ *plural noun* in a company's accounts, the cost of staff and property

establishment officer /ɪˌstæblɪʃmənt ˈɒfɪsə/ *noun* a civil servant in charge of personnel in a government department

estate /ɪˈsteɪt/ *noun* **1.** an interest in or right to hold and occupy land **2.** all the property that is owned by a person, especially a person who has recently died ○ *His estate was valued at £100,000* or *he left estate valued at £100,000.* □ **estate duty**, **estate tax** *US* tax on property left by a person now dead

estate agency /ɪˈsteɪt ˌeɪdʒənsi/ *noun* an office which arranges for the sale of property

estate agent /ɪˈsteɪt ˌeɪdʒənt/ *noun* the person in charge of an estate agency

estate duty /ɪˈsteɪt ˌdjuːti/ *noun US* a tax paid on the property left by a dead person

estop /əˈstɒp/ *verb* to stop someone doing something, e.g. exercising a right

estoppel /ɪˈstɒp(ə)l/ *noun* a rule of evidence whereby someone is prevented from denying or asserting a fact in legal proceedings

estoppel by conduct /ɪˌstɒp(ə)l baɪ ˈkɒndʌkt/ *noun* the rule that no one can deny things which he or she has done or failed to do which have had an effect on other persons' actions if that person has acted in a way which relied on the others' behaviour

estoppel by deed /ɪˌstɒp(ə)l baɪ ˈdiːd/ *noun* the rule that a person cannot deny having done something which is recorded in a deed

estoppel of record /ɪˌstɒp(ə)l əv ˈrekɔːd/ *noun* the rule that a person cannot reopen a matter which has already been decided by a court

estovers /ɪˈstəʊvəz/ *plural noun* right of a tenant to take wood and timber from land which he or she rents

estreat /ɪˈstriːt/ *verb* to get a copy of a record of bail or a fine awarded by a court

estreated recognizance /ɪˌstriːtɪd rɪˈkɒgnɪz(ə)ns/ *noun* recognisance which is forfeited because the person making it has not come to court

et al. /et ˈæl/**, et alia** *phrase* a Latin phrase meaning 'and others' or 'and other things'

ethnic /ˈeθnɪk/ *adjective* referring to a specific nation or race

ethnic group /ˈeθnɪk gruːp/ *noun* a group of people with the same background and culture, different from those of other groups

ethnic minority /ˌeθnɪk maɪˈnɒrɪti/ *noun* a group of people of one race in a country where most people are of another race

etiquette /ˈetɪket/ *noun* the set of rules governing the way people should behave, such as the way in which a solicitor or barrister behaves towards clients in court

et seq., **et sequentes** *phrase* a Latin phrase meaning 'and the following'

euro /ˈjʊərəʊ/ *noun* the main currency unit of the European Union, used as local currency in most Member States since 2002

Euro-constituency /ˌjʊərəʊ kən ˈstɪtjʊənsi/ *noun* a constituency which elects an MEP to the European Parliament

Eurocrat /ˈjʊərəʊkræt/ *noun* a bureaucrat working in the European Union or the European Parliament (*informal*)

European Atomic Energy Community Treaty /ˌjʊərəpiːən əˌtɒmɪk ˌenədʒi kəˌmjuːnəti ˈtriːti/ *noun* a treaty established in 1957 to develop nu-

mainp - softvnn.com

Law.fm Page 111 Friday, June 11, 2004 2:08 PM

clear energy within the Common Market. Abbreviation **EURATOM**

European Commission /ˌjʊərəpiːən kəˈmɪʃ(ə)n/ *noun* the main executive body of the European Union, made up of members nominated by each Member State

European Communities /ˌjʊərəpiːən kəˈmjuːnɪtiz/ *plural noun* same as **European Community**

European Community /ˌjʊərəpiːən kəˈmjuːnɪti/ *noun* the collective body formed by the merger in 1967 of the administrative networks of the European Atomic Energy Community, the European Coal and Steel Community, and the European Economic Community. Abbreviation **EC**. Also called **European Communities** (NOTE: The Treaty on European Union made it the official title of the European Economic Community (EEC).)

European Convention on Human Rights /ˌjʊərəpiːən kənˌvenʃ(ə)n ɒn ˌhjuːmən ˈraɪts/ *noun* a convention signed by all members of the Council of Europe covering the rights of all its citizens. The key provisions are now incorporated by the Human Rights Act 1998, which came into force in the UK in October 2000.

COMMENT: The convention recognises property rights, religious rights, the right of citizens to privacy, the due process of law, the principle of legal review. Note that the European Convention on Human Rights does not form part of English law.

European Council /ˌjʊərəpiːən ˈkaʊns(ə)l/ *noun* a group formed by the heads of government of the Member States of the European Union. The president of the European Council is the head of the Member State which is currently president of the Council of Ministers. (NOTE: Do not confuse with the **Council of the European Union**.)

European Court of Human Rights /ˌjʊərəpiːən kɔːt əv ˌhjuːmən ˈraɪts/ *noun* a court considering the rights of citizens of states which are parties to the European Convention for the Protection of Human Rights. ◊ **European Convention on Human Rights** (NOTE: Its formal name is the **European Court for the Protection of Human Rights**.)

European Court of Justice /ˌjʊərəpiːən ˌkɔːt əv ˈdʒʌstɪs/ *noun* a court set up to see that the principles of law as laid out in the Treaty of Rome are observed and applied correctly in the European Union. The court is responsible for settling disputes relating to European Community Law, and also acting as a last Court of Appeal against judgments in individual Member States. Abbreviation **ECJ**. Also called **Court of Justice of the European Communities**

COMMENT: The ECJ has 15 judges and 8 Advocates General; these are appointed by the governments of Member States for a period of six years. The judges come from all the Member States, and bring with them the legal traditions of each state. The court can either meet as a full court, or in chambers where only two or three judges are present. The court normally conducts its business in French, though if an action is brought before the court by or against a Member State, that Member State can choose the language in which the case will be heard. The Court can hear actions against institutions, actions brought either by the Commission or by a Member State against another Member State. The Court also acts as Court of Appeal for appeals from the Court of First Instance. The court also interprets legislation and as such acts in a semi-legislative capacity.

European Parliament /ˌjʊərəpiːən ˈpɑːləmənt/ *noun* the parliament of members elected in each Member State of the European Union, representing the peoples of each Member State

COMMENT: The members of the European Parliament (**MEPs**) are elected by constituencies in the 25 Member States. The number of MEPs per country depends on the size of the state they come from: the largest member state, Germany, has 99 MEPs, and the smallest, Luxembourg, has only 6. The European Parliament has the duty to supervise the working of the European Commission, and can if necessary, decide to demand the resignation of the entire Commission, although it cannot demand the resignation of an individual commissioner. The Parliament takes part in making the legislation of the EU, especially by

mainp - softvnn.com

Law.fm Page 112 Friday, June 11, 2004 2:08 PM

advising on new legislation being proposed by the Commission.

European Union /ˌjʊərəpiːən ˈjuːniən/ *noun* a group of European nations that form a single economic community and have agreed on social and political cooperation (NOTE: It was established by the Treaty on European Union in 1992 and increased to 25 members in 2004.)

euthanasia /ˌjuːθəˈneɪziə/ *noun* the act of killing a very sick or very old person to end to his or her suffering

evade /ɪˈveɪd/ *verb* to try to avoid something □ **to evade tax** to try illegally to avoid paying tax

evasion /ɪˈveɪʒ(ə)n/ *noun* **1.** the practice of avoiding something that you should do **2.** something said in order to hide the truth ○ *His account was full of lies and evasions.*

evasive /ɪˈveɪsɪv/ *adjective* trying to avoid □ **to give evasive answers** to try to avoid answering questions directly

evict /ɪˈvɪkt/ *verb* to force someone, especially a tenant to leave a property ○ *All the tenants were evicted by the new landlords.*

eviction /ɪˈvɪkʃən/ *noun* the act of forcing someone, especially a tenant, to leave a property

evidence /ˈevɪd(ə)ns/ *noun* a written or spoken statement of facts which helps to prove or disprove something at a trial ○ *All the evidence points to arson.* □ **the secretary gave evidence against her former employer** the secretary was a witness, and her statement suggested that her former employer was guilty □ **to plant evidence** to put items at the scene of a crime after the crime has taken place, so that a person is incriminated and can be arrested □ **to turn Queen's evidence**, **to turn state's evidence** *US* to confess to a crime and then act as witness against the other criminals involved, in the hope of getting a lighter sentence ■ *verb* to show ○ *the lack of good will, as evidenced by the defendant's behaviour in the witness stand*

evidence in chief /ˌevɪd(ə)ns ɪn ˈtʃiːf/ *noun* the questioning of a witness by the party who called them. Opposite **cross-examination** (NOTE: The opposite is **cross-examination**.)

ex /eks/ *noun* a former married or unmarried partner ○ *still in contact with her ex* ■ *preposition* out of, or from ■ *prefix* **1.** former ○ *an ex-convict* ○ *She claimed maintenance from her ex-husband.* **2.** not, or without

examination /ɪgˌzæmɪˈneɪʃ(ə)n/ *noun* **1.** the process of asking someone questions to find out facts, e.g. the questioning of a prisoner by a magistrate. ◊ **cross-examination 2.** an act looking at something very carefully to see if it is acceptable

examination in chief /ɪgˌzæmɪ ˈneɪʃ(ə)n ɪn tʃiːf/ *noun* same as **direct examination**

examine /ɪgˈzæmɪn/ *verb* to look at someone or something very carefully to see if it can be accepted ○ *The customs officials asked to examine the inside of the car.* ○ *The police are examining the papers from the managing director's safe.*

examining justice /ɪgˌzæmɪnə ˈdʒʌstɪs/ *noun* a magistrate who hears a case when it is presented for the first time, and decides if there should be a prosecution

excepted /ɪkˈseptɪd/ *adverb* not including

excepted persons /ɪkˌseptɪd ˈpɜːs(ə)ns/ *plural noun* types of employees listed in an insurance policy as not being covered by the insurance

exception /ɪkˈsepʃən/ *noun* **1.** something which is not included with others ○ *All the accused were acquitted with the exception of Jones who was sent to prison for three months.* **2.** an objection raised to the ruling of a judge □ **to take exception to something** to object to something, to protest against something ○ *Counsel for the defence took exception to the witness' remarks.* ○ *He has taken exception to the reports of the trial in the newspapers.*

exceptional items /ɪkˌsepʃən(ə)l ˈaɪtəmz/ *plural noun* items in a balance sheet which do not appear there each year

mainp - softvnn.com

Law.fm Page 113 Friday, June 11, 2004 2:08 PM

excess /ɪk'ses/ *noun* **1.** the amount which is more than what is allowed □ **excess alcohol in the blood** more alcohol in the blood than a driver is permitted to have □ **in excess of** above, more than ○ *quantities in excess of twenty-five kilos* **2.** the amount to be paid by the insured as part of any claim made under the terms of an insurance policy ○ *She has to pay a £50 excess, and the damage came to over £1,000.*

excess fare /'ekses feə/ *noun* an extra fare to be paid in some circumstances such as when travelling first class on a train with a second class ticket

excess of jurisdiction /ɪkˌses əv ˌdʒʊərɪs'dɪkʃən/ *noun* a case where a judge or magistrate has exceeded his or her powers

excess profits /ˌekses 'prɒfɪts/ *plural noun* profits which are more than is considered to be normal

excess profits tax /ˌekses 'prɒfɪts tæks/ *noun* a tax on profits which are higher than what is thought to be normal

exchange /ɪks'tʃeɪndʒ/ *noun* □ **rate of exchange**, **exchange rate** price at which one currency is exchanged for another ■ *verb* **1.** □ **to exchange an article for another** to give one thing in place of something else **2.** □ **to exchange contracts** to hand over a contract when buying or selling a property (done by both buyer and seller at the same time)

exchange controls /ɪks'tʃeɪndʒ kənˌtrəʊlz/ *plural noun* government restrictions on changing the local currency into foreign currency ○ *The government imposed exchange controls to stop the rush to buy dollars.*

Exchange Equalization Account /ɪksˌtʃeɪndʒ ˌiːkwəlaɪ'zeɪʃ(ə)n ə ˌkaʊnt/ *noun* an account with the Bank of England used by the government when buying or selling foreign currency to influence the exchange rate for the pound

exchange of contracts /ɪks ˌtʃeɪndʒ əv 'kɒntrækts/ *noun* a point in the conveyance of a property when the solicitors for the buyer and seller hand over the contract of sale which then becomes binding

exchange premium /ɪks'tʃeɪndʒ ˌpriːmiəm/ *noun* an extra cost above the normal rate for buying foreign currency ○ *The dollar is at a premium.*

exchanger /ɪks'tʃeɪndʒə/ *noun* somebody who buys and sells foreign currency

exchange transaction /ɪks'tʃeɪndʒ trænˌzækʃən/ *noun* the purchase or sale of foreign currency

Exchequer /ɪks'tʃekə/ *noun* a fund of all the money received by the government of the UK from taxes and other revenues. ◊ **Chancellor**

excise /ɪk'saɪz/ *verb* to cut out ○ *The chairman ordered the remarks to be excised from the official record.*

excise duty /'eksaɪz ˌdjuːti/**, excise tax** /'ɪksaɪz tæks/ *noun* a tax on the sale of goods such as alcohol and petrol which are produced in the country, or a tax on imports where the duty was not paid on entry into the country

exciseman /'eksaɪzmæn/ *noun* somebody who works in the Excise Department

exclude /ɪk'sluːd/ *verb* **1.** to keep something out, or not include something ○ *The right to enter can be excluded to a EU citizen on the grounds of danger to public health or safety.* **2.** to remove someone from a group ○ *He complained about being excluded from the short list.* **3.** to officially tell a student that they cannot attend a school, either temporarily or permanently, because of very bad behaviour

excluding /ɪk'sluːdɪŋ/ *preposition* not including ○ *The regulations apply to members of the public, excluding those serving in the emergency services.* □ **not excluding** including ○ *Government servants, not excluding judges, are covered by the Bill.*

exclusion /ɪk'sluːʒ(ə)n/ *noun* **1.** something which is not included **2.** a situation where someone is prevented from entering or taking part in something □ **to the exclusion of** not including, without including **3.** the situation where a student is officially prevented from attending school, either temporarily or permanently, because of very bad behaviour □ **to**

mainp - softvnn.com

Law.fm Page 114 Friday, June 11, 2004 2:08 PM

the exclusion of focusing only on one particular thing or person and ignoring anything or anyone else ○ *His wife complained he had spent all his time working to the exclusion of family life.*

exclusion clause /ɪk'skluːʒ(ə)n klɔːz/ *noun* a clause in an insurance policy or contract which says which items are not covered by the policy and gives details of circumstances in which the insurance company will refuse to pay

exclusion order /ɪkˌskluːʒ(ə)n 'ɔːdə/ *noun* formerly, a court order in matrimonial proceedings which stopped a wife or husband from going into the matrimonial home (NOTE: It is now replaced by an 'occupation order'.)

exclusion zone /ɪk'skluːʒn ˌzəʊn/ *noun* an area, usually an area of sea near a country, which the military forces of other countries are not allowed to enter

exclusive /ɪk'skluːsɪv/ *adjective* **1.** □ **exclusive right to market a product** right to be the only person to market the product **2.** □ **exclusive of** not including

exclusive agreement /ɪkˌskluːsɪv ə 'griːmənt/ *noun* an agreement where a person or firm is made sole agent for a product in a market

exclusive licence /ɪkˌskluːsɪv 'laɪs(ə)ns/ *noun* a licence where the licensee is the only person to be able to enjoy the licence

exclusivity /ˌeksklu:'sɪvɪtɪ/ *noun* the exclusive right to market a product

ex-con /eks 'kɒn/ *noun* same as **ex-convict** (*informal*)

ex-convict /eks 'kɒnvɪkt/ *noun* someone who was imprisoned for a crime but has served their sentence and been released

ex-directory number /ˌeks daɪ ˌrektri 'nʌmbə/ *noun* a telephone number which is not printed in the list of people having telephone numbers

execute /'eksɪˌkjuːt/ *verb* **1.** to carry out an order **2.** to carry out (the terms of a contract) **3.** to seal (a deed) **4.** to kill someone who has been sentenced to death by a court ○ *He was executed by firing squad.*

executed consideration /ˌeksɪkjuːtɪd kənˌsɪdə'reɪʃ(ə)n/ *noun* a consideration where one party has made a promise in exchange for which the other party has done something for him or her

execution /ˌeksɪ'kjuːʃ(ə)n/ *noun* **1.** the carrying out of a court order or of the terms of a contract **2.** the seizure and sale of goods belonging to a debtor **3.** the killing of someone who has been sentenced to death by a court

executioner /ˌeksɪ'kjuːʃ(ə)nə/ *noun* somebody who executes people who have been sentenced to death

executive /ɪg'zekjʊtɪv/ *adjective* **1.** putting decisions into action **2.** referring to the branch of government which puts laws into effect **3.** *US* referring to the President of the USA as head of government ■ *noun* a person such as a manager or director who takes decisions in an organisation ◇ **the Executive** *US* **1.** section of a government which puts into effect the laws passed by Parliament **2.** the president

executive clemency /ɪgˌzekjʊtɪv 'klemənsi/ *noun US* a pardon granted by the President

executive detention /ɪgˌzekjʊtɪv dɪ'tenʃən/ *noun* the act of holding suspected terrorists, illegal immigrants, etc., in custody for a limited period

executive director /ɪgˌzekjʊtɪv daɪ 'rektə/ *noun* a director who actually works full-time in the company

executive document /ɪgˌzekjʊtɪv ˌdɒkjʊ'ment/ *noun US* a document such as a treaty sent by the President of the USA to the Senate for ratification

executive order /ɪgˌzekjʊtɪv 'ɔːdə/ *noun US* an order by the president of the USA or of a state governor

executive power /ɪgˌzekjʊtɪv 'paʊə/ *noun* the right to act as director or to put decisions into action

executive privilege /ɪgˌzekjʊtɪv 'prɪvɪlɪdʒ/ *noun US* the privilege of the President of the USA not to reveal matters which he or she considers secret

executor /ɪg'zekjʊtə/ *noun* someone who is appointed by a person making his or her will who will see that the terms of the will are carried out ○ *He was named executor of his brother's will.*

mainp - softvnn.com

Law.fm Page 115 Friday, June 11, 2004 2:08 PM

executorship /ɪg'zekjʊtəʃɪp/ *noun* the position of being an executor

executory /ɪg'zekjʊt(ə)ri/ *adjective* still being carried out

executory consideration /ɪg ˌzekjʊt(ə)ri kənˌsɪdə'reɪʃ(ə)n/ *noun* a consideration where one party makes a promise in exchange for a counter-promise from the other party

exemplary /ɪg'zempləri/ *adjective* being so good that it serves as an example to others ○ *Her conduct in the case was exemplary.*

exemplary damages /ɪgˌzempləri 'dæmɪdʒɪz/ *plural noun* an extra award of damages which aims to punish the defendant's actions in addition to compensating the harm done to the claimant

exemplary sentence /ɪgˌzempləri 'sentəns/ *noun* a particularly harsh sentence which aims at deterring others from committing the same type of crime

exempt /ɪg'zempt/ *adjective* **1.** not covered by a law □ **exempt from tax**, **tax-exempt** not required to pay tax **2.** not forced to obey a law ■ *verb* to free something from having tax paid on it, or free someone from having to pay tax ○ *Non profit-making organisations are exempted from tax.* ○ *Food is exempted from sales tax.* ○ *The government exempted trusts from tax.*

exempt information /ɪgˌzempt ˌɪnfə'meɪʃ(ə)n/ *noun US* information which may be kept secret from the public because if it were disclosed it might be unfair to an individual or harmful to the authorities ○ *The council resolved that the press and public be excluded for item 10 as it involved the likely disclosure of exempt information.*

exemption /ɪg'zempʃ(ə)n/ *noun* the act of exempting something from a contract or from a tax ○ *The Commission is the only body which can grant exemptions from Community competition law.* □ **exemption from tax**, **tax exemption** the situation of not being required to pay tax ○ *as a non profit-making organization you can claim tax exemption*

exemption clause /ɪg'zempʃ(ə)n klɔːz/ *noun* a clause in a contract exempting a party from some liabilities

exempt supplies /ɪgˌzempt sə 'plaɪz/ *plural noun* sales of goods or services on which VAT does not have to be paid

exercise /'eksəsaɪz/ *noun* the use of powers, skills or official rights ○ *A court can give directions to a local authority as to the exercise of its powers in relation to children in care.* ■ *verb* to use or to put something into practice □ **to exercise your discretion** to decide on which of several possible ways to act ○ *The magistrates exercised their discretion and let the accused off with a suspended sentence.* □ **to exercise an option** to carry out something which you have been given the power to do ○ *He exercised his option to acquire sole marketing rights for the product.* ○ *Not many shareholders exercised their option to buy the new issue of shares.*

ex gratia /ˌeks 'greɪʃə/ *phrase* a Latin phrase meaning 'as a favour' □ **an ex gratia payment** payment made as a gift, with no obligations

exhibit /ɪg'zɪbɪt/ *noun* any object which is shown as evidence to a court

exile /'eksaɪl/ *noun* **1.** the punishment of being sent to live in another country ○ *The ten members of the opposition party were sent into exile.* **2.** somebody who has been sent to live in another country as a punishment ■ *verb* to send someone to live in another country as a punishment ○ *He was exiled for life.* ○ *She was exiled to an island in the North Sea.*

ex officio /ˌeks ə'fɪʃiəʊ/ *phrase* a Latin phrase meaning 'because of an office held' ○ *The treasurer is ex officio a member* or *an ex officio member of the finance committee.*

exonerate /ɪg'zɒnəreɪt/ *verb* to remove any blame from a person previously accused of an offence ○ *The judge exonerated the driver from all responsibility for the accident.*

exoneration /ɪgˌzɒnə'reɪʃ(ə)n/ *noun* the act of exonerating

ex parte /ˌeks 'pɑːti/ *phrase* a Latin phrase meaning 'on behalf of', or 'on the part of one side only'. an application pursued by one party only. ○ *The wife applied ex parte for an ouster order against her husband.* (NOTE: It has been re-

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Law.fm Page 116 Friday, June 11, 2004 2:08 PM

placed by the term 'without notice'.) □ **an ex parte application** an application made to a court where only one side is represented and no notice is given to the other side (often where the application is for an injunction). ◊ **inter partes**

expatriate /eks'pætriət/ *noun* somebody who lives abroad ○ *There is a large expatriate community* or *a large community of expatriates in Geneva.* ■ *verb* to force someone to leave the country where he or she is living

expatriation /eksˌpætri'eɪʃ(ə)n/ *noun* the act of leaving the country where you are living

expectancy /ɪk'spektənsi/**, expectation** /ˌekspek'teɪʃ(ə)n/ *noun* the hope that you will inherit something

expectation of life /ˌekspek 'teɪʃ(ə)n əv laɪf/ *noun* the number of years a person is likely to live

expectations /ˌekspek'teɪʃ(ə)nz/ ◆ **legitimate expectations**

expenditure /ɪk'spendɪtʃə/ *noun* the amount of money spent

expense /ɪk'spens/ *noun* money spent □ **at great expense** having spent a lot of money

expenses /ɪk'spensɪz/ *plural noun* money paid for doing something □ **all expenses paid** with all the costs of an activity paid by someone else □ **overhead expenses**, **general expenses, running expenses** money spent on the day-to-day costs of a business □ **travelling expenses** money spent on travelling and hotels for business purposes

COMMENT: In the UK, there is a limit to the amount of money each individual candidate can spend, so as not to favour rich candidates against poor ones. After the election the candidates and their agents have to make a return of expenses to show that they have not overspent. There is no limit to the spending of the political parties on a national level, and most of the campaign expenditure is made in this way, with national TV advertising, advertisements in the national press, etc. In the USA, the government subsidizes election expenses by paying an equivalent sum to that raised by each candidate. The candidates for the main elected positions (especially that of President) have to be rich, or at any rate to have rich supporters.

expert /'ekspɜːt/ *noun* somebody who knows a lot about something ○ *an expert in the field of fingerprints* or *a fingerprints expert* ○ *The company asked a financial expert for advice* or *asked for expert financial advice.*

expert evidence /ˌekspɜːt 'evɪd(ə)ns/ *noun* evidence given by an expert witness

expert's report /ˌekspɜːtz rɪ'pɔːt/ *noun* a report written by an expert, usually for a court case

expert witness /ˌekspɜːt 'wɪtnəs/ *noun* a witness who is a specialist in a subject and is asked to give his or her opinion on technical matters

expiration /ˌekspə'reɪʃ(ə)n/ *noun* the end of something ○ *expiration of an insurance policy* ○ *to repay before the expiration of the stated period* □ **on expiration of the lease** when the lease comes to an end

expire /ɪk'spaɪə/ *verb* to come to an end ○ *The lease expires in 2010.* □ **his passport has expired** his passport is no longer valid

expiry /ɪk'spaɪəri/ *noun* the end of something ○ *expiry of an insurance policy*

expiry date /ɪk'spaɪəri deɪt/ *noun* **1.** the date when something will end, such as the last date for exercising an option **2.** the last date on which a credit card can be used

explicit /ɪk'splɪsɪt/ *adjective* which is clearly stated ○ *His explicit intention was to leave his house to his wife.*

explicitly /ek'splɪsɪtli/ *adverb* in a clear way ○ *The contract explicitly prohibits sale of the goods in Europe.*

export *noun* /'ekspɔːt/ the sending of goods to a foreign country to be sold ■ *verb* /ɪk'spɔːt/ to send goods abroad to be sold ○ *Most of the company's products are exported to the USA.*

export licence /'ekspɔːt ˌlaɪs(ə)ns/ *noun* a permit which allows a company to send products abroad to be sold

export permit /'ekspɔːt ˌpɜːmɪt/ *noun* an official document which allows goods to be exported

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Law.fm Page 117 Friday, June 11, 2004 2:08 PM

export trade /'ekspɔːt treɪd/ *noun* the business of selling to other countries

ex post facto /ˌeks pəʊst 'fæktəʊ/ *phrase* a Latin phrase meaning 'after the event'

exposure /ɪk'spəʊʒə/ *noun* the act of showing something which was hidden ○ *The report's exposure of corruption in the police force.*

expressio unius est exclusio alterius /ɪkˌspresiəʊ ˌuːniəs est ɪks ˌkluːziəʊ ɔːl'teriəs/ *phrase* a Latin phrase meaning 'the mention that one thing is included implies that another thing is excluded'

expressly /ɪk'spresli/ *adverb* clearly in words ○ *The contract expressly forbids sales to the United States.* ○ *The franchisee is expressly forbidden to sell goods other than those supplied by the franchiser.*

express malice /ɪkˌspres 'mælɪs/ *noun US* the intention to kill someone

express term /ɪk'spres tɜːm/ *noun* a term in a contract which is agreed by both parties and clearly stated, i.e. either written or spoken. Compare **implied term**

expropriation /ɪksˌprəʊprɪ'eɪʃ(ə)n/ *noun* **1.** the action of the state in taking private property for public use without paying compensation **2.** *US* the action of the state in taking private property for public use and paying compensation to the former owner (NOTE: The British equivalent is **compulsory purchase**.)

expunge /ɪk'spʌndʒ/ *verb* to remove information from a record ○ *Inadmissible hearsay evidence was expunged from the report.*

extended credit /ɪkˌstendɪd 'kredɪt/ *noun* credit allowing the borrower a longer time to pay

extended family /ɪkˌstendɪd 'fæm(ə)li/ *noun* a group of related people, including distant relatives and close friends

extended sentence /ɪkˌstendɪd 'sentəns/ *noun* a sentence which is made longer than usual because the criminal is likely to repeat the offence ○ *He was sentenced to five years imprisonment, extended.*

extension /ɪk'stenʃən/ *noun* the act of allowing more time for an activity □ **an extension of credit** an allowance of more time to pay back money that is owed □ **extension of a contract** a further period of time after a contract has finished □ **extension of time** an allowance by court of more time in which to do or complete something ○ *the defendant applied for an extension of time in which to serve her defence*

extenuating circumstances /ɪkˌstenjueɪtɪŋ 'sɜːkəmstənsɪz/ *plural noun* factors which excuse a crime in some way

extenuation /ɪkˌstenju'eɪʃ(ə)n/ *noun* □ **in extenuation of something** in order to excuse something ○ *Counsel pleaded the accused's age in extenuation of his actions.*

external audit /ɪkˌstɜːn(ə)l 'ɔːdɪt/ *noun* an audit carried out by an independent auditor

external auditor /ɪkˌstɜːn(ə)l 'ɔːdɪtə/ *noun* an independent person who audits the company's accounts

extinguishment /ɪk'stɪŋgwɪʃmənt/ *noun* the act of cancelling a right or a power, especially the right to sue for non-payment once payment has been made

extort /ɪk'stɔːt/ *verb* to get money, promises or a confession from someone by using threats ○ *He extorted £20,000 from local shopkeepers.*

extortion /ɪk'stɔːʃ(ə)n/ *noun* the activity of getting money by threats

extortionate credit bargain /ɪkˌstɔːʃ(ə)nət 'kredɪt ˌbɑːgɪn/ *noun* a transaction whereby money is lent at a very high rate of interest, thereby rendering the transaction illegal

extortionist /ɪk'stɔːʃ(ə)nɪst/ *noun* someone who extorts money from people

extortion racket /ɪkˌstɔːʃ(ə)n 'rækɪt/ *noun* a racket to make money by threatening people

extra- /ekstrə/ *prefix* outside

extra-authority payments /ˌekstrə ɔːˌθɒrɪti 'peɪmənts/ *noun* payments made to another authority for services provided by that authority

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Law.fm Page 118 Friday, June 11, 2004 2:08 PM

extract *noun* /'ekstrækt/ a printed document which is part of a larger document ○ *The solicitor sent an extract of the deeds.* ■ *verb* /ɪk'strækt/ to get something such as information or a promise from someone by force, threats or close questioning ○ *The confession was extracted under torture.* ○ *The magistrate extracted an admission from the witness that she had not seen the accident.*

extradite /'ekstrədaɪt/ *verb* to bring an arrested person from another country to your country because he or she is wanted for trial for a crime committed in your country ○ *He was arrested in France and extradited to stand trial in Germany.*

extradition /ˌekstrə'dɪʃ(ə)n/ *noun* the act of extraditing ○ *The USA is seeking the extradition of the leader of the drug gang.*

extradition treaty /ˌekstrə'dɪʃ(ə)n ˌtriːti/ *noun* an agreement between two countries that a person arrested in one country can be sent to the other to stand trial for a crime committed there

Extraordinary General Meeting /ɪkˌstrɔːd(ə)n(ə)ri ˌdʒen(ə)rəl 'miːtɪŋ/ *noun* a special meeting of shareholders or members of a club to discuss an important matter which cannot wait until the next Annual General Meeting. Abbreviation **EGM**

extraordinary items /ɪk 'strɔːd(ə)n(ə)ri ˌaɪtəmz/ *plural noun* items in accounts which do not appear each year and need to be noted

extra-territoriality /ˌekstrə ˌterɪtɔːri'ælɪti/ *noun* (*of diplomats*) being outside the territory of the country where you are living, and so not subject to its laws (used of diplomats)

extra-territorial waters /ˌekstrə ˌterɪtɔːriəl 'wɔːtəz/ *plural noun* international waters, outside the jurisdiction of any one country

extremism /ɪk'striːmɪz(ə)m/ *noun* ideas and practices that favour very strong action, even including the use of violence

extremist /ɪk'striːmɪst/ *noun* a person in favour of very strong, sometimes violent methods, regarded as unreasonable by most other people ■ *adjective* in favour of very strong, sometimes violent methods ○ *extremist political parties*

extrinsic evidence /eksˌtrɪnsɪk 'evɪd(ə)ns/ *noun* evidence used in the interpretation of a document which is not found in the document itself. Compare **intrinsic evidence**

ex turpi causa non oritur actio /ˌeks ˌtʊəpi ˌkaʊzə nɒn ˌɒrɪtə 'æktiəʊ/ *phrase* a Latin phrase meaning 'from a base cause no action can proceed': it is not legally possible to enforce an illegal contract

eye witness /ˌaɪ 'wɪtnəs/ *noun* a person who saw something such as an accident or a crime happen ○ *She gave an eye witness account of the bank hold-up.*

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face /feɪs/ *verb* □ **to face a charge** to appear in court and be charged with a crime ○ *He faces three charges relating to firearms.*

facie ➧ **prima facie**

facsimile /fæk'sɪmɪlɪ/, **facsimile copy** /fækˌsɪmɪli 'kɒpi/ *noun* an exact copy of a document

fact /fækt/ *noun* something which is true and real, especially something which has been proved by evidence in court ○ *The chairman of the tribunal asked to see all the facts on the income tax claim.* □ **in fact**, **in point of fact** really

faction /'fækʃən/ *noun* a group of people within a larger organisation such as a political party who have different views or aims from the other members (*sometimes as criticism*) ○ *Arguments broke out between different factions at the party conference.* ○ *The Prime Minister has the support of most factions in the party.*

factional /'fækʃən(ə)l/ *adjective* referring to factions ○ *Factional infighting has weakened the party structure.*

facto ➧ **de facto, ipso facto**

factoring /'fæktərɪŋ/ *noun* the activity of selling debts to a debt factor

factors of production /ˌfæktəz əv prə'dʌkʃən/ *noun* the three things needed to produce a product (land, labour and capital)

Faculty of Advocates /ˌfæk(ə)lti əv 'ædvəʊkəts/ *noun* the legal body to which Scottish barristers belong

failing prompt payment /ˌfeɪlɪŋ prɒmpt 'peɪmənt/ *phrase* if the payment is not made on time

failure to appear /ˌfeɪljə tə ə'pɪə/ *noun* a failure to come to court when expected (NOTE: The case may continue in the absence of one of the parties, but not of both.)

fair /feə/ *adjective* honest or correct

fair comment /ˌfeə 'kɒment/ *noun* a defence to a charge of defamation on a matter of public interest asserting that the statement in question was true, fair and honestly made

fair copy /ˌfeə 'kɒpi/ *noun* a document which is written or typed with no changes or mistakes

fair dealing /ˌfeə 'diːlɪŋ/ *noun* **1.** the legal buying and selling of shares **2.** the practice of quoting small sections of a copyright work

fair dismissal /ˌfeə dɪs'mɪs(ə)l/ *noun* the situation when an employee is deemed to have been dismissed from their employment for a lawful reason, i.e. (1) capability; (2) qualifications or conduct; (3) redundancy; (4) illegality; (5) some other substantial reason (SOSR)

fair price /ˌfeə 'praɪs/ *noun* a good price for both buyer and seller

fair rent /ˌfeə 'rent/ *noun* reasonable rent for a property, bearing in mind the size and type of property and its situation

fair trade /ˌfeə 'treɪd/ *noun* an international business system where countries agree not to charge import duties on items imported from their trading partners

fair trading /ˌfeə 'treɪdɪŋ/ *noun* a way of carrying business which is reasonable and does not harm the consumer

fair use /ˌfeə 'juːs/ *noun* the use which can be legally made of a quotation from a copyright text without the permission of the copyright owner

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Law.fm Page 120 Friday, June 11, 2004 2:08 PM

fair value /ˌfeə ˈvæljuː/ *noun* a price paid by a buyer who knows the value of what he is buying to a seller who also knows the value of what he is selling, i.e. neither is cheating the other

fair wear and tear /ˌfeə weər ən ˈteə/ *noun* acceptable damage caused by normal use ○ *The insurance policy covers most damage, but not fair wear and tear to the machine.*

faith /feɪθ/ *noun* □ **to have faith in something, someone** to believe that something or a person is good or will work well □ **in good faith** in an honest way □ **he acted in good faith** he acted honestly □ **he acted in bad faith** he acted dishonestly □ **to buy something in good faith** to buy something honestly, in the course of an honest transaction ○ *He bought the car in good faith, not knowing it had been stolen.*

fake /feɪk/ *noun* a copy made for criminal purposes ○ *The shipment came with fake documentation.* ■ *verb* to make an imitation for criminal purposes ○ *They faked a break-in to make the police believe the documents had been stolen.*

fall /fɔːl/ *verb* **1.** to happen on a particular day or date ○ *The national holiday falls on a Monday.* **2.** to become ○ *Her husband fell ill and couldn't work.* □ **to fall due on** to become ready to be paid on a particular date ○ *The bill fell due on the last day of March.* □ **to fall foul of** to get into trouble with someone, or break the law ○ *His plan fell foul of the local authorities.* ○ *The venture quickly fell foul of the law.* □ **to fall under someone's influence *or* sway** to become strongly influenced by someone else, especially to do something wrong ◇ **fall in with someone** to become associated with someone, especially someone who is a bad influence ◇ **fall outside** not to belong to a particular area of knowledge or activity ○ *That question falls outside my specialist knowledge.* ◇ **fall within** to belong to a particular area of knowledge or activity ○ *Does this fall within the terms of the agreement?*

false /fɔːls/ *adjective* not true or not correct ○ *to make a false entry in the record* □ **by *or* under false pretence(s)** by doing or saying something to trick someone ○ *he was sent to prison for obtaining money by false pretences*

false accounting /ˌfɔːls əˈkaʊntɪŋ/ *noun* the notifiable offence of changing, destroying or hiding financial records for money, punishable by up to seven years' imprisonment

false description of contents /fɔːls dɪˌskrɪpʃən əv kənˈtents/ *noun* wrongly stating the contents of a packet to trick customers into buying it

falsehood /ˈfɔːlshʊd/ *noun* a deliberately incorrect statement

false imprisonment /ˌfɔːls ɪm ˈprɪz(ə)nmənt/ *noun* unlawful detainment of an individual which restricts their right to freedom of movement to leave an area, rather than actually being put in prison. Examples are an unlawful arrest or preventing a person from leaving a room.

false positive /ˌfɔːls ˈpɒzɪtɪv/ *noun* an incorrect result occurring when data about a person is matched against a checklist, e.g. when a passenger profile is matched against a list of suspected terrorists

false representation /fɔːls ˌreprɪzenˈteɪʃ(ə)n/ *noun US* the offence of making a wrong statement which misleads someone

false weight /ˌfɔːls ˈweɪt/ *noun* a weight on shop scales which is wrong and so cheats customers

falsification of accounts /fɔːlsɪfɪˌkeɪʃ(ə)n əv əˈkaʊnts/ *noun* the action of making false entries in a record or of destroying a record

falsify /ˈfɔːlsɪfaɪ/ *verb* to change something to make it wrong □ **to falsify accounts** to change or destroy a record

family /ˈfæm(ə)li/ *noun* **1.** a group of people who are related by birth or marriage **2.** a group of organised Mafia gangsters (*slang*)

family company /ˈfæm(ə)li ˌkʌmp(ə)ni/ *noun* a company where most of the shares are owned by members of the same family

Family Division /ˌfæm(ə)li dɪˈvɪʒ(ə)n/ *noun* one of the three divisions of the High Court which deals with di-

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Law.fm Page 121 Friday, June 11, 2004 2:08 PM

vorce cases and cases involving parents and children

family law /ˈfæm(ə)li lɔː/ *noun* law relating to families or to the rights and duties of the members of a family

family life /ˈfæm(ə)li laɪf/ *noun* a qualified right to family life. Interference is allowed on the grounds of legitimate public interest but must be proportionate. It is found in Article 8 of the European Convention of Human Rights and was introduced into UK law by the Human Rights Act 1998. ◊ **emergency protection order, threshold criteria**

fast track /ˈfɑːst træk/ *noun* a case management system normally applied to civil cases involving sums between £5000 and £15,000

COMMENT: The timetable for the fast track is given in the directions for the case. A typical timetable starts from the date of the notice of allocation, and gives four weeks to disclosure, 10 weeks for the exchange of experts' reports, 20 weeks for the court to send out listing questionnaires and 30 weeks to the hearing; the trial must not last more than one day, and such issues as liability and quantum may be decided separately.

fast-track /ˌfɑːst ˈtræk/ *adjective* moving forward at a faster rate ○ *There is a new fast-track procedure for hearing claims.*

fatal /ˈfeɪt(ə)l/ *adjective* causing a death ○ *He took a fatal dose of drugs.* ○ *There were six fatal accidents in the first week of the year.*

FBI /efbiːˈaɪ/ *abbreviation* Federal Bureau of Investigation

feasant ◆ **damage feasant**

feasibility /ˌfiːzəˈbɪlɪti/ *noun* the ability to be done

feasibility study /ˌfiːzəˈbɪlɪti ˌstʌdi/ *noun* research done to see if something which has been planned is a good idea ○ *The council asked the planning department to comment on the feasibility of the project.* ○ *The department has produced a feasibility report on the development project.*

feasibility test /ˌfiːzəˈbɪlɪti test/ *noun* a test to see if something is possible

feasible /ˈfiːzɪb(ə)l/ *adjective* possible ○ *The Planning Department says it is not feasible to produce draft plans at this stage.*

Federal Bureau of Investigation /ˌfed(ə)rəl ˌbjʊərəʊ əv ɪnˌvestɪ ˈgeɪʃ(ə)n/ *noun US* the section of the US Department of Justice which investigates crimes against federal law and subversive acts in the USA. Abbreviation **FBI**

federal court /ˈfed(ə)rəl kɔːt/, **federal laws** /ˈfed(ə)rəl lɔːs/ *noun US* the court or laws of the USA, as opposed to state courts or state laws

Federal Reserve Bank /ˌfed(ə)rəl rɪˈzɜːv ˌbæŋk/ *noun US* one of the twelve central banks in the USA which are owned by the state and directed by the Federal Reserve Board

Federal Reserve Board /ˌfed(ə)rəl rɪˈzɜːv bɔːd/ *noun US* a government organisation which runs the central banks in the USA

fee /fiː/ *noun* **1.** the money paid for work carried out by a professional person such as an accountant, doctor or lawyer ○ *a barrister's fees* ○ *We charge a small fee for our services.* **2.** the money paid for something ○ *entrance fee* or *admission fee* ○ *registration fee* **3.** ownership of land which may be inherited

fee simple /ˌfiː ˈsɪmpəl/ *noun* freehold ownership of land with no restrictions to it ○ *to hold an estate in fee simple*

fee tail /ˈfiː teɪl/ *noun* a legal interest in land which is passed on to the owner's direct descendants, and which cannot be passed to anyone else (NOTE: The creation of these interests is no longer possible.)

felonious /fəˈləʊniəs/ *adjective* criminal ○ *He carried out a felonious act.*

felony /ˈfeləni/ *noun* an old term for a serious crime ○ *to commit a felony* (NOTE: still used in the expression **treason felony**)

feme covert /ˌfem ˈkəʊvət/ *phrase* a French phrase meaning 'married woman'

feme sole /ˌfem ˈsəʊl/ *phrase* a French phrase meaning 'unmarried woman'

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Law.fm Page 122 Friday, June 11, 2004 2:08 PM

fence /fens/ *noun* somebody who receives and sells stolen goods (*informal*) ■ *verb* to receive stolen goods to sell

feudal society /ˌfjuːd(ə)l səˈsaɪəti/ *noun* a society where each class or level has a duty to serve the class above it

fiat /ˈfiːæt/ *noun* an agreement, e.g. of the Attorney-General, to bring a prosecution

fiat justitia /ˌfiːæt dʒʌsˈtɪsiə/ *phrase* a Latin phrase meaning 'let justice be done'

fiat money /ˈfiːæt ˌmʌni/ *noun* coins or notes which are not worth much as paper or metal, but are said by the government to have a value

fiction of law /ˌfɪkʃən əv ˈlɔː/ *noun* the act of assuming something to be true, even if it is not proved to be so, which is a procedural device of courts to avoid problems caused by statute

fictitious /fɪkˈtɪʃəs/ *adjective* not existing, and sometimes intended to deceive people

fictitious assets /fɪkˌtɪʃəs ˈæsets/ *plural noun* assets which do not really exist, but are entered as assets to balance the accounts

fide ➧ **bona fide purchaser, bona fides**

fiduciary /fɪˈdjuːʃjəri/ *adjective* acting as trustee for someone else, or being in a position of trust ○ *A company director owes a fiduciary duty to the company.* □ **to act in a fiduciary capacity** to act as a trustee ■ *noun* a trustee

fieri facias /ˌfaɪraɪ ˈfeɪʃiæs/ *phrase* a Latin phrase meaning 'make it happen'

fi. fa. *abbreviation* **fieri facias**

FIFO *abbreviation* first in first out

Fifth Amendment /ˌfɪfθ əˈmendmənt/ *noun US* an amendment to the constitution of the USA, which says that no person can be forced to give evidence which might incriminate himself or herself □ **to plead the Fifth Amendment**, **to take the Fifth Amendment** to refuse to give evidence to a court, tribunal or committee, because the evidence might incriminate you

file /faɪl/ *noun* **1.** documents kept for reference, either on paper or as data on a computer, such as information on staff salaries, address list, customer accounts ○ *The police keep a file of missing vehicles.* ○ *Look up her description in the missing persons' file.* □ **to place something on file** to keep a record of something □ **to keep someone's name on file** to keep someone's name on a list for reference **2.** a cardboard holder for documents, which can fit in the drawer of a filing cabinet ○ *Put these letters in the unsolved cases file.* ○ *Look in the file marked 'Scottish police forces'.* ■ *verb* **1.** □ **to file documents** to put documents in order so that they can be found easily **2.** to make an official request □ **to file a petition in bankruptcy** to ask officially to be made bankrupt, to ask officially for someone else to be made bankrupt **3.** to send a document to court ○ *When a defendant is served with particulars of claim he can file a defence.* □ **the defence must be filed and served in seven days** the defence must be sent to court and to the other party within seven days **4.** to register something officially ○ *to file an application for a patent* ○ *to file a return to the tax office*

file copy /ˈfaɪl ˌkɒpi/ *noun* a copy of a document which is filed in an office for reference

filing /ˈfaɪlɪŋ/ *noun* the delivery of a legal document to the court office by hand, post, fax, etc.

filing basket /ˈfaɪlɪŋ ˌbɑːskɪt/ *noun* a container kept on a desk for documents which have to be filed

filing card /ˈfaɪlɪŋ kɑːd/ *noun* a card with information written on it, used to classify information into the correct order

filing clerk /ˈfaɪlɪŋ klɑːk/ *noun* a clerk who files documents

final date for payment /ˌfaɪn(ə)l deɪt fə ˈpeɪmənt/ *noun* the last date by which payment should be made

final demand /ˌfaɪn(ə)l dɪˈmɑːnd/ *noun* the last reminder from a supplier, after which he or she will sue for payment

final discharge /ˌfaɪn(ə)l dɪsˈtʃɑːdʒ/ *noun* the final payment of what is left of a debt

mainp - softvnn.com

Law.fm Page 123 Friday, June 11, 2004 2:08 PM

final dividend /ˌfaɪn(ə)l ˈdɪvɪdend/ *noun* a dividend paid at the end of a year

final hearing /ˌfaɪn(ə)l ˈhɪərɪŋ/ *noun* the actual hearing of a case in the small claims track, which aims at being informal and rapid

final judgment /ˌfaɪn(ə)l ˈdʒʌdʒmənt/ *noun* a judgment which is awarded at the end of an action after trial. Compare **interlocutory judgment**

Finance Act /ˈfaɪnæns ækt/ *noun* an annual Act of the British Parliament which gives the government power to raise taxes as proposed in the budget (NOTE: Use **under** when referring to an Act of Parliament: *a creditor seeking a receiving order under the Bankruptcy Act*; *She does not qualify under section 2 of the 1979 Act*.)

Finance Bill and Finance Act /ˌfaɪnæns bɪl ən ˈfaɪnæns ˌækt/ *noun* an annual Bill and Act of Parliament which gives the Government the power to raise taxes to produce money for the Exchequer, and which then can be spent as proposed in the Budget

finance charge /ˈfaɪnæns tʃɑːdʒ/ *noun* **1.** the cost of borrowing money **2.** an additional charge made to a customer who asks for extended credit

finance company /ˈfaɪnæns ˌkʌmp(ə)ni/ *noun* a company which provides money for hire-purchase

finance corporation /ˈfaɪnæns ˌkɔːpəreɪʃ(ə)n/ *noun* a company which provides money for hire purchase

Finance Minister /ˌfaɪnæns ˈmɪnɪstə/ *noun* a government minister responsible for finance (both taxation and expenditure)

financial /faɪˈnænʃəl/ *adjective* referring to money or finance ○ *He has a financial interest in the company.* □ **to make financial provision for someone** to arrange for someone to receive money to live on (by attachment of earnings, etc.)

COMMENT: In most countries, the government department dealing with finance is called the Finance Ministry, with a Finance Minister in charge. Both in the UK and the USA, the department is called the Treasury, and the minister in charge is the Chancellor of the Exchequer in the UK, and the Treasury Secretary in the USA.

financial assistance /faɪˌnænʃəl əˈsɪstəns/ *noun* help in the form of money

financial commitments /faɪˌnænʃəl kəˈmɪtmənts/ *plural noun* money which is owed to someone for bills or purchases

financial provision order /faɪˌnænʃəl prəˈvɪʒ(ə)n ˌɔːdə/ *noun* an order which, during the course of family proceedings, is made on or after the granting of a decree of divorce or annulment, providing for a financial settlement between the parties, or a lump sum

financial relief /faɪˌnænʃ(ə)l rɪˈliːf/ *noun* any or all of the following orders available during family proceedings: maintenance pending suit orders, financial provision orders, property adjustment orders and court orders for maintenance during marriage (NOTE: Maintenance for children of a marriage falls outside of the jurisdiction of the court and must be made to the Child Support Agency directly, the only exception being when the children of the marriage have special needs or are adopted.)

financial review /faɪˌnænʃəl rɪˈvjuː/ *noun* an examination of an organisation's finances

financial statement /faɪˌnænʃəl ˈsteɪtmənt/ *noun* a document which shows the financial situation of a company at the end of an accounting period and the transactions which have taken place during that period. It includes the balance sheet, the profit and loss account, etc.

find /faɪnd/ *verb* **1.** to get something which was not there before ○ *to find backing for a project* **2.** to make a legal decision in court ○ *The tribunal found that both parties were at fault.* ○ *The court found the accused guilty on all charges.* □ **the judge found for the defendant** the judge decided that the defendant was right

finder's fee /ˈfaɪndəz fiː/ *noun* a fee paid to a person who finds a client for another

findings /ˈfaɪndɪŋz/ *noun* a decision reached by a court □ **the findings of a**

mainp - softvnn.com

Law.fm Page 124 Friday, June 11, 2004 2:08 PM

commission of enquiry the conclusions of the commission

fine /faɪn/ *noun* a sum of money ordered to be paid by a defendant as punishment on conviction for an offence ○ *The court sentenced him to pay a £25,000 fine.* ○ *We had to pay a £10 parking fine.* ○ *The sentence for dangerous driving is a £1,000 fine or two months in prison.* ■ *verb* to order a defendant who has been convicted of an offence to pay a sum of money as punishment. The court is must look into the financial circumstances of the offender before fixing the amount of the fine, and must ensure that it reflects the severity of the offence committed. ○ *to fine someone £2,500 for obtaining money by false pretences*

fingerprint /ˈfɪŋgəprɪnt/ *noun* a mark left on a surface by fingers, from which a person may be identified ○ *They found his fingerprints on the murder weapon.* ○ *The court heard evidence from a fingerprint expert.* □ **to take someone's fingerprints** to take a copy of a person's fingerprints (by printing them with ink on film or a filing card) so that he or she can be identified in future ■ *verb* to take someone's fingerprints ○ *The police fingerprinted the suspect after charging him.*

fingertip search /ˈfɪŋgətɪp ˌsɜːtʃ/ *noun* a very careful search of a crime scene and the surrounding area carried out by hand in the hope of finding evidence

fire /faɪə/ *noun* **1.** burning ○ *The shipment was damaged in the fire on board the cargo boat.* ○ *Half the stock was destroyed in the warehouse fire.* □ **to catch fire** to start to burn ○ *The papers in the waste paper basket caught fire.* **2.** the act of shooting □ **the police opened fire on the crowd** the police started to shoot at the crowd ■ *verb* **1.** to shoot a gun ○ *He fired two shots at the crowd.* **2.** □ **to fire someone** to dismiss someone from a job ○ *The new managing director fired half the sales force.*

firearm /ˈfaɪərɑːm/ *noun* a gun or other weapon used to shoot

firearms certificate /ˌfaɪəɑːmz sə ˈtɪfɪkət/ *noun* an official document saying that someone has permission to own a gun

fire certificate /ˈfaɪə səˌtɪfɪkət/ *noun* a document from the municipal fire department to say that a building is properly protected against fire

fire damage /ˈfaɪə ˌdæmɪdʒ/ *noun* damage to land caused by a fire

fire-damaged goods /ˌfaɪə ˌdæmɪdʒd ˈgʊdz/ *plural noun* goods which have been damaged in a fire

fire door /ˈfaɪə dɔː/ *noun* a special door to prevent fire going from one part of a building to another

fire hazard /ˈfaɪə ˌhæzəd/ *noun* a situation or materials which could start a fire ○ *That warehouse full of paper is a fire hazard.*

fire insurance /ˈfaɪər ɪnˌʃʊərəns/ *noun* insurance against damage by fire

fire-proof safe /ˌfaɪə pruːf ˈseɪf/ *noun* a safe which cannot be harmed by fire

fire-raiser /ˈfaɪə ˌreɪzə/ *noun* a person who sets fire to property

fire-raising /ˈfaɪə ˌreɪzɪŋ/ *noun* the act of setting fire to property on purpose. ◊ **arson, arsonist**

fire regulations /faɪə ˌregjʊ ˈleɪʃ(ə)nz/ *plural noun* local or national regulations which owners of buildings used by the public have to obey in order to be granted a fire certificate

fire safety /ˌfaɪə ˈseɪfti/ *noun* a set of safety measures and procedures in case of fire

fire safety officer /faɪə ˈseɪfti ˌɒfɪsə/ *noun* the person responsible for fire safety in a building

firing squad /ˈfaɪərɪŋ skwɒd/ *noun* a group of soldiers who execute someone by shooting

firm /fɜːm/ *noun* a partnership or any other business which is not a company ○ *a firm of accountants* ○ *an important publishing firm* ○ *He is a partner in a law firm.* (NOTE: Firm is often used when referring to incorporated companies, but this is not correct.) ■ *verb* to remain at a price and seem likely to go up ○ *The shares firmed at £1.50.*

mainp - softvnn.com

Law.fm Page 125 Friday, June 11, 2004 2:08 PM

firm price /ˌfɜːm ˈpraɪs/ *noun* a price which will not change

First Amendment /ˌfɜːst ə ˈmen(d)mənt/ *noun US* the first amendment to the Constitution of the USA, guaranteeing freedom of speech and religion

first degree murder /fɜːst dɪˌgriː ˈmɜːdə/ *noun US* the premeditated and deliberate killing of a person

first in first out /ˌfɜːst ɪn ˌfɜːst ˈaʊt/ *noun* **1.** a redundancy policy, where the people who have been working longest are the first to be made redundant **2.** an accounting policy where stock is valued at the price of the oldest purchases

first offence /ˌfɜːst əˈfens/ *noun* committing an offence for the first time, which makes it less likely to result in a prison sentence in the case of summary offences

first offender /ˌfɜːst əˈfendə/ *noun* somebody who has committed an offence for the first time

first option /ˌfɜːst ˈopʃən/ *noun* the right to be the first to have the possibility of deciding or having something

FISA *abbreviation* Foreign Intelligence Surveillance Act

FISA court *noun* a US court composed of a rotating panel of federal judges that reviews in secret prosecutors' requests to tap the phones of suspected spies and terrorists and to carry out searches

fiscal measures /ˌfɪskəl ˈmeʒəz/ *plural noun* tax changes made by a government to improve the working of the economy

fishing expedition /ˈfɪʃɪŋ ˌekspɪdɪʃ(ə)n/ *noun* the use of the pre-hearing disclosure of documents to try to find other documents belonging to the defendant which the claimant does not know about and which might help him with his claim (*informal*)

fit /fɪt/ *adjective* physically or mentally able to do something ○ *The solicitor stated that his client was not fit to plead.*

fitness for purpose /ˌfɪtnəs fə ˈpɜːpəs/ *noun* an implied contractual term that goods sold will be of the necessary standard to be used for the purpose for which they were bought

fittings /ˈfɪtɪŋz/ ♦ **fixtures and fittings**

fixed capital /ˌfɪkst ˈkæpɪt(ə)l/ *noun* capital in the form of buildings and machinery

fixed charge /ˌfɪkst ˈtʃɑːdʒ/ *noun* a charge over a particular asset or property

fixed costs /ˌfɪkst ˈkɒsts/ *plural noun* **1.** a set amount of money to which a claimant is entitled in legal proceedings **2.** the cost of producing a product, which does not increase with the amount of product made, e.g. rent

fixed deposit /ˌfɪkst dɪˈpɒzɪt/ *noun* a deposit which pays a stated interest over a set period

fixed expenses /ˌfɪkst ɪkˈspensɪz/ *plural noun* money which is spent regularly, e.g. rent, electricity, or telephone costs

fixed income /ˌfɪkst ˈɪnkʌm/ *noun* an income such as from an annuity which does not change in amount from year to year

fixed interest /ˌfɪkst ˈɪntrəst/ *noun* interest which is paid at a set rate

fixed-interest investments /fɪkst ˌɪntrəst ɪnˈvestmənts/ *plural noun* investments producing an interest which does not change

fixed-price agreement /fɪkst ˈpraɪs əˌgriːmənt/ *noun* an agreement where a company provides a service or a product at a price which stays the same for the whole period of the agreement

fixed rate /ˌfɪkst ˈreɪt/ *noun* a charge which cannot be changed

fixed scale of charges /ˌfɪkst skeɪl əv ˈtʃɑːdʒɪz/ *plural noun* rate of charging which cannot be altered

fixed term /ˌfɪkst ˈtɜːm/ *noun* a period which is fixed when a contract is signed and which cannot be changed afterwards

fixture /ˈfɪkstʃə/ *noun* an item such as a sink or lavatory which is permanently attached to a property and which passes to a new owner with the property itself

fixtures and fittings /ˌfɪkstʃəz ən ˈfɪtɪŋz/ *plural noun* objects in a property which are sold with the property, including both objects which are permanently fixed and those which can be removed

mainp - softvnn.com

Law.fm Page 126 Friday, June 11, 2004 2:08 PM

flag /flæg/ *verb* □ **to flag a ship** to give a ship the right to fly a flag, by registering it. ◊ **reflag** ◇ **to fly a flag 1.** to attach the flag in an obvious position to show that your ship belongs to a certain country ○ *ship flying the British flag* **2.** to act in a certain way to show that you are proud of belonging to a certain country or working for a certain company ○ *ship flying a flag of convenience* ○ *the Trade Minister has gone to the World Fair to fly the flag* ○ *he is only attending the conference to fly the flag for the company*

flag of convenience /ˌflæg əv kən ˈviːniəns/ *noun* the flag of a country which may have no ships of its own but allows ships of other countries to be registered in its ports

flagrant /ˈfleɪgrənt/ *adjective* clear and obvious ○ *A flagrant case of contempt of court.* ○ *A flagrant violation of human rights.*

flagrante ◊ **in flagrante delicto**

flat rate /ˌflæt ˈreɪt/ *noun* a charge which always stays the same ○ *We pay a flat rate for electricity each quarter.* ○ *He is paid a flat rate of £2 per thousand.*

flotsam and jetsam /ˌflɒtsəm ən ˈdʒetsəm/ *noun* rubbish floating in the water after a ship has been wrecked and rubbish washed on to the land

flout /flaʊt/ *verb* to break or act go against a rule or the law ○ *By selling alcohol to minors, the shop is deliberately flouting the law.*

FO *abbreviation* Foreign Office

f.o.b. *abbreviation* free on board

follow /ˈfɒləʊ/ *verb* to act in accordance with a rule ○ *The court has followed the precedent set in the 1972 case.*

follow-up letter /ˈfɒləʊ ʌp ˌletə/ *noun* a letter sent to someone after a previous letter or after a visit

foolscap /ˈfuːlskæp/ *noun* a large size of writing paper ○ *The letter was on six sheets of foolscap.* □ **a foolscap envelope** large envelope which takes foolscap paper

forbear /fɔːˈbeə/ *verb* □ **to forbear from doing something** not to do something which you intended to do ○ *He forbore from taking any further action.*

forbearance /fɔːˈbeərəns/ *noun* an act of not doing something, such as enforcing payment of a debt, which could have been done

force /fɔːs/ *noun* **1.** physical strength or violence **2.** influence or effect □ **to be in force** to be operating or working ○ *The rules have been in force since 1946.* □ **to come into force** to start to operate or work ○ *The new procedures will come into force on January 1st.* □ **the force of law**, **legal force** the power of being controlled by law ○ *The new regulations have the force of law.*

forced sale /ˌfɔːst ˈseɪl/ *noun* a sale which takes place because a court orders it or because it is the only way to avoid insolvency

force majeure /ˌfɔːs mæˈʒɜː/ *noun* something which happens which is out of the control of the parties who have signed a contract, such as a war or a storm, and which prevents the contract being fulfilled. ◊ **act of God**

forcible /ˈfɔːsɪb(ə)l/ *adjective* using force

forcible entry /ˌfɔːsɪb(ə)l ˈentri/ *noun* formerly, the criminal offence of entering a building or land and taking possession of it by force

forcible feeding /ˌfɔːsɪb(ə)l ˈfiːdɪŋ/ *noun* the act of giving food by force to a prisoner on hunger strike

foreclose /fɔːˈkləʊz/ *verb* to take possession of a property because the owner cannot repay money which he or she has borrowed using the property as security ○ *to foreclose on a mortgaged property*

foreclosure /fɔːˈkləʊʒə/ *noun* the act of foreclosing

foreclosure order absolute /fɔːˌkləʊʒə ˌɔːdə ˈæbsəluːt/ *noun* a court order giving the mortgagee full rights to the property

foreclosure order nisi /fɔːˌkləʊʒə ˌɔːdə ˈnaɪsaɪ/ *noun* a court order which makes a mortgagor pay outstanding debts to a mortgagee within a specified period of time

foreign /ˈfɒrɪn/ *adjective* not belonging to one's own country ○ *Foreign cars have flooded our market.* ○ *We are in-*

mainp - softvnn.com

Law.fm Page 127 Friday, June 11, 2004 2:08 PM

creasing our trade with foreign countries.

foreign currency /ˌfɒrɪn ˈkʌrənsi/ *noun* the currency of another country

foreign exchange broker /ˌfɒrɪn ɪksˈtʃeɪndʒ ˌbrəʊkə/ *noun* somebody who deals on the foreign exchange market

foreign exchange dealing /ˌfɒrɪn ɪksˈtʃeɪndʒ ˌdiːlɪŋ/ *noun* the activity of buying and selling foreign currencies

foreign exchange market /ˌfɒrɪn ɪksˈtʃeɪndʒ ˌmɑːkɪt/ *noun* dealings in foreign currencies

foreign exchange reserves /ˌfɒrɪn ɪksˈtʃeɪndʒ rɪˌzɜːvz/ *plural noun* foreign money held by a government to support its own currency and pay its debts

foreign exchange transfer /ˌfɒrɪn ɪksˈtʃeɪndʒ ˌtrænsfɜː/ *noun* the sending of money from one country to another

foreign goods /ˌfɒrɪn ˈgʊdz/ *plural noun* goods produced in other countries

foreign investments /ˌfɒrɪn ɪn ˈvestmənts/ *plural noun* money invested in other countries

foreign money order /ˌfɒrɪn ˈmʌni ˌɔːdə/ *noun* money order in a foreign currency which is payable to someone living in a foreign country

Foreign Office /ˈfɒrɪn ˌɒfɪs/, **Foreign and Commonwealth Office** /ˌfɒrɪn ən ˌkɒmənwelθ ˈɒfɪs/ *noun* the British government department dealing with relations with other countries

foreign policy /ˌfɒrɪn ˈpɒlɪsi/ *noun* a policy followed by a country when dealing with other countries

foreign rights /ˌfɒrɪn ˈraɪtz/ *plural noun* legal entitlement to sell something in a foreign country

Foreign Service /ˌfɒrɪn ˈsɜːvɪs/ *noun* a government department responsible for a country's representation in other countries

foreign trade /ˌfɒrɪn ˈtreɪd/ *noun* trade with other countries

foreman of the jury /ˌfɔːmən əv ðə ˈdʒʊəri/ *noun* a person elected by the other jurors, who chairs the meetings of a jury and pronounces the verdict in court afterwards

forensic /fəˈrensɪk/ *adjective* referring to courts, the law, pleading a case or punishing crime

forensic medicine /fəˌrensɪk ˈmed(ə)sɪn/ *noun* medical science concerned with solving crimes against people

forensic science /fəˌrensɪk ˈsaɪəns/ *noun* science used in solving legal problems and criminal cases

foresee /fɔːˈsiː/ *verb* to guess or assess correctly what is going to happen in the future (NOTE: **foreseeing – foresaw – has foreseen**)

foreseeability /fɔːˌsiːəˈbɪlɪti/ *noun* the ability of something to be foreseen

foreseeability test /fɔːˌsiːəˈbɪlɪti ˌtest/ *noun* a test for calculating liability on the part of a person who should have foreseen the consequences of his or her action, especially in cases of negligence

forfeit /ˈfɔːfɪt/ *noun* the removal of something as a punishment ▫ **the goods were declared forfeit** the court said that the goods had to be taken away from their owner ■ *verb* to have something taken away as a punishment ▫ **to forfeit a deposit** to lose a deposit because you have decided not to buy the item

forfeit clause /ˈfɔːfɪt klɔːz/ *noun* a clause in a contract which says that goods or a deposit will be forfeited if the contract is not obeyed

forfeiture /ˈfɔːfɪtʃə/ *noun* the act of forfeiting a property or a right

forfeiture of shares /ˌfɔːfɪtʃə əv ˈʃeəz/ *plural noun* losing the right to shares which a shareholder has not claimed

forfeiture rule /ˈfɔːfɪtʃə ruːl/ *noun* the unwritten rule that someone who has unlawfully killed another person should not benefit from the dead person's will

forge /fɔːdʒ/ *verb* to copy something such as a document or banknote illegally to use as if it were real ○ *He tried to enter the country with forged documents.* ○ *She wanted to pay the bill with a forged £10 note.*

forgery /ˈfɔːdʒəri/ *noun* **1.** the crime of making an illegal copy of something

mainp - softvnn.com

Law.fm Page 128 Friday, June 11, 2004 2:08 PM

such as a document or banknote to use as if it were real ○ *He was sent to prison for forgery.* **2.** an illegal copy ○ *The signature was proved to be a forgery.*

forgery and uttering /ˌfɔːdʒəri ən ˈʌtərɪŋ/ *noun* a notifiable offence of forging and then using an official document such as a prescription for drugs

fori ♦ **lex fori**

form /fɔːm/ *noun* an official printed paper with blank spaces which have to be filled in with information ○ *you have to fill in form A20* ○ *customs declaration form* ○ *a pad of order forms*

forma /ˈfɔːmə/ ♦ **pro forma**

formal /ˈfɔːm(ə)l/ *adjective* clearly and legally written ○ *to make a formal application* ○ *to send a formal order*

formality /fɔːˈmælɪti/ *noun* a formal procedure, thing which has to be done to obey the law or because it is the custom ○ *The chairman dispensed with the formality of reading the minutes.*

formally /ˈfɔːməli/ *adverb* in a formal way ○ *We have formally applied for planning permission for the new shopping precinct.*

form of words /ˌfɔːm əv ˈwɜːdz/ *plural noun* words correctly laid out for a legal document

forthwith /fɔːθˈwɪθ/ *adverb* immediately

fortiori ♦ **a fortiori**

forum /ˈfɔːrəm/ *noun* a place where matters are discussed or examined ○ *The magistrates' court is not the appropriate forum for this application.*

forward /ˈfɔːwəd/ *adverb* **1.** □ **to date an invoice forward** to put a later date than the present one on an invoice **2.** □ **to buy forward** to buy foreign currency, gold or commodities before you need them, in order to be certain of the exchange rate □ **to sell forward** to sell foreign currency, commodities, etc., for delivery at a later date **3.** □ **balance brought forward**, **carried forward** balance which is entered in an account at the end of a period or page and is then taken to be the starting point of the next period or page ■ *verb* □ **to forward something to someone** to send something to someone □ **please forward**, **to be forwarded** words written on an envelope, asking the person receiving it to send it on to the person whose name is written on it

foster /ˈfɒstə/ *verb* to look after and bring up a child who is not your own

foster child /ˈfɒstə tʃaɪld/ *noun* a child who is cared for by someone other than its natural or adopted parents

foster home /ˈfɒstə həʊm/ *noun* a home where a foster child is brought up

foster parent /ˌfɒstə ˈmʌðə/ *noun* a woman or man who looks after a child and brings it up

foul bill of lading /ˌfaʊl bɪl əv ˈleɪdɪŋ/ *noun* a bill of lading which says that the goods were in bad condition when received by the shipper

fourth quarter /ˌfɔːθ ˈkwɔːtə/ *noun* a period of three months from October to the end of the year ○ *The instalments are payable at the end of each quarter.* ○ *The first quarter's rent is payable in advance.*

frais ♦ **sans frais**

frame /freɪm/ *verb* to arrange for someone to appear to be guilty (*informal*) □ **he has been framed** he is innocent, but the situation has been arranged in such a way that he appears guilty

franchise /ˈfræntʃaɪz/ *noun* **1.** a right granted to someone to do something, especially the right to vote in local or general elections **2.** a licence to trade using a brand name and paying a royalty for it ○ *He has bought a printing franchise* or *a hot dog franchise.* ■ *verb* to sell licences for people to trade using a brand name and paying a royalty ○ *His sandwich bar was so successful that he decided to franchise it.*

franchisee /ˌfræntʃaɪˈziː/ *noun* somebody who runs a franchise

franchiser /ˈfræntʃaɪzə/ *noun* somebody who licenses a franchise

franchising /ˈfræntʃaɪzɪŋ/ *noun* the act of selling a licence to trade as a franchise ○ *He runs his sandwich chain as a franchising operation.*

franchisor /ˈfræntʃaɪzə/ *noun* same as **franchiser**

franco /ˈfræŋkəʊ/ *adverb* free

frank /fræŋk/ *verb* to stamp the date and postage on a letter

mainp - softvnn.com

Law.fm Page 129 Friday, June 11, 2004 2:08 PM

franking machine /ˈfræŋkɪŋ mə ˌʃiːn/ *noun* a machine which marks the date and postage on letters so that the person sending them does not need to use stamps

fraud /frɔːd/ *noun* **1.** harming someone (by obtaining property or money from him) after making him believe something which is not true ○ *He got possession of the property by fraud.* ○ *He was accused of frauds relating to foreign currency.* □ **to obtain money by fraud** to obtain money by saying or doing something to cheat someone **2.** the act of deceiving someone in order to make money ○ *She was convicted of a series of frauds against insurance companies.*

COMMENT: Frauds are divided into **fraud by a director** and other fraud.

Fraud Squad /ˈfrɔːd skwɒd/ *noun* a department of a police force which deals with cases of fraud

fraudster /ˈfrɔːdstə/ *noun* a criminal who obtains money or other advantage by deceiving someone

fraudulent /ˈfrɔːdjʊlənt/ *adjective* not honest, and aiming to deceive people

fraudulent conveyance /ˌfrɔːdjʊlənt kənˈveɪəns/ *noun* an act of putting a property into someone else's possession to avoid it being seized to pay creditors

fraudulently /ˈfrɔːdjʊləntli/ *adverb* not honestly ○ *goods imported fraudulently*

fraudulent misrepresentation /ˌfrɔːdjʊlənt mɪsˌreprɪzenˈteɪʃ(ə)n/ *noun* a false statement made to deceive someone, or persuade someone to enter into a contract

fraudulent preference /ˌfrɔːdjʊlənt ˈpref(ə)rəns/ *noun* payment made by an insolvent company to a particular creditor in preference to other creditors

fraudulent trading /ˌfrɔːdjʊlənt ˈtreɪdɪŋ/ *noun* the activity of carrying on the business of a company, knowing that the company is insolvent

fraudulent transaction /ˌfrɔːdjʊlənt trænˈzækʃən/ *noun* a transaction which aims to cheat someone

free /friː/ *adjective*, *adverb* **1.** not costing any money ○ *price list sent free on request* ○ *He was given a free ticket to the exhibition.* ○ *The price includes free delivery.* ○ *Goods are delivered free.* □ **free of charge** with no payment to be made **2.** not in prison □ **to set someone free** to let someone leave prison ○ *The crowd attacked the police station and set the three prisoners free.* **3.** with no restrictions □ **free of tax**, **tax-free** with no tax having to be paid □ **free of duty**, **duty-free** with no duty to be paid **4.** not occupied ○ *Are there any tables free in the restaurant?* ○ *The solicitor will be free in a few minutes.* ○ *The hearing was delayed because there was no courtroom free.* ■ *verb* to release someone from a responsibility or from prison ○ *Will the new law free owners from responsibility to their tenants?* ○ *The new president freed all political prisoners.*

free circulation of goods /friː ˌsɜːkjʊˈleɪʃ(ə)n əv gʊdz/ *plural noun* movement of goods from one country to another without import quotas or other restrictions

free collective bargaining /ˌfriː kə ˌlektɪv ˈbɑːgɪnɪŋ/ *noun* negotiations between employers and workers' representatives over wages and conditions

free competition /ˌfriː kɒmpə ˈtɪʃ(ə)n/ *noun* the situation of being free to compete without government interference

free currency /ˌfriː ˈkʌrənsi/ *noun* a currency which a government allows to be bought or sold without restriction

freedom /ˈfriːdəm/ *noun* **1.** not being held in custody ○ *The president gave the accused man his freedom.* **2.** the ability to do something without restriction

freedom of assembly /ˌfriːdəm əv əˈsemblɪ/ *noun* the right of being able to meet other people in a group without being afraid of prosecution, provided that you do not break the law

freedom of association /ˌfriːdəm əv əsəʊsiˈeɪʃ(ə)n/ *noun* the right of being able to join together in a group with other people without being afraid of prosecution, provided that you do not break the law

mainp - softvnn.com

Law.fm Page 130 Friday, June 11, 2004 2:08 PM

freedom of information /ˌfriːdəm əv ɪnfəˈmeɪʃ(ə)n/ *noun* allowing citizens access to information which is held by government departments and other bodies

freedom of movement /ˌfriːdəm əv ˈmuːvmənt/ *noun* (*in the EU*) the fundamental right of citizens within the EU to be able to move to other EU countries to seek work

COMMENT: Freedom of movement has been extended to three types of people who are not economically active: students, retired people and people with sufficient private income.

freedom of speech /ˌfriːdəm əv ˈspiːtʃ/ *noun* the right of being able to say what you want without being afraid of prosecution, provided that you do not break the law

freedom of the press /ˌfriːdəm əv ðə ˈpres/ *noun* the right of being able to write and publish what you wish in a newspaper, or on radio or TV, without being afraid of prosecution, provided that you do not break the law

freedom of thought, conscience and religion /ˌfriːdəm əv ˌθɔːt ˌkɒnʃəns ən rɪˈlɪdʒən/ *noun* a qualified right to belief or religion, subject to limitations which are imposed if it is considered to be interfering with the public interest. It is found in Article 9 of the European Convention of Human Rights and was introduced into UK law by the Human Rights Act 1998. (NOTE: By contrast, the freedom of thought is an absolute right and therefore cannot be restricted, even if it does interfere with the public interest.)

freehold /ˈfriːhəʊld/ *noun* the absolute right to hold land or property for an unlimited time without paying rent

freeholder /ˈfriːhəʊldə/ *noun* somebody who holds a freehold property

freehold property /ˈfriːhəʊld ˌprɒpəti/ *noun* property which the owner holds in freehold

free movement /ˌfriː ˈmuːvmənt/ *noun* a right for workers from any EU Member State to enter other Member States to work, and to remain as workers, with the same rights as the nationals of those Member States

free on board /ˌfriː ɒn ˈbɔːd/ *noun US* **1.** an international contract whereby the seller promises to deliver goods on board ship and notify the buyer of delivery, and the buyer arranges freight, pays the shipping cost and takes the risk once the goods have passed onto the ship **2.** a contract for sale whereby the price includes all the seller's costs until the goods are delivered to a certain place ▸ abbreviation **f.o.b.**

free pardon /ˌfriː ˈpɑːd(ə)n/ *noun* a pardon given to a convicted person where both the sentence and conviction are recorded as void

freeze /friːz/ *verb* to order a person not to move money or sell assets ○ *The court ordered the company's bank account to be frozen.*

freezing injunction /ˌfriːzɪŋ ɪn ˈdʒʌŋkʃən/ *noun* a court order to freeze the assets of a defendant or of a person who has gone overseas or of a company based overseas to prevent them being taken out of the country. The injunction can apply to assets within the jurisdiction of the court, or on a worldwide basis. (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has replaced **Mareva injunction**.)

freight charges /ˈfreɪt ˌtʃɑːdʒɪz/ *plural noun* money charged for carrying goods

fresh pursuit /ˌfreʃ pəˈsjuːt/ *noun* the act of chasing a thief, etc., to get back what has been stolen

friend /frend/ ◗ **litigation friend, next friend**

frisk /frɪsk/ *verb* to search someone by passing your hands over his or her clothes to see if that person is carrying a weapon or a package

frivolous complaint /ˌfrɪvələs kəm ˈpleɪnt/ *noun* a complaint or action which is not brought for a serious reason

frolic /ˈfrɒlɪk/ *noun* □ **frolic of his own** a situation where an employee does damage outside the normal course of employment, for which his or her employer cannot be held responsible

front /frʌnt/ *noun* an organisation or company which serves to hide criminal

mainp - softvnn.com

Law.fm Page 131 Friday, June 11, 2004 2:08 PM

activity ○ *His ice-cream shop was just a front for an extortion racket.*

front benches /ˌfrʌnt 'bentʃɪz/ *noun* two rows of seats in the House of Commons, facing each other with the table between them, where Government ministers or members of the Opposition Shadow Cabinet sit □ **the Government front bench**, **the Treasury bench** the seats where the members of the Government sit ◇ **the front benches 1.** the seat for the Opposition Shadow Cabinet **2.** the Shadow Cabinet

front organisation /'frʌnt ˌɔːgənaɪzeɪʃ(ə)n/ *noun* an organisation which appears to be neutral, but is in fact an active supporter of a political party or is actively engaged in illegal trade

frozen /'frəʊz(ə)n/ ♦ **freeze**

frozen assets /ˌfrəʊz(ə)n 'æsets/ *plural noun* assets of a company which cannot be sold because someone has a claim against them

frustrate /frʌ'streɪt/ *verb* to prevent something, especially the terms of a contract, being fulfilled

frustration /frʌ'streɪʃ(ə)n/ *noun* a situation where the terms of a contract cannot possibly be fulfilled, e.g. when the contract requires the use of something which is destroyed

fugitive /'fjuːdʒɪtɪv/ *noun* a person who has done something illegal and is trying to avoid being found by the police

fugitive offender /ˌfjuːdʒɪtɪv ə 'fendə/ *noun* somebody running away from the police who, if he or she is caught, is sent back to the place where the offence was committed

fulfil /fʊl'fɪl/ *verb* to do everything which is promised in a contract ○ *The company has fulfilled all the terms of the agreement.* (NOTE: The US spelling is **fulfill**.)

full costs /ˌfʊl 'kɒsts/ *plural noun* all the costs of manufacturing a product, including both fixed and variable costs

full cover /ˌfʊl 'kʌvə/ *noun* insurance against all types of risk

full payment /ˌfʊl 'peɪmənt/ *noun* payment for all money owed

full rate /ˌfʊl 'reɪt/ *noun* full charge, with no reductions

full repairing lease /ˌfʊl rɪ'peərɪŋ ˌliːs/ *noun* a lease where the tenant has to pay for all repairs to the property

full title /ˌfʊl 'taɪt(ə)l/ *noun* the complete title of an Act of Parliament

full trial /ˌfʊl 'traɪəl/ *noun* a properly organised trial according to the correct procedure

functus officio /ˌfʌnktəs ɒ'fɪʃiəʊ/ *phrase* a Latin phrase meaning 'no longer having power or jurisdiction' because the power has been exercised ○ *The justices' clerk asserted that the justices were functi officio.* (NOTE: The plural is **functi officio**.)

fund /fʌnd/ *noun* □ **to convert funds to one's own use** to use someone else's money for yourself

fundamental breach /ˌfʌndə 'ment(ə)l briːtʃ/ *noun* a breach of an essential or basic term of a contract by one party, entitling the other party to treat the contract as terminated

funds /fʌndz/ *plural noun* money available for a purpose

fungible goods /'fʌndʒəb(ə)l gʊdz/, **fungibles** *plural noun* goods such as seeds or coins which are measured by weight or counted

furandi ♦ **animus furandi**

furnished lettings /ˌfɜːnɪʃt 'letɪŋs/ *noun* furnished property to let

furniture department /ˌfɜːnɪtʃə dɪ 'pɑːtmənt/ *noun* a department in a large store which sells furniture

furniture depository /'fɜːnɪtʃə dɪ ˌpɒzɪt(ə)ri/ *noun* a warehouse where you can store household furniture

further information /ˌfɜːðə ˌɪnfə 'meɪʃ(ə)n/ *noun* a request made by a party through the court for another party to provide more details which will help clarify the case. The second party may refuse to respond for various reasons. (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has replaced **interrogatories**.)

future delivery /ˌfjuːtʃə dɪ'lɪv(ə)ri/ *noun* delivery at a later date

mainp - softvnn.com

Law.fm Page 132 Friday, June 11, 2004 2:08 PM

future estate /ˌfjuːtʃə ɪˈsteɪt/ *noun* an old term for the possession and enjoyment of an estate at some time in the future

future interest /ˌfjuːtʃə ˈɪntrəst/ *noun* an interest in property which will be enjoyed in the future

fuzz /fʌz/ *noun* the police (*slang*)

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G

gag /gæg/ *verb* to try to stop someone talking or writing ○ *The government was accused of using the Official Secrets Act as a means of gagging the press.*

gain /geɪn/ *verb* to get, to obtain ○ *He gained some useful experience working in a bank.* □ **to gain control of a business** to buy more than 50% of the shares so that you can direct the business □ **to gain control of a council** to win a majority of the seats

gainful employment /ˌgeɪnf(ə)l ɪm ˈplɔɪmənt/ *noun* employment for which someone is paid

gainfully employed /ˈgeɪnf(ə)li/ *adjective* having regular paid work

gallery /ˈgæləri/ *noun* the seats above and around the benches in the House of Commons and House of Lords, where the public and journalists sit □ **the Speaker ordered the galleries to be cleared** the Speaker asked for all visitors to leave the Chamber

gallows /ˈgæləʊz/ *plural noun* wooden support from which criminals are executed by hanging

game licence /ˌgeɪm ˈlaɪs(ə)ns/ *noun* an official permit which allows someone to sell game

game of chance /ˌgeɪm əv ˈtʃɑːns/ *noun* a game such as roulette where the result depends on luck

gaming licence /ˈgeɪmɪŋ ˌlaɪs(ə)ns/ *noun* an official permit which allows someone or a club to organise games of chance

gang /gæŋ/ *noun* a group of criminals working together ○ *a drugs gang* ○ *a gang of jewel thieves*

gangland /ˈgæŋlænd/ *noun* all gangs considered as a group □ **a gangland murder** murder of a gangster by another gangster

gangster /ˈgæŋstə/ *noun* somebody who is a member of a gang of criminals ○ *The police shot three gangsters in the bank raid.*

gaol /dʒeɪl/ *noun* a prison. ◊ **jail** ■ *verb* to put someone in prison

gaoler /ˈdʒeɪlə/ *noun* somebody who works in a prison or who is in charge of a prison. ◊ **jailer**

garden leave clause /ˈgɑːdən liːv ˌklɔːz/ *noun* in employment contracts, a clause which prevents an employee attending the workplace during the course of the notice period, which can be anything up to a year, during which time they remain as an employee of the company and therefore continue to receive a salary (NOTE: Such a clause is used to safeguard the trade secrets of a business and minimise the effects of a highly skilled worker from leaving their current employment to join a rival company.)

garnish /ˈgɑːnɪʃ/ *verb* to tell a debtor to pay his or her debts, not to the creditor, but to a creditor of the creditor who has a judgment

garnishee /ˌgɑːnɪˈʃiː/ *noun* a person who owes money to a creditor and is ordered by a court to pay that money to a creditor of the creditor, and not to the original creditor

garnishee order /ˌgɑːnɪˈʃiː ˌɔːdə/ *noun* a court order, making a garnishee pay money to a creditor who has a judgment

garnishee proceedings /ˌgɑːnɪˈʃiː prəˌsiːdɪŋz/ *noun* a court proceedings against a debtor leading to a garnishee order

mainp - softvnn.com

Law.fm Page 134 Friday, June 11, 2004 2:08 PM

gas chamber /ˈgæs ˌtʃeɪmbə/ *noun* a room in which a convicted prisoner is executed by poisonous gas

COMMENT: Used in some states in the USA.

gavel /ˈgæv(ə)l/ *noun* a small wooden hammer used by a chairman of a meeting to call the meeting to order ○ *The chairman banged his gavel on the table and shouted to the councillors to be quiet.*

COMMENT: There is no mace in the American Senate. Instead, a ceremonial gavel is placed on the Vice-President's desk when the Senate is in session.

gazump /gəˈzʌmp/ *verb* □ **he was gazumped** his agreement to buy the house was cancelled because someone offered more money before exchange of contracts

gazumping /gəˈzʌmpɪŋ/ *noun* **1.** (*of a buyer*) the act of offering more money for a house than another buyer has done, so as to be sure of buying it **2.** the act of removing a house from a sale which has been agreed, so as to accept a higher offer

GBH *abbreviation* grievous bodily harm

general amnesty /ˌdʒen(ə)rəl ˈæmnəsti/ *noun* a pardon granted to all prisoners

general damages /ˌdʒen(ə)rəl ˈdæmɪdʒɪz/ *plural noun* damages awarded by court to compensate for a loss which cannot be calculated, e.g. an injury

general lien /ˌdʒen(ə)rəl ˈliːən/ *noun* the holding of goods or property until a debt has been paid

general office /ˈdʒen(ə)rəl ˌɒfɪs/ *noun* the main administrative office of a company

Geneva Convention, Geneva Conventions *noun* international treaties signed in Geneva, governing behaviour of countries at war ○ *The attacking army was accused of violating the Geneva Convention.*

Geneva Conventions for the Protection of Victims of War (1949) *noun* an international treaty relating to the treatment of civilians and other non-combatants

Geneva Conventions on Negotiable Instruments (1930) *noun* an international treaty relating to international bills of exchange, cheques, letters of credit, etc.

gentleman's agreement /ˈdʒent(ə)lmənz əˌgriːmənt/**, gentlemen's agreement** *US noun* a verbal agreement between two parties who trust each other (NOTE: A gentleman's agreement is not usually enforceable by law.)

genuine /ˈdʒenjuɪn/ *adjective* true or real ○ *a genuine Picasso* ○ *a genuine leather purse* □ **the genuine article** real article, not an imitation

genuine dispute /ˌdʒenjuɪn dɪ ˈspjuːt/ *noun* a real conflict between parties ○ *The ECJ refused to hear the reference because it considered there was no genuine dispute between the parties.*

genuineness /ˈdʒenjʊɪnnəs/ *noun* the fact of not being an imitation

genuine purchaser /ˌdʒenjuɪn ˈpɜːtʃɪsə/ *noun* someone who is really interested in buying

geographic profiling /dʒiːəˌgræfɪk ˈprəʊfaɪlɪŋ/ *noun* the science of predicting where a criminal lives, based on where and when the crimes were committed, based on the principle that most crimes are carried out relatively locally

geoprofiling /ˈdʒiːəʊˌprəʊfaɪlɪŋ/ *noun* same as **geographic profiling**

germane /dʒɜːˈmeɪn/ *adjective* referring to, or relevant to ○ *The argument is not germane to the motion.*

get /get/**, gett** *noun* a divorce according to Jewish religious custom, where the husband agrees to a divorce which his wife has requested

gift /gɪft/ *verb* to give

COMMENT: A gift is irrevocable.

gift inter vivos /ˌgɪft ɪntə ˈviːvəʊs/ *noun* a present given by a living person to another living person

Gillette defence /dʒɪˈlet dɪˌfens/ *noun* a defence against a claim for infringement of patent, by which the defendant claims that they were using the process before it was patented

COMMENT: Called after the case of *Gillette v. Anglo American Trading.*

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Law.fm Page 135 Friday, June 11, 2004 2:08 PM

gloss /glɒs/ *noun* **1.** a note which explains or gives a meaning to a word or phrase **2.** an interpretation given to a word or phrase ■ *verb* □ **to gloss over** to cover up a mistake or fault ○ *The report glosses over the errors made by the officials in the department.*

godfather /'gɒdfɑːðə/ *noun* a Mafia boss (*slang*)

going equipped for stealing /ˌgəʊɪŋ ɪˌkwɪpd fə 'stiːlɪŋ/ *noun* the notifiable offence of carrying tools which could be used for burglary

golden rule /ˌgəʊld(ə)n 'ruːl/ *noun* a rule that when interpreting a statute, the court should interpret the wording of the statute to give the closest effect to the one Parliament intended when passing the law

good behaviour /ˌgʊd bɪ'heɪvjə/ *noun* a way of behaving this is peaceful and lawful ○ *The magistrates bound him over to be of good behaviour.* ○ *She was sentenced to four years in prison, but was released early for good behaviour.*

good cause /ˌgʊd 'kɔːz/ *noun* a reason which is accepted in law ○ *The court asked the accused to show good cause why he should not be sent to prison.* (NOTE: not used with **'the'**)

good consideration /gʊd kənˌsɪdə 'reɪʃ(ə)n/ *noun* proper consideration

good faith /ˌgʊd 'feɪθ/ *noun* general honesty □ **in good faith** in an honest way □ **he acted in good faith** he acted honestly □ **to buy something in good faith** to buy something honestly, in the course of an honest transaction ○ *He bought the car in good faith, not knowing that it had been stolen.*

goods /gʊdz/ *plural noun* items which can be moved and are for sale □ **goods (held) in bond** goods held by the customs until duty has been paid

goods and chattels /ˌgʊdz ən 'tʃæt(ə)lz/ *plural noun* movable property

goods train /'gʊdz treɪn/ *noun* a train for carrying freight

good title /ˌgʊd 'taɪt(ə)l/ *noun* a title to a property which gives the owner full rights of ownership

goodwill /gʊd'wɪl/ *noun* the good reputation of a business and its contacts with its customers, e.g. the name of the product which it sells or its popular appeal to customers ○ *She paid £10,000 for the goodwill of the shop and £4,000 for the stock.*

COMMENT: Goodwill can include the trading reputation, the patents, the trade names used, the value of a 'good site', etc., and is very difficult to establish accurately. It is an intangible asset, and so is not shown as an asset in a company's accounts, unless it figures as part of the purchase price paid when acquiring another company.

go to law /ˌgəʊ tə 'lɔː/ *verb* to start legal proceedings about something ○ *We went to law to try to regain our property.*

government contractor /ˌgʌv(ə)nmənt kən'træktə/ *noun* a company which supplies goods or services to the government on contract (NOTE: **government** can take a singular or plural verb: *The government have decided to repeal the Act*; *The government feels it is not time to make a statement.* Note also that the word **government** is used, especially by officials, without the article 'the': *Government has decided that the plan will be turned down*; *The plan is funded by central government.*)

government-controlled /ˌgʌv(ə)nmənt kən'trəʊld/ *noun* ruled by a government

government economic indicators /ˌgʌv(ə)nmənt ˌiːkənɒmɪk 'ɪndɪkeɪtəz/ *plural noun* figures which show how the country's economy is going to perform in the short or long term

government-regulated price /ˌgʌv(ə)nmənt ˌregjʊleɪtɪd 'praɪs/ *noun* a price which is imposed by the government

government stocks /'gʌv(ə)nmənt stɒkz/ *plural noun* government securities

gown /gaʊn/ *noun* a long black item of clothing worn by a lawyer, judge, etc., over normal clothes when appearing in court. ◊ **silk**

grace /greɪs/ *noun* a favour shown by granting a delay □ **to give a debtor a pe-**

mainp - softvnn.com

Law.fm Page 136 Friday, June 11, 2004 2:08 PM

riod of grace, **two weeks' grace** to allow a debtor two weeks to pay

graduated pension scheme /ˌgrædʒueɪtɪd 'penʃən skiːm/ *noun* a pension scheme where the benefit is calculated as a percentage of the salary of each person in the scheme

graft /grɑːft/ *noun* the corruption of officials (*informal*)

grand jury /ˌgrænd 'dʒʊri/ *noun US* a group of 12–24 jurors who meet before a trial to decide if an indictment should be issued to start criminal proceedings

grand larceny /ˌgrænd 'lɑːs(ə)ni/ *noun US* the theft of goods valued at more than a specified price

grant /grɑːnt/ *noun* **1.** the act of giving something to someone permanently or temporarily by a written document, where the object itself cannot be physically transferred ○ *The government made a grant of land to settlers.* **2.** money given by the government, local authority or other organisation to help pay for something ○ *The institute has a government grant to cover the cost of the development programme.* ○ *The local authority has allocated grants towards the costs of the scheme.* ○ *Many charities give grants for educational projects.* ■ *verb* to agree to give someone something or allow someone to do something ○ *to grant someone permission to build a house* or *to leave the country* ○ *The local authority granted the company an interest-free loan to start up the new factory.* ○ *He was granted parole.* ○ *The government granted an amnesty to all political prisoners.*

grant-aided scheme /ˌgrɑːnt 'eɪdɪd skiːm/ *noun* a scheme which is backed by funds from the government

grantee /grɑːn'tiː/ *noun* somebody who is assigned an interest in a property or who receives a grant

grant-in-aid /ˌgrɑːnt ɪn 'eɪd/ *noun* money given by central government to local government to help pay for a project

grant of letters of administration /ˌgrɑːnt əv ˌletəz əv ədˌmɪnɪ 'streɪʃ(ə)n/ *noun* the giving of documents to administrators to enable them to administer the estate of a dead person who has not made a will

grant of probate /ˌgrɑːnt əv 'prəʊbeɪt/ *noun* an official document proving that a will is genuine, given to the executors so that they can act on the terms of the will

grantor /grɑːn'tɔː/ *noun* a person who assigns an interest in a property, especially to a lender, or who makes a grant

grass /grɑːs/ *noun* a criminal who gives information to the police about other criminals. ◊ **supergrass** ■ *verb* □ **to grass on someone** to give information to the police about someone

grass roots /ˌgrɑːs 'ruːts/ *noun* the ordinary members of society or of a political party ○ *What is the grass-roots reaction to the constitutional changes?* ○ *The party has considerable support at grass-roots level.* ○ *The Chairman has no grass-root support.*

grata ◊ **persona non grata**

gratia ◊ **ex gratia**

gratis /'grɑːtɪs/ *adverb* not costing anything, or without paying anything ○ *We got into the exhibition gratis.*

gratuitous /grə'tjuːɪtəs/ *adjective* **1.** without justifiable cause ○ *scenes containing gratuitous sex and violence* **2.** without money being offered

gratuitous promise /grəˌtjuːɪtəs 'prɒmɪs/ *noun* a promise that cannot be enforced because no money has been involved

Gray's Inn /ˌgreɪz 'ɪn/ *noun* one of the four Inns of Court in London

Great Seal /ˌgreɪt 'siːl/ *noun* a seal kept by the Lord Chancellor, used for sealing important public documents on behalf of the Queen

Green Book /ˌgriːn 'bʊk/ *noun* the book of procedural rules of the County Courts

green card /ˌgriːn 'kɑːd/ *noun* a registration card for a non-US citizen going to live permanently in the USA

green form /'griːn fɔːm/ *noun* formerly, the form upon which an application for both legal advice and financial assistance (legal aid) could be made □ **the green form scheme** a scheme where a solicitor will give advice to someone

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Law.fm Page 137 Friday, June 11, 2004 2:08 PM

free of charge or at a reduced rate, if the client has filled in the green form

Green Paper /ˌgriːn ˈpeɪpə/ *noun* a report from the British government on proposals for a new law to be discussed in Parliament

grievance /ˈgriːv(ə)ns/ *noun* a complaint made by an employee to the employers

grievous bodily harm /ˌgriːvəs ˌbɒdɪli ˈhɑːm/ *noun* the crime of causing serious physical injury to someone. Abbreviation **GBH**

gross /grəʊs/ *adjective* **1.** (*of a sum of money*) without deductions **2.** serious

gross earnings /ˌgrəʊs ˈɜːnɪŋz/ *noun* total earnings before tax and other deductions

gross indecency /ˌgrəʊs ɪn ˈdiːs(ə)nsi/ *noun* a crime entailing unlawful sexual contact between men or with a child, which falls short of full sexual intercourse

gross negligence /ˌgrəʊs ˈneglɪdʒəns/ *noun* the act showing very serious neglect of duty towards other people

gross receipts /ˌgrəʊs rɪˈsiːts/ *plural noun* total amount of money received before expenses are deducted

gross weight /ˌgrəʊs ˈweɪt/ *noun* the weight of both the container and its contents

ground landlord /ˈgraʊnd ˌlændlɔːd/ *noun* a person or company which owns the freehold of a property which is then leased and subleased

ground lease /ˈgraʊnd liːs/ *noun* the first lease on a freehold building

ground rent /ˈgraʊnd rent/ *noun* rent paid by a lessee to the ground landlord

grounds /graʊndz/ *plural noun* basic reasons ○ *Does he have good grounds for complaint?* ○ *There are no grounds on which we can be sued.* ○ *What are the grounds for the claim for damages?* (NOTE: can be used in the singular if only one reason exists: *The judge refused the application on the ground that he had discretion to remove the hearsay evidence from the report.*)

guarantee /ˌgærənˈtiː/ *noun* **1.** a legal document which promises that an item purchased is of good quality and will work properly ○ *certificate of guarantee* or *guarantee certificate* ○ *The guarantee lasts for two years.* ○ *The dishwasher is sold with a two-year guarantee.* □ **the car is still under guarantee** the car is still covered by the maker's certificate of guarantee **2.** a promise made by someone that they will do something such as pay another person's debts if the other person fails to do it. Compare **indemnity** (NOTE: In English law, a guarantee must usually be in writing; the person making a guarantee is secondarily liable if the person who is primarily liable defaults.) **3.** something given as a security ○ *to leave share certificates as a guarantee* ■ *verb* to give a promise that something will happen □ **to guarantee a debt** to promise that you will pay a debt incurred by someone else if that person fails to pay it □ **to guarantee an associated company** to promise that an associate company will pay its debts □ **to guarantee a bill of exchange** to promise to pay a bill □ **the product is guaranteed for twelve months** the maker states that the product will work well for twelve months, and promises to mend it free of charge if it breaks down within that period

guarantor /ˌgærənˈtɔː/ *noun* somebody who gives a guarantee □ **to stand guarantor for someone** to promise to pay someone's debts

guaranty /ˈgær(ə)ntiː/ *noun US* same as **guarantee**

guard /gɑːd/ *noun* **1.** somebody whose job is to protect people or property ○ *There were three guards on duty at the door of the bank* or *three bank guards were on duty.* ○ *The prisoner was shot by the guards as he tried to escape.* **2.** the state of being protected by a guard ○ *The prisoners were brought into the courtroom under armed guard.* ■ *verb* to prevent someone being harmed or from escaping ○ *The building is guarded by a fence and ten guard dogs.* ○ *The prisoners are guarded night and day.*

guardian /ˈgɑːdiən/ *noun* an adult person or an authority such as the High Court appointed by law to act on behalf

mainp - softvnn.com

Law.fm Page 138 Friday, June 11, 2004 2:08 PM

of someone such as a child who cannot act on his or her own behalf

guardian ad litem /ˌgɑːdiən æd ˈliːtəm/ *noun* somebody who acts on behalf of a minor who is a defendant in a court case

guardianship /ˈgɑːdiənʃɪp/ *noun* the state of being a guardian

guardianship order /ˈgɑːdiənʃɪp ˌɔːdə/ *noun* a court order appointing a local authority to be the guardian of a child

guerilla /gəˈrɪlə/ *noun* an armed person who is not a regular soldier who engages in unofficial war ○ *The train was attacked by guerillas.* ○ *The appeal was made by a guerilla radio station.*

guidelines /ˈgaɪdlaɪnz/ *plural noun* unofficial suggestions from the government or some other body as to how something should be done ○ *The government has issued guidelines on increases in wages and prices.* ○ *The Law Society has issued guidelines to its members on dealing with rape cases.* ○ *The Secretary of State can issue guidelines for expenditure.* ○ *The Lord Justice said he was not laying down guidelines for sentencing.*

guillotine /ˈgɪlətiːn/ *noun* a machine used in France for executing criminals by cutting off their heads ■ *verb* to execute someone by cutting his or her head off with a guillotine

guilt /gɪlt/ *noun* being guilty, the state of having committed a crime or done some other legal wrong □ **he admitted his guilt** he admitted that he had committed the crime

guilt by association /ˌgɪlt baɪ əˌsəʊsiˈeɪʃ(ə)n/ *noun* the presumption that a person is guilty because of his or her connection with a guilty person

guilty /ˈgɪlti/ *adjective* **1.** finding after a trial that a person has done something which is against the law ○ *He was found guilty of libel.* ○ *The company was guilty of evading the VAT regulations.* □ **to find someone guilty, to return a verdict of guilty, to return a guilty verdict** (*of a judge or jury*) to say at the end of the trial that the accused is guilty **2.** □ **to plead guilty** (*of an accused person*) to say at the beginning of a trial that you did commit the crime of which you are accused □ **to plead not guilty** to say at the beginning of a trial that you did not commit the crime of which you are accused ○ *The accused pleaded not guilty to the charge of murder, but pleaded guilty to the lesser charge of manslaughter.*

gun /gʌn/ *noun* a weapon used for shooting ○ *The police are not allowed to carry guns.* ○ *They shouted to the robbers to drop their guns.*

gun court /ˈgʌn kɔːt/ *noun* a court that hears only those cases that deal with gun-related crimes

gun down /ˌgʌn ˈdaʊn/ *verb* to kill someone with a gun ○ *He was gunned down in the street outside his office.* (NOTE: **gunned – gunning**)

gunman /ˈgʌnmən/ *noun* a man who carries and uses a gun ○ *The security van was held up by three gunmen.*

gunpoint /ˈgʌnpɔɪnt/ *noun* □ **at gunpoint** with a gun pointing at you ○ *He was forced at gunpoint to open the safe.*

gunshot /ˈgʌnʃɒt/ *noun* the result of shooting with a gun ○ *He died of gunshot wounds.*

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H

habeas corpus /ˌheɪbiəs ˈkɔːpəs/ *phrase* a Latin phrase meaning 'may you have the body': legal remedy against being wrongly imprisoned

habendum /hæˈbendəm/ *noun* a section of a conveyance which gives details of how the property is to be assigned to the purchaser, using the words 'to hold'

habitual /həˈbɪtʃuəl/ *adjective* (*of a person*) doing something frequently □ **habitual criminal**, **habitual offender** person who has been convicted of a similar crime at least twice before □ **habitual drunkard** somebody who drinks alcohol so frequently that he or she is almost always dangerous or incapable

habitual residence /həˌbɪtʃuəl ˈrezɪd(ə)ns/ *noun* **1.** the fact of living normally in a place **2.** the place where someone normally lives

Hague conventions /ˈheɪg kən ˌvenʃ(ə)nz/ *plural noun* international agreements regarding the definition of war, and the barring of the use of chemical and biological weapons. ◊ **Geneva Convention**

hallmark /ˈhɔːlmɑːk/ *noun* a mark put on gold or silver items to show that the metal is of the correct quality ■ *verb* to put a hallmark on a piece of gold or silver ○ *a hallmarked spoon*

hand /hænd/ *noun* **1.** □ **by hand** using the hands, not a machine □ **to send a letter by hand** to ask someone to carry and deliver a letter personally, not sending it through the post **2.** □ **in hand**, **on hand** *US* kept in reserve **3.** □ **goods left on hand** goods which have not been sold and are left with the retailer or producer **4.** □ **out of hand** immediately, without taking time to think ○ *The justices dismissed his evidence out of hand.* **5.** □ **to hand** here, present □ **I have the invoice to hand** I have the invoice in front of me **6.** □ **to change hands** to be sold to a new owner ○ *The shop changed hands for £100,000.*

handcuff /ˈhændkʌf/ *verb* to put handcuffs on someone

handcuffed /ˈhændkʌfd/ *adjective* secured by handcuffs ○ *The accused appeared in court handcuffed to two policemen.*

handcuffs /ˈhændkʌfs/ *plural noun* two metal rings chained together which are locked round the wrists of someone who is being arrested

hand down /ˌhænd ˈdaʊn/ *verb* **1.** to pass property from one generation to another ○ *The house has been handed down from father to son since the 19th century.* **2.** □ **to hand down a verdict** to announce a verdict

handgun /ˈhændgʌn/ *noun* a small gun which is carried in the hand ○ *The police found six handguns when they searched the car.*

handling /ˈhændlɪŋ/ *noun* the management of a situation or the movement and transfer of goods □ **handling stolen goods** the notifiable offence of receiving or selling things which you know to have been stolen

COMMENT: Handling stolen goods is a more serious crime than theft, and the penalty can be higher.

hand over /ˌhænd ˈəʊvə/ *verb* to pass something to someone ○ *She handed over the documents to the lawyer.* □ **he handed over to his deputy** he passed his responsibilities to his deputy

hand up /ˌhænd ˈʌp/ *verb* to pass to someone who is in a higher place ○ *The exhibit was handed up to the judge.*

mainp - softvnn.com

Law.fm Page 140 Friday, June 11, 2004 2:08 PM

handwriting /'hændraɪtɪŋ/ *noun* **1.** writing produced with a pen or pencil and not with a machine □ **send a letter of application in your own handwriting** written by you with a pen, and not typed **2.** a particular way of committing a crime which identifies a criminal (*slang*)

handwriting expert /ˌhændraɪtɪŋ 'ekspɜːt/ *noun* somebody who is able to identify somebody by examining his or her handwriting

hang /hæŋ/ *verb* to execute someone by hanging him or her by a rope round the neck. ◊ **hung** (NOTE: **hanging – hanged**. Note: not **hung**.)

hanging /'hæŋɪŋ/ *noun* the act of executing someone by hanging ○ *The hangings took place in front of the prison.*

hangman /'hæŋmən/ *noun* a man who executes criminals by hanging them

harass /'hærəs, hə'ræs/ *verb* to worry or to bother someone, especially by continually checking up on them

harassment /'hærəsmənt, hə 'ræsmənt/ *noun* the action of harassing someone ○ *He complained of police harassment* or *of harassment by the police.*

harassment restraining order /ˌhærəsmənt rɪ'streɪnɪŋ ˌɔːdə/ *noun* same as **restraining order**

harbour /'hɑːbə/ *verb* to give shelter and protection to a criminal

hard /hɑːd/ *adjective* □ **to drive a hard bargain** to be a difficult negotiator □ **to strike a hard bargain** to agree a deal where the terms are favourable to you

hard bargain /ˌhɑːd 'bɑːgɪn/ *noun* a bargain with difficult terms

hard cash /ˌhɑːd 'kæʃ/ *noun* money in notes and coins which is ready at hand ○ *He paid out £100 in hard cash for the chair.*

hardened criminal /ˌhɑːdənd 'krɪmɪn(ə)l/ *noun* a criminal who has committed many crimes and who will never go straight

hard labour /ˌhɑːd 'leɪbə/ *noun* formerly, the punishment of sending someone to prison to do hard manual labour

harmonise /'hɑːmənaɪz/**, harmonize** *verb* (*in the EU*) to try to make things such as tax rates or VAT rates the same in all Member States

hawkish /'hɔːkɪʃ/ *adjective* acting like a hawk ○ *The agreement will not satisfy the more hawkish members of the Cabinet.*

hazard /'hæzəd/ *noun* a danger

H-block /'eɪtʃ blɒk/ *noun* a building in a prison built with a central section and two end wings, forming the shape of the letter H

headed paper /ˌhedɪd 'peɪpə/ *noun* a notepaper with the name and address of the company printed on it

head lease /'hed liːs/ *noun* the first lease given by a freeholder to a tenant

head licence /'hed ˌlaɪs(ə)ns/ *noun* the first licence given by the owner of a patent or copyright to someone who will use it

headnote /'hednəʊt/ *noun* a note at the beginning of a law report, giving a summary of the case

head of damage /ˌhed əv 'dæmɪdʒ/ *noun* an item of damage in a pleading or claim

head of department /ˌhed əv dɪ 'pɑːtmənt/ *noun* the person in charge of a department

head of government /ˌhed əv 'gʌv(ə)nmənt/ *noun* the leader of a country's government

headquarters /hed'kwɔːtəz/ *plural noun* main office

heads of agreement /ˌhedz əv ə 'griːmənt/ *noun* a draft agreement containing the most important points but not all the details

Health and Safety at Work Act /ˌhelθ ən ˌseɪfti ət 'wɜːk ˌækt/ *noun* an Act of Parliament which regulates what employers must do to make sure that their employees are kept healthy and safe at work

hear /hɪə/ *verb* **1.** to sense a sound with the ears ○ *You can hear the printer in the next office.* ○ *The traffic makes so much noise that I cannot hear my phone ringing.* **2.** to have a letter or a phone call from someone ○ *We have not heard from them for some time.* ○ *We hope to hear from the lawyers within a few days.* **3.** to listen to the arguments in a court case ○ *The judge heard the case in chambers.* ○ *The case will be heard next month.* ○ *The*

mainp - softvnn.com

Law.fm Page 141 Friday, June 11, 2004 2:08 PM

court has heard the evidence for the defence. **4.** □ **hear! hear!** words used in a meeting to show that you agree with the person speaking

hearing /'hɪərɪŋ/ *noun* **1.** a case which is being heard by a committee, tribunal or court of law ○ *The hearing about the planning application lasted ten days.* □ **hearing in private** court case which is heard with no member of the public present **2.** the process of a case being considered by an official body ○ *He asked to be given a hearing by the full council so that he could state his case.*

hearsay evidence /ˌhɪəseɪ 'evɪd(ə)ns/ *noun* evidence by a witness who has heard it from another source, but did not witness the acts personally

COMMENT: Hearsay evidence may not be given as much weight by the court as direct witness evidence. If a party intends to rely on hearsay evidence, they must serve notice to that effect.

heavily /'hevɪli/ *adverb* □ **he had to borrow heavily to pay the fine** he had to borrow a lot of money

heavy /'hevi/ *adjective* severe or harsh ○ *The looters were given heavy jail sentences.* ○ *She was sentenced to pay a heavy fine.* ■ *noun* a strong man employed to frighten people (*slang*)

heir /eə/ *noun* somebody who receives or will receive property when someone dies ○ *His heirs split the estate between them.*

heir apparent /ˌeər ə'pærənt/ *noun* an heir who will certainly inherit if a person dies before him

heiress /'eərəs/ *noun* a female heir

heirloom /'eəluːm/ *noun* a piece of family property such as silver, a painting or a jewel which has been handed down for several generations ○ *The burglars stole some family heirlooms.*

heir presumptive /ˌeə prɪ'zʌmptɪv/ *noun* an heir who will inherit if a person dies at this moment, but whose inheritance may be altered in the future

heirs, successors and assigns /ˌeəz sək ˌsesəz ənd ə'saɪnz/ *plural noun* people who have inherited property and had it transferred to them

heist /haɪst/ *noun* a holdup (*slang*)

henceforth /hens'fɔːθ/ *adverb* from this time on ○ *Henceforth it will be more difficult to avoid customs examinations.*

here- /hɪə/ *prefix* this time, or this place

hereafter /hɪər'ɑːftə/ *adverb* from this time or point on

hereby /hɪə'baɪ/ *adverb* in this way ○ *We hereby revoke the agreement of January 1st 1982.*

hereditament /ˌherɪ'dɪtəmənt/ *noun* property, including land and buildings, which can be inherited

hereditary /hə'redɪt(ə)ri/ *adjective* passed from one member of a family to another

hereditary office /həˌredɪt(ə)ri 'ɒfɪs/ *noun* an official position which is inherited

herein /ˌhɪər'ɪn/ *adverb* in this document ○ *the conditions stated herein* ○ *see the reference herein above*

hereinafter /ˌhɪərɪn'ɑːftə/ *adverb* stated later in this document ○ *the conditions hereinafter listed*

hereof /ˌhɪər'ɒv/ *adverb* of this □ **in confirmation hereof we attach a bank statement** to confirm this we attach a bank statement

hereto /ˌhɪə'tuː/ *adverb* to this ○ *according to the schedule of payments attached hereto* □ **as witness hereto** as a witness of this fact □ **the parties hereto** the parties to this agreement

heretofore /'hɪətəˌfɔː/ *adverb* previously or earlier ○ *the parties heretofore acting as trustees*

hereunder /ˌhɪər'ʌndə/ *adverb* under this heading, or below this phrase ○ *see the documents listed hereunder*

herewith /hɪə'wɪð/ *adverb* together with this letter ○ *please find the cheque enclosed herewith*

Her Majesty's government /ˌhɜː ˌmædʒəstɪz 'gʌv(ə)nmənt/ *noun* the official title of the British government

Her Majesty's pleasure /ˌhɜː ˌmædʒəstɪz 'pleʒə/ *noun* □ **detention at *or* during Her Majesty's pleasure** imprisonment for an indefinite period, until the Home Secretary decides that a prisoner can be released

mainp - softvnn.com

Law.fm Page 142 Friday, June 11, 2004 2:08 PM

COMMENT: Used as a punishment for people under a disability and children who commit murder.

hidden asset /ˌhɪd(ə)n 'æset/ *noun* an asset which is valued in the company's accounts at much less than its true market value

hidden reserves /ˌhɪd(ə)n rɪ'zɜːvz/ *plural noun* illegal reserves which are not declared in the company's balance sheet

High Court /haɪ 'kɔːt/, **High Court of Justice** /haɪ kɔːt əv 'dʒʌstɪs/ *noun* the main civil court in England and Wales, based on the six circuits

High Court of Justiciary /ˌhaɪ kɔːt əv dʒʌ'stɪʃiəri/ *noun* the supreme criminal court of Scotland

high judicial office /haɪ dʒuːˌdɪʃ(ə)l 'ɒfɪs/ *noun* an important position in the legal system, e.g. Lord Chancellor, a High Court judge, etc.

high office /ˌhaɪ 'ɒfɪs/ *noun* an important position or job

high official /ˌhaɪ ə'fɪʃ(ə)l/ *noun* an important person in a government department

high seas /ˌhaɪ 'siːz/ *plural noun* the part of the sea which is further than three miles or five kilometres from a coast, and so is under international jurisdiction (NOTE: usually used with 'the': *an accident on the high seas*)

High Sheriff /ˌhaɪ 'ʃerɪf/ *noun* a senior representative appointed by the government in a county

high treason /ˌhaɪ 'triːz(ə)n/ *noun* a formal way of referring to treason

highway /'haɪweɪ/ *noun* a road or path with a right of way which anyone may use

COMMENT: The Highway Code is not itself part of English law.

Highway Code /ˌhaɪweɪ 'kəʊd/ *noun* the rules which govern the behaviour of people and vehicles using roads

hijack /'haɪdʒæk/ *noun* the act of taking control by force of a plane, ship, train, bus or lorry which is moving ○ *The hijack was organised by a group of opponents to the government.* ■ *verb* to take control by force of a moving plane, ship, train, bus or lorry, with passengers on board ○ *The plane was hijacked by six armed terrorists.* ○ *The bandits hijacked the lorry and killed the driver.*

hijacker /'haɪdʒækə/ *noun* somebody who hijacks a vehicle

hijacking /'haɪdʒækɪŋ/ *noun* the act of taking control of a moving plane, ship, train, bus or lorry by force ○ *The hijacking took place just after the plane took off.* ○ *There have been six hijackings so far this year.*

Hilary /'hɪləri/ *noun* **1.** one of the four sittings of the law courts **2.** one of the four law terms

hire purchase agreement /ˌhaɪə 'pɜːtʃɪs əˌgriːmənt/ *noun* a contract to pay for something by instalments

hire-purchase company /ˌhaɪə 'pɜːtʃɪs ˌkʌmp(ə)ni/ *noun* a company which provides money for hire purchase (NOTE: The US term is **installment plan**.)

hirer /'haɪrə/ *noun* somebody who hires something

hit and run /ˌhɪt ən 'rʌn/ *noun* a situation where a vehicle hits someone and continues without stopping

hit man /'hɪt mæn/ *noun* a person who will kill someone for a fee (*slang*)

hoax /həʊks/ *noun* an action which is designed to trick someone into believing something □ **hoax phone call** call to inform the police or fire service of a dangerous situation which does not exist

hoc ➧ ad hoc

hold /həʊld/ *verb* **1.** to keep someone in custody ○ *The prisoners are being held in the police station.* ○ *Twenty people were held in the police raid.* ○ *She was held for six days without being able to see her lawyer.* **2.** to give as a formal decision ○ *The court held that there was no case to answer.* ○ *The appeal judge held that the defendant was not in breach of his statutory duty.* (NOTE: **holding – held**)

holder /'həʊldə/ *noun* **1.** somebody who owns or keeps something ○ *the holder of an insurance policy* or *a policy holder* ○ *She is a British passport holder* or *she is the holder of a British passport.* **2.** the person to whom a cheque is made payable and who has possession of it **3.** somebody who is holding a bill of ex-

mainp - softvnn.com

Law.fm Page 143 Friday, June 11, 2004 2:08 PM

change or promissory note **4.** something which keeps or protects something

holder in due course /ˌhəʊldə ɪn djuː ˈkɔːs/ *noun* somebody who takes a bill, promissory note or cheque before it becomes overdue or is dishonoured

holding /ˈhəʊldɪŋ/ *noun* a ruling given by a court of law, especially one that decides a legal issue raised by a particular case

holding charge /ˈhəʊldɪŋ tʃɑːdʒ/ *noun* a minor charge brought against someone so that he or she can be held in custody while more serious charges are being prepared

holding over /ˈhəʊldɪŋ əʊvə/, **holdover** *US noun* a situation where a person who had a lease for a period continues to occupy the property after the end of the lease

hold out /ˌhəʊld ˈaʊt/ *verb* **1.** to behave in a way which misleads others ▫ **he held himself out as a director of the company** he behaved as if he were a director of the company **2.** ▫ **to hold out for** to ask for something and refuse to act until you get what you asked for ○ *He held out for a 50% discount.*

hold to /ˈhəʊld tuː/ *verb* not to allow something to change ▫ **we will try to hold him to the contract** we will try to make sure that he follows the terms of the contract ▫ **the government hopes to hold wage increases to 5%** the government hopes that wage increases will not be more than 5%

hold up /ˌhəʊld ˈʌp/ *verb* **1.** to go into a bank, stop a lorry, etc., in order to steal money ○ *Six gunmen held up the bank* or *the security van.* **2.** to stay at a high level ○ *Share prices have held up well.* ○ *Sales held up during the tourist season.* **3.** to delay ○ *The shipment has been held up at the customs.* ○ *Payment will be held up until the contract has been signed.*

hold-up /ˈhəʊld ʌp/ *noun* **1.** the act of holding up a bank, etc. ○ *The gang committed three armed hold-ups on the same day.* **2.** a delay ○ *The traffic congestion caused hold-ups for people on their way to work.*

holiday entitlement /ˈhɒlɪdeɪ ɪn ˌtaɪt(ə)lmənt/ *noun* the number of days' paid holiday which an employee has the right to take

holiday pay /ˈhɒlɪdeɪ peɪ/ *noun* a salary which is still paid during the holiday

holograph /ˈhɒləgrɑːf/ *noun* a document written by hand

holographic will /ˌhɒləgræfɪk ˈwɪl/ *noun US* same as **holograph will**

holograph will /ˈhɒləgrɑːf ˌwɪl/ *noun* a will, written out by hand, and not necessarily witnessed

home court /ˈhəʊm kɔːt/ *noun* the County Court for the district in which a defendant lives or has his or her address for service (NOTE: The US term is **domestic court**.)

homeless person /ˌhəʊmləs ˈpɜːs(ə)n/ *noun* a person with no fixed accommodation, who is therefore eligible for the provision of accommodation by a local council

home market /ˌhəʊm ˈmɑːkɪt/ *noun* the market in the country where the selling company is based

Home Office /ˈhəʊm ˌɒfɪs/ *noun* British government ministry dealing with internal affairs including law and order, the police and prisons

Home Office pathologist /həʊm ˌɒfɪs pəˈθɒlədʒɪst/ *noun* an official government pathologist employed by the Home Office to examine corpses

Home Secretary /ˌhəʊm ˈsekrət(ə)ri/ *noun* a member of the British government, the minister in charge of the Home Office, dealing with law and order, the police and prisons

COMMENT: In most countries the government department dealing with the internal order of the country is called the Ministry of the Interior, with a Minister of the Interior in charge.

homestead /ˈhəʊmsted/ *noun US* the house and land where a family lives

COMMENT: A homestead cannot be the subject of a sale by court order to satisfy creditors.

home trade /ˌhəʊm ˈtreɪd/ *noun* trade in the country where a company is based

homicidal /ˌhɒmɪˈsaɪd(ə)l/ *adjective* (*of a person*) likely or wanting to commit murder

mainp - softvnn.com

Law.fm Page 144 Friday, June 11, 2004 2:08 PM

homicide /'hɒmɪsaɪd/ *noun* **1.** the accidental or illegal killing of a person ○ *He was found guilty of homicide.* ○ *The homicide rate has doubled in the last ten years.* **2.** murder

COMMENT: Homicide covers the crimes of murder, manslaughter and infanticide.

Homicide Squad /'hɒmɪˌsaɪd skwɒd/ *noun US* a department of a police force which deals with cases of murder

honest /'ɒnɪst/ *adjective* not lying or cheating □ **to play the honest broker** to act for the parties in a negotiation to try to help them agree to a solution

honestly /'ɒnɪstli/ *adverb* acting in an open and truthful way

honesty /'ɒnɪsti/ *noun* the fact of being open and truthful ○ *The court praised the witness for her honesty in informing the police of the crime.*

honorarium /ˌɒnə'reəriəm/ *noun* a sum of money paid to a professional person such as an accountant or a lawyer which is less than a full fee

honour /'ɒnə/ *verb* to accept and pay a cheque or bill of exchange (NOTE: The US spelling is **honor**.) □ **to honour a debt** to pay a debt because it is owed and is correct □ **to honour a signature** to pay something because the signature is correct

hoodlum /'huːdləm/ *noun US* a gangster

hooligan /'huːlɪgən/ *noun* somebody who behaves violently in public ○ *The police put up barriers to prevent the football hooligans from damaging property.*

hooliganism /'huːlɪgənɪz(ə)m/ *noun* violent behaviour □ **football hooliganism** violent behaviour by football supporters in connection with football matches

hopper /'hɒpə/ *noun US* a box where bills are put after being introduced in the House of Representatives

horse-trading /'hɔːs ˌtreɪdɪŋ/ *noun* bargaining between groups of people to obtain a general agreement for something ○ *After a period of horse-trading, the committee agreed on the election of a member of one of the smaller parties as Chairman.*

hospital block /'hɒspɪt(ə)l blɒk/ *noun* the section of a prison which contains the hospital

hospital order /ˌhɒspɪt(ə)l 'ɔːdə/ *noun* a court order putting an insane offender in hospital instead of in prison

hostage /'hɒstɪdʒ/ *noun* a person captured by an enemy or by criminals and kept until a ransom is paid ○ *She was taken hostage by the guerillas.* ○ *The bandits took away the bank manager and kept him hostage.* ○ *The terrorists released three hostages.*

hostage taker /ˌhɒstɪdʒ 'teɪkə/ *noun* somebody who takes someone hostage ○ *Two of the hostage takers were killed in a shootout with the security forces.*

hostile /'hɒstaɪl/ *adjective* not friendly

hostile witness /ˌhɒstaɪl 'wɪtnəs/ *noun* a witness called by a party, whose evidence goes unexpectedly against that party, and who can then be cross-examined by his own side as if he were giving evidence for the other side ○ *She was ruled a hostile witness by the judge.*

hot /hɒt/ *adjective* stolen or illegal (*informal*) ○ *hot jewels* ○ *a hot car*

hotchpot /'hɒtʃpɒt/ *noun* the act of bringing together into one fund money to be distributed under a will

hotchpot rule /'hɒtʃpɒt ruːl/ *noun* the rule that money passed to one child during his or her lifetime by a deceased person should be counted as part of the total estate to be distributed to all the children in the case where the person died intestate

hot money /ˌhɒt 'mʌni/ *noun* **1.** money which is moved from country to country to get the best interest rates **2.** stolen money, or money which has been obtained illegally

hot pursuit /ˌhɒt pə'sjuːt/ *noun* the right in international law to chase a ship into international waters, or to chase suspected criminals across an international border into another country

house /haʊz/ *noun* one of the two parts of the British Parliament (the House of Commons and the House of Lords) ○ *The*

mainp - softvnn.com

Law.fm Page 145 Friday, June 11, 2004 2:08 PM

minister brought a matter to the attention of the House.

house arrest /ˈhaʊs əˌrest/ *noun* the situation of being ordered by a court to stay in your house and not to leave it ○ *The opposition leader has been under house arrest for six years.*

housebreaker /ˈhaʊsbreɪkə/ *noun US* a burglar, a person who breaks into houses and steals things

housebreaking /ˈhaʊsbreɪkɪŋ/ *noun US* burglary, entering a house and stealing things

household effects /ˌhaʊshəʊld ɪˈfekts/ *plural noun* furniture and other items used in a house, and moved with the owner when he or she moves house

householder /ˈhaʊshəʊldə/ *noun* somebody who occupies a private house

House of Commons /ˌhaʊs əv ˈkɒmənz/ *noun* **1.** the lower house of the British Parliament, made up of 659 elected members **2.** the lower house of a legislature (as in Canada)

COMMENT: Members of the House of Commons (called MPs) are elected for five years, which is the maximum length of a Parliament. Bills can be presented in either the House of Commons or House of Lords, and sent to the other chamber for discussion and amendment. All bills relating to revenue must be introduced in the House of Commons, and most other bills are introduced there also.

House of Lords /ˌhaʊs əv ˈlɔːdz/ *noun* the non-elected upper house of Parliament in the United Kingdom, made up of life peers, some hereditary peers and some bishops

COMMENT: The composition of the House of Lords was changed by the House of Lords act 1999; hereditary peers no longer sit there by right, although 92 remain, elected by their own party or crossbench (non-party) groups, or as Deputy Speakers, Committee Chairs, or to fill two hereditary royal appointments, the Earl Marshal and the Lord Great Chamberlain. As a court, the decisions of the House of Lords are binding on all other courts, and the only appeal from the House of Lords is to the European Court of Justice.

House of Representatives /ˌhaʊs əv reprɪˈzentətɪvz/ *noun* **1.** *US* the lower house of the Congress of the United States, made up of 435 elected members **2.** the lower house of a legislature (as in Australia)

COMMENT: The members of the House of Representatives (called Congressmen) are elected for two years. All bills relating to revenue must originate in the House of Representatives; otherwise bills can be proposed in either the House or the Senate and sent to the other chamber for discussion and amendment.

house property /ˈhaʊs ˌprɒpəti/ *noun* private houses, not shops, offices or factories

human error /ˌhjuːmən ˈerə/ *noun* a mistake made by a person, not by a machine

human rights /ˌhjuːmən ˈraɪts/ *plural noun* the rights of individual men and women to basic freedoms such as freedom of association, freedom of speech

COMMENT: The Human Rights Act 1998, in force since October 2000, incorporated into UK law the European Convention for the Protection of Human Rights and Fundamental Freedoms. The Convention rights may now be relied on by litigants in the UK without the need to take a case to the European Court of Human Rights in Strasbourg.

human rights act /ˌhjuːmən ˈraɪts ˌækt/ *noun* legislation introduced into domestic law for the whole of the UK in October 2000, in order to comply with the obligations set out in European Convention of Human Rights. The Act creates a statutory duty that all laws, past or present, must be interpreted in a way that is compatible to the Convention.

humble address /ˌhʌmbəl əˈdres/ *noun* a formal communication from one or both Houses of Parliament to the Queen

hung /hʌŋ/ *adjective* with no majority

hunger strike /ˈhʌŋgə straɪk/ *noun* a protest, often by a prisoner, where the person refuses to eat until his or her demands have been met ○ *He went on hunger strike until the prison authorities allowed him to receive mail.*

hung jury /ˌhʌŋ ˈdʒʊəri/ *noun* a jury which cannot arrive at a unanimous or majority verdict

mainp - softvnn.com

Law.fm Page 146 Friday, June 11, 2004 2:08 PM

hung parliament /ˌhʌŋ ˈpɑːləmənt/ *noun* a parliament where no single party has enough votes to form a government

hurdle /ˈhɜːd(ə)l/ *noun* something which prevents something happening ○ *The defendant will have to overcome two hurdles if his appeal is to be successful.*

hush money /ˈhʌʃ ˌmʌni/ *noun* money paid to someone to stop him or her talking (*informal*)

hustings /ˈhʌstɪŋz/ *noun* □ **at the hustings** at a parliamentary election

COMMENT: The hustings were formerly the booths where votes were taken, or the platform on which candidates stood to speak, but now the word is used simply to mean 'an election'.

Hybrid Bill /ˈhaɪbrɪd bɪl/ *noun* a term used to refer to a Public Bill which affects the private interests of a particular person or organisation

hybrid offence /ˌhaɪbrɪd əˈfens/ *noun* an offence which can be tried either by magistrates or by a judge and jury

hypothecation /haɪˌpɒθəˈkeɪʃ(ə)n/ *noun* **1.** the use of property such as securities as collateral for a loan, without transferring legal ownership to the lender, as opposed to a mortgage, where the lender holds the title to the property **2.** the action of earmarking money derived from specific sources for related expenditure, e.g. investing the taxes from private cars or petrol sales solely in public transport

hypothetical question /ˌhaɪpə θetɪk(ə)l ˈkwestʃ(ə)n/ *noun* a question about a possible rather than an actual situation which is posed for discussion during a decision-making process

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ibid /'ɪbɪd/**, ibidem** *adverb* just the same, or in the same place in a book

ICC *abbreviation* International Criminal Court

id /ɪd/**, idem** *pronoun* the same thing, or the same person

ID *abbreviation* identity

identification /aɪˌdentɪfɪ'keɪʃ(ə)n/ *noun* the act of identifying someone or something

identification parade /aɪˌdentɪfɪ 'keɪʃ(ə)n pəˌreɪd/ *noun* an arrangement where a group of people including a suspect stand in a line at a police station so that a witness can point out the person whom he or she recognises

identify /aɪ'dentɪˌfaɪ/ *verb* to say who someone is or what something is ○ *She was able to identify her attacker.* ○ *Passengers were asked to identify their suitcases.* ○ *The dead man was identified by his fingerprints.*

Identikit /aɪ'dentɪkɪt/ *noun* a trademark for a method of making a picture of a criminal from descriptions given by witnesses, using pieces of photographs and drawings of different types of faces ○ *The police issued an identikit picture of the mugger.* (NOTE: Now replaced by **Photofit pictures**.)

identity /aɪ'dentɪti/ *noun* who someone is □ **he changed his identity** he assumed a different name, changed his appearance, etc., (usually done to avoid being recognised) □ **he was asked for proof of identity** he was asked to prove he really was the person he said he was □ **case of mistaken identity** situation where a person is wrongly thought to be someone else

identity of parties /aɪˌdentɪti əv 'pɑːtiz/ *noun* a situation where the parties in different actions are the same

identity parade /aɪ'dentɪti pəˌreɪd/ *noun* same as **identification parade**

identity theft /aɪ'dentɪti θeft/ *noun* the theft of personal data such as the details of someone's credit card

ignorance /'ɪgnərəns/ *noun* lack of knowledge □ **ignorance of the law is no excuse** the fact that someone does not know that he or she has committed an offence does not make the offence any the less

ignorantia legis non excusat, ignorantia legis neminem excusat, ignorantia legis haud excusat *phrase* a Latin phrase meaning 'ignorance of the law is not an excuse for anyone'

ILEX *abbreviation* institute of legal executives

illegal /ɪ'liːg(ə)l/ *adjective* not legal in criminal law ○ *the illegal carrying of arms* ○ *Illegal immigrants are deported.*

illegal contract /ɪˌliːg(ə)l 'kɒntrækt/ *noun* a contract which cannot be enforced in law, e.g. a contract to commit a crime

illegal immigrant /ɪˌliːg(ə)l 'ɪmɪgrənt/ *noun* somebody who enters a country to live permanently without having the permission of the government to do so

illegality /ˌɪliː'gælɪti/ *noun* the fact of being illegal

illegitimacy /ˌɪlɪ'dʒɪtɪməsi/ *noun* the state of being illegitimate

illegitimate /ˌɪlɪ'dʒɪtɪmət/ *adjective* **1.** against the law **2.** born to parents who are not married to each other

mainp - softvnn.com

Law.fm Page 148 Friday, June 11, 2004 2:08 PM

COMMENT: Children who are illegitimate can nevertheless inherit from their parents.

illicit /ɪ'lɪsɪt/ *adjective* not allowed by the law or by other rules ○ *illicit sale of alcohol* ○ *trade in illicit alcohol*

ILO *abbreviation* International Labour Organization

IMF *abbreviation* International Monetary Fund

imitation /ˌɪmɪ'teɪʃ(ə)n/ *noun* something which copies another □ **beware of imitations** be careful not to buy low quality goods which are made to look like other more expensive items

immaterial /ˌɪmə'tɪəriəl/ *adjective* not relevant or important □ **immaterial evidence** evidence that is not relevant to a particular case

immemorial /ˌɪmə'mɔːriəl/ *adjective* so old it cannot be remembered □ **from time immemorial** for so long that no one can remember when it started ○ *Villagers said that there had been a footpath across the field from time immemorial.*

immemorial existence /ˌɪməmɔːriəl ɪg'zɪstəns/ *noun* the period before 1189, the date from which events are supposed to be remembered. ◊ **legal memory**

immigrant /'ɪmɪgrənt/ *noun* somebody who moves to this country to live permanently

immigrate /'ɪmɪgreɪt/ *verb* to move to this country to live permanently. Compare **emigrate**

immigration /ˌɪmɪ'greɪʃ(ə)n/ *noun* an act of moving into a country to live permanently

Immigration Laws /ˌɪmɪ'greɪʃ(ə)n lɔːz/ *plural noun* legislation regarding immigration into a country

immigration officer /ˌɪmɪ'greɪʃ(ə)n ˌɒfɪsə/ *noun* an official at an airport or port, whose job is to check the passports and visas of people entering the country

immoral earnings /ɪˌmɒrəl 'ɜːnɪŋz/ *plural noun* money earned from prostitution

immovable /ɪ'muːvəb(ə)l/ *adjective* being unable to be moved

immovable property /ɪˌmuːvəb(ə)l 'prɒpəti/ *noun* houses and other buildings on land, as well as land itself

immunity /ɪ'mjuːnɪti/ *noun* protection from arrest or prosecution □ **when he offered to give information to the police, he was granted immunity from prosecution** he was told he would not be prosecuted

COMMENT: Immunity from prosecution is also granted to magistrates, counsel and witnesses as regards their statements in judicial proceedings. Families and servants of diplomats may be covered by diplomatic immunity. In the USA, immunity is the protection of members of Congress against being sued for libel or slander for statements made on the floor of the House (in the UK this is called **privilege)**.

impanel *verb US* same as **empanel**

impartial /ɪm'pɑːʃ(ə)l/ *adjective* not biased or prejudiced ○ *to give someone a fair and impartial hearing* ○ *A judgment must be impartial.*

impartiality /ɪmˌpɑːʃi'ælɪti/ *noun* the state of being impartial ○ *The newspapers doubted the impartiality of the judge.*

impartially /ɪm'pɑːʃ(ə)li/ *adverb* not showing any bias or favour towards someone ○ *The adjudicator has to decide impartially between the two parties.*

impeach /ɪm'piːtʃ/ *verb* **1.** formerly, to charge a person with treason before Parliament **2.** *US* to charge a head of state with treason **3.** *US* to charge any government official with misconduct **4.** *US* to discredit a witness

impeachment /ɪm'piːtʃmənt/ *noun* **1.** *US* a charge of treason brought against a head of state **2.** in the USA, a charge of misconduct against any public official

impersonate /ɪm'pɜːsəneɪt/ *verb* to pretend to be someone else ○ *He gained entrance to the house by impersonating a local authority inspector.*

impersonation /ɪmˌpɜːsə'neɪʃ(ə)n/ *noun* the activity of pretending to be someone else in order to deceive people ○ *He was charged with impersonation of a police officer.*

impleader /ɪm'pliːdə/ *noun US* a procedure to join a third party to an original action, undertaken either by the plaintiff

mainp - softvnn.com

Law.fm Page 149 Friday, June 11, 2004 2:08 PM

or the defendant (NOTE: The British equivalent is **third party proceedings**.)

implication /ˌɪmplɪˈkeɪʃ(ə)n/ *noun* **1.** the possible effect of an action ○ *What will the implications of this decision be?* **2.** an involvement with a crime or something that is morally wrong ○ *The newspaper revealed his implication in the affair of the stolen diamonds.* **3.** a suggestion that something such as a criticism or accusation is true although it has not been expressed directly ○ *I resent the implication that I knew anything about the report in advance.*

implicit /ɪmˈplɪsɪt/ *adjective* implied rather than clearly stated

implied /ɪmˈplaɪd/ *adjective* being presumed to exist or which can be established by circumstantial evidence

implied contract /ɪmˌplaɪd kən ˈtrækt/ *noun* an agreement which is considered to be a contract, because the parties intended it to be a contract or because the law considers it to be a contract

implied malice /ɪmˌplaɪd ˈmælɪs/ *noun* the intention to commit grievous bodily harm on someone

implied term /ɪmˈplaɪd tɜːm/ *noun* a term in a contract which is not clearly set out in the contract. Compare **express term**

implied terms and conditions /ɪm ˌplaɪd tɜːmz ən kənˈdɪʃ(ə)nz/ *plural noun* terms and conditions which are not written in a contract, but which are legally taken to be present in the contract

implied trust /ɪmˌplaɪd ˈtrʌst/ *noun* a trust which is implied by the intentions and actions of the parties

imply /ɪmˈplaɪ/ *verb* to suggest that something may be true without stating it clearly ○ *Counsel implied that the witness had not in fact seen the accident take place.* ○ *Do you wish to imply that the police acted improperly?*

import licence /ˈɪmpɔːt ˌlaɪs(ə)ns/ *noun* a permit which allows a company to bring a particular type of product into a country

import permit /ˈɪmpɔːt ˌpɜːmɪt/ *noun* an official document which allows goods to be imported

import quota /ˈɪmpɔːt ˌkwəʊtə/ *noun* a fixed quantity of a particular type of goods which the government allows to be imported ○ *The government has imposed a quota on the import of cars.* ○ *The quota on imported cars has been lifted.*

import surcharge /ˈɪmpɔːt ˌsɜːtʃɑːdʒ/ *noun* an extra charge on imported goods

import trade /ˈɪmpɔːt treɪd/ *noun* the business of buying from other countries

importune /ˌɪmpəˈtjuːn/ *verb* (*of prostitutes looking for clients, or of men looking for prostitutes*) to ask someone to have sexual relations

importuning /ˌɪmpəˈtjuːnɪŋ/ *noun* the crime of asking someone to have sexual relations with you, usually for money

impose /ɪmˈpəʊz/ *verb* **1.** to ask someone to pay a fine ○ *to impose a tax on bicycles* ○ *The court imposed a fine of £100.* ○ *They tried to impose a ban on smoking.* **2.** to put a tax or a duty on goods ○ *The government imposed a special duty on oil.* ○ *The customs have imposed a 10% tax increase on electrical items.*

imposition /ˌɪmpəˈzɪʃ(ə)n/ *noun* the introduction of something such as a rule or tax

impossibility of performance /ɪm ˌpɒsəbɪlɪti əv pəˈfɔːməns/ *noun* a situation where a party to a contract is unable to perform his or her part of the contract

impound /ɪmˈpaʊnd/ *verb* to take something away and keep it until a tax is paid or until documents are checked to see if they are correct ○ *The customs impounded the whole cargo.*

impounding /ɪmˈpaʊndɪŋ/ *noun* the act of taking something and keeping it

imprison /ɪmˈprɪz(ə)n/ *verb* to put someone in prison ○ *He was imprisoned by the secret police for six months.*

imprisonment /ɪmˈprɪz(ə)nmənt/ *noun* the punishment of being put in prison ○ *The penalty for the first offence is a fine of £200 or six weeks' imprisonment.* □ **a term of imprisonment** time which a prisoner has to spend in prison ○

mainp - softvnn.com

Law.fm Page 150 Friday, June 11, 2004 2:08 PM

He was sentenced to the maximum term of imprisonment.

COMMENT: Life imprisonment is a term of many years, but in the UK not necessarily for the rest of the prisoner's life.

improper /ɪm'prɒpə/ *adjective* not correct, not as it should be

improperly /ɪm'prɒpəli/ *adverb* not correctly ○ *The police constable's report was improperly made out.* ○ *She was accused of acting improperly in going to see the prisoner's father.*

impunity /ɪm'pjuːnɪti/ *noun* □ **with impunity** without punishment ○ *No one can flout the law with impunity.*

imputation /ˌɪmpjuː'teɪʃ(ə)n/ *noun* a suggestion that someone has done something wrong

imputation of malice /ˌɪmpjuːteɪʃ(ə)n əv 'mælɪs/ *noun* the suggestion that someone acted out of malice

impute /ɪm'pjuːt/ *verb* to suggest □ **to impute a motive to someone** to suggest that someone had a motive in acting as he did

in absentia /ɪn æb'senʃə/ *adverb* in someone's absence ○ *She was tried and sentenced to death in absentia.*

inadmissible /ˌɪnəd'mɪsɪb(ə)l/ *adjective* not able to be used in court as evidence

inalienable /ɪn'eɪliənəb(ə)l/ *adjective* referring to a right which cannot be taken away from a person or transferred to someone else

inapplicable /ˌɪnə'plɪkəb(ə)l/ *adjective* being unable to be applied ○ *The government argued that the national legislation had not been applied and was inapplicable in this case.*

Inc *abbreviation* incorporated

in camera /ɪn 'kæm(ə)rə/ *adverb* with no members of the public permitted to be present ○ *The case was heard in camera.* (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has been replaced by **in private**.)

incapable /ɪn'keɪpəb(ə)l/ *adjective* not able ○ *He was incapable of fulfilling the terms of the contract.* ○ *A child is considered legally incapable of committing a crime.*

incapacity /ˌɪnkə'pæsɪti/ *noun* the state of not being legally able to do something ○ *The court had to act because of the incapacity of the trustees.*

incarcerate /ɪn'kɑːsəreɪt/ *verb* to put in prison ○ *He was incarcerated in a stone tower.*

incarceration /ɪnˌkɑːsə'reɪʃ(ə)n/ *noun* an act of putting a criminal in prison

inception /ɪn'sepʃən/ *noun* a beginning ○ *Some people believe that subsidiarity has existed in the Community ever since its inception.*

incest /'ɪnsest/ *noun* a notifiable offence of having sexual intercourse with a close relative such as a daughter, son, mother or father

in chambers /ɪn 'tʃeɪmbəz/ *adverb* in the office of a judge and not in a courtroom ○ *The judge heard the application in chambers.*

inchoate /ɪn'kəʊət/ *adjective* just beginning to form but not complete

inchoate instrument /ɪnˌkəʊət 'ɪnstrʊmənt/ *noun* a document which is not complete

inchoate offences /ɪnˌkəʊət ə 'fenss/ *plural noun* offences such as incitement, attempt or conspiracy to commit a crime even though the crime itself may not have been committed

incidence /'ɪnsɪd(ə)ns/ *noun* how often something happens ○ *The incidence of cases of rape has increased over the last years.* ○ *A high incidence of accidents relating to drunken drivers.*

incident /'ɪnsɪd(ə)nt/ *noun* something which happens at a particular time, e.g. a crime, accident or violent event ○ *Three incidents were reported when police vehicles were attacked by a crowd.* ■ *adjective* □ **incident to something** depending on something else

incidental /ˌɪnsɪ'dent(ə)l/ *adjective* not important

incidental expenses /ˌɪnsɪdent(ə)l ɪk'spensɪz/ *plural noun* small amounts of money spent on different things at various times in connection with an activity

mainp - softvnn.com

Law.fm Page 151 Friday, June 11, 2004 2:08 PM

○ *an allowance for travel, meals and incidental expenses*

incident room /'ɪnsɪd(ə)nt ruːm/ *noun* a special room in a police station to deal with a particular crime or accident

incident tape /'ɪnsɪd(ə)nt teɪp/ *noun* wide yellow and black tape that is used to isolate an area and keep people away from a crime scene (NOTE: The US term is crime scene tape.)

incite /ɪn'saɪt/ *verb* to encourage, persuade or advise someone to commit a crime

incitement /ɪn'saɪtmənt/ *noun* the crime of encouraging, persuading or advising someone to commit a crime

COMMENT: It is not necessary for a crime to have been committed for incitement to be proved.

incitement to racial hatred /ɪn ˌsaɪtmənt tə ˌreɪʃ(ə)l 'heɪtrɪd/ *noun* the offence of encouraging people by words, actions or writing to attack others because of their race

inciter /ɪn'saɪtə/ *noun* somebody who incites someone to commit a crime

income /'ɪnkʌm/ *noun* money that a person receives as salary, dividend or interest □ **income from rents** money received from allowing other people to use property such as offices, houses or land that you own

income bracket /'ɪnkʌm ˌbrækɪt/ *noun* a range between two amounts of income, to which a specific tax percentage applies ○ *People in the lowest income bracket pay the lowest rate of tax.*

income support /'ɪnkʌm səˌpɔːt/ *noun* financial help given by the state to families with low incomes. An individual must not work more than sixteen hours a week in order to qualify.

income tax /'ɪnkʌm tæks/ *noun* a tax on salaries and wages, calculated at different rates according to how much you earn

incompetency /ɪn'kɒmpɪt(ə)nsi/ *noun* the state of not being legally competent to do something

incompetent /ɪn'kɒmpɪt(ə)nt/ *adjective* **1.** unable to carry out duties to the required standard ○ *The sales manager is quite incompetent.* ○ *The company has an incompetent sales director.* **2.** not legally able to do something ○ *He is incompetent to sign the contract.*

incorporate /ɪn'kɔːpəˌreɪt/ *verb* **1.** to bring something in to be part of something else, e.g. to make a document part of another document ○ *Income from the 1998 acquisition is incorporated into the accounts.* ○ *The list of markets is incorporated into the main contract.* **2.** to form a registered company ○ *a company incorporated in the USA* ○ *an incorporated company* ○ *J. Doe Incorporated*

incorporation /ɪnˌkɔːpə'reɪʃ(ə)n/ *noun* the act of incorporating a company

incorporeal /ˌɪnkɔː'pɔːriəl/ *adjective* not having physical form, so being unable to be touched

incorporeal chattels /ˌɪnkɔːpɔːriəl 'tʃæt(ə)lz/ *plural noun* items such as patents and copyrights which have intellectual rather than physical existence

incorporeal hereditaments /ˌɪnkɔːpɔːriəl ˌherɪ'dɪtəmənts/ *plural noun* rights such as patents or copyrights which can form part of an estate and be inherited

incorrigible /ɪn'kɒrɪdʒɪb(ə)l/ *adjective* having bad behaviour and unwilling to change it

incriminate /ɪn'krɪmɪneɪt/ *verb* to show that a person has committed a criminal act ○ *He was incriminated by the recorded message he sent to the victim.*

incriminating /ɪn'krɪmɪneɪtɪŋ/ *adjective* which shows that someone has committed a crime ○ *Incriminating evidence was found in his car.*

incumbent /ɪn'kʌmbənt/ *adjective* □ **it is incumbent upon him** he has to do this, because it is his duty ○ *It is incumbent on us to check our facts before making an accusation.* ○ *It is incumbent upon justices to give some warning of their doubts about a case.* ■ *noun* somebody who holds an official position ○ *There will be no changes in the governor's staff while the present incumbent is still in office.*

incumbrance /ɪn'kʌmbrəns/ *noun* same as **encumbrance**

mainp - softvnn.com

Law.fm Page 152 Friday, June 11, 2004 2:08 PM

incur /ɪn'kɜː/ *verb* to make yourself liable to □ **to incur the risk of a penalty** to make it possible that you risk paying a penalty □ **to incur debts, costs** to do something which means that you owe money, that you will have to pay costs □ **the company has incurred heavy costs to implement the development programme** the company has had to pay large sums of money

incuriam ◗ **per incuriam**

indebted /ɪn'detɪd/ *adjective* owing money to someone ○ *to be indebted to a property company*

indebtedness /ɪn'detɪdnəs/ *noun* the amount of money owed by someone

indecency /ɪn'diːs(ə)nsi/ *noun* the state of being offensive and shocking to most people □ **to commit an act of gross indecency** (*of a man*) to have unlawful sexual contact with another man or with a child

indecent /ɪn'diːs(ə)nt/ *adjective* **1.** offensive and shocking to most people, especially in relation to sexual matters **2.** not polite and considerate □ **indecent haste** unsuitably fast action ○ *They accepted the suggestion of compensation with indecent haste.*

indecent assault /ɪnˌdiːsənt ə'sɔːlt/ *noun* the crime of assaulting a person together with an indecent act or proposal

indecent exposure /ɪnˌdiːs(ə)nt ɪk 'spəʊʒə/ *noun* an offence where a male person shows his sexual organs in a public place

indefeasible right /ˌɪndɪfiːzɪb(ə)l 'raɪt/ *noun* a right which cannot be made void

indemnification /ɪndemnɪfɪ'keɪʃən/ *noun* payment for damage

indemnify /ɪn'demnɪfaɪ/ *verb* to pay for damage suffered ○ *to indemnify someone for a loss*

indemnity /ɪn'demnɪti/ *noun* **1.** compensation for a loss or a wrong **2.** a statement of liability to pay compensation for a loss or for a wrong in a transaction to which you are a party ○ *She had to pay an indemnity of £100.* Compare **guarantee**. ◗ **letter of indemnity** (NOTE: The person making an indemnity is primarily liable and can be sued by the person with whom he makes the transaction.) **3.** (*in civil cases*) the right of someone to recover from a third party the amount which is liable to be paid

indenture /ɪn'dentʃə/ *noun* a deed made between two or more parties ■ *verb* to contract with a trainee who will work for some years to learn a trade ○ *He was indentured to a builder.*

indentures /ɪn'dentʃəz/ *noun* a contract by which a trainee craftsman works for a master for some years to learn a trade

independence /ˌɪndɪ'pendəns/ *noun* freedom from the rule, control or influence of others ○ *The colony struggled to achieve independence.* ○ *Britain granted her colonies independence in the years after the Second World War.* ○ *An independence movement grew in the colony.*

independent /ˌɪndɪ'pendənt/ *adjective* not controlled by anyone else

independent rights /ˌɪndɪ'pendənt raɪts/ *plural noun* rights of employed people, students, retired people and people with private incomes, to enter, live and work in a EU country

indict /ɪn'daɪt/ *verb* to charge someone with a crime ○ *She was indicted for murder.*

indictable offence /ɪnˌdaɪtəb(ə)l ə 'fens/ *noun* formerly, a serious offence which could be tried in the Crown Court (NOTE: Now called **notifiable offence**.)

indictment /ɪn'daɪtmənt/ *noun* a written statement of the details of the crime with which someone is charged in the Crown Court ○ *The clerk to the justices read out the indictment.*

indirect discrimination /ˌɪndaɪrekt ˌsekjʊəl dɪsˌkrɪmɪ'neɪʃ(ə)n/ *noun* discrimination caused by the application of an abstract principle, where the result is that people of different sexes are treated differently

indirect sexual discrimination /ˌɪndaɪrekt ˌsekjʊəl dɪsˌkrɪmɪ 'neɪʃ(ə)n/ *noun* an instance of sexual discrimination that is covert, where employment conditions are such that it would be difficult for one sex to fulfil them An example would be where promotion is based on continuous employ-

mainp - softvnn.com

Law.fm Page 153 Friday, June 11, 2004 2:08 PM

ment, meaning that a woman taking maternity leave be less likely to get promoted than a man where all else is equal. ◊ **direct sexual discrimination**

individual exemption /ˌɪndɪvɪdʒuəl ɪgˈzempʃ(ə)n/ *noun* an exemption granted to a person or small business, exempting them from specific obligations

individual retirement account /ˌɪndɪvɪdʒuəl rɪˈtaɪəmənt əˌkaʊnt/ *noun US* a privately managed pension plan, to which individuals can make contributions which are separate from a company pension plan. Abbreviation **IRA** (NOTE: The British equivalent is a **personal pension plan**.)

indorse /ɪnˈdɔːs/ *verb* to write something on the back of a document, especially to note details of a claimant's claim on a writ ○ *The writ was indorsed with details of the claimant's claim.* □ **he indorsed the cheque over to his solicitor** he signed the cheque on the back so as to make it payable to his solicitor

indorsement /ɪnˈdɔːsmənt/ *noun* the act of writing notes on a document, especially writing the details of a claimant's claim on a writ

induce /ɪnˈdjuːs/ *verb* to help persuade someone to do something ○ *He was induced to steal the plans by an offer of a large amount of money.*

inducement /ɪnˈdjuːsmənt/ *noun* something which helps to persuade someone to do something ○ *They offered him a company car as an inducement to stay.*

inducement to break contract /ɪnˌdjuːsmənt tə breɪk ˈkɒntrækt/ *noun* the tort of persuading someone to break a contract he or she has entered into

industrial /ɪnˈdʌstriəl/ *adjective* relating to work

industrial accident /ɪnˌdʌstriəl ˈæksɪd(ə)nt/ *noun* an accident which takes place at work

industrial arbitration tribunal /ɪnˌdʌstriəl ˌɑːbɪˈtreɪʃ(ə)n traɪˌbjuːn(ə)l/ *noun* a court which decides in industrial disputes ○ *to accept the ruling of the arbitration board*

industrial development /ɪnˌdʌstriəl dɪˈveləpmənt/ *noun* the planning and building of new industries in special areas

industrial disputes /ɪnˌdʌstriəl dɪˈspjuːt/ *plural noun* arguments between management and workers

industrial espionage /ɪnˌdʌstriəl ˈespiənɑːʒ/ *noun* the activity of trying to find out the secrets of a competitor's work or products, usually by illegal means

industrial estate /ɪnˈdʌstriəl ɪˌsteɪt/ *noun* an area of land near a town specially for factories and warehouses

industrial injuries /ɪnˌdʌstriəl ˈɪndʒəriz/ *plural noun* injuries caused to employees at work

industrial property /ɪnˌdʌstriəl ˈprɒpəti/ *noun* an item with intellectual rather than physical existence such as a patent, trademark or company name which is owned by a company

industrial relations /ɪnˌdʌstriəl rɪˈleɪʃ(ə)nz/ *plural noun* relations between management and workers

industrial tribunal /ɪnˌdʌstriəl traɪˈbjuːn(ə)l/ *noun* same as **employment tribunal**

in esse /ˌɪn ˈeseɪ/ *phrase* a Latin phrase meaning 'in being'

infant /ˈɪnfənt/ *noun* a person aged less than eighteen years. Under this age a person cannot make legal decisions for themselves. (NOTE: This is an old term, now replaced by **minor**.)

infanticide /ɪnˈfæntɪsaɪd/ *noun* the notifiable offence of killing a child, especially the killing of a child by its mother before it is 12 months old

infer /ɪnˈfɜː/ *verb* to reach an opinion about something ○ *He inferred from the letter that the accused knew the murder victim.* ○ *Counsel inferred that the witness had not been present at the time of the accident.*

inferior court /ɪnˈfɪəriə kɔːt/ *noun* a lower court such as a magistrates' court or County Court

in flagrante delicto /ɪn fləˌgrænti dɪˈlɪktəʊ/ *phrase* a Latin phrase meaning '(caught) in the act of committing a crime'

mainp - softvnn.com

Law.fm Page 154 Friday, June 11, 2004 2:08 PM

influence peddling /ˈɪnfluəns ˌpedlɪŋ/ *noun* the act of offering to use personal influence, especially political power, for payment in order to help a person or group achieve something

inform /ɪnˈfɔːm/ *verb* **1.** to tell someone officially ○ *I regret to inform you that your tender was not acceptable.* ○ *We are pleased to inform you that your offer has been accepted.* ○ *We have been informed by the Department of Trade that new tariffs are coming into force.* **2.** □ **to inform on someone** to tell the police that someone has committed a crime

informant /ɪnˈfɔːmənt/ *noun* a person who gives information to someone secretly ○ *Is your informant reliable?*

in forma pauperis /ˌɪn ˌfɔːmə ˈpɔːpərɪs/ *phrase* a Latin phrase meaning 'as a poor person'

COMMENT: A term formerly used to allow a person who could prove that he had little money to bring an action even if he could not pay the costs of the case; now replaced by Legal Aid.

information /ˌɪnfəˈmeɪʃ(ə)n/ *noun* **1.** the details which explain something ○ *to disclose a piece of information* ○ *to answer a request for information* ○ *Have you any information on* or *about deposit accounts?* ○ *I enclose this leaflet for your information.* ○ *For further information, please write to Department 27.* □ **disclosure of confidential information** telling someone information which should be secret **2.** the details of a crime drawn up by the clerk and given to a magistrate □ **laying (an) information** starting criminal proceedings in a magistrates' court by informing the magistrate of the offence

information bureau /ˌɪnfəˈmeɪʃ(ə)n ˌbjʊərəʊ/ *noun* an office where someone can answer questions from members of the public

information officer /ˌɪnfəˈmeɪʃ(ə)n ˌɒfɪsə/ *noun* **1.** a person whose job is to give information about a company, an organisation or a government department to the public **2.** a person whose job is to give information to other departments in the same organization

informed /ɪnˈfɔːmd/ *adjective* having the latest information ○ *Informed opinion thinks that she will lose the appeal.*

informed consent /ɪnˌfɔːmd kən ˈsent/ *noun* an agreement that an operation can be carried out which is given by a patient or the guardians of a patient after they have been given all the information they need to make the decision

informer /ɪnˈfɔːmə/ *noun* somebody who gives information to the police about a crime or about criminals

infringe /ɪnˈfrɪndʒ/ *verb* to break a law or a right □ **to infringe a copyright** to copy a copyright text illegally □ **to infringe a patent** to make a product which works in the same way as a patented product and not pay a royalty to the patent holder

infringement /ɪnˈfrɪndʒmənt/ *noun* an act of breaking a law or a right

infringement of copyright /ɪn ˌfrɪndʒmənt əv ˈkɒpɪraɪt/ *noun* the act of illegally copying a work without proper permission or the consent of the copyright owner

infringement of patent /ɪn ˌfrɪndʒmənt əv ˈpeɪtənt/ *noun* the act of illegally using, making or selling an invention which is patented without the permission of the patent holder

infringer /ɪnˈfrɪndʒə/ *noun* a person who infringes a right such as a copyright ○ *a copyright infringer*

infringing goods /ɪnˌfrɪndʒɪŋ ˈgʊdz/ *plural noun* goods which are made in infringement of a copyright or patent

inherit /ɪnˈherɪt/ *verb* to acquire something from a person who has died ○ *When her father died she inherited the shop.* ○ *He inherited £10,000 from his grandfather.*

inheritance /ɪnˈherɪt(ə)ns/ *noun* property which is received by someone from a person who has died

inheritor /ɪnˈherɪtə/ *noun* somebody who receives something from somebody who has died

iniquity /ɪnˈɪkwɪti/ *noun* doing wrong

initial /ɪˈnɪʃ(ə)l/ *adjective* happening at the beginning of something ■ *verb* to write your initials on a document to show

mainp - softvnn.com

Law.fm Page 155 Friday, June 11, 2004 2:08 PM

you have read it and approved ○ *to initial an amendment to a contract* ○ *Please initial the agreement at the place marked with an X.*

initial capital /ɪˌnɪʃ(ə)l ˈkæpɪt(ə)l/ *noun* capital which is used to start a business ○ *He started the business with an initial expenditure* or *initial investment of £500.*

initials /ɪˈnɪʃ(ə)lz/ *plural noun* first letters of the words in a name ○ *What do the initials QC stand for?* ○ *The chairman wrote his initials by each alteration in the contract he was signing.*

initio ◗ **ab initio**

injunction /ɪnˈdʒʌŋkʃ(ə)n/ *noun* a court order telling someone to stop doing something, or not to do something ○ *He got an injunction preventing the company from selling his car.* ○ *The company applied for an injunction to stop their competitor from marketing a similar product.* □ **interlocutory injunction**, **temporary injunction** injunction which is granted until a case comes to court

injure /ˈɪndʒə/ *verb* to hurt someone ○ *Two employees were injured in the fire.*

injured party /ˌɪndʒəd ˈpɑːti/ *noun* a party in a court case which has been harmed by another party

injurious /ɪnˈdʒʊəriəs/ *adjective* being capable of causing injury

injurious falsehood /ɪnˌdʒʊəriəs ˈfɔːlshʊd/ *noun* a tort of making a wrong statement about someone so as to harm their reputation, usually in relation to their business or property

injury /ˈɪndʒəri/ *noun* **1.** violation of a person's rights **2.** hurt caused to a person

injury benefit /ˈɪndʒəri ˌbenɪfɪt/ *noun* money paid to an employee who has been hurt at work

injustice /ɪnˈdʒʌstɪs/ *noun* the lack of justice

inland freight charges /ˌɪnlənd ˈfreɪt ˌtʃɑːdʒɪz/ *plural noun* charges for carrying goods from one part of the country to another

Inland Revenue /ˌɪnlənd ˈrevənjuː/ *noun* the British government department dealing with income tax

in loco parentis /ˌɪn ˌləʊkəʊ pə ˈrentɪs/ *phrase* a Latin phrase meaning 'in the place of a parent' ○ *The court is acting in loco parentis.*

Inner Temple /ˌɪnə ˈtemp(ə)l/ ◗ **Inns of Court**

innocence /ˈɪnəs(ə)ns/ *noun* the state of being innocent ○ *He tried to establish his innocence.*

innocent /ˈɪnəs(ə)nt/ *adjective* not guilty of a crime ○ *The accused was found to be innocent.* ○ *In English law, the accused is presumed to be innocent until he is proved to be guilty.*

Inns of Court /ˌɪnz əv ˈkɔːt/ *plural noun* four societies in London, of which the members are lawyers and are called to the bar as barristers

innuendo /ˌɪnjuˈendəʊ/ *noun* spoken words which are defamatory because they have a double meaning ○ *An apparently innocent statement may be defamatory if it contains an innuendo.*

in personam /ɪn pɜːˈsəʊnæm/ *phrase* a Latin phrase meaning 'against a person' □ **action in personam** court case in which one party claims that the other should do some act or should pay damages. ◊ **in rem**

in private /ɪn ˈpraɪvət/ *adverb* **1.** with no members of the public permitted to be present ○ *The case was heard in private.* (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has replaced **in camera** or **in chambers**.) **2.** away from other people (*general meaning*) ○ *He asked to see the managing director in private.*

input tax /ˈɪnpʊt tæks/ *noun* VAT paid on goods or services bought

inquest /ˈɪŋkwest/ *noun* an inquiry by a coroner into a death

COMMENT: An inquest has to take place where death is violent or unexpected, where death could be murder or manslaughter, where a prisoner dies and when police are involved.

inquire /ɪnˈkwaɪə/**, enquire** *verb* **1.** to ask questions about something ○ *The police are inquiring into his background.* **2.** to conduct an official investigation into something

inquiry /ɪnˈkwaɪəri/**, enquiry** *noun* a question about something ○ *The police are making inquiries into the whereabouts of the stolen car.* □ **to help police**

mainp - softvnn.com

Law.fm Page 156 Friday, June 11, 2004 2:08 PM

with their inquiries to be taken to the police station for questioning

COMMENT: If the police want someone to help them with their inquiries and he refuses, they can arrest him and force him to go to the police station. Anyone who helps the police with their inquiries voluntarily has the right to leave the police station when he wants (unless the police arrest him).

inquisitorial procedure /ɪn ˌkwɪzɪtɔːriəl prəˈsiːdʒə/ *noun* in countries where Roman law is applied, a procedure by which an examining magistrate has the duty to investigate a case and produce the evidence. Compare **accusatorial procedure**

inquorate /ɪnˈkwɔːreɪt/ *adjective* without a quorum, i.e. without the minimum number of people present who are required to make the transaction legal ○ *The meeting was declared inquorate and had to be abandoned.*

in re /ɪn ˈreɪ/ *phrase* a Latin phrase meaning 'concerning' or 'in the case of'

in rem /ɪn ˈrem/ *phrase* a Latin phrase meaning 'against a thing' □ **action in rem** court case in which one party claims property or goods in the possession of the other. ◊ **in personam**

insane /ɪnˈseɪn/ *adjective* suffering from a state of mind which makes it impossible for a person to know that they are doing wrong and so cannot be held responsible for their actions

insanity /ɪnˈsænɪti/ *noun* the state of being insane

COMMENT: Where an accused is found to be insane, a verdict of 'not guilty by reason of insanity' is returned and the accused is ordered to be detained at Her Majesty's pleasure.

inside /ɪnˈsaɪd/ *adjective* known or carried out by people who belong to a particular group or organisation □ **inside information *or* knowledge** special knowledge about something because of working for an organisation or being part of a particular group ■ *adjective, adverb* in prison (*slang*) ○ *He spent six months inside in 1996.*

inside job /ˈɪnˌsaɪd dʒɒb/ *noun* a crime which has been committed on a company's property by one of the employees of the company

insider /ɪnˈsaɪdə/ *noun* a person who works in an organisation and therefore knows its secrets

insider dealing /ɪnˌsaɪdə ˈdiːlɪŋ/ *noun* the illegal buying or selling of shares by staff of a company or other persons who have secret information about the company's plans

inside story /ˌɪnsaɪd ˈstɔːri/ *noun* special knowledge about how an organisation or group works ○ *John used to work for them so he can give us the inside story.*

inside worker /ˈɪnsaɪd ˌwɜːkə/ *noun* a worker who works in an office or factory and does not work outside or travel about

insolvency /ɪnˈsɒlvənsi/ *noun* the state of not being able to pay debts □ **the company was in a state of insolvency** it could not pay its debts

insolvent /ɪnˈsɒlvənt/ *adjective* not able to pay debts ○ *The company was declared insolvent.* (NOTE: **insolvent** and **insolvency** are general terms, but are usually applied to companies; individuals or partners are usually described as **bankrupt** once they have been declared so by a court.)

inspect /ɪnˈspekt/ *verb* to examine in detail ○ *to inspect a machine* or *a prison* ○ *to inspect the accounts of a company* □ **to inspect products for defects** to look at products in detail to see if they have any defects

inspection /ɪnˈspekʃən/ *noun* **1.** a close examination of something, e.g. the examination of the site of a crime by a judge and jury ○ *to make an inspection* or *to carry out an inspection of a machine* or *a new prison* ○ *inspection of a product for defects* □ **to carry out a tour of inspection** to visit various places, offices or factories to inspect them □ **to issue an inspection order** to order a defendant to allow a claimant to inspect documents, where the claimant thinks the defendant has not disclosed all relevant documents **2.** the examination of documents after disclosure ○ *Inspection was ordered to take place seven days after disclosure.*

inspection stamp /ɪnˈspekʃən stæmp/ *noun* a stamp placed on something to show it has been inspected

mainp - softvnn.com

Law.fm Page 157 Friday, June 11, 2004 2:08 PM

inspector /ɪn'spektə/ *noun* **1.** an official who inspects □ **inspector of taxes**, **tax inspector** official of the Inland Revenue who examines tax returns and decides how much tax people should pay **2.** a rank in the police force above a sergeant and below chief inspector

Inspectorate of Prisons /ɪn ˌspekt(ə)rət əv 'prɪzənz/ *noun* a section of the Prison Service which deals with the inspection of prisons to see that they are being run correctly and efficiently

inspector of factories /ɪnˌspektər əv 'fækt(ə)riz/ *noun* a government official who inspects factories to see if they are safely run

inspector of weights and measures /ɪnˌspektər əv ˌweɪts ən 'meʒəz/ *noun* a government official who inspects weighing machines and goods sold in shops to see if the quantities and weights are correct

inst *abbreviation* instant

instance /'ɪnstəns/ *noun* **1.** a particular example or case ○ *In this instance we will overlook the delay.* **2.** ♦ **court of first instance**

in statu quo /ɪn ˌstætuː 'kwəʊ/ *phrase* a Latin phrase meaning 'in the present state'

institute /'ɪnstɪtjuːt/ *verb* to start something ○ *to institute proceedings against someone*

institution /ˌɪnstɪ'tjuːʃ(ə)n/ *noun* **1.** an organisation or society set up for a particular purpose □ **the Community institutions** (*in the EU*) the four bodies which legally form the European Community – the Commission, the Council, the European Parliament and the European Court of Justice **2.** building for a special purpose

institutional /ˌɪnstɪ'tjuːʃ(ə)n(ə)l/ *adjective* referring to an institution □ **institutional buying**, **selling** buying or selling shares by financial institutions

institutionalised /ˌɪnstɪ 'tjuːʃ(ə)nəlaɪzd/ *noun* **1.** unable to live independently after having been in prison, hospital or other institution for a long time **2.** happening so often that it is considered to be normal even though wrong or harmful ○ *institutionalised racism*

instruct /ɪn'strʌkt/ *verb* **1.** to give an order to someone □ **to instruct someone to do something** to tell someone officially to do something ○ *He instructed the credit controller to take action.* **2.** □ **to instruct a solicitor** to give information to a solicitor and to ask him to start legal proceedings on your behalf □ **to instruct a barrister** (*of a solicitor*) to give a barrister all the details of a case which he or she will plead in court

instructions /ɪn'strʌkʃənz/ *plural noun* **1.** order which tells what should be done or how something is to be used ○ *He gave instructions to his stockbroker to sell the shares immediately.* □ **to await instructions** to wait for someone to tell you what to do □ **to issue instructions** to tell everyone what to do □ **in accordance with**, **according to instructions** as the instructions show □ **failing instructions to the contrary** unless different instructions are given □ **forwarding instructions**, **shipping instructions** details of how goods are to be shipped and delivered **2.** the details of a case given by a client to a solicitor, or by a solicitor to a barrister

instructions to the jury /ɪn ˌstrʌkʃənz tə ðə 'dʒʊəri/ *noun US* a speech by a judge at the end of a trial where he or she reviews all the evidence and arguments and notes important points of law for the benefit of the jury (NOTE: The British term is **summing up**.)

instrument /'ɪnstrʊmənt/ *noun* **1.** a tool or piece of equipment ○ *The technical staff have instruments to measure the output of electricity.* **2.** a legal document

insulting behaviour /ɪnˌsʌltɪŋ bɪ 'heɪvjə/ *noun* the offence of shouting or making rude signs in a way which shows that you are insulting someone

insurable /ɪn'ʃʊərəb(ə)l/ *adjective* being able to be insured

insurable interest /ɪnˌʃʊərəb(ə)l 'ɪntrəst/ *noun* an interest which a person taking out an insurance policy must have in what is being insured

insurance /ɪn'ʃʊərəns/ *noun* an agreement that in return for regular small

mainp - softvnn.com

Law.fm Page 158 Friday, June 11, 2004 2:08 PM

payments, a company will pay compensation for loss, damage, injury or death ▫ **to take out an insurance against fire** to pay a premium, so that if a fire happens, compensation will be paid

insurance broker /ɪn'ʃʊərəns ˌbrəʊkə/ *noun* somebody who sells insurance to clients

insurance claim /ɪn'ʃʊərəns kleɪm/ *noun* a request to an insurance company to pay for damages or for loss

insurance company /ɪn'ʃʊərəns ˌkʌmp(ə)ni/ *noun* a company whose business is insurance

insurance cover /ɪn'ʃʊərəns ˌkʌvə/ *noun* protection guaranteed by an insurance policy ○ *Do you have cover against theft?*

insurance policy /ɪn'ʃʊərəns ˌpɒlɪsi/ *noun* a document which shows the conditions of an insurance contract

insurance premium /ɪn'ʃʊərəns ˌpriːmiəm/ *noun* a payment made by the insured person or a company to an insurance company

insurance rates /ɪn'ʃʊərəns reɪts/ *plural noun* amount of premium which has to be paid per £1,000 of insurance

insure /ɪn'ʃʊə/ *verb* to have a contract with a company where, if regular small payments are made, the company will pay compensation for loss, damage, injury or death ○ *to insure a house against fire* ○ *to insure baggage against loss* ○ *to insure against bad weather* ○ *to insure against loss of earnings* ○ *He was insured for £100,000.* ▫ **the life insured** the person whose life is covered by a life assurance ▫ **the sum insured** the largest amount which an insurer will pay under the terms of an insurance

insurer /ɪn'ʃʊərə/ *noun* a company which insures someone or something (NOTE: For life insurance, British English prefers to use **assurer**.)

intangible /ɪn'tændʒɪb(ə)l/ *adjective* being unable to be touched

intangible assets /ɪnˌtændʒɪb(ə)l 'æsets/ *plural noun* assets which have a value, but which have no physical presence, e.g. goodwill, a patent or a trademark

integrity /ɪn'tegrɪti/ *noun* the original state of something which has not been adapted or changed in any way ○ *The electronic signature confirms the integrity of the document.*

intellectual /ˌɪntɪ'lektʃuəl/ *adjective* belonging to the mind

intellectual property /ɪntɪˌlektjʊəl 'prɒpəti/ *noun* something such as a copyright, patent or design which someone has created or produced that no-one else can legally copy, use or sell

intellectual property rights /ɪntɪˌlektjʊəl 'prɒpəti ˌraɪts/ *plural noun* the rights of ownership of something such as a copyright, patent or design. Abbreviation **IPR**

intelligible /ɪn'telɪdʒɪb(ə)l/ *adjective* able to be easily understood ○ *A key is required to make an encrypted message intelligible.*

intend /ɪn'tend/ *verb* to plan to do something ○ *The company intends to sue for damages.* ○ *We intend to offer jobs to 250 unemployed young people.*

intended murder /ɪnˌtendɪd 'mɜːdə/ *noun US* murder which was planned in advance

intent /ɪn'tent/ *noun* what is planned

intention /ɪn'tenʃən/ *noun* **1.** the wish or plan to do something ○ *He was accused of perjury with the intention of incriminating his employer.* **2.** the belief that something will happen as the result of an action **3.** the meaning of the words in a document such as a will which may not be the same as what the maker of the document had actually written

COMMENT: Intention to create a legal relationship is one of the essential elements of a contract.

intentional /ɪn'tenʃən(ə)l/ *adjective* deliberate ○ *an act of intentional cruelty*

intentionally /ɪn'tenʃən(ə)li/ *adverb* deliberately ○ *She gave an intentionally misleading account of what happened.*

inter alia /ˌɪntə 'eɪliə/ *phrase* a Latin phrase meaning 'among other things'

inter-bank loan /ˌɪntə bæŋk 'ləʊn/ *noun* a loan from one bank to another

intercept /ˌɪntə'sept/ *verb* to stop something as it is passing ○ *We have in-*

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Law.fm Page 159 Friday, June 11, 2004 2:08 PM

tercepted a message from one of the enemy agents in London.

interception /ˌɪntəˈsepʃən/ *noun* the action of intercepting a message

inter-company comparisons /ɪnˌtɜːˌkʌmp(ə)ni kəmˈpærɪs(ə)nz/ *plural noun* comparing the results of one company with those of another in the same product area

inter-company dealings /ɪnˌtɜːˌkʌmp(ə)ni ˈdiːlɪŋz/ *plural noun* dealings between two companies in the same group

interdict /ˈɪntədɪkt/ *noun* (*in Scotland*) a ban, a written court order telling someone not to do something

interest /ˈɪntrəst/ *noun* **1.** special attention ○ *The managing director takes no interest in the staff club.* ○ *The police showed a lot of interest in the abandoned car.* ◊ **public interest 2.** a payment made by a borrower for the use of money, calculated as a percentage of the capital borrowed **3.** money paid as income on investments or loans ○ *to receive interest at 5%* ○ *deposit which yields* or *gives* or *produces* or *bears 5% interest* ○ *account which earns interest at 10%* or *which earns 10% interest* ○ *The bank pays 10% interest on deposits.* **4.** a percentage charge to be paid for borrowing money **5.** the right or title to a property, money invested in a company or financial share in, and part control over, a company ▫ **he has a controlling interest in the company** he owns more than 50% of the shares and so can direct how the company is run ▫ **to acquire a substantial interest in the company** to buy a large number of shares in a company ▫ **to declare, disclose an interest** to state in public that you own shares in a company which is being investigated, or that you are connected with someone who may benefit from your contacts ■ *verb* to attract someone's attention ○ *He tried to interest several companies in his new invention.* ▫ **interested in** paying attention to ○ *The managing director is interested only in increasing profitability.*

interest-bearing deposits /ˌɪntrəst ˌbeərɪŋ dɪˈpɒzɪts/ *plural noun* deposits which produce interest

interest charges /ˈɪntrəst ˌtʃɑːdʒɪz/ *plural noun* cost of paying interest

interested party /ˌɪntrestɪd ˈpɑːti/ *noun* a person or company with a financial interest in a company

interest-free credit /ˌɪntrəst friː ˈkredɪt/, **interest-free loan** /ˈɪntrəst friː ləʊn/ *noun* credit or a loan where no interest is paid by the borrower

interest in remainder /ˌɪntrəst ɪn rɪ ˈmeɪndə/ *noun* an interest in land which will come into someone's possession when another person's interest ends

interest rate /ˈɪntrəst reɪt/ *noun* a percentage charge to be paid for borrowing money

interfere /ˌɪntəˈfɪə/ *verb* to get involved with something which is not your concern

interference /ˌɪntəˈfɪərəns/ *noun* the process of deliberately getting involved with something that is not your concern ▫ **interference with vehicles** an offence where someone tries to break into a vehicle with the intention of stealing it, or part of it, or of stealing its contents

interfere with /ˌɪntəˈfɪə wɪð/ *verb* **1.** to act in a way that stops something happening or developing ○ *He was accused of interfering with the course of justice.* **2.** to use or try to use something that does not belong to you or to which you have no right, especially if damage is caused ○ *He had been seen interfering with the lock.* **3.** to persuade someone such as a witness or a juror to give false information or change their opinion **4.** to touch a child in a sexual way

interim /ˈɪntərɪm/ *adjective* intended to happen or be used only until something more permanent is available ▫ **in the interim** meanwhile, for the time being

interim dividend /ˌɪntərɪm ˈdɪvɪdend/ *noun* a dividend paid at the end of a half-year

interim injunction /ˌɪntərɪm ɪn ˈdʒʌŋkʃən/ *noun* an injunction which prevents someone from doing something until a specified date

interim order /ˌɪntərɪm ˈɔːdə/ *noun* an order given which has effect while a case is still being heard

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Law.fm Page 160 Friday, June 11, 2004 2:08 PM

interim payment /ˌɪntərɪm ˈpeɪmənt/ *noun* a part payment of a dividend or of money owed

interim relief /ˌɪntərɪm rɪˈliːf/ *noun* same as **interim remedy**

interim remedy /ˌɪntərɪm ˈremədi/ *noun* an action by a court to grant relief to a party while a claim is being processed, and even after judgment has been given

COMMENT: Interim remedies include interim injunctions, freezing injunctions, search orders, inspection of property, interim payments, etc.

interim report /ˌɪntərɪm rɪˈpɔːt/ *noun* **1.** a report (from a commission) which is not final **2.** a financial report given at the end of a half-year

interlocutory /ˌɪntəˈlɒkjʊt(ə)ri/ *adjective* **1.** temporary or provisional **2.** happening at a court hearing which takes place before full trial

interlocutory injunction /ˌɪntəlɒkjʊt(ə)ri ɪnˈdʒʌŋkʃ(ə)n/ *noun* an injunction which is granted for the period until a case comes to court

interlocutory judgment /ˌɪntəlɒkjʊt(ə)ri ˈdʒʌdʒmənt/ *noun* a judgment given during the course of an action before full trial. Compare **final judgment**

interlocutory matter /ˌɪntəlɒkjʊt(ə)ri ˈmætə/ *noun* a subsidiary dispute which is dealt with before full trial

interlocutory proceedings /ˌɪntəlɒkjʊt(ə)ri prəˈsiːdɪŋz/ *plural noun* court hearings that take place before the full trial

intermeddle /ˌɪntəˈmed(ə)l/ *verb* to deal in someone's affairs ○ *If an executor pays the debts of an estate, this can be considered intermeddling, and thus is acceptance of the office of executor.*

intermediary /ˌɪntəˈmiːdiəri/ *noun* somebody who is the link between parties who do not agree or who are negotiating ○ *He refused to act as an intermediary between the two directors.*

intern /ɪnˈtɜːn/ *verb* to put someone in prison or other place of detainment without trial, usually for political reasons

internal /ɪnˈtɜːn(ə)l/ *adjective* referring to the inside ▫ **internal affairs of a country** the way in which a country deals with its own citizens ○ *it is not usual for one country to criticize the internal affairs of another*

internal audit /ɪnˌtɜːn(ə)l ˈɔːdɪt/ *noun* an audit carried out by a department inside the company

internal auditor /ɪnˌtɜːn(ə)l ˈɔːdɪtə/ *noun* a member of staff who audits a company's accounts

international /ˌɪntəˈnæʃ(ə)nəl/ *adjective* working between countries

International Bar Association /ˌɪntənæʃ(ə)nəl ˈbɑː əˌsəʊsieɪʃ(ə)n/ *noun* an international lawyers' organisation formed to promote international law

International Court of Justice /ˌɪntənæʃ(ə)nəl ˌkɔːt əv ˈdʒʌstɪs/ *noun* the court of the United Nations, which sits in the Hague, Netherlands

International Labour Organization /ˌɪntənæʃ(ə)nəl ˈleɪbə ˌɔːgənaɪzeɪʃ(ə)n/ *noun* a section of the United Nations which tries to improve working conditions and workers' pay in member countries. Abbreviation **ILO**

international law /ˌɪntənæʃ(ə)nəl ˈlɔː/ *noun* law governing relations between countries

international lawyer /ˌɪntənæʃ(ə)nəl ˈlɔːjə/ *noun* a person who specialises in international law

international politics /ˌɪntənæʃ(ə)nəl ˈpɒlɪtɪks/ *plural noun* relationships between governments of different political parties and systems

internee /ˌɪntɜːˈniː/ *noun* somebody who is interned

internment /ɪnˈtɜːnmənt/ *noun* the act of being putting someone in prison or other place of detention without trial

inter partes /ˌɪntə ˈpɑːteɪz/ *phrase* a Latin phrase meaning 'between the parties': case heard where both parties are represented ○ *The court's opinion was that the case should be heard inter partes as soon as possible.* ◊ **ex parte**

interpleader /ˌɪntəˈpliːdə/ *noun* a court action started by a person who holds property which is claimed by two or more people, or by a person who may

mainp - softvnn.com

Law.fm Page 161 Friday, June 11, 2004 2:08 PM

be sued by two different parties (NOTE: Do not confuse with the US term **impleader**.)

Interpol /ˈɪntəpɒl/ *noun* an international police organisation whereby the member countries co-operate in solving crimes ○ *They warned Interpol that the criminals might be disguised as women.* (NOTE: used without **the**)

interpret /ɪnˈtɜːprɪt/ *verb* **1.** to say what you think a law or precedent means ○ *The role of the ECJ is to interpret a law, while the role of the national court is to apply it.* ○ *Courts in Member States cannot give authoritative rulings on how community law should be interpreted.* **2.** to translate what someone has said into another language ○ *My assistant knows Greek, so he will interpret for us.*

interpretation /ɪnˌtɜːprɪˈteɪʃ(ə)n/ *noun* what someone thinks is the meaning of a law or precedent ○ *Interpretation of the Treaty has been entrusted to the European Court of Justice.* □ **to put an interpretation on something** to make something have a different meaning ○ *His ruling puts quite a different interpretation on the responsibility of trustees.*

Interpretation Act /ɪnˌtɜːprɪˈteɪʃ(ə)n ækt/ *noun* an Act of Parliament which rules how words used in other Acts of Parliament are to be understood

interpretation clause /ɪnˌtɜːprɪˈteɪʃ(ə)n klɔːz/ *noun* a clause in a contract stating the meaning to be given to terms in the contract

interpreter /ɪnˈtɜːprɪtə/ *noun* somebody who translates what someone has said into another language ○ *My secretary will act as interpreter.* ○ *The witness could not speak English and the court had to appoint an interpreter.*

interpretive /ɪnˈtɜːrprɪtɪv/ *adjective* (*in the EU*) referring to interpretation ○ *There is an interpretive obligation on Member States to interpret national laws in a way which accords with the aims and objectives of the directives of the EU.*

interregnum /ˌɪntəˈregnəm/ *noun* **1.** a period between the death or deposition of one monarch and the accession of the next **2.** a period during which no-one is at the head of an organisation or area until a new leader is appointed

interrogate /ɪnˈterəgeɪt/ *verb* to ask questions in a severe manner ○ *The prisoners were interrogated for three hours.*

interrogation /ɪnˌterəˈgeɪʃ(ə)n/ *noun* severe questioning ○ *He confessed to the crime during his interrogation.* ○ *Under interrogation, she gave the names of her accomplices.*

interrogator /ɪnˈterəgeɪtə/ *noun* somebody who interrogates

interrogatories /ˌɪntəˈrɒgət(ə)riz/ *plural noun* questions put in writing during a civil action by one side to the other and which have to be answered on oath (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has been replaced by **further information**.)

in terrorem /ɪn teˈrɔːrem/ *phrase* a Latin phrase meaning 'in order to cause terror': used when a threat is implied in a contract in which case the contract is invalid

interrupt /ˌɪntəˈrʌpt/ *verb* to try to speak or to shout when someone else is talking

COMMENT: In the House of Commons, an MP is allowed to interrupt another MP only if he wants to ask the member who is speaking to explain something or to raise a point of order.

intervene /ˌɪntəˈviːn/ *verb* **1.** to come between people or things so as to make a change □ **to intervene in a dispute** to try to settle a dispute **2.** to become a party to an action

intervener /ˌɪntəˈviːnə/ *noun* somebody who intervenes in an action to which he or she was not originally a party

intervention /ˌɪntəˈvenʃən/ *noun* an act made to make a change ○ *the government's intervention in the foreign exchange markets* ○ *the central bank's intervention in the banking crisis* ○ *the Association's intervention in the labour dispute*

interview /ˈɪntəvjuː/ *noun* a meeting between a suspect and one or more police officers, who ask him or her questions

mainp - softvnn.com

Law.fm Page 162 Friday, June 11, 2004 2:08 PM

COMMENT: Suspects must be cautioned before an interview takes place. The interview should be recorded and the record must be shown to the suspect at the end of the interview. If there is any possibility that the police have threatened the suspect so as to get a confession, that confession will not be admitted in court.

interview room /'ɪntəvjuː ruːm/ *noun* a room where a person is asked questions or is interviewed

inter vivos /ˌɪntə 'viːvəʊs/ *phrase* a Latin phrase meaning 'among living people'

COMMENT: An inter vivos transfer of property can be used as a way of passing property to someone without using a will; it does not necessarily take effect when someone dies, but can be put into effect as soon as it is signed.

intestacy /ɪn'testəsi/ *noun* dying without having made a will

intestate /ɪn'testeɪt/ *adjective* □ **to die intestate** to die without having made a will

COMMENT: When someone dies intestate, the property automatically goes to the surviving marital partner, unless there are children.

intestate succession /ɪnˌtestət sək'seʃ(ə)n/ *noun* the rules which apply when someone dies without having made a will

intimidate /ɪn'tɪmɪdeɪt/ *verb* to frighten someone to make him do something or to prevent him from doing something ○ *The accused was said to have intimidated the witnesses.*

intimidation /ɪnˌtɪmɪ'deɪʃ(ə)n/ *noun* the act of frightening someone to make them do something or to prevent them from doing something

intoxicated /ɪn'tɒksɪkeɪtɪd/ *adjective* showing the effects of having drunk alcohol

intoxication /ɪnˌtɒksɪ'keɪʃ(ə)n/ *noun* the state of being drunk

in transit /ɪn 'trænzɪt/ *adverb* □ **goods in transit** goods being carried from one place to another

intra vires /ˌɪntrə 'vaɪriːz/ *phrase* a Latin phrase meaning 'within the permitted powers' ○ *The minister's action was ruled to be intra vires.* ◊ **ultra vires**

intrinsic evidence /ɪnˌtrɪnsɪk 'evɪd(ə)ns/ *noun* evidence used to interpret a document which can be found in the document itself. Compare **extrinsic evidence**

invalid /'ɪnvəlɪd/ *adjective* **1.** not legally effective ○ *a claim which has been declared invalid* ○ *The permit is out-of-date and therefore invalid.* ○ *National courts cannot find EU legislation to be invalid.* **2.** not based on the facts that are known ○ *an invalid argument*

invalidate /ɪn'vælɪdeɪt/ *verb* to make something invalid ○ *Because the company has been taken over, the contract has been invalidated.*

invalidation /ɪnˌvælɪ'deɪʃən/ *noun* the act of making something invalid

invalidity /ˌɪnvə'lɪdɪti/ *noun* the fact of being invalid ○ *The invalidity of the contract.*

invasion of privacy /ɪnˌveɪʒ(ə)n əv 'prɪvəsi/ *noun* action which causes disturbance to someone's private life, e.g. being followed intrusively by newspaper reporters

inventory /'ɪnvənt(ə)ri/ *noun* a complete list of all the things occurring in something such as a house for sale, an office for rent, or the estate of a deceased person ■ *verb* to make a list of the contents of a property

invest /ɪn'vest/ *verb* to put money into something such as a bank or a company where it is expected to increase in value ○ *He invested all his money in a shop.* ○ *She was advised to invest in real estate.*

investigate /ɪn'vestɪˌgeɪt/ *verb* to examine something which may be wrong

investigation /ɪnˌvestɪ'geɪʃ(ə)n/ *noun* an examination to find out what is wrong ○ *to conduct an investigation into irregularities in share dealings*

investigator /ɪn'vestɪgeɪtə/ *noun* somebody who investigates ○ *a government investigator*

investor /ɪn'vestə/ *noun* a person or company which invests money

invitee /ˌɪnvaɪ'tiː/ *noun* somebody who has accepted an invitation to go into a property

mainp - softvnn.com

Law.fm Page 163 Friday, June 11, 2004 2:08 PM

involuntarily /ɪn'vɒlənt(ə)rəlɪ/ *adverb* not willingly ○ *The accused's defence was that she acted involuntarily.*

involuntary /ɪn'vɒlənt(ə)ri/ *adjective* **1.** not done willingly **2.** without wanting to

involuntary conduct /ɪn ˌvɒlənt(ə)ri kən'dʌkt/ *noun* conduct beyond a person's control, offered as a defence to a criminal charge

involuntary manslaughter /ɪn ˌvɒlənt(ə)ri 'mænslɔːtə/ *noun* the killing someone through negligence, without having intended to do so

IOU /ˌaɪ əʊ 'juː/ *noun* a signed document promising that you will pay back money borrowed ○ *to pay a pile of IOUs* Full form **I owe you**

IPR *abbreviation* intellectual property rights

ipso facto /ˌɪpsəʊ 'fæktəʊ/ *phrase* a Latin phrase meaning 'by this very fact' or 'the fact itself shows' ○ *The writing of the letter was ipso facto an admission of guilt.* ○ *He was found in the vehicle at the time of the accident and ipso facto was deemed to be in charge of it.*

ipso jure /ˌɪpsəʊ 'dʒʊəreɪ/ *phrase* a Latin phrase meaning 'by the operation of the law itself'

irreconcilable /ɪˌrekən'saɪləb(ə)l/ *adjective* so opposed that agreement is not possible □ **irreconcilable differences** strong disagreement between a husband and wife which leads to divorce

irrecoverable /ˌɪrɪ'kʌv(ə)rəb(ə)l/ *adjective* being impossible to get back

irrecoverable debt /ɪrɪ ˌkʌv(ə)rəb(ə)l 'det/ *noun* a debt which will never be paid

irredeemable /ɪrɪ'diːməb(ə)l/ *adjective* being impossible to redeem

irredeemable bond /ɪrɪˌdiːməb(ə)l 'bɒnd/ *noun* a bond which has no date of maturity and which therefore provides interest but can never be redeemed at full value

irredentism /ˌɪrɪ'dentɪz(ə)m/ *noun* the act of trying to get back a colony or territory which has been lost to another country or which is felt to belong to the country because of similar language, culture, etc.

irredentist /ˌɪrɪ'dentɪst/ *noun* somebody who wants a territory returned

irregular /ɪ'regjʊlə/ *adjective* not following the usual rules, or not done in the way regarded as being correct ○ *irregular documentation* ○ *This procedure is highly irregular.*

irregularity /ɪˌregjʊ'lærɪti/ *noun* a situation in which the usual rules or ways of doing something have not been followed (*often plural*) ○ *to investigate irregularities in the share dealings*

irrelevant /ɪ'reləvənt/ *adjective* not relevant or important to what is being considered

irresistible impulse /ˌɪrɪzɪstəb(ə)l 'ɪmpʌls/ *noun* a strong wish to do something which you cannot resist because of insanity

irretrievable /ˌɪrɪ'triːvəb(ə)l/ *adjective* which cannot be brought back to its former state □ **irretrievable breakdown of a marriage** situation where the two spouses can no longer live together, where the marriage cannot be saved and therefore divorce proceedings can be started

irrevocable /ɪ'revəkəb(ə)l/ *adjective* being impossible to change

irrevocable acceptance /ɪ ˌrevəkəb(ə)l ək'septəns/ *noun* an acceptance which cannot be withdrawn

irrevocable letter of credit /ɪ ˌrevəkəb(ə)l ˌletər əv 'kredɪt/ *noun* a letter of credit which cannot be cancelled or changed

IRS *abbreviation US* Internal Revenue Service

Islamic Law /ɪz'læmɪk lɔː/ *noun* the law of some Muslim countries set out in the Koran and the teachings of the prophet Muhammad. The law cannot be changed, but it can be interpreted in different ways.

isolation /ˌaɪsə'leɪʃ(ə)n/ *noun* **1.** the state of being separated from other people **2.** □ **in isolation** kept on your own away from other people ○ *He had been kept in isolation for several weeks.*

isolationist /ˌaɪsə'leɪʃ(ə)nɪst/ *noun* somebody who believes that his or her country should not get involved in the af-

mainp - softvnn.com

Law.fm Page 164 Friday, June 11, 2004 2:08 PM

fairs of other countries, especially should not fight wars to protect other countries

issuance /ˈɪʃuəns/ *noun* the act of issuing ○ *Upon issuance of the order, the bailiffs seized the property.*

issue /ˈɪʃuː/ *noun* **1.** a subject that is discussed or argued about ○ *safety issues* ◊ **collateral issue** □ **at issue** under discussion as the most important aspect of a subject ○ *The point at issue is the ownership of the property.* □ **to have issues with *or* around something** to disagree or have problems with something (*informal*) ○ *I have issues around the idea of completely free access.* □ **to make an issue of something** to treat something as more important than it is ○ *I don't want to make an issue of it, but I thought her information could have been more detailed.* □ **to take issue with someone *or* over something** to disagree with someone or about something ○ *I have to take issue with you over the handling of the case.* ○ *Barristers took issue over the proposals to change the system.* **2.** a child or children of a parent ○ *He had issue two sons and one daughter.* ○ *She died without issue.* ○ *They have no issue.* (NOTE: In this meaning issue is either singular or plural and is not used with **the**.) **3.** the act of giving something to someone or making something available ○ *The issue of new parking permits is expected soon.* □ **issue of new shares**, **share issue** selling new shares in a company to the public ■ *verb* to announce or give something officially ○ *to issue a letter of credit* ○ *to issue shares in a new company* ○ *to issue a writ against someone* ○ *The government issued a report on London's traffic.* ○ *The Secretary of State issued guidelines for expenditure.* ○ *He issued writs for libel in connection with allegations made in a Sunday newspaper.*

issued capital /ˌɪʃuːd ˈkæpɪt(ə)l/ *noun* the amount of capital which is given out as shares to shareholders

issued price /ˌɪʃuːd ˈpraɪs/ *noun* the price of shares in a new company when they are offered for sale for the first time

issuing bank /ˈɪʃuɪŋ bæŋk/ *noun* a bank which organises the selling of shares in a new company

itemise /ˈaɪtəmaɪz/, **itemize** *verb* to make a detailed list of things ○ *itemising the sales figures will take about two days.*

itemised account /ˌaɪtəmaɪzd ə ˈkaʊnt/ *noun* a detailed record of money paid or owed

item of expenditure /ˌaɪtəm əv ɪk ˈspendɪtʃə/ *noun* something such as goods or a service which has been paid for and appears in the accounts

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J

J /dʒeɪ/ *abbreviation* Justice ○ *Smith J said he was not laying down guidelines for sentencing.* (NOTE: often put after the name of a High Court judge: **Smith J** is spoken as 'Mr Justice Smith')

jactitation /ˌdʒæktɪˈteɪʃ(ə)n/ *noun* the act of boasting that something is true when it is not

jactitation of marriage /ˌdʒæktɪteɪʃ(ə)n əv ˈmærɪdʒ/ *noun* the act of boasting that you are married to someone when you are not

jail /dʒeɪl/ *noun* a place where criminals are kept before trial or after they have been convicted ○ *He spent ten years in jail.* ■ *verb* to put someone in prison ○ *She was jailed for three years.* ○ *He was jailed for manslaughter.* (NOTE: also spelled **gaol** in British English)

jailbird /ˈdʒeɪlbɜːd/ *noun* somebody who is in prison or who has often been sent to prison

jailbreak /ˈdʒeɪlbreɪk/ *noun* escape from prison

jailer /ˈdʒeɪlə/ *noun* somebody who works in a jail or who is in charge of a jail

jaywalker /ˈdʒeɪwɔːkə/ *noun* somebody who walks across a street at a place which is not a proper crossing place

jaywalking /ˈdʒeɪwɔːkɪŋ/ *noun* the offence of walking across a street at a place which is not a proper crossing point for pedestrians

jeopardise /ˈdʒepədaɪz/, **jeopardize** *verb* to be likely to harm ○ *Her arrest for drunken driving may jeopardise her work as a doctor specialising in child care.*

jeopardy /ˈdʒepədi/ *noun* □ **to be in jeopardy** to be in danger of punishment or of harm □ **his driving licence is in jeopardy** he may lose his driving licence. ◊ **double jeopardy**

Job Centre /ˈdʒɒb ˌsentə/ *noun* a government office which lists and helps to fill jobs which are vacant

job evaluation /ˈdʒɒb ɪvælju ˌeɪʃ(ə)n/ *noun* the assessment of different jobs within an organisation to see what skills and qualifications are needed to carry them out, with a view to establishing appropriate salaries

job openings /ˈdʒɒb ˌəʊp(ə)nɪŋz/ *plural noun* jobs which are empty and need filling

John Doe /ˌdʒɒn ˈdəʊ/ *noun* a name used as an example in fictitious cases

join /dʒɔɪn/ *verb* □ **to join someone to an action** to attach someone's name as one of the parties to an action

joinder /ˈdʒɔɪndə/ *noun* the act of bringing together several actions or several parties in one action. ◊ **misjoinder, nonjoinder**

joint /dʒɔɪnt/ *adjective* **1.** with two or more organisations or people linked together **2.** of two or more people who work together or who are linked ○ *joint beneficiary* ○ *joint managing director* ○ *joint owner* ○ *joint signatory* ■ *noun* a place or building (*slang*) □ **to case a joint** to look at a building carefully before deciding how to break into it

joint account /ˈdʒɔɪnt əˌkaʊnt/ *noun* a bank account for two people

joint and several /ˌdʒɔɪnt ən ˈsev(ə)rəl/ *adjective* as a group together and also separately

joint and several liability /ˌdʒɔɪnt ən ˌsev(ə)rəl ˌlaɪəˈbɪlɪti/ *noun* a situation where two or more parties share a single liability, and each party is also liable for the whole claim

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Law.fm Page 166 Friday, June 11, 2004 2:08 PM

joint commission of inquiry /dʒɔɪnt kəˌmɪʃ(ə)n əv ɪnˈkwaɪəri/, **joint committee** /ˌdʒɔɪnt kəˈmɪti/ *noun* a commission or committee with representatives of various organisations on it

joint committee /ˌdʒɔɪnt kəˈmɪti/ *noun* a committee formed of equal numbers of members of the House of Commons and House of Lords

joint discussions /ˌdʒɔɪnt dɪ ˈskʌʃ(ə)nz/ *plural noun* discussions between employers and employees before something is done

joint heir /ˌdʒɔɪnt ˈeə/ *noun* somebody who is an heir with someone else

joint liability /dʒɔɪnt ˌlaɪəˈbɪlɪti/ *noun* a situation where two or more parties share a single liability

jointly /ˈdʒɔɪntli/ *adverb* together with one or more other people ○ *to own a property jointly* ○ *to manage a company jointly* ○ *They are jointly liable for damages.* □ **jointly and severally liable** liable both as a group and as individuals

joint management /ˌdʒɔɪnt ˈmænɪdʒmənt/ *noun* management by two or more people

joint ownership /ˌdʒɔɪnt ˈəʊnəʃɪp/ *noun* a situation where two or more persons own the same property

joint-stock bank /ˌdʒɔɪnt ˈstɒk ˌbæŋk/ *noun* a bank which is a public company quoted on the Stock Exchange

joint-stock company /ˈdʒɔɪnt stɒk ˌkʌmp(ə)ni/ *noun* a company whose shares are held by many people

joint tenancy /ˌdʒɔɪnt ˈtenənsi/ *noun* a situation where two or more persons acquire an interest in a property together, where if one of the joint tenants dies, his or her share goes to those surviving. ◊ **tenancy in common**

joint tortfeasors /ˌdʒɔɪnt tɔːt ˈfiːzəz/ *plural noun* two or more people who are responsible and liable for a tort

jointure /ˈdʒɔɪntʃə/ *noun* the estate settled on a wife as part of the marriage settlement

joint venture /ˌdʒɔɪnt ˈventʃə/ *noun* a very large business partnership where two or more companies join together as partners for a limited period

joy riding /ˈdʒɔɪ ˌraɪdɪŋ/ *noun* the offence of taking a car without the permission of the owner and using it to drive about

JP *abbreviation* justice of the peace (NOTE: The plural is **JPs**.)

judge /dʒʌdʒ/ *noun* **1.** an official who presides over a court and in civil cases decides which party is in the right ○ *a County Court judge* ○ *a judge in the Divorce Court* ○ *The judge sent him to prison for embezzlement.* (NOTE: In the UK it is planned to transfer the appointment of judges to a Judicial Appointments Board.) **2.** one of the fifteen members of the European Court of Justice, appointed by the Member States ■ *verb* to decide ○ *He judged it was time to call an end to the discussions.*

COMMENT: In England, judges are appointed by the Lord Chancellor. The minimum requirement is that one should be a barrister or solicitor of ten years' standing. The majority of judges are barristers, but they cannot practise as barristers. Recorders are practising barristers who act as judges on a part-time basis. The appointment of judges is not a political appointment, and judges remain in office unless they are found guilty of gross misconduct. Judges cannot be Members of Parliament. In the USA, state judges can be appointed by the state governor or can be elected; in the federal courts and the Supreme Court, judges are appointed by the President, but the appointment has to be approved by Congress.

Judge Advocate-General /dʒʌdʒ ˌædvəkət ˈdʒen(ə)rəl/ *noun* a lawyer appointed by the state to advise on all legal matters concerning the army

Judge Advocate-General of the Forces /ˌdʒʌdʒ ˌædvəkət ˌdʒen(ə)rəl əv ðə ˈfɔːsɪz/ *noun* a lawyer appointed by the state to advise on all legal matters concerning the Army and Air Force

Judge Advocate of the Fleet /ˌdʒʌdʒ ˌædvəkət əv ðə ˈfliːt/ *noun* a lawyer appointed by the state to advise on all legal matters concerning the Royal Navy

judge in chambers /ˌdʒʌdʒ ɪn ˈtʃeɪmbəz/ *noun* a judge who hears a case in private rooms without the public being present and not in open court

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Law.fm Page 167 Friday, June 11, 2004 2:08 PM

Judges' Rules /ˌdʒʌdʒɪz ˈruːlz/ *noun* an informal set of rules governing how the police may question a suspect

judgment /ˈdʒʌdʒmənt/**, judgement** *noun* an official decision of a court □ **to pronounce judgment**, **to give one's judgment on something** to give an official or legal decision about something □ **to enter judgement**, **to take judgment** to record an official judgment on a case □ **to enter judgment for the claimant** to make a legal judgment that the claimant's claim is accepted □ **to enter judgment against the claimant** to make a legal judgment that the claimant's claim is not accepted □ **the claimant entered judgment in default** the claimant took judgment (because the defendant failed to defend the case)

judgment by default /ˌdʒʌdʒmənt baɪ dɪˈfɔːlt/ *noun US* a judgment without trial against a defendant who fails to respond to a claim

judgment creditor /ˌdʒʌdʒmənt ˈkredɪtə/ *noun* somebody who has been given a court order making a debtor pay a debt

judgment debtor /ˈdʒʌdʒmənt ˌdetə/ *noun* somebody who has been ordered by a court to pay a debt

judgment summons /ˌdʒʌdʒmənt ˈsʌmənz/ *noun* a summons by a court to enforce a court order, such as ordering a judgment debtor to pay or to go to prison (NOTE: The spelling **judgment** is used by lawyers.)

judicata ◗ **res judicata**

judicature /ˈdʒuːdɪkətʃə/ *noun* administration of justice □ **judicature paper** thick heavy paper on which court documents are engrossed. ◊ **Supreme Court**

judice ◗ **sub judice**

judicial /dʒuːˈdɪʃ(ə)l/ *adjective* **1.** referring to a judge or the law □ **the Judicial Committee of the House of Lords** the highest appeal court in England and Wales **2.** done in a court or by a judge

Judicial Committee of the House of Lords /dʒuːˌdɪʃ(ə)l kəˈmɪti əv ðiː haʊz lɔːds/ *noun* the highest court of appeal in both civil and criminal cases in England and Wales

Judicial Committee of the Privy Council /dʒuːˌdɪʃ(ə)l kəˌmɪti əv ðə ˌprɪvi ˈkaʊns(ə)l/ *noun* the appeal court for appeals from courts outside the UK, such as the courts of some Commonwealth countries

judicial immunity /dʒuːˌdɪʃ(ə)l ɪ ˈmjuːnɪti/ *noun* a safety from prosecution granted to judges when acting in a judicial capacity

judicial notice /dʒuːˌdɪʃ(ə)l ˈnəʊtɪs/ *noun* facts and matters which a judge is presumed to know, so that evidence does not have to be produced to prove them, such as that New Year's Day is January 1st or that a small baby is not capable of walking

judicial precedent /dʒuːˌdɪʃ(ə)l ˈpresɪd(ə)nt/ *noun* a precedent set by a court decision, which can be reversed only by a higher court

judicial processes /dʒuːˌdɪʃ(ə)l ˈprəʊsesɪz/ *plural noun* the ways in which the law works

judicial review /dʒuːˌdɪʃ(ə)l rɪˈvjuː/ *noun* a review by a higher court of the actions of a lower court or of an administrative body

judicial separation /dʒuːˌdɪʃ(ə)l ˌsepəˈreɪʃ(ə)n/ *noun* a decree of a court acknowledging the separation of a married couple, but neither person is allowed to marry again because they are not divorced. Also called **legal separation**

judiciary /ˈdʒʊˈdɪʃəri/ *noun* □ **the judiciary** all judges, the court system, the judicial power in general

jump /dʒʌmp/ ◗ **bail**

junior /ˈdʒuːniə/ *adjective* younger or lower in rank □ **John Smith, Junior** the younger John Smith (i.e. the son of John Smith, Senior) ■ *noun* **1.** a barrister who is not a Queen's Counsel **2.** a barrister appearing with a leader ▸ also called **junior barrister**

junior clerk /ˌdʒuːniə ˈklɑːk/ *noun* a clerk, usually young person, who has lower status than a senior clerk

junior executive /ˌdʒuːniə ɪg ˈzekjʊtɪv/ *noun* a less important manager in a company

mainp - softvnn.com

Law.fm Page 168 Friday, June 11, 2004 2:08 PM

junior partner /ˌdʒuːniə ˈpɑːtnə/ *noun* somebody who has a small part of the shares in a partnership

jurat /ˈdʒʊərət/ *noun* words at the end of an affidavit, showing the details of when and by whom it was sworn

juridical /dʒʊˈrɪdɪk(ə)l/ *adjective* referring to the law or to judges

jurisdiction /ˌdʒʊərɪsˈdɪkʃən/ *noun* legal power over someone or something □ **within the jurisdiction of the court** in the legal power of a court □ **outside the jurisdiction of the court** not covered by the legal power of the court □ **the prisoner refused to recognize the jurisdiction of the court** the prisoner said that he or she did not believe that the court had the legal right to try them

jurisdictional /ˌdʒʊərɪsˈdɪkʃənəl/ *adjective* referring to court's jurisdiction

jurisprudence /ˌdʒʊərɪsˈpruːdəns/ *noun* the study of the law and the legal system

jurist /ˈdʒʊərɪst/ *noun* a person who has specialised in the study and practice of law

juristic /ˌdʒʊəˈrɪstɪk/ *adjective* according to the practice of law

juror /ˈdʒʊərə/ *noun* a member of a jury

COMMENT: Jurors can be selected from registered electors who are between eighteen and sixty-five years old and who have been resident in the UK for five years. Barristers, solicitors, judges, priests, doctors, Members of Parliament, people who are insane are among the categories of people disqualified from being jurors.

jury /ˈdʒʊəri/ *noun* a group of twelve citizens who are sworn to decide whether someone is guilty or not guilty on the basis of the evidence they hear in court □ **he has been called for jury service**, **for jury duty** *US* he has been asked to do his duty as a citizen and serve on a jury □ **'Members of the jury'** way of speaking to a jury in court □ **the foreman of the jury** the chief juror, elected by the other jurors, who chairs the discussions of the jury and pronounces the verdict in court afterwards

COMMENT: Juries are used in criminal cases, and in some civil actions, notably actions for libel. They are also used in some coroner's inquests. The role of the jury is use their common sense to decide if the verdict should be for or against the accused. Jurors have no knowledge of the law and follow the explanations given to them by the judge. Anyone whose name appears on the electoral register and who is between the ages of 18 and 70 is eligible for jury service. Judges, magistrates, barristers and solicitors are not eligible for jury service, nor are priests, people who are on bail, and people suffering from mental illness. People who are excused jury service include members of the armed forces, Members of Parliament and doctors. Potential jurors can be challenged if one of the parties to the case thinks they are or may be biased.

jury box /ˈdʒʊəri bɒks/ *noun* a place where the jury sit in the courtroom

juryman /ˈdʒʊərimən/ *noun* a member of a jury (NOTE: The plural is **jurymen**.)

jury room /ˈdʒʊəri ruːm/ *noun* a room where a jury meet to discuss the trial and reach a verdict

jury service /ˈdʒʊəri ˌsɜːvɪs/ *noun* the duty which each citizen has of serving on a jury if asked to do so

jury vetting /ˌdʒʊəri ˈvetɪŋ/ *noun* the examination of each of the proposed members of a jury to see if he or she is qualified to be a juror

jus /dʒʌs/ *noun* a Latin word meaning 'law' or 'right'

jus accrescendi /ˌdʒʌs ˌækreˈsendi/ ◗ **survivorship**

just /dʒʌst/ *adjective* fair or right □ **to show just cause** to show a reason which is fair and acceptable in law □ **just war** war which is considered to be morally right

justice /ˈdʒʌstɪs/ *noun* **1.** fair treatment under the law □ **to administer justice** to provide justice □ **to bring a criminal to justice** to find a criminal and charge him with an offence **2.** a magistrate **3.** a judge **4.** the title given to a High Court judge ○ *Mr Justice Adams*

justice of the peace /ˌdʒʌstɪs əv ðə ˈpiːs/ *noun* a magistrate or local judge. Abbreviation **JP**

justices' chief executive /ˌdʒʌstɪsɪz ˌtʃiːf ɪgˈzekjʊtɪv/ *noun* a senior administrator appointed by a mag-

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Law.fm Page 169 Friday, June 11, 2004 2:08 PM

istrates' courts committee to run the courts in an area, but not to give legal advice

justices' clerk /ˌdʒʌstɪsɪz 'clɑːk/ *noun* an official of a magistrates' court who gives advice to the justices on law, practice or procedure; he or she reports to the justices' chief executive of their area

justiciable /dʒʌs'tɪʃəb(ə)l/ *adjective* referring to a legal principle which can be subject to laws ○ *Some people question whether subsidiarity is justiciable.*

justiciary /dʒʌs'tɪʃəri/ *noun* all judges

justifiable /'dʒʌstɪfaɪəb(ə)l/ *adjective* excusable

justifiable homicide /ˌdʒʌstɪfaɪəb(ə)l 'hɒmɪsaɪd/ *noun* the act of killing a person for an acceptable reason such as self-defence

justification /ˌdʒʌstɪfɪ'keɪʃ(ə)n/ *noun* an acceptable reason for doing something □ **in justification** as an acceptable excuse for something ○ *In justification, the accused claimed that the burglar had attacked him with an axe.* ○ *He wrote a letter in justification of his decision.* ○ *The defendant entered defence of justification.* □ **with some justification** having a good reason for something ○ *She claimed, with some justification, that she could not have known about the change as the letter had gone to the wrong address.*

justify /'dʒʌstɪˌfaɪ/ *verb* to give an excuse for □ **the end justifies the means** if the result is right, the means used to reach it are acceptable

justitia ➧ **fiat justitia**

juvenile /'dʒuːvənaɪl/ *noun*, *adjective* a young person under seventeen years of age

Juvenile Court /'dʒuːvəˌnaɪl kɔːt/ *noun* a court which tries young offenders ○ *The appeal court quashed the care order made by the juvenile court.* (NOTE: The **Juvenile Court** is now called the **Youth Court**.)

juvenile delinquent /ˌdʒuːvənaɪl dɪ 'lɪŋkwənt/ *noun* a young criminal who commits minor crimes, especially against property

juvenile offender /ˌdʒuːvənaɪl ə 'fendə/ *noun* the former term for a young person tried in a Juvenile Court (NOTE: Now replaced by **young offender**.)

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K

kangaroo court /ˌkæŋgəˈruː kɔːt/ *noun* an unofficial and illegal court set up by a group of people

KC *abbreviation* King's Counsel

keeper /ˈkiːpə/ *noun* somebody who keeps something

Keeper of the Great Seal /ˌkiːpər əv ðiː ˌɡreɪt ˈsiːl/ *noun* the Lord Chancellor

Keogh plan /ˈkiːəʊ ˌplæn/ *noun US* a private pension programme which allows self-employed businessmen and professionals to set up pension plans for themselves

kerb crawling /ˌkɜːb ˈkrɔːlɪŋ/ *noun* driving slowly in order to importune women standing on the pavement

key money /ˈkiː ˌmʌni/ *noun* a premium paid when taking over the keys of a flat or office which you are renting

kickback /ˈkɪkbæk/ *noun* an illegal commission paid to someone, especially a government official, who helps in a business deal

kidnap /ˈkɪdnæp/ *verb* to take away someone and keep them somewhere against their will, usually asking for money to be paid or conditions to be met before they can be released

kidnapper /ˈkɪdnæpə/ *noun* somebody who kidnaps someone

kidnapping /ˈkɪdnæpɪŋ/ *noun* the notifiable offence of taking away a person by force

kill /kɪl/ *verb* to make someone die ○ *He was accused of killing his girlfriend with a knife.*

killer /ˈkɪlə/ *noun* somebody who kills ○ *The police are searching for the girl's killer.*

kin /kɪn/ *plural noun* relatives or close members of the family. ◊ **next of kin**

King's Counsel /ˌkɪŋz ˈkaʊnsəl/ *noun* abbreviation **KC**. ◆ **Queen's Counsel** (NOTE: There is no plural for **counsel** which is always used in the singular whether it refers to one barrister or several, and it is never used with the article **the** or **a**. On the other hand, the abbreviation QC can have a plural: *Two QCs represented the defendant.*)

kitemark /ˈkaɪtmɑːk/ *noun* a mark put on British goods to show that they meet official standards

kleptomania /ˌkleptəʊˈmeɪniə/ *noun* a mental illness which makes someone steal things

kleptomaniac /ˌkleptəʊˈmeɪniæk/ *noun* somebody who steals things because he or she suffers from kleptomania

knock-for-knock agreement /ˌnɒk fə ˌnɒk əˈɡriːmənt/ *noun* an agreement between two insurance companies that they will not take legal action against each other, and that each will pay the claims of their own clients

knowingly /ˈnəʊɪŋli/ *adverb* deliberately ○ *It was charged that he knowingly broke the Official Secrets Act by publishing the document in his newspaper.*

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L

labour /'leɪbə/ *noun* **1.** heavy work □ **to charge for materials and labour** to charge for both the materials used in a job and also the hours of work involved **2.** the workforce in general (NOTE: [all senses] The US spelling is **labor**.) □ **skilled labour** workers who have special knowledge or qualifications

labourer /'leɪbərə/ *noun* somebody who does unskilled work (NOTE: The US spelling is **laborer**.)

labour-intensive industry /ˌleɪbər ɪnˌtensɪv 'ɪndəstri/ *noun* an industry which needs large numbers of employees or where labour costs are high in relation to turnover

labour law /'leɪbə lɔː/**, labour laws** /'leɪbə lɔːz/**, labour legislation** /ˌleɪbə ˌledʒɪ'sleɪʃ(ə)n/ *noun US* law relating to the employment of workers

laches /'lætʃɪz/ *noun* long delay or neglect in asserting a legal right. ◊ **statute of limitations**

lading /'leɪdɪŋ/ ◆ **bill of lading**

Lady Day /'leɪdi deɪ/ *noun* 25th March, one of the quarter days when rent is paid for land

laissez-faire /ˌleɪseɪ 'feə/**, laisser-faire** *noun* a political theory where a government does nothing to control the economy ○ *Laissez-faire policies resulted in increased economic activity, but contributed to a rise in imports.*

land /lænd/ *noun* an area of earth

COMMENT: Under English law, the ownership of all land is vested in the Crown; individuals or other legal persons may however hold estates in land, the most important of which are freehold estates (which amount to absolute ownership) and leasehold estates (which last for a fixed period of time). Ownership of land usually confers ownership of everything above and below the land. The process of buying and selling land is 'conveyancing'. Any contract transferring land or any interest in land must be in writing. Interests in land can be disposed of by a will.

land agent /'lænd ˌeɪdʒənt/ *noun* somebody who manages a farm or large area of land for someone

land certificate /'lænd səˌtɪfɪkət/ *noun* a document which shows who owns a piece of land, and whether there are any charges on it

land charges /'lænd ˌtʃɑːdʒɪz/ *plural noun* covenants, mortgages, etc., which are attached to a piece of land

landing card /'lændɪŋ kɑːd/ *noun* a card given to passengers who have passed customs and can land from a ship or an aircraft

landing charges /'lændɪŋ ˌtʃɑːdʒɪz/ *plural noun* payment for putting goods on land and for customs duties

landing order /'lændɪŋ ˌɔːdə/ *noun* a permit which allows goods to be unloaded into a bonded warehouse without paying customs duty

landlady /'lændleɪdi/ *noun* a woman who owns a property which she lets

landlord /'lændlɔːd/ *noun* a person or company which owns a property which is let

Landlord and Tenant Act /ˌlændlɔːd ən 'tenənt ˌækt/ *noun* an Act of Parliament which regulates the letting of property

landmark decision /ˌlændmɑːk dɪ 'sɪʒ(ə)n/ *noun* a legal or legislative decision which creates an important legal precedent

mainp - softvnn.com

Law.fm Page 172 Friday, June 11, 2004 2:08 PM

landowner /ˈlændəʊnə/ *noun* somebody who owns large areas of land

land register /ˈlænd ˌredʒɪstə/ *noun* a register of land, showing who owns it and what buildings are on it

land registration /ˈlænd redʒɪ ˌstreɪʃ(ə)n/ *noun* a system of registering land and its owners

Land Registry /ˈlænd ˌredʒɪstri/ *noun* the British government office where details of land and its ownership are kept

lands /lændz/ *plural noun* large areas of land owned by one owner

Lands Tribunal /ˈlɑːndz traɪ ˌbjuːn(ə)l/ *noun* a court which deals with compensation claims relating to land

land tax /ˈlænd tæks/ *noun* a tax on the amount of land owned

land tenure /ˈlænd ˌtenjə/ *noun* a way in which land is owned such as leasehold or freehold

lapse /læps/ *noun* **1.** □ **a lapse of time** a period of time which has passed **2.** the ending of a right, a privilege or an offer, e.g. the termination of an insurance policy because the premiums have not been paid **3.** the failure of a legacy because the beneficiary has died before the testator ■ *verb* to stop being valid or effective □ **to let an offer lapse** to allow time to pass so that an offer is no longer valid □ **lapsed passport** passport which is out of date

lapsed legacy /ˌlæpst ˈlegəsi/ *noun* a legacy which cannot be put into effect because the person who should have received it died before the person who made the will

lapsed policy /ˌlæpst ˈpɒlɪsi/, **lapsed insurance policy** /ˌlæpst ɪnˌʃʊərəns ˈpɒlɪsi/ *noun* insurance which is no longer valid because the premiums have not been paid

larceny /ˈlɑːs(ə)ni/ *noun* the crime of stealing goods which belong to another person ○ *She was convicted of larceny.*

COMMENT: Larceny no longer exists in English law, having been replaced by the crime of theft.

last /lɑːst/ *adjective, adverb* coming at the end of a series ○ *Out of a queue of twenty people, I was served last.* ○ *This is our last board meeting before we move to our new offices.* ○ *This is the last case which the magistrates will hear before lunch.*

last in first out /ˌlɑːst ɪn ˌfɜːst ˈaʊt/ *phrase* **1.** in a redundancy situation, the dismissal of the people who have been most recently appointed before people who have longer service **2.** accounting method where stock is valued at the price of the latest purchases ▸ abbreviation **LIFO**

last will and testament /ˌlɑːst ˌwɪl ən ˈtestəmənt/ *noun* a document by which a person says what they want to happen to their property when they die

late /leɪt/ *adjective* **1.** after the time stated or agreed ○ *We apologise for the late start of this meeting.* □ **there is a penalty for late delivery** if delivery is later than the agreed date, the supplier has to pay a fine **2.** at the end of a period of time □ **latest date for signature of the contract** the last acceptable date for signing the contract **3.** dead ○ *She inherited a fortune from his late uncle.*

latent /ˈleɪt(ə)nt/ *adjective* existing but not obvious or visible

latent ambiguity /ˌleɪt(ə)nt ˌæmbɪ ˈgjuːɪti/ *noun* a word or phrase in a contract which can mean two or more things, but which does not appear to be misleading at first

latent defect /ˌleɪt(ə)nt ˈdiːfekt/ *noun* a fault which cannot be seen immediately

launder /ˈlɔːndə/ *verb* to transfer illegal or stolen money into an ordinary bank account, usually by a complex process to avoid detection (*slang*) ○ *The proceeds of the robbery were laundered through a bank in the Caribbean.*

law /lɔː/ *noun* **1.** a written or unwritten rule by which a country is governed and the activities of people and organisations are controlled. A written law in the UK is an Act of Parliament which has received the Royal Assent, or, in the US, an Act of Congress which has been signed by the President or which has been passed by Congress over the President's veto. ○ *A law has to be passed by Parliament.* ○ *The government has proposed a new law to regulate the sale of goods on Sundays.*

mainp - softvnn.com

Law.fm Page 173 Friday, June 11, 2004 2:08 PM

2. □ **contract law, the law of contract** laws relating to agreements □ **to take someone to law** to sue someone □ **inside the law, within the law** obeying the laws of a country □ **against the law, outside the law** not according to the laws of a country ○ *Dismissing an employee without reason is against the law.* ○ *The company is operating outside the law.* □ **in law** according to the law ○ *What are the duties in law of a guardian?* □ **to break the law** to do something which is against the law ○ *He is breaking the law by selling goods on Sunday.* ○ *You will be breaking the law if you try to take that computer out of the country without an export licence.* **3.** a general rule **4.** □ **the law** the police and the courts (*informal*) ○ *The law will catch up with him in the end.* ○ *If you don't stop making that noise I'll have the law on you.* □ **the strong, long arm of the law** ability of the police to catch criminals and deal with crime

law and order /ˌlɔː ənd ˈɔːdə/ *noun* a situation where the laws of a country are being obeyed by most people ○ *There was a breakdown of law and order following the assassination of the president.*

lawbreaker /ˈlɔːˌbreɪkə/ *noun* somebody who breaks the law

law-breaking /ˈlɔː ˌbreɪkɪŋ/ *noun* the act of doing something which is against the law

Law Centre /ˈlɔː ˌsentə/ *noun* a local office, especially in London, with full-time staff who advise and represent clients free of charge

Law Commission /ˈlɔː kəˌmɪʃ(ə)n/ *noun* a permanent committee which reviews English law and recommends changes to it

law court /ˈlɔː kɔːt/ *noun* a place where trials are held

COMMENT: In civil cases he decides which party is right legally; in criminal cases the decision is made by a jury, and the judge passes sentence.

law enforcement /ˈlɔː ɪnˌfɔːsmənt/ *noun* the activity of making sure that laws are obeyed

law enforcement officers /ˈlɔːr ɪn ˌfɔːsmənt ˌɒfɪsːəz/ *plural noun* people who have the official role of making sure that people obey the law, e.g. police officers

lawful /ˈlɔːf(ə)l/ *adjective* acting within the law

lawfully /ˈlɔːfʊli/ *adverb* acting within the law

lawful picketing /ˌlɔːf(ə)l ˈpɪkətɪŋ/ *noun* picketing which is allowed by law

lawful practice /ˌlɔːf(ə)l ˈpræktɪs/ *noun* an action which is permitted by the law

lawful trade /ˌlɔːf(ə)l ˈtreɪd/ *noun* trade which is allowed by law

lawless /ˈlɔːləs/ *adjective* not controlled by the law or by the police ○ *The magistrates criticised the lawless behaviour of the football crowd.*

lawlessness /ˈlɔːləsnəs/ *noun* the state of being lawless ○ *The government is trying to fight lawlessness in large cities.*

Law List /ˈlɔː lɪst/ *noun* an annual published list of barristers and solicitors

Law Lords /ˈlɔː lɔːdz/ *plural noun* members of the House of Lords who are or were judges, including the Lord Chancellor and the Lords of Appeal in Ordinary

law-making /ˈlɔː ˌmeɪkɪŋ/ *noun* the process of making of laws ○ *Parliament is the law-making body in Great Britain.*

lawman /ˈlɔːmæn/ *noun US* a policeman (NOTE: The plural is **lawmen**.)

law merchant /ˈlɔː ˌmɜːtʃənt/ *noun* same as **mercantile law**

Law Officers /ˈlɔːr ˌɒfɪsːəz/ *plural noun* members of the British government, but not members of the Cabinet: the Attorney-General and Solicitor-General in England and Wales, and the Lord Advocate and Solicitor-General in Scotland

COMMENT: The Law Officers advise the government and individual ministries on legal matters. The Attorney-General will prosecute in trials for serious crimes.

law of master and servant /lɔː əv ˌmɑːstə ən ˈsɜːvənt/ *noun* same as **employment law**

law of property /ˌlɔː əv ˈprɒpəti/ *noun* a branch of the law dealing with the rights of ownership

mainp - softvnn.com

Law.fm Page 174 Friday, June 11, 2004 2:08 PM

law of succession /ˌlɔː əv sək ˈseʃ(ə)n/ *noun* law relating to how property shall pass to others when the owner dies

law of supply and demand /ˌlɔːr əv səˌplaɪ ən dɪˈmɑːnd/ *noun* the general rule that the amount of a product which is available is related to the needs of possible customers

law reform /ˌlɔː rɪˈfɔːm/ *noun* the continuing process of revising laws to make them better suited to the needs of society

Law Reports /ˈlɔː rɪˌpɔːts/ *plural noun* regular reports of new cases and legislation

law school /ˈlɔː skuːl/ *noun US* a school where lawyers are trained

Law Society /ˌlɔː səˈsaɪəti/ *noun* an organisation of solicitors in England and Wales, which represents and regulates the profession

Laws of Oleron /ˌlɔːz əv ˈɒlərɒn/ *plural noun* the first maritime laws, drawn up in 1216 and used as a base for subsequent international laws

law stationer /ˈlɔː ˌsteɪʃ(ə)nə/ *noun* a person who specialises in supplying stationery to legal firms

lawsuit /ˈlɔːsuːt/ *noun US* a case brought to a court by a private person □ **to bring a lawsuit against someone** to tell someone to appear in court to settle an argument □ **to defend a lawsuit** to appear in court to state your case

lawyer /ˈlɔːjə/ *noun* a person who has studied law and can act for people on legal business

lay /leɪ/ *verb* □ **to lay down** to state clearly ○ *The conditions are laid down in the document.* ○ *The guidelines lay down rules for dealing with traffic offences.* ■ *adjective* not belonging to a specific profession

lay assessor /ˈleɪ əˌsesə/ *noun* a person who is not a lawyer who has technical knowledge of a subject and advises a court on specialised matters

lay magistrate /ˌleɪ ˈmædʒɪstreɪt/ *noun* an unpaid magistrate who is not usually a qualified lawyer. Compare **stipendiary magistrate**

layperson /ˈleɪmən/, **layman, laywoman** *noun* somebody who does not belong to the legal profession (NOTE: The plural is **laymen**.)

lay representative /leɪ ˌreprɪˈzentətɪv/ *noun* a person representing someone in a case in the small claims track who is not a solicitor, barrister or legal executive

LC *abbreviation* Lord Chancellor

L/C *abbreviation* letter of credit

LCJ *abbreviation* Lord Chief Justice

lead /liːd/ *noun* a piece of information which may help solve a crime ○ *The police are following up several leads in the murder investigation.* ■ *verb* **1.** to be the first or in front ○ *The company leads the market in cheap computers.* **2.** to be the main person in charge of a group **3.** to be the main person in a team of barristers appearing for one side in a case ○ *The prosecution is led by J.M. Jones, QC.* ○ *Mr Smith is leading for the Crown.* **4.** to start to do something such as present a case in court ○ *Mr Jones led for the prosecution.* ○ *The Home Secretary will lead for the Government in the emergency debate.* **5.** to bring evidence before a court **6.** to try to make a witness answer a question in court in a specific way ○ *Counsel must not lead the witness.* (NOTE: **leading – led – has led**)

leader /ˈliːdə/ *noun* **1.** somebody who manages or directs others ○ *She is the leader of the trade delegation to Nigeria.* ○ *The minister was the leader of the party of lawyers on a tour of American courts.* **2.** the main barrister, usually a QC, in a team appearing for one side in a case **3.** a product which sells best □ **a market leader** product which sells most in a market or company which has the largest share of a market

COMMENT: Normally a party leader has a great deal of power when it comes to making appointments and deciding party policy. In Britain, the leader of a party may feel bound to follow policy decisions laid down by the party conference. This may restrict the leader's room for manoeuvre.

leading /ˈliːdɪŋ/ *adjective* most important ○ *Leading shares rose on the Stock Exchange* ○ *Leading businessmen feel the end of the recession is near.* ○ *Lead-*

mainp - softvnn.com

Law.fm Page 175 Friday, June 11, 2004 2:08 PM

ing shareholders in the company forced a change in management policy. ○ *They are the leading company in the field.*

COMMENT: Leading questions may be asked during cross-examination or during examination in chief.

leading cases /ˌliːdɪŋ ˈkeɪsɪz/ *plural noun* important cases which have set precedents

leading counsel /ˌliːdɪŋ ˈkaʊnsəl/ *noun* the main barrister, usually a QC, in a team appearing for one side in a case

leading question /ˌliːdɪŋ ˈkweʃtʃən/ *noun* a question put by a barrister to a witness which strongly suggests to the witness what the answer ought to be, e.g. a question which can only be answered 'Yes' or 'No'

leak /liːk/ *noun* the unofficial passing of information which has not yet been published, by officials, MPs or employees to newspapers. TV or radio stations, or other public forums. ○ *The government is investigating the latest leak of documents relating to the spy trial.* ■ *verb* to make secret information public without being authorised to do so ○ *The details of the plan have been leaked to the press to test public reaction.*

lease /liːs/ *noun* **1.** a written contract for letting or renting of a building, a piece of land or a piece of equipment for a period of time on payment of a fee □ **the lease expires**, **runs out in 2010** the lease comes to an end in 2010 □ **on expiration of the lease** when the lease comes to an end. ◊ **demise 2.** □ **to hold an oil lease in the North Sea** to have a lease on a section of the North Sea to explore for oil ■ *verb* **1.** to let or rent offices, land or machinery for a period ○ *to lease offices to small firms* ○ *to lease equipment* **2.** to use an office, land or machinery for a time and pay a fee to the landlord or lessor ○ *to lease an office from an insurance company* ○ *All our company cars are leased.*

lease back /ˌliːs ˈbæk/ *verb* to sell a property or machinery to a company and then take it back on a lease ○ *They sold the office building to raise cash, and then leased it back for twenty-five years.*

lease-back /ˈliːs bæk/ *noun* an arrangement by which property is sold and then taken back on a lease ○ *They sold the office building and then took it back under a lease-back arrangement.*

leasehold /ˈliːshəʊld/ *adjective, adverb* on the basis of a lease ○ *a leasehold property* ○ *to purchase a flat leasehold* ■ *noun* a property which is held for a period of time on the basis of a lease ○ *The company has some valuable leaseholds in the city centre.*

leasehold enfranchisement /ˌliːshəʊld ɪnˈfræntʃaɪzmənt/ *noun* the right of a leaseholder to buy the freehold of the property which he or she is leasing

leaseholder /ˈliːshəʊldə/ *noun* somebody who holds a property on a lease

leasing /ˈliːsɪŋ/ *noun* the activity of let someone use something for a period on payment of a fee ○ *The company has branched out into car leasing.* ■ *adjective* providing something on the basis of a lease ○ *to run a photocopier under a leasing arrangement* ○ *a computer-leasing company*

leave /liːv/ *noun* **1.** permission to do something ○ *Counsel asked leave of the court to show a film taken of the accident.* □ **'by your leave'** with your permission □ **leave to defend** permission from a court allowing someone to defend himself against an accusation **2.** a permitted period of being away from work. ◊ **maternity leave, paternity leave, sick leave** □ **leave of absence** permission to be away from work for a period for an unexpected reason □ **to go on leave**, **to be on leave** to be away from work on holiday ○ *She is away on sick leave* or *on maternity leave.* ■ *verb* **1.** to go away from somewhere or someone ○ *The next plane leaves at 10.20.* ○ *He left his office early to go to the meeting.* **2.** to give property to someone when you die ○ *He left his house to his wife.* ○ *I was left £5,000 by my grandmother in her will.* **3.** to resign ○ *She left her job and started up a new business.* (NOTE: **leaving – left – has left**)

left /left/ *noun* □ **swing to the left** movement of support towards socialist principles

left of centre /ˌleft əv ˈsentə/ *adjective* tending towards socialism

mainp - softvnn.com

Law.fm Page 176 Friday, June 11, 2004 2:08 PM

legacy /'legəsi/ *noun* money or personal property excluding land given by someone to someone else in a will ○ *She received a small legacy in her uncle's will.*

COMMENT: Freehold land left to someone in a will is a **devise**.

legal /'liːg(ə)l/ *adjective* **1.** according to or allowed by the law ○ *The company's action was completely legal.* **2.** referring to the law □ **to take legal action**, **to start legal proceedings** to sue someone, to take someone to court □ **to take legal advice** to ask a lawyer to advise about a problem in law □ **legal department**, **legal section** section of a company dealing with legal matters

legal adviser /ˌliːg(ə)l ədˈvaɪzə/ *noun* somebody who advises clients about problems in law

legal age /'liːg(ə)l eɪdʒ/ *noun US* the age at which a person can sue or can be sued or can undertake business

Legal Aid /ˌliːg(ə)l 'eɪd/ *noun* a former British government scheme whereby a person with very little money could have legal representation and advice paid for by the state. Now administered by the Legal Services Commission.

Legal Aid Centre /ˌliːg(ə)l 'eɪd ˌsentə/ *noun* formerly, a local office giving advice to clients with legal problems, assisting with Legal Aid applications and recommending clients to solicitors. ◊ **Legal Services Commission**

legal certainty /ˌliːg(ə)l 'sɜːt(ə)nti/ *noun* in European law, a principle which states that vested rights are not retroactive, that legislation shall not have retrospective effect, and that the legitimate expectations of a claimant must be respected

legal charge /ˌliːg(ə)l 'tʃɑːdʒ/ *noun* a charge created over property by a legal mortgage

legal claim /'liːg(ə)l kleɪm/ *noun* a statement that someone owns something legally ○ *He has no legal claim to the property.*

legal claim to something /ˌliːg(ə)l kleɪm tə 'sʌmθɪŋ/ *noun* a statement that you think you own something legally ○ *He has no legal claim to the property* or *to the car.*

legal costs /'liːg(ə)l kɒsts/ *noun* money spent on fees to lawyers

legal currency /ˌliːg(ə)l 'kʌrənsi/ *noun* the money that is legally used in a country

legal executive /ˌliːg(ə)l ɪg 'zekjʊtɪv/ *noun* a clerk in a solicitor's office who is not a solicitor and is not articled to become one, but has passed the examinations of the Institute of Legal Executives

COMMENT: Legal executives deal with a lot of the background work in solicitors' offices, including probate, conveyancing, matrimonial disputes, etc. They can speak before a judge on questions which are not contested.

legal expenses insurance /ˌliːg(ə)l ɪkˌspensɪz ɪn'ʃʊərəns/ *noun* insurance which will pay the costs of a court case

legal expert /'liːg(ə)l ˌekspɜːt/ *noun* somebody who has a wide knowledge of the law

legal holiday /ˌliːg(ə)l 'hɒlɪdeɪ/ *noun* a day when banks and other businesses are closed

legalisation /ˌliːgəlaɪ'zeɪʃ(ə)n/, **legalization** *noun* the process of making something legal ○ *the campaign for the legalisation of abortion*

legalise /'liːgəlaɪz/, **legalize** *verb* to make something legal

legality /lɪ'gælɪti/ *noun* the fact of being allowed by law ○ *There is doubt about the legality of the company's action in dismissing him.*

legally /'liːgəli/ *adverb* according to the law □ **the contract is legally binding** according to the law, the contract has to be obeyed □ **the directors are legally responsible** the law says that the directors are responsible

legal memory /ˌliːg(ə)l 'mem(ə)ri/ *noun* the period since 1189, the accepted date to which legal title can be traced ○ *This practice has existed from before the time of legal memory.* ◊ **immemorial existence**

legal person /ˌliːg(ə)l 'pɜːs(ə)n/ *noun* a company or corporation considered as a legal body

mainp - softvnn.com

Law.fm Page 177 Friday, June 11, 2004 2:08 PM

legal personality /ˌliːg(ə)l ˌpɜːsə ˈnælətɪ/ *noun* existence as a body and so ability to be affected by the law

legal proceedings /ˈliːg(ə)l prə ˌsiːdɪŋz/ *plural noun* a legal action ○ *The court proceedings were adjourned.*

legal representative /ˌliːg(ə)l ˌreprɪ ˈzentətɪv/ *noun* a barrister, solicitor, or legal executive, who acts on behalf of a party in a case

legal right /ˈliːg(ə)l raɪt/ *noun* a right which exists under law

legal secretary /ˌliːg(ə)l ˈsekrət(ə)ri/ *noun* a secretary in a firm of solicitors or the legal department of a company

legal separation /ˌliːg(ə)l ˌsepə ˈreɪʃ(ə)n/ *noun* same as **judicial separation**

Legal Services Commission /ˌliːg(ə)l ˌsɜːvɪsɪz kəˈmɪʃ(ə)n/ *noun* a body set up to run the Community Legal Service and the Criminal Defence Service. Abbreviation **LSC**. Former name **Legal Aid**

legal status /ˈliːg(ə)l ˌsteɪtəs/ *noun* a legal identity of a person or body such as a company or partnership

legal tender /ˌliːg(ə)l ˈtendə/ *noun* coins or notes which can be legally used to pay a debt (NOTE: Small denominations cannot be used to pay large debts.)

legal writer /ˌliːg(ə)l ˈraɪtə/ *noun* somebody who writes and publishes commentaries on legal problems

legatee /ˌlegəˈtiː/ *noun* somebody who receives a legacy from someone who has died

legis ◗ **corpus legis, ratio legis**

legislate /ˈledʒɪsleɪt/ *verb* to make a law ○ *Parliament has legislated against the sale of drugs* or *to prevent the sale of drugs.*

legislation /ˌledʒɪˈsleɪʃ(ə)n/ *noun* the set of laws that have been agreed by Parliament and are implemented by the courts

legislative /ˈledʒɪslətɪv/ *adjective* used to make laws ○ *Parliament has a legislative function.*

legislative initiative /ˌledʒɪslətɪv ɪˈnɪʃətɪv/ *noun* the power to propose legislation ○ *Member States of the EU have the right of initiative in all legal and internal matters.*

legislative veto /ˌledʒɪslətɪv ˈviːtəʊ/ *noun* a clause written into legislation relating to government agencies, which states that the agency cannot act in a way that the US Congress does not approve

legislator /ˈledʒɪsleɪtə/ *noun* a person who makes or passes laws as a member of a national or other legislative body

legislature /ˈledʒɪslətʃə/ *noun* **1.** the part of a national or other government which makes or changes laws ○ *Members of the legislature voted against the proposal.* (NOTE: The other parts are the **executive** and the **judiciary**.) **2.** the building where a Parliament meets ○ *The protesters marched towards the State Legislature.*

legitimacy /lɪˈdʒɪtɪməsi/ *noun* **1.** the state of being legitimate ○ *The court doubted the legitimacy of his claim.* **2.** a court case to make someone legitimate

legitimate *adjective* /lɪˈdʒɪtɪmət/ **1.** allowed by law ○ *He has a legitimate claim to the property.* **2.** born to parents who are married to each other ○ *He left his property to his legitimate offspring.* ◊ **illegitimate** ■ *verb* /lɪˈdʒɪtɪmeɪt/ to make a child legitimate

legitimate expectations /lɪˌdʒɪtɪmət ˌekspekˈteɪʃ(ə)nz/ *plural noun* expectations of an employee which are usual and what one might expect employees to have

legitimation /lɪˌdʒɪtɪˈmeɪʃ(ə)n/, **legitimisation** /lɪˌdʒɪtɪmaɪˈzeɪʃ(ə)n/ *noun* the act of making a child legitimate, e.g. by the marriage of the parents

lend /lend/ *verb* to allow someone to use something for a period ○ *to lend something to someone* or *to lend someone something* ○ *He lent the company money* or *he lent money to the company.* ○ *She lent the company car to her daughter.* ○ *The bank lent him £50,000 to start his business.*

lender /ˈlendə/ *noun* somebody who lends money

mainp - softvnn.com

Law.fm Page 178 Friday, June 11, 2004 2:08 PM

lender of the last resort /ˌlendə əv ðɪ lɑːst rɪˈzɔːt/ *noun* a central bank which lends money to commercial banks

lending /ˈlendɪŋ/ *noun* the act of letting someone use money for a time

lending limit /ˈlendɪŋ ˌlɪmɪt/ *noun* a limit on the amount of money a bank can lend

lessee /leˈsiː/ *noun* a person who pays rent for a property he or she leases from a lessor

lessor /leˈsɔː/ *noun* somebody who grants a lease on a property to a lessee

let /let/ *verb* **1.** to allow someone to do something ○ *The magistrate let the prisoner speak to his wife.* **2.** to lend a property such as house, office, farm to someone for a payment □ **to let an office** to allow someone to use an office for a time in return for payment of rent □ **offices to let** offices which are available to be leased by companies ■ *noun* **1.** a period of the lease of a property ○ *They took the office on a short let.* **2.** □ **without let or hindrance** without any obstruction

let-out clause /ˈlet aʊt ˌklɔːz/ *noun* a clause which allows someone to avoid doing something in a contract ○ *He added a let-out clause to the effect that the payments would be revised if the exchange rate fell by more than 5%.*

letter /ˈletə/ *noun* **1.** a piece of writing sent from one person or company to another to give information **2.** □ **air letter** special thin blue paper which when folded can be sent by air without an envelope □ **airmail letter** letter sent by air **3.** □ **to acknowledge receipt by letter** to write a letter to say that something has been received **4.** a written or printed symbol such as A, B, C ○ *Write your name and address in block letters* or *in capital letters.*

letter before action /ˌletə bɪˌfɔː ˈækʃən/ *noun* a letter written by a lawyer to give a party the chance to pay the client before he or she sues

letter of acknowledgement /ˌletər əv əkˈnɒlɪdʒmənt/ *noun* a letter which says that something has been received

letter of allotment /ˌletər əv ə ˈlɒtmənt/ *noun* a letter which tells someone how many shares in a new company he or she has been allotted

letter of application /ˌletər əv æplɪ ˈkeɪʃ(ə)n/ *noun* a letter in which someone applies for a job or applies for shares in a new company

letter of appointment /ˌletər əv ə ˈpɔɪntmənt/ *noun* a letter in which someone is appointed to a job

letter of attorney /ˌletər əv əˈtɜːni/ *noun* a document showing that someone has power of attorney

letter of comfort /ˌletər əv ˈkʌmfət/ *noun* a letter supporting someone who is trying to get a loan

letter of complaint /ˌletər əv kəm ˈpleɪnt/ *noun* a letter in which someone complains

letter of credit /ˌletə əv ˈkredɪt/ *noun* a letter from a bank authorising payment of a specific sum to a person or company, usually in another country. Abbreviation **L/C**

letter of demand /ˌletə əv dɪˈmɑːnd/ *noun US* a letter issued by a party or lawyer demanding payment before taking legal action

letter of indemnity /ˌletər əv ɪn ˈdemnɪti/ *noun* a letter promising payment of compensation for a loss

letter of intent /ˌletər əv ɪnˈtent/ *noun* a letter which states what someone intends to do if a specific thing takes place

letter of reference /ˌletər əv ˈref(ə)rəns/ *noun* a letter in which an employer or former employer recommends someone for a new job

letter of renunciation /ˌletər əv rɪ ˌnʌnsiˈeɪʃ(ə)n/ *noun* a form sent with new shares, which allows the person who has been allotted the shares to refuse to accept them and so sell them to someone else

letter of request /ˌletə əv rɪˈkwest/ *noun* a letter to a court in another country, asking for evidence to be taken from someone under that court's jurisdiction

letters of administration /ˌletəz əv ədmɪnɪˈstreɪʃ(ə)n/ *noun* a document given by a court to allow someone to deal with the estate of a person who has died without leaving a will or where the exec-

mainp - softvnn.com

Law.fm Page 179 Friday, June 11, 2004 2:08 PM

utor appointed under the will cannot act (NOTE: not used in the singular)

letters patent /ˌletəz ˈpeɪtənt/ *plural noun* an official document from the Crown, which gives someone the exclusive right to do something such as becoming a lord or making and selling an invention

letting agency /ˈletɪŋ ˌeɪdʒənsi/ *noun* an agency which deals in property to let

levy /ˈlevi/ *noun* a type of tax which is collected by the government or an official body ■ *verb* to demand payment of a tax or an extra payment and to collect it ○ *to levy a duty on the import of computer parts* ○ *The government has decided to levy a tax on imported cars.*

lex /leks/ *noun* a Latin word meaning 'law'

lex fori /ˌleks ˈfɔːri/ *noun* the law of the place where the case is being heard

lex loci actus /ˌleks ˌləʊkaɪ ˈæktəs/ *noun* the law of the place where the act took place

lex loci contractus /ˌleks ˌləʊkaɪ kənˈtræktəs/ *noun* the law of the place where the contract was made

lex loci delicti /ˌleks ˌləʊkaɪ dɪ ˈlektaɪ/ *noun* the law of the place where the crime was committed

liabilities /ˌlaɪəˈbɪlɪtiz/ *plural noun* debts of a business ○ *The balance sheet shows the company's assets and liabilities.*

liability /ˌlaɪəˈbɪlɪti/ *noun* **1.** the fact of being legally responsible for paying for damage or loss incurred ○ *His insurers have admitted liability but the amount of damages has not yet been agreed.* □ **to accept**, **to admit liability for something** to agree that you are responsible for something □ **to refuse liability for something** to refuse to agree that you are responsible for something **2.** □ **he was not able to meet his liabilities** he could not pay his debts □ **to discharge one's liabilities in full** to repay all debts

liability clause /ˌlaɪəˈbɪlɪti klɔːz/ *noun* a clause in the articles of association of a company which states that the liability of its members is limited

liable /ˈlaɪəb(ə)l/ *adjective* **1.** legally responsible for something ○ *The customer is liable for breakages.* ○ *The chairman was personally liable for the company's debts.* ○ *He was found by the judge to be liable for the accident.* ○ *He will be found liable if he assists a trustee to commit a dishonest breach of trust.* **2.** officially due to pay or do something ○ *sales which are liable to stamp duty* ○ *Such an action renders him liable to a fine.*

libel /ˈlaɪb(ə)l/ *noun* **1.** a published or broadcast statement which damages someone's character ○ *She claimed that the newspaper report was a libel.* **2.** the act of making a libel □ **action for libel**, **libel action** case in a law court where someone says that another person has written a libel about him ■ *verb* to damage someone's character in writing or in a broadcast (NOTE: **libelling – libelled**. The US spelling is **libeling – libeled**.)

libeller /ˈlaɪb(ə)lə/ *noun* somebody who has libelled someone

libellous /ˈlaɪbələs/ *adjective* casting a slur on someone's character ○ *She said that the report was libellous.*

liberty /ˈlɪbəti/ *noun* the situation of being free □ **at liberty** free, not in prison ○ *They are still at liberty while waiting for charges to be brought.* □ **liberty of the individual** freedom for each person to act within the law □ **liberty of the press** freedom of newspapers to publish what they want within the law without censorship □ **liberty of the subject** the right of a citizen to be free unless convicted of a crime which is punishable by imprisonment

licence /ˈlaɪs(ə)ns/, **license** *US* /ˈlaɪs(ə)ns/ *noun* **1.** an official document which allows someone to do something or to use something ○ *He granted his neighbour a licence to use his field.* □ **licence to sell liquor**, **liquor licence** document given by the Magistrates' Court allowing someone to sell alcohol □ **on licence** a licence to sell alcohol for drinking on the premises, usually in a bar or restaurant **2.** permission given by someone to another person to do something which would otherwise be illegal **3.** permission for someone to leave prison be-

mainp - softvnn.com

Law.fm Page 180 Friday, June 11, 2004 2:08 PM

fore the end of his or her sentence **4.** □ **goods manufactured under licence** goods made with the permission of the owner of the copyright or patent

license /ˈlaɪs(ə)ns/ *noun* US spelling of **licence** ■ *verb* to give someone official permission to do something ○ *licensed to sell beers, wines and spirits* ○ *to license a company to produce spare parts* ○ *He is licensed to drive a lorry.* ○ *She is licensed to run an employment agency.*

licensed deposit-taker /ˌlaɪs(ə)nst dɪˈpɒzɪt ˌteɪkə/ *noun* a business such as a bank which takes deposits from individuals and lends the money to others

licensed premises /ˌlaɪs(ə)nst ˈpremɪsɪz/ *plural noun* a pub, restaurant, bar or shop which has a licence to sell alcohol

licensee /ˌlaɪs(ə)nˈsiː/ *noun* a person who has a licence allowing them to carry out an activity such as selling alcohol or manufacturing or extracting something

licensing /ˈlaɪs(ə)nsɪŋ/ *adjective* relating to licences

licensing agreement /ˈlaɪs(ə)nsɪŋ ə ˌgriːmənt/ *noun* an agreement where a person is granted a licence to manufacture or use something

licensing hours /ˈlaɪs(ə)nsɪŋ ˌaʊəz/ *plural noun* hours of the day where alcohol can be bought to be drunk on the premises

licensing magistrates /ˌlaɪs(ə)nsɪŋ ˈmædʒɪstreɪts/ *plural noun* magistrates who grant licences to persons or premises for the sale of alcohol

licit /ˈlɪsɪt/ *adjective* legal

lie /laɪ/ *noun* a statement which is not true

lie detector /ˈlaɪ dɪˌtektə/ *noun* a machine which detects if a person is telling the truth

lien /ˈliːən/ *noun* the legal right to hold someone's goods and keep them until a debt has been paid ○ *The garage had a lien on her car until she paid the repair bill.*

lien on shares /ˌliːən ɒn ˈʃeəz/ *noun* a right of a company to sell shares which have not been fully paid up, when the shareholder refuses to pay for them fully

lieu /ljuː/ *noun* □ **in lieu of** instead of □ **to give someone two months' salary in lieu of notice** to give an employee money equivalent to the salary for two months' work and ask him to leave immediately

lie upon the table /laɪ ʌˌpɒn ðə ˈteɪb(ə)l/ *verb* (*of a petition*) to have been put before the House of Commons

COMMENT: After a petition has been presented by an MP it is said to 'lie upon the table'.

life /laɪf/ *noun* **1.** the time when a person is alive □ **for life** for as long as someone is alive ○ *His pension gives him a comfortable income for life.* □ **the life assured**, **the life insured** the person whose life has been covered by the life assurance **2.** the period of time when something is in existence ○ *the life of a loan* ○ *during the life of the agreement* □ **shelf life of a product** length of time when a product can stay in the shop and still be good to use

life annuity /ˈlaɪf əˌnjuːɪti/ *noun* annual payments made to someone for the rest of their life

life assurance /ˈlaɪf əˌʃʊərəns/ *noun* insurance which pays a sum of money when someone dies, or at a specified date if the person is still alive

life imprisonment /ˌlaɪf ɪm ˈprɪz(ə)nmənt/ *noun* the punishment of being sent to prison for a serious crime, but not necessarily for the whole of your life (NOTE: As a penalty for murder, life imprisonment lasts on average ten years in the UK)

life insurance /ˈlaɪf ɪnˌʃʊərəns/ *noun* same as **life assurance**

life interest /ˌlaɪf ˈɪntrəst/ *noun* a situation where someone benefits from a property as long as he or she is alive

life peer /ˈlaɪf pɪə/ *noun* a member of the House of Lords who is appointed for life and whose title does not pass to another member of the family

life preserver /ˈlaɪf prɪˌzɜːvə/ *noun* a heavy club or cosh

lifer /ˈlaɪfə/ *noun* somebody serving a life sentence (*slang*)

LIFO *abbreviation* last in first out

mainp - softvnn.com

Law.fm Page 181 Friday, June 11, 2004 2:08 PM

lift /lɪft/ *verb* **1.** to take away or to remove ○ *The government has lifted the ban on imports of technical equipment.* ○ *The minister has lifted the embargo on the export of firearms.* ○ *Proceedings will continue when the stay is lifted.* **2.** to steal (*informal*)

lightning factor /ˌlaɪtnɪŋ ˈfæktə/ *noun* the possibility that even a good case may fail for an unexpected reason, which is one of the factors to be taken into account when preparing a conditional fee agreement (*informal*)

likelihood /ˈlaɪklihʊd/ *noun* the fact of being likely

likelihood of bias /ˌlaɪklihʊd əv ˈbaɪəs/ *noun* the possibility that bias will occur because of a connection between a member of the court and a party in the case

limit /ˈlɪmɪt/ *noun* a point at which something ends □ **to set limits to imports**, **to impose limits on imports** to allow only a specific amount of goods to be imported □ **he has exceeded his credit limit** he has borrowed more money than he is allowed to do ■ *verb* to stop something from going beyond a specific point ○ *The court limited damages to £100.* □ **the banks have limited their credit** the banks have allowed their customers only a limited amount of credit

limitation /ˌlɪmɪˈteɪʃ(ə)n/ *noun* the act of allowing only a limited amount of something ○ *The contract imposes limitations on the number of cars which can be imported.*

limitation of actions /ˌlɪmɪteɪʃ(ə)n əv ˈækʃ(ə)nz/ *noun* a law which allows only a specific amount of time, usually six years, for someone to start legal proceedings in order to claim property or compensation for damage

limitation of liability /ˌlɪmɪteɪʃ(ə)n əv ˌlaɪəˈbɪlɪti/ *noun* **1.** making someone liable for only a part of the damage or loss **2.** making shareholders in a limited company liable for the debts of the company only in proportion to their shareholding

limitation period /ˌlɪmɪˈteɪʃ(ə)n ˌpɪəriəd/ *noun* a period during which someone who has a right to claim against another person must start court proceedings. If the claim is not made in time, this may be used as a defence argument.

limited /ˈlɪmɪtɪd/ *adjective* restricted

limited liability /ˌlɪmɪtɪd laɪəˈbɪlɪti/ *noun* the legal principle that individual members of limited liability company are liable for that company's debts only to the value of their shares

limited liability company /ˌlɪmɪtɪd laɪəˌbɪlɪti ˈkʌmp(ə)ni/ *noun* a company where each shareholder is responsible for repaying the company's debts only to the face value of the shares he or she owns

limited market /ˌlɪmɪtɪd ˈmɑːkɪt/ *noun* a market which can take only a specific quantity of goods

limited partner /ˌlɪmɪtɪd ˈpɑːtnə/ *noun* a partner who has only limited liability for the partnership debts

limited partnership /ˌlɪmɪtɪd ˈpɑːtnəʃɪp/ *noun* a partnership where the liability of some of the partners is limited to the amount of capital they have each provided to the business while other working partners are fully liable for all the obligations of the partnership. These partners with limited liability may not take part in the running of the business.

limited warranty /ˌlɪmɪtɪd ˈwɒrəntɪ/ *noun* a warranty which is limited in some way such as being valid only for a specific period of time or under special conditions of use

limiting /ˈlɪmɪtɪŋ/ *adjective* restricting ○ *a limiting clause in a contract* ○ *The short holiday season is a limiting factor on the hotel trade.*

Lincoln's Inn /ˌlɪnkənz ˈɪn/ *noun* one of the four Inns of Court in London

lineal descent /ˌlɪniəl dɪˈsent/ *noun* direct descent from parent to child

line management /ˈlaɪn ˌmænɪdʒmənt/ *noun* a type of business organisation where each manager is directly responsible for a stage in the operation of the business

liquid assets /ˌlɪkwɪd ˈæsets/ *noun* cash, or bills which can be quickly converted into cash

liquidate /ˈlɪkwɪdeɪt/ *verb* □ **to liquidate a company** to wind up a company, to close down a company and sell its as-

mainp - softvnn.com

Law.fm Page 182 Friday, June 11, 2004 2:08 PM

sets □ **to liquidate a debt** to pay a debt in full □ **to liquidate assets**, **stock** to sell assets or stock to raise cash

liquidated damages /ˌlɪkwɪdeɪtɪd ˈdæmɪdʒɪz/ *plural noun* specific amount which has been calculated as the loss suffered

liquidation /ˌlɪkwɪˈdeɪʃ(ə)n/ *noun* **1.** □ **liquidation of a debt** payment of a debt in full **2.** the closing of a company and selling of its assets □ **the company went into liquidation** the company was closed and its assets sold

liquidator /ˈlɪkwɪdeɪtə/ *noun* somebody who administers the assets and supervises the winding up of a company

liquidity /lɪˈkwɪdɪti/ *noun* the situation of having cash or assets which can easily be sold to raise cash ○ *The company was going through a liquidity crisis and had to stop payments.*

lis /lɪs/ *noun* a Latin word meaning 'lawsuit'

lis alibi pendens /ˌlɪs ˌælɪbaɪ ˈpendenz/ *noun* a legal action has been started in another place

lis pendens /ˌlɪs ˈpendenz/ *noun* pending suit

list /lɪst/ *noun* **1.** a set of several items written one after the other ○ *list of debtors* ○ *to add an item to a list* ○ *to cross someone's name off a list* ○ *list of cases to be heard* **2.** a particular court to which cases are allocated according to their subject **3.** a catalogue ■ *verb* **1.** to write a series of items one after the other ○ *The catalogue lists products by category.* **2.** to decide on the date at which a case will be heard ○ *The case is listed to be heard next week.*

listed building /ˌlɪstɪd ˈbɪldɪŋ/ *noun* a building of special interest, often because it is old, which the owners cannot alter or demolish

listing /ˈlɪstɪŋ/ *noun* the action of scheduling a case to be heard on a specific date

listing hearing /ˌlɪstɪŋ ˈhɪərɪŋ/ *noun* a hearing which may be held at which a court decides on the date at which a case will be heard

listing questionnaire /ˌlɪstɪŋ k(w)estʃəˈneə/ *noun* a questionnaire sent by a court to the parties in a case allocated to the fast track, in which they must give details of things such as documents, witnesses, expert evidence. The questionnaire has to be filed with the court within 14 days and is used by the court to decide on scheduling the date when the case will be heard.

list of documents /lɪst əv ˈdɒkjʊˌments/ *noun* a list prepared by parties in a civil action giving disclosure of documents relevant to the action

list of members /ˌlɪst əv ˈmembəz/ *noun* an annual return made by a company listing its shareholders

litem ➧ **ad litem**

literal rule /ˈlɪt(ə)rəl ruːl/ *noun* a rule that, when interpreting a statute, the court should give the words of the statute their most obvious meaning

litigant /ˈlɪtɪgənt/ *noun* somebody who brings a lawsuit against someone

litigant in person /ˌlɪtɪgənt ɪn ˈpɜːs(ə)n/ *noun* a person bringing a lawsuit who also speaks on his or her own behalf in court without the help of a lawyer

litigate /ˈlɪtɪgeɪt/ *verb* to bring a lawsuit against someone to have a dispute settled

litigation /ˌlɪtɪˈgeɪʃ(ə)n/ *noun* the action of bringing a lawsuit against someone to have a dispute settled ○ *He has got into litigation with the county council.*

litigation friend /ˌlɪtɪˈgeɪʃ(ə)n frend/ *noun* somebody who represents a child or patient in court, and whose duty is to act in the best interests of the child or patient

litigation practitioner /ˌlɪtɪˈgeɪʃ(ə)n prækˌtɪʃ(ə)nə/ *noun* a lawyer who specialises in litigation

litigious /lɪˈtɪdʒəs/ *adjective* very willing to bring a lawsuit against someone to settle a disagreement

living off immoral earnings /ˌlɪvɪŋ ɒf ɪˌmɒrəl ˈɜːnɪŋz/ *noun* the offence of making a living from money obtained from prostitutes

LJ *abbreviation* Lord Justice (NOTE: written after the surname of the judge in legal reports: *Smith LJ said he was not laying down any guidelines for sentenc-*

mainp - softvnn.com

Law.fm Page 183 Friday, June 11, 2004 2:08 PM

ing but **Smith LJ** is spoken as 'Lord Justice Smith'.)

LJJ *abbreviation* lord justices

LL.B., LL.M., LL.D. *abbreviation* letters written after someone's name, showing that he or she has the degree of Bachelor of Laws, Master of Laws or Doctor of Laws

Lloyd's /lɔɪdz/ *noun* a central London market for underwriting insurances □ **ship which is A1 at Lloyd's** ship which is in best condition according to Lloyd's Register

Lloyd's Register /ˌlɔɪdz 'redʒɪstə/ *noun* a classified list showing details of all the ships in the world

Lloyd's underwriter /ˌlɔɪdz 'ʌndəraɪtə/ *noun* a member of an insurance group at Lloyd's who accepts to underwrite insurances

loan /ləʊn/ *noun* money that has been lent □ **short-term loan**, **long-term loan** loans which have to be repaid within a few weeks or some years ■ *verb* to lend

loan stock /'ləʊn stɒk/ *noun* money lent to a company at a fixed rate of interest

lobby /'lɒbi/ *noun* a group of people or pressure group which tries to influence MPs or the passage of legislation □ **the car lobby** people who try to persuade government that cars should be encouraged and not restricted □ **the environmentalist lobby** people who try to persuade government that the environment must be protected, pollution stopped, etc.

lobbyist /'lɒbiɪst/ *noun* somebody who is paid to represent a pressure group

local call /ˌləʊk(ə)l 'kɔːl/ *noun* a call to a number on the same exchange

local court /'ləʊk(ə)l kɔːt/ *noun* a court such as a magistrates' court which hears cases coming from its local area

local custom /ˌləʊk(ə)l 'kʌstəm/ *noun* the way in which things are usually done in a particular place

loc. cit. *phrase* a Latin phrase meaning 'in the place which has been mentioned' (NOTE: used when referring to a point in a legal text: '**see also Smith J in** *Jones v. Associated Steel Ltd* **loc. cit. line 26**')

locking up /ˌlɒkɪŋ 'ʌp/ *noun* □ **the locking up of money in stock** investing money in stock so that it cannot be used for other, possibly more profitable, investments

lock up /ˌlɒk 'ʌp/ *verb* **1.** to put someone in prison or a psychiatric hospital **2.** □ **to lock up a shop**, **an office** to close and lock the door at the end of the day's work □ **to lock up capital** to have capital invested in such a way that it cannot be used for other investments

lock-up /'lɒk ʌp/ *adjective* □ **lock-up shop** shop which has no living accommodation which the proprietor locks at night when it is closed ■ *noun* a prison (*informal*)

loco ➧ **in loco parentis**

locum /'ləʊkəm/**, locum tenens** /ˌləʊkəm 'tenənz/ *noun* somebody who takes the place of another person for a time ○ *locums wanted in South London*

locus /'ləʊkəs/ *noun* a Latin word meaning 'place'

locus sigilli /ˌləʊkəs sɪ'dʒɪlaɪ/ *phrase* a Latin phrase meaning 'place of the seal': used to show where to put the seal on a document

locus standi /ˌləʊkəs 'stændaɪ/ *phrase* a Latin phrase meaning 'place to stand': the right to be heard in a court ○ *The taxpayer does not have locus standi in this court.*

lodge /lɒdʒ/ *verb* to deposit something such as a document officially □ **to lodge caution** to deposit a document with the Land Registry which prevents land or property being sold without notice □ **to lodge a complaint against someone** to make an official complaint about someone □ **to lodge money with someone** to deposit money with someone □ **to lodge securities as collateral** to put securities into a bank to be used as collateral for a loan

lodger /'lɒdʒə/ *noun* somebody who lives in a house or part of a house which is owned by a resident landlord

logrolling /'lɒgrəʊlɪŋ/ *noun US* the act of attaching a bill to another more popular bill before Congress in the hope that the two will be passed together

mainp - softvnn.com

Law.fm Page 184 Friday, June 11, 2004 2:08 PM

loitering with intent /ˌlɔɪtərɪŋ wɪð ɪnˈtent/ *noun* the offence of walking slowly, stopping frequently, especially to solicit sexual relations

London gold fixing /ˌlʌndən ˈgəʊld ˌfɪksɪŋ/ *noun* a system where the world price for gold is set each day in London

long credit /ˌlɒŋ ˈkredɪt/ *noun* credit terms which allow the borrower a long time to pay

long-dated bills /ˌlɒŋ ˌdeɪtɪd ˈbɪlz/ *plural noun* bills of exchange which are payable in more than three months' time

long-distance call /ˌlɒŋ dɪstəns ˈkɔːl/ *noun* a call to a number in a different zone or area

long lease /ˌlɒŋ ˈliːs/ *noun* a lease which runs for fifty years or more ○ *to take an office building on a long lease*

longs /lɒŋz/ *plural noun* government stocks which mature in over fifteen years' time

long-standing customer /lɒŋ ˌstændɪŋ ˈkʌstəmə/ *noun* somebody who has been a customer for many years

long tenancy /ˌlɒŋ ˈtenənsi/ *noun* tenancy for a period of more than 21 years

long-term /ˌlɒŋ ˈtɜːm/ *adjective* □ **on a long-term basis** for a long period of time

long-term debts /ˌlɒŋ tɜːm ˈdets/ *plural noun* debts which will be repaid many years later

long-term forecast /ˌlɒŋ tɜːm ˈfɔːkɑːst/ *noun* a forecast for a period of over three years

long-term liabilities /ˌlɒŋ tɜːm ˌlaɪə ˈbɪlɪtiz/ *plural noun* debts which are not due to be repaid for some years

long-term loan /ˌlɒŋ tɜːm ˈləʊn/ *noun* a loan to be repaid many years later

long-term objective /ˌlɒŋ tɜːm əb ˈdʒektɪv/**, short-term objective** /ˌʃɔːt tɜːm əbˈdʒektɪv/ *noun* an aim which you hope to achieve within a few years or a few months

long-term objectives /ˌlɒŋ tɜːm əb ˈdʒektɪvz/ *plural noun* aims which will take years to fulfil

Long Vacation /ˌlɒŋ vəˈkeɪʃ(ə)n/ *noun* the summer holiday of the law courts and universities

loophole /ˈluːphəʊl/ *noun* □ **to find a loophole in the law** to find a means of doing what you want to do, by finding a way of getting round a law which otherwise would prevent you from acting □ **to find a tax loophole** to find a means of legally not paying tax

loot /luːt/ *noun* stolen money or goods ■ *verb* to steal goods from shops, warehouses or homes during a period of unrest, disaster or lack of government control ○ *The stores were looted by a mob of hooligans.*

looter /ˈluːtə/ *noun* a person who steals valuables from shops, warehouses or homes during a period of unrest, disaster or lack of government control

looting /ˈluːtɪŋ/ *noun* the act of stealing valuable goods ○ *The police cordoned off the area to prevent looting.*

Lord Advocate /ˌlɔːd ˈædvəkət/ *noun* a member of the government who is one of the two Law Officers in Scotland

Lord Chancellor /ˌlɔːd ˈtʃɑːnsələ/ *noun* the member of the British government and cabinet who is responsible for the administration of justice and the appointment of judges in England and Wales and who also presides over the debates in the House of Lords. The post is to be abolished and the role will be undertaken by the Secretary of State for Constitutional Affairs.

Lord Chief Justice /ˌlɔːd tʃiːf ˈdʒʌstɪs/ *noun* the chief judge of the Queen's Bench Division of the High Court who is also a member of the Court of Appeal

Lord Justice /ˌlɔːd ˈdʒʌstɪs/ *noun* the title given to a judge who is a member of the House of Lords and the Court of Appeal (NOTE: It may be written abbreviated as **LJ**, or **LJJ** for the plural, after a surname: *Smith LJ* or *Jones and White LJJ.*)

Lord Justice Clerk /ˌlɔːd ˌdʒʌstɪs ˈklɑːk/ *noun* the second most important judge in the Scottish High Court of Justiciary (NOTE: Lord Justice is written **LJ**

mainp - softvnn.com

Law.fm Page 185 Friday, June 11, 2004 2:08 PM

after the name: **Smith LJ** = Lord Justice Smith)

Lord Justice General /lɔːd ˌdʒʌstɪs ˈdʒen(ə)rəl/ *noun* the chief judge in the Scottish High Court of Judiciary

Lord Lieutenant /ˌlɔːd lefˈtenənt/ *noun* the representative of the Crown in a county

Lord of Appeal /ˌlɔːd əv əˈpiːl/ *noun* a member of the House of Lords who sits when the House is acting as a Court of Appeal

Lord of Appeal in Ordinary /lɔːd əv əˌpiːl ɪn ˈɔːd(ə)n(ə)ri/ *noun* one of eleven lords who are paid to sit as members of the House of Lords when it acts as a Court of Appeal

Lord Ordinary /ˌlɔːd ˈɔːd(ə)n(ə)ri/ *noun* a judge of first instance in the outer house of the Scottish Court of Session

Lord President /ˌlɔːd ˈprezɪdənt/ *noun* a judge of the Scottish Court of Session

Lord President of the Council /lɔːd ˌprezɪdənt əv ðə ˈkaʊns(ə)l/ *noun* a senior member of the UK government, who is a member of the House of Lords and head of the Privy Council Office and has other duties allocated by the Prime Minister

Lords /lɔːdz/ *plural noun* **1.** the House of Lords ○ *The Lords voted to amend the Bill.* **2.** members of the House of Lords □ **the Law Lords** members of the House of Lords who are or were judges, and are entitled to sit on the Court of Appeal

lose /luːz/ *verb* **1.** not to be successful in a legal case ○ *He lost his appeal to the House of Lords.* ○ *She lost her case for compensation.* **2.** not to have something any more □ **to lose an order** not to get an order which you were hoping to get ○ *During the strike, the company lost six orders to American competitors.* □ **to lose control of a company** to find that you have less than 50% of the shares and so are no longer able to direct the company □ **she lost her job when the factory closed** she was made redundant **3.** to have less money ○ *He lost £25,000 in his father's computer company.* □ **the pound has lost value** the pound is worth less **4.** to drop to a lower price ○ *The dollar lost two cents against the pound.* ○ *Gold shares lost 5% on the market yesterday.* (NOTE: **losing – lost – has lost**)

loss /lɒs/ *noun* **1.** □ **the car was written off as a dead loss, a total loss** the car was so badly damaged that the insurers said it had no value **2.** □ **loss in weight** goods which weigh less than when they were packed □ **loss in transport** amount of weight which is lost while goods are being shipped

loss adjuster /ˈlɒs əˌdʒʌstə/ *noun* same as **average adjuster**

loss-leader /ˈlɒs ˌliːdə/ *noun* an article which is sold very cheaply to attract customers

lost profits /ˌlɒst ˈprɒfɪts/ *plural noun* profits which would have been made from a transaction which is the subject of an action for breach of contract

Lower Chamber /ˌləʊə ˈtʃeɪmbə/ *noun* the less important of the two houses in a bicameral system of government. Opposite **Upper Chamber** (NOTE: The opposite is **upper**.)

LSC *abbreviation* Legal Services Commission

lump sum /ˌlʌmp ˈsʌm/ *noun* an amount of money that is paid in one single payment, not in several small amounts ○ *He received a lump sum payment of £500.* ○ *The company offer a lump sum of £1,000 as an out-of-court settlement.*

lynch /lɪntʃ/ *verb* to catch an accused person and kill him, usually by hanging, without a trial

lynch law /ˈlɪntʃ lɔː/ *noun* the killing of accused persons by a mob without a trial

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M

mace-bearer /ˈmeɪs ˌbeərə/ *noun* an official who carries a mace in procession

machine-readable codes /məˌʃiːn ˈriːdəb(ə)l kəʊds/ *plural noun* sets of signs or letters such as bar codes or post codes which can be read by computers

machine shop /məˈʃiːn ʃɒp/ *noun* a place where working machines are kept

Madam Chairman /ˌmædəm ˈtʃeəmən/ *noun* a way of addressing a woman who is in the chair at the meeting

Mafia /ˈmæfiə/ *noun* any organised group of criminals ○ *the Russian drugs mafia*

magistrate /ˈmædʒɪstreɪt/ *noun* a usually unpaid official who tries cases in a police court

COMMENT: The Magistrates' Courts hear cases of petty crime, adoption, affiliation, maintenance and violence in the home; they hear almost all criminal cases. The court can commit someone for trial or for sentence in the Crown Court. A stipendiary magistrate is a qualified lawyer who usually sits alone; lay magistrates usually sit as a bench of three, and can only sit if there is a justices' clerk present to advise them.

magistrates' clerk /ˈmædʒɪstreɪts klɑːk/ *noun* an official of a magistrates' court who gives advice to the magistrates on law, practice or procedure

magistrates' court /ˈmædʒɪstreɪts kɔːt/ *noun* **1.** a building where magistrates try cases **2.** a court presided over by magistrates

magistrates' courts committee /ˌmædʒɪstreɪts ˌkɔːt kəˈmɪti/ *noun* a committee which organises the administration of the courts in one or more petty sessions areas

mail-order selling /ˈmeɪl ɔːdə ˌselɪŋ/ *noun* the activity of selling by taking orders and supplying a product by post

maintenance /ˈmeɪntənəns/ *noun* **1.** the activity of keeping things going or working ○ *The maintenance of law and order is in the hands of the local police force.* **2.** a payment made by a divorced or separated husband or wife to the former spouse, to help pay for living expenses and the cost of bringing up the children **3.** formerly, the crime or tort of unlawfully providing someone with money to help that person to pay the costs of suing a third party

maintenance agreement /ˌmeɪntənəns əˈgriːmənt/ *noun* an agreement drawn up between a married couple, detailing the financial arrangements which will be set up if they separate

maintenance contract /ˈmeɪntənəns ˌkɒntrækt/ *noun* a contract by which a company keeps a piece of equipment in good working order

maintenance order /ˌmeɪntənəns ˈɔːdə/ *noun* a court order which orders a divorced or separated husband or wife to pay maintenance to the former spouse

maintenance pending suit /ˌmeɪntənəns ˈpendɪŋ suːt/ *noun* maintenance obtained by a spouse in matrimonial proceedings until there is a full hearing to deal with the couple's financial affairs (NOTE: The US term is **alimony**.)

Majesty /ˈmædʒəsti/ *noun* the title given to a King or Queen ○ *His Majesty, the King* ○ *Their Majesties, the King and Queen* ○ *'Your Majesty, the Ambassador has arrived'* □ **on Her Majesty's Serv-**

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Law.fm Page 187 Friday, June 11, 2004 2:08 PM

ice (OHMS) words printed on official letters from government departments. ◊ **Her Majesty's pleasure**

majeure /mæ'ʒɜː/ ♦ **force majeure**

majority /mə'dʒɒrɪti/ *noun* **1.** a larger group than any other □ **a majority of the jury** more than 50% of the jury □ **the board accepted the proposal by a majority of three to two** three members of the board voted to accept and two voted against □ **a majority shareholder** person who owns more than half the shares in a company **2.** the age at which someone becomes responsible for his actions and can sue, be sued or undertake business transactions

COMMENT: The age of majority in the UK and USA is eighteen.

majority verdict /mə,dʒɒrɪti 'vɜːdɪkt/ *noun* a verdict reached by a jury where at least ten jurors vote for the verdict (NOTE: In US English **plurality** is used to indicate a majority over another candidate, and **majority** is used to indicate having more votes than all other candidates put together.)

major shareholder /,meɪdʒə 'ʃeəhəʊldə/ *noun* a shareholder with a large number of shares

maladministration /,mæləd,mɪnɪ 'streɪʃ(ə)n/ *noun* incompetent or illegal administration

mala in se /,mælə ɪn 'seɪ/ *phrase* a Latin phrase meaning 'wrongs in themselves': acts such as murder which are in themselves crimes

mala prohibita /,mælə prəʊ'hɪbɪtə/ *phrase* a Latin phrase meaning 'forbidden wrongs': acts such as walking on the grass in a park which are not crimes in themselves, but which are forbidden

malfeasance /mæl'fiːz(ə)ns/ *noun* an unlawful act

malice /'mælɪs/ *noun* the act of intentionally committing an act from wrong motives, or the intention to commit a crime □ **with malice aforethought** with the intention of committing a crime (especially murder)

malicious /mə'lɪʃəs/ *adjective* intending to cause harm

malicious damage /mə,lɪʃəs 'dæmɪdʒ/ *noun* the deliberate and intentional harming of property

maliciously /mə'lɪʃəsli/ *adverb* in a malicious way, with the intention of causing harm ○ *He claimed that he had been prosecuted maliciously.*

malicious prosecution /mə,lɪʃəs ,prɒsɪ'kjuːʃ(ə)n/ *noun* the tort of charging someone with a crime out of malice and without proper reason

malicious wounding /mə,lɪʃəs 'wuːndɪŋ/ *noun* the offence of inflicting grievous bodily harm on someone with the purpose of causing them injury

malpractice /mæl'præktɪs/ *noun* (*referring to a lawyer, doctor, accountant or other professional person*) acting in an unprofessional or illegal way

managing clerk /'mænɪdʒɪŋ klɑːk/ *noun* a former term for a legal executive

mandamus /mæn'deɪməs/ *Latin word meaning* 'we command': a court order from the Divisional Court of the Queen's Bench Division, ordering a body such as a lower court or tribunal to perform a legal duty ○ *The Chief Constable applied for an order of mandamus directing the justices to rehear the case.*

mandate *noun* /'mændeɪt/ the authority given to a person or persons to act on behalf of the person or persons giving the authority and carry out their wishes ○ *The government has a mandate from the people to carry out the plans put forward in its manifesto.* □ **to seek a new mandate** to try to be re-elected to a position ■ *verb* /mæn'deɪt/ to give a person or persons the authority to carry out a specific action on behalf of another person or persons and according to their wishes ○ *The government has been mandated to revise the tax system.*

mandatory /'mændət(ə)ri/ *adjective* obligatory

mandatory injunction /,mændət(ə)ri ɪn'dʒʌŋkʃən/ *noun* an order from a court which compels someone to do something

mandatory meeting /,mændət(ə)ri 'miːtɪŋ/ *noun* a meeting which must be held or which all members have to attend

manendi ♦ **animus manendi**

mainp - softvnn.com

Law.fm Page 188 Friday, June 11, 2004 2:08 PM

manifest /ˈmænɪfest/ *adjective* obvious ○ *a manifest injustice*

manipulate /məˈnɪpjʊˌleɪt/ *verb* □ **to manipulate the accounts** to make false accounts so that the company seems profitable □ **to manipulate the market** to work to influence share prices in your favour

manslaughter /ˈmænslɔːtə/ *noun* the notifiable offence of killing someone without having intended to do so, or of killing someone intentionally but with mitigating circumstances ○ *He was accused of manslaughter.* ○ *She was convicted of the manslaughter of her husband.*

manual labour /ˌmænjʊəl ˈleɪbə/ *noun* work done by hand

manual labourer /ˌmænjʊəl ˈleɪbərə/ *noun* somebody who does work with their hands

Mareva injunction /məˈreɪvə ɪn ˌdʒʌŋkʃ(ə)n/ *noun* formerly, a court order to freeze the assets of a person who has gone overseas or of a company based overseas to prevent them being taken out of the country (NOTE: Called after the case of *Mareva Compania Naviera SA v. International Bulk-Carriers SA*. Since the introduction of the new Civil Procedure Rules in April 1999, this term has been replaced by **freezing injunction**.)

marine insurance /məˌriːn ɪn ˈʃʊərəns/ *noun* insurance of ships and their cargoes

marine underwriter /məˌriːn ˈʌndəraɪtə/ *noun* somebody who insures ships and their cargoes

marital /ˈmærɪt(ə)l/ *adjective* referring to a marriage

marital privileges /ˌmærɪt(ə)l ˈprɪvəlɪdʒs/ *plural noun* privilege of a spouse not to give evidence against the other spouse in some criminal proceedings

marital rape /ˈmærɪt(ə)l reɪp/ *noun* the act of a husband forcing his wife to have sexual intercourse without her consent

maritime law /ˌmærɪtaɪm ˈlɔː/ *noun* the set of laws referring to ships, ports, etc.

maritime lawyer /ˌmærɪtaɪm ˈlɔːjə/ *noun* a lawyer who specialises in legal matters concerning ships and cargoes

maritime lien /ˌmærɪtaɪm ˈliːən/ *noun* the right to seize a ship against an unpaid debt

maritime trade /ˌmærɪtaɪm ˈtreɪd/ *noun* the activity of carrying commercial goods by sea

mark /mɑːk/ *noun* a cross ('X') put on a document in place of a signature by someone who cannot write

market /ˈmɑːkɪt/ *noun* **1.** □ **to pay black market prices** to pay high prices to get items which are not easily available **2.** □ **a buyer's market** market where goods are sold cheaply because there is little demand □ **a seller's market** market where the seller can ask high prices because there is a large demand for the product **3.** □ **the foreign exchange markets** market where people buy and sell foreign currencies **4.** □ **to buy shares in the open market** to buy shares on the Stock Exchange, not privately

marketable title /ˌmɑːkɪtəb(ə)l ˈtaɪt(ə)l/ *noun* a title to a property which can be sold, i.e. it is free of major encumbrances

market capitalisation /ˌmɑːkɪt ˌkæpɪtəlaɪˈzeɪʃ(ə)n/ *noun* the value of a company calculated by multiplying the price of its shares on the Stock Exchange by the number of shares issued

market day /ˈmɑːkɪt deɪ/ *noun* the day when a market is regularly held

market dues /ˌmɑːkɪt ˈdjuːz/ *plural noun* rent for a place in a market

market overt /ˌmɑːkɪt əʊˈvɜːt/ *noun* a market in which a sale gives good title to a buyer, even though the seller's title may be defective

COMMENT: This was only applied to certain open-air antique markets, and has been abolished.

market price /ˈmɑːkɪt praɪs/ *noun* the price at which a product can be sold

market value /ˌmɑːkɪt ˈvæljuː/ *noun* the value of an asset, product or company, if sold today

marksman /ˈmɑːksmən/ *noun* **1.** somebody who can shoot a gun very accurately **2.** a person who cannot write

mainp - softvnn.com

Law.fm Page 189 Friday, June 11, 2004 2:08 PM

and who has to put an 'X' in place of a signature

mark up /ˌmɑːk ˈʌp/ *verb* □ **to mark up a bill** *US* to make changes to a bill as it goes through committee

marriage /ˈmærɪdʒ/ *noun* the act or state of being joined together as husband and wife □ **by marriage** because of being married ○ *She became a British citizen by marriage.*

marriage of convenience /ˌmærɪdʒ əv kənˈviːniəns/ *noun* a form of marriage arranged for the purpose of acquiring the nationality of a spouse or for some other financial reason

marriage settlement /ˌmærɪdʒ ˈset(ə)lmənt/ *noun* an agreement which is made before marriage where money or property is given on trust for the benefit of the future spouse

marshal /ˈmɑːʃ(ə)l/ *noun US* **1.** an official who carries out the orders of a court (NOTE: The British equivalent is a **bailiff**.) **2.** a federal officer with the same functions as a sheriff at state level

marshalling /ˈmɑːʃ(ə)lɪŋ/ *noun* the action of a beneficiary of an estate to recover money due to them which was paid to a creditor

Marshal of the Admiralty Court /ˌmɑːʃ(ə)l əv ðiː ˈædm(ə)rəlti ˌkɔːt/ *noun* an official in charge of the Admiralty Court

martial /ˈmɑːʃ(ə)l/ *adjective* relating to the armed services

martial law /ˌmɑːʃ(ə)l ˈlɔː/ *noun* rule of a country or part of a country by the army on the orders of the government when ordinary civil law has been suspended ○ *The president imposed* or *declared martial law in two provinces.* ○ *The government lifted martial law.*

mass jailbreak /mæs ˈdʒeɪlˌbreɪk/ *noun* the escape from prison of several prisoners at the same time

master /ˈmɑːstə/ *noun* **1.** an official in the Queen's Bench Division or Chancery Division of the High Court whose work is to examine and decide on preliminary matters before trial **2.** main or original □ **master copy of a file** main copy of a computer file, kept for security purposes

master and servant /ˌmɑːstər ən ˈsɜːvənt/ *noun* employer and employee

Master of the Rolls /ˌmɑːstə əv ðə ˈrəʊlz/ *noun* a senior judge who presides over the Civil Division of the Court of Appeal and is responsible for admitting solicitors to the Roll of Solicitors

Masters of the Bench /ˌmɑːstəz əv ðə ˈbentʃ/ *plural noun* senior members of one of the Inns of Court

material /məˈtɪəriəl/ *adjective* important or relevant

material alteration /məˌtɪəriəl ˌɔːltəˈreɪʃ(ə)n/ *noun* a change made to a legal document which alters the rights or duties in it

material evidence /məˌtɪəriəl ˈevɪd(ə)ns/ *noun* evidence which has important relevance to a case

material witness /məˌtɪəriəl ˈwɪtnəs/ *noun* a witness whose evidence is important to the case

maternity leave /məˈtɜːnɪti liːv/ *noun* a period when a woman is away from work to have a baby

matricide /ˈmætrɪsaɪd/ *noun* the murder of your own mother

matrimonial /ˌmætrɪˈməʊniəl/ *adjective* referring to marriage

matrimonial causes /ˌmætrɪ ˈməʊniəl kɔːzs/ *plural noun* proceedings concerned with rights of partners in a marriage, e.g. divorce or separation proceedings

matrimonial home /ˌmætrɪ ˈməʊniəl həʊm/ *noun* the place where a husband and wife live together

matrimony /ˈmætrɪməni/ *noun* the state of being legally married

matter /ˈmætə/ *noun* **1.** a problem □ **it is a matter of concern to the members of the committee** the members of the committee are worried about it **2.** a question or problem to be discussed ○ *the most important matter on the agenda* ○ *We shall consider first the matter of last month's fall in prices.* ■ *verb* to be important ○ *Does it matter if one month's sales are down?*

matter of fact /ˌmætə əv ˈfækt/ *noun* a question of fact which has to be decided

mainp - softvnn.com

Law.fm Page 190 Friday, June 11, 2004 2:08 PM

matters of fact /ˌmætəz əv ˈfækt/ *plural noun* facts relevant to a case which is being tried at court

matters of law /ˌmætəz əv ˈlɔː/ *noun* the law relevant to a case which is tried at court ○ *It is a matter of fact whether the parties entered into the contract, but it is a matter of law whether or not the contract is legal.*

mature /məˈtjʊə/ *verb* to be due for payment ○ *bill which will mature in three months*

maturity /məˈtjʊərɪti/ *noun* the time when a bill, government stock or insurance is due for payment

maxim /ˈmæksɪm/ *noun* a short phrase which formulates a principle, e.g. 'let the buyer beware'

maximum /ˈmæksɪməm/ *noun* the largest possible quantity, price or number ■ *adjective* largest possible ○ *the maximum penalty*

mayhem /ˈmeɪhem/ *noun* **1.** a general riot or disturbance **2.** the violent removal of a person's arm or leg

mayoralty /ˈmeər(ə)lti/ *noun* the position of a mayor ○ *the time for which someone is mayor*

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means /miːnz/ *plural noun* money which is available

measure /ˈmeʒə/ *noun* **1.** a way of calculating size or quantity **2.** an action to achieve something, e.g. a law passed by Parliament or a statutory instrument ○ *a government measure to reduce crime in the inner cities* □ **to take measures to prevent something happening** to act to stop something happening □ **to take emergency measures** to act rapidly to stop a dangerous situation developing □ **an economy measure** action to try to save money or materials □ **as a precautionary measure** to prevent something taking place

measurement of profitability /ˌmeʒəmənt əv ˌprɒfɪtəˈbɪlɪti/ *noun* a way of calculating how profitable something is

measure of damages /ˌmeʒə əv ˈdæmɪdʒɪz/ *noun* a calculation of how much money a court should order one party to pay another to compensate for a tort or breach

mechanical reproduction rights /mɪˌkænɪk(ə)l ˌriːprəˈdʌkʃ(ə)n ˌraɪts/ *plural noun* the rights to make a recording of a piece of music or a photocopy or other copy of something, usually for a fee

mechanic's lien /mɪˌkænɪks ˈliːən/ ➧ **lien**

mediate /ˈmiːdieɪt/ *verb* to try to make the two sides in an argument come to an agreement ○ *to mediate between the manager and his staff* ○ *The government offered to mediate in the dispute.*

mediation /ˌmiːdɪˈeɪʃ(ə)n/ *noun* an attempt by a third party to make the two sides in an argument agree ○ *The employers refused an offer of government mediation.* ○ *The dispute was ended through the mediation of a disinterested party.*

medical certificate /ˈmedɪk(ə)l sə ˌtɪfɪkət/ *noun* a certificate from a doctor to show that an employee has been ill

medical inspection /ˈmedɪk(ə)l ɪn ˌspekʃ(ə)n/ *noun* the examination of a place of work to see if the conditions are safe

medical officer of health /ˌmedɪk(ə)l ˌɒfɪsə əv ˈhelθ/ *noun* the person responsible for the health services in a town. Abbreviation **MOH**

medium-term /ˌmiːdiəm ˈtɜːm/ *adjective* for a period of one or two years

meeting /ˈmiːtɪŋ/ *noun* **1.** the coming together of a group of people **2.** □ **to hold a meeting** to organise a meeting of a group of people ○ *The meeting will be held in the committee room.* □ **to open a meeting** to start a meeting □ **to conduct a meeting** to be in the chair for a meeting □ **to close a meeting** to end a meeting □ **to put a resolution to a meeting** to ask a meeting to vote on a proposal

member /ˈmembə/ *noun* **1.** somebody who belongs to a group or a society **2.** an organisation which belongs to a society ○ *the member countries* or *the Member States of the EU* ○ *the members of the United Nations* ○ *the member firms of the Stock Exchange*

Member of the European Parliament /ˌmembə əv ðə ˌjʊərəpiːən

mainp - softvnn.com

Law.fm Page 191 Friday, June 11, 2004 2:08 PM

ˈpɑːləmənt/ *noun* a person elected to represent a Euro-constituency in the European Parliament. Abbreviation **MEP**

Member State /ˈmembə steɪt/ *noun* (*in the EU*) a state which is a member of the European Union

memorandum /meməˈrændəm/ *noun* a short note

memorandum of association /ˌmemərændəm əv əˌsəʊsiˈeɪʃ(ə)n/ *noun* a legal document setting up a limited company and giving details of its aims, capital structure, and registered office

memorandum of satisfaction /ˌmemərændəm əv ˌsætɪsˈfækʃən/ *noun* a document showing that a company has repaid a mortgage or charge (NOTE: The plural is **memoranda**.)

menace /ˈmenɪs/ *noun* a threat or action which frightens someone ▫ **demanding money with menaces** crime of getting money by threatening another person

mens rea /ˌmens ˈreɪə/ *phrase* a Latin phrase meaning 'guilty mind': the mental state required to be guilty of committing a crime (intention, recklessness or guilty knowledge). See Comment at **crime**. Compare **actus reus**

mental /ˈment(ə)l/ *adjective* referring to the mind

mental cruelty /ˌment(ə)l ˈkruːəlti/ *noun US* cruelty by one spouse to the other, which may harm his or her mental state (NOTE: It is grounds for divorce in the USA.)

mental disorder /ˌment(ə)l dɪs ˈɔːdə/ *noun* a temporary or permanent change in a person's mental state which makes them function less effectively than they would usually

mentally /ˈment(ə)li/ *adverb* in the mind ○ *Mentally ill criminals are committed to special establishments.*

mention /ˈmenʃən/ *noun* a short hearing at court

mentis ➧ **compos mentis**

MEP *abbreviation* Member of the European Parliament

mercantile law /ˈmɜːkəntaɪl lɔː/ *noun* law relating to commerce

merchantable quality /ˌmɜːtʃəntəb(ə)l ˈkwɒlɪti/ *noun* a quality of goods for sale, which are suitable for the purpose for which they are to be used and conform to the description and price given fro them in the manufacturer's catalogue

merchant marine /ˌmɜːtʃənt mə ˈriːn/ *noun* all the commercial ships of a country

mercy /ˈmɜːsi/ *noun* the act of treating or punishing someone less severely than you could

mercy killing /ˈmɜːsi ˌkɪlɪŋ/ *noun* same as **euthanasia**

merge /mɜːdʒ/ *verb* to join together ○ *The two companies have merged.* ○ *The firm merged with its main competitor.*

merger /ˈmɜːdʒə/ *noun* **1.** the joining of a small estate to a large one ○ *As a result of the merger, the company is the largest in the field.* **2.** the joining together of two or more companies

merit award /ˈmerɪt əˌwɔːd/ *noun US* extra money given to an employee because he or she has worked well

merit increase /ˈmerɪt ˌɪnkriːs/ *noun US* an increase in pay given to someone because his or her work is good

merits of the case /ˌmerɪts əv ðə ˈkeɪs/ *plural noun* main question which is at issue in an action

mesne /miːn/ *adjective* in the middle ▫ **action for mesne profits** action to recover money that should be paid to a landowner in place of rent by a person who is in wrongful possession

mesne process /ˈmiːn ˌprəʊses/ *noun* a process in a legal action, which comes after the first writ but before the outcome of the action has been decided

messuage /ˈmeswɪdʒ/ *noun* a house where people live, and the land and buildings attached to it

metropolitan /ˌmetrəˈpɒlɪt(ə)n/ *adjective* referring to a large city

Metropolitan District Council /ˌmetrəpɒlɪt(ə)n ˌdɪstrɪkt ˈkaʊns(ə)l/ *noun* a large administrative area covering an urban area in England or Wales

Metropolitan Police /ˌmetrəpɒlɪt(ə)n pəˈliːs/ *noun* the po-

mainp - softvnn.com

Law.fm Page 192 Friday, June 11, 2004 2:08 PM

lice force of Greater London, which is directly responsible to the Home Secretary (NOTE: The higher ranks in the Metropolitan Police are Deputy Assistant Commissioner, Assistant Commissioner, and Commissioner.) □ **solicitor for the Metropolitan Police** solicitor responsible for prosecutions brought by the Metropolitan Police

Metropolitan Police Commissioner /ˌmetrəpɒlɪt(ə)n pəˌliːs kə ˈmɪʃ(ə)nə/ *noun* the head of the Metropolitan Police, appointed directly by the Home Secretary (NOTE: The other high ranks in the Metropolitan Police are Assistant Commissioner and Deputy Assistant Commissioner.)

Michaelmas /ˈmɪk(ə)lməs/ *noun* **1.** 29th September, one of the quarter days when rent is payable on land **2.** one of the four sittings of the law courts **3.** one of the four law terms

Middle Temple /ˌmɪd(ə)l ˈtemp(ə)l/ *noun* one of the four Inns of Court in London

Midland and Oxford Circuit /ˌmɪdlənd ənd ˈɒksfəd ˌsɜːkɪt/ *noun* in the UK, one of the six circuits of the Crown Court to which barristers belong, with its centre in Birmingham

Midsummer day /ˌmɪdˈsʌmə deɪ/ *noun* 24th June, one of the four quarter days when rent is payable on land

militant /ˈmɪlɪtənt/ *noun* a person who uses extreme methods to actively support and work for a cause ■ *adjective* using extreme methods in supporting a cause

military police /ˌmɪlɪt(ə)ri pəˈliːs/ *noun* soldiers who act as policemen to keep order among other soldiers

minder /ˈmaɪndə/ *noun* a person employed as a bodyguard to protect someone (*slang*)

minimis ♦ **de minimis non curat lex**

minimum /ˈmɪnɪməm/ *noun* the smallest possible quantity, price or number ○ *to keep expenses to a minimum* ○ *to reduce the risk of a loss to a minimum* ■ *adjective* smallest possible

minimum payment /ˌmɪnɪməm ˈpeɪmənt/ *noun* the smallest payment necessary

minimum sentence /ˌmɪnɪməm ˈsentəns/ *noun* the shortest possible sentence allowed in law for an offence

minimum wage /ˌmɪnɪməm ˈweɪdʒ/ *noun* the lowest hourly wage that a company can legally pay its workers

mining concession /ˈmaɪnɪŋ kən ˌseʃ(ə)n/ *noun* the right to dig a mine on a piece of land which you do not own

ministerial tribunal /ˌmɪnɪstɪəriəl traɪˈbjuːn(ə)l/ *noun* a tribunal set up by a government minister to hear appeals from local tribunals

Minister of State /ˌmɪnɪstə əv ˈsteɪt/ *noun* somebody who is in charge of a section of a government department

Minister without Portfolio /ˌmɪnɪstə wɪˌðaʊt pɔːtˈfəʊliəʊ/ *noun* a minister who does not have responsibility for any particular department

Ministry of Defence /ˌmɪnɪstri əv dɪˈfens/ *noun* a government department in charge of the armed forces

Ministry of the Interior /ˌmɪnɪstri əv ðə ɪnˈtɪəriə/ *noun* in some countries, a government department dealing with law and order, usually including the police

minor /ˈmaɪnə/ *adjective* less important ○ *minor expenditure* ○ *minor shareholders* □ **a loss of minor importance** not a very serious loss ■ *noun* a person less than eighteen years old

minority /maɪˈnɒrɪti/ *noun* **1.** the state of being less than eighteen years old ○ *A person is not liable for debts contracted during minority.* **2.** a period during which someone is less than eighteen years old **3.** a number or quantity which is less than half of the total ○ *A minority of board members opposed the chairman.* □ **in the minority** being fewer than half ○ *The small parties are in the minority on the local council.*

minority shareholder /maɪˌnɒrəti ˈʃeəhəʊldə/ *noun* somebody who owns a group of shares but less than half of the shares in a company

minority shareholding /maɪˌnɒrəti ˈʃeəhəʊldɪŋ/ *noun* a group of shares which are less than one half of the shares in a company

mainp - softvnn.com

Law.fm Page 193 Friday, June 11, 2004 2:08 PM

minor official /ˌmaɪnə əˈfɪʃ(ə)l/ *noun* a person in a low position in a government department

minute /ˈmɪnɪt/ *noun* □ **to take the minutes** to write notes of what happened at a meeting □ **the chairman signed the minutes of the last meeting** he signed them to show that they were a correct record of what was said and what decisions were taken □ **this will not appear in the minutes of the meeting** this is unofficial and will not be noted as having been said ■ *verb* to put something into the minutes of a meeting ○ *The chairman's remarks about the auditors were minuted.* □ **I do not want that to be minuted**, **I want that not to be minuted** do not put that remark into the minutes of the meeting

minutebook /ˈmɪnɪtbɒk/ *noun* a book in which the minutes of a meeting are kept

minutes /ˈmɪnɪts/ *plural noun* the record of what was said at a meeting

minutes of order /ˌmɪnɪts əv ˈɔːdə/ *plural noun* a draft order submitted to a court when a party wishes the court to make an order

misadventure /ˌmɪsədˈventʃə/ *noun* an accident □ **death by misadventure** accidental death ○ *The coroner's verdict was death by misadventure.*

misappropriate /ˌmɪsəˈprəʊprieɪt/ *verb* to steal or use illegally money which is not yours, but with which you have been trusted

misappropriation /ˌmɪsəprəʊpriˈeɪʃ(ə)n/ *noun* the illegal use of money by someone who is not the owner but who has been trusted to look after it

misbehaviour /mɪsbɪˈheɪvjə/ *noun* bad behaviour, especially a criminal offence committed by a public official

miscalculate /mɪsˈkælkjʊleɪt/ *verb* to calculate wrongly ○ *The salesperson miscalculated the discount, so we hardly broke even on the deal.*

miscalculation /mɪsˌkælkjʊˈleɪʃ(ə)n/ *noun* a mistake in calculating

miscarriage of justice /ˌmɪskærɪdʒ əv ˈdʒʌstɪs/ *noun* **1.** a decision wrongly or unjustly reached by a court **2.** a decision which goes against the rights of a party in a case, in such a way that the decision may be reversed on appeal

mischief rule /ˈmɪstʃɪf ruːl/ *noun* the rule that when interpreting a statute, the court should try to see what the wrong was that the statute tried to remedy and what the remedy was that Parliament has enacted

misconduct /mɪsˈkɒndʌkt/ *noun* an illegal action which can harm someone

misdeed /mɪsˈdiːd/ *noun* a crime

misdemeanour /ˌmɪsdɪˈmiːnə/ *noun* a minor crime ○ *He was charged with several misdemeanours, including driving without a valid licence and creating a disturbance.* (NOTE: The US spelling is **misdemeanor**.)

misdescription /ˌmɪsdɪˈskrɪpʃ(ə)n/ *noun* a false or misleading description of the subject of a contract

misdirect /mɪsdaɪˈrekt/ *verb* to give wrong directions to a jury on a point of law

misdirection /ˌmɪsdɪˈrekʃ(ə)n/ *noun* the giving of wrong directions to a jury on a point of law

misfeasance /mɪsˈfiːz(ə)ns/ *noun* acting improperly or illegally in performing an action that is in itself lawful

misinterpret /ˌmɪsɪnˈtɜːprɪt/ *verb* to understand something wrongly ○ *The fire-fighters misinterpreted the instructions of the police.*

misinterpretation /ˌmɪsɪnˌtɜːprɪˈteɪʃ(ə)n/ *noun* a wrong interpretation or understanding of something □ **clause which is open to misinterpretation** clause which can be wrongly interpreted

misjoinder /mɪsˈdʒɔɪndə/ *noun* wrongly joining someone as a party to an action

misprision /mɪsˈprɪʒ(ə)n/ *noun* generally, the situation of knowing that a crime is being committed, but doing nothing about it

misprision of treason /mɪsˌprɪʒ(ə)n əv ˈtriːz(ə)n/ *noun* the crime of knowing that treason has been committed and not reporting it

misrepresent /ˌmɪsrepɪˈzent/ *verb* to report facts wrongly

mainp - softvnn.com

Law.fm Page 194 Friday, June 11, 2004 2:08 PM

misrepresentation /ˌmɪsˌreprɪzen ˈteɪʃ(ə)n/ *noun* the act of making a wrong statement with the intention of persuading someone to enter into a contract

mistake in venue /mɪˌsteɪk ɪn ˈvenjuː/ *noun* the starting of legal proceedings in the wrong court

mistaken identity /mɪˌsteɪkən aɪ ˈdentɪti/ *noun* a situation where someone is wrongly thought to be another person ○ *He was arrested for burglary, but released after it had been established that it was a case of mistaken identity.*

mistrial /ˈmɪstraɪəl/ *noun* a trial which is not valid

misuse /mɪsˈjuːs/ *noun* wrong use ○ *misuse of funds or of assets*

mitigate /ˈmɪtɪgeɪt/ *verb* to make a crime or a punishment less serious

mitigating circumstances /ˌmɪtɪgeɪtɪŋ ˈsɜːkəmstænsɪz/ *plural noun* things which make a crime less serious or which can excuse a crime

mitigation /ˌmɪtɪˈgeɪʃ(ə)n/ *noun* a reduction of a sentence or of the seriousness of a crime ○ *In mitigation, counsel submitted evidence of his client's work for charity.* ○ *Defence counsel made a speech in mitigation.*

mitigation of damages /ˌmɪtɪgeɪʃ(ə)n əv ˈdæmɪdʒɪz/ *noun* a reduction in the extent of damages awarded

mixed hereditaments /ˌmɪkst ˌherɪ ˈdɪtəmənts/ *noun* properties which are used for both domestic and business purposes

M'Naghten Rules /məkˌnɔːtən ˈruːlz/ *noun* rules which a judge applies in deciding if a person charged with a crime is insane

COMMENT: To prove insanity, it has to be shown that because of a diseased mind, the accused did not know what he was doing or did not know that his action was wrong. Based on the case of *R v. M'Naghten* (1843) in which the House of Lords considered and ruled on the defence of insanity.

mob /mɒb/ *noun US* the Mafia

mobster /ˈmɒbstə/ *noun US* a member of an organised crime group

mock auction /ˌmɒk ˈɔːkʃən/ *noun* a sale where gifts are given to purchasers or where only some purchasers are allowed to make bids

modus operandi /ˌməʊdəs ɒpə ˈrændiː/ *phrase* a Latin phrase meaning 'way of working': especially a particular way of committing crimes which can identify a criminal

modus vivendi /ˌməʊdəs vɪˈvendiː/ *phrase* a Latin phrase meaning 'way of living', an informal agreement between two or more parties such as employers and employees to exist peacefully together ○ *After years of confrontation, they finally have achieved a modus vivendi.*

MOH *abbreviation* medical officer of health

moiety /ˈmɔɪəti/ *noun* half

molest /məˈlest/ *verb* to threaten violent behaviour against a child or a woman, especially a spouse, in a sexual way ○ *He was accused of molesting children in the park.*

molestation /ˌməʊleˈsteɪʃ(ə)n/ *noun* the act of threatening violent behaviour towards a child or a woman, especially a spouse

molester /məˈlestə/ *noun* somebody who molests ○ *a convicted child molester*

money claim /ˈmʌni kleɪm/ *noun* a claim which involves the payment of money. e.g. a claim for repayment of a debt or a claim for damages.

moneylender /ˈmʌniˌlendə/ *noun* somebody who lends money at interest

money markets /ˌmʌni ˈmɑːkɪts/ *plural noun* markets for buying and selling short-term loans

money order /ˈmʌni ˌɔːdə/ *noun* a document which can be bought for sending money through the post

monies /ˈmʌniz/ *plural noun* sums of money ○ *monies owing to the company* ○ *to collect monies due*

monogamy /məˈnɒgəmi/ *noun* a system of society where a person is allowed one spouse only. Compare **bigamy, polygamy**

Monopolies Commission, Monopolies and Mergers Commission *noun* a British body which examines

mainp - softvnn.com

Law.fm Page 195 Friday, June 11, 2004 2:08 PM

takeovers and mergers to make sure that a monopoly is not being created (NOTE: US English uses **trust** more often than **monopoly**.)

monopolisation /mə,nɒpəlaɪ 'zeɪʃ(ə)n/, **monopolization** *noun* the process of making a monopoly

monopolise /mə'nɒpəlaɪz/ *verb* to get control of all the supply of a product

monopoly /mə'nɒpəli/ *noun* **1.** a situation where one person or company controls all the market in the supply of a product ○ *to have the monopoly of alcohol sales* or *to have the alcohol monopoly* ○ *The company has the absolute monopoly of imports of French wine.* **2.** the right given to one person or company to control all the market in the supply of a product

monopsony /mə'nɒpsəni/ *noun* a situation where one person or company controls all the purchasing in a market

Monroe doctrine /mʌn'rəʊ ,dɒktrɪn/ *noun US* the principle that the USA has an interest in preventing outside interference in the internal affairs of other American states

COMMENT: So called because it was first proposed by President Monroe in 1823.

moonlight /'muːnlaɪt/ *verb* to do a second job for cash, often in the evening, as well as a regular job, usually not declaring the money earned to the income tax authorities (*informal*)

moonlighter /'muːnlaɪtə/ *noun* somebody who moonlights

moonlighting /'muːnlaɪtɪŋ/ *noun* the activity of doing a second job without telling the tax authorities ○ *He makes thousands a year from moonlighting.*

moot /muːt/ *adjective* legally insignificant because of having already been decided or settled

moot case /,muːt 'keɪs/ *noun* a legal case to be discussed on its own, to establish a precedent

moral /'mɒrəl/ *adjective* referring to the difference between what is right and what is wrong ○ *The high moral standard which should be set by judges.*

moral rights /,mɒrəl 'raɪts/ *noun* the rights of a copyright holder to be identified as the creator of the work, not to have the work subjected to derogatory treatment, and to prevent anyone else from claiming to be the author of the work. Also called **paternity**

morals /'mɒrəlz/ *plural noun* standards of behaviour □ **to corrupt someone's morals** to make someone willing to commit a crime or to act against usual standards of behaviour

moratorium /,mɒrə'tɔːriəm/ *noun* a temporary stop to repayments of money owed ○ *The banks called for a moratorium on payments.* (NOTE: The plural is **moratoria**.)

mortality tables /mɔː'tælətɪ ,teɪb(ə)lz/ *plural noun* charts, used by insurers, that show how long a person can be expected to live, on average

mortem ➧ **post mortem**

mortgage /'mɔːgɪdʒ/ *noun* **1.** an agreement where someone lends money to another person so that he or she can buy a property, the property being used as the security ○ *to take out a mortgage on a house* **2.** money lent in this way ○ *to buy a house with a £20,000 mortgage* □ **to foreclose on a mortgaged property** to take possession of a property because the owner cannot pay the interest on the money which he or she has borrowed using the property as security □ **to pay off a mortgage** to pay back the principal and all the interest on a loan to buy a property ■ *verb* to accept a loan with a property as security ○ *The house is mortgaged to the bank.* ○ *He mortgaged his house to set up in business.*

mortgage bond /'mɔːgɪdʒ bɒnd/ *noun* a certificate showing that a mortgage exists and that the property is security for it

mortgage debenture /'mɔːgɪdʒ dɪ ,bentʃə/ *noun* a debenture where the lender can be repaid by selling the company's property

mortgagee /mɔːgə'dʒiː/ *noun* a person or company which lends money for someone to buy a property and takes a mortgage of the property as security

mortgage payments /,mɔːgɪdʒ 'peɪmənts/, **mortgage repayments** /,mɔːgɪdʒ rɪ'peɪmənts/ *plural noun*

mainp - softvnn.com

Law.fm Page 196 Friday, June 11, 2004 2:08 PM

money paid each month as interest on a mortgage, together with repayment of a small part of the capital borrowed

mortgagor /ˈmɔːgɪdʒə/ *noun* somebody who borrows money, giving a property as security

mortis /ˈmɔːtɪs/ ♦ **donatio mortis causa, rigor mortis**

most favoured nation /məʊst ˌfeɪvəd ˈneɪʃ(ə)n/ *noun* a country which has the best trade terms

most-favoured-nation clause /məʊst ˌfeɪvəd ˈneɪʃ(ə)n klɔːz/ *noun* an agreement between two countries that each will offer the best possible terms in commercial contracts

Mother of Parliaments /ˌmʌðə əv ˈpɑːləmənts/ *noun* the British Parliament at Westminster

motion /ˈməʊʃ(ə)n/ *noun* **1.** the action of moving **2.** a proposal which will be put to a meeting for that meeting to vote on ○ *to propose* or *to move a motion* ○ *to speak against* or *for a motion* ○ *The meeting voted on the motion.* □ **the motion was carried**, **was defeated by 220 votes to 196** the motion was approved *or* not approved **3.** an application to a judge in court, asking for an order in favour of the person making the application ◇ **to table a motion** *US* **1.** to put forward a proposal for discussion by putting details of it on the table at a meeting **2.** to remove a proposal from discussion by a meeting for an indefinite period

motion of censure /ˌməʊʃ(ə)n əv ˈsenʃə/ *noun* a proposal from the Opposition to pass a vote to criticise the government

movable /ˈmuːvəb(ə)l/, **moveable** *adjective* being able to be moved

movable property /ˌmuːvəb(ə)l ˈprɒpəti/ *noun* chattels and other objects which can be moved, as opposed to land

movables /ˈmuːvəb(ə)lz/ *plural noun* same as **movable property**

move /muːv/ *verb* **1.** to go from one place to another ○ *The company is moving from London Road to the centre of town.* ○ *We have decided to move our factory to a site near the airport.* **2.** to propose formally that a motion be accepted by a meeting ○ *He moved that the accounts be agreed.* ○ *I move that the meeting should adjourn for ten minutes.* **3.** to make an application to the court

movements of capital /ˌmuːvmənts əv ˈkæpɪt(ə)l/ *plural noun* changes of investments from one country to another

mover /ˈmuːvə/ *noun* somebody who proposes a motion

MP *abbreviation* Member of Parliament *or* military police

MR *abbreviation* Master of the Rolls (NOTE: usually written after the surname: *Lord Smith, MR* but spoken as 'the Master of the Rolls, Lord Smith')

Mr Big /ˌmɪstə ˈbɪg/ *noun* a criminal whose name is not known, who is the person in control of a large criminal operation (*informal*)

mug /mʌg/ *noun* (*informal*) **1.** somebody who is easily cheated **2.** a face ■ *verb* to attack and rob someone ○ *The tourists were mugged in the station.* ○ *He was accused of mugging an old lady in the street.* (NOTE: **mugging – mugged**)

mugger /ˈmʌgə/ *noun* somebody who attacks and robs someone

mugging /ˈmʌgɪŋ/ *noun* the act of attacking and robbing someone ○ *The number of muggings has increased sharply over the last few years.*

mug shot /ˈmʌg ʃɒt/ *noun* a photograph of a criminal taken after he or she has been detained, kept in the police records

mule /mjuːl/ *noun* a person who takes illegal drugs from one country to another by hiding them on or in their body

multiple ownership /ˌmʌltɪp(ə)l ˈəʊnəʃɪp/ *noun* a situation where something is owned by several parties

multi-track /ˈmʌlti træk/ *noun* (*in civil cases*) the case management system which applies to cases involving sums of more than £15,000 or which present particular complications

COMMENT: The multi-track is the track for most High Court actions including claims regarding professional negligence, fatal accidents, fraud, defamation and claims against the police. The timetable for a multi-track action is as follows: the court fixes a date for a case management conference, then

mainp - softvnn.com

Law.fm Page 197 Friday, June 11, 2004 2:08 PM

one for listing questionnaires to be sent and filed, and finally a date for the trial.

municipal law /mjuːˈnɪsɪp(ə)l lɔː/ *noun* law which is in operation within a state. Compare **international law**

muniments /ˈmjuːnɪmənts/ *plural noun* title deeds

murder /ˈmɜːdə/ *noun* **1.** the notifiable offence of killing someone illegally and intentionally ○ *He was charged with murder.* ○ *She was found guilty of murder.* ○ *The murder rate has fallen over the last year.* **2.** an act of killing someone illegally and intentionally ○ *Three murders have been committed during the last week.* ◊ **first degree murder, second degree murder** ■ *verb* to kill someone illegally and intentionally ○ *He was accused of murdering his wife.*

murderer /ˈmɜːdərə/ *noun* somebody who commits a murder

murderess /ˈmɜːdəres/ *noun* a woman who commits a murder

mutineer /ˌmjuːtɪˈnɪə/ *noun* somebody who takes part in a mutiny

mutiny /ˈmjuːtɪni/ *noun* an agreement between two or more members of the armed forces to disobey commands of superior officers and to try to take command themselves ■ *verb* to carry out a mutiny

mutuality /ˌmjuːtʃuˈælɪti/ *noun* a state where two parties are bound contractually to each other

mutual wills /ˌmjuːtʃuəl ˈwɪlz/ *plural noun* wills made by two people, usually each leaving their property to the other (NOTE: Mutual wills are less capable of being revoked than normal wills.)

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N

named /neɪmd/ *adjective* □ **person named in the policy** person whose name is given on an insurance policy as the person insured

nark /nɑːk/ *noun* a person, often a criminal, who gives information about other criminals to the police (*slang*)

national /ˈnæʃ(ə)nəl/ *adjective* referring to a particular country ■ *noun* somebody who is a citizen of a state ○ *The government ordered the deportation of all foreign nationals.* ○ *Any national of a Member State has the right to work in another Member State, under the same conditions as nationals of that state.* Compare **non-national**

National Anthem /ˌnæʃ(ə)nəl ˈænθəm/ *noun* a piece of music (sometimes with words which are sung to it) which is used to represent the nation officially, and is played at official ceremonies ○ *Everyone stood up when the National Anthem was played.* ○ *The British National Anthem is 'God Save the Queen'.*

National Audit Office /ˌnæʃ(ə)nəl ˈɔːdɪt ˌɒfɪs/ *noun* an independent body, headed by the Comptroller and Auditor-General, which examines the accounts of government departments

National Crime Squad /ˌnæʃ(ə)nəl ˈkraɪm ˌskwɒd/ *noun* a section of the national police which deals with crime on a nation-wide basis and is not part of any local police force. Abbreviation **NCS**

National Criminal Intelligence Service /ˌnæʃ(ə)nəl ˌkrɪmɪn(ə)l ɪn ˈtelɪdʒ(ə)ns ˌsɜːvɪs/ *noun* a central police department which keeps records of criminals from national and international sources and makes them available to police forces all over the country. Abbreviation **NCIS**

National Insurance contributions /ˌnæʃ(ə)nəl ɪnˈʃʊərəns ˌkɒntrɪbjuːʃ(ə)nz/ *plural noun* money paid into the National Insurance scheme by the employer and the worker. Abbreviation **NIC**

nationalise /ˈnæʃ(ə)nəlaɪz/**, nationalize** *verb* to put a privately owned industry under state ownership and control

National Offender Management Service /ˌnæʃ(ə)nəl əˈfendə ˌmænɪdʒmənt ˌsɜːvɪs/ *noun* in the UK, a service merging the Prison and Probation services which is responsible for improving the rehabilitation of offenders in order to reduce repeat offences and crime

nation state /ˈneɪʃ(ə)n steɪt/ *noun* a country which is an independent political unit, usually formed of people with the same language and traditions

natural-born subject /ˌnætʃ(ə)rəl bɔːn ˈsʌbdʒɪkt/ *noun* a term formerly applied to a person born in the UK or a Commonwealth country who was a British citizen by birth

natural child /ˌnætʃ(ə)rəl ˈtʃaɪld/ *noun* a child, especially an illegitimate child, of a particular parent

naturalisation /ˌnætʃ(ə)rəlaɪˈzeɪʃ(ə)n/**, naturalization** *noun* the granting of citizenship of a state to a foreigner ○ *She has applied for naturalisation.* ○ *You must fill in the naturalisation papers.*

naturalised /ˈnætʃ(ə)rəlaɪzd/**, naturalized** *adjective* having legally become a citizen of another country ○ *He is a naturalised American citizen.*

mainp - softvnn.com

Law.fm Page 199 Friday, June 11, 2004 2:08 PM

natural justice /ˌnætʃ(ə)rəl ˈdʒʌstɪs/ *noun* the general principles of justice

natural law /ˌnætʃ(ə)rəl ˈlɔː/ *noun* generally accepted rules of human behaviour, applied in all societies

natural parent /ˌnætʃ(ə)rəl ˈpeərənt/ *noun* same as **biological parent**

natural person /ˌnætʃ(ə)rəl ˈpɜːs(ə)n/ *noun* a human being, as opposed to a legal or artificial 'person' such as a company ○ *In this case, the term 'establishment' is not confined to legal persons, but is extended to natural persons.*

natural right /ˌnætʃ(ə)rəl ˈraɪt/ *noun* the general right that people have to live freely, usually stated in a written constitution

NCIS *abbreviation* National Criminal Intelligence Service

NCS *abbreviation* National Crime Squad

negative easement /ˌnegətɪv ˈiːzmənt/ *noun* an easement where the servient owner stops the dominant owner from doing something

negative integration /ˌnegətɪv ˌɪntɪ ˈgreɪʃ(ə)n/ *noun* the removal of trade barriers within the European Union, according to the interpretation of legislation by the European Court of Justice

neglect /nɪˈglekt/ *noun* **1.** failure to do a duty ○ *The children were suffering from neglect.* **2.** a lack of care towards someone or something ■ *verb* **1.** to fail to take care of someone ○ *He neglected his three children.* **2.** □ **to neglect to do something** to forget or omit to do something which has to be done ○ *He neglected to return his income tax form.*

neglected /nɪˈglektɪd/ *adjective* not well looked after ○ *The local authority applied for a care order for the family of neglected children.*

negligence /ˈneglɪdʒəns/ *noun* **1.** failure to give proper care to something, especially a duty or responsibility, with the result that a person or property is harmed) **2.** the tort of acting carelessly towards others so as to cause harm, entitling the injured party to claim damages

negligent /ˈneglɪdʒənt/ *adjective* failing to give proper care or attention to something ○ *The defendant was negligent in carrying out his duties as a trustee.*

negligently /ˈneglɪdʒənt(ə)li/ *adverb* in a way which shows negligence ○ *The guardian acted negligently towards his ward.*

negotiability /nɪˌgəʊʃiəˈbɪlɪti/ *noun* the ability of a document to be legally transferred to a person simply by passing it to him

negotiable /nɪˈgəʊʃiəb(ə)l/ *adjective* **1.** able to be changed by discussion □ **not negotiable** fixed and unable to be changed ○ *The terms of the agreement are not negotiable.* **2.** able to be exchanged for money □ **not negotiable** not able to be exchanged for cash (*sometimes written on a cheque to indicate that only the person named on the cheque can cash it*)

negotiable cheque /nɪˌgəʊʃiəb(ə)l ˈtʃek/ *noun* a cheque made payable to bearer, i.e. to anyone who holds it

negotiable instrument /nɪˌgəʊʃiəb(ə)l ˈɪnstrʊmənt/ *noun* a document such as a bill of exchange or cheque which can be legally transferred to another owner simply by passing it to him or her or by endorsing it, or which can be exchanged for cash

negotiable paper /nɪˌgəʊʃiəb(ə)l ˈpeɪpə/ *noun* a document which can be transferred from one owner to another for money

negotiate /nɪˈgəʊʃieɪt/ *verb* □ **to negotiate with someone** to discuss a problem formally with someone, so as to reach an agreement ○ *The management refused to negotiate with the union.* □ **to negotiate terms and conditions**, **to negotiate a contract** to discuss and agree the terms of a contract

negotiation /nɪˌgəʊʃiˈeɪʃ(ə)n/ *noun* a discussion of terms and conditions to reach an agreement □ **contract under negotiation** contract which is being discussed □ **a matter for negotiation** something which must be discussed before a decision is reached □ **to enter into negotiations**, **to start negotiations** to start discussing a problem □ **to resume nego-**

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Law.fm Page 200 Friday, June 11, 2004 2:08 PM

tiations to start discussing a problem again, after talks have stopped for a time ▫ **to break off negotiations** to refuse to go on discussing a problem ▫ **to conduct negotiations** to negotiate

negotiator /nɪ'gəʊʃieɪtə/ *noun* somebody who discusses with the aim of reaching an agreement

neighbourhood watch /ˌneɪbəhʊd 'wɒtʃ/ *noun* a system where the people living in an area are encouraged to look out for criminals or to report any breakdown of law and order

nemine contradicente /ˌnemɪneɪ ˌkɒntrædɪ'senteɪ/, **nem con** /ˌnem 'kɒn/ *phrase* a Latin phrase meaning 'with no one contradicting': phrase used to show that no one voted against the proposal ○ *The motion was adopted nem con.*

nemo dat quod non habet /ˌneɪməʊ dæt kwɒd nɒn 'hæbet/ *phrase* a Latin phrase meaning 'no one can give what he does not have': the rule that no one can pass or sell to another person something such as stolen goods to which he or she has no title

neo- /niːəʊ/ *prefix* meaning 'new' or 'in a new form' ○ *a neo-fascist movement* ○ *a neo-Nazi organisation*

neocolonialism /ˌniːəʊkə 'ləʊniəlɪz(ə)m/ *noun* the policy of controlling weaker countries as if they were colonies

net /net/, **nett** *adjective, adverb* remaining after money has been deducted for tax, expenses, etc. ○ *The company's net profit was £10,000.*

net earnings /ˌnet 'ɜːnɪŋz/ *noun* total earnings after tax and other deductions

net estate /ˌnet ɪ'steɪt/ *noun* the estate of a deceased person less administration charges and funeral costs

net gain /ˌnet 'geɪn/ *noun* the total number of seats gained after deducting seats lost ○ *The government lost twenty seats and gained thirty one, making a net gain of eleven.* Opposite **gross** (NOTE: The opposite is **gross**.)

net price /ˌnet 'praɪs/ *noun* a price which cannot be reduced by a discount

net profit /ˌnet 'prɒfɪt/ *noun* a result where income from sales is larger than all expenditure

neutral /'njuːtrəl/ *adjective* not taking sides in a dispute

neutralism /'njuːtrəlɪz(ə)m/ *noun* a state of affairs where a country does not belong to one or other of the superpower groupings

new trial /ˌnjuː 'traɪəl/ *noun* a trial which can be ordered to take place in civil cases, when the first trial was improper in some way

next friend /ˌnekst 'frend/ *noun* somebody who brings an action on behalf of a minor

next of kin /ˌnekst əv 'kɪn/ *noun* the person or persons who are most closely related to someone ○ *His only next of kin is an aunt living in Scotland.* ○ *The police have informed the next of kin of the people killed in the accident.* (NOTE: can be singular or plural)

NIC *abbreviation* National Insurance contributions

nick /nɪk/ *noun* a police station ■ *verb* **1.** to steal **2.** to arrest

night duty /'naɪt ˌdjuːti/ *noun* work done at night ○ *PC Smith is on night duty this week.*

night rate /'naɪt reɪt/ *noun* cheap telephone calls at night

night safe /'naɪt seɪf/ *noun* a safe in the outside wall of a bank, where money and documents can be deposited at night, using a special door

nil return /ˌnɪl rɪ'tɜːn/ *noun* a report showing no sales, no income, no tax, etc.

nisi ➧ **decree nisi, foreclosure order nisi**

nobble /'nɒb(ə)l/ *verb* to interfere with, bribe or influence a juror or jury (*slang*) ○ *He tried to nobble one of the jurors.*

no-claims bonus /nəʊ 'kleɪmz ˌbəʊnəs/ *noun* the reduction of premiums paid because no claims have been made against an insurance policy

noise abatement /'nɔɪz əˌbeɪtmənt/ *noun* measures taken to reduce unacceptable or vibrations, or to protect peo-

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Law.fm Page 201 Friday, June 11, 2004 2:08 PM

ple form exposure to it ○ *A noise abatement notice was served on the club.*

noise pollution /'nɔɪz pəˌluːʃ(ə)n/ *noun* unpleasant sounds which cause discomfort

nolle prosequi /ˌnɒli 'prɒsɪkwaɪ/ *phrase* a Latin phrase meaning 'do not pursue': power used by the Attorney-General to stop a criminal trial

nominal /'nɒmɪn(ə)l/ *adjective* **1.** (*of an amount*) very small ○ *We make a nominal charge for our services.* ○ *They are paying a nominal rent.* **2.** referring to the official value of something rather than the actual value ○ *property with a nominal value of £1 million* **3.** referring to something that is not what it seems ○ *He was the nominal leader of the group but his wife made all the important decisions.*

nominal damages /ˌnɒmɪn(ə)l 'dæmɪdʒɪz/ *plural noun* a very small amount of damages, awarded to show that the loss or harm suffered was technical rather than actual

nominate /'nɒmɪneɪt/ *verb* to officially suggest someone for a position or a prize ○ *He was nominated as Labour candidate.* □ **to nominate someone to a post** to appoint someone to a post without an election □ **to nominate someone as proxy** to name someone as your proxy

nominator /'nɒmɪneɪtə/ *noun* somebody who is entitled to receive money and writes a nomination

nominee /ˌnɒmɪ'niː/ *noun* **1.** a person who has been officially suggested for a position or a prize **2.** a person who is appointed to deal with financial matters on behalf of another person ○ *He is the Party leader's nominee for the post.*

nominee account /ˌnɒmɪ'niː əˌkaʊnt/ *noun* an account held on behalf of another person

nominee shareholder /ˌnɒmɪniː 'ʃeəhəʊldə/ *noun* a person named as the owner of shares, when the shares are in fact owned by another person

non-acceptance /ˌnɒn ək'septəns/ *noun* a situation where the person who should pay a bill of exchange does not accept it

non-arrestable offence /ˌnɒn əˌrestəb(ə)l ə'fens/ *noun* a crime for which a person cannot be arrested without a warrant

COMMENT: Non-arrestable offences are usually crimes which carry a sentence of less than five years imprisonment.

non-capital crime /ə'fens/**, offence** *noun* a crime or offence for which the punishment is not death

non compos mentis /ˌnɒn ˌkɒmpəs 'mentɪs/ *phrase* a Latin phrase meaning 'mad' or 'not fully sane'

non-conformance /ˌnɒn kən 'fɔːməns/ *noun* the act of not conforming ○ *He was criticised for non-conformance with the regulations.*

non-consummation /nɒn ˌkɒnsə 'meɪʃ(ə)n/ *noun* □ **non-consummation of marriage** not having sexual intercourse (between husband and wife)

non-contributory pension scheme /nɒn kənˌtrɪbjʊt(ə)ri 'penʃən skiːm/ *noun* a pension scheme where the employee does not make any contributions and the company pays everything

non-direction /ˌnɒn daɪ'rekʃən/ *noun* (*of a judge*) the fact of not giving instructions to a jury about how to consider something

non-disclosure /ˌnɒn dɪs'kləʊʒə/ *noun* the failure to disclose information which one has a duty to disclose

non-executive director /nɒn ɪgˌzekjʊtɪv daɪ'rektə/ *noun* a director who attends board meetings and gives advice, but does not work full time for a company

nonfeasance /nɒn'fiːzəns/ *noun* failure to do something which should be done by law

nonjoinder /nɒn'dʒɔɪndə/ *noun* a plea that a claimant has not joined all the necessary parties to his or her action

non-molestation order /nɒn ˌməʊle'steɪʃ(ə)n ˌɔːdə/ *noun* an order made by a court to prevent one party, particularly a co-habitant or spouse, from threatening, attacking or making contact with the other

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Law.fm Page 202 Friday, June 11, 2004 2:08 PM

non-national /nɒn 'næʃ(ə)nəl/ *noun* somebody who is not a citizen of a particular state ○ *Non-nationals can be barred from working in an EU country if they do not speak the language.*

non-negotiable instrument /nɒn nɪˌgəʊʃəb(ə)l 'ɪnstrʊmənt/ *noun* a document such as a crossed cheque which is not payable to bearer and so cannot be exchanged for cash

non-payment /ˌnɒn 'peɪmənt/ *noun* □ **non-payment of a debt** not paying a debt due

non-proliferation treaty /ˌnɒn prə ˌlɪfə'reɪʃ(ə)n ˌtriːti/ *noun* a treaty to prevent the possession and development of nuclear weapons spreading to countries which do not yet possess them

non-recurring items /nɒn rɪˌkɜːrɪŋ 'aɪtəmz/ *noun* special items in a set of accounts which appear only once

non-refundable /ˌnɒn rɪ'fʌndəb(ə)l/ *adjective* being ineligible for refund

non-resident /ˌnɒn 'rezɪd(ə)nt/ *noun* somebody who is not considered a resident of a country for tax purposes

non-retroactivity /nɒn ˌretrəʊæk 'tɪvɪti/ *noun* (*in the EU*) the state of not being retroactive

non-returnable /ˌnɒn rɪ'tɜːnəb(ə)l/ *adjective* being impossible to return

non-returnable packing /nɒn rɪ ˌtɜːnəb(ə)l 'pækɪŋ/ *noun* packaging which is to be thrown away when it has been used and not returned to the person who sent it

nonsufficient funds /nɒnsəˌfɪʃənt 'fʌndz/ *noun US* a sum of money in an account which is less than is needed to pay a cheque which has been presented

nonsuit, nonsuited ◇ **to be nonsuit, to be nonsuited 1.** situation in civil proceedings where a claimant fails to establish a cause of action and is forced to abandon his proceedings **2.** situation in criminal proceedings where a judge directs a jury to find the defendant not guilty

non-taxable /ˌnɒn 'tæksəb(ə)l/ *adjective* being ineligible for tax

non-verbal evidence /nɒn ˌvɜːb(ə)l 'evɪd(ə)ns/ *noun* evidence produced in court in the form of maps, photographs or other documents

COMMENT: Verbal evidence may be written or spoken. British lawyers refer specifically to spoken evidence as oral evidence.

non-voting shares /ˌnɒn ˌvəʊtɪŋ 'ʃeəz/ *plural noun* shares which do not allow the shareholder to vote at meetings

North-Eastern Circuit, Northern Circuit /ˌnɔːθ 'iːstən ˌsɜːkɪt/ *noun* two of the six circuits of the Crown Court to which barristers belong, with centres in Leeds and Manchester

noscitur a sociis /ˌnɒskɪtɜː ɑː 'səʊsɪis/ *phrase* a Latin phrase meaning 'the meaning of the words can be understood from the words around them': ambiguous words or phrases can be clarified by referring to the context in which they are used

notarial /nəʊ'teəriəl/ *adjective* referring to notaries public

notarial act /nəʊˌteəriəl 'ækt/ *noun* an act which can be carried out only by a notary public

notary public /ˌnəʊtəri 'pʌblɪk/**, notary** *noun* a lawyer, usually but not necessarily a solicitor, who has the authority to draw up and witness specific types of document and so make them official (NOTE: The plural is **notaries public**.)

note /nəʊt/ *verb* □ **to note a bill** to attach a note to a dishonoured bill of exchange, explaining why it has not been honoured

note of costs /ˌnəʊt əv 'kɒsts/ *noun* a bill or invoice

note of hand /ˌnəʊt əv 'hænd/ *noun* a document stating that someone promises to pay an amount of money on a specified date

not guilty /ˌnɒt 'gɪlti/ ◗ **guilty**

notice /'nəʊtɪs/ *noun* **1.** a piece of written information ○ *The company secretary pinned up a notice about the pension scheme.* **2.** information given to warn someone officially that something is going to happen, e.g. that a contract is going to end, that terms of a contract are going to be changed, that an employee will leave a job at a specific date, or that a tenant must leave the property being occupied □ **to give someone notice**, **to**

mainp - softvnn.com

Law.fm Page 203 Friday, June 11, 2004 2:08 PM

serve notice on someone to give someone a legal notice □ **to give a tenant notice to quit**, **to serve a tenant with notice to quit** to inform a tenant officially that he has to leave the premises by a specified date □ **she has handed in**, **given her notice** she has said she will quit her job □ **until further notice** until different instructions are given □ **at short notice** with very little warning □ **you must give seven days' notice of withdrawal** you must ask to take money out of the account seven days before you want it **3.** a legal document informing someone of something □ **to give notice of appeal** to start official proceedings for an appeal to be heard **4.** knowledge of a fact

notice of allocation /ˌnəʊtɪs əv ˌæləˈkeɪʃ(ə)n/ *noun* an official letter from a court, telling the parties to which of three management tracks their case has been allocated

notice of dishonour /ˌnəʊtɪs əv dɪsˈɒnə/ *noun* a letter or document warning a person to pay a cheque or risk being sued

notice of motion /ˌnəʊtɪs əv ˈməʊʃ(ə)n/ *noun* a document telling the other party to a case that an application will be made to the court

notice of opposition /ˌnəʊtɪs əv ˌɒpəˈzɪʃ(ə)n/ *noun* a document opposing a patent application

notice of service /ˌnəʊtɪs əv ˈsɜːvɪs/ *noun* a document issued by a court to show that a claim has been served

notice to quit /ˌnəʊtɪs tə ˈkwɪt/ *noun* formal notice served by a landlord on a tenant before proceedings are started for possession

notifiable /ˈnəʊtɪfaɪəb(ə)l/ *adjective* being necessary to be notified

notifiable offence /ˌnəʊtɪfaɪəb(ə)l əˈfens/ *noun* a serious offence which can be tried in the Crown Court

not proven /ˌnɒt ˈpruːv(ə)n/ *adjective* referring to a verdict that a prosecution has not produced sufficient evidence to allow the accused to be proved guilty

notwithstanding /ˌnɒtwɪðˈstændɪŋ/ *preposition* in spite of ○ *The case proceeded notwithstanding the objections of the defendant.* ■ *adverb* despite the fact or thing previously mentioned ○ *We had to close the advice centre for lack of funds, its excellent work notwithstanding.*

novation /nəʊˈveɪʃ(ə)n/ *noun* a transaction in which a new contract is agreed by all parties to replace an existing contract, e.g. where one of the parties to the old contract is released from their liability under the old contract and this liability is assumed by a third party

no win no fee /nəʊ ˌwɪn nəʊ ˈfiː/ *noun* same as **conditional fee agreement**

NSF *abbreviation US* nonsufficient funds

nuisance /ˈnjuːs(ə)ns/ *noun* something which causes harm or inconvenience to someone or to property

null /nʌl/ *adjective* without legal value or effect □ **the contract was declared null and void** the contract was said to be no longer valid □ **to render a decision null** to make a decision useless, to cancel a decision

nullification /ˌnʌlɪfɪˈkeɪʃ(ə)n/ *noun* the act of making something invalid

nullify /ˈnʌlɪfaɪ/ *verb* to make something lose its legal value or effect

nullity /ˈnʌlɪti/ *noun* **1.** an action which is void or invalid **2.** a situation where a marriage is ruled never to have been in effective existence

nuncupative will /ˌnʌnkʌpətɪv ˈwɪl/ *noun* a will made orally in the presence of a witness, e.g. a will made by a soldier in time of war

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oath /əʊθ/ *noun* a solemn legal promise that someone will say or write only what is true ▫ **he was on oath**, **under oath** he had promised in court to say what was true ▫ **to administer an oath to someone** to make someone swear an oath ▫ **to take the oath** to swear allegiance to the Queen before taking one's seat as an MP ○ *After taking the oath, the new MP signs the test roll.*

oath of allegiance /ˌəʊθ əv ə ˈliːdʒəns/ *noun* **1.** an oath which is sworn to put the person under the orders or rules of a country, an army, etc ○ *all officers swore an oath of allegiance to the new president* **2.** an oath sworn by all MPs before they can take their seats in the House of Commons (or alternatively they can affirm)

obiter dicta /ˌɒbɪtə ˈdɪktə/ *phrase* a Latin phrase meaning 'things which are said in passing': part of a judgment which is not essential to the decision of the judge and does not create a precedent. ⇨ **ratio decidendi** (NOTE: The singular is **obiter dictum**.)

object *noun* /ˈɒbdʒekt/ purpose or aim ■ *verb* /əbˈdʒekt/ to say that you do not accept or agree with something ○ *to object to a clause in a contract* ▫ **to object to a juror** to ask for a juror not to be appointed because he or she may be biased

objection /əbˈdʒekʃən/ *noun* ▫ **to raise an objection to something** to object to something ○ *One of the parties raised an objection to the wording of the agreement.*

objective /əbˈdʒektɪv/ *noun* something which you try to do ■ *adjective* considered from a general point of view and not from that of the person involved ○ *to carry out an objective review of current legislation* ○ *The judge asked the jury to be objective in considering the evidence put before them.* ○ *You must be objective in assessing the performance of the staff.*

objects clause /ˈɒbdʒɪkts klɔːz/ *noun* a section in a company's memorandum of association which says what work the company will do

obligate /ˈɒblɪgeɪt/ *verb* ▫ **to be obligated to do something** *especially US* to have a legal duty to do something

obligation /ˌɒblɪˈgeɪʃ(ə)n/ *noun* **1.** a duty to do something ▫ **to be under an obligation to do something** to feel it is your duty to do something ▫ **he is under no contractual obligation to buy** he has signed no agreement to buy ▫ **to fulfil one's contractual obligations** to do what is stated in a contract ▫ **two weeks' free trial without obligation** situation where the customer can try the item at home for two weeks without having to buy it at the end of the test **2.** a debt ▫ **to meet one's obligations** to pay one's debts

obligatory /əˈblɪgət(ə)ri/ *adjective* necessary according to the law or rules ○ *Each new member of staff has to pass an obligatory medical examination.*

obligee /ˌɒblɪˈdʒiː/ *noun* somebody who is owed a duty

obligor /ˌɒblɪˈgɔː/ *noun* somebody who owes a duty to someone

obscene /əbˈsiːn/ *adjective* likely to offend public morals and accepted standards of decency, or to deprave or corrupt someone ○ *The magazine was classed as an obscene publication.* ○ *The police seized a number of obscene films.*

obscene publication /əbˌsiːn ˌpʌblɪˈkeɪʃ(ə)n/ *noun* a book or maga-

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Law.fm Page 205 Friday, June 11, 2004 2:08 PM

zine which is liable to deprave or corrupt someone who sees or reads it ○ *The magazine was classed as an obscene publication and seized by customs.*

obscenity /əb'senɪti/ *noun* the state of being obscene ○ *The magistrate commented on the obscenity of some parts of the film.*

obscenity laws /əb'senɪti lɔːz/ *plural noun* law relating to obscene publications or films

observance /əb'zɜːv(ə)ns/ *noun* doing what is required by a law ○ *The government's observance of international agreements.*

observe /əb'zɜːv/ *verb* **1.** to obey a rule or a law ○ *failure to observe the correct procedure* ○ *All members of the association should observe the code of practice.* **2.** to watch or to notice what is happening ○ *Officials have been instructed to observe the conduct of the election.*

observer /əb'zɜːvə/ *noun* somebody who observes ○ *Two official observers attended the meeting.*

obsolete /'ɒbsəliːt/ *adjective* no longer being used or in force and replaced by something else ○ *The law has been made obsolete by new developments in forensic science.*

obstruct /əb'strʌkt/ *verb* to stop something progressing ○ *The parked cars are obstructing the traffic.* □ **obstructing the police** the offence of doing something which prevents a police officer carrying out his or her duty

obstruction /əb'strʌkʃən/ *noun* **1.** something which gets in the way ○ *The car caused an obstruction to the traffic.* **2.** an act of obstructing someone □ **obstruction of the police** doing anything which prevents a police officer from doing his or her duty

obstructive /əb'strʌktɪv/ *adjective* deliberately causing problems ○ *obstructive behaviour*

obtain /əb'teɪn/ *verb* **1.** to get something ○ *to obtain supplies from abroad* ○ *to obtain an injunction against a company* ○ *We find these items very difficult to obtain.* ○ *He obtained control by buying the family shareholding.* □ **to obtain a property by fraud**, **by deception** to trick someone into handing over possession of property □ **obtaining a pecuniary advantage by deception** offence of deceiving someone so as to derive a financial benefit **2.** to exist, be generally accepted, or have legal status ○ *a rule obtaining in international law* ○ *This right does not obtain in judicial proceedings.*

obtaining by deception /əbˌteɪnɪŋ baɪ dɪ'sepʃən/ *noun* the act of acquiring money or property by tricking someone into handing it over

obtaining credit /əbˌteɪnɪŋ 'kredɪt/ *noun* an offence whereby an undischarged bankrupt obtains credit above a limit of £50

occasion /ə'keɪʒ(ə)n/ *noun* the time when something takes place ○ *The opening of the trial was the occasion of protests by the family of the accused.* ■ *verb* to make something happen ○ *He pleaded guilty to assault occasioning actual bodily harm.*

occasional /ə'keɪʒ(ə)n(ə)l/ *adjective* happening from time to time

occasional licence /əˌkeɪʒ(ə)n(ə)l 'laɪs(ə)ns/ *noun* a licence to sell alcohol at a specific place and time only

occupancy /'ɒkjʊpənsi/ *noun* **1.** the act of occupying a property such as a house, office, or room in a hotel □ **with immediate occupancy** empty and available to be occupied immediately **2.** the fact of occupying a property which has no owner and so acquiring title to the property

occupant /'ɒkjʊpənt/ *noun* a person or company which occupies a property

occupation /ˌɒkjʊ'peɪʃ(ə)n/ *noun* **1.** the act of occupying a property which has no owner, and so acquiring title to the property **2.** the work that someone does

occupational /ˌɒkjʊ'peɪʃ(ə)nəl/ *adjective* referring to a job □ **occupational accident** accident which takes place at work □ **occupational disease** a disease which affects people in some jobs □ **occupational hazards** dangers which apply to specific jobs

occupational pension /ˌɒkjʊpeɪʃ(ə)nəl 'penʃə/ *noun* a pension which is paid by the company by which an employee has been employed

mainp - softvnn.com

Law.fm Page 206 Friday, June 11, 2004 2:08 PM

occupational pension scheme /ˌɒkjʊpeɪʃ(ə)nəl ˈpenʃən skiːm/ *noun* a pension scheme where the employee gets a pension from the company he or she has worked for

occupation order /ˌɒkjʊˈpeɪʃ(ə)n ˌɔːdə/ *noun* a court order in marital proceedings which decides the rights of a spouse to use the marital home. It may exclude them entirely or allow them access to the whole or part of the home. Former name **exclusion order**

occupier /ˈɒkjʊpaɪə/ *noun* somebody who lives in a property

COMMENT: The occupier has the right to stay in or on a property, but is not necessarily an owner.

occupier's liability /ˌɒkjʊpaɪəz ˌlaɪəˈbɪlɪti/ *noun* the duty of an occupier to make sure that visitors to a property are not harmed

occupy /ˈɒkjʊpaɪ/ *verb* to enter and stay in a property illegally ○ *The rebels occupied the Post Office.* ○ *Squatters are occupying the building.*

offence /əˈfens/ *noun* an illegal act ○ *He was charged with three serious offences.* ○ *The minister was arrested and charged with offences against the Official Secrets Act.* (NOTE: The US spelling is **offense**.) □ **offence against the person** a criminal act which harms a person physically, e.g. murder or actual bodily harm □ **offence against property** a criminal act which damages or destroys property, e.g. theft, forgery or criminal damage □ **offence against public order** a criminal act which disturbs the general calm of society, e.g. riot or affray □ **offence against the state** an attack on the lawful government of a country, e.g. sedition or treason □ **offence triable either way** an offence which can be tried before a magistrates' court or a Crown Court

offend /əˈfend/ *verb* to commit a crime

offender /əˈfendə/ *noun* somebody who commits a crime

offensive weapon /əˌfensɪv ˈwepən/ *noun* an object which can be used to harm a person or property □ **carrying offensive weapons** the offence of holding a weapon or something such as a bottle which could be used as a weapon

COMMENT: Many things can be considered as offensive weapons if they are used as such: a brick, a bottle, a piece of wire, etc.

offer /ˈɒfə/ *noun* **1.** a statement by one party to a contract that he or she proposes to do something (NOTE: The offer (and acceptance by the other party) is one of the essential elements of a contract.) **2.** □ **the house is under offer** someone has made an offer to buy the house and the offer has been accepted provisionally □ **open to offers** willing to discuss changing something that has been put forward □ **or near offer (o.n.o.)** or an offer of a price which is slightly less than the price asked ○ *asking price: #200 o.n.o.* **3.** □ **he received six offers of jobs, six job offers** six companies told him he could have a job with them ■ *verb* **1.** to propose something to someone, or propose to do something ○ *he offered to buy the house* ○ *to offer someone £100,000 for his house* ○ *he offered £10 a share* □ **to offer someone a job** to tell someone that he or she can have a job in your company **2.** to say that you are willing to sell something ○ *We offered the house for sale.*

offeree /ˌɒfəˈriː/ *noun* somebody who receives an offer

offer for sale /ˌɒfə fə ˈseɪl/ *noun* a situation where a company advertises new shares for sale

offer of amends /ˌɒfə əv əˈmendz/ *plural noun* an offer to write an apology by someone who has libelled another person

offeror /ˈɒfərə/ *noun* somebody who makes an offer

offer price /ˈɒfə praɪs/ *noun* the price at which new shares are put on sale

offer to buy /ˌɒfə tə ˈbaɪ/ *noun* a statement that you are willing to pay a specific amount of money to buy something ○ *to make an offer for a company* ○ *to accept an offer of £1,000 for the car* ○ *He made an offer of £10 a share.* ○ *We made a written offer for the house.* ○ *£1,000 is the best offer I can make.*

offer to sell /ˌɒfə tə ˈsel/ *noun* a statement that you are willing to sell something

office /ˈɒfɪs/ *noun* **1.** a set of rooms where a company works or where busi-

mainp - softvnn.com

Law.fm Page 207 Friday, June 11, 2004 2:08 PM

ness is done **2.** a room where someone works and does business ○ *Come into my office.* ○ *She has a pleasant office which looks out over the park.* ○ *The senior partner's office is on the third floor.* **3.** □ **information office**, **inquiry office** office where someone can answer questions from members of the public **4.** a post or position ○ *He holds* or *performs the office of treasurer.* □ **compensation for loss of office** payment to a director who is asked to leave a company before his or her contract ends

office creeper /ˈɒfɪs ˌkriːpə/ *noun* a well-dressed, well-spoken thief who pretends to be someone such as a sales or repair person and steals valuable items such as laptop computers from offices

office junior /ˌɒfɪs ˈdʒuːniə/ *noun* a young man or woman who does all types of work in an office

Office of Fair Trading /ˌɒfɪs əv feə ˈtreɪdɪŋ/ *noun* the British government department which protects consumers against unfair or illegal business

office of profit /ˌɒfɪs əv ˈprɒfɪt/**, office of profit under the Crown** /ˌɒfɪs əv ˌprɒfɪt ˈʌndə ðɪ kraʊn/ *noun* a government post which disqualifies someone from being a Member of Parliament

officer /ˈɒfɪsə/ *noun* **1.** somebody who has an official position □ **the company officers**, **the officers of a company** the main executives or directors of a company **2.** an official, usually unpaid, of a club or society ○ *The election of officers of an association.*

office security /ˌɒfɪs sɪˈkjʊərɪti/ *noun* the means taken to protect an office against theft of equipment, personal property or information

office space /ˈɒfɪs speɪs/ *noun* the space available for offices or occupied by offices

office staff /ˌɒfɪs ˈstɑːf/ *noun* people who work in offices

official /əˈfɪʃ(ə)l/ *adjective* **1.** done because it has been authorised by a government department or organisation ○ *He left official documents in his car.* ○ *She received an official letter of explanation.* □ **speaking in an official capacity** speaking officially □ **to go through official channels** to deal with officials, especially when making a request **2.** done or approved by a director or by a person in authority ○ *This must be an official order – it is written on the company's notepaper.* ■ *noun* somebody working in a government department

official copy /əˌfɪʃ(ə)l ˈkɒpɪ/ *noun* a copy of an official document which has been sealed by the office which issued it

Official Journal /əˌfɪʃ(ə)l ˈdʒɜːn(ə)l/ *noun* a publication which lists the regulations, statutory instruments and directives of the EC

officially /əˈfɪʃ(ə)li/ *adverb* in an official way ○ *Officially he knows nothing about the problem, but unofficially he has given us a lot of advice about it.*

official mediator /əˌfɪʃ(ə)l ˈmiːdieɪtə/ *noun* a government official who tries to make the two sides in an industrial dispute agree

Official Receiver /əˌfɪʃ(ə)l rɪˈsiːvə/ *noun* a government official who is appointed to close down a company which is in liquidation or deal with the affairs of a bankrupt

official referee /əˌfɪʃ(ə)l ˌrefəˈriː/ *noun* a judge with specialist knowledge who is appointed by the High Court to try complicated, usually technical, cases of a particular type

official return /əˌfɪʃ(ə)l rɪˈtɜːn/ *noun* an official report or statement

official secret /əˌfɪʃ(ə)l ˈsiːkrət/ *noun* a piece of information which is classified as important to the state and which it is a crime to reveal

Official Secrets Act /əˌfɪʃ(ə)l ˈsiːkrəts ˌækt/ *noun* an Act of Parliament which governs the publication of secret information relating to the state

Official Solicitor /əˌfɪʃ(ə)l səˈlɪsɪtə/ *noun* a solicitor who acts in the High Court for parties who have no-one to act for them, usually because they are under a legal disability

official strike /əˌfɪʃ(ə)l ˈstraɪk/ *noun* a strike which has been approved by the union

officio /əˈfɪʃɪəʊ/ ◗ **ex officio, functus officio**

mainp - softvnn.com

Law.fm Page 208 Friday, June 11, 2004 2:08 PM

off-licence /'ɒf ˌlaɪs(ə)ns/ *noun* **1.** a licence to sell alcohol for drinking away from the place where you buy it **2.** a shop which sells alcohol for drinking at home

offspring /'ɒfˌsprɪŋ/ *noun* a child or children of a parent ○ *His offspring inherited the estate.* ○ *They had two offspring.* (NOTE: offspring is both singular and plural)

off the record /ˌɒf ðə 'rekɔːd/ *adverb* unofficially or in private ○ *He made some remarks off the record about the rising crime figures.*

Old Bailey /ˌəʊld 'beɪli/ *noun* the Central Criminal Court in London

old lag /ˌəʊld 'læg/ *noun* a criminal who has served many (short) prison sentences, one who will never go straight (*informal*)

oligarchical /ˌɒlɪ'gɑːkɪk(ə)l/**, oligarchic** /ˌɒlɪ'gɑːkɪk/ *adjective* referring to an oligarchy

ombudsman /'ɒmbʊdzmən/ *noun* an official who investigates complaints by the public against government departments or other large organisations. Also called **Parliamentary Commissioner**

COMMENT: There are in fact several ombudsmen: the main one is the Parliamentary Commissioner, but there are also others, such as the Health Service Commissioner, who investigates complaints against the Health Service, and the Local Ombudsman who investigates complaints against local authorities, the Banking Ombudsman, who investigates complaints against banks, etc. In 1990, a Legal Services Ombudsman was appointed to investigate complaints against non-legal professional people who supply legal services, such as conveyancing. Although an ombudsman will make his recommendations to the department concerned, and may make his recommendations public, he has no power to enforce them. The Parliamentary Commissioner may only investigate complaints which are addressed to him through an MP; the member of the public first brings his complaint to his MP, and if the MP cannot get satisfaction from the department against which the complaint is made, then the matter is passed to the Ombudsman.

omission /əʊ'mɪʃ(ə)n/ *noun* the failure to do something

one minute speech /ˌwʌn 'mɪnət ˌspiːtʃ/ *noun US* a short speech by a member of the House of Representatives on any subject at the beginning of the day's business

o.n.o. *abbreviation* or near offer

onus /'əʊnəs/ *noun* responsibility for doing something difficult □ **onus of proof**, **onus probandi** the duty to prove that what has been alleged in court is correct ○ *The onus of proof is on the claimant.* ◊ **burden of proof**

op. cit. *phrase* a Latin phrase meaning 'in the work mentioned' (NOTE: used when referring to a legal text: '**see Smith LJ in** *Jones v. Amalgamated Steel Ltd* **op. cit. p. 260**')

open /'əʊpən/ *adjective* □ **in open court** in a courtroom with members of the public present ■ *verb* to begin speaking ○ *Counsel for the prosecution opened with a description of the accused's family background.* □ **to open negotiations** to begin negotiating

open account /ˌəʊpən ə'kaʊnt/ *noun* an amount owed with no security offered

open cheque /ˌəʊpən 'tʃek/ *noun* a cheque which is not crossed and can be exchanged for cash anywhere

open court /'əʊpən kɔːt/ *noun* a court where the hearings are open to the public

open credit /ˌəʊpən 'kredɪt/ *noun* bank credit given to good customers without security up to a maximum sum

open-ended /ˌəʊpən 'endɪd/**, open-end** *US* /ˌəʊpən 'end/ *adjective* with no fixed limit, or with some items not specified ○ *an open-ended agreement*

open hearing /ˌəʊpən 'hɪərɪŋ/ *noun* a hearing that the public and journalists may attend

opening /'əʊp(ə)nɪŋ/ *noun* □ **a market opening** possibility of starting to do business in a new market ■ *adjective* happening at the beginning of something ○ *the judge's opening remarks* ○ *the opening speech from the defence counsel* or *from the Home Secretary*

opening balance /'əʊp(ə)nɪŋ ˌbæləns/ *noun* the balance at the beginning of an accounting period

mainp - softvnn.com

Law.fm Page 209 Friday, June 11, 2004 2:08 PM

opening bid /ˌəʊp(ə)nɪŋ ˈbɪd/ *noun* the first bid at an auction

opening entry /ˈəʊp(ə)nɪŋ ˌentri/ *noun* the first entry in an account

opening price /ˌəʊp(ə)nɪŋ ˈpraɪs/ *noun* the price at the start of a day's trading

opening stock /ˌəʊp(ə)nɪŋ ˈstɒk/ *noun* the details of stock at the beginning of an accounting period

open policy /ˌəʊpən ˈpɒlɪsi/ *noun* a marine insurance policy, where the value of what is insured is not stated

open prison /ˌəʊpən ˈprɪz(ə)n/ *noun* a prison with minimum security where category 'D' prisoners can be kept

open ticket /ˌəʊpən ˈtɪkɪt/ *noun* a ticket which can be used on any date

open verdict /ˌəʊpən ˈvɜːdɪkt/ *noun* a verdict in a coroner's court which does not decide how the dead person died ○ *The court recorded an open verdict on the two policemen.*

operandi ➧ **modus operandi**

operating /ˈɒpəreɪtɪŋ/ *noun* the general running of a business or of a machine

operating budget /ˈɒpəreɪtɪŋ ˌbʌdʒɪt/ *noun* income and expenditure which is expected to be incurred over a period of time

operating costs /ˈɒpəreɪtɪŋ ˌkɒsts/ *plural noun* costs of the day-to-day organisation of a company

operating loss /ˈɒpəreɪtɪŋ lɒs/ *noun* a loss made by a company in its usual business

operation /ˌɒpəˈreɪʃ(ə)n/ *noun* □ **in operation** working, being used ○ *The system will be in operation by June.* ○ *The new system came into operation on June 1st.*

operational /ˌɒpəˈreɪʃ(ə)nəl/ *adjective* □ **the system became operational on June 1st** the system began working on June 1st

operational budget /ˌɒpəreɪʃ(ə)nəl ˈbʌdʒɪt/ *noun* expenditure which is expected to be made in running a business, office or other organisation such as police force

operational costs /ˌɒpəreɪʃ(ə)nəl ˈkɒsts/ *plural noun* costs of running a business or a police force

operational planning /ˌɒpəreɪʃ(ə)nəl ˈplænɪŋ/ *noun* the activity of planning how something is to be run

operational research /ˌɒpəreɪʃ(ə)nəl rɪˈsɜːtʃ/ *noun* a study of a method of working to see if it can be made more efficient and cost-effective

operations review /ˌɒpəreɪʃ(ə)nz rɪˈvjuː/ *noun* an assessment of the way in which a company or department works to see how it can be made more efficient and profitable

operative words /ˌɒp(ə)rətɪv ˈwɜːdz/ *plural noun* words in a conveyancing document which transfer the land or create an interest in the land

opinion /əˈpɪnjən/ *noun* **1.** □ **to be of the opinion** to believe or to think ○ *The judge was of the opinion that if the evidence was doubtful the claim should be dismissed.* **2.** a piece of expert advice ○ *to ask an adviser for his opinion on a case* ○ *The lawyers gave their opinion.* ○ *Counsel prepared a written opinion.* **3.** a judgment delivered by a court, especially the House of Lords **4.** (*in the EU*) an opinion of the European Community which is not legally binding

opinion poll /əˈpɪnjən pəʊl/ *noun* the activity of asking a sample group of people what they feel about something in order to assess the opinion of the whole population

opponent /əˈpəʊnənt/ *noun* somebody who is against you or who votes against what you propose ○ *The prosecution tried to discredit their opponents in the case.*

oppose /əˈpəʊz/ *verb* **1.** to try to stop something happening ○ *We are all opposed to the takeover.* ○ *Counsel for the claimant opposed the defendant's application for an adjournment.* □ **the police opposed bail**, **opposed the granting of bail** the police said that bail should not be granted to the accused **2.** to vote against something ○ *A minority of board members opposed the motion.*

mainp - softvnn.com

Law.fm Page 210 Friday, June 11, 2004 2:08 PM

opposition /ˌɒpəˈzɪʃ(ə)n/ *noun* strong disagreement with a suggestion or plan, often including action to try to change or stop it ○ *There was considerable opposition to the plan for reorganising the divorce courts.* ○ *The voters showed their opposition to the government by voting against the proposal in the referendum.*

option /ˈɒpʃən/ *noun* an offer to someone of the right to enter into a contract at a later date □ **option to purchase, to sell** giving someone the possibility to buy or sell something within a period of time or when a specific event happens □ **to grant someone a six-month option on a product** to allow someone six months to decide if he or she wants to be the agent for a product, or if he or she wants to manufacture the product under licence □ **to take up an option, to exercise an option** to accept the option which has been offered and to put it into action ○ *He exercised his option* or *he took up his option to acquire sole marketing rights to the product.* □ **I want to leave my options open** I want to be able to decide what to do when the time is right □ **to take the soft option** to decide to do something which involves the least risk, effort or problems

option contract /ˈɒpʃən ˌkɒntrækt/ *noun* the right to buy or sell shares at a fixed price

oral /ˈɔːrəl/ *adjective* spoken

oral evidence /ˌɔːrəl ˈevɪd(ə)ns/ *noun* spoken evidence, as opposed to written evidence

orally /ˈɔːrəli/ *adverb* in speech, not in writing

order /ˈɔːdə/ *noun* **1.** a general state of calm, where everything is working as planned and ruled ○ *There was a serious breakdown of law and order.* □ **offence against public order, public order offence** riot, street fight, etc. **2.** □ **orders** legislation made by ministers, under powers delegated to them by Act of Parliament, but which still have to be ratified by Parliament before coming into force **3.** □ **to call a meeting to order** to start proceedings officially □ **to bring a meeting to order** to get a meeting back to discussing the agenda again (after an interruption) □ **order ! order!** call by the Speaker of the House of Commons to bring the meeting to order **4.** □ **pay to Mr Smith or order** pay money to Mr Smith or as he orders □ **pay to the order of Mr Smith** pay money directly into Mr Smith's account

order book /ˈɔːdə bʊk/ *noun* a list showing the House of Commons business for the term of Parliament

Order in Council /ˌɔːdə ɪn ˈkaʊns(ə)l/ *noun* legislation approved by the Queen in Council, which is allowed by an Act of Parliament and does not have to be ratified by Parliament

order of certiorari /ˌɔːdə əv ˌsɜːʃiə ˈreərai/ *noun* an order which transfers a case from a lower court to the High Court for investigation into its legality ○ *He applied for judicial review by way of certiorari.* ○ *The court ordered certiorari following judicial review, quashing the order made by the juvenile court.*

order of committal /ˌɔːdə əv kə ˈmɪt(ə)l/ *noun* same as **committal order**

order of discharge /ˌɔːdə əv ˈdɪstʃɑːdʒ/ *noun* a court order releasing a person from bankruptcy

order paper /ˌɔːdə ˈpeɪpə/ *noun* the agenda of business to be discussed each day in the House of Commons

ordinance /ˈɔːdɪnəns/ *noun* **1.** a special decree of a government **2.** *US* a rule made by a municipal authority, and effective only within the jurisdiction of that authority

ordinarily /ˈɔːd(ə)n(ə)rɪli/ *adverb* normally or usually

ordinarily resident /ˌɔːd(ə)n(ə)rɪli ˈrezɪd(ə)nt/ *noun* someone who is usually resident in a particular country

ordinary /ˈɔːd(ə)n(ə)ri/ *adjective* normal or not special

ordinary member /ˌɔːd(ə)n(ə)ri ˈmembə/ *noun* somebody who pays a subscription to belong to a club or group

ordinary resolution /ˌɔːd(ə)n(ə)ri ˌrezəˈluːʃ(ə)n/ *noun* a resolution which can be passed by a simple majority of shareholders

mainp - softvnn.com

Law.fm Page 211 Friday, June 11, 2004 2:08 PM

ordinary shareholder /ˌɔːd(ə)n(ə)ri ˈʃeəhəʊldə/ *noun* somebody who owns ordinary shares in a company

organised crime /ˌɔːgənaɪzd ˈkraɪm/ *noun* criminal activities which are run as a business, with groups of specialist criminals, assistants, security staff, etc., all run by a group of directors or by a boss

organised labour /ˌɔːgənaɪzd ˈleɪbə/ *noun* all the employees who are members of trade unions

original /əˈrɪdʒən(ə)l/ *noun* the first copy made ○ *Send the original and file two copies.*

original evidence /əˌrɪdʒən(ə)l ˈevɪd(ə)ns/ *noun* evidence given by a witness, based on facts which he or she knows to be true as opposed to hearsay

originate /əˈrɪdʒɪneɪt/ *verb* to begin to exist

originating application /əˌrɪdʒɪneɪtɪŋ ˌæplɪˈkeɪʃ(ə)n/ *noun* a way of beginning some types of case in the County Court

originating summons /əˌrɪdʒɪneɪtɪŋ ˈsʌmənz/ *noun* a summons whereby a legal action is commenced, usually in the Chancery Division of the High Court in cases relating to land or the administration of an estate

orphan /ˈɔːf(ə)n/ *noun* a child whose parents have died

ostensible /ɒˈstensɪb(ə)l/ *adjective* appearing to be something, but not really so

ostensible partner /ɒˌstensɪb(ə)l ˈpɑːtnə/ *noun* a person who appears to be a partner in a business by allowing his or her name to be used but really has no interest

otherwise /ˈʌðəwaɪz/ *adverb* in another way ○ *John Smith, otherwise known as 'the Butcher'.* □ **except as otherwise stated** except where it is stated in a different way □ **unless otherwise agreed** unless different terms are agreed

ouster /ˈaʊstə/ *noun* the removal of an occupier from a property so that he or she has to sue to regain possession, used especially in matrimonial proceedings against a violent spouse ○ *He had to apply for an ouster order.* ○ *The judge made an ouster order.* Compare **eject**

Outer House /ˈaʊtə haʊz/ *noun* part of the Scottish Court of Session, formed of five judges

outlaw /ˈaʊtlɔː/ *noun* an old term for a person who was thrown out of society as a punishment ■ *verb* to say that something is unlawful ○ *The government has proposed a bill to outlaw drinking in public.*

outline planning permission /ˌaʊt(ə)laɪn ˈplænɪŋ pəˌmɪʃ(ə)n/ *noun* general permission to build a property on a piece of land, but not final because there are no details provided

out of court /ˌaʊt əv ˈkɔːt/ *adverb, adjective* settled without going to court to end a dispute □ **a settlement was reached out of court** a dispute was settled between two parties privately without continuing a court case

out of pocket /ˌaʊt əv ˈpɒkɪt/ *adjective, adverb* having paid out money personally □ **out-of-pocket expenses** the amount of money to pay an employee back for his or her own money which has been spent on company business

output tax /ˈaʊtpʊt tæks/ *noun* VAT charged by a company on goods or services sold

outright /ˌaʊtˈraɪt/ *adverb, adjective* completely □ **to purchase something outright**, **to make an outright purchase** to buy something completely, including all rights in it

outside /ˈaʊtsaɪd/ *adjective, adverb* not in a prison or institution □ **on the outside** outside a prison or institution ○ *They need help with returning to life on the outside.*

outside dealer /ˌaʊtsaɪd ˈdiːlə/ *noun* somebody who is not a member of the Stock Exchange but is allowed to trade

outside director /ˌaʊtsaɪd daɪ ˈrektə/ *noun* a director who is not employed by the company

outside line /ˌaʊtsaɪd ˈlaɪn/ *noun* a line from an internal office telephone system to the main telephone exchange

outside worker /ˈaʊtsaɪd ˌwɜːkə/ *noun* a worker who does not work in a company's offices

mainp - softvnn.com

Law.fm Page 212 Friday, June 11, 2004 2:08 PM

outstanding /aʊt'stændɪŋ/ *adjective* not yet paid or completed □ **matters outstanding from the previous meeting** questions which were not settled at the previous meeting

outstanding debts /aʊtˌstændɪŋ 'dets/ *plural noun* debts which are waiting to be paid

outstanding offences /aʊt ˌstændɪŋ ə'fenss/ *plural noun* offences for which a person has not yet been convicted, which can be considered at the same time as a similar offence for which he or she faces sentence

Oval Office /ˌəʊvəl 'ɒfɪs/ *noun* the room in the White House which is the personal office of the President of the United States (NOTE: also used to mean the President himself: *The Oval Office was not pleased by the attitude of the Senate.*)

overall majority /ˌəʊvərɔːl mə 'dʒɒrɪti/ *noun* same as **absolute majority**

overdue /ˌəʊvə'djuː/ *adjective* having not been paid on time □ **interest payments are three weeks overdue** interest payments which should have been made three weeks ago. Compare **outstanding**

overreaching /ˌəʊvə'riːtʃɪŋ/ *noun* a legal principle where an interest in land is replaced by a direct right to money

override /ˌəʊvə'raɪd/ *verb* **1.** to be more important than something else ○ *They believe public safety overrides individual preference.* **2.** to use official power to change someone else's decision ○ *The appeal court overrode the decision of the lower court.*

COMMENT: If the President of the USA disapproves of a bill sent to him by Congress for signature, he can send it back with objections within ten days of receiving it. Then if the Congress votes with a two-thirds majority in both Houses to continue with the bill, the bill becomes law and the President's veto is overridden.

overrider /'əʊvəraɪdə/, **overriding commission** /ˌəʊvəraɪdɪŋ kə'mɪʃ(ə)n/ *noun* a special extra commission which is above all other commissions

overriding interest /ˌəʊvəraɪdɪŋ 'ɪntrəst/ *noun* an interest which comes before that of another party ○ *His wife established an overriding interest in the property against the bank's charge on it.* (NOTE: **overriding – overrode – has overridden**)

overrule /ˌəʊvə'ruːl/ *verb* **1.** (*of a higher court*) to set a new precedent by deciding a case on a different principle from one laid down by a lower court ○ *The Supreme Court can overrule any other court in the USA.* **2.** (*in a meeting*) not to allow something because you are more powerful than others ○ *Mr Smith tried to object but his objection was overruled by the chairman.* ○ *Community law must overrule national constitutions of Member States.*

overseas call /ˌəʊvəsiːz 'kɔːl/ *noun* a call to another country

overt /əʊ'vɜːt/ *adjective* clear and obvious

overt act /əʊ'vɜːt ækt/ *noun* an act which is obviously aimed at committing a criminal offence

overtime /'əʊvətaɪm/ *adverb* □ **to work overtime** to work longer hours than in the contract of employment

overtime pay /'əʊvətaɪm peɪ/ *noun* pay for extra time worked

overturn /ˌəʊvə'tɜːn/ *verb* to cancel a judgment on appeal

own /əʊn/ *verb* to have or to possess □ **a wholly-owned subsidiary** a subsidiary which belongs completely to the parent company □ **a state-owned industry** an industry which is nationalised

owner /'əʊnə/ *noun* somebody who owns something □ **goods sent at owner's risk** situation where it is the owner of the goods who has to insure them while they are being shipped

owner-occupier /ˌəʊnər 'ɒkjʊpaɪə/ *noun* somebody who owns the property which he or she occupies

ownership /'əʊnəʃɪp/ *noun* the act of owning something □ **the ownership of the company has passed to the banks** the banks have become owners of the company

oyez /əʊ'jez/ *French word meaning* 'hear!': used at the beginning of some types of official proceedings

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P

pack /pæk/ *verb* to fill a group such as a committee or a jury with members who are sympathetic to your views ○ *The left-wing group packed the general purposes committee with activists.*

pact /pækt/ *noun* a formal agreement between two parties or countries ○ *The countries in the region signed a non-aggression pact.* ○ *The two minority parties signed an electoral pact not to oppose each other in specific constituencies.*

pais ◆ **estoppel**

palimony /'pælɪməni/ *noun* the money that a court orders a man to pay regularly to a woman with whom he has been living and from whom he has separated

pan- /pæn/ *prefix* meaning 'covering all'

pandering /'pændərɪŋ/ *noun* the crime of attempting to solicit customers for prostitutes

panel /'pæn(ə)l/ ◆ **empanel**

Papal Nuncio /ˌpeɪp(ə)l 'nʌnsiəʊ/ *noun* an ambassador sent by the Pope to a country

paper /'peɪpə/ *noun* **1.** a thin material for writing on or for wrapping **2.** an outline report ○ *The Treasurer asked his deputy to write a paper on new funding.* ○ *The planning department prepared a paper for the committee on the possible uses of the site.* ◇ **Green Paper, White Paper 3.** □ **papers** documents ○ *The solicitor sent me the relevant papers on the case.* ○ *The police have sent the papers on the fraud to the Director of Public Prosecutions.* ○ *He has lost the customs papers.* ○ *The office is asking for the VAT papers.* **4.** □ **on paper** as explained in writing, but not tested in practice ○ *On paper the system is ideal, but we have to see it working before we will sign the contract.* **5.** documents such as bills of exchange or promissory notes which can represent money **6.** □ **paper money, paper currency** banknotes **7.** a newspaper

paper feed /'peɪpə fiːd/ *noun* a device which puts paper into a printer or copying machine

paper loss /ˌpeɪpə 'lɒs/ *noun* the loss made when an asset has fallen in value but has not been sold

paper money /ˌpeɪpə 'mʌni/ *noun* money in notes, not coins

paper profit /ˌpeɪpə 'prɒfɪt/ *noun* the profit made when an asset has increased in value but has not been sold

paralegal /ˌpærə'liːg(ə)l/ *adjective* related to, but not part of, the law ■ *noun* somebody with no legal qualifications who works in a lawyer's office

paramount /'pærəmaʊnt/ *adjective* superior

parasitic rights /ˌpærə'sɪtɪk raɪts/ *noun* (*in the EU*) the rights of persons to live in a EU country if they are dependent for their means of living on persons who have the right to reside and to have employment

pardon /'pɑːd(ə)n/ *noun* the action of forgiving an offence by a Parliament or by a monarch ■ *verb* to forgive an offence ○ *The political prisoners were pardoned by the president.*

COMMENT: Not the same as 'quashing' a conviction, which means that the conviction has been made void; both 'pardoning' and 'quashing' have the same effect.

parens patriae /ˌpærenz 'pætrɪi/ *phrase* a Latin phrase meaning 'parent of the nation', referring to a king, queen or other head of state as the sovereign

mainp - softvnn.com

Law.fm Page 214 Friday, June 11, 2004 2:08 PM

and guardian of children or people suffering from a legal disability

parent /ˈpeərənt/ *noun* □ **parents** father and mother

parental responsibility /pəˌrent(ə)l rɪˌspɒnsɪˈbɪlɪti/ *noun* a concept introduced by the Children's Act 1989, which encompasses all the rights, duties and responsibilities that by law a parent of a child is entitled to have. Former name **custody** (NOTE: Parental responsibility is automatically acquired by both parents if married and in cases of unmarried couples, given to the mother alone. An unmarried father is able to acquire parental responsibility by consent of the mother or by obtaining a parental responsibility order which is issued by a court.)

parent company /ˈpeərənt ˌkʌmp(ə)ni/ *noun* a company which owns more than half of another company's shares

parentis ➧ **in loco parentis**

pari passu /ˌpæri ˈpæsuː/ *phrase* a Latin phrase meaning 'equally' or 'with no distinction between them' ○ *The new shares will rank pari passu with the existing ones.*

parity /ˈpærɪti/ *noun* the fact of being equal □ **the female staff want parity with the men** they want to have the same rates of pay and conditions as the men □ **the pound fell to parity with the dollar** the pound fell to a point where one pound equalled one dollar

parking offence /ˈpɑːkɪŋ əˌfens/ *noun* an offence caused when parking a vehicle, e.g. parking on yellow lines, or too near to street corners or pedestrian crossings

parliament /ˈpɑːləmənt/ *noun* an elected group of representatives who form the legislative body which votes the laws of a country. In the UK, it is formed of the House of Commons and House of Lords.

parliamentary /ˌpɑːləˈment(ə)ri/ *adjective* referring to parliament

parliamentary agent /ˌpɑːləment(ə)ri ˈeɪdʒ(ə)nt/ *noun* a person, usually a solicitor or barrister, who advises private individuals who wish to promote a Bill in Parliament

Parliamentary Commissioner /ˌpɑːləˌment(ə)ri kəˈmɪʃ(ə)nə/, **Parliamentary Commissioner for Administration** /ˌpɑːləment(ə)ri kəˌmɪʃ(ə)nə fər ədmɪnɪˈstreɪʃ(ə)n/ *noun* the official who investigates complaints by the public against government departments. Also called **Ombudsman**

parliamentary counsel /ˌpɑːləment(ə)ri ˈkaʊnsəl/ *noun* a solicitor who is responsible for drafting Bills going before Parliament

Parliamentary privilege /ˌpɑːləment(ə)ri ˈprɪvɪlɪdʒ/ *noun* the right of a Member of Parliament or Member of the House of Lords to speak freely to the House without possibility of being sued for slander

parol /pəˈrəʊl/ *adjective* done by speaking

parol agreement /pəˈrəʊl əˌgriːmənt/ *noun* a simple contract, informal or oral contract

parole /pəˈrəʊl/ *noun* **1.** allowing a prisoner to leave prison for a short time, on condition that he or she behaves well ○ *He was given a week's parole to visit his mother in hospital.* **2.** permission for a prisoner who has behaved well to be released from prison early on condition that he continues to behave well ○ *After six month's good conduct in prison she is eligible for parole.* ○ *He was let out on parole and immediately burgled a house.* ■ *verb* to allow a prisoner to leave prison before the end of their sentence on condition that he or she behaves well ○ *If you're lucky you will be paroled before Christmas.*

parole board /pəˈrəʊl bɔːd/ *noun* a group of people who advise the Home Secretary if a prisoner should be released on parole before the end of his or her sentence

parolee /pəˈrəʊliː/ *noun US* a prisoner who is let out on parole

parol evidence /pəˈrəʊl ˌevɪdəns/ *noun* evidence given orally

part /pɑːt/ *noun* **1.** a piece or section ○ *Part of the shipment was damaged.* ○ *Part of the staff is on overtime.* ○ *Part of*

mainp - softvnn.com

Law.fm Page 215 Friday, June 11, 2004 2:08 PM

the expenses will be refunded. **2.** one of the sections of an Act, Bill, or other official document (*below*) **3.** □ **in part** not completely ○ *to contribute in part to the costs* ○ *to pay the costs in part*

Part 20 claim /ˌpɑːt ˈtwenti ˌkleɪm/ *noun* any claim other than a claim filed by a claimant against a defendant in the particulars of claim

COMMENT: Part 20 claims include counterclaims by a defendant against a claimant, or against other persons who are not parties to the case, or a claim by another person against any other person. These claims are dealt with under Part 20 of the new Civil Procedure Rules, hence the name.

Part 36 offer, Part 36 payment *noun* an offer or payment made by a defendant (the offeror) to a claimant (the offeree) to settle all or part of a claim after proceedings have started (these offers or payments do not apply to small claims)

parte ➧ **ex parte, inter partes, audi alteram partem**

partial /ˈpɑːʃ(ə)l/ *adjective* **1.** not complete □ **he was awarded partial compensation for the damage to his house** he was compensated for part of the damage **2.** showing unfair support for one person or group compared with others ○ *The defendant complained that the judge was partial.*

partial defence /ˌpɑːʃ(ə)l dɪˈfens/ *noun* a defence such as self-defence which is not enough to acquit the defendant, but which can reduce their charge to a lesser one

partial intestacy /ˌpɑːʃ(ə)l ɪnˈtestəsi/ *noun* a situation where a person dies leaving a will which does not cover all his or her estate

partial loss /ˈpɑːʃ(ə)l lɒs/ *noun* a situation where only part of the insured property has been damaged or lost

particular /pəˈtɪkjʊlə/ *plural noun* **particulars 1.** detailed information about something or someone ○ *sheet which gives particulars of the items for sale* ○ *the inspector asked for particulars of the missing car* □ **to give full particulars of something** to list all the known details about something □ **request for further and better particulars** pleading served by one party on another in civil proceedings, asking for information about the other party's claim or defence **2.** a statement of the facts of a case, made by a party in civil proceedings or a County Court pleading, setting out the claimant's claim

particular average /pəˌtɪkjʊlə ˈæv(ə)rɪdʒ/ *noun* a situation where part of a shipment is lost or damaged and the insurance costs are borne by the owner of the lost goods and not shared among all the owners of the shipment

particular lien /pəˌtɪkjʊlə ˈliːən/ *noun* the right of a person to keep possession of another person's property until debts relating to that property have been paid

particulars /pəˈtɪkjʊləz/ *plural noun* details, especially a statement of the facts of a case made by a party in civil proceedings or a County Court pleading setting out the claimant's claim ○ *Sheet which gives particulars of the items for sale.* ○ *The inspector asked for particulars of the missing car.*

particulars of claim /pəˌtɪkjʊləz əv ˈkleɪm/ *noun* a document containing details of a claimant's case and the relief sought against the defendant (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has replaced **statement of claim**.)

COMMENT: Particulars of claim are usually included in the claim form filed by the claimant. They should give a statement of the facts of the claim, together with details of interest or damages claimed. They must include the following if they are to form part of the claim to be pleaded: details of fraud, illegality, breach of trust, default, or unsoundness of mind on the part of the defendant.

partition /pɑːˈtɪʃ(ə)n/ *noun* the division of land which is held by joint tenants or tenants in common

partly-paid capital /ˌpɑːt(ə)li peɪd ˈkæpɪt(ə)l/ *noun* capital which represents partly-paid shares

partly-paid up shares /ˌpɑːt(ə)li peɪd ʌp ˈʃeəz/ *plural noun* shares where the shareholders have not paid the full face value

mainp - softvnn.com

Law.fm Page 216 Friday, June 11, 2004 2:08 PM

partly-secured creditors /ˌpɑːtli sɪ ˌkjʊəd ˈkredɪtəs/ *plural noun* creditors whose debts are not fully covered by the value of the security

partnership at will /ˌpɑːtnəʃɪp ət ˈwɪl/ *noun* a partnership with no fixed time limit stated

part-owner /ˌpɑːt ˈəʊnə/ *noun* somebody who owns something jointly with one or more other persons

part-ownership /ˌpɑːt ˈəʊnəʃɪp/ *noun* a situation where two or more persons own the same property

part payment /ˌpɑːt ˈpeɪmənt/ *noun* the payment of part of an amount which is owed

part performance /ˌpɑːt pə ˈfɔːməns/ *noun* a situation where a party has carried out part of a contract, but not complied with all the terms of it

party /ˈpɑːti/ *noun* **1.** a person or group of people involved in a legal dispute, legal agreement or crime ○ *One of the parties to the suit has died.* ○ *The company is not a party to the agreement.* □ **to be party to something** to be involved in a legal action ○ *How important is this case to those persons who are not party to it?* **2.** □ **a third party candidate** candidate for one of the smaller parties

party and party costs /ˌpɑːtɪ ən ˌpɑːtɪ ˈkɒsts/ *plural noun* normal basis for assessment of costs which includes all costs incurred in the party's case

party wall /ˌpɑːti ˈwɔːl/ *noun* a wall which separates two adjoining properties such as houses or land and belongs to both owners equally

pass /pɑːs/ *noun* a permit allowing someone to go into a building ○ *You need a pass to enter the ministry offices.* ○ *All members of staff must show their passes.* ■ *verb* **1.** to vote to approve ○ *The finance director has to pass an invoice before it is paid.* ○ *The loan has been passed by the board.* □ **to pass a resolution** to vote to agree to a resolution **2.** to vote to make a law ○ *Parliament passed the Bill which has now become law.* **3.** □ **to pass sentence on someone** to give a convicted person the official legal punishment ○ *The jury returned a verdict of guilty, and the judge will pass sentence next week.* **4.** □ **to pass a dividend** to pay no dividend in a specific year

passenger manifest /ˌpæsɪndʒə ˈmænɪfest/ *noun* a list of passengers on a ship or plane

passing off /ˌpɑːsɪŋ ˈɒf/ *noun* the action of trying to sell goods by giving the impression that they have been made by someone else, using that other person's reputation to make a sale

pass off /ˌpɑːs ˈɒf/ *verb* □ **to pass something off as something else** to pretend that it is another thing in order to cheat a customer

pass over /ˌpɑːs ˈəʊvə/ *verb* to avoid using someone who has been appointed, and use someone else instead

COMMENT: An executor can be passed over in favour of someone else is if he has disappeared, is serving a life sentence in prison, etc.

passport /ˈpɑːspɔːt/ *noun* an official document proving that someone is a citizen of a country, which has to be shown when travelling from one country to another ○ *We had to show our passports at the customs post.* ○ *His passport is out of date.* ○ *The passport officer stamped my passport.*

passport holder /ˌpɑːspɔːt ˈhəʊldə/ *noun* somebody who holds a passport ○ *She is a British passport holder.*

passport section /ˌpɑːspɔːt ˈsekʃən/ *noun* a part of an embassy which deals with passport inquiries

patent /ˈpeɪtənt, ˈpætənt/ *noun* an official document showing that a person has the exclusive right to make and sell an invention ○ *to take out a patent for a new type of light bulb* ○ *to apply for a patent for a new invention* ○ *He has received a grant of patent for his invention.* □ **patent applied for**, **patent pending** words on a product showing that the inventor has applied for a patent for it □ **to forfeit a patent** to lose a patent because payments have not been made □ **to infringe a patent** to make a product which works in the same way as a patented product and not pay a royalty to the patent holder □ **to file a patent application** to apply for a patent ■ *verb* □ **to patent an invention** to register an invention with the patent office to prevent other

mainp - softvnn.com

Law.fm Page 217 Friday, June 11, 2004 2:08 PM

people from copying it ■ *adjective* very obvious ○ *The prisoner's statement is a patent lie.*

COMMENT: To qualify for a patent an invention must be new and not previously disclosed, it must be an advance on previous inventions, it must be able to be manufactured and it must not involve anything excluded from patent cover. Things excluded from patent cover include scientific theories (because they are confidential information), games and computer programs (which are covered by copyrights), medical treatments, some newly developed plants, animals and other biological processes. When a patent is granted, it gives the patentee a monopoly in his invention for 20 years.

patentability /ˌpætəntəˈbɪlɪti/ *noun* the ability to be the subject of a patent

patentable /ˈpeɪtəntəb(ə)l/ *adjective* able to be the subject of a patent ○ *Computer programs are not patentable because they are covered by copyright.*

patent agent /ˈpeɪtənt ˌeɪdʒənt/ *noun* somebody who advises on patents and applies for patents on behalf of clients

patent defect /ˌpeɪtənt dɪˈfekt/ *noun* an obvious defect

patented /ˈpeɪtəntɪd, ˈpætəntɪd/ *adjective* being protected by a patent

patentee /ˌpeɪtənˈtiː/ *noun* somebody who has been granted a patent

patent examiner /ˌpeɪtənt ɪgˈzæmɪnə/ *noun* an official who checks patent applications to see if the inventions are really new

patent holder /ˌpeɪtənt ˈhəʊldə/ *noun* somebody who has been granted a patent

patent number /ˌpeɪtənt ˈnʌmbə/ *noun* a reference number given to a patented invention

patent office /ˈpeɪtənt ˌɒfɪs/ *noun* a government office which grants patents and supervises them

patent pending /ˌpeɪtənt ˈpendɪŋ/ *noun* a phrase printed on a product to show that its inventor has applied for a grant of patent but has not yet received it

patent proprietor /ˌpeɪtənt prəˈpraɪətə/ *noun* a person who holds a patent

patent rights /ˈpeɪtənt raɪts/ *plural noun* rights which an inventor holds under a patent

patent specification /ˌpeɪtənt ˌspesɪfɪˈkeɪʃ(ə)n/ *noun* the full details of an invention which is the subject of a patent application

paternity /pəˈtɜːnɪti/ *noun* **1.** the action of being a father **2.** the moral right of a copyright holder to be identified as the creator of the work

paternity action /pəˌtɜːnɪti ˈækʃən/, **suit** /suːt/ *noun* a lawsuit brought by the mother of an illegitimate child to force the putative father to maintain the child

paternity leave /məˈtɜːnɪti liːv/ *noun* a period when a man is away from work because his partner is about to have, or has had a baby

pathologist /pəˈθɒlədʒɪst/ *noun* a doctor who specialises in pathology, especially a doctor who examines corpses to find out the cause of death

patrial /ˈpeɪtriəl/ *noun* a person who has the right to live in the UK because they has close family ties with the country such a grandparent being British

patricide /ˈpætrɪsaɪd/ *noun* the murder of your own father

Patriot Act /ˈpætriət ˌækt/ *noun* in the USA, a set of federal anti-terrorism measures that allows lower standards of probable cause to be accepted for obtaining intelligence warrants against suspected spies and terrorists

patrol /pəˈtrəʊl/ *noun* a group of people who walk through an area to see what is happening □ **a police patrol** group of policemen who are patrolling an area □ **on patrol** walking through an area to see what is happening ○ *We have six squad cars on patrol in the centre of the town.* □ **on foot patrol** patrolling an area on foot, not in a car ■ *verb* to walk regularly through an area to see what is happening ○ *Groups of riot police were patrolling the centre of the town.*

patrol car /pəˈtrəʊl kɑː/ *noun* a car used by police on patrol

patrolman /pəˈtrəʊlmən/ *noun US* the lowest rank of policeman ○ *Patrolman Jones was at the scene of the accident.*

mainp - softvnn.com

Law.fm Page 218 Friday, June 11, 2004 2:08 PM

patronage secretary /ˌpætrənɪdʒ ˈsekrət(ə)ri/ *noun* an official of the Prime Minister's staff who deals with appointments to posts

pauperis ➧ **in forma pauperis**

pawn /pɔːn/ *verb* □ **to pawn a watch** to leave a watch with a pawnbroker who gives a loan against it

pawnshop /ˈpɔːnʃɒp/ *noun* a pawnbroker's shop

pawn ticket /ˈpɔːn ˌtɪkɪt/ *noun* a receipt given by the pawnbroker for the object left in pawn

pay /peɪ/ *noun* a salary, wage, or money given to someone for work done ■ *verb* **1.** to give money to buy an item or a service □ **to pay in advance** to give money before you receive the item bought or before the service has been completed □ **to pay in instalments** to give money for an item by giving small amounts regularly □ **to pay cash** to pay the complete sum in cash □ **to pay costs** to pay the costs of a court case □ **to pay on demand** to pay money when it is asked for, not after a period of credit □ **to pay a dividend** to give shareholders a part of the profits of a company □ **to pay interest** to give money as interest on money borrowed or invested **2.** to give an employee money for work done ○ *The employees have not been paid for three weeks.* ○ *We pay good wages for skilled employees.* ○ *How much do they pay you per hour?* □ **to be paid by the hour** to get money for each hour worked □ **to be paid at piece-work rates** to get money calculated on the number of pieces of work finished

payable /ˈpeɪəb(ə)l/ *adjective* being due to be paid □ **payable in advance** being payable before the goods are delivered □ **payable on delivery** being payable when the goods are delivered □ **payable on demand** being payable when payment is asked for □ **payable at sixty days** being payable by sixty days after the date of invoice □ **cheque made payable to bearer** cheque which will be paid to the person who has it, not to any particular name written on it □ **shares payable on application** shares which must be paid for when you apply to buy them □ **electricity charges are payable by the tenant** the tenant (and not the landlord) must pay for the electricity

pay as you earn /ˌpeɪ əz juː ˈɜːn/ *noun* a tax system by which income tax is deducted from the salary before it is paid to the worker. Abbreviation **PAYE** (NOTE: The US term is **pay-as-you-go**.)

pay-as-you-go /ˌpeɪ əz juː ˈgəʊ/ *noun* **1.** *US* same as **pay as you earn 2.** a system of summarily assessing costs in a trial

pay back /ˌpeɪ ˈbæk/ *verb* to give money back to someone ○ *I lent her £50 and she promised to pay me back in a month.* ○ *He has never paid me back the money he borrowed.*

payback /ˈpeɪbæk/ *noun* the repayment of money which has been borrowed

payback clause /ˈpeɪbæk klɔːz/ *noun* a clause in a contract which states the terms for repaying a loan

payback period /ˈpeɪbæk ˌpɪəriəd/ *noun* the period of time over which a loan is to be repaid or an investment is to pay for itself

pay cheque /ˈpeɪ tʃek/ *noun* a salary cheque given to an employee (NOTE: The US term is **paycheck**.)

pay down /ˌpeɪ ˈdaʊn/ *verb* □ **to pay money down** to make a deposit ○ *He paid £50 down and the rest in monthly instalments.*

PAYE *abbreviation* pay as you earn

payee /peɪˈiː/ *noun* somebody who receives money from someone, the person whose name is on a cheque or bill of exchange

pay in /ˌpeɪ ˈɪn/**, into** /ˈɪntə, ˈɪntʊ, ˈɪntuː/ *verb* □ **to pay in**, **to pay money into court** (*of a defendant*) to deposit money with the court at the beginning of a case, to try to satisfy the claimant's claim

COMMENT: If at trial the claimant fails to recover more than the amount the defendant has paid in, he will have to pay the defendant's costs from the date of the payment in.

paying party /ˌpeɪɪŋ ˈpɑːti/ *noun* the party in a case who is liable to pay costs (NOTE: The other party is the **receiving party**.)

mainp - softvnn.com

Law.fm Page 219 Friday, June 11, 2004 2:08 PM

payment /'peɪmənt/ *noun* **1.** the transfer of money from one person to another to satisfy a debt or obligation ○ *payment in cash* or *cash payment* ○ *payment by cheque* □ **payment on account** paying part of the money owed before a bill is delivered ○ *The solicitor asked for a payment of £100 on account.* □ **payment on invoice** paying money as soon as an invoice is received **2.** money paid

payment into court /ˌpeɪmənt 'ɪntə kɔːt/ *noun* the depositing of money by the defendant into the court before the case starts, to try to satisfy the claimant's claim

pay negotiations /'peɪ nɪgəʊʃi ˌeɪʃ(ə)nz/ *plural noun* discussions between employers and employees about pay increases

pay off /ˌpeɪ 'ɒf/ *verb* **1.** to finish paying money which is owed ○ *to pay off a mortgage* ○ *to pay off a loan* **2.** to pay all the money owed to someone and terminate his or her employment ○ *When the company was taken over the factory was closed and all the employees were paid off.*

payoff /'peɪɒf/ *noun* money paid to finish paying something which is owed

pay restraint /'peɪ rɪˌstreɪnt/ *noun* the activity of keeping increases in wages under control

pay up /ˌpeɪ 'ʌp/ *verb* to give money which is owed ○ *The company paid up only when we sent them a letter from our solicitor.* ○ *He finally paid up six months late.*

PC *abbreviation* police constable *or* Privy Council *or* Privy Councillor (NOTE: The plural is **PCs**.)

PDs *abbreviation* practice directions

pecuniary /pɪ'kjuːniəri/ *adjective* referring to money □ **obtaining a pecuniary advantage by deception** crime of tricking someone into handing over money □ **he gained no pecuniary advantage** he made no financial gain

pecuniary default judgment /pɪˌkjuːniəri dɪˌfɔːlt 'dʒʌdʒmənt/ *noun* a judgment without trial against a defendant who fails to respond to a claim, which gives the claimant the money claimed including interest

pecuniary legacy /pɪˌkjuːniəri 'legəsi/ *noun* a legacy in the form of money

pedestrian precinct /pəˌdestriən 'priːsɪŋkt/ *noun* part of a town which is closed to traffic so that people can walk about and shop

peer group /'pɪə ˌgruːp/ *noun* a group of persons of the same level or rank ○ *The Magna Carta gave every person the right to be tried by his or her peers.* ○ *Children try to behave like other members of their peer group.*

penal /'piːn(ə)l/ *adjective* referring to punishment

penal code /'piːn(ə)l kəʊd/ *noun* a set of laws governing crime and its punishment

penal colony /ˌpiːn(ə)l 'kɒləni/ *noun* a prison camp in a distant place, where prisoners are sent for long periods

penal institution /'piːn(ə)l ˌɪnstɪtjuːʃ(ə)n/ *noun* a place such as a prison where convicted criminals are kept

penalise /'piːnəlaɪz/, **penalize** *verb* to punish someone for doing something wrong, especially by fining them ○ *to penalise a supplier for late deliveries* ○ *They were penalised for bad service.*

penal laws /'piːn(ə)l lɔːs/ *plural noun* system of punishments relating to different crimes

penal servitude /ˌpiːn(ə)l 'sɜːvɪtjuːd/ *noun* a former punishment by imprisonment with hard labour

penal system /ˌpiːn(ə)l 'sɪstəm/ *noun* same as **penal laws**

penalty /'pen(ə)lti/ *noun* a punishment such as a fine which is imposed if something is not done or if a law is not obeyed ○ *The penalty for carrying an offensive weapon is a fine of £2,000 and three months in prison.*

COMMENT: Penalty clauses in a contract are sometimes unenforceable.

penalty clause /'pen(ə)lti klɔːz/ *noun* a clause which lists the penalties which will be imposed if the terms of the contract are not fulfilled

pendens ▸ **lis pendens**

mainp - softvnn.com

Law.fm Page 220 Friday, June 11, 2004 2:08 PM

pendente lite /pen,dentei 'laitei/ *phrase* a Latin phrase meaning 'during the lawsuit.' ◊ **alimony**

pending /'pendiŋ/ *adjective* waiting

pending action /,pendiŋ 'ækʃən/ *noun* an action concerned with land which has not been heard

pending suit /'pendiŋ su:t/ *noun* while a lawsuit is being heard

penitentiary /,peni'tenʃəri/ *noun US* a large prison ○ *the Pennsylvania State Penitentiary*

penology /pi:'nɒlədʒi/ *noun* the study of sentences in relation to crimes

pensionable age /,penʃənəb(ə)l 'eidʒ/ *noun* the age after which someone can take a pension

pension contributions /'penʃən kɒntri,bju:ʃ(ə)nz/ *plural noun* money paid by a company or employee into a pension fund

pension entitlement /'penʃən in ,tait(ə)lmənt/ *noun* the amount of pension which someone has the right to receive when he or she retires

pension fund /'penʃən fʌnd/ *noun* money which provides pensions for retired members of staff

pension plan /'penʃən plæn/ *noun* a plan worked out by an insurance company which arranges for an employee to pay part of his or her salary over many years and receive a regular payment on retirement

peppercorn rent /,pepəkɔ:n 'rent/ *noun* a very small or nominal rent ○ *to pay a peppercorn rent* ○ *to lease a property for* or *at a peppercorn rent*

per annum /pər 'ænəm/ *adverb* in each year ○ *The rent is £2,500 per annum.* ○ *What is their turnover per annum?*

per autre vie /,pɜ:r ,əutrə 'vi:/ *phrase* a French phrase meaning 'for the lifetime of another person'

per capita /pə 'kæpitə/ *adjective*, *adverb* **1.** divided among beneficiaries individually. Compare **per stirpes 2.** for each person □ **per capita expenditure** total money spent divided by the number of people involved

percentage increase /pə,sentidʒ 'inkri:s/ *noun* an increase in costs above base costs, which is negotiated as part of a conditional fee agreement

per contra /,pɜ: 'kɒntrə/ *noun* a phrase that shows that a contra entry has been made

per curiam /pɜ: 'kju:riəm/ *phrase* a Latin phrase meaning 'by a court': a decision correctly made by a court, which can be used as a precedent

per diem /,pɜ: 'di:em/ *phrase* a Latin phrase meaning 'for each day'

peremptory challenge /pə ,rempt(ə)ri 'tʃælindʒ/ *noun* an objection made about a juror without stating any reason

perfect right /,pɜ:fikt 'rait/ *noun* a correct and legally acceptable right

perform /pə'fɔ:m/ *verb* to carry out a task or duty, or something which is required in a contract

performance /pə'fɔ:məns/ *noun* **1.** the way in which someone or something acts □ **the poor performance of the shares on the stock market** the fall in the share price on the stock market □ **as a measure of the company's performance** as a way of judging if the company's results are good or bad □ **performance of personnel against objectives** how personnel have worked, measured against the objectives set **2.** the activity of carrying out of something, such as a duty or the terms of a contract □ **they were asked to put up a £1m performance bond** they were asked to deposit £1m as a guarantee that they would carry out the terms of the contract

performance review /pə'fɔ:məns ri ,vju:/ *noun* a yearly interview between an employer and each employee to discuss how the employee has worked during the year

performing right /pə'fɔ:miŋ rait/ *noun* the right to allow the playing of a copyright piece of music

peril /'peril/ *noun* danger, especially a possible accident covered by an insurance policy □ **perils of the sea**, **maritime perils** accidents which can happen at sea

mainp - softvnn.com

Law.fm Page 221 Friday, June 11, 2004 2:08 PM

per incuriam /ˌpɜː ɪnˈkjuːriəm/ *phrase* a Latin phrase meaning 'because of lack of care': a decision wrongly made by a court which does not therefore set a precedent

periodic /ˌpɪəriˈɒdɪk/, **periodical** /ˌpɪəriˈɒdɪk(ə)l/ *adjective* happening regularly from time to time

periodical payments /ˌpɪəriɒdɪk(ə)l ˈpeɪmənts/ *plural noun* regular payments, e.g. maintenance paid to a divorced spouse

periodic tenancy /ˌpɪəriɒdɪk ˈtenənsi/ *noun* a tenancy where the tenant rents for several short periods but not for a fixed length of time

period of notice /ˌpɪəriəd əv ˈnəʊtɪs/ *noun* the time stated in the contract of employment which the employee or company has to allow between resigning or being fired and the employee actually leaving his or her job

period of qualification /ˌpɪəriəd əv kwɒlɪfɪˈkeɪʃ(ə)n/ *noun* the time which has to pass before something qualifies for something

period of validity /ˌpɪəriəd əv vəˈlɪdɪti/ *noun* the length of time for which a document is valid

perjure /ˈpɜːdʒə/ *verb* □ **to perjure yourself** to tell lies when you have made an oath to say what is true

perjury /ˈpɜːdʒəri/ *noun* the notifiable offence of telling lies when you have made an oath to say what is true in court ○ *He was sent to prison for perjury.* ○ *She appeared in court on a charge of perjury* or *on a perjury charge.*

permissive waste /pəˌmɪsɪv ˈweɪst/ *noun* damage to a property which is caused by a tenant not carrying out repairs

permit *noun* /ˈpɜːmɪt/ an official document which allows someone to do something ■ *verb* /pəˈmɪt/ to allow someone to do something ○ *This document permits the export of twenty-five computer systems.* ○ *The ticket permits three people to go into the exhibition.*

per my et per tout /pɜː maɪ ˌiː ˈtiː taʊt/ *phrase* a French phrase meaning 'by half and by all': used to indicate the relationship between joint tenants

perpetrate /ˈpɜːpɪtreɪt/ *verb* to commit a crime

perpetrator /ˈpɜːpɪtreɪtə/ *noun* a person who does something harmful or dishonest, especially a person who commits a crime

perpetuity /ˌpɜːpɪtˈjuːɪti/ *noun* □ **in perpetuity** for ever

per pro /pə ˈprəʊ/ *abbreviation* per procurationem □ **the secretary signed per pro the manager** the secretary signed on behalf of, and with the authority of, the manager

per procurationem /pə ˌprɒkjʊræsɪ ˈəʊnəm/ *phrase* a Latin phrase meaning 'with the authority of'

per quod /pɜː ˈkwɒd/ *phrase* a Latin phrase meaning 'by which' or 'whereby'

per se /ˌpɜː ˈseɪ/ *phrase* a Latin phrase meaning 'on its own' or 'alone'

persistent offender /pəˌsɪstənt əˈfendə/ *noun* a person who has been convicted of a crime at least three times before and is likely to commit the crime again

person /ˈpɜːs(ə)n/ *noun* a man or woman ○ *insurance policy which covers a named person* □ **the persons named in the contract** people whose names are given in the contract □ **the document should be witnessed by a third person** someone who is not named in the document should witness it □ **in person** someone himself or herself □ **this important package is to be delivered to the chairman in person** the package has to be given to the chairman himself (and not to his secretary, assistant, etc.) □ **he came to see me in person** he himself came to see me

persona /pəˈsəʊnə/ *noun* something such as a company which has property

personal /ˈpɜːs(ə)n(ə)l/ *adjective* **1.** referring to one person □ **personal service** the act of giving legal documents to someone as part of a legal action, e.g. serving someone with a writ **2.** private ○ *I want to see the director on a personal matter.*

personal action /ˌpɜːs(ə)n(ə)l ˈækʃən/ *noun* **1.** a legal action brought by a person himself or herself **2.** com-

mainp - softvnn.com

Law.fm Page 222 Friday, June 11, 2004 2:08 PM

mon law term for an action against a person arising out of a contract or tort

personal allowances /ˌpɜːs(ə)n(ə)l əˈlaʊənsɪz/ *plural noun* part of a person's income which is not taxed ○ *allowances against tax* or *tax allowances*

personal assets /ˌpɜːs(ə)n(ə)l ˈæsets/ *plural noun* moveable assets which belong to a person

personal assistant /ˌpɜːs(ə)n(ə)l əˈsɪstənt/ *noun* a secretary who can take on responsibility in various ways when the boss is not there

personal chattels /ˌpɜːs(ə)n(ə)l ˈtʃæt(ə)lz/ *noun* household things such furniture, clothes, or cars which belong to a person and which are not land

personal conduct /ˌpɜːs(ə)n(ə)l kənˈdʌkt/ *noun* (*in the EU*) the way in which a person acts in society

COMMENT: Personal conduct can be used as a reason for excluding a national of another EU state from entering a country and taking up work.

personal effects /ˌpɜːs(ə)n(ə)l ɪˈfekts/ *plural noun* personal belongings

personal estate /ˌpɜːs(ə)n(ə)l ɪˈsteɪt/ *noun* the set of things, excluding land, which belong to someone and can be inherited by their heirs

personal income /ˌpɜːs(ə)n(ə)l ˈɪnkʌm/ *noun* income received by an individual person before tax is paid

personal injury /ˌpɜːs(ə)n(ə)l ˈɪndʒəri/ *noun* injury to the body suffered by the victim of an accident

personality /ˌpɜːsəˈnælɪti/ *noun* the qualities of mind and spirit which make one person different from another

personal property /ˌpɜːs(ə)n(ə)l ˈprɒpəti/ *noun* property which belongs to one person, excluding land and buildings, but including money, goods, securities, etc.

personal representative /ˌpɜːs(ə)n(ə)l ˌreprɪˈzentətɪv/ *noun* **1.** a person who is the executor of a will or the administrator of the estate of a deceased person. Abbreviation **pr 2.** a person appointed to deal with the estate of a person who dies intestate

COMMENT: A personal representative can be the executor of the estate, usually appointed by the deceased person in the will, or an administrator who is appointed to deal with the estate of a deceased person who died intestate, or who did not appoint an executor in the will. The personal representative holds the property on trust, pays any liabilities and expenses, and invests money until such time as the estate is distributed.

personalty /ˈpɜːs(ə)n(ə)lti/ *noun* personal property or chattels as opposed to land

personam ♦ **action**

persona non grata /pəˌsəʊnə nɒn ˈgrɑːtə/ *noun* a foreign person who is not acceptable to a government (*used especially of diplomats*)

personation /ˌpɜːsəˈneɪʃ(ə)n/ *noun* the crime of fraudulently pretending to be someone else

person injuries /ˈpɜːs(ə)n ˌɪndʒəriz/ *noun* injuries to a person caused by disease which impair that person's mental or physical condition

person-to-person call /ˌpɜːs(ə)n tə ˈpɜːs(ə)n kɔːl/ *noun* a call where you ask the operator to connect you with a named person

per stirpes /pɜː ˈstɜːpiːz/ *phrase* a Latin phrase meaning 'by branches': phrase used in wills where the entitlement is divided among branches of a family rather than among individuals (which is 'per capita')

persuasive precedent /pəˌsweɪsɪv ˈpresɪd(ə)nt/, **persuasive authority** /pəˌsweɪsɪv ɔːˈθɒrəti/ *noun* precedent which a judge is not obliged to follow but is of importance in reaching a judgment, as opposed to a binding precedent

pertain /pəˈteɪn/ *verb* □ **to pertain to** to refer to or to relate to ○ *the law pertaining to public order*

perverse verdict /pəˌvɜːs ˈvɜːdɪkt/ *noun* a verdict by a jury which goes against what anyone would usually feel to be the right decision, or which goes against the direction of the judge

pervert /pəˈvɜːt/ *verb* to change or to interfere □ **to attempt to pervert the course of justice** to try to influence the outcome of a trial by tampering with the evidence, bribing the jurors, etc.

mainp - softvnn.com

Law.fm Page 223 Friday, June 11, 2004 2:08 PM

COMMENT: Perverting the course of justice is a notifiable offence.

petition /pə'tɪʃ(ə)n/ *noun* **1.** a written application to a court □ **to file a petition in bankruptcy** to ask officially to be made bankrupt, to ask officially for someone else to be made bankrupt **2.** a written request accompanied by a list of signatures of people supporting it ○ *They presented a petition with a million signatures to Parliament, asking for the law to be repealed.* ■ *verb* to make an official request ○ *He petitioned the government for a special pension.* ○ *The marriage had broken down and the wife petitioned for divorce.*

COMMENT: Petitions to the House of Commons are written by hand, and have a set form of words. After a petition is presented in the House of Commons at the beginning of the day's business, it is said to 'lie upon the table' and is placed in a bag behind the Speaker's Chair.

petitioner /pə'tɪʃ(ə)nə/ *noun* somebody who puts forward a petition

petty /'peti/ *adjective* not important

petty cash /ˌpeti 'kæʃ/ *noun* a small amount of money kept in an office to make small purchases

petty crime /ˌpeti 'kraɪm/ *noun* small crimes which are not very serious

petty jury /ˌpeti 'dʒʊəri/ *noun mainly US* an ordinary jury of twelve jurors

petty larceny /ˌpeti 'lɑːs(ə)ni/ *noun* minor thefts

petty-sessional division /ˌpeti ˌseʃ(ə)n(ə) dɪ'vɪʒ(ə)n/, **petty sessions area** /ˌpeti ˌseʃ(ə)nz 'eəriə/ *noun* an area of the country covered by a magistrates' courts committee for administration purposes

COMMENT: England and Wales are divided into 45 petty sessions areas.

petty sessions /ˌpeti 'seʃ(ə)nz/ *plural noun* magistrates' court

petty theft /ˌpeti 'θeft/ *noun* the theft of small items or small amounts of money

petty thief /ˌpeti 'θiːf/ *noun* somebody who steals small items or small amounts of money (NOTE: The plural is **thieves**.)

Photofit /'fəʊtəʊfɪt/ a trademark for a method of making a picture of a criminal from descriptions given by witnesses, using pieces of photographs of different types of faces ○ *The police issued an Photofit picture of the mugger.*

picker /'pɪkə/ *noun* a person in a team of pickpockets who performs the act of picking the victim's pocket while the others cause distractions (*slang*) Compare **runner**

picket line /'pɪkɪt laɪn/ *noun* a line of pickets at the gate of a factory

pickpocket /'pɪkpɒkɪt/ *noun* somebody who steals things from people's pockets

pilfer /'pɪlfə/ *verb* to steal small objects or small amounts of money

pilferage /'pɪlfərɪdʒ, 'pɪlfərɪŋ/, **pilfering** /'pɪlfərɪŋ/ *noun* the offence of stealing small amounts of money or small items

pilferer /'pɪlfərə/ *noun* somebody who steals small objects or small amounts of money

pimp /pɪmp/ *noun* a man who organises prostitutes and lives off their earnings

pinch /pɪntʃ/ *verb* (*informal*) **1.** to steal **2.** to arrest

piracy /'paɪrəsi/ *noun* **1.** a robbery at sea, by attacking ships **2.** the activity of copying patented inventions or copyright works ○ *laws to ban book piracy*

pirate /'paɪrət/ *noun* **1.** somebody who attacks a ship at sea to steal cargo **2.** somebody who copies a patented invention or a copyright work and sells it ○ *a pirate copy of a book* □ **pirate radio station** a radio station which broadcasts without a licence from outside a country's territorial waters ■ *verb* to copy a copyright work ○ *a pirated book* or *a pirated design* ○ *The drawings for the new dress collection were pirated in the Far East.*

pith and marrow /ˌpɪθ ən 'mærəʊ/ *noun* the doctrine that a patent can be applied to separate parts of an invention or process as well as to a single invention itself

placement /'pleɪsmənt/ *noun* the activity of finding work for someone

mainp - softvnn.com

Law.fm Page 224 Friday, June 11, 2004 2:08 PM

place of performance /ˌpleɪs əv pə ˈfɔːməns/ *noun* a place where a contract is to be performed

place of work /ˌpleɪs əv ˈwɜːk/ *noun* an office, factory or other premises where people work

placing /ˈpleɪsɪŋ/ *noun* □ **the placing of a line of shares** finding a buyer for a large number of shares in a new company or a company which is going public

plagiarise /ˈpleɪdʒəraɪz/**, plagiarize** *verb* to copy the text of a work created by someone else and pass it off as your own

plagiarism /ˈpleɪdʒərɪz(ə)m/ *noun* the activity of copying the text of a work created by someone else and passing it off as your own

plainclothes /ˈpleɪnkləʊðz/ *adjective* (*of a police officer*) working in ordinary clothes, not in uniform ○ *A group of plainclothes police went into the house.* ○ *A plainclothes detective travelled on the train.*

plaint /ˈpleɪnt/ *noun* a claim brought by one party (the claimant) against another party (the defendant)

plaintiff /ˈpleɪntɪf/ *noun* somebody who starts an action against someone in the civil courts. Compare **defendant** (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has been replaced by **claimant**.)

plaint note /ˈpleɪnt nəʊt/ *noun* a note issued by a County Court at the beginning of a County Court action

planned economy /ˌplænd ɪ ˈkɒnəmi/ *noun* a system where the government plans all business activity

planning authority /ˈplænɪŋ ɔː ˌθɒrəti/ *noun* a local body which gives permission for changes to be made to existing buildings or for new use of land

planning department /ˈplænɪŋ dɪ ˌpɑːtmənt/ *noun* a section of a local government office which deals with requests for planning permission

planning inquiry /ˈplænɪŋ ɪn ˌkwaɪri/ *noun* a hearing before a government inspector relating to the decision of a local authority in planning matters

planning permission /ˈplænɪŋ pə ˌmɪʃ(ə)n/ *noun* an official document allowing a person or company to plan new buildings on empty land or to alter existing buildings □ **outline planning permission** general permission to build a property on a piece of land, but not the final approval because there are no details given ○ *he was refused planning permission* ○ *we are waiting for planning permission before we can start building* ○ *the land is to be sold with outline planning permission for four houses*

plant /plɑːnt/ *verb* □ **to plant evidence** to put items at the scene of a crime after the crime has taken place, so that a person is incriminated and can be arrested

plastic bullet /ˌplæstɪk ˈbʊlɪt/ *noun* a thick bullet made of plastic fired from a special gun, used by the police only in self-defence. Also called **baton round**

plea /pliː/ *noun* **1.** in civil law, an answer made by a defendant to the case presented by the claimant **2.** in criminal law, a statement made by a person accused in court in answer to the charge □ **to enter a plea of not guilty** to answer the charge by stating that you are not guilty

plea bargaining /ˈpliː ˌbɑːgɪnɪŋ/ *noun* an arrangement where the accused pleads guilty to some charges and the prosecution drops other charges. ◊ **dilatory**

plead /pliːd/ *verb* **1.** to make an allegation in legal proceedings ○ *If fraud is to be pleaded as part of a claim, details of it must be given in the particulars of claim.* **2.** to answer a charge in a criminal court □ **fit to plead** mentally capable of being tried □ **to plead guilty** to say at the beginning of a trial that you did commit the crime of which you are accused □ **to plead not guilty** to say at the beginning of a trial that you did not commit the crime of which you are accused **3.** to speak on behalf of a client in court

pleader /ˈpliːdə/ *noun* somebody who pleads a case in court ○ *The pleader of the defence must deal with each allegation made in the particulars of claim.*

pleading /ˈpliːdɪŋ/ *noun* the action of speaking in court on someone's behalf

pleadings /ˈpliːdɪŋz/ *plural noun* documents setting out the claim of the claimant or the defence of the defendant, or giving the arguments which the two sides

mainp - softvnn.com

Law.fm Page 225 Friday, June 11, 2004 2:08 PM

will use in proceedings ○ *The damage is itemised in the pleading.* ○ *The judge found that the claimant's pleadings disclosed no cause of action.* ○ *Pleadings must be submitted to the court when the action is set down for trial.* (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has been replaced by **statements of case**.)

plea in mitigation /ˌpliː ɪn ˌmɪtɪ ˈgeɪʃ(ə)n/ *noun* a statement in court on behalf of a guilty party to persuade the court to impose a lenient sentence

pleasure /ˈpleʒə/ ♦ **Her Majesty's pleasure**

pledge /pledʒ/ *noun* **1.** the transfer of objects or documents to someone as security for a loan **2.** an object given by someone such as a pawnbroker as security for a loan □ **to redeem a pledge** to pay back a loan and interest and so get back the security ■ *verb* □ **to pledge share certificates** to deposit share certificates with the lender as security for money borrowed

pledgee /ˌpledʒˈiː/ *noun* somebody who receives objects or documents as security for money lent

pledger /ˈpledʒə/ *noun* somebody who gives objects or documents as security for money borrowed

plenary /ˈpliːnəri/ *adjective* full or complete

plenipotentiary /ˌplenɪpəˈtenʃəri/ *noun* an official person acting on behalf of a government in international affairs

PLP *abbreviation* Parliamentary Labour Party

pluralism /ˈplʊərəlɪz(ə)m/ *noun* a system allowing different political or religious groups to exist in the same society

pluralist state /ˌplʊərəlɪst ˈsteɪt/ *noun* a state where various political pressure groups can exist and exert influence over the government

PM *abbreviation* Prime Minister

p.m. /ˌpiːˈem/**, post meridiem** *phrase* a Latin phrase meaning 'after 12 o'clock midday' ○ *The train leaves at 6.50 p.m.* ○ *If you phone New York after 6 p.m. the calls are at a cheaper rate.*

PO *abbreviation* post office

poaching /ˈpəʊtʃɪŋ/ *noun* **1.** the crime of killing game which belongs to another person or trespassing on someone's land to kill game **2.** the activity of persuading employees to work for another company, or to leave one trade union and join another

pocket veto /ˌpɒkɪt ˈviːtəʊ/ *noun US* a veto by the President of a bill after Congress has adjourned

COMMENT: Normally the President has ten days to object to a bill which has been passed to him by Congress; if Congress adjourns during that period, the President's veto kills the bill.

point /pɔɪnt/ *noun* a question relating to a matter □ **to take a point** to agree that the point made by another speaker is correct □ **point taken**, **I take your point** I agree that what you say is valid □ **in point of fact** really or actually

COMMENT: When raising a point of order, a member will say: 'on a point of order, Mr. Chairman', and the Chairman should stop the discussion to hear what the person raising the point wishes to say.

point duty /ˈpɔɪnt ˌdjuːti/ *noun* the work of a policeman or traffic warden to direct the traffic at crossroads

point of fact /ˌpɔɪnt əv ˈfækt/ *noun* a question which has to be decided regarding the facts of a case

point of law /ˌpɔɪnt əv ˈlɔː/ *noun* a question relating to the law as applied to a case ○ *Counsel raised a point of law.* ○ *The case illustrates an interesting point of legal principle.*

point of order /ˌpɔɪnt əv ˈɔːdə/ *noun* a question relating to the way in which a meeting is being conducted ○ *He raised a point of order.* ○ *On a point of order, Mr Chairman, can this committee approve its own accounts?* ○ *The meeting was adjourned on a point of order.*

poison /ˈpɔɪz(ə)n/ *noun* a substance which can kill if eaten or drunk ○ *She killed the old lady by putting poison in her tea.* ■ *verb* to kill someone, or make them very ill, using poison ○ *He was not shot, he was poisoned.*

poison-pen letter /ˌpɔɪz(ə)n pen ˈletə/ *noun* an anonymous letter containing defamatory allegations about someone

mainp - softvnn.com

Law.fm Page 226 Friday, June 11, 2004 2:08 PM

police /pə'liːs/ *noun* a group of people who keep law and order in a country or town ○ *The police have cordoned off the town centre.* ○ *The government is relying on the police to keep law and order during the elections.* ○ *The bank robbers were picked up by the police at the railway station.*

COMMENT: Under English law, a policeman is primarily an ordinary citizen who has certain powers at common law and by statute. The police are organized by area, each area functioning independently with its own police force. London, and the area round London, is policed by the Metropolitan Police Force under the direct supervision of the Home Secretary. Outside London, each police force is answerable to a local police authority, although day-to-day control of operations is vested entirely in the Chief Constable.

police authority /pəˌliːs ɔː'θɒrɪti/ *noun* a local committee which supervises a local police force

police bail /pəˌliːs 'beɪl/ *noun* bail granted by the police from police custody

Police Commissioner /pəˌliːs kə 'mɪʃ(ə)nə/ *noun* the highest rank in some police forces

Police Community Support Officer /pəˌliːs kəˌmjuːnɪti sə'pɔːt ˌɒfɪsə/ *noun* a person whose job is to patrol the streets, especially in cities, providing assistance to the public, dealing with incidents of nuisance and anti-social behaviour which don't require full police powers, and issuing some fixed penalty notices to offenders. Abbreviation **PCSO**. Also called **community support officer**

Police Complaints Board /pəˌliːs kəm'pleɪnts ˌbɔːd/ *noun* a group which investigates complaints made by members of the public against the police

Police Complaints Committee /pəˌliːs kəm'pleɪnts kəˌmɪti/ *noun* a group of people who investigate complaints made by members of the public against the police

police constable /pə'liːs ˌkʌnstəb(ə)l/ *noun* an ordinary member of the police ○ *Police Constables Smith and Jones are on patrol.* ○ *Woman Police Constable MacIntosh was at the scene of the accident.* (NOTE: usually abbreviated to **PC** and **WPC**)

police cordon /pəˌliːs 'kɔːd(ə)n/ *noun* a line of barriers and police officers put round an area to prevent anyone moving in or out of the area

police court /pə'liːs kɔːt/ *noun* a magistrates' court

police force /pə'liːs fɔːs/ *noun* a group of policemen organised in a certain area ○ *The members of several local police forces have collaborated in the murder hunt.* ○ *The London police force is looking for more recruits.* ◊ **detective, Metropolitan Police**

COMMENT: The ranks in a British police force are: **Police Constable, Police Sergeant, Inspector, Chief Inspector, Superintendent, Chief Superintendent, Assistant Chief Constable, Deputy Chief Constable and Chief Constable**.

police headquarters /pəˌliːs hed 'kwɔːtəz/ *noun* the main offices of a police force

police inspector /pəˌliːs ɪn'spektə/ *noun* a rank in the police force above a sergeant

policeman /pə'liːsmən/ *noun* a man who is a member of the police (NOTE: The plural is **policemen**.)

police officer /pə'liːs ˌɒfɪsə/ *noun* a member of the police

police precinct /pəˌliːs 'priːsɪŋ(k)t/ *noun US* a section of a town with its own police station

police protection /pəˌliːs prə 'tekʃən/ *noun* the services of the police to protect someone who might be harmed ○ *The minister was given police protection.*

police sergeant /pəˌliːs 'sɑːdʒənt/ *noun* a rank in the police force above constable and below inspector

police station /pə'liːs ˌsteɪʃ(ə)n/ *noun* a local office of a police force

police superintendent /pəˌliːs ˌsuːpərɪn'tendənt/ *noun* a high rank in a police force, above Chief Inspector and below Chief Superintendent

policewoman /pə'liːswʊmən/ *noun* a female member of a police force (NOTE: The plural is **policewomen**.)

mainp - softvnn.com

Law.fm Page 227 Friday, June 11, 2004 2:08 PM

policing /pə'liːsɪŋ/ *noun* the activity of keeping law and order in a place, using the police force

policy holder /'pɒlɪsi ˌhəʊldə/ *noun* somebody who is insured by an insurance company

political crime /pəˌlɪtɪk(ə)l 'kraɪm/ *noun* a crime such as an assassination committed for a political reason

political prisoner /pəˌlɪtɪk(ə)l 'prɪz(ə)nə/ *noun* a person kept in prison because he or she is an opponent of the political party in power

poll /pəʊl/ *noun* □ **she changed her name by deed poll** she executed a legal document to change her name ■ *verb* □ **to poll a sample of the population** to ask a sample group of people what they feel about something □ **to poll the members of the club on an issue** to ask the members for their opinion on an issue

poll tax /'pəʊl tæks/ *noun* a tax levied equally on each adult member of the population. ◊ **community charge**

pollutant /pə'luːt(ə)nt/ *noun* a substance or agent which pollutes ○ *Discharge pipes take pollutants away from the coastal area into the sea.*

pollute /pə'luːt/ *verb* to discharge harmful substances into the environment naturally, accidentally or deliberately

polluter /pə'luːtə/ *noun* a person or company which causes pollution ○ *Certain industries are major polluters of the environment.*

polluter pays principle /pəˌluːtə 'peɪz ˌprɪnsəp(ə)l/ *noun* the principle that if pollution occurs, the person or company responsible should be required to pay for the consequences of the pollution and for avoiding it in future

pollution /pə'luːʃ(ə)n/ *noun* the presence of harmful substances in the environment, especially when produced by human activity

COMMENT: Pollution is caused by natural sources or by human action. It can be caused by a volcanic eruption or by a nuclear power station. Pollutants are not only chemical substances, but can be a noise from a grinding works or an unpleasant smell from a sewage farm.

pollution charges /pə'luːʃ(ə)n tʃɑːdʒɪz/ *plural noun* cost of repairing or stopping environmental pollution

pollution control /pə'luːʃ(ə)n kən ˌtrəʊl/ *noun* a means of limiting pollution

polygamous /pə'lɪgəməs/ *adjective* referring to polygamy □ **a polygamous society** a society where men are allowed to be married to more than one wife at the same time

polygamy /pə'lɪgəmi/ *noun* the state of having more than one wife. Compare **bigamy, monogamy**

polygraph /'pɒligrɑːf/ *noun* a machine which tells if a person is lying by recording physiological changes which take place while the person is being interviewed. Also called **lie detector**

popular vote /ˌpɒpjʊlə 'vəʊt/ *noun* a vote of the people

pornography /pɔː'nɒgrəfi/ *noun* obscene publications or films

porridge /'pɒrɪdʒ/ *noun* imprisonment (*slang*) □ **to do porridge** to serve a term of imprisonment

portion /'pɔːʃ(ə)n/ *noun* money or property given to a young person to provide money for them as income

port of registry /ˌpɔːt əv 'redʒɪstri/ *noun* the port where a ship is registered

position /pə'zɪʃ(ə)n/ *noun* a job or role in an organisation ○ *to apply for a position as manager* ○ *We have several positions vacant.* ○ *All the vacant positions have been filled.* ○ *She retired from her position in the accounts department.*

position of trust /pəˌzɪʃ(ə)n əv 'trʌst/ *noun* a job where an employee is trusted by his or her employer to look after money, confidential information, etc.

positive discrimination /ˌpɒzɪtɪv dɪskrɪmɪ'neɪʃ(ə)n/ *noun* discrimination in favour of one category of workers, such as women, to enable them to be more equal ○ *The council's policy of positive discrimination has ensured that more women are appointed to senior posts.*

positive vetting /ˌpɒzɪtɪv 'vetɪŋ/ *noun* a thorough examination of a person before that person is allowed to work with classified information

mainp - softvnn.com

Law.fm Page 228 Friday, June 11, 2004 2:08 PM

possess /pə'zes/ *verb* to own or to be in occupation of or to be in control of ○ *The company possesses property in the centre of the town.* ○ *He lost all he possessed when his company was put into liquidation.*

possession /pə'zeʃ(ə)n/ *noun* **1.** control over property **2.** physically holding something which does not necessarily belong to you □ **the documents are in his possession** he is holding the documents □ **how did it come into his possession**, **how did he get possession of it?** how did he acquire it? □ **unlawful possession of drugs** offence of having drugs

possession in law /pəˌzeʃ(ə)n ɪn 'lɔː/ *noun* ownership of land or buildings without actually occupying them

possessive action /pəˌzesɪv 'ækʃən/ *noun* an action to regain possession of land or buildings

possessory /pə'zesəri/ *adjective* referring to possession of property

possessory title /pəˌzesəri 'taɪt(ə)l/ *noun* a title to land acquired by occupying it continuously, usually for twelve years

post /pəʊst/ *verb* to pay a bond or bail for someone

post- /pəʊst/ *prefix* later

post code /'pəʊst kəʊd/ *noun* the letters and numbers that are used to indicate a town or street in an address on an envelope

posteriori ◆ **a posteriori**

posthumous /'pɒstjʊməs/ *adjective* **1.** happening after someone's death ○ *posthumous publication of her book* **2.** born after the death of a father ○ *a posthumous child*

post mortem /ˌpəʊst 'mɔːtəm/ *noun* an examination of the body of a dead person to see how he or she died ○ *The post mortem was carried out* or *was conducted by the police pathologist.*

post obit bond /ˌpəʊst 'əʊbɪt ˌbɒnd/ *noun* an agreement where a borrower will repay a loan when he or she receives money as a legacy from someone

post scriptum /ˌpəʊst 'skrɪptəm/ *noun* full form of **P.S.**

power /'paʊə/ *noun* **1.** strength, ability or capacity **2.** authority or legal right ○ *the powers of a local authority in relation to children in care* ○ *the powers and duties conferred on the tribunal by the statutory code* ○ *The president was granted wide powers under the constitution.* □ **the full power of the law** the full force of the law when applied ○ *We will apply the full power of the law to regain possession of our property.* **3.** a powerful country or state ○ *one of the important military powers in the region*

power of advancement /ˌpaʊə əv əd'vɑːnsmənt/ *noun* the power of a trustee to advance funds from a trust to a beneficiary

power of appointment /ˌpaʊər əv ə 'pɔɪntmənt/ *noun* a power given to one person such as a trustee to dispose of property belonging to another

power of attorney /ˌpaʊər əv ə 'tɜːni/ *noun* an official power giving someone the right to act on someone else's behalf in legal matters ○ *His solicitor was granted power of attorney.*

power of search /ˌpaʊər əv 'sɜːtʃ/ *noun* the authority to search premises, which is given to the police and some other officials such as Customs and Excise officers

power politics /ˌpaʊə 'pɒlɪtɪks/ *noun* the threat to use economic or military force by one country to try to get other countries to do what it wants

p.p. *verb* □ **to p.p. a receipt**, **a letter** to sign a receipt or a letter on behalf of someone ○ *The secretary p.p.'d the letter while the manager was at lunch.* ◊ **per procurationem**

PR *abbreviation* public relations

practice /'præktɪs/ *noun* **1.** a way of doing things ○ *His practice was to arrive at work at 7.30 and start counting the cash.* **2.** a way of working in court **3.** the business premises and clients of a professional person ○ *She has set up in practice as a solicitor* or *a patent agent.* ○ *He is a partner in a country solicitor's practice.* **4.** the carrying on of a profession ○ *He has been in practice for twenty years.*

practice directions /ˌpræktɪs daɪ 'rekʃənz/ *plural noun* notes made by

mainp - softvnn.com

Law.fm Page 229 Friday, June 11, 2004 2:08 PM

judges as to how specific procedures or formalities should be carried out. Abbreviation **PDs**

practice form /ˈpræktɪs fɔːm/ *noun* a form which lays out practice in a specific case

Practice Master /ˌpræktɪs ˈmɑːstə/ *noun* the Master on duty in the High Court, who will hear solicitors without appointment and give directions in relation to the general conduct of proceedings

practise /ˈpræktɪs/ *verb* to work in a profession, especially law or medicine ○ *He is a practising solicitor.*

practising certificate /ˌpræktɪsɪŋ səˈtɪfɪkət/ *noun* a certificate from the Law Society allowing someone to work as a solicitor

praecipe /ˈpriːsɪpi/ *noun* a written request addressed to a court, asking that court to prepare and issue a document such as a writ of execution or a witness summons

pray /preɪ/ *verb* to ask □ **to pray in aid** to rely on something when pleading a case ○ *I pray in aid the Statute of Frauds.*

prayer /preə/ *noun* words at the end of a petition or pleading, which summarise what the litigant is asking the court to do

pre-action /priː ˈækʃən/ *adjective* before an action starts

pre-action practice /priː ˌækʃən ˈpræktɪs/ *noun* the way of working before a case comes to court

pre-action protocol /priː ˌækʃən ˈprəʊtəkɒl/ *noun* a set of statements which are agreed before the hearings start between lawyers representing different parties about how a case should proceed, which are then approved by the court in the practice direction. These protocols should try to encourage the parties to try to settle without proceeding to litigation.

preamble /priˈæmb(ə)l/ *noun* the first words in an official document such as a contract, introducing the document and setting out the main points in it

precatory /ˈprekət(ə)ri/ *adjective* requesting

precatory words /ˌprekət(ə)ri ˈwɜːdz/ *noun* in a document such as a will, words which ask for something to be done

precedent /ˈpresɪd(ə)nt/ *noun* something such as a judgment which has happened earlier than the present, and which can be a guide to what should be done in the present case □ **to set a precedent** to make a decision in court which will show other courts how to act in future □ **to follow a precedent** to decide in the same way as an earlier decision in the same type of case ○ *The court followed the precedent set in 1926.*

COMMENT: Although English law is increasingly governed by statute, the doctrine of precedent still plays a major role. The decisions of higher courts bind lower courts, except in the case of the Court of Appeal, where the court has power to change a previous decision reached per incuriam. Cases can be distinguished by the courts where the facts seem to be sufficiently different.

precept /ˈpriːsept/ *noun* an order asking for local taxes to be paid

precepting body /ˌpriːseptɪŋ ˈbɒdi/ *noun* an organisation which levies a precept

preclude /prɪˈkluːd/ *verb* to forbid or to prevent ○ *The High Court is precluded by statute from reviewing such a decision.* ○ *This agreement does not preclude a further agreement between the parties in the future.*

predecease /ˌpriːdɪˈsiːs/ *verb* to die before someone ○ *He predeceased his father.* ○ *His estate is left to his daughter, but should she predecease him, it will be held in trust for her children.*

predecessor /ˈpriːdɪsesə/ *noun* somebody who had a job or position before someone else ○ *He took over from his predecessor last May.* ○ *She acquired her predecessor's list of clients.*

pre-emption /ˌpriː ˈempʃən/ *noun* the right of first refusal to purchase something before it is sold to someone else

pre-emption clause /priː ˈempʃən ˌklɔːz/ *noun* a clause in a private company's articles of association which requires any shares offered for sale to be offered first to existing shareholders

mainp - softvnn.com

Law.fm Page 230 Friday, June 11, 2004 2:08 PM

prefer /prɪ'fɜː/ *verb* **1.** to pay one creditor before any others **2.** to bring something before a court ▫ **to prefer charges** to charge someone with an offence

preference /'pref(ə)rəns/ *noun* **1.** something which is preferred **2.** the payment of one creditor before other creditors

preferential /ˌprefə'renʃəl/ *adjective* showing that something is preferred more than another

COMMENT: In the case of a company liquidation, preferential debts are debts owed to the government or its agencies and include PAYE owed to the Inland Revenue, VAT, social security contributions, contributions to state pensions schemes.

preferential creditor /ˌprefərenʃ(ə)l 'kredɪtə/ *noun* a creditor who must be paid first if a company is in liquidation

preferential debt /ˌprefə'renʃəl det/ *noun* a debt which is paid before all others

preferential duty /ˌprefərenʃ(ə)l 'djuːti/ *noun* a special low rate of tax

preferential payment /ˌprefərenʃəl 'peɪmənt/ *noun* payment made to one creditor before others

preferential terms /ˌprefə'renʃ(ə)l tɜːms/ *plural noun* terms or way of dealing which is better than usual

preferment of charges /prɪ ˌfɜːrmənt əv 'tʃɑːdʒɪz/ *noun* the act of charging someone with a criminal offence

preferred creditor /prɪˌfɜːd 'kredɪtə/ *noun* a creditor who must be paid first if a company is in liquidation

preferred shares /prɪˌfɜːd 'ʃeəz/ *plural noun* shares which receive their dividend before all other shares, and which are repaid first (at face value) if the company is in liquidation

prejudge /priː'dʒʌdʒ/ *verb* to judge an issue before having heard the evidence ○ *Do not prejudge the issue – hear what defence counsel has to say.*

prejudice /'predʒʊdɪs/ *noun* **1.** an unreasonable view of someone or something based on feelings or opinions rather than facts **2.** harm done to someone ○ *Forgery is the copying of a real document, so that it is accepted as genuine to someone's prejudice.* ▫ **without prejudice** phrase spoken or written in letters when attempting to negotiate a settlement, meaning that the negotiations cannot be referred to in court or relied upon by the other party if the discussions fail ▫ **to act to the prejudice of a claim** to do something which may harm a claim ■ *verb* to harm ○ *to prejudice someone's claim*

preliminary /prɪ'lɪmɪn(ə)ri/ *adjective* happening before other things as an introduction or in preparation

preliminary discussion /prɪ ˌlɪmɪn(ə)ri dɪ'skʌʃ(ə)n/ *noun* a discussion or meeting which takes place before the main discussion or meeting starts

preliminary hearing /prɪˌlɪmɪn(ə)ri 'hɪərɪŋ/ *noun* **1.** court proceedings where the witnesses and the defendant are examined to see if there are sufficient grounds for the case to proceed **2.** in the small claims track, a hearing to decide if special directions should be issued, or if the statement of case should be struck out **3.** court proceedings to try a specific issue rather than the whole case

preliminary inquiries /prɪ ˌlɪmɪn(ə)ri ɪn'kwaɪəriz/ *plural noun* investigation by the solicitor for the purchaser addressed to the vendor's solicitor concerning the vendor's title to the property for which the purchaser has made an offer

preliminary investigation /prɪ ˌlɪmɪn(ə)ri ɪnˌvestɪ'geɪʃ(ə)n/ *noun* an examination of the details of a case by a magistrate who then has to decide if the case should be committed to a higher court for trial

preliminary reference /prɪ ˌlɪmɪn(ə)ri 'ref(ə)rəns/ *noun* a reference from a court in a Member State of the European Union to the European Court of Justice on a question of interpretation of EU law, the aim being to ensure that the laws are interpreted uniformly throughout the EU, and that all national courts are familiar with it. The ECJ has used preliminary references as a means of extending the scope of EU law.

mainp - softvnn.com

Law.fm Page 231 Friday, June 11, 2004 2:08 PM

preliminary ruling /prɪˌlɪmɪn(ə)ri ˈruːlɪŋ/ *noun* a provisional decision of the European Court of Justice

premeditated /priːˈmedɪteɪtɪd/ *adjective* having been thought about carefully or which has been planned ○ *a premeditated murder* ○ *The crime was premeditated.*

premeditation /ˌpriːmedɪˈteɪʃ(ə)n/ *noun* the activity of thinking about and planning a crime such as murder

premises /ˈpremɪsɪz/ *plural noun* **1.** building and the land it stands on □ **office premises**, **shop premises** building which houses an office or shop □ **lock-up premises** shop which is locked up at night when the owner goes home □ **on the premises** in the building ○ *There is a doctor on the premises at all times.* **2.** things that have been referred to previously (NOTE: used at the end of a pleading: *In the premises the defendant denies that he is indebted to the claimant as alleged or at all.*)

premium /ˈpriːmiəm/ *noun* **1.** a sum of money paid by one person to another, especially one paid regularly **2.** the amount to be paid to a landlord or a tenant for the right to take over a lease ○ *flat to let with a premium of £10,000* ○ *annual rent: £8,500 – premium: £25,000* **3.** an extra charge

prerogative /prɪˈrɒgətɪv/ *noun* a special right which someone has

prerogative of mercy /prɪˌrɒgətɪv əv ˈmɜːsi/ *noun* the power (used by the Home Secretary) to commute or remit a sentence

prerogative order /prɪˌrɒgətɪv ˈɔːdə/ *noun* a writ from the High Court, which requests a body to do its duty, or not to do some act, or to conduct an inquiry into its own actions

prerogative powers /prɪˌrɒgətɪv ˈpaʊəs/ *plural noun* special powers used by a government, acting in the name of the King or Queen, to do something such as declare war, nominate judges or ministers without needing to ask Parliament to approve the decision

prescribe /prɪˈskraɪb/ *verb* **1.** to claim rights which have been enjoyed for a long time **2.** to lay down rules

prescribed limits /prɪˌskraɪbd ˈlɪmɪts/ *plural noun* limits which are set down in legislation, e.g. the limit on the amount of alcohol a driver is allowed to drink and still drive

prescription /prɪˈskrɪpʃən/ *noun* the act of acquiring a right or exercising a right over a period of time

present /ˈprez(ə)nt/ *noun* □ **these presents** this document itself □ **know all men by these presents** be informed by this document ■ *verb* to bring or send and show a document □ **to present a bill for acceptance** to send a bill for payment by the person who has accepted it □ **to present a bill for payment** to send a bill to be paid

presentation /ˌprez(ə)nˈteɪʃ(ə)n/ *noun* the process or an act of offering or showing information for other people to consider or make a decision about ○ *The presentation of the case took several days.* □ **on presentation of** by showing ○ *Admission only on presentation of this pass.*

presentment /prɪˈzentmənt/ *noun* the act of showing a document ○ *presentment of a bill of exchange*

preservation order /ˌprezəˈveɪʃ(ə)n ˌɔːdə/ *noun* a court order which prevents a building from being demolished or a tree from being cut down

preside /prɪˈzaɪd/ *verb* to be chairman ○ *to preside over a meeting* ○ *The meeting was held in the committee room, Mr Smith presiding.*

presidential-style /ˌprezɪˈdenʃəl staɪl/ *adjective* working in a similar way to the United States presidency □ **presidential-style government** governing in the same way as a President of the USA, who is not a member of the elected legislature □ **presidential-style campaign** election campaign which concentrates on the person of the leader of the party, and not on the party's policies ○ *The Prime Minister was accused of running a presidential-style election campaign.*

President of the Family Division /ˌprezɪdənt əv ðə ˈfæm(ə)li dɪˌvɪʒ(ə)n/ *noun* a judge who is responsible for the work of the Family Division of the High Court

mainp - softvnn.com

Law.fm Page 232 Friday, June 11, 2004 2:08 PM

presiding judge /prɪˌzaɪdɪŋ ˈdʒʌdʒ/ *noun* a High Court judge who is responsible for a main Crown Court in a circuit

press /pres/ *verb* ▫ **to press charges against someone** to say formally that someone has committed a crime ○ *He was very angry when his neighbour's son set fire to his car, but decided not to press charges.*

Press Complaints Commission /ˌpres kəmˈpleɪnts kəˌmɪʃ(ə)n/ *noun* a voluntary body concerned with the self-regulation of the press

press conference /ˈpres ˌkɒnf(ə)rəns/ *noun* a meeting where reporters from newspapers and TV are invited to ask a minister questions, to hear the result of a court case, etc. (NOTE: In some political parties (such as the British Labour Party), the word **Conference** is used without **the** to indicate that it is not simply a meeting, but a decision-making body: *Decisions of Conference are binding on the Executive*; *Conference passed a motion in support of trade unions.*)

press coverage /ˈpres ˌkʌv(ə)rɪdʒ/ *noun* reports about something in the newspapers, on TV, etc. ○ *The company had good media coverage for the launch of its new model.*

press release /ˈpres rɪˌliːs/ *noun* a sheet giving news about something which is sent to newspapers and TV and radio stations so that they can use the information

press secretary /ˈpres ˌsekrət(ə)ri/ *noun* the person responsible for contacts with journalists ○ *The information was communicated by the President's Press Secretary.*

pressure group /ˈpreʃə ɡruːp/ *noun* a group of people with similar interests, who try to influence government policies

pressure politics /ˌpreʃə ˈpɒlɪtɪks/ *noun* an attempt to change a government's policies by political pressure

presume /prɪˈzjuːm/ *verb* to suppose something is correct ○ *The court presumes the maintenance payments are being paid on time.* ○ *The company is presumed to be still solvent.* ○ *We presume the shipment has been stolen.* ○ *Two sailors are missing, presumed drowned.*

COMMENT: In English law, the accused is presumed to be innocent until he is proved to be guilty, and presumed to be sane until he is proved to be insane.

presumption /prɪˈzʌmpʃən/ *noun* something which is assumed to be correct, because it is based on other facts

presumption of death /prɪˌzʌmpʃən əv ˈdeθ/ *noun* a situation where a person has not been seen for seven years and is presumed to be legally dead

presumption of innocence /prɪˌzʌmpʃən əv ˈɪnəs(ə)ns/ *noun* the act of assuming that someone is innocent, until they have been proved guilty

presumptive evidence /prɪˌzʌmptɪv ˈevɪd(ə)ns/ *noun* circumstantial evidence

pretrial /priːˈtraɪəl/ *adjective* before a trial starts

pretrial detention /priːˌtraɪəl dɪˈtenʃən/ *noun US* the situation of being kept in prison until your trial starts (NOTE: The British equivalent is **remanded in custody**.)

pretrial release /priːˌtraɪəl rɪˈliːs/ *noun US* the release of an accused person pending his or her return to court to face trial (NOTE: The British equivalent is **bail**.)

pretrial review /priːˌtraɪəl rɪˈvjuː/ *noun US* a meeting of the parties before a civil action to examine what is likely to arise during the action, so that ways can be found of making it shorter and so reduce costs

prevail /prɪˈveɪl/ *verb* ▫ **to prevail upon someone to do something** to persuade someone to do something ○ *Counsel prevailed upon the judge to grant an adjournment.*

prevaricate /prɪˈværɪkeɪt/ *verb* not to give a clear and straightforward answer to a question

prevention /prɪˈvenʃən/ *noun* the act of stopping something from taking place ▫ **the prevention of terrorism** stopping terrorist acts taking place

prevention of corruption /prɪˌvenʃən əv kəˈrʌpʃən/ *noun US* activi-

mainp - softvnn.com

Law.fm Page 233 Friday, June 11, 2004 2:08 PM

ty undertaken to stop corruption taking place

preventive /prɪ'ventɪv/ *adjective* trying to stop something happening □ **to take preventive measures against theft** to try to stop things from being stolen

COMMENT: Now replaced by **extended sentence**.

preventive detention /prɪˌventɪv dɪ'tenʃən/ *noun US* formerly, the imprisonment of someone who frequently committed a specific crime, so as to prevent them from doing it again

previous /'priːviəs/ *noun* a previous conviction or convictions for criminal offences

price controls /'praɪs kənˌtrəʊlz/ *plural noun* legal measures to prevent prices rising too fast

price/earnings ratio /ˌpraɪs 'ɜːnɪŋz ˌreɪʃiəʊ/ *noun* the ratio between the market price of a share and the current earnings it produces

price ex warehouse /ˌpraɪs eks 'weəhaʊs/ *noun* the price for a product which is to be collected from the factory or from an agent's warehouse and so does not include delivery

price ex works /ˌpraɪs eks 'wɜːks/ *noun* the price not including transport from the maker's factory

price fixing /'praɪs ˌfɪksɪŋ/ *noun* an illegal agreement between companies to charge the same price for competing products

pricing /'praɪsɪŋ/ *noun* the activity of giving a price to a product

pricing policy /'praɪsɪŋ ˌpɒlisi/ *noun* a company's policy in setting prices for its products

primacy /'praɪməsi/ *noun* supremacy, one of the twin pillars of EU law. ◊ **supremacy**

prima facie /ˌpraɪmə 'feɪʃi/ *phrase* a Latin phrase meaning 'on the face of it' or 'as things seem at first' □ **there is a prima facie case to answer** one side in a case has shown that there is a case to answer, and so the action should be proceeded with

primarily /'praɪm(ə)rɪli/ *adverb* in the first place ○ *He is primarily liable for his debts.* ◊ **secondarily**

primary evidence /ˌpraɪməri 'evɪd(ə)ns/ *noun* the most reliable type of evidence, e.g. original documents, or evidence from eye witnesses

primary legislation /ˌpraɪməri ˌledʒɪ'sleɪʃ(ə)n/ *noun* legislation of the Member States of the European Union, as opposed to legislation of the EU itself

prime /praɪm/ *adjective* **1.** most important **2.** basic

prime bills /ˌpraɪm 'bɪlz/ *plural noun* bills of exchange which do not involve any risk

prime rate /'praɪm reɪt/ *noun* the best rate of interest at which a bank lends to its customers

prime time /'praɪm taɪm/ *noun* the most expensive advertising time for TV advertisements

primogeniture /ˌpraɪməʊ'dʒenɪtʃə/ *noun* a former rule that the oldest son inherits all his father's estate

primus inter pares /ˌpraɪməs ɪn'tɜː peəs/ *phrase* a Latin phrase meaning 'first among equals': used to refer to the office of Prime Minister, implying that all ministers are equal, and the PM is simply the most important of them

principal /'prɪnsɪp(ə)l/ *noun* a person who is responsible for something, especially person who is in charge of a company or a person who commits a crime

principle /'prɪnsɪp(ə)l/ *noun* a general point or rule that is used as the basis of the way something is done □ **in principle** in agreement with a general rule □ **it is against his principles** it goes against what he believes to be the correct way to act. Compare **principal**

printed matter /'prɪntɪd ˌmætə/ *noun* books, newspapers, advertising material, etc.

prior /'praɪə/ *adjective* earlier □ **without prior knowledge** without knowing before

prior agreement /ˌpraɪə ə'griːmənt/ *noun* an agreement which was reached earlier

prior charge /ˌpraɪə 'tʃɑːdʒ/ *noun* a charge which ranks before others

priori ▸ **a priori**

mainp - softvnn.com

Law.fm Page 234 Friday, June 11, 2004 2:08 PM

prison /ˈprɪz(ə)n/ *noun* **1.** a safe building where criminals can be kept locked up after they have been convicted or while they await trial ○ *The government has ordered the construction of six new prisons.* ○ *This prison was built 150 years ago.* **2.** a place where prisoners are kept as a punishment ○ *She was sent to prison for six years.* ○ *They have spent the last six months in prison.* ○ *He escaped from prison by climbing over the wall.* (NOTE: no plural for sense 2, which is also usually written without the article: *in prison*; *out of prison*; *sent to prison*.)

prison chaplain /ˌprɪz(ə)n ˈtʃæplɪn/ *noun* a priest or minister who works in a prison

prisoner /ˈprɪz(ə)nə/ *noun* somebody who is in prison

prisoner at the bar /ˌprɪz(ə)nə ət ðə ˈbɑː/ *noun* a prisoner who is being tried in court

prisoner of war /ˌprɪz(ə)nə əv ˈwɔː/ *noun* a member of the armed forces captured and put in prison by the enemy in time of war

prisoner on remand /ˌprɪz(ə)nə ɒn rɪˈmɑːnd/ *noun* a prisoner who has been told to reappear in court at a later date

prison governor /ˈprɪz(ə)n ˌgʌv(ə)nə/ *noun* the person in charge of a prison

prison officer /ˈprɪz(ə)n ˌɒfɪsə/ *noun* a member of staff in a prison

prison visitor /ˌprɪz(ə)n ˈvɪzɪtə/ *noun* ◗ **visitor**

privacy /ˈprɪvəsi/ *noun* a private life

private /ˈpraɪvət/ *adjective* belonging to a single person, not a company or the state

Private Bill /ˈpraɪvət bɪl/ *noun* a Bill or Act relating to a particular person, corporation or institution

private business /ˌpraɪvət ˈbɪznɪs/ *noun* a business dealing with the members of a group or matters which cannot be discussed in public ○ *The committee held a special meeting to discuss some private business.*

private carrier /ˌpraɪvət ˈkæriə/ *noun* a firm which carries goods or passengers, but which is not contractually bound to offer the service to anyone

private client /ˌpraɪvət ˈklaɪənt/ *noun* a client dealt with by a professional person or by a salesperson as an individual person, not as a company

private detective /ˌpraɪvət dɪˈtektɪv/ *noun* a person who for a fee will try to find missing people, keep watch on someone, or find out information

private effects /ˌpraɪvət ɪˈfekts/ *plural noun* goods which belong to someone and are used by him

private eye /ˌpraɪvət ˈaɪ/ *noun* somebody who for a fee will try to solve mysteries, to find missing persons or to keep watch on someone (*informal*)

private law /ˈpraɪvət lɔː/ *noun* a law such as the law of contract relating to relations between individual people

private letter /ˌpraɪvət ˈletə/ *noun* a letter which deals with personal matters

Private Member's Bill /ˌpraɪvət ˈmembəz ˌbɪl/ *noun* a Bill which is drafted and proposed as legislation in the House of Commons by an ordinary Member of Parliament, not by a government minister on behalf of the government

private nuisance /ˌpraɪvət ˈnjuːs(ə)ns/ *noun* a tort, a nuisance which causes harm or damage to a particular person or their rights

private ownership /ˌpraɪvət ˈəʊnəʃɪp/ *noun* a situation where a company is owned by private shareholders

private property /ˌpraɪvət ˈprɒpəti/ *noun* property which belongs to a private person, not to the public

private prosecution /ˌpraɪvət ˌprɒsɪˈkjuːʃ(ə)n/ *noun* a prosecution for a criminal act, brought by an ordinary member of the public and not by the police

privatise /ˈpraɪvətaɪz/, **privatize** *verb* to sell a nationalised industry to private shareholders

privilege /ˈprɪvɪlɪdʒ/ *noun* **1.** protection from the law given in some circumstances. ◊ **Crown privilege, professional privilege 2.** the right of a party not to disclose a document, or to refuse to answer questions, on the ground of

mainp - softvnn.com

Law.fm Page 235 Friday, June 11, 2004 2:08 PM

some special interest **3.** *US* the order of priority ▫ **motion of the highest privilege** motion which will be discussed first, before all other motions

privileged /ˈprɪvɪlɪdʒd/ *adjective* protected by privilege

privileged communication /ˌprɪvɪlɪdʒd kəˌmjuːnɪˈkeɪʃ(ə)n/ *noun* a letter which could be libellous, but which is protected by privilege, e.g. a letter from a client to his lawyer

privileged meeting /ˌprɪvɪlɪdʒd ˈmiːtɪŋ/ *noun* a meeting where what is said will not be repeated outside

privileged questions /ˌprɪvɪlɪdʒd ˈkwestʃ(ə)ns/ *plural noun US* order of priority of motions to be discussed

privileged will /ˈprɪvɪlɪdʒd wɪl/ *noun* a will which is not made in writing and is not signed or witnessed, e.g. a will made by a soldier on the battlefield or a seaman while at sea

COMMENT: Privileged wills are not like ordinary wills, in that they may be oral, or if written, need not be signed or witnessed. It is sufficient that the intention of the testator was made clear at the time.

privity of contract /ˌprɪvɪti əv ˈkɒntrækt/ *noun* a relationship between the parties to a contract, which makes the contract enforceable as between them

Privy Council /ˌprɪvi ˈkaʊnsəl/ *noun* a body of senior advisers who advise the Queen on specific matters

COMMENT: The Privy Council is mainly formed of members of the cabinet, and former members of the cabinet. It never meets as a group, but three Privy Councillors need to be present when the Queen signs Orders in Council.

Privy Councillor /ˌprɪvi ˈkaʊnsələ/ *noun* a member of the Privy Council

prize court /ˈpraɪz kɔːt/ *noun* a court set up to rule on the ownership of prizes

pro /prəʊ/ *preposition* for or on behalf of

probable cause /ˌprɒbəb(ə)l ˈkɔːz/ *noun US* the fact of believing that it is likely that a crime has been committed and by an identified person, which is a necessary part of police stop and search procedures

probate /ˈprəʊbeɪt/ *noun* legal acceptance that a document, especially a will, is valid ▫ **the executor was granted probate**, **obtained a grant of probate** the executor was told officially that the will was valid

Probate Registry /ˈprəʊbeɪt ˌredʒɪstri/ *noun* a court office which deals with the granting of probate

probation /prəˈbeɪʃ(ə)n/ *noun* **1.** a legal system for dealing with criminals, often young offenders, where they are not sent to prison provided that they continue to behave well under the supervision of a probation officer ○ *She was sentenced to probation for one year.* **2.** a period when a new employee is being tested before being confirmed as having a permanent job ◇ **on probation 1.** being tested ○ *he is on three months' probation* **2.** being under a probation order from a court ○ *to take someone on probation*

probationer /prəˈbeɪʃ(ə)nə/ *noun* somebody who has been put on probation

probation officer /prəˈbeɪʃ(ə)n ˌɒfɪsə/ *noun* an official of the social services who supervises young people on probation

probation order /prəˌbeɪʃ(ə)n ˈɔːdə/ *noun* a court order putting someone on probation

probative /ˈprəʊbətɪv/ *adjective* relating to proof

probative value /ˈprəʊbətɪv ˌvæljuː/ *noun US* the value of an item as evidence in a trial

problem area /ˈprɒbləm ˌeəriə/ *noun* an area of work which is difficult to manage ○ *Drug-related crime is a problem area in large cities.*

procedural /prəˈsiːdʒərəl/ *adjective* referring to legal procedure

procedural judge /prəˈsiːdʒərəl dʒʌdʒ/ *noun* a judge who deals with the management of a case, its allocation to a particular track, etc.

procedural law /prəˈsiːdʒərəl lɔː/ *noun* law relating to how the civil or criminal law is administered by the courts. Compare **substantive law**

procedural problem /prəˌsiːdʒərəl ˈprɒbləm/ *noun* a question concerning

mainp - softvnn.com

Law.fm Page 236 Friday, June 11, 2004 2:08 PM

procedure ○ *The hearing was held up while counsel argued over procedural problems.*

procedure /prə'siːdʒə/ *noun* a way in which something is done, especially the correct or agreed way to deal with something ○ *to follow the proper procedure* ○ *criticised police procedures* □ **this procedure is very irregular** this is not the set way to do something

proceed /prə'siːd/ *verb* to continue doing something ○ *The negotiations are proceeding slowly.* □ **to proceed against someone** to start a legal action against someone □ **to proceed with something** to go on doing something

proceedings /prə'siːdɪŋz/ *plural noun* □ **to institute or to start proceedings against someone** to start a legal action against someone

proceedings in tort /prəˌsiːdɪŋz ɪn 'tɔːt/ *plural noun* court action for damages for a tort

process /prəʊ'ses/ *noun* **1.** the way in which a court acts to assert its jurisdiction **2.** the writs issued by a court to summon a defendant to appear in court **3.** a legal procedure □ **the due process of the law** the formal work of a fair legal action ■ *verb* to deal with something in the usual routine way ○ *to process an insurance claim* ○ *The incident room is processing information received from the public.*

processing /'prəʊsesɪŋ/ *noun* □ **the processing of a claim for insurance** putting a claim for compensation through the usual office routine in the insurance company

process-server /prəʊˌses 'sɜːvə/ *noun* a person who delivers legal documents such as a writ or summons to people in person

proctor /'prɒktə/ *noun* (*in a university*) an official who is responsible for keeping law and order

procurationem ➧ **per procurationem**

Procurator Fiscal /ˌprɒkjureɪtə 'fɪsk(ə)l/ *noun* (*in Scotland*) a law officer who decides whether an alleged criminal should be prosecuted

procure /prə'kjʊə/ *verb* to get someone to do something, especially to arrange for a woman to provide sexual intercourse for money

procurer /prə'kjʊərə/ *noun* somebody who procures women

procuring /prə'kjʊəmənt/**, procurement** *noun* the notifiable offence of getting a woman to provide sexual intercourse for money

Production Centre /prəˌdʌkʃ(ə)n 'sentə/ *noun* a central office which issues claim forms

product liability /ˌprɒdʌkt laɪə 'bɪlɪti/ *noun* the liability of the maker of a product for negligence in the design or production of the product

proferentem ➧ **contra proferentem**

profession /prə'feʃ(ə)n/ *noun* **1.** work which needs special learning over a period of time □ **the managing director is a lawyer by profession** he trained as a lawyer **2.** a group of specialised workers □ **the legal profession** all lawyers □ **the medical profession** all doctors

professional /prə'feʃ(ə)n(ə)l/ *adjective* **1.** referring to one of the professions ○ *The accountant sent in his bill for professional services.* ○ *We had to ask our lawyer for professional advice on the contract.* □ **a professional man** somebody who works in one of the professions, e.g. a lawyer, doctor, accountant □ **professional qualifications** documents showing that someone has successfully finished a course of study which allows him to work in one of the professions **2.** expert ■ *noun* a person with special skills and qualifications in a particular subject

professional misconduct /prəˌfeʃ(ə)n(ə)l mɪs'kɒndʌkt/ *noun* behaviour by a professional person such as a lawyer, accountant or doctor which the body which regulates that profession considers to be wrong, e.g. an action by a solicitor which is considered wrong by the Law Society

professional privilege /prəˌfeʃ(ə)n(ə)l 'prɪvɪlɪdʒ/ *noun* confidentiality of communications between a client and his or her lawyer

profit after tax /ˌprɒfɪt ɑːftə 'tæks/ *noun* the profit after tax has been deducted

mainp - softvnn.com

Law.fm Page 237 Friday, June 11, 2004 2:08 PM

profit and loss account /ˌprɒfɪt ən ˈlɒs əˌkaʊnt/ *noun* a statement of a company's expenditure and income over a period of time, almost always one calendar year, showing whether the company has made a profit or loss

profit à prendre /ˌprɒfi æ ˈprɒndrə/ *noun* a right to take from land or a river passing through it something such as game or fish

profit before tax /ˌprɒfɪt bɪfɔː ˈtæks/ *noun* the profit of a company after expenses have been deducted but before tax has been calculated

profiteer /ˌprɒfɪˈtɪə/ *noun* somebody who makes too much profit, especially when goods are rationed or in short supply

pro forma /ˌprəʊ ˈfɔːmə/ *phrase* a Latin phrase meaning 'for the sake of form' ▫ **pro forma (invoice)** invoice sent to a buyer before the goods are sent, so that payment can be made or that business documents can be produced ▫ **pro forma letter** formal letter which informs a court of a decision of another court

progress report /ˈprəʊgres rɪˌpɔːt/ *noun* a document which describes what progress has been made

prohibit /prəʊˈhɪbɪt/ *verb* to say that something must not happen ○ *Parking is prohibited in front of the garage.* ○ *The law prohibits the sale of alcohol to minors.*

prohibited degrees /prəʊˌhɪbɪtɪd dɪˈgriːs/ *plural noun* the relationships which make it illegal for a man and woman to marry, e.g. father and daughter

prohibited goods /prəʊˌhɪbɪtɪd ˈgʊdz/ *plural noun* goods which are not allowed to be imported

prohibition /ˌprəʊɪˈbɪʃ(ə)n/ *noun* **1.** the act of forbidding something **2.** a High Court order forbidding a lower court from doing something which exceeds its jurisdiction

prohibitory injunction /prəˌhɪbɪt(ə)ri ɪnˈdʒʌŋkʃən/ *noun* an order from a court preventing someone from doing an illegal act

promisee /ˌprɒmɪˈsiː/ *noun* somebody to whom a promise is made

promisor /ˌprɒmɪˈsɔː/ *noun* somebody who makes a promise

promissory /ˈprɒmɪsəri/ *adjective* promising

promissory estoppel /ˌprɒmɪsəri ɪˈstɒp(ə)l/ *noun* a promise made by one person to another, so that the second person relies on the promise and acts in way that is detrimental, and the first person is stopped from denying the validity of the promise

promote /prəˈməʊt/ *verb* **1.** to introduce a new Bill into Parliament **2.** to encourage something to grow ▫ **to promote a new company** to organise the setting up of a new company

promoter /prəˈməʊtə/ *noun* somebody who introduces a new Bill into Parliament

prompt /prɒmpt/ *verb* to tell someone what to say ○ *The judge warned counsel not to prompt the witness.*

proof /pruːf/ *noun* **1.** evidence or other thing which shows that something is true ▫ **proof beyond reasonable doubt** proof that no reasonable person could doubt (the proof needed to convict a person in a criminal case) **2.** the statement or evidence of a creditor to show that he or she is owed money by a bankrupt or by a company in liquidation

proofing /ˈpruːfɪŋ/ *noun* ▫ **proofing of witnesses** action of looking into witnesses' statements

proof of debt /ˌpruːf əv ˈdet/ *noun* proceedings for a creditor to claim payment from a bankrupt's assets

proof of evidence /ˌpruːf əv ˈevɪd(ə)ns/ *noun* a written statement of what a witness intends to say in court

proof of identification /ˌpruːf əv aɪˌdentɪfɪˈkeɪʃ(ə)n/ *noun* **1.** proving that something is what the evidence says it is ○ *the policeman asked him for proof of identification* **2.** proving that someone is who they say they are

proof of service /ˌpruːf əv ˈsɜːvɪs/ *noun* proof that that legal documents have been delivered to someone

property /ˈprɒpəti/ *noun* **1.** things that are owned by someone ○ *They have no respect for other people's property.* ○ *He was known to be a receiver of stolen*

mainp - softvnn.com

Law.fm Page 238 Friday, June 11, 2004 2:08 PM

property. ○ *The books are my property, but the bookshelves belong to John.* **2.** land and buildings ○ *He owns a lot of property in the north.* **3.** a building such as a house, shop or factory ○ *There are several properties for sale in the centre of the town.* ■ *adjective* relating to land and buildings ○ *a rise in property prices*

proportionality /prə,pɔːʃ(ə)'nælɪti/ *noun* **1.** the principle that a government or local authority can only act if the action is in proportion to the aim which is to be achieved, the aim being to protect the rights of ordinary citizens **2.** the principle that a legal action can only take place if the costs are proportionate to the aim to be achieved ○ *The requirement of proportionality may be a reason for a party to refuse to respond to a request for further information.*

proportionate /prə'pɔːʃ(ə)nət/ *adjective* directly related to or in proportion to something

proposal form /prə'pəʊz(ə)l fɔːm/ *noun* an official document with details of a property or person to be insured which is sent to the insurance company when asking for an insurance

propose /prə'pəʊz/ *verb* □ **to propose to** to say that you intend to do something ○ *I propose to repay the loan at £20 a month.*

proprietary drug /prə,praɪət(ə)ri 'drʌg/ *noun* a drug which is made by a particular company and marketed under a brand name

proprietary right /prə'praɪət(ə)ri raɪt/ *noun* the right of someone who owns a property

proprietor /prə'praɪətə/ *noun* the owner of a property

proprietorship /prə'praɪətəʃɪp/ *noun* the act of being the proprietor of land

proprietorship register /prə 'praɪətəʃɪp ˌredʒɪstə/ *noun* land register which shows the details of owners of land

proprietress /prə'praɪətrəs/ *noun* a female owner

pro rata /ˌprəʊ 'rɑːtə/ *adjective*, *adverb* at a rate which changes according to the importance of something ○ *a pro rata payment* ○ *to pay someone pro rata*

prorogation /ˌprəʊrə'geɪʃ(ə)n/ *noun* the end of a session of Parliament

prorogue /prə'rəʊg/ *verb* to end a session of Parliament ○ *Parliament was prorogued for the summer recess.*

proscribe /prəʊ'skraɪb/ *verb* to ban □ **a proscribed organization**, **political party** an organisation or political party which has been banned

prosecute /'prɒsɪkjuːt/ *verb* **1.** to bring someone to court to answer a criminal charge ○ *She was prosecuted for embezzlement.* **2.** to speak against the accused person on behalf of the party bringing the charge ○ *Mr Smith is prosecuting, and Mr Jones is appearing for the defence.*

prosecution /ˌprɒsɪ'kjuːʃ(ə)n/ *noun* **1.** the act of bringing someone to court to answer a charge ○ *his prosecution for embezzlement* ◊ **Crown Prosecution Service, Director of Public Prosecutions 2.** a party who brings a criminal charge against someone ○ *The costs of the case will be borne by the prosecution.* **3.** the group of lawyers representing the party who brings a criminal charge against someone

prosecution counsel /ˌprɒsɪ 'kjuːʃ(ə)n ˌkaʊnsəl/ *noun* a lawyer acting for the prosecution

prosecution witness /ˌprɒsɪ 'kjuːʃ(ə)n ˌwɪtnəs/ *noun* a person called by the prosecution side to give evidence against the defendant or the accused

prosecutor /'prɒsɪkjuːtə/ *noun* somebody who brings criminal charges against someone

prosequi ◊ **nolle prosequi**

prostitute /'prɒstɪtjuːt/ *noun* somebody who provides sexual intercourse in return for payment

prostitution /ˌprɒstɪ'tjuːʃ(ə)n/ *noun* the activity of providing sexual intercourse in return for payment

protect /prə'tekt/ *verb* to defend something against harm ○ *The employees are protected from unfair dismissal by government legislation.* ○ *The computer is protected by a plastic cover.* ○ *The cov-*

mainp - softvnn.com

Law.fm Page 239 Friday, June 11, 2004 2:08 PM

er protects the machine from dust. □ **to protect an industry by imposing tariff barriers** to stop a local industry from being hit by foreign competition by stopping foreign products from being imported

protected information /prəˌtektɪd ˌɪnfəˈmeɪʃ(ə)n/ *noun* an electronic text which is not intelligible without a decryption key

protected person /prəˌtektɪd ˈpɜːs(ə)n/ *noun* an important person such as a President or Prime Minister who has special police protection

protected tenancy /prəˌtektɪd ˈtenənsi/ *noun* a tenancy where the tenant is protected from eviction (NOTE: You protect someone **from** something or **from having** something done to him.)

protection /prəˈtekʃən/ *noun* the action of protecting

protection racket /prəˌtekʃən ˈrækɪt/ *noun* an illegal organisation where people demand money from someone such as a small businessperson to pay for 'protection' against criminal attacks

protective /prəˈtektɪv/ *adjective* shielding from potential danger □ **to take someone into protective custody** to put someone in a safe place, e.g. police station cells, to protect him or her from being harassed or attacked

protective tariff /prəˌtektɪv ˈtærɪf/ *noun* a tariff which tries to ban imports to stop them competing with local products

pro tem /ˌprəʊ ˈtem/**, pro tempore** *adverb* for a short time

protest *noun* /ˈprəʊtest/ **1.** a statement or action to show that you do not approve of something ○ *to make a protest against high prices* □ **in protest at** showing that you do not approve of something ○ *The staff occupied the offices in protest at the low pay offer.* □ **to do something under protest** to do something, but say that you do not approve of it **2.** an official document from a notary public which notes that a bill of exchange has not been paid ■ *verb* /prəˈtest/ **1.** □ **to protest against something** to say that you do not approve of something ○ *The retailers are protesting against the ban on imported goods.* **2.** □ **to protest a bill** to draw up a document to prove that a bill of exchange has not been paid

protester /prəˈtestə/ *noun* someone who makes their opposition to something public

protest march /ˈprəʊtest mɑːtʃ/ *noun* a demonstration where protesters march through the streets

protest strike /ˈprəʊtest straɪk/ *noun* a strike in protest at a particular grievance

protocol /ˈprəʊtəkɒl/ *noun* **1.** a draft memorandum. ◊ **pre-action protocol 2.** a list of things which have been agreed. ◊ **pre-action protocol 3.** correct diplomatic behaviour

provable /ˈpruːvəb(ə)l/ *adjective* being able to be proved

provable debts /ˌpruːvəb(ə)l ˈdets/ *plural noun* debts which a creditor can prove against a bankrupt estate

proven /ˈpruːv(ə)n/ *adjective* □ **not proven** (*in Scotland*) verdict that the prosecution has not produced sufficient evidence to prove the accused to be guilty

provide /prəˈvaɪd/ *verb* **1.** □ **to provide for something** to allow for something which may happen in the future ○ *These expenses have not been provided for* ○ *The contract provides for an annual increase in charges.* □ **to provide for someone** to put aside money to give someone enough to live on ○ *He provided for his daughter in his will.* **2.** □ **to provide someone with something** to supply something to someone ○ *The defendant provided the court with a detailed account of his movements.* ○ *Duress provides no defence to a charge of murder.*

provided that /prəˈvaɪdɪd ˈðæt/**, providing** /prəˈvaɪdɪŋ/ *conjunction* on condition that ○ *The judge will sentence the convicted man next week provided (that)* or *providing the psychiatrist's report is received in time.* (NOTE: In deeds, the form **provided always that** is often used.)

province /ˈprɒvɪns/ *noun* □ **the Province** Northern Ireland

mainp - softvnn.com

Law.fm Page 240 Friday, June 11, 2004 2:08 PM

provision /prə'vɪʒ(ə)n/ *noun* **1.** □ **to make provision for** to see that something is allowed for in the future □ **to make financial provision for someone** to arrange for someone to receive money to live on (by attachment of earnings, etc.) □ **there is no provision for, no provision has been made for car parking in the plans for the office block** the plans do not include space for cars to park **2.** money put aside in accounts in case it is needed in the future ○ *The company has made a £2m provision for bad debts.* **3.** a legal condition □ **the provisions of a Bill** conditions listed in a Bill before Parliament □ **we have made provision to this effect** we have put into the contract terms which will make this work

provisional /prə'vɪʒ(ə)n(ə)l/ *adjective* temporary, not final or permanent ○ *They wrote to give their provisional acceptance of the contract.*

provisional damages /prə ˌvɪʒ(ə)n(ə)l 'dæmɪdʒɪz/ *plural noun* damages claimed by a claimant while the case is still being heard

provisional injunction /prə ˌvɪʒ(ə)n(ə)l ɪn'dʒʌŋkʃən/ *noun* a temporary injunction granted until a full court hearing can take place

provisional liquidator /prə ˌvɪʒ(ə)n(ə)l 'lɪkwɪdeɪtə/ *noun* an official appointed by a court to protect the assets of a company which is the subject of a winding up order

proviso /prə'vaɪzəʊ/ *noun* a condition in a contract or deed ○ *We are signing the contract with the proviso that the terms can be discussed again in six months' time.* (NOTE: A proviso usually begins with the phrase **'provided always that'**.)

provocateur ➧ **agent provocateur**

provocation /ˌprɒvə'keɪʃ(ə)n/ *noun* encouragement to commit a crime or carry out an action which you had not intended to do ○ *He acted under provocation.*

provoke /prə'vəʊk/ *verb* to make someone do something or to make something happen ○ *The strikers provoked the police to retaliate.* ○ *The murders provoked a campaign to increase police protection for politicians.* (NOTE: You provoke someone **to do** something.)

proxy /'prɒksi/ *noun* **1.** a document which gives someone the power to act on behalf of someone else ○ *to sign by proxy* **2.** somebody who acts on behalf of someone else, especially somebody appointed by a shareholder to vote on his or her behalf at a company meeting ○ *to act as proxy for someone*

P.S. *noun* an additional note at the end of a letter ○ *Did you read the P.S. at the end of the letter?* Full form **post scriptum**

PSBR *abbreviation* public sector borrowing requirement

Pty *abbreviation* proprietary company

public /'pʌblɪk/ *adjective* □ **the company is going public** the company is going to place some of its shares for sale on the Stock Exchange so that anyone can buy them ■ *noun* □ **the public, the general public** the people in general □ **in public** in front of everyone

public administration /ˌpʌblɪk əd ˌmɪnɪ'streɪʃ(ə)n/ *noun* **1.** the means whereby government policy is carried out **2.** the people responsible for carrying out government policy

publication /ˌpʌblɪ'keɪʃ(ə)n/ *noun* **1.** the act of making something public either in speech or writing ○ *Publication of Cabinet papers takes place after thirty years.* **2.** the act of making a libel known to people other than the person libelled **3.** a printed work shown to the public

Public Bill /ˌpʌblɪk 'bɪl/ *noun* an ordinary Bill relating to a matter applying to the public in general, introduced by a government minister

public disorder /ˌpʌblɪk dɪs'ɔːdə/ *noun* same as **civil disorder**

public domain /ˌpʌblɪk dəʊ'meɪn/ *noun* land, property or information which belongs to and is available to the public

public expenditure /ˌpʌblɪk ɪk 'spendɪtʃə/ *noun* the spending of money by the local or central government

public funds /ˌpʌblɪk 'fʌndz/ *plural noun* government money available for expenditure

mainp - softvnn.com

Law.fm Page 241 Friday, June 11, 2004 2:08 PM

public image /ˌpʌblɪk ˈɪmɪdʒ/ *noun* the idea which the people have of a company or a person ○ *The police are trying to improve their public image.*

public interest /ˌpʌblɪk ˈɪntrəst/ *noun* the usefulness of a piece of information to the public, in matters concerning national security, fraud, medical malpractice, etc., used as a defence against accusations of passing on confidential information or of invasion of privacy

COMMENT: Public interest implies that the actions of someone or information held by someone might affect the public in some way: if a newspaper discloses that a group of companies are fixing prices so as not to compete with each other, this disclosure might be held to be in the public interest. If a TV programme reveals that a Member of Parliament apparently took drugs, then this might be held to be in the public interest.

public law /ˌpʌblɪk ˈlɔː/ *noun* laws which refer to people in general such as administrative and constitutional law

public monopoly /ˌpʌblɪk mə ˈnɒpəli/ *noun* a situation where the state is the only supplier of a product or service

public nuisance /ˌpʌblɪk ˈnjuːs(ə)ns/ *noun* a criminal act which causes harm or damage to members of the public in general or to their rights

public opinion /ˌpʌblɪk əˈpɪnjən/ *noun* what people think about something

public order /ˌpʌblɪk ˈɔːdə/ *noun* a situation were the general public is calm and there are no riots

public ownership /ˌpʌblɪk ˈəʊnəʃɪp/ *noun* a situation where an industry is nationalised ○ *The company has been put into state ownership.*

public place /ˌpʌblɪk ˈpleɪs/ *noun* a place such as a road or park where the public have a right to be

public policy /ˌpʌblɪk ˈpɒlɪsi/ *noun* the policy of the government of a Member State of the European Union which protects its nationals, and which can be used to exclude nationals of other EU states from entering the country to take up work, though this excuse cannot be used for economic reasons

public prosecutor /ˌpʌblɪk ˈprɒsɪkjuːtə/ *noun* a government official who brings charges against alleged criminals. In the UK, it is the Director of Public Prosecutions.

public sector borrowing requirement /ˌpʌblɪk ˌsektə ˌbɒrəʊɪŋ rɪ ˈkwaɪəmənt/ *noun* the amount of money which a government has to borrow to pay for its own spending. Abbreviation **PSBR**

Public Trustee /ˌpʌblɪk ˌtrʌˈstiː/ *noun* an official who is appointed as a trustee of an individual's property

publish /ˈpʌblɪʃ/ *verb* to have a document such as a catalogue, book, magazine, newspaper or piece of music written and printed and then sell or give it to the public ○ *The society publishes its list of members annually.* ○ *The government has not published the figures on which its proposals are based.* ○ *The company publishes six magazines for the business market.*

puisne /ˈpjuːni/ *adjective* less important

puisne judge /ˌpjuːni ˈdʒʌdʒ/ *noun* a High Court judge

puisne mortgage /ˌpjuːni ˈmɔːgɪdʒ/ *noun* a mortgage where the deeds of the property have not been deposited with the lender

punish /ˈpʌnɪʃ/ *verb* to make someone pay the penalty for a crime which he or she has committed ○ *You will be punished for hitting the policeman.*

punishable /ˈpʌnɪʃəb(ə)l/ *adjective* able to be punished ○ *crimes punishable by imprisonment*

punishment /ˈpʌnɪʃmənt/ *noun* **1.** the act of punishing someone **2.** treatment of someone as a way of making them suffer for their crime ○ *The punishment for treason is death.*

punitive damages /ˌpjuːnɪtɪv ˈdæmɪdʒɪz/ *plural noun* heavy damages which punish the defendant for the loss or harm caused to the claimant, awarded to show that the court feels the defendant has behaved badly towards the claimant. Also called **exemplary damages**

mainp - softvnn.com

Law.fm Page 242 Friday, June 11, 2004 2:08 PM

pupil /ˈpjuːp(ə)l/ *noun* a trainee barrister, undergoing a year-long training period before qualification

pupillage /ˈpjuːpɪlɪdʒ/ *noun* a training period of one year after completing studies at university and passing all examinations, which a person has to serve before he or she can practise independently as a barrister

pur autre vie /ˌpuːə ˌəʊtrə ˈviː/ ♦ **per autre vie**

purchase order /ˈpɜːtʃɪs ˌɔːdə/ *noun* an official paper which places an order for something

purchaser /ˈpɜːtʃɪsə/ *noun* a person or company that buys something

purge /pɜːdʒ/ *verb* □ **to purge one's contempt**, **to purge a contempt of court** to do something such as make an apology to show that you are sorry for the lack of respect you have shown

purpose /ˈpɜːpəs/ *noun* an aim, plan or intention □ **on purpose** intentionally ○ *She hid the knife on purpose.* □ **we need the invoice for tax purposes**, **for the purpose of declaration to the tax authorities** in order for it to be declared to the tax authorities

purposive /ˈpɜːpəsɪv/ *adjective* referring to the purpose behind something ○ *a purposive interpretation of the Treaty on European Union*

pursuant to /pəˈsjuːənt tə/ *adverb* relating to or concerning ○ *matters pursuant to Article 124 of the EC treaty* ○ *pursuant to the powers conferred on the local authority*

pursue /pəˈsjuː/ *verb* to continue with something such as the proceedings in court

pursuit /pəˈsjuːt/ ♦ **fresh pursuit, hot pursuit**

purview /ˈpɜːvjuː/ *noun* the general scope of an Act of Parliament

put aside /ˌpʊt əˈsaɪd/ *verb* to decide to cancel an order, judgment or decision

putative father /ˌpjuːtətɪv ˈfɑːðə/ *noun* a man who is supposed to be or who a court decides must be the father of an illegitimate child

put away /ˌpʊt əˈweɪ/ *verb* to send to prison ○ *He was put away for ten years.*

put down /ˌpʊt ˈdaʊn/ *verb* **1.** to make a deposit ○ *to put down money on a house* **2.** to write an item in an account book ○ *to put down a figure for expenses*

put in /ˌpʊt ˈɪn/ *verb* □ **to put in a bid for something** to offer (usually in writing) to buy something □ **to put in an estimate for something** to give someone a written calculation of the probable costs of carrying out a job □ **to put in a claim for damage**, **loss** to ask an insurance company to pay for damage or loss

put into /ˌpʊt ˈɪntʊ/ *verb* □ **to put money into a business** to invest money in a business

put on /ˌpʊt ˈɒn/ *verb* □ **to put an item on the agenda** to list an item for discussion at a meeting □ **to put an embargo on trade** to forbid trade

put option /ˈpʊt ˌɒpʃən/ *noun* the right to sell shares at a specific price at a specific date

pyramiding /ˈpɪrəmɪdɪŋ/ *noun* illegally using new investors' deposits to pay the interest on the deposits made by existing investors

pyramid selling /ˈpɪrəmɪd ˌselɪŋ/ *noun* an illegal way of selling goods to the public, where each selling agent pays for the right to sell and sells that right to other agents, so that in the end the commissions earned by the sales of goods will never pay back the agents for the payments they themselves have already made

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Q

QB *abbreviation* Queen's Bench

QBD *abbreviation* Queen's Bench Division

QC *abbreviation* Queen's Counsel (NOTE: written after the surname of the lawyer: **W. Smith QC**. Note also that the plural is written **QCs**.)

qua /kwɑː/ *conjunction* as or acting in the capacity of ○ *a decision of the Lord Chancellor qua head of the judiciary*

qualification shares /ˌkwɒlɪfɪ ˈkeɪʃ(ə)n ʃeəs/ *plural noun* number of shares which a person has to hold to be a director of a company

qualified /ˈkwɒlɪfaɪd/ *adjective* **1.** having passed special examinations in a subject ○ *She is a qualified solicitor.* □ **highly qualified** with very good results in examinations ○ *All our staff are highly qualified.* ○ *They employ twenty-six highly qualified legal assistants.* **2.** with some reservations or conditions ○ *qualified acceptance of a bill of exchange* ○ *The plan received qualified approval from the board.*

qualified accounts /ˌkwɒlɪfaɪd ə ˈkaʊnts/ *plural noun* accounts which have been commented on by the auditors because they contain something with which the auditors do not agree

qualified auditors' report /ˌkwɒlɪfaɪd ˈɔːdɪtəz rɪˌpɔːt/ *noun* a report from a company's auditors which points out areas in the accounts with which the auditors do not agree or about which they are not prepared to express an opinion, or where the auditors believe the accounts as a whole have not been prepared correctly or where they are unable to decide whether the accounts are correct or not

qualified privilege /ˌkwɒlɪfaɪd ˈprɪvɪlɪdʒ/ *noun* protection from being sued for defamation, which is given to someone only if it can be proved that the statements were made without malice

qualified title /ˌkwɒlɪfaɪd ˈtaɪt(ə)l/ *noun* a title to a property which is not absolute because there is some defect

qualify /ˈkwɒlɪfaɪ/ *verb* **1.** □ **to qualify for** to be in the right position for or to be entitled to ○ *He does not qualify for Legal Aid.* ○ *She qualifies for unemployment benefit.* **2.** □ **to qualify as** to follow a specialised course and pass examinations so that you can do a particular job ○ *She has qualified as an accountant.* ○ *He will qualify as a solicitor next year.* **3.** to change a statement □ **the auditors have qualified the accounts** the auditors have found something in the accounts of the company which they do not agree with, and have noted it

qualifying period /ˈkwɒlɪfaɪɪŋ ˌpɪərɪəd/ *noun* a time which has to pass before something qualifies as suitable for something ○ *There is a six month qualifying period before you can get a grant from the local authority.*

quantum /ˈkwɒntəm/ *noun* an amount of damages ○ *Liability was admitted by the defendants, but the case went to trial because they could not agree the quantum of damages.*

quantum meruit /ˌkwæntʊm ˈmeruɪt/ *phrase* a Latin phrase meaning 'as much as he has deserved': a rule that, when claiming for breach of contract, a party is entitled to payment for work done

quarantine /ˈkwɒrəntiːn/ *noun* a period when a ship, animal or person newly arrived in a country has to be kept away

mainp - softvnn.com

Law.fm Page 244 Friday, June 11, 2004 2:08 PM

from others in case there is a danger of carrying diseases ○ *The animals were put in quarantine on arrival at the port.* ○ *Quarantine restrictions have been lifted on imported animals from that country.* (NOTE: used without **the**: *The dog was put in quarantine or was held in quarantine or was released from quarantine.*) ■ *verb* to put in quarantine ○ *The ship was searched and all the animals on it were quarantined.*

quarter /ˈkwɔːtə/ *noun* a period of three months

COMMENT: In England the quarter days are 25th March (Lady Day), 24th June (Midsummer Day), 29th September (Michaelmas Day) and 25th December (Christmas Day).

quarter day /ˈkwɔːtə deɪ/ *noun* the day at the end of a quarter, when rents should be paid

quarterly /ˈkwɔːtəli/ *adjective, adverb* happening every three months, i.e. four times a year ○ *There is a quarterly charge for electricity.* ○ *The bank sends us a quarterly statement.* ○ *We agreed to pay the rent quarterly* or *on a quarterly basis.*

Quarter Sessions /ˈkwɔːtə ˌseʃ(ə)nz/ *plural noun* old name for the criminal court replaced by the Crown Court

quash /kwɒʃ/ *verb* **1.** to stop something from continuing **2.** to announce officially that a decision is incorrect and cannot be accepted ○ *The appeal court quashed the verdict.* ○ *He applied for judicial review to quash the order.* ○ *A conviction obtained by fraud or perjury by a witness will be quashed.*

quasi- /kweɪzaɪ/ *prefix* partly ○ *a quasi-official body* ○ *a quasi-judicial investigation*

quasi-contract /ˌkweɪzaɪ ˈkɒntrækt/ *noun* same as **implied contract**

Queen's Bench /ˌkwiːnz ˈbentʃ dɪ ˌvɪʒ(ə)n/ *noun* full form of **QB**

Queen's Bench Division /ˌkwiːnz ˈbentʃ/ *noun* one of the main divisions of the High Court. Abbreviation **QBD**

Queen's Counsel /ˌkwiːnz ˈkaʊnsəl/ *noun* a senior British barrister, appointed by the Lord Chancellor. Abbreviation **QC** (NOTE: There are no new QCs being appointed currently as the need for the title QC and the system of appointment is currently under review.)

Queen's evidence /ˌkwiːnz ˈevɪd(ə)ns/ *noun* □ **to turn Queen's evidence** to confess to a crime and then act as witness against the other criminals involved, in the hope of getting a lighter sentence

Queen's Proctor /ˌkwiːnz ˈprɒktə/ *noun* a solicitor acting for the Crown in matrimonial and probate cases

Queen's Speech /ˌkwiːnz ˈspiːtʃ/ *noun* a speech made by the Queen at the opening of a session of Parliament, which outlines the government's plans for legislation

COMMENT: The Queen's Speech is not written by the Queen herself, but by her ministers, and she is not responsible for what is in the speech.

question /ˈkwestʃ(ə)n/ *noun* **1.** a sentence which needs an answer ○ *Counsel asked the witness questions about his bank accounts.* ○ *Counsel for the prosecution put three questions to the police inspector.* ○ *The managing director refused to answer questions about redundancies.* ○ *The market research team prepared a series of questions to test the public's attitude to problems of law and order.* **2.** a problem ○ *He raised the question of the cost of the lawsuit.* ○ *The main question is that of time.* ○ *The tribunal discussed the question of redundancy payments.* ■ *verb* **1.** to ask questions ○ *The police questioned the accounts staff for four hours.* ○ *She questioned the chairman about the company's investment policy.* **2.** to query or to suggest that something may be wrong ○ *Counsel questioned the reliability of the witness' evidence.* ○ *The accused questioned the result of the breathalyser test.*

questioning /ˈkwestʃ(ə)nɪŋ/ *noun* the action of asking someone questions ○ *The man was taken to the police station for questioning.* ○ *During questioning by the police, she confessed to the crime.* ○ *The witness became confused during questioning by counsel for the prosecution.*

mainp - softvnn.com

Law.fm Page 245 Friday, June 11, 2004 2:08 PM

questionnaire /ˌkwestʃəˈneə/ *noun* a printed list of questions given to people to answer

question of fact /ˌkwestʃ(ə)n əv ˈfækt/ *noun* a fact relevant to a case which is tried at court

question of law /ˌkwestʃ(ə)n əv ˈlɔː/ *noun* the law relevant to a case which is tried at court

question of privilege /ˌkwestʃ(ə)n əv ˈprɪvɪlɪdʒ/ *noun* a matter which refers to the House or a member of it

Question Time /ˈkwestʃ(ə)n taɪm/ *noun* the period in the House of Commons when Members of Parliament can put questions to ministers about the work of their departments

quickie /ˈkwɪki/**, quickie divorce** /ˌkwɪki dɪˈvɔːs/ *noun* a divorce which is processed rapidly through the court by use of the special procedure

quid pro quo /ˌkwɪd prəʊ ˈkwəʊ/ *phrase* a Latin phrase meaning 'one thing for another': action done in return for something done or promised

quiet enjoyment /ˌkwaɪət ɪn ˈdʒɔɪmənt/ *noun* the right of an occupier to occupy property peacefully under a tenancy without the landlord or anyone else interfering with that right

quit /kwɪt/ *verb* to leave rented accommodation

quo ▸ **quid pro quo, status quo**

quorate /ˈkwɔːreɪt/ *adjective* having a quorum ○ *The resolution was invalid because the shareholders' meeting was not quorate.* ◊ **inquorate**

quorum /ˈkwɔːrəm/ *noun* the minimum number of people who have to be present at a meeting to make it valid □ **to have a quorum** to have enough people present for a meeting to go ahead ○ *Do we have a quorum?* ○ *The meeting was adjourned since there was no quorum.*

quota system /ˈkwəʊtə ˌsɪstəm/ *noun* a system where imports, exports or supplies are regulated by fixing maximum amounts

quotation /kwəʊˈteɪʃ(ə)n/ *noun* □ **quotation on the Stock Exchange**, **Stock Exchange quotation** listing of the price of a share on the Stock Exchange □ **the company is going for a quotation on the Stock Exchange** the company has applied to the Stock Exchange to have its shares listed

quote /kwəʊt/ *verb* to repeat a reference number ○ *In reply please quote this number: PC 1234.*

quoted company /ˌkwəʊtɪd ˈkʌmp(ə)ni/ *noun* a company whose shares are listed on the Stock Exchange

quo warranto /ˌkwəʊ ˈwærəntəʊ/ *phrase* a Latin phrase meaning 'by what authority': action which questions the authority of someone

q.v., quod vide *phrase* a Latin phrase meaning 'which see'

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R

R *abbreviation* Regina *or* Rex (NOTE: used in reports of cases where the Crown is a party: *R. v. Smith Ltd*)

race /reɪs/ *noun* a group of people with distinct physical characteristics or culture who are considered to be different from other groups

race relations /ˌreɪs rɪˈleɪʃ(ə)nz/ *plural noun* the relationships between different racial groups in a country

racial /ˈreɪʃ(ə)l/ *adjective* referring to race

racial discrimination /ˌreɪʃ(ə)l dɪs ˌkrɪmɪˈneɪʃ(ə)n/ *noun* unfair treatment of someone because of their racial background

racial hatred /ˌreɪʃ(ə)l ˈheɪtrɪd/ *noun* a violent dislike of someone because of their racial background

racial prejudice /ˌreɪʃ(ə)l ˈpredʒʊdɪs/ *noun* an unreasonably hostile attitude towards someone because of their racial background

racial profiling /ˌreɪʃ(ə)l ˈprəʊfaɪlɪŋ/ *noun* the alleged policy of some police officers to stop and question members of some ethnic groups more than others without reasonable cause

racial segregation /ˌreɪʃ(ə)l ˌsegrɪ ˈgeɪʃ(ə)n/ *noun* a policy of keeping people of different races separate in society, especially in such areas as education, housing, transport or leisure activities

racism /ˈreɪsɪz(ə)m/, **racialism** /ˈreɪʃ(ə)lɪz(ə)m/ *noun* a belief in racist ideas or actions based on racist ideas ○ *The minority groups have accused the council of racism in their allocation of council houses.*

racist /ˈreɪsɪst/, **racialist** /ˈreɪʃ(ə)lɪst/ *adjective* believing that people from other racial groups are different and should receive different and usually inferior treatment ■ *noun* somebody with racist ideas

racket /ˈrækɪt/ *noun* an illegal business which makes a lot of money by fraud ○ *He runs a cheap ticket racket.* ◊ **protection**

racketeer /ˌrækɪˈtɪə/ *noun* somebody who runs a racket

racketeering /ˌrækɪˈtɪərɪŋ/ *noun* the activity of running an illegal racket

rack rent /ˈræk rent/ *noun* **1.** full yearly rent of a property let on a normal lease **2.** a very high rent

raid /reɪd/ *noun* a sudden attack or search ○ *Six people were arrested in the police raid on the club.* ■ *verb* to make a sudden attack or search ○ *The police have raided several houses in the town.* ○ *Drugs were found when the police raided the club.*

raison d'état /ˌreɪzɒn deɪˈtæ/ *noun* the reason for a political action, which says that an action is justified because it is for the common good

COMMENT: Raison d'état is open to criticism because it can be used to justify acts such as the abolition of individual rights, if the general good of the people may seem to require it at the time.

ransom /ˈræns(ə)m/ *noun* money paid to abductors to get back someone who has been abducted ○ *The daughter of the banker was held by kidnappers who asked for a ransom of £1m.* □ **to hold someone to ransom** to keep someone secretly until a ransom is paid ■ *verb* to pay money so that someone is released ○ *She was ransomed by her family.*

ransom note /ˈræns(ə)m nəʊt/ *noun* a message sent by kidnappers asking for a ransom to be paid

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Law.fm Page 247 Friday, June 11, 2004 2:08 PM

rap /ræp/ *noun* a criminal charge brought against somebody

rape /reɪp/ *noun* the notifiable offence of forcing a person to have sexual intercourse without their consent ○ *He was brought to court and charged with rape.* ○ *The incidence of cases of rape has increased over the last years.* ■ *verb* to force a person to have sexual intercourse without their consent

rapporteur /ˌræpɔːˈtɜː/ *noun* one of the judges in the European Court of Justice who is assigned to a particular case and whose job it is to examine the written applications and the defence to them, and then prepare a report on the case before the court starts oral hearings

rapprochement /ræˈprɒʃmɒŋ/ *French word meaning* 'coming closer', used to refer to a situation where two parties reach an understanding after a period of tension ○ *Political commentators have noted the rapprochement which has been taking place since the old president died.*

rata /ˈrɑːtə/ *abbreviation* pro rata (*see*)

rate /reɪt/ *verb* □ **to rate someone highly** to value someone, to think someone is very good

rateable value /ˌreɪtəb(ə)l ˈvæljuː/ *noun* the value of a property as a basis for calculating local taxes

rate of inflation /ˌreɪt əv ɪnˈfleɪʃ(ə)n/ *noun* a percentage increase in prices over the period of one year

rate of return /ˌreɪt əv rɪˈtɜːn/ *noun* the amount of interest or dividend which comes from an investment, shown as a percentage of the money invested

rates /reɪts/ *plural noun* local tax on property

ratification /ˌrætɪfɪˈkeɪʃ(ə)n/ *noun* official approval of something which then becomes legally binding

ratify /ˈrætɪfaɪ/ *verb* to approve officially something which has already been agreed ○ *The treaty was ratified by Congress.* ○ *The agreement has to be ratified by the board.* ○ *Although the directors had acted without due authority, the company ratified their actions.*

ratio decidendi /ˌrætiəʊ ˌdeɪsɪˈdendi/ *phrase* a Latin phrase meaning 'reason for deciding': main part of a court judgment setting out the legal principles applicable to the case and forming the binding part of the judgment to which other courts must pay regard. ◊ **obiter dicta**

ratio legis /ˌrætiəʊ ˈledʒɪs/ *phrase* a Latin phrase meaning 'reason of the law': the principle behind a law

RCJ *abbreviation* Royal Courts of Justice

re /riː/ *preposition* about, concerning, or referring to ○ *re your inquiry of May 29th* ○ *re: Smith's memorandum of yesterday* ○ *re: the agenda for the AGM* □ **in re** concerning, in the case of ○ *in re Jones & Co. Ltd* ◊ **res**

re- /riː/ *prefix* again

rea ♦ mens rea

reading /ˈriːdɪŋ/ *noun* **1.** □ **First Reading**, **Second Reading, Third Reading** the three stages of discussion of a Bill in Parliament **2.** (*in the EU*) an examination in detail of proposed legislation by the European Parliament

COMMENT: First Reading is the formal presentation of the Bill when the title is read to MPs; Second Reading is the stage when MPs have printed copies of the Bill and it is explained by the Minister proposing it, there is a debate and a vote is taken; the Bill is then discussed in Committee and at the Report Stage; Third Reading is the final discussion of the Bill in the whole House of Commons or House of Lords. European legislation is placed before the European Parliament for discussion. This is the First Reading, and can be decided by a simple majority in the Parliament. If the Council of the European Union sets out a common position on proposed legislation and communicates this to Parliament, Parliament will consider the proposal and may approve it by an absolute majority of its members.

ready money /ˌredi ˈmʌni/ *noun* money which is immediately available

real /rɪəl/ *adjective* **1.** not imitation ○ *His case is made of real leather* or *he has a real leather case.* □ **in real terms** actually or really ○ *Sales have gone up by 3% but with inflation running at 5% that is a fall in real terms.* **2.** referring to things as opposed to persons **3.** referring to land, especially freehold land

mainp - softvnn.com

Law.fm Page 248 Friday, June 11, 2004 2:08 PM

real estate /'rɪəl ɪˌsteɪt/ *noun* land or buildings considered from a legal point of view

real income /ˌrɪəl 'ɪnkʌm/ *noun* income which is available for spending after tax and any other deductions have been made

realisation /ˌrɪəlaɪ'zeɪʃ(ə)n/, **realization** *noun* the process of making something happen ▫ **the realization of a project** putting a plan into action

realisation of assets /ˌrɪəlaɪzeɪʃ(ə)n əv 'æsets/ *plural noun* selling of assets for money

realise /'rɪəlaɪz/, **realize** *verb* **1.** to make something become real ▫ **to realize a project**, **a plan** to put a project or a plan into action **2.** to sell something to produce money ○ *to realise property* or *assets* ○ *The sale realised £100,000.*

realizable assets /ˌrɪəlaɪzəb(ə)l 'æsets/ *plural noun* assets which can be sold for money

realpolitik /reɪ'ɑːlpɒlɪtɪk/ *noun* a German word meaning 'politics based on real and practical factors and not on moral ideas'

real-time system /'rɪəl taɪm ˌsɪstəm/ *noun* a computer system where data is inputted directly into the computer which automatically processes it to produce information which can be used immediately

realty /'rɪəlti/ *noun* property, real estate or legal rights to land

reasonable /'riːz(ə)nəb(ə)l/ *adjective* fair and sensible ○ *The magistrates were very reasonable when she explained that the driving licence was necessary for her work.* ▫ **beyond reasonable doubt** almost certain proof needed to convict a person in a criminal case ○ *The prosecution in a criminal case has to establish beyond reasonable doubt that the accused committed the crime.* ▫ **no reasonable offer refused** we will accept any offer which is not too low

reasonable financial provision /ˌriːz(ə)nəb(ə)l faɪˌnænʃəl prə 'vɪʒ(ə)n/ *noun* a provision which relatives and dependants of a deceased person may ask a court to provide in cases where the deceased died intestate, or where no provision was made for them under the will. Abbreviation **rfp**

reasonable force /ˌriːz(ə)nəb(ə)l 'fɔːs/ *noun* the least amount of force needed to do something ○ *The police were instructed to use reasonable force in dealing with the riot.*

reasonable man /'riːz(ə)nəb(ə)l mæn/ *noun* an imaginary person with average judgment and intelligence, who is used as a reference point for usually expected standards of social behaviour

reasoned /'riːz(ə)nd/ *adjective* carefully thought out and explained

rebate /'riːbeɪt/ *noun* money returned

rebel /'reb(ə)l/ *noun* somebody who fights against the government or against people in authority ○ *Anti-government rebels have taken six towns.* ○ *Rebel councillors forced a vote.* ■ *verb* to fight against authority ○ *Some teachers have threatened to rebel against the new procedures.* ○ *It's natural for teenagers to rebel but this has got out of hand.* (NOTE: **rebelling – rebelled**)

rebut /rɪ'bʌt/ *verb* to contradict or to go against ○ *He attempted to rebut the assertions made by the prosecution witness.* (NOTE: **rebutting – rebutted**)

rebuttable /rɪ'bʌtəb(ə)ll/ *adjective* being able to be rebutted

rebuttal /rɪ'bʌt(ə)l/ *noun* the act of rebutting

recall *noun* /rɪ'kɔːl/ a request for someone to come back again ■ *verb* **1.** /riː 'kɔːl/ to ask someone to come back ○ *MPs are asking for Parliament to be recalled to debate the financial crisis.* ○ *The witness was recalled to the witness box.* **2.** /rɪ'kɔːl/ to remember ○ *The witness could not recall having seen the papers.*

recd *abbreviation* received

receipt /rɪ'siːt/ *verb* to stamp or sign something such as a document to show that it has been received or an invoice to show that it has been paid

receipt book /rɪ'siːt bʊk/ *noun* a book of blank receipts to be filled in when purchases are made

receipt in due form /rɪˌsiːt ɪn djuː 'fɔːm/ *noun* a correctly written receipt

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Law.fm Page 249 Friday, June 11, 2004 2:08 PM

receipts /rɪ'siːts/ *plural noun* money taken in sales ○ *to itemise receipts and expenditure* ○ *Receipts are down against the same period of last year.*

receivable /rɪ'siːvəb(ə)l/ *adjective* being able to be received

receivables /rɪ'siːvəb(ə)lz/ *plural noun* money which is owed to a company

receive /rɪ'siːv/ *verb* □ **to receive stolen goods** crime of taking in and disposing of property which you know to be stolen

receiver /rɪ'siːvə/ *noun* **1.** somebody who receives something **2.** somebody who receives stolen goods and disposes of them

receiver of wrecks /rɪˌsiːvər əv 'reks/ *noun* an official of the Department of Trade who deals with legal problems of wrecked ships within his or her area

receivership /rɪ'siːvəʃɪp/ *noun* administration of a company by a receiver □ **the company went into receivership** the company was put into the hands of a receiver

receiving /rɪ'siːvɪŋ/ *noun* the act of taking something which has been delivered □ **receiving stolen property** the crime of taking in and disposing of goods which are known to be stolen

receiving clerk /ri'siːvɪŋ klɑːk/ *noun* an official who works in a receiving office

receiving department /ri'siːvɪŋ dɪ ˌpɑːtmənt/ *noun* the section of a company which deals with goods or payments which are received by the company

receiving office /rɪ'siːvɪŋ ˌɒfɪs/ *noun* an office where goods or payments are received

receiving order /ri'siːvɪŋ ˌɔːdə/ *noun* a court order made placing the Official Receiver in charge of a person's assets before a bankruptcy order is made

receiving party /rɪˌsiːvɪŋ 'pɑːtɪ/ *noun* a party who is entitled to be paid costs (NOTE: The other party is the **paying party**.)

recess /rɪ'ses/ *noun* **1.** a period when the court does not meet, but is not formally adjourned **2.** a period when an official body is not sitting ○ *The last meeting before the summer recess will be on 23rd July.* ■ *verb* not to meet, but without formally adjourning ○ *The Senate recessed at the end of the afternoon.*

recidivist /rɪ'sɪdɪvɪst/ *noun* a criminal who commits a crime again

reciprocal /rɪ'sɪprək(ə)l/ *adjective* according to an arrangement by which each party involved agrees to benefit the other in the same way

reciprocal holdings /rɪˌsɪprək(ə)l 'həʊldɪŋz/ *plural noun* situation where two companies own shares in each other to prevent takeover bids

reciprocal trade /rɪˌsɪprək(ə)l 'treɪd/ *noun* trade between two countries

reciprocal wills /rɪ'sɪprək(ə)l wɪlz/ *plural noun* wills where two people, usually husband and wife, leave their property to each other

reciprocate /rɪ'sɪprəkeɪt/ *verb* to do the same thing to someone as he or she has just done to you ○ *They offered us an exclusive agency for their cars and we reciprocated with an offer of the agency for our buses.*

reciprocity /ˌresɪ'prɒsɪti/ *noun* an arrangement which applies from one party to another and vice versa

recitals /rɪ'saɪt(ə)lz/ *plural noun* introduction to a deed or conveyance which sets out the main purpose and the parties to it

reckless /'rekləs/ *adjective* taking a risk knowing that the action may be dangerous

COMMENT: Causing death by reckless driving is a notifiable offence.

reckless driving /ˌrekləs 'draɪvɪŋ/ *noun* the offence of driving a vehicle in such a way that it may cause damage to property or injure people, where the driver is unaware of causing a risk to other people

recklessly /'rekləsli/ *adverb* taking risks and being unaware of the likely effect on other people ○ *The company recklessly spent millions of pounds on a new factory.* ○ *He was accused of driving recklessly.*

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Law.fm Page 250 Friday, June 11, 2004 2:08 PM

recklessness /'rekləsnəs/ *noun* the act of taking risks

reclaim /rɪ'kleɪm/ *verb* to claim back money which has been paid earlier

recognise /'rekəgˌnaɪz/, **recognize** *verb* **1.** to know someone or something because you have seen or heard them before ○ *She recognised the man who attacked her.* ○ *I recognised his voice before he said who he was.* ○ *Do you recognise the handwriting on the letter?* **2.** to approve something as being legal □ **to recognize a government** to say that a government which has taken power in a foreign country is the legal government of that country □ **the prisoner refused to recognize the jurisdiction of the court** the prisoner said that he or she did not believe that the court had the legal right to try them

recognised agent /ˌrekəgnaɪzd 'eɪdʒənt/ *noun* an agent who is approved by the company for which he or she acts

recognizance /rɪ'kɒgnɪz(ə)ns/ *noun* an obligation undertaken by someone to a court that he, she or someone else will appear in the court at a later date to answer charges, or if not, will pay a penalty ○ *He was bound over on his own recognizance of £4,000.* □ **release on recognizance** *US* the release of an accused person, provided that he or she promises to come back to court when asked to do so

recommendation /ˌrekəmen 'deɪʃ(ə)n/ *noun* a piece of advice about how something should be done ○ *He was sentenced to life imprisonment, with a recommendation that he should serve at least twenty years.* ○ *He was released on the recommendation of the Parole Board* or *on the Parole Board's recommendation.*

recommendations /ˌrekəmen 'deɪʃ(ə)nz/ *noun* a decision of the European Community which is not legally binding

recommittal /ˌriːkə'mɪt(ə)l/ *noun US* the act of sending a bill back to a committee for further discussion

reconcile /'rekənsaɪl/ *verb* to make two accounts or statements agree ○ *to reconcile one account with another* ○ *to reconcile the accounts*

reconciliation /ˌrekənsɪli'eɪʃ(ə)n/ *noun* the act of making two accounts, parties or statements agree

reconciliation statement /ˌrekənsɪli'eɪʃ(ə)n ˌsteɪtmənt/ *noun* a statement which explains why two accounts do not agree

reconsider /ˌriːkən'sɪdə/ *verb* to think again ○ *The applicant asked the committee to reconsider its decision to refuse the application.* □ **motion to reconsider a vote** *US* motion at the end of a discussion of any bill, but especially one passed with a close vote, so that a second vote has to be taken to settle the matter

reconstruction of a crime /ˌriːkən 'strʌkʃən əv eɪ kraɪm/ *noun* the use of people to act a crime again in order to try to get witnesses to remember details of it

reconsultation /riːˌkɒnsəl'teɪʃ(ə)n/ *noun* the act of consulting again, as when the Council of the European Union looks again at proposed legislation, taking into account objections raised by the European Parliament

reconvict /ˌriːkən'vɪkt/ *verb* to convict someone again who has previously been convicted of a crime

reconviction /ˌriːkən'vɪkʃ(ə)n/ *noun* the conviction of someone who has been previously convicted of a crime ○ *The reconviction rate is rising.*

record *noun* /'rekɔːd/ **1.** a report of something which has happened, especially an official transcript of a court action ○ *The chairman signed the minutes as a true record of the last meeting.* □ **a matter of record** something which has been written down and can be confirmed □ **for the record**, **to keep the record straight** to note something which has been done □ **on record** (fact) which has been noted ○ *The chairman is on record as saying that profits are set to rise.* **2.** a description of what has happened in the past ○ *the clerk's record of service* or *service record* ○ *The company's record in industrial relations.* **3.** a result which is better or higher than anything before □ **record crime figures**, **record losses, record profits** crime figures, losses or profits which are higher than ever before ■ *verb* /rɪ'kɔːd/ to note or to report ○ *The*

mainp - softvnn.com

Law.fm Page 251 Friday, June 11, 2004 2:08 PM

company has recorded another year of increased sales. ○ *Your complaint has been recorded and will be investigated.* ○ *The court recorded a plea of not guilty.* ○ *The coroner recorded a verdict of death by misadventure.*

recorded delivery /rɪˌkɔːdɪd dɪ ˈlɪv(ə)ri/ *noun* a mail service where the letters are signed for by the person receiving them

recorder /rɪˈkɔːdə/ *noun* a part-time judge of the Crown Court

Recorder of London /rɪˌkɔːdə əv ˈlʌndən/ *noun* the chief judge of the Central Criminal Court

records /ˈrekɔːdz/ *plural noun* documents which give information ○ *The names of customers are kept in the company's records.* ○ *We find from our records that our invoice number 1234 has not been paid.*

recours ◆ **sans recours**

recourse /rɪˈkɔːs/ *noun* □ **to decide to have recourse to the courts** to decide in the end to start legal proceedings

recover /rɪˈkʌvə/ *verb* **1.** to get back something which has been lost ○ *to recover damages from the driver of the car* ○ *to start a court action to recover property* ○ *He never recovered his money.* ○ *The initial investment was never recovered.* **2.** to get better or to rise ○ *The market has not recovered from the rise in oil prices.* ○ *The stock market fell in the morning, but recovered during the afternoon.*

recoverable /rɪˈkʌv(ə)rəb(ə)l/ *adjective* being possible to get back

recovery /rɪˈkʌv(ə)ri/ *noun* **1.** the process of getting back something which has been lost or stolen ○ *to start an action for recovery of property* ○ *We are aiming for the complete recovery of the money invested.* **2.** the movement upwards of shares or of the economy ○ *the recovery of the economy after a recession* ○ *The economy showed signs of a recovery.*

rectification /ˌrektɪfɪˈkeɪʃ(ə)n/ *noun* the process of making changes to a document or register to make it correct

rectify /ˈrektɪˌfaɪ/ *verb* **1.** to make changes to a document to make it correct ○ *The court rectified its mistake.* **2.** to make something correct

recusal /rɪˈkjuːz(ə)l/ *noun* the disqualification of a judge or jury because of bias

red bag /ˌred ˈbæg/ *noun* the bag in which a barrister carries his or her gown, given them by a QC. ◊ **blue bag**

red box /ˌred ˈbɒks/ *noun* a large briefcase covered in red leather in which government papers are delivered to ministers

redeem /rɪˈdiːm/ *verb* **1.** to pay back all the principal and interest on a loan, a debt or a mortgage **2.** □ **to redeem a bond** to sell a bond for cash

redeemable /rɪˈdiːməb(ə)l/ *adjective* being possible to sell for cash

redeemable preference shares /rɪˌdiːməb(ə)l ˈpref(ə)rəns ʃeəs/ *plural noun* preference shares which the company may buy back from the shareholder for cash

redemption /rɪˈdempʃən/ *noun* **1.** the repayment of a loan □ **redemption before due date** paying back a loan before the date when repayment is due **2.** the repayment of a debt or a mortgage

redemption date /rɪˈdempʃən deɪt/ *noun* the date on which a loan, etc., is due to be repaid

redemption value /rɪˈdempʃən ˌvæljuː/ *noun* the value of a security when redeemed

red tape /ˌred ˈteɪp/ *noun* **1.** a red ribbon used to tie up a pile of legal documents ○ *The application has been held up by red tape.* **2.** unhelpful rules which slow down administrative work

reduced /rɪˈdjuːst/ *adjective* lower ○ *He received a reduced sentence on appeal.*

redundancy /rɪˈdʌndənsi/ *noun* a state where someone is no longer employed, because the job being done is no longer needed

redundancy payment /rɪˈdʌndənsi ˌpeɪmənt/ *noun* a payment made to an employee to compensate for losing his or her job

redundant /rɪˈdʌndənt/ *adjective* **1.** more than is needed **2.** useless **3.** something which is no longer needed ○ *a re-*

mainp - softvnn.com

Law.fm Page 252 Friday, June 11, 2004 2:08 PM

dundant clause in a contract ○ *This law is now redundant.* ○ *The new legislation has made clause 6 redundant.* **4.** □ **to make someone redundant** to decide that an employee is not needed any more

redundant staff /rɪˌdʌndənt ˈstɑːf/ *noun* staff who have lost their jobs because they are not needed any more

re-entry /ˌriː ˈentri/ *noun* the act of going back into a property

re-examination /ˌriː ɪgˌzæmɪ ˈneɪʃən/ *noun* the activity of asking a witness more questions after cross-examination by counsel for the other party

re-examine /ˌriːɪgˈzæmɪn/ *verb* (*of a barrister*) to ask his or her own witness more questions after the witness has been cross-examined by counsel for the other party

refer /rɪˈfɜː/ *verb* **1.** to mention, deal with or write about something ○ *referring to the court order dated June 4th* ○ *We refer to your letter of May 26th.* ○ *He referred to an article which he had seen in 'The Times'.* □ **the schedule before referred to** the schedule which has been mentioned earlier **2.** to pass a problem on to someone else to decide ○ *to refer a question to a committee* ○ *We have referred your complaint to the tribunal.* **3.** □ **the bank referred the cheque to drawer** the bank returned the cheque to person who wrote it because there was not enough money in the account to pay it □ **'refer to drawer'** words written on a cheque which a bank refuses to pay **4.** (*in the EU*) to pass a case to the ECJ for a ruling (NOTE: **referring – referred**)

referee /ˌrefəˈriː/ *noun* **1.** somebody who can give a report on someone's character, ability or speed of work, etc. ○ *to give someone's name as referee* ○ *She gave the name of her boss as a referee.* ○ *When applying please give the names of three referees.* **2.** somebody to whom a problem is passed for a decision ○ *The question of maintenance payments is with a court-appointed referee.*

reference /ˈref(ə)rəns/ *noun* **1.** the act of passing a problem to a someone for his or her opinion **2.** a comment that mentions someone or something ○ *with reference to your letter of May 25th* □ **with reference to** used to introduce something that will be talked or written about ○ *with reference to your letter of 18th August* **3.** the numbers or letters given to a document which make it possible to find it after it has been filed ○ *our reference: SJ/JA 134* ○ *Thank you for your letter (reference MA 25.2).* ○ *Please quote this reference in all correspondence.* ○ *When replying please quote reference GS/km 264.* **4.** a written report on someone's character, ability, etc. ○ *to write someone a reference* or *to give someone a reference* ○ *to ask applicants to supply references* □ **to ask a company for trade references**, **for bank references** to ask for reports from traders or a bank on the company's financial status and reputation **5.** □ **to hear a reference** (*of the ECJ*) to discuss a legal point which has been referred to them □ **to make a reference** (*of a national court*) to ask the ECJ to decide on a legal point. ◊ **preliminary reference 6.** somebody who reports on someone's character, ability, etc. ○ *to give someone's name as reference* ○ *Please use me as a reference if you wish.*

referral /rɪˈfɜːrəl/ *noun* **1.** the act of passing a problem on to someone else for a decision ○ *the referral of the case to the planning committee* **2.** (*in the EU*) the action of referring a case to the ECJ

reflag /riːˈflæg/ *verb* to register a ship in a different country, giving it the right to fly a different flag

reform /rɪˈfɔːm/ *noun* a change made to something to make it better ○ *They have signed an appeal for the reform of the remand system.* ○ *The reform in the legislation was intended to make the court procedure more straightforward.* ■ *verb* to change something to make it better ○ *The group is pressing for the prison system to be reformed.* ○ *The prisoner has committed so many crimes of violence that he will never be reformed.*

refrain /rɪˈfreɪn/ *verb* □ **to refrain from something** to agree not to do something which you were doing previously ○ *He was asked to give an undertaking to refrain from political activity.*

refresher /rɪˈfreʃə/ *noun* a fee paid to counsel for the second and subsequent

mainp - softvnn.com

Law.fm Page 253 Friday, June 11, 2004 2:08 PM

days of a hearing ○ *Counsel's brief fee was £1,000 with refreshers of £250.*

regard /rɪ'gɑːd/ *noun* □ **having regard to**, **as regards, regarding** concerning a particular subject ○ *having regard to the opinion of the European Parliament* ○ *Regarding the second of the accused, the jury was unable to reach a majority verdict.*

regarding /rɪ'gɑːdɪŋ/ *preposition* concerning a particular subject ○ *I wrote last week regarding my appointment.*

regardless /rɪ'gɑːdləs/ *adverb* □ **regardless of** without concerning ○ *Such conduct constitutes contempt of court regardless of intent.* ○ *The court takes a serious view of such crimes, regardless of the age of the accused.*

regime /reɪ'ʒiːm/ *noun* (*sometimes as criticism*) **1.** a type of government ○ *Under a military regime, civil liberties may be severely curtailed.* **2.** a period of rule ○ *Life was better under the previous regime.*

Regina /rɪ'dʒaɪnə/ *Latin word meaning* 'the Queen': the Crown or state, as a party in legal proceedings (NOTE: In written reports, usually abbreviated to **R: the case of** *R. v. Smith.*)

register /'redʒɪstə/ *noun* an official list ○ *to enter something in a register* ○ *to keep a register up to date* ■ *verb* to write something in an official list or record ○ *to register a company* ○ *to register a sale* ○ *to register a property* ○ *to register a trademark* ○ *to register a marriage* or *a death*

registered /'redʒɪstəd/ *adjective* having been noted on an official list □ **a company's registered office** the address of a company which is officially registered with the Registrar of Companies and to which specific legal documents must normally be sent

registered company /ˌredʒɪstəd 'kʌmp(ə)ni/ *noun* a company which has been properly formed and incorporated

registered land /'redʒɪstəd lænd/ *noun* land which has been registered with the land registry

registered letter /ˌredʒɪstəd 'letə/, **registered parcel** /ˌredʒɪstəd 'pɑːs(ə)l/ *noun* a letter or parcel which is noted by the post office before it is sent, so that compensation can be claimed if it is lost ○ *to send documents by registered mail* or *registered post*

registered office /ˌredʒɪstəd 'ɒfɪs/ *noun* in Britain, the office address of a company which is officially registered with the Companies' Registrar and to which legal documents must normally be sent

registered trade mark /ˌredʒɪstəd 'treɪd ˌmɑːk/ *noun* a name, design or other feature which identifies a commercial product, has been registered by the maker and cannot be used by other makers ○ *You cannot call your beds 'Softn'kumfi' – it is a registered trademark.*

registered user /ˌredʒɪstəd 'juːzə/ *noun* a person or company which has been officially given a licence to use a registered trademark

register of charges /ˌredʒɪstə əv 'tʃɑːdʒɪz/ *noun* an index of charges affecting land

register of debentures /ˌredʒɪstə əv dɪ'bentjʊəz/ *noun* a list of debentures over a company's assets

register of directors /ˌredʒɪstə əv daɪ'rektəz/ *noun* an official list of the directors of a company which has to be sent to the Registrar of Companies

register of electors /ˌredʒɪstər əv ɪ 'lektəz/ *noun* an official list of names and addresses of people living in a specific area who are eligible to vote in local or national elections

Register Office /ˌredʒɪstə 'ɒfɪs/ *noun* a local office where records of births, marriages and deaths are kept and where civil marriages can be performed

register of members /ˌredʒɪstə əv 'membəs/ *noun* a list of shareholders in a company with their addresses

registrar /ˌredʒɪ'strɑː/ *noun* **1.** somebody who keeps official records **2.** an official of a court who can hear preliminary arguments in civil cases **3.** the head of the registry of the European Court of Justice, who is the manager of the court and maintains the files of all pleadings

Registrar-General /ˌredʒɪstrɑː 'dʒen(ə)rəl/ *noun* an official who is re-

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Law.fm Page 254 Friday, June 11, 2004 2:08 PM

sponsible for the process of registering all births, marriages and deaths

Registrar of Companies /ˌredʒɪstrɑː əv ˈkʌmp(ə)niz/ *noun* an official who keeps a record of all incorporated companies, the details of their directors and financial state

registrar of trademarks /ˌredʒɪstrɑː əv ˌtreɪdˈmɑːks/ *noun* an official who keeps a record of all trademarks

registration /ˌredʒɪˈstreɪʃ(ə)n/ *noun* the act of having something noted on an official list ○ *registration of a trademark* or *of a share transaction*

registration fee /ˌredʒɪˈstreɪʃ(ə)n fiː/ *noun* **1.** money paid to have something registered **2.** money paid to attend a conference

registration number /ˌredʒɪˈstreɪʃ(ə)n ˌnʌmbə/ *noun* an official number of something which has been registered such as a car

registry /ˈredʒɪstri/ *noun* **1.** a place where official records are kept **2.** the registering of a ship **3.** (*in the EU*) an office which administers the ECJ

regulate /ˈregjʊleɪt/ *verb* **1.** to adjust something so that it works well or is correct **2.** to change or maintain something by law ▫ **prices are regulated by supply and demand** prices are increased or lowered according to supply and demand

regulation /ˌregjʊˈleɪʃ(ə)n/ *noun* the act of making sure that something will work well ○ *The regulation of trading practices.*

regulations /ˌregjʊˈleɪʃ(ə)nz/ *plural noun* **1.** rules made by ministers, which then have to be submitted to Parliament for approval ○ *the new government regulations on standards for electrical goods* ○ *safety regulations which apply to places of work* ○ *regulations concerning imports and exports* **2.** rules laid down by the Council or Commission of the European Communities, according to the European Union treaties, which are binding on all Member States of the EU without any implementing legislation being passed. Compare **directive**

COMMENT: Regulations are binding on people in general as citizens of Member States of the EU; they have a direct effect on all Member States and on all citizens of Member States.

regulatory /ˈregjʊlət(ə)ri/ *adjective* making something work according to law ○ *The independent radio and television companies are supervised by a regulatory body.* ○ *Complaints are referred to several regulatory bodies.*

rehabilitate /ˌriːəˈbɪlɪteɪt/ *verb* to help a criminal become a responsible member of society again

rehabilitation /ˌriːəbɪlɪˈteɪʃ(ə)n/ *noun* the process of making someone fit to be a member of society again ▫ **rehabilitation of offenders** the principle whereby a person convicted of a crime and being of good character after a period of time is treated as if he or she had not had a conviction

COMMENT: By the Rehabilitation of Offenders Act, 1974, a person who is convicted of an offence, and then spends a period of time without committing any other offence, is not required to reveal that he has a previous conviction.

rehear /riːˈheə/ *verb* to hear a case again when the first hearing was in some way invalid

rehearing /riːˈheərɪŋ/ *noun* the hearing of a case again

reinsurance /ˌriːɪnˈʃʊərəns/ *noun* insurance where a second insurer (the reinsurer) agrees to cover part of the risk insured by the first insurer

reject /rɪˈdʒekt/ *verb* **1.** to refuse to accept something ○ *The appeal was rejected by the House of Lords.* ○ *The magistrate rejected a request from the defendant.* ▫ **the company rejected the takeover bid** the directors recommended that the shareholders should not accept the bid **2.** to say that something is not satisfactory

rejection /rɪˈdʒekʃən/ *noun* a refusal to accept ○ *the rejection of the defendant's request* ○ *the rejection of the appeal by the tribunal*

rejoinder /rɪˈdʒɔɪndə/ *noun* formerly, a plea served in answer to a claimant's reply

related /rɪˈleɪtɪd/ *adjective* connected, linked, being of the same family ○ *offences related to drugs* or *drug-related*

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Law.fm Page 255 Friday, June 11, 2004 2:08 PM

offences ○ *the law which relates to drunken driving*

related company /rɪˌleɪtɪd ˈkʌmp(ə)ni/ *noun* a company which is partly owned by another company

relation /rɪˈleɪʃ(ə)n/ *noun* **1.** □ **in relation to** referring to or connected with ○ *documents in relation to the case* ○ *the court's powers in relation to children in care* **2.** a procedure by which, for legal purposes, an act is deemed to have been done at an earlier time than was actually the case ■ *plural noun* **1. relations** links with other people or other groups. ◊ **industrial relations 2.** □ **to enter into relations with someone** to start discussing a business deal with someone □ **to break off relations with someone** to stop dealing with someone

relation back /rɪˈleɪʃ(ə)n bæk/ *noun* the ability of the administrator of an estate to take action to recover funds which were removed from the estate in the interval between the death and the grant of administration

relator /rɪˈleɪtə/ *noun* a private person who suggests to the Attorney-General that proceedings should be brought, usually against a public body

release /rɪˈliːs/ *noun* **1.** an act of setting someone free, or allowing someone to leave prison **2.** the abandoning of rights by someone in favour of someone else ■ *verb* **1.** to free someone or something, or allow someone to leave prison ○ *The president released the opposition leader from prison.* ○ *Customs released the goods against payment of a fine.* □ **to release someone from a debt**, **from a contract** to make someone no longer liable for the debt or for the obligations under the contract **2.** to make something public ○ *The company released information about the new mine in Australia.* ○ *The government has refused to release figures for the number of unemployed women.*

release on licence /rɪˌliːs ɒn ˈlaɪs(ə)ns/ *noun* permission to leave prison on parole ○ *The appellant will be released on licence after eight months.*

relevance /ˈreləv(ə)ns/ *noun* a connection with a subject being discussed ○ *Counsel argued with the judge over the relevance of the documents to the case.*

relevant /ˈreləv(ə)nt/ *adjective* having to do with what is being discussed ○ *The question is not relevant to the case.* ○ *Which is the relevant government department?* ○ *Can you give me the relevant papers?*

reliable /rɪˈlaɪəb(ə)l/ *adjective* being able to be trusted ○ *He is a reliable witness* or *the witness is completely reliable.* ○ *The police have reliable information about the gang's movements.*

relief /rɪˈliːf/ *noun* a remedy sought by a claimant in a legal action ○ *The relief the claimant sought was an injunction and damages.*

rem /rem/ ◆ **in rem**

remainder /rɪˈmeɪndə/ *noun* **1.** something left behind ○ *The remainder of the stock will be sold off at half price.* **2.** what is left of an estate, or the right to an estate which will return to the owner at the end of a lease ■ *verb* □ **to remainder books** to sell new books off cheaply

remainderman /rɪˈmeɪndəmən/ *noun* somebody who receives the remainder of an estate

remand /rɪˈmɑːnd/ *noun* the act of sending a prisoner away for a time when a case is adjourned to be heard at a later date ■ *verb* **1.** to send a prisoner away to reappear later to answer a case which has been adjourned □ **he was remanded in custody**, **remanded on bail for two weeks** he was sent to prison *or* allowed to go free on payment of bail while waiting to return to court two weeks later **2.** *US* to send a case back to a lower court after a higher court has given an opinion on it

remand centre /rɪˈmɑːnd ˌsentə/ *noun* a special prison for keeping young persons who have been remanded in custody

remanded in custody /rɪˌmɑːndɪd ɪn ˈkʌstədi/ *noun* remanded to be kept in prison until the trial starts

remedy /ˈremədi/ *noun* a way of repairing harm or damage suffered ○ *The claimant is seeking remedy through the courts.* ■ *verb* to help repair harm or damage

mainp - softvnn.com

Law.fm Page 256 Friday, June 11, 2004 2:08 PM

remission /rɪˈmɪʃ(ə)n/ *noun* the reduction of a prison sentence ○ *He was sentenced to five years, but should serve only three with remission.* ○ *She got six months' remission for good behaviour.*

remit *noun* /ˈriːmɪt/ an area of responsibility given to someone ○ *This department can do nothing on the case as it is not part of our remit* or *it is beyond our remit.* ■ *verb* /rɪˈmɪt/ **1.** to reduce a prison sentence **2.** to send money ○ *to remit by cheque* (NOTE: **remitting – remitted**)

remittance /rɪˈmɪt(ə)ns/ *noun* money that is sent ○ *Please send remittances to the treasurer.* ○ *The family lives on a weekly remittance from their father in the USA.*

remote /rɪˈməʊt/ *adjective* too far to be connected ○ *The court decided that the damage was too remote to be recoverable by the claimant.*

remoteness /rɪˈməʊtnəs/ *noun* the fact of not being connected or relevant to something □ **remoteness of damage** legal principle that damage that is insufficiently connected or foreseeable by a defendant should not make the defendant liable to the claimant

render /ˈrendə/ *verb* **1.** to provide something **2.** to make someone or something become something ○ *Failure to observe the conditions of bail renders the accused liable to arrest.* ○ *The state of health of the witness renders his appearance in court impossible.* **3.** to officially announce a judgment or verdict ○ *The jury rendered a guilty verdict.*

renew /rɪˈnjuː/ *verb* to grant something again so that it continues for a further period of time ○ *to renew a bill of exchange* or *to renew a lease* □ **to renew a subscription** to pay a subscription for another year □ **to renew an insurance policy** to pay the premium for another year's insurance

renewal /rɪˈnjuːəl/ *noun* the act of renewing ○ *renewal of a lease* or *of a subscription* or *of a bill* ○ *The lease is up for renewal next month.* ○ *When is the renewal date of the bill?*

renewal notice /rɪˈnjuːəl ˌnəʊtɪs/ *noun* a note sent by an insurance company asking the insured person to renew the insurance

renewal premium /rɪˈnjuːəl ˌpriːmiəm/ *noun* a premium to be paid to renew an insurance

renounce /rɪˈnaʊns/ *verb* to give up a right or a planned action ○ *The government has renounced the use of force in dealing with international terrorists.*

rent /rent/ *noun* money paid, or occasionally a service provided, in return for using something such as an office, house, factory, car or piece of equipment for a period of time □ **high rent**, **low rent** expensive or cheap rent

rent action /ˈrent ˌækʃən/ *noun* proceedings to obtain payment of rent owing

rental /ˈrent(ə)l/ *noun* money paid to use something such as an office, house, factory, car or piece of equipment for a period of time

rental income /ˈrent(ə)l ˌɪnkʌm/ *noun* income from letting property

rent allowance /ˈrent əˌlaʊəns/ *noun* a state subsidy paid to people who do not have enough income to pay their rents

rental value /ˈrent(ə)l ˌvæljuː/ *noun* the full value of the rent for a property if it were charged at the current market rate, i.e. calculated between rent reviews

rentcharge /ˈrenttʃɑːdʒ/ *noun* payment of rental on freehold land

COMMENT: Rare except in the case of covenants involving land.

rent controls /ˈrent kənˌtrəʊlz/ *plural noun* government regulation of rents charged by landlords

rent review /ˈrent rɪˌvjuː/ *noun* an increase in rents which is carried out during the term of a lease. Most leases allow for rents to be reviewed every three or five years.

rent tribunal /ˈrent traɪˌbjuːn(ə)l/ *noun* a court which adjudicates in disputes about rents and awards fair rents

renunciation /rɪˌnʌnsiˈeɪʃ(ə)n/ *noun* the act of giving up a right, especially the ownership of shares

reoffend /ˌriːəˈfend/ *verb* to commit an offence again ○ *He came out of prison and immediately reoffended.*

reoffender /ˌriːəˈfendə/ *noun* somebody who commits an offence again

reopen /riːˈəʊpən/ *verb* **1.** to start investigating a case again ○ *After receiving*

mainp - softvnn.com

Law.fm Page 257 Friday, June 11, 2004 2:08 PM

new evidence, the police have reopened the murder inquiry. **2.** to start an activity such as a hearing or inquiry again ○ *The hearing reopened on Monday afternoon.*

reorganisation /riːˌɔːgənaɪ ˈzeɪʃ(ə)n/**, reorganization** *noun* the action of organising a company in a different way. In the USA, a bankrupt company applies to be treated under Chapter 11 to be protected from its creditors while it is being reorganised. (NOTE: In the USA, a bankrupt company applies to be treated under Chapter 11 to be protected from its creditors while it is being reorganised.)

repairer's lien /rɪˈpeərəz ˌliːn/ *noun* the right of someone who has been carrying out repairs to keep the goods until the repair bill has been paid (NOTE: You have a lien **on** an item.)

repatriate /riːˈpætrieɪt/ *verb* to force someone to leave the country he or she is living in and go back to their country of birth

repatriation /riːˌpætriˈeɪʃ(ə)n/ *noun* **1.** the act of forcing someone to return to their own country **2.** the return of foreign investments, profits, etc., to the home country of their owner

repeal /rɪˈpiːl/ *noun* the act of saying that a law is no longer valid ○ *pressing for the repeal of the Immigration Act* ■ *verb* to say officially that a law no longer has legal authority ○ *The Bill seeks to repeal the existing legislation.* ○ *Member States must repeal national legislation which conflicts with Community legislation.*

COMMENT: Since the UK does not have a written constitution, all EC law has to be incorporated into UK law by acts of Parliament. Since no act of one parliament can be considered binding on another parliament, these acts can in theory be repealed by subsequent parliaments. No parliament can bind subsequent parliaments to the principle of the supremacy of EC law.

repeat /rɪˈpiːt/ *verb* □ **to repeat an offence** to commit an offence again

repetition /ˌrepɪˈtɪʃ(ə)n/ *noun* the act of repeating something ○ *Repetition of a libel is an offence.*

replevin /rɪˈplevɪn/ *noun* an action brought to obtain possession of goods which have been seized, by paying off a judgment debt

reply /rɪˈplaɪ/ *noun* **1.** a written statement by a claimant in a civil case in answer to the defendant's defence. The reply must be filed at the same time as the claimant files his allocation questionnaire. **2.** a speech by prosecution counsel or counsel for the claimant which answers claims made by the defence ■ *verb* **1.** to answer claims made by an opponent **2.** to give an opposing view in a discussion

report /rɪˈpɔːt/ *noun* **1.** a statement describing what has happened or describing a state of affairs ○ *to make a report* or *to present a report* or *to send in a report* ○ *The court heard a report from the probation officer.* ○ *The chairman has received a report from the insurance company.* □ **the company's annual report, the chairman's report, the directors' report** document sent each year by the chairman of a company or the directors to the shareholders, explaining what the company has done during the year □ **the treasurer's report** document from the honorary treasurer of a society to explain the financial state of the society to its members **2.** □ **a report in a newspaper, a newspaper report** article or news item **3.** an official document from a government committee ○ *The government has issued a report on the problems of inner city violence.* ■ *verb* to make a statement describing something ○ *The probation officer reported on the progress of the two young criminals.* ○ *He reported the damage to the insurance company.* ○ *We asked the bank to report on his financial status.* □ **reporting restrictions were lifted** journalists were allowed to report details of the case

reported case /rɪˌpɔːtɪd ˈkeɪs/ *noun* a case which has been reported in the Law Reports because of its importance as a precedent

reporting restrictions /rɪˌpɔːtɪŋ rɪ ˈstrɪkʃ(ə)ns/ *plural noun* restrictions on information about a case which can be reported in newspapers

repossess /ˌriːpəˈzes/ *verb* to take back an item which someone is buying under a hire-purchase agreement or a

mainp - softvnn.com

Law.fm Page 258 Friday, June 11, 2004 2:08 PM

property which someone is buying under a mortgage because the purchaser cannot continue the repayments

repossession /ˌriːpəˈzeʃ(ə)n/ *noun* the act of repossessing something, such as taking possession of a mortgaged property where the purchaser cannot continue the mortgage repayments

represent /ˌreprɪˈzent/ *verb* **1.** to state or to show ○ *He was represented as a man of great honour.* **2.** to act on behalf of someone ○ *The defendant is represented by his solicitor.*

representation /ˌreprɪzenˈteɪʃ(ə)n/ *noun* **1.** a statement, especially a statement made to persuade someone to enter into a contract **2.** □ **to make representations** to complain **3.** the process of being represented by a solicitor □ **the applicant had no legal representation** he had no lawyer to represent him in court **4.** a system where the people of a country elect representatives to a Parliament which governs the country

Representation of the People Act /ˌreprɪzenteɪʃ(ə)n əv ðə ˈpiːp(ə)l ˌækt/ *noun* an Act of Parliament which states how elections must be organised

representative /ˌreprɪˈzentətɪv/ *noun* somebody who represents another person ○ *The court heard the representative of the insurance company.*

reprieve /rɪˈpriːv/ *noun* temporarily stopping the carrying out of a sentence or court order ■ *verb* to stop a sentence or order being carried out ○ *He was sentenced to death but was reprieved by the president.*

reprimand /ˈreprɪmɑːnd/ *noun* an official criticism ○ *The police officer received an official reprimand after the inquiry into the accident.* ■ *verb* to criticise someone officially ○ *He was reprimanded by the magistrate.*

reproduction /ˌriːprəˈdʌkʃ(ə)n/ *noun* the process of making a copy of something ○ *The reproduction of copyright material without the permission of the copyright holder is banned by law.*

republication /riːˌpʌblɪˈkeɪʃ(ə)n/ *noun* the action of publishing a will again

republish /riːˈpʌblɪʃ/ *verb* to make an existing will valid again from the date of republication. This makes possessions acquired since the will was originally made fall within the dispositions of the will.

repudiate /rɪˈpjuːdieɪt/ *verb* to refuse to accept □ **to repudiate an agreement, a contract** to refuse to perform one's obligations under an agreement or contract

repudiation /rɪˌpjuːdiˈeɪʃ(ə)n/ *noun* **1.** a refusal to accept **2.** a refusal to perform one's obligations under an agreement or contract

reputable /ˈrepjʊtəb(ə)l/ *adjective* with a good reputation ○ *a reputable firm of accountants* ○ *We use only reputable carriers.*

reputation /ˌrepjʊˈteɪʃ(ə)n/ *noun* the opinion of someone or something held by other people ○ *company with a reputation for quality* ○ *She has a reputation for being difficult to negotiate with.*

requesting state /rɪˈkwestɪŋ steɪt/ *noun* a state which is seeking the extradition of someone from another state

requisition /ˌrekwɪˈzɪʃ(ə)n/ *verb* to take private property into the ownership of the state for the state to use ○ *The army requisitioned all the trucks to carry supplies.*

requisition on title /ˌrekwɪzɪʃ(ə)n ɒn ˈtaɪt(ə)l/ *noun* a request to the vendor of a property for details of the title to the property

res /rez/ *noun* a Latin word meaning 'thing' or 'matter'

resale price maintenance /riːˌseɪl ˈpraɪs ˌmeɪntənəns/ *noun* a system where the price for an item is fixed by the manufacturer and the retailer is not allowed to sell it for a lower price. Abbreviation **RPM**

COMMENT: This system applies in the UK to certain products only, such as newspapers.

rescind /rɪˈsɪnd/ *verb* to annul or to cancel ○ *to rescind a contract* or *an agreement* ○ *The committee rescinded its earlier resolution on the use of council premises.*

rescission /rɪˈsɪʒ(ə)n/ *noun* **1.** a cancellation of a contract **2.** *US* an item in an

mainp - softvnn.com

Law.fm Page 259 Friday, June 11, 2004 2:08 PM

appropriation bill which cancels money previously appropriated but not spent

rescue /ˈreskjuː/ *verb* to save someone from injury or death

COMMENT: If a rescuer is injured while rescuing someone from danger caused by the defendant's negligence, the defendant may be liable for damages to the rescuer as well as to the person rescued.

research institute /rɪˈsɜːtʃ ˌɪnstɪtjuːt/ *noun* an organisation set up to do research

reservation /ˌrezəˈveɪʃ(ə)n/ *noun* the act of keeping something back ▫ **reservation of title clause** clause in a contract whereby the seller provides that title to the goods does not pass to the buyer until the buyer has paid for them. ◊ **Romalpa clause**

reserve /rɪˈzɜːv/ *noun* a supply of something that might be needed in future ▫ **in reserve** kept to be used at a later date ■ *verb* **1.** to ask for a room, table or seat to be kept free for you ○ *I want to reserve a table for four people.* ○ *Can you reserve a seat for me on the train to Glasgow?* **2.** to keep something back ▫ **to reserve one's defence** not to present any defence at a preliminary hearing, but to wait until full trial ▫ **to reserve judgment** not to pass judgment immediately, but keep it back until later so that the judge has time to consider the case ▫ **to reserve the right to do something** to indicate that you consider that you have the right to do something, and intend to use that right in the future ○ *He reserved the right to cross-examine witnesses.* ○ *We reserve the right to appeal against the tribunal's decision.*

reserve currency /rɪˈzɜːv ˌkʌrənsi/ *noun* a strong currency held by other countries to support their own weaker currencies

reserve for bad debts /rɪˌzɜːv fə ˌbæd ˈdets/ *noun* money kept by a company to cover debts which may not be paid

reserve fund /rɪˈzɜːv fʌnd/ *noun* profits in a business which have not been paid out as dividend but which have been ploughed back into the business

res gestae /ˌreɪz ˈdʒestaɪ/ *phrase* a Latin phrase meaning 'things which have been done'

reside /rɪˈzaɪd/ *verb* to live in a place

residence /ˈrezɪd(ə)ns/ *noun* **1.** a place where someone lives ○ *He has a country residence where he spends his weekends.* **2.** the act of living or operating officially in a country

COMMENT: In the European Union, a residence permit is a document which permits the holder to live in a country while not being a citizen of that country. Normally a residence permit is valid for five years and can be renewed automatically. A residence permit is not withdrawn if the person becomes unemployed involuntarily (if a worker gives up his job and makes no effort to find another, his residence permit may be withdrawn).

residence permit /ˈrezɪd(ə)ns ˌpɜːmɪt/ *noun* an official document allowing a non-resident to live in a country ○ *He has applied for a residence permit.* ○ *She was granted a residence permit for one year.*

resident /ˈrezɪd(ə)nt/ *adjective* living or operating in a country ○ *The company is resident in France.* ▫ **person ordinarily resident in the UK** somebody who normally lives in the UK ■ *noun* a person living in a country

resident alien /ˌrezɪd(ə)nt ˈeɪliən/ *noun* an alien who has permission to live in a country without having citizenship

residual /rɪˈzɪdjuəl/ *adjective* remaining after everything else has gone

residuary /rɪˈzɪdjuəri/ *adjective* referring to what is left

residuary body /rɪˈzɪdjuəri ˌbɒdi/ *noun* a body set up to administer the ending of a local authority and to manage those of its functions which have not been handed over to other authorities

residuary devise /rɪˌzɪdjuəri dɪ ˈvaɪz/ *noun* devise to someone of what is left of the testator's property after other devises have been made and taxes have been paid

residuary devisee /rɪˌzɪdjuəri ˌdiːvaɪˈziː/ *noun* somebody who receives the rest of the land when the other bequests have been made

mainp - softvnn.com

Law.fm Page 260 Friday, June 11, 2004 2:08 PM

residuary estate /rɪˌzɪdjuəri ɪˈsteɪt/ *noun* **1.** the estate of a dead person which has not been bequeathed in his will **2.** what remains of an estate after the debts have been paid and bequests have been made

residuary legacy /rɪˌzɪdjuəri ˈlegəsi/ *noun* a legacy of what remains of an estate after debts, taxes and other legacies have been paid

residuary legatee /rɪˌzɪdjuəri ˌlegəˈtiː/ *noun* somebody who receives the rest of the personal property after specific legacies have been made

residue /ˈrezɪˌdjuː/ *noun* what is left over, especially what is left of an estate after debts and bequests have been made ○ *After paying various bequests the residue of his estate was split between his children.*

resign /rɪˈzaɪn/ *verb* to leave a job ○ *He resigned from his post as treasurer.* ○ *He has resigned with effect from July 1st.* ○ *She resigned as Education Minister.*

res ipsa loquitur /ˌreɪz ˌɪpsəˈlɒkwɪtə/ *phrase* a Latin phrase meaning 'the matter speaks for itself': a situation where the facts seem so obvious, that it is for the defendant to prove he or she was not negligent rather than for the claimant to prove his or her claim

resisting arrest /rɪˌzɪstɪŋ əˈrest/ *noun* the offence of refusing to allow yourself to be arrested

res judicata /ˌreɪz ˌdʒuːdɪˈkætə/ *phrase* a Latin phrase meaning 'matter on which a judgment has been given'

resolution /ˌrezəˈluːʃ(ə)n/ *noun* the action of solving a dispute ○ *The aim of the small claims track is the rapid resolution of disputes.*

COMMENT: There are three types or resolution which can be put to an AGM: the 'ordinary resolution', usually referring to some general procedural matter, and which requires a simple majority of votes; and the 'extraordinary resolution' and 'special resolution', such as a resolution to change a company's articles of association in some way, both of which need 75% of the votes before they can be carried.

resort /rɪˈzɔːt/ *verb* □ **to resort to** to come to use ○ *He had to resort to threats of court action to get repayment of the money owing.* ○ *Workers must not resort to violence in industrial disputes.*

respect /rɪˈspekt/ *noun* □ **with respect to**, **in respect of** concerning ○ *his right to an indemnity in respect of earlier payments* ○ *The defendant counterclaimed for loss and damage in respect of a machine sold to him by the claimant.*

respondeat superior /rɪˌspɒndeɪæt suˈperiɔː/ *phrase* a Latin phrase meaning 'let the superior be responsible': rule that a principal is responsible for actions of the agent or the employer for actions of the employee

respondent /rɪˈspɒndənt/ *noun* **1.** the other side in a case which is the subject of an appeal **2.** a person against whom an order is sought by an application notice **3.** somebody who answers a petition, especially one who is being sued for divorce ▸ ⇨ **co-respondent**

responsible for /rɪˈspɒnsɪb(ə)l fɔː/ *noun* being in charge of or being in control of ○ *The tenant is responsible for all repairs to the building.* ○ *The consignee is held responsible for the goods he has received on consignment.* ○ *She was responsible for a series of thefts from offices.*

responsible government /rɪˌspɒnsɪb(ə)l ˈgʌv(ə)nmənt/ *noun* a form of government which acts in accordance with the wishes of the people and which is accountable to Parliament for its actions

responsible to someone /rɪˌspɒnsɪb(ə)l tə ˈsʌmwʌn/ *noun* being under someone's authority ○ *Magistrates are responsible to the Lord Chancellor.*

restitutio in integrum /restɪˌtuːtiəʊ ɪn ɪnˈtegrəm/ *phrase* a Latin phrase meaning 'returning everything to the state as it was before'

restitution /ˌrestɪˈtjuːʃ(ə)n/ *noun* **1.** the return of property which has been illegally obtained ○ *The court ordered the restitution of assets to the company.* **2.** compensation or payment for damage or loss

restitution order /ˌrestɪˈtjuːʃ(ə)n ˌɔːdə/ *noun* a court order asking for property to be returned to someone

mainp - softvnn.com

Law.fm Page 261 Friday, June 11, 2004 2:08 PM

restrain /rɪ'streɪn/ *verb* **1.** to control or to hold someone back ○ *The prisoner fought and had to be restrained by two policemen.* **2.** to tell someone not to do something ○ *The court granted the claimant an injunction restraining the defendant from breaching copyright.*

restraining order /rɪ'streɪnɪŋ ˌɔːdə/ *noun* a court order which tells a defendant not to do something while the court is still taking a decision

restraint /rɪ'streɪnt/ *noun* control

restraint of trade /rɪˌstreɪnt əv 'treɪd/ *noun* **1.** a situation where an employee is not allowed to move to another job in the same trade because the experience acquired with the present employer might be sensitive or unfairly beneficial to the new employer **2.** an attempt by companies to fix prices, create monopolies or reduce competition, which could affect free trade

restriction /rɪ'strɪkʃ(ə)n/ *noun* something that limits what can happen or what someone can do □ **to impose restrictions on imports**, **on credit** to start limiting imports or credit □ **to lift credit restrictions** to allow credit to be given freely □ **reporting restrictions were lifted** journalists were allowed to report details of the case

restrictive /rɪ'strɪktɪv/ *adjective* limiting

restrictive covenant /rɪˌstrɪktɪv 'kʌvənənt/ *noun* a clause in a contract which prevents someone from doing something

restrictive practices /rɪˌstrɪktɪv 'præktɪsɪz/ *plural noun* ways of working which exclude free competition in relation to the supply of goods or labour in order to maintain high prices or wages

Restrictive Practices Court /rɪ ˌstrɪktɪv 'præktɪsɪz ˌkɔːt/ *noun* a court which decides in cases of restrictive practices

retail /'riːteɪl/ *noun* the sale of small quantities of goods to individual customers

retailer /'riːteɪlə/ *noun* a person who runs a business that sells goods to the public

retail price /'riːteɪl ˌpraɪs/ *noun* the price at which the retailer sells to the final customer

retail shop /'riːteɪl ʃɒp/ *noun* a shop where goods are sold only to the public

retain /rɪ'teɪn/ *verb* □ **to retain a lawyer to act for you** to agree with a lawyer that he or she will act for you (and pay a fee in advance)

retained income /rɪˌteɪnd 'ɪnkʌm/ *noun* profit which is not distributed to the shareholders as dividend

retainer /rɪ'teɪnə/ *noun* **1.** a fee paid to a barrister **2.** money paid in advance to someone when they are not actively working for you so that they will work for you on the occasions when they are needed ○ *We pay him a retainer of £1,000 per annum.*

retiral /rɪ'taɪərəl/ *noun Scotland, US* same as **retirement**

retire /rɪ'taɪə/ *verb* **1.** to stop work and take a pension ○ *She retired with a £6,000 pension.* ○ *The chairman of the company retired at the age of 65.* ○ *The shop is owned by a retired policeman.* **2.** to make an employee stop work and take a pension ○ *They decided to retire all staff over 50 years of age.* **3.** to come to the end of an elected term of office ○ *The treasurer retires after six years.* ○ *Two retiring directors offer themselves for re-election.* **4.** to go away from a court for a period of time ○ *The magistrates retired to consider their verdict.* ○ *The jury retired for four hours.*

retirement /rɪ'taɪəmənt/ *noun* **1.** the act of retiring from work □ **to take early retirement** to leave work before the usual age **2.** (*of a jury*) the act of leaving a courtroom to consider a verdict

retirement age /rɪ'taɪəmənt eɪdʒ/ *noun* the age at which people retire (in the UK usually 65 for men and 60 for women) (NOTE: In the UK, this is usually 65 for men and 60 for women.)

retirement pension /rɪ'taɪəmənt ˌpenʃən/ *noun* a state pension given to a man who is over 65 or woman who is over 60

retirement plan /rɪ'taɪəmənt plæn/ *noun* a plan set up to provide a person for someone when he or she retires

mainp - softvnn.com

Law.fm Page 262 Friday, June 11, 2004 2:08 PM

retiring age /rɪ'taɪərɪŋ eɪdʒ/ *noun* the age at which people retire (in the UK usually 65 for men and 60 for women) (NOTE: In the UK, this is usually 65 for men and 60 for women.)

retrial /'riːˌtraɪəl/ *noun* a new trial ○ *The Court of Appeal ordered a retrial.*

retroactive /ˌretrəʊ'æktɪv/ *adjective* taking effect from a time in the past ○ *They received a pay rise retroactive to last January.*

retroactively /ˌretrəʊ'æktɪvli/ *adverb* going back to a time in the past

retrospective /ˌretrəʊ'spektɪv/ *adjective* going back in time ○ *Legislation is enacted with the presumption that it should not be retrospective.* □ **with retrospective effect** applying to a past period

retrospective legislation /ˌretrəʊspektɪv ˌledʒɪ'sleɪʃ(ə)n/ *noun* an Act of Parliament which applies to the period before the Act was passed

retrospectively /ˌretrəʊ'spektɪvli/ *adverb* in a retrospective way ○ *The ruling is applied retrospectively.*

retry /ˌriː'traɪ/ *verb* to try a case a second time ○ *The court ordered the case to be retried.*

return /rɪ'tɜːn/ *noun* □ **to make a return to the tax office**, **to make an income tax return** to send a statement of income to the tax office □ **to fill in a VAT return** to complete the form showing VAT income and expenditure

return address /rɪ'tɜːn əˌdres/ *noun* an address to send back something

return on investment /rɪˌtɜːn ɒn ɪn 'vestmənt/ *noun* profit shown as a percentage of money invested

reus ◗ **actus reus**

revenue expenditure /ˌrevənjuː ɪk 'spendɪtʃə/ *noun* the day-to-day costs of a council such as salaries and wages, maintenance of buildings, etc.

revenue officer /'revənjuː ˌɒfɪsə/ *noun* somebody working in a government tax office

reversal /rɪ'vɜːs(ə)l/ *noun* **1.** the change of a decision to the opposite ○ *The reversal of the High Court ruling by the Court of Appeal.* **2.** a change from being profitable to unprofitable ○ *The company suffered a reversal in the Far East.*

reverse /rɪ'vɜːs/ *adjective* opposite, in the opposite direction ■ *verb* to change a decision to the opposite one ○ *The Appeal Court reversed the decision of the High Court.*

reverse charge call /rɪˌvɜːs tʃɑːdʒ 'kɔːl/ *noun* a telephone call where the person receiving the call agrees to pay for it

reverse takeover /rɪˌvɜːs 'teɪkəʊvə/ *noun* a takeover where the company which has been taken over ends up owning the company which has taken it over

reversion /rɪ'vɜːʃ(ə)n/ *noun* the return of property to an original owner when a lease expires □ **he has the reversion of the estate** he will receive the estate when the present lease ends or when the present owner dies

reversionary /rɪ'vɜːʃ(ə)n(ə)ri/ *adjective* referring to property which passes to another owner on the death of the present one

reversionary annuity /rɪˌvɜːʃ(ə)n(ə)ri ə'njuːɪti/ *noun* an annuity paid to someone on the death of another person

reversionary right /rɪˌvɜːʃ(ə)n(ə)ri 'raɪt/ *noun* the right of a writer's heir to his or her copyrights after his or her death

revert /rɪ'vɜːt/ *verb* to go back to the previous state or owner ○ *The property reverts to its original owner in 2010.*

review /rɪ'vjuː/ *noun* a general examination of something again ○ *to conduct a review of sentencing policy* ○ *The coroner asked for a review of police procedures.* ■ *verb* to examine something generally ○ *A committee has been appointed to review judicial salaries.* ○ *The High Court has reviewed the decision.*

revise /rɪ'vaɪz/ *verb* to change a document, decision or opinion in some way ○ *The judge revised his earlier decision not to consider a submission from defence counsel.*

revision /rɪ'vɪʒ(ə)n/ *noun* the act of changing something ○ *The Lord Chancellor has proposed a revision of the divorce procedures.*

mainp - softvnn.com

Law.fm Page 263 Friday, June 11, 2004 2:08 PM

revival /rɪ'vaɪv(ə)l/ *noun* the act of making a will that has been revoked but not destroyed valid again

revive /rɪ'vaɪv/ *verb* to make a revoked will become valid again

revocable /'revəkəb(ə)l/ *adjective* being able to be revoked. Opposite **irrevocable** (NOTE: The opposite is **irrevocable**.)

revocandi ◗ **animus revocandi**

revocation /ˌrevəʊ'keɪʃ(ə)n/ *noun* the act of cancelling a permission, right, agreement, offer or will

COMMENT: A will may be revoked by marriage, by writing another will which changes the dispositions of the first one, or by destroying the will intentionally.

revoke /rɪ'vəʊk/ *verb* to cancel a permission, right, agreement, offer or will ○ *to revoke a clause in an agreement* ○ *The treaty on fishing rights has been revoked.*

reward /rɪ'wɔːd/ *noun* a payment given to someone who does a service such as finding something which has been lost or giving information about something ○ *She offered a £50 reward to anyone who found her watch.* ○ *The police have offered a reward for information about the man seen at the bank.*

Rex /reks/ *Latin word meaning* 'the King': the Crown or state, as a party in legal proceedings (NOTE: In written reports, usually abbreviated to **R**: **the case of** *R. v. Smith*.)

rfp *abbreviation* reasonable financial provision

rider /'raɪdə/ *noun* **1.** a clause added to a document such as contract or report **2.** *US* a clause attached to a bill, which may have nothing to do with the subject of the bill, but which the sponsor hopes will help the bill to pass into law more easily

right /raɪt/ *noun* a legal entitlement to something ○ *right of renewal of a contract* ○ *She has a right to the property.* ○ *He has no right to the patent.* ○ *The staff have a right to know what the company is doing.*

rightful /'raɪtf(ə)l/ *adjective* legally correct

rightful claimant /ˌraɪtf(ə)l 'kleɪmənt/ *noun* somebody who has a legal claim to something

rightful owner /ˌraɪtf(ə)l 'əʊnə/ *noun* the legal owner

Right Honourable /ˌraɪt 'ɒn(ə)rəb(ə)l/ *noun* the title given to members of the Privy Council (NOTE: usually written **Hon.**: *the Hon. Member; the Rt. Hon. William Smith, M.P.*)

right of abode /ˌraɪt əv ə'bəʊd/ *noun* the right to live in a country

right of audience /ˌraɪt əv 'ɔːdiəns/ *noun* the right to speak to a court, which can be used by the parties in the case or their legal representatives ○ *A barrister has right of audience in any court in England and Wales.* (NOTE: Solicitors now have right of audience in some courts.)

COMMENT: Solicitors have a right of audience in a limited number of courts. Solicitor-advocates have the same rights of audience as barristers.

right of centre /ˌraɪt əv 'sentə/ *adjective* tending towards conservatism ○ *a left-of-centre political group* ○ *The Cabinet is formed mainly of right-of-centre supporters of the Prime Minister.* (NOTE: usually used with **the**: *The centre combined with the right to defeat the motion.*)

right of establishment /ˌraɪt əv ɪ 'stæblɪʃmənt/ *noun* the right of an EC citizen to live and work in any EC country

right of re-entry /ˌraɪt əv ri'entri/ *noun* **1.** the right of a landlord to take back possession of the property if the tenant breaks his agreement **2.** the right of a person resident in a country to go back into that country after leaving it for a time

right of reply /ˌraɪt əv rɪ'plaɪ/ *noun* the right of someone to answer claims made by an opponent ○ *He demanded the right of reply to the newspaper allegations.*

right of silence /ˌraɪt əv 'saɪləns/ *noun* the right of an accused not to say anything when charged with a criminal offence

right of survivorship /ˌraɪt əv sə 'vaɪvəʃɪp/ *noun* a right of the survivor

mainp - softvnn.com

Law.fm Page 264 Friday, June 11, 2004 2:08 PM

of a joint tenancy to the estate rather than of the heirs of the deceased tenant (*also*) (NOTE: The right of survivorship is also called by its Latin name: *jus accrescendi*.)

right of way /ˌraɪt əv ˈweɪ/ *noun* the right to go lawfully along a path on another person's land

right to enter /ˌraɪt tə ˈentə/ *noun* the right of a EU citizen to go into another EU country to look for work

right to reside /ˌraɪt tə rɪˈzaɪd/ *noun* one of the fundamental rights of citizens and workers in the European Union, the right of living in any another EU Member State

rigor mortis /ˌrɪgə ˈmɔːtɪs/ *phrase* a Latin phrase meaning 'stiffening of the dead': a state where a dead body becomes stiff some time after death, which can allow a pathologist to estimate the time of death in some cases

ring /rɪŋ/ *verb* to alter chassis or engine numbers on a car, so as to falsify its origin

riot /ˈraɪət/ *noun* a notifiable offence when three or more people meet illegally and plan to use force to achieve their aims or to frighten the public ■ *verb* to form an illegal group to use force

rioter /ˈraɪətə/ *noun* somebody who takes part in a riot ○ *Rioters attacked the banks and post offices.*

riotous assembly /ˌraɪətəs əˈsemblɪ/ *noun* formerly, a meeting of twelve or more people who come together to use force to achieve their aims or frighten other people

riparian /raɪˈpeərɪən/ *adjective* referring to the bank of a river

riparian rights /raɪˈpeərɪən ˌraɪts/ *plural noun* the rights that apply to people who own land on the bank of a river, e.g. the right to fish in the river

risk /rɪsk/ *noun* **1.** possible harm, loss or chance of danger □ **at risk** in a situation where something bad or dangerous is likely to happen ○ *His careless driving had put his passengers as well as other road-users at risk.* ○ *The school was known to be at risk of flooding.* □ **at owner's risk** a situation in which goods shipped or stored are the responsibility of the owner, not of the shipping company or storage company □ **to run a risk *or* run the risk of something** to be likely to suffer harm ○ *She knew she was running a risk in not reporting the accident.* ○ *In allowing him to retain his passport, the court runs the risk of the accused leaving the country.* **2.** loss or damage against which you are insured □ **he is a bad risk** it is likely that an insurance company will have to pay out compensation as far as he is concerned ○ *He is likely to die soon, so is a bad risk for an insurance company*

road rage /ˈrəʊd reɪdʒ/ *noun* a violent attack by a driver on another car or its driver, caused by anger at the way the other driver has been driving ○ *There have been several incidents of road rage lately.* ○ *In the latest road rage attack, the driver leapt out of his car and knocked a cyclist to the ground.*

road tax /ˈrəʊd tæks/ *noun* an annual tax levied on cars and other vehicles

rob /rɒb/ *verb* to steal something from someone, usually violently ○ *They robbed a bank in London and stole a car to make their getaway.* ○ *The gang robbed shopkeepers in the centre of the town.* (NOTE: **robbing – robbed**. Note also that you rob someone **of** something.)

robber /ˈrɒbə/ *noun* somebody who robs people

robbery /ˈrɒbərɪ/ *noun* **1.** the offence of stealing something from someone using force or threatening to use force **2.** the act of stealing something with violence ○ *He committed three petrol station robberies in two days.*

robbery with violence /ˌrɒbərɪ wɪð ˈvaɪələns/ *noun* the offence of stealing goods and harming someone at the same time

rogatory letter /ˈrɒgət(ə)rɪ ˌletə/ *noun* a letter of request to a court in another country, asking for evidence to be taken from someone under that court's jurisdiction

rolling contract /ˌrəʊlɪŋ ˈkɒntrækt/ *noun* **1.** a contract for a period of more than one year that is renewed annually for the same period, subject to a favourable review **2.** a contract that is open-end-

mainp - softvnn.com

Law.fm Page 265 Friday, June 11, 2004 2:08 PM

ed and runs until one of the contracting parties cancels it

Roll of Solicitors /ˌrəʊl əv sə ˈlɪsɪtəz/ *noun* a list of admitted solicitors

roll over /ˌrəʊl ˈəʊvə/ *verb* □ **to roll over credit** to make credit available over a continuing period

Romalpa clause /rəʊˈmɒlpə ˌklɔːz/ *noun* a clause in a contract, whereby the seller provides that title to the goods does not pass to the buyer until the buyer has paid for them

COMMENT: Called after the case of *Aluminium Industrie Vaassen BV v. Romalpa Ltd.*

Roman law /ˈrəʊmən lɔː/ *noun* the set of laws which existed in the Roman Empire

COMMENT: Roman law is the basis of the laws of many European countries but has had only negligible and indirect influence on the development of English law.

Rome Convention /ˌrəʊm kən ˈvenʃ(ə)n/ *noun* a copyright convention signed in Rome, covering the rights of record producers, musical performers, broadcasters and television companies, etc.

root of title /ˌruːt əv ˈtaɪt(ə)l/ *noun* the basic title deed which proves that a vendor has the right to sell a property

ROR *abbreviation US* release on recognizance

rotation /rəʊˈteɪʃ(ə)n/ *noun* the activity of taking turns □ **to fill the post of chairman by rotation** each member of the group is chairman for a period then gives the post to another member □ **two directors retire by rotation** two directors retire because they have been directors longer than any others, but can offer themselves for re-election

rough copy /ˌrʌf ˈkɒpi/ *noun* a draft of a document which is expected to have changes made to it before it is complete

rough draft /ˌrʌf ˈdrɑːft/ *noun* a plan of a document which may have changes made to it before it is complete

rough justice /ˌrʌf ˈdʒʌstɪs/ *noun* legal processes which are not always very fair

round table conference /ˌraʊnd ˌteɪb(ə)l ˈkɒnf(ə)rəns/ *noun* a conference at which each party at the meeting is of equal status to the others ○ *The government is trying to get the rebel leaders to come to the conference table.*

rout /raʊt/ *noun* the offence of gathering together of people to do some unlawful act

Royal Assent /ˌrɔɪəl əˈsent/ *noun* the act of signing of bill by the Queen, confirming that the bill is to become law as an Act of Parliament

Royal Commission /ˌrɔɪəl kə ˈmɪʃ(ə)n/ *noun* a group of people specially appointed by a minister to examine and report on a major problem

Royal Courts of Justice /ˌrɔɪəl ˌkɔːts əv ˈdʒʌstɪs/ *noun* the central civil court in London, where serious claims covering fatal accidents, professional negligence, defamation, and claims against the police are heard. Abbreviation **RCJ**

Royal pardon /ˌrɔɪəl ˈpɑːd(ə)n/ *noun* a pardon whereby a person convicted of a crime is forgiven and need not serve a sentence

Royal prerogative /ˌrɔɪəl prɪ ˈrɒgətɪv/ *noun* a special right belonging only to a king or queen such as the right to appoint ministers or end a session of Parliament

royalty /ˈrɔɪəlti/ *noun* money paid to an inventor, writer, or the owner of land for the right to use his property. It is usually an agreed percentage of sales or an amount per sale. ○ *Oil royalties make up a large proportion of the country's revenue.* ○ *He is receiving royalties from his invention.*

rozzer /ˈrɒzə/ *noun* a policeman (*informal*)

RPM *abbreviation* resale price maintenance

RSC *abbreviation* Rules of the Supreme Court

rule /ruːl/ *noun* **1.** a general order of conduct which says how things should be done, e.g. an order governing voting procedure in Parliament or Congress ○ *The debate followed the rules of procedure used in the British House of Commons.* □

mainp - softvnn.com

Law.fm Page 266 Friday, June 11, 2004 2:08 PM

to work to rule to work strictly according to the rules agreed by the company and union, and therefore to work very slowly **2.** *US* a special decision made by the Rules Committee which states how a particular bill should be treated in the House of Representatives **3.** the way in which a country is governed ○ *The country has had ten years of military rule.* □ **the rule of law** principle of government that all persons and bodies and the government itself are equal before and answerable to the law and that no person shall be punished without trial **4.** a decision made by a court □ **Rule in Rylands v. Fletcher** a rule that when a person brings a dangerous thing (substance or animal) to his or her own land, and the dangerous thing escapes and causes harm, then that person is absolutely liable for the damage caused ■ *verb* **1.** to give an official decision ○ *We are waiting for the judge to rule on the admissibility of the defence evidence.* ○ *The commission of inquiry ruled that the company was in breach of contract.* **2.** to be in force or to be current ○ *prices which are ruling at the moment* **3.** to govern a country ○ *The country is ruled by a group of army officers.*

rule against perpetuities /ˌruːl ə ˌgenst ˌpɜːpɪtˈjuːɪtiz/ *noun* a rule that an interest can only last for a period of no more than 21 years

rule of evidence /ˌruːl əv ˈevɪd(ə)ns/ *noun* a rule established by law which determines the type of evidence which a court will consider and how such evidence must be given

Rules of the Supreme Court /ˌruːlz əv ðə sʊˌpriːm ˈkɔːt/ *plural noun* rules governing practice and procedure in the Supreme Court. Abbreviation **RSC**. ◊ **Civil Procedure Rules, County Court Rules, White Book**

ruling /ˈruːlɪŋ/ *noun* a decision made by someone with official authority such as a judge, magistrate, arbitrator or chairman ○ *According to the ruling of the court, the contract was illegal.* ■ *adjective* **1.** in power or in control ○ *the ruling Democratic Party* ○ *The actions of the ruling junta have been criticised in the press.* **2.** most important ○ *The ruling consideration is one of cost.* **3.** in operation at the moment ○ *We invoiced at ruling prices.*

runner /ˈrʌnə/ *noun* a member of a gang of pickpockets who takes the items stolen and runs away with them to a safe place (*slang*)

run-up /ˈrʌn ʌp/ *noun* □ **run-up to an election** period before an election ○ *In the run-up to the General Election, opinion polls were forecasting heavy losses for the government.*

rustle /ˈrʌs(ə)l/ *verb* to steal livestock, especially cows and horses

rustler /ˈrʌslə/ *noun* somebody who steals livestock ○ *a cattle rustler*

rustling /ˈrʌs(ə)lɪŋ/ *noun* the crime of stealing cattle or horses

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S

sabotage /ˈsæbətɑːʒ/ *noun* malicious damage done to machines or equipment ○ *Several acts of sabotage were committed against radio stations.* (NOTE: no plural; for the plural say **acts of sabotage**)

sack /sæk/ *noun* □ **to get the sack** to be dismissed from a job ■ *verb* □ **to sack someone** to dismiss someone from a job ○ *He was sacked after being late for work.*

sacking /ˈsækɪŋ/ *noun* dismissal from a job ○ *The scandal led to the sacking of several employees*

safe /seɪf/ *noun* a heavy metal box which cannot be opened easily, in which valuable items such as documents or money can be kept ○ *Put the documents in the safe.* ○ *We keep the petty cash in the safe.* ■ *adjective* **1.** out of danger □ **keep the documents in a safe place** in a place where they cannot be stolen or destroyed **2.** referring to a judgment of a court which is well-based and is not likely to be quashed on appeal ○ *The court of appeal found that the original conviction was not safe.* ◊ **unsafe**

safe deposit /ˈseɪf dɪˌpɒzɪt/ *noun* a safe in a bank vault where you can leave jewellery or documents

safe deposit box /ˌseɪf dɪˈpɒzɪt ˌbɒks/ *noun* a small box which you can rent to keep jewellery or documents in a bank's safe

safeguard /ˈseɪfɡɑːd/ *noun* an action or plan for doing something that prevents something unwanted from happening ○ *The proposed legislation will provide a safeguard against illegal traders.* ■ *verb* to protect someone or something against something unwanted happening ○ *The court acted to safeguard the interests of the shareholders.* ○ *The management had failed to safeguard their employees against exposure to the hazard.*

safekeeping /ˌseɪf ˈkiːpɪŋ/ *noun* care and protection ○ *We put the documents into the bank for safe keeping.*

safe seat /ˌseɪf ˈsiːt/ *noun* a seat where the Member of Parliament has a large majority and is not likely to lose the seat at an election

safety /ˈseɪfti/ *noun* the situation of being free from danger or risk □ **to take safety precautions**, **safety measures** to act to make sure something is safe

safety margin /ˈseɪfti ˌmɑːdʒɪn/ *noun* time or space allowed for something to be safe

safety measures /ˈseɪfti ˌmeʒəz/ *plural noun* actions to make sure that something is or will be safe

safety regulations /ˈseɪfti reɡjʊ ˌleɪʃ(ə)nz/ *plural noun* rules to make a place of work safe for the workers

salary /ˈsæləri/ *noun* payment for work made to an employee with a contract of employment, especially in a professional or office job (NOTE: The plural is **salaries**.)

sale /seɪl/ *noun* **1.** the act of selling or transferring an item or a property from one owner to another in exchange for a consideration, usually in the form of money **2.** □ **for sale** ready to be sold □ **to offer something for sale**, **to put something up for sale** to announce that something is ready to be sold ○ *They put the factory up for sale.* **3.** the selling of goods at specially low prices ○ *The shop is having a sale to clear old stock.* ○ *The sale price is 50% of the normal price.* □ **half-price sale** sale of items at half the usual price □ **the sales** period when ma-

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Law.fm Page 268 Friday, June 11, 2004 2:08 PM

jor stores sell many items at specially low prices

sale and lease-back /ˌseɪl ən 'liːs bæk/ *noun* a situation where a company sells a property to raise cash and then leases it back from the purchaser

Sale of Goods Act /ˌseɪl əv 'gʊdz ˌækt/ *noun* an Act of Parliament which regulates the selling of goods but not land, copyrights or patents ○ *The law relating to the sale of goods is governed by the Sale of Goods Act.*

sale or return /ˌseɪl ɔː rɪ'tɜːn/ *noun* a system which allows unsold goods to be delivered to a person, who then has the right to keep the goods for a specified time while deciding whether or not to purchase them

sales department /'seɪlz dɪ ˌpɑːtmənt/ *noun* the section of a company which deals in selling the company's products or services

salvage /'sælvɪdʒ/ *noun* **1.** a right of a person who saves a ship from being wrecked or cargo from a ship which has been wrecked in order to receive compensation **2.** goods saved from a wrecked ship or from a fire or other accident ○ *a sale of flood salvage items* ■ *verb* to save goods or a ship from being wrecked ○ *We are selling off a warehouse full of salvaged goods.*

salvage agreement /ˌsælvɪdʒ ə 'griːmənt/ *noun* an agreement between the captain of a sinking ship and a salvage crew, giving the terms on which the ship will be saved

salvage vessel /'sælvɪdʒ ˌves(ə)l/ *noun* a ship which specialises in saving other ships and their cargoes

sample /'sɑːmpəl/ *noun* a small part of something taken to show what the whole is like ○ *They polled a sample group of voters.* ■ *verb* to take a small part of something and examine it ○ *The suspect's urine was sampled and the test proved positive.*

sanction /'sæŋkʃən/ *noun* **1.** an official order to do something ○ *You will need the sanction of the local authorities before you can knock down the office block.* ○ *The payment was made without official sanction.* **2.** *US* punishment by a court for failure to comply with an order. If the sanction is payment of costs, the party in default may obtain relief by appealing. **3.** a punishment for an act which goes against what is generally accepted behaviour □ **(economic) sanctions** restrictions on trade with a country in order to influence its political situation or in order to make its government change its policy ○ *to impose sanctions on a country* or *to lift sanctions* ■ *verb* to approve or permit something officially ○ *The board sanctioned the expenditure of £1.2m on the development plan.*

sane /seɪn/ *adjective* mentally well ○ *Was he sane when he made the will?*

sanity /'sænɪti/ *noun* the ability to make rational decisions

sans frais /ˌsænz 'freɪs/ *phrase* a French phrase meaning 'with no expense'

sans recours /ˌsænz rə'kuːəz/ *phrase* a French phrase meaning 'with no recourse': used to show that someone such as an agent acting for a principal in endorsing a bill is not responsible for paying it

satisfaction /ˌsætɪs'fækʃən/ *noun* **1.** the acceptance of money or goods by an injured party who then cannot make any further claim **2.** payment or giving of goods to someone in exchange for that person's agreement to stop a claim

satisfy /'sætɪsfaɪ/ *verb* **1.** to convince someone that something is correct ○ *When opposing bail the police had to satisfy the court that the prisoner was likely to try to leave the country.* **2.** to fulfil or to carry out fully ○ *Has he satisfied all the conditions for parole?* ○ *The company has not satisfied all the conditions laid down in the agreement.* ○ *We cannot produce enough to satisfy the demand for the product.*

scaffold /'skæfəʊld/ *noun* a raised platform on which executions take place

scale /skeɪl/ *noun* □ **large scale**, **small scale** working with large or small amounts of investment, staff, etc. □ **to start in business on a small scale** to start in business with a small staff, few products or little investment ■ *verb* □ **to scale down**, **to scale up** to lower or to increase in proportion

mainp - softvnn.com

Law.fm Page 269 Friday, June 11, 2004 2:08 PM

scale of charges /ˌskeɪl əv ˈtʒɑːdʒɪz/ *noun* a list showing various prices

scale of salaries /ˌskeɪl əv ˈsæləriz/ *noun* a list of salaries showing different levels of pay in different jobs in the same company

scam /skæm/ *noun* a dishonest plan to deceive someone, especially in order to obtain money (*informal*)

scene-of-crime /ˌsiːn əv ˈkraɪm/ *adjective* relating or belonging to the part of the police force responsible for collecting forensic evidence at crime scenes

schedule /ˈʃedjuːl/ *noun* **1.** a plan of the times when something will happen □ **to be ahead of schedule** to be early □ **to be on schedule** to be on time □ **to be behind schedule** to be late ○ *I am sorry to say that we are three months behind schedule.* **2.** an additional document attached to a contract ○ *schedule of markets to which a contract applies* ○ *see the attached schedule* or *as per the attached schedule* ○ *the schedule before referred to* **3.** a list ○ *We publish our new schedule of charges.* (NOTE: For the schedules applying to drugs, see **drug**.) ■ *verb* **1.** to list officially ○ *scheduled prices* or *scheduled charges* **2.** to plan the time when something will happen ○ *The building is scheduled for completion in May.*

Schedule A /ˌʃedjuːl ˈeɪ/ *noun* a schedule to the Finance Acts under which tax is charged on income from land or buildings

Schedule B /ˌʃedjuːl ˈbiː/ *noun* a schedule to the Finance Acts under which tax is charged on income from woodlands

Schedule C /ˌʃedjuːl ˈsiː/ *noun* a schedule to the Finance Acts under which tax is charged on profits from government stock

Schedule D /ˌʃedjuːl ˈdiː/ *noun* a schedule to the Finance Acts under which tax is charged on income from trades, professions, interest and other earnings which do not come from employment

Schedule F /ˌʃedjuːl ˈef/ *noun* a schedule to the Finance Acts under which tax is charged on income from dividends

scheme of arrangement /ˌskiːm əv əˈreɪndʒmənt/ *noun* a scheme drawn up by an individual offering ways of paying debts and so avoiding bankruptcy proceedings

scire facias /ˌsaɪəri ˈfeɪʃiæs/ *noun* a writ that requires a defendant to appear in court to show why the plaintiff should not be permitted to take a specific legal step

scope /skəʊp/ *noun* the limits covered by something ○ *The question does not come within the scope of the authority's powers.* ○ *The Bill plans to increase the scope of the tribunal's authority.*

Scotland Yard /ˌskɒtlənd ˈjɑːd/ *noun* the headquarters of the Metropolitan Police in London

screen /skriːn/ *verb* □ **to screen candidates** to examine candidates to see if they are completely suitable

screening /ˈskriːnɪŋ/ *noun* □ **the screening of candidates** examining candidates to see if they are suitable

screw /skruː/ *noun* a prison warder (*slang*)

scrip /skrɪp/ *noun* a certificate showing that someone owns shares in a company

scuttle /ˈskʌt(ə)l/ *verb* to sink a ship deliberately by making holes in the bottom of it

seal /siːl/ *noun* **1.** a piece of wax or red paper attached to a document to show that it is legally valid **2.** a stamp printed or marked on a document to show that it is valid **3.** a mark put on a document by a court to show that it has been correctly issued by that court ○ *The document bears the court's seal and is admissible in evidence.* **4.** a piece of paper, metal or wax attached to close something, so that it can be opened only if the paper, metal or wax is removed or broken ○ *The seals on the ballot box had been tampered with.* ■ *verb* **1.** to close something tightly ○ *The computer disks were sent in a sealed container.* **2.** (*of a court*) to attach a mark to a document to show that it has been issued by that court ○ *A court must seal a claim form when it is issued.* **3.** to attach a seal ○ *The customs sealed the*

mainp - softvnn.com

Law.fm Page 270 Friday, June 11, 2004 2:08 PM

shipment. **4.** to stamp something with a seal

sealed envelope /ˌsiːld ˈenvələʊp/ *noun* an envelope where the back has been stuck down to close it ○ *The information was sent in a sealed envelope.*

sealed instrument /ˌsiːld ˈɪnstrʊmənt/ *noun* a document which has been signed and sealed

sealed tender /ˌsiːld ˈtendə/ *noun* tenders sent in sealed envelopes, which will all be opened together at a specified time

seal off /ˌsiːl ˈɒf/ *verb* to put barriers across a street or an entrance to prevent people from going in or out ○ *Police sealed off all roads leading to the courthouse.*

search /sɜːtʃ/ *noun* an act of examining a place to try to find something. ◊ **power of search** ■ *verb* to examine a place or a person to try to find something ○ *The agent searched his files for a record of the sale.* ○ *All drivers and their cars are searched at the customs post.* ○ *The police searched the area round the house for clues.* □ **to stop and search** to stop a person in a public place and search them for weapons, implements used for burglary, stolen articles, etc.

search order /ˈsɜːtʃ ˌɔːdə/ *noun* an order by a court in a civil case allowing a party to inspect and photocopy or remove a defendant's documents, especially where the defendant might destroy evidence. The search should be done in the presence of an independent solicitor. (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has replaced **Anton Piller order**.)

search warrant /ˈsɜːtʃ ˌwɒrənt/ *noun* an official document signed by a magistrate allowing the police to enter premises and look for persons suspected of being criminals, objects which are believed to have been stolen, or dangerous or illegal substances

secede /sɪˈsiːd/ *verb* to break away from an organisation or a federation ○ *The American colonies seceded from Great Britain in 1776 and formed the USA.*

secession /sɪˈseʃ(ə)n/ *noun* the act of seceding

second /ˈsekənd/ *verb* □ **to second a motion**, **a candidate** to agree to support a motion after it has been proposed by the proposer, but before a vote is taken ○ *The motion is proposed by Mr Smith, seconded by Mr Jones.* ○ *The name of Mr Brown has been proposed for the post of treasurer, who is going to second him?*

secondarily /ˌsekənˈdeərɪli/ *adverb* in second place ○ *The person making a guarantee is secondarily liable if the person who is primarily liable defaults.* ◊ **primarily**

secondary /ˈsekənd(ə)ri/ *adjective* second in importance

secondary action /ˌsekənd(ə)ri ˈækʃən/ *noun* the picketing of another factory or place of work which is not directly connected with a strike to prevent it supplying a striking factory or receiving supplies from it

secondary banks /ˌsekənd(ə)ri ˈbæŋks/ *plural noun* companies which provide money for hire-purchase deals

secondary evidence /ˌsekənd(ə)ri ˈevɪd(ə)ns/ *noun* evidence which is not the main proof, e.g. copies of documents and not the original documents themselves. Secondary evidence can be admitted if there is no primary evidence available.

secondary legislation /ˌsekənd(ə)ri ˌledʒɪˈsleɪʃ(ə)n/ *noun* legislation passed by the European Union, as opposed to primary legislation passed by the Member States themselves

second degree murder /ˌsekənd dɪ ˌgriː ˈmɜːdə/ *noun US* the unlawful killing of a person without premeditation and not committed at the same time as rape or robbery

second mortgage /ˌsekənd ˈmɔːgɪdʒ/ *noun* a further mortgage on a property which is already mortgaged. The first mortgage has prior claim.

second quarter /ˌsekənd ˈkwɔːtə/ *noun* a period of three months from April to the end of June

Second Reading /ˌsekənd ˈriːdɪŋ/ *noun* **1.** a detailed presentation of a Bill in the House of Commons by the respon-

mainp - softvnn.com

Law.fm Page 271 Friday, June 11, 2004 2:08 PM

sible minister, followed by a discussion and vote **2.** *US* a detailed examination of a Bill in the House of Representatives, before it is passed to the Senate

secret agent /ˌsiːkrət ˈeɪdʒənt/ *noun* somebody who tries to find out information in secret about other countries, other governments or other armed forces

Secretary-General /ˌsekrətri ˈdʒen(ə)rəl/ *noun* a main administrator in a large organisation such as the United Nations or a political party

Secretary of State for Defence /ˌsekrətri əv steɪt fə dɪˈfens/ *noun* a government minister in charge of the armed forces. Also called **Defence Secretary** (NOTE: The US term is **Secretary for Defense**.)

Secretary of the Treasury /ˌsekrət(ə)ri əv ðə ˈtreʒəri/ *noun US* a senior member of the government in charge of financial affairs

Secretary to the Senate /ˌsekrətri tə ðə ˈsenət/ *noun US* the head of the administrative staff in the Senate

secret police /ˌsiːkrət pəˈliːs/ *noun* police officers who work in secret, especially dealing with people working against the state

section /ˈsekʃən/ *noun* **1.** a department in an office □ **legal section** department dealing with legal matters in a company **2.** part of an Act of Parliament or bylaw ○ *He does not qualify for a grant under section 2 of the Act.* (NOTE: When referring to a section of an act, it is abbreviated to **s**: *s 24 LGA*.)

secure /sɪˈkjʊə/ *adjective* **1.** safe from danger or harm **2.** firmly fastened or held ○ *The documents should be kept in a secure place.* ○ *The police and army have made the border secure.* ■ *verb* □ **to secure a loan** to pledge a property or other assets as a security for a loan

secured creditor /sɪˌkjʊəd ˈkredɪtə/ *noun* a person who is owed money by someone and holds a mortgage or charge on that person's property as security

secured debts /sɪˌkjʊəd ˈdet/ *plural noun* debts which are guaranteed by assets

secured loan /sɪˈkjʊəd ləʊn/ *noun* a loan which is guaranteed by the borrower giving valuable property as security

secure investment /sɪˌkjʊə ɪn ˈvestmənt/ *noun* an investment where you are not likely to lose money

secure job /sɪˌkjʊə ˈdʒɒb/ *noun* a job from which you are not likely to be made redundant

secure tenant /sɪˌkjʊə ˈtenənt/ *noun* a tenant of a local authority who has the right to buy the freehold of the property he or she rents at a discount

securities trader /sɪˈkjʊərɪtiz ˌtreɪdə/ *noun* somebody whose business is buying and selling stocks and shares

security /sɪˈkjʊərɪti/ *noun* **1.** safety from danger or harm **2.** the state of being protected **3.** a guarantee that someone will repay money borrowed □ **to stand security for someone** to guarantee that if the person does not repay a loan, you will repay it for him

security for costs /sɪˌkjʊərɪti fə ˈkɒsts/ *noun* a guarantee that a party in a dispute will pay costs ○ *The master ordered that the claimant should deposit £2,000 as security for the defendant's costs.*

COMMENT: Where a foreign claimant or a company which may become insolvent brings proceedings against a defendant, the defendant is entitled to apply to the court for an order that the proceedings be stayed unless the claimant deposits money to secure the defendant's costs if the claimant fails in his action.

security guard /sɪˈkjʊərɪti gɑːd/ *noun* somebody whose job is to protect money, valuables or an office against possible theft or damage

security of employment /sɪˌkjʊərɪti əv ɪmˈplɔɪmənt/ *noun* the feeling by an employee that he or she has the right to keep a job until retirement

security of tenure /sɪˌkjʊərɪti əv ˈtenjə/ *noun* the right to keep a position or rented accommodation, provided that conditions are met

security printer /sɪˈkjʊərɪti ˌprɪntə/ *noun* a printer who prints paper money or material such as secret government documents

mainp - softvnn.com

Law.fm Page 272 Friday, June 11, 2004 2:08 PM

sedition /sɪ'dɪʃ(ə)n/ *noun* the crime of doing acts or speaking or publishing words which bring the royal family or the government into hatred or contempt and encourage civil disorder

COMMENT: Sedition is a lesser crime than treason.

seditious /sɪ'dɪʃəs/ *adjective* provoking sedition

seek /siːk/ *verb* **1.** to ask for ○ *a creditor seeking a receiving order under the Bankruptcy Act* ○ *They are seeking damages for loss of revenue.* ○ *The applicant sought judicial review to quash the order.* ○ *The Bill requires a social worker to seek permission of the Juvenile Court.* □ **to seek an interview** to ask if you can see someone ○ *she sought an interview with the minister* **2.** to look for someone or something ○ *The police are seeking a tall man who was seen near the scene of the crime.* ○ *Two men are being sought by the police.* **3.** to try to do something ○ *The local authority is seeking to place the ward of court in accommodation.* (NOTE: **seeking – sought – has sought**)

segregate /'segrɪgeɪt/ *verb* to separate or keep apart, especially to keep different ethnic groups in a country apart ○ *Single-sex schools segregate boys from girls.*

seised /siːzd/ *adjective* □ **seised of a property** being legally in possession of property

seisin /'siːzɪn/ *noun* possession of land (*feudal law*)

seizin /'siːzɪn/ *noun* another spelling of **seisin**

seizure /'siːʒə/ *noun* the act of taking possession of something ○ *The court ordered the seizure of the shipment* or *of the company's funds.*

selection board /sɪ'lekʃən bɔːd/ *noun* a committee which chooses a candidate for a job

selection procedure /sɪ'lekʃən prə ˌsiːdʒə/ *noun* a general method of choosing a candidate for election or for a job

self-defence /ˌself dɪ'fens/ *noun* actions or skills that you use to try to protect yourself when attacked ○ *He pleaded that he had acted in self-defence when he had hit the mugger.*

COMMENT: This can be used as a defence to a charge of a crime of violence, where the defendant pleads that his actions were attributable to defending himself rather than to a desire to commit violence.

self-incrimination /ˌself ɪnˌkrɪmɪ 'neɪʃ(ə)n/ *noun* the act of incriminating yourself, of saying something which shows you are guilty □ **right against self-incrimination** right not to say anything, when questioned by the police, in case you may say something which could incriminate you

sell /sel/ *verb* to transfer the ownership of property to another person in exchange for money ○ *to sell cars* or *to sell refrigerators* ○ *to sell something on credit* ○ *They have decided to sell their house.* ○ *They tried to sell their house for £100,000.* ○ *Her house is difficult to sell.* ○ *Their products are easy to sell.* □ **to sell forward** to sell foreign currency, commodities, etc., for delivery at a later date

seller /'selə/ *noun* **1.** somebody who sells ○ *There were few sellers in the market, so prices remained high.* **2.** something which sells ○ *This book is a good seller.*

selling price /'selɪŋ praɪs/ *noun* the price at which someone is willing to sell

semble /'semb(ə)l/ *noun* a French word meaning 'it appears': word used in discussing a court judgment where there is some uncertainty about what the court intended

semi-autonomous /ˌsemi ɔː 'tɒnəməs/ *noun* with a limited amount of autonomy

senate /'senət/ *noun* **1.** an upper house of a legislative body ○ *France has a bicameral system: a lower house or Chamber of Deputies and a upper house or Senate.* **2.** *US* the upper house of the American Congress ○ *The US Senate voted against the proposal.* ○ *The Secretary of State appeared before the Senate Foreign Relations Committee.* **3.** the ruling body of a university, college or other institution

senator /'senətə/, **Senator** *noun* a member of a senate (NOTE: written with a

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Law.fm Page 273 Friday, June 11, 2004 2:08 PM

capital letter when used as a title: *Senator Jackson*)

senatorial /ˌsenəˈtɔːriəl/ *adjective* referring to a senate or to senators

COMMENT: The US Senate has 100 members, each state electing two senators by popular vote. Bills may be introduced in the Senate, with the exception of bills relating to finance. The Senate has the power to ratify treaties and to confirm presidential appointments to federal posts.

sender /ˈsendə/ *noun* somebody who sends a letter, parcel or message

senior /ˈsiːniə/ *adjective* **1.** more important **2.** having been employed in a job for longer than someone else

seniority /ˌsiːniˈɒrɪti/ *noun* **1.** the state of being older or more important than someone else ▫ **the managers were listed in order of seniority** the manager who had been an employee the longest or the manager with the most important job was put at the top of the list **2.** the fact of having been employed in a job for longer than someone else, often a reason for an employee to earn more pay than another, even if the two jobs are the same

senior manager /ˌsiːniə ˈmænɪdʒə/ *noun* a manager or director who has a higher rank than others

senior partner /ˌsiːniə ˈpɑːtnə/ *noun* somebody who has a large part of the shares in a partnership

sentence /ˈsentəns/ *noun* a legal punishment given by a court to a convicted person ○ *He received a three-year jail sentence.* ○ *The two men accused of rape face sentences of up to six years in prison.* ▫ **to pass sentence on someone** to give a convicted person the official legal punishment ○ *The jury returned a verdict of manslaughter and the judge will pass sentence next week.* ■ *verb* to give someone an official legal punishment ○ *The judge sentenced him to six months in prison* or *he was sentenced to six months' imprisonment.* ○ *The accused was convicted of murder and will be sentenced next week.* Compare **convict**

sentencer /ˈsentənsə/ *noun* a person such as a judge who can pass a legal sentence on someone

sentencing /ˈsentənsɪŋ/ *noun* the act of giving a judicial sentence to a defendant

separate property /ˌsep(ə)rət ˈprɒpəti/ *noun US* property owned by a husband and wife before their marriage (as opposed to 'community property'). Compare **community property**

separation /ˌsepəˈreɪʃ(ə)n/ *noun* **1.** an agreement between a husband and wife to live apart from each other **2.** *US* the act of leaving a job by resigning, retiring, being fired or made redundant **3.** the act of keeping things separate from each other

COMMENT: In the USA, the three parts of the power of the state are kept separate and independent: the President does not sit in Congress; Congress cannot influence the decisions of the Supreme Court, etc. In the UK, the powers are not separated, because Parliament has both legislative powers (it makes laws) and judicial powers (the House of Lords acts as a court of appeal); the government (the executive) is not independent and is responsible to Parliament which can outvote it and so cause a general election. In the USA, members of government are not members of Congress, though their appointment has to be approved by Senate; in the UK, members of government are usually Members of Parliament, although some are members of the House of Lords.

separation of powers /ˌsepəreɪʃ(ə)n əv ˈpaʊəs/ *noun* a system in which the power in a state is separated between the legislative body which passes laws, the judiciary which enforces the law, and the executive which runs the government

seq ➧ **et seq.**

sequester /sɪˈkwestə/, **sequestrate** /ˈsiːkwɪstreɪt, sɪˈkwestreɪt/ *verb* to take and keep property because a court has ordered it

sequestration /ˌsiːkweˈstreɪʃ(ə)n/ *noun* the taking and keeping of property on the order of a court, especially seizing property from someone who is in contempt of court ○ *His property has been kept under sequestration.*

sequestrator /ˈsiːkwɪstreɪtə, sɪˈkwestreɪtə/ *noun* somebody who takes

mainp - softvnn.com

Law.fm Page 274 Friday, June 11, 2004 2:08 PM

and keeps property on the order of a court

seriatim /ˌsɪəriˈeɪtɪm/ *Latin word meaning* 'one after the other in order'

Serious Fraud Office /ˌsɪərɪəs ˈfrɔːd ˌɒfɪs/ *noun* a government department in charge of investigating major fraud in companies. Abbreviation **SFO**

Serjeant ➧ **Common Serjeant**

serve /sɜːv/ *verb* **1.** to deal with (a customer), to do a type of work □ **to serve articles** to work in a solicitor's office as a trainee □ **to serve on a jury** to act as a member of a jury **2.** to give someone a legal document that requires them to do something ○ *They were served notice to quit the premises in two months' time.* □ **to serve someone with a writ**, **to serve a writ on someone** to give someone an official notice of a court case which has to be defended or judgment will be taken in the person's absence **3.** to spend a period of time in prison after being sentenced to imprisonment ○ *He served six months in a local jail.* ○ *She still has half her sentence to serve.* □ **to serve time** to spend a period of time in prison for a particular crime ○ *Her brother has served time for robbery.*

service /ˈsɜːvɪs/ *noun* □ **service (of process)**, **personal service** the delivery of a document such as a writ or summons to someone in person or to his or her legal representative □ **to acknowledge service** to confirm that a legal document such as a claim form has been received □ **service by an alternative method** serving a legal document on someone other than by the legally prescribed method, e.g. by posting it to the last known address, or by advertising

COMMENT: The Civil Procedure Rules give five methods of service of documents: (i) personal service (i.e. physically to a person himself); (ii) by first-class post; (iii) by sending or leaving the document at an address for service; (iv) by sending the document through a document exchange; (v) by fax or other electronic means, though this method is only used in certain circumstances, such as sending documents to a legal representative. Note also that under the new rules, documents are prepared and usually served by the court itself and not by one or other of the parties concerned.

service charge /ˈsɜːvɪs tʃɑːdʒ/ *noun* **1.** a charge made by a landlord to cover general work done to the property such as cleaning stairs or collecting rubbish **2.** a charge made in a restaurant for serving the customer

service contract /ˈsɜːvɪs ˌkɒntrækt/ *noun* same as **contract of employment**

servient /ˈsɜːviənt/ *adjective* being less important

servient owner /ˌsɜːviənt ˈəʊnə/ *noun* the owner of land over which someone else (the dominant owner) has a right to use a path

servient tenement /ˌsɜːviənt ˈtenəmənt/ *noun* land over which the owner (the servient owner) grants an easement to the owner (the dominant owner) of another property (the dominant tenement)

session /ˈseʃ(ə)n/ *noun* **1.** the period when a group of people meets ○ *The morning session will be held at 10.30 a.m.* □ **opening session**, **closing session** first part, last part of a conference **2.** the period during which formal meetings of a body are being held ○ *The Act was passed in the last session of Parliament* or *the last Parliamentary session.* (NOTE: The Parliamentary session starts in October with the Opening of Parliament and the Queen's Speech. It usually lasts until August. In the USA, a new congressional session starts on the 3rd of January each year.) □ **in session** taking place and carrying out the usual activities

COMMENT: The Parliamentary session starts in October with the Opening of Parliament and the Queen's Speech. It usually lasts until August. In the USA, a new congressional session starts on the 3rd of January each year.

sessional Select Committee /ˌseʃ(ə)n(ə)l sɪˌlekt kəˈmɪti/ *noun* a Select Committee set up at the beginning of each session of parliament ○ *the Select Committee on Defence* or *the Defence Select Committee*

sessions /ˈseʃ(ə)nz/ *plural noun* court

mainp - softvnn.com

Law.fm Page 275 Friday, June 11, 2004 2:08 PM

set /set/ *noun* □ **set (of chambers)** series of offices for a group of barristers who work together

set aside /ˌset əˈsaɪd/ *verb* to decide not to apply a decision, or to cancel an order, judgment or step taken by a party in legal proceedings ○ *The arbitrator's award was set aside on appeal.*

set down /ˌset ˈdaʊn/ *verb* to arrange for a trial to take place by putting it on one of the lists of trials ○ *Pleadings must be submitted to the court when the action is set down for trial.*

set forth /ˌset ˈfɔːθ/ *verb* to put down in writing ○ *The argument is set forth in the document from the European Court.*

set-off /ˈset ɒf/ *noun* a counterclaim by a defendant which should be deducted from the sum being claimed by the claimant

set out /ˌset ˈaʊt/ *verb* **1.** to put down in writing ○ *The claim is set out in the enclosed document.* ○ *The figures are set out in the tables at the back of the book.* **2.** to try to do something ○ *Counsel for the prosecution has set out to discredit the defence witness.*

settle /ˈset(ə)l/ *verb* **1.** □ **to settle an account** to pay what is owed □ **to settle a claim** to agree to pay what is asked for ○ *The insurance company refused to settle his claim for storm damage.* □ **the two parties settled out of court** the two parties reached an agreement privately without continuing the court case **2.** □ **to settle property on someone** to arrange for land to be passed to trustees to keep for the benefit of future owners **3.** to write out in final form ○ *Counsel is instructed to settle the defence.*

settled land /ˌset(ə)ld ˈlænd/ *noun* land which is subject of a settlement

settlement /ˈset(ə)lmənt/ *noun* **1.** payment of an account □ **our basic discount is 20% but we offer an extra 5% for rapid settlement** we take a further 5% off the price if the customer pays quickly **2.** an agreement reached after an argument □ **to effect a settlement between two parties** to bring two parties together and make them agree to a settlement □ **to accept something in full settlement** to accept money or service from a debtor and agree that it covers all the claim **3.** an arrangement where land is passed to trustees to keep for the benefit of future owners

settlement day /ˈset(ə)lmənt deɪ/ *noun* the day when accounts have to be settled

settle on /ˈset(ə)l ɒn/ *verb* to leave property to someone when you die ○ *He settled his property on his children.*

settlor /ˈset(ə)lə/ *noun* somebody who settles property on someone

sever /ˈsevə/ *verb* to split off from the rest ○ *The property was severed from the rest of his assets and formed a specific legacy to his friend.*

severable /ˈsev(ə)rəb(ə)l/ *adjective* being able to be divided off from the rest ○ *the deceased's severable share of a joint property*

several /ˈsev(ə)rəl/ *adjective* **1.** some ○ *Several judges are retiring this year.* ○ *Several of our clients have received long prison sentences.* **2.** separate

severally /ˈsev(ə)rəli/ *adverb* separately or not jointly □ **they are jointly and severally liable** they are liable both together as a group and as individuals

several tenancy /ˌsev(ə)rəl ˈtenənsi/ *noun* the holding of property by a number of people, each separately and not jointly with any other person

severance /ˈsev(ə)rəns/ *noun* **1.** the ending of a joint tenancy **2.** the ending of a contract of employment

severance pay /ˈsev(ə)rəns peɪ/ *noun* money paid as compensation to someone who is losing his or her job

sexual /ˈsekʃuəl/ *adjective* relating to the two sexes

sexual discrimination /ˌsekʃuəl dɪskrɪmɪˈneɪʃ(ə)n/ *noun* the unfair treatment of someone because of their sex, either before or after entering a contract of employment or during the course of their employment. It may be 'direct' or 'indirect'.

sexual intercourse /ˌsekʃuəl ˈɪntəkɔːs/ *noun* a sexual act between a man and a woman ○ *Sexual intercourse with a girl under sixteen is an offence.*

sexual offence /ˌsekʃuəl əˈfens/ *noun* criminal acts where sexual intercourse takes place, e.g. rape, incest

mainp - softvnn.com

Law.fm Page 276 Friday, June 11, 2004 2:08 PM

SFO *abbreviation* Serious Fraud Office

shady /'ʃeɪdi/ *adjective* not honest ○ *a shady deal*

sham /ʃæm/ *adjective* false or not true

share capital /'ʃeə ˌkæpɪt(ə)l/ *noun* the value of the assets of a company held as shares

share certificate /'ʃeə səˌtɪfɪkət/ *noun* a document proving that you own shares

shareholder /'ʃeəhəʊldə/ *noun* somebody who owns shares in a company

shareholders' agreement /ˌʃeəhəʊldəz ə'griːmənt/ *noun* an agreement showing the rights of shareholders in a company

shareholders' equity /ˌʃeəhəʊldəz 'ekwɪti/ *noun* the amount of a company's capital which is owned by shareholders

share option /'ʃeər ˌɒpʃən/ *noun* the right to buy or sell shares at a specific price at a time in the future

share quoted ex dividend /ʃeə ˌkwəʊtɪd eks 'dɪvɪdend/ *noun* a share price not including the right to receive the next dividend

sharp practice /ˌʃɑːp 'præktɪs/ *noun* a way of doing business which is not honest or fair, but is not illegal

sheriff /'ʃerɪf/ *noun* **1.** *US* an official in charge of justice in a county (NOTE: At federal level, the equivalent is a **marshal**.) **2.** (*in Scotland*) the chief judge in a district

Sheriff Court /'ʃerɪf kɔːt/ *noun* a court presided over by a sheriff

sheriff's sale /'ʃerɪfs ˌseɪl/ *noun* a public sale of the goods of a person whose property has been seized by the courts because he or she has defaulted on payments

shipper /'ʃɪpə/ *noun* a person who sends goods or who organises the sending of goods for other customers

shipping agent /'ʃɪpɪŋ ˌeɪdʒənt/ *noun* a company which specialises in the sending of goods

shipping company /'ʃɪpɪŋ ˌkʌmp(ə)ni/ *noun* a company which owns ships

shipwreck /'ʃɪprek/ *noun* the action of sinking or badly damaging a ship

shoot /ʃuːt/ *verb* **1.** to fire a gun **2.** to hit or kill a person or animal by firing a gun

shootout /'ʃuːtaʊt/ *noun* a fight between people who are using guns

shop /ʃɒp/ *verb* □ **to shop (for) something** to look for things in shops

shoplifter /'ʃɒplɪftə/ *noun* somebody who steals goods from shops ○ *At Christmas time gangs of shoplifters target the stores in Oxford Street.*

shoplifting /'ʃɒplɪftɪŋ/ *noun* the offence of stealing goods from shops, by taking them when the shop is open and not paying for them

Short Cause List /ˌʃɔːt 'kɔːz ˌlɪst/ *noun* the set of cases to be heard in the Queen's Bench Division which the judge thinks are not likely to take very long to hear

shorthand writer /ˌʃɔːthænd 'raɪtə/ *noun* somebody who takes down in shorthand evidence or a judgment given in court

shorthold tenancy /ˌʃɔːthəʊld 'tenənsi/ *noun* a protected tenancy for a limited period of less than five years

short lease /ˌʃɔːt 'liːs/ *noun* a lease which runs for up to two or three years ○ *to rent office space on a twenty-year lease* ○ *We have a short lease on our current premises.*

short sharp shock /ˌʃɔːt ˌʃɑːp 'ʃɒk/ *noun* formerly, a type of punishment for young offenders where they were subjected to harsh discipline for a short period in a detention centre

short title /ˌʃɔːt 'taɪt(ə)l/ *noun* the usual name by which an Act of Parliament is known

show of hands /ˌʃəʊ əv 'hændz/ *noun* a way of casting votes where people show how they vote by raising their hands ○ *The motion was carried on a show of hands.*

shrink-wrap licence /ʃrɪŋk ræp 'laɪs(ə)ns/, **license** /'laɪs(ə)ns/ *noun* a manufacturer's licence applied to software sold to a customer under which the manufacturer grants only limited warranty over the product

mainp - softvnn.com

Law.fm Page 277 Friday, June 11, 2004 2:08 PM

COMMENT: In general, the customer does not own the software he has bought, and the manufacturer has no liability for damages consequent on using the product.

SI *abbreviation* statutory instrument

sic /sɪk/ *noun* used to show that this was the way a word was actually written in the document in question even if it looks like a mistake ○ *The letter stated 'my legal adviser intends to apply for attack (sic) of earnings'.*

sick leave /ˈsɪk liːv/ *noun* a period when an employee is away from work because of illness

sight draft /ˈsaɪt drɑːft/ *noun* a bill of exchange which is payable when it is presented

signatory /ˈsɪgnət(ə)ri/ *noun* a person who signs an official document such as a contract ○ *You have to get the permission of all the signatories to the agreement if you want to change the terms.*

signature /ˈsɪgnɪtʃə/ *noun* **1.** a surname and personal name or initials written by person in the same typical way every time they sign a document so that it can be recognised as belonging only to that person ○ *a pile of letters waiting for the managing director's signature* ○ *The contract has been engrossed ready for signature.* ○ *A will needs the signature of the testator and two witnesses.* ○ *All the company's cheques need two signatures.* ◊ **electronic signature 2.** the action of signing a document ○ *Are the letters ready for signature yet?*

silk /sɪlk/ *noun* □ **a silk** a Queen's Counsel (*informal*) □ **to take silk** to become a QC

similiter /sɪˈmɪlɪtə/ *adverb* a Latin word meaning 'similarly' or 'in a similar way'

simple contract /ˌsɪmpəl ˈkɒntrækt/ *noun* a contract which is not under seal, but is made orally or in writing. Compare **contract under seal**

sine die /ˌsiːni ˈdiːeɪ/ *phrase* a Latin phrase meaning 'with no day' □ **the hearing was adjourned sine die** the hearing was adjourned without saying when it would meet again

sine qua non /ˌsɪni kwɑː ˈnɒn/ *phrase* a Latin phrase meaning 'without which nothing': condition without which something cannot work ○ *Agreement by the management is a sine qua non of all employment contracts.*

sinking fund /ˈsɪŋkɪŋ fʌnd/ *noun* a fund built up out of amounts of money put aside regularly to meet a future need

sit-down protest /ˈsɪt daʊn ˌprəʊtest/ *noun* an action by members of the staff who occupy their place of work and refuse to leave

sitting /ˈsɪtɪŋ/ *noun* a meeting of a court, tribunal or parliament (NOTE: There are four sittings in the legal year: **Michaelmas, Hilary, Easter** and **Trinity**.)

sittings /ˈsɪtɪŋz/ *plural noun* periods when courts sit

sitting tenant /ˌsɪtɪŋ ˈtenənt/ *noun* a tenant who is living in a house when the freehold or lease is sold

situate /ˈsɪtʃueɪtɪd/**, situated** *adjective* in a specific place ○ *a freehold property situated in the borough of Richmond*

situations vacant /ˌsɪtʃueɪʃ(ə)nz ˈveɪkənt/ *plural noun* a list of jobs which are available

skeleton /ˈskelɪt(ə)n/ *noun* the basic details of something

skeleton key /ˌskelɪt(ə)n ˈkiː/ *noun* a key which will fit several different doors in a building

skimming /ˈskɪmɪŋ/ *noun* the crime of fraudulently reusing the electronic information from a swiped credit card or payment card

slander /ˈslɑːndə/ *noun* an untrue spoken statement which damages someone's character. ◊ **defamation of character** □ **action for slander, slander action** case in a law court where someone says that another person had slandered him ■ *verb* □ **to slander someone** to damage someone's character by saying untrue things about him. Compare **libel**

slanderous /ˈslɑːnd(ə)rəs/ *adjective* being slander ○ *He made slanderous statements about the Prime Minister on television.*

slip /slɪp/ *noun* **1.** a small piece of paper, especially a note of the details of a marine insurance policy ○ *He handed a slip of paper to the person sitting next to*

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Law.fm Page 278 Friday, June 11, 2004 2:08 PM

him. **2.** a slip of paper used for a particular purpose ○ *a voting slip* **3.** a small mistake ○ *He made a couple of slips in repeating what he had said the day before.*

slip law /ˈslɪp lɔː/ *noun US* a law published for the first time after it has been approved, printed on a single sheet of paper or as a small separate booklet

slip rule /ˈslɪp ruːl/ *noun* the name for one of the Rules of the Supreme Court allowing minor errors to be corrected on pleadings

small ads /ˈsmɔːl ædz/ *plural noun* short private advertisements in a newspaper selling small items, offering or requesting jobs, etc.

small claim /ˌsmɔːl ˈkleɪm/ *noun* a claim for less than £5000 in the County Court

small claims court /ˌsmɔːl ˈkleɪmz ˌkɔːt/ *noun* a court which deals with disputes over small amounts of money

small claims track /ˌsmɔːl ˈkleɪmz ˌtræk/ *noun* the case management system which applies to claims under £5,000

COMMENT: The aim of the small claims track is to deal with disputes as rapidly as possible, especially where the litigants appear in person. Lawyers are discouraged, but lay representatives can appear. There is only a limited right of appeal in this track.

smuggle /ˈsmʌg(ə)l/ *verb* to take goods into or out of a country without declaring them to the customs ○ *They had to smuggle the spare parts into the country.*

smuggler /ˈsmʌglə/ *noun* somebody who smuggles

smuggling /ˈsmʌglɪŋ/ *noun* the offence of taking goods illegally into or out of a country, without paying any tax ○ *He made his money in arms smuggling.*

snatch squad /ˈsnætʃ skwɒd/ *noun* a group of police officers trained to find and arrest the leaders of groups causing public disorder

snatch theft /ˈsnætʃ θeft/ *noun* the theft of an item of personal property such as a bag or mobile phone in a public place

social advantage /ˌsəʊʃ(ə)l əd ˈvɑːntɪdʒ/ *noun* a benefit which some people are given, e.g. a bus pass given to a retired person or a special loan given to a family with many children

social class /ˌsəʊʃ(ə)l ˈklɑːs/ *noun* a group of people who have a position in society

social ownership /ˌsəʊʃ(ə)l ˈəʊnəʃɪp/ *noun* a situation where an industry is nationalised and run by a board appointed by the government

social worker /ˈsəʊʃ(ə)l ˌwɜːkə/ *noun* somebody who works in a social services department, visiting and looking after people who need help

SOCO /ˈsɒkəʊ/ *noun* a police officer responsible for collecting forensic evidence. Full form **scene of crime officer**

sodomy /ˈsɒdəmi/ *noun* same as **buggery**

soft loan /ˌsɒft ˈləʊn/ *noun* a loan from a company to an employee or from one government to another with no interest payable

sole /səʊl/ *adjective* only

solemn /ˈsɒləm/ *adjective* □ **solemn and binding agreement** agreement which is not legally binding, but which all parties are supposed to obey

sole owner /ˌsəʊl ˈəʊnə/ *noun* a person who owns a business and has no partners

sole trader /ˌsəʊl ˈtreɪdə/ *noun* a person who runs a business, usually without partners, but has not registered it as a company

solicit /səˈlɪsɪt/ *verb* **1.** □ **to solicit orders** to ask for orders, to try to get people to order goods **2.** to ask for something immoral, especially to offer to provide sexual intercourse for money

soliciting /səˈlɪsɪtɪŋ/ *noun* the offence of offering to provide sexual intercourse for money

solicitor /səˈlɪsɪtə/ *noun* a lawyer who has passed the examinations of the Law Society and has a valid certificate to practise, who gives advice to members of the public and acts for them in legal matters, and who may have right of audience in some courts □ **to instruct a solicitor** to give orders to a solicitor to act on your behalf □ **the Official Solicitor** solicitor

mainp - softvnn.com

Law.fm Page 279 Friday, June 11, 2004 2:08 PM

who acts in the High Court for parties who have no one to act for them, usually because they are under an official disability

COMMENT: Solicitors of ten years standing can be appointed as judges. Solicitor-advocates are fully qualified solicitors who have taken additional advocacy exams. Solicitor-advocates have the same rights of audience as barristers.

Solicitor-General /sə,lɪsɪtə 'dʒen(ə)rəl/ *noun* one of the law officers, a Member of the House of Commons and deputy to the Attorney-General

Solicitor-General for Scotland /sə ,lɪsɪtə ,dʒen(ə)rəl fə 'skɒtlənd/ *noun* a junior law officer in Scotland

solicitors' charges /sə'lɪsɪtəz ,tʃɑːdʒɪz/ *plural noun* payments to be made to solicitors for work done on behalf of clients

solitary confinement /,sɒlɪt(ə)ri kən'faɪnmənt/ *noun* the practice of keeping someone alone in a cell, without being able to see or speak to other prisoners ○ *He was kept in solitary confinement for six months.*

solus agreement /,səʊləs ə 'griːmənt/ *noun* an agreement where one party is linked only to the other party, especially an agreement where a retailer buys all their stock from a single supplier

solvency /'sɒlv(ə)nsi/ *noun* the ability to pay all debts. ◊ **insolvency**

solvent /'sɒlv(ə)nt/ *adjective* having enough money to pay debts ○ *When he bought the company it was barely solvent.* ■ *noun* a powerful glue

solvent abuse /'sɒlvənt ə,bjuːs/ *noun* the activity of sniffing solvent, which acts as a hallucinatory drug

SOSR *abbreviation* some other substantial reason

sought /sɔːt/ ◆ **seek**

sound /saʊnd/ *adjective* reliable, effective or thorough ○ *The company's financial situation is very sound.* ○ *The solicitor gave us some very sound advice.* ○ *The evidence brought forward by the police is not very sound.* □ **of sound mind** sane, mentally well ○ *He was of sound mind when he wrote the will.*

soundness /'saʊndnəs/ *noun* the fact of being reasonable

source /sɔːs/ *noun* a place where something comes from ○ *source of income* ○ *You must declare income from all sources to the Inland Revenue.* □ **income which is taxed at source** where the tax is removed before the income is paid

South-Eastern Circuit /saʊθ ,iːst(ə)n 'sɜːkɪt/ *noun* one of the six circuits of the Crown Court to which barristers belong, with its centre in London

sovereign /'sɒvrɪn/ *adjective* having complete freedom to govern itself

sovereign immunity /,sɒvrɪn ɪ 'mjuːnɪti/ *noun* immunity of a foreign head of state or former head of state from prosecution outside his or her country for crimes committed inside his or her country in the course of exercising public function

sovereign rights /,sɒvrɪn 'raɪts/ *noun* the rights of a state, which are limited by the application of EU law

Speaker /'spiːkə/ *noun* somebody who presides over a meeting of a parliament □ **discussions held behind the Speaker's chair** informal discussions between representatives of opposing political parties meeting on neutral ground away from the floor of the House

COMMENT: In the House of Commons, the speaker is an ordinary Member of Parliament chosen by the other members; the equivalent in the House of Lords is the Lord Chancellor. In the US Congress, the speaker of the House of Representatives is an ordinary congressman, elected by the other congressmen; the person presiding over meetings of the Senate is the Vice-President.

Speaker's Chaplain /,spiːkəz 'tʃæplɪn/ *noun* a priest who reads prayers at the beginning of each sitting of the House of Commons

special /'speʃ(ə)l/ *adjective* referring to one particular thing

special agent /,speʃ(ə)l 'eɪdʒənt/ *noun* **1.** a person who represents someone in a particular matter **2.** a person who does secret work for a government

Special Branch /'speʃ(ə)l brɑːnʃ/ *noun* a department of the British police which deals with terrorism

mainp - softvnn.com

Law.fm Page 280 Friday, June 11, 2004 2:08 PM

special constable /ˌspeʃ(ə)l ˈkʌnstəb(ə)l/ *noun* a part-time policeman who works mainly at weekends or on important occasions

special damages /ˌspeʃ(ə)l ˈdæmɪdʒɪz/ *plural noun* damages awarded by court to compensate for a loss such as the expense of repairing something, which can be calculated (NOTE: Damages are noted at the end of a report on a case as: *Special damages: £100; General damages: £2,500.*)

special deposits /ˌspeʃ(ə)l dɪ ˈpɒzɪts/ *plural noun* large sums of money which banks have to deposit with the Bank of England

special directions /ˌspeʃ(ə)l daɪ ˈrekʃənz/ *plural noun* instructions given by a court in a specific case, which are additional to the standard instructions

special indorsement /ˌspeʃ(ə)l ɪn ˈdɔːsmənt/ *noun* full details of a claim involving money, land or goods which a claimant is trying to recover

specialise /ˈspeʃəlaɪz/ *verb* **1.** to study one particular subject ○ *He specialised in employment cases.* **2.** to produce one thing in particular ○ *The company specialises in electronic components.* (NOTE: **specialised - specialising**)

special procedure /ˌspeʃ(ə)l prə ˈsiːdʒə/ *noun* a special system for dealing quickly with undefended divorce cases whereby the parties can obtain a divorce without the necessity of a full trial

special resolution /ˌspeʃ(ə)l ˌrezə ˈluːʃ(ə)n/ *noun* a resolution of the members of a company which is only valid if it is approved by 75% of the votes cast at a meeting

COMMENT: 21 days' notice that special resolution will be put to a meeting must be given. A special resolution might deal with an important matter, such as a change to the company's articles of association, a change of the company's name, or of the objects of the company.

special sessions /ˌspeʃ(ə)l ˈseʃ(ə)ns/ *plural noun* a Magistrates' Court for a district which is held for a special unusual reason

specialty contract /ˌspeʃ(ə)lti kən ˈtrækt/ *noun* a contract made under seal

specific devise /spəˌsɪfɪk dɪˈvaɪz/ *noun* devise of a specified property to someone

specific disclosure /spəˌsɪfɪk dɪs ˈkləʊʒə/ *noun* an order by a court for a party to disclose specific documents or to search for them and disclose them if they are found to exist

specific legacy /spəˌsɪfɪk ˈlegəsi/ *noun* a legacy of a specific item to someone in a will

specific performance /spəˌsɪfɪk pə ˈfɔːməns/ *noun* a court order to a party to carry out his or her obligations in a contract

specimen /ˈspesɪmɪn/ *noun* something which is given as a sample □ **to give specimen signatures on a bank mandate** to write the signatures of all people who can sign cheques on an account so that the bank can recognise them

speeding /ˈspiːdɪŋ/ *noun* an offence committed when driving a vehicle faster than the speed limit ○ *He was booked for speeding.*

spent conviction /ˌspent kən ˈvɪkʃən/ *noun* a conviction for which an accused person has been sentenced in the past and which must not be referred to in open court when trying a different case

sphere of influence /ˌsfɪə əv ˈɪnfluəns/ *noun* an area of the world where a very strong country can exert powerful influence over other states ○ *Some Latin American states fall within the USA's sphere of influence.*

splendid isolation /ˌsplendɪd ˌaɪsə ˈleɪʃ(ə)n/ *noun* a policy where a country refuses to link with other countries in treaties

spoils of war /ˌspɔɪlz əv ˈwɔː/ *plural noun* goods or valuables taken by an army from an enemy

spoilt ballot paper /spɔɪlt ˌbælət ˈpeɪpə/ *noun* a voting paper which has not been filled in correctly by the voter (NOTE: **spoiling – spoiled** *or* **spoilt**)

spokesperson /ˈspəʊksˌpɜːs(ə)n/ *noun* somebody who speaks in public on behalf of a group (NOTE: The word **spokesperson** is now often used, as it

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Law.fm Page 281 Friday, June 11, 2004 2:08 PM

avoids making a distinction between men and women.)

spot price /ˈspɒt praɪs/ *noun* the price for immediate delivery of a commodity

spouse /spaʊs/ *noun* **1.** a husband or wife **2.** a person who is married to another person

springing use /ˌsprɪŋɪŋ ˈjuːs/ *noun* a use which will come into effect if something happens in the future

spy /spaɪ/ *noun* somebody who tries to find out secrets about another country ○ *He spent many years as a spy for the enemy.* ○ *He was arrested as a spy.* ■ *verb* **1.** to watch another country secretly to get information ○ *She was accused of spying for the enemy.* **2.** to see □ **I spy strangers** words said by an MP when he or she wants to tell the Speaker to clear the public galleries

squad /skwɒd/ *noun* **1.** a special group of police **2.** a special group of soldiers or workers

squad car /ˈskwɒd kɑː/ *noun* a police patrol car

square measure /ˌskweə ˈmeʒə/ *noun* area in square feet or metres, calculated by multiplying width and length

squat /skwɒt/ *verb* to occupy premises belonging to another person unlawfully and without title or without paying rent (NOTE: **squatting – squatted**)

squatter /ˈskwɒtə/ *noun* somebody who squats in someone else's property

COMMENT: If a squatter has lived on the premises for a long period (over 12 years) and the owner has not tried to evict him or her, he or she may have rights over the premises.

squatter's rights /ˈskwɒtəz ˌraɪts/ *plural noun* rights of a person who is squatting in another person's property to remain in unlawful possession of premises until ordered to leave by a court

squeal /skwiːl/ *verb* to inform the police about other criminals (*slang*)

squire /ˈskwaɪə/ *noun US* a local legal official such as a magistrate

stabvest /ˈstæbvest/ *noun* a padded waistcoat, designed to protect a police or security officer against attacks with knives

staff turnover /ˌstɑːf ˈtɜːnəʊvə/ *noun* the regular changes in staff that occur in a workplace, when some leave and others join

stakeholder /ˈsteɪkhəʊldə/ *noun* **1.** someone with a personal interest in how something happens **2.** a person or group of people who have invested in and own part of a business **3.** a person who holds money impartially, such as money deposited by one of the parties to a wager, until it has to be given it up to another party

stakeholder pension /ˈsteɪkhəʊldə ˌpenʃən/ *noun* a pension scheme available to employees through their employer, although the employer does not have to contribute any funds to it

stamp duty /ˈstæmp ˌdjuːti/ *noun* a tax on documents recording legal activities such as the conveyance of a property to a new owner or the contract for the purchase of shares

stamped addressed envelope /ˌstæmpd əˌdresd ˈenvələʊp/ *noun* an envelope with your own address written on it and a stamp stuck on it to pay for the return postage

stand /stænd/ *noun* **1.** an active campaign against something ○ *the government's stand against racial prejudice* ○ *The police chief criticised the council's stand on law and order.* **2.** the position of a member of Congress on a question (either for or against) **3.** □ **to take the stand** to go into the witness box to give evidence ■ *verb* **1.** to offer yourself as a candidate in an election ○ *He stood as a Liberal candidate in the General Election.* ○ *He is standing against the present deputy leader in the leadership contest.* ○ *She was persuaded to stand for parliament.* ○ *He has stood for office several times, but has never been elected.* **2.** to exist, to be in a state ○ *The report stood referred to the Finance Committee.* (NOTE: **standing – stood**)

standard /ˈstændəd/ *noun* the normal quality or normal conditions against which other things are judged □ **production standards** quality of production □ **up to standard** of acceptable quality

mainp - softvnn.com

Law.fm Page 282 Friday, June 11, 2004 2:08 PM

standard agreement /ˌstændəd ə ˈgriːmənt/ *noun* a normal printed contract form

standard directions /ˌstændəd daɪ ˈrekʃənz/ *plural noun* directions as laid out in the practice direction for a particular track

standard disclosure /ˌstændəd dɪs ˈkləʊʒə/ *noun* a statement by a party about the existence of documents which will support his case, or which do not support his case, or which will support the case of the other party

standard form contract /ˌstændəd fɔːm ˈkɒntrækt/ *noun* a contract which states the conditions of carrying out a common commercial arrangement such as chartering a ship

standard letter /ˌstændəd ˈletə/ *noun* a letter which is sent with only minor changes to various correspondents

standard of living /ˌstændəd əv ˈlɪvɪŋ/ *noun* a quality of personal home life such as amount of food or clothes bought or the size of a family car

standard rate /ˈstændəd reɪt/ *noun* a general level of tax such as the level of income tax which is paid by most taxpayers or the level of VAT which is levied on most goods and services

Standard Time /ˈstændəd taɪm/ *noun* normal time as in the winter months

stand down /ˌstænd ˈdaʊn/ *verb* to withdraw your name from an election ○ *The wife of one of the candidates is ill and he has stood down.*

standi ➧ **locus standi**

stand in for /ˌstænd ˈɪn fɔː/ *verb* to take the place of someone ○ *Mr Smith is standing in for the chairman who is away on holiday.*

standing /ˈstændɪŋ/ *adjective* permanent ■ *noun* good reputation ○ *the financial standing of a company*

standing committee /ˈstændɪŋ kəˌmɪti/ *noun* a permanent committee which deals with matters not given to other committees, e.g. a parliamentary committee which examines Bills not sent to other committees

standing orders /ˌstændɪŋ ˈɔːdəz/ *plural noun* rules or regulations which control the conduct of any official institution or committee

stand over /ˌstænd ˈəʊvə/ *verb* to adjourn ○ *The case has been stood over to next month.*

Star Chamber /ˈstɑː ˌtʃeɪmbə/ *noun* formerly, a royal court which tried cases without a jury

stare decisis /ˌstɑːreɪ dɪˈsaɪsɪs/ *phrase* a Latin phrase meaning 'stand by preceding decisions': principle that courts must abide by precedents set by judgments made in higher courts

state /steɪt/ *noun* **1.** a semi-independent section of a federal country such as the USA **2.** the government of a country □ **offence against the state** an act of attacking the lawful government of a country, e.g. sedition, treason ■ *verb* to say clearly ○ *The document states that all revenue has to be declared to the tax office.*

state capital /ˌsteɪt ˈkæpɪt(ə)l/ *noun* the main town in a state or province

State Capitol /ˌsteɪt ˈkæpɪt(ə)l/ *noun* in the USA, a building which houses the State legislature in the main city of a state

state-controlled /ˈsteɪt kənˌtrəʊld/ *adjective* run by the state ○ *state-controlled television*

state enterprise /ˌsteɪt ˈentəpraɪz/ *noun* a company run by the state ○ *The bosses of state industries are appointed by the government.*

stateless person /ˌsteɪtləs ˈpɜːs(ə)n/ *noun* somebody who is not a citizen of any state

statement /ˈsteɪtmənt/ *noun* **1.** an announcement of something in public ○ *The company issued a statement denying the allegations.* ○ *The celebrity's manager made a brief statement to the press.* **2.** a formal account of what happened or what was seen at a particular time, given to the police who are investigating a crime □ **to make a statement** to give details of something to the police □ **to make a false statement** to give wrong details to the police about something that happened or was seen **3.** the presentation of information about something □ **statements of case** (*in a civil court*) docu-

mainp - softvnn.com

Law.fm Page 283 Friday, June 11, 2004 2:08 PM

ments relating to a claim, including the claim form, the particulars of claim, the defence and counterclaim, the reply and the defence to the counterclaim □ **statement of claim** a pleading containing details of a claimant's case and the relief sought against the defendant □ **statement of truth** a statement attached to a claim form or the particulars of claim by which the claimant or defendant states that he believes that the facts given are true (if it can be proved that he signed the statement without believing it to be true, he is guilty of contempt of court) □ **statement of value** a document filed by the claimant as part of his claim, detailing the value of the claim, or a document filed by the defendant giving his estimate of value in reply to the claim **4.** a document that shows the amount of money in a bank account or information about business accounts ○ *a financial statement* ○ *a monthly statement*

statement of account /ˌsteɪtmənt əv əˈkaʊnt/ *noun* a list of invoices and credits and debits sent by a supplier to a customer at the end of each month

statement of affairs /ˌsteɪtmənt əv əˈfeəz/ *noun* an official statement made by an insolvent company, listing its assets and liabilities

statement of claim /ˌsteɪtmənt əv ˈkleɪm/ *noun* ♦ **particulars of claim** (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has been replaced by **particulars of claim**.)

Statement of Means /ˌsteɪtmənt əv ˈmiːnz/ *noun* a statement showing the financial position of the claimant, attached to an application for Legal Aid

statement of truth /ˌsteɪtmənt əv ˈtruːθ/ *noun* a statement attached to a claim form or the particulars of a claim by which the claimant or defendant states that he or she believes that the facts given are true. If it can be proved that the statement was signed without believing it to be true, the claimant is guilty of contempt of court.

statement of value /ˌsteɪtmənt əv ˈvæljuː/ *noun* a document filed by the claimant as part of a claim, detailing the value of the claim, or a document filed by the defendant giving an estimate of value in reply to the claim

statements of case /ˌsteɪtmənts əv ˈkeɪs/ *plural noun* documents relating to a claim, including the claim form, the particulars of claim, the defence and counterclaim, the reply and the defence to the counterclaim (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has replaced **pleadings**.)

state of indebtedness /ˌsteɪt əv ɪn ˈdetɪdnəs/ *noun* the state of owing money

state of repair /ˌsteɪt əv rɪˈpeə/ *noun* the physical condition of something ○ *The house was in a bad state of repair when he bought it.*

State of the Union message /steɪt əv ðə ˌjuːnjən ˈmesɪdʒ/ *noun US* an annual speech by the President of the USA which summarises the political situation in the country

States of the Union /ˌsteɪts əv ðə ˈjuːnjən/ *plural noun* the states joined together to form the United States of America

statistical discrepancy /stə ˌtɪstɪk(ə)l dɪˈskrepənsi/ *noun* the amount by which two sets of figures differ

statistics /stəˈtɪstɪks/ *plural noun* study of facts in the form of figures ○ *He asked for the birth statistics for 1998.* ○ *Council statistics show that the amount of rented property in the borough has increased.* ○ *Government trade statistics show that exports to the EC have fallen over the last six months.*

status inquiry /ˈsteɪtəs ɪnˌkwaɪəri/ *noun* a request for a check on a customer's credit rating

status quo /ˌsteɪtəs ˈkwəʊ/ *noun* the state of things as they are now ○ *The contract does not alter the status quo.*

status quo ante /ˌsteɪtəs ˌkwəʊ ˈænti/ *noun* the situation as it was before

statute /ˈstætʃuːt/ *noun* an established written law, especially an Act of Parliament

statute-barred /ˌstætʃuːt ˈbɑːd/ *adjective* being unable to take place be-

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Law.fm Page 284 Friday, June 11, 2004 2:08 PM

cause the time laid down in the statute of limitations has expired

statute book /'stætʃuːt bʊk/ *noun* all laws passed by Parliament which are still in force

statute of limitations /ˌstætʃuːt əv ˌlɪmɪ'teɪʃ(ə)nz/ *noun* a law which allows only a certain amount of time (usually six years) for someone to start legal proceedings to claim property or compensation for damage, etc.

statutorily /'stætʃʊt(ə)rɪli/ *adverb* by statute ○ *a statutorily protected tenant*

statutory /'stætʃʊt(ə)ri/ *adjective* fixed by law or by a statute ○ *powers conferred on an authority by the statutory code* ○ *There is a statutory period of probation of thirteen weeks.* ○ *The authority has a statutory obligation to provide free education to all children.*

statutory books /ˌstætʃʊt(ə)ri 'bʊks/ *plural noun* official registers which a company must keep

statutory declaration /ˌstætʃʊt(ə)ri ˌdeklə'reɪʃ(ə)n/ *noun* **1.** a statement made to the Registrar of Companies that a company has complied with certain legal conditions **2.** a declaration signed and witnessed for official purposes

statutory duty /ˌstætʃʊt(ə)ri 'djuːti/ *noun* a duty which someone must perform and which is laid down by statute

statutory holiday /ˌstætʃʊt(ə)ri 'hɒlɪdeɪ/ *noun* a holiday which is fixed by law

statutory instrument /ˌstætʃʊt(ə)ri 'ɪnstrʊmənt/ *noun* an order with the force of law made under authority granted to a minister by an Act of Parliament. Abbreviation **SI**

statutory legacy /ˌstætʃʊt(ə)ri 'legəsi/ *noun* the amount of money which is distributed to a surviving spouse of a person who dies intestate and has other surviving relatives but no surviving children

statutory trust /ˌstætʃʊt(ə)ri 'trʌst/ *noun* an arrangement for holding property on behalf of the children of a person who has died intestate

statutory undertakers /ˌstætʃʊt(ə)ri ˌʌndə'teɪkəz/ *plural noun* bodies formed by statute and having legal duties to provide services such as gas, electricity or water

statutory will /ˌstætʃʊt(ə)ri 'wɪl/ *noun* a will made on behalf of a person who is judged unable to do so themselves on the instructions of the Court of Protection

stay /steɪ/ *noun* the temporary stopping of an order made by a court ■ *verb* to stop an action temporarily ○ *The defendant made an application to stay the proceedings until the claimant gave security for costs.* ○ *One of the parties asked for the action to be stayed for a month to allow for a settlement to be attempted.*

stay away order /ˌsteɪ ə'weɪ ˌɔːdə/ *noun* a court order that tells someone to have no contact or communication with another person

stay of execution /ˌsteɪ əv eksɪ 'kjuːʃ(ə)n/ *noun* a temporary prevention of someone from enforcing a judgment ○ *The court granted the company a two-week stay of execution.* ○ *The stay was extended for a further four weeks.*

stay of proceedings /ˌsteɪ əv prə 'siːdɪŋz/ *noun* the stopping of a case which is being heard ○ *Proceedings will continue when the stay is lifted.*

steal /stiːl/ *verb* to take something which does not belong to you ○ *Two burglars broke into the office and stole the petty cash.* ○ *One of our managers left to form her own company and stole the list of our clients' addresses.* ○ *One of our biggest problems is stealing in the wine department.* □ **handling, receiving stolen goods** the offence of dealing with goods (receiving them or selling them) which you know to have been stolen

stealing /'stiːlɪŋ/ *noun* the crime of taking property which belongs to someone else □ **going equipped for stealing** notifiable offence of carrying tools which could be used for burglary

steaming /'stiːmɪŋ/ *noun* an offence committed by a group of youths, usually unarmed, who rush down a street or through a public place such as a department store, stealing items and harassing people

mainp - softvnn.com

Law.fm Page 285 Friday, June 11, 2004 2:08 PM

stenographer /stə'nɒgrəfə/ *noun* an official person who can write in shorthand and so take records of what is said in court

step- /step/ *prefix* showing a family relationship through a parent who has married again

stepfather /'stepfɑːðə/ *noun* a man who has married a child's mother but is not the natural father of the child

stepmother /'stepmʌðə/ *noun* a woman who has married a child's father but is not the natural mother of the child

stepparent /'step,peərənt/ *noun* a stepfather or stepmother

stinger /'stɪŋə/ *noun* a device covered in spikes that can be thrown across a road to puncture a car's tyres if the police want to stop someone

stipendiary magistrate /staɪ ,pendiəri 'mædʒɪstreɪt/ *noun* a magistrate who is a qualified lawyer and who receives a salary (as opposed to an unpaid Justice of the Peace). Compare **lay magistrate** (NOTE: Now called **District Judge** *or* **Senior District Judge**.)

stipulate /'stɪpjʊleɪt/ *verb* to demand that a condition be put into a contract ○ *to stipulate that the contract should run for five years* ○ *to pay the stipulated charges* ○ *The company failed to pay on the stipulated date* or *on the date stipulated in the contract.* ○ *The contract stipulates that the seller pays the buyer's legal costs.*

stipulation /,stɪpjʊ'leɪʃ(ə)n/ *noun* a condition in a contract

stirpes ➧ **per stirpes**

stirpital /'stɜːpɪt(ə)l/ *adjective* referring to an entitlement which is divided among branches of a family rather than among individuals ○ *The judge placed a stirpital construction on the rule that children of a deceased person dying intestate must bring interest received from that person into hotchpot.*

stock /stɒk/ *noun* □ **in stock**, **out of stock** available or not available in the warehouse or store

stockbroking /'stɒkbrəʊkɪŋ/ *noun* the trade of dealing in shares for clients ○ *a stockbroking firm*

stock certificate /'stɒk sə,tɪfɪkət/ *noun* a document proving that someone owns shares in a company

Stock Exchange listing /'stɒk ɪks ,tʃeɪndʒ ,lɪstɪŋ/ *noun* an official list of shares which can be bought or sold on the Stock Exchange

Stock Exchange operation /,stɒk ɪks,tʃeɪndʒ ,ɒpə'reɪʃ(ə)n/ *noun* buying or selling of shares on the Stock Exchange

stock market manipulator /,stɒk ,mɑːkɪt mə'nɪpjʊleɪtə/ *noun* somebody who tries to influence the price of shares in his or her own favour

stock market valuation /,stɒk ,mɑːkɪt ,vælju'eɪʃ(ə)n/ *noun* the value of shares based on the current market price

stock movements /'stɒk ,muːvmənts/ *plural noun* passing of stock into or out of the warehouse

stock option /'stɒk ,ɒpʃən/ *noun* the right to buy shares at a cheap price given by a company to its employees

stock transfer form /,stɒk 'trænsfɜː fɔːm/ *noun* a form to be signed by the person transferring shares to another

stock valuation /,stɒl vælju 'eɪʃ(ə)n/ *noun* estimation of the value of stock at the end of an accounting period

stolen goods /,stəʊlən 'gʊdz/ *plural noun* goods which have been stolen

stop and search /stɒp ən sɜːtʃ/, **stop and frisk** *US* /stɒp ən frɪsk/ *noun* the power held by a police officer to stop anyone and search them, even though there is no evidence that the person has committed any offence

storm damage /'stɔːm ,dæmɪdʒ/ *noun* damage caused by a storm

straight /streɪt/ *adjective* not dishonest □ **to play straight**, **to act straight with someone** to act honestly with someone □ **to go straight** to stop criminal activities

stranger crime /'streɪndʒə ,kraɪm/ *noun* a violent crime in which the attacker is someone whom the victim does not know

street crime /'striːt kraɪm/ *noun* criminal activity in a public place, espe-

mainp - softvnn.com

Law.fm Page 286 Friday, June 11, 2004 2:08 PM

cially an urban area, especially theft of personal possessions or cars, or the illegal possession or use of firearms

street vendor /ˈstriːt ˌvendə/ *noun* somebody who sells food or small items in the street

strict liability /strɪkt ˌlaɪəˈbɪlɪti/ *noun* total liability for an offence which has been committed whether you are at fault or not

strife /straɪf/ *noun* violent public arguments and disorder

strike /straɪk/ *noun* **1.** the activity of stopping work because of inability to reach agreement with management or because of orders from a union **2.** □ **to take strike action** to go on strike ■ *verb* **1.** to stop working because there is no agreement with management ○ *to strike for higher wages* or *for shorter working hours* ○ *to strike in protest against bad working conditions* **2.** to hit someone or something ○ *Two policemen were struck by bottles.* ○ *He was struck on the head by a cosh.* **3.** □ **to strike from the record** to remove words from the written minutes of a meeting because they are incorrect or offensive ○ *The chairman's remarks were struck from the record.*

strike off /ˌstraɪk ˈɒf/ *verb* to delete a name or item from a list or record □ **to strike someone off the rolls** to stop a solicitor from practising by removing his or her name from the list of solicitors

strike out /ˈstraɪk aʊt/ *verb* **1.** to delete a word or words from a document □ **to strike out the last word** *US* way of getting permission of the chair to speak on a question, by moving that the last word of the amendment or section being discussed should be deleted **2.** to order something written to be deleted, so that it no longer forms part of the case ○ *to strike out a pleading* or *a statement of case* ○ *A party can apply for a statement of case to be struck out if it is not verified.* ○ *A court may strike out a statement of case if it appears that the statement shows no grounds for bringing the claim.*

strip search /ˈstrɪp sɜːtʃ/ *noun* the searching of a person after he or she has removed their clothes (strip searches should be carried out by a doctor or nurse, or at least by a police officer of the same sex as the person being searched) (NOTE: Strip searches should be carried out by a doctor or nurse, or at least by a police officer of the same sex as the person being searched.)

strongbox /ˈstrɒŋbɒks/ *noun* a heavy metal box which cannot be opened easily, in which valuable documents, money, etc., can be kept

strongroom /ˈstrɒŋruːm/ *noun* a special room in a bank where valuable documents, money, gold, etc., can be kept

STV *abbreviation* single transferable vote

sub- /sʌb/ *prefix* less important

sub-agency /ˈsʌb ˌeɪdʒənsɪ/ *noun* a small agency which is part of a large agency

sub-agent /ˈsʌb ˌeɪdʒənt/ *noun* somebody who is in charge of a sub-agency

sub-clause /ˌsʌb ˈklɔːz/ *noun* part of a clause in a Bill being considered by Parliament, which will become a sub-section when the Bill becomes an Act

sub-committee /ˈsʌb kəˌmɪti/ *noun* a small committee which reports on a special subject to a main committee ○ *He is chairman of the Finance Sub-Committee.*

subcontract *noun* /ˈsʌbˌkɒntrækt/ a contract between the main contractor for a whole project and another firm who will do part of the work ○ *They have been awarded the subcontract for all the electrical work in the new building.* ○ *We will put the electrical work out to subcontract.* ■ *verb* /ˌsʌbkənˈtrækt/ to agree with a company that they will do part of the work for a project ○ *The electrical work has been subcontracted to Smith Ltd.*

subcontractor /ˈsʌbkənˌtræktə/ *noun* a company which has a contract to do work for a main contractor

subject /ˈsʌbdʒɪkt/ *noun* **1.** what something is concerned with ○ *The subject of the action was the liability of the defendant for the claimant's injuries.* **2.** somebody who is a citizen of a country and bound by its laws ○ *He is a British subject.* ○ *British subjects do not need visas to visit Common Market countries.* □

mainp - softvnn.com

Law.fm Page 287 Friday, June 11, 2004 2:08 PM

liberty of the subject the right of a citizen to be free unless convicted of a crime which is punishable by imprisonment

subject to /ˈsʌbdʒɪkt tə/ *adjective* **1.** depending on ▫ **the contract is subject to government approval** the contract will be valid only if it is approved by the government ▫ **agreement**, **sale subject to contract** agreement or sale which is not legal until a proper contract has been signed ▫ **offer subject to availability** the offer is valid only if the goods are available **2.** being able to receive ▫ **these articles are subject to import tax** import tax has to be paid on these articles

sub judice /ˌsʌb ˈdʒuːdɪsi/ *phrase* a Latin phrase meaning 'under the law': being considered by a court and so not decided (NOTE: Cases which are 'sub judice' cannot be mentioned in the media or in Parliament if the mention is likely to prejudice the trial, and so would constitute contempt of court.)

sublease *noun* /ˈsʌbliːs/ a lease from a tenant to another tenant ■ *verb* /sʌb ˈliːs/ to lease a leased property from another tenant ○ *They subleased a small office in the centre of town.*

sublessee /ˌsʌbleˈsiː/ *noun* a person or company which holds a property on a sublease

sublessor /ˌsʌbleˈsɔː/ *noun* a tenant who lets a leased property to another tenant

sublet /sʌbˈlet/ *verb* to let a leased property to another tenant ○ *We have sublet part of our office to a financial consultancy.* (NOTE: **subletting – sublet – has sublet**)

submission /səbˈmɪʃ(ə)n/ *noun* **1.** a statement made to a judge or other person considering a case ○ *The court heard the submission of defence counsel that there was no case to answer.* or *In the submission of defence counsel there was no case to answer.* **2.** a document outlining a proposal given to someone who has to make a decision about it ○ *The deadline for submissions is the end of June.* **3.** the process of presenting something for consideration **4.** the state of giving in or having to obey someone

submit /səbˈmɪt/ *verb* **1.** to put something forward to be examined ○ *to submit a proposal to the committee* ○ *She submitted a claim to the insurers.* **2.** to plead an argument in court ○ *Counsel submitted that the defendant had no case to answer.* ○ *It was submitted that the right of self-defence can be available only against unlawful attack.* **3.** to agree to be ruled by something ○ *He refused to submit to the jurisdiction of the court.* (NOTE: **submitting – submitted**)

subornation of perjury /ˌsʌbɔːneɪʃ(ə)n əv ˈpɜːdʒəri/ *noun* the offence of getting someone to commit perjury

subpoena /səˈpiːnə/ *noun* a court order requiring someone to appear in court ■ *verb* to order someone to appear in court ○ *The finance director was subpoenaed by the prosecution.*

subpoena ad testificandum /sə ˌpiːnə æd ˌtestɪfɪˈkændəm/ *noun* a court order requiring someone to appear as a witness

subpoena duces tecum *noun* a court order requiring someone to appear as a witness and bring with them documents relevant to the case (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, these terms have been replaced by **witness summons**.)

subrogation /ˌsʌbrəʊˈgeɪʃ(ə)n/ *noun* a legal principle whereby someone stands in the place of another person and acquires that person's rights and is responsible for that person's liabilities

subscribe /səbˈskraɪb/ *verb* **1.** ▫ **to subscribe to a magazine** to pay for a series of issues of a magazine **2.** ▫ **to subscribe for shares** to apply to buy shares in a new company

sub-section /ˈsʌb ˌsekʃən/ *noun* a part of a section of a document such as an Act of Parliament ○ *You will find the information in sub-section 3 of Section 47.*

subsequent /ˈsʌbsɪkwənt/ *adjective* following because of something

subsidiarity /səbˌsɪdiˈærɪti/ *noun* (*in the EU*) a principle that the Community shall only decide on matters which are better decided at Community level than at the level of the individual Member States and that other matters shall be left

mainp - softvnn.com

Law.fm Page 288 Friday, June 11, 2004 2:08 PM

to each Member State to decide (NOTE: Subsidiarity only operates in those areas where the EU does not have exclusive jurisdiction.)

subsidiary /səb'sɪdiəri/ *adjective* related to, but less important than, something else ○ *He faces one serious charge and several subsidiary charges arising out of the main charge.*

subsidiary company /səbˌsɪdiəri 'kʌmp(ə)ni/ *noun* a company which is owned by a parent company

subsidise /'sʌbsɪdaɪz/, **subsidize** *verb* to help by giving money ○ *The government has refused to subsidise the car industry.*

subsidised accommodation /ˌsʌbsɪdaɪzd əˌkɒmə'deɪʃ(ə)n/ *noun* cheap accommodation which is partly paid for by someone else such as an employer or a local authority

substance /'sʌbstəns/ *noun* **1.** a drug, solvent, gas or other material on which someone can become dependent or which can cause harm ○ *regulations on the transport of dangerous substances such as corrosive chemicals* ○ *illegal substances* ◊ **controlled drug 2.** the real basis of a report or argument ○ *There is no substance to the stories about his resignation.*

substance abuse /'sʌbstəns əˌbjuːs/ *noun* the practice of drinking too much alcohol or using illegal drugs or other substances

substantive /səb'stæntɪv/ *adjective* real or actual

substantive law /ˌsʌbstəntɪv 'lɔː/ *noun* all laws including common law and statute law which deal with legal principles (as opposed to procedural law which refers to the procedure for putting law into practice). Compare **procedural law**

substantive motion /səbˌstæntɪv 'məʊʃ(ə)n/ *noun* a motion which is complete in itself

substantive offence /ˌsʌbstəntɪv ə 'fens/ *noun* an offence which has actually taken place

substitute /'sʌbstɪtjuːt/ *noun* somebody or something which takes the place of someone or something else ■ *verb* **1.** to take the place of something else **2.** to put something in the place of something else ○ *They made an application to substitute a party, but the claimant refused his consent.*

substituted service /ˌsʌbstɪtjuːtɪd 'sɜːvɪs/ *noun* serving a legal document on someone other than by the legally prescribed method, e.g. by posting it to the last known address, or by advertising in the press (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has been replaced by **service by an alternative method**.)

substitution /ˌsʌbstɪ'tjuːʃ(ə)n/ *noun* an act of putting something or someone in the place of something else ○ *The substitution of a party may take place if the court agrees that the original party was named by mistake.*

substitutionary /ˌsʌbstɪ 'tjuːʃ(ə)n(ə)ri/ *adjective* acting as a substitute ○ *He made a will leaving everything to his wife, but with the substitutionary provision that if she died before him, his estate devolved on their children.*

subtenancy /sʌb'tenənsi/ *noun* an agreement to sublet a property

subtenant /sʌb'tenənt/ *noun* a person or company to which a property has been sublet

subversive /səb'vɜːsɪv/ *adjective* acting secretly against the government ○ *The police is investigating subversive groups in the student organisations.*

success fee /sək'ses fiː/ *noun* a fee which is only paid to a lawyer if the case he or she has taken has been successful for his or her client

succession /sək'seʃ(ə)n/ *noun* the act of acquiring property or title from someone who has died

successor /sək'sesə/ *noun* somebody who takes over from someone ○ *Mr Smith's successor as chairman will be Mr Jones.*

sue /sjuː/ *verb* to start legal proceedings against someone to get compensation for a wrong ○ *to sue someone for damages* ○ *He is suing the company for £50,000 compensation.*

sufferance /'sʌfərəns/ *noun* an agreement to something which is not

mainp - softvnn.com

Law.fm Page 289 Friday, June 11, 2004 2:08 PM

stated, but assumed because no objection has been raised ○ *He has been allowed to live in the house on sufferance.*

suffrage /ˈsʌfrɪdʒ/ *noun* the right to vote in elections

suggestion box /səˈdʒestʃən bɒks/ *noun* a place in a company where members of staff can put forward their ideas for making the company more efficient and profitable

suicide /ˈsuːɪsaɪd/ *noun* **1.** the act of killing yourself ○ *The police are treating the death as suicide, not murder.* □ **to commit suicide** to kill yourself ○ *After shooting his wife, he committed suicide in the bedroom.* **2.** somebody who has committed suicide

COMMENT: Aiding suicide is a notifiable offence.

suicide pact /ˈsuːɪsaɪd pækt/ *noun* an agreement between two or more people that they will all commit suicide at the same time

sui generis /ˌsuːaɪ ˈdʒenərɪs/ *phrase* a Latin phrase meaning 'of its own right': being in a class of its own

sui juris /ˌsuːaɪ ˈdʒʊərɪs/ *phrase* a Latin phrase meaning 'in one's own right': legally able to make contracts and sue others or be sued. Compare **alieni juris**

suit /suːt/ *noun* a civil legal case

sum /sɒm/ *verb* □ **to sum up** (*of a judge*) to speak at the end of a trial and review all the evidence and arguments for the benefit of the jury

summarily /ˈsʌmərɪli/ *adverb* immediately ○ *Magistrates can try a case summarily or refer it to the Crown Court.*

summarise /ˈsʌməraɪz/ *verb* to write or give a short account of what has been said or what happened (NOTE: **summarised – summarising**)

summary /ˈsʌməri/ *noun* a short account of what has happened or of what has been written ○ *The chairman gave a summary of his discussions with the German delegation.* ○ *The police inspector have a summary of events leading to the raid on the house.* ■ *adjective* happening immediately

summary arrest /ˌsʌməri əˈrest/ *noun* an arrest without a warrant

summary conviction /ˌsʌməri kən ˈvɪkʃən/ *noun* a conviction by a magistrate sitting without a jury

summary dismissal /ˌsʌməri dɪs ˈmɪs(ə)l/ *noun* the dismissal of an employee without giving the notice stated in the contract of employment

summary judgment /ˌsʌməri ˈdʒʌdʒmənt/ *noun* an immediate judgment of a case without a trial. This can be decided by the court itself or can be applied for by a party believing the opposing party has no real chance of succeeding with the case.

summary jurisdiction /ˌsʌməri ˌdʒʊərɪsˈdɪkʃən/ *noun* the power of a magistrates' court to try a case without a jury or to try a case immediately without referring it to the Crown Court

summary offence /ˌsʌməri əˈfens/ *noun* a minor crime which can be tried only in a magistrates' court

summary trial /ˌsʌməri ˈtraɪəl/ *noun* the trial of a petty offence by magistrates

summing up /ˌsʌmɪŋ ˈʌp/ *noun* a speech by a judge at the end of a trial, reviewing all the evidence and arguments and noting important points of law for the benefit of the jury (NOTE: The US term is **instructions**.)

summit conference /ˌsʌmɪt ˈkɒnf(ə)rəns/ *noun* the meeting of two or more heads of government ○ *The summit conference* or *summit meeting was held in Geneva.* ○ *The matter will be discussed at next week's summit of the EC leaders.*

summon /ˈsʌmən/ *verb* to call someone to come ○ *He was summoned to appear before the committee.*

summons /ˈsʌmənz/ *noun* an official command from a court requiring someone to appear in court to be tried for a criminal offence or to defend a civil action ○ *He tore up the summons and went on holiday to Spain.*

Sunday closing /ˌsʌndeɪ ˈkləʊzɪŋ/ *noun* the act of not opening a shop on Sundays

sunshine law /ˈsʌnʃaɪn ˌlɔː/ *noun* a law that prohibits closed meetings of public bodies

mainp - softvnn.com

Law.fm Page 290 Friday, June 11, 2004 2:08 PM

super /ˈsuːpə/ *noun* same as **police superintendent**

supergrass /ˈsuːpəgrɑːs/ *noun* a person, usually a criminal, who gives information to the police about a large number of criminals (*slang*)

supervision order /ˌsuːpəˈvɪʒ(ə)n ˌɔːdə/ *noun* a court order for a young offender to be placed under the supervision of the probation service

supplemental /ˌsʌplɪˈmentəl/ *adjective* being additional to something

supplementary /ˌsʌplɪˈment(ə)ri/ *adjective* additional

supply and demand /səˌplaɪ ən dɪ ˈmɑːnd/ *noun* the amount of a product which is available at a specific price and the amount which is wanted by customers at that price

Supply Bill /səˈplaɪ bɪl/ *noun* a Bill for providing money for government requirements

supply price /səˈplaɪ praɪs/ *noun* the price at which something is provided

suppress /səˈpres/ *verb* **1.** to hide documents **2.** to prevent evidence being given

suppressio veri /səˌpresiəʊ ˈveraɪ/ *phrase* a Latin phrase meaning 'suppressing the truth': act of not mentioning some important fact

supra /ˈsuːprə/ *adverb* above

supremacy /sʊˈpreməsi/ *noun* **1.** a situation where one person or group is much more powerful than any other ▫ **the supremacy of Parliament** the situation where the UK Parliament can both pass and repeal laws **2.** the feeling that the ethnic group you belong to is superior to other groups **3.** one of the twin pillars of EU law, by which it cannot be overridden by national laws even if the national laws existed before the EU law. It is based on all forms of EU law, i.e. treaty articles, community acts and agreements with third parties. ◊ **direct effect**

Supreme Court /sʊˌpriːm ˈkɔːt/ *noun* **1.** ▫ **Supreme Court (of Judicature)** the highest court in England and Wales, consisting of the Court of Appeal and the High Court of Justice **2.** in the United Kingdom, a court that is planned as a replacement for the Law Lords committee as the highest court in the land **3.** the highest federal court in the USA and other countries

surcharge /ˈsɜːtʃɑːdʒ/ *noun* **1.** an extra charge **2.** a penalty for incurring expenditure without authorisation

surety /ˈʃʊərəti/ *noun* **1.** somebody who guarantees that someone will do something, especially by paying to guarantee that someone will keep the peace ○ *to stand surety for someone* **2.** something such as money, deeds or share certificates deposited as security for a loan

surrender /səˈrendə/ *noun* **1.** the giving up of a right or power **2.** the giving up of an insurance policy before the contracted date for maturity ○ *The contract becomes null and void when these documents are surrendered.* ■ *verb* to give in a document, to give up a right ○ *The court ordered him to surrender his passport.* ○ *She surrendered her rights to the piece of land.*

surrender value /səˈrendə ˌvæljuː/ *noun* money which an insurer will pay if an insurance policy is given up before it matures

surrogate /ˈsʌrəgət/ *noun* a person appointed to act in place of someone else

surrogate mother /ˌsʌrəgət ˈmʌðə/ *noun* a woman who has a child by artificial insemination for a couple when the wife cannot bear children, with the intention of handing the child over to them when it is born

surveillance /səˈveɪləns/ *noun* the activity of keeping careful watch on someone to find out what they are doing ○ *The diplomats were placed under police surveillance.* ○ *Surveillance at international airports has been increased.*

surveillance device /səˌveɪləns dɪ ˈvaɪs/ *noun* same as **bug**

survive /səˈvaɪv/ *verb* to live longer than another person ○ *he survived his wife* ○ *She is survived by her husband and three children.* ▫ **he left his estate to his surviving relatives** to the relatives who were still alive

surviving spouse /səˌvaɪvɪŋ ˈspaʊs/ *noun* the living husband or wife of a person who has died, who is usually

mainp - softvnn.com

Law.fm Page 291 Friday, June 11, 2004 2:08 PM

the beneficiary of the estate, even if the dead person died intestate. If there are living children, then the spouse takes the personal chattels, a statutory sum as legacy, and interest in half the remaining estate.

survivor /sə'vaɪvə/ *noun* someone who lives longer than another person

survivorship /sə'vaɪvəʃɪp/ *noun* the state of being the survivor of two or more people who hold a joint tenancy on a property

SUS law /'sʌs lɔː/ *noun* formerly, a law which allowed the police to stop and arrest a person whom they suspected of having committed an offence

suspect *noun* /'sʌspekt/ somebody whom the police think has committed a crime ○ *The police have taken six suspects into custody.* ○ *The police are questioning the suspect about his movements at the time the crime was committed.* ■ *verb* /sə'spekt/ to believe that someone has done something ○ *He was arrested as a suspected spy.* ○ *The police suspect that the thefts were committed by a member of the shop's staff.* (NOTE: You suspect someone **of** committing a crime.)

suspend /sə'spend/ *verb* **1.** to stop something happening for a period of time ○ *We have suspended payments while we are waiting for news from our agent.* ○ *The hearings have been suspended for two weeks.* ○ *Work on the preparation of the case has been suspended.* ○ *The employers decided to suspend negotiations.* **2.** to stop someone working for a period of time ○ *She was suspended on full pay while the police investigations were proceeding.* **3.** to punish a student by refusing to allow him to attend school or college ○ *Three boys were suspended from school for fighting.*

suspended sentence /sə,spendɪd 'sentəns/ *noun* a sentence of imprisonment which a court orders shall not take effect unless the offender commits another crime

suspension /sə'spenʃən/ *noun* the act of stopping something for a time ○ *suspension of payments* ○ *suspension of deliveries*

COMMENT: When an MP is 'named' by the Speaker, the House will vote to suspend him. Suspension is normally for five days, though it may be for longer if the MP is suspended twice in the same session of Parliament.

suspicion /sə'spɪʃ(ə)n/ *noun* □ **on suspicion** feeling that someone has committed a crime ○ *He was arrested on suspicion of being an accessory to the crime.*

suspicious /sə'spɪʃəs/ *adjective* which makes someone suspect ○ *The police are dealing with the suspicious package found in the car.* ○ *Suspicious substances were found in the man's pocket.*

swear /sweə/ *verb* to promise that what you will say will be the truth ○ *He swore to tell the truth.* □ **'I swear to tell the truth, the whole truth and nothing but the truth'** words used when a witness takes the oath in court

swear in /,sweə 'ɪn/ *verb* to make someone take an oath before taking up a position ○ *He was sworn in as a Privy Councillor.*

swearing-in /,sweərɪŋ 'ɪn/ *noun* the act of making someone take an oath before taking up a position

swindle /'swɪnd(ə)l/ *noun* an illegal deal in which someone is cheated out of his or her money ■ *verb* to cheat someone out of his or her money ○ *He made £50,000 by swindling small shopkeepers.* ○ *The gang swindled the bank out of £1.5m.*

swindler /'swɪndlə/ *noun* somebody who swindles

syllabus /'sɪləbəs/ *noun US* a headnote giving a short summary of a case

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T

table /ˈteɪb(ə)l/ *noun* □ **to let a bill lie on the table** *US* not to proceed with discussion of a bill, but to hold it over to be debated later ◇ **to lay a bill on the table** *US* **1.** to present a bill to the House of Commons for discussion **2.** to kill debate on a bill in the House of Representatives ◇ **to table a motion** *US* **1.** to put forward a proposal for discussion by putting details of it on the table at a meeting **2.** to remove a motion from consideration for an indefinite period

Table A /ˌteɪb(ə)l ˈeɪ/ *noun* model articles of association of a limited company set out in the Companies Act, 1985

Table B /ˌteɪb(ə)l ˈbiː/ *noun* a model memorandum of association of a limited company set out in the Companies Act, 1985

Table C /ˌteɪb(ə)l ˈsiː/ *noun* a model memorandum and articles of association set out in the Companies Act, 1985 for a company limited by guarantee having no share capital

Table D /ˌteɪb(ə)l ˈdiː/ *noun* a model memorandum and articles of association of a public company with share capital limited by guarantee, set out in the Companies Act, 1985

Table E /ˌteɪb(ə)l ˈiː/ *noun* a model memorandum and articles of association of an unlimited company with share capital set out in the Companies Act, 1985

tabs /tæbz/ *plural noun* bands of white cloth worn by a barrister round his or her neck, instead of a tie

tacit /ˈtæsɪt/ *adjective* agreed but not stated ○ *He gave the proposal his tacit approval.* ○ *The committee gave its tacit agreement to the proposal.*

tail /teɪl/ ➧ **fee tail**

take in /ˌteɪk ˈɪn/ *verb* to trick someone into believing something that is not true ○ *We were taken in by his promise of quick profits.*

take out /ˌteɪk ˈaʊt/ *verb* □ **to take out a patent for an invention** to apply for and receive a patent □ **to take out insurance against theft** to pay a premium to an insurance company, so that if a theft takes place the company will pay compensation

take over /ˌteɪk ˈəʊvə/ *verb* **1.** to start to do something in place of someone else ○ *Miss Black took over from Mr Jones on May 1st.* ○ *The new chairman takes over on July 1st.* □ **the take-over period is always difficult** the period when one person is taking over work from another **2.** □ **to take over a company** to buy a business by offering to buy most of its shares ○ *The company was taken over by a large international corporation.*

takeover /ˈteɪkəʊvə/ *noun* the activity of one business buying another □ **to make a takeover bid for a company** to offer to buy a majority of the shares in a company □ **to withdraw a takeover bid** to say that you no longer offer to buy most of the shares in a company □ **the company rejected the takeover bid** the directors recommended that the shareholders should not accept the bid

Takeover Panel /ˈteɪkəʊvə ˌpæn(ə)l/ *noun* a non-statutory body which examines takeovers and applies the City Code on Takeovers and Mergers

talaq /ˈtælæk/ *noun* an Islamic form of divorce where the husband may divorce his wife unilaterally by an oral declaration made three times

tamper /ˈtæmpə/ *verb* □ **to tamper with something** to change something or

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Law.fm Page 293 Friday, June 11, 2004 2:08 PM

to act in such a way that something does not work ○ *The police were accused of tampering with the evidence.* ○ *The charges state that she had tampered with the wheels of the victim's car.*

tangible assets /ˌtændʒɪb(ə)l ˈæsets/ *plural noun* assets which are visible, e.g. machinery, buildings, furniture or jewellery

tariff /ˈtærɪf/ *noun* the minimum period of time which a life prisoner must serve in prison

tax /tæks/ *noun* **1.** money taken compulsorily by the government or by an official body to pay for government services **2.** □ **to levy a tax**, **to impose a tax** to make a tax payable ○ *The government has imposed a 15% tax on petrol.* □ **to lift a tax** to remove a tax □ **tax deducted at source** tax which is removed from a salary, interest payment or dividend payment before the money is paid out □ **tax loophole** legal means of not paying tax □ **tax planning** planning one's financial affairs so that one pays as little tax as possible ■ *verb* **1.** to impose a tax on something, or make someone pay a tax ○ *to tax businesses at 50%* ○ *Income is taxed at 29%.* ○ *These items are heavily taxed.* **2.** to have the costs of a legal action assessed by the court ○ *The court ordered the costs to be taxed if not agreed.* **3.** to assess the bill presented by a Parliamentary agent

tax abatement /ˈtæks əˌbeɪtmənt/ *noun* the reduction of tax

taxable /ˈtæksəb(ə)l/ *adjective* being able to be taxed □ **taxable items** items on which a tax has to be paid

taxable income /ˌtæksəb(ə)l ˈɪnkʌm/ *noun* income on which a person has to pay tax

tax advantage /ˈtæks ədˌvɑːntɪdʒ/ *noun* a special tax reduction accorded to some classes of taxpayers such as those with low pay, which must be extended to workers who are not nationals of the country

tax allowances /ˈtæks əˌlaʊənsɪz/ *plural noun* part of one's income which a person is allowed to earn and not pay tax on

taxation of costs /tækˌseɪʃ(ə)n əv ˈkɒsts/ *noun* formerly, the assessment of the costs of a legal action by the Taxing Master (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has been replaced by **assessment of costs**.)

tax avoidance /ˈtæks əˌvɔɪd(ə)ns/ *noun* a legal attempt to minimise the amount of tax to be paid

tax code /ˈtæks kəʊd/ *noun* a number given to indicate the amount of tax allowances a person has

tax concession /ˈtæks kənˌseʃ(ə)n/ *noun* a reduction in the amount of tax that has to be paid

tax consultant /ˈtæks kənˌsʌltənt/ *noun* somebody who gives advice on tax problems

tax court /ˈtæks kɔːt/ *noun US* a tribunal which hears appeals from taxpayers against the Internal Revenue Service

tax credit /ˈtæks ˌkredɪt/ *noun* a part of a dividend on which a company has already paid tax, so that the shareholder is not taxed on it again

tax-deductible /ˌtæks dɪˈdʌktɪb(ə)l/ *adjective* being possible to deduct from an income before tax is calculated □ **these expenses are not tax-deductible** tax has to be paid on these expenses

tax deductions /ˈtæks dɪˌdʌkʃənz/ *plural noun US* **1.** money removed from a salary to pay tax **2.** business expenses which can be claimed against tax

taxed costs /ˌtæksd ˈkɒsts/ *plural noun* varying amount of costs which can be awarded in legal proceedings

tax evasion /ˈtæks ɪˌveɪʒ(ə)n/ *noun* illegally trying not to pay tax

tax-exempt /ˌtæks ɪgˈzempt/ *adjective* **1.** (*of a person or organisation*) not required to pay tax **2.** (*of income or goods*) not subject to tax

tax exemption /ˈtæks ɪgˌzempʃən/ *noun US* **1.** the state of being free from payment of tax **2.** a part of income which a person is allowed to earn and not pay tax on

tax-free /ˌtæks ˈfriː/ *adjective* on which tax does not have to be paid

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Law.fm Page 294 Friday, June 11, 2004 2:08 PM

tax haven /ˈtæks ˌheɪv(ə)n/ *noun* a country where taxes levied on foreigners or foreign companies are low

tax holiday /ˈtæks ˌhɒlɪdeɪ/ *noun* the period when a new business is exempted from paying tax

Taxing Master /ˌtæksɪŋ ˈmɑːstə/ *noun* an official of the Supreme Court who assesses the costs of a court action (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has been replaced in some contexts by **costs judge**.)

taxing officer /ˌtæksɪŋ ˈɒfɪsə/ *noun* a person appointed by the House of Commons to assess the charges presented by a Parliamentary agent

tax inspector /ˈtæks ɪnˌspektə/ *noun* an official of the Inland Revenue who examines tax returns and decides how much tax someone should pay

taxpayer /ˈtækspeɪə/ *noun* a person or company which has to pay tax ○ *basic taxpayer* or *taxpayer at the basic rate*

tax point /ˈtæks pɔɪnt/ *noun* **1.** the date when goods are supplied and VAT is charged **2.** the date at which a tax begins to be applied

tax relief /ˈtæks rɪˌliːf/ *noun* a reduction in the amount of tax that has to be paid

tax return /ˈtæks rɪˌtɜːn/ *noun* a completed tax form, with details of income and allowances

tax schedules /ˈtæks ˌʃedjuːlz/ *plural noun* six types of income as classified in the Finance Acts for British tax

TD *abbreviation* Teachta Dala

Teachta Dala /ˌtɪæxtə ˈdælə/ *noun* a member of the lower house of the parliament of the Republic of Ireland, the Dáil. Abbreviation **TD**

technical /ˈteknɪk(ə)l/ *adjective* referring to a specific legal point, using a strictly legal interpretation ○ *Nominal damages were awarded as the harm was judged to be technical rather than actual.*

technicality /ˌteknɪˈkælɪti/ *noun* a special interpretation of a legal point ○ *The Appeal Court rejected the appeal on a technicality.*

teleological /ˌtiːliəˈlɒdʒɪk(ə)l/ *adjective* referring to the final purpose of something ○ *The ECJ uses a teleological approach to legislation.*

telephone book /ˈtelɪfəʊn bʊk/ *noun* a book which lists names of people or companies with their addresses and telephone numbers

telephone hearing /ˌtelɪfəʊn ˈhɪərɪŋ/ *noun* a hearing conducted by telephone and recorded on tape, using a telephone conferencing system

tem /tem/ ♦ **pro tem**

Temple ♦ **Middle Temple**

temporary employment /ˌtemp(ə)rəri ɪmˈplɔɪmənt/ *noun* full-time work which does not last for more than a few days or months

tenancy /ˈtenənsi/ *noun* **1.** an agreement by which a person can occupy a property **2.** the period during which a person has an agreement to occupy a property **3.** the period during which a barrister occupies chambers

tenancy at sufferance /ˌtenənsi ət ˈsʌf(ə)rəns/ *noun* a situation where a previously lawful tenant is still in possession of property after the termination of the lease

tenancy at will /ˌtenənsi ət ˈwɪl/ *noun* a situation where the owner of a property allows a tenant to occupy it as long as either party wishes

tenancy in common /ˌtenənsi ɪn ˈkɒmən/ *noun* a situation where two or more persons jointly lease a property and each can leave his or her interest to an heir on their death

tenant /ˈtenənt/ *noun* a person or company which rents a house, flat or office in which to live or work ○ *The tenant is liable for repairs.*

tenant at will /ˌtenənt ət ˈwɪl/ *noun* a tenant who holds a property at the will of the owner

tenant for life /ˌtenənt fə ˈlaɪf/ *noun* somebody who can occupy a property for life

tender /ˈtendə/ *noun* □ **tender before claim** defence that the defendant offered the claimant the amount of money claimed before the claimant started proceedings against him. Also called **de-**

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Law.fm Page 295 Friday, June 11, 2004 2:08 PM

fence before claim ■ *verb* **1.** □ **to tender for a contract** to put forward an estimate of cost for work to be carried out under contract ○ *to tender for the construction of a hospital* **2.** □ **to tender one's resignation** to give in one's resignation

tenderer /ˈtendərə/ *noun* a person or company which tenders for work ○ *The company was the successful tenderer for the project.*

tenement /ˈtenəmənt/ *noun* **1.** property which is held by a tenant **2.** in Scotland, a building which is divided into rented flats

tenens /ˈtenənz/ ◆ **locum**

tenure /ˈtenjə/ *noun* **1.** the right to hold property or a position **2.** the time when a position is held ○ *during his tenure of the office of chairman*

term /tɜːm/ *noun* **1.** a period of time ○ *the term of a lease* ○ *to have a loan for a term of fifteen years* ○ *during his term of office as chairman* ○ *The term of the loan is fifteen years.* □ **term of years** a fixed period of several years (of a lease) **2.** □ **term**, **terms** conditions or duties which have to be carried out as part of a contract, arrangements which have to be agreed before a contract is valid ○ *He refused to agree to some of the terms of the contract.* ○ *By* or *under the terms of the contract, the company is responsible for all damage to the property.* **3.** a part of a legal year when courts are in session. The four law terms are Easter, Hilary, Michaelmas and Trinity. ○ *The autumn* or *winter term starts in September.* **4.** a word or phrase which has a particular meaning ○ *Counsel used several technical terms which the prisoner didn't understand.*

term deposit /ˈtɜːm dɪˌpɒzɪt/ *noun* money invested for a fixed period which gives a higher rate of interest than normal

terminable /ˈtɜːmɪnəb(ə)l/ *adjective* being possible to terminate

terminate /ˈtɜːmɪˌneɪt/ *verb* to end something, bring something to an end, or come to an end ○ *to terminate an agreement* ○ *His employment was terminated.* ○ *An offer terminates on the death of the offeror.*

termination /ˌtɜːmɪˈneɪʃ(ə)n/ *noun* **1.** bringing to an end ○ *the termination of an offer* or *of a lease* ○ *to appeal against the termination of a foster order* **2.** *US* the act of leaving a job by resigning, retiring, or being fired or made redundant

termination clause /ˌtɜːmɪˈneɪʃ(ə)n klɔːz/ *noun* a clause which explains how and when a contract can be terminated

term insurance /ˈtɜːm ɪnˌʃʊərəns/ *noun* life assurance which covers a person's life for a fixed period of time

term loan /ˈtɜːm ləʊn/ *noun* a loan for a fixed period of time

term shares /ˈtɜːm ʃeəz/ *plural noun* type of building society deposit for a fixed period of time at a higher rate of interest

terms of employment /ˌtɜːmz əv ɪmˈplɔɪmənt/ *plural noun* conditions set out in a contract of employment

terms of payment /ˌtɜːmz əv ˈpeɪmənt/ *plural noun* conditions for paying something

terms of reference /ˌtɜːmz əv ˈref(ə)rəns/ *plural noun* areas which a committee or an inspector can deal with ○ *Under the terms of reference of the committee, it cannot investigate complaints from the public.* ○ *The tribunal's terms of reference do not cover traffic offences.*

terms of sale /ˌtɜːmz əv ˈseɪl/ *plural noun* same as **conditions of sale**

territorial /ˌterɪˈtɔːriəl/ *adjective* referring to land □ **territorial claims** claims to own land which is part of another country □ **territorial waters** sea waters near the coast of a country, which is part of the country and governed by the laws of that country □ **outside territorial waters** in international waters, where a single country's jurisdiction does not run

territoriality /ˌterɪtɔːriˈælɪti/ *noun* the principle that a country has jurisdiction only over its own territory. ◊ **extra-territory** /ˈterɪt(ə)ri/ *noun* an area of land over which a government has control ○ *Their government has laid claim to part of our territory.*

terrorism /ˈterərɪz(ə)m/ *noun* the use of violent actions such as assassination

mainp - softvnn.com

Law.fm Page 296 Friday, June 11, 2004 2:08 PM

or bombing for political reasons ○ *The act of terrorism was condemned by the Minister of Justice.*

terrorist /'terərɪst/ *noun* somebody who commits a violent act for political reasons ○ *The bomb was planted by a terrorist group* or *by a group of terrorists.* ○ *Six people were killed in the terrorist attack on the airport.*

testacy /'testəsi/ *noun* the condition of having made a legally valid will

testamentary /testə'mentəri/ *adjective* referring to a will

testamentary capacity /testə ˌmentəri kə'pæsɪti/ *noun* the legal ability of someone to make a will

COMMENT: A testator must be able to make a will: he must be of sound mind (i.e. must know what he is doing, what property he has, and who he is leaving it to), he must approve of the will (for example, in cases where a will is prepared for a testator by someone else), he must be acting freely (not coerced by anyone else, not tricked into making a fraudulent will).

testamentary disposition /testə ˌmentəri ˌdɪspə'zɪʃ(ə)n/ *noun* the passing of property to someone in a will

testamentary freedom /testə ˌmentəri 'friːdəm/ *noun* freedom to dispose of your property in a will as you want

testate /'testeɪt/ *adjective* having made a will ○ *Did he die testate?* ◊ **intestate**

testator /te'steɪtə/ *noun* a man who has made a will

testatrix /te'steɪtrɪks/ *noun* a woman who has made a will

test case /'test keɪs/ *noun* a legal action where the decision will fix a principle which other cases can follow

test certificate /'test səˌtɪfɪkət/ *noun* a certificate to show that something has passed a test

testify /'testɪfaɪ/ *verb* to give evidence in court

testimonium clause /ˌtestɪ 'məʊniəm ˌklɔːz/ *noun* the last section of a document such as will or conveyance which shows how it has been witnessed

COMMENT: The testimonium clause usually begins with the words: 'in witness whereof I have set my hand'.

testimony /'testɪməni/ *noun* an oral statement given by a witness in court about what happened ○ *She gave her testimony in a low voice.*

test of effectiveness /ˌest əv ɪ 'fektɪvnəs/ *noun* in the European Union, a test to show if an action is more effective when taken by a Member State than when taken centrally. It is one of the tests used to decide on subsidiarity.

test of scale /ˌtest əv 'skeɪl/ *noun* in the European Union, a test to show if an action is more effective when taken centrally than when taken by a Member State. It is one of the tests used to decide on subsidiarity.

TEU *abbreviation* Treaty on European Union

textbook /'tekstbʊk/ *noun* a book of legal commentary which can be cited in court

theft /θeft/ *noun* **1.** the crime of taking of property which belongs to someone else with the intention of depriving that person of it ○ *to take out insurance against theft* ○ *We have brought in security guards to protect the store against theft.* ○ *The company is trying to reduce losses caused by theft.* **2.** the act of stealing ○ *There has been a wave of thefts from newsagents.*

COMMENT: Types of theft which are notifiable offences are: theft from the person of another; theft in a dwelling; theft by an employee; theft of mail, pedal cycle or motor vehicle; theft from vehicles, from a shop or from an automatic machine or meter.

there- /ðeə/ *prefix* that thing

thereafter /ðeər'ɑːftə/ *adverb* after that

thereby /ðeə'baɪ/ *adverb* by that

therefor /ðeə'fɔː/ *adverb* for that

therefrom /ðeə'frʌm/ *adverb* from that

therein /ðeər'ɪn/ *adverb* in that

thereinafter /ˌðeərɪn'ɑːftə/ *adverb* afterwards listed in that document

thereinbefore /ˌðeərɪnbɪ'fɔː/ *adverb* mentioned before in that document

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Law.fm Page 297 Friday, June 11, 2004 2:08 PM

thereinunder /ˌðeərɪnˈʌndə/ *adverb* mentioned under that heading

thereof /ðeərˈɒv/ *adverb* of that □ **in respect thereof** regarding that thing

thereto /ðeəˈtuː/ *adverb* to that

theretofore /ˌðeətʊˈfɔː/ *adverb* before that time

therewith /ðeəˈwɪð/ *adverb* with that

thief /θiːf/ *noun* somebody who steals or who takes property which belongs to someone else ○ *Thieves broke into the office and stole the petty cash.*

third party /ˌθɜːd ˈpɑːti/ *noun* **1.** any person other than the two main parties involved in proceedings or contract □ **the case is in the hands of a third party** the case is being dealt with by someone who is not one of the main interested parties. ◊ **party 2.** the other person involved in an accident

third party insurance /ˌθɜːd pɑːti ɪnˈʃʊərəns/ *noun* insurance which pays compensation if someone who is not the insured person incurs loss or injury

third party notice /θɜːd ˌpɑːtɪ ˈnəʊtɪs/ *noun* a pleading served by a defendant on another party joining that party to an existing court action

third party proceedings /θɜːd ˌpɑːti prəˈsiːdɪŋz/ *plural noun* the introduction of a third party into a case by the defendant, or by the claimant in the case of a counterclaim (NOTE: The US term is **impleader**.)

third quarter /ˌθɜːd ˈkwɔːtə/ *noun* a period of three months from July to the end of September

Third Reading /ˌθɜːd ˈriːdɪŋ/ *noun* a final discussion and vote on a Bill in Parliament

threat /θret/ *noun* **1.** spoken or written words which say that something unpleasant may happen to someone, and which frighten that person **2.** an action or situation that could be harmful or dangerous ○ *The introduction of ID cards might be regarded as a threat to civil liberties.*

threaten /ˈθret(ə)n/ *verb* to warn someone that unpleasant things may happen to him or her ○ *He threatened to take the tenant to court* or *to have the tenant evicted.* ○ *She complained that her husband had threatened her with a knife.* □ **threatening behaviour** acting in a way which threatens someone

threshold criteria /ˈθreʃhəʊld kraɪ ˌtɪəriə/ *plural noun* the conditions that need to be met before the social services of a local authority can begin care proceedings, mainly, whether the child is suffering or likely to suffer significant harm if left in the care of its natural parents, indicating that the child is beyond parental control (NOTE: Since the introduction of the Human Rights Act 1998, the court must be satisfied that such an order does not contravene Article 8, which guarantees a right to family life. Consequently, the court must be satisfied that any intervention is proportionate to the legitimate aim of protecting family life.)

ticket office /ˈtɪkɪt ˌɒfɪs/ *noun* an office where tickets can be bought

tied cottage /ˌtaɪd ˈkɒtɪdʒ/ *noun* a house owned by an employer and let to an employee for the period of his or her employment

time and motion study /ˌtaɪm ən ˈməʊʃ(ə)n ˌstʌdi/ *noun* a study in an office or factory of the time taken to do specific jobs and the movements employees have to make to do them

time-bar /ˈtaɪm bɑː/ *verb* to stop someone doing something such as exercising a right because a set time limit has expired (NOTE: **time-barring – time-barred**)

time charter /ˈtaɪm ˌtʃɑːtə/ *noun* an agreement to charter a ship for a fixed period

time limit /ˈtaɪm ˌlɪmɪt/ *noun* the maximum time which can be taken to do something

time limitation /ˈtaɪm lɪmɪˌteɪʃ(ə)n/ *noun* the amount of time which is available

time lock /ˈtaɪm lɒk/ *noun* a lock such as one in a bank vault which will open only at a specific time of day

time policy /ˈtaɪm ˌpɒlɪsi/ *noun* a marine insurance policy which runs for a fixed period of time

time summons /ˈtaɪm ˌsʌmənz/ *noun* a summons issued to apply to the

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Law.fm Page 298 Friday, June 11, 2004 2:08 PM

court for more time in which to serve a pleading

timetable /'taɪmteɪb(ə)l/ *noun* a printed list which shows the times of things that are going to happen

tip off /ˌtɪp 'ɒf/ *verb* □ **to tip someone off** to warn someone (*informal*) ○ *We think he tipped the burglars off that the police were outside.* ○ *She tipped them off that a police investigation was about to take place.*

tip-off /'tɪp ɒf/ *noun* a piece of useful information, given secretly (*informal*) ○ *Acting on a tip-off from a member of the public, customs officials stopped the truck.* ○ *The police received a tip-off about a bomb in the building.* ○ *The police raided the club after a tip-off from a member of the public.*

tipstaff /'tɪpstɑːf/ *noun* an official of the Supreme Court who is responsible for arresting persons in contempt of court

title /'taɪt(ə)l/ *noun* **1.** the right to hold goods or property ○ *She has no title to the property.* **2.** a document proving a right to hold a property ○ *He has a good title to the property.* □ **to have a clear title to something** to have a right to something with no limitations or charges **3.** the name of a bill which comes before Parliament or of an Act of Parliament

title deeds /'taɪt(ə)l ˌdiːdz/ *plural noun* document showing who owns a property ○ *We have deposited the deeds of the house in the bank.*

token charge /ˌtəʊkən 'tʃɑːdʒ/ *noun* a small charge which does not cover the real costs ○ *A token charge is made for heating.*

token payment /'təʊkən ˌpeɪmənt/ *noun* a small payment to show that a payment is being made

token rent /ˌtəʊkən 'rent/ *noun* a very low rent payment to show that a rent is being asked

toll /təʊl/ *verb US* to suspend a law for a period

top security prison /tɒp sɪˌkjʊərɪti 'prɪz(ə)n/ *noun* a prison with very strict security where category 'A' prisoners are kept

tort /tɔːt/ *noun* a civil wrong done by one person to another and entitling the victim to claim damages □ **action in tort** a case brought by a claimant who alleges he or she has suffered damage or harm caused by the defendant

tortfeasor /tɔːt'fiːzə/ *noun* somebody who has committed a tort

tortious /'tɔːʃəs/ *adjective* referring to a tort □ **tortious act** a wrong, an act which damages someone □ **tortious liability** liability for harm caused by a breach of duty

torture /'tɔːtʃə/ *verb* to hurt someone badly so as to force him or her to give information

torturer /'tɔːtʃərə/ *noun* somebody who tortures

total intestacy /ˌtəʊt(ə)l ɪn'testəsi/ *noun* a state where a person has not made a will, or where a previous will has been revoked

total loss /ˌtəʊt(ə)l 'lɒs/ *noun* □ **the cargo was written off as a total loss** the cargo was so badly damaged that the insurers said it had no value

toties quoties /ˌtəʊʃɪiːz 'kwəʊʃɪiːz/ *phrase* a Latin phrase meaning 'as often as necessary'

totting up /ˌtɒtɪŋ 'ʌp/ *noun* the procedure of adding previous convictions for traffic offences to a present conviction. Each conviction leads to an endorsement of the driver's licence and he or she may be sufficient for disqualification from driving if all the endorsements are added together.

tourist visa /'tʊərɪst ˌviːzə/ *noun* a visa which allows a person to visit a country for a short time on holiday

town planner /ˌtaʊn 'plænə/ *noun* a person who supervises the design of a town, the way the streets and buildings in a town are laid out and how the land in a town used

town planning /ˌtaʊn 'plænɪŋ/ *noun* the activity of supervising the design of a town and the use of land in a town

trace /treɪs/ *verb* to look for someone or something ○ *We have traced the missing documents.* ○ *The police traced the two men to a hotel in London.*

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Law.fm Page 299 Friday, June 11, 2004 2:08 PM

tracing action /ˌtreɪsɪŋ ˈækʃən/ *noun* a court action begun to trace money or the proceeds of a sale

track /træk/ *noun* one of three management systems by which a court case is processed: the small claims track, the fast track or the multi-track

track record /ˈtræk ˌrekɔːd/ *noun* the success or failure of someone in the past ○ *He has a good track record as a detective.* ○ *The company has no track record in the computer market.*

trade /treɪd/ *noun* **1.** the business of buying and selling **2.** □ **to ask a company to supply trade references** to ask a company to give names of traders who can report on the company's financial situation and reputation **3.** all the people or companies dealing in the same type of product ○ *He is in the secondhand car trade.* ○ *She is very well known in the clothing trade.*

trade agreement /ˈtreɪd əˌgriːmənt/ *noun* an international agreement between countries over general terms of trade

trade association /ˈtreɪd əsəʊsi ˌeɪʃ(ə)n/ *noun* a group which joins together companies in the same type of business

trade description /ˌtreɪd dɪ ˈskrɪpʃən/ *noun* a description of a product to attract customers

Trade Descriptions Act /ˌtreɪd dɪ ˈskrɪpʃənz ækt/ *noun* an Act of Parliament which limits the way in which products can be described so as to protect consumers from wrong descriptions made by the makers

trade dispute /ˈtreɪd dɪˌspjuːt/ *noun* **1.** an international dispute over trade matters **2.** a dispute between management and workers over conditions of employment or union membership

trade fixtures /ˌtreɪd ˈfɪkstʃəz/ *plural noun* equipment attached to a property by a tenant so that they can exercise their trade, which may be removed at the end of the tenancy

trade paper /ˌtreɪd ˈpeɪpə/ *noun* a newspaper aimed at people working in a particular industry

Trades Union Congress /ˌtreɪdz ˈjuːnjən ˌkɒŋgres/ *noun* a central organisation for all British trade unions. Abbreviation **TUC** (NOTE: Although **Trades Union Congress** is the official name for the organisation, **trade union** is commoner than **trades union**.)

trade terms /ˈtreɪd tɜːmz/ *plural noun* special discount for people in the same trade

trade union /ˌtreɪd ˈjuːnjən/**, trades union** /ˌtreɪdz ˈjuːnjən/ *noun* an organisation which represents employees in discussions about wages and conditions of employment with employers ○ *They are members of a trade union* or *they are trade union members.* ○ *He has applied for trade union membership* or *he has applied to join a trade union.*

trading loss /ˌtreɪdɪŋ ˈlɒs/ *noun* a situation where the company's receipts are less than its expenditure

trading profit /ˈtreɪdɪŋ ˌprɒfɪt/ *noun* a result where the company' receipts are higher than its expenditure

Trading Standards Department /ˌtreɪdɪŋ ˈstændədz dɪˌpɑːtmənt/ *noun* a department of a council which deals with weighing and measuring equipment used by shops and other consumer matters. Also called **Weights and Measures Department**

trading standards officer /ˌtreɪdɪŋ ˈstændədz ˌɒfɪsə/ *noun* an official in charge of a council's Trading Standards Department

traffic /ˈtræfɪk/ *verb* to buy and sell something illegally ○ *He was charged with trafficking in drugs.*

trafficking /ˈtræfɪkɪŋ/ *noun* the activity of dealing in illegal goods ○ *drug trafficking* □ **trafficking in persons** the illegal practice of finding and using human beings for unpaid often unpleasant work in situations their circumstances prevent them from leaving

traffic offences /ˈtræfɪk əˌfensɪz/ *plural noun* offences committed by drivers of vehicles

traffic police /ˈtræfɪk pəˌliːs/ *noun* a section of the police concerned with problems on the roads

mainp - softvnn.com

Law.fm Page 300 Friday, June 11, 2004 2:08 PM

traffic warden /'træfɪk ˌwɔːdən/ *noun* a person whose job is to regulate the traffic under the supervision of the police, especially to deal with cars which are illegally parked

trainee /treɪ'niː/ *noun* a young person who is learning a skill or job

traineeship /treɪ'niːʃɪp/ *noun* the period during which someone is working in a solicitor's office to learn the law

trainee solicitor /treɪˌniː sə'lɪsɪtə/ *noun* someone who is bound by a training contract to work in a solicitor's office for some years to learn the law (NOTE: This term has officially replaced **articled clerk**.)

training contract /ˌtreɪnɪŋ 'kɒntrækt/ *noun* a contract under which a trainee works in a solicitor's office to learn the law (NOTE: This term has officially replaced **articles**.)

training levy /'treɪnɪŋ ˌlevi/ *noun* a tax to be paid by companies to fund the government's training schemes

training officer /'treɪnɪŋ ˌɒfɪsə/ *noun* somebody who deals with the training of staff

transact /træn'zækt/ *verb* □ **to transact business** to carry out a piece of business

transaction /træn'zækʃən/ *noun* □ **a transaction on the Stock Exchange** purchase or sale of shares on the Stock Exchange

transcript /'trænˌskrɪpt/ *noun* a record in full of something noted in shorthand or of recorded speech ○ *The judge asked for a full transcript of the evidence.*

transfer *noun* /'trænsfɜː/ **1.** the movement of someone or something to a new place **2.** the movement of the hearing of a case to another court ■ *verb* /træns'fɜː/ to pass to someone else

transferable /træns'fɜːrəb(ə)l/ *adjective* being able to be passed to someone else □ **the season ticket is not transferable** the ticket cannot be given or lent to someone else to use

transferee /ˌtrænzfə'riː/ *noun* somebody to whom property or goods are transferred

transfer of property /ˌtrænsfɜː əv 'prɒpəti/, **transfer of shares** /ˌtrænsfɜː əv 'ʃeəz/ *noun* the movement of the ownership of property or shares from one person to another

transferor /træns'fɜːrə/ *noun* somebody who transfers goods or property to another

transit /'trænsɪt/ ◗ **in transit**

transit visa /'trænsɪt ˌviːzə/ *noun* a visa which allows someone to spend a short time in one country while travelling to another country

transparency /træns'pærənsi/ *noun* the state of being open and easy to understand ○ *Too many different decision-making processes can cause a lack of transparency.*

transparent /træns'pærənt/ *adjective* **1.** completely obvious ○ *Her explanation was a transparent lie.* **2.** open and honest about official actions ○ *The government insists on the importance all its actions being transparent.*

traveller's cheques /'træv(ə)ləz tʃeks/ *plural noun* cheques used by a traveller which can be exchanged for cash in a foreign country

traverse /trə'vɜːs/ *noun* denial in a pleading by one side in a case that the facts alleged by the other side are correct

treason /'triːz(ə)n/ *noun* a notifiable offence of betraying one's country, usually by helping the enemy in time of war ○ *He was accused of treason.* ○ *Three men were executed for treason.* ○ *The treason trial lasted three weeks.*

treasonable /'triːz(ə)nəb(ə)l/ *adjective* being considered as treason ○ *He was accused of making treasonable remarks.*

treason felony /ˌtriːz(ə)n 'feləni/ *noun* the notifiable offence of planning to remove a King or Queen, or of planning to start a war against the United Kingdom

treasure /'treʒə/ *noun* gold, silver or jewels, especially when found or stolen ○ *Thieves broke into the palace and stole the king's treasure.*

treasure trove /ˌtreʒə 'trəʊv/ *noun* treasure which has been hidden by some-

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Law.fm Page 301 Friday, June 11, 2004 2:08 PM

one in the past and has now been discovered

COMMENT: Formerly, any treasure found was declared to the coroner, who decided if it was treasure trove. If it was declared treasure trove, it belonged to the state, though the person who found it usually got a reward equal to its market value. Since 1997 there is a new Treasure Act regarding treasure. The word now covers objects made of at least 10% gold or silver and over 300 years old, whether they have been buried intentionally or simply lost. It also covers other items of value such as pottery. Anyone finding treasure still has to report it to the local coroner, but they will only receive a reward if a museum wants to acquire the object. The reward is based on an independent expert's valuation. The owner of the land where the object was found is now also eligible for a reward.

treasury /'treʒəri/ *noun* □ **the Treasury Benches** front benches in the House of Commons where the government ministers sit

COMMENT: In most countries, the government's finances are the responsibility of the Ministry of Finance, headed by the Finance Minister. In the UK, the Treasury is headed by the Chancellor of the Exchequer.

treasury bonds /'treʒəri bɒnd/ *plural noun* bonds issued by the Treasury of the USA

Treasury counsel /ˌtreʒəri 'kaʊnsəl/ *noun* a barrister who pleads in the Central Criminal Court on behalf of the Director of Public Prosecutions

Treasury Solicitor /ˌtreʒəri sə 'lɪsɪtə/ *noun* the solicitor who is the head of the Government's legal department in England and Wales and legal adviser to the Cabinet Office and other government departments

treaty /'triːti/ *noun* **1.** a written legal agreement between countries ○ *commercial treaty* ○ *cultural treaty* **2.** a formal written agreement, especially between two or more countries □ **to sell (a house) by private treaty** to sell (a house) to another person not by auction

Treaty of Accession /ˌtriːti əv ək 'seʃn/ *noun* the treaty whereby the UK joined the EC

Treaty of Rome /ˌtriːti əv 'rəʊm/ *noun* the treaty which established the EC in 1957

Treaty on European Union /ˌtriːti ɒn ˌjʊərəpiːən 'juːnjən/ *noun* the treaty which created the European Union, with three main pillars: the European Community, the Common Foreign and Security Policy, and the Common Home Affairs and Justice Policy. Abbreviation **TEU**

COMMENT: The TEU established a committee of the regions; the Court of Auditors became part of the Community; more emphasis was put on cooperation in culture, education, etc.; the European Parliament had a greater role than before; capital can move freely between Member States.

trespass /'trespəs/ *noun* the tort of interfering with the land or goods of another person (note that trespass on someone's property is not a criminal offence) (NOTE: Trespass on someone's property is not a criminal offence.) □ **trespass to goods** tort of harming, stealing or interfering with goods which belong to someone else □ **trespass to land** tort of interfering with, going on someone's property or putting things or animals on someone's property without permission □ **trespass to the person** tort of harming someone by assault or false imprisonment ■ *verb* to offend by going on to property without the permission of the owner

trespasser /'trespəsə/ *noun* somebody who commits trespass by going onto land without the permission of the owner

triable /'traɪəb(ə)l/ *adjective* referring to an offence for which a person can be tried in a court □ **offence triable either way** offence which can be tried before the Magistrates' Court or before the Crown Court

triad /'traɪæd/ *noun* a secret Chinese criminal organisation

trial /'traɪəl/ *noun* **1.** a criminal or civil court case heard before a judge ○ *The trial lasted six days.* ○ *The judge ordered a new trial when one of the jurors was found to be the accused's brother.* □ **he is on trial, is standing trial for embezzlement** he is being tried for embezzlement

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Law.fm Page 302 Friday, June 11, 2004 2:08 PM

□ **to commit someone for trial** to send someone to a court to be tried **2.** a test to see if something is good ◇ **on trial 1.** being tested ○ *the product is on trial in our laboratories* **2.** before a court

trial balance /ˈtraɪəl ˌbæləns/ *noun* a draft adding of debits and credits to see if they balance

trial bundle /ˌtraɪəl ˈbʌnd(ə)l/ *noun* all the documents brought together by the claimant for a trial in a ring binder

trial by jury /ˌtraɪəl baɪ ˈdʒʊəri/ *noun* proceedings where an accused is tried by a jury and judge

trial judge /ˈtraɪəl dʒʌdʒ/ *noun* a judge who is hearing a trial

trial location /ˌtraɪəl ləʊˈkeɪʃ(ə)n/ *noun* a place where a trial is to be held

trial period /ˌtraɪəl ˈpɪəriəd/ *noun* the time when a customer can test a product before buying it

trial sample /ˈtraɪəl ˌsɑːmpəl/ *noun* a small piece of a product used for testing

trial timetable /ˌtraɪəl ˈtaɪmteɪb(ə)l/ *noun* a detailed timetable of a hearing, set out in the listing directions, including information such as the length of time allowed for speeches and for cross-examination of witnesses

trial window /ˌtraɪəl ˈwɪndəʊ/ *noun* a period of three weeks during which a trial is scheduled to take place

tribunal /traɪˈbjuːn(ə)l/ *noun* a specialist court outside the judicial system which examines special problems and makes judgments

trier of fact /ˌtraɪə əv ˈfækt/ *noun US* a person such as a member of a jury whose role it is to find out the true facts about a case

Trinity /ˈtrɪnɪti/ *noun* **1.** one of the four sittings of the law courts **2.** one of the four law terms

Trinity House /ˌtrɪnɪti ˈhaʊz/ *noun* a body which superintends lighthouses and pilots in some areas of the British coast

trove ➧ **treasure**

trover /ˈtrəʊvə/ *noun* an action to recover property which has been converted, or goods which have been taken or passed to other parties

true /truː/ *adjective* correct or accurate □ **true copy** exact copy ○ *I certify that this is a true copy.* ○ *The document has been certified as a true copy.*

true bill /ˌtruː ˈbɪl/ *noun* the verdict by a grand jury that an indictment should proceed

trust /trʌst/ *noun* **1.** a feeling of confidence that something is correct, will work, etc. □ **we took his statement on trust** we accepted his statement without examining it to see if it was correct **2.** the duty of looking after goods, money or property which someone (the beneficiary) has passed to you (the trustee) ○ *He left his property in trust for his grandchildren.* **3.** the management of money or property for someone ○ *They set up a family trust for their grandchildren.* **4.** *US* a small group of companies which control the supply of a product ■ *verb* □ **to trust someone with something** to give something to someone to look after ○ *Can he be trusted with all that cash?*

trust company /ˈtrʌst ˌkʌmp(ə)ni/ *noun US* an organisation which supervises the financial affairs of private trusts, executes wills, and acts as a bank to a limited number of customers

trust deed /ˈtrʌst diːd/ *noun* a document which sets out the details of a trust

trustee /trʌˈstiː/ *noun* a person who has charge of money or property in trust ○ *the trustees of the pension fund*

trustee in bankruptcy /trʌˌstiː ɪn ˈbæŋkrʌptsi/ *noun* somebody who is appointed by a court to run the affairs of a bankrupt and pay his or her creditors

trusteeship /trʌˈstiːʃɪp/ *noun* the position of being a trustee ○ *The territory is under United Nations trusteeship.*

trust for sale /ˌtrʌst fə ˈseɪl/ *noun* a trust whereby property is held but can be sold and the money passed to the beneficiaries

trust fund /ˈtrʌst fʌnd/ *noun* assets such as money, securities or property that are held in trust for someone

trust territory /ˌtrʌst ˈterɪt(ə)ri/ *noun* a territory which is being administered by another country under a trusteeship agreement

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Law.fm Page 303 Friday, June 11, 2004 2:08 PM

trusty /ˈtrʌsti/ *noun* a prisoner who is trusted by the prison warders (*slang*)

truth in sentencing /ˌtruːθ ɪn ˈsentənsɪŋ/ *noun* the principal, often enforced by government legislation, that convicted criminals should serve the full sentence they have been given and not become eligible for early parole

try /traɪ/ *verb* to hear a civil or criminal trial ○ *He was tried for murder and sentenced to life imprisonment.* ○ *The court is not competent to try the case.*

TUC *abbreviation* Trades Union Congress

turnkey operation /ˈtɜːnkiː ɒpə ˌreɪʃ(ə)n/ *noun* a contract where a company takes all responsibility for building, fitting and staffing for a building such as a school, hospital or factory so that it is completely ready for the purchaser to take over at an agreed date

turn over /ˌtɜːn ˈəʊvə/ *verb* to have a specific amount of sales ○ *We turn over £2,000 a week.*

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uberrimae fidei /uːˌberɪmiː 'faɪdeɪ/ *phrase* a Latin phrase meaning 'of total good faith': state which should exist between parties to some types of legal relationship such as partnerships or insurance ○ *An insurance contract is uberrimae fidei.*

UCC *abbreviation* Universal Copyright Convention

UDI *abbreviation* Unilateral Declaration of Independence

ulterior motive /ʌlˌtɪəriə 'məʊtɪv/ *noun* a reason for doing something which is not immediately connected with the action, but is done in anticipation of its result and so is an act of bad faith

ultimate consumer /ˌʌltɪmət kən 'sjuːmə/ *noun* the person who actually uses the product

ultimate owner /ˌʌltɪmət 'əonə/ *noun* the real or true owner

ultimatum /ˌʌltɪ'meɪtəm/ *noun* a statement to someone that unless something is done within a period of time a punishment will follow (NOTE: The plural is **ultimatums** or **ultimata**.)

ultra-leftist /ˌʌltrə 'leftɪst/ *noun* extremely left-wing

ultra vires /ˌʌltrə 'vaɪriːz/ *phrase* a Latin phrase meaning 'beyond powers.' ◊ **intra vires** □ **their action was ultra vires** they acted in a way which exceeded their legal powers

umpire /'ʌmpaɪə/ *noun* a person called in to decide when two arbitrators cannot agree

unadmitted /ˌʌnəd'mɪtɪd/ *adjective* (*of a member of staff of a solicitor's office*) not having been admitted as a solicitor

unanimous /juː'nænɪməs/ *adjective* where everyone votes in the same way ○ *There was a unanimous vote against the proposal.* ○ *They reached unanimous agreement.* □ **unanimous verdict** verdict agreed by all the jurors ○ *The jury reached a unanimous verdict of not guilty.*

unanimously /juː'næmɪməsli/ *adverb* with everyone agreeing ○ *The appeal court decided unanimously in favour of the defendant.*

unascertained /ˌʌnæsə'teɪnd/ *adjective* not identified ○ *Title to unascertained goods cannot pass to the buyer until the goods have been ascertained.*

unborn /ʌn'bɔːn/ *adjective* referring to a child still in the mother's body and not yet born

unchallenged /ʌn'tʃælɪndʒd/ *adjective* not questioned or argued about

unclean ◊ **clean hands**

unconditional /ˌʌnkən'dɪʃ(ə)nəl/ *adjective* with no conditions attached ○ *unconditional acceptance of the offer by the board* ○ *On the claimant's application for summary judgment the master gave the defendant unconditional leave to defend.* □ **the offer went unconditional last Thursday** the takeover bid was accepted by the majority of the shareholders and therefore the conditions attached to it no longer apply

unconfirmed /ˌʌnkən'fɜːmd/ *adjective* having not been confirmed ○ *There are unconfirmed reports that a BBC reporter has been arrested.*

unconstitutional /ˌʌnkɒnstɪ 'tjuːʃ(ə)n(ə)l/ *adjective* **1.** being not according to the constitution of a country ○ *Legislation which is contrary to European Community regulations is declared*

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Law.fm Page 305 Friday, June 11, 2004 2:08 PM

unconstitutional. ○ *The Appeal Court ruled that the action of the Attorney-General was unconstitutional.* **2.** being not allowed by the rules of an organisation ○ *The chairman ruled that the meeting was unconstitutional.*

uncontested /ˌʌnkənˈtestɪd/ *adjective* being not contested or defended ○ *an uncontested divorce case* or *election*

uncrossed cheque /ˌʌnkrɒst ˈtʃek/ *noun* a cheque which does not have two lines across it and can be exchanged for cash anywhere

undefended /ˌʌndɪˈfendɪd/ *adjective* referring to a case in which the defendant does not acknowledge service and does not appear at the court to defend the case ○ *an undefended divorce case*

undercover agent /ˌʌndəkʌvə ˈeɪdʒənt/ *noun* someone acting secretly to get information or catch criminals

underlease /ˈʌndəliːs/ *noun* a lease from a tenant to another tenant

underlet /ˈʌndəlet/ *verb* to let a property which is held on a lease

undermentioned /ˌʌndə ˈmenʃ(ə)nd/ *adjective* mentioned lower down in a document

undersheriff /ˈʌndəˌʃerɪf/ *noun* a person who is second to a High Sheriff and deputises for him

undersigned /ˌʌndəˈsaɪnd/ *noun* somebody who has signed a letter □ **we, the undersigned** we, the people who have signed below

understanding /ˌʌndəˈstændɪŋ/ *noun* a private agreement ○ *The two parties came to an understanding about the division of the estate.* □ **on the understanding that** on condition that, provided that ○ *We accept the terms of the contract, on the understanding that it has to be ratified by the full board.*

undertake /ˌʌndəˈteɪk/ *verb* to promise to do something ○ *to undertake an investigation of the fraud* ○ *The members of the jury have undertaken not to read the newspapers.* ○ *He undertook to report to the probation office once a month.* (NOTE: **undertaking – undertook – has undertaken**)

undertaking /ˈʌndəˌteɪkɪŋ/ *noun* **1.** a business ○ *a commercial undertaking* **2.** a promise to do something that has legal force ○ *They have given us a written undertaking that they will not infringe our patent.* ○ *The judge accepted the defendant's undertaking not to harass the claimant.*

undertenant /ˌʌndəˈtenənt/ *noun* somebody who holds a property on an underlease

underworld /ˈʌndəwɜːld/ *noun* the world of criminals ○ *The police has informers in the London underworld.* ○ *The indications are that it is an underworld killing.*

underwrite /ˌʌndəˈraɪt/ *verb* **1.** to accept responsibility for □ **to underwrite a share issue** to guarantee that a share issue will be sold by agreeing to buy all shares which are not subscribed ○ *The issue was underwritten by three underwriting companies.* □ **to underwrite an insurance policy** to accept liability for the payment of compensation according to the policy **2.** to agree to pay for costs ○ *The government has underwritten the development costs of the building.* (NOTE: **underwriting – underwrote – has underwritten**)

underwriter /ˈʌndəraɪtə/ *noun* **1.** somebody who underwrites a share issue **2.** somebody who accepts liability for an insurance

undesirable alien /ˌʌndɪzaɪrəb(ə)l ˈeɪliən/ *noun* a person who is not a citizen of a country, and who the government considers should not be allowed to stay in the country ○ *He was deported as an undesirable alien.*

undischarged bankrupt /ˌʌndɪstʃɑːdʒd ˈbæŋkrʌpt/ *noun* somebody who has been declared bankrupt and has not been released from that state

undisclosed /ˌʌndɪsˈkləʊzd/ *adjective* not identified

COMMENT: The doctrine of the undisclosed principal means that the agent may be sued as well as the principal if his identity is discovered.

undisclosed principal /ˌʌndɪskləʊzd ˈprɪnsɪp(ə)l/ *noun* a principal who has not been identified by his or her agent

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Law.fm Page 306 Friday, June 11, 2004 2:08 PM

undue influence /ˌʌndjuː ˈɪnfluəns/ *noun* wrongful pressure put on someone which prevents that person from acting independently

unemployment /ˌʌnɪmˈplɔɪmənt/ *noun* absence of work ○ *the unemployment figures* or *the figures for unemployment are rising*

unemployment pay /ˌʌnɪm ˈplɔɪmənt peɪ/ *noun* money given by the government to someone who is unemployed

unenforceable /ˌʌnɪnˈfɔːsəb(ə)l/ *adjective* unable to be enforced

unequivocal /ˌʌnɪˈkwɪvək(ə)l/ *adjective* clear and not ambiguous in any way

unfair /ʌnˈfeə/ *adjective* not just or reasonable

unfair competition /ˌʌnfeə ˌkɒmpə ˈtɪʃ(ə)n/ *noun* an attempt to do better than another company by using methods such as importing foreign products at very low prices or by wrongly criticising a competitor's products

unfair contract term /ˌʌnfeə ˈkɒntrækt tɜːm/ *noun* a term in a contract which is held by law to be unjust

unfair dismissal /ˌʌnfeə dɪs ˈmɪs(ə)l/ *noun* the act of removing someone from a job in a way that appears not to be reasonable such as dismissing someone who wants to join a union

COMMENT: An employee can complain of unfair dismissal to an employment tribunal.

unfit to plead /ʌnˌfɪt tə ˈpliːd/ *noun* mentally not capable of being tried

uni- /juːni/ *prefix* meaning single

Uniform Commercial Code /ˌjuːnɪfɔːm kəˌmɜːʃ(ə)l ˈkəʊd/ *noun* in the USA, a set of uniform laws governing commercial transactions

unilateral /ˌjuːnɪˈlæt(ə)rəl/ *adjective* on one side only, or done by one party only ○ *They took the unilateral decision to cancel the contract.*

unilaterally /ˌjuːnɪˈlæt(ə)rəli/ *adverb* by one party only ○ *They cancelled the contract unilaterally.*

unincorporated association /ˌʌnɪnkɔːpəreɪtɪd əˌsəʊsiˈeɪʃ(ə)n/ *noun* a group of people, such as a club or partnership, which is not legally incorporated

uninsured /ʌnɪnˈʃʊəd/ *adjective* with no valid insurance ○ *The driver of the car was uninsured.*

United Kingdom /juːˌnaɪtɪd ˈkɪŋdəm/ *noun* an independent country, formed of England, Wales, Scotland and Northern Ireland ○ *He came to the UK to study.* ○ *Does she have a UK passport?* ○ *Is he a UK citizen?* Abbreviation **UK**

United Nations /juːˌnaɪtɪd ˈneɪʃ(ə)nz/**, United Nations Organization** *noun* an international organisation including almost all sovereign states in the world, where member states are represented at meetings. Abbreviation **UNO**

United States Code /juːˌnaɪtɪd steɪts ˈkəʊd/ *noun* a book containing all the permanent laws of the USA, arranged in sections according to subject, and revised from time to time

United States of America /juːˌnaɪtɪd steɪts əv əˈmerɪkə/ *noun* an independent country, a federation of 50 states in North America. Abbreviation **USA**

COMMENT: The federal government (based in Washington D.C.) is formed of a legislature (the Congress) with two chambers (the Senate and House of Representatives), an executive (the President) and a judiciary (the Supreme Court). Each of the fifty states making up the USA has its own legislature and executive (the Governor) as well as its own legal system and constitution.

Universal Copyright Convention /ˌjuːnɪvɜːs(ə)l ˈkɒpiraɪt kənˌvenʃ(ə)n/ *noun* an international agreement on copyright set up by the United Nations in Geneva in 1952. Abbreviation **UCC**

COMMENT: Both the Berne Convention of 1886 and the UCC were drawn up to try to protect copyright from pirates; under the Berne Convention, published material remains in copyright until 50 years after the death of the author and for 25 years after publication under the UCC. In both cases, a work which is copyrighted in one country is automatically covered by the copyright legislation of all countries signing the convention.

universal franchise /ˌjuːnɪvɜːs(ə)l ˈfræntʃaɪz/ *noun* the right to vote which

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Law.fm Page 307 Friday, June 11, 2004 2:08 PM

is given to all adult members of the population

universal suffrage /ˌjuːnɪvɜːs(ə)l ˈsʌfrɪdʒ/ *noun* same as **universal franchise**

unjust /ʌnˈdʒʌst/ *adjective* not according to legal or reasonable moral standards

unlawful /ʌnˈlɔːf(ə)l/ *adjective* against the law □ **unlawful sexual intercourse** sexual intercourse with someone who is under the age of consent, etc. □ **verdict of unlawful killing** (*in a coroner's court*) verdict that a person's death was murder or manslaughter

unlawful assembly /ʌnˌlɔːf(ə)l ə ˈsemblɪ/ *noun* a notifiable offence when a number of people come together to commit a breach of the peace or any other crime

unless order /ənˌles ˈɔːdə/ *noun* an order that a statement of claim will be struck out if a party does not comply with the order

unlimited company /ʌnˌlɪmɪtɪd ˈkʌmp(ə)ni/ *noun* a company where the shareholders have no limit as regards liability

unlimited liability /ʌnˌlɪmɪtɪd ˌlaɪə ˈbɪlɪti/ *noun* a situation where a sole trader or each single partner is responsible for all the firm's debts with no limit at the amount each may have to pay

unliquidated claim /ˌʌnlɪkwɪdeɪtd ˈkleɪm/ *noun* a claim for unliquidated damages

unliquidated damages /ˌʌnlɪkwɪdeɪtɪd ˈdæmɪdʒɪz/ *plural noun* damages which are not for a fixed amount of money but are awarded by a court as a matter of discretion depending on the case

COMMENT: Torts give rise to claims for unliquidated damages.

unmarried /ʌnˈmærid/ *adjective* not legally married

unofficial /ˌʌnəˈfɪʃ(ə)l/ *adjective* not official

unofficially /ʌnəˈfɪʃəli/ *adverb* not officially ○ *The tax office told the company, unofficially, that it would be prosecuted.*

unopposed /ˌʌnəˈpəʊzd/ *adjective* (motion) with no one voting against

unparliamentary /ʌnˌpɑːlə ˈment(ə)ri/ *adjective* not suitable for Parliament

COMMENT: Various terms of abuse are considered unparliamentary, in particular words which suggest that an MP has not told the truth. In a recent exchange in the House of Commons, a Member called others 'clowns' and 'drunks'; the Deputy Speaker said: 'Order. That is unparliamentary language, and I must ask the hon. Member to withdraw'. Another recent example occurred when an MP said: 'if the hon. Member were honest, I suspect that he would have to do the same'. *Mr. Speaker:* 'Order. All hon. Members are honest.'.

unprecedented /ʌnˈpresɪdentɪd/ *adjective* having not happened before, or having no legal precedent ○ *In an unprecedented move, the tribunal asked the witness to sing a song.*

unprofessional conduct /ʌnprəˌfeʃən(ə)l ˈkɒndʌkt/ *noun* a way of behaving which is not suitable for a professional person and goes against the code of practice of a profession

unquantifiable /ʌnˌkwɒntɪˈfaɪəb(ə)l/ *adjective* unable to be stated exactly

unreasonable /ʌnˈriːz(ə)nəb(ə)l/ *adjective* not fair or acceptable according to what might be usually expected

unreasonable conduct /ʌnˌriːz(ə)nəb(ə)l kənˈdʌkt/ *noun* behaviour by a spouse which is not reasonable and which shows that a marriage has broken down

unreasonably /ʌnˈriːz(ə)nəbli/ *adverb* in a way which is not reasonable or which cannot be explained ○ *Approval of any loan will not be unreasonably withheld.*

unredeemed pledge /ˌʌnrɪdiːmd ˈpledʒ/ *noun* a pledge which the borrower has not claimed back by paying back his or her loan

unregistered /ʌnˈredʒɪstəd/ *adjective* referring to land which has not been registered

unreliable /ˌʌnrɪˈlaɪəb(ə)l/ *adjective* being impossible to rely on ○ *The prose-*

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Law.fm Page 308 Friday, June 11, 2004 2:08 PM

cution tried to show that the driver's evidence was unreliable. ○ *The defence called two witnesses and both were unreliable.*

unreported /ˌʌnrɪˈpɔːtɪd/ *adjective* **1.** not reported to the police ○ *There are thousands of unreported cases of theft.* **2.** not reported in the Law Reports ○ *Counsel referred the judge to a number of relevant unreported cases.*

unsafe /ʌnˈseɪf/ *adjective* referring to a judgment which is not acceptable in law and may be quashed on appeal

unsecured creditor /ˌʌnsɪkjʊəd ˈkredɪtə/ *noun* a creditor who is owed money, but has no mortgage or charge over the debtor's property as security

unsecured debt /ˌʌnsɪkjʊəd ˈdet/ *noun* a debt which is not guaranteed by assets

unsecured loan /ˌʌnsɪkjʊəd ˈləʊn/ *noun* a loan made with no security

unsolicited /ʌnsəˈlɪsɪtɪd/ *adjective* having not been asked for ○ *an unsolicited gift*

unsolicited goods /ˌʌnsəlɪsɪtɪd ˈgʊdz/ *plural noun* goods which are sent to someone who has not asked for them, suggesting that he or she might like to buy them

unsolved /ʌnˈsɒlvd/ *adjective* not solved ○ *an unsolved crime*

unsound /ʌnˈsaʊnd/ *adjective* □ **persons of unsound mind** people who are not sane

unsworn /ʌnˈswɔːn/ *adjective* having not been made on oath ○ *an unsworn statement*

unwritten agreement /ʌnˌrɪt(ə)n əˈgriːmənt/ *noun* an agreement which has been reached orally but has not been written down

unwritten law /ʌnˌrɪt(ə)n ˈlɔː/ *noun* a rule which is established by precedent

uphold /ʌpˈhəʊld/ *verb* to keep in good order □ **to uphold the law** to make sure that laws are obeyed □ **to uphold a sentence** to reject an appeal against a sentence ○ *The Appeal Court upheld the sentence.*

uplift /ˈʌplɪft/ *noun* in a conditional fee agreement, an extra fee paid by a client to a lawyer if the case is won

Upper Chamber /ˌʌpə ˈtʃeɪmbə/ *noun* the House of Lords or the Senate

upper class /ˈʌpə klɑːs/ *noun* the aristocracy and the richest and most influential business and professional people

upper middle class /ˌʌpə ˈmɪd(ə)l klɑːs/ *noun* wealthy professional people and businessmen

urine sample /ˌjʊərɪn ˈsɑːmpəl/ *noun* a small amount of urine taken from someone to be tested

urine test /ˈjʊərɪn test/ *noun* a test of a sample of a person's urine to see if it contains drugs or alcohol

use /juːs/ *noun* **1.** land held by the legal owner on trust for a beneficiary **2.** □ **land zoned for industrial use** land where planning permission has been given to build factories

user's guide /ˈjuːzəz gaɪd/ *noun* a book showing someone how to use something

usher /ˈʌʃə/ *noun* somebody who guards the door leading into a courtroom and maintains order in court

usufruct /ˈjuːsjufrʌkt/ *noun* the right to enjoy the use or the profit of the property or land of another person

usurp /juːˈzɜːp/ *verb* to take and use someone's else role, position or right when you do not have the authority to do it

usurpation /juːzɜːˈpeɪʃ(ə)n/ *noun* the activity of taking and using a right which is not yours

usurper /juːˈzɜːpə/ *noun* somebody who usurps power ○ *The army killed the usurper and placed the king back on his throne again.*

usury /ˈjuːʒəri/ *noun* the practice of lending money at very high interest

utter /ˈʌtə/ *verb* to use a forged document criminally

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V

v. against. Abbreviation of **versus** (NOTE: Titles of cases are quoted as *Hills v. The Amalgamated Company Ltd; R. v. Smith.*)

vacant /ˈveɪkənt/ *adjective* not occupied

vacantia ◗ **bona vacantia**

vacant possession /ˌveɪkənt pəˈzeʃ(ə)n/ *noun* the right to occupy a property immediately after buying it because it is empty ○ *The property is to be sold with vacant possession.*

vacate /vəˈkeɪt/ *verb* □ **to vacate the premises** to leave premises, so that they become empty

vacation /vəˈkeɪʃ(ə)n/ *noun* **1.** a period when the courts are closed between sittings **2.** *US* a period when people are not working

vagrancy /ˈveɪgrənsi/ *noun* the state of being a vagrant ○ *He was charged with vagrancy.*

vagrant /ˈveɪgrənt/ *noun* somebody who goes about with no work and no place to live

valid /ˈvælɪd/ *adjective* **1.** being acceptable because it is true ○ *That is not a valid argument* or *excuse.* **2.** being able to be used lawfully ○ *The contract is not valid if it has not been witnessed.* ○ *Ticket which is valid for three months.* ○ *He was carrying a valid passport.*

validate /ˈvælɪˌdeɪt/ *verb* **1.** to check to see if something is correct ○ *The document was validated by the bank.* **2.** to make something valid ○ *The import documents have to be validated by the customs officials.*

validation /ˌvælɪˈdeɪʃ(ə)n/ *noun* the act of making something valid

validity /vəˈlɪdɪti/ *noun* the state of being valid ○ *A national court can ask the ECJ for a ruling about the validity of a Community act.*

valorem /vəˈlɔːrəm/ ◗ **ad valorem**

valuable /ˈvæljʊəb(ə)l/ *adjective* being worth a lot of money

valuable consideration /ˌvæljʊəb(ə)l kənˌsɪdəˈreɪʃ(ə)n/ *noun* something of value which is passed from one party (the promisee) to another (the promisor) as payment for what is promised

valuable property /ˌvæljʊb(ə)l ˈprɒpəti/ *noun* personal items which are worth a lot of money

valuation /ˌvæljuˈeɪʃ(ə)n/ *noun* an estimate of how much something is worth ○ *to ask for a valuation of a property before making an offer for it*

value /ˈvæljuː/ *noun* the amount of money which something is worth ○ *the fall in the value of the dollar* ○ *He imported goods to the value of £250.* ○ *The valuer put the value of the stock at £25,000.* ■ *verb* to estimate how much money something is worth ○ *goods valued at £250* ○ *He valued the stock at £25,000.* ○ *We are having the jewellery valued for insurance.*

Value Added Tax /ˌvæljuː ædɪd ˈtæks/ *noun* a tax imposed as a percentage of the invoice value of goods and services. Abbreviation **VAT**

valued policy /ˌvæljuːd ˈpɒlɪsi/ *noun* a marine insurance policy where the value of what is insured is stated

valuer /ˈvæljʊə/ *noun* somebody who values property for insurance purposes

vandal /ˈvænd(ə)l/ *noun* somebody who destroys property, especially public

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Law.fm Page 310 Friday, June 11, 2004 2:08 PM

property, wilfully ○ *Vandals have pulled the telephones out of the call boxes.*

vandalise /'vændəlaɪz/, **vandalize** *verb* to destroy property wilfully ○ *None of the call boxes work because they have all been vandalised.*

vandalism /'vændəˌlɪz(ə)m/ *noun* the wilful destruction of property

variable /'veəriəb(ə)l/ *adjective* changing

variable costs /ˌveəriəb(ə)l 'kɒsts/ *plural noun* costs of producing a product or service which change according to the amount produced

variance /'veəriəns/ *noun* the difference

variation /ˌveəri'eɪʃ(ə)n/ *noun* **1.** the amount by which something changes □ **seasonal variations** changes which take place because of the seasons **2.** a change in conditions ○ *The petitioner asked for a variation in her maintenance order.*

vary /'veəri/ *verb* to change ○ *The court has been asked to vary the conditions of the order.* ○ *Demand for social services varies according to the weather.*

VAT /ˌviː eɪ 'tiː, væt/ *abbreviation* Value Added Tax

VAT declaration /'væt deklə ˌreɪʃ(ə)n/ *noun* a statement declaring VAT income to the VAT office

vault /vɔːlt/ *noun* an underground strongroom usually built under a bank

VC *abbreviation* Vice Chancellor

vendee /ven'diː/ *noun* somebody who buys

vendible /'vendɪb(ə)l/ *adjective* able to be sold ○ *For a patent application to succeed, the product being patented must be vendible.*

vendor /'vendə/ *noun* somebody who sells ○ *the solicitor acting on behalf of the vendor*

venue /'venjuː/ *noun* a place where a meeting or hearing is held

verbal /'vɜːb(ə)l/ *adjective* **1.** using spoken words, not writing **2.** referring to spoken or written evidence ■ *verb* to use threatening words when interviewing a suspect

verbal agreement /ˌvɜːb(ə)l ə 'griːmənt/ *noun* an agreement which is spoken and not written down

verbal evidence /ˌvɜːb(ə)l 'evɪd(ə)ns/ *noun* written or spoken evidence. Compare **non-verbal evidence** (NOTE: British lawyers refer specifically to spoken evidence as oral evidence.)

verbally /'vɜːbəli/ *adverb* using spoken words, not writing ○ *They agreed to the terms verbally, and then started to draft the contract.*

verbals /'vɜːb(ə)lz/ *plural noun* words spoken to a police officer by a suspect (*informal*)

verbal warning /ˌvɜːb(ə)l 'wɔːnɪŋ/ *noun* a stage in warning an employee that his or her work is not satisfactory, followed by a written warning, if performance does not improve

verbatim /vɜː'beɪtɪm/ *adjective*, *adverb* in the exact words ○ *a verbatim transcript of the trial* ○ *Hansard provides a verbatim account of the proceedings of the House of Commons.*

verdict /'vɜːdɪkt/ *noun* **1.** the decision of a jury or magistrate □ **to bring in**, **to return a verdict** to state a verdict at the end of a trial ○ *The jury brought in* or *returned a verdict of not guilty.* □ **to come to a verdict**, **to reach a verdict** to decide whether the accused is guilty or not ○ *The jury took two hours to reach their verdict.* **2.** the decision reached by a coroner's court ○ *The court returned a verdict of death by misadventure.*

versa ➧ **vice versa**

versus /'vɜːsəs/ *preposition* against (NOTE: usually abbreviated to **v.** as in **the case of** *Smith v. Williams*)

vest /vest/ *verb* to transfer to someone the legal ownership and possession of land or of a right ○ *The property was vested in the trustees.* (NOTE: You vest something **in** *or* **on** someone.)

vested interest /ˌvestɪd 'ɪntrəst/ *noun* an interest in a property which will come into a person's possession when the interest of another person ends

vested remainder /ˌvestɪd rɪ 'meɪndə/ *noun* a remainder which is absolutely vested in a person

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Law.fm Page 311 Friday, June 11, 2004 2:08 PM

vesting assent /ˌvestɪŋ əˈsent/ *noun* a document which vests settled land on a tenant for life

vesting order /ˌvestɪŋ ˈɔːdə/ *noun* a court order which transfers property

vet /vet/ *verb* to examine someone or a document carefully to see if there is any breach of security ○ *All applications are vetted by the Home Office.*

veto /ˈviːtəʊ/ *noun* a ban or order not to allow something to become law, even if it has been passed by a parliament ○ *The President has the power of veto over Bills passed by Congress.* ○ *The UK used its veto in the Security Council.* ■ *verb* to refuse to allow something, especially to use an official power to do so ○ *The resolution was vetoed by the president.* ○ *The council has vetoed all plans to hold protest marches in the centre of town.*

COMMENT: In the United Nations Security Council, each of the five permanent members has a veto. In the USA, the President may veto a bill sent to him by Congress, provided he does so within ten days of receiving it. The bill then returns to Congress for further discussion, and the President's veto can be overridden by a two-thirds majority in both House of Representatives and Senate.

vexatious /vekˈseɪʃəs/ *adjective* annoying

vexatious action /vekˌseɪʃəs ˈækʃən/ *noun* a case brought in order to annoy the defendant

vexatious litigant /vekˌseɪʃəs ˈlɪtɪgənt/ *noun* somebody who frequently starts legal actions to annoy people and who is barred from bringing actions without leave of the court

viable /ˈvaɪəb(ə)l/ *adjective* able to be done □ **not commercially viable** not likely to make a profit □ **viable alternative** different proposal which may work

vicarious /vɪˈkeəriəs/ *adjective* not personally interested

COMMENT: If the employee is on a frolic of his own, the employer may not be liable.

vicarious liability /vɪˌkeəriəs ˌlaɪə ˈbɪlɪti/ *noun* a liability of one person for torts committed by another, especially the liability of an employer for acts committed by an employee in the course of work

vicariously /vɪˈkeəriəsli/ *adverb* not directly

vicarious performance /vɪˌkeəriəs pəˈfɔːməns/ *noun* the performance of a contract where the work has been done by a third party

vice /vaɪs/ *Latin word meaning* 'in the place of' ○ *was present: Councillor Smith (vice Councillor Brown)*

Vice Chancellor /ˌvaɪs ˈtʃɑːnsələ/ *noun* a senior judge in charge of the Chancery Division of the High Court. Abbreviation **VC**

vice-consul /ˌvaɪs ˈkɒnsəl/ *noun* a diplomat with a rank below consul

Vice-President /ˌvaɪs ˈprezɪdənt/ *noun* the deputy to a president

COMMENT: In the USA, the Vice-President is the president (i.e. the chairman) of the Senate. He also succeeds a president if the president dies in office (as Vice-President Johnson succeeded President Kennedy).

vice versa /ˌvaɪsi ˈvɜːsə/ *phrase* a Latin phrase meaning 'reverse position': in the opposite way ○ *the responsibilities of the employer towards the employee and vice versa*

victim /ˈvɪktɪm/ *noun* somebody who suffers a crime or a wrong ○ *The mugger left his victim lying in the road.* ○ *He was the victim of a con trick.* ○ *The accident victims* or *victims of the accident were taken to hospital.*

victimless crime /ˌvɪktɪmləs ˈkraɪm/ *noun* a crime where there is no obvious victim, e.g. drug pushing or prostitution

vide /ˈvɪdi/ *Latin word meaning* 'see': used in written texts to refer to another reference

videlicet /ˈvɪdiːlɪset/ *phrase* a Latin word meaning 'that is' (NOTE: usually abbreviated to **viz**)

video conferencing /ˈvɪdiəʊ ˌkɒnf(ə)rənsɪŋ/ *noun* a system of conducting a hearing using closed-circuit television and recording the events on tape

Vienna Conventions /viˌenə kən ˈvenʃ(ə)nz/ *noun* conventions signed in

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Law.fm Page 312 Friday, June 11, 2004 2:08 PM

Austria, generally relating to international treaties and the rights of diplomats

villain /ˈvɪlən/ *noun* a criminal (*informal*) ○ *The job of the policeman is to catch villains.*

villainy /ˈvɪləni/ *noun* a wilful illegal act

violate /ˈvaɪəleɪt/ *verb* to break a rule or a law ○ *The council has violated the planning regulations.* ○ *The action of the government violates the international treaty on commercial shipping.* ○ *The legislation was inapplicable in this case, and the country had not violated the Treaty.*

violation /ˌvaɪəˈleɪʃ(ə)n/ *noun* the act of breaking a rule ○ *The number of traffic violations has increased.* ○ *The court criticised the violations of the treaty on human rights.* □ **in violation of a rule** breaking a rule

violence /ˈvaɪələns/ *noun* an action using force □ **violence against the person** one of the types of notifiable offences against the person, e.g. murder, assault

violent /ˈvaɪələnt/ *adjective* using force ○ *a violent attack on the police* □ **the prisoner became violent** the prisoner tried to attack

virement /ˈvaɪəmənt/ *noun* the transfer of money from one account to another or from one section of a budget to another ○ *The council may use the virement procedure to transfer money from one area of expenditure to another.*

vires ➧ **intra vires, ultra vires**

virtue /ˈvɜːtʃuː/ *noun* good quality

virtute officii /vɜːˌtuːti ɒˈfɪsɪi/ *phrase* a Latin phrase meaning 'because of his office'

visa /ˈviːzə/ *noun* a special document or special stamp in a passport which allows someone to enter a country ○ *You will need a visa before you go to the USA.* ○ *She filled in her visa application form.*

visitor /ˈvɪzɪtə/ *noun* somebody who goes to see someone for a short time

visitor's visa /ˈvɪzɪtəz ˌviːzə/ *noun* a visa which allows a person to visit a country for a short time

vis major /ˌvɪs ˈmeɪdʒə/ *noun* Latin words meaning 'superior force': force of people or of nature such as a revolution or an earthquake which cannot be stopped

vital statistics /ˌvaɪt(ə)l stəˈtɪstɪks/ *noun* statistics dealing with births, marriages and deaths in a town or district

viva voce /ˌvaɪvə ˈvəʊtʃi/ *phrase* a Latin phrase meaning 'orally', 'by speaking'

vivos /ˈvaɪvəʊs/ *plural noun* a Latin word meaning 'living people'

viz ➧ **videlicet**

void /vɔɪd/ *adjective* not having any legal effect □ **the contract was declared null and void** the contract was said to be no longer valid ■ *verb* □ **to void a contract** to make a contract invalid

voidable /ˈvɔɪdəb(ə)l/ *adjective* being able to be made void

COMMENT: A contract is void where it never had legal effect, but is voidable if it is apparently of legal effect and remains of legal effect until one or both parties take steps to rescind it.

voided /ˈvɔɪdɪd/ *adjective* deprived of legal force

void marriage /ˌvɔɪd ˈmærɪdʒ/ *noun* a marriage which is declared not to have had any legal existence

volenti non fit injuria /vəʊˌlenti nəʊn fɪt ɪnˈdʒʊəriə/ *phrase* a Latin phrase meaning 'there can be no injury to a person who is willing': a rule that if someone has agreed to take the risk of an injury he or she cannot sue for it, as in the case of someone injured in a boxing match

volition /vəˈlɪʃ(ə)n/ *noun* the will to do something □ **of your own volition** because you decide to do something yourself ○ *She gave up her job of her own volition.*

voluntary /ˈvɒlənt(ə)ri/ *adjective* **1.** done without being forced or without being paid **2.** without being paid a salary

voluntary confession /ˌvɒlənt(ə)ri kənˈfeʃ(ə)n/ *noun* a confession made by an accused person without being threatened or paid

voluntary disposition /ˌvɒlənt(ə)ri ˌdɪspəˈzɪʃ(ə)n/ *noun* the transfer of property without any valuable consideration

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Law.fm Page 313 Friday, June 11, 2004 2:08 PM

voluntary liquidation /ˌvɒlənt(ə)ri ˌlɪkwɪ'deɪʃ(ə)n/ *noun* a situation where a company itself decides it must close and sell its assets

voluntary manslaughter /ˌvɒlənt(ə)ri 'mænslɔːtə/ *noun* the offence of killing someone intentionally, but under mitigating circumstances such as provocation or diminished responsibility. ◊ **involuntary manslaughter**

voluntary organisation /'vɒlənt(ə)ri ˌɔːgənaɪzeɪʃ(ə)n/ *noun* an organisation which has no paid staff

voluntary redundancy /ˌvɒlənt(ə)ri rɪ'dʌndənsi/ *noun* a situation where the employee asks to be made redundant, usually in return for a payment

voluntary unemployment /ˌvɒlənt(ə)ri ʌnɪm'plɔɪmənt/ *noun* a situation where an employee resigns from a job of his or her own free will and does not look for another

volunteer /ˌvɒlən'tɪə/ *noun* **1.** somebody who gives or receives property without consideration **2.** somebody who offers to do something without being forced ■ *verb* **1.** to offer information without being asked ○ *He volunteered the information that the defendant was not in fact a British subject.* **2.** to offer to do something without being forced ○ *Six men volunteered to go into the burning house.*

vote down /ˌvəʊt 'daʊn/ *verb* □ **to vote down** to defeat a motion ○ *The proposal was voted down.*

vote in /ˌvəʊt 'ɪn/ *verb* □ **to vote someone in** to elect someone ○ *The Tory candidate was voted in.*

vote out /ˌvəʊt 'aʊt/ *verb* □ **to vote someone out** to make someone lose an election ○ *The government was voted out of office within a year.*

voter /'vəʊtə/ *noun* somebody who votes

voting /'vəʊtɪŋ/ *noun* the act of making a vote

voting paper /'vəʊtɪŋ ˌpeɪpə/ *noun* a piece of paper on which the voter puts a cross to show for whom he or she wants to vote

voting rights /'vəʊtɪŋ raɪts/ *plural noun* rights of shareholders to voting at company meetings

vouch for /'vaʊtʃ fɔː/ *verb* **1.** to state that you believe something is correct, to say that you take responsibility for something ○ *I cannot vouch for the correctness of the transcript of proceedings.* **2.** to say that you take responsibility for something

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W

wage claim /ˈweɪdʒ kleɪm/ *noun* a request for an increase in wages

wage review /ˈweɪdʒ rɪˌvjuː/ *noun* an examination of salaries or wages in a company to see if the employees should earn more

waive /weɪv/ *verb* to give up a right ○ *He waived his claim to the estate.* □ **to waive a payment** to say that payment is not necessary

waiver /ˈweɪvə/ *noun* an act of voluntarily giving up a right, or removing the conditions of a rule ○ *If you want to work without a permit, you will have to apply for a waiver.*

waiver clause /ˈweɪvə klɔːz/ *noun* a clause in a contract giving the conditions under which the rights in the contract can be given up

Wales and Chester Circuit /ˌweɪlz ən ˈtʃestə ˌsɜːkɪt/ *noun* one of the six circuits of the Crown Court to which barristers belong, with its centre in Cardiff

walking possession /ˌwɔːkɪŋ pə ˈzeʃ(ə)n/ *noun* temporary possession of a debtor's goods taken by a bailiff or sheriff until they can be sold to satisfy execution

wall safe /ˈwɔːl seɪf/ *noun* a safe fixed in a wall

wanted /ˈwɒntɪd/ *adjective* required for questioning as a suspect in a crime

war crimes /ˈwɔː kraɪmz/ *plural noun* criminal acts committed by a country, or by people in positions of power during time of war

ward /wɔːd/ *noun* **1.** a division of a town or city for administrative purposes □ **an electoral ward** area of a town represented by a councillor on a local council **2.** a minor protected by a guardian ○ *Mr Jones acting on behalf of his ward, Miss Smith.* **3.** a minor protected by a court ■ *verb* to make a child a ward ○ *The court warded the girl.*

warden /ˈwɔːd(ə)n/ *noun* **1.** somebody who is in charge of an institution **2.** *US* the head of a prison (NOTE: The British equivalent is **prison governor**.) **3.** somebody who sees that rules are obeyed

warder /ˈwɔːdə/ *noun* a guard in a prison

ward of court /ˌwɔːd əv ˈkɔːt/ *noun* a minor under the protection of the High Court ○ *The High Court declared the girl ward of court, to protect her from her uncle who wanted to take her out of the country.*

wardship /ˈwɔːdʃɪp/ *noun* **1.** the role of being in charge of a ward ○ *The judge has discretion to exercise the wardship jurisdiction.* **2.** the power of a court to take on itself the rights and responsibilities of parents in the interests of a child

warehousing /ˈweəhaʊzɪŋ/ *noun* the act of storing goods ○ *Warehousing costs are rising rapidly.* □ **warehousing in bond** keeping imported goods in a warehouse without payment of duty, either to be exported again, or for sale into the country when the duty has been paid

warrant /ˈwɒrənt/ *noun* **1.** an official document from a court which allows someone to do something □ **to issue a warrant for the arrest of someone**, **to issue an arrest warrant for someone** to make out and sign an official document which authorises the police to arrest someone **2.** an official document authorising the payment of money ○ *a dividend warrant*

warrantee /ˌwɒrənˈtiː/ *noun* somebody who is given a warranty

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Law.fm Page 315 Friday, June 11, 2004 2:08 PM

warrant of attachment /ˌwɒrənt əv əˈtætʃmənt/ *noun* a warrant which authorises the bailiff to arrest a person in contempt of court

warrant of committal /ˌwɒrənt əv kəˈmɪt(ə)l/ *noun* same as **committal warrant**

warrant of execution /ˌwɒrənt əv ˌeksɪˈkjuːʃ(ə)n/ *noun* a warrant issued by a court which gives the bailiffs or sheriffs the power to seize goods from a debtor in order to pay his or her debts

warrantor /ˌwɒrənˈtɔː/ *noun* somebody who gives a warranty

warranty /ˈwɒrənti/ *noun* **1.** a guarantee ○ *The car is sold with a twelve-month warranty.* ○ *The warranty covers spare parts but not labour costs.* **2.** a contractual term which is secondary to the main purpose of the contract **3.** a statement made by an insured person which declares that the facts stated by them are true

wash sale /ˈwɒʃ seɪl/ *noun* the activity of buying stock and selling it almost immediately, to give the impression that business is good

wasted costs order /ˌweɪstɪd kɒsts ˈɔːdə/ *noun* an order by a court that a party has to pay the costs involved in a case which has to be postponed because the party's representative is badly prepared or incompetent

watch /wɒtʃ/ *noun* a group of people who patrol the streets to maintain law and order

watch committee /ˈwɒtʃ kəˌmɪti/ *noun* a committee of a local authority which supervises the policing of an area

watchdog /ˈwɒtʃdɒg/, **watchdog body** /ˈwɒtʃdɒg ˌbɒdi/ *noun* **1.** a body which sees that the law is obeyed ○ *The Commission acts as the watchdog for competition law.* **2.** a body which takes note of what official bodies such as government departments or commercial firms are doing to see that regulations are not being abused

water pollution /ˈwɔːtə pəˌluːʃ(ə)n/ *noun* the polluting of the sea, rivers, lakes or canals

weapon /ˈwepən/ *noun* □ **dangerous, offensive weapon** an item which can be used to harm someone physically, e.g. a gun, a knife □ **carrying offensive weapons** the offence of holding a weapon or something such as a bottle which could be used as a weapon

Weekly Law Reports /ˌwiːkli ˈlɔː rɪ ˌpɔːts/ *plural noun* regular reports of cases published by the Council of Law Reporting. Abbreviation **WLR**

weight limit /ˈweɪt ˌlɪmɪt/ *noun* the maximum permitted weight

welfare /ˈwelfeə/ *noun* the state of being well cared for ○ *It is the duty of the juvenile court to see to the welfare of children in care.*

Wells notice /ˈwelz ˌnəʊtɪs/ *noun* a notice from the US Securities and Exchange Commission informing the recipient that a lawsuit will be filed against him or he and outlining the charges and evidence supporting them

Western Circuit /ˌwestən ˈsɜːkɪt/ *noun* one of the six circuits of the Crown Court to which barristers belong, with its centre in Bristol

whatsoever /ˌwɒtsəʊˈevə/ *adjective* of any sort ○ *There is no substance whatsoever in the report.* ○ *The police found no suspicious documents whatsoever.* (NOTE: always used after a noun and after a negative)

whereas /weərˈæz/ *conjunction* as the situation is stated, taking the following fact into consideration ○ *whereas the property is held in trust for the appellant* ○ *whereas the contract between the two parties stipulated that either party may withdraw at six months' notice*

whereby /weəˈbaɪ/ *adverb* by which ○ *a deed whereby ownership of the property is transferred*

wherein /weərˈɪn/ *adverb* in which ○ *a document wherein the regulations are listed*

whereof /weərˈɒv/ *adverb* of which □ **in witness whereof I sign my hand** I sign as a witness that this is correct

whereon /weərˈɒn/ *adverb* on which ○ *land whereon a dwelling is constructed*

wheresoever /ˌweəsəʊˈevə/ *adverb* in any place where ○ *the insurance covering jewels wheresoever they may be kept*

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Law.fm Page 316 Friday, June 11, 2004 2:08 PM

White Book /ˈwaɪt bʊk/ *noun* a book containing the Rules of the Supreme Court and a commentary on them

white collar crime /ˌwaɪt ˌkɒlə ˈkraɪm/ *noun* crime committed by business people or office workers, e.g. embezzlement, computer fraud or insider dealings

White Paper /ˌwaɪt ˈpeɪpə/ *noun* a report issued by the government as a statement of government policy on a particular problem, often setting out proposals for changes to legislation for discussion before a Bill is drafted. Compare **Green Paper**

whole-life insurance /ˌhəʊl ˈlaɪf ɪn ˌʃʊərəns/ *noun* an insurance policy for which the insured person pays premiums for an entire lifetime and the insurance company pays a sum when he or she dies (NOTE: For life insurance, British English prefers to use **assurance**.)

wholesale /ˈhəʊlseɪl/ *adjective*, *adverb* buying goods direct from the producers and selling in large quantities to traders who then sell in smaller quantities to the general public

wholesale dealer /ˈhəʊlseɪl ˌdiːlə/ *noun* somebody who buys in bulk from producers and sells to retailers

wholly-owned subsidiary /ˌhəʊlli əʊnd səbˈsɪdjəri/ *noun* a company which is owned completely by another company

wilful /ˈwɪlf(ə)l/ *adjective* **1.** (person) who is determined to do what he or she wants **2.** done because someone wants to do it, regardless of the effect it may have on others (NOTE: [all senses] The US spelling is **willful**.)

wilfully /ˈwɪlfʊli/ *adverb* done because someone wants to do it, regardless of the effect on others ○ *He wilfully set fire to the building.*

wilful misconduct /ˌwɪlf(ə)l mɪs ˈkɒndʌkt/ *noun* an act of doing something which harms someone while knowing it is wrong

wilful murder /ˌwɪlf(ə)l ˈmɜːdə/ *noun* murder which is premeditated

wilful neglect /ˌwɪlf(ə)l nɪˈglekt/ *noun* intentionally not doing something which it is your duty to do

will /wɪl/ *noun* ♦ **last will and testament**

COMMENT: To make a valid will, a person must be of age and of sound mind; normally a will must be signed and witnessed in the presence of two witnesses who are not interested in the will. In English law there is complete freedom to dispose of one's property after death as one wishes. However, any dependant may apply for provision to be made out of the estate of a deceased under the Inheritance (Provision for Family and Dependants) Act.

winding up /ˌwaɪndɪŋ ˈʌp/ *noun* liquidation, the closing of a company and selling its assets

winding up petition /ˌwaɪndɪŋ ʌp pəˈtɪʃ(ə)n/ *noun* an application to a court for an order that a company be put into liquidation

window /ˈwɪndəʊ/ *noun* □ **window of opportunity** short moment when the conditions for something are especially favourable

wind up /ˌwaɪnd ˈʌp/ *verb* **1.** to end something such as a meeting ○ *He wound up the meeting with a vote of thanks to the committee.* **2.** □ **to wind up a company** to put a company into liquidation ○ *The court ordered the company to be wound up.*

wire fraud /ˈwaɪə frɔːd/ *noun* in the USA, the crime of using interstate telecommunications systems to obtain money or some other benefit by deception

wiretapping /ˈwaɪətæpɪŋ/ *noun* the action of secretly listening in on a telephone line

with costs /ˌwɪð ˈkɒsts/ *adverb* □ **judgment for someone with costs** judgment that the party's plea was correct and that all the costs of the case should be paid by the other party

withdraw /wɪðˈdrɔː/ *verb* **1.** to say that a charge, accusation or statement is no longer valid ○ *The prosecution has withdrawn the charges against him.* ○ *He was forced to withdraw his statement.* ○ *The chairman asked him to withdraw the remarks he had made about the finance director.* **2.** to take money out of an account ○ *to withdraw money from the bank* or *from your account* ○ *You can withdraw up to £50 from any bank on presentation*

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Law.fm Page 317 Friday, June 11, 2004 2:08 PM

of a banker's card. **3.** to take back an offer ▫ **one of the company's backers has withdrawn** he stopped supporting the company financially

withhold /wɪð'həʊld/ *verb* not to give something such as information which should be given ○ *She was charged with withholding information from the police.* ○ *Approval of any loan will not be unreasonably withheld.*

without /wɪ'ðaʊt/ *preposition* ▫ **without prejudice** phrase spoken or written in letters when attempting to negotiate a settlement, meaning that the negotiations cannot be referred to in court or relied upon by the other party if the discussions fail ▫ **without reserve** sale at an auction where an item has no reserve price

witness /'wɪtnəs/ *noun* **1.** somebody who sees something happen or who is present when something happens ▫ **to act as a witness to a document, a signature** to sign a document to show that you have watched the main signatory sign it ▫ **in witness whereof** first words of the testimonium clause, where the signatory of the will or contract signs **2.** somebody who appears in court to give evidence ■ *verb* to sign a document to show that you guarantee that the other signatures on it are genuine ○ *to witness an agreement* or *a signature* ▫ **'now this deed witnesseth'** words indicating that the details of the agreement follow

witness box /'wɪtnəs ˌbɒks/ *noun* a place in a courtroom where the witnesses give evidence

witness of fact /ˌwɪtnəs əv 'fækt/ *noun* somebody who gives evidence to say that facts in a claim are true

witness statement /ˌwɪtnəs 'steɪtmənt/ *noun* a written statement made by a witness and signed, containing evidence which he or she will make orally in court

witness summary /ˌwɪtnəs 'sʌməri/ *noun* a short document which summarises the evidence which will be in a witness statement, or which lists points which a witness will be questioned on in court

witness summons /'wɪtnəs ˌsʌmənz/ *noun* a court order requiring someone to appear as a witness and if necessary produce documents relevant to the case (NOTE: Since the introduction of the new Civil Procedure Rules in April 1999, this term has replaced **subpoena ad testificandum** and **subpoena duces tecum**.)

WLR *abbreviation* Weekly Law Reports

woman police constable /ˌwʊmən pəˌliːs 'kʌnstəb(ə)l/ *noun* the lowest rank of police officer ○ *The sergeant and six constables searched the premises.* (NOTE: Constable can be used to address a policeman; also used with a name: **Constable Smith**; it is usually abbreviated to PC or WPC.)

Woolsack /'wʊlsæk/ *noun* the seat of the Lord Chancellor in the House of Lords

word /wɜːd/ *noun* ▫ **to give one's word** to promise ○ *He gave his word that the matter would remain confidential.*

wording /'wɜːdɪŋ/ *noun* a series of words ○ *Did you understand the wording of the contract?*

words of art /ˌwɜːdz əv 'ɑːt/ *noun* words that have a special meaning in law

working party /'wɜːkɪŋ ˌpɑːti/ *noun* a group of experts who study a problem ○ *The government has set up a working party to study the problems of industrial waste.* ○ *Professor Smith is the chairman of the working party on drug abuse.*

work in hand /ˌwɜːk ɪn 'hænd/ *noun* work which is in progress but not finished

work permit /'wɜːk ˌpɜːmɪt/ *noun* an official document which allows someone who is not a citizen to work in a country

wound /wuːnd/ *noun* a cut done to the skin of a person ○ *She has a knife wound in her leg.* ■ *verb* to injure or to hurt someone in such a way that his or her skin is cut ○ *He was wounded in the fight.*

wounding with intent /ˌwuːndɪŋ wɪð ɪn'tent/ *noun* the offence of injuring someone, especially when trying to avoid arrest

WPC *abbreviation* woman police constable

wreck /rek/ *noun* **1.** the action of sinking or badly damaging a ship ○ *They saved the cargo from the wreck.* **2.** a ship which has sunk or which has been badly

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Law.fm Page 318 Friday, June 11, 2004 2:08 PM

damaged and cannot float ○ *Oil poured out of the wreck of the ship.* **3.** a company which has become insolvent ○ *He managed to save some of his investment from the wreck of the company.* ○ *Investors lost thousands of pounds in the wreck of the investment company.* ■ *verb* to damage badly or to ruin ○ *They are trying to salvage the wrecked ship.* ○ *The defence case was wrecked by the defendant's behaviour in court.*

writ /rɪt/ *noun* **1.** □ **to serve someone with a writ** to give someone a writ officially, so that he or she has to defend it or allow judgment to be taken in their absence **2.** a legal action to hold a by-election □ **to move a writ** to propose in the House of Commons that a by-election should be held

write in /ˌraɪt ˈɪn/ *verb US* to write the name of a candidate in a space on the voting paper

write-in candidate /ˌraɪt ɪn ˈkændɪdeɪt/ *noun* a candidate whose name has been written by the voters on their voting papers

writ of fieri facias /ˌrɪt əv ˌfaɪraɪ ˈfeɪʃiæs/ *noun* a court order to a sheriff telling them to seize the goods of a debtor against whom judgment has been made (NOTE: often abbreviated to **fi. fa.**)

writ of habeas corpus /ˌrɪt əv ˌheɪbiəs ˈkɔːpəs/ *noun* a writ to obtain the release of someone who has been unlawfully held in prison or in police custody, or to make the person holding them bring them to court to explain why they are being held

writ of summons /ˌrɪt əv ˈsʌmənz/ *noun* ➧ **claim form**

written application /ˌrɪt(ə)n ˌæplɪ ˈkeɪʃ(ə)n/ *noun* the first part of proceedings in the European Court of Justice, where an applicant makes a written application against which the defendant may reply in writing. The papers will then be examined by the judge rapporteur and one of the Advocates General, before moving on to oral hearings.

wrong /rɒŋ/ *noun* an act against natural justice or which infringes someone else's right ○ *Civil wrongs against persons or property are called 'torts'.*

wrongdoer /ˈrɒŋduːə/ *noun* somebody who commits an offence

wrongdoing /ˈrɒŋduːɪŋ/ *noun* activity which is against the law

wrongful /ˈrɒŋf(ə)l/ *adjective* unlawful

wrongful dismissal /ˌrɒŋf(ə)l dɪs ˈmɪs(ə)l/ *noun* the removal of someone from a job for a reason which does not justify dismissal and is in breach of the contract of employment

COMMENT: An employee can complain of wrongful dismissal to a county court or, where the compensation claimed is less than £25 000, to an employment tribunal.

wrongfully /ˈrɒŋf(ə)li/ *adverb* in an unlawful way ○ *He claimed he was wrongfully dismissed.* ○ *She was accused of wrongfully holding her clients' money.*

wrongly /ˈrɒŋli/ *adverb* not correctly ○ *He wrongly invoiced Smith Ltd for £250, when he should have credited them with the same amount.*

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YZ

year and a day rule /ˌjɪə ənd ə ˈdeɪ ˌruːl/ *noun* an ancient rule that a person could not be convicted of murder if the victim died more than 366 days after the attack

COMMENT: The rule was abolished in 1996, as it had come to be used as a defence in cases of work-related deaths, such as from asbestosis or radiation, which may occur many years after the first contamination.

year end /ˌjɪə ˈend/ *noun* the end of the financial year, when a company's accounts are prepared ○ *The accounts department has started work on the year-end accounts.*

yellow dog contract /ˌjeləʊ ˈdɒg ˌkɒntrækt/ *noun US* a contract of employment where the employee is forbidden to join a trade union

young offender /jʌŋ əˈfendə/, **youthful offender** *US* /ˌjuːθf(ə)l əˈfendə/ *noun* a person aged between seventeen and twenty years of age who has committed an offence

Young Offender Institution /ˌjʌŋ əˈfendə ˌɪnstɪtjuːʃ(ə)n/, **young offenders institution** *noun* a centre where young offenders are sent for training if they have committed crimes which would usually be punishable by a prison sentence

young person /ˌjʌŋ ˈpɜːs(ə)n/ *noun* somebody over fourteen years of age, but less than seventeen

youth /juːθ/ *noun* a young man

Youth Court /ˈjuːθ kɔːt/ *noun* a court which tries offenders between the ages of 10 and 18. Former name **Juvenile Court**

youth custody order /juːθ ˌkʌstədi ˈɔːdə/ *noun* a sentence sending a young person to detention in a special centre

zebra crossing /ˌzebrə ˈkrɒsɪŋ/ *noun* a place in a street marked with white lines, where pedestrians have right of way to cross

zero inflation /ˌzɪərəʊ ɪnˈfleɪʃ(ə)n/ *noun* inflation at 0%

zero-rated /ˌzɪərəʊ ˈreɪtɪd/ *adjective* having a VAT rate of 0%

zip code /ˈzɪp ˈkəʊd/ *noun US* a series of numbers used to represent the area or part of a city or town where an address is situated (NOTE: The British term is **post code**.)

zipper clause /ˈzɪpə klɔːz/ *noun US* a standard clause in a contract of employment, which tries to prevent any discussion of employment conditions during the life of the agreement

zoning /ˈzəʊnɪŋ/ *noun* an order by a local council that land shall be used only for one type of building

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SUPPLEMENTS

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Legislative procedure in the UK

Green Paper Stage	a paper discussing the issues surrounding the proposed bill (optional)
White Paper Stage	a paper stating current policy on the issues surrounding the proposed bill (optional)
Draft Bill Stage	the wording of the Bill is drafted
First Reading	the Bill is presented formally in Parliament as a reading with no debate or decision
Second Reading	the Bill is read again to the House and a debate takes place
Committee stage	a standing committee (a committee of about 18 house members, more for long or complicated bills) debates whether each clause and schedule of the Bill should be kept or dropped
Report Stage	the whole house looks at the amendments proposed by the standing committee and propose and debate any of their own
Third Reading Stage	the whole redrafted Bill is read once more in the House and briefly discussed
Lords Approval Stage	the House of Lords takes the Bill and goes through the same procedure from First to Third Reading, debating any amendments. The Lords and Commons agree on a final text
Royal Assent Stage	royal approval is given and the Bill becomes a statute (Act of Parliament)

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Legislative procedure in the UK *continued*

Important Note: The Parliament Act
The entire process must take place in one Session of Parliament, meaning that a Bill may not be passed purely because it has run out of time. This means that the House of Lords may 'kill' a Bill they don't wish to pass (for example the Hunting Bill 2002) by taking an overly long time to discuss it. In this case the Parliament Act means that the Bill can be reintroduced and passed in the following Session *without* the approval of the Lords, with the following conditions:

1. The Lords had enough time to debate it before the end of the session (at least one month).

2. The wording of the Bill hasn't changed since the last presentation.

3. One year has passed since the Bill was given its Second Reading in the Commons.

Private Members' Bills go through the same procedure from First Reading. However, there is intense competition for the little Parliamentary time available for considering these. Unless the Bill is completely uncontroversial it is likely to be formally objected to at some stage and therefore dropped; otherwise it is more or less 'nodded through' without much debate.

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Legislative procedure in the European Union

Proposal	the European Commission drafts the text of a Bill
First Reading	the European Parliament submits the Bill to a committee reading and a report is prepared with suggested amendments
Common Position	the European Council either accepts the amended Bill or suggests its own amendments (NB this is the first point at which the Bill can be passed)
Recommendation	a further committee assessment is undertaken of the Council's proposed amendments at Parliament and a recommendation given
Second Reading	Parliament debates the committee's report and vote by absolute majority whether to accept the Council's amendments and on further amendments of their own
Amended proposal	the Commission looks at Parliament's second reading decisions and drafts an amended proposal for the Council, who vote whether to accept or modify it (this is the second point at which the Bill can be passed)
Conciliation committee	a committee of members from both the Council and Parliament meet to agree on a joint text
Third Reading	Parliament meets to finally discuss whether to adopt the Bill as law. If no mutual agreement can be reached the Bill will lapse.

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Legislative procedure in the US

Introduction	the draft Bill is submitted to the House without reading or debate (any time while the House is in session)
Referral to Committee	the Bill is published and assigned an identification number, then sent to the appropriate committee (of 19) according to its subject
Committee Action 1	relevant offices and departments give their input, reports are prepared on the validity of the Bill and committee meetings are held
Committee Action 2	a public hearing may be held before a subcommittee with the questioning of witnesses and the attendance of interested parties
Markup	the subcommittee prepares a report on the hearing with any relevant amendments to the Bill
Final Committee Action	the full committee reads and amends the Bill and either reports it back favourably to the House, tables it or discharges it (thereby preventing it from progressing any further), or reports it back without recommendation (rare)
House Floor Consideration	the committee report is debated in the House and any further amendments voted on
Resolving Differences	the Bill is sent to the Senate for house floor consideration and an identical version is agreed on by both bodies, possibly with the help of a mediating committee
Final Step	the Bill is approved (signed) by the President and becomes a Law

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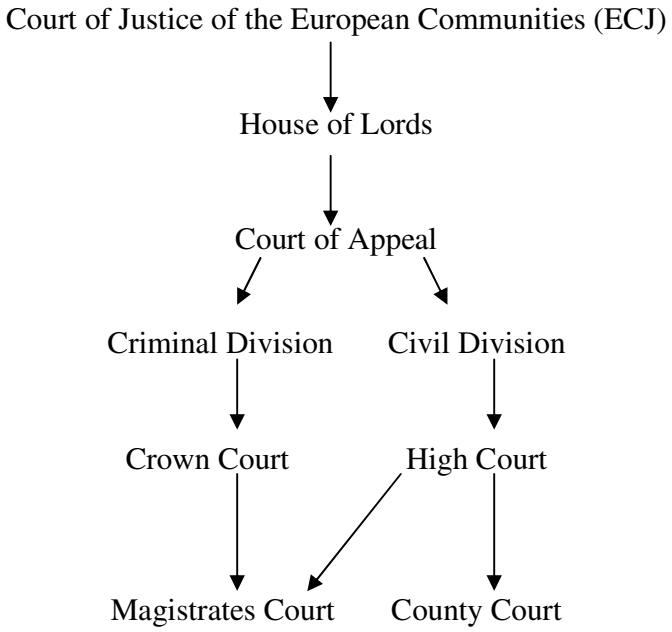
UK court structure



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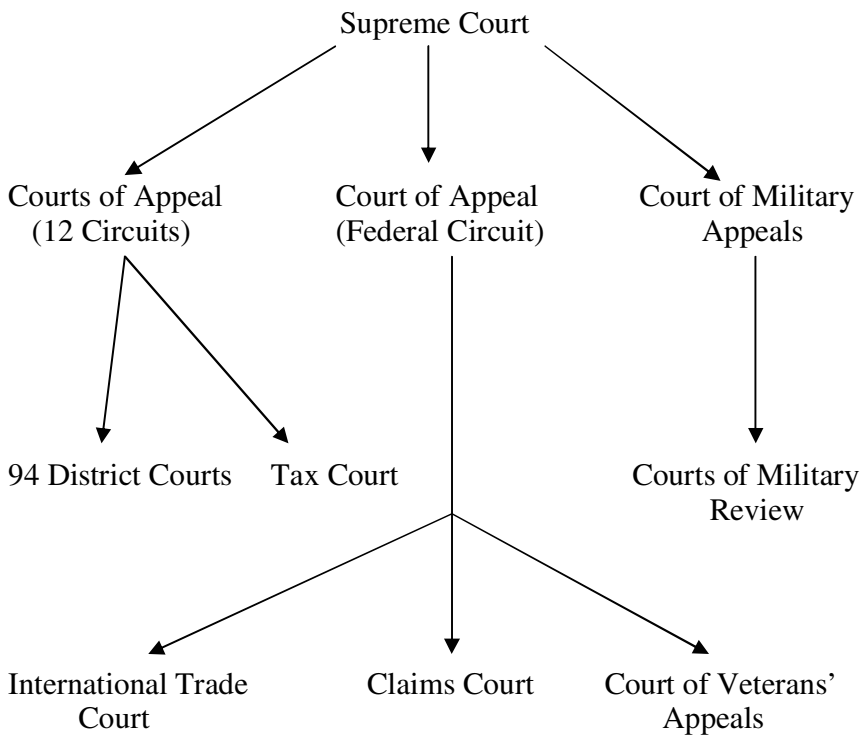
US court structure



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Useful Internet Links

UNITED KINGDOM

The United Kingdom Parliament: www.parliament.uk

Casetrack: www.casetrack.com

UK Court Service: www.courtservice.gov.uk

Her Majesty's Stationery Office (published Acts of Parliament): www.hmso.gov.uk/acts.htm

Citizens Advice Bureau Online: www.nacab.org.uk

The Crown Prosecution Service: www.cps.gov.uk

The British and Irish Legal Information Institute: www.bailii.org

Legal Week (an online newspaper for people in the legal profession): www.legalweek.net

Infolaw (a legal web portal): www.infolaw.co.uk

The Law Society: www.lawsoc.org.uk

The Law Commission: www.lawcom.gov.uk

Just ask! (Community Legal Service online): www.justask.org.uk/index.jsp

Law Campus (online resource for law students): www.lexisnexis.co.uk/lawcampus/student/student_index.htm

Scotland Legislation: www.scotland-legislation.hmso.gov.uk

Wales Legislation: www.wales-legislation.hmso.gov.uk

Northern Ireland Legislation: www.northernireland-legislation.hmso.gov.uk

EUROPEAN UNION

Europa (Summaries of EU legislation by area): http://europa.eu.int/scadplus/scad_en.htm

UNITED STATES

Office of the Law Revision Council (complete guide to the US code): http://uscode.house.gov

Enactment of a Law (legislative procedure in the United States): http://thomas.loc.gov/home/enactment/enactlaw.html

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The Complete Photo Guide to

homeowner basics

100 essential projects every homeowner needs to know

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CONTENTS

Introduction 4

WIRING 7

Before You Begin

Putting Together a Wiring Kit 8

Understanding Electrical Circuits . . . 10

1. Replacing Phone Jacks 18
2. Removing Broken Lightbulbs 22
3. Fixing Lamp Sockets 26
4. Fixing Doorbells 30
5. Fixing Pull-Chain Switches 34
6. Installing Programmable Thermostats 38
7. Adding Wireless Light Switches 42
8. Replacing Bad Receptacles 48
9. Childproofing Receptacles 52
10. Installing GFCI Receptacles 58
11. Replacing Bad Light Switches 64
12. Installing Dimmers 70
13. Installing Timer Switches 76
14. Replacing Ceiling-Mounted Fixtures 80
15. Replacing Hanging Light Fixtures 86
16. Installing Track Lights 90
17. Installing Motion-Sensing Floodlights 96
18. Repairing Fluorescent Light Fixtures 100
19. Fixing Ceiling Fans 106
20. Installing Raceway Wiring 112

PLUMBING 123

Before You Begin

The Home Plumbing System 124

Plumbing Tools 128

Evaluating Your Plumbing 132

1. Shutting Off the Water 134
2. Recovering Items from Drains 138
3. Preventing Frozen Pipes 142
4. Fixing Dripping Sink Faucets 146
5. Adjusting Water Pressure 156
6. Fixing Running Toilets 162
7. Clearing Clogged Toilets 170
8. Fixing Leaky Tubs & Showers 174
9. Adjusting Bathtub or Shower Drainage 180
10. Clearing Kitchen Sink Drains 186
11. Fixing Leaky Sink Strainers 190
12. Clearing Clogged Floor Drains . . . 192
13. Adding a Shower to a Tub 196
14. Replacing Bathtub Spouts 200

15. Replacing Widespread Bathroom Faucets 204
16. Installing New Bathroom Faucets 210
17. Replacing Kitchen Sprayers 214
18. Repairing Burst Pipes 218
19. Replacing Kitchen Faucets 222
20. Replacing Pop-up Stoppers 228
21. Replacing Toilets 232

FLOORING 239
Before You Begin
Understanding Floors 240
Choosing Flooring 242
Evaluating Floors 244
Cleaning Floors 246
1. Repairing Splinters & Gouges 250
2. Fixing Squeaky Floors from Below 254
3. Fixing Squeaky Floors from Above 258
4. Repairing Resilient Flooring 262
5. Patching Resilient Sheet Flooring 264
6. Repairing Loose Carpet Seams . . . 268
7. Replacing Ceramic Tiles 272
8. Replacing Laminate Floorboards . . . 278
9. Patching Carpet 282
10. Removing Resilient Flooring 286
11. Removing Carpet 290
12. Sealing Concrete Floors 294
13. Refinishing Hardwood Floors 302
14. Painting Wood Floors 308
15. Installing Laminate Flooring 312
16. Installing Floor Tile 321

PAINTING & DECORATING 329
Before You Begin
Painting Tools 330
Decorating Tools 332
Prep Materials 334
Choosing Paint 335
1. Hanging Pictures & Mirrors 336
2. Replacing Towel Bars 340
3. Hanging Curtains 344
4. Installing Window Blinds & Shades 346
5. Anchoring Bookcases 352
6. Draping & Taping 356
7. Painting Walls 360
8. Preparing Unfinished Wood for Paint 364
9. Painting Millwork & Trim 368
10. Painting Wood Cabinets 374
11. Painting Concrete Block Walls 376
12. Stripping Wallcoverings 380
13. Hanging Wallcoverings 384

OUTDOOR PROJECTS 395
Before You Begin
Outdoor Tool Kit 396
1. Clearing Clogged Gutters 398
2. Touching Up Exterior Paint 402
3. Fixing Sliding Screen Doors 406
4. Installing Storm Doors 410
5. Tuning Up Double-Hung Windows 416
6. Exterior Caulking 420
7. Pestproofing Your House 424
8. Fixing Concrete Walkways 428
9. Repairing Asphalt Driveways 432
10. Fixing Broken Glass Panes 438
11. Repairing Concrete Steps 442
12. Repairing Siding 446
13. Repairing Stucco 450
14. Renewing a Wood Deck 454
15. Replacing Damaged Roof Shingles 458
16. Installing Locksets & Deadbolts 462
17. Tuning Up Garage Doors 468
18. Installing House Gutters 474
19. Installing Landscape Lighting 478
20. Pressure Washing a House 484

Resources 488
Metric Equivalents 489
Glossary 490
Index 492

NOTICE TO READERS

For safety, use caution, care, and good judgment when following the procedures described in this book. The Publisher and Black & Decker cannot assume responsibility for any damage to property or injury to persons as a result of misuse of the information provided.

The techniques shown in this book are general techniques for various applications. In some instances, additional techniques not shown in this book may be required. Always follow manufacturers' instructions included with products, since deviating from the directions may void warranties. The projects in this book vary widely as to skill levels required: some may not be appropriate for all do-it-yourselfers, and some may require professional help.

Consult your local Building Department for information on building permits, codes and other laws as they apply to your project.

Introduction

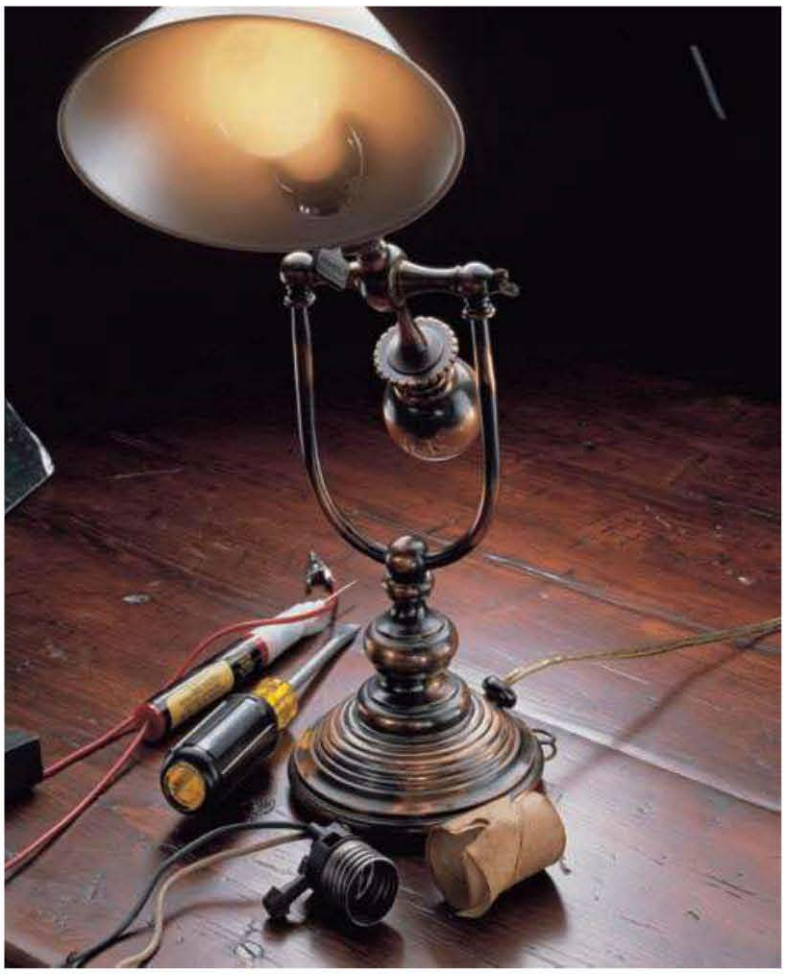
OWNING A NEW HOME IS A CHALLENGING YET REWARDING EXPERIENCE. Whether the house itself is new or not, there exists an overwhelming number of remodeling and decorating options you have as a new homeowner. And it doesn't matter if you've bought your first or tenth home, it's still new and brimming with potential to you.

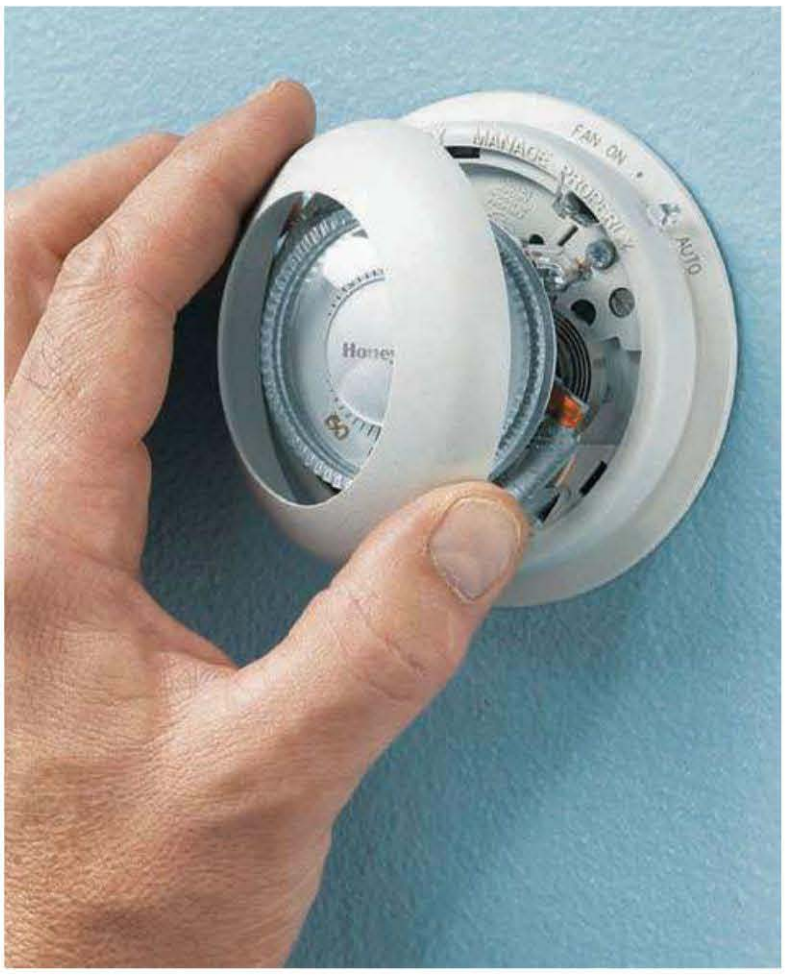
After unpacking all the stuff, where does one start? You'll probably have a list a mile long that looks something like this: install a new toilet, repair the light fixtures, fix the doorbell, replace the exterior siding, hang new window treatments, refinish the kitchen cabinets, install a new livingroom floor or paint the existing floor or refinish the wood that may be under the existing carpet.

With *The Complete Photo Guide to Homeowner Basics* you'll have the information to accomplish all of the most common repairs and installations homeowners face, and you do not need any previous experience because this book explains it all for you in five sections: Wiring, Plumbing, Flooring, Painting & Decorating, and Outdoor Projects. The first few pages of each section give you the background information and technical knowledge that will be helpful. Then the most common projects follow.

Each project has a detailed overview of the parts you'll be working on and the terms you'll need to know as well as photographs that show you all of the tools and materials you'll need. Then step-by-step instructions follow. Virtually every step is photographed so you'll see exactly how to do the work, and along the way you'll find helpful sidebars that show you what to do if something unexpected happens, how to use tools correctly, and which safety precautions to take. Before you know it, you'll be successfully completing one home repair after the next. And because you do it yourself, you'll save hundreds if not thousands of dollars: all the more money to allow you to tackle that next project sooner rather than later.

MAIN

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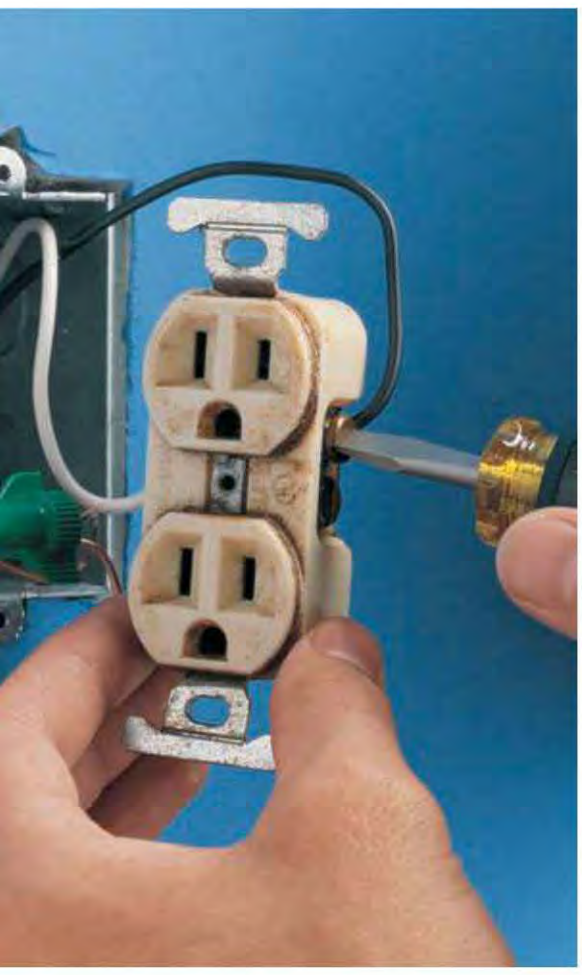
Wiring

THE WIRING SECTION OF THIS BOOK IS UNIQUE IN THAT YOU DON'T NEED TO HAVE ANY PRIOR KNOWLEDGE TO SUCCESSFULLY EXECUTE THE WIRING REPAIRS AND INSTALLATIONS. ALMOST EVERY WIRING BOOK REQUIRES YOU TO HAVE SOME FAMILIARITY WITH THE SUBJECT MATTER BEFORE YOU BEGIN. IF YOU HAPPEN TO BE A TRUE BEGINNER, YOU'RE ALREADY AT A DISADVANTAGE. THIS BOOK DOESN'T ASSUME YOU ALREADY KNOW A LOT ABOUT THE SUBJECT. AND IT'S ALSO A BOOK THAT WON'T LEAVE OUT ANY INFORMATION.

On the following pages you'll find directions for solving the most universal wiring problems and projects in your home. No knowledge is assumed, and no question is left unanswered.



IN THIS CHAPTER:

- ❑ Before You Begin
  - Putting Together a Wiring Kit
  - Understanding Electrical Circuits
- ❑ Replacing Phone Jacks
- ❑ Fixing Lamp Sockets
- ❑ Fixing Doorbells
- ❑ Fixing Pull-Chain Switches
- ❑ Installing Programmable Thermostats
- ❑ Adding Wireless Light Switches
- ❑ Replacing Bad Receptacles
- ❑ Childproofing Receptacles
- ❑ Installing GFCI Receptacles
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- ❑ Installing Dimmers
- ❑ Installing Timer Switches
- ❑ Replacing Ceiling-Mounted Fixtures
- ❑ Replacing Hanging Light Fixtures
- ❑ Installing Track Lights
- ❑ Installing Motion-Sensing Floodlights
- ❑ Repairing Fluorescent Light Fixtures
- ❑ Fixing Ceiling Fans
- ❑ Installing Raceway Wiring

Before You Begin: Putting Together a Wiring Kit

Here's pretty much all you'll need to complete most of the repairs and projects in this book. They are available at any home improvement center or hardware store.

UNLIKE SOME OTHER TYPES OF HOME IMPROVEMENT SKILLS, MAKING BASIC wiring repairs doesn't require very much at all in the way of tools and materials. Investing $30 to $40 puts you in a position to save hundreds of dollars on routine wiring repairs. We recommend that you keep a small toolbox with items dedicated to your wiring tools. That way, you can bring your kit to your work site, and will have the screwdrivers, pliers, and other things you need handy, and won't have to hunt for a screwdriver at the most inconvenient time. Here are the things we recommend for your wiring tool kit:

• **Electrical tape.** These days, tape isn't used to make wire connections, but to help label wires temporarily as you replace fixtures. Some electricians, though, do wrap a loop of electrical tape around plastic wire connectors to reinforce the connections.

• **Toolbox.** A small plastic toolbox is just fine; one with a divided tray for holding wire connectors, screws and other small items is a good choice.

• **Wire connectors.** Sometimes known as "wire nuts," after one manufacturer's product. They're used to join wires together, and you'll be using them a lot. They're color coded for convenience. Green connectors are used for bare copper grounding wires. With most manufacturers, orange connectors are used for two small wires, yellow for two or three wires, red for three or more wires. But you should follow the recommendations on the box, in case you buy a different brand.

• **Lamp sockets.** Repairs to lamps and light fixtures are very common, so you can save yourself time by having a few of these on hand. Besides, they're very inexpensive.

• **Switches & receptacles.** Because these are so frequently needed, and so inexpensive, keep a few on hand. Sooner or later, you'll need them.

• **Cord kit.** Another inexpensive item that's good to have on hand. Lamp cord kits have preattached plugs, to make rewiring a lamp very easy.

• **Screwdrivers.** Have at least two screwdrivers; one with a slot-shaped tip, the other with an X-shaped Phillips tip. It's even better to have several sizes of each type.

• **Needlenose pliers.** This tool is used for almost every wiring project, and is used mostly for bending and connecting wires.

• **Current sensor.** This clever tool tells you if the wires you want to work on are carrying electricity or not. Best of all, this new-style tool doesn't require that you touch any wires.

• **Combination tool.** This workhorse does it all: cuts cables, identifies wire sizes, strips wires. It is the single most important wiring tool you can have.

There are handful of other workshop tools you may use in your wiring projects. They include: a portable drill, a hammer, a level, a utility knife, a tape measure, and a stud finder. If you don't already own them, you may need to buy or borrow them when you get to projects that require them.

Before You Begin: Understanding Electrical Circuits

NO QUESTION ABOUT IT: WIRING AND ELECTRICITY MAKE MOST PEOPLE JUST A LITTLE NERVOUS. Understanding a bit about how electricity behaves in the wires that run through your house will help take away a bit of the scary mystery, and will also give you some confidence to make these repairs. So let's take a short tour of your electrical system. You might even carry the book along with as you walk through your home looking for the things we describe.

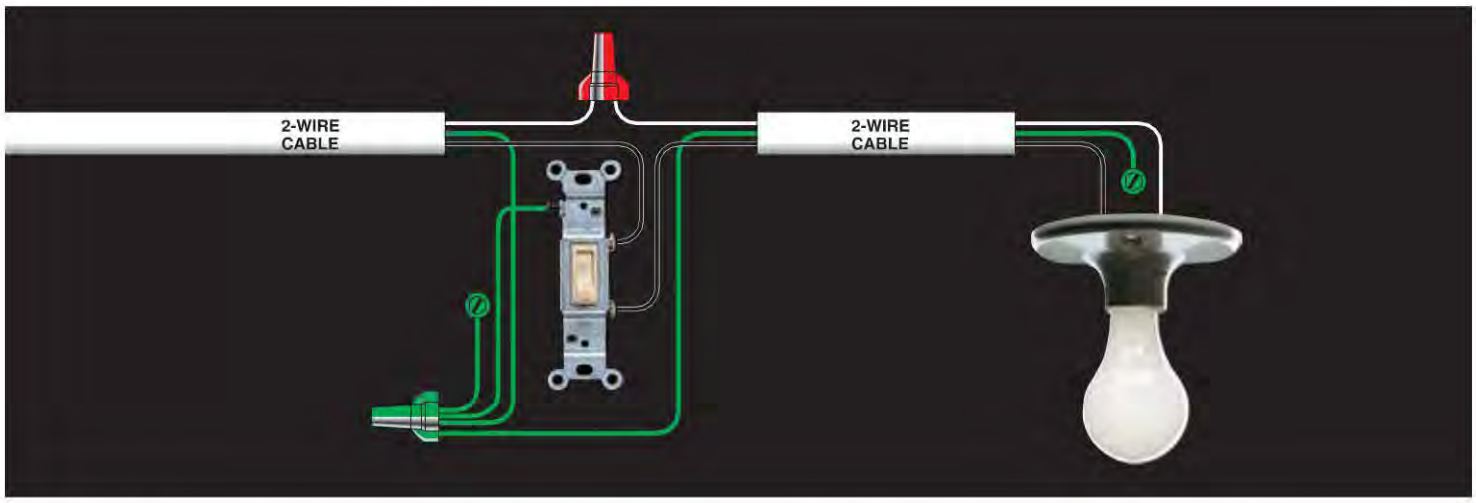
Electricity is really nothing more than a form of magnetism running through wires. Electrical energy is obviously invisible, but it's useful to think of it in much the same way as you'd think about water flowing through plumbing pipes. Like water, the electricity is present but not really moving until you "open the faucet" by turning on a light switch, or turning on the motor for an appliance.

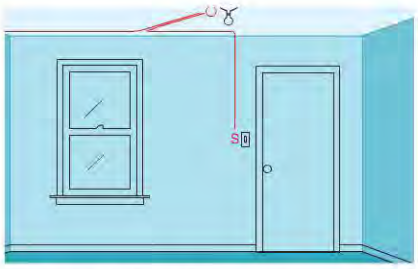
Problems occur when the wires (the "pipes") carrying current become broken or blocked, or if they "leak" electricity outside the system. If you're ever been shocked, you know one result of electricity leaking outside its wires. Because flowing electricity generates heat, leaking electricity can also cause fires. These are the reasons electricity makes people a little nervous: it's an invisible energy, it can cause shocks, and it can cause fires.

Fortunately, the system has lots of safety features built in to prevent these problems. And to stay perfectly safe while making repairs to the system, all that's necessary is for you to shut off the flow of electricity in the wires you want a work on. This is very, very easy to do, as you'll soon see. Let's start the tour:

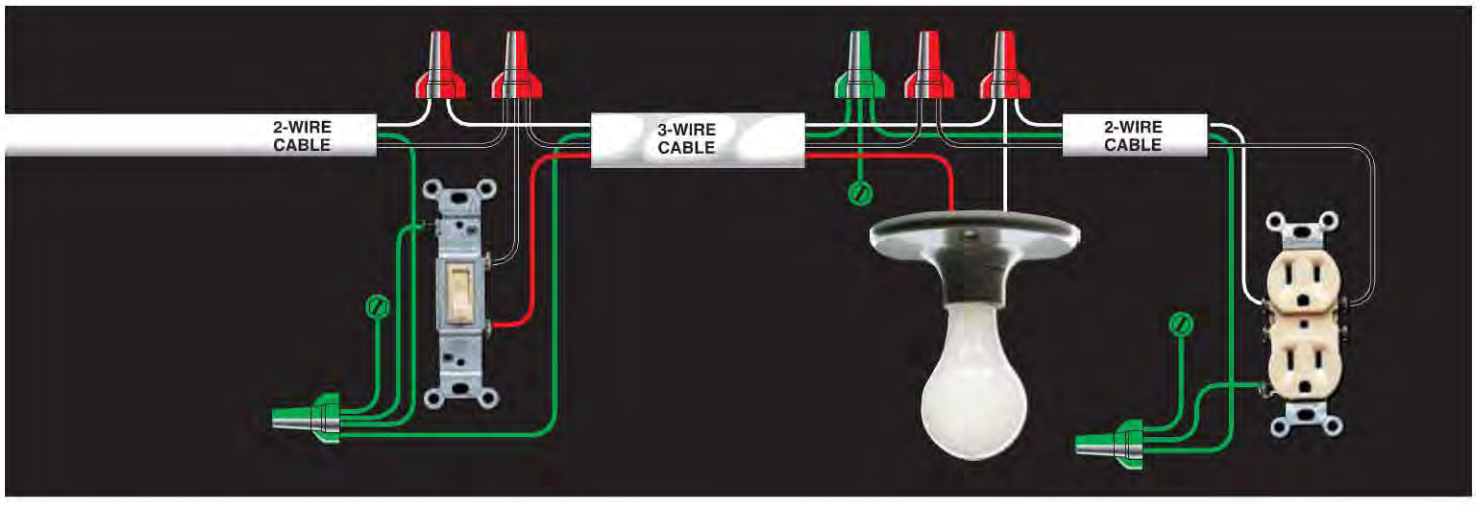
1 For all intents and purposes, your electrical system begins for you with the **main service panel.** Usually this is a gray metal box located in a utility area of your home—the basement, the garage, or a utility room. Sometimes, though, it might be located inside a wooden wall cabinet in a finished basement room.

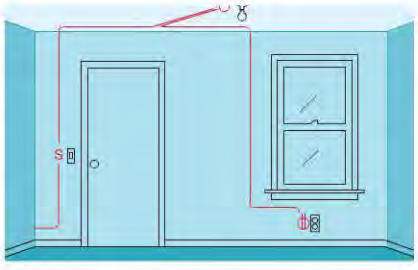
2 Inside the service panel are rows of toggle switches. These are **circuit breakers**. They serve two functions. First, they protect wires from having too much current flowing through them. If you've ever had a circuit breaker trip and lights go out suddenly, you've experienced this safety feature. Secondly, the circuit breakers let you shut off the power to wires when you want to work on them.





3 Each of the circuit breakers in the service panel sends and controls electricity through a **circuit**—a continuous loop of wire that runs from the service panel, out to one or more receptacles, appliances, or light fixtures, and back again. This diagram shows a simplified circuit. Even the most complicated circuits are just variations of this basic idea. Electricity changes its nature as it flows through the circuit wires. It begins as **"hot" current**. This current is under **"pressure,"** which means that it carries voltage. After the electricity does its work, by creating light or heat or moving mechnical parts in an appliance, it loses its pressure, or charge, and becomes **"neutral"** as it flows back to the service panel. The wires carrying hot current are normally black or red, while neutral wires are usually white. In addition to the hot and neutral wires, a circuit has a loop of bare copper wire (or sometimes an insulated green wire). This **grounding wire** is a safety feature that carries stray electricity back to the service panel if the other wires "leak" their electricity.

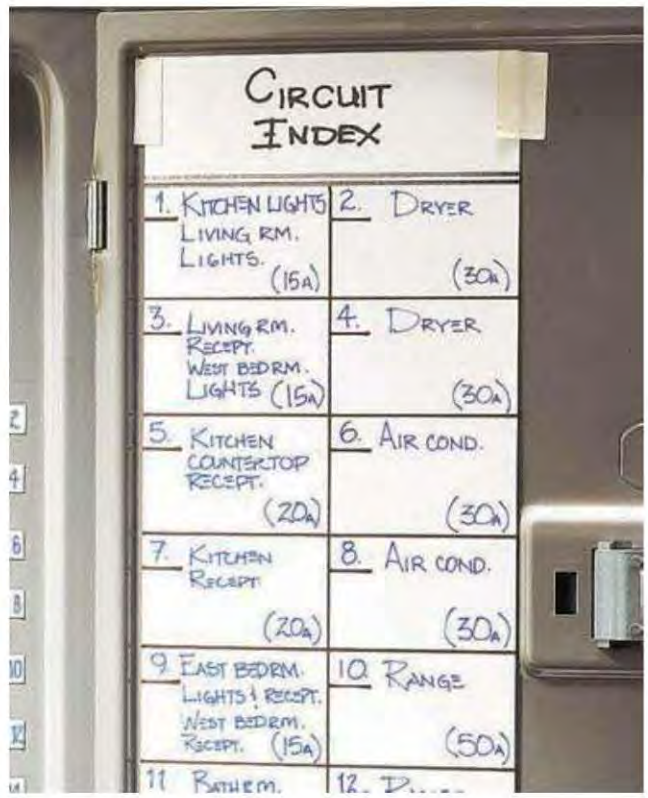




4 Here's another circuit map that shows how a more complicated circuit works. This circuit sends electricity to both a switch/light combination, and a receptacle outlet. If you follow the path of the black wire, you'll see how it works. As the black wire carrying hot current reaches the switch location, it branches, sending one black wire that passes all the way through the light fixture and goes to the receptacle. This allows the receptacle to operate independently from the switch and light. Back at the switch, you'll see that another black wire leads to the switch. The hot current passes through the switch, then is carried to the light fixture through a red wire, which is part of a cable containing three insulated wires. From both the light fixture and the receptacle, white wires carry "depressurized" neutral current back to the service panel.

HOW TO TURN OFF THE POWER

1 Find your main service panel (see page 10). Make sure there is no moisture on the floor below the panel. In very rare instances, people have been shocked when they touch a service panel while standing in water. Open the door of the panel, and look for the index on the inside face of the door. If your electrical service has been properly mapped, the index will tell you exactly which circuit breaker controls the circuit wires you want to work on. This isn't always the case, though. Sometimes you'll need to switch them off one at a time, identifying the correct breaker through trial and error.



2 With your finger, snap the lever on the circuit breaker to the OFF position. You will hear an audible click, and on some breakers a red window will appear on the face of the breaker. Now, close the panel door, and make very sure that everyone in the house knows you'll be working on wires, and that they shouldn't touch the service panel. **DO NOT** actually work on wires until you've tested for current (next page).

WHAT IF...?

If you have an older home with an electrical panel that contains fuses rather than circuit breakers, you will shut off power to the circuits by removing the fuses.

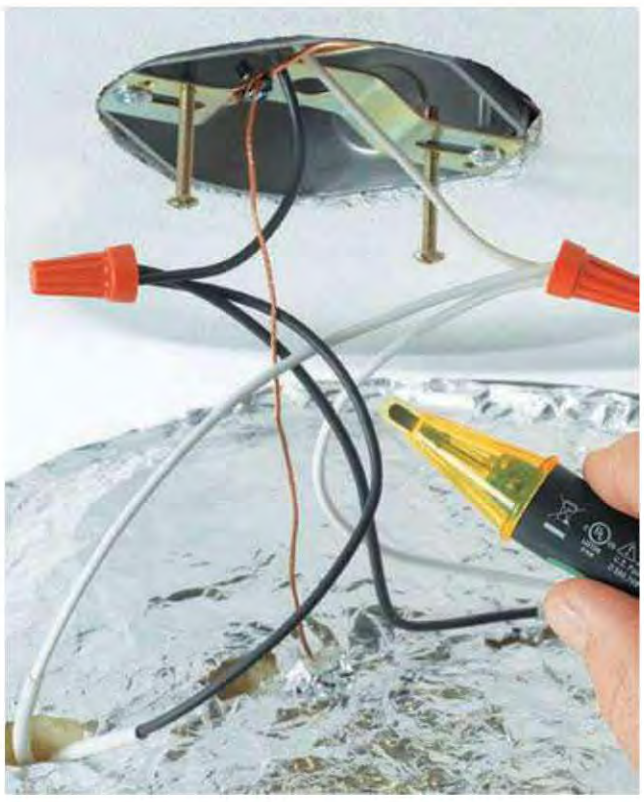
1 Locate the fuse that controls the circuit wires you plan to work on. Like a circuit breaker panel, fuse panels usually have an index that labels the circuits. The circuits that control ordinary wall outlets and light fixtures are usually screw-in fuses. The fuses for large appliances are usually cartridge fuses that fit into a fuse block you pull out of the panel.

2 Unscrew the fuse, being careful to touch only the insulated rim of the fuse.

HOW TO TEST FOR CURRENT

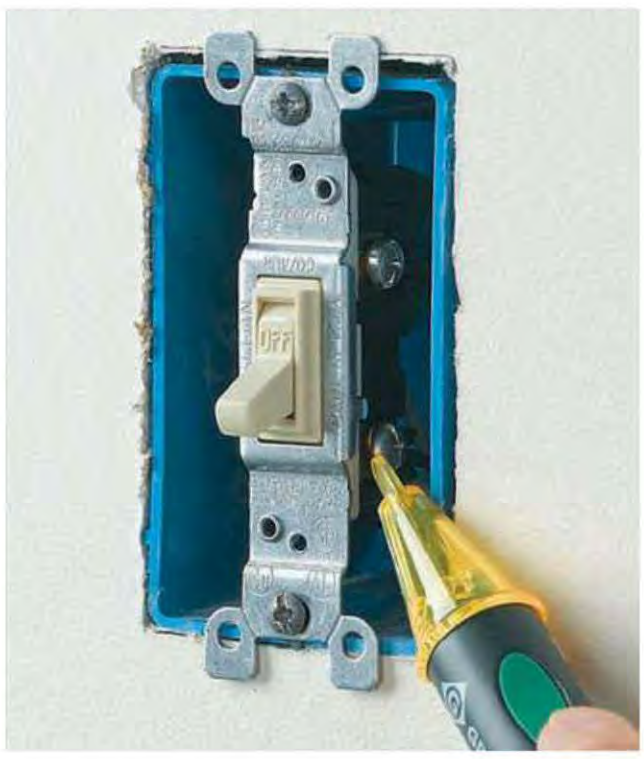
TOOL TIP

No-touch current testers are very easy to use, but they are accurate only if they are working properly. Before trusting it to test wires to make sure they are safe to work on, test the tool on a fixture that is carrying live current—the power cord on a lamp that is turned on, for example. Turn the tester to ON, then move the probe around the lamp wires until the tester glows or sounds its audible alarm. Now you know the tool works correctly, and can trust it to accurately test wires for live current.



Light fixtures: Loosen mounting screws and carefully lower the light fixture away from the ceiling box. With the wall switch in the ON position, pass the tip of the current tester within ½" of each wire.

Receptacles: Remove the coverplate on the receptacle. Turn the tester on, and verify it works by testing it on wires you know to be live. Now insert the probe tip on the receptacle into the electrical box on each side of the receptacle. If the tester does not indicate current, you know the wires are now safe to work on.



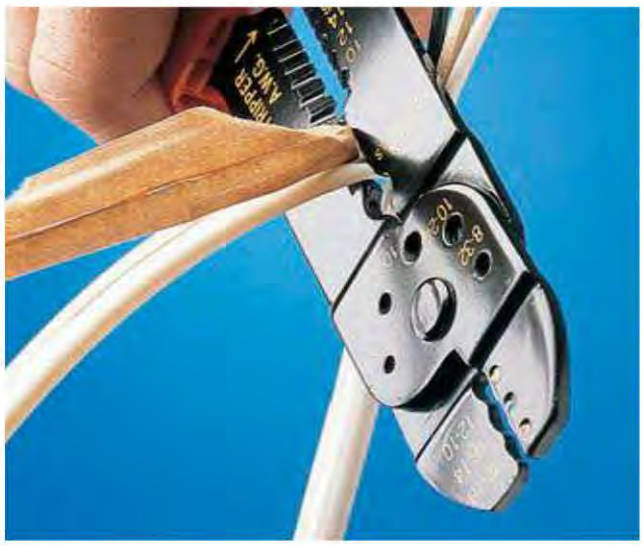
Wall switches: Remove the coverplate on the switch, and insert the tip of the current tester into the box, passing it within ½" of each of the screw terminals on the side of the switch. If the tester does not light up or beep, the wires are safe to work on.

HOW TO MAKE WIRE CONNECTIONS

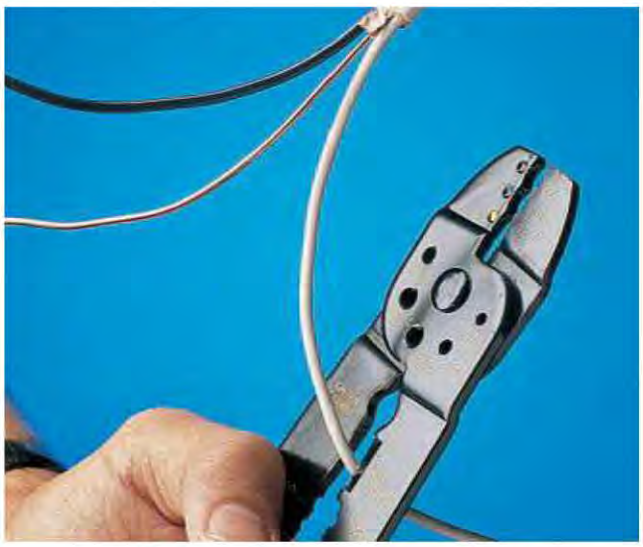
ONE OF THE FEW SKILLS THAT IS UNIVERSAL TO MOST WIRING PROJECTS IS STRIPPING WIRES OF THEIR OUTER PLASTIC JACKETS, exposing the bare wires, and then connecting those wires to each other or to wire leads or screw connectors on switches, outlet receptacles, light fixtures, or other devices. So before moving on to any actual repairs in this book, practice the following skills:

- Stripping cables and wires
- Connecting wires
- Making screw terminal connections
- Making push-in connections
- Making set-screw connections

HOW TO STRIP WIRES



1 If you need to, cut away any plastic sheathing on the cable containing the wires, using the cutting jaws of a combination tool, or a utility knife. (If you use a utility knife, make sure not to nick the plastic jacket on the individual wires. If necessary, you can trim the wires down to size, using the cutting jaws on the combination tool.

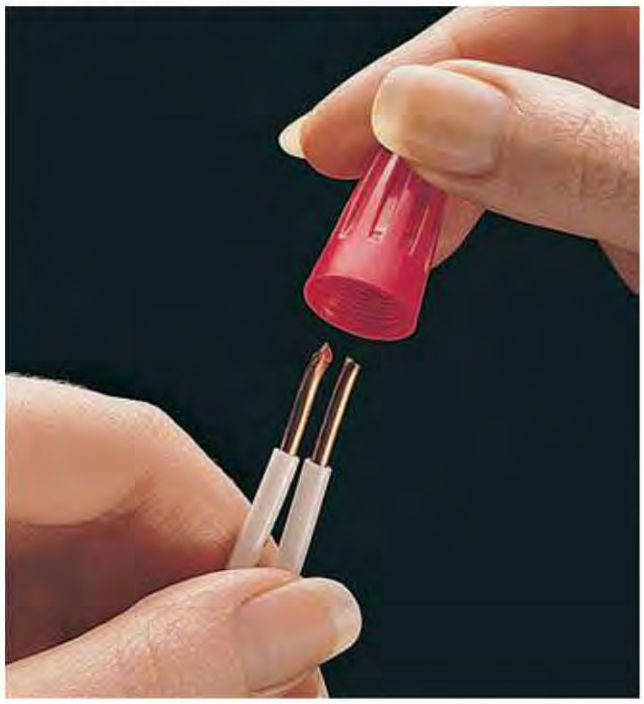


2 Determine how much wire to strip. Many receptacles and other devices come with a gauge that tells you how much wire to strip. Usually, it's about ¾".

3 To strip insulation from the individual wire, select the opening on the combination tool that matches the size of the wires. In most instances, you'll be using the 12-gauge or 14-gauge openings on the tool. Open the jaws and place the wire in the correct slot, then close the jaws of the tool around it. Tug on the wire until it comes free from the insulation.

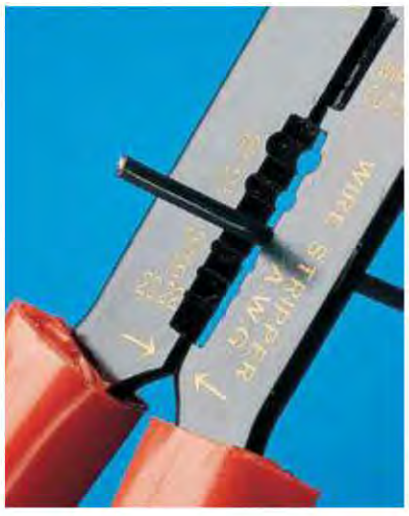
HOW TO CONNECT WIRES WITH SCREW CONNECTORS

1 Screw connectors are used to join circuit wires together, or to join circuit wires to the wire leads on a light fixture, dimmer switch or other device. Choose a wire connector appropriate for the number of wires you're connecting, and for their size. Wire connector packages come with recommendations for usage. Green wire connectors are reserved for grounding wires.



2 Hold the wires together and slide a wire connector onto them. Twist clockwise until the wires are snug. You shouldn't be able to see any bare wire exposed. Tug on the wires gently to make sure they're firmly attached.

HOW TO MAKE SCREW TERMINAL CONNECTIONS

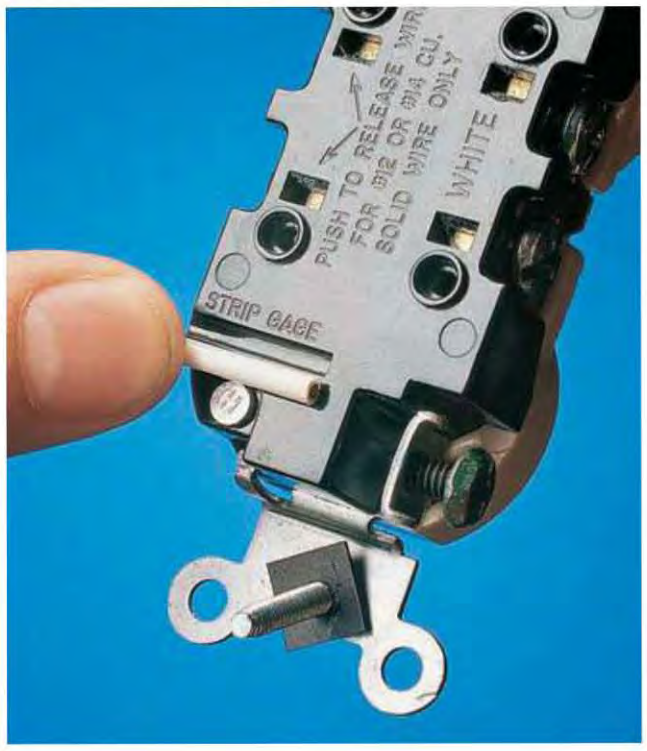


1 Strip about ¾" of insulation from each wire, using your combination tool. Choose the slot in the tool that corresponds to the wire size—this will almost always be 14-gauge or 12-gauge wire for the type of wiring you're doing.

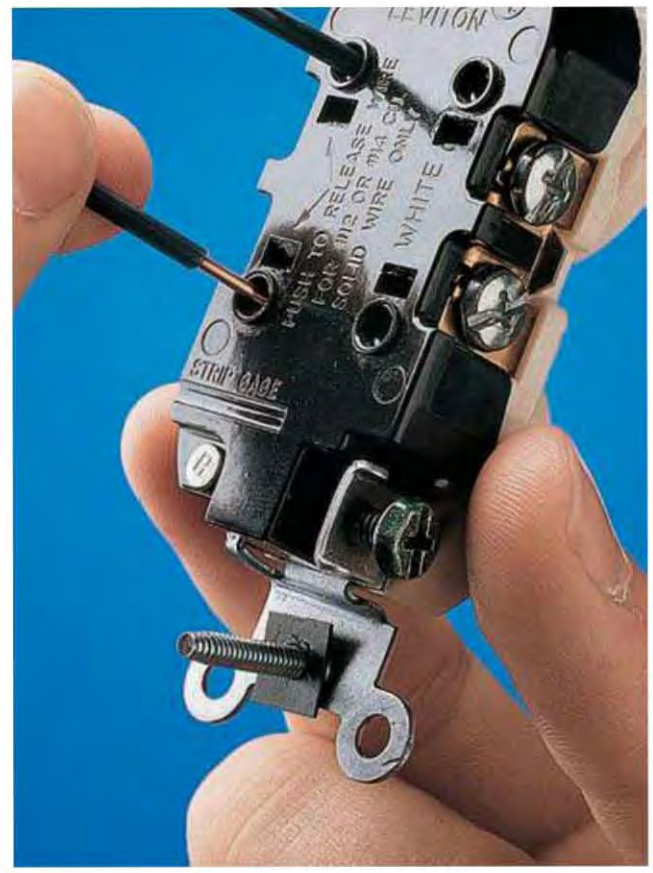
2 Form a C-shaped loop in the end of the wire, using a needlenose pliers. Make sure the wire has no nicks or deep scratches. If it does, clip it off and restrip the ends of the wire.

3 Hook each wire around the appropriate screw terminal on the device, so it forms a clockwise loop. Attach only one wire under each screw terminal. Tighten the screw securely. The plastic insulation on the wire should just touch the screw, and the end of the wire should be under the screw, not extending beyond it.

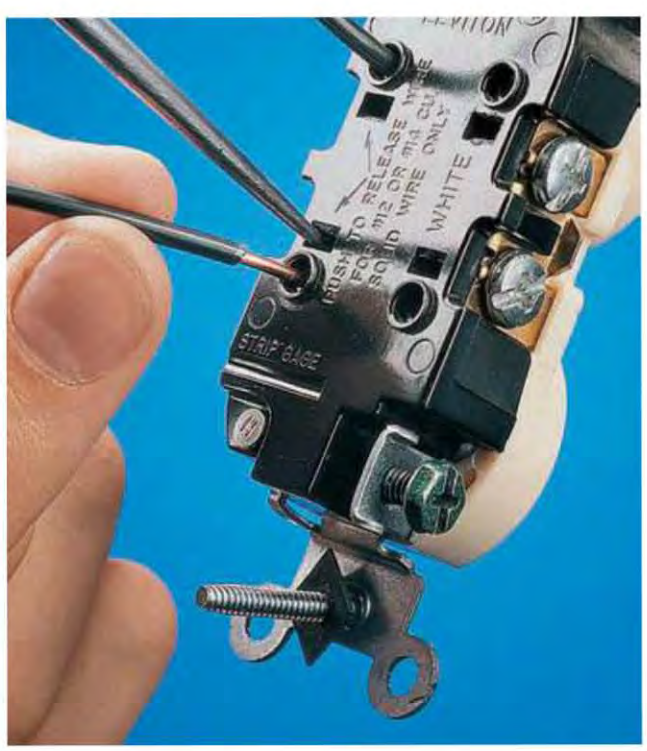
HOW TO MAKE PUSH-IN CONNECTIONS



1 Although they are not as secure as screw connections, you can also use push-in connections on some switches. Some devices also have push-in connections. To make this connection, use the strip gauge on the back of the device to mark the wire for stripping. Use a combination tool to strip the wire.



2 Insert the bare copper wires firmly into the push-in fittings on the back of the switch or receptacle. There shouldn't be any bare wire exposed. Tug gently to make sure the wire is firmly gripped. If not, remove the wire and reinsert. If the device won't grip the wire tightly, connect the wire using the screw terminals instead.



3 If you need to remove a wire from a push-in fitting, insert a small nail or screwdriver into the release opening next to the wire. The wire should pull out easily.

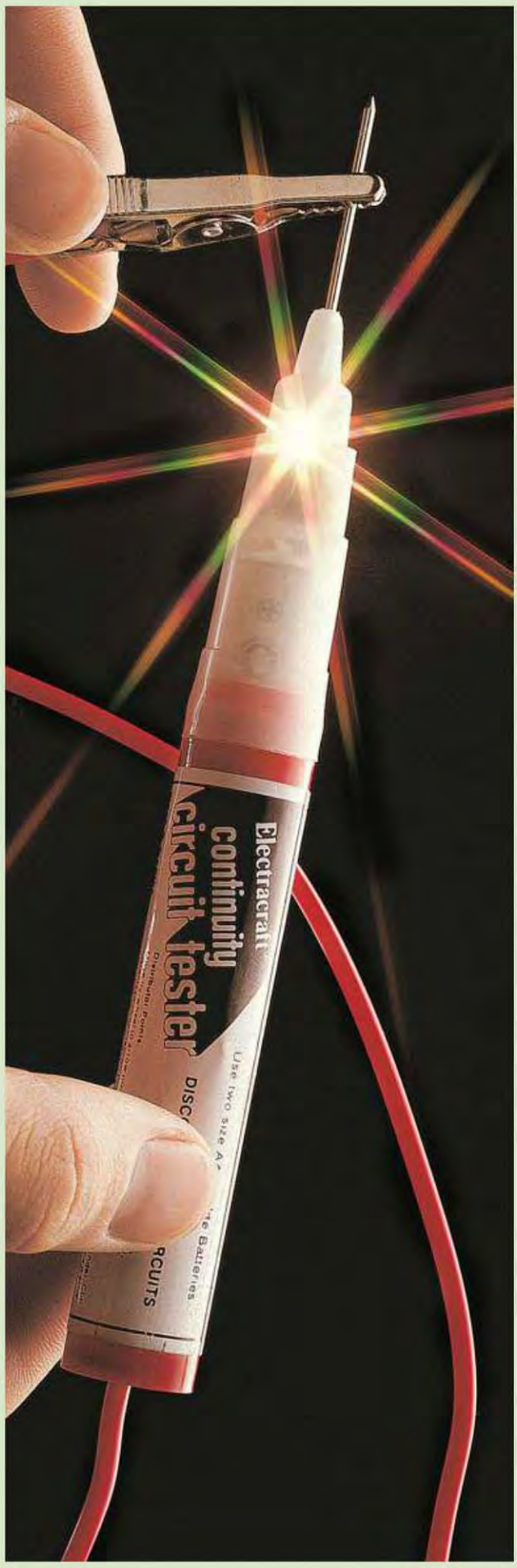
WHAT IF...?

A new type of wire connector looks like a twist connector, but instead uses a simple push-in action. Strip the wires to the length indicated, then simply slide the bare wires into the holes on the connector.

CONTINUITY TESTER

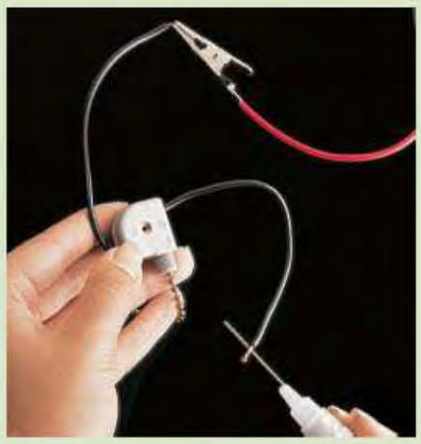
A continuity tester is a specialty tool that can be used to test lamp cords, switches, sockets, switches, and other devices to see if they are working correctly. The continuity tester is a battery-operated tool that sends a very faint electrical current through the metal components on a device, and senses whether or not there is a continuous pathway for household current to follow. If you have doubts about the condition of a device, the continuity tester offers a quick way to tell if the device is faulty or not.

Although there's only one project in this book that calls for a continuity tester, it's useful tool you might want to add to your wiring tool kit.

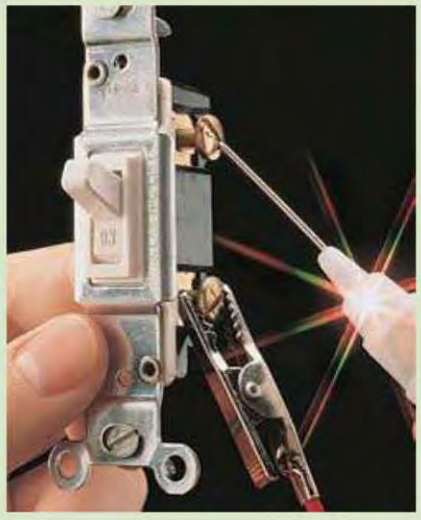


On lamp cords, use the continuity tester to check the pathway from the prongs on the plug to the ends of the cords.

On pull-chain switches, attach the clip of the tester to one of the switch leads, and hold the tester to the other lead. Pull the chain. If the switch is good, the tester will glow when the switch is in one position, but not in the other.



On wall switches, attach the clip of the tester to one of the screw terminals and touch the probe to the other screw. Flip the switch lever from ON to OFF. If the switch is good, the tester will glow when the switch is ON, but not when OFF.



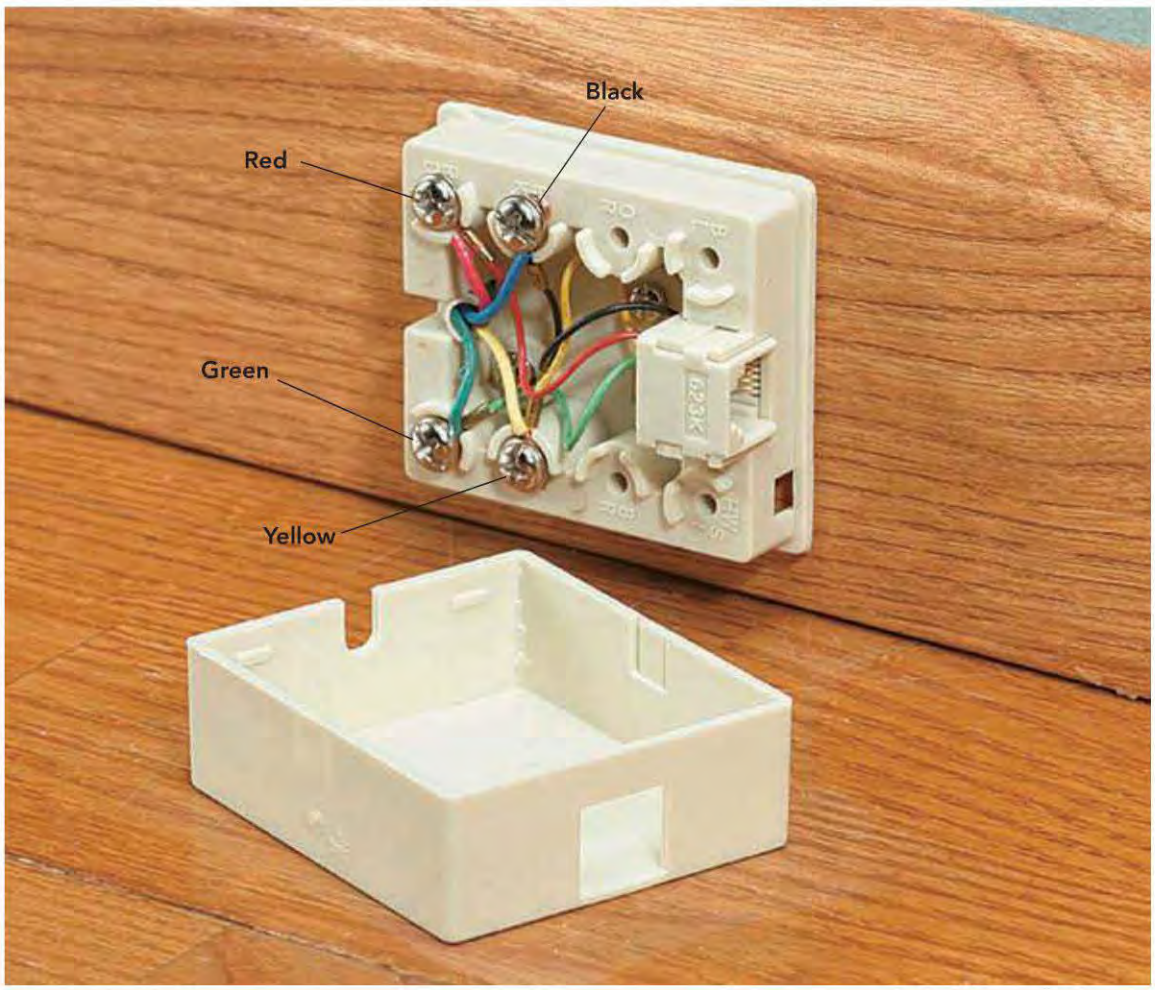
1 Replacing Phone Jacks

Phone jacks are easily damaged. Whether they get smashed by an errant chair leg or their wires get rattled loose, a faulty jack can degrade the quality of the sound on your phone—or disconnect you altogether. The good news is that working on phone wiring is easy and very safe.

REPAIRING OR REPLACING A BROKEN PHONE JACK is a project that offers a lot of bang for the buck. If a phone jack somewhere in your house has stopped working or has very poor sound quality, you can probably fix it by investing $5 and less than an hour of your time.

The phone system is separate from the household wiring, and runs on a very mild current, which means you don't have to worry about shock. You don't have to turn anything off to replace a phone jack.

PHONE JACKS 101



Phone jacks generally have four thin colored wires in them. The wires are connected to screw terminals or to slotted brackets. The four wires are usually colored red, yellow, green and black. Connect the individual system wires to the screw or bracket connected to the matching color leads leading to the modular plug.

CHEAT SHEET

If your wires don't match the color scheme shown here, don't worry. Use this chart as a reference for connecting wires to the screw terminals:

The red terminal will accept:	• a red wire • a blue wire (or blue with white stripe)
The green terminal will accept:	• a green wire • a white wire with blue stripe
The yellow terminal will accept:	• a yellow wire • an orange wire (or orange with white stripe)
The black terminal will accept:	• a black wire • a white wire with orange stripe

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

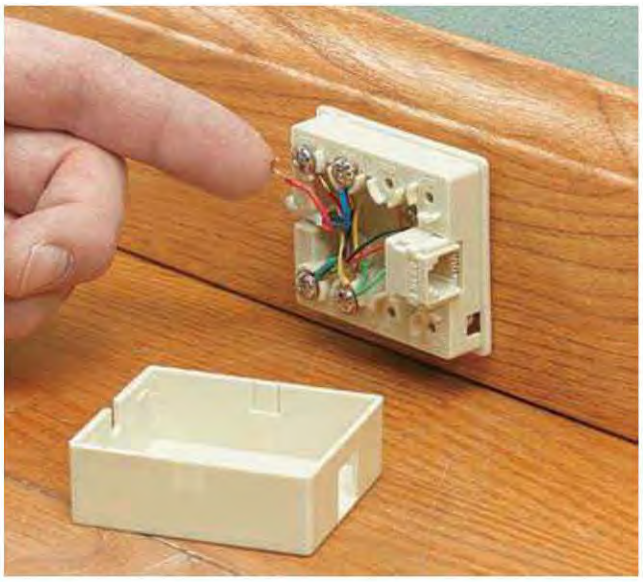
- Making wire connections (page 14)

DIFFICULTY LEVEL

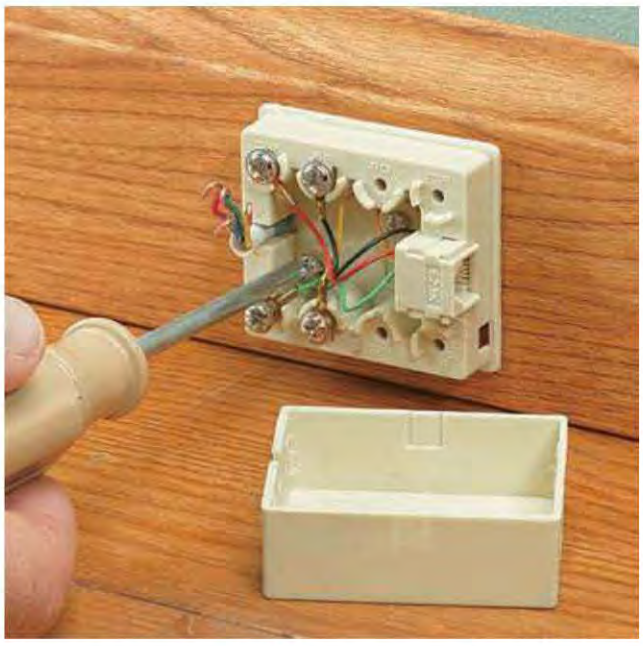
You'll likely finish this in 30 minutes or less.

HOW TO REPAIR A PHONE JACK

1 If the jack has no visible damage, you may be able to get it working again by reconnecting loose wires inside. Pry the cover off the jack with a small screwdriver.



2 Under the cover, you'll see six or eight wires in four colors. Each of the wires should be firmly seated under a screw terminal or in a forked metal tab. If one of the wires is loose, reattach it to the terminal of matching color. Plug in the phone to test it. If it still doesn't work, continue with replacing the jack.

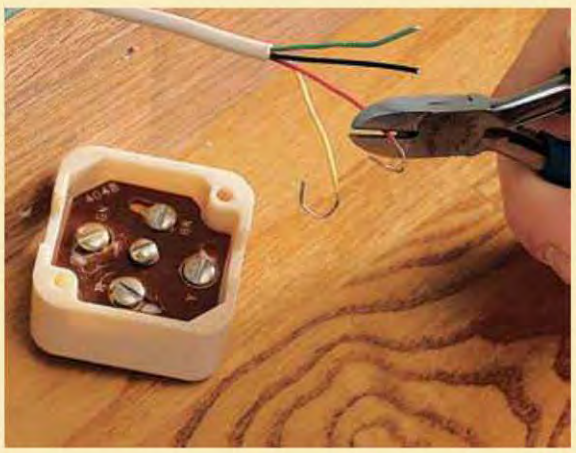


3 To remove the jack, first disconnect all the wires from their screw terminals or forked tabs. Then, unscrew the screws (there may be one or two) holding the jack to the wall. Tape the phone wires to the wall so they don't get knocked into the wall cavity.

4 Take the old jack to a hardware store or home center and try to find a similar replacement jack so you can use the same mounting holes. Remove the cover from the new jack. Carefully thread the phone wire through the back of the new jack, and connect the wires to the screw terminals of matching color. Attach the jack to the wall, replace the cover, and test the phone.

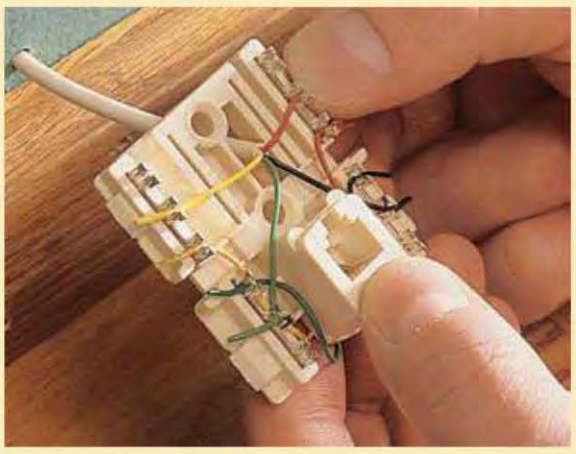
WHAT IF...?

What if I have a *really* old jack? Older style phones used a four-pin system rather than modular plugs. New phones won't work with these jacks, so you'll need to replace them with new modular jacks.



1 Unscrew the old jack from the wall, and carefully pull it away from the wall.

2 On the back of the old jack, you'll find two or four colored wires connected to screws. Unscrew the screws to free the wires and then clip away the stripped portion of the wires. Buy a new modular phone jack.



3 If your new jack uses forked tab connectors, thread the phone cable through the opening in the back of the jack, then press each of the four wires into a forked tab that already contains a wire of the same color running to the plug-in opening. If your new jack uses screw terminals, follow the instructions on the opposite page. After all the wires are connected, plug in a phone. You should have a clear dial tone.

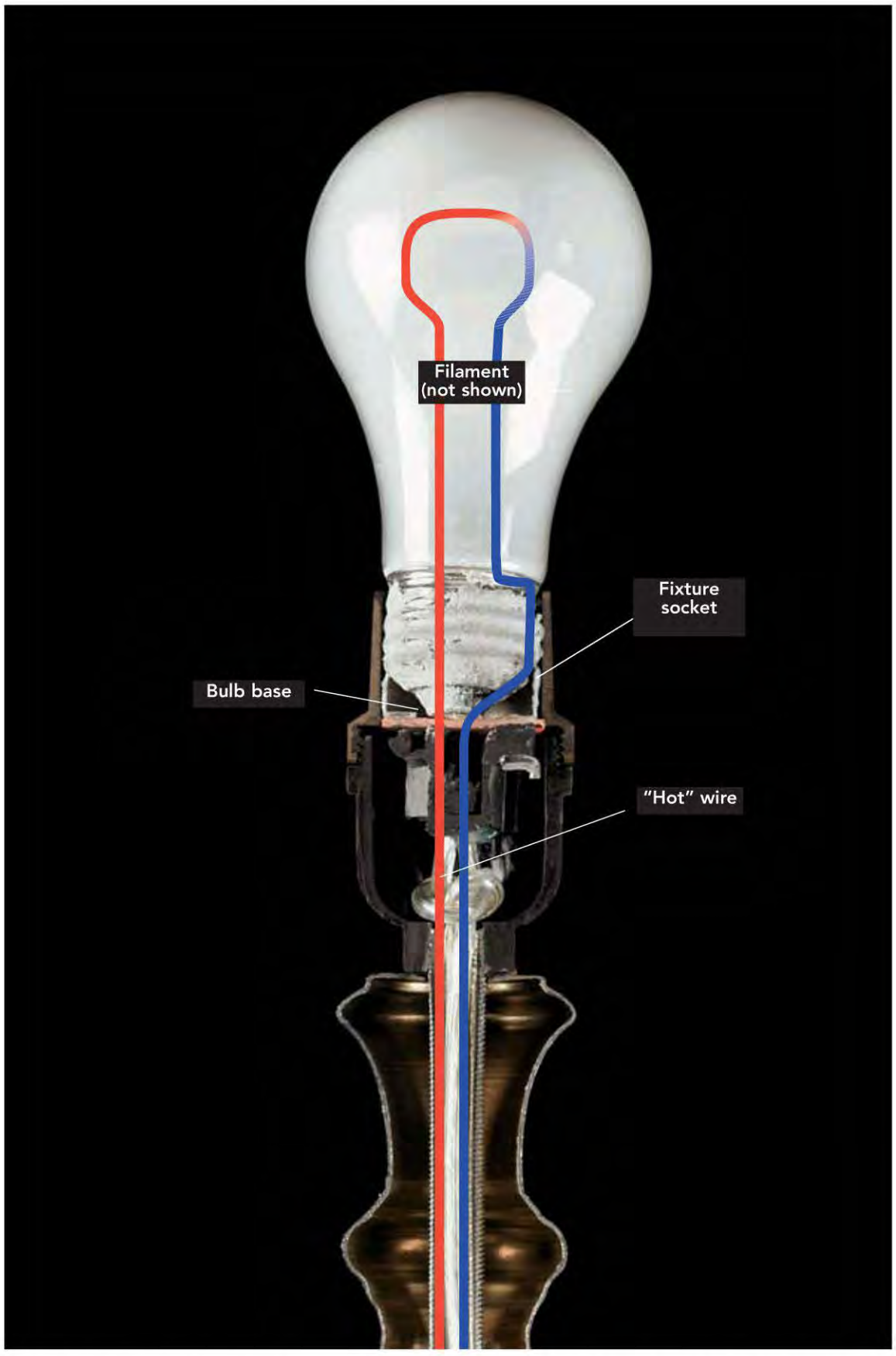
4 Set the jack over the old mounting holes and make sure the wire isn't being pinched against the wall. Drive the mounting screws back into the holes. Snap the cover back onto the jack and plug in your phone.

2 Removing Broken Lightbulbs

Even with the simplest wiring repairs, using a voltage sensor to check for power is a good idea. We'll then show you how the pros handle this job—using a needlenose pliers to remove the broken lightbulb. This technique works on even the most corroded and rusted light fixture sockets.

IF YOU'VE EVER TRIED TO REMOVE A LIGHTBULB THAT'S CORRODED AND STUCK in a fixture socket, you know that the lightbulb can easily break, leaving the bulb's aluminum base stuck in the fixture. There are several solutions to this common problem; some work better than others. For example, you may have heard of the old potato trick that suggests you push a raw potato into the broken socket and turn. But this introduces moisture and other debris into the fixture, and it doesn't work that well, especially if your broken bulb is really stuck. The bar of soap technique isn't much better. Effective methods include using a pair of needlenose pliers or a bulb extractor device, which can be found at most hardware or home improvement stores.

LIGHT SOCKETS 101



Over time, the aluminum base of a lightbulb may become corroded and difficult to remove from its socket. You can almost always remove the bulb without damaging the socket. In this cutaway lamp, you can see exactly how a light fixture socket works. Current flows up into the lightbulb through the "hot" wire and through the central contact in the base of the bulb. The current flows through the filament inside the light bulb, loses its charge by producing light, then the neutral current flows back to the neutral wire through the threaded metal portion of the bulb and socket.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Turning off the power (page 10)
- Testing for current (page 11)

DIFFICULTY LEVEL

You'll finish this job in just a few minutes.

HOW TO REMOVE A BROKEN LIGHTBULB

1 Before you start to remove the broken bulb, turn off the power to the light (or unplug the lamp, if that's what you're working on). Then, with the light switch in the ON position, place the tip of your voltage sensor in the broken bulb base. If the sensor beeps or lights up, then the wires are still live and are not safe to work. Check the main circuit panel again and trip the correct breaker to disconnect power to the light. If the sensor does not beep or light up, the circuit is dead and safe to work on.

2 Put on safety glasses and a pair of heavy leather work gloves. Use your needlenose pliers to remove any broken shards of glass still attached to the lightbulb base. If you're working on a ladder, have a helper hold the base of the ladder.

3 Insert the needlenose pliers into the broken bulb base as far as they will go. Spread the handles of the pliers firmly apart (this will cause the jaws to press against the inside of the socket), and turn the pliers slowly counterclockwise, unscrewing the bulb base. If the bulb won't budge, try wrapping the jaws of the pliers in duct tape for extra grip.

TOOL TIP

Needlenose pliers are handy for all sorts of household repairs, not just wiring. They come in many sizes. A good basic pair should have jaws around 3" long and comfortable handles.

4 If the lamp is still stuck, use the tip of needle-nose pliers to grab the lip of the bulb base and bend it in slightly on one side. Grip the bent portion firmly with the pliers, and pull the base counter clockwise to unscrew the bulb.

5 If the broken bulb is in a hard-to-reach location or if you're not comfortable working on top of a ladder, you can buy a broken bulb extractor (available at hardware stores for less than $10) and screw it on to the end of a broom handle or extension pole. Simply insert the extractor into the socket. Its rubber sides grip the edge of the bulb base and give enough grip to allow you to turn the base out of the socket.

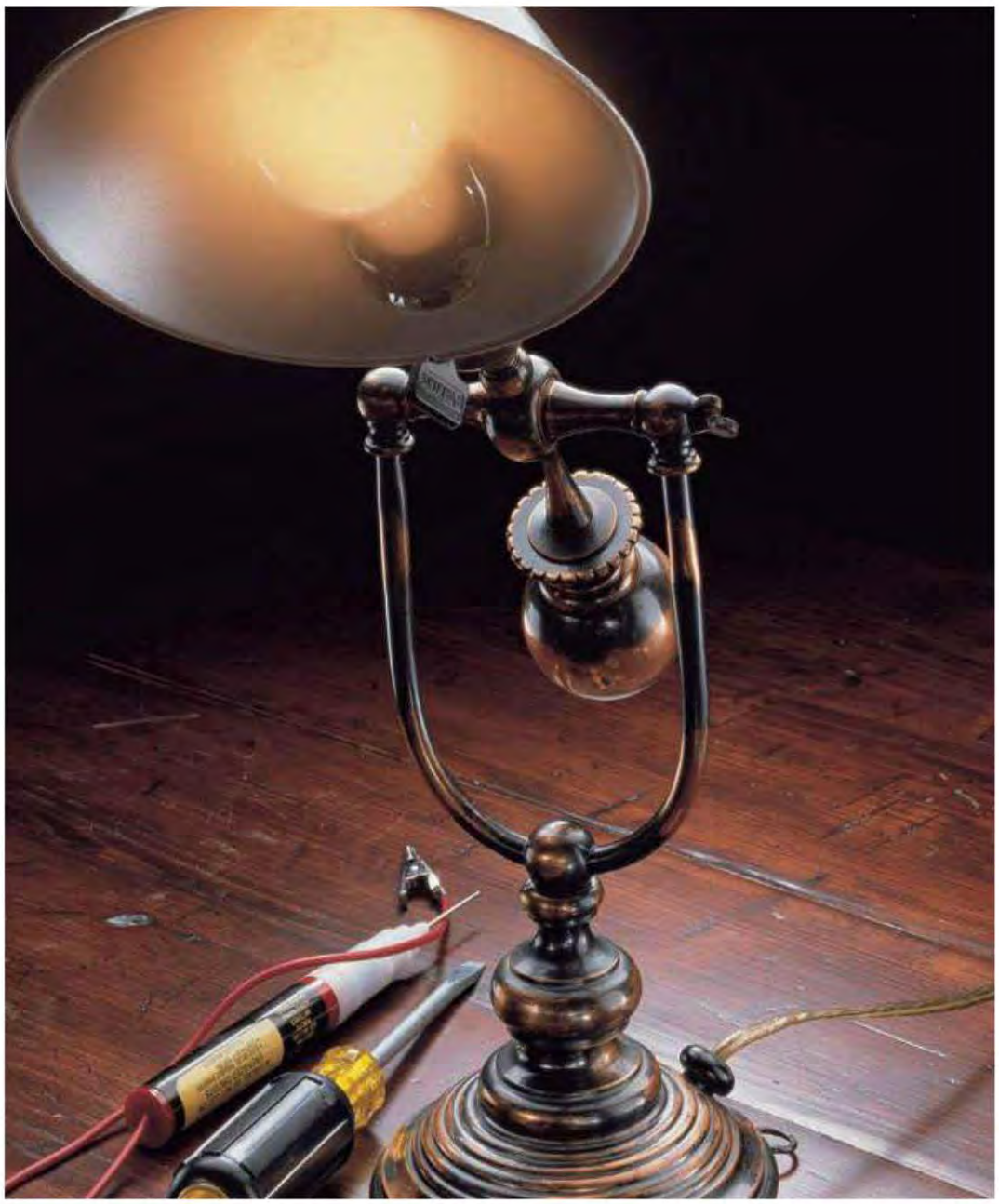
WHAT IF...?

What if the bulb still won't turn?

The base of the bulb is soft aluminum, and, if you pull hard enough, it will begin to tear much like a pop can. If you can't twist the bulb out, you may be able to create a little tear in the edge of the base. Try to fold the tear back. You'll probably rip a piece of the bulb off. Eventually, you'll have the whole socket out.

6 Once the bulb is out, wipe away any corrosion in the socket with a rag. If bulbs often get stuck in a particular fixture, use a bulb socket lubricant (available at hardware stores) to lubricate the lightbulb base and prevent corrosion. And remember, there's no need to twist hard when installing a bulb.

3 Fixing Lamp Sockets



Fixing an old lamp is a satisfying and surprisingly simple process. No matter what a lamp looks like on the outside, they almost always have the same electrical components.

WHEN A LAMP STOPS WORKING, IT'S OFTEN CAUSED BY A BAD LIGHTBULB SOCKET UNIT—that's the piece containing the switch or pull chain that holds the lightbulb. No need to throw the lamp away: for a few dollars, you can replace the socket and restore the lamp to like new. Replacing a socket is easy, and most hardware stores and home centers sell a variety of replacement sockets.

LAMP SOCKETS 101

Lamp sockets and switches are usually interchangeable—choose whatever type you want. Included here from top left: twist knob, remote switch, pull chain, push lever.

QUICK FIX

Sometimes, you'll get lucky and you can fix the faulty socket very easily. With the lamp unplugged and its bulb and shade removed, use a small flat screwdriver to pry up the small metal tab on the base of the socket. The tab should be angled slightly upward, not pressed flat in the socket. If the tab doesn't touch the base of the bulb, electricity will not flow though the bulb. Prying it up may restore the current flow. Replace the bulb and test the lamp.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Stripping and connecting wires (pages 14 and 15)
- Testing for continuity (page 17)

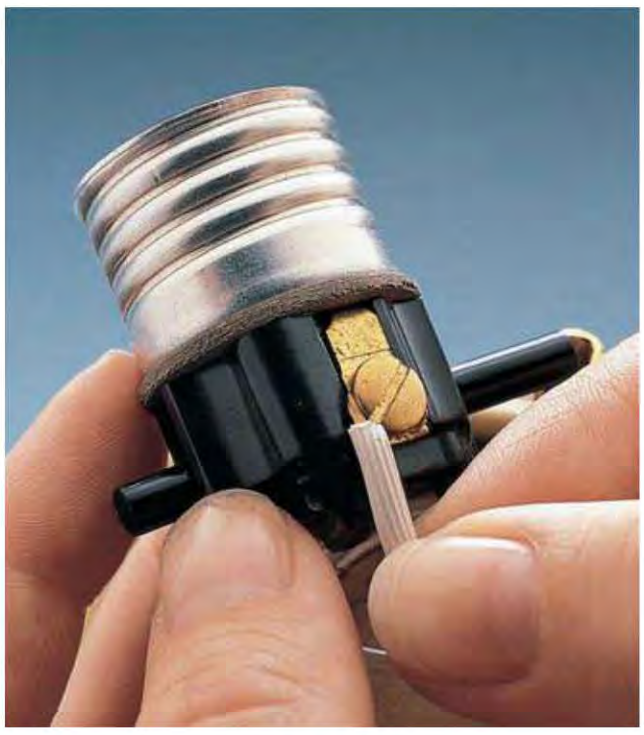
DIFFICULTY LEVEL

This job takes 30 to 60 minutes.

HOW TO FIX A LAMP SOCKET

1 With the lamp unplugged, the shade off, and the bulb out, you can remove the socket. Squeeze the outer shell of the socket just above the base and pull the shell out of the base (the shell is often marked "Press" at some point along its perimeter. Press there and then pull).

2 Under the outer shell, you'll find a cardboard insulating sleeve. Pull this off and you'll reveal the socket attached to the end of the cord.



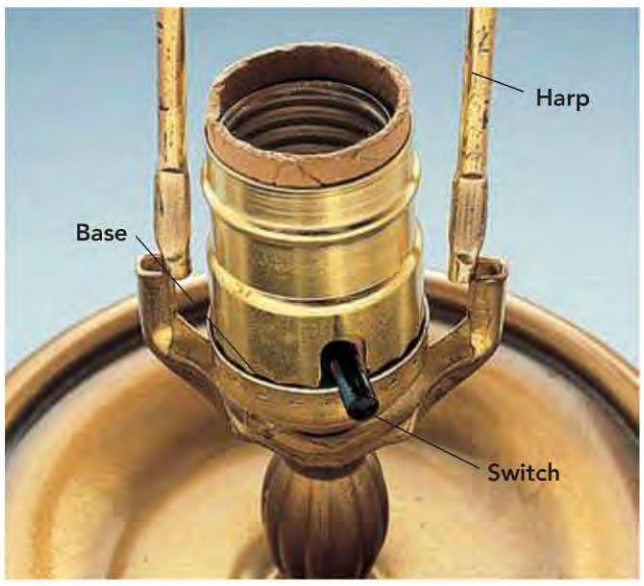
3 With the shell and insulation set aside, pull the socket away from the lamp (it will still be connected to the cord). Look at the two screws on the sides of the socket. One half of the cord should be connected securely to each. If the screws are loose or if either of the wires is unattached, you've found the problem. Reconnect the ends of the cord and tighten the screws. But if the connections seem sound, then you'll need to continue by unscrewing the two screws to disconnect the socket.

WHAT IF...?

What if my lamp is old and the shell is held in place by screws?

Some older lamps may have an outer shell held together with small screws. Simply undo the screws, remove the outer shell, and proceed as described here.

4 To rule out a bad cord as the cause of the problem, attach the clip of your continuity tester to one prong of the lamp's plug; then touch the probe first to one of the bare wires and then to the other. Do the same test for the other prong. The tester should light up once for each prong. If the tester never lights or lights on both wires for the same prong, you'll need to replace the cord. If it lights up once for each prong, the socket is the problem.



6 Set the socket on the base of the lamp. Make sure the switch isn't blocked by the "harp"— the part that holds the shade on some lamps. Slide the cardboard insulating sleeve over the socket, so the sleeve's notch aligns with the switch. Now slide the outer sleeve over the socket, aligning the notch with the switch. It should snap into the base securely. Screw in a lightbulb, plug the lamp in, and test it.

5 Attach the ribbed half of the wire to the silver screw terminal on the new socket. Attach the other wire to the brass-colored screw terminal. If the stripped ends of the cord are frayed or blackened, cut them off with your combination tool and strip away ¾" of insulation to reveal clean wire.

HERE'S HOW

Here's how to buy a replacement socket. First, make sure it accepts the same size bulb (you'll be able to see this by looking). Next, if your old socket has a twist-, push-, or pull-chain-style switch, find a replacement that has the same style. (If the socket doesn't have a switch, you'll need to find a socket without one.) Finally, make sure it has the same watt rating as the old socket. Somewhere on the inside or outside of the socket, you'll find a number (between 20 and 120) followed by a *W*. This is the watt rating.

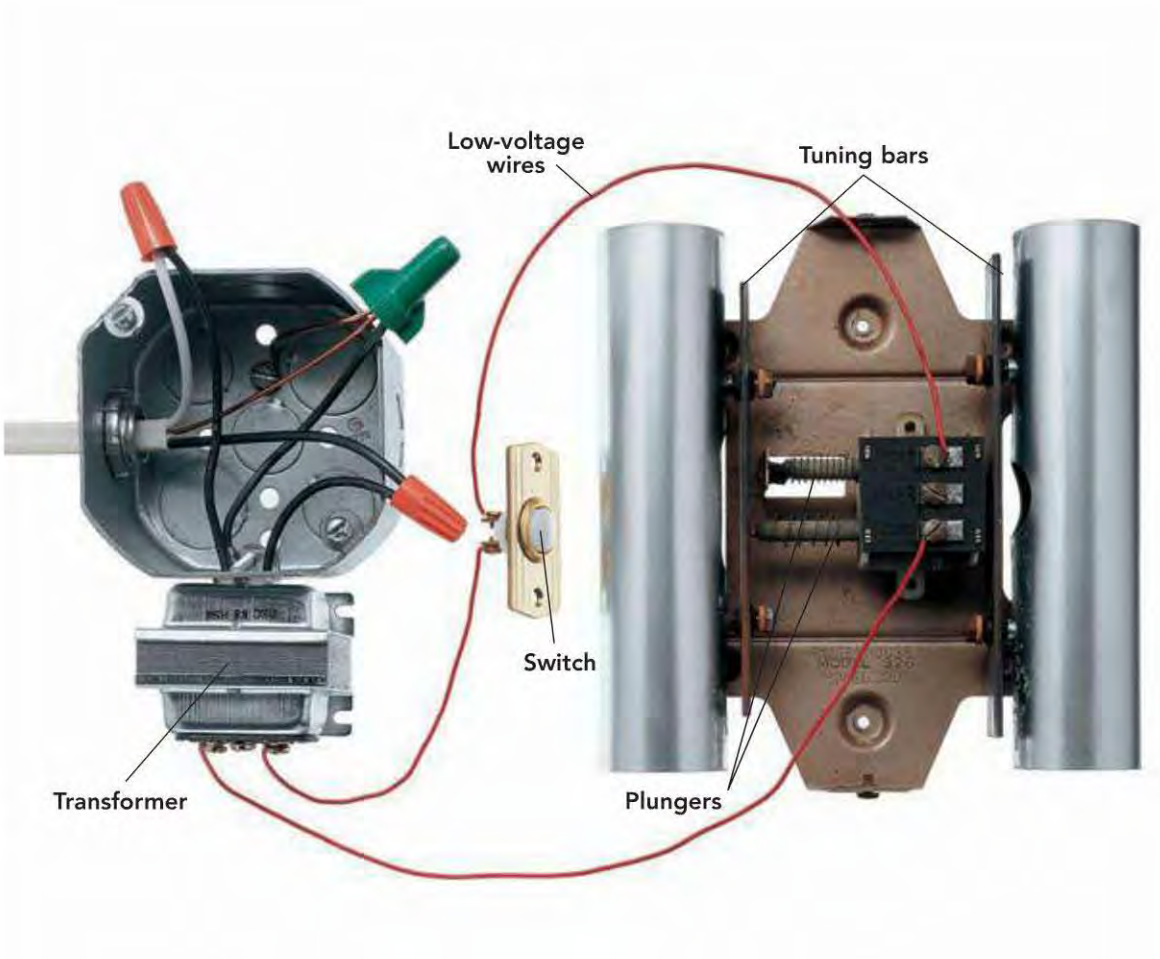
4 Fixing Doorbells

A wireless kit is a quick and easy way to replace a failed doorbell system. The kit consists of a battery-powered doorbell button that sends a wireless signal to a plug-in chime unit somewhere in the house. Some models come with two button units, one for the front door and one for the back.

WHAT DO YOU DO IF YOUR DOORBELL DOESN'T CHIME? The repair may be as simple as repairing loose wires or replacing a $2 button. The most common causes of doorball malfunction—loose wiring and worn-out buttons—are the easiest to fix, requiring only a screwdriver.

If the problem is with the wiring itself or the chime unit, it's generally simpler and cheaper to replace the system with a wireless doorbell kit, which take only minutes to install and cost very little.

DOORBELLS 101



Repairing or replacing a doorbell is a simple project that often doesn't even require you to shut off the power. Doorbells are powered by a transformer that reduces household current to 24 volts or less. This low-voltage current goes from the transformer to the switch by the door and on to a chime unit. When you press the doorbell button, it completes a low-voltage pathway and causes the plunger to strike a musical tuning bar. To distinguish between the front and back door signals, one of the doorbell switch-and-plunger pairs strikes two tuning bars in succession, creating the characteristic "ding-dong" sound. The other switch and plunger strikes only one tuning bar.

HERE'S HOW

Rarely, it may be a loose wire connection on the doorbell chime unit that causes the problem. Remove the cover on the chime unit, look for loose wires, and tighten them with a screwdriver. More often, though, the problem will be with the push-button switch, or with a chime unit that has simply reached the end of its life.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Turning off the power (page 12)
- Testing for power (page 13)
- Making wire connections (page 14)

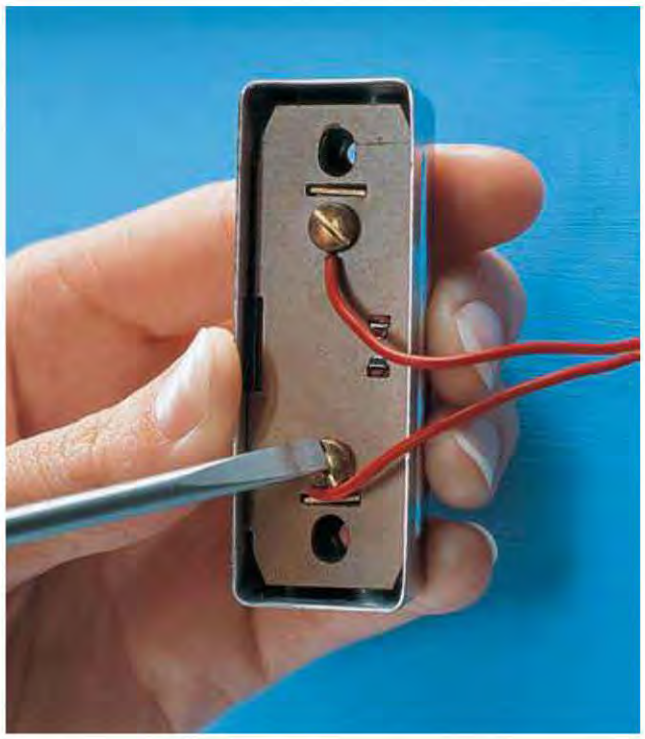
DIFFICULTY LEVEL

Takes about 1 hour or less.

HOW TO FIX A DOORBELL

1 Begin by testing the button to make sure it works. Doorbell buttons are commonly the culprit. Use a screwdriver to remove the two screws that secure the doorbell cover to the house.

3 If the doorbell still doesn't work, loosen the screws on the back of the doorbell, remove the wires, and touch their bare copper ends together. If the bell sounds, the problem is a faulty button you'll need to replace (go to step 4). If the bell doesn't sound, the problem is elsewhere in the system (go to step 5). If you're replacing the switch, disconnect the wires and tape them to the wall to keep them from falling inside and getting lost.



2 Carefully pull the switch away from the wall. Check the two wire connections on the back of the switch. If the wires are loose, reconnect them to the screws on the back of the button. Test the doorbell by pressing the button. Check the two wire connections on the back of the switch. If the wires are loose, reconnect them to the screws on the back of the button. Test the doorbell by pressing the button.

4 To replace the switch, simply buy a replacement that has the mounting holes in the same location as the old one. Wrap each of the wires around one of the screws on the back of the switch and tighten the screws. Position the button over the mounting holes and attach the new button to the wall with a screwdriver.

5 If the bell didn't ring, check the transformer, which is probably located in the basement or utility room near your main service panel. Check the two wires connected to the surface of the transformer, and reconnect them if they're loose. Test the doorbell by pressing the button. If the doorbell still doesn't sound, go to step 6.

7 Install the battery into the battery compartment of the doorbell button. Go outside your front door and press the button to make sure the chime rings. If not, you may need to move the indoor receiver to a receptacle closer to the door.

6 If nothing else has worked, now it's time to install a new wireless doorbell kit. First, plug in the chime unit to a centrally located receptacle in your house. Disconnect the doorbell switch by your door, and clip off the wires as close to the wall as possible, using lineman's pliers.

8 Mount the button to the door frame where you removed the old doorbell. You may have to drill two new holes before securing the new button to the wall with screws. Some doorbells come with double-sided tape that can be used to secure the button to the wall or to door molding. Push the doorbell button to make sure it works.

5 Fixing Pull-Chain Switches

The pull-chain switch is actually a separate piece of the fixture. It's held in place with a retaining nut and connected to circuit wires with two wire leads.

CHANCES ARE YOU'VE GOT A LIGHT FIXTURE WITH A PULL-CHAIN somewhere in your house—in a closet, attic crawl space, or maybe even your bathrom vanity. And, chances are, if you use it enough, you will eventually pull a little too hard and the switch will fail. Fortunately, you can easily replace a pull-chain switch, generally for only a dollar or two.

This is the first project where you actually touch circuit wires, so make sure you read the information on shutting off power and testing for current, found at the beginning of this book.

PULL CHAINS 101

On some utility light fixtures, the pull-chain switch is part of the lightbulb socket. On these fixtures, you'll need to replace the entire socket/switch unit (inset).

WHAT IF...?

If you have a light fixuture or lamp with a push-button switch, replacing the switch is exactly the same as for a pull-chain switch.

Just buy a replacement switch that matches the old switch, and replace it using the same technique described on the following pages.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

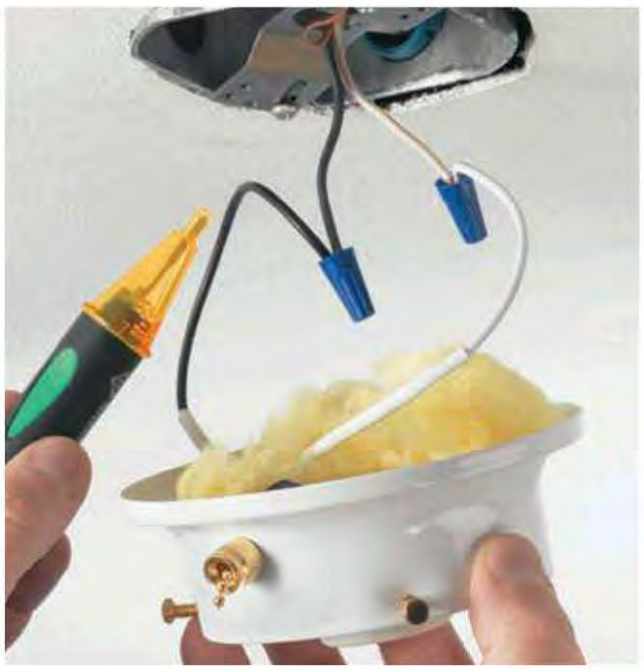
- Turning off the power (page 12)
- Testing for power (page 13)
- Making wire connections (page 14)

DIFFICULTY LEVEL

This project takes less than 1 hour.

HOW TO REPLACE A PULL-CHAIN SWITCH

1 First, make sure that the switch is broken, not just the chain. If you find a short bit of chain sticking out of the fixture, pull on it to see if the light turns on and off. If so, you can buy and attach a new length of pull chain. If there's no chain left or if the switch doesn't work when you pull the remaining chain, go ahead and replace the switch.

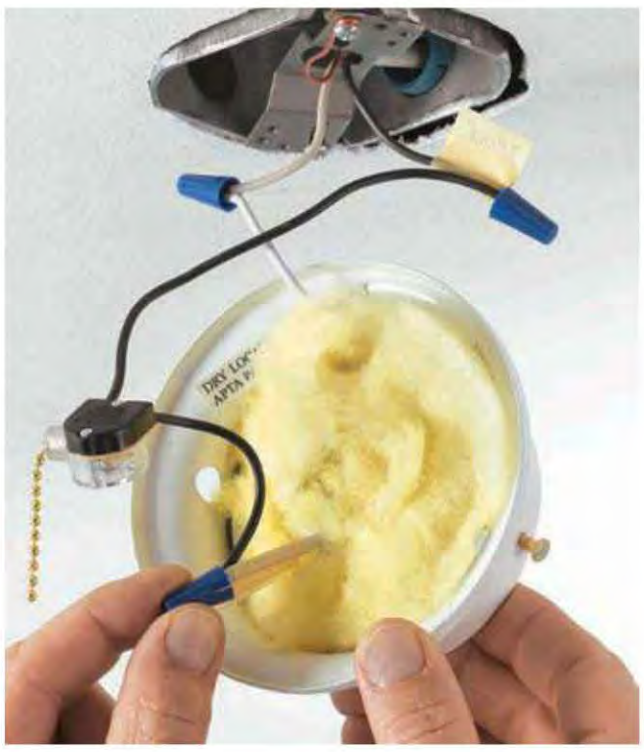


3 Test for current by holding your voltage sensor within ½" of the circuit wires. The black wires should cause the sensor to beep if power is present. Check all the wires for power in case the light was wired improperly. If the sensor beeps or lights up, then the circuit is still live and is not safe to work. Check the main circuit panel again and trip the correct breaker to disconnect power to the fixture. If the sensor does not beep or light up, the wires are dead and safe to work on.

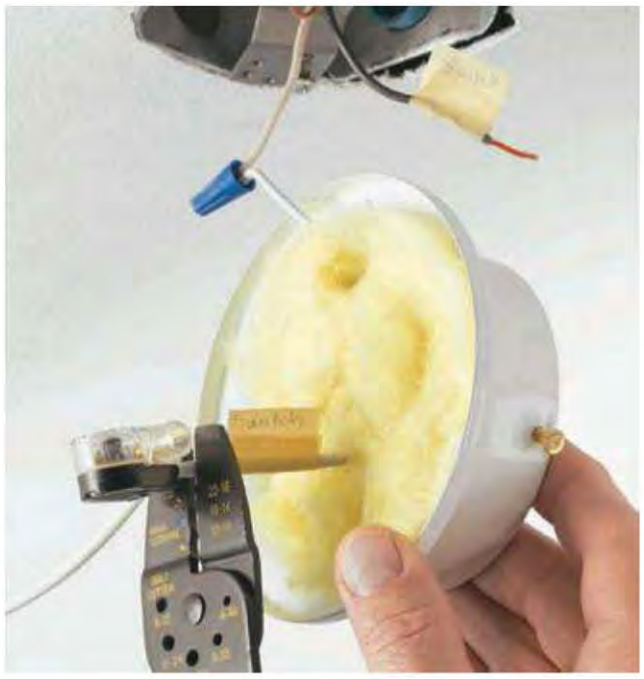
2 First, turn off the power to the fixture. Now, remove the globe and lightbulb, and loosen the mounting screws that hold the fixture to the electrical box. Lower the fixture away from the ceiling.

4 Hold the fixture steady with one hand and turn the knurled retaining nut at the base of the pull chain. You should be able to turn it with your fingers. If it sticks, use needlenose pliers to turn it. Once the retaining nut is off, pull the switch out of the fixture.

5 Remove the two wire leads coming from the switch from the wires they are attached to by unscrewing the wire connectors. On most fixtures, one of the switch's leads will be connected to a circuit wire, the other lead to the light fixture itself.



7 Attach the wire leads on the new switch to the disconnected wires, using wire connectors. Then, insert the threaded portion of the switch through the hole. Slip the retaining nut over the pull chain and thread it on to the switch until it is snug.



6 If the switch is part of the fixture itself, snip off its connection, using a combination tool. You'll connect the new switch to the wire you've just snipped, so strip about ¾" of insulation off that wire.

8 Reattach the fixture to the ceiling by holding it over the electrical box in the ceiling so that the mounting holes in the fixture line up with the screw holes in the box. Make sure all the wires are in the box and not pinched between the ceiling and the fixture. Insert the mounting screws and tighten them down with a screwdriver. Now you can replace the bulbs, restore the power, and test the fixture.

6 Installing Programmable Thermostats

Programmable thermostats come in many varieties, but all of them will help save on energy costs. Most models have instructions for programming printed on the access plate.

TRADITIONAL FURNACE THERMOSTATS ARE LOW-VOLTAGE MODELS THAT DO A simple, but necessary, job. They sense changes in the house air temperature and when it's too low, the thermostat turns on the heat and when it's too high, the thermostat turns off the heat. For many years this was all we needed to make our homes comfortable and no one gave much thought to improving this performance. Then, fuel shortages and high energy costs made everyone interested in lowering the heating fuel bill.

One innovation that has advanced this effort is the programmable thermostat. This provided more control over furnaces and, as a result, reduced energy consumption. If everyone in the house is gone during the day, there's no reason to keep the heat at 68 or 70 degrees or more. And when everyone goes to sleep at night, these thermostats turn down the heat automatically and turn it back on before anyone gets up. Different models that offer different levels of control are available. Generally, the more capability a unit has, the more it costs. While there is variety in what the units can do, most are easy to install, as shown here.

THERMOSTATS 101

PROGRAMMABLE THERMOSTATS

Programmable thermostats contain sophisticated circuitry that allows you to set the heating and cooling systems in your house to adjust automatically at set times of day. Replacing a manual thermostat with a programmable model is a relatively simple job that can have big payback on heating and cooling energy savings.

CHECK BEFORE YOU BUY

When buying a new thermostat, make sure the new unit is compatible with your heating/air conditioning system. For reference, bring the brand names and model numbers of the old thermostat, the furnace, and the central air conditioning unit to the store and provide the information to the sales assistant.

TERMS YOU'LL NEED TO KNOW

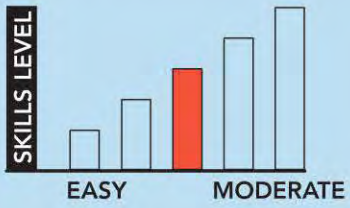
LOW-VOLTAGE WIRES—Electrical wires that carry lower voltage, usually 12 volts, than the standard household current, which is 120 volts. Often used for thermostats, doorbells, and outdoor lighting.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Reading package directions
- Making wire connections (page 14)

DIFFICULTY LEVEL



Allow 1 to 2 hours for this project.

HOW TO INSTALL A PROGRAMMABLE THERMOSTAT

1 Turn off the power to the furnace at the main service panel. Then, remove the thermostat cover.

2 The body of the thermostat is held to a wall plate with screws. Remove these screws and pull the body away from the wall plate. Set the body aside.

3 The low-voltage wires that power the thermostat are held by screw terminals to the mounting plate. Do not remove the wires until you label them with tape, according to the letter printed on the terminal to which each wire is attached.

4 Once all the wires are labeled and removed from the mounting plate, tape the cable that holds these wires to the wall to keep it from falling back into the wall. Then unscrew the mounting plate and set it aside (see sidebar, next page).

5 Position the new thermostat base on the wall and guide the wires through the central opening. Screw the base to the wall.

7 These thermostats require batteries to store the programs so they won't disappear if the electric power goes out in a storm. Make sure to install these batteries before you snap the thermostat cover in place. Then program the new unit to fit your needs and turn on the power to the furnace.

6 Check the manufacturer's instructions to establish the correct terminal for each low-voltage wire. Then connect the wires to these terminals, making sure each screw is secure.

MERCURY THERMOSTATS

Older model thermostats (and even a few still being made today) often contained one or more small vials of mercury totaling 3 to 4 grams in weight. Because mercury is a highly toxic metal that can cause nerve damage in humans, along with other environmental problems, DO NOT dispose of an old mercury thermometer with your household waste. Instead, bring it to a hazardous waste disposal site, or a mercury recycling site if your area has one (check with your local solid waste disposal agency). The best way to determine if you old thermostat contains mercury is simply to remove the cover and look for the small glass vials or ampules containing the silver mercury substance. If you are unsure, it is always better to be safe and keep the device in question out of the normal waste stream.

7 Adding Wireless Light Switches

Wireless switch kits are a simple and inexpensive way to add a second switch to an existing fixture.

SOMETIMES A LIGHT SWITCH IS JUST IN THE WRONG PLACE, or it would be more convenient to have two switches controlling a single fixture. Adding a second switch the conventional way generally requires hours of work and big holes in walls. (Electricians call this a "three-way" switch installation.) Fortunately, wireless switch kits are available to perform basically the same function for a fraction of the cost and effort. There is a bit of real wiring involved here, but it's not nearly as complicated as the traditional method of adding a three-way switch installation.

The kits work by replacing a conventional switch with a unit that has a built-in radio-frequency receiver that will "read" a remote device mounted within a 50 ft. radius. The kits come with a remote, battery-powered switch (it looks like a standard light switch) that you can attach to a wall with double-sided tape.

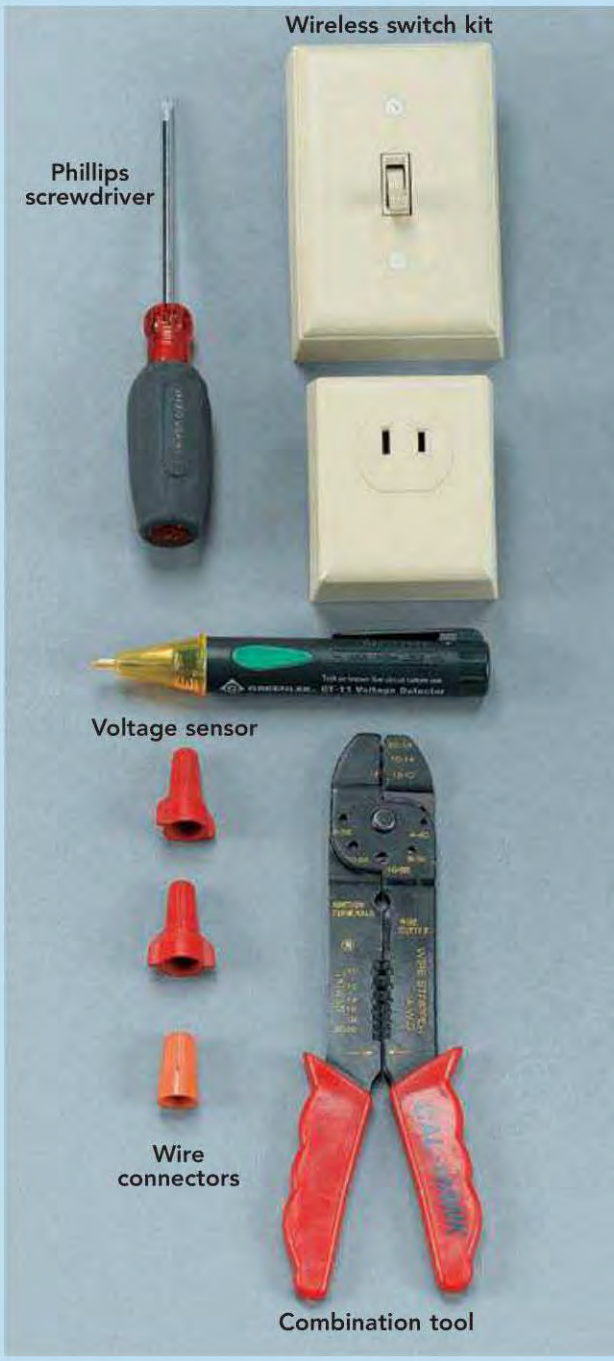
Two other similar types of wireless switch kits are also available. One allows you to control a plugged-in lamp or appliance with a remote light switch. The second type allows you to control a conventional light fixture remotely, but instead of replacing the switch, the receiver screws in below the lightbulb. This is particularly useful if you want to control a pull-chain light from a wall switch.

WIRELESS SWITCHES 101

Wireless kits are available to let you switch lights on and off remotely in a variety of ways, at the switch, at the plug, or at the bulb socket.

The remote switch is a wireless transmitter that requires a battery. The transmitter switch attaches to the wall with adhesive tape or velcro strips.

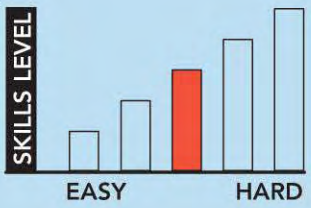
TOOLS & SUPPLIES YOU'LL NEED



SKILLS YOU'LL NEED

- Turning off the power (page 12)
- Testing for power (page 13)
- Making wire connections (page 14)

DIFFICULTY LEVEL



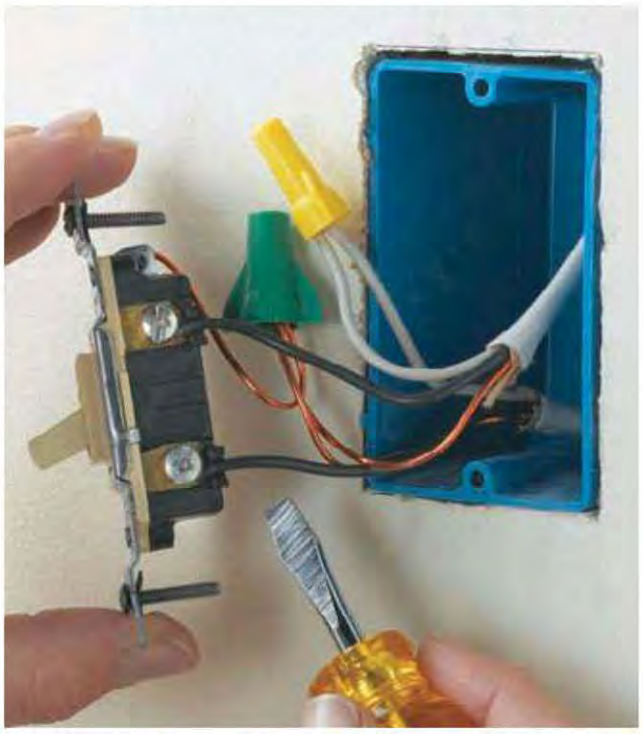
This is real wiring, but you should be able to finish in about 1 hour.

HOW TO REMOVE A WALL SWITCH

1 To remove the old switch, first shut off the power to the switch. Remove the decorative cover-plate from the switch by unscrewing the two screws that hold the plate to the switch box. Set the screws and the plate aside. With the cover-plate off, you will be able to see the switch and the electrical box it is attached to.

2 Use a voltage sensor to make sure the wires are dead. Hold your voltage sensor's probe within 1/2" of the wires on either side of the switch. If the sensor beeps or lights up, then the switch is still live, and you'll need to trip the correct breaker to disconnect power to the switch. If the sensor does not beep or light up, the circuit is dead and you're safe to continue.

3 Remove the switch from the box by unscrewing the two long screws that hold the switch to the box at the top and the bottom. Once the screws are out, hold the top and bottom of the switch, and carefully pull the switch away from the box.

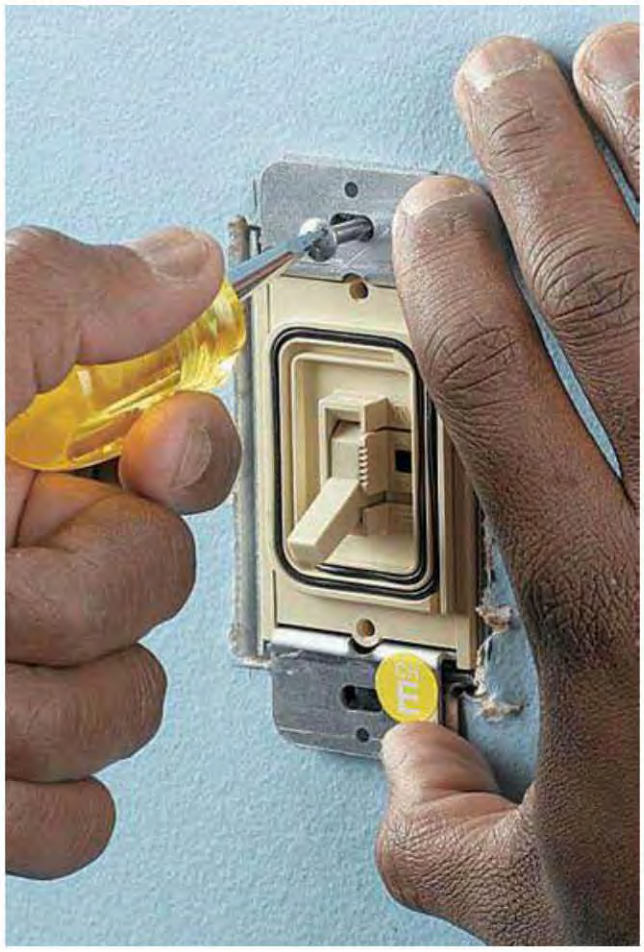


4 Remove the switch completely by disconnecting the wires. In many cases, there will also be two white wires connected with a wire connector in the box. You won't have to deal with these in your installation.

HOW TO INSTALL A WIRELESS WALL SWITCH

1 To install the receiver switch, you'll need to determine which wire carries current from the service panel. Bend both the wires so they are as far apart as possible. Turn the power back on temporarily. Without touching either wire, pass your voltage sensor over both. One should make your sensor beep and light up and the other won't. The one that trips your sensor carries current. Turn off the power and label that wire with a piece of tape.

2 Identify the wire lead on the receiver switch marked "line" and attach it to the circuit wire you marked with tape, using a wire connector. Connect the other wire lead on the switch to the remaining circuit wire in the same way.



3 Once the wires are firmly connected, you can attach the switch to the box. Tuck the new switch and wires neatly back into the box. Then drive the two long screws that are attached to the new switch into the two holes in the electrical box.

4 Reattach the coverplate. Then, turn the power back on at the main panel and test the switch for operation. You should be able to turn the light on and off as normal.

5 Now you can install the transmitter switch. Install the 9-volt battery in the transmitter switch. Remove the backing from the double-sided tape on the back of the switch and place the switch on a wall within 50 ft. of the receiver switch.

6 Test the operation of both switches. Each switch should successfully turn the light fixture on and off. You've just successfully created a three-way switch installation, without running any new wires.

VARIATION: WIRELESS LAMP SWITCH

1 You can also purchase wireless switch kits that control plug-in fixtures. Plug the receiver unit into any receptacle.

2 The unit has a receptacle on its face. Plug a lamp or any other plug-in device into the unit (this is an especially handy way to control Christmas lights).

VARIATION: WIRELESS SWITCH FOR A CEILING FIXUTURE

1 A third type of wireless switch uses a transmitter that screws into the bulb socket of the light fixture. If you need to control a light with a pull-chain switch or if you don't want to replace a wall switch as shown above, this is the best choice. Remove the lightbulb and thread the receiver into the bulb socket.

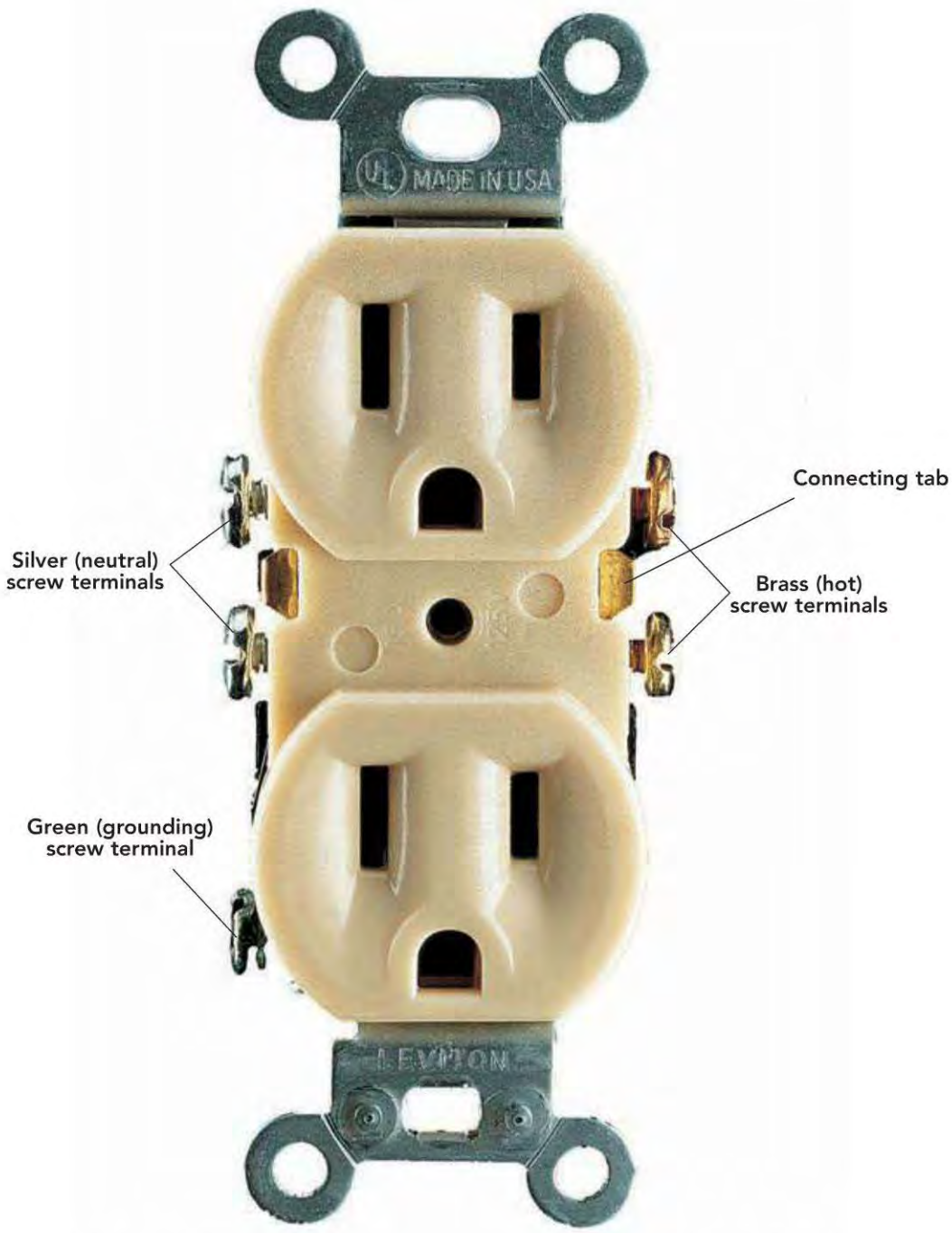
2 Screw the lightbulb into the receiver socket.

8 Replacing Bad Receptacles

Since receptacles don't have moving parts, they don't wear out quickly, but they don't last forever. If a receptacle won't hold a plug or if it's hot to the touch or sparks when you pull a plug, it needs some attention and possibly replacement. If you have a GFCI receptacle (inset) see pages 58 to 63 to replace it.

THE THING YOU'VE PROBABLY CALLED AN "OUTLET" IS MORE PROPERLY KNOWN AS AN ELECTICAL "RECEPTACLE." A receptacle that gets a lot of use will eventually wear out—you'll know this has happened if appliance plugs feel loose in the receptacle, or if a lamp flickers when the plug is jiggled. Another common problem is wires that work loose, causing the receptacle to stop working. This project will show you how to check the wire connections, then replace the receptacle if it's bad.

RECEPTACLES 101



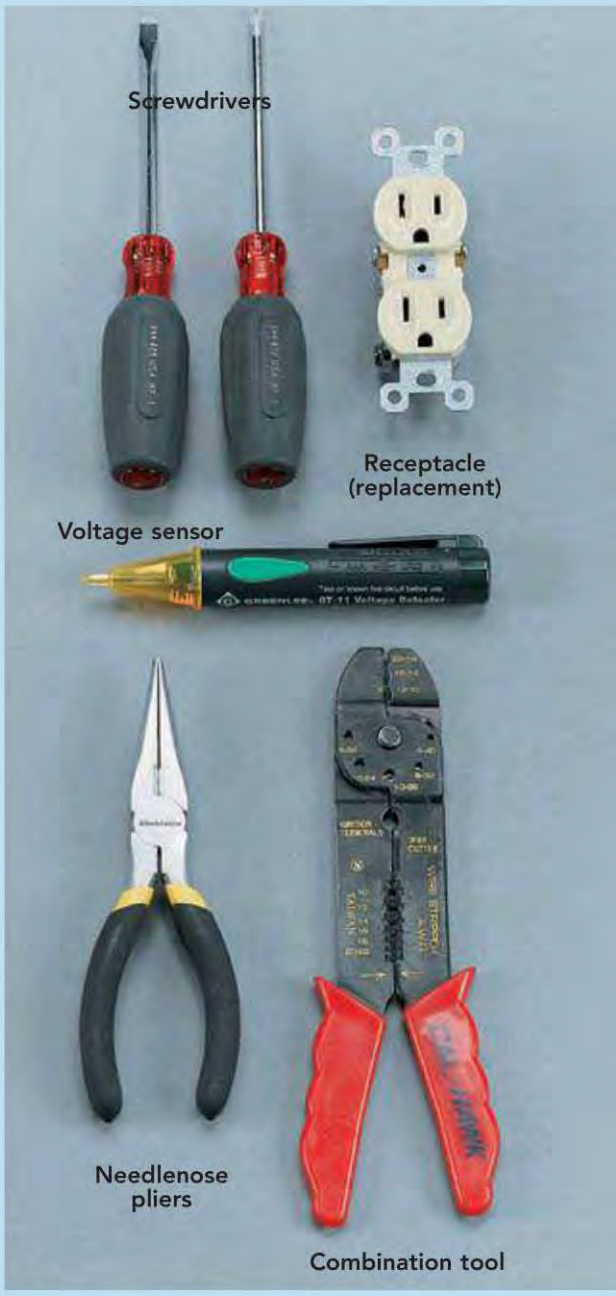
Receptacles have five screws for connecting wires: two silver, two brass colored, and one green. Some installations don't use all of these screws. Disconnecting and connecting a switch is only a matter of connecting the right wires to the right screws.

TERMS YOU NEED TO KNOW

MOUNTING STRAP—the metal piece that holds the plastic body of the receptacle to the electrical box.

SCREW TERMINALS—the silver and brass-colored screws used to connect the lamp wire to the socket.

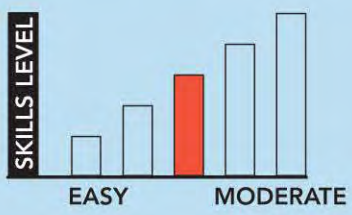
TOOLS & SUPPLIES YOU'LL NEED



SKILLS YOU'LL NEED

- Turning off the power (page 12)
- Testing for power (page 13)
- Making wire connections (page 14)

DIFFICULTY LEVEL

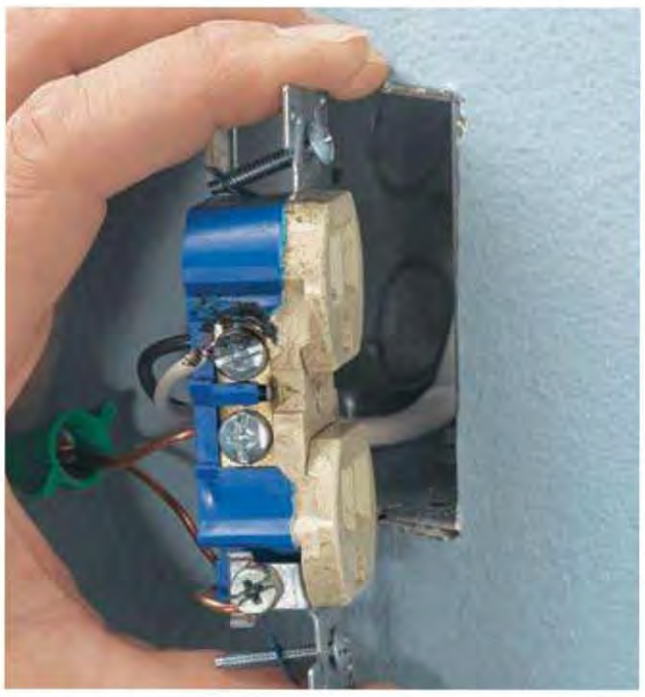


This project takes about 1 hour.

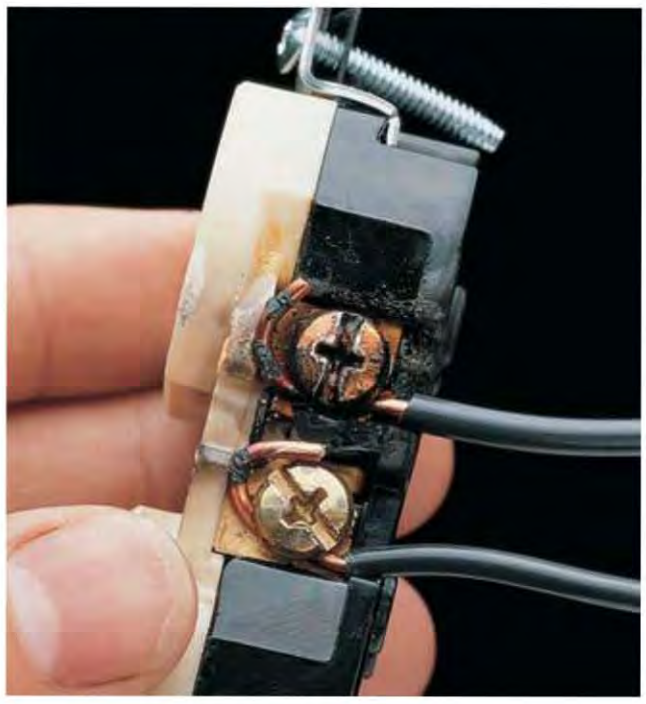
HOW TO FIX A BAD RECEPTACLE

1 Shut off the power to the switch at the main service panel. Remove the decorative coverplate from the receptacle. Set the screw and the plate aside. With the coverplate off, you will be able to see the receptacle and the electrical box it is attached to.

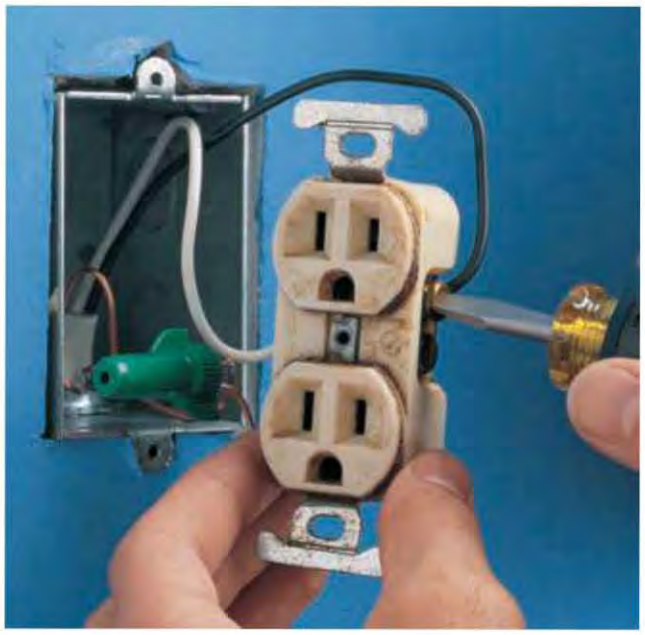
2 Use a voltage sensor to make sure that the circuit is dead. Hold your voltage sensor's probe within ½" of the wires on either side of the receptacle. If the sensor beeps or lights up, then the receptacle is still live, and you'll need to trip the correct breaker to disconnect power to the receptacle. If the sensor does not beep or light up, the receptacle is dead and you're safe to continue.



3 Remove the receptacle from the box by unscrewing the two long screws that hold the switch to the box at the top and the bottom. Once the screws are out, carefully pull the receptacle away from the box. Depending on how your receptacle has been wired, it may be connected to two colored wires and a bare grounding wire, or four colored wires and a bare wire.

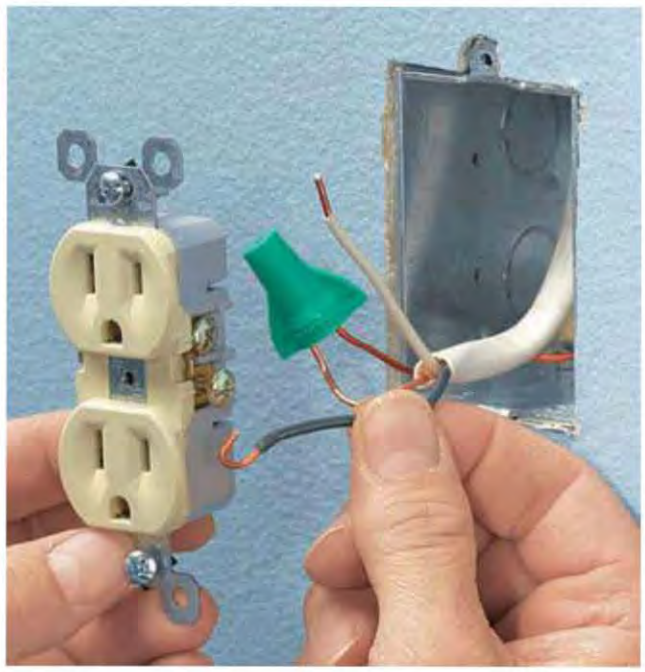


4 Inspect the screws where the wires connect to the switch. They should be tight and the connections should be clean and free of any scorch marks. If the connections were good, the problem is likely with the receptacle itself. If one of the wires is loose or if the connections are scorched, the problem is probably a loose screw causing a short circuit. You can follow the directions below to reattach the old switch or you can install a new one to be on the safe side.



5 Loosen the screw terminals and remove the circuit wires. Inspect the wires, and if they're damaged, clip them off and strip about ¾" of bare wire, using a combination tool. Check the connecting tabs on the sides of the receptacle. If they have been snapped off, you'll need to also do this on the new receptacle, using needlenose pliers.

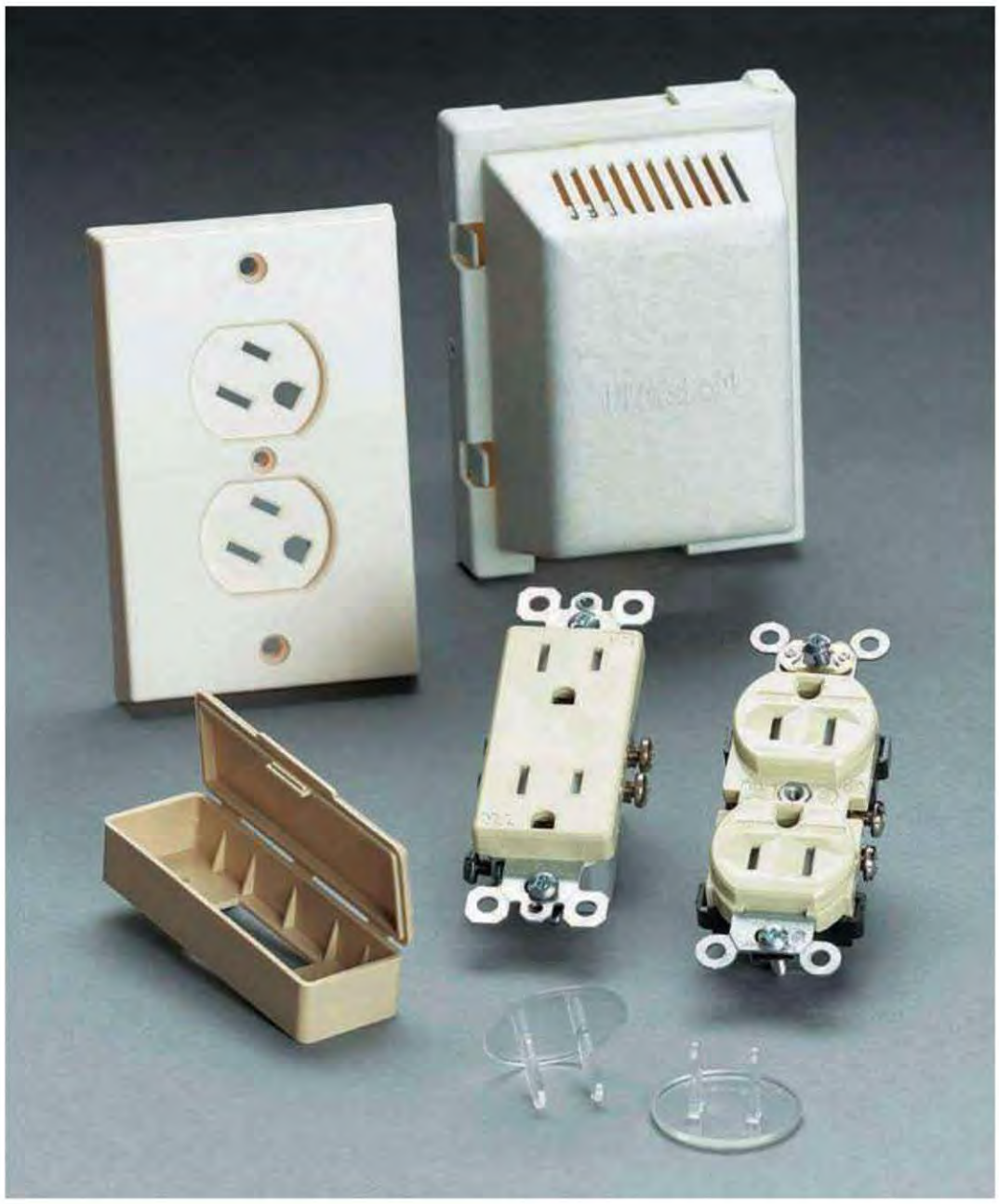
7 Now take one of the white wires and wrap the end of the wire around one of the silver screws. Tighten the screw so it's snug. Do the same for the second white wire if there is one. Connect the copper wire to the green-colored screw on the bottom of the receptacle.



6 Use needlenose pliers to bend the stripped portions in small, clockwise hooks. Now you can connect the wires to the receptacle. Take one of the black wires and wrap the end of the wire around one of the two brass-colored screws on the side of the switch. Tighten the screw so it's snug. If there is a second black wire, wrap it around the other brass-colored screw in the same way.

8 Once the connections are made, gently tuck the wires and the receptacle in to the box so the holes at top and bottom of the receptacle align with the holes in the box. Use a screwdriver to drive the two long mounting screws that hold the receptacle to the box. Replace the cover plate. Restore the power and test your receptacle.

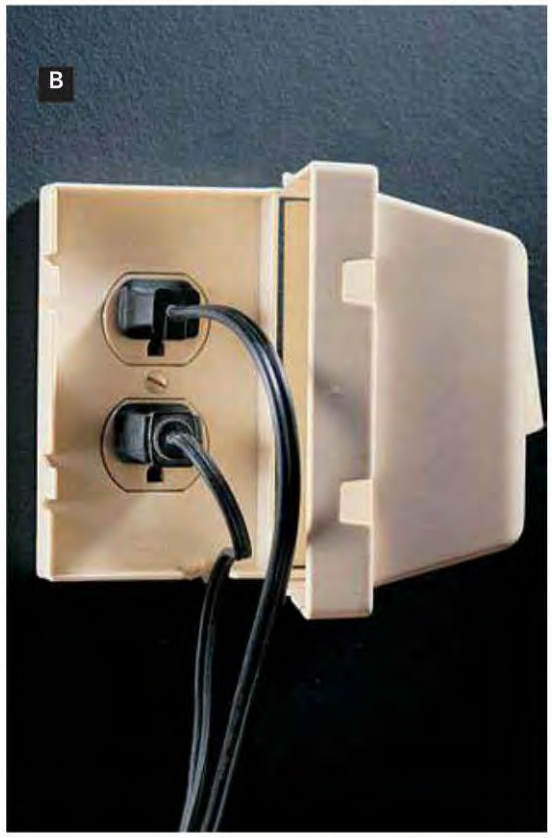
9 Childproofing Receptacles



Standard receptacles present a real shock hazard to small children. Fortunately, there are many ways you can make receptacles safer without making them less convenient.

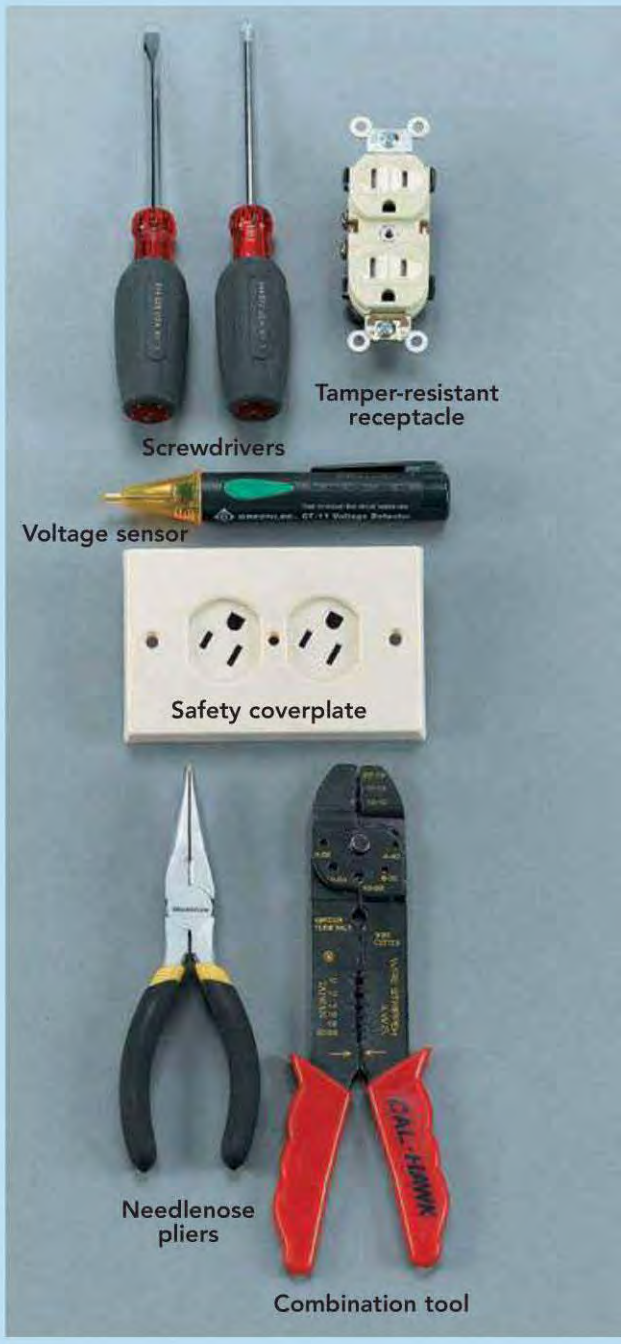
THOUSANDS OF CHILDREN ARE SHOCKED EVERY YEAR when they insert foreign objects in receptacles. Plug-in safety caps are an effective solution, but they make receptacles less convenient. Installing a tamper-resistant receptacle is an easy variation of replacing a bad receptacle (pages 54 to 55). And there are some other simple solutions that will allow you to childproof receptacles in just a few minutes.

CHILDPROOFING 101



Safety coverplates (A) are designed so plugs need to be twisted before they can be fully inserted. Plug covers (B) replace standard coverplates and allow you to plug in lamps or other devices and then cover the plugs, preventing curious fingers from removing the plugs. Tamper-resistant receptacles (C) feature spring-loaded shutters that remain closed unless the two prongs of a plug enter the slots simultaneously; they won't open for a single pointed object, like a screwdriver or key. A very easy solution is plug-in inserts, which effectively block the receptacle slots completely.

TOOLS & SUPPLIES YOU'LL NEED



SKILLS YOU'LL NEED

- Turning off the power (page 12)
- Testing for power (page 13)
- Making wire connections (page 14)

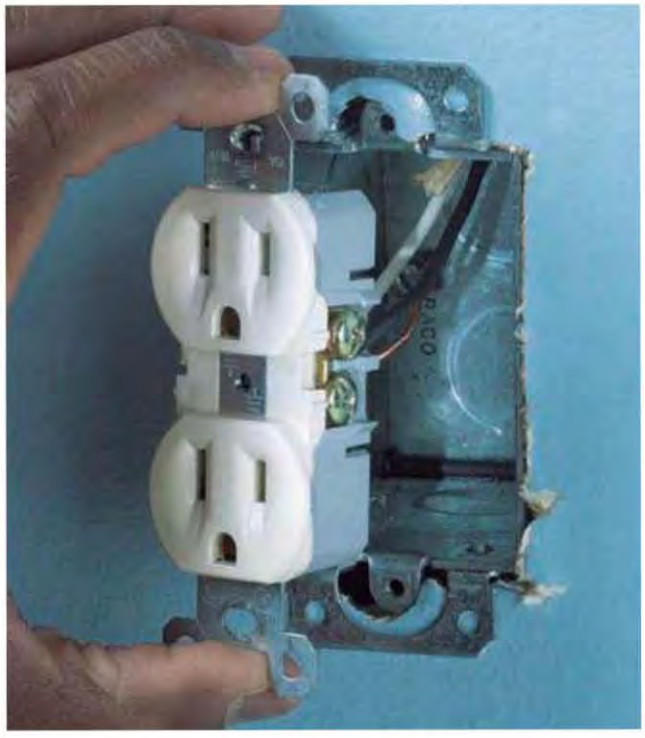
DIFFICULTY LEVEL

This project will take about 1 hour.

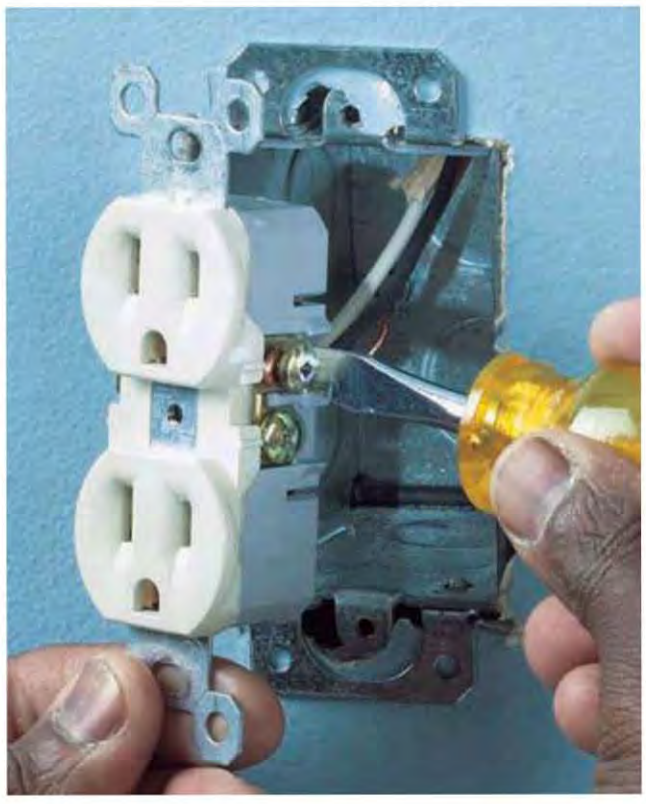
INSTALLING A TAMPER-RESISTANT RECEPTACLE

1 Shut the power to the switch off. Remove the decorative coverplate from the receptacle by unscrewing the screw that holds the plate to the electrical box. Set the screw and the plate aside.

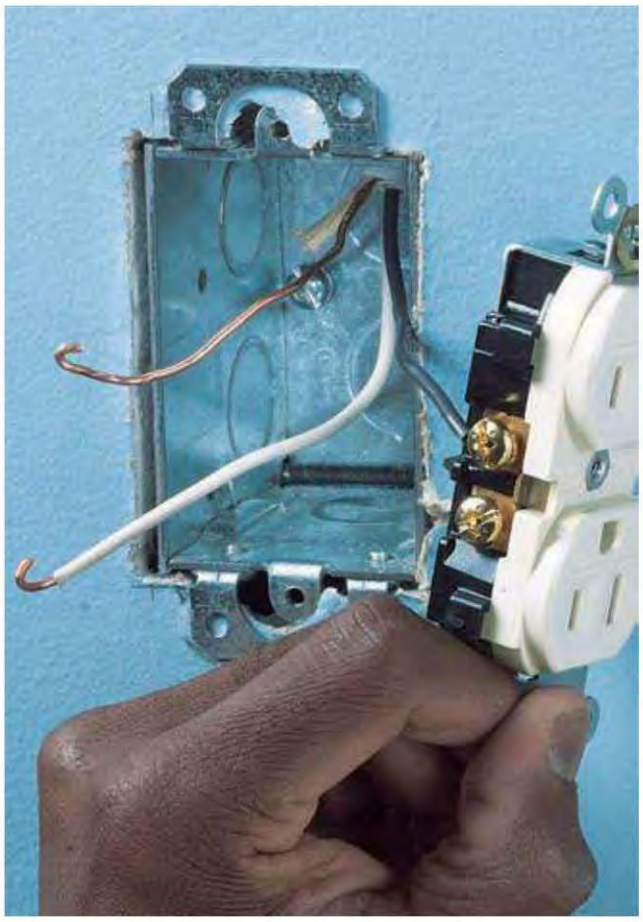
2 Use a voltage sensor to double-check that the circuit is dead. Hold your voltage sensor's probe within ½" of the wires on either side of the receptacle. If the sensor beeps or lights up, then the receptacle is still live, and you'll need to trip the correct breaker to disconnect power to the receptacle. If the sensor does not beep or light up, the receptacle is dead and you can proceed safely.



3 Remove the receptacle from the box by unscrewing the two long screws that hold the switch to the box, one at the top and another at the bottom. Once the screws are out, gently pull the receptacle away from the box. Depending on how your receptacle has been wired, there may be two colored wires and a bare wire or four colored wires and a bare wire.



4 Remove the receptacle completely by unscrewing the screws that hold the wires. Disconnect each wire by turning the screws on the sides of the receptacle just enough to free the wires.

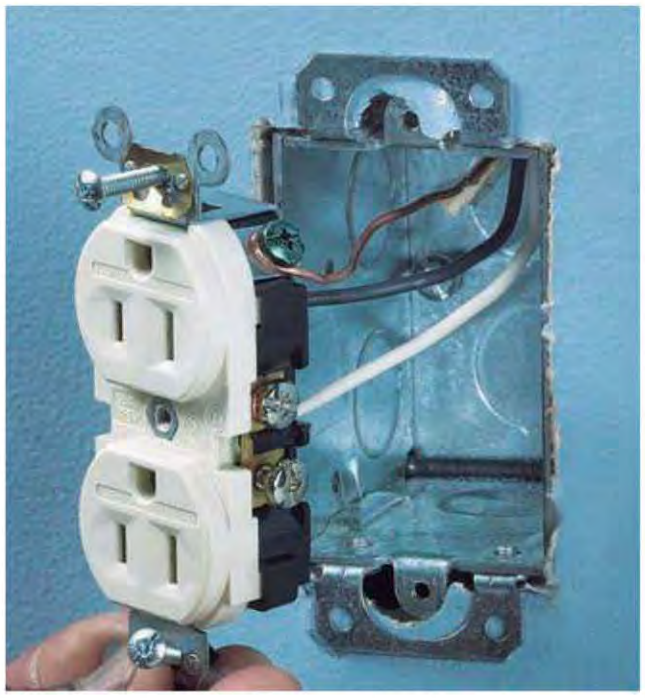


5 Clip off the stripped ends of the wires and use your combination tool to strip away about ¾" of insulation. Then use your needlenose pliers to bend the stripped portions in small, clockwise hooks. Take one of the black wires and wrap the end of the wire around one of the two brass-colored screws on the side of the switch. Tighten the screw so it's snug. If there is a second black wire, wrap it around the other brass screw in the same way.

WHAT IF...?

What if I want a tamper-resistant GFCI receptacle?

No problem. GFCIs are available with the same shutter mechanism. Follow project #10 on page 58 to install one.



6 Now take one of the white wires and wrap the end of the wire around one of the silver screws. Tighten the screw so it's snug. Do the same for the second white wire, if there is one. Connect the copper wire to the green-colored screw on the receptacle.

7 Once the connections are made, gently tuck the wires and the receptacle in to the box so the holes at top and bottom of the receptacle align with the holes in the box. Use a screwdriver to drive the two long mounting screws that hold the receptacle to the box. Replace the coverplate. Restore the power and test your receptacle.

INSTALLING SAFETY COVERPLATES

1 You can get much of the protection of a tamperproof outlet with a safety coverplate. Adding one takes only minutes and requires no contact with wiring. Remove the old coverplate from the receptacle by unscrewing the screw that holds the plate to the electrical box.

2 Hold the safety coverplate over the receptacle. Use a small screwdriver to tighten the screws.

3 To plug a device in, push the slider aside and insert the plug. The shutters automatically snap over the slots when nothing is plugged in.

SAFETY TIP

Push-in slot covers cost just pennies, and can be very effective at keeping kids from poking objects into electrical receptacles. Buy several packages, and use them to plug any receptacle that your child might be tempted to play with.

INSTALLING A PLUG COVER

1 Plug covers are designed to replace coverplates on receptacles where devices are plugged in more or less permanently to prevent children from unplugging them. After removing the old coverplate, hold the plug cover's base plate over the receptacle and screw it in with a small screwdriver.

2 Plug in your lamp or other device and snap the plug cover into the new base plate. Cords should fit through the slots in the plug cover.

SAFETY TIP

Any receptacle is made safer by installing it "upside down" with the rounded grounding slot at the top. Three-prong receptacles are almost always installed with the round third prong facing down, but some experts recommend wiring receptacles with the third prong on top. This is because the third prong is the grounding prong and doesn't carry any current under normal operation. In theory, if something were to fall on a partially inserted plug, it would hit the harmless grounding prong and not the current-carrying slot prongs. Either way, you're wiring it right, but upside down may be slightly safer.

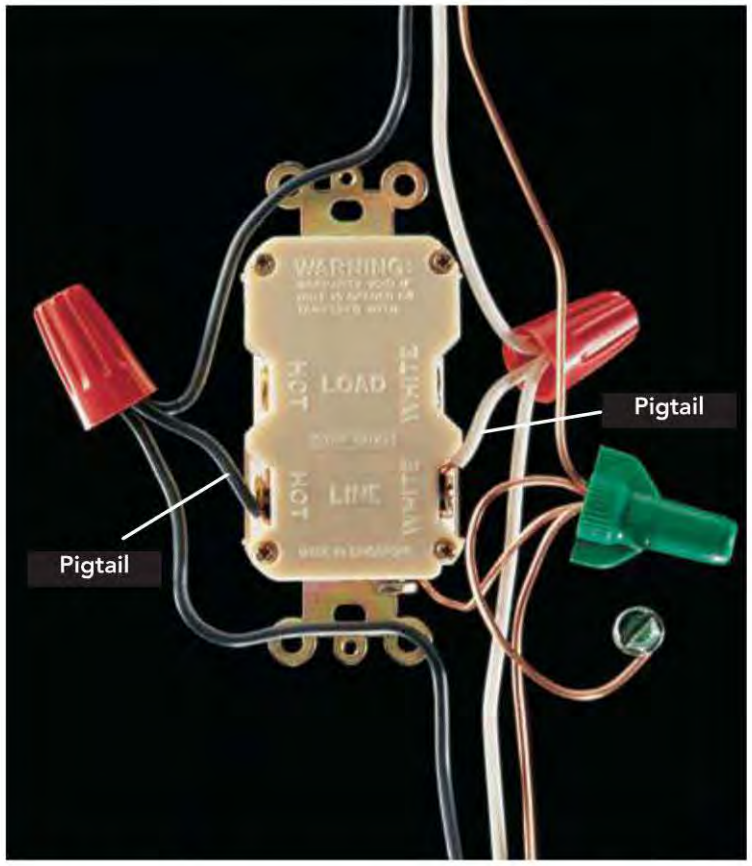
10 Installing GFCI Receptacles

GFCI receptacles are an important protection against shocks. They work just like a normal receptacle, but they have special circuitry that helps prevent shocks. They're required by building code in all wet locations but can help improve safety anywhere.

A GROUND-FAULT CIRCUIT-INTERRUPTER RECEPTACLE (called a GFCI by pros) works just like a standard receptacle with an added feature. In the event of a short, the receptacle shuts off—"trips"—in a tiny fraction of a second. This will protect you from a dangerous shock, and this is why building codes require GFCIs in wet locations like bathrooms, kitchens, and garages.

If you need to replace a faulty receptacle in a kitchen, bathroom, or garage, replace it with a GFCI. Even if your existing receptacles work fine, you can add a measure of safety (and practice your wiring skills) by installing GFCIs. In a child's bedroom, for example, it's a good idea to install a GFCI.

GFCI 101



Wiring a GFCI isn't much different from wiring a standard receptacle. The main difference is that, in this installation, you'll only use one pair of the four screws, the ones labeled "line." If there were only two colored wires attached to the old receptacle, the new GFCI is attached in the same way (left photo). But if you have more than one of each color of wire connected to the old receptacle, you'll need to use a technique called pigtailing to connect the GFCI (shown in the image at right). Don't worry; it's easy and you'll see how on the next page.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Turning off the power (page 12)
- Testing for power (page 13)
- Making wire connections (page 14)

TERMS YOU NEED TO KNOW

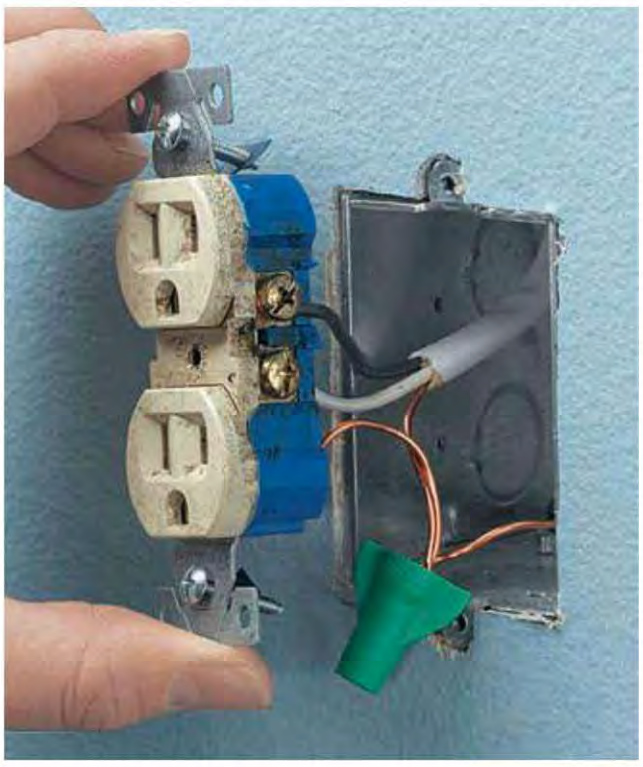
LOAD—In this installation, you're ignoring the screws labeled "load" and using only the ones labeled "line." The load screws literally put a load on the GFCI circuitry of the receptacle by making the GFCI protect other devices on the same circuit (so, other receptacles on the same household circuit could also trip the GFCI in the event of a short). This sounds like a good thing and it is in certain situation. But for your purposes, it will cause a lot of "nuisance" trips, where the GFCI will shut down for no apparent reason. This is why you should use the line screws only.

DIFFICULTY LEVEL

This project usually takes about 1 hour.

HOW TO REPLACE A GFCI RECEPTACLE

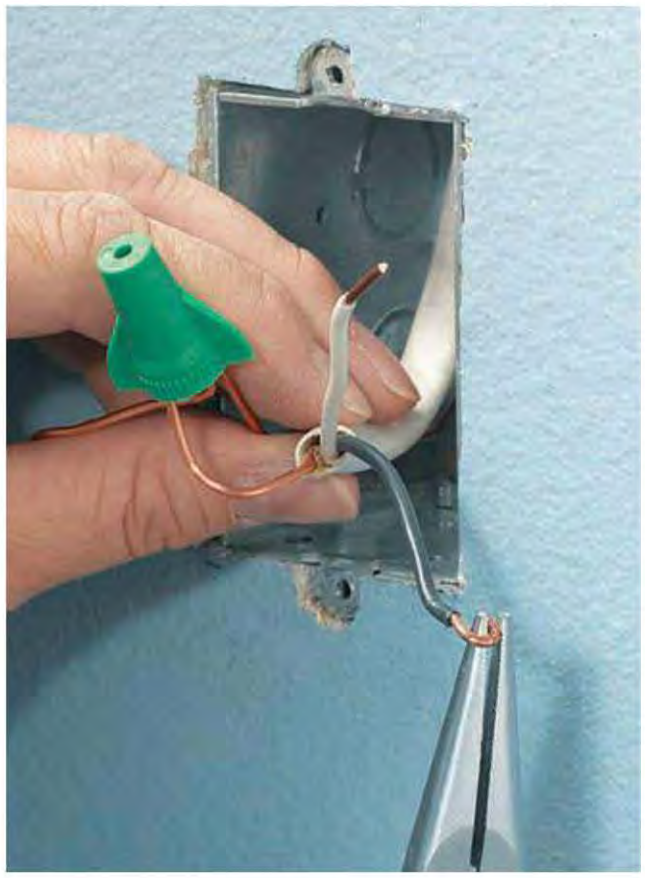
1 Remove the decorative coverplate from the receptacle. With the coverplate off, you will be able to see the receptacle and the electrical box it is attached to.



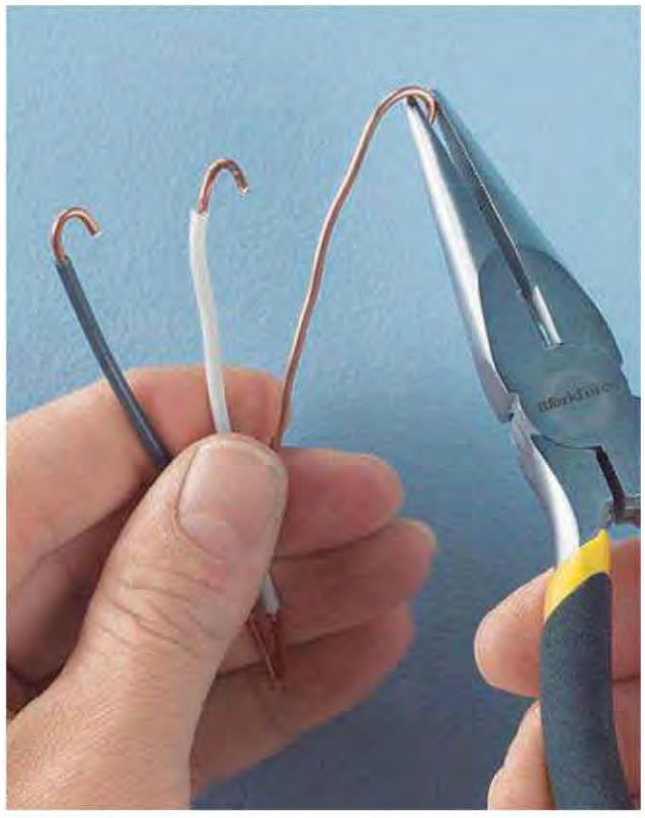
3 Remove the receptacle from the box by unscrewing the long screws at the top and the bottom. Once the screws are out, gently pull the receptacle away from the box. It won't pull away easily, since the wires are still attached, so pull firmly. Depending on how your receptacle has been wired, there may be two colored wires and a bare wire or four colored wires and a bare wire.

2 Before you remove the old receptacle, use a voltage sensor to make sure the circuit is dead. Hold your voltage sensor's probe within 1/2" of the wires on either side of the receptacle. If the sensor beeps or lights up, then the receptacle is still live, and you'll need to trip the correct breaker to disconnect power to the receptacle. If the sensor does not beep or light up, the receptacle is dead and you can proceed safely.

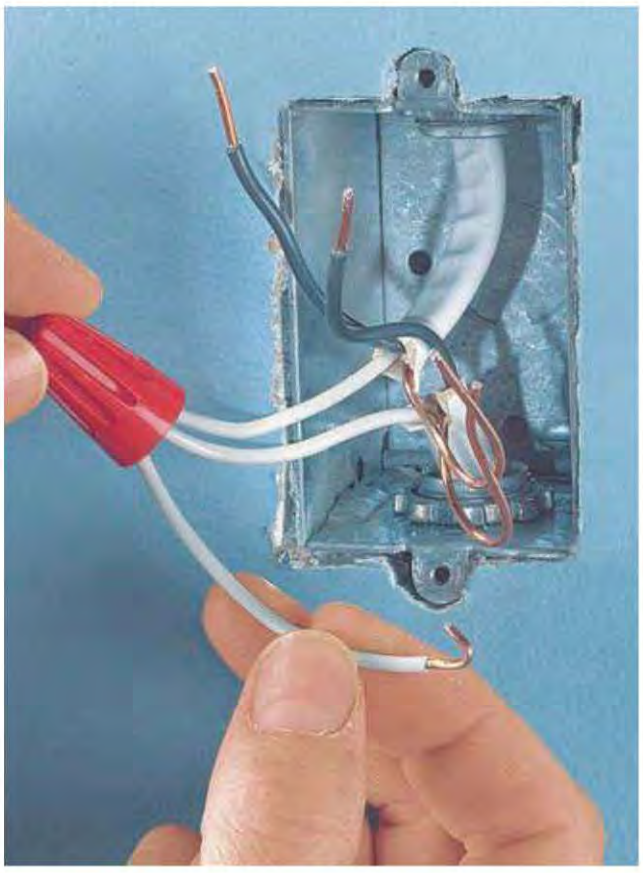
4 Remove the receptacle completely by unscrewing the screws that hold the wires. Disconnect each wire by turning the screws on the sides of the receptacle just enough to free the wires.



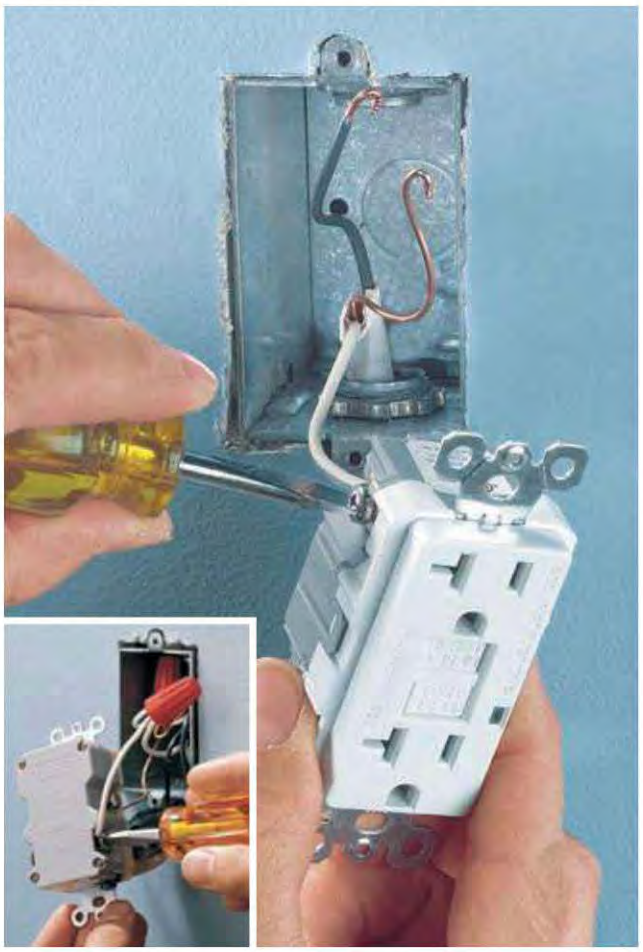
5 Now you can start to connect the GFCI. To begin, count the number of wires you just disconnected from the old receptacle. You'll either have three wires—one each of white, black, and bare wires—or you'll have five—a pair of white and black wires and a single bare wire. If you've got five wires, skip to steps 6A and B. If you've got three wires, clip off the stripped ends of the wires and use your combination tool to strip away about 3/4" of insulation. Then use your needlenose pliers to bend the stripped portions in small, clockwise hooks and go to step 7.



6A If you've got five wires, clip off the stripped ends of the wires and use your combination tool to strip away about 3/4" of insulation. Now cut three 3" pieces of 14-gauge wire—one bare, one white, and one black. Strip about 3/4" of wire from both ends and then use your needlenose pliers to make a clockwise hook at one end of each. These are your pigtails.



6B Hold the straight end of the white pigtail next to the ends of the two white wires coming from the electrical box. Slide a wire connector over the ends and twist it clockwise until the connector is snug. No bare wire should be visible. Repeat this procedure for the black wires and black pigtail, and then for the two bare wires and the bare pigtail.

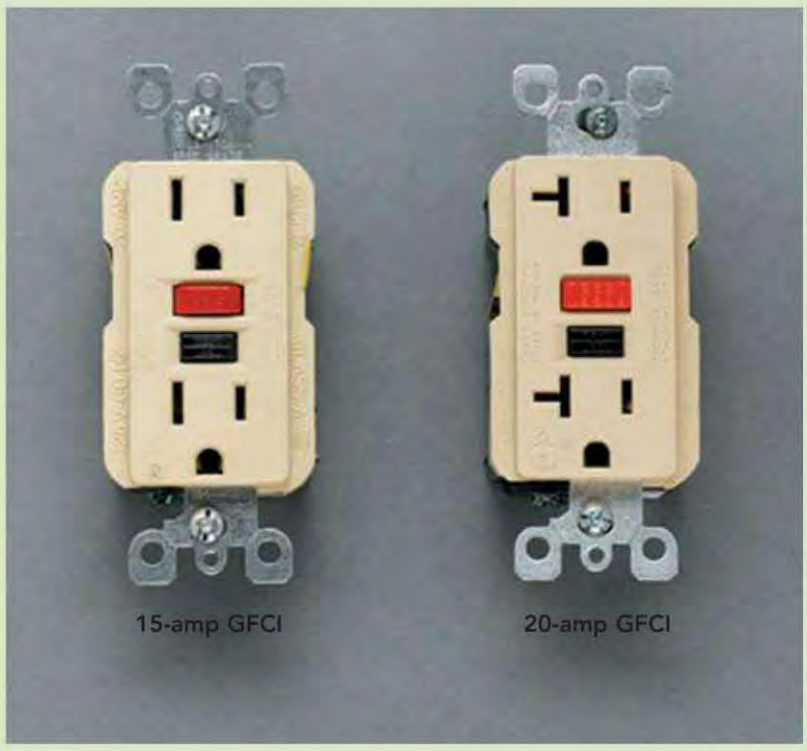


7 Connect the white wire (or the white pigtail; see inset photo) to the silver-colored screw labeled "line."

8 Connect the black wire (or the black pigtail; see inset photo) to the copper-colored screw labeled "line."

BUYING TIP

Not all GFCI receptacles are created alike. Make sure you buy one that's rated the same as the receptacle you're replacing. Many household circuits carry 15 amps of power. Receptacles for 15-amp circuits look like the one on the left. But a 20-amp circuit should have receptacles rated for 20 amps, like the one shown on the right. 20-amp receptacles have one T-shaped slot that accepts special T-shaped plugs on appliances with heavy power loads, such as window air conditioners or hot tubs.

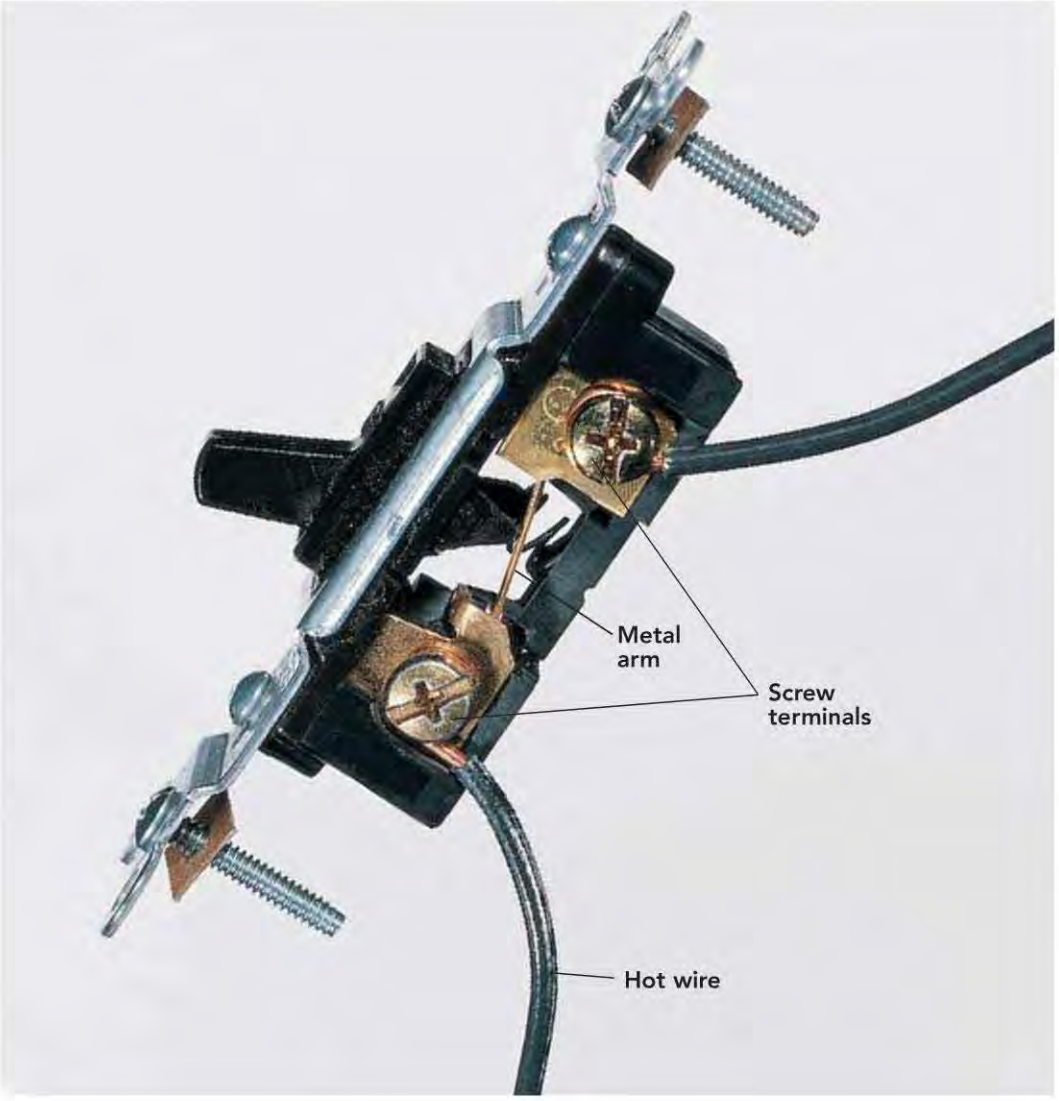


9 Connect the bare wire (or the bare pigtail; see inset photo) to the green grounding screw on the bottom of the receptacle.

10 Once the connections are made, gently tuck the wires and the receptacle into the box so the holes in the top and bottom of the receptacle align with the holes in the box. Use a screwdriver to drive the two long mounting screws that hold the receptacle to the box. Replace the coverplate. If your GFCI didn't come with its own coverplate, you'll need to buy one with a square cutout to fit the GFCI.

11 Restore the power and test your receptacle. In addition to plugging something in to the receptacle, you need to test the two buttons on the face of the receptacle. Press the TEST button. The receptacle should make a clicking noise, the RESET button should pop out, and whatever you've plugged in should stop working. If this happens, the GFCI is wired correctly and working. Push RESET and the receptacle will work again.

11 Replacing Bad Light Switches



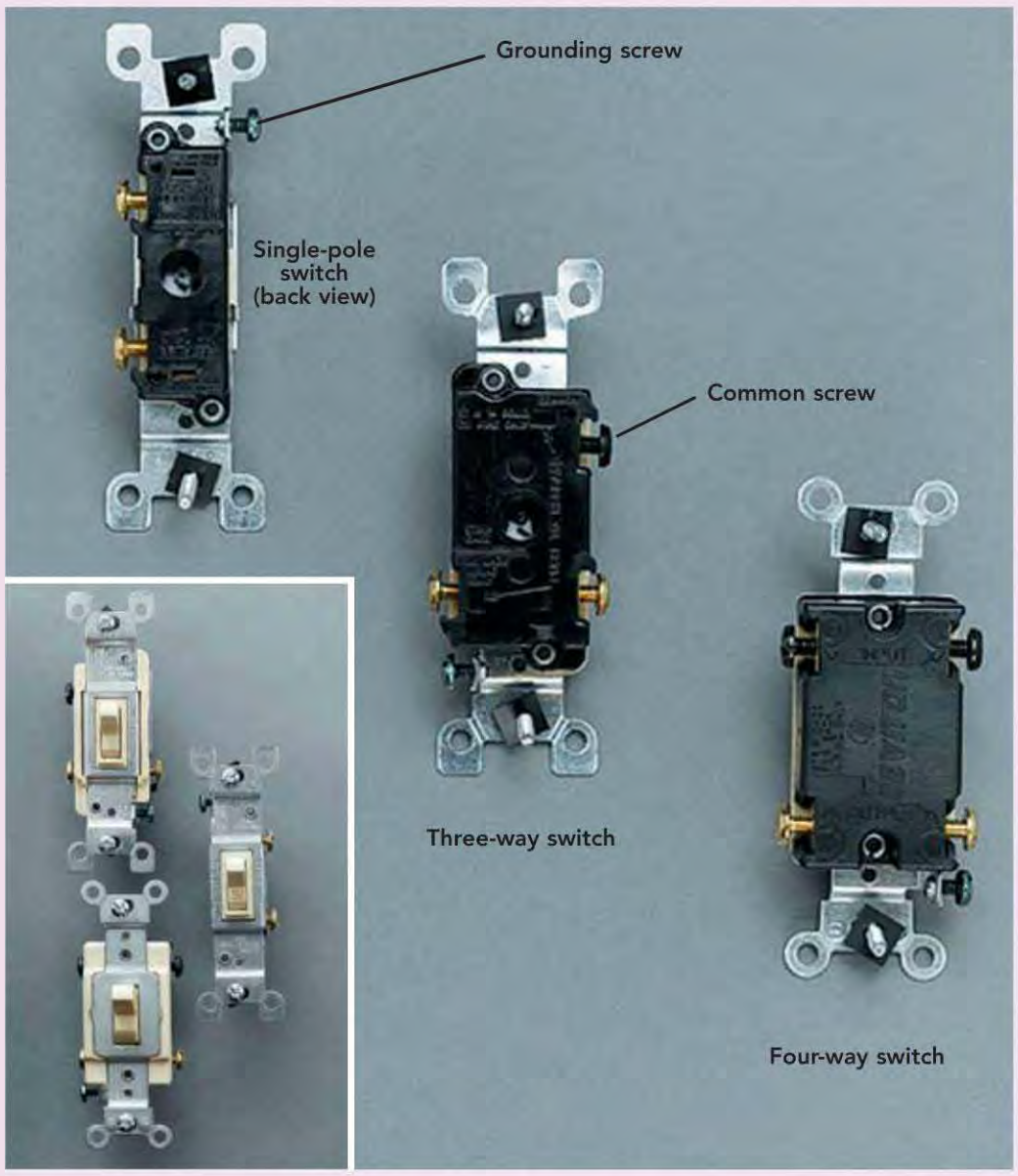
Light switches have moving parts, so they do eventually wear out or stop working reliably. As shown in this cutaway, most switches have a movable metal arm that opens and closes the electrical circuit, and eventually the metal arm loses its resilience, or snaps off. You might also want to replace a switch just because you want a new look, or to install a dimmer (see page 70 to see how).

THERE ARE SEVERAL REASONS WHY YOU MIGHT NEED TO REPLACE A LIGHT SWITCH. If the switch won't stay in position (won't stay on), if it buzzes, if it gets hot, or if a breaker trips when you flip the switch, it might be time to replace the switch. And, of course, you might want to replace the switch for aesthetic reasons or to gain the added functionality of a dimmer. Dimmers not only provide greater control, but they save energy and make light-bulbs last much longer than they would at full power.

Fortunately, swapping an old switch for a new one is a very simple project. You can easily replace the standard light switch with another standard light switch using basic hand tools.

LIGHT SWITCHES 101

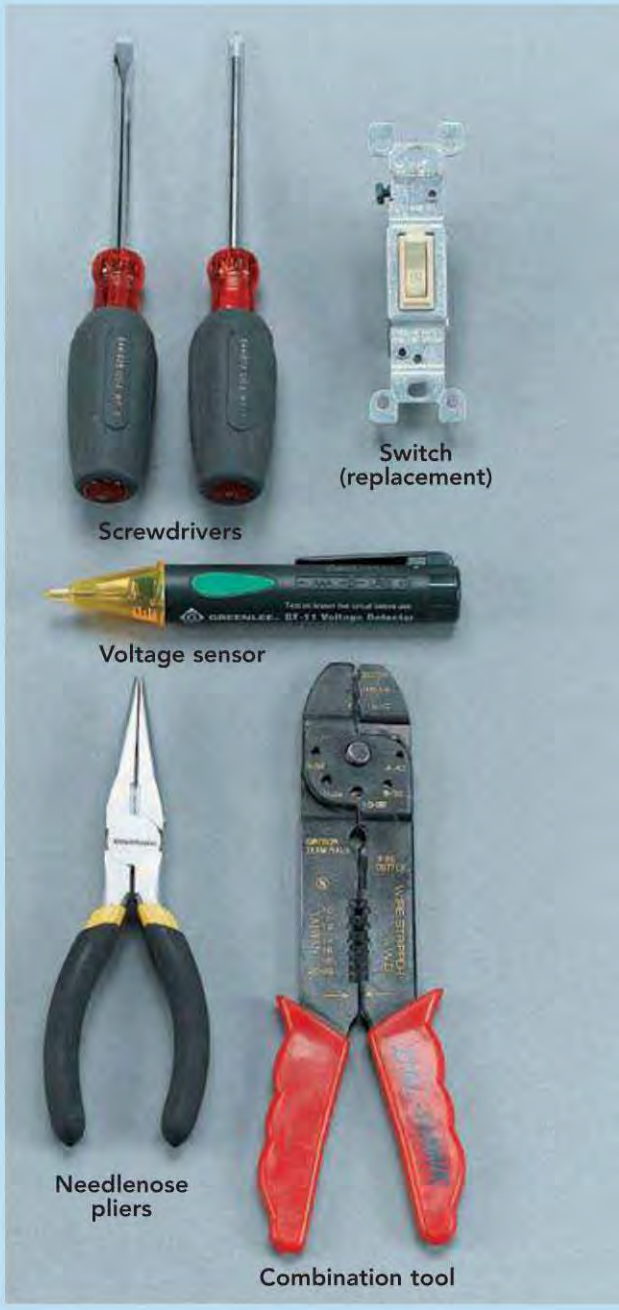
TERMS YOU NEED TO KNOW



Wall switches come in three types, and it's crucial you buy the right replacement. Single-pole switches (left) are used when a light fixture is controlled from one switch location only. Notice that it has two screw terminals on the side of the switch (the screw on the metal strap used to connect the grounding wire isn't counted when you talk about circuit wires). A three-way switch (center) is used when a light fixture is controlled from two different wall locations. It has three screws on the body of the switch. One screw is known as the common terminal, the others are called travelers. A four-way switch (right) is used when a light fixture is controlled from three or more different wall locations. It has four screws on the body of the switch. Four-way switches are a little rare; you may not have any of them in your house.

When replacing a switch, remember to buy a replacement that matches the old switch, and connect the wires in the same way they were connected to the old switch.

TOOLS & SUPPLIES YOU'LL NEED



SKILLS YOU'LL NEED

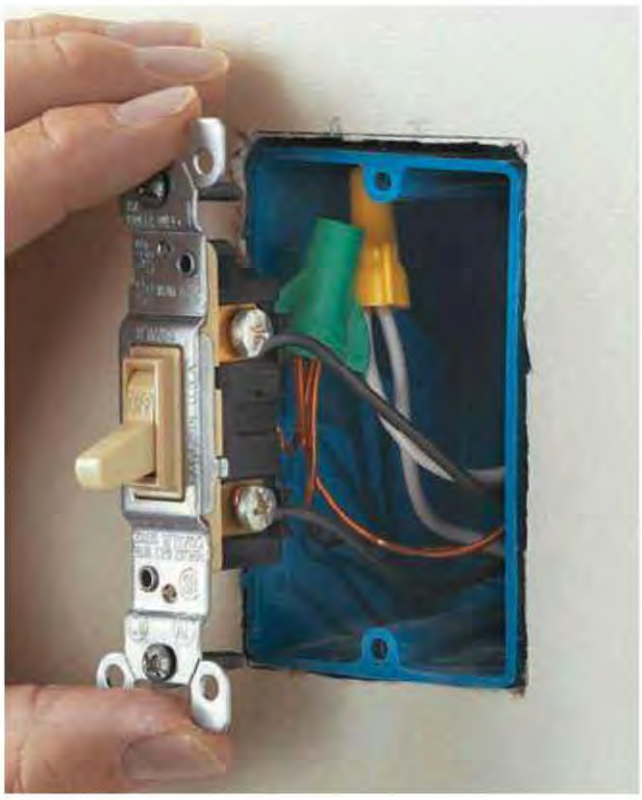
- Turning off the power (page 12)
- Testing for power (page 13)
- Making wire connections (page 14)

DIFFICULTY LEVEL

Allow about 1 hour for this project.

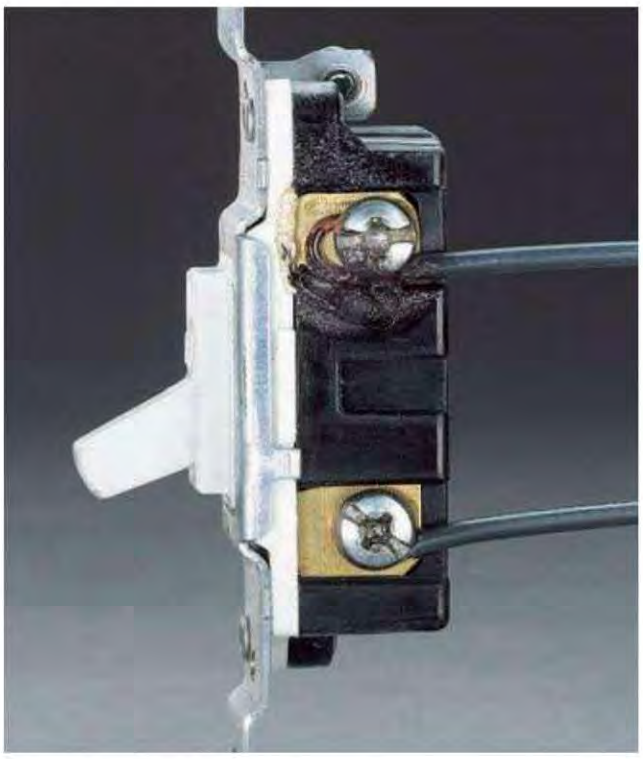
HOW TO REPLACE A BAD WALL SWITCH

1 First shut off the power to the switch. Remove the decorative coverplate from the switch by unscrewing the two screws that hold the plate to the switch box. Set the screws and the plate aside. With the coverplate off, you will be able to see the switch and the electrical box it is attached to.

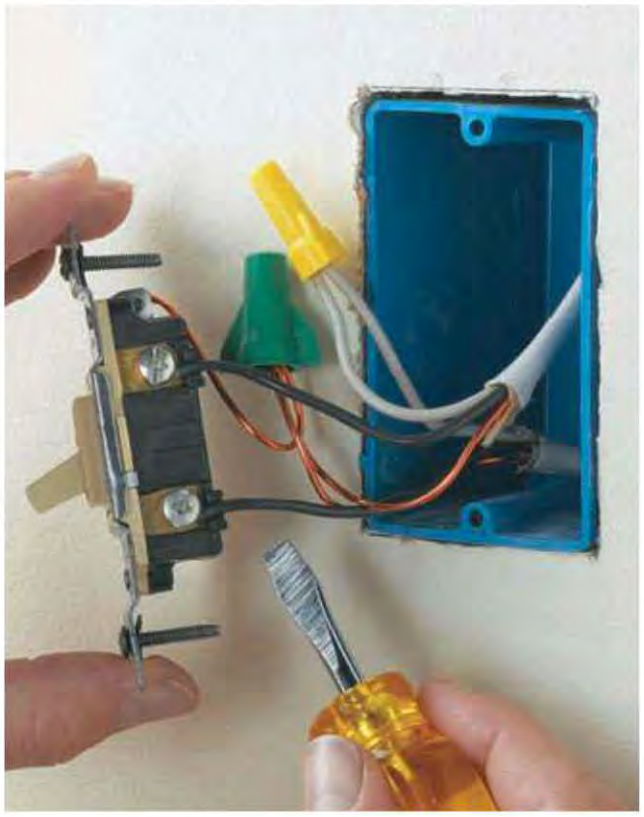


3 Remove the switch from the box by unscrewing the two long screws that hold the switch to the box, one at the top, the other at the bottom. Once the screws are free, gently pull the switch away from the box.

2 Use a voltage sensor to make sure the circuit is dead. Hold the sensor's probe within ½" of the wires on either side of the switch. If the sensor beeps or lights up, then the switch is still live, and you'll need to trip the correct breaker to disconnect power to the switch. If the sensor does not beep or light up, the circuit is dead and you're safe to continue.



4 Inspect the screw connections. They should be tight and free of any scorch marks. If one of the connections is loose or scorched, the problem is probably a loose screw causing a short circuit. Reattach the wires, reassemble the switch and coverplate, and see if the switch works. If this isn't the problem, continue to the next step.



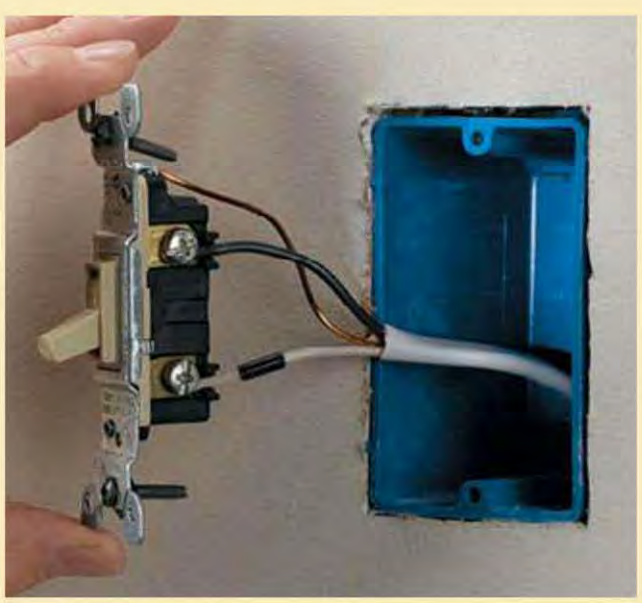
5 Loosen all the screw connections and detach the switch from the wires. (If there are three or four colored wires attached to the switch instead of just two, see the "WHAT IF" variation on the next page.) In many cases, there will also be two white wires connected with a wire connector in the box. You won't have to deal with these in your installation. Take the old switch to a hardware store or home center and purchase an identical replacement.

6 Before you begin to wire your new switch, clip of the ends of the wires and use your combination tool to strip away about ¾"of insulation. Then use your needlenose pliers to bend the stripped portion in a small clockwise hook.

WHAT IF...?

What if there is a white wire connected to the switch?

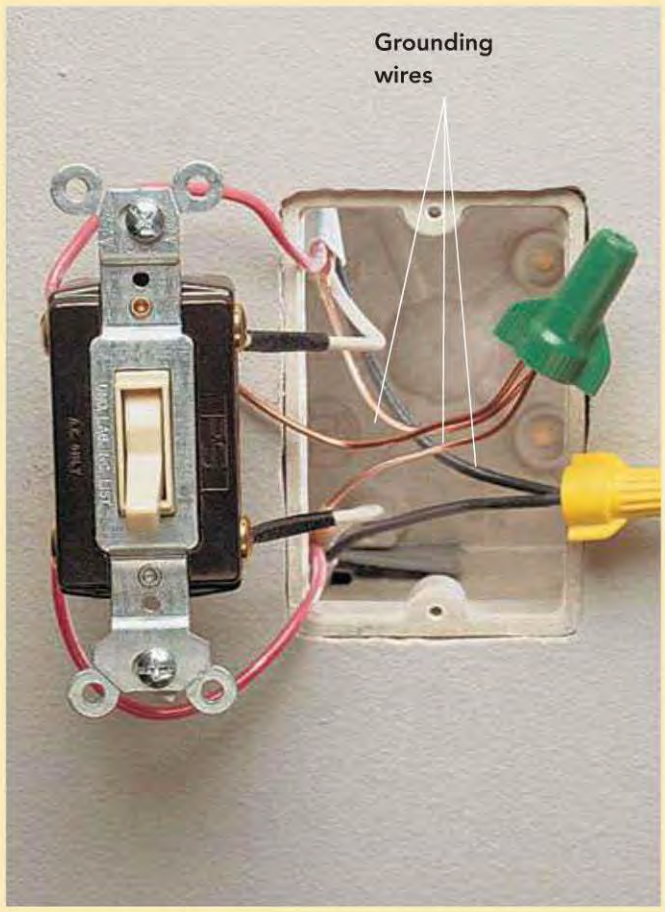
In certain installations, a switch is connected with one black wire and one white wire. (The pros call this installation a "switch loop.") If the electrician did a good job, the end of the white wire should have black tape, indicating that it carries current. Treat it just like a black wire when you install your new switch. If there is no tape on the end of the white wire, wrap a bit of electrical tape on the end. The next person who works on the circuit will thank you.



WHAT IF...?

What if there are more than two colored wires connected to the switch? If this is the case, you're dealing with a three-way switch (if there are three colored wires) or a four-way switch (if there are four colored wires). Before removing a three- or four-way switch, use masking tape to label the wires to identify which screw terminals they are attached to.

For a three-way switch, one screw terminal is labeled "common," and is almost always darker in color than the other two. Make sure the wire that was attached to the common screw terminal on the old switch is connected to the common screw terminal on the new switch. The other two wires aren't critical; they can be attached to either of the remaining screw terminals.



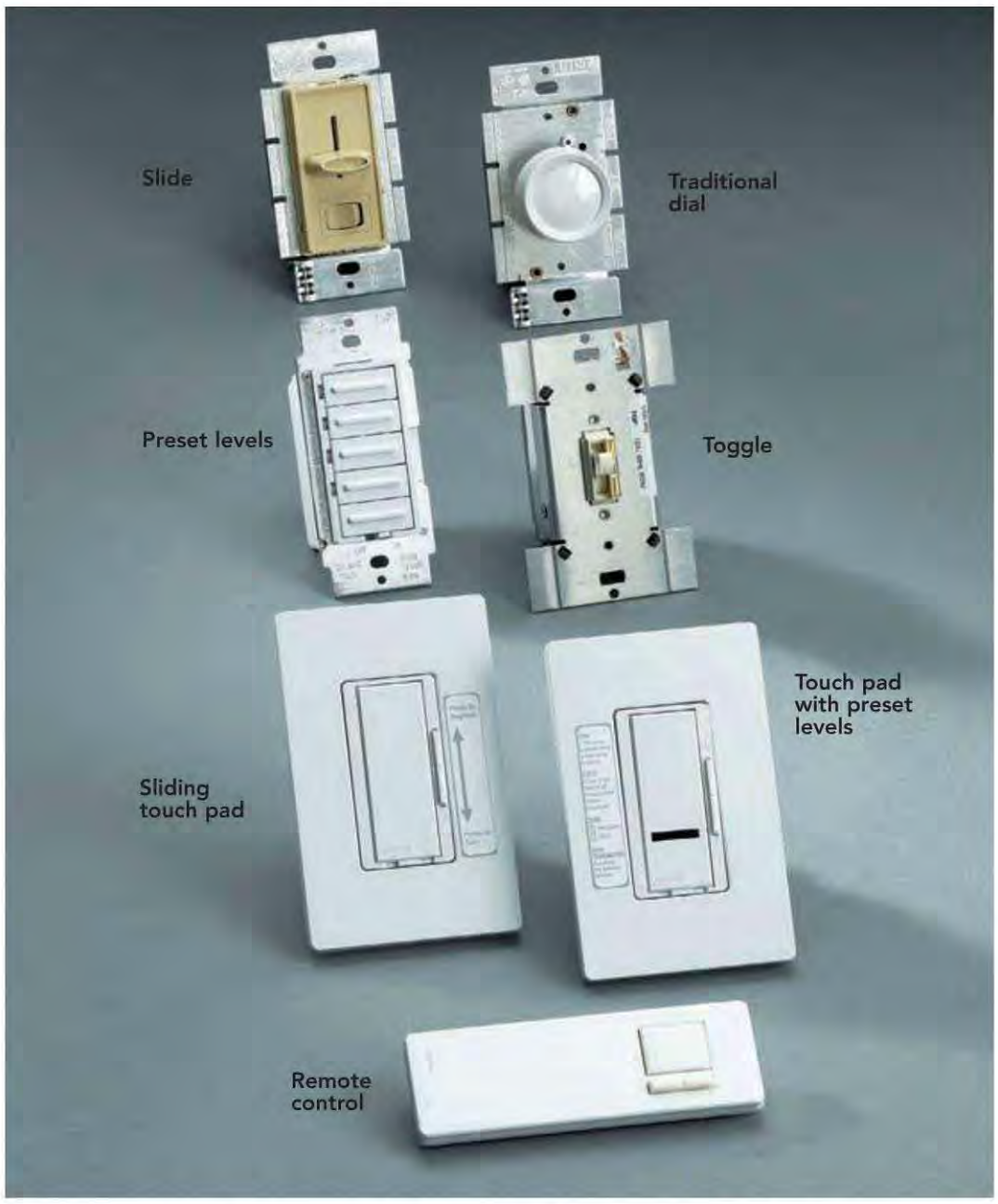
Four-way switches are a little trickier. In most cases, you'll be attaching the pair of wires attached to the top two screw terminals on the old switch to the same screws on the new switch. Then you'll attach the other pair of wires to the bottom pair of screws. Some manufacturers, though, use a different pairing system, with one screw terminal pair on the right side of the switch, the other on the left. A good way to avoid problems is by buying a replacement made by the same manufacturer that made the old switch.

7 Position the switch so the ON/OFF markings read correctly. Take one of the colored circuit wires and wrap the end of the wire clockwise around one of the two screw terminals on the side of the switch. Tighten the screw so it's snug. Wrap the second colored wire around the other screw in the same way. If there was a bare copper wire connected to the old switch, connect it to the green-colored screw on the switch in the same way you connected the two black wires. (If you're installing a three-way or four-way, see the information on the opposite page.) Then connect the rest of the wires as described above. The other two screws are interchangeable, so it doesn't matter which of the remaining colored wires connects to which screw.

8 Check to make sure the white circuit wires (they're called the neutrals) are snugly connected. If not, then use a wire nut to join them.

9 Once the connections are made, gently tuck the wires and the switch into the box so the holes in the top and bottom of the switch align with the holes in the box. Use a screwdriver to drive the two long mounting screws that hold the switch to the box. Replace the coverplate. Restore the power and test your switch.

12 Installing Dimmers

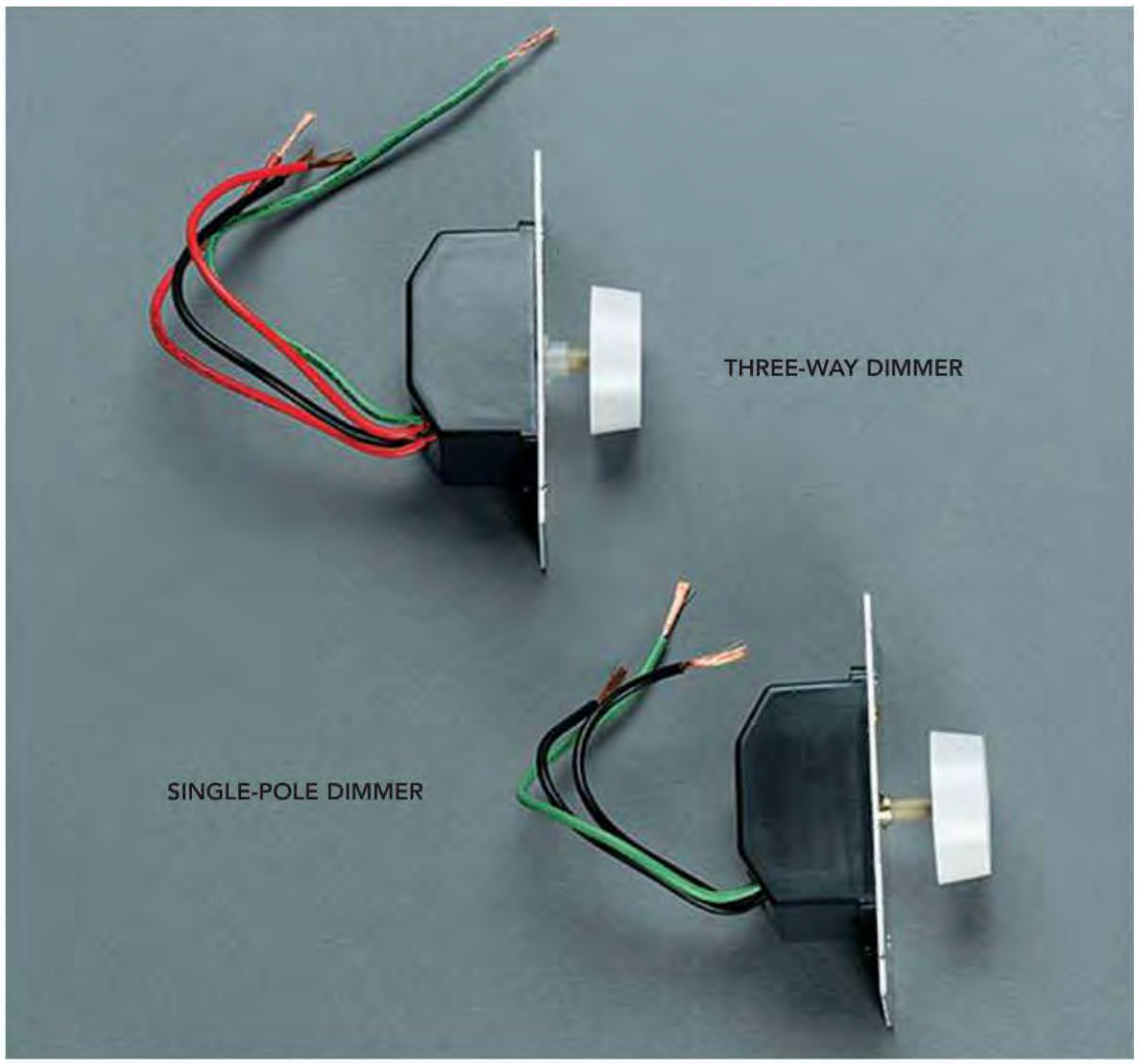


Dimmers not only allow you to fine-tune the amount of light in a room, but also they save energy and extend lightbulb life. There is a wide variety of dimmer switches available to replace almost any standard ON/OFF switch. Whether you flip, turn, slide, or touch them, they all work the same. The one exception is an automatic dimmer, which has an electronic sensor that adjusts the light fixture to compensate for the changing levels of natural light. An automatic dimmer also can be operated manually.

DIMMER SWITCHES ARE SIMPLY LIGHT SWITCHES that allow you to control the intensity of light that comes from a fixture. The control may be a dial, a touch pad, a slider, or a faux-toggle switch, but they all function in basically the same way.

Installing a dimmer is no more difficult than installing a light switch. The only possible obstacles are the size of the electrical box and the type of light in the fixture. In some older homes, the metal box that contains the old switch may not be large enough for a dimmer. If the fixture uses fluorescent lightbulbs, you will not be able to use a standard dimmer.

DIMMER SWITCHES 101



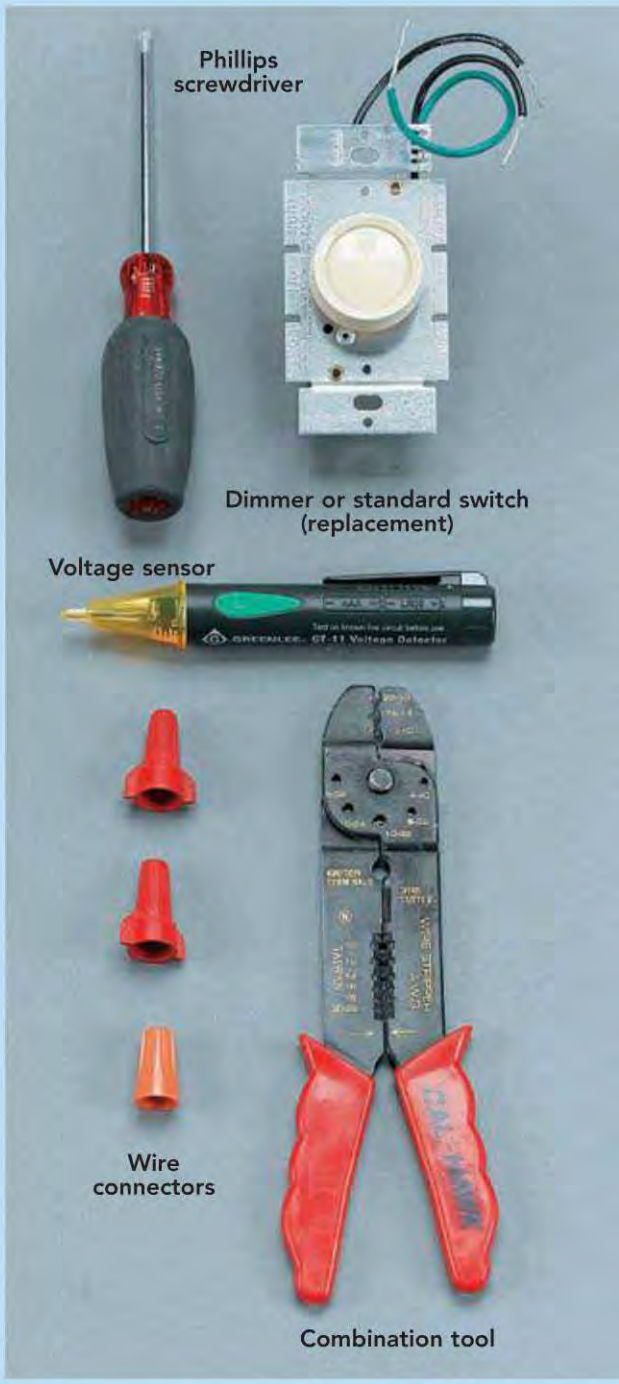
Unlike standard light switches, dimmers are connected to the household electrical wires by short lengths of wire called "leads." Leads come pre-attached to the dimmer. You attach them to the household wiring with wire connectors. Single-pole dimmers have two wire leads (plus a green grounding lead). Use this type for switches where the light fixture is controlled from a single wall location. Three-way dimmers have three black and red wire leads, and are used when a light fixture is controlled from two wall locations.

TERMS YOU NEED TO KNOW

COMMON WIRE—On a three-way wall switch or dimmer, one of the screw terminals or wire leads is designated as "common." Depending on where the switch is in the circuit, the common wire receives electrical current from the power source, or sends current to the light fixture. The common screw terminal or wire lead is the one that is a different color from the other two screws or wire leads.

TRAVELER WIRE—On three way switches and dimmers, the travelers are the two wires other than the common (see above). The traveler wires run between the two switches, providing alternative paths for electrical current.

TOOLS & SUPPLIES YOU'LL NEED



SKILLS YOU'LL NEED

- Turning off the power (page 12)
- Testing for power (page 13)
- Making wire connections (page 14)

DIFFICULTY LEVEL

Allow 1 to 2 hours for this job.

HOW TO INSTALL A DIMMER SWITCH

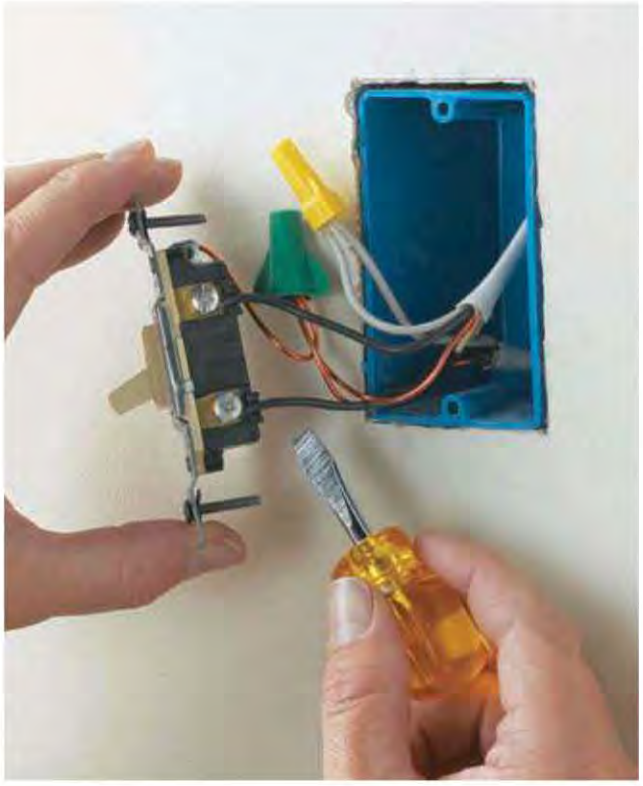
1 First shut off the power to the switch. Remove the decorative coverplate from the switch by unscrewing the two screws that hold the plate to the switch box. Set the screws and the plate aside. With the coverplate off, you will be able to see the switch and the electrical box it is attached to.

2 Use a voltage sensor to make sure that the circuit is dead. Hold your voltage sensor's probe within ½" of the wires on either side of the switch. If the sensor beeps or lights up, then the switch is still live, and you'll need to trip the correct breaker to disconnect power to the switch. If the sensor does not beep or light up, the circuit is dead and you are safe to continue.

3 Remove the switch from the box by unscrewing the two long screws that hold it. One is at the top and another at the bottom. Once the screws are out, hold the top and bottom of the switch, and gently pull the switch away from the box.

WHAT IF...?

What if my electrical box seems too small to hold the dimmer switch? Dimmer switches have much bigger bodies than standard switches, and they are connected with twist wire connectors rather than screw terminal connections. This means that the electrical box might be too small to hold the switch and the connections. If so, don't try to force the switch into the box. Instead, see the Here's How feature on page 75.



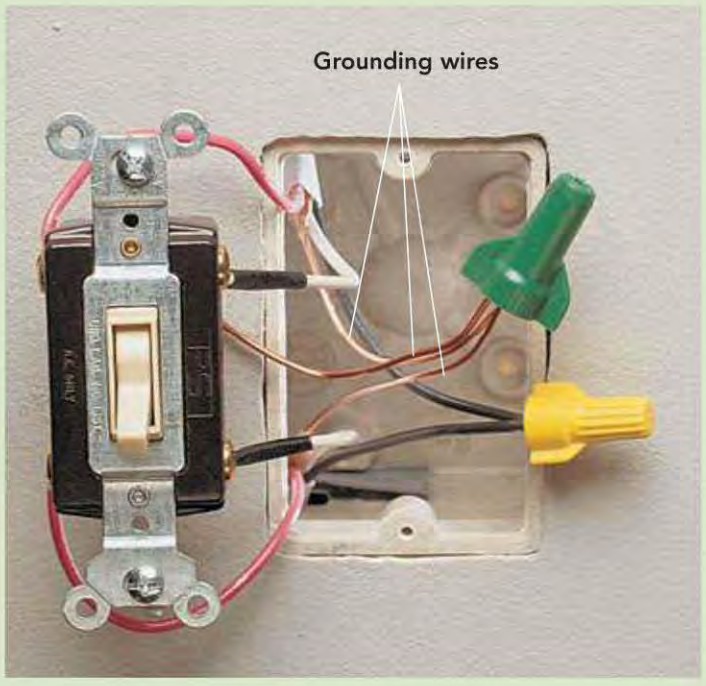
4 Remove the switch completely by unscrewing the screws that hold the wires. There may be as many as four wires connected to the switch: black, white, bare copper, and red. Disconnect each one by turning the screws on the sides of the switch just enough to free the wires. In many cases, there will also be two white wires connected with a wire connector in the box. You won't have to deal with these in your installation.

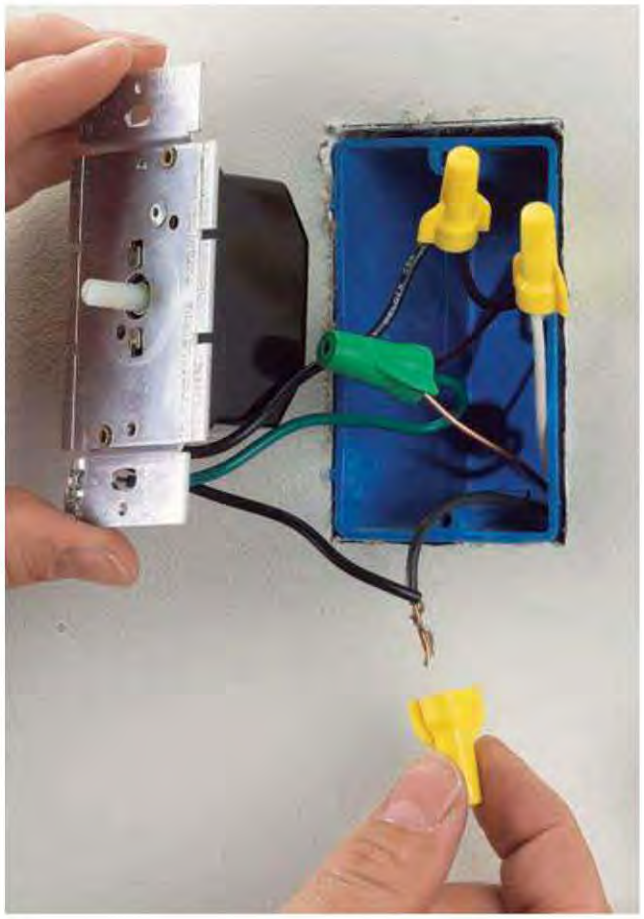
5 Buy a dimmer suited for your replacement. Choose a single-pole or three-way dimmer, as needed. Second, buy a dimmer rated for the maximum wattage of all light fixtures the switch will serve. For example, if the standard light switch you are replacing controls three recessed 60-watt lights, then the dimmer switch should be rated for 180 watts ($60 \times 3 = 180$).

WHAT IF...?

What if you find four colored wires attached to your switch?

This is a four-way switch, a type of switch used to control light fixtures from three or more different switch locations. A four-way switch can't be replaced with a dimmer, so if you run into this situation, you'll need to reassemble the switch. However, four-way switch installations are always installed in conjunction with three-way switches in the other switch locations. You will be able to replace one of the three-way switches at a different wall location with a three-way dimmer switch.



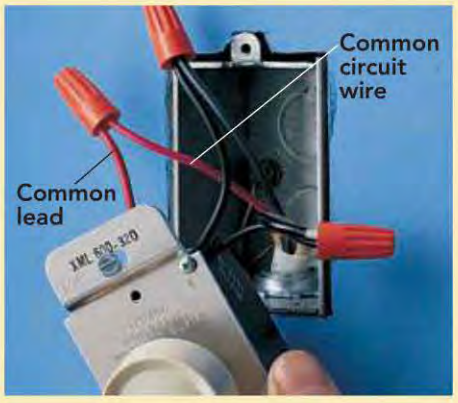


6 The dimmer will have two black wires, called leads, coming out of the dimmer's plastic body. The leads, like the two black wires coming out of the wall, are interchangeable, so you can't mix them up. Place the stripped end of one of the black leads and the end of one of the existing black wires into a wire connector (the dimmer will come with twist-on wire connectors). Twist the wire connector clockwise until it is tight. Hold the wires and tug gently on the connector to ensure that it is tight. Connect the other lead to the other wire from the wall in the same way. (If you are installing a three-way dimmer, see "WHAT IF...?" at right.)

7 Once the wires are firmly connected, you can attach the switch to the box. Tuck the new switch and wires neatly back into the box. Then drive the two long screws that are attached to the new switch into the two holes in the electrical box. These screws are typically long, so an electric screwdriver is handy. Reattach the coverplate. Then, turn the power back on at the main panel and test the switch for operation.

WHAT IF...?

If you're installing a three-way dimmer, attach the wire lead identified as the common to the circuit wire you tagged as the common in step 4. Now attach the other two wire leads to the other two colored circuit wires, using wire connectors. These wires, called the travelers, are interchangeable. It doesn't make any difference which of the two remaining circuit wires they get attached to.



HERE'S HOW: REPLACE AN ELECTRICAL BOX

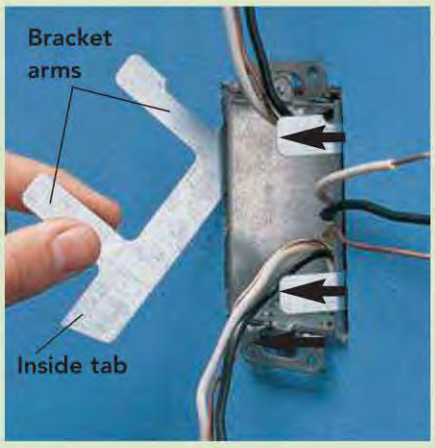
Dimmer switches have larger bodies than traditional toggle switches, so you may find that the existing electrical box is too small to comfortably hold the new dimmer switch. Shallow, 2"-deep electrical boxes will not easily accommodate dimmer switches, especially if there are more than one set of wires inside the electrical box. If you purchase a dimmer and can't seem to get it to fit, don't force it. Dimmers produce more heat than standard switches, and it is a potential fire hazard to crowd the electrical box. You may be able to find a dimmer with a smaller body that will fit. Or, you can install a new, larger wall box.

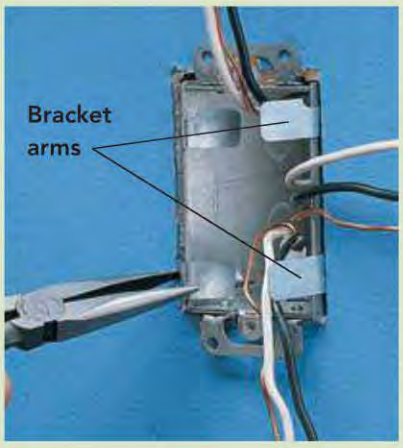
Installing a new wall box is a somewhat advanced project, so you may want to hire a professional to do this work. But if you're up to the task, you can do it yourself by following the directions below. Allow yourself a full afternoon for this graduate school project.

1 Remove the old switch, following steps 1 through 5 on pages 72 and 73. To remove the old box, identify the location of the nails holding the electrical box to the wall studs. Use a reciprocating saw or jigsaw equipped with a metal-cutting blade to cut through the nails holding the box.

2 Bind the cable ends together and attach them to strings so they don't fall into the wall cavity when the old box is removed. Disconnect the cable clamps and slide the old box out.

3 Feed the cable into the new box, tighten the cable clamps, and secure the box in the opening. The retrofit box shown here uses bracket arms that are inserted into the sides of the box, then bent around the front edges to secure the box in the opening. Other styles of retrofit boxes have other means of attachment. Attach the new dimmer, following steps 6 and 7 on the preceding page.





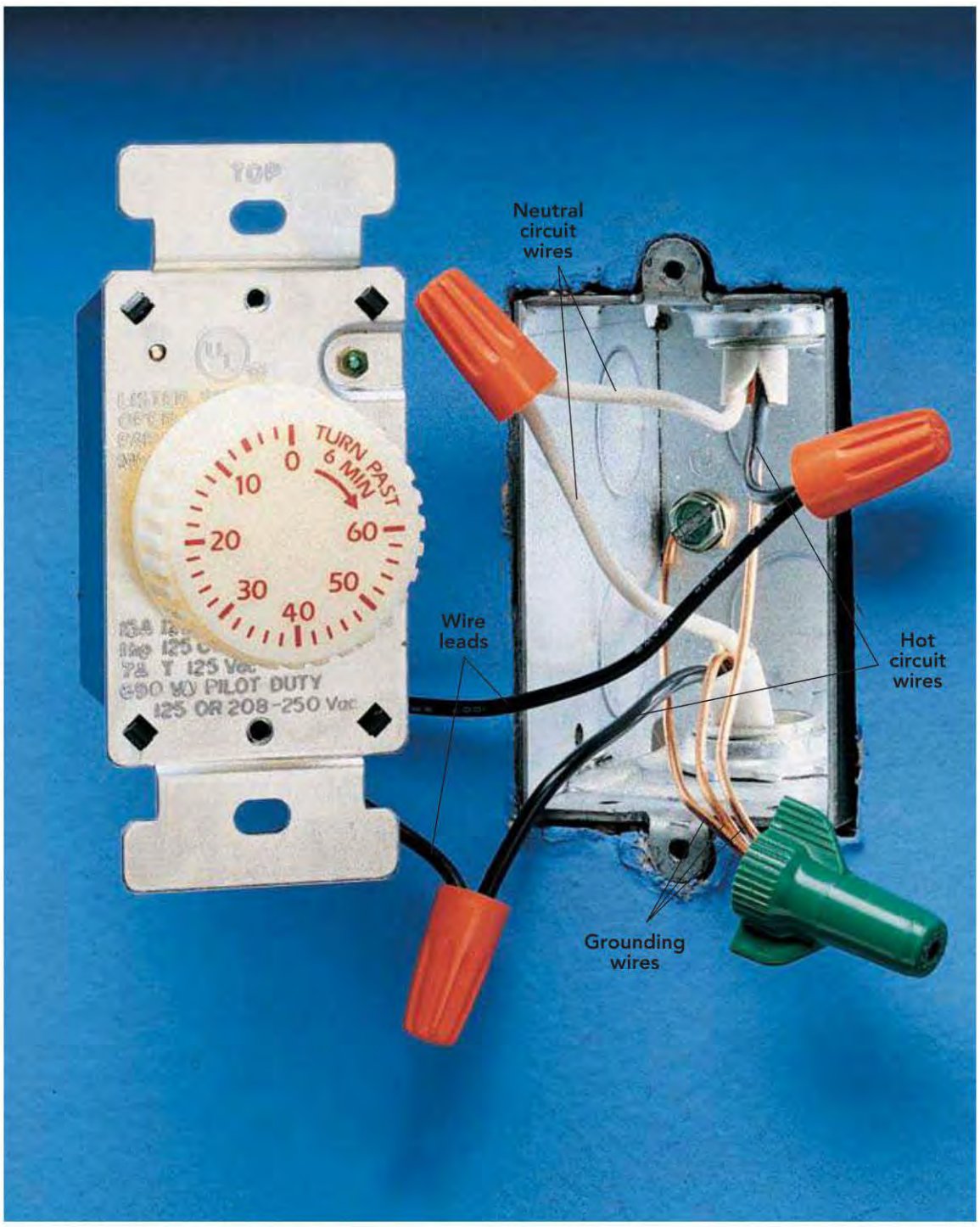
13 Installing Timer Switches

There are two common types of timer switch. Dial-type timers are commonly used to control bathroom vents and outdoor lights. To turn on the light and set the timer, simply twist the dial to the desired setting. When the dial winds down, the light or fan goes off. Push-button timers are commonly used to control lights. They have three or four switches, each with a preset time setting.

TIMER SWITCHES ARE SIMPLY SWITCHES THAT TURN ON OR OFF after a determined amount of time. This is useful for controlling some types of exterior lights and for controlling bathroom vent fans. With outdoor lights, you can use a timer to turn on landscape and security lighting at preset times. In the bathroom, the timer can vastly increase the efficacy of your vent fan by making sure it runs long enough to completely evacuate moist air. You can also use push-button-type timer switches to control room lights, thus assuring that no light is left burning indefinitely.

Installing a timer is no more difficult than installing a light switch. As with dimmers, the size of the box holding the switch in the wall is a consideration. In some older homes, the metal box that contains the old switch may not be large enough for a timer. If so, see page 75 for information on changing the box.

TIMER SWITCHES 101



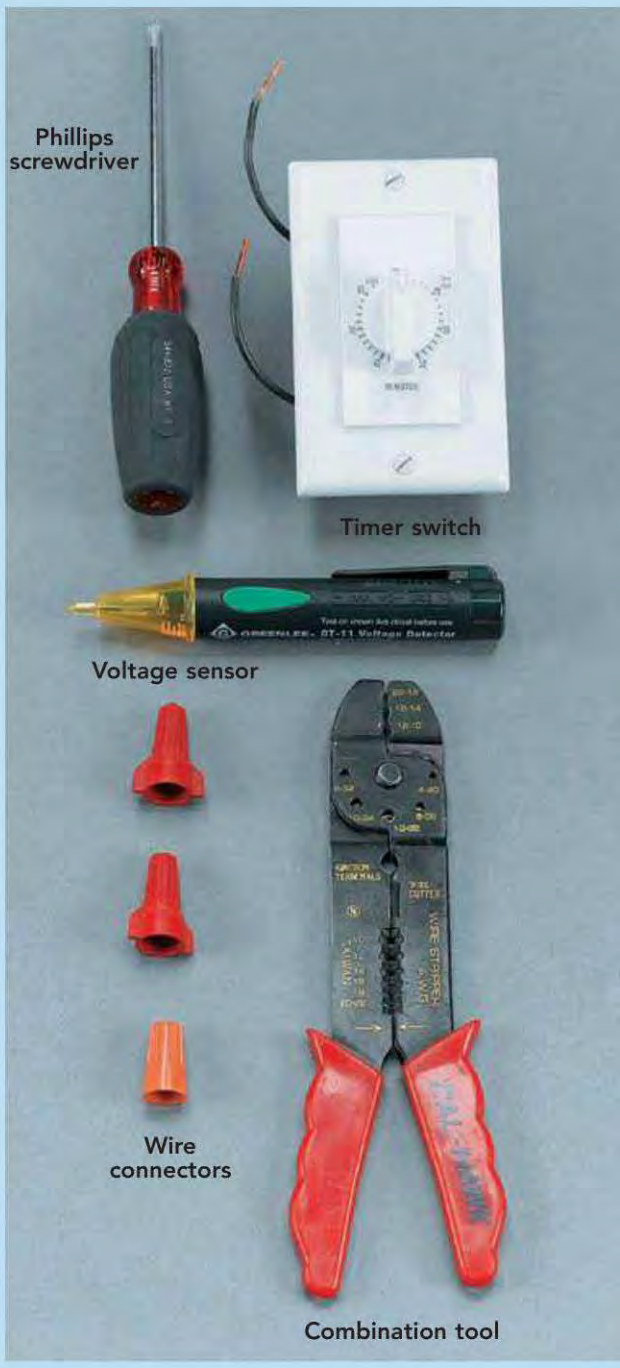
Unlike standard light switches and like dimmers, most timers are connected to the household electrical wires by short lengths of wire called leads. Leads come preattached to the timer. You attach them to the household wiring with wire connectors.

TERMS YOU NEED TO KNOW

LEADS—The preattached black wires attached to a timer switch.

GROUNDING WIRES—The bare copper circuit wires in an electrical box.

TOOLS & SUPPLIES YOU'LL NEED



SKILLS YOU'LL NEED

- Turning off the power (page 12)
- Testing for power (page 13)
- Making wire connections (page 14)

DIFFICULTY LEVEL

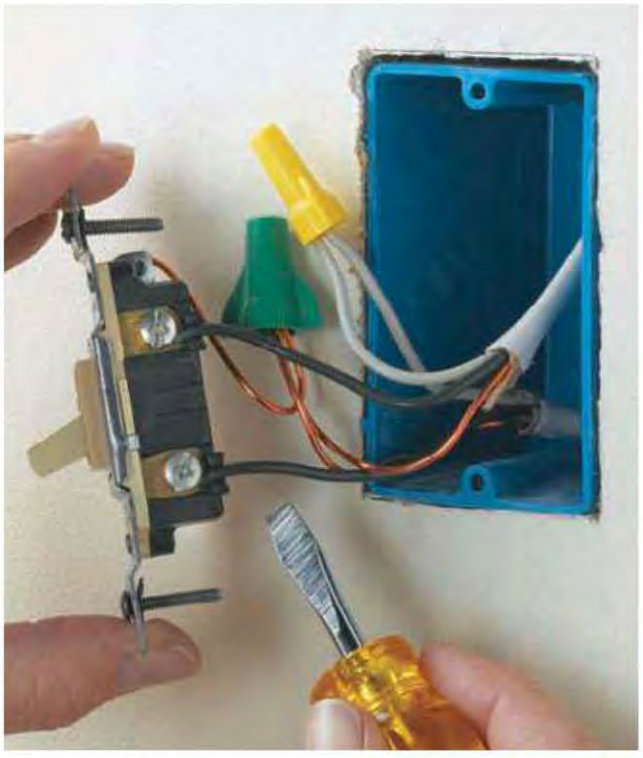
This project takes about 1 hour.

HOW TO INSTALL A TIMER SWITCH

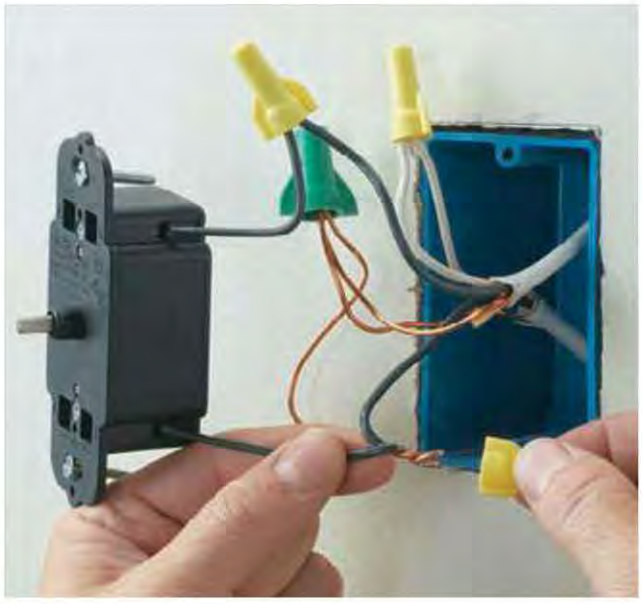
1 First shut off the power to the switch. Remove the decorative coverplate from the switch by unscrewing the two screws that hold the plate to the switch box. Set the screws and the plate aside.

2 Use a voltage sensor to make sure the circuit is dead. Hold your voltage sensor's probe within ½" of the wires on either side of the switch. If the sensor beeps or lights up, then the switch is still live, and you'll need to trip the correct breaker to disconnect power to the switch. If the sensor does not beep or light up, the circuit is dead and you're safe to continue.

3 Remove the switch from the box by unscrewing the two long screws that hold the switch to the box at the top and at the bottom. Once the screws are out, hold the top and bottom of the switch, and carefully pull the switch away from the box.



4 Remove the switch completely by unscrewing the screws that hold the two wires to the switch. In most cases, there will also be two white wires connected with a wire connector in the box. You won't have to deal with these in your installation.



5 The timer will have two black wires, called leads, coming out of the timer's plastic body. The leads, like the two black wires coming out of the wall, are interchangeable, so you can't mix them up. Place the stripped end of one of the black leads and the end of one of the existing black wires into a wire connector (the dimmer will come with twist-on wire connectors). Twist the wire connector clockwise until it is tight. Hold the wires and tug gently on the connector to ensure that it is tight. Connect the other lead to the other wire from the wall in the same way.

6 Once the wires are firmly connected, you can attach the switch to the box. Tuck the new timer switch and wires neatly back into the box. Then drive the two long screws that are attached to the new switch into the two holes in the electrical box. These screws are typically long, so an electric screwdriver is handy. Pull the dial off the timer so the coverplate will fit over it. Reattach the coverplate and push the dial back onto the timer stem. Then, turn the power back on at the main panel and test the switch.

WHAT IF...?

What if there's a light switch right next to the fan switch?

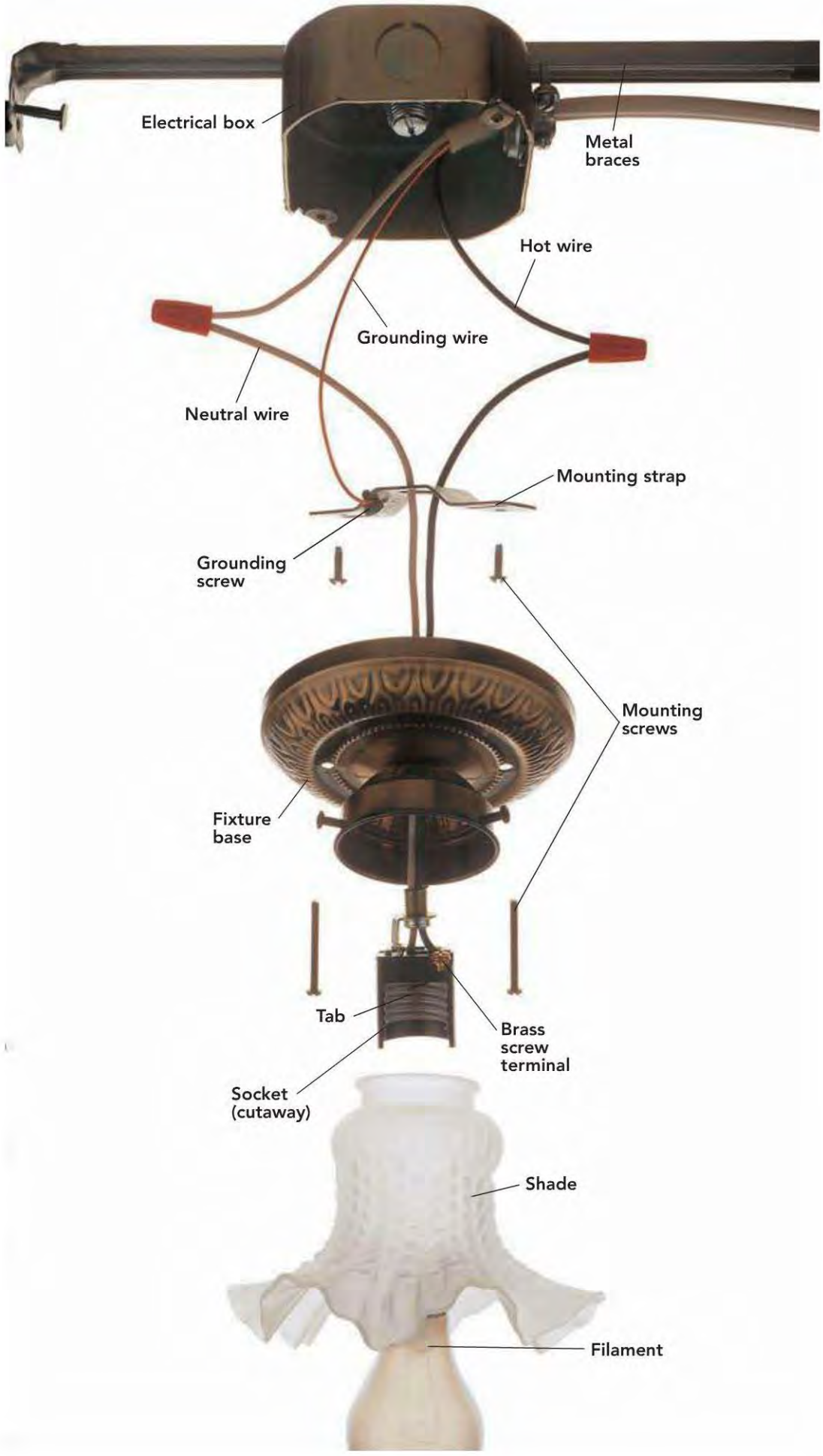
This is a common arrangement. You might even find a group of three switches together. Behind the single coverplate, you'll find one large electrical box, called a "double-gang" box if there are two switches, that contains all the connections. This won't affect your installation except in one way: the coverplate. The coverplate that comes with your timer will be for a single switch. You'll need to buy a double-gang coverplate with a cutout for your timer (a small hole in the center) and one for a standard light switch.

14 Replacing Ceiling-Mounted Fixtures

Installing a new ceiling fixture can provide more light to a space, not to mention an aesthetic lift. It's one of the easiest upgrades you can do.

CEILING FIXTURES DON'T HAVE ANY MOVING PARTS and their wiring is very simple, so, other than changing bulbs, you're likely to get decades of trouble-free service from a fixture. This sounds like a good thing, but it also means that the fixture probably won't fail and give you an excuse to update a room's look with a new one. Fortunately, you can don't need an excuse. Upgrading a fixture is easy and can make a dramatic impact on a room. You can substantially increase the light in a room by replacing a globe-style fixture by one with separate spot lights, or you can simply install a new fixture that matches the room's décor.

CEILING FIXTURES 101



No matter what a ceiling light fixture looks like on the outside, they all attach in basically the same way. An electrical box in the ceiling is fitted with a mounting strap, which holds the fixture in place. The bare wire from the ceiling typically connects to the mounting strap. The two wires coming from the fixture connect to the black and white wires from the ceiling.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Turning off the power (page 12)
- Testing for power (page 13)
- Making wire connections (page 14)

DIFFICULTY LEVEL

This project should take you 2 hours or less, and will be easier if you have a helper.

HOW TO REPLACE A CEILING-MOUNTED LIGHT FIXTURE

1 Begin by turning off the power to the fixture. Remove the globe by unthreading the globe (turning it counterclockwise) or by loosening the three screws that pinch the globe in place (the screws usually go through a collar around the base of the globe). Next, remove the lightbulbs from the fixture.

3 Before you touch the wires that feed the existing light, use a voltage sensor to verify that the circuit is now dead. With the fixture's switch in the ON position, insert the sensor's probe into the electrical box and hold the probe within ½" of the black wires inside. If the sensor beeps or lights up, then the circuit is still live, and you'll need to trip the correct breaker to disconnect power to the fixture. If the sensor does not beep or light up, the circuit is dead and you can proceed safely.

2 Detach the old light from the ceiling electrical box. Most traditional fixtures use two long screws to secure the fixture base to the metal electrical box in the ceiling. Have a helper hold the fixture with one hand so it doesn't fall, while you use a screwdriver to remove the two screws. Gently pull the light straight down, exposing the wiring that powers the fixture.

HERE'S HOW

Here's how to remove the shade. Most are secure in the center by a decorative nut. You can probably unscrew it by hand (hold on to the shade or have a helper support it). If it's stuck, try a pliers.

4 Once you have verified that the power to the light is off at the main panel, remove the fixture by disconnecting the wires. Use your hands to unscrew the wire connectors by turning them counterclockwise. After removing the wire connectors, pull the fixture completely away from the box (you can recycle it or save it). If you need to stop working and restore the power, first separate the wires coming from the ceiling box and cap them each with a wire connector.

5 Before you install the new fixture, check the ends of the wires coming from the ceiling electrical box. They should be clean and free of nicks or scorch marks. If they're dirty or worn, clip off the stripped portion with your combination tool. Then, strip away about ¾" of insulation from the end of each wire.

WHAT IF...?

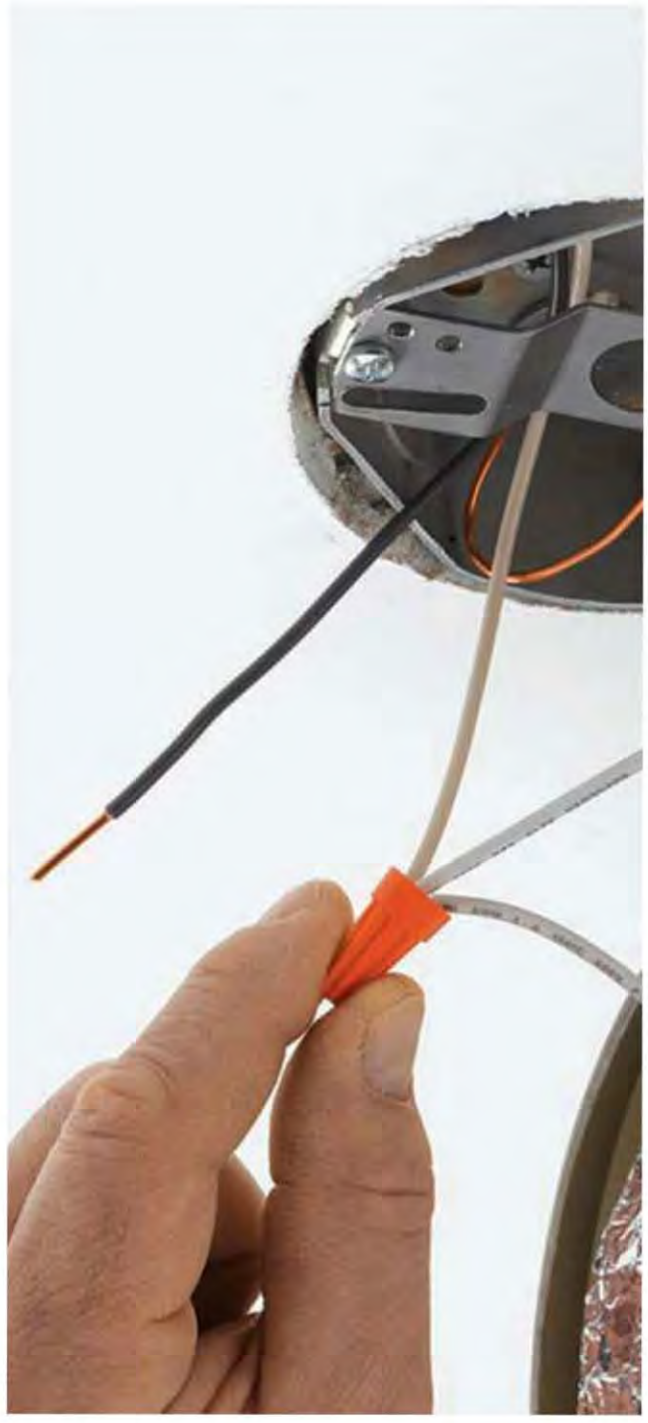
What if there are no wire connectors?

If the fixture is small, the wires from the box may be connected directly to the fixture. To disconnect them, simply loosen the screws enough to free the wires.

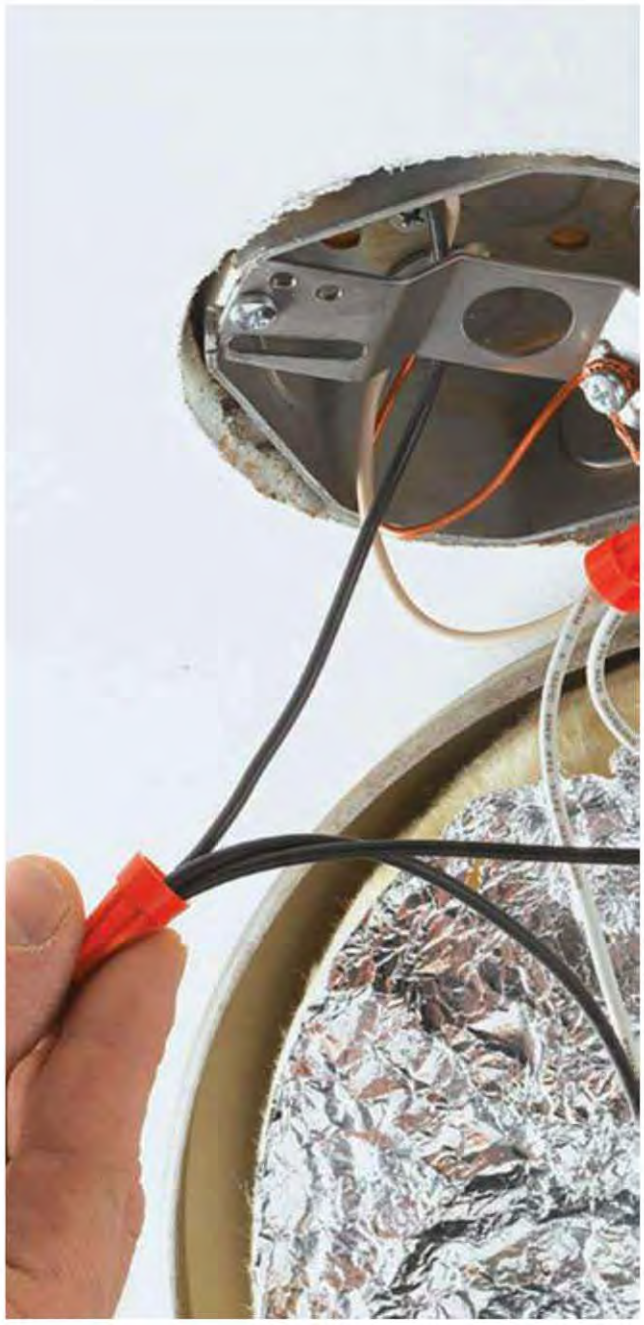
6 Now, take a look at the electrical box. Most fixtures installed in the last few decades are attached to a mounting strap, a strip of metal reaching from one side of the electrical box to another and attached with two screws. Older light fixtures were often mounted directly to the holes in the box (inset), a less safe installation that doesn't meet current electrical codes.

8 You will probably find a bare copper wire in the box. Connect this wire to the screw near the center of the mounting strap. Wrap the wire clockwise around the screw and turn the screw until it is snug.

7 If the box doesn't have a mounting strap, attach one. One might be included with your new fixture; otherwise, you can buy one at any hardware store or home center.



9 Set the new fixture on top of a ladder or have a helper support it. You'll find two short wires—called leads—coming from the fixture, one white and one black. If the ends of the leads are not already stripped, remove about ¾" of insulation from each wire end. Hold the white lead from the fixture next to the white wire from the ceiling. Push the ends into a wire connector, and twist the connector clockwise until it is snug.



10 Now connect the black wire to the black lead with a wire connector in the same way. Give both connections a gentle tug to make sure the connectors are tight.

SAFETY TIP

When picking a new ceiling fixture, select one with a bulb wattage rating appropriate to the bulb size you'll be using. For example, if you're installing a fixture that uses two bulbs, and you want to use 100-watt bulbs for maximum light, your fixture must be rated for 200 watts or more. A 120-watt fixture, on the other hand, can accept two 60-watt bulbs.

11 Tuck the wire connections into the ceiling box on either side of the mounting strap. Hold the fixture over the electrical box so its two mounting holes line up with the holes on the mounting strap. Secure the light to the ceiling box by driving the fixture's mounting screws through the holes in the fixture base and into the strap. These screws are typically quite long, so an electric screwdriver is helpful.

12 With the fixture secured to the box, you can install the lightbulbs and shades. Each fixture is a little different; follow the manufacturer's instructions. Once the bulbs are in, restore power to the fixture and test it.

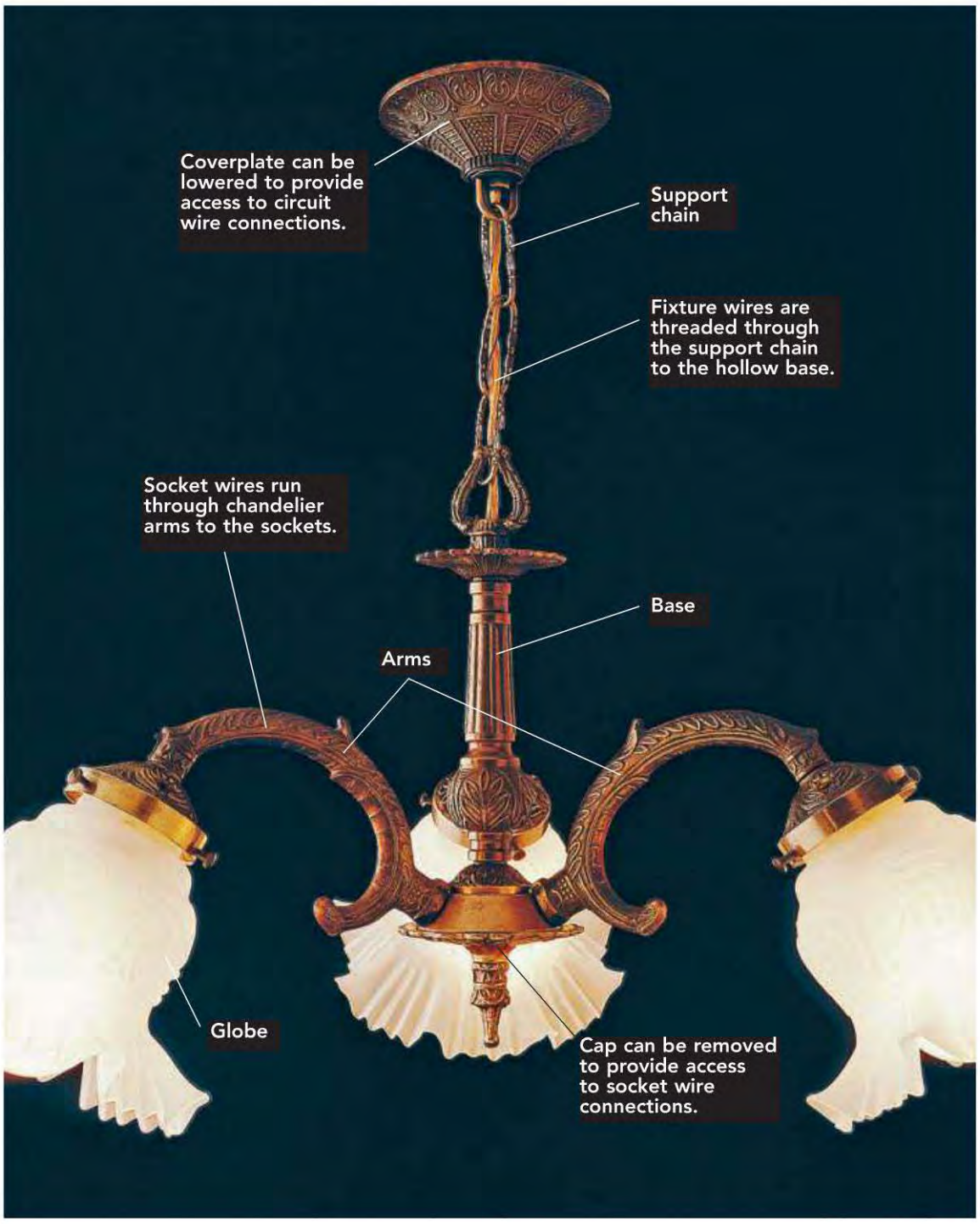
15 Replacing Hanging Light Fixtures

Replacing an old chandelier is a quick and easy way to make a big change to a room's character, not to mention the quality of its light.

CHANDELIERS AND OTHER HANGING FIXTURES EXIST IN A HUGE VARIETY OF STYLES, so chances are good that you might acquire a house with a chandelier you find less than attractive. Of course, you might also have a chandelier stop working for some reason. Either way, they're easy enough to replace.

A properly installed chandelier has more bracing behind it than a standard ceiling fixture, so don't try to replace a simple ceiling globe with a 50-pound chandelier. You'll likely find a broken chandelier on your dining room table if you do.

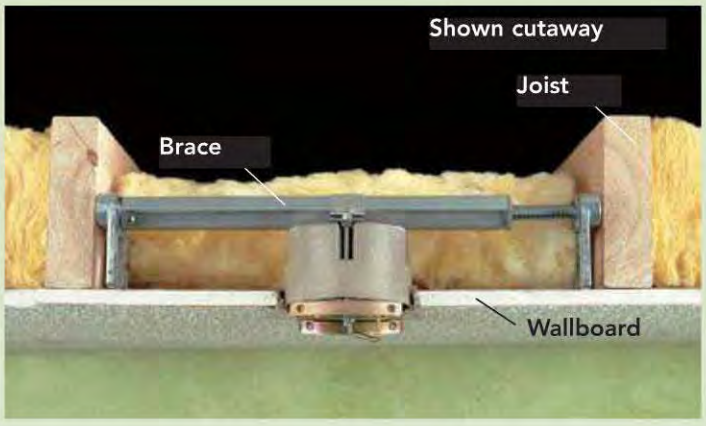
CHANDELIERS 101



Chandeliers can be a maze of wires, but fortunately, to install one, you only need to deal with the two fixture wires that snake up the chain.

HERE'S HOW

Heavy chandeliers and ceiling fans are suspended from electrical boxes that are secured between ceiling joists with heavy-duty braces.



TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Making wire connections (page 14)

Note: This job is easier with two people.

DIFFICULTY LEVEL

Allow about 2 hours for this project.

HOW TO INSTALL A NEW CHANDELIER

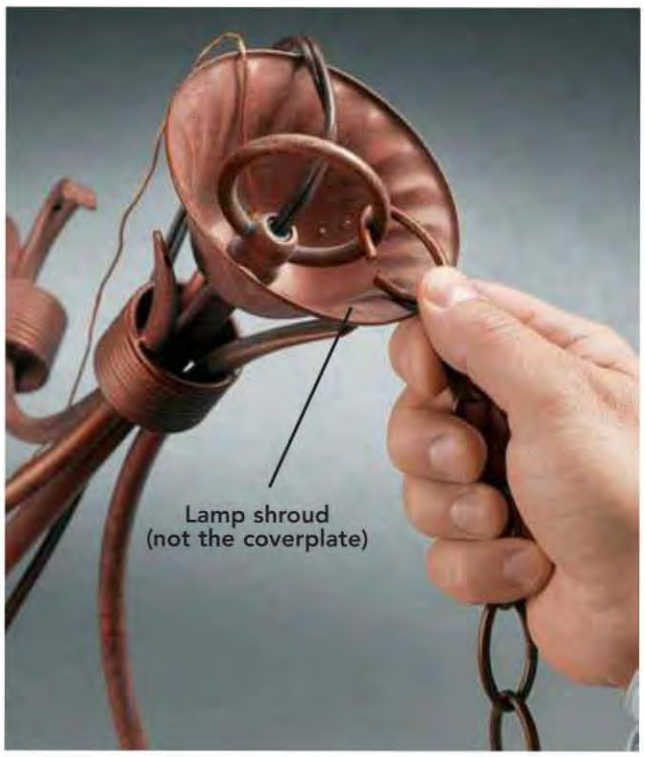
SAFETY TIP

Chandeliers are heavy, as you will learn very quickly when you're removing or installing one. It's better to rig up some means of temporary support for the fixture than to rely on a helper to hold it or—worse still—try to hold it yourself (you will need both hands to make the connections). One solution is to position a tall stepladder directly below the work area so you can rest the fixture on the top platform. And just in case the fixture falls, remove all the bulbs and globes before you do any of the work.

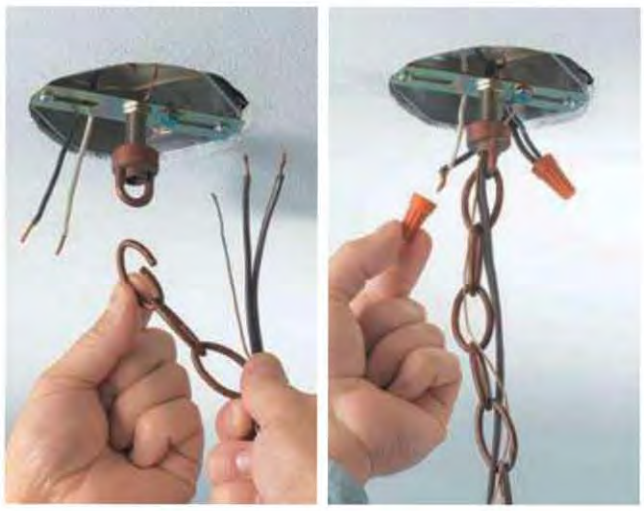
2 Turn off the power to the old fixture at the main service panel. Use a voltage sensor to verify that the circuit is dead. With the light switch turned on, insert the sensor's probe into the electrical box within ½" of the wires inside. If the sensor beeps or lights up, then the circuit is live and you've shut off the wrong circuit. Shut off additional circuits until the probe confirms that you've shut off the correct one.

1 Remove the old light fixture. To gain access to the wiring connections, unfasten the retainer nut that secures the coverplate for the electrical box. On some chandeliers (such as the one above), the ring that holds the support chain for the chandelier is integral to the retainer nut, so unfastening it will mean the fixture is being supported only by the electrical wires.

3 Remove the wire connectors from all the wires in the box and separate the wires. If the support chain is still attached, unscrew the mounting nut from the end of the threaded nipple inside the box. Disconnect the bare copper wire from the screw near the center of the mounting strap. Pull the old wires down through the threaded nipple.



4 Adjust the length of the support chain on the new chandelier (if necessary) so it will hang at the desired height when mounted. This is normally done by disconnecting the chain from the support ring on the fixture, removing the required number of links and then reattaching the chain.



6 Hang the new fixture from the threaded nipple (unless the chain support nut is integral to the coverplate retainer, as in step 1). You may need to screw the threaded nipple farther into the mounting plate so it does not extend past the coverplate. Or, you may need to replace the mounting strap and nipple with correctly sized hardware (usually provided with the new fixture). Make the wire connections, including attaching the bare copper wire to the grounding screw on the mounting strap.

5 There will be two insulated wires and a bare copper ground woven in with the chain on your new fixture. There should be 6" to 12" of extra wire at the top of the chain. If the ends of these wires aren't stripped, use your combination tool to strip away ¾" of insulation.

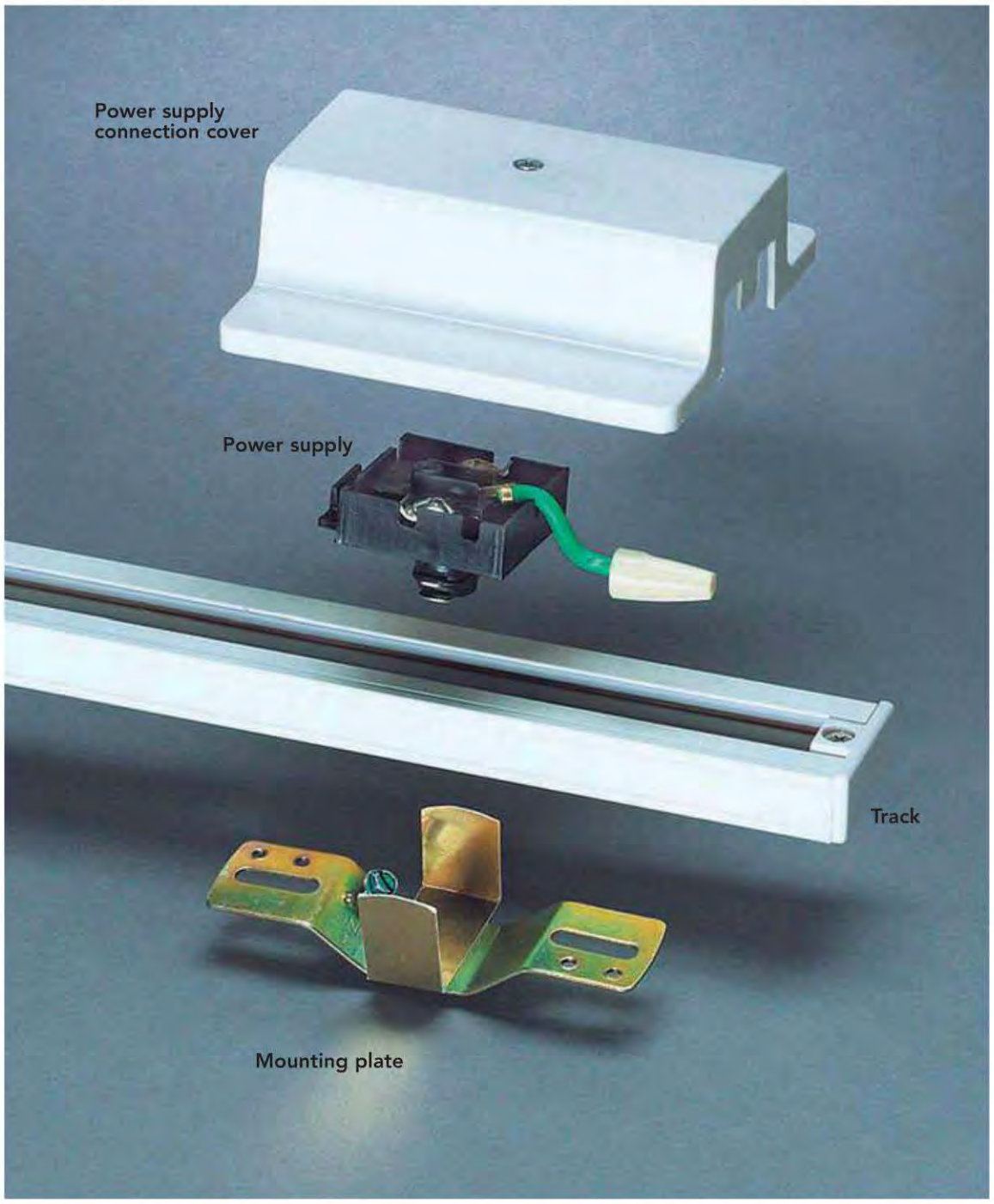
7 Carefully tuck the wires into the electrical box and then tighten the retainer for the coverplate so it is snug against the ceiling. Restore power and test the fixture.

16 Installing Track Lights

If you currently have a ceiling-mounted light fixture that is not meeting your lighting needs, it's simple to replace it with a track-lighting fixture. With track lighting you can easily change the type and number of lights, their position on the track, and the direction they aim. These fixtures come in many different styles, including short three-foot track systems with just one or two lights up to 12-foot systems with five or more lights.

TRACK LIGHTING OFFERS A BEAUTIFUL AND FUNCTIONAL WAY TO INCREASE THE AMOUNT OF LIGHT in a room or simply to update its look. A variety of fixture and lamp options lets you control the shape, color, and intensity of the light. Installing track lighting in place of an existing ceiling-mounted light fixture involves basic wiring and hand-tool skills, but the connections are even easier to make than with traditional light fixtures. Once installed, the system is very easy to upgrade or expand in the future.

TRACK LIGHTING 101



Track systems include a lot of components, but fortunately you can buy all-inclusive starter kits containing everything you need for a basic installation, as well as a foundation for later upgrades if you wish.

TERMS YOU NEED TO KNOW

POWER SUPPLY—This little piece of hardware varies in appearance from kit to kit, but in all cases, it feeds power from the household wiring to the electrified pathways inside the track (and this powers the lights).

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Turning off power (page 12)
- Testing for power (page 13)
- Making wire connections (page 14)
- Light carpentry skills

DIFFICULTY LEVEL

This project will take about half a day.

HOW TO REMOVE A CEILING-MOUNTED LIGHT FIXTURE

1 Locate the breaker for the light circuit you're working on and switch that breaker into the OFF position. If you have an older electrical service panel, you may have glass fuses instead of breakers. If so, pull the fuse for that circuit. Close the cover of the breaker or fuse cabinet.

2 Remove the globe and the lightbulbs from the fixture. Detach the old light from the ceiling electrical box. Most fixtures use two long screws to secure the fixture base to the electrical box in the ceiling. Hold the fixture with one hand while you use a screwdriver to remove the two screws. Gently pull the light straight down, exposing the wiring.

3 Use a voltage sensor to verify that the circuit is dead. Insert the sensor's probe into the electrical box within ½" of the black wires inside. If the sensor beeps or lights up, then the circuit is still live, and you'll need to trip the correct breaker to disconnect power to the fixture. If the sensor does not beep or light up, the circuit is dead and you can proceed safely.

4 Remove the fixture by disconnecting the wires. Use your hands to unscrew the wire connectors by turning them counterclockwise. After removing the wire connectors, pull the fixture completely away from the box (you can recycle it or save it). If you need to stop working and restore the power, first separate the wires coming from the ceiling box and cap them each with a wire connector.

1 Turn off power (step 1, opposite page). Thread the three wires from the power supply hardware through the hole in the center of the mounting plate. Connect the power supply wires using wire connectors (the kit will come with them). The green wire on the power supply is connected to the bare copper wire coming out of the electrical box. Connect the white and black wires from the power supply to the white wire and black wires coming from the electrical box in the same way.

WHAT IF...?

What if the track is too long? Most types of track can be cut to length easily with a hacksaw. Use a saw fitted with a sharp blade and make a straight cut.

2 Carefully tuck the wires back up into the ceiling box and attach the mounting plate using the screws provided with the kit. The power supply can simply hang by its wires for the time being.

3 Draw a reference line on the ceiling to mark the track's path from the mounting plate to the end of the track. If possible, position the track directly underneath a ceiling joist so you can screw it to the joists. Otherwise, you will need to use toggle bolts to hold the tracks in the ceiling. Snap the track temporarily onto the mounting plate so it follows the reference line.

4 Mark the screw hole locations on the ceiling by making a dot through each hole in the track. After you mark the screw locations, remove the track and drill holes in the ceiling for the mounting screws. Begin by threading the bolts onto the track. First, unscrew the toggle bolt from the spring-loaded wings. Insert the toggle bolts through the holes in the track. Hold the wing on the ceiling-side of the track, then screw the bolt back into the toggle wings with two or three turns of the bolt.

HERE'S HOW

Here's how to add another section of track. You can link sections of track together with connectors (your kit may include some or you can buy them separately, along with additional track sections). Connector pieces will also allow you to make 90-degree turns or T's on your track path. The connectors snap into the end of the track and are secured with screws.

5 Drill holes slightly larger then the thickness of the closed toggle wings. Pinch the wings of one toggle together and push it into the hole in the ceiling. The wings will snap open once they enter the cavity and hold the bolt in place. Push the other toggle bolts into their holes in the same way. Once all the bolts for a track section are in their holes, fit the track end to the mounting plate, and then tighten all the toggle bolts. Tighten the two screws on the mounting plate.

6 Now you can connect the power supply to the track. Insert the power supply into the track and twist the connector until it snaps securely into place (connector installation may vary by manufacturer). The connector is made so that it cannot be snapped in the wrong way, so you'll know when it's in correctly. Attach the white and black wires to the screw terminals on the power supply.

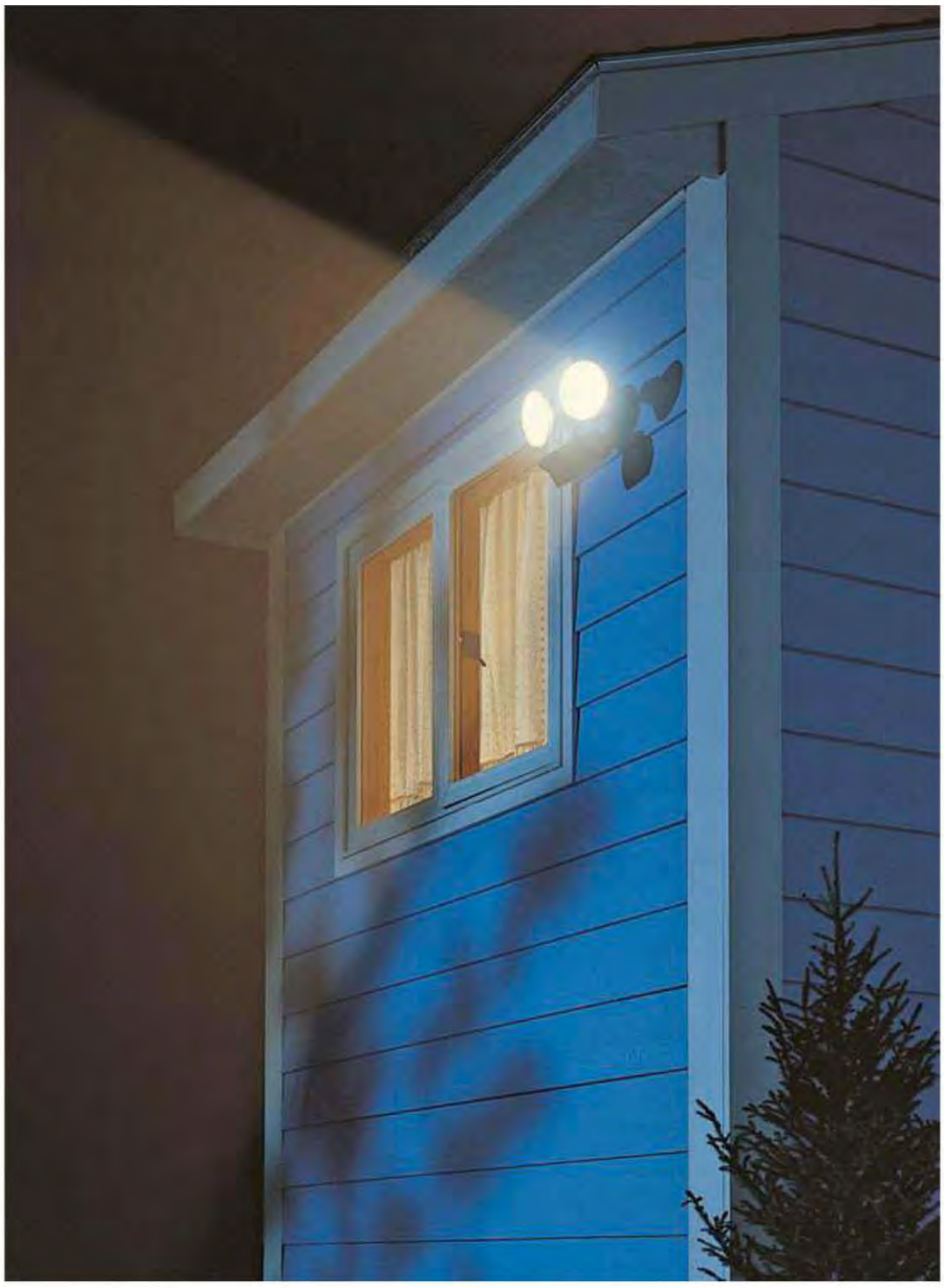
7 Most kits will require you to cap the open ends of track dead ends. Snap them onto the ends of track pieces and secure them with screws.

9 You can begin inserting the light heads into the track at this point. These should simply twist-lock into place. Turn on power and test the light head.

8 Now you can fit the decorative cover over the mounting plate. It may snap in place or be secured with screws. This will cover up the mounting plate completely.

10 If the light works, locate a position you like and push down the locking tab on the side of the fixture to secure the light in this location. Install appropriate bulbs in the light sockets, according to the manufacturer's instructions. Install the remaining heads.

17 Installing Motion-Sensing Floodlights



An exterior floodlight with a motion sensor is an effective security measure. Make sure you keep the motion sensor adjusted so it doesn't give false alarms.

MOST HOUSES AND GARAGES HAVE FLOODLIGHTS ON THEIR EXTERIORS. You can easily upgrade these fixtures so that they provide additional security by replacing them with motion-sensing floodlights. Motion-sensing floods can be set up to detect motion in a specific area—like a walkway or driveway—and then cast light into that area. And there are few things intruders like less than the spotlight. These lights typically have timers that allow you to control how long the light stays on and photosensors that prevent the light from coming on during the day.

FLOODLIGHTS 101

A motion-sensing light fixture provides inexpensive and effective protection against intruders. It has an infrared eye that triggers the light fixture when a moving object crosses its path. Choose a light fixture with: a photo cell (A) to prevent the light from turning on in daylight; an adjustable timer (B) to control how long the light stays on; and range control (C) to adjust the reach of the motion-sensor eye.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Turning off the power (page 12)
- Testing for power (page 13)
- Making wire connections (page 14)

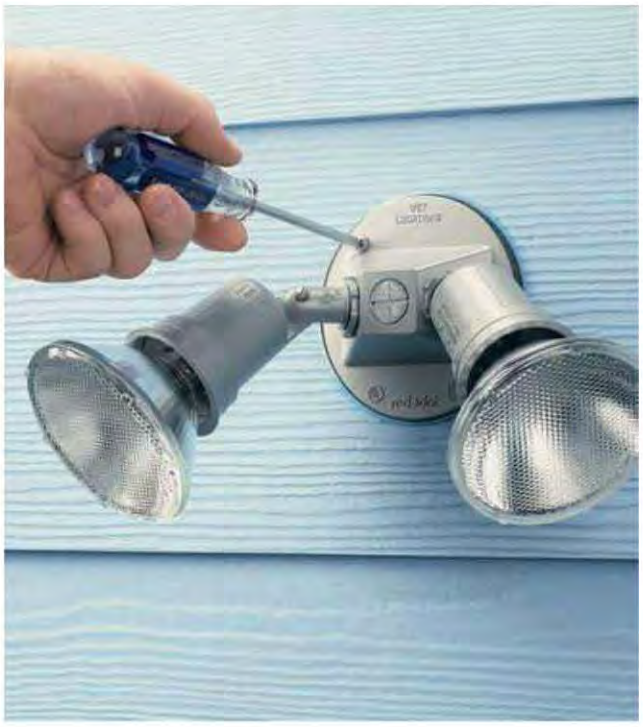
HERE'S HOW

Here's how to make sure no one accidentally turns off your security lights—or any other light you don't want turned off. Switch locks are inexpensive plastic covers that lock a switch in the ON or OFF position. You can find them at any hardware store or home center.

DIFFICULTY LEVEL

This project will take about 1 hour.

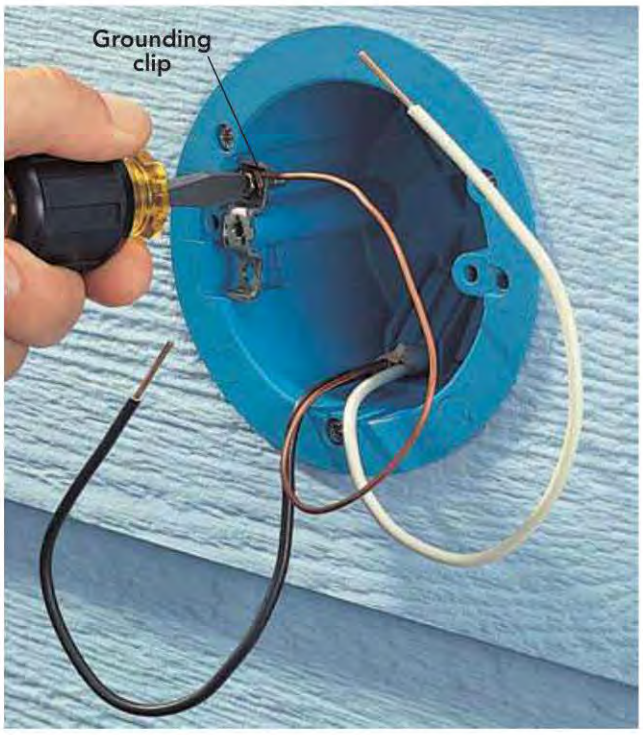
HOW TO INSTALL A MOTION-SENSING FLOODLIGHT



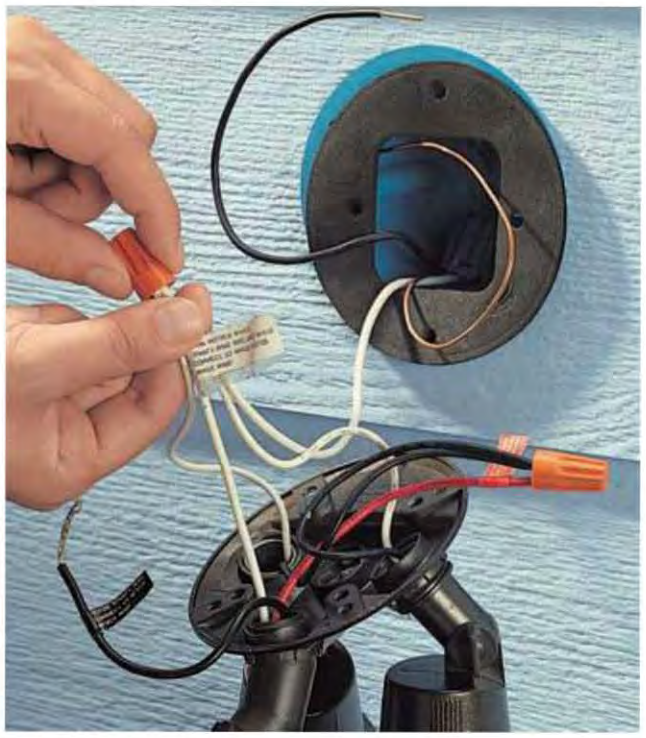
1 Turn off power to the old fixture. To remove it, unscrew the mounting screws on the part of the fixture attached to the wall. There will probably be four of them. Carefully pull the fixture away from the wall, exposing the wires. Don't touch the wires yet.

2 Before you touch any wires, use a voltage sensor to verify that the circuit is dead. With the light switch turned ON, insert the sensor's probe into the electrical box and hold the probe within ½" of the wires inside to confirm that there is no voltage flow. Disconnect the wire connectors and remove the old fixture.

3 Examine the ends of the three wires coming from the box (one white, one black, and one bare copper). They should be clean and free of corrosion. If the ends are in poor condition, clip them off and then strip ¾" of wire insulation with a combination tool.

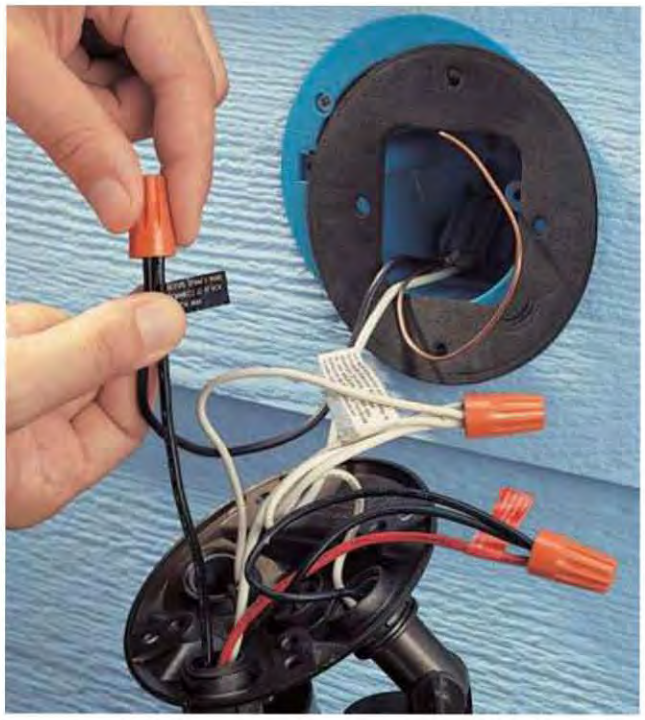


4 If the electrical box is nonmetallic and does not have a metal grounding clip, install a grounding clip or replace the box with one that does have a clip and make sure the ground wire is attached to it securely. Some light fixtures have a grounding terminal on the base. If yours has one, attach the grounding wire from the house directly to the terminal.



5 Now you can attach the new fixture. Begin by sliding a rubber or foam gasket (usually provided with the fixture) over the wires and onto the flange of the electrical box. Set the new fixture on top of a ladder or have a helper hold it while you make the wiring connections. There may be as many as three white wires coming from the fixture. Join all white wires, including the feed wire from the house, using a wire connector.

7 Neatly tuck all the wires into the box so they are behind the gasket. Align the holes in the gasket with the holes in the box, and then position the fixture over the gasket so its mounting holes are also aligned with the gasket. Press the fixture against the gasket and drive the four mounting screws into the box. Install floodlight bulbs (exterior rated) and restore power.



6 Next, join the black wire from the box and the single black wire from the fixture with a wire connector. You may see a couple of black wires and a red wire already joined on the fixture. You can ignore these in your installation.

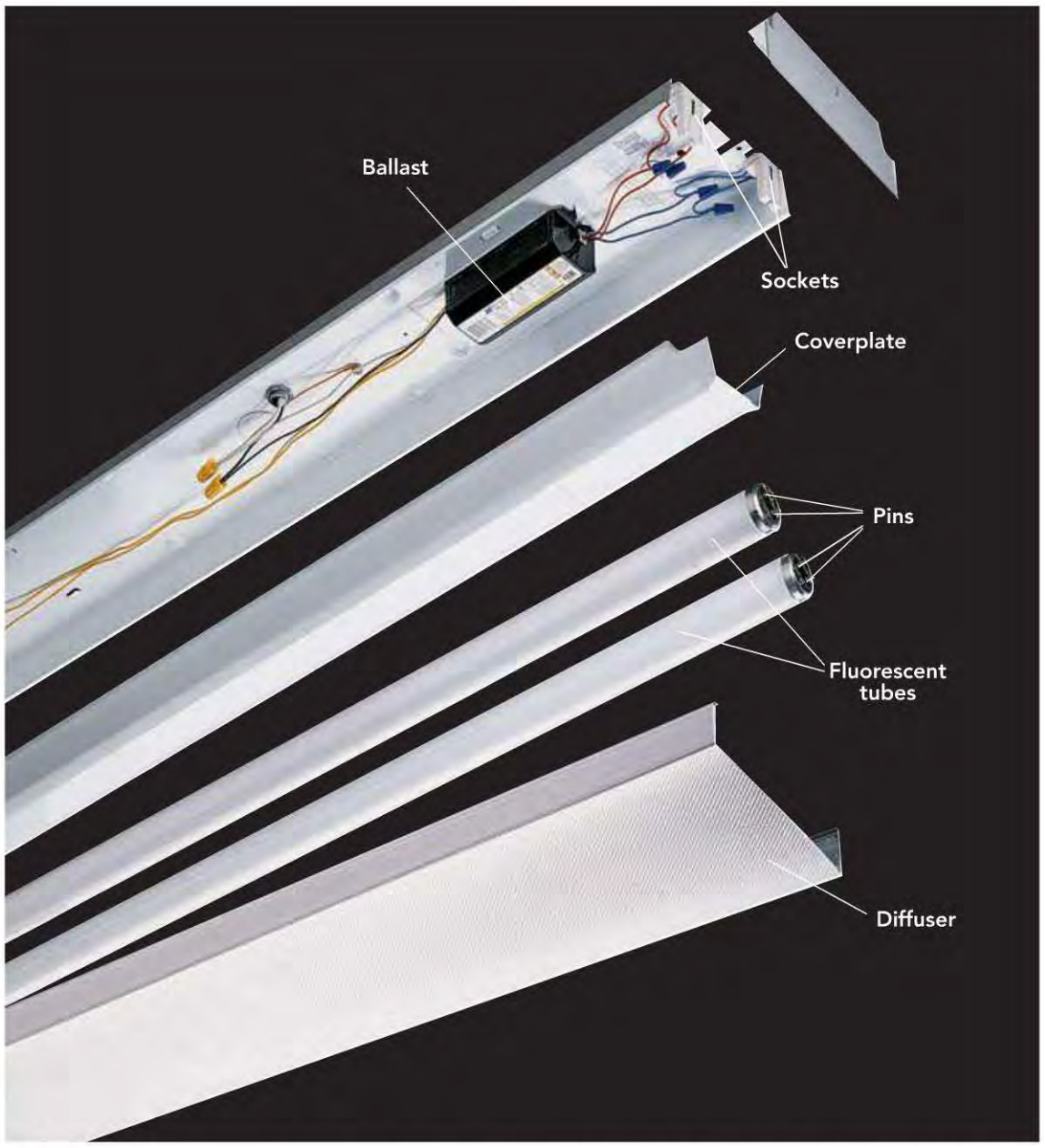
8 Test the fixture. You will still be able to turn it on and off with the light switch inside. Flip the switch to ON and pass your hand in front of the motion sensor. The light should come on. Adjust the motion sensor to cover the traffic areas and pivot the light head to illuminate the intended area.

18 Repairing Fluorescent Light Fixtures

Troubleshooting a fluorescent light that's flickering or won't work is a process of testing and checking that begins with inspecting the fluorescent tubes to make sure they're making good contact with the fixture sockets and are in good condition.

FLUORESCENT FIXTURES ARE GREAT LIGHTING CHOICES because they save energy and offer many different quality-of-light options, from the hue and color of the light to its brightness. And fluorescent lamps have a much longer life than regular incandescent lamps. But as fluorescent fixtures age, small parts begin to fail. Replacing the tubes is easy, and replacing the ballast (a transformer-type part that distributes power to the sockets) is only slightly more difficult. But if the fixture is old it may make more sense to replace the entire fixture with a newer (and probably quieter) model.

FLUORESCENT LIGHTS 101



Fluorescent fixtures come in lots of different lengths, from 6 inches to 6 feet. They all work basically the same. The fixture consists of a diffuser and a coverplate and housing that contain a ballast that connects to the sockets that hold the tubes.

BUYER'S TIP

Here's how to buy a fluorescent tube: You'll need three pieces of information: the length of the tube, the end type, and the wattage. There are a couple different styles of pin configuration for the ends of tubes. The two-pin style shown here is most common, but there are others. If yours looks different, take it with you to the hardware store to find an exact match. The wattage of the fluorescent tube will be printed somewhere along its length. Buy a new tube with the same watt rating. For best value, buy fluorescent tubes in multiple tube packs, as you would with other types of lightbulbs.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Turning off power (page 12)
- Testing for power (page 13)
- Making wire connections (page 14)

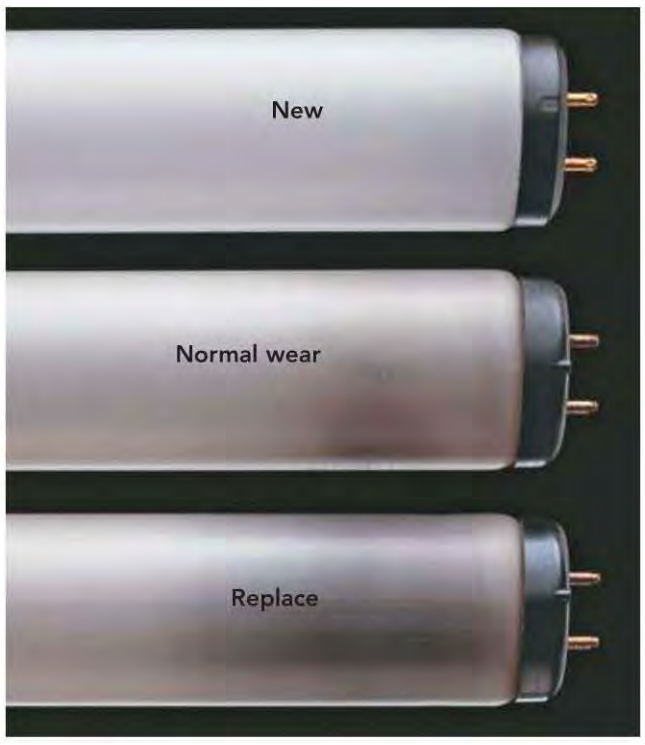
Note: This may be easier with two people.

DIFFICULTY LEVEL

Allow about 2 hours for this project.

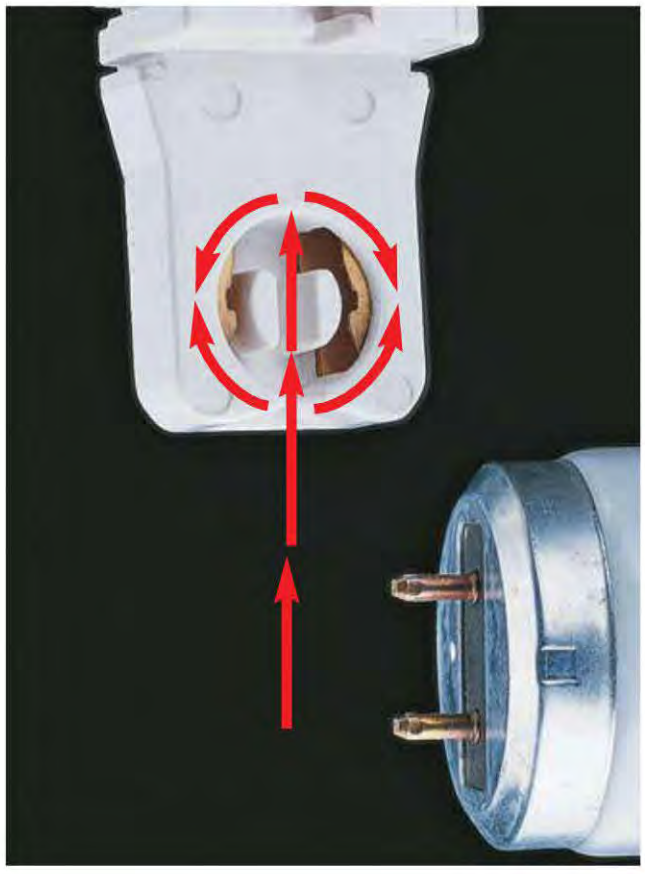
HOW TO REPLACE A FLUORESCENT TUBE

1 If your fluorescent light is flickering or not working, check the tubes first. Start by removing the plastic diffuser that covers the light so you can access the florescent tubes. The diffuser normally snaps into place. Squeeze it slightly at its sides to remove it.



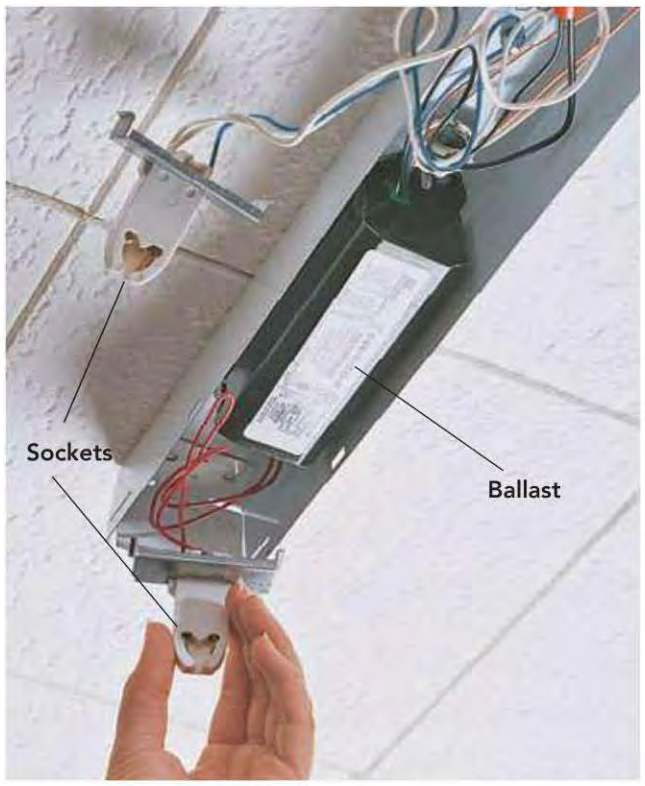
3 Take a look at the ends of the bulb. A little light gray coloring at the ends of a used fluorescent bulb is normal. But if one or more of the tube ends is blackened, the tube should be replaced.

2 Twist the tubes to confirm that they are seated correctly in the sockets. If they are securely in the sockets but the light won't light, remove the tubes by rotating them a quarter turn in each direction and pulling down.

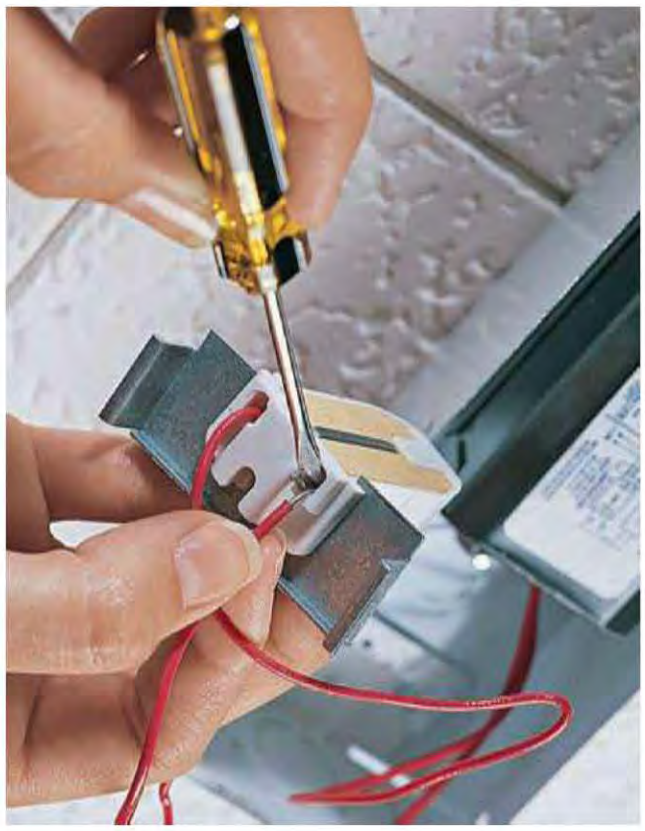


4 Purchase a replacement tube (see page 101) and install the new tubes by holding the tube so the pins are vertical. Slide the pins into the grooves in the sockets and push up. Then, turn the tube a quarter turn in each direction. Replace the diffuser and test the fixture.

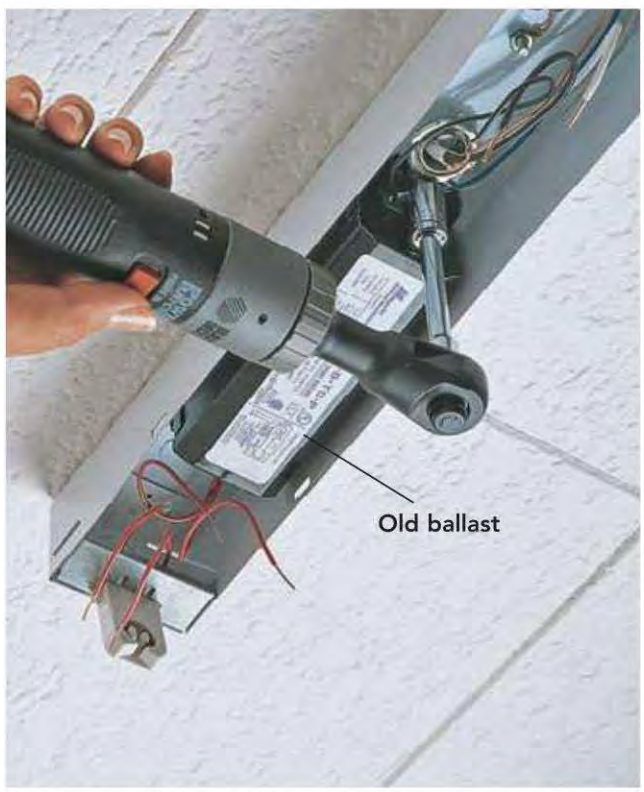
HOW TO REPLACE A BALLAST



1 Turn off the power at the main service panel, then remove the diffuser, fluorescent tube, and coverplate. Test for power. Remove the sockets from the fixture housing by sliding them out, or by removing the mounting screws and lifting the sockets out.



2 Disconnect the wires that lead from the ballast to the sockets by pushing a small screwdriver into the release openings (as seen above) or loosening the screw terminals. On some socket styles you'll need to cut the wires to within 2" of the socket to remove the ballast.



3 Remove the old ballast, using a ratchet wrench or screwdriver. Make sure to support the ballast so it does not fall (a little duct tape will do the job).

4 Install a new ballast that has the same ratings as the old ballast. Attach the ballast wires to the socket wires and reinstall the coverplate, fluorescent tube, and diffuser. Turn on power to the light fixture at the main service panel.

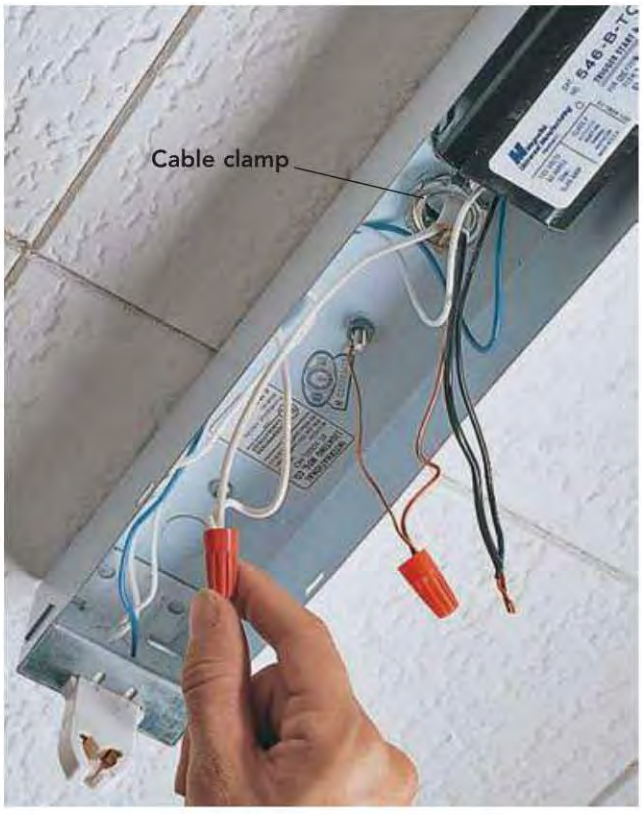
HOW TO REPLACE A FLUORESCENT FIXTURE

1 If replacing the tube or ballast doesn't fix the problem, it's best to replace the whole light fixture. Start by removing the diffuser and the tubes. Then, turn off the power to the fixture at the service panel and test with a voltage tester.

2 Loosen the screws at each end of the metal coverplate on the fixture. If there are no screws, you may be able to remove the cover by pinching its ends and pulling down. Pull the coverplate free and set it aside.

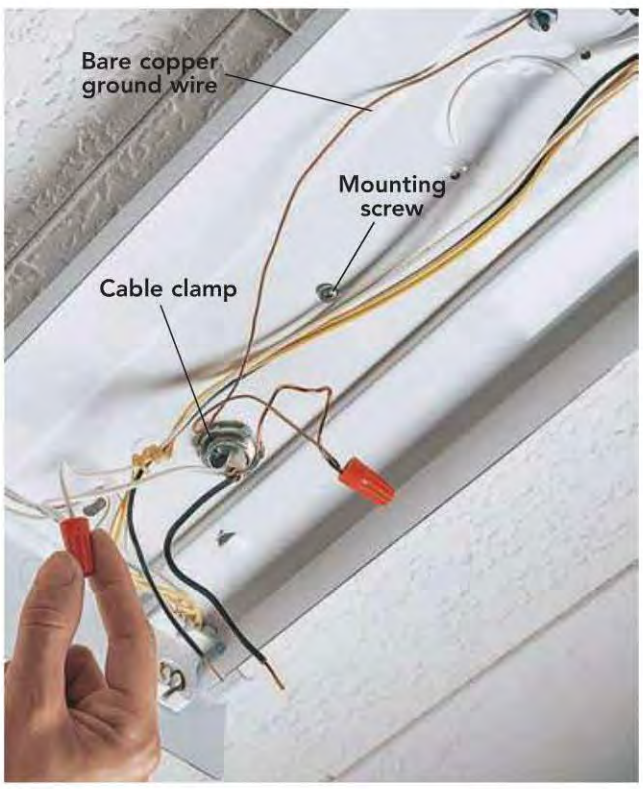
BUYER'S TIP

How to buy a new fluorescent fixture: Look for a fixture of the same length and with the same number of tubes as the one you're replacing. You'll also want one rated for the same number of watts as your old one. The watt rating will be printed somewhere on the inside of the fixture.



3 Disconnect the fixture by unscrewing the wire connectors inside the fixture housing. Straighten out the three wires feeding into the fixture through the cable clamp and then unscrew the cable clamp.

4 You can now completely remove the fixture by unscrewing the mounting screws. It's a good idea to have a helper support the fixture as you undo the screws. Move the fixture away from the ceiling, pulling the three wires through the hole.



6 Attach the fixture to the ceiling with screws or toggle bolts driven up through mounting screw holes in the top of the fixture, and then tighten a retaining nut around the cable clamp. Make the wire connections (white to white, black to black, bare copper ground to grounding screw on fixture).

5 Remove the coverplate from the new fixture. On the bottom of the new fixture, you'll find several knockout holes. Remove a knockout that will fall under the electrical box in the ceiling when the fixture is installed (drive a screwdriver through the knockout to remove it). Attach a cable clamp in the knockout hole and feed the three wires from the ceiling box through the cable clamp as you raise the fixture up against the ceiling.

7 Reattach the coverplate on the new fixture, install the fluorescent tubes and snap in the diffuser. Restore power and test the fixture.

19 Fixing Ceiling Fans

Even ceiling fans that are operated only occasionally are prone to failure or problems like excess wobble. Following the steps in this chapter will help you diagnose and solve common ceiling fan maladies.

CEILING FANS THAT WORK PROPERLY WILL SAVE MONEY on heating and cooling costs and add to the comfort of your home. But over time ceiling fans can fail to work, become noisy, the blades may wobble, or the pull-chain switch may become unreliable or just plain faulty. Before putting many hours of time and hard labor—not to mention the expense—into a new fan installation, diagnose the old fan to see if it can be easily repaired using these steps. Keep in mind that most consumer-level ceiling fans will never be completely silent when the fan is operating—moving air does make some noise, after all.

CEILING FANS 101

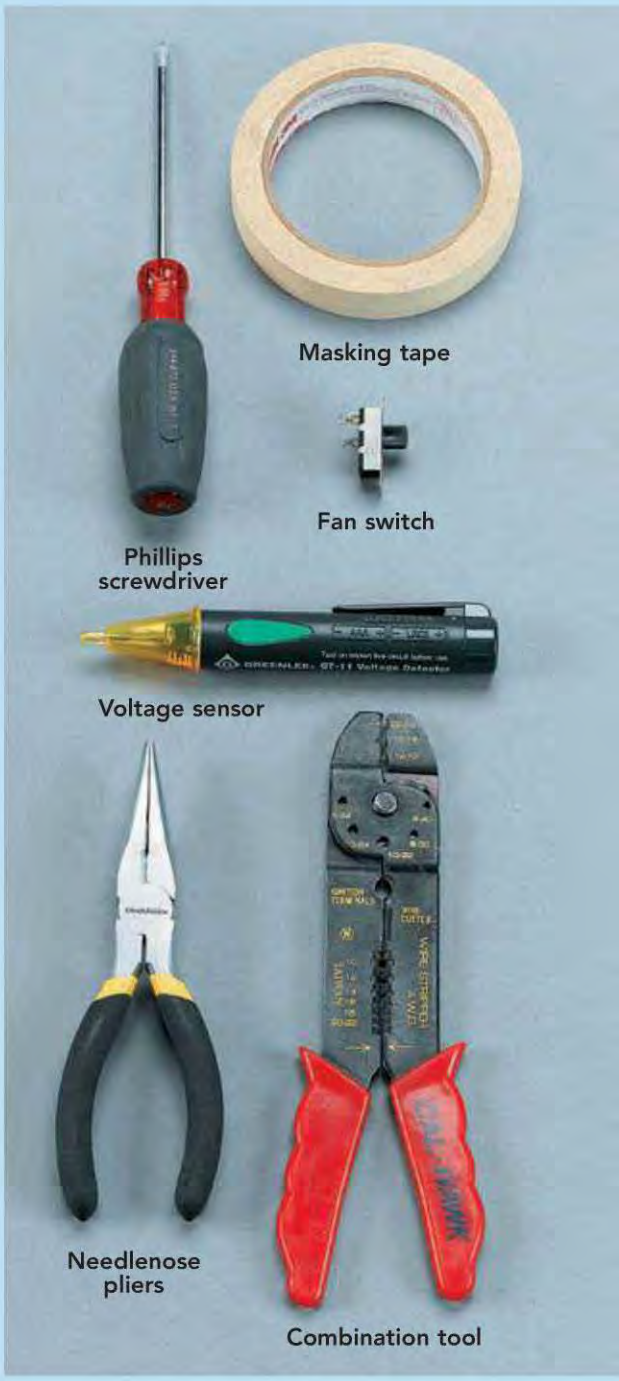
A ceiling fan is suspended from a sturdy mounting bracket and the connection is concealed by a decorative canopy.

FAN NOT WORKING? TRY THIS FIRST:

1 Make sure that the wall switch that controls the ceiling fan is in the ON position. Reach up to the fan and move the fan direction switch back and forth to confirm that it is fully engaged in one of the two positions (clockwise blade movement for summer, counterclockwise for winter). If the fan blades do not start rotating, even though the switch feels secure in one of the two positions, go to step 2.

2 Put your hand on the switch housing to feel for vibration. If a vibration or humming is present, the fan motor is malfunctioning and you should consider replacing the entire unit. No hum or vibration? Proceed to the further diagnostics beginning on page 108.

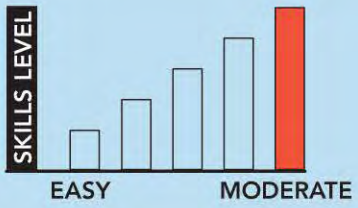
TOOLS & SUPPLIES YOU'LL NEED



SKILLS YOU'LL NEED

- Turning off power (page 12)
- Testing for power (page 13)
- Making wire connections (page 14)

DIFFICULTY LEVEL



Allow 2 to 4 hours, and work with a helper.

HOW TO FIX A CEILING FAN

1 A leading cause of fan failure is loose wire connections. To inspect these connections, first shut off the power to the fan. Remove the fan blades to gain access, then remove the canopy that covers the ceiling box and fan mounting bracket. Most canopies are secured with screws on the outside shell. Have a helper hold the fan while you remove the screws so it won't fall.

2 Once the canopy is lowered, you'll see black, white, green, copper, and possibly blue wires. Hold a voltage sensor within ½" of these wires with the wall switch that controls the fan in the ON position. The black and blue wires should cause the sensor to beep if power is present.

HERE'S HOW

One common problem with older ceiling fans is that over time or due to incorrect initial installation, the blades begin to wobble as they spin. If you're within earshot, the vibration from wobbling is irritating, but it can also damage the fan and shorten its life. Wobbling has three main causes: (1) the fan blades may not be balanced properly, (2) the fan may not be tightly secured to the ceiling fan box, or (3) one or more of the fan blades may have become warped. Fixing any of these situations requires minimal effort and time.

1 Start by checking and tightening all hardware used to attach the blades to the mounting arms and the mounting arms to the motor. Hardware tends to loosen over time and this is frequently the cause of wobble.

2 If wobble persists, try switching around two of the blades. Often, this is all it takes to get the fan back into balance. If a blade is damaged or warped, try to locate a replacement blade.

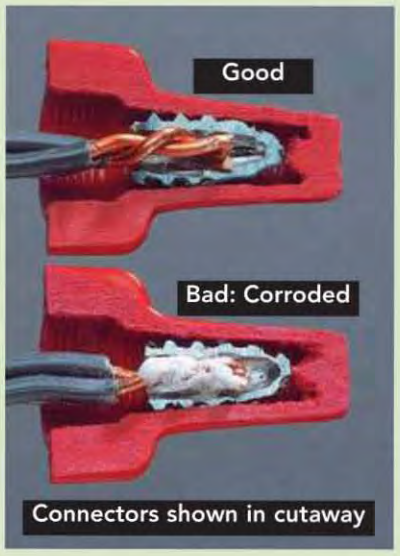
3 If you still have wobble, turn the power off at the panel, remove the fan canopy, and inspect the mounting brace and the connection between the mounting pole and the fan motor. Tighten any loose connections and replace the canopy.

3 When you have confirmed that there is no power, check all the wire connections to make certain each is tight and making good contact. You may be able to see that a connection has come apart and needs to be remade. But even if you see one bad connection, check them all by gently tugging on the wire connectors. If the wires pull out of the wire connector or the connection feels loose, unscrew the wire connector from the wires.

4 Twist the wires back together the same way you found them, making sure the bare wires are making good contact with each other. Secure them with a new wire twist connector.

HERE'S HOW

Bad wiring connections often are caused by failed wire connectors. Inspect connections for signs of burning, corrosion, or rust. If the inside of any wire connector does not look clean and shiny, replace it with a new connector of the same size.



5 If everything works, reinstall the canopy by replacing the screws that were holding it in place. Reattach the fan blades and then restore power. If all connections are secure but the fan still doesn't work, try replacing the pull chain to resolve the problem (see next page).

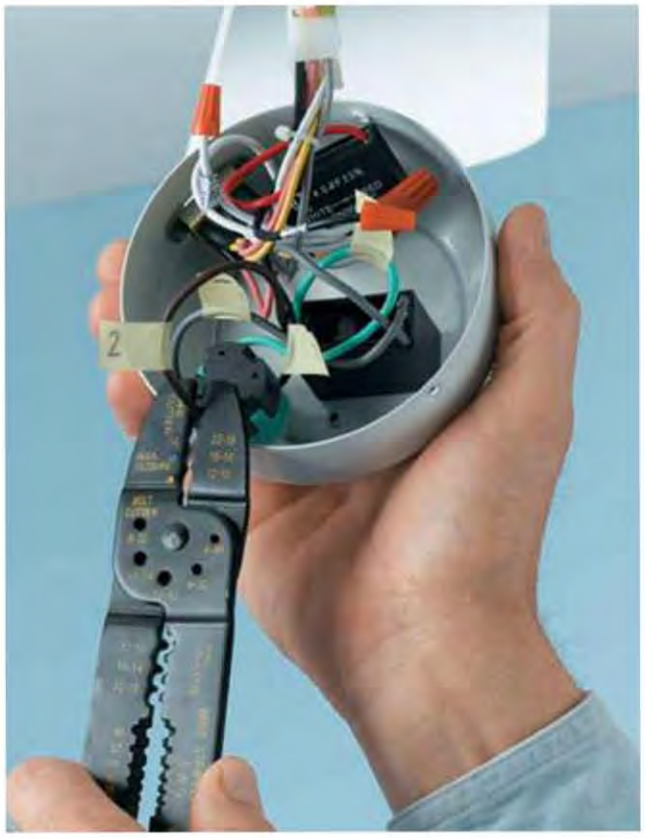
HOW TO REPLACE A PULL-CHAIN SWITCH

1 Turn off the power at the main service panel. Use a screwdriver to remove the three to four screws that secure the bottom cap on the fan switch housing. Lower the cap to expose the wires that supply power to the pull-chain switch.

2 Test the wires by placing a voltage sensor within ½" of the wires. If the sensor beeps or lights up, then the circuit is still live, and is not safe to work. When the sensor does not beep or light up, the circuit is dead and may be worked upon.

3 Locate the switch unit (the part that the pull chain used to be attached to if it broke off); it's probably made of plastic. You'll need to replace the whole switch. Fan switches are connected with from three to eight wires, depending on the number of speed settings.

4 Attach a small piece of tape to each wire that enters the switch and write an identifying number on the tape. Start at one side of the switch and label the wires in the order they're attached.

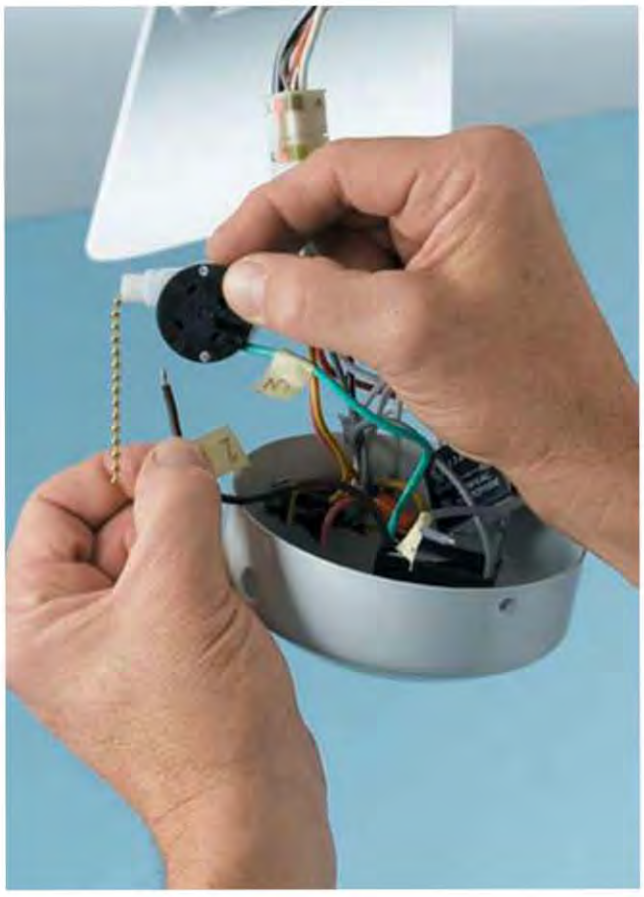


5 Disconnect the old switch wires, in most cases by cutting the wires off as close to the old switch as possible. Unscrew the retaining nut that secures the switch to the switch housing.

6 Remove the switch. There may be one or two screws that hold it in place or it may be secured to the outside of the fan with a small, knurled nut, which you can loosen with needlenose pliers. Purchase an identical new switch.

BUYER'S TIP

Here's how to buy a new switch. Bring the old switch to the hardware store or home center, and find an identical new switch—one with the same number and color of wires. It should also attach to the fan motor wires in the same way (slots or screw terminals or with integral wires and wire connectors) and that attaches to the fan in the same way. If you are unable to locate an identical switch, find the owners manual for your ceiling fan and contact the manufacturer. Or, find the brand and model number of the fan and order a switch from a ceiling fan dealer or electronics supply store.



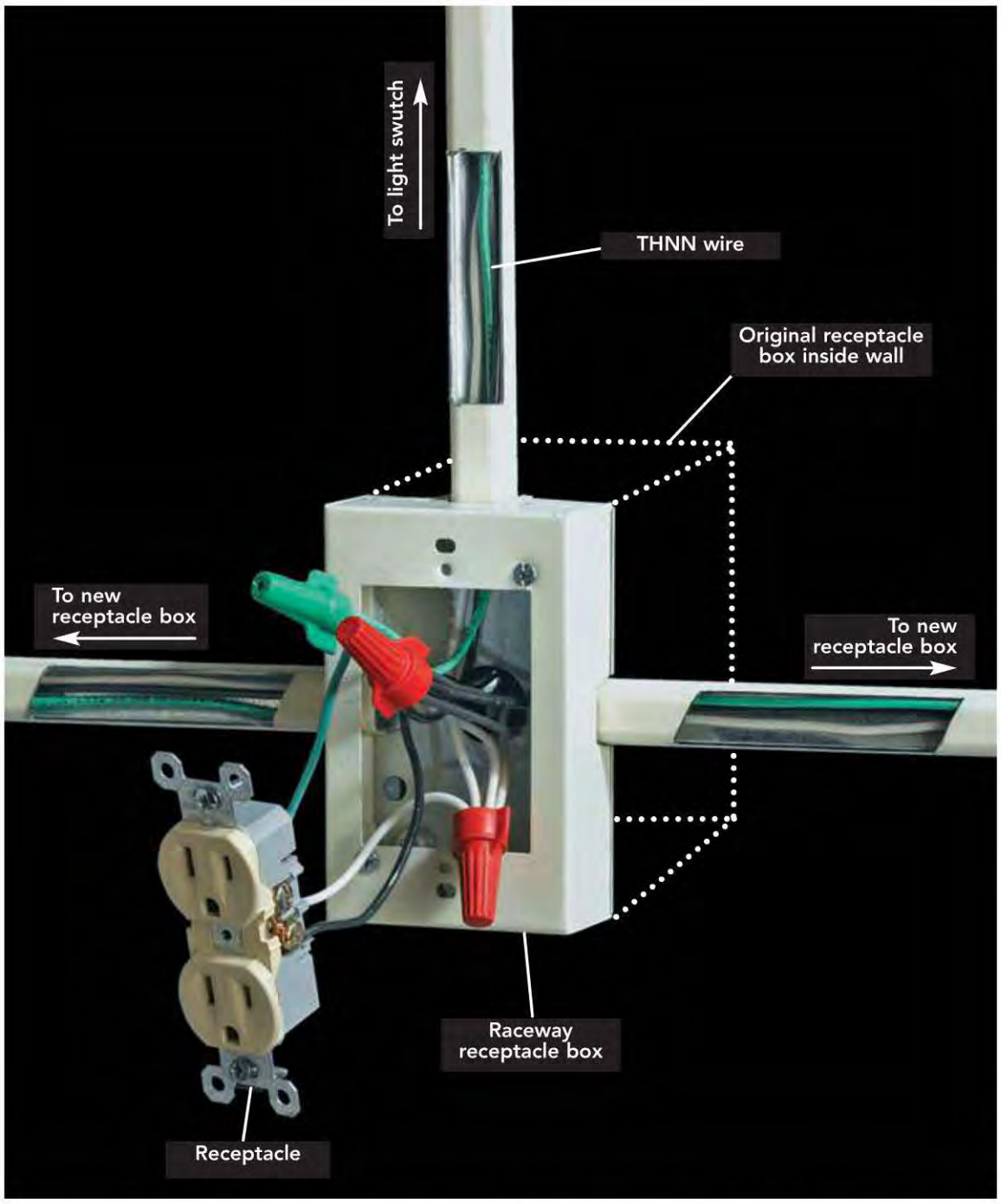
7 Connect the new switch using the same wiring configuration as on the old model. To make connections, first use a wire stripper to strip ¾" of insulation from the ends of each of the wires coming from the fan motor (the ones you cut in step 5). Attach the wires to the new switch in the same order and configuraion as they were attached to the old switch. Secure the new switch in the housing and make sure all wires are tucked neatly inside. Reattach the bottom cap. Test all the fan's speeds to make sure all the connections are good.

20 Installing Raceway Wiring

Raceway wiring systems are surface-mounted networks of electrical boxes and hollow metal tracks that allow you to expand an existing wiring circuit without cutting into your walls.

SURFACE WIRING CAN BE USED TO EXTEND POWER FROM ANY EXISTING RECEPTACLE to another location without cutting into walls, floors, or ceilings. If you're relying on an ugly (not to mention dangerous) tangle of extension cords to compensate for a shortage of proper receptacles, a raceway system of surface wiring may be your solution. Surface wiring uses inconspicuous metal channels that are mounted to the walls. The channels are easily removed and can be extended again or rerouted as your needs change.

RACEWAYS 101



The raceway receptacle box is mounted directly to the original electrical box (usually for a receptacle) and raceway tracks are attached to it. The tracks house THNN wires that run from the raceway box to new receptacles and light switches.

HERE'S HOW

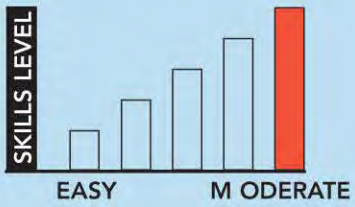
Here's how to determine if an electrical circuit has enough capacity for you to add a new receptacle or light. Count the number of receptacles and lights that are already part of the circuit. Multiply this number by 1.5 amps. The result should not exceed the amperage of the circuit (usually 15 or 20 amps). The 1.5 amps estimate is for everyday small appliances, lamps, and lighting. Do not add onto a circuit if it supplies or is intended to supply power to high-draw appliances such as a refrigerator, microwave oven, or electric heater. Overloading a circuit is unsafe and will cause the circuit breaker to trip. It's always a good idea to consult your local electrical inspector before you start.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Turning off power (page 12)
- Testing for power (page 13)
- Making wire connections (page 14)
- Light carpentry skills

DIFFICULTY LEVEL



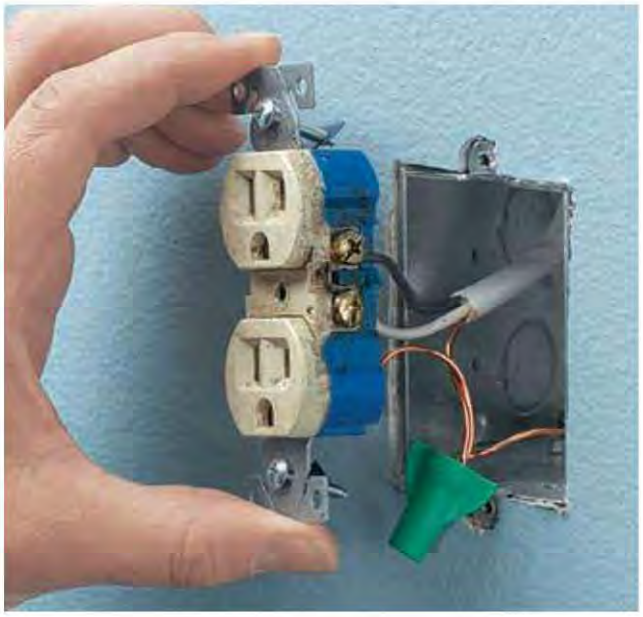
Allow half a day for this project.

HOW TO INSTALL RACEWAY WIRING

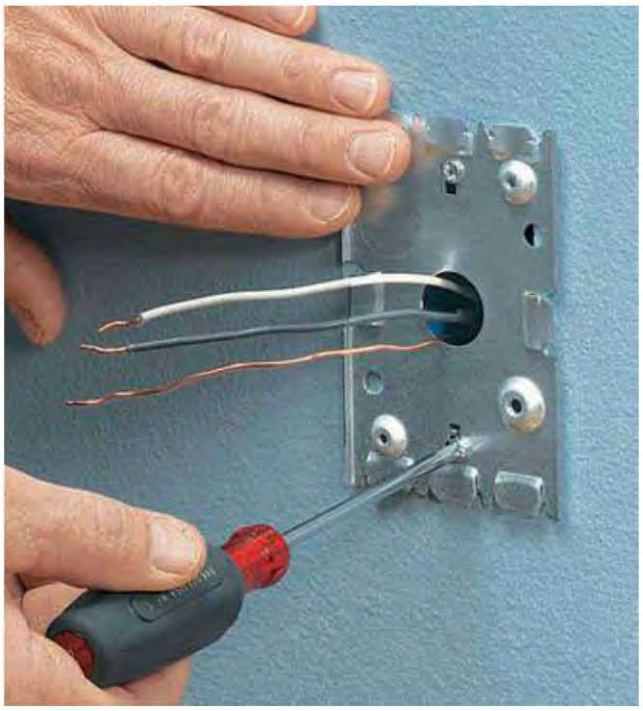
1 Confirm that the circuit you want to expand will support a new receptacle or light (see page 113). Mark the planned location of the new receptacle or switch on the wall and mea-sure to the nearest existing receptacle. Purchase enough raceway to cover this distance plus about 10 percent extra. Buy a surface-mounted starter box, new receptacle box, and fittings for your project (the raceway product packaging usually provides guidance for shopping).

2 First shut off the power to the switch. Remove the coverplate from the receptacle by unscrewing the screw that holds the plate to the electrical box. Set the screws and the plate aside. With the coverplate off, you will be able to see the receptacle and the electrical box it is attached to.

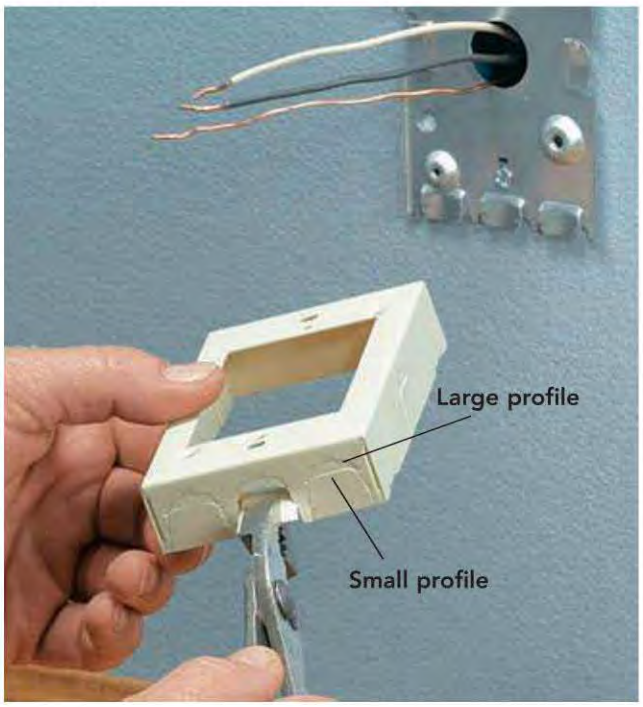
3 Before you remove the old receptacle, use a voltage sensor to double-check that the circuit is dead. Hold your voltage sensor's probe within ½" of the wires on each side of the receptacle. If the sensor beeps or lights up, then the receptacle is still live, and you'll need to trip the correct breaker to disconnect power to the receptacle. If the sensor does not beep or light up, the receptacle is dead and you can proceed safely.



4 Remove the receptacle from the box by unscrewing the two long screws that hold the switch to the box. Once the screws are out, gently pull the receptacle away from the box. It won't pull away easily, since the wires are still attached, so pull firmly. Depending on how your receptacle has been wired, you may find two insulated wires and a bare copper wire or four insulated wires and a bare wire. Detach these wires and set the receptacle aside.



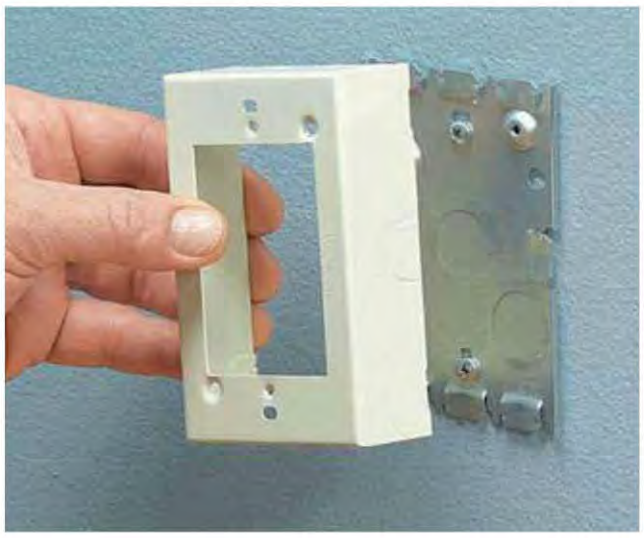
5 Your starter box includes a box and a mounting plate with a hole in its center. Pull all the wires you just disconnected through the hole, taking care not to scrape them on the edges of the hole. Screw the mounting plate to the existing receptacle box with the included mounting screws.



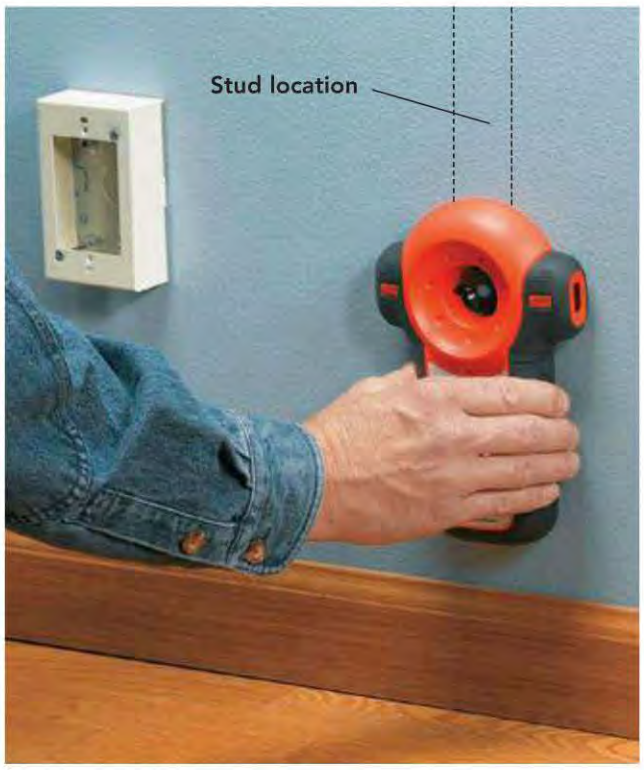
6 Remove a knockout from the starter box to create an opening for the raceway track, using pliers. Often, the prepunched knockouts have two profile options—make sure the knockout you remove matches the profile of your track.

7 Hold the box portion of the starter box over the mounting plate on the existing receptacle. Drive the mounting screws through the holes in the box and into the threaded openings in the mounting plate.

8 Set the mounting bracket for an elbow connector ¼" above the baseboard (having the track run along the baseboard edge looks better than running it in a straight line out of the starter box). Measure from the knockout in the starter box to the top of the bracket and cut a piece of raceway ½" longer than this measurement.



9 At the new receptacle location, use a laser level to transfer the height of the top of the starter box and mark a reference line. If possible, locate the box so at least one screw hole in the mounting plate falls over a wall stud. Position the mounting plate for the receptacle box up against the laser line and secure it with screws driven through the mounting plate holes. If the plate is not located over a wall stud, use wall anchors (see below left).



10 Use a stud finder to locate and mark all of the wall framing members between the old receptacle and the new one. There should be a stud every 16" along the wall, and the studs should be about 1½" wide.

TOOL TIP

Here's how to cut metal raceway. Secure the track in a vise or clamping work support and cut with a hacksaw. Make sure the mounting bracket and the track cover are aligned at the end and cut through both at the same time. For best results, use long, slow strokes and don't bear down too hard on the saw.

11 At stud locations, use a laser level as a reference for marking a line ¼" above the top of the baseboard. Attach mounting clips for the raceway track at these marks.

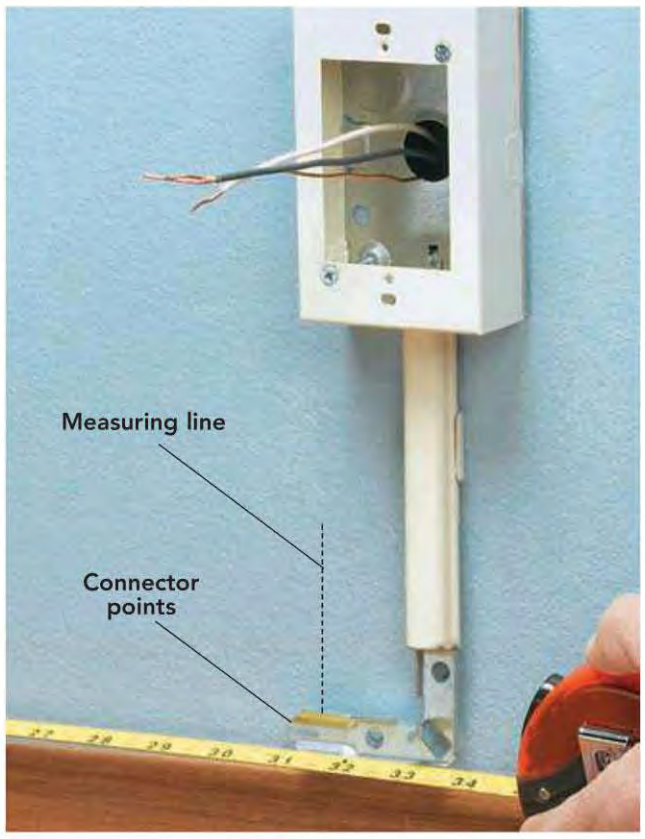
HERE'S HOW

Here's how to install wall anchors. Mark screw locations on the wall, then drill ¼" holes through the wall at the marks. Tap a plastic wall anchor into the hole with a hammer so the underside of the top flange is flush against the surface of the wall. When a screw is driven into the wall anchor sleeve, the sleeve will expand in the hole and hold the screw securely.

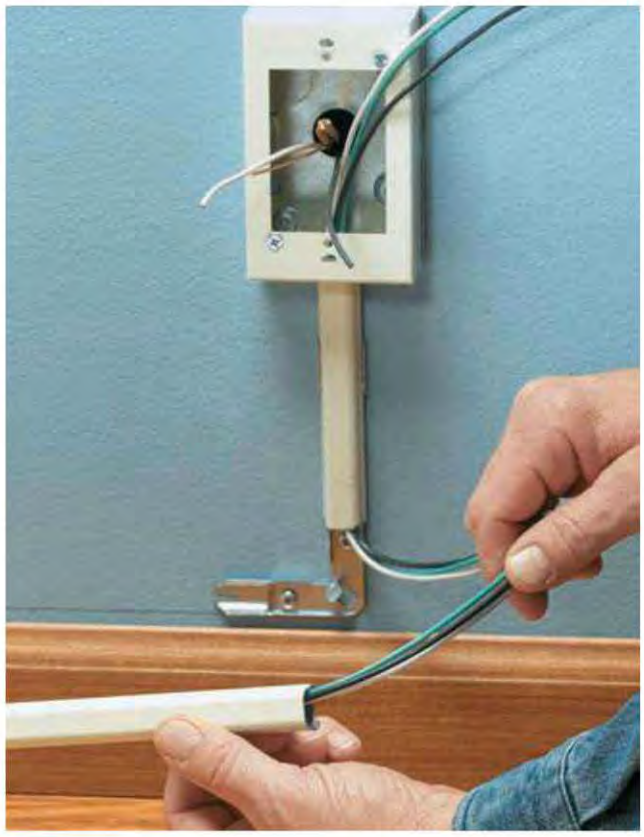
12 Install mounting clips ½" or so below the knockouts on both the starter box and the new receptacle box. The clips should line up with the knockouts.

13 At the starter box slide one end of the short piece of raceway into the knockout so that about ⅛" extends into the box. Snap the raceway into the clip below the knockout. Repeat this same procedure at the new receptacle box. Slip a bushing (included with installation kit) over the ends of the tracks where they enter the box.

14 The elbow piece will have two parts, a mounting plate and a cap. Install the mounting plates directly below the pieces of track entering the receptacle boxes.



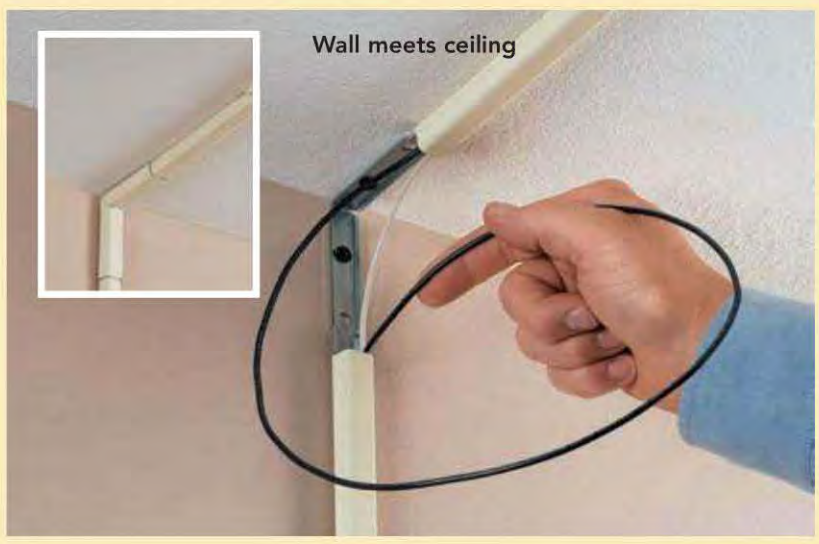
15 Now you can measure and cut the long piece of raceway that fits between the two receptacles. Measure the distance between the ends of the horizontal parts of the elbows, and cut a length of raceway to that length. Be sure to measure all the way to the base of the clip, not just to the tips of the connector points.



16 Cut black, white, and green THNN wire about 2-ft. longer than the length of each wiring run. Snake the end of each wire into the starter box, through the knockout, and into the vertical raceway. Then snake the wire all the way through the long piece of raceway so about 12" to 16" come out on each side.

WHAT IF...?

What if I need to go around a corner? Use corner pieces to guide raceway around corners. Corners are available for inside or outside corners and consist of a mounting plate and a cap piece. Inside corners may be used at wall/ceiling junctures.



WHAT IF...?

What if I need a piece of raceway track that's longer than the longest piece available at the hardware store (usually 5 ft.)?

You can use straight connector pieces to join two lengths of raceway. Much like an elbow piece, they have a mounting plate and a cover that snaps over the wiring.

18 Finish the raceway by snapping the elbow cover pieces into place over the mounting plates, one at the starter box and another at the new receptacle location. You may need to rap the plate with a rubber mallet to get enough force to snap it on. Make sure all of the wire fits completely within the cover pieces.

17 Now you can snap the long piece of raceway into the mounting clips. Line one end of the raceway up with the end of an elbow and begin pressing the raceway into the clips until it is snapped into all of the clips. At the new receptacle location, snake the ends of the wires up through the vertical piece of raceway and into the new receptacle box. There should be about 6" of wire coming out at each box.

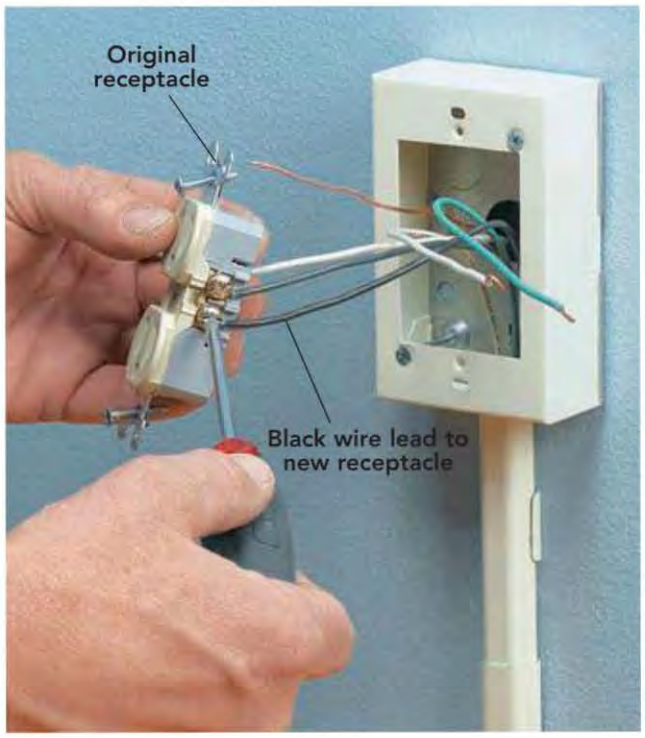
19 Now you can wire the receptacles. Begin at the new receptacle location. Take the black wire and wrap the end of the wire around the bottom gold screw on the side of the receptacle. Tighten the screw so it's snug.

20 Now take the white wire and wrap the end of the wire around the silver screw opposite the copper one you just used. Tighten the screw so it's snug. Connect the green wire to the green-colored screw on the bottom of the receptacle.

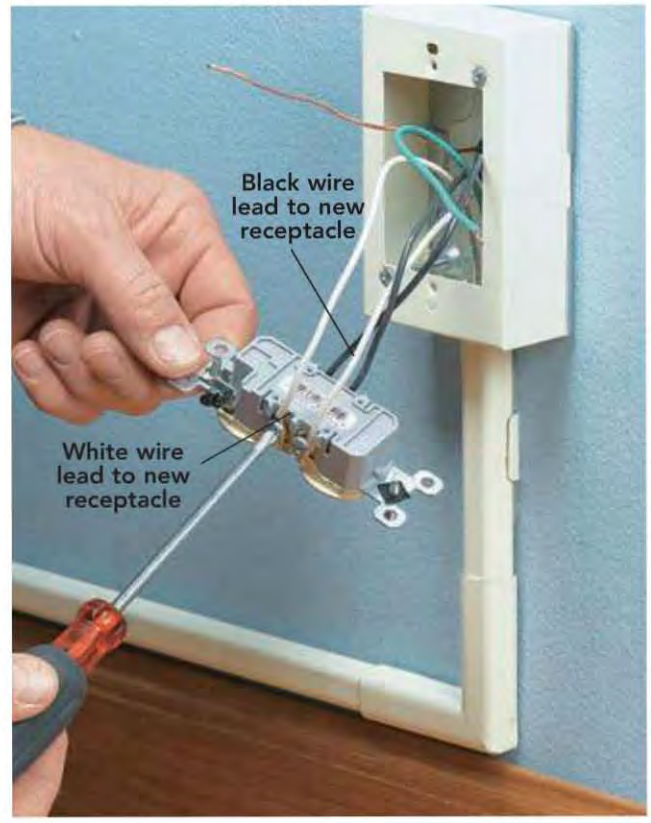
21 Once the connections are made, gently tuck the wires and the receptacle into the box so the holes in the top and bottom of the receptacle align with the holes in the box. Use a screwdriver to drive the two long mounting screws that hold the receptacle to the box. Attach the cover plate.

22 Now you can reinstall the old receptacle (or a replacement) at the starter box. First, make sure the power is still off with your voltage tester. Take the old black wire and wrap the end of the wire around the top gold screw on the side of the receptacle. Tighten the screw so it's snug.

23 Take the old white wire and wrap the end of the wire around the silver screw opposite the copper one you just used. Tighten the screw so it's snug.



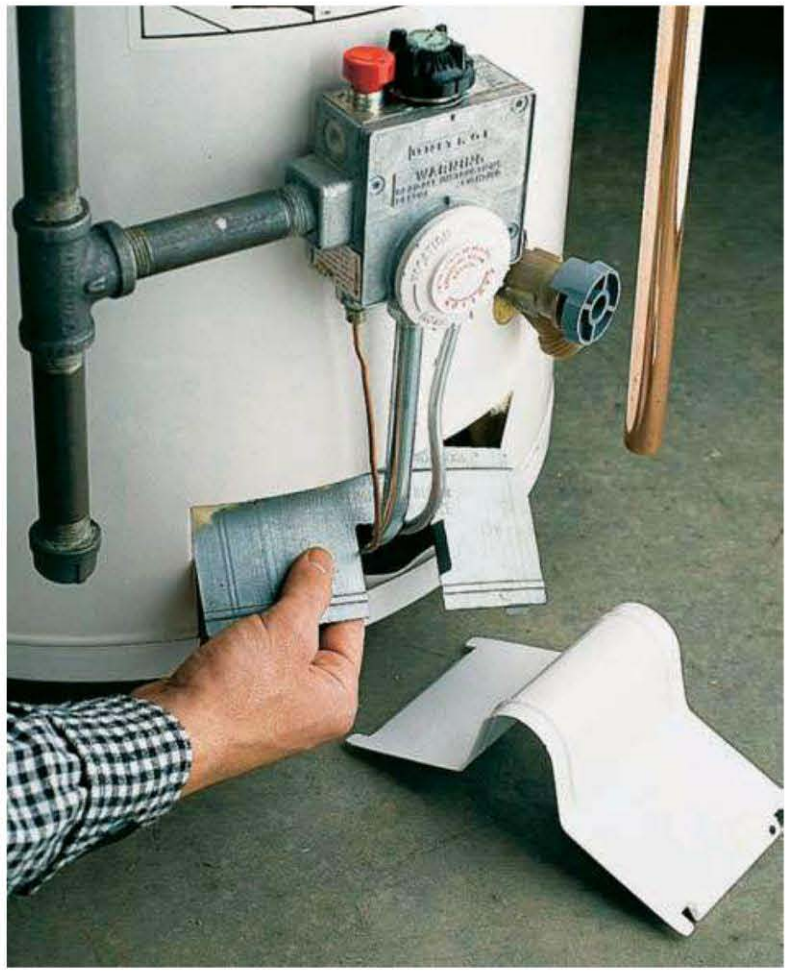
24 The next step connects the old receptacle to the new one. Take the black wire that goes into the raceway and wrap the end of the wire around the bottom gold screw on the side of the receptacle. Tighten the screw so it's snug.



25 Take the old white wire and wrap the end of the wire around the silver screw opposite the copper one you just used. Tighten the screw so it's snug.

26 Finally, cut a piece of green wire about 6" long and strip ¾" from both ends (this is called a pigtail wire). Join one end of the pigtail with the ends of the bare and green wires in the box, using a wire connector. Wrap the other end of the pigtail around the green screw on the receptacle. Tighten the screw until it's snug.

27 Once the connections are made, gently tuck the wires and the receptacle into the box so the holes in the top and bottom of the receptacle align with the holes in the box. Use a screwdriver to drive the two long mounting screws that hold the receptacle to the box. Install the coverplate. You can now restore the power and test your new receptacle.


WARNING

Plumbing

LET'S FACE IT, PLUMBERS SPEND A LOT OF TIME FISHING SOCKS OUT OF TOILETS AND REPLACING FIVE-CENT WASHERS ON DRIPPY FAUCETS. NOTHING WRONG WITH THAT, EXCEPT THEY CHARGE $100 AN HOUR AND PROMISE TO MEET YOU AT THE DOOR "OH, SOMETIME BETWEEN TEN AND THREE O'CLOCK." WE THINK YOU HAVE BETTER WAYS TO SPEND YOUR TIME AND MONEY.

In this section you'll find down-to-earth repairs and replacements—the kinds of projects that will keep the plumbing in your house running smoothly and looking good. Most important, they're doable.

IN THIS CHAPTER:

- ❑ Before You Begin
  - The Home Plumbing System
  - Water Supply System
  - Drain-Waste-Vent System
  - Plumbing Tools
  - Plumbing Materials
  - Evaluating Your Plumbing
- ❑ Shutting Off the Water
- ❑ Recovering Items from Drains
- ❑ Preventing Frozen Pipes
- ❑ Fixing Dripping Sink Faucets
- ❑ Adjusting Water Pressure
- ❑ Fixing Running Toilets
- ❑ Clearing Clogged Toilets
- ❑ Fixing Leaky Tubs & Showers
- ❑ Adjusting Bathtub or Shower Drainage
- ❑ Clearing Kitchen Sink Drains
- ❑ Fixing Leaky Sink Strainers
- ❑ Clearing Clogged Floor Drains
- ❑ Adding a Shower to a Tub
- ❑ Replacing Bathtub Spouts
- ❑ Replacing Widespread Bathroom Faucets
- ❑ Installing New Bathroom Faucets
- ❑ Replacing Kitchen Sprayers
- ❑ Repairing Burst Pipes
- ❑ Replacing Kitchen Faucets
- ❑ Replacing Pop-up Stoppers
- ❑ Replacing Toilets

Before You Begin: The Home Plumbing System

A TYPICAL HOME PLUMBING SYSTEM INCLUDES THREE BASIC PARTS: a water supply system, a fixture and appliance set, and a drain system. These three parts can be seen clearly in the photograph of the cut-away house on the opposite page.

Fresh water enters a home through a main supply line (1). This fresh water source is provided by either a municipal water company or a private underground well. If the source is a municipal supplier, the water passes through a meter (2) that registers the amount of water used. A family of four uses about 400 gallons of water each day.

Immediately after the main supply enters the house, a branch line splits off (3) and is joined to a water heater (4). From the water heater, a hot water line runs parallel to the cold water line to bring the water supply to fixtures and appliances throughout the house. Fixtures include sinks, bathtubs, showers, and laundry tubs. Appliances include water heaters, dishwashers, clothes washers, and water softeners. Toilets and exterior sillcocks are examples of fixtures that require only a cold water line.

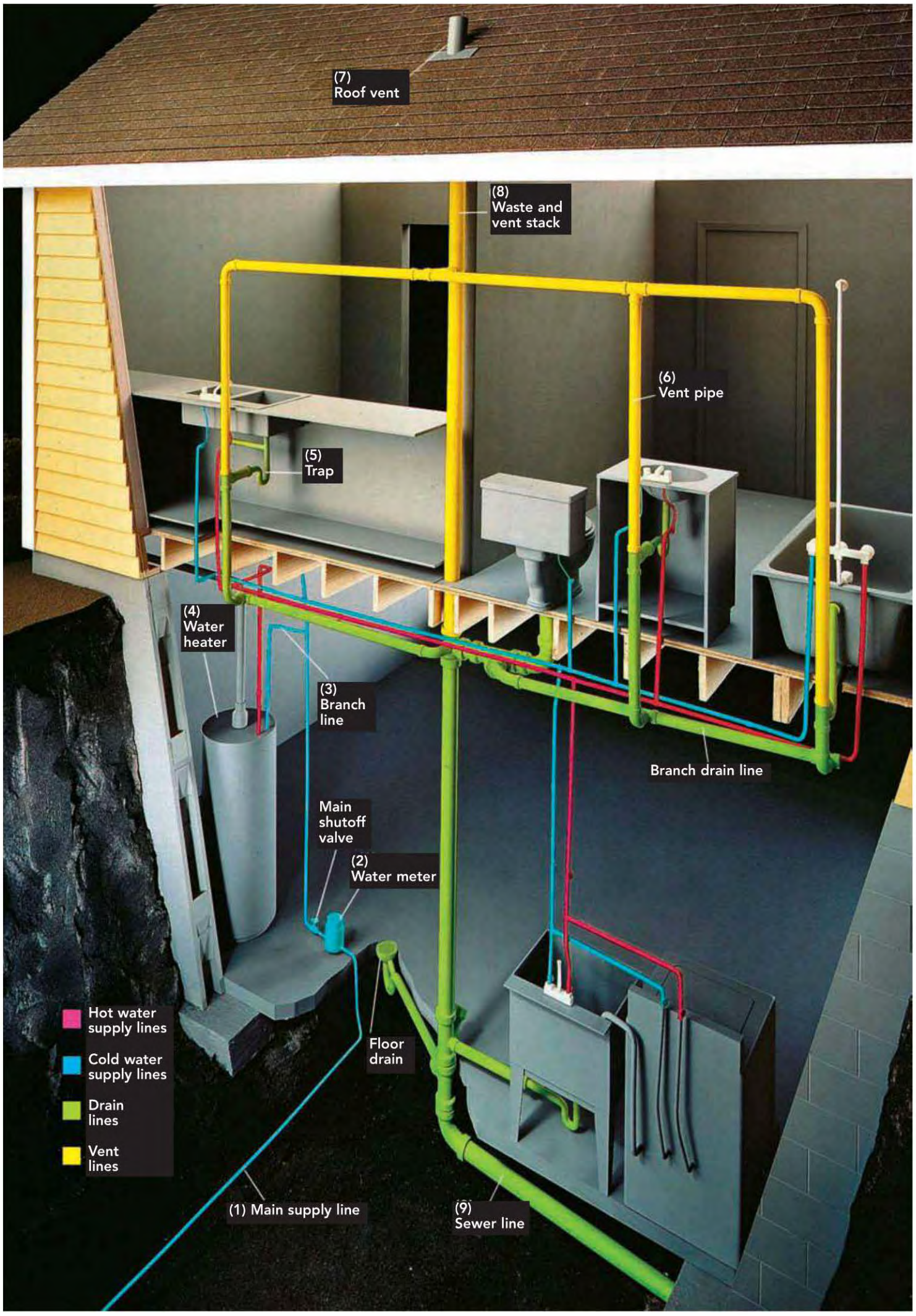
The water supply to fixtures and appliances is controlled with faucets and valves. Faucets and valves have moving parts and seals that eventually may wear out or break, but they are easily repaired or replaced.

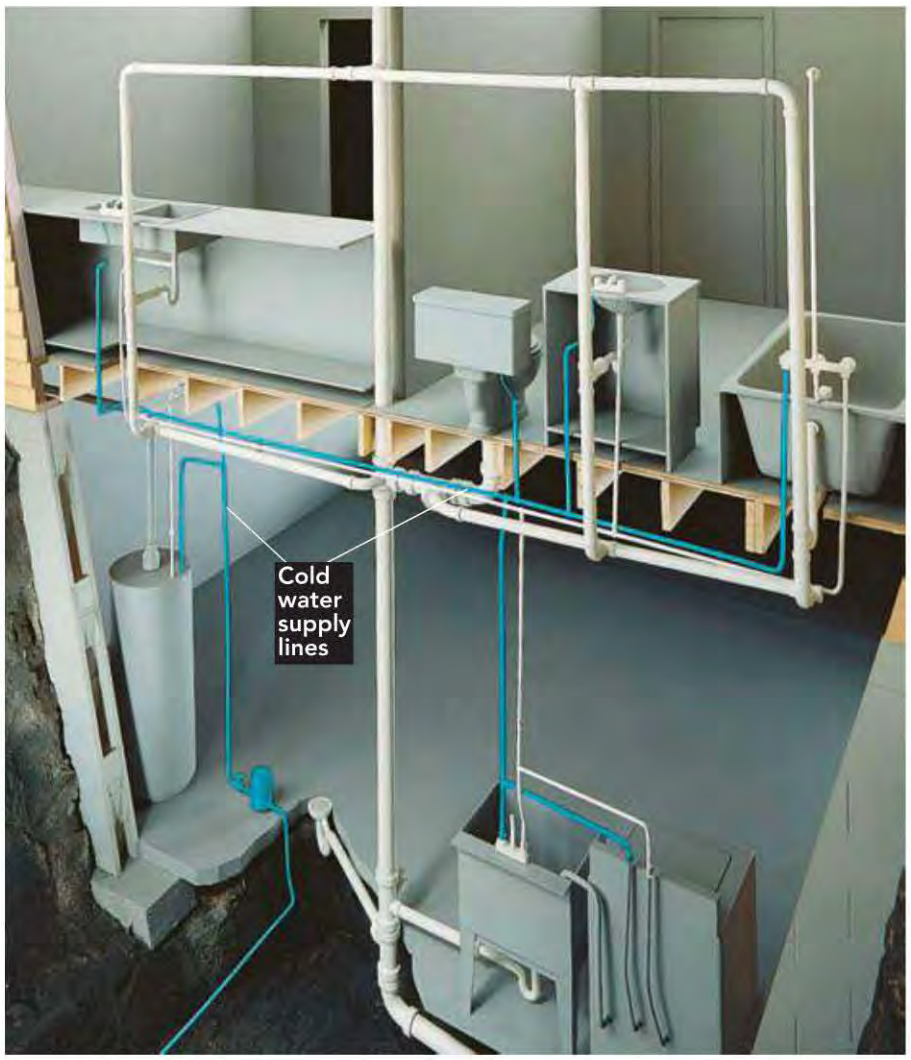
Waste water then enters the drain system. It first must flow past a trap (5), a U-shaped piece of pipe that holds standing water and prevents sewer gases from entering the home. Every fixture must have a drain trap.

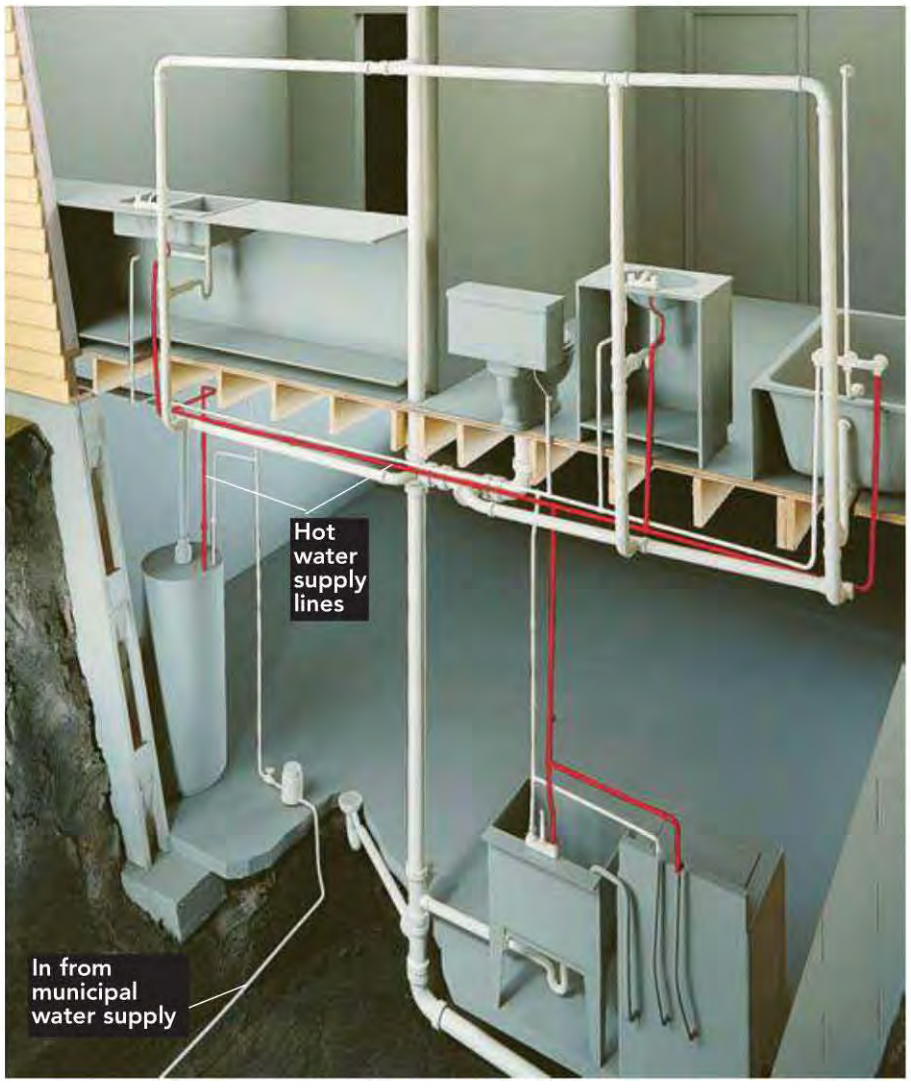
The drain system works entirely by gravity, allowing waste water to flow downhill through a series of large-diameter pipes. These drain pipes are attached to a system of vent pipes. Vent pipes (6) bring fresh air to the drain system, preventing suction that would slow or stop drain water from flowing freely. Vent pipes usually exit the house at a roof vent (7).

All waste water eventually reaches a main waste and vent stack (8). The main stack curves to become a sewer line (9) that exits the house near the foundation. In a municipal system, this sewer line joins a main sewer line located near the street. Where sewer service is not available, waste water empties into a septic system.

Water meter and main shutoff valves are located where the main water supply pipe enters the house. The water meter is the property of your local municipal water company. If the water meter leaks, or if you suspect it is not functioning properly, call your water company for repairs.


(7)
Roof vent
(8)
Waste and
vent stack
(6)
Vent pipe
(5)
Trap
(4)
Water
heater
(3)
Branch
line
Branch drain line
Main
shutoff
valve
(2)
Water meter
Hot water
supply lines
Cold water
supply lines
Drain
lines
Vent
lines
Floor
drain
(1) Main supply line
(9)
Sewer line



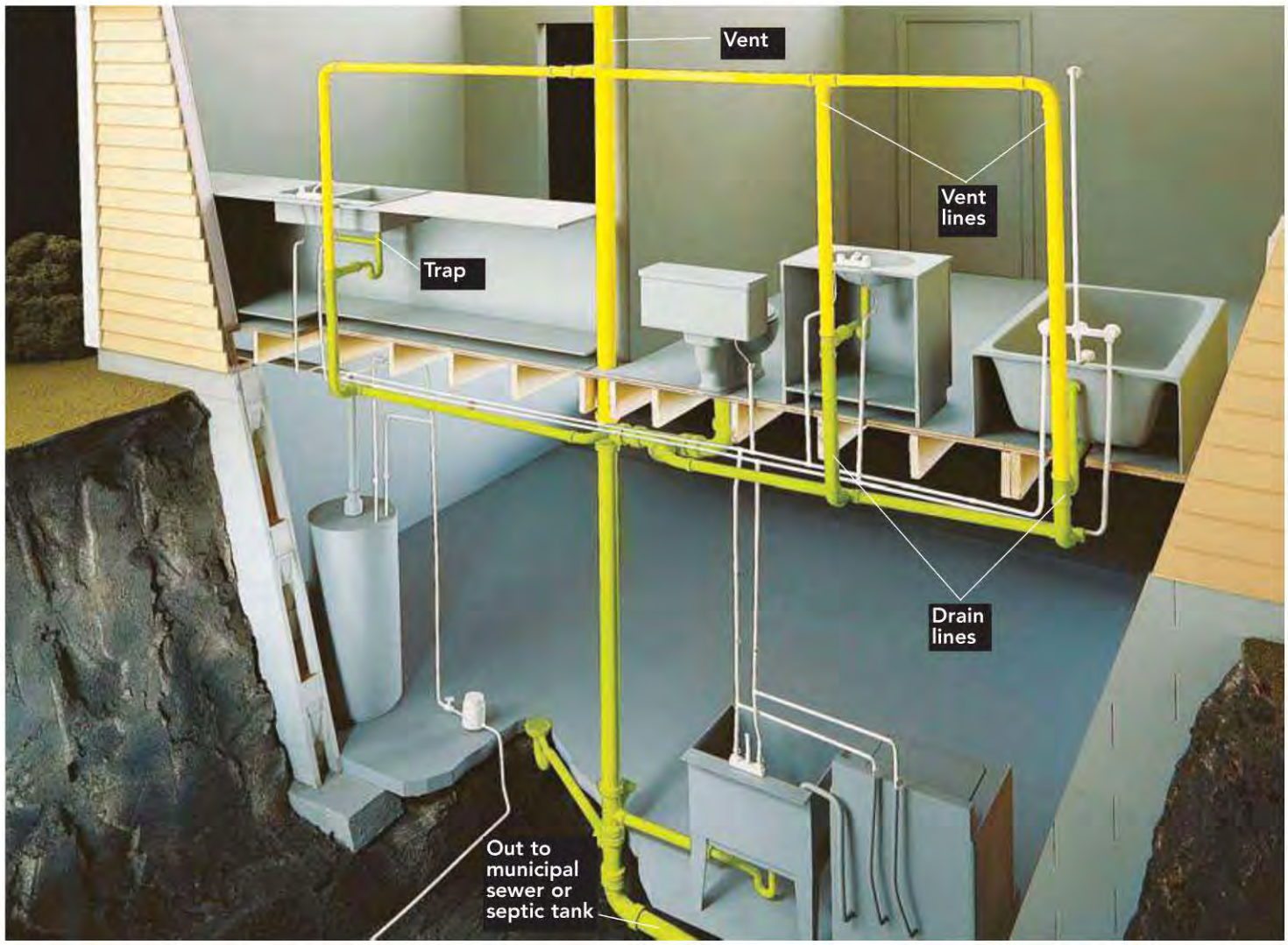


WATER SUPPLY SYSTEM

Water supply pipes carry hot and cold water throughout a house. In homes built before 1960, the original supply pipes are usually made of galvanized iron. Newer homes have supply pipes made of copper. In most areas of the country, supply pipes made of rigid plastic or PEX are accepted by local plumbing codes. Water supply pipes are made to withstand the high pressures of the water supply system. They have small diameters, usually ½" to ¾", and are joined with strong, watertight fittings. The hot and cold lines run in tandem to all parts of the house. Usually, the supply pipes run inside wall cavities or are strapped to the undersides of floor joists.

Hot and cold water supply pipes are connected to fixtures or appliances. Fixtures include sinks, tubs, and showers. Some fixtures, such as toilets or hose bibs, are supplied only by cold water. Appliances include dishwashers and clothes washers. Tradition says that hot water supply pipes and faucet handles are found on the left-hand side of a fixture, with cold water on the right.

Because it is pressurized, the water supply system is prone to leaks. This is especially true of galvanized iron pipe, which has limited resistance to corrosion.



DRAIN-WASTE-VENT SYSTEM

Drain pipes use gravity to carry waste water away from fixtures, appliances, and other drains. This waste water is carried out of the house to a municipal sewer system or septic tank.

Drain pipes are usually plastic or cast iron. In some older homes, drain pipes may be made of copper or lead. Because they are not part of the supply system, lead drain pipes pose no health hazard. However, lead pipes are no longer manufactured for home plumbing systems.

Drain pipes have diameters ranging from 1½" to 4". These large diameters allow waste water to pass through easily.

Traps are an important part of the drain system. These curved sections of drain pipe hold standing water, and they are usually found near any drain opening. The standing water of a trap prevents sewer gases from backing up into the home. Each time a drain is used, the standing trap water is flushed away and is replaced by new water.

In order to work properly, the drain system requires air. Air allows waste water to flow freely down drain pipes.

To allow air into the drain system, drain pipes are connected to vent pipes. All drain systems must include vents, and the entire system is called the drain-waste-vent (DWV) system. One or more vent stacks, located on the roof, provide the air needed for the DWV system to work.

Before You Begin: Plumbing Tools

Files are used to smooth the edges of metal, wood, or plastic. The round file (top) can be used to remove burrs from the insides of pipes. The flat file is used for all general smoothing tasks.

Screwdrivers include the two most common types: the slotted (top), and the Phillips.

Adjustable wrench has a movable jaw that permits the wrench to fit a wide variety of bolt heads or nuts.

Channel-type pliers has a movable handle that allows the jaws to be adjusted for wide or narrow fittings. The insides of the jaws are serrated to prevent slipping.

Needlenose pliers has thin jaws for gripping small objects or for reaching into confined areas.

Putty knife is especially helpful for scraping away old putty or caulk from appliances and fixtures.

Ball peen hammer is made for striking metallic objects, like a cold chisel. The head of a ball peen hammer is made to resist chipping.

Wooden mallet is used for striking nonmetallic objects, such as plastic drywall anchors.

Level is used to set new fixtures and check drainline slope.

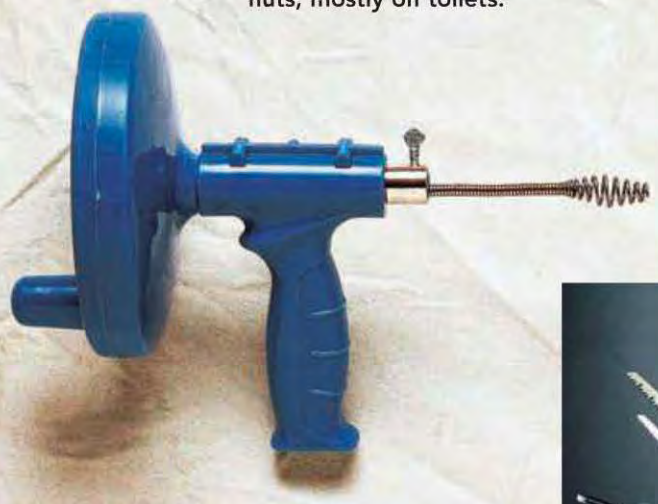
Tape measure should have a retractable steel blade at least 16 feet long.

Pipe wrenches have a movable jaw that adjusts to fit a variety of pipe diameters. They can be rented.

Closet auger is used to clear toilet clogs. A bend in the tube allows the auger to be positioned in the bottom of the toilet bowl. The bend is usually protected with a rubber sleeve to prevent scratching the toilet.

Spud wrench is specially designed for removing or tightening large nuts, mostly on toilets.

Plunger clears drain clogs with water and air pressure. A flanged plunger used to clear toilet traps is shown here (the flap is folded up for clearing sink and shower lines).



Hand auger, sometimes called a snake, is used to clear clogs in drain lines. A long, flexible steel cable is stored in the disk-shaped crank. A pistol-grip handle allows the user to apply steady pressure on the cable.

Useful power tools include a cordless screwdriver, reciprocating saw, and drill/driver.

PLUMBING MATERIALS

Check local plumbing code for materials allowed in your area. Common pipe types include:

A) Cast iron for main drain stack

B) ABS drain pipe (no longer allowed)

C) PVC drain pipe

D) Chromed brass fixture drain pipe

E) CPVC supply pipe

F) Galvanized supply pipe (seldom used)

G) Rigid copper supply tube

H) Chromed copper fixture supply pipe

I) PE plastic supply tube (mostly used in irrigation)

J) Flexible copper supply tube

K) PEX (cross-linked polyethylene) flexible supply line

Before You Begin: Evaluating Your Plumbing

You don't have to possess the knowledge and experience of a journeyman plumber to do some basic evaluations of your plumbing system. Taking a few moments to examine the system helps you learn which parts are which and identify any parts of your system that may be in disrepair or hold the potential for future problems.

Fixture Units	Minimum Gallons per Minute (GPM)
10	8
15	11
20	14
25	17
30	20

The tips on the next page offer a bit of guidance on how to be a home plumbing sleuth. By following them you can quickly and accurately identify cold and hot supply lines, drain lines, the water main, and shutoff valve locations. And the tips below will help you test your water supply capacity to find out if the pressure and volume are adequate to meet your water needs.

Minimum recommended water capacity is based on total demand on the system, as measured by fixture units, a standard of measurement assigned by the plumbing code. First, add up the total units of all the fixtures in your plumbing system (see chart above). Then, perform the water supply capacity test described below. Finally, compare your water capacity with the recommended minimums listed above. If it falls below that recommended GPM, then the main water supply pipe running from the city water main to your home is inadequate and should be replaced with a larger pipe by a licensed contractor.

HOW TO DETERMINE YOUR WATER SUPPLY CAPACITY

1 Shut off the water at the valve on your main water meter, run a faucet on every floor to empty the supply lines, and then disconnect the pipe on the house side of the meter. You can do this by counter-rotating the large nuts on the line with two pipe wrenches (you can rent these if you don't want to invest in a pair).

2 Make a downspout like the one seen above from 2" PVC pipe sections and position it over the water line to direct water down into a garbage can. Open the main supply valve and let the water run for 30 seconds. Shut off the water, then measure the water in the container by bailing with a 1-gallon container. Multiply this figure by two to find your water capacity in gallons per minute (GPM).

HOW TO INSPECT YOUR PLUMBING

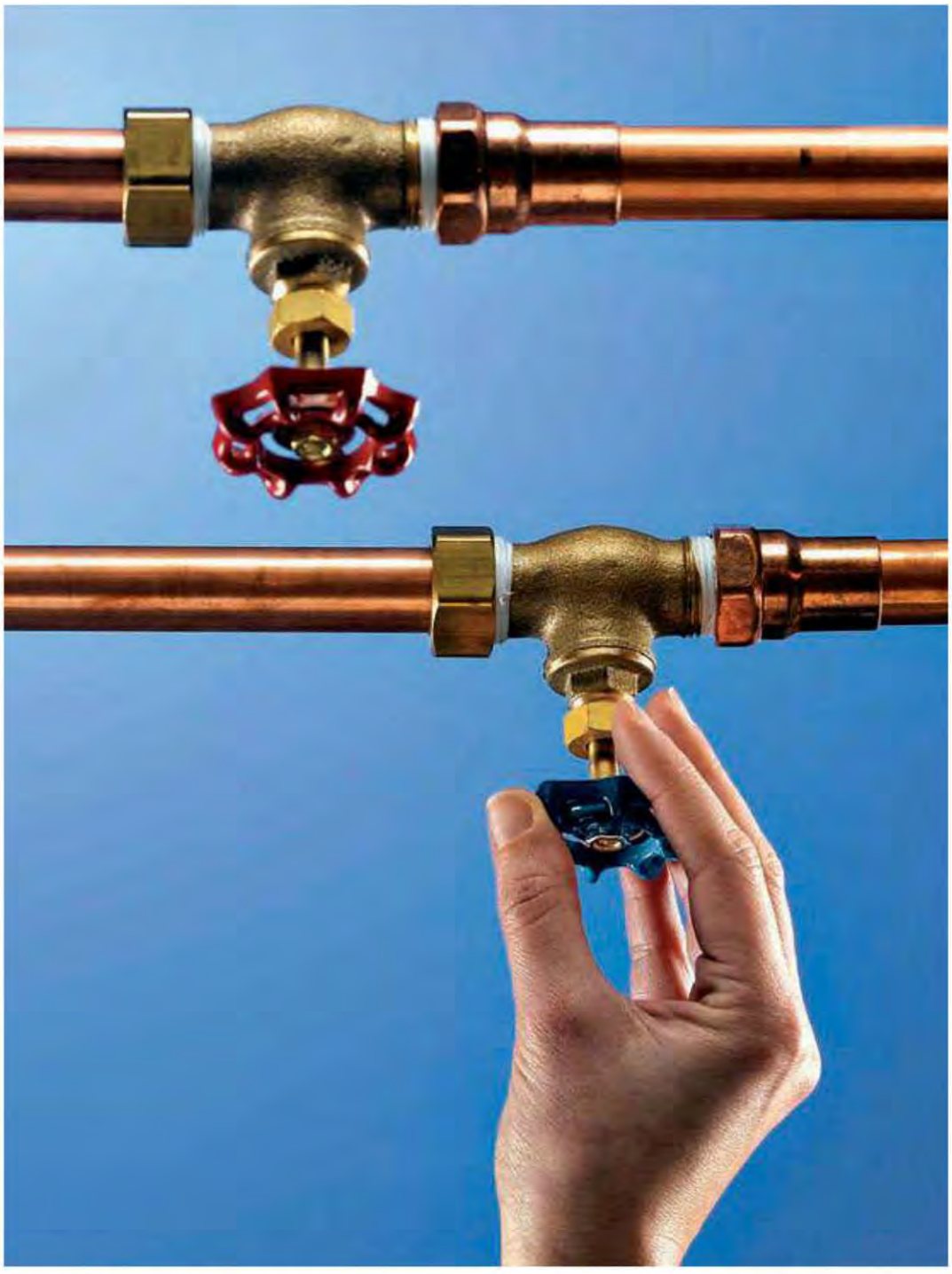
There are two basic kinds of pipes in a plumbing system: supply pipes and drain pipes. Supply pipes are always full of water under pressure and drain pipes (which include vent pipes that only move air) are empty when not in use. Supply pipes usually are ½" or ¾" in diameter and drain pipes are anywhere from 1½" to 4" or more. The largest drain pipes are the main drain stack (multi-level houses) and horizontal house drains fed by branch lines.

Trace hot water pipes from the water heater (the outlet side will be labeled "Hot" on the appliance). Hot supply lines will be hot to the touch when the fixture they connect to is in use.

In your basement, branch drain lines run horizontally at a very low slope and ultimately feed into the main drain stack or house drain. They enter the basement through the floor, usually directly under walls. Look for moisture or discoloration around joints. On copper supply lines, visually inspect the soldered joints for pinholes or other signs of deterioration.

To identify which supply pipes feed which fixture, you can sometimes measure from the fixture to a heating register. Then, locate the ductwork directly below the register and measure out from it and look for supply lines.

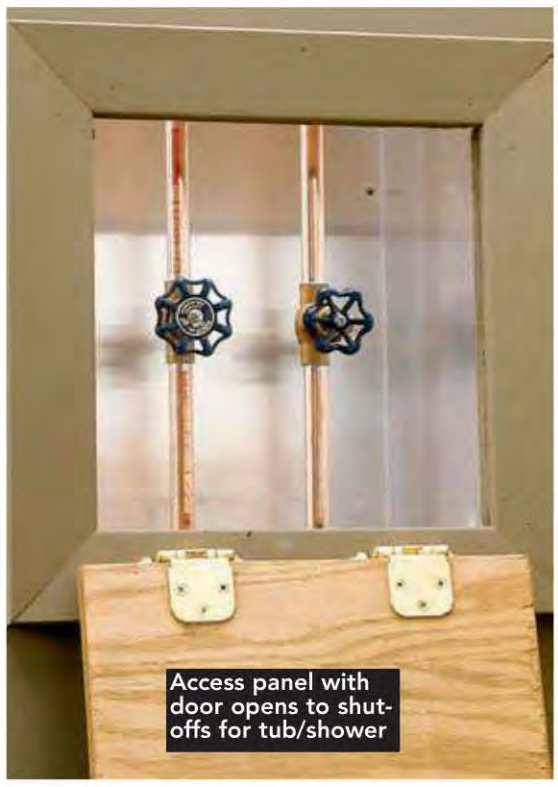
1 Shutting Off the Water



Just as the first step in any wiring project is to shut off the power at the main service panel, most plumbing projects begin with shutting off the water supply at one of the shutoff valves in the plumbing system.

USUALLY THERE ARE TWO OR THREE WAYS TO TURN OFF THE WATER. First, try to close the stop valves at the fixture or appliance that's broken. If these are damaged or absent, turn off the water at intermediate shutoff valves that control the hot and cold water to the part of the house with the problem. The whole hot water system usually can be turned off near the hot water heater. Finally, you can stop the water to the entire house at a main shutoff located near the water meter. As a last resort, your municipal water works can shut off your water before it gets to your house. If you have a well, find the shutoff on the pipe between the pressure tank and the rest of your plumbing.

WATER STOP VALVES 101



Water stop valves and shutoff valves function much like faucets, except most of them are left open all the time. Unfortunately, valves used on potable water (water for drinking and cooking) lines may be similar to valves used on natural gas lines, heating oil pipes, and hot water heating pipes. Finding the valves you need may require some careful tracing of pipes from a fixture back to the water meter. The photos here show common water shutoff valves.

TERMS YOU NEED TO KNOW

VALVE— any device that regulates the flow of fluids or gases through a pipe.

STOP VALVE—a valve used to stop hot or cold water to a single faucet, toilet, or appliance.

INTERMEDIATE SHUTOFF VALVE—a valve on a pipe used to stop hot or cold water to part of a house or building; often a gate valve or globe valve.

HOT WATER SHUTOFF VALVE—a valve that shuts off cold water supply to the hot water tank.

MAIN SHUTOFF VALVE—a valve that shuts off all the water to a house or building.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

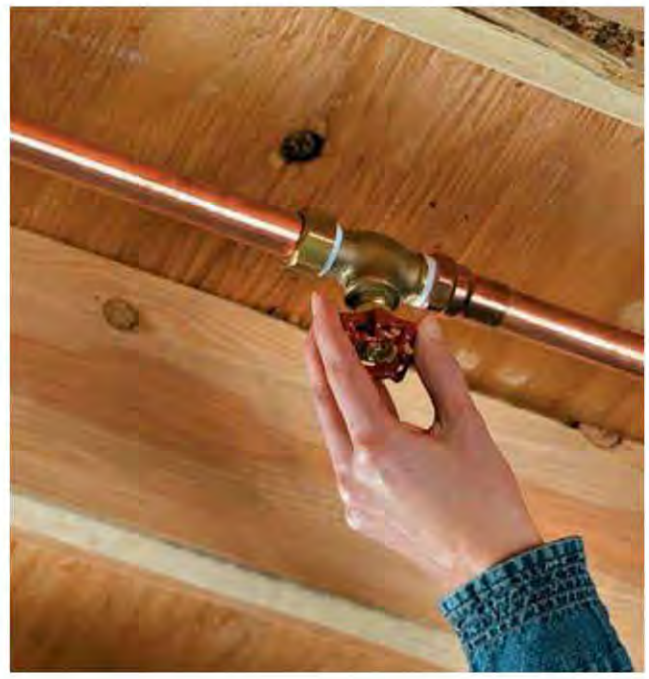
- Using locking pliers
- Loosening stuck valve handles

DIFFICULTY LEVEL

Time: A few minutes to ½ hour

HOW TO SHUT OFF HOT AND COLD WATER

1 Try to shut off the water locally first. Toilets and sinks usually have stop valves under them. Tubs and showers may have hot and cold shutoffs on the faucet itself or through a wall access panel in a room adjoining the bathroom. Washing machines are connected to shutoff valves with hot and cold supply hoses. Dishwashers sometimes share a two-outlet shutoff with the hot water supply tube for the kitchen faucet.



2 If you can't locate or operate the stop valve, look for intermediate shutoffs that control multiple fixtures in a supply line. Finding the right intermediate shutoff(s) can require trial and error and detective work. Hot water pipes will always lead back to a hot water heater and cold water pipes will lead back to a water meter (below) or a well pressure tank.

3 The hot water shutoff is located at or near the water heater and lets you turn off all the hot water in the house. There will usually be a valve on the pipe supplying cold water to the heater, and there may also be a valve on the outgoing pipe from the heater. If your water is heated by gas, do not be confused by the gas pipe and gas shutoff. The gas pipe leads to the thermostat at the bottom of the water heater.

4 The main water shutoff will be located near the water meter, generally found in your basement. Do not confuse it with the gas meter shutoff, which has a disc shaped device associated with it and generally turns off with a wrench or lever, rather than by hand-spinning. In an emergency, your municipal water works may be contacted to shut off the water with a key (a special wrench) between the public water main on the street and your house. NOTE: Some municipal water works do not meter water use.

WHAT IF...?

What if the valve is stuck?

1 Stop valves and shutoff valves may become fused by corrosion if they are not used regularly. If your valve won't operate, rap lightly on the valve body with a wrench handle or hammer and try again to turn the handle clockwise.

2 If rapping the valve doesn't work, try loosening the packing nut with your adjustable wrench until it leaks just a little bit of water. Then, retighten the nut and try the handle again.

3 If the valve handle won't turn the stem, remove it so you can grip the valve stem directly. Start by unscrewing the screw that secures the handle to the valve. Remove the screw and the handle.

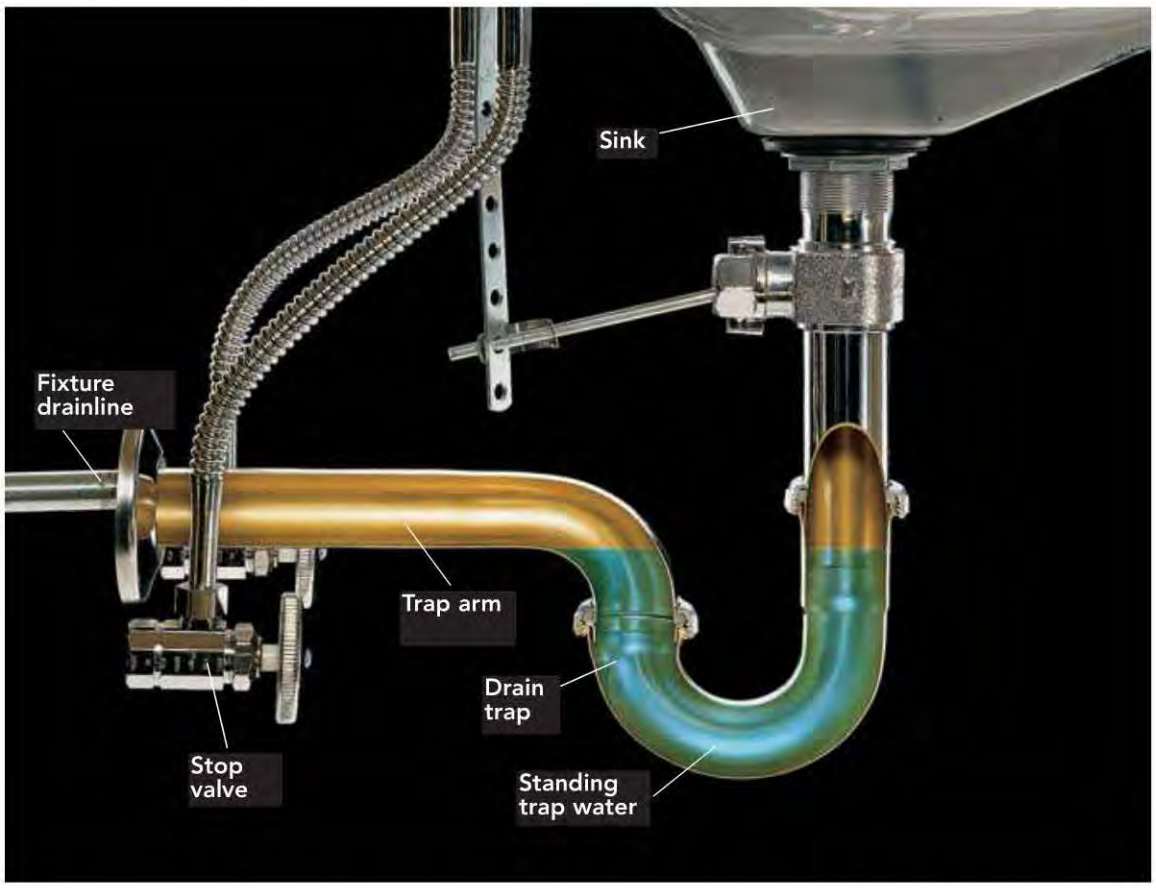
4 Grip the end of the handle stem with channel-type pliers or locking pliers and twist clockwise. Don't overdo it; you can break the valve and create a flood.

2 Recovering Items from Drains

Your wedding ring fell down the drain? Don't panic yet. Chances are good that the P-trap caught it.

EVERY PLUMBING FIXTURE IN YOUR HOUSE HAS A TRAP—a downward facing drainage loop that can collect small, heavy items (like wedding rings) that accidentally fall into the drain. The main function of a trap is not to catch rings, but to hold water. The water in a trap acts as a plug to keep sewer gases from rising into the house. Sink traps are located beneath the sink basin. Bathtub and shower traps are located near the drain and are sometimes accessible through a panel in an adjoining room. A toilet trap is an integral part of the fixture—the front part of the trap is the bowl itself. You can fish out an object from a toilet trap with coat-hanger wire since the bend only goes back a little way from the visible side before bending up again. But if an object is swept out of a trap, it has embarked on a journey through the sewer system, and you may be out of luck.

TRAPS 101



A *drain trap* is a section of pipe attached near the top of a *fixture drain* that loops downward and then upward again. This creates a "trap" for water that blocks sewer gases from rising up though your drainlines and out the drain opening of a *fixture*. It also creates a blockage point for debris and a catch basin for small objects that find their way into the drain opening. Traps are designed to be easy to take apart for cleaning or retrieval.

TERMS YOU NEED TO KNOW

TRAP—downward bend in a drain in or near a fixture that can catch small objects. The standing water in a trap keeps sewer gases from rising into the house.

S-TRAP—The S-shaped trap is an older design used when the waste pipe comes out of the floor.

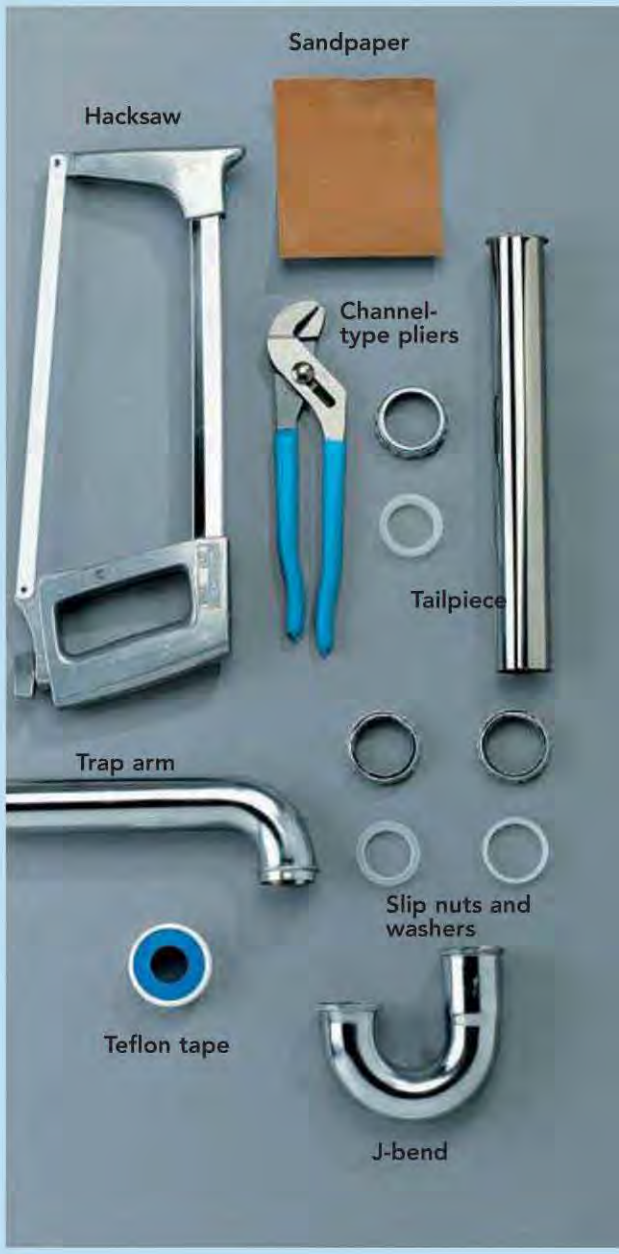
P-TRAP—Modern sink, tub, and shower traps are shaped like a P tipped on its face.

J-BEND—also called a "drain bend" or simply a "trap", this is the part that forms the low bend on a P-Trap or S-Trap.

TRAP ARM—also called a "wall tube," this extends from the J-bend to the trap adapter at the wall on a P-trap.

TRAP ADAPTER—also called a "drain pipe connector," this is a common transition fitting that lets you attach a light gauge chromed-brass or plastic trap arm to the larger heavy-gauge waste pipe coming out of the wall. It uses a washer and slip nut.

TOOLS & SUPPLIES YOU'LL NEED



SKILLS YOU'LL NEED

- Unscrewing and retightening compression-style slip joints

DIFFICULTY LEVEL

Time: ½ hour to 1 hour

REMOVING AND REPLACING SINK TRAP COMPONENTS

1 Before removing a sink trap, place a bucket under the trap to catch water that spills out. Loosen the slip nut at one end of the trap (a P-trap is seen here). Use channel-type pliers if the nut won't unscrew by hand.

2 Loosen the slip nut on the other end of the trap and pull both nuts away from the union. You will find a compression washer at each union. Slide these back as well and remove the trap by pulling down on it.

3 Keep track of slip nuts and washers and note their up/down orientation. Clean out debris within the trap and examine it. If the trap or the slip nuts and washers are in poor repair (very common), purchase replacement parts, making sure they are made from the same material and are the same size as the rest of the trap.

4 Reassemble the trap pieces just as they came off, or follow instructions on replacement parts. If the trap is made of plastic, hand tighten only. Wrap Teflon tape onto the male threads of metal tubes and then tighten a quarter turn beyond hand tight with channel-type pliers. Tighten joints that leak.

WHAT IF...?

What if your trap looks like this?

Some sink, tub, and shower traps are made out of the same heavy plastic (Schedule 40 PVC) or metal as the rest of your DWV plumbing and do not fit together like light plastic or chromed drain traps. But even if some parts are permanently fused together by a process called solvent-welding (these typically have a tell-tale purple band of color around the joint) you may still be able to access the trap by untwisting a union. Threaded joints are a sign that you've got a removable trap.

To access the trap, simply unscrew the joint fittings as on the previous page. Unlike a tubular trap, the nut at the DWV trap arm union unscrews counterclockwise from below. That's because the nut faces up instead of down. The slip nut on the fixture side of the trap is loosened like that of a tubular trap.

WHAT IF...?

What if my trap is permanently solvent-welded to the drain and trap arm?

Often, bathtubs or showers have a drain trap system that is completely solvent-welded together, making it impossible to disassemble without cutting the pipes. But if you're lucky, the trap will have a cleanout plug at the bottom, like the one above.

The cleanout plug can be removed to clear the trap and retrieve lost items. Try hand-loosening the plug first, although unless your plumbing is virtually brand new you'll probably need an adjustable wrench to remove the plug. Fair warning—your hand is very likely to be drenched with fairly disgusting drain water, but hopefully, it will be worth it.

3 Preventing Frozen Pipes

Spending a little time and money on protecting your water pipes from freezing is one of the best investments a homeowner can make.

BURST FREEZING PIPES lead to about a quarter million families suffering catastrophic water damage to their houses each year. That's the big picture. The small picture works like this: A section of one of your hot or cold water pipes is exposed to below freezing temperatures. You don't use the water in that pipe during the time it takes for an ice plug to develop. As the ice plug grows, it compresses the water between the plug and the faucet(s) at the end of that line. The pressure becomes extreme and bursts the pipe, sometimes in an area away from the ice plug. The plug thaws. Water spews out of the crack, irreparably damaging walls, floors and your possessions. Another scenario goes like this: You take immediate action to thaw and relieve pressure on frozen pipes and then take short- and long-term steps to prevent refreezing. We'll give you pointers here.

FREEZE-PROOFING 101

Paintable acrylic caulk is good for sealing small gaps, especially in areas where appearance is important. Pipe insulation products include narrow strips of *fiberglass*, *foam insulation tubes* sized to fit common pipe sizes, and *pre-formed valve covers* for protecting outdoor faucets (hose bibs). *Foil tape* may be used to secure and seal pipe insulation products. *Thermostatically controlled heat cables* prevent pipes that are exposed to long periods of below freezing temperatures from freezing. Expanding foam (not shown here) is effective for stopping large cold air leaks, although it can be unsightly.

HOW TO THAW PIPES

Open the faucet affected by the frozen pipes. Beginning at the faucet, use a hair dryer to warm the pipe, working back toward the likely area of the freeze. Leave water on until full flow is restored, then take steps to prevent refreezing. If the pipe has burst, see pages 218 to 221. WARNING: Never use an open flame to thaw pipes.

TERMS YOU NEED TO KNOW

CPVC—This is a kind of plastic water pipe that's incompatible with some kinds of foam insulation (which cause it to soften) and needs to be protected with foil if heat tape is used.

THERMAL ENVELOPE—is the sometimes-murky boundary that divides heated from unheated space. Inside spaces that may be outside the thermal envelope include crawl spaces, attics, garages, basements, and three-season rooms. Pipes that may need your attention are those near or outside the thermal envelope.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Investigative skills
- Cutting and fitting

DIFFICULTY LEVEL

Time: variable

HOW TO FROST-PROOF YOUR PLUMBING

OUTDOOR FAUCETS. Remove hoses from all outside faucets when freezing weather approaches. Shut off the water to the faucet at the shutoff valve inside. Drain the pipe from the shut off to the spout by opening a waste nut on the shutoff and the outside faucet itself.

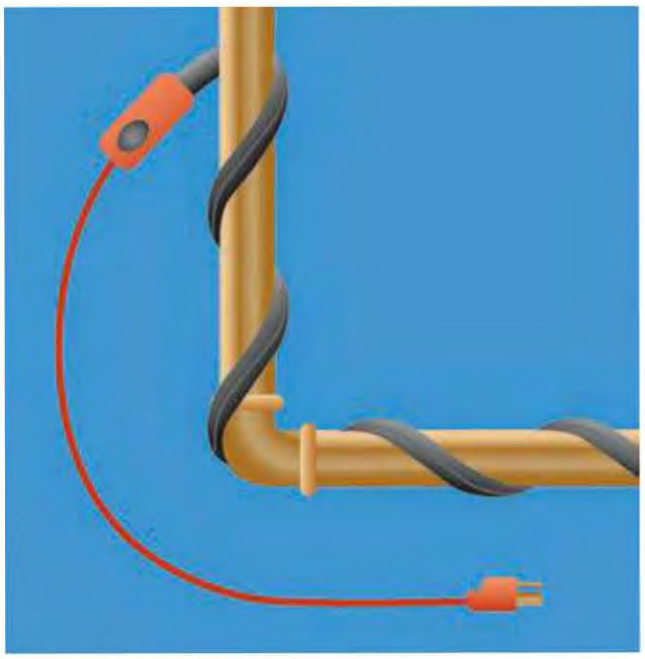
IMMINENT DANGER OF FREEZING. Leave vulnerable lines open to a fast drip if you suspect any of your supply pipes may be in imminent danger of freezing. Even slowly moving water will not freeze. This may not be water and energy efficient (although if you're around, you can collect water in a bucket), but it gives you time to come up with a permanent solution.

PIPES NEAR EXTERIOR WALLS. Permit air to circulate from the heated interior of the house to plumbing near outside walls. This could mean opening the dishwasher door and service panel, sink cabinet doors, and plumbed rooms that aren't heated directly. WARNING: Inappropriate warming of pipes is a major cause of house fires.

AIR LEAKS NEAR PIPES. Seal gaps that can jet cold air onto pipes. Use caulk for small gaps and expanding foam or fiberglass for large gaps. WARNING: Expanding foam expands more than you think it will and cures to an unsightly rust color when exposed to sun.

INSULATE SUPPLY PIPES. Insulate pipes that pass through unavoidably cold spaces like crawl spaces and attics. Measure a pipe's diameter by closing an adjustable wrench on it and then measuring the span of the wrench jaws. Measure the length of pipes to be insulated so you know how many linear feet of insulation to buy. Buy self-sealing side-slit foam tubes for pipes of your diameter(s). Cut double 45-degree notches with a scissors to turn corners (inset photo). Seal all slits and joints that are not self-adhering with foil tape.

PIPE UNIONS. For irregular and jointed pipes, use fiberglass strip insulation secured with foil tape. Wind the insulation in an overlapping spiral. The tape should not compress the fiberglass too tightly and should form a continuous vapor seal to prevent condensation on the pipes in the summer.



PIPES EXPOSED TO BELOW FREEZING TEMPERATURES for long periods will freeze, insulated or not. Wrap your most vulnerable pipes with U.L. approved thermostatically controlled heat cables according to manufacturer instructions. In the long run, these pipes should be moved to a more protected location or the thermal envelope should be extended to include the pipes.

WHILE YOU'RE AWAY. Don't set the thermostat below 55 degrees F, and have somebody who knows how to shut off the water check on the house daily.

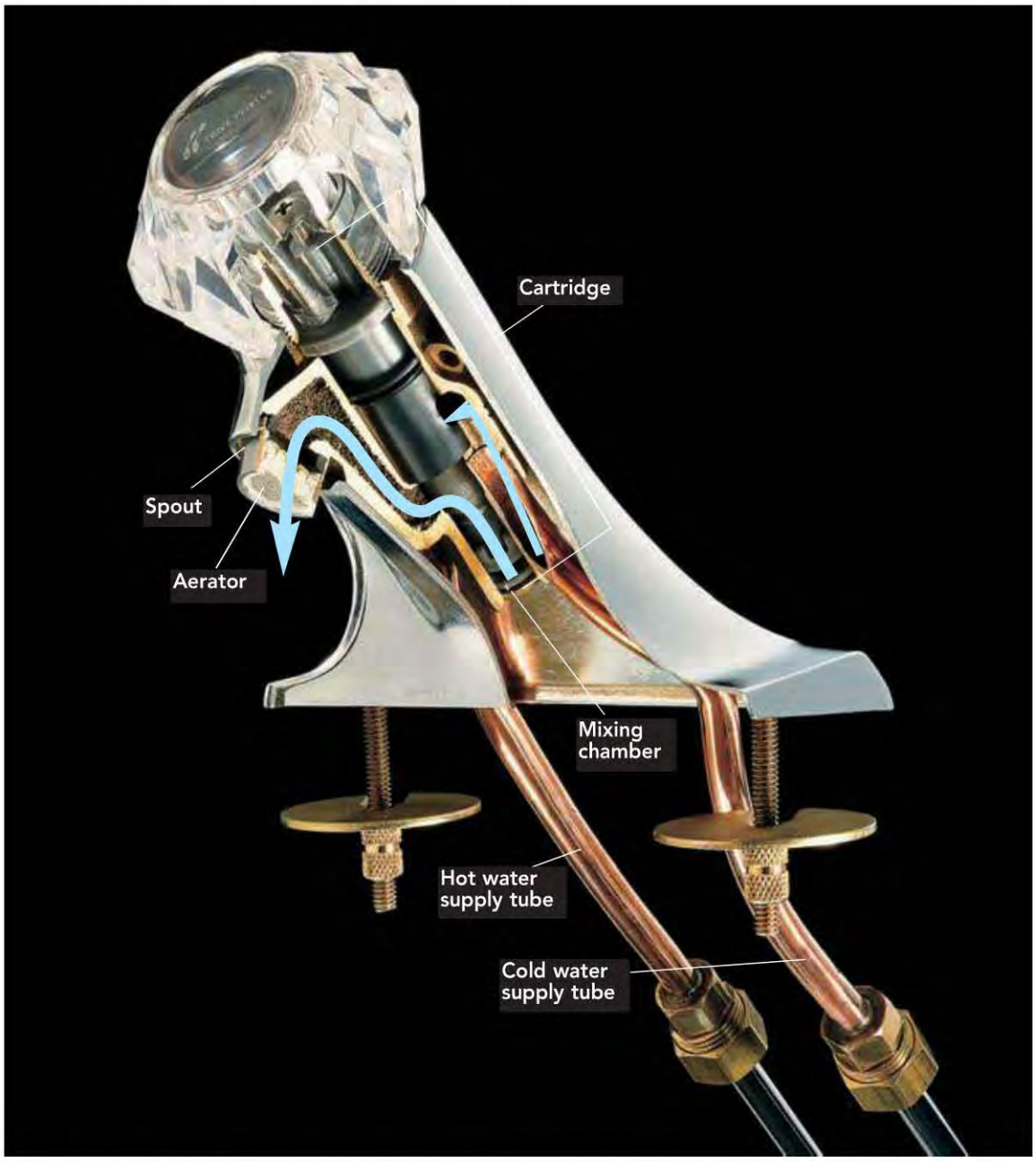
4 Fixing Dripping Sink Faucets

Eventually, just about every faucet develops leaks and drips. Repairs can usually be accomplished simply by replacing the mechanical parts inside the faucet body (the main trick is figuring our which kind of parts your faucet has).

IT'S NOT SURPRISING THAT SINK FAUCETS LEAK AND DRIP. Any fitting that contains moving mechanical parts is susceptible to failure. But add to the equation the persistent force of water pressure working against the parts, and the real surprise is that faucets don't fail more quickly or often. It would be a bit unfair to say that the inner workings of a faucet are regarded as disposable by manufacturers, but it is safe to say that these parts have become more easy to remove and replace.

The most important aspect of sink faucet repair is identifying which type of faucet you own. In this chapter we show all of the common types and provide instructions on repairing them. In every case, the easiest and most reliable repair method is to purchase a replacement kit with brand new internal working parts for the model and brand of faucet you own.

SINK FAUCETS 101



Almost all leaks are caused by malfunctioning faucet valve mechanisms. Whether your sink faucet is a one-handle cartridge type (above) or a two-handle compression type or anything in between, the solution to fixing the leak is to clean or replace the parts that seal off the hot and cold water inlets from the spout.

TERMS YOU NEED TO KNOW

COMPRESSION VALVE—a valve type in which a spindle moves a washer up and down to stop or allow water flow through a valve seat.

CARTRIDGE VALVE—a valve type containing a cartridge, usually made of plastic or plastic and metal, in which a channel is slid open and closed by rotating a handle (see the example above).

NEOPRENE—a rubber-like, usually black material from which washers, rings, gaskets, and other seal-forming valve parts are made.

TELEPHONE—an invaluable tool used to contact your faucet's manufacturer, a font of information specific to the repair of your particular faucet.

TOOLS & SUPPLIES YOU'LL NEED

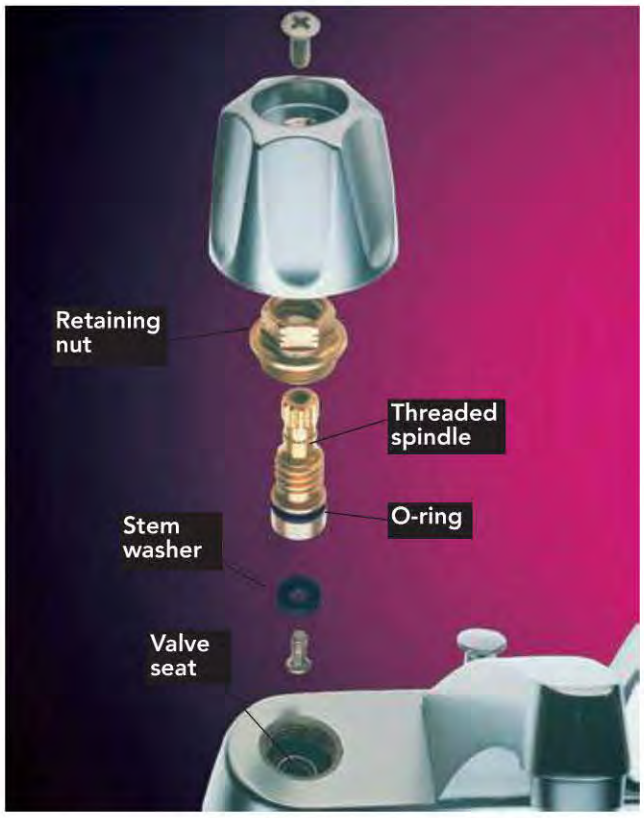
SKILLS YOU'LL NEED

- Using channel-type pliers
- Tracking the order and arrangement of parts
- Phone or computer research

DIFFICULTY LEVEL

Time: 30 minutes to 1 hour plus research and shopping

HOW TO FIX A COMPRESSION FAUCET



Most compression valves have a threaded metal spindle with a disc-shaped stem washer on the end. When the spindle is screwed all the way in, the stem washer covers a hole, and water flow to the spout is stopped. Drips from the spout happen when the seal between the stem washer and the rim of the hole (called the "valve seat") is imperfect. Usually, replacing the stem washer is enough to stop the drip.

2 Use channel-type pliers to unscrew a retaining nut or the entire stem assembly from the faucet body. If what you find looks similar to the stem assembly shown in step 3, you're in the right place.

1 Turn off the water at the stop valves for the faucet you are fixing then open the faucet and let the water drain out. Remove the handles by prying an index cap off the top with a dull knife or screwdriver and removing the screw hidden underneath.

3 Unscrew the stem screw and remove the stem washer. You must find an exact replacement. A flat washer should always be replaced with a flat washer, for example, even if a profiled washer fits. Your washer may have a size code printed on the back, but it's usually easiest to bring the whole stem into the hardware store or home center and try on new neoprene parts there.

4 Pry or cut off the O-ring on the stem with a utility knife. This keeps water from leaking under the handle when the faucet is on.

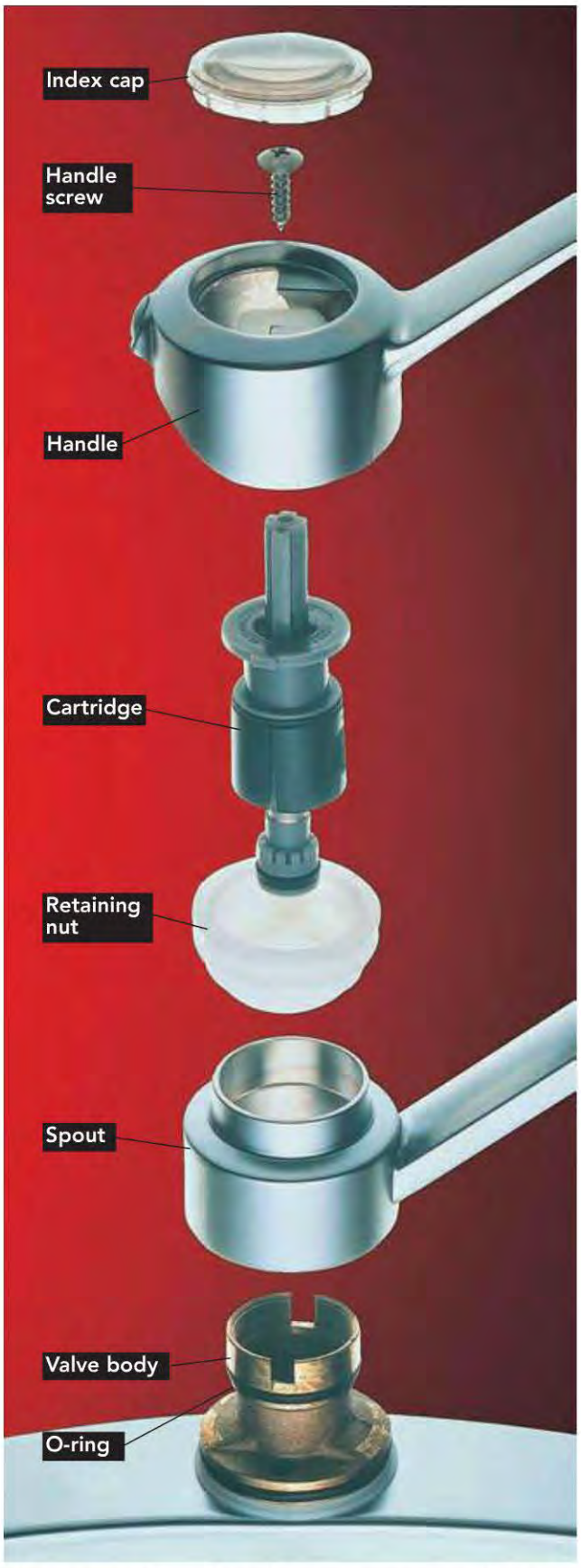
6 Wrap Teflon tape onto the retaining nut threads and screw it onto the faucet body. Tighten lightly with channel-type pliers. Replace the handle, the handle screw, and the index cap. TIP: Unscrew the aerator at the tip of the spout and open the faucet before turning the water back on. This will flush debris from the system.

5 Coat the new O-ring and washer with heatproof grease and install them. Tighten the stem screw enough to hold the washer in place, but do not distort the washer by overtightening. Coat the large threaded spindle threads with heatproof grease to lubricate the action of the faucet valve.

HERE'S HOW

There are many ways to classify sink faucets, but perhaps the most useful distinction is compression style versus washerless. These names refer to the type of mechanism inside the faucet. Many older faucets are compression type, but most newer ones are washerless, which can be one of three principal types: cartridge, ball, or disc. All one-handle faucets are washerless. The best way to tell if your faucet is a compression type or washerless is to turn the handle. With compression faucets you can feel the compression building as you crank the handle, even after the water flow has stopped. On washerless models, the handle comes to an abrupt stop.

HOW TO FIX A CARTRIDGE FAUCET



Both one- and two-handle faucets are available with replaceable plastic cartridges inside the faucet body. These cartridges (used by Price-Pfister, Sterling, Kohler, Moen, and others) regulate the flow of water through the spout, and in single-handle faucets they also mix the hot and cold water to alter the temperature out of the spout. To locate the correct replacement cartridge for your faucet, knowing the manufacturer and model number is a great help.

1 Turn off the water at the stop valves. To avoid losing small parts, put a rag in the drain if it has no stopper. Some cartridge faucets have an index cap covering a handle screw. Other handles, especially on one-handle faucets, are secured with a recessed set screw that can be loosened with a 3/32" or 7/64" hex wrench. A lever type handle with no set screw may be removed with channel-type pliers.

SHOPPING TIP

Replacement cartridges are not interchangeable among brands or sometimes even among models from the same manufacturer. It's always a good idea to bring the old cartridge with you to the hardware store to help you select the correct replacement.

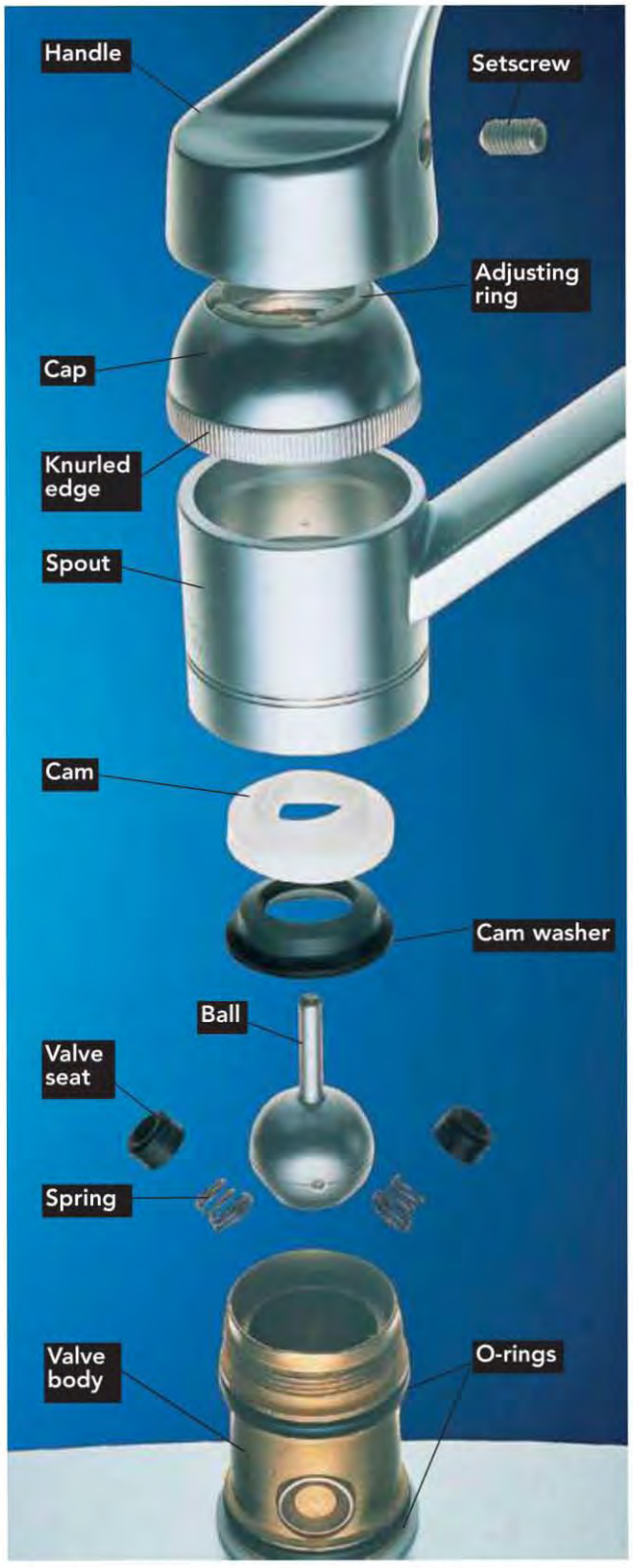
2 Remove the retaining nut, if there is one, with channel-type pliers. A recessed nut with notches can be removed with open needlenose pliers or a tool provided by the faucet manufacturer. With other kinds, you'll remove a sleeve and three screws before extracting the cartridge.

3 Record the direction the cartridge is facing by noting the orientation of some distinctive part of the cartridge (some are cast with an orientation tab that generally should point straight forward). Pull the cartridge straight up and out with pliers. You may need to twist the cartridge back and forth to break the seal.

4 Purchase a replacement cartridge. Apply heat-proof grease to the valve seat and O-rings, then install the cartridge in the correct orientation and with its tabs seated in the slotted body of the faucet.

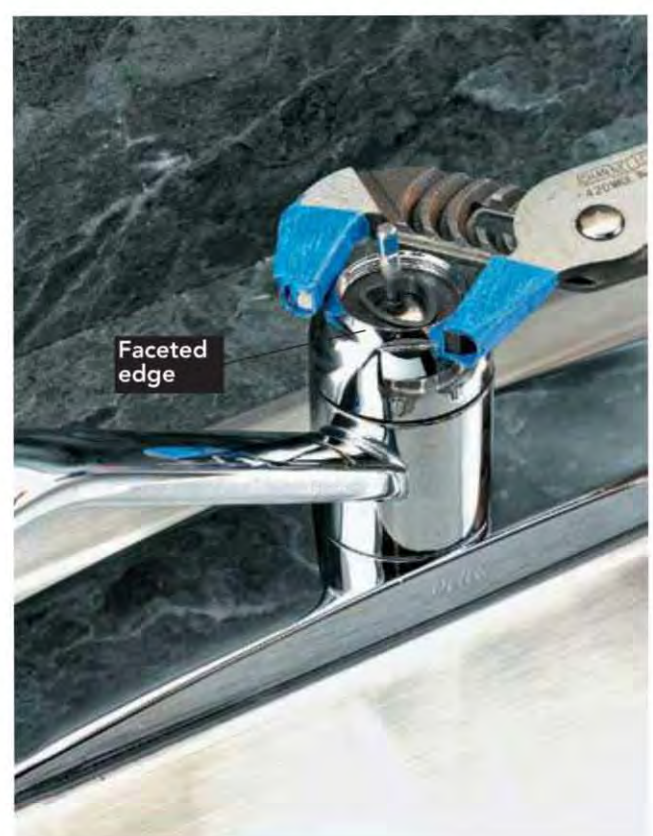
5 Reattach the handle, remove the aerator, turn on the water, and test. If the faucet doesn't work, the cartridge may be facing the wrong direction. Remove it and reinsert it facing the other way, still making sure the tabs fit into the slots on the valve body.

HOW TO FIX A BALL FAUCET

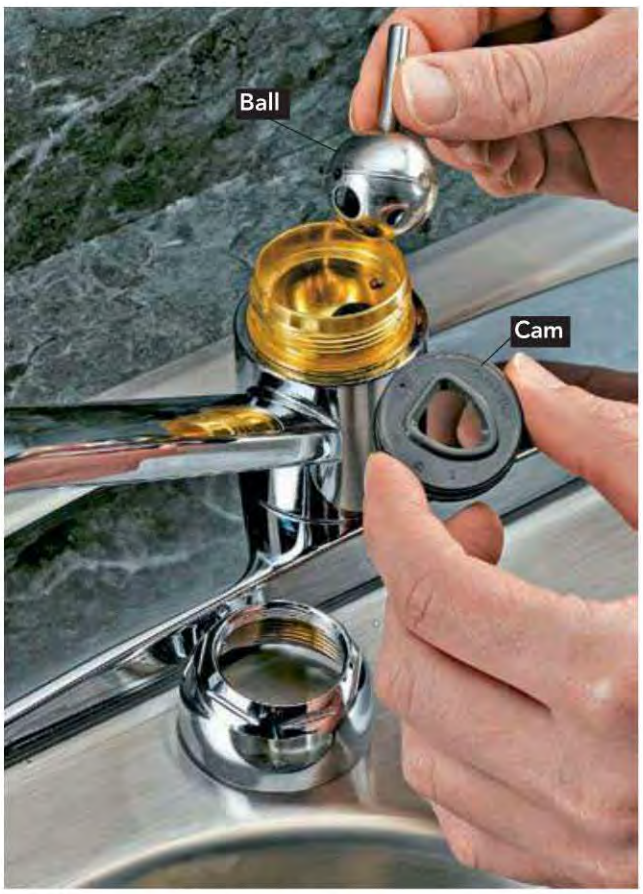


The ball-type faucet is used by Delta, Peerless, and a few others. The ball fits into the faucet body and is constructed with three holes (not visible here)—a hot inlet, a cold inlet, and the outlet, which fills the valve body with water that then flows to the spout or sprayer. Depending on the position of the ball, each inlet hole is open, closed, or somewhere in-between. The inlet holes are sealed to the ball with valve seats, which are pressed tight against the ball with springs. If water drips from the spout, replace the seats and springs. Or go ahead and purchase an entire replacement kit and replace all or most of the working parts.

1 Turn off the hot and cold water at the stop valves and open the faucet to let any water drain from the pipes. Plug the sink drain with a towel to avoid losing small parts. Pry off a red and blue hot/cold button or a knob-handle button, if present, with a small screwdriver or dull knife. Loosen the setscrew hidden underneath with the hex wrench on the ball faucet tool. Now remove the handle.



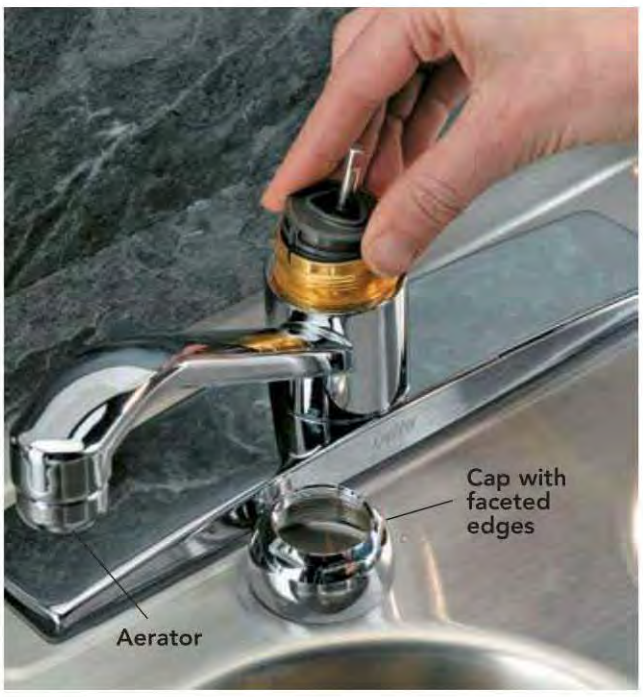
2 Wrap the jaws of your channel-type pliers with masking tape to protect the faucet finish. Grasp the faceted or knurled edges of the round ball cap with the pliers and twist to remove.



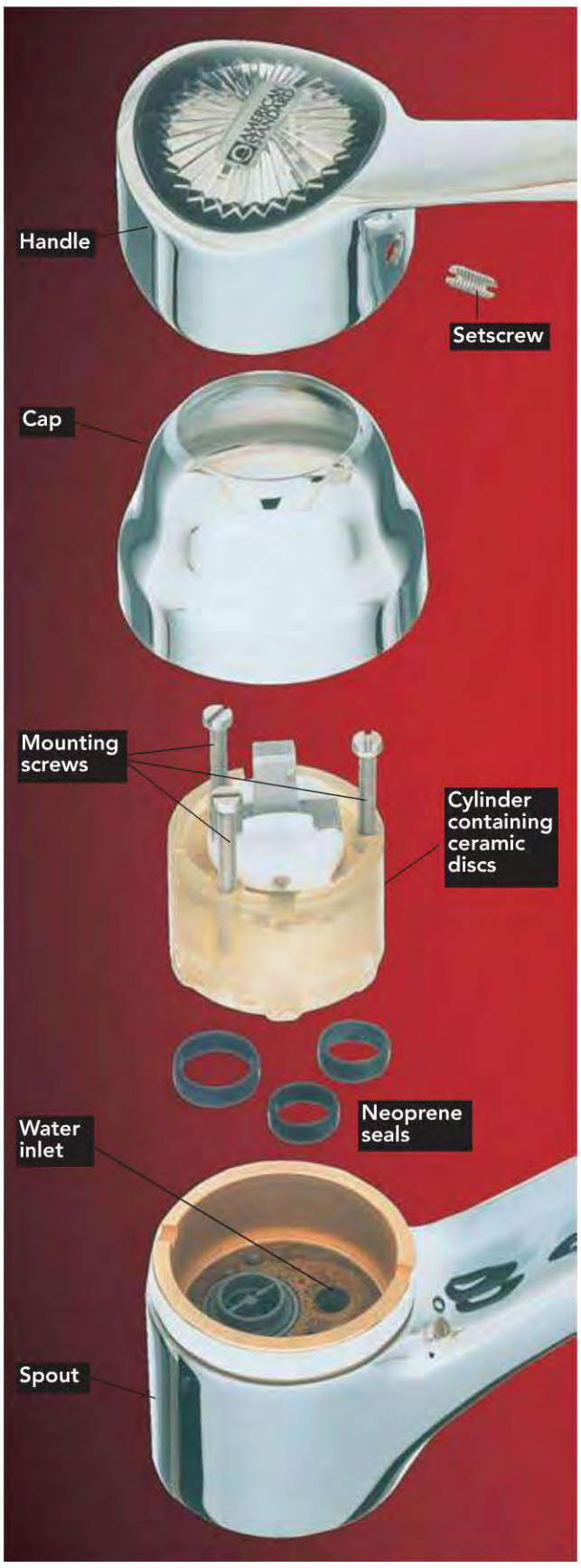
3 Pull out the ball, noticing for later how a pin in the faucet body fits in a slit in the ball. Clean the ball with white vinegar and a toothbrush or replace it if it is scratched.

4 If your faucet drips from the spout, it's because the seal between the ball and the hot- or cold-water intake has failed. Pull the neoprene valve seats and springs from the intakes with a screwdriver. Note how the cupped sides of the valve seats fit over the narrow sides of the springs and how the wide base of the springs fit into holes in the intakes.

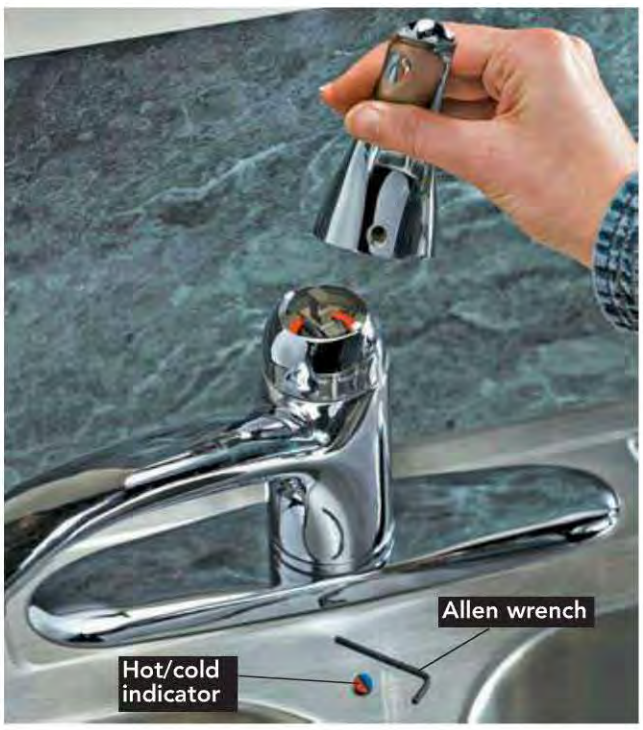
5 Replace parts in the reverse order they came off. Each spring/seat washer combo can be lined up on a screwdriver, set in place, and pushed in with a finger. The pin in the faucet body fits in a slit on the ball. The pointy side of the cam faces forward, and lugs on the sides of the cam fit in notches in the valve body.



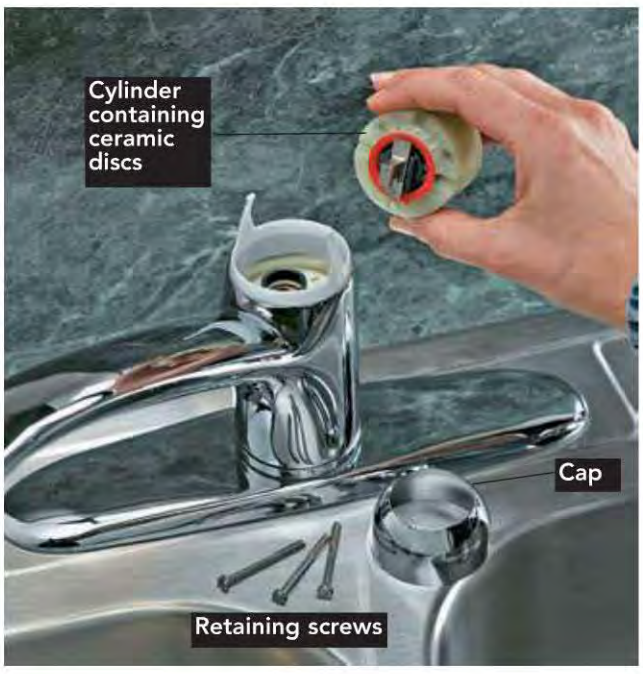
6 Make sure the adjusting ring is partly backed off before screwing the cap on. After the cap is on, gently tighten down the adjusting ring with the ball faucet tool. Remove the aerator, turn on the water supply and test. If water leaks from under the handle or if the handle action is stiff, tighten or loosen the adjusting ring. Replace the aerator.



The disc-type faucet used by American Standard, among others, has a wide disc cartridge hidden beneath the handle and the cap. Mounting screws hold the cartridge in the valve body. Two tight-fitting ceramic discs with holes in them are concealed inside the cartridge. The handle slides the top disc back and forth and from side to side over the stationary bottom disc. This brings the holes in the disks into and out of alignment, adjusting the flow and mix of hot and cold water.



1 Turn off the hot and cold water at the stop valves, open the faucet to let any water drain out, and plug the sink drain. Pry the index cap (and possibly a hot/cold indicator) off the handle with a small screwdriver or a dull knife. Loosen the handle setscrew with a Phillips or slotted screwdriver or an Allen wrench and remove the handle.



2 Remove the chrome cap and/or a plastic or metal retaining ring with channel-type pliers (cover the jaws with masking tape). Remove the cylinder containing the discs, generally by first removing three long retaining screws. Take time to line up parts in the orientation and order in which they were installed.

3 If your faucet leaks under the handle, remove the three neoprene seals from the underside of the disc cylinder. Bring them to the hardware store and find matching replacements. For a leak out of the spout, you need to replace the entire cylinder.

4 If you are reusing the cylinder, clean the water inlets, scouring with a toothbrush and white vinegar if they are crusty.

5 Lightly coat the new neoprene seals with heatproof grease and insert them in the appropriate openings in the cylinder. The seals will be slippery and you'll need to contort them a bit to fit the shapes of the openings, so be sure to do this over a clean, light colored surface so you don't lose the seals.

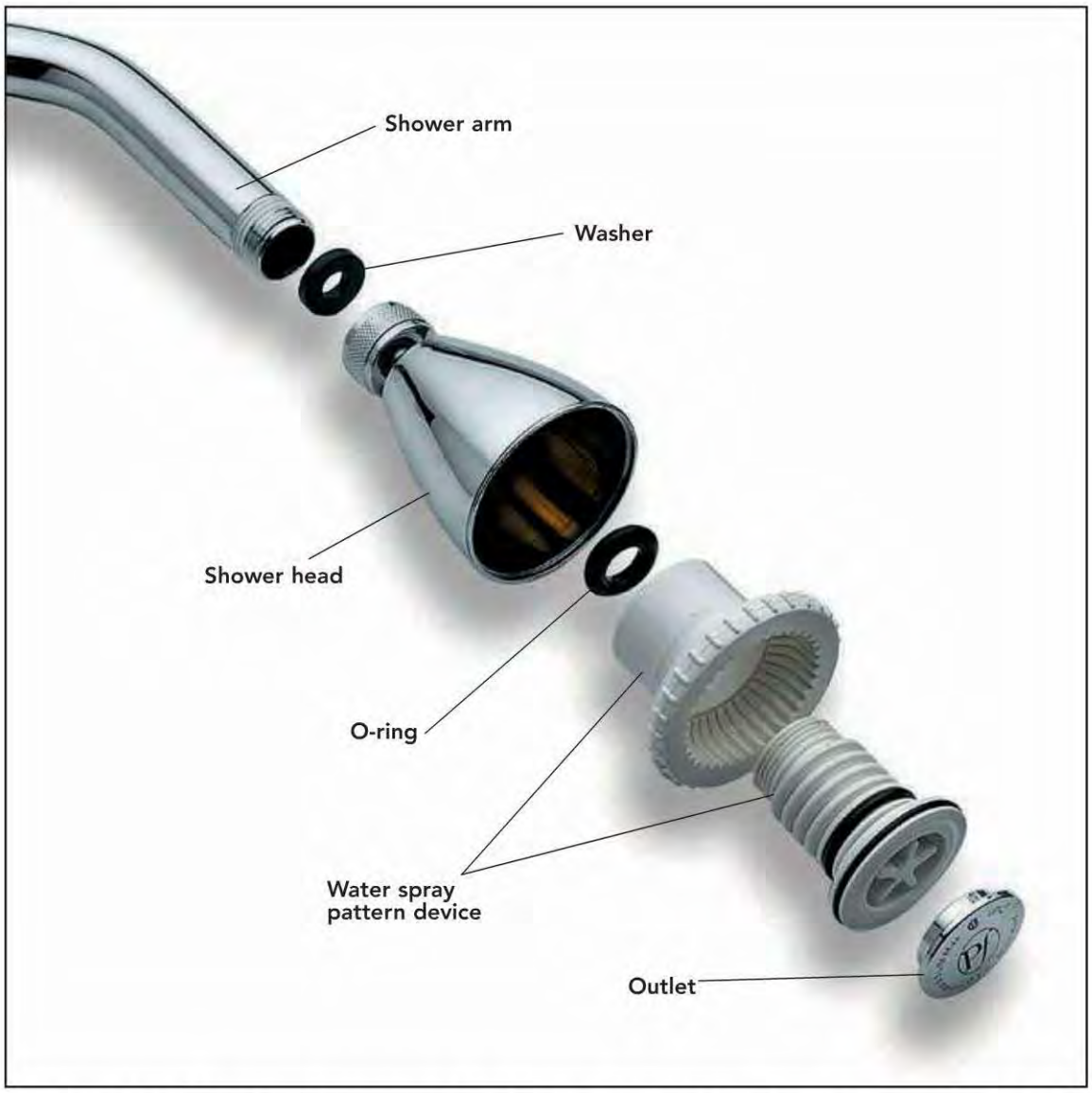
6 Insert the cylinder and secure it to the faucet body with the cylinder screws. Reattach the retaining nut. Reattach the handle, then turn on the hot and cold supplies and test the faucet. Remove the aerator from the spout to allow debris to escape.

5 Adjusting Water Pressure

Restoring vigorous water pressure to your water outlets can be as simple as cleaning a filter in a faucet or showerhead.

CORRECTING LOW WATER PRESSURE AT A SINK OR SHOWER MAY BE EASIER THAN YOU'D EXPECT. Minerals and rust can collect in the finely perforated screens and sprayers in sink spouts and showerheads. Clean these out and, voilà, the water flows with vigor; no plumber needed. Before water reaches any fixture or appliance, it passes through a shutoff valve or two. Make sure these are fully open. Washing machines also draw water through filters. Clean these screens and your washer may fill faster. Old iron water pipes are subject to mineral buildup. A professional can replace these with modern copper or plastic pipes that resist buildup and corrosion.

WATER FLOW 101



A showerhead is easy to remove for cleaning or repair. Once you remove it from the shower arm, you take it apart, clean the parts (you may need to check the flow restrictor), and then reassemble it and reattach it to the arm.

TERMS YOU NEED TO KNOW

AERATOR—a small cylinder on the end of a bathroom or kitchen sink spout that breaks up the water stream so it doesn't splash.

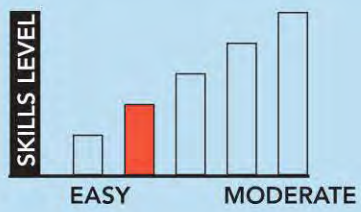
FLOW RESTRICTOR—a disc-shaped part on the inlet side of a showerhead with a small hole or holes designed to restrict water flow and conserve water.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Using channel-type pliers
- Using a wrench

DIFFICULTY LEVEL



Time: less than ½ hour per fixture

HOW TO CLEAN A SHOWERHEAD

1 Remove the showerhead from the shower arm by unscrewing the collar nut that houses the swivel ball and is threaded onto the shower arm. You may need to grip the shower arm with channel-type pliers to keep it from twisting. Wrap the jaws of the pliers with masking tape to protect shower parts.

2 Once the showerhead is fully removed, run water through the shower arm for a couple of minutes to clear it.

THE FIRST SPOT TO CHECK

Water may flow through two or three shutoff valves between the city water line or the well and your shower or sink. Make sure all the shutoff valves are functioning properly and are opened fully. If the valves are all open, the problem could be in the internal working of your outlet valves. Check the filters and aerators first, as we show you in this project. If the water flow is still subpar, refer to the project that show you how to repair and replace faucets.

3 Disassemble the showerhead. On newer showerheads, the swivel ball or the inlet side of the showerhead will have flow restriction parts. These contain one or more small holes and exist mainly to conserve water. Remove these parts, if you can, with a small knife or screwdriver.

4 Keep all parts in order and oriented in the correct up/down position. If the house water pressure is very poor, you may leave the flow restriction parts (inset photo) out when you put the showerhead back together. WARNING: Removing flow restrictor parts can dramatically increase your water and energy bills.

6 Coat the rubber O-ring that contacts the swivel ball with silicone grease before reassembling the head. Hand-tighten the collar nut that holds the swivel fitting to the showerhead.

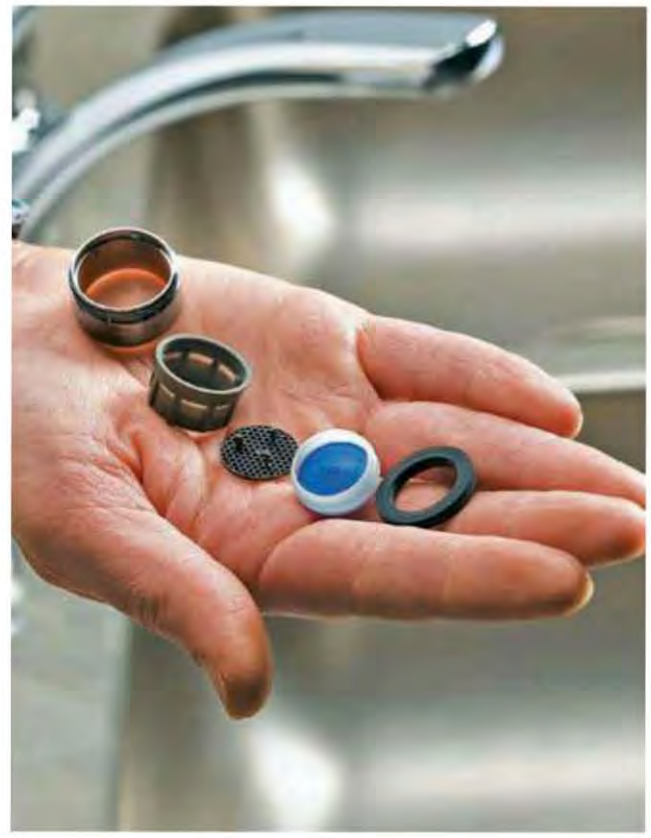
5 Use a paper clip or pin to clean the outlet holes on the showerhead then flush all parts clean with water. Soak encrusted parts overnight in white vinegar to soften mineral deposits.

7 Wrap the shower arm threads with two or three layers of Teflon tape in a clockwise direction before replacing the head. Tighten the head to the shower arm a little more than hand tight using your adjustable wrench. Tighten a little more if the joint drips with the shower on. If the showerhead does not work to your satisfaction, replace it.

HOW TO CLEAN A FAUCET AERATOR

1 Dry and wrap the aerator with masking tape to protect the finish. Adjust channel-type pliers to fit comfortably over the aerator and twist the aerator counterclockwise to loosen.

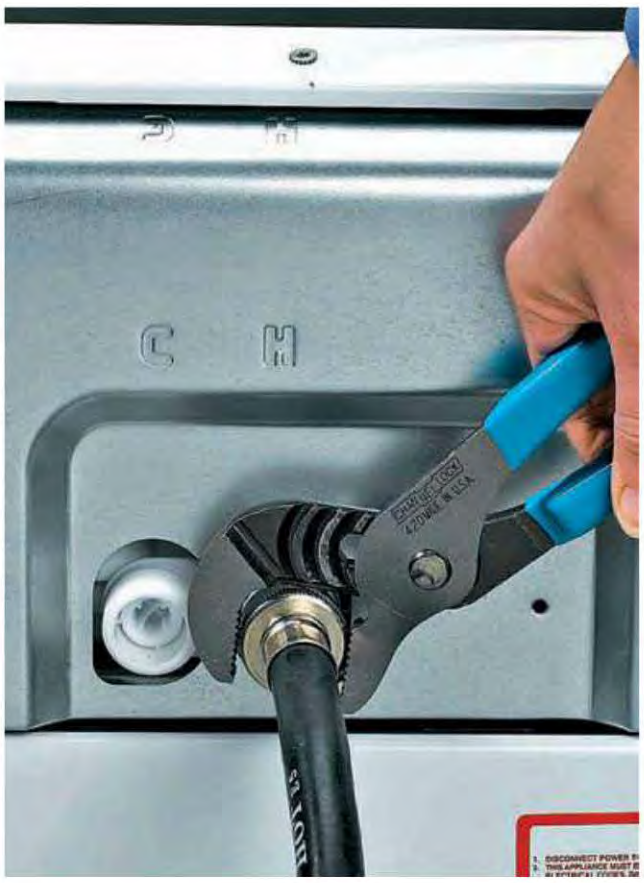
3 Clean parts with white vinegar and a toothbrush. Soften mineral deposits by soaking overnight in the vinegar. Replace the aerator at a hardware store or home center if parts are damaged or difficult to clean. A standard replacement aerator has both male and female threads and fits most faucets, but take in your old aerator in case yours is a non-standard size.



2 Finish unscrewing the aerator by hand then gently prod apart its components with your finger or a needle or other pointed tool. Be careful to lay out pieces in the order they fit together and in the correct up/down orientation. TIP: Turn on the water while the aerator is removed to flush any built-up materials out the spout.

4 Reassemble the aerator exactly as it came apart and hand-tighten it onto the spout. Remove the tape. Replace the aerator if it still doesn't work right.

WASHING MACHINE FILLS SLOWLY?



1 Turn off hot and cold water to the machine and unscrew supply hoses where they join the machine or at the first accessible coupling.

2 Some water supply hoses for washing machines contain filter screens in the hose couplings that connect to the water supply and to the water inlets in the washing machine. If you find these filters, carefully remove and clean them.

3 Most washing machines contain filter screens at the water inlet port. Remove the cone filter with needlenose pliers and clear debris from the filter screen. If the filter is in poor condition, replace it.

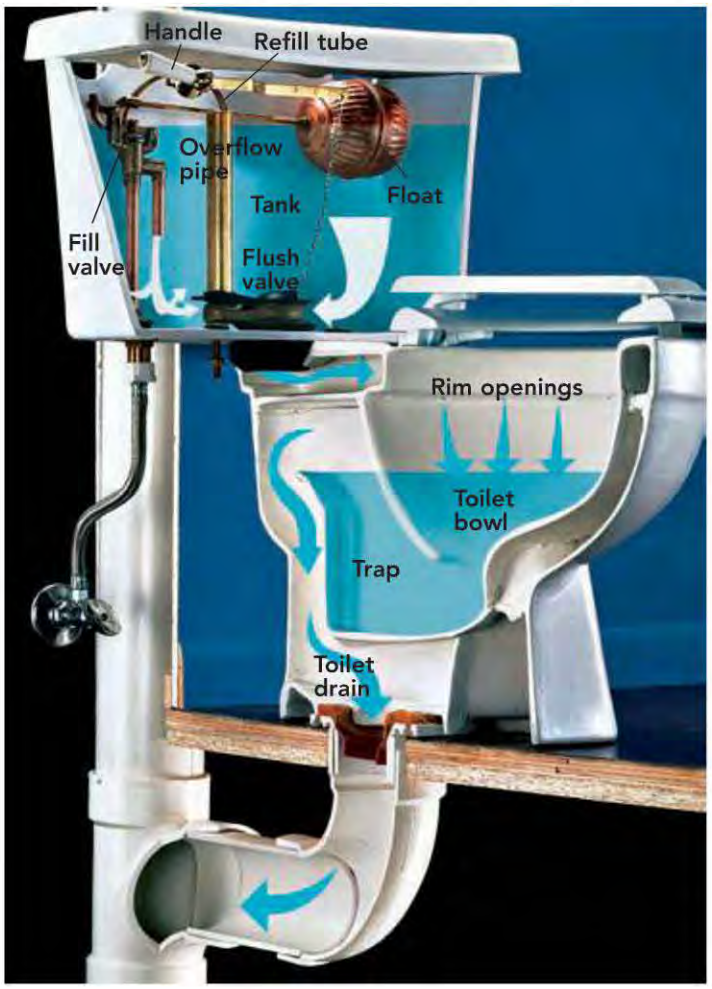
4 Apply Teflon tape to the male pipe threads at the water inlet connection and retighten all hoses.

6 Fixing Running Toilets

Jiggling the handle can make a running toilet stop, but it's only a temporary solution. Making real repairs is a lot easier than you might think.

SNORING, TICKING CLOCKS, DRIPPING FAUCETS, AND RUNNING TOILETS are perhaps the four greatest nighttime annoyances. Together they conspire to keep you from the blissful slumber you deserve. For help on fixing leaky faucets, see pages 146 to 155. If your toilet runs and runs and you just can't seem to catch up with it, you're in the right place. This project will show you how to diagnose and remedy the most common causes for the perpetually running toilet.

TOILET TROUBLE SHOOTING 101



Five steps of a perfect flush: 1.The *handle* opens the *flush valve*, emptying the *tank* into the *toilet bowl*. 2. Water races through *rim openings* and the *siphon jet* at the base of the bowl. 3. The sudden surge causes the water to exit the *trap* and bowl as a unit, siphoning itself down the *toilet drain*. 4. The *ballcock* (fill valve) opens when the *float* drops to refill the tank. The *refill tube* directs some of the water down the *overflow pipe* to refill the bowl. 5. The *float* turns off the *fill valve* when enough water has entered the *tank*.

Most toilets can be fixed with generic replacement parts. However, some brands require special parts, especially newer models, which may have larger flush valves. Contact your manufacturer or go to a well-equipped plumbing-supply house. Identify your toilet brand, which is often written behind (not on) the seat, and its model number (usually stamped inside the tank or tank lid). Always bring old parts with you to the store for reference.

TERMS YOU NEED TO KNOW

BALLCOCK/FILL VALVE—These terms both refer to the valve that fills the tank after you flush the toilet. Traditionally, the ballcock is turned on and off by a float ball on a rod. Modern cup-float fill valves can be used to replace most old ballcocks.

FLUSH VALVE—the assembly that releases water from the tank into the bowl when the toilet is flushed. It includes the overflow pipe, the valve seat (hole), and the flapper or tank ball that covers the hole. Universal flapper-style flush valves can replace old tank ball or flapper flush valves on most toilets.

STOP VALVE—the valve that turns off water to the toilet.

SUPPLY—the hose or tube that takes water from the stop valve to the tank.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

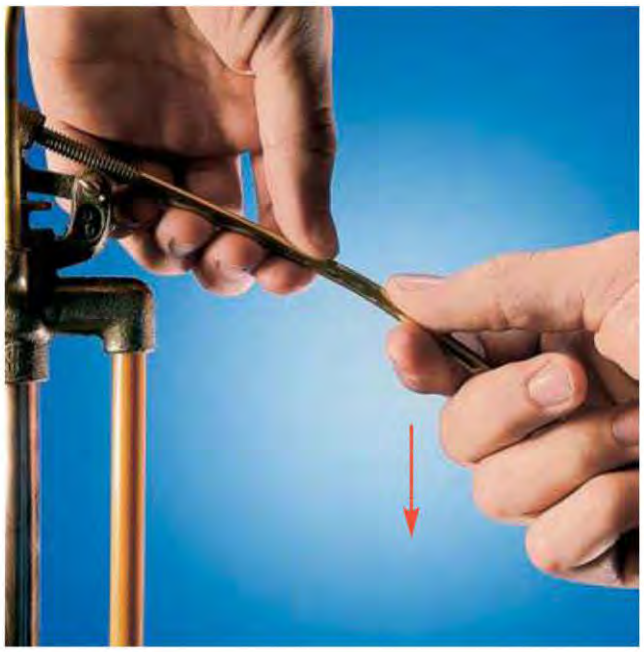
- Patience
- Observation
- Willingness to call a manufacturer help center if you get into trouble

DIFFICULTY LEVEL

Time: 5 minutes or hours depending on problem

HOW TO RESET THE TANK WATER LEVEL

1 Perhaps the most common cause of running toilets is a minor misadjustment that fails to tell the water to shut off when the toilet tank is full. The culprit is usually a float ball or cup that is adjusted to set a water level in the tank that's higher than the top of the overflow pipe, which serves as a drain for excess tank water.



2 A ball float is connected to a float arm that's attached to a plunger on the other end. As the tank fills, the float rises and lifts one end of the float arm. At a certain point, the float arm depresses the plunger and stops the flow of water. By simply bending the float arm downward a bit you can cause it to depress the plunger at a lower tank water level, solving the problem.

3 A diaphragm fill valve usually is made of plastic and has a wide bonnet that contains a rubber diaphragm. Turn the adjustment screw clockwise to lower the water level and counter-clockwise to raise it.

4 A float cup fill valve is made of plastic and is easy to adjust. Lower the water level by pinching the spring clip with fingers or pliers and moving the clip and cup down the pull rod and shank. Raise the water level by moving the clip and cup upward.

WHAT IF THE FLUSH STOPS TOO SOON?

1 Sometimes there is plenty of water in the tank, but not enough of it makes it to the bowl before the flush valve shuts off the water from the tank. Modern toilets are designed to leave some water in the tank, since the first water that leaves the tank does so with the most force. (It's pressed out by the weight of the water on top). To increase the duration of the flush, shorten the length of the chain between the flapper and the float (yellow in the model shown).

2 The handle lever should pull straight up on the flapper. If it doesn't, reposition the chain hook on the handle lever. When the flapper is covering the opening, there should be just a little slack in the chain. If there is too much slack, shorten the chain and cut off excess with the cutters on your pliers. Turn the water back on at the stop valve and test the flush.

3 If the toilet is not completing flushes and the lever and chain for the flapper or tank ball are correctly adjusted, the problem could be that the handle mechanism needs cleaning or replacement. Remove the chain/linkage from the handle lever. Remove the nut on the backside of the handle with an adjustable wrench. It unthreads clockwise (the reverse of standard nuts). Remove the old handle from the tank.

4 Unless the handle parts are visibly broken, try cleaning them with an old toothbrush dipped in white vinegar. Replace the handle and test the action. If it sticks or is hard to operate, replace it. Most replacement handles come with detailed instructions that tell you how to install and adjust them.

HOW TO REPLACE A FILL VALVE

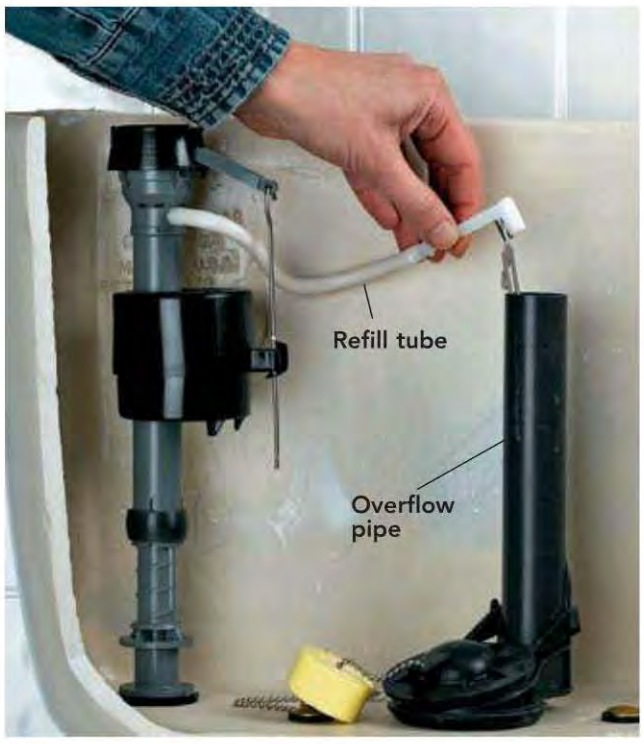
1 Toilet fill valves degrade eventually and need to be replaced. Before removing the old fill valve, shut off the water supply at the fixture stop valve located on the tube that supplies water to the tank. Flush the toilet and sponge out the remaining water. Then, remove the old fill valve assembly by loosening and removing the mounting nut on the outside of the tank wall that secures the fill valve.

2 Fill valves need to be coordinated with the flush valve so the tank water level is not higher than the overflow pipe and so the fill valve is not low enough in the tank that it creates a siphoning hazard. New fill valves have a "critical level" mark ("CL") near the top of the valve.

3 The new fill valve must be installed so the Critical Level ("CL") mark is at least 1" above the overflow pipe. Slip the shank washer on the threaded shank of the new fill valve and place the valve in the hole so the washer is flat on the tank bottom. Compare the locations of the CL mark and the overflow pipe.

4 Adjust the height of the fill valve shank so the "CL" line and overflow pipe will be correctly related. Different products are adjusted in different ways—the fill valve shown here telescopes when it's twisted.

5 Position the valve in the tank. Push down on the valve shank (not the top) while hand tightening the locknut onto the threaded valve stem (thread the mounting nut on the exterior side of tank). Hand-tighten only.



7 If the overflow pipe has a cap, remove it. Attach one end of the refill tube from the new valve to the plastic angle adapter and the other end to the refill nipple near the top of the valve. Attach the angle adapter to the overflow pipe. Cut off excess tubing with scissors to prevent kinking. WARNING: Don't insert the refill tube into the overflow pipe. The outlet of the refill tube needs to be above the top of pipe for it to work properly.

6 Hook up the water by attaching the coupling nut from the supply riser to the threaded shank at the bottom end of the new fill valve. Hand-tighten only.

8 Turn the water on fully. Slightly tighten any fitting that drips water. Adjust the water level in the tank by squeezing the spring clip on the float cup with needlenose pliers and moving the cup up or down on the link bar. Test the flush.

HOW TO REPLACE A FLUSH VALVE

1 If the fixes on the previous pages still do not stop your toilet from running, the next step it to try replacing the flush valve. Before removing the old flush valve, shut off the water supply at the fixture stop valve located on the tube that supplies water to the tank. Flush the toilet and sponge out the remaining water. To make this repair you'll need to remove the tank from the bowl. Start by unscrewing the water supply coupling nut from the bottom of the tank.

2 Unscrew the bolts holding the toilet tank to the bowl by loosening the nuts from below. If you are having difficulty unscrewing the tank bolts and nuts because they are fused together by rust or corrosion, apply penetrating oil or spray lubricant to the threads, give it a few minutes to penetrate and then try again. If that fails, slip an open-ended hacksaw (or plain hacksaw blade) between the tank and bowl and saw through the bolt (inset photo).

3 Unhook the chain from the handle lever arm. Remove the tank and carefully place it upside-down on an old towel. Remove the spud washer and spud nut from the base of the flush valve using a spud wrench or large channel-type pliers. Remove the old flush valve.

4 Place the new flush valve in the valve hole and check to see if the top of the overflow pipe is at least 1" below the Critical Level line (see page 166) and the tank opening where the handle is installed. If the pipe is too tall, cut it to length with a hacksaw.

5 Position the flush valve flapper below the handle lever arm and secure it to the tank from beneath with the spud nut. Tighten the nut one-half turn past hand tight with a spud wrench or large channel-type pliers. Over tightening may cause the tank to break. Put the new spud washer over the spud nut, small side down.

6 With the tank lying on its back, thread a rubber washer onto each tank bolt and insert it into the bolt holes from inside the tank. Then, thread a brass washer and hex nut onto the tank bolts from below and tighten them to a quarter turn past hand tight. Do not overtighten.

7 With the hex nuts tightened against the tank bottom, carefully lower the tank over the bowl and set it down so the spud washer seats neatly over the water inlet in the bowl and the tank bolts fit through the holes in the bowl flange. Secure the tank to the bowl with a rubber washer, brass washer, and nut or wing nut at each bolt end. Press the tank to level as you hand-tighten the nuts. Hook up the water supply at the fill valve inlet.

8 Connect the chain clip to the handle lever arm and adjust the number of links to allow for a little slack in the chain when the flapper is closed. Leave a little tail on the chain for adjusting, cutting off remaining excess. Attach the refill tube to the top of the overflow pipe the same way it had been attached to the previous refill pipe. Turn on the water supply at the stop valve and test the flush. (Some flush valve flappers are adjustable.)

7 Clearing Clogged Toilets

A blockage in the toilet bowl leaves flush water from the tank nowhere to go but on the floor.

THE TOILET IS CLOGGED AND HAS OVERFLOWED, or perhaps its gorge has simply risen, lapped the canyon walls but not yet topped the rim. Have patience. Now is the time for considered action. A second flush is a tempting but unnecessary gamble. First, do damage control. Mop up the water if there's been a spill. Next, consider the nature of the clog. Is it entirely "natural" or might a foreign object be contributing to the congestion? Push a natural blockage down the drain with a plunger. A foreign object should be removed, if possible, with a closet auger. Pushing anything more durable than toilet paper into the sewer may create a more serious blockage in your drain and waste system. If the tub, sink, and toilet all become clogged at once, the branch drainline that serves all the bathroom fixtures is probably blocked and your best recourse is to call a drain clearing service.

CLOGGED TOILETS 101

The *trap* is the most common catching spot for toilet clogs, Once the clog forms, flushing the toilet cannot generate enough water power to clear the trap, so flush water backs up. Traps on modern 1.6-gallon toilets have been redesigned to larger diameters and are less prone to clogs than the first generation of 1.6 gallon toilets.

Not all plungers were created equal. The *standard plunger* (left) is simply an inverted rubber cup and is used to plunge sinks, tubs, and showers. The *flanged plunger,* also called a *force cup,* is designed to get down into the trap of a toilet drain. But in a pinch you can fold the flange up into the flanged plunger cup and use it as a standard plunger.

TERMS YOU NEED TO KNOW

WATER SEAL—Because of the loop-like shape of a toilet's plumbing, there is always water in the bowl and in the passage directly behind the bowl. This water seal keeps sewer gases from rising into the house.

TOILET TRAP—A "trap" in plumbing refers to a bend that holds a water seal, so technically, the toilet bowl is part of the trap. But usually people are talking about the back, hidden portion of that bend when they speak of the toilet trap.

FLUSH VALVE—is the flapper covering the hole in the bottom of the tank that sits behind the bowl. The toilet flushes when this is opened.

CONTROLLED FLUSH—the letting of water from the tank to bowl by manually lifting and closing the flush valve. This prevents bowl overflow when you're not sure the clog is gone.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Vigorous plunging
- Using a closet auger

DIFFICULTY LEVEL

Time: 15 to 30 minutes

HOW TO PLUNGE A CLOGGED TOILET

TOOL TIP

A flanged plunger fits into the mouth of the toilet trap and creates a tight seal so you can build up enough pressure in front of the plunger to dislodge the blockage and send it on its way.

1 Plunging is the easiest way to remove "natural" blockages. Take time to lay towels around the base of the toilet and remove other objects to a safe, dry location, since plunging may result in splashing. Sometimes, allowing a very full toilet to sit for twenty or thirty minutes will permit some of the water to drain to a less precarious level, or you can bail it out. WARNING: Don't use a plunger if the toilet is plugged with a diaper, washcloth, or other object that could get pushed into the drainpipe. It may create a worse clog in a pipe that's beyond your reach. Try to remove the object with a closet auger.

2 There should be enough water in the bowl to completely cover the plunger. Fold out the skirt from inside the plunger to form a better seal with the opening at the base of the bowl. Pump the plunger vigorously half-a-dozen times, take a rest, and then repeat. Try this for 10 to 15 cycles.

3 If you force enough water out of the bowl that you are unable to create suction with the plunger, put a controlled amount of water in the bowl by lifting up on the flush valve in the tank. Resume plunging. When you think the drain is clear, you can try a controlled flush, with your hand ready to close the flush valve should the water threaten to spill out of the bowl. Once the blockage has cleared, dump a five-gallon pail of water into the toilet to blast away any residual debris.

HOW TO CLEAR CLOGS WITH A CLOSET AUGER

TOOL TIP

A closet auger is a semirigid cable housed in a tube. The tube has a bend at the end so it can be snaked through a toilet trap (without scratching it) to snag blockages.

1 Place the business end of the auger firmly in the bottom of the toilet bowl with the auger tip fully withdrawn. A rubber sleeve will protect the porcelain at the bottom bend of the auger. The tip will be facing back and up, which is the direction the toilet trap takes.

2 Rotate the handle on the auger housing clockwise as you push down on the rod, advancing the rotating auger tip up into the back part of the trap. You may work the cable backward and forward as needed, but keep the rubber boot of the auger firmly in place in the bowl. When you feel resistance, indicating you've snagged the object, continue rotating the auger counterclockwise as you withdraw the cable and the object.

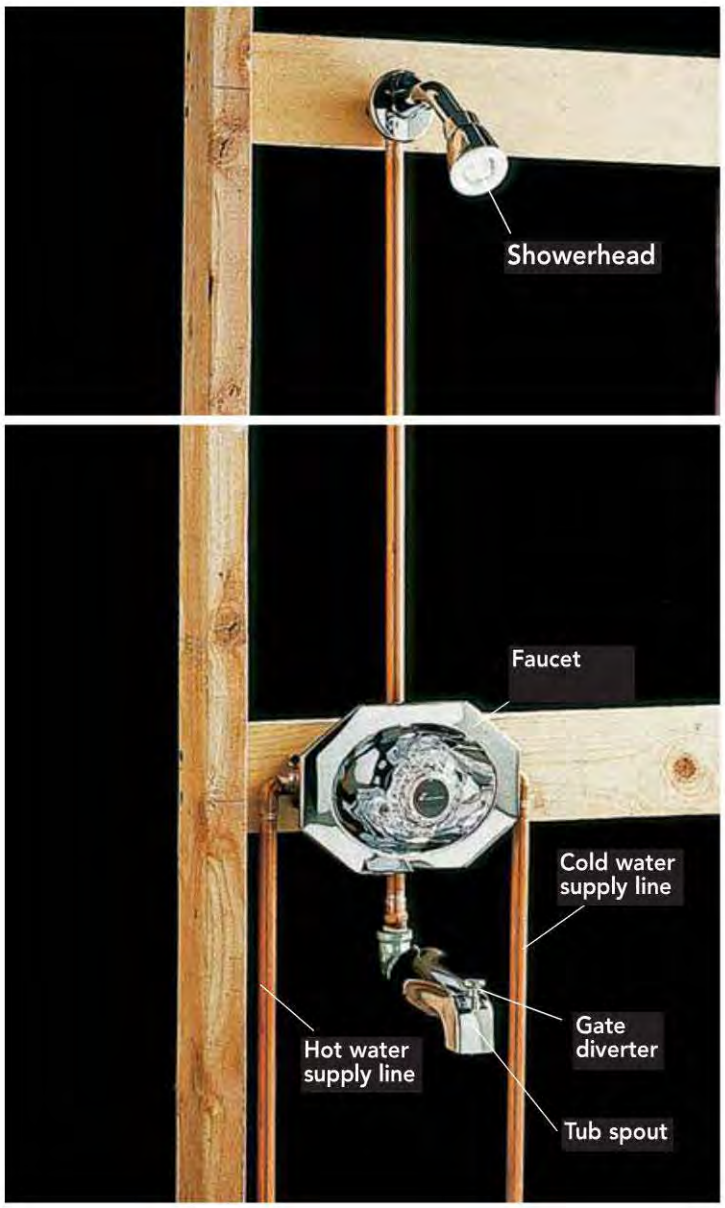
3 Fully retract the auger until you have recovered the object. This can be frustrating at times, but it is still a much easier task than the alternative—to remove the toilet and go fishing.

8 Fixing Leaky Tubs & Showers

Tub/shower plumbing is notorious for developing drips from the tub spout and the showerhead. In most cases, the leak can be traced to the valves controlled by the faucet handles.

DOES YOUR TUB/SHOWER DRIP, DRIP, DRIP from the spout or the showerhead even when the water is turned off? Chances are, a washer or cartridge in the faucet valve needs attention or replacement. But these parts vary widely by type and by brand name. The most critical part of a good repair job does not involve wrenches and screwdrivers, but the telephone and possibly a computer. That's because finding the brand name, model number, and ultimately part numbers will let you get the exact materials you'll need to do the job right. From there, it's a pretty easy repair.

TUB & SHOWER FAUCETS 101



If you could make your tub/shower and the tub surround above it disappear, you'd see pipes and plumbing parts similar to this. The *faucet* seen here only has one handle that controls the water volume and temperature. The water is directed to either the *tub spout* or the *showerhead* with a *diverter* located in the tub spout. Some two-handle models are joined by a third handle that serves as a diverter instead of the gate on the spout.

As the stem assemblies (right) demonstrate, sink and tub compression valves share the same genetics but vary in size and the particulars.

TERMS YOU NEED TO KNOW

COMPRESSION FAUCET—a two-or three-handle faucet that uses a simple stem and washer compression valve.

CARTRIDGE FAUCET—a one-, two-, or three-handle faucet with a valve or valves that uses a narrow, cylinder-shaped cartridge, which is moved in the valve body by the handle to channel hot and cold water.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Using channel-type pliers
- Tracking the order and arrangement of parts
- Phone or computer research

DIFFICULTY LEVEL

Time: 1 hour plus research and shopping

HOW TO FIX A LEAKY ONE-HANDLE FAUCET

1 Single-handle tub and shower faucets have one valve controlling both hot and cold water. This valve sits directly behind the one large knob or lever. If your tub spout drips all the time, you need to fix this valve. The first step involves information and materials gathering (see "Steps to Successful Shopping" on page 179). Next, turn off the hot and cold water supplies. Make sure the diverter is in the tub-filling position, then drain residual water out of the plumbing by opening the faucet to hot and cold water. Lay towels in the tub to prevent damaging the finish with tools and losing small parts.

2 Remove the handle of the damaged valve by first prying an index cap off the front with a dull knife or screwdriver and removing the screw hidden underneath. Pull off the handle. Remove any other parts obstructing the escutcheon, then remove the escutcheon. Keep parts in a safe place. Line them up and orient them as they sit in the faucet. If it's helpful, take digital pictures to remember how the parts went together.

3 Many one-handle tub and shower faucets have hot and cold shutoffs built in to the faucet body. Turn these off clockwise with a large slotted screwdriver. Integral stops are useful if you need to leave the water off for some time during a repair, and the only other turnoff to the tub and shower takes other fixtures out of commission. If you'd rather, you may turn off water at the nearest shutoff valves instead.

4 Remove the threaded retaining ring that secures the cartridge or stem and bonnet assembly (some models may use retaining screws to hold the stem). This unit is what turns the water on and controls the mix of hot and cold water.

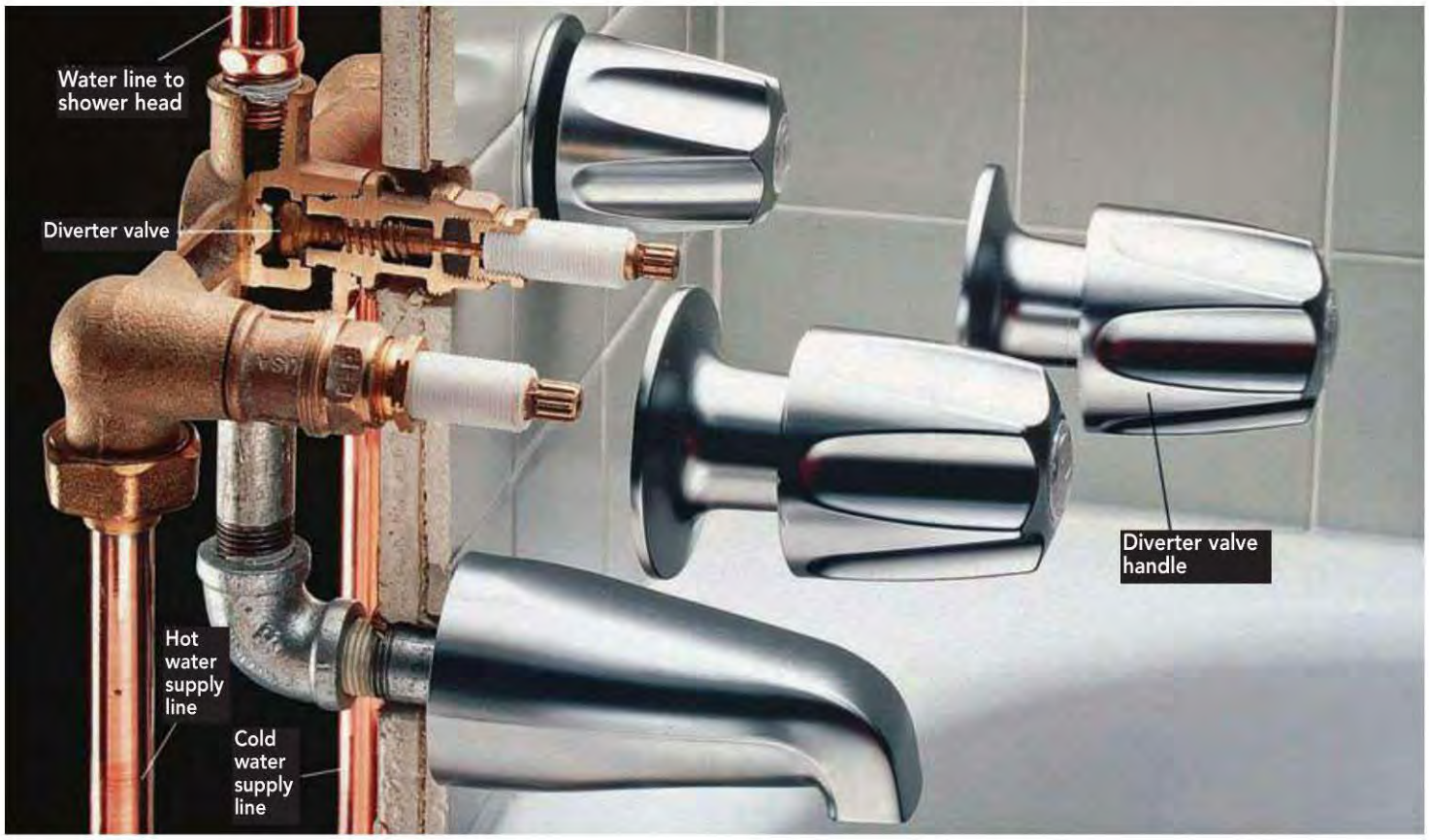
5 Remove the cartridge, pulling gently on the stem with a pair of pliers if necessary. With the cartridge out, now is a good time to flush out the system by opening the shutoffs in the valve or in the supply line. Watch out, though, the water will come out of the valve opening, not the spout.

SAFETY TIP

A balancing cartridge is included in many newer single-handle faucets. This unit prevents sudden swings in water temperature due to relative pressure changes in the hot and cold supplies (such as those that result from flushing a toilet or turning on a sink tap). The relative pressure of the hot and cold water exiting the cartridge remains the same. If your faucet has a balancing cartridge, note that the faucet will not work at all if only one of the supply pipes is open. If the O-rings on the back of the balancing cartridge are worn, replace them.

6 Clean the cartridge by flushing with warm water and replace the O-ring at the end (coat the new O-ring with heatproof grease). If the cartridge is old or visibly damaged, replace it. Reinstall the faucet parts in reverse order.

HOW TO FIX A LEAKY TWO- OR THREE-HANDLE FAUCET



1 Both three-handle and two-handle faucets have a hot-water valve and a cold-water valve behind their hot and cold faucet handles. If water drips from the spout when the faucet is off, you need to determine which valve isn't working by shutting off the water supply on each line in turn at the shutoff valve. Two- and three-handle faucets are repaired in the same manner, except that the middle handle on the three-handle models is a diverter valve (the diverter on two-handle models is in the spout). If the showerhead on your three-handle system drips, or if you continue to get a high volume of water through the spout when it should be coming out the showerhead, it's the diverter handle that needs attention.

2 Determine which valve is causing the leak (see previous step) and remove the handle cover for that valve (in this case, the diverter valve is being worked upon). Also remove the escutcheon that covers the wall opening for that valve.

3 Remove the bonnet nut from the stem assembly using an adjustable wrench. If your faucet has cartridges, not compression valves as shown here, simply remove the cartridge (see p. 177).

4 Unscrew the stem assembly using a deep-set socket and a ratchet wrench. You may need to enlarge the opening in the wall slightly with a cold chisel and ball-peen hammer to gain clearance for the socket. TIP: You can purchase a shower valve socket wrench at most hardware stores. The most common sizes are 29/32" and 31/32".

SHOPPING TIP

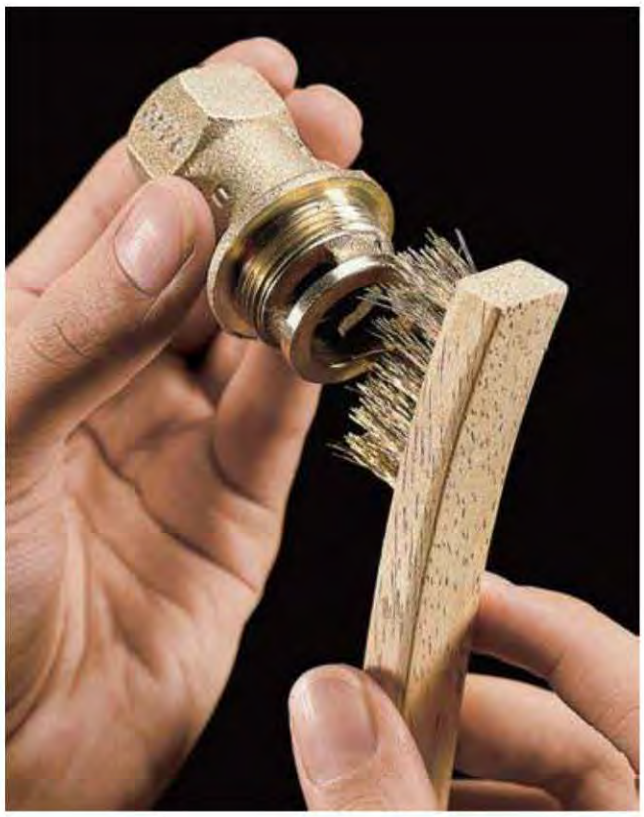
STEPS TO SUCCESSFUL SHOPPING

Identify the brand. This may be written on the faucet handle, on a plate behind the handle or handles, or elsewhere on the hardware of the tub or shower. Be aware that a name on a pop-up stopper, overflow cap, or showerhead may or may not be the manufacturer of your faucet.

Identify the model. The major brands have web sites and toll-free numbers. Use these to identify your model.

Identify replacement parts. It may be that all you will need for replacement parts are washers, screws, and a few common valve parts available at a well-equipped home center or hardware store. But if you need to replace a cartridge or other intricate faucet component, your manufacturer can provide parts numbers and tell you how to order these.

5 Remove the brass stem screw from the compression valve. Find an exact match for the stem washer that's held in place by the stem screw. Disassemble the spindle and the valve retaining nut.



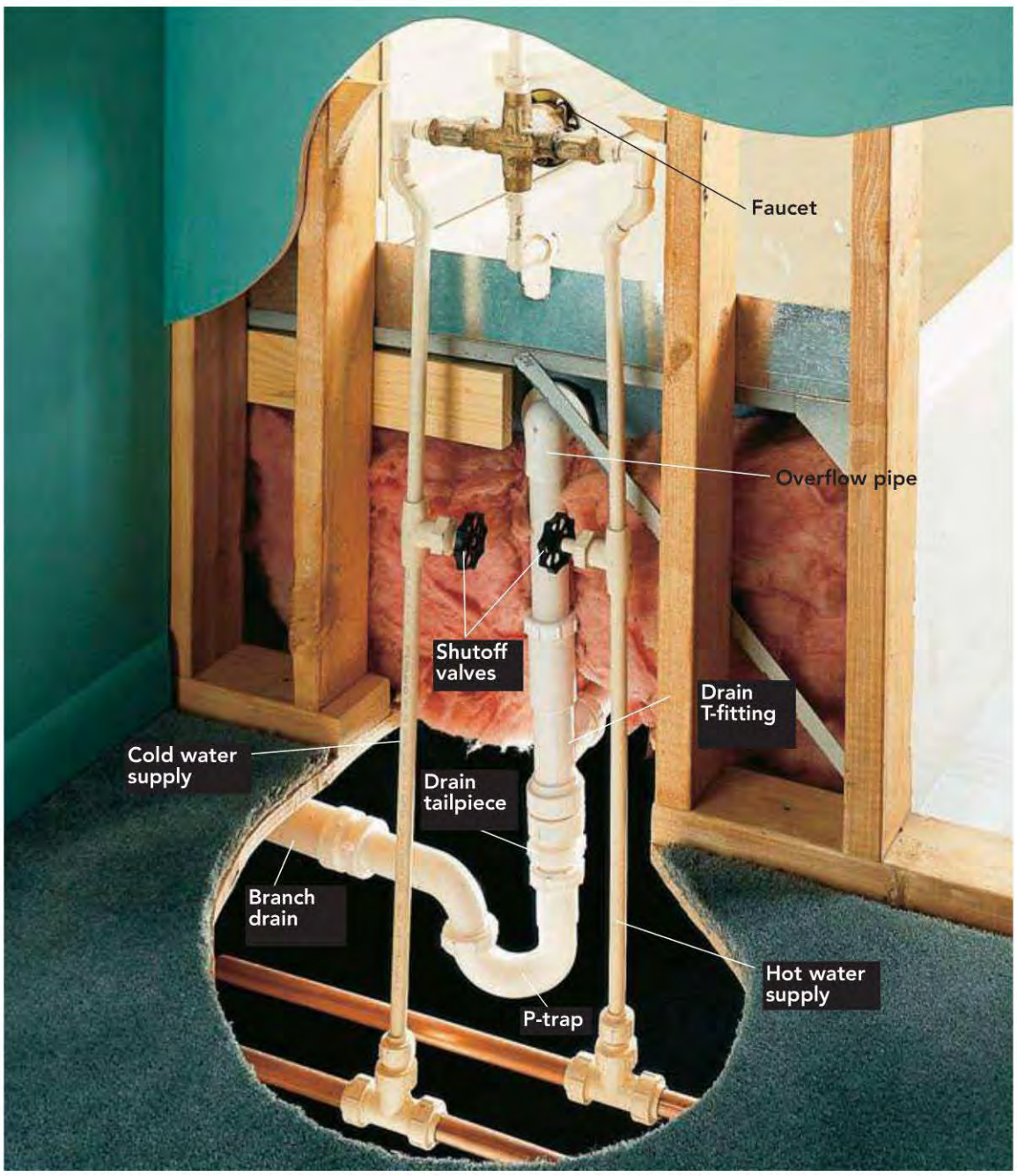
6 Clean the valve parts with white vinegar and a toothbrush or small wire brush. Coat all washers with heatproof grease and reassemble then reinstall the valve.

9 Adjusting Bathtub or Shower Drainage

As with bathroom sinks, tub and shower drain pipes may become clogged with soap and hair. The drain stopping mechanisms can also require cleaning and adjustment.

TUB OR SHOWER NOT DRAINING? First, make sure it's only the tub or shower. If your sink is plugged, too, it may be a coincidence or it may be that a common branch line is plugged. A sure sign of this is when water drains from the sink into the tub. This could require the help of a drain cleaning service, or a drum trap that services both the sink and tub needs cleaning. If the toilet also can't flush (or worse, water comes into the tub when you flush the toilet), then the common drain to all your bathroom fixtures is plugged. Call a drain cleaning service. If you suspect the problem is only with your tub or shower, then read on. We'll show you how to clear drainlines and clean and adjust two types of tub stopper mechanisms. Adjusting the mechanism can also help with the opposite problem: a tub that drains when you're trying to take a bath.

BATH DRAINS 101



If you removed the wall behind your tub/shower along with part of the floor, this is pretty much what you would see. From the photo you can tell that having to access your drain for outside the tub is not easy, and that maintaining the drain system to avoid major problems and blockages is well worth the effort. Fortunately, maintenance is not difficult, and minor clogs are relatively easy to track down and eliminate.

TERMS YOU NEED TO KNOW

POP-UP DRAIN—a mechanical drain stopper where a metal drain cover is raised and lowered with a lever mounted on the cover of the overflow opening.

PLUNGER-TYPE DRAIN—another mechanical drain stopper where a plunger is lowered through the overflow pipe to block the drain.

HAND AUGER—a long bendable cable with a crank at one end that is snaked into a drain line to retrieve or break up a blockage.

TOOLS & SUPPLIES YOU'LL NEED

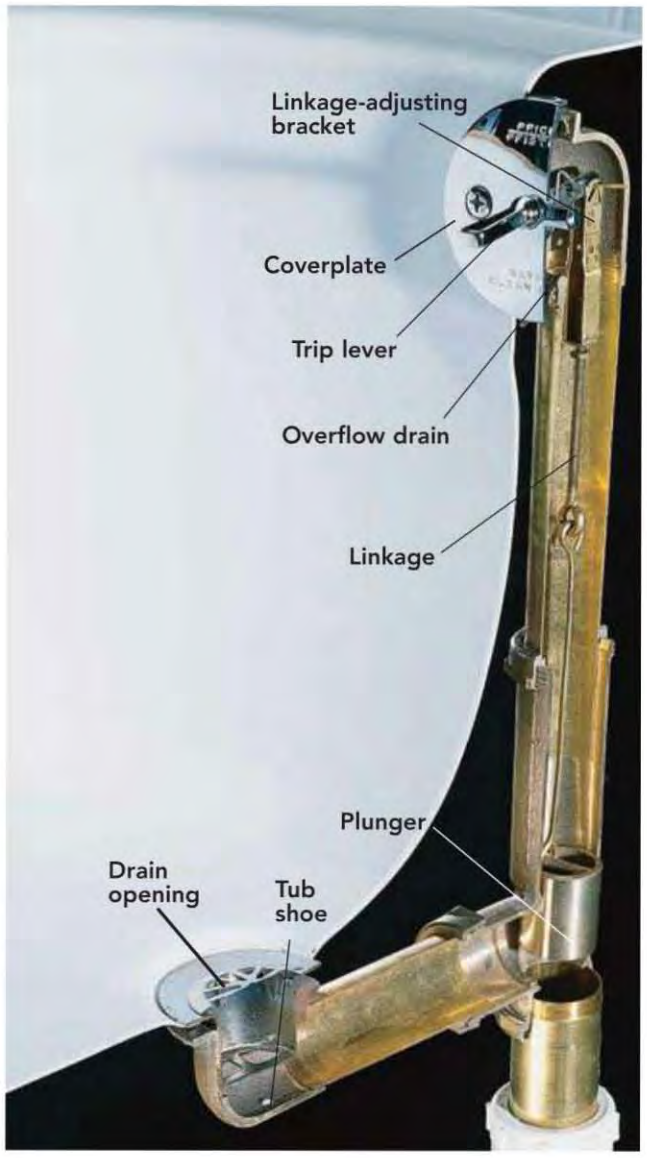
SKILLS YOU'LL NEED

- Vigorous plunging
- Using an auger

DIFFICULTY LEVEL

Time: ½ to 1½ hours

HOW TO FIX A PLUNGER-TYPE DRAIN

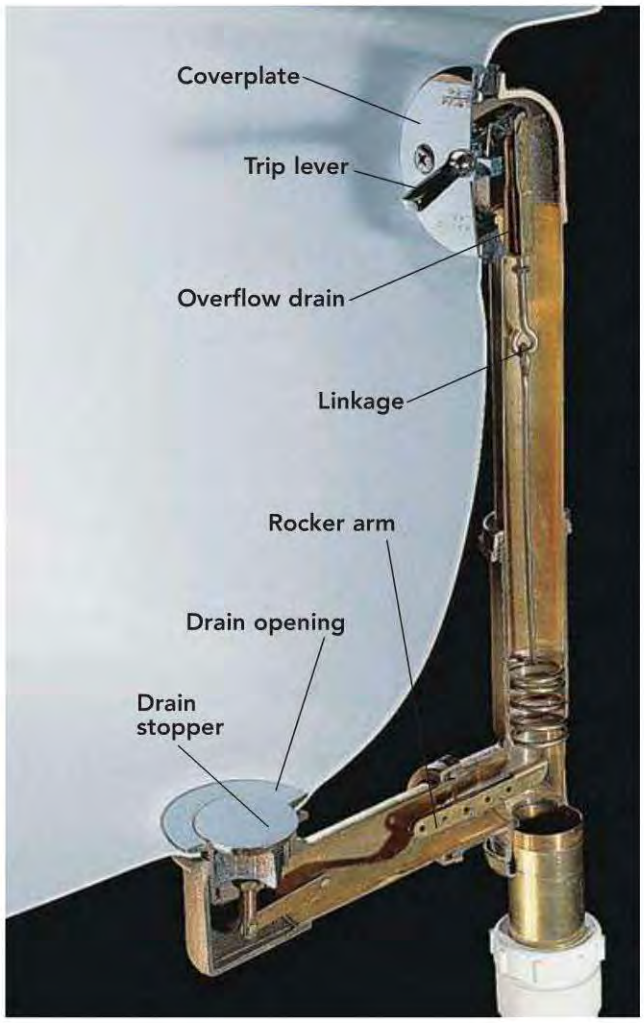


2 Clean hair and soap off the plunger with a scrub brush. Mineral buildup is best tackled with white vinegar and a toothbrush or a small wire brush.

1 A plunger-type tub drain has a simple grate over the drain opening and a behind-the-scenes plunger stopper. Remove the screws on the overflow coverplate with a slotted or Phillips head screwdriver. Pull the coverplate, linkage, and plunger from the overflow opening.

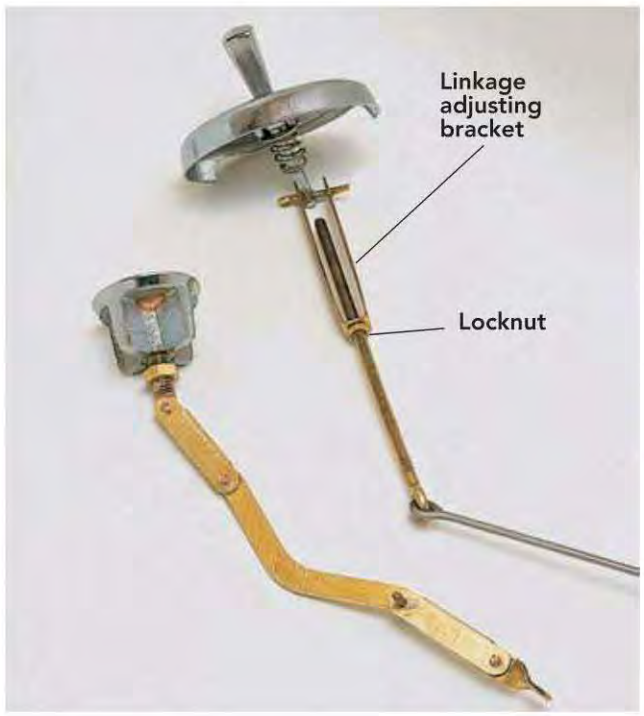
3 Adjust the plunger. If your tub isn't holding water with the plunger down, it's possible the plunger is hanging too high to fully block water from the tub shoe. Loosen the locknut with needlenose pliers then screw the rod down about ⅛". Tighten the locknut down. If your tub drains poorly, the plunger may be set too low. Loosen the locknut and screw the rod in an ⅛" before retightening the locknut.

HOW TO FIX A POP-UP DRAIN



1 Raise the trip lever to the open position. Pull the stopper and rocker arm assembly from the drain. Clean off soap and hair with a dishwashing brush in a basin of hot water. Clean off mineral deposits with a toothbrush or small wire brush and white vinegar.

2 Remove the screws from the cover plate. Pull the trip lever and the linkage from the overflow opening. Clean off soap and hair with a dish scrubbing brush in a basin of hot water. Remove mineral buildup with white vinegar and a wire brush. Lubricate moving parts of the linkage and rocker arm mechanism with heatproof grease.



3 Adjust the pop-up stopper mechanism by first loosening the locknut on the lift rod. If the stopper doesn't close all the way, shorten the linkage by screwing the rod ⅛" farther into the linkage-adjusting bracket. If the stopper doesn't open wide enough, extend the linkage by unscrewing the rod ⅛". Tighten the locknut before replacing the mechanism and testing your adjustment.

HOW TO CLEAR A SHOWER OR TUB DRAIN

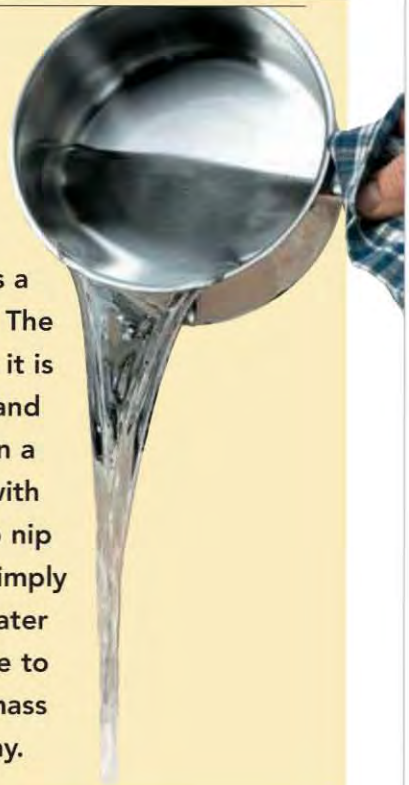
1 To plunge a shower drain, first remove the drain stopper equipment, including the strainer cover (if there is one) from the drain of a tub or shower. Pop the strainer out with a screwdriver, or remove a screw in the middle. Clear any hair from the pipe below the drain with a stiff bent wire.

TIP: If you can't clear a stubborn clog with a plunger, insert the tip of a hand auger into the drain opening (see next page).

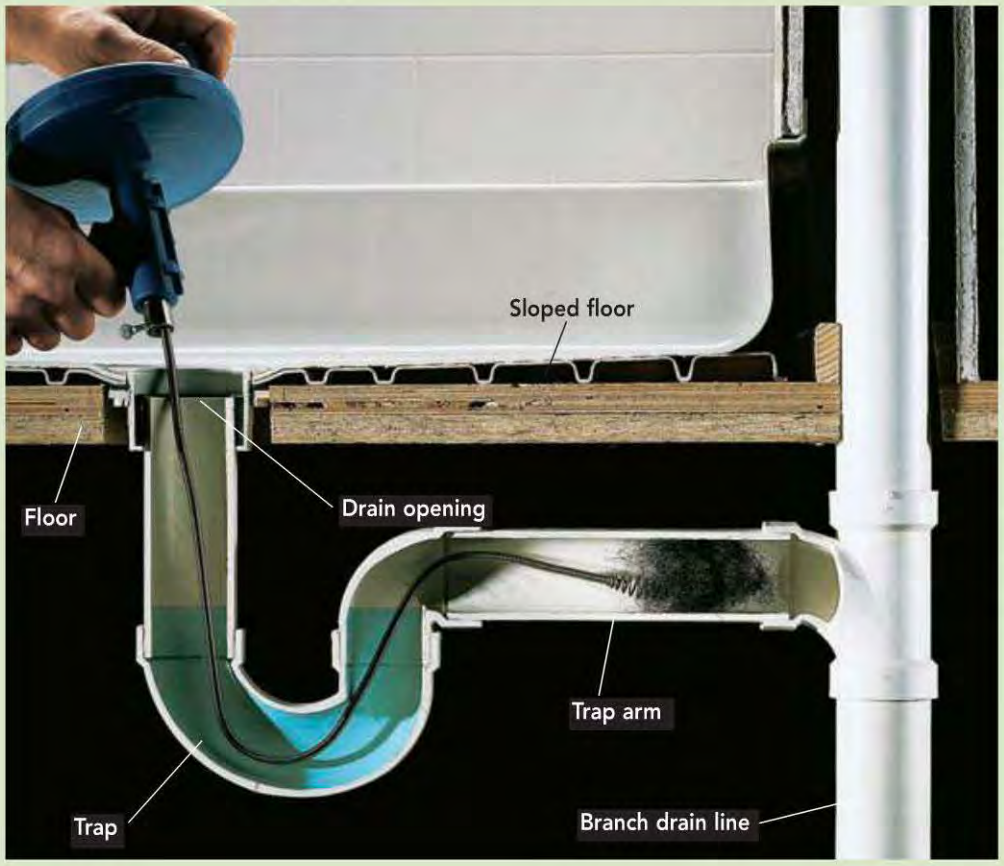
2 If you can't see and remove an obstruction in the drain, try plunging. Position the plunger over the drain opening. If using a force-cup type of plunger, as seen above, fold the skirt up inside the plunger head. Completely cover the plunger with water. Plunge rhythmically through half-a-dozen ups and downs with increasing vigor, then yank up hard on the plunger. Repeat this cycle for up to 15 minutes. Promising signs: crud from the clog may rise into the tub before the weight of the water pushes the clog down the drain.

MAINTENANCE TIP

Like bathroom sinks, tubs and showers face an ongoing onslaught from soap and hair. When paired, this pesky combination is a sure-fire source of clogs. The soap scum coagulates as it is washed down the drain and binds the hair together in a mass that grows larger with every shower or bath. To nip these clogs in the bud, simply pour boiling hot clean water down the drain from time to time to melt the soapy mass and wash the binder away.



USING A HAND AUGER ON A SHOWER DRAIN



On shower drains, feed the head of the auger in through the *drain opening* after removing the strainer. Crank the handle of the auger to extend the cable and the auger head down into the trap and, if the clog is further downline, toward the branch drain. When clearing any drain, it is always better to retrieve the clog than to push it further downline.

USING A HAND AUGER ON A TUB DRAIN

On combination tub/showers, it's generally easiest to insert the auger through the *overflow opening* after removing the coverplate and lifting out the drain linkage (see pages 182 to 183 for more information on drain linkages). Crank the handle of the auger to extend the cable and the auger head down into the trap and, if the clog is further downline, toward the branch drain. When clearing any drain, it is always better to retrieve the clog than to push it further downline.

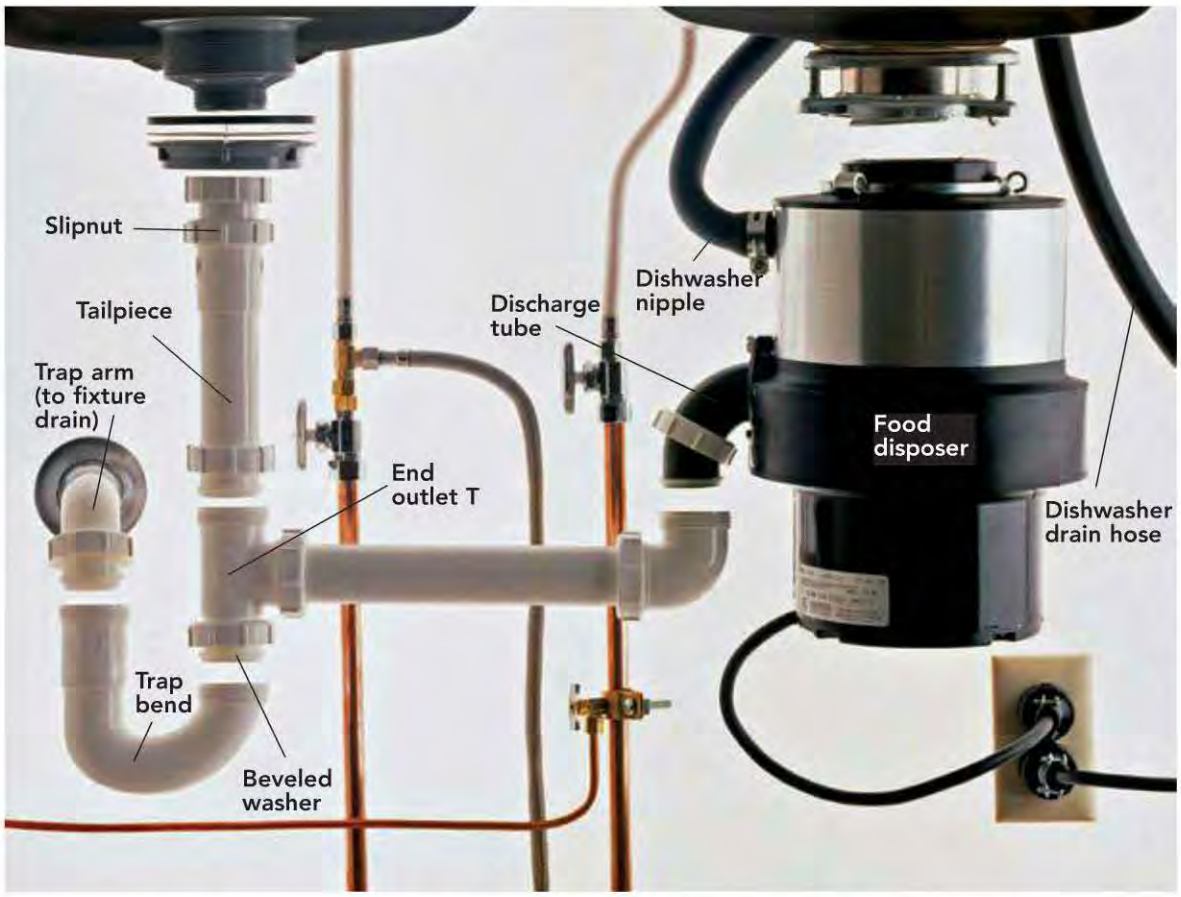
10 Clearing Kitchen Sink Drains

Drain clearing isn't all drudgery and filth. Some people find the plunger to be as much a tool of personal transformation as an implement for removing clogs.

IT'S A WEEK TO PAYDAY, and that austerity plan you've arranged with your creditors gives you 67 dollars and change to last until then. Alas, the kitchen sink is clogged; you can't afford a plumber! Don't despair—your enemy is merely a wad of coffee grounds and some bacon fat. If plunging doesn't work, you'll go after it where it lives, remove the trap, look in the disposer, explore the fixture drain with a hand auger. With the right tool, you are like Thor and his thunderbolt, Zeus and his trident. You, we are confident, will locate the clog and break it up or drag it into the light, slap it into a basin, and sluice its slimy spawn into the sewer with a triumphant blast of tap water. You. Will. Win.

TIP: Avoid chemical clog removers. They can damage your pipes, your fixtures, and you, and they don't work very well. They're so dangerous to people, in fact, that drain cleaning services often charge extra if you've used them prior to their visit.

KITCHEN SINKS 101



Kitchen sink drain components are usually connected with *slipnuts*, which means everything from the *tailpiece* beneath a basket strainer to the *trap arm* can be removed for cleaning. Clogs commonly occur in the *trap bend* and the *end outlet T*. With the trap arm off, the *fixture drain* can be augered. Make sure your *beveled washers* are facing the right direction when you put things back together. Clogs can happen in the *discharge tube* and *drain chamber* of a disposer. The *impellers* in the grinding chamber of a disposer can get stuck to the *grinding ring* with tough or fibrous waste materials. The *dishwasher drain hose* should be clamped where it joins the disposer if you wish to plunge the sink drain.

TERMS YOU NEED TO KNOW

BASKET STRAINER—This is the typical strainer, plug, and drain found on a kitchen sink that doesn't have a disposer.

TAILPIECE—takes the waste from the basket strainer to the trap.

GRINDING CHAMBER—the chamber visible through the drain of a disposer where wastes are ground.

IMPELLER—one of two or four steel lugs on the metal plate at the bottom of a disposer grinding chamber. Its function is to push food waste against the grinding ring as the plate rotates.

GRINDING RING—a stationary, toothed ring at the bottom perimeter of the disposer grinding chamber. Food wastes are ground against it until they are small enough to be washed into the drain chamber below.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Working with slip joints
- Plunging
- Flexibility

DIFFICULTY LEVEL

Time: ½ to 1½ hours.

KITCHEN SINK STOPPED? PLUNGE IN

1 Plunging a kitchen sink is not difficult, but you need to create an uninterrupted pressure lock between the plunger and the clog. If you have a dishwasher, the drain tube needs to be clamped shut and sealed off at the disposer or drainline. The pads on the clamp should be large enough to flatten the tube across its full diameter (or you can clamp the tube ends between small boards).

2 If there is a second basin, have a helper hold a basket strainer plug in its drain or put a large pot or bucket full of water on top of it. If you just set the strainer plug in place, the pressure of your plunging will pop the plug instead of the clog. Unfold the skirt within the plunger and place this in the drain of the sink you are plunging. There should be enough water in the sink to cover the plunger head. Plunge rhythmically for six repetitions with increasing vigor, pulling up hard on the last rep. Repeat this sequence until the clog or you are vanquished. Flush out a cleared clog with plenty of hot water.

CLEARING THE TRAP AND BEYOND

1 If plunging doesn't work, remove the trap and clean it out. With the trap off, see if water flows freely from both sinks (if you have two). Sometimes clogs will lodge in the T-fitting or one of the waste pipes feeding it. These may be pulled out manually or cleared with a bottlebrush or wire. When reassembling the trap, apply Teflon tape clockwise to the male threads of metal waste pieces. Tighten with your channel-type pliers. Plastic pieces need no tape and should be hand-tightened only.

2 If you suspect the clog is downstream of the trap, remove the trap arm from the fitting at the wall. Look in the fixture drain with a penlight. If you see water, that means the fixture drain is plugged. Clear it with a hand auger (page 185).

DISPOSER NOT GRINDING?

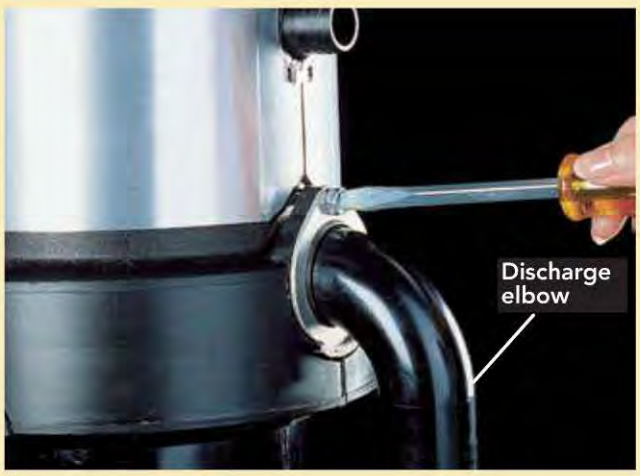
1 Press the reset button located on the base of the disposer and switch the appliance on. If the motor hums but cannot move, the grinders are clogged and need to be cleared.

Unplug disposer before inserting tools

3 Look for and remove any material that's keeping the metal plate from rotating. Make sure the disposer is unplugged and then shine a light into the disposer and look for hard or fibrous debris between the impellers and the grinding ring. Use needlenose pliers to pull debris free.

2 Unplug the disposer. Look for a wrench with a hex shaped head that came with the disposer. Stick this in a fitting in the base of the disposer. This manipulates the metal plate that holds the impellers. Typically, some hard or fibrous object is binding an impeller to the grinding ring. Rock the plate back and forth with the wrench to unbind the impeller. You can also attempt to rotate the plate from above by pushing against an impeller with a broom handle.

DRAINING SLOWLY?



Waste buildup in the drain chamber beneath the impeller disc can lead to a slow-draining disposer. Remove the discharge elbow from the disposer body by withdrawing one or two screws or bolts. These may require a screwdriver or an adjustable wrench. Clear debris from the discharge elbow then shine a light into the drain chamber. Reach into the drain chamber with needlenose pliers to remove any fibrous buildup.

11 Fixing Leaky Sink Strainers

If your waste water takes a wrong turn on the way to the sewer, it may be time to reseat, or replace, your sink strainer.

THE SINK STRAINER IS THE PERFORATED BASKET IN THE BOTTOM OF YOUR KITCHEN SINK THAT CATCHES SPAGHETTI AND BROCCOLI SPEARS BEFORE THEY DIVE DOWN THE DRAIN. If your sink is simply not holding water, you may need to replace only the basket. These are available at any hardware store. If water is leaking onto the floor in the cabinet, you may need to reseat or replace the sink strainer body. A replacement includes the basket and the metal well that cradles the basket and forms a seal with your sink and the drain pipe.

FIXING A LEAKY SINK STRAINER

1 Clear out the cabinet under the sink. Unscrew slipnuts from both ends of the drain tailpiece with channel-type pliers. Lower the tailpiece into the trap bend or remove the tailpiece. NOTE: If you have a double sink and your tailpiece is very short, you may need to loosen slipnuts elsewhere and remove a larger piece of the drain assembly to access the strainer body.

3 Remove old putty from the drain opening with a putty knife. If reusing the old strainer body, clean off the old putty from under the flange. Knead plumber's putty into a snake shape and apply to the lip of the drain opening. Press the strainer body into the drain opening. Any writing on the strainer should be read from the front.

2 Loosen the locknut with a spud wrench or channel-type pliers. Unthread the locknut completely, then push the strainer body up out of the sink.

4 From under the sink, place the rubber gasket and the friction washer over the strainer body and secure the body to the sink deck with the locknut. Tap the nubs on the locknut with a screwdriver to tighten it. Reattach the drain by tightening the slipnut over the threaded end of the tailpiece.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Using wrenches
- Putty rolling
- Making slip-joint connections

DIFFICULTY LEVEL

Time: ½ to 1 hour plus shopping

TERMS YOU NEED TO KNOW

PLUMBER'S PUTTY—a clay-like material used to seal metal hardware to the sink.

TEFLON TAPE—a thin white tape used to lubricate and seal threaded fittings and keep them from sticking together.

PIPE JOINT COMPOUND—a paste that may be used instead of Teflon tape.

BASKET STRAINER—another name for a sink strainer.

Clearing Clogged Floor Drains

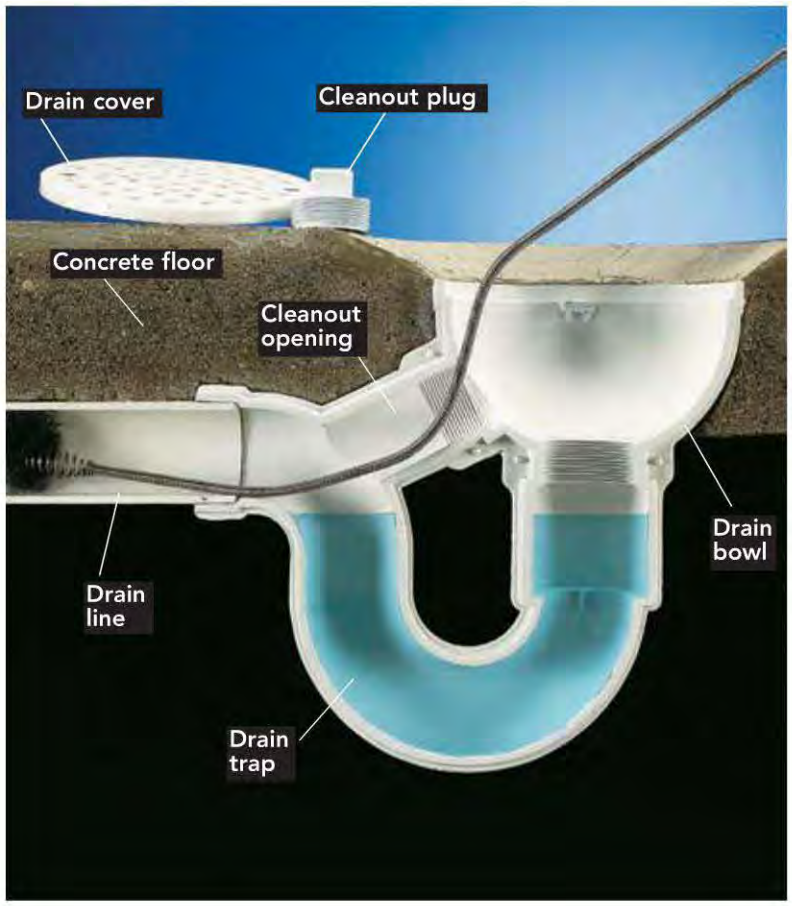
12

When the going gets tough, the tough rent power tools. The medium duty auger shown here is perfect for augering the 2-inch-diameter floor drainlines and branch drainlines.

WHEN PLUNGERS AND HAND AUGERS MEET A CLOG THEY CAN'T DISLODGE, you have one more DIY option before you call a professional drain cleaning service. Most rental centers stock power augers in several sizes. These electric tools work in much the same manner as a hand auger, but with much more tenacity. With spear tools, cutting tools, and spring tools, they can push or cut through a clog, or snag an object and drag it out from your floor or branch drainline.

Always read the instructions carefully and be sure to get through operating instructions at the rental center. If used improperly, power augers can cause major damage to your plumbing system. They are designed to be inserted beyond the trap or through cleanouts in the drainline, so they do not need to be forced through the drain trap. Never run a power auger through a toilet—it could scratch the porcelain or even break the fixture.

POWER AUGERING 101



Floor drains can develop extremely robust clogs, especially if the drain cover is absent. A *power auger* that's inserted through the cleanout opening can travel 50 feet or more to hunt down and remove stubborn clogs. These rental tools come in several sizes and may also be used to clear tub/shower drainlines, branch drainlines and even a 3- to 4-inch diameter soil stack or house drain.

TOOL TIP

Power augers can be fitted with three different head styles. The spring tool is affixed to the cable end to snag and retrieve an obstruction. The spear tool is used to penetrate a clog and puncture it to create a starter hole for the cutting tool, which can cut apart very resistant clogs (often tree roots).

TERMS YOU NEED TO KNOW

TRAP—a U-shaped bend of drain pipe behind or under every fixture. It's always full of water to keep sewer gases from rising into the house. If possible, remove the trap before augering the drainline to a fixture. With the floor drain, you bypass the trap by opening a cleanout plug.

CLEANOUTS—are access ports in drain pipes kept covered with threaded caps.

CLEANING TOOL—the spring, spear, or cutter attached to the tip of a cable auger. These are interchangeable.

BRANCH OR FIXTURE DRAIN—the run of pipe in the wall or floor that drains a fixture (except a toilet). It's usually 1½ to 2-inches in diameter. It may join with a toilet drain, a stack, or the house drain.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Driving to rental center
- Exercising caution

DIFFICULTY LEVEL

Time: ½ to 1 hour plus renting equipment

HOW TO POWER-AUGER A FLOOR DRAIN

THE LOWDOWN ON THE LOW DOWN:

If you choose to auger a larger line, you may find yourself opening a cleanout with 10 or 20 vertical feet of waste water behind it. Be careful. The cap may unexpectedly burst open when it's loose enough, spewing noxious waste water uncontrollably over anything in its path, including you! Here are some precautions:

Whenever possible, remove a trap or cleanout close to the top of the backed-up water level. Run your auger through this. Make sure the auger and its electric connections will not get wet should waste water spew forcefully from the cleanout opening.

Use the spear tool on the power auger first, to let the water drain out through a smaller hole before widening it with a larger cutting tool. If you are augering through a 3- or 4-inch cleanout, use three bits: the spear, a small cutter, and then a larger cutter to do the best job.

1 Remove the cover from the floor drain using a slotted or Phillips screwdriver. On one wall of the drain bowl you'll see a cleanout plug. Remove the cleanout plug from the drain bowl with your largest channel-type pliers. This cleanout allows you to bypass the trap. If it's stuck, apply penetrating oil to the threads and let it sit a half an hour before trying to free it again. If the wrench won't free it, rent a large pipe wrench from your home center or hardware store. You can also auger through the trap if you have to.

2 Rent an electric drum auger with at least 50 feet of ½-inch cable. The rental company should provide a properly sized, grounded extension cord, heavy leather gloves, and eye protection. The auger should come with a spear tool, cutter tool, and possibly a spring-tool suitable for a 2-inch drainline. Attach the spearhead first (with the machine unplugged).

3 Wear close-fitting clothing and contain long hair. Place the power auger machine in a dry location within three feet of the drain opening. Plug the tool into a grounded, Ground Fault Interrupted (GFI) protected circuit. Put on eye protection and gloves; you will be holding a rotating metal cable and may be exposed to dangerous bacteria and caustic drain cleaning chemicals. Position the footswitch where it is easy to actuate; visualize using the machine without having to overreach the rotating drum or exposed belts. Make sure the FOR/REV switch is in the Forward position (inset photo). Hand feed the cleaning tool and some cable into the drain or cleanout before turning the machine on.

4 Stationary power augers (as opposed to pistol-grip types) are controlled by a foot pedal called an actuator so you can turn the power on and off hands-free.

6 Gradually work through the clog by pulling back on the cable whenever the machine starts to bog down and pushing it forward again when it gains new momentum. Again, never let the cable stop turning when the motor is running. When you have broken through the clog (or if you are using the spring head and believe you have snagged an object) withdraw the cable from the line. Manually pull the cable from the drain line while continuing to run the drum Forward. If it's practical, have a helper hose off the cable as its withdrawn and recoiled. When the cleaning tool is close to the drain opening, release the foot actuator and let the cable come to a stop before feeding the remaining two or three feet of cable into the drum by hand.

5 With both gloved hands on the cable, depress the foot actuator to start the machine. Gradually push the rotating cable into the drain opening. If the rotation slows or you cannot feed more cable into the drain, pull back on the cable before pushing it forward again. Don't force it. The cable needs to be rotating whenever the motor is running or it can kink and buckle, destroying the cable (although a clutch on the drum should prevent this). If the cleaning tool becomes stuck, turn the FOR/REV switch to Reverse and back the tool off the obstruction before switching back to Forward again.

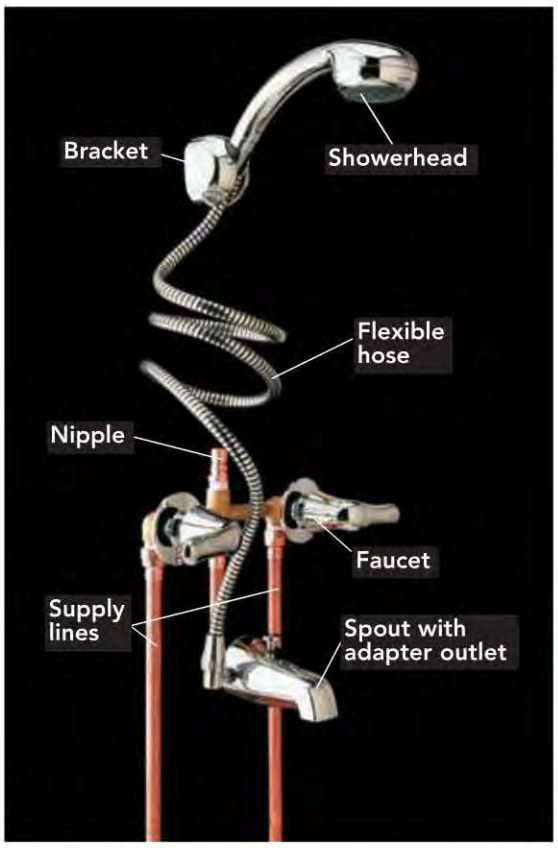
7 After clearing the drain pipe, run the auger through the trap. Finish cleaning the auger. Wrap Teflon tape clockwise onto the plug threads and replace the plug. Run hot water through a hose from the laundry sink or use a bucket to flush remaining debris through the trap and down the line.

13 Adding a Shower to a Tub

Converting a plain bathtub into a tub/shower is a relatively easy task when you use a flexible shower adapter that fits onto a special replacement tub spout.

FORGET THE LAZY 8 TRUCK STOP. Forget the locker room at the health club. You may be able to enjoy the luxury of a real shower right in your own home or apartment. If you have an old built-in tub but no shower, we'll show you how you can remove the spout and replace it with one equipped with an adapter hose outlet. A flexible shower hose can be screwed to this. We'll also show you how to install a mounting bracket so you can hang the showerhead and free up your hands. Add a telescoping shower curtain rod and a shower curtain and your new shower stall is ready for duty.

SHOWER ADAPTERS 101



The appearance of the spout gives good clues as to which kind of nipple it is connected to. A) Spout with no diverter is probably connected to a 3" long threaded nipple. To install a diverter spout you'll need to replace the 3" threaded nipple with a shorter threaded nipple that sticks out no more than ½" from the wall—not too big of a job. B) If the spout already has a diverter knob, it already has a showerhead, and you're doing the wrong project (although there is no reason you couldn't hook up a shower adapter if you want a handheld shower). C) If the spout has a small setscrew in a slot on the underside, it is probably attached with a slip fitting to a ½" copper supply nipple. Unless you are able to solder a new transition fitting onto the old pipe after cutting it, call a plumber to install the new spout here. D) Spouts with outlets for shower adapters require a short threaded nipple (or comparable union) that sticks out from the wall no more than ¾".

TERMS YOU NEED TO KNOW

NIPPLE—a short piece of iron or brass pipe that's threaded on both ends. It may be unscrewed from the wall.

COPPER STUB—a short piece of copper pipe with or without a threaded adapter on the end. It cannot be unscrewed from the wall.

REDUCING BUSHING—a little piece of pipe with interior and exterior threads. In this case, to allow a ¾-inch tub spout to screw onto a ½-inch nipple.

TEFLON TAPE—a white or thin tape wound on pipe threads to seal and lubricate the joint.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Making pipe connections
- Cutting tile or tileboard
- Working with wall anchors

DIFFICULTY LEVEL

Time: 1 to 2 hours

HOW TO ADD A SHOWER WITH AN ADAPTER SPOUT

1 Make sure the old spout is not held in place with a setscrew (see previous page) and then remove it by wrapping it with a cloth and turning the spout with channel-type pliers or a pipe wrench.

2 If you have a long iron or brass nipple like this, you need to replace it with a short one. Threaded nipples have threads at each end, so you can usually unscrew the old ones. Mark the nipple at the face of the wall and write "front" on your side. Unscrew it counterclockwise with a pipe wrench. Get a threaded brass nipple of the same diameter that is about half an inch longer than the distance from the back of your old nipple to your line.

TOOL TIP

A long-bladed screwdriver or a dowel inserted into the mouth of the spout can be used to spin the spout free from the nipple.

3 Wrap six layers of Teflon tape clockwise on the nipple and thread into the wall. Thread the reducing bushing onto the nipple if it will fit. Thread the adapter spout on. Tighten further with a screwdriver or dowel to orient the spout correctly.

4 Attach flexible shower hose to the adapter hose outlet. Tighten with an adjustable wrench.

5 Determine the location of showerhead bracket. Use hose length as a guide, and make sure showerhead can be easily lifted off the bracket.

6 Mark hole locations. Obtain a glass-and-tile drill bit for your electric drill in the size recommended by the shower bracket manufacturer. Put on eye protection and drill holes in ceramic tile on your marks.

7 Insert anchors into holes, and tap in place with a wooden or rubber mallet. Fasten showerhead holder to the wall using a Phillips screwdriver and the mounting screws.

14 Replacing Bathtub Spouts

The bathtub spout may need replacing for many reasons, including a failed diverter like the one above. You also may want to add a flexible shower adapter (see pages 196 to 199), or the old spout could just be disgusting beyond repair.

IN MANY SITUATIONS, REPLACING A BATHTUB SPOUT can be almost as easy as hooking up a garden hose to an outdoor spigot. There are some situations where it is a bit more difficult, but still pretty simple. The only time it's a real problem is when the spout is attached to a plain copper supply nipple, rather than a threaded nipple. You'll know this is the case if the spout has a setscrew on the underside where it meets the wall. Many bathtub spouts are sold in kits with a matching showerhead and handle or handles. But for a simple one-for-one replacement, spouts are sold separately. You just need to make sure the new spout is compatible with the existing nipple (see pages 202 and 203).

TUB SPOUTS 101

In many bathtub/shower plumbing systems, the *spout* has the important job of housing the diverter switch—a *gate* inside the spout that is operated by a lever with a knob for pulling. When the gate is open, water comes out of the spout when the faucet is turned on. When the *diverter* is pulled shut, the water is redirected up a *riser pipe* and to the *showerhead*. Failure of the diverter is one of the most common reasons for replacing a spout.

TERMS YOU NEED TO KNOW

TUB SPOUT GATE DIVERTER—a knob-operated gate valve on the tip of a tub spout. When it's pulled up, water cannot pass through the spout and is forced to rise to the showerhead.

HANDLE-OPERATED DIVERTER VALVE—the diverter valve behind the central handle on a three-handle faucet. It uses a compression stem and washer or a cartridge to divert water from the spout so the shower can be used.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Using channel-type pliers
- Tracking the order and arrangement of parts

DIFFICULTY LEVEL

Time: 1 hour plus research and shopping

HOW TO REPLACE A SLIP-FIT SPOUT

1 Check underneath the tub spout to look for an access slot or cutout, which indicates the spout is a slip-fit style that is held in place with a setscrew and mounted on a copper supply nipple. Loosen the screw with a hex (Allen) wrench. Pull off the spout.

2 Clean the copper nipple with steel wool. If you find any sharp edges where the nipple was cut, smooth them out with emery paper. Then, insert the O-ring that comes with spout onto the nipple (see the manufacturer's instructions) and slide the spout body over the nipple in an upside-down position.

3 With the spout upside down for ease of access, tighten the setscrews on the clamp, working through the access slot or cutout, until you feel resistance.

4 Spin the spout so it's right-side up and then tighten the setscrew from below, making sure the wall end of the spout is flush against the wall. Do not overtighten the setscrew.

HOW TO REPLACE A THREADED SPOUT

1 If you see no setscrew or slot on the underside of the spout, it is attached to a threaded nipple. Unscrew the tub spout by inserting a heavy-duty flat screwdriver into the spout opening and spinning it counterclockwise.

2 Wrap several courses of Teflon tape clockwise onto the pipe threads of the nipple. Using extra Teflon tape on the threads creates resistance if the spout tip points past six o'clock when tight.

TOOL TIP

Alternatively, grip the spout with a padded pipe wrench or channel-type pliers. Buy a compatible replacement spout at a home center or hardware store.

3 Twist the new spout onto the nipple until it is flush against the wall and the spout is oriented properly. If the spout falls short of six o'clock, you may protect the finish of the spout with tape and twist it a little beyond hand tight with your channel-type pliers—but don't over do it; the fitting can crack.

Replacing Widespread Bathroom Faucets

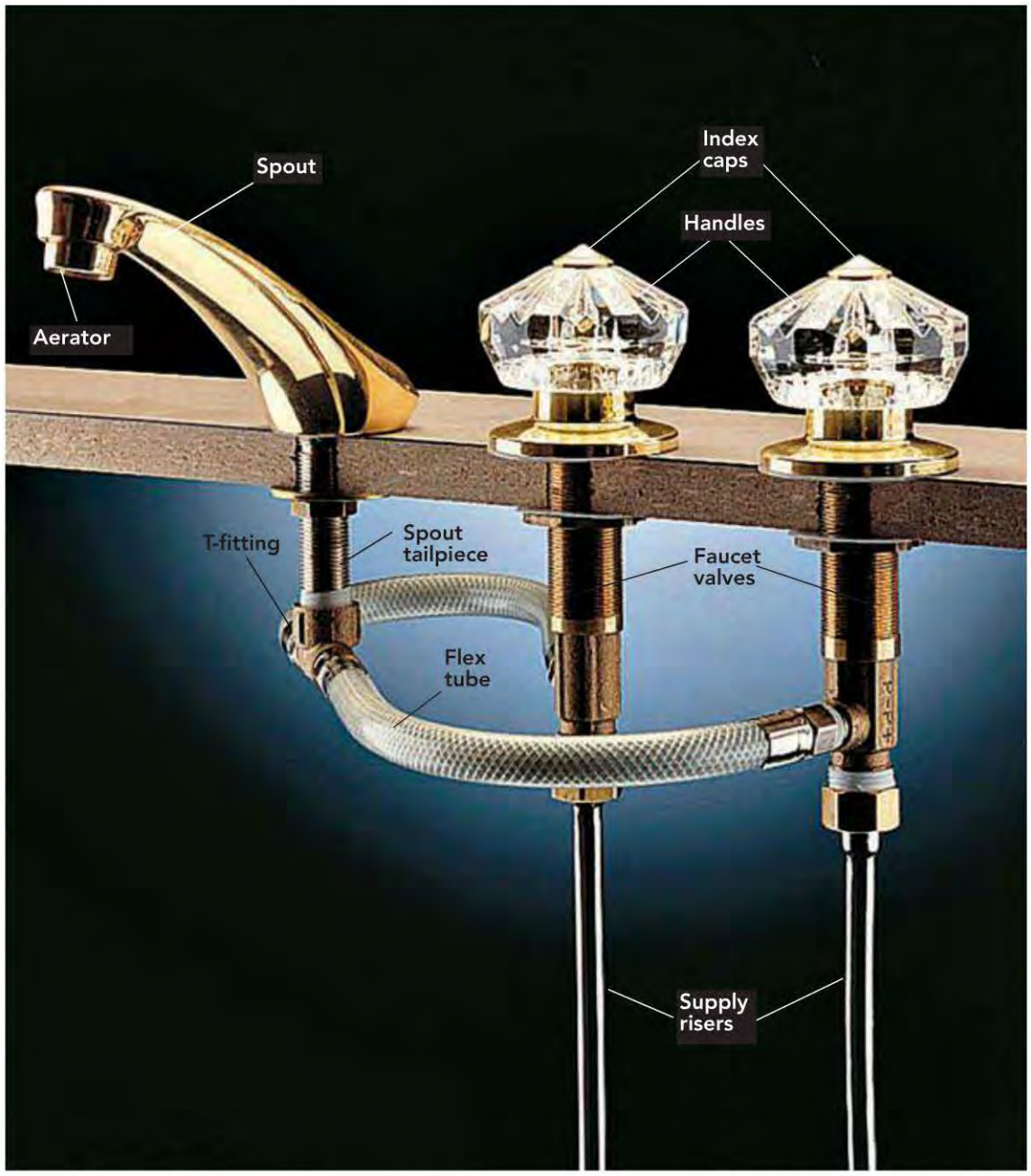
15

Three-piece (widespread) faucets are as classy as a good three-piece suit, and the styles are virtually unlimited.

WIDESPREAD FAUCETS COME IN THREE PIECES INSTEAD OF ONE: a hot tap, a cold tap, and the spout. Each piece is mounted separately in its own hole in the sink. The hot and cold taps (valves) are connected to hot and cold water supplies respectively. The spout is connected to the valves with reinforced flexible hoses. The great advantage to this configuration is that you gain flexibility when locating your spout and handles. If your faucet set has a long enough hose, you can even create arrangements such as locating the handles near one end of the tub and the spout near the other so you can turn the water on and off or adjust the temperature without getting up. Even models made for bathroom lavatories, like the one you see here, offer many creative configuration options.

TIP: Save your paperwork. Should you ever need to service your faucet, the product literature will be useful for troubleshooting and identifying and replacing parts.

WIDESPREAD FAUCETS 101



Widespread faucets come in three pieces, a *spout* and two *valves*. *Supply risers* carry hot and cold water to the valves, which are turned to regulate the amount of water going to the spout, where the water is mixed. Water travels from the valves to the spout through *flex tubes*, which attach to the *spout tailpiece* via a *T-fitting*. Three-piece faucets designed to work with a pop-up stopper have a *clevis* and a *lift rod* (see pages 228 to 229). The *handles* attach with *handle screws* that are covered with *index caps*. An *aerator* is screwed on the faucet spout after debris is flushed from the faucet.

TERMS YOU NEED TO KNOW

PLUMBER'S PUTTY—a soft clay-like material used to seal faucet parts to sink parts.

TEFLON TAPE—a thin, white tape used to lubricate and seal threaded fittings.

PIPE JOINT COMPOUND—a paste that may be used instead of Teflon tape.

LAVATORY—another name for a bathroom sink.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

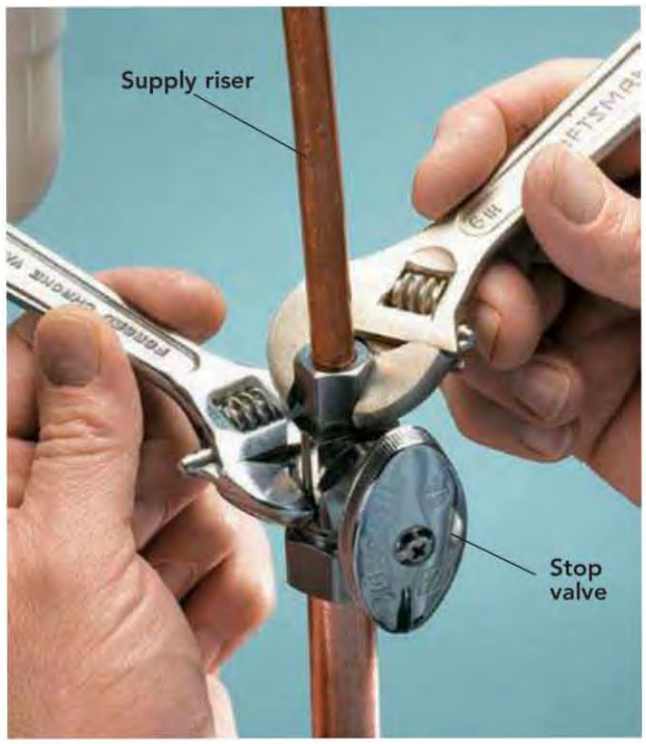
- Using a basin wench
- Working in confined spaces
- Making compression unions

DIFFICULTY LEVEL

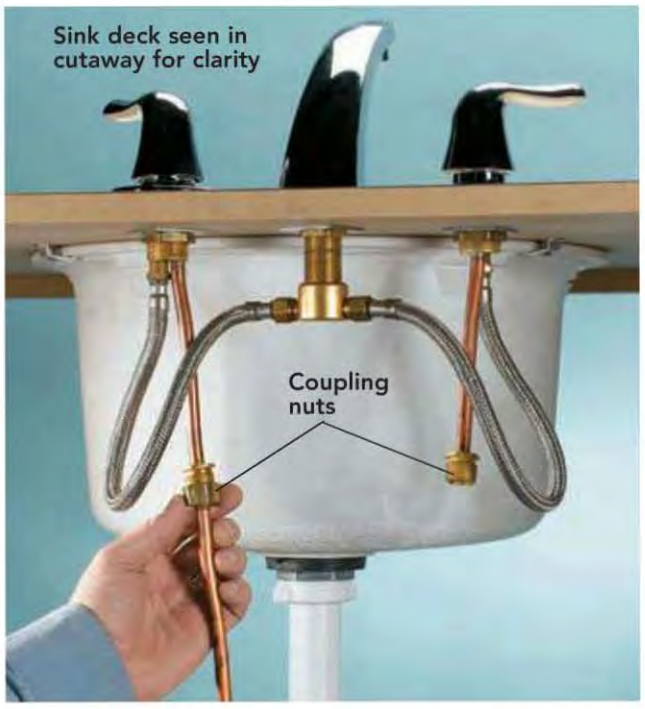
Time: 1 to 3 hours

HOW TO REMOVE A WIDESPREAD FAUCET

1 Clear out the cabinet under the sink and lay down towels. Turn off the hot and cold stop valves, and open the hot and cold taps. If you have difficulty turning the water off, turn to page 134.



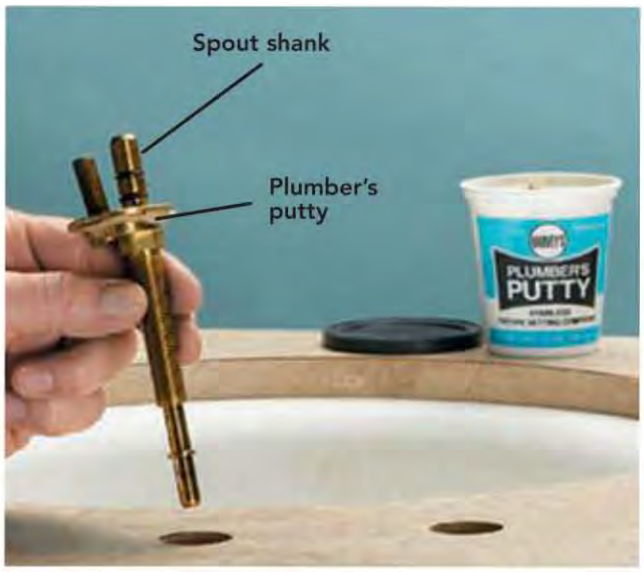
2 Unthread the compression nuts that connect the hot and cold supply risers to the stop valves. If a compression nut is frozen, stabilize the valve body with another wrench before applying more force.



3 Remove the coupling nuts holding the risers to the supply tubes from the faucet, stabilizing the tubes with a second wrench. Don't reuse old metal supply risers; the soft metal ends have been press-formed to the supply tubes of the old faucet.

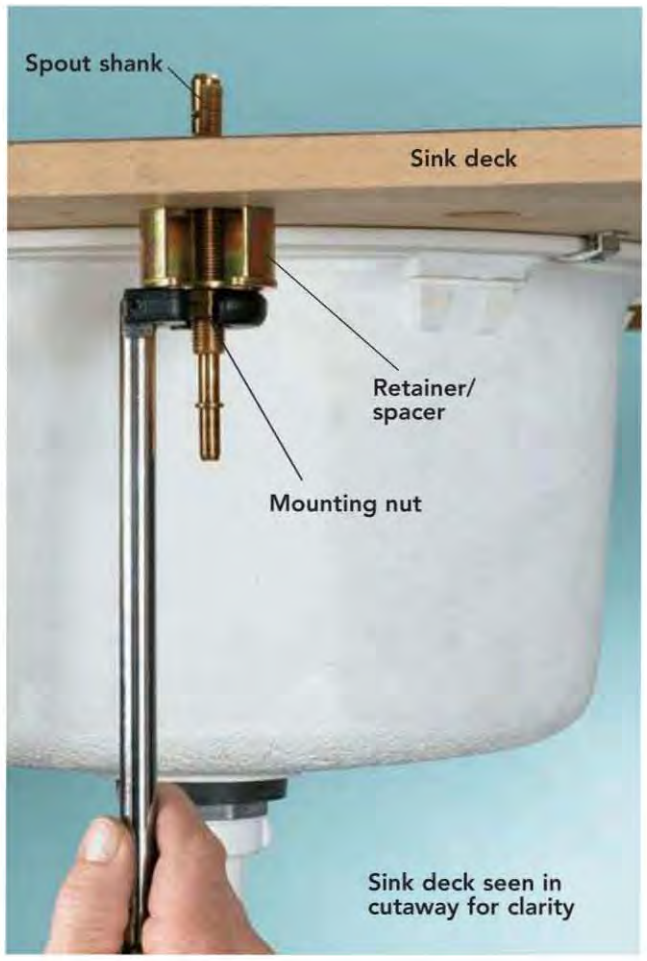
4 Using a basin wrench, disconnect all three mounting nuts holding the two faucet handles and the spout. You may need to have somebody hold the spout or valve steady from above. Remove the old faucet parts and clean the installation area in preparation for the new faucet.

HOW TO INSTALL A WIDESPREAD FAUCET

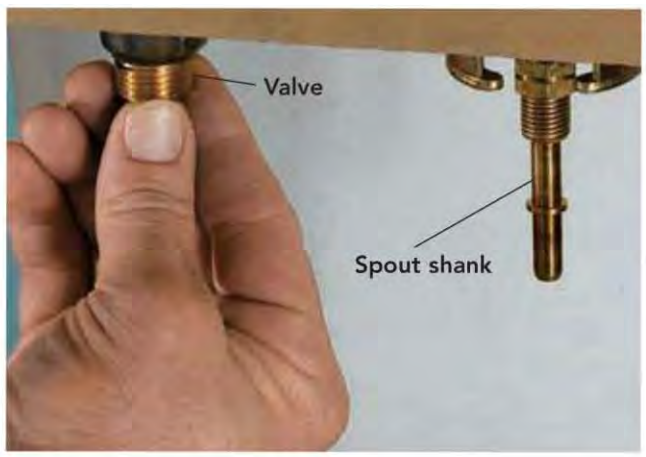


1 Insert the shank of the faucet spout through one of the holes in the sink deck (usually the center hole but you can offset it in one of the end holes if you prefer). If the faucet is not equipped with seals or O-rings for the spout and handles, pack plumber's putty on the undersides before inserting the valves into the deck. NOTE: If you are installing the widespread faucet in a new sink deck, drill three holes of the size suggested by the faucet manufacturer (see page 204 for tips on locating the holes).

3 Mount the valves to the deck using whichever method the manufacturer specifies (it varies quite a bit). In the model seen here, a mounting ring is positioned over the deck hole (with plumber's putty seal) and the valve is inserted from below. A clip snaps onto the valve from above to hold it in place temporarily (you'll want a helper for this).



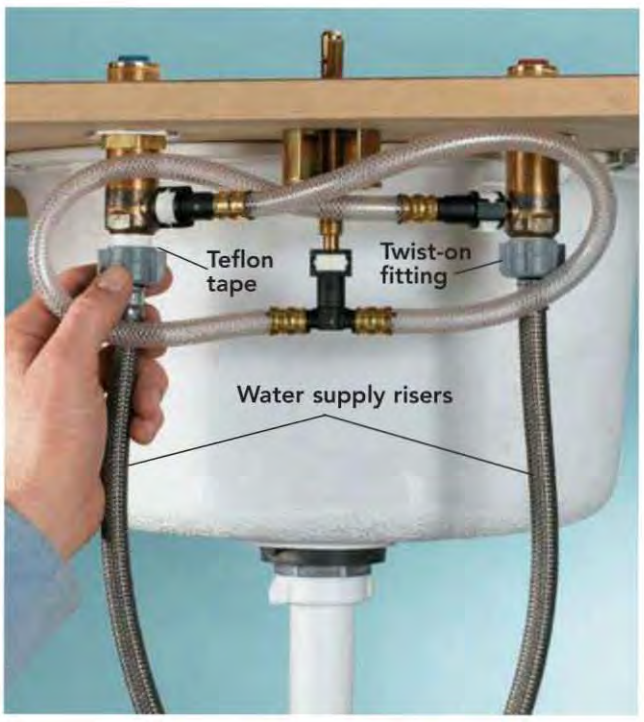
2 In addition to mounting nuts, many spout valves for widespread faucets have an open retainer fitting that goes between the underside of the deck and the mounting nut. Others have only a mounting nut. In either case, tighten the mounting nut with pliers or a basin wrench to secure the spout valve. You may need a helper to keep the spout centered and facing forward.



4 From below, thread the mounting nuts that secure the valves to the sink deck. Make sure the cold water valve (usually has a blue cartridge inside) is in the right-side hole (from the front) and the hot water valve (red cartridge) is in the left hole. Install both valves.

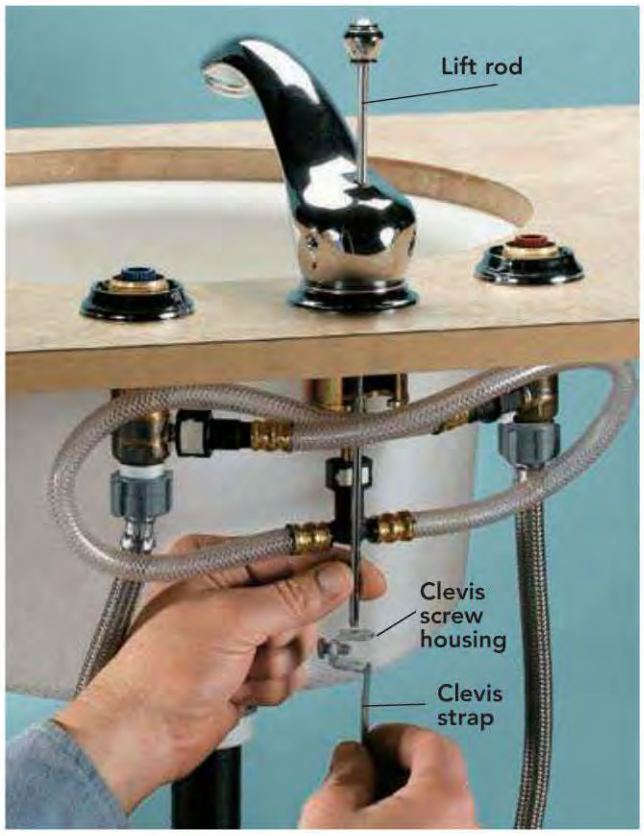
5 Once you've started the nut on the threaded valve shank, secure the valve with a basin wrench squeezing the lugs where the valve fits against the deck. Use an adjustable wrench to finish tightening the lock nut onto the valve. The valves should be oriented so the water outlets are aimed at the inlet on the spout shank.

6 Attach the flexible supply tubes (supplied with the faucet) to the water outlets on the valves. Some twist onto the outlets, but others (like the ones above) click into place. The supply hoses meet in a T-fitting that is attached to the water inlet on the spout.

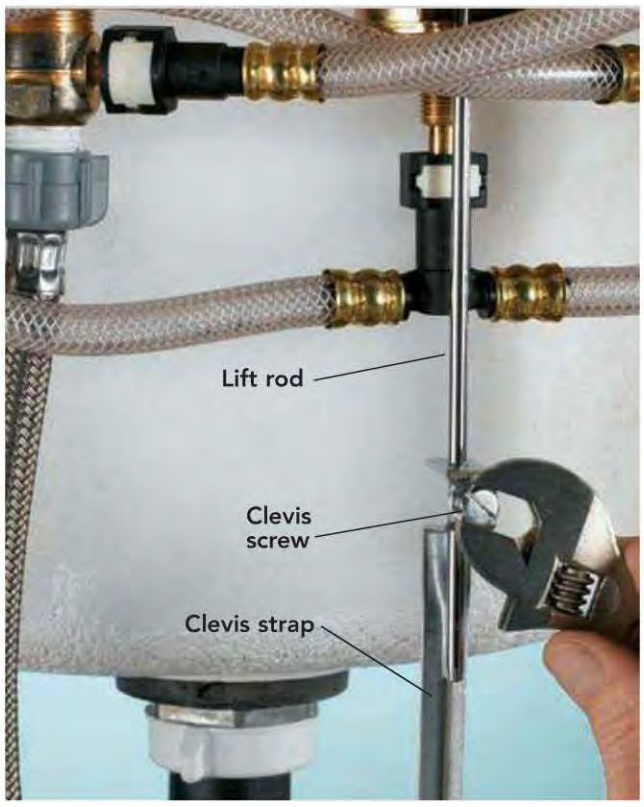


7 Attach flexible braided metal supply risers to the water stop valves and then attach the tubes to the inlet port on each valve (usually with Teflon tape and a twist-on fitting at the valve end of the supply riser).

8 Attach the spout. The model shown here comes with a special hex wrench that is threaded through the hole in the spout where the lift rod for the pop-up drain will be located. Once the spout is seated cleanly on the spout shank you tighten the hex wrench to secure the spout. Different faucets will use other methods to secure the spout to the shank.

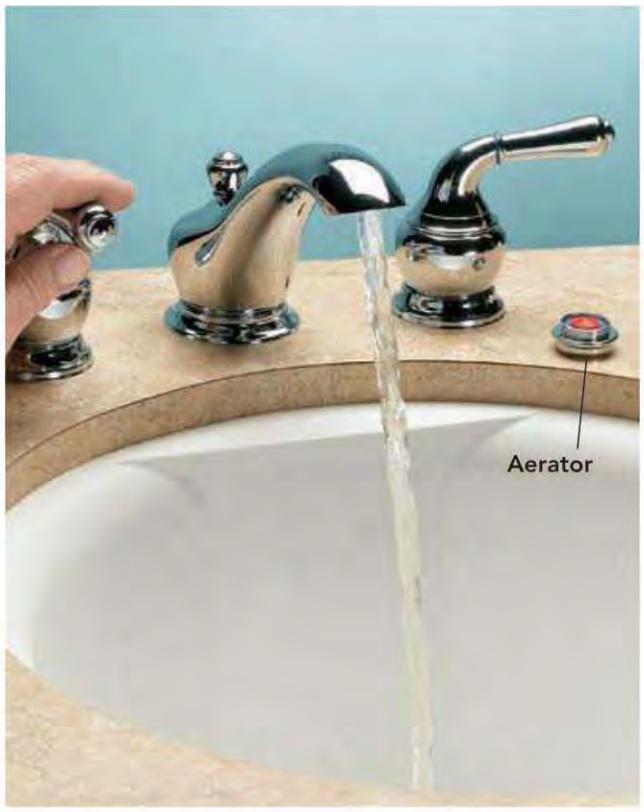


9 If your sink did not have a pop-up stopper, you'll need to replace the sink drain tailpiece with a pop-up stopper body (often supplied with the faucet). See pages 228 to 231. Insert the lift rod through the hole in the back of the spout and, from below, thread the pivot rod through the housing for the clevis screw.



10 Attach the clevis strap to the pivot rod that enters the pop-up drain body and adjust the position of the strap so it raises and lowers properly when the lift rod is pulled up. Tighten the clevis screw at this point. It's hard to fit a screwdriver in here, so you may need to use a wrench or pliers.

11 Attach the faucet handles to the valves using whichever method is required by the faucet manufacturer. Most faucets are designed with registration methods to ensure that the handles are symmetrical and oriented in an ergonomic way once you secure them to the valves.



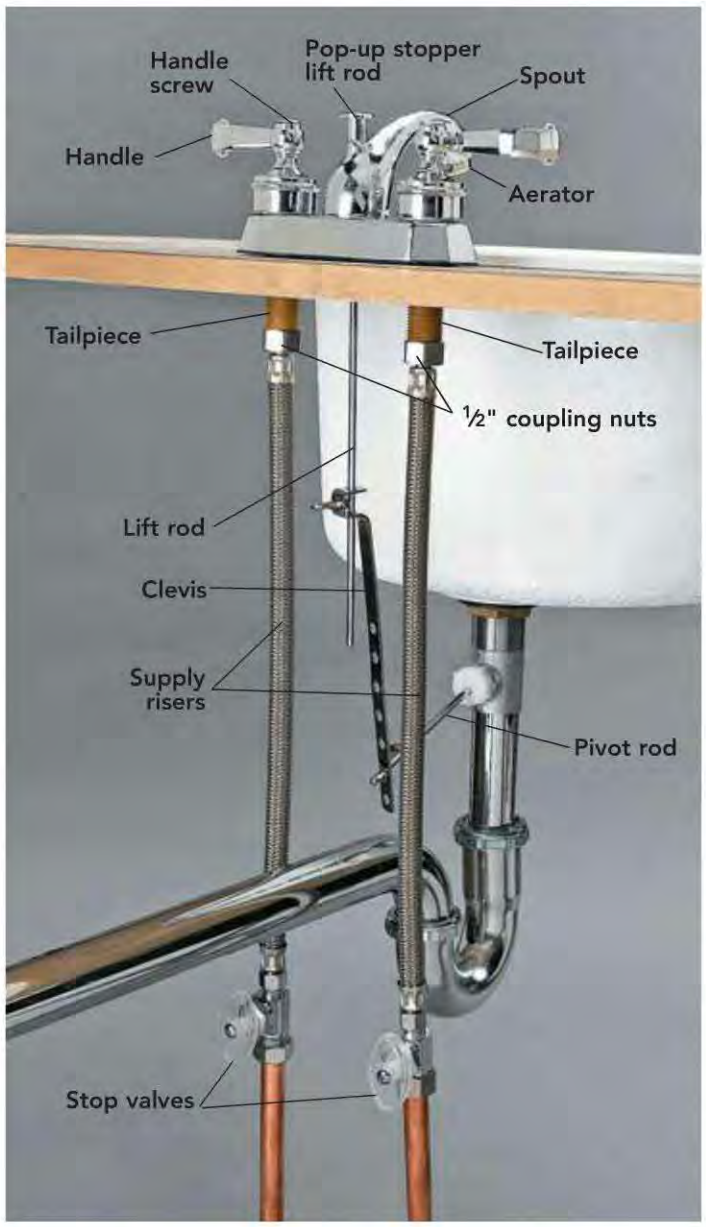
12 Turn on the water supply and test the faucet. Remove the faucet aerator so any debris in the lines can clear the spout.

16 Installing New Bathroom Faucets

Standard one-handle, deck-mounted bathroom faucets are interchangeable with two-handle models, fitting in the same two or three holes in the bathroom sink.

ONE-PIECE BATHROOM FAUCETS ARE EASY TO REPLACE. They're attached to the sink with a couple of mounting nuts and to the water supply with coupling nuts. With the faucet gone, you'll be looking at two or three holes in the faucet deck. The outside holes take tailpieces or mounting posts for the faucet, and the middle hole is for the pop-up stopper lift rod. The outside holes are spaced four inches apart and will accept any standard deck-mounted, one-piece bathroom faucet, except if you don't have a middle hole, you can't have one with a pop-up stopper. We'd advise you to buy a heavy, quality faucet made of brass (chrome or another metal on the outside). Cheap chromed-plastic faucets tend to wear out at the handle attachments, and chrome-plated steel tends to rust. Faucets usually come with a pop-up stopper mechanism. We show you how to replace these on pages 228 to 231.

ONE-PIECE FAUCETS 101



The tailpieces of a standard deck-mounted, one-piece bathroom sink faucet are 4" apart on center. As long as the two outside holes in the back of your sink measure 4" from center to center, and you have a middle hole for a pop-up stopper, you can put in any standard one-piece bathroom faucet with *pop-up stopper.*

The faucet is secured to the sink with *mounting nuts* that screw onto the tailpieces from below. Also get two *flexible stainless steel supply risers* for sinks, long enough to replace the old tubes. These typically attach to the stop valves with ⅜-inch *compression-sized coupling nuts* and to the faucet with standard *faucet coupling nuts.* But take your old tubes and the old compression nuts from the stop valves to the store to ensure a match. The *clevis, lift rod,* and *pivot rod* are parts of the pop-up stopper assembly. (Replaced on pages 126 to 129.) The handles attach with *handle screws* that are covered with *index caps.* An *aerator* is screwed on the faucet spout after debris is flushed from the faucet.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Making plumbing connections
- Ability to work in confined space

TERMS YOU NEED TO KNOW

PLUMBER'S PUTTY—a soft clay-like material used to seal faucet parts to sink parts.

TEFLON TAPE—a thin white tape used to lubricate and seal threaded fittings.

PIPE JOINT COMPOUND—a paste that may be used instead of Teflon tape.

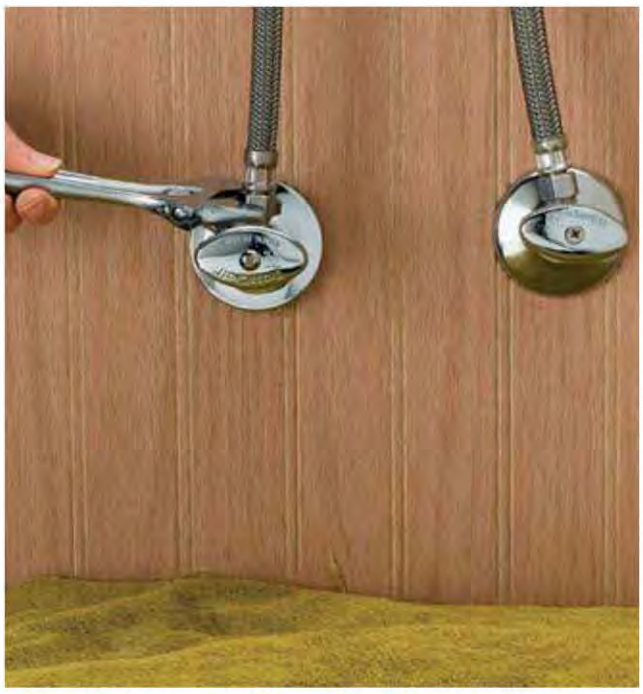
DECK-MOUNTED FAUCET—another name for a one-piece faucet.

LAVATORY—another name for a bathroom sink.

DIFFICULTY LEVEL

TIME: 1 to 2 hours plus shopping

HOW TO REPLACE A ONE-PIECE FAUCET

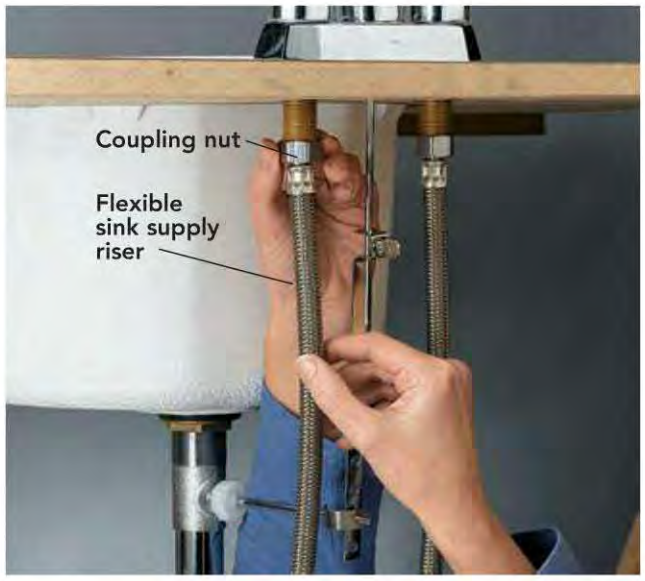


1 Clear out the cabinet under the sink and lay down towels. Turn off the hot and cold stop valves and open the faucet. Unscrew the compression nuts that are holding the hot and cold supply tubes in the stop valves. Remove the coupling nuts holding the supply tubes to the tailpieces of the faucet and remove the tubes.

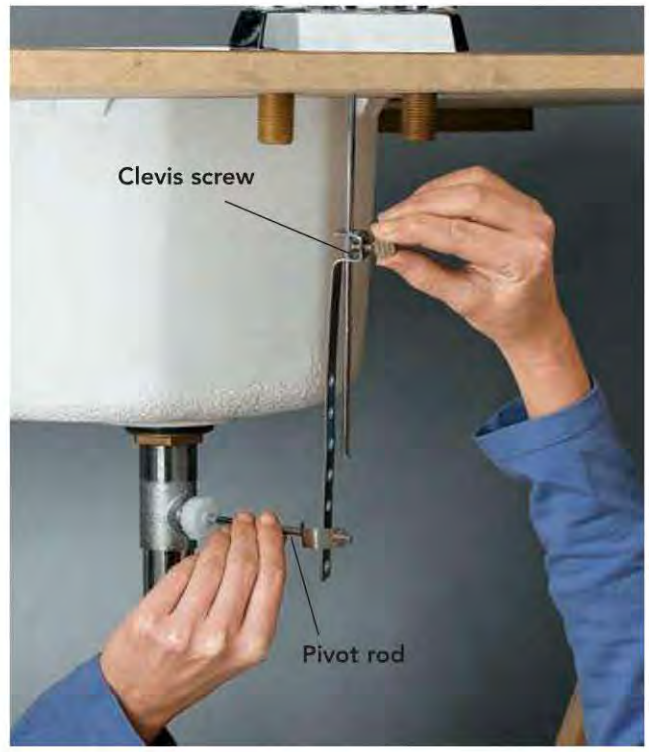
2 Put on protective eyewear! Debris will be falling in your face. Loosen the clevis screw (counterclockwise) holding the clevis strap to the lift rod. Remove the mounting nuts on the tailpieces of the faucet with a basin wrench or channel-type pliers. If the mounting nuts are rusted in place, apply penetrating oil, let stand ten minutes, and try again. TIP: Attach locking pliers to the basin wrench handle for greater leverage.

3 Pull the faucet body from the sink. Scrape off old putty or caulk with a putty knife and clean off the sink with a scouring pad and an acidic scouring cleaner like Barkeeper's Friend. Take your old supply tubes and the stop valve compression nuts to the home center so you'll know what size flexible supply risers to get.

4 Most faucets come with a plastic or foam gasket to seal the bottom of the faucet to the sink deck. These gaskets will not always form a watertight seal. If you want to ensure no splash water gets below the sink, discard the seal and press a ring of plumber's putty into the sealant groove built into the underside of the faucet body.

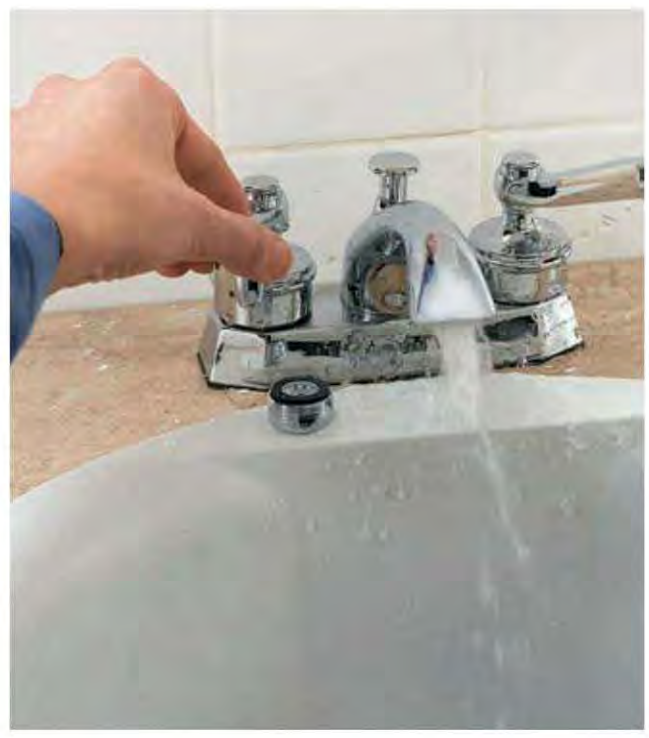


5 Insert the faucet tailpieces through the holes in the sink. From below, thread washers and mounting nuts over the tailpieces, then tighten the mounting nuts with a basin wrench until snug. Put a dab of pipe joint compound on the threads of the stop valves and thread the metal nuts of the flexible supply risers to these. Wrench tighten about a half turn past hand tight. Overtightening these nuts will strip the threads. Now tighten the coupling nuts to the faucet tailpieces with a basin wrench.



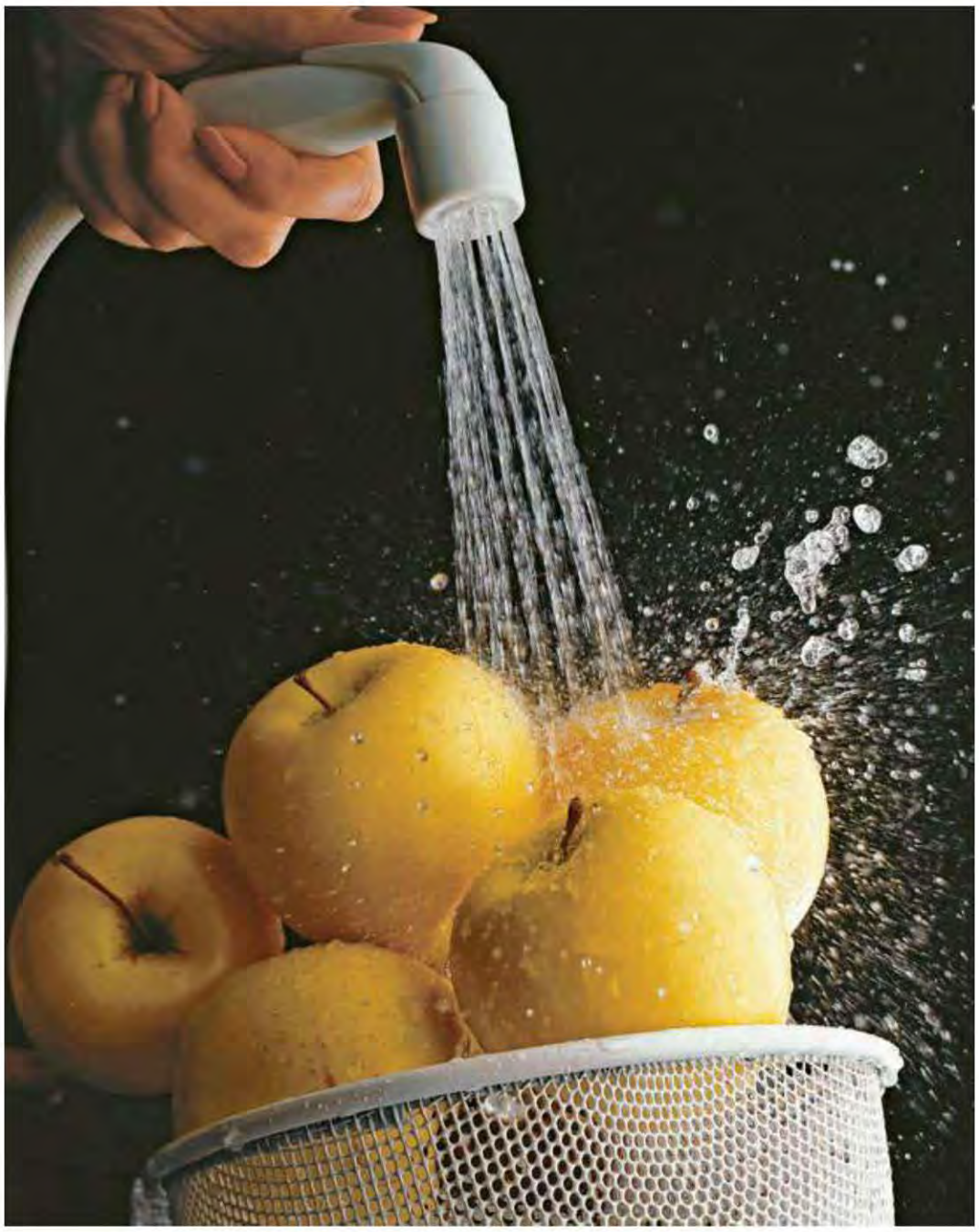
6 Slide the lift rod of the new faucet into its hole behind the spout. Thread it into the clevis past the clevis screw. Push the pivot rod all the way down so the stopper is open. With the lift rod also all the way down, tighten the clevis to the lift rod.

7 Grease the fluted valve stems with heatproof grease, then put the handles in place. Put a drop of Loctite on each handle screw before tightening it on. (This will keep your handles from coming loose). Cover each handle screw with the appropriate index cap—Hot or Cold.



8 Unscrew the aerator from the end of the spout. Turn the hot and cold water taps on full. Turn the water back on at the stop valves and flush out the faucet for a couple of minutes before turning off the water at the faucet. Check the riser connections for drips. Tighten a compression nut only until the drip stops.

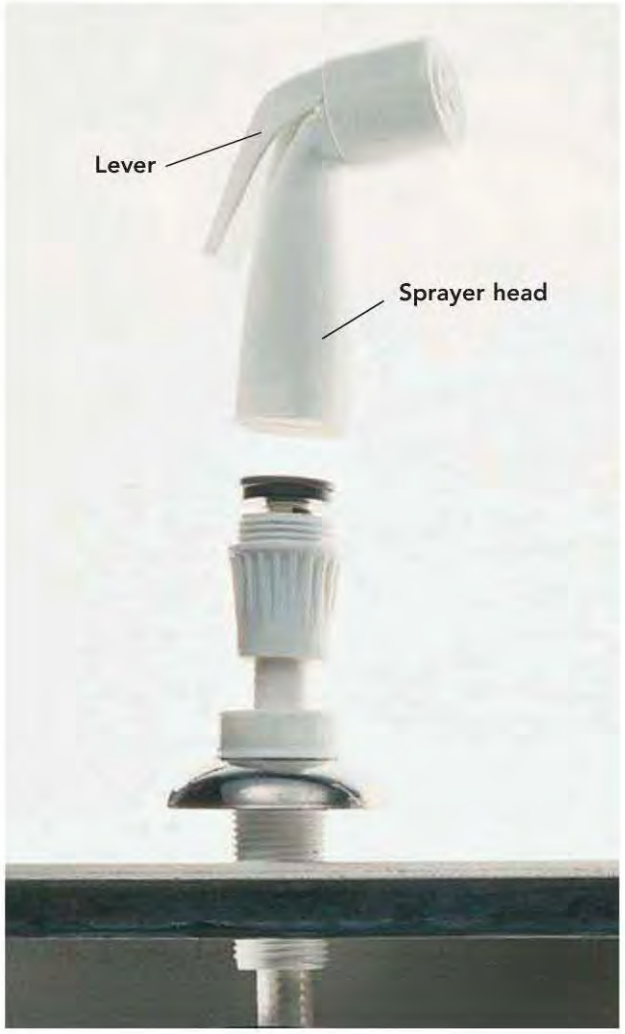
17 Replacing Kitchen Sprayers



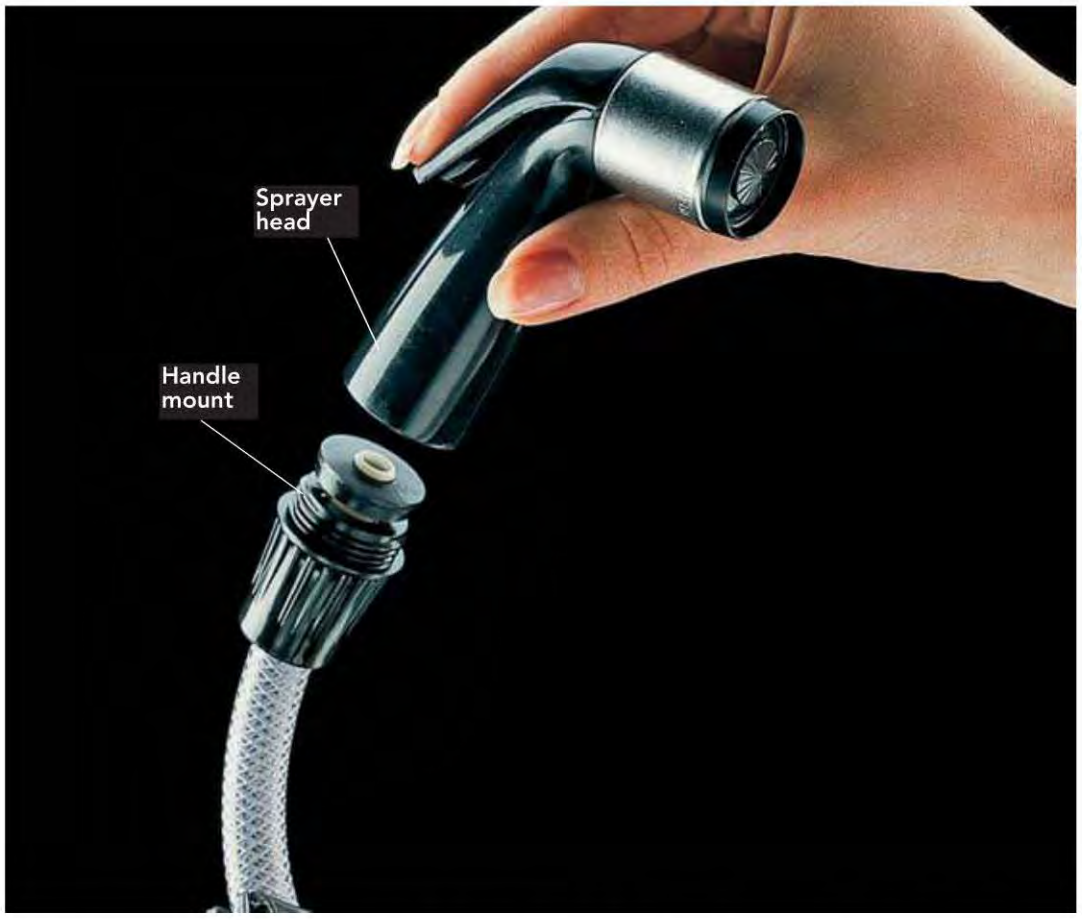
When most of us think of kitchen sprayers, the image that comes to mind doesn't closely resemble the powerful stream of accurately directed water that's cleansing the fresh apples in the photo above. For a variety of reasons, sink sprayers seldom seem to function as designed. But improving the performance of your kitchen sprayer is a simple job with a high likelihood of success.

IF THE FLOW TO YOUR SPRAYER IS WEAK, first make sure the hose under the sink isn't kinked. If the hose is damaged, you will need to replace the hose and sprayer. If the screen at the base of the sprayer is clogged with debris, remove it and flush it clean. If you dislodged other parts from the base of the sprayer, clean these and put them back in the order in which they were removed. If the sprayer leaks from the base, replace the neoprene washer. If the sprayer doesn't turn off fully, replace the sprayer. If water isn't fully diverted from spout to sprayer, you may need to replace the diverter.

KITCHEN SPRAYERS 101



When you squeeze the *lever* on your properly functioning kitchen sprayer, water flows out through the *sprayer head,* which causes a diverter valve in the faucet to close off water to the spout.



Older spray hoses are easy to work with—you simply grasp the *sprayer head* and twist counterclockwise. The screen inside can then be removed and cleaned or replaced. Twist the sprayer head back on in a clockwise direction.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

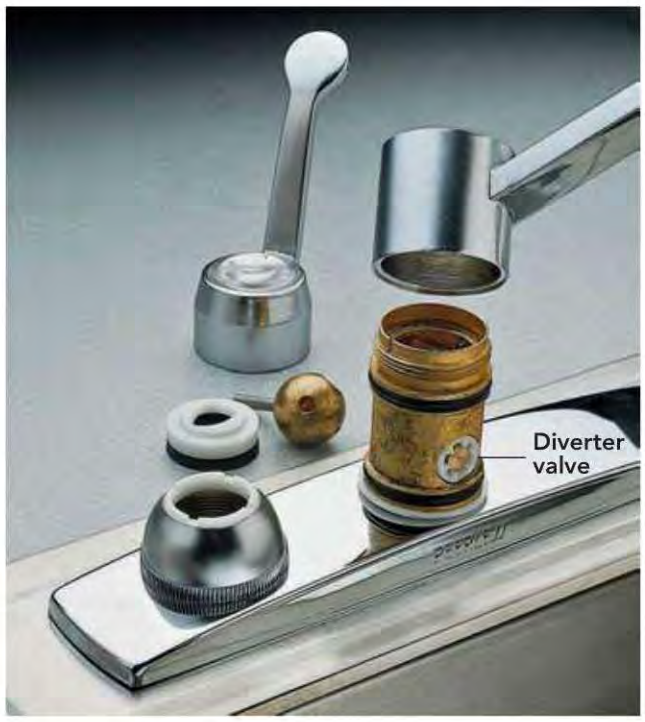
- Making pipe connections
- Working with putty

DIFFICULTY LEVEL

Time: About an hour

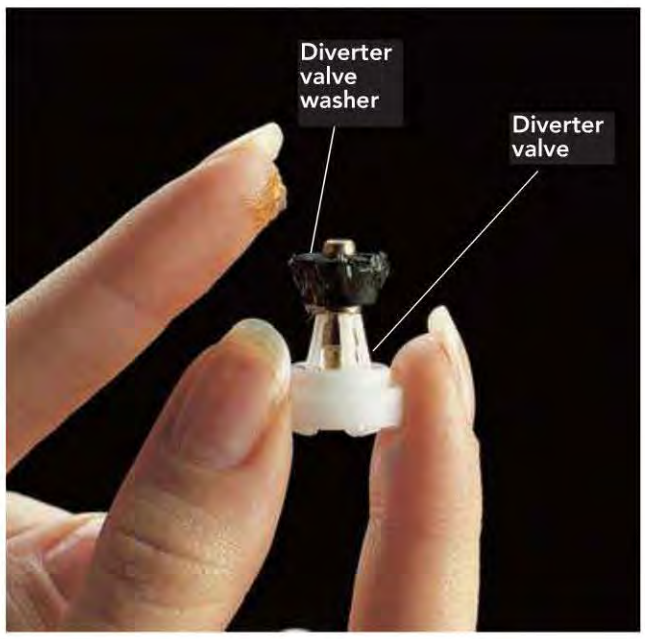
HOW TO REPLACE A SPRAYER DIVERTER VALVE

1 Shut off the water at the stop valves and remove the faucet handle to gain access to the faucet parts. Disassemble the faucet handle and body to expose the diverter valve. Ball-type faucets like the one shown here require that you also remove the spout to get at the diverter.



2 Locate the diverter valve, seen here at the base of the valve body. Because different types and brands of faucets have differently configured diverters, do a little investigating beforehand to try and locate information about your faucet. The above faucet is a ball type (see page 152).

3 Pull the diverter valve from the faucet body with needlenose pliers. Use a toothbrush dipped in white vinegar to clean any lime buildup from the valve. If the valve is in poor condition, bring it to the hardware store and purchase a replacement.

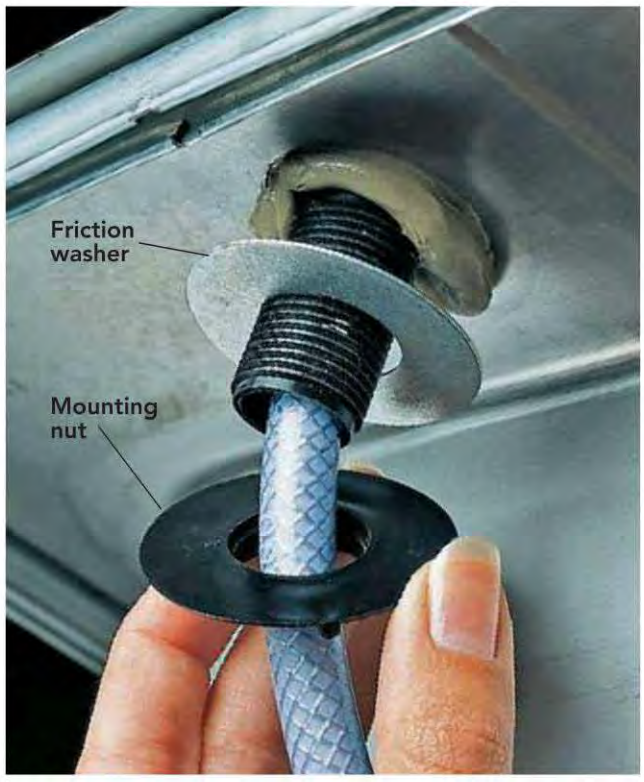


4 Coat the washer or O-ring on the new or cleaned diverter valve with heatproof grease. Insert the diverter valve back into the faucet body. Reassemble the faucet. Turn on the water and test the sprayer. If it still isn't functioning to your satisfaction, remove the sprayer tip and run the sprayer without the filter and aerator in case any debris has made its way into the sprayer line during repairs.

HOW TO REPLACE A KITCHEN SPRAYER

1 To replace a sprayer hose, start by shutting off the water at the shutoff valves. Clear out the cabinet under your sink and put on eye protection. Unthread the coupling nut that attaches the old hose to a nipple or tube below the faucet spout. Use a basin wrench if you can't get your channel-type pliers on the nut.

2 Unscrew the mounting nut of the old sprayer from below and remove the old sprayer body. Clean the sink deck and then apply plumber's putty to the base of the new sprayer. Insert the new sprayer tailpiece into the opening in the sink deck.



3 From below, slip the friction washer up over the sprayer tailpiece. Screw the mounting nut onto the tailpiece and tighten with a basin wrench or channel-type pliers. Do not overtighten. Wipe away any excess plumber's putty.

4 Screw the coupling for the sprayer hose onto the hose nipple underneath the faucet body. For a good seal, apply pipe joint compound to the nipple threads first. Tighten the coupling with a basin wrench, turn on the water supply at the shutoff valves, and test the new sprayer.

Repairing Burst Pipes

Water supply pipes can burst for many reasons, but the most common cause is water freezing and expanding inside the pipe. First turn off the water, then apply a fix.

IF A WATER PIPE FREEZES AND BREAKS, your first priority may be getting it working again—whatever it takes. There are a number of temporary fix products out there, some involving clamps and sleeves, others, epoxy putties and fiberglass tape. These repairs usually can get you through a weekend okay. We also show you how to apply full slip repair couplings, a more permanent fix. Whatever repair approach you take, please, please, please, don't leave for the store without first determining a) the diameter of your pipe and b) the material of your pipe.

WATER PIPE REPAIR PRODUCTS 101

Plumber's epoxy putty may stem a leak at a fitting, at least partially or temporarily. *Fiberglass tape with polyurethane resin* can produce a durable patch; it's sometimes used in conjunction with epoxy putty. A *clamp and sleeve* is quick and cheap. A *full slip repair coupling* is the closest to a permanent fix, but it requires straight and unblemished pipes of the right diameter and material. All of these products require that you carefully follow manufacturer's directions, or they simply will not work.

WARNING: A damaged pipe section with a patch should be replaced as soon as possible. Because of the natural movement of pipes, patches may leak again in time.

If a water supply pipe bursts, your first stop should be a shutoff. If there is a shutoff near the burst pipe, go ahead and turn off the water there or shut off the water to the whole house (right). Open faucets on every floor of the house to drain the supply system if your repair product requires dry pipe.

TERMS YOU NEED TO KNOW

OUTSIDE DIAMETER—clamps and slip couplings require that you know the outside diameter of the pipe. Close an adjustable wrench on the pipe then measure the distance between the jaws.

PIPE MATERIAL—Certain repair products work on certain pipe types. Make sure you know yours before heading out to the home center.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

- Using a tubing cutter
- Making a compression joint

DIFFICULTY LEVEL

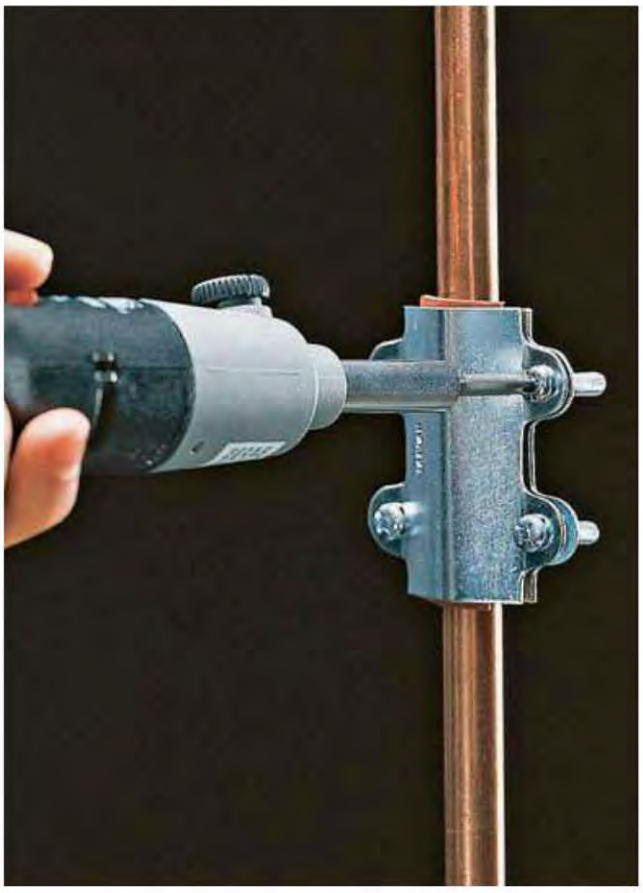
Time: a few minutes plus shopping

HOW TO APPLY A SLEEVE AND CLAMP REPAIR KIT

1 Make temporary repairs to a burst copper supply pipe with a sleeve clamp repair kit, available at most hardware stores. With the water supply shut off at the main, smooth out any rough edges around the damage with a metal file.

2 Center rubber sleeve of repair clamp over the rupture. If the sleeve enfolds the pipe, the seam should be opposite the rupture.

3 Place the two metal repair clamps around the sleeve.

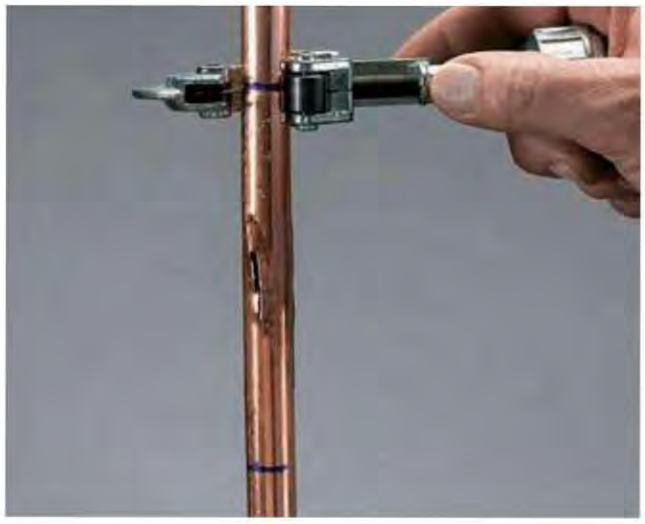


4 Tighten the screws with a Phillips screwdriver. Open water supply and watch for leaks. If it does leak, start from the beginning with the sleeve in a slightly different place. Have the section of ruptured pipe replaced as soon as possible.

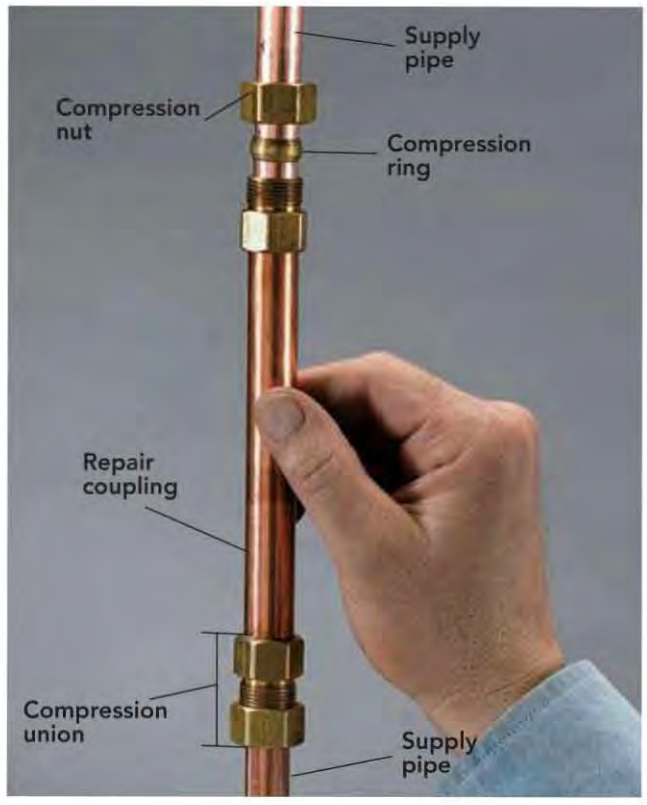
HOW TO APPLY A REPAIR COUPLING TO A COPPER PIPE

1 For a longer-lasting (not permanent) repair, use a compression-fit, full slip repair coupling (these come with parts to make a compression union—you can also buy a slip coupling that's just a piece of copper tubing with an inside diameter equal to the outside diameter of the tubing being repaired, but these require soldering). Turn off water at the meter. Mark the boundaries of the pipe to be replaced. This should include pipe beyond the damaged area. The cutout section must fall within the bare copper section of the repair coupling.

3 Deburr the inside of the pipes with the triangular blade on the tubing cutter.



2 Lightly tighten the tubing cutter onto the pipe on a cutting line. Both wheels of the cutter should rest evenly on the pipe. Rotate the cutter around the pipe. The line it cuts should make a perfect ring, not a spiral. Tighten the cutter a little with each rotation until the pipe snaps. Repeat at your other mark.



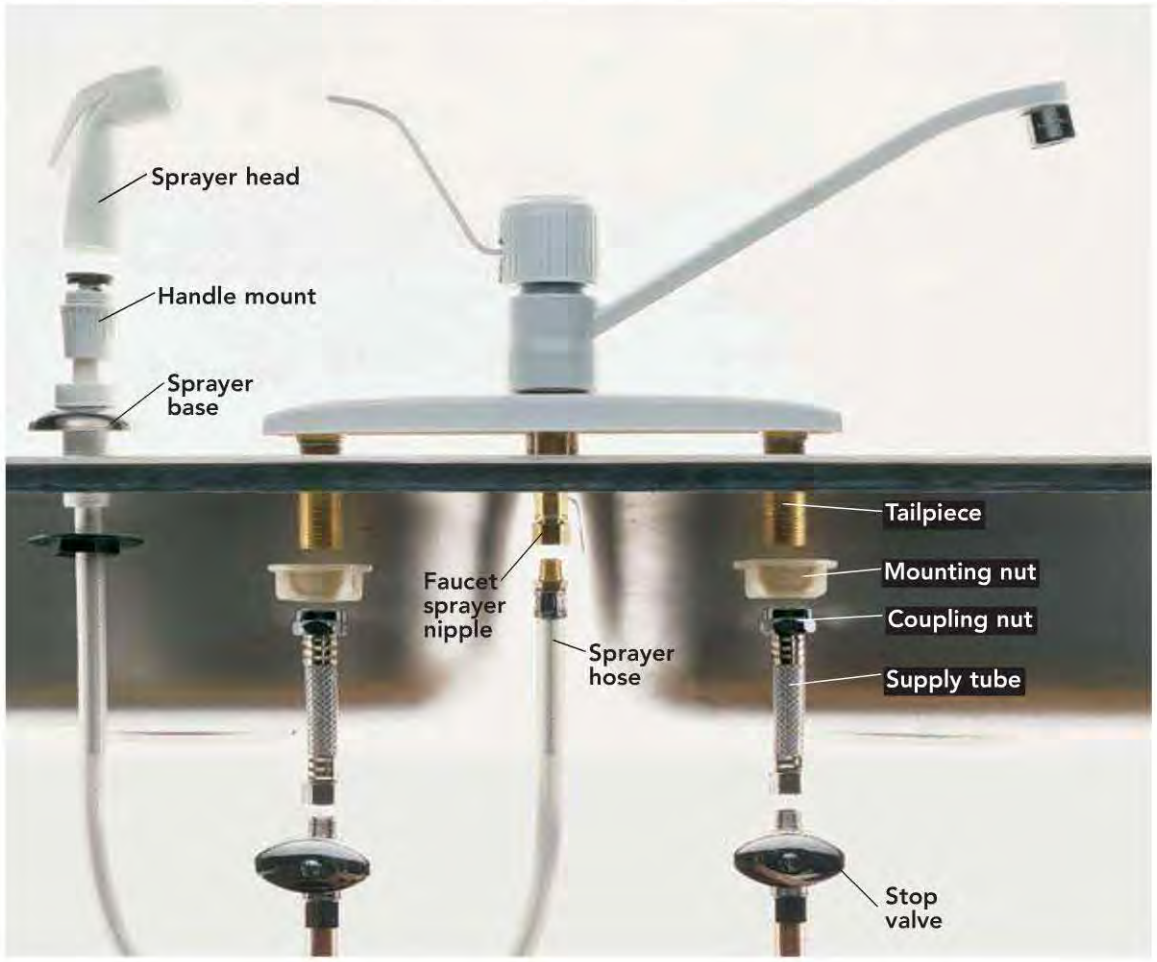
4 Slip the compression nuts and rings supplied with the repair coupling onto the cut ends of the pipe being repaired and then slip the repair coupling over one end. Slide the coupling further onto the pipe and then slide it back the other way so it fits over the other pipe section and the repair area is centered inside the coupling. Tighten each compression nut with pliers while stabilizing the coupling with an adjustable wrench.

19 Replacing Kitchen Faucets

Kitchen faucets don't last forever: in styling or in function. When it's time for you to say goodbye to yours, take comfort in knowing that if you choose one that's the same configuration, the project is quite simple.

MOST MODERN KITCHEN SINK FAUCETS ARE DECK MOUNTED, which means the bulk of the faucet sits on top of the back rim of the sink or counter. Typically, these faucets attach to the sink or counter and to their hot and cold water supplies through three holes. A fourth hole may hold a kitchen sprayer. Standard kitchen sinks (or pre-drilled counters) have three or four holes spaced 4" apart. It's best to look for a new faucet that uses the same number of holes as your current model, although any old holes that aren't used may be covered with a cap or a stand-alone accessory, like a liquid soap dispenser, that doesn't require additional plumbing work (there are several plumbed options, too, such as a water filter spout and a dishwasher air gap).

KITCHEN SINK FAUCETS 101



In this section, we show you how to install one of the most popular faucet types for home use: a *single-lever kitchen sink faucet* with *hose sprayer,* configured for a four-hole sink with standard 4-inch spacing between the holes. If the faucet you want to install isn't quite the same type as this, keep reading anyway. The basic installation requirements are the same: the *faucet body* must be secured firmly to the sink or counter, and the *hot and cold supply tubes* must be connected to the *hot and cold water supplies.*

TERMS YOU NEED TO KNOW

COMPRESSION FITTING—a way of attaching copper tubes to stop valves.

FLEXIBLE SUPPLY LINES—flexible hoses that are used to attached to the hot and cold stop valves.

PLUMBER'S PUTTY—a soft clay-like material used to seal faucet parts to sink parts.

TEFLON TAPE—a thin, white tape used to lubricate and seal threaded fittings.

PIPE JOINT COMPOUND—a paste that may be used instead of Teflon tape.

DECK-MOUNTED FAUCET—a faucet that mounts on top of a sink or counter, usually in two to four holes spaced 4 inches on center.

TOOLS & SUPPLIES YOU'LL NEED

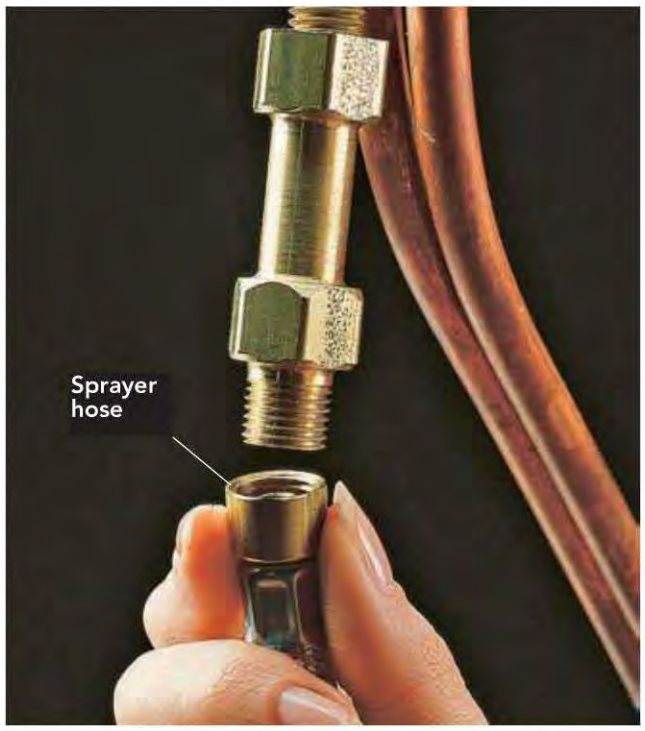
SKILLS YOU'LL NEED

- Working with tools in tight spots
- Making compression joints

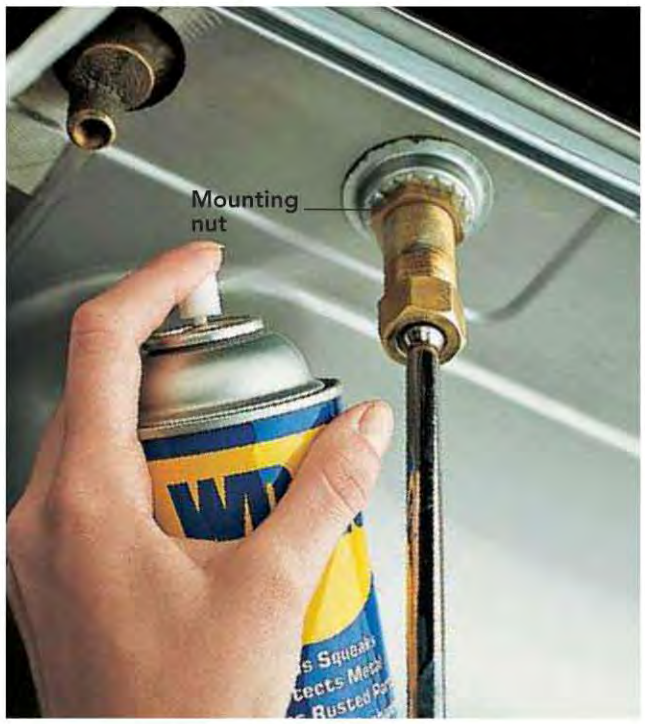
DIFFICULTY LEVEL

Time: 2 to 3 hours for removal and installation plus shopping

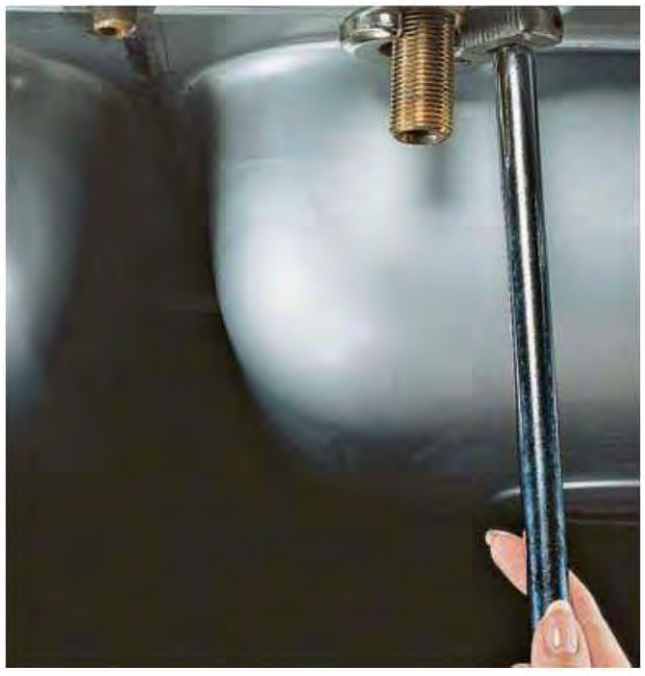
HOW TO REMOVE THE OLD FAUCET



1 To remove the old faucet, start by clearing out the cabinet under the sink and laying down towels. Turn off the hot and cold stop valves and open the faucet to make sure the water is off. Detach the sprayer hose from the faucet sprayer nipple and unscrew the retaining nut that secures the sprayer base to the sink deck. Pull the sprayer hose out through the sink deck opening.



2 Spray the mounting nuts that hold the faucet or faucet handles (on the underside of the sink deck) with penetrating oil for easier removal. Let the oil soak in for a few minutes.



3 Unhook the supply tubes at the stop valves. Don't reuse old chrome supply tubes. If the stops are missing or unworkable, replace them. Then, remove the coupling nuts and the mounting nuts on the tailpieces of the faucet with a basin wrench or channel-type pliers.

4 Pull the faucet body from the sink. Remove the sprayer base, if you wish to replace this. Scrape off old putty or caulk with a putty knife and clean off the sink with a scouring pad and an acidic scouring cleaner like Barkeeper's Friend.
TIP: Scour stainless steel with a back and forth motion to avoid leaving unsightly circular markings.

HOW TO INSTALL A KITCHEN FAUCET

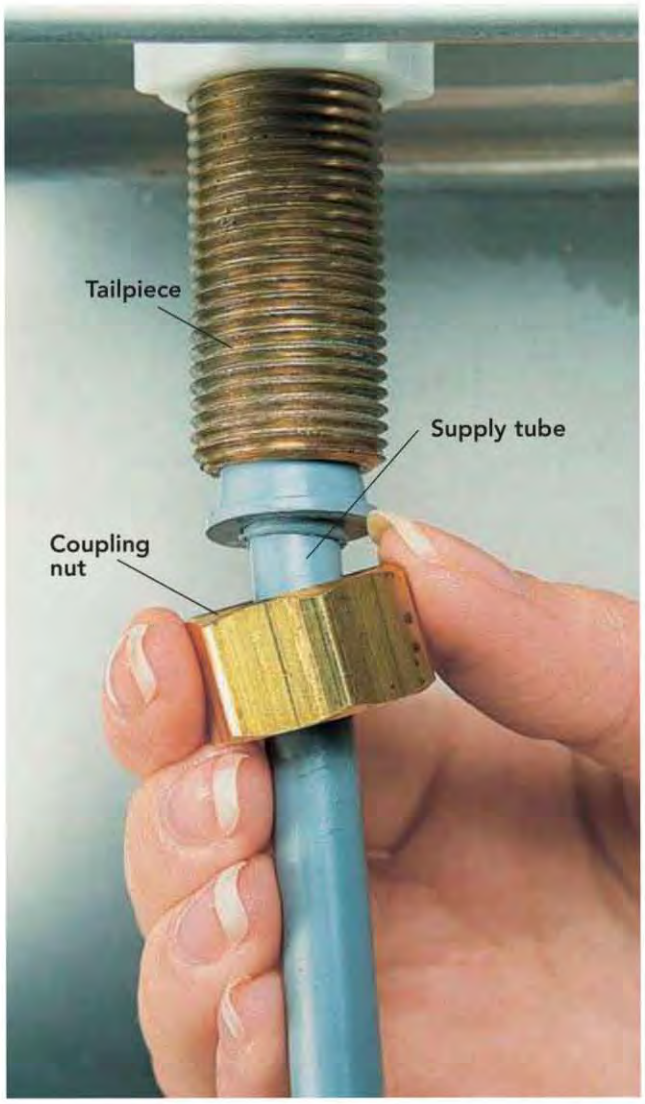
1 Apply a thick bead of silicone caulk to the underside of the faucet base then insert the tailpieces of the faucet through the appropriate holes in the sink deck. Press down lightly on the faucet to set it in the caulk.

2 Slip a friction washer onto each tailpiece and then hand-tighten a mounting nut. Tighten the mounting nut with channel-type pliers or a basin wrench. Wipe up any silicone squeeze-out on the sink deck with a wet rag before it sets up.

SHOPPING TIP

Take a close look at the faucet material:

Under a pretty chrome finish a faucet may be brass, steel, or even plastic. A solid brass faucet with heavy brass handles will last longest. Regular (not stainless) steel will eventually rust, even if there is another metal on the top (brass- and chrome-plated steel nuts and screws are notorious for rusting into gobs of unmovable metal). Plastic or lightweight brass will wear out, especially where the handles attach to the valves.

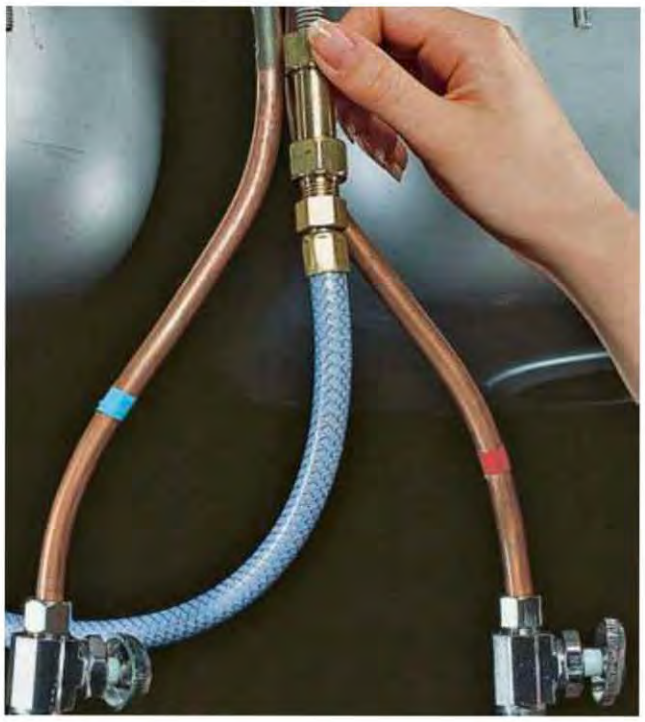


3 Connect supply tubes to the faucet tailpieces—make sure the tubes you buy are long enough to reach the stop valves and that the coupling nuts will fit the tubes and tailpieces.

4 Attach the supply tubes to the shutoff valves, using compression fittings. Make sure you connect the hot supply to the hot stop valve. Hand-tighten the nuts, then use an adjustable wrench to tighten them an additional quarter turn. It's a good idea to hold the shutoff valve with another wrench to stabilize it while you tighten the nut. It's also a good idea to wrap some Teflon tape around the threads of the shutoff body.

6 From beneath, slip the friction washer over the sprayer tailpiece and then screw the mounting nut onto the tailpiece. Tighten with channel-type pliers or a basin wrench. Wipe any excess putty or caulk on the sink deck from around the base.

5 Apply a ¼" bead of plumber's putty or silicone caulk to the underside of the sprayer base. With the base threaded onto the sprayer hose, insert the tailpiece of the sprayer through the opening in the sink deck.

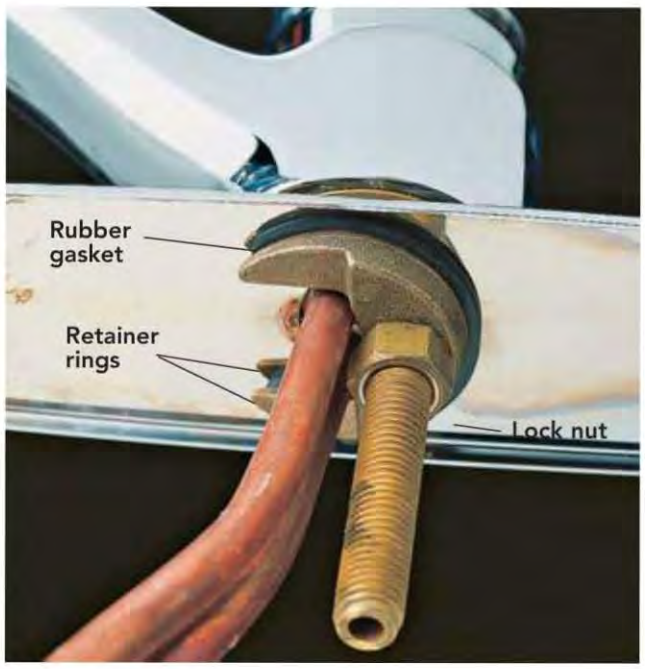


7 Screw the sprayer hose onto the hose nipple on the bottom of the faucet. Hand-tighten and then give the nut one quarter turn with pliers or a basin wrench. Turn on the water supply at the shutoff, remove the aerator and flush debris from the faucet.

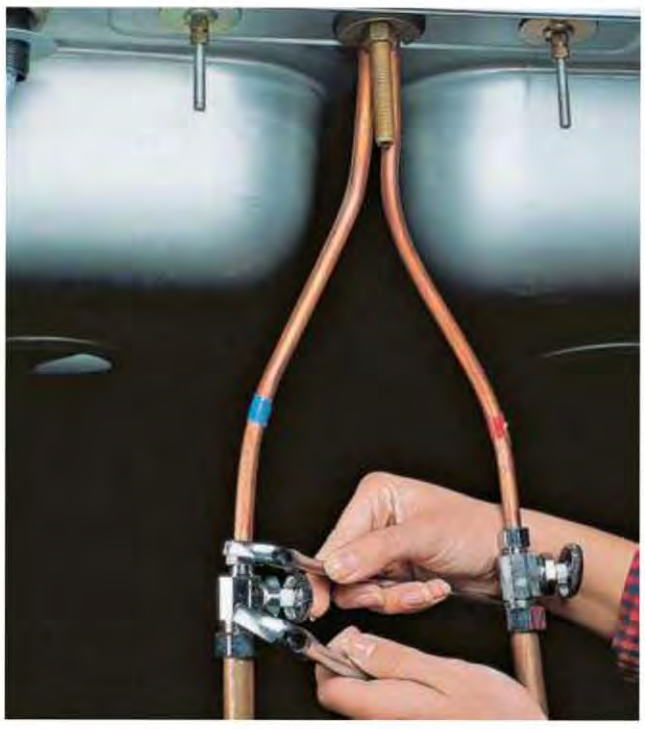
VARIATION: INSTALLING A KITCHEN FAUCET WITH PREATTACHED COPPER SUPPLY TUBES

1 Some faucets come with the copper supply tubes preattached to the faucet body. This minimizes the number of connections so you can hook the new faucet directly to the shutoff valves. To install a single-handle lever-type faucet with preattached supply tubes, start by caulking the faucet base and setting it on the deck, as in step 1, on page 123. The copper supply tubes and the sprayer nipple should go through the center hole and then mounting bolts on each side should go through the two outside holes.

3 Attach retainer rings and washers to the two mounting bolts as well and hand-tighten the mounting nuts. Tighten all nuts with pliers or a basin wrench.



2 Secure the faucet to the sink deck by placing a rubber gasket between the retainer rings and the underside of the countertop. Orient the cutout in the retainer to fit around the supply tubes. Thread a lock nut onto the threaded sprayer nipple and hand-tighten up to the retainer.



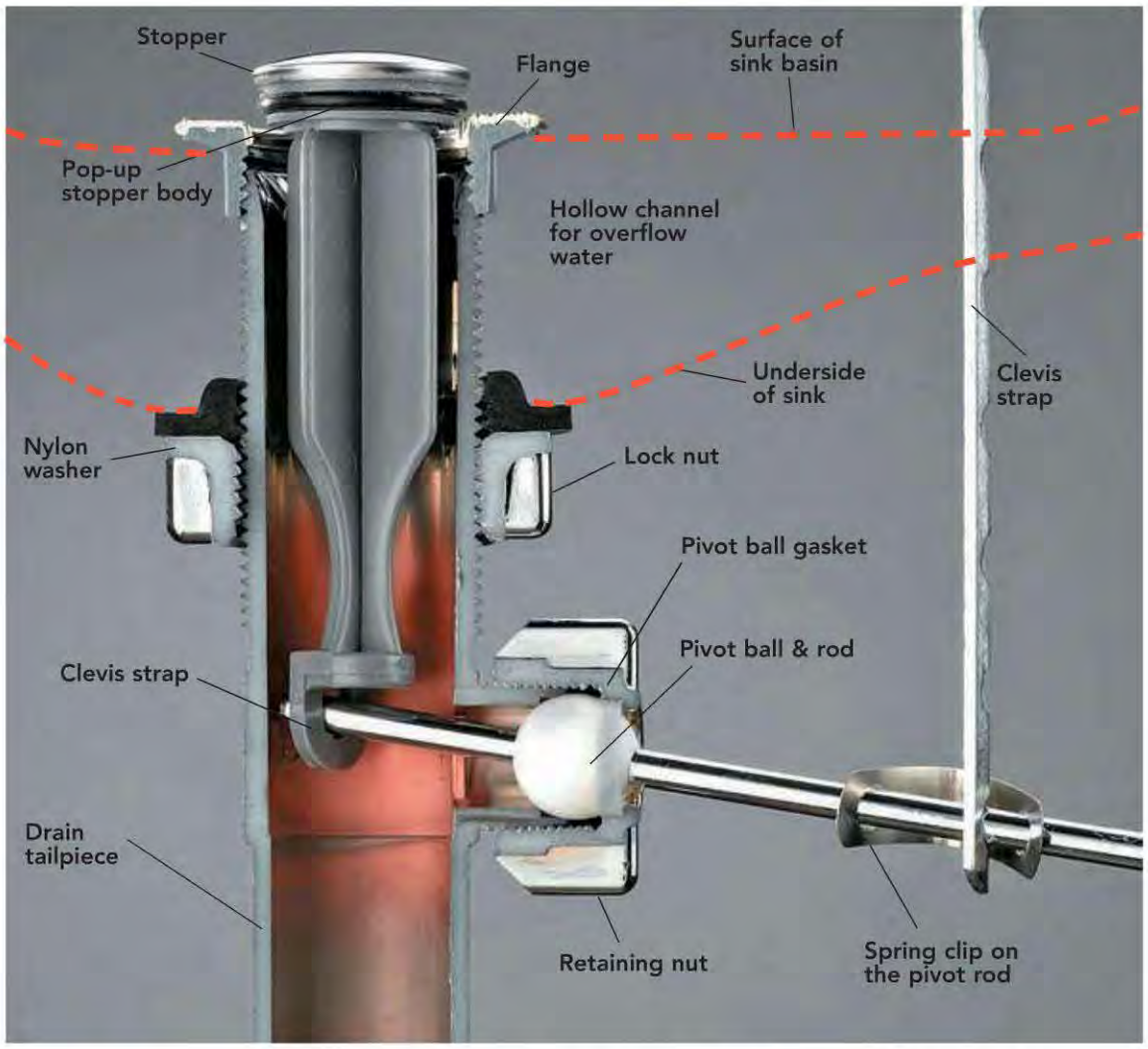
4 Bend the copper faucet tubes so they are in straight up-and-down positions as they meet the stop valves. You may need to trim them with a tubing cutter. Connect the tubes to the stop valves with compression nuts and rings (attach the hot supply tube to the hot supply pipe). Install the sprayer as shown on the previous page. Turn on the water at the shutoffs and test the faucet.

20 Replacing Pop-up Stoppers

A bum pop-up stopper may require complete regime change. Not just the stopper, but the tube and lever apparatus under it may need to be replaced.

POP-UP STOPPERS ARE THOSE CHROME-PLATED, LONG-LEGGED PLUGS IN BATHROOM SINKS that are opened and closed with a knob behind the spout. The stopper itself is just the glory guy for a behind-the-scenes assembly that makes sure the stopper sits and stands on cue. New faucets come with their own pop-up stopper assemblies, assuming they use one, but you may also purchase one by itself. This will include everything from the stopper to the pipe that drops into the trap (the trap is that drooping piece of drainpipe under your sink). If you choose to buy a pop-up stopper assembly, we recommend one that's heavy brass under the chrome finish. This will hold up better to time and abuse than a plastic or light-gauge metal model.

POP-UP STOPPERS 101



Pop up stoppers **keep objects from falling down the drain, and they make filling and draining the sink easy. When you pull up on the *lift rod*, the *clevis strap* is raised, which raises the *pivot rod*, which seesaws on the *pivot ball* and pulls the *pop-up stopper* down against the *flange*. This blocks water through the sink drain, but water may still overflow into the *overflow channel*, and get into the stopper body and down the drain through *overflow ports* in the pop-up body, which is a nice feature if you leave the water running in a plugged basin by mistake.**

TERMS YOU NEED TO KNOW

PLUMBER'S PUTTY—a soft clay-like material used to seal metal parts to the sink.

TEFLON TAPE—a thin, white tape used to lubricate and seal threaded fittings.

PIPE JOINT COMPOUND—a paste that may be used instead of Teflon tape.

POP-UP WASTE—another term for a pop-up assembly.

TAILPIECE—takes the waste from the pop-up stopper body to the J-bend.

J-BEND—a J-shaped bend of drainpipe below the sink. It's the part of the trap that's always full of water to keep sewer gases from rising into the house.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

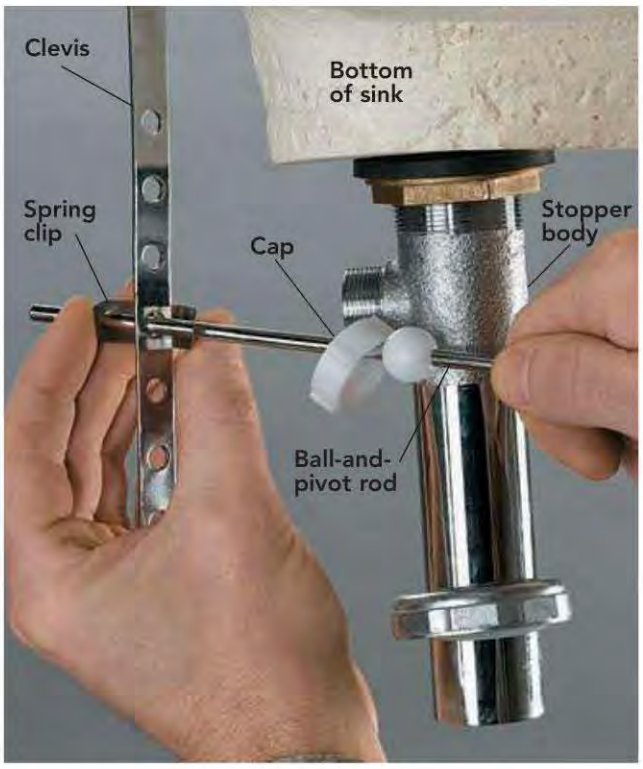
- Making slip joints
- Handling small parts
- Cutting metal with a hacksaw

DIFFICULTY LEVEL

Time: 1 to 2 hours plus shopping

HOW TO REPLACE A POP-UP STOPPER

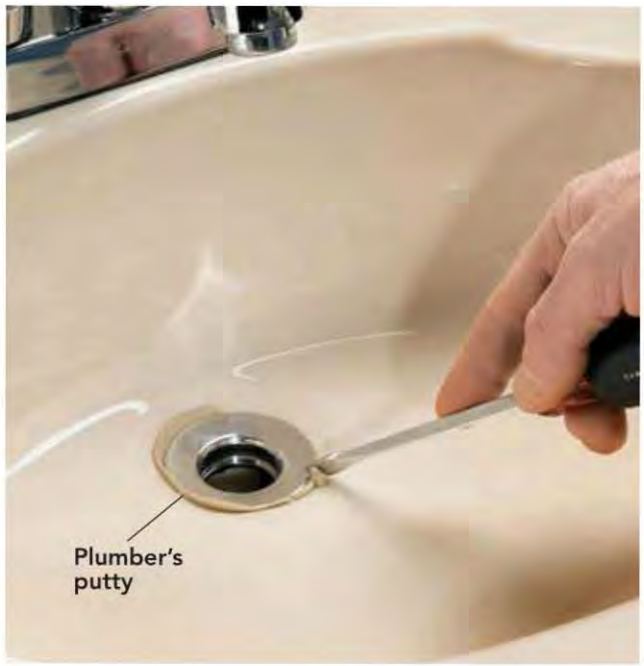
1 Put a basin under the trap to catch water. Loosen the nuts at the outlet and inlet to the trap J-bend by hand or with channel-type pliers and remove the bend. The trap will slide off the pop-up body tailpiece when the nuts are loose. Keep track of washers and nuts and their up/down orientation by leaving them on the tubes.



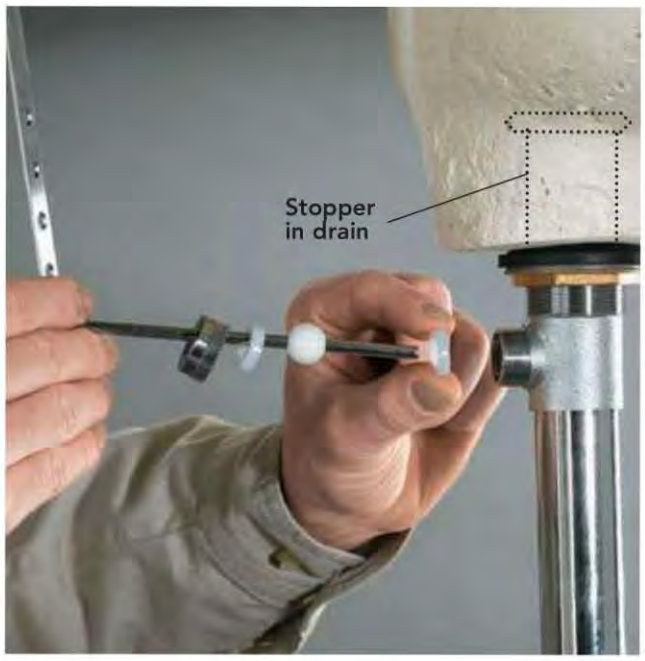
2 Unscrew the cap holding the ball-and-pivot rod in the pop-up body and withdraw the ball. Compress the spring clip on the clevis and withdraw the pivot rod from the clevis.

3 Remove the pop-up stopper. Then, from below, remove the lock nut on the stopper body. If needed, keep the flange from turning by inserting a large screwdriver in the drain from the top. Thrust the stopper body up through the hole to free the flange from the basin, and then remove the flange and the stopper body.

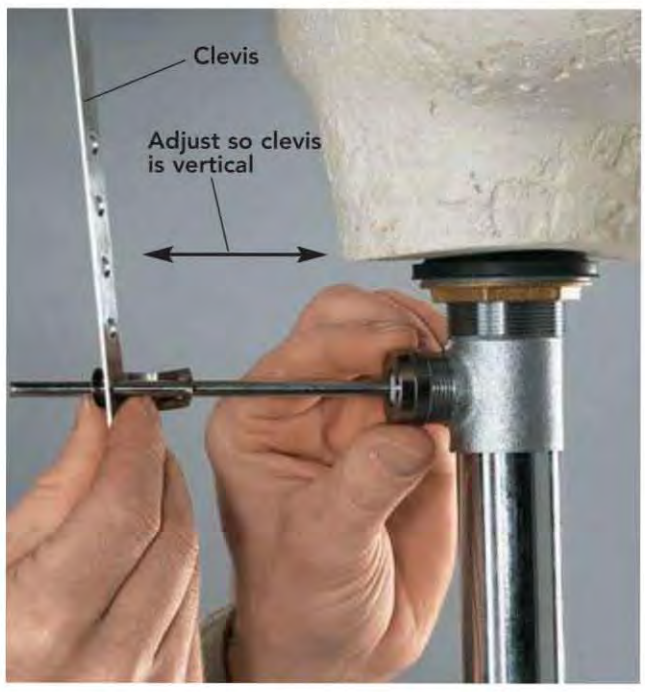
4 Clean the drain opening above and below, and then thread the locknut all the way down the new pop-up body followed by the flat washer and the rubber gasket (beveled side up). Wrap three layers of Teflon tape clockwise onto the top of the threaded body. Make a ½"-dia. snake from plumber's putty, form it into a ring and stick the ring underneath the drain flange.



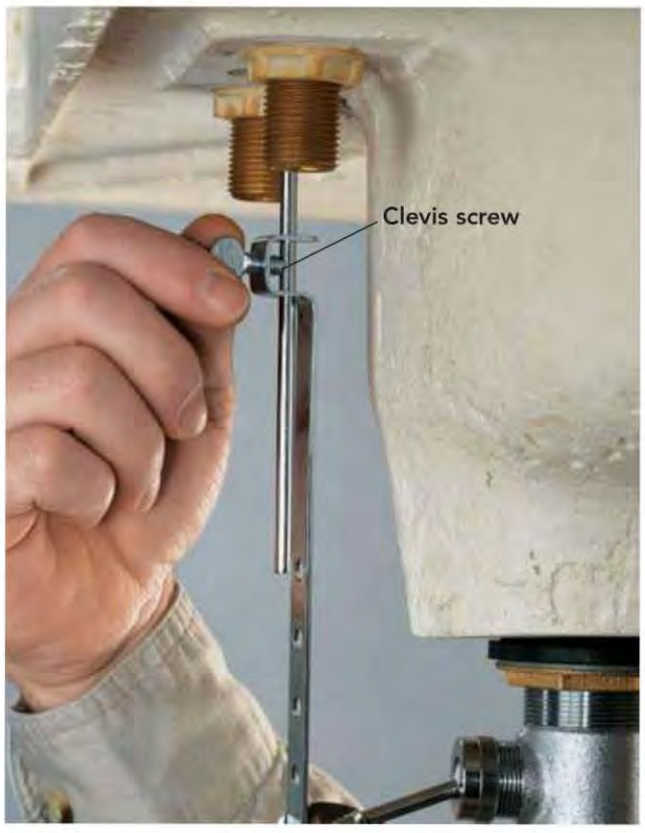
5 From below, face the pivot rod opening directly back toward the middle of the faucet and pull the body straight down to seat the flange. Thread the locknut/washer assembly up under the sink, then fully tighten the locknut with channel-type pliers. Do not twist the flange in the process, as this can break the putty seal. Clean off the squeezeout of plumber's putty from around the flange.



6 Drop the pop-up stopper into the drain hole so the hole at the bottom of its post is closest to the back of the sink. Put the beveled nylon washer into the opening in the back of the pop-up body with the bevel facing back.



7 Put the cap behind the ball on the pivot rod as shown. Sandwich a hole in the clevis with the spring clip and thread the long end of the pivot rod through the clip and clevis. Put the ball end of the pivot rod into the pop-up body opening and into the hole in the the stopper stem. Screw the cap on to the pop-up body over the ball.



8 Loosen the clevis screw holding the clevis to the lift rod. Push the pivot rod all the way down (which fully opens the pop-up stopper). With the lift rod also all the way down, tighten the clevis screw to the rod. If the clevis runs into the top of the trap, cut it short with your hacksaw or tin snips. Reassemble the J-bend trap.

21 Replacing Toilets

Replacing a toilet is simple, and the latest generation of 1.6-gallon water-saving toilets has overcome the performance problems of earlier models.

YOU CAN REPLACE A POORLY FUNCTIONING TOILET WITH A HIGH-EFFICIENCY, HIGH-QUALITY NEW TOILET FOR UNDER TWO HUNDRED AND FIFTY DOLLARS, but don't, as Ben Franklin would say, be penny wise and pound foolish. All toilets made since 1996 have been required to use 1.6 gallons or less per flush, which has been a huge challenge for the industry. Today, the most evolved 1.6-gallon toilets have wide passages behind the bowl and wide (three-inch) flush valve openings—features that facilitate short, powerful flushes. This means fewer second flushes and fewer clogged toilets. These problems were common complaints of the first generation of 1.6-gallon toilets and continue to beleaguer inferior models today. See what toilets are available at your local home center in your price range, then go online and see what other consumers' experiences with those models have been. New toilets often go through a "de-bugging" stage when problems with leaks and malfunctioning parts are more common. Your criteria should include ease of installation, good flush performance, and reliability. With a little research, you should be able to purchase and install a high-functioning economical gravity-flush toilet that will serve you well for years to come.

TOILETS 101

Buy a toilet that will fit the space. Measure the distance from the floor bolts back to the wall (if your old toilet has two pairs of bolts, go by the rear pair). This is your *rough-in distance* and will be either 10" or approximately 12". Make note of the *bowl shape*, round or oval (long). Oval bowls (also called elongated bowls) are a few inches longer for greater comfort, but may be too big for your space. The safest bet is to buy a replacement with the same bowl shape.

TERMS YOU NEED TO KNOW

CLOSET FLANGE—the metal or plastic slotted ring on the floor around the drain opening to which the toilet is bolted.

CLOSET ELBOW—the drain elbow the closet flange attaches to.

WAX RING—a compressible ring that forms a seal between the toilet and the closet flange; it fits either a 3-inch or 4-inch closet elbow.

CLOSET BOLTS—the pair of bolts that attach the toilet to the flange.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU'LL NEED

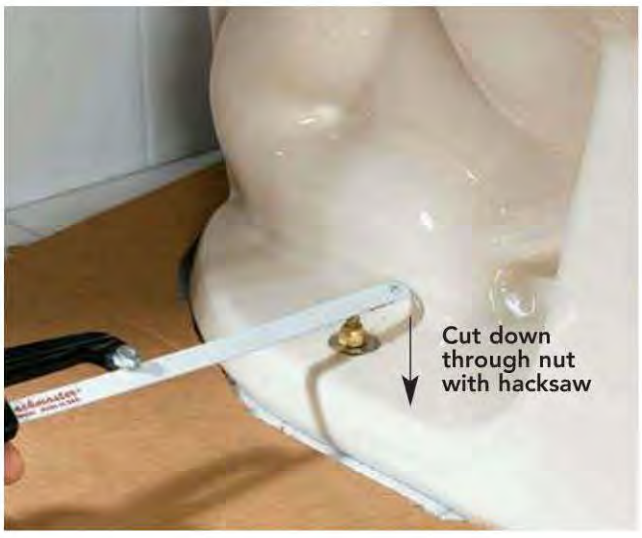
- Making compression joints
- Lifting 50 pounds
- Hand tool usage

DIFFICULTY LEVEL

Time: Allow about 1 hour for this project

1 Remove the old toilet. First, turn off the water at the stop valve (see page 136 if you have trouble). Flush the toilet holding the handle down for a long flush, and sponge out the tank. Unthread the coupling nut for the water supply below the tank using channel-type pliers if needed. TIP: If you have a wet vac, use this here and in step three to clear any remaining water out of the tank and bowl.

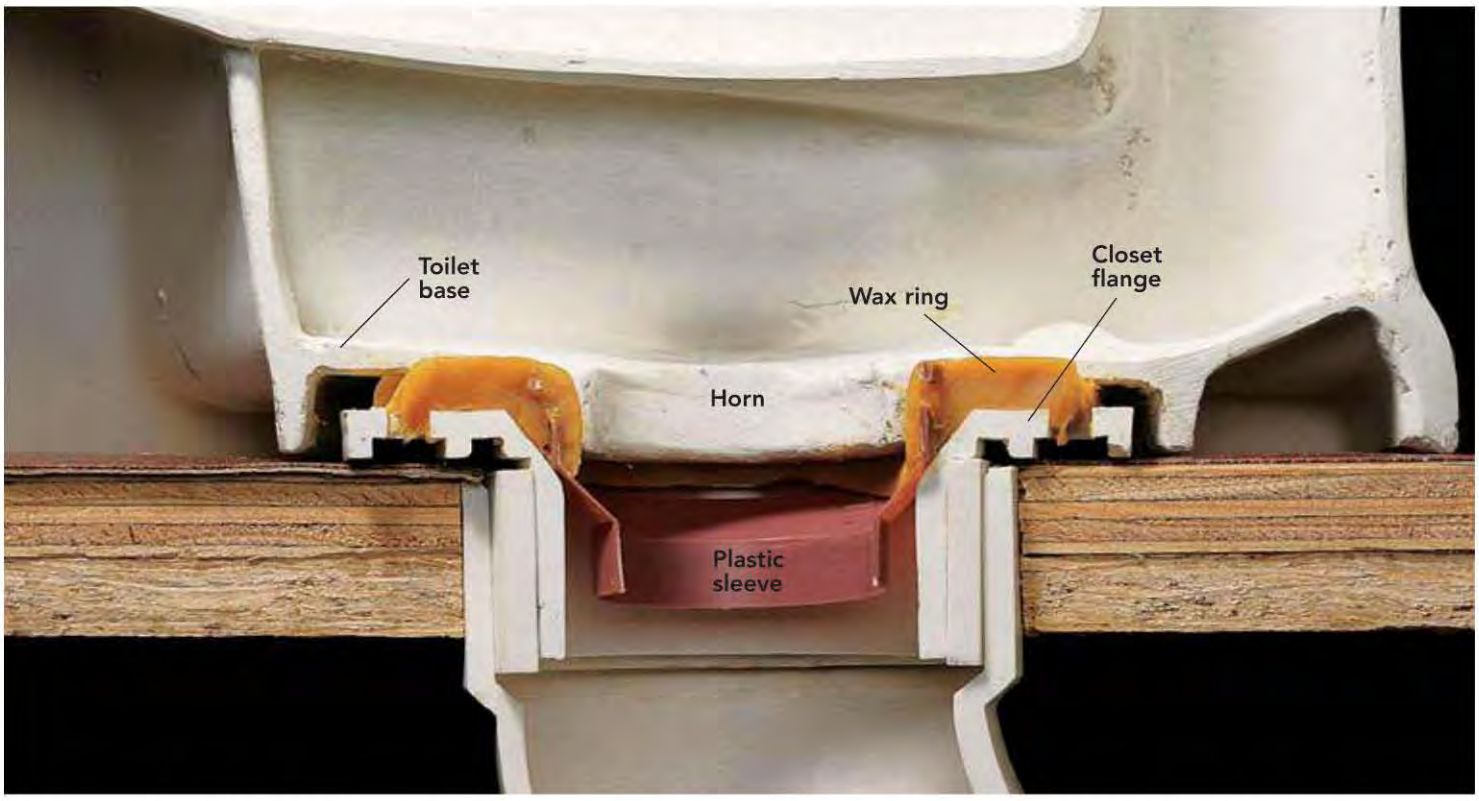
2 Grip each tank bolt nut with a box wrench or pliers and loosen it as you stabilize each tank bolt from inside the tank with a large slotted screwdriver. If the nuts are stuck, apply penetrating oil to the nut and let it sit before trying to remove them again. You may also cut the tank bolts between the tank and the bowl with an open-ended hacksaw (inset). Remove and discard the tank.



3 Remove the nuts that hold the bowl to the floor. First, pry off the bolt covers with a screwdriver. Use a socket wrench, locking pliers, or your channel-type pliers to loosen the nuts on the tank bolts. Apply penetrating oil and let it sit if the nuts are stuck, then take them off. As a last resort, cut the bolts off with a hacksaw by first cutting down through one side of the nut. Tilt the toilet bowl over and remove it.

TECHNIQUE TIP

Removing an old wax ring is one of the more disgusting jobs you'll encounter in the plumbing universe (the one you see here is actually in relatively good condition). Work a stiff putty knife underneath the plastic flange of the ring (if you can) and start scraping. In many cases the wax ring will come off in chunks. Discard each chunk right away—they stick to everything. If you're left with a lot of residue, scrub with mineral spirits. Once clean, stuff a rag in a bag in the drain opening to block sewer gas.



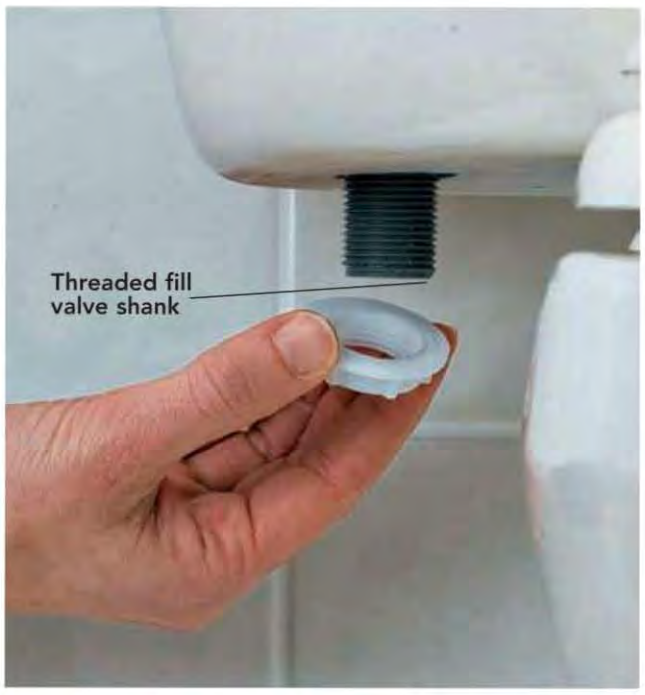
A cross-section of the connection between the toilet stool and the drain reveals that it really is only a ring of wax that makes the difference between a pleasant water closet and something that smells like an open sewer.

4 Remove the rag-in-a-bag from the drain opening and put new all-brass toilet bolts into the slots on the closet flange at 3 and 9 o-clock and rotate each ¼ turn so the elongated heads cannot be withdrawn. Put the plastic keepers or extra washers and nuts on the bolts to secure them to the flange. Unwrap the wax ring and position it over the flange so it looks like the one in the cross section photo at the top of this page.

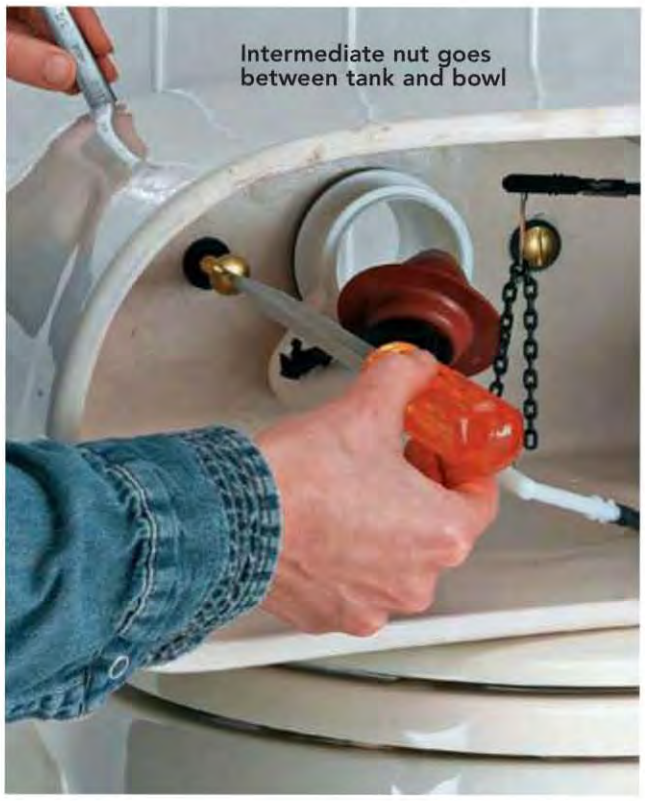
5 Lower the new toilet down over the wax ring so the bolts go through the holes on the bottom of the stool (this can be tricky—be patient and get help). Press down on the toilet to seat it in the wax ring and check for level. If the bowl is not quite level, you can shim the low side with a few pennies. Thread washers and nuts onto the floor bolts and tighten them a little at a time, alternating. Do not overtighten. Cut the bolts off above the nuts with a hacksaw and add the caps. Lay a bead of tub and tile caulk around the base of the toilet, but leave the back open to let water escape so you'll know if there's ever a leak.

6 Attach the toilet tank. Some tanks come with a flush valve and a fill valve preinstalled, but if yours does not, insert the flush valve through the tank opening and tighten a spud nut over the threaded end of the valve. Place a foam spud washer on top of the spud nut.

7 If necessary, adjust the fill valve as noted in the directions (also see pages 166 to 169).



8 Position the valve in the tank. Push down on the valve shank (not the top) while hand-tightening the locknut onto the threaded valve shank (thread the nut on the exterior side of tank). Hand-tighten only.



9 With the tank lying on its back, thread a rubber washer onto each tank bolt and insert it into the bolt holes from inside the tank. Then, thread a brass washer and hex nut onto the tank bolts from below and tighten them to a quarter turn past hand tight. Do not overtighten.

10 Position the tank on the bowl, spud washer on opening, bolts through bolt holes. Put a rubber washer followed by a brass washer and a wing nut on each bolt and tighten these up evenly.

11 You may stabilize the bolts with a large slotted screwdriver from inside the tank, but tighten the nuts, not the bolts. You may press down a little on a side, the front, or the rear of the tank to level it as you tighten the nuts by hand. Do not overtighten and crack the tank. The tank should be level and stable when you're done.

12 Hook up the water supply by connecting the supply tube to the threaded fill valve with the coupling nut provided. Turn on the water and test for leaks.

13 Attach the toilet seat by threading the plastic or brass bolts provided with the seat through the openings on the back of the rim and attaching nuts.

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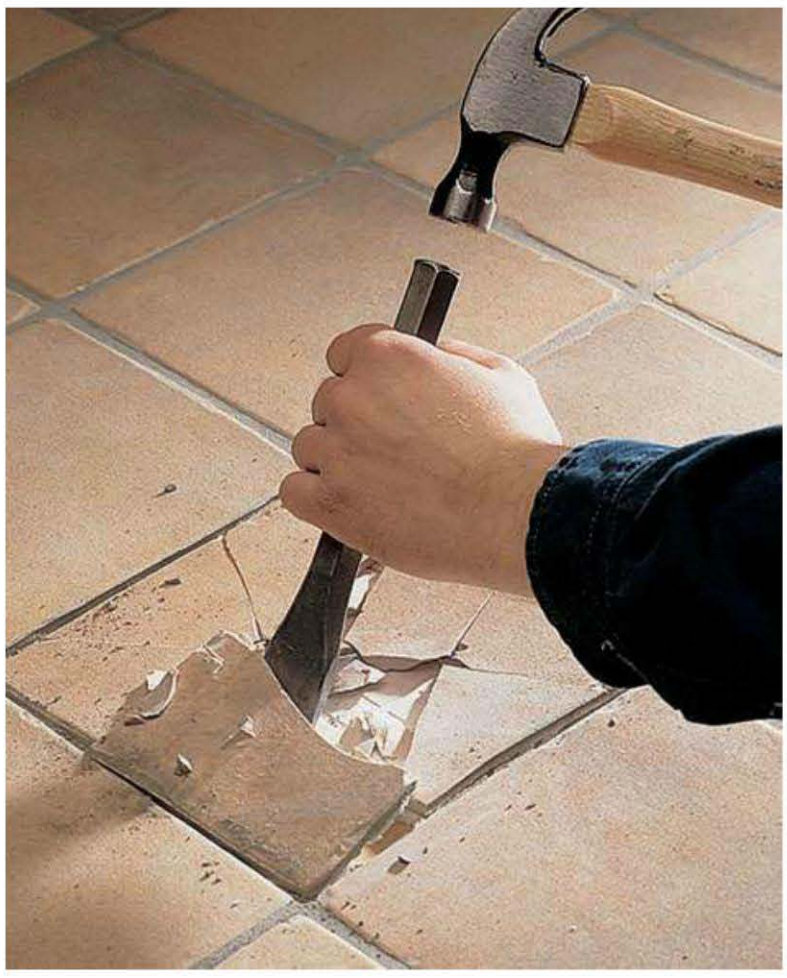


Flooring

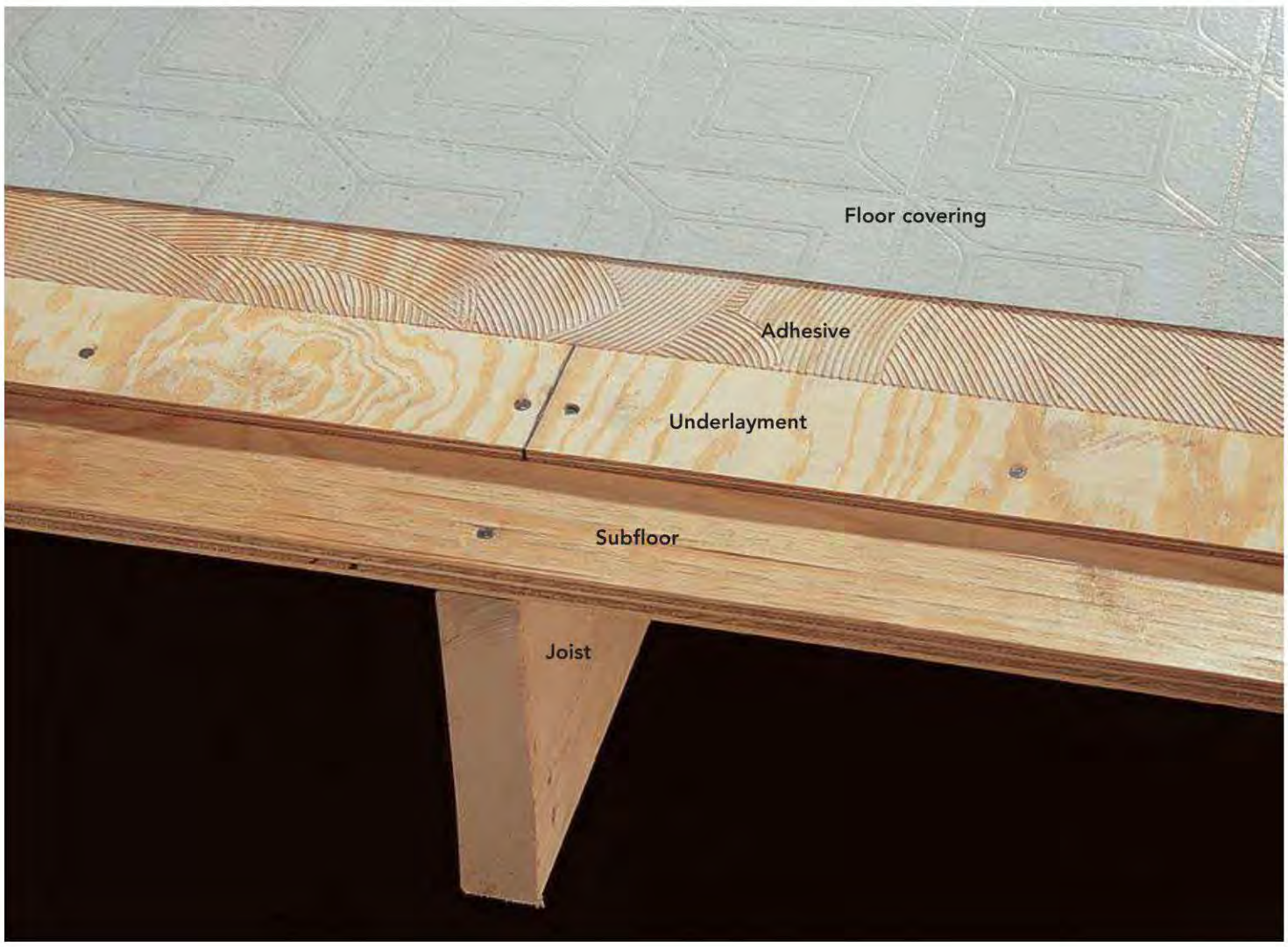
FLOORING PLAYS A VITAL ROLE IN THE LOOK AND FEEL OF YOUR HOME. BECAUSE IT IS ONE OF THE LARGEST ELEMENTS IN A ROOM, A FLOOR CREATES INSTANT IMPACT. IT'S IMPORTANT TO ADDRESS BOTH THE FUNCTION AND BEAUTY OF THE FLOORING IN YOUR HOME. AND, OF COURSE, IT'S IMPORTANT TO MAINTAIN THE FLOORS IN YOUR HOME TO GET THE MOST OUT OF THEM.

This section of the book will help you better understand the basic types of flooring so you can approach repairs and installations with confidence. It will walk you, step by step, through 16 very common flooring projects. Even if you have no previous experience with flooring, you'll find everything you need right here to make your project a success.

IN THIS CHAPTER:

- ❑ Before You Begin
  - Understanding Floors
  - Choosing Flooring
  - Evaluating Floors
  - Cleaning Floors
- ❑ Repairing Splinters & Gouges
- ❑ Fixing Squeaky Floors from Below
- ❑ Fixing Squeaky Floors from Above
- ❑ Repairing Resilient Flooring
- ❑ Patching Resilient Sheet Flooring
- ❑ Repairing Loose Carpet Seams
- ❑ Replacing Ceramic Tiles
- ❑ Replacing Laminate Floorboards
- ❑ Patching Carpet
- ❑ Removing Resilient Flooring
- ❑ Removing Carpet
- ❑ Sealing Concrete Floors
- ❑ Refinishing Hardwood Floors
- ❑ Painting Wood Floors
- ❑ Installing Laminate Flooring
- ❑ Installing Floor Tile

Before You Begin: Understanding Floors



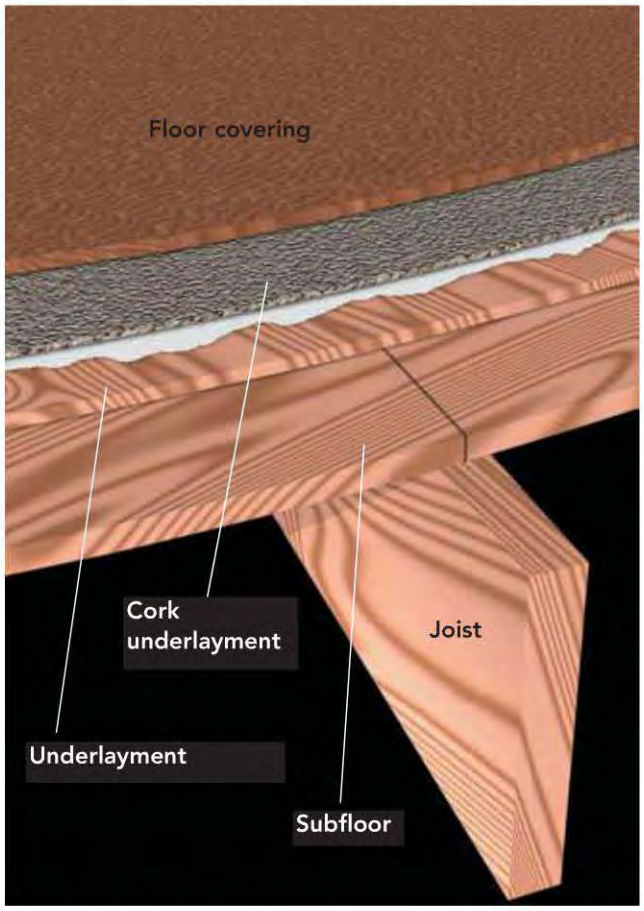
ANATOMY OF A FLOOR

When most of us think of a floor we envision the top layer: in effect, the decorative covering—hardwood, ceramic tile, laminate, or carpet. The "real" floor is hidden underneath.

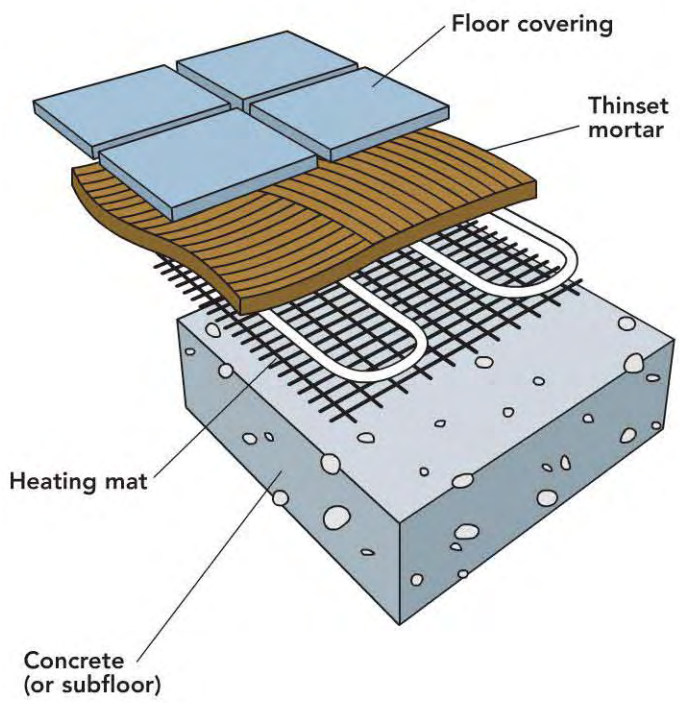
Your floor is made of a sturdy plywood or composite panel subfloor that spans supportive floor joists. The subfloor may be large sheets or planks (and the planks may be arranged in a staggered or diagonal fashion). The joists sit on sills along the foundation and are often supported at a midpoint by a steel girder or wood beam.

An elevated framed floor, like the one shown above, is supported by beams that run perpendicular to the joists. In most cases, the joists are tied together with bridging for extra stability (see photo next page, lower right).

Depending on the type of flooring used, the subfloor may be covered with an additional layer of underlayment, such as a cement board. The top layer of flooring is installed on the underlayment or subfloor and may rest on some type of cushioning layer. Of course, there are always custom options, such as soundproofing or heating, that may be layered into your floor plan. It's important to know what is under your floor covering and how your floor is supported before starting any repairs on that floor.



Soundproofed floors have an extra layer to dampen noise. When patching a damaged area of your floor, replace the floor covering on top of the sound barrier material. The sound barrier is not altered.



Radiant floor heating systems use hot water coils or electricty. Even concrete floors without floor covering may be heated.

Basement floors are uniquely layered to compensate for the hard concrete base. When patching your damaged floor, only remove the floor covering on top of the plywood subfloor.

The bridging between joists for extra stability could be wood or metal.

Before You Begin: Choosing Flooring

Today's homeowner is faced with an extensive range of flooring choices. Selecting the right floor can almost be harder than installing it.

If installing new floors, it is fun to choose the colors, patterns, and other design qualities of the floor you desire. But there are some other qualities to consider, including: cost, comfort, ease of maintenance, and durability.

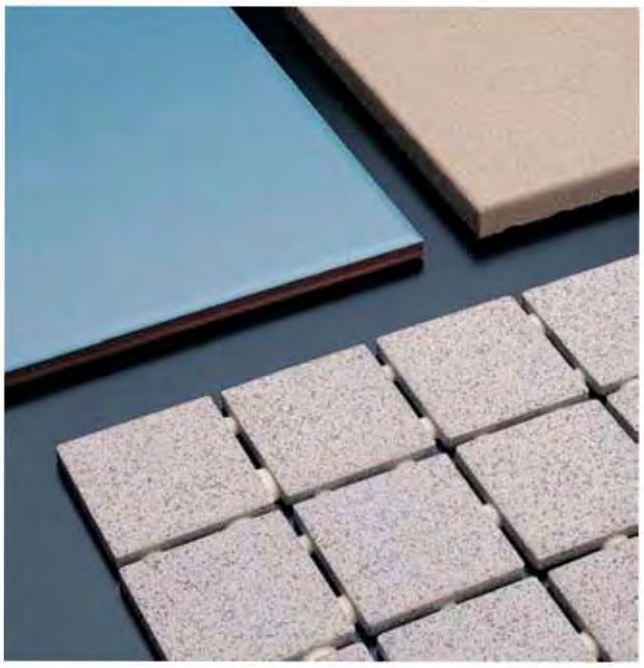
The varying characteristics of the floors discussed here will help you decide which floor is best for your space. For example, hard flooring—such as ceramic tiles or concrete—is tough, attractive, and great for high-traffic areas. Soft floors, like carpet, are still popular in both bedrooms and living areas because they offer comfort, warmth, and a feeling of luxury.

If your floors are already installed—often homes have four or more types of flooring—the following discussion will help you recognize their strong points. Knowing what your floor can handle helps with maintenance, decorating, and cleaning.

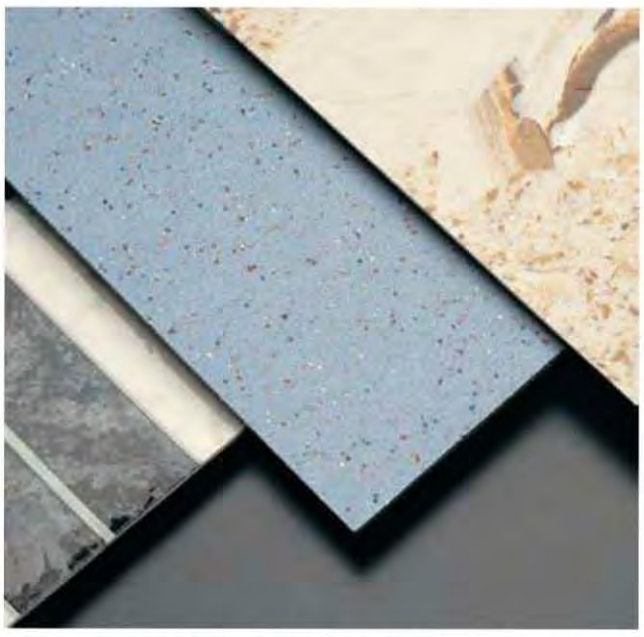
Parquet tile floors offer the beauty and feel of wood in the block shape of tiles. Decorative patterns make these floors appear to be high end when they are actually quite affordable. All parquet tiles feature tongue-and-groove edges that snap together. You can find parquet tiles with self-adhesive backs, but dry-back tiles to which you apply standard flooring adhesive stay put longer.

Concrete floors are typically found in basements and garages for obvious reasons. They are tough and can withstand high traffic, heavy equipment, messy spills (including sitting water), scratches, and scuffs. But concrete is increasingly popular for interior spaces, especially when finished with paint or decorative acid stains.

Laminate floors are available in planks or squares. They snap together with tongue-and-groove joints and then "float" on top of the floor, meaning they are not fastened directly to the subfloor or underlayment. A laminate floor consists of a very durable surface-wear layer; a photographic print layer, which allows it to replicate the appearance of other surfaces; and a solid core.



Ceramic tile floors look spectacular, and they are durable. At the same time, they tend to be cold, they conduct sound, and they are expensive. Upon installation, they are evenly spaced and then the joints are filled with grout. These joints are then sealed.



Resilient floors include vinyl, linoleum, cork, and rubber. They are comfortable underfoot and easy to clean. They are impervious to water—except at the seams or where torn. Depending upon the material, resilient flooring comes in either large sheets, which need to be cut to size, or easy-to-install tiles. Resilient floors are often cost effective and are available in a staggering number of patterns and colors. They are usually thin, which means the subfloor must be level.

Manufactured wood flooring materials include: fiberboard surfaced with a synthetic laminate layer (right), plywood topped with a thin hardwood veneer (center), and parquet tile made of wood strips (left). Wood floors come in planks or strips. The planks fit together with tongue-and-groove joints or square edges and, depending on manufacturer recommendations, they float on top of the subfloor or are secured in place with nails, staples, and/or glue.

Carpet is the most popular choice for living rooms and bedrooms because it produces a warm, comfortable environment. It is available in conventional, cushion-back, or tile forms. Wall-to-wall carpet is laid with fittings, such as tackless strips and padding. Cushion-backed carpet is glued directly to the subfloor.

Before You Begin: Evaluating Floors

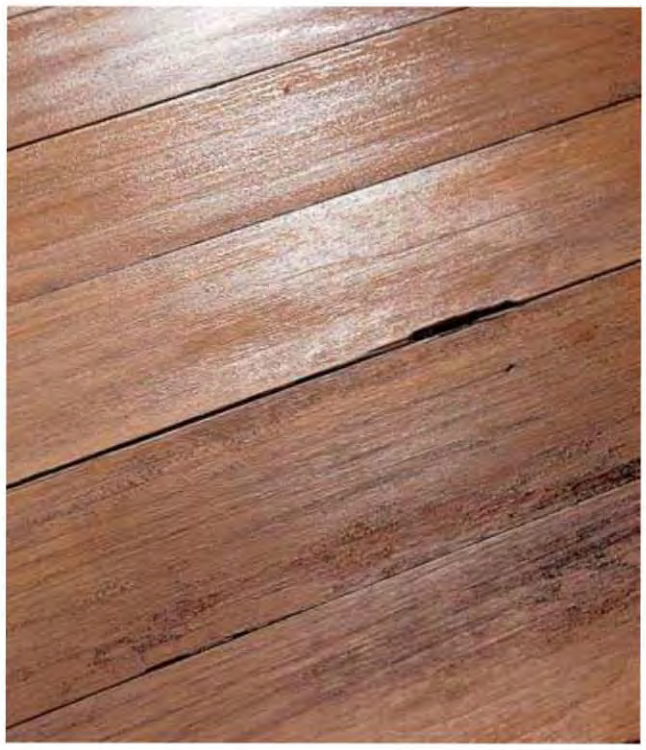
Floor coverings wear out faster than other interior surfaces because they get more wear and tear. Surface damage can affect more than just appearance. Scratches in resilient flooring and cracks in grouted tile joints allow moisture to wear away at adhesive, eventually pushing up the floor covering or tile. Hardwood floors lose their finish and become discolored. And loose floorboards squeak. If that problem appears to be minor now, the question is: Clean, repair, or replace?

Before answering that question, you must thoroughly inspect your entire floor. Look for stains, tears, rips, cracks, buckles, bubbles, or damp spots. Specific concerns for each type of flooring material are listed in this section. Once the problem is classified, you may move on to the repair project specific to the problem.

Concrete floors are hard and durable, but still require care. If unsealed, concrete is vulnerable to all kinds of stains. Oil and grease are particularly troublesome. Cracks are also common.

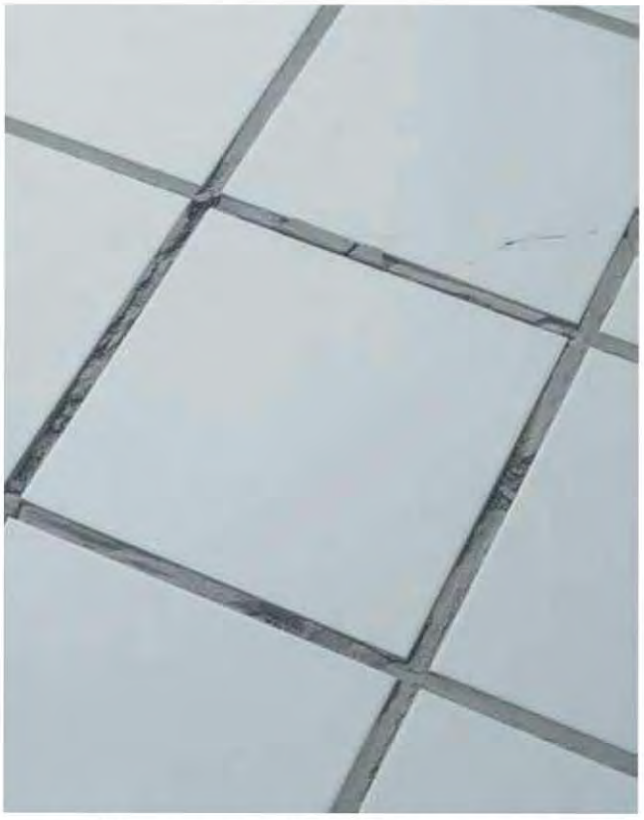
Look for tears, stains, or excessive wear in carpet. Cleaning the spots should always be the first step, and there are carpet-cleaning products for almost every possible stain. If this doesn't do the trick, these damaged areas may be fixed with a patch (as shown in photo).

A severely damaged section of tile or plank may be completely removed (as is being done in photo) and replaced. Normal wear and tear is probably the result of years of accumulated dirt from foot traffic. Unfortunately, this is unavoidable. Often touch-up sticks to repair scratches are available from manufacturers.



Moisture can cause wood floors to swell. Swollen planks should be removed so you can inspect the subfloor. Allowing the subfloor to dry out allows you to then replace the damaged boards with new, tight-fitting planks.

Though quite durable, parquet tiles are still vulnerable to stains, especially from heavy spills or water that sits on the floor for some time. It is important to clean up spills immediately. Soak a cloth in mineral spirits for troublesome stains.



Even durable ceramic tiles develop signs of wear. To evaluate ceramic tiles, check for loose, cracked, or dirty grout joints. Remove failed grout and regrout tile joints.

A common problem for resilient sheet floors is air bubbles. For resilient tiles (inset), the most common problem is loose seams. Tiles with small curls may be reattached, but tiles with dirt under them must be completely removed and replaced.

Before You Begin: Cleaning Floors

Immediately clean spills with a dry cloth. Avoid rubbing the spill into the floor. Once the spill is soaked up, use a damp cloth to blot the remaining residue on the floor. Rinse your cloth often and thoroughly wring it out before using it again. Use a dry, clean cloth to dry the area when you are done. If it is still sticky, allow the area to dry and then use a damp mop.

If a liquid spill fades your hardwood floor, lightly sand the damaged area and apply new finish. Do not use a wax finish over a surface finish.

HERE'S HOW

Make sure you know what sort of finish (wax or urethane) is on your wood floor, and use products specifically for your floor surface. Look for products labeled "for wood floor cleaning," for example. Avoid ammonia products or soaps with oil; use pH-balanced cleaners for routine cleaning.

As a last resort, stubborn sticky wood floors need to be wet mopped. Only wet mop the floor if the finish is in good condition. A sponge mop moistened with a mixture of water and a mild wood floor cleaner or a neutral pH soap or detergent (1 gal.: ½ cup cleaner) is all that is required. The mop should just barely be damp at any given time. Excess water can seriously damage wood floors. After cleaning, use a towel to thoroughly dry the floor.

WHAT IF . . . ?

If you have laminate flooring, follow the cleaning recommendations provided by the manufacturer. Many manufacturers caution against cleaning with water or any cleaner that's mixed with water.

Use nonmarking floor protectors on your furniture's "feet." Sets often include nails or screws to attach the feet. There are also special protectors for wheels. Be sure to buy the correct size and style for your furniture.

Carpet cleaning machines can be rented by the hour or by the day. To deep clean your carpet push the machine forward over a 3-ft. square area, releasing the detergent and rotating the brush. At this time hot water is often used, causing steam. When you pull back, cold water is used as a rinse. Some machines allow you to manually adjust the water temperature. Always be sure to rinse thoroughly. Slowly go over the same area a couple of times to work the cleaner into the carpet. Repeat this process until the entire carpet is cleaned. Allow the carpet to dry. Vacuum.

PRO TIP

It usually takes a day for carpet to dry. Wait at least this long before replacing furniture.

Use a large spoon to pick up spills. Spoons capture liquids well without damaging fibers. Scoop toward the center of the stain to avoid spreading. Do not rub stains—blot them (see inset). Apply cleaning solution to a cloth or paper towel, then blot the stain, working from the outside toward the center to avoid spreading the stain.

Raise crushed fibers by first dampening the area with water (or allow a small ice cube to melt on each dent overnight). Work up the crushed fibers with your hand (or a spoon, if they are stubborn). A hair dryer on medium temperature not only helps dry the spots while you raise the fibers, but the heat helps raise the fibers. Sometimes simply holding a steam iron above the dent will pop up the crushed carpet.

Dry mop daily to gently remove particles that could scratch your tile.

Use pH-balanced cleaners or soapless detergents for bi-weekly mopping. Having a bucket with a wringer helps to ensure you do not oversaturate the mop. Alternatively, use a sponge mop with an attachment to wring out sponge. Always dry mop or vacuum first. If you prefer not to use commercial cleaning products, use a steam cleaner (be sure not to buy a deep cleaner, which often incorporates shampoo).

If water doesn't bead on tiles or on grout joints during regular cleaning, it's time to apply another coat of sealer. For instructions on grouting and sealing ceramic tile joints, see pages 274 to 277.

For heavy stains on natural stone tile, try a manufacturer poultice specifically for porous stone materials. Cover the stain with the poultice, then tape plastic over it. Let the poulitice set, according to the manufacturer's instructions, then remove it.

HERE'S HOW

Add glass cleaner to the water in your cleaning bucket to prevent streaks from showing up once the floor is dry. If the floor has a dull finish, it may be time to reseal the floor. If water absorbs into the grout lines, the grout joints need to be resealed. It is still necessary to clean the floor before sealing.

Vacuum grout joints with a bare-floor attachment once a week. Use a soft-bristle broom or handheld broom and dustpan to pick up debris that the vacuum missed. If dirt or sand is a regular problem, try to find out how it is tracked in. Place rugs or mats at those entryways. Be sure to regularly shake out the rugs.

CLEANING RESILIENT & LAMINATE FLOORS

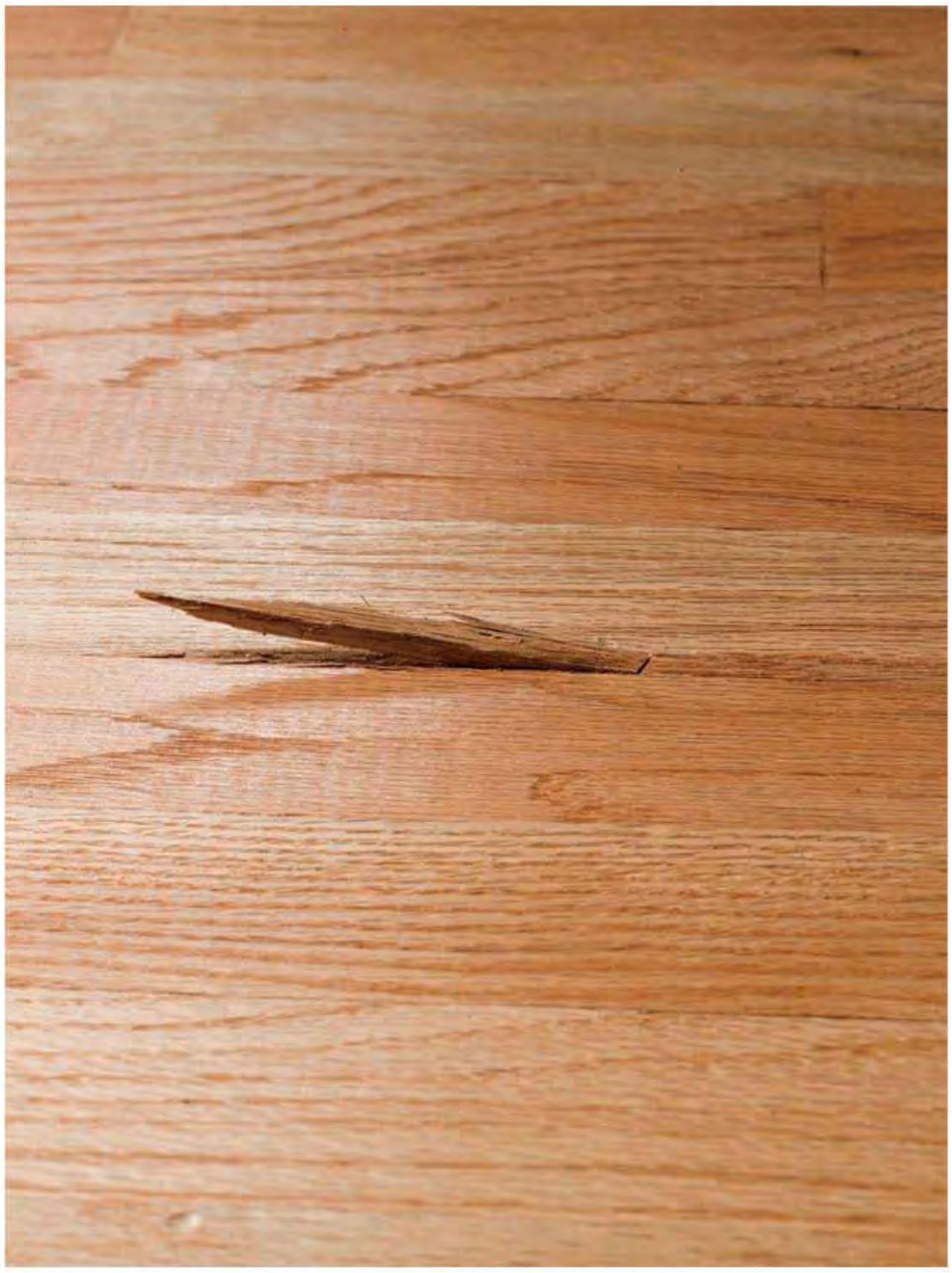
Remove tough stains with mineral spirits or household bleach. Wet a rag with the solution, and place it over the stain. Lay a plastic bag over the rag to slow evaporation. Wait 1 to 2 hours, then wipe up the stain. Always test solvents in an inconspicuous area before using them elsewhere on the floor. Bleach may strip the protective finish off the floor, leaving it dull.

Occasionally wet mop. Regular dry mopping and vacuuming is necessary, but it doesn't remove sticky spots. Sometimes all that is necessary is a little warm water. Also be sure to inspect seams in tile and the perimeter of full-spread sheet flooring. Use a slightly damp cloth to pick up dirt or dust stuck in seams or corners—especially around thresholds, where material tends to settle after sweeping.

If your floor is dull even after you clean it, you should polish. Put manufacturer polish into a clean bucket, dip a cloth into it, and wring about half the polish out of the cloth. Working in a 3- to 4-ft. square, wipe the cloth over the floor in straight lines. Apply 2 to 3 coats; let the polish dry for at least 30 minutes between coats and about an hour (minimum) when you're done.

On vinyl and laminate, you can remove tough spots like shoe polish or tar with nail polish remover containing acetone. When the spot is gone, wipe the area with a clean, damp cloth.

1 Repairing Splinters & Gouges



Ouch! If a floorboard begins to splinter, it's a good idea to repair it before the splinter completely dislodges and disappears—or worse, completely dislodges into someone's bare foot.

IT IS COMMON FOR SPLINTERS TO APPEAR IN FLOORS THAT ARE DRIED OUT and brittle. When hardwood floors are damaged by high heels or pushed chair legs, a portion of the grain may dislodge; because the grain of wood runs only in one direction, it splinters rather than simply creating a hole. Floorboards that have splinters or gouges don't necessarily have to be replaced; a splinter can be reattached with some glue and a hole can be filled with some wood putty.

SPLINTERS & GOUGES 101

Wood flooring is susceptible to splintering and gouges. How you repair the damage depends on whether the planks are laminated or solid wood.

TERMS YOU NEED TO KNOW

RECONDITIONING FLOORS—Lightly sanding only the finish of the floor (to dull the surface) and then reapplying a new coat of finish.

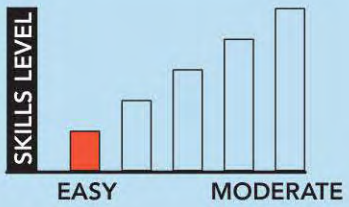
FEATHER SAND—Sanding with lighter and lighter strokes as you move away from a more heavily sanded area. This creates a smooth transition between sanded and non-sanded areas.

TOOLS & SUPPLIES YOU NEED

SKILLS YOU NEED

- Gluing
- Using a putty knife
- Sanding
- Applying a top coat (polyurethane and wax)

DIFFICULTY LEVEL



This project can be completed in less than an hour (not including drying time).

HOW TO GLUE DOWN A SPLINTER

1 If you still have the splintered piece of wood, but it has been entirely dislodged from the floor, it's a good bet that the hollowed space left by the splinter has collected a lot of dirt and grime. Combine a 1:3 mixture of distilled white vinegar and water in a bucket. Dip an old toothbrush into the solution and use it to clean out the hole left in the floor. While you're at it, wipe down the splinter with the solution, too. Allow the floor and splinter to thoroughly dry.

2 If the splinter is large, apply wood glue to the hole and splinter. Use a cotton swab or toothpick to apply small amounts of wood glue under smaller splinters. Soak the cotton swab in glue; you don't want cotton swab fuzz sticking out of your floor once the glue dries.

3 Press the splinter back into place. To clean up the excess glue, use a slightly damp, lint-free cloth. Do not oversoak the cloth with water.

4 Allow the adhesive to dry. Cover the patch with wax paper and a couple of books. Let the adhesive dry overnight.

HOW TO REPAIR A GOUGE

1 Repair small holes with wood putty. Use putty that matches the floor color. Force the compound into the hole with a putty knife. Continue to press the putty in this fashion until the depression in the floor is filled. Scrape excess compound from the area. Use a damp, lint-free cloth while the putty is still wet to smooth the top level with the surrounding floor. Allow to dry.

3 With a clean, lint-free cloth, apply a matching stain (wood sealer or "restorer") to the sanded area. Read the label on the product to make sure it is appropriate for sealing wood floors. Work in the stain until the patched area blends with the rest of the floor. Allow area to completely dry. Apply two coats of finish. Be sure the finish is the same as that which was used on the surrounding floor.

2 Sand the area with fine (100- to 120-grit) sandpaper. Sand with the wood grain so the splintered area is flush with the surrounding surface. To better hide the repair, feather sand the area. Wipe up dust with a slightly damp cloth.

HERE'S HOW

Surface finish (poly or wax)

Penetrant finish

Wax finish

To determine what kind of surface you have, use a coin to lightly scrape the floor in a hidden corner. If flakes appear, you have either a surface finish or a wax coat. If no flakes appear, it's a penetrant. To check for wax, sprinkle water on the floor. If the beads turn white after 10 minutes, it's waxed.

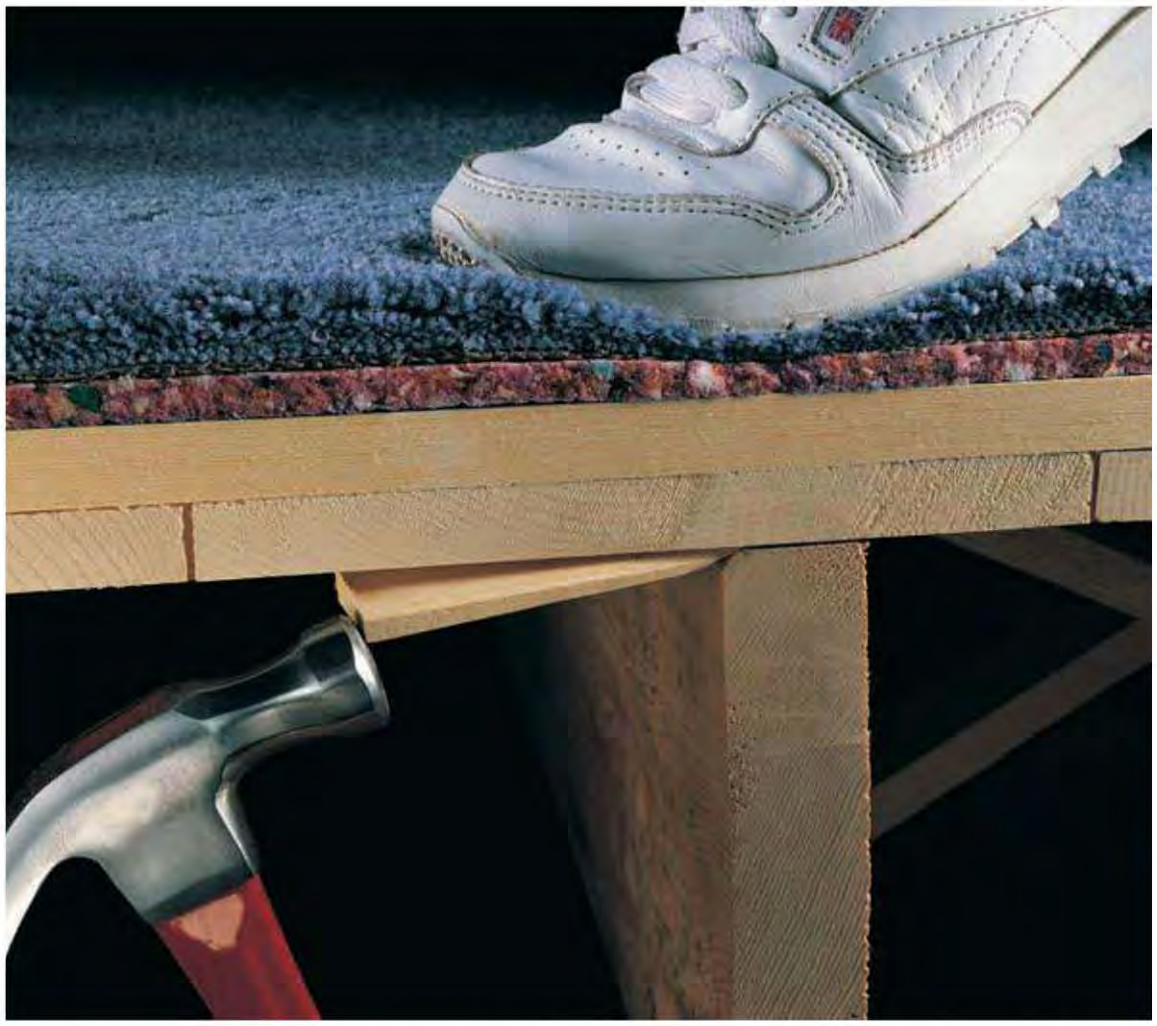
2 Fixing Squeaky Floors from Below

Squeak-elimination tools, such as the Squeak-Ender (shown), tighten the joist to the subfloor and eliminate squeaks. See page 256 for instructions.

LOTS OF HOUSES SQUEAK, SO MOST OF US JUST ACCEPT IT AS A FACT OF LIFE. It doesn't have to be, though. With a little work, you can get rid of those pesky squeaks. The cause of a floor talking back to you is no mystery; it's just the sound of wood rubbing against a nail or another piece of wood. More often than not the squeaking is just caused by the wood expanding due to humidity, contracting due to dryness. Wood is a very porous material. It just does that.

So how do we make it stop? If you have access to the area below the squeaky floor (as is the case if the immediate level below has an unfinished ceiling), please read on. . . .

FLOOR SQUEAKS 101



To pinpoint the source of a squeak, have someone walk around upstairs while you're below the floor (on the lower level). Make a pencil mark on the unfinished ceiling where you hear the offending chirp or squawk. The subfloor may even visually move away from the joists when you hear the squeak. If you don't see any movement, the finished flooring has buckled up away from the subfloor. If this is the case, have the person upstairs place a heavy weight, such as a couch leg or cinder block, on the spot that squeaks. If the squeak is immediately over a joist, use a hammer to tap a wood shim in between the joist and subfloor. Directions to do so are given in this project (starting on the next page).

TERMS YOU NEED TO KNOW

SUBFLOOR—The base layer of wood or plywood that supports the underlayment and surface flooring.

UNDERLAYMENT—The intermediate layer between the surface flooring material and the subfloor. The underlayment for laminate flooring combines a poly-water barrier and a foam cushion sound barrier in a rollout or rigid-plank form.

JOISTS—Supporting beams set parallel from wall to wall to support the subfloor.

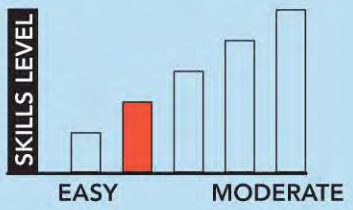
SQUEAK-ENDER FLOOR SQUEAK ELIMINATOR—A commercial squeak-elimination tool. It consists of a threaded rod attached to a flat mounting plate and a steel bracket fitted with a squared-off hook on one end.

TOOLS & SUPPLIES YOU NEED

SKILLS YOU NEED

- Drilling
- Hammering
- Wrench and screwdriver work

DIFFICULTY LEVEL



This project can be completed in as little as 10 minutes or as much as 2 hours.

HOW TO FILL GAPS BETWEEN JOISTS & FLOORBOARDS

1 If there is a gap or movement between the subfloor and joist at the squeak location, tap a tapered wood shim into the gap. First smear it with construction adhesive or wood glue. Squirt some glue into the gap, too. Don't overtap; it makes the gap bigger. Wait for the glue to dry. If this doesn't stop the squeak, go to Step 2.

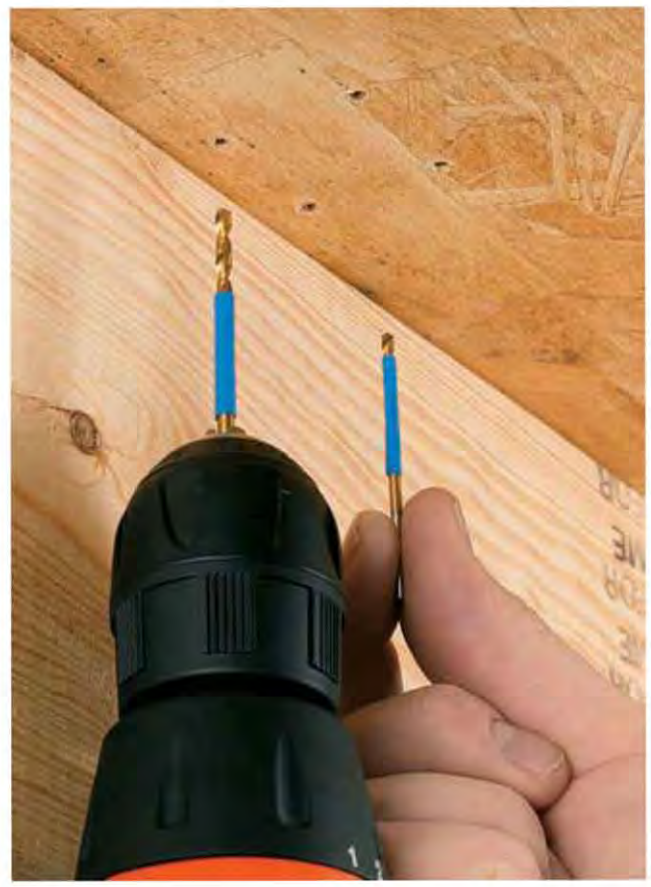
2 To use a Squeak-Ender, or another comparable squeak-elimination tool, insert the head of the hanger bolt into the concave part of the anchor plate. Use a Phillips screwdriver to screw the mounting plate to the underside of the subfloor (four screws are often provided). You want the plate to be touching the nearest joist in the general area of the squeak.

3 Slide the top part of the joist bracket through the threaded hanger rod and the bottom part under the joist.

4 Slip the washer and hex nut onto the rod. With a wrench, tighten the nut until the subfloor is pulled snug against the joist. Avoid overtightening.

HOW TO CINCH FLOORING TO JOISTS

1 If you've made it this far, the squeak is not caused by a gap between the subfloor and the joist. It's likely the floorboards have buckled up, creating a gap between the floor and the subfloor. We're going to drill up through the subfloor and pull the flooring down tight against the subfloor with some wood screws. To figure out how long the screws should be, first determine the combined thickness of the floor and subfloor by measuring at existing cutouts in the floor.



2 Drill pilot holes. The length of screw we need is ¼" less than the total depth of the top floor and subfloor combined. Mark that depth with masking tape on a #8 wood drill bit. On a #10 drill bit, mark the depth of the subfloor only. Now, drill some pilot holes around the squeak: 1. Drill through the subfloor with the thicker #10 bit. 2. Drill into the same holes a little deeper with the #8 bit. Make sure you don't drill deeper than the masking tape marks.

WHAT IF . . . ?

If there are no cutouts, determine the thickness by carefully boring a hole up into the subfloor. The hole should be large enough to fit a tape measure into it. Just to be safe, work in an inconspicuous corner of the basement. Use a ¾" spade drill bit to drill up into the subfloor. Stop drilling every so often to see how close to the finish floor you are—you may need a flashlight to see clearly. Stop once you get to the finish floor. Measure. Do not drill all the way through your wood floor above.

To find out the thickness of the top floor, measure the depth of the floor on the first stair down to the basement, if you have one.

HERE'S HOW

The length of screw we need for Step 2 is the same length we marked on the #8 drill bit. The thread thickness, though, is going to be a #10. This way, as the screw is tightened, the hole left in the subfloor by the #10 drill bit will not offer any resistance, but the hole left in the top flooring with the #8 drill bit will be snug and pull the loose board down against the subfloor. To distribute the pressure around the screw, slip each screw through a large fender washer before driving the screws into each pilot hole. This will secure the subfloor to the wood floor and stop the squeak.

3 Fixing Squeaky Floors from Above

It's a little more work to fix squeaks from above the floorboards than from below, but it's a lot easier than you might think.

THE SOUND OF WOOD RUBBING ON WOOD OR AGAINST A NAIL CAN BE infuriating, but fortunately this problem is not too complicated to fix. If the ceiling below the squeaky floor is unfinished, you can go downstairs and actually watch for movement in the subfloor while someone else walks on the floor upstairs. If you can't get to the floor from below, you have to fix the squeak from above. This is done by setting loose boards or surface nailing them down. Alternatively, a squeak-ender designed specifically for above floors may be used.

There are a few key topics discussed in this section. Learn how to:

- Apply lubricants to the floorboards to eliminate subtle squeaks caused by dryness.
- Safely use a hammer to tap loose floorboards into place.
- Carefully drill a small hole through the surface of the floor to surface-nail gaps, and then hide the evidence.

SQUEAK ELIMINATION 101

There are squeak-elimination tools for working above and below the floor. Even if your floor is carpeted, a squeak-elimination tool can drive screws through the subfloor and into the joists for you. The device controls the depth.

Keep in mind, that annoying squeak in your floor is caused by any of four things: 1. two floorboards rubbing together; 2. the subfloor rubbing against the joist below it; 3. the subfloor rubbing against the floorboards above it; 4. a loose nail in any of these places.

TERMS YOU NEED TO KNOW

SUBFLOOR—The base layer of wood or plywood that supports the underlayment and surface flooring.

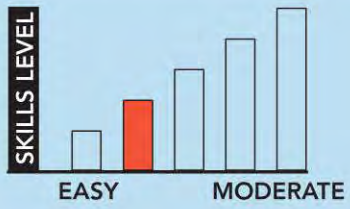
JOISTS—Supporting beams set parallel from wall to wall to support the subfloor.

TOOLS & SUPPLIES YOU NEED

SKILLS YOU NEED

- Hammering
- Drilling
- Using a putty knife
- Using a nail set

DIFFICULTY LEVEL



This project can be completed in as little as 10 minutes or as much as 2 hours.

HOW TO SET LOOSE BOARDS

HERE'S HOW

Because small squeaks can be caused by dirt between floorboards or by dryness, clean the floor at least once a week and apply lubricants to areas that tend to be extra dry or squeaky.

Oils: graphite, mineral oil, or floor oil. Use powdered or liquid graphite sparingly; it can make a mess. Similarly, a few drops of mineral oil will do the trick, but using too much can stain the surface. Floor oil, applied generously into the joints, soaks into the wood, making it expand. This results in a snug tongue-and-groove fitting. That pesky squeak may just disappear at this stage, at least temporarily.

Powders: graphite and talcum powder. To use talcum powder, dust a generous amount of the powder wherever the floor makes noise. Use a dry, clean cloth to work it into the tongue-and-groove joints, especially near any visible nails. Slightly dampen the cloth with water to wipe away excess powder.

2 Place the 2 × 4 at right angles to the squeaky floorboards. Tap the 2 × 4 with a hammer to reseat any loose boards or nails. Start at the perimeter of the squeaky section, moving the 2 × 4 in a rectangular pattern until you get to the center.

1 Make a "beater" block. If loose nails are the problem, you can tap the floorboards down where you hear the squeak. Wrap a 2 × 4 scrap (length of 1 ft. should do) in a heavy towel or scrap of carpet so that you don't scratch the floor surface. Tack the carpet to the top of the 2 × 4 with nails.

3 Squeaks in hardwood floors caused by floorboards rubbing against each other or against a nail can sometimes be eliminated for a few weeks or months just by adding a hardwood floor lubricant at the point of friction. First remove dirt and debris from between the floorboards, using an old toothbrush. With a clean toothbrush or a clean cloth, apply the lubricant to the floor joints.

HOW TO FASTEN LOOSE BOARDS

1 As a last resort, reattach buckled floorboards to the subfloor by nailing them down (from above the floorboards) with flooring nails. To reduce the risk of the boards splitting, drill pilot holes slightly smaller than the diameter of the nails. For maximum holding power, drill at opposing angles in a staggered pattern every 4" to 6" along the squeaky boards. The goal is to drill through the surface flooring of the buckled board and into the subfloor; better yet, drill into the subfloor and a joist.

HERE'S HOW

LOCATE JOISTS Not all of the nails can hit a joist, but you get a stronger connection wherever they do. Use a stud finder to find the joists.

COUNTERSINK NAILS Hide the head of the nails beneath the surface of the wood by gently tapping the nails down with a nail set. This is called "countersinking" the nails. Fill nail holes with tinted putty. Use a slightly damp sponge to smooth excess putty.

PROTECT YOUR FLOOR FROM DENTS Before tapping nails into your pre-drilled holes, cut out small squares of cardboard to set around the nailing area. It's a good idea to use a smooth-faced hammer as well.

REMOVE DENTS Some hammer dents can be removed by placing a damp cloth on the spot and applying pressure with a hot iron. This raises the damaged surface back to the common surface.

2 Set the nails with a nail set.

3 Fill nail holes with wood putty, using a putty knife. Force the compound into the hole by pressing the knife blade downward until it lies flat on the floor. Allow the patch to dry completely.

4 Sand the patch flush with the surrounding surface. Use fine-grit sandpaper and sand in the direction of the wood grain. Apply wood restorer to the area (inset) until it blends with the surrounding floor.

4 Repairing Resilient Flooring

Air pockets and curls are unsightly and they only get worse over time. Curls invite debris and moisture to settle under the tile, thus weakening the surrounding tiles; and bubbles continue to swell, destroying the adhesive holding the sheet of flooring in place. These problems must be addressed immediately.

RESILIENT FLOORING IS DURABLE, BUT FROM TIME TO TIME MINOR REPAIRS must be addressed. Air pockets are caused by the adhesive no longer working. This is common as floors age, and the resulting bubble is fairly easy to deflate and rebond to the subfloor. If not attended to, the area will eventually harden, split, and crack—making the problem more noticeable and difficult to fix. Even a curled edge on an otherwise healthy vinyl tile can be easily glued back into place. If the repair doesn't hold, the entire tile must be replaced.

HOW TO FIX A BUBBLE

1 Deflate air pocket. Use a utility knife to lightly score and then slice through the bulge. This allows air to escape. Extend the cut a little (½") beyond the blister at both ends. If possible, cut along a line in the pattern to hide the cut.

2 Choose an appropriately sized tool to force fresh vinyl adhesive through the slit and under the bubble. Press the edges together. Wipe up any excess adhesive with a damp cloth. Cover the patch with wax paper and some books while the adhesive dries.

HOW TO FIX A CURL

1 If the corner or edge of vinyl tile is curling, but the rest of the tile is in good shape, you can refasten it. Use an electric heat gun to warm the area. This makes the vinyl easier to work with and it softens the underlying adhesive.

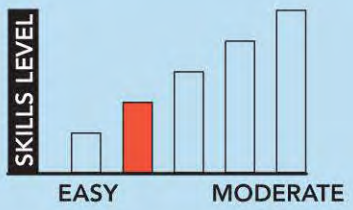
2 Use a flexible tool (such as a small putty knife) to lift the tile just enough to spread the underside with fresh adhesive. Wipe up excess glue with a damp cloth or sponge.

TOOLS & SUPPLIES YOU NEED

SKILLS YOU NEED

- Cutting with a utility knife
- Applying glue with a flexible tool
- Using a heat gun
- Applying seam sealer

DIFFICULTY LEVEL



This project can be completed in 30 minutes, not including drying time.

5 Patching Resilient Sheet Flooring

Resilient flooring is vulnerable when it comes to extreme heat and heavy objects falling on it. Burn marks and dents can be fixed by cutting out the damaged section and replacing it with a new patch of matching flooring.

RESILIENT SHEET FLOORING IS A DURABLE, PRACTICAL MATERIAL. There are no seams, so it is impervious to spills. However, it is not impervious to tears, dents, gouges, punctures, or burns. To repair a damaged section of sheet flooring, cut out the damaged area and glue in a replacement patch from a leftover remnant. If you don't have any leftover pieces available, you could settle for a close match or choose a piece that offers an interesting contrast.

SHEET VINYL PATCHES 101

Remember to thoroughly sweep and vacuum underlayment before installing a vinyl patch. Sometimes the tiniest bits and pieces of debris create noticeable bumps. And if old adhesive is not completely removed, a yellow discoloration will form on your new patch.

TERMS YOU NEED TO KNOW

UNDERLAYMENT—The intermediate layer between the surface flooring material and the subfloor.

PERIMETER-INSTALL—Vinyl sheet flooring that is glued only around the edges.

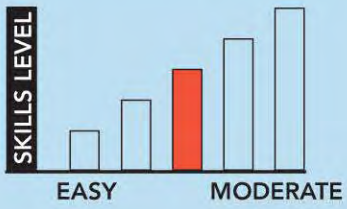
TROWEL—A flat-blade hand tool with a raised handle used for scooping, spreading, leveling, smoothing, or shaping substances such as cement, mortar, or adhesive. Usually, a tile trowel has notches on one edge for combing mortar or adhesive into even rows.

TOOLS & SUPPLIES YOU NEED

SKILLS YOU NEED

- Measuring
- Cutting
- Scraping
- Vacuuming
- Simple trowel work

DIFFICULTY LEVEL



This project can be completed in 1 hour, not including drying time.

HOW TO PATCH RESILIENT SHEET FLOORING

1 Measure the width and length of the damaged area. Place the new flooring remnant on a surface you don't mind making some cuts on—like a scrap of plywood. Use a carpenter's square for cutting guidance. Make sure your cutting size is a bit larger than the damaged area.

2 Lay the patch over the damaged area, matching pattern lines. Secure the patch with duct tape. Using a carpenter's square as a cutting guide, cut through the new vinyl (on top) and the old vinyl (on bottom). Press firmly with the knife to cut both layers.

3 Use tape to mark one edge of the new patch with the corresponding edge of the old flooring as placement marks. Remove the tape around the perimeter of the patch and lift up.

4 Soften the underlying adhesive with an electric heat gun and remove the damaged section of floor. Work from edges in. When the tile is loosened, insert a putty knife and pry up the damaged area.

5 Scrape off the remaining adhesive with a putty knife or chisel. Work from the edges to the center. Dab mineral spirits (or Goo Gone) or spritz warm water on the floor to dissolve leftover goop, taking care not to use too much; you don't want to loosen the surrounding flooring. Use a razor-edged scraper (flooring scraper) to scrape to the bare wood underlayment.

6 Apply adhesive to the patch, using a notched trowel (with ⅛" V-shaped notches) held at a 45° angle to the back of the new vinyl patch.

7 Set one edge of the patch in place. Lower the patch onto the underlayment. Press into place. Apply pressure with a J-roller or rolling pin to create a solid bond. Start at the center and work toward the edges, working out air bubbles. Wipe up adhesive that oozes out the sides with a clean, damp cloth or sponge.

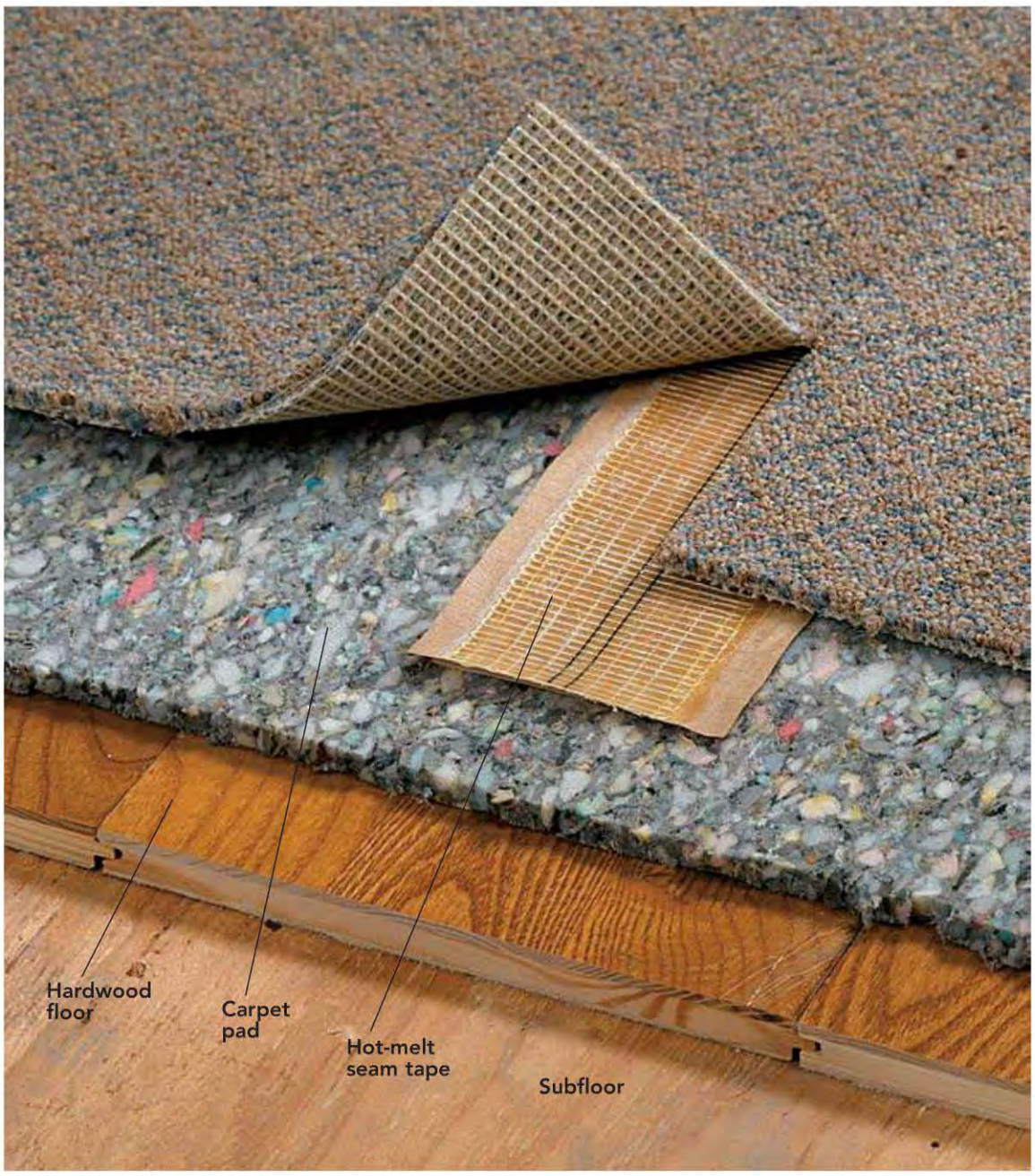
8 Let the adhesive dry overnight. The next day, hide the seams with liquid seam sealer. Use a soft cloth dipped in lacquer thinner to clean the area. Mix the seam sealer according to the manufacturer's directions. Use an applicator bottle to apply a thin bead of sealer onto the cutlines.

6 Repairing Loose Carpet Seams

Sliding furniture across the floor can catch loose carpet seams and further pull them away from the seam tape, leaving a big gap to invite dust and other debris under your carpet. To avoid further problems down the road, fix loose carpet seams immediately—and always lift furniture, instead of sliding it.

SEAM PROBLEMS CAN BE CAUSED BY A SNAG, HEAVY FOOT TRAFFIC, POOR quality, longterm wear, or improper installation. Whatever the cause, if the seams of your wall-to-wall carpet have begun to come apart, fix them as soon as you can. The longer you wait, the more likely your carpet is to fray and the more likely debris will start to accumulate under the carpet. The good news is that the repair requires only minimal skills and simple tools that you can rent at any carpet dealership. Read on . . . you can definitely solve the problem yourself.

CARPET SEAMS 101



Carpet seams are held down with seam tape laid over the foam carpet pad. The tape sticks to the underside of the carpet. If the carpet is set onto the seam tape crookedly, it will leave a noticeable gap. In this case, the tape should be removed, and the seams should be reset.

TERMS YOU NEED TO KNOW

ROWS OF PILE—Pile (also called "nap") is the surface of carpet. Pile is composed of tufts of yarn, either cut or looped, woven into the back of the carpet.

CUT-PILE CARPET—Carpet composed of tufts of yarn that are cut off at the top, as opposed to looped.

SEAM TAPE—Hot-glue seam tape or self-adhesive seam tape is used to join carpet pieces together.

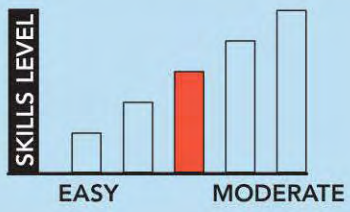
SUBFLOOR—The base layer of wood or plywood that supports the underlayment and surface flooring.

TOOLS & SUPPLIES YOU NEED

SKILLS YOU NEED

- Measuring
- Cutting
- Using a seam iron
- Using a small carpet roller

DIFFICULTY LEVEL



This project can be completed in under an hour.

HOW TO REPAIR A CARPET SEAM

1 Separate the carpet fibers along the seam with your fingers, so you can clearly see the seam. Use a carpet or utility knife to cut through the seam tape stuck to the underside of the carpet. Open up the entire length of the seam and remove any remaining tape. Be careful not to cut the carpet pad. If you cut the pad, repair it with duct tape.

2 If there are any loose carpet fibers that could accidentally be pulled, snip them close to the base of the carpet.

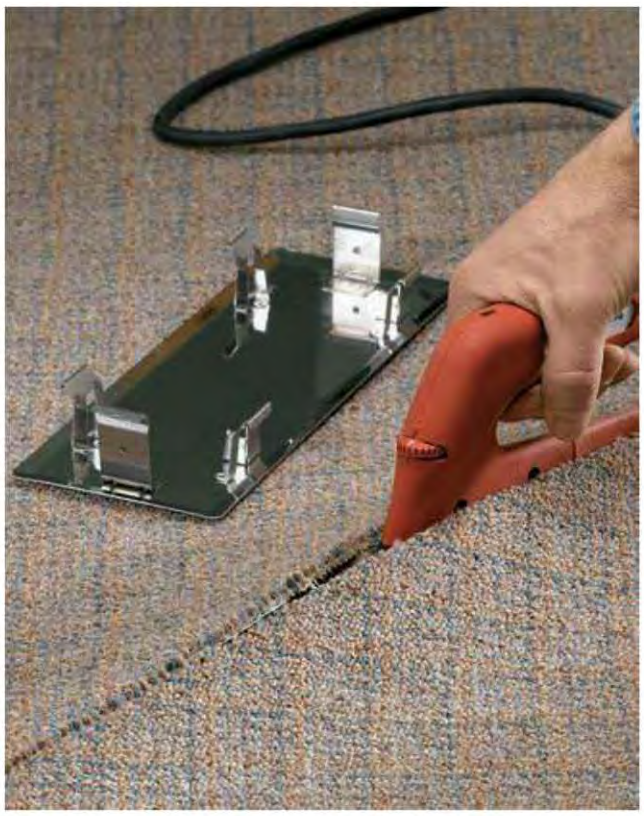
3 Measure the length of the split seam and cut a new piece of hot-melt seam tape to size. Hold back one edge of carpet (not the carpet pad) while you slip the seam tape, adhesive side up, under the seam. Center the tape between the two pieces of carpet.

SAFETY FIRST

Be sure to regularly replace the blades in your utility knife. A dull utility knife requires you to use more pressure, which makes accurate cutting more difficult.

4 Place the seam iron on a board or old carpet remnant and pre-heat it to the appropriate temperature, as recommended by the seam-tape manufacturer (usually 250°).

6 Set the carpet to the seam tape by walking over the seam. Alternatively, roll over the seam with a handheld, spiked seam roller (available at most home-improvement stores).

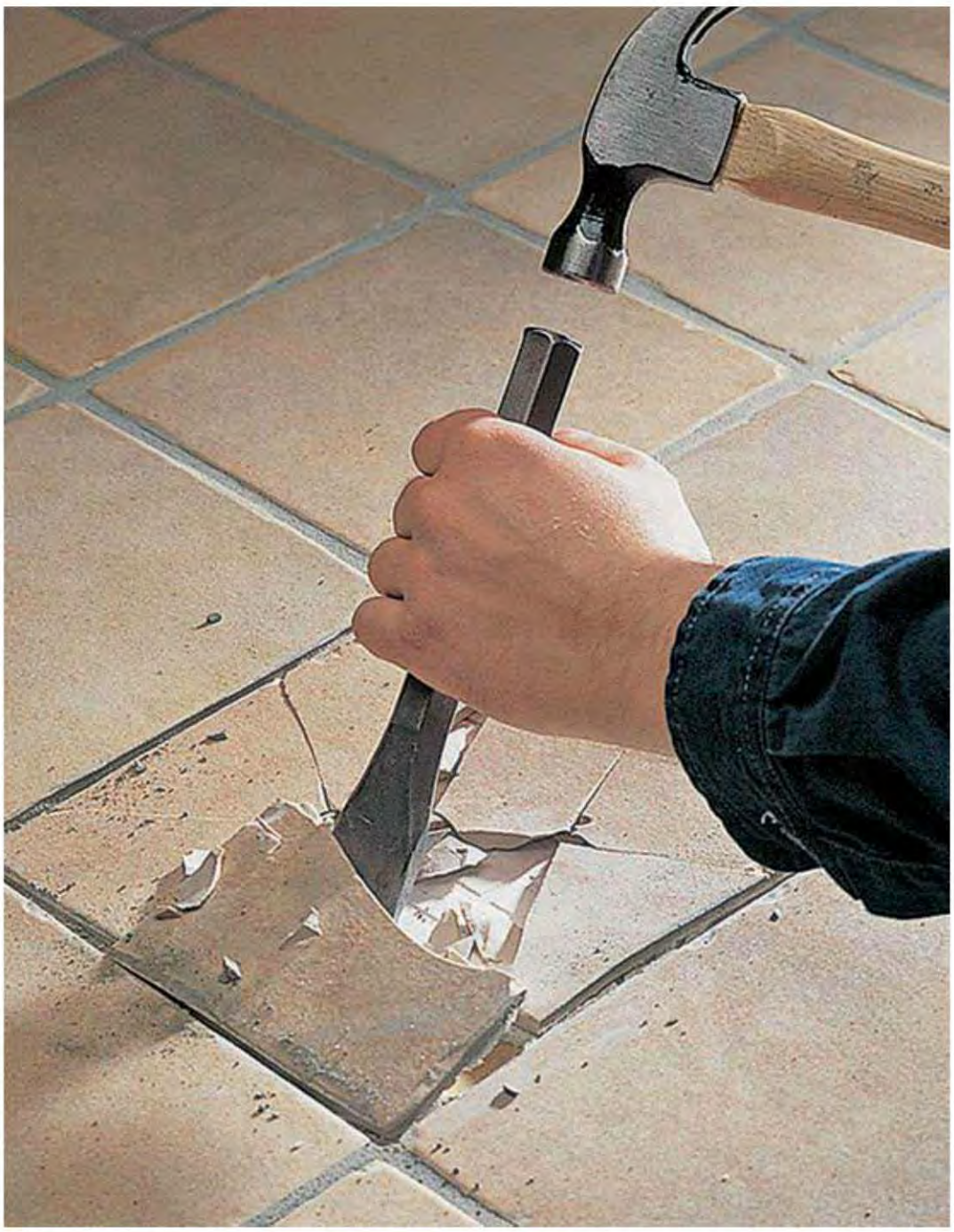


5 Hold back one side of the carpet and place the hot iron directly on the tape at one end of the seam. Hold it there for about 30 seconds, so that it melts the tape glue. Let the carpet flop down over the iron and slowly draw the iron along the entire length of the seam. Go about a foot at a time. Check to make sure the carpet is not too hot and then press the carpet down into the heated adhesive with the other hand. As you go, make sure the backings are butted together. The glue will harden in just a couple of minutes.

HERE'S HOW

To ensure that the carpet will not fray at the seams, apply a continuous bead of seam glue along the seam edges.

7 Replacing Ceramic Tiles



Removing a damaged tile requires a little elbow grease. The first step is to weaken the tile with the appropriate tools (as will be explained in this project). From that point, the job is much easier if you have a large, sturdy chisel to remove chunks of the tile.

A CRACKED OR BROKEN CERAMIC TILE IS EASY ENOUGH TO REPLACE, PROVIDED you have a suitable replacement tile. Before starting this project, shop around a bit for the replacement tile. If you have to buy a new tile, make sure you only look at tile specifically for floors. Take the exact measurement of the broken tile with you. If possible, take a fragment of the tile along with you so the sales person can match the finish and composition. If you absolutely cannot find a replacement tile, consider turning the problem into a design challenge by replacing a few tiles in a pattern of your choice with a contrasting tile. If you need to replace multiple tiles for whatever reason, see page 276 for grouting and sealing large areas.

CERAMIC TILE MATERIALS 101

Replacing a tile requires a new tile, adhesive, grout, and a sealer. The joints between ceramic tiles are filled with a cement-based filler called "grout." This must be removed and replaced when a single tile is replaced. It is good to occasionally check the condition of the grout over the entire floor. (To regrout floors, see page 74). Grout is available in tinted colors to match your tile. You must also seal all grout lines with silicone sealer. Seal the joints every two years or so.

TERMS YOU NEED TO KNOW

SUBFLOOR—The base layer of wood or plywood that supports the underlayment and surface flooring.

UNDERLAYMENT—The intermediate layer between the surface flooring material and the subfloor. The underlayment for a ceramic tile floor can be plywood or cementboard.

THINSET MORTAR—A cement-based adhesive used to adhere ceramic tile to the underlayment.

TILE SPACERS—Small plastic spacers used to position tiles for uniform grout lines. Available in different sizes to create grout joints of different widths.

GROUT—A very fine cement mortar, sometimes tinted, used to fill the joints between ceramic tiles.

METAL LATHE—An open fabric of metal that holds poured mortar used as a base for ceramic tile. You are most likely to see this in older tile installations.

CARBIDE-TIPPED GROUT SAW—A scraping tool with a sharp carbide-coated blade to remove old, hardened grout.

TOOLS & SUPPLIES YOU NEED

Rubber gloves

¼" notched trowel

SKILLS YOU NEED

- Hammering and chiseling
- Trowel work
- Grouting and sealing

DIFFICULTY LEVEL

This project can be completed in a day or so, including drying time, depending on how many tiles need to be replaced.

HOW TO REPLACE A CERAMIC TILE

1 With a carbide-tipped grout saw, apply firm but gentle pressure across the grout until you expose the unglazed edges of the tile. Do not scratch the glazed tile surface. If the grout is stubborn, use a hammer and screwdriver to first tap the tile (Step 2).

3 To remove the tile, insert a chisel into one of the cracks and gently tap the tile. Start at the center and chip outward so you don't damage the adjacent tiles. Be aware that cement board looks a lot like mortar when you're chiseling. Remove and discard the broken pieces.

2 If the tile is not already cracked, use a hammer to puncture the tile by tapping a nail set or center punch into it. Alternatively, if the tile is significantly cracked, use a chisel to pry up the tile.

4 Use a putty knife to scrape away old thinset adhesive; use a chisel for poured mortar installation. Note: If the underlayment is covered with metal lathe you won't be able to get the area smooth, just clean it out the best you can. Once the adhesive is scraped from the underlayment, smooth the rough areas with sandpaper. If there are gouges in the underlayment, fill them with epoxy-based thinset mortar (for cementboard) or a floor-leveling compound (for plywood). Allow the area to completely dry.

SAFETY FIRST

Chipping out a ceramic tile can create flying shards of very sharp ceramic fragments. When doing this work, use patient, gentle blows of your hammer on the chisel. Always wear eye protection when using a hammer and chisel.

TOOL TIP

Before puncturing the tile with a nail set, you may want to weaken the tile by scoring deep fracture lines into it with a glasscutter and straightedge.

5 Use a ¼" notched trowel to apply thinset adhesive to the back of the replacement tile. Set the tile down into the space, and use plastic spacers around the tile to make sure it is centered within the opening.

7 Remove the spacers with needlenose pliers. Get the mortar or thinset adhesive out of the grout joints with a small screwdriver and a cloth. Also, wipe away any adhesive from the surface of the tiles, using a wet sponge. Let the area dry for 24 hours (or according to the manufacturer's recommendations).

6 Set the tile in position and press down until it is even with the adjacent tiles. Twist it a bit to get it to sit down in the mortar. Use a mallet or hammer and a block of wood covered with cloth or a carpet scrap (a "beater block") to lightly tap on the tile, setting it into the adhesive. Use a level or other straight surface to make sure the tile is level with the surrounding tiles. If necessary, continue to tap the tile until it's flush with the rest of the surrounding tiles.

8 Use a putty knife to apply grout to the joints. Fill in low spots by applying and smoothing extra grout with your finger. Use the round edge of a toothbrush handle to create a concave grout line, if desired.

ALTERNATIVE: HOW TO GROUT & SEAL LARGE AREAS

1 To grout and seal a large area, mix a batch of floor grout in a bucket, according to the directions on the label.

2 Pour the grout over the tile, then use a rubber grout float or rubber squeegee to spread it over the grout joints. Press down with a wiggling motion to force the grout deeply into the joints. Then tilt the face of the float 45° and diagonally drag the float across the joints to evenly apply the grout.

3 Let the grout set for 10 to 15 minutes, then use the grout float to remove excess grout from the surface of the tile. Hold the grout float on its edge and use a scraping motion.

HERE'S HOW

Before applying grout to porous tile, coat the tiles with a release agent (sold at tile shops) to keep the grout from discoloring the tile.

4 Use a barely damp sponge to wipe away excess grout from the surface of the tile. Be gentle with the joints themselves, though—you don't want to pull grout out of the joints you've just filled.

6 Use a foam brush to seal the grout after it cures. Do this every 1 to 2 years to protect against stains and to prevent it from crumbling.

5 Let the grout dry for about 4 hours, then polish the tile with a soft cloth.

HERE'S HOW

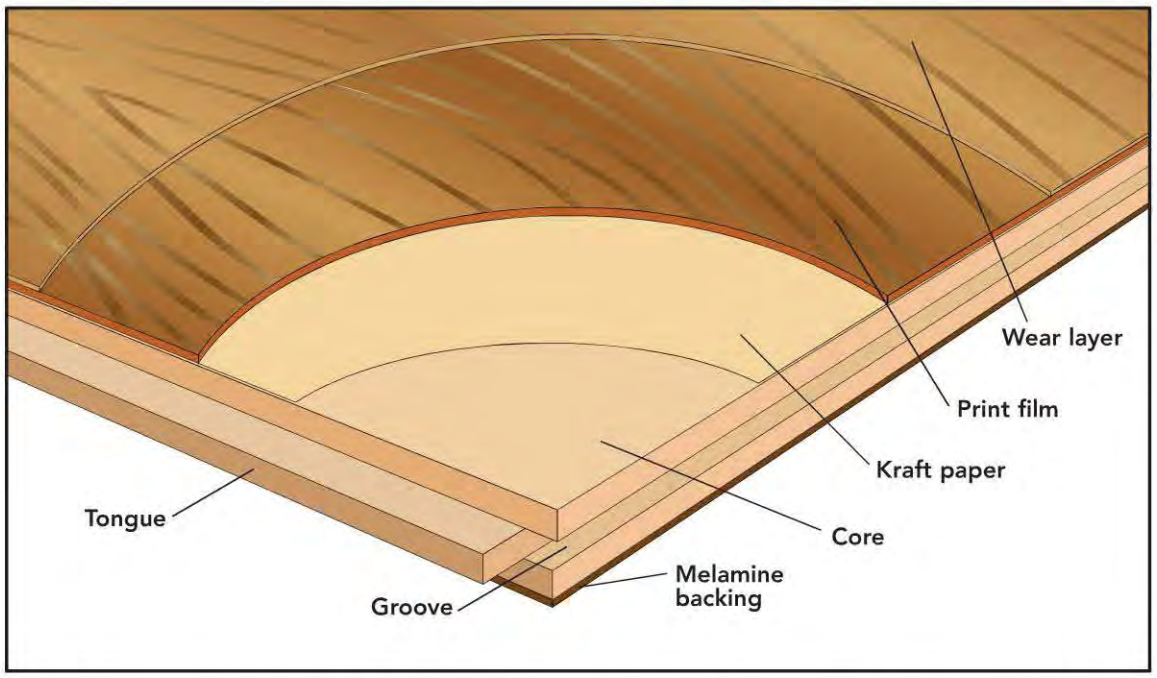
To determine if your grout needs to be resealed, test the existing sealer by putting a few drops of water on a grout line. If the water beads up, the sealer is still working. If the water absorbs into the grout, it needs to be resealed.

8 Replacing Laminate Floorboards

As indestructible as laminate floors may seem, minor scratches caused by normal day-to-day wear and tear are unavoidable. Whether the damaged plank is close to a wall or in the middle of the floor, this project will show you how to replace it.

IN THE EVENT THAT YOU NEED TO REPLACE A LAMINATE PLANK, YOU MUST first determine how to remove the damaged plank. If you have a glueless "floating" floor it is best to unsnap and remove each plank starting at the wall and moving in until you reach the damaged plank. However, if the damaged plank is far from the wall it is more time-efficient to cut out the damaged plank (see page 280). Fully-bonded laminate planks have adhesive all along the bottom of the plank and are secured directly to the underlayment. When you remove the damaged plank you run the risk of gouging the subfloor, so we recommend calling in a professional if you find that your laminate planks are completely glued to the subfloor.

LAMINATE FLOORBOARDS 101



From bottom to top, laminate planks are engineered to resist moisture, scratches, and dents. A melamine base layer protects the inner core layer, which is most often HDF (high-density fiberboard). This is occasionally followed by kraft paper saturated in resins for added protection and durability. The print film is a photographic layer that replicates the look of wood or ceramic. The surface is a highly protective wear layer. The tongue-and-groove planks fit together tightly and may be (according to manufacturer's instructions) glued together for added stability.

TERMS YOU NEED TO KNOW

SUBFLOOR—The base layer of wood or plywood that supports the underlayment and surface flooring.

UNDERLAYMENT—The intermediate layer between the surface flooring material and subfloor. The rollout underlayment for laminate flooring combines a poly-water barrier and a foam cushion sound barrier.

FLOATING FLOORS—Flooring that does not fasten directly to the subfloor or underlayment, but rather "floats" on top. The flooring material is held together with a snap-together, interlocking system, either with or without adhesive at the joints. When replacing a cut out plank, you must use adhesive at the joints where the tongue-and-groove edges have been removed.

GLUELESS LAMINATE FLOORS—Flooring that does not require glue for installation, but instead relies upon a tight tongue-and-groove system.

FULLY-BONDED LAMINATE FLOORS—Laminate flooring that is attached to the subfloor with adhesive.

PLUNGE CUT—A technique used to cut out a rectangular area from the center of a piece of wood. Adjust the cut to the exact wood thickness. Turn on the saw and ease it down into the wood. Repeat along the entire cutline.

TOOLS & SUPPLIES YOU NEED

SKILLS YOU NEED

- Hammering using a nail set
- Drilling
- Using pry bar, chisel, and pliers
- Plunge cutting with a circular saw
- Using a router

DIFFICULTY LEVEL

This project can be completed in less than a day, not including 24 hours for adhesive drying time.

HOW TO REPLACE LAMINATE PLANKS

1 Draw a rectangle in the middle of the damaged board with a 1½" border between the rectangle and factory edges. At each rectangle corner and inside each corner of the plank, use a hammer and nail set to make indentations. At each of these indentations, drill 3⁄16" holes into the plank. Only drill the depth of the plank.

2 To protect the floor from chipping, place painter's tape along the cutlines. Set the circular saw depth to the thickness of the replacement plank. Plunge cut the damaged plank and push the saw from the center of the line out to each end. Stop ¼" in from each corner. Pry up the middle section and remove.

3 Pry up the remaining outer edges of the damaged plank, using a scrap 2 x 4 wood block as leverage. Use a pliers to grab the 1½" border strip in front of the pry bar. Press downward until a gap appears at the joint, and then remove the border piece. Repeat for the other sides.

4 Place a scrap of cardboard in the opening to protect the underlayment foam while you remove all of the old glue from the factory edges with a chisel. Vacuum up the wood and glue flakes.

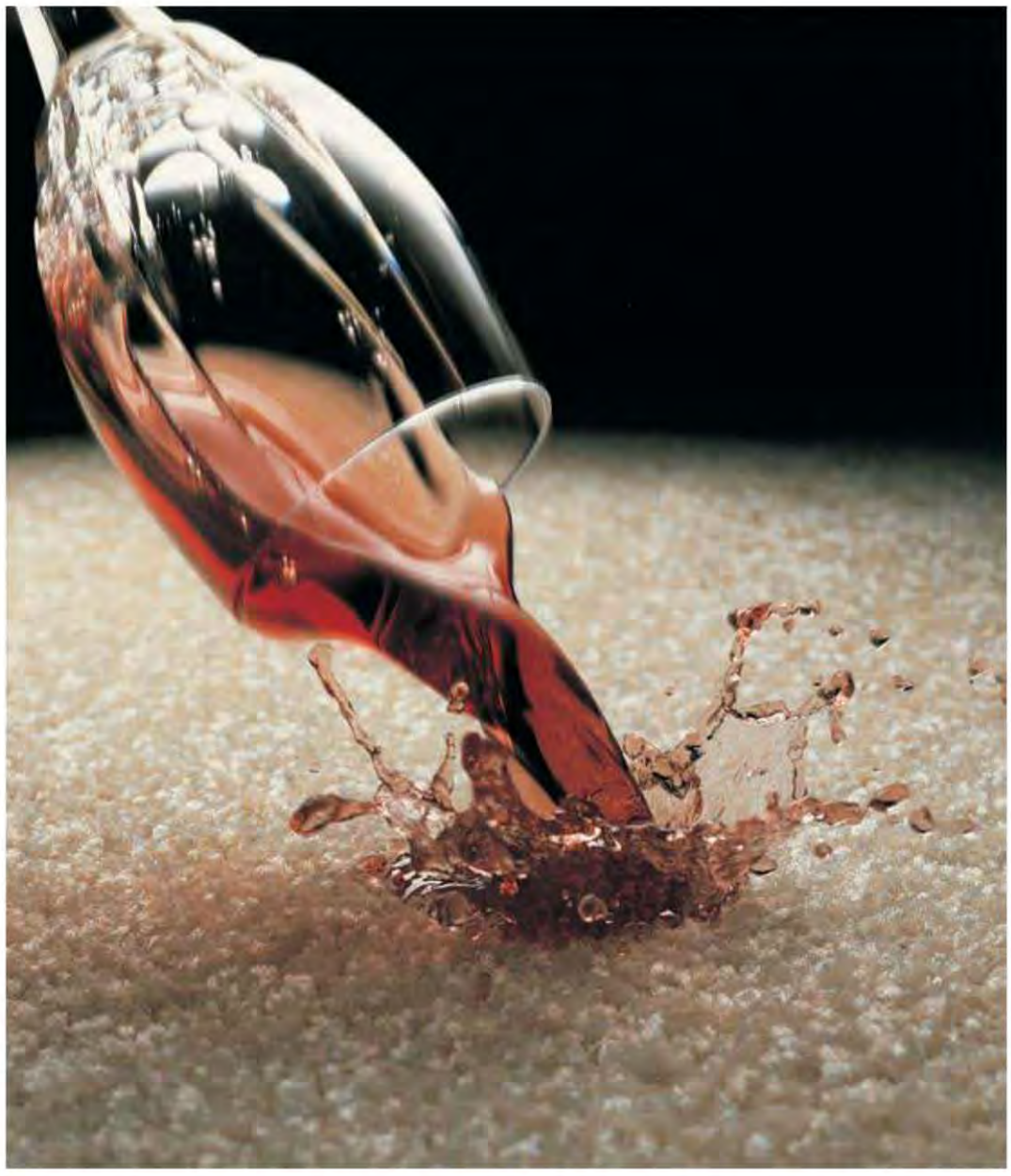
5 To remove the tongues on one long and one short end, lay the replacement plank face down onto a protective scrap of plywood (or 2 × 4). Clamp a straight cutting guide to the replacement plank so the distance from the guide causes the bit to align with the tongue and trim it off. Pressing the router against the cutting guide, slowly move along the entire edge of the replacement plank to remove the tongue. Clean the edges with sandpaper.

6 Dry-fit the grooves on the replacement board into the tongues of the surrounding boards and press into place. If the board fits snugly in between the surrounding boards, pry the plank up with a manufacturer suction cup. If the plank does not sit flush with the rest of the floor, check to make sure you routered the edges off evenly. Sand any rough edges that should have been completely removed and try to fit the plank again.

7 Set the replacement plank by applying laminate glue to the removed edges of the replacement plank and into the grooves of the existing planks. Firmly press the plank into place.

8 Clean up glue with a damp towel. Place a strip of wax paper over the new plank and evenly distribute some books on the wax paper. Allow the adhesive to dry for 12 to 24 hours.

9 Patching Carpet



Large spills often soak into carpet quickly and then start to spread. This can permanently damage a significant portion of your carpet. In such a case, a large carpet patch is in order.

IF A RELATIVELY LARGE AREA OF CARPET IS STAINED, BURNED, WORN, OR damaged, you can replace the damaged section with a matching carpet remnant. A large patch will likely be noticeable if the surrounding carpet is worn or faded, but a clean patch will prevent further damage—no matter how much you clean it, a large stain will attract oils and debris because the surface will be different from that of the surrounding carpet.

If you don't have a leftover remnant, you still have some options: If the carpet isn't too old, you may be able to find a matching remnant at a carpet dealer. If not, consider cutting a piece from the back of a closet or from under a couch that you don't intend to move. If these options are unsatisfactory, consider using a different type of carpet altogether and extending the patch to the nearest transition, such as a door threshold or wall. This will make your carpet design unique, and no one will track your inspiration to a damaged piece of carpet!

CARPET PATCHING 101

Before you start, be aware that even the best patching job may be noticeable if your carpet is faded or very worn. Any difference between the patch and the surrounding carpet will fade somewhat over time and become less noticeable. The difference is somewhat minimalized if you make sure the carpet nap of the patch matches the surrounding area (inset).

TERMS YOU NEED TO KNOW

WALL-TO-WALL CARPET—Two layers of woven backing are laid over separate padding. Installed by stretching onto tackless strips.

CUSHION-BACKED CARPET—One layer of woven backing is manufactured with a foam backing bonded to its underside and needs no additional padding. It is glued to the floor, rather than being installed under tension. Cushion-backed carpet was more common 15 years ago than it is now.

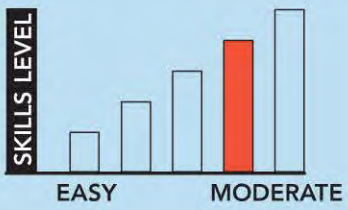
KNEE KICKER—A tool used for stretching carpet. The teeth at the front end of the tool grip the carpet; the back end is shaped so the user can apply forward pressure with the knee.

TOOLS & SUPPLIES YOU NEED

SKILLS YOU NEED

- Using simple knee kicker
- Cutting
- Hammering tacks
- Gluing

DIFFICULTY LEVEL



This project can be completed in a couple of hours, not including adhesive drying time.

HOW TO PATCH CARPET

1 Use a utility knife to cut four strips from a carpet remnant, each a little wider and longer than the cuts you plan to make around the damaged part of your carpet. Most wall-to-wall carpet is installed under tension; so to relieve that tension, set the knee kicker 6" to 1 ft. from the area to be cut out and nudge it forward (toward the patch area). If you create a hump in the carpet, you've pushed too hard and need to back off. Now place one of the strips upside down in front of the knee kicker and tack it to the floor at 2" to 4" intervals. Repeat the same process on the other three sides.

2 Use a marker to draw arrows on tape. Fan the carpet with your hand to see which direction the fibers are woven, and then use the pieces of tape to mark that direction on both the carpet surrounding the damaged area and the remnant you intend to use as a patch. Place a carpet remnant on plywood and cut out a carpet patch slightly larger than the damaged section, using a utility knife. As you cut, use a Phillips screwdriver to push carpet tufts or loops away from the cutting line. Trim loose pile, and then place the patch right side up over the damaged area.

TOOL TIP

Knee kickers have teeth that grab the carpet backing. These teeth should be set to grab the backing without grabbing the padding. There is an adjustable knob to do this. You can tell if the knee kicker is grabbing the padding by the increased pressure needed to move it forward. To release the tension just before a damaged area of carpet you intend to patch, place the feet on the floor and use your knee to press it toward the damaged area.

3 Tack one edge of the patch through the damaged carpet and into the floor, making sure the patch covers the entire damaged area. Use a utility knife to cut out the damaged carpet, following the border of the new patch as a template. If you cut into the carpet padding, use duct tape to mend it. Remove the patch and the damaged carpet square.

5 Line up your arrows and press the patch into place. Take care not to press too much, because glue that squeezes up onto the newly laid carpet creates a mess. Use an awl to free tufts or loops of pile crushed in the seam. Lightly brush the pile of the patch to make it blend with the surrounding carpet. Leave the patch undisturbed for 24 hours. Check the drying time on the adhesive used and wait at least this long before removing the carpet tacks.

4 Cut four lengths of carpet seam tape, each about 1" longer than an edge of the cut out area, using a utility knife or scissors. Cover half of each strip with a thin layer of seam adhesive and then slip the coated edge of each strip, sticky side up, along the underside edges of the original carpet. Apply more adhesive to the exposed half of tape, and use enough adhesive to fill in the tape weave.

WHAT IF . . . ?

If you have cushion-backed, fully-bonded carpet, you can follow the instructions above to make a large patch, except:

1. **You won't need a knee kicker.**
2. **Use a putty knife to scrape away any dried cement from the hole you make.**
3. **Apply multi-purpose flooring adhesive to the floor with a 3/32" trowel.**
4. **Instead of seam tape, just use a thin bead of cushion-back seam adhesive along the perimeter of the hole.**

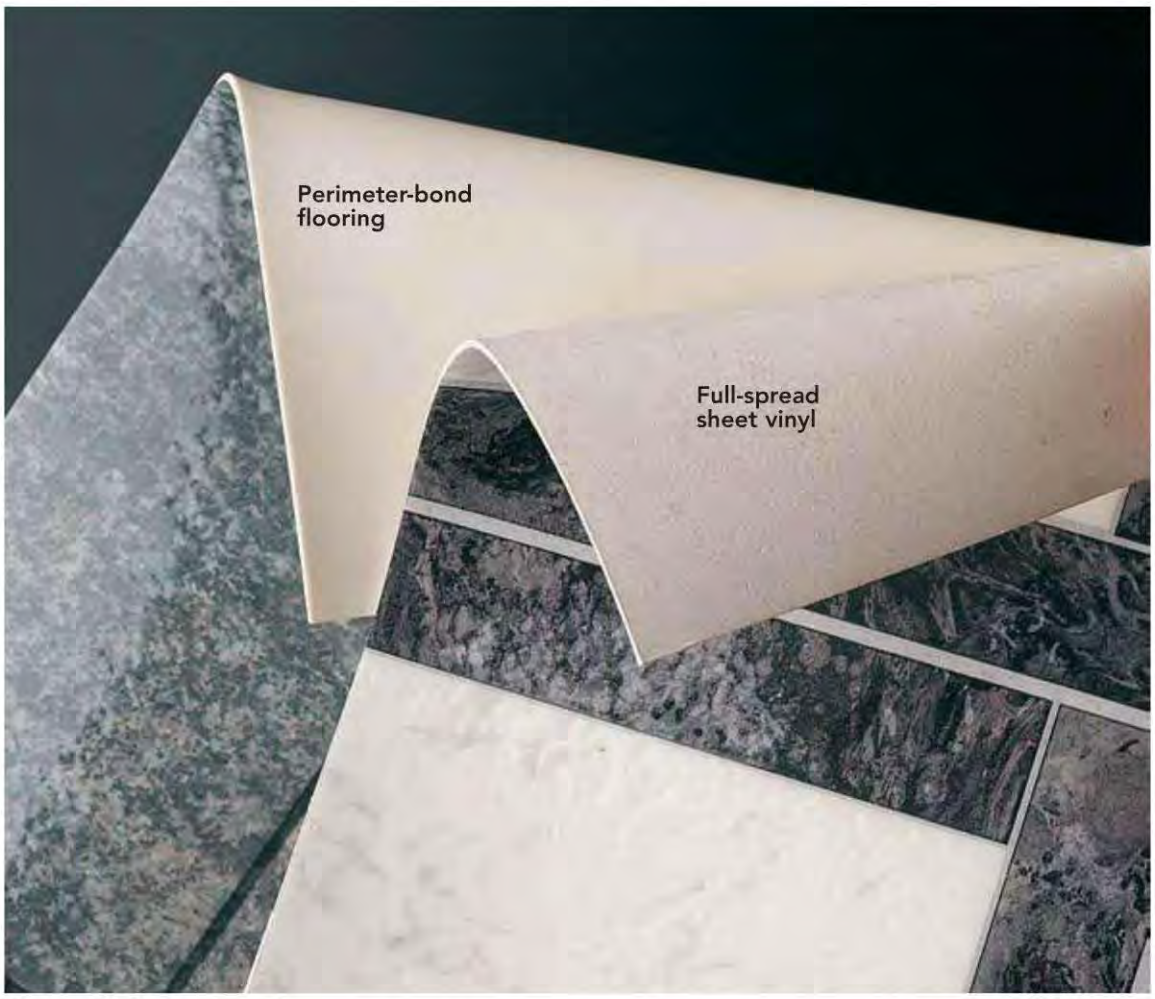
10 Removing Resilient Flooring

If adhesives are not properly removed before installing new resilient flooring, the oils may chemically react to the new material and produce a yellow discoloration, essentially destroying the vinyl floor. These spots cannot be removed with cleaning products. In these cases, the old resilient flooring should be removed entirely before you install new flooring.

REMOVING GLUED-DOWN RESILIENT FLOORING IS LABOR INTENSIVE, BUT IT'S necessary to do so if the surface is in very poor condition (or if you plan to replace the old resilient flooring with ceramic tile). Oils that cause yellow discoloration can eventually dry out and crack or seep through the vinyl, damaging new floor laid on top of it. Moreover, any unevenness or debris under the old vinyl will clearly show through new resilient flooring.

Note: It is true that resilient floor can serve as the foundation for most new floorings, including resilient flooring, hardwood, or carpet, but only if the existing surface is smooth and sound. Even if the existing flooring has loose seams, small tears, or air bubbles, then you must apply embossing leveler to the entire floor and let it dry before laying new resilient flooring. Alternatively, you can lay a new ¼" plywood underlayment over the old floor or you can remove the entire subfloor with the vinyl flooring and lay a new subfloor. These methods are worth consideration if you find that the subfloor is being heavily damaged as you begin to remove full-spread sheet vinyl, but they are also very time-consuming and require a considerable amount of precision.

SHEET FLOORING 101



Resilient sheet vinyl comes in full-spread and perimeter-bond styles. Full-spread sheet vinyl has felt-paper backing and is secured with adhesive that's spread over the entire floor before installation. Perimeter-bond flooring, identifiable by its smooth, white PVC backing, is laid directly on the underlayment and is secured by adhesive spread along the edges and seams.

TOOLS & SUPPLIES YOU NEED

TERMS YOU NEED TO KNOW

SUBFLOOR—The base layer of wood or plywood that supports the underlayment and surface flooring.

UNDERLAYMENT—The intermediate layer between the surface flooring material and the subfloor.

PERIMETER-BOND SHEET VINYL—A synthetic resilient flooring that is installed in a single sheet, cut to fit the room it will be installed in, and glued to the underlayment at the room's edges.

FULL-SPREAD SHEET VINYL—A synthetic resilient flooring that is installed in a single sheet, cut to fit the room it will be installed in, and glued to the underlayment on a full-room bed of adhesive.

FLOOR SCRAPER—Designed like a shovel, a floor scraper removes resilient flooring products and scrapes off leftover adhesives or backings. The long handle provides leverage and force, and it allows you to work in a comfortable standing position.

SKILLS YOU NEED

- Cutting with a utility knife
- Scraping
- Using a heat gun

DIFFICULTY LEVEL

This project can be completed in a few hours.

HOW TO REMOVE RESILIENT SHEET FLOORING

1 Remove baseboards. Beginning in a corner of the room, slowly move a heat gun back and forth 4 to 6" above the floor until you can pry up the corner. Alternatively, to use an iron, place aluminum foil on the floor to prevent melting or burning the floor, and keep the temperature at a low setting (inset).

2 Once the adhesive is warm, insert a wide-blade putty knife under the loosened corner and pry back the flooring. If the glue is only around the perimeter of the room, measure from the wall to the approximate point where the glue stops and cut a strip that wide along the entire perimeter of the room (inset). Go on to Step 3, knowing you will remove the strip you just cut along the wall last.

3 With a utility knife, cut the flooring into strips about three feet wide (or smaller, if you find smaller strips are easier to handle and have the extra time needed for extra cutting and rolling). If you have perimeter-installed sheet flooring, start cutting the strips inside the perimeter cut you made in Step 2. Simply roll up the strips and bind them with duct tape (inset).

4 Start pulling up the strips by hand. Grip the material close to the floor to minimize tearing. Dispose of the waste in heavy-duty construction garbage bags.

5 Scrape the remaining sheet vinyl and backing, using a floor scraper. Use a hammer to tap a putty knife under loose edges to chip apart pieces.

6 For stubborn spots, peel up as much of the floor covering as possible, using a putty knife. Spray a solution of water and liquid dishwashing detergent under the surface layer to separate the backing. With the help of the detergent, continue to use the putty knife to scrape up the stubborn patches.

7 For very sticky and stubborn glue, hold a heat gun about 4 to 6" above the floor. Constantly move the heat gun as you scrape the gooey mess into a pile with a wide-blade putty knife. Occasionally pick up glue and dispose of it, and wipe the putty knife clean.

8 Now you just need to sweep up the debris and clean up with a wet/dry vacuum. To contain the dust, fill the wet vac with about 1" of water.

HERE'S HOW

Some old linoleum is secured to the floor with a tar-based adhesive. Tar-based adhesives are dark or tan colored and can be scrubbed away with steel wool and mineral spirits (or paint thinner).

11 Removing Carpet

When removing fully-bonded, cushion-backed carpet, be prepared to find carpet adhesive and foam padding on the floor underneath. It is a time-consuming process to remove the adhesive, but your new floor is well worth the effort needed to properly prepare a clean, level underlayment.

REMOVING CARPET IS NECESSARY IF IT HAS BEEN BADLY DAMAGED OR YOU ARE ready to install a different type of flooring. It is time-consuming work, but you can save money by removing carpet even if you intend to hire someone to install new flooring. Carpet is either installed with tack strips along the perimeter of a room, with adhesive spread along the perimeter of the room, or with adhesive spread along the entire floor.

CARPET BACKING 101

Perimeter tackless strips with an independent pad

Cushion-backed carpet

Wall-to-wall carpet is stretched and secured to tackless strips along the perimeter of the room. Once lifted from the strips, the carpet and pad can be rolled up. The tackless strips are often nailed down and must be removed. Cushion-backed carpet has a foam backing bonded to it. It is secured to the floor with general-purpose adhesive. When removing this carpet, pieces of the pad will stick to the floor. Removing all of the stubborn pieces requires time and a considerable amount of effort.

TERMS YOU NEED TO KNOW

SUBFLOOR—The base layer of wood or plywood that supports the underlayment and surface flooring.

WALL-TO-WALL CARPET—Carpet with two layers of woven backing. Usually, it's laid over separate padding. Installed by stretching onto tackless strips.

CUSHION-BACKED CARPET—One layer of woven backing is manufactured with a foam backing bonded to its underside and needs no additional padding. Usually, it's glued to the floor, rather than being installed under tension.

TACKLESS STRIPS ("TACK STRIPS")—Plywood strips with 2 to 3 rows of sharp nails angled away from the center of the room. The strips are installed along the perimeter to hold wall-to-wall carpet in place.

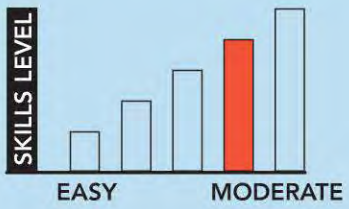
TOOLS & SUPPLIES YOU NEED

Vacuum cleaner

SKILLS YOU NEED

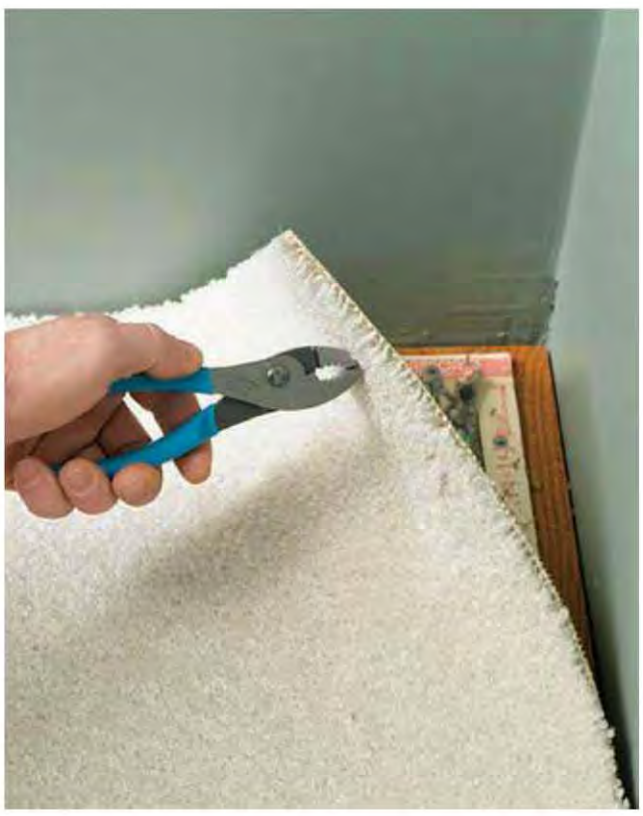
- Cutting
- Using a pry bar
- Pulling up staples

DIFFICULTY LEVEL

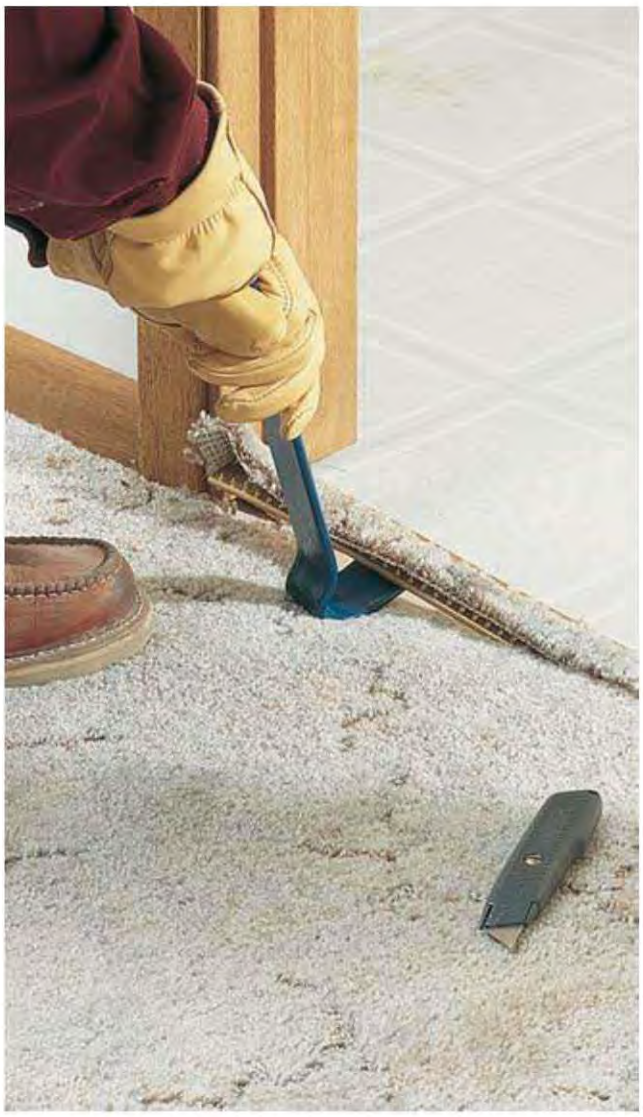


This project can be completed in a day.

1 Because you're about to be handling your old carpet for a few hours, vacuum the entire floor thoroughly.



3 Use pliers to grab carpet fibers along the edge of the room; then lift the carpet to release it from the tack strips. Continue to release the carpet from tack strips along the room perimeter .



2 Use a utility knife to cut around metal threshold strips. Use a flat pry bar to lift up the strips until they release from the floor. Dispose the strips in construction-grade garbage bags. You may be able to pull the carpet up without removing the baseboards.

WHAT IF . . . ?

If you do not find tackless strips, your carpet is secured with adhesive—either around the perimeter or everywhere. If it's just around the perimeter, pull back the carpet in a corner of the room until it is no longer bonded to the floor with adhesive. From that point, measure out away from the wall about 1 ft. past the glue and cut around the perimeter of the room, using a utility knife. For now, leave one wall side uncut. This side will hold the carpet in place when you begin to cut strips.

4 Use your utility knife to cut the carpet into strips. Once part of the first strip of carpet is lifted, lay a scrap 2 × 4 under the carpet and use that as a cutting base—this step is necessary only if you want to protect the floor underneath (for example, if you have wood floors). After the first strip is cut, set the board on top of the carpet and fold the carpet back over the board, cutting from the underside. You may be able to cut the carpet pad and carpet at the same time; if not, you can cut the carpet pad separately later. Cut the strips into sizes that are manageable to you.

6 Sweep up pieces of carpet padding and put them into a construction-grade garbage bag. If the pad was held down with staples, don't clean away the bits of pad still attached to the staples—the padding makes it easier to find and remove the staples.

5 Roll up the strips of carpet and secure them with duct tape. You may have to pull up on the strips with some effort if the carpet pad is stapled down. If you were not able to cut through the carpet pad, you will have to cut that into strips and roll the strips up once the carpet is removed. If you have perimeter-bonded carpet you must now remove the remaining perimeter piece glued to the floor.

7 To remove tack strips, slowly and patiently lift the strips up with a pry bar. Place a thin piece of hard material (like a piece of ⅛" wood veneer) under the pry bar to protect the floor. Tack strips are attached to the floor with small nails spaced approximately 6 to 8" apart. The pry bar is most effective when placed directly under these points. If it is difficult to insert the pry bar under the tack strip in places, use a hammer to tap the short bent end of the pry bar underneath the tack strip where it is attached by a nail; then pry back.

12 Sealing Concrete Floors

Although concrete is most common in garages and basements, it is not limited to these parts of the house. Along with stainless steel appliances, warehouse and loft construction, and industrial design, concrete floors are part of today's design trends, making concrete maintenance and repair increasingly relevant to today's homeowner.

CONCRETE IS A VERSATILE BUILDING MATERIAL. MOST PEOPLE ARE ACCUSTOMED to thinking of concrete primarily as a utilitarian substance, but it can also mimic a variety of flooring types and be a colorful and beautiful addition to any room.

Whether your concrete floor is a practical surface for the garage or an artistic statement of personal style in your dining room, it should be sealed. Concrete is a hard and durable building material, but it is also porous. Consequently, concrete floors are susceptible to staining. Many stains can be removed with the proper cleaner, but sealing and painting prevents oil, grease, and other stains from penetrating the surface in the first place; thus, cleanup is a whole lot easier.

CONCRETE SEALING 101

Even after degreasing a concrete floor, residual grease or oils can create serious adhesion problems for coatings of sealant or paint. To check to see whether your floor has been adequately cleaned, pour a glass of water on the concrete floor. If it is ready for sealing, the water will soak into the surface quickly and evenly. If the water beads, you may have to clean it again. Detergent used in combination with a steam cleaner can remove stubborn stains better than a cleaner alone.

There are four important reasons to seal your concrete floor:

- To protect the floor from dirt, oil, grease, chemicals, and stains
- To dust-proof the surface
- To protect the floor from abrasion and sunlight exposure
- To repel water and protect the floor from freeze-thaw damage

TERMS YOU NEED TO KNOW

CONCRETE—A mixture of portland cement, water, and mineral aggregate (usually sand and gravel). Sometimes fly ash, pozzolans, or other additives are included in the mix.

ACID ETCHING—This is a technique in which acid is used to open the pores in concrete surfaces so a sealer can bond to it.

TOOLS & SUPPLIES YOU NEED

SKILLS YOU NEED

- Cleaning
- Sweeping
- Painting floors
- Vacuuming
- Working with strong acids

DIFFICULTY LEVEL

This project can be completed in a weekend.

1 Clean and prepare the surface by first sweeping up all debris. Next, remove all surface muck: mud, wax, and grease. Finally, remove existing paints or coatings. See the chapter on cleaning concrete for tips on using cleaners specially designed for concrete floors.

2 Saturate the surface with clean water. The surface needs to be wet before acid etching. Use this opportunity to check for any areas where water beads up. If water beads on the surface, contaminants still need to be cleaned off with a suitable cleaner or chemical stripper.

HERE'S HOW

Prepare the concrete for sealer application by acid etching. Etching opens the pores in concrete surfaces, allowing sealers to bond with it. All smooth or dense concrete surfaces, such as garage floors, should be etched before applying stain. The surface should feel gritty, like 120-grit sandpaper, and allow water to penetrate it. If you're not sure whether your floor needs to be etched or not, it's better to etch. If you don't etch when it is needed, you have to remove the sealer residue before trying again. This easily becomes a time-consuming process that is best to avoid from the get-go.

THERE IS A VARIETY OF ACID ETCHING PRODUCTS AVAILABLE:

CITRIC ACID **is a biodegradable acid that does not produce chlorine fumes. It is the safest etcher and the easiest to use, but it may not be strong enough for some very smooth concretes.**

SULFAMIC ACID **is less aggressive than phosphoric acid or muriatic acid, and it is perhaps the best compromise between strength of solution and safety.**

PHOSPHORIC ACID **is a stronger and more noxious acid than the previous two, but it is considerably less dangerous than muriatic acid. It is currently the most popular etching choice.**

MURIATIC ACID **(Hydrochloric Acid) is an extremely dangerous acid that quickly reacts and creates very strong fumes. This is an etching solution of last resort. It should only be used by professionals or by the most serious DIYers.**

NOTE: **Never add water to acid—only add acid to water.**

3 Test your acid-tolerant pump sprayer with water to make sure it releases a wide, even mist. Once you have the spray nozzle set, check the manufacturer's instructions for the etching solution and fill the pump sprayer with the recommended amount of water.

5 Apply the acid solution. Using the sprinkling can or acid-tolerant pump spray unit, evenly apply the diluted acid solution over the concrete floor. Do not allow acid solution to dry at any time during the etching and cleaning process. Etch small areas at a time, 10 × 10 ft. or smaller. If there is a slope, begin on the low side of the slope and work upward.

4 Add the acid etching contents to the water in the acid-tolerant pump sprayer (or sprinkling can). Follow the directions (and mixing proportions) specified by the manufacturer. Use caution.

SAFETY FIRST

All of these acids are dangerous. Use caution.

With any of these acid etches it is critical that there be adequate ventilation and that you wear protective clothing including:

- **Safety goggles**
- **Respirator**
- **Rubber gloves**
- **Rubber boots**
- **Long pants and a long-sleeve shirt (to prevent acid contact with the skin)**

6 Use a stiff bristle broom or scrubber to work the acid solution into the concrete. Let the acid sit for 5–10 minutes, or as indicated by the manufacturer's directions. A mild foaming action indicates that the product is working. If no bubbling or fizzing occurs, it means there is still grease, oil, or a concrete treatment on the surface that is interfering with the etching product.

WHAT IF . . . ?

If no fizzing occurs when the acid solution is put on the concrete, stop the process and clean the surface. Use a nylon bristle scrub brush to scrub the area with hot liquid dish soap and water, laundry soap and water, or a biodegradable degreasing cleaner. You can also try using a pressure washer. If degreasing doesn't solve the problem, the concrete may already be sealed with a concrete sealer. A surface sealer can only be removed mechanically by abrasive blasting; penetrant sealers may not be removable at all.

7 Once the fizzing has stopped, the acid has finished reacting with the alkaline concrete surface and formed pH-neutral salts. Neutralize any remaining acid with an alkaline-base solution. Put a gallon of water in a 5-gallon bucket and then stir in an alkaline-base neutralizer. Using a stiff bristle broom, make sure the concrete surface is completely covered with the solution. Continue to sweep until the fizzing stops.

8 Use a garden hose with a pressure nozzle or, ideally, a pressure washer in conjunction with a stiff bristle broom to thoroughly rinse the concrete surface. Rinse the surface 2 to 3 times. Reapply the acid (repeat Steps 5, 6, 7, and 8).

9 If you have any leftover acid you can make it safe for your septic system by mixing more alkaline solution in the 5-gallon bucket and carefully pouring the acid from the spray unit into the bucket until all of the fizzing stops.

11 To check for residue, rub a dark cloth over a small area of concrete. If any white residue appears, continue the rinsing process. Check for residue again. You may be sick of the cleanup by now, but an inadequate acid rinse is even worse than not acid etching at all when it's time to add the sealant.

10 Use a wet-vacuum to clean up the mess. Some sitting acids and cleaning solutions can harm local vegetation, damage your drainage system, and are just plain environmentally unfriendly. Check your local disposal regulations for proper disposal of the neutralized spent acid.

TOOL TIP

Mix one of these alkaline products with a gallon of water for a suitable acid-neutralizing solution:

- **One cup of ammonia**
  OR
- **Four cups of gardener's lime**
  OR
- **A generous amount of baking soda**
  OR
- **4 oz. of "Simple Green" cleaning solution**

12 Let the concrete dry for at least 24 hours and sweep up dust, dirt, and particles leftover from the acid etching process. Your concrete should now have the consistency of 120-grit sandpaper and be able to accept concrete sealants.

TOOL TIP

THERE ARE BASICALLY TWO CATEGORIES OF SEALERS:

FILM FORMERS create a barrier on the concrete's surface, blocking penetration of water and contaminants and providing a gloss or sheen. Film formers do not allow the concrete to breathe; they may trap moisture beneath the concrete surface. In cold areas this results in cracks due to the moisture freezing and expanding.

PENETRANTS increase water repellency and stain resistance by actually penetrating into the concrete surface to a depth of about 1 to 4 mils, providing an invisible protection without changing the surface appearance.

13 Once etched, clean, and dry, your concrete is ready for clear sealer or liquid repellent. Mix the sealer in a bucket with a stir stick. Lay painter's tape down for a testing patch. Apply sealer to this area and allow to dry to ensure desired appearance. Concrete sealers tend to make the surface slick when wet. Add an anti-skid additive to aid with traction, especially on stairs.

WHAT IF . . . ?

The most common sealing practice is to use clear sealant but there are also stained sealants and paints.

If you decide to paint instead of applying a clear or stained sealant, be sure to use paint designed for concrete floors. Also, once the paint has dried for a few days, apply two or three coats of water-based polyurethane.

14 Use wide painter's tape to protect walls and then, using a good quality 4"-wide synthetic bristle paintbrush, coat the perimeter with sealer.

16 Apply a second coat in the opposite direction to the first coat, so if the first coat was north to south, the second coat should be east to west.

15 Use a long-handled paint roller with at least ½" nap to apply an even coat to the rest of the surface. Do small sections at a time (about 2' × 3'). Work in one orientation (e.g., north and south). Avoid lap marks by always maintaining a wet edge. Do not work the area once the coating has partially dried; this could cause it to lift from the surface. Allow surface to dry according to the manufacturer's instructions, usually 8 to 12 hours, minimum.

17 Clean tools, wet/dry vac and spray equipment with clean, warm water or mineral spirits.

13 Refinishing Hardwood Floors

Reviving your hardwood floors is definitely worth the hard work. By refinishing a tired-looking floor you suddenly realize why hardwood floors are so durable and long-lasting: They clean up beautifully.

MAKING WORN AND DULL HARDWOOD FLOORS LOOK NEW AGAIN DRAMATICALLY IMPROVES THE APPEARANCE OF A HOME. And the fact that very old hardwood floors can be completely restored to showroom condition is one of their real advantages over other types of flooring. Refinishing floors is time-consuming, messy, and disruptive to your household routine. Depending on the size of the room, be prepared to devote a weekend, minimally, to this project.

If you don't want to do the entire job yourself, you can still save money by doing some prep work yourself. Professionals often add on additional fees for removing and replacing shoe molding, nailing or gluing down loose boards, filling gouges and dents with wood putty, setting protruding nails, putting up plastic, cleaning the floor, and even moving furniture.

NOTE: If your floors are less than ½" thick, they are probably unsuitable for refinishing.

REFINISHING 101

Refinishing a floor requires some heavy machinery, namely drum and edge sanders that may be rented from home stores or floor rental establishments. You can purchase sandpaper at the time of the rental.

TYPES OF FINISHES

SURFACE FINISH—A floor finish applied to the wood surface, providing a harder and more durable coating than a sealer with a wax covering (for example, polyurethane (oil- or water-based) varnish, shellac, and lacquer).

PENETRANT FINISH—Penetrant floor finishes seep into the wood pores and become an integral part of the wood (for example, stains or sealers).

STAINS—Penetrants that alter the natural color of the wood. They can be used with a surface finish or protected with a sealer and wax.

SEALERS—Either clear or tinted penetrants that need to be protected with a wax or surface finish.

WAX—Wood floors not protected with a surface finish need to be covered with a coat of liquid, non-waterbased wax. Wax is not as durable as surface finish; periodically, it must be reapplied. The advantage is that patched areas easily blend in.

TERMS YOU NEED TO KNOW

REFINISHING FLOORS—Aggressively sanding floors to entirely remove previous finish and to level the floor before reapplying new floor finish.

FEATHER SAND—Sanding with lighter and lighter strokes as you move away from a more heavily sanded area. This creates a smooth transition between sanded and non-sanded areas.

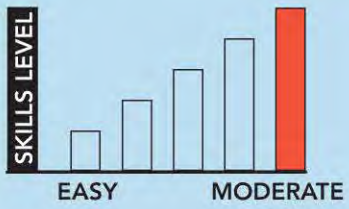
ZIP DOOR—A plastic sheet with a long vertical zipper. It's taped over entryways for a convenient way to enter and exit rooms for the duration of a project.

TOOLS & SUPPLIES YOU NEED

SKILLS YOU NEED

- Operating power sanders
- Using a large stapler
- Scraping floor with paint scraper
- Applying polyurethane finish with a pad and brush
- Hammering

DIFFICULTY LEVEL



This project can be completed in a weekend (not including drying time between finish coats).

1 Staple plastic on all doorways. Place a zip door over the entryway you plan to use for the duration of the project.

2 Use painter's tape and plastic to cover heating and cooling registers, ceiling fans, and light fixtures.

3 Finally, place a fan in a nearby window to blow the circulating dust outside.

SAFETY FIRST

Even with proper ventilation, inhaling sawdust is a health risk. We recommend getting a respirator. If you don't use one, you must at least wear a dust mask. Eye protection is also a must; and you'll thank yourself for buying a good pair of strong work gloves—they make the sander vibrations a little more bearable.

Important! Always unplug the sander whenever loading or unloading sandpaper.

SHOPPING TIP: SANDPAPER

Grits	Grade	Use
20, 30, 40, 60	Coarse	To level uneven boards.
100, 120	Medium	To minimize scratches from coarse grits.
150, 180	Fine	To eliminate scratches from medium grits.

Sandpaper becomes less effective over time; it may even rip. Buy 3–5 sheets of every grade for each room you want to refinish. You won't use them all, but most rentals allow you to return what you don't use. It's far better to have too many than to find yourself unable to continue until the next day because you ran out and the hardware store is closed.

Reminder: Before you leave the rental shop, have an employee explain to you how to load the paper. Every machine is a little different.

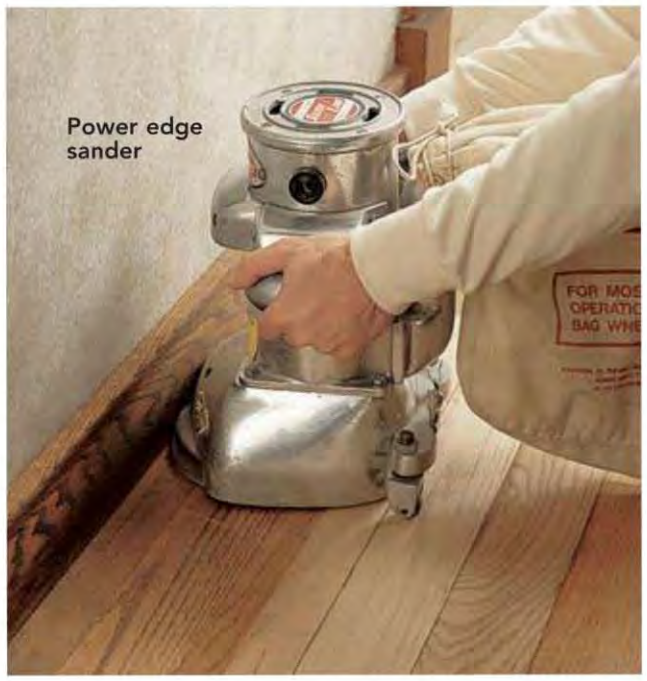
4 Wedge a pry bar between the shoe molding and baseboards. Move along the wall as nails loosen. Once removed, place a scrap 2 × 4 board against the wall and, with a pry bar, pry out baseboard at nails (inset). Maintain the gap with wood shims. Number the sections for easy replacement. Place wide masking tape along the baseboards. Drive protruding nails in floor ⅛" below the surface with a nail set.

5 Practice with the drum sander turned off. Move forward and backward. Tilt or raise it off the floor a couple of times. A drum sander is heavy, bulky, and awkward. Once it touches the floor, it walks forward; if you stop it, it gouges the floor.

6 For the initial pass with the drum sander, sand with the grain, using 40- or 60-grit paper; if there are large scratches, use 20 or 30. Start two-thirds down the room length on the right side; work your way to the left. Raise drum. Start motor. Slowly lower drum to floor. Lift the sander off the floor when you reach the wall. Move to the left 2 to 4" and then walk it backwards the same distance you just walked forward. Repeat.

7 When you get to the far left side of the room, turn the machine around and repeat the process. Overlap the sanded two-thirds to feather out the ridgeline.

Repeat the sanding process 3 or 4 more times using 120-grit sandpaper. Sand the entire floor. For the final passes, use finer sandpaper (150- to 180-grit) to remove scratches left by coarser papers.



8 To sand hard-to-reach spots, first use a power edge sander along the walls, using the same grit that you last used with the drum sander. Make a succession of overlapping half-circles starting in the corner on one wall. Pull out in an arc and then swirl back to the wall. Continue around the room. Blend together any lines left by the drum and edge sanders by running a rotary buffer over the floor twice: first with an 80-grit screen and then with a 100-grit screen. Finally, use a 5" random orbital sander to smooth out the floor. The random motion naturally feathers out bumps.

HERE'S HOW

During the refinishing process it is very likely you will have to change the sandpaper and empty the contents of the dust bag. You should empty the contents of the dust bag when it is two-thirds full. When the machine is turned off, you can see how full the bag is. To check the wear of the sandpaper, turn off your machine every so often and tilt back the machine to check the paper on the underside. If it appears to be thinning, you want to change it.

Correctly replacing the sandpaper can be tricky. A rental professional should be able to walk you through the steps to change the paper and the dust bag, so be sure to consult with him or her before you leave the store.

9 Use a paint scraper to get to corners and hard-to-reach nooks and crannies. Pull the scraper toward you with a steady downward pressure. Pull with the grain. Next, sand with a sanding block.

10 Prepare the room for finish by sweeping and vacuuming. Remove plastic on the doors, windows, and fixtures. Sweep and vacuum again. Wipe up fine particles with a tack cloth.

11 Apply polyurethane finish. Mix equal parts water-based polyurethane and water. Use a natural bristle brush to apply the mixture along walls and around obstacles. To apply the mixture in the middle of the room, use a painting pad on a pole. Apply 2 coats diagonally across the grain and a final coat in the direction of the grain.

13 Apply at least two coats of undiluted polyurethane finish to get a hard, durable finish. Allow the finish to dry; repeat Step 12 and then add a final coat. Do not overbrush.

12 Allow the finish to dry after each coat. Lightly buff the floor with a fine to medium abrasive pad (or buffing pad). Clean the floor with a damp cloth and wipe the area dry with a towel.

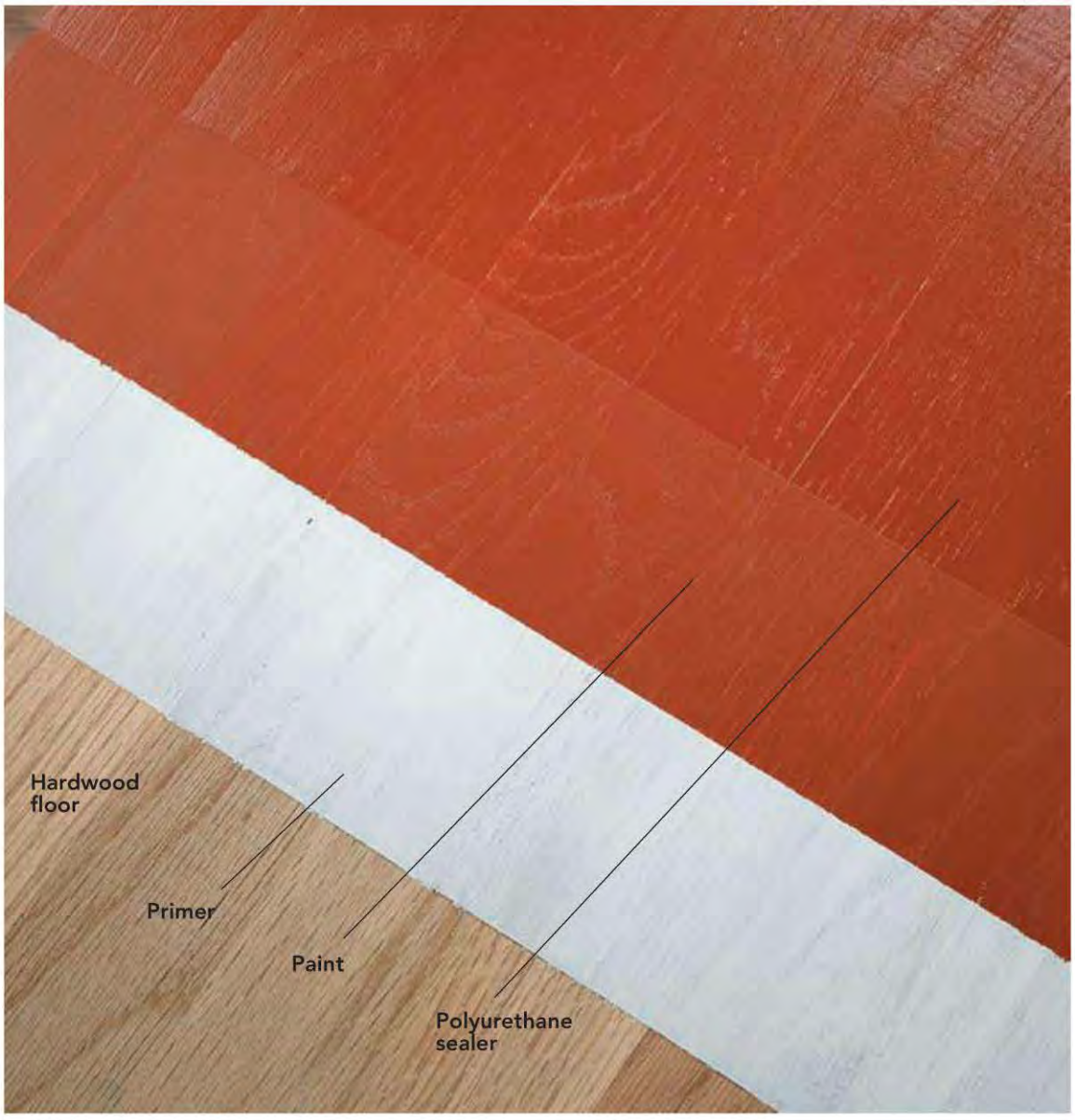
14 After the final coat is dry, buff the surface with water and a fine abrasive pad. This removes surface imperfections and diminishes gloss. After finishing, wait at least 72 hours before replacing the shoe molding. Your newly refinished floor is now complete!

14 Painting Wood Floors

Just when it appears as though you've hit a wall in reviving your tired, wornout wood floor, try a coat of paint to bring back its brilliance. You'll be pleasantly surprised with the paint's ability to not only disguise flaws but its ability to add warmth and character to the room.

PAINT IS A QUICK, COST-EFFECTIVE WAY TO COVER UP WOOD FLOORS THAT may need work, but a floor doesn't have to be distressed or damaged to benefit from painting. Floors in perfect condition in both formal and informal spaces can be decorated with paint to add color and personality. For example, one could unify a space by extending a painted floor through a hallway to a staircase. And stencil designs or faux finishes can make an oversized room feel cozy and inviting. There are even techniques for disguising worn spots. One such disguising method also happens to create a fun, yet classical design: the checkerboard pattern allows homeowners to hide worn boards under a darker color while still maintaining a unique floor.

FLOOR PAINTING 101



To paint a wood floor you must apply primer first; then you apply the paint and you follow that with a polyurethane sealer. Make sure the products you choose are specifically for floors.

TERMS YOU NEED TO KNOW

LACQUER THINNER—A strong, highly flammable solvent such as ethyl alcohol, ethyl acetate and toluene that is used to dilute, dissolve and clean up lacquer based paints, ink and adhesive residue.

PRIMER—A specially-formulated paint that is used to seal raw surfaces and to provide a base coat of paint that succeeding finish coats can better adhere to.

WATER-BASED POLYURETHANE—A clear finish used for coating natural or stained wood that provides a durable, glossy surface that is highly resistant to water, is just as durable as oil-based polyurethane, is easier to clean-up, and does not produce a yellowing discoloration.

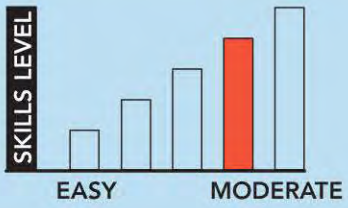
SEALER—A finish coating, either clear or pigmented, that is applied on top of the paint.

TOOLS & SUPPLIES YOU'LL NEED

SKILLS YOU NEED

- Cleaning and sanding
- Using a hammer and nail set
- Using a paintbrush and roller

DIFFICULTY LEVEL



This project can be completed in a day (not including drying time), depending upon how much prep work is needed and how large the room is.

HOW TO PAINT WOOD FLOORS

1 Prepare the painting area by first moving furniture. Lift pieces instead of dragging them to prevent gouges. Sweep or vacuum.

2 Use a paint scraper to smooth rough spots. Use a pole sander to sand with the grain of the wood. For coarse wood, use medium-grit sandpaper. Scuff glossy hardwoods with fine sandpaper (#120) for good adhesion.

3 When finished sanding, sweep or vacuum. Use a damp cloth to remove fine dust. Use a cloth dampened with lacquer thinner for a final cleaning. If you see any nails sticking up, tap them down with a hammer and nail set.

4 Protect the baseboards with wide painter's tape. Press the tape edges down so paint doesn't seep underneath.

5 Mix primer well. Use a 4"-wide brush to apply the primer around the perimeter of the room. Then paint the remaining floor with a roller on an extension pole. Allow the primer to dry.

6 To mix paint, pour half of the paint into another can, stirring the paint in both containers with a wooden stir stick before recombining them. As you stir, you want a smooth consistency.

7 Paint. Use a 4" brush to apply a semi-gloss paint around the border. To paint the rest of the floor, use a roller on an extension pole. Always roll from a dry area to a wet area to minimize lap lines. Allow paint to dry. Apply second coat of paint. Allow to dry.

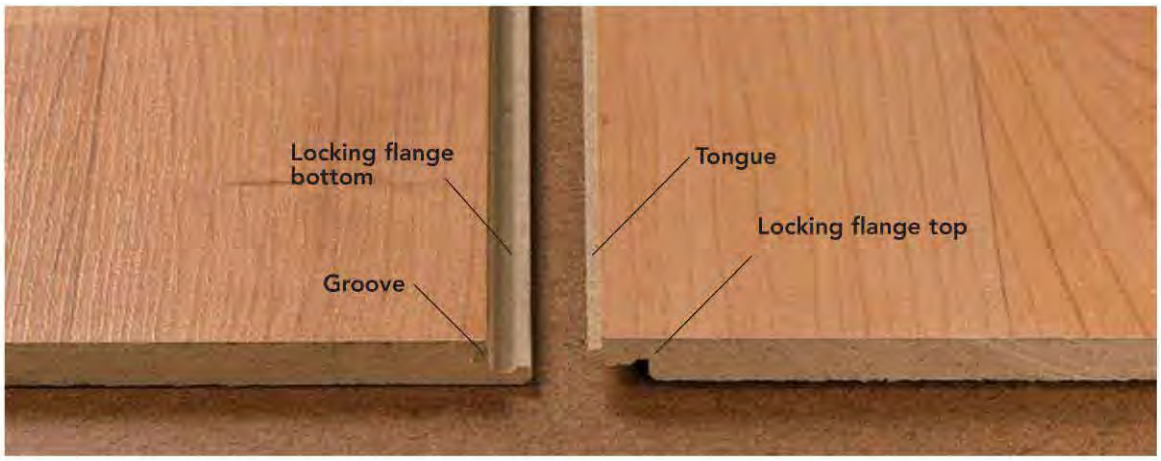
8 Apply 2 or 3 coats of a matte-finish, water-based polyurethane sealer, using a painting pad on a pole. Allow the sealer to dry. Sand with a pole sander, using fine sandpaper. Clean up dust with a tack cloth.

15 Installing Laminate Flooring

The rich wood tones of beautiful laminate planks may cause you to imagine hours of long, hard installation work, but this is a DIY project that you can do in a single weekend. Buy the manufactured planks at a home-improvement or flooring store and install laminate flooring with the step-by-step instructions offered in the following pages.

LAMINATE FLOORING COMES IN A FLOATING SYSTEM THAT IS SIMPLE TO INSTALL, even if you have no experience with other home-improvement projects. You may install a floating laminate floor right on top of plywood, concrete slab, sheet vinyl, or hardwood flooring (follow the manufacturer's instructions). The pieces are available in planks or squares in a variety of different sizes, colors, and faux finishes—including wood and ceramic. Tongue-and-groove edges lock pieces together, and the entire floor floats on the underlayment. At the end of this project there are a few extra steps to take if your flooring manufacturer recommends using glue on the joints.

LAMINATE JOINTS 101



The joint design for laminate planks and squares is intended to make installation and replacement a breeze, while also providing a barrier from moisture and debris. Today, tongue-and-groove joints are often supplemented with positively locking flanges to provide a tight fit on both the top and bottom of the board. The tongue on one side fits into the groove of the adjacent board; then the the plank is "clicked" into place by pressing down on the plank to join the flanges. Planks without the snap-together ("click") feature sometimes require glue for an extra snug fit (read the manufacturer's instructions carefully and follow all recommendations).

TERMS YOU NEED TO KNOW

SUBFLOOR—The base layer of wood or plywood that supports the underlayment and surface flooring.

UNDERLAYMENT—The intermediate layer between the surface floor and the subfloor.

FLOATING FLOORS—Floors that are not fastened to the subfloor or underlayment, but rather "float" on top. The flooring is held together with a snap-together, interlocking system.

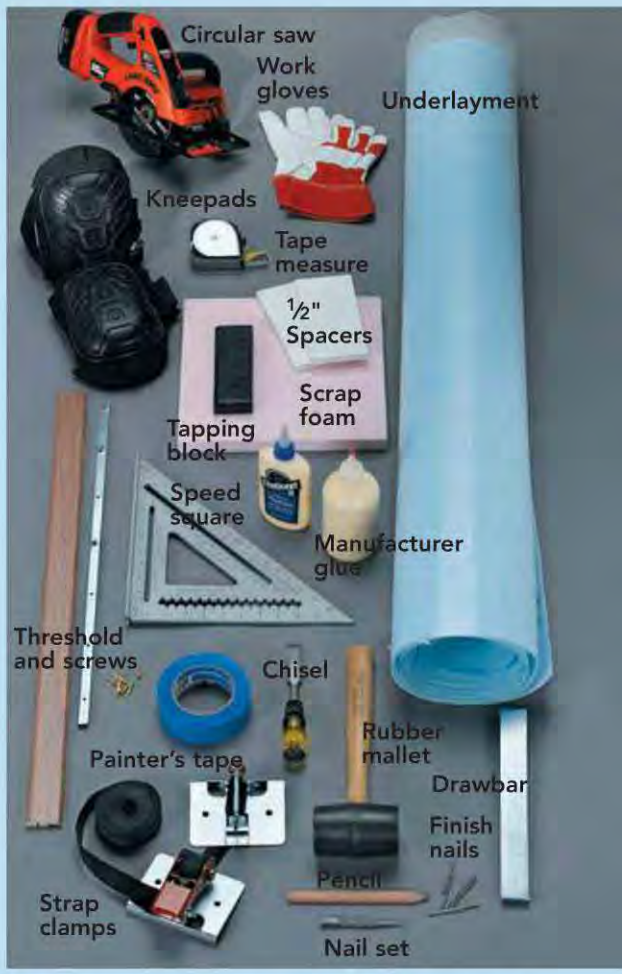
GLUELESS LAMINATE FLOORING (also called "click-floors")—Laminate flooring that does not require glue for installation, but instead relies upon tight tongue-and-groove joints. No-glue flooring is far easier to install and repair than glued laminate flooring, but it may not be as resistant to moisture—so avoid installing it in bathrooms or basements.

GLUED LAMINATE FLOORING—Laminate flooring that requires glue at each plank joint in order to effectively seal together the tongue-and-groove planks.

DRAWBAR—A metal bar used to pull together the final two planks in a row. There are two hooks—one to attach to the end of a plank close to the wall (where a rubber mallet would not fit to tap the final plank into the adjacent plank), and one on the other end to pull the plank in tight with the adjacent board.

STRAP CLAMPS—A device used to hold several planks together tightly while adhesive in between joints dries.

TOOLS & SUPPLIES YOU NEED



For shoe molding removal and replacement: pry bar, wood shims, chisel, hammer, nail set, finish nails.

For glued laminate flooring:
Wood block, rubber mallet, ½" spacers, strap clamps, damp cloth, plastic scraper.

SKILLS YOU NEED

- Measuring
- Using a drawbar
- Drilling
- Simple cuts with a circular saw
- Gluing
- Possibly ripcuts with a jigsaw

If removing base molding:

- Chiseling
- Hammering
- Countersinking nails

DIFFICULTY LEVEL

This project can be completed in a weekend.

HOW TO INSTALL LAMINATE FLOORING

HERE'S HOW

Laminate flooring, like hardwood, can shrink or expand when the temperature or humidity in a room changes. This movement can cause planks to buckle, so be sure to allow your new laminate flooring stock to acclimate to the conditions in your house. Simply keep the planks in the room where they will be used for a few days prior to installation.

2 To install the underlayment, start in one corner and unroll the underlayment to the opposite wall. Cut the underlayment to fit, using a utility knife or scissors. Overlap the second underlayment sheet according to the manufacturer's recommendations, and secure the pieces in place with adhesive tape.

1 Remove the shoe molding by wedging a pry bar between the shoe molding and baseboards and pry outward. Continue along the wall until the entire shoe is removed. Next, place a scrap board against the wall and use a pry bar to pull the baseboard away from the wall. Maintain the gap with wood shims. Number the sections for easy replacement. Drive protruding nails in floor ⅛" below the surface with a nail set.

3 Working from the left corner of the room to right, set wall spacers and dry lay planks (tongue side facing the wall) against the wall. The spacers allow for expansion. If you are flooring a room more than 26 ft. long or wide, you need to buy appropriate-sized expansion joints. Note: Some manufacturers suggest facing the groove side to the wall.

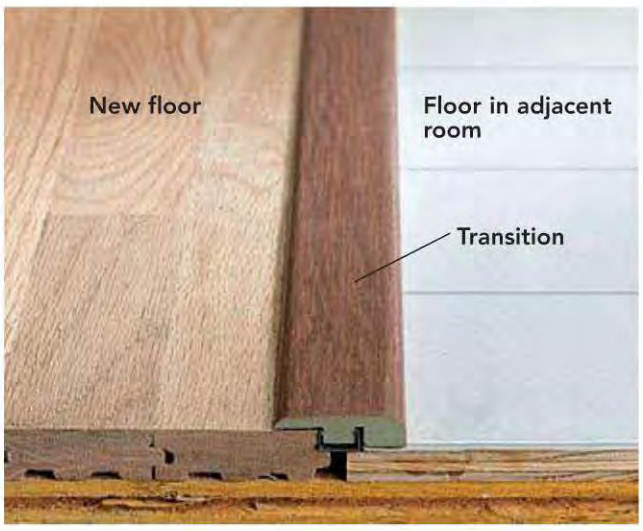
4 Set a new plank right side up, on top of the previously laid plank, flush with the spacer against the wall at the end run. Line up a speed square with the bottom plank edge and trace a line. That's the cutline for the final plank in the row.

6 Clamp the board (face down) and rigid foam insulation or plywood to a work table. The foam discourages chipping. Clamp a speed square on top of the plank, as though you are going to draw another line parallel to the cutline—use this to eye your straight cut. Place the circular saw's blade in front (waste side) of the actual cutline and cut.

5 Press painter's tape along the cutline on the top of the plank to prevent chips when cutting. Score the line drawn in Step 4 with a utility knife. Turn the plank over and extend the pencil line to the backside.

7 To create a tight fit for the last plank in the first row, place a spacer against the wall and wedge one end of a drawbar between it and the last plank. Tap the other end of the drawbar with a rubber mallet or hammer. Protect the laminate surface with a thin cloth.

8 Continue to lay rows of flooring, making sure the joints are staggered. Staggering joints prevents the entire floor from relying on just a few joints, thus preventing the planks from lifting. Staggering also stengthens the floor, because the joints are shorter and evenly distributed.



10 Install transition thresholds at room borders where the new floor joins another floor covering. These thresholds are used to tie together dissimilar floor coverings, such as laminate flooring and wood or carpet. They may also be necessary to span a distance in height between flooring in one room and the next.

9 To fit the final row, place two planks on top of the last course; slide the top plank up against the wall spacer. Use the top plank to draw a cutline lengthwise on the middle plank. Cut the middle plank to size using the same method as in Step 4 (only now you are "ripcutting" a lengthwise cut—see page 319 for instructions on ripcuts). The very last board must be cut lengthwise and widthwise to fit.

HERE'S HOW

To stagger joints, first check the manufacturer's instructions to determine what the minimum distance should be between the staggered joints. The range is usually between 8" and 18" (minimum). The first plank in the second row can sometimes be the waste piece from the cut you made at the end of the last run. But if you don't have a long enough scrap, the first plank in each row should alternate between being ⅓ and ⅔ the length of a full plank. This creates a pattern that is not only pleasing to the eye, but it ensures a solid installation.

HOW TO WORK AROUND OBSTACLES

1 Position a plank end against the spacers on the wall next to the obstacle. Use a pencil to make two marks along the length of the plank, indicating the points where the obstacle begins and ends.

3 Use a speed square to extend the four lines. The space at which they all intersect is the part of the plank that needs to be removed to make room for the obstacle to go through it. Use a drill with a Forstner bit, or a hole saw the same diameter as the space within the intersecting lines, and drill through the plank at the X. You'll be left with a hole; extend the cut to the edges with a jigsaw.

2 Once the plank is snapped into the previous row, position the plank end against the obstacle. Make two marks with a pencil, this time on the end of the plank to indicate where the obstacle falls along the width of the board.

4 Install the plank by locking the tongue-and-groove joints with the preceding board. Fit the end piece in behind the pipe or obstacle. Apply manufacturer-recommended glue to the cut edges, and press the end piece tightly against the adjacent plank. Wipe away excess glue with a damp cloth.

1 After dry-fitting each row, completely fill the groove of the plank with the manufacturer glue (or at least as instructed by the manufacturer).

2 Close the gaps between end joints and lengthwise joints, using a rubber mallet to gently tap a block (often supplied by the manufacturer) into the edge or end of the last plank. Use a drawbar for the last planks butted up to a wall. Wipe away excess glue in the joints with a damp cloth before it dries.

3 Rent 6 to 10 strap clamps to hold a few rows of planks together as adhesive dries (about an hour). Fit one end of the strap clamp over the plank nearest the wall, and the other end (the one with the ratchet lever) over the last plank. Use the ratchet to tighten straps until joints are snug.

WHAT IF . . . ?

If you need to cut a plank to fit snugly against another plank or a wall with an obstacle in the middle (such as a heat vent), measure in to the appropriate cutline to fit the board flush with the adjacent board or wall (on the other side of the obstacle). Draw a line across the plank in this location. Then measure the obstacle and transfer those measurements to the plank, using your pencil again. Mark a starter hole on the inside of the lines. Drill the hole just large enough to fit your jigsaw blade into it. Starting in the drilled hole, cut the plank along the drawn lines, using a jigsaw. Set the board in place by locking the tongue-and-groove joints with the preceding board.

HERE'S HOW

1 Ripcut planks from the back side to avoid splintering the top surface. For accurate straight cuts, mark the cut with a chalk line. If you have drawn a pencil line that is not straight, double check your tracing—it may be that your wall is not perfectly straight, and in this case you'd cut along your hand-drawn pencil line.

2 Place another piece of flooring next to the piece marked for cutting to provide a stable surface for the foot of the saw. Also, clamp a cutting guide to the planks at the correct distance from the cutting line to ensure a straight cut.

16 Installing Floor Tile

Tiles can be hand-picked to customize your floor. Picking out complementary colors within a single style is one way to make your floor unique. Not only is it fun to design your floor with tiles, but the installation requires only a single weekend.

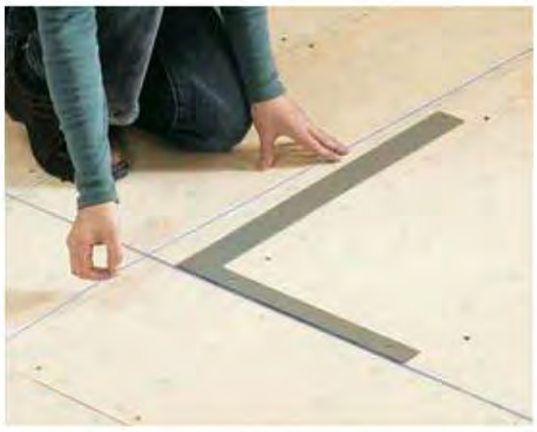
AS WITH ANY TILE INSTALLATION, RESILIENT TILE REQUIRES CAREFULLY POSITIONED LAYOUT lines. Before committing to any layout and applying tile, conduct a dry run to identify potential problems.

Keep in mind the difference between reference lines (see opposite page) and layout lines. Reference lines mark the center of the room and divide it into quadrants. If the tiles don't lay out symmetrically along these lines, you'll need to adjust them slightly, creating layout lines. Once layout lines are established, installing the tile is a fairly quick process. Be sure to keep joints between the tiles tight and lay the tiles square.

Tiles with an obvious grain pattern can be laid so the grain of each tile is oriented identically throughout the installation. You can also use the quarter-turn method, in which each tile has its pattern grain running perpendicular to that of adjacent tiles. Whichever method you choose, be sure to be consistent throughout the project.

REFERENCE LINES 101

1 Position a reference line (X) by measuring along opposite sides of the room and marking the center of each side. Snap a chalk line between these marks.



2 Measure and mark the centerpoint of the chalk line. From this point, use a framing square to establish a second reference line perpendicular to the first one. Snap the second line (Y) across the room.

3 Check the reference lines for squareness using the 3-4-5 triangle method. Measure along reference line X and make a mark 3 ft. from the centerpoint. Measure from the centerpoint along reference line Y and make a mark at 4 ft.

4 Measure the distance between the marks. If the reference lines are perpendicular, the distance will measure exactly 5 ft. If not, adjust the reference lines until they're exactly perpendicular to each other.

TERMS YOU NEED TO KNOW

SUBFLOOR—The base layer of wood or plywood that supports the underlayment and surface flooring.

UNDERLAYMENT—The intermediate layer between the surface flooring material and the subfloor.

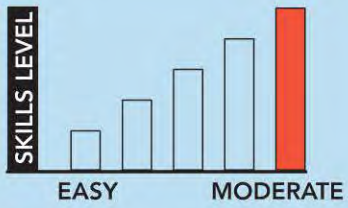
STICKY-BACK VINYL TILE—Resilient flooring available in 12" or 16" squares. Each vinyl tile has self-adhesive backing.

TOOLS & SUPPLIES YOU NEED

SKILLS YOU NEED

- Measuring
- Cutting
- Pushing a 75- or 100-pound floor roller
- Using a trowel
- Hammering

DIFFICULTY LEVEL



This project can be completed in a weekend.

HOW TO INSTALL DRY-BACKED RESILIENT TILE

1 Snap perpendicular reference lines with a chalk line. Dry-fit tiles along layout line Y so a joint falls along reference line X. If necessary, shift the layout to make the layout symmetrical or to reduce the number of tiles that need to be cut.

2 If you shift the tile layout, create a new line that is parallel to reference line X and runs through a tile joint near line X. The new line, X1, is the line you'll use when installing the tile. Use a different colored chalk to distinguish between lines.

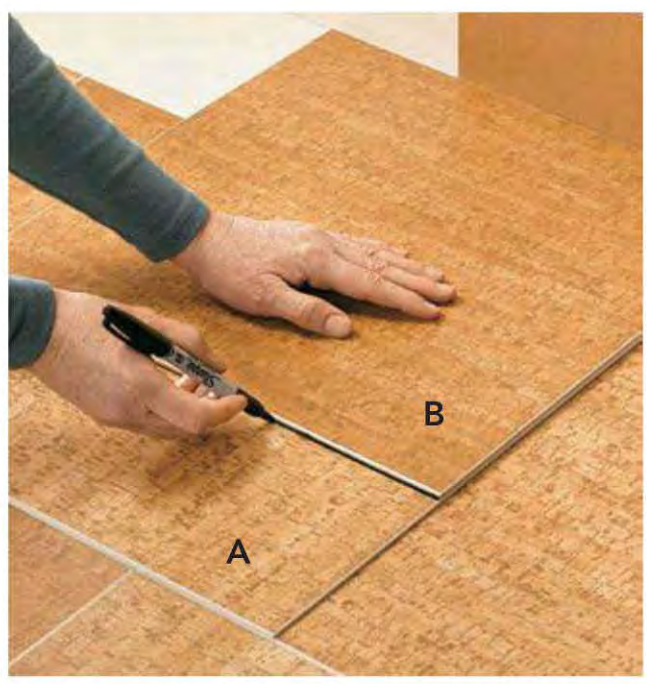
3 Dry-fit tiles along the new line, X1. If necessary, adjust the layout line as in steps 1 and 2.

4 If you adjusted the layout along X1, measure and make a new layout line, Y1, that's parallel to reference line Y and runs through a tile joint. Y1 will form the second layout line you'll use during installation.

5 Apply adhesive around the intersection of the layout lines using a trowel with 1/16" V-shaped notches. Hold the trowel at a 45° angle and spread adhesive evenly over the surface.

6 Spread adhesive over most of the installation area, covering three quadrants. Allow the adhesive to set according to the manufacturer's instructions, then begin to install the tile at the intersection of the layout lines. You can kneel on installed tiles to lay additional tiles.

7 When the first three quadrants are completely tiled, spread adhesive over the remaining quadrant, then finish setting the tile.



8 To cut tiles to fit along the walls, place the tile to be cut (A) face up on top of the last full tile you installed. Position a 1/8"-thick spacer against the wall, then set a marker tile (B) on top of the tile to be cut. Trace along the edge of the marker tile to draw a cutting line.

9 Cut tile to fit using a utility knife and straightedge. Hold the straightedge securely against the cutting line to ensure a straight cut. Option: You can use a ceramic-tile cutter to make straight cuts in thick vinyl tiles (see inset).

10 Install cut tiles next to the walls. If you're precutting all tiles before installing them, measure the distance between the wall and install tiles at various points in case the distance changes.

11 Continue installing tile in the remaining quadrants until the room is completely covered. Check the entire floor. If you find loose areas, press down on the tiles to bond them to the underlayment. Install metal threshold bars at room borders where the new floor joins another floor covering.

TOOL TIP

To mark tiles for cutting around outside corners, make a cardboard template to match the space, keeping a 1/8" gap along the walls. After cutting the template, check to make sure it fits. Place the template on a tile and trace its outline.

HOW TO INSTALL SELF-ADHESIVE RESILIENT TILE

1 Once your reference lines are established, peel off the paper backing and install the first tile in one of the corners formed by the intersecting layout lines. Lay three or more tiles along each layout line in the quadrant. Rub the entire surface of each tile to bond the adhesive to the floor underlayment.

2 Begin installing tiles in the interior area of the quadrant. Keep the joints tight between tiles. Use a floor roller to set tile and prevent bubbles.

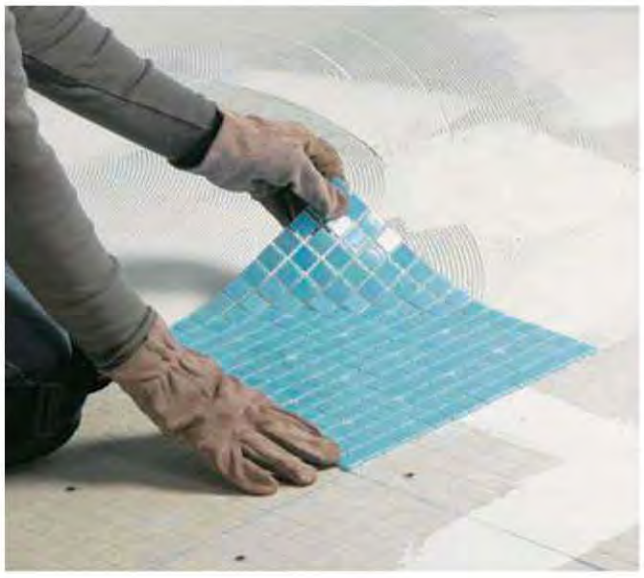
3 Finish setting full tiles in the first quadrant, then set the full tiles in an adjacent quadrant. Set the tiles along the layout lines first, then fill in the interior tiles.

4 Continue installing the tile in the remaining quadrants until the room is completely covered. Check the entire floor. If you find loose areas, press down on the tiles to bond them to the underlayment. Install metal threshold bars at room border where the new floor joins another floor covering.

HOW TO INSTALL A GLASS MOSAIC FLOOR

1 Beginning at the intersection of the horizontal and vertical lines, apply the recommended adhesive in one quadrant. Spread it outward evenly with a notched trowel. Lay down only as much adhesive as you can cover in 10 to 15 minutes.

2 Stabilize a sheet of tile by randomly inserting plastic spacers into the open joints.



3 Pick up diagonally opposite corners of the square and move it to the intersection of the horizontal and vertical references lines. Align the sides with the reference lines and gently press one corner into place on the adhesive. Slowly lower the opposite corner, making sure the sides remain square with the reference lines. Massage the sheet into the adhesive, being careful not to press too hard or twist the sheet out of position. Continue setting tile, filling in one square area after another.

4 When two or three sheets are in place, lay a scrap of 2 × 4 wrapped in carpet across them and tap it with a rubber mallet to set the fabric mesh into the adhesive and force out any trapped air.

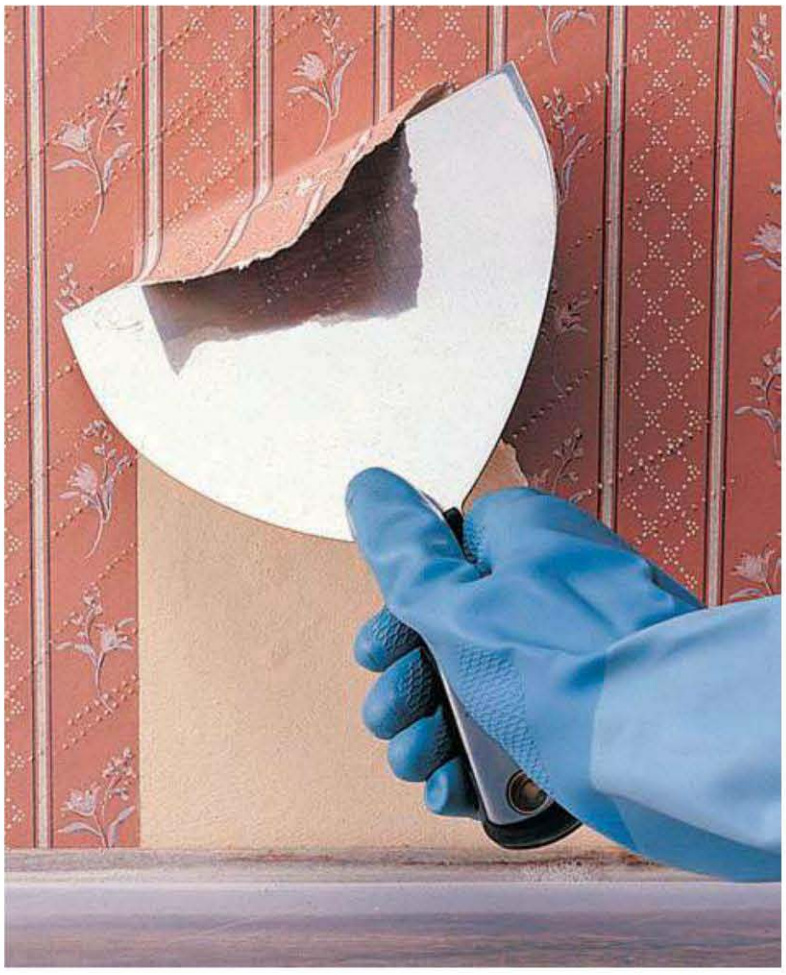
5 When you've tiled up close to the wall or another boundary, lay a full mosaic sheet into position and mark it for trimming. Use a glass cutter to score along the cut line.

6 After you've scored the tiles, cut them each individually with a pair of tile nippers.

7 Set tile in the remaining quadrants. Let the adhesive cure according to the manufacturer's instructions. Remove spacers with a needlenose pliers. Mix a batch of grout and fill the joints (see page 276). Allow the grout to dry, according to manufacturer's instructions.

8 Mosaic tile has a much higher ratio of grout to tile than larger tiles do, so it is especially important to seal the grout with a quality sealer after it has cured. Follow the manufacturer's instructions.

BLACK & DECKER
BULLS-EYE



WET PAINT
PAINTING

Painting & Decorating

YOU'VE SEEN THE HOME MAKEOVER SHOWS ON TV; YOU'VE ADMIRED YOUR FRIENDS' PROJECTS; YOU'VE READ ON-LINE ARTICLES ABOUT HOW EASY THIS ALL IS. AND YET, YOU'RE STILL JUST A LITTLE UNSURE ABOUT THIS IDEA OF TACKLING A DECORATING PROJECT.

Relax. You've come to exactly the right place. This book was written with you in mind—a new homeowner or, perhaps, someone who's just new to decorating. Even if you are seasoned with decorating experience, you will find valuable tips and professional procedures to incorporate into your next project. The information you need is all right here.

IN THIS CHAPTER:

- ❑ Before You Begin
  - Painting Tools
  - Decorating Tools
  - Prep Materials
  - Choosing Paint
- ❑ Hanging Pictures & Mirrors
- ❑ Replacing Towel Bars
- ❑ Hanging Curtains
- ❑ Installing Window Blinds & Shades
- ❑ Anchoring Bookcases
- ❑ Draping & Taping
- ❑ Painting Walls
- ❑ Preparing Unfinished Wood for Paint
- ❑ Painting Millwork & Trim
- ❑ Painting Wood Cabinets
- ❑ Painting Concrete Block Walls
- ❑ Stripping Wallcoverings
- ❑ Hanging Wallcoverings

Before You Begin: Painting Tools

These are the tools you'll need for your painting toolbox. All these tools are available at almost every home improvement center, paint store, and hardware store.

WHEN IT COMES TO PAINTING TOOLS, SOME PEOPLE PREFER DISPOSABLE TOOLS WHILE OTHERS value traditional versions. The differences between the two are cost and quality.

•PAINTBRUSHES: All-purpose brushes are made from a blend of polyester and nylon. Brushes blended with hog or ox bristles should only be used with oil-based paints. Your kit should include a 3" straightedged wall brush, 2" straightedged trim brush, and tapered sash brush. A good-quality brush has a shaped handle, non-corrosive metal ferrule, and several spacer plugs between bristles. Split ("flagged") and tapered ("chiseled") bristle ends make clean edges.

•ROLLER TRAYS: Sturdy trays are a must. Disposable pan liners minimize cleanup, but they are not substitutes for roller trays.

•STANDARD ROLLER FRAMES: Choose a well-balanced frame with nylon bearings and a comfortable handle. Extensions are available for painting ceilings.

•STANDARD ROLLER COVERS: Most jobs can be done with ⅜" synthetic rollers. Special corner roller covers allow you to paint corners without cutting in the edges. Good-quality roller covers create an attractive finish without leaving fibers in the paint.

•SPECIAL CONTAINERS: Large and small containers simplify large projects. For large projects, some paint manufacturers sell their paint in 5-gallon containers, so you can paint straight from the container. If the paint you choose doesn't come in a container like this, you may want to buy one. For cutting-in and touch-ups, small, easy-to-hold containers are a good idea.

•PAINT-MIXING BIT AND DRILL: Stirring paint is extremely important. The best way to stir large amounts of paint is with a drill and special paint-mixing bit. These bits are easy to use and clean up quickly.

•LEAD TEST KIT: If your home was built before 1978, it's critical that you test paint before cleaning, sanding, or repainting it. Easy-to-use lead test kits are available at home centers, hardware stores, and paint retailers everywhere. If the test indicates the presence of lead, consult a lead abatement specialist before starting any project.

Once you get to the chapters, you'll notice there may be a red toolbox in the Materials List. If you see that, it means you'll need your toolbox with all of the above tools in it for that particular project. There may be additional tools needed that are specific to the project at hand, but having this toolbox organized and at-hand will save a lot of time.

Before You Begin: Decorating Tools

These are the tools you'll need for your decorating toolbox. All these tools are available at almost every home improvement center, paint store, and hardware store.

•CARPENTER'S OR LASER LEVEL: A carpenter's level contains two or more bubble gauges used to check the level of work surfaces. A laser level creates level, square lines on any surface.

•HAMMER: Designed for driving, setting, and pulling nails, hammers are essential. A 16-ounce, curved claw hammer with a high-carbon steel head and a handle made of hickory, fiberglass, or solid steel is a practical choice for typical home repairs.

•DRILL: Variable-speed reversing drills are handy for driving and removing screws, nuts, and bolts, as well as for drilling holes and stirring paint. For most decorating projects, a medium-voltage cordless drill is a good choice. Look for features such as a keyless chuck, adjustable clutch, and electronic level.

•CORDLESS SCREWDRIVER: For small projects, cordless power screwdrivers are a great alternative to standard screwdrivers. These tools come with a universal ¼" drive as well as a slotted bit and a #2 Phillips bit. Other bits, such as Torx and square drive, are also available.

•POWER SANDERS: Sanders smooth surfaces to be painted or decorated.

•SCREWDRIVERS: Standard screwdrivers—both slotted and Phillips—are essential. Choose quality screwdrivers with hardened-steel blades and easy-to-grip handles. Insulated handles protect you from electric shock, and oxide-coated tips provide a strong hold on screw heads.

•TAPE MEASURES: A high-quality, retractable steel tape measure will last for decades. Choose a tape that has a locking mechanism and a belt clip. Make sure the tape you choose has a standout of at least 7 ft.

•STUD FINDER: A stud finder has an indicator that lights up when it passes over a stud.

•AWL: An awl is a tool that has a metal shaft with a sharpened end. It is used to poke holes in drywall and other surfaces when drilling a pilot hole isn't necessary.

•NAIL SET: This is a metal shaft with a rounded end that is used to drive finish nails below a work surface.

•DRYWALL KNIVES ("PUTTY" KNIVES): These knives have thin, somewhat flexible blades attached to sturdy handles. They are used to spread spackle and drywall compound and can also be used to scrape away debris before cleaning walls or filling holes.

•RAZOR KNIFE: A razor knife is a sharp, retractable, disposable blade in a sturdy handle.

If you see a yellow toolbox in a materials list, it means that some or all of the above tools are needed to get that particular job done.

Before You Begin: Prep Materials

If you want a decorating project to turn out well, you simply have to do the necessary preparation work. With the help of the tools and materials available today, preparation stages go smoothly and easily.

A) HOLE-PATCHING KITS: Sturdy, self-adhesive mesh and backing materials used to repair large holes in walls.

B) SELF-ADHESIVE SEAM TAPE: Used to smooth drywall compound over joints and cracks.

C) SPACKLE: A quick-drying drywall compound. Some types of spackle are pink when wet and turn white as they dry, which makes it easy to tell when the patch is ready to be sanded.

D) WOOD FILLER: Compound used to fill holes in wood. It can be sanded and painted or stained.

E) SPONGES: Used to smooth damp joint compound, which reduces the amount of sanding needed later.

F) TRISODIUM PHOSPHATE: Cleaning agent used for washing walls before painting or hanging wallpaper.

G) SAFETY EQUIPMENT: Rubber gloves, safety glasses, and dust masks or respirators; these are necessary when using strong or caustic chemicals.

H) PREPARATION LIQUIDS: A latex-bonding agent makes plaster repairs more durable; liquid deglosser dulls glossy surfaces so paint can adhere properly.

I) WALLPAPER STRIPPER: A chemical agent that loosens wallpaper adhesive so it can be removed easily.

J) PRESSURE SPRAYER: Used to apply wallpaper stripper over large areas.

K) EASY-RELEASE PAINTER'S TAPE: Tape designed for easy and clean removal (does not leave an adhesive residue).

Before You Begin: Choosing Paint

Paint prices are often accurate reflections of quality. As a general rule, buy the best paint your budget allows. High-quality paint is easier to use and looks better than less expensive paint. Quality paints often last longer and require fewer coats, too.

LATEX PAINT: Water-based paint that's easy to use and cleans up with soap and water. Latex paint is suitable for nearly every application.

ALKYD PAINT: Oil-based paint that produces a durable finish; cleans up with paint thinner or mineral spirits. Some painters feel that alkyd paint produces a smoother finish, but local regulations restrict its use in some communities.

Paint comes in various sheens, ranging from flat to high-gloss enamel. Gloss enamels dry to a shiny finish and are best for surfaces that need to be washed often, such as bathroom or kitchen walls or woodwork in any room. Flat paints are used for walls and ceilings.

PRIMER: Primer bonds well to all surfaces and provides a durable base that helps keep the finish coat from cracking or peeling. Always use a good primer to prepare surfaces for painting.

TINTED PRIMER: When using deep colors, tinted primer reduces the number of coats of paint necessary to achieve good coverage.

1 Hanging Pictures & Mirrors

Hanging pictures and mirrors instantly personalizes a room, and it's easy to do when you approach it with the right tools and a good attitude. We'll show you how to position a piece properly and hang it securely—the first time.

IF YOU'VE EVER MADE SIX HOLES IN A WALL TO HANG ONE PICTURE, YOU KNOW HOW FRUSTRATING THE PROCESS CAN BE. Most of us have done it, and none of us want to repeat the experience. Great news! By following the steps outlined here and using the right hardware, you can hang a picture without making a single unnecessary hole.

Before getting out your tools, study the size and shape of the room. Designers and decorators often suggest placing the center of a picture or mirror at eye level—57 to 60 inches above the floor—but that's a guideline, not a hard and fast rule. If you're placing a mirror behind a sideboard or a picture over a mantle, let the style of the room and a sense of balance guide its placement.

HOW TO HANG PICTURES & MIRRORS

Frames and mirrors remain level and secure when they're supported by wall studs and sturdy hardware. Before you can choose hardware, find out what the piece weighs. While shopping, check the labels on the hardware you're considering to make sure it will support the weight of the piece you're going to hang.

TERMS YOU NEED TO KNOW

STUD—The lumber used to frame a wall. Typically 2 × 4s spaced 16" apart.

STUD FINDER—A handheld device used to locate studs behind drywall and wall coverings.

TOOLS & SUPPLIES YOU NEED

* Match to weight of piece to be hung.

SKILLS YOU NEED

- Measuring accurately
- Light carpentry tool skills

DIFFICULTY LEVEL

This project takes less than 30 minutes.

HOW TO HANG A PICTURE

1 On each side of the frame, mark 8" down from the top. Purchase D-rings or picture hooks rated to support the approximate weight of the picture or mirror (package labels on the hardware give the suggested weight ranges).

2 Set the D-rings aside, and then use an awl to punch a hole at each mark on the frame. Reposition the first D-ring and drive a screw into the mark, securely attaching the D-ring to the frame. Repeat on the other side.

3 Attach a self-adhesive felt pad at each corner of the frame.

4 In the area where you want to hang the frame, place a piece of tape at the appropriate height, measured from the floor (usually 57 to 60", depending on the room's dimensions). Following manufacturer's directions, use a stud finder to locate the studs and mark the tape to indicate their positions.

5 Measure the width of the frame and divide that number by 2—this is the center of your frame. On the tape, mark the proposed center of the frame, and then mark the edge of the frame the calculated distance on each side. If possible, align the frame so that the three points are near your stud marks.

6 Measure down 8" from the frame side marks for the D-ring placement. If studs are not available, drive self-tapping hollow wall anchors into the holes (as shown), and then drill a screw into each anchor. If studs are available, drill wood screws directly into the studs.

7 Slip the D-rings or picture hooks over the screws on the wall. Your picture should now be straight and secure with nary an extra hole to repair.

QUICK FIX

Putting a felt pad at each corner of a frame helps it hang straight and keeps it from marking the walls. If you don't have any on hand, don't despair: Silicone caulk will do the trick quite nicely. Put a dot of caulk (about the diameter of a pencil eraser) on each corner. As soon as the caulk dries, you're good to go.

2 Replacing Towel Bars

New accessories update a bathroom in a flash, without much trouble or expense. The important thing is to make sure the hanging hardware is supported by studs or hollow wall anchors rated for the bar's weight.

EVEN WHEN IT COMES TO TOWEL BARS AND OTHER BATHROOM ACCESSORIES, STYLES CHANGE WITH THE TIMES. No matter how much we love them now, in a decade or so, today's hot styles will be hopelessly out of date. And so it goes.

If the towel bars in your bathroom are damaged, out of date, or just plain ugly, it's time to replace them. There are a few things to think about before you go shopping. First, take a look at the finish on the faucets in the room. Generally, it's best to choose accessories that match or coordinate with the faucets. Next, measure the mounting plates on the existing accessories. It's easier to produce professional-looking results if the plates on the new accessories are the same size or larger than the existing ones.

Although we're showing a towel bar in this project, most bathroom accessories are installed in a similar fashion. Once you understand the process, you'll be ready to add any accessory you want or need.

HOW TO REPLACE A TOWEL BAR

Towel bars and other bathroom accessories are supported by mounting plates attached to walls. The mounting plate must be securely supported by wall studs or hollow wall anchors.

TERMS YOU NEED TO KNOW

SETSCREW—A small screw that holds a part in place. On towel bars, they're typically found on the bottom, out of sight as much as possible.

MOUNTING PLATE—The hardware that supports the weight of the towel bar or accessory.

SPACKLE—A filler for cracks and holes in walls. Available premixed in small containers for routine repairs.

TOOLS & SUPPLIES YOU NEED

SKILLS YOU NEED

- Measuring accurately
- Light carpentry tool skills

DIFFICULTY LEVEL

This project takes less than 30 minutes.

HOW TO INSTALL A NEW TOWEL BAR

1 Position the towel bar and make a mark along the outside of the mounting trim on each side. (Try to avoid positioning the bar so the new holes will fall directly over the old ones.) Repeat for the other side.

TOOL TIP

If the old plates are secure, leave them in place. To ensure the new towel bar fits your existing plates, measure the mounting plates remaining on the wall.

2 Center the mounting plate between the marks made in step 1, and then make marks for the screw locations. Repeat this process on the other side. Check the marks with a level, and adjust if necessary. Use a stud finder to check if the marks are located over studs.

3 Drill pilot holes, and then hold the first mounting plate in place and drive screws to attach it to the wall. Repeat on the other side.

Option: If studs will not support the screws, use an awl to make a small hole at each mark, and then drive a self-tapping hollow wall anchor into the wall.

4 Settle the towel bar onto the mounting plates. Tighten the setscrews that hold the bar to the mounting plates. (Again, these setscrews typically are found on the bottom of the mounting trim.)

WHAT IF...?

What if I want to install a towel bar on a ceramic tile wall?

Follow the directions as given, but use a ceramic tile bit with a carbide tip to drill the pilot holes. Before beginning to drill, scratch a dimple into the tile with an awl or a sharp nail. (Starting beyond the tile's glaze helps keep the bit from dancing around on the tile.)

3 Hanging Curtains

Curtains can dress a room in elegance, lighten the room's mood, or do little more than filter incoming light—it's completely up to you. Choosing them may take some time, but hanging them can be a breeze.

PUTTING UP CURTAINS IS ONE OF THOSE PROJECTS THAT MANY HOMEOWNERS DREAD: IT INVOLVES CREATING HOLES IN THE WALLS, AND MISTAKES OR MISCALCULATIONS SHOW IMMEDIATELY. Take a deep breath. There's no reason to let hanging curtains become an exercise in frustration. With the information we're about to give you and some advance planning, you'll be able to get it right the first time, every time. Honestly.

There are several decisions to be made long before the measuring and drilling starts, and each is important to the success of the project. First, how much of the window will the curtains cover? Do they need to open and close? And what kind of hanging hardware do you like?

HOW TO HANG CURTAINS

1 Measure the height and width of the window. Make a quick diagram of the window and note the measurements you took. Before purchasing curtains or hardware, decide where you want the curtains to start and stop, and indicate those measurements on your diagram. Attach the brackets for the sheer rod. Place the sheer rod and check for level. Adjust if necessary.

2 Attach the brackets for the decorative curtain rod a few inches outside and above the sheer brackets. Use wall anchors if the bracket is not located over a stud.

3 Place the curtain over the sheer rod, and then place the rod for the sheer into the mounting plate. Repeat for the decorative curtains and rod.

TOOLS & SUPPLIES YOU NEED

SKILLS YOU NEED

- Measuring accurately
- Light carpentry tool skills

DIFFICULTY LEVEL

This project takes 60 to 90 minutes.

Installing Window Blinds & Shades

4

Horizontal blinds and shades improve energy efficiency and light control in an easy-to-install, reasonably priced package. Many retailers will cut them to fit while you wait—all you have to do is provide accurate measurements.

HORIZONTAL BLINDS AND SHADES CAN BE OPENED OR CLOSED COMPLETELY WITH A PUSH OF A BUTTON OR A TUG ON A CORD. Plus, just a twist of a rod tilts blinds to filter light or direct light as needed. And then there are hybrid products—sheer shades sandwiched around slats that can be louvered like blinds. With the many products available today, it's easy to find one that suits your needs as well as your room's needs.

With blinds and shades, as with most window treatments, the key to easy installation is careful measurement and good preparation. It's important to decide exactly what you want the blinds to accomplish before shopping—even before measuring. A quick evaluation of the room and window in question is the basis for all the decisions you'll have to make.

BLINDS & SHADES 101

Typical roll-up window shades are mounted to the inside edges of the jamb, as shown above. Many styles of blinds are mounted to the wall above the window (called "outside mount").

TERMS YOU NEED TO KNOW

WINDOW FRAME—The enclosure in which a window sash is mounted.

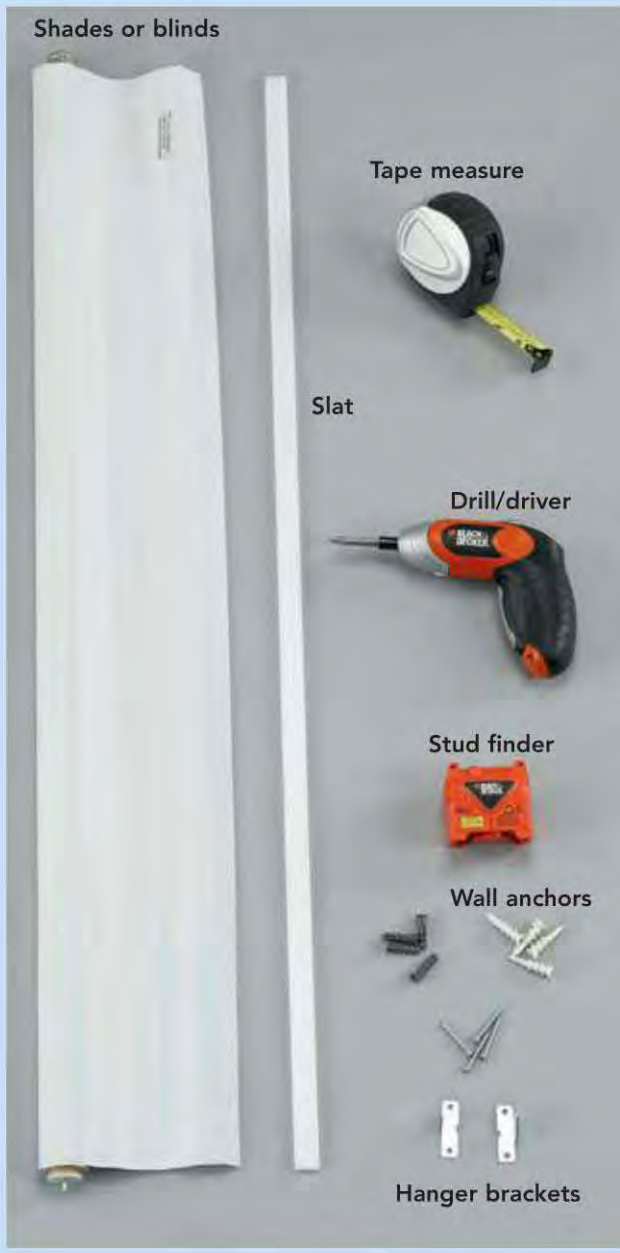
WINDOW JAMB—The vertical pieces that form the sides of a window.

HEAD RAIL—The top part of the blinds where the mechanisms are housed.

VALANCE—A decorative piece that covers the top of a window treatment. On blinds, the valance covers the head rail and brackets.

HOLD-DOWN CLIP—A small piece of hardware that holds the lower edge of a blind or shade in place. Keeps blinds from flapping against the frame when the window is open.

TOOLS & SUPPLIES YOU NEED



SKILLS YOU NEED

- Measuring accurately
- Light carpentry tool skills

DIFFICULTY LEVEL

This project takes 30 to 60 minutes.

HOW TO HANG ROLL-UP SHADES

1 At the top, bottom, and middle of the window frame, measure the opening between the side jambs. Make a quick diagram of the window and note the smallest of the three measurements.

2 Measure the height of the window frame (between the top and bottom), at each side, and in the middle. Add the largest of these measurements to your diagram. With your diagram in hand, purchase blinds or shades to fit the window. If possible, have the retailer cut the blinds or shades to your specifications. If that's not possible, buy the closest size (a bit smaller) to the window opening.

3 To cut standard roll-up shades to length, remove the slat from the bottom edge and cut through the hem with scissors. Carefully tear the material until you reach the roller tube. Follow the manufacturer's specific instructions.

4 Remove the excess cardboard, and then remove the roller end from the tube. Cut the tube to length with a hacksaw (metal) or finetooth wood saw (cardboard).

5 Roll the shade material back up, and then push the roller end inward and replace the end cap.

6 Cut the slat (that fits into hems) to length, according to manufacturer's instructions. For basic roller shades, you simply snap the slat apart at the desired location.

7 Position the first bracket flush with the upper front corner of the window frame, and mark its screw holes. Drill a pilot hole at each mark, hold the bracket in place, and then drive in the screws to secure it. Repeat for the other bracket, making sure the two brackets are level.

8 Slide the pin end of the head rail into the bracket on one end, and then slide the slatted end into the other bracket.

VARIATION: OUTSIDE MOUNT

1 To mount blinds outside the window frame, measure the width from the outside edges of the window frame and the height from 2" to 3" above to 2" to 3" below the frame. If the window doesn't have a frame, measure the opening and add a few inches on each side. Make a diagram of the measurements and refer to it when purchasing blinds to fit.

2 Position the first bracket as indicated by the diagram you made in step 1, and mark its screw holes. Use a stud finder to locate nearby studs. If a stud is in the bracket area, drill pilot holes at the marks and attach the bracket to the wall. If no stud is available, use an awl to make a small hole at each mark, and then drive a screw into each anchor. Finally, drive a screw into each anchor.

3 Shoot a line with a laser level or use a standard level to draw a level line across the wall from the top edge of the bracket to the planned position for the second bracket. Position the second bracket and fasten it to the wall as described in step 2.

4 Lift the blinds into place and install them in the brackets on the wall. Follow the manufacturer's instructions to ensure a secure fit.

HERE'S HOW: BUYING TIPS

HORIZONTAL BLINDS are available in a variety of materials and slat sizes. Mini-blinds (½" to ⅝" slats) work well for small or shallow windows. Venetian blinds (approximately 2" slats) minimize the space the blinds take when closed.

CELLULAR SHADES are energy efficient, attractive, and blend well into most rooms. Their honeycomb construction and opaque materials provide excellent insulation and privacy.

WINDOW SHADINGS, a hybrid of blinds and cellular shades, consist of sheer shades sandwiched around opaque blinds that can be tilted to control light. They give you energy efficiency and privacy.

Metal, vinyl, and aluminum (shown) blinds offer unique colors and textures.

Wood blinds (shown), bamboo, and natural materials have a casual, green feel.

Honeycomb (cellular) shades come in a variety of colors and transparencies.

Mini-blinds have slats that range from ½" to ⅝".

Venetian blinds have larger slats, usually 2" or more.

There are several varieties of blinds/cellular shades. This combination allows for the perfect amount of light at any given time.

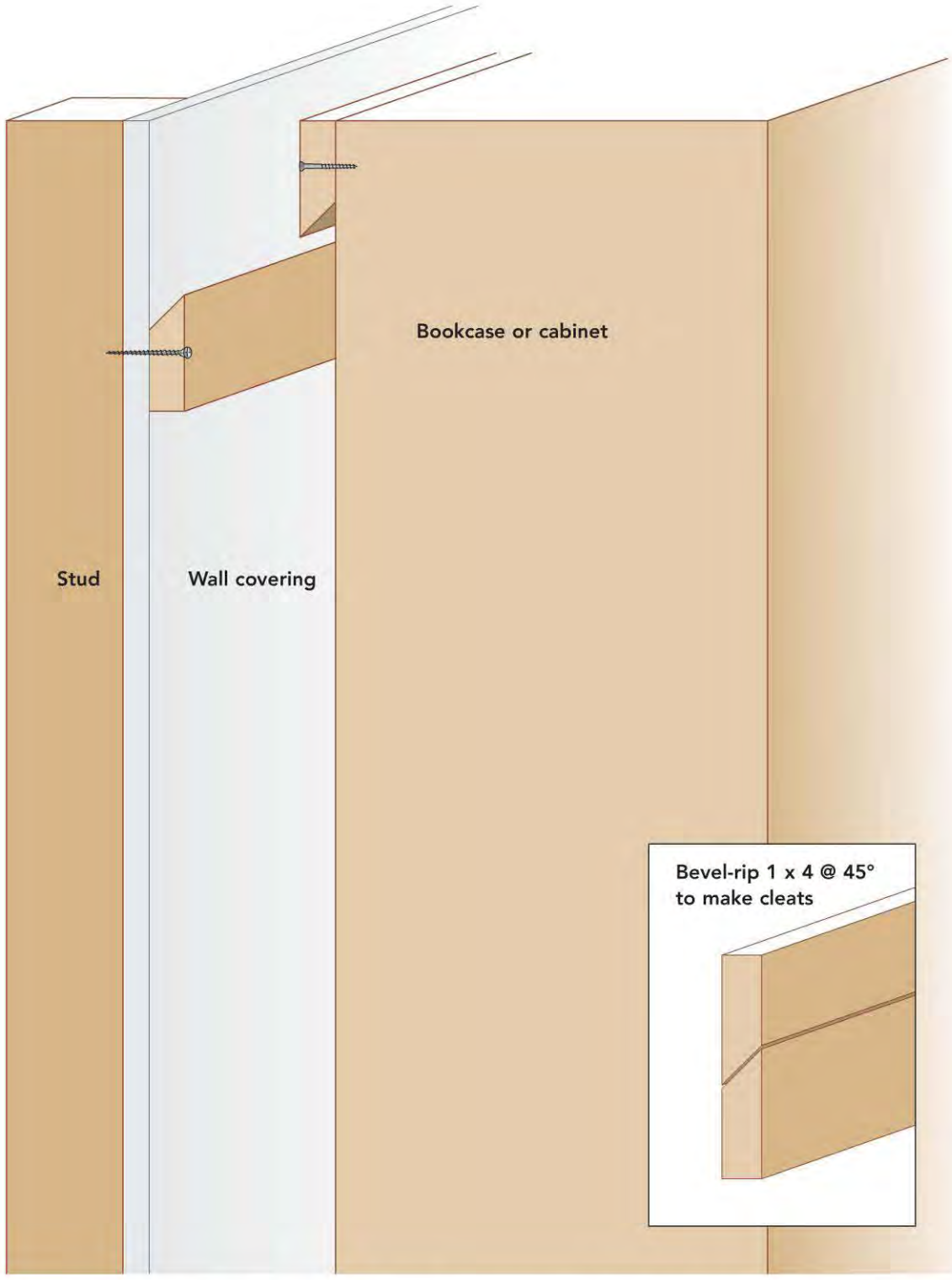
5 Anchoring Bookcases

Anchoring bookcases to a wall keeps them securely in place, no matter how they're loaded or used.

FREESTANDING BOOKCASES ARE TOP-HEAVY, ESPECIALLY WHEN FULLY LOADED WITH BOOKS AND OTHER OBJECTS. This can be dangerous, especially in homes with children. Anchoring bookcases eliminates the possibility of one falling over, which is especially valuable if you live in an earthquake-prone area.

Anchoring a bookcase is very easy to do, as long as you're comfortable using a circular saw. Don't worry! We'll walk you through the steps of using this tool as well.

FRENCH CLEAT 101



A cleat is a simple device—really nothing more than a 1 × 4 or 1 x 6 rip-cut at a 45° bevel. One half of the cleat is attached to the bookcase with the angled edge down and the other is attached to the wall with the angled edge up. When the bookcase is in place, the cleat on the back of the bookcase is supported by the one attached to the wall. Studs or sturdy wall anchors must support the screws holding the cleat to the wall.

TERMS YOU NEED TO KNOW

FRENCH CLEAT—A piece of wood that's bevel-ripped and used to attach an item (such as a cabinet or bookcase) to a wall.

TOOLS & SUPPLIES YOU NEED

SKILLS YOU NEED

- Measuring accurately
- Light carpentry tool skills

DIFFICULTY LEVEL

This project takes 60 minutes.

HOW TO ANCHOR A BOOKCASE

1 Cut a piece of 1 × 4 or 1 × 6 that is 8" less than the width of the bookcase. Mark a rip-cutting line that's offset about ½" from the middle.

2 Set the bevel on a circular saw to 45° and cut along the marked line, rip-cut using a straitedge guide. Or, use a tablesaw if you have access to one.

TOOL TIP

The angle of the blade on a circular saw can be set for beveled cuts. Check the owner's manual for specific directions, but in general you push or unscrew a safety release, set the angle according to a marked gauge, then reset the safety.

3 Center one cleat so the square edge is flush with the top and bottom of the bookcase. Use wood screws to attach it to the bookcase, with the angled points facing down. Be sure to screw into the bookcase frame, not just the backing material.

4 Measure the height of the bookcase, and draw or shoot a level line onto the wall in the area where the bookcase will be anchored, flush with the top and as wide as the bookcase. Using a stud finder, locate and mark the studs above the line. If you are working near the ceiling, allow enough space for the top cleat to clear the bottom cleat.

5 Center the top of the wall cleat against the line marked on the wall, with the angled point facing up. Attach the cleat to the wall by driving 2½" drywall screws through it and into the studs as marked.

6 Lift the bookcase and settle the bookcase cleat onto the wall cleat. Adjust the bookcase until it's secure against the wall.

6 Draping & Taping

A little time spent applying tape and laying out plastic sheeting and drop cloths saves hours of cleanup at the end of a project.

NO MATTER HOW CAREFUL YOU ARE, PAINTING PROJECTS CAN GET MESSY. Dry paint—even latex paint—is virtually impossible to remove from most fabrics and not much fun to remove from any other surface. Careful draping and taping saves your precious belongings and reduces the amount of cleanup necessary when the project is complete.

DRAPING & TAPING 101

Painting projects go quickly and smoothly when the project area has been prepared and surfaces not to be painted have been draped and taped off to protect them from splatters and other mistakes. Tape off woodwork with easy-release painter's tape, cover floors with drop cloths, and cover walls that will not be painted with plastic sheeting.

TERMS YOU NEED TO KNOW

PLATE COVER—A decorative piece that covers the opening for a light fixture.

EASY-RELEASE PAINTER'S TAPE—A type of low-tack tape designed to be easy to remove without leaving adhesive residue.

TOOLS & SUPPLIES YOU NEED

SKILLS YOU NEED

- Working on a ladder
- Taping with accuracy

DIFFICULTY LEVEL

This project takes 1 to 2 hours.

HOW TO DRAPE & TAPE BEFORE PAINTING A CEILING

1 In rooms with hanging light fixtures, shut off the power to the circuit, lower the plate cover, and pull a trash bag up from the bottom of the fixture. Tie a knot at the top, neatly covering the entire piece. In bathrooms, place a lawn-sized trash bag over the toilet and tape it in place.

2 Remove as many objects as possible from the room, then cover everything else with plastic. Cover the remaining area of the floor with canvas drop cloths.

3 Press the top half of 2" masking tape along the joint between the ceiling and the wall. Leave the bottom half of the tape loose.

4 Slide sheet plastic under the masking tape, and press the tape down just enough to hold it in place. Make sure the plastic is long enough to protect the baseboards as well as the walls.

HOW TO TAPE BEFORE PAINTING WALLS OR MILLWORK

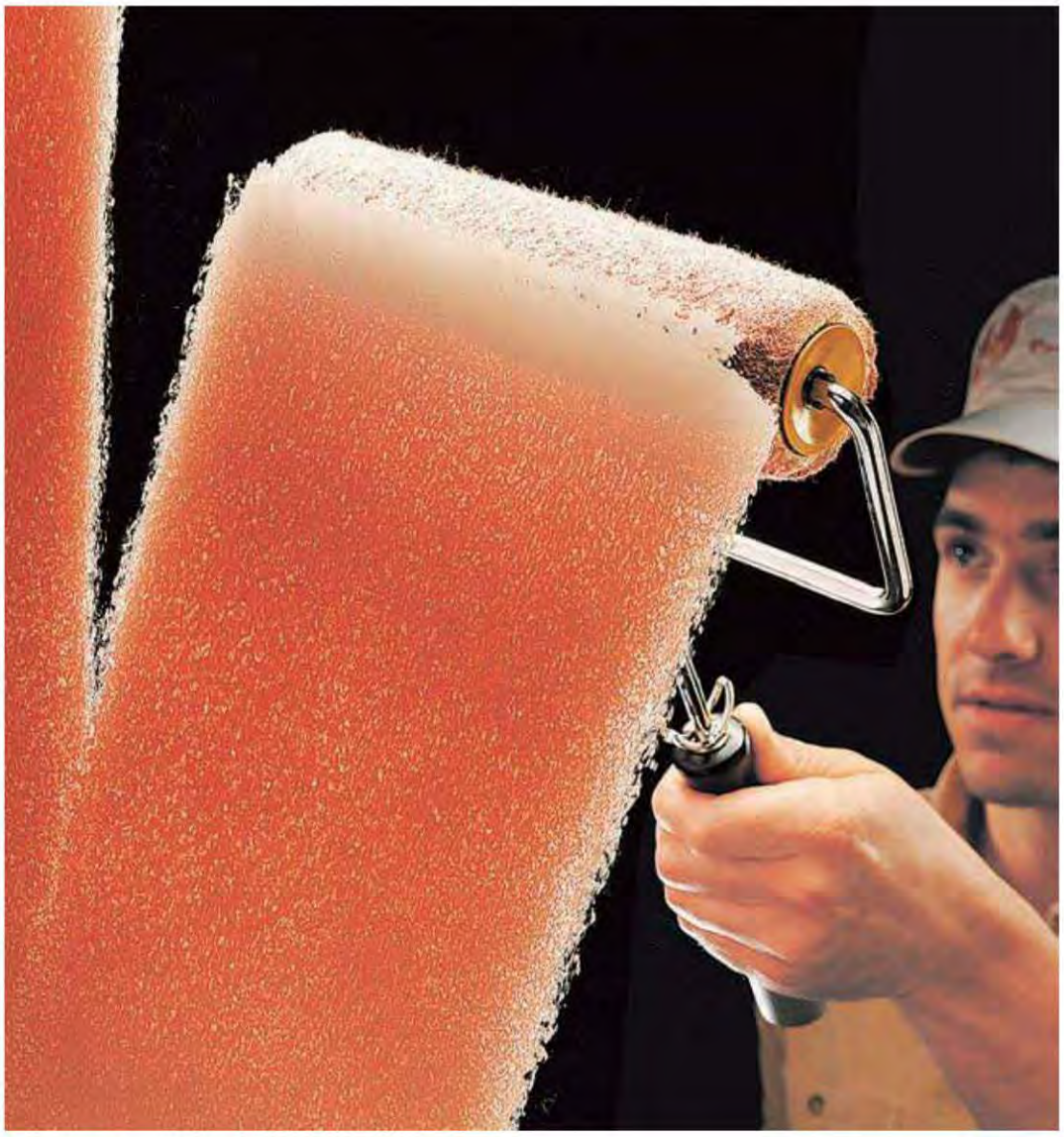
1 Shut off the electricity to the circuits in the room. Remove the covers from receptacles and switches as well as heating and air-conditioning duct covers. Tape over gaps between the boxes and the switch or receptacle. Restore power.

2 Align painter's tape with the outside edge of the window molding; press in place. Run the tip of a putty knife along the edge of the tape to seal it so paint can't seep under the edges.

3 Align wide painter's tape with the top edge of the baseboard. Run the tip of a putty knife along the inside edge to seal it, but leave the tape parallel to the floor to shield the rest of the baseboard.

4 Before painting trim and millwork, tape off edges of the walls. Line up the tape with the edge of the millwork and press it into place.

7 Painting Walls



Painting a wall is a simple matter of distributing paint evenly. The simple techniques described here will help you do that with ease.

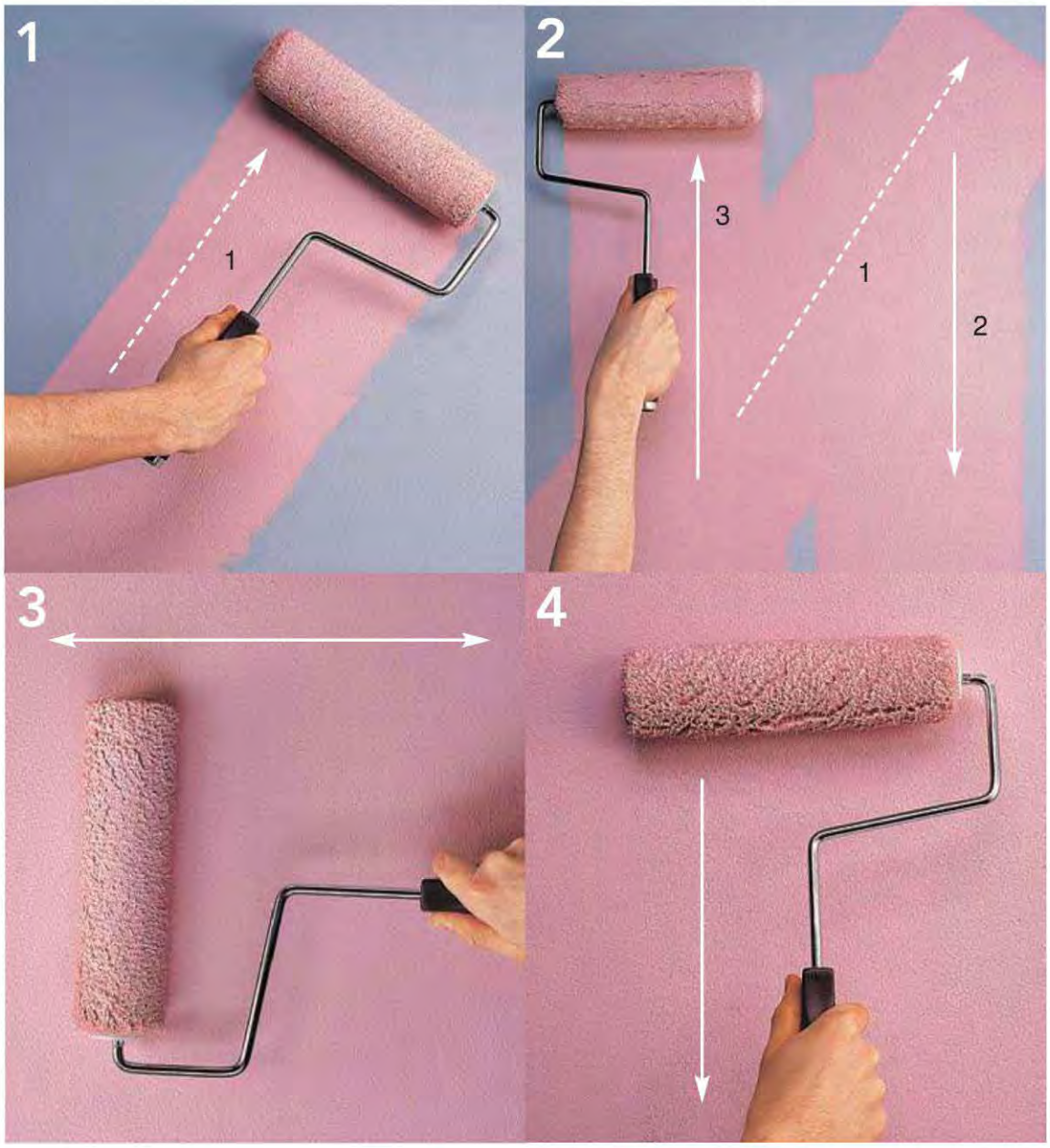
PREPARING TO PAINT CAN BE TEDIOUS. Actually painting is fun: It goes fairly quickly and progress is immediately obvious.

It's much easier to see missed areas in natural light, so try to complete the project in daylight. Use high-quality paint and tools, and work with full brushes and rollers to keep lap marks to a minimum.

When painting bare drywall or plaster, apply a coat of primer to the entire project area and let it dry before applying the paint. When applying dark or deep colors (especially reds), have the primer tinted to match the paint; tinted primer reduces the number of paint coats required for full coverage.

Roll one 2 × 4-ft. section at a time, cutting in the edges and corners before rolling the main area. Roll the area while the areas that have been cut in are still wet, and start the next section while the edges of the first are still wet. This technique, called "painting to a wet edge," keeps lap marks from showing on the finished wall.

WALL PAINTING 101



Paint surfaces in small sections, working from dry surfaces back into wet paint to avoid roller marks. 1. With loaded roller, make a diagonal sweep (1) about 4' long on the surface. On walls, roll upward on the first stroke to avoid spilling paint. Use slow roller strokes to avoid splattering. 2. Draw the roller straight down (2) from the top of the diagonal sweep. Shift the roller to the beginning of the diagonal and roll up (3) to complete the unloading of the roller. 3. Distribute paint over the rest of the section with horizontal back-and-forth strokes. 4. Smooth the area by lightly drawing the roller vertically from the top to the bottom of the painted area. Lift the roller and return it to the top of the area after each stroke.

TERMS YOU NEED TO KNOW

CUT IN—To brush paint onto the edges of an area to be painted.

WET EDGE—Fresh paint. Rolling paint onto the main areas of the wall or ceiling while the paint is still wet in the areas that have been "cut in" prevents lines or shadows between those areas after the paint has dried.

TOOLS & SUPPLIES YOU NEED

SKILLS YOU NEED

- Loading a roller
- Cutting in edges and corners
- Rolling paint smoothly

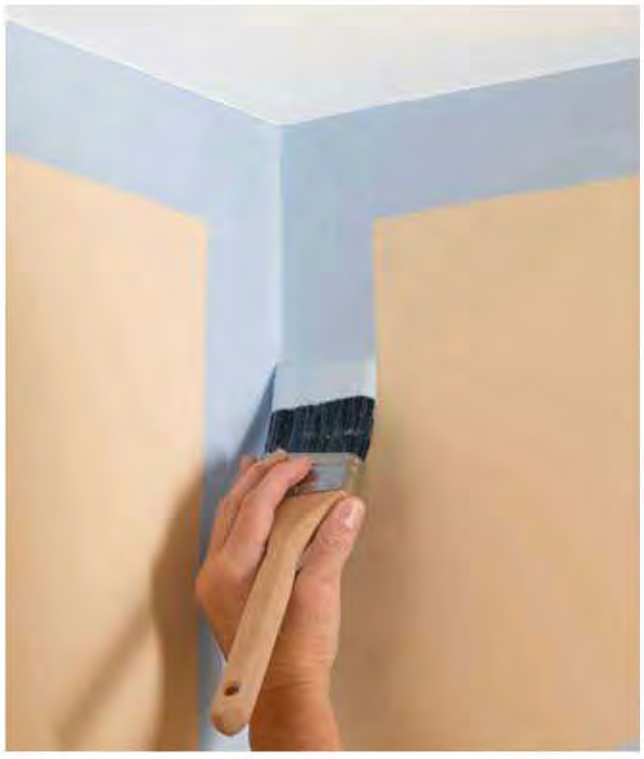
DIFFICULTY LEVEL

This project takes 3 to 4 hours, depending on the size of the area being covered.

HOW TO PAINT A WALL

1 Stir the paint, using a variable-speed drill and paint-mixing bit. Set the drill on a low speed and keep the head of the bit in the paint until it completely stops turning. Paint separates quickly, so stir it thoroughly from time to time.

2 Cut in the edges of a 2 × 4-ft. section of the first wall, using the narrow edge of a paintbrush. Press down just enough to flex the bristles. Use long, slow strokes, and paint from dry areas back into wet paint.



3 Cut in any corners in the section, using the wide edge of the paintbrush or use a specialty corner roller.

HERE'S HOW

Here's how to avoid having the paint look different from one wall to the next. Paint—especially custom-mixed paint—can vary a tiny bit from one can to another. If your project is large, mix the cans together in a large pail and stir it thoroughly. This is known as boxing.

4 Load the roller with paint. With the loaded roller, make a diagonal sweep about 4 ft. long on the wall. Roll upward on the first stroke to avoid spilling paint. Roll slowly to avoid splattering.

5 Draw the roller straight down from the top of the diagonal sweep. Shift the roller to the beginning of the diagonal stroke and roll upward to complete the unloading of the roller.

6 Roll back and forth across the section to smooth the area. Lightly draw the roller down the section from top to bottom. Lift the roller and start again at the top after each stroke. Finally, slide the roller cover slightly off of the roller frame and roll the cut-in areas to minimize brush marks.

7 Cut in and roll the section directly under the first one. Continue with adjacent areas, cutting in and rolling the top sections before the bottom sections. Roll all finish strokes toward the floor.

8 Preparing Unfinished Wood for Paint

Raw wood needs to be carefully prepared before being painted.

PREPARING RAW WOOD FOR PAINT INVOLVES FILLING NAIL HOLES, SANDING THE SURFACE, AND APPLYING A COAT OF PRIMER. While none of this is difficult, it can be time consuming, so it's important to plan plenty of time for this project. A small putty knife works well for filling nail holes, but sometimes your index finger is the perfect tool.

RAW WOOD SANDING 101

New woodwork contains nail holes that must be filled with wood filler. The surface must then be sanded and the sanding dust removed. Finally, the woodwork must be sealed with a coat of primer.

TERMS YOU NEED TO KNOW

COUNTERSINK—To drive the head of a nail below the surface of the surrounding wood.

NAIL SET—A tool used to set nails below the surface.

TOOLS & SUPPLIES YOU NEED

SKILLS YOU NEED

- Sanding
- Light carpentry skills

DIFFICULTY LEVEL

This project takes 2 to 4 hours, depending on the amount of woodwork you need to finish.

HOW TO PREPARE WOOD FOR PAINT

1 Check the woodwork to identify any nail or screw heads that have not been countersunk below the wood surface.

2 Countersink nailheads by placing the end of a nail set on the head of the nail and striking the top of the nail set with a hammer. Continue until the head of the nail is 1/16" below the wood's surface.

3 Apply wood filler to any nail holes, dents, or damaged areas. In detailed or carved areas, make sure the filler does not fill in the details or carvings. If necessary, remove filler with a small screwdriver or awl.

4 Sand the surface of the woodwork. Start with a fine-grit sponge and progress to an extra-fine grit sponge, sanding with the grain of the wood.

5 Tape off the woodwork (see page 370).

6 Apply a coat of primer, using a paintbrush (a 2½" sash brush works well). Let the primer dry, according to the manufacturer's directions.

SAFETY TIP

If your home was built before 1978 and you will be sanding painted wood, test the painted wood for lead before taking any further action. You can purchase a lead-testing kit for this job. If the test indicates the presence of lead, collect a sample and consult a lead-abatement specialist.

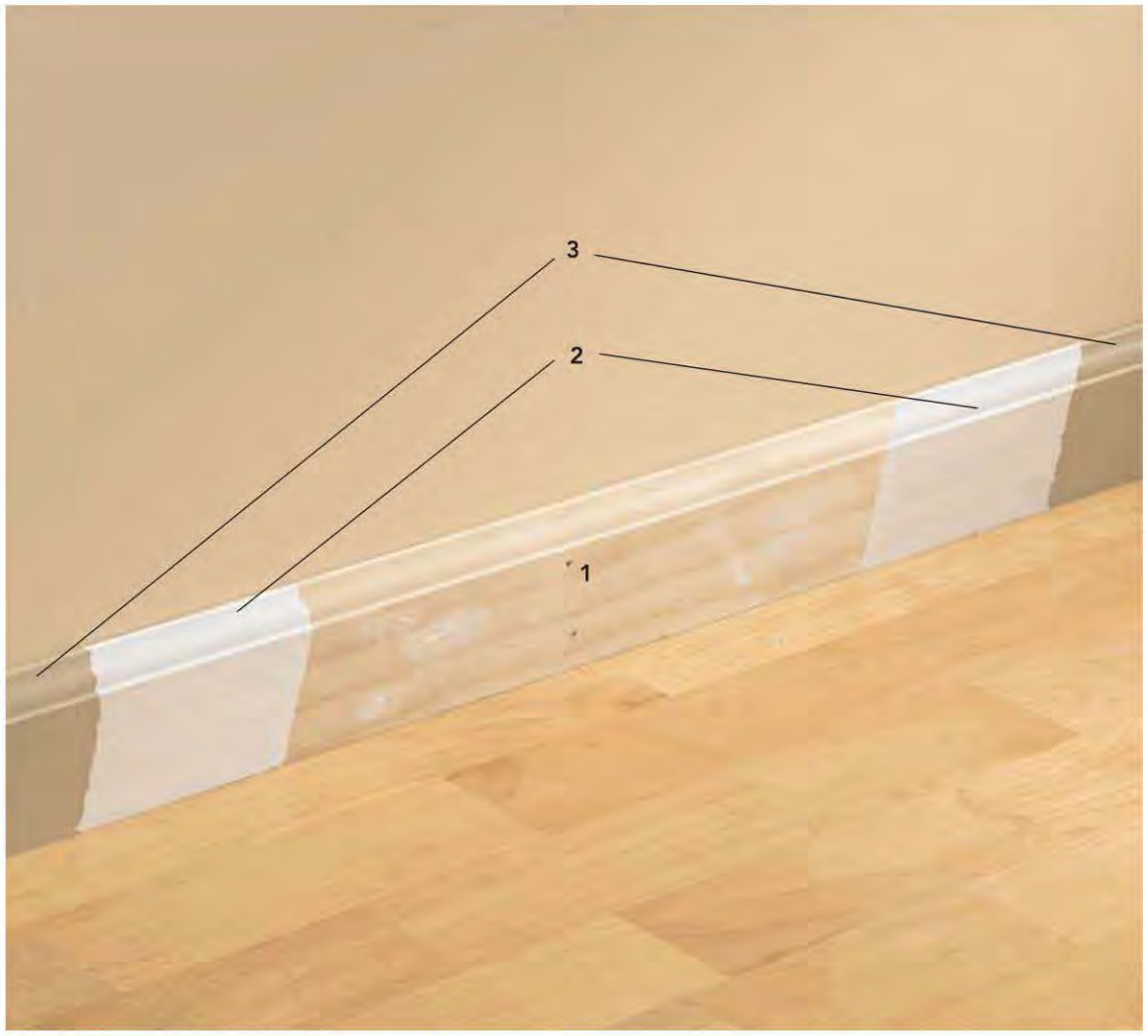
7 Lightly sand the primed woodwork and wipe the surface with a tack cloth.

9 Painting Millwork & Trim

Windows, doors, and trim are on the frontline of the daily bump and grind. A new coat of paint makes them look more attractive and last longer.

WHEN PAINTING AN ENTIRE ROOM, PAINT THE TRIM FIRST, THEN THE WALLS. When painting trim, start at the inside edges and work your way out toward the walls. On windows, that means working from the sashes toward the case molding. On doors, it means working from the main surface of the door out to the case molding. On baseboards, it's best to cut in the top edge and work down toward the floor.

MILLWORK PAINTING 101



To achieve a smooth, even finish on millwork, nail holes and dents are filled with latex wood filler; the surface is sanded, primed, and sanded again. Finally, one or two coats of paint are applied.

TERMS YOU NEED TO KNOW

APRON—A vertical board at the bottom of a double-hung window.

BASEBOARDS—The wood that covers the joint between a wall and the floor.

CASEMENT WINDOW—A window with vertical sashes that open out from the frame on hinge-like mechanisms. Operated by means of a crank located on the lower sash.

CASE MOLDING—The trim that surrounds a window sash or door, covering the joint between the window sashes and the walls.

DOUBLE-HUNG WINDOW—A window that has two sashes that move up and down, one behind the other, along tracks in the opening.

MILLWORK—A generic term for door and window trim as well as baseboards and other trim.

RAILS—The horizontal framework of a door.

STILES—The vertical framework of a door.

WINDOWSILL—The horizontal board at the bottom of a window.

TOOLS & SUPPLIES YOU NEED

SKILLS YOU NEED

- Sanding
- Painting

DIFFICULTY LEVEL

This project takes approximately 2 hours, depending on the amount of millwork you are working on.

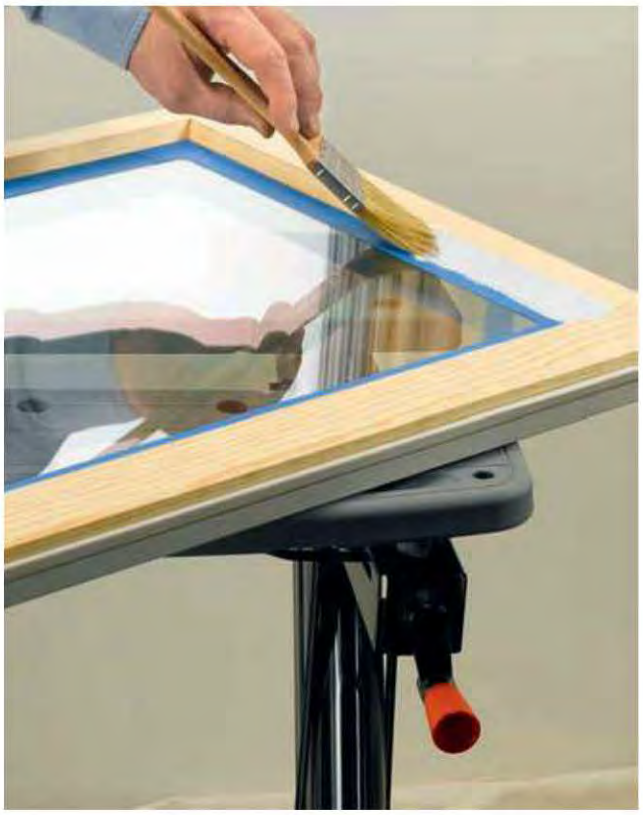
HOW TO PAINT WINDOW MILLWORK

1 Prepare window to be painted. Remove hardware where possible and use painter's tape to mask the rest.

2 Apply tape or corner masks to glass and put tape around outside edges of case molding.

3 Remove double-hung window sashes from their frames when possible. To release a spring-mounted, double-hung window sash, press against the frame and pull the sash toward you.

4 To paint sashes that have been removed, drill holes and drive 3" nails into the legs of a wooden stepladder. Set the window on the nails as though on an easel. Windows can also be placed flat on a bench or sawhorses.



5 Using a tapered sash brush, begin by painting the wood next to the glass. Use the narrow edge of the brush, and overlap the paint onto the tape on the glass.

6 Paint the flat portions of the sash. Use slow brush strokes and smooth the paint carefully. Do not paint the sides or bottom of the window sash.

7 Paint the case moldings, sill, and apron. Again, paint slowly and evenly. Let the paint dry completely.

8 Sand lightly and apply a second coat of paint, using the same method as described above. When the second coat is dry, remove the tape and replace the sashes.

HOW TO PAINT A CASEMENT WINDOW

1 Apply tape and masks as described on page 370.

2 First paint the wood next to the glass, then the flat portions of the sash, followed by the case moldings and sills. Move the sash in and out to comfortably reach all areas. Do not paint sides, top, or bottom of the sash.

HOW TO PAINT BASEBOARDS AND TRIM

1 Prepare baseboards for painting. Starting at the top edge of the baseboard and working toward the floor, apply a light coat of paint. Hold a drywall knife or plastic shielding tool beneath the baseboard as you paint; wipe the tool each time it is moved.

2 Paint deeply patterned surfaces with a stiff-bristled brush, such as a stenciling brush. Use small circular strokes to penetrate recesses.

HOW TO A PAINT DOOR

1 Remove the door by driving out the lower hinge pin, using a screwdriver and hammer. Next, have a helper hold the door in place while you drive out the middle and then the upper hinge pins.

2 Place the door flat on a pair of sawhorses. On paneled doors, use a paintbrush to paint in the following order: 1) recessed panels, 2) horizontal rails, and 3) vertical stiles. Let the paint dry thoroughly. If a second coat is required, sand the door lightly and wipe it with a tack cloth before applying it.

3 Seal the unpainted edges of the door with clear wood sealer. Allow the sealer and paint to completely dry. Rehang the door in the same location, using the old screw locations as well.

TIP

If the screw holes in the wall no longer support the screws firmly, fill them with latex wood patch and drill pilot holes before hanging the door.

10 Painting Wood Cabinets

Painting wood cabinets is an inexpensive way to give a kitchen a face-lift.

PAINT IS A GOOD FINISH FOR CABINETS OF ALL SORTS: IT'S ATTRACTIVE, EASY TO CLEAN, AND (WHEN HEAVY-DUTY ENAMEL IS USED) DURABLE. Although painting cabinets is not difficult, it is time consuming: Most require two coats of paint, all surfaces have to be sanded lightly between coats, and both sides of the doors need to be painted.

HOW TO PAINT WOOD CABINETS

1 Empty the cabinets, and then remove the shelf pins and shelves. For stubborn shelf pins, use a pliers to pull them out. Unfasten the hinge screws and all hardware, then remove the cabinet doors from the frames.

2 Wash the cabinets with a mild detergent solution. Rinse with clean water and a sponge. Fill scratches, dents, or cracks with latex wood filler, using a putty knife. Let the wood filler dry completely. Sand all surfaces with an orbital sander and 150-grit sandpaper.

3 Brush paint onto the interior of the cabinet frames, starting with the back wall, then the top, sides, and bottom. Roll paint the outside surfaces, working from top to bottom.

4 Using a trim brush, paint the inside of each door. Once dry, paint the other side using a tapered sash brush. Let the drawers dry for several days, then replace the hardware and rehang the doors.

TOOLS & SUPPLIES YOU NEED

SKILLS YOU NEED

- Sanding
- Painting smoothly

DIFFICULTY LEVEL

This project takes about 2 hours per foot of cabinets

Painting Concrete Block Walls

11

Paint dresses up concrete block walls, and some products also help the blocks resist water infiltration.

UNPAINTED CONCRETE BLOCKS ARE DULL AND INSTITUTIONAL-LOOKING. They're also slightly porous, so in situations where hydrostatic pressure is present, water can seep through them. Paint provides a long-lasting, durable surface that improves the appearance of blocks as well as increases their water resistance.

Concrete blocks must be cured for at least 30 days before being painted. Before they can be patched and painted, they must also be free of mildew, dust and dirt, and efflorescence. The paint fills the pores of the blocks and helps them become more water resistant.

The products used to prepare concrete blocks for paint emit irritating fumes. Provide adequate ventilation or wear a respirator when working with them.

CONCRETE BLOCK PAINTING 101

Paint concrete walls in sections for a professional finish. First cut in corners and paint the perimeter with a paintbrush. Then paint the interior in 2-ft. sections, as shown above. Be sure to patch holes with hydraulic cement and allow to dry before painting.

TERMS YOU NEED TO KNOW

EFFLORESCENCE—A white, crystalline mineral deposit sometimes found on masonry surfaces.

ETCHER—A product used to "etch" or make tiny grooves in the surface of the concrete blocks.

TOOLS & SUPPLIES YOU NEED

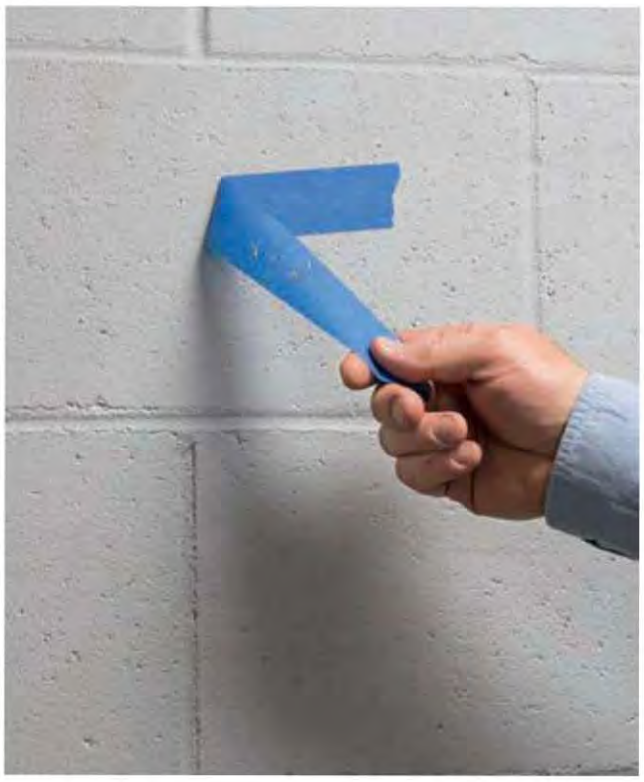
SKILLS YOU NEED

- General cleaning skills
- Working with safety equipment
- Painting

DIFFICULTY LEVEL

This project takes 4 to 6 hours, not including curing times.

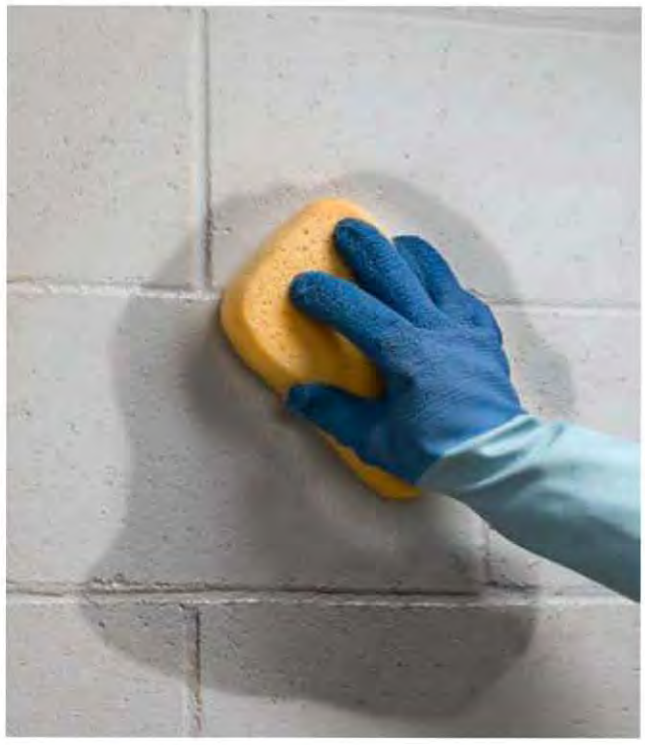
HOW TO PREPARE CONCRETE BLOCK FOR PAINT



1 Press a piece of masking tape onto the blocks in several places. Pull the tape away: If the tape doesn't pull concrete away from the surface, it can be painted. If loose concrete comes away with the tape, all loose bits need to be scraped away with a wire brush.

2 Apply hydraulic cement in layers no more than ½" thick, until the patch is slightly higher than the surrounding area. Feather the patch until the edges are even with the surface. Let the patch dry, according to manufacturer's directions.

3 Evaluate the blocks, looking for holes and cracks. If you find any, use a masonry chisel or a bottle opener and a wire brush to remove any debris or dirt. Clean all dust and debris from the surface with a hand vacuum.



4 Clean the concrete blocks with a cleaner and degreaser (or etcher). Thoroughly rinse the blocks with water and then let them dry. Be sure to wear safety glasses and heavy-duty rubber gloves. Check the ventilation in the area, and put on a respirator if necessary.

HOW TO PAINT A CONCRETE BLOCK WALL

1 Stir the paint, using a variable-speed drill and a paint-mixing bit. If the project requires more than one can of paint, mix the cans together in a large bucket before stirring. Use a paintbrush to cut in the edges of a 2 × 4-ft. section, starting at the top.

2 While the cut-in edges are still wet, roll paint onto the first section. Work the paint into the surface, making certain paint fills any pores or voids. Repeat with the section immediately beneath the first, and then continue to the next section (starting at the top once again). Let the paint dry according to manufacturer's instructions.

TIP

After painting the entire wall, apply a second coat of paint to cover the entire area and fill any voids left after the first coat. Let the paint dry and reevaluate the blocks. If water has been a problem in the past, check for leaks. If leaks are still present, apply more paint in these areas.

12 Stripping Wallcoverings

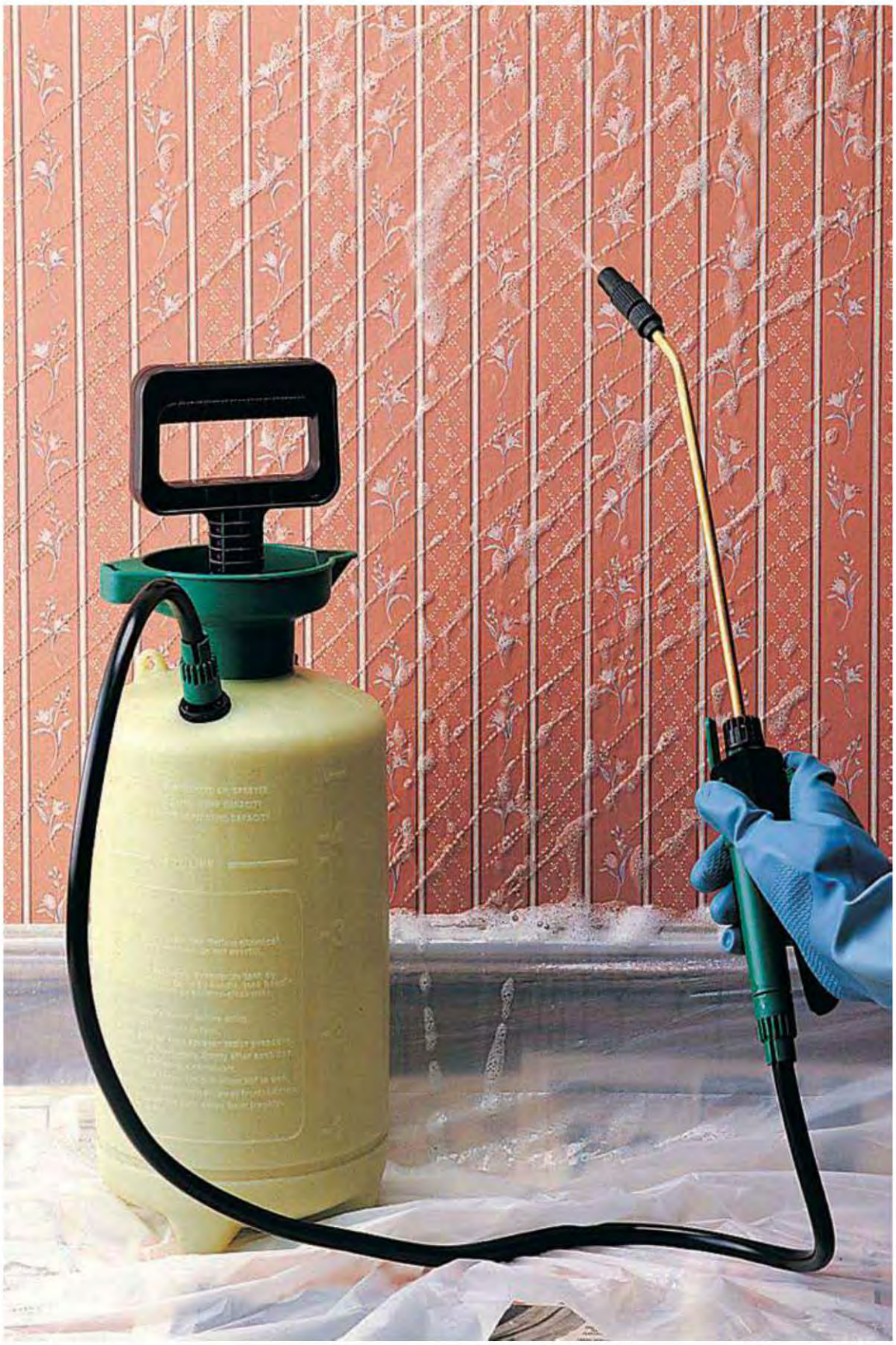
Stripping wallcoverings can be quite tedious, depending on the type of wallcovering it is and how it was applied.

NEWER VINYL WALLCOVERINGS ARE DESIGNED TO BE "STRIPPABLE," WHICH MEANS THEY CAN BE REMOVED BY HAND. All you have to do is find a loose edge and pull upward. Some other wallcoverings leave a layer of paper that can be scraped off easily when it's dampened with water. Still others can be removed only with a fair amount of time and effort.

If wallcovering is hung over unsealed drywall, it's virtually impossible to remove it without destroying the drywall. You may be able to paint or hang new wallcovering directly over the old, but you have to make sure the surface is smooth and prime it with an alkyd drywall primer.

The only way to find out what's lurking beneath your wallcovering is to grab an edge and pull!

WALLPAPER STRIPPING 101



Properly applied wallcovering—good-quality coverings that have been applied with good wallpaper adhesive over primed walls—can be stripped with a remover solution, drywall knife, and a little time and patience.

TERMS YOU NEED TO KNOW

ALKYD—An oil-based primer or paint.

TOOLS & SUPPLIES YOU NEED

SKILLS YOU NEED

- Patience

DIFFICULTY LEVEL

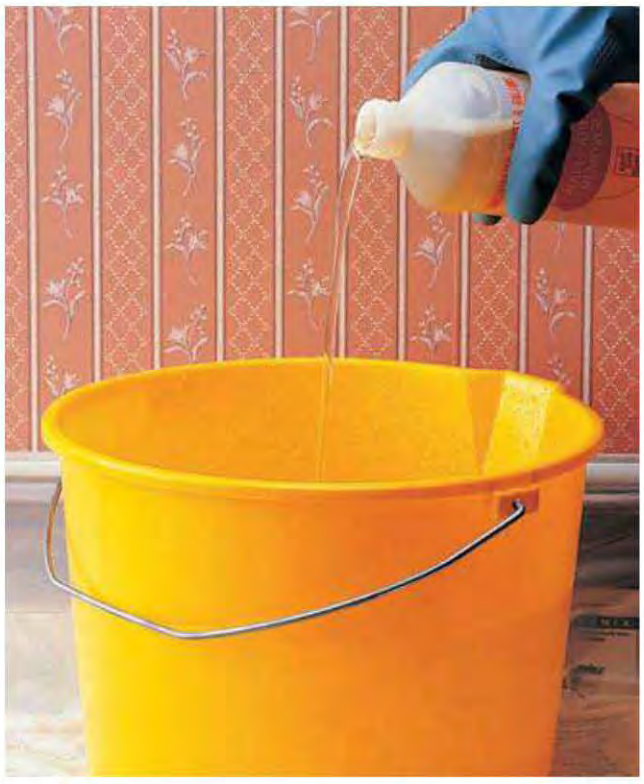
This project takes 15 minutes to an entire weekend, depending on the size of the room you're working in and the type of wallpaper.

HOW TO STRIP WALLCOVERINGS

1 Find a loose corner and pull upward. If there are no loose corners, use a putty knife to pry one loose and pull. If the paper comes off easily, you're home free. Just keep pulling until it's all off the walls.

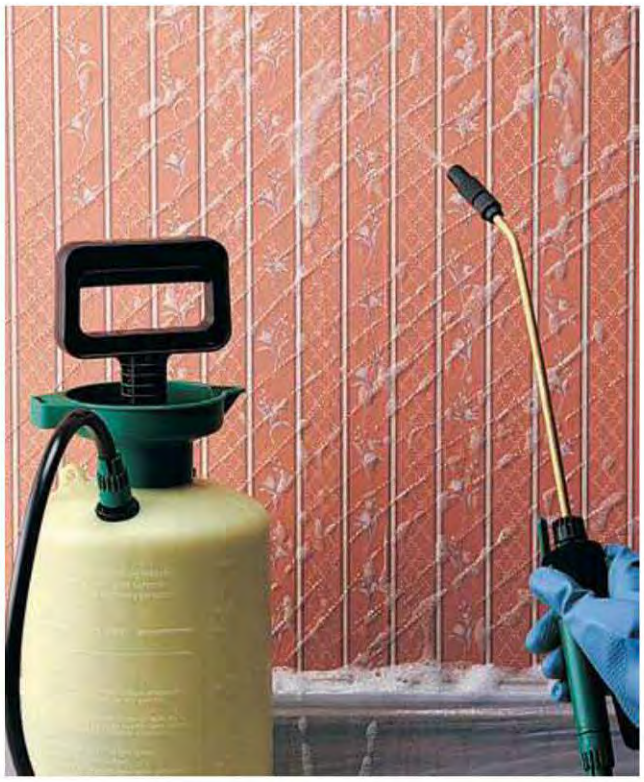
2 Dilute wallpaper remover in water, according to the manufacturer's directions. Wash the walls, working from the top toward the bottom of the walls. Rinse the walls with clear water and let them dry completely.

HOW TO REMOVE STUBBORN WALLCOVERINGS

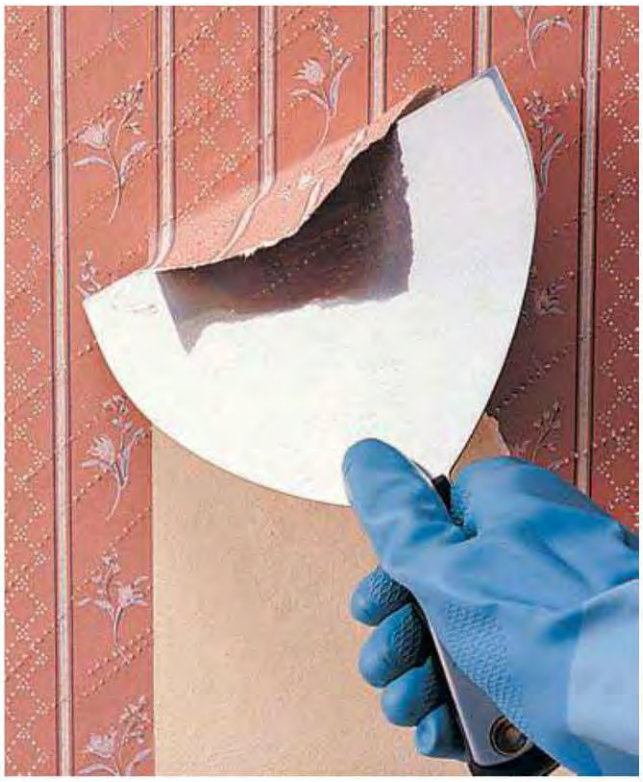


1 If the wallcovering doesn't pull off easily, it's time to bring in the big guns. Cover the floor with drop cloths, and then dilute wallpaper remover in a bucket of water, following the manufacturer's directions.

2 Run a perforating tool over the surface of the wallcovering. (It creates holes that let the remover solution penetrate the surface to loosen the adhesive.)



3 Use a pressure sprayer to apply the remover solution. Let the solution soak into the covering, according to the manufacturer's directions.



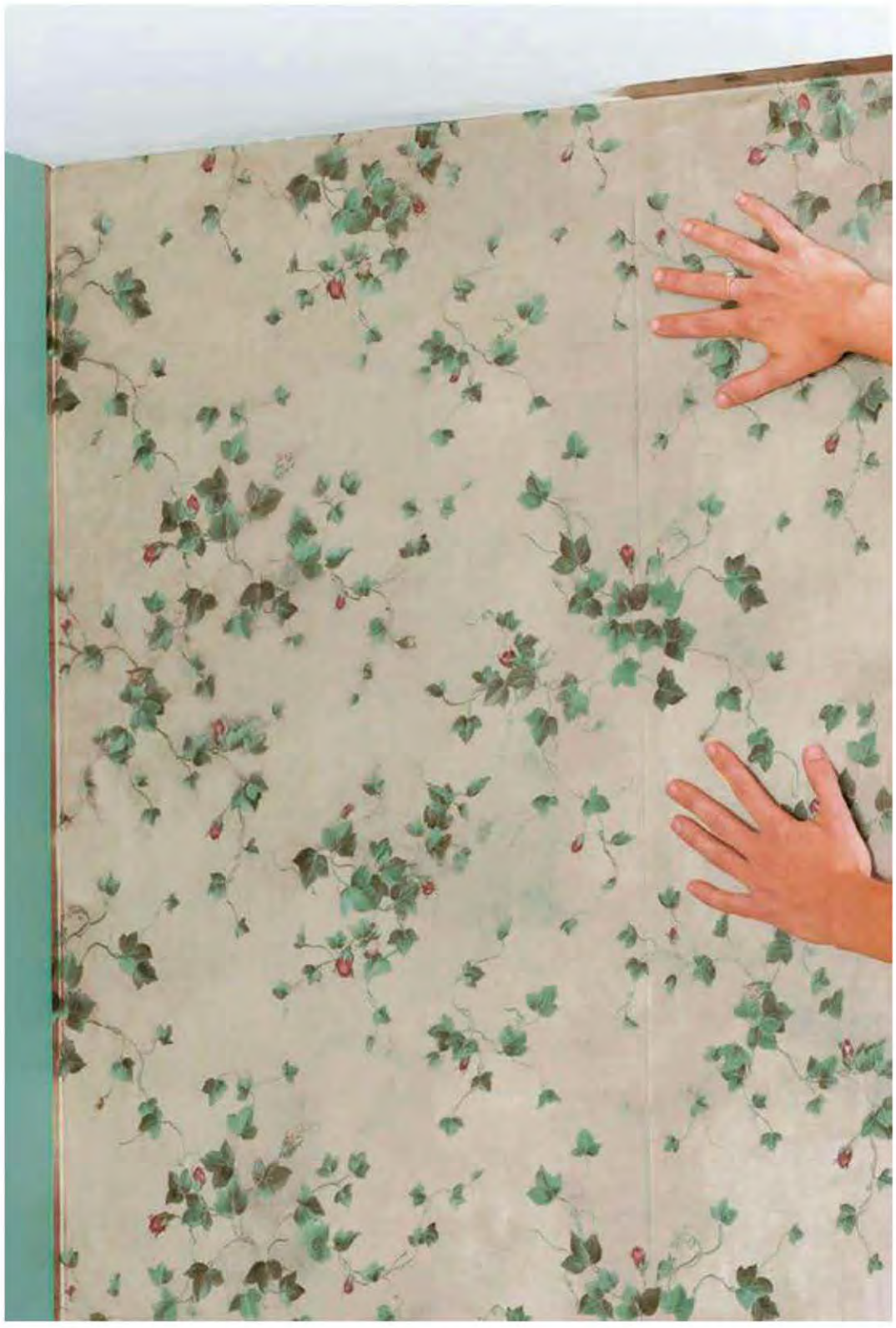
4 Scrape away loosened wallcovering with a wide drywall knife. Be careful not to damage the wall behind the paper, and make sure you remove any backing paper or other layers.

5 Rinse adhesive residue from the wall with remover solution. Rinse with clear water and let the walls dry.

TIP

To check the cleaned wall for remaining adhesive, holes, or other flaws, illuminate the wall from the side, using a bright light. Inspect the walls carefully, making sure they are completely clean and repaired before painting or hanging new wallcoverings.

13 Hanging Wallcoverings

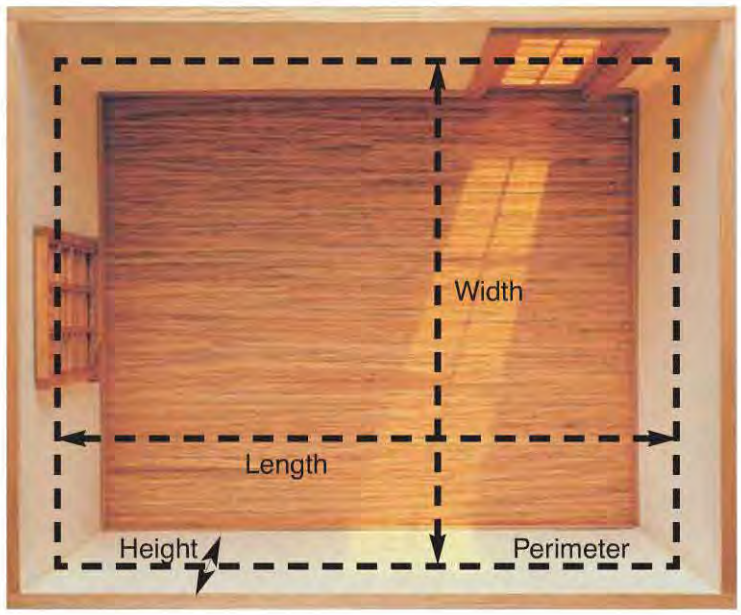


Hanging wallcoverings requires careful planning and attention to detail. The work is not difficult, but it's a challenging project.

THE OLD ADAGE IN CARPENTRY, "MEASURE TWICE, CUT ONCE," IS JUST AS APPLICABLE TO WALLCOVERING PROJECTS. The materials are expensive and mistakes immediately obvious. The only way to avoid problems is to plan meticulously.

First, measure the room and sketch out a hanging plan. Next, prepare the room and recruit a helper or two. Plan to work during daylight hours whenever possible, as the light is better and the adhesive dries more evenly.

HANGING WALLCOVERING 101



TERMS YOU NEED TO KNOW

BOOK—To lightly fold moistened wallcovering so that the pasted sides face one another. Allows adhesive to cure in preparation for hanging.

BUBBLESTICK—A plastic ruler with a level bubble in it. This tool is lightweight and easy to use when establishing plumb lines and when cutting.

MISMATCH—Point where a full strip meets a partial strip, typically placed behind a door or in an inconspicuous spot. Few rooms can be covered without one partial strip—the math just doesn't come out that way very often.

RAZOR KNIFE—A small, lightweight knife used for trimming wallcovering. Tip of blade can be snapped off to renew tip.

SMOOTHING BRUSHES—Tools used to press wallpaper onto wall. Short-nap brushes are best for vinyl wallcoverings. Brushes with a long, soft nap are used for fragile wallcoverings, such as grasscloth.

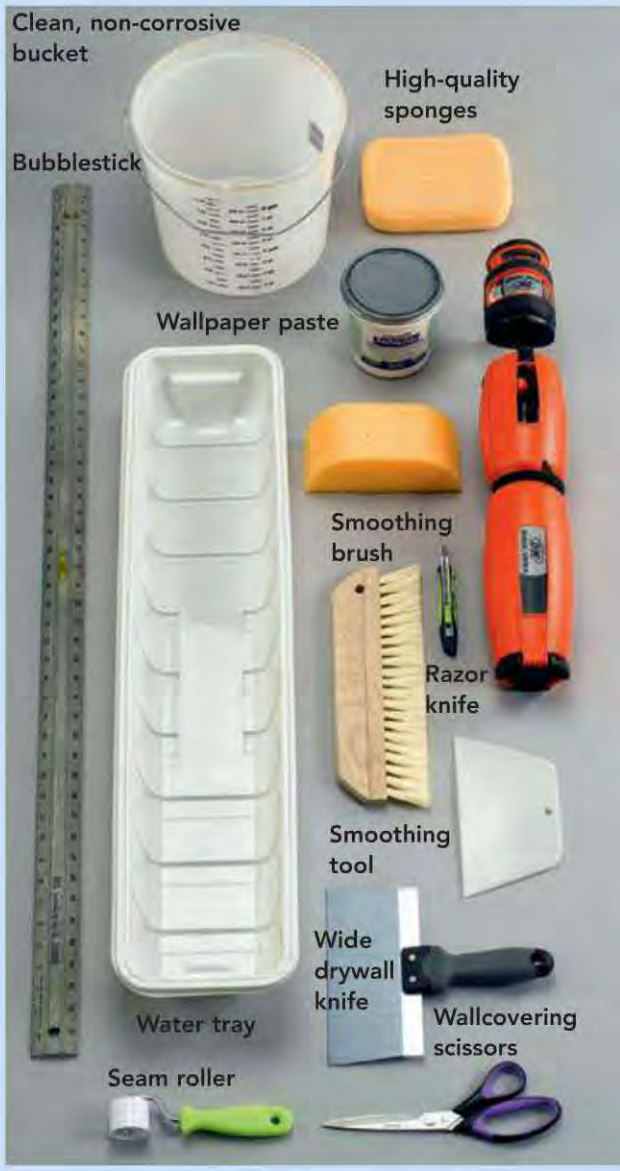
SMOOTHING TOOL—A lightweight piece of plastic used to smooth out bubbles in wallcovering.

Successful wallcovering projects start with careful planning. The mismatch should be placed in an inconspicuous area, such as behind a door. The actual hanging starts at a focal point, such as a fireplace or large window. In rooms that don't have an obvious focal point, it starts at the corner farthest from the entry. The wallcovering should always overlap at the corners: at least ½" on inside corners and 1" on outside corners.

Each strip should start with a full pattern at the ceiling line and should overlap both the ceiling and baseboard by about 2" so it can be trimmed precisely during the hanging process.

Turn off the power to the circuit in the room and remove covers on receptacles and switches before starting a wallcovering project.

TOOLS & SUPPLIES YOU NEED



SKILLS YOU NEED

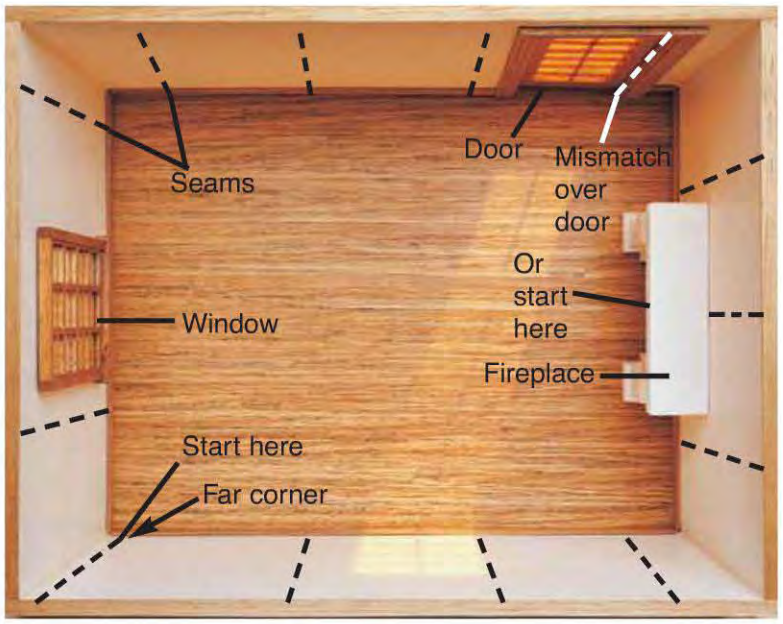
- Measuring accurately
- Establishing plumb lines
- Cutting accurately

DIFFICULTY LEVEL

Allow at least one full day per room.

HOW TO CREATE A HANGING PLAN

1 Measure the room and create a sketch of the hanging plan. Center a plumb line on a focal point, such as a fireplace or window, and sketch out a plan in both directions from the center line.

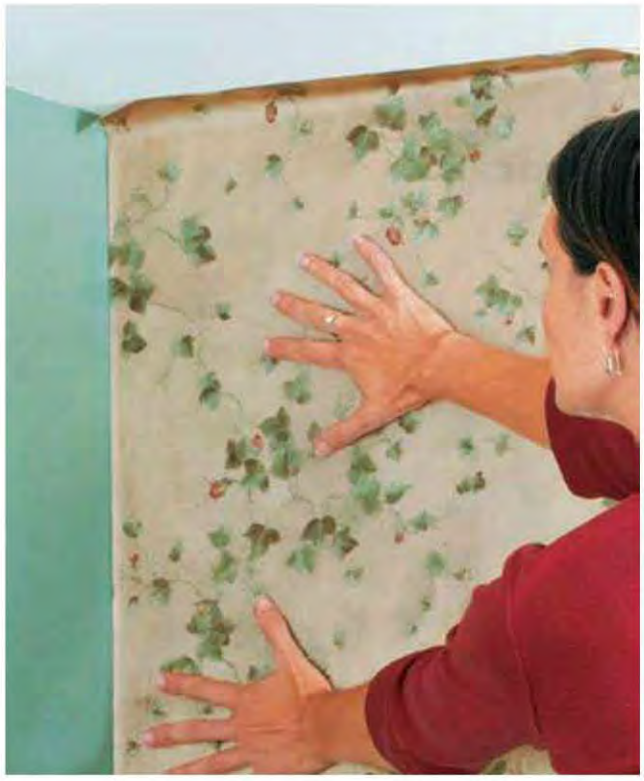


2 If the room doesn't have an obvious focal point, start at the corner farthest from the entry, measure a distance equal to the width of the wallcovering and mark a point. Work in both directions, marking the points where seams will fall.

3 Adjust the hanging plan for corners that fall exactly on seam lines. Make sure the wallcovering will overlap at least ½" on inside corners and 1" on outside corners.

4 Adjust for seams that fall in difficult locations, such as near the edges of windows or doors. Shift the starting point so the seams leave workable widths of wallcovering around obstacles.

HOW TO PREPARE WALLCOVERING STRIPS



1 Hold the wallcovering against the wall so there is a full pattern at the ceiling line and the strip overlaps both the ceiling and the baseboard by at least 2". Cut the strip to length, using scissors.

2 Fill a water tray half full of lukewarm water. Roll the cut strip loosely with the pattern side in. Soak the roll in the tray as directed by the manufacturer, usually about one minute, to activate the prepasted adhesive.

3 Hold up a second strip and find the pattern match with the previously hung strip. Measure and cut the new strip with about 2" of excess at each end.

TIP

If wallpaper can be "booked" (check manufacturer's directions), fold each end of the strip to the center, with the pasted side in. Do not crease the folds. Let the strip cure for about 10 minutes.

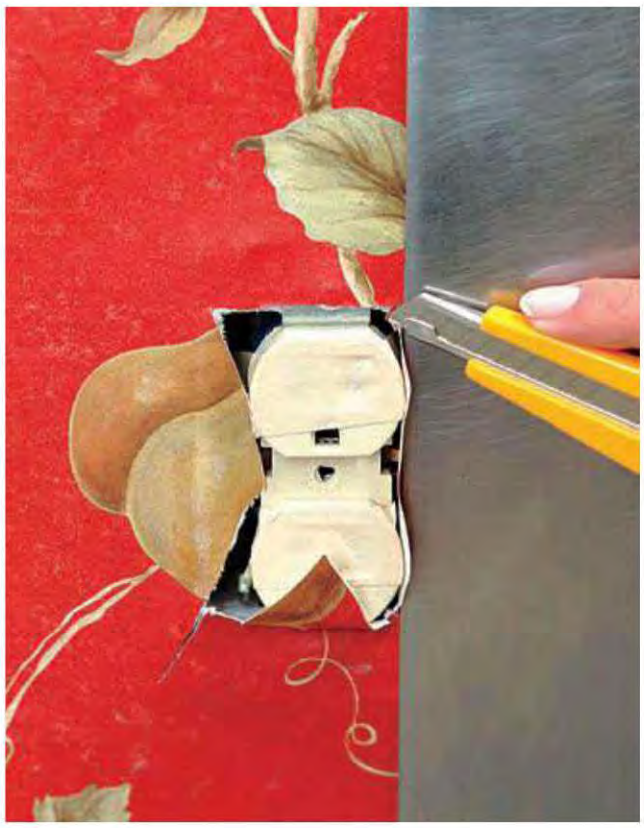
1 From the starting point shown in your hanging plan, measure a distance equal to the width of the wallcovering minus ½" and mark a point. Draw a vertical plumb line from the ceiling to the floor, using a bubblestick or level.

2 Cut and prepare the first strip (see page 387). Unfold the top portion of the booked strip and position it against the plumb line so the strip extends beyond the ceiling joint by about 2".

3 At the corner fold line, snip the top of the strip so the wallcovering wraps around the corner without wrinkling. Using your open palms, slide the strip into position with the edge butted against the plumb line. Smooth the strip with a smoothing brush.

4 Unfold the bottom of the strip. Use your open palms to position it against the plumb line. Smooth the strip with a smoothing brush, carefully pressing out any bubbles.

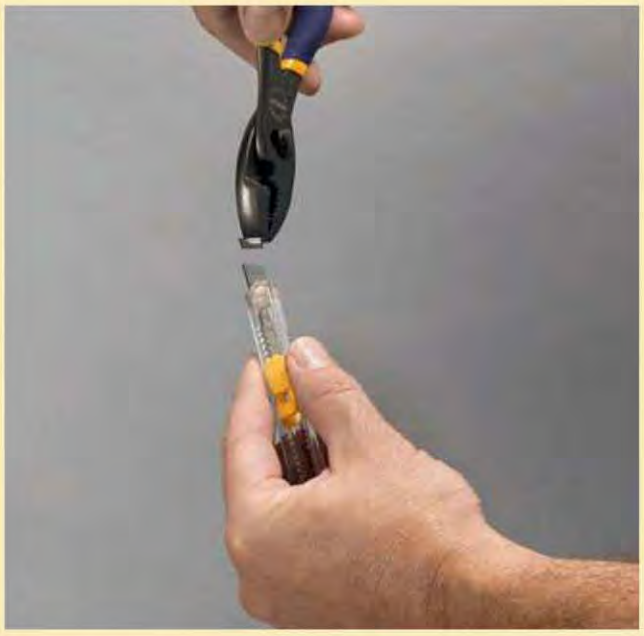
5 Trim the excess wallcovering at the ceiling and baseboard, using a drywall knife and a utility knife. With clean water and a sponge, rinse any adhesive from the surface of the wallcovering.



7 Where wallcovering covers receptacle or switch boxes, use a razor knife to make small diagonal cuts to expose the box. Finally, trim the paper to the edges of the box. Note: Turn off power to the circuit and remove switch and receptacle covers before starting the project.

6 Hang additional strips, sliding strips into place so the pattern matches exactly. Let the strips stand for about half an hour, then roll the seams with a seam roller. (On embossed or fabric wallcoverings, set the seams with a smoothing brush.)

TOOL TIP



Dull blades tear wallcovering rather than cutting it cleanly. To renew the blade on a disposable razor knife, break the tip away. For safety, grasp the blade with pliers and bend down until the old tip of the blade breaks away at the scored line.

HOW TO HANG WALLCOVERING AROUND AN INSIDE CORNER

1 Cut and prepare a full strip. While the strip cures, measure from the edge of the preceding strip to the corner at several points; add ½" to the longest of these measurements. Make sure the edges of the booked strip are aligned perfectly, then mark this distance near the top and bottom of the booked strip. Hold a straightedge against the marks and cut the strip.

2 Position the strip. Make corner slits at the top and bottom of the strip to wrap the overlap around the corner without wrinkles. Smooth the strip with a smoothing brush, then trim the excess at the ceiling and baseboard.

3 Measure a distance equal to the remainder of the strip you cut in step 1, and mark a point equal to this measurement. At this mark, draw a plumb line from the ceiling to the floor on the next wall.

4 Position the strip on the wall with the cut edge in the corner and the uncut edge against the plumb line drawn in step 3. Smooth and trim the strip. If the wallcovering is vinyl, peel back the edge and apply a bead of vinyl-on-vinyl adhesive to the lapped area. Press the seam flat and let it cure before rolling the seams.

HOW TO HANG WALLCOVERING AROUND DOORS AND WINDOWS

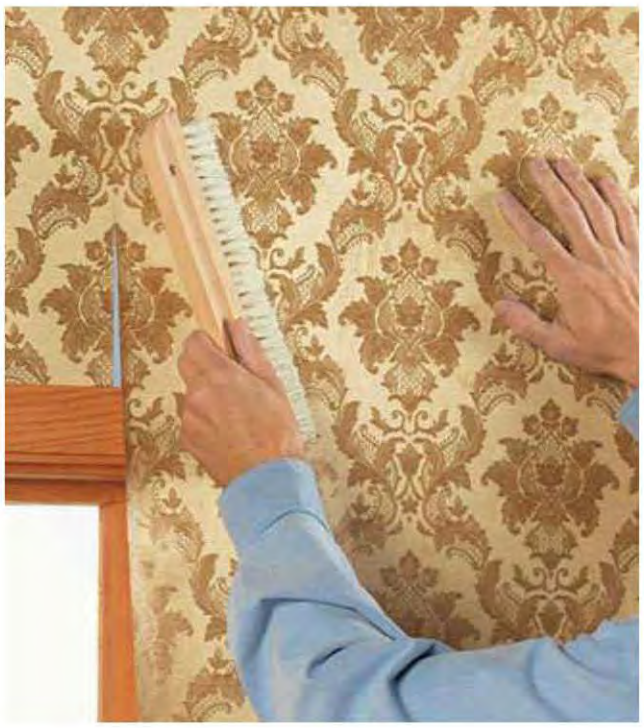
1 Position the strip on the wall as usual, running the wallcovering over the window or door. Smooth the wallcovering, pressing the strip tightly against the case molding.

2 Use scissors to make diagonal cuts at the corners of the casings. Trim away excess wallcovering to about 1" around the inside of the frame.

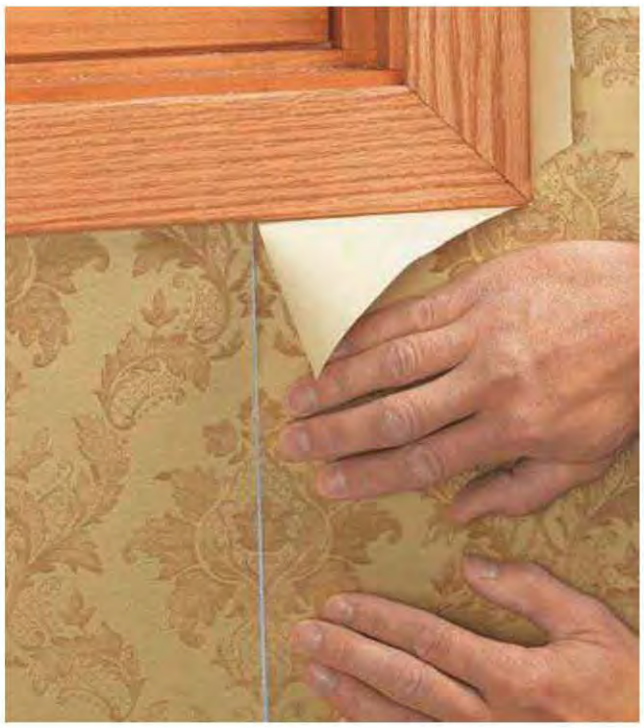
3 Hold a drywall knife and use a razor knife to trim the strip.

4 Cut short strips to hang above (and below, if this is a window) the opening. Check your scraps to see whether any will fill the space while maintaining the repeat of the pattern.

HOW TO HANG WALLCOVERING AROUND DOORS AND WINDOWS (CONTINUED)



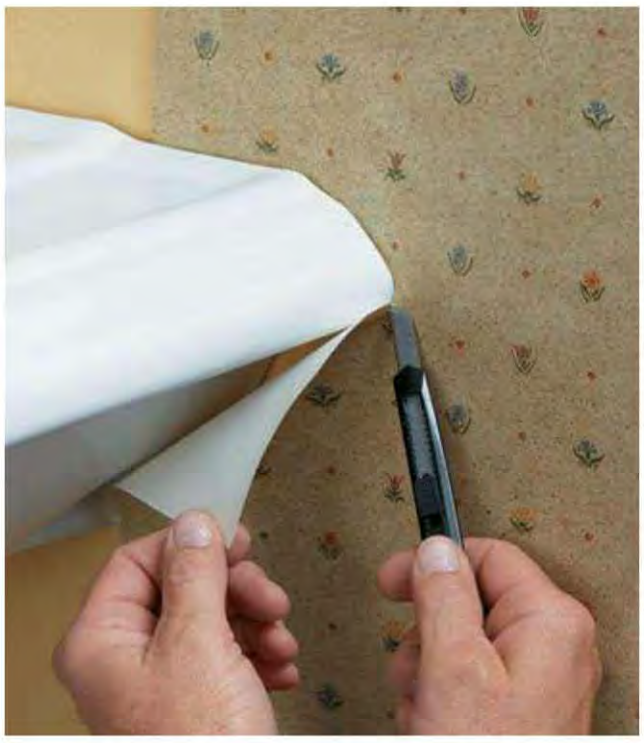
5 At the other side of the opening, position a strip and smooth it into place. Snip the corner diagonally and trim away excess as described in step 2 above.



6 Match the pattern at the seam on the bottom half and slide the strip into place. Trim the excess as described in steps 2 and 3 above. Rinse the wallcovering and casings, using a damp sponge.

HOW TO HANG WALLCOVERING AROUND A WALL-MOUNTED SINK

1 Cut and position the strip, brushing it up to the edge of the sink. Cut slits in the wallcovering, leaving a ¼" overlap around the edges of the sink.



2 Trim the wallcovering around the sink, leaving a slight overlap. Smooth the strip, tucking the overlap into a gap around the sink, if possible. Or, neatly trim the overlap.

HOW TO HANG WALLCOVERING AROUND A PIPE

1 Pull the escutcheon plate out from the wall. Hold the strip against the wall so the pattern matches the previous strip. From the closest edge of the strip, cut the slit to reach the pipe.

2 Press the strip flat up to the pipe with a smoothing brush.

3 Cut a hole at the end of the slit to fit around the pipe. Butt the edges of the slit together and brush them smooth.

HERE'S HOW

Cutting slits in your favorite wallpaper may feel intimidating at first. It gets easier with time, especially if you take the time to make the slits along a pattern line, which helps disguise them.

Outdoor Projects

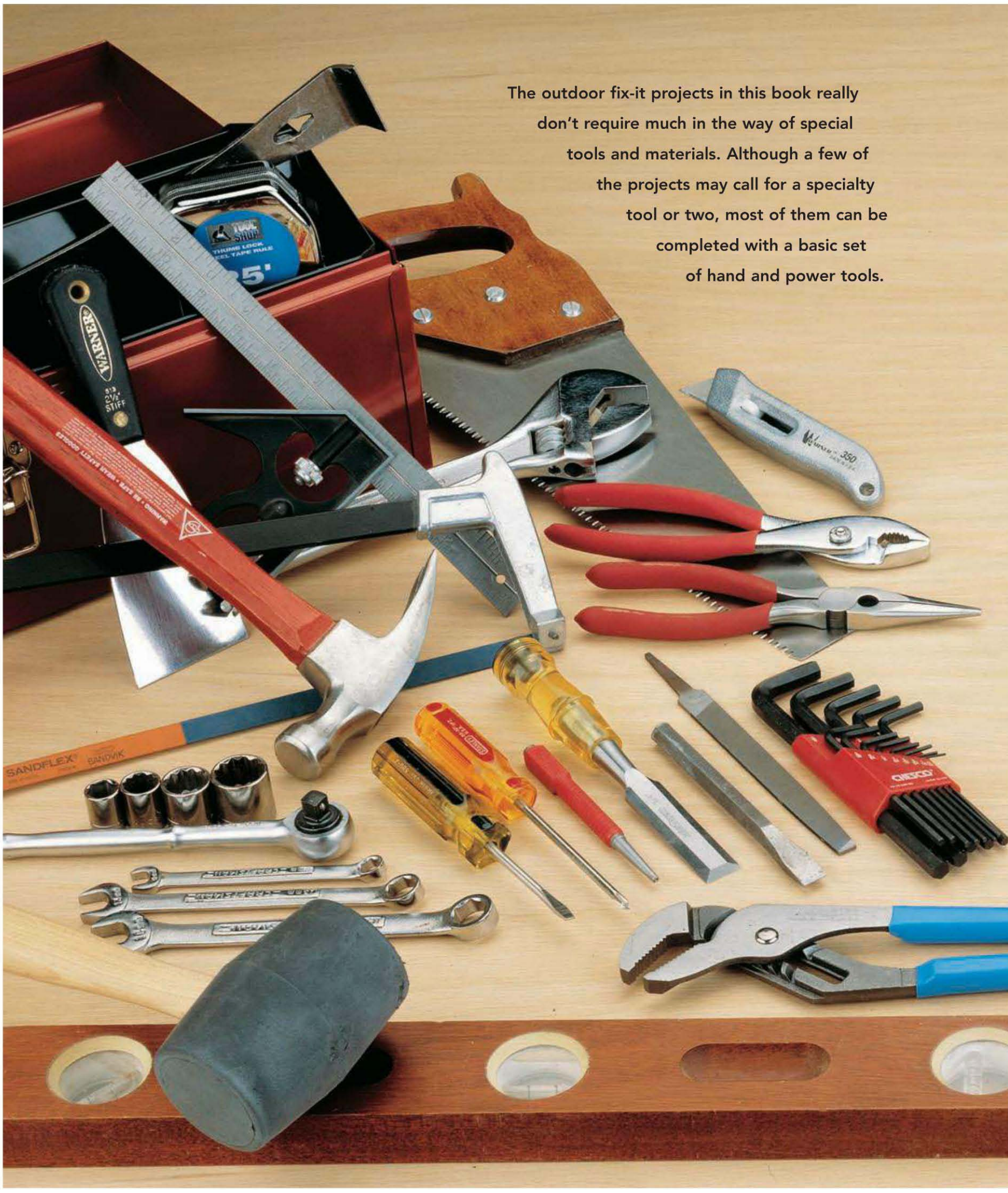
THOUGH THEY'RE NOT ALWAYS THE FLASHIEST PROJECTS, REPAIRS TO THE EXTERIOR WALLS, ROOF, FOUNDATION, WINDOWS, SIDING, AND DOORS ARE AMONG THE MOST IMPORTANT YOU CAN DO. NEGLECT THEM, AND YOUR HOUSE BECOMES SUSCEPTIBLE TO DETERIORATION FROM THE OUTSIDE IN; DO THEM DILIGENTLY AND YOUR HOME WILL PROVIDE A SECURE AND COMFORTABLE LIVING PLACE FOR YOU AND YOUR FAMILY FOR YEARS TO COME (AND THE NEIGHBORS WILL APPRECIATE YOUR WORK, TOO).

In this section you'll learn how to repair and maintain your home to prevent and fix damage caused by the outside elements. Like all other sections in this book, the projects here can help you even if you know nothing at all about home repairs or improvements. All the information you'll need to get the job done is right here.

IN THIS CHAPTER:

- ❑ Before You Begin
  - Outdoor Tool Kit
- ❑ Clearing Clogged Gutters
- ❑ Touching Up Exterior Paint
- ❑ Fixing Sliding Screen Doors
- ❑ Installing Storm Doors
- ❑ Tuning Up Double-Hung Windows
- ❑ Exterior Caulking
- ❑ Pestproofing
- ❑ Fixing Concrete Walkways
- ❑ Repairing Asphalt Driveways
- ❑ Fixing Broken Glass Panes
- ❑ Repairing Concrete Steps
- ❑ Repairing Siding
- ❑ Repairing Stucco
- ❑ Renewing Wood Decks
- ❑ Replacing Damaged Roof Shingles
- ❑ Installing Locksets & Deadbolts
- ❑ Tuning Up Garage Doors
- ❑ Installing House Gutters
- ❑ Installing Landscape Lighting
- ❑ Pressure Washing a House

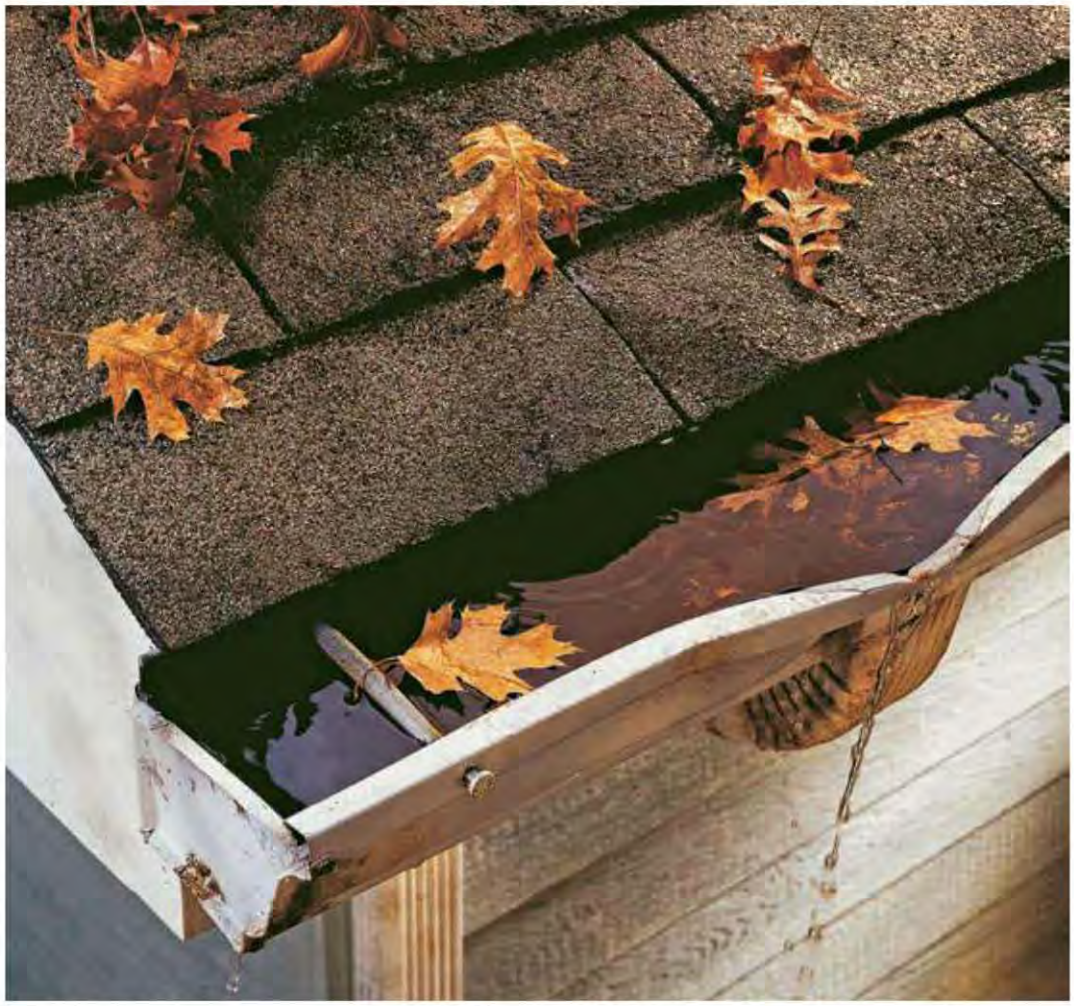
Before You Begin: Outdoor Tool Kit



The outdoor fix-it projects in this book really don't require much in the way of special tools and materials. Although a few of the projects may call for a specialty tool or two, most of them can be completed with a basic set of hand and power tools.

The group of tools shown here is a collection that will put you well on your way to doing the projects in this book, as well as most general carpentry repair projects around the house. But don't worry if you don't yet own them. You can gradually assemble your tool kit as you take on project after project. Or, you can borrow them from a neighbor or friend as you need them.

1 Clearing Clogged Gutters

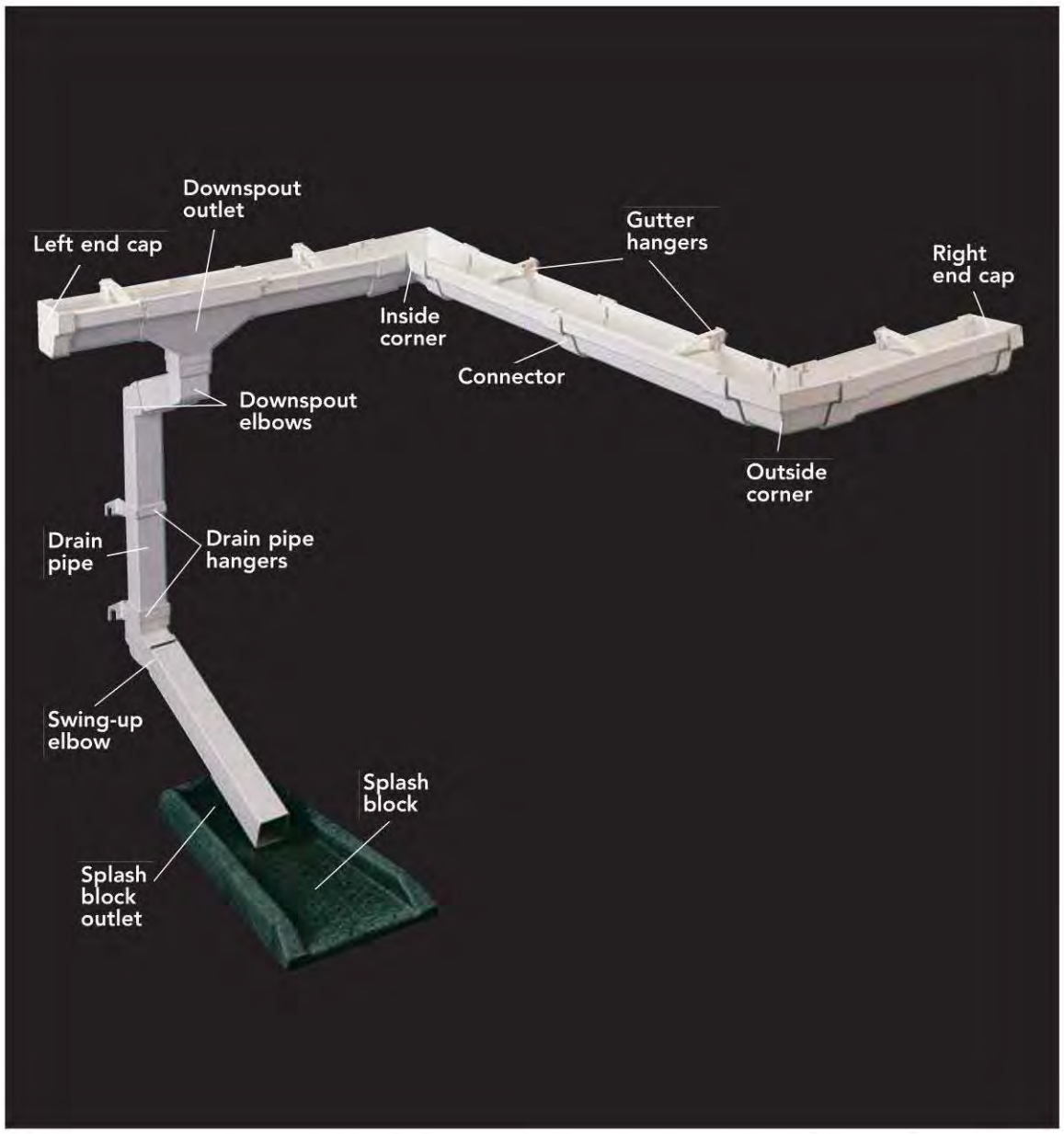


Gutter systems play a critical role in protecting both the exterior and interior of your house. By catching runoff water from the roof, gutters keep the siding dry. They also prevent water from pooling around the foundation—the most common cause of wet basements.

THE IDEA BEHIND GUTTERS IS SIMPLE: JUST COLLECT THE RAINWATER THAT FALLS ON A ROOF AND DIVERT IT FROM THE FOUNDATION OF THE HOUSE. Ironically the root cause of gutter dysfunction is rarely the water itself. Instead it's the leaves and twigs that get trapped in the gutters and clog the downspouts. When these exits are blocked, the water runs over the lip of the gutter and falls exactly where you don't want it to fall: next to the foundation. Clogged gutters lead to stained siding in the summer and ice dams in the winter. The solution is obvious: clean the gutters a couple of times a year.

Cleaning gutters means working from ladders. To do the job right, lean an extension ladder against the house (with rubber ladder end guards to protect the siding) or against the roof (using a ladder stabilizer). Climb up with a garden hose and bucket in hand. If there's just a little bit of debris, try washing it out with the garden hose. But heavy congestion has to be removed by hand. A putty knife is a good tool for this job. Just lift out the mess and put it in the bucket. To free clogged downspouts, push a garden hose down the pipe and run the water at full force until the clog breaks loose and the pipe is clear.

GUTTERS 101



Clogs can occur anywhere in a gutter system, but the most likely trouble spots are at the downspout outlets and in the drain pipe.

TERMS YOU NEED TO KNOW

END CAPS—Placed at the end of gutter runs.

INSIDE/OUTSIDE CORNERS—Used on corners with no water outlet to carry water around a corner.

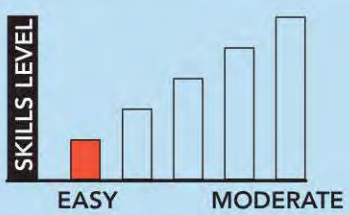
DOWNSPOUT OUTLETS—Should be placed at least every 35 feet.

DRAIN PIPE HANGERS—Should use at least two per drain pipe.

DOWNSPOUT ELBOWS—Recommended three per downspout.

TOOLS & SUPPLIES YOU NEED

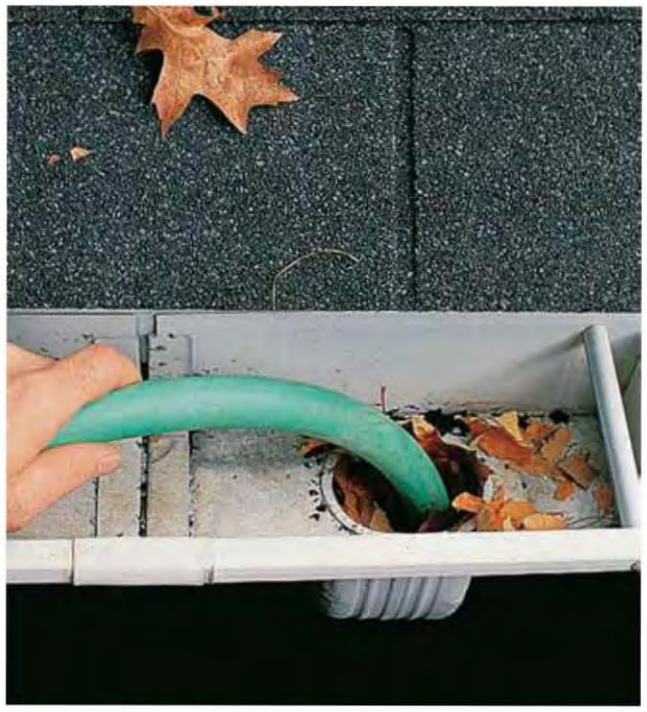
DIFFICULTY LEVEL



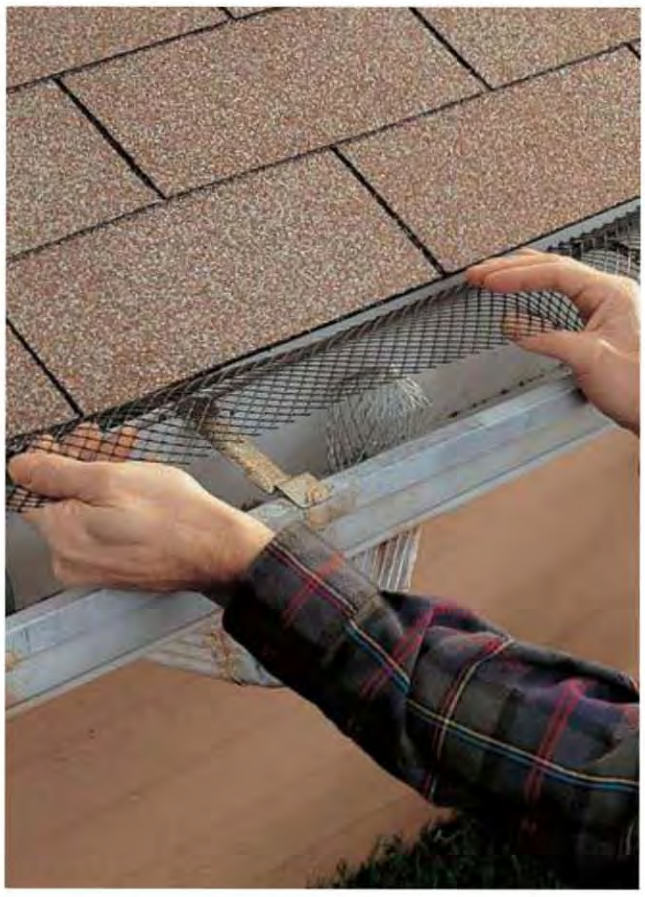
This project can be completed in 4 to 6 hours.

HOW TO CLEAN & REPAIR CLOGGED GUTTERS

1 Clean dense debris from gutters using a putty knife or a narrow drywall knife. Put the debris in a bucket instead of dropping it on the ground.

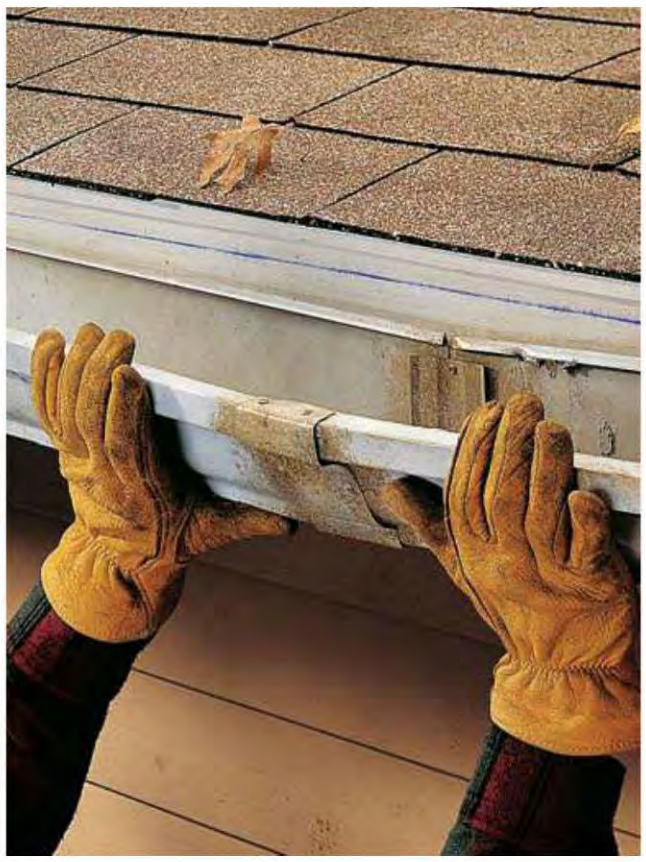


2 Stubborn clogs in downspouts can be loosened and flushed away with a garden hose. Just push the end of the hose down the pipe and turn on the water full blast.



3 If your gutter collects a lot of leaves and frequently clogs the downspouts, slide a ball-shaped screen into the top of each pipe or cover the entire gutter with a protective screen.

4 Leaky joints between sections of gutter or at downspout connections can be patched with gutter seal. Just clean out any debris, dry the seam, and fill it well with sealer. Smooth the bead with your fingertip or a putty knife.



5 To straighten a sagging gutter, remove hangers or spikes in the sagging area. Snap a chalkline at the correct height, raise the gutter to the line, and then reinstall the hangers.

7 Splash blocks are designed to direct water from the downspouts away from the house foundation. If you have these blocks, make sure they're positioned directly under the downspouts. If you don't have the blocks, buy and install them.

6 To straighten gutters that are supported with hanging brackets, loosen the brackets, lift the gutter and reinstall the brackets.

FYI

A folding extension is a gutter accessory that mounts on the bottom on a downspout and works like a splash block to send the water away from the house. Because it's hinged, the pipe can be folded up out of the way when mowing or working in planting beds next to the house.

2 Touching Up Exterior Paint

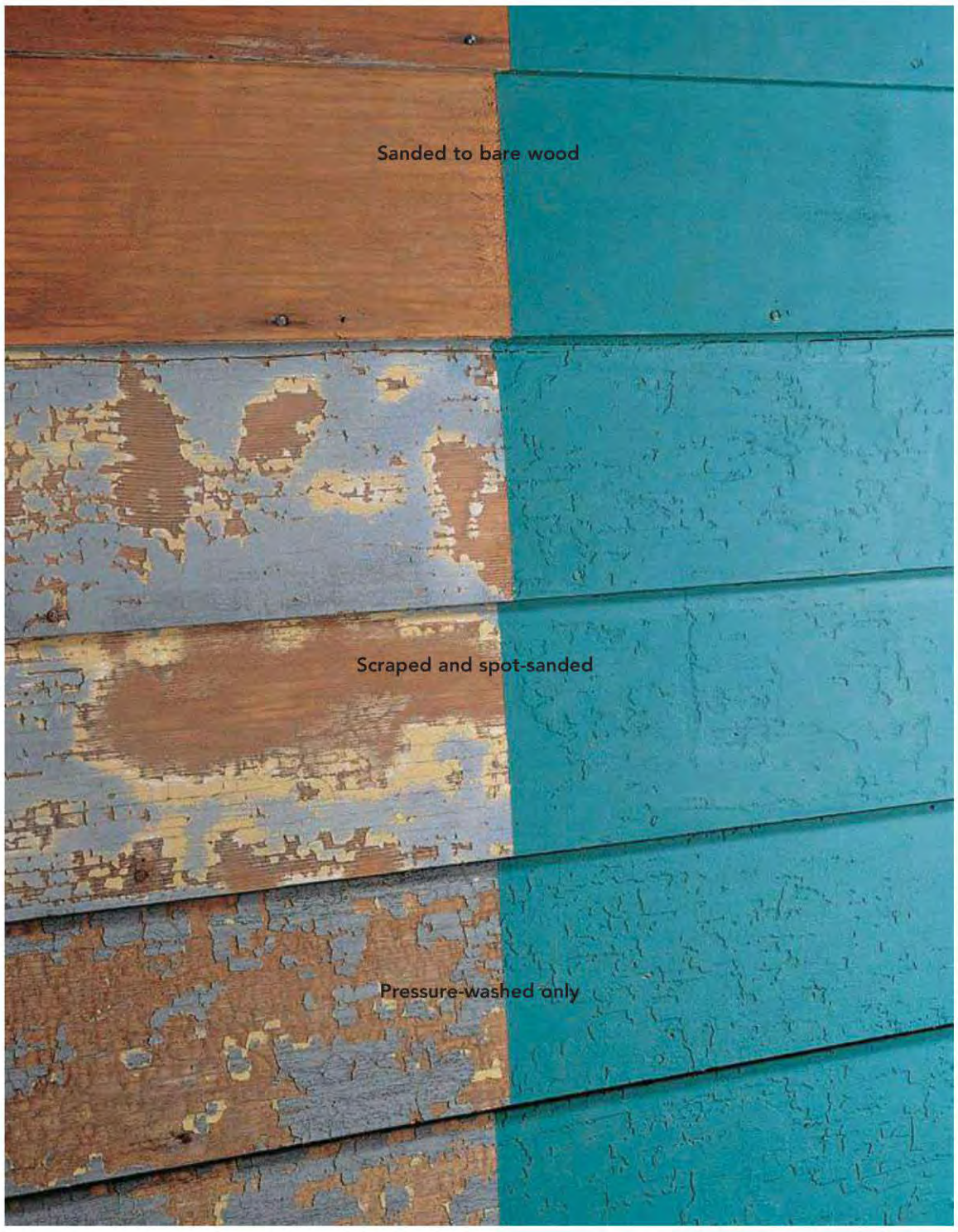
Few projects will go further than touching up painted siding when it comes to freshening up the appearance of your house.

IF YOU OWN A HOUSE WITH A PAINTED EXTERIOR, YOU ALREADY KNOW ABOUT PERPETUAL MAINTENANCE. It goes something like this. You painted your house the year your daughter graduated from eighth grade. It was a big deal because you had to get it done between her end-of-school party (in your backyard) and the family reunion in August (also in your backyard). Of course you spent your whole vacation doing it, except for the two days when nearly every in-law asked why you didn't hire a professional to do the job. Sometimes doing the right thing doesn't seem like the right thing to do.

But once the job was done, you enjoyed (for about three years) not thinking about paint. Then it started. At first it was just a little flaking along the bottom edge of the fascia. Then it spread to the window casing boards and the top edge of the water table, behind the bushes. Suddenly, it became clear that the whole house would need repainting just when your daughter would be graduating from high school. Talk about perpetual maintenance.

Unfortunately, there's no happy ending to this dark story. But there is a way to protect your flank while retreating: routine paint touch-ups. If you fix the little things when they go bad, you can easily postpone a major repainting for several years. And every summer without drop cloths and extension ladders is a blessing to be counted by all.

SANDING SIDING 101



The amount of surface preparation you do will largely determine the final appearance of your paint job. Decide how much sanding and scraping you're willing to do to obtain a finish you'll be happy with.

TERMS YOU NEED TO KNOW

CAR-WASHING BRUSH—A common automotive maintenance tool that consists of a soft-bristle brush mounted on the end of a wand made of aluminum tubing. The wand attaches to a garden hose.

FLAP SANDER—An accessory designed for electric drills made of narrow pieces of abrasive paper attached to a steel arbor. The drill turns the arbor and paper in a rotary motion.

TOOLS & SUPPLIES YOU NEED

DIFFICULTY LEVEL

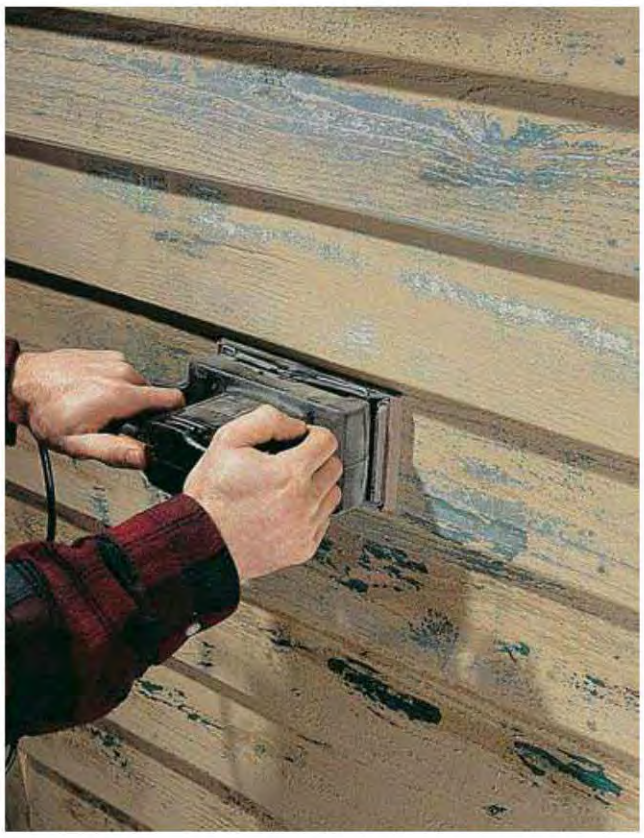
This project can be completed in five to seven days.

1 Wash your siding with an inexpensive hose-mounted brush, such as a car-washing brush. Work from the top of the wall to the bottom. Use household detergent on tough spots and rinse all soapy areas thoroughly.

2 Scrape away peeling paint with a paint scraper. Don't gouge the wood, and be sure to change (or sharpen) the scraper blade frequently to make the work go faster.

3 Use 100-grit sandpaper over a sanding block to smooth the scraped areas. Feather the edges so they match the surrounding surface.

4 Use a flap sander mounted in an electric drill (or a cordless drill for very quick jobs) to remove peeling paint from curved surfaces. This tool works on both concave and convex boards.



5 On larger scraped areas, use an electric sander to smooth the surface. Use 100-grit sandpaper and be sure to brush the sanding dust off the siding or trim when you're done.

7 Prime and then paint all sanded areas. And, try not to over-brush. Because paint tends to fade over time, your touch-ups will look brighter than the original paint covering. Keeping their size as small as possible will make them less noticeable.

6 Fill any cracks between the siding and the door and window trim using a caulk gun and paintable, exterior caulk. Fill deep cracks in a couple of passes to keep the caulk from smearing on the siding.

8 Try to remove any paint splatters from window glass before they dry. Once the paint hardens it's much harder to remove.

3 Fixing Sliding Screen Doors

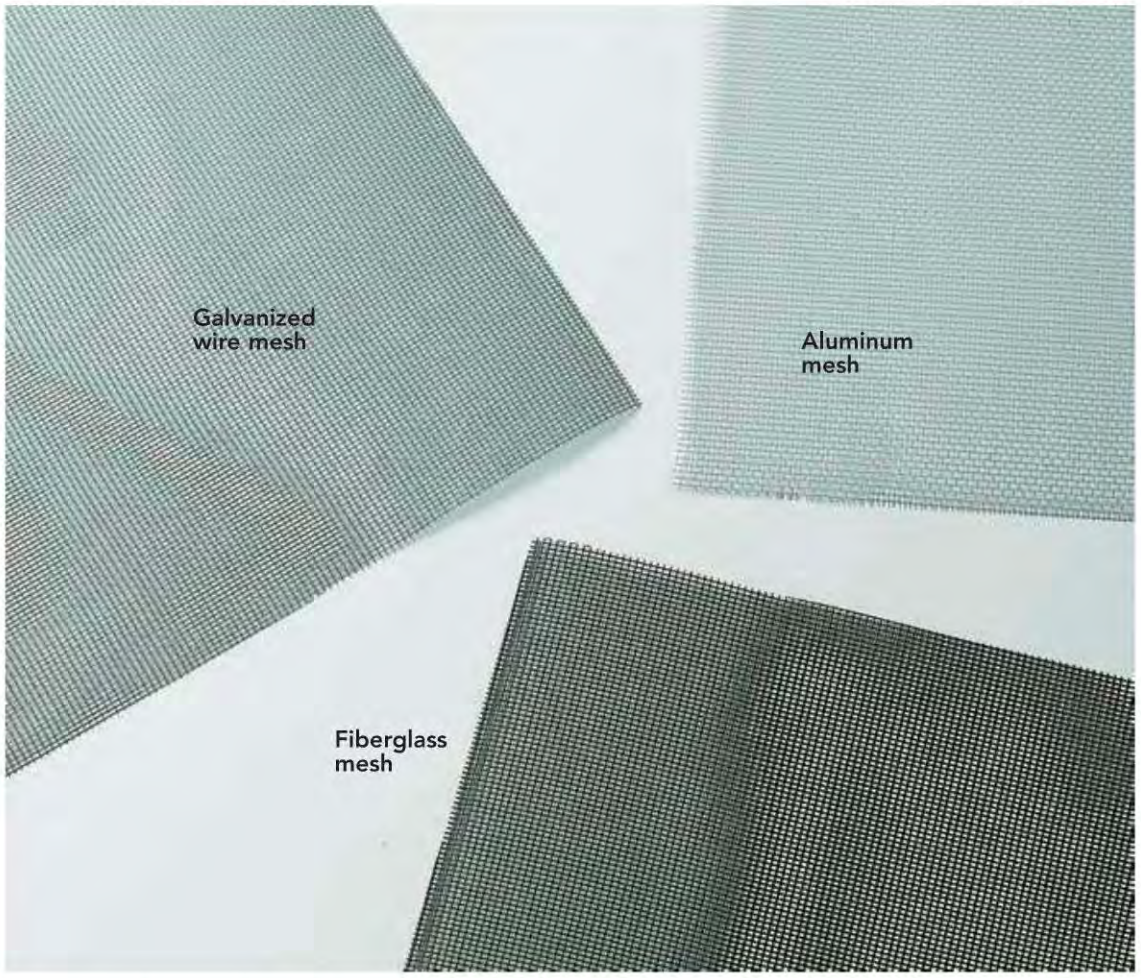
Screen doors are extremely vulnerable to damage from feet, pets and a host of other hazards. But fixing them is a breeze.

SLIDING GLASS DOORS ARE MOSTLY GOOD THINGS. They let in a lot of light and when the sliding panel is open, they let in a lot of air. And, because all these doors have sliding screens, the air they let in is reasonably bug free. The problem is, the large screen easily falls victim to pets and children and often needs repair.

To replace the screen, you need to remove the screen door panel. It is held in grooves by four spring-loaded wheels, one at each corner of the door. It is nearly impossible, and very frustrating, to try to replace a screen with the panel in place. The screen is held in place with a flexible plastic spline cord which you can easily pull out.

Take a short section of the old spline to a hardware store or home center and buy new spline material that matches the diameter of the old one. Also buy replacement screening and an installation tool that is designed for the size of spline you are installing. These tools come with a roller on both ends. One is convex shaped and is used to forced the screen into the door groove. The other roller has a concave edge to force the spline over the screen.

WINDOW SCREENING 101



Window screening (technically, it's called insect mesh) is woven from three different materials: galvanized wire, aluminum wire and black fiberglass strands. Each has its advantages and drawbacks: galvanized wire is inexpensive and easy to find, but can become misshapen or rusty; aluminum is less common, but it is strong and won't discolor as easily; fiberglass is easy to work with and won't rust or corrode, but it is prone to tearing. The best advice is simply to buy screening that matches the windows on the rest of your house.

TERMS YOU NEED TO KNOW

SPLINE—For sliding screen doors, a flexible plastic material (round in cross section) that holds screening tight in door grooves. Sold in long strings and sized to fit different width grooves.

SPLINE ROLLER—A specialty tool designed to force spline cords into the spline channel of the screen frame.

TOOLS & SUPPLIES YOU NEED

DIFFICULTY LEVEL

This project can be completed in two to three hours.

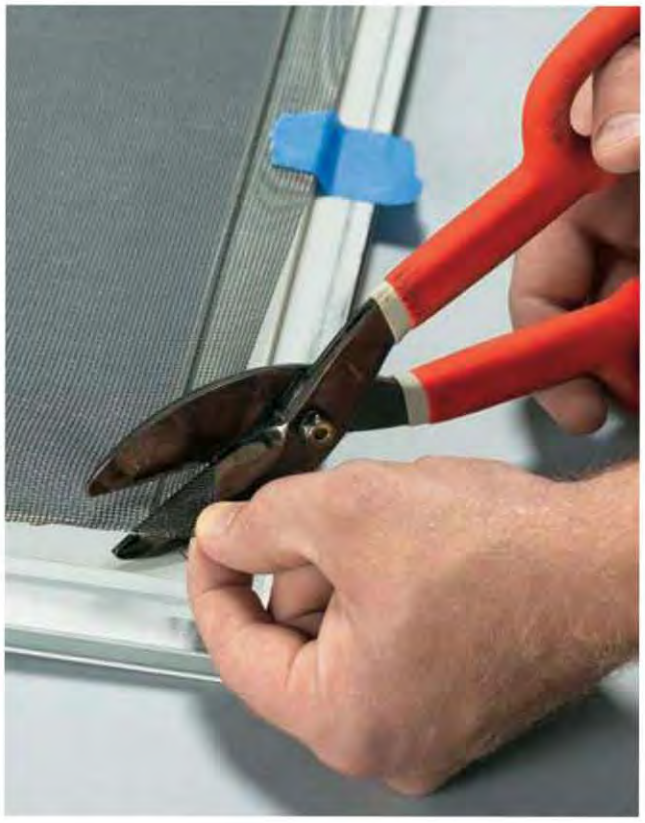
HOW TO FIX A SLIDING SCREEN DOOR

1 You can't remove the screen door until you release the tension on the roller wheels. Back off the adjustment screws, then lift the door out of the channel that holds it captive.

2 Remove the door rollers using a screwdriver. Sometimes these rollers can just be pried out. Other times you'll have to remove a small screw.

3 Clean the rollers with mineral spirits and an old paint brush. Once all the dirt and grime is removed, dry the rollers and lubricate them with light oil.

4 Pry up one corner of the old spline and then gently pull it out of the screen channel. If this plastic spline is still soft and flexible, it can be reused for the new screen.



5 Tape the new screen onto the door frame with masking tape. Then make a diagonal cut at each corner to remove the excess screen. This will keep the screen from bulging at the corner when it is pressed into its channel.

6 Force the screen into the door groove using the convex wheel on the spline roller installation tool. Don't force the screen in with a single pass. Rather, make several lighter passes until the screen reaches the bottom of the channel.

7 Once the screen is in the channel, install the spline material. Use the concave wheel and work slowly to make sure the spline is forced all the way into the channel. Several passes may be required.

8 Trim off any excess screening with a sharp utility knife. Do not cut the spline. Reinstall the wheels and replace the panel in the door.

4 Installing Storm Doors

A quality storm door helps seal out cold drafts, keeps rain and snow off your entry door, and lets a bug-free breeze into your home when you want one.

STORM DOORS PROTECT THE ENTRY DOOR FROM DRIVING RAIN OR SNOW. They create a dead air buffer between the two doors that acts like insulation. When the screen panels are in place, the door provides great ventilation on a hot day. And, they deliver added security, especially when outfitted with a lockset and a deadbolt lock.

If you want to install a brand new storm door or replace an old one that's seen better days, your first job is to go shopping. Storm doors come in many different styles to suit just about anyone's design needs. And they come in different materials, including aluminum, vinyl, and even fiberglass. (Wood storm doors are still available but not in preassembled form.) All these units feature a pre-hung door in a frame that is mounted on the entry door casing boards. Depending on the model you buy, installation instructions can vary. So be sure to check the directions that came with your door before starting the job.

STORM DOORS 101

DOOR CLOSERS—Storm doors are relatively lightweight and because they open outward they are susceptible to catching the wind and becoming damaged. For this reason, a storm door should be equipped with a spring-protected safety chain at the top and a pneumatic closer that can be located anywhere on the door (usually about handle level).

TERMS YOU NEED TO KNOW

DOOR JAMBS—The boards that line the rough opening of the doorway. The door swings between them and the hinges and strike plate are mounted on them.

DOOR CASING BOARDS—Boards that are nailed to the jambs and the wall surrounding any door opening. They lay flat against the wall covering inside, and flat against the wall sheathing on the outside.

TOOLS & SUPPLIES YOU NEED

DIFFICULTY LEVEL

This project can be completed in six to eight hours.

HOW TO INSTALL A STORM DOOR

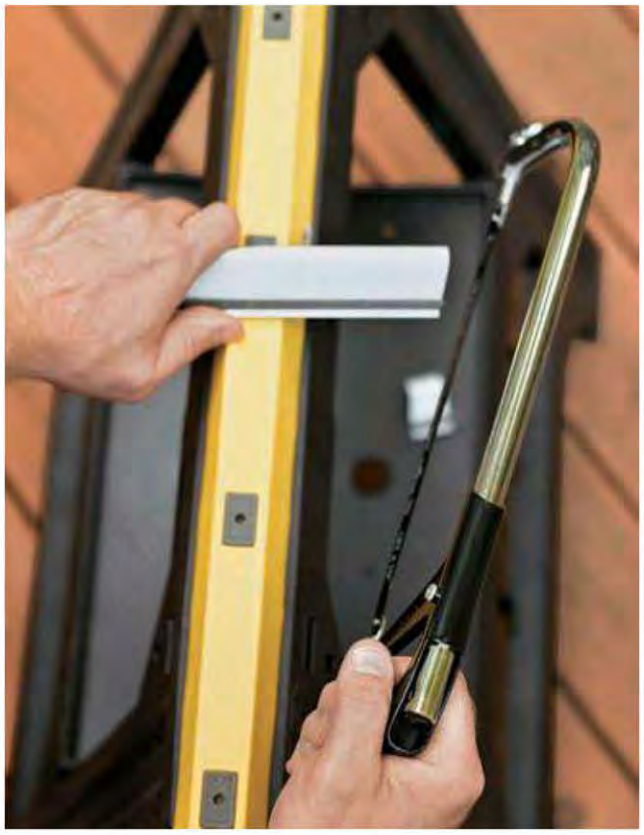
1 Test fit the door in the opening. If it is loose, add a shim to the hinge side of the door. Cut the piece with a circular saw and nail it to the side of the jamb, flush with the front of the casing.

2 Install the rain cap at the top of the door opening. The directions for the door you have will explain exactly how to do this. Sometimes it's the first step, like we show here; sometimes it's installed after the door is in place.

3 Measure the height of the opening and cut the hinge flange to match this measurement. Use a hacksaw and work slowly so the saw won't hop out of the cut and scratch a visible area of the hinge.

4 Lift the door and push it tightly into the opening. Partially drive one mounting screw near the bottom and another near the top. Check the door for plumb, and when satisfied, drive all the mounting screws tight to the flange.

5 Measure from the doorway sill to the rain cap to establish the length of the latch-side mounting flange.



6 Cut the latch-side flange with a hacksaw. Work carefully so you don't pull out the weather-stripping from the flange channel as you cut.

7 Install the latch-side flange with a couple of partially-driven screws. Then check that the opening width is the same at the top, middle and bottom. When you're satisfied that that this flange is parallel to the hinge flange, install all the mounting screws securely.

8 To install the door sweep, slide it over the bottom of the door and install its mounting screws loosely. Make sure the sweep forms a tight seal with the sill, then tighten the screws.

9 Install the lockset by pushing the outside half of the unit into the mounting holes from the outside of the door. Hold it in place with masking tape.

10 Mount the other half of the lockset on the inside of the door. Just line up the screws and push them into the threaded tubes on the outside half of the unit. Tighten the screws securely.

11 Install the deadbolt in the same way you installed the lockset. Slide the outside half in first and then add the inside half and tighten the mounting screws.

12 Install the strike plates for both the lockset (shown here) and the deadbolt locks. These plates are just screwed to the door jamb where the lock bolt and deadbolt fall (see pages 462 to 467).

13 Begin installing the door closer by screwing the jamb bracket in place. Most of these brackets have slotted screw holes so you can make minor adjustments without taking off the bracket.

14 Install the door closer bracket on the inside of the door. Then mount the closer on the jamb bracket and the door bracket. Usually the closer is attached to these with some form of short locking pin.

15 Adjust the automatic door closer so it closes the door completely without slamming it. The adjustment is usually made by turning a set screw in and out with a screwdriver.

16 Some doors feature a storage compartment for the glass sash and the screen sash between the bottom panels of the door. To change sashes, just unlock one and slide it down. Then pull up the other and lock it in place.

5 Tuning Up Double-Hung Windows

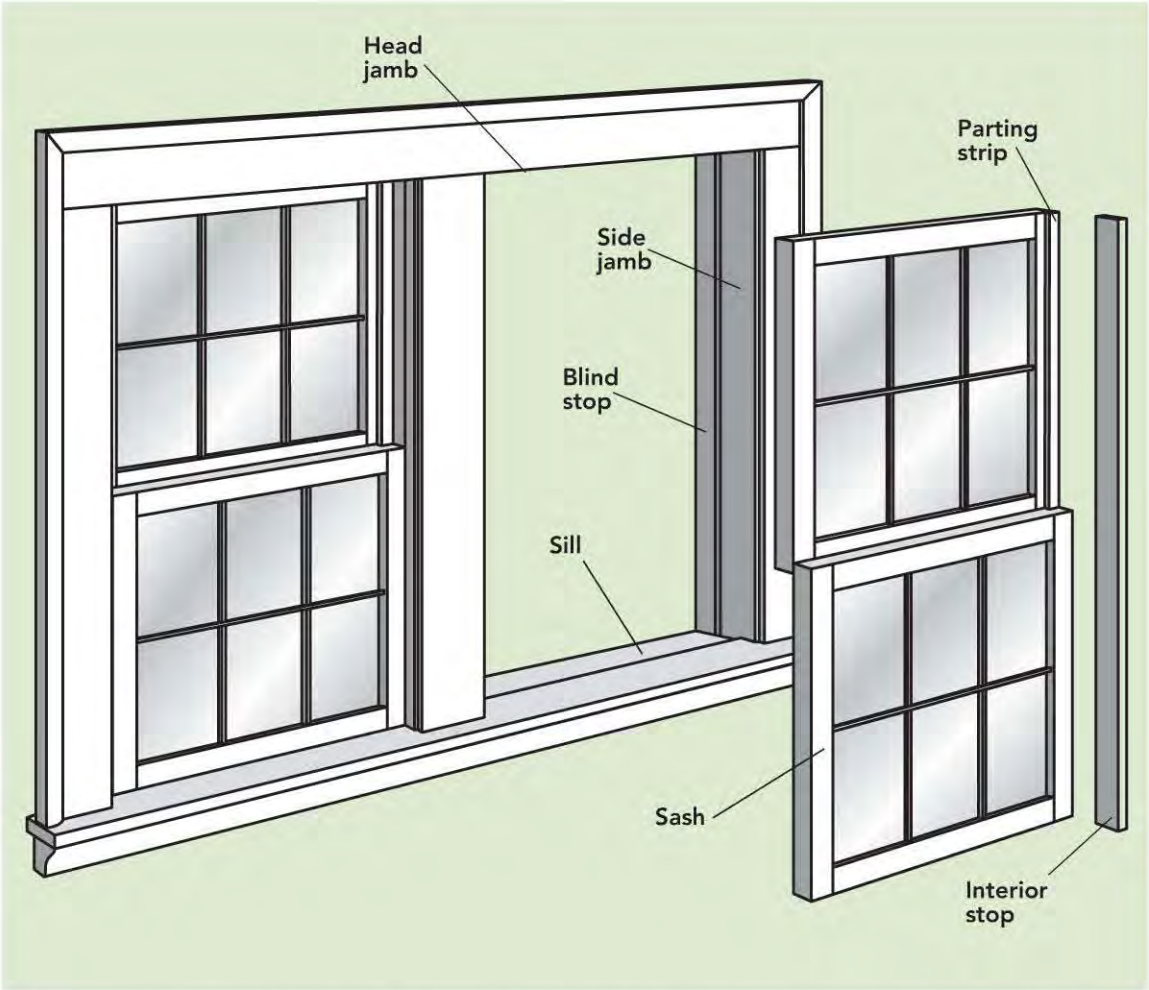
Double-hung windows stick from time to time and often are painted shut. A special serrated paint tool is made for breaking the paint lines, but a plain putty knife can also do the job.

DOUBLE-HUNG WINDOWS ARE THE MOST COMMON WINDOW TYPES. It's not hard to understand why. They don't open outward, which would expose them to more potential weather damage than they already confront. And, they don't open inward, which would tangle curtains and drapes every time you wanted some air. They don't have elaborate hinge mechanisms that wear over time and need service or replacement.

Newer models are much more energy efficient than older ones, and almost never need any maintenance beyond cleaning. Unfortunately, they don't look as good as older versions, unless you buy the top-drawer models. Many well-built windows still come with snap-in grills to simulate the muntins found on old sashes.

If you are have old windows and you want to keep them, know this: there will be some window maintenance in your future to keep things running smoothly.

DOUBLE-HUNG WINDOWS 101



When they are working well, there's nothing like an old double-hung window. You can open and close a heavy sash with just one finger because the sashes are tied to counter weights that slide up and down in channels behind the side jambs. The balance between the weights and sash is so delicate that gentle finger pressure will start the weights moving down which will carry the sash up. Though the sash cords do break eventually, most poor performance is caused by binding sashes.

TERMS YOU NEED TO KNOW

MUNTINS—Secondary framing members that hold multiple glass panes within a single window sash.

SASH STOP—A small trim board that is nailed to both window jambs to hold the sash in place. Also called a window stop.

PARTING STRIP—A narrow strip that separates two sashes on a typical double-hung window.

TOOLS & SUPPLIES YOU NEED

DIFFICULTY LEVEL

This project can be completed in one to two hours per window.

HOW TO TUNE UP DOUBLE-HUNG WINDOWS

1 Loosen a stuck window sash by forcing a putty knife between the sash and the window stop or parting strip. If hand pressure isn't enough to push in the blade, tap the handle with a hammer. Loosen both sides of the sash.

2 Once the sash is free, push it out of the way and clean out any debris from the sash channel using an old chisel or stiff, narrow putty knife.

3 Clean up the channel by sanding all three surfaces smooth. Use 100-grit paper wrapped around a scrap block of wood. Brush away the sanding dust or vacuum it up.

TIP:

Sashes that bind only slightly can often be freed by tapping the stop with a small block of wood. Don't strike the block too hard. This could split the stop. Firm taps should do the trick.

4 Paraffin is a good lubricant for sash channels. Just rub a candle vigorously against all three surfaces of both channels.

5 To remove a bottom sash, take off the stop trim on both jambs that hold the sash in place. Slide a chisel or putty knife between the two surfaces and pry gently to avoid splitting the stop.

6 Once the stops are removed the sash can swing free. Remove the weight cords from the sides and cut or plane the sash so it fits the channels better.

7 To free the upper sash, remove the parting strip on both jambs. Grip each strip at the bottom or top with pliers and pull. The parting strips are held only by friction, no fasteners are used. Protect the strip with small scrap blocks on both sides.

6 Exterior Caulking

Caulk guns are used to deliver a wide range of household products, not simply caulk. The guns are tricky to use at first, but with practice you'll get the hang of it.

WHEN YOU VISIT EVEN A MODEST HARDWARE STORE YOU WILL BE CONFRONTED WITH AT LEAST TEN DIFFERENT KINDS OF CAULK, ALL IN THE SAME-SIZE TUBES. It is possible, naturally, to read the labels and find out what the manufacturer says the caulk should do. But who wants to spend that kind of time and effort on cheap goop?

Well, maybe you should, if you want to save money on heating and air-conditioning costs, keep insects out, and prevent water from working its way behind your siding. Caulk can do all of this and more. You just have to buy a couple of tubes, spring for a caulk gun (about $4), and spend a little time filling house holes.

Any holes cut through the outside envelope of the house for services, like electricity, telephone, cable or satellite dishes, gas pipes, clothes dryer vents, outdoor receptacles and light fixtures, and garden hose sillcocks are candidates for caulking. Then hunt down the cracks that open up between the siding boards and the trim boards, like the window and door casings, the corner boards and baseboard trim along the bottom of the walls.

CAULK 101

Among the many products available for purchase in caulk-style cartridges are true caulks (usually made of silicone, acrylic, latex or a combination), but you'll also find specialty products that are formulated for specific materials, such as concrete. Some manufacturers list longevity ratings, which should really only be used for comparison purposes among similar brands.

TERMS YOU NEED TO KNOW

SILICONE ACRYLIC CAULK—A resilient gap-filling compound made with acrylic and silicone resins that's very flexible, durable, and has a low coefficient of thermal expansion. Cleans up with soap and water.

TOOLS & SUPPLIES YOU NEED

DIFFICULTY LEVEL

This project can be completed in one to six hours.

COMMON SPOTS FOR CAULKING

1 Exterior light fixtures rarely fit tightly to the siding. To block the air infiltration, apply a bead of caulk all the way around the base. Smooth the bead with a wet finger.

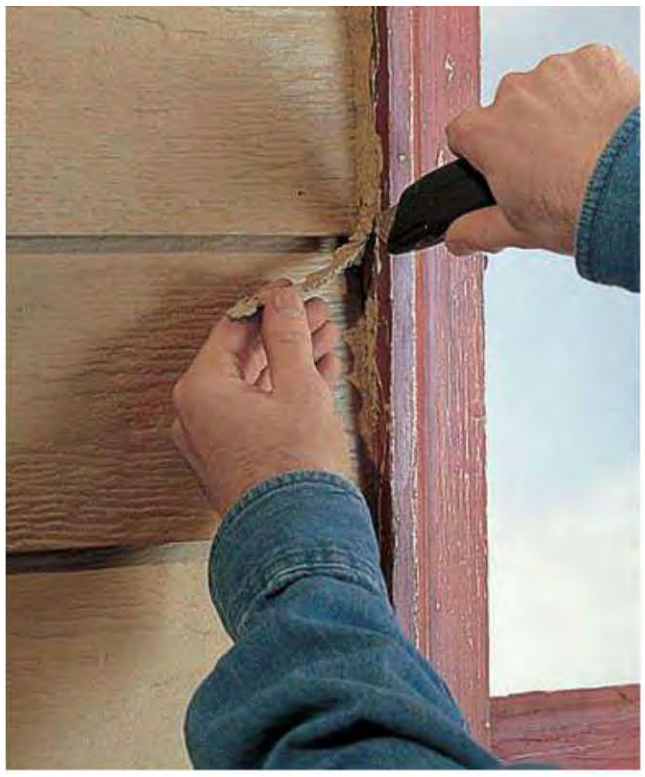
3 Dryer vent hoods occupy a lot of area and a loose one lets in a lot of air. If the hood rests on beveled siding, there may be large voids where the siding boards lap. Fill these holes with caulk and smooth the bead with your finger.

2 Exterior receptacles have a gasket between the cover plate and the box. However, nothing blocks the air movement around the box. Caulk around the box to fill these holes.

CAULK APPLICATIONS

Wading through the variety of caulks available is imposing but, fortunately, not impossible. For exterior use you want something flexible and durable, and the best choice is a silicone acrylic caulk. These products are more expensive than basic acrylic latex caulk but they perform better. They also clean up with water, which is a real plus. Sometimes this caulk is available in colors but usually you'll find it only in clear and white versions. If you need color, you'll have to paint over the caulk after it's dry—but make sure you buy paintable caulk.

Using caulk is messy, especially if you over-fill holes and then try to wipe off the excess. Cut the tip off the tube applicator to match the size of most of the holes you want to fill. Use a sharp utility knife and angle the cut to about 45 degrees to get the best bead. Poke the inside membrane of the tube by pushing a long nail down through the applicator. Then slide the tube into the gun, click the trigger a few times so the plunger bears against the bottom of the tube and squeeze the handle. As the caulk starts flowing, move the tip along the hole or crack until it's full.



4 Old caulk that is cracked or pulling away from the joint should be removed. Cut both sides of the old caulk using a carpet knife or utility knife and pull the debris from the joint. Remove dust with an old paintbrush.

5 Once the caulk is removed, prime the crack with exterior primer. Make sure to coat all the exposed wood.

6 After the primer dries, caulk the joint and smooth the bead with your finger or a putty knife.

7 Finish up the job by brushing on two coats of paint. Allow the caulk to dry, according to the manufacturer's instructions, before you paint.

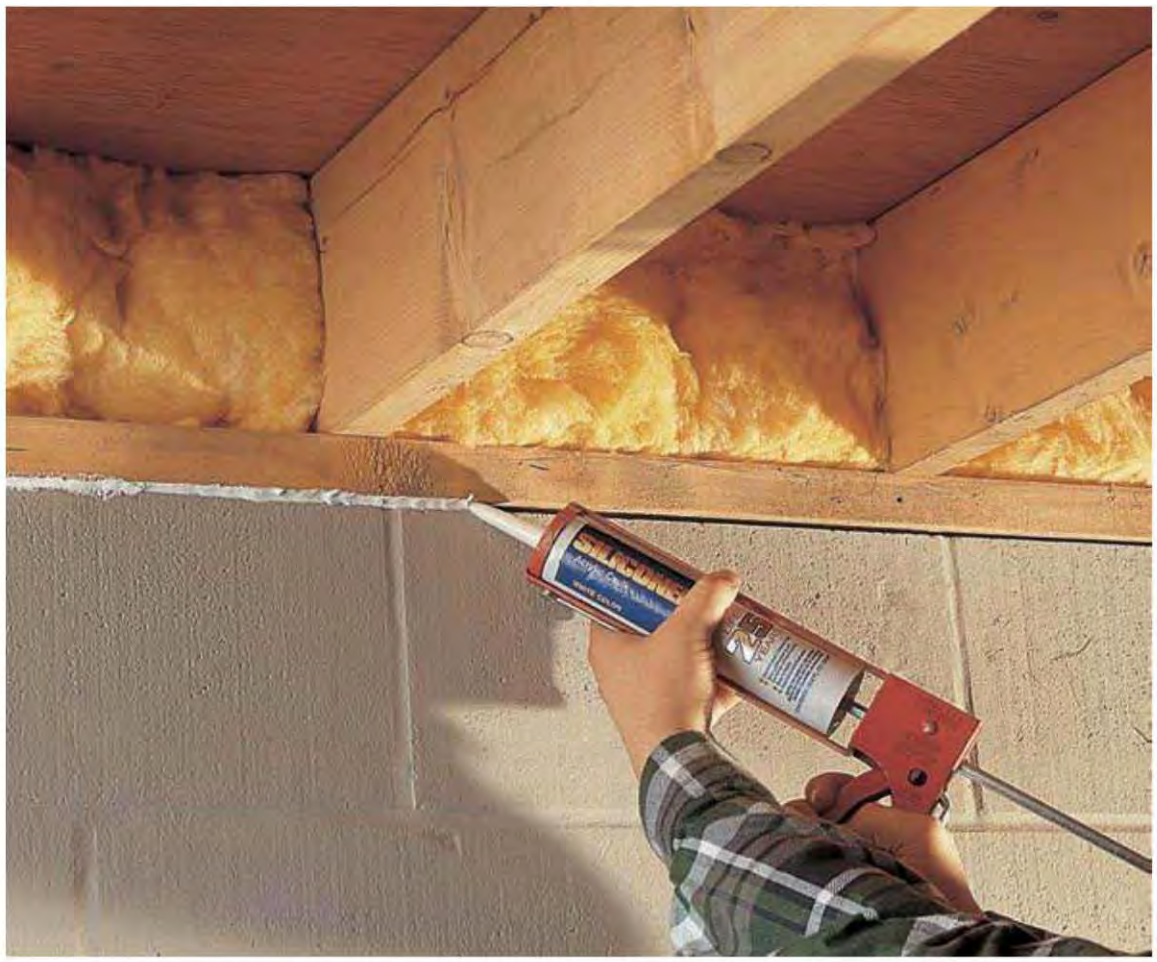
7 Pestproofing Your House

They might be cute as a button or perfectly gruesome, but uninvited pests can do enormous damage to your home and need to be kept out.

IN THE END, IT MAY BE A SIMPLE QUESTION OF ETIQUETTE. If you invite pests into your house, you can't feel put out when they decide to accept. And, what constitutes an invitation? Well, lots of things, like holes that aren't caulked, chimneys without protective flue covers, damaged vent screening and so on. Of course, taking such a hard line is a little bit like blaming the victim. Is everybody really supposed to know where all the holes in the house are and be familiar with the travel patterns of all the local squirrels? Probably not, at least when it comes to the squirrels.

The most common entry points are small holes along the foundation and soffits, and sometimes next to windows and doors. These should all be filled with silicone acrylic caulk. Holes much wider than ¼ in. should be stuffed with caulk backer before caulking. Also fill any gaps around where phone, gas, cable, electric, water and other services enter the house. Once you are done filling the obvious gaps, look for evidence of infestation like animal droppings or nesting materials. Remove these and check the area for any entry points that you might have missed. If the rodents persist, you can fight back with spring-loaded death traps or Havahart-type traps that capture the animal so it can be released outside.

PESTPROOFING 101



The mudsill is the area formed by the foundation wall and the sill plates of your exterior walls. It is the most likely point of pest invasions and should be inspected (look for light coming in from outdoors) and caulked regularly.

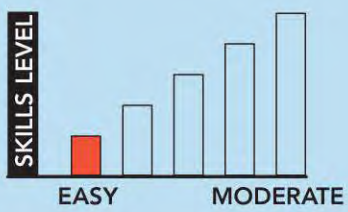
GETTING THEM OUT WHEN THEY'RE IN

There are many hardware-store products designed to help you get rid of pests inside your house. For insects in the attic and basement, pesticide foggers are one option. These shouldn't be used around food prep areas or when anyone is in the house. The usual approach is to activate the fogger and then leave for a few hours. No matter which product you buy, follow the use instructions carefully.

Common roach and ant traps do capture a lot of pests, but will not solve the problem unless the source from outside is eliminated. The same is true of all sorts of mousetraps. If you've closed all the entry points that you can find, and you've trapped all the pests that should have been inside when you plugged the holes, then you need help. Call a reputable exterminator and let them handle the job.

TOOLS & SUPPLIES YOU NEED

DIFFICULTY LEVEL



This project can be completed in one to four hours.

1 If your chimney flue doesn't have a cap, you are inviting birds, bats, and squirrels into the flue, especially if you never use the fireplace. A chimney cap with screening or mesh on the sides will keep all these pests out.

2 Most roof vents come with screens installed to keep insects out of the house. If this screen is torn or missing, staple new screening (it's actually called insect mesh at the store) to the backside of the vent with ¼"-long staples.

3 Replace typical flap-type dryer vents (inset) with protected vent hoods. These keep out insects and small rodents, and are designed to be a universal replacement for standard vent hoods.

4 Sill plates are supposed to be installed over a sealer material that keeps out insects. But sometimes the sealer is left off. If you see evidence that insects are coming through the joint, fill it with caulk outside and inside (see page 425).

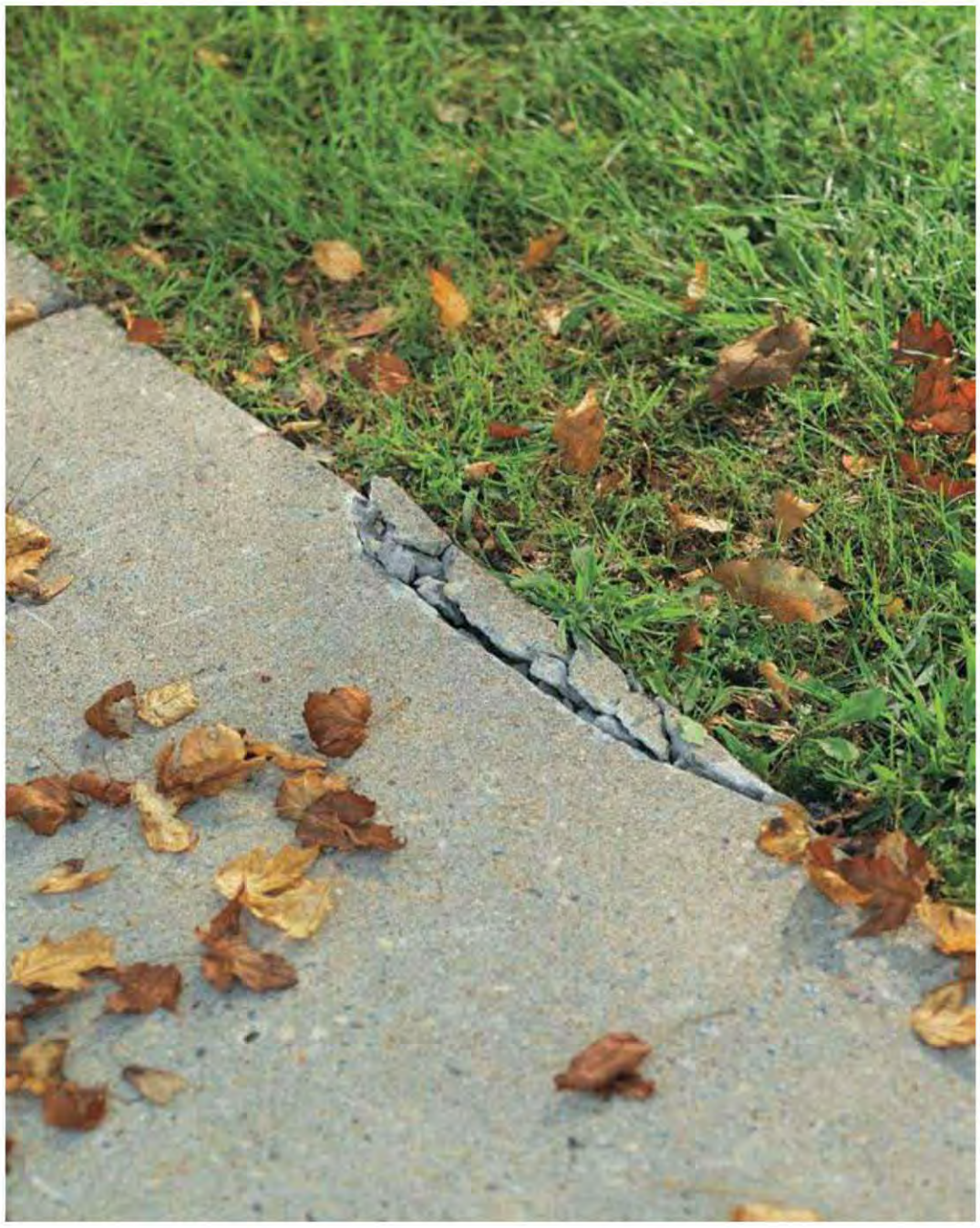
5 Insects can easily enter your house through a basement floor drain. The drain hole can be filled with a tennis ball that will float out of the way to allow water into the drain if the floor is flooded.

6 Check the foundation of your house for anthills, wasp's nests and termite tunnels. If you find any of these nests, remove them and close off the points of entry.

7 Be especially watchful in moist areas of the house where many insects prefer to be. Eliminate the access points and install a dehumidifier to make the area less attractive to pests.

8 If you ever find evidence of termite-eaten wood, call an exterminator immediately. These technicians can kill all the termites and check for other harmful species, like carpenter ants.

8 Fixing Concrete Walkways



Once a concrete sidewalk or driveway starts to fail, you can bet that it's just the beginning of the problem. By fixing the crack or chip-out right away you can preserve the concrete.

CONCRETE CERTAINLY HAS AN ATTITUDE. It's hard, stubborn, and uncompromising; it won't bend even when a little give-and-take would make everything easier. Fortunately, it's more than just tough. It's also durable, long lasting, and faithful.

Everybody thinks concrete is so tough that they can do anything to it and it will be fine. Up to a point this is true. There isn't too much that puny humans can do, in the normal course of life, to cause any real damage. But the weather is something else, especially the kind of weather that gets below freezing in the winter. The freeze and thaw cycle creates little cracks that soon become bigger cracks as water seeps in, freezes and expands. If repairs aren't made when the problems are small, the problems will never be small again.

CONCRETE CRACKS 101

Cracks in concrete typically must be made worse before they are made better. By chiseling the top of the crack so the walls slope down and away from the crack, you create a bell shape that will hold the repair material in place. You can fill cracks up to about ½" in. wide × ½" deep with a liquid polymer crack filler available at lumberyards and home centers. Fill the cracks just slightly below the surrounding surface for the best appearance. Then cover the cracks for two days so they aren't damaged by foot traffic. Deeper cracks should first be filled to within ½" of the top with foam backer rods. These should be compressed in the crack with a screwdriver or a putty knife and then covered with crack filler. If the crack is over ½" wide, fill the gap in a couple of applications so everything has time to cure properly. Breaks along the edge of the walk are the hardest to repair, but with a little effort, you can help that walk maintain its edge just a bit longer.

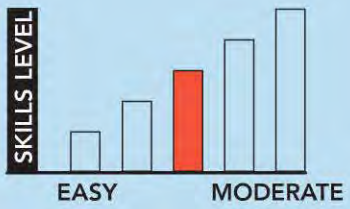
TERMS YOU NEED TO KNOW

FOAM BACKER RODS—Tube-shaped sections of foam for filling wide holes before caulking is applied. Commonly available in various lengths and in diameters from ¼" up to 2 in.

SPALLED CONCRETE—Concrete surface damage that appears as a flaking away of the top layer, usually less than 1/16" deep.

TOOLS & SUPPLIES YOU NEED

DIFFICULTY LEVEL



This project can be completed in one to two hours per four foot square section of sidewalk.

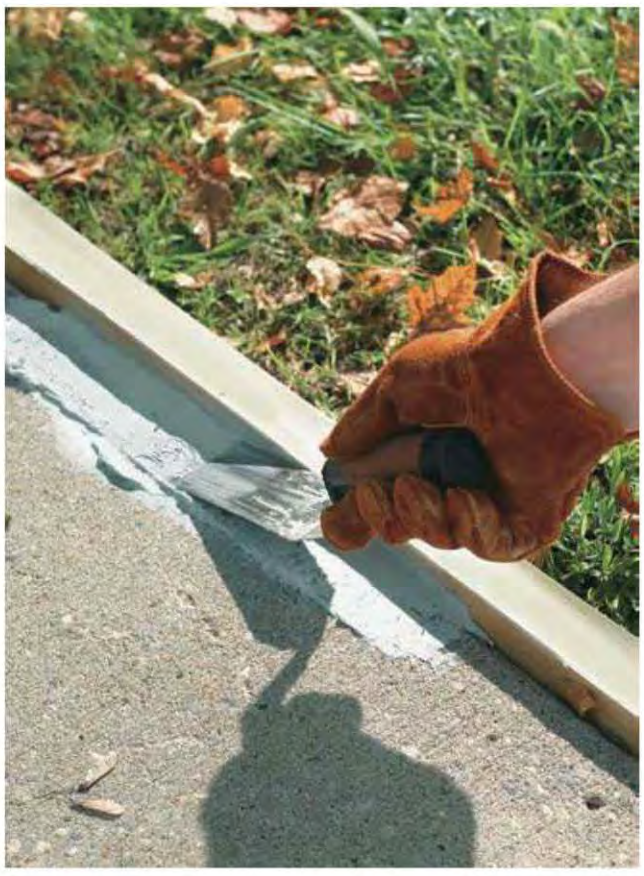
HOW TO FIX A CONCRETE CHIP-OUT

1 Drive a form board next to the sidewalk and undercut the broken section with a cold chisel and hammer. This will create a modest keyway that will give the patch something extra to grip.

CONCRETE REPAIR PRODUCTS

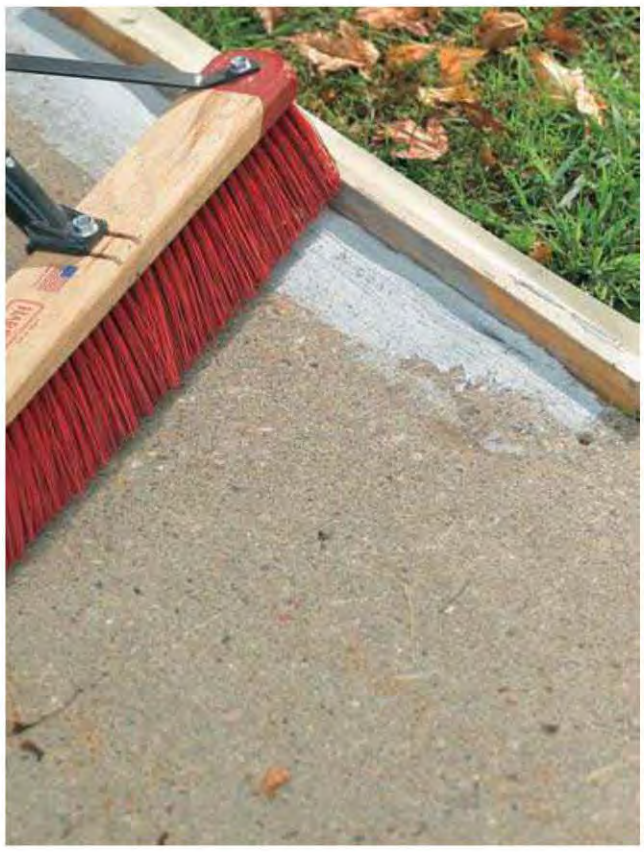
CONCRETE PATCHING materials contain additives and reinforcement to accomplish specific tasks. Shop carefully at your building center to make sure you buy the best product for your repair.

2 Just prior to applying the patch, brush some clean water onto the broken area to help the patch bond better.



3 Use a small mortar trowel to apply the mortar patch. Be sure to force the patch to the bottom of the hole and feather the edges so the patch blends in well with the surrounding surfaces.

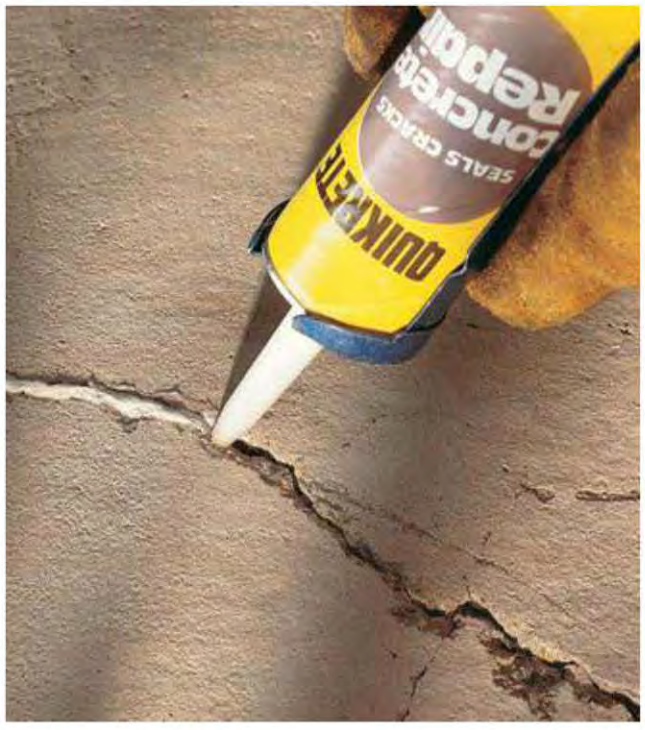
4 To reduce the chance of the edge breaking again, round it off using an edging tool. Gently move the tool over the patch and try to match the edge troweling on the rest of the walk.



5 Lightly brush the surface of the patch with a stiff broom. This creates better traction for bad weather conditions. When you're done, cover the patch with a plastic tarp for 6 or 7 days.

HOW TO FIX A CONCRETE CRACK

1 Remove any dust and debris from cracks with a wire brush, vacuum cleaner or a compressor with a hose-mounted spray nozzle.



2 Squeeze crack filler in the crack, stopping just below the surface of the walk. This protects the cracks without running the risk of smearing the filler across the surrounding surfaces.

9 Repairing Asphalt Driveways

Asphalt is a relatively forgiving paving material. When popouts or cracks occur, repairing them is basically a matter of dumping in fresh material and picking a way to compress it.

THE TWO MOST POPULAR HARD SURFACE DRIVEWAY MATERIALS ARE ASPHALT AND CONCRETE. Both are used, almost interchangeably, throughout the country in cold and hot climates. But there are some basic differences. Concrete generally costs more to install and asphalt generally costs more to maintain as the years go by. And, concrete doesn't always perform well in cold areas. It's susceptible to damage from the freeze-and-thaw cycle and it can be damaged by exposure to road salt. Asphalt, on the other hand, doesn't always perform well in hot climates. It absorbs a lot of heat from the sun and tends to stay soft during very hot periods. And, of course, when the surface is soft, it can wear more quickly.

It's a good thing that concrete doesn't need much routine maintenance because doing just about anything to concrete is difficult. Asphalt, however, is very easy to maintain and repair. And there are plenty of products in local home centers to help anyone do the work. In many ways, fixing an asphalt driveway is a lot like repainting a house that is in bad shape. Most of the work deals with surface preparation. Applying a new coat of driveway sealer is only the last of many steps.

DRIVEWAY SEALER 101

Some driveway sealers are made of coal tar, others are asphalt emulsions. Coal tar is compatible with asphalt paving and has some durability advantages over asphalt because it has ultra-violet stabilizers in the mix. These keep the black color of the sealer from fading quickly. Coal tar also resists damage from gas and oil spills better than asphalt. Both types are sold in 5 gal. buckets that sell for about $20 and cover between 300 and 400 sq. ft. of surface area.
The trick with applying sealers is to do it in warm weather (nothing below 50 degrees F.). Also, you should apply the sealer in thinner, rather than thicker, coats. If you build up too thick a coat, the sealer can peel. The container directions on the product you buy will indicate the proper coverage rate.

TERMS YOU NEED TO KNOW

ASPHALT—A combination of bitumens—that are by-products of coal tar distillation—and aggregates—that are a mixture of sand and gravel. Installed when hot.

ASPHALT SEALER—A bituminous coating, sometimes including sand as a fine aggregate, that is used to seal the surface of asphalt pavement.

ASPHALT—A paste-like combination of bitumens, very fine aggregate and additives to keep the mixture malleable.

ASPHALT CRACK FILLER—Comes in different formulations. One is a rubberized liquid emulsion that stays flexible permanently.

COLD-PATCH ASPHALT MIX—A combination of asphalt and synthetic polymers that keep the asphalt workable when it's cool.

TOOLS & SUPPLIES YOU NEED

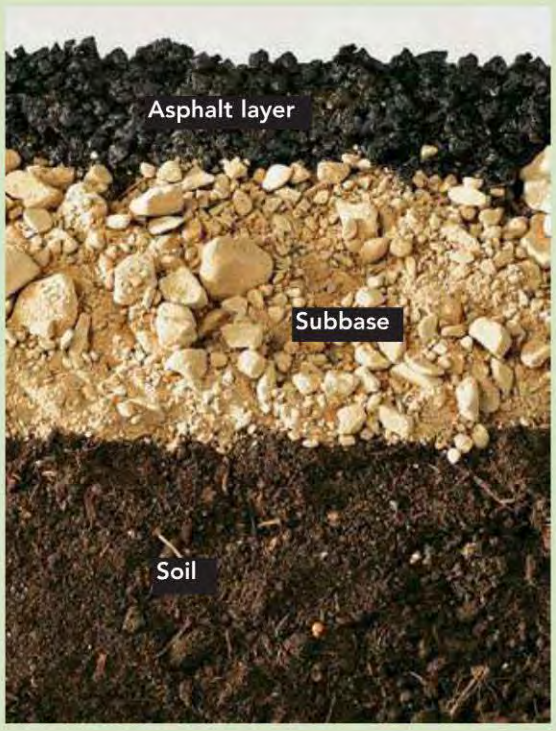
DIFFICULTY LEVEL

This project can be completed in eight to twelve hours.

HOW TO REPAIR AN ASPHALT DRIVEWAY

1 Begin the maintenance routine by removing any grass, weeds and other vegetation from the surface and sides of the driveway. Use a long-handle ice scraper or a square-tip shovel.

X-SECTION OF ASPHALT DRIVEWAY



A typical asphalt driveway is formed by pouring and compressing a layer of hot asphalt over a subbase of compacted gravel.

2 Carefully inspect the asphalt surface for any oil and grease stains. Then remove them with driveway cleaner or household detergent. Scrub the cleaner into the surface with a soft brush and rinse the area clean with a garden hose. Repeat until the stain is gone. If using driveway cleaner, wear the recommended safety equipment.

3 Once the stains are removed, thoroughly rinse the entire driveway with a garden hose and nozzle. The goal is to wash away any debris and to remove the dust and dirt from the surface cracks.

4 Repair the small cracks first. Chip out any loose debris with a cold chisel and hammer. Then clean out all debris with a wire brush. Remove all the dust with a shop vacuum. A crevice tool on the end of the hose will do the best job.

6 Compact the patch material with a small piece of 2 × 4. Tamp the board up and down with your hand, or strike the board with a hammer. Keep working until you can't compress the patch any more.

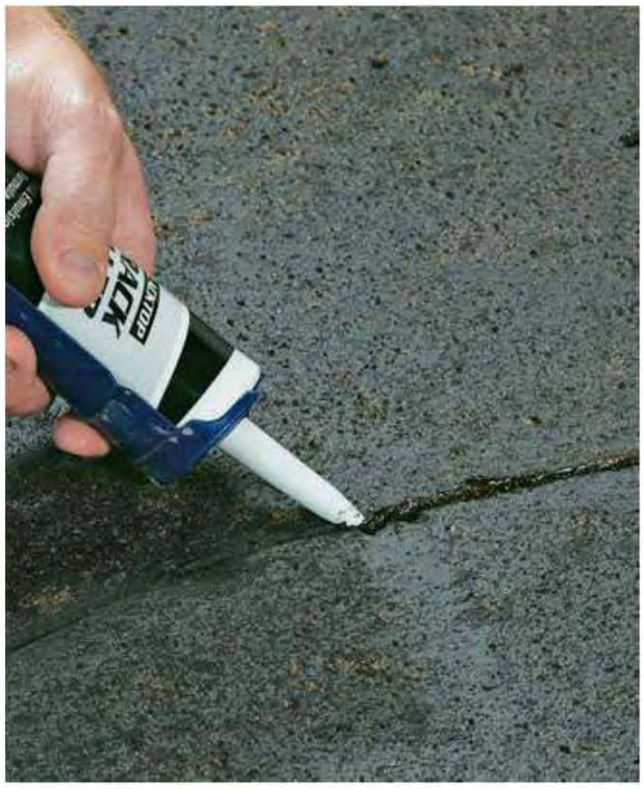
5 Place asphalt patching compound in the holes with a small trowel. Overfill the hole so the patch material is about ½" higher than the surrounding asphalt surface.

7 Finish the patch by covering it with a piece of 2 × 6 and striking it with a hammer or mallet. Work back and forth across the board to smooth out the entire patch and make it flush to the surrounding surface.

8 On narrower patches, the compound can be smoothed with a small trowel. Just move the tool across the surrounding surface and then over the patch. This should flatten the patch. Finish up by compressing the compound by pushing it down with the trowel.

9 Prepare larger potholes by undercutting the edges with a cold chisel and a hammer. Then, remove all the debris and fill the hole with cold-patch asphalt mix. Working directly from the bag, fill the hole about 1 in. higher than the surrounding surface. Then compact it with a 2×4, as before.

10 One great way to compress cold-patch asphalt is to cover the patch with a piece of plywood. Then, drive your car onto the plywood and stop when one tire is centered on the panel. Wait a few minutes, then move the car back and forth a few times.



11 Once the hole patching is done, fill the routine cracks (less than ¼" wide) with asphalt crack filler. This material comes in a caulk tube, which makes it very easy to apply. Just clean the crack with a wire brush and a vacuum, then squeeze the filler into the crack.

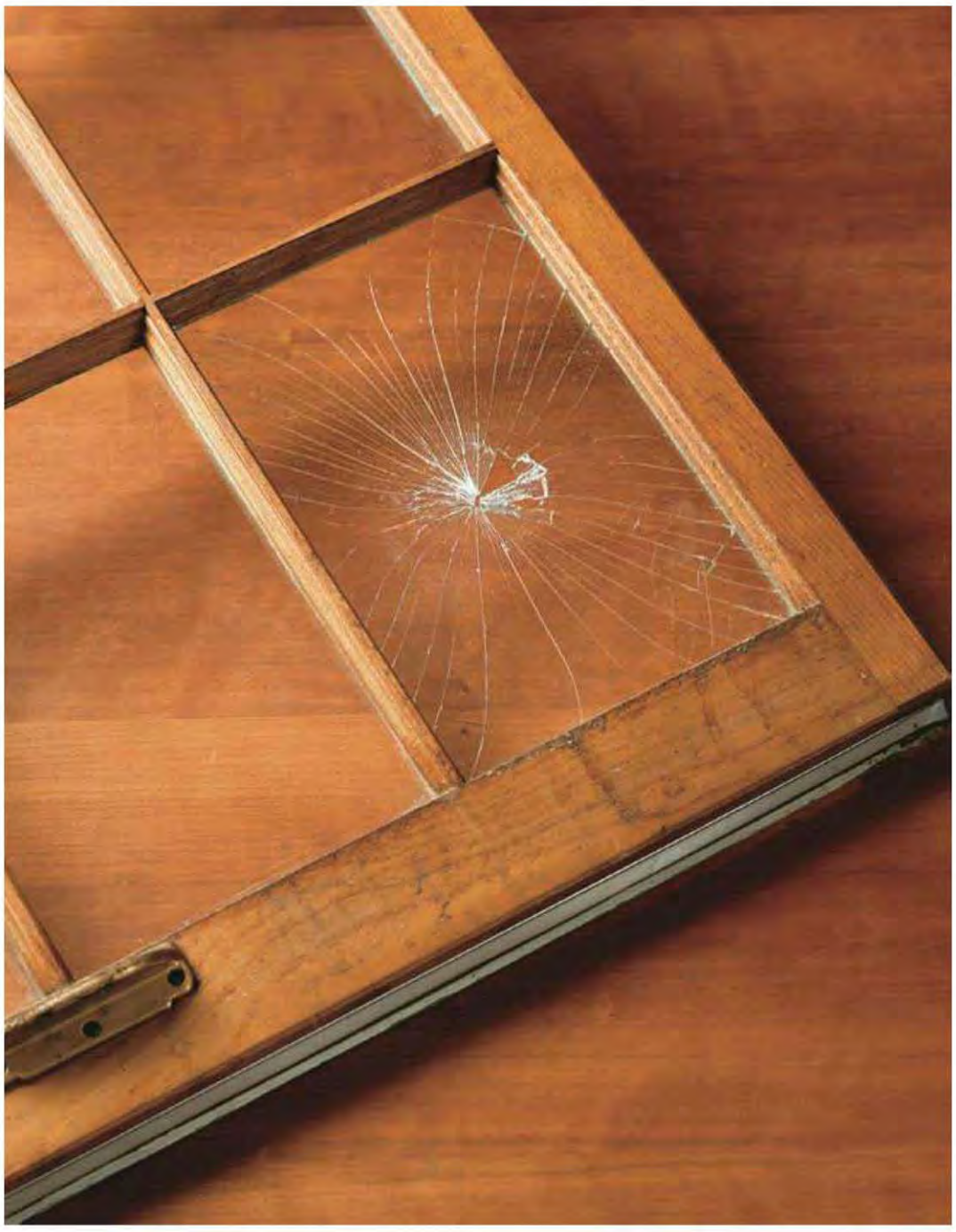
12 After the crack filler has cured for about 10 or 15 minutes, smooth it out with a putty knife as you force the filler down into the crack. If this creates small depressions, fill these with a second application of filler.

13 Driveway sealer should always be mixed thoroughly before use. Take a 2× stir stick that's about 30 in. long and stir the sealer until it has a uniform consistency. Pour out enough to cover a strip across the driveway that's about 3-ft. or 4-ft. wide.

14 Spread the sealer with the squeegee side of the application brush. Try to keep this coat as uniform as possible. Work the sealer into the small cracks and pull it gently over the big patches.

15 Flip the squeegee over to the brush side and smooth out the lap marks and other irregularities that were left from the application coat. Work at right angles to the first pass.

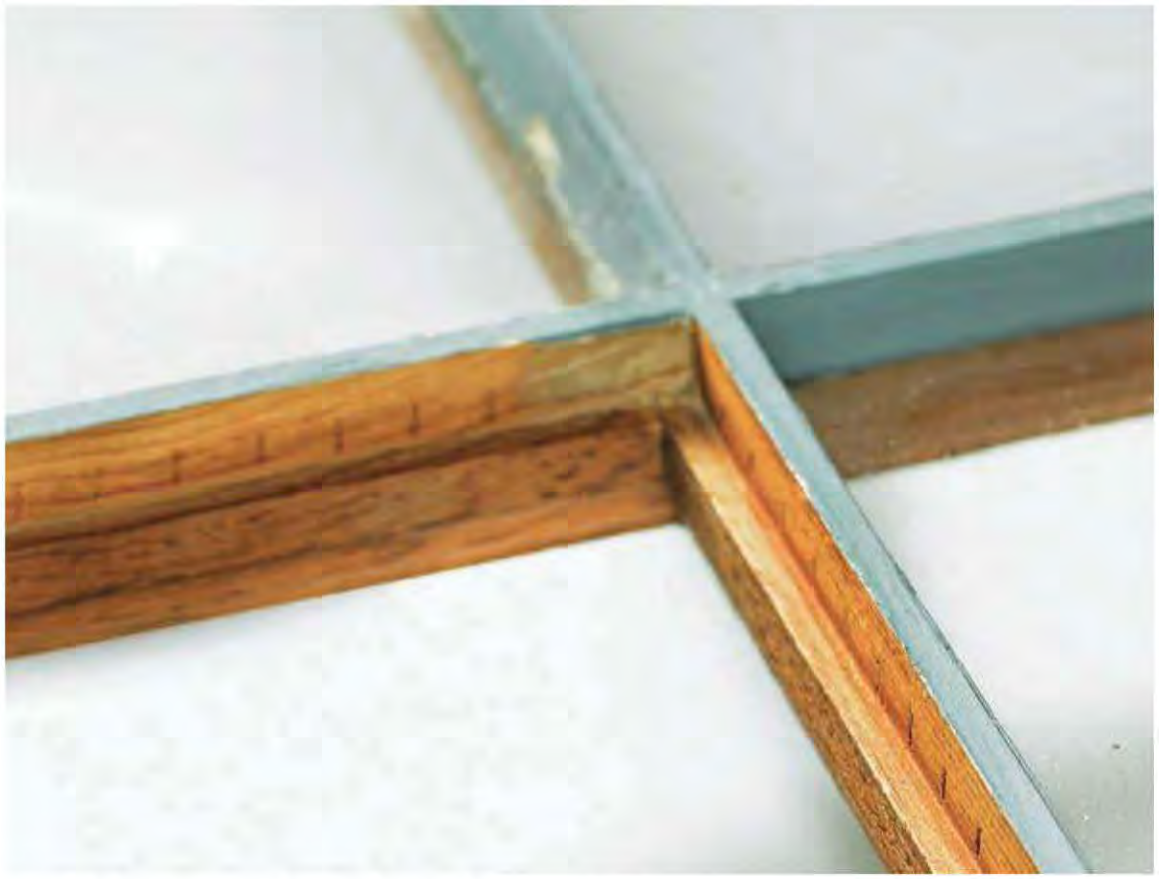
10 Fixing Broken Glass Panes



Replacing a broken glass pane isn't nearly as common an occurrence today as it was a decade or two ago. But it's still a great skill to have for owners of older homes.

FOR PEOPLE WHO LIVE IN NEW, WELL-MADE HOUSES THE WINDOWS FROM THE GROUND TO THE RIDGE ARE BOUND TO BE DOUBLE-GLAZED UNITS THAT PERFORM WITH COMMENDABLE ENERGY EFFICIENCY. This is a good thing, mostly. But these hi-tech units can break just like their older single-pane siblings, and you just can't fix double-glazed sashes yourself. People who live in older houses have it better. Their single pane sashes and storm windows are easy and inexpensive to repair. If you have just one pane to replace, most people can finish up the job in a couple of hours. Usually the hardest part of this chore is working off a ladder. You'll need one to remove the storm windows and to fix a regular sash because the repair needs to be made on the outside of the window.

GLASS PANES 101



Each glass pane in a typical wood sash is held in place on the inside by the wood that forms the sash and on the outside by glazing compound. This compound is a soft, caulk-like material when it's installed. But it hardens over time to form a durable seal that keeps the glass in the frame and the water out. If you wiggle the pieces of broken glass in-and-out, this will loosen the compound and you can pull the shards out. Measure the space, go to the hardware store for a $2 piece of glass, pop it in and glaze.

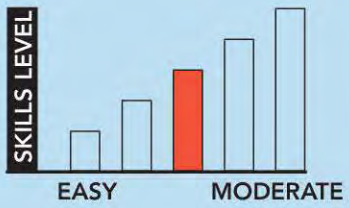
TERMS YOU NEED TO KNOW

WINDOW SASH—Any framework that holds window glazing, as in a double-hung window with two sashes (that is, two wood frames that each hold one or multiple pieces of glass).

GLAZIER'S POINTS—Small triangular pieces of steel with one side bent up at a 90-degree angle. Made for holding glass panes within wood frames, these points are pushed into place with a putty knife or flat blade screwdriver.

TOOLS & SUPPLIES YOU NEED

DIFFICULTY LEVEL



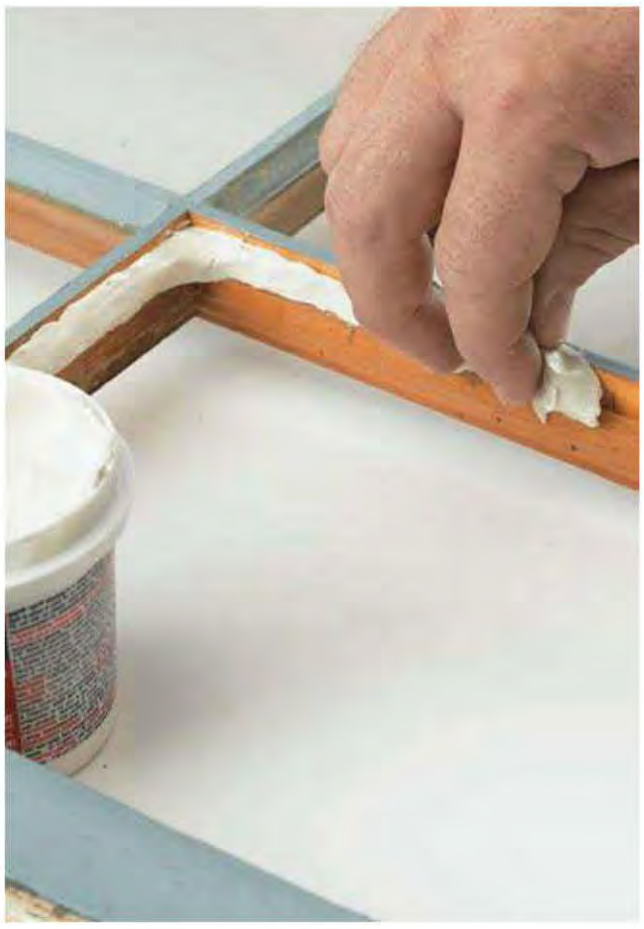
This project can be completed in two to three hours.

HOW TO FIX A BROKEN WINDOW PANE

1 Wearing heavy leather gloves, remove the broken pieces of glass. Then, soften the old glazing compound using a heat gun or a hair dryer. Don't hold the heat gun too long in one place because it can be hot enough to scorch the wood.

2 Once a section of compound is soft, remove it using a putty knife. Work carefully to avoid gouging the wood frame. If a section is difficult to scrape clean, reheat it with the heat gun. Soft compound is always easy to remove.

3 Once the wood opening is scraped clean, seal the wood with a coat of linseed oil or primer. If the wood isn't sealed, the dry surface will draw too much moisture from the glazing compound and reduce its effectiveness.



4 Apply a thin bed of glazing compound to the wood frame opening and smooth it in place with your thumb.

5 Press the new pane into the opening, making sure to achieve a tight seal with the compound on all sides. Wiggle the pane from side-to-side and up-and-down until the pane is seated. There will be some squeeze-out, but do not press all the compound out.

6 Drive glazier's points into the wood frame to hold the pane in place. Use the tip of a putty knife to slide the point against the surface of the glass. Install at least 2 points of each side of the pane.

7 Make a rope of compound (about ½" diameter) by rolling it between your hands. Then press it against the pane and the wood frame. Smooth it in place by drawing a putty knife, held at a 45-degree angle, across its surface. Scrape off excess.

8 Allow the glazing compound at least one week to dry completely. Then prime and paint it to match the rest of the sash. Be sure to spread the paint over the joint between the compound and the glass. This will seal the joint completely. When the paint is dry, scrape off the extra with a razor blade paint scraper.

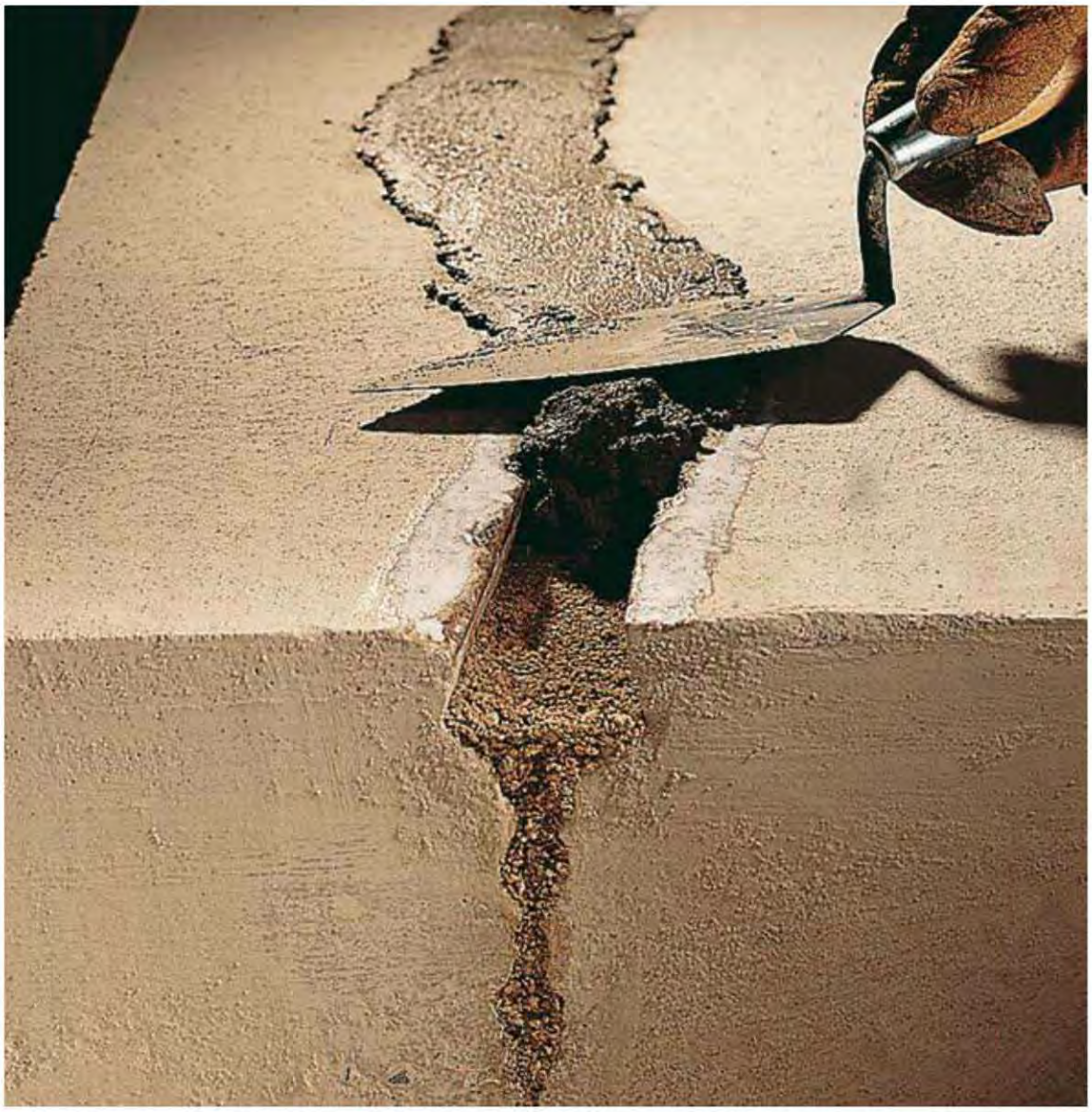
11 Repairing Concrete Steps

A little concrete patching material and some know-how will keep your concrete steps looking brand new.

BUILDERS USE A LOT OF DIFFERENT MATERIALS FOR ENTRY STEPS. Many familiar varieties of stone and brick are common choices. Wood is also a favorite, especially for rustic buildings or those that are blessed with a large front porch. But when you look at all the houses and all the entry doors, including those at the back and side of the house, concrete has to be the top choice, by far. That's because it's cheap, durable, and long lasting.

The biggest problem involved in making a successful concrete step repair is binding the patch material to the existing material. Strong bonds can be created with the use of a bonding agent, usually part of the patching mix. The second bonding problem is that the repair surface must be free of all dust, dirt, grease and debris. Unless it is thoroughly cleaned, the patch won't hold for long.

CONCRETE CRACK REPAIR 101



Small cracks (about ¼ in. wide and deep) can be filled with concrete crack filler. Just brush out the crack and squeeze in the filler, stopping just a bit below the top of the crack. For wider cracks, one good approach is to fill the crack with mortar. Breaks along the edges and corners are repaired with a form board (or boards) nailed to the side of the steps. Then the edges of the break are undercut with a cold chisel and the void filled with a concrete patch mix. For big breaks, it's a good idea to drive masonry nails into the middle of the void to act as reinforcement for the patch. Make sure to drive these nails deep enough so their heads won't sit above the finished surface.

TERMS YOU NEED TO KNOW

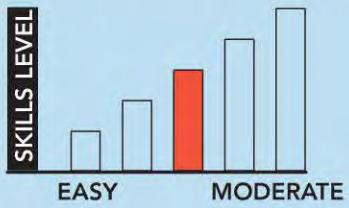
CONCRETE CRACK FILLER—A liquid polymer substance that dries into a flexible, watertight seal.

BONDING AGENT—An adhesive chemical substance that's applied between a concrete substrate and a mortar patching mix.

MORTAR PATCHING MIX—A mixture of cement, sand, water and admixtures like bonding agents and plasticizers to make the material more workable.

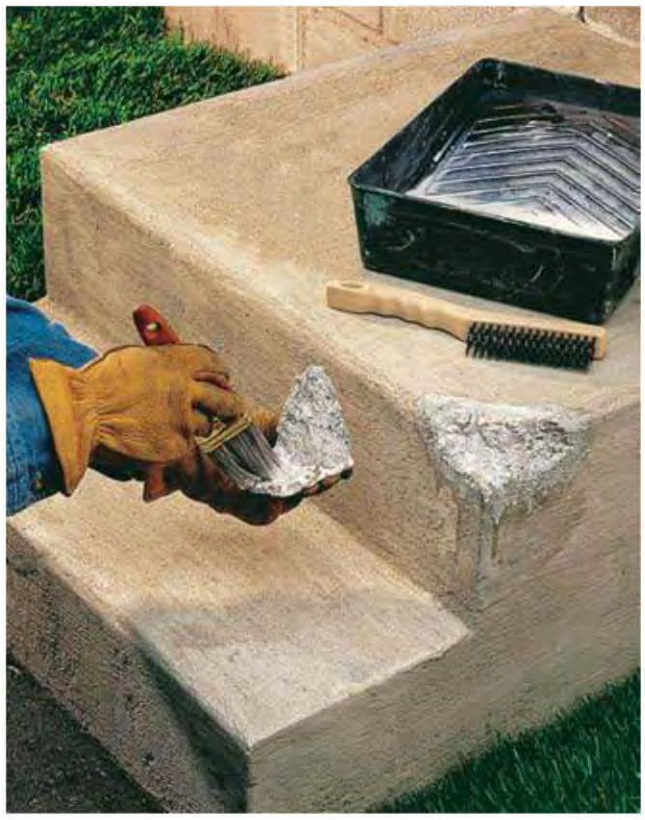
TOOLS & SUPPLIES YOU NEED

DIFFICULTY LEVEL

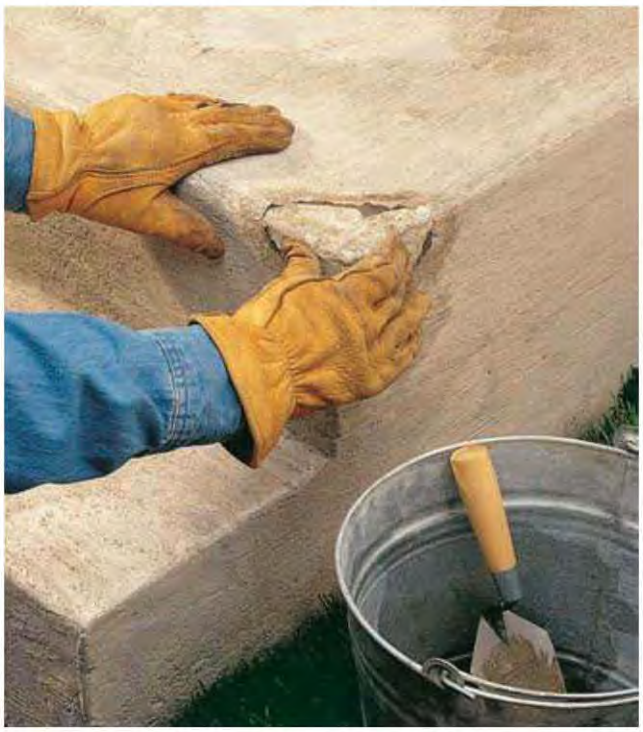


This project can be completed in two to five hours.

HOW TO REPAIR BROKEN CONCRETE



1 Retrieve the broken corner, then clean it and the mating surface with a wire brush. Apply latex bonding agent to both surfaces. If you do not have the broken piece, you can rebuild the corner with patching compound.

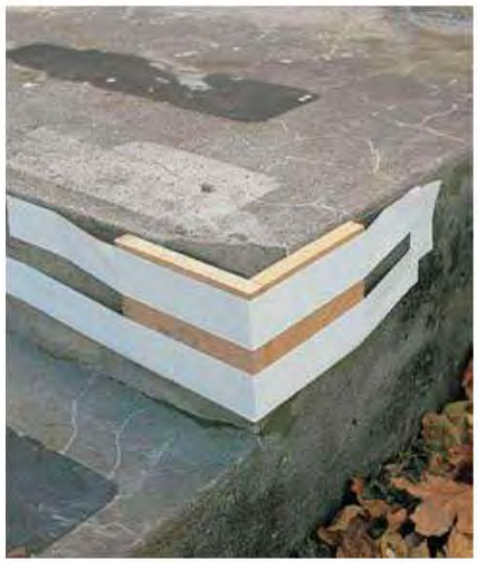


2 Spread a heavy layer of fortified patching compound on the surfaces to be joined, then press the broken piece into position. Lean a heavy brick or block against the repair until the patching compound sets (about 30 minutes). Cover the repair with plastic and protect it from traffic for at least one week.

HOW TO REBUILD WITH PATCHING COMPOUND

1 Clean chipped concrete with a wire brush. Brush the patch area with latex bonding agent.

2 Mix patching compound with latex bonding agent, as directed by the manufacturer. Apply the mixture to the patch area, then smooth the surfaces and round the edges, as necessary, using a flexible knife or trowel.



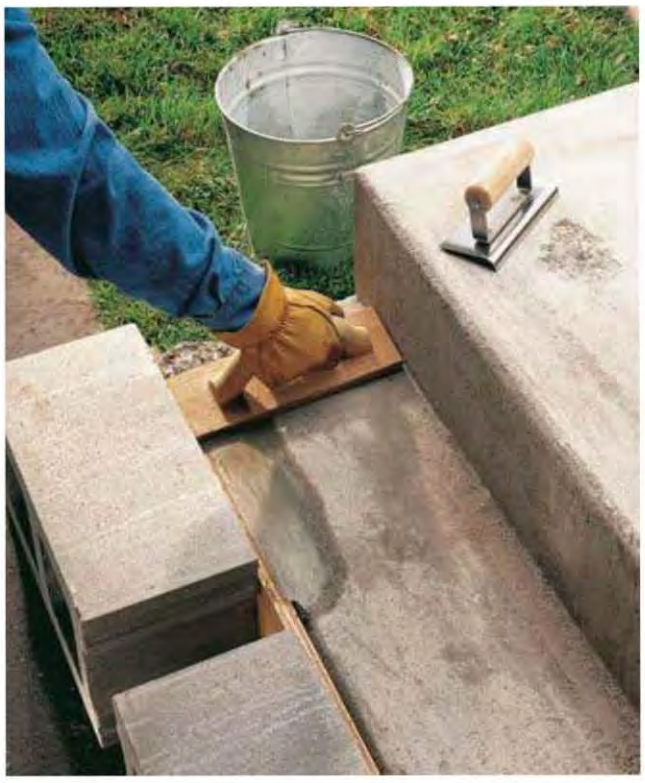
3 Tape scrap lumber pieces around the patch as a form. Coat the insides with vegetable oil or commercial release agent so the patch won't adhere to the wood. Remove the wood when the patch is firm. Cover with plastic and protect from traffic for at least one week.

HOW TO REBUILD A BROKEN STEP

1 Make a cut in the stair tread just outside the damaged area, using a circular saw with a masonry-cutting blade. Make the cut so it angles toward the back of the step. Make a horizontal cut on the riser below the damaged area, then chisel out the area in between the two cuts.

2 Cut a form board the same height as the step riser. Coat one side of the board with vegetable oil or commercial release agent to prevent it from bonding with the repair, then press it against the riser of the damaged step, and brace it in position with heavy blocks. Make sure the top of the form is flush with the top of the step tread.

3 Apply latex bonding agent to the repair area with a clean paint brush, wait until the bonding agent is tacky (no more than 30 minutes), then press a stiff mixture of quick-setting cement into the damaged area with a trowel.



4 Smooth the concrete with a float, and let it set for a few minutes. Round over the front edge of the nose with an edger. Use a trowel to slice off the sides of the patch, so it is flush with the side of the steps. Cover the repair with plastic and wait a week before allowing traffic on the repaired section.

12 Repairing Siding

Siding is like the skin of your house and, like the skin on your body, sometimes it gets a scratch or bruise or cut. Here we'll show you how to bandage the damage.

EXPLAINING HOW TO MAKE BASIC SIDING REPAIRS IS HARDER THAN IT SOUNDS. That's because there are a lot of different siding types and a lot of variation in the way the same siding is installed. We show here the repair basics for the most common sidings: clapboard, tongue-and-groove, wood shingles, board-and-batten and vinyl or metal. The chance that your siding is installed exactly the way you see here is slight, but it's a good place to start.

Clapboard siding is bevel-lap siding boards made of redwood or cedar or pine. This siding can last for well over 100 years, if it's properly maintained.

Tongue-and-groove siding creates a very tight exterior seal and, if the paint and caulk are well maintained, it is virtually trouble free. But it is difficult and time-consuming to install.

Wood shingles are typically made of cedar or cyprus and may be either split or sawn. This type of siding may be painted or allowed to weather to a silvery gray.

Vinyl and aluminum siding are designed, installed and repaired in much the same way. Both products expand and contract a great deal with changes in temperature.

Board-and-batten, in this day and age, normally refers to wood panels (textured plywood) with thin strips of lumber installed to cover the seams between panels.

EXTERIOR WALLS 101

Regardless of what type of siding you have, the inside of your exterior walls will look something like this. When you're working on siding, it's important that you identify the locations of wall studs and that you avoid penetrating or tearing the vapor barriers on either side of the wall.

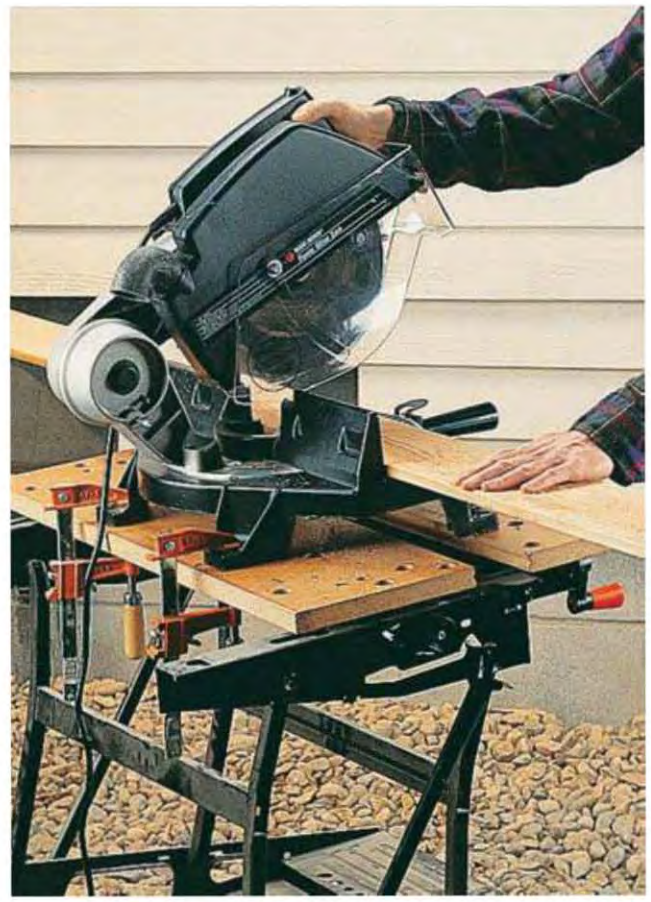
TOOLS & SUPPLIES YOU NEED

DIFFICULTY LEVEL

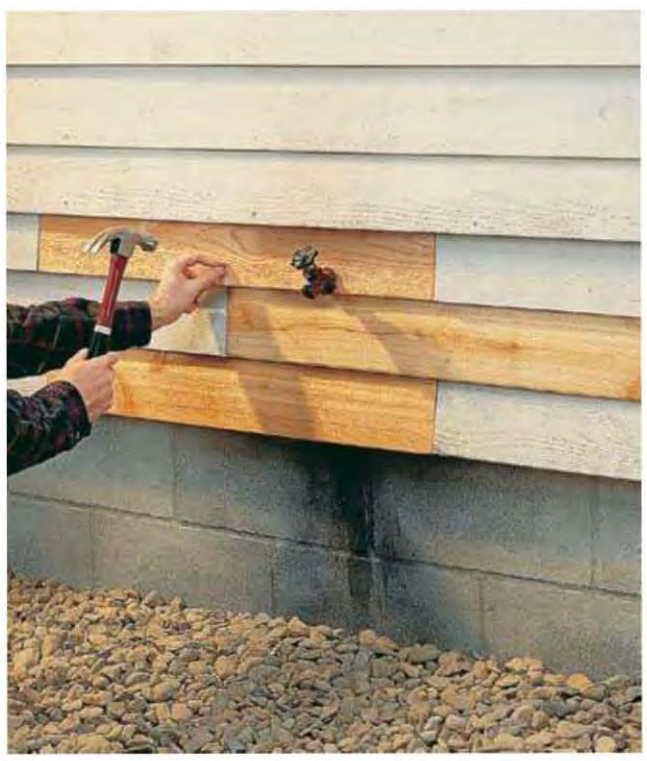
This project can be completed in two to three hours, for simple repairs.

HOW TO REPAIR WOOD CLAPBOARD

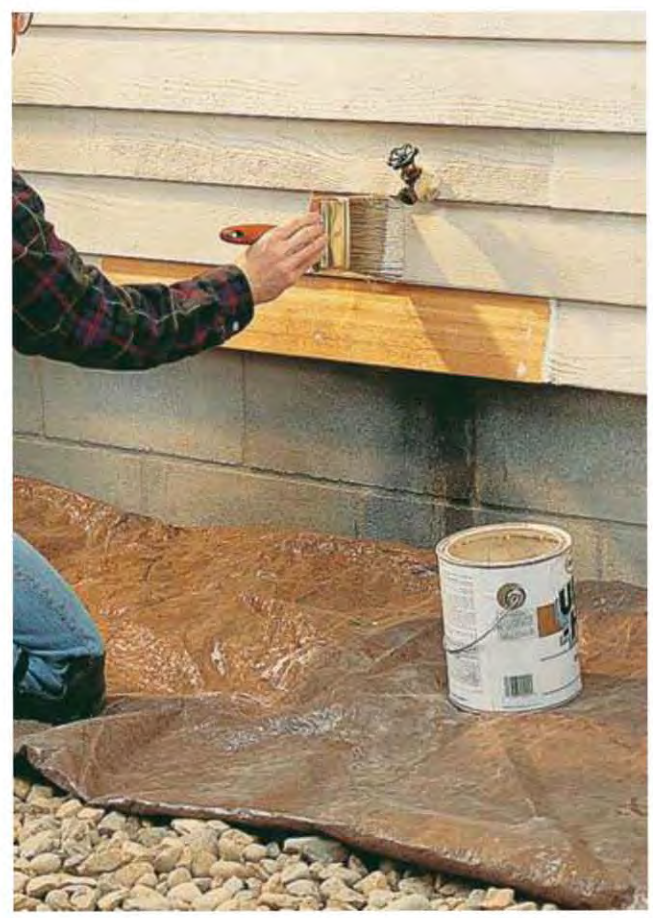
1 Locate and mark framing members inside the wall (use a stud finder) so you can draw cutting lines around the damage that fall over studs. Starting at the bottom, cut clapboards at the cutting lines with a keyhole saw or a wallboard saw. For access, slip wood shims under the clapboard above the one you're cutting. NOTE: The repair will look better if you stagger cutting lines so they don't fall on the same stud.



2 Cut replacement clapboards to fit, using a miter saw or power miter saw.



3 Nail the replacement clapboards in the patching area (you can use tape to hold them in place if you like). Follow the same nailing pattern used for the boards around it. Set nail heads with a nailset.



4 Caulk the gaps between clapboards and fill nailholes with exterior putty or caulk. Prime and paint the repaired section to match.

HOW TO REPAIR BOARD & BATTEN

1 With a flat pry bar, remove the battens on each side of the damaged area. To protect the painted surfaces, cut along the joints between the boards and battens with a utility knife before removing the battens.

2 Remove the damaged panel (or make vertical cuts with a circular saw underneath the batten locations if any of the battens are only decorative). Cut a replacement panel from matching material, sized to leave a ⅛" gap between the original panels and the new patch. Nail panel in place, caulk the repair seams and reinstall the battens. Prime and paint to match.

HOW TO REPAIR TONGUE & GROOVE

1 To repair tongue-and-groove siding, first mark both ends of the damage and rip-cut the board down the middle, from end to end, with a circular saw or trim saw. Then use the trim saw to cut along the vertical lines. Finish all cuts with a keyhole saw. Split the damaged board with a pry bar or a wide chisel. Then pull the pieces apart and out of the hole. If the building paper below the damaged section was cut or torn, repair it.

2 Cut the replacement board to fit, then cut off the backside of the groove so the board can clear the tongue on the course below. Prime the board, let it dry, then nail it into place. Paint to match.

13 Repairing Stucco

Small stucco problems rarely turn into major problems—if you catch them when they are still small. A caulk product designed for masonry will fix small stucco woes. The patched area can then be covered with touch-up paint so that it blends in.

STUCCO IS ONE OF THE MOST DURABLE SIDING MATERIALS USED ON HOMES. But damp climates can be especially hard on these surfaces, and if left unattended, small cracks can lead to some pretty big problems. A few years of water damage can cause large sections of stucco to loosen and even fall away from your house.

Fortunately, these problems aren't all that hard to repair, even for beginners. And keeping stucco in good condition is one of the easiest maintenance tasks of all. All you really need to do is inspect your stucco once each year and fill any small cracks you find—which won't happen that often. But let's say you forgot, and your stucco has a more major problem. Don't panic; just keep reading.

STUCCO 101

Your original stucco walls were made from three layers of cement-based stucco laid over a metal fabric, called lathe, which is nailed over the building paper and plywood or plank sheathing covering the skeleton of the walls. Today, though, you can just use a single premixed stucco product, sold in plastic buckets, to make repairs to stucco.

TERMS YOU NEED TO KNOW

BROWN COAT—The second of three stucco layers, the brown coat uses the same formulation as the scratch coat, but is applied in a smooth layer.

SCRATCH COAT —The first of three layers of stucco, it earns its name because it is scored with grooves while still wet so that the following coats will adhere to it.

FINISH COAT—The top layer of stucco, which is often tinted and textured to provide a decorative finish.

METAL LATH—This porous steel fabric is nailed to wall sheathing to provide the base for the first, or scratch coat of stucco.

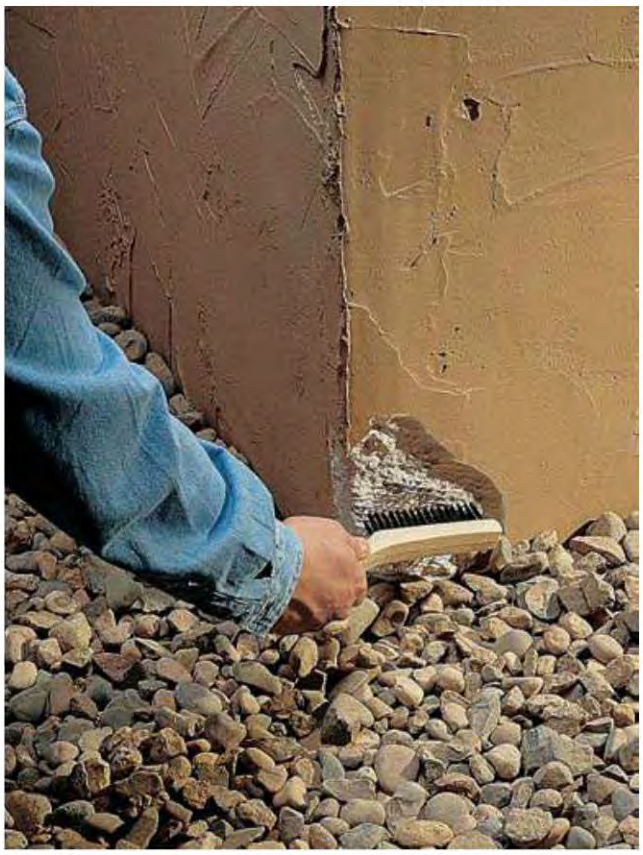
SQUARE-END TROWEL—a straight, smooth metal tool used to apply stucco and other masonry substances.

TOOLS & SUPPLIES YOU NEED

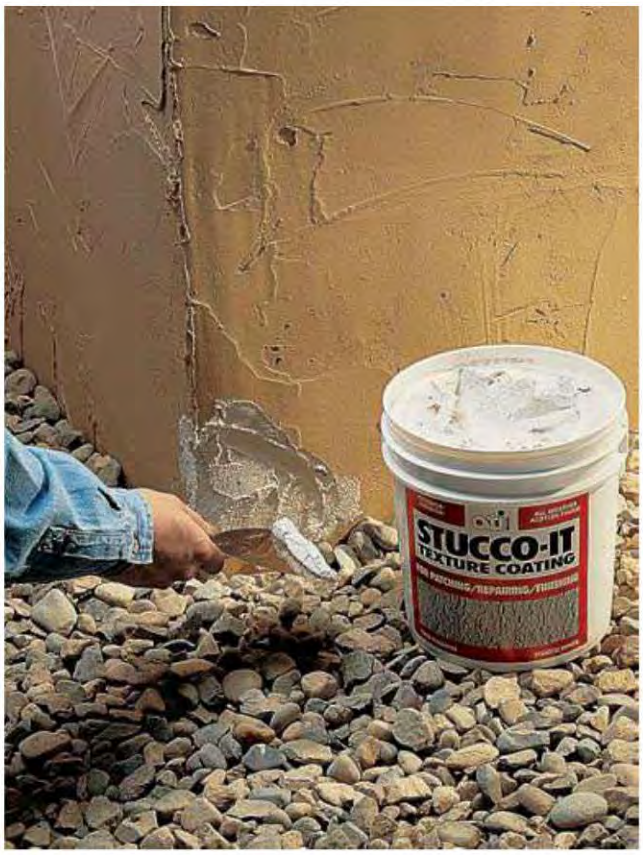
DIFFICULTY LEVEL

This project can be completed in two to four days.

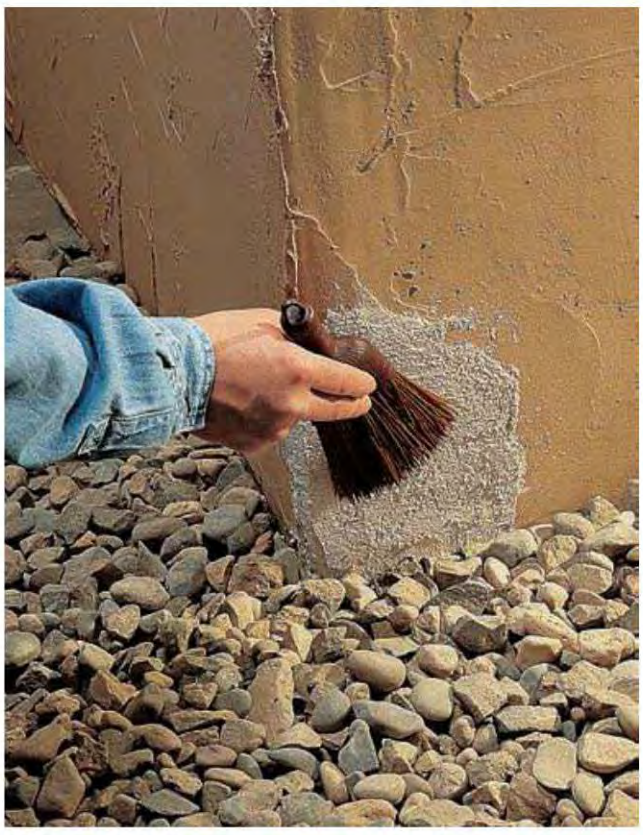
HOW TO PATCH STUCCO



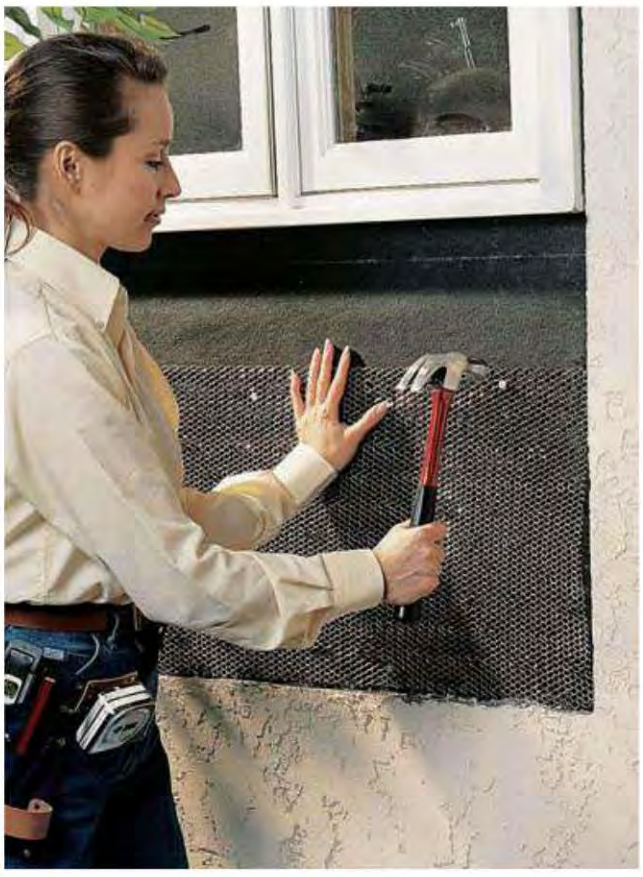
1 Remove loose material from the repair area, using a wire brush. If the underlying metal lath has any rust, brush this away, too.



2 Use a broad putty knife or small trowel to apply premixed stucco repair compound to the repair area, with enough depth to slightly overfill the depression.



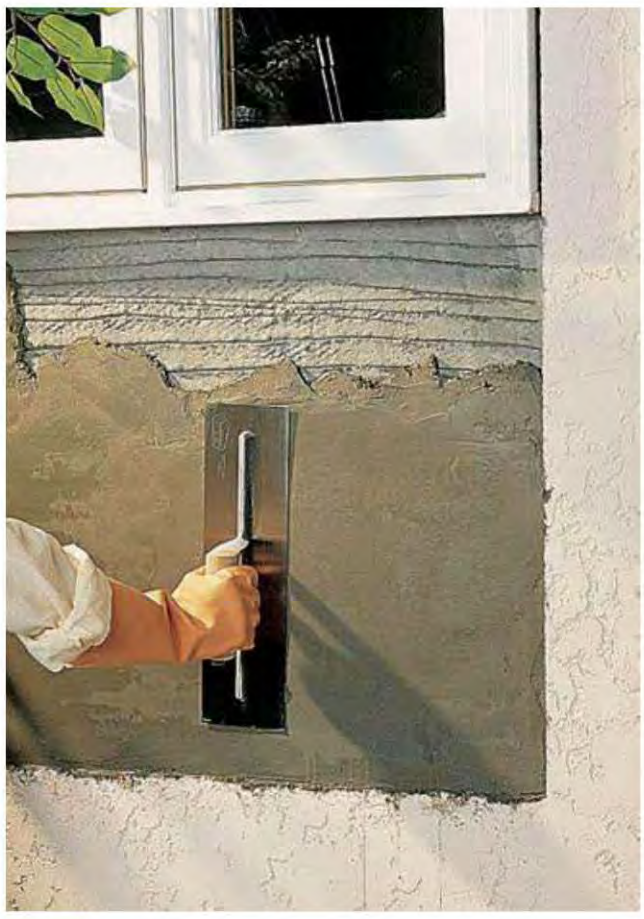
3 Smooth out the repair area with your knife or trowel, taking care to make the borders of the repair blend smoothly into the surrounding wall surface. Use a whisk broom or trowel to duplicate the texture of the wall.



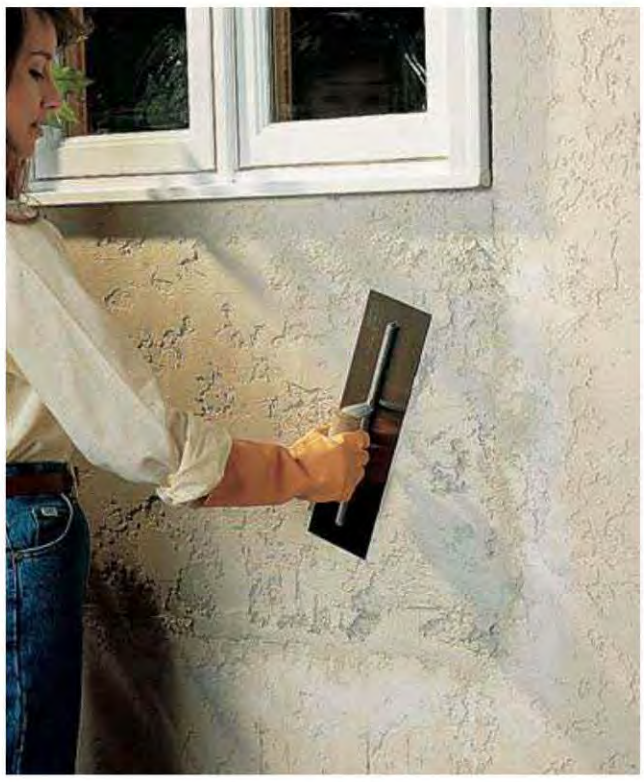
4 If you have any bigger patch areas, chip away the loose stucco, cut away the loose metal lath, then cut and attach new lath to the wall sheathing.

5 If your large patch area includes a corner, cut and install a piece of metal edging along the corner of the wall. Sheet metal is sharp, so make sure you wear gloves and eye protection when cutting it.

6 Apply a base, or scratch coat of premixed stucco compound over the lath, with a thickness of about ⅜". Score closely spaced horizontal lines in the wet surface, using a scratching tool or a nail. Let the stucco dry for a couple of days.

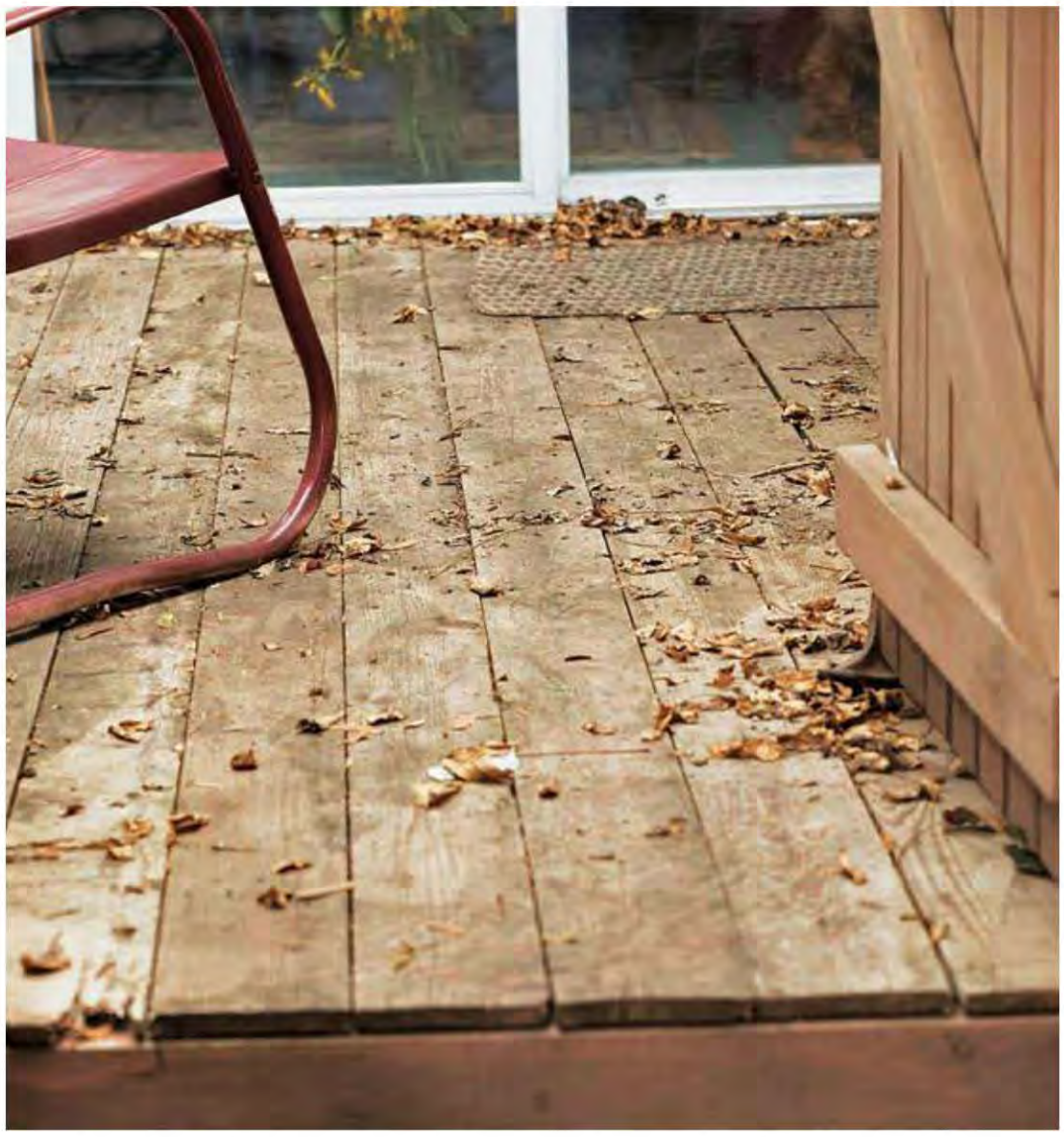


7 Apply the second coat of stucco patch compound, to withing ¼" of the original surface. Let the patch dry for a day or two.



8 Apply the final coat of stucco, then texture it to match the surrounding wall, using a whisk broom or trowel. After the stucco dries, you can either paint the patch area to match the surrounding wall, or paint the entire wall for nearly invisible blend.

14 Renewing Wood Decks



Weathered wood has true romantic appeal, but when the wood is the only thing between your feet and the ground it ought to be in pristine shape. Refinishing a wood deck is vital to that cause (and you'll need to learn how, since you'll be doing it practically every year).

WOOD DECKS CAN BE GREAT THINGS. They give you a place to relax and entertain outside, while maintaining one of the big advantages of staying in: a flat stable floor. In the last 30 years, decks have overtaken the old fashioned patio. One reason for this is that decks are made of wood, not masonry, so the design possibilities are almost limitless. Masonry products, whether concrete, brick, or natural stone, are much harder to work with and are more expensive. Wood decks do wear out and must be maintained to last a long time and look good while doing it.

If you have a small deck (anything under 200 sq. ft.), refinishing is a pretty easy job. But on larger decks, refinishing can develop into quite a chore. The thing to remember, when you've been scrubbing off the old finish for hours, is that replacing a deck can eat up $10,000 nearly as fast as a college bursar. So it pays to take care of things before the deck damage gets out of control.

DECK FINISHING 101

Refinishing a deck involves three separate steps. The first is to remove the old finish. The second is to wash away all the dirt, mildew, and other residues. And the third is to reseal the surface with a new finish. There are lots of products on the market for cleaning decks. The trick is to get the product that's right for your situation. Anything that just says "deck cleaner" is not what's needed. These help lift off dirt and grime but won't do much to remove an old finish. If your deck is covered with just a transparent sealer or a light stain, then a product called a "stain/sealer remover" is what you need. If you have a heavy, solid-color stain, you'll want something stronger. These are sometimes called simply "deck finish strippers," and are made to lift off everything from the surface.

TERMS YOU NEED TO KNOW

DRILL/DRIVER—A cordless drill outfitted with an adjustable clutch that lets the user preset the amount of force used to drive any fastener. Once the drill reaches the preset torque limit, the clutch prevents the chuck from rotating and thus the bit from turning.

LAG SCREWS—A steel screw with a hexagonal head and a thin body with a coarse thread. Used for drawing heavy boards together without using a standard bolt, nut and washers.

CUPPED BOARD—A board that has a convex deviation (a bump) across its width, not its length or thickness.

TOOLS & SUPPLIES YOU NEED

DIFFICULTY LEVEL

This project can be completed in one to two days depending on size of deck.

HOW TO RENEW A WOOD DECK FINISH

1 Apply a heavy coat of deck stripper to the deck boards. Usually a garden sprayer works for this job. But you can also use a paint roller with a long nap roller to spread the stripper.

2 Let the stripper set for as long as the container directions recommend (usually around 15 minutes). Then brush it vigorously with a stiff bristle deck brush. Try to avoid splattering the stripper on nearby plants, the siding, trim or windows and doors.

3 Rinse off the stripper using a garden hose with a spray attachment or use a pressure washer. Be sure to rinse any adjacent surfaces that might have been splattered with stripper.

4 Next comes the deck cleaner, which is often sold in a concentrated form. Mix it thoroughly in a large bucket, according to the container's directions.

5 Using a stiff deck brush, spread the deck cleaner over the boards and scrub until the wood brightens. Usually, this happens almost immediately. Keep scrubbing until the surface looks new.

TIP

Keep in mind, when working with the brush, that it tends to hold less sealer than a paint roller. So, to ensure even coverage, load up the brush with extra sealer and apply it in a heavier coat.

6 Protect surrounding surfaces with masking tape and paper, then start brushing on the sealer. Use the brush just for hard to reach areas. Use a roller on everything else.

7 Apply sealer to the open areas with a roller that has a ¾"-nap roller cover. As you move, press the roller down forcefully so the sealer squeezes between the boards and covers their edges.

15 Replacing Damaged Roof Shingles

A little bit of localized damage doesn't mean it's time to reroof your whole house. Replacing an old shingle or two can buy you many more years of coverage, but only if the roof doesn't show widespread wear.

THE WORLD OF RESIDENTIAL ROOFING IS PRETTY VARIED. Asphalt, fiberglass-reinforced asphalt, rolled asphalt, wood shingles, wood shakes, slate, concrete, terra cotta tiles, steel, and rubber are just some of the current roofing choices. Why is it with all this choice what you see practically everywhere is asphalt shingles, row after row, all clean-cut, well behaved and just a little bit dull? Well, cost is one thing. Standard three-tab asphalt shingles are priced at about $80 per square (100 square feet of coverage), which is a lot cheaper than other options. Asphalt is also reliable and durable. Twenty-year lifespans are not uncommon.

If you have asphalt shingles on your roof and a small section is damaged, you're in luck. The repair is easy and quick, if only a couple of shingles are involved, so you can do it yourself. There are only two significant obstacles to the job. The first is working from a ladder. If this makes you uncomfortable, hire the job done. The second is that the repair involves a small amount of plastic roof cement. No matter how much you use, this material will get all over you and every tool you touch.

ROOF SAFETY 101

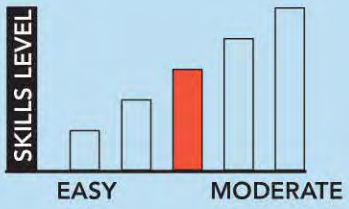
If your roof pitch is 6:12 (6 in. of vertical rise for every 12 in. of horizontal run) or less, then you should be able to work on the roof comfortably and safely. But if your roof is steeper than 6:12, consider getting a contractor. A fall, from even a one-story roof, is a serious matter. To measure a slope, hold a carpenter's square against the roofline, with the top arm horizontal (check it with a level). Position the square so it intersects the roof at the 12" mark. On the vertical arm, measure down from the top to the point of intersection to find the rise.

PROBLEMS YOU'LL NEED TO SOLVE

You can't repair a roof if you don't have some replacement shingles. Fortunately many builders save the shingles that were left over from the original installation. These will be a bit brighter than the ones on the roof that have been faded by the sun. But they'll be close enough. If you don't have any original shingles and can't buy a good match at your local lumberyard, your best strategy is to harvest repair shingles from a less noticeable section of the roof. This means you'll have to repair two roof sections instead of one, but you'll end up with a better looking job.

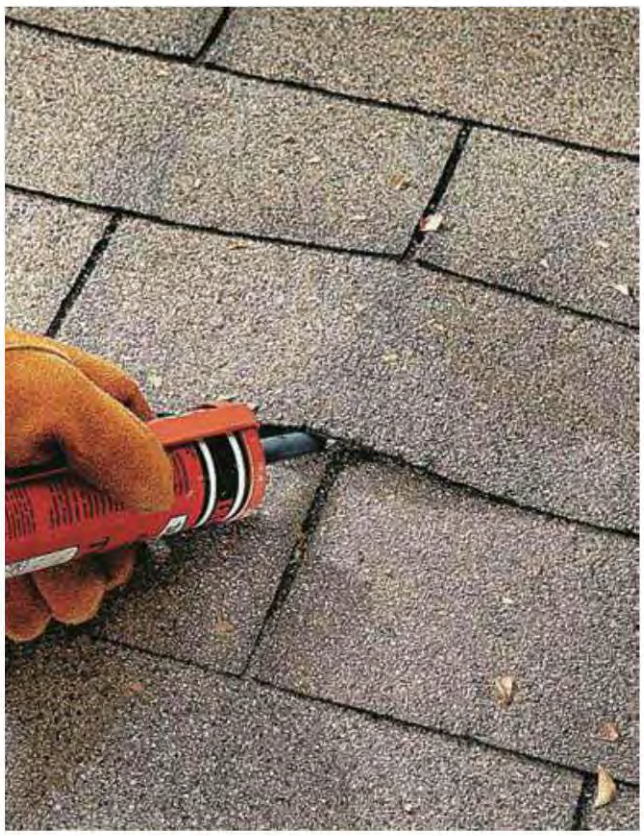
TOOLS & SUPPLIES YOU NEED

DIFFICULTY LEVEL



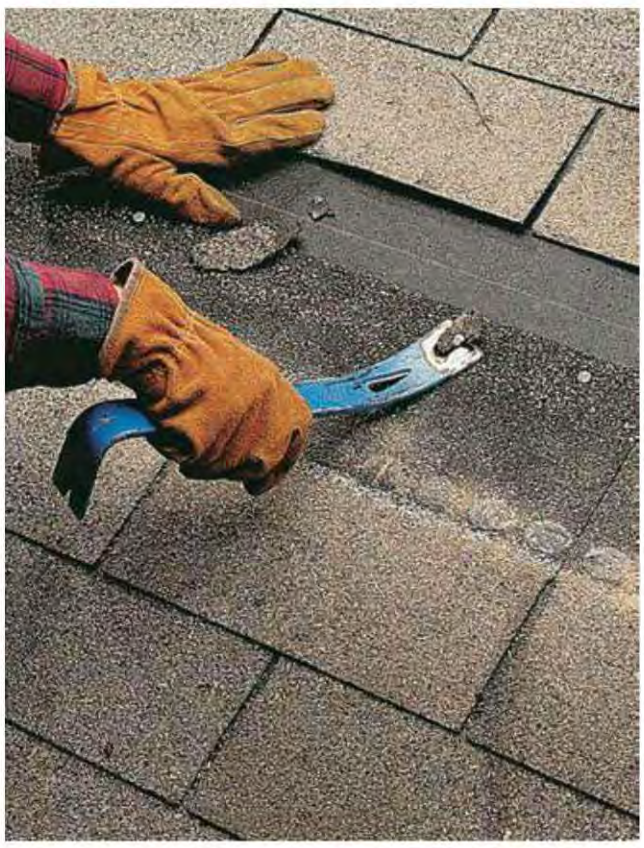
This project can be completed in three to five hours.

HOW TO REPLACE DAMAGED ROOF SHINGLES



1 To flatten a buckled shingle, squeeze some plastic roof cement under the buckle then weigh down the shingle with a brick or two for a couple of hours.

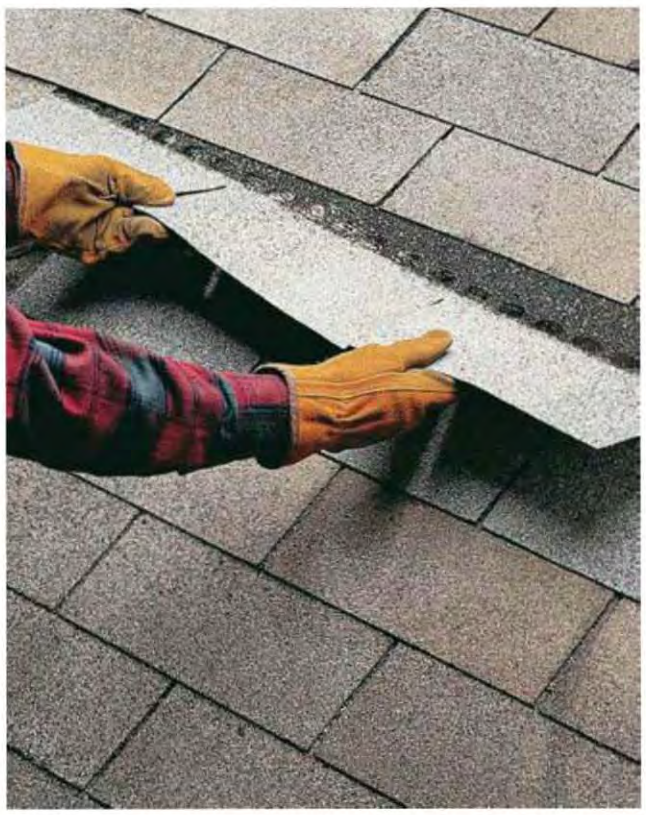
2 To remove a damaged shingle, grip its bottom edge (with gloves on) and wiggle it back and forth as you pull down. This will pull it free from the roofing nails that hold it in place.



3 Remove any exposed nails with a flat pry bar or a nail puller. If the roofing felt (the layer below the shingles) is damaged, repair the patch with some plastic roof cement.

4 Nail the new shingles in place, starting at the lowest course and working up. The new shingle will not be as faded as the old ones surrounding it. But over time the difference between the two will be less noticeable.

5 Before installing the last shingle, turn it over and apply a bead of plastic roof cement to the back top edge. Keep this bead about 1 in. below the top edge.



6 Carefully slide the last shingle into place. The plastic roof cement will smear across the underside of the shingle, which will improve the bond with the shingle below. Press the repair shingle flat, then lift up the shingle above and drive nails in the typical way.

7 If the damaged shingle falls in a roof valley, take it out and clean any old cement from the valley flashing. Then apply two beads of plastic roof cement along the edge of the valley.

8 Cut the repair shingle to size and slide it into position. Press it firmly into the valley cement to achieve the best bond.

16 Installing Locksets & Deadbolts

You never know when you'll need to replace a door lockset or deadbolt, but there are many situations when you'll be glad you know how to do it.

HOME SECURITY IS NOT SO MUCH A MATTER OF TENACIOUS CRIME PREVENTION AS IT IS A QUESTION OF PEACE OF MIND. If you have been burglarized, you're bound to feel vulnerable. So we all have an interest in keeping what's outside, outside. There are many different approaches to accomplishing this. Some cost a lot of money, and some don't cost much at all. The first (and most expensive) is having a whole-house security system installed that notifies the police if there's any trouble. But not everyone needs or wants something so involved. A more passive approach serves their needs. This generally means a combination of motion-activated floodlights and quality door locks. When someone carefully approaches a back door at night, there are few things as alarming as having a bright light suddenly flash in their eyes. And there's nothing quite as discouraging as trying to break through a door with a deadbolt lock when you want to go unnoticed. If you only care to do one of these security building jobs, pick installing better locks. They're on the job every day, all day and all night, whether the power is on or off.

LOCKSETS & DEADBOLTS 101

LOCKSETS—A good door deserves a good lockset. Inexpensive locksets are available for $10 to $15 and high quality ones cost around $40. Locksets for interior doors are called passage locks and are not suitable for exterior doors.

DEADBOLTS—A good deadbolt should cost around $25. There are several styles to choose from that differ in ways other than finish. Some are keyed on the outside and have a thumblatch on the interior side. If you have a glass sidelight or door panel, think about buying a model that's keyed on both the exterior and interior so an intruder can't break your glass and reach in to unlock the deadbolt.

TOOLS & SUPPLIES YOU NEED

TERMS YOU NEED TO KNOW

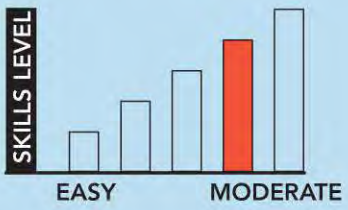
DOOR JAMB—Boards that define a door opening. The door hinges are hung on one jamb board and the strike plates for any locks are installed on the opposite jamb.

TEMPLATE—A pattern that establishes the proper layout for a procedure. In this case, a piece of paper taped to a door to indicate where clearance holes should be drilled.

LOCKSET—A complete locking system including knobs, locking mechanism, locking bolt, and decorative roses. Used on entry doors and interior doors where locking is desired.

DEADBOLT—A heavy-duty locking bolt that goes deep into the door jamb to prevent tampering.

DIFFICULTY LEVEL



This project can be completed in two to three hours.

HOW TO INSTALL A LOCKSET

1 Remove the old lockset. The knob on the inside of the door is usually held in place with a small clip. This is located on the side of the sleeve that extends from the knob to the flange on the door surface. To release this clip, just push it into the flange with a screwdriver or an awl. Then pull off the knob.

2 Remove the flange next. These are usually snapped in place over the lock mechanism underneath. To remove one, just pry it off with a screwdriver pushed into a slot designed for it. Other flanges are held by small spring clips. By pushing down on the clip with a screwdriver, the flange can easily be pulled off with your fingers.

3 Once the flange is off, the lock mechanism will be accessible. The two sides of the lock are joined together by two screws. Remove these screws and take the lock components out of the lockset hole in the door.

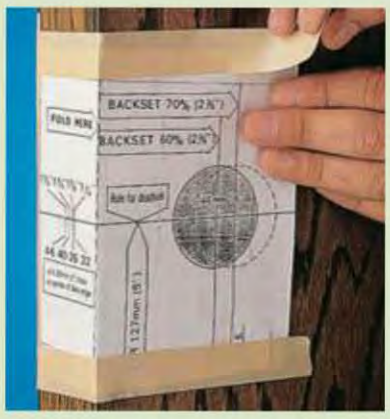
4 With both sides of the lock removed, the lock bolt can be taken out. Remove the screws that hold the bolt plate to the edge of the door. Then pull out the bolt mechanism.

5 Install the new bolt assembly and make sure that the screws in the bolt plate are driven tightly into the door. Separate the lock halves and slide them together with the door and bolt assembly sandwiched between.

6 While holding one side of the lock against the door, maneuver the other side of the lock so the screws fall in the slots made for them. Once the screw heads have cleared the slots, tighten the screws so both halves of the lock are tight against the door. Install the new knobs and new strike plate.

HOW TO INSTALL A DEADBOLT

TEMPLATE TIP



Many doors sold today come with holes for the lockset predrilled. Some also are predrilled for a deadbolt, but very often you'll need to drill holes for the actual deadbolt you purchase. To assist in this, manufacturers provide a template that you tape to the door for reference. Following the manufacturer's instructions, tape the hole template to the door (make sure you've oriented the template to correspond to the actual thickness of your door) and mark the center point of each hole, including the bolt hole in the edge of the door. The deadbolt is usually located 7" or 8" above the lockset.

1 Determine the size of holesaw you need by checking the installation instructions that came with the lock. Then chuck this tool into a drill and bore the hole. Stop boring when the tip of the drill bit, at the center of the holesaw, breaks through the other side.

2 Go to the other side of the door and slide the pilot bit of the hole saw into the hole and cut out the rest of the waste material. If you try to cut through the door in a single pass, you risk tearing the steel covering (on steel-clad doors) as the hole-saw teeth break through the surface.

4 Push the bolt assembly into the bolt hole so the bolt plate is flat on the edge of the door. Trace around the plate with a utility knife. Remove the mechanism and cut a ⅛"-deep mortise in the edge of the door with a sharp chisel (see next page).

3 Drill the bolt hole through the edge of the door, using a spade bit or forstner bit. Make sure to keep the bit level so the bolt hole will enter the lock hole at the proper point.

5 Once you're satisfied with the fit, press the bolt plate into its mortise and attach it by driving in the two plate screws. Slide both sides of the lock into the bolt mechanism (inset) and attach them by driving the screws that hold the two parts together. Make sure these screws are tight.

MORTISING TECHNIQUE

Installing hardware plates requires using a wood chisel to create a mortise for the hardware.

1 Deepen the outline for the mortise to ⅛" with a wood chisel (try to find a chisel the same width as the mortise). With the beveled face of the chisel blade facing into the mortise, rap the handle with a mallet.

2 Chisel a series of ⅛"-deep parallel cuts about ¼" apart.

3 Position the chisel bevel-side down at about a 45-degree angle. Strike with a mallet to chisel out the waste. Smooth the mortise bottom.

6 Extend the lock bolt and color its end with lipstick, a grease pencil, or a crayon. Then retract the bolt, close the door and extend the bolt so its end hits the jamb. This will yield the precise location of the bolt hole that's needed on the jamb. Drill a hole (usually 1½" deep) for the bolt with a spade bit (see installation instructions for actual hole size requirements).

7 Close the door and test the deadbolt to make sure the bolt fits into the bolt hole in the jamb. If not, enlarge the hole slightly. Once the bolt fits, center the strike plate over the bolt hole and trace it with a utility knife. Cut a mortise for the strike plate using a sharp chisel.

8 Finish up by installing the strike plate on the jamb. Some of these plates are oversized like the one above. But most look more like standard lockset strike plates. Both types, however, feature long screws that are driven through the jamb and deep into the wall studs behind.

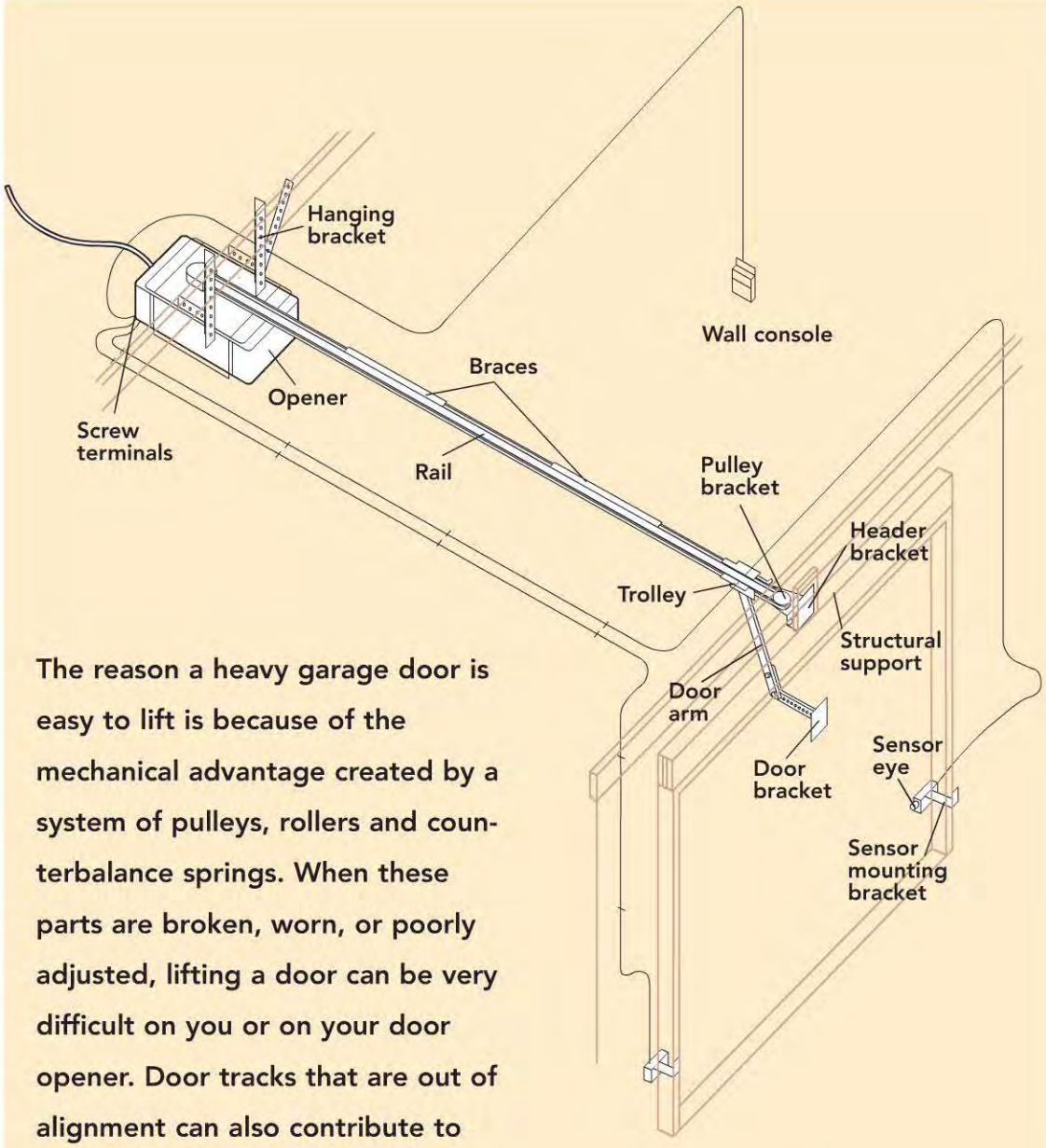
17 Tuning Up Garage Doors

A garage door that's well maintained and a working garage door opener are modern conveniences that are easy to take for granted.

IS THIS A GREAT COUNTRY OR WHAT? YOU'RE DRIVING HOME LATE AT NIGHT, IT'S POURING OUTSIDE, AND YOU'RE FREEZING BECAUSE YOU'VE GOT THE FLU. Then, you turn into your driveway, punch a little button, and your garage door opens, a light comes on, you pull in, and you're HOME. You didn't have to get drenched, or lift a door that felt like heavy metal, or scream at the heavens for making you so miserable. You danced away from all of this, and that is a good thing.

Unfortunately, over time, many good things become bad things, especially if they aren't well-maintained. And an overhead garage door is no exception. To keep everything running smoothly requires effort on three fronts: the door, the opener, and the electronic safety sensors that prevent the door from closing on cars, pets or people.

GARAGE DOORS 101



The reason a heavy garage door is easy to lift is because of the mechanical advantage created by a system of pulleys, rollers and counterbalance springs. When these parts are broken, worn, or poorly adjusted, lifting a door can be very difficult on you or on your door opener. Door tracks that are out of alignment can also contribute to the problem. Lock problems are common in garage doors: either the cylinder is hard to operate or the lock bar doesn't fit in its track opening.

Most door openers have a chain drive that may require tightening or lubrication. And sensors located on both sides of the door can be easily knocked out of alignment.

TERMS YOU NEED TO KNOW

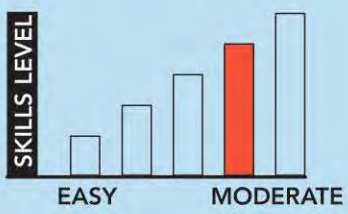
CHAIN-DRIVE OPENER—An electric opener that lifts and lowers a garage door with a chain that's driven by a motor mounted sprocket.

SCREW-DRIVE OPENER—An electric opener that lifts and lowers a garage door with a continuous screw that's driven by a gear in the motor.

CLOSING FORCE SENSITIVITY—This is a measurement of how quickly a garage door opener will stop and reverse the door's travel when an obstruction is sensed or hit.

TOOLS & SUPPLIES YOU NEED

DIFFICULTY LEVEL



This project can be completed in four to eight hours.

HOW TO TUNE-UP A GARAGE DOOR

1 Begin the tune-up by lubricating the door tracks, pulleys and rollers. Use a lightweight oil, not grease, for this job. The grease catches too much dust and dirt.

2 Remove clogged or damaged rollers from the door by backing off the nuts that hold the roller brackets. The roller will come with the bracket when the bracket is pulled free.

3 Mineral spirits and kerosene are good solvents for cleaning roller bearings. Let the bearing sit for a half-hour in the solvent. Then brush away the grime build-up with an old paint brush or toothbrush.

4 If the rollers are making a lot of noise as they move over the tracks, the tracks are probably out of alignment. To fix this, check the tracks for plumb. If they are out of plumb the track mounting brackets must be adjusted.

5 To adjust out-of-plumb tracks, loosen all the track mounting brackets (usually 3 or 4 per track) and push the brackets into alignment.

6 It's often easier to adjust the brackets by partially loosening the bolts and tapping the track with a soft-faced mallet. Once the track is plumb, tighten all the bolts.

7 Sometimes the door lock bar opens sluggishly because the return spring has lost its tension. The only way to fix this is to replace the spring. One end is attached to the body of the lock; the other end hooks onto the lock bar.

8 If a latch needs lubrication, use graphite in powder or liquid form. Don't use oil because it attracts dust that will clog the lock even more.

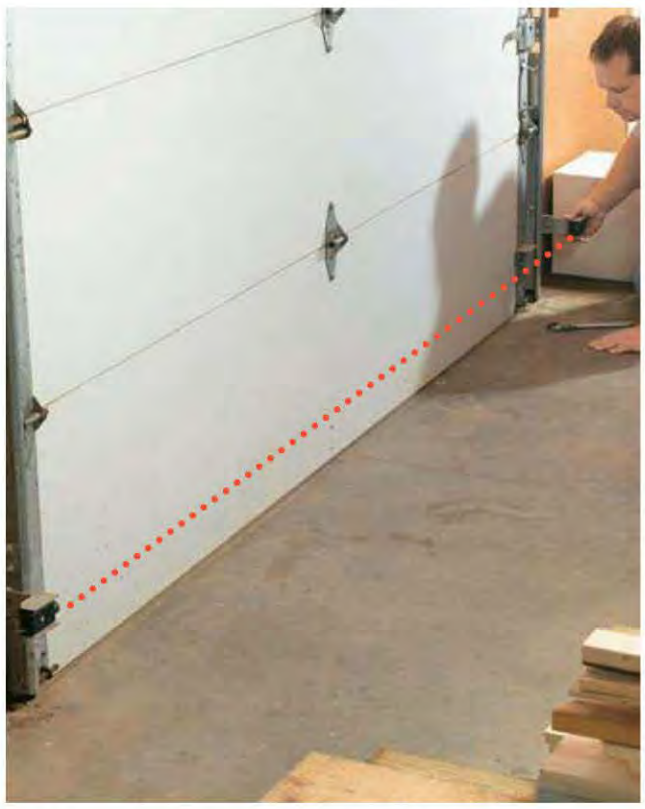
9 Sometimes the lock bar won't lock the door because it won't slide into its opening on the door track. To fix this, loosen the guide bracket that holds the lock bar and move it up or down until the bar hits the opening.

10 Worn or broken weatherstripping on the bottom edge of the door can let in a lot of cold air and stiff breezes. Check to see if this strip is cracked, broken, or has holes along its edges. If so, remove the old strip and pull any nails left behind.

11 Measure the width of your garage door, then buy a piece of weatherstripping to match. These strips are standard lumber yard and home center items. Sometimes they are sold in kit form, with fasteners included. If not, just nail the stripping in place with galvanized roofing nails.

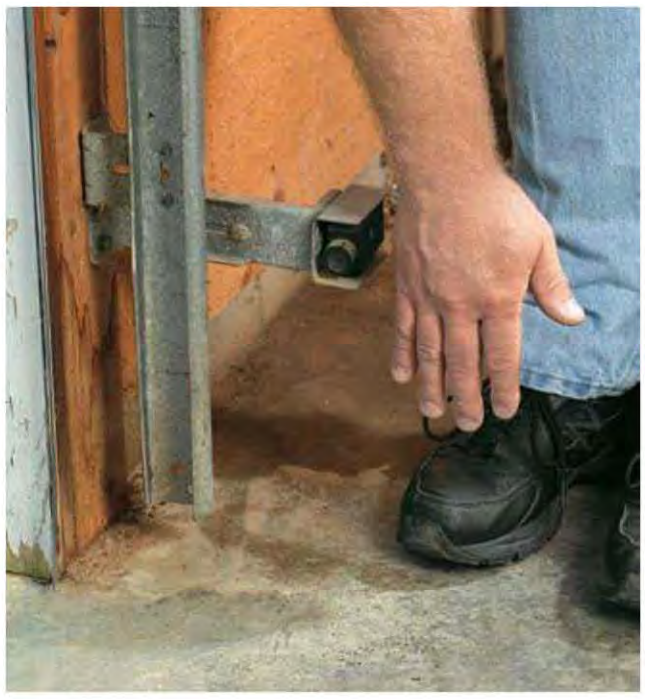
12 If the chain on your garage door opener is sagging more than ½" below the bottom rail, it can make a lot of noise and cause drive sprocket wear. Tighten the chain according to the directions in the owner's manual.

13 On openers with a drive screw instead of a chain, lubricate the entire length of the screw with lightweight oil. Do not use grease.



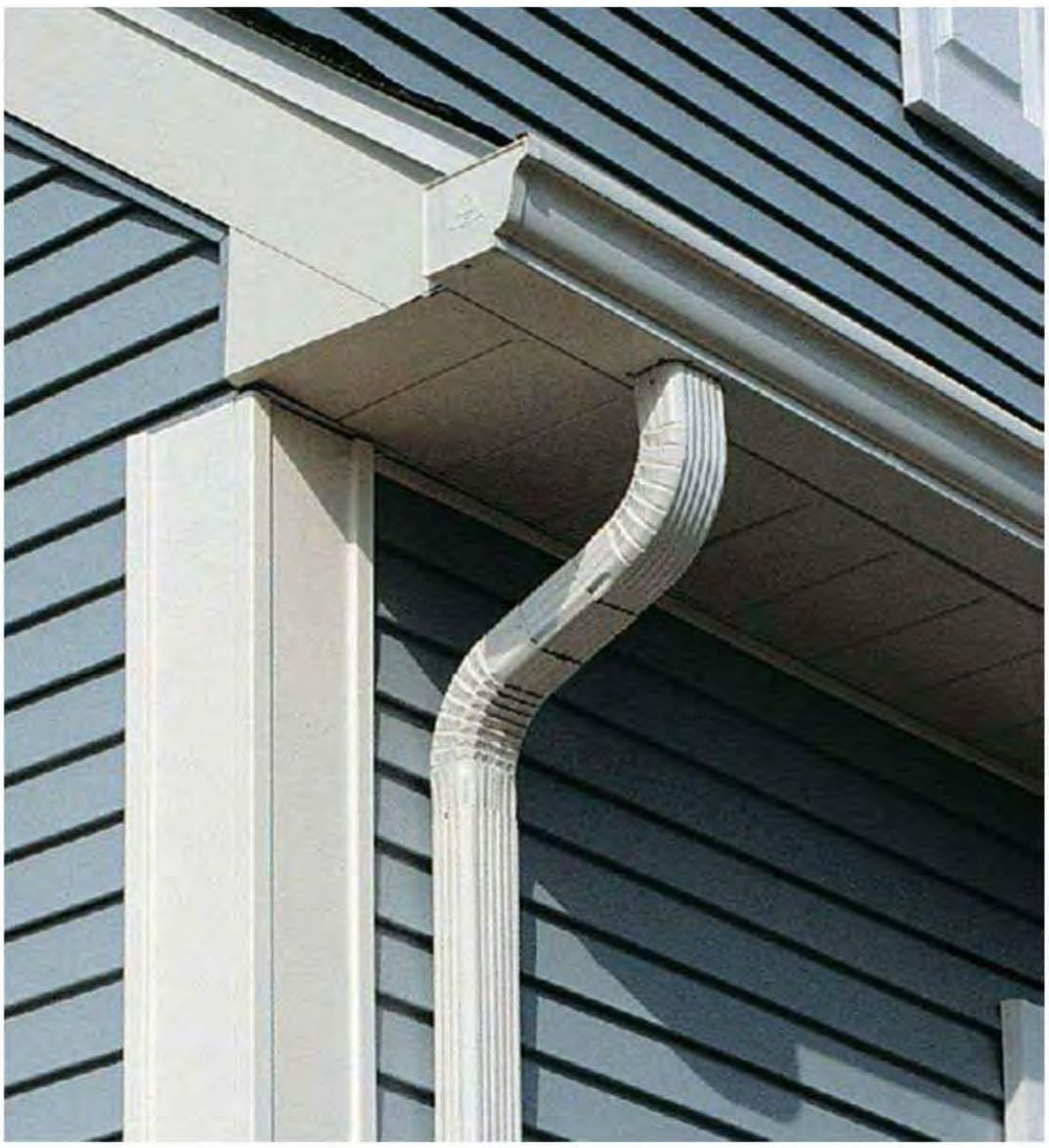
15 Check for proper alignment on the safety sensors near the floor. They should be pointing directly at one another and their lenses should be clean of any dirt and grease.

14 Test the door's closing force sensitivity and make adjustments at the opener's motor case if needed. Because both the sensitivity and the adjustment mechanism vary greatly between opener models, you'll have to rely on your owner's manual for guidance. If you don't have the owner's manual, you can usually download one from the manufacturer's website.



16 Make sure that the sensors are talking to the opener properly. Start to close the door, then put your hand down between the two sensors. If the door stops immediately and reverses direction, it's working properly. If it's not, make the adjustment recommended in the owner's manual. If that doesn't do the trick, call a professional door installer and don't use the door until it passes this test.

18 Installing House Gutters



Installing a snap-together vinyl gutter system is a manageable task for most do-it-yourselfers. Before you purchase new gutters, create a detailed plan and cost estimate. Include all the necessary parts, not just the gutter and drain pipe sections; they make up only part of the total system. Test-fit all the pieces on the ground before you begin the actual installation.

GUTTERS PREVENT RUNOFF FROM YOUR ROOF THAT CAN DAMAGE FOUNDATION PLANTINGS. THEY HELP KEEP WATER OUT OF YOUR BASEMENT, AND THEY REDIRECT WATER AWAY FROM ENTRYWAYS. In short, there are plenty of good reasons to install gutters on a house that doesn't have a gutter system, or to replace a failing gutter system. However, be aware that installing new gutters in cold climates can be a real problem. (As the old saying goes: You can't live with them and you can't live without them.) They have a bad rep because they cause so many ice dams. Without gutters, this water would just run off the edge of the roof. So consider all the pluses and minuses carefully before investing in a gutter system. If you decide to go for it, here's one tip: When calculating the costs, don't be fooled by the relatively low per-foot cost for a run of gutter or downspouts, since it's the fittings and connectors that make up most of the cost of DIY gutter installations.

GUTTERS 101

ESTIMATING GUTTER PARTS

GUTTER SECTIONS: Measure total length of run: add 15% for waste. Sold in 10-ft. lengths.

GUTTER HANGERS: One for every 2 ft. of gutter.

INSIDE/OUTSIDE CORNERS: One per corner with no outlet.

CONNECTORS: Two per corner; one per 10 ft. of gutter.

END CAPS (right or left): One per end.

DOWNSPOUT OUTLETS: One for every 35 ft. of gutter.

DOWNSPOUT ELBOWS: Three per downspout.

DRAIN PIPE: One pipe per downspout outlet. Measure gutter height, and add 5 ft. for each pipe (for splash block outlet and waste). Sold in 10-ft. lengths.

DRAIN PIPE HANGERS: Two per drain pipe.

Steel, aluminum and vinyl gutter materials are available at a number of different outlets, including lumber yards, home centers and some hardware stores. To make a shopping list, first measure the length of gutter you need. Then calculate the amount of downspout required (generally sold in 10-ft. lengths.) A good rule of thumb for 5-in. gutters says that any gutter run less than 40 ft. only needs one downspout. For longer ones, a downspout should be installed at both ends of the run. After you total up the gutters and downspouts, list the fittings. Each downspout requires an outlet fitting, and both ends of the completed gutter need an end cap. Any joints need a splice fitting, and any inside or outside corners need inside or outside corner fittings. Two elbows are required to make the transition between the outlet fitting and its downspout. And two fastener brackets are needed for each section of downspout. You'll also need hanging brackets for the gutters. Buy enough to install one every 2 ft.

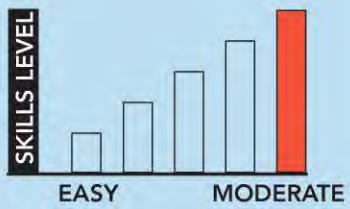
TERMS YOU NEED TO KNOW

GUTTER PITCH—This is the amount that a gutter slopes from its high to low points, usually expressed as difference in height per 10 ft. of run.

GUTTER RUN—The gutter sections and fittings that fall between gutter end caps.

TOOLS & SUPPLIES YOU NEED

DIFFICULTY LEVEL

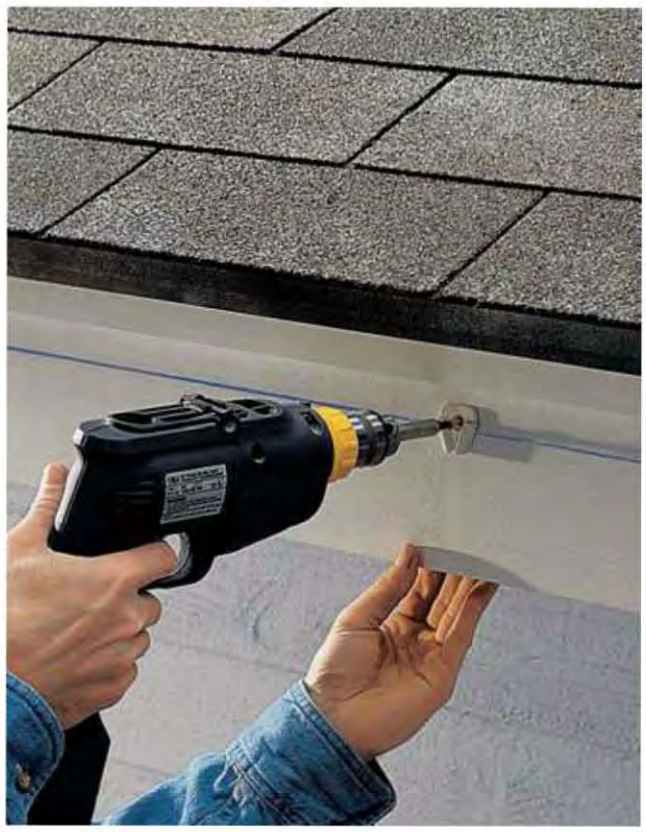


This project can be completed in two to four days.

HOW TO INSTALL VINYL GUTTERS

1 Mark a point at the high end of each gutter run, 1" from the top of the fascia. Snap chalk lines that slope toward downspouts. For runs longer than 35 ft., mark a slope from a high point in the center toward downspouts at each end.

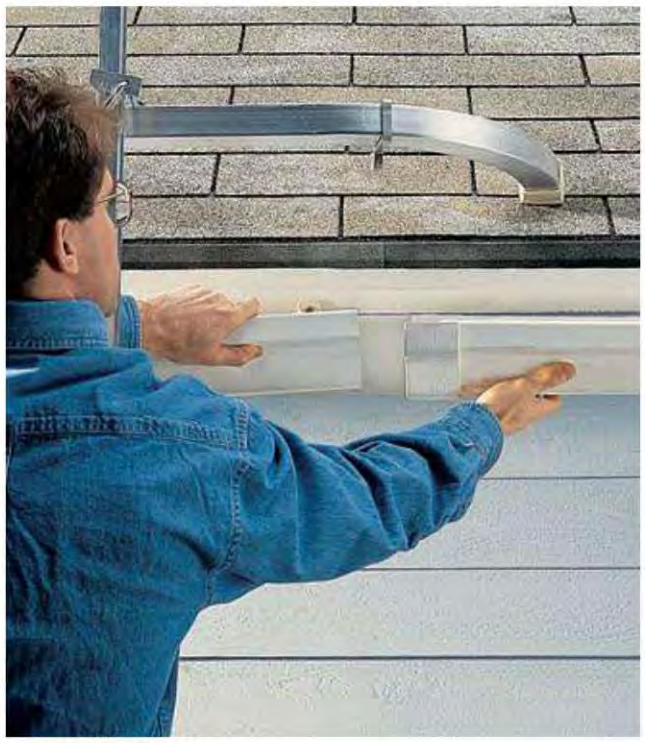
2 Install downspout outlets near the ends of gutter runs (at least one outlet for every 35 ft. of run). The tops of the outlets should be flush with the slope line, and they should align with end caps on the corners of the house, where drain pipes will be attached.



3 Following the slope line, attach hangers or support clips for hangers for a complete run. Attach them to the fascia at 24" intervals, using deck screws.

4 Following the slope line, attach outside and inside corners at all corner locations that don't have end caps.

5 Use a hacksaw to cut gutter sections to fit between outlets and corners. Attach the end caps and connect the gutter sections to the outlets. Cut and test-fit gutter sections to fit between outlets, allowing for expansion gaps.



6 Join the gutter sections together, using connectors. Attach gutter hangers to the gutter (for models with support clips mounted on the fascia). Hang the gutters, connecting them to the outlets.

7 Cut a section of drain pipe to fit between two downspout elbows. One elbow should fit over the tail of the downspout outlet and the other should fit against the wall. Assemble the parts, slip the top elbow onto the outlet, and secure the other to the siding with a drain pipe hanger.

8 Cut a piece of drain pipe to fit between the elbow at the top of the wall and the end of the drain pipe run, staying at least 12" above the ground. Attach an elbow, and secure the pipe to the wall with a drain pipe hanger. Add accessories, such as splash blocks, to help channel water away from the house (inset).

19 Installing Landscape Lighting

Low-voltage lights are safe to install and use to beautify your outdoor spaces. Unlike solar landscape lights, they are powered by good old reliable electricity, so they really can stay on all night if you wish them to.

SOME LANDSCAPE LIGHTING MANUFACTURERS PITCH THEIR SYSTEMS AS SECURITY PRODUCTS. If you keep the outside of your house well lit, the reasoning goes, the thieves will turn elsewhere to find easier pickings. It's possible that the companies are right about this. But probably the stronger arguments are for improved safety and appearance.

It can't be surprising that adding some light to the dark makes going places safer. This idea has been around for a long time—a very long time. But the notion that you can improve the look of your house, by adding some nightlights, is more recent. In fact, decorating with exterior lights became widespread only in the last 25 years, when low-voltage landscape lighting showed up. The beauty of low-voltage lighting is that it can be installed by anyone without the risk of being shocked.

Low-voltage lights are powered by a transformer that steps 120-volt current down to a safe 12 volts. Choosing the location for the transformer is an important part of planning. You have two options: inside the house and outside the house. The outside installation is a little easier, but the inside one is a little better, especially from a security standpoint. Also take some time to review your light placement. Once you are happy with the plan, drive a small stake where you want each light to go.

LOW-VOLTAGE LIGHT KITS 101

Landscape lighting can be ordered in kit form or as individual pieces. Kits include a few light heads, some wire and a transformer that changes standard house current into low-voltage power. If you want half a dozen lights along the front walk, for example, then the kit is a good idea. It's cheaper, very easy to install and will last a long time unless the lights get run over by a lawnmower. Predictably, the individual parts approach offers a much wider range of light heads, a selection of transformers that can handle bigger jobs, and all the wire and other accessories anyone could need. Of course, this choice costs more money. A typical starter kit retails for about $150, while a collection of 20 expensive light heads, a big transformer and lots of wire can gobble up $1000 or more.

TERMS YOU NEED TO KNOW

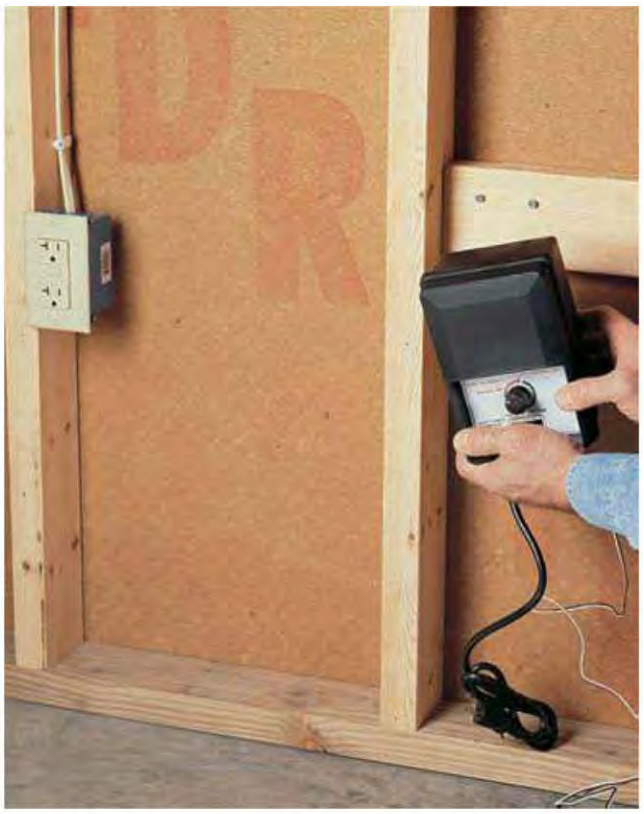
LOW-VOLTAGE—Usually about 12 volts of current, instead of the standard 120 volts, used to power devices like outdoor landscape lights.

TRANSFORMER—A smaller version of the gray pods that are mounted at the top of electrical power poles. Changes current of one voltage to another. In this case, from the standard (and dangerous) 120-volt electrical service to a much safer 12-volt service.

TOOLS & SUPPLIES YOU NEED

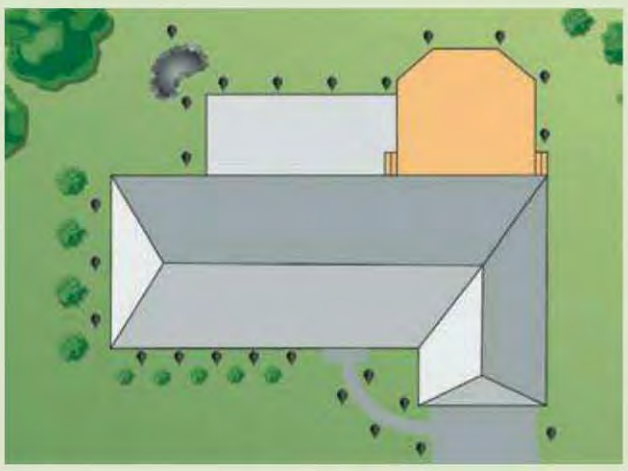
DIFFICULTY LEVEL

This project can be completed in eight to twelve hours.



1 Install your transformer or transformers. If you are installing one in a garage, mount it on a wall within 24" of the GFCI receptacle and at least 12" off the floor. If you are using an outdoor receptacle on a wall or a post, mount the transformer on the same post or an adjacent post at least 12" off the ground and not more than 24" inches from the receptacle. Do not use an extension cord.

PLANNING TIP



Make a diagram of your yard and mark the location of new fixtures. Note the wattages of the fixtures and use the diagram to select a transformer and plan the circuits.

2 Drill a hole through the wall or rim joist for the low-voltage cable and any sensors to pass through (inset). If a circuit begins in a high-traffic area, it's a good idea to protect the cable by running it through a short piece of PVC pipe or conduit and then into the shallow trench.

3 Attach the end of the low-voltage wire to the terminals on the transformer. Make sure that both strands of wire are held tightly by their terminal screws.

4 Transformers usually have a simple mechanism that allows you to set times for the lights to come ON and go OFF automatically. Set these times before hanging the transformer.

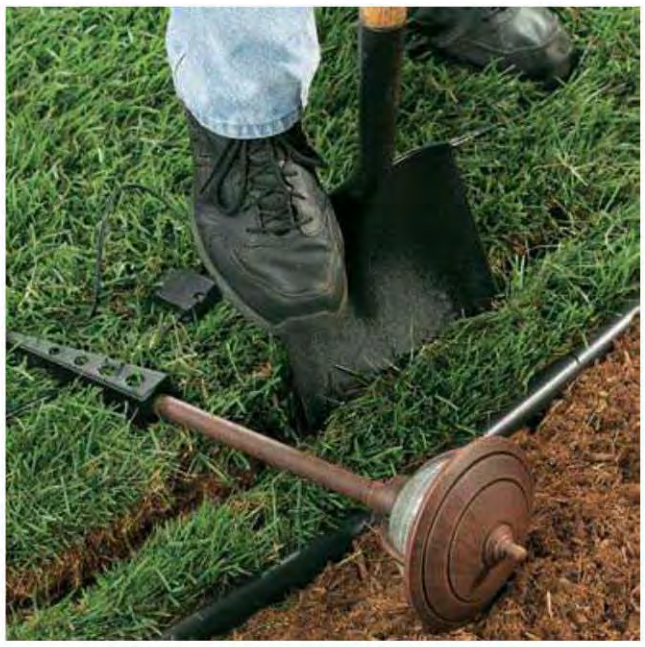
5 Many low-voltage light fixtures are modular, consisting of a spiked base, a riser tube and a lamp. On these units, feed the wires and the wire connector from the light section down through the riser tube and into the base.

6 Take apart the connector box and insert the ends of the fixture wire and the low voltage landscape cable into it. Puncture the wire ends with the connector box leads. Reassemble the connector box.

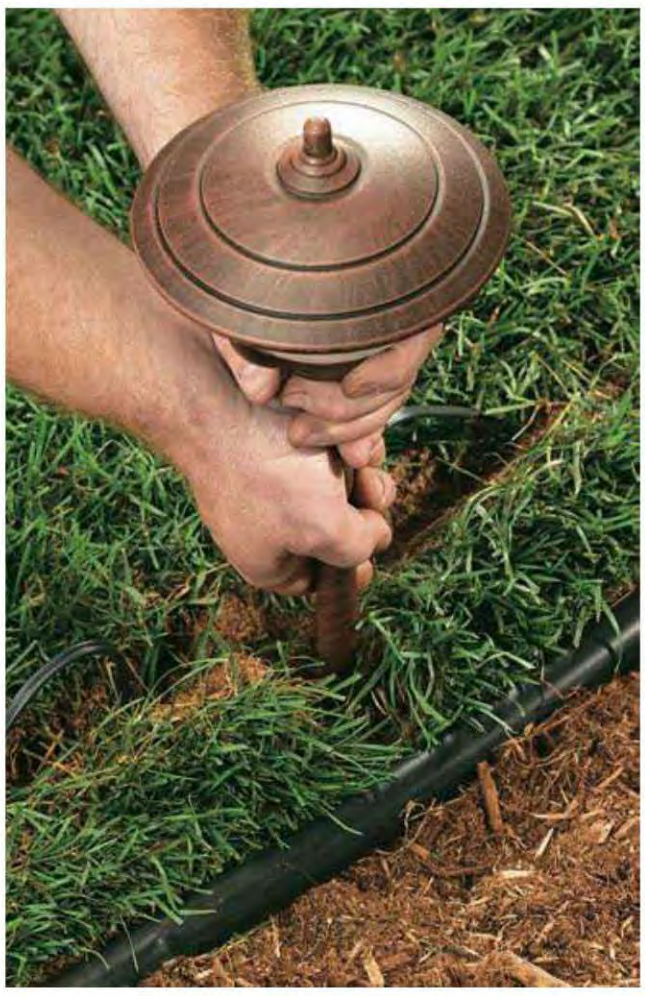
7 Feed the wire connector back into the light base and attach it according to directions that came with the lamp. In this model, all that was required was pushing the connector into a locking slot in the base.

8 After the bulb is installed, assemble the fixture parts that cover it, including the lens cap and reflector.

10 Gently force the cable into the slot formed by the spade; don't tear the wire insulation. A paint stick (or a cedar shingle) is a good tool for this job. Push the wire to the bottom of the slot.



9 Lay out the lights, with the wires attached, in the pattern you have chosen. Then cut the sod between fixtures with a spade. Push the blade about 5 in. deep and pry open a seam by rocking the blade back and forth.



11 Firmly push the light into the slot in the sod. It the lamp doesn't seat properly, pull it out and cut another slot at a right angle to the first and try again.

12 Once the lamp is stabilized, tuck any extra wire into the slot using the paint stick. If you have a lot of extra wire, you can fold it and push the excess to the bottom of the slot. No part of the wire should be exposed when you are done with the job.

FIXTURE TIPS:

Specialty lights can cost a lot more than the standard plastic spike-base lamps. Because of this, many people modify the cheaper units to serve other purposes. To do this, first cut off the spike-base with a hacksaw.

To install a modified light on a deck, bore a wire-clearance hole through a deck board. Then feed the low-voltage wire through this hole and attach the base to the deck with screws. The same technique can be used to install modified units on planters or railings.

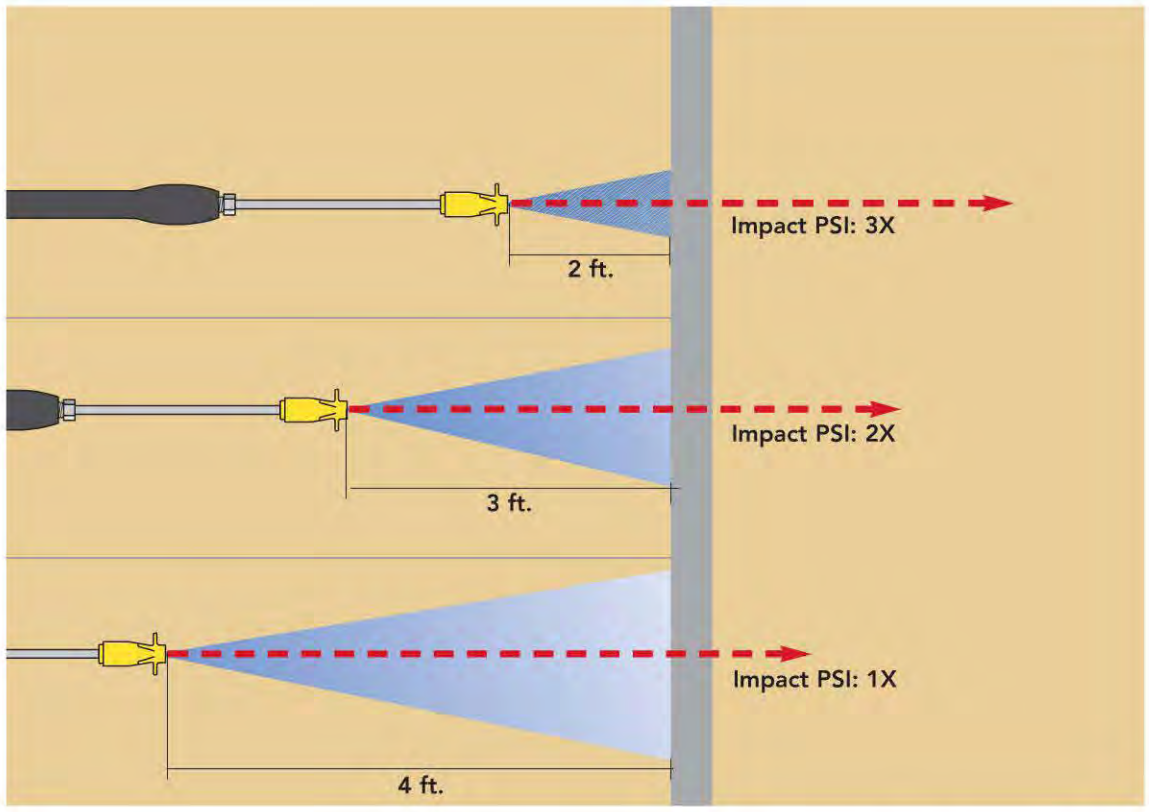
Many different specialty lights are available for use on a wood deck. This model mounts directly on the surface and the wires feed through an access hole under the light. Other lights that are thinner, but mount the same way, are designed for the underside of stair treads. These light up the stairs and reduce the chance of people stumbling in the dark.

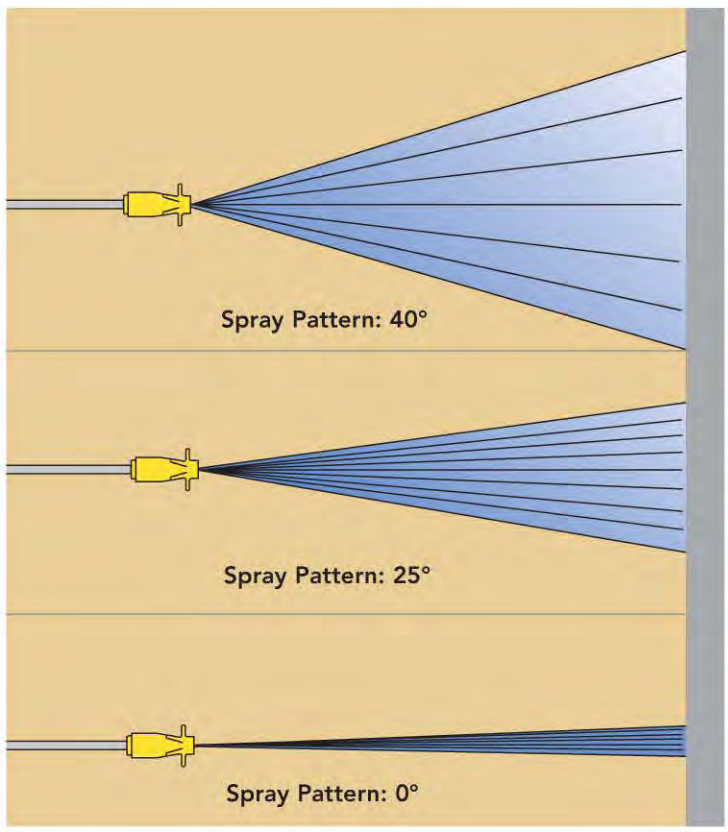
20 Pressure Washing a House

Pressure washers can be rented or you can buy your own light-duty model for around $100. Washing your siding is just one of the many useful chores a pressure washer can perform.

SELF-SERVICE CAR WASHES ARE A GREAT IDEA. THEY LET YOU WASH YOUR CAR THE WAY YOU WANT TO WASH IT, AND THEY LEAVE YOU ALONE. If you could fit your house into a self-serve car wash, you might never need a pressure washer of your own. That is, until you think a little. What about washing the car at home, getting off the caked-on grass from the bottom of the mower, blowing away the stains on the garage floor, banishing the dirt from your backyard deck, and prevailing over the mildew on all that plastic outdoor furniture? A pressure washer makes all these jobs easier and quicker than other approaches. And, it does a wonderful job of washing your house.

PRESSURE WASHERS 101





There are two ways to adjust cleaning power using the pressure washer. You can adjust the distance (above) that you hold the nozzle from the surface you are cleaning. The second way is to change the spray pattern (left). Some pressure washers also allow you to adust the pressure regulator knob on the engine or water pump. This enables you to fine-tune the water pressure without altering the distance or spray pattern.

BUYING A PRESSURE WASHER

You can find a very good pressure washer for as little as $100, but it won't be a 3000 psi machine that you could use to spruce up the Sears Tower. Instead, it will be an electric model that delivers about 1500 psi and about 2 gallons per minute (gpm) of flow. Multiplying the pressure (psi) and water flow (gpm) ratings yields a rating a figure called the cleaning power (CP) for each model. A machine with a CP rating of 3000 will do everything you want around the house without the risk of injury from puncture wounds that are possible with the higher pressure machines.

TOOLS & SUPPLIES YOU NEED

DIFFICULTY LEVEL

This project can be completed in one to three days.

1 If using detergents, cover the plants around your house with tarps or plastic sheeting. Leave the cover on only when you are working. If it stays on for long periods during hot weather, the plants can die from exposure to too much heat.

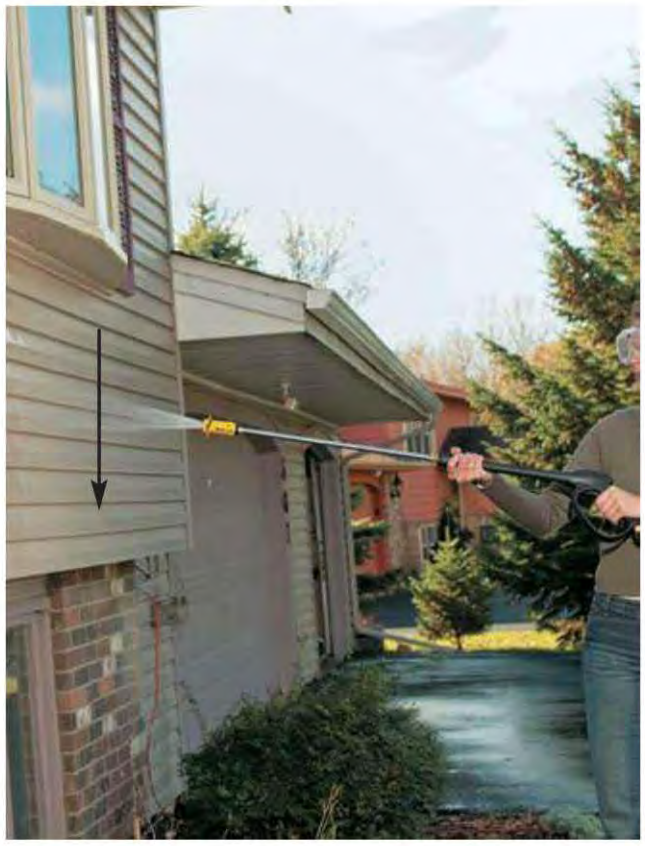
2 You have the option to add cleaning detergent to the machine's water flow by installing a standard siphon tube between the machine and a container of detergent.

TIP FOR REMOVING STAINS

Stubborn mildew and rust stains usually need hand scrubbing with a weak bleach solution. Use a sponge or brush to clean the area and rinse the area thoroughly. Be sure to wear protective gloves.

3 If the siding is very dirty, you may have to use a rotating scrub brush accessory to clean the surface. The brush can use either clean water or dispense a soapy solution. This is a bit like precleaning stains on clothing before laundering.

4 To prevent streaks on house siding, start pressure washing on the bottom and work up. Use the same approach whether you're using plain water or soapy water.



5 To rinse the side, start at the top and work down. The clean water will flush away any dirt and soap residue and leave behind a clean surface.

CLEANING OTHER OUTDOOR SURFACES

A pressure washer also works on surfaces like wood decks. Sometimes a quick spraying with plain water will do the trick. But more typically, the deck has to be cleaned chemically and then rinsed with plain water.

Concrete steps, walks and driveways respond very well to pressure washing. Because the spray tip can be held so close to the surface without causing any damage, usually water alone will do the trick. But oil stains on a garage floor will require a detergent wash and possibly a prewash with a degreaser solution.

RESOURCES

American Standard
American Standard and Porcher brand lavatories, toilets, shower systems, bathtubs, kitchen sinks, faucets
800-442-1902
www.americanstandard-us.com

Armstrong World Industries
717-397-0611
www.armstrong.com

Clopay Garage Doors
800-225-6729
www.clopaydoor.com

Crane Plumbing
Crane, Fiat, Sanymetal, Showerite and Universal Rundle toilets and plumbing products
www.craneplumbing.com

Delta Faucet Co.
Kitchen and bathroom faucets
800-345-3358
www.deltafaucet.com

Electric Eel
Power augers for sale or rent
(937) 323-4644
www.electriceel.com

Eljer, Inc.
Eljer, Titan and Endurocast toilets, tubs, lavatories, faucets
800-423-5537
(972) 560-2000
www.eljer.com

Elkay Cos.
Sinks and faucets
(630) 572-3192 (U.S.)
800-661-1795 (Canada)
www.elkayusa.com

Fluidmaster
Fill valves, flush valves, toilet repair parts
www.fluidmaster.com

Grohe
Kitchen and bathroom faucets
(630) 582-7711 (U.S.)
(905) 271-2929 (Canada)
www.groheamerica.com

Hunter Douglas
800-265-1363
www.hunterdouglas.com

In-Sink-Erator
Garbage disposers and hot water dispensers
800-558-5700
www.insinkerator.com

International Association of Plumbing and Mechanical Officials
20001 E. Walnut Drive South
Walnut, CA 91789-2825
www.iapmo.org

International Conference of Building Officials
5360 Workman Mill Rd.
Whittier, CA 90601-2298
800-284-4406

Kohler Plumbing
Kohler brand kitchen and bathroom fixtures
800-456-4537
www.kohler.com

LASCO Bathware
Tub and shower products
800-945-2726
www.lascobathware.com

Moen
Sinks, faucets and related accessories for kitchen and bath
800-289-6636
www.moen.com

National Kitchen & Bath Association
800-843-6522
www.nkba.com

Plumbing and Drainage Institute
45 Bristol Drive
South Easton, MA 02375
www.pdionline.org

Plumbing Heating Cooling Information Bureau
222 Merchandise Mart Plaza
Chicago, IL 60654

Price Pfister
Kitchen and bathroom faucets
800-732-8238 (U.S.)
800-340-7608 (Canada)
www.pricepfister.com

Sterling Plumbing
Sterling brand tub and shower surrounds, shower doors, toilets, kitchen sinks and related kitchen and bathoom fixtures
888-783-7546
www.sterlingplumbing.com

The Institute of Plumbing and Heating Engineering
64 Station Lane, Hornchurch
Essex, RM12 6NB, England
www.worldplumbing.org

Toto USA Inc.
Toilets, faucets, lavatories and other bathroom fixtures
888-295-8134
www.totousa.com

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Metric Equivalents

Inches (in.)	1/64	1/32	1/25	1/16	1/8	1/4	3/8	2/5	1/2	5/8	3/4	7/8	1	2	3	4	5	6	7	8	9	10	11	12	36	39.4
Feet (ft.)																								1	3	3 1/2
Yards (yd.)																									1	1 1/2
Millimeters (mm)	0.40	0.79	1	1.59	3.18	6.35	9.53	10	12.7	15.9	19.1	22.2	25.4	50.8	76.2	101.6	127	152	178	203	229	254	279	305	914	1,000
Centimeters (cm)							0.95	1	1.27	1.59	1.91	2.22	2.54	5.08	7.62	10.16	12.7	15.2	17.8	20.3	22.9	25.4	27.9	30.5	91.4	100
Meters (m)																								.30	.91	1.00

Converting Measurements

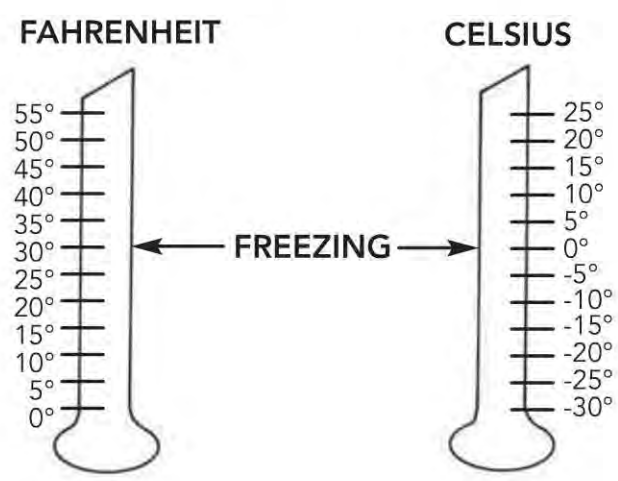
TO CONVERT:	TO:	MULTIPLY BY:
Inches	Millimeters	25.4
Inches	Centimeters	2.54
Feet	Meters	0.305
Yards	Meters	0.914
Miles	Kilometers	1.609
Square inches	Square centimeters	6.45
Square feet	Square meters	0.093
Square yards	Square meters	0.836
Cubic inches	Cubic centimeters	16.4
Cubic feet	Cubic meters	0.0283
Cubic yards	Cubic meters	0.765
Pints (U.S.)	Liters	0.473 (Imp. 0.568)
Quarts (U.S.)	Liters	0.946 (Imp. 1.136)
Gallons (U.S.)	Liters	3.785 (Imp. 4.546)
Ounces	Grams	28.4
Pounds	Kilograms	0.454
Tons	Metric tons	0.907

TO CONVERT:	TO:	MULTIPLY BY:
Millimeters	Inches	0.039
Centimeters	Inches	0.394
Meters	Feet	3.28
Meters	Yards	1.09
Kilometers	Miles	0.621
Square centimeters	Square inches	0.155
Square meters	Square feet	10.8
Square meters	Square yards	1.2
Cubic centimeters	Cubic inches	0.061
Cubic meters	Cubic feet	35.3
Cubic meters	Cubic yards	1.31
Liters	Pints (U.S.)	2.114 (Imp. 1.76)
Liters	Quarts (U.S.)	1.057 (Imp. 0.88)
Liters	Gallons (U.S.)	0.264 (Imp. 0.22)
Grams	Ounces	0.035
Kilograms	Pounds	2.2
Metric tons	Tons	1.1

Converting Temperatures

Convert degrees Fahrenheit (F) to degrees Celsius (C) by following this simple formula: Subtract 32 from the Fahrenheit temperature reading. Then, mulitply that number by 5/9. For example, 77°F - 32 = 45. 45 × 5/9 = 25°C.

To convert degrees Celsius to degrees Fahrenheit, multiply the Celsius temperature reading by 9/5. Then, add 32. For example, 25°C × 9/5 = 45. 45 + 32 = 77°F.



GLOSSARY

Adhesive — Bonding agent used to adhere the floor covering to the underlayment. Adhesives are also available for installing a floor covering on nonporous surfaces, such as sheet vinyl.

American National Standards Institute (ANSI) — A standards-making organization that rates tile for water permeability.

Baseboard — Strip of wood molding, available in various designs and thicknesses, applied at the bottom of the wall to cover the gap between the floor covering and the wall.

Baseboard shoe — A narrow piece of molding, often quarter round, attached to the bottom of baseboard to hide gaps between the floor covering and baseboard and to add a decorative edge.

Baseboard tile — Baseboard-shaped tile used instead of wood baseboards. Used in conjunction with tile floors.

Base-shoe molding — A strip of molding nailed to baseboard at the floor to conceal gaps and add a decorative edge.

Berber carpet — Looped pile running in parallel lines. Berber carpet has the same color throughout the fibers.

Bevel cut — An angled cut through the width or thickness of a board or other piece of stock.

Blindnail — Driving nails at an angle through the tongues of hardwood flooring so the next piece of flooring will cover the nail.

Box nail — A nail similar in appearance to a common nail, but with a thinner shaft. Used for lighter construction and on materials that split easily.

Brick molding — Used between the exterior surface of a house and a window or doorframe.

Building code — A set of building regulations and ordinances regulating the way a house can be built or remodeled. Most building codes are controlled by a local municipality.

Building permit — Permit obtained from the local building department allowing you to remodel your home.

Casing — Any trim around a window, door, or other opening.

Casing nail — Similar to a finishing nail, but with a slightly larger dimpled head for better holding power.

Cat's paw — A type of prying tool used primarily in demolition; the tool is good for extracting nails.

Cementboard — Underlayment used for ceramic tile and some hardwood installations. Cementboard is the best underlayment in areas likely to get wet.

Chalk line — The line left by chalk, usually blue or red, after the chalk string is pulled tight between two points and snapped against the floor.

Coefficient of friction — A measurement of a tile's slip resistance. Tiles with high numbers are more slip resistant.

Common nail — A heavy-shaft nail used primarily for framing work, available from 2d to 60d.

Coping saw — A handsaw with a flexible blade and fine teeth for cutting intricate curves and bends in wood.

Cripple stud — A short stud that is normally located above or below window and door openings.

Crosscut — Cutting a piece of wood perpendicular to the wood grain.

Cut-pile carpet — Individual carpet fibers woven tightly together. The fibers are colored on the outside, but not on the inside.

Door casing — Wood molding and trim placed around a door opening to give it a finished look.

Drip edge — A piece of molding placed over any exterior opening so that water runs or drips away from the opening.

Dry-fit — Installing tile without mortar to test the layout.

Dry mix — Packaged mix (usually sold in bags) that can be combined with water to form mortar.

Embossing leveler — A mortarlike substance used to prepare resilient flooring or ceramic tile for use as an underlayment.

Endnailing — Joining two boards at a right angle by driving nails through the face of one board into the end of another.

Engineered flooring — Flooring that's manufactured to look like solid hardwood, but is easier to install, less expensive, and more resistant to wear. Engineered flooring is available in strips or planks.

Expansion joint — A joint in a tile layout filled with a flexible material, such as caulk, instead of grout. The expansion joint allows the tile to shift without cracking.

Facenailing — Joining two parallel boards by driving nails through the faces of both boards.

Fiber/cementboard underlayment — A thin, high-density underlayment used under ceramic tile and resilient flooring where floor height is a concern.

Field tile — Tile that's not part of a design or border.

Finish nail — A nail with a small, dimpled head, used for fastening wood trim and other detailed work.

Flagstone — Quarried stone cut into slabs usually less than 3" thick, used for outdoor floors.

Floating floor — Wood or laminate floor covering that rests on a thin foam padding and is not fastened or bonded to the subfloor or underlayment.

Floor board — A strip or plank in a wood floor.

Floor tile — Any type of tile designated for use on floors.

Floor-warming systems — A system of heating elements installed directly under the floor covering. Floor-warming systems provide supplemental radiant heat to warm up a floor.

Framing member — A common term for a single structural element of a construction framework, such as a stud, joist, truss, or beam.

Full-, half-, quarter-sheet — Referring to the size of a sheet good relative to a 4 × 8-ft. sheet. A half-sheet is 4 × 4-ft., a quarter-sheet is 2 × 4-ft.

Full-spread vinyl — Sheet vinyl with a felt-paper backing that is secured to the underlayment with adhesive.

GFCI receptacle — A receptacle outfitted with a ground-fault circuit-interrupter. Also used on some extension cords to reduce the possibility of electric shock when operating an appliance or power tool.

Glue laminate — A type of engineered lumber specifically created for headers or support beams, in which layers of wood are bonded to form a solid unit.

Grout — A dry powder, usually cement-based, that is mixed with water and pressed into the joints between tiles. Grout also comes with latex or acrylic additive for greater adhesion and impermeability.

Header — A piece of lumber used as a support beam over a doorway or window opening.

Isolation membrane — A flexible material installed in sheets or troweled onto an unstable or damaged base floor or subfloor before installing tile. Isolation membrane prevents shifts in the base from damaging the tile above.

Jack stud — A wall-framing member used to support a header in a doorway or window opening.

Jamb — The top and side pieces that make up the finished frame of a door opening.

Joists — The framing members that support the floor.

King studs — The first studs on either side of a framed opening to span from the sole plate to the top plate.

Latex patching compound — Compound used to fill cracks and chips in old underlayment and to cover screw or nail heads and seams in new underlayment.

Load-bearing wall — Any wall (interior or exterior) that bears some of the structural weight of a house. All exterior walls are load-bearing.

Locknailing — Strengthening a miter joint in window or door casings by driving nails through the middle of the joint from the outer edge of the casing. This technique also works well with picture frames.

Miter cut — An angle cut in the end of a piece of flooring or molding.

Molding — Decorative strips of wood installed along walls and floors.

O.C. (on center) — The distance from the center of one framing member to the center of the next.

Partition wall — An interior, non-loadbearing wall.

Pennyweight — A measure used to indicate nail size and length, commonly shown as a lower case "d."

Perimeter-bond vinyl — Sheet vinyl with a PVC backing that is placed directly on underlayment and secured by adhesives along the edges and seams.

Planks — Wood or laminate flooring that is 4" or more wide.

Platform framing — A type of framing construction in which the studs only span a single story, and each floor acts as a platform to build and support the next higher level. Most common framing method in modern home construction.

Plumb bob — A device consisting of a pointed weight on the end of a string, used to determine whether a surface is exactly vertical or to transfer marks along a vertical plane.

Plunge cut — A cut that begins in the field of a board or piece of plywood by slowly pivoting the blade into the wood.

Plywood — A common underlayment for resilient and ceramic tile installations.

Portland cement — A combination of silica, lime, iron, and alumina that has been heated, cooled, and pulverized to form a fine powder from which mortar products are made.

PVC — Acronym for polyvinyl chloride. PVC is a rigid plastic material that is highly resistant to heat and chemicals.

Reciprocating saw — A type of power saw that cuts with a back and forth action through wood, metal, and plastic.

Reference lines — Lines marked on the subfloor to guide the placement of the floor covering.

Rip — Cutting a piece of wood parallel to the grain.

Rise — The height of a step in a stairway.

Rough opening — The opening of the rough framing for a window or door.

Run — The length of a step in a stairway.

Sealants — Product used to protect non- and semi-vitreous tile from stains and water damage. Sealants are also used to protect grout.

Sheet vinyl — Flooring material made from vinyl and other plastics in the form of sheets that are 6 ft. or 12 ft. wide and approximately ⅛" thick.

Shim — A thin wedge of wood used to make slight adjustments in doors or windows during installation.

Sister joist — Dimensional lumber attached alongside an existing joist to provide additional strength.

Soffits & chases — Boxes made with dimensional lumber and plywood or wallboard to cover up existing mechanicals or other obstructions.

Spacers — Plastic lugs inserted between tiles to help maintain uniform installation during installation.

Stain — Water-based or oil-based agent used to penetrate and change the color of a wood floor.

Strip flooring — Wood flooring that has multiple strips, usually three, fastened together to form a single plank.

Strips — Wood or laminate flooring that is less than 4" wide.

STC (sound transmission class) — A rating system referring to how well sound is contained within a room due to the construction. Normal wall construction has a rating of 32 STC.

Stud — A vertical framing member used in the framework of a house or building.

Subfloor — The surface, usually made of plywood, attached to the floor joists.

Tack cloth — Lint free cloth, usually cheese cloth, used to clean floors and wipe away dust. Tack cloth is treated with a resin to make it sticky.

Tackless strips — Strips of wood nailed around the perimeter of a room. The teeth of the strips hold carpet in place.

Threshold — The area in a doorway where two floor coverings meet.

Toenailing — Joining two boards at a right angle by driving nails at a 45° angle through the side of one board into the face of another.

Tongue-and-groove flooring — Wood or laminate floor coverings that have a tongue and a groove in each individual piece. The flooring is assembled by placing the tongue and groove joints together.

Top plate — A piece of dimensional lumber that rests on top of the studs in a wall and supports the ends of rafters.

Treated wood — Lumber that has been impregnated with chemicals to make it resistant to pests and rot.

Underlayment — Material placed on top of the subfloor, such as plywood, fiber/cementboard, cementboard, and isolation membrane.

Vapor barrier — Plastic sheeting used as a barrier to keep water from a concrete floor from penetrating the floor covering installed over it.

Wallboard — Also known as drywall; flat panels available in various sizes made of gypsum covered with durable paper; Used for most interior wall and ceiling surfaces.

WIRING INDEX

B
Ballasts, replacing, 103
Blades of ceiling fans, wobbly, 108

C
Ceiling fans, fixing, 106–111
Ceiling-mounted fixtures
  installing, 80–85
  installing wireless switches for, 47
  removing, 92
Chandeliers, replacing, 86–89
Childproofing receptacles, 52–57
Circuit breakers
  described, 10
  turning off, 12
Circuits, understanding, 10–11
Combination tool, 9
Common wires, 71
Connectors/nuts, 9
Cord kits, 9
Current sensors/testers, 9, 13

D
Dial-type timers, 76
Dimmer switches, installing, 70–75
Doorbells, fixing, 30–33
Double-gang boxes and coverplates, 79

E
Electrical boxes, replacing, 75
Electrical circuit, determining capacity, 113
Electrical tape, 9
Electricity, understanding, 10–11

F
Floodlights, installing motion-sensing, 96–99
Fluorescent light fixtures, replacing, 100–105
Fluorescent tubes, buying, 101, 104
Four-way switches, 65, 68, 73
Fuses, 12

G
GFCI (ground-fault circuit-interrupter)
  receptacles
    overview of, 58–59
  ratings, 62
  replacing, 60–63
  tamper resistant, 55
Grounding wires, 11, 77

H
Hot current, 11, 23

L
Lamp cords
  kits for, 9
  testing, 17
Lamp sockets
  buying replacement, 9, 29
  fixing, 26–29
Lamp switches, wireless, 47
Leads, 77
Light bulbs
  choosing wattage, 85
  removing broken, 22–25
Light fixtures
  ceiling-mounted, installing, 80–85
  ceiling-mounted, removing, 92
  fluorescent, replacing, 100–105
  hanging, replacing, 86–89
  supporting weight of, 87, 88
  testing for current, 13
  track, installing, 90–95
Light sockets, described, 23
Light switches
  adding wireless, 42–46
  replacing, 64–69
  types of, 65
Line screws, 59
Load screws, 59
Low-voltage wires, overview of, 39

M
Main service panel, 10, 12
Mercury thermostats, 41
Motion-sensing floodlights, installing, 96–99
Mounting straps, 49

N
Needlenose pliers, 9, 24
Neutral current, 11, 23

P
Phone jacks, repairing, 18–21
Pliers, 9, 24
Plug covers (for receptacles), 53, 57
Power, turning off, 12
Power supply, 91
Programmable thermostats
  installing, 38–41
  overview of, 38–39
Pull-chain switches
  fixing, 34–37
  replacing, 110–111
  testing, 17
Push-button switches, replacing, 35
Push-button timers, 76
Push-in connections, 16
Push-in slot covers, 53, 56

R
Raceway wiring, installing, 112–121
Receptacles
  buying, 9
  childproofing, 52–57
  replacing bad, 48–51
  replacing GFCI, 60–63
  testing for current, 13

S
Safety coverplates, 53, 56
Screw connectors, 15
Screwdrivers, 9
Screws, types of, 59
Screw terminals, 49
Sensors, 9
Single-pole switches, 65
Supplies, 8–9, 53
Switches
  buying, 9
  for ceiling fans, 111
  dimmer, installing, 70–75
  light, adding wireless, 42–46
  pull-chain, fixing, 34–37
  pull-chain, replacing, 110–111
  push-button, replacing, 35
  testing, 13, 17
  timer, installing, 76–79
  wall, replacing, 64–69
Switch locks, 97

T
Tamper-resistant receptacles, 53, 54–55
Tape, 9
Terminal connectors, 15
Testers/testing for current, 9, 13, 17
Thermostats
  mercury, 41
  programmable
  installing, 38–41
  overview of, 38–39
Three-way switches, 68
  described, 65
  installing, 42–46
  traveler wires on, 71, 74
Timer switches, installing, 76–79
Tool box, 9, 17
Tools
  basic, 8–9, 24
  see also specific tools
Track lights, installing, 90–95
Traveler wires, 71, 74

U
Upside down installations, 57

W
Wall anchors, installing, 116
Wall switches
  removing, 44
  replacing, 64–69
  testing, 13, 17
  types of, 65
  wireless, installing, 45–46
Wattage
  of fluorescent tubes, 101, 104
  of incandescent bulbs, 85
Weight of fixtures, supporting, 87, 88
Wire connections, making, 14–16
Wire connectors/nuts, 9, 109
Wireless light switches, 43
Wires
  color coding of, 9, 19, 67
  connecting, 15, 16
  grounding, 11, 77
  installing raceway system, 112–121
  low-voltage, 39
  stripping, 14

PLUMBING INDEX

A
Aerators, 157, 160
Air, need for, 127
Augers
  cable, 193
  closet, 173, 181
  electric drum, 194
  hand, 185
  power, 192–195
  stationary power, 195

B
Basket strainers, described, 187, 191
Bathtubs. See Showers/tubs
Burst pipes, repairing, 218–221

C
Chemical drain cleaners, 186
Cleaning tools, described, 193
Cleanout plugs, 141
Cleanouts, described, 193
Clogged toilets, clearing, 170–173
Closet bolts, 233
Closet elbows, described, 233
Closet flanges, described, 233
Cold water, 126, 136–137
Compression fittings, described, 223
Controlled flushes, described, 171
Copper pipes, 126, 127, 221
Copper stubs, described, 197
CPVC, described, 143

D
Disposal units, fixing, 189
Diverters for kitchen sprayers, repairing, 216
Diverters for showers/tubs, 201
Drain bends, described, 139
Drain pipe connectors, described, 139
Drains, 180–188, 192–195
Drain traps. *See* Traps
Drain-waste-vent (DWV) system, 124, 127

F
Faucets
  aerators, 157, 160
  buying, 225
  deck-mounted, 210–213, 222–227
  fixing ball, 152–153
  fixing cartridge, 147, 150–151
  fixing compression, 148–149
  fixing disc, 154–155
  fixing leaky tub and shower, 174–179
  fixing one-handle, 176–177
  fixing two- or three-handle, 178–179
  installing one-piece bathroom, 210–213
  location of hot and cold, 126
  overview of sink, 146–147
  replacing bathroom, 204–209
  replacing kitchen, 222–227
  replacing widespread, 205–209
  types of, 149, 175
  washerless, 149
Fixtures
  shutoff valves for, 136
  trap locations for, 138, 139
  water lines to, 124, 126
  see also specific fixtures
Flexible supply lines, described, 223
Flow restrictors, described, 157
Freezing pipes, preventing, 142–145

G
Galvanized iron pipes, 126
Gas meter shutoff, 136
Grinding chambers, described, 187
Grinding rings, described, 187

H
Home plumbing system, 124–127
Hot water, 126, 135–137

I
Impellers, described, 187
Inspecting plumbing, 133

J
J-bends, described, 139, 229

L
Lavatories. *See* Faucets; Sinks; Toilets
Lead pipes, 127
Leaks, looking for, 133

N
Neoprene, 147
Nipples, described, 197

O
Outside diameter (O.D.) of pipes, 219

P
PEX pipes, 126
Pipe joint compound, described, 191, 205, 211, 223, 229
Pipes
  drain, 124, 127, 133
  plastic, 126, 127
  preventing freezing of, 142–145
  repairing burst, 218–221
  supply, 126, 133
  thawing, 143
Plumber's putty, described, 191, 205, 211, 223, 229
Plumbing, evaluating, 132–133
Plungers, types of, 171, 172
Pop-up stoppers, replacing, 228–231
Pop-up wastes, described, 229

R
Reducing bushing, described, 197
Replacing sprayers, 214–215, 217
Rigid plastic pipes, 126

S
Showers/tubs
  adding showers to tubs, 196–199
  cleaning showerheads, 158–159
  improving drain flow, 180–185
  replacing spouts, 200–203
Shutting off water, 124, 134–137
Sinks
  adjusting drainage in bathroom, 180–185
  clearing kitchen drains, 186–188
  fixing leaky strainers, 190–191
  removing and replacing trap components, 140–141
  replacing pop-up stoppers in bathroom, 126–127
  see also Faucets
Sleeve and clamp pipe repairs, 220
Slip-fit spouts, 202
Sprayers (kitchen), 214–217
Stopper assemblies, 228–231
Supplies, buying, 179
Supply hose/tube, described, 163
Supply pipes, 126, 133

T
Tailpieces, described, 187, 229
Teflon tape, described, 191, 197, 205, 211, 223, 229
Thawing pipes, 143
Thermal envelopes, described, 143
Threaded plastic joints, 141
Threaded spouts, 203
Toilets
  buying, 233
  fixing flushing problems, 165, 180
  replacing, 232–237
  replacing valves, 166–169
  resetting tank water level, 164
  troubleshooting, 163
  unclogging, 170–173
Tools, 128–130
  see also specific tools
Traps
  described, 124, 139, 193
  importance of, 127
  location of, 138, 139
  purpose of, 138, 139
  solvent-welded, 141
  toilet, described, 171
Tubs. *See* Showers/tubs

V
Valves
  repairing kitchen sprayer diverter, 216
  replacing toilet, 166–169
  shutoff, 124, 135, 136
  stuck, 137
  types of, 135, 147, 163, 171, 201
Vent pipes, purpose of, 127

W
Washing machines, increasing water fill speed, 156, 161
Waste water, 124
Water, shutting off, 124, 134–137
Water meter location, 124
Water pressure, adjusting, 156–157
Water seals, described, 171
Water supply
  determining capacity of, 132
  system described, 124, 126
  toilet tank level, 164
  washing machine fill speed, 156, 161
Water temperature, adjusting shower, 177
Wax rings, 233, 234

FLOORING INDEX

A
Acid etching, 295, 296, 297
Adhesives
  carpets and, 292
  linoleum and, 289

B
Beams, 240
Bridging, 241
Bubbles in resilient floors, fixing, 263
Buckled floors, 257, 314

C
Carbide-tipped grout saws, 273
Carpeting
  about, 243
  cleaning, 247
  problems with, 244
  removing, 290–293
  repairing damaged, 282–285
  repairing loose seams, 268–271
Ceramic tile floors
  about, 243
  cleaning, 248
  problems with, 245
  replacing, 272–277
Click-floors, 313
Concrete floors
  about, 242
  problems with, 244
  sealing, 294–301
Cork floors, 243
Curls in resilient floors, fixing, 263
Cushion-backed, fully bonded carpeting, 285
Cushion-backed carpeting, 283
Cut-pile carpet, 269

D
Dents, 261, 279
Drawbars, 313
Dry-backed resilient tiles, installing, 322–324

F
Feather sanding, 251, 303
Finishes, types of, 253, 303, 309
Floating floors, 279, 313
Floorboards, removing gaps between joists &, 256
Floors
  evaluating, 244–246
  layers of, 240
  reconditioning, 251
  types of, 242–243
Floor scrapers, 289
Full-spread sheet vinyls, 289
Fully-bonded laminate flooring, 279

G
Glass mosaic floors, installing, 326–327
Glue, 271
Glueless laminate flooring, 279, 313
Gouges, repairing, 253
Grout, 273, 275, 276

H
Holes, repairing small, 253

J
Joists
  cinching flooring to, 257
  described, 240, 241, 255
  locating, 261
  removing gaps between floorboards &, 256

K
Knee kickers, 283, 284

L
Lacquer thinners, 309
Laminate floors
  about, 242
  cleaning, 246, 249
  installing, 312–319
  problems with, 244
  replacing planks, 278–281
Linoleum floors, 243
Loose boards, reattaching, 261
Lubricants, 260

M
Metal lathes, 273

N
Nails, countersinking, 261
Nap (of carpet), 269

O
Oil, applying, 260

P
Parquet tile floors
  about, 242
  problems with, 245
Perimeter-bond sheet vinyl, 289
Primers, 309

R
Radiant floor heating systems, 241
Resilient floors
  about, 243
  cleaning, 249
  installing tiles, 320–325
  patching, 264–267
  problems with, 245
  removing sheets, 286–289
  repairing, 262–263
  using templates, 324
Rows of pile, 269

S
Safety
  using acid etches, 297
  when repairing carpets, 270
  when replacing ceramic tile, 274
Sanding, 251
Sandpaper, purchasing, 304
Scratches, 279
Sealers, 300, 309
Seam tape, 269
Self-adhesive resilient tiles, installing, 325
Sheet vinyl floors. See Resilient floors
Soundproofed floors, 241
Spills, cleaning
  from carpet, 247
  from laminate floors, 246
  from wood floors, 246
Splinters, repairing, 250–252
Squeak-ender floor squeak eliminator, 255, 256
Squeaky floors
  fixing from above, 258–261
  fixing from below, 254–257
Sticky-back vinyl tiles, 326
Strap clamps, 313
Subfloors, 240, 255, 289

T
Tackless strips, 291
Thinset mortar, 273
Tile spacers, 273
Tools. See specific tools

U
Underlayment, 240, 255, 289

V
Vinyl floors. *See* Resilient floors

W
Wall-to-wall carpet, 283
Wood floors
  about, 243
  cleaning, 246
  fixing squeaks
  from above, 258–261
  from below, 254–257
  painting, 308–311
  problems with, 245
  refinishing, 302–307
  repairing splinters, 250–252

Z
Zip doors, 303

DECORATING INDEX

A
Alkyd, 381
Alkyd paint, 335
Aprons, 369
Awls, described, 333

B
Baseboards
described, 369
painting, 372
Beveled cuts, making, 354
Blinds
installing, 346–350
types of, 351
Bookcases, anchoring, 352–355
Booking, 385
Boxing paint, 362
Bubblesticks, 385

C
Cabinets, painting wood, 374–375
Carpenter's levels, buying, 333
Casements windows
described, 369
painting, 372
Case moldings, 369
Ceilings, preparing for painting, 358
Cellular shades, described, 351
Ceramic tile walls, mounting towel bars on, 343
Circular saws, blade angle, 354
Cleats, 353
Concrete blocks
painting, 376–377, 379
repairing cracks, 378
Cordless screwdrivers, buying, 333
Countersinking, 365
Cracks, repairing in concrete blocks, 378
Curtains, hanging, 344–345
Cutting in, 361

D
Decorating tools, overview of, 332–333
Doors
hanging wallcovering around, 391–392
painting, 373
Double-hung windows, 369
Draping for painting, 356–359
Drills, buying, 333
Drywall, wallcovering on, 380
Drywall knives, described, 333

E
Easy-release painter's tape, 334, 357
Efflorescence, 377
Etcher, 377

F
Felt pads, 339
French cleats, 353

H
Hammers, buying, 333
Head rails, 347
Hold-down clips, 347
Hole-patching kits, described, 334
Horizontal blinds, described, 351

L
Laser levels, buying, 333
Latex paint, 335
Lead test kits, 331, 367

M
Materials
choosing paint, 335
preparation, 334
see also specific types
Millwork
described, 369
painting, 359, 368–373
Mirrors, hanging, 336–339
Mismatches, 385
Mounting plates, 341

N
Nail sets, described, 333, 365

P
Paint
choosing, 335
color consistency, 362
mixing, 331
Paintbrushes, buying, 331
Painting preparation, 356–359
Painting tools, overview of, 330–331
Pictures, hanging, 336–339
Pipes, hanging wallcovering around, 393
Plate covers, 357
Preparation liquids, described, 334
Pressure sprayers, described, 334
Primers, 335
Putty knives, described, 333

R
Rails, described, 369
Raw wood, preparing for painting, 364–367
Razor knives
described, 333, 385
renewing blades, 389
Roller covers, buying, 331
Roller frames, buying, 331
Roller trays, buying, 331
Roll-up shades, hanging window, 346–350

S
Safety equipment needed, 334
Sanding raw wood, 365–367
Screwdrivers, buying, 333
Seam tape, described, 334
Self-adhesive seam tape, described, 334
Setscrews, 341
Shades, hanging window, 346–350
Silicone caulk, 339
Sinks, hanging wallcovering around, 392
Smoothing tools, 385
Spackle, described, 334, 341
Sponges, need for, 334
Stiles, described, 369
Stud finders, described, 333, 337
Studs, described, 337

T
Tape measures, buying, 333
Taping for painting, 356–359
Tinted primers, 335
Tools
overview of decorating, 332–333
overview of painting, 330–331
see also specific tools
Towel bars, replacing, 340–343
Trim
painting, 368–373, 372
preparation, 359
Trisodium phosphate, described, 334

U
Unfinished wood, preparing for painting, 364–367

V
Valances, 347

W
Wallcovering
hanging
applying, 388–393
planning, 384–386
preparing strips, 387
stripping, 334, 380–383
Walls
inspecting for flaws, 383
mounting towel bars on ceramic tiles, 343
painting, 359, 360–363
Wet edges, 361
Window frames, 347
Window jambs, 347
Windows
hanging wallcovering around, 391–392
painting, 368–373, 372
painting preparation, 359
Window shadings, described, 351
Windowsills, described, 369
Window treatments
buying, 351
hanging curtains, 344–345
installing blinds & shades, 346–350
Wood, unfinished, preparing for painting, 364–367
Wood cabinets, painting, 374–375
Wood filler, described, 334

OUTDOOR INDEX

A
Air-conditioning costs, 420
Aluminum siding, 446
Ant traps, 425
Asphalt driveways, repairing, 432–437

B
Board-and-batten, repairing, 446, 449
Bonding agents, 443
Brown coat, 451

C
Caulking
  basic exterior, 420–423
  exterior painting and, 405
  to keep pests out, 424, 426
  types of caulk, 421
Chain-drive openers, 469
Chimney flue caps, 426
Chip-outs, repairing concrete, 430–431
Clapboard siding, repairing, 446, 448
Clogged gutters, cleaning & repairing, 398–401
Closing force sensitivity, 469
Cold-patch asphalt mix, 433
Concrete surfaces
  cleaning, 487
  driveways, 432
  rebuilding steps, 445
  repairing cracks, 443
  repairing steps, 442–444
  repairing walkways, 428–431
  spalled, 429
Connectors for gutters, estimating, 475
Corners for gutters, estimating, 475
Cracks
  repairing in asphalt driveways, 433, 434–435
  repairing in concrete steps, 443
  repairing in concrete walkways, 428–429, 431
Cupped board, 455

D
Deadbolts, installing, 462–463, 465–467
Decks
  cleaning, 487
  renewing wood finishes, 454–457
Door casing boards, 411
Door jambs, 411, 463
Doors
  installing storm, 410–415
  repairing sliding screen, 406–409
Double-hung windows, maintaining, 416–419
Downspout elbows & outlets, 399, 475
Drain pipe hangers, 399, 475
Drain pipes, estimating, 475
Drills/drivers, 455
Driveways
  cleaning, 487
  concrete, 432
  repairing asphalt, 432–437

E
End caps, 399
Exterior paint, touching up, 402–405
Exterior wall construction, 447, 451

F
Fixtures for landscape lighting, 483
Flap sanders, 403
Foam backer rods, 429
Foggers, pesticide, 425
Folding gutter extensions, 401

G
Garage doors, tuning up, 468–473
Garage floors, cleaning, 487
Glass panes, repairing broken, 438–441
Glazier's points, 439
Gutter parts. estimating, 475
Gutter pitch, 475
Gutter run, 475
Gutters
  cleaning & repairing clogged, 398–401
  folding extensions for, 401
  installing, 474–477

H
Hardware mortising technique, 467
Heating costs, 420

I
Insect mesh, 426
Insects, keeping out, 424–427

L
Lag screws, 455
Landscape lighting, installing, 478–483
Locksets, installing, 462–465
Low-voltage light kits, 479

M
Metal laths, 451
Mice, 424–427
Mildew stains, removing, 486
Mortar patching mix, 443
Mortising technique for hardware, 467
Mousetraps, 425
Muntins, 417

P
Parting strips, 417
Patching compound, using, 444
Pesticide foggers, 425
Pestproofing, 424–427
Pressure washing, 484–487

R
Rain gutters, installing, 474–477
Roach traps, 425
Roofs, replacing shingles, 458–461
Roof vent screens, 426
Rust stains, removing, 486

S
Safety
  installing landscape lighting for, 478–483
  installing locksets & deadbolts for, 462–467
  roof, 459
Sash stops, 417
Scratch coat, 451
Screens, repairing, 406–409
Screw-drive openers, 469
Sealers, applying, 457
Sealers for driveway, 433
Shingles, roof, 459
Shingles, siding, 446
Siding, basic repairs, 446–449
Silicone acrylic caulk, 421
Sliding screen doors, repairing, 406–409
Small animal pests, 424–427
Spalled concrete, 429
Spline, 407
Spline rollers, 407
Stains, removing, 486
Steps
  cleaning, 487
  rebuilding concrete, 445
  repairing concrete, 442–444
Storm doors, installing, 410–415
Stucco, repairing, 450–453

T
Templates, 463
Termites, 427
Tongue-and-groove siding, repairing, 446, 449
Tools and supplies
  basic, 396–397
    see also specific supplies; specific tools
Transformers, 479
True caulks, 421

V
Vinyl siding, repairing, 446

W
Windows
  maintaining double-hung, 416–419
  repairing broken glass panes, 438–441
  repairing screening, 407
  sashes, 439
Wooden structures
  cleaning decks, 487
  renewing deck finishes, 454–457
Wood shingles, repairing, 446

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Contents

Advanced Home Wiring

Introduction
Working Safely
Circuit Maps
Common Household Circuits
Advanced Wiring Projects
Electrical Panels
Installing Circuit Breakers
Installing a Subpanel
Upgrading Service Panels
Grounding & Bonding an Upgraded System
Adding Circuits
Wiring a Room Addition
Wiring a Kitchen
Installing a Solar Light Circuit
Backup Power Supply
Installing a Transfer Switch
Troubleshooting & Repairs
Common Residential Wiring Codes
Electrical Receptacle Installation

Ground-fault (GFCI) & Arc-fault (AFCI) Protection

Junction Boxes, Device Boxes & Enclosures

Credits/Resources

Conversions

Index

Introduction

Home wiring is a skill that is worth developing beyond the basics of replacing a switch or rewiring a lamp. There is no such thing as a simple wiring project, inasmuch as the consequences of any mistake can be severe. But advancing your skillset to include more challenging and complicated projects is the surest way to make your initial investment in the fundamentals of electrical service pay maximum dividends. This new 3rd edition of *Black & Decker Advanced Home Wiring* is directed specifically at homeowners who have some wiring experience and are interested in upgrading their capabilities.

Home wiring projects fall into three general categories: installing wiring fixtures such as ceiling lights or baseboard heaters; installing or upgrading wiring circuitry; and troubleshooting and repair. You'll find advanced-level projects in all three categories, but for the most part, the more challenging projects tend to be in the circuitry and repair groups. Almost all of the advanced wiring projects featured in this book involve new circuitry, panel upgrades, or

troubleshooting with diagnostic equipment. Among the high-level projects you're not likely to find in other DIY wiring books: making a direct-current, solar-electric circuit; upgrading the grounding and bonding on your new 200-amp or larger home circuit; installing an automatic transfer switch for your backup power supply; and using a multimeter to precisely locate an open neutral in a home circuit.

Even though the projects found in this book are advanced in nature, do not attempt any of them unless you are confident in your abilities. Consult a professional electrician if you have any concerns—in many cases your best solution might be to do some of the work yourself, such as pulling new sheathed cable through walls, and to have the electrical contractor do the other work, such as making the connections. Because most wiring projects require a permit from your local building department, you will need to be able to plot out and explain clearly your project strategies, materials, and costs, and in some cases arrange for field inspections. But do keep in mind that home wiring can be a fun and fascinating pursuit, and successfully accomplishing a major project is personally gratifying and can also save you substantial amounts of money.

Working Safely

Safety should be the primary concern of anyone working with electricity. Although most household electrical repairs are simple and straightforward, always use caution and good judgment when working with electrical wiring or devices. Common sense can prevent accidents.

The basic rule of electrical safety is: Always turn off power to the area or device you are working on. At the main service panel, remove the fuse or shut off the circuit breaker that controls the circuit you are servicing. Then check to make sure the power is off by testing for power with a voltage tester. *Tip: Test a live circuit with the voltage tester to verify that it is working before you rely on it.* Restore power only when the repair or replacement project is complete.

Follow the safety tips shown on these pages. Never attempt an electrical project beyond your skill or confidence level. Never attempt to repair or replace your main service panel or service entrance head. These are jobs for a qualified electrician and require that the power company shut off power to your house.

Shut power OFF at the main service panel or the main fuse box before beginning any work.

Create a circuit index and affix it to the inside of the door to your main service panel. Update it as needed.

Confirm power is OFF by testing at the outlet, switch, or fixture with a voltage tester.

Use only UL-approved electrical parts or devices. These devices have been tested for safety by Underwriters Laboratories.

Tips for Working Safely

Wear rubber-soled shoes while working on electrical projects. On damp floors, stand on a rubber mat or dry wooden boards.

Use fiberglass or wood ladders when making routine household repairs near the service mast.

Extension cords are for temporary use only. Cords must be rated for the intended usage.

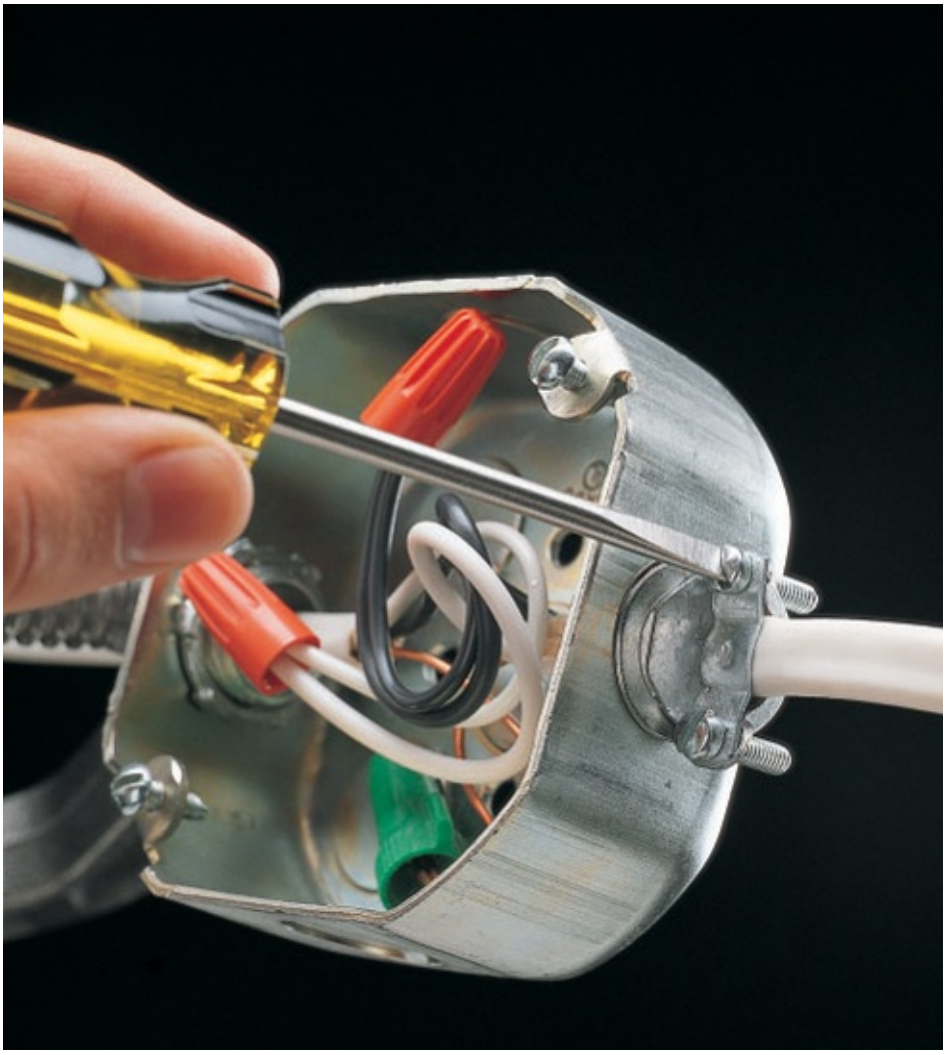
Breakers and fuses must be compatible with the panel manufacturer and match the circuit capacity.

Never alter the prongs of a plug to fit a receptacle. If possible, install a new grounded receptacle.

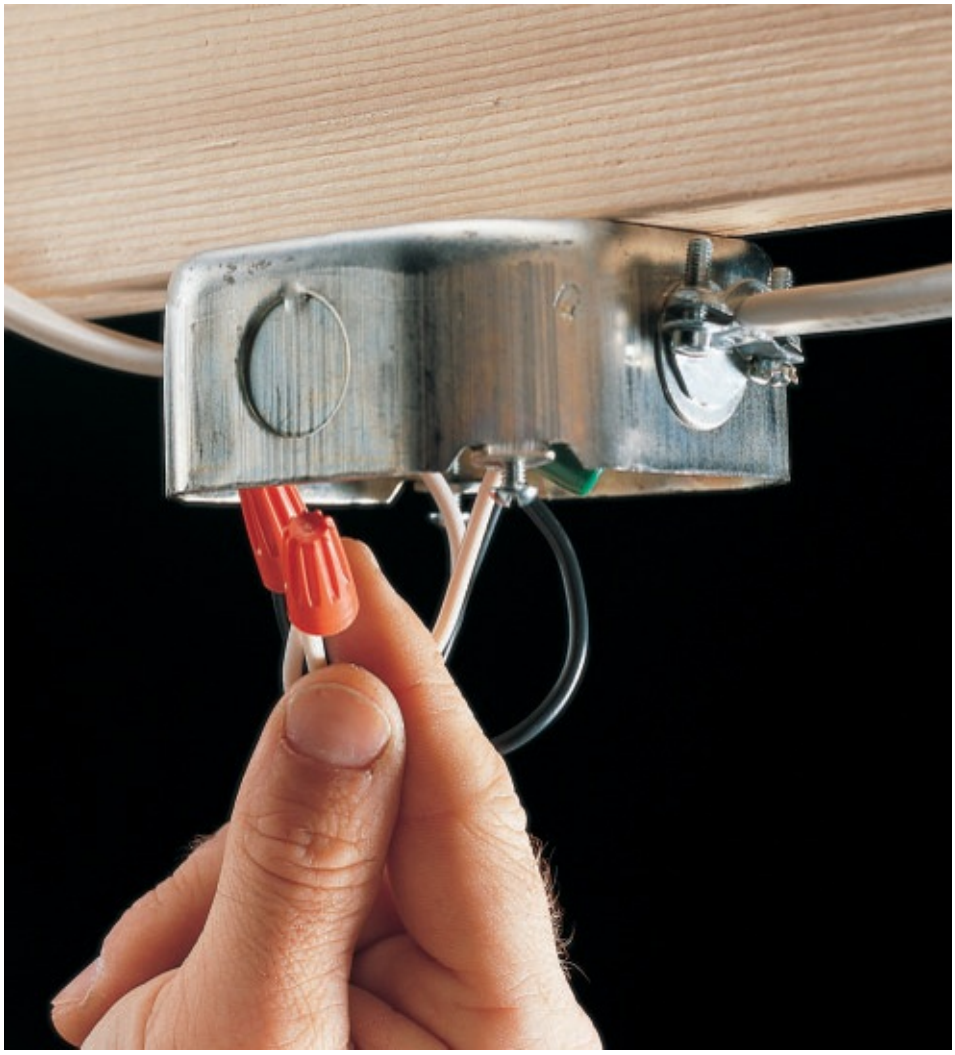
Do not penetrate walls or ceilings without first shutting off electrical power to the circuits that may be hidden.

Anchor the cable to the side of the framing members at least 1-1/4" from the edge using plastic staples. NM (nonmetallic) cable should be stapled every 4-1/2 ft. and within 8" of each electrical box.

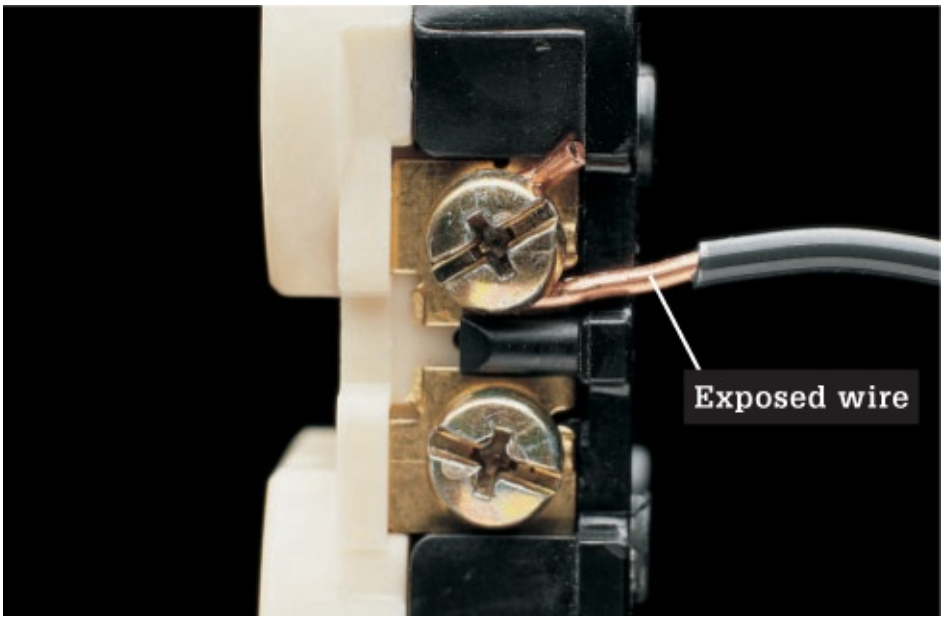
Install metal nail guards to protect cable from damage. Nail guards are available at hardware stores and home centers.



Anchor the cable to the electrical box with a cable clamp. Several types of cable clamps are available at hardware stores and home centers.



Bring installation up to code by enclosing the splice inside a metal or plastic electrical box. Make sure the box is large enough to accommodate the number of wires it contains.

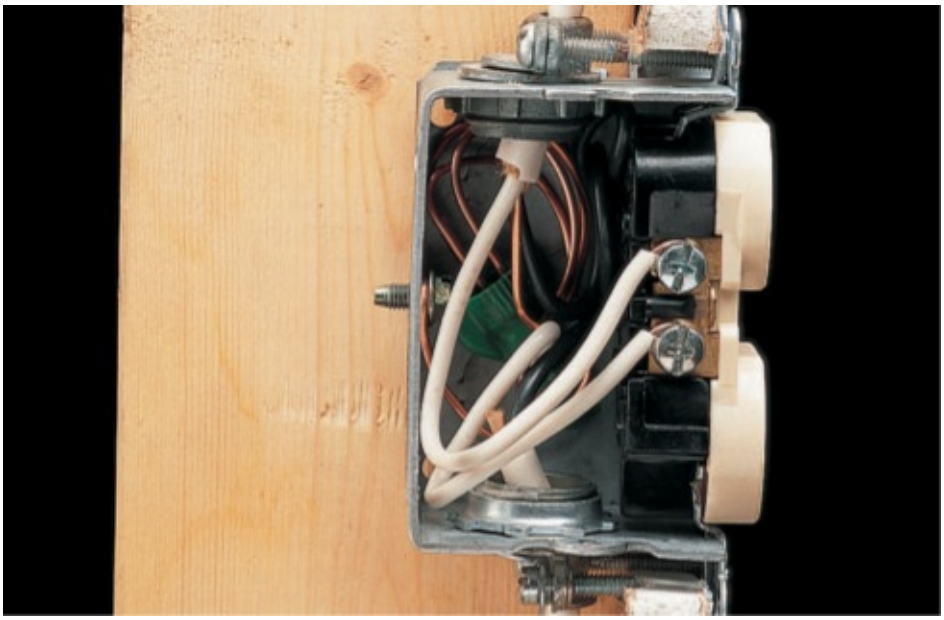


Problem: Bare wire extends past a screw terminal. Exposed wire can cause a short circuit if it touches the metal box or another circuit wire.

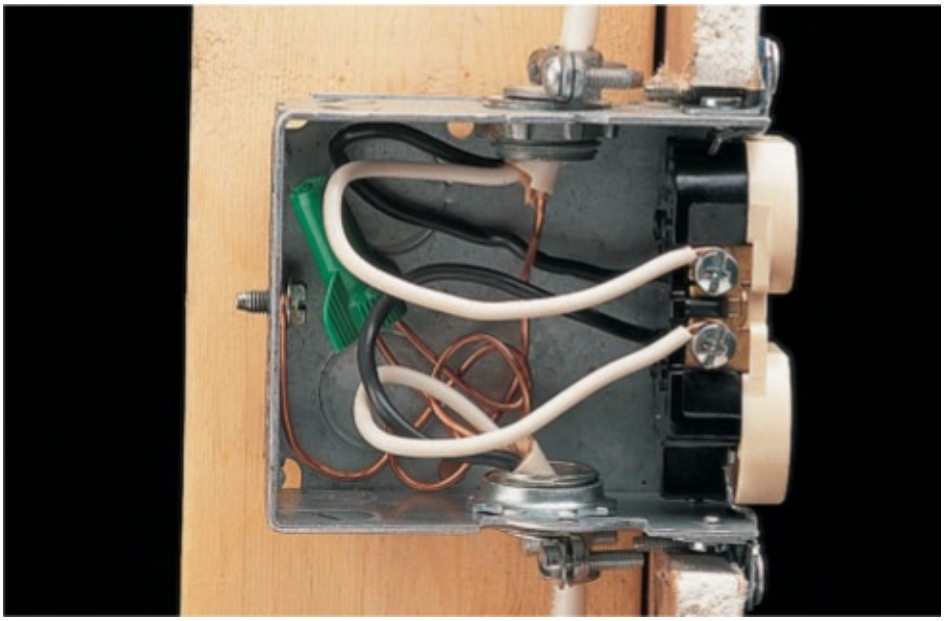
Solution: Clip the wire and reconnect it to the screw terminal. In a proper connection, the bare wire wraps completely around the screw terminal, and the plastic insulation just touches the screw head.

Problem: A recessed electrical box is hazardous, especially if the wall or ceiling surface is made from a flammable material, like wood paneling. The National Electrical Code prohibits this type of installation.

Solution: Add an extension ring to bring the face of the electrical box flush with the surface. Extension rings come in several sizes and are available at hardware stores.

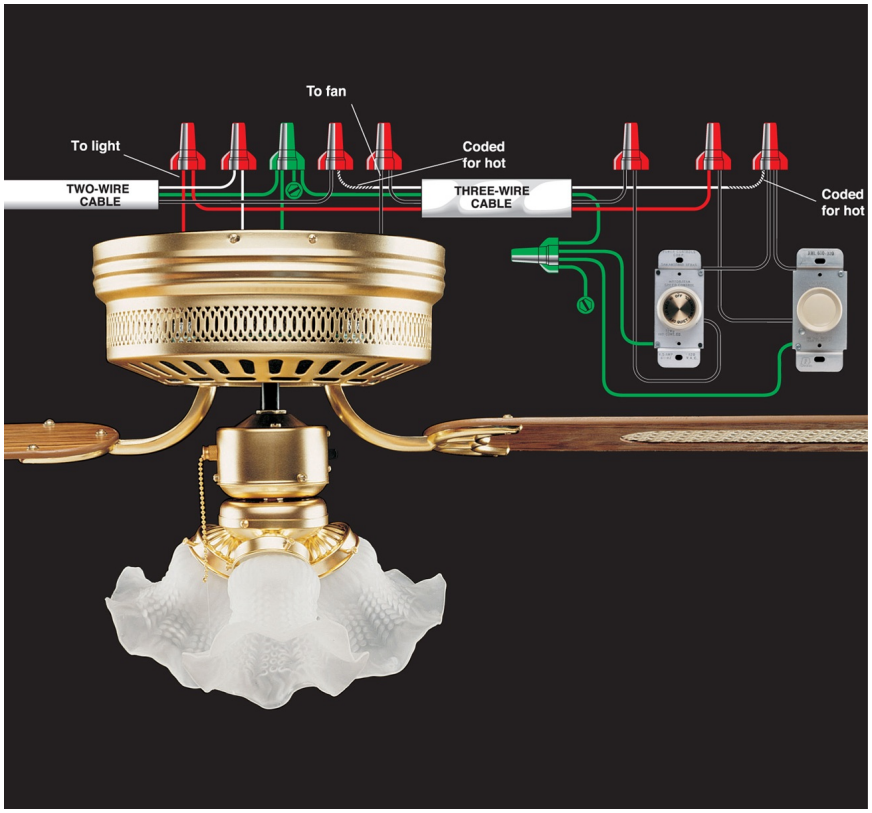


Problem: Crowded electrical box (shown cutaway) makes electrical repairs difficult. This type of installation is prohibited because wires can be damaged easily when a receptacle or switch is installed.



Solution: Replace the electrical box with a deeper electrical box.

Circuit Maps



The circuit maps on the following pages show the most common wiring variations for typical electrical devices. Most new wiring you install will match one or more of the maps shown. Find the maps that match your situation and use them to plan your circuit layouts.

Note: For clarity, all grounding conductors in the circuit maps are colored green. In practice, the grounding wires inside sheathed cables usually are bare copper.

Circuit Maps:

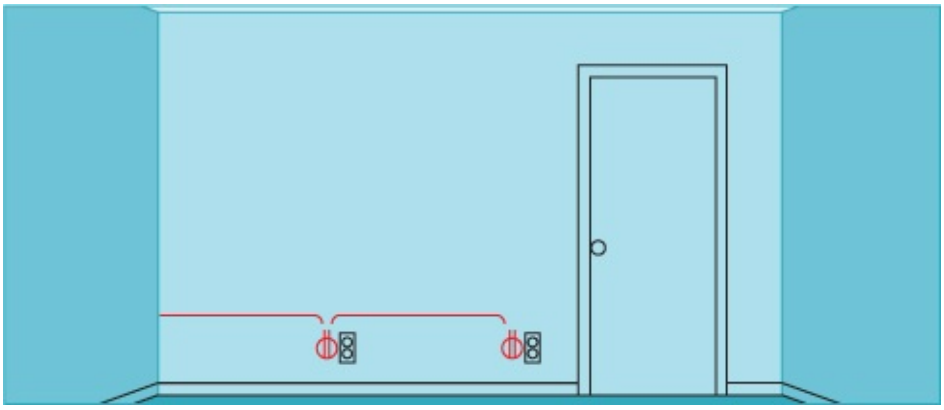
1. 120-volt duplex receptacles wired in sequence
2. GFCI receptacles (single-location protection)
3. GFCI receptacle, switch & light fixture (wired for multiple location protection)
4. Single-pole switch & light fixture (light fixture at end of cable run)

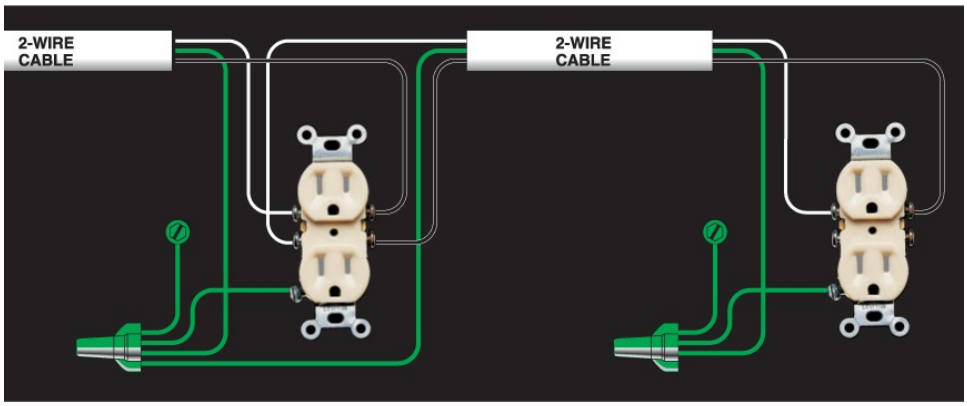
5. Single-pole switch & light fixture (switch at end of cable run)
6. Single-pole switch & two light fixtures (switch between light fixtures, light at start of cable run)
7. Single-pole switch & light fixture, duplex receptacle (switch at start of cable run)
8. Switch-controlled split receptacle, duplex receptacle (switch at start of cable run)
9. Switch-controlled split receptacle (switch at end of cable run)
0. Double receptacle circuit with shared neutral wire (receptacles alternate circuits)
1. Double receptacle small-appliance circuit with GFCIs & shared neutral wire
2. Double receptacle small-appliance circuit with GFCIs & separate neutral wires
3. 120/240-volt range receptacle
4. 240-volt baseboard heaters, thermostat
5. 240-volt appliance receptacle
6. Ganged single-pole switches controlling separate light fixtures
7. Ganged switches controlling a light fixture and a vent fan
8. Three-way switches & light fixture (fixture between switches)
9. Three-way switches & light fixture (fixture at start of cable run)
0. Three-way switches & light fixture (fixture at end of cable run)
1. Three-way switches & light fixture with duplex receptacle
2. Three-way switches & multiple light fixtures (fixtures between switches)
3. Three-way switches & multiple light fixtures (fixtures at beginning of run)
4. Four-way switch & light fixture (fixture at start of cable run)
5. Four-way switch & light fixture (fixture at end of cable run)
6. Multiple four-way switches controlling a light fixture
7. Ceiling fan/light fixture controlled by ganged switches (fan at end of cable run)
8. Ceiling fan/light fixture controlled by ganged switches (switches at end of cable run)

Common Household Circuits

1. 120-VOLT DUPLEX RECEPTACLES WIRED IN SEQUENCE

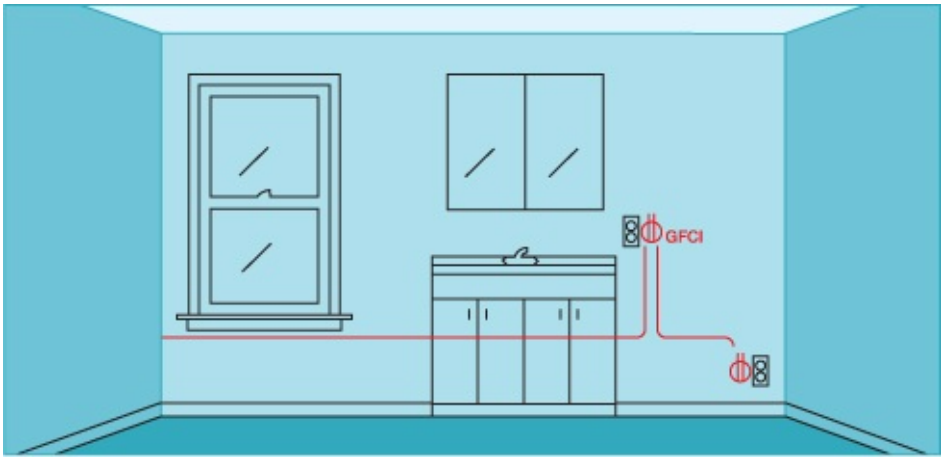
Use this layout to link any number of duplex receptacles in a basic lighting/receptacle circuit. The last receptacle in the cable run is connected like the receptacle shown at the right side of the circuit map below. All other receptacles are wired like the receptacle shown on the left side. Requires two-wire cables.

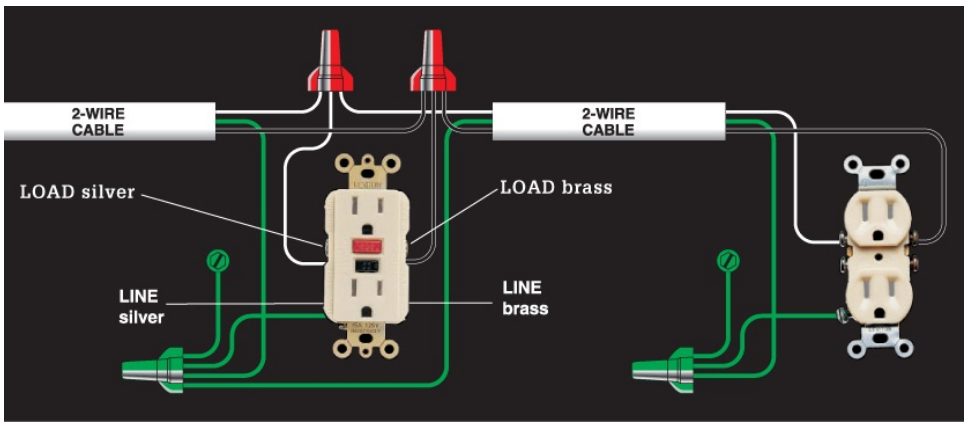




2. GFCI RECEPTACLES (SINGLE-LOCATION PROTECTION

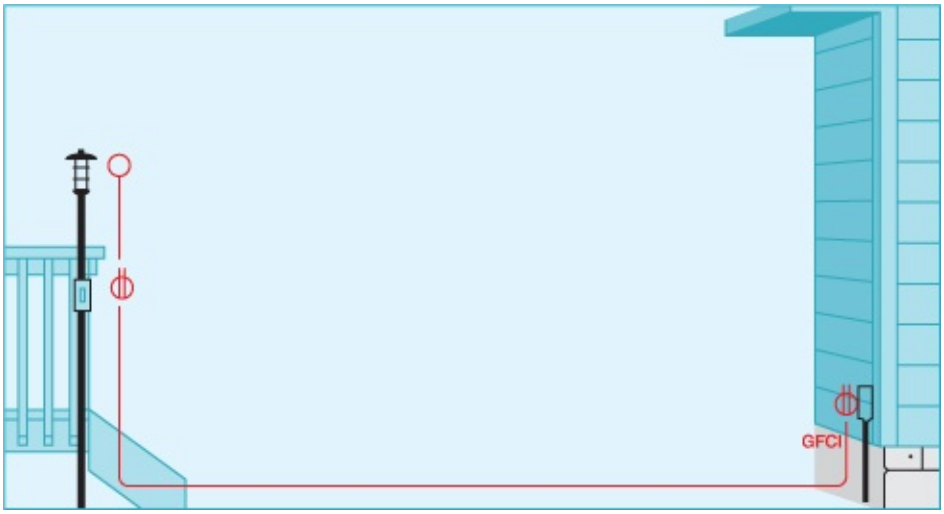
Use this layout when receptacles located in a room with a water source, like a kitchen or a bathroom. In this configuration, only devices plugged into the GFCI receptacle will be protected—the downstream receptacle is not wired in series and will continue to function if the GFCI trips. Requires two-wire cables. Where a GFCI must protect other fixtures, use circuit map 3.

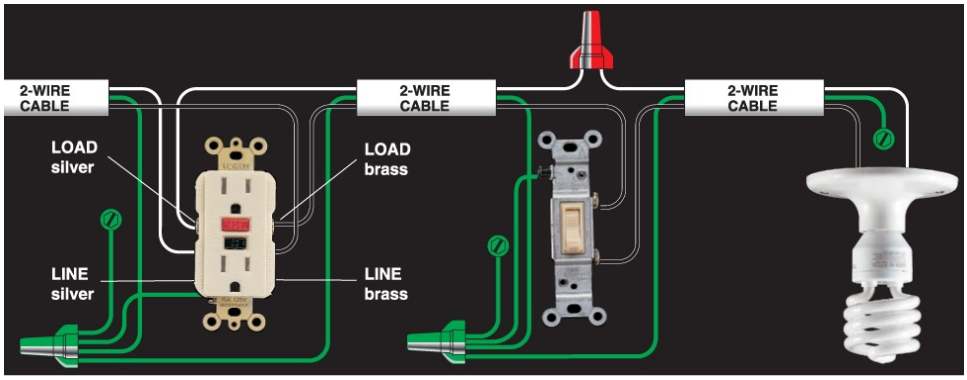




3. GFCI RECEPTACLE, SWITCH & LIGHT FIXTURE (WIRED FOR MULTIPLE-LOCATION PROTECTION)

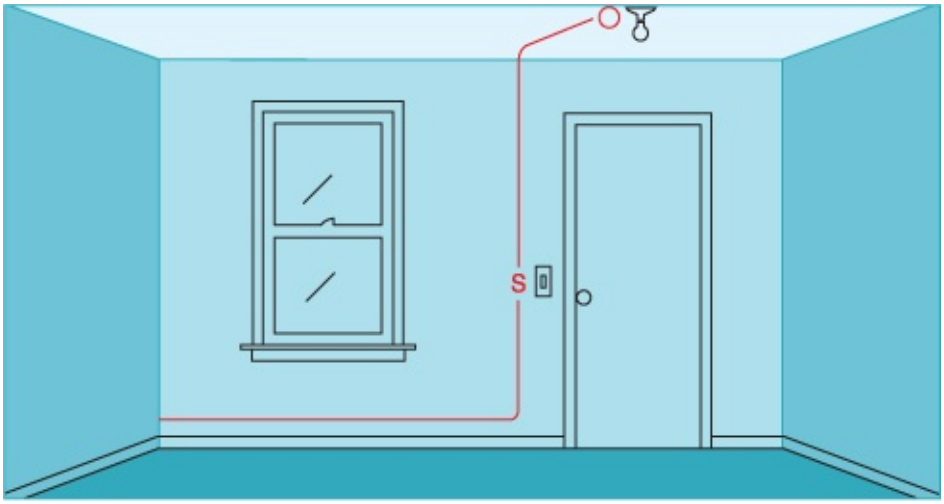
In some locations, such as an outdoor circuit, it is a good idea to connect a GFCI receptacle so it also provides shock protection to the wires and fixtures that continue to the end of the circuit. Wires from the power source are connected to the line screw terminals; outgoing wires are connected to load screws. Requires two-wire cables.

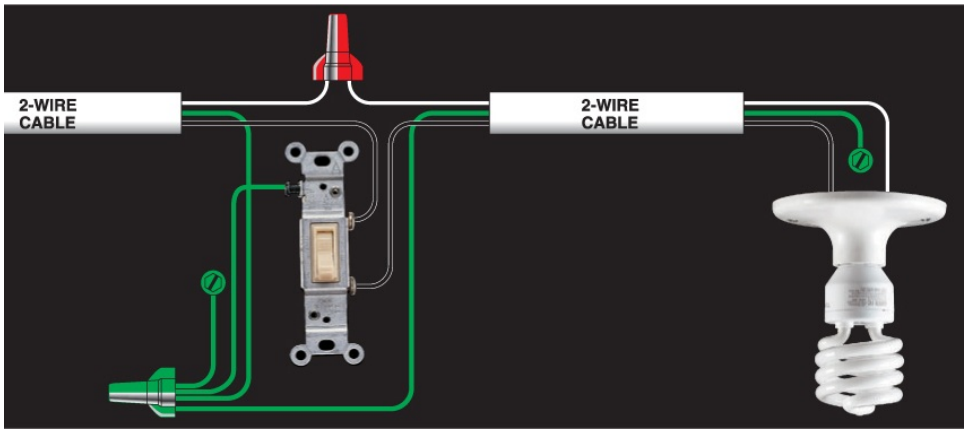




4. SINGLE-POLE SWITCH & LIGHT FIXTURE (LIGHT FIXTURE AT END OF CABLE RUN)

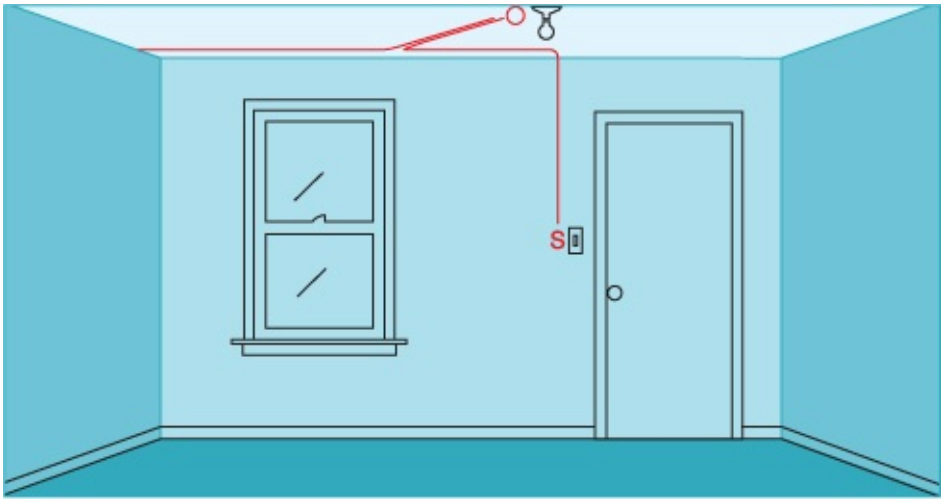
Use this layout for light fixtures in basic lighting/receptacle circuits throughout the home. It is often used as an extension to a series of receptacles (circuit map 1). Requires two-wire cables.

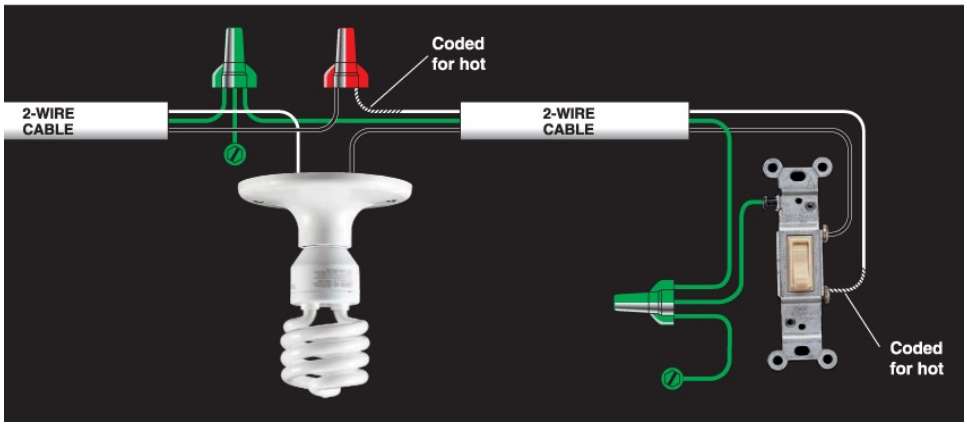




5. SINGLE-POLE SWITCH & LIGHT FIXTURE (SWITCH AT END OF CABLE RUN)

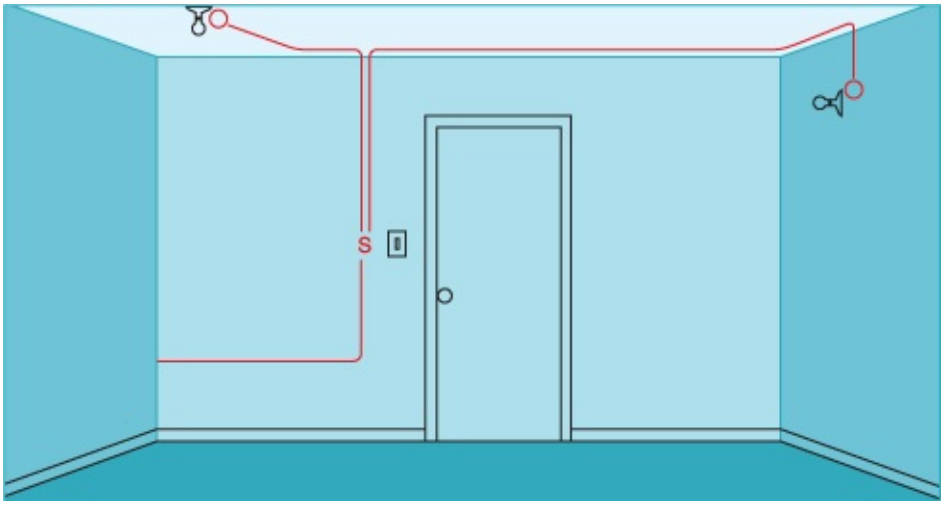
Use this layout, sometimes called a switch loop, where it is more practical to locate a switch at the end of the cable run. In the last length of cable, both insulated wires are hot; the white wire is tagged with black tape at both ends to indicate it is hot. Requires two-wire cables.

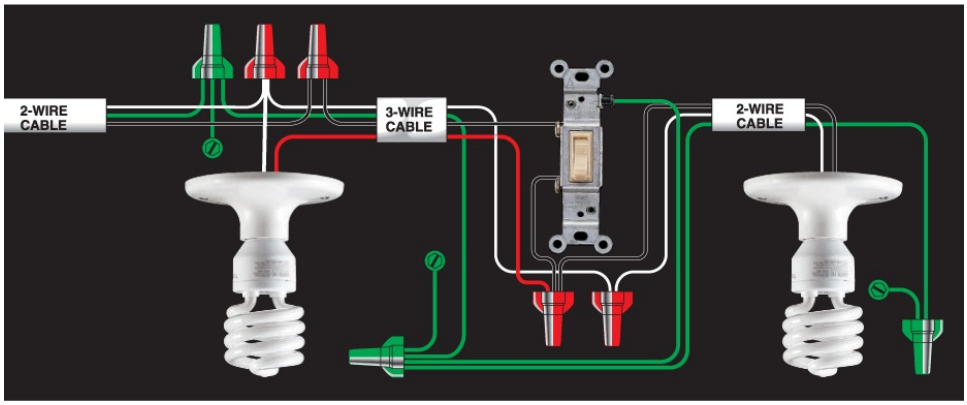




6. SINGLE-POLE SWITCH & TWO LIGHT FIXTURES (SWITCH BETWEEN LIGHT FIXTURES, LIGHT AT START OF CABLE RUN)

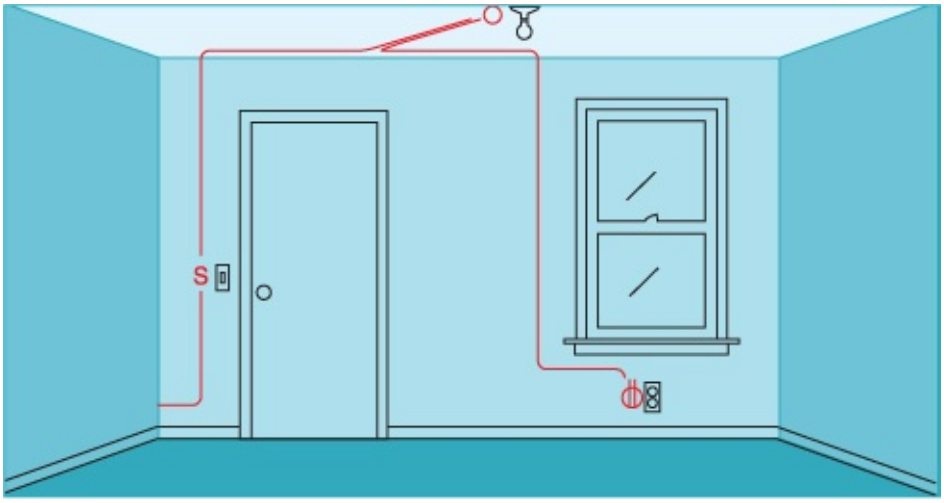
Use this layout when you need to control two fixtures from one single-pole switch and the switch is between the two lights in the cable run. Power feeds to one of the lights. Requires two-wire and three-wire cables.

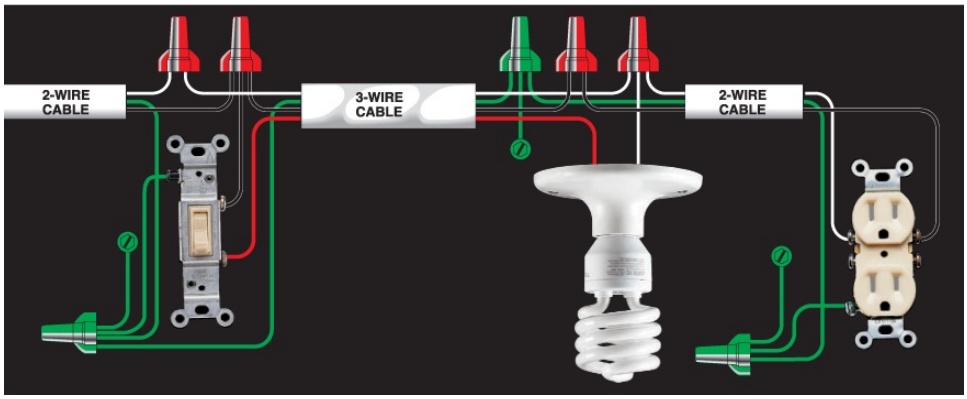




7. SINGLE-POLE SWITCH & LIGHT FIXTURE, DUPLEX RECEPTACLE (SWITCH AT START OF CABLE RUN)

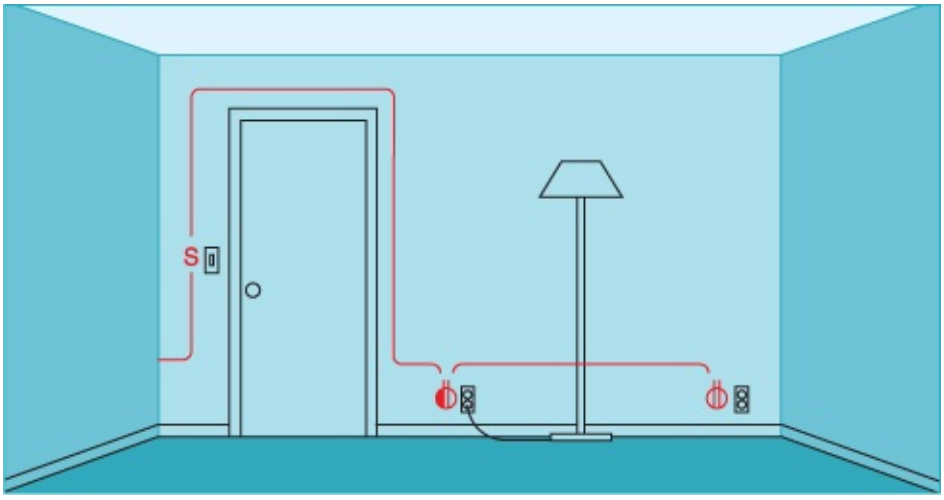
Use this layout to continue a circuit past a switched light fixture to one or more duplex receptacles. To add multiple receptacles to the circuit, see circuit map 1. Requires two-wire and three-wire cables.

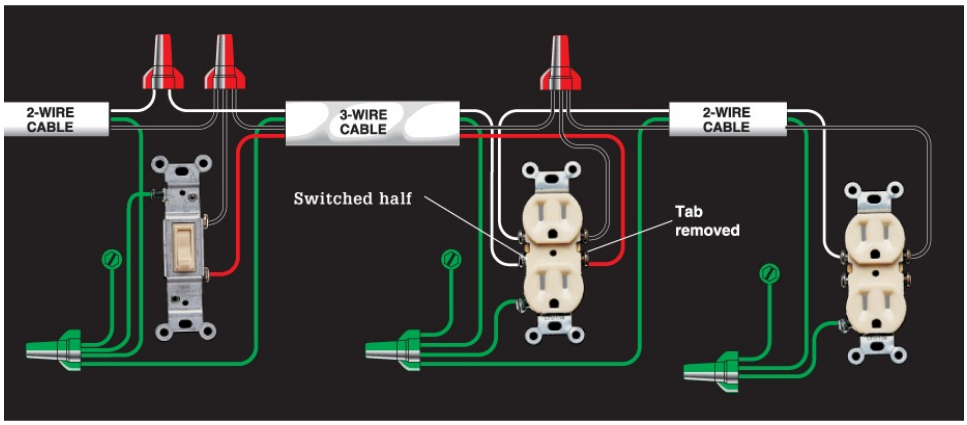




8. SWITCH-CONTROLLED SPLIT RECEPTACLE, DUPLEX RECEPTACLE (SWITCH AT START OF CABLE RUN)

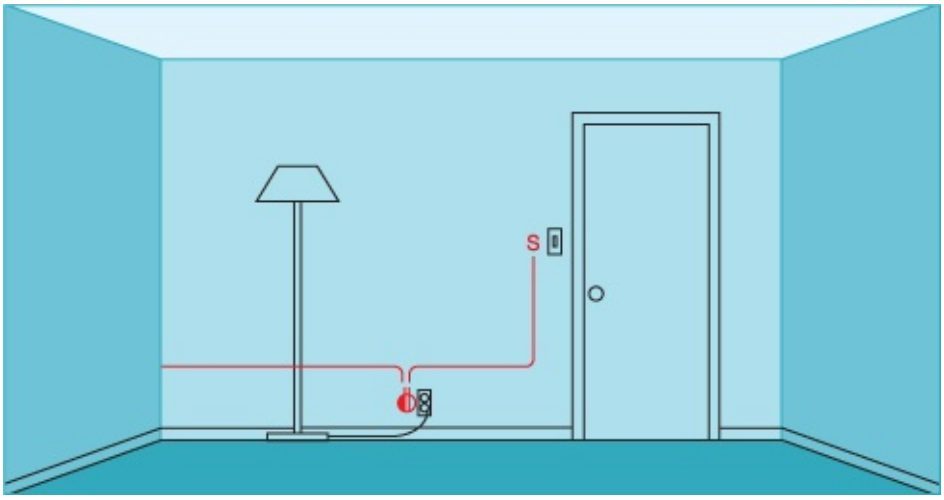
This layout lets you use a wall switch to control a lamp plugged into a wall receptacle. Only the bottom half of the first receptacle is controlled by the wall switch; the top half of the receptacle and all additional receptacles on the circuit are always hot. Requires two-wire and three-wire cables.

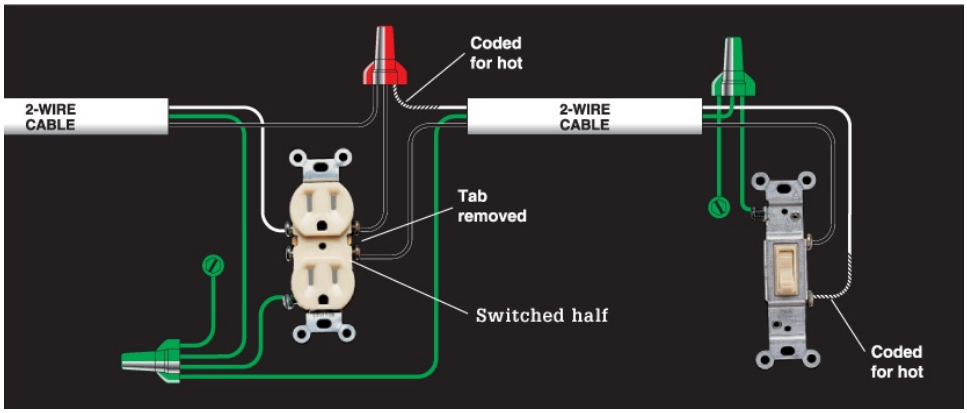




9. SWITCH-CONTROLLED SPLIT RECEPTACLE (SWITCH AT END OF CABLE RUN)

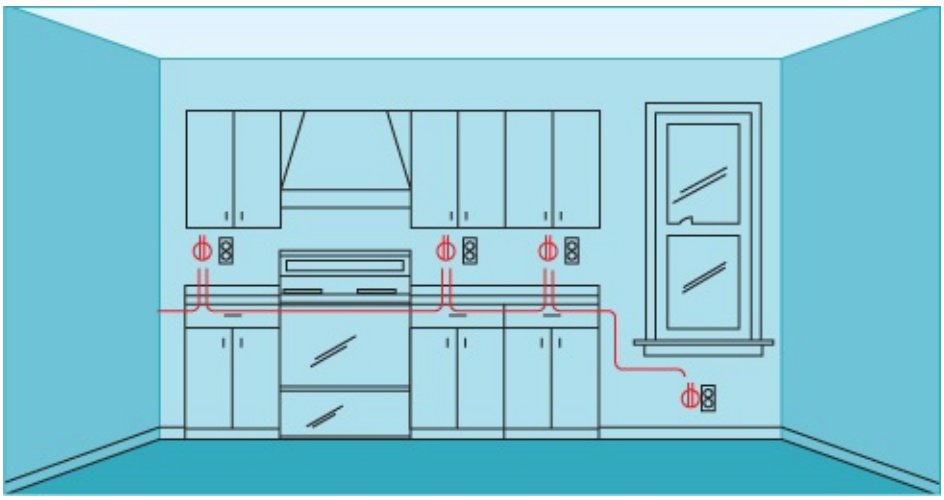
Use this switch loop layout to control a split receptacle (see circuit map 7) from an end-of-run circuit location. The bottom half of the receptacle is controlled by the wall switch, while the top half is always hot. White circuit wire attached to the switch is tagged with black tape to indicate it is hot. Requires two-wire cable.

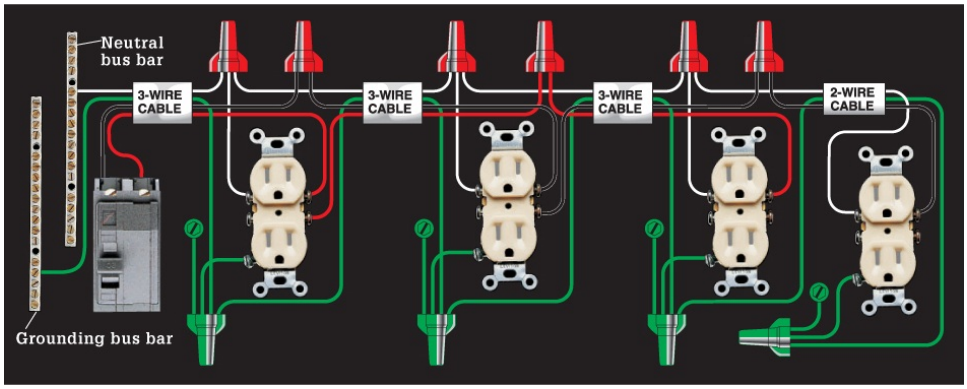




10. DOUBLE RECEPTACLE CIRCUIT WITH SHARED NEUTRAL WIRE (RECEPTACLES ALTERNATE CIRCUITS)

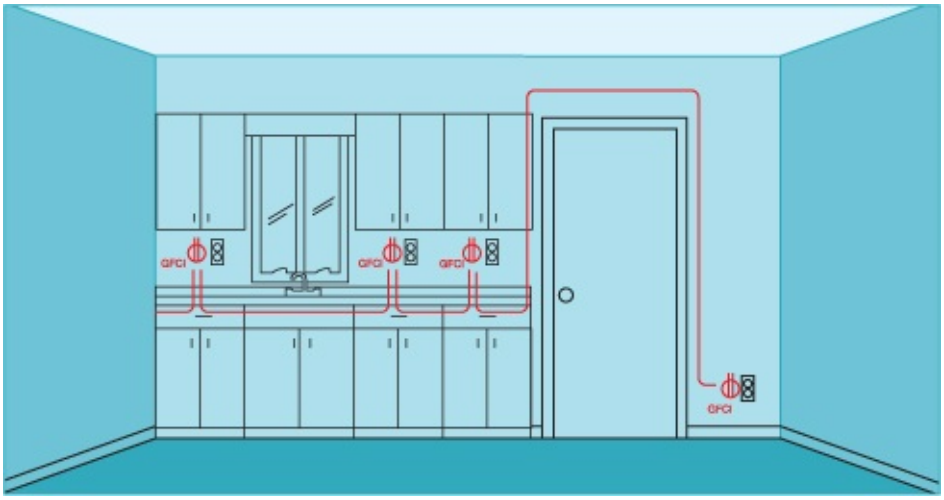
This layout features two 120-volt circuits wired with one three-wire cable connected to a double-pole circuit breaker. The black hot wire powers one circuit; the red wire powers the other. The white wire is a shared neutral that serves both circuits. When wired with 12/2 and 12/3 cable and GFCI receptacles rated for 20-amps, this layout can be used for the two small-appliance circuits required in a kitchen.

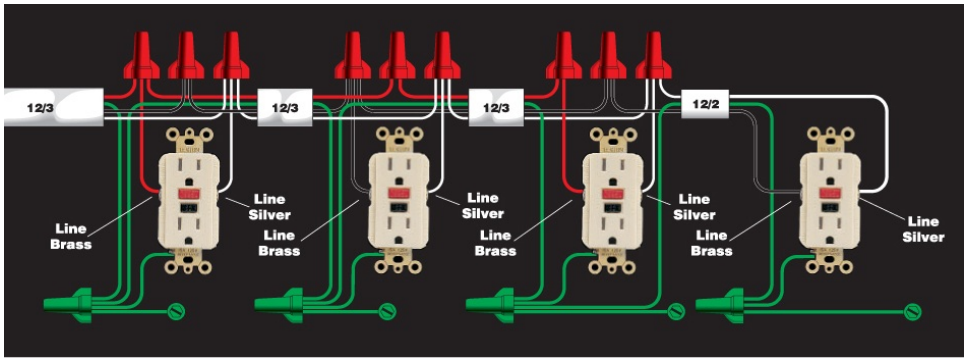




11. DOUBLE RECEPTACLE SMALL-APPLIANCE CIRCUIT WITH GFCIS & SHARED NEUTRAL WIRE

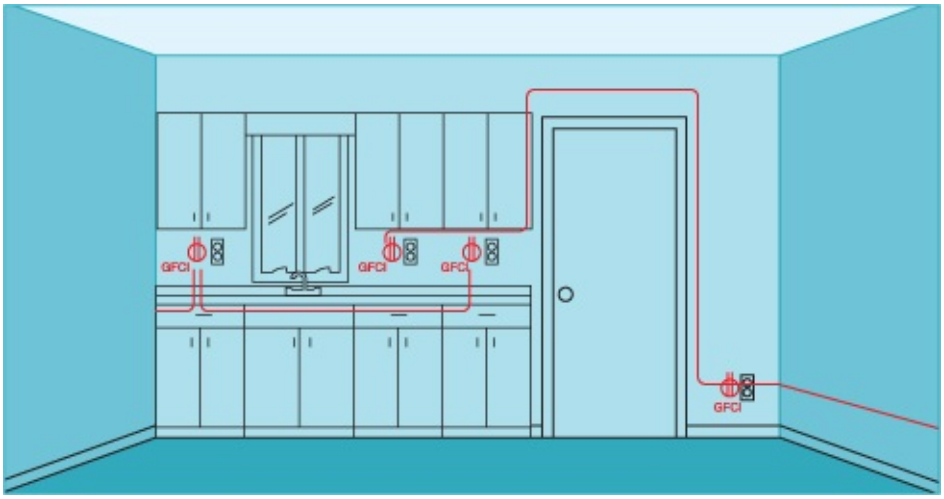
Use this layout variation of circuit map 10 to wire a double receptacle circuit when code requires that some of the receptacles be GFCIs. Each GFCI is wired for single-location protection (see circuit map 2). Requires three-wire and two-wire cables. Best used when retrofitting GFCI receptacles—in new construction it is cheaper to wire so one GFCI protects multiple locations.

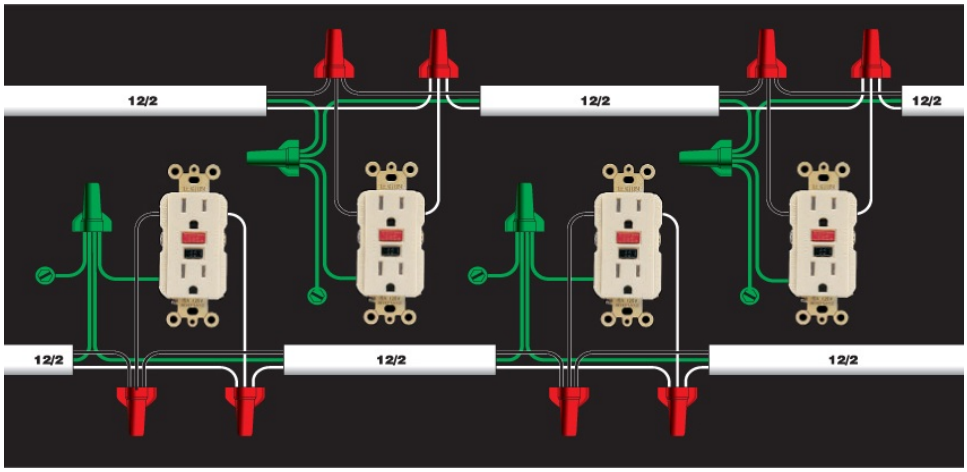




12. DOUBLE RECEPTACLE SMALL APPLIANCE CIRCUIT WITH GFCIS & SEPARATE NEUTRAL WIRES

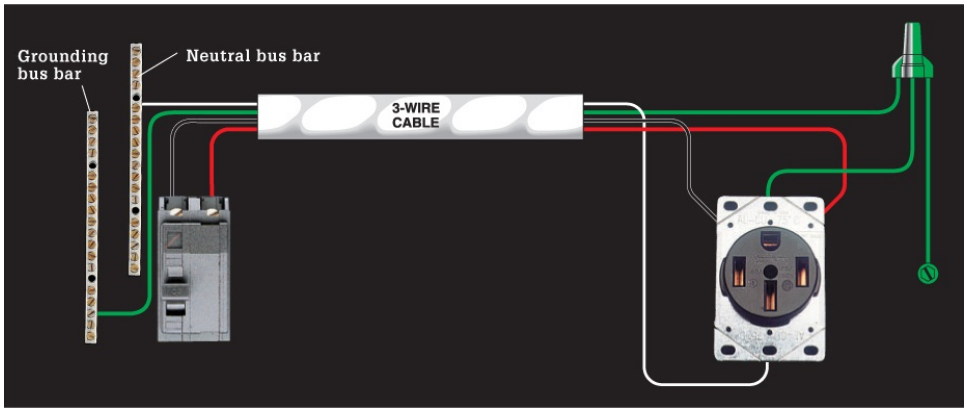
If the room layout or local codes do not allow for a shared neutral wire, use this layout instead. The GFCIs should be wired for single-location protection (see circuit map 2). Requires two-wire cable.





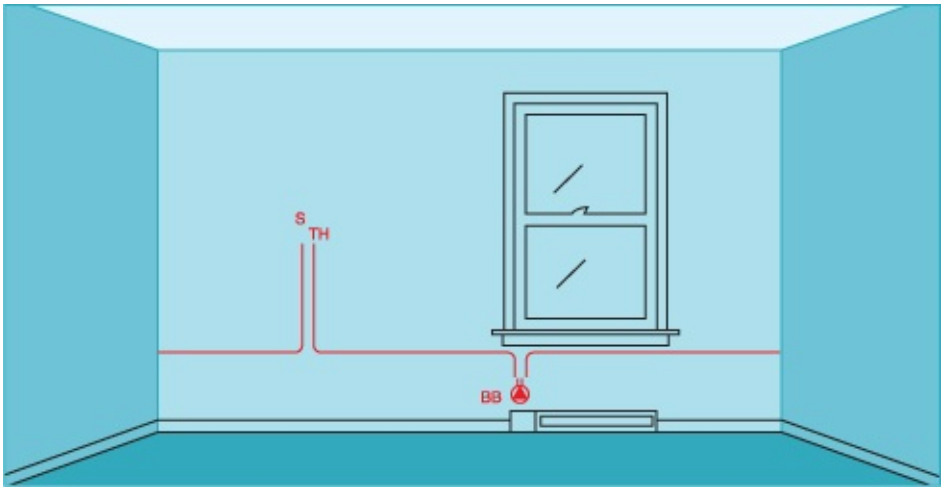
13. 120/240-VOLT RANGE RECEPTACLE

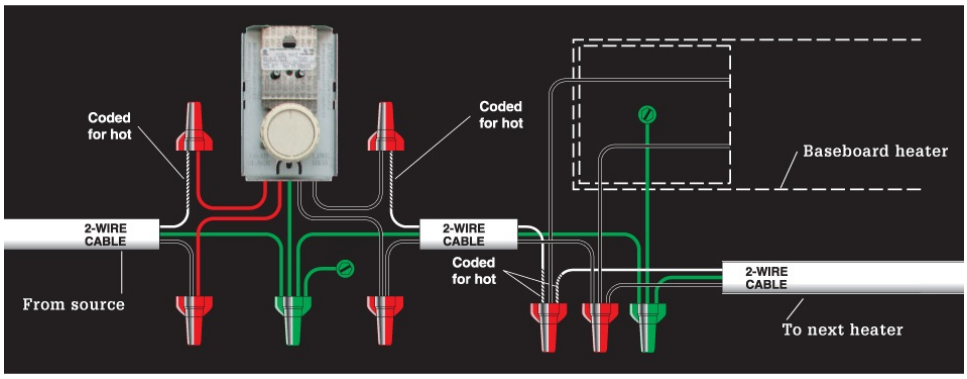
This layout is for a 40 or 50-amp, 120/240-volt dedicated appliance circuit wired with 8/3 or 6/3 copper cable, as required by code for a large kitchen range. The black and red circuit wires, connected to a double-pole circuit breaker in the circuit breaker panel, each bring 120 volts of power to the setscrew terminals on the receptacle. The white circuit wire attached to the neutral bus bar in the circuit breaker panel is connected to the neutral setscrew terminal on the receptacle.



14. 240-VOLT BASEBOARD HEATERS, THERMOSTAT

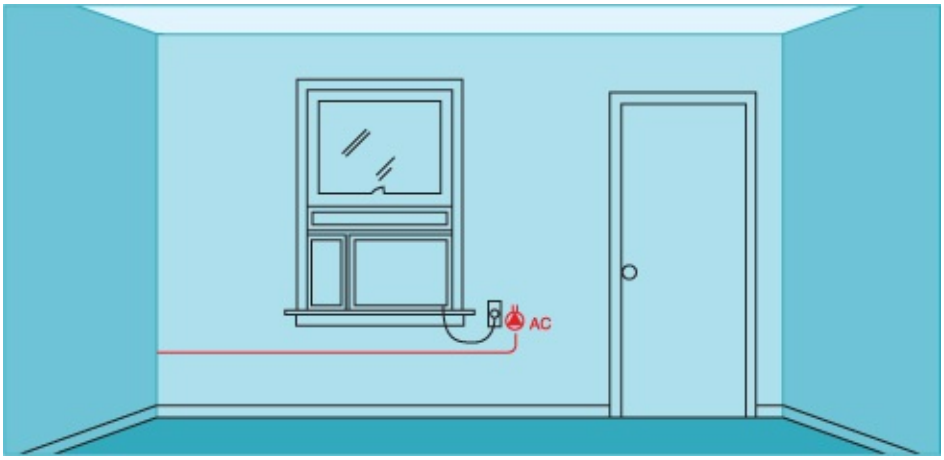
This layout is typical for a series of 240-volt baseboard heaters controlled by a wall thermostat. Except for the last heater in the circuit, all heaters are wired as shown below. The last heater is connected to only one cable. The size of the circuit and cables are determined by finding the total wattage of all heaters. Requires two-wire cable.

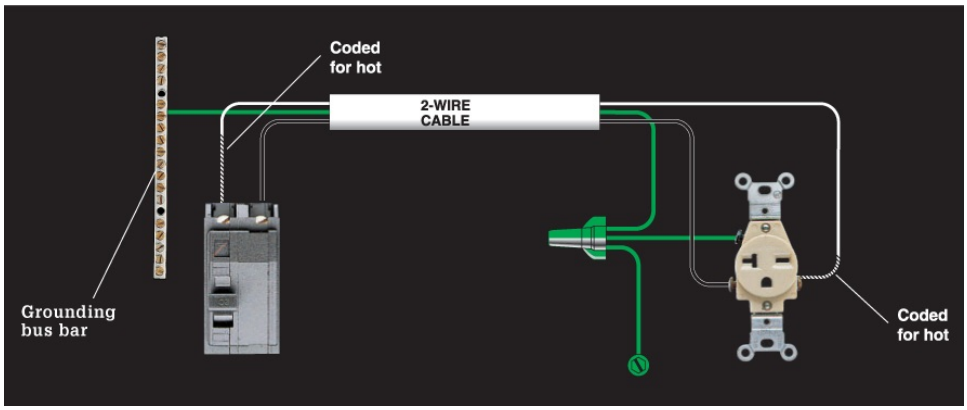




15. 240-VOLT APPLIANCE RECEPTACLE

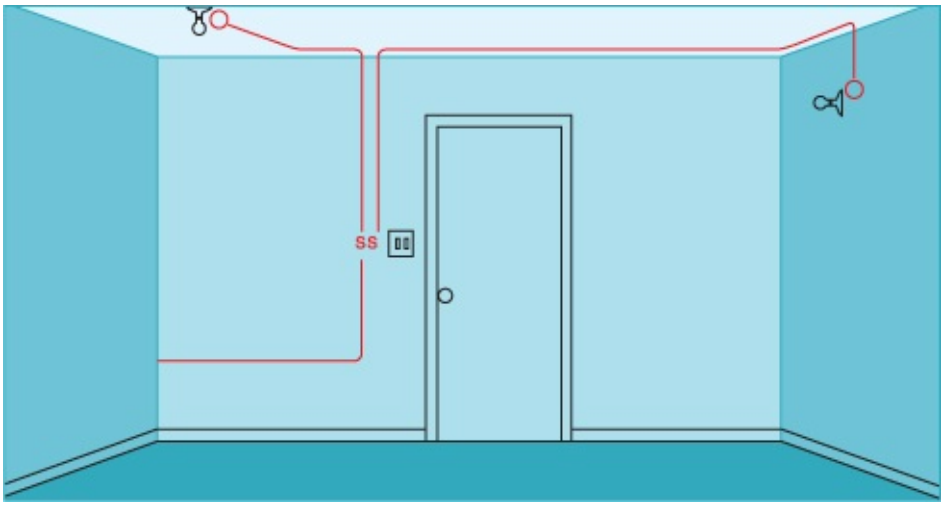
This layout represents a 20-amp, 240-volt dedicated appliance circuit wired with 12/2 cable, as required by code for a large window air conditioner. Receptacles are available in both singleplex (shown) and duplex styles. The black and the white circuit wires connected to a double-pole breaker each bring 120 volts of power to the receptacle (combined, they bring 240 volts). The white wire is tagged with black tape to indicate it is hot.

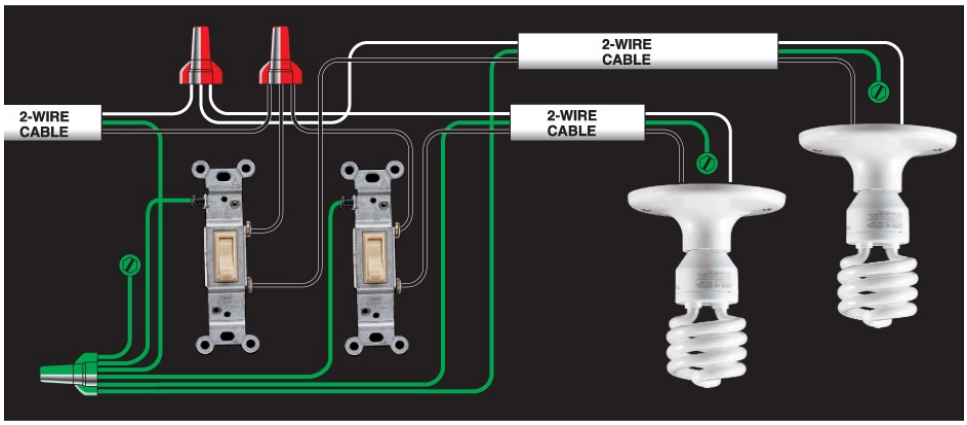




16. GANGED SINGLE-POLE SWITCHES CONTROLLING SEPARATE LIGHT FIXTURES

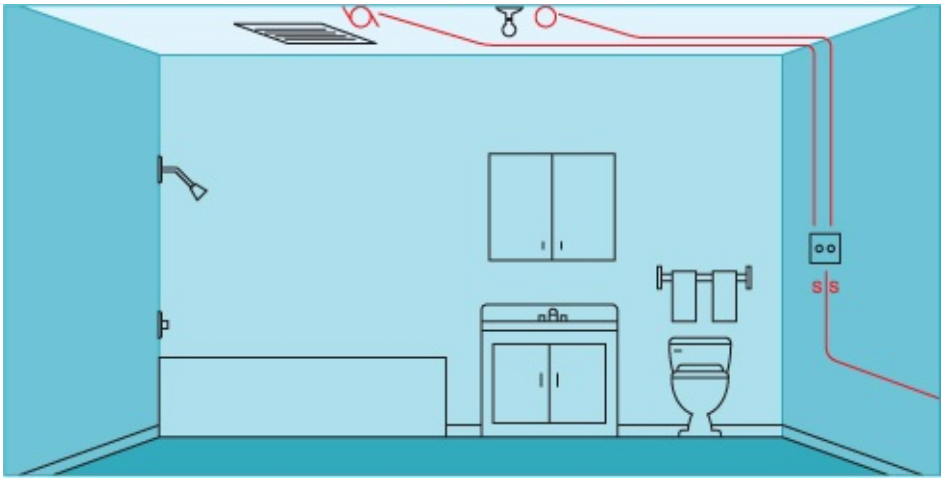
This layout lets you place two switches controlled by the same 120-volt circuit in one double-gang electrical box. A single feed cable provides power to both switches. A similar layout with two feed cables can be used to place switches from different circuits in the same box. Requires two-wire cable.

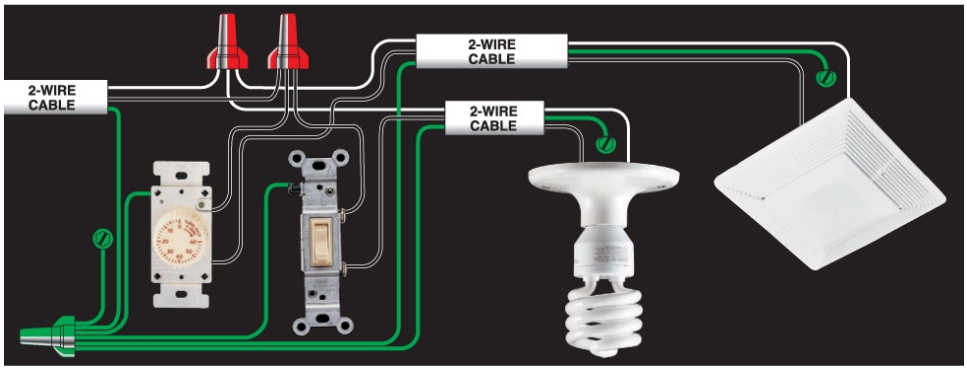




17. GANGED SWITCHES CONTROLLING A LIGHT FIXTURE AND A VENT FAN

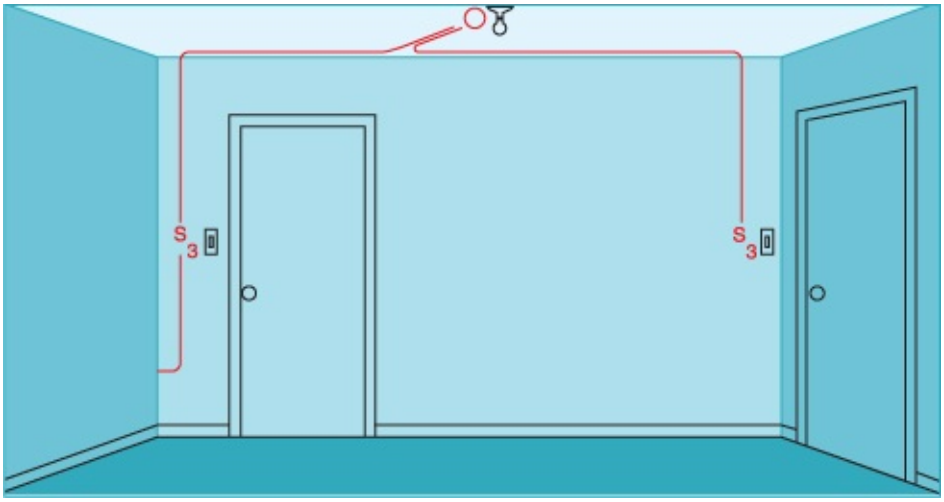
This layout lets you place two switches controlled by the same 120-volt circuit in one double-gang electrical box. A single feed cable provides power to both switches. A standard switch controls the light fixture and a time-delay switch controls the vent fan.

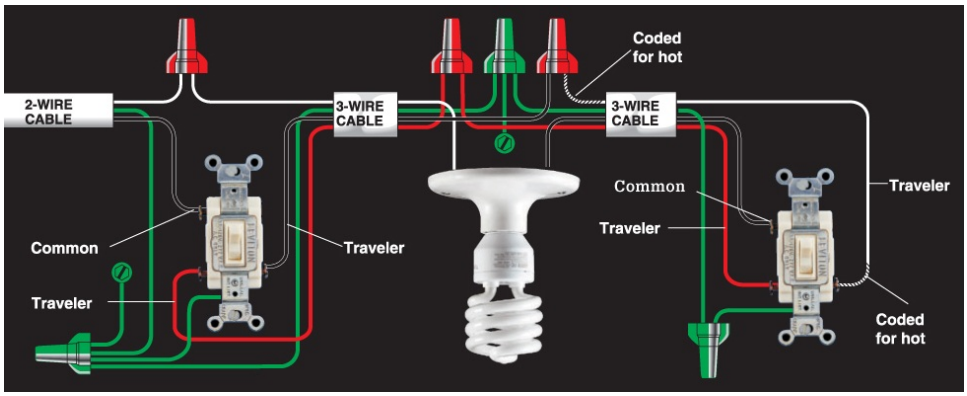




18. THREE-WAY SWITCHES & LIGHT FIXTURE (FIXTURE BETWEEN SWITCHES)

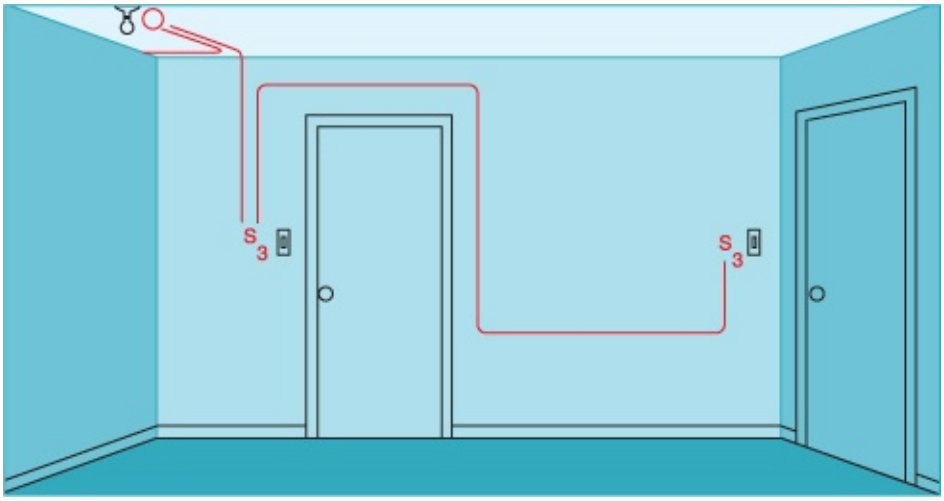
This layout for three-way switches lets you control a light fixture from two locations. Each switch has one common screw terminal and two traveler screws. Circuit wires attached to the traveler screws run between the two switches, and hot wires attached to the common screws bring current from the power source and carry it to the light fixture. Requires two-wire and three-wire cables.

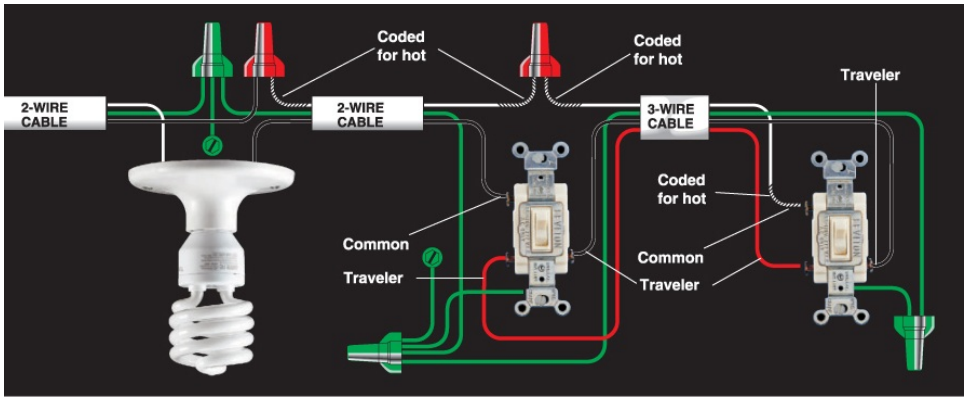




19. THREE-WAY SWITCHES & LIGHT FIXTURE (FIXTURE AT START OF CABLE RUN)

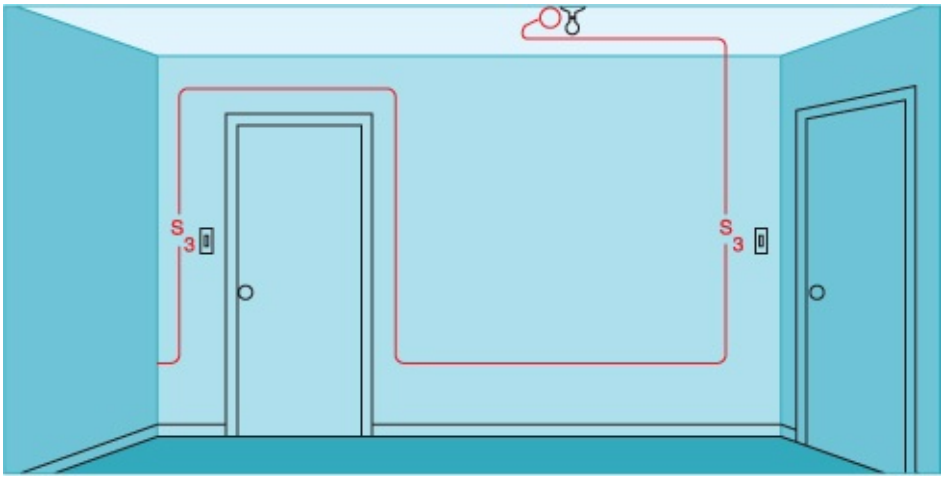
Use this layout variation of circuit map 19 where it is more convenient to locate the fixture ahead of the three-way switches in the cable run. Requires two-wire and three-wire cables.

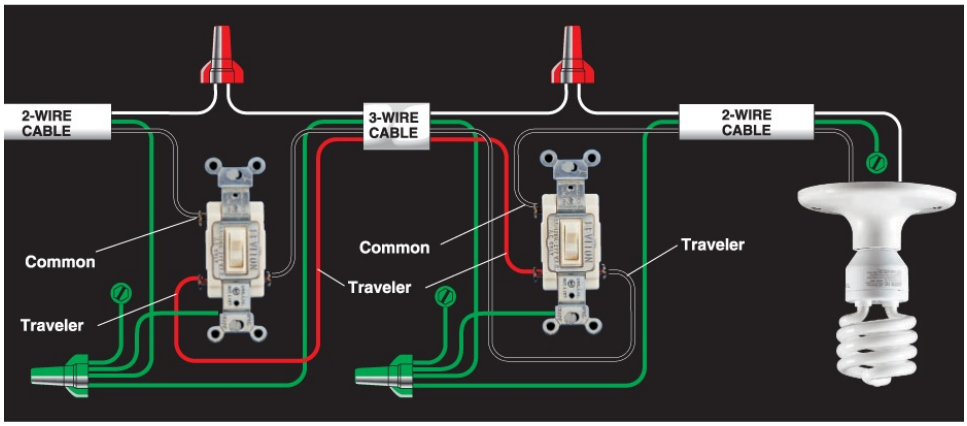




20. THREE-WAY SWITCHES & LIGHT FIXTURE (FIXTURE AT END OF CABLE RUN)

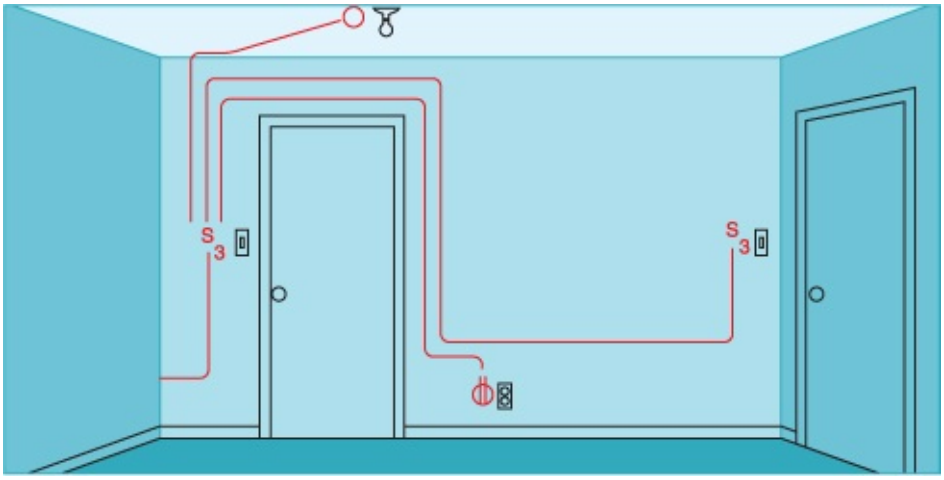
This variation of the three-way switch layout (circuit map 20) is used where it is more practical to locate the fixture at the end of the cable run. Requires two-wire and three-wire cables.

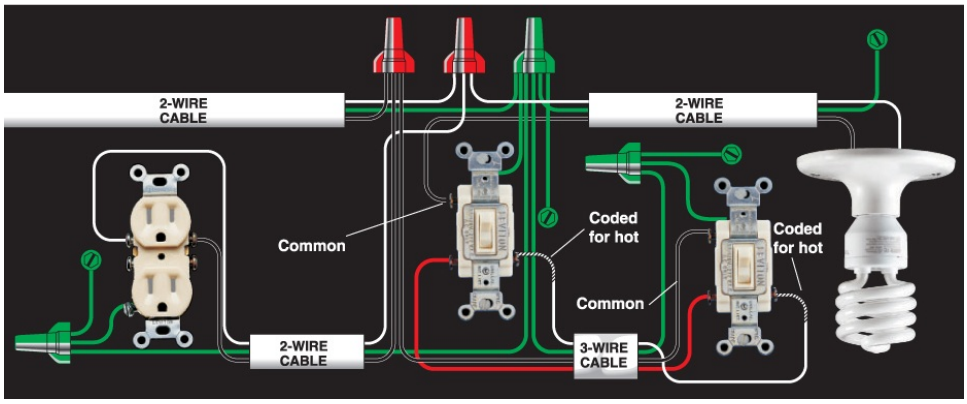




21. THREE-WAY SWITCHES & LIGHT FIXTURE WITH DUPLEX RECEPTACLE

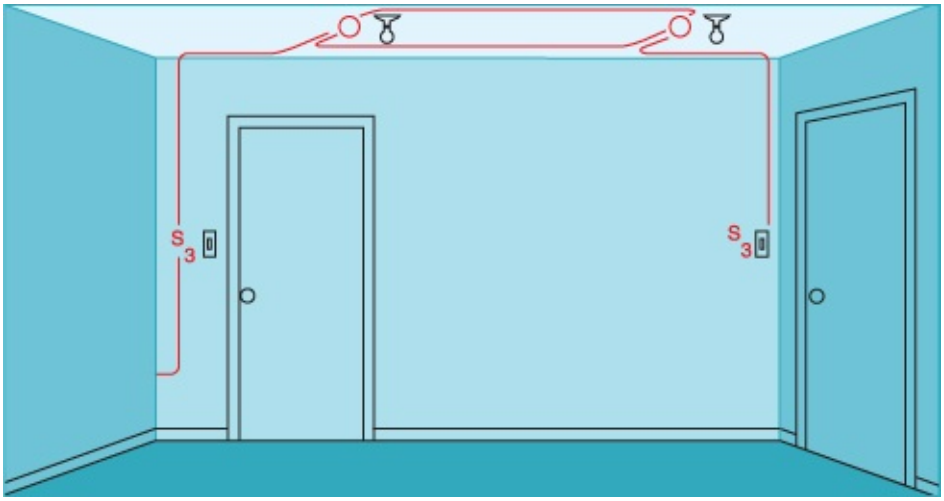
Use this layout to add a receptacle to a three-way switch configuration (circuit map 21). Requires two-wire and three-wire cables.

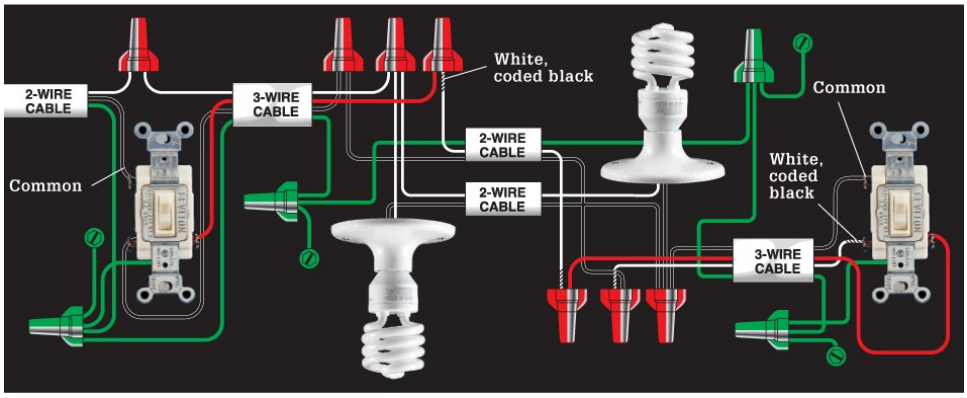




22. THREE-WAY SWITCHES & MULTIPLE LIGHT FIXTURES (FIXTURES BETWEEN SWITCHES)

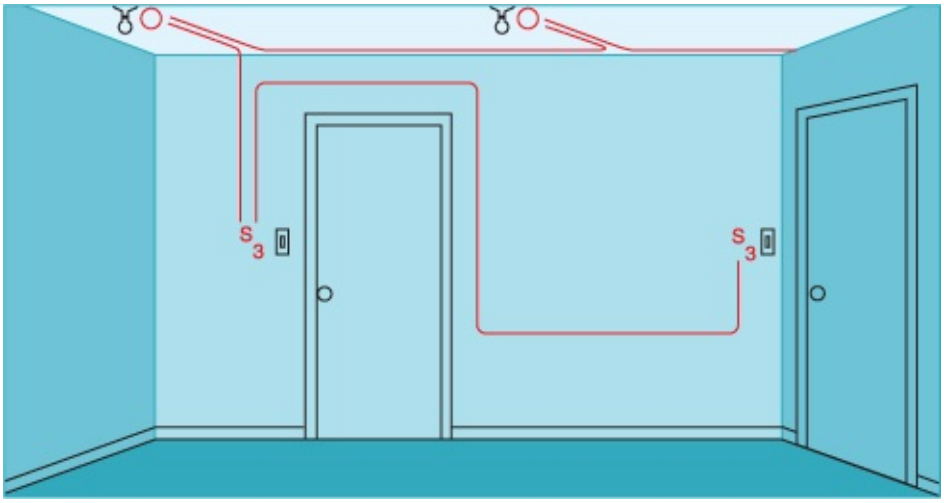
This is a variation of circuit map 20. Use it to place multiple light fixtures between two three-way switches where power comes in at one of the switches. Requires two-and three-wire cable.

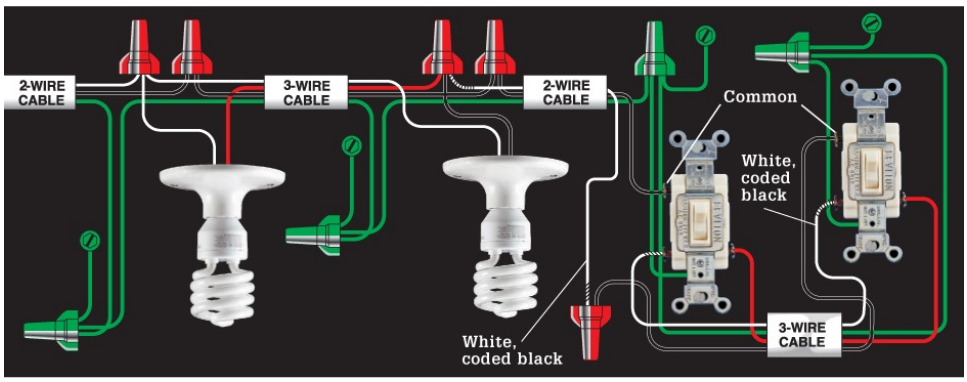




23. THREE-WAY SWITCHES & MULTIPLE LIGHT FIXTURES (FIXTURES AT BEGINNING OF RUN)

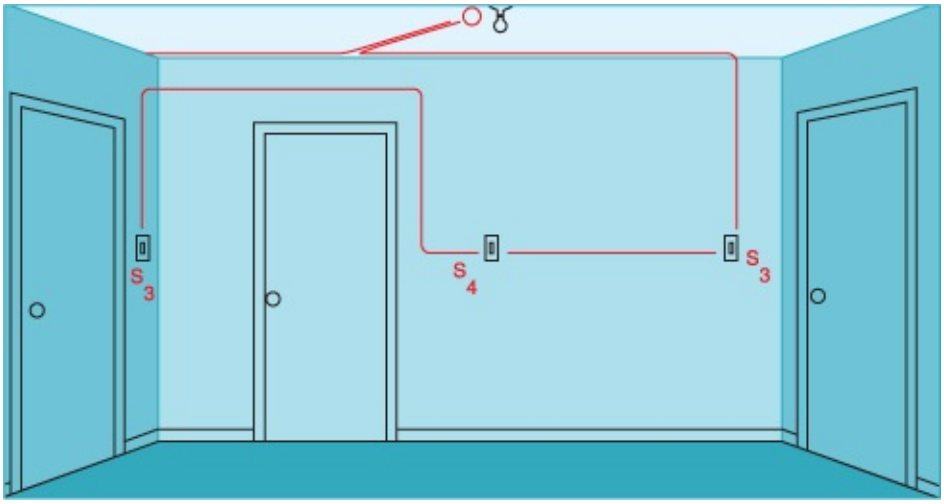
This is a variation of circuit map 21. Use it to place multiple light fixtures at the beginning of a run controlled by two three-way switches. Power comes in at the first fixture. Requires two-and three-wire cable.

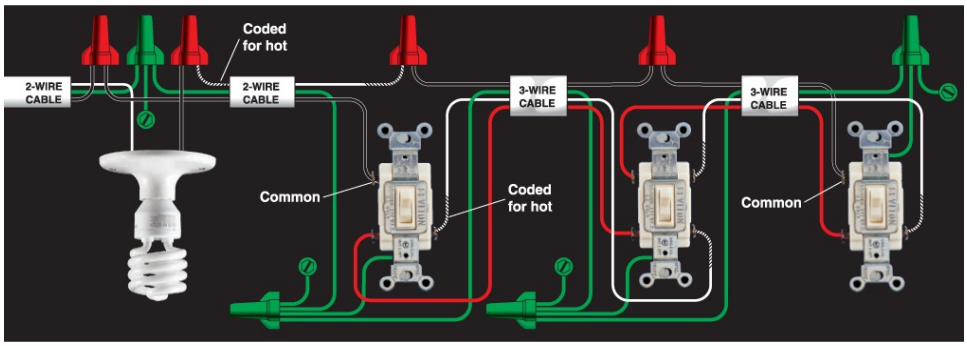




24. FOUR-WAY SWITCH & LIGHT FIXTURE (FIXTURE AT START OF CABLE RUN)

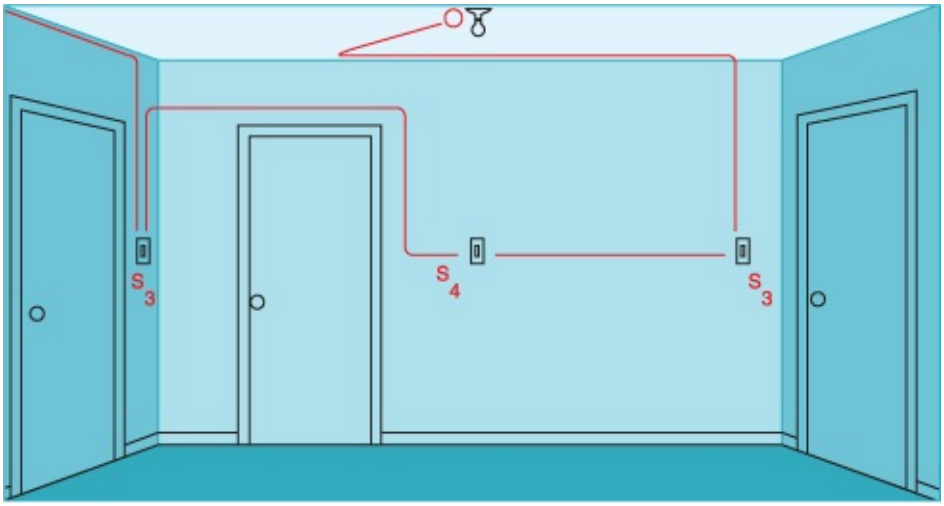
This layout lets you control a light fixture from three locations. The end switches are three-way and the middle is four-way. A pair of three-wire cables enter the box of the four-way switch. The white and red wires from one cable attach to the top pair of screw terminals (line 1) and the white and red wires from the other cable attaches to the bottom screw terminals (line 2). Requires two three-way switches and one four-way switch and two-wire and three-wire cables.

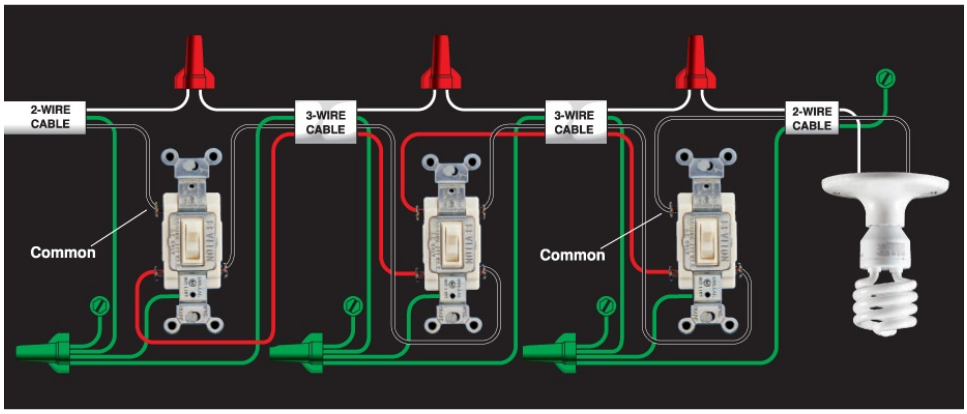




25. FOUR-WAY SWITCH & LIGHT FIXTURE (FIXTURE AT END OF CABLE RUN)

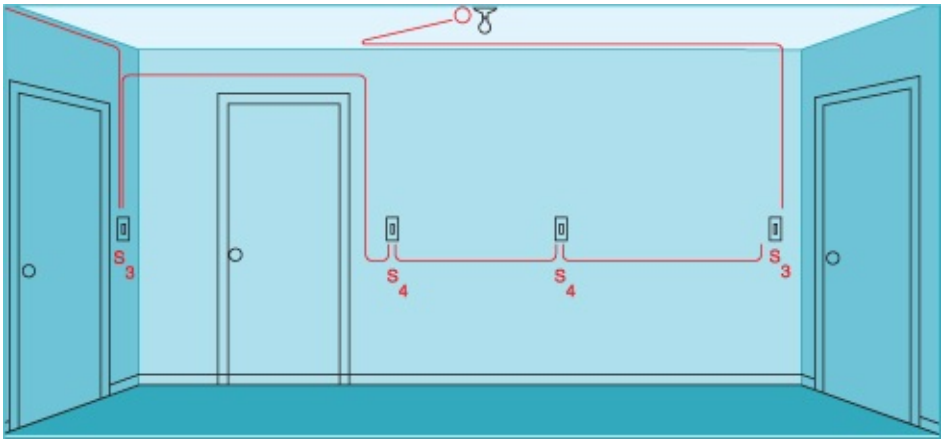
Use this layout variation of circuit map 26 where it is more practical to locate the fixture at the end of the cable run. Requires two three-way switches and one four-way switch and two-wire and three-wire cables.

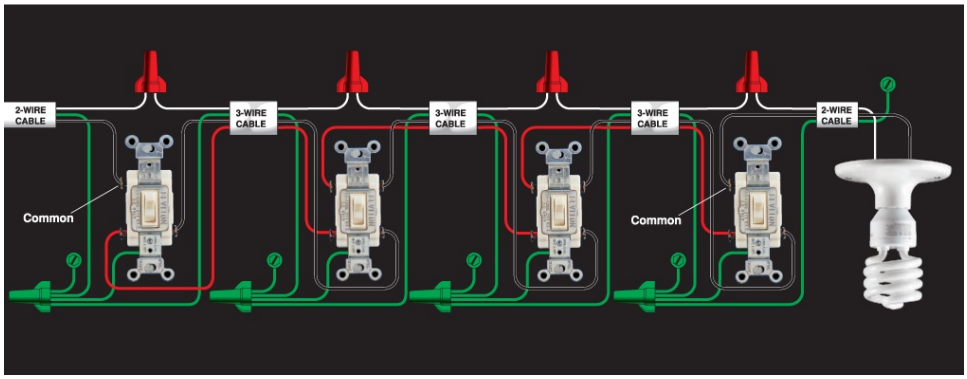




26. MULTIPLE FOUR-WAY SWITCHES CONTROLLING A LIGHT FIXTURE

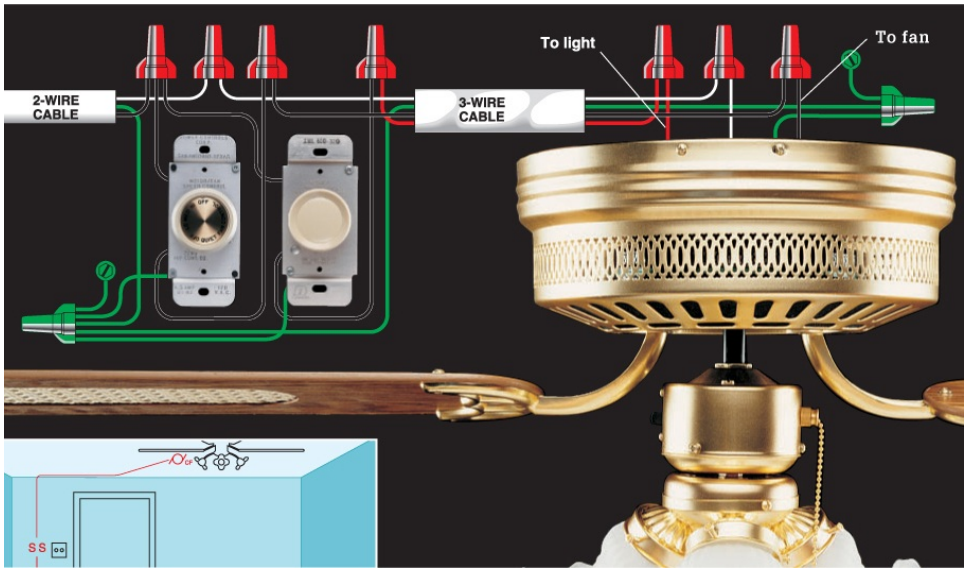
This alternate variation of the four-way switch layout (circuit map 27) is used where three or more switches will control a single fixture. The outer switches are three-way and the middle are four-way. Requires two three-way switches and two four-way switches and two-wire and three-wire cables.





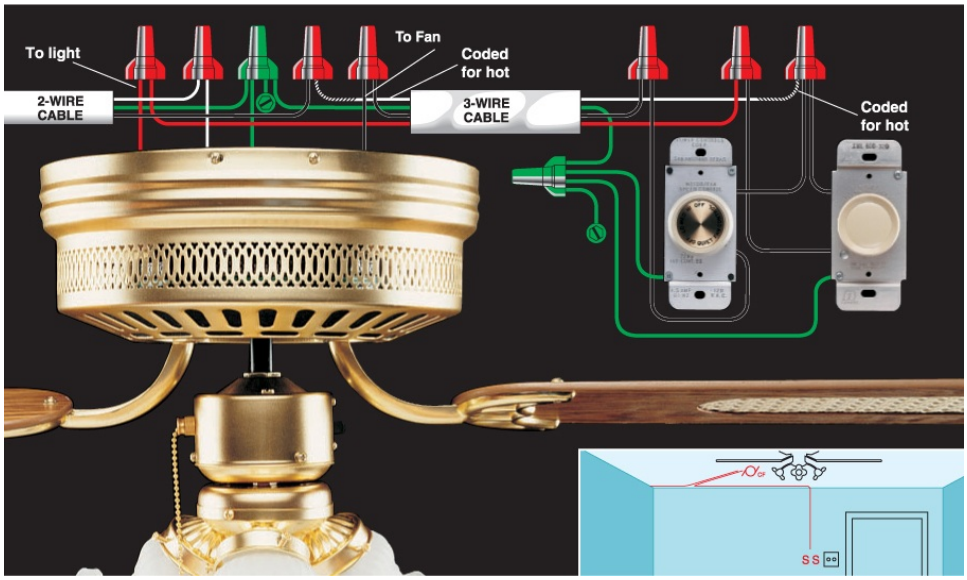
27. CEILING FAN/LIGHT FIXTURE CONTROLLED BY GANGED SWITCHES (FAN AT END OF CABLE RUN)

This layout is for a combination ceiling fan/light fixture controlled by a speed-control switch and dimmer in a double-gang switch box. Requires two-wire and three-wire cables.



28. CEILING FAN/LIGHT FIXTURE CONTROLLED BY GANGED SWITCHES (SWITCHES AT END OF CABLE RUN)

Use this switch loop layout variation when it is more practical to install the ganged speed control and dimmer switches for the ceiling fan at the end of the cable run. Requires two-wire and three-wire cables.



Advanced Wiring Projects

The following pages contain step-by-step information and photos that reveal exactly how to accomplish several of the most common advanced home wiring projects. Most of these projects fall into three basic categories: panel projects that are accomplished in the main service panel or an electrical subpanel; adding new electrical circuits; and troubleshooting. To allow ample space for demonstrating the specific techniques and strategies that are necessary for these projects, we have not gone into great detail for some of the more basic planning and materials-handling steps that every project should include—no matter how advanced it may be. Basic mapping of your system and circuitry, estimating materials, applying for permits and arranging for inspections are all important to the safe conduct of any electrical project. If you are unfamiliar with the requirements for any of these steps, consult your local electrical inspector for advice. Drawing an accurate circuit map may not be glamorous or “advanced” in some definitions, but it is critically important.

In this chapter:

- Electrical Panels
- Installing Circuit Breakers
- Installing a Subpanel
- Upgrading Service Panels
- Grounding & Bonding an Upgraded System
- Adding Circuits
- Wiring a Room Addition
- Wiring a Kitchen
- Installing a Solar Light Circuit
- Backup Power Supply
- Installing a Transfer Switch
- Common Residential Wiring Codes
- Electrical Receptacle Installation
- Ground-fault (GFCI) & Arc-fault (AFCI) Protection
- Junction Boxes, Device Boxes & Enclosures

Electrical Panels

Every home has a main service panel that distributes electrical current to the individual circuits. The main service panel usually is found in the basement, garage, or utility area, and can be identified by its metal casing. Before making any repair to your electrical system, you must shut off power to the correct circuit at the main service panel. The service panel should be indexed so circuits can be identified easily.

Service panels vary in appearance, depending on the age of the system. Very old wiring may operate on 30-amp service that has only two circuits. New homes can have 200-amp service with 30 or more circuits. Find the size of the service by reading the amperage rating printed on the main fuse block or main circuit breaker.

Regardless of age, all service panels have fuses or circuit breakers that control each circuit and protect them from overloads. In general, older service panels use fuses, while newer service panels use circuit breakers.

In addition to the main service panel, your electrical system may have a subpanel that controls some of the circuits in the home. A subpanel has its own circuit breakers or fuses and is installed to control circuits that have been added to an existing wiring system.

The subpanel resembles the main service panel but is usually smaller. It may be located near the main panel, or it may be found near the areas served by the new circuits. Garages and basements that have been updated often have their own subpanels. If your home has a subpanel, make sure that its circuits are indexed correctly.

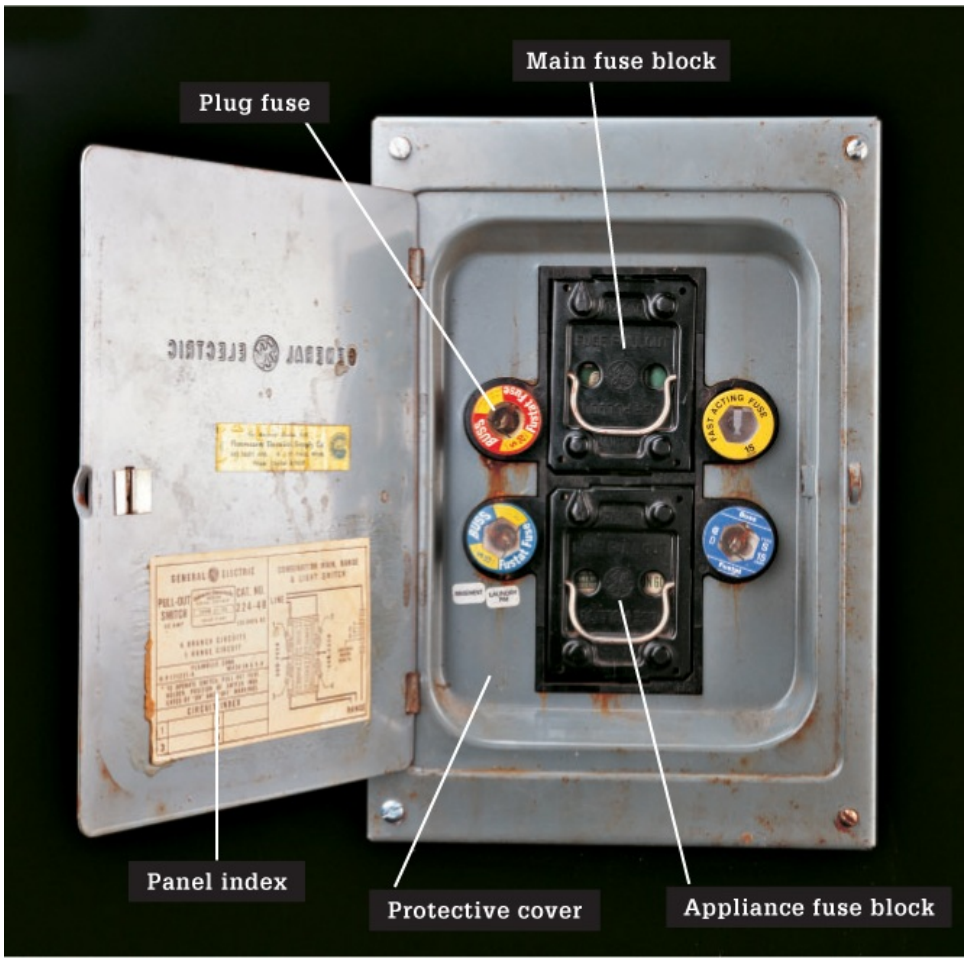
When handling fuses or circuit breakers, make sure the area around the service panel is dry. Never remove the protective cover on the service panel. After turning off a circuit to make electrical repairs, remember to always test the circuit for power before touching any wires.

The main service panel is the heart of your wiring system. As our demand for household energy has increased, the panels have also grown in capacity. Today, a 200-amp panel is considered the minimum for new construction.

A circuit breaker panel providing 100 amps or more of power is common in wiring systems installed during the 1960s and later. A circuit breaker panel is housed in a gray metal cabinet that contains two rows of individual circuit breakers. The size of the service can be identified by reading the amperage rating of the main circuit breaker, which is located at the top or bottom of the main service panel.

A 100-amp service panel is now the minimum standard for all new housing. It is considered adequate for a medium-sized house with no more than three major electric appliances. However, most newer houses have a 200-amp or larger panel.

To shut off power to individual circuits in a circuit breaker panel, flip the lever on the appropriate circuit breaker to the OFF position. To shut off the power to the entire house, turn the main circuit breaker or breakers to the OFF position.



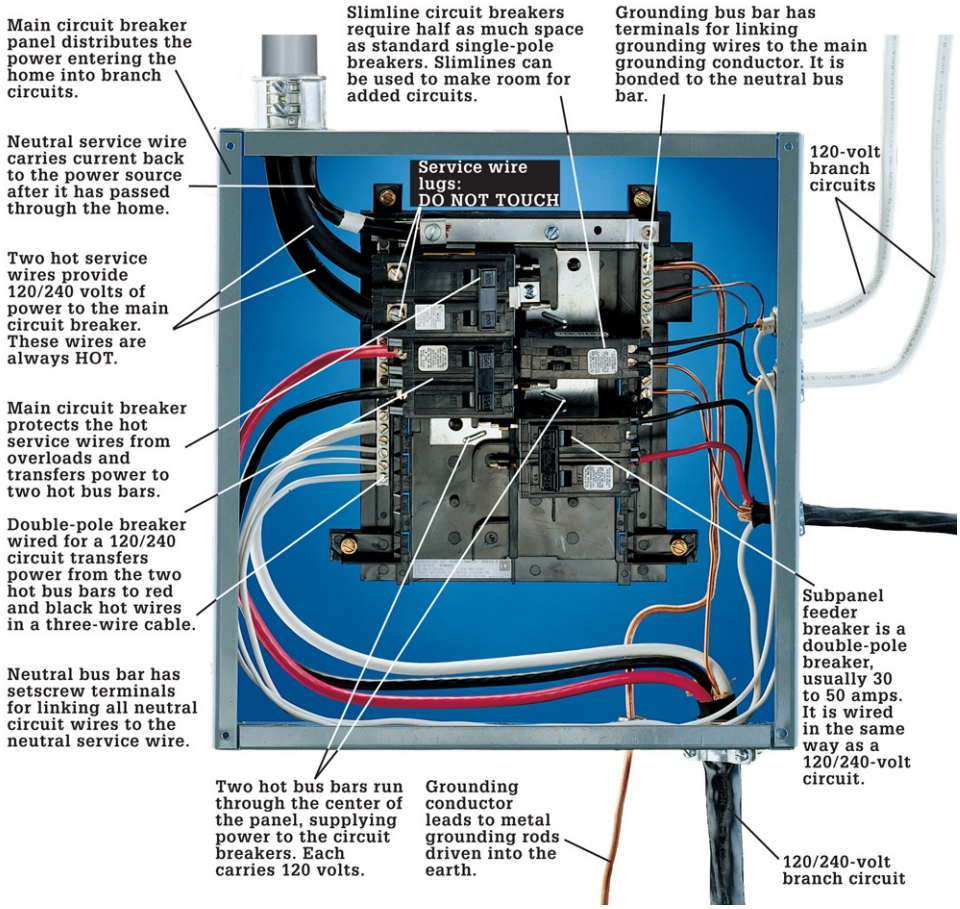
A 60-amp fuse panel often is found in wiring systems installed between 1950 and 1965. It usually is housed in a gray metal cabinet that contains four individual plug fuses, plus one or two pull-out fuse blocks that hold cartridge fuses. This type of panel is regarded as adequate for a small, 1,100-square-foot house that has no more than one 240-volt appliance. Many homeowners update 60-amp service to 100 amps or more so that additional lighting and appliance circuits can be added to the system. Home loan programs also may require that 60-amp service be updated before a home can qualify for financing.

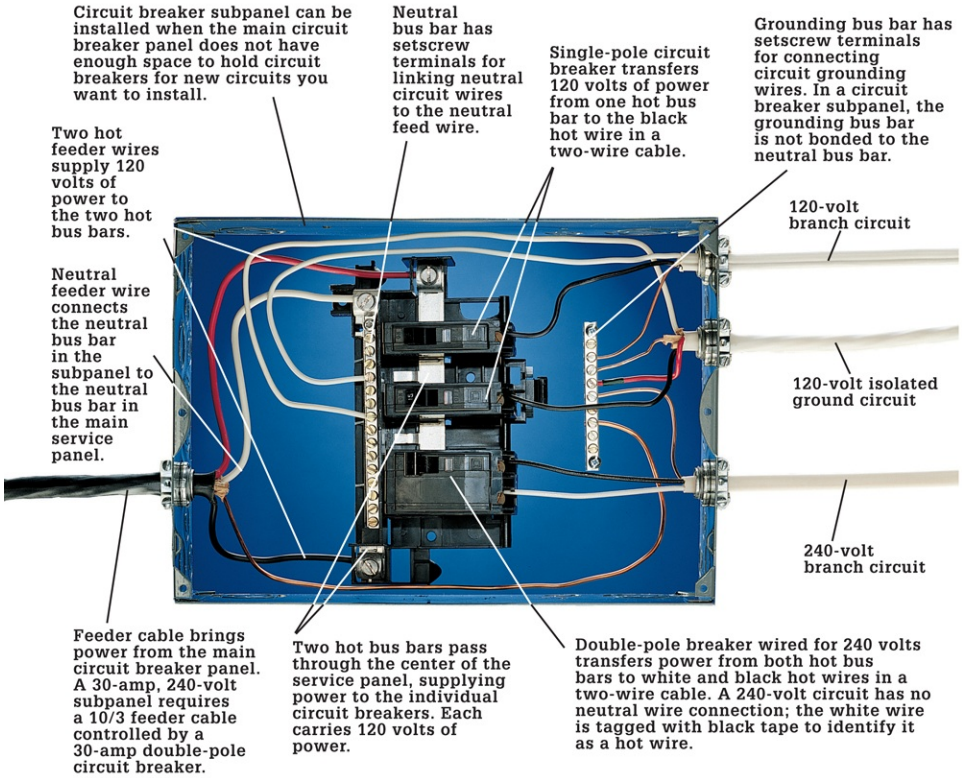
To shut off power to a circuit, carefully unscrew the plug fuse, touching only its insulated rim. To shut off power to the entire house, hold the handle of the main fuse block and pull sharply to remove it. Major appliance circuits are controlled with another cartridge fuse block. Shut off the appliance circuit by pulling out this fuse block.

Circuit Breaker Panels

The circuit breaker panel is the electrical distribution center for your home. It divides the current into branch circuits that are carried throughout the house. Each branch circuit is controlled by a circuit breaker that protects the wires from dangerous current overloads. When installing new circuits, the last step is to connect the wires to new circuit breakers at the panel. Working inside a circuit breaker panel is not dangerous if you follow basic safety procedures. Always shut off the main circuit breaker and test for power before touching any parts inside the panel, and never touch the service wire lugs. If unsure of your own skills, hire an electrician to make the final circuit connections. (If you have an older electrical service with fuses instead of circuit breakers, always have an electrician make these final hookups.)

If the main circuit breaker panel does not have enough open slots to hold new circuit breakers, install a subpanel (page 34). This job is well within the skill level of an experienced do-it-yourselfer, although you can also hire an electrician to install the subpanel.


Main circuit breaker panel distributes the power entering the home into branch circuits.
Slimline circuit breakers require half as much space as standard single-pole breakers. Slimlines can be used to make room for added circuits.
Grounding bus bar has terminals for linking grounding wires to the main grounding conductor. It is bonded to the neutral bus bar.
Neutral service wire carries current back to the power source after it has passed through the home.
Service wire lugs: DO NOT TOUCH
120-volt branch circuits
Two hot service wires provide 120/240 volts of power to the main circuit breaker. These wires are always HOT.
Main circuit breaker protects the hot service wires from overloads and transfers power to two hot bus bars.
Double-pole breaker wired for a 120/240 circuit transfers power from the two hot bus bars to red and black hot wires in a three-wire cable.
Subpanel feeder breaker is a double-pole breaker, usually 30 to 50 amps. It is wired in the same way as a 120/240-volt circuit.
Neutral bus bar has setscrew terminals for linking all neutral circuit wires to the neutral service wire.
Two hot bus bars run through the center of the panel, supplying power to the circuit breakers. Each carries 120 volts.
Grounding conductor leads to metal grounding rods driven into the earth.
120/240-volt branch circuit



Before installing any new wiring, evaluate your electrical service to make sure it provides enough current to support both the existing wiring and any new circuits. If your service does not provide enough power, have an electrician upgrade it to a higher amp rating. During the upgrade, the electrician will install a new circuit breaker panel with enough extra breaker slots for the new circuits you want to install.

Safety Warning

Never touch any parts inside a circuit breaker panel until you have checked for power (page 29). Circuit breaker panels differ in appearance, depending on the manufacturer. Never begin work in a circuit breaker panel until you understand its layout and can identify the parts.

Installing Circuit Breakers

The last step in a wiring project is connecting circuits at the breaker panel. After this is done, the work is ready for the final inspection.

Circuits are connected at the main breaker panel, if it has enough open slots, or at a circuit breaker subpanel (page 34). When working at a subpanel, make sure the feeder breaker at the main panel has been turned off, and test for power (photo, right) before touching any parts in the subpanel.

Make sure the circuit breaker amperage does not exceed the ampacity of the circuit wires you are connecting to it. Also be aware that circuit breaker styles and installation techniques vary according to manufacturer. Use breakers designed for your type of panel. For most rooms in a home, in addition to the kitchen, basement, and bathroom, an AFCI breaker needs to be installed.

Tools & Materials

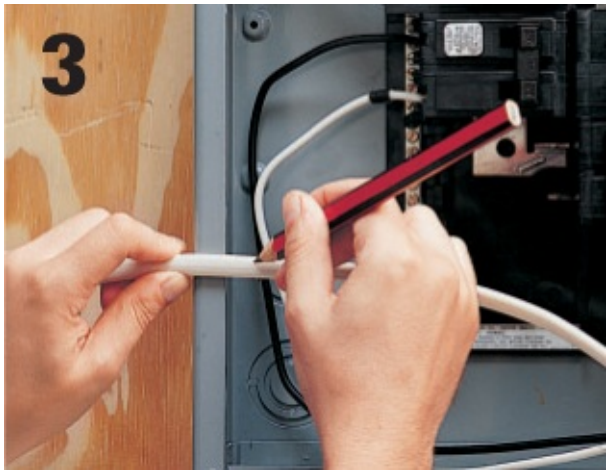
Screwdriver
Hammer
Pencil
Combination tool
Cable ripper
Circuit tester
Pliers
Cable clamps
Single-and double-pole circuit breakers

Test for current before touching any parts inside a circuit breaker panel. With main breaker turned off but all other breakers turned on, touch one probe of a neon tester to the neutral bus bar, and touch the other probe to each setscrew on one of the double-pole breakers (not the main breaker). If tester does not light for either setscrew, it is safe to work in the panel. *Note: Touchless circuit testers are preferred in most situations where you are testing for current because they're safer. But in some instances you'll need a tester with individual probes to properly check for current.*

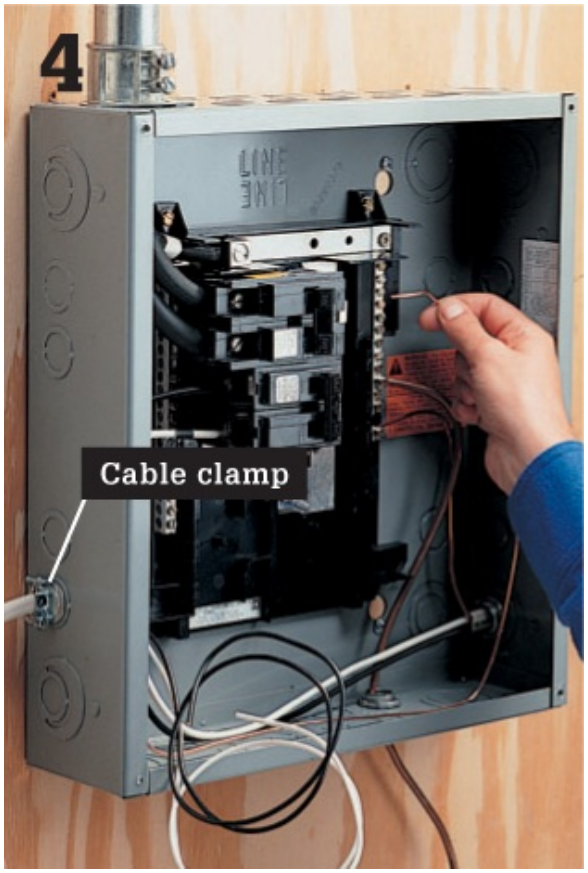
How to Connect Circuit Breakers

Shut off the main circuit breaker in the main circuit breaker panel (if you are working in a subpanel, shut off the feeder breaker in the main panel). Remove the panel cover plate, taking care not to touch the parts inside the panel. Test for power (photo, top).

Open a knockout in the side of the circuit breaker panel using a screwdriver and hammer. Attach a cable clamp to the knockout.

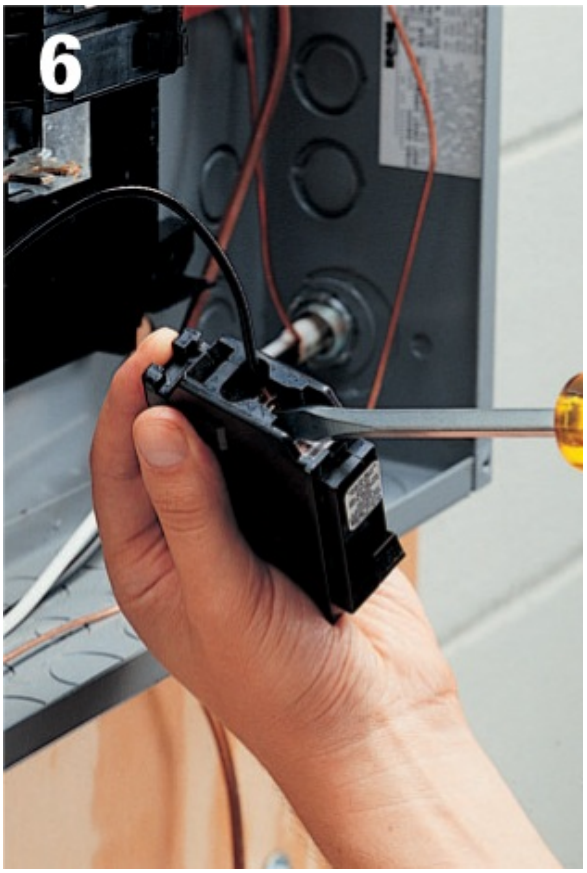


Hold cable across the front of the panel near the knockout, and mark sheathing about 1/2" inside the edge of the panel. Strip the cable from the marked line to the end using a cable ripper. (There should be 18" to 24" of excess cable.) Insert the cable through the clamp and into the service panel, then tighten the clamp.

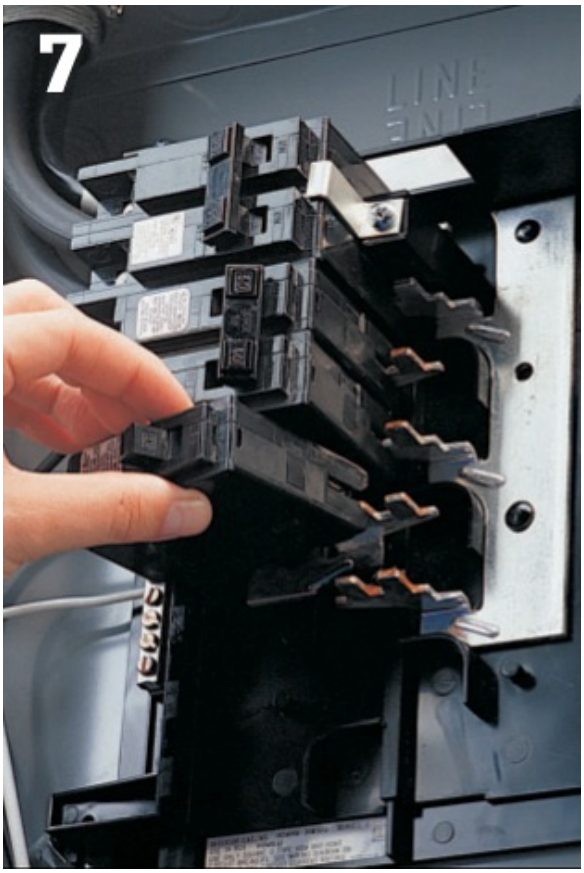


Bend the bare copper grounding wire around the inside edge of the panel to an open setscrew terminal on the grounding bus bar. Insert the wire into the opening on the bus bar, and tighten the setscrew. Fold excess wire around the inside edge of the panel.

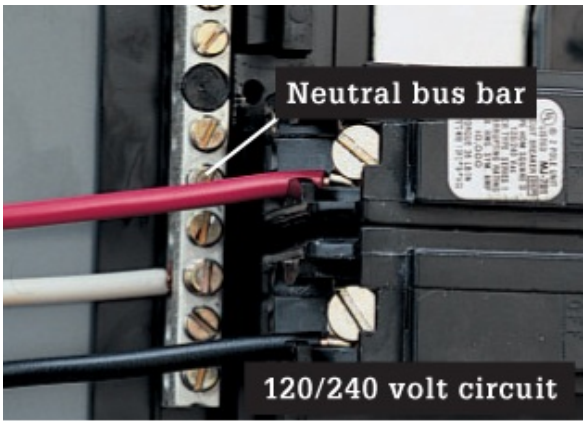
For 120-volt circuits, bend the white circuit wire around the outside of the panel to an open setscrew terminal on the neutral bus bar. Clip away excess wire, then strip 1/2" of insulation from the wire using a combination tool. Insert the wire into the terminal opening, and tighten the setscrew.

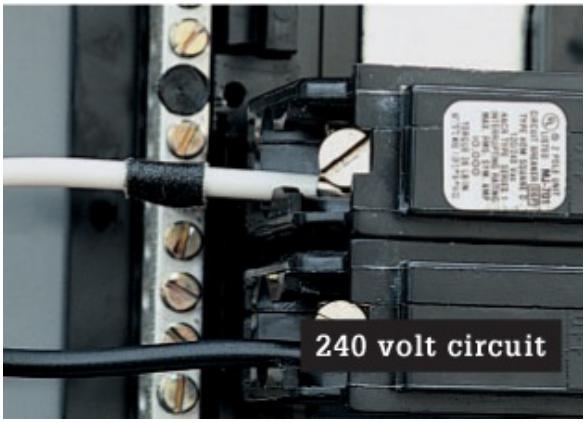


Strip 1/2" of insulation from the end of the black circuit wire. Insert the wire into the setscrew terminal on a new single-pole circuit breaker, and tighten the setscrew.



Slide one end of the circuit breaker onto the guide hook, then press it firmly against the bus bar until it snaps into place. (Breaker installation may vary, depending on the manufacturer.) Fold excess black wire around the inside edge of the panel.





Variations: 120/240-volt circuits (top): Connect red and black wires to double-pole breaker. Connect white wire to neutral bus bar, and grounding wire to grounding bus bar. For 240-volt circuits (bottom), attach white and black wires to double-pole breaker, tagging white wire with black tape. There is no neutral bus bar connection on this circuit.

Tip: Remove the appropriate breaker knockout on the panel cover plate to make room for the new circuit breaker. A single-pole breaker requires one knockout, while a double-pole breaker requires two knockouts. Reattach the cover plate, and label the new circuit on the panel index.

Installing a Subpanel

Install a circuit breaker subpanel if the main circuit breaker panel does not have enough open breaker slots for the new circuits you are planning. Called non-service rated panels in most code books, the subpanel serves as a second distribution center for connecting circuits. It receives power from a double-pole feeder circuit breaker you install in the main circuit breaker panel.

If the main service panel is so full that there is no room for the double-pole subpanel feeder breaker, you can reconnect some of the existing 120-volt circuits to special slimline breakers (photos below). *Note: There are limits to how many slimline breakers you may use in a single panel.*

Plan your subpanel installation carefully, making sure your electrical service supplies enough power to support the extra load of the new subpanel circuits. Assuming your main service is adequate, consider installing an oversized subpanel feeder breaker in the main panel to provide enough extra amps to meet the needs of future wiring projects.

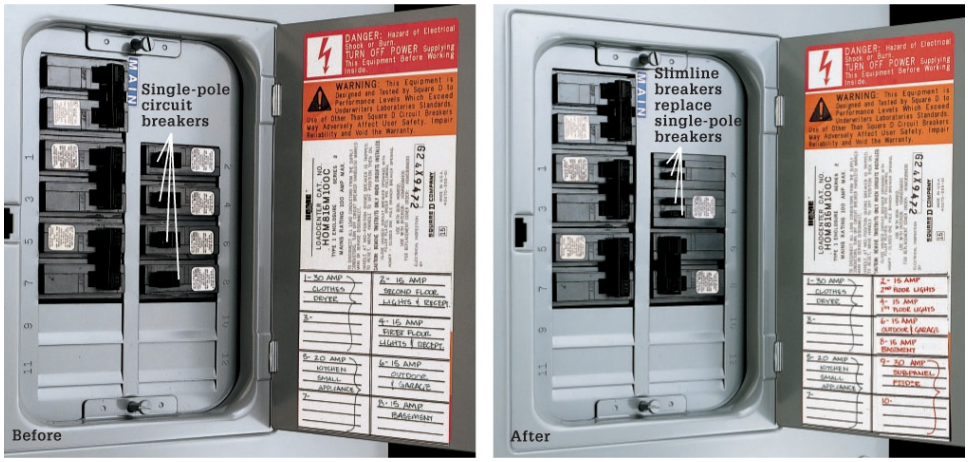
Also consider the physical size of the subpanel, and choose one that has enough extra slots to hold circuits you may want to install later. The smallest panels have room for up to six single-pole breakers (or three double-pole breakers), while the largest models can hold up to 20 single-pole breakers.

Subpanels often are mounted near the main circuit breaker panel. Or, for convenience, they can be installed close to the areas they serve, such as in a new room addition or a garage. In a finished room, a subpanel can be painted or housed in a decorative cabinet so it is less of a visual distraction. If it is covered, make sure the subpanel is easily accessible and clearly identified.

Tools & Materials

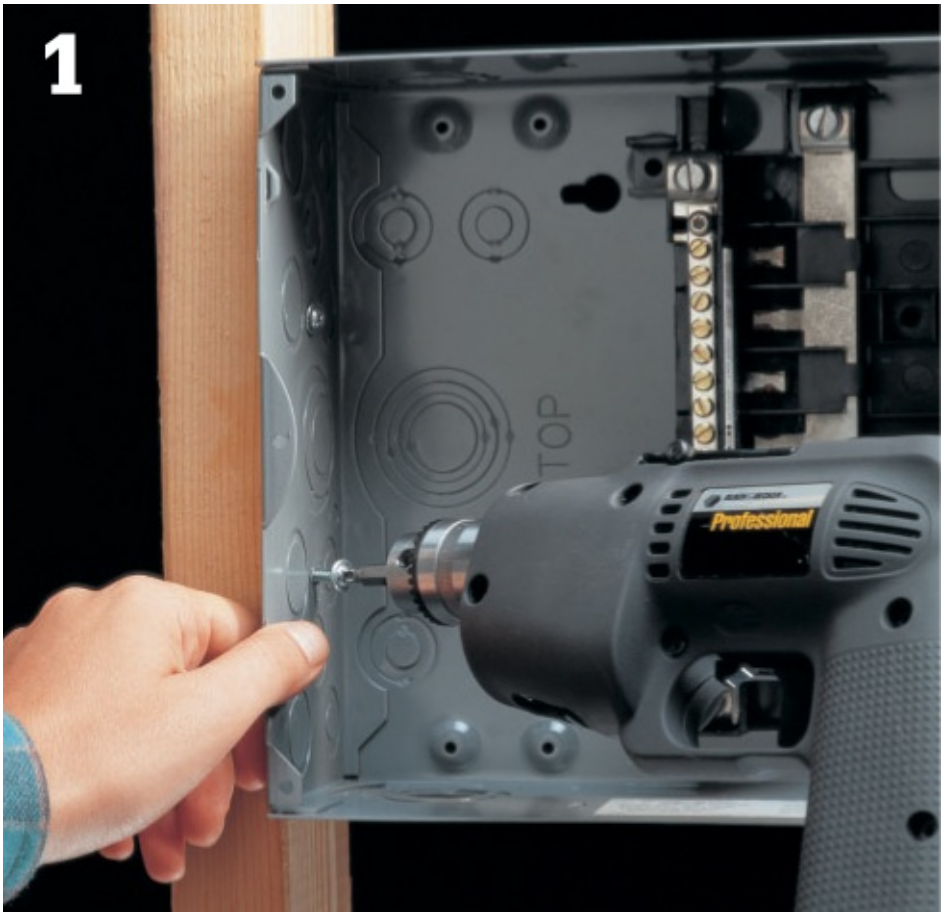
Hammer
Screwdriver
Circuit tester
Cable ripper
Combination tool
Screws
Cable clamps
Three-wire NM cable

Cable staples
Double-pole circuit breaker
Circuit breaker subpanel
Slimline circuit breakers



To conserve space in a service panel, you can replace single-pole breakers with slimline breakers. Slimline breakers take up half the space of standard breakers, allowing you to fit two circuits into one single slot on the service panel. In the service panel shown above, four single-pole 120-volt breakers were replaced with slimline breakers to provide the double opening needed for a 30-amp, 240-volt subpanel feeder breaker. Use slimline breakers (if your municipality allows them) with the same amp rating as the standard single-pole breakers you are removing, and make sure they are approved for use in your panel.

How to Install a Subpanel



Mount the subpanel at shoulder height following manufacturer's recommendations. The subpanel can be mounted to the sides of studs or to plywood attached between two studs. Panel shown here extends 1/2" past the face of studs so it will be flush with the finished wall surface.

Open a knockout in the subpanel using a screwdriver and hammer. Run the feeder cable from the main circuit breaker panel to the subpanel, leaving about 2 ft. of excess cable at each end.

Attach a cable clamp to the knockout in the subpanel. Insert the cable into the subpanel, then anchor it to framing members within 8" of each panel, and every 4 ft. thereafter.

Tips for a Subpanel Installation

1 Calculate your maximum feeder load (consult your local electrical inspector) and multiply by 1.25. This safety adjustment is required by the National Electrical Code. Convert the load into amps by dividing by 230. This gives the required amperage needed to power the subpanel.

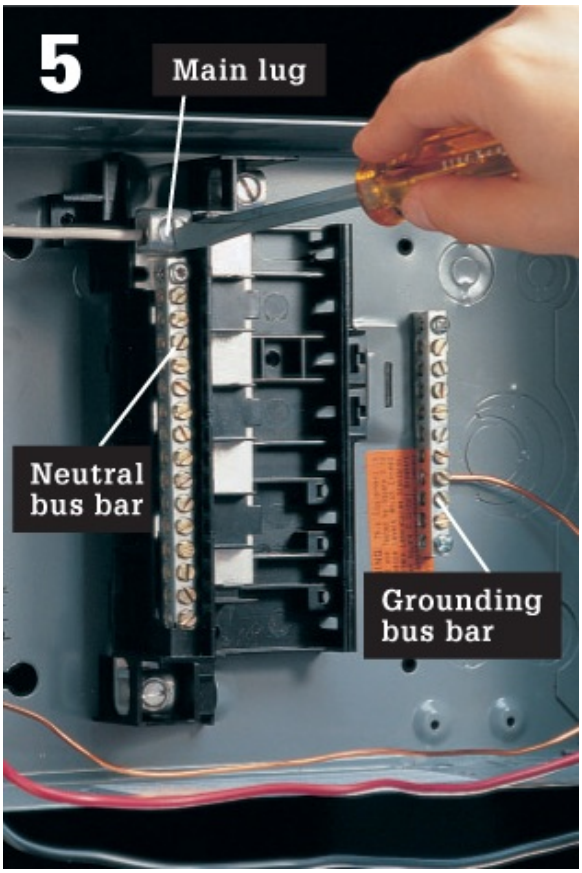
2 For the subpanel feeder breaker, choose a double-pole circuit breaker with an amp rating equal to or greater than the required subpanel amperage. Example: In a room addition that requires 27 amps, choose a 30-amp double-pole feeder breaker.

3 For the feeder cable bringing power from the main circuit breaker panel to the subpanel, choose three-wire NM copper cable with an ampacity equal to the rating of the subpanel feeder breaker. Example: For a 40-amp subpanel feeder breaker, choose 8/3 cable for the feeder.

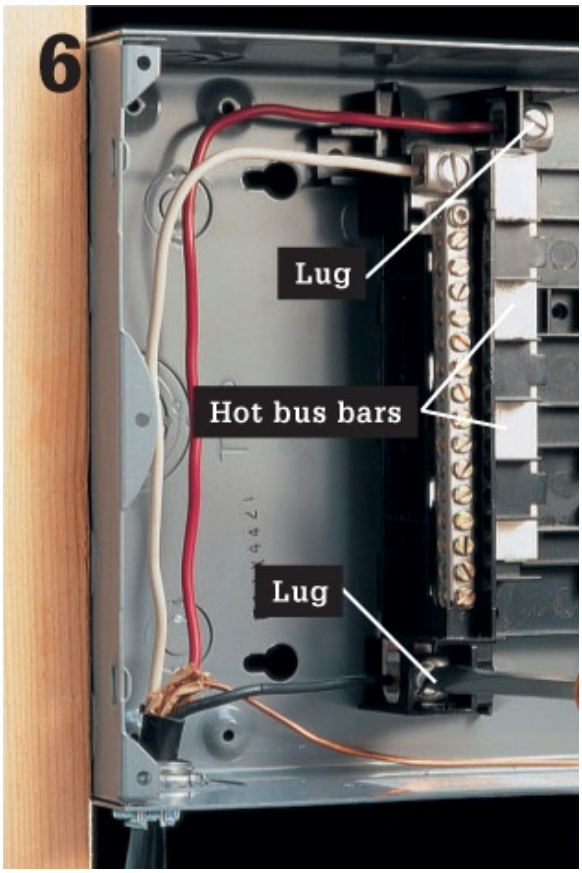
4 If the subpanel is installed in a separate building from the primary dwelling,

such as a garage, the subpanel must be grounded to earth with its own ground rod.

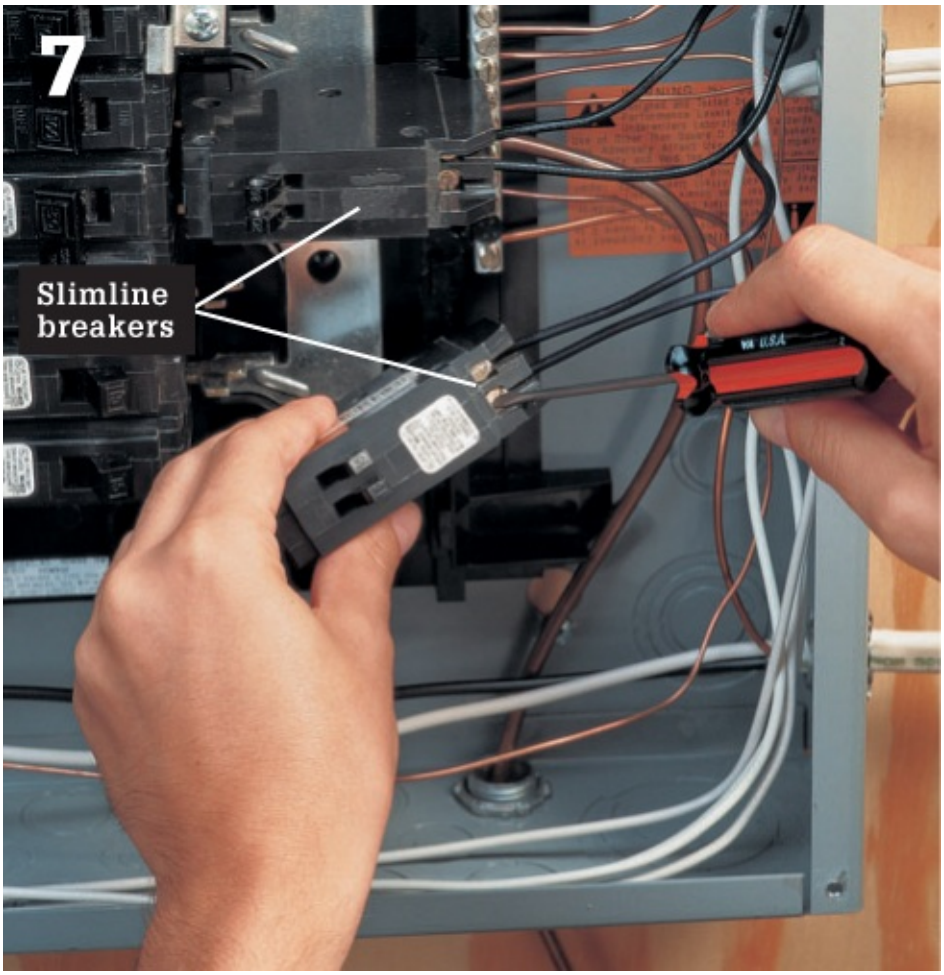
Strip away outer sheathing from the feeder cable using a cable ripper. Leave at least 1/4" of sheathing extending into the subpanel. Tighten the cable clamp screws so cable is held securely but not so tightly that the wire sheathing is crushed.



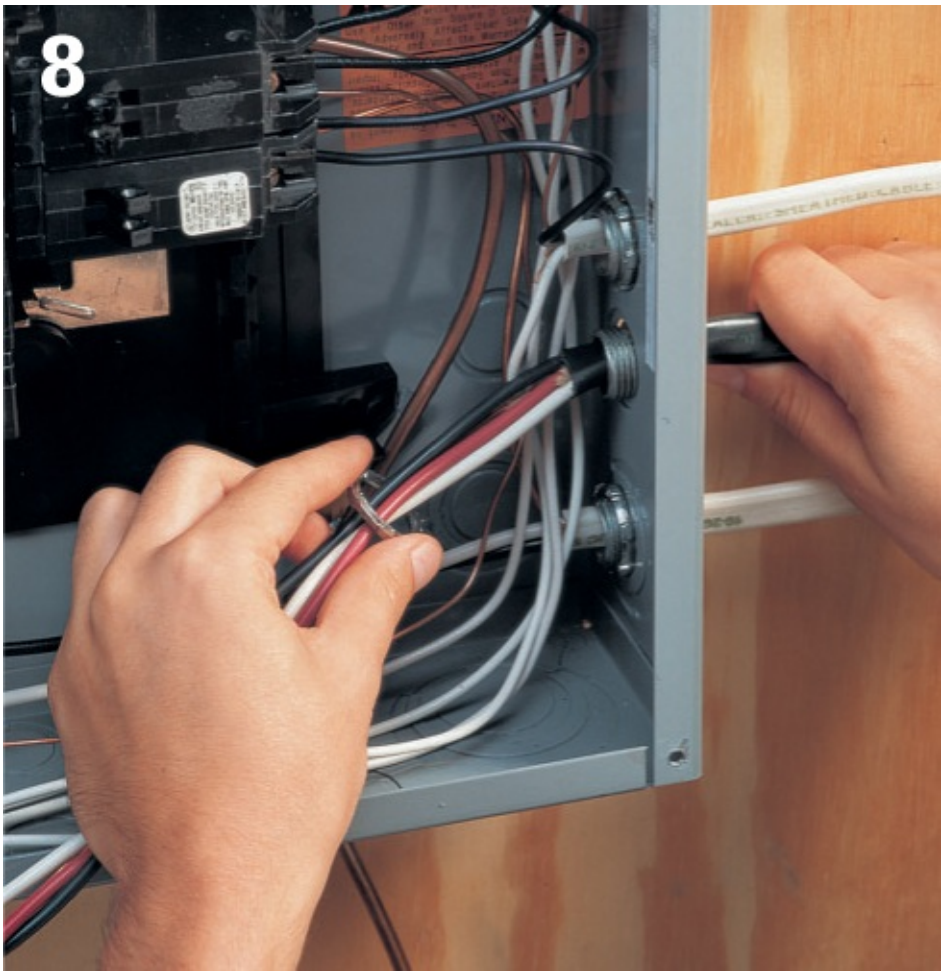
Strip 1/2" of insulation from the white neutral feeder wire, and attach it to the main lug on the subpanel neutral bus bar. Connect the grounding wire to a setscrew terminal on the grounding bus bar. Fold excess wire around the inside edge of the subpanel.



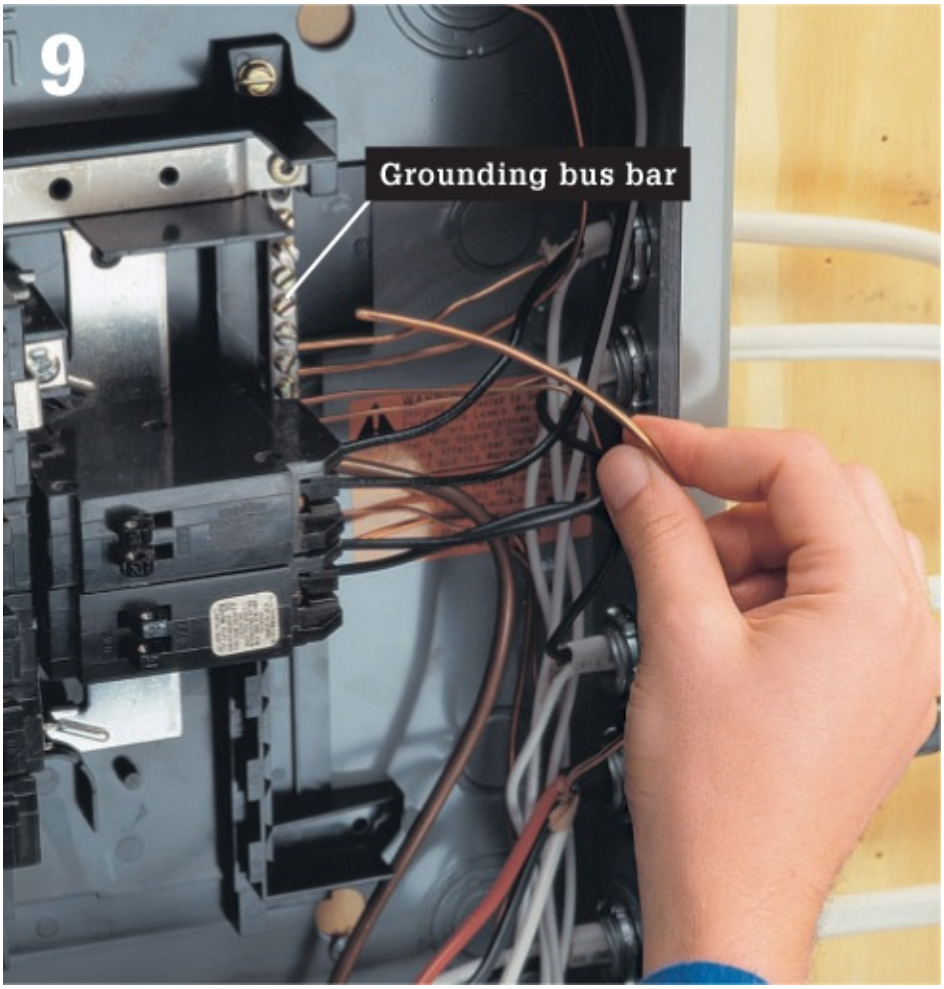
Strip away 1/2" of insulation from the red and the black feeder wires. Attach one wire to the main lug on each of the hot bus bars. Fold excess wire around the inside edge of the subpanel.



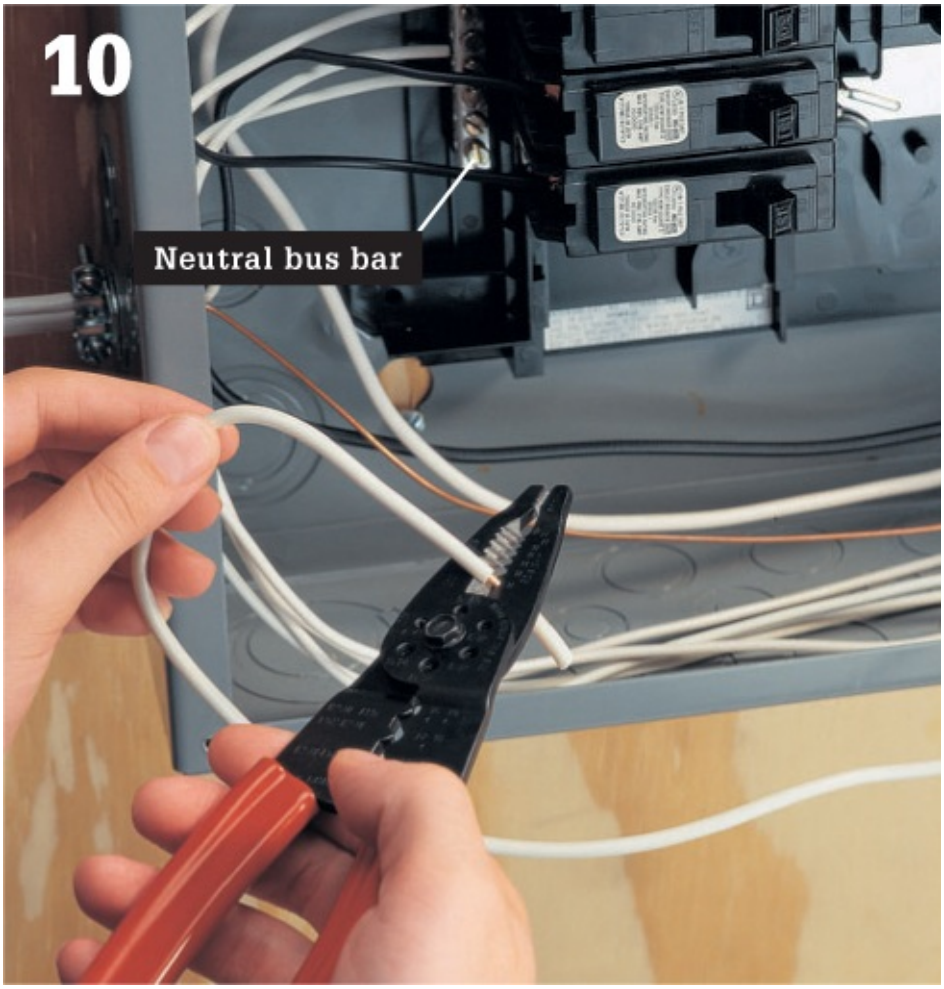
At the main circuit breaker panel, shut off the main circuit breaker, then remove the coverplate and test for power (page 32). If necessary, make room for the double-pole feeder breaker by removing single-pole breakers and reconnecting the wires to slimline circuit breakers. Open a knockout for the feeder cable using a hammer and screwdriver.



Strip away the outer sheathing from the feeder cable so that at least 1/4" of sheathing will reach into the main service panel. Attach a cable clamp to the cable, then insert the cable into the knockout, and anchor it by threading a locknut onto the clamp. Tighten the locknut by driving a screwdriver against the lugs. Tighten the clamp screws so the cable is held securely, but not so tightly that the cable sheathing is crushed.



Bend the bare copper wire from the feeder cable around the inside edge of the main circuit breaker panel, and connect it to one of the setscrew terminals on the grounding bus bar.



Strip away 1/2" of insulation from the white feeder wire. Attach the wire to one of the setscrew terminals on the neutral bus bar. Fold excess wire around the inside edge of the service panel.

Strip 1/2" of insulation from the red and the black feeder wires. Attach one wire to each of the setscrew terminals on the double-pole feeder breaker. *Note: If your subpanel arrived with a preinstalled grounding screw in the panel back, remove and discard it.*

Hook the end of the feeder circuit breaker over the guide hooks on the panel, then push the other end forward until the breaker snaps onto the hot bus bars (follow manufacturer's directions). Fold excess wire around the inside edge of the circuit breaker panel.

If necessary, open two knockouts where the double-pole feeder breaker will fit, then reattach the cover plate. Label the feeder breaker on the circuit index. Turn main breaker on, but leave feeder breaker off until all subpanel circuits have been connected and inspected.

Upgrading Service Panels

Only a generation ago, fuse boxes were commonplace. But as our demands for power increased, homeowners replaced the 60-amp boxes with larger, safer, and more reliable circuit breaker panels. Typical new homes were built with perfectly adequate 100-amp load centers. But today, as average home size has risen to more than 2,500 sq. ft. and the number of home electronics has risen exponentially, 100 amps is adequate service. As a result, many homeowners have upgraded to 200-amp service, and new single-family homes often include 250 amps or even 400 amps of power.

Upgrading your electrical service panel from 100 amps to 200 amps is an ambitious project that requires a lot of forethought. To do the job, you will need to have your utility company disconnect your house from electrical service at the transformer that feeds your house. Not only does this involve working them into your schedule, it means you will have no power during the project. You can rent a portable generator to provide a circuit or two, or you can run a couple extension cords from a friendly neighbor. But unless you are a very fast worker, plan on being without power for at least one to two days while the project is in process.

Also check with your utility company to make sure you know what equipment is theirs and what belongs to you. In most cases, the electric meter and everything on the street side belongs to the power company, and the meter base and everything on the house side is yours. Be aware that if you tamper with the sealed meter in any way, you likely will be fined. Utility companies will not re-energize your system without approval from your inspecting agency.

Upgrading a service panel is a major project. Do not hesitate to call for help at any point if you're unsure what to do. It is a good idea to alert your utility about the upgrades. They can check the service drop size to make sure it is adequate.

Tools & Materials

200-amp load center (service panel)

200-amp bypass meter base

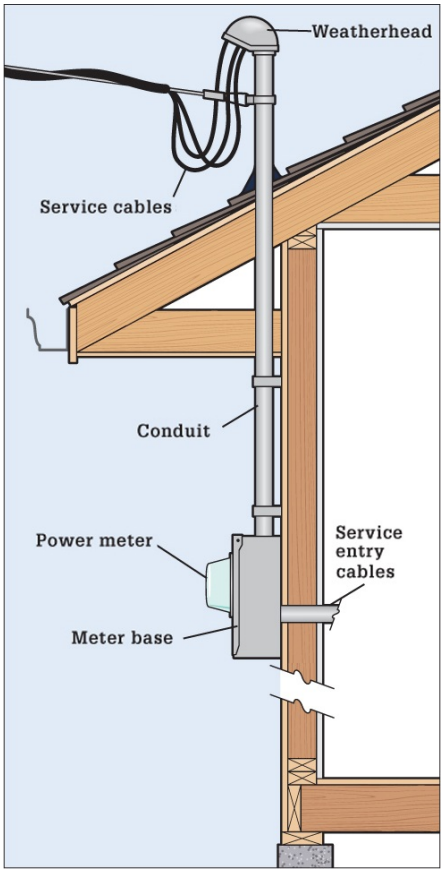
Circuit breakers

Schedule 80 or IMC conduit and fittings

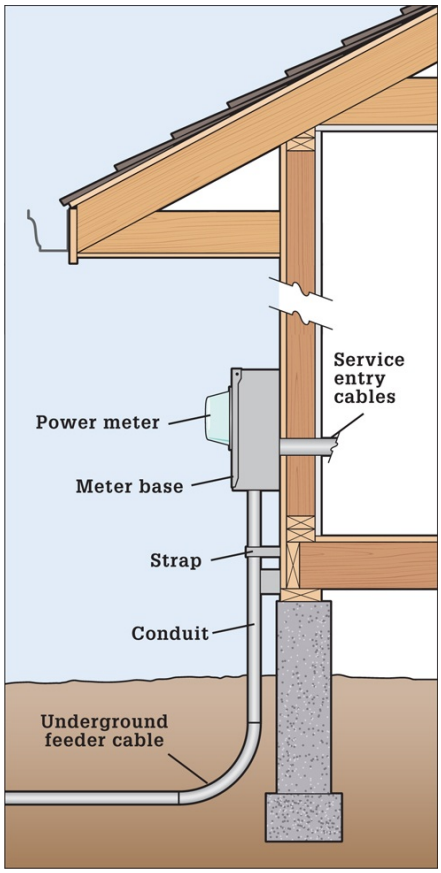
Weatherhead
Service entry cable
Circuit wires
Plywood backer board
Screwdrivers
Drill/driver
Tape
Allen wrench
Circuit tester
Multimeter

Modern homeowners consume more power than our forebears, and it is often necessary to upgrade the electrical service to keep pace. While homeowners are not allowed to make the final electrical service connections, removing the old panel and installing the new panel and meter base yourself can save you hundreds or even thousands of dollars.

Service Entry Options



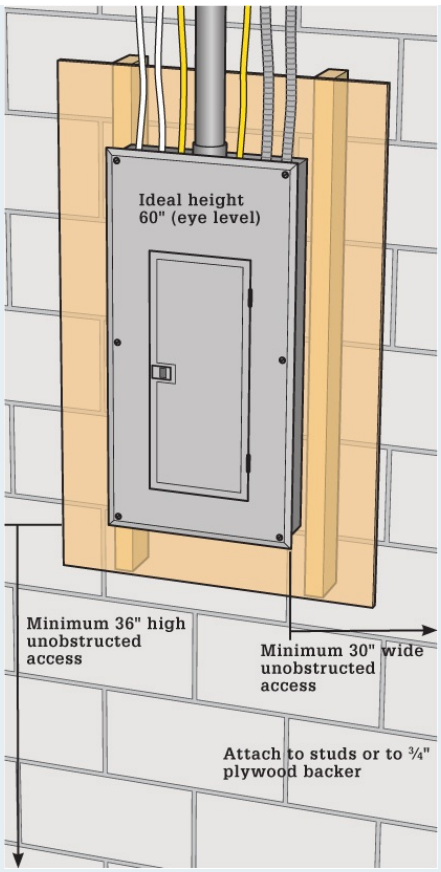
Aboveground meter with riser. In this common configuration, the power cables from the closest transformer (called the service drop) are connected to the power distribution system in your house inside a protective hood called a weatherhead. The service cables from the weatherhead are routed to a power meter that's owned by your utility company but is housed in a base that's considered your property. From the meter the cables (called service entry conductors or SECs) enter your house through the wall and are routed to the main service panel, where they are connected to the main circuit breaker.



Underground service lateral. Increasingly, homebuilders are choosing to have power supplied to their new homes underground instead of an overhead service drop. Running the cables in the ground eliminates problems with power outages caused by ice accumulation or fallen trees, but it entails a completely different set of cable and conduit requirements. For the homeowner, however, the differences are minimal because the hookups are identical once the power service reaches the meter.

Locating Your New Panel

Local codes dictate where the main service panel may be placed relative to other parts of your home. Although the codes may vary (and always take precedence), national codes stipulate that a service panel (or any other distribution panel) may not be located near flammable materials, in a bathroom, or directly above a workbench or other permanent work station or appliance. The panel also can't be located in a crawl space. The panel must be framed with at least 36" of clear space on all sides. If you are installing a new service entry hookup, there are many regulations regarding height of the service drop and the meter (the meter should be located 66" above grade). Contact your local inspections office for specific regulations.

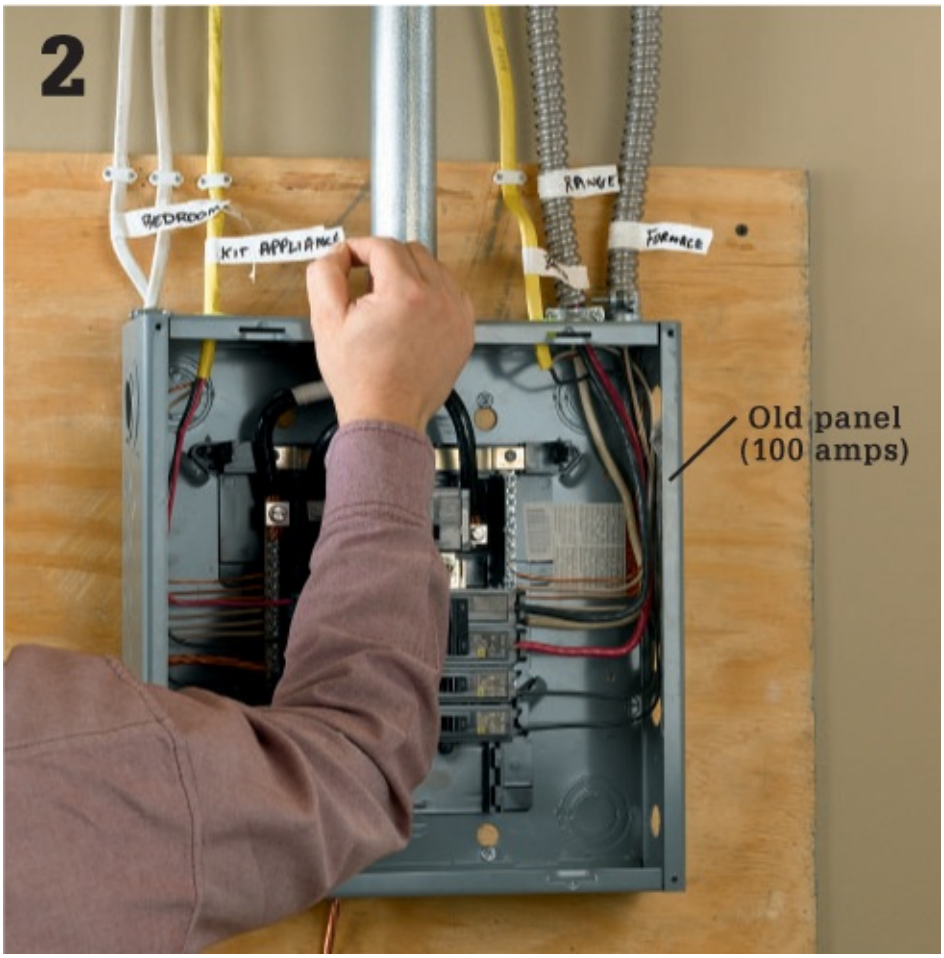

Ideal height
60" (eye level)
Minimum 36" high
unobstructed
access
Minimum 30" wide
unobstructed
access
Attach to studs or to ¾"
plywood backer

All the equipment you'll need to upgrade your main panel is sold at most larger building centers. It includes (A) a new 200-amp panel; (B) a 200-amp bypass meter base (also called a socket); (C) individual circuit breakers (if your new panel is the same brand as your old ones you may be able to reuse the old breakers); (D) new, THW, THHW, THWN-2. RHW, RHW-2, XHHW (2/0 copper seen here); (E) 2" dia. rigid conduit; (F) weatherhead shroud for mast.

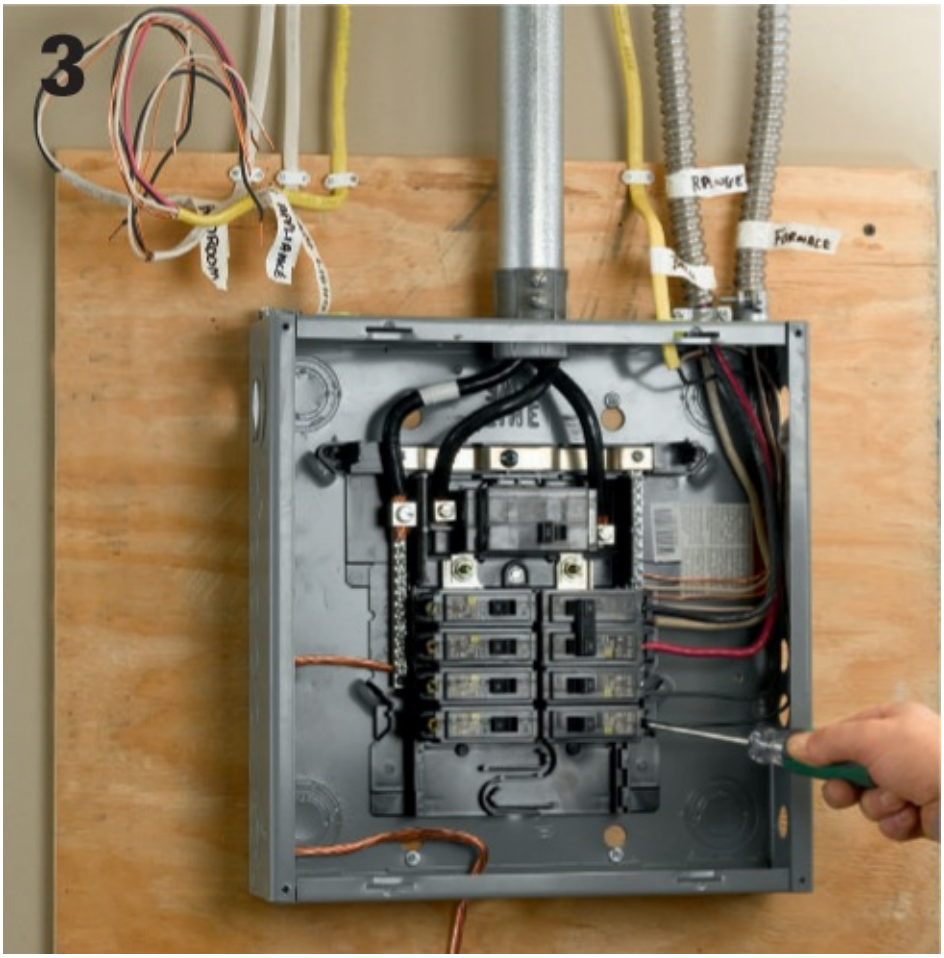
A shutoff switch next to the electric meter is required if your main service panel is too far away from the point where the service cable enters your house. The maximum distance allowed varies widely, from as little as 3 ft. to more than 10 ft. Wiring the service cable through the shutoff has the effect of transforming your main service panel into a subpanel, which will impact how the neutral and ground wires are attached (see Subpanels, page 34).

How to Replace a Main Service Panel

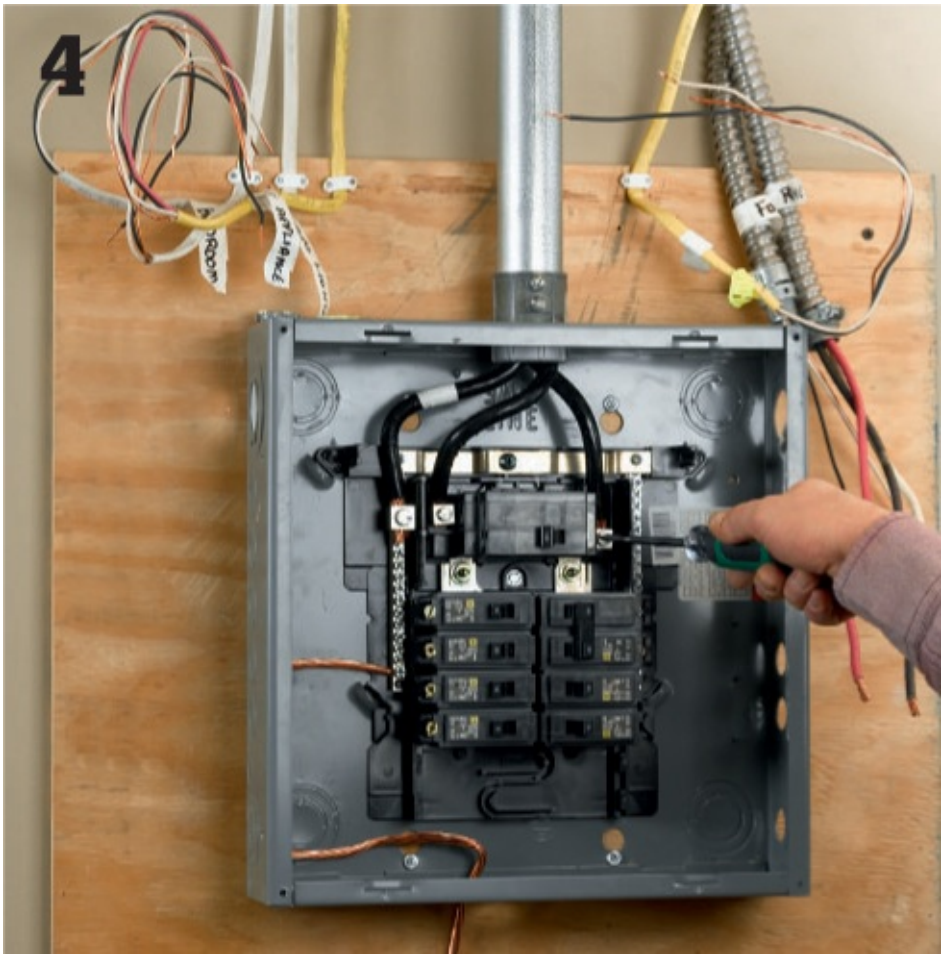
Shut off power to the house at the transformer. This must be done by a technician who is certified by your utility company. Also have the utility worker remove the old meter from the base. It is against the law for a homeowner to break the seal on the meter.



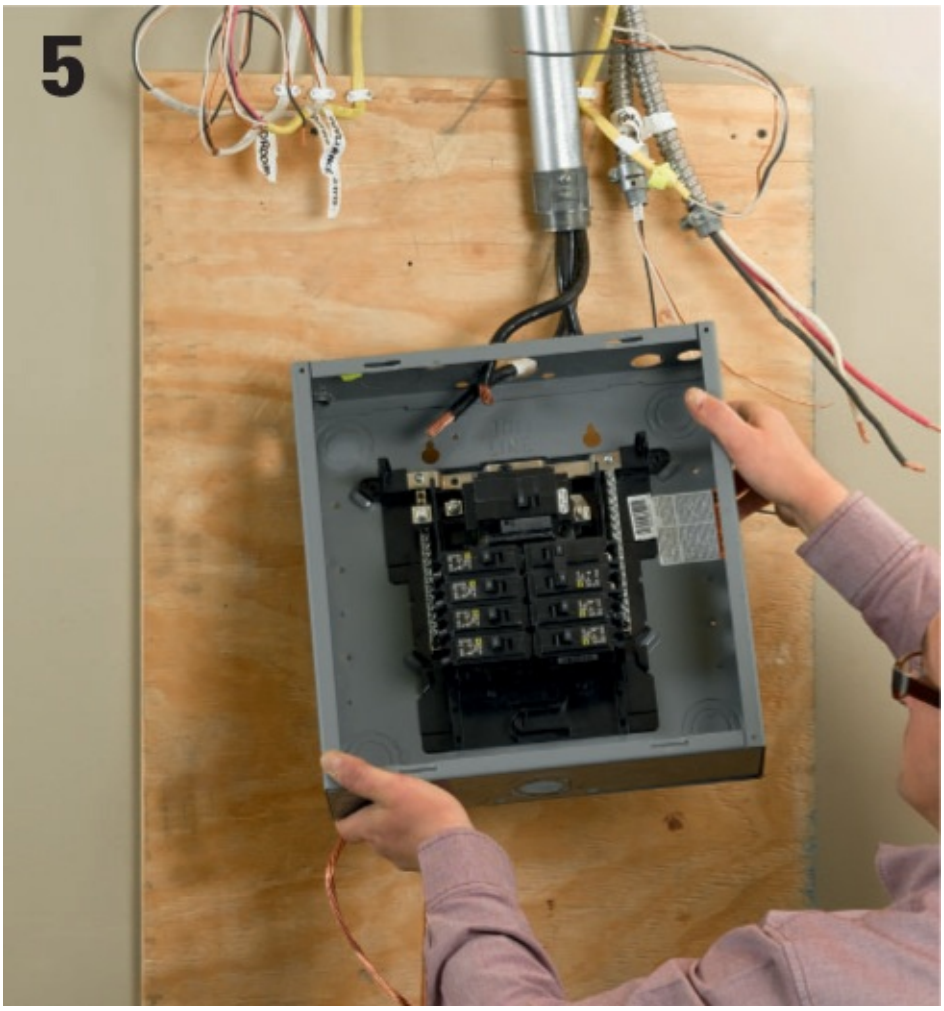
Label all incoming circuit wires before disconnecting them. Labels should be written clearly on tape that is attached to the cables outside of the existing service panel.



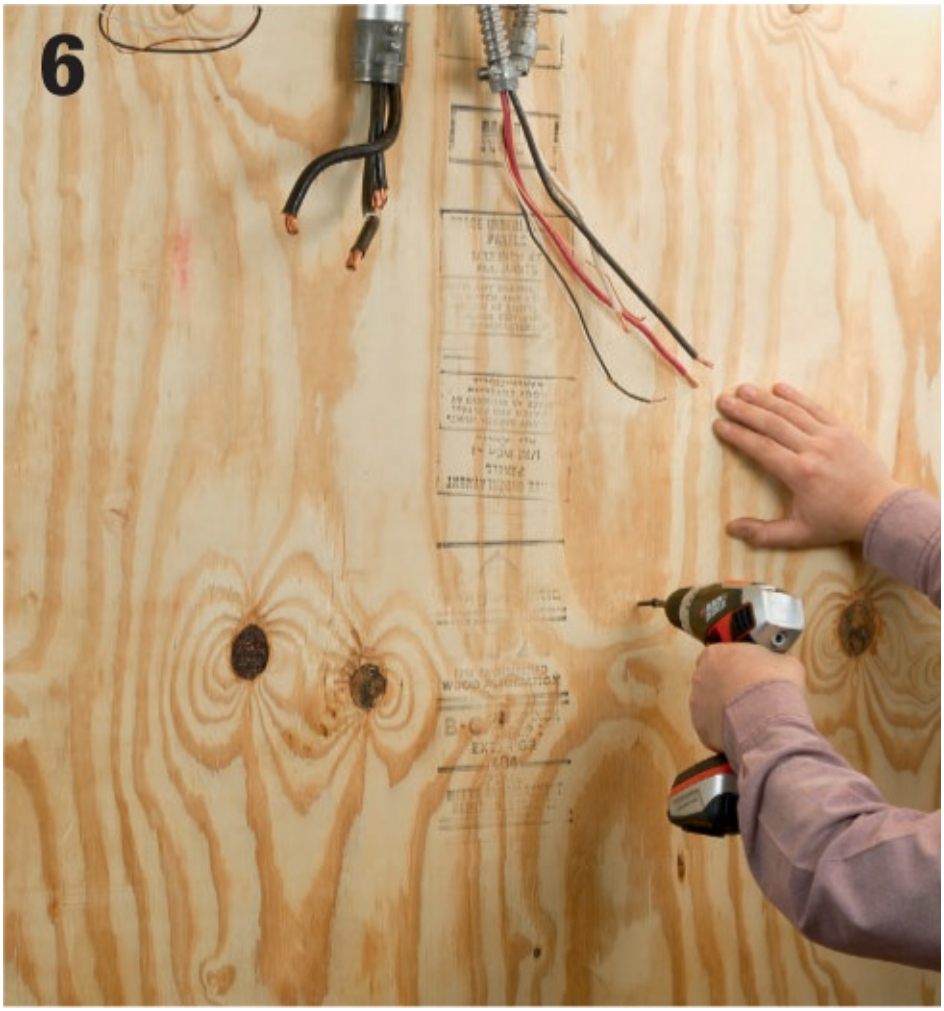
Disconnect incoming circuit wires from breakers, grounding bar, and neutral bus bar. Also disconnect cable clamps at the knockouts on the panel box. Retract all circuit wires from the service panel and coil up neatly, with the labels clearly visible.



Unscrew the lugs securing the service entry cables at the top of the panel. For 240-volt service, you will find two heavy-gauge SE cables, probably with black sheathing. Each cable carries 120 volts of electricity. A neutral service cable, usually of lighter gauge than the SE cables, will be attached to the neutral bus bar. This cable returns current to the source.



Remove the old service panel box. Boxes are rated for a range of power service; and if you are upgrading, the components in the old box will be undersized for the new service levels. The new box will have a greater number of circuit slots as well.



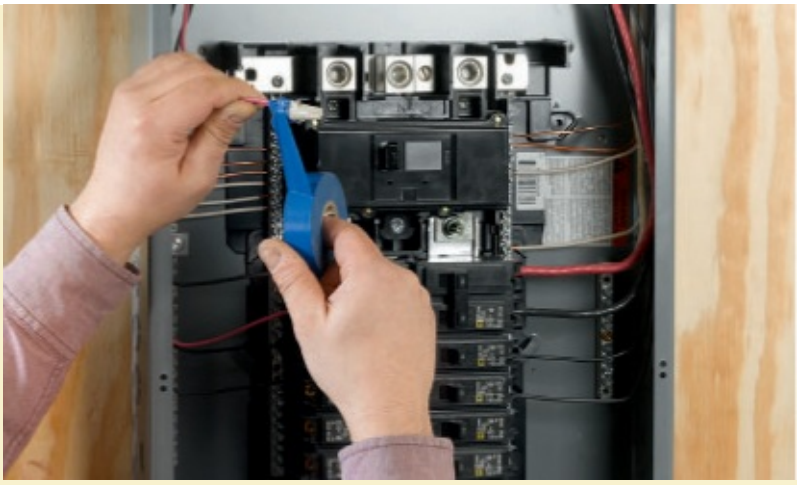
Replace the old panel backer board with a larger board in the installation area (see sidebar, page 40). A piece of 3/4" plywood is typical. Make sure the board is well secured at wall framing members.

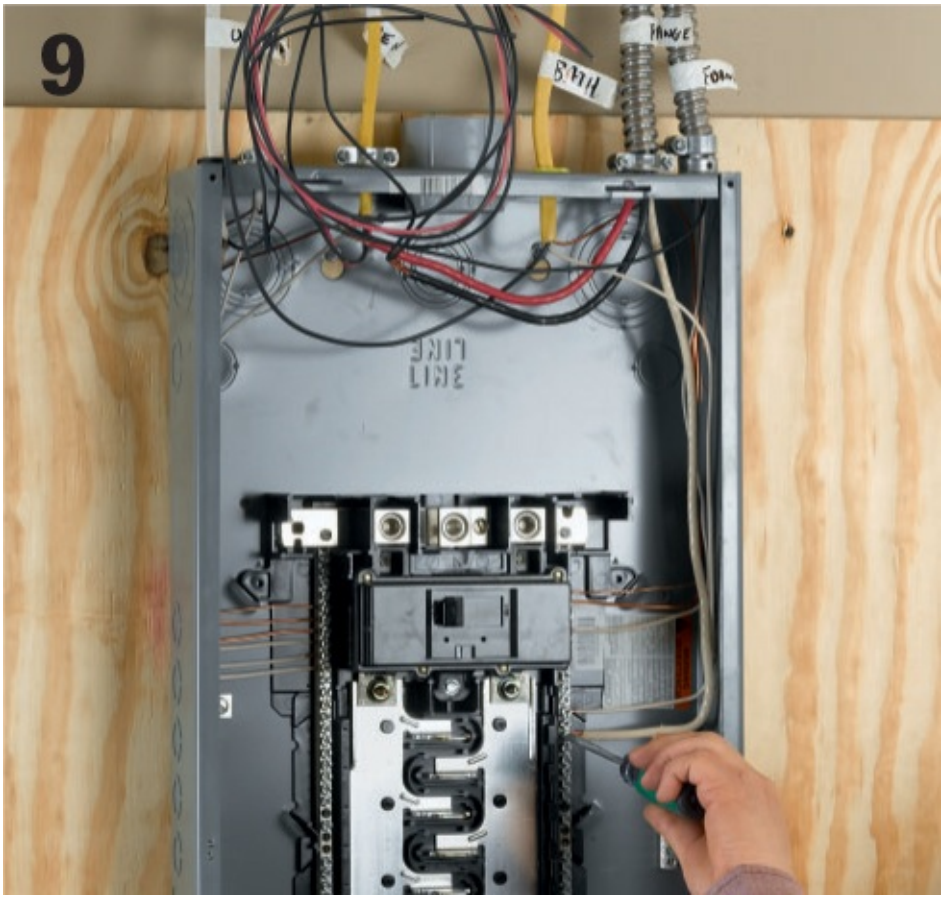
Attach the new service panel box to the backer board, making sure that at least two screws are driven through the backer and into wall studs. Drill clearance holes in the back of the box at stud locations if necessary. Use roundhead screws that do not have tapered shanks so the screwhead seats flat against the panel.

Attach properly sized cable clamps to the box at the knockout holes. Do not crowd multiple lines into a knockout hole, and plan carefully to avoid removing knockouts that you do not need to remove (if you do make a mistake, you can fill the knockout hole with a plug).

Splicing in the Box

Some wiring codes allow you to make splices inside the service panel box if the circuit wire is too short. Use the correct wire cap and wind electrical tape over the conductors where they enter the cap. If your municipality does not allow splices in the panel box, you'll have to rectify a short cable by splicing it in a junction box before it reaches the panel, and then replacing the cable with a longer section for the end of the run. Make sure each circuit line has at least 12" of slack.





Attach the white neutral from each circuit cable to the neutral bus bar. Most panels have a preinstalled neutral bus bar, but in some cases you may need to purchase the bar separately and attach it to the panel back. The panel should also have a separate grounding bar that you may need to purchase separately. Attach the grounds as well. Do not attach more than one neutral wire to the same lug.

Attach the hot lead wire to the terminal on the circuit breaker and then snap the breaker into an empty slot. When loading slots, start at the top of the panel and work your way downward. It is important that you balance the circuits as you go to equalize the amperage. For example, do not install all the 15-amp circuits on one side and all the 20-amp circuits on the other. Also, if you have multiple larger-capacity circuits, such as a 50-amp dryer and a 50-amp range, do not install them on the same side of the panel in case they will be drawing electricity at the same time.

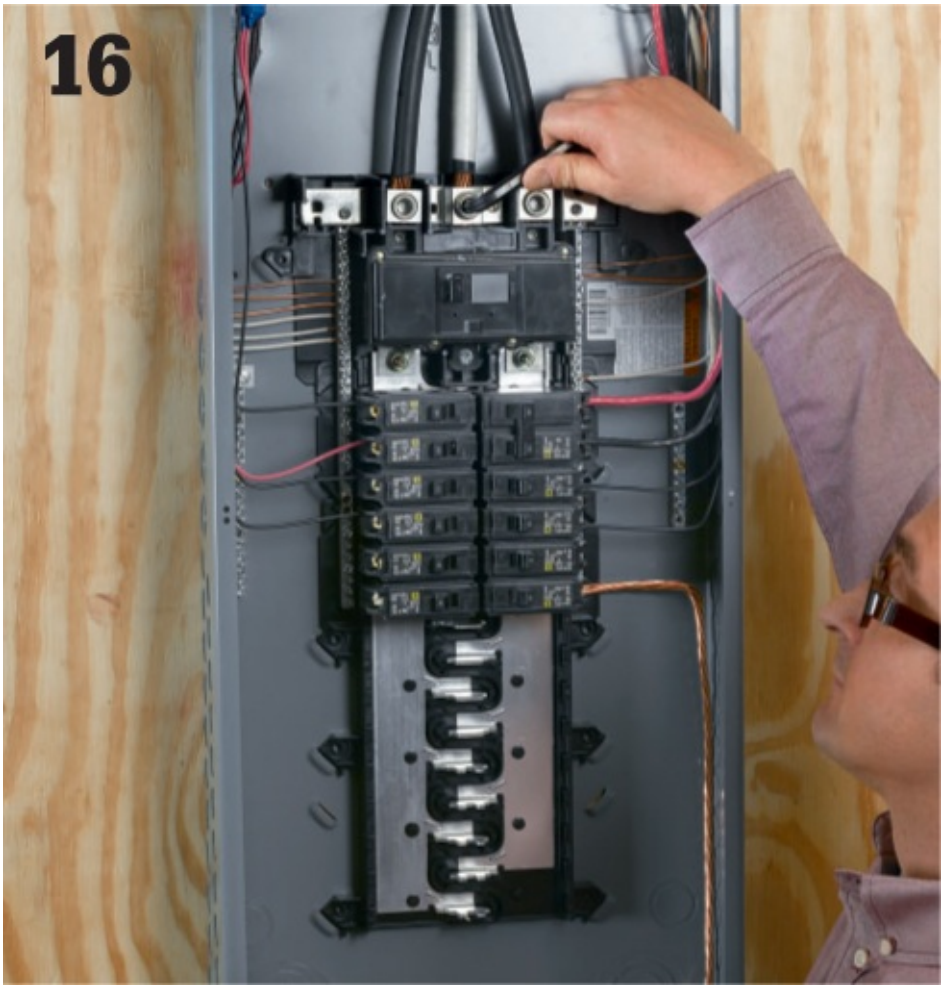
Create an accurate circuit index and affix it to the inside of the service panel door. List all loads that are on the circuit as well as the amperage. Once you have restored power to the new service panel (see step 18), test out each circuit to make sure you don't have any surprises. With the main breakers on, shut off all individual circuit breakers and then flip each one on by itself. Walk through your house and test every switch and receptacle to confirm the loads on that circuit.

Install grounding conductors (see pages 46 to 51). Local codes are very specific about how the grounding needs to be accomplished. For example, some require multiple rods driven at least 6 ft. apart. Discuss your grounding requirements thoroughly with your inspector or an electrician before making your plan.

Replace the old meter base (have the utility company remove the meter when they shut off power to the house, step 1). Remove the old meter base, also called a socket, and install a new base that's rated for the amperage of your new power service. Here, a 200-amp bypass meter base is being installed.

Update the conduit that runs from your house to the bottom of the meter base. This should be 2" rigid conduit in good repair. Attach the conduit to the base and wall with the correct fittings. Rigid metal conduit is a good option, but Schedule 80 PVC is probably the best choice for housing the service entry cables.

Install new service entry wires. Each wire carries 120 volts of current from the meter to the service wire lugs at the top of your service panel. Code is very specific about how these connections are made. In most cases, you'll need to tighten the terminal nuts with a specific amount of torque that requires a torque wrench to measure. Also attach the sheathed neutral wire to the neutral/grounding lug.

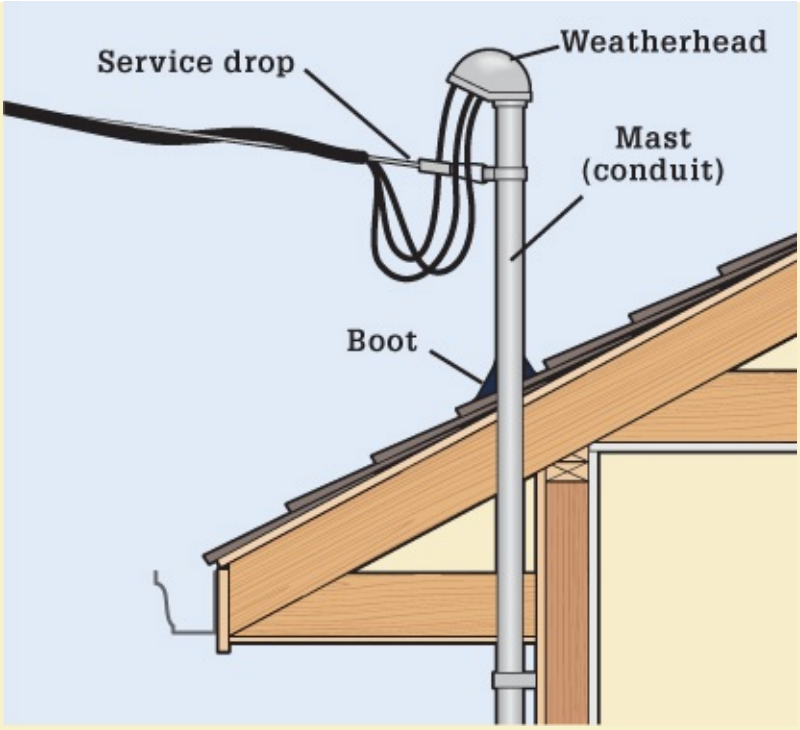


Attach the SE wires to the lugs connected to the main breakers at the top of your service entry panel. Do not remove too much insulation on the wires—leaving the wires exposed is a safety hazard. The neutral service entry wire is attached either directly to the neutral bus bar or to a metal bridge that is connected to the neutral bonding bus bar. Install the green grounding screw provided with the panel.

Install service entry wires from the meter to the weatherhead, where the connections to the power source are made. Only an agent for your public utility company may make the hookup at the weatherhead.

Tall Mast, Short Roof

The service drop must occur at least 10 ft. above ground level, and as much as 14 ft. in some cases. Occasionally, this means that you must run the conduit for the service mast up through the eave of your roof and seal the roof penetration with a boot.


Service drop
Weatherhead
Mast
(conduit)
Boot

Have the panel and all connections inspected and approved by your local building department, and then contact the public utility company to make the connections at the power drop. Once the connections are made, turn the main breakers on and test all circuits.

Grounding & Bonding an Upgraded System

All home electrical supply systems must be bonded and grounded in accordance with code standards. This entails two tasks: the metal water and gas pipes must be connected electrically to create a contiguous wire path leading to a ground; and the main electrical panel must be grounded to a grounding rod or rods driven into the earth near the foundation of your house. Although the piping system often is bonded to the ground through your main electrical service panel, the panel grounding and the piping bonding are unrelated when it comes to function. The grounding wire that runs from your electrical panel to grounding rods in the earth is an important safeguard in your electrical system. The wires that bond and ground your metal piping are preventative, and they only become important in the relatively unlikely event that an electrical conductor contacts one of the bare pipes, energizing it. In that case, correct grounding of the piping system will ensure that the current does not remain or build up in the system, where it could electrocute anyone who touches a part of the system, such as a faucet handle. Bonding is done relatively efficiently at the water heater, as the gas piping and water piping generally there.

Tools & Materials

Hammer

Slotted screwdriver

Drill

1/2” drill bit

Copperwire: #4 stranded for 100 amps and above; #6 solid for less than 100 amps

Cable staples

3 pipe ground clamps

Eye and ear protection

Work gloves

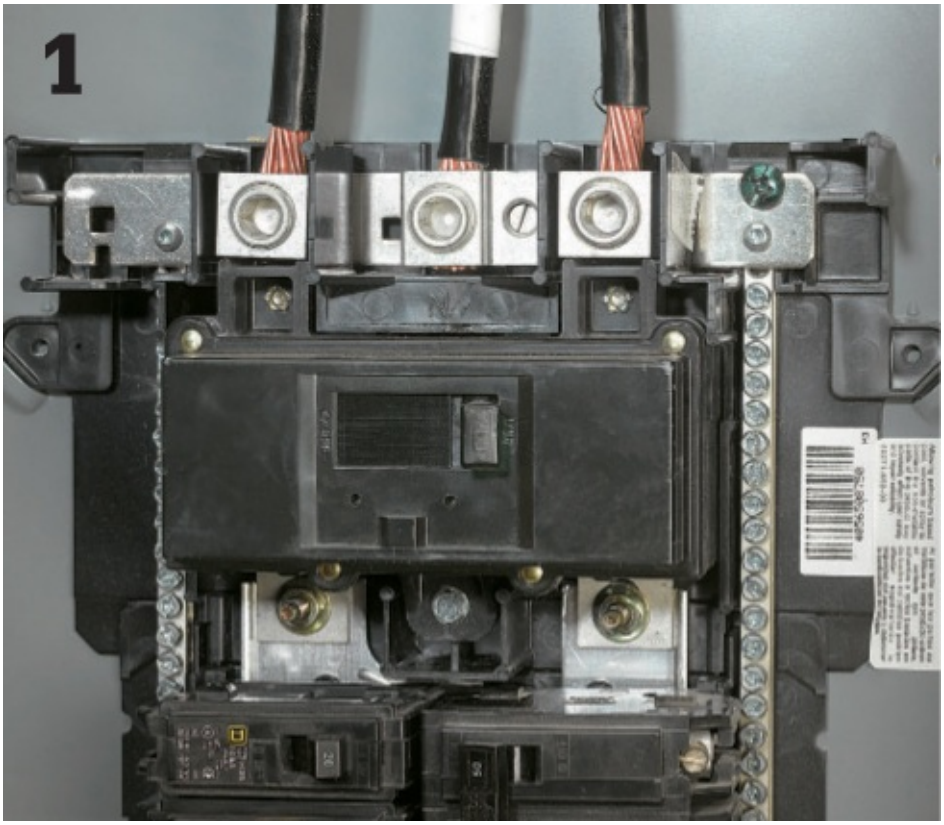
Grounding rods (8-ft.-long copper-coated steel)

5-lb. maul

Caulk

A pair of 8-ft.-long metal grounding rods are driven into the earth next to your house to provide a path to ground for your home wiring system.

How to Bond Metallic Piping



Determine the amperage rating of your electrical service by looking at your main breakers. The system amperage (usually 100 or 200 amps) determines the required gauge of the bonding wire you need. For service up to 125 amps use #8 copper strand wire. For more than 125 amps use #6 copper strand.

Run the grounding wire from a bonding point near your water heater (a convenient spot if you have a gas-fueled heater) to an exit point where the wire can be bonded to the grounding wire that leads to the exterior grounding rods. This is frequently done at the service panel. Run this wire as you would any other cable, leaving approximately 6 to 8 ft. of wire at the water heater. If you are running this wire through the ceiling joists, drill a 1/2" hole as close to the center as possible to not weaken the joist. Staple the wire every 4 ft. if running it parallel to the joists.

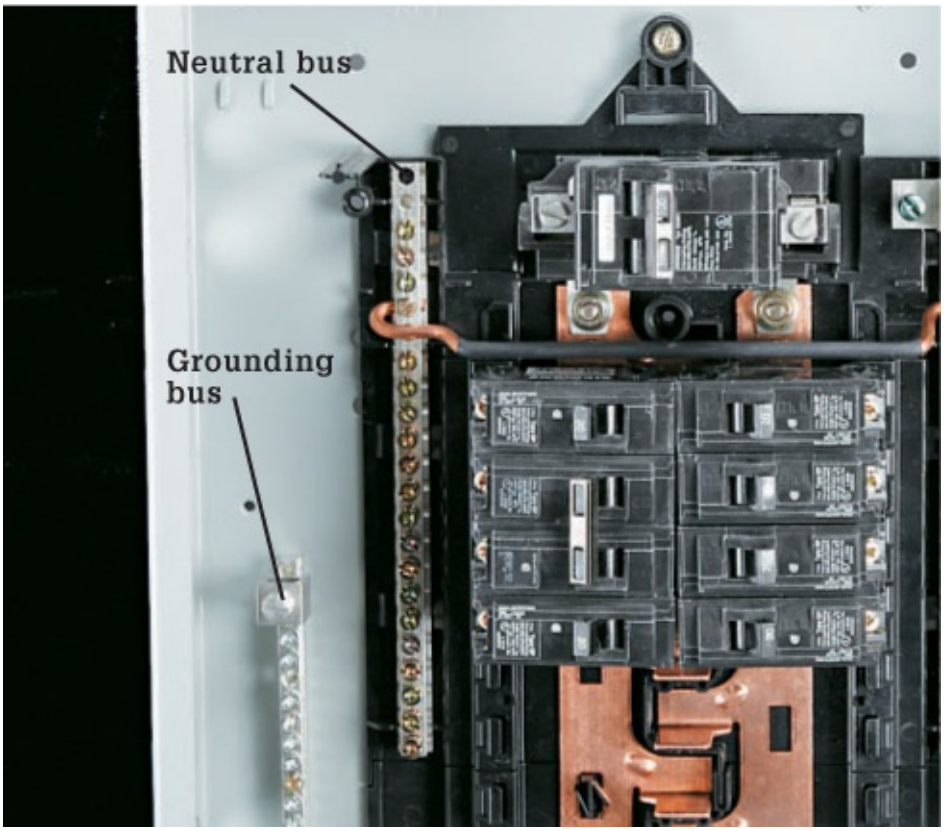
Install pipe ground clamps on each pipe (hot water supply, cold water supply, gas), roughly a foot above the water heater. Do not install clamps near a union or elbow because the tightening of the clamps could break or weaken soldered joints. Also make sure the pipes are free and clear of any paint, rust, or any other contaminant that may inhibit a good clean connection. Do not overtighten the clamps.

Route the ground wire through each clamp wire hole and then tighten the clamps onto the wire. Do not cut or splice the wire: The same wire should run through all clamps.

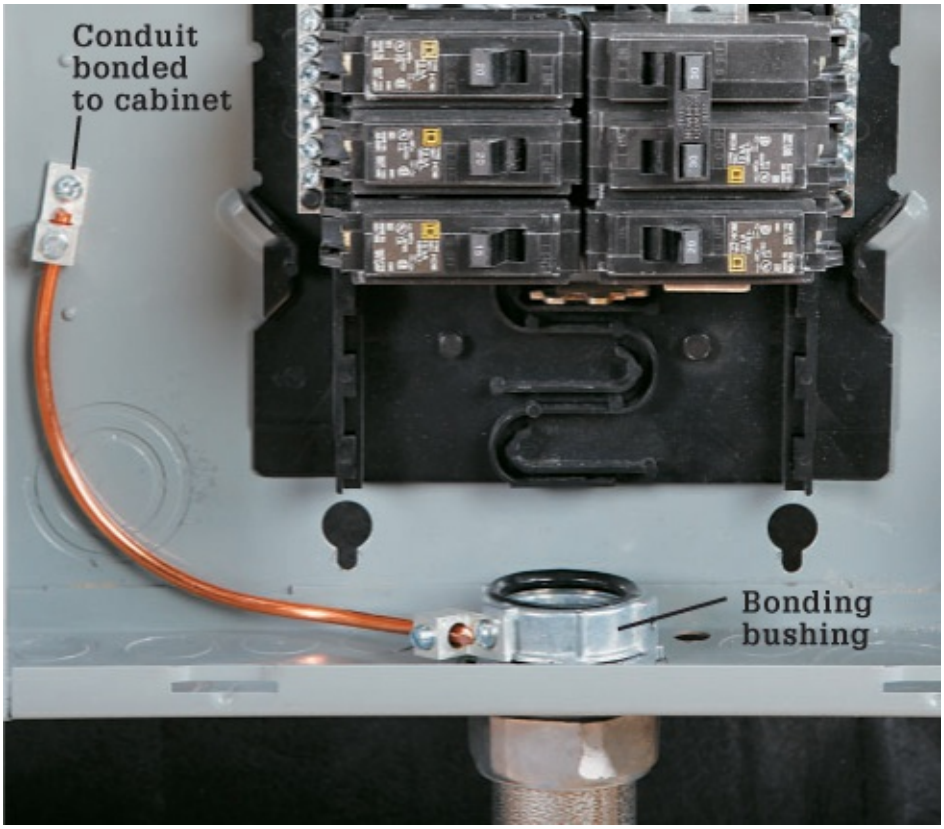
At the panel, turn off the main breaker. Open the cover by removing the screws and set the cover aside. Route the ground wire through a small 3/8" hole provided towards the rear of the panel on the top or bottom. You will generally have to knock the plug out of this hole by placing a screwdriver on it from the outside and tapping with a hammer. Make sure the ground wire will not come into contact with the copper bus bars in the middle of the panel or any of the load terminals on the breakers.

Locate an open hole on your ground and neutral bus and insert the ground wire. Newer service panels will have a separate neutral and grounding bus to conform to current codes in this case, connect to the grounding bus. These holes are large enough to accommodate up to a #4 awg wire, but it may be difficult at times. Secure the set screw at the lug. Replace the panel cover and turn the main breaker back on.

Tips for Grounding the Panel



The neutral and grounding wires should not be connected to the same bus in most subpanels. The grounding bus should be bonded to the subpanel cabinet. The neutral bus should not be bonded to the subpanel cabinet.



Metallic conduit must be physically and electrically connected to panel cabinets. A bonding bushing may be required in some cases, where all of a knockout is not removed.

Ground Rod Installation

The ground rod is an essential part of the grounding system. Its primary function is to create a path to ground for unrestricted electrical currents, such as lightning, line surges, and unintentional contact with high voltage lines. As a lot of homes are now being plumbed with nonmetallic pipes (which, unlike metallic pipes, cannot be used for equipment grounding), the need to properly install a grounding electrode system is more important than ever. In this day and age, only brand-new houses will have no grounding electrode system. However, it is not uncommon for electrodes to deteriorate in the ground and require replacement. Also, if you upgrade your electrical services you likely will need to upgrade your grounding wire and rods to meet code.

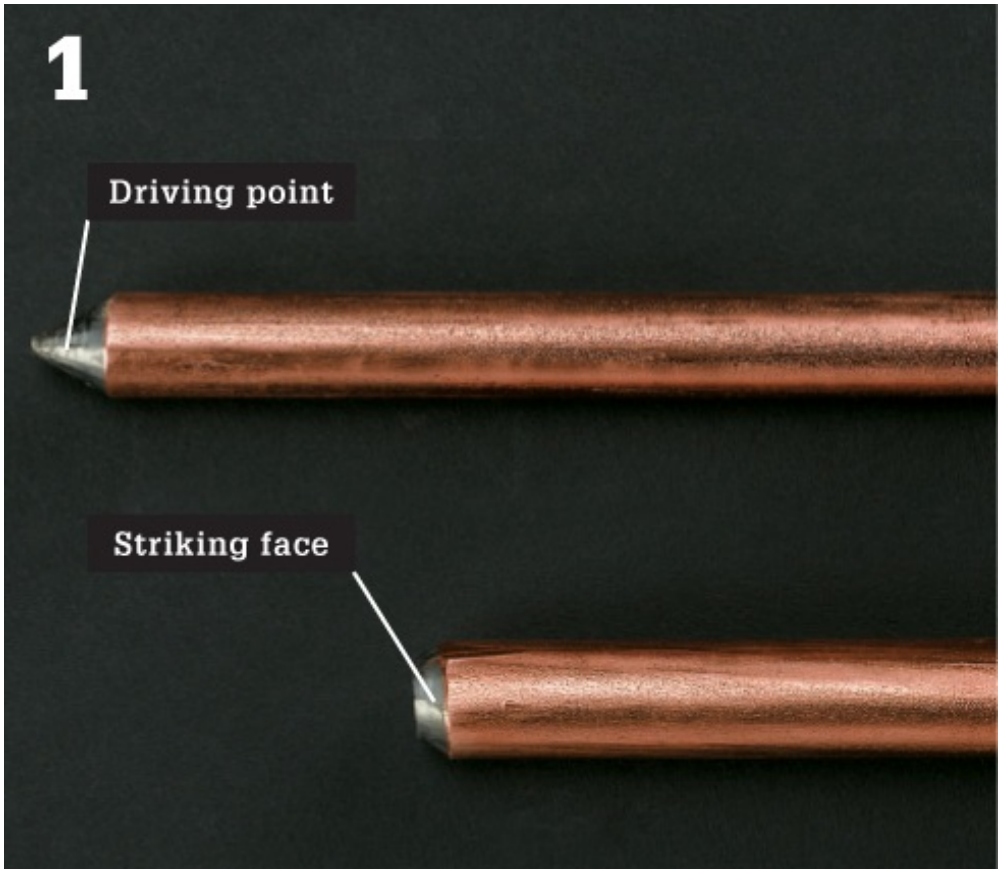
Note: Different municipalities have different requirements for grounding, so be sure to check with the AHJ (Authority Having Jurisdiction) first before attempting to do this yourself.

Call before you dig! Make sure the area where you will be installing the ground rods is free and clear from any underground utilities.

Exercise Your Breakers

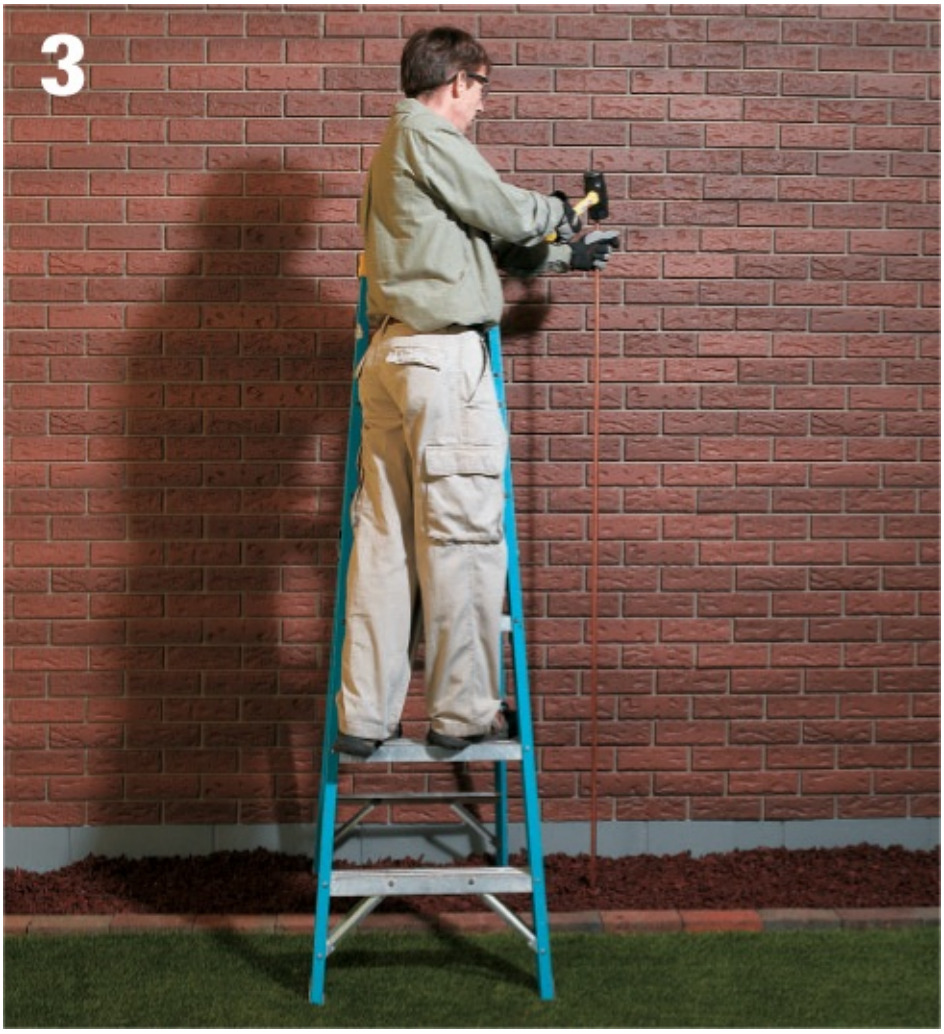
Your breakers (including the main) should be “exercised” once a year to ensure proper mechanical function. Simply turn them off and then back on. A convenient time to perform the exercise is at daylight savings time, when you’ll need to reset all of your clocks anyway.

How to Install a Grounding Electrode System



First, determine what size ground rods you'll need: either 1/2" dia. by 8-ft. long for 100 amp service, or 5/8" dia. by 8-ft. long for services that exceed 100 amps. Grounding rods have a driving point on one end and a striking face on the other end. They are made of hardened, solid steel coated in copper for increased conductivity.

Drill a hole for the grounding conductor in the rim joist of your house, as close as practical to the main service panel. Drill all the way through to the outside of the house above the ground level at least 6" using an extended drill bit.



About a foot from the foundation of the house, pound one ground rod into the earth with a five-pound maul. If you encounter a rock or other obstruction, you can pound the ground rod at an angle as long as it does not exceed 45°. Drive until only 3" or 4" of the rod is above ground. Measure at least 6 ft. from the first ground rod and pound in another one.

Run grounding conductor from the ground bus in your main service panel through the hole in the rim joist and to the exterior of the house, leaving enough wire to connect the two ground rods together. Make sure wire is sized correctly—see page 49.

Using a brass connector commonly referred to as an acorn, connect the wire to the first ground rod, pulling the wire taut so no slack exists. Continue pulling the wire to reach the second grounding rod, creating a continuous connection.

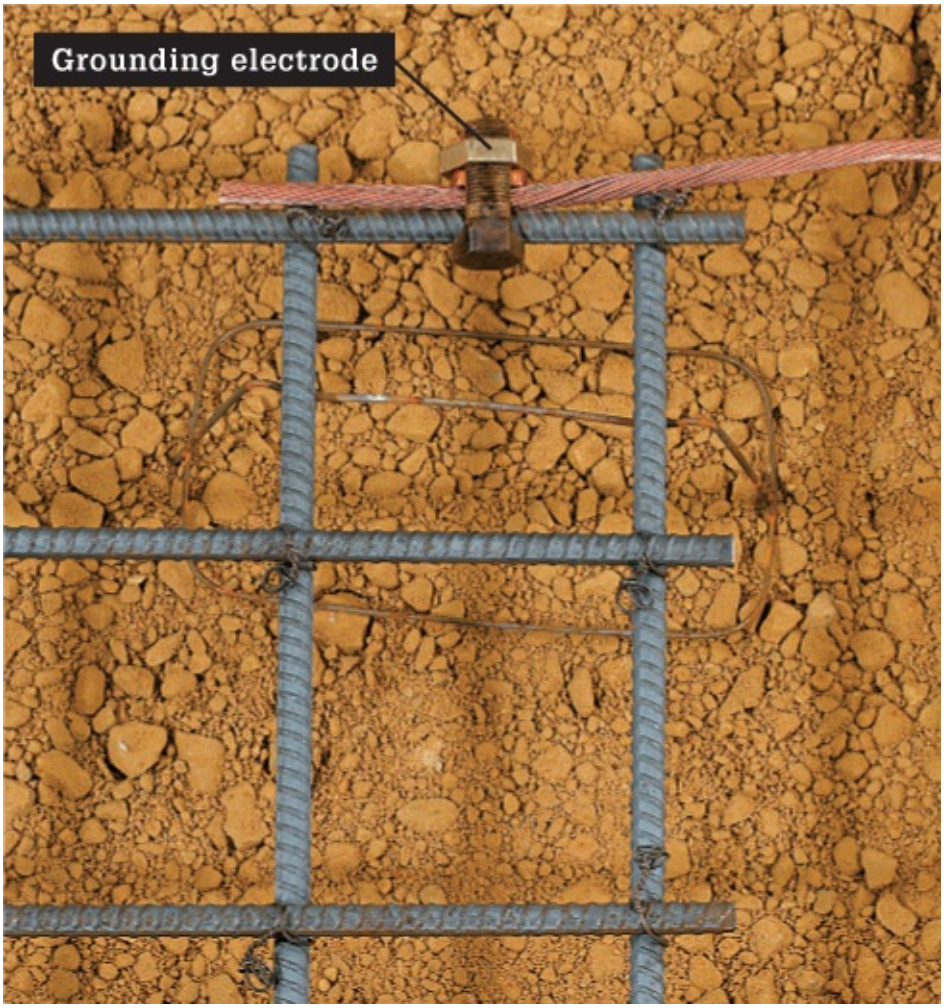
Connect the second ground rod with another acorn to the uncut grounding wire previously pulled through the first acorn. Trim the excess wire.

Dig out a few inches around each rod to create clearance for the five-pound maul. Creating a shallow trench beneath the grounding wire between the rods is also a good idea. Drive each rod with the maul until the top of the rod is a few inches below grade.

Inject caulk into the hole in the rim joist on both the interior and exterior side.

Tips for Grounding

A listed metal strap may be used to ground indoor communication wires to bonded conduit such as telephone and cable TV.



A piece of reinforcing bar encased in a concrete footing is a common grounding electrode in new construction. Called a ufer, the electrode must be No. 4 or larger rebar and at least 20 ft. long. (Shown prior to pouring concrete.)

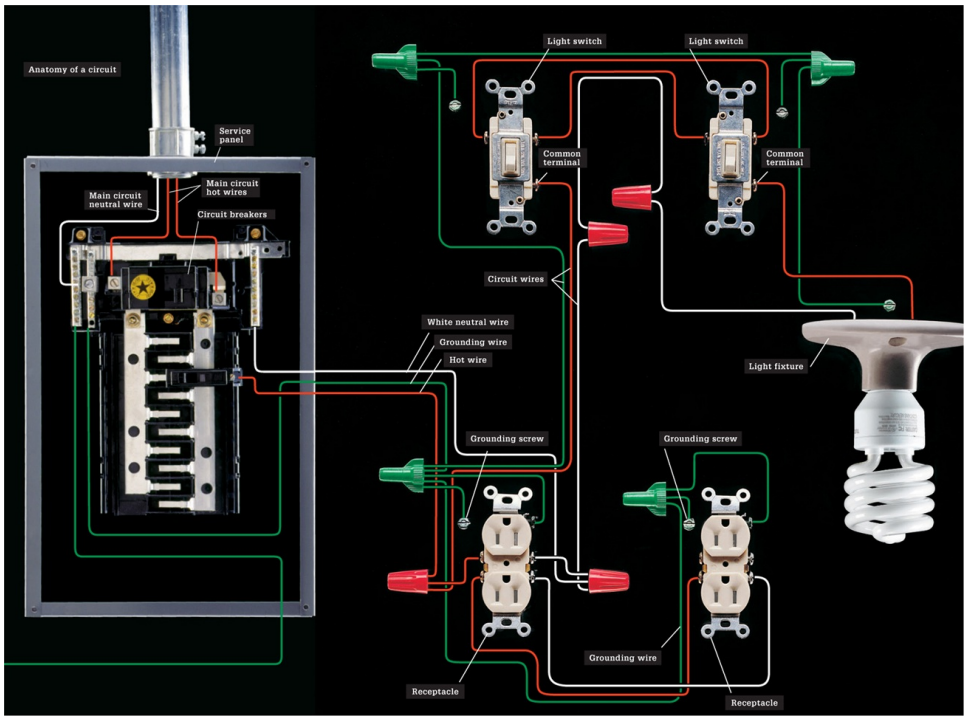
Adding Circuits

An electrical circuit is a continuous loop. Household circuits carry power from the main service panel, throughout the house, and back to the main service panel. Several switches, receptacles, light fixtures, or appliances may be connected to a single circuit.

Current enters a circuit loop on hot wires and returns along neutral wires. These wires are color coded for easy identification. Hot wires are black or red, and neutral wires are white or light gray. For safety, most circuits include a bare copper or green insulated grounding wire. The grounding wire conducts current in the event of a ground fault, and helps reduce the chance of severe electrical shock. The service panel also has a grounding wire connected to a metal water pipe and metal grounding rod buried underground.

If a circuit carries too much power, it can overload. A fuse or a circuit breaker protects each circuit in case of overloads.

Current returns to the service panel along a neutral circuit wire. Current then becomes part of a main circuit and leaves the house on a large neutral service wire that returns it to the utility pole transformer.



Wiring a Room Addition

The photo below shows the circuits you would likely want to install in a large room addition. This example shows the framing and wiring of an unfinished attic converted to an office or entertainment room with a bathroom. This room includes a subpanel and five new circuits plus telephone and cable-TV lines.

A wiring project of this sort is a potentially complicated undertaking that can be made simpler by breaking the project into convenient steps, and finishing one step before moving on to the next. Turn to pages 56 to 57 to see this project represented as a wiring diagram.

Individual Circuits

#1: Bathroom circuit. This 20-amp dedicated circuit supplies power to bathroom lights and fans, as well as receptacles that must be GFCI-protected at the box or at the receptacle. As with small appliance circuits in the kitchen, you may not tap into this circuit to feed any additional loads.

#2: Computer circuit. A15-amp dedicated circuit with isolated ground is recommended, but an individual branch circuit is all that is required by most codes.

Circuit breaker subpanel receives power through a 10-gauge, three-wire feeder cable connected to a 30-amp, 240-volt circuit breaker at the main circuit breaker panel. Larger room additions may require a 60-amp or a 100-amp feeder circuit breaker.

#3: Air-conditioner circuit. A 20-amp, 240-volt dedicated circuit. In cooler climates, or in a smaller room, you may need an air conditioner and circuit rated for only 120 volts.

#4: Basic lighting/receptacle circuit. This 15-amp, 120-volt circuit supplies power to most of the fixtures in the bedroom and study areas.

#5: Heater circuit. This 20-amp, 240-volt circuit supplies power to the bathroom blower-heater and to the baseboard heaters. Depending on the size of your room and the wattage rating of the baseboard heaters, you may need a 30-amp, 240-volt heating circuit.

Telephone outlet is wired with 22-gauge four-wire phone cable. If your home phone system has two or more separate lines, you may need to run a cable with eight wires, commonly called four-pair cable.

Cable television jack is wired with coaxial cable running from an existing television junction in the utility area.

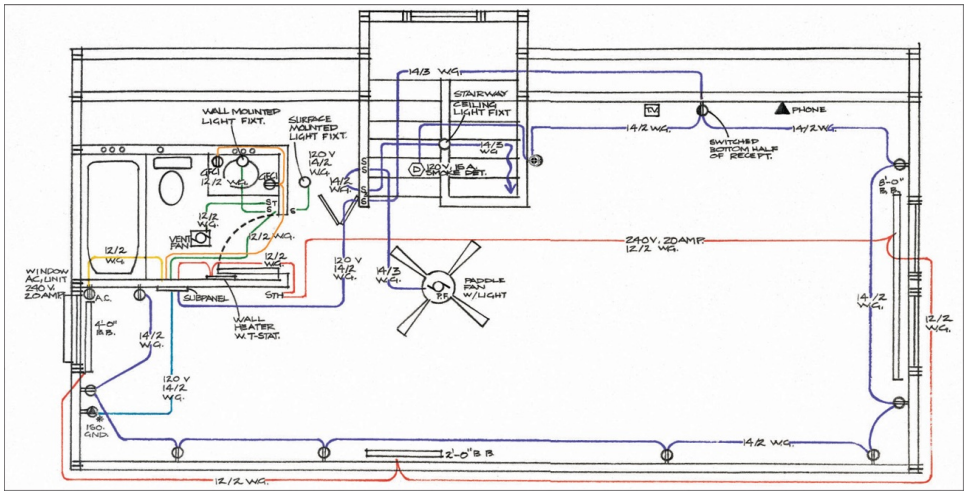
Diagram View

The diagram below shows the layout of the five circuits and the locations of their receptacles, switches, fixtures, and devices as shown in the photo on the previous pages. The circuits and receptacles are based on the needs of a 400-sq.-ft. space. An inspector will want to see a diagram like this one before issuing a permit. After you've received approval for your addition, the wiring diagram will serve as your guide as you complete your project.

Circuit #1: A 20-amp, 120-volt circuit serving the bathroom and closet area. Includes: 12/2 NM cable, double-gang box, timer switch, single-pole switch, 4 × 4" box with single-gang adapter plate, two plastic light fixture boxes, vanity light fixture, closet light fixture, 15-amp single-pole circuit breaker.

Circuit #2: A 15-amp, 120-volt computer circuit. Includes: 14/2 NM cable, single-gang box, 15-amp receptacle, 15-amp single-pole circuit breaker.

Circuit #3: A 20-amp, 240-volt air-conditioner circuit. Includes: 12/2 NM cable; single-gang box; 20-amp, 240-volt receptacle (singleplex style); 20-amp double-pole circuit.



Circuit #4: A 15-amp, 120-volt basic lighting/receptacle circuit serving most of the fixtures in the bedroom and study areas. Includes: 14/2 and 14/3 NM cable, two double-gang boxes, fan speed-control switch, dimmer switch, single-pole switch, two three-way switches, two plastic light fixture boxes, light fixture for stairway, smoke detector, metal light fixture box with brace bar, ceiling fan with light fixture, 10 single-gang boxes, 4" × 4" box with single-gang adapter plate, 10 duplex receptacles (15-amp), 15-amp single-pole circuit breaker.

Circuit #5: A 20-amp, 240-volt circuit that supplies power to three baseboard heaters controlled by a wall thermostat, and to a bathroom blower-heater controlled by a built-in thermostat. Includes: 12/2 NM cable, 750-watt blower-heater, single-gang box, line-voltage thermostat, three baseboard heaters, 20-amp double-pole circuit breaker.

TV **Cable television jack:** Coaxial cable with F-connectors, signal splitter, cable television outlet with mounting brackets.

Circuit #6: A 20-amp, 120-volt, GFCI-protected bathroom receptacle circuit for the bathroom. Includes GFCI breaker, 12/2 NM cable, boxes and 20-amp receptacles.

Circuit Map Details

Make the final connections for receptacles, switches, and fixtures only after the rough-in inspection is done, and all walls and ceilings are finished. The circuit maps are especially useful if your wiring configurations differ from those shown on the following pages. The last step is to hook up the new circuits at the breaker panel.

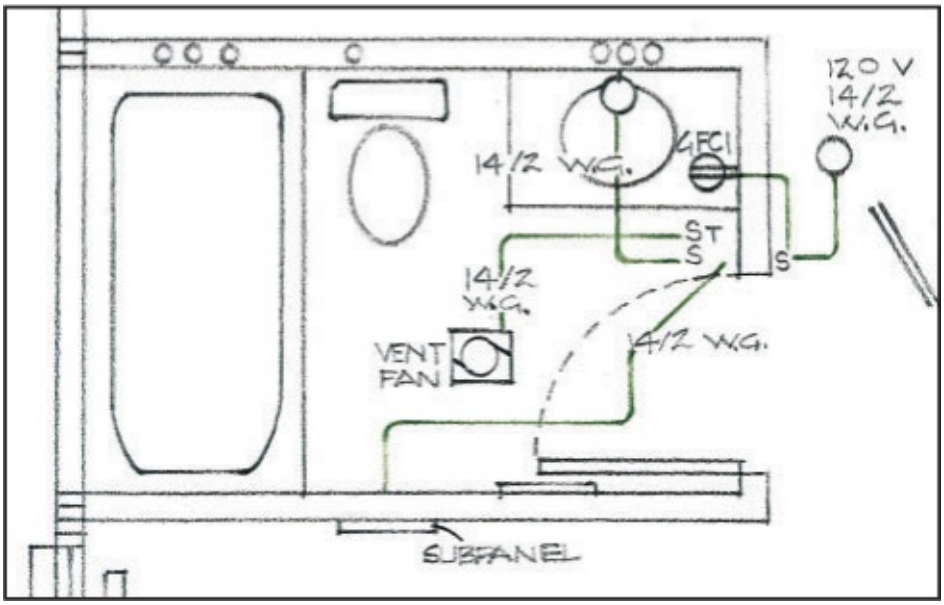
After all connections are done, your work is ready for the final inspection. If you have worked carefully, the final inspection will take only a few minutes. The inspector may open one or two electrical boxes to check wire connections, and will check the circuit breaker hookups to make sure they are correct.

Tools & Materials

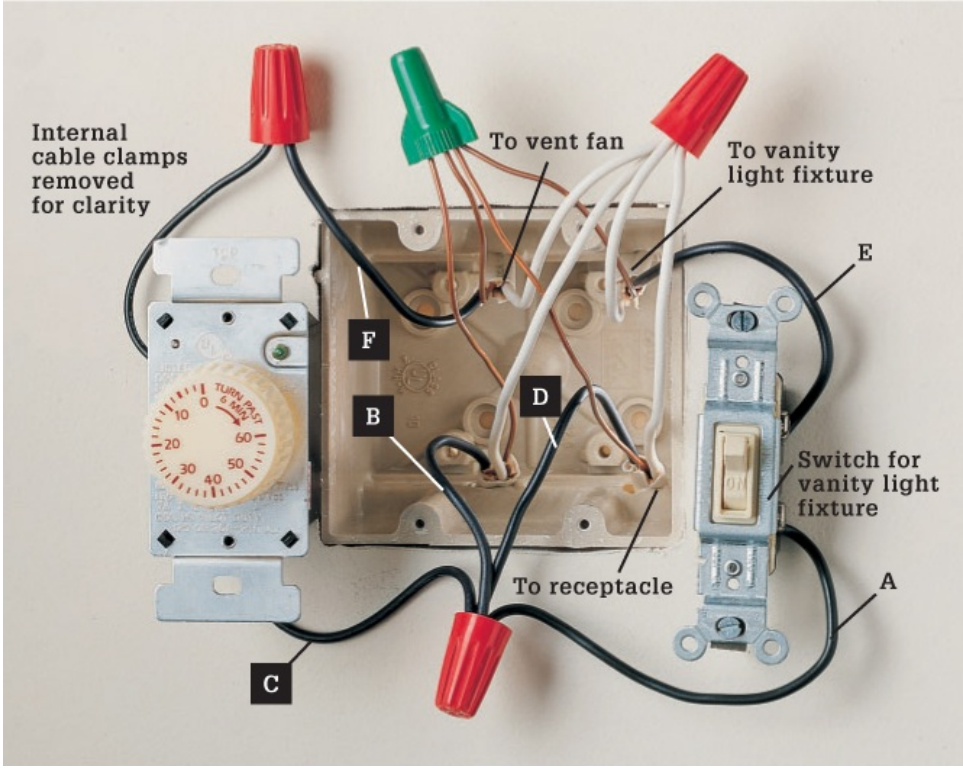
Combination tool
Screwdrivers
Needlenose pliers
Nut driver
Pigtail wires
Wire connectors
Green & black tape

CIRCUIT #1 A 15-amp, 120-volt circuit serving the bathroom & closet.

- Timer & single-pole switch
- Vent fan
- Two light fixtures
- GFCI receptacle
- Single-pole switch
- 15-amp single-pole circuit breaker

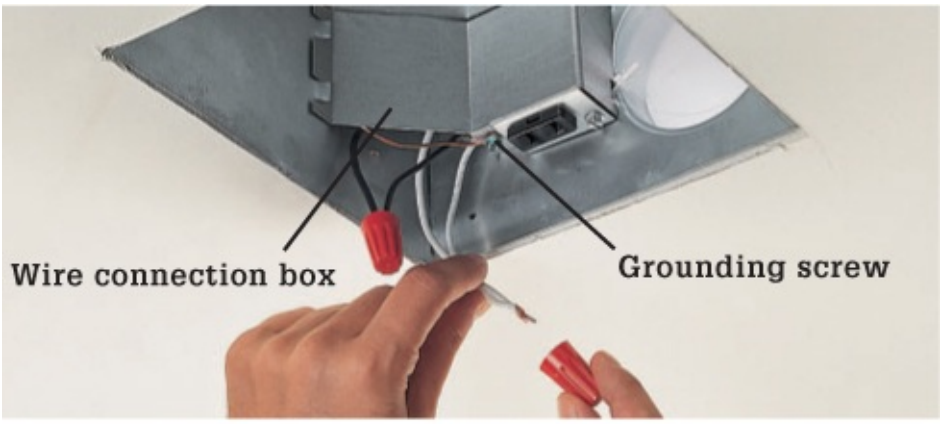

120 V
14/2
W.G.
GFCI
14/2 W.G.
ST
S
S
14/2
W.G.
VENT
FAN
14/2 W.G.
SUBPANEL

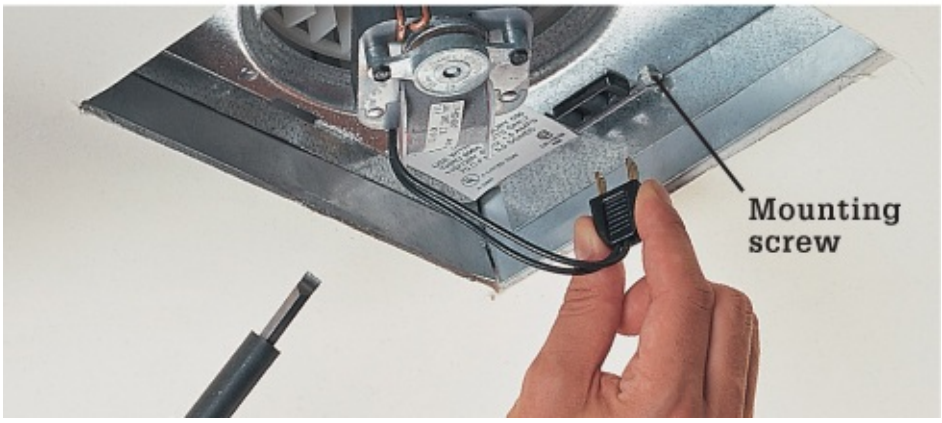
How to Connect the Timer & Single-pole Switch



Attach a black pigtail wire (A) to one of the screw terminals on the switch. Use a wire connector to connect this pigtail to the black feed wire (B), to one of the black wire leads on the timer (C), and to the black wire carrying power to the bathroom receptacle (D). Connect the black wire leading to the vanity light fixture (E) to the remaining screw terminal on the switch. Connect the black wire running to the vent fan (F) to the remaining wire lead on the timer. Use wire connectors to join the white wires and the grounding wires. Tuck all wires into the box, then attach the switches, coverplate, and timer dial.

How to Connect a Vent Fan





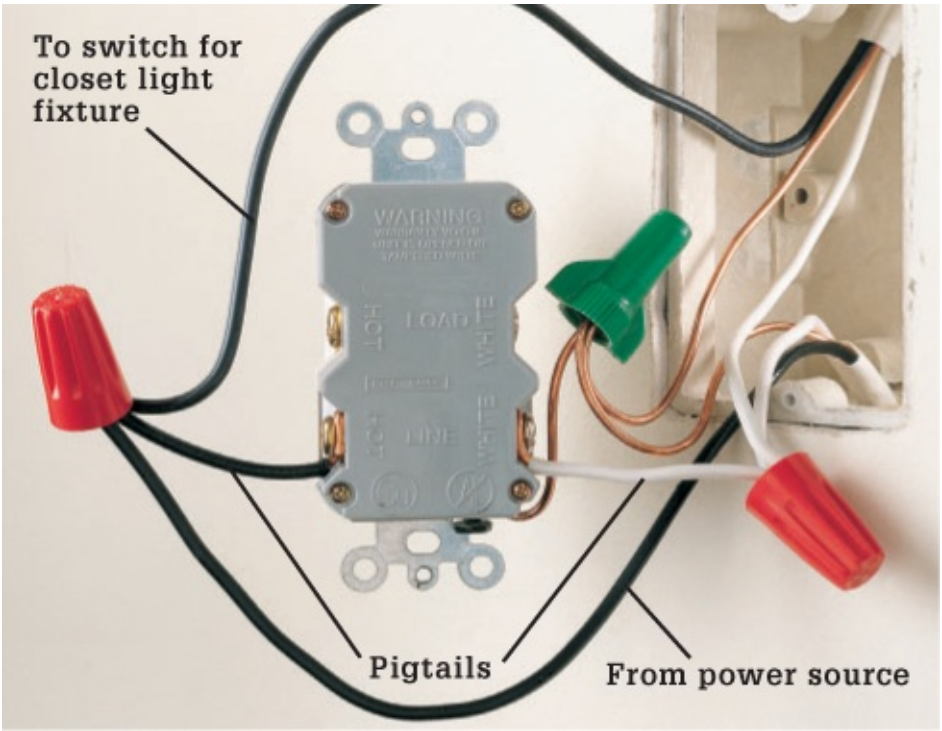
In the wire connection box (top) connect black circuit wire to black wire lead on fan, using a wire connector. Connect white circuit wire to white wire lead. Connect grounding wire to the green grounding screw.

Insert the fan motor unit (bottom), and attach mounting screws. Connect the fan motor plug to the built-in receptacle on the wire connection box. Attach the fan grill to the frame, using the mounting clips included with the fan kit.

How to Connect Light Fixtures

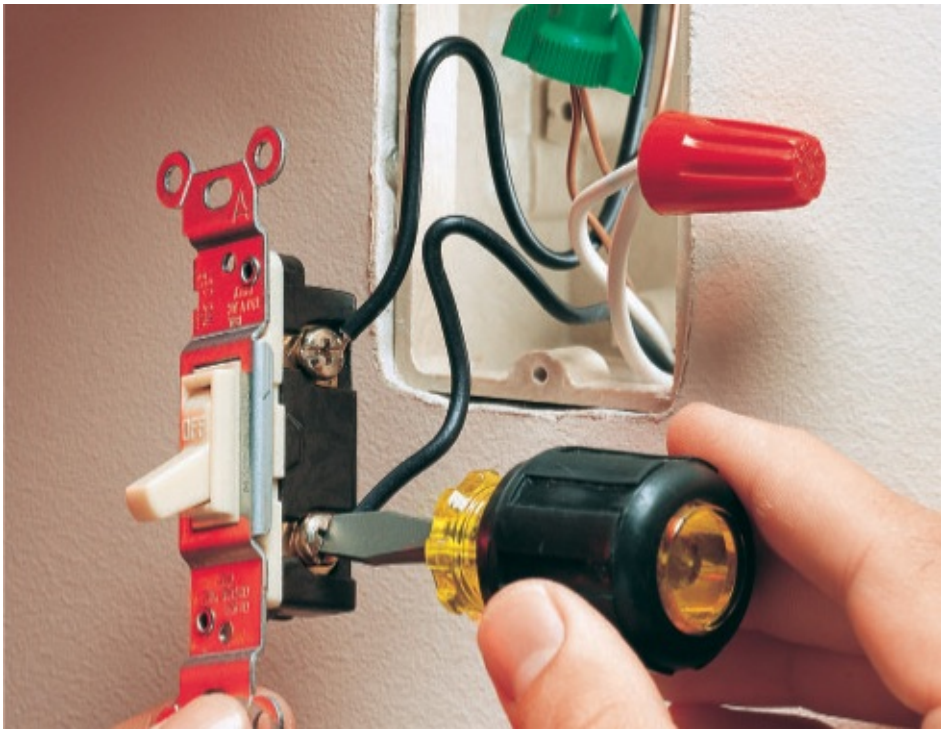
Attach a mounting strap with threaded nipple to the box, if required by the light fixture manufacturer. Connect the black circuit wire to the black wire lead on the light fixture, and connect the white circuit wire to the white wire lead. Connect the circuit grounding wire to the grounding screw on the mounting strap. Carefully tuck all wires into the electrical box, then position the fixture over the nipple, and attach it with the mounting nut.

How to Connect the Bathroom GFCI Receptacle



Attach a black pigtail wire to brass screw terminal marked line. Join all black wires with a wire connector. Attach a white pigtail wire to the silver screw terminal marked line, then join all white wires with a wire connector. Attach a grounding pigtail to the green grounding screw, then join all grounding wires. Tuck all wires into the box, then attach the receptacle and the coverplate.

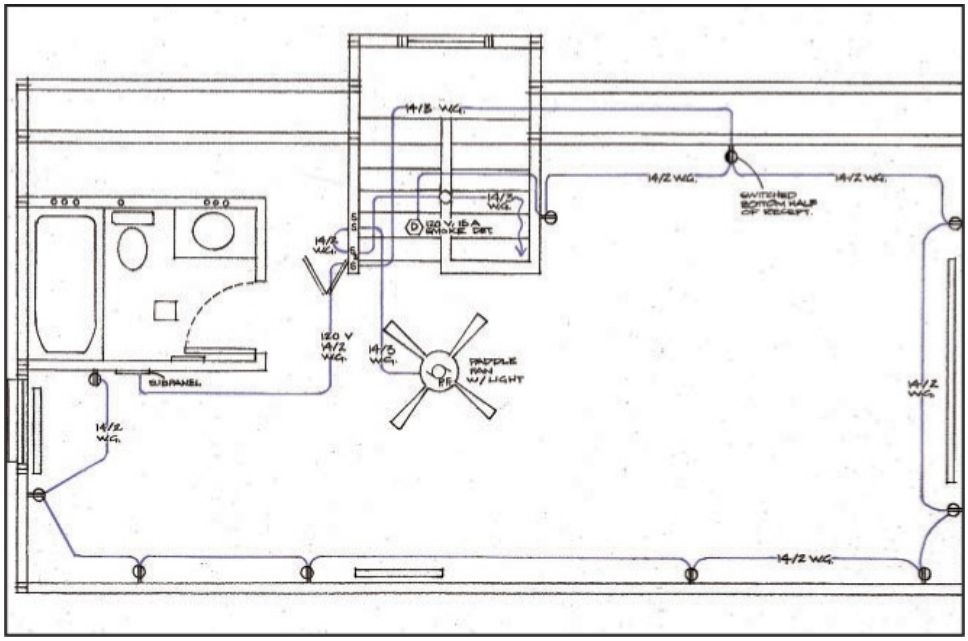
How to Connect the Single-pole Switch



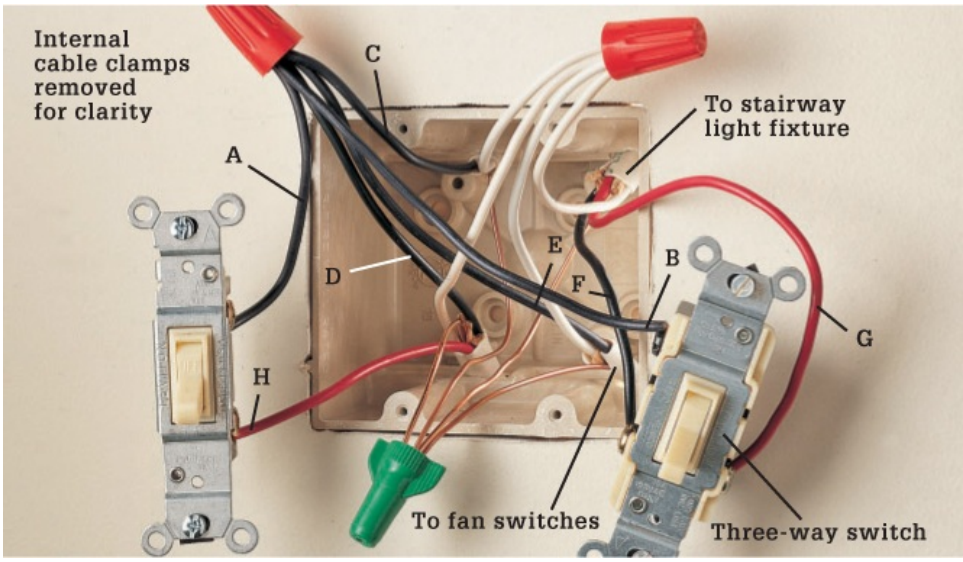
Attach the black circuit wires to the brass screw terminals on the switch. Use wire connectors to join the white neutral wires together and the bare copper grounding wires together. Tuck all wires into the box, then attach the switch and the coverplate.

CIRCUIT #4 A 15-amp, 120-volt basic lighting/receptacle circuit serving the office and bedroom areas.

- Single-pole switch for split receptacle, three-way switch for stairway light fixture
- Speed-control and dimmer switches for ceiling fan
- Switched duplex receptacle
- 15-amp, 120-volt receptacles
- Ceiling fan with light fixture
- Smoke detector
- Stairway light fixture
- 15-amp single-pole circuit breaker

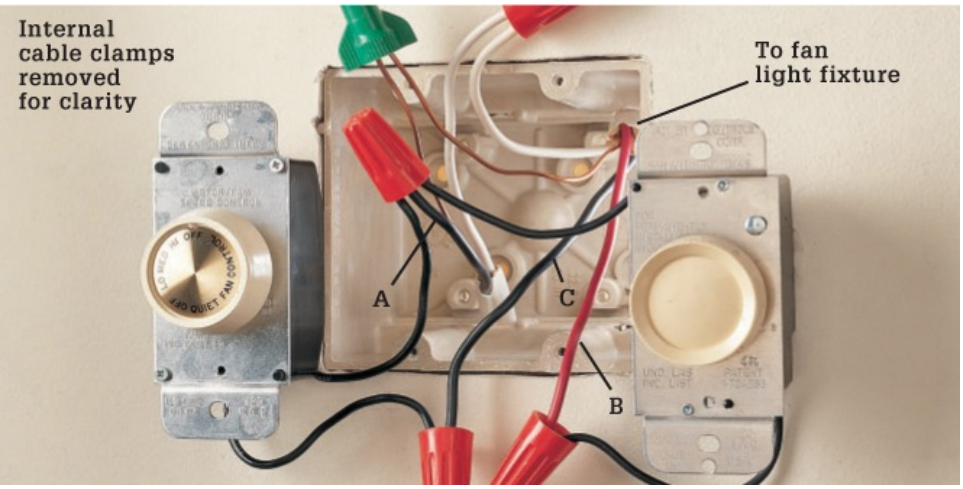

14/3 WIG.
14/2 WIG.
14/2 WIG.
SWITCHED BOTTOM HALF OF RECEPT.
14/3 WIG.
D 120 V. 15 A WHOLE DET.
14/2 WIG.
120 V 14/2 WIG.
14/3 WIG.
PADDLE FAN W/ LIGHT
SUBPANEL
14/2 WIG.
14/2 WIG.
14/2 WIG.

How to Connect Switches for Receptacle & Stairway Light



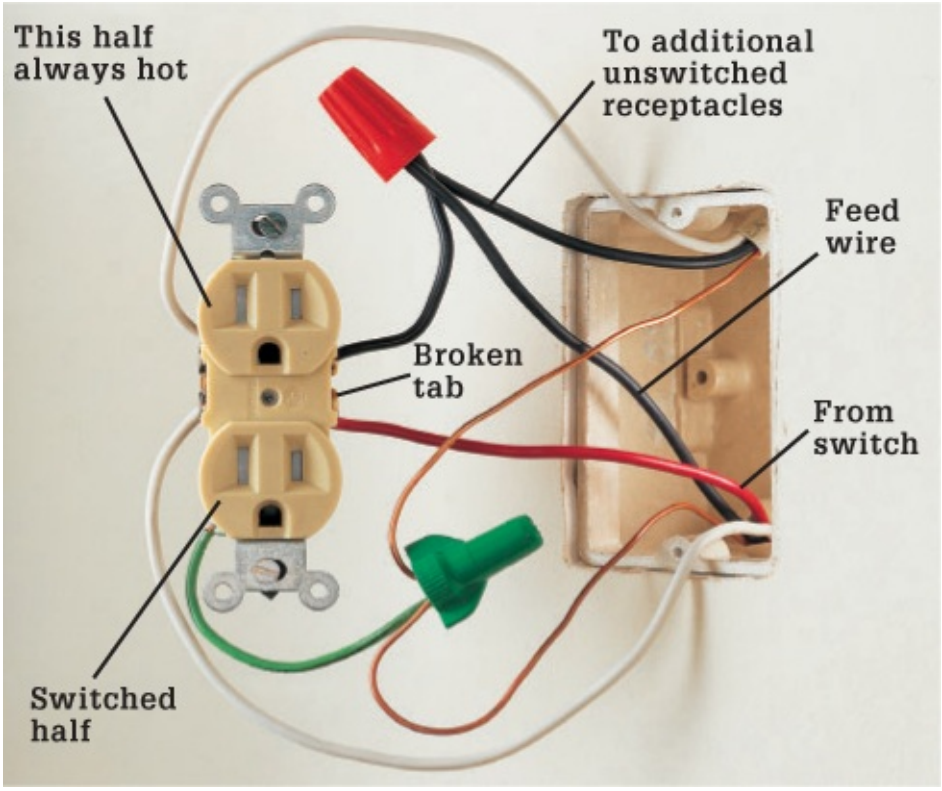
Attach a black pigtail wire (A) to one of the screws on the single-pole switch and another black pigtail (B) to common screw on three-way switch. Use a wire connector to connect pigtail wires to black feed wire (C), to black wire running to unswitched receptacles (D), and to the black wire running to fan switches (E). Connect remaining wires running to light fixture (F, G) to traveler screws on three-way switch. Connect red wire running to switched receptacle (H) to remaining screw on single-pole switch. Use wire connectors to join white wires and grounding wires. Tuck all wires into box, then attach switches and coverplate.

How to Connect the Ceiling Fan Switches



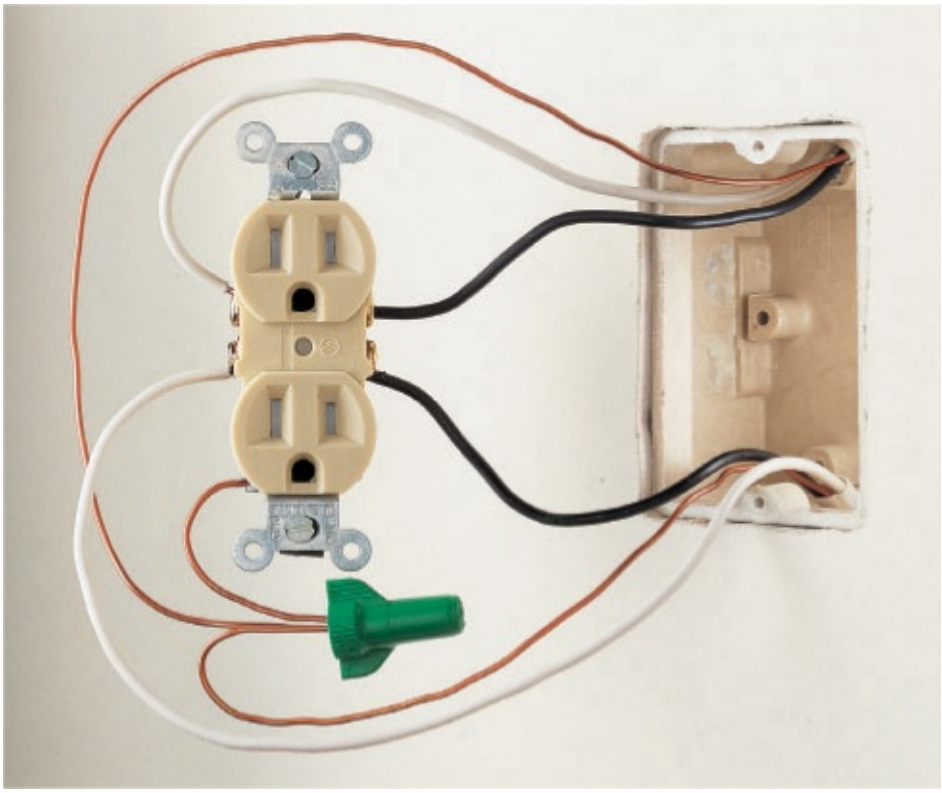
Connect the black feed wire (A) to one of the black wire leads on each switch, using a wire connector. Connect the red circuit wire (B) running to the fan light fixture to the remaining wire lead on the dimmer switch. Connect the black circuit wire (C) running to the fan motor to the remaining wire lead on the speed-control switch. Use wire connectors to join the white wires and the grounding wires. Tuck all wires into the box, then attach the switches, coverplate, and switch dials.

How to Connect a Switched Receptacle



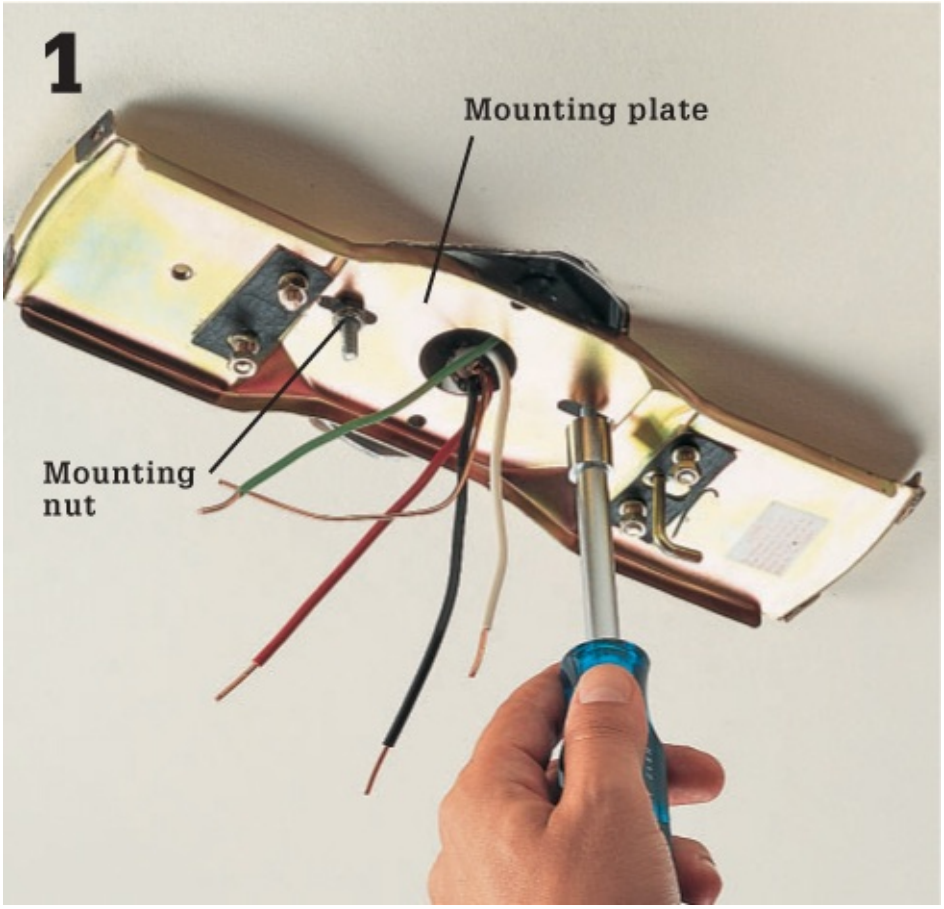
Break the connecting tab between the brass screw terminals on the receptacle, using needlenose pliers. Attach the red wire to the bottom brass screw. Connect a black pigtail wire to the other brass screw, then connect all black wires with a wire connector. Connect white wires to silver screws. Attach a grounding pigtail to the green grounding screw, then join all the grounding wires, using a wire connector. Tuck the wires into the box, then attach the receptacle and coverplate.

How to Connect Receptacles

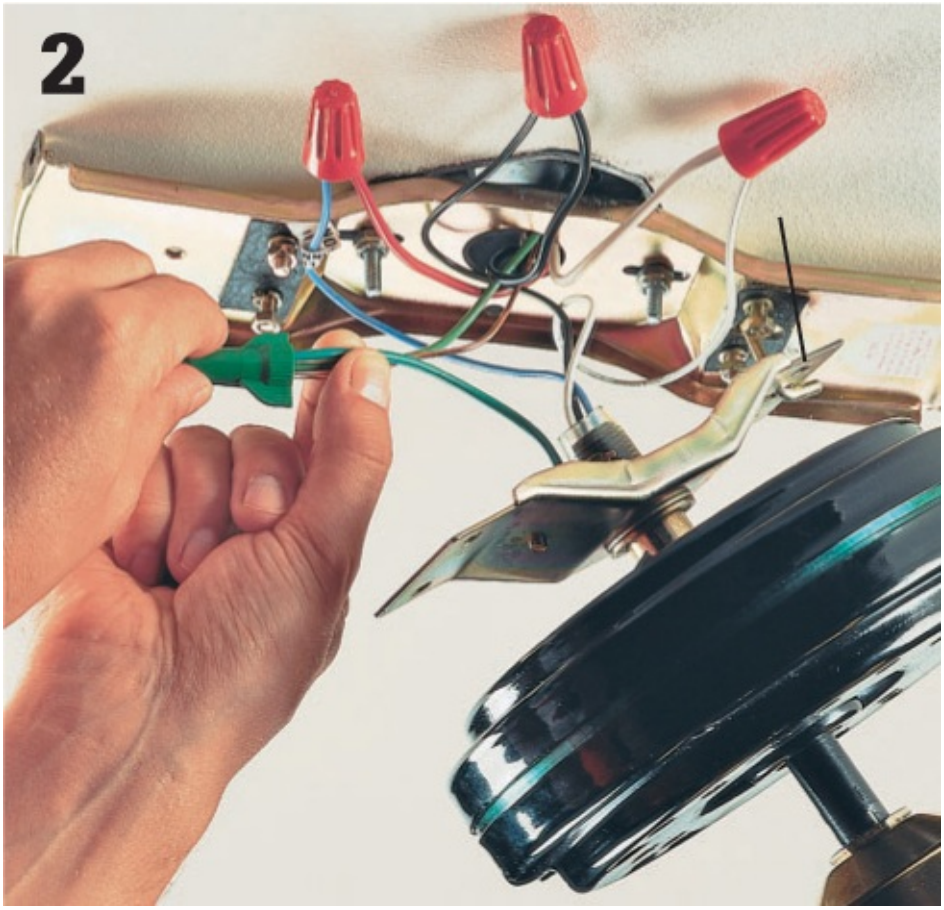


Connect the black circuit wires to the brass screw terminals on the receptacle, and the white wires to the silver terminals. Attach a grounding pigtail to the green grounding screw on the receptacle, then join all grounding wires with a wire connector. Tuck the wires into the box, then attach the receptacle and coverplate.

How to Connect a Ceiling Fan/Light Fixture



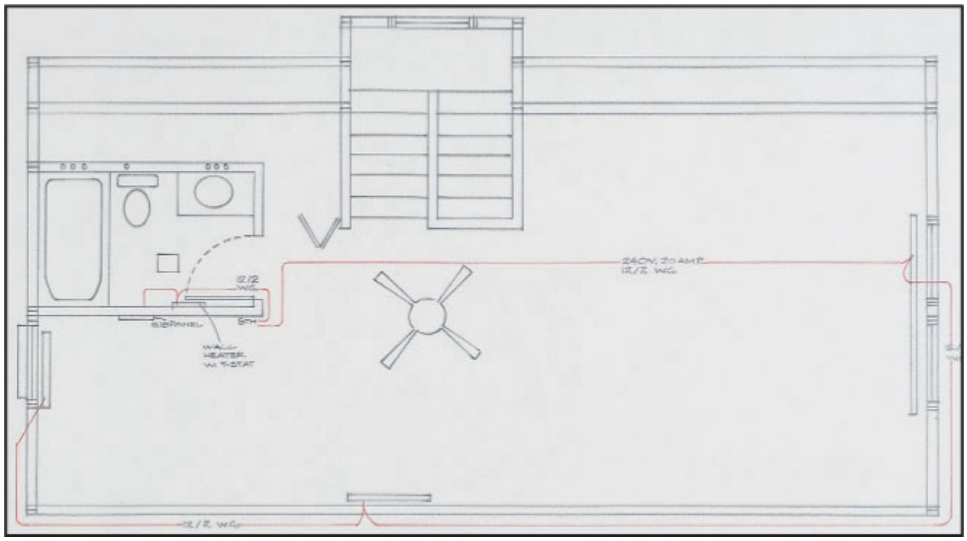
Place the ceiling fan mounting plate over the stove bolts extending through the electrical box. Pull the circuit wires through the hole in the center of the mounting plate. Attach the mounting nuts, and tighten them with a nut driver.



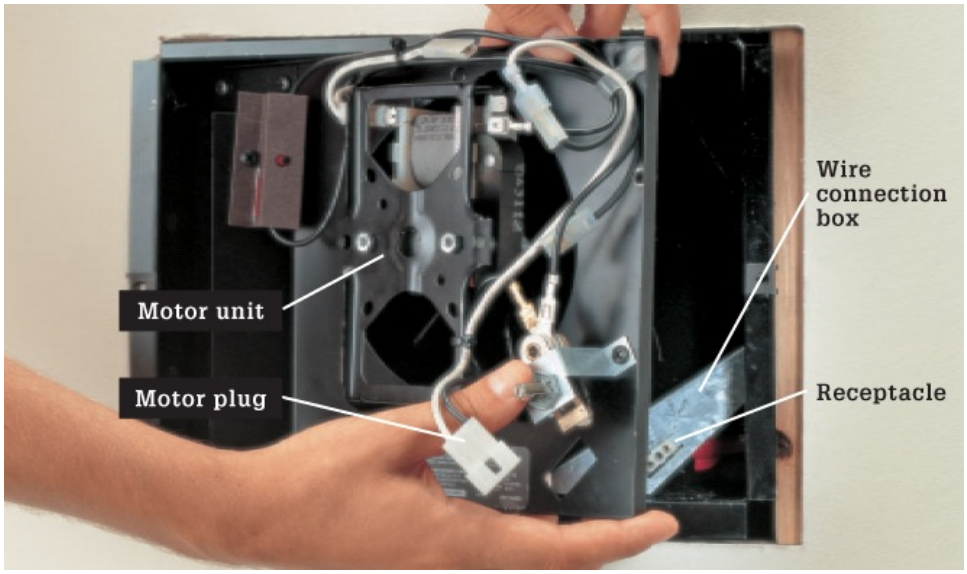
Hang fan motor from mounting hook. Connect black circuit wire to black wire lead from fan, using a wire connector. Connect red circuit wire from dimmer to blue wire lead from light fixture, white circuit wire to white lead, and grounding wires to green lead. Complete assembly of fan and light fixture, following manufacturer's directions.

CIRCUIT #5 A 20-amp, 240-volt circuit serving the bathroom blower-heater and three baseboard heaters controlled by a wall thermostat.

- 240-volt blower-heater
- 240-volt thermostat
- 240-volt baseboard heaters
- 20-amp double-pole circuit breaker (see pages 38 to 39 for instructions on hooking up the circuit at the circuit breaker panel)

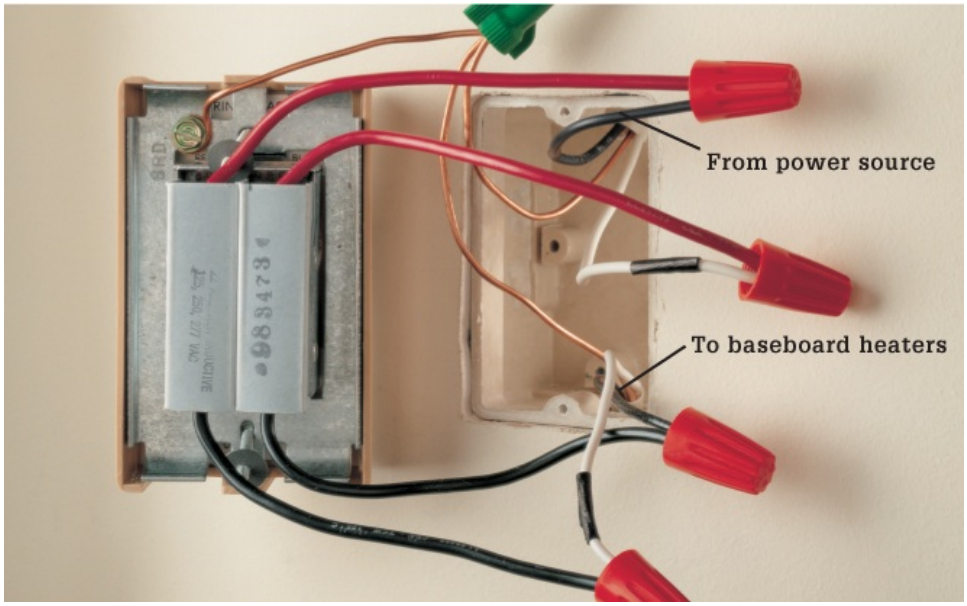

12/2
WG
SUB PANEL
WALL
HEATER
W/ T-STAT
240V, 20 AMP
12/2 WG.
12/2 WG.

How to Connect a 240-volt Blower-Heater



Blower-heaters: In the heater's wire connection box, connect one of the wire leads to the white circuit wires, and the other wire lead to the black circuit wires, using same method as for baseboard heaters (page, opposite). Insert the motor unit, and attach the motor plug to the built-in receptacle. Attach the coverplate and thermostat knob. *Note: Some types of blower-heaters can be wired for either 120 volts or 240 volts. If you have this type, make sure the internal plug connections are configured for 240 volts.*

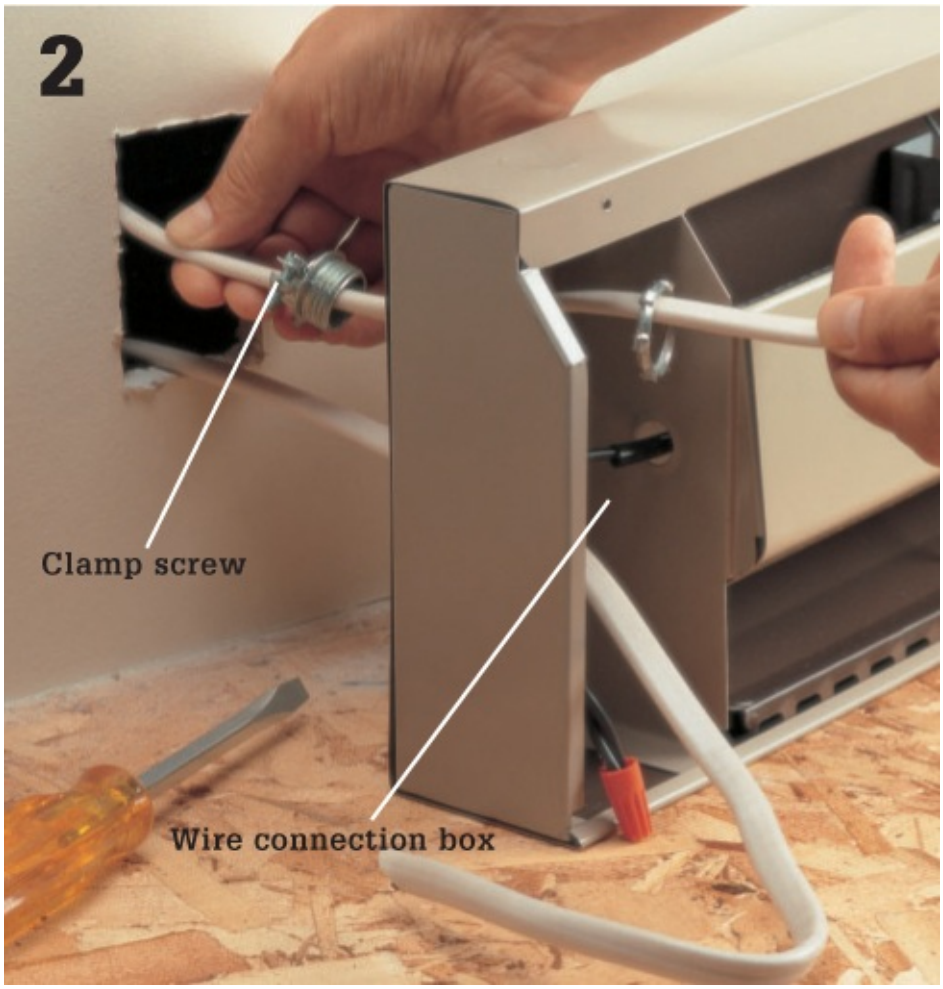
How to Connect a 240-volt Thermostat



Connect the red wire leads on the thermostat to the circuit wires entering the box from the power source, using wire connectors. Connect black wire leads to circuit wires leading to the baseboard heaters. Tag the white wires with black tape to indicate they are hot. Attach a grounding pigtail to the grounding screw on the thermostat, then connect all grounding wires. Tuck the wires into the box, then attach the thermostat and coverplate. Follow manufacturer's directions: the color coding for thermostats may vary.

How to Connect 240-volt Baseboard Heaters

At the cable location, cut a small hole in the wallboard, 3" to 4" above the floor, using a wallboard saw. Pull the cables through the hole, using a piece of stiff wire with a hook on the end. Middle-of-run heaters will have 2 cables, while end-of-run heaters have only 1 cable.



Remove the cover on the wire connection box. Open a knockout for each cable that will enter the box, then feed the cables through the cable clamps and into the wire connection box. Attach the clamps to the wire connection box and tighten the clamp screws until the cables are gripped firmly.

Anchor heater against wall, about 1" off floor, by driving flat-head screws through back of housing and into studs. Strip away cable sheathing so at least 1/4" of sheathing extends into the heater. Strip 3/4" of insulation from each wire, using a combination tool.

Use wire connectors to connect the white circuit wires to one of the wire leads on the heater. Tag white wires with black tape to indicate they are hot. Connect the black circuit wires to the other wire lead. Connect a grounding pigtail to the green grounding screw in the box, then join all grounding wires with a wire connector. Reattach cover.

Wiring a Kitchen

The photo at left shows the circuits you would probably want to install in a total kitchen remodel. Kitchens require a wide range of electrical services, from simple 15-amp lighting circuits to 120/240, 50-amp appliance circuits. This kitchen example has seven circuits, including separate dedicated circuits for a dishwasher and food disposer. Some codes allow the disposer and dishwasher to share a single circuit.

All rough carpentry and plumbing should be in place before beginning any electrical work. As always, divide a project of this scale into manageable steps, and finish one step before moving on. Turn to pages 66 to 67 to see this project represented as a wiring diagram.

Individual Circuits

#1 & #2: Small-appliance circuits. Two 20-amp, 120-volt circuits supply power to countertop and eating areas for small appliances. All general-use receptacles must be on these circuits. One 12/3 cable fed by a 20-amp double-pole breaker wires both circuits. These circuits share one electrical box with the disposer circuit (#5), and another with the basic lighting circuit (#7). Other circuits may also service the area, as with a dedicated refrigerator circuit.

#3: Range circuit. A 40 or 50-amp, 120/240-volt dedicated circuit supplies power to the range/ oven appliance. It is wired with 6/3 copper cable.

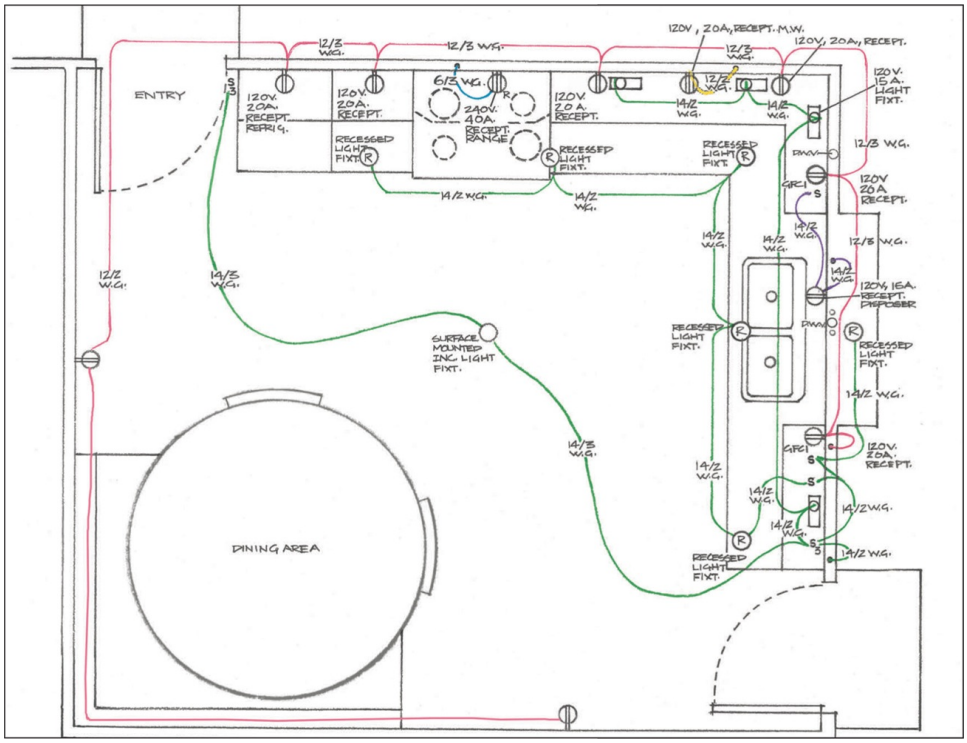
#4: Microwave circuit. It is wired with 12/2 cable. Microwaves that use less than 300 watts can be

installed on a 15-amp circuit or plugged into the small-appliance circuits.

#5: Food disposer/dishwasher circuit. A dedicated 15-amp, 120-volt circuit supplies power to the disposer. It is wired with 14/2 cable. Some local codes may allow disposer to be on the same circuit as the dishwasher if it is a 20-amp circuit.

#6: Basic lighting circuit. A 15-amp, 120-volt circuit powers the ceiling fixture, recessed fixtures, and undercabinet task lights. 14/2 and 14/3 cables connect the fixtures and switches in the circuit. Each task light has a self-contained switch.

Diagram View



The diagram at left shows the layout of the seven circuits and the locations of their receptacles, switches, fixtures, and devices as shown in the photo on the previous pages. The circuits and receptacles are based on the needs of a 175-sq.-ft. space kitchen. An inspector will want to see a diagram like this one before issuing a permit. After you've received approval for your addition, the wiring diagram will serve as your guide as you complete your project.

Circuits #1 & #2: Two 20-amp, 120-volt small-appliance circuits wired with one cable. All general-use receptacles must be on these circuits, and they must be GFCI units. Includes: two GFCI receptacles rated for 20 amps, five electrical boxes that are 4 × 4", and 12/3 cable.

Circuit #3: A 50-amp, 120/240-volt dedicated circuit for the range. Includes: a 4 × 4" box; a 120/240-volt, 50-amp range receptacle; and 6/3 NM copper cable.

Circuit #4: A 20-amp, 120-volt dedicated circuit for the microwave. Includes: a 20-amp duplex receptacle, a single-gang box, and 12/2 NM cable.

Circuit #5: A 15-amp, 120-volt dedicated circuit for the food disposer. Includes: a 15-amp duplex receptacle, a single-pole switch (installed in a double-gang box with a GFCI receptacle from the small-appliance circuits), one single-gang box, and 14/2 cable.

Circuit #6: A 15-amp, 120-volt basic lighting circuit serving all of the lighting needs in the kitchen. Includes: two single-pole switches, two three-way switches, single-gang box, 4 × 4" box, triple-gang box (shared with one of the GFCI receptacles from the small-appliance circuits), plastic light fixture box with brace, ceiling light fixture, four fluorescent undercabinet light fixtures, six recessed light fixtures, 14/2 and 14/3 cables.

Making Connections

Make the final connections for switches, receptacles, and fixtures after the rough-in inspection. First make final connections on recessed fixtures (it is easier to do this before wallboard is installed). Then finish the work on walls and ceiling, install the cabinets, and make the rest of the final connections. Use the photos on the following pages and the circuit maps as a guide for making the final connections. The last step is to connect the circuits at the breaker panel. After all connections are made, your work is ready for the final inspection.

Tools & Materials

Pigtail wires

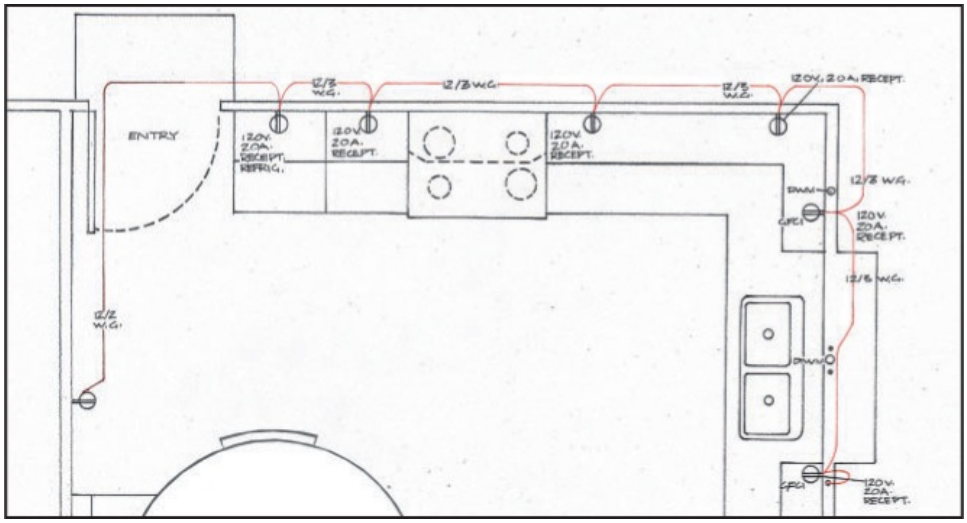
Wire connectors

Black electrical tape

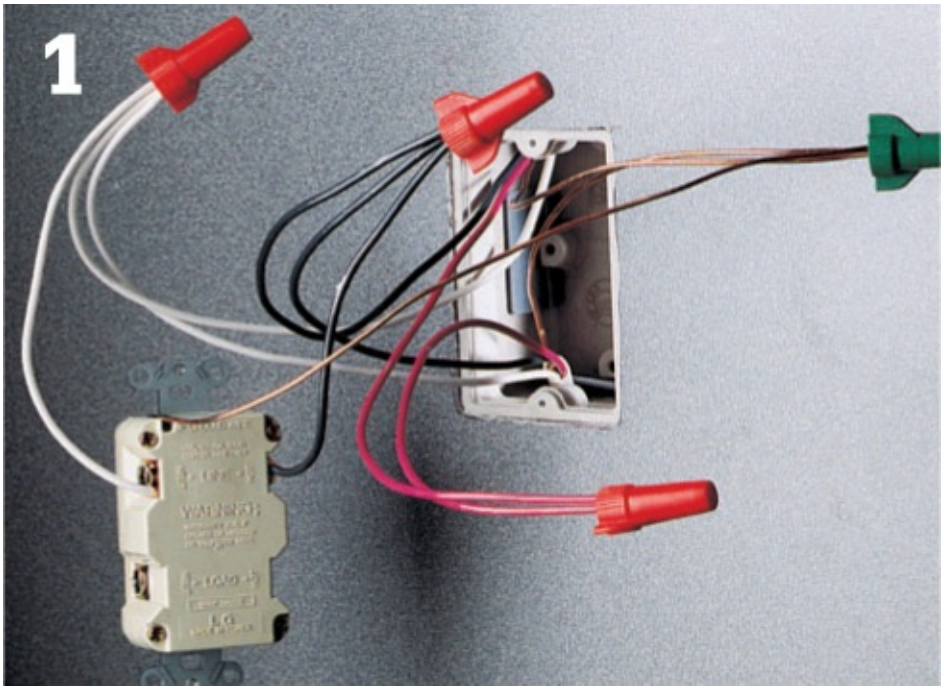
CIRCUITS #1 & #2 Two 20-amp, 120-volt small-appliance circuits.

- 2 GFCI receptacles
- 20-amp double-pole circuit breaker

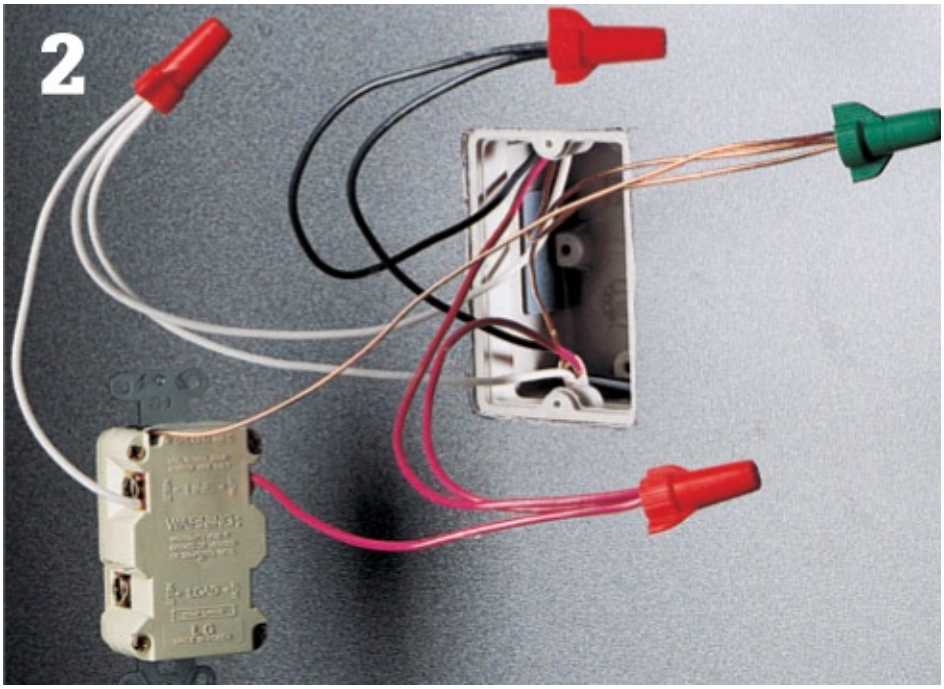
Note: *In this project, two of the GFCI receptacles are installed in boxes that also contain switches from other circuits (page opposite).*



How to Connect Small-appliance Receptacles (two alternating 20-amp circuits in one 12/3 cable)

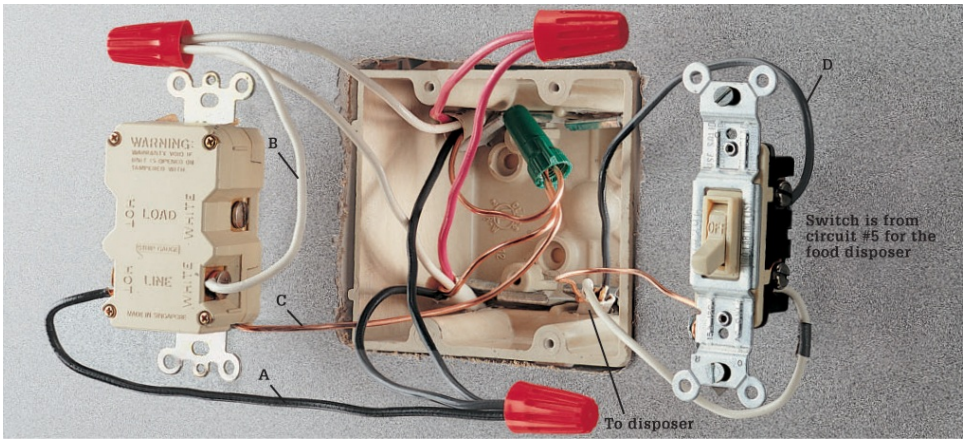


At alternate receptacles in the cable run (first, third, etc.), attach a black pigtail to a brass screw terminal marked line on the receptacle and to black wire from both cables. Connect a white pigtail to a silver screw (line) and to both white wires. Connect a grounding pigtail to the grounding screw and to both grounding wires. Connect both red wires together. Tuck wires into box, then attach the receptacle and coverplate.



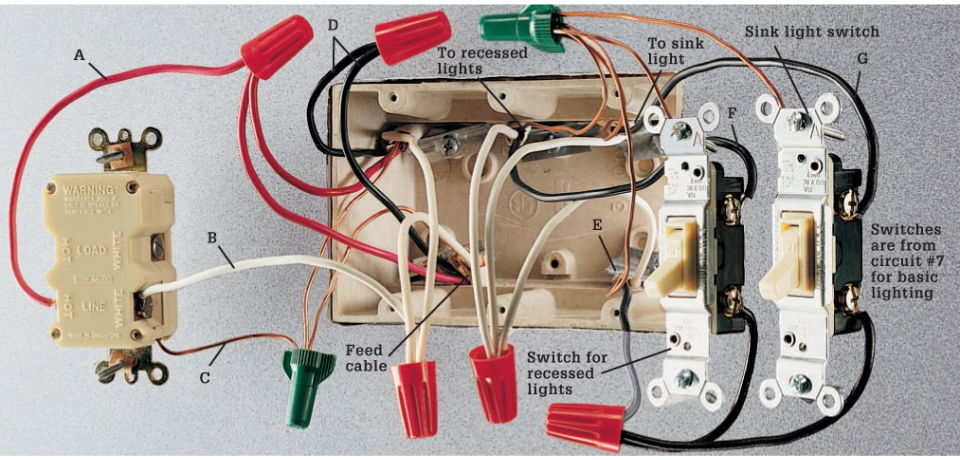
At remaining receptacles in the run, attach a red pigtail to a brass screw terminal (line) and to red wires from the cables. Attach a white pigtail to a silver screw terminal (line) and to both white wires. Connect a grounding pigtail to the grounding screw and to both grounding wires. Connect both black wires together. Tuck wires into box, attach receptacle and coverplate.

How to Install a GFCI & a Disposer Switch



Connect black pigtail (A) to GFCI brass terminal marked line, and to black wires from three-wire cables. Attach white pigtail (B) to silver terminal marked line, and to white wires from three-wire cables. Attach grounding pigtail (C) to GFCI grounding screw and to grounding wires from three-wire cables. Connect both red wires together. Connect black wire from two-wire cable (D) to one switch terminal. Attach white wire to other terminal, and tag it black indicating it is hot. Attach grounding wire to switch grounding screw. Tuck wires into box; attach switch, receptacle, and coverplate.

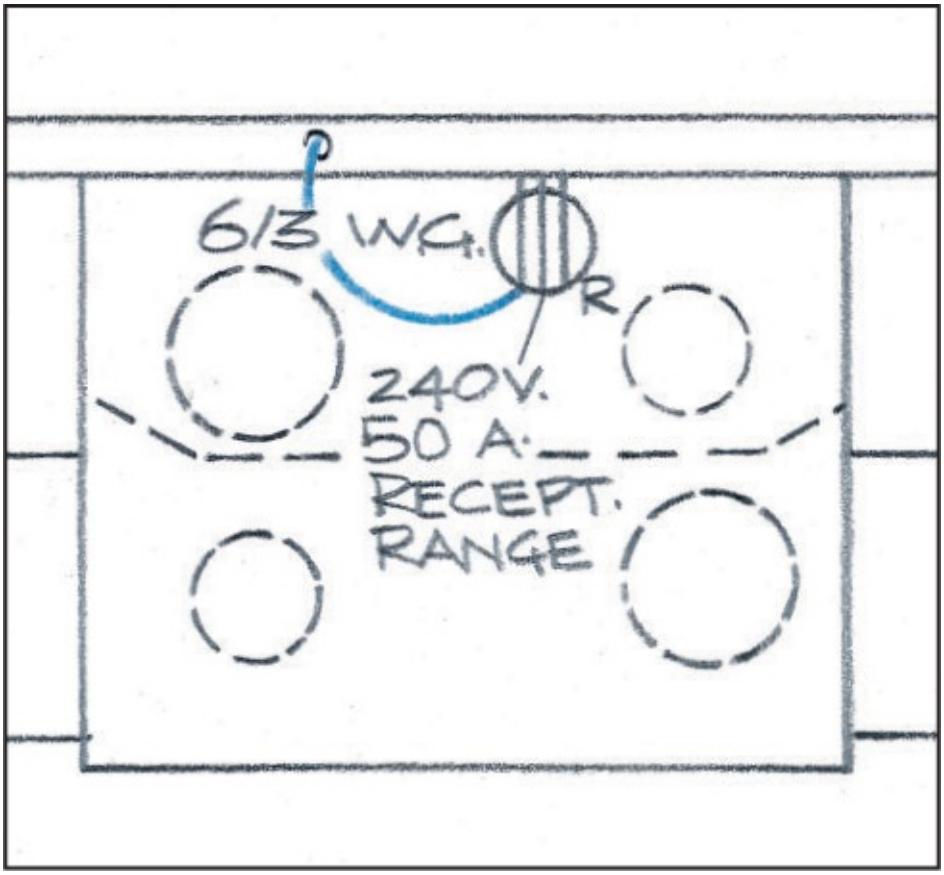
How to Install a GFCI & Two Switches for Recessed Lights



Connect red pigtail (A) to GFCI brass terminal labeled line, and to red wires from three-wire cables. Connect white pigtail (B) to silver line terminal and to white wires from three-wire cables. Attach grounding pigtail (C) to grounding screw and to grounding wires from three-wire cables. Connect black wires from three-wire cables (D) together. Attach a black pigtail to one screw on each switch and to black wire from two-wire feed cable (E). Connect black wire (F) from the two-wire cable leading to recessed lights to remaining screw on the switch for the recessed lights. Connect black wire (G) from two-wire cable leading to sink light to remaining screw on sink light switch. Connect white wires from all two-wire cables together. Connect pigtails to switch grounding screws and to all grounding wires from two-wire cables. Tuck wires into box; attach switches, receptacle, and coverplate.

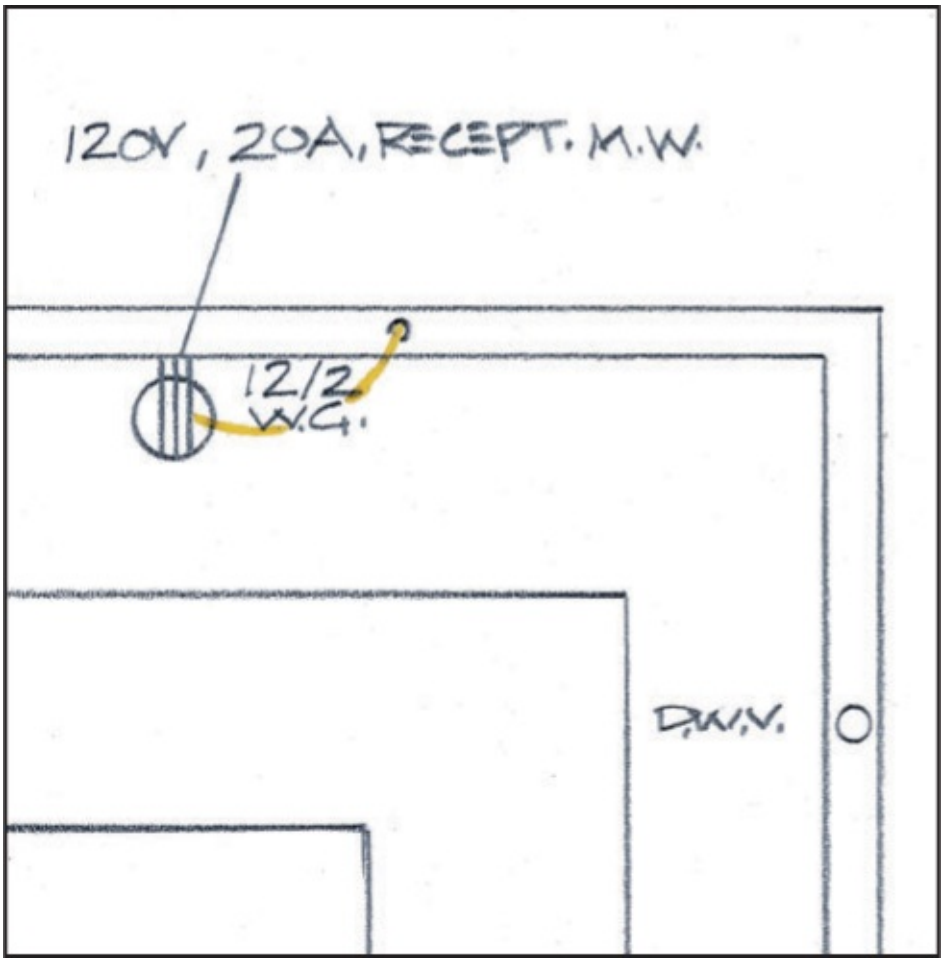
CIRCUIT #3 A 50-amp, 120/240-volt circuit serving the range.

- 50-amp receptacle for range
- 50-amp double-pole circuit breaker

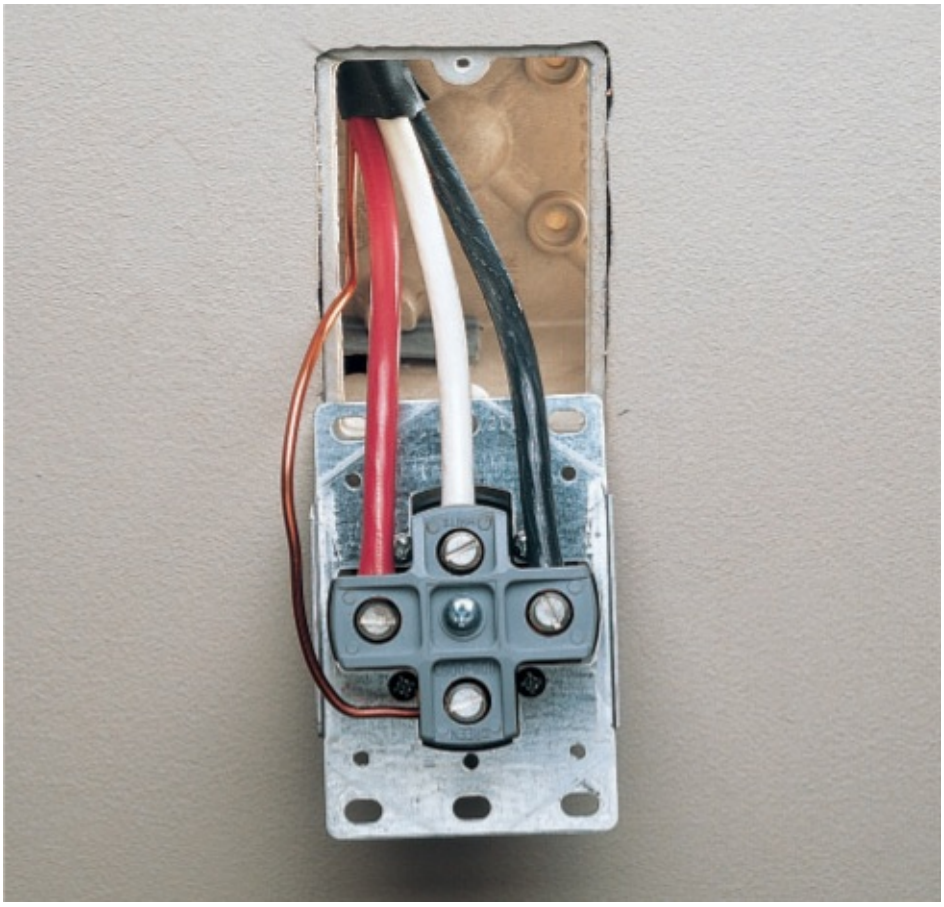


CIRCUIT #4 A 20-amp, 120-volt circuit for the microwave.

- 20-amp duplex receptacle
- 20-amp single-pole circuit breaker

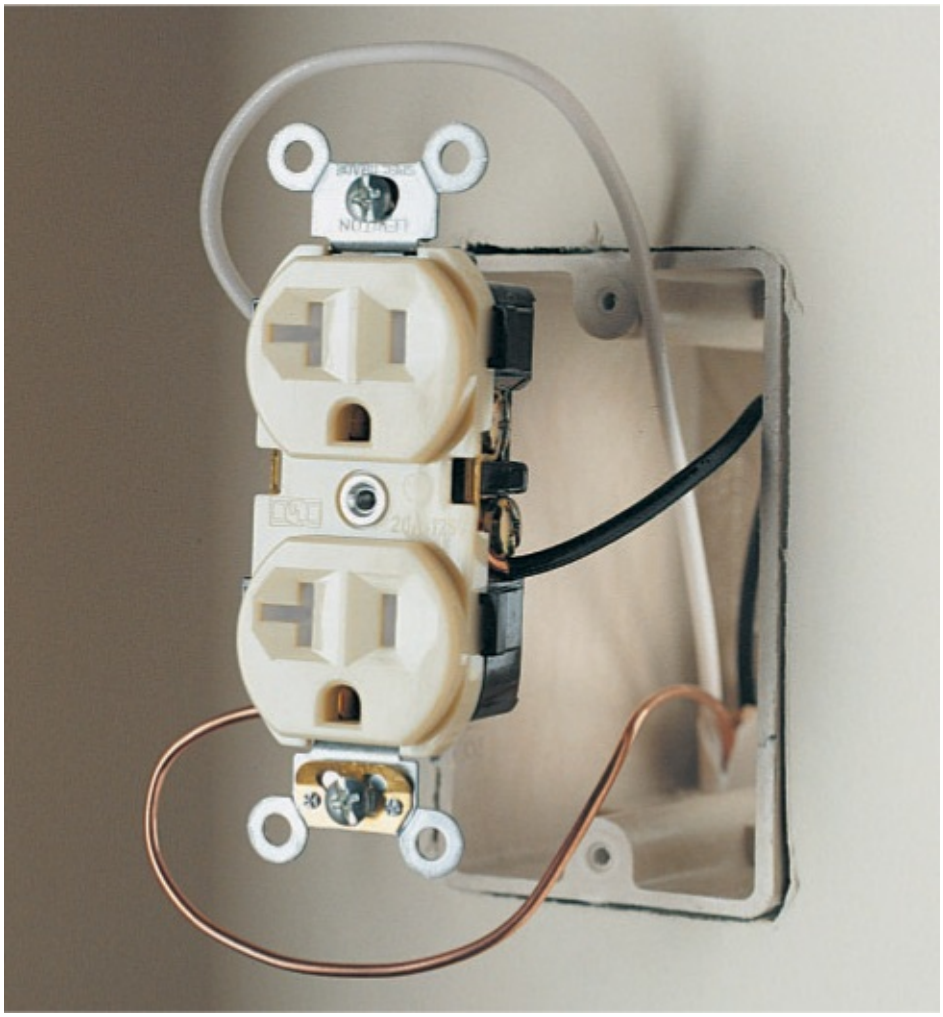

120V, 20A, RECEPT. M.W.
12/2
W.G.
D.W.V.

How to Install 120/240 Range Receptacle



Attach the white wire to the neutral terminal and the black and red wires to the remaining terminals. Attach the bare copper grounding wire to the grounding screw on the receptacle. Attach receptacle and coverplate.

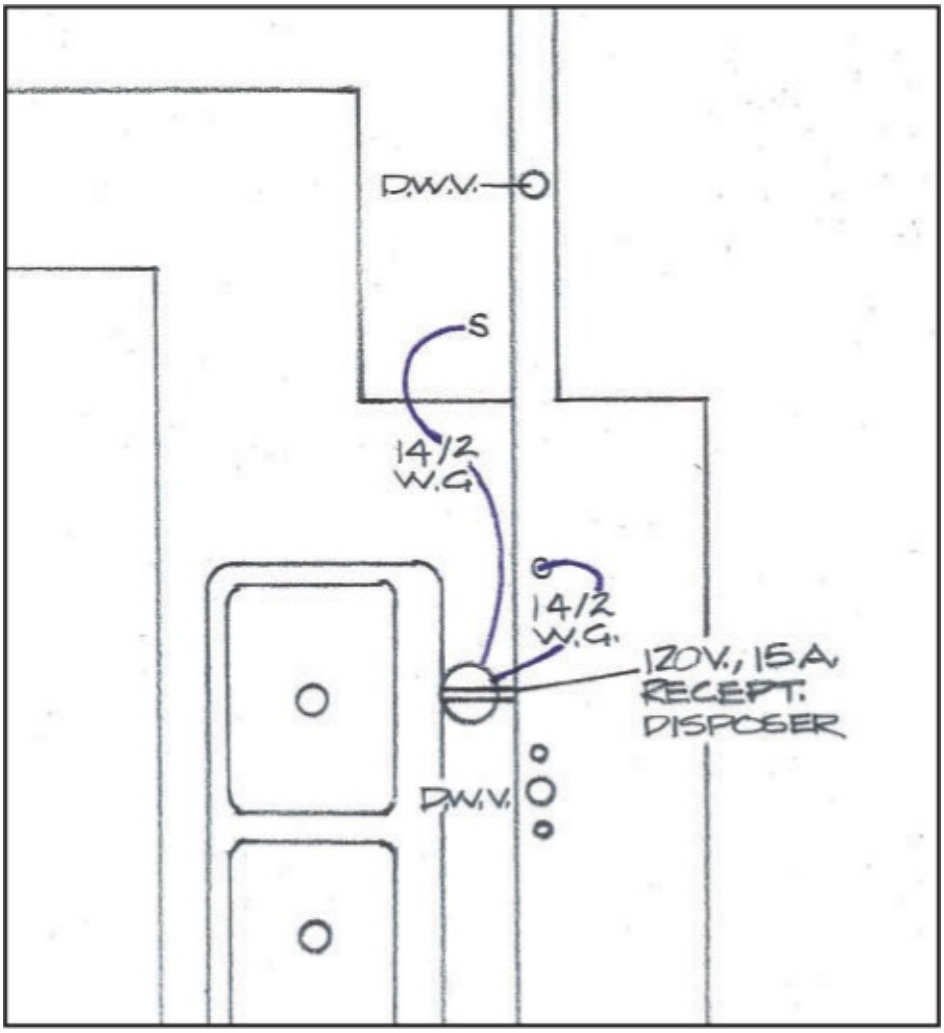
How to Connect Microwave



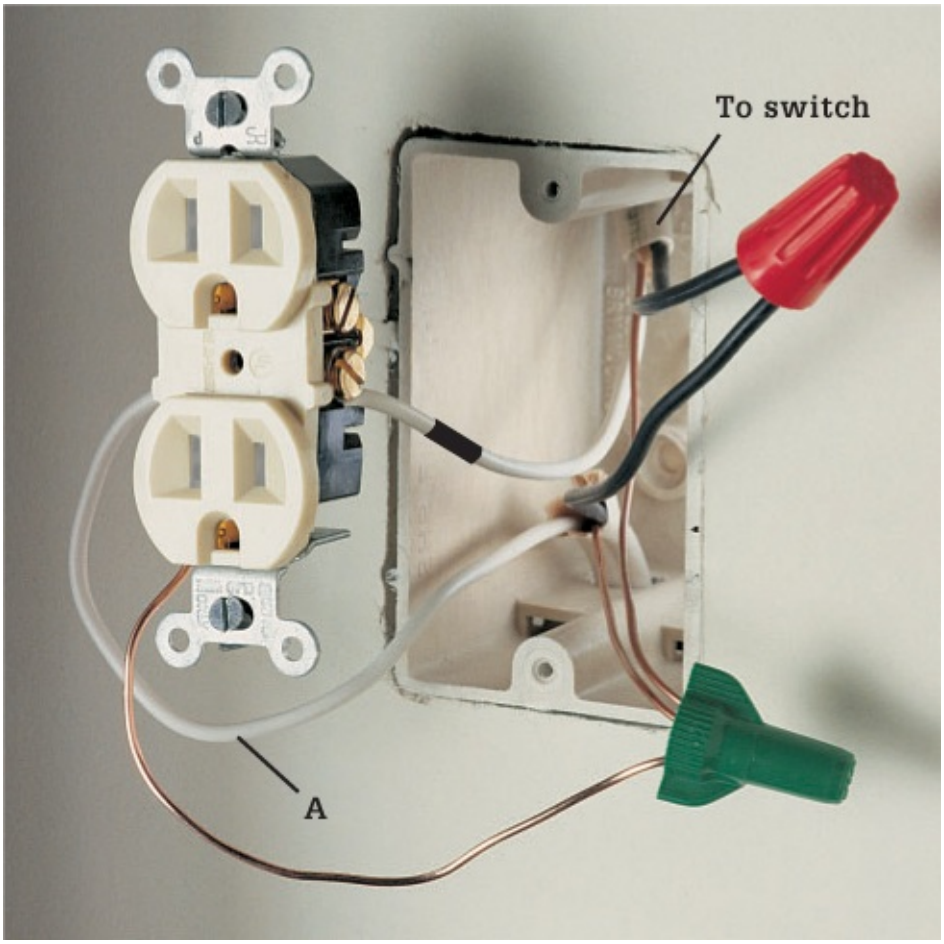
Connect black wire from the cable to a brass screw terminal on the receptacle. Attach the white wire to a silver screw terminal and the grounding wire to the receptacle's grounding screw. Tuck wires into box, then attach the receptacle and the coverplate.

CIRCUIT #5 A 15-amp, 120-volt circuit for the food disposer.

- 15-amp duplex receptacle
- Single-pole switch
- 15-amp single-pole circuit breaker


D.W.V.
S
14/2
W.G.
14/2
W.G.
120V., 15A.
RECEPT.
DISPOSER
D.W.V.

How to Connect Disposer Receptacle

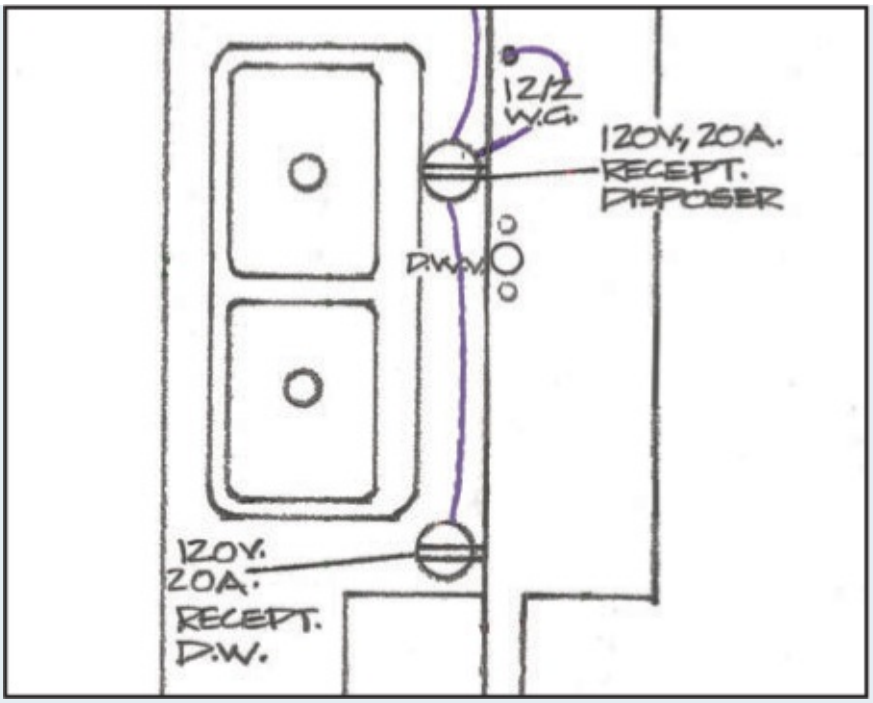


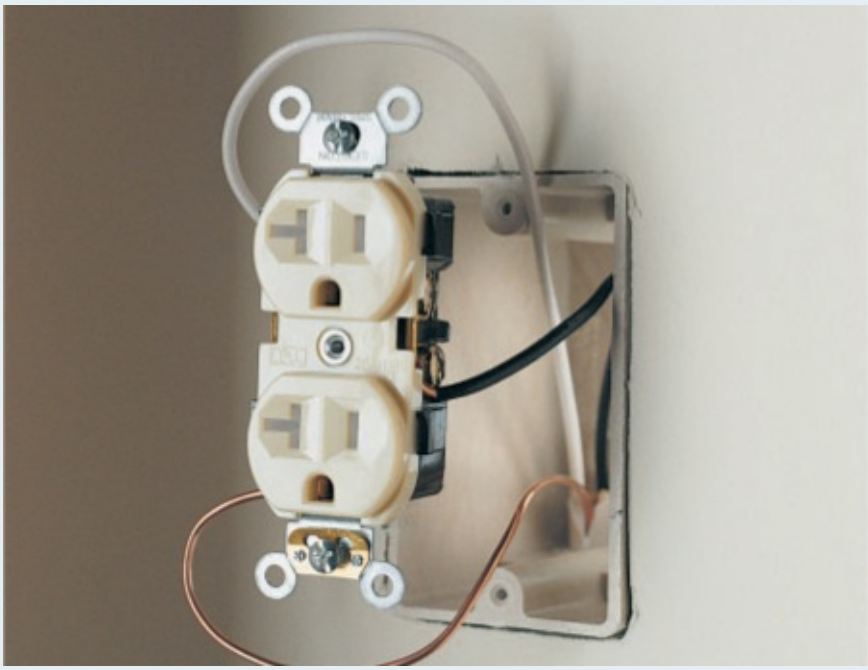
Connect black wires together. Connect white wire from feed cable (A) to silver screw on receptacle. Connect white wire from cable going to the switch to a brass screw terminal on the receptacle, and tag the wire with black indicating it is hot. Attach a grounding pigtail to grounding screw and to both cable grounding wires. Tuck wires into box, then attach receptacle and coverplate.

Circuit #5 Option:

A 20-amp, 120-volt circuit for disposer and dishwasher.

- 20-amp duplex receptacles
- 20-amp single-pole circuit breaker





Connect the black wire to a brass screw terminal. Attach the white wire to a silver screw terminal. Connect the grounding wire to the grounding screw. Tuck wires into box, then attach receptacle and coverplate. *Note:* Appliances with high amperage ratings may not be suitable for this configuration. Check with your local electrical inspector.

CIRCUIT #6 A 15-amp basic lighting circuit serving the kitchen.

• 2 three-way switches with grounding screws

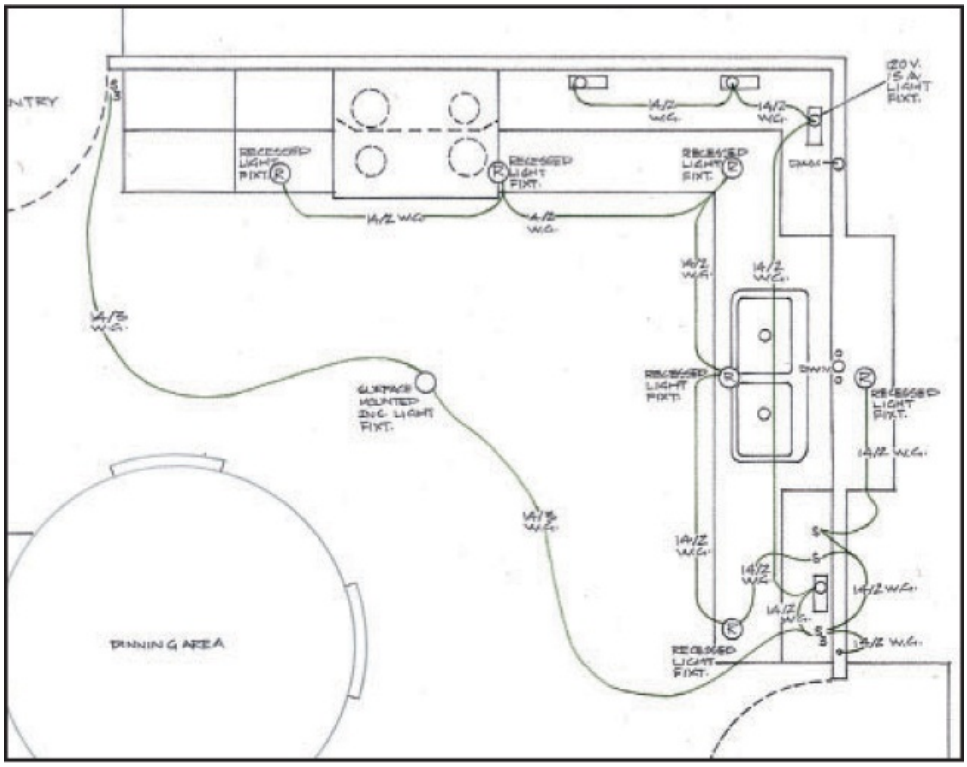
• 2 single-pole switches with grounding screws

• Ceiling light fixture

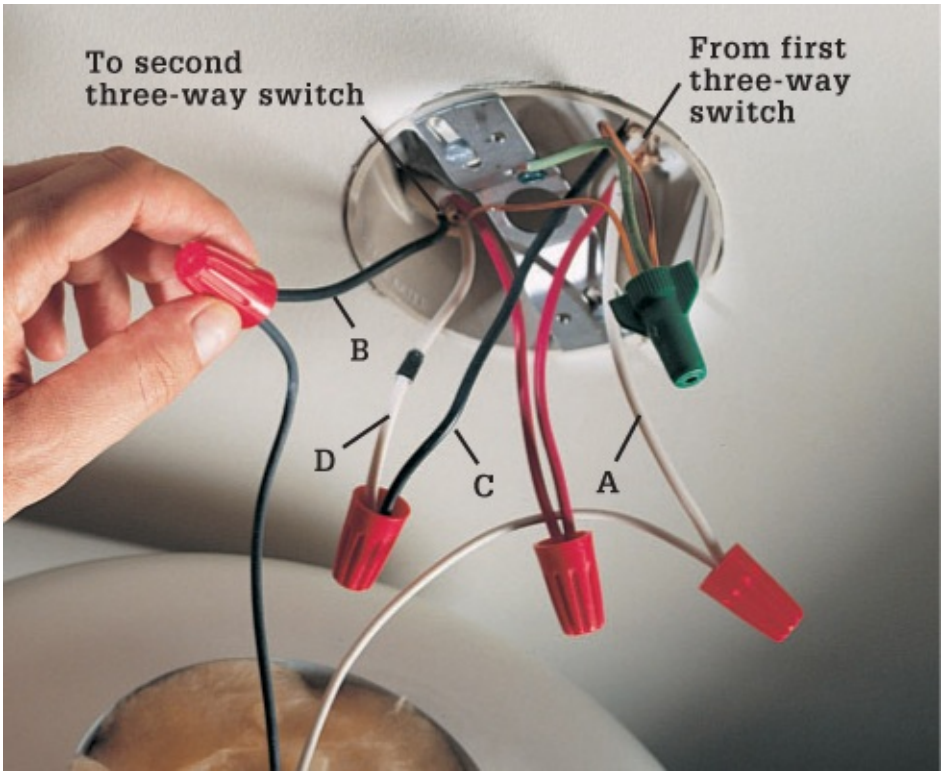
• 6 recessed light fixtures

• 4 fluorescent undercabinet fixtures

• 15-amp single-pole circuit breaker

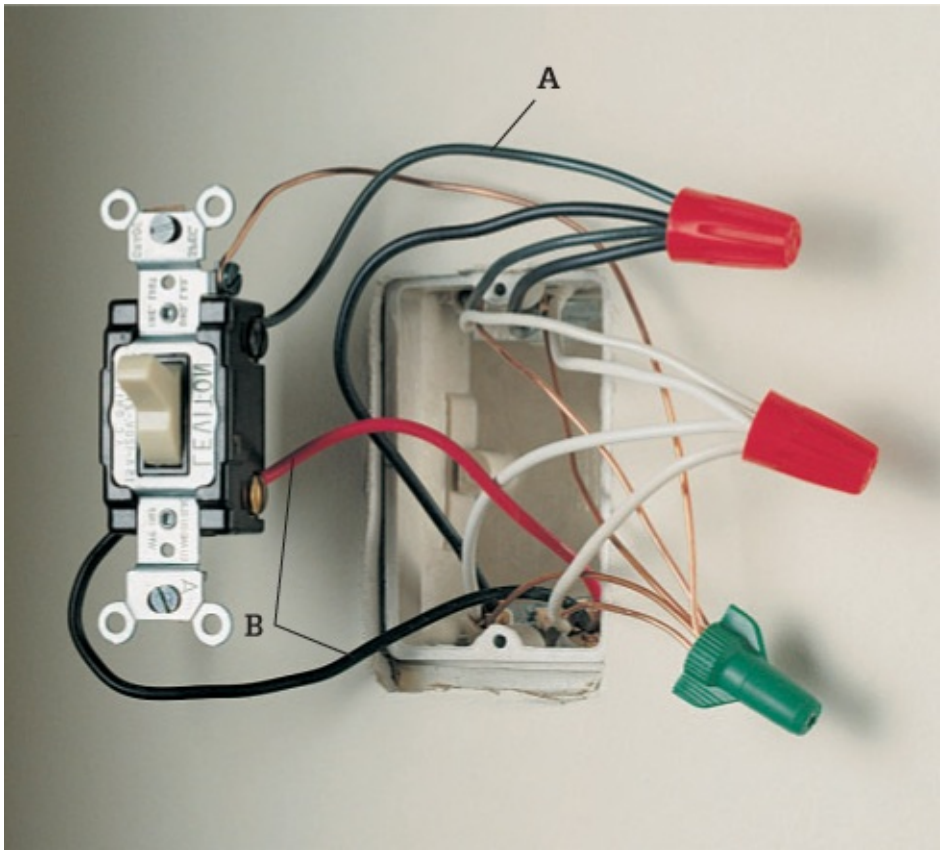


How to Connect Surface-mounted Ceiling Fixture



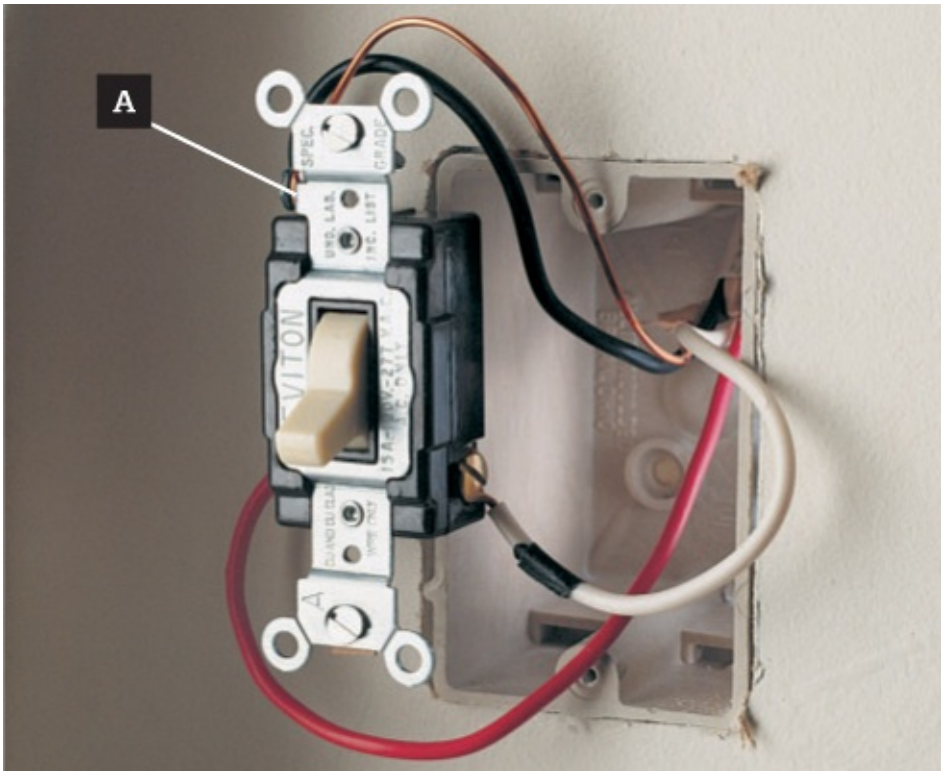
Connect white fixture lead to white wire (A) from first three-way switch. Connect black fixture lead to black wire (B) from second three-way switch. Connect black wire (C) from first switch to white wire (D) from second switch, and tag this white wire with black. Connect red wires from both switches together. Connect all grounding wires together. Mount fixture following manufacturer's instructions.

How to Connect First Three-way Switch



Connect a black pigtail to the common screw on the switch (A) and to the black wires from the two-wire cable. Connect black and red wires from the three-wire cable to traveler terminals (B) on the switch. Connect white wires from all cables entering box together. Attach a grounding pigtail to switch grounding screw and to all grounding wires in box. Tuck wires into box, then attach switch and coverplate.

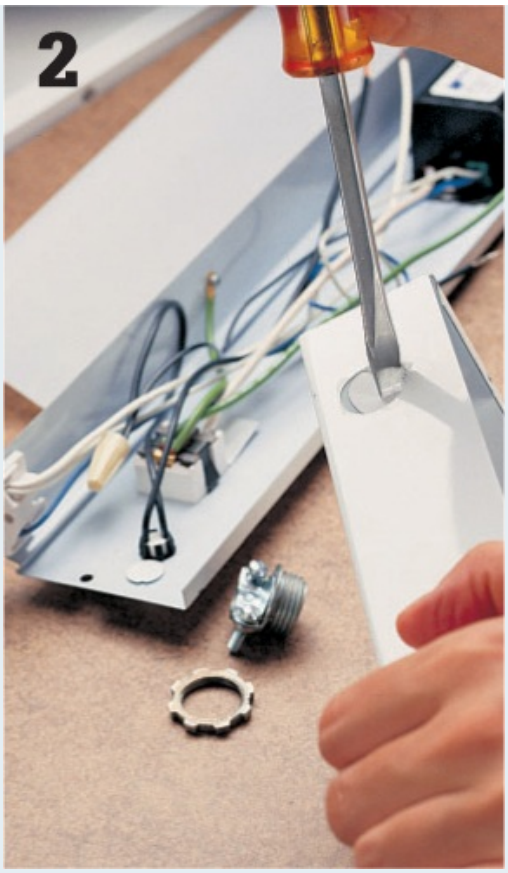
How to Connect Second Three-way Switch



Connect black wire from the cable to the common screw terminal (A). Connect red wire to one traveler screw terminal. Attach the white wire to the other traveler screw terminal and tag it with black indicating it is hot. Attach the grounding wire to the grounding screw on the switch. Tuck wires in box, then attach switch and coverplate.

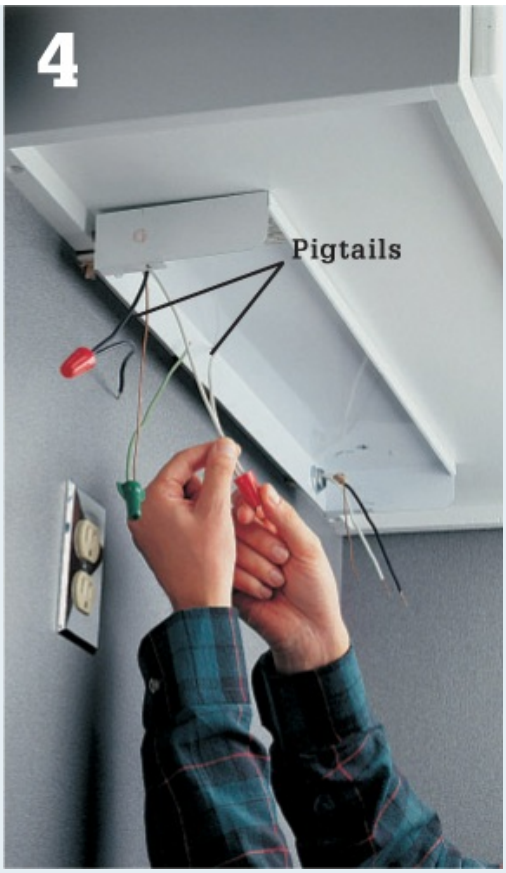
Installing Undercabinet Lights

Drill 5/8" holes through wall and cabinet at locations that line up with knockouts on the fixture, and retrieve cable ends.

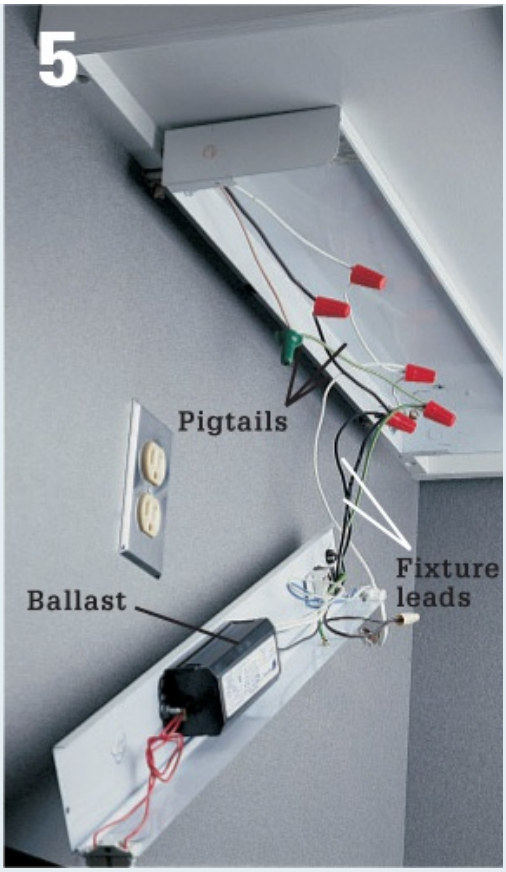


Remove access cover on fixture. Open one knockout for each cable that enters fixture box, and install cable clamps.

Strip 8" of sheathing from each cable end. Insert each end through a cable clamp, leaving 1/4" of sheathing in fixture box.



Screw fixture box to cabinet. Attach black, white, and green pigtails of THHN/THWN wire to wires from one cable entering box. Pigtails must be long enough to reach the cable at other end of box.



Connect black pigtail and circuit wire to black lead from fixture. Connect white pigtail and circuit wire to white lead from fixture. Attach green pigtail and copper circuit wire to green grounding wire attached to the fixture box.

Tuck wires into box, and route THHN/THWN pigtails along one side of the ballast. Replace access cover and fixture lens.

Installing a Solar Light Circuit

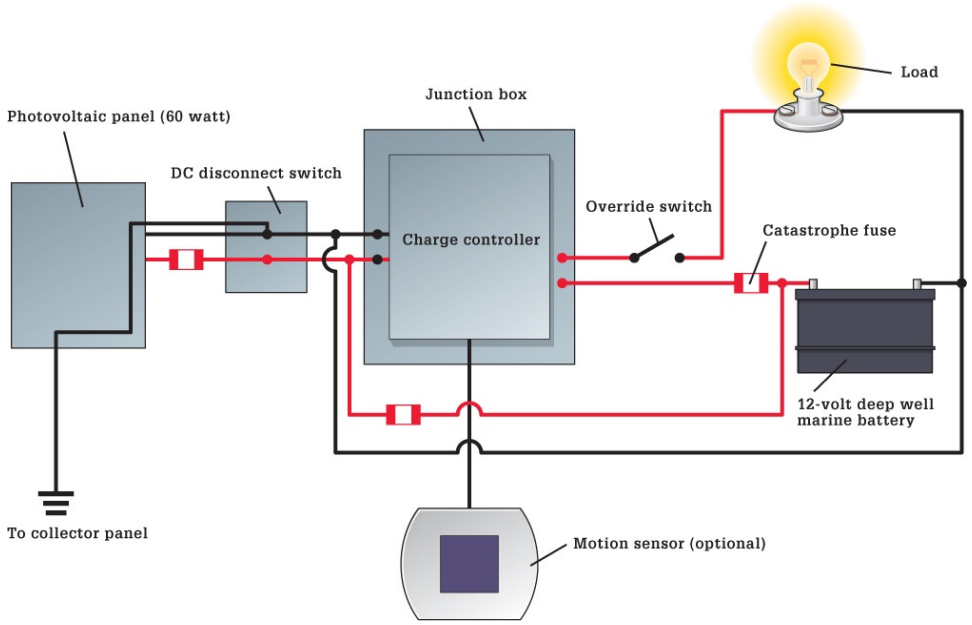
A self-contained electrical circuit with dedicated loads, usually 12-volt light fixtures, is one of the most useful solar amenities you can install. A standalone system is not tied into your power grid, which greatly reduces the danger of installing the components yourself. Plus, the fact that your light fixtures are independent of the main power source means that even during a power outage you will have functioning emergency and security lights.

Installing a single solar-powered circuit is relatively simple, but don't take the dangers for granted. Your work will require permits and inspections in most jurisdictions, and you can't expect to pass if the work is not done to the exact specifications required.

Solar panels that convert the sun's energy into electricity are called photovoltaic (PV) panels, and they produce direct current (DC) power. PV solar panel systems can be small and designed to accomplish a specific task, or they can be large enough to provide power or supplementary power to an entire house. Before you make the leap into a large system, it's a good idea to familiarize yourself with the mechanics of solar power. The small system demonstrated in this project is relatively simple and is a great first step into the world of solar. The fact that the collector, battery, and lights are a standalone system makes this a very easy project to accomplish. By contrast, installing panels that provide direct supplementary power through your main electrical service panel is a difficult wiring job that should be done by professional electricians only.

This 60-watt solar panel is mounted on a garage roof and powers a self-contained home security lighting system. Not only does this save energy costs, it keeps the security lights working even during power outages.

Schematic Diagram for an Off-the-Grid Solar Lighting System



Tools & Materials

Tape measure
Drill/driver with bits
Caulk gun
Crimping tool
Wiring tools
Metal-cutting saw
Photovoltaic panel (50 to 80 watts)
Charge controller
Catastrophe fuse
Battery sized for 3 day autonomy
Battery case
Battery cables
12 volt LED lights including motion-sensor light
Additional 12-volt light fixtures as desired

20 ft. Unistrut 1-7/8” thick U-channel (See Resources, page 125)
(4) 45° Unistrut connectors
(2) 90° Unistrut angle brackets
(4) Unistrut hold down clamps
(12) 3/8” spring nuts
(12) 3/8”-dia. × 1”-long hex-head bolts with washers
DC-rated disconnect or double throw snap switch
6” length of 1/2”-dia. liquid-tight flexible metallic conduit
(2) 1/2” liquid tight connectors
(2) Lay-in grounding lugs
(2) Insulated terminal bars to accept one 2-gauge wire and 4 12-gauge wires
(2) Cord cap connectors for 1/2”-dia. cable
1/2” ground rod and clamp
Copper wire (6, 12-gauge)
Green ground screws
1/2” Flexible metallic conduit or Greenfield
1/2” Greenfield connectors
(4) 11/16” junction boxes with covers
(4) square boxes with covers
PVC 6 × 6” junction box with cover
14/2 UF wire
1/4 × 20 nuts and bolts with lock washers
Roof flashing boot
Roof cement
Silicon caulk
Eye protection

Mounting PV Panels

The mounting stand for the PV panel is constructed from metal U-channel (a product called Unistrut is seen here. See Resources page 125) and pre-bent fasteners. Position the solar panel where it will receive the greatest amount of sunlight for the longest period of time each day—typically the south-facing side of a roof or wall. For a circuit with a battery reserve that powers two to four 12-volt lights, a collection panel rated between 40 and 80 watts of output should suffice. These panels can range from $200 to $600 in price, depending on the output and the overall quality.

The stand components are held together with bolts and spring-loaded fasteners. The 45° and 90° connectors are manufactured specifically for use with this Unistrut system.

Connections for the feed wires that carry current from the collector are made inside an electrical box mounted on the back of the collector panel.

An EPDM rubber boot seals off the opening where the PVC conduit carrying the feed wires penetrates the roof.

How to Wire a DC Lighting Circuit

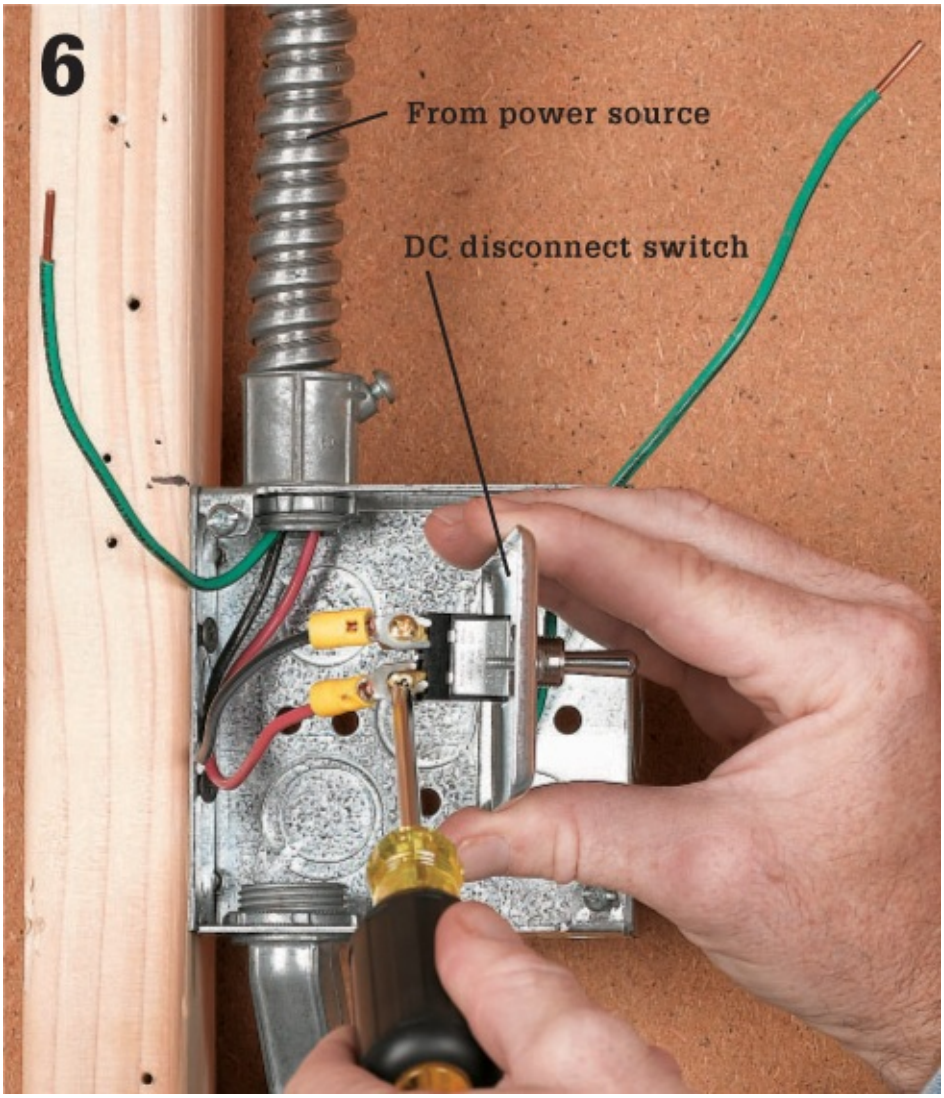
Mount a junction box inside the building where the conduit and wiring enter from the power source. Secure the box to the conduit with appropriate connectors. Run two #14 awg wires through the conduit and connect them to the positive and negative terminals on the panel.

Plan the system layout. Determine the placement of the battery and then decide where you will position the charge controller and DC disconnect. The battery should be placed at least 18" off the floor, in a well-ventilated area where it won't be agitated by everyday activity. Mark locations directly on the wall.

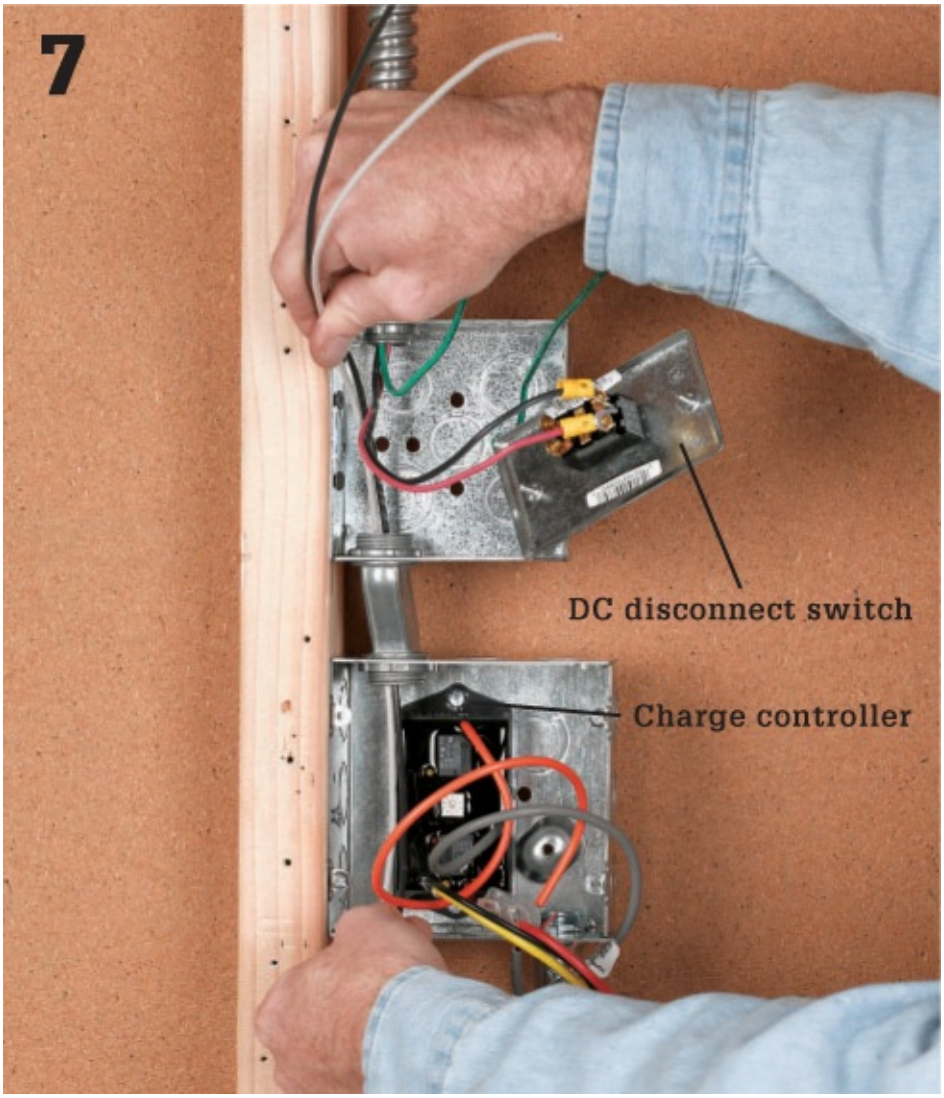
Attach a junction box for enclosing the DC disconnect, which is a heavy-duty switch, to a wall stud near the battery and charge controller location. Use a metal single-gang box with mounting flanges.

Run flexible metal conduit from the entry point at the power source to the junction box for the DC disconnect box. Use hangers rated for flexible conduit.

Attach a double gang metal junction box to the building's frame beneath the DC disconnect box to enclose the charge controller. Connect the boxes with a suitable conduit fitting or with flexible conduit.



Attach the DC disconnect switch to the wire leads from the power source.

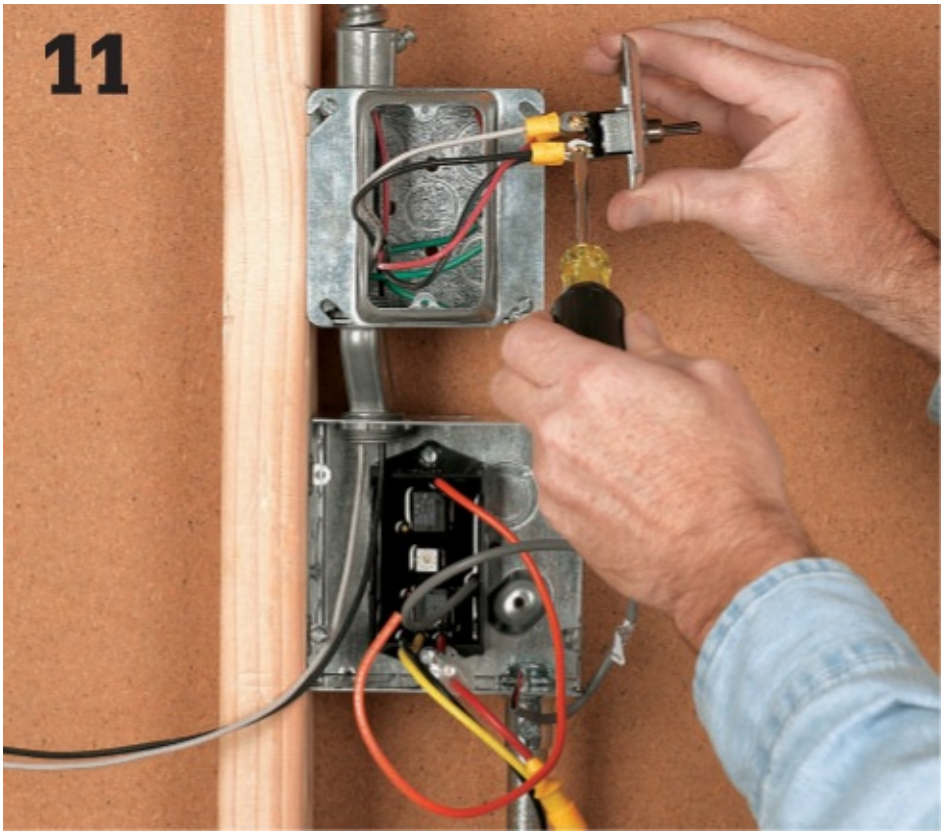


Install the charge controller inside the box.

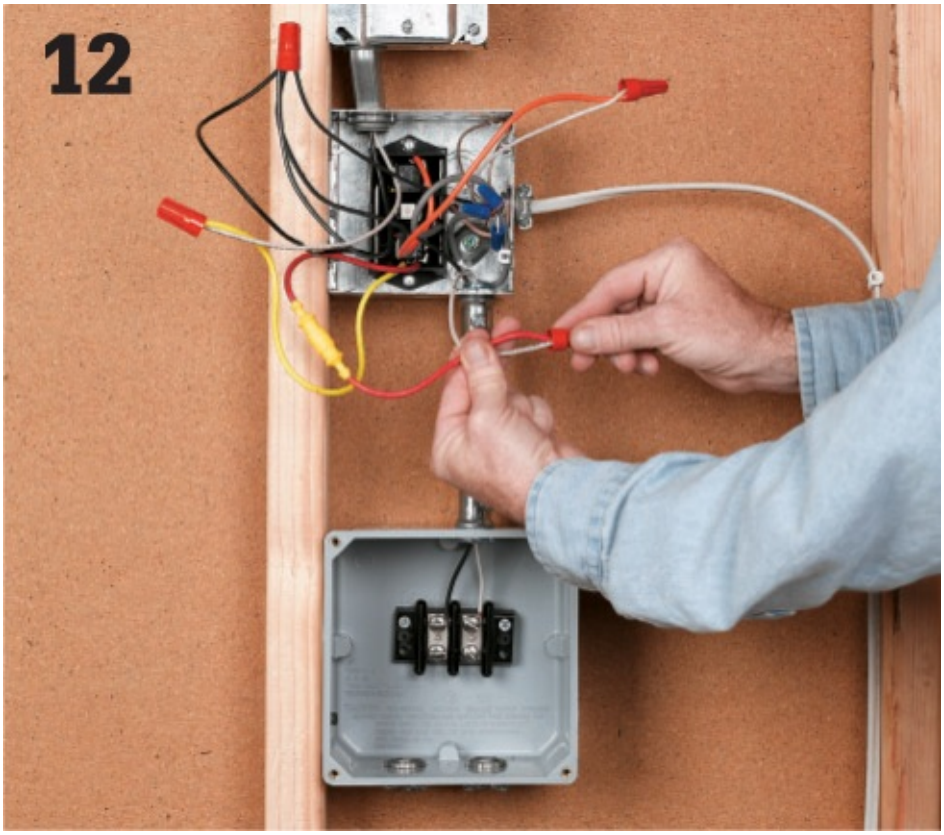
Mount a PVC junction box for the battery controller about 2 ft. above the battery location and install an insulated terminal bar within the box.

Build a support shelf for the battery. The shelf should be at least 12" to 18" above ground. Set the battery on the shelf in a sturdy plastic case.

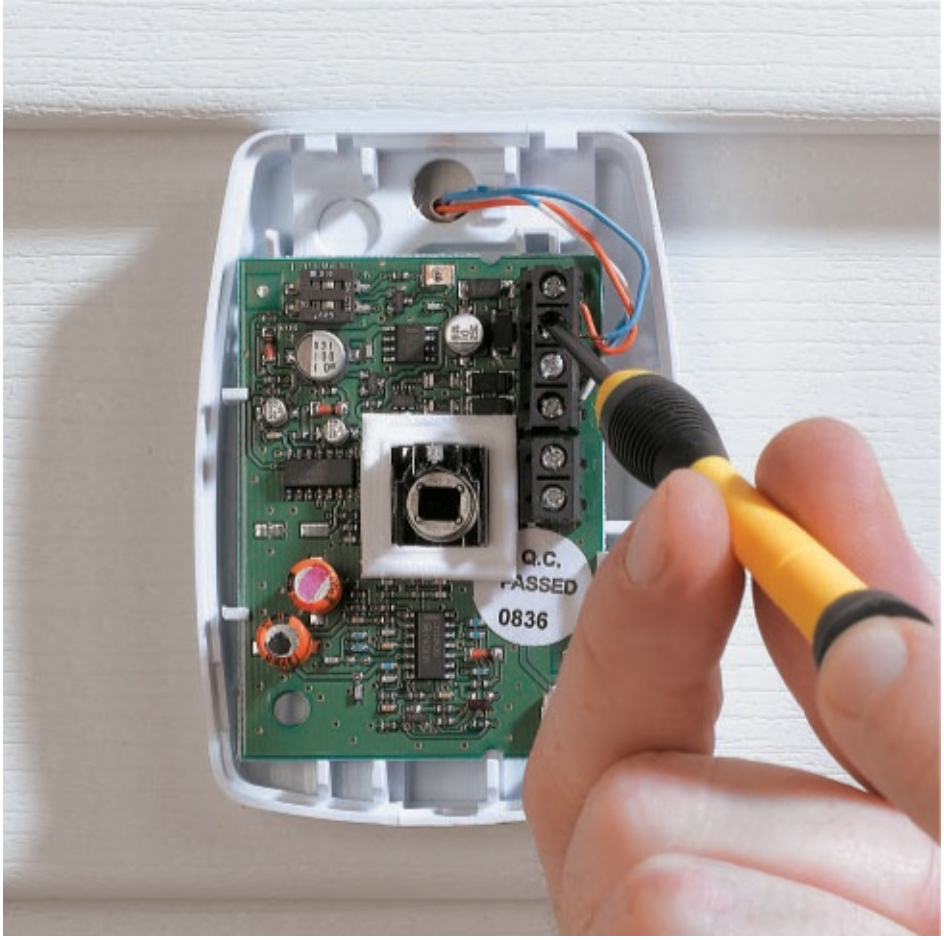
Set up grounding protection. Pound an 8-ft. long, 1/2"-dia. ground rod into the ground outside the building, about 1 ft. from the wall on the opposite side of the charge controller. Leave about 2" of the rod sticking out of the ground. Attach a ground rod clamp to the top of the rod. Drill a 5/16" hole through the wall (underneath a shake or siding piece) and run the #6-gauge THWN wire to the ground rod. This ground will facilitate lightning protection. See pages 46 to 51 for more information on grounding the system.



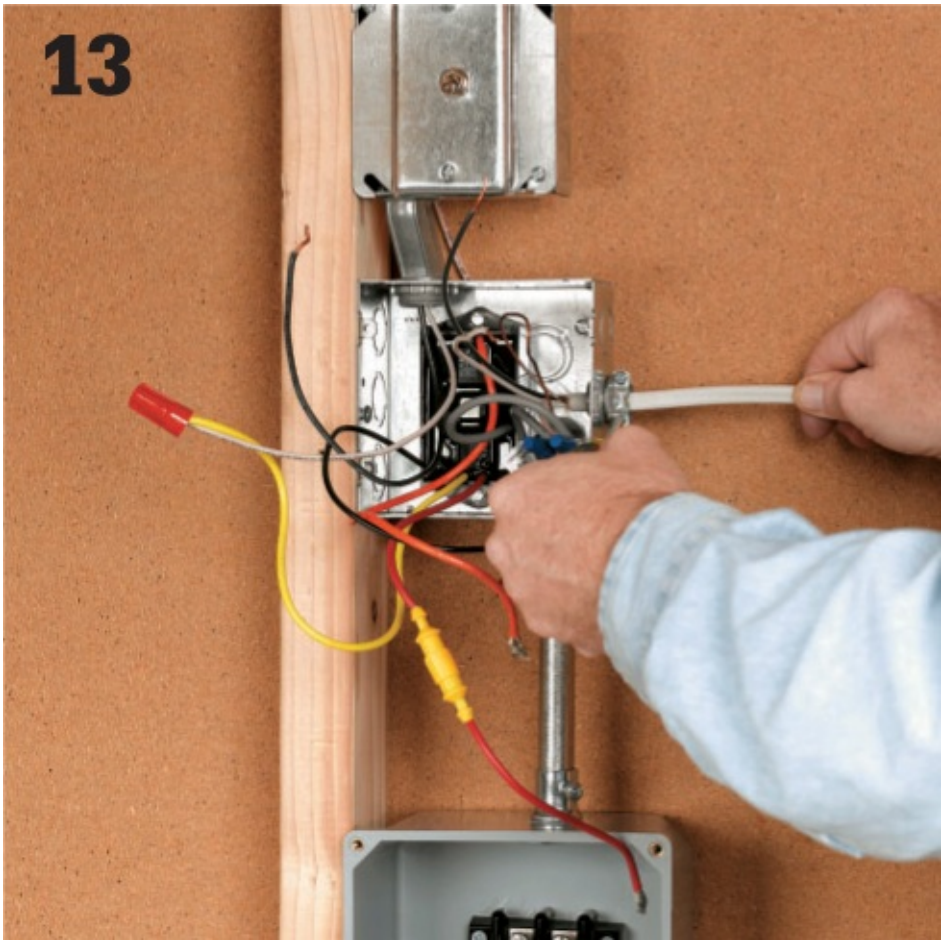
Wire the DC disconnect. Attach the two #14-gauge wires to the two terminals labeled "line" on the top of the DC disconnect switch.



Wire the charge controller. Route two more #14-gauge wires from the bottom of the DC disconnect terminals into the 4 × 11/16 junction box and connect to the "Solar Panel In" terminals on the charge controller. The black wire should connect to the negative terminal in the PVC box and the red to the positive lead on the charge controller. Finish wiring of the charge controller according to the line diagram provided with the type of controller purchased. Generally the load wires connect to the orange lead and the red wire gets tied to the battery through a fuse.

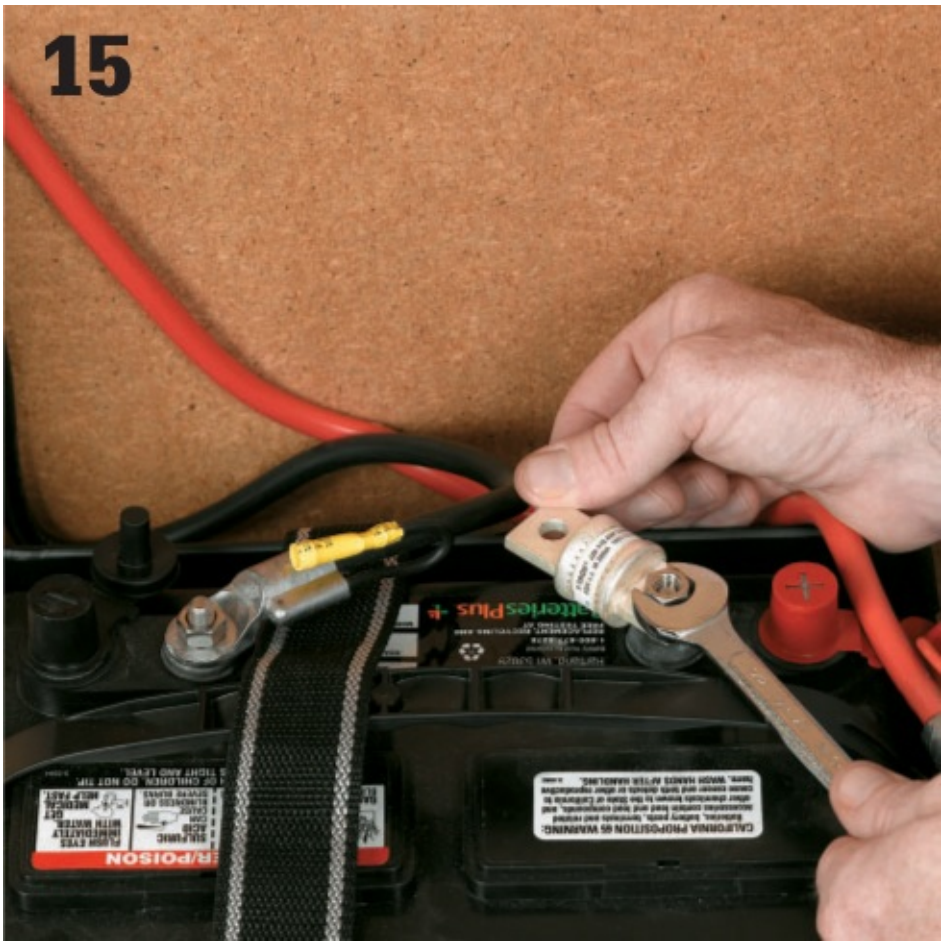


Option: Attach a motion sensor. Some charge controllers come equipped with a motion sensor to maximize the efficiency of your lighting system—these are especially effective when used with security lighting. The motion sensor is typically mounted to a bell box outside and wired directly to the charge controller with an 18-gauge × 3-conductor insulated cable. A system like this can support up to three motion sensors. Follow the manufacturer's directions for installing and wiring the motion sensor.

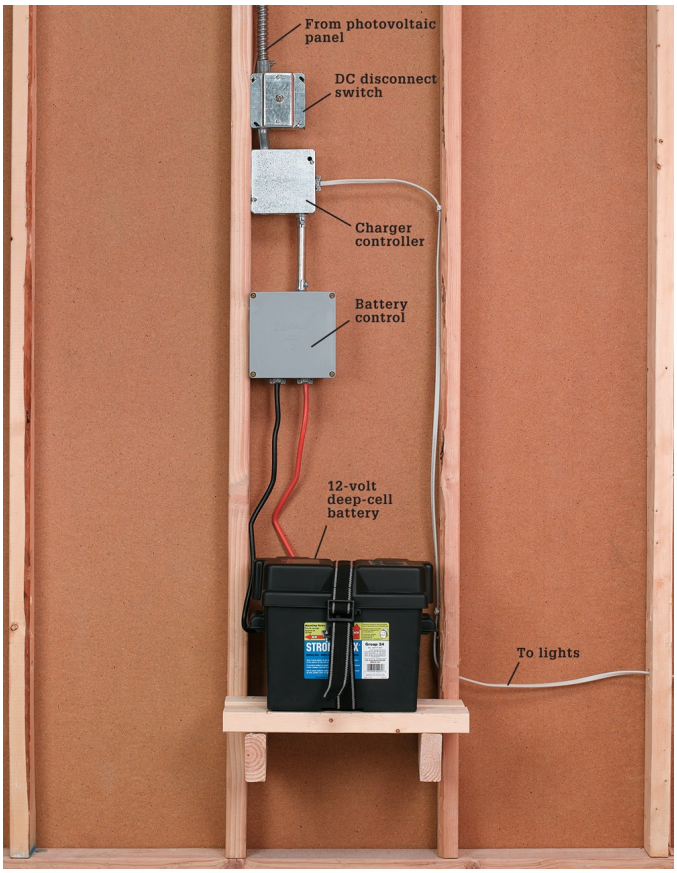


Run wiring to the loads (exterior DC lighting fixtures in this case) from the charge controller. DC light fixtures (12-volt) with LED bulbs can be purchased at marine and RV stores if you can't find them in your home center or electrical supply store.

Install the battery. Here, a deep-cell 12-volt marine battery is used. First, cut and strip each of the two battery cables at one end and install into the battery control junction box through cord cap connectors. Terminate these wires on two separate, firmly mounted insulated terminal blocks.



Install the catastrophe fuse onto the positive terminal using nuts and bolts provided with the battery cables. Connect the battery cables to the battery while paying close attention to the polarity (red to positive and black to negative). Make sure all connections have been made and double check.



Cover all junction boxes, then remove the bag from the collector panel and turn the DC disconnect switch on to complete the circuit. Test the lights and adjust the time to desired setting.

Backup Power Supply

Installing a backup generator is an invaluable way to prepare your family for emergencies. The simplest backup power system is a portable gas-powered generator and an extension cord or two. A big benefit of this approach is that you can run a refrigerator and a few worklights during a power outage with a tool that can also be transported to remote job sites or on camping trips when it's not doing emergency backup duty. This is also the least expensive way to provide some backup power for your home. You can purchase a generator at most home centers and be up and running in a matter of hours. If you take this approach, it is critically important that you make certain any loads being run by your generator are disconnected from the utility power source.

The next step up is to incorporate a manual transfer switch for your portable generator. Transfer switches are permanently hardwired to your service panel. They are mounted on either the interior or the exterior of your house between the generator and the service panel. You provide a power feed from the generator into the switch. The switch is wired to selected essential circuits in your house, allowing you to power lights, furnace blowers, and other loads that can't easily be run with an extension cord. But perhaps the most important job a transfer switch performs is to disconnect the utility power. If the inactive utility power line is attached to the service panel, "backfeed" of power from your generator to the utility line can occur when the generator kicks in. This condition could be fatal to line workers who are trying to restore power. The potential for backfeed is the main reason many municipalities insist that only a licensed electrician hook up a transfer switch. Using a transfer switch not installed by a professional may also void the warranty of the switch and the generator.

Automatic transfer switches turn on the generator and switch off the utility supply when they detect a significant drop in line voltage. They may be installed with portable generators, provided the generator is equipped with an electric starter.

Large standby generators that resemble central air conditioners are the top of the line in backup power supply systems. Often fueled by home natural gas lines or propane tanks that offer a bottomless fuel source, standby generators are made in sizes with as much as 20 to 40 kilowatts of output—enough to supply all of the power needs of a 5,000-sq.-ft. home.

Generators have a range of uses. Large hardwired models can provide instant emergency power for a whole house. Smaller models (below) are convenient for occasional short-term backup as well as job sites or camping trips.

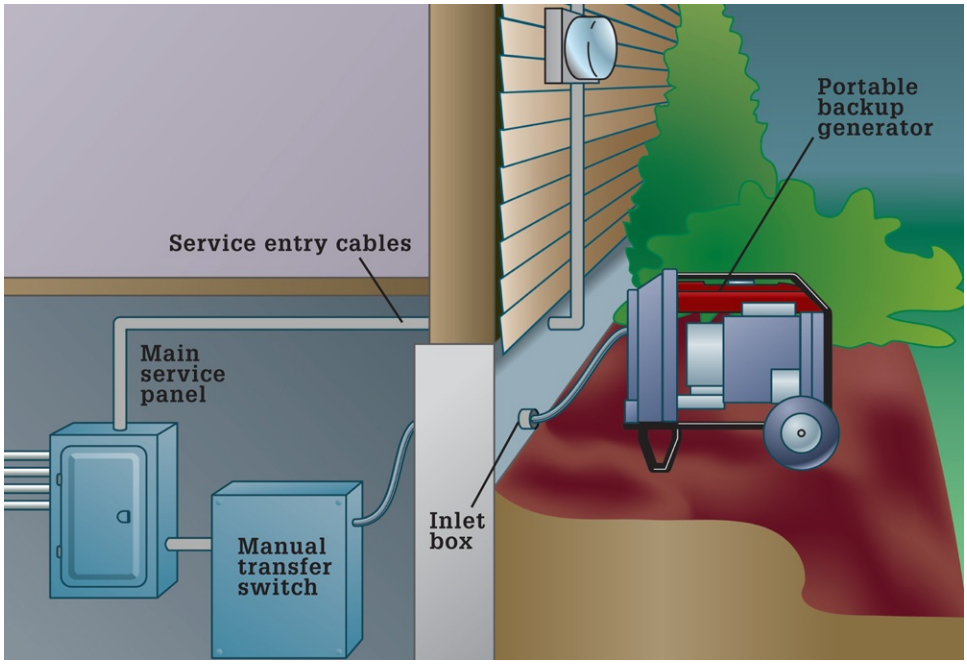
Choosing a Backup Generator

A 2,000-to 5,000-watt gas-powered generator and a few extension cords can power lamps and an appliance or two during shorter-term power outages. Appliances must not be connected to household wiring and the generator simultaneously. Never plug a generator into an outlet. Never operate a generator indoors. Run extension cords through a garage door.

A permanent transfer switch patches electricity from a large portable generator through to selected household circuits via an inlet at your service panel (inset), allowing you to power hardwired fixtures and appliances with the generator.

For full, on-demand backup service, install a large standby generator wired through to an automatic transfer panel. In the event of a power outage, the household system instantly switches to the generator.

A Typical Backup System



Backup generators supply power to a manual transfer switch, which disconnects the house from the main service wires and routes power from the generator through selected household circuits.

Choosing a Generator

Choosing a generator for your home's needs requires a few calculations. The chart below gives an estimate of the size of generator typically recommended for a house of a certain size. You can get a more accurate number by adding up the power consumption (the watts) of all the circuits or devices to be powered by a generator. It's also important to keep in mind that, for most electrical appliances, the amount of power required at the moment you flip the ON switch is greater than the number of watts required to keep the device running. For instance, though an air conditioner may run on 15,000 watts of power, it will require a surge of 30,000 watts at startup (the power range required to operate an appliance is usually listed somewhere on the device itself). These two numbers are called run watts and surge watts. Generators are typically sold according to run watts (a 5,000-watt generator can sustain 5,000 watts). They are also rated for a certain number of surge watts (a 5,000-watt generator may be able to produce a surge of 10,000 watts). If the surge watts aren't listed, ask or check the manual. Some generators can't develop many more surge watts than run watts; others can produce twice as much surge as run wattage.

It's not necessary to buy a generator large enough to match the surge potential of all your circuits (you won't be turning everything on simultaneously), but surge watts should factor in your purchasing decision. If you will be operating the generator at or near capacity, it is also a wise practice to stagger startups for appliances.

SIZE OF HOUSE (IN SQUARE FEET)	RECOMMENDED GENERATOR SIZE (IN KILOWATTS)
Up to 2,700	5–11
2,700–3,700	14–16
3,700–4,700	20
4,700–7,000	42–47

Cord-connected Transfer Switches

Cord-connected transfer switches (shown above) are hardwired to the service panel (in some cases they're installed after the service panel and operate only selected circuits). These switches contain a male receptacle for a power supply cord connected to the generator. Automatic transfer switches (not shown) detect voltage drop-off in the main power line and switch over to the emergency power source.

When using a cord-connected switch, consider mounting an inlet box to the exterior wall. This will allow you to connect a generator without running a cord into the house.

Generator Tips

If you'll need to run sensitive electronics such as computers or home theater equipment, look for a generator with power inverter technology that dispenses "clean power" with a stable sine wave pattern.

A generator that will output 240-volt service is required to run most central air conditioners. If your generator has variable output (120/240), make sure the switch is set to the correct output voltage.

Running & Maintaining a Backup System

Even with a fully automatic standby generator system fueled by natural gas or propane, you will need to conduct some regular maintenance and testing to make sure all systems are ready in the event of power loss. If you're depending on a portable generator and extension cords or a standby generator with a manual transfer switch, you'll also need to know the correct sequence of steps to follow in a power emergency. Switches and panels also need to be tested on a regular basis, as directed in your owner's manual. And be sure that all switches (both interior and exterior) are housed in an approved enclosure box.

Smaller portable generators often use pull-cords instead of electric starters.

ANATOMY OF A PORTABLE BACKUP GENERATOR

Portable generators use small gasoline engines to generate power. A built-in electronics panel sets current to AC or DC and the correct voltage. Most models will also include a built-in circuit breaker to protect the generator from damage in the event it is connected to too many loads. Better models include features like built-in GFCI protection. Larger portable generators may also feature electric starter motors and batteries for push-button starts.

Operating a Manual System During an Outage

Plug the generator in at the inlet box. Make sure the other end of the generator's outlet cord is plugged into the appropriate outlet on the generator (120-volt or 120/240-volt AC) and the generator is switched to the appropriate voltage setting.

Start the generator with the pull-cord or electric starter (if your generator has one). Let the generator run for several minutes before flipping the transfer switch.

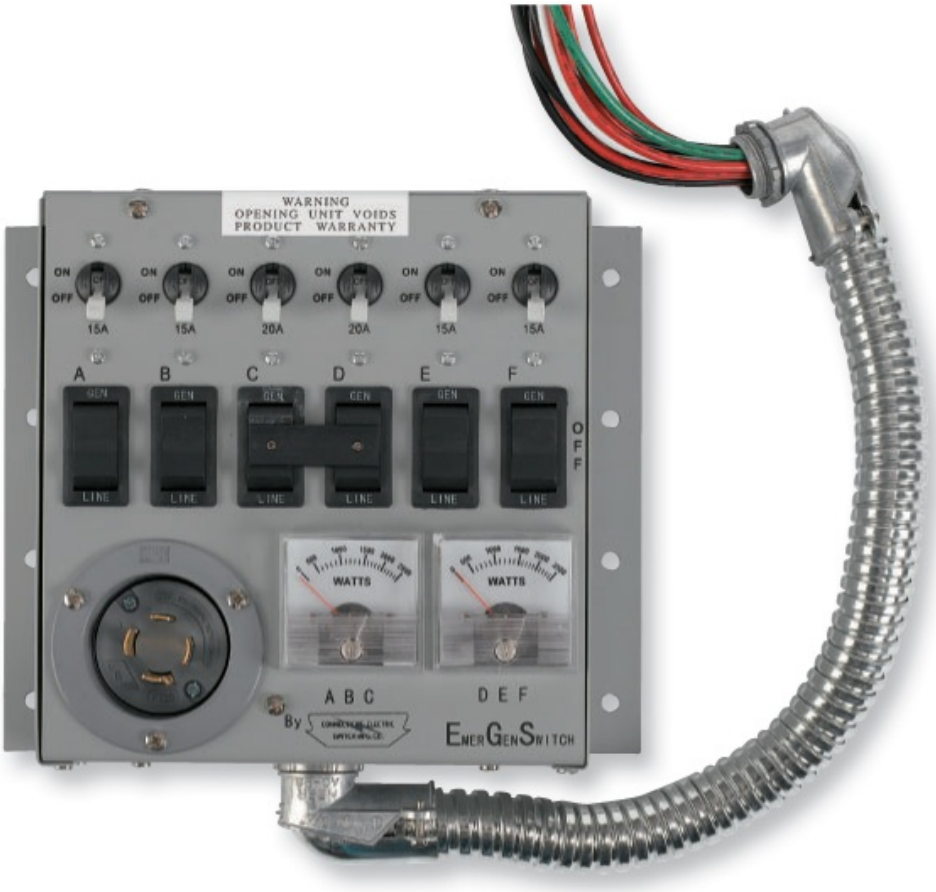
Flip the manual transfer switch. Begin turning on loads one at a time by flipping breakers on, starting with the ones that power essential equipment. Do not overload the generator or the switch and do not run the generator at or near full capacity for more than 30 minutes at a time.

Maintaining and Operating an Automatic Standby Generator

If you choose to spend the money and install a dedicated standby generator of 10,000 watts or more and operate it through an automatic transfer switch or panel, you won't need to lift a hand when your utility power goes out. The system kicks in by itself. However, you should follow the manufacturer's suggestions for testing the system, changing the oil, and running the motor periodically.

Installing a Transfer Switch

A transfer switch is installed next to the main service panel to override the normal electrical service with power from a backup generator during a power outage. Manual transfer switches require an operator to change the power source, while automatic switches detect the loss of power, start the back-up generator and switch over to the backup power feed. Because the amount of electricity created by a backup generator is not adequate to power all of the electrical circuits in your house, you'll need to designate a few selected circuits to get backup current (See Sidebar).



A manual transfer switch connects emergency circuits in your main panel to a standby generator.

Tools & Materials

Circuit tester

Drill/driver
Screwdrivers
Hammer
Wire cutters
Cable ripper
Wire strippers
Level
Manual transfer switch
Screws
Wire connectors (yellow)
Standby power generator

One flip of a switch reassigns the power source for each critical circuit so your backup generator can keep your refrigerator, freezer and important lights running during an outage of utility power.

Selecting Backup Circuits

Before you purchase a backup generator, determine which loads you will want to power from your generator in the event of a power loss. Generally, you will want to power your refrigerator, freezer, and maybe a few lights. Add up the running wattage ratings of the appliances you will power up to determine how large your backup generator needs to be. Because the startup wattage of many appliances is higher than the running wattage, avoid starting all circuits at the same time—it can cause an overload situation with your

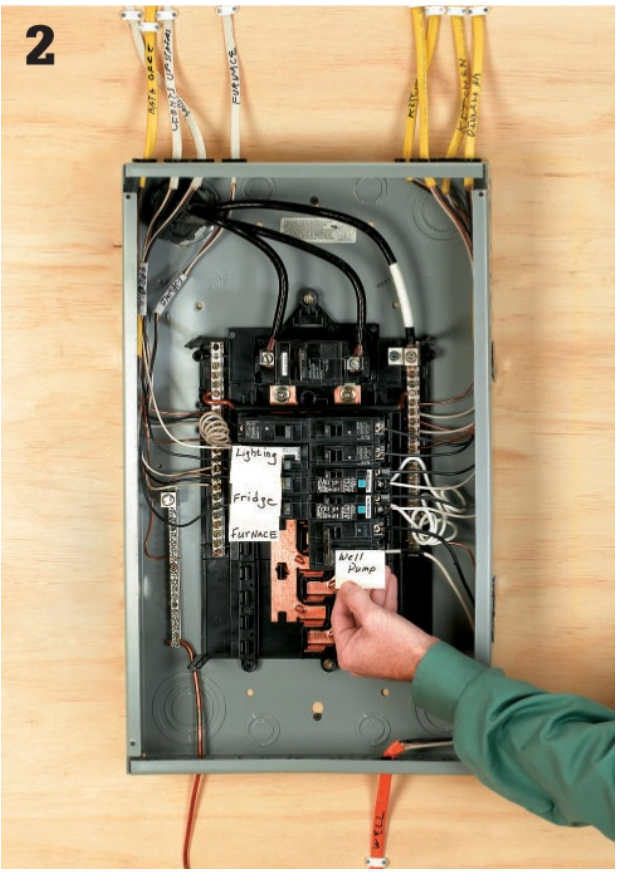
generator. Here are some approximate running wattage guidelines.

- Refrigerator: 750 watts
- Forced air furnace: 1100 to 1500 watts.
- Incandescent lights: 60 watts per bulb (CFL and LED lights use less wattage)
- Sump pump: 800 to 1000 watts
- Garage door opener: 550 to 1100 watts
- Television: 300 watts

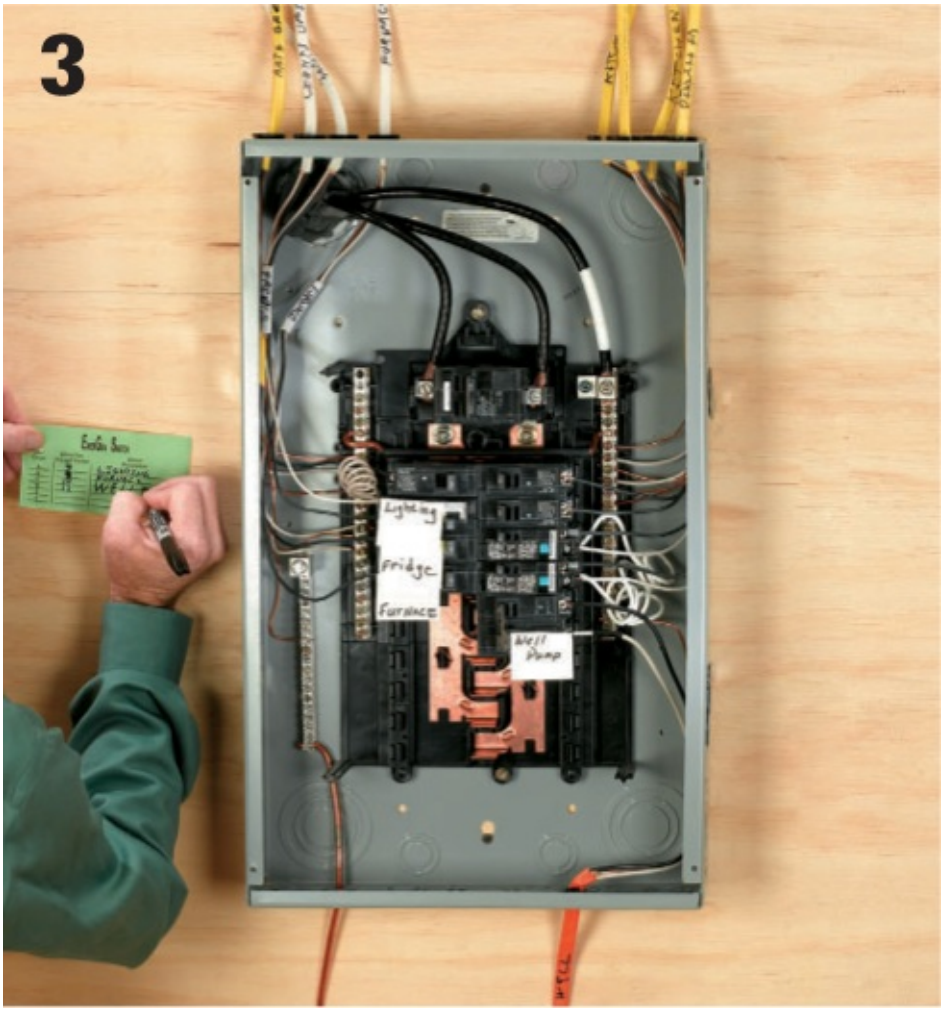
Add the wattage values of all the loads you want to power and multiply the sum by 1.25. This will give you the minimum wattage your generator must produce. Portable standby generators typically output 5,000 to 7,500 watts. Most larger, stationary generator can output 10,000 to 20,000 watts (10 to 20 kilowatts).

How to Install a Manual Transfer Switch

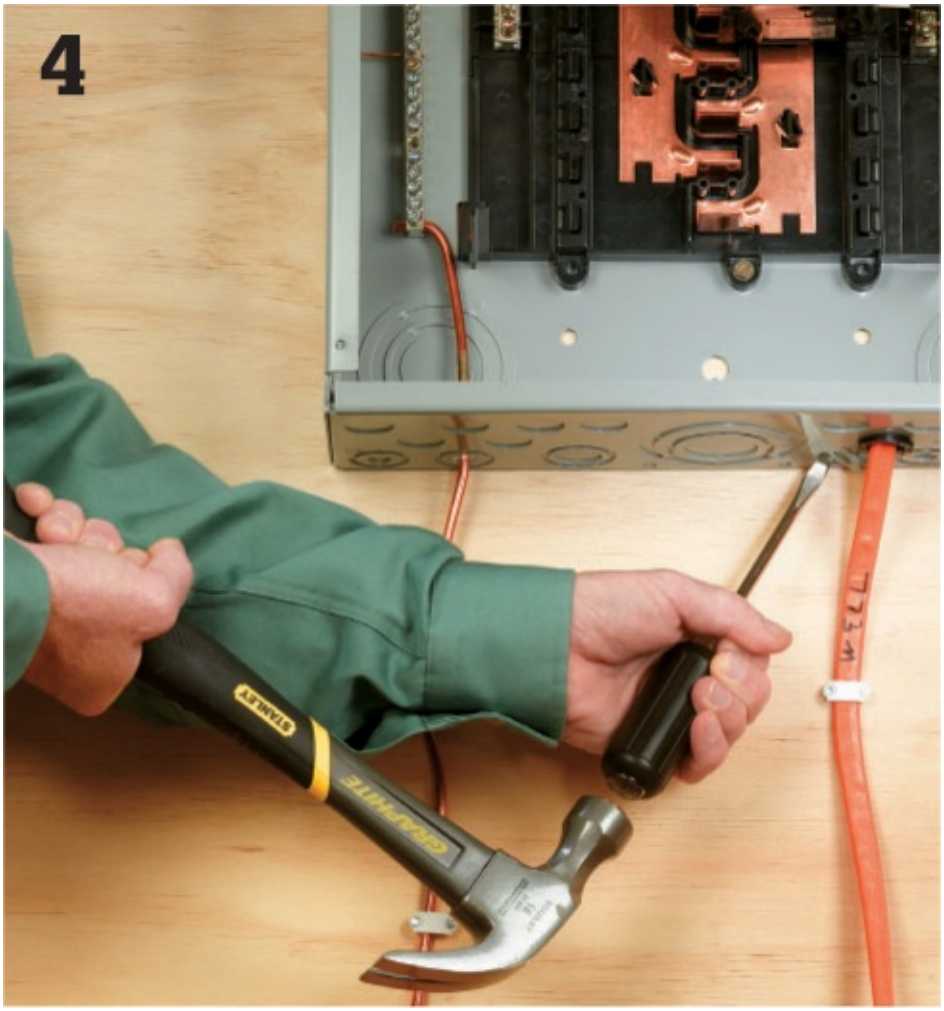
Turn off the main power breaker in your electrical service panel. CAUTION: The terminals where power enters the main breakers will still be energized.



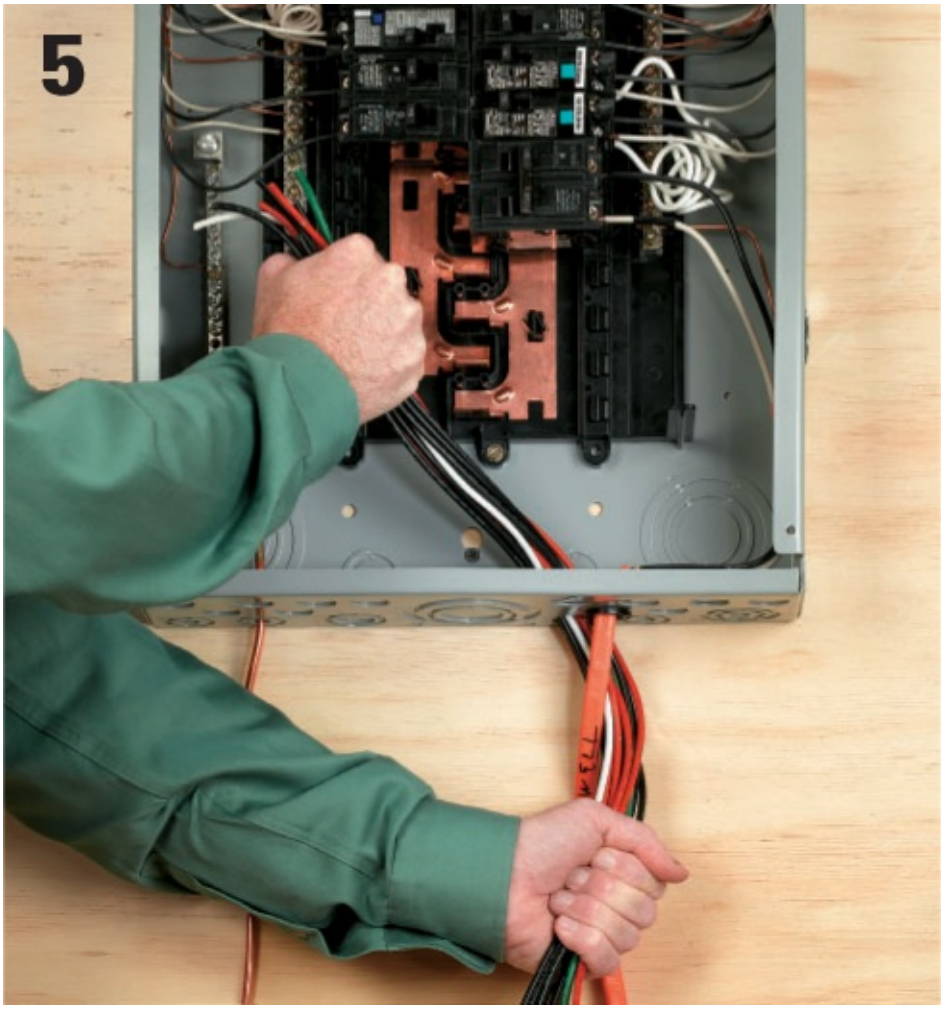
Determine which household circuits are critical for emergency usage during a power outage. Typically, this will include the refrigerator, freezer, furnace, and at least one light or small appliance circuit.



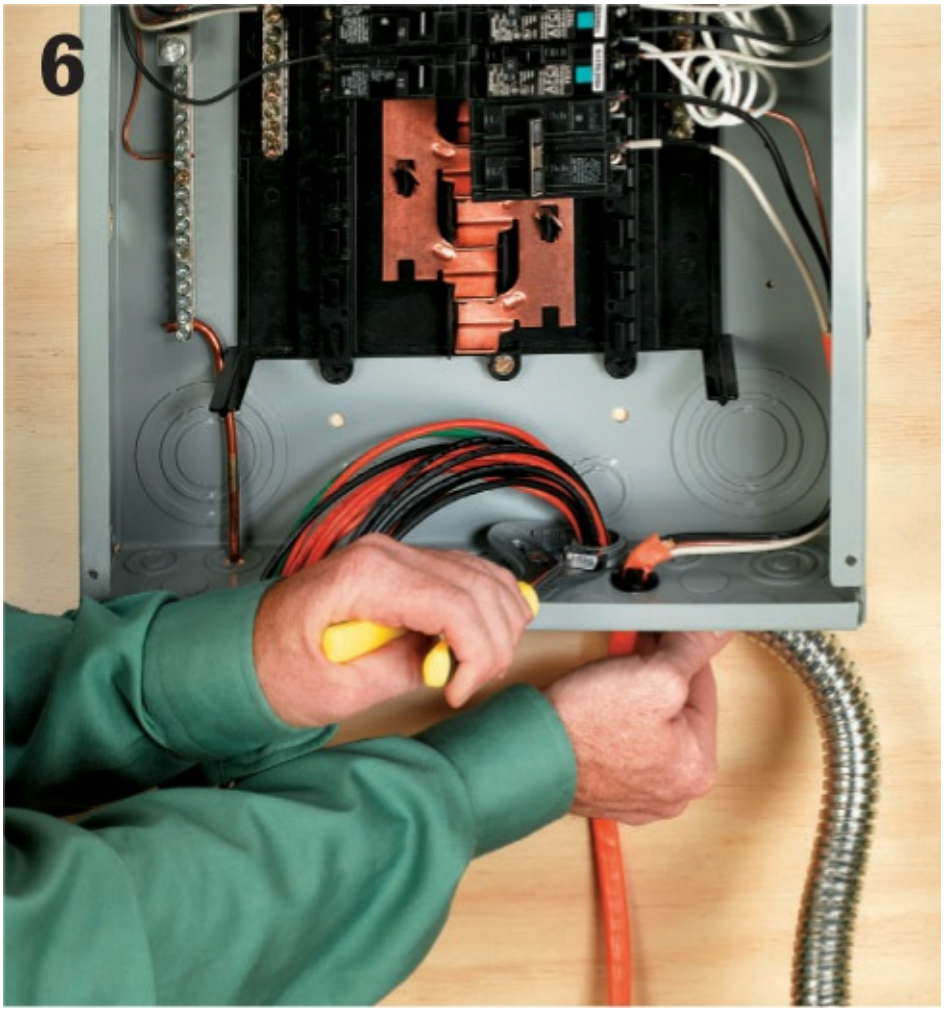
Match your critical circuits with circuit inlet on your pre-wired transfer switch. Try to balance the load as best you can: for example, if your refrigerator is on the leftmost circuit, connect your freezer to the circuit farthest to the right. Double-pole (240-volt) circuits will require two 120-volt circuit connections. Also make sure that 15-amp and 20-amp circuits are not mismatched with one another.



Select a knockout at the bottom of the main service panel box and remove the knockout. Make sure to choose a knockout that is sized to match the connector on the flexible conduit coming from the transfer switch.

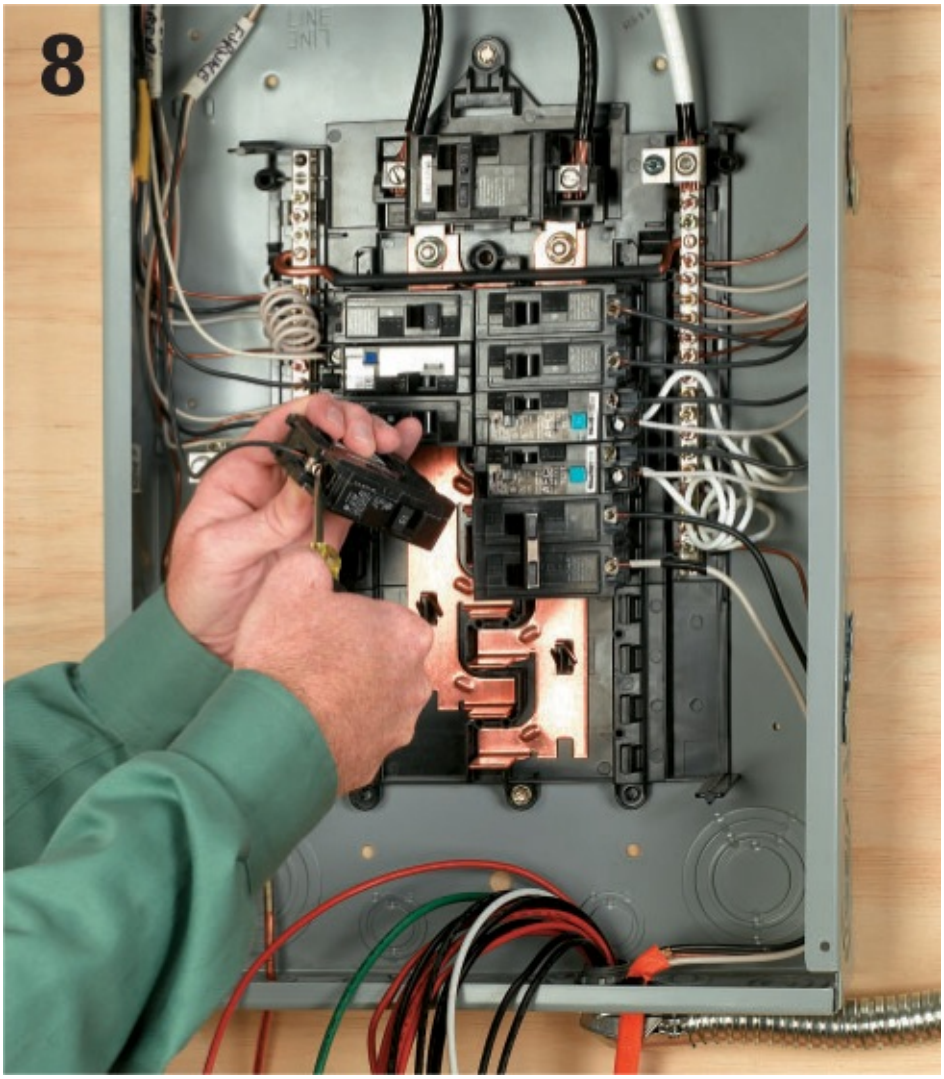


Feed the wires from the transfer switch into the knock out hole, taking care not to damage the insulation. You will note that each wire is labeled according to which circuit in the switch box it feeds.

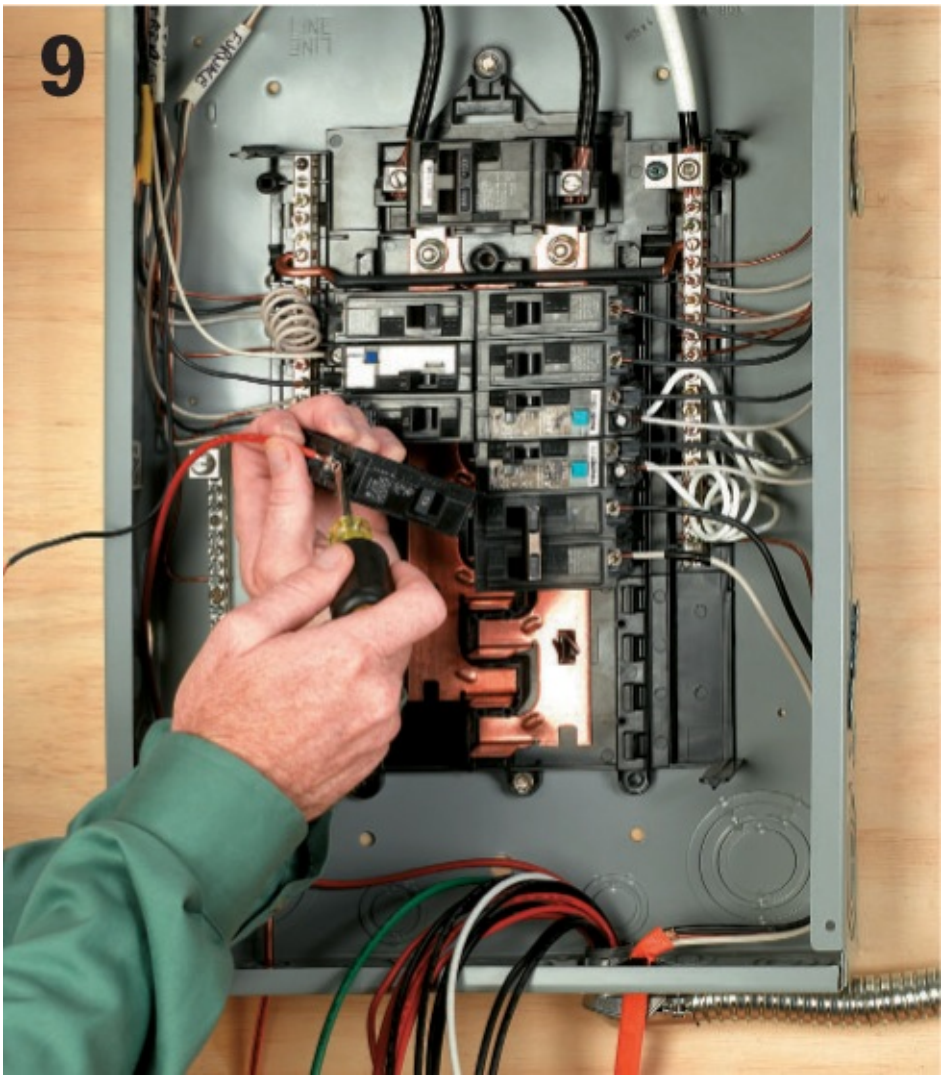


Secure the flexible conduit from the switch box to the main service panel using a locknut and a bushing where required.

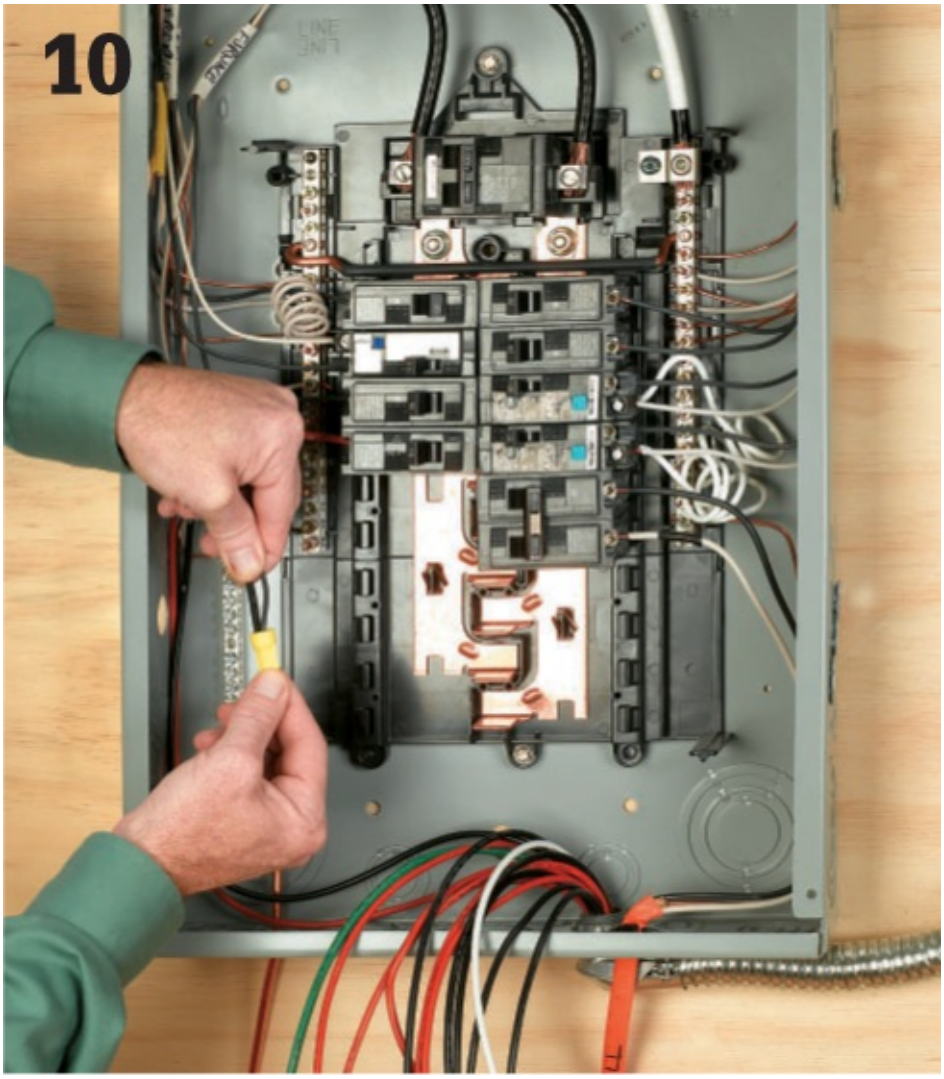
Attach the transfer switch box to the wall so the closer edge is about 18" away from the center of the main service panel. Use whichever connectors make sense for your wall type.



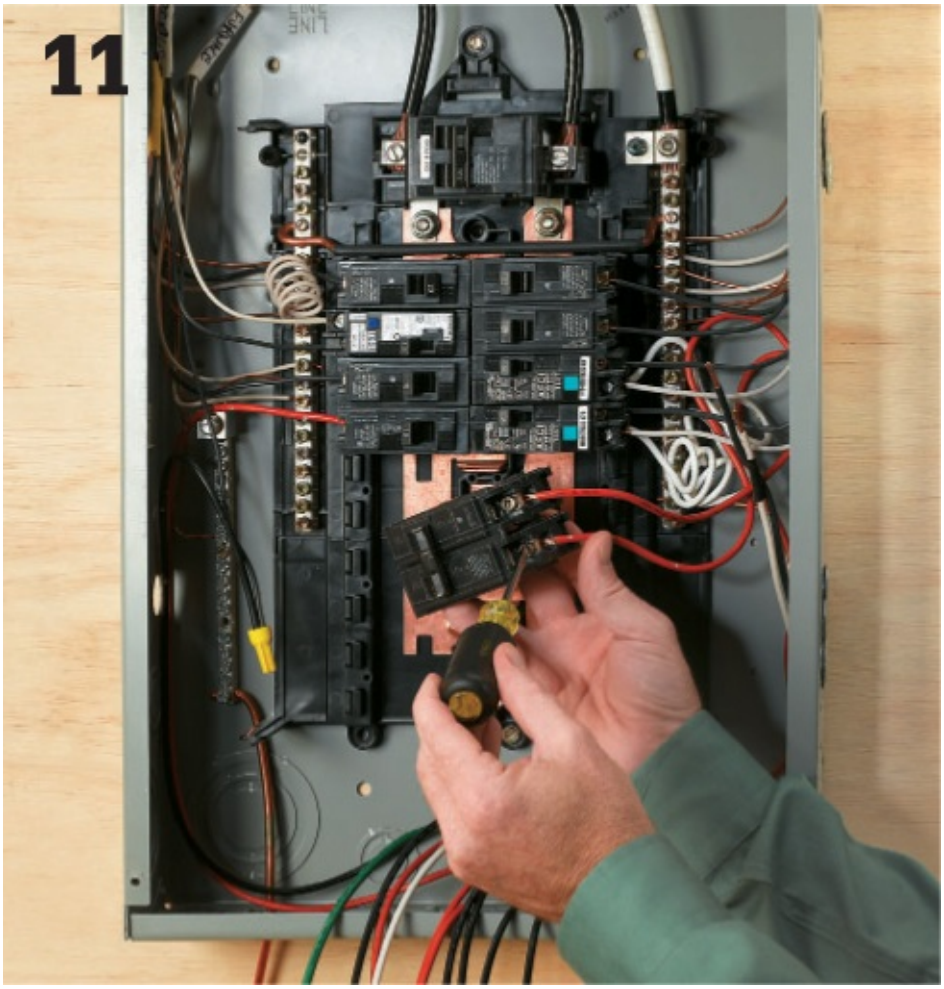
Remove the breaker for the first critical circuit from the main service panel box and disconnect the hot wire lead from the lug on the breaker.



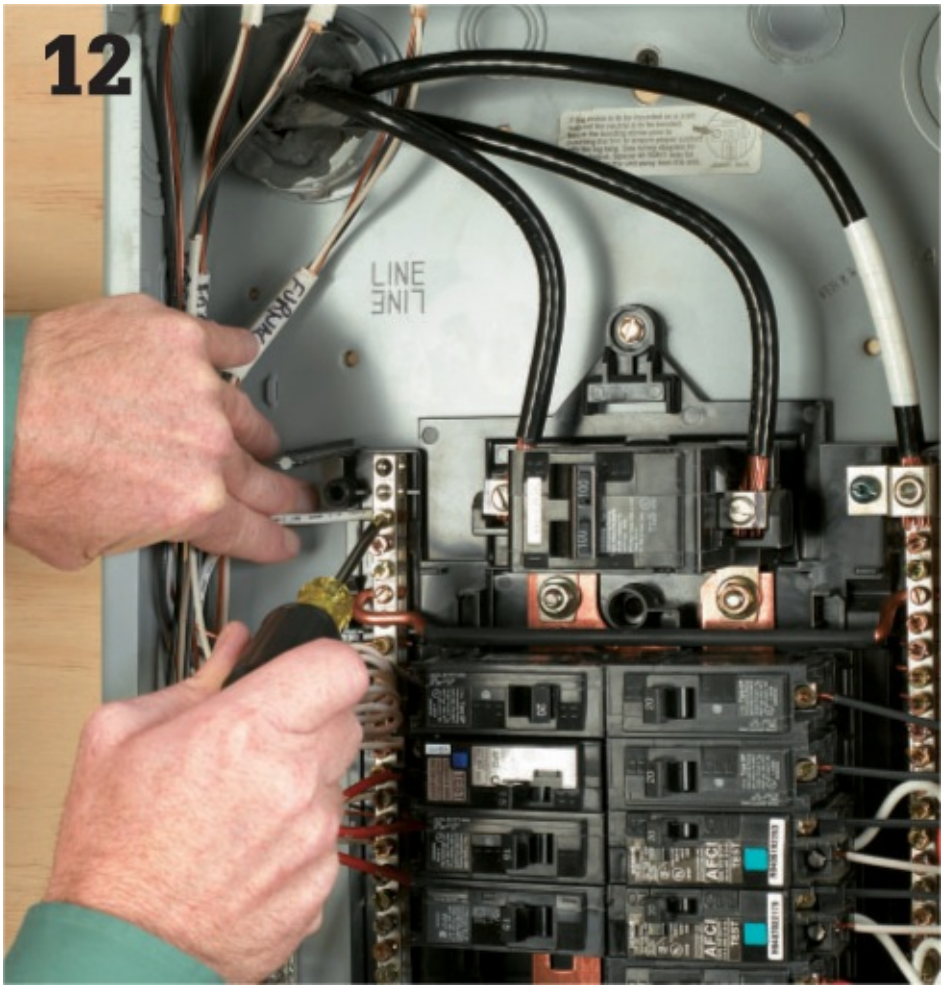
Locate the red wire for the switch box circuit that corresponds to the circuit you've disconnected. Attach the red wire to the breaker you've just removed and then reinstall the breaker.



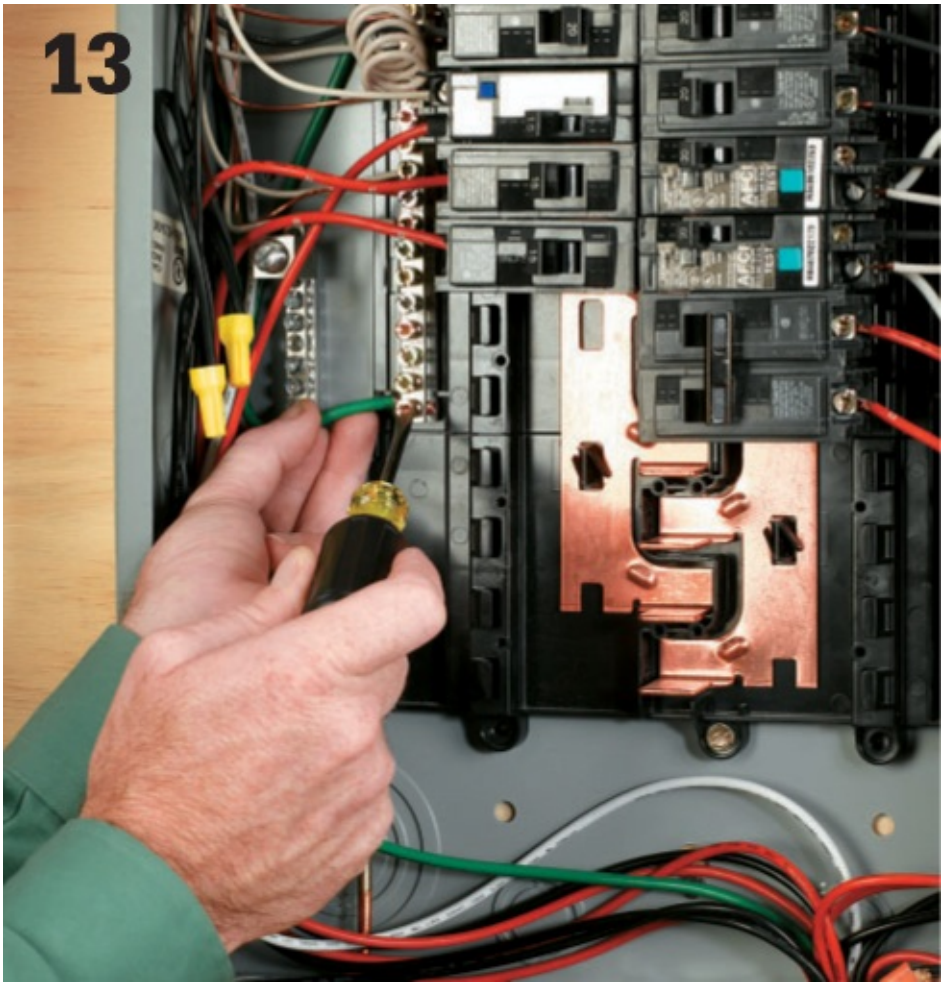
Locate the black wire from the same transfer switch circuit and twist it together with the old feed wire, using a yellow wire connector. Tuck the wires neatly out of the way at the edges of the box. Proceed to the next circuit and repeat the process.



If any of your critical circuits are 240-volt circuits, attach the red leads from the two transfer switch circuits to the double-pole breaker. The two circuits originating in the transfer switch should be next to one another and their switches should be connected with a handle tie. If you have no 240-volt circuits you may remove the preattached handle tie and use the circuits individually.



Once you have made all circuit connections, attach the white neutral wire from the transfer switch to an opening in the neutral bus bar of the main service panel.



Attach the green ground wire from the transfer switch to an open port on the grounding bar in your main service panel. This should complete the installation of the transfer switch. Replace the cover on the service panel box and make sure to fill in the circuit map on your switch box.

Begin testing the transfer switch by making sure all of the switches on the transfer switch box are set to the LINE setting. The power should still be OFF at the main panel breakers.

Standby Generators

Make sure your standby generator is operating properly and has been installed professionally. See page 83 for information on choosing a generator that is sized appropriately for your needs.

Before turning your generator on, attach the power cord from the generator to the switch box. Never attach or detach a generator cord with the generator running. Turn your standby power generator on and let it run for a minute or two.

Flip each circuit switch on the transfer switch box to GEN, one at a time. Try to maintain balance by moving back and forth from circuits on the left and right side. Do not turn all circuits on at the same time. Observe the onboard wattage meters as you engage each circuit and try to keep the wattage levels in balance. When you have completed testing the switch, turn the switches back to LINE and then shut off your generator.

A digital autoranging multimeter is the primary diagnostic tool for troubleshooting most home wiring systems and fixtures. Here, the multimeter is indicating a voltage drop outside the normal range.

Troubleshooting & Repairs

Running new circuits and hooking up new fixtures are fairly predictable projects when it comes to estimating time and expense. This is less true with repairing problems in your system and fixtures. In some cases, a repair is as simple as opening an electrical box, spotting a loose wire connector and remaking the connection. But there are also times when fixing a dead circuit or device is a highly frustrating proposition. Such cases are almost always caused by tricky diagnostic challenges. Wires are hidden behind walls and there very often are no visual clues to system breakdowns. So essentially, minimizing repair frustration boils down to learning to deploy logical, systematic diagnostics. Educated troubleshooting, you could say.

In this project you'll learn how to use the most important diagnostic tool in any electrician's toolkit: the multimeter. These handy devices come in a dizzying array of types and qualities, but for diagnostic purposes they are used to take readings for current (amperage), voltage and continuity (whether an electrical path is open or closed). Once you learn the basics of operating a multimeter, you can enlist it in a logical, deductive manner to track down the source of a wiring problem. Once located, correcting the problem is usually very simple.

Diagnostic tools for home wiring use include: Touchless circuit tester (A) to safely check wires for current

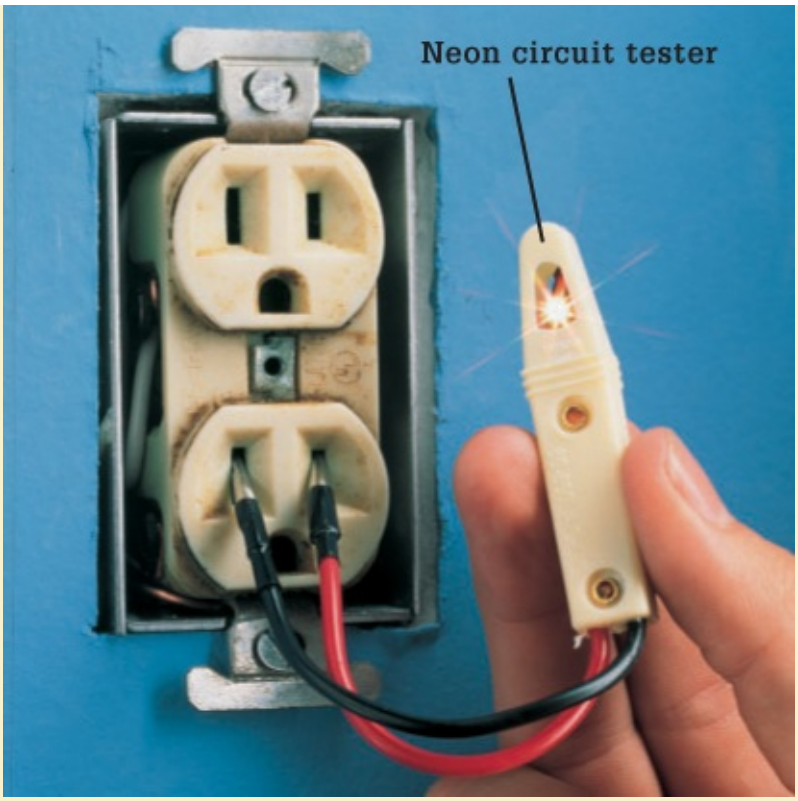
and confirm that circuits are dead; Plug-in tester (B) to check receptacles for correct polarity, grounding and circuit protection; Multimeter (C) to measure AC/DC voltage, AC/DC current, resistance, capacitance, frequency and duty cycle (model shown is an autoranging digital multimeter with clamp-on jaws that measure through sheathing and wire insulation).

Multimeters

Multimeters are nearly indispensible diagnostic tools for doing intermediate to advanced level electrical work (as well as automotive and electronics repair). They are used to measure voltage, current (amperage) and a few other conditions such as continuity, capacitance and frequency. For your home electrical system, by far the most used feature of a multimeter is testing voltage and current, although there are occasions where testing for resistance is needed. Among professional electricians, the most common and widely used multimeters have a clamp-on ammeter that measures current through the wire insulation so you don't have to disconnect the circuit and expose bare wire. Most clamp-on multimeters also are fitted with insertible probes with which you can measure voltage and continuity in the traditional way. An example of a clamp-on multimeter can be seen on the next page. Among homeowners, however, the most common multimeters these days are digital, autoranging tools that use probes or alligator clamps at the ends of wire leads for diagnostic work. Older multimeters that do not have autoranging capability must be pre-set to estimated calibration levels before use. Non-digital multimeters or ammeters usually have a dial gauge that gives readouts. These tools are somewhat more difficult to use and are less precise. Considering that digital, autoranging multimeters can be found for just a few dollars (the top of the line models cost over $100) there is really no good reason not to replace your old device with one that resembles the tools seen on these pages.

Time to Replace that Neon Tester

Neon circuit testers are inexpensive and easy to use (if the light glows the circuit is hot), but they are less sensitive than multimeters and can be unsafe. In some cases, neon testers won't detect the presence of lower voltage in a circuit. This can lead you to believe that a circuit is shut off when it is not—a dangerous mistake. The small probes on a neon circuit tester also force you to get too close to live terminals and wires. For the most reliable readings, buy and learn to use a multimeter. At the very least, switch to a touchless tester like the one on page 101, Step 1.


Neon circuit tester

A digital, autoranging multimeter must be adjusted to the proper setting for the reading you want to take. The probe leads also must be inserted into the correct inlet at the bottom of the tool. Inserting the red lead into the incorrect inlet can cause the tool to trip an internal fuse. Study your owner's manual carefully before using any tool.

How to Measure Current

Create access to the wires you need to test. In most cases this requires that you remove the cover to an electrical service panel or an electrical box (inset).

Set the multimeter to test for amperage (current is measured in amperes or amps). On some multimeters you need to select between amperage settings that are above or below 40 amps. Use the rated amperage of the circuit as a guide (amperage is printed on the circuit breaker switch).

Clamp the jaws of a clamp-on multimeter onto the conductor or one of the conductors (if more than one) leading to a circuit breaker. If you are using a non-clamping multimeter, touch one probe to the screw terminal where the hot lead is attached to the breaker and touch the other probe to the metal panel box. The readout on your meter is the amount of current flowing in that circuit.

Taking Measurements at a Receptacle

You may use a multimeter to measure for voltage at a wall receptacle. Regardless of whether the outlet is in service, if it is live you will get a voltage reading in the approximate range of the receptacle rating—here, 120 volts. To detect live current, measured in amps, the receptacle must be in use, with an appliance drawing from it. Taking an amperage reading in such an instance will only yield the amount of current being drawn, which is a factor of the appliance, not the circuit capacity.

How to Measure Voltage

To measure voltage using the multimeter, you will have to use the two probes provided with the multimeter and have access to a live terminal or slot as well as a grounded terminal or slot. If your meter has probe holders at the top, snap the probes into them. They are like extra hands.

Turn the multimeter to the VAC setting to measure AC voltage that is found in your house. Set the multimeter to VDC if measuring DC voltage, such as in a car or a battery-fed device. On some multimeters, like the one above, you select "V" for voltage then change between AC and DC with the "FUNC" button.

To measure the AC voltage, place one probe on a grounded surface, such as the metallic junction box or the bare ground wire. Place the other probe on the hot screw terminal or into the receptacle slot associated with the hot wire. The voltage readout should be in the range of 120 volts, plus or minus 5 volts (usually 120 volts in a residence in the US).

240 VOLTS. You can also measure voltage across the two hot leads to determine if you have 240 volts. This can be done at your range receptacle, dryer receptacle, or any other 240-volt receptacle. Place one probe in one of the small slots and the other probe in the other slot directly across from it. The voltage should read 240 volts, plus or minus 5 volts.

DC Voltage. When testing DC voltage, such as in a car battery, you can measure exactly the same way as for AC as long as the meter is set to the DC function. For more accurate results, test the voltage while the battery is in use.

How to Test for Continuity

Continuity is a condition in a circuit where the conductors form an unbroken pathway through which current may flow. When measuring for continuity, always make sure there is no power present on the circuit you are testing or damage may occur to the meter. You can also measure the resistance in this mode as well.

The setting for continuity is an "audible" or diode symbol display on the dial. Select this setting.

Verify that the continuity tester is functional by touching the two probes together. You should hear an alert sound and/or see a reading of zero ohms (Ohms is a value of the resistance to current flow).

To test a circuit, touch one probe to one of the wires on a given circuit and the other to the second wire of the circuit. If you hear an audible sound or read a value of resistance other than zero, you have a complete or unbroken path for current to flow.

How to Test a 3-way Switch

Remove the switch from the circuit and place one of the probes onto the common terminal and the other probe onto one of the other two terminals used for the traveler wires. If the meter indicates infinity ohms or there is no sound, flip the switch and if it is in working order the meter should read zero ohms or emit an audible sound. It should only work in one direction or the other, not both.

Troubleshooting an Open Neutral

An open neutral is an electrical problem where the circuit is broken on the return path wire or neutral (white wire). When this situation occurs anything plugged into or connected to this circuit can experience low or high voltage, which could damage voltage sensitive electronics such as a computer or flat screen TV. The lights will be dim or not work at all, depending upon where the problem lies within the circuit.

Possible Symptoms of an Open Neutral

1. When a whole circuit does not work and the breaker associated with that circuit is operating normally.
2. When the neutral or white wire registers as a hot wire by using a non contact voltage tester when the circuit breaker is on. This most likely indicates a problem between the main service panel and the utility transformer. The condition should be readable on other receptacles as well.
3. If you register a voltage lower than 110 volts between the hot and neutral.
4. When the incandescent lights work, but are very dim.
5. When the fluorescent lights are barely lit and are flickering.
6. Discoloration of the wires or exposed copper turning green under the wirenut holding the neutral wires together.

1
KLEIN TOOLS
0.899

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3
KLEIN TOOLS
092.4

6

How to Troubleshoot an Open Neutral

Verify which lights and receptacles are on the circuit by turning the breaker off and by checking for power with a non-contact voltage tester. It is helpful to either draw a map of the house or place some tape on every affected opening.

Start at the outlet nearest to the panel. With the breaker off and using a multimeter, check for continuity between the neutral (white wire) and the ground (bare or green wire). These two wires land at the same point electrically in your electrical panel. If there is an indication of continuity between these two wires, the neutral and ground connections are sound and you should proceed to the next outlet as you move away from the panel.

When you encounter a point at which you read infinity ohms or there is no continuity between the neutral and ground wires, the problem lies within the connections in that box or the box just upstream (toward) the panel from the one you are checking. Sometimes you will see evidence of arcing on the wire cap containing the connection which may include discoloration, or a blackish char near the copper.

When you have found the problem connection, remove the wire cap and, if it is possible, cut the damaged portions of the wires off and restrip the wires to expose new copper. Line the wire ends up and twist on a new wire cap.

Turn the circuit breaker back on and verify the proper voltage is present at your receptacles by measuring with a multimeter.

Troubleshooting a Short Circuit

Short circuits are a direct connection between the hot or power wire (black or red) and to either the neutral (white) or ground (bare) wire. This connection between the two will cause your circuit breaker or fuse to blow, which should interrupt power to the affected circuit.

Short circuits are a common problem and can usually be solved by taking the following steps. The idea behind electrical troubleshooting is to simplify the circuit by checking it at certain points, in order to narrow down the problem point by process of elimination. Generally, the problem is that there is a bare ground wire touching a hot terminal within a switch or an outlet box. There will usually be a black scorched mark or some sign of an electrical arc where the problem lies.

How to Troubleshoot a Short Circuit

Turn the power off at the affected breaker and verify with a non-contact voltage tester that there is no power present. Unplug everything from the receptacles and turn the lights off on the circuit that is affected.

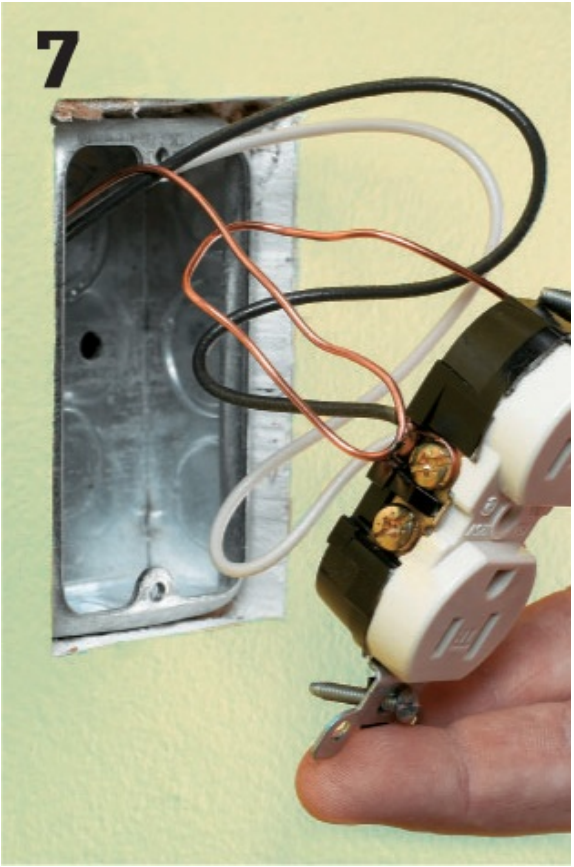
Using a multimeter set to the ohms or continuity setting, check the wires at the panel. Touch one of the probes to the hot or black wire and the other probe to the ground or bare wire. If the meter rings or indicates a low resistance value, you have a direct short to ground. If the meter does not ring or indicates a high resistance value the circuit is clear. If the meter does not ring, start by turning the switches on one-by-one and re-testing to verify the resistance value. If the meter indicates a low resistance value or a short circuit, the problem is downstream from the switch or within the light fixture itself.

If the meter consistently rings or indicates a low resistive value, you will need to find the electrical box that contains the affected circuit. Choose a box that is convenient to open and preferably in the middle of the run, such as a receptacle. Verify there is no power present by touching all of the wires within the box with a non-contact voltage tester.

If the box you have chosen is in fact in the middle of the run, it will contain at least two cables. Remove the receptacle from the two cables and separate all of the wires.

Check the resistance between the black and the ground on both sets of cables. One of the cables should cause the continuity alert to ring and the other should not. Mark the affected one with a piece of black tape and place wire caps over the exposed ends of the black wires.

Check the wires at the panel to see if the short has cleared. If the short is clear, the problem lies down stream from the opened box and it is now safe to turn the breaker back on to help eliminate further problem points. If the short is still present, the problem lies between the opened electrical box and the panel.

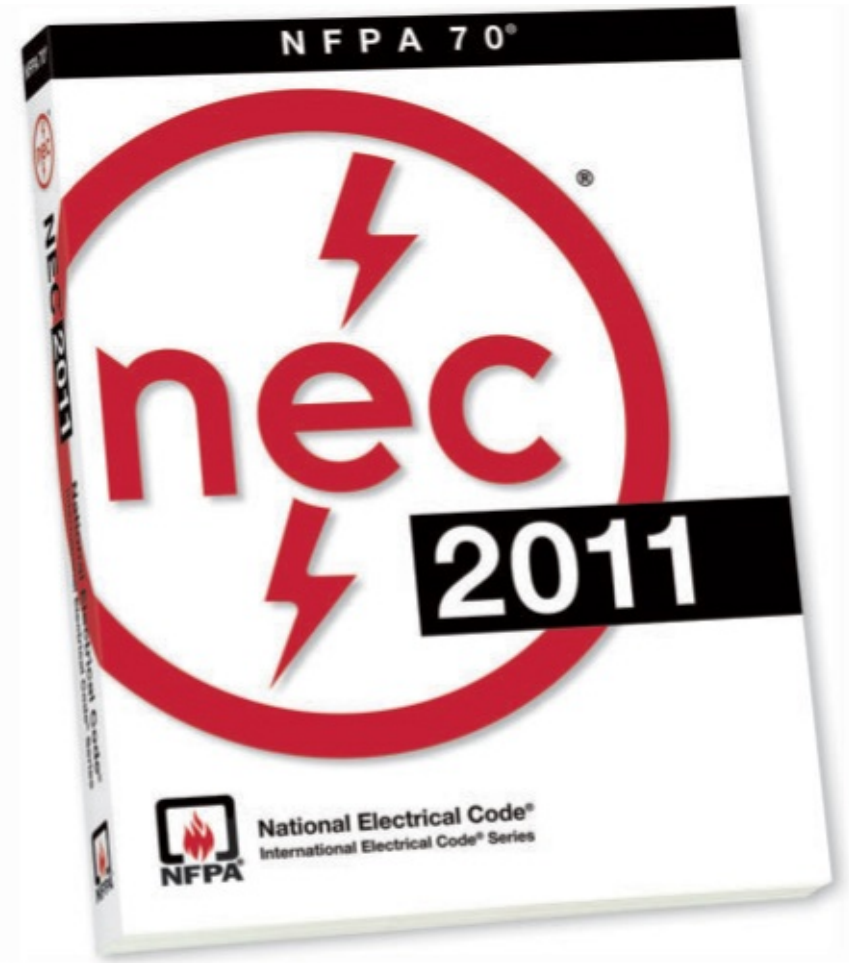


Choose another box in the middle of the affected circuit, there by narrowing down the possible problem areas until the short circuit can be positively identified and corrected. When you have discovered the short circuit, verify the wires are still in good shape and repair the connection.

Common Residential Wiring Codes

Home wiring is a very popular do-it-yourself subject that is fundamentally hazardous. When it comes to electricity, mistakes and accidents do pose threats including fire, injury, and death. Therefore, safety is the primary focus of the electrical code provisions.

In this chapter you will find many of the rules governing safe installation of electrical wires, electrical equipment—including conduit, electrical receptacles, switches, lights, and other fixtures. Use this information to inspect your wiring and make sure it all conforms to code. If it does not, or if you are unsure about it, have a professional electrician upgrade your electrical system.



The National Electrical Code (NEC), and local electrical codes and building codes, provide guidelines for determining how much power and how many circuits your home needs. Your local electrical inspector can tell you which regulations apply to your job.

Prepare for inspections. Remember that your work must be reviewed by your local electrical inspector. When planning your wiring project, always follow the inspector's guidelines for quality workmanship.

General Requirements

CLOSURE OF UNUSED OPENINGS

1. Close all openings in boxes, conduit bodies, and cabinets with material that provides protection equal to the original opening cover. This means using plastic or metal knockout covers. Tape and cardboard do not provide equal protection.
2. Recess metal knockout covers in nonmetallic boxes and conduit bodies at least 1/4 inch from the surface of the box or conduit body.
3. Cover open outlet boxes with a blank cover, a blank plate, or fixture canopy. Switch plates and receptacle plates do not provide complete closure for electrical boxes.
4. Ground metal covers and plates.

IDENTIFICATION OF CIRCUITS IN ELECTRICAL PANELS

1. Provide a legible and permanent marking or label that identifies the purpose of circuit breakers, fuses, and other equipment used to disconnect power from a circuit. Identify the circuit in enough detail so that it can be distinguished from all other circuits. Example: do not identify a circuit as general lighting. Identify the specific rooms or outlets served by the circuit. A marking or label is not required if the purpose of the disconnecting equipment is self-evident. Use marking or labeling materials that will withstand the environment where the disconnecting equipment is located.
2. Locate the circuit identification on the face of the panelboard enclosure or on the inside panelboard door.

Cover open conduit knockouts in electrical boxes with an approved plastic or metal cap (inset).

Cover open circuit breaker knockouts with an approved plastic or metal cover.

PROHIBITED LOCATIONS FOR EXISTING ELECTRICAL PANELS

1. Do not locate electrical panels and circuit breakers or fuses in clothes closets, bathrooms, or spaces designated for storage.

Label each circuit in all electrical panels so that the purpose of each circuit is clear.

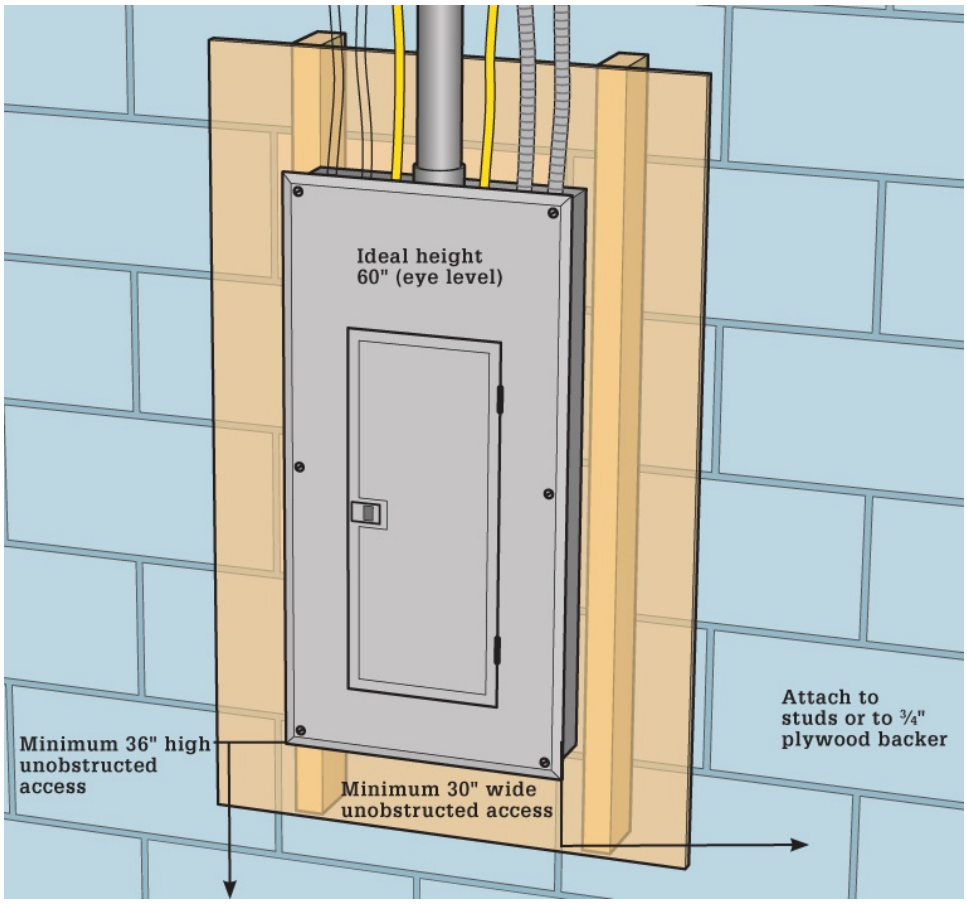
WORKING CLEARANCES AROUND ELECTRICAL PANELS

1. Inspect your electrical service panel to make sure it conforms to code. If not, hire a professional electrician to relocate it. Panel should have a clear working space in front of electrical panel enclosures and other equipment and enclosures that require access while interior parts are energized. Examples of other enclosures and equipment include air conditioner and furnace service-disconnect boxes.
2. Clear working space should be at least 36 inches deep, and at least 30 inches wide (or as wide as the enclosure, if it is wider than 30 inches), and at least 78 inches high. Measure the clear working space in front of the enclosure beginning at the front of the enclosure. Measure the clear working space from the energized parts, if the parts requiring access are not in an enclosure.
3. Panel should have enough clearance so that the enclosure door can be opened at least 90 degrees.
4. Do not allow any objects located above or below the electrical enclosures to extend into the clear working space more than six inches beyond the front of the electrical enclosure.
5. Panel should provide access to the clear working space. Do not block access

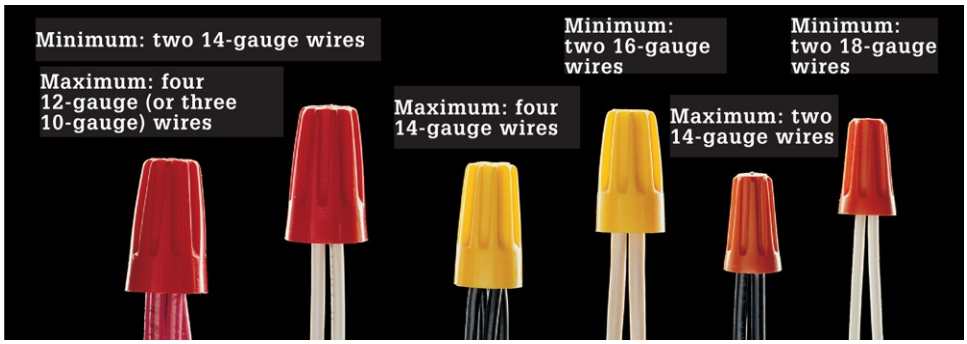
with shelves, workbenches, or other difficult to move objects.

CLEAR SPACE ABOVE & BELOW ELECTRICAL PANEL ENCLOSURES

1. Maintain a clear space directly above and below electrical panel enclosures, free from any components not associated with the electrical system. This space is intended for wires entering and leaving the electrical panel. Do not install plumbing pipes, HVAC ducts, and similar components in this space.
2. Maintain a clear space that is at least the width and depth of the electrical panel enclosure.



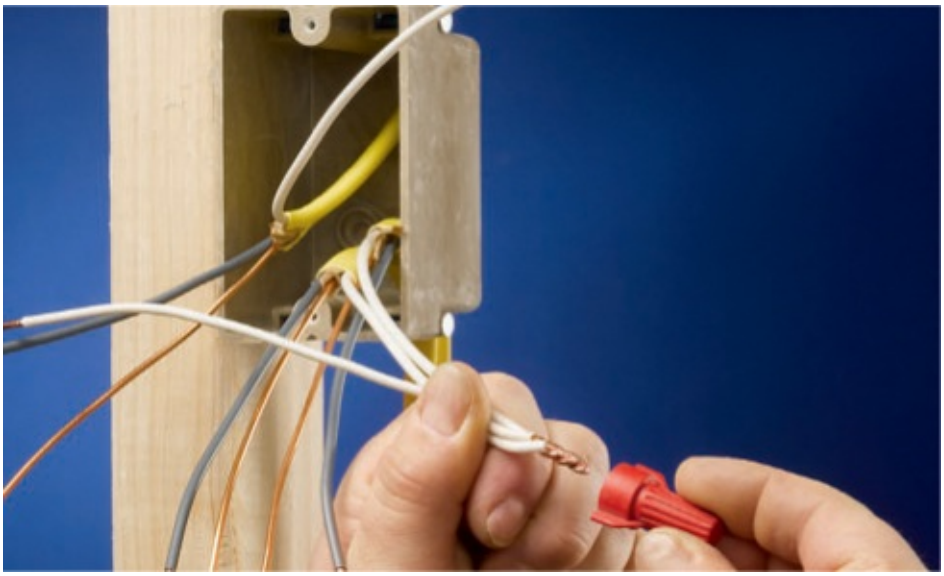
Your equpment should include a safe space above, in front of, and below all electrical panels and similar electrical equipment. If your panel does not meet these standards, have it relocated by a professional.



Use wire connectors rated for the wires you are connecting. Wire connectors are color-coded by size, but the coding scheme varies according to manufacturer. The wire connectors shown above come from one major manufacturer. To ensure safe connections, each connector is rated for both minimum and maximum wire capacity. These connectors can be used to connect both conducting wires and grounding wires. Green wire connectors are used only for grounding wires.

SPLICING WIRES

1. Splice (join) wires using only listed devices such as appropriate sized wire connectors. Use wire connector according to manufacturer's recommendations regarding the minimum and maximum number and size of wires that the connector can accommodate.
2. Cover spliced wires with material equal to the original insulation. This does not include electrical tape or similar materials.
3. For splice wires that will be buried in the ground, use only devices listed for direct burial and install them according to manufacturer's instructions.
4. Provide access to spliced wires, unless the splice and splicing device are specifically allowed to be concealed. Access is usually provided by an accessible, covered junction box.
5. Do not place wire splices in a raceway unless the raceway has a removable cover.



Twist wire connectors over the ends of individual conductors that have been stripped of insulation. Pre-twist wires together with pliers or linesmans' pliers (optional). Do not leave bare wire exposed beneath bottom of connector.

Push-in connectors are a relatively new product for joining wires. Instead of twisting the bare wire ends together, you strip off about 3/4" of insulation and insert them into a hole in the connector. The connectors come with two to four holes sized for various gauge wires. These connectors are perfect for inexperienced DIYers because they do not pull apart like a sloppy twisted connection can.

SPLICING ALUMINUM & COPPER WIRES

1. Splice (join) aluminum and copper wires together using devices listed for splicing aluminum and copper wires. Look for a mark or label such as AL/CU

on the device or on the package for assurance that the device is listed for splicing aluminum and copper wires. Some wire nuts sold for residential use are not listed for splicing aluminum and copper wires.

2. Use only inhibitors and antioxidant compounds that are approved for splicing aluminum and copper wires. These materials should not degrade or damage the wires, wire insulation, or equipment. Read and follow manufacturer's instructions.

LENGTH OF WIRES EXTENDING FROM BOXES

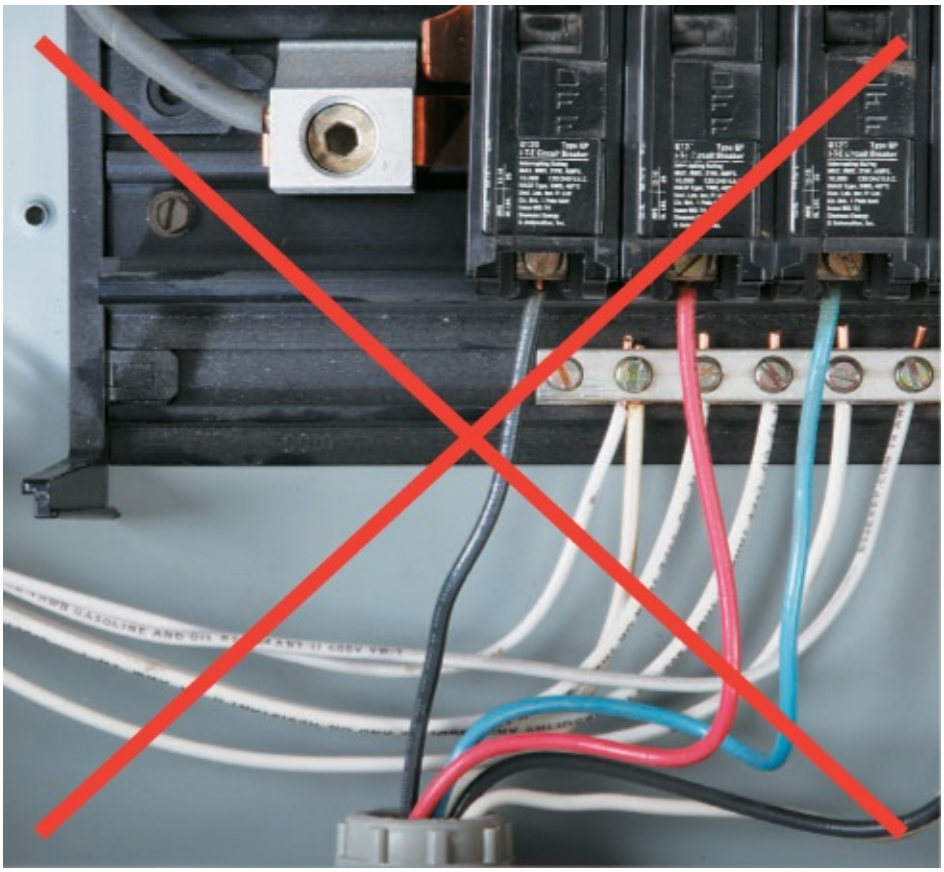
1. Extend wires at least three inches beyond the opening of any electrical box, junction, or switch point, if the opening is less than eight inches in any direction. This applies to most switch, receptacle, and light fixture mounting boxes used in residential electrical systems.
2. Extend wires at least six inches beyond where the wires emerge from the raceway or cable sheathing. Example: NM cable enters a single residential switch box with one inch of intact sheathing (outer cover). Begin the six inches measurement where the sheathing ends. The cable should extend at least seven inches from the rear of the box. The NM cable should also extend at least three inches beyond the outside edge of the box.

CONNECTING WIRES TO TERMINALS

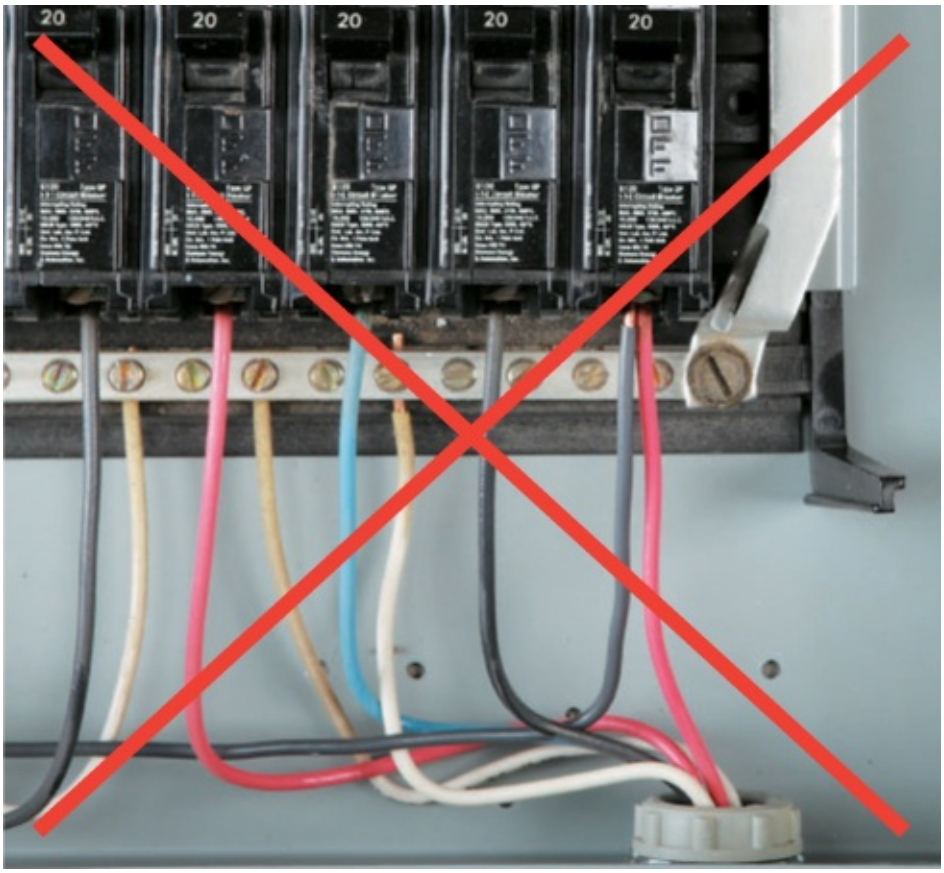
1. Remove insulation from wires and connect wires to terminals without damaging the wire. Do not connect damaged wires to terminals. Example: if you nick, damage, or cut strands from a stranded wire, cut the wire back to where it is full size and use the full, undamaged wire.
2. Connect more than one wire to a terminal only if the terminal is identified to accept multiple wires. Example: many panelboards require one wire per terminal for the grounded (neutral) wires and allow two or more same gauge wires per terminal for the equipment grounding wires. Example: many circuit breakers allow only one hot (ungrounded) wire per circuit breaker terminal.

Extend wires past the box opening at least 3".

3. Connect aluminum wires to terminals only if the terminal is identified to accept aluminum wires.



VIOLATION! Do not connect multiple neutral or hot wires to a terminal unless specifically allowed (neutral bus bar seen here has two neutral conductors connected to single terminal).



VIOLATION! Never connect multiple hot wires to the same terminal on circuit breakers or other electrical devices unless specifically allowed by the manufacturer.

WIRE COLOR CODES

1. Use wires with white or gray colored insulation or wires with three white stripes on other than green insulation as neutral (grounded) wires. You may use wires with other than white or gray colored insulation as neutral (grounded) wires if they are larger than #6 AWG and if you mark them with a permanent white marking at all wire terminations.
2. Use wires with green colored insulation or wires with green colored insulation and at least one yellow stripe as equipment grounding wires. You may use uninsulated (bare) wires as equipment grounding wires in most circuits.
3. You may use any color other than white, gray, or green as hot (ungrounded) wires. The common colors are red and black. You may use a wire with white or gray insulation as a hot (ungrounded) wire if the wire is part of a cable (such as NM) and if you permanently mark it as a hot (ungrounded) conductor at all places where the wire is visible and accessible. This marking is usually done by wrapping the end of the wire with black or red electrical tape.

Wire Color Chart

WIRE COLOR		FUNCTION
	White	neutral wire: at zero voltage in many, but not all, circuits
	Black	hot wire carrying current at full voltage
	Red	hot wire carrying current at full voltage
	White, Black markings	hot wire carrying current at full voltage
	Green	serves as a grounding pathway
	Bare copper	serves as a grounding pathway

Individual wires are color-coded to identify their function. In some circuit installations, the white wire serves as a hot wire that carries voltage. If so, this white wire may be labeled with black tape or paint to identify it as a hot wire.

Wire Size Chart

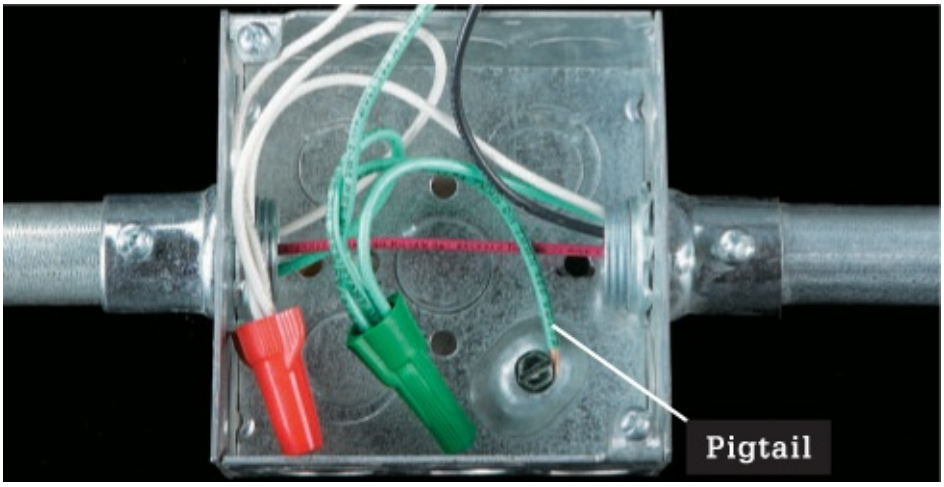
WIRE GAUGE		WIRE CAPACITY & USE
	#6	55 amps; central air conditioner, electric furnace
	#8	40 amps; electric range, central air conditioner

	#10	30 amps; window air conditioner, clothes dryer
	#12	20 amps; light fixtures, receptacles, microwave oven
	#14	15 amps; light fixtures, receptacles
	#16	light-duty extension cords
	#18 to 22	thermostats, doorbells, security systems

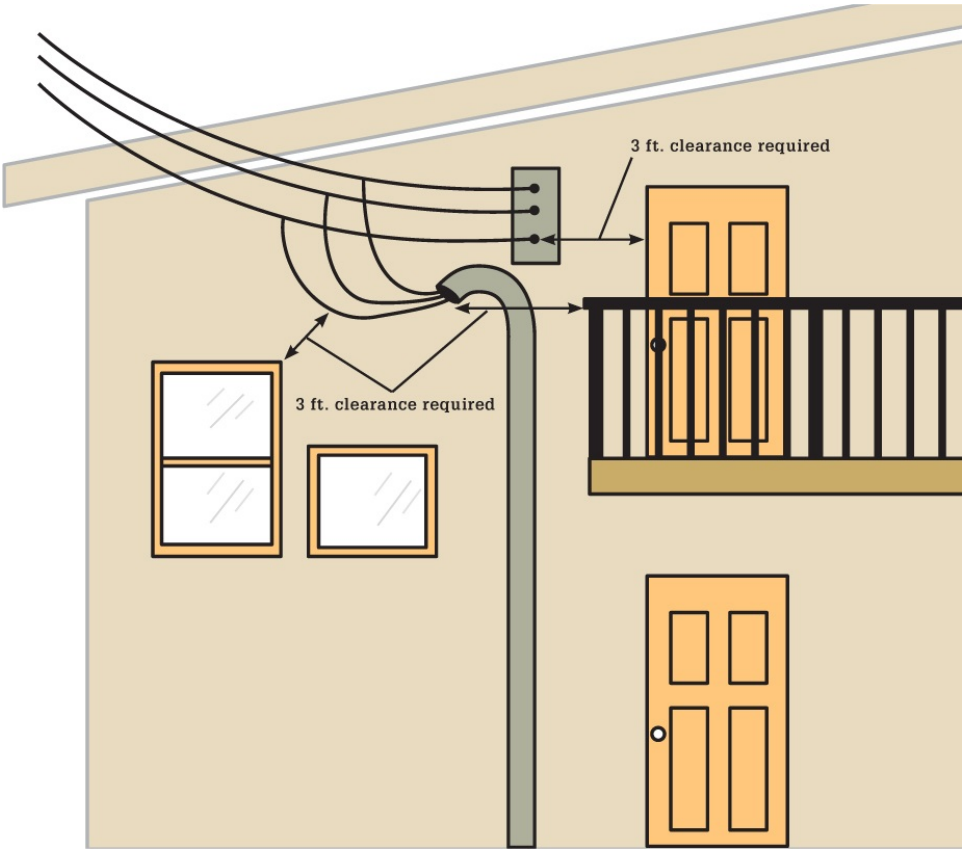
Wire sizes (shown actual size) are categorized by the American Wire Gauge system. The larger the wire size, the smaller the AWG number.

NEUTRAL & EQUIPMENT GROUNDING WIRE CONTINUITY

1. Connect neutral (grounded) wires together in device boxes if the neutral (grounded) wire is part of a multiwire branch circuit. Do not rely on any device, such as a receptacle or light fixture, to provide the connection for the neutral (grounded) wire in a multiwire branch circuit.
2. Connect equipment grounding wires together in all device boxes. Do not rely on any device, such as a receptacle or light fixture, to provide the connection for the equipment grounding wire in any circuit.
3. Install a wire (called a pigtail) between the connected wires and any device in the box.



Use a pigtail when you need to connect multiple wires together and use one wire to connect to a terminal.



Inspect your service clearance to make sure individual service wires are within 3 ft. from doors, operable windows, and decks.

OVERHEAD SERVICE DROP WIRE CLEARANCES

1. Service should provide at least three feet clearance between service drop and service entrance wires and porches, decks, stairs, ladders, fire escapes, balconies, sides of doors, and sides and bottoms of operable windows (not the

tops of windows). Clearance should be provided only to service drops and service entrance wires that consist of individual wires and wires that are not protected by a raceway or outer jacket. This means that clearances are usually required for utility service drop wires and are not required for SE type service entrance cable and for wires or cables installed in conduit or tubing.

2. Service should provide at least eight feet vertical clearance between service drop wires and a roof not designed for regular pedestrian traffic with a slope less than four inches in 12 inches.
3. Service should provide at least 10 feet vertical clearance between service drop wires and a roof designed for regular pedestrian traffic. Access to such a roof would usually be by stairs or by a door and the roof edges would be protected by a guard.
4. Service should provide at least three feet vertical clearance between service drop wires and roof with a slope at least four inches in 12 inches.
5. Service should provide at least 18 inches vertical clearance between service drop wires and a roof if: (a) the wires pass only over the overhang portion of the roof, and if (b) not more than six feet of wire pass over not more than four linear feet of roof surface measured horizontally, and if (c) the wires enter a through-the-roof mast or terminate at an approved support.

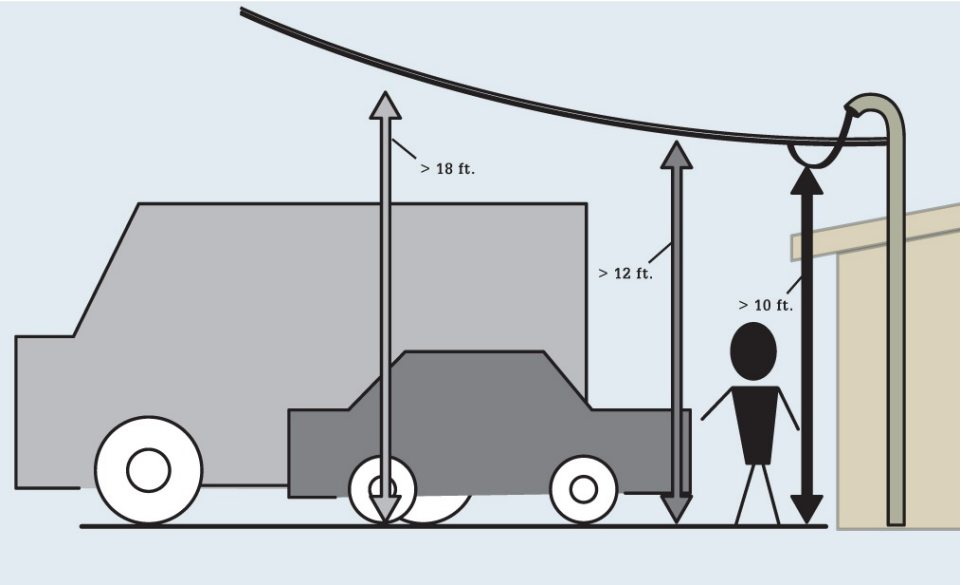
SERVICE DROP CLEARANCE ABOVE GROUND

1. Measure the vertical clearance between service drop wires and the ground, walkway, driveway, or street beginning at the lowest point of the service drop wires and ending at the surface under the wire's lowest point. The lowest point of the service drop wires is often at the drip loop, but it could be at the point of attachment to the house or it could be where the wires enter the house.
2. Provide at least 10 feet vertical clearance between service drop wires and areas or sidewalks accessed by pedestrians only.
3. Provide at least12 feet vertical clearance between service drop wires and residential property and driveways.
4. Provide at least 18 feet vertical clearance between service drop wires and public streets, alleys, roads, or parking areas subject to truck traffic.

Safety Tip

If your electrical service entry does not conform to the codes, hire a professional to update it.

The service drop must occur at least 10 ft. above ground level, and as much as 18 ft. in some cases. Occasionally, this means that you must run the conduit for the service mast up through the eave of your roof and seal the roof penetration with a boot.

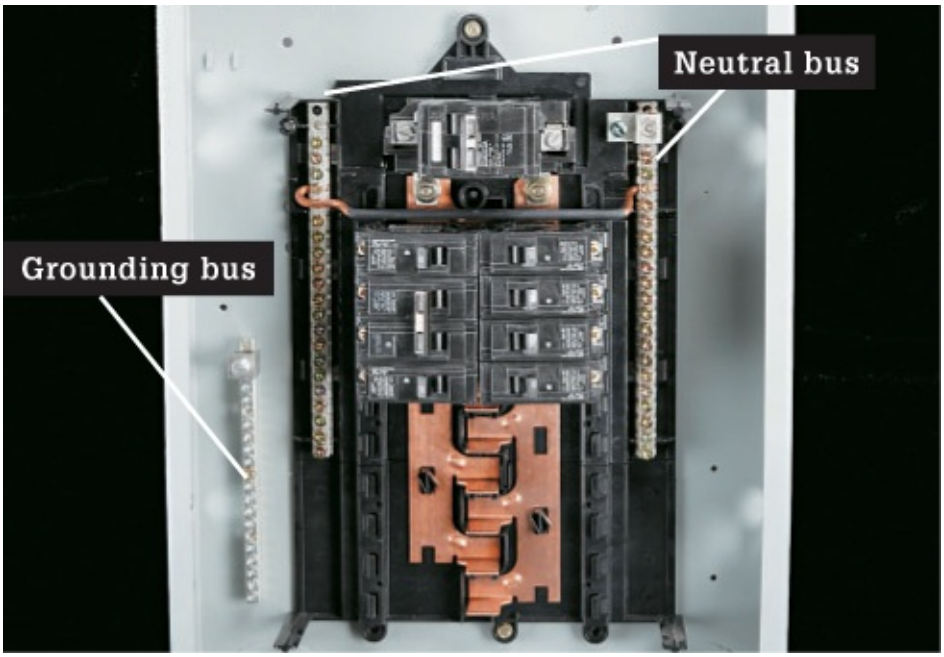


Safe clearance between service drop wires and the ground.

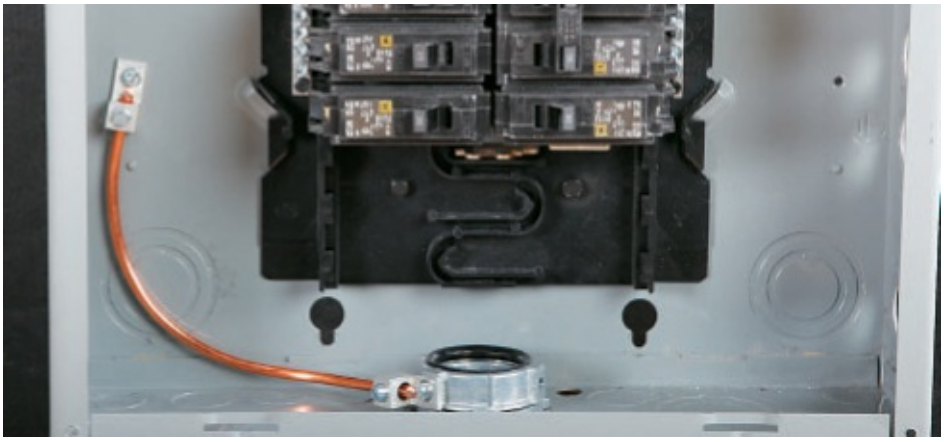
Inspect Electrical Panels for Proper Grounding

GROUNDING & BONDING AT SERVICE PANELS AND SUBPANELS

1. The neutral (grounded) wire should be connected to the grounding electrode wire at the nearest accessible point at or before the service equipment (main disconnect). The service equipment is usually the most convenient accessible grounding point because the meter enclosure and points before it are usually locked or secured and not accessible. The grounding electrode wire connects the neutral (grounded) wire to a grounding electrode.

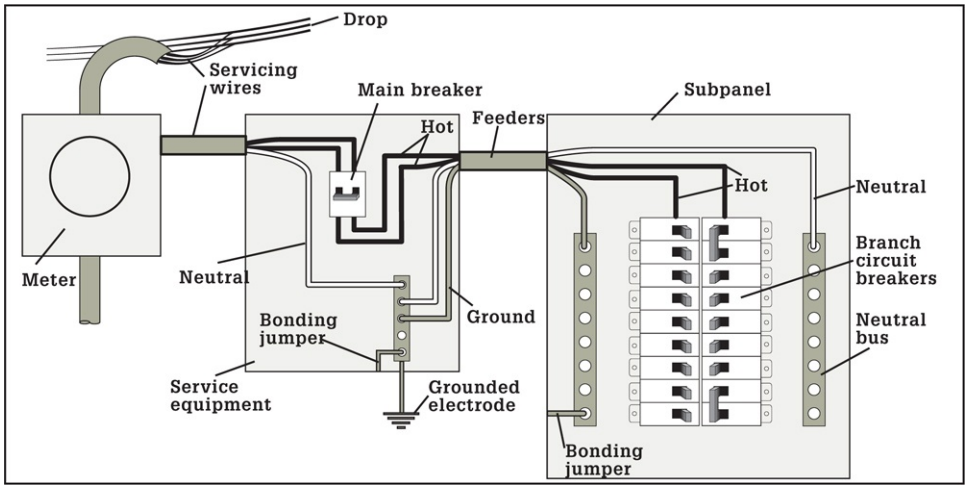


The neutral and grounding wires should not be connected to the same bus in most subpanels. The grounding bus should be bonded to the subpanel cabinet. The neutral bus should not be bonded to the subpanel cabinet.



Metallic conduit must be physically and electrically connected to panel cabinets. A bonding bushing may be required, in some cases, where all of a knockout is not removed.

2. The neutral (grounded) wire should not be connected to ground at any other place downstream from the service equipment grounding point. An exception to this rule exists when two buildings are supplied by one electric service.
3. All metal parts of the electrical system should be connected to the neutral (grounded) wire. This includes service equipment and panelboard cases, any metal electrical conduit or tubing, and all metal pipes in the building (such as metal water and gas pipe).



Parts of a common electrical service configuration.

SERVICE GROUNDING AT TWO BUILDINGS USING FOUR-WIRE FEEDER

1. This is the procedure that should be used when installing a new feeder cable to a second building from the building with the primary electric service. This procedure is not required if there is only one branch circuit in the second building and if the new feeder cable contains an equipment grounding wire.

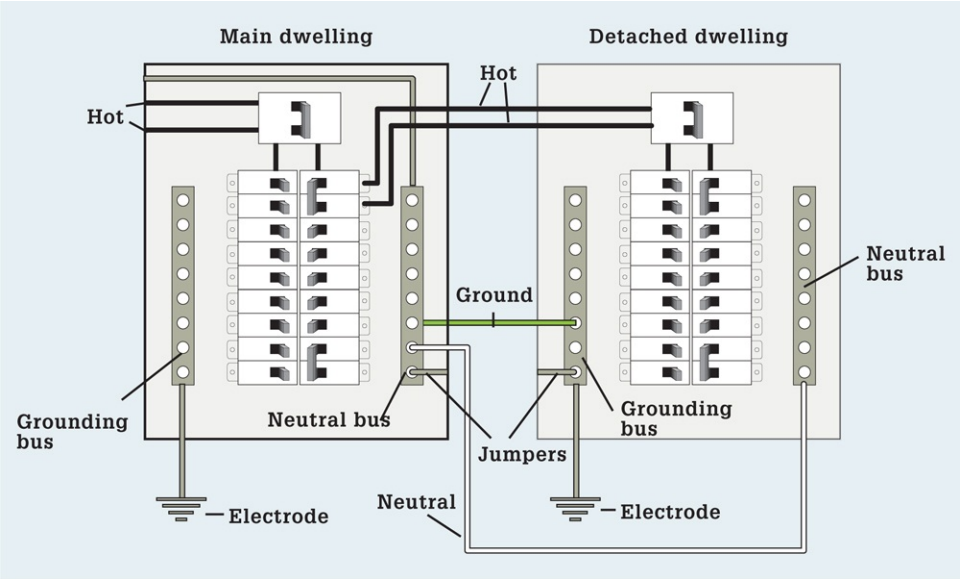
a) A feeder cable should be installed to the second building that contains an equipment grounding wire. The equipment grounding wire should have been sized as required by International Residential Code Section E3908.

b) A grounding electrode should be installed at both buildings.

c) The feeder cable equipment grounding wire should be connected to the grounding electrode wire at the second building subpanel grounding bus. All second building branch circuit equipment grounding wires should be connected to the grounding bus.

d) The subpanel case should be bonded to the grounding bus.

e) The feeder cable neutral (grounded) wire should be connected to an isolated grounded bus at the second building subpanel. The grounded bus should not be connected to the subpanel case or to the grounding bus.



Wiring diagram for wiring a 4-wire feeder from the main service panel to a subpanel in a separate building.

Grounding Electrodes & Electrode Wires

GENERAL REQUIREMENTS

1. Every electrical service should be provided at least one approved type of grounding electrode. The most common grounding electrodes are underground metal water pipe, driven rod and pipe, and concrete encased.
2. All grounding electrodes that may be available at a building should be bonded together. General codes do not require that all possible types of grounding electrodes be installed. They require that if a grounding electrode is installed, it must be connected (bonded) to all other grounding electrodes and to the neutral (grounded) wire.
3. A bonding jumper at least as large as the grounding electrode wire should be used to connect (bond) the grounding electrodes. Bonding jumpers may be connected between grounding electrodes at any convenient point.
4. The grounding electrode wire may be connected at any convenient grounding electrode.
5. Metal underground gas pipe should never be used as a grounding electrode.

Current Wiring Methods

The table “Current Wiring Methods” lists the wiring methods currently allowed in residential construction. Note that certain wiring methods may not be used in certain applications.

APPROVED USES FOR WIRING METHODS

1. The table “Current Wiring Methods Allowed Usesg” lists when a wiring method may be used in a specific application. Note that some wiring methods have restrictions or limitations shown by the following superscripts in the table: (1) use less than six feet of LFC if the conduit walls are not reinforced, (2) insulate the neutral (grounded) wire unless the cable is used to supply other buildings on the same property, (3) insulate the neutral (grounded) wire, (4) use wires approved for wet locations and seal raceways to prevent water entry, (5) use materials listed as sunlight resistant, (6) protect metal raceways from corrosion, (7) use Schedule 80 RNC, (8) use materials listed as sunlight resistant if exposed to direct sunlight, (9) use less than six feet of conduit.

Current Wiring Methods

WIRING METHOD	ABBREVIATION
Armored cable	AC
Electrical metallic tubing	EMT
Electrical nonmetallic tubing	ENT
Flexible metal conduit	FMC
Intermediate metal conduit	IMC
Liquidtight flexible conduit	LFC
Metal-clad cable	MC
Nonmetallic sheathed cable	NM
Rigid nonmetallic conduit	RNC

Rigid metallic conduit	RMC
Service entrance cable	SE
Surface raceways	SR
Underground feeder cable	UF
Underground service cable	USE

Current Wiring Methods Allowed Uses

ALLOWED APPLICATION	AC	EMT	ENT	FMC	IMC RMC RNC	LFC[1]
Service entrance	NO	OK	OK[8]	OK[9]	OK	OK[9]
Feeder	OK	OK	OK	OK	OK	OK
Branch circuits	OK	OK	OK	OK	OK	OK
Indoors (e.g., in stud walls)	OK	OK	OK	OK	OK	OK
Wet locations & exposed to sunlight	NO	OK	OK[8]	OK[4]	OK	OK
Damp locations	NO	OK	OK	OK[4]	OK	OK
Embedded in concrete in dry location	NO	OK	OK	NO	OK	NO
Embedded in concrete below grade	NO	OK[6]	OK	NO	OK[6]	NO
Embedded in plaster in dry location	OK	OK	OK	OK	OK	OK
Embedded in masonry	NO	OK	OK	NO	OK[6]	OK
In masonry voids & cells in damp location or below grade	NO	OK[6]	OK	OK[4]	OK[6]	OK
Fished in masonry voids	OK	NO	NO	OK	NO	OK
In masonry voids & cells in dry location	OK	OK	OK	OK	OK	OK
Exposed not subject to damage	OK	OK	OK	OK	OK	OK
Exposed subject to damage	NO	NO	NO	NO	OK[7]	NO
Direct burial	NO	OK[6]	NO	NO	OK[6]	OK

Current Wiring Methods Allowed Uses

ALLOWED APPLICATION	MC	NM	SR	SE	UF	USE
Service entrance	OK	NO	NO	OK	NO	OK
Feeder	OK	OK	NO	OK[2]	OK	OK[2]
Branch circuits	OK	OK	OK	OK[3]	OK	NO
Indoors (e.g., in stud walls)	OK	OK	OK	OK	OK	NO
Wet locations & exposed to sunlight	OK	NO	NO	OK	OK[5]	OK[5]
Damp locations	OK	NO	NO	OK	OK	OK
Embedded in concrete in dry location	NO	NO	NO	NO	NO	NO
Embedded in concrete below grade	NO	NO	NO	NO	NO	NO
Embedded in plaster in dry location	OK	NO	NO	OK	OK	NO
Embedded in masonry	OK	NO	NO	NO	NO	NO
In masonry voids & cells in damp location or below grade	OK	NO	NO	OK	OK	NO
Fished in masonry voids	OK	OK	NO	OK	OK	NO
In masonry voids & cells in dry location	OK	OK	NO	OK	OK	NO
Exposed not subject to damage	OK	OK	OK	OK	OK	OK
Exposed subject to damage	NO	NO	NO	NO	NO	NO
Direct burial	OK[6]	NO	NO	NO	OK	NO

RULES FOR NM CABLE

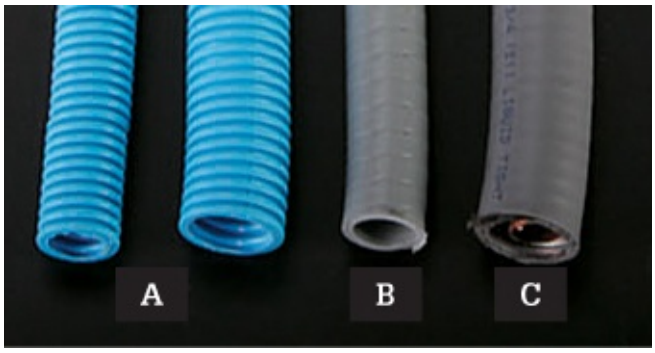
1. Use table "NM Cable Maximum Ampacity" to determine the maximum ampacity and overcurrent protection of NM cable. NM cable is often referred to by the trade name *Romex*. This table will apply to almost all branch circuit and feeder wiring in modern residential electrical systems. Example: the maximum rating for a circuit breaker protecting Number 12 copper wire is 20 amps.

NM Cable Maximum Ampacity

WIRE SIZE (AWG)	COPPER WIRE (AMPS)	ALUMINUM WIRE (AMPS)
14	15	

		-
12	20	15
10	30	25
8	40	30
6	55	40
4	70	55
3	85	65
2	95	75
1	110	85

Rigid metal conduit has threaded ends for making watertight connections with female-threaded fittings and couplings.



Electrical nonmetallic tubing (A) is an interior-rated material. Liquidtight flexible conduit can be all nonmetallic (B) or it can be metallic conduit with a nonmetallic sheath (C).

Nonmetallic sheathed cable is available in the most common gauges used in residential construction.

Maximum Hole or Notch Size in Studs and Joists

FRAMING MEMBER	MAXIMUM HOLE SIZE	MAXIMUM NOTCH SIZE
2 × 4 load-bearing stud	1-7/16” diameter	7/8” deep
2 × 4 nonload-bearing stud	2-1/8” diameter	1-7/16” deep
2 × 6 load-bearing stud	2-1/4” diameter	1-3/8” deep
2 × 6 nonload-bearing stud	3-5/16” diameter	2-3/16” deep
2 × 6 joists	1-7/8” diameter	7/8” deep
2 × 8 joists	2-3/8” diameter	1-1/4” deep
2 × 10 joists	3-1/16” diameter	1-1/2” deep
2 × 12 joists	3-3/4” diameter	1-7/8” deep

This framing member chart shows the maximum sizes for holes and notches that can be cut into studs and joists when running cables. When boring holes, there must be at least 5/8" of wood between the edge of a stud and the hole, and at least 2" between the edge of a joist and the hole. Joists can be notched only in the end 1/3 of the overall span, never in the middle 1/3 of the joist.

NM & UF CABLE INSTALLATION

1. Use NM and UF cable where the cable is not subject to physical damage.

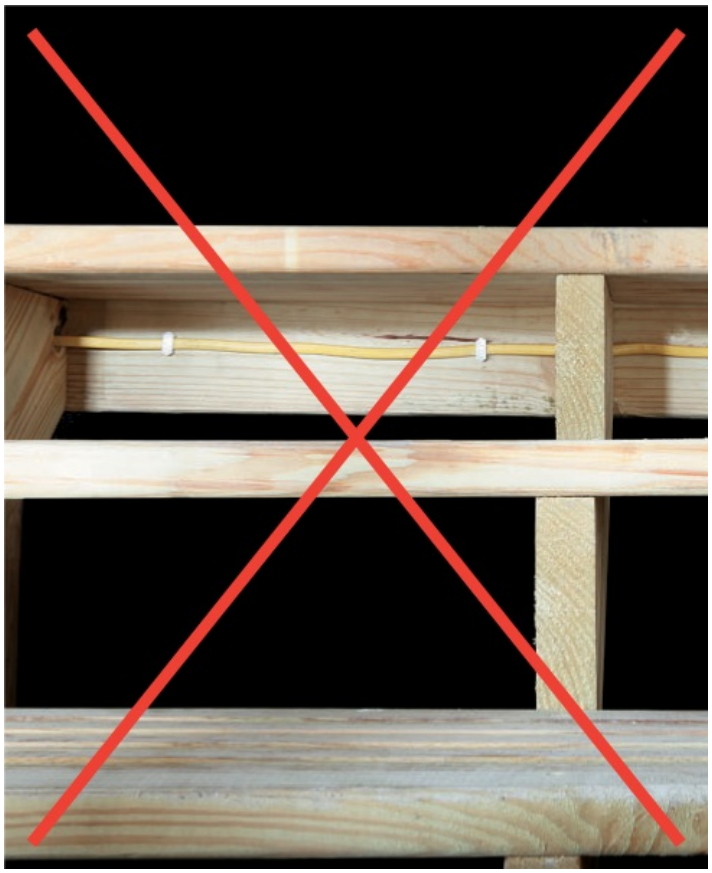
Physical damage can occur unless the cable is covered by drywall or other material or unless the cable is run in conduit or tubing. Physical damage includes damage by sunlight.

2. Protect NM and UF cable using RMC, IMC, EMT, or Schedule 80 RNC when the cable is subject to physical damage. Extend the protection at least six inches above the floor when the cable runs through the floor. This provision applies to exposed wall framing, such as unfinished basements and garages, and to cable that runs through framed and concrete slab floors. This provision does not apply to cable run in attics and in basement ceiling joists.
3. Protect NM and UF cable using nail guards or other approved physical protection when the cable is installed: **(a) through holes, notches, or grooves that are closer** than 1-1/4 inches to the edge of a stud or joist, (b) in notches and grooves in places such as drywall, plaster, and under carpet, unless the groove or notch is deeper than 1-1/4 inches, (c) through holes in metal framing (use grommets or bushings), and (d) parallel to the edge of a stud, joist, or furring strip when the cable is closer than 1-1/4 inches to the edge of the framing member.
4. Support NM and UF cable every 4-1/2 feet. Use wire staples or other approved fasteners to secure vertical runs of NM and UF cable. Staple the cable only on the flat edge. NM and UF cable run across the tops of joists is usually considered supported.
5. Secure NM and UF cable not more than 8 inches from boxes and terminations that do not have cable clamps. This includes most plastic boxes. Secure NM and UF cable not more than 12 inches from boxes and terminations that have cable clamps. This includes most metal boxes. Measure the support distance from where the cable sheathing ends in the box, not from the box itself.
6. Use NM cable only in dry locations that are indoors and not within concrete or masonry that is exposed to the ground. Do not use NM cable in conduit that is buried in the ground. Buried conduit is considered a wet location. You may use UF cable in wet locations including outdoors and underground if it is not subject to damage.

VIOLATION! Do not install NM and UF cable on drywall.

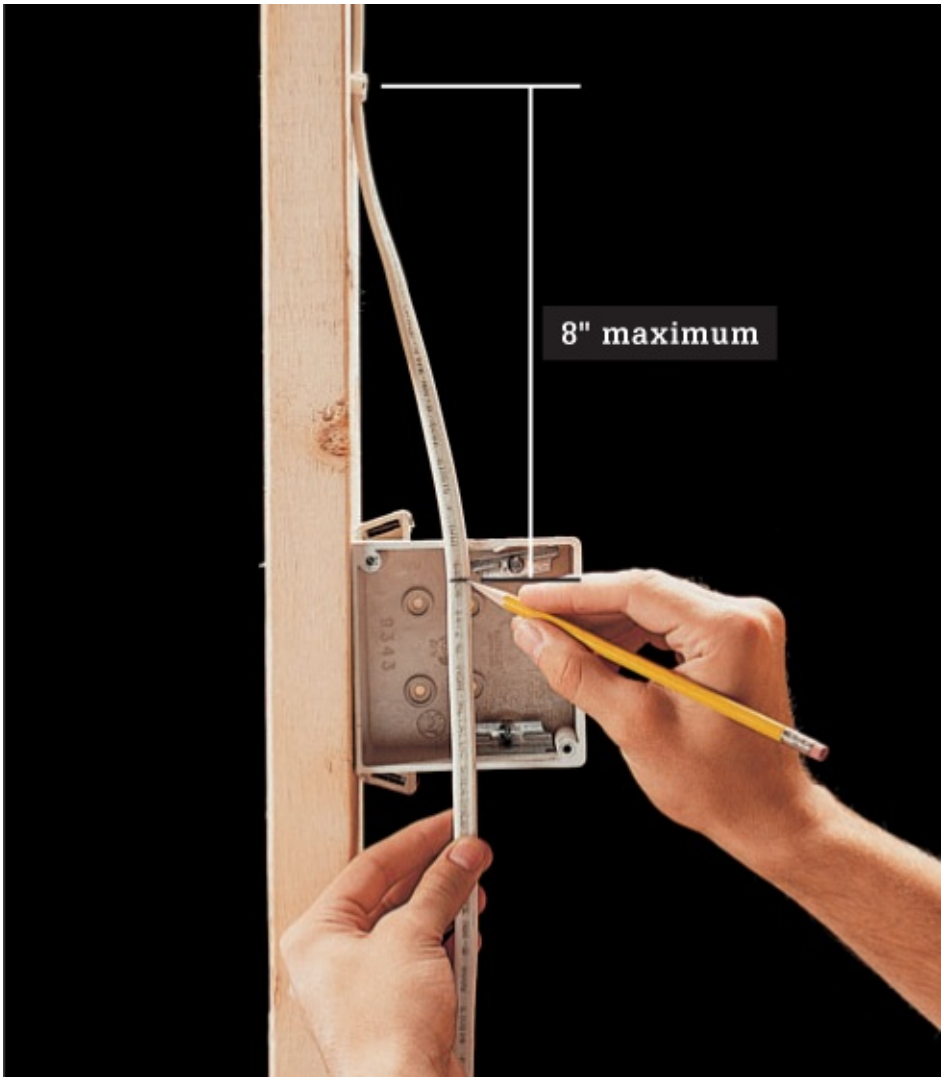
VIOLATION! Do not install NM and UF cable inside cabinets.

VIOLATION! Do not install NM and UF cable in exposed walls and ceilings. You may install NM and UF cable in exposed basement ceilings and attics under certain conditions.



VIOLATION! Do not install NM cable outdoors. Outdoors includes buried conduit. You may install UF cable outdoors if it is protected from physical damage.

Support NM and UF cable at least every 4-1/2 ft. Cable on top of ceiling joists is considered supported.



Secure NM and UF cable within 8" from where the cable enters or leaves a plastic box. Measure from where the cable sheathing ends in the box, not from the edge of the box.

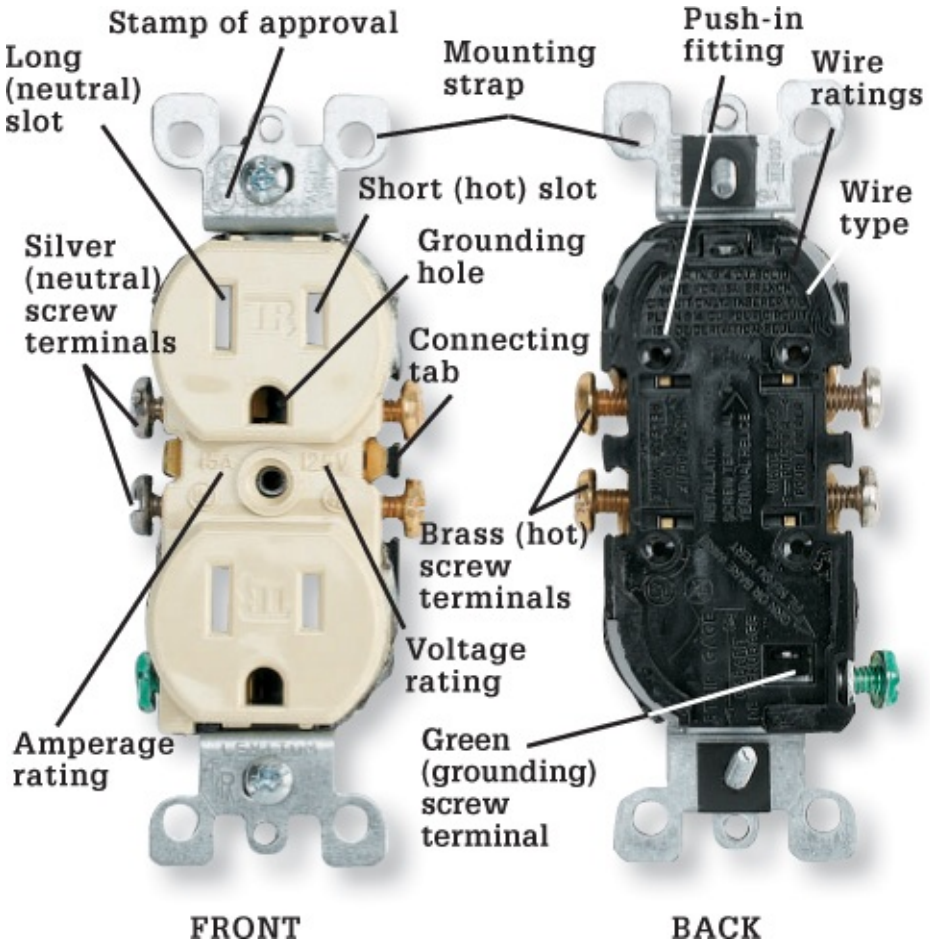
Electrical Receptacle Installation

Whether you call them outlets, plug-ins, or receptacles, these important devices represent the point where the rubber meets the road in your home wiring system. From the basic 15-amp, 120-volt duplex receptacle to the burly 50-amp, 240-volt appliance receptacle, the many outlets in your home do pretty much the same thing: transmit power to a load.

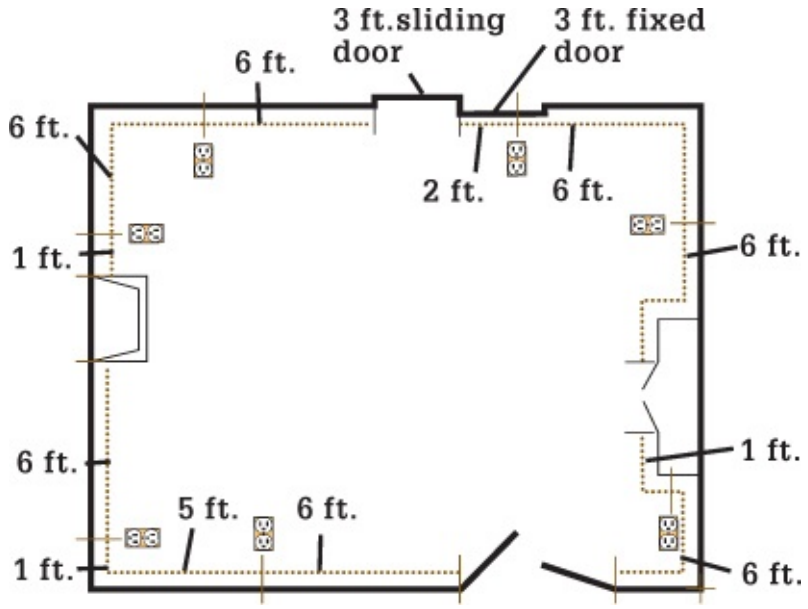
Learning the essential differences between receptacles does not take long. Amperage is the main variable, as each receptacle must match the amperage and voltage of the circuit in which it is installed. A 15-amp circuit should be wired with 15-amp receptacles; a 20-amp circuit needs 20-amp receptacles (identified by the horizontal slot that Ts into each tall polarized slot). A 20-amp multi-receptacle circuit may use either 15 or 20-amp receptacles. Receptacles for 240-volt service have unique slot configurations so you can't accidentally plug in an appliance that's not rated for the amperage in the circuit. Some receptacles can be wired using the push-in wire holes, but this is not recommended. Some receptacles provide built-in, ground-fault circuit protection, tripping the circuit breaker if there is a short circuit or power surge. These are easy to identify by reset and test buttons.

RECEPTACLE INSTALLATION IN ROOMS

1. Apply these provisions to receptacles in living rooms, family rooms, bedrooms, dens, sunrooms, recreation rooms, dining rooms, breakfast rooms, libraries, and similar living areas. Kitchens, bathrooms, hallways, garages, laundry rooms, and exterior receptacles have their own installation requirements.
2. Install the required interior receptacles so that any point along a wall is not more than six feet from a receptacle. Do not include operable doors, fireplaces, closet interiors, and similar openings when measuring a wall. A wall begins at the edge of an opening and continues around any corners to the next opening. Walls include fixed (not sliding) panels in doors that are at least two feet wide. Walls include partial height walls that serve functions such as room dividers and walls that form breakfast bars and similar bar-type counters. Walls include guards and railings at balconies, raised floors, and other areas where furniture could be placed.



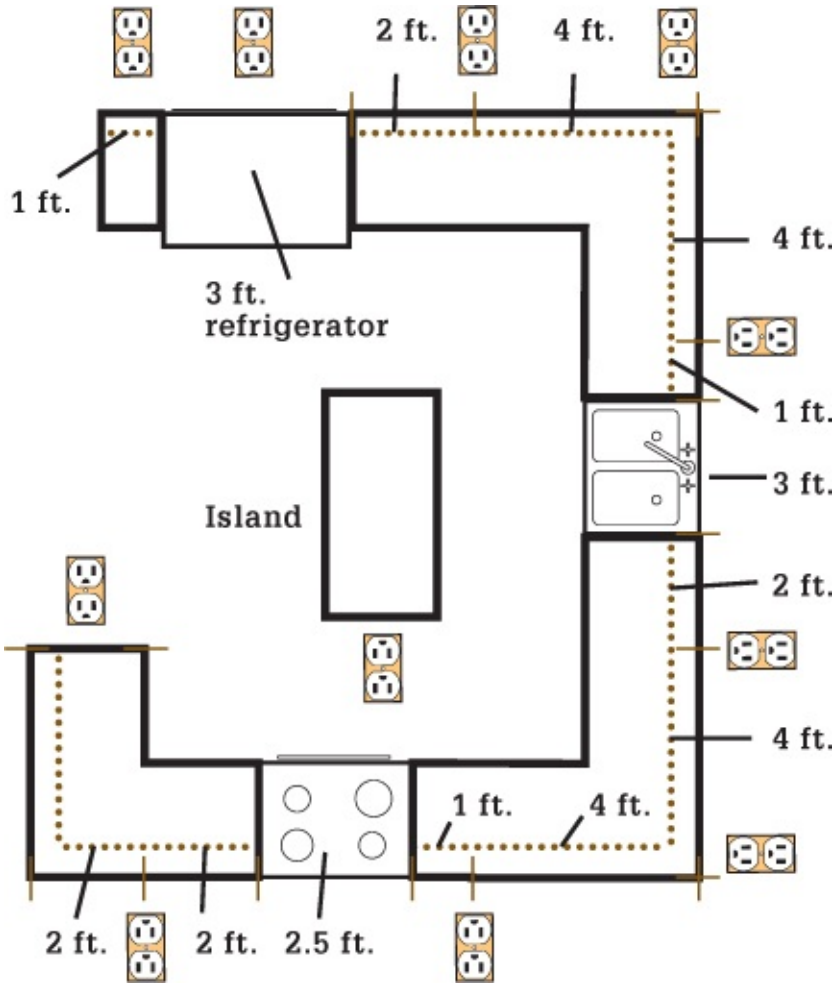
3. Locate floor receptacles intended to serve as required interior receptacles not more than 18 inches from the wall. You may install interior floor receptacles at any safe place, but you may count only receptacles not more than 18 inches from the wall among the required receptacles.
4. Install receptacles not more than 66 inches above the finished floor. You may install receptacles at any height, but you may count only receptacles not more than 66 inches above the finished floor among the required receptacles.



Example of receptacle spacing requirements in a typical room. Measure receptacle spacing distance along the wall line. Install receptacles along partial height walls and along balcony guards in lofts and similar areas.

KITCHEN COUNTERTOP RECEPTACLE INSTALLATION

1. Install a GFCI protected receptacle at every kitchen countertop that is at least 12 inches wide.
2. Install kitchen countertop receptacles so that all points along the countertop wall are not more than two feet from a receptacle. A wall begins at the edge of an opening or appliance and continues around any corners and ends at the next opening or appliance. Include windows when measuring the wall unless the window is above a sink or cooking appliance.
3. Install receptacles behind a sink or cooking appliance located along a straight wall if the countertop behind the sink or cooking appliance is at least 12 inches wide. Install receptacles behind a sink or cooking appliance located along a wall corner if the countertop behind the sink or cooking appliance is at least 18 inches wide.
4. Install receptacles not more than 20 inches above the countertop. You may install receptacles at any height, but you may include only receptacles not more than 20 inches above the countertop among the required kitchen countertop receptacles.
5. Do not include among the required kitchen countertop receptacles: (a) receptacles located in appliance garages, and (b) receptacles dedicated for a fixed-in-place appliance, and (c) receptacles not readily accessible for use by small appliances.
6. Do not install receptacles face up on work surfaces.



Example of countertop receptacle spacing in a typical kitchen.

You must install receptacles behind a short run of countertop if it is at least 12" wide along a straight wall.

You must install receptacles behind a sink or cooking appliance if the countertop behind the sink or cooking appliance is at least 18" wide in a corner cabinet.

Safety Tip

Always shut off power at the main service panel before inspection, repairing, or installing receptacles.

Ground-fault (GFCI) & Arc-fault (AFCI) Protection

GROUND-FAULT LOCATION REQUIREMENTS

1. Kitchen. Install ground-fault circuit interrupt (GFCI) protection on all 120-volt receptacles that serve kitchen countertops. This does not include receptacles under the kitchen sink and receptacles located on kitchen walls that do not serve the countertop.
2. Bathroom. Install ground-fault circuit interrupt (GFCI) protection on all 120-volt receptacles located in bathrooms. This applies to all receptacles regardless of where they are located in the bathroom and includes receptacles located at countertops, inside cabinets, and along bathroom walls. Install ground-fault circuit interrupt (GFCI) protection on all circuits serving electrically heated floors in bathrooms.
3. Garage and Accessory Building Receptacles. Install ground-fault circuit interrupt (GFCI) protection on all 120-volt receptacles located in garages and grade-level areas of unfinished accessory buildings. You do not need to provide GFCI protection for receptacles that are not readily accessible such as receptacles in the garage ceiling. You do not need to provide GFCI protection for dedicated receptacles that serve an appliance that is not easily moved. Examples of dedicated receptacles include receptacles for water softeners, refrigerators, alarm systems, and central vacuums. The receptacle must be a single receptacle when serving a single appliance or a duplex receptacle if serving two appliances. A duplex receptacle serving one appliance is a violation.
4. Exterior receptacles. Install ground-fault circuit interrupt (GFCI) protection on all 120-volt receptacles located outdoors. This does not apply to receptacles that are dedicated for deicing equipment and are located under the eaves. This applies to holiday lighting receptacles located under the eaves.
5. Basement receptacles. Install ground-fault circuit interrupt (GFCI) protection on all 120-volt receptacles located in unfinished basements. An unfinished basement is not intended as habitable space and is limited to storage and work space. The exceptions for garage receptacles apply to unfinished basement receptacles.

Ground-fault receptacles and circuit breakers detect unwanted current running between an energized wire and a grounded wire.

A combination ARC-fault circuit breaker detects sparking (arcing) faults along damaged energized wires and detects these faults between wires. A branch ARC-fault circuit breaker only detects arcing faults between wires. Use only combination ARC-fault circuit breakers in new work and when replacing old ARC-fault breakers.

6. Crawl space receptacles. Install ground-fault circuit interrupt (GFCI) protection on all 120-volt receptacles located in crawl spaces. Receptacles in crawl spaces are not required unless equipment requiring service is located there.
7. Laundry, utility, and bar sink receptacles. Install ground-fault circuit interrupt (GFCI) protection on all 120-volt receptacles that are located within six feet of the outside edge of a laundry, utility, or bar sink. This includes wall, floor, and countertop receptacles. This includes any appliance receptacles within the six feet distance, such as the washing machine receptacle.
8. Boathouse receptacles. Install ground-fault circuit interrupt (GFCI) protection on all 120-volt receptacles located in boathouses.
9. Spas, tubs, and other circuits requiring ground-fault protection. Install ground-fault circuit interrupt (GFCI) protection on all circuits serving spa tubs, whirlpool tubs, hot tubs, and similar equipment. Refer to the general codes for

more information about receptacles serving these components.

ARC-FAULT LOCATION REQUIREMENTS

1. Install an arc-fault circuit interrupter (AFCI) on each 120-volt branch circuit serving bedrooms. This means that lighting, smoke alarm, receptacle, and any other bedroom outlets must be AFCI protected. Install the AFCI at the origination of the branch circuit.
2. Use only combination type AFCI after January 1, 2008.
3. You may install the AFCI not more than six feet from the origination of the branch circuit if you run the wires in metal conduit or a metallic sheath. Measure the six feet along the branch circuit wires.
4. Note that the 2008 National Electrical Code (NEC) requires AFCI protection for all 15 and 20-amp branch circuits. This requirement is controversial and may not be adopted in every jurisdiction. Verify local adoption of the 2008 NEC requirement with your local building official.

Receptacles for whirlpool tubs must be GFCI protected.

Junction Boxes, Device Boxes & Enclosures

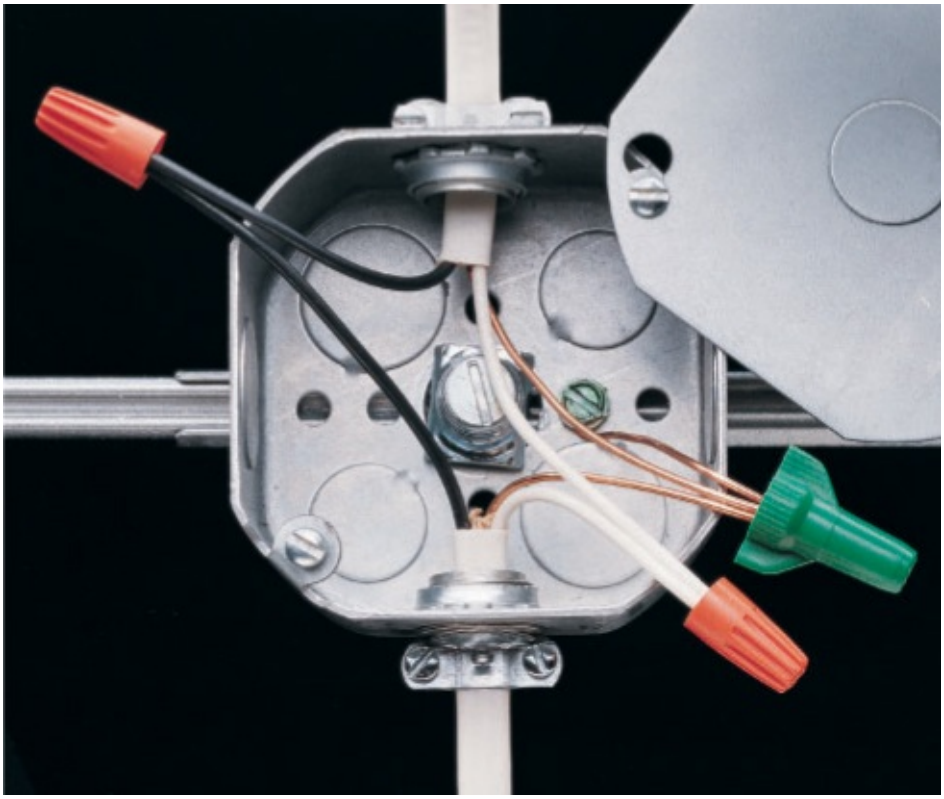
All electrical boxes are available in different depths. A box must be deep enough so a switch or receptacle can be removed or installed easily without crimping and damaging the circuit wires. Replace an undersized box with a larger box using the Electrical Box Fill Chart (see page 124) as a guide. **The NEC also says that all electrical boxes must remain accessible. Never cover an electrical box with drywall, paneling, or wall coverings.**

NONMETALLIC BOX INSTALLATION

1. Use nonmetallic boxes only with NM type cable or with nonmetallic conduit or tubing. You may use nonmetallic boxes with metallic conduit or tubing if you maintain the electrical continuity of the metallic conduit or tubing by installing a bonding jumper through the box. In many situations it is easier to use a metallic box with metallic conduit or tubing.
2. Extend NM cable sheathing at least 1/4 inch into a nonmetallic box knockout opening.
3. Secure NM cable, conduit, and tubing to each box. You may secure NM cable with cable clamps inside the box or with compression tabs provided where the cable enters the box. You do not need to secure NM cable to a standard single-gang box (2-1/4 by four inches) mounted in a wall or ceiling if you fasten the cable not more than eight inches from the box and if the sheathing enters the box at least 1/4 inch. Measure the eight inches along the length of the sheathing, not from the outside of the box.

LIGHT FIXTURE BOX INSTALLATION

1. Use boxes designed for mounting light fixtures if a light fixture is to be mounted to the box. These boxes are usually four-inch round or octagonal. You may use other boxes if the light fixture weighs not more than six pounds and is secured to the box using at least two #6 or larger screws.
2. Support light fixtures weighing at least 50 pounds independently from the light fixture box. You may use the light fixture box to support light fixtures weighing less than 50 pounds. Note that ceiling fans are not light fixtures.



Box shape is directly related to function, as electrical fixtures are created to fit on boxes of a particular shape. Octagonal and round boxes generally are designed for ceiling mounting, while square and rectangular boxes are sized for single-pole, duplex, and other standard switch and receptacle sizes.

Do not support heavy light fixtures using only the light fixture electrical box. The eye hook supporting this chandelier is driven into the same ceiling joist to which the electrical box is mounted.

BOX CONTENTS LIMITATIONS

1. Limit the number of wires, devices (such as switches and receptacles), and fittings in a box. This limitation is primarily based on the heat generated by the wires and devices in the box. The actual size of the box relative to its contents is a secondary consideration.
2. Use the cubic inch volume printed on the box or provided in the box manufacturer's instructions to determine box volume. Do not attempt to measure the box volume. Do not estimate box volume from the volume of similar size boxes. You will probably not get the same volume as provided by the manufacturer.
3. Use table "Wire Volume Unit" to determine the volume units required by

wires, devices, and fittings in a box.

BOX INSTALLATION TOLERANCES

1. Install boxes in non-combustible material, such as masonry, so that the front edge is not more than 1/4 inch from the finished surface.
2. Install boxes in walls and ceilings made of wood or other combustible material so that the front edge is flush with the finished surface or projects from the finished surface.
3. Cut openings for boxes in drywall and plaster so that the opening is not more than 1/8 inch from the perimeter of the box.

Boxes must be installed so the front edges are flush with the finished wall surface, and the gap between the box and the wall covering is not more than 1/8".

Wire Volume Unit

WIRE SIZE (AWG)	WIRE VOLUME
18	1.50 $in.^3$
16	1.75 $in.^3$
14	2.00 $in.^3$
12	2.25 $in.^3$
10	2.50 $in.^3$

8	3.00 in.^{3}
6	5.00 in.^{3}

Volume Units

Calculate the volume units required by wires, devices, and fittings based on the following definitions:

Volume units for current-carrying wires. Allow one volume unit for each individual hot (ungrounded) and neutral (grounded) wire in the box. Use Table 47 to determine the volume units of common wire sizes. Example: two pieces of #14/2 NM are in a box. Each piece of this cable contains one hot (ungrounded) and one neutral (grounded) wire and one grounding wire. From table “Wire Volume Unit”, each #14 wire uses 2.00 cubic inches in the box. The total volume units required by the hot (ungrounded) and neutral (grounded) wires is eight cubic inches.

Volume units for devices. Allow two volume units for each device (switch or receptacle) in the box. Base the volume units on the largest hot (ungrounded) or neutral (grounded) wire in the box. Example: NM cable size #14 and #12 are in a box. From Table 47, #14 wire uses 2.00 cubic inches and #12 wire uses 2.25 cubic inches. Allow 4.5 cubic inches volume units (2 × 2.25 cubic inches) for each switch or receptacle in the box based on the volume of the larger #12 NM cable.

Volume units for grounding wires. Allow one volume unit for all grounding wires in the box. Base the volume unit on the largest hot (ungrounded) or neutral (grounded) wire in the box.

Volume units for clamps. Allow one volume unit for all internal cable clamps in the box, if any. Base the volume unit on the largest hot (ungrounded) or neutral (grounded) wire in the box.

Volume units for fittings. Allow one volume unit for all fittings in the box, if any. Base the volume unit on the largest hot (ungrounded) or neutral (grounded) wire in the box.

Electrical Box Fill Chart

BOX SIZE AND	MAXIMUM NUMBER OF VOLUME

SHAPE	UNITS PERMITTED (SEE NOTES BELOW)			
(If volume not labeled by manufacturer)	**14 AWG**	**12 AWG**	**10 AWG**	**8 AWG**
JUNCTION BOXES				
4 × 11/4” R or O	6	5	5	4
4 × 11/2” R or O	7	6	6	5
4 × 2-1/8” R or O	10	9	8	7
4 × 11/4” S	9	8	7	6
4 × 11/2” S	10	9	8	7
4 × 2-1/8” S	15	13	12	10
411/16 × 11/4” S	12	11	10	8
411/16 × 11/2” S	14	13	11	9
411/16 × 2-1/8” S	21	18	16	14
DEVICE BOXES				
3 × 2 × 11/2"	3	3	3	2
3 × 2 × 2"	5	4	4	3
3 × 2 × 21/4"	5	4	4	3
3 × 2 × 21/2"	6	5	5	4
3 × 2 × 23/4"	7	6	6	4
3 × 2 × 31/2"	9	8	7	6
4 × 2-1/8 × 1-1/2"	5	4	4	3

4 × 2-1/8 × 1-7/8”	6	5	5	4
4 × 2-1/8 × 2-1/8"	7	6	5	4

Notes:

- R = Round; O = Octagonal; S = Square or rectangular
- Each hot or neutral wire entering the box is counted as one volume unit
- Grounding wires are counted as one volume unit in total—do not count each one individually.
- Raceway fittings and external cable clamps do not count. Internal cable connectors and straps count as one volume unit.
- Devices (switches and receptacles mainly) each count as two volume units.
- When calculating total volume units, any non-wire components should be assigned the gauge of the largest wire in the box.
- For wire gauges not shown here, contact your local electrical inspections office.

BOX SUPPORT IN WALLS, CEILINGS & FLOORS

1. Provide support for boxes that rigidly and securely fasten them in place. You may use nails or screws to support these boxes.
2. Protect screws inside boxes so that the threads will not damage the wires.
3. Wood braces used to support boxes must be at least one by two inches.
4. Use “cut-in” or “old work” retrofit boxes only if they have approved clamps or anchors that are identified for the location where they are installed.

DAMP LOCATIONS

1. Install a receptacle box cover that is weatherproof when the cover is closed and a plug is not inserted into a receptacle located in a damp location. This applies to 15-amp and 20-amp receptacles. A damp area is protected from direct contact with water. Refer to the definition of damp location. You may use a receptacle cover suitable for wet locations in a damp location.
2. Install a watertight seal between a flush-mounted receptacle and its faceplate. This will require a gasket or sealant between the finished surface (such as stucco, brick, or siding) and the faceplate.

WET LOCATIONS

1. Install a receptacle box cover that is weatherproof when the cover is closed on any receptacle located in a wet location. This applies to 15-amp and 20-amp receptacles in any indoor or outdoor wet location. This applies regardless of whether or not a plug is inserted into the receptacle.
2. Install a watertight seal between a flush-mounted receptacle and its faceplate. This will require a gasket or sealant between the finished surface (such as stucco, brick, or siding) and the faceplate.

Resources & Photo Credits

Applied Energy Innovations
Solar, wind, geothermal installations
612-532-0384
www.appliedenergyinnovations.org

Black & Decker
Portable power tools and more
www.blackandddecker.com

Broan-NuTone, LLC
Vent fans
800-558-1711
www.broan.com

Generac Power Systems
Standby generators and switches
www.generac.com
www.guardiangenerators.com

Honda Power Equipment/American Honda Motor Company, Inc.
Standby generators
678-339-2600
www.hondapowerequipment.com

Kohler
Standby generators
800-4-Kohler
www.kohlerco.com

Pass & Seymour Legrand
Home automation products
800-223-4185
www.passandseymour.com

Red Wing Shoes Co.
Work shoes and boots shown throughout book

800-733-9464
www.redwingshoes.com

Unistrut Metal Framing
Solar panel mounts
800-521-7730
www.unistrut.com

Westinghouse
Ceiling fans, decorative lighting, solar outdoor lighting, & other lighting fixtures and bulbs
800-245-5874
Purchase here: www.budgetlighting.com
www.westinghouse.com

Photos on p. 41, inset 45, and 82 (left) courtesy of istock.com

Photos on p. 83 (top right & lower) courtesy of Generac Power Systems, Inc.

Index

A

AFCI, location requirements, 121
Air-conditioning
  circuit maps for 240-volt receptacles for window units, 19
  circuit needed for, 55
  generators and, 84, 85
Amperage
  measuring, 96–97
  receptacles and, 118
  service panels and, 28–29
Appliances
  dishwashers
    circuit needed for, 65
    connecting receptacle for, 71
  food disposers
    circuit needed for, 65
    connecting GFCI receptacle and switch for, 69
    connecting receptacle for, 71
  microwaves
    circuit needed for, 65
    connecting, 70
  ranges
    circuit map for 120/240-volt receptacle, 18
    circuit needed for, 65
    installing 120/240-volt receptacle for, 70
  small
    circuit maps for, 17
    circuit needed for, 65
    connecting receptacles for, 68
  window air conditioners, circuit map for 240-volt receptacles for, 19

B

Backup power supply

choosing a generator for, 83, 84
cord-connected transfer switches, 85
generator tips, 85
maintaining and operating automatic standby generator, 87
operating manual system, 87
overview of, 82
running & maintaining, 86
typical system, 84
Baseboard heaters
circuit maps for 240-volt, 18
connecting 240-volt, 63
Basic problems and solutions, 9
Bathrooms
circuit for, 54
connecting GFCI receptacle and, 59
diagram for circuit map for 15-amp, 120-volt circuit for bathroom & closet, 56–57
Bedrooms, diagram for circuit map for 15-amp, 120-volt basic lighting/receptacle circuit for, 56–57
Bonding. see Grounding & bonding an upgraded system

C

Cable television jacks
circuit needed for, 55
circuit shown on wiring diagram, 57
Cables, non-metallic (NM), 115–117
Ceiling fan/light fixture combinations
circuit maps for units controlled by ganged switches, 20
connecting, 61
Ceiling fans, connecting switches for, 60
Ceiling fixture, connecting surface-mounted, 72
Circuit breaker panels
connecting circuit breakers, 32–33
description of parts of, 30–31
installing subpanels, 34–37
overview of, 28–29
safety and, 28, 31

upgrading
locating, 40
overview of, 38–39
replacing main service panels, 41–45
Circuit breakers, installing, 32–33
Circuit maps
ceiling fans/light fixtures controlled by ganged switches, 25
diagrams for
bedroom and bathroom wiring, 56–57
kitchen wiring, 66–67
double receptacle circuits with shared neutral wire, 16
double receptacle small-appliance with GFCI & separate neutral wire, 17
double receptacle small-appliance with GFCI & shared neutral wire, 17
four-way switches and light fixture, 23–24
ganged single-pole switches controlling separate light fixtures, 19
ganged switches controlling vent fan and light fixtures, 20
GFCI receptacles
multiple-location protection with switch & light, 13
single-location protection, 12
multiple four-way switches controlling light fixtures, 24
120/240-volt range receptacle, 18
120-volt duplex receptacles wired in sequence, 12
overview of, 11
single-pole switch & light fixtures, 13–15
switch-controlled split receptacles, 15–16
three-way switches & light fixtures, 20–21
three-way switches & light fixtures with duplex receptacle, 22
three-way switches & multiple light fixtures, 22–23
240-volt appliance receptacles, 19
240-volt baseboard heaters, thermostat, 18
Circuit tester, touchless, 95
Circuits, selecting backup, 89
Circuits, short, 102–103
Clearances, 110–111
Codes
current wiring methods, 114
general requirements, 105–111

National Electrical Code, inspections and knowledge of, 104
overview of, 104
for range, 18
requirements for rooms without overhead lights, 15
for window air conditioner, 19
Computers, circuit needed for, 54
Continuity
neutral & equipment grounding wire, 109
testing for, 99
Current, measuring, 97

D

DC lighting circuit, how to wire, 77–81
Device boxes, 122–124
Diagnostic tools, 94–95
Dishwashers
circuit needed for, 65
connecting receptacle for, 71
Disposers
circuit needed for, 65
connecting GFCI receptacle and switch for, 69
connecting receptacle for, 71

E

Electrical box fill chart, 124
Electrical code. see Codes
Electrical panels
general requirements for, 105–106
inspecting for proper grounding, 112
installing subpanels, 34–37
overview of, 28–29
Electrode wires, 113
Enclosures, 122–123

F

Feeders, 113
Food disposers

circuit needed for, 65
connecting GFCI receptacle and switch for, 69
connecting receptacle for, 71
Four-way switches, circuit maps for, 23–24
Framing member chart, 115

G

Generators
choosing, 83, 84
on-demand, 83
maintaining and operating automatic standby, 87
portable, 83, 86
standby, 93
tips for, 85
transfer switches for, 85
GFCI receptacles
circuit maps for
double receptacle small-appliance, 17
multiple-location protection, 13
single-location protection, 12
connecting bathroom, 59
installing
disposer switch and, 69
two switches for recessed lights and, 69
location requirements, 120–121
Grounding & bonding
at service panels and subpanels, 112
upgraded system
ground rod installation, 49
how to bond metallic piping, 47–48
how to install a grounding electrode system, 49–51
overview of, 46
tips for, 51
tips for grounding the panel, 48
Grounding electrodes, 113
Grounding wires, 52

H

Heaters
circuit map for thermostat and 240-volt baseboard, 18
circuit needed for, 55
connecting 240-volt baseboard, 63
connecting 240-volt blower, 62
Hot wires, 52

I

Inspections, preparing for, 104

J

Junction boxes, 122–124

K

Kitchen remodels
circuits likely wanted, 64–65
diagrams for circuit maps, 66–67
installing under-cabinet lights, 73
wiring connections, 68–73
wiring diagram for, 66–67
see also Appliances

L

Light fixtures
box installation, 122
circuit maps for
ceiling fans/light fixtures controlled by ganged switches, 25
four-way switches and, 23–24
ganged single-pole switches controlling separate, 19
ganged switches controlling vent fan and light fixtures, 20
GFCI receptacle, switch & light fixture wired for multiple-location protection, 13
multiple four-way switches and, 24
single-pole switch and, 13–15
three-way switches & multiple, 22–23
three-way switches and, 20–22

connecting, 59
ceiling fan/light fixture combinations, 61
GFCI and two switches for recessed, 69
installing under-cabinet, 73

M

Main service panels
overview of, 28
replacing
locating, 40
overview of, 38–39
steps in, 41–45
safety and, 6
Microwaves
circuit needed for, 65
connecting, 70
Multimeters
clamp-on, 96
digital autoranging, 94, 95, 96
overview of, 96

N

National Electrical Code (NEC), 104 *see also* Codes Neutral wires, 52, 100–101
Non-metallic (NM) cables
installation of, 116–117
maximum ampacity, 115
rules for, 115

O

Open neutrals
overview of, 100
possible symptoms of, 100
troubleshooting, 101

P

Permits. see Codes
Plug-in tester, 95

PV panels, mounting, 76

R

Ranges
circuit map for 120/240-volt receptacle, 18
circuit needed for, 65
installing 120/240-volt receptacle for, 70
Receptacles
amperage and, 118
circuit maps for
double receptacle small-appliance with GFCI & separate neutral wires, 17
double receptacle small-appliance with GFCI & shared neutral wire, 17
double with shared neutral wire, 16
GFCI receptacle, switch & light fixture wired for multiple-location protection, 13
GFCI receptacle wired for single-location protection, 12
light fixtures with three-way switches and duplex receptacle, 22
switch-controlled split, 15–16
240-volt appliance receptacles, 19
connecting, 61
dishwashers, 71
food disposers, 71
small appliance, 68
switched, 61
switches for stairway lights and, 61
installing
20-amp, 120-volt for microwaves, 70
kitchen countertop, 119
120/240-volt for ranges, 70
in rooms, 118
measuring at, 97
Room additions
circuits likely wanted, 54–55
wiring diagram for, 56–57

S

Safety

overview of, 6
tips for, 7–9
Service drops, 110–111
Service entrance head, safety and, 6
Service grounding at two buildings using four-wire feeder, 113
Service panels
connecting circuit breakers, 32–33
grounding & bonding at, 112
installing subpanels, 34–37
overview of, 28
safety and, 28
upgrading
locating, 40
overview of, 38–39
replacing main service panels, 41–45
Single-pole switches
connecting, 59
connecting timer and, 58
Single-pole switches & light fixtures
circuit map for ganged controlling separate, 19
circuit maps for, 13–15
Small appliances
circuit maps for, 17
circuit needed for, 65
connecting receptacles for, 68
Solar light circuit
how to wire a DC lighting circuit, 77–81
mounting PV panels, 76
overview of, 74
schematic diagram for, 75
Stairway lights, connecting switches for receptacle and, 60
Subpanels
grounding & bonding at, 112
installing
overview of, 34
planning, 35
steps in, 35–37

overview of, 28
room additions and, 54–55
Switched receptacles, connecting, 61
Switches
circuit maps for
ceiling fans/light fixtures controlled by ganged, 25
ganged controlling vent fans and light fixtures, 20
GFCI receptacle, switch & light fixture wired for multiple-location protection, 13
light fixtures and four-way, 23–24
light fixtures and multiple four-way, 24
light fixtures with duplex receptacle and three-way, 22
single-pole ganged controlling separate light fixtures, 19–20
single-pole switch & light fixtures, 13–14
switch-controlled split receptacles, 15–16
three-way & light fixture, 20–22
three-way & multiple light fixtures, 22–23
connecting
ceiling fans, 60
GFCI and two switches for recessed lights, 69
GFCI receptacle and disposer, 69
receptacle & stairway light, 60
single-pole, 59
three-way, 72
timer and single-pole, 58
three-way, testing, 99
transfer, 83, 85
installing manual, 88–93

T

Telephone outlets, circuit for, 55
Testers, 95
Thermostats
circuit maps for, 18
circuit needed for, 5
connecting 250-volt, 62
Three-way switches

circuit maps for
light fixtures and, 20–21
light fixtures with duplex receptacle and, 22
multiple light fixtures and, 22–23
connecting, 72
testing, 99
Timers, connecting single-pole switches and, 58
Troubleshooting
basic problems and solutions, 9
diagnostic tools & testing and, 95–99
open neutrals, 100–101
overview of, 95
short circuits, 102–103
240-volt baseboard heaters
circuit map for thermostat and, 14
connecting, 63
240-volt blower heaters, connecting, 62
240-volt thermostats, connecting, 62

U

Under-cabinet lights, installing, 73

V

Vent fans
circuit maps for ganged switches controlling light fixtures and, 20
connecting, 59
Voltage, measuring, 98
Volume unit chart, 123

W

Window air conditioners, circuit map for 240-volt receptacles for, 19
Wire gauge
capacity and, 109
connectors and, 107
Wires
color coding, 109
connecting to terminals, 108

extended from boxes, 108
size chart, 109
splicing, 107
volume unit chart, 123

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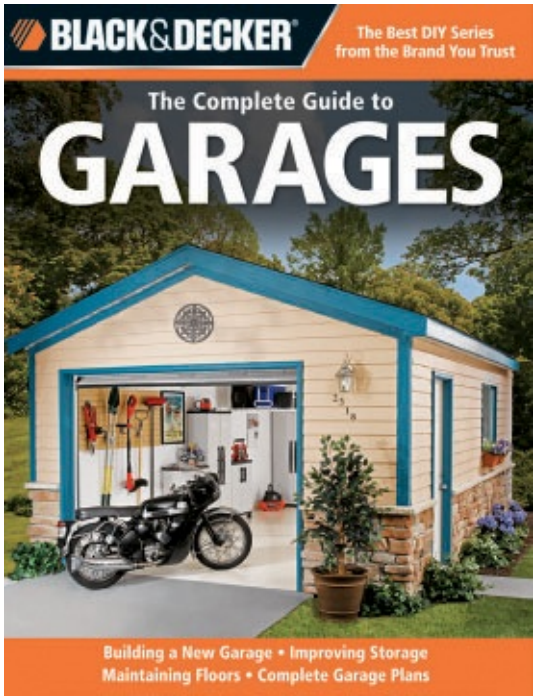

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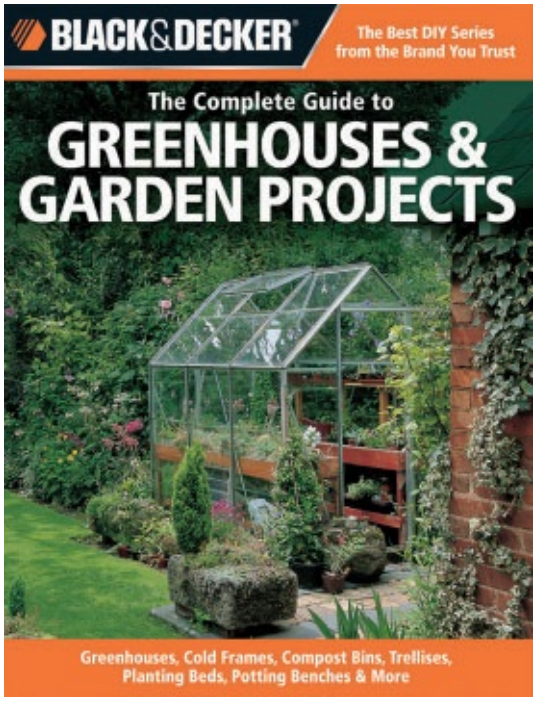

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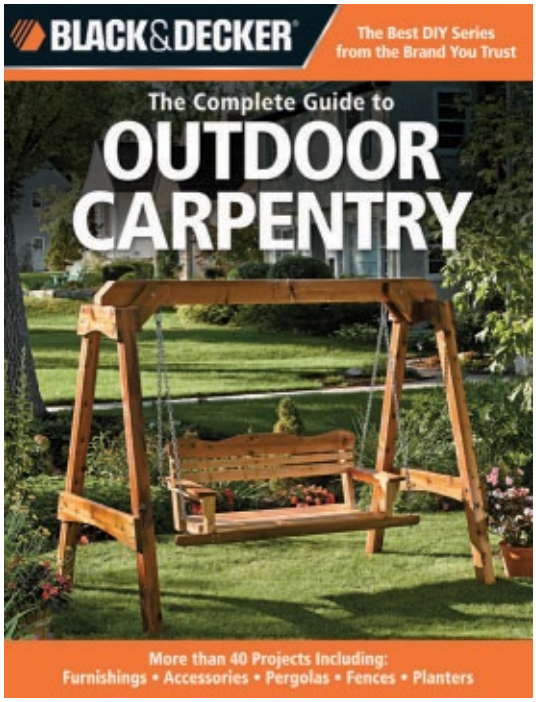

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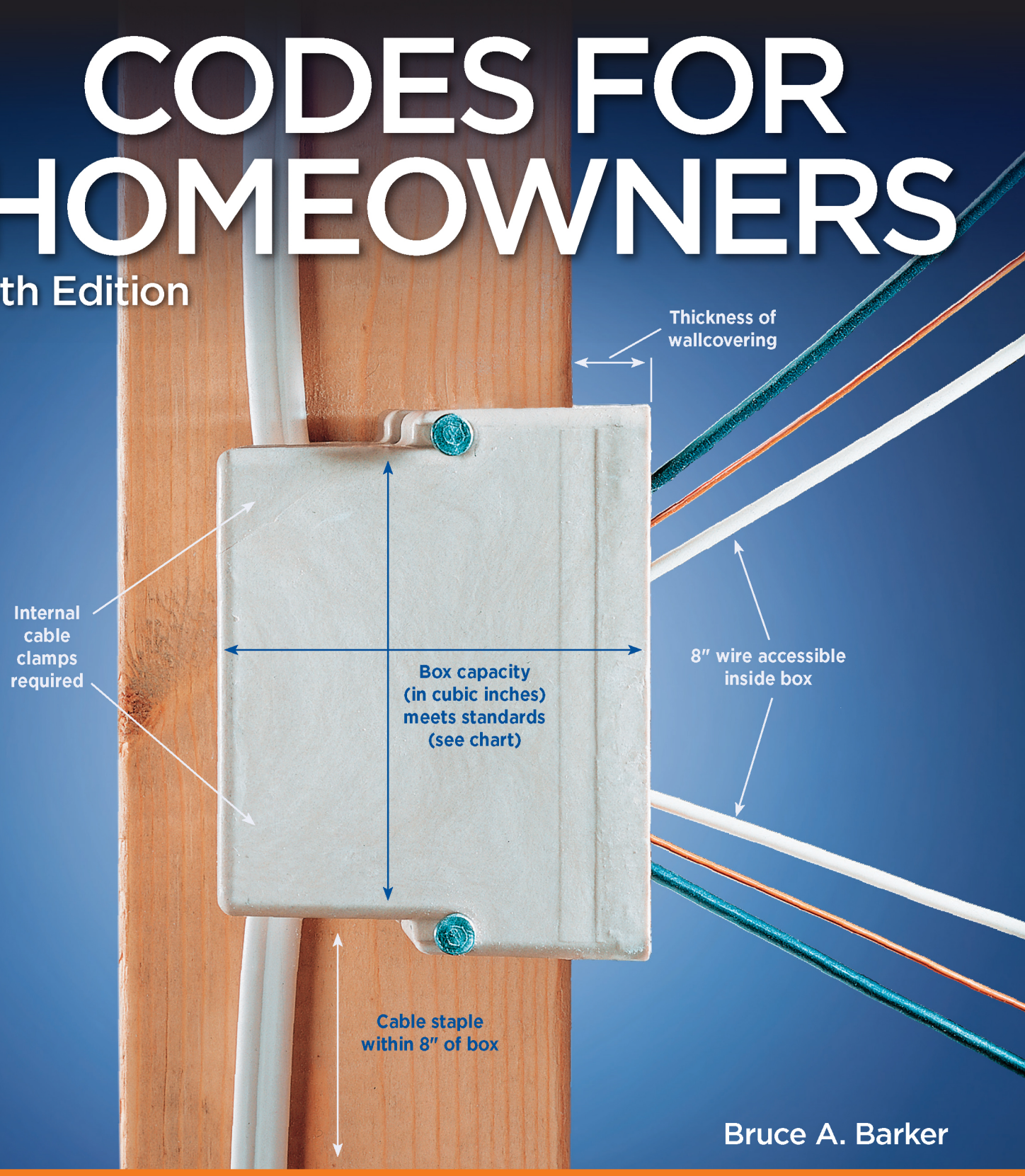

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Contents

Codes for Homeowners

Introduction	**7**
Codes & Permits: The Basics	8
BUILDING DESIGN & SAFETY	**19**
Habitable Rooms	20
Fire Separations	22
Stairways	24
Emergency Escape Openings	30
Egress Doors	32
Exterior Doors	33
Door & Window Hazards	34
Ventilation & Exhaust	36
Smoke & Carbon Monoxide Alarms	42

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Page:3

Contents (Cont.)

STRUCTURAL COMPONENTS	**45**
Foundations	48
Crawlspaces	52
Decks	54
Floor Systems	62
Wall Systems	70
Wall Penetration Flashing	84
Roof Systems	86
EXTERIOR COMPONENTS	**97**
Shingle Roof-Covering Installation	98
Fireplaces & Chimneys	104
HEATING & AIR CONDITIONING	**109**
HVAC Appliances	110
HVAC Duct Installation	116
Combustion Air for Fuel-Burning Appliances	118
Vents for Fuel-Burning Appliances	121
PLUMBING SYSTEM	**125**
The Home Plumbing System	130
Water Supply Piping	131

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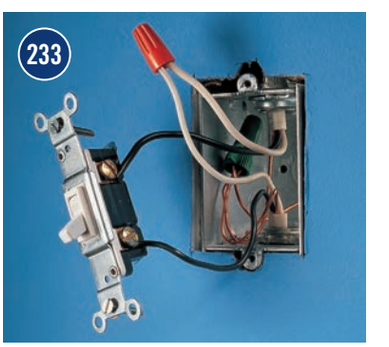
Drain, Waste & Vent Piping (DWV)	137
Plumbing Vents	148
Plumbing Traps	156
Plumbing Appliances & Fixtures	157
ELECTRICAL SYSTEM	**169**
Understanding Electrical Circuits	173
Electrical Grounding & Bonding	184
Electrical Branch Circuit Requirements	189
Electrical Receptacle Installation	198
Ground-Fault (GFCI) & Arc-Fault (AFCI) Protection	202
Junction Boxes, Device Boxes & Enclosures	204
Switch Installation	212
Light Fixture Installation	214
Satellite Dishes, Television & Radio Antennas	218
Broadband Cable Wiring	220
Appendix	**222**
Measurement Conversions	**234**
Resources	**234**
Photo Credits	**234**
Index	**235**



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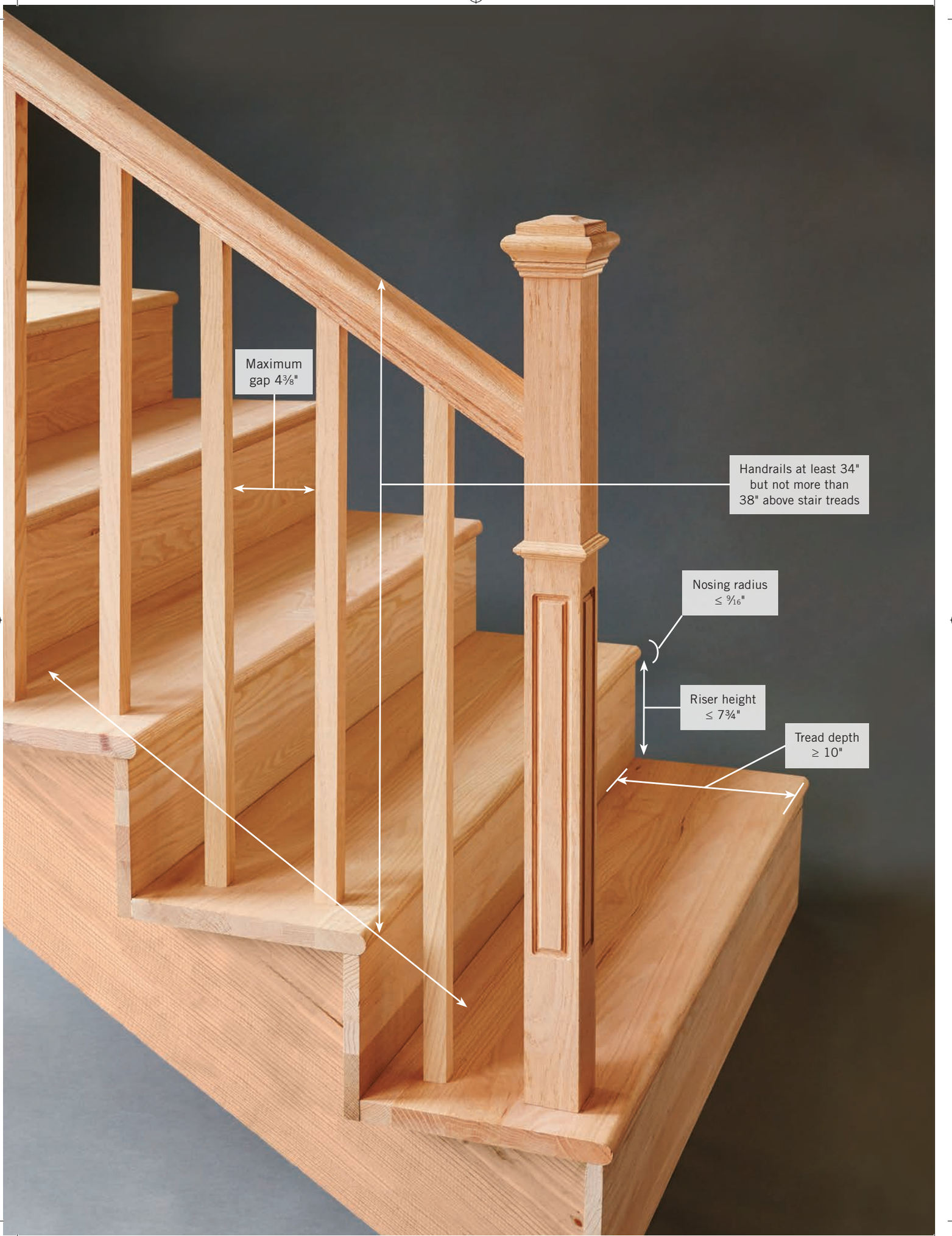

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Introduction

The purpose of the 2018 International Residential Code (IRC), and of all building codes for that matter, is expressed in IRC Section R101.3: "The purpose of this code is to establish minimum requirements to safeguard the public safety, health, and general welfare . . ." This statement provides important information about building codes and code inspections. Building codes are minimum requirements. A house built to minimum requirements is not necessarily a high-quality house built by craftsmen according to best practices. Code inspections are about safety and health. They are not about fit, finish, and other cosmetic issues. They are not even about functional issues that are not specifically addressed in the code. Understanding the purpose of building codes helps you set realistic expectations about the limits of building codes and code inspections.

Building codes change; most do so on a three-year cycle. Many code changes are little more than rewording or reorganization in an attempt to make code provisions easier to understand and easier to find. Many code changes and additions are substantive, and homeowners should be aware of these as they perform repairs and remodeling projects. Substantive additions and changes are the reasons for this updated edition of *Codes for Homeowners*.

Trying to condense a 900-page code book that is mostly text and tables in very small print into significantly fewer pages filled with pictures and illustrations is a challenge. We have not included many code provisions, because homeowners will not use them. The provisions we include have been simplified to make them easier to understand. This means that *Codes for Homeowners* is not your local building code. Your local building code, as interpreted by your building inspector, is the code with which you must comply. You must do so even if you do not obtain a building permit for your work. **If you have any doubts or questions about how a building code provision applies in your area, you should ask your local building inspectors.** In almost every case, if you approach them as a resource and not as an obstacle, you will find your local inspectors to be friendly, knowledgeable, and eager to help.

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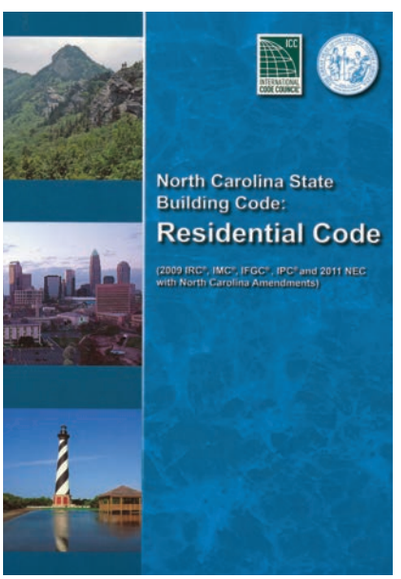
Codes & Permits: The Basics

In just the United States you will find hundreds of code books describing thousands upon thousands of building code provisions. On top of this, there are even more books that look and feel like code books but are really only attempting to describe best practices. Almost all of these have their own inherent value. But almost none of them apply to a typical homeowner living in a typical single-family home. As a homeowner and DIYer, perhaps the hardest thing about building codes is learning how to tell which one applies to you and, if there is a disagreement, which takes precedence. As an introduction, here are some brief biographies of the more common codes and enforcement agencies you're likely to encounter.

The International Residential Code has no jurisdiction of its own but is the basis for many state and local residential building codes.

The International Residential Code

The IRC 2018 is one of an extensive collection of model building codes published by the International Code Council (ICC). A model building code is a recommended building code developed by a national organization that specializes in writing building codes. When adopted by a government agency, the IRC regulates the construction, renovation, maintenance, and repair of buildings used as homes. The IRC, by itself, has no formal legal status. A government agency must first adopt the IRC before it has any legal status in a local area.



Some states and cities have their own building codes.

State & Local Building Codes

Almost all areas of the United States have adopted some version of a building code. Some states, such as California, Florida, and New York, have a state building code. Some large cities, such as Chicago and New York City, have a city building code. Many of these state and local building codes are based on model building codes from the ICC.

Smaller cities and counties often use ICC model building codes, such as the IRC. Some rural areas may not have adopted a building code, but this is becoming a rare situation. If you do any work that is regulated by the local building code, you are responsible for knowing, or for hiring someone who knows, the applicable building code where the building is located. Ignorance of the code is no excuse.

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Local Code Amendments

Most building departments that use the IRC adopt local changes to the IRC. Many of these changes are minor and help to adapt the IRC to local conditions and needs. Some of these changes can significantly alter IRC provisions. The building department should publish, in writing, any changes adopted by the local government. You are responsible for knowing and complying with all local changes. Ask the building official if there are any local code changes.

Most jurisdictions have their own code amendments. Your city or municipality likely maintains a website with building ordinances posted and updated regularly.

Other Building Codes

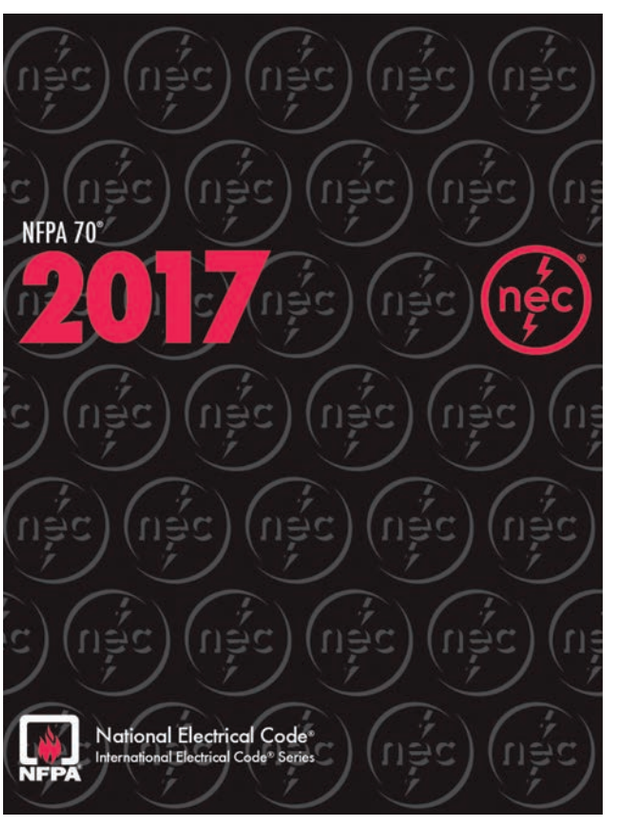
The IRC is not the only building code. Others commonly used include: The International Building Code (IBC), The International Mechanical Code (IMC), The International Plumbing Code (IPC), The Uniform Plumbing Code (UPC), The International Fuel Gas Code (IFG), The National Electrical Code (NEC), and The International Energy Conservation Code (IECC). Each of these building codes regulates a different aspect of building construction.

The IBC regulates the structural aspects of all buildings, although it is not commonly applied to residential buildings. The IBC usually applies to commercial, industrial, and multi-family buildings, such as apartments. The IRC references the IBC and the IECC when a part of a residential building is not addressed by the IRC.

Each major system in a building has its own code. The IMC regulates heating, ventilation, and air conditioning systems; the IPC regulates plumbing systems; and the IFG regulates gas piping and gas equipment. These codes usually apply to commercial-type buildings. The UPC is a separate code, published by another code-writing organization, that also regulates plumbing systems. It may replace the IRC plumbing chapters in areas that adopt the UPC. The NEC regulates electrical systems. The IRC contains an adapted version of the NEC in the IRC electrical chapters. When the IRC does not address an electrical situation in a home, the NEC usually applies.

The IECC regulates energy-related aspects of all buildings. These aspects include: insulation, air infiltration, and window and door energy efficiency. The IRC contains a simplified subset of the IECC.

You should know which codes apply to your construction project. Ask your local building official which codes apply in your area.



Trade-oriented building codes with a more specific focus apply in some situations. Most of these are primarily for nonresidential construction.

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Page:9

Zoning Ordinances

Many areas, particularly the more densely populated ones, have land use and zoning ordinances that control what you can build on your property. You are responsible for knowing and complying with them. In larger jurisdictions, the planning and zoning department may be separate from the building inspection department, and sometimes one does not know what the other is doing. It is possible that the building inspection department might issue a permit that would create a zoning violation. Projects that might run afoul of zoning ordinances include new, free-standing buildings, basement remodels that add a bedroom, bathroom, and kitchen, and any project that adds an additional full kitchen on property zoned for single-family use.

Buildings Governed by the IRC

Apply the IRC to buildings containing one or two individual residential dwelling units in one building. Duplex is a common term for one building containing two individual dwelling units.

Apply the IRC to townhouses. A townhouse contains at least three individual dwelling units in one building.

Each dwelling unit in any building within the scope of the IRC must have a separate means of egress. This is often interpreted to mean that each dwelling unit must have a separate door to the outside.

Apply the IRC to residential buildings with not more than three stories above grade plane. A story above grade plane is: (a) one where the finished floor is entirely above grade plane, (b) is more than 6 feet above grade plane, or (c) is more than 12 feet above finished ground level at any point. The definition of grade plane is complex and is measured at the lowest point 6 feet from each building foundation wall. Refer to the definitions in the IRC and consult the local building official if there is a question about whether a basement is a story above grade plane.

Apply the IRC to owner-occupied guest accommodations (such as a bed and breakfast) if the building contains not more than five guest rooms and if a fire suppression system is installed in the building.

Do not apply the IRC to buildings used for business, office, commercial, industrial, or other residential purposes, such as a fraternity house. This is true even if the building was once used as a residence. You may apply the IRC to an office in the home if the office is incidental to the residential use of the building. Refer to the IBC and other applicable codes for code provisions governing buildings not governed by the IRC.

Apply the IRC to all single-family homes.

Apply the IRC to multi-family buildings, such as duplexes and townhomes.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:10

Building Departments

A local building department enforces the building code in its jurisdiction. The technical term often used to describe this department is the Authority Having Jurisdiction (AHJ). The term used to describe the person responsible for enforcing the code is the Building Official or Chief Building Official. The public name for the local building department varies by jurisdiction. Many building departments will have the terms "building" or "safety" somewhere in the name. In some larger jurisdictions, the building department may be a division of a larger agency that is also responsible for land planning, zoning, and development. Some building department names may not sound like they have anything at all to do with building code enforcement. If you do any work that requires a building permit, you are responsible for finding and contacting the building department. Work done without a permit can have serious legal and financial consequences.

Consider your local building department to be a friendly place with extremely valuable resources to help you get your projects done correctly.

Working with Government Building Inspectors

The building official is the king of his building jurisdiction. Don't mess with the king. He can make your life very difficult. If you must disagree with him, do so respectfully and with facts that support your position. The building official has the right to interpret any code provision. While he does not have the right to waive code provisions or to require more than the code requires, interpretations can sometimes have that effect. Even if his interpretation seems unreasonable, eventually it will probably prevail. In almost all cases, you should just smile and do what he tells you.

Most building officials and inspectors are honest, hardworking people who want to ensure that your project is safe and complies with local building codes. They can be a valuable resource. Take advantage of that resource. Ask questions and work with them. Most will, in turn, work with you.

Who Is Responsible for Code Compliance?

The general answer is that everybody associated with the project is responsible for code compliance, but with one exception. The primary responsibility usually falls on the permit holder, which is one reason why it is a warning signal if a contractor asks the property owner to pull the permit. A contractor who does not want to pull a permit may not have an active license, may have a bad reputation with the building inspectors, or there may be other reasons, few of which are good.

The one exception is the building inspectors. Building inspectors are not responsible for code compliance. They are responsible for inspecting to catch code violations, but they are usually not responsible if they do not catch a violation. Thus, passing an inspection and obtaining a certificate of occupancy is not a guarantee of code compliance.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:11

WORKING WITH PRIVATE BUILDING INSPECTORS

Time is not the friend of government building inspectors. From an eight-hour day, they must subtract doing paperwork, discussing inspections with stakeholders, traveling between inspections, and performing other duties. Divide the remaining time by 20 to 30 inspections per day, or more, and they may have only a few minutes to perform each inspection. It's a credit to government inspectors that they find many major code violations. Most will admit, however, that they cannot find all code violations. They will also admit that they are not even looking for issues that, although they are not code violations, can have a significant negative impact on the cost to operate and maintain the home.

Private building inspectors fill this quality control gap for many people. People building homes and people performing major remodeling projects hire a private inspector who helps the government inspector and the contractor provide quality construction. A private inspector can perform a far more thorough inspection than a government inspector, because a private inspector can invest more time on each inspection. In addition, a private inspector usually inspects areas such as attics and roofs, where government inspectors rarely go.

When building a new home or during a major remodeling project, a private inspector is often most useful at two critical points. The most critical point is just before insulation and drywall are installed. This inspection is sometimes called the pre-drywall inspection and is the most important inspection a home will ever have. At this time, an inspector can see many important components that will be covered by finish materials and, in most cases, will never be visible again. The other critical point is at the end of construction. At this time, an inspector can see and test important systems in the home.

Private inspectors are increasingly common on construction sites. While some contractors welcome private inspectors, many do not. Even if you decide not to engage a private inspector, it is wise to discuss the option with the contractor before signing a contract, and it is wise to agree, in writing, to how the contractor will work with the private inspector during construction.

Private building inspectors (such as the author, seen here) may be hired by a client to check the contractor's work at key points.

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305471 - B&D Codes for Homeowners 4th Edition Edition_001-017.indd 12 1/10/18 10:20 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:12

Manufacturer's Instructions

The IRC requires installing all components, equipment, and appliances according to the manufacturer's instructions. This requirement is so important that it is repeated many times in the IRC. Manufacturer's instructions are an enforceable extension of the IRC. This means that it is a code violation to install something in a manner that does not conform to manufacturer's instructions.

Manufacturer's instructions are an important part of ensuring that components are safe. Independent organizations test many components used to build homes. This includes almost all manufactured components. The tests are conducted under defined conditions that include using the manufacturer's instructions to install the component. The testing organization certifies that the component is safe when installed and used according to manufacturer's instructions. The testing organization places the certified components on a list maintained by the testing organization. This process is called listing, and the components are referred to in the IRC as listed.

The IRC cannot anticipate every possible building component and every possible way the component could be installed. As such, the IRC relies on the manufacturer's instructions to specify how components should be installed.

When a difference between the IRC and the manufacturer's instructions occurs, the IRC assumes that the manufacturer is in a better position to know its product and how it should be installed in a given situation. This is why the IRC usually defers to the manufacturer's instructions. Ask the local building official for an interpretation if there is a difference between the manufacturer's instructions and the IRC.

Manufacturer's installation instructions must be followed to the letter, and they are an enforceable extension of the IRC.

Grandfathering Existing Work

In almost all situations, you are not required to abandon, remove, or alter existing work that is lawfully in existence and safely functioning. Lawfully in existence means the work was inspected and complied with the code when installed and/or modified.

In almost all situations, when updating, modifying, or repairing existing work, you are required to perform the update, modification, or repair according to the code in force when the work is performed. You are usually not required to make the existing work comply with current code.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:13

Building Permits & Inspections

Contact your local building officials to determine which construction activities require a building permit and to determine the documents and procedures required to obtain a permit. The building official you speak with may not enforce some building permit requirements contained in the IRC, but may add building permit requirements not contained in the IRC.

You must wait until the required permit is issued before beginning work. Beginning work before the permit is issued may result in fines, and the building official could require removal of the work.

Comply with the building code applicable to where the building is located. The applicable building code is usually the code in force when the permit is issued. If you do not obtain a building permit, comply with the building code in force when the work is performed. The building code applies whether or not you obtain a building permit. This is important. Lack of a building permit does not relieve the building owner or the contractor of responsibility for code compliance.

WHEN IS A PERMIT REQUIRED?

You typically will need a building permit for:

- Construction of new buildings
- Additions and structural modifications to existing buildings
- Structural repairs to existing buildings
- Replacement of or major repairs to building components, such as roof coverings and exterior wall coverings
- Movement and demolition of existing buildings
- Changes to building occupancy. A change to building occupancy means changing how the building is used. Example: using a single-family home as a place of business is a change in occupancy that may require a building permit and may require a zoning change or zoning waiver.
- Additions to, major changes to, and/or replacement of electrical, plumbing, gas, and HVAC components

You may not need a building permit for:

- Building or installation of one-story detached accessory structures (such as storage sheds and playhouses) with a floor area not more than 200 sq. ft.
- Fences not more than 7' tall
- Retaining walls not more than 4' tall measured from the bottom of the footing to the top of the wall and not supporting a surcharge (a surcharge is a vertical load in addition to and/or above the retained ground)
- Driveways and sidewalks
- Painting, papering, floor covering installation, cabinet and countertop installation, and similar finish work
- Installation of portable plug-and-cord connected decorative lights and similar plug-and-cord connected electrical equipment
- Replacement of fuses and circuit breakers
- Low-voltage lights and other electrical wires and equipment operating at less than 25 volts and not more than 50 watts
- Installation of portable gas heating, cooking, and clothes-drying equipment
- Installation of portable HVAC equipment (such as window air conditioners)
- Clearing of plumbing stoppages and repair of plumbing leaks and removal and reinstallation of toilets if the repairs do not involve replacement or rearrangement of valves, pipes, or fixtures
- Decks that are not more than 30" aboveground, are not more than 200 sq. ft. in area, are not attached to the building, and do not serve the required egress door

You usually do not need a building permit for:

- Routine maintenance of existing buildings, fixtures, and equipment, if the building structure is not affected and if the nature and use of the electrical, plumbing, gas, or HVAC system is not changed

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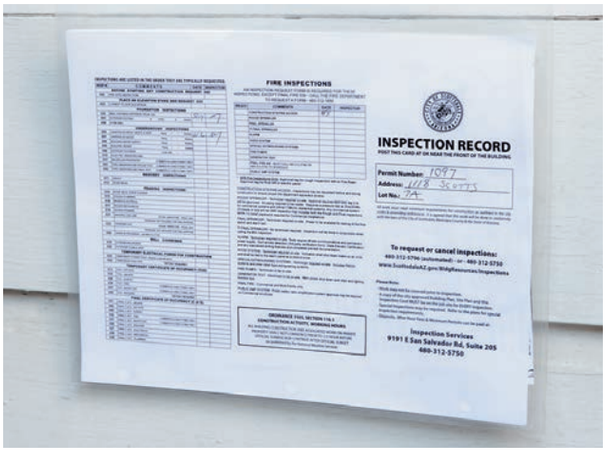
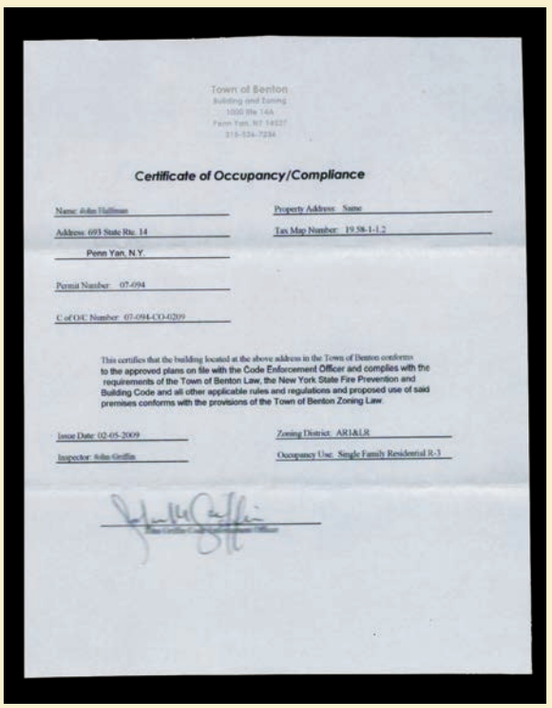
Page:14



Post the job site inspection card so the inspector can see it.

CERTIFICATES OF OCCUPANCY

A certificate of occupancy is issued by your building official to affirm that your structure is safe to inhabit. Do not move into or occupy a building until after the building official issues a certificate of occupancy. Do not change the use of a building without a new certificate of occupancy. Example: do not use a building as an office if the building was once a home without receiving a new certificate of occupancy. The new certificate of occupancy may require changes to the building that reflect its new commercial use. You are not required to obtain a certificate of occupancy for accessory structures.



Town of Benton
Building and Zoning
1000 Rte 14A
Penn Yan, NY 14527
315-534-7284

Certificate of Occupancy/Compliance

Name: John Hallman
Property Address: Same
Address: 693 State Rte. 14
Tax Map Number: 19.58-1-1.2
Penn Yan, N.Y.
Permit Number: 07-094
C of OC Number: 07-094-CO-0209

This certifies that the building located at the above address in the Town of Benton conforms to the approved plans on file with the Code Enforcement Officer and complies with the requirements of the Town of Benton Law, the New York State Fire Prevention and Building Code and all other applicable rules and regulations and proposed use of said premises conforms with the provisions of the Town of Benton Zoning Law.

Issue Date: 02-05-2009
Zoning District: AR1&LR
Inspector: John Griffin
Occupancy Use: Single Family Residential R-3

PERMIT EXPIRATION

Verify building permit expiration rules with your local building official. A building permit may expire if more than 180 days lapse without an inspection or without some other evidence that work is progressing on the project.

Required Inspections

Contact the building official to determine the required inspections for a construction project. Each jurisdiction has its own rules for inspections. These rules include: which inspections it performs, what work must be complete before requesting the inspection, how and when to schedule the inspection, and how it handles inspections of work that fails inspection.

Note that some jurisdictions conduct a separate inspection for each trade, some jurisdictions conduct one inspection when all trade work is complete, and some jurisdictions conduct trade inspections during the framing inspection. Check with the building official to determine if other inspections are required. Further required inspections may include flood plain and elevation, roof coverings, insulation and energy efficiency, interior drywall, and exterior wall coverings, such as stucco and masonry.

Final Inspections

Prior to final inspection, you should: Install all plumbing, HVAC, and electrical fixtures, equipment, and appliances and install all required safety components, such as stair handrails and guards, safety glazing, and smoke alarms. Note that jurisdictions have different rules about whether you must install finish components, such as floor coverings, before the final inspection. Jurisdictions also differ on whether tasks such as final grading and landscaping must be installed.

Do not assume that passing an inspection or receiving a certificate of occupancy is a waiver of any code violations. The building owner and contractor are responsible for any code violations regardless of whether the building has passed inspections.

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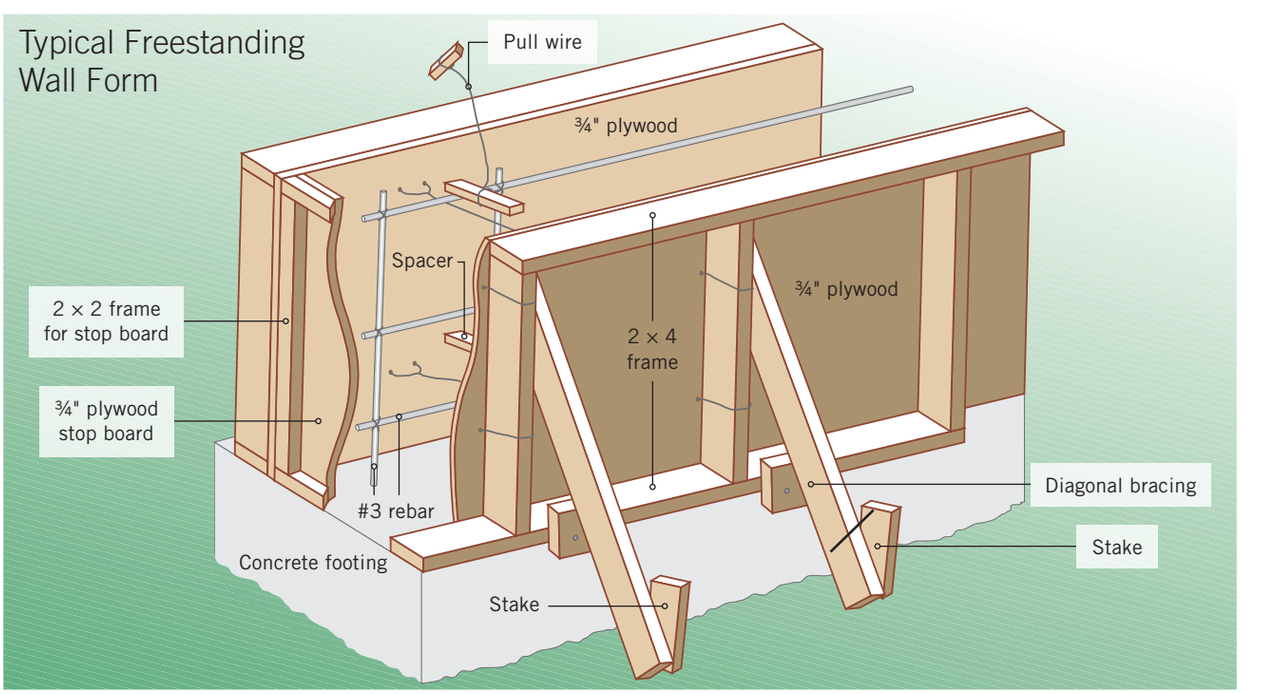
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:15

Preparing for Inspections

Concrete footing inspections must be done before concrete is poured. Try to coordinate the inspection for the day before the planned pour, so you leave enough time to make corrections if required.

1. Install, square, and level forms.
2. Dig footing and pier trenches.
3. Install any required reinforcing bars.

Isolated footings, such as those used to support deck columns, must be inspected before the concrete is poured. The footings will be inspected for size and depth. Some footings may require reinforcing bars.



Concrete foundation wall inspections will focus on the wall thickness, base preparation, and reinforcement. All forms must be approved prior to the pour.

1. Install, square, straighten, plumb, and secure wall forms.
2. Install any required reinforcing bars.

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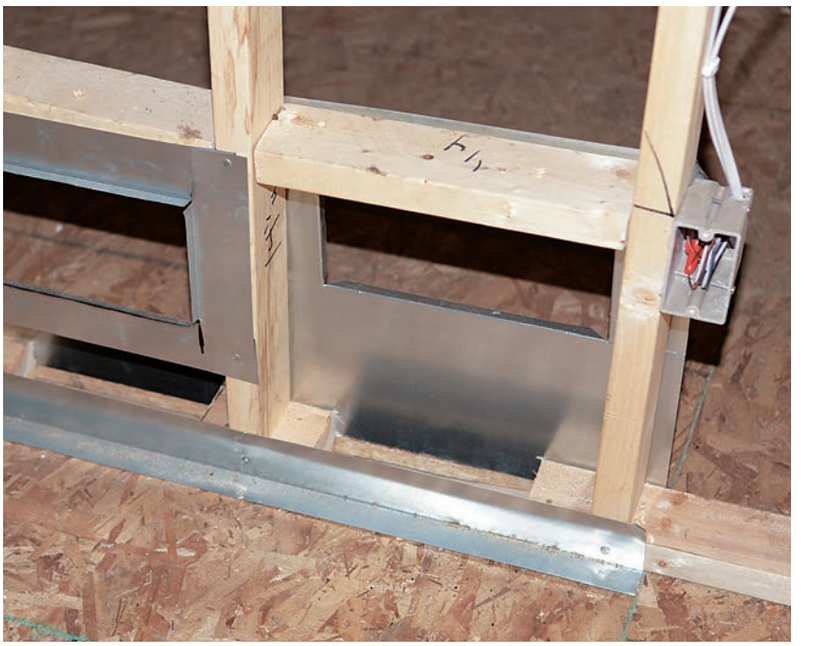
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:16

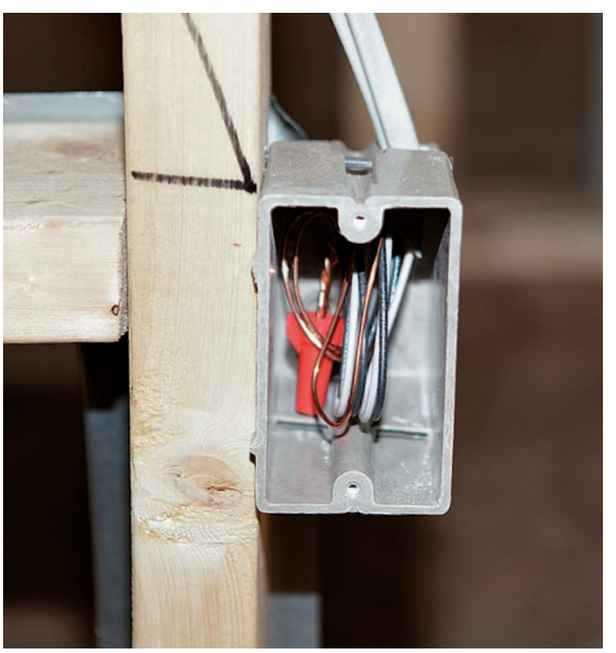
Plumbing rough-in inspection

1. Install plumbing water supply and drain pipes in the building. The building sewer pipe inspection is usually a different inspection from the interior drainage and water supply pipe inspection. Install fixtures, such as tubs and showers, that may be difficult to install after the wall construction is complete.



HVAC inspection

1. Install HVAC ducts, pipes, and thermostat wires.
2. Install (or have installed) appliances, such as furnaces and air handlers, that may be difficult to install after the construction is complete.



Electrical rough-in inspection

1. Have electrical service panel and subpanel cabinets installed.
2. Install boxes for switches, receptacles, fixtures, and all electrical cables.

Framing inspection

1. Install all interior and exterior walls, floor joists and subflooring, ceiling joists and rafters, and roof sheathing. Install all required wall bracing, firestops, and draftstops.
2. Note that some jurisdictions may require installation of other components, such as moisture barriers and roofing felt, before calling for a framing inspection.

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Page:17

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:18

Building Design & Safety

One of the most important reasons for building codes is to promote the health and safety of building occupants. Health issues involve topics such as minimum room size, minimum ceiling height, and requirements for removing moisture and fumes that could damage your home and make you sick. **Safety issues involve topics such as the size and location of emergency escape openings, design and construction of stairs (one of the most dangerous areas in a home), and the location and installation of smoke and carbon monoxide alarms.**

This chapter will help you understand building code requirements that you may encounter when doing projects such as adding rooms and remodeling basements and attics. While this chapter will help you avoid the most common health and safety code violations, it does not address all code requirements. You should refer to other sources for more information before tackling complex projects.

In this chapter:

- Habitable Rooms
- Fire Separations
- Stairways
- Emergency Escape Openings
- Egress Doors
- Exterior Doors
- Door & Window Hazards
- Ventilation & Exhaust
- Smoke & Carbon Monoxide Alarms

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:19

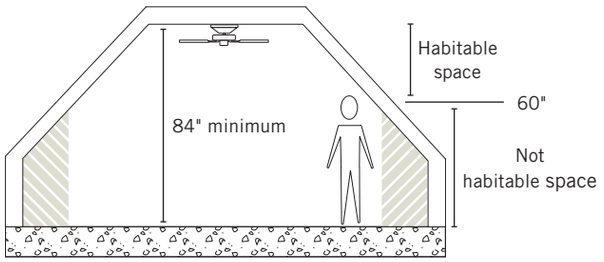
Habitable Rooms

Habitable rooms (also called habitable spaces) are living, sleeping, eating, and cooking rooms. Bathrooms, toilet rooms, closets, hallways, storage, and utility rooms are not habitable rooms. Habitable rooms have their own set of requirements for size, ceiling height, heating, lighting, and ventilation. Rooms that are not habitable do not have these requirements.

Measure between finished floor and the lowest part of the ceiling in most rooms and basements to determine if minimum ceiling height standards are met. Ceiling-mounted lights and fans do not factor into the height measurement.

HABITABLE ROOM AREA REQUIREMENTS

- Provide every habitable room with an area of at least 70 sq. ft.
- Provide every habitable room with a horizontal dimension of at least 84". Kitchens may be excepted: In some conditions you may design a kitchen that is smaller than 70 sq. ft. or with a horizontal dimension less than 84".



Provide at least 84" of clear ceiling height between the finished floor and the ceiling at the center of the room. If the ceiling slopes, only that floorspace where the ceiling height is at least 60" may be considered habitable. Heights less than 60", such as kneewall areas, may be useful for storage, but they aren't considered living space.

Minimum Ceiling Height

1. Provide at least an 84-inch-tall finished ceiling height in habitable rooms and in hallways, including a basement containing habitable rooms and hallways. Measure ceiling height from the finished floor to the lowest projection from the ceiling. Projections usually include components such as joists, beams, and ducts. Projections do not usually include light fixtures and ceiling fans.

2. You may have obstructions that are at least 76 inches above the finished floor in a basement containing habitable rooms and hallways.

3. Provide at least an 80-inch-tall finished ceiling height in a basement that does not contain habitable rooms or hallways. You may have obstructions that are at least 76 inches above the finished floor in these basement areas. Use these basement areas only for mechanical equipment and for storage.

4. Provide at least an 80-inch finished ceiling height in bathrooms and laundry rooms. This does not mean that all of the bathroom must have an 80-inch-tall ceiling. The ceiling height above sinks and toilets may be less than 80 inches high but must be high enough to safely use the fixture. How much less is subject to interpretation by the building inspector.

5. Provide at least an 84-inch-tall finished ceiling height in habitable rooms with a sloped ceiling. Provide this ceiling height for at least 35 square feet of the finished floor area. Do not count any area with a ceiling height less than 60 inches toward the minimum 70-square-foot habitable room floor area.

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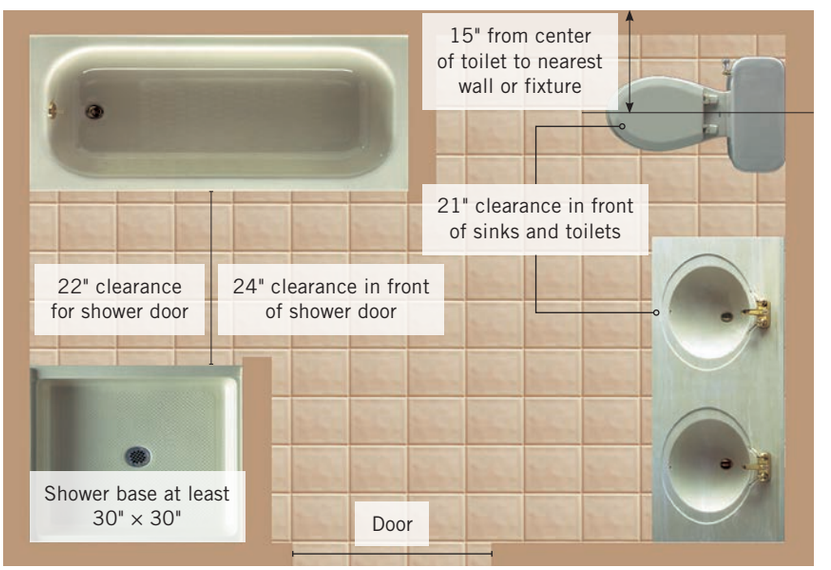
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:20

Bathroom Design Standards

A 6'-tall person should be able to use a sink or toilet without bumping his or her head on the ceiling.

Provide at least 80" of finished ceiling height for all of the required floor area in showers and in tubs containing showers.



Codes (and good design practices) insist on ample space between bathroom fixtures.

Shower Size

1. Provide showers with a finished area of at least 900 square inches and a finished minimum dimension of at least 30 inches. Maintain the minimum dimensions from the top of the threshold to at least 70 inches above the shower drain outlet. Measure the shower from the center line of the threshold (curb). You may install valves, shower heads, soap dishes, and grab bars that encroach into the minimum dimensions. You may install a fold-down seat in the shower if the minimum dimensions are maintained when the seat is up.
2. You may provide a shower with a finished minimum dimension of at least 25 inches if the finished area is at least 1,300 square inches.
3. Provide a shower compartment entry opening of at least 22 inches finished width.
4. Swing hinged shower doors out from the shower stall. Hinged doors may swing into the shower stall if they also swing out. Sliding shower doors are also allowed.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:21

Fire Separations

Fire Separation: Garage & Home

Many fires begin in garages. Unfortunately, garage fires often are more intense than fires that start elsewhere, because gasoline, cardboard, newspapers, and other flammable materials are usually stored in the garage. **Fire safety is an important rationale for many IRC provisions. Because of this the IRC has special requirements to help prevent the spreading of garage fires into the home.**

A fire-rated door with a minimum rating of 20 minutes is required in walls shared between a garage and a home.

VIOLATION! DO NOT install pet doors in doors that separate the garage from the dwelling.

Fire Separation Doors

In walls that are shared between your dwelling and your garage, use at least a 20-minute fire-rated door. These may be made from solid wood or honeycomb-core steel. Use doors that are at least 1⅜ inch thick.

Doors in a garage wall may not open directly into a bedroom. You also may not install pet doors or other openings in doors or walls from a garage into the home unless the pet door or opening is listed to maintain fire separation. Install self-closing hinges on doors between the garage and the home.

DEFINITION OF A GARAGE

A garage is defined as a space for parking motor vehicles that is completely closed to the outdoors on three or more sides. It typically has an overhead door, but a structure that meets the requirement but has no door is still considered a garage. A carport is a space for parking motor vehicles that is open to the outdoors on at least two sides. A space with two solid walls (often the house walls), a partially open wall, and an opening without a vehicle door is considered a carport. Garages and carports may be attached to, or detached from, the dwelling. Garage fire separation requirements do not normally apply to carports.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:22

Fire Separation Walls & Ceilings

Walls and ceilings that separate the home from the garage should be covered on the garage side with gypsum drywall that's at least ½ inch thick. A garage must have a ceiling made of Type X drywall that's a minimum of ⅝ inch thick if the garage is beneath a habitable room. (Type X has fibrous reinforcement to help the drywall maintain its integrity when exposed to high heat).

Maintain the same fire separation for drywall penetrations, such as attic scuttle holes, pull-down attic stairs, gas vents, and plumbing pipes, as provided by the gypsum drywall. Most pull-down attic stairs interrupt the ceiling fire separation, because the panel to which the stairs are attached is thin plywood. Seal penetrations between the garage and the home, such as pipes and ducts, with materials that resist the free flow of fire and smoke. Such materials include fire-resistant caulk.

Type X drywall is required on garage ceilings if the space above is habitable.

VIOLATION! Do not install pull-down stairs in a garage ceiling unless they maintain the required fire separation. The standard plywood covers do not maintain fire separation.

HVAC Ducts & Registers in Garages

Use at least 26-gauge sheet steel or other approved material to construct HVAC ducts that are installed in a garage and ducts that pass through garage walls and ceilings. Do not install HVAC supply or return air openings in the garage. This restriction does not apply to an independent HVAC system that serves only the garage. Do not use flexible HVAC duct or duct board to penetrate garage walls and ceilings. Flexible ducts and duct board may attach to steel ducts after the steel ducts penetrate the garage firewall.

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Page:23

Stairways

Interior and exterior stairways are regulated closely by most codes because they are inherently very dangerous parts of a house. Many of the regulations deal with lighting issues, including the type and location of fixtures and switches. The size, grippability, and location of handrails and railing balusters also account for much of the regulatory wording on stairways. Regulations for interior stairways also apply to exterior stairways. They include riser height, tread depth, and handrails and guards. It is important to comply with exterior stairway regulations, because they are used when wet or covered with snow and ice.

Interior Stairway Lighting & Switching

You should install as many light fixtures as necessary to illuminate all stairway landings and treads. The areas at the top and bottom of stairs are landings, so the lights should illuminate them too. For example, a light fixture at the top of a stairway may not provide enough light to illuminate the bottom landing, especially if the stairway changes direction. The light must be capable of illuminating treads and landings to at least 1 foot-candle.

NOTE: A foot-candle is a unit of light measurement approximating the amount of light you receive from a birthday cake candle when it is held 12 inches from your eyes. Photographer's light meters may be used to measure foot-candles.

You must locate a switch for interior stairway lights at the top and bottom of all interior stairs with at least six risers. Only one switch is required for interior stairs with fewer than six risers. Locate all stair switches so they can be used without climbing any steps.

Exterior Stairway Lighting & Switching

Codes for outdoor stairway lighting differ somewhat from interior requirements and recommendations. In exterior areas, you must locate a light fixture near the top landing for stairs providing access to doors above grade level. You must also locate a light fixture near the bottom landing for stairs providing access to doors below grade level. Locate the switch inside the dwelling for exterior stairs.

DEFINITIONS OF STAIRWAY TERMS

Landing: A landing is a flat surface at the top and bottom of a stairway, or it may also occur at points within a stairway. A landing must be at least as wide as the stairway and at least 36" deep.

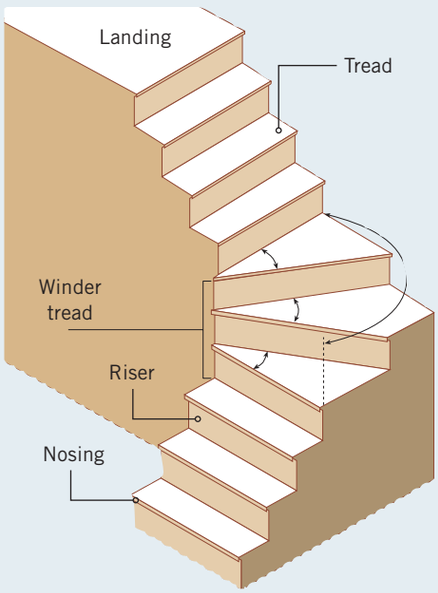
Nosing: A tread nose (nosing) is the part of a horizontal stair surface that projects outward beyond a solid (closed) riser below.

Riser: A riser is the vertical part of a stair. A closed riser is created with solid material between adjacent treads. An open riser has no material (except for any required guards) between adjacent treads.

Stairway (flight of stairs): A series of risers and treads that is not interrupted by a landing, a flight of stairs includes the landings at the top and bottom of the flight. A stairway with only a top and bottom landing has one flight of stairs. A stairway with a landing in the middle has two flights of stairs.

Tread: A tread is the horizontal part of a stair. A tread is sometimes called the step.

Winder tread: A winder is a tread with one end wider than the other. Winders are often used to change a stairway's direction.



Stairway components include: tread, winder tread, nosing, riser, landing, flight of stairs.

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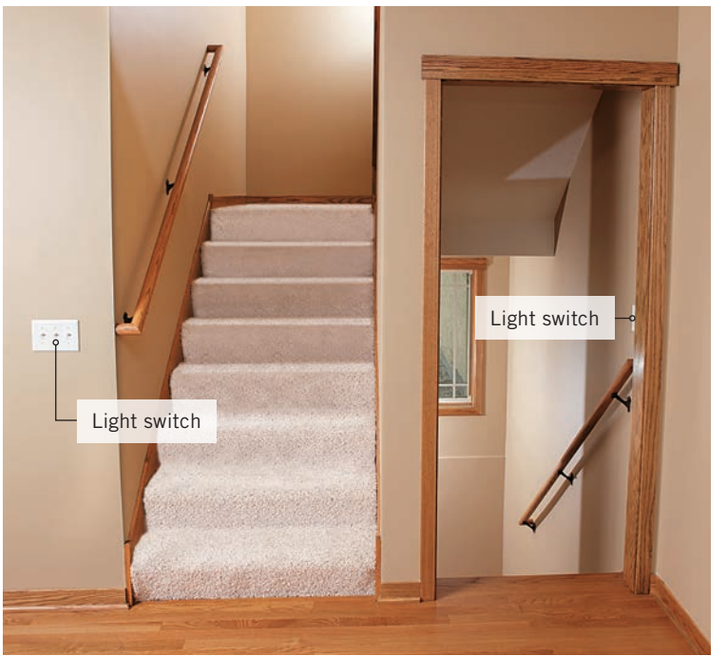
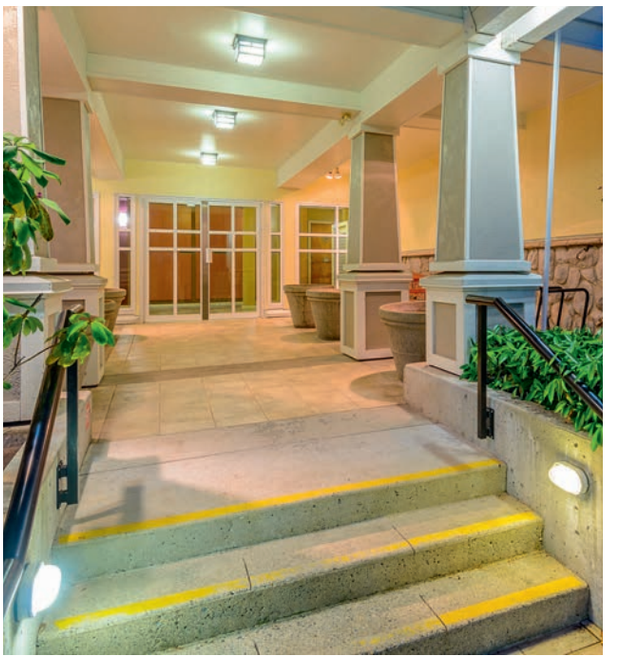
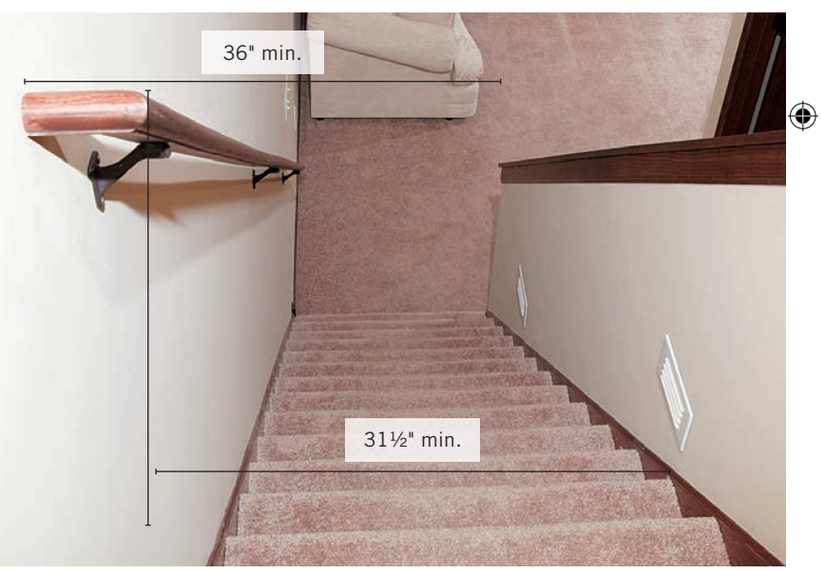


Install a light switch at the top and bottom of stairways with at least six risers.



Install a light at the top landing of above-grade exterior stairs.

One light at a center landing may not be enough to illuminate the top and bottom landings.



Provide a finished width of at least 36" above the handrail and at least 31½" at and below one handrail.

Stairway Width

1. Provide a finished stairway width of at least 36 inches above handrail to the minimum headroom height.

2. Provide a finished stairway width of at least 31½ inches at and below the handrail for stairs with one handrail and at least 27 inches at and below both handrails for stairs with two handrails.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:25

Riser Height

1. Provide a finished riser height of not more than 7¾ inches. Measure riser height vertically from leading edges of adjacent treads. The IRC does not mandate a minimum riser height.

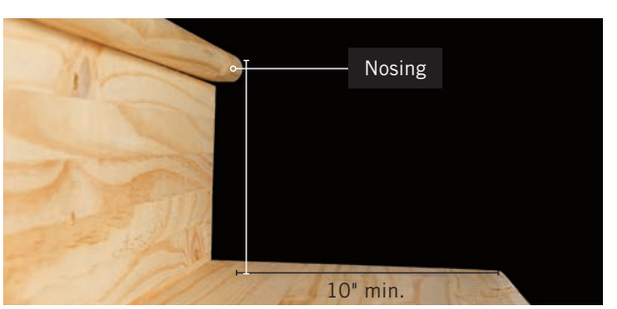
2. Do not exceed ⅜-inch finished riser height difference between any two risers in a flight of stairs.

3. Do not allow open risers to fit a 4-inch-diameter sphere for passthrough. This includes interior stairs and exterior stairs, such as stairs for decks and balconies, but does not include spiral stairs.

4. Do not include the height of carpets, carpet pads, rugs, and runners when measuring riser height.

Maximum riser height is 7¾". Maximum difference between two risers in a flight of stairs is ⅜".

Open risers have the potential to trap the head of a small child. Do not allow an open riser to pass a 4" diameter sphere. Install filler strips to reduce riser opening size, beginning with the fourth riser.



Provide a tread depth of at least 10" if treads have a nosing or at least 11" if treads have no nosing.

Tread Depth

1. Provide a finished tread depth of at least 10 inches. Measure tread depth horizontally from the leading edges of adjacent treads and at a right angle to the tread's leading edge.

2. Do not exceed ⅜-inch finished tread depth difference between any two treads in a flight of stairs. This does not apply to consistently shaped winder treads contained within the same flight of stairs.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:26

Tread Nosing

1. Provide a finished tread nosing depth of at least ¾ inch and not more than 1¼ inches for stairs with solid risers. Add the nosing depth to the 10-inch minimum tread depth. Tread nosing is not required if treads are at least 11 inches deep.

2. Do not exceed ⅜-inch finished tread nosing depth difference between any two treads for all treads between two stories, including at floors and landings. Note that this differs from the tread and riser maximum difference. The tread and riser differences are for a flight of stairs, and the nosing depth difference is for all treads between two stories.

3. Do not exceed 9⁄16 inch for the curvature radius of a tread nosing, and do not exceed ½ inch for the bevel of a tread nosing.

Tread Slope

1. Slope treads and landings not more than 2 percent from horizontal in any direction.

Winder Stair Treads

1. Locate the winder tread walkline at 12 inches from the inside of where the winder tread turns. Measure the tread depth at the widest point along the walkline.

2. Provide a finished winder tread depth of at least 6 inches at any point on a winder tread within the finished width of the stairway and at least 10 inches at the walkline.

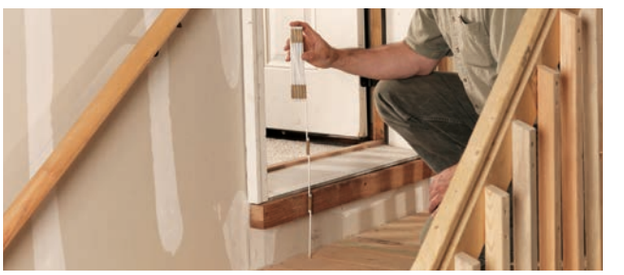
3. Do not exceed ⅜-inch finished tread depth difference between any two treads in a flight of stairs measured at the walk line.

4. Do not compare the depth of winder treads to the depth of rectangular treads in a flight of stairs if: (a) the winder treads all have a consistent shape, and (b) the winder treads comply with the winder tread depth requirements. Winder treads will not have the same depth as the rectangular treads, so the winder tread depth will not be within ⅜ inch of the rectangular tread depth.

Stairway Headroom Height

1. Provide a finished stairway headroom height of at least 80 inches measured vertically from a sloped plane connecting the tread nosing or from the finished floor of a landing. Projections from the ceiling are permitted above the minimum finished headroom height.

Provide a tread nosing depth of at least ¾" and not more than 1¼". Do not exceed 9⁄16" radius for a curved nosing or ½" depth for a beveled nosing.



The step up from landings should be not more than 7¾". Measure the step to the top of the threshold. Make landings at least as wide as the stairway and at least 36" deep.

Stairway Landings

1. Provide a landing or floor at the top and bottom of most stairs.

2. You are not required to provide a landing or floor at the top of interior stairs, including stairs in an attached garage, unless a door swings over those stairs. This means you may terminate a flight of interior stairs directly into a door if the door swings away from the stairs.

3. Do not exceed 151 inches vertical rise of a flight of stairs without providing a landing or a floor. Example: do not install more than twenty 7⅜-inch-high risers without an intermediate landing.

4. Make rectangular and square landing widths at least as wide as the stairway. Example: if the stairway is 36 inches wide, build the landing at least 36 inches wide.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:27

5. Make rectangular and square landings depth at least 36 inches, measured in the direction of travel.

6. You may make landings with shapes other than rectangular or square if: (a) the depth of the landing at walk line is at least as wide as the stairway and (b) the total area of the landing is at least as large as a ¼ circle with a radius equal to the required width of the landing. The walk line is 12 inches from the narrow side of the landing. The area of a circle is 3.14 multiplied by the circle's radius squared. Example: the minimum area of a curved landing serving a 36-inch-wide stairway is calculated $(36 \text{ in.}^2 \times 3.14) \times .25 = 1{,}017.9$ square inches.

Guards: Definition

A guard is a barrier that protects occupants from falling from a raised surface, such as a stairway, deck, or balcony. Guards are often call guardrails when the guard also serves as a handrail; however, guards need not be an open rail. A guard may be a partial height solid wall, a partial height wall containing safety glazing, or any other structure that complies with IRC requirements.

Handrails & Guards: Location

1. Provide a handrail on at least one side of every continuous flight of stairs with four or more risers.

2. Provide a guard at raised walking surfaces more than 30 inches above an adjacent interior or exterior surface. Areas that require guards include porches, balconies, decks, hallways, screened enclosures, ramps, and the open sides of stairs with a total rise of more than 30 inches.

Height

1. Install the handrail at least 34 inches and not more than 38 inches above the treads measured vertically from a sloped plane connecting the tread nosing or from the finished floor of a ramp.

2. You may exceed the 38-inch maximum height where a handrail connects with a guard to provide a continuous structure. Example: a handrail connects to a guard at an intermediate stairway landing. The handrail height at the beginning and ending of the intermediate landing guard may exceed 38 inches high.

3. Provide guards at least 36 inches tall at raised surfaces other than the open sides of stairs.

4. Provide guards at least 34 inches high on the open sides of stairs. Measure the guards vertically from the nosing of the treads.

5. Limit the height of guards that are also handrails to not more than 38 inches. The IRC does not limit guard height other than for handrails.

Install a handrail on stairways with at least four risers. Provide a continuous handrail beginning above the first riser and ending at or above the last riser.

Install handrails at least 34" and not more than 38" above a sloped line connecting the stair treads.

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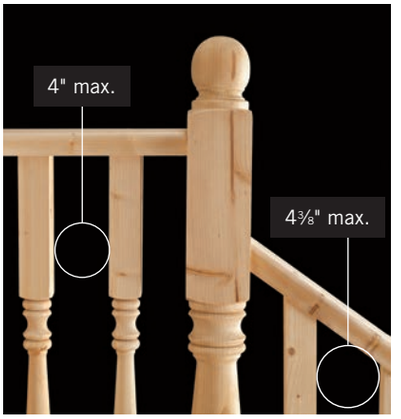
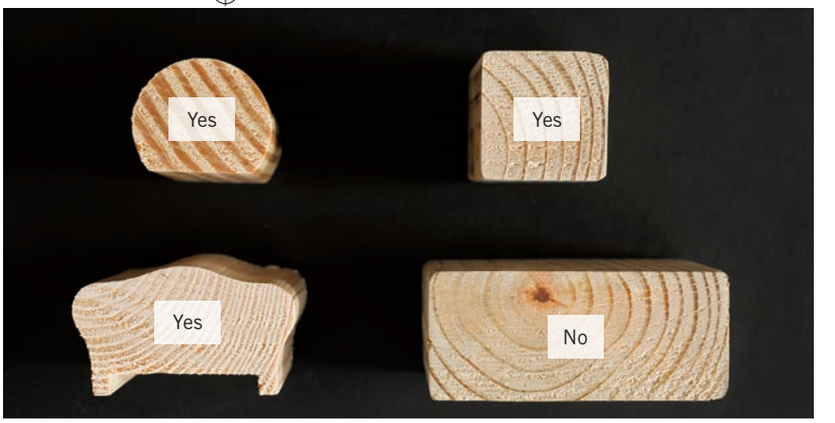
Page:28



The maximum space between guard vertical members is a 4"-diameter sphere. The maximum space for stairway guards is a 4⅜" diameter sphere.



Install handrails that have the required gripping surface dimensions. Three of the above profiles will suffice. Handrails using 2 × 4 and larger lumber are too large to be grippable and thus do not meet the dimensions standard.

Continuity

1. Run the handrail continuously from at least a point directly above the top riser of the flight of stairs to at least a point directly above the lowest riser of the flight.

2. Begin and end all handrails with a newel post, volute, starting easing, or starting newel.

3. Project handrails at least 1½ inches and not more than 4½ inches from any adjacent wall.

4. You may interrupt a handrail with a newel post at a turn.

5. Provide continuous guards for open sides of the entire flight of stairs, even if some of the flight is less than 30 inches above an adjacent surface.

6. You need not provide a guard if the entire flight of stairs is less than 30 inches above an adjacent surface. This applies even if a lower flight of stairs connects with an upper flight of stairs at a landing. Example: a landing occurs before the last three risers of a stairway. The last three risers are a separate flight of stairs and do not require a guard or a handrail.

Shape

1. Use material with an outside diameter of at least 1¼ inches and not more than 2 inches for Type 1 circular handrails.

2. Use material with a perimeter dimension of at least 4 inches and not more than 6¼ inches and a cross-section dimension of not more than 2¼ inches for Type 1 non-circular handrails.

3. Provide Type 2 handrails that have a perimeter dimension greater than 6¼ inches with a graspable finger recess on both sides of the profile.

4. Apply handrail shape requirements to interior and exterior stairways, including stairways for decks and balconies.

Openings

1. Do not allow openings in horizontal guards to pass a 4-inch-diameter sphere.

2. Do not allow stair guard openings, such as balusters, to pass a 4⅜-inch-diameter sphere.

3. Do not allow openings under stair guards formed by a riser, tread, and the guard's bottom rail to pass a 6-inch-diameter sphere.

Handrails & Guards Live Loads

1. Install handrails and guards so they will resist a uniform distributed force of at least 200 pounds per square foot applied in any direction at any point along the top.

The maximum space in the triangle formed by a tread, riser, and stair guard bottom rail is a 6" diameter sphere.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:29

Emergency Escape Openings

An emergency escape and rescue opening, commonly called an egress opening, is required in all bedrooms and in most basements. Codes are very specific concerning the minimum clearances of the openings and how they can be accessed, as well as how they can be exited from the exterior. Rooms that are not intended for sleeping typically do not need to meet egress requirements. **You may use an operable window or a side-hinged or sliding door as the escape opening.**

Egress windows allow emergency exit from a structure and must meet certain minimum size and accessibility codes. They are required primarily in bedrooms and basements.

Escape Opening Locations

1. Provide at least one escape opening in every bedroom, including bedrooms above, at, and below ground level.

2. Provide at least one escape opening in most basements. You are not required to provide a basement escape opening if: (a) the basement area is not more than 200 square feet and (b) the basement is used only to house mechanical appliances.

3. Provide each basement bedroom with an escape opening. You are not required to provide other escape openings in basements in addition to the bedroom escape openings.

4. Open all escape openings directly onto an area that leads directly to a public way. This means that escape openings cannot open onto an enclosed courtyard or onto a similar area that does not lead directly and without obstruction to an area that is accessible by the public.

5. You may open an escape opening under a deck or porch if: (a) the escape opening can be opened to the full required dimensions and (b) the space under the deck or porch is at least 36 inches high.

6. Note that an escape opening may be required when converting a previously unfinished basement into finished space, especially if the finished space is a bedroom. Verify requirements with the local building official.

LOCKS & BARS ON OPENINGS

Do not cover or obstruct escape openings with locks, bars, screens, or similar devices unless they can be operated from the inside without tools, keys, lock combinations, and special knowledge, and can be operated with the same force required to open the escape opening.

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305471 - B&D Codes for Homeowners 4th Edition Edition_018-043.indd 30 1/10/18 10:23 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:30

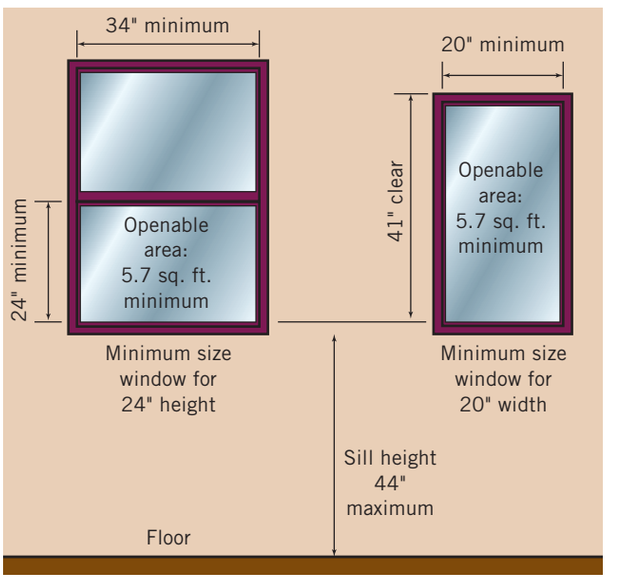
Escape Opening Size

1. Provide escape openings with a clear opening area of at least 5.7 square feet. This includes escape openings above and below grade level. You may reduce an escape opening at grade level to at least 5.0 square feet.

2. Provide each escape opening with a clear opening at least 24 inches high and at least 20 inches wide.

3. Locate the sill of each escape opening not more than 44 inches above the finished floor. Measure the sill height from the finished floor to the where the clear opening begins (the bottom of the opening).

4. Measure escape opening height and width using the clear opening area, which does not include obstructions, such as window frames.



To satisfy building codes for egress, a basement window must have a minimum opening of 5.7 sq. ft. through one sash, with at least 20" of clear width and 24" of clear height. Casement, double-hung, and sliding window styles may be used as long as their dimensions for width and height meet these minimum requirements.

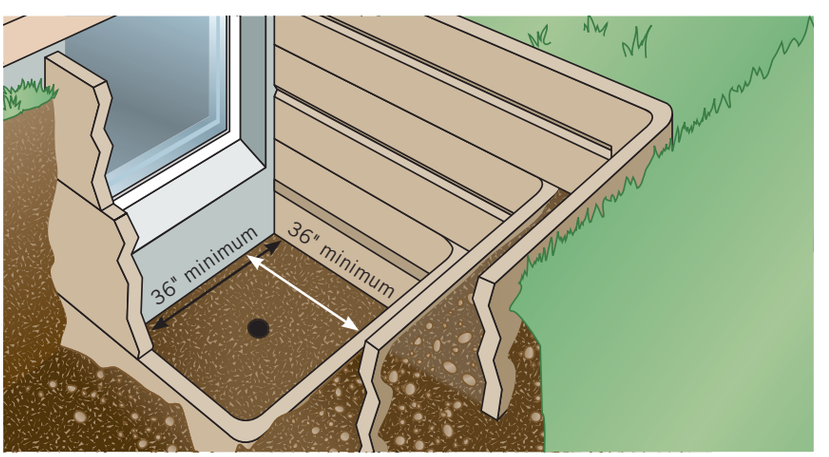
NOTE: If the window opening is the minimum in both dimensions, it will be too small; at least one dimension must be more than minimum to meet the code requirement.

Window & Area Wells

1. Provide all below-grade escape windows with a window well and below-grade escape doors with an area well. The following apply to both window wells and area wells.

2. Provide each well with at least a 9-square-foot clear opening area and a depth and width of at least 36 inches in each direction.

3. Install a permanent ladder if the well bottom is more than 44 inches below grade. Ladder rung specifications include: a rung width of at least 12 inches, a rung projection of at least 3 inches from the well wall, and a rung vertical spacing of not more than 18 inches apart. A ladder may encroach not more than 6 inches into the minimum well width or depth dimension.



Egress wells must be at least 36" wide and project 36" from the foundation. Those deeper than 44" must have a means of escape, such as an attached ladder or a tiered design that forms steps. Drainage at the bottom of the well should be connected to the foundation drain or to another approved drainage system.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:31

Egress Doors

The egress door opens to the outside and meets all egress door requirements for accessibility and opening size. Every dwelling must have at least one egress door. The egress door is usually the front door. Other exterior doors need not comply with the egress door requirements.

Egress Door Requirements

1. Provide at least one egress door that: (a) is accessible from all areas of the home and (b) allows people to go directly outside without traveling through the garage.

2. Install a side-hinged egress door that provides a clear opening at least 32 inches wide and 78 inches high. Measure door width between the face of the door when open to 90 degrees and the outer edge of the door stop. Measure door height between the top of the threshold and the bottom of the stop. This means that a 36-inch by 80-inch door is required when using standard-size doors.

3. Provide a landing on the interior and exterior sides of the door. Build each landing at least as wide as the door. Example: if the door is 36 inches wide, then build each landing at least 36 inches wide. Build each landing at least 36 inches deep, measured in the direction of travel.

4. Build the interior and exterior landings not more than 1½ inches below the top of the threshold.

5. You may build the exterior landing not more than 7¾ inches below the top of the threshold, if the egress door does not swing over the landing. You may build the exterior landing with not more than a 2 percent slope away from the door. You may have a storm door or a screen door swing over any landing.

6. Provide a ramp or a stairway to any egress door that is not at grade level.

Build a landing at least 36" deep on both sides of the egress door. You may build the exterior landing not more than 7¾" below the top of the threshold.

EGRESS DOOR LOCK

Do not install a double cylinder dead bolt lock or any other lock or device that requires use of a key, tool, or any special knowledge or effort to open the egress door. This includes screen and security doors.

VIOLATION! Use only thumb-latch deadbolts on egress doors.

305471 - B&D Codes for Homeowners 4th Edition Edition_018-043.indd 32 1/10/18 10:24 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_018-043.indd 32 1/10/18 10:23 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:32

Exterior Doors

A landing area is required on both sides of exterior doors.

Exterior Door Landing Requirements

1. Provide a landing on the interior and exterior sides of exterior doors.

2. Build each landing at least as wide as the door served. Example: if the door is 36 inches wide, then build each landing at least 36 inches wide.

3. Build each landing at least 36 inches deep, measured in the direction of travel.

4. Build each landing not more than 1½ inches below the top of the threshold.

5. You may build the exterior landing with not more than a 2 percent slope away from the door.

6. You are not required to build a landing on the exterior side of a door if: (a) a stairway of not more than two risers is on the exterior side and (b) the exterior door does not swing over the stairway.

7. You may build an exterior landing not more than 7¾ inches below the top of the door threshold if the exterior door does not swing over the landing.

8. Provide a ramp or a stairway to any exterior door that is not at grade level.

9. You may have a storm door or a screen door swing over any stairway and landing serving as a door into the house.

10. You are not required to build a landing on the exterior side of a door that opens to a narrow, above-grade balcony or similar structure.

SITE ADDRESS

Install approved building address numbers or letters that are clearly legible from the road fronting the property. This is so emergency responders can quickly locate the property. Make the letters and/or numbers Arabic type that are at least 4" tall and at least ½" wide. Make the letters or numbers contrast with the background.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:33

Door & Window Hazards

You may have seen pictures of people severely cut when they fell or were pushed through doors and windows containing regular glass. Regular glass usually breaks into large pieces that can cause severe injury. Safety glass shatters into very small pieces that are less likely to cause severe cuts.

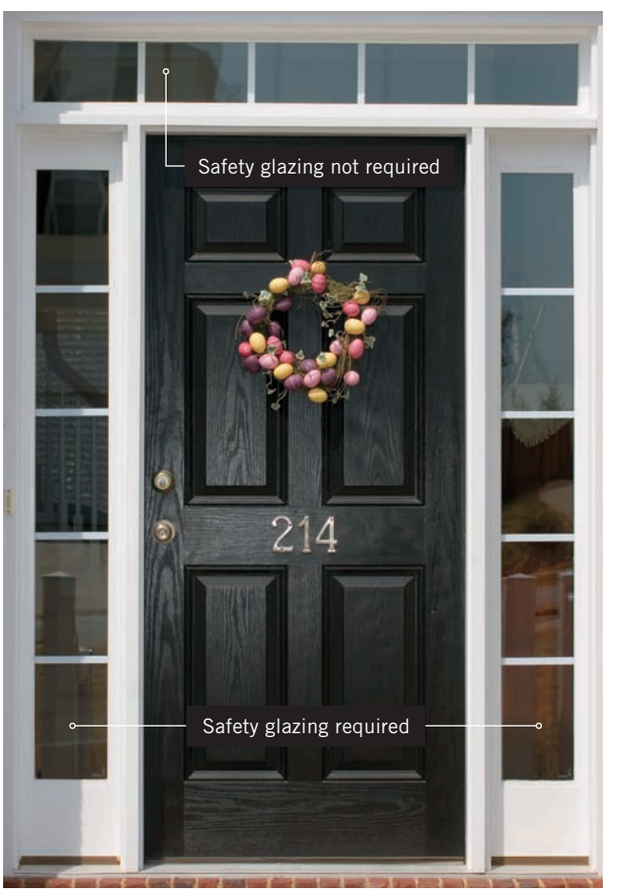
General codes designate several locations as hazardous, where people could fall or be pushed through glass. These locations are mostly near doors, near water, and near stairs. A large window where the sill is close to the floor is also a hazardous location.

Safety glazing usually means tempered glass; however, other materials also qualify. This is why it is called safety glazing, not safety glass. Most safety glazing should be identified with permanent writing in one corner of the glazing. This writing can be very difficult to see, so look closely before deciding that glazing is not safety glazing.

Laminated glass is one type of safety glazing that has a clear membrane in the center layer to keep the shattered glass more or less in place when it breaks. Tempered glass is another common type of safety glazing.

Another window hazard involves children falling from windows where the sill is close to the floor. Recent general codes require a mechanism that prevents a child from opening these windows enough so that they can climb through them and fall.

Safety glazing and fall hazard rules are complicated and have many exceptions. Our objective here is to introduce the subject and point out some hazardous locations that you might encounter if you remodel or add to your home.



The sidelights on both sides of the door should contain safety glazing. Safety glazing is not required in the transom above the door.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:34

Windows along stairways and at landings should contain safety glazing if the bottom edge of the glazing is less than 36" above the stair walking surface.

Safety Glazing In & Near Doors

1. Use safety glazing in doors, including swinging and sliding doors, outside doors, and interior doors such as French doors. Exceptions include decorative glazing, such as stained glass, and glazing in very small openings in the door.

2. Use safety glazing in windows that are within 24 inches on either side of a door. Exceptions include decorative glazing and windows when the bottom edge of the glazing is located 60 inches or more above the walking surface.

Safety Glazing Near Stairs & In Guards

1. Use safety glazing in guards, including guards at decks, balconies, raised walkways, and similar locations.

2. Use safety glazing in stairway handrail guards.

3. Use safety glazing in windows within stairways when the bottom edge of the glazing is less than 36 inches above the adjacent walking surface. Exceptions include if a handrail is between the stairs and the window and if the window is 36 inches or more away from the nearest part of the stairs.

4. Use safety glazing in windows within 60 inches of the last tread at the bottom of a stairway when the bottom of the glazing is less than 36 inches above the adjacent walking surface.

Windows above bathtubs and showers should contain safety glazing unless the bottom of the glazing is located 60" or more above the tub or shower floor.

Safety Glazing Near Wet Surfaces

1. Use safety glazing in bathtub and shower doors and enclosures.

2. Use safety glazing in walls, enclosures, and fences that are less than 60 inches horizontally from the edge of bathtubs, showers, swimming pools, whirlpool tubs, hot tubs, saunas, and steam rooms. Exceptions include windows when the bottom edge of the glazing is located 60 inches or more above the walking surface and windows that do not face the bathtub, etc.

Window Fall Protection

1. Install a means to restrict the distance that an operable window can open so that a 4-inch-diameter sphere cannot pass when: (a) the top of the window sill is less than 24 inches above the finished floor and (b) the top of the window sill is more than 72 inches above the exterior surface below.

2. You may comply with this provision by permanently restricting the window opening distance, except where the window serves as an emergency escape and rescue opening.

3. You may comply with this provision by installing a window opening control device that complies with ASTM F2090.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:35

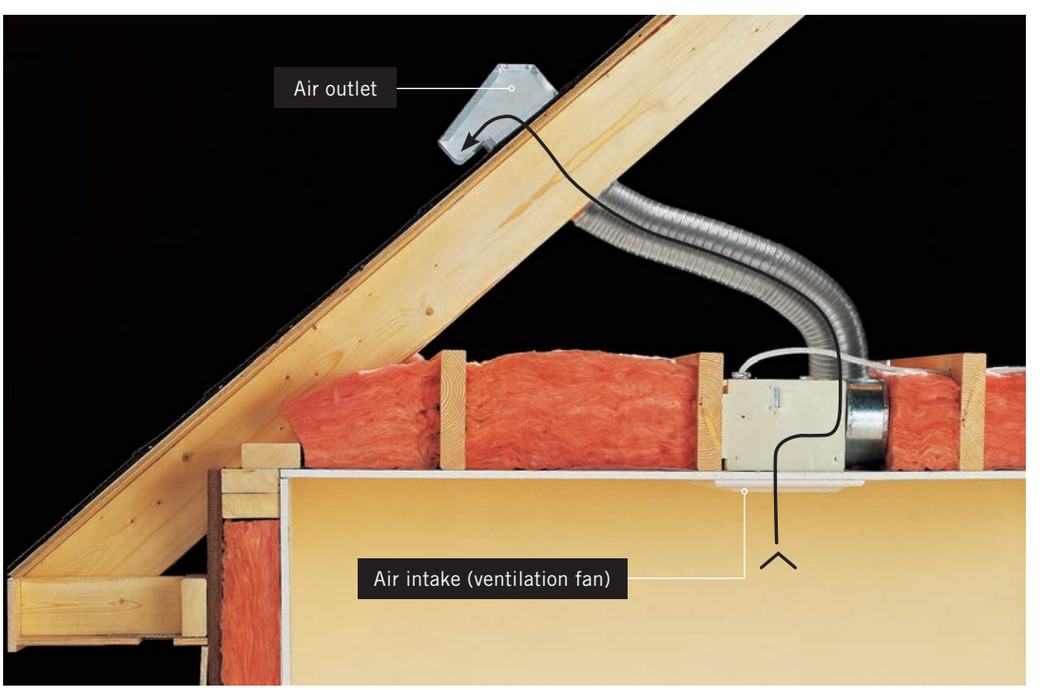
Ventilation & Exhaust

Controlling moisture levels in a home is important for your comfort and health, as well as for the health of your home. Although inadequate moisture levels can cause discomfort for some people and can cause furnishings and some construction materials to become brittle, it is not usually a significant risk to you or to your home, so the IRC has no provisions governing minimum moisture and humidity levels. Too much moisture, however, can be a significant risk to you and your home, so the IRC has several provisions governing the removal of excess moisture. Current indoor air quality best practices also encourage removal of excess moisture and other contaminants from the home.

The greatest threat posed by water vapor is that it provides one of the three things that mold needs to grow. The other two are the correct temperature and food. Mold grows at the same temperatures we humans prefer, so there is little we can do about that. Because mold eats almost any wood-based product and our homes are filled with these products, there is little we can do about the food risk. The one thing we can do something about is moisture.

Water vapor travels in the air. When water vapor condenses on visible surfaces, it provides the moisture that mold needs. We then see what is often called mildew. Mildew is another name for mold. When water vapor travels into attics and wall cavities, it can condense and provide moisture for mold. Mold can grow in these hidden spaces for long periods before it is discovered. Damage to your home and health can be significant when mold grows for long periods of time.

Water vapor is always present in every home. Some water vapor occurs naturally in the air. We introduce some water vapor into the home with every breath we take. Much of the water vapor in a home results from activities such as bathing, cooking, and clothes drying. The IRC has provisions that help remove the excess water vapor caused by these activities.



Moisture exhaust requirements generally are met with a combination of natural (windows and doors) and mechanical (ventilation fans) solutions. The bathroom and kitchen are the two rooms where ventilation is most critical.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:36

Air Movement Requirements

1. Provide outdoor light and ventilation to bathrooms, toilet rooms, and similar areas using windows or doors containing glazing. Provide a total glazing area of at least 3 square feet with at least 1½ square feet operable. Open the glazing directly onto a street, public alley, or onto a yard or court located on the same lot. Best practice is to equip every bathroom with a ventilation fan.

2. You may replace the glazing with artificial light and exhaust ventilation. Provide exhaust ventilation of at least 20 cubic feet per minute (cfm) continuous ventilation or at least 50 cfm for a switched ventilation fan.

3. Comply with the ventilation fan manufacturer's instructions or general codes about exhaust duct type and length. Three-inch diameter duct may not be allowed as an exhaust duct. Four-inch diameter or larger duct may be required.

4. Discharge bathroom and toilet room ventilation fan exhaust directly outdoors. Discharging a ventilation fan exhaust duct into or toward an attic, soffit, or crawl space ventilation opening does not comply with this provision.

5. Terminate exhaust fans at least: (a) 3 feet from property lines, gravity air intake openings, operable windows and doors; (b) 10 feet horizontally or 3 feet above mechanical air intake openings (such as for a heat recovery ventilation unit).

6. Do not recirculate air from bathrooms within a residence or into another residence.

7. Provide an automatic or gravity-operated damper for exhaust systems that will close the damper when the system is not operating.

8. Do not direct outdoor exhaust openings, such as from bathroom and kitchen exhaust fans, onto a walkway.

9. Protect outdoor air intake and exhaust openings with a corrosion-resistant screen having openings at least ¼ and not more than ½ inch or by louvers, dampers, or similar means. This does not include clothes dryer exhaust openings. Do not cover clothes dryer exhaust openings with a screen.

10. Protect outdoor openings against local weather conditions, such as rain and snow infiltration and blockage by snow accumulation.

EXHAUST FAN LABELS

Check the information label attached to each exhaust fan. Bathroom fans that are switch-operated should be rated at least 50 cfm. Baths over 100 sq. ft., or multiple tubs or showers, should have higher-capacity fans. The sone rating refers to the relative quietness of the unit, rated on a scale of 1 to 7. (Quieter fans have lower sone ratings.)

Terminate exhaust ducts directly outdoors with a cover that protects against weather and pest infiltration.

VIOLATION! Do not terminate exhausts into attic or crawl space areas.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:37

Kitchen Exhaust Requirements

General Installation Requirements

1. You need not install either a recirculating or an externally ducted kitchen exhaust hood; however, externally ducted kitchen exhaust hoods are recommended. Verify kitchen exhaust hood requirements with the local building official, because interpretation of kitchen exhaust hood requirements can vary among jurisdictions.

2. Terminate a kitchen exhaust hood duct, if any, to the outdoors when natural or mechanical ventilation is not provided in the kitchen area. Natural ventilation usually means an operable window in the kitchen area. Mechanical ventilation may be provided by a ducted central heating system that is connected to a ventilation opening terminating outdoors. Mechanical ventilation may be provided by a heat recovery or energy recovery ventilation system. Most homes have either natural or mechanical ventilation in the kitchen area, so external discharge of range hoods is rarely required.

3. You may, but are not required to, install a recirculating kitchen hood if the kitchen is provided with natural or mechanical ventilation.

4. Provide a backdraft damper at the duct termination or other approved location. Many kitchen hoods and cabinet-mounted microwave ovens have backdraft dampers integrated into the appliances.

Aboveground Exhaust Duct Construction

1. Discharge the kitchen exhaust fan to the outdoors using a duct. Do not discharge the fan through a framed cavity.

2. Use galvanized steel, stainless steel, or copper to construct kitchen exhaust ducts.

3. Seal the exhaust duct air tight to avoid leaking flammable grease into wall or floor cavities or between the kitchen exhaust hood and the kitchen cabinet.

Use galvanized metal ductwork for range hood ducts, and be sure to seal the joints very well so the airborne grease doesn't escape into walls and cabinets, where it poses a fire hazard.

Externally exhausted range hoods are not required by codes except in very rare situations. Typical cabinet-mounted models, such as the one seen here, are quite popular, however, and are recommended whenever practical.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:38

Exhaust Duct Termination

1. Terminate kitchen exhaust hood ducts outside the building. This does not include attics and crawl spaces.

2. Provide a backdraft damper at the duct termination or other approved location. Many kitchen exhaust hoods and cabinet-mounted microwave ovens have backdraft dampers integrated into the equipment.

Kitchen Exhaust Fan Rates

1. Provide an exhaust rate of at least 100 cfm for intermittently operated exhaust hoods or at least 20 cfm for continuously operating exhaust hoods.

2. Provide makeup air for exhaust fans with a capacity of more than 400 cfm. Install a gravity operated or an electrically operated damper to open and close the takeup air duct.

Replacing a Range Hood with a Microwave Oven

This is a popular upgrade that is often installed incorrectly. Failure to read and follow manufacturer's instructions can be a fire hazard and a burn hazard. It can also reduce the microwave's service life. The following address some of the most frequent installation errors.

1. Leave enough space between the microwave and the range top. A typical instruction is to have at least 66 inches between the floor and the top of the microwave, at least 30 inches between the range top and the bottom of the cabinet, and at least 2 inches between the bottom of the microwave and the range control panel.

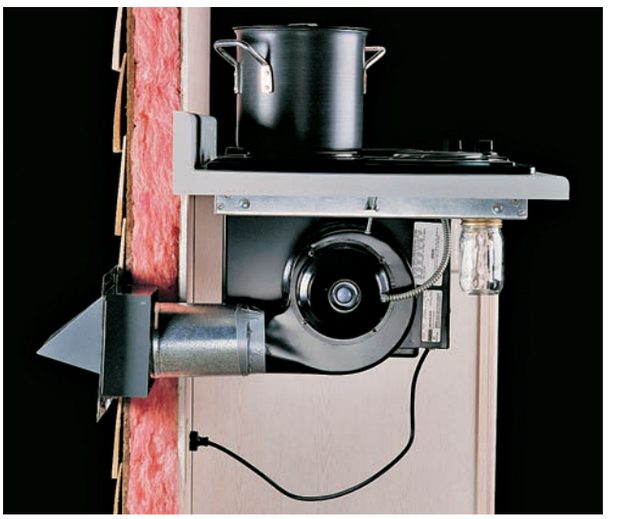
2. Connect the microwave to a dedicated 120-volt circuit. Most microwaves should be served by a 20-amp circuit.

3. Plug a microwave that comes with an attachment plug into a receptacle. Do not connect the microwave directly to the electrical wires, and do not use an extension cord.

4. Use the size and type of exhaust duct material and termination fittings specified by the microwave manufacturer. Do not exceed the exhaust duct effective length specified by the manufacturer. Effective length adds for the losses created by elbows and termination fittings.

5. Connect the microwave to the exhaust duct. Do not simply blow the exhaust at the hole in the cabinet where the exhaust duct is located.

6. Install the backdraft damper if one is supplied with the microwave.



Downdraft ventilation is a space-saving alternative to exhaust hoods, often used on kitchen islands with built-in cooktops. It is less efficient but will mitigate some of the cooking vapors and airborne particulate matter.

Many manufacturers recommend at least 66" between the floor and the top of the microwave.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:39

Clothes Dryer Exhaust Requirements

General Installation Requirements

1. Construct, install, and terminate clothes dryer exhaust ducts according to the clothes dryer manufacturer's installation instructions. If the clothes dryer manufacturer is not known during construction, use general requirements.

2. Do not connect clothes dryer exhaust ducts to any other system, such as bathroom exhaust fan ducts, plumbing vents, or fuel-burning equipment vents and flues.

3. Do not install clothes dryer exhaust ducts in or through any fireblocking-, draftstopping-, or fire-resistance-rated assembly, unless the duct is constructed and installed to maintain the code that requires fireblocking or draftstopping.

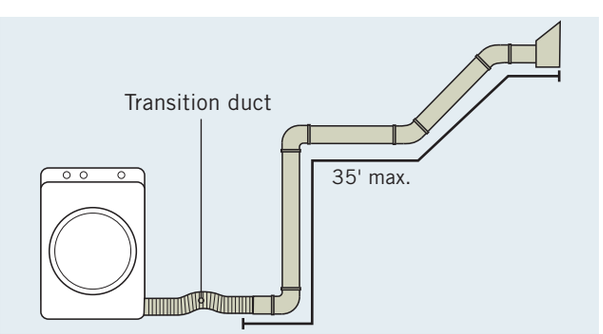
4. Do not run clothes dryer exhaust ducts into or through other ducts or plenums. Example: do not run a clothes dryer exhaust duct into or through an HVAC supply or return duct or into or through a combustion air duct.

5. Install the clothes dryer exhaust duct during construction if space for a clothes dryer is provided.

6. You may install a dryer duct booster fan to extend the dryer exhaust duct's length. Install the fan according to the fan manufacturer's instruction.

Duct Construction

1. Use a 4-inch-diameter, smooth wall metal duct that is at least 28 gauge, unless the clothes dryer manufacturer's instructions allow another diameter.



Limit clothes dryer exhaust duct developed length to not more than 35'.

Use strap hangers to support rigid ducts. Install hangers at joints at intervals not exceeding 12'.

2. Install duct joints so that the inside part of the joint fits into the outside part of the joint in the direction of the air flow.

3. Fasten duct joints with mechanical fasteners, such as screws or pop rivets. Do not use screws or other fasteners that penetrate the duct more than ⅛ inch. Longer fasteners could trap lint.

4. Seal the duct joints with metal tape or mastic.

5. Support the duct at least every 12 feet. Joints and elbows are vulnerable areas for separation.

6. Protect the duct with at least 16-gauge shield plates if the duct is within 1¼ inches from the edge of a framing member. Extend the shield plate at least 2 inches above sole plates and below top plates. Protect the duct with shield plates at any other location where it is likely to be penetrated by fasteners.

Duct Length

1. Do not exceed 35 feet developed length between the beginning of the clothes dryer duct and the duct termination, unless the clothes dryer manufacturer's installation instructions allow a longer length. Developed length means the straight line length of the duct, reduced by bends in the duct. The clothes dryer manufacturer is rarely known during construction, so the manufacturer's installation instruction exception rarely applies.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:40

2. Add 2½ feet for every 45-degree bend and 5 feet for every 90-degree bend to the dryer duct's developed length. You may use the manufacturer-provided developed length for smooth radius bends. You may use the IRC table for smooth radius bend developed length if the manufacturer's instructions are not available.

3. Do not include the transition duct in the dryer duct developed length.

4. Locate a permanent label within 6 feet of the clothes dryer exhaust duct connection that shows the exhaust duct's developed length. This requirement applies only when the duct developed length is more than 35 feet.

Duct Termination

1. Terminate clothes dryer exhaust ducts outside the building. Outside the building does not include attics or crawl spaces.

2. Locate the clothes dryer exhaust duct termination at least 3 feet from: (a) the property line and (b) operable and non-operable openings. Operable openings include windows and doors. Non-operable openings include eave ventilation openings and combustion air openings. This provision does not apply if the clothes dryer manufacturer's installation instructions allow other locations. The clothes dryer manufacturer is rarely known during construction, so the manufacturer's installation instruction exception rarely applies.

3. Provide a backdraft damper at the duct termination or at another approved location.

4. Do not install a screen at the exhaust duct termination. A screen will trap lint.

5. Make the open area of the exhaust duct termination at least 12.5 square inches.

Transition Duct

1. The transition duct is the duct (usually flexible duct) between the dryer and the start of the smooth wall dryer exhaust duct.

2. Limit the transition duct length to 8 feet.

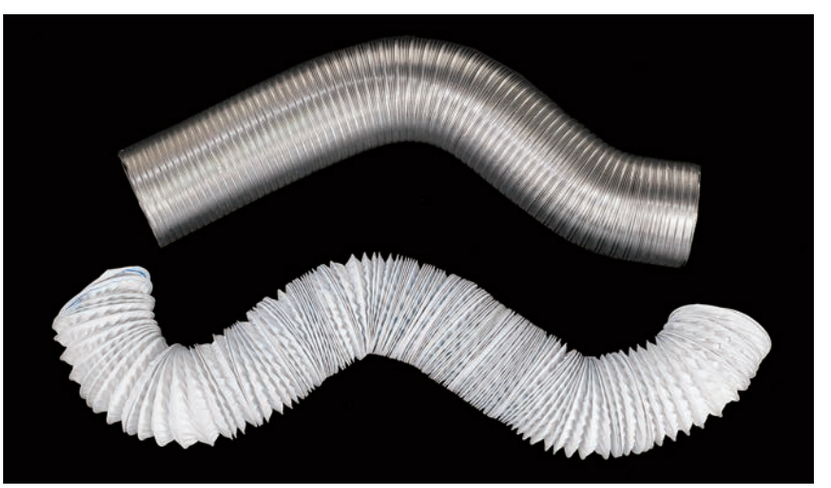
3. Use only one piece of transition duct. Do not splice together two or more lengths of transition duct material.

4. Do not run the transition duct through walls or in concealed spaces.

Clothes Dryer Makeup Air

1. Provide makeup air for clothes dryers that exhaust more than 200 cubic feet per minute. General codes do not specify how to provide makeup air or specify that the makeup air come from outdoors.

2. Provide a net free opening of at least 100 square inches when clothes dryers are installed in closets or provide makeup air by other approved means.



Use and install transition ducts according to the clothes dryer's instructions. Replace plastic transition ducts (bottom) with flexible metal transition ducts (top).

Cut the transition duct to the shortest length possible. Eliminate bends and kinks that will reduce air flow.

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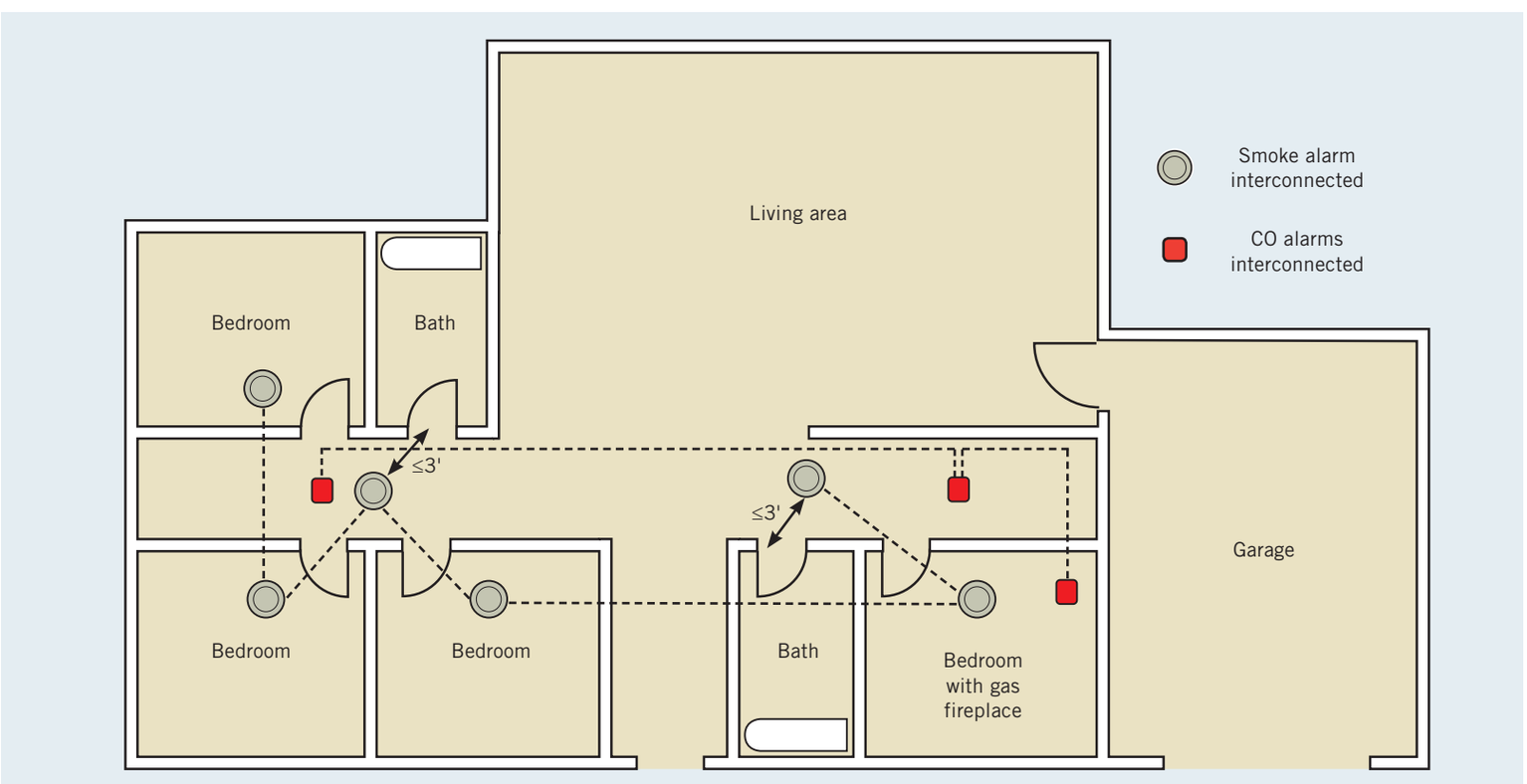
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:41

Smoke & Carbon Monoxide Alarms

Smoke alarms and carbon monoxide (CO) alarms have been required in houses for many years. Combination smoke and CO alarms are not preferred, because the service life of the different alarms are different, meaning that one alarm could fail before the other.

You should replace old smoke and carbon monoxide alarms. Smoke alarms have a useful life of about 10 years. Carbon monoxide alarms have a useful life of about 7 years. Install carbon monoxide alarms near all bedrooms and inside bedrooms with a fuel-burning appliance, such as a gas fireplace.

Smoke alarms and carbon monoxide (CO) alarms have been required in houses for many years. Carbon monoxide alarms (A) are triggered by the presence of carbon monoxide gas. Smoke alarms are available in photoelectric and ionization models. In ionization alarms (B), a small amount of current flows in an ionization chamber. When smoke enters the chamber, it interrupts the current, triggering the alarm. Photoelectric alarms (C) rely on a beam of light, which when interrupted by smoke triggers an alarm. Heat alarms (D) sound an alarm when they detect areas of high heat in the room. Also available are combination smoke/CO alarms and ionization/photoelectric smoke alarms. The combination ionization/photoelectric alarms are recommended, because they detect smoke from different types of fires.



Install smoke alarms in and near all bedrooms and on all levels of a home.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:42

Smoke & CO Alarm Required Locations

1. Locate a smoke alarm: (a) in every bedroom; (b) outside all bedroom areas in the immediate vicinity (usually about 10 feet) of all bedrooms; (c) on every level in the home, including basements; and (d) within 3 feet horizontally from the door of a bathroom containing a tub or a shower.

2. Do not install an ionization smoke alarm closer than 20 feet horizontally from a permanently installed cooking appliance. Do not install a photoelectric smoke alarm closer than 6 feet horizontally from a permanently installed cooking appliance.

3. You may substitute a security system that includes smoke alarms if it provides the same protection as hard-wired smoke alarms. The security system smoke alarms must: (a) comply with the National Fire Protection Association (NFPA) 72 standard and (b) must be a permanent fixture in the home. Security system smoke alarms installed as a substitute system cannot be leased. They must be a permanent part of the home.

4. You are not required to locate smoke alarms: (a) in crawl spaces and in uninhabitable attics, and (b) on the middle level of split-level homes if smoke alarms are installed on the upper level, if the middle level is less than one story below upper level, and if there is no door between levels. Note that some jurisdictions require smoke alarms on all levels of a split-level home.

Smoke Alarm Power Source

1. Install smoke alarms that take primary power from the building electrical wiring and that have a battery backup.

2. Connect all smoke alarms together so one alarm activates all alarms (interconnection). Physical interconnection is not required if the alarms are listed for wireless interconnection.

3. Provide arc-fault circuit-interrupter protection for the smoke alarm primary power.

Do not locate a smoke alarm closer than 4" to the intersection of a wall and ceiling. The smoke alarm may not detect smoke in this dead air zone.

Smoke Alarm Installation

1. Install smoke alarms according to manufacturer's instructions. This often includes locating the smoke alarm on the ceiling or on a wall not more than 12 inches from the ceiling. Do not locate a smoke alarm closer than 4 inches to the intersection of a wall and ceiling. The smoke alarm may not detect smoke in this dead air zone.

Smoke Alarm & CO Alarm Updates When Remodeling

1. Update the entire smoke alarm and carbon monoxide alarm system to current code requirements (including alarm interconnection and hard-wiring) when building alterations, repairs, or additions require a permit. This update requirement does not apply to: (a) exterior work such as roofing, siding, window, and door repair and replacement, (b) installation of or repairs to plumbing and HVAC systems, and (c) situations where access does not exist to allow installing electrical wires that would provide power and interconnection to the carbon monoxide alarms.

Carbon Monoxide Alarm Requirements

1. Install carbon monoxide alarms in homes equipped with fuel-fired appliances, such as gas and oil-fired furnaces, and in homes with an attached garage or a fireplace. The alarms must comply with UL2034.

2. Install an alarm outside of bedroom areas in the immediate vicinity (usually about 10 feet) of all bedrooms.

3. Connect all carbon monoxide alarms together so one alarm activates all alarms (interconnection). Physical interconnection is not required if the alarms are listed for wireless interconnection.

4. Install carbon monoxide alarms in a bedroom if a fuel-fired appliance is located in the bedroom or in an attached bathroom.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:43

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:44

Structural Components

A safe and healthy building begins with a solidly built structure. The building's foundation should rest on stable soil and should be strong enough to support the home during normal conditions as well as during disasters, such as hurricanes and earthquakes. The building's floors, walls, and roof should be secured to the foundation and to each other and should be strong enough to support the home during extreme conditions.

This chapter will help you understand basic structural requirements for building as defined by the building codes. The intent is to help you identify work that may violate building codes so that you can bring it to the attention of a contractor or other qualified professional. Except for projects such as simple decks and storage sheds, you should seek guidance from qualified professionals before using the information in this chapter to design you own buildings or to perform structural remodeling on existing buildings.

In this chapter:

- Foundations
- Crawlspaces
- Decks
- Floor Systems
- Wall Systems
- Wall Penetration Flashing
- Roof Systems

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:45

Special Requirements for High Wind & Seismic Risk Areas

Seismic Design Areas

1. Provide increased strength and structural integrity for foundations, walls, roofs, gas pipes and appliances, and other components in seismic design areas. Refer to the IRC and consult a qualified engineer or other qualified professional when building in seismic design areas.

Hurricane ties. If building codes in your area require them, nail metal hurricane ties to the wall top plates before installing the rafters.

2. Verify the seismic design category with the local building official. The following may be in seismic design areas: large parts of Alaska, California, Hawaii, Nevada, Oregon, and Washington State; small parts of Arizona, Colorado, Idaho, Montana, New Mexico, New York, and Utah; the area near Memphis, Tennessee, and the area near Charleston, South Carolina.

High Wind Design Areas

1. Provide increased strength and structural integrity for foundations, walls, roofs, windows, and other components in high wind design areas. Refer to the IRC and consult a qualified engineer or other qualified professional when building in high wind design areas.

2. Verify the wind design category with the local building official. The following may be in high wind design areas: much of Florida and Hawaii; the areas within about 100 miles of the coastlines of Alabama, Alaska, Georgia, Louisiana, Mississippi, North and South Carolina, Texas, and Virginia; the areas within about 50 miles of the coastlines of Connecticut, Delaware, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, and New York. Several "Special Wind Areas" exist in scattered areas of the country. These areas are mostly in mountainous areas and in the West.

Deflection of Structural Components

Most readers should not deal with bending of structural components, such as floors, walls, ceilings, and roofs. Leave this to qualified engineers and contractors. Because "spongy" floors and rattling walls are common complaints, this section explains some basic concepts involved in deflection and helps you understand when deflection may be excessive.

Deflection & Loads: Definitions

Deflection is when a component of a building bends under a load. It can be a single component, such as a floor joist, or it can be a system, such as a floor or a wall. Deflection causes a component to compress on one side (compression) and expand on the other side (tension).

A load is a force (weight) placed on a component of a building. Example: a building's foundation carries the load of the entire building. The dead load is the weight of the construction materials, such as drywall, shingles, siding, and floor coverings, and the weight of fixed equipment, such as a water heater. The live load is the weight of people and furnishings that occupy a building. A point load is a load in a small area. The heel of a high-heel shoe is an example of a point load. Environmental loads include wind, snow, and forces created during earthquakes.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:46

A point load is a type of live load that is concentrated in a small area, such as a footstep. Point loads are temporary, and in many cases they can exceed the deflection minimums without causing any particular problems.

Deflection Under Live Load

1. Install structural components, such as joists, studs, and rafters, so that they will not bend more than the amount shown in Table 1 under an evenly distributed live load. L is the unsupported length of the component in inches. H is the unsupported height of the component in inches. Example: for a bedroom floor, the general codes assume that a live load of at least 30 pounds of people, floor coverings, and furnishings will be placed over each square foot of the floor area. Example: the maximum deflection of bedroom floor joists with the length between supports of 180 inches would be $^{180}/_{360}$, or ½ inch.

TABLE 1: DEFLECTION UNDER LIVE LOAD

STRUCTURAL COMPONENT	MAXIMUM DEFLECTION (INCHES)
Rafters with greater than 3/12 slope & no attached ceiling finish	L/180
Interior walls	H/180
Floors & plastered ceilings	L/360
Exterior walls with plaster or stucco finish	H/360
Other structural members	L/240
Ceilings with flexible finishes, such as drywall	L/240
Exterior walls with flexible finishes, such as vinyl or fiber cement siding & drywall inside	H/180

DEFLECTION DISCUSSION

Walking on a floor or slamming a door hard does not generate the live load assumed in deflection tables. In fact, the load created by walking on a floor or slamming a door may be greater than the design live load at the point where the load is applied. Thus, even a floor that feels “spongy” or a wall that shakes often may not exceed the maximum deflection allowed. If a “spongy” floor or a shaky wall is not causing other problems, such as cracking drywall or plaster, then it is probably not exceeding the maximum allowed deflection and should be of little concern.

Note that the maximum deflection allowed by general codes does not apply to some rigid floor coverings, such as tile. Refer to the manufacturer’s design and installation instructions when installing stiff finish materials. The manufacturer may stipulate a maximum deflection that’s below the amount allowed by codes.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:47

Foundations

Soil Load-Bearing Capacities

1. Place structural footings on undisturbed soil of known bearing capacity or on a bed of fill material approved by an engineer.

2. Have a geotechnical engineer evaluate the soil in areas known to have expansive or other unfavorable soils or if the soil-bearing capacity is unknown. Beware of clay soils. Some clay soils are unstable and can cause serious foundation problems.

3. Use the following table to estimate soil-bearing capacity if the soil type is known and if the local building official approves.

TABLE 2: SOIL LOAD-BEARING CAPACITIES

SOIL TYPE	PRESUMED SOIL BEARING CAPACITY
Bedrock (e.g., granite)	12,000 psi
Sedimentary-type rock	4,000 psi
Gravel & sandy gravel	3,000 psi
Sand, silty sand, clayey sand, silty gravel, clayey gravel	2,000 psi
Clay, sandy clay, silty clay, clayey silt, silt, sandy silt	1,500 psi

Common Soil Types

Gravel and sandy gravel soils have a presumed 3,000 psi load-bearing capacity.

Sandy soils have a presumed 2,000 psi load-bearing capacity.

Clay and silt soils have a presumed 1,500 psi load-bearing capacity.

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305471 - B&D Codes for Homeowners 4th Edition Edition_044-095.indd 48 1/10/18 10:25 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:48

Footing Width & Depth

Footing Width

1. Use the tables in general codes to determine the minimum footing width and depth required to support load-bearing walls. You may also use material found in The American Concrete Institute document ACI 332 (see Resources, page 234).

2. Refer to general codes for special footing and footing reinforcement requirements in seismic design areas.

Footing Thickness & Slope

1. Make spread footings at least 6 inches thick.

2. Project spread footings at least 2 inches beyond the foundation wall. Do not project the footing beyond the foundation wall more than the thickness of the footing. Example: if the footing is 6 inches thick, then the edge of the footing should be not more than 6 inches beyond the edge of the foundation wall.

3. Locate the bottom of footings at least 12 inches below finish grade or below the local frost line, whichever is deeper. This does not apply to accessory buildings with an area 600 square feet or less and an eave height of 10 feet or less, and this does not apply to decks not supported by the home.

4. Do not place footings on frozen ground unless the frozen condition is permanent (permafrost).

5. Make the top surface of footings level.

6. You may slope the bottom of footings not more than 10 percent, without reducing the minimum thickness.

7. Make step footing thickness at least 6 inches. Make step footing height not more than the length of the footing above the step.

Leveling footing forms is very important. Measure footing depth and width at the top of the forms. Here, batterboards and strings are used to level footing forms.

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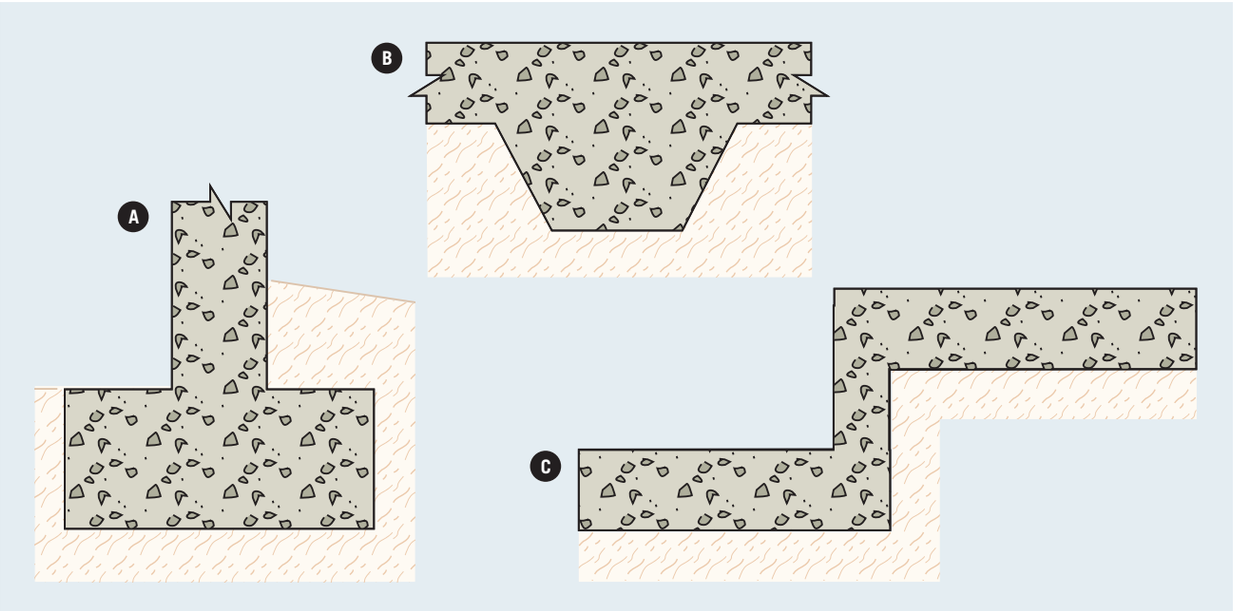
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:49



Spread footing for basement or crawlspace (A), interior load-bearing wall footing (B), or step footing (C).

Specifications for Foundation Concrete

Concrete in Basement Slabs & Interior Slabs-on-Grade (Not Garage Floors)

1. Use at least 2,500 psi concrete in all weathering potential environments.

2. Use air-entrained concrete (between 5 and 7 percent total air content) in severe weathering potential environments if the concrete may be subject to freezing and thawing during construction.

Concrete in Foundation Walls, Exterior Walls & Other Vertical Concrete Exposed to Weather

1. Use at least 2,500 psi concrete in environments with negligible weathering potential.

2. Use at least 3,000 psi air-entrained concrete (between 5 and 7 percent total air content) in moderate and severe weathering potential environments.

Concrete in Porches, Garage & Carport Floors & Other Horizontal Concrete Exposed to Weather

1. Use at least 2,500 psi concrete in environments with negligible weathering potential.

2. Use at least 3,000 psi air-entrained concrete (between 5 and 7 percent total air content) in moderate weathering potential environments.

3. Use at least 3,500 psi air-entrained concrete (between 5 and 7 percent total air content) in severe weathering potential environments.

4. You may use at least 4,000 psi air-entrained concrete with at least 3 percent total air content in steel-troweled garage floors in moderate and severe weathering potential environments.

Confirm with the concrete provider that the product you've ordered meets specs for your area, and be sure to have your forms inspected and approved well in advance of the delivery.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:50

Foundation Anchors

1. Install at least ½-inch-diameter bolts in exterior footings, stem walls, basement walls, interior braced walls, monolithic slabs, and other places to which sill or sole plates for load-bearing and braced walls will be attached.

2. Install and tighten a nut and washer on each bolt. Verify washer size with your local building official.

3. Locate the bolts at least seven bolt diameters and not more than 12 inches from the ends of each plate and not more than every 6 feet on center in between.

4. Locate bolts in the middle third of the plate.

5. Install at least two bolts per plate section.

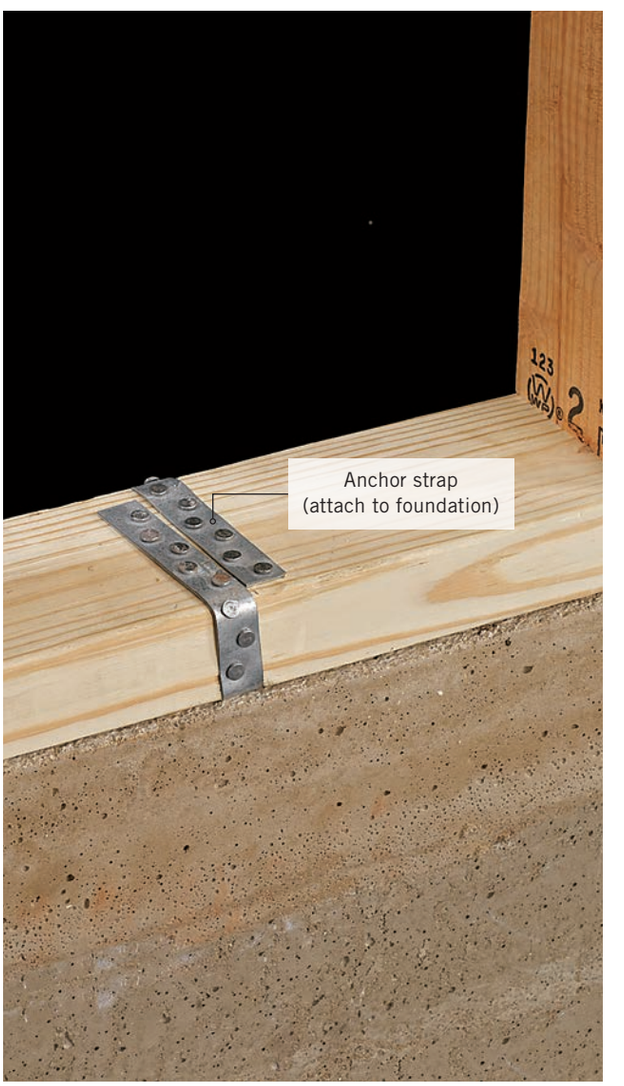
6. Embed the bolts at least 7 inches into the foundation.

7. Use approved fasteners to anchor the sole plates of interior load-bearing walls that are not braced walls.

8. You may substitute anchor straps for bolts if they provide equal anchorage. Place straps in the same locations as bolts, or per strap manufacturer's instructions.

9. Refer to general codes for foundation anchor exceptions involving braced walls 24 inches long and shorter. These walls may require 1 or 0 foundation anchors.

Install ½"-diameter anchor bolts every 6', not more than 12" from the end of each bottom plate, and in the middle ⅓ of the plate.



You may substitute anchor straps for anchor bolts.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:51

Crawlspaces

Crawlspace Ventilated to Exterior

1. Provide at least 1 square foot of net free ventilation area for every 150 square feet of crawlspace floor in a ventilated crawlspace. You may reduce the net free ventilation area to at least 1 square foot for every 1,500 square feet of crawlspace floor if you cover the floor with a vapor retarder, such as 6-mil polyethylene sheeting.

2. Install covers in the ventilation openings. Use screens, grates, grills, or plates with openings at least ⅛ inch and not more than ¼ inch.

3. Subtract the space used by opening covers from the net free ventilation area of a ventilation opening. Example: a 1-square-foot opening may be reduced to an effective ⅔-square-foot opening when covered by a cast iron grill or grate. The cover manufacturer's instructions should indicate the cover's opening reduction amount.

4. Locate a ventilation opening not more than 3 feet from every corner of the crawlspace wall.

5. There is considerable controversy about the effectiveness of crawlspace ventilation, particularly in warm, humid climates. Check with a qualified energy efficiency professional before adding insulation between floor joists in crawlspaces. Check the condition of existing floor joist insulation in crawlspaces at least annually.

Unventilated Crawlspace

1. You may eliminate crawlspace ventilation openings by insulating the crawlspace walls or floor system as required by general codes and by installing all the following moisture control and ventilation components:

   (a) Cover all exposed soil in the crawlspace floor with an approved vapor retarder, such as 6-mil, preferably thicker, polyethylene sheeting.

   (b) Lap all vapor retarder seams by at least 6 inches, and seal or tape the seams.

   (c) Extend the vapor retarder at least 6 inches up the crawlspace wall, and attach and seal the vapor retarder to the wall.

Unventilated crawlspaces are recommended by experts for most crawlspaces.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:52

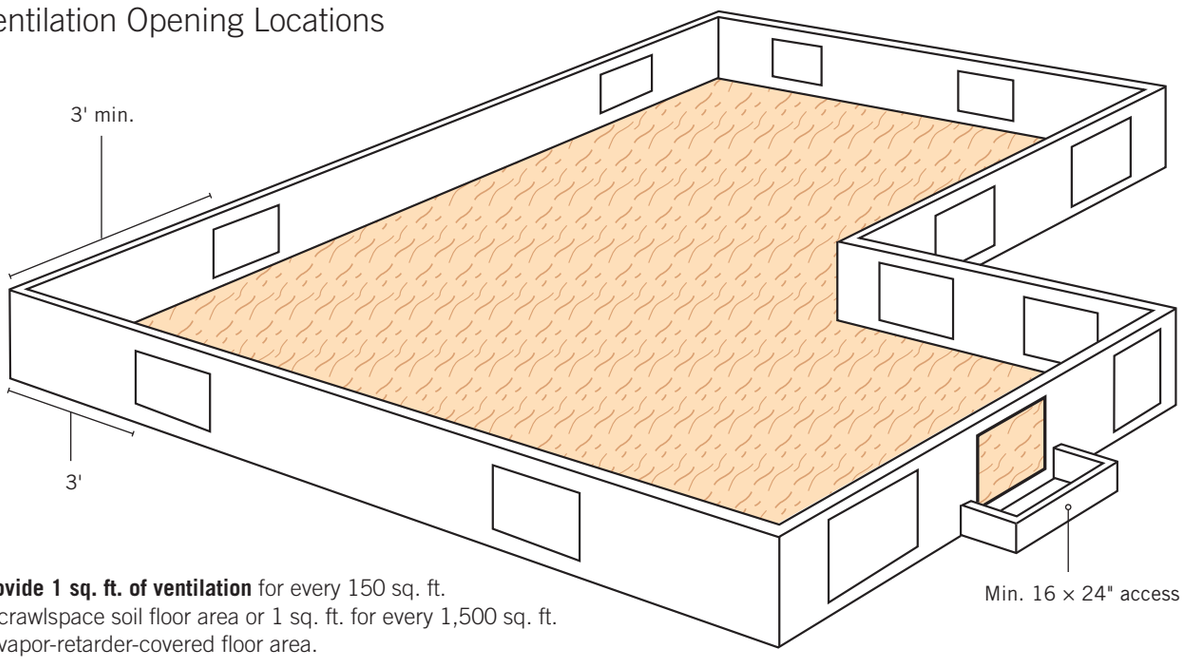
(d) Provide one of the following ventilation methods:

- continuous mechanical exhaust ventilation
- a conditioned air supply at a rate of 1 cfm for every 50 square feet of crawl space floor area and provide a return air opening to the building interior
- dehumidification designed to provide at least 70 pints of moisture removal per day for every 1,000 square feet of crawlspace floor area

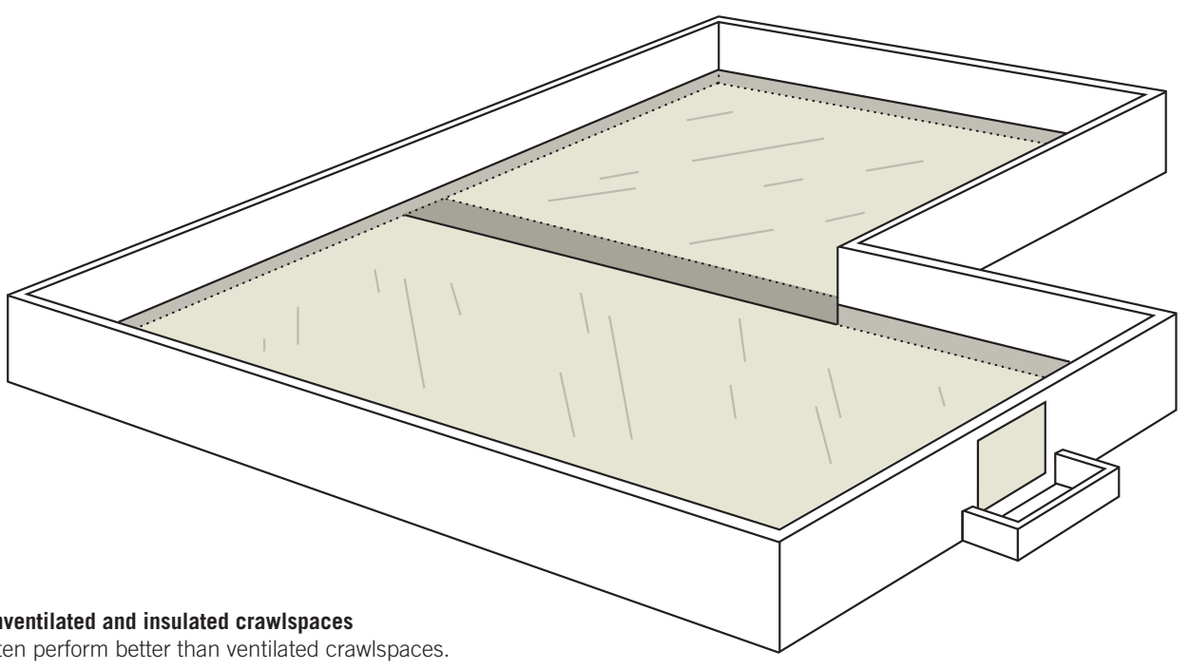
2. Do not connect the return air opening for the building interior to a forced-air return duct. Use an opening in the floor or use an unpressurized duct between the crawl space and the building interior.

3. There is some controversy about providing conditioned air to a crawl space. Do not exceed the 1 cfm conditioned air ventilation rate.

Ventilation Opening Locations



Provide 1 sq. ft. of ventilation for every 150 sq. ft. of crawlspace soil floor area or 1 sq. ft. for every 1,500 sq. ft. of vapor-retarder-covered floor area.



Unventilated and insulated crawlspaces often perform better than ventilated crawlspaces.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:53

Decks

Most decks are relatively simple structures, but even a basic deck project must conform to the requirements of building codes in your area. In fact, virtually every aspect of your deck—from its location on your property to the design you choose and the materials you buy to build it—must meet stringent guidelines for safety. Codes vary, sometimes significantly, among jurisdictions. Your local building inspector can provide you with a list of the relevant deck codes and help you interpret them so you can create code-compliant plans for your deck project. You may also want to download a free PDF copy of the "DCA6-12 Prescriptive Residential Deck Construction Guide" (see Resources, page 234).

Meet or exceed all lumber size codes. For example, use lumber that is at least 4 × 4" posts for decks up to 8' above the footing and 6 × 6" posts for decks up to 14' above the footing.

General Deck Building Guidelines

1. Use hot-dipped zinc-coated galvanized steel for all fasteners (nails and screws) and hardware (joist hangers and support post caps and bases). Stainless-steel fasteners and hardware are recommended when building decks near water, and are required for decks located within 300 feet from saltwater.

2. Drill holes for bolts at least 1/32 inch and not more than 1/16 inch larger than the bolt. Predrill holes for ½-inch-diameter and larger lag screws.

3. Use hot-dipped zinc-coated galvanized steel or flexible flashing material when installing flashing at the deck ledger. Be sure that the flexible flashing is approved for exposure to sunlight. Do not use aluminum flashing.

4. Use at least #2 grade preservative-treated lumber or #2 grade naturally durable lumber for deck structural members. Lumber for deck structural components should be rated for ground contact, UC4A or better. You may use approved composite materials for components, such as deck flooring and railings. Read and follow manufacturer's instructions when using composite materials.

5. Field-treat cuts, holes, and notches in preservative-treated wood with an approved preservative, such as copper napthenate.

6. Consult with the building inspector or a qualified engineer when building decks in seismic and high wind zones, in areas with heavy snowfall, and when building complex decks, such as multi-level decks.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:54

Deck Ledger Attachment to the Home

1. Install a preservative-treated #2 grade or better Southern Pine or Hem Fir deck ledger board that's at least a 2 × 8 in size.

2. Secure the deck ledger to one of the following band or rim joists: (a) 2-inch-thick (1½-inch actual thickness) SPF sawn lumber, (b) 1 inch minimum thickness by 9½ inches deep Douglas fir laminated veneer lumber, or (c) another approved engineered material.

3. Secure the band or rim joist to sawn lumber joists or wood I-joists that are perpendicular to the band or rim joist.

4. Use hold-down tension devices to provide lateral load connections. You may use one of the following methods.

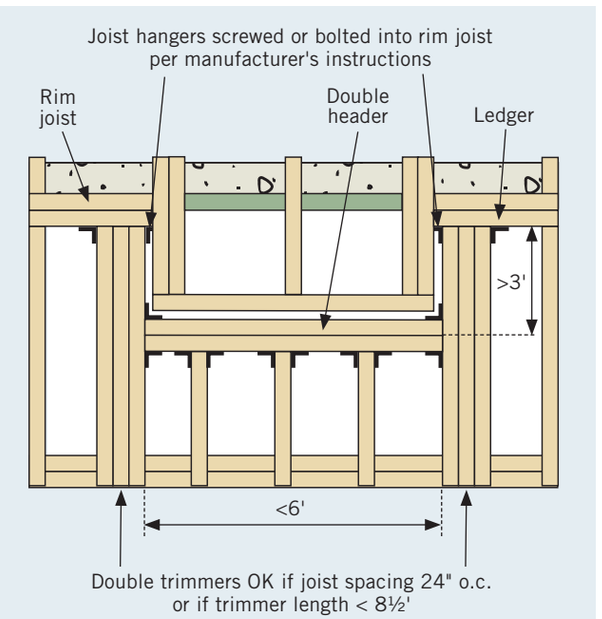
   (a) Install two 1,500 pound hold-down tension devices according to the device manufacturer's instructions.

   (b) Install four 750 pound hold-down tension devices according to the device manufacturer's instructions.

5. Support the band or rim joist directly on the foundation or on a wall supported directly on the foundation. Do not support the band or rim joist using a cantilevered structure, such as a bay window or a framed chimney. Do not support the band or rim joist on veneer, such as masonry and stone.

6. You may use other methods and materials when the details are designed by a qualified structural engineer.

7. You may make a deck entirely self-supporting as an alternative to attaching the deck to the home.



Hang a double joist between joists to support the deck in areas where obstructions won't allow a ledger.

Do not attach the ledger directly to siding or other wall coverings. Remove all wall coverings in the installation area so you can attach the ledger to the wall framing members. Cut the siding with a circular saw, and finish the corners with a chisel. Do not attach the ledger to brick or stone wall coverings. A self-supporting deck may be necessary.

Lateral load connector hardware should be attached to the deck joists and house rim joist to minimize lateral sway. A Simpson Strong-Tie DTT1 connector is seen here. *Photo courtesy Simpson Strong-Tie*

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:55

Deck Ledger Attachment Using Screws or Bolts

1. Install the screws or bolts in the deck ledger board and in the band joist or rim board according to Table 5A. Stagger the screws or bolts vertically along the length of the deck ledger board.

2. Install at least ½-inch hot-dipped galvanized lag screws or machine bolts (not carriage bolts) as specified in Table 3B.

NOTE: there are proprietary screws that are thinner than ½ inch and are approved for attaching deck ledgers to the home. Read and follow the manufacturer's instructions if you use these screws.

3. Install a washer on each end of the machine bolts and a washer on the head end of the lag screws.

4. Make the distance between the interior face of the ledger board and the exterior face of the band board (rim joist) not more than 1 inch.

5. Use lag screws that are long enough to penetrate the band or rim board but not long enough to penetrate through the interior wall.

Deck Footings

1. Place the bottom of footings for deck support posts below the local frost line. You do not need to place deck footings below the frost line if the deck is not attached to the home (but it is best practice to do so anyway).

Install staggered fasteners on the ledger board using spacing specified in Table 3B.

2. Place the bottom of footings for deck support posts that are within 5 feet from the house at the same level as the house footings.

3. Refer to DCA-6 or local codes for footing size and thickness.

4. Space footings as required for beam support. See the DECK BEAMS section on page 58.

Deck Joists

1. Use the correct size joist hanger to attach joists to ledgers and beams.

2. Fasten joist hangers using the size and type of fastener specified by the joist hanger

TABLE 3A: LOCATION OF LAG SCREWS & BOLTS IN BAND JOISTS & DECK LEDGER BOARDS

	TOP EDGE	BOTTOM EDGE	ENDS	ROW SPACING
LEDGER	≥ 2"	≥ ¾"	≥ 2" & ≤ 5"	≥ 1⅝" & ≤ 5"
DIMENSION LUMBER BAND JOIST	≥ ¾"	≥ 2"	≥ 2" & ≤ 5"	≥ 1⅝" & ≤ 5"

TABLE 3B: DECK LEDGER ATTACHMENT USING SCREWS OR BOLTS

JOIST SPAN	≤ 6'	> 6' & ≤ 8'	> 8' & ≤ 10'	> 10' & ≤ 12'	> 12' & ≤ 14'	> 14' & ≤ 16'	> 14' & ≤ 18'
	FASTENER SPACING O.C.						
½" lag screw with ≤ ½" sheathing	30"	23"	18"	15"	13"	11"	10"
½" lag bolt with ≤ ½" sheathing	36"	36"	34"	29"	24"	21"	19"
½" lag bolt with ≤ 1" sheathing or ≤ ½" sheathing & ≤ ½" stacked washers	36"	36"	29"	24"	21"	18"	16"

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:56

manufacturer. In general, place a fastener in every round and oblong hole.

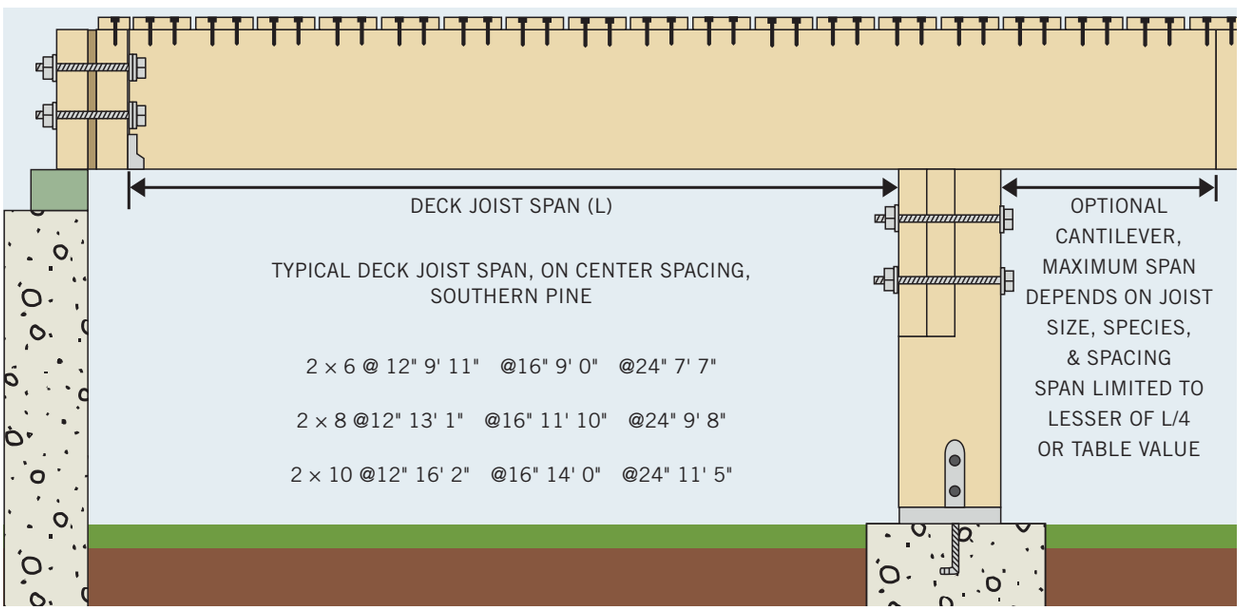
3. Support joists on a joist hanger (the joist should be fully seated in the hanger), on at least 1½ inches of wood, or on at least 3 inches of concrete or masonry.

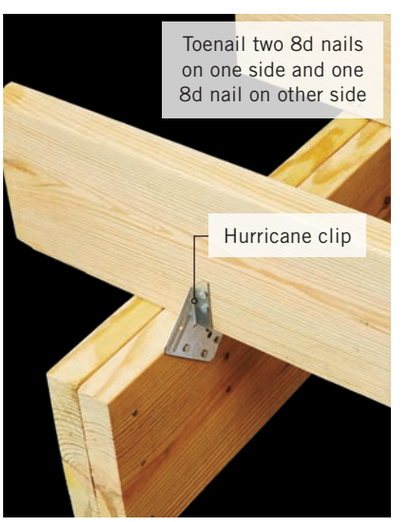
4. You may use three 8d nails to fasten joists that bear on top of a beam to the beam if the deck is supported by the house. Best practice is to use hurricane clips to fasten all joists to a beam.

5. Secure the rim joist to the deck floor joists using at least three 10d nails or three #10 × 3-inch wood screws.

6. Use Table 3C or local codes to determine the correct joist span and on center spacing.

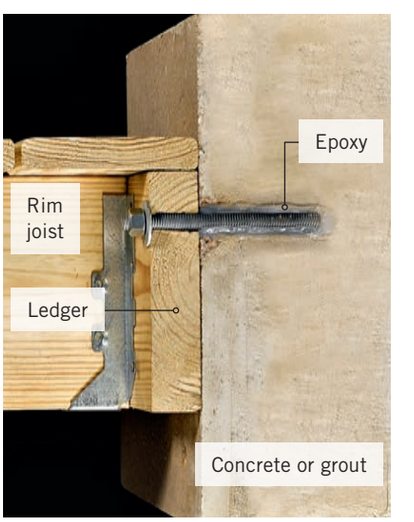
Measuring Deck Joist Span





You may toenail joists to a beam only if the deck is attached to the house. Best practice is to secure joists to the beam using a hurricane clip.

Rim joist connections. Attach rim joists to the end of each joist with three #10 × 3" minimum wood screws. Secure decking to the top of rim joists with two #10 × 3" wood screws in each piece of decking to attach the decking to each joist.



Ledgers and block walls. When fastening ledgers to hollow concrete block walls, the block cells in the ledger attachment areas must be filled with concrete or grout. Secure the attachment bolts to the wall with approved epoxy anchors with washers.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:57

TABLE 3C: DECK FLOOR JOIST ON CENTER SPACING

SPECIES#2 GRADE	JOIST SIZE	DECK JOIST SPACING, NO CANTILEVER (INCHES)			MAXIMUM CANTILEVER (INCHES)		
		12	16	24	12	16	24
Southern Pine	2 × 6	9-11	9-0	7-7	1-3	1-4	1-6
	2 × 8	13-1	11-10	9-8	2-1	2-3	2-5
	2 × 10	16-2	14-0	11-5	3-4	3-6	2-10
Redwood Western Cedar	2 × 6	8-10	8-0	7-0	1-0	1-1	1-2
	2 × 8	11-8	10-7	8-8	1-8	1-10	2-0
	2 × 10	14-11	13-0	10-7	2-8	2-10	2-8

TABLE 3D: DECK SUPPORT POST ON CENTER SPACING

SPECIES #2 GRADE	BEAM SIZE	DECK JOIST SPAN LESS THAN OR EQUAL TO (FEET)					
		6	8	10	12	14	16
Southern Pine	2-2 × 8	8-9	7-7	6-9	6-2	5-9	5-4
	2-2 × 10	10-4	9-0	8-0	7-4	6-9	6-4
	2-2 × 12	12-2	10-7	9-5	8-7	8-0	7-6
	3-2 × 8	10-10	9-6	8-6	7-9	7-2	6-8
	3-2 × 10	13-0	11-3	10-0	9-2	8-6	7-11
	3-2 × 12	15-3	13-3	11-10	10-9	10-0	9-4
Redwood Western Cedar	2-2 × 8	6-10	5-11	5-4	4-10	4-6	4-1
	2-2 × 10	8-4	7-3	6-6	5-11	5-6	5-1
	2-2 × 12	9-8	8-5	7-6	6-10	6-4	5-11
	3-2 × 8	9-8	8-6	7-7	6-11	6-5	6-0
	3-2 × 10	12-0	10-5	9-4	8-6	7-10	7-4
	3-2 × 12	13-11	12-1	10-9	9-10	9-1	8-6

Deck Beams

1. Fasten beam members to each other using two staggered rows of at least 10d nails spaced not more than 16 inches on center.

2. Place splices between beam members above deck posts.

3. Use Table 3D or local codes to determine the correct beam span and on-center post spacing.

Deck Posts

1. You may use preservative-treated 4 × 4 wood posts for decks up to 8 feet tall and 6 × 6 posts for decks up to 14 feet tall. Measure post height from the top of the footing to the bottom of the beam.

2. Consult with the building official or an engineer about wood deck support posts taller than 14 feet

Fasten beam members using two staggered rows of 10d nails at 16" on center. Fasten 3-member beams from both sides of the beam.

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305471 - B&D Codes for Homeowners 4th Edition Edition_044-095.indd 58 1/10/18 10:25 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:58

and about support posts that are not preservative-treated wood, such as steel posts.

3. Secure the post to the footing. You may embed the post in the footing; however, this is not recommended because the post may deteriorate over time. Best practice is to use a post base.

4. Secure the post to the beam as described in the photo caption (right).

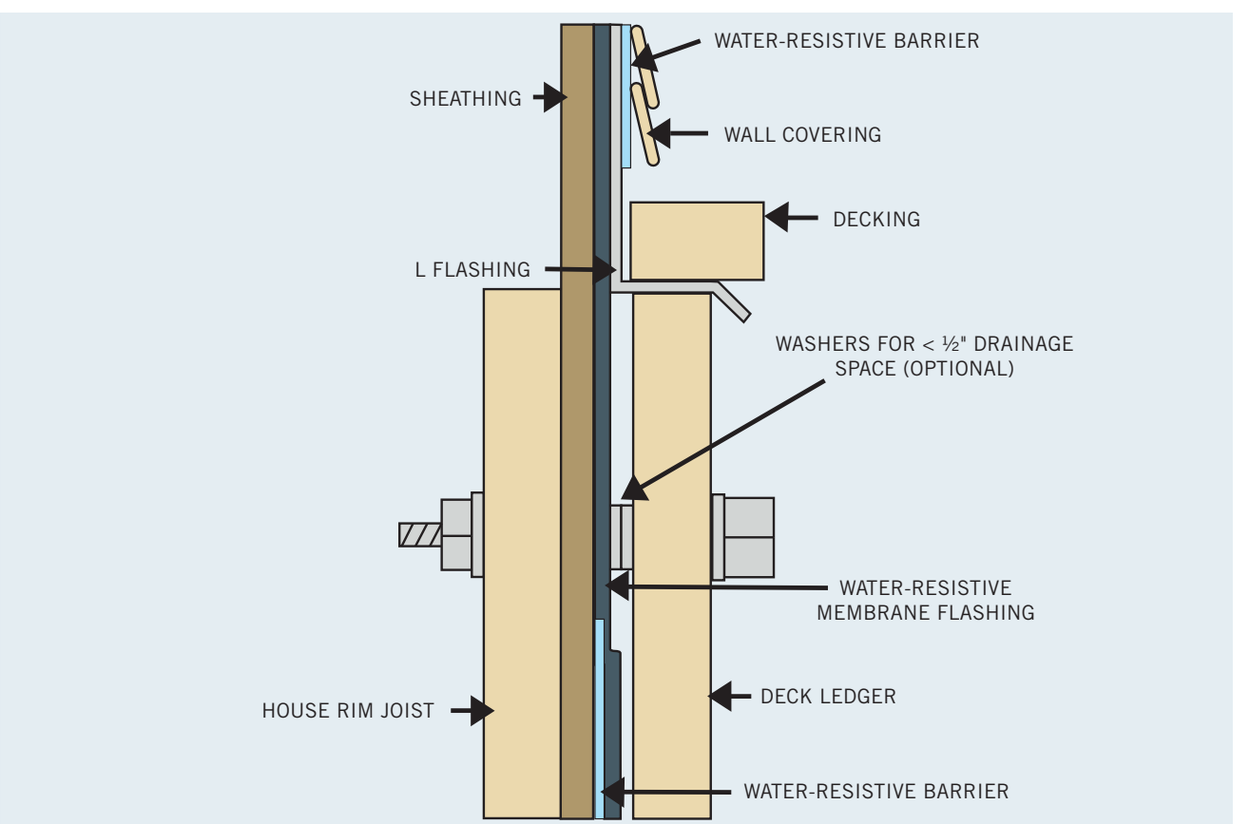
Deck Flashing

1. Install flashing between the deck ledger and the house when the deck is attached to the house. Proper flashing is essential. A common cause of deck collapse is the deck pulling away from rotted wood caused by improper flashing.

One way to attach a beam to a 6 × 6 post is to notch the post and secure the beam using ½"-diameter galvanized steel machine bolts and washers. Or, you can mount beams on top of posts with galvanized post cap hardware.

Joists may not be attached to posts with through bolts, even when mortises are cut into the posts to house the joists.

Best Practice for Installing Deck Flashing



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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:59

Deck flooring made from composite materials may last longer and require less maintenance than wood flooring. Install composite materials according to the manufacturer's instructions.

Deck Flooring

1. You may use 2-inch-thick (nominal) wood, 1¼-inch-thick wood (5/4 board), or other listed deck flooring (wood composites, metal) material as deck flooring.

2. Do not install 2-inch-thick flooring across joists that are more than 24 inches on center when the flooring is perpendicular to the joist or more than 16 inches on center when the flooring is diagonal (maximum 45 degrees) to the joist.

3. Do not install 1¼-inch-thick flooring across joists that are more than 16 inches on center when the flooring is perpendicular to the joist or more than 12 inches on center when the flooring is diagonal (maximum 45 degrees) to the joist.

4. Install two 8d threaded nails or two #8 × 3-inch wood screws per floorboard in each joist.

5. Install flooring across at least 4 joists.

6. Leave about ⅛ inch between flooring boards, including at the ends, to allow for drainage and for expansion.

7. Install other listed deck flooring material according to manufacturer's instructions.

Deck Stairs Recommendations

1. Use 2 × 12 #2 or better Southern Pine or equivalent lumber for deck stair stringers.

2. Leave at least 5 inches of uncut wood when cutting the stair risers and treads into the stringers. Do not cut the stringer past the riser and tread.

3. Do not exceed 6 feet of unsupported length for deck stair stringers where the risers and treads are cut into the stringer (cut stringers).

4. Do not exceed 13 feet, 3 inches of unsupported length for deck stair stringers where the risers and treads are not cut into the stringer (solid stringers).

5. Measure stringer length horizontally. You may support long stringers near the center to reduce the unsupported length.

6. Provide a solid landing, such as concrete, at the bottom of deck stairs. Support the stringers on the landing or by appropriate footings.

7. Support the entire stringer plumb cut at the top landing on the deck rim board or by other approved means.

8. Attach the stringers to the top landing support using hangers or brackets. Do not rely only on nails or screws to attach stringers to supports.

9. Do not exceed 18 inches of unsupported length for deck stair treads using 2 × 4 or 5/4 Southern Pine. Refer to DCA-6 for maximum stair tread lengths for other lumber sizes and species. Install treads made from composite materials according to manufacturer's instructions.

Deck Guards & Handrails (Recommended)

1. Refer to the guards and handrails section of this book for general guidelines about installing guards and handrails for decks. The guidelines for interior guards and handrails apply to exterior guards and handrails too (see page 28).

2. Space deck guard 4 × 4 support posts at least every 6 feet. This also applies to stair guards and handrails.

3. Secure the deck guard support posts to deck floor joists using at least ½-inch-diameter bolts and attachment hardware. Do not rely only on the

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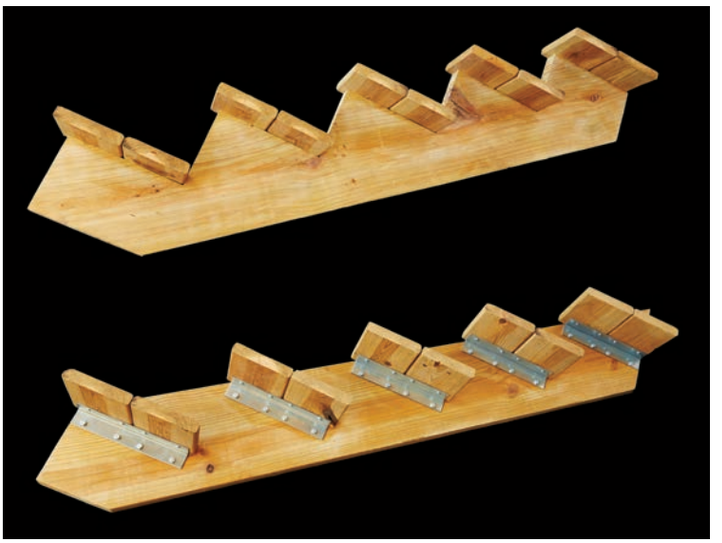


Cut stringers (top) should be supported every 6'. Solid stringers (bottom) should be supported every 13' to 3".

Attach stringers to support using a hanger, not just nails.

deck band and rim boards to secure deck guard support posts.

4. Refer to DCA-6 or attachment hardware manufacturer's instructions for information about attaching deck guard support posts if the posts do not line up with deck floor joists.

Deck Bracing Recommendations

1. Install bracing between the deck support posts and the deck beam on all decks that are more than 2 feet above the ground.

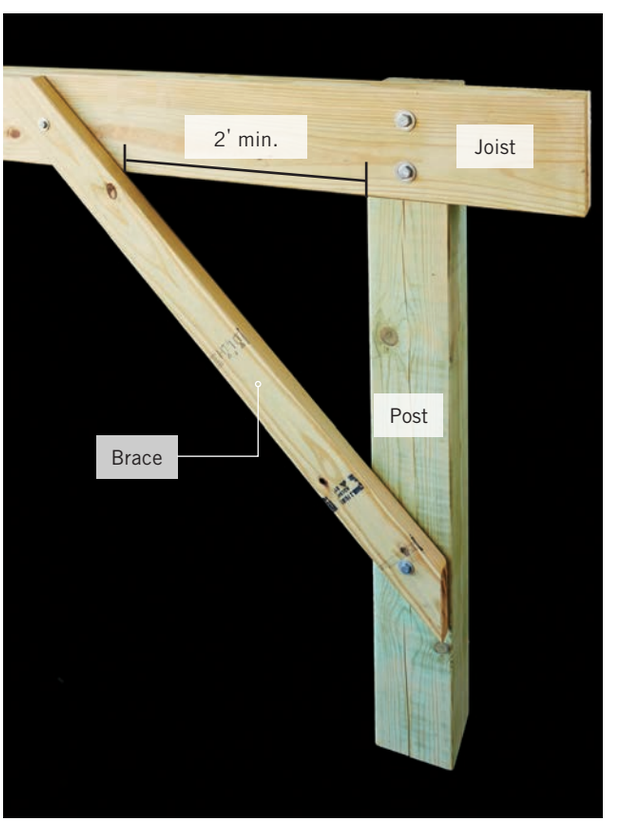
2. Install bracing between the deck support posts and a deck rim board, floor joist, or blocking on free-standing decks that are more than 2 feet aboveground.

3. Use 2 × 4 or larger lumber for the brace.

4. Secure the braces using at least ⅜-inch-diameter bolts with washers on both ends.

5. Secure the brace at least 2 feet away from the support post.

Deck guard support posts should be secured using attachment hardware for long-term strength.



Bracing is recommended to reduce movement that can weaken the deck and cause it to collapse.

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Page:61

Floor Systems

Floor Joist Span Tables (Selected)

1. Use 30 psf live load and 10 psf dead load for joists under bedrooms and in attics with access by permanent stairs, in most cases. Permanent stairs do not include pull-down folding attic ladders.

2. Use 40 psf live load and 10 psf dead load for joists under living areas, other than bedrooms, and under decks, and balconies, in most cases.

3. Use L/360 deflection (length of joist span in inches divided by 360) for all floor joists.

4. Refer to the IRC or to the AF&PA Span Tables for Joists and Rafters to find joist spans not contained in the following tables.

5. Apply the following tables to floor systems framed with nominal 2-inch-wide dimensional lumber, such as 2 × 10. **An engineer must design floor truss and I-Joist systems.**

Floor joists must conform to minimum span rating codes according to how long they are, how far apart they are spaced, and the type and grade of wood from which they are made.

TABLE 4: BEDROOM FLOOR JOIST SPANS AT 16" ON CENTER

SPECIES	GRADE	2 × 8 FEET-INCHES	2 × 10 FEET-INCHES	2 × 12 FEET-INCHES
Douglas fir	2	14-2	17-5	20-3
Hem fir	2	13-2	16-10	19-8
Southern pine	2	13-3	15-8	18-6
Spruce-pine-fir	2	13-6	17-2	19-11

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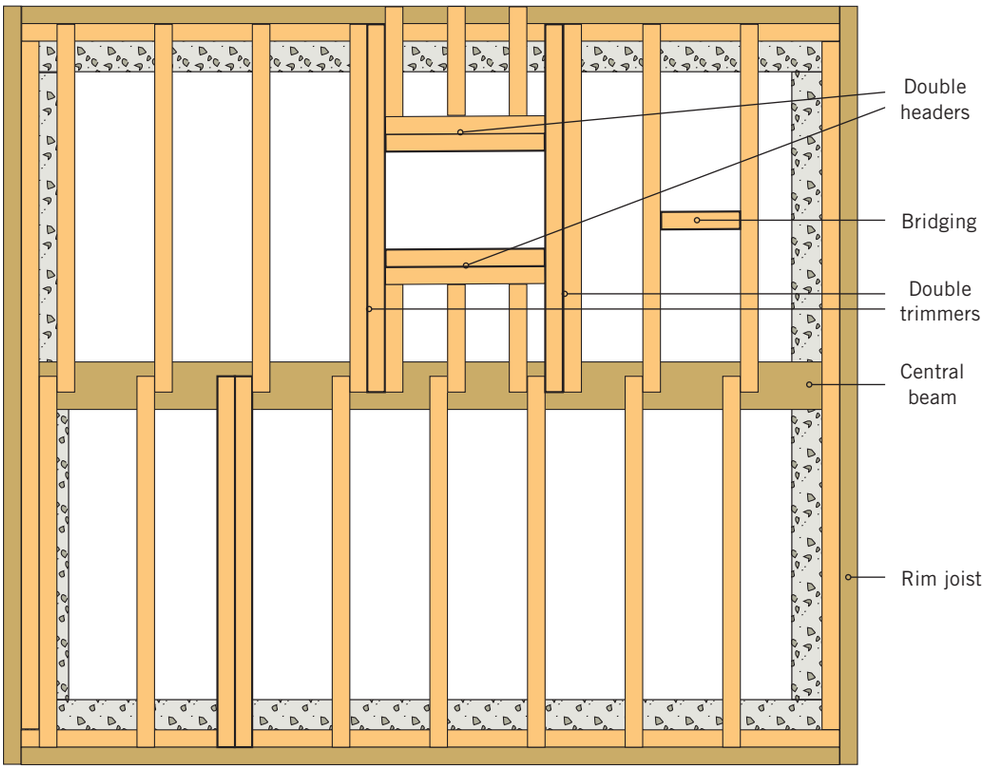

Install floor system framing members according to this illustration. The provisions in this section refer to floor system framing using nominal 2"-thick dimensional lumber. Follow engineering instructions when using floor truss and I-joist systems.

TABLE 5: BEDROOM FLOOR JOIST SPANS AT 24" ON CENTER

SPECIES	GRADE	2 × 8 FEET-INCHES	2 × 10 FEET-INCHES	2 × 12 FEET-INCHES
Douglas fir	2	11-8	14-3	16-6
Hem fir	2	11-4	13-10	16-1
Southern pine	2	10-10	12-10	15-1
Spruce-pine-fir	2	11-6	14-1	16-3

TABLE 6: LIVING AREA FLOOR JOIST SPANS AT 16" ON CENTER

SPECIES	GRADE	2 × 8 FEET-INCHES	2 × 10 FEET-INCHES	2 × 12 FEET-INCHES
Douglas fir	2	12-9	15-7	18-1
Hem fir	2	12-0	15-2	17-7
Southern pine	2	11-10	14-0	16-6
Spruce-pine-fir	2	12-3	15-5	17-10

TABLE 7: LIVING AREA FLOOR JOIST SPANS AT 24" ON CENTER

SPECIES	GRADE	2 × 8 FEET-INCHES	2 × 10 FEET-INCHES	2 × 12 FEET-INCHES
Douglas fir	2	10-5	12-9	14-9
Hem fir	2	10-2	12-5	14-4
Southern pine	2	9-8	11-5	13-6
Spruce-pine-fir	2	10-3	12-7	14-7

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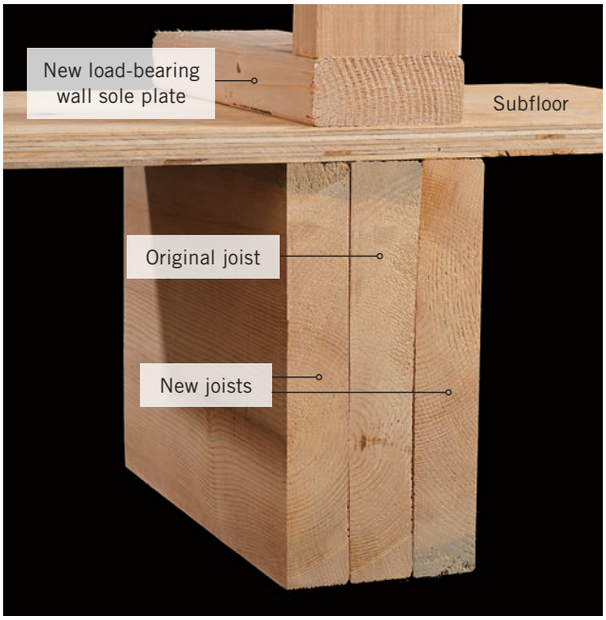
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:63

Floor Joists Under Load-Bearing Walls

1. Install additional floor joists under load-bearing walls that run parallel with the floor joists. Ensure that the number of joists is sufficient to support the load imposed by the wall and the loads supported by the wall. Parallel floor joists run the same direction as the wall being supported. Example: install at least two floor joists under a wall supporting a roof and at least three floor joists under a wall supporting a full story and a roof.

2. You may separate the additional joists under a load-bearing wall, if necessary, to fit pipes, vents, or ducts. Install solid 2-inch-thick blocking at least every 4 feet along the full depth of the separated joists.

3. Place load-bearing walls that run perpendicular to the floor joists not more than one joist depth from the supporting wall or beam below unless the joists are sized to carry the load. Perpendicular joists run at a 90-degree angle to the wall being supported. Example: place a load-bearing wall that runs perpendicular to 2 × 10 floor joists not more than 10 inches from the supporting wall or beam below.



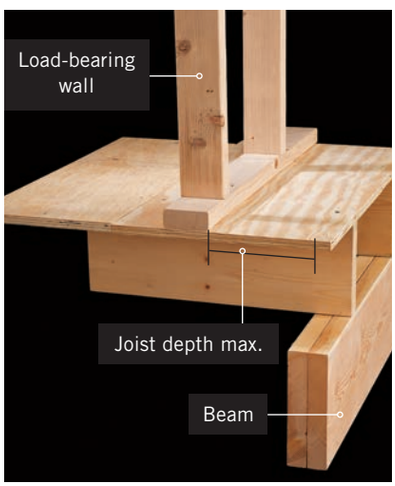
Place additional joists under load-bearing walls running parallel to the joists.

Header, Girder & Floor Joist Bearing on Supports

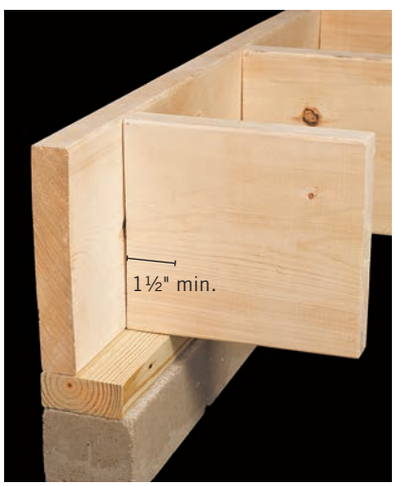
1. Place at least 1½ inches of a floor joist, header, girder, or beam on the supporting wood or metal wall. Supporting wood includes a sill plate bearing on a masonry or concrete wall.

2. Place at least 3 inches of a floor joist, header, girder, or beam on the supporting masonry or concrete wall. Comply with this requirement when the member bears directly on the masonry or concrete wall, not on a sill plate that bears on the wall. This requirement usually applies to beams and girders.

3. You may support floor joists on at least a 1 × 4 ledger if the ledger is attached to each stud and if the joist is attached to a stud.



Place load-bearing walls running perpendicular to the joists not more than one joist depth away from the supporting wall or beam.



Place at least 1½" of wood on the supporting wood.

Place at least 3" of wood on supporting concrete or masonry.

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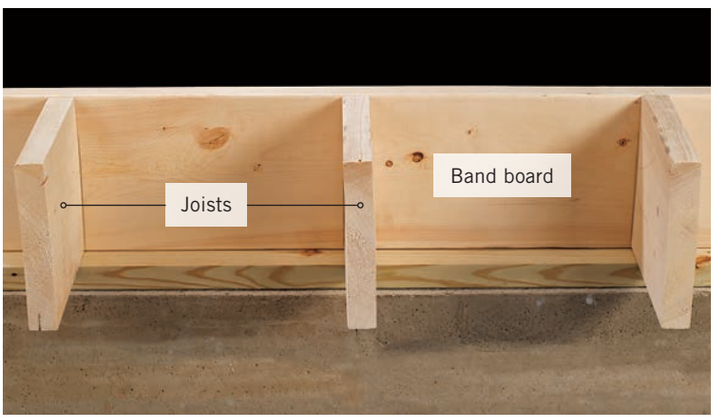
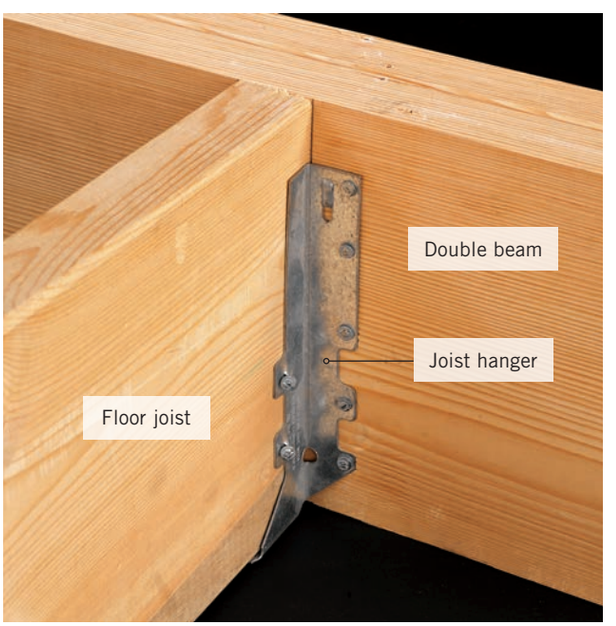
Page:64

Lap joists that meet over supports with at least 3" overlap. Reinforce the lap joint with at least three 10d nails.



Attaching the ends of the floor joists to a band board is a common way to keep joists from twisting.



Attach floor joists to beams using metal joist hanger hardware.

Floor Joist Lap at Supports

1. Lap floor joists from opposite sides that meet over a bearing support at least 3 inches at the support, and nail the joists at the lap using at least three 10d nails. You may substitute a wood or metal splice of equal or greater strength for the nailed lap.

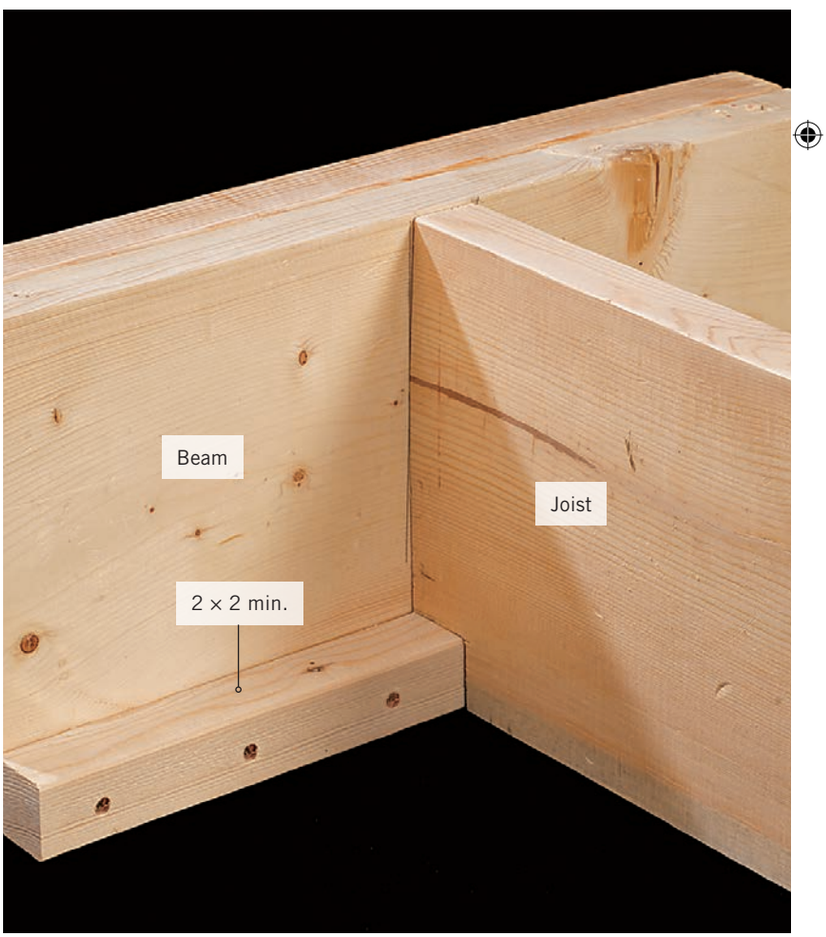
Floor Joist Attachment to Beams

1. Use an approved joist hanger or at least a 2 × 2 wood ledger to support floor joists that connect to a beam or girder.

Floor Joist Blocking

1. Install full-depth solid blocking that's at least 2 inches thick at both ends of floor joists. Or, attach the joists to a header, band, or rim joist or to an adjoining stud. This helps reduce joist twisting.

2. Install blocking at all intermediate load-bearing supports in seismic design areas.



Attach floor joists to beams using a 2 × 2 or larger ledger for support.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:65

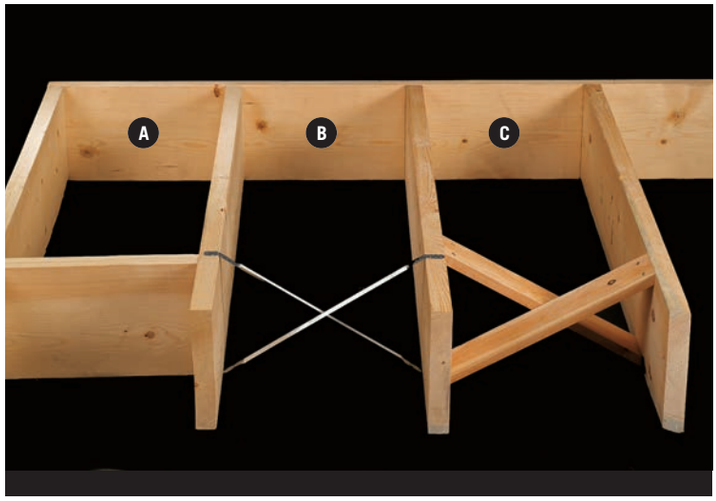
Floor Joist Bridging

1. Install bridging at intervals not more than every 8 feet of floor joist length on floor joists deeper than 2 × 12.

2. You may use solid, full-depth blocking, wood or metal diagonal bridging, or other means to provide required floor joist bridging. Some code officials require bridging on all floor joists regardless of what the code stipulates.

BRIDGING

Metal bridging (left) can be secured with joist hanger nails. For wood X-bridging, drive 10d common nails to secure the board ends to the floor joists.



Options for floor bridging include: Full depth lumber bridging (A); metal X bridging (B); wood X bridging (C).

FLOOR JOIST OPENINGS

Framed openings in floor joists are used mostly for stairways between floors and for chimneys. The header joists distribute the load of the tail joists to the trimmer joists.

Floor Joist Openings Not More than 4 Feet Wide

1. Install double trimmer joists on both sides of header joists. You may use a single trimmer joist on both sides of the header joists if the header is not more than 3 feet from the trimmer bearing point.

2. You may use a single header joist if the header joist span is not more than 4 feet wide.

3. Install approved joist hangers or a 2 × 2 ledger strip to connect tail joists to header joists and header joists to trimmer joists.

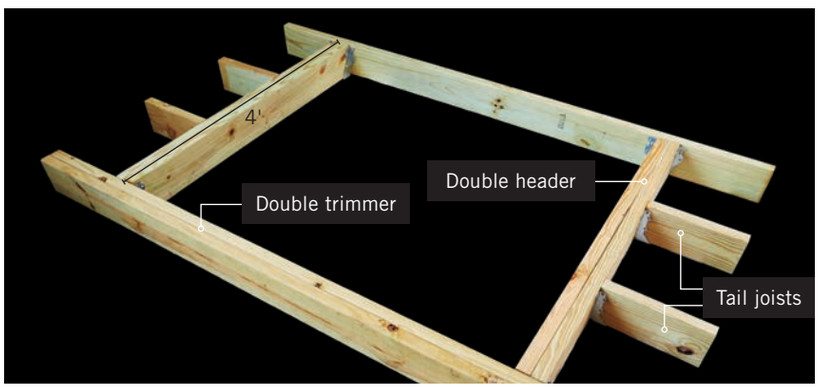
Floor Joist Openings More than 4 Feet Wide

1. Install double trimmer joists and double header joists if the header joist span is more than 4 feet wide.

2. Install approved joist hangers to connect header joists to trimmer joists if the header joist span is more than 6 feet wide.

3. Install approved joist hangers or a 2 × 2 ledger strip to connect tail joists to header joists if the tail joists are more than 12 feet long.

Use double trimmer joists at most openings. Use double header joists if the opening is more than 4' wide.



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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:66

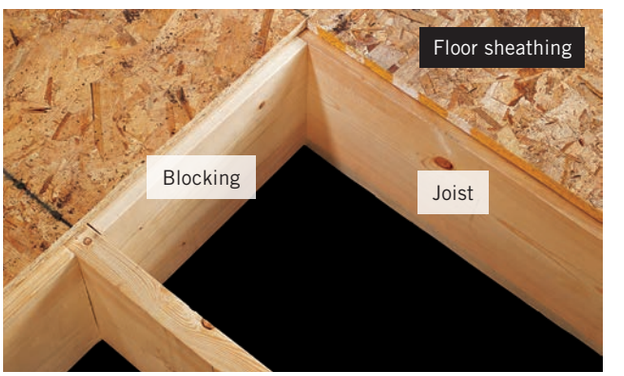
Floor Sheathing

1. Install wood floor sheathing panels: (a) so that they continuously span at least two framing members, (b) with the long dimension perpendicular (90-degree angle) to supports, and (c) that are at least 24 inches wide. Panels less than 24 inches wide can deflect or fail under load.

2. Support wood floor sheathing panel edges with solid blocking, tongue-and-groove edges, or other approved means. An additional underlayment layer that is at least ¼ inch or ¾-inch wood floor covering can substitute for edge support in some cases.

3. You may use wood floor sheathing panels (such as 23/32-inch and ¾-inch nominal thickness plywood or OSB and ¾-inch sanded plywood) as a combination subfloor and underlayment. Install combination subflooring as described in #1 above. Be aware that while combination subflooring panels comply with the IRC, they may not comply with manufacturer's installation for some floor coverings, such as tile.

Support edges of floor sheathing with tongue-and-groove edges.

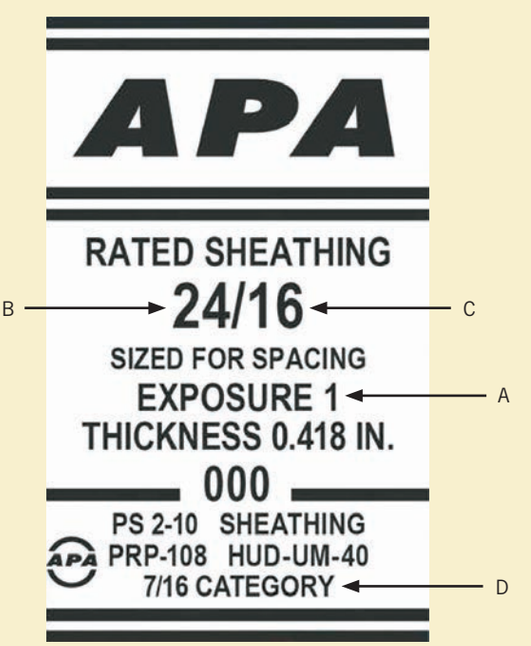


Support edges of floor sheathing with solid blocking.

HOW TO READ THE LABEL ON PLYWOOD AND OSB

A plywood or OSB panel label contains much information. Here is the most important information you need to know when buying these products.

- **Exposure 1 (A):** Exposure 1 means the panel can withstand some exposure to weather during construction but is not designed for long-term weather exposure; Exterior means the panel is designed for long-term weather exposure.
- **Number before slash (B):** maximum on-center support span when used as roof sheathing; edge support may be required to achieve the rated span.
- **Number after slash (C):** maximum on-center support span when used as floor sheathing; on panels with one number, the number is the floor sheathing span.
- **Performance category (D):** use this when referencing the panel's thickness in the IRC.



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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:67

Draftstopping

Draftstopping helps limit the spread of fires in floor framing and in floor/ceiling assemblies. It is most often required when using open web floor trusses and when a ceiling is suspended under a floor. Do not confuse draftstopping with fireblocking. Fireblocking occurs in wall assemblies.

Installing Draftstopping

1. Install draftstopping when usable space exists both above and below the floor/ceiling assembly and when the open area within the concealed floor/ceiling assembly exceeds 1,000 square feet.

2. Use at least ½-inch drywall, ⅜-inch wood structural panels (plywood or OSB), or other approved material.

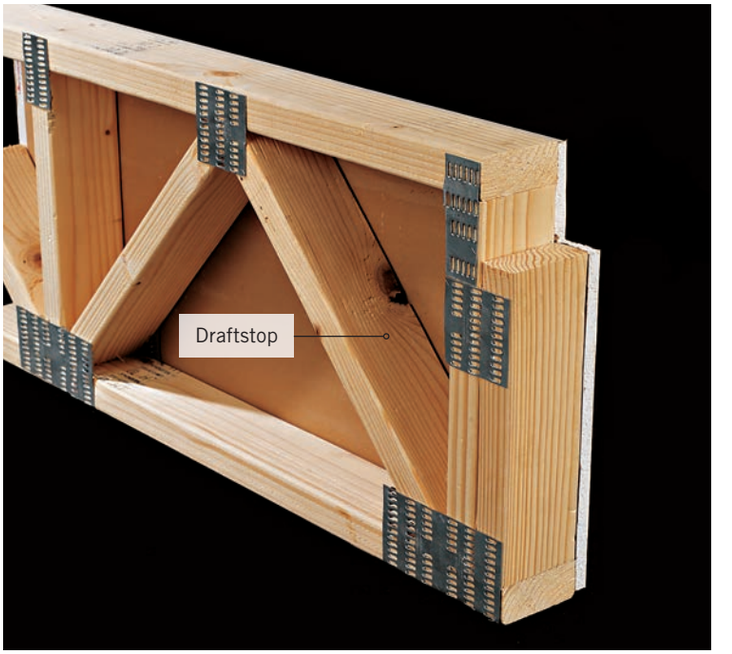
3. Divide the space to be draftstopped into areas that are approximately equal.

4. Install the draftstopping material parallel with the framing.

5. Repair draftstopping that is damaged or penetrated by pipes, ducts, or other materials.

Fire Protection of Floor Framing

1. Install at least ½-inch-thick drywall or ⅝-inch-thick wood structural panels on the bottom side of floor systems in basements and in crawlspaces containing fuel-fired or electric-powered heating appliances. This provision does not apply if the floor system is built using 2 × 10 or larger dimensional lumber; it will usually apply only to floor systems built using wood I-joists.



Some floor trusses require draftstopping to prevent horizontal air movement that can conduct fire. Solid wood floor joist systems typically do not, because they are naturally closed off. Install a draftstop in web floor trusses when there is usable space above and below and when the concealed area is more than 1,000 sq. ft. Drywall and wood structural panels may be used for draftstops.

NOTCHES & HOLES IN I-JOISTS TRUSSES

Notch, bore, splice, or alter wood I-joists, trusses, or engineered wood members only according to manufacturer's instructions and with written approval.

Altering the top and bottom flange of I-joists is usually not allowed. Hole boring is usually allowed in the middle third of the span and is restricted near the I-joist ends.

Cutting the ends of engineered wood beams and I-joists to length is usually permitted.

Beam types: Laminated beam (A); web-type truss, metal plate connected (B); I-joist (C).

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:68

Notches & Holes in Joists & Rafters

Boring & Notching Definitions

A bore is a hole drilled in a stud or joist. Use the actual dimensions to determine the depth of framing lumber and when calculating the maximum hole diameter.

A notch is a piece cut from the smaller dimension of framing lumber, such as a stud or joist. Use the actual dimensions to determine the depth of framing lumber and when calculating the maximum notch depth. Actual dimensions are the dimensions of framing lumber after finishing at the mill. Example: the nominal dimensions of a 2 × 6 are 2 inches by 6 inches, and the actual dimensions, after finishing, are about 1½ inches by 5½ inches.

Wood Joist Notching & Boring

1. You may notch solid lumber rafters, floor and ceiling joists, and beams not deeper than ⅙ the depth of the member. You may notch the ends of the member not deeper than one fourth the depth of the member. Example: notch a 2 × 10 joist not deeper than 1½ inches, except at the ends, where you may notch not deeper than 2⁵⁄₁₆ inches.

2. You may notch solid lumber rafters, floor and ceiling joists, and beams not longer than one-third the depth of the member. Example: notch the top or bottom of a 2 × 10 joist not longer than 3¹⁄₁₆ inches.

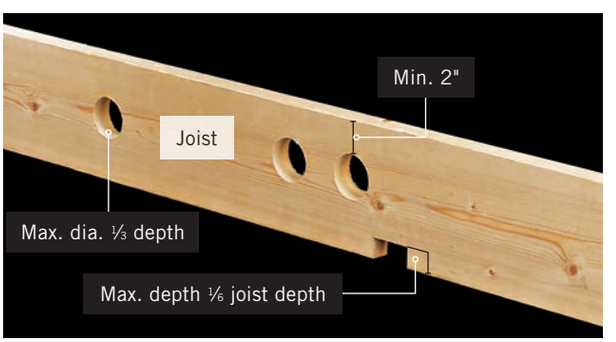
3. You may notch solid lumber rafters, floor and ceiling joists, and beams only within the outer one-third of the span. Example: notch a 10-foot-long joist only within 40 inches from each end.

4. You may notch the tension side (bottom) of solid lumber rafters, floor and ceiling joists, and beams more than 4 inches thick only at the ends.

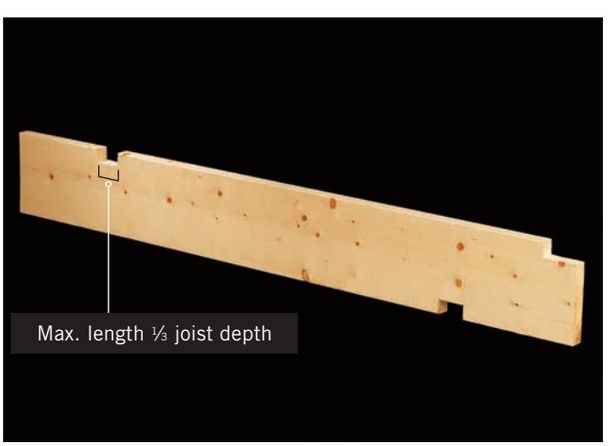
5. You may drill holes in solid lumber rafters, floor and ceiling joists, and beams with a diameter not more than ⅓ of the depth of the member. Example: drill a hole with a diameter not more than 3⅛ inches in a 2 × 10 joist.

6. Locate holes at least 2 inches from the edge of the member and at least 2 inches from any other hole or notch.

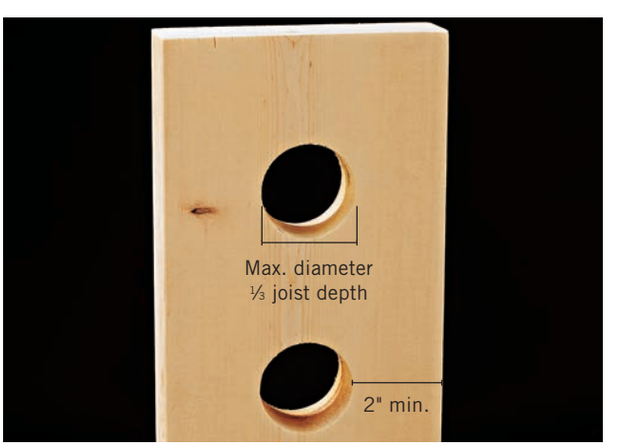
7. Use actual joist depths, not nominal joist depths. Example: use 9¼ inches for a 2 × 10 joist, not the nominal depth of 10 inches.



Drill holes not more than ⅓ of the member depth and cut member notches not deeper than ⅙ of the member depth.



Notch wood joists and rafters not longer than ⅓ of the depth and only in the outer ⅓ of the member.



Drill holes in wood joists and rafters not larger than ⅓ the depth and at least 2" from the edge of the member.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:69

Wall Systems

Whether they are interior or exterior, load-bearing or nonload-bearing, made from wood studs or metal, walls must meet very specific construction standards to ensure that they do not impede the structural integrity of a house and do their part to prevent fires from spreading within wall cavities. Nevertheless, be aware that designing and building load-bearing walls is a closely regulated process. **In most cases, you would be well advised to consult a structural engineer to make sure that the lumber sizes and spacing conform to code standards and that any beams are appropriately sized, properly supported, and made from qualifying materials.**

Even nonload-bearing walls must conform to construction codes.

WOOD NAILING DEFINITIONS

Using the proper size and type of nail and installing the nail where required is critical to the structural integrity of a building. Analysis of building failures frequently shows that failures result from improper nailing. The following are definitions of nailing methods and installation requirements contained in the IRC.

Edge spacing: Edge spacing means installing a nail every indicated number of inches around the perimeter of a wood structural panel. If blocking is required by the IRC, then edge spacing includes nailing the panel to the blocking.

Endnailing: An endnail is driven straight into the end of the member. An example of endnailing is attaching studs to sill plates through the sill plate before the sill plate is attached to the foundation or subfloor.

Facenailing: A facenail is driven straight into the member, often into the long dimension of the member. Examples of facenailing include ceiling and floor joist laps over supports and attaching wood panels to studs and joists.

Intermediate spacing: Intermediate spacing means installing a nail every indicated number of inches at studs or joists in the interior area of a wood structural panel.

O.C. means "on center." Install nails every indicated number of inches.

Toenailing: A toenail is driven at an angle through the edge of the member. Toenailing usually occurs when one member is already attached in place, such as when a stud is toenailed to a sill plate that is already attached.

Endnailing (A), toenailing (B), facenailing (C).

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305471 - B&D Codes for Homeowners 4th Edition Edition_044-095.indd 70 1/10/18 10:25 AM
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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:70

Wood Nailing Requirements

Wood Nailing General Installation Requirements

1. Use nails that are at least as thick and long as indicated in the following tables. Common nails and box nails are thicker and longer than hand-driven sinker nails and pneumatic-driven nails commonly used in residential construction. You cannot directly substitute sinker and gun nails for common, box, or deformed shank nails. Substitution of sinker and gun nails should be based on engineering analysis.

Wood Nailing to Framing Materials

1. Use Tables 8, 9, and 10 to determine the type of nail and nail spacing for attaching wood framing materials to other wood framing materials in other than high wind and seismic design areas. Refer to the general codes for fastener type, quantity, and spacing in high wind and seismic design areas.

Install nails around the edge of wood panels and at intermediate supports at the required on-center spacing.

TABLE 8: NAILING OSB & PLYWOOD SHEATHING TO FRAMING

PANEL THICKNESS	NAIL TYPE	EDGE SPACING	INTERMEDIATE SPACING
⅜ to ½"	6d common (2 × 0.113") subfloor & wall 8d common (2½ × 0.131") roof	6" o.c.	12" o.c.
19⁄32 to 1"	8d common (2½ × 0.131")	6" o.c.	12" o.c.
1⅛ to 1¼"	10d common (3 × 0.148") or 8d deformed (2½ × 0.120")	6" o.c.	12" o.c.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:71

TABLE 9: NAILING ONE-PIECE SUBFLOOR TO FRAMING

PANEL THICKNESS	NAIL TYPE	EDGE SPACING	INTERMEDIATE SPACING
¾" & less	6d deformed (2 × 0.120") or 8d common (2½ × 0.131")	6" o.c.	12" o.c.
⅞ to 1"	8d common (2½ × 0.131") or 8d deformed (2½ × 0.120")	6" o.c.	12" o.c.
1⅛ to 1¼"	10d common (3 × 0.148") or 8d deformed (2½ × 0.120")	6" o.c.	12" o.c.

TABLE 10: NAILING STRUCTURAL LUMBER

LUMBER DESCRIPTION, NAILING METHOD	NUMBER/TYPE OF FASTENERS	FASTENER SPACING
FLOOR NAILING		
Joist to sill, girder, plate, toenail	3-8d common (2½" × 0.131") OR 3-3" × 0.131" (gun nail)	--
Rim joist, band joist, or blocking to sill or to top plate, toenail	8d common (2½" × 0.131") OR 3-3" × 0.131" (gun nail)	6" o.c.
Ledger supporting joists	3-16d common (3½" × 0.162") OR 4-3" × 0.131" (gun nail)	under each joist
Built-up beams, using 2"-thick lumber	10d box (3" × 0.128") OR 3" × 0.131" (gun nail) AND 3-10d box (3" × 0.128") OR 3-3" × 0.131" (gun nail)	24" o.c. face nail stagger at top & bottom on opposite sides face nail at ends & at splices
Band or rim joist to joist, end nail	3-16d common (3½" × 0.162") OR 4-3" × 0.131" (gun nail)	--
Bridging or blocking to joist	2-8d common (2½" × 0.131") OR 2-3" × 0.131" (gun nail)	Toenail each end
WALL NAILING		
Sill or sole plate to joist, rim joist, or blocking (not a braced wall)	16d common (3½" × 0.162") OR 3" × 0.131" (gun nail)	16" o.c. face nail 12" o.c. face nail
Sill or sole plate to joist, rim joist, or blocking (at a braced wall)	2-16d common (3½" × 0.162") OR 4-3" × 0.131" (gun nail)	2 each 16" o.c. face nail 4 each 12" o.c. face nail
Stud to top or bottom plate, toenail	4-8d common (2½" × 0.131") OR 4-3" × 0.131" (gun nail)	--
Stud to top or bottom plate, end nail	2-16d common (3½" × 0.162") OR 3-3" × 0.131" (gun nail)	--
Stud to stud (not braced wall panel), face nail	16d common (3½" × 0.162") OR 3" × 0.131" (gun nail)	24" o.c., 16" o.c.
Stud to stud (at a braced wall panel), face nail	16d common (3½" × 0.162") OR 3" × 0.131" (gun nail)	12" o.c., 16" o.c.
Double top plate, face nail	16d common (3½" × 0.162") OR 3" × 0.131" (gun nail)	16" o.c., 12" o.c.
Double top plate splice	8-16d common (3½" × 0.162") OR 12-3" × 0.131" (gun nail)	Face nail on each side of end joint (min. 24" lap splice length on each side of end joint)
Top plates, laps at corners & intersections	2-16d common (3½" × 0.162") OR 3-3" × 0.131" (gun nail)	--
Stud to stud & studs connecting at intersecting walls (at a braced wall panel)	16d common (3½" × 0.162") OR 3" × 0.131" (gun nail)	16" o.c. 12" o.c.
Headers: 2-piece with ½" spacer	16d common (3½" × 0.162") 16" o.c. face nail	--
Header to stud, toenail	5-8d box (2½" × 0.113") OR 4-8d common 2½" × 0.131"	--
1" let-in brace to each stud & plate, face nail	3-8d box (2½" × 0.113") OR 2-8d common 2½" × 0.131"	--
ROOF NAILING		
Blocking between joists or rafters to top plate, toenail	3-8d common (2½" × 0.131") OR 3-3" × 0.131" (gun nail)	--
Ceiling joist to plate, toenail	3-8d common (2½" × 0.131") OR 3-3" × 0.131" (gun nail)	--
Collar tie to rafter and joist, face nail or 1¼" by 20-gauge strap	3-10d common (3" × 0.148") OR 4-3" × 0.131" (gun nail)	--
Rafter or truss to plate, toenail	3-16d box (3½" × 0.135") OR 4-3" × 0.131" (gun nail)	2 toenails on one side and other nails on other side of rafter or truss
Rafters to ridge, valley, or hip rafters, toenail	4-16d (3½" × 0.135") OR 4-3" × 0.131" (gun nail)	--
Rafters to ridge, valley, or hip rafters, end nail	3-16d (3½" × 0.135") OR 3-3" × 0.131" (gun nail)	--

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:72

Wall Stud Size & Spacing

Wood Grades Used in Wall Construction

1. Use Number 3, standard, or stud grade wood for most load-bearing walls not more than 10 feet tall. Do not use this wood for load-bearing walls more than 10 feet tall. Use Number 2 grade or better lumber for walls more than 10 feet tall.

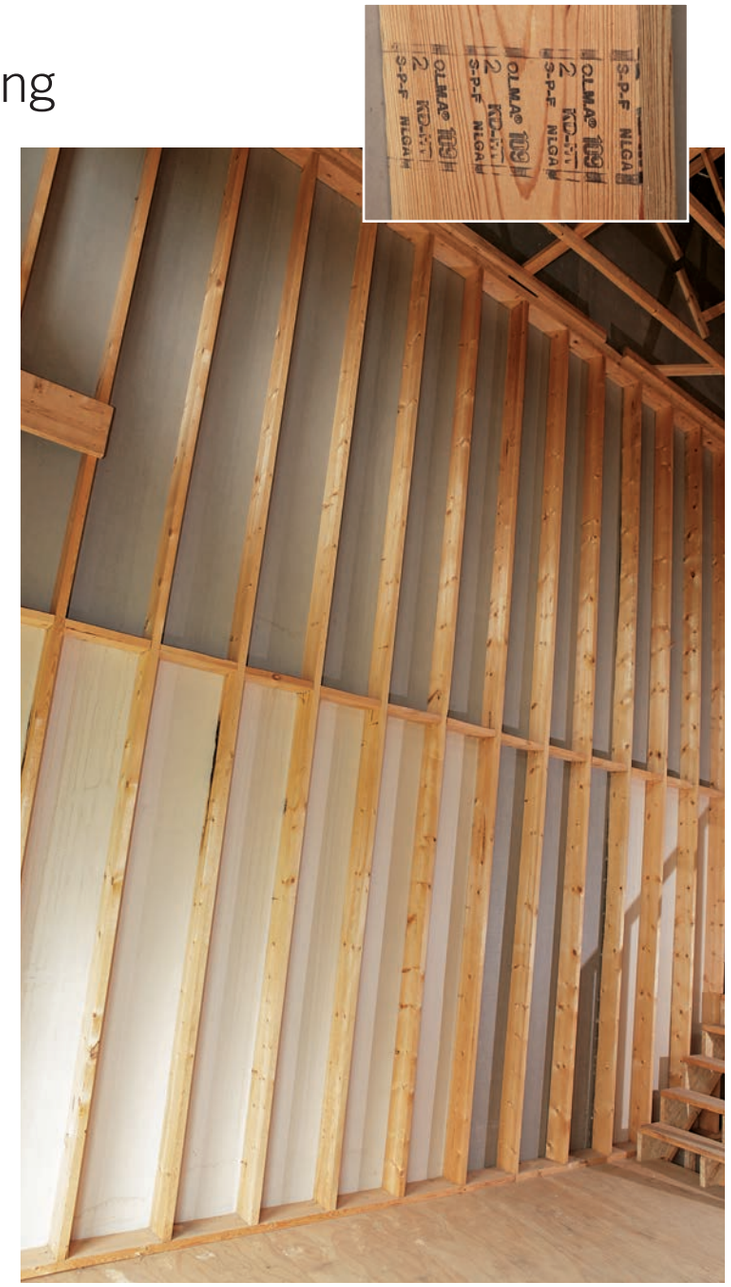
2. You may use utility grade wood for nonload-bearing walls.

3. Refer to general codes for more information about other wall height and stud spacing combinations.

4. Refer to general codes for wall height and stud spacing requirements in high wind, heavy snow load, and seismic design areas.

Stud Size & Spacing for Load-Bearing Walls Not More than 10 Feet Tall

1. Use Table 11 to determine stud size and spacing when the unsupported vertical height of an exterior load-bearing wall is not more than 10 feet. Measure vertical height between points of horizontal (lateral) support between studs. Vertical wall height is usually measured between the bottom of the sole or sill plate and the bottom of the floor or ceiling. Consult a qualified engineer before measuring unsupported vertical wall height between points other than at floor levels.



Wall studs taller than 10' require No. 2 or better grade construction lumber. Shorter walls may be built with cheaper No. 3 grade in most cases.

TABLE 11: STUD SIZE & SPACING FOR LOAD-BEARING WALLS

STUD SIZE (INCHES)	MAXIMUM STUD SPACING SUPPORTING ONLY ONE FLOOR, OR SUPPORTING A CEILING & ROOF WITH OR WITHOUT A HABITABLE ATTIC	MAXIMUM STUD SPACING SUPPORTING ONE FLOOR & A CEILING & ROOF WITH OR WITHOUT A HABITABLE ATTIC	MAXIMUM STUD SPACING SUPPORTING TWO FLOORS & A CEILING & ROOF WITH OR WITHOUT A HABITABLE ATTIC
2 × 4	24"	16"	Not allowed
2 × 6	24"	24"	16"

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305471 - B&D Codes for Homeowners 4th Edition Edition_044-095.indd 73 1/10/18 10:25 AM
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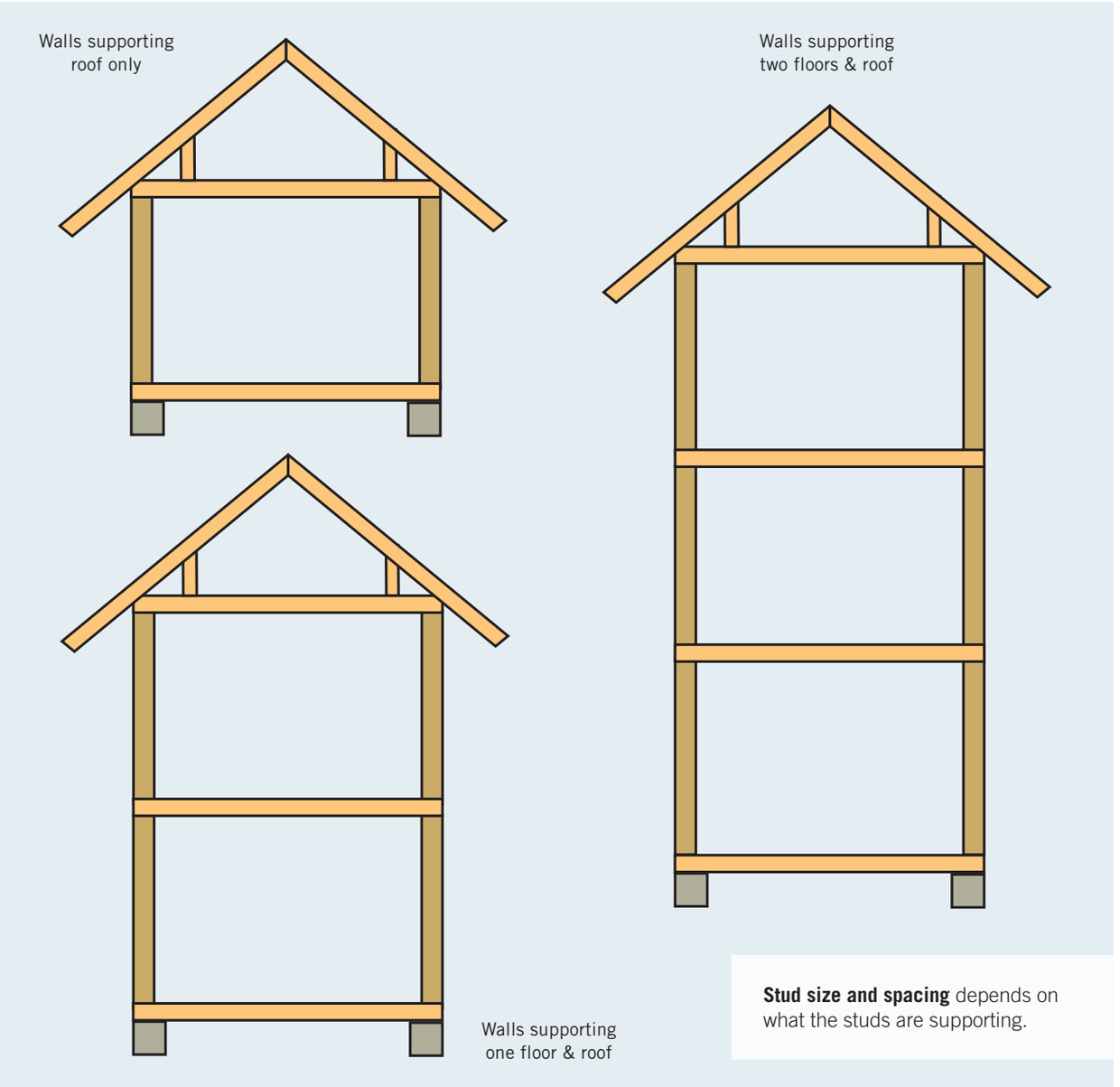
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:73



Stud size and spacing depends on what the studs are supporting.

TABLE 12: STUD SIZE & SPACING FOR NONLOAD-BEARING WALLS

STUD SIZE	MAXIMUM STUD HEIGHT	MAXIMUM STUD SPACING
2 × 4	14'	24"
2 × 6	20'	24"

Stud Size & Spacing for Nonload-Bearing Walls

1. Use Table 12 to determine stud size and spacing for nonload-bearing walls. Measure vertical height between points of horizontal (lateral) support between studs. Vertical wall height is usually measured between the bottom of the sole or sill plate and the bottom of the floor or ceiling. Consult a qualified engineer before measuring unsupported vertical wall height between points other than at floor levels.

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305471 - B&D Codes for Homeowners 4th Edition Edition_044-095.indd 74 1/10/18 10:25 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:74

Top & Bottom Plate Construction

1. Use at least two 2-inch-deep (nominal) top plates that are at least as wide as the studs at the top of load-bearing walls. Examples: use two 2 × 4 top plates on top of a 2 × 4 wall, and use 2 × 6 top plates on top of 2 × 6 walls.

2. Offset joints where two pieces of top plate meet by at least 24 inches. You do not need to place a stud under a joint in a top plate unless the stud would be placed there for other reasons.

3. Lap one top plate from one wall over the top plate of an intersecting wall at the wall corners and at the intersection with load-bearing walls.

4. You may use a single top plate at the top of nonload-bearing walls.

5. Install one galvanized metal strap at least 0.054 inch thick (16 gauge) and 1½ inches wide on a top plate if it is cut more than 50 percent of its actual depth. These metal straps are sometimes called FHA straps. It is not necessary to install a strap on both top plates for purposes of this section. You may need to install shield plate to protect plumbing pipes and electrical wires.

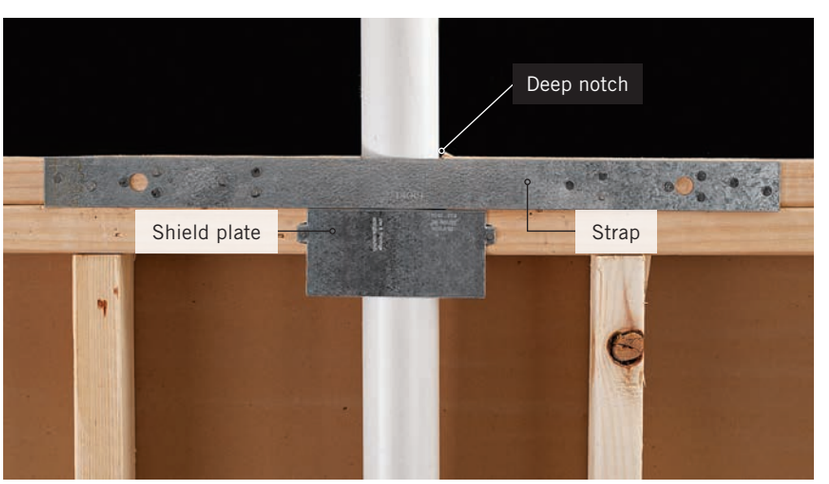
6. Extend the strap at least 6 inches beyond each side of the cut opening. Secure the strap with at least eight 16d nails on each side of the strap.

7. Apply this strap requirement to top plates in exterior and interior load-bearing walls.

8. You do not need to install the strap if wood structural panel sheathing covers the entire side of the wall with the notched or cut top plates.

9. Use at least one 2-inch-deep (nominal) bottom plate that is at least as wide as the studs. Note that some jurisdictions allow treated plywood to serve as the bottom plate for curved walls. Verify this local exception with the building official.

Offset joints where two top plates meet by at least 24". Nail the top plate on each side of the splice as described in Table 10.



Install a strap across one top plate when it is notched more than half its width. Install another strap or a shield plate when required to protect pipes and electrical wires.

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Page:75

Notches & Holes in Wall Studs

Boring & Notching Definitions

A bore is a hole drilled in a stud or joist. Use the actual dimensions to determine the depth of framing lumber and when calculating the maximum hole diameter.

A notch is a piece cut from the smaller dimension of framing lumber, such as a stud or joist. Use the actual dimensions to determine the depth of framing lumber and when calculating the maximum notch depth. Actual dimensions are the dimensions of framing lumber after finishing at the mill. Example: the nominal dimensions of a 2 × 6 are 2 inches by 6 inches, and the actual dimensions, after finishing, are about 1½ inches by 5½ inches.

Wood Stud Notching

1. Notch a load-bearing stud not more than 25 percent of its actual depth. Example: notch a 2 × 6 load-bearing stud not more than 1⅜ inches.

2. Notch a nonload-bearing stud not more than 40 percent of its actual depth. Example: notch a 2 × 6 nonload-bearing stud not more than 2¼ inches.

Wood Stud Boring

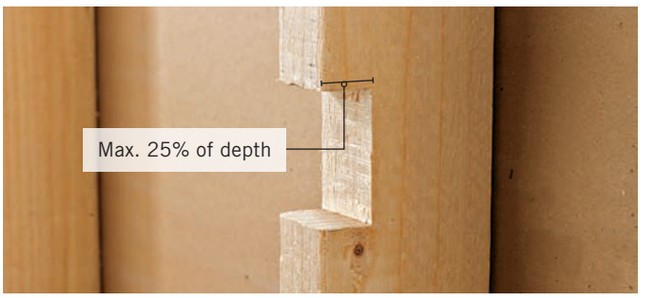
1. Bore a hole in a single load-bearing stud not more than 40 percent of its actual depth. Example: bore a 2 × 6 load-bearing stud not more than 2¼ inches in diameter.

2. You may bore holes in load-bearing studs not more than 60 percent of their actual depth if you install a double stud and do not bore more than two successive studs.

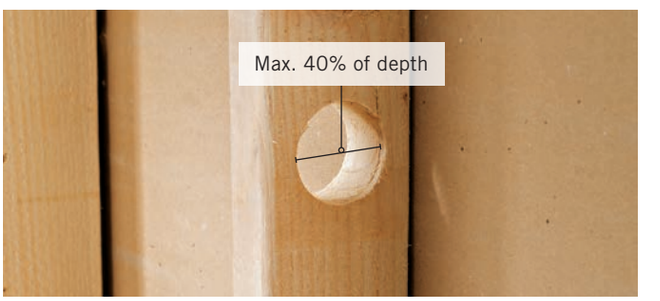
3. Bore a hole in a nonload-bearing stud not more than 60 percent of its actual depth. Example: bore a 2 × 6 nonload-bearing stud not more than 3¼ inches in diameter.

4. Leave at least ⅝ inch of undisturbed wood between the hole and the stud edge.

5. Do not place a hole and a notch in the same horizontal section of the stud.



Notch a load-bearing stud not more than 25 percent of its actual depth.



Drill a hole in a load-bearing stud not more than 40 percent of its actual depth.

Double two load-bearing studs if the holes are not more than 60 percent of their actual depth.

VIOLATION! Do not locate a notch and a hole in the same part of the stud.

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305471 - B&D Codes for Homeowners 4th Edition Edition_044-095.indd 76 1/10/18 10:25 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:76

Cripple Wall Framing

Cripple Wall Requirements

1. Install cripple walls using studs that are at least the same width as the wall studs above.

2. Frame cripple walls more than 4 feet tall as though they are full height walls. This means using the stud sizes and framing requirements previously described. Example: if full height wall studs on the same floor level as the cripple wall are 2 × 6, use 2 × 6 studs for the cripple wall.

3. Brace cripple walls using the same bracing method and length as the wall above, except multiply the cripple wall brace length by 1.15. Example: if the cripple wall is a 2-foot-tall basement wall and the wall brace length for the first story wall above is 3 feet, brace at least 3.45 feet (3 × 1.15) of the cripple wall.

4. Install sheathing that covers at least one full side of a cripple wall less than 14 inches tall. Fasten the sheathing to both the top and bottom plates.

5. Support cripple walls on a continuous foundation.

6. You may substitute solid blocking for a framed and sheathed cripple wall less than 14 inches tall.

7. Anchor cripple walls to the foundation like other framed walls.

8. Refer to the IRC for additional bracing requirements in seismic design areas.

CRIPPLE WALL DEFINITION

A cripple wall is a framed wall that is less than one story tall. Cripple walls often occur with basement foundations that are stepped down to follow finished grade, and they may occur in split-level homes.

Cripple walls may be load-bearing or nonload-bearing. This bearing version is used to bridge a gap between the foundation wall and the first floor framing members. Anchor cripple walls to the foundation, and brace as required.

Cripple walls are often combined with egress window framing. The cap plate on the block wall supports the floor trusses for this addition. The 2 × 6 construction allows the project to meet minimum wall insulation codes.

305471 - B&D Codes for Homeowners 4th Edition Edition_044-095.indd 77 1/10/18 10:26 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_044-095.indd 77 1/10/18 10:25 AM
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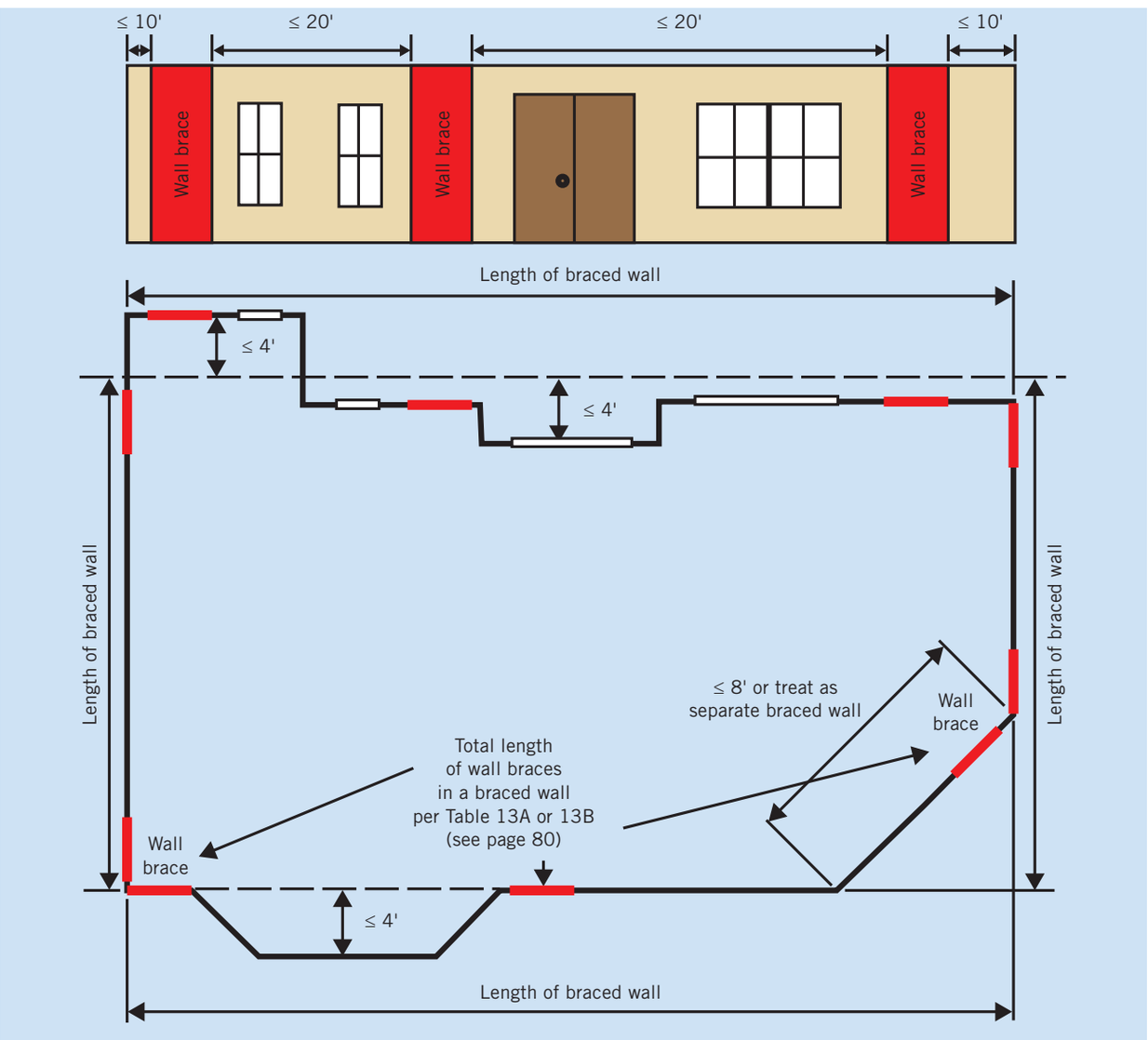
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:77

Wall Bracing

General codes present many methods and rules for framed wall bracing. This section discusses two common wall bracing methods and some general rules about how to install them. Wall bracing is very complicated. The intent of this section is to introduce you to the concepts. Refer to general codes and consult with qualified professionals for more information about wall bracing, particularly when dealing with wall bracing in high wind, seismic design, and heavy snow load areas.

Wall Brace & Braced Wall Definitions

Braced wall (braced wall line). A braced wall is a mostly straight interior or exterior wall that contains the required length of approved wall braces (braced wall panels). Most exterior walls and some interior walls are braced walls. The illustration shows examples of where wall braces are installed in braced walls. Offsets from a straight wall are allowed if the offset is not more than 4 feet. Angled walls are allowed if the angled wall is not more than 8 feet long.



Structural panel wall bracing. To prevent framed walls from racking or leaning, bracing is required. In most cases, bracing can be accomplished by fastening full-height structural panels to the wall framing at defined intervals, near corners and around wall openings.

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305471 - B&D Codes for Homeowners 4th Edition Edition_044-095.indd 78 1/10/18 10:25 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:78

Wall brace (braced wall panel). A wall brace is a full height wall with no vertical or horizontal offsets that has approved wall bracing material attached. A wood structural panel (such as OSB) and panel-type siding are common examples of approved wall bracing materials. Each braced wall must have an approved total length of wall braces. The total length of wall braces depends on: (a) the criteria described in the next section; (b) the type of bracing material, such as wood structural panels and panel siding bracing; (c) the story being braced; (d) the design wind speed; and (e) the seismic design category.

Wall Bracing Methods

1. Use one of the approved wall bracing methods. Common wall bracing methods include wood structural panel sheathing that is at least ⅜ inch thick, hardboard panel siding that is at least 7⁄16 inch thick, let-in bracing, and portal frame braces that provide shorter length bracing near large openings and garage doors. Each of these methods is an intermittent bracing method. This means that individual wall braces are installed near the ends of each braced wall.

2. You may use a continuous sheathing wall bracing method. This means that all braced walls have sheathing, such as wood structural panels applied continuously to the walls, including above and below openings and on gable end walls. Refer to the IRC for requirements regarding panel lengths near openings and for panel installation and hold-down straps at the ends of continuously sheathed braced walls.

3. Refer to the IRC for information about other wall bracing materials and methods. Refer to manufacturer's instructions for information about manufactured wall braces.

4. You may use different wall bracing methods within the same braced wall, and you may use different bracing methods on different stories. Example: you may use let-in bracing at one end of a braced wall and structural panel bracing on the other end. Use the highest required bracing length in the table when using different bracing methods in the same braced wall. Refer to the IRC for some restrictions when mixing wall bracing methods.

Wall Bracing General Installation Requirements

1. Install a wall brace near the end of each braced wall.

2. Begin the wall brace not more than 10 feet from the end of a braced wall.

3. Begin a wall brace not less than 20 feet from the closest edge of the next wall brace in the braced wall.

4. Do not exceed 60 feet between braced walls. Smaller distances between braced walls are required in the D series seismic design areas. Refer to the IRC.

Wall Brace Length

1. The following discussion and table 13A (see page 80) assumes the house: (a) is located in an urban area or suburban subdivision that is not in an earthquake risk area, (b) has a roof that is not more than 30 feet above the first story floor, (c) the height of the wall being braced is not more than 10 feet, and (d) wood structural panels or panel-type siding is used for the wall brace. This a simplified explanation. Refer to the IRC for more detailed information.

2. Install at least two 48-inch-long wall braces in braced walls longer than 16 feet. Install at least one 48-inch-long wall brace or two smaller wall braces in braced walls 16 feet long or less. Install these braces even if Table 13A specifies a smaller length. Install the length of wall braces specified in Table 13A if the wall brace length in Table 13A is longer than 48 inches.

Fastening Wall Braces

1. Fasten wall bracing material to framing according to the fastening schedules in the Wood Nailing Requirements section of the IRC or according to the brace manufacturer's instructions.

2. Fasten vertical joints at panel sheathing edges to studs. Fasten horizontal joints to at least (≥) 1½-inch-thick blocking.

3. Use fasteners and uplift connectors as required by good engineering practices to connect rafters and trusses to wall braces and to connect the wall braces to framing in stories below.

4. Install at least (≥) ½-inch drywall on the interior side of wall braces. You will need to multiply the wall brace length by 1.40 if drywall is omitted. Space drywall fasteners not more than (≤) 8 inches on center at panel edges when using let-in wall braces.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:79

TABLE 13A: MINIMUM TOTAL LENGTH OF WALL BRACES IN A BRACED WALL FOR WOOD STRUCTURAL PANELS (WSP) & PANEL-TYPE SIDING (HPS)

STORIES ABOVE BRACED WALL	DISTANCE BETWEEN BRACED WALLS (FEET)	DESIGN WIND SPEED (MPH)	WSP & HPS (FEET)
0	10	≤110	2.0
0	20	≤110	3.5
0	30	≤110	5.0
0	40	≤110	6.5
1	10	≤110	3.5
1	20	≤110	6.5
1	30	≤110	9.5
1	40	≤110	12.5
2	10	≤110	5.5
2	20	≤110	10.0
2	30	≤110	14.0
2	40	≤110	18.5

TABLE 13B: SIMPLE WALL BRACING MINIMUM NUMBER OF BRACING UNITS (WIND SPEED NOT MORE THAN 115 MPH, URBAN & SUBURBAN AREA)

STORIES ABOVE	EAVE TO RIDGE HEIGHT (FEET)	LONG SIDE (FEET)						SHORT SIDE (FEET)					
		10	20	30	40	50	60	10	20	30	40	50	60
0	10	1	2	2	2	3	3	1	2	2	2	3	3
1	10	2	3	3	4	5	6	2	3	3	4	5	6
0	15	1	2	3	3	4	4	1	2	3	3	4	4
1	15	2	3	4	5	6	7	2	3	4	5	6	7

Simple Wall Bracing

1. You may use a less complex wall bracing method for certain homes that are basically rectangles with insets and pop-outs. The home must comply with all of the following to qualify for this less complex method: (a) wind speed area not more than 130 miles per hour; (b) wind exposure category is B or C; (c) wall height not more than 10 feet; (d) seismic design category A, B, or C for one- and two-family homes; (e) not more than three stories above a concrete or masonry foundation or basement wall; (f) cantilevered floors extend not more than 24 inches beyond the bearing point; (g) roof eave to ridge height not more than 15 feet; (h) at least (≥) ½-inch drywall installed on the interior side of all exterior walls; and (i) no cripple walls allowed in three-story homes.
2. Use wood structural panels that are at least ⅜ inch thick as the wall bracing material. Fasten ⅜-inch-thick wood structural panels using 6d common nails. Fasten 7⁄16-inch-thick wood structural panels using 8d common nails. Space the nails 6 inches on center at the edges and 12 inches on center at intermediate supports.
3. Build bracing units as full height walls with no openings and no vertical or horizontal offsets. A bracing unit must be one fully sheathed vertical wall segment.
4. Use bracing units that are at least 3 feet long when the walls are continuously sheathed with the wall bracing material. Continuously sheathed means all wall areas have structural sheathing

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:80

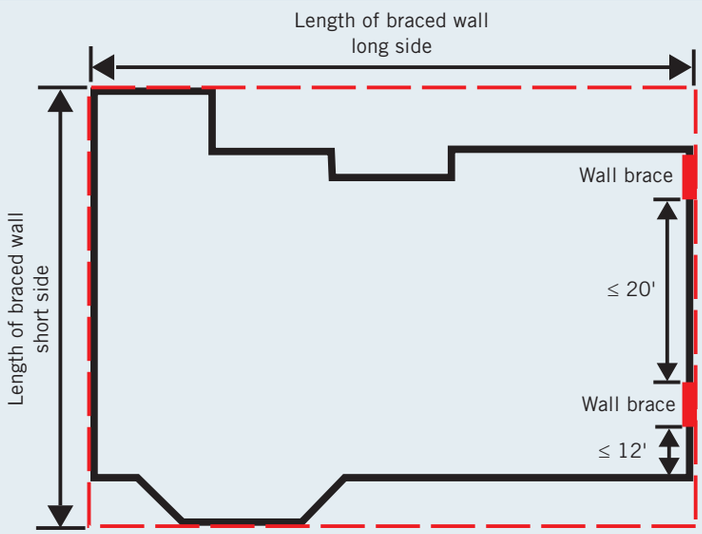
applied, including above and below openings and at gable wall ends. Use bracing units that are at least 4 feet long when the walls are not continuously sheathed.

5. Begin a bracing unit not more than 12 feet from a wall corner. Make the distance between adjacent bracing units in the same wall not more than 20 feet. Place at least one bracing unit in any wall more than 8 feet long.

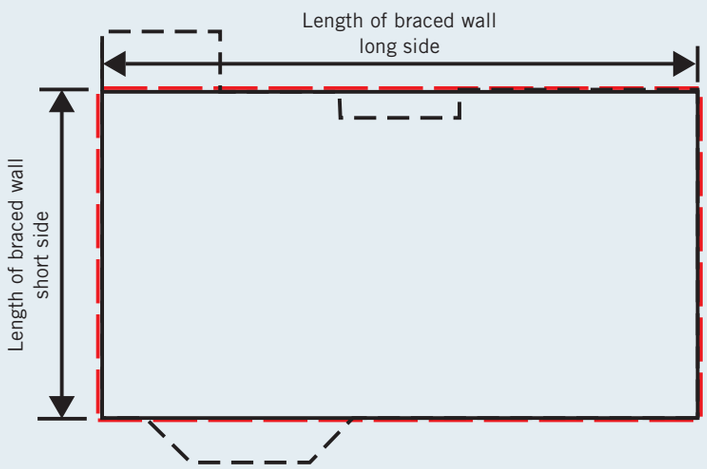
6. Determine the length of exterior walls as shown in the illustration on page 78. Do not include open structures, such as porches, decks, and carports. Interior walls do not count as braced walls.

7. You may count bracing units that are wider than the minimum width as multiple bracing units. Divide the width of the bracing unit by the minimum bracing unit width to determine the number of bracing units. Example: a bracing unit is 7 feet wide. The wall is not continuously sheathed, so the minimum bracing unit width is 4 feet. The 7-foot-wide bracing unit counts as 1¾ bracing units (7/4 = 1.75).

8. Do not count sheathed wall segments that are narrower than the 3- or 4-foot minimum lengths as bracing units. Refer to the IRC for exceptions involving certain continuous sheathing methods at garage doors and large openings.



FIRST STORY PLAN



SECOND STORY PLAN

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:81

Wood Structural Panel Wall Bracing

1. Install wood structural panel wall bracing using 4 × 8 or 4 × 9 panels at least ⅜ inch thick (span rating 24/0).

2. Install panels that are at least 48 inches wide and cover at least three stud bays for studs spaced 16 inches on center.

3. Secure ⅜-inch-thick wood structural panel bracing to studs using at least 6d common nails spaced not more than 6 inches on center at panel edges and 12 inches on center at intermediate supports. Secure 7⁄16-inch-thick panels (span rating 24/16) using 8d common nails spaced as previously described.

Wood structural panel wall bracing may be used on all stories and in all seismic and wind design areas.

4. Install solid blocking where panel joints occur between studs to maintain fastener spacing. Use at least 1½-inch-thick wood for blocking. The blocking is usually the same dimensions as the studs. Example: 2 × 6 blocking is normally used with 2 × 6 studs, although 2 × 4 blocking is acceptable.

5. You may use wood structural panel wall bracing on all stories and in all wind speed and seismic design areas.

Fireblocking

Fireblocking (also called firestopping) limits the spread of fires vertically between stories in concealed wood-framed walls and horizontally in long concealed areas, such as double walls, framed openings, and drop soffits above cabinets. Concealed vertical spaces in wood-framed walls can act like a chimney, providing fire an easy and rapid path between stories. Lack of fireblocking increases the chance of property damage and loss of life during a fire. Lack of fireblocking is a common reason for failing government inspections.

Do not confuse fireblocking with draftstopping (see page 68). Draftstopping limits the horizontal movement of air in concealed floor/ceiling assemblies.

Where Fireblocking Is Required

1. Install fireblocking in any concealed wall space if an opening exists that would allow fire to spread from one story to another or from a lower story into the attic. Examples of such openings include: openings for plumbing pipes, openings for electrical wires and conduit, HVAC duct chases between stories, laundry chutes, and openings at the tops of framed columns, niches, and arches.

2. Install fireblocking in concealed wall spaces at every ceiling and floor level. An intact top and bottom plate usually provides fireblocking in platform framing.

3. Install fireblocking where concealed vertical and horizontal wall spaces intersect. Examples of concealed horizontal spaces include soffits for kitchen cabinets and recessed vanity lights, and drop ceilings.

4. Install fireblocking between stair stringers at the top and bottom of each flight of stairs. Also install drywall (at least ½ inch thick) on all walls and soffits if the area under the stairs is accessible by a door or access panel.

5. Install fireblocking around chimneys and flues where they intersect framing at floor and ceiling levels.

6. Install fireblocking in concealed wall spaces if the concealed space is open for more than 10 feet horizontally. A common example of a long concealed horizontal wall space is a double wall built using two rows of staggered studs. Another example is a large arched opening between rooms.

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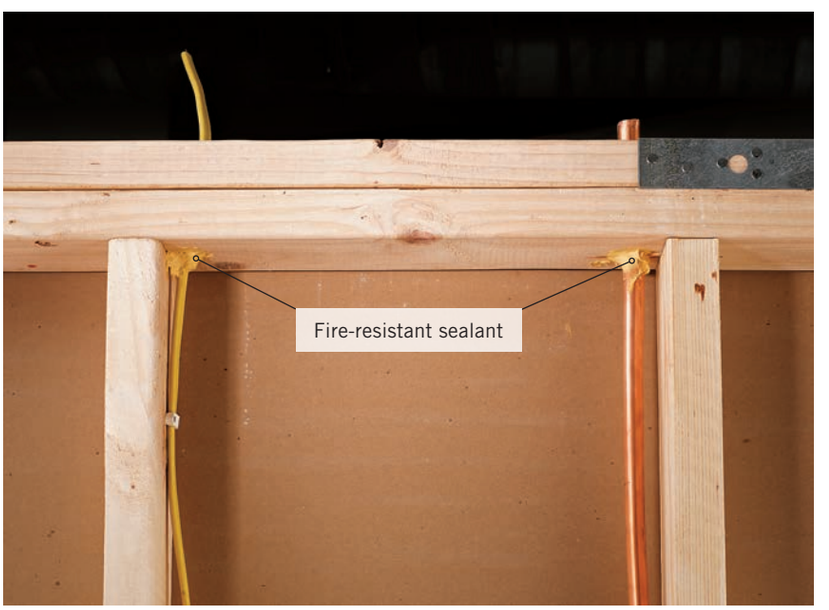
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:82

Install fireblocking in framed columns, framed arches, and similar openings between stories.



Install listed fire-resistant caulk or foam sealant at penetrations for wires, pipes, and ducts. This helps reduce the spread of fires and helps limit air and moisture flow.

Fireblocking Materials & Installation

1. You may use any of the following fireblocking materials: (a) 2-inch-thick lumber (example: a 2 × 4), (b) two pieces of 1-inch-thick lumber with staggered joints (example: two 1 × 4), (c) at least 23/32-inch-thick wood structural panels, (d) at least ¾-inch-thick particleboard, (e) at least ½-inch-thick drywall, (f) at least ¼-inch-thick cement-based millboard, or (g) unfaced batts or blankets of mineral wool or fiberglass insulation if it is secured in place.

2. Install backing at any joints in fireblocking material when using wood structural panels or particleboard. Use the same fireblocking material for the backing. Example: if a joint exists in OSB fireblocking material, place another piece of the same OSB material over the joint. Most general codes do not state how far to extend the backing.

3. Do not use loose fill insulation as a fireblocking material unless it is specifically tested and approved for the intended location and installation method.

4. Repair fireblocking that is damaged or penetrated by pipes, ducts, or other materials.

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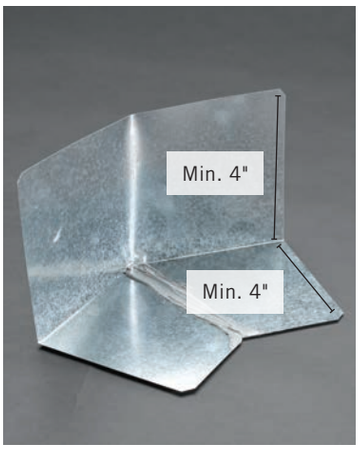
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:83

Wall Penetration Flashing



Kick-out flashing is inserted between the underside of the roof-covering layer and a sidewall to redirect water away from the sidewall. Flashing should be at least 4" tall and 4" wide.

It is not possible to overstate the importance of flashing to the long-term integrity and health of your home. Sealants, such as caulk, degrade over time and require maintenance. Exterior wall coverings move and crack, creating gaps into which moisture can flow. People often do not maintain caulking and sealants as they should. The best long-term solution to avoiding moisture intrusion is a combination of a water-resistant barrier and flashing integrated to form a drainage plane that prevents moisture from reaching vulnerable wood framing materials and drains the moisture away from the structure.

Flashing General Requirements

1. Use only corrosion-resistant flashing material, such as aluminum, galvanized steel, and peel-and-stick material. Corrosion resistance includes fasteners or other materials used to secure the flashing.

2. Use flashing, fasteners, and other materials that are compatible with each other and with surrounding materials. Incompatible materials will react with each other and degrade over time. Example: do not use galvanized material with aluminum or with copper.

3. Flash and seal all wall penetrations and other vulnerable areas so that moisture will not enter the structure. Flash and seal any point where moisture could enter the structure, regardless of whether it is mentioned in the list of areas where flashing is specifically required.

4. Install flashing "shingle fashion" so that upper flashing laps over lower flashing, resulting in a drainage plane that will drain water toward a designated discharge point. This includes integrating flashing with the water-resistant barrier.

5. Extend flashing to the surface of the exterior wall finish material if necessary to assure that water is drained. This may be necessary with brick veneer, at horizontal joints in panel siding, with Z flashing at window and door headers, and at other drainage points.

Flashing Required Locations

1. Install flashing at all window and door openings. Refer to the window and door manufacturer's installation instructions and to the instructions for any weather-resistive material (such as house wrap) or flashing material.

2. Install pan flashing at the window and door sills unless the window or door manufacturer's instructions state otherwise. Integrate the pan flashing with jamb (side) flashing, header (top), and the weather-resistant barrier. Install all window and door flashing so that water drains away from the opening and out from the structure.

3. Install sidewall flashing where chimneys or other masonry construction intersect with walls.

4. Install projecting lips (sometimes called kick-out flashing) at chimneys and other sidewalls where a roof extends past a vertical sidewall. Kick-out flashing helps divert water away from this vulnerable intersection.

5. Install header/sidewall flashing under and at the ends of all copings and sills, including masonry, metal, and wood.

6. Install header/sidewall flashing above all wood trim that projects from the adjoining wall and forms a shelf where water can collect.

7. Install flashing at the attachment point of exterior porches, decks, balconies, stairs, or floor assemblies to wood-framed construction.

8. Install sidewall flashing at all roof and wall intersections.

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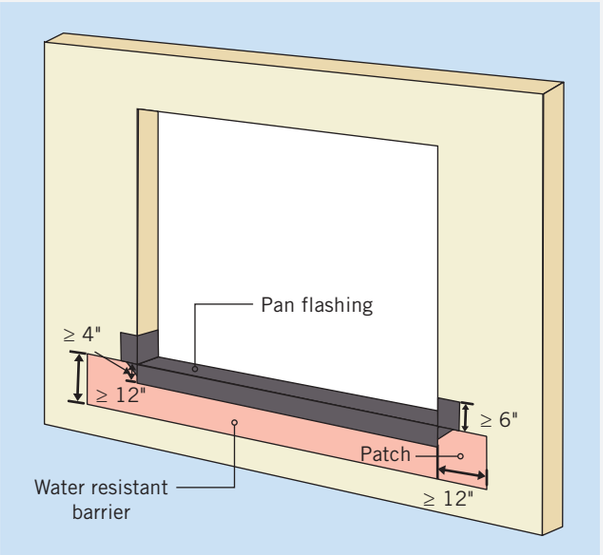
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:84

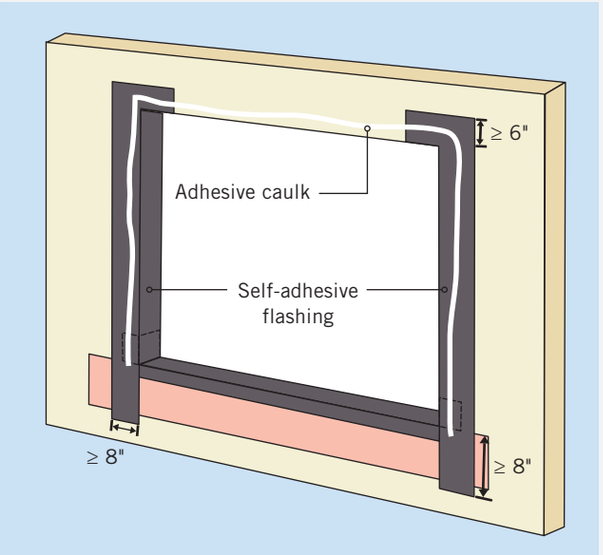
How to Flash a Window & a Door

1

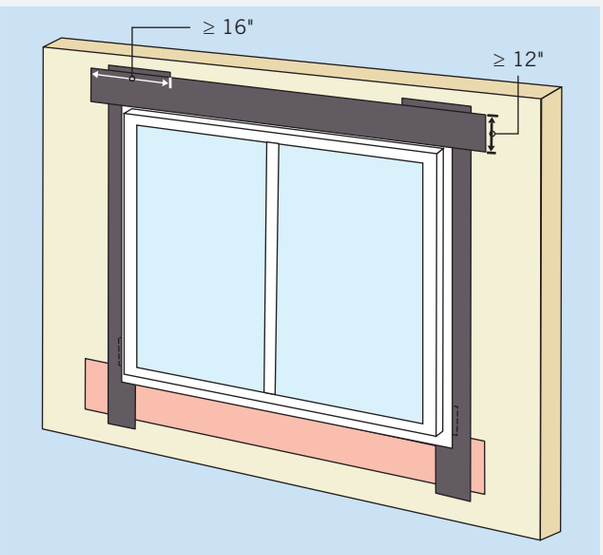


Install a water-resistant barrier, such as flexible flashing, to the sheathing beneath the window opening. Attach the barrier at the top only so material may be slipped underneath later. Install a metal or peel-and-stick window pan in the opening. Cut small patches of adhesive membrane to cover the corners where the pan climbs up the side jambs.

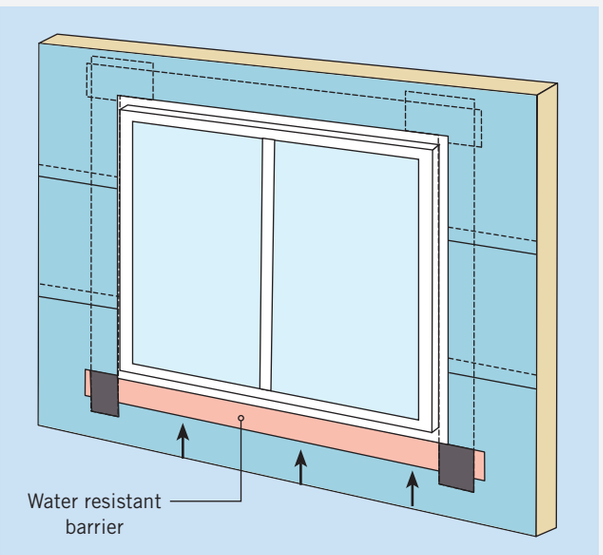
NOTE: If building wrap has already been installed, remove just enough to expose the exterior wall sheathing around the window opening.



Cut strips of self-adhesive flashing membrane and apply them to the wall at each side of the window opening. The flashing should extend into the window opening an amount roughly equal to the thickness of the wall. Make slits in the flashing at the top and bottom and fold over to cover the side jambs and the vertical portion of the pan. Apply a bead of adhesive caulk around the sides and top of the opening.



Install the window according to the manufacturer's directions. Apply a strip of self-adhesive flashing membrane across the top of the opening, covering the top window nailing flange.



Install building wrap according to the manufacturer's instructions. The edges of the wrap at the window opening should be secured to the flanges with building wrap tape supplied by the building wrap manufacturer. At the bottom of the window, slide the top edge of the building wrap behind the moisture barrier that was left unfastened at the bottom.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:85

Roof Systems

This section addresses the roof structural system. Refer to other sections of this book, general codes, and manufacturer's instructions for information about installing roof coverings. The number and size of the rafters or trusses is a vital element of home design, as are the methods for fastening these elements to the house structure. If you live in a coastal area or any region that is prone to earthquakes or hurricanes, a separate set of codes exists for your roof system. Be sure to enforce its more rigorous standards when you build.

Ridge, Valley & Hip Rafter Framing

1. Install at least a 1-inch (nominal thickness) ridgeboard at roof ridges in houses built with rafters (truss-built roofs do not have ridgeboards). Install a ridgeboard that is at least as deep as the (plumb) cut end of the rafter. Install rafters across from each other (within 1½ inch) at the ridgeboard. You may omit the ridgeboard if you secure the rafters to each other with a gusset plate, collar tie, or ridge strap.

2. Install at least a 2-inch (nominal thickness) hip rafter and valley rafter at all hips and valleys, including valleys formed when one roof is framed on top of another, collar tie, or ridge strap.

3. Support hip and valley rafters at the ridge with a brace to a load-bearing wall, or design the hip and valley rafters to bear the load at the ridge.

4. Design and support ridge, hip, and valley rafters as beams when the roof pitch is less than 3/12.

5. Design and support the ridge as a beam and design the walls supporting the ridge board to bear the ridgeboard load when framing cathedral and vaulted ceilings without ceiling joists and rafter ties.

A roof system comprises rafters or trusses that support roof sheathing. The sheathing is covered with an underlayment and roofing materials. Soffits, flashing, and ventilation are also important parts of the roof system.

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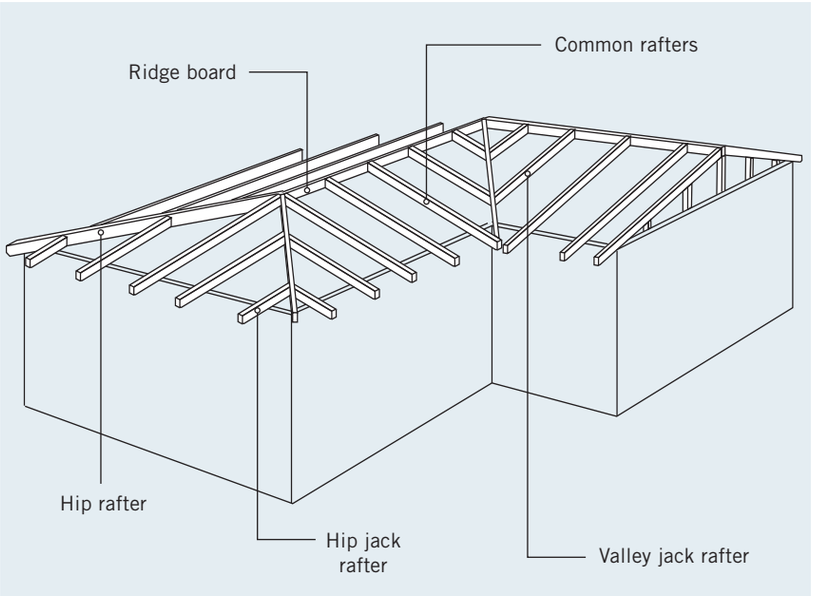
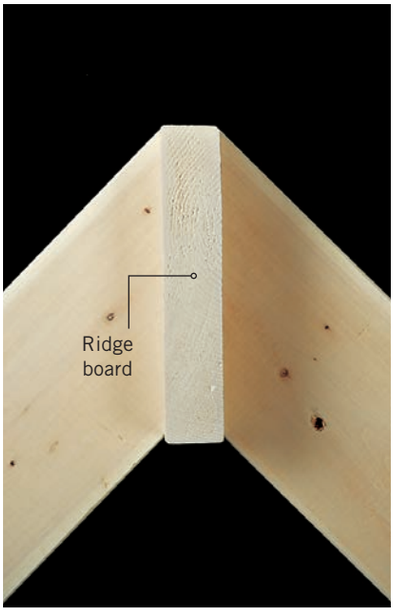
Page:86



Rafters have specific names that are assigned according to their function in the roof system.



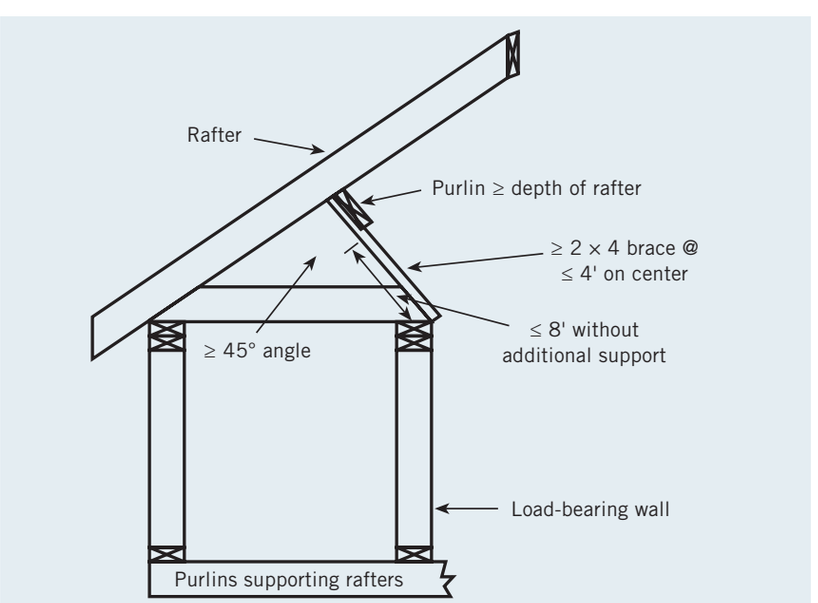
Position rafters across from each other on a ridgeboard or beam that is at least as deep as the rafter plumb cut.

Purlins

1. You may use purlins to support rafters that would otherwise span a greater distance than allowed. Example: a properly installed purlin at the center of an 18-foot-long rafter would allow you to use 9 feet as the rafter span distance.

2. Install purlins that are at least the same depth as the rafters they support. Example: use a 2 × 6 purlin to support a 2 × 6 rafter.

3. Use at least one 2 × 4 brace to carry the purlin load to a load-bearing wall. The purlin brace length should not exceed 8 feet without additional bracing (usually an additional 2 × 4 nailed to the brace). Purlin braces should bear on a load-bearing wall and may not slope at less than a 45-degree angle from horizontal. Space the purlin braces not more than 4 feet apart.



Use purlins to support rafters if the rafter span is longer than allowed.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:87

Collar Ties

1. You may install collar ties, gusset plates, or ridge straps if installing rafters without a ridge board. Collar ties, gusset plates, and ridge straps are not required if a ridge board is installed.

2. Space collar ties not more than 4 feet on center.

3. Locate collar ties in the upper one-third of the attic space.

4. Connect collar ties and rafters as specified in Table 10 (see page 72).

Rafter & Ceiling Joist Bearing on Support

1. Install rafters and ceiling joists with at least 1½ inches of the rafter or joist bearing on supporting wood members (such as a top plate or a valley rafter) and at least 3 inches of the rafter or joist bearing on masonry or concrete.

2. Toenail rafters to the top plate as specified in Table 10 (see page 72).

3. Install plates with a bearing area of at least 48 square inches when the plate bears on concrete or masonry. This means that the plate should have at least 48 square inches of surface area in contact with the masonry or concrete.

Rafter & Ceiling Joist Bridging & Lateral Support

1. Install bridging on rafters and ceiling joists deeper than 2 × 12 (six-to-one depth-to-thickness ratio). Space bridging not more than every 8 feet. Bridging should consist of solid, full-depth blocking, wood or metal diagonal bridging or by nailing at least a 1 × 3 wood strip to each rafter or ceiling joist. Bridging is required by some building officials on ceiling joists smaller than 2 × 12.

2. Install lateral support at bearing points on rafters and ceiling joists deeper than 2 × 10 (five-to-one depth-to-thickness ratio).

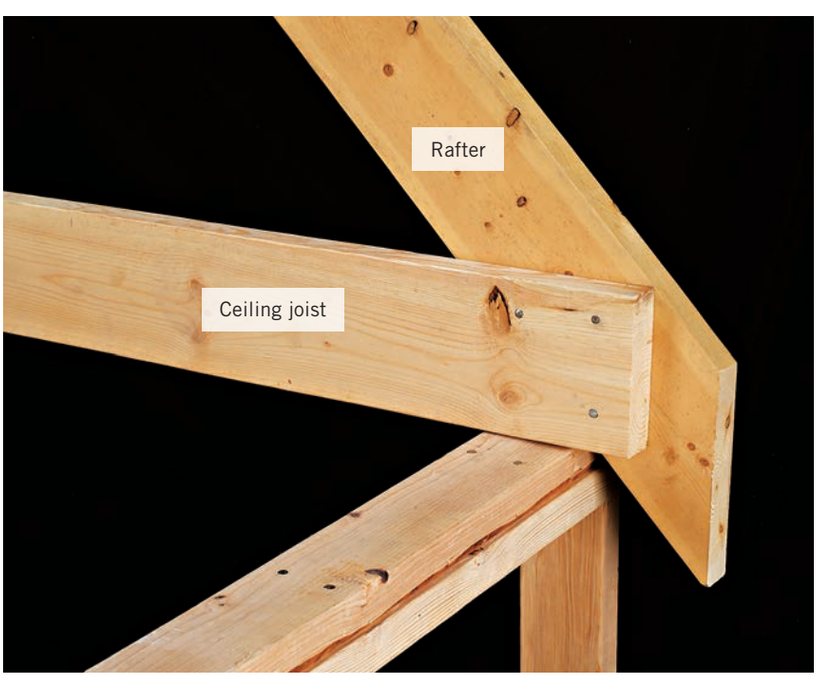
Ceiling Joist & Rafter Notching & Boring

1. Notch and bore dimensional lumber ceiling joists and rafters using the same rules as for floor joists, except as indicated below.

2. Leave at least 3½ inches of wood above the notch (bird mouth cut) where the rafter bears on the exterior wall, and do not cantilever the rafter past the wall more than 24 inches.

3. Do not taper a ceiling joist more than the actual depth of the ceiling joist divided by 4 if notching the ceiling joist where it bears on the wall. Example: do not cut more than 1⅞ inch of a 2 × 8 ceiling joist where it bears on the wall.

Connect one ceiling joist to one rafter when the ceiling joists and rafters are parallel.



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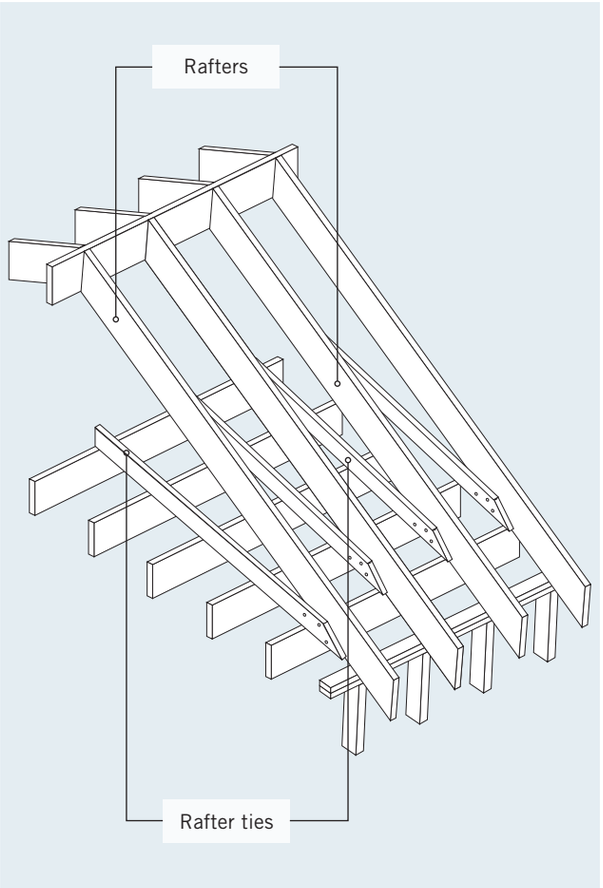
Page:88



Connect one rafter tie to one rafter.

Ceiling Joist Nailing to Rafter

1. Toenail all rafters to the top plate as specified in Table 10 (see page 72).

2. Install a method to prevent rafter thrust from pushing on supporting walls. You may use ceiling joists, rafter ties, or kickers to comply with this requirement.

3. Connect one rafter to one ceiling joist when the ceiling joists are parallel to the rafters. Locate the ceiling joists in the lower third of the attic area, if possible. Facenail these ceiling joists to rafters using 16d common nails or 40d box nails. (See Table 14, page 90.)

4. Connect one rafter to one rafter tie and connect the rafter tie to the corresponding rafter on the other side of the roof when the ceiling joists are not parallel to the rafters. Locate the rafter ties in the bottom one-third of the rafter height, if possible. Facenail rafters ties to rafters using the quantity of 16d common nails or 40d box nails indicated in Table 14. Use 2 × 4 or larger lumber for rafter ties.

5. You may substitute 2 × 4 kickers for rafter ties if the ceiling joists are not parallel to the rafters. Fasten the kickers to the rafters and to the ceiling joists as if the kickers were ceiling joists or rafter ties.

6. Lap ceiling joists that meet over interior walls or beams at least 3 inches, and facenail using the same quantity and type of nails indicated in Table 14. Apply this requirement when the ceiling joists are designed to resist rafter lateral thrust. This requirement usually applies when the ceiling joists are attached to the rafters.

7. You may butt the ends of ceiling joists together over interior walls or beams. Fasten the ceiling joists as specified in Table 10 (see page 72) if the ceiling joists are not designed to resist rafter lateral thrust. This exception usually applies when the ceiling joists are not attached to the rafters.

Ceiling Joist Nailing to Rafter Exceptions

1. Note the following exceptions to the quantity of nails required by codes:

   (a) You may reduce the required quantity of nails by 25 percent if the nails are clinched (the pointed ends sticking out from the wood are bent over).

   (b) You may use fewer fasteners if you support the ridge board on load-bearing walls or if you design and support the ridge as a beam.

   (c) You may use a smaller roof span column if you install purlins to support the rafters. Example: if you install purlins at the center of rafters with a roof span of 24 feet, you may reduce the roof span by 50 percent and use the 12-foot roof span column.

   (d) You may reduce the actual rafter slope by one-third if you substitute rafter ties for ceiling joists, Example: if the actual rafter slope is 9/12, use 6/12 as the adjusted rafter slope, but because there is no 6/12 slope row, use the nearest more conservative 5/12 row.

   (e) Increase the quantity of nails in the table if the ceiling joists or rafter ties are not located at the bottom of the attic space.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:89

TABLE 14: NAIL QUANTITIES CEILING JOISTS & RAFTER TIES TO RAFTERS

Rafter Slope	Rafter Spacing (inches)	GROUND SNOW LOAD (PSF) 20				30				50				70			
		Roof Span (feet)															
		12	20	28	36	12	20	28	36	12	20	28	36	12	20	28	36
3/12	12	4	6	8	10	4	6	8	11	5	8	12	15	6	11	15	20
	16	5	8	10	13	5	8	11	14	6	11	15	20	8	14	20	26
	24	7	11	15	21	7	11	16	21	9	16	23	30	12	21	30	39
4/12	12	3	5	6	8	3	5	6	8	4	6	9	11	5	8	12	15
	16	4	6	8	10	4	6	8	11	5	8	12	15	6	11	15	20
	24	5	8	12	15	5	9	12	16	7	12	17	22	9	16	23	29
5/12	12	3	4	5	6	3	4	5	7	3	5	7	9	4	7	9	12
	16	3	5	6	8	3	5	7	9	4	7	9	12	5	9	12	16
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12/12	12	3	3	3	3	3	3	3	3	3	3	3	4	3	3	4	5
	16	3	3	4	4	3	3	3	4	3	3	4	5	3	4	5	7
	24	3	4	4	5	3	3	3	6	3	4	6	8	3	6	8	10

Rafter & Truss Connection to Walls

1. Attach trusses and rafters to the supporting walls as specified in Table 10 (see page 72). This applies when: (a) roof uplift force is not more than 200 pounds and the trusses and rafters are spaced not more than 24 inches on center; or when (b) the wind speed is not more than 115 miles per hour, the wind exposure category is B and the is not more than 32 feet, and the roof pitch is at least 5/12. The truss design drawings supersede this requirement.

2. Refer to the IRC or engineered plans for wall attachment requirements when the limitations in #1 above do not apply. Some building inspectors require hurricane ties on all trusses and rafters.

Hurricane ties (also called clips) are recommended for all rafter or truss connections to walls. In some areas, they are required.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:90

CEILING JOIST & RAFTER SPAN DEFINITIONS

Selecting the correct size and type of ceiling joist requires that you know whether the attic may be used for storage. Selecting the correct size and type of rafter requires that you know the loads imposed by roof covering materials and loads imposed by snow accumulation on the roof.

Use these attic storage definitions to help you determine the correct ceiling joist span table. Access to attics with limited storage may be through a scuttle hole or by pull-down stairs. If attic access is by a permanent stairway, then consider the attic to be habitable space, and use the bedroom floor joist span tables instead of the ceiling joist span tables.

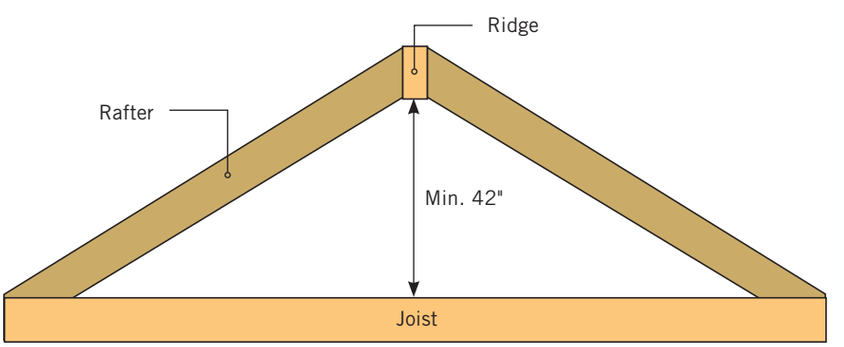
These attic storage definitions do not affect the requirements for access to attics. Refer to the Attic Access section (page 95) for attic access requirements.

An attic without storage, built with joists and rafters, has less than 42" between the top of the ceiling joists and the bottom of the rafters. An attic without storage, built with trusses, has fewer than three adjacent trusses with the same web configuration that could contain a cube not more than 42" wide and 24" tall located in the same plane (area) of the truss.

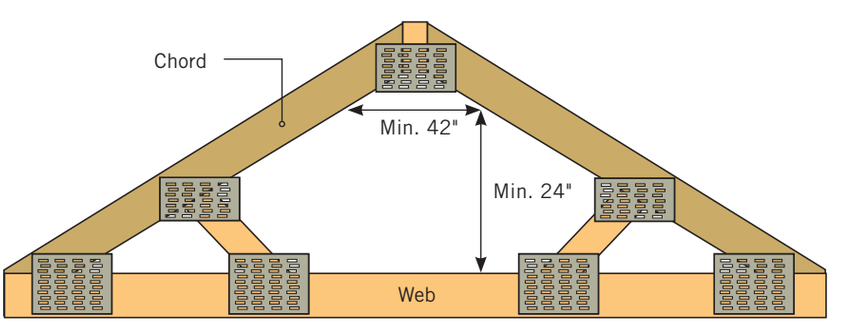
An attic with limited storage, built with joists and rafters, has at least 42" between the top of the ceiling joists and the bottom of the rafters. An attic with limited storage, built with trusses, has three or more adjacent trusses with the same web configuration that could contain a cube more than 42" wide and 24" tall located in the same plane (area) of the truss. An attic with limited storage is designed with an additional 10 psf live load compared to an attic without storage. Verify the storage capacity of truss-built attics with the truss engineer before using the attic for storage.

Roof live and snow load. Use the roof live load 20 psf tables in areas where the design ground snow load is less than (<) 30 psf. Use the rafter snow load tables in areas of the country with ground snow loads of 30 psf or more. Verify the design ground snow load with the local building official.

Rafter dead loads. Use the 10 psf rafter dead load columns when using one layer of roof coverings such as fiberglass shingles and wood. Use the 20 psf rafter dead load columns when using roof coverings such as tile and slate.



"Limited storage" in attic with rafters



"Limited storage" in attic with trusses

"Limited storage" in an attic with joists and rafters requires a clear span of 42" tall. In an attic built with trusses, you must have at least three consecutive bays where a 24"-high by 42"-wide cube can pass through without changing direction.

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Page:91

Ceiling Joist & Rafter Deflection

1. All ceiling joist spans in the tables below use L/240 deflection, where L is the length of the joist or rafter in inches divided by 240.

2. All rafter spans in the tables below use L/180 deflection.

Ceiling Joist & Rafter Span Tables

1. Use the following tables to determine the maximum unsupported horizontal distance that ceiling joists and rafters can span.

2. Refer to the IRC or to the AF&PA Span Tables for Joists and Rafters to determine spans for lumber widths, species, grades, and snow load factors not in these tables.

3. These tables apply to roof systems framed using standard 2-inch (nominal thickness) dimensional lumber. An engineer must design roof truss systems.

TABLE 15: CEILING JOIST SPANS 16" ON CENTER UNINHABITABLE ATTICS, NO STORAGE

SPECIES	GRADE	2 × 6 FT.-IN.	2 × 8 FT.-IN.	2 × 10 FT.-IN.
Douglas fir	2	17-8	23-4	>26-0
Hem fir	2	16-6	21-9	>26-0
Southern pine	2	16-11	21-7	>25-7
Spruce-pine-fir	2	16-11	22-4	>26-0

TABLE 16: CEILING JOIST SPANS 24" ON CENTER UNINHABITABLE ATTICS, NO STORAGE

SPECIES	GRADE	2 × 6 FT.-IN.	2 × 8 FT.-IN.	2 × 10 FT.-IN.
Douglas fir	2	15-0	19-1	23-3
Hem fir	2	14-5	18-6	22-7
Southern pine	2	13-11	17-7	20-11
Spruce-pine-fir	2	14-9	18-9	22-11

TABLE 17: CEILING JOIST SPANS 16" ON CENTER UNINHABITABLE ATTICS WITH LIMITED STORAGE

SPECIES	GRADE	2 × 6 FT.-IN.	2 × 8 FT.-IN.	2 × 10 FT.-IN.
Douglas fir	2	13-9	17-5	21-3
Hem fir	2	12-8	16-0	19-7
Southern pine	2	12-0	15-3	18-1
Spruce-pine-fir	2	12-10	16-3	19-10

TABLE 18: CEILING JOIST SPANS 24" ON CENTER UNINHABITABLE ATTICS WITH LIMITED STORAGE

SPECIES	GRADE	2 × 6 FT.-IN.	2 × 8 FT.-IN.	2 × 10 FT.-IN.
Douglas fir	2	10-8	13-6	16-5
Hem fir	2	10-4	13-1	16-0
Southern pine	2	9-10	12-6	14-9
Spruce-pine-fir	2	10-6	13-3	16-3

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:92

TABLE 19: RAFTER SPANS 16" ON CENTER, ROOF LIVE LOAD 20 PSF, CEILING NOT ATTACHED

DEAD LOAD	10 PSF	10 PSF	10 PSF	20 PSF	20 PSF	20 PSF
SPECIES-GRADE	2 × 6 FT.-IN.	2 × 8 FT.-IN.	2 × 10 FT.-IN.	2 × 6 FT.-IN.	2 × 8 FT.-IN.	2 × 10 FT.-IN.
Douglas fir - 2	14-4	18-2	22-3	12-5	15-9	19-6
Hem fir - 2	14-2	17-11	21-11	12-3	15-6	18-11
Southern pine - 2	13-6	17-1	20-3	11-8	14-9	17-6
Spruce pine fir - 2	14-4	18-2	22-3	12-5	15-9	19-3

TABLE 20: RAFTER SPANS 24" ON CENTER, ROOF LIVE LOAD 20 PSF, CEILING NOT ATTACHED

DEAD LOAD	10 PSF	10 PSF	10 PSF	20 PSF	20 PSF	20 PSF
SPECIES-GRADE	2 × 6 FT.-IN.	2 × 8 FT.-IN.	2 × 10 FT.-IN.	2 × 6 FT.-IN.	2 × 8 FT.-IN.	2 × 10 FT.-IN.
Douglas fir - 2	11-11	15-1	18-5	10-4	13-0	15-11
Hem fir - 2	11-7	14-8	17-10	10-0	12-8	15-6
Southern pine - 2	11-0	10-11	16-6	9-6	12-1	14-4
Spruce pine fir - 2	11-9	14-10	18-2	10-2	12-10	15-8

TABLE 21: RAFTER SPANS 16" ON CENTER, GROUND SNOW LOAD 30 PSF, CEILING NOT ATTACHED

DEAD LOAD	10 PSF	10 PSF	10 PSF	20 PSF	20 PSF	20 PSF
SPECIES-GRADE	2 × 6 FT.-IN.	2 × 8 FT.-IN.	2 × 10 FT.-IN.	2 × 6 FT.-IN.	2 × 8 FT.-IN.	2 × 10 FT.-IN.
Douglas fir - 2	12-1	15-4	18-9	10-10	13-8	16-9
Hem fir - 2	11-9	14-11	18-2	10-6	13-4	16-3
Southern pine - 2	11-2	14-2	16-10	10-0	12-8	15-1
Spruce pine fir - 2	11-11	15-1	18-5	10-8	13-6	16-6

TABLE 22: RAFTER SPANS 24" ON CENTER, GROUND SNOW LOAD 30 PSF, CEILING NOT ATTACHED

DEAD LOAD	10 PSF	10 PSF	10 PSF	20 PSF	20 PSF	20 PSF
SPECIES-GRADE	2 × 6 FT.-IN.	2 × 8 FT.-IN.	2 × 10 FT.-IN.	2 × 6 FT.-IN.	2 × 8 FT.-IN.	2 × 10 FT.-IN.
Douglas fir - 2	9-10	12-6	15-3	8-10	11-2	13-8
Hem fir - 2	9-7	12-2	14-10	8-7	10-10	13-3
Southern pine - 2	9-2	11-7	13-9	8-2	10-4	12-3
Spruce pine fir - 2	9-9	12-4	15-1	8-8	11-0	13-6

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Page:93

Roof Truss Installation

Truss Design & Bracing Written Specifications Requirements

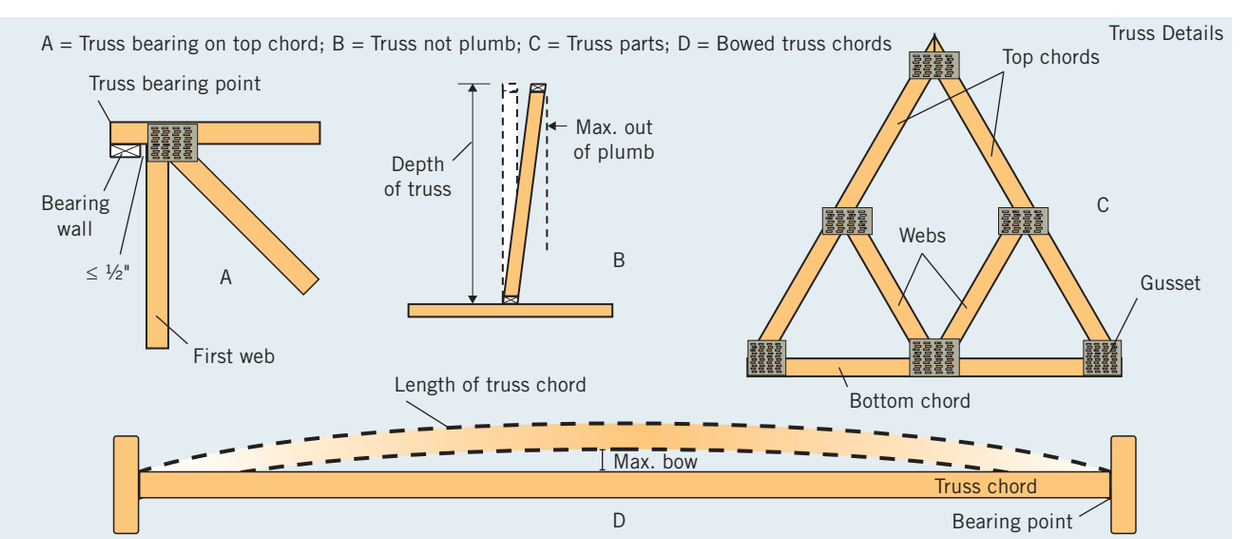
1. Use a qualified engineer to design all wood trusses, such as roof and floor trusses. The engineer and/or truss manufacturer should provide written truss design and installation specifications and deliver them to the job site with the trusses. These specifications should include engineering information, such as chord live and dead loads; assembly information, such as the size, species, and grade of each truss member; and installation instructions, such as where each truss should be located on the structure and how the trusses should be permanently braced.

Truss Installation Tolerance Recommendations

1. Install trusses according to the installation tolerances contained in the written truss specifications. Use the following installation tolerances from the booklet *Guide to Good Practice for Handling, Installation & Bracing of Metal Plate Connected Wood Trusses* only if the engineer and/or truss manufacturer does not provide installation instructions. The IRC does not specifically require installation to these tolerances; however, installation to these tolerances is implied by the general IRC requirement that components be installed according to manufacturer's installation instructions.
2. Install trusses so that a bow in either the top or bottom chord is not more than L/200 or 2 inches, whichever is less. L is the length of the truss chord in inches.
3. Install trusses that are out-of-plumb (vertical) by not more than D/50 or 2 inches, whichever is less. D is the depth of the truss in inches at the point of measurement.
4. Install trusses at load-bearing points not more than ¼ inch from the location on the plans.
5. Install trusses that use the top chord as the weight-bearing point with a gap of not more than ½ inch between the inside of the load-bearing support and the first diagonal or vertical truss web.

Alteration & Repair of Trusses

1. Do not alter trusses in any way, including cutting, notching, boring, and splicing, without written instructions from a qualified engineer.
2. Do not use trusses to carry the weight of equipment (such as furnaces or water heaters), use the attic area for storage, or hang storage units from trusses unless the trusses have been designed to carry the additional weight.
3. Do not repair damaged trusses without written instructions from a qualified engineer.



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Page:94

Attic Access

General Attic Access Requirements

1. Provide an access opening to every attic with at least 30 square feet of attic area and a vertical height of at least 30 inches at some point in the 30 square feet. Measure the vertical height from the top of the ceiling joists (or truss bottom chord) to the bottom of the rafters (or truss top chord).

2. Provide a rough opening (size before finishing) for a ceiling attic access of at least 22 inches by 30 inches. Locate the opening in a hallway or other readily accessible location. Locate the opening so that at least 30 inches of unobstructed headroom exists at some point above the opening.

3. Provide a rough opening (size before finishing) for a wall attic access of at least 22 inches wide by 30 inches high.

4. You do not need to provide attic access if the ceiling and roof systems are built using non-combustible materials. This is rare in residential construction.

5. Refer to the IRC for additional access requirements if appliances are located in the attic.

Insulation Clearance to Heat-Producing Devices

1. Provide at least 3 inches clearance between combustible insulation and heat-producing devices, such as recessed lighting fixtures and fan motors. Most insulation used in modern homes is considered combustible.

2. You may reduce the 3-inch clearance requirement if the device is listed for a lesser clearance and is installed according to manufacturer's instructions.

3. Install an insulation shield around any gas or oil vent that passes through an attic or other insulated area (such as a floor/ceiling assembly).

4. Use at least 26-gauge sheet metal for the insulation shield.

5. Extend the shield at least 2 inches above attic insulation material.

6. Secure the insulation shield to prevent movement of the shield.

Install an insulation shield around equipment vents that pass through insulation.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:96

Exterior Components

The primary function of the exterior components of a building is to keep the elements out. Of these elements, the most destructive is water. Water causes more damage than almost any other natural source, including fire and termites. Water can destroy most building materials, and it is an essential ingredient for mold growth.

In this chapter you will learn about three common water control issues. Shingle roof coverings are the most common type of material for keeping water that falls on the roof out of the home. You will learn about the code requirements for shingle installation and about where to install flashing that keeps water away from vulnerable areas, such as where roofs intersect with walls and chimneys. You will also learn about code requirements for water control around your home so that water stays out of basements and crawl spaces.

This chapter also contains information about fireplaces and chimneys. Water infiltration is common around these components, and fire safety is an additional important consideration.

In this chapter:

- Shingle Roof-Covering Installation
- Fireplaces & Chimneys

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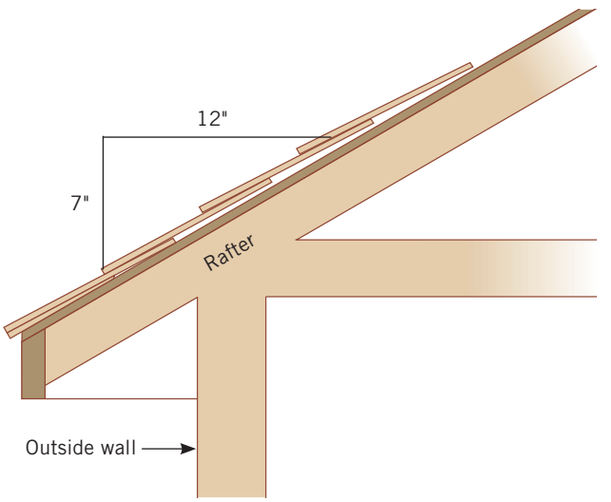
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:97

Shingle Roof-Covering Installation

When it comes to installing roof coverings, it can be a little hard to define where enforceable codes end and ordinary best practices begin. But it is safe to say that most codes contain guidelines for installing roof coverings that, if followed, will ensure a long-lasting roof that keeps moisture from penetrating your house. The following information applies to asphalt shingles. It does not include asphalt-based roll roofing. This section applies to shingle roof-covering installation in almost all areas. Consult your local building inspector for additional requirements if you live in a very high wind speed design area, such as near the ocean.

Always read and follow the shingle manufacturer's instructions. They are printed on every package of shingles. Details that seem minor, such as failing to install the starter course or incorrectly installing nails, can make a big difference in how the shingles perform under stress. Failing to follow instructions can void the shingle warranty. This section applies to shingle roof-covering installation in almost all areas. Consult your local building inspector for additional requirements if you live in a very high wind speed design area, such as near the ocean.

"Asphalt shingles" is a fairly general description that includes three-tab, dimensional, and laminated shingles.



Roof slope is measured by the number of inches the roof increases in height (rise) in 12" horizontally (run).

Roof Slope & Sheathing

Roof Slope Restriction

1. Do not install shingles on roofs with a slope less than 2/12. Low slope and flat roofs require a roof covering designed for a low slope roof. Membranes, such as modified bitumen and EPDM, and standing seam metal are examples of low slope roof coverings.

2. Install a double underlayment layer under shingles on roofs with a slope between 2/12 and 4/12.

3. Verify shingle manufacturer's instructions about minimum roof slope. Some do not allow installation on slopes less than 2½/12.

Roof Deck Type Restriction

1. Install shingle roof covering only on solid sheathed roofs. In residential construction this means roofs covered by OSB or plywood, which includes virtually all houses built in the last generation or two.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:98

Endorsed products for roofing underlayment include roofing felt (building paper) in both #15 and #30 thickness as well as self-adhesive ice dam underlayment. Elastomeric roof cement is used for minor patching and sealing as well as for binding underlayment courses together.

Underlayment Specifications

1. Use at least #15 roofing felt (also called building paper). Other material, such as modified bitumen sheets and proprietary products from the shingle manufacturer, may be acceptable. Refer to general codes and manufacturer's instructions for other acceptable underlayment materials.

Underlayment Application for Roof Slopes 4-in-12 & Greater

1. Begin at the eaves and apply at least a 36-inch-wide strip of underlayment parallel to the eaves.

2. Lap horizontal joints at least 2 inches with the upper strip over the lower strip.

3. Lap end joints as specified by the shingle manufacturer. End joint laps are usually between 4 and 6 inches.

4. Offset end joints by at least 6 feet.

5. Use sufficient fasteners to hold underlayment in place. The IRC does not specify fastener type and quantity.

6. Minimize wrinkles and distortions in the underlayment. Wrinkles should not interfere with the ability of the shingle's sealing strips to seal. Underlayment wrinkles and distortions can appear through the shingles, creating a cosmetic issue.

Drip Edge

1. Install drip edge flashing at eaves and at gable rakes.

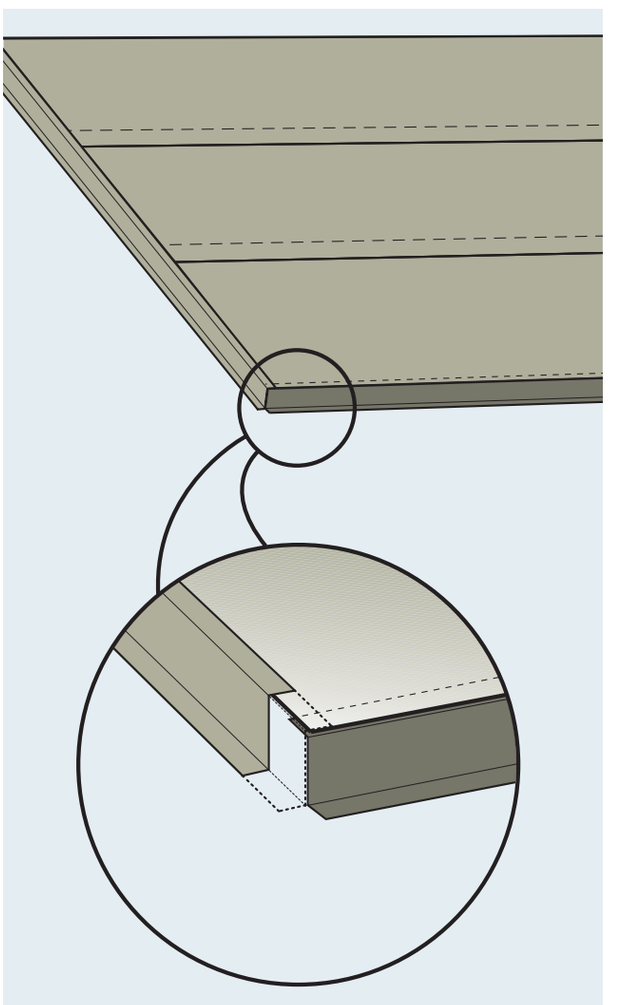
2. Use drip edge flashing that extends at least ¼ inch below the roof sheathing and extends at least 2 inches up the roof deck.

3. Lap adjacent drip edge pieces at least 2 inches.

4. Attach drip edge using roofing nails spaced not more than 12 inches on center.

5. Install underlayment under the drip edge at rakes.

6. Install underlayment over the drip edge at eaves.



Proper installation of underlayment is important for reducing roof leaks. The underlayment should overlap the top of the drip edge at the eave, with the drip edge along the rake edges installed after the underlayment so it overlaps and directs runoff onto the underlayment.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:99

Underlayment Application for Roof Slopes Between 2-in-12 & 4-in-12

1. Begin at the eaves and apply at least a 19-inch-wide strip of underlayment parallel to the eaves.

2. Begin again at the eaves and apply at least a 36-inch-wide strip of underlayment.

3. Lap each successive layer at least 19 inches over the previous layer, with the upper layer lapping over the lower layer.

4. Lap end joints at least 6 inches.

5. Use sufficient fasteners to hold underlayment in place. Most codes do not specify fastener type and quantity.

6. Install drip edge as previously described.

Underlayment Application in Ice Dam Areas

1. Install ice dam underlayment where there is a history of water backup at the eaves caused by ice. Verify ice dam requirements with the local building official. You do not need to install ice dam underlayment on unconditioned detached accessory structures, such as an unheated garage.

2. Install either a sheet of self-adhering, polymer-modified bitumen roofing or at least two layers of roofing felt bonded together with roofing cement. Begin the ice dam underlayment at the lowest edge of all roof surfaces, and extend it at least 24 inches beyond the exterior wall of the building.

3. Measure distances horizontally, not up the roof sheathing. Begin the 24-inch measurement from the interior side of the wall. Example: if the eaves extend 12 inches horizontally from the exterior wall of the building, extend the ice dam underlayment at least 39 inches horizontally from the edge of the eaves (assuming a 2 × 4 wall).

Install one or two courses (depending on local codes) of fully-bonded, self-adhesive ice dam underlayment in cold-weather climates. Ice dam underlayment helps prevent liquid water from running under the shingles and leaking into your home.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:100

Roof Flashing

Roof flashing used with asphalt shingles is typically made of metal: primarily galvanized steel, aluminum, or copper. The timing for installing it depends on the type of flashing. Some, such as valley flashing, is installed prior to the finished roof covering (shingles). Other types, such as step-flashing, is interwoven with the shingles during the installation process. In some cases, formable, self-adhesive flashings can be used instead of metal. In some code areas, roll roofing may be used as valley flashing—check with your building inspector.

Closed-Cut Valley Flashing

1. Before installing the shingles, install valley flashing material according to the shingle manufacturer's instructions. You may use at least a 36-inch-wide strip of smooth roll roofing material as valley flashing material with at least 18 inches on each side of the valley; or you may use any open valley lining material.

2. Place nails at least 6 inches away from the valley centerline, unless other spacing is approved by the shingle manufacturer.

3. Apply the shingles across one side of the valley at least 12 inches, or as recommended by the shingle manufacturer.

4. Apply shingles from the other direction to before the valley centerline, and trim the edges as recommended by the shingle manufacturer. Seal the cut shingles in a closed-cut valley, as recommend by the manufacturer. Sealing the cut shingles is frequently omitted.

Woven valleys are a common shingle valley treatment. Some manufacturers do not allow these valleys when using laminated shingles.

Closed-cut valley shingles are cut in a straight line about 2" from the valley center line. The cut should be on the side where the least amount of water is likely to flow.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:101

Chimney Crickets

1. Install a cricket (also called a saddle) on chimneys that are more than 30 inches wide in the dimension parallel to the roof ridgeline. A cricket is not required if the chimney intersects the roof ridgeline. This also applies to factory-built chimneys that are installed inside a wood chimney chase.

2. Flash the cricket at the chimney wall using step and counter flashing that is compatible with the roof covering material.

3. Install the cricket with a vertical height at the chimney based on Table 23. W is the width of the chimney. Leave at least a 1-inch air space between a wood-framed cricket and a masonry chimney wall.

Step Flashing

1. Install step flashing at the intersections of a sloped roof and a vertical side wall. Use flashing that is at least 4 inches wide by 4 inches high. Install kick-out flashing at the end of the wall to direct water away from the side wall.

2. Flash the intersection of a sloped roof and a chimney according to the shingle manufacturer's instructions. This typically includes step flashing covered with counter flashing.

3. Flash other roof penetrations, such as plumbing and gas vents, according to the shingle manufacturer's instructions.

4. Flash skylights according to the skylight manufacturer's instructions.

TABLE 23: CHIMNEY CRICKET HEIGHT

ROOF SLOPE	CRICKET HEIGHT
12/12	1/2 W
8/12	1/3 W
6/12	1/4 W
4/12	1/6 W
3/12	1/8 W

A cricket is a triangle-shaped raised area of a roof installed on the high side of a chimney to divert water around the chimney and help prevent leaking at the chimney. Improper installation and flashing of chimney crickets is a common cause of roof leaks.

Flash roof and sidewall intersections using step and counter flashing. Install kick-out flashing (inset) at the end of the wall.

Flash all penetrations, such as plumbing vents and equipment vents, with preformed flashing, often called boots. Make sure the flashing conforms to your roof slope.

Most skylights for residential installation come with a flashing kit. Improper installation and flashing of skylights is a common cause of roof leaks.

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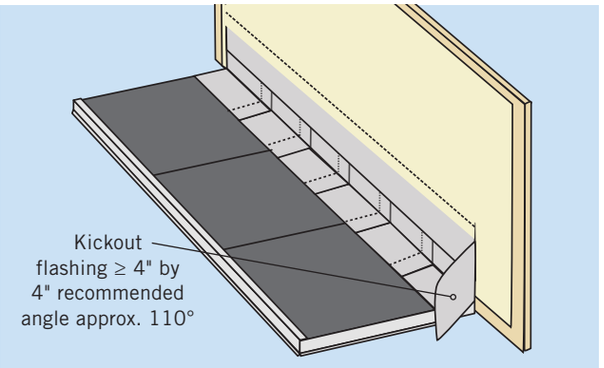
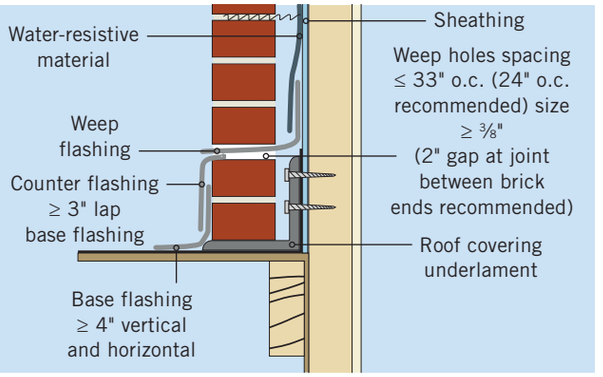
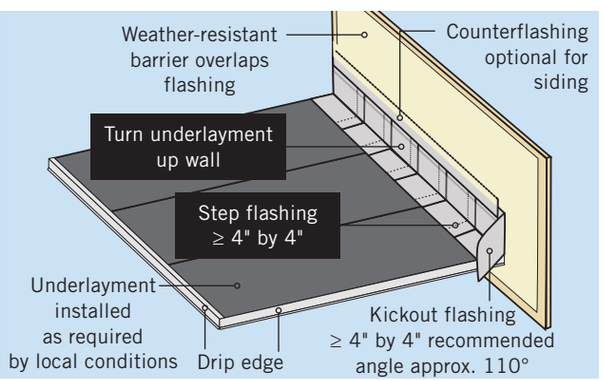
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:102



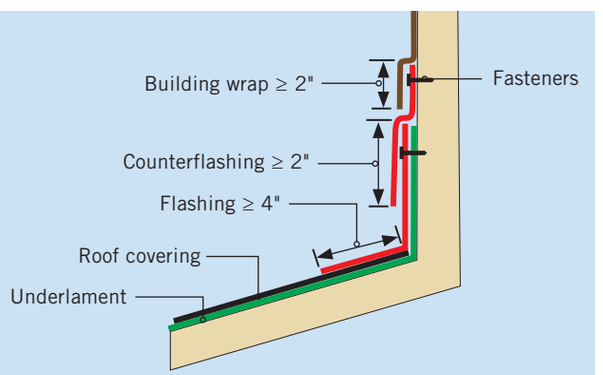
Integrate kickout flashing with sidewall flashing and the water-resistive material.



Flash brick veneer using base and counterflashing that is integrated with the water-resistant material.



A properly flashed roof/sidewall intersection includes roof covering underlayment, base and counterflashing, water-resistive material, and kickout flashing.



A headwall is where a roof rises to meet a sidewall. Flash headwalls using base and counterflashing integrated with water-resistive material.

Roofing Fasteners

Fastener Type & Quantity in Standard Shingling Conditions

1. Use the type and quantity of fasteners recommended by the shingle manufacturer. Locate nails on the shingle strip precisely as recommended by the shingle manufacturer. Some manufacturers recommend installing nails below the black adhesive seal strip. Other manufacturers leave a gap in the seal strip for installing nails. Do not install nails above the seal strip unless allowed by the manufacturer. Failure to comply with manufacturer's installation instructions is a code violation and may void the manufacturer's warranty.

2. Use corrosion-resistant roofing nails (usually galvanized steel) with at least a 12-gauge shank and a ⅜-inch-diameter head. Use nails long enough to penetrate into the roof sheathing at least ¾ inch and completely through any sheathing that is less than ¾ inch thick. Install at least four nails per shingle strip, with a nail at 1 inch from each end and two nails equally spaced in the center of the strip.

STAPLES AS SHINGLE FASTENERS

Staples are not endorsed in general codes as an approved shingle fastener. Some shingle manufacturers allow staples, but few recommend them. Avoid using staples as shingle fasteners in both new construction and when replacing an existing shingle roof.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:103

Fireplaces & Chimneys

Provide a hearth extension (the area of the floor adjoining the fireplace) that meets minimum size standards based on the square footage of the fireplace opening.

Installing a factory-built or gas fireplace is a do-it-yourself project because you can design and build the fireplace frame to suit your needs and add your own finish treatments. It all starts with some careful planning. Once you decide on the fireplace model and determine where to place it, order all of the vent pipes and fittings needed to complete the vent run.

NOTE: Consult the manufacturer's instructions for the specifications regarding placement, clearances, and venting methods for your fireplace.

Start your planning by determining the best location for the fireplace. Placing the unit next to an exterior wall simplifies the venting required. One important specification for a direct-vented gas fireplace located in a basement is that the termination cap (on the outside end of the vent) must be 12 inches above the ground and away from openings, such as windows and doors.

For help with any of these planning issues, talk with knowledgeable dealers in your area. They can help you choose the best fireplace model for your situation and help you with venting and other considerations. Remember that all installation specifications are governed by local building codes and that a building permit will be required. Check with the building department to make sure your plans conform to regulations.

NOTE: The information on pages 104 to 105 apply specifically to masonry fireplaces, but many are useful guidelines for gas fireplaces as well.

Masonry Fireplace Clearance to Combustible Materials

Masonry Fireplace Hearth Extension Clearance to Combustible Materials

1. The hearth extension is the area in front of the firebox. It must be made of non-combustible material upon which sparks and hot materials from the firebox may land without starting a fire. Tile and masonry units are typical.

2. Build a hearth extension for a masonry fireplace at least 16 inches in front of the firebox opening and at least 8 inches to the sides of the firebox opening, if the firebox opening is less than 6 square feet.

3. Build a hearth extension for a masonry fireplace at least 20 inches in front of the firebox opening and at least 12 inches to the side of the firebox opening, if the firebox opening is 6 square feet or more.

4. Build a hearth extension for a factory-built fireplace according to the fireplace manufacturer's instructions. The hearth extension size is often the same as for a masonry fireplace.

Masonry Fireplace Clearance to Mantels & Trim

1. Locate all combustible mantels and wood trim at least 6 inches from a masonry fireplace opening.

2. Provide at least 1 inch of clearance to the masonry firebox opening for every ⅛ inch that combustible material projects from the fireplace surround. This applies to materials within 12 inches of the fireplace opening. Example: locate 1-inch-thick fireplace mantel legs at least 8 inches from the fireplace opening. Example: locate greater than 12 inches from the fireplace opening any part of a fireplace mantel or mantel leg that is more than 1½ inches thick.

3. Provide clearance to combustible materials for a factory-built fireplace according to the fireplace

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305471 - B&D Codes for Homeowners 4th Edition Edition_096-107.indd 104 1/10/18 11:39 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:104

manufacturer's instructions. The clearance is often the same as for a masonry fireplace.

Spark Arrestor & Rain Cap

1. You are not required to install a spark arrestor or a rain cap on a masonry chimney, unless the local building official requires one. They are, however, recommended to protect the home and surrounding area from fire and to protect the chimney and home interior from water damage.

2. Comply with all of the following requirements for installed spark arrestors: (a) make the unobstructed arrestor area at least four times the area of the flue it serves; (b) make the arrestor screen using heat- and corrosion-resistant material equal to 19-gauge galvanized steel or 24-gauge stainless steel; (c) build the arrestor screen so it does not pass ½-inch-diameter spheres and does not obstruct ⅜-inch-diameter spheres; (d) make the arrestor accessible for cleaning and make the cap removable to allow for flue cleaning.

Chimney Used as Appliance Vent

1. Have a qualified contractor evaluate a chimney before using it to vent an appliance, such as a gas furnace or water heater, an oil-fired furnace, or a pellet stove. Chimneys that are too small may allow unsafe backdrafting of carbon monoxide into your home. Chimneys that are too large may allow water to condense in the chimney and cause considerable damage to the chimney.

2. Do not use a chimney as a gas appliance vent if any side of the chimney is exposed to the outdoors below the roofline. This means that a chimney must be completely enclosed within the house walls until it reaches the attic.

3. You may use a chimney as a vent for one draft hood-equipped gas water heater if the area of the chimney flue as at least as large as the area of the draft hood outlet and not more than seven times the area of the draft hood outlet.

Locate wood trim far enough from the firebox to avoid fires.

4. Do not use a chimney as a vent for one fan-assisted, medium efficiency gas furnace.

5. Do not connect an appliance vent to a masonry chimney flue if the area of the appliance connector is larger than the area of the chimney flue.

6. Install a permanent label in a conspicuous location warning occupants if a chimney has been relined and warning them what types of appliances may be connected to the chimney.

7. Have gas appliance vents connected to masonry chimney flues according to the provisions for gas appliance vents in IRC Chapter 24.

Wood-Burning Fireplace Energy Efficiency Requirements

1. Install an air barrier on fireplace walls.

2. Install doors with gaskets at fireplace openings.

3. Install a tight-fitting flue damper.

Combustion Air For Fireplaces

1. Provide combustion air from outside for solid fuel-burning masonry and factory-built fireplaces. Install combustion air ducts for factory-built fireplaces according to manufacturer's instructions.

2. Provide combustion air from the outside for vented gas and oil fireplaces according to manufacturer's instructions.

3. Locate the outside combustion air inlet at or below the firebox level. Cover the inlet with a screen having ¼-inch mesh.

4. Install combustion air openings and ducts that have an area of at least 6 square inches and not more than 55 square inches. Use a combustion air duct that is designed for that purpose, or keep the duct at least 1 inch away from combustible materials within 5 feet from the firebox.

5. Locate the inside combustion air outlet in the back or side of the firebox or at hearth level and not more than 24 inches from the firebox opening.

6. Install a closure mechanism at the combustion air outlet.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:105

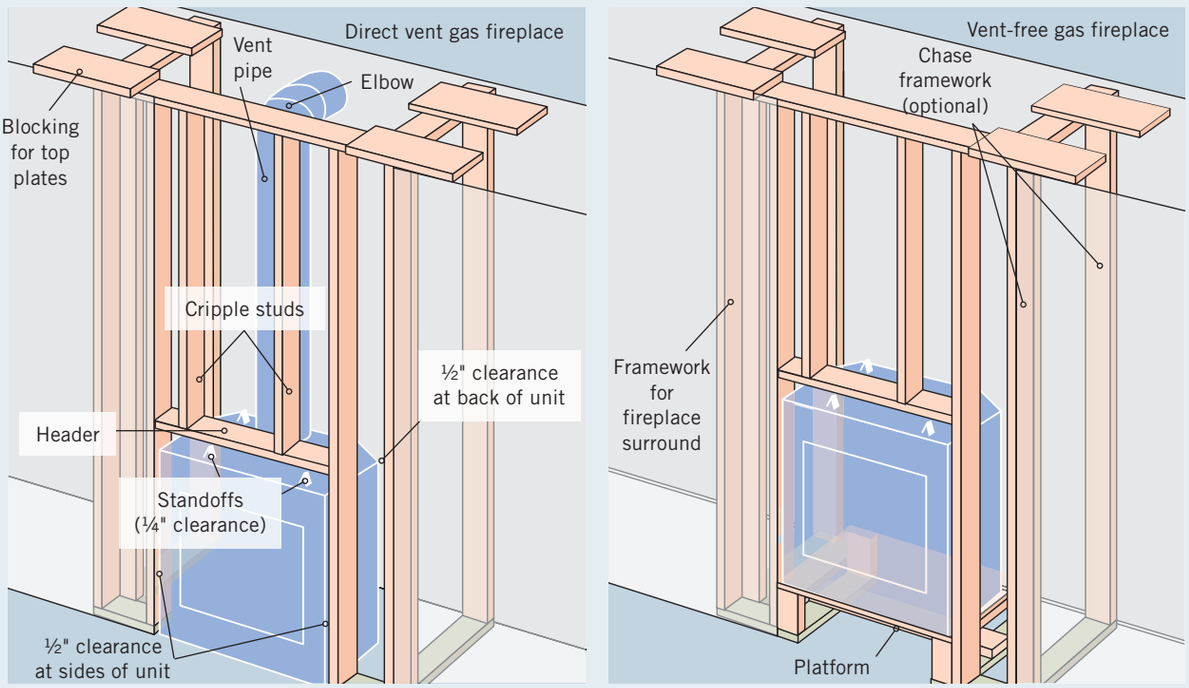
Factory-Built Fireplaces

Factory-built fireplaces and chimneys include components tested, listed, and labeled to be installed together as a system. Such fireplaces are usually designed to burn solid fuels, such as wood, though they may be converted to use gas if approved by the fireplace manufacturer. Do not mix components from different manufacturers unless approved by the fireplace manufacturer.

Fireplaces designed to burn only gas are not really fireplaces. They are decorative gas appliances. Vented decorative gas appliances are more like a water heater than like a fireplace. Unvented decorative gas appliances are more like a gas range than like a fireplace. Install and use decorative gas appliances according to manufacturer's instructions and IRC Chapter 24. Note that some jurisdictions do not allow unvented decorative gas appliances. Also note that manufacturers of unvented decorative gas appliances recommend limits on the duration of use.

Create wall surrounds for fireplaces with cementboard, which has some heat-resistant qualities and also makes a good backer for ceramic tile—a popular choice for finished fireplace surrounds.

GAS FIREPLACES



A gas fireplace behaves more like a water heater than like a fireplace, but these appliances do produce dangerous gases and are by their very nature a fire hazard. The two most common types are direct-vent gas fireplaces, which produce heat that can contribute to your home heat plan and are vented to the exterior, and vent-free gas fireplaces (not allowed in some states) that are purely decorative. Because the amount of gas they consume is so small (comparable to a gas range with all burners on), they do not require venting.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:106

Factory-Built Fireplace & Chimney Installation

Install factory-built chimneys and fireplaces according to the manufacturer's instructions. These instructions include requirements for hearth extensions, clearances to combustible materials, and installation of combustion air ducts.

Decorative Chimney Covers

Do not install decorative chimney covers, shrouds, or similar components at the chimney termination unless the component is listed and labeled for use with your particular fireplace system.

Structural Support for Factory-Built Fireplaces

Provide adequate structural support for factory-built fireplaces and chimneys according to manufacturer's recommendations.

Direct-vent gas fireplaces may be vented through a sidewall. Chimneys for wood-burning fireplaces are vertical.

Vents for gas fireplaces must have a protective termination cap (supplied by manufacturer). Note the black stain on the termination. This stain may indicate that the gas fireplace is not functioning properly.

Factory-built fireplaces (including direct-vent and vent-free gas fireplaces) typically require structural support. If the fireplace is recessed into a wall, structural support is in the form of a mounting platform located on the other side.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:107

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:108

Heating & Air Conditioning

Safety is the primary focus of code provisions governing heating and air conditioning systems. Improper appliance installation can cause the appliance to malfunction, creating a fire hazard as well as the potential for carbon monoxide poisoning. Fuel-burning appliances, such as gas and oil furnaces, must be installed in safe locations and must be provided with enough outside air to support fuel combustion. Vents for these appliances must be installed so that they do not ignite combustible materials and so that combustion gases are not circulated back into the building.

In this chapter you will learn about the safe installation of heating and air conditioning appliances and their associated venting equipment. You will also learn about how to identify improperly installed forced-air ducts that can increase your energy costs and decrease your appliance's useful life.

In this chapter:

- HVAC Appliances
- HVAC Duct Installation
- Combustion Air for Fuel-Burning Appliances
- Vents for Fuel-Burning Appliances

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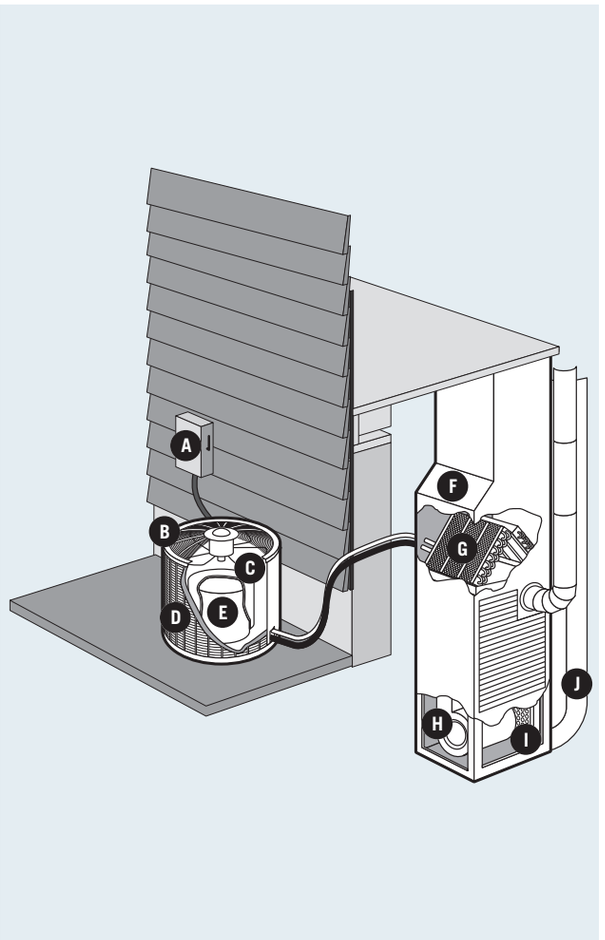
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:109

HVAC Appliances

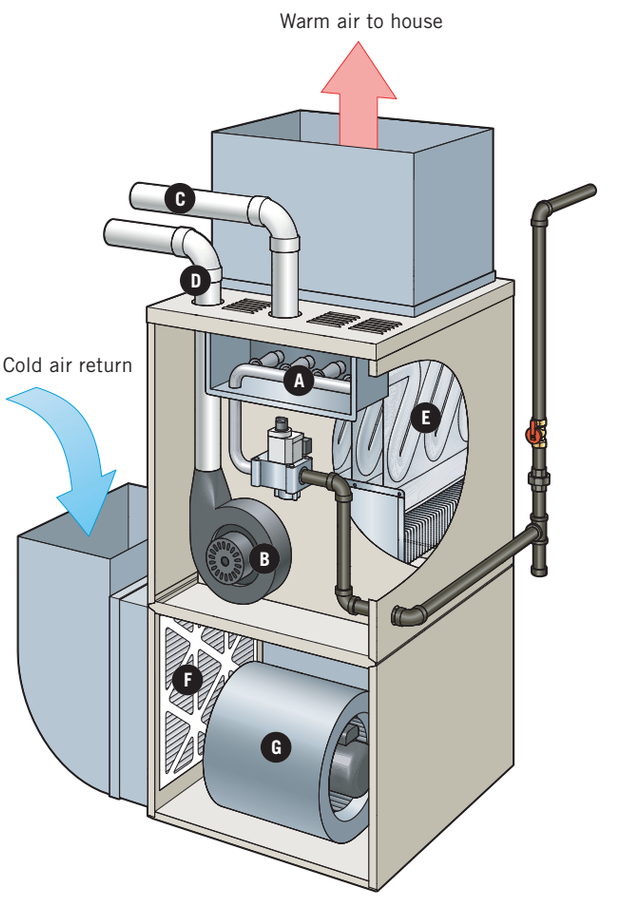
Heating, ventilation, and air conditioning systems are often referred to as a group by the term HVAC. This is because they share a common purpose: to keep the air in your home comfortable. All HVAC systems—even hot-water-based systems—rely on the flow of air to heat, cool, and ventilate your home.

Most homes today include two separate major appliances in the HVAC system: a furnace and a central air conditioning unit. In most cases, even when the AC has been retrofitted, the appliances share ductwork.

The information in this chapter is intended mostly for general education purposes and to assist with diagnosing system problems. **Unless you are a very experienced DIYer, installing and servicing HVAC equipment is a job best left to professionals.**



Central air conditioner parts include: (A) Power shutoff for service personnel, (B) Condenser unit, (C) Fan, (D) Condenser coil, (E) Compressor, (F) Plenum, (G) Evaporator coil, (H) Blower motor, (I) Filter, (J) Air return.



Gas furnace parts include: (A) Inshot burners, (B) Draft inducer fan, (C) Combustion air pipe, (D) Vent, (E) Heat exchanger, (F) Filter, (G) Blower motor.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:110

Prohibited Locations for Appliance Installation

1. Do not locate gas or other fuel-burning appliances in bedrooms, bathrooms, toilet rooms, or storage closets. Do not draw combustion air for any fuel-burning appliance from these rooms regardless of where the appliance is located.

2. Do not locate appliances anywhere that is not approved by the manufacturer's instructions.

3. Do not apply this provision to appliances powered only by electricity, such as heat pump air handlers and electric water heaters.

Exceptions: Prohibited Locations for Appliance Installation

1. You may install direct-vent appliances in prohibited locations if the appliance draws all combustion air directly from the outdoors.

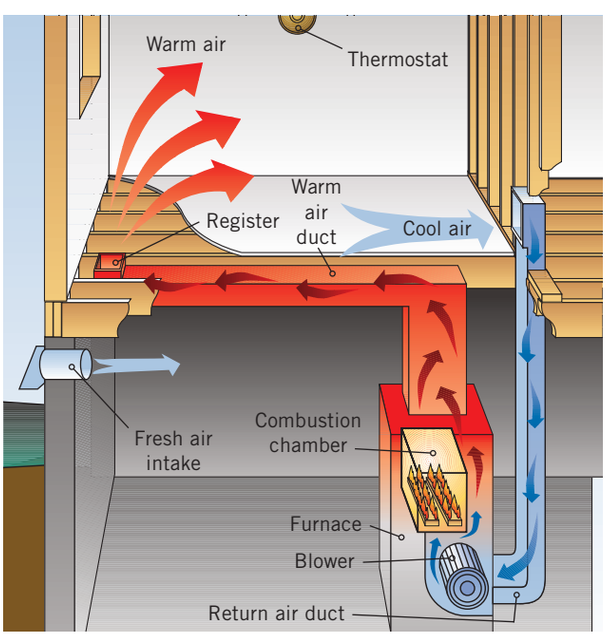
2. You may install vented room heaters, vented wall furnaces, vented decorative appliances, and decorative appliances listed for installation in vented, solid fuel-burning fireplaces (such as gas logs) in prohibited locations if the room satisfies combustion air volume requirements.

3. You may install one listed, wall-mounted, unvented room heater in a bathroom if the appliance has an oxygen depletion safety shutoff system, the appliance input rating is not more than 6,000 BTU/hour, and the bathroom satisfies combustion air volume requirements.

4. You may install one listed, wall-mounted, unvented room heater in a bedroom if the appliance has an oxygen depletion safety shutoff system, the appliance input rating is not more than 10,000 BTU/hour, and the bedroom satisfies combustion air volume requirements.

5. You may install appliances in an enclosure accessible from the prohibited locations if all combustion air is drawn directly from the outdoors and the enclosure is equipped with a self-closing door that is weather-stripped.

6. The standard combustion air volume requirement is at least 50 cubic feet per 1,000 BTU/hour appliance input rating. This standard volume requirement does not apply if the home is tightly sealed with a known air infiltration rate of less than 0.40 air changes per hour. Tightly sealed homes are rare.



A typical forced air heating system delivers heated air to a room through registers while drawing cool air through return ducts. The cool air is reheated in the furnace and recirculated for maximum efficiency. A fresh air intake provides a constant supply of combustion air.

An air intake vent that draws combustion air into the system allows you to install appliances in areas that lack adequate combustion air. The vent shown is for a high-efficiency gas furnace.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:111

Electric baseboard heaters often are used to provide supplementary heat. Models (such as the one here) that do not produce external temperatures greater than 125°F may be mounted directly to drywall walls, but a clear space should be maintained between the appliance and the floor.

Electric Radiant (Baseboard) Heating Systems

Electric radiant heating systems provide heat to a single room. They usually have no fan and provide heat by natural movement of the heated air and by thermal radiation. They are common in small, seasonally occupied buildings, some rural homes, and in buildings without ducts for forced-air heating and cooling. These elements become very hot, and proper installation is important to prevent fires and electrical problems.

Installation Requirements

1. Install electric radiant heating panels according to manufacturer's installation instructions and applicable provisions of general and local codes.
2. Install radiant panels parallel to wood framing members, and fasten the panels to the surface of the framing members or mount the panels between framing members.
3. Install fasteners only in areas of the appliance's radiant panel designed for fasteners. Install fasteners at least ¼ inch away from a heating element.
4. Install radiant panels as complete units, unless listed and labeled for field modifications.
5. Do not install radiant panels on drywall unless the panel's maximum operating temperature is not more than 125 degrees Fahrenheit.

ESTIMATE YOUR HEATER NEEDS

1. Measure the area of the room in sq. ft. (length × width): _____
2. Divide the area by 10 to get the baseline minimum wattage: _____
3. Add 5% for each newer window or 10% for each older window: _____
4. Add 10% for each exterior wall in the room: _____
5. Add 10% for each exterior door: _____
6. Add 10% if the space below is not insulated: _____
7. Add 20% if the space above is not well insulated: _____
8. Add 10% if the ceiling is more than 8' high: _____
9. Total of the baseline wattage plus all additions: _____
10. Divide this number by 250 (the wattage produced per foot of standard baseboard heater): _____
11. Round up to a whole number. This is the minimum number of feet of heater you need. _____

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:112

Appliances Installed in Garages

In warmer areas of the country some major household appliances are routinely located in garages to conserve interior floorspace. Water heaters are code-regulated to be installed in garages. Others, such as central vacuum units, should be installed following the manufacturer's instructions and best practices, but typically they are not subject to specific codes beyond applicable wiring, plumbing, and fire safety codes.

Elevated Appliances in Garages

1. Elevate the appliance ignition source at least 18 inches above the floor when the appliance is located in a garage or in an unconditioned room that opens directly into the garage. Appliances with a potential ignition source include gas and electric water heaters, gas and electric clothes dryers, gas and electric furnaces, and heat pumps with auxiliary resistance-heating elements. Rooms that open directly into the garage include storage and utility rooms that are not part of the conditioned living space. These rooms include rooms separated from the garage by a door opening into the garage.

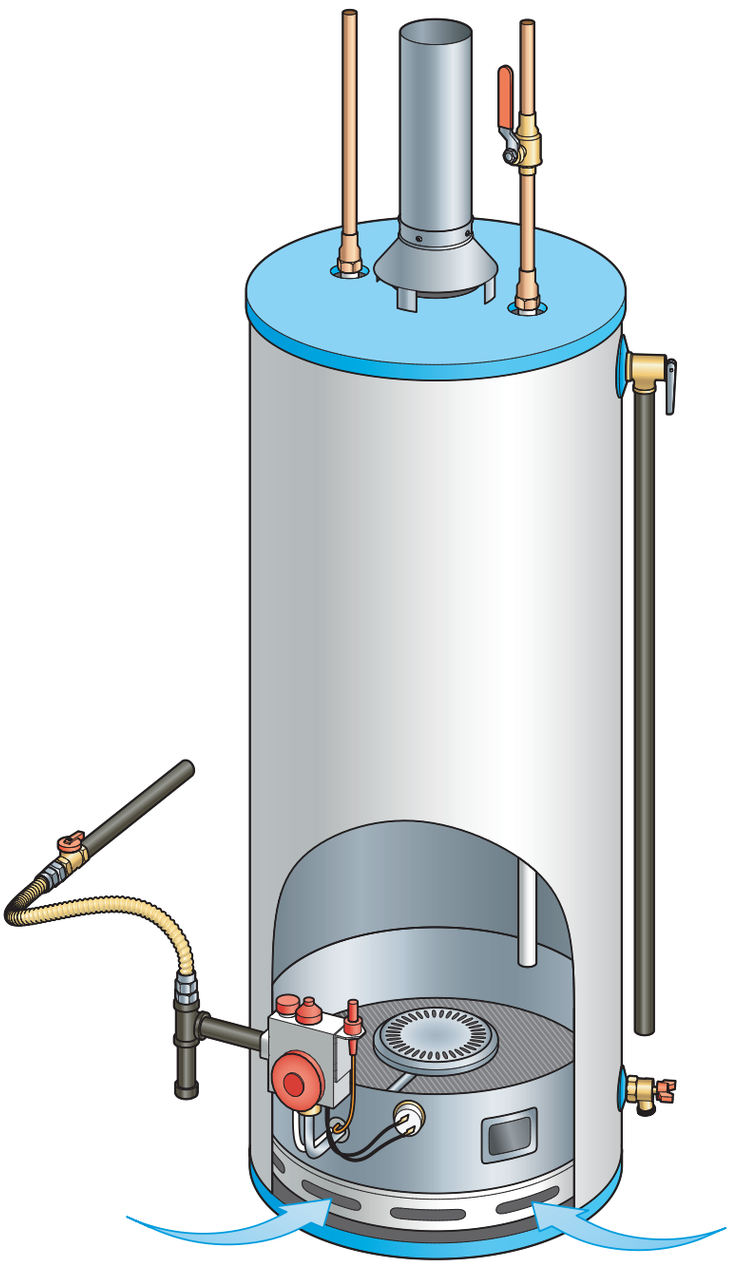
2. Measure the elevation distance to the ignition source in the equipment, not to the bottom of the equipment (unless the ignition source is at the bottom of the equipment).

3. You may install appliances on the floor in rooms that are adjacent to a garage but do not have an opening into the garage.

4. You are not required to elevate the ignition source of flammable vapor ignition resistant (FVIR) gas water heaters. All new gas water heaters are FVIR (and have been for many years).

Protection of Appliances from Vehicles

1. Protect HVAC appliances and water heaters from vehicle impact. The appliance or water heater does not need to be located in a garage or carport to qualify for protection from vehicle impact. General codes do not specify how to provide this protection. Common protection methods include steel poles called bollards, vehicle tire stops, and encasing the equipment in substantial framing.



Appliances, such as water heaters, that are installed in a garage must have the ignition source elevated at least 18" off the floor.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:113

HVAC Appliance & Duct Sizing

Appliance Sizing

1. Size heating and cooling appliances according to The Air Conditioning Contractors of America (ACCA) Manual S or a similar approved method. Manual S and Manual J account for conditions such as the direction the structure faces, the size and type of windows and doors, local temperature conditions, and insulation. Contractors should provide a copy of the sizing calculations for all new construction and when replacing existing appliances. Improper appliance sizing may cause inefficient appliance operation or may allow excessive moisture to remain in the home. Excessive moisture can damage the home and provide moisture for mold growth.

Duct Design

1. Design duct systems according to ACCA Manual D or a similar approved method. Contractors should provide a copy of the duct design calculations for all new construction. Improper duct sizing and installation can cause inefficient appliance operation and can cause uneven temperatures in the home.

Air Conditioner Condensate Disposal

The process of removing heat from the air is often called air conditioning. Water is a byproduct of air conditioning, because water vapor condenses out from the air when the air temperature is reduced. In areas with high humidity, air conditioning can produce significant amounts of water. The water removed from the air during air conditioning is called condensate.

Condensate Disposal Location Requirements

1. Do not discharge condensate onto a street, alley, or any other place that would create a nuisance. Some jurisdictions, particularly in warm, moist areas, require that you discharge condensate away from the foundation. Verify discharge location requirements with the local building official.

Condensate Discharge Pipe Requirements

1. Use at least ¾-inch-diameter pipe for primary and auxiliary condensate discharge pipes. Do not decrease pipe size between the collection and discharge point.

2. Install horizontal pipe sections with a uniform slope in the direction of the discharge point of at least ⅛ inch in 12 inches.

3. Use fittings, primers, cements, hangers, and other components that are compatible with the pipe material. Install the pipe according to the provisions in general codes.

4. Use pipe material use a pipe size that will accommodate the condensate temperature,

Condensate from air conditioner units should be directed to a drain through discharge pipes. NOTE: Due to acidity, avoid draining condensate to floor drain in older homes with cast iron sewer lines.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:114

pressure, and flow rate produced by the air conditioning system.

5. Install a trap in the primary condensate discharge pipe according to the appliance manufacturer's instructions. The minimum trap depth is often about 2 inches.

6. You may use most water supply and drain pipes for condensate discharge pipes. The most common condensate discharge pipes are PVC, CPVC, and ABS.

7. Connect a condensate pump to the appliance it serves so that the appliance will not operate if the pump will not operate. This applies to pumps located in spaces such as attics and crawlspaces.

Condensate Auxiliary (Backup) System Requirements

1. Install an auxiliary condensate system when the air conditioner evaporator coil is located where building damaage may occur if the primary condensate discharge system malfunctions. This usually applies to evaporator coils installed in or above finished space. Many jurisdictions require auxiliary condensate systems for all air conditioning systems, unless all of the equipment is located outside the building.

2. Install one of the following auxiliary condensate systems when an auxiliary condensate system is required: (a) **Install an auxiliary drain pan** under the evaporator coil. Use a pan that is at least 1½ inches deep and at least 3 inches larger than the evaporator coil in both length and width. Construct the pan using either at least 0.0276-inch galvanized sheet metal or at least a 0.0625-inch, nonmetallic pan. Slope the pan toward the discharge pipe connection. Install the auxiliary discharge pipe using the same materials and methods as the primary discharge pipe. Terminate the auxiliary discharge pipe at a conspicuous point so that the occupants can see when the primary condensate discharge system is not functioning properly (a conspicuous point often means above a window). (b) **Install a water level cutoff switch** above the primary condensate discharge pipe where it connects to the evaporator coil and below the evaporator coil interior condensate pan overflow rim. Or, you may install the switch in the primary or secondary discharge pipes. The switch location should allow the switch to shut off the air conditioner before water overflows into the building.

MAINTENANCE TIP: KEEP DISCHARGE TUBES CLEAR

Condensate discharge tubes that run from your air conditioner evaporator have a strong tendency to become clogged with mildew, algae, bacteria, and other unappealing nuisances. To prevent clogging, flush the discharge tube every couple of months with a solution of 2 tablespoons household chlorine bleach dissolved into a cup of hot water.

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305471 - B&D Codes for Homeowners 4th Edition Edition_108-123.indd 115 1/10/18 11:41 AM
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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:115

HVAC Duct Installation

Improper duct installation and duct damage are common problems. Ducts that leak, have sharp bends, or sag reduce the volume of air that moves through the duct and increase the friction between the air and the duct walls. This causes the HVAC system to work harder and longer than necessary, wasting energy and money.

Flexible HVAC Duct Installation

General Installation Requirements

1. Install flexible ducts according to manufacturer's installation instructions. The installation instructions that follow are based on material from the Air Diffusion Council. The full, original version may be downloaded from their website (see Resources, page 234).

2. Use flexible ducts that are labeled at least every 36 inches with information, such as the manufacturer's name and the R-value of the duct insulation.

3. Do not expose flexible ducts to direct sunlight, such as may occur under roof vents. Direct sunlight can damage the duct outer cover.

4. Extend flexible duct to its full length. Do not leave excess duct material in a duct run, and do not compress the duct.

Duct Support

1. Support flexible ducts using material at least 1½ inches wide. You may support flexible ducts on 1½-inch-wide framing.

2. Support flexible ducts at not more than 4-foot intervals. You may use a fitting or distribution plenum to provide initial flexible duct support.

3. Do not allow flexible duct to sag between supports more than ½ inch per foot.

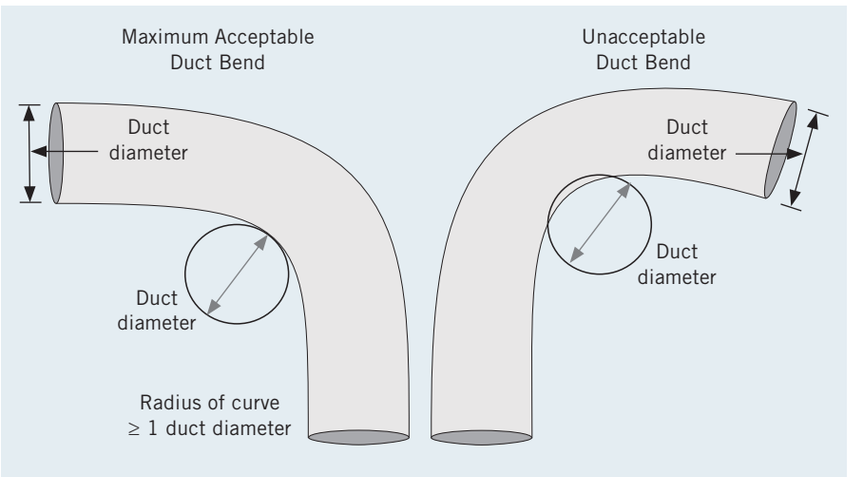
4. Support bends in long horizontal runs of flexible duct at not more than one duct diameter on both sides of the bend.

5. Support bends in flexible duct that occur near the plenum connection. Allow flexible ducts to run at least several inches beyond a plenum connection before making a bend.

6. Provide independent support for duct fittings and distribution plenums. Support duct fittings at not more than 1 foot from the fitting.

7. Support vertical runs of flexible duct at more than 6-foot intervals.

Flexible ductwork may not be bent at an overly tight angle. The radius of any curved bend should be no less than the diameter of the duct.



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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:116

Intervals between supports (hangers) for flexible HVAC ductwork can be no more than 4' apart.

Duct Bends

1. Do not bend flexible ducts at sharp angles across obstructions, such as framing lumber and pipes. Such bends reduce the duct area and restrict air flow.

2. Do not bend flexible ducts so that the bend radius at the centerline is less than one duct diameter.

3. Avoid changing the shape of the duct. The area of a round duct is greater than the area of the same duct compressed into an ellipse.

Duct Connections & Splices

1. Connect and splice ducts according to manufacturer's instructions.

2. Connect flexible ducts to metal collars that are at least 2 inches long.

3. Splice two ducts together using a metal sleeve at least 4 inches long.

4. Use approved clamps and tape to secure nonmetallic flexible ducts to metal collars and sleeves.

5. Use approved tape and mastic to seal duct collars, plenums, and other fittings to ensure minimum air leakage.

Duct Insulation & Sealing

1. Insulate HVAC supply ducts located in attics to at least R-8. Insulate all other ducts to at least R-6.

2. You are not required to insulate ducts that are completely within conditioned space.

3. Seal ducts, furnaces, air handler, filter boxes, junction boxes, and fittings.

4. Verify duct and air handler sealing with a duct pressure test. You may perform this test during rough-in or after final installation of the HVAC system. Refer to the IRC for test requirements.

5. Do not use framing cavities, such as stud walls and floor framing, as HVAC ducts or plenums.

Prohibited Sources for Return & Outdoor Air

Prohibited Sources of Return Air

1. Do not locate a return air register in a closet, bathroom, toilet room, kitchen, garage, mechanical room, furnace room, or an unconditioned attic.

2. Do not locate a return register closer than 10 feet in any direction to an open combustion chamber or to a draft hood-equipped appliance. Common examples of these prohibited sources include a fireplace and a water heater.

3. Do not take more return air from a room or a space than is supplied to that room or space.

Prohibited Sources of Outdoor Air

1. Locate outdoor air intake openings connected to forced-air heating and cooling systems at least 10 feet horizontally from contaminant sources, including gas equipment vents, chimneys, plumbing vents, or the discharge outlet of an exhaust fan.

2. You may locate outdoor air intake openings closer than 10 feet horizontally to a contaminant source if the outdoor air intake opening is at least 3 feet below the contaminant source.

3. Do not locate outdoor air intake openings where objectionable odors, fumes, or flammable vapors may be present.

4. Locate outdoor air intake openings at least 10 feet above a public walkway or driveway.

5. Do not locate outdoor air intake openings at grade level next to a sidewalk, street, alley, or driveway.

6. Provide an automatic or gravity-operated damper for air intake systems that will close the damper when the system is not operating.

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305471 - B&D Codes for Homeowners 4th Edition Edition_108-123.indd 117 1/10/18 11:41 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:117

Combustion Air for Fuel-Burning Appliances

Fuel-burning appliances, such as gas furnaces, boilers, and water heaters, need air to support the fuel-burning (combustion) process. These appliances also need air for cooling, ventilation of the appliance, and for proper operation of the vent system that expels combustion byproducts outside. The air required to support operation of fuel-burning appliances is called combustion air.

Without adequate combustion air, incomplete fuel combustion may occur. Byproducts of incomplete fuel combustion can include carbon monoxide and soot that can damage the appliance and its vent. This is a health and safety hazard. Appliances operating without adequate combustion air can cost more to operate and maintain.

Do not confuse combustion air with the similar term "makeup air." Makeup air replaces air that is exhausted by clothes dryers, exhaust fans, fireplaces, and similar devices.

Fuel for appliances (natural gas, propane, fuel oil) requires an adequate supply of fresh combustion air for efficient burning, as well as a means of effective venting.

Appliances Needing Combustion Air

1. Provide combustion air for Category I gas appliances and for liquid fuel-burning (oil) appliances according to the appliance manufacturer's recommendations and to code requirements. Category I gas appliances include the gas furnaces and water heaters found in most homes.

2. Provide combustion air for direct vent and for Category II, III, and IV gas appliances according to the appliance manufacturer's instructions. Do not apply combustion air requirements to these appliances. Category II appliances do not currently exist. Category III and IV appliances include medium and high-efficiency gas appliances that operate with positive vent pressure.

3. Do not apply combustion air requirements to fireplaces and fireplace stoves. Refer to other general codes for fireplace combustion air requirements.

COMBUSTION AIR DEPLETION BY OTHER SYSTEMS

Other appliances compete with gas- and oil-burning appliances for combustion air. This can create negative pressure that can interfere with operation of the gas- and oil-burning appliances and their vents. General codes do not define how to account for air exhausted by other appliances. Gas- and oil-burning appliances located in or near rooms containing clothes dryers, exhaust fans, and fireplaces require special attention to ensure that combustion air and venting needs are satisfied.

Account for air exhausted by appliances (such as clothes dryers, bathroom and kitchen exhaust fans, fireplaces), and account for combustion air used by other fuel-burning appliances when determining combustion air requirements. This is important when drawing all combustion air from inside the home.

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305471 - B&D Codes for Homeowners 4th Edition Edition_108-123.indd 118 1/10/18 11:41 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:118

Combustion Air Duct Materials & Construction

1. Use galvanized steel to construct combustion air ducts. Refer to other general codes for duct material specifications.

2. You may use unobstructed stud and joist spaces as combustion air ducts if only one required fireblock is removed.

3. Terminate combustion air ducts in unobstructed space that allows free air movement.

4. Do not open combustion air ducts into more than one room or enclosure.

5. Do not use the same combustion air duct for both the upper and lower duct openings.

6. Do not install a screen on any combustion air duct opening in the attic.

7. Do not slope horizontal combustion air ducts downward toward the source of combustion air. Make the duct level or slope it toward the appliance.

8. Do not use the space in a masonry, metal, or factory-built chimney that surrounds a chimney liner, gas vent, plastic piping, or other devices as a combustion air duct.

9. Locate the lowest point of an exterior combustion air opening at least 12 inches above exterior grade.

AIRTIGHT CONSTRUCTION

Homes built using airtight construction techniques do not allow enough air infiltration into the home to safely support fuel combustion. The lack of adequate combustion air can cause many problems, including the production of carbon monoxide and soot that can be a health hazard and can damage appliances and vents. Do not draw combustion air from inside the home if it is built using airtight construction techniques. You'll need to bring it in from outdoors. Even when drawing combustion air from inside is allowed, it is not considered best practice. You should consider direct-vented appliances that draw combustion air from outdoors when replacing existing appliances.

Although most homes built today use some energy-efficient construction techniques, few are so tight that they are considered "airtight" and therefore require supplementary combustion air. To be considered airtight, a home must have measured air changes that are less than 0.4 per hour. You'll need to contact a qualified building energy analyst to determine whether your house meets this standard, but here are some hints:

- If your home is airtight, the thermal envelope walls have a continuous air barrier and any openings in the air barrier are sealed.
- Doors and operable windows meet air leakage requirements of the International Energy Conservation Code.
- Gaps and spaces are sealed—including gaps and spaces between windows and doors and the surrounding framing, between sill plates and floors, between wall and ceiling joints, between wall panels, and at wall penetrations for utilities, such as plumbing, electrical, and gas.

Windows that meet air leakage requirements should come with a rating label from a sanctioned source. Among these sources are the International Energy Conservation Code and the National Fenestration Rating Council, which employs the California Energy Commission standards for air infiltration.

Older homes rarely satisfy these requirements. Newer homes may satisfy the first two requirements, but it is still rare for some builders to seal all framing and utility penetration gaps as intended by the third requirement. Many homes may obtain combustion air from inside the home, but you should verify with the builder if the home was built using airtight construction techniques.

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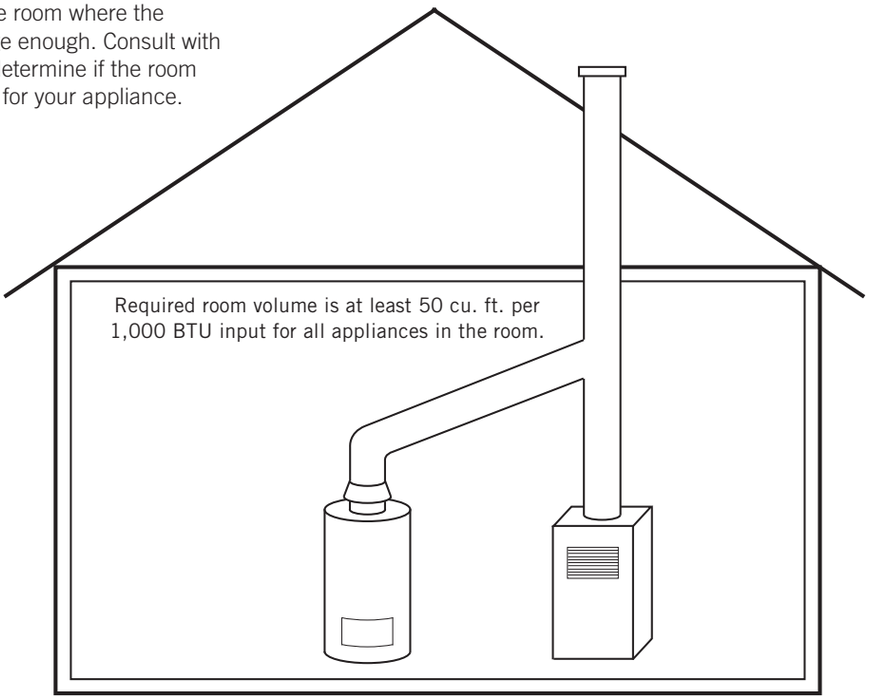
305471 - B&D Codes for Homeowners 4th Edition Edition_108-123.indd 119 1/10/18 11:41 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:119

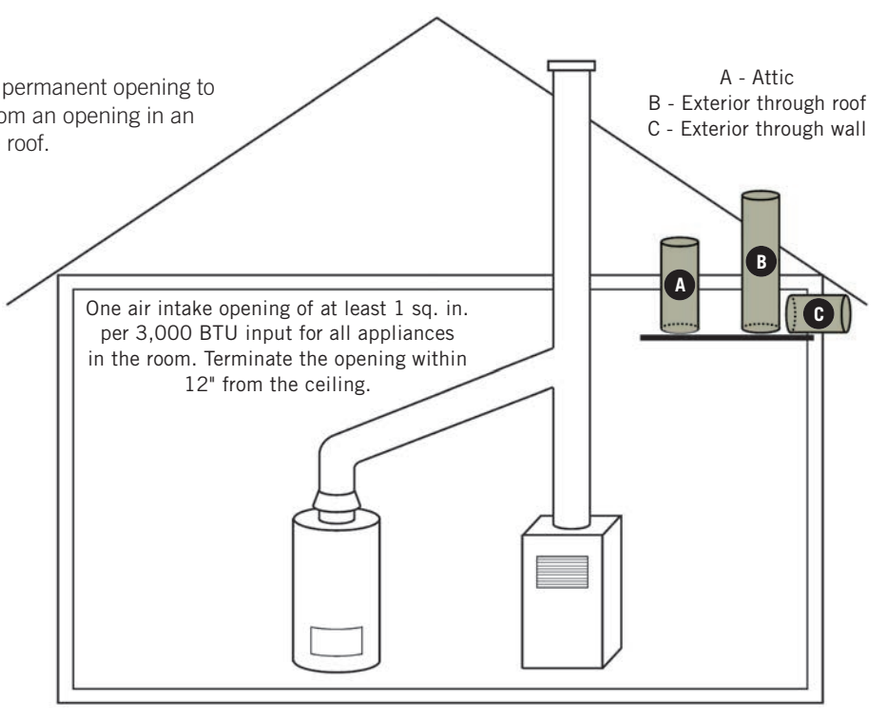
Combustion Air from Within a Room

Combustion air may be drawn from the room where the appliance is located if the room is large enough. Consult with an engineer or inspector to help you determine if the room meets the minimum size requirement for your appliance.



Combustion Air Using One Permanent Opening to Outdoors

Import combustion air by creating one permanent opening to the outdoors. To do this, draw air in from an opening in an exterior wall or from an opening in the roof.



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305471 - B&D Codes for Homeowners 4th Edition Edition_108-123.indd 120 1/10/18 11:41 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:120

Vents for Fuel-Burning Appliances

A vent is generally a vertical component, such as a metal pipe, that conducts combustion products from a gas- or oil-burning appliance to the outdoors. A vent for a single appliance begins at the fitting where the vent connector, if any, connects to the vent. A common vent for multiple appliances begins at the highest connector fitting. If a vent is located directly over the appliance draft hood or flue collar, or if the vent connects directly to the appliance, then the vent begins at the appliance and there is no vent connector.

A vent connector is a pipe that connects an appliance to its vent or flue. A vent connector is required if the appliance is not located directly under its vent. A vent connector for a Category I gas appliance may be a listed vent material, such as a Type B vent; a listed flexible vent connector; or a field-constructed, single-wall metal pipe made of at least 28-gauge galvanized steel. While a vent connector is part of the venting system, it is not the vent itself.

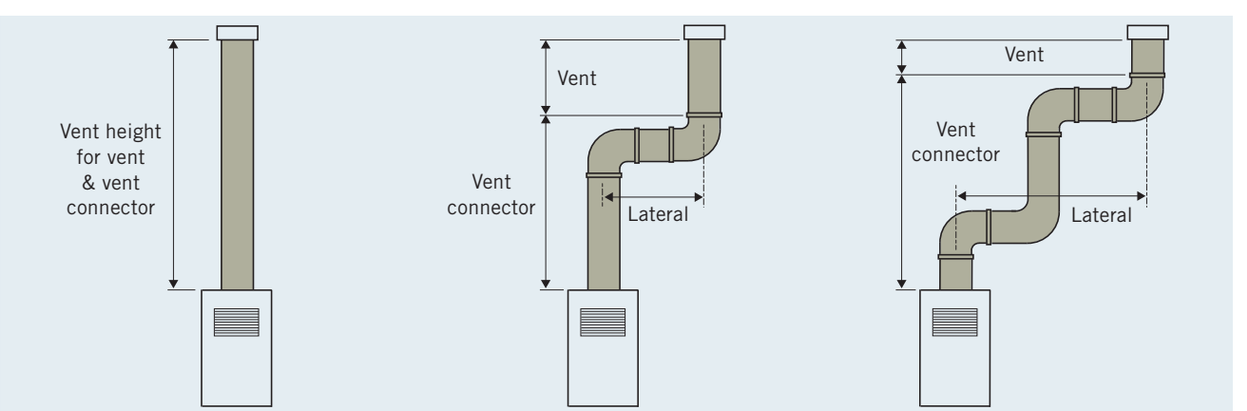
Common types of vents and vent connectors include the Type B vent used with most gas appliances, Type L vents used with oil-burning appliances, flexible connectors used with gas appliances, and single-wall connectors that may be used with either gas or oil-burning appliances.

The material in this section deals with vents for low- and medium-efficiency appliances. Fewer of these appliances are being installed in favor of high-efficiency appliances and appliances with special venting requirements. Examples of special-vented appliances include high-efficiency gas furnaces (vented with plastic pipe), sidewall-vented appliances, and appliances using positive pressure vent systems. Do not apply the material in this section to special-vented appliances.

Venting of special-vented appliances is governed by the appliance manufacturer's instructions. These instructions will vary by manufacturer and by appliance model. Thus, the only way to determine if a special-vented appliance vent is installed properly is to compare the appliance vent installation to the instructions for the appliance in question.

Vents for special-vented appliances are frequently improperly installed. Proper vent (and combustion air) installation is important for proper and safe appliance operation. It is a good idea to evaluate and confirm vent installation for special-vented appliances.

Vent connectors and fittings include: (A) Single wall-vent connector; (B) Type B elbow; (C) Type B vent; (D) Type L vent; (E, F) vent caps.



Vents and vent connectors often look the same, but they have different installation requirements.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:121

Vent Clearance to Combustible Materials

1. Provide the distance between a vent or a vent connector and combustible materials based on the vent or vent connector manufacturer's installation instructions and based on the appliance manufacturer's installation instructions. Table 24 contains typical clearance distances for common types of vents and vent connectors. Confirm the distances in Table 24 with the appliance manufacturer's instructions and the vent manufacturer's instructions.

Avoid fires by maintaining distance between vents and combustible materials.

Vent Clearance to Roof & Obstructions

1. Terminate a Type L vent at least 2 feet above the roof and at least 2 feet above any part of the home within 10 feet of the vent. Measure termination height above the roof from the highest point where the vent penetrates the roof to the bottom of the vent cap.

2. Terminate a masonry chimney at least 3 feet above the roof and at least 2 feet above any part of the building within 10 feet of the chimney. Measure termination height above the roof from the highest point where the chimney penetrates the roof to where the flue exits the chimney. This provision also applies to many factory-built chimneys. Confirm factory-built chimney termination height using the manufacturer's installation instructions.

3. Use Table 25 to determine the minimum height above the roof of a Type B gas vent not more than 12 inches in diameter. Measure termination height above the roof from the highest point where the vent penetrates the roof to the bottom of the listed cap. For thick roof-covering materials, such as tile, measure from the tile to the bottom of the listed cap.

4. Do not use Table 25 if a Type B vent is closer than 8 feet to a vertical side wall, gable end, or similar vertical obstruction. Terminate these vents at least 2 feet higher than the highest point where the vent penetrates the roof and at least 2 feet higher than any part of the roof or building within 10 feet horizontally.

5. Terminate all vents and chimneys at least 8 feet horizontally from operable windows unless the vent is at least 3 feet above the window.

6. Do not install a vent terminal where a door can swing within 12 inches horizontally from the vent terminal. This will apply mostly to direct vent terminals.

7. Do not install a decorative shroud or surround at a vent termination unless the shroud or surround is listed for use with the specific venting system and unless the shroud or surround is installed according to manufacturer's instructions. This prevents an unlisted shroud from interfering with the drafting characteristics of the vent system.

TABLE 24: TYPICAL CLEARANCE DISTANCES TO COMBUSTIBLE MATERIALS FOR COMMON TYPES OF VENTS & VENT CONNECTORS

VENT OR CONNECTOR TYPE	APPLICATION	TYPICAL CLEARANCE DISTANCE
Type B vent & vent connector	Category I gas appliance	1"
Type L vent & vent connector	Oil-burning & Category I gas appliance	3"
Single-wall vent & vent connector	Category I gas appliance	6"
Single-wall vent & vent connector	Oil-burning appliance listed for Type L vent	9"

305471 - B&D Codes for Homeowners 4th Edition Edition_108-123.indd 122 1/10/18 11:42 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_108-123.indd 122 1/10/18 11:41 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:122

Joints Between Vents & Vent Connector Sections

1. Secure joints between the vent or vent connector and the flue collar or draft hood, vent or vent connector sections, and vent connector and the vent using (a) sheet metal screws (usually three); (b) listed, interlocking vent material (such as Type B vent) connected according to the vent manufacturer's instructions; or (c) other approved means.

Slope of Vents & Vent Connectors

1. Slope vents and vent connectors up toward the roof termination at least ¼ inch per foot. Do not allow any dips or sags in the vent or vent connector.

Appliances Not Requiring a Vent

1. You are not required to vent the following gas appliances: (a) ranges and other domestic cooking appliances listed and labeled for optional venting; (b) domestic (Type 1) clothes dryers; (c) portable, countertop, and similar small kitchen and laundry appliances; (d) gas-fueled refrigerators; (e) listed, unvented room heaters; and (f) listed, unvented decorative gas appliances (unvented gas fireplaces).
2. Verify venting requirements using manufacturer's instructions. Some manufacturers of appliances such as unvented gas fireplaces recommend limiting the duration of use and/or opening a window while the appliance is operating.

TABLE 25: TYPE B GAS VENT HEIGHT ABOVE ROOF

ROOF PITCH	MIN. VENT HEIGHT
Flat to 6/12	12"
Over 6/12 to 7/12	15"
Over 7/12 to 8/12	18"
Over 8/12 to 9/12	24"
Over 9/12 to 10/12	30"
Over 10/12 to 11/12	39"
Over 11/12 to 12/12	48"
Over 12/12 to 14/12	60"
Over 14/12 to 16/12	72"
Over 16/12 to 18/12	84"
Over 18/12 to 20/12	90"

A gas vent roof terminator cap protects the vent from moisture and pests. These caps are designed so they do not impede or restrict air flow.

SAFETY TIP

Always have combustion vent installations diagnosed and inspected by a qualified professional.

305471 - B&D Codes for Homeowners 4th Edition Edition_108-123.indd 123 1/10/18 11:42 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_108-123.indd 123 1/10/18 11:41 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:123

305471 - B&D Codes for Homeowners 4th Edition Edition_124-167.indd 124 1/10/18 11:55 AM
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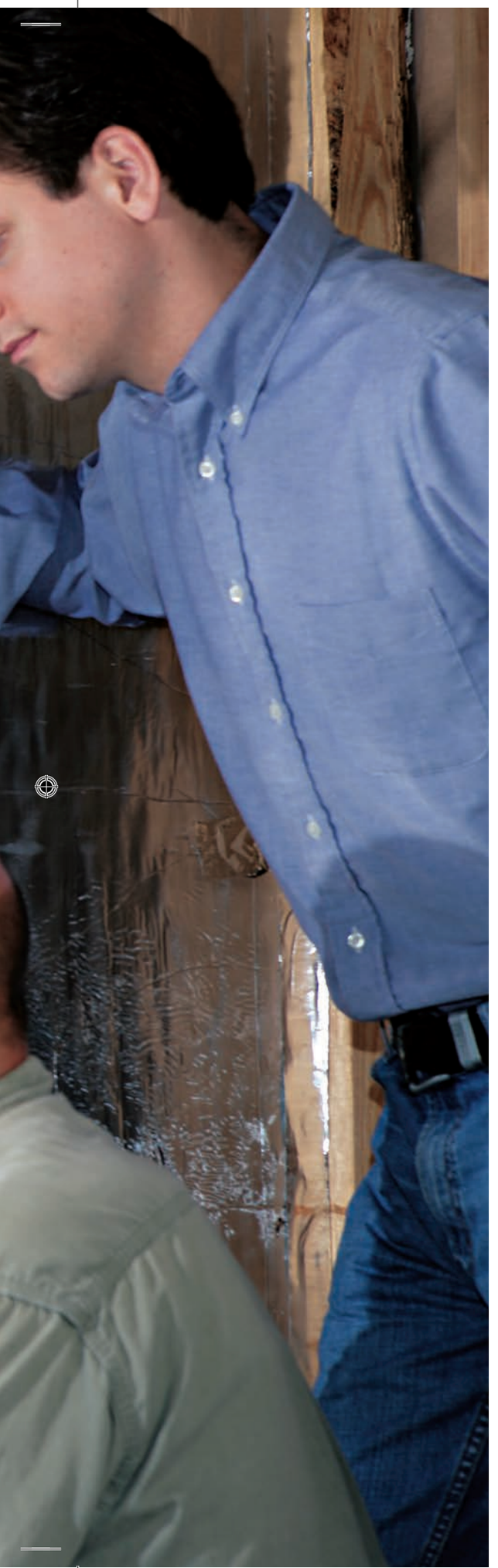
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:124



Plumbing System

Plumbing projects are popular among do-it-yourselfers, so naturally there's a strong demand for information on home plumbing subjects to make sure home projects are accomplished correctly. Water supply pipes must be properly sized, supported, and connected to avoid water leaks and low water flow at fixtures.

Wastewater drain pipes must be properly installed to avoid water leaks and sewage backups. Traps and vents must be correctly hooked up in drain lines.

Finally, in this chapter you'll learn basic requirements for installing water supply pipes and water drain and vent pipes, as well as for installing common plumbing fixtures, such as water heaters, faucets, tubs, and showers.

In this chapter:

- The Home Plumbing System
- Water Supply Piping
- Drain, Waste & Vent Piping (DWV)
- Plumbing Vents
- Plumbing Traps
- Plumbing Appliances & Fixtures

305471 - B&D Codes for Homeowners 4th Edition Edition_124-167.indd 125 1/10/18 11:55 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_124-167.indd 125 1/10/18 11:43 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:125

DEFINITIONS OF PLUMBING TERMS

Air admittance valve: An air admittance valve (AAV) is a one-way valve attached to a plumbing vent pipe. It is used when extending a vent to the roof or to another vent is impractical or not desirable. The valve allows air into the vent system when there is negative pressure in the vent pipe and closes to limit the flow of sewer gas into the home.

Branch drain: A branch drain is a drainage pipe that takes soil and waste from fixture drains to a stack or to the building drain.

Branch vent: A branch vent connects other vents, usually individual and common vents, to a vent stack or stack vent.

Braze (brazing): A method of joining metal pipe (such as copper and brass) at temperatures exceeding 1,000 degrees Fahrenheit. Brazing is sometimes called "silver soldering," because it uses a silver alloy as the brazing material. Brazed joints are stronger than soldered joints.

Building drain: The building drain is usually the lowest horizontal drainpipe in the building and collects material from branches and stacks. It extends to 30" beyond the foundation, where it connects with the building sewer. A building with fixtures below the building drain (such as in a basement) has a building sub-drain. Material in a sub-drain must be pumped up to the building drain.

Building sewer: Building sewer usually refers to the pipes beginning at the building drain and ending at the public sewer or septic tank.

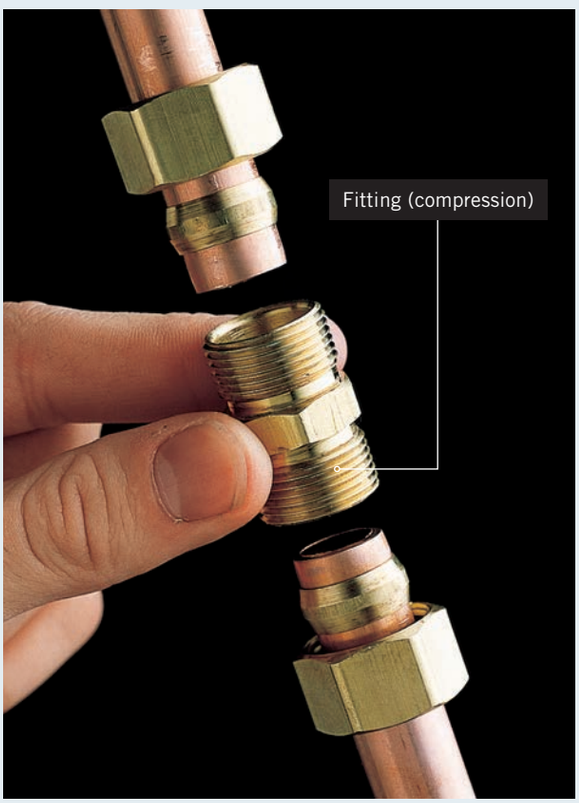
Drainpipe: Drainpipe usually refers to the pipes inside the building that take soil and waste to the building sewer pipe.

Fittings: These are devices that connect parts of the plumbing system together and allow pipes to change direction. Drainage fittings include wyes, sweeps, bends, tees, and couplings. Water supply fittings include elbows, tees, couplings, and valves.

Fixture: Any device that connects to water supply pipes and connects to plumbing waste pipes is a fixture. Fixtures include toilets (water closets), bathroom sinks (lavatories), kitchen and laundry sinks, bathtubs, and showers.

Fixture drain: This horizontal pipe between a trap outlet and the fitting connects it to another drain pipe. A fixture

The AAV has been endorsed as a substitute for exterior vent termination by most codes.



The general term "fitting" is for any device from any material that is used to connect plumbing pipes. A brass compression fitting for copper supply pipe is shown here.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:126

The fixture drain, or trap arm, is a piece of drain tubing that connects a fixture and its drain line to the drain stub-out in the wall or floor.

An indirect waste receptor collects drain water from a source and introduces it to the drain system, but it is not connected directly to the wastewater source. Floor drains (above) are common indirect receptors.

The hub is the enlarged fitting, usually in cast-iron drain pipe. The spigot is the end of the pipe that fits into the hub.

drain is sometimes called a "trap arm." Any pipe after the fixture drain fitting is not part of the fixture drain.

Hub: An enlarged opening molded on the end of a pipe or a fitting into which a section of pipe (the spigot) is inserted is a hub. In older plumbing, cast-iron hubs and spigots were sealed with oakum or hemp and lead. In modern plumbing, you may seal cast-iron hubs and spigots with an elastomeric O-ring gasket, or you may remove the hub and convert the pipe into a hubless pipe. Hubless pipe joints are often sealed by an elastomeric sleeve held in place by stainless steel rings (also called a banded coupling).

Laundry tray: A sink, usually located in a laundry area, used for various laundry-related and other purposes, is also known as a laundry sink or a deep sink. You may discharge a clothes washing machine into a laundry tray instead of a standpipe.

Offset: In a vertical drainpipe (drain stack), offsets change in direction in the pipe from vertical to an angle other than vertical, then back to vertical. Offsets are most often used to run a stack around an obstruction (such as a wall or beam) that cannot be drilled or notched. An offset that is not more than 45 degrees from vertical is defined to be vertical.

Receptor (indirect waste): The term receptor refers to a device such as a floor sink or a floor drain. Indirect waste receptors have a source of water that is not directly and permanently connected to the receptor. Example: a floor drain could receive condensate water from an air conditioning system. The condensate drain is not directly and permanently connected to the floor drain.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:127

DEFINITIONS OF PLUMBING TERMS

Install slip joints only on accessible traps.

Saddle fitting: A saddle fitting is a connection between pipes where a new pipe is attached to an existing pipe by puncturing the existing pipe and clamping the new pipe to the existing pipe. Saddle fittings are prohibited on water supply pipes, but are sometimes used to tap existing water supply pipes for low volume applications, such as refrigerator ice-makers and reverse osmosis water treatment systems. Saddle fittings are also prohibited in drainage pipes, but are often used in low volume applications, such as reverse osmosis water treatment system discharge tubing connection to trap arms.

Slip joint: A hand-tightened joint installed on tubular waste pipes between a fixture outlet and waste pipes. Slip joints are most common at the inlet and outlet sides of traps. Slip joints allow easy removal of the trap for cleaning. Slip joints must be accessible by an opening at least 12" in the smallest dimension.

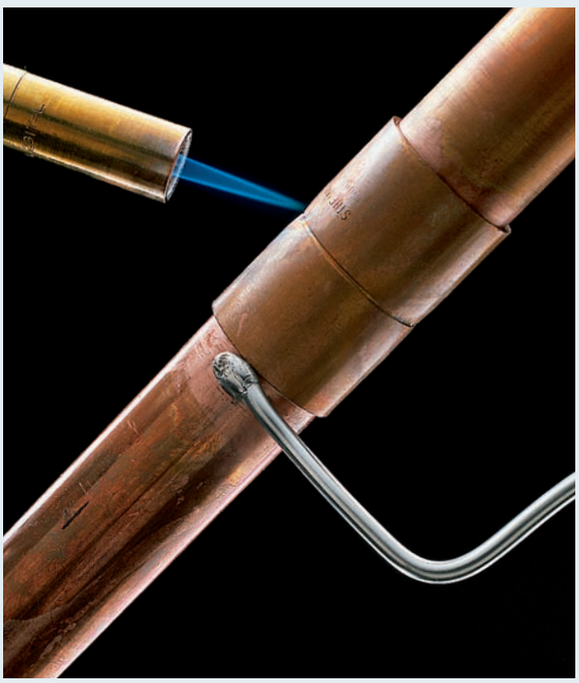
Soil: Material in the plumbing drainage system that contains urine or fecal material.

Solder (soldering): A method of joining metal pipe (such as copper and brass) at temperatures that do not exceed 800 degrees Fahrenheit. Soldering usually uses a tin alloy as the joining material. Soldered joints are weaker than brazed joints.

Stack: A stack is a vertical plumbing drain or waste pipe that extends one or more stories. A stack collects waste material from horizontal drainage pipes and conducts it to the building drain or other horizontal drain.

Stack vent: A dry vent that connects to a soil or waste stack above the highest horizontal drainage connection and may extend through the roof to the outdoors or may terminate with a stack-type air admittance valve.

Saddle fittings are prohibited on drainage pipes, but they are sometimes used in low volume applications such as this water filter discharge tube. Ask your building department if saddle fittings are allowed in your area.



Soldering is a technique, often called "sweating," that's used to join copper and brass tubing and fittings. It is weaker than brazing, but code approved for virtually all residential plumbing joints.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:128

Standpipe: A vertical pipe used as an indirect waste receptor. Standpipes are most often used as the receptor for a clothes washing machine.

Stop-and-waste valve: A water supply valve with an opening that allows draining of the non-pressure side. These valves are most common in cold climates and are used to protect exterior water fixtures from freeze damage.

Tailpiece: A tailpiece is a short piece of vertical pipe that runs from the plumbing fixture waste outlet (drain) to the inlet side of the fixture's trap.

Trap: A trap is a fitting, usually located either inside or under fixtures, that prevents sewer gases from escaping from the plumbing waste pipes. Traps maintain a water seal (trap seal) extending from the trap's crown weir to its dip. Vents help protect the water seal from siphoning.

Vent: Pipe or mechanical device that allows air into the plumbing drainpipes to equalize air pressure in the pipes. Plumbing vents help avoid draining (siphoning) traps and help wastewater flow freely through the system. Plumbing vents usually terminate on the roof, although mechanical vents (called air admittance valves) are allowed in some circumstances.

Vent stack: Dry vent that connects at or near the connection of a soil or waste stack and a horizontal drain. A vent stack runs vertically and often runs parallel to the soil or waste stack that it vents.

Yard hydrant (freeze proof): A freeze proof yard hydrant is an outdoor water supply outlet that has a valve and outlet aboveground and a drain opening below the frost level. When the valve is opened, water flows. When the valve is closed, the water supply to the hydrant is shut off below the frost level and a drain hole is opened that allows the water in the yard hydrant pipe to drain into a gravel bed. This drains the yard hydrant and its riser so that the hydrant will not freeze.

Waste: Liquid material in the plumbing drainage system that does not contain urine or fecal material. Waste is sometimes referred to as gray water. Waste comes from all plumbing fixtures except toilets and urinals.

A standpipe is an open pipe mounted vertically and leading into a branch drain system. Standpipes often are installed as receptors for washing machine discharge tubes.

Traps are the S- or P-shaped pipes in a fixture drain. Their purpose is to prevent sewer gas from coming up through the drain opening.

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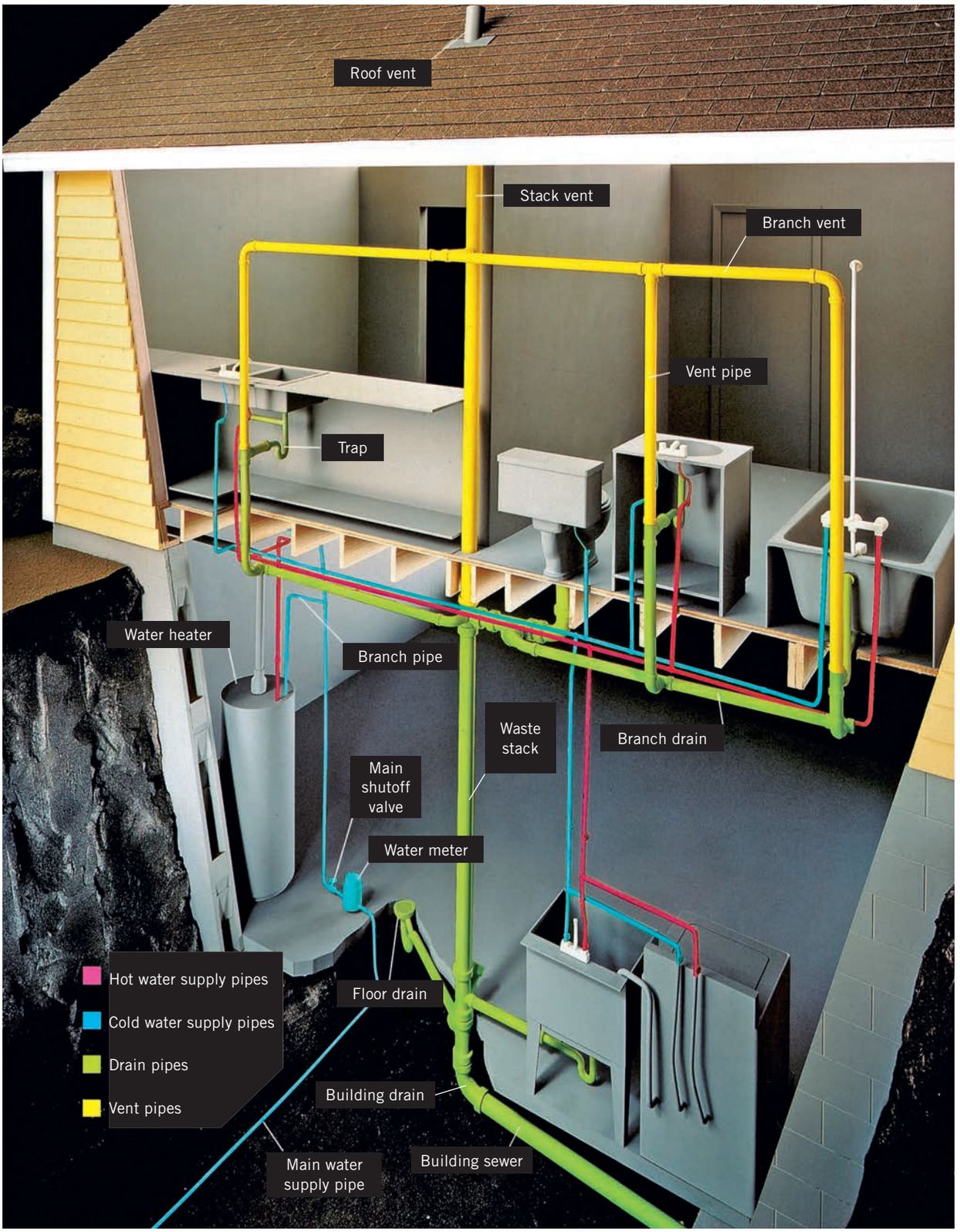
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:129

The Home Plumbing System



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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:130

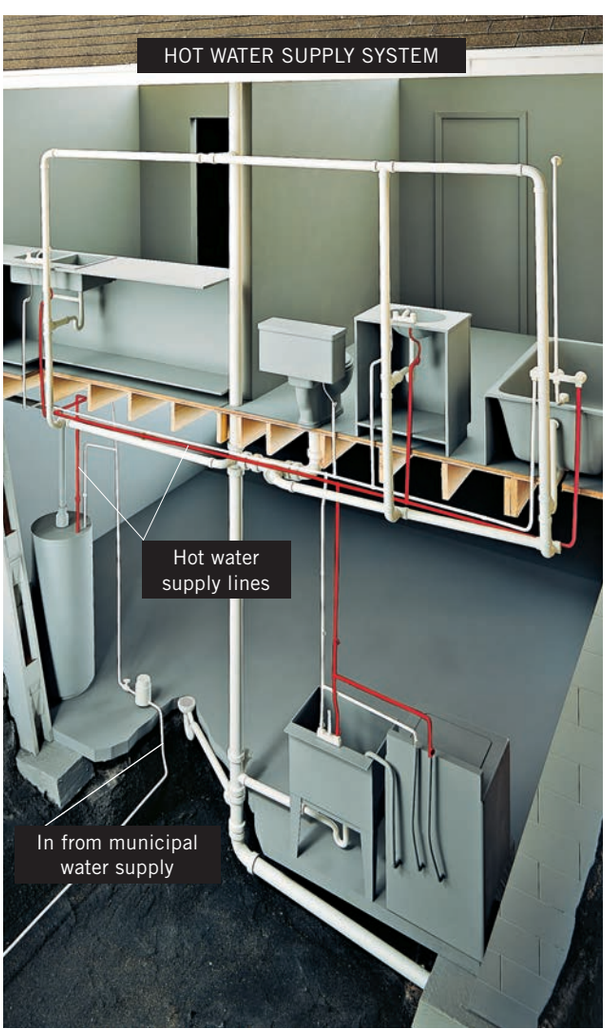
Water Supply Piping

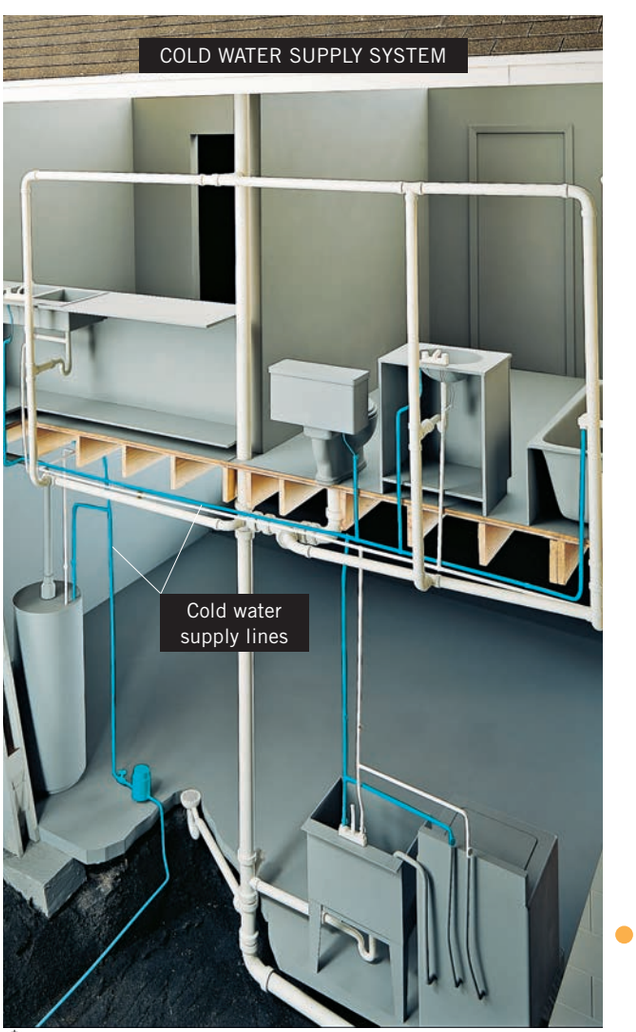
Water supply pipes carry hot and cold water throughout a house. In homes built before 1960, the original supply pipes were usually made of galvanized steel. Newer homes have supply pipes made of copper. In most areas of the country, supply pipes made of rigid plastic or PEX are accepted by local plumbing codes.

Water supply pipes are made to withstand the high pressures of the water supply system. They have small diameters, usually ½ inch to 1 inch, and are joined with strong, watertight fittings. The hot and cold pipes run in tandem to most parts of the house. Usually, the supply pipes run inside wall cavities or are strapped to the undersides of floor joists. They are sometimes run in the attic in warm climates.

Hot and cold water supply pipes are connected to most fixtures and appliances. Fixtures include sinks, tubs, and showers. Some fixtures, such as toilets and hose bibbs, are supplied only by cold water. Appliances include dishwashers and clothes washers. A refrigerator icemaker uses only cold water. Tradition and codes say that hot water supply pipes and faucet handles are found on the left-hand side of a fixture, with cold water on the right.

Because it is pressurized, the water supply system is prone to leaks. This is especially true of galvanized iron pipe, which has limited resistance to corrosion.





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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:131

Water Pressure vs. Water Flow

Water flow and water pressure are often confused. Water flow is the amount of water you can get from a full water pipe. Water pressure is the amount of force that the water exerts on the walls of a full water pipe. Once a pipe is full of water, a water pressure increase will not increase the water flow in the pipe. In fact, a water pressure increase beyond a certain amount will cause the pipe to burst. The ideal water pressure is between 40 and 60 pounds per square inch (psi).

Water flow is primarily a function of the size, type, and installation of water supply pipes and supply fixtures. You can achieve more flow in a larger pipe than you can in a smaller pipe. Different pipe materials, such as PEX and copper, have different flow rates for the same size pipe. Many current water supply fixtures have flow restriction devices that limit the water flow rate to conserve water.

Water pressure is primarily a function of the force behind the water as it enters the piping system. A system with too little water pressure may not provide sufficient water flow when multiple supply fixtures are being used. Too much water pressure, exceeding 80 psi, can cause premature failure of water supply pipes and fixtures. A pressure regulator is recommended to reduce excessive water pressure.

Install a pressure regulator when the water pressure exceeds 80 psi.

Minimum & Maximum Water Pressure

1. Provide each dwelling with enough water pressure to provide adequate water flow at all fixtures. There is no specific minimum water pressure. This applies to both public and private (well supplied) water supplies.

2. Do not exceed 80 psi static water pressure.

3. Install an approved pressure regulator at the main water supply connection to the dwelling if the static pressure exceeds the maximum. Measure the water pressure to the point where the water supply enters the building as closely as possible.

TABLE 26: MIN. WATER FLOW RATE AT FIXTURE SUPPLY PIPE

FIXTURE	MINIMUM FLOW RATE (GPM)
Bathtub	4
Bidet	2
Dishwasher	2.75
Hose bibb	5
Laundry tub	4
Lavatory	0.8
Shower	2.5
Sink	1.75

Minimum Flow Rate at Fixtures

1. Provide at least the water flow rate in Table 26 for the indicated fixtures. Water flow rate is measured in gallons per minute (gpm). Water flow rate means the water flow from the pipe without the fixture attached. The water flow rate in the table does not mean that the water flow from the fixture must be at least the amount in the table. Some fixtures contain required flow restrictors that will limit the actual water flow from the fixture to less than the water flow rate in the table. Example: the minimum water flow rate for a shower is 3 gallons per minute, but the maximum flow-restricted rate from the showerhead is 2.5 gallons per minute.

TABLE 27: MAX. WATER FLOW RATE AT FIXTURE

FIXTURE	MAXIMUM WATER FLOW RATE AT DESIGN PRESSURE
Lavatory	2.2 gpm at 60 psi
Shower head	2.5 gpm at 80 psi
Sink	2.2 gpm at 60 psi

Maximum Flow Rate at Fixtures

1. Use fixtures that allow a water flow rate that is not more than the flow rate in Table 27. Water flow rate is measured in gallons per minute (gpm). If either the water supply pressure to the building or the water pressure loss in the pipes reduces the water pressure at the fixture to less than the design pressure, the flow rate at a flow-restricted fixture may be less than the maximum.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:132

Common Water Distribution Pipes

1. Install water service pipe that has a working pressure rating of at least 160 psi at 73 degrees Fahrenheit or the highest available pressure, whichever is greater.

2. Common water distribution pipe materials used in modern residential construction include those in Table 28.

3. You may use other approved materials if allowed by local codes. Copper, CPVC, and PEX are the most common water distribution pipes.

TABLE 28: COMMON WATER DISTRIBUTION PIPE MATERIALS

COMMON WATER DISTRIBUTION PIPE MATERIALS	APPROVED FOR USE UNDER CONCRETE SLABS
CPVC plastic pipe	yes
Copper & copper alloy pipe & tubing	Copper tubing, minimum Type M
PEX-AL-PEX pipe	yes
PEX tubing	yes
PE-AL-PE pipe	yes

Water supply pipes include: copper, CPVC, and PEX (blue for cold, red for hot).

Fittings for water supply lines include: (A) CPVC tee, elbow and coupling; (B) copper tees and elbows; (C) brass compression fittings; (D) brass fittings, with barbs.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:133

Water Distribution Pipe Joints & Connections

1. Use fittings made from the same material as the pipe when connecting pipes made from the same material. Example: use copper fittings to connect copper pipe and CPVC fittings to connect CPVC pipe. Use solder or brazing to connect copper pipes. Use PVC cement and primer to connect CPVC pipes.

2. You may use flared fittings to make connections between soft copper water tubing and valves and fixtures. Use approved fittings and a flaring tool to form and connect these joints.

3. Use fittings and crimping tools approved by the tubing manufacturer when connecting PEX and other water supply materials to each other. Most homeowners should not attempt to install PEX and similar materials using these fittings and tools because this requires training and experience.

4. Use push-fit fittings only with copper tubing, CPVC, and PEX. Do not use push-fit fittings with other pipe and tubing, such as polybutylene.

5. You may use mechanical fittings to connect pipes made from the same materials and pipes made from different materials. Install the fittings according to manufacturer's instructions.

Flexible Water Connectors

1. Use flexible water connectors to connect water supply pipes to appliances and fixtures. Examples of proper uses of flexible water connectors: connecting water supply pipes and a water heater, connecting valves and a clothes washing machine or a dishwashing machine, connecting a refrigerator icemaker and a valve, and connecting a valve and a faucet.

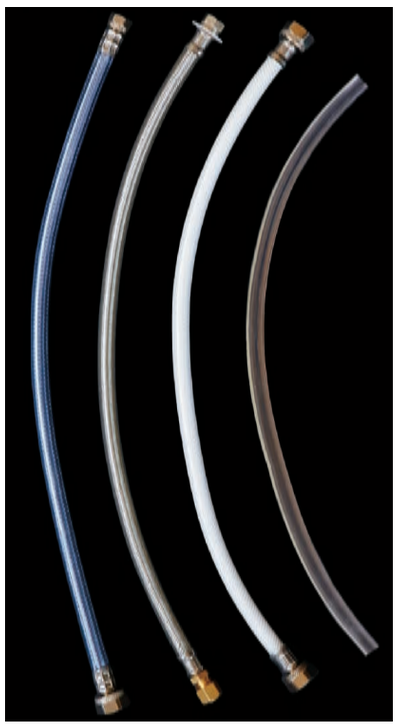
2. Use a flexible water connector that is approved for the application. Example: do not use a connector intended for a clothes washing machine to connect a water heater to the hot water supply pipe.

3. Do not run flexible water connectors through walls, ceilings, and floors or in concealed spaces.

4. Do not use flexible water connectors as a substitute for permanent water supply pipes.

Using fittings made from the same material as the pipe is the least expensive way to connect pipes.

Using mechanical fittings is a good (but more expensive) way for homeowners to connect different pipe types together and to connect pipes of the same type together.



Use flexible water connectors according to manufacturer's instructions. Avoid using plastic tubing. This material can burst and cause significant water damage.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:134

TABLE 29: PLUMBING PIPE SUPPORT, WATER SUPPLY & DWV PIPES

PIPE MATERIAL	MAXIMUM HORIZONTAL SPACING	MAXIMUM VERTICAL SPACING	MID STORY GUIDE REQ'D FOR PIPE DIA. ≤ 2"
ABS pipe	48"	120"	yes
Cast-iron pipe	60"*	180"	no
Copper tubing (≤ 1¼" dia.)	72"	120"	no
Copper tubing (≥ 1½" dia.)	120"	120"	no
CPVC pipe or tubing (≤ 1" dia.)	36"	120"	yes
CPVC pipe or tubing (≥ 1¼" dia.)	48"	120"	yes
Polybutylene (PB) pipe or tubing	32"	48"	no
PEX	32"	120"	yes
PEX-AL-PEX and PE-AL-PE	32"	48"	yes
PVC pipe	48"	120"	yes
Steel pipe	144"	180"	no

* You may increase cast-iron pipe horizontal spacing to 120" when using 10' pipe lengths.

Pipe Support

1. Support pipes so they will maintain alignment and will not sag.

2. Support and install pipes so they can move with the normal expansion and contraction of the piping system without scraping or rubbing against supports or framing materials.

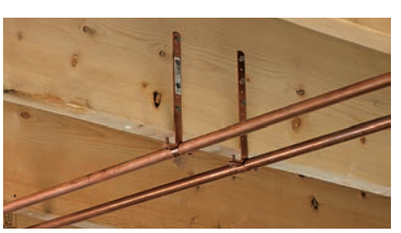
3. Use pipe supports that will carry the weight of the pipe and that are sufficiently wide to prevent crimping and distortion of the pipe.

4. Use pipe supports that will not cause corrosion or galvanic reaction between the pipe and the support. Example: do not use steel supports with copper pipe or copper supports with cast-iron pipe.

5. Provide rigid sway bracing at changes in pipe direction more than 45 degrees for pipe sizes at least 4 inches in diameter.

6. Provide horizontal and vertical support for pipes according to Table 30 (see page 138).

Support hangers and clamps for: CPVC and PVC (A), Copper (B), PEX (C).



Support copper tubing with compatible hangers.

Support for PEX tubing is particularly important near manifolds and fittings.

Provide vertical support for pipes running parallel to wall studs. Install supports according to Table 29.

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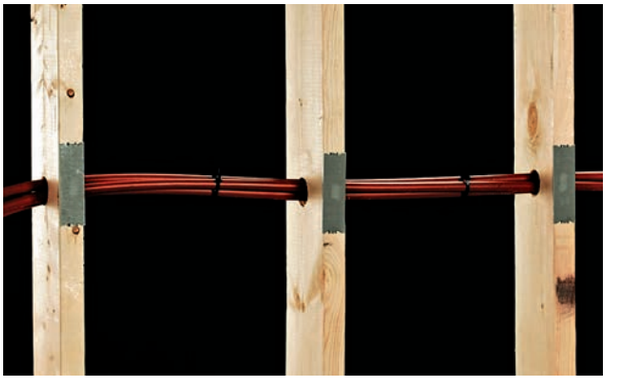
Page:135



Protect pipes 1½" from the edges of studs and joists.

Protecting Pipes from Puncture & Corrosion

1. Protect plumbing pipes (other than cast iron or galvanized steel) with shield plates, if the pipe is run through holes that are closer than 1¼ inches from the edge of studs, joists, rafters, or similar framing members. Extend the shield plate at least 2 inches below top plates and at least 2 inches above bottom plates.

2. Use shield plates at least 1/16-inch thick.

3. Apply these rules to pipes running through holes and notches in framing materials. While not required by most general codes, it is a best practice to protect pipes (other than cast iron or galvanized steel) that are closer than 1½ inches from the edge of framing materials. The most common example of such pipes is a pipe installed parallel to the edge of a stud or joist.

4. Protect copper plumbing pipe from corrosion where it passes through masonry or concrete. You may use pipe wrapping material designed for this purpose, or you may enclose the pipe in a sleeve.

5. Protect gas pipes, other than steel, with shield plates if the pipe is closer than 1½ inches from the edge of studs, joists, rafters, or similar framing members. Extend the shield plate at least 4 inches below top plates and at least 4 inches above bottom plates.

Protecting Pipes from Freezing

1. Do not install water supply and waste pipes outside of a building, in exterior building walls, in attics and crawl spaces, or in any other place subject to freezing temperatures, unless the pipes are protected by insulation or heat or both.

2. Install water service pipe at least 12 inches deep or at least 6 inches below the frost line.

3. Verify minimum water service and building sewer pipe depth with the local building official.

4. Apply these requirements only to areas with a winter design temperature of 32 degrees Fahrenheit or less.

Fixture Cutoff Valve (Angle Stop)

1. Provide each plumbing fixture, except for bathtubs and showers, with an accessible cutoff valve on the hot and cold water supply pipes. These valves are sometimes called "angle stop valves." You may install cutoff valves at bathtubs and showers, but these valves are not required.

Valves & Outlets Installed Below Ground

1. Do not install water supply outlets and stop-and-waste valves below ground. Example: do not install a hose bibb below ground.

2. You may install a freeze-proof yard hydrant below ground if the water supply to the hydrant is protected with a backflow preventer and the yard hydrant is permanently labeled as a "non-potable water source."

Hose Bibb Cutoff Valve

1. Provide hose bibbs that are subject to freezing with a stop-and-waste valve inside the building. This includes frost-proof hose bibbs.

2. You need not install a stop-and-waste valve on a frost-proof hose bibb if the stem extends into an open heated or semi-conditioned area of the building.

Hose bibbs that are subject to freezing require a stop-and-waste valve inside the building.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:136

Drain, Waste & Vent Piping (DWV)

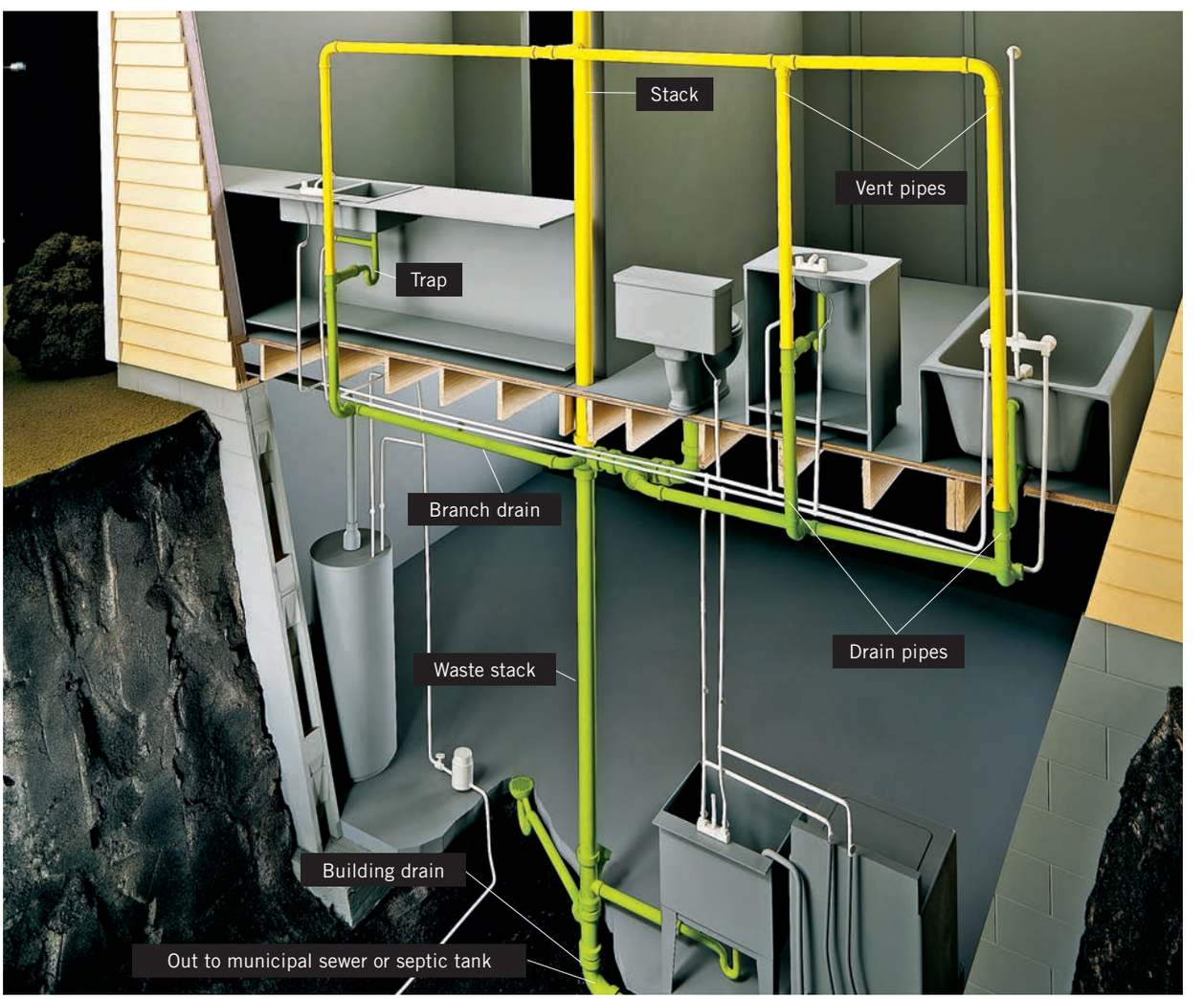
Drainpipes use gravity to carry wastewater away from fixtures, appliances, and other drains. This wastewater is carried out of the house to a municipal sewer system or septic tank.

Drainpipes are usually plastic or cast iron. In some older homes, drainpipes may be made of copper, galvanized steel, or lead. Because they are not part of the supply system, lead drainpipes pose no health hazard. However, lead pipes are no longer manufactured for home plumbing systems.

Drainpipes have diameters ranging from 1¼ inches to 4 inches. These large diameters allow waste to pass through easily.

Traps are an important part of the drain system. These curved sections of drainpipe hold standing water, and they are usually found near any drain opening. The standing water of a trap prevents sewer gases from backing up into the home. Each time a drain is used, the standing trap water is flushed away and replaced by new water.

In order to work properly, the drain system requires air. Air protects trap from being drained. To allow air into the drain system, drainpipes are connected to vent pipes. All drain systems must include vents, and the entire system is called the drain-waste-vent (DWV) system. One or more vents, located on the roof, provide the air needed for the DWV system to work.



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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:137

Use vent tee fittings only in vent pipes, not in drain pipes that carry wastewater. Drain pipes must maintain a minimum 2 percent slope.

Common sewer pipe materials PVC (A) or ABS (B) are allowed for use in DWV systems. Cast iron is also allowed but is rarely used in residential construction.

Drain & Sewer Pipe General Requirements

1. Install fittings that have a smooth interior surface and are compatible with the pipe to which they are attached. Example: do not use ABS fittings with PVC pipe.

2. Do not use fittings that contain ledges, shoulders, or reductions that may retard or obstruct drainage flow.

3. Install fittings that maintain a 2 percent slope and are approved for use where installed. Example: do not use a vent tee in a drainage pipe where water flows.

4. Do not use threaded connections in pipes where the threads run on the inside of the pipe and could retard or obstruct drainage flow.

5. Do not drill, tap, burn, or weld drainage, sewer, or vent pipes. Example: do not drill into a vent pipe to insert the discharge hose from a water softener.

6. Do not use the following types of joints and connections: cement or concrete, mastic or hot-pour bituminous, fittings not approved for the specific type of pipe or installation, joints between different pipe diameters made with elastomeric rolling O-rings, solvent-cement joints between different types of plastic pipe, and saddle fittings.

Common DWV Pipe Material

1. You may use any of the common drainage and sewer pipe materials listed in Table 30. You may use other materials listed if approved by your local codes.

2. Install galvanized steel drainage pipe at least 6 inches above the ground.

TABLE 30: COMMON DRAINAGE & SEWER PIPE MATERIALS

COMMON DRAINAGE & SEWER PIPE MATERIALS	USED FOR DRAINAGE	USED FOR SEWER
Cast-iron soil pipe	yes	yes
ABS-DWV pipe	yes	yes
PVC-DWV pipe	yes	yes
Steel pipe (black or galvanized)	yes	no

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:138

Water Closet Connection between Closet Flange & Pipe

1. You may use a 3-inch quarter bend to connect to a closet flange if you install a 4-inch-by-3-inch flange to receive the closet fixture horn.

2. You may use a 4-inch-by-3-inch reducing closet bend to connect to the closet flange.

Tailpieces

1. Provide sinks, dishwashers, laundry tubs, and similar fixtures with tailpieces and traps at least 1½ inches in diameter.

2. Provide vanity sinks, bidets, and similar fixtures with tailpieces and traps at least 1¼ inches.

4 × 3 reducing closet bend (horn).

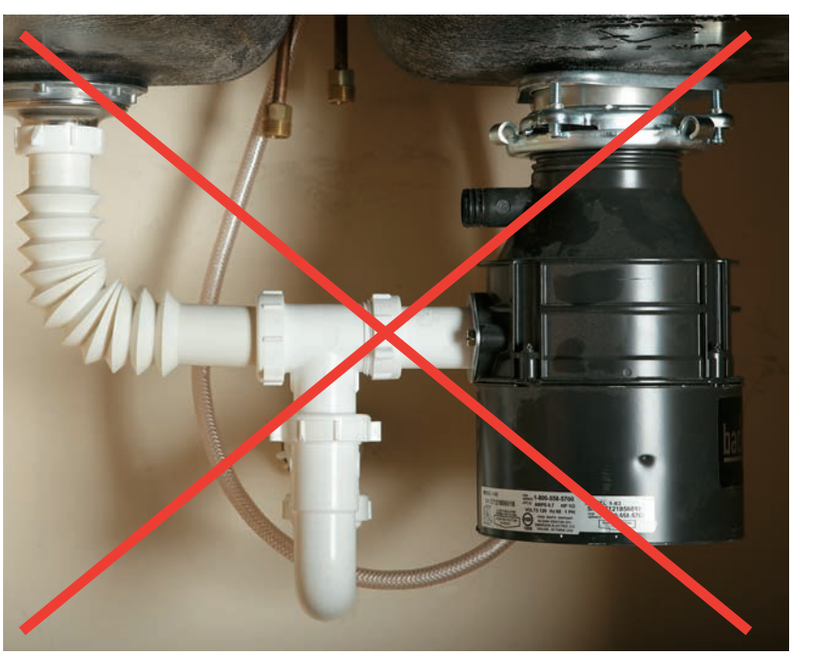
Chromed P-trap with slip joints on lavatory sink.

Slip Joints

1. Use slip joints only between the fixture outlet and the connection with the drainage pipe.

2. Provide slip joints with access of at least 12 by 12 inches.

Drain tailpieces must match the diameter of the other pipes in the drain kit: 1¼ or 1½" depending on the type of fixture being drained.



VIOLATION! Flexible, ribbed material may be used only in a vertical direction as a sink tailpiece.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:139

DWV FITTING DESCRIPTIONS

Bend (Elbow): A bend is a drainage fitting used to change the direction of flow. A bend is often called an elbow. Bends are available as a single fitting with two openings, and some are available as a double fitting with three or more openings. Some bends have inlets in addition to the openings. Use vent bends only in the dry vent sections of vent pipes. Quarter bends are sometimes called short sweeps in plastic pipes. See the definition of sweep. Quarter bends with a longer turn radius are sometimes called long turn quarter bends or long sweeps. Bends are made with the angles shown in Table 31.

Closet bend: A fitting used to connect a closet flange (a part of your toilet drain system) to other plumbing pipes. Closet bends often reduce the pipe size from the 4" of the closet flange to 3".

Closet flange: The fitting upon which a toilet (water closet) sits. Many different closet flanges are available to accommodate different fitting and pipe configurations. One type of closet flange allows you to offset the closet flange around a floor joist.

Coupling: A fitting used to join two lengths of pipe in a straight line. It has two female openings, one on each end.

Inlet: An additional opening in a fitting. A low-heel-inlet is located in a straight line with one opening of the fitting. A high-heel-inlet is located above the curved portion of the fitting. A side-inlet occurs on one side of the fitting.

TABLE 31: BEND DIRECTION CHANGE

BEND NAME	DIRECTION CHANGE
¼ bend	90°
⅙ bend	60°
⅛ bend	45°
1⁄16 bend	22½°

Bend pipes for DWV systems include: ¼ street bend (A), ¼ bend (B), ¼ vent bend (C), and ¼ bend with side inlet (D).

Parts of a toilet drain system include: closet bend (A), closet flange (B), and offset closet flange (C).

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305471 - B&D Codes for Homeowners 4th Edition Edition_124-167.indd 140 1/10/18 11:43 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:140

Sanitary tee: A sanitary tee is a tee fitting combined with a ¼-bend fitting.

Street fitting: A street fitting has a female opening (hub) on one end and a male opening (spigot) on the other end. Most drainage fittings have female openings on both ends.

Sweep: A sweep is a drainage fitting used to make a 90-degree change in the direction of flow. A short sweep is the same as a quarter bend in plastic pipes. Short sweeps and quarter bends are different fittings in cast iron pipes. A quarter bend with a longer radius bend is sometimes called a long sweep or a long turn quarter bend.

Tee: A fitting with three openings. Two openings are in a straight line, and one opening is at an approximate 90-degree angle to the others. Double tees, with four openings, are also available. Use vent tees only in the dry vent sections of vent pipes.

Wye: A fitting with three openings. Two openings are in a straight line and one opening is at an approximate 45-degree angle to the others. Wye fittings can be made with other fittings to make combination fittings, such as a tee-wye and a combination wye and ⅛ bend. Double wye and double tee-wye fittings are also available.

Inlet fittings include: bend with low-heel inlet (A) and bend with side inlet (B).

Tees for use in DWV systems include: Double sanitary tee (A), vent tee (B), and test tee (C).

Two types of sanitary tees include: Single sanitary tee (A) and double sanitary tee (B).

Wye fittings for DWV use include: Wye (A), double wye (B), and tee-wye (C).

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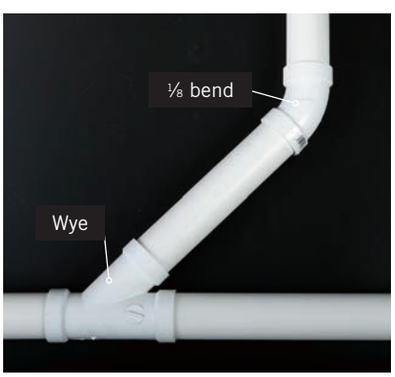
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:141

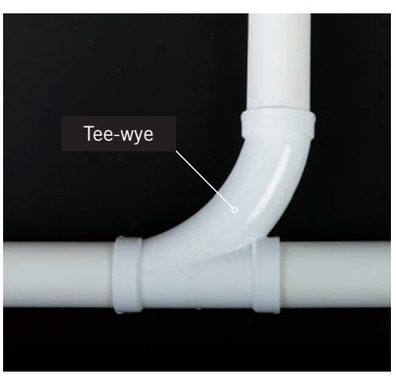
TABLE 32: APPROVED DRAINAGE FITTINGS FOR CHANGING FLOW DIRECTION

TYPE OF FITTING	HORIZ. TO VERT.	VERT. TO HORIZ.	HORIZ. TO HORIZ.
22½° elbow (1/16 bend)	yes	yes	yes
45° elbow (⅛ bend)	yes	yes	yes
60° elbow (⅙ bend)	yes	yes	yes
90° elbow (¼ bend) (cast-iron pipes only)	yes	YES for fixture drains ≤ 2" NO for other pipes & sizes	YES for fixture drains ≤ 2" NO for other pipes & sizes
90° elbow (¼ bend & short sweep) (plastic pipes)	yes	YES for fixture drains ≤ 2" & all pipes ≥ 3"	YES for fixture drains ≤ 2" NO for other pipes & sizes
90° elbow (long sweep & long turn ¼ bend) (all pipes)	yes	yes	yes
sanitary tee	yes limits on multiple connection fittings	no	no
wye	yes	yes	yes
tee-wye	yes	yes	yes

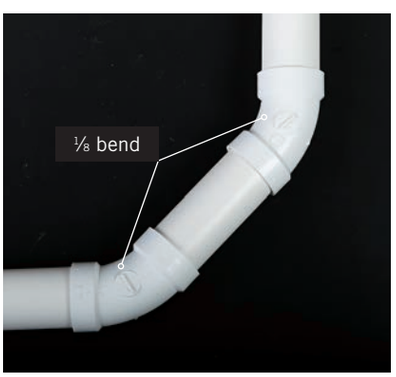
Drain & Sewer Pipe Connections & Joints



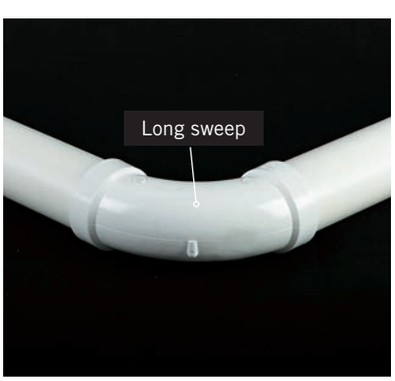
Changing flow direction from vertical to horizontal using a wye fitting and ⅛ bend.



Changing flow direction from vertical to horizontal using a tee-wye.

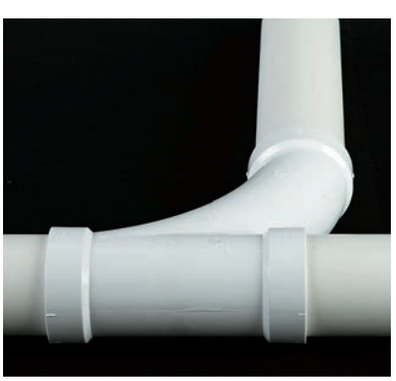


Changing flow direction from vertical to horizontal using two ⅛ bends.



Changing flow direction from horizontal to horizontal using a long sweep fitting.

Changing flow direction from horizontal to horizontal using a wye fitting.



Changing flow direction from horizontal to horizontal using a long-radius tee-wye fitting.

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305471 - B&D Codes for Homeowners 4th Edition Edition_124-167.indd 142 1/10/18 11:43 AM
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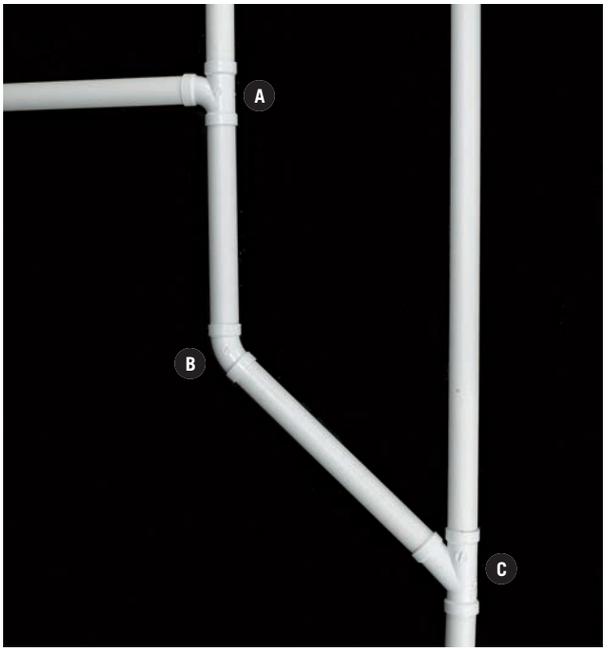
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:142



Changing flow direction from horizontal to vertical using: sanitary tee (A), ⅛ bend (B), wye (C).

Drainage & Sewer Pipe Fittings for Changing Flow Direction

1. Use the fittings in Table 32 to change the direction of flow in drainage and sewer pipes.

Drainage & Sewer Pipe Fittings: Changing from Horizontal to Vertical Using Multiple Fittings

1. You may use multiple fittings and double fittings (such as double sanitary tees) to connect back-to-back fixtures and two or more branch drains on the same level if directly opposite fitting connections are from the same size pipe and if directly opposite fitting connections are from similar fixture types or fixture groups.

2. Do not use a double sanitary tee to receive discharge from back-to-back toilets or from fixtures or appliances with pumping action (such as washing machines and dishwashers). You may use a double sanitary tee if the distance between the center of the closet flange and the inlet of the sanitary tee is at least 18 inches.

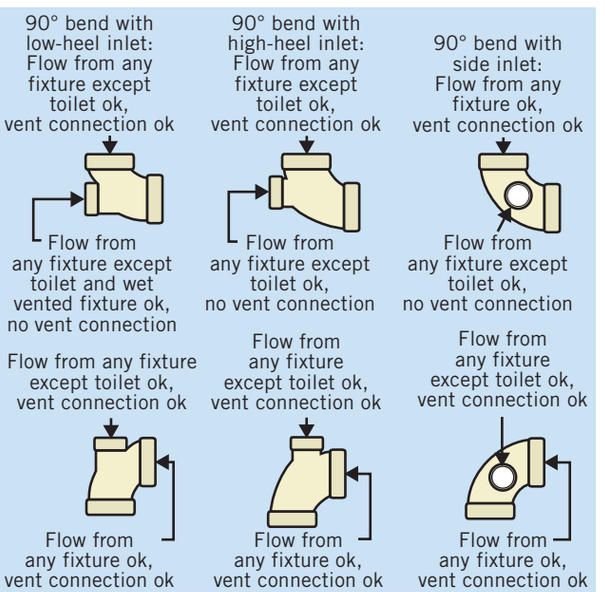
Quarter Bends with Heel or Side-Inlet

1. You may not use a heel inlet quarter bend to change flow direction from vertical to horizontal if the fitting serves a toilet. You may use a heel inlet quarter bend to change flow direction from horizontal to vertical without restrictions.

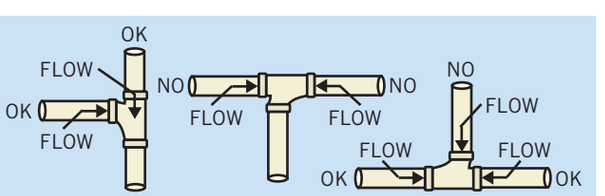
2. You may not connect wet vented fixtures to the low heel inlet of a heel inlet quarter bend.

3. You may use the side inlet of a quarter bend to change the flow direction when the inlet is horizontal (side facing), but not when the inlet is vertical (facing up). The side inlet may accept drainage flow from any fixture except a toilet. Side and heel inlets are usually 1½- or 2-inch openings, and you may not connect a toilet to any opening less than (<) 3 inches.

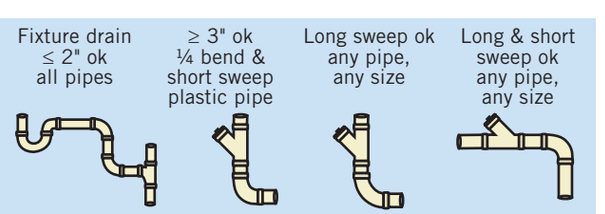
4. You may connect a dry vent to the quarter bend side or heel inlet only when the inlet is vertical (facing up). You may connect a dry vent to a quarter bend side or heel inlet when the inlet is horizontal (side facing) only when the entire quarter bend fitting is used as part of a dry vent.



Allowed uses of 90° bends with an inlet



Sanitary tee allowed flow direction change



90° bend allowed direction change

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305471 - B&D Codes for Homeowners 4th Edition Edition_124-167.indd 143 1/10/18 11:43 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:143

Drain & Sewer Pipe Connections & Joints

ABS Plastic Pipe Joints

1. You may use approved branded couplings to join buried ABS pipes. Do not use branded couplings to join aboveground ABS pipes unless the use is approved by the building official.

2. You may use solvent cement to join ABS pipes above and below ground. Clean and dry pipes and fittings before applying solvent cement to all joint surfaces. Make the joint while the solvent cement is wet. Use solvent cement that complies with ASTM D 2235. Do not use PVC cement with ABS pipe.

3. You may use threaded joints for Schedule 80 and heavier ABS pipe. The threads should be NPT type. Do not place threads on the pipe's interior.

You may use a product called transition cement to join ABS and PVC pipe if the product is approved by your local jurisdiction. This product is not currently approved by general codes for most applications but is frequently used.

Steel Pipe Joints

1. You may use threaded joints for galvanized steel pipes. The threads should be NPT type.

2. You may use approved branded couplings to join galvanized steel pipes. Install the branded couplings according to manufacturer's instructions.

PVC Plastic Pipe Joints

1. You may use approved branded couplings to join buried PVC pipes. Do not use branded couplings to join aboveground PVC pipes unless the use is approved by the building official.

2. You may use solvent cement to join PVC pipes above and below ground. Clean and dry pipes and fittings before applying primer to all joint surfaces. Apply primer that complies with ASTM F 656 if required by your local jurisdiction. Apply solvent cement that complies with ASTM D 2564. Make the joint while the solvent cement is wet. Do not use ABS cement with PVC pipe.

Use the correct solvent cement and primer, if required, for the type of pipe you're using: PVC and CPVC should be connected with PVC solvent cement and primer; ABS requires ABS solvent cement (no primer is required).

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305471 - B&D Codes for Homeowners 4th Edition Edition_124-167.indd 144 1/10/18 11:43 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:144

3. You may use threaded joints for Schedule 80 and heavier PVC pipe. The threads should be NPT type. Do not place threads on the pipe's interior.

Joints between Different Types of Pipe

1. Use branded couplings approved for joining the different types of pipe. Install all branded couplings according to manufacturer's instructions.

2. Use an approved brass ferrule with a caulked joint or a mechanical compression joint when joining copper tubing to cast-iron pipe.

3. Use a brass converter fitting or a dielectric fitting when joining copper tubing to galvanized steel pipe.

Drain & Sewer Pipe Slope

1. Install horizontal drainage and sewer pipe with a uniform slope and alignment.

2. Install pipe not more than 2½ inches in diameter with at least a ¼ unit in 12 units (2 percent) slope.

3. Install pipe at least 3 inches diameter with at least a ⅛ unit in 12 units (1 percent) slope.

Drain & Sewer Pipe Size Reduction

1. Do not reduce drainage and sewer pipe size in the direction of the waste flow. Example: do not drain a 2-inch trap into a 1½-inch drainpipe.

NOTE: A 4-inch-by-3-inch closet bend fitting is not classified as a reduction in size.

Cast-iron drain pipe joints originally were made with hubbed fittings. Since new cast iron is seldom installed, joinery with cast iron is normally accomplished by connecting the original cast iron to another material, such as PVC, with a branded coupling.

Install and support DWV pipe to maintain the required uniform slope.

305471 - B&D Codes for Homeowners 4th Edition Edition_124-167.indd 145 1/10/18 11:56 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_124-167.indd 145 1/10/18 11:43 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:145

Drain & Sewer Cleanout Openings

Cleanout Locations & Spacing

1. Install a cleanout in every horizontal drainpipe so that the distance between cleanouts is not more than 100 feet, measured along the pipe's developed length. Install at least one cleanout for every horizontal drainpipe regardless of drainpipe length. This provision applies to the building drain, building sewer, and horizontal branch drains, not to fixture drains.

2. Install a cleanout within 10 feet of the building drain and building sewer junction. You may install this cleanout inside or outside the building. Make this cleanout accessible. Measure the 10 feet along the developed length of the pipe from the cleanout fitting to the building drain and sewer junction.

3. Install a cleanout at every change of pipe direction more than 45 degrees when the direction change uses one fitting. When multiple direction changes occur in one pipe run, only one cleanout is required, spaced not more than 40 feet apart. This provision applies to the building drain, building sewer, and horizontal branch drains.

Cleanout Size

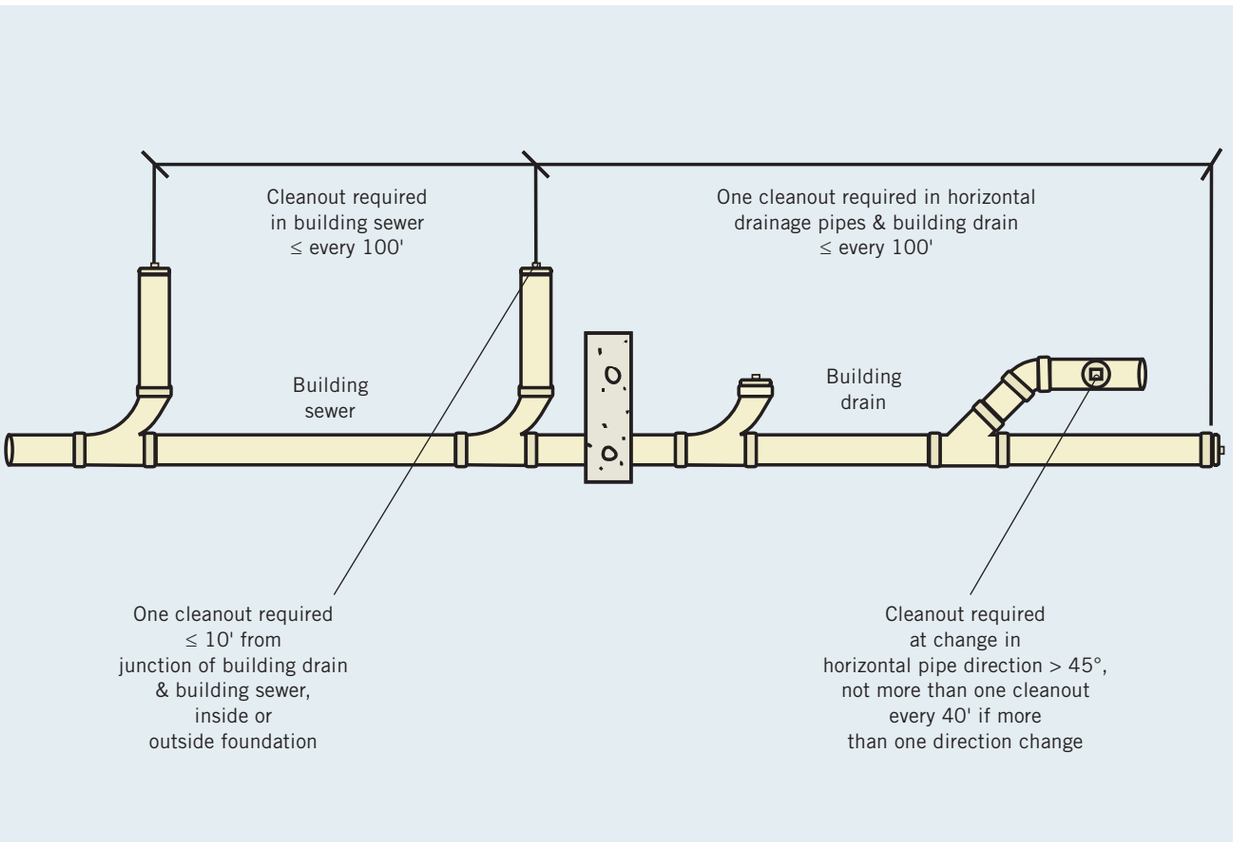
1. Install cleanouts that are the same size as the largest pipe served by the cleanout. Example: you may not use 1½-inch fixture drain as a cleanout for a 2-inch branch drain.

2. You may install a cleanout in a vertical stack that is one pipe size smaller than the stack pipe size.

Cleanout Accessibility

1. Provide at least 18 inches between the cleanout and any obstruction. Measure the distance perpendicular to the front of the cleanout.

2. Do not conceal cleanouts with permanent finishing materials.



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305471 - B&D Codes for Homeowners 4th Edition Edition_124-167.indd 146 1/10/18 11:43 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:146

3. Extend underground cleanouts to or above finished grade. Do not extend cleanouts above surfaces where they may become trip hazards or where they may be damaged by traffic.

Cleanout Plugs

1. Install brass or plastic plugs in cleanout fittings.

2. Make cleanouts gas and liquid tight.

Cleanout Direction

1. Install cleanouts so that they open toward the direction of the waste flow.

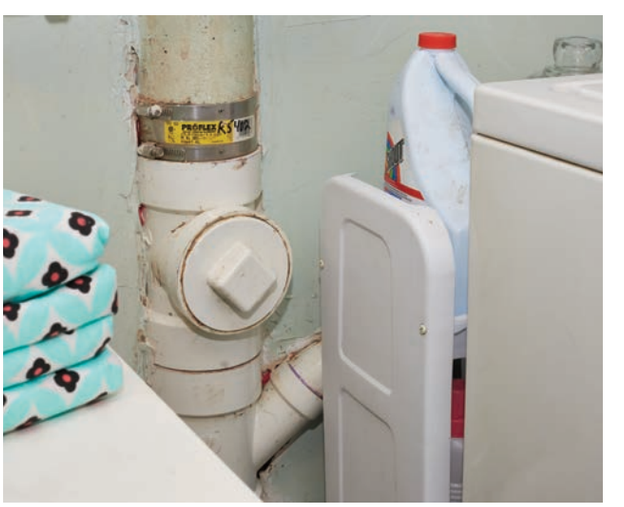
Cleanout Fixture Connections

1. Do not connect other pipes or fixtures to an existing cleanout unless you install an alternate cleanout. Example: do not remove a cleanout plug and use the cleanout opening as the drain for a laundry sink.

A cleanout is a threaded, removable cap positioned in a drainpipe run to allow access for equipment that clears clogs. Every horizontal line should have a cleanout that is no smaller in diameter than the largest drainpipe in the line.

Seal cleanout plugs before capping cleanout fittings.

For your convenience, keep access clear to cleanouts. Position movable objects, such as this washing machine, so they will not interfere with drain cleaning tools. Permanent obstructions must be kept at least 18" away from the cleanout, measured perpendicular to the opening.



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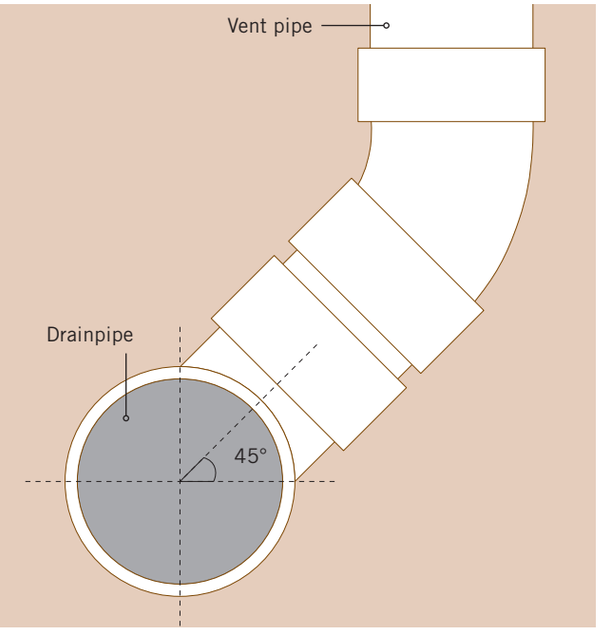
305471 - B&D Codes for Homeowners 4th Edition Edition_124-167.indd 147 1/10/18 11:43 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:147

Plumbing Vents

To understand the purpose of plumbing vents, you must first understand the purpose of plumbing traps. A trap is required for all fixture drains connected to the DWV pipes. A trap can be a separate fitting, such as a P-trap for a sink or a shower, or it can be part of the fixture, such as the trap in a toilet. A trap maintains a water seal that keeps noxious and potentially explosive sewer gas in the DWV pipes and away from the air in the home. Water flows into a fixture and through a trap when you use a fixture. When you stop using the fixture, some of the water remains in the trap and recharges the trap's water seal.

When water flows in a pipe near a trap, the suction caused by the flowing water can create enough negative pressure at the trap to pull the water out of the trap. This is sometimes called siphoning the trap, because it is similar to what happens when you use a hose to siphon fuel out of a fuel tank. If the trap looses its water seal, the home is open to the flow of sewer gas.

A plumbing vent protects the trap's water seal by allowing air into the DWV pipes. The air provided by the vent replaces the air that is drawn along with the flowing water. This replacement air reduces the suction and protects the trap. Without properly sized and installed vents, the DWV system will not function as intended.



Vent pipes should extend in an upward direction from drains. This ensures that wastewater cannot flow into the vent pipe and block it. At the opposite end, a vent pipe should connect to an existing vent stack or stack vent at a point at least 6" above the flood rim of the highest fixture draining into the system.

Support vent pipes so they slope toward drain pipes.

Vent Slope & Connection to Pipes

Plumbing Vents Required

1. Install an approved vent for every trap and trapped fixture. This means that every plumbing fixture (such as a sink or a shower) and every plumbing fixture with an integrated trap (such as a toilet) must be protected by an individual vent or an approved vent system in which one vent protects multiple fixtures.

2. Terminate at least one vent outdoors. Connect the outdoor vent to the building drain or to a branch or extension of the building drain. The branch or extension cannot be an island fixture vent.

Vent Pipe Slope & Support

1. Install all vent pipes using adequate supports so that the vent pipes slope toward the soil or waste pipe. Moisture in any form should flow toward the soil or waste pipe by gravity. General codes do not specify support intervals for vent pipes. Supporting vent pipes at the same interval required for drain pipes is recommended, but not required.

305471 - B&D Codes for Homeowners 4th Edition Edition_124-167.indd 148 1/10/18 11:56 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_124-167.indd 148 1/10/18 11:43 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:148

Vent Pipe Connection to Horizontal Drainage Pipes

1. Connect vent pipes to horizontal drainage pipes above the centerline of the horizontal drainage pipe. This protects the vent pipe from filling with solid material.

Vent Connection Height Minimums

1. Connect dry vent pipes to vent stacks, stack vents, and to stack-type air admittance valves so that the connection point is at least 6 inches above the flood rim level of the highest fixture served by the vent. A common violation of this provision is when a dry vent runs parallel to the drainage pipes under the fixture. This provision helps protect the vent pipe from filling with solid material.

Connect vent pipes to other vents at least 6" above the highest fixture so that the vent pipe will not become clogged with solid materials.

VIOLATION! Do not connect the vent pipe within 2 pipe diameters of the trap weir.

2. Install horizontal branch vent pipes at least 6 inches above the flood rim level of the highest fixture served by the vent.

Vent Rough-in for Future Fixtures

1. Install a vent for roughed-in (future) fixtures that is at least ½ the diameter of the drainpipe rough-in.

2. Connect the roughed-in vent to the vent system or provide another approved means to terminate the roughed-in vent.

3. Label the roughed-in vent pipe to indicate that it is a vent.

Crown Venting

1. Connect the vent fitting at least two pipe diameters from the trap weir.

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305471 - B&D Codes for Homeowners 4th Edition Edition_124-167.indd 149 1/10/18 11:43 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:149

Vent Termination

Vent Height Above Roof

1. Extend vent pipes above the roof at least 6 inches, or the number of inches required by local snow accumulation and temperature conditions, whichever is higher. Measure vent height from the high side where the vent exits the roof. Obtain the snow accumulation height from the local building official.

Use approved vent flashing boots to seal around the vent projections in a roof. Make sure boot angle is compatible with your roof slope.

2. Extend vent pipes at least 7 feet above any roof used as a balcony, observation deck, or similar accessible walking surface.

Vent Freezing & Frost Closure Protection

1. Protect exterior vent terminals from freezing by using heat, insulation, or both.

2. Increase the diameter of exterior vent terminal pipes to at least 3 inches, beginning at least 1 foot below the roof or inside the wall.

3. These provisions apply only where the 97.5 percent winter design temperature is less than 0 degrees Fahrenheit. Obtain this information from IRC Chapter 3 and from your local building official.

Vent Flashing

1. Use approved flashing to make vent pipes extending through a roof watertight.

2. Use caulk to make vent pipes extending through a wall watertight.

Vent Exterior Termination Locations

1. Locate plumbing vent terminations at least 4 feet below, at least 3 feet above, or at least 10 feet horizontally from any: (a) door or operable window, (b) other air intake opening of the building, and (c) air intake opening of any adjacent building.

2. Locate plumbing vent terminations running through a side wall at least 10 feet from the lot line and at least 10 feet above the highest grade within 10 feet horizontally from the vent termination.

3. Locate plumbing vent terminations at least 7 feet above a roof used for recreational purposes, such as an observation deck or sunbathing.

4. Protect side-wall vent terminations from entry by birds or rodents.

5. Do not locate vent terminations directly under the building's overhang if the overhang contains soffit vents.

305471 - B&D Codes for Homeowners 4th Edition Edition_124-167.indd 150 1/10/18 11:56 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_124-167.indd 150 1/10/18 11:43 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:150

Vent Connection Distance from Trap

1. Use Table 33 to determine the maximum length of a fixture drain between a trap weir and a vent fitting. The vent fitting may be at a vent pipe, such as an individual vent, or at a vented pipe, such as a wet vent. Uniform Plumbing Code fixture drain lengths are different.

2. The table does not apply to self-siphoning fixtures, such as toilets. No fixture drain length limitations apply to these fixtures.

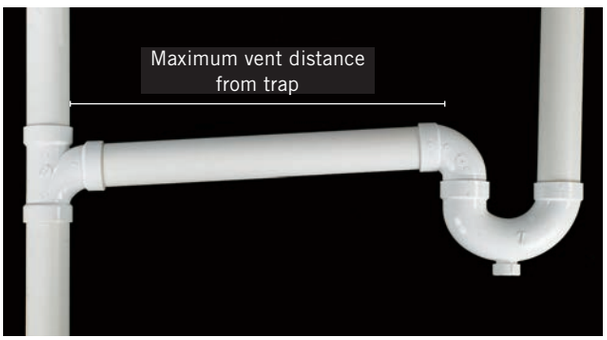
Fixture Drain Slope

1. Connect the fixture drain pipe with not more than one pipe diameter of fall between the bottom of the trap outlet and the bottom of the vent fitting inlet. This parallels the distance requirements in Table 33 and reduces the chance that the trap will drain because the fitting is below the trap. Example: 5 feet by ¼ inch per foot equals 1¼ inches. See the first row of Table 33.

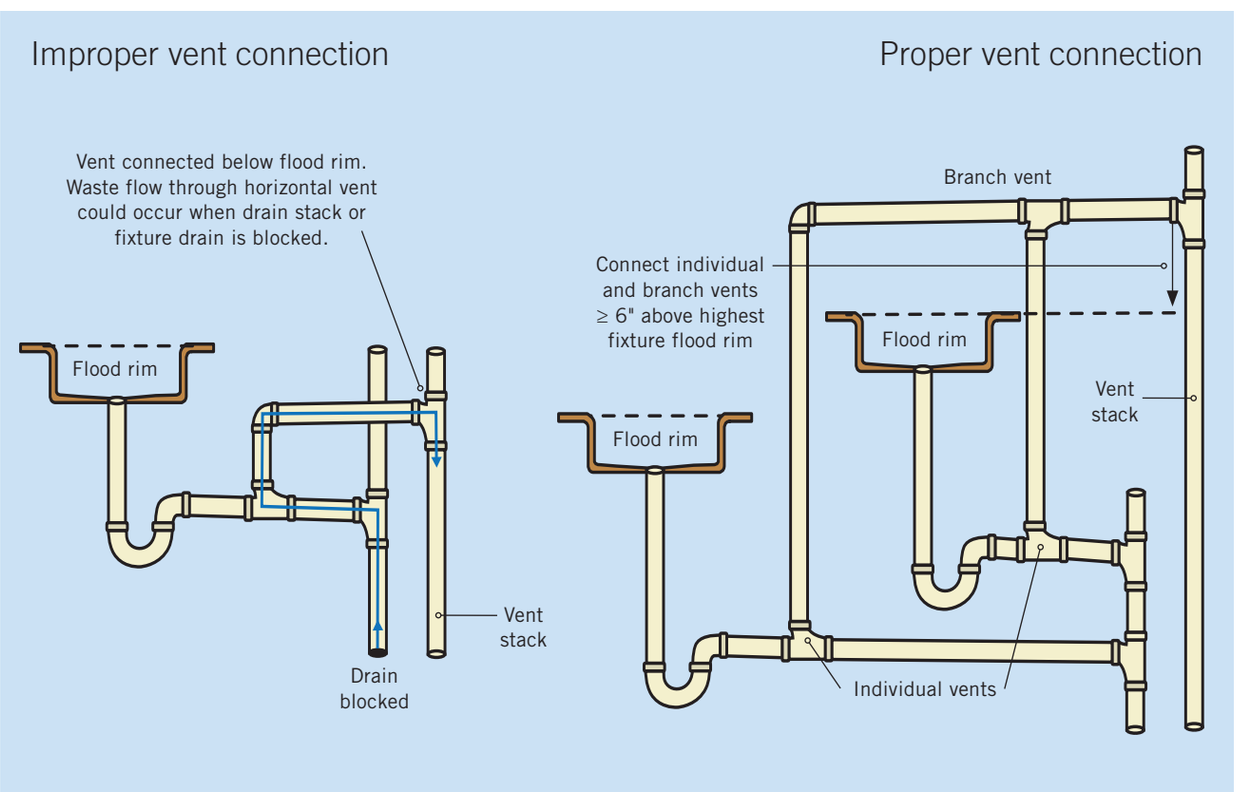
2. Connect the top of the fixture drainpipe to the vent fitting above the trap weir. This provision does not apply to toilet fixture drains.

TABLE 33: VENT DISTANCE FROM TRAP

TRAP SIZE	SLOPE	DISTANCE FROM TRAP TO VENT FITTING
1¼	¼" per ft.	5'
1½	¼" per ft.	6'
2	¼" per ft.	8'
3	⅛" per ft.	12'
4	⅛" per ft.	16'

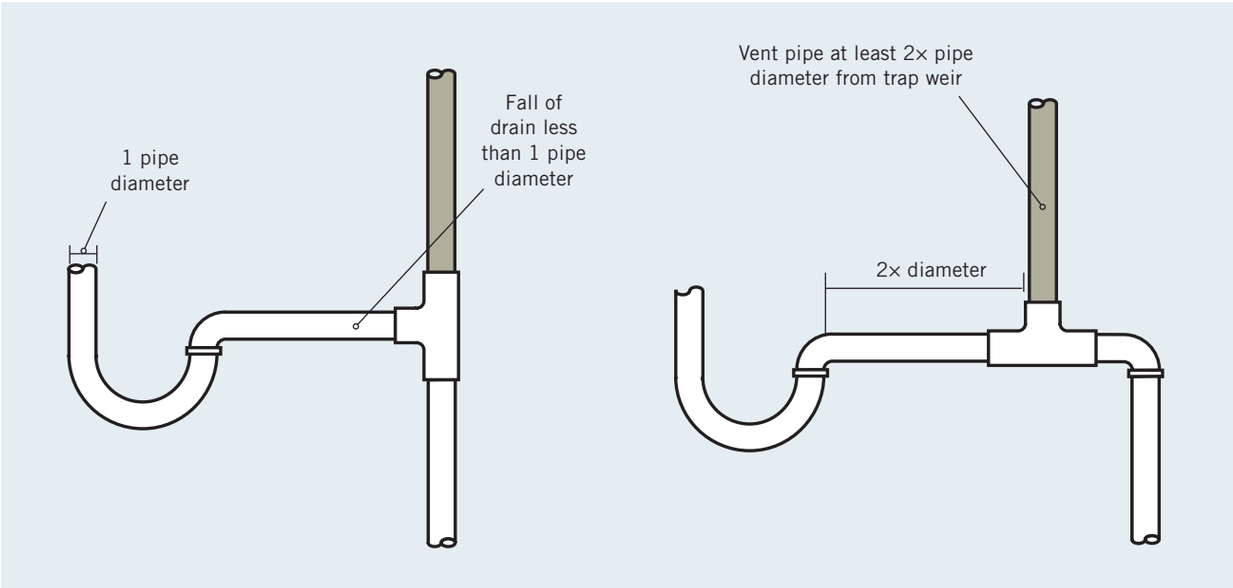


The distance from the trap to the vent fitting is limited. Note that the vent fitting may connect to a vent pipe or to a pipe that is vented, such as a wet vented pipe.



When a vent is connected to a vent stack, the connection should be at least 6" above the fixture flood rim level. This helps avoid improper waste flow through the trap.

305471 - B&D Codes for Homeowners 4th Edition Edition_124-167.indd 151 1/10/18 11:56 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_124-167.indd 151 1/10/18 11:43 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:151



Examples of correct individual vent configurations.

Vent Pipe Size

1. Use at least a 1¼-inch-diameter vent pipe or a vent pipe at least ½ the diameter of the drainpipe being vented, whichever is larger, as the dry vent.

2. Increase the vent pipe diameter by at least one pipe size over the entire length of the vent pipe when the vent's developed length is greater than 40 feet.

Vent Pipe Developed Length

1. Measure the developed length of individual, branch, and circuit vents beginning where the vent connects to the drainage system and ending where the vent connects to a vent stack, stack vent, air admittance valve, or the vent's termination point outside the building.

Individual Vents

1. Fixture types: Use an individual vent to protect any fixture.

2. Number of fixtures: Use an individual vent to protect only one fixture.

3. Fixture location: Use an individual vent to protect one fixture located anywhere in the structure.

4. Individual vent connection location: Connect the individual vent on the fixture drain of the fixture being vented or at the fixture drain connection to the drainage system.

Individual vents are the easiest to install. They protect one fixture.

5. Fixture drain length to vent connection: Use Table 33 to determine the maximum distance between the fixture trap weir and the individual vent fitting.

6. Individual vent pipe size: Use at least a 1¼-inch pipe or a pipe at least ½ the size of the drainpipe being vented, whichever is larger.

Common Vents

1. Fixture types: Use a common vent to protect any two fixtures. You may common vent different types of fixtures, such as a sink and a shower or a shower and a toilet.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:152

2. Number of fixtures: Use a common vent to protect only two fixtures.

3. Fixture location: Use a common vent only for fixtures located on the same floor level. You may connect the fixture drains at different vertical levels if the fixtures are on the same floor level.

4. Common vent connection location: You may connect the common vent where the fixture drains intersect. You may connect the common vent downstream from where the fixture drains intersect only when the fixture drains connect to the branch drainpipe at the same horizontal level.

5. Fixture drain length to vent connection: Use Table 33 to determine the maximum distance between each fixture trap weir and the common vent fitting.

6. Common vent pipe size: Use at least 1¼ inches of pipe or a pipe at least ½ the size of the drainpipe being vented, whichever is larger, for the common vent.

Wet Vents

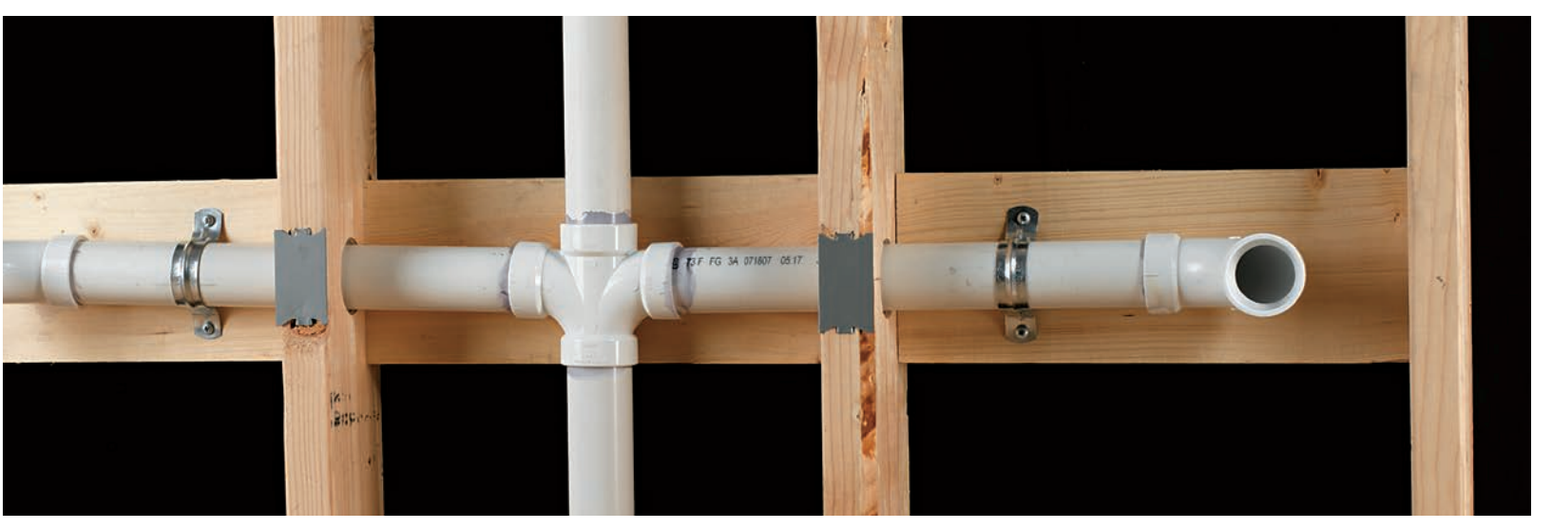
1. Fixture types: Use a wet vent to protect any combination of fixtures from not more than two bathroom groups.

2. Number of fixtures: Use a wet vent to protect not more than two toilets, two bathtubs or showers, two lavatory sinks, or two bidets.

3. Fixture location: Use a wet vent only for approved bathroom fixtures located on the same floor level.

4. Wet vent connection location: (a) Begin the wet vent with an individual or common vent for a lavatory, bidet, shower, or bathtub. This vent does not need to be at the first wet vented fixture in a horizontal wet vent. This vent must be at the first wet vented fixture in a vertical wet vent. End the wet vent at the last wet vented fixture connection to the wet vented pipe. (b) Do not connect more than one fixture upstream from the beginning individual or common vent in a horizontal wet vent. (c) Connect each fixture individually to the wet vented pipe. Do not connect two or more fixtures together and connect that branch drain to the wet vented pipe.

5. Horizontal wet vent fixture drain connection location: (a) Connect each individual fixture drain horizontally to a horizontal wet-vented pipe. Example: you may not install a wye fitting vertically and connect a fixture drain to the vertical opening of the wye in a horizontal wet vent. You may install the wye horizontally and connect the horizontal fixture drain to the horizontal opening of the wye. (b) You may connect a fixture drain vertically to a horizontal wet-vented pipe if you install a dry vent on the vertically connected fixture. Example: you may install a wye fitting vertically if you connect an individual vent to the fixture. (c) Do not connect any fixtures to the horizontal wet-vented pipe other than those fixtures being wet-vented. You may connect other fixtures to the horizontal pipe downstream after the wet vent ends. Example: do not connect a bedroom bar sink to a wet-vented pipe.



Common vent with vent connecting at fixture drain intersection.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:153

6. Vertical wet vent fixture drain connection location: (a) Connect all toilet fixture drains at the same vertical level. (b) Connect fixture drains from bathtubs, showers, lavatory sinks, and bidets at or above where the toilet fixture drains connect to the vertical wet vent.

7. Fixture drain length to wet-vented pipe: Use Table 33 (see page 151) to determine the maximum distance between each fixture trap weir and the fixture drain fitting at the wet-vented drain pipe. You may use individual and common vents to protect any fixture where the fixture drain length limit is a problem.

8. Wet vent pipe size: (a) Use a dry vent that is at least a 1¼-inch pipe or a pipe at least ½ the size of the wet-vented pipe, whichever is larger, for the individual or common vent that begins the wet vent. (b) Use Table 34 to size the horizontal and vertical wet-vented drainage pipe. You may not connect a toilet to a drainage pipe smaller than 3 inches regardless of what is allowed in the table.

Island Fixture Vent

1. Fixture types: Use an island fixture vent to protect only sinks such as those in kitchens and bathrooms. You may connect a dishwasher and disposal to a kitchen sink.

2. Use an island fixture vent to protect any number of approved fixture types.

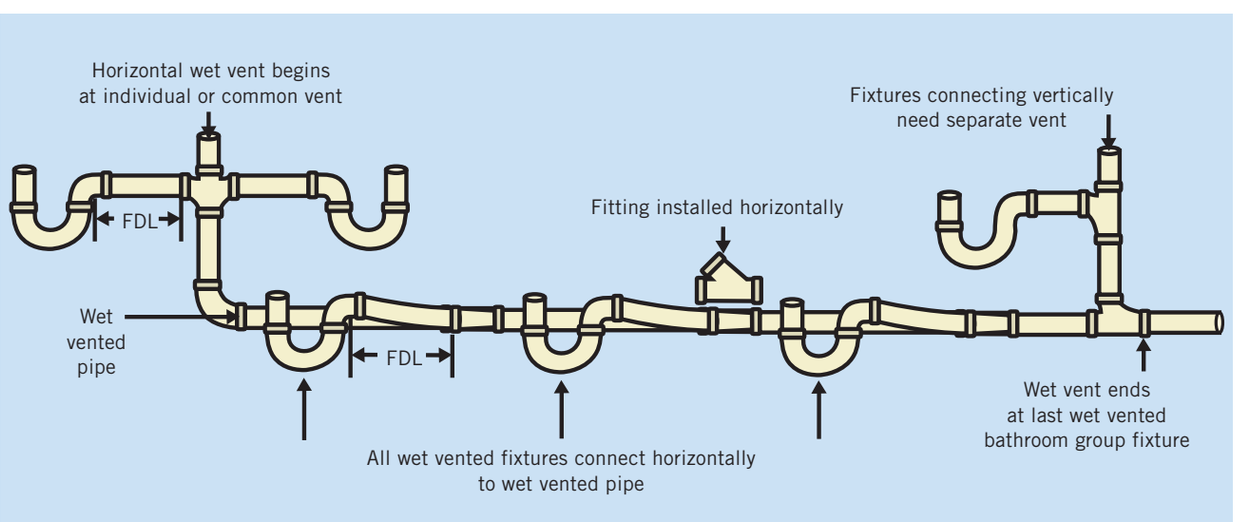
3. Use an island fixture vent only for fixtures located in the same island and on the same floor level.

4. Pipe configuration: (a) Extend the loop portion of the island fixture vent vertically to above the drain outlet of the fixture being vented before extending the horizontal and/or vertical downward portion. (b) Use drainage fittings and pipe slopes for any portion of the vent below the fixture flood rim level. Do not use vent fittings or slope the vent pipe as a vent below the fixture flood rim level. (c) Connect the downward portion of the vent loop downstream from where the fixture drain connects with the horizontal drainage pipe. Make the connection using a full size fitting. (d) Provide cleanouts at the downward portion of the loop vent and in the vertical portion of the vent pipe before it connects to the exterior vent pipe.

5. Dry vent connection location: (a) Connect the dry vent to the drainage system using a full size fitting. Connect the dry vent to a vertical drain pipe or the top half of a horizontal drain pipe. (b) Extend any dry vent at least 6 inches above the flood rim

TABLE 34: HORIZ. & VERT. WET-VENTED DRAINAGE PIPE SIZE

WET-VENTED PIPE SIZE	MAX. DRAIN FIXTURES LOAD
1½"	1
2"	4
2½"	6
3"	12
4"	32



Using a wet vent eliminates the need for an individual vent for each fixture.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:154

level of the highest fixture being vented before any connection to the outside vent.

6. Fixture drain length to vent connection: Use Table 33 to determine the maximum distance between the fixture trap weir and the fixture drain connection to the island vent.

7. Vent pipe size: Use at least a 1¼ inches pipe or a pipe at least ½ the size of the drain pipe size being vented as the dry portion of the vent, whichever is larger.

Air Admittance Valves

1. Install air admittance valves according to manufacturer's installation instructions and general code provisions.

2. You may use air admittance valves to vent individual vents, branch vents, circuit vents, and stack vents. Use individual and branch-type air admittance valves to vent fixtures that are on the same floor level and that are connected to a horizontal branch drain.

3. Use air admittance valves that are rated for the vent size to which the valve is connected.

4. Locate individual and branch-type air admittance valves at least 4 inches above the horizontal branch drain or fixture drain being vented.

5. Locate stack-type air admittance valves at least 6 inches above the flood rim level of the highest fixture being vented.

6. Locate the air admittance valve within the vent's developed length limits.

7. Locate air admittance valves in attics at least 6 inches above insulation.

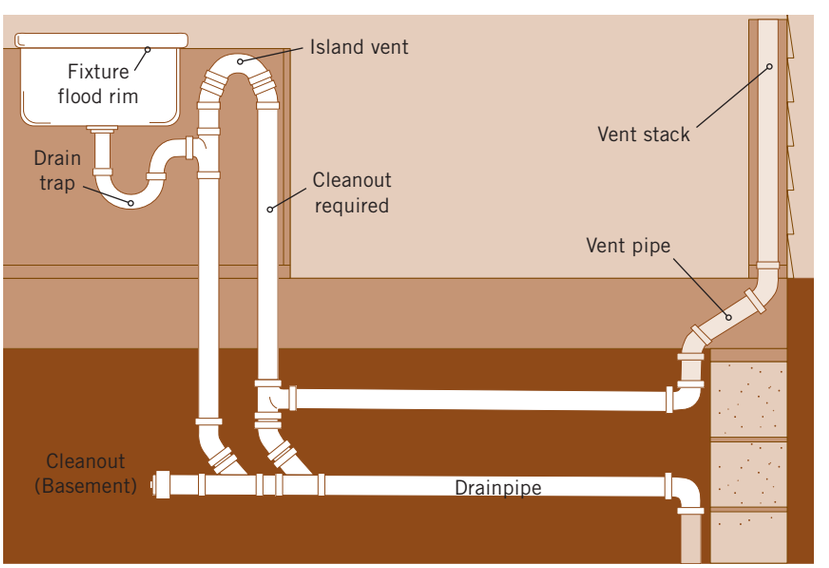
8. Provide air admittance valves with access and adequate ventilation.

9. Install air admittance valves within 15 degrees of vertical, and do not install air admittance valves outdoors unless allowed by the manufacturer's instructions.

10. Do not use an air admittance valve as the vent for a sewage ejector tank unless the vent system for the tank is designed by a qualified engineer.

11. Look for the UPC symbol on the air admittance valve. Air admittance valves without this symbol are for use only in manufactured homes. They may not be used in homes governed by the IRC.

12. Do not install air admittance valves outside unless allowed by manufacturer's instructions. Do not install them outside to evade vent clearance requirements to air intake openings.



An island fixture vent is a fairly complicated venting configuration used to vent fixtures installed in a kitchen island. To further complicate matters, many codes now require that the vent pipe from the fixture connect to the vent stack at least 6" above the fixture flood rim.

Air admittance valves can be installed in an island cabinet to vent a sink drain line, greatly simplifying the venting process.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:155

Plumbing Traps

Trap Size

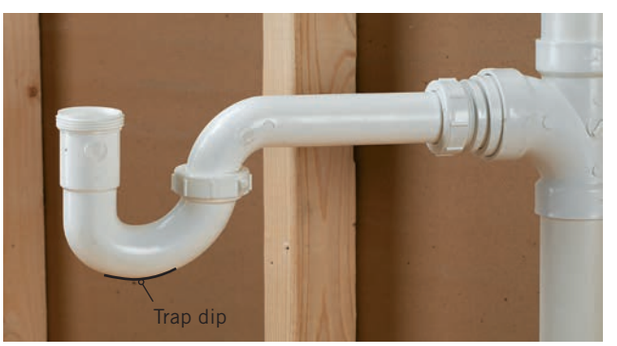
1. Use Table 35 to determine the minimum trap size for most plumbing fixtures.

2. Do not install separate traps on toilets, urinals, and other fixtures that have traps in the fixture itself.

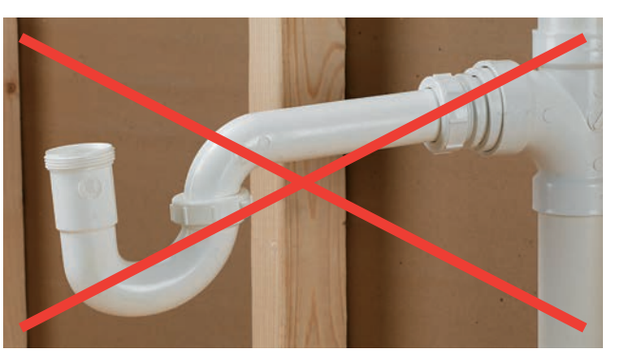
3. Do not install a trap that is larger than the drainage pipe into which the trap discharges. Example: do not connect a 2-inch trap to a 1½-inch pipe on the discharge side of the trap.

Trap Seal

1. Install traps with a water seal of at least 2 inches and not more than 4 inches.



Measure the water seal from the trap dip to the crown weir.



VIOLATION! Install traps so that the water seal is level. Traps set out of level may lose their water seal and will not drain properly.

TABLE 35: MINIMUM TRAP SIZE FOR PLUMBING FIXTURES

PLUMBING FIXTURE	MINIMUM TRAP SIZE
Bathtub (equipped or not equipped with shower head or whirlpool)	1½"
Bidet	1¼"
Clothes washing machine standpipe	2"
Dishwasher (separately trapped)	1½"
Floor drain	2"
Kitchen sink (equipped or not equipped with dishwasher or disposal & trapped using one or two traps)	1½"
Laundry tubs (≥ 1 compartments)	1½"
Lavatory	1¼"
Shower (total flow rate of all showerheads & body sprays) ≤ 5.7 gallons per minute (gpm) > 5.7 gpm & ≤ 12.3 gpm > 12.3 gpm & ≤ 25.8 gpm > 25.8 gpm & ≤ 55.6 gpm	1½" 2" 3" 4"

2. Install floor drain traps that have a deep seal (near 4 inches) design or a trap primer. Connect trap primer valves above the trap seal level.

Trap Installation

1. Set traps level with respect to their water seal.

2. Protect traps from freezing.

3. Provide access to traps with slip joints at the trap inlet or outlet.

4. Do not install more than one trap per fixture.

5. Limit the vertical distance between the fixture drain outlet and the trap weir to not more than 24 inches.

6. Limit the horizontal distance between the fixture drain outlet and the center of the trap inlet to not more than 30 inches. Note that this 30-inch horizontal distance may be eliminated or not enforced in some jurisdictions. Verify if this provision applies in your jurisdiction.

Prohibited Traps

1. Do not install the following types of traps: bell traps, drum traps, S-traps, traps with moving parts, and building traps.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:156

Plumbing Appliances & Fixtures

The installation and hookup of appliances that are part of your home plumbing system is the part of the plumbing process that DIYers are most likely to attempt. The information in this section provides a good general backdrop for making plumbing hookups, but be sure to read the manufacturer's installation recommendations carefully. As always, manufacturer instructions take precedence over codes.

Water Heaters

Replacing a water heater is a relatively easy DIY plumbing task as long as it is a like-for-like replacement. In an ideal situation, you'd replace the old unit with one of the exact same size and make, and thereby avoid having to move any gas, water, or electrical lines. But if you choose to upgrade or downgrade in size, or perhaps replace an old electric water heater with a gas water heater that costs less to run, you'll find that relocating the necessary lines isn't that difficult. Be sure to check with your local building department to determine if a permit is required to replace a water heater. A permit probably is required unless you are replacing like-for-like.

Water heaters for primary duty in residences range in size from 30 gallons to 65 gallons. For a family of four, a 40- or 50-gallon model should be adequate. While you don't want to run out of hot water every morning, you also don't want to pay to heat more water than you use. Base your choice on how well your current water heater is meeting your demand.

Prohibited Locations for Water Heaters

1. Do not install fuel-fired water heaters in rooms used as storage closets. You may install water heaters in closets used solely to store the water heater if you provide adequate combustion air in the closet. You may install electric water heaters in any closet when allowed by the manufacturer.
2. Do not install fuel-fired water heaters in bedrooms or bathrooms unless the water heater is installed in a sealed enclosure where combustion air does not come from the living space. This restriction does not apply to direct vent water heaters.
3. You may provide access to water heaters located in attics or crawl spaces through bedrooms, bathrooms, or their closets if ventilation of the bedroom, bathroom, or closet complies with codes.

Water heaters typically last for at least 10 years, but once they start to show signs of aging, it's a good idea to replace them with a new, more efficient appliance.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:157

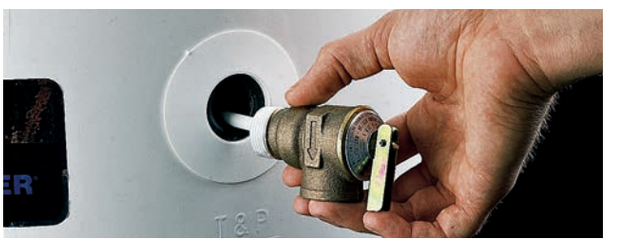
Water Heater Relief Valves

1. Install either a separate temperature relief valve and a separate pressure relief valve or a combination temperature and pressure relief valve on all appliances used to heat or store hot water. Combination temperature and pressure relief valves (T&P valves) are used almost exclusively in modern water heaters. This provision applies to tank-type, tankless, and swimming pool water heaters.

2. Install the temperature relief or T&P valve on the top of the water heater or on the side of the water heater within 6 inches of the top. Do not install an extension pipe between the water heater and the T&P valve.

3. Do not install a check valve or shutoff valve anywhere that might interfere with the operation of the relief valve or the flow of water or steam from the discharge pipe.

The T&P valve is a critical safety device that is required on all water heaters.



T&P valves should be installed on your water heater prior to placing the appliance in position. Many water heaters today come with the T&P valve preinstalled.

Water Heater Relief Valve Discharge Pipe

1. Use water distribution pipe listed in Table 28 (see page 133) as the relief valve discharge pipe. Copper and CPVC are the most commonly used discharge pipes. It is difficult to maintain uniform slope and fall on flexible pipes, such as PEX.

2. Install the discharge pipe so hot water and steam will not cause personal injury or property damage if the relief valve discharges.

3. Install the discharge pipe so that any leaking from the pipe outlet is readily observable by the building occupants.

4. Use a discharge pipe that is at least as large as the relief valve opening. The size is usually ¾ inch in diameter. Use 1-inch-diameter pipe or tubing if insert fittings are installed in the discharge pipe. PEX tubing is the most common example of this situation.

5. Run the discharge pipe full size to the floor, to an indirect waste receptor (such as a floor drain) inside the building, to the water heater drip pan, or outside the building. If the area is subject to freezing, terminate the discharge pipe through an air gap into an indirect waste receptor located inside the building. You may use other discharge points in areas subject to freezing, if approved by the local building official.

6. Slope the discharge pipe so that it drains by gravity from the relief valve to the discharge point.

7. Do not connect the discharge pipe directly to the building's drain, waste, and vent system. Leave an air gap between the discharge pipe and the floor, ground, or other termination point.

8. Do not install a trap or a valve or a threaded outlet in the discharge pipe.

9. Terminate the discharge pipe through an air gap not more than 6 inches and not less than 1½ inches above the floor.

10. Do not connect more than one appliance to a discharge pipe.

SAFETY TIP

T&P valve manufacturers recommend testing the valve at least once per year. They also recommend having a licensed plumber inspect the valve at least every 3 years. Minerals in the water can collect on the sensor and render the valve inoperable. Check and follow the safety instructions for your T&P valve.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:158

Install a drip pan under a water heater when water leaks might damage surrounding areas. Use at least a ¾"-diameter discharge pipe to drain the drip pan. Use a larger discharge pipe if the connection to the drip pan is more than ¾" diameter.

Water Heater Drip Pans

1. Install a drip pan under storage tank water heaters located where leakage could cause damage. These locations often include attics and all areas within the conditioned area of the home, including finished basements. Drip pans are not required under tankless water heaters, unless required by local codes.

2. Use a drip pan at least 1½ inches deep and made with at least 24-gauge galvanized steel or other approved materials. Use a pan with a size and shape to catch all leaks and condensation from the water heater. Do not install a plastic pan under a gas-fired water heater unless the pan is listed for installation under a gas-fired water heater.

3. Run the discharge pipe to an indirect waste receptor (such as a floor drain) or to the outside of the building. Terminate the pipe not more than 24 inches or not less than 6 inches above the ground or a waste receptor, such as a floor drain.

4. You are not required to install a pan under a replacement water heater if no pan is currently installed.

The vent for a gas water heater should be connected securely to the draft hood at the top of the appliance.

Do not connect PEX supply tubing directly to a water heater. Install metal connector tubes to the inlet ports first, and then attach the PEX to the tubes.

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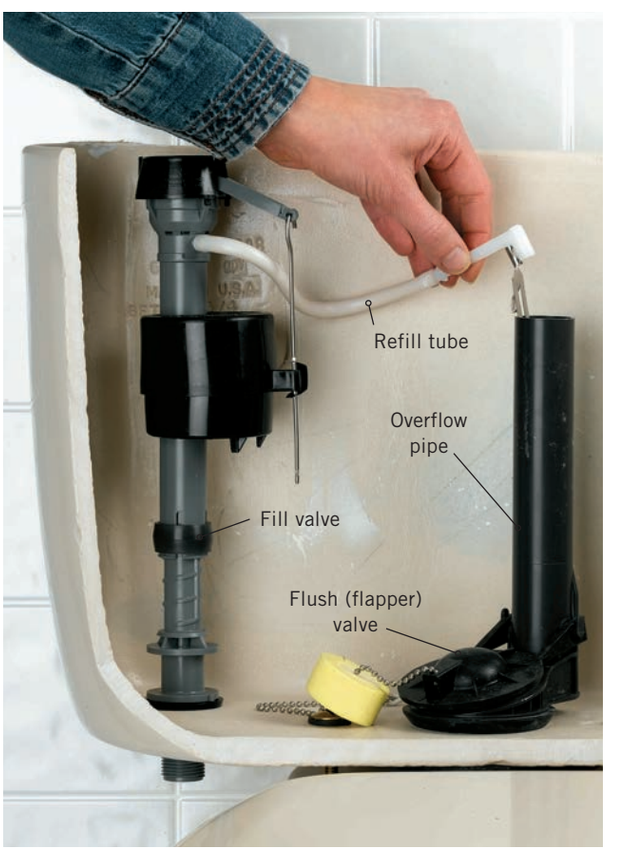
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:159

Toilets

You can replace a poorly functioning or inefficient toilet with a high-efficiency, high-quality new toilet in just a single afternoon. All toilets made since 1994 have been required to use 1.6 gallons or less per flush, which has been a huge challenge for the industry. Today, the most evolved 1.6-gallon toilets have wide passages behind the bowl and wide (3-inch) flush valve openings—features that facilitate short, powerful flushes. This means fewer second flushes and fewer clogged toilets. These problems were common complaints of the first generation of 1.6-gallon toilets and continue to beleaguer inferior models today. See what toilets are available at your local home center in your price range, then go online and see what other consumers' experiences with those models have been. New toilets often go through a "debugging" stage when problems with leaks and malfunctioning parts are more common.



Most toilet tanks today are equipped with a float cup style fill valve rather than the float ball types that were common previously. Some have power-assisted flush mechanisms to boost today's low-flow toilets.

Your criteria should include ease of installation, good flush performance, and reliability. With a little research, you should be able to purchase and install a high-functioning, economical gravity-flush toilet that will serve you well for years to come.

General Requirements

1. Install toilets with an approved flushing mechanism that provides enough water to clear and refill the toilet bowl and refill the toilet's internal trap. Approved flushing mechanisms are the common gravity feed flush tanks (one- and two-piece tanks) and power-assisted tanks or valves.

2. Install toilets that use an average of not more than 1.6 gallons per flush.

3. Provide the toilet with an adequate supply of water. Control the water supply with an automatic device (such as a float valve) that will refill the toilet tank after each flush and completely stop the flow of water to the tank when the tank is full. The device should also supply enough water to refill the toilet.

4. Install toilets with a flush valve seat in the toilet tank that is at least 1 inch above the flood level of the toilet bowl. An alternate design (used by low-profile one-piece toilets) is acceptable. This design closes the flush valve when the toilet is clogged and prevents water from flowing back into the tank.

5. Provide toilet tanks with an overflow pipe or mechanism that is sufficient to prevent the tank from flooding if the fill valve malfunctions.

6. Provide access to all parts in the toilet tank for repair and replacement. Do not install permanent counter tops or similar obstructions that restrict access to the tank.

7. Use toilet seats made of smooth, non-absorbent material properly sized for the toilet bowl.

8. Use corrosion-resistant screws, nuts, bolts, and washers to secure toilets to the closet flange.

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305471 - B&D Codes for Homeowners 4th Edition Edition_124-167.indd 160 1/10/18 11:43 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:160

Backflow Protection of Toilet Fill Valves

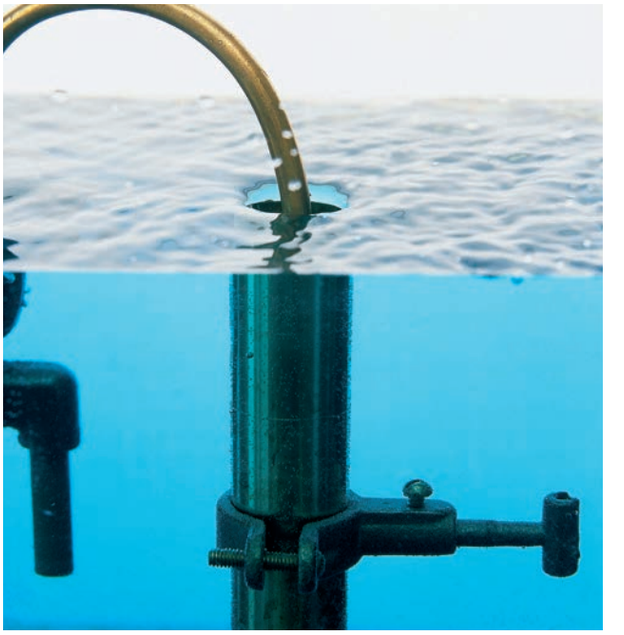
1. Protect toilets with an approved antisiphon fill valve.

2. Locate the backflow preventer at least 1 inch above the opening of the overflow pipe. Fill valves with all parts below the tank water line usually violate this provision.

Toilet (Closet) Flange

1. Install a closet flange that is firmly attached to a structural support (floor) to connect a toilet to drainage piping. Use a closet flange that is compatible with the connected drainage pipe. Example: do not use a PVC closet flange with ABS pipe. Do not use the closet flange to provide structural support to the toilet.

2. Use non-corrosive bolts and an approved gasket (O-ring) or other approved setting compound to secure the toilet and closet flange and to make the seal watertight.



An overflow tube must be provided inside the toilet tank to keep water from rising out of the tank if the fill valve is malfunctioning.

The water inlet of a fill valve should usually be above the tank's water line to reduce backflow of wastewater into the drinking water system.

The closet flange and O-ring seal the plumbing connection. The closet flange does not support the toilet.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:161

Dishwashing Machines

General Requirements

1. You may discharge a dishwashing machine, a disposal, and a kitchen sink into one 1½-inch-diameter drain (trap). Use a ¾-inch-diameter dishwashing machine drain tube when discharging the dishwashing machine into either a sink drain (trap) or a disposal. Connect the dishwashing machine drain tube to a wye fitting in the sink tailpiece when connecting the drain line directly to the sink tailpiece. Loop the dishwashing machine drain line as high as possible in the sink cabinet and securely fasten or install an air gap device. An air gap device is not necessary in the dishwashing machine drain tube unless required by local codes.

Use a wye tailpiece fitting when connecting a dishwashing machine drain tube directly to a sink.

A dishwashing machine drain tube high loop is one method of backflow prevention. Secure the tube as high as possible in the sink base cabinet.

A dishwashing machine drain air gap device is one method of backflow prevention. Install the device according to manufacturer's instructions. These are required in some jurisdictions instead of a high loop.

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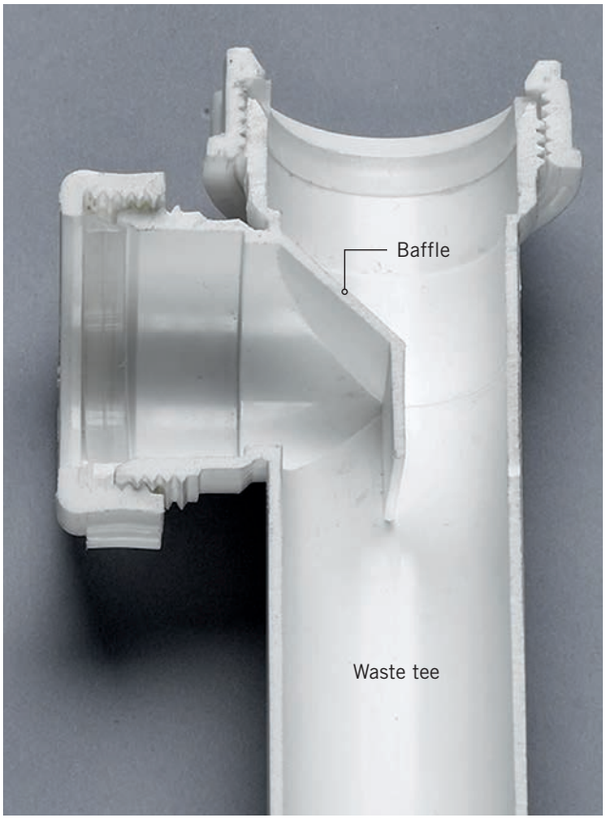
305471 - B&D Codes for Homeowners 4th Edition Edition_124-167.indd 162 1/10/18 11:43 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:162

Food Disposers

Fittings

1. Use an approved directional fitting on the tailpiece when connecting a disposal or dishwashing machine. This helps direct the waste down into the plumbing drain system and avoids blockage and blow back up the tailpiece when these appliances discharge under pressure. Examples of directional fittings include the waste tee with a baffle and a sanitary tee.

A sanitary tee fitting is one possible directional fitting when draining a dishwashing machine or food disposer into a kitchen sink.



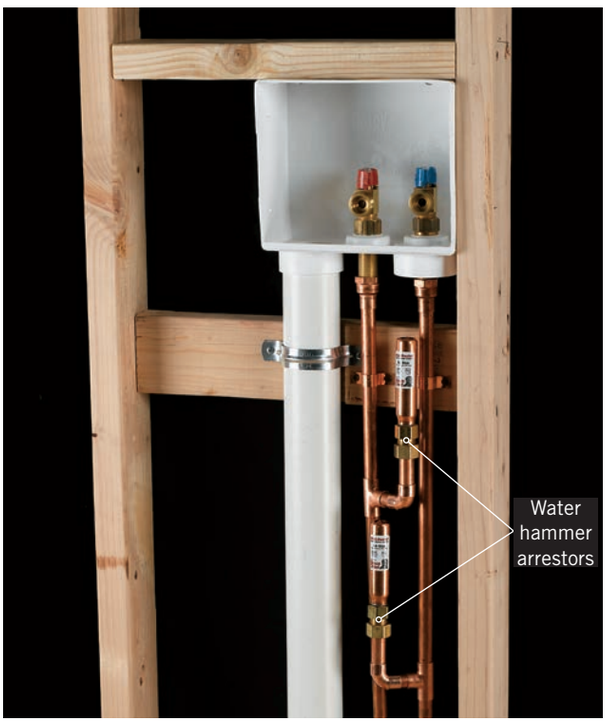
A waste tee with a baffle is one possible directional fitting when draining a dishwashing machine or food disposer into a kitchen sink.

Clothes Washing Machines

Fittings

1. Discharge the wastewater from a clothes washing machine through an air gap. Do not connect the clothes washing machine drain line directly to the plumbing waste pipes. Inserting the clothes washing machine drain hose into the standpipe is the most common acceptable method of providing the required air gap.

2. Install a water-hammer arrestor where required to control water flow and reduce the possibility of water hammer. A water-hammer arrestor may be used near a quick-closing valve, such as in a clothes washing machine.



Water-hammer arrestors may be required in some jurisdictions at clothes washing machine hose connections.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:163

Whirlpool Bathtubs (Jetted Baths)

General Requirements

1. Install whirlpool tubs according to manufacturer's instructions. This includes testing the tub for leaks and pump operation, usually prior to installation, and providing adequate support for the tub, water, and occupants. Some whirlpool tub manufacturers allow plaster as a tub support method. Plaster is not the same as drywall joint compound. Do not use drywall joint compound to support bathtubs unless it is specifically approved by the tub manufacturer.

2. Provide a door or access panel large enough to allow service personnel to repair and replace the pump. The door size will depend on where the pump is located relative to the door. The door may have to be larger than the specified minimum size if the pump is located far away from the door.

3. Make the access opening at least 12 inches by 12 inches if the manufacturer does not specify an opening size. Make the access opening at least 18 inches by 18 inches if the pump is located more than 2 feet away from the opening. Do not place obstructions, such as tub support framing and pipes, between the access opening and the pump.

4. Locate the circulation pump above the crown weir of the trap.

5. Install circulation pipes and pump drain line so that they are self-draining and retain minimum possible water after using the tub.

6. Install whirlpool bathtub motors on a GFCI protected circuit. Do not use the bathroom receptacle circuit for this purpose.

7. Install a copper bonding wire at least #8 AWG connecting all metal pipes, pump motors, and other electrical equipment associated with the whirlpool bathtub. Do not bond grounded double insulated whirlpool bathtub pump motors.

Whirlpool tub motors need access for maintenance and replacement. The access opening must be large enough to allow effective access to the motor. Connect a bonding wire between the tub motor and metal water pipes for electrical safety.

A bathtub can crack and drain connections can loosen and leak unless it is properly supported. Here, the tub is installed on a bed of hardened mortar.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:164

Showers

Shower Size

1. Provide showers with a finished area of at least 900 square inches and a finished minimum dimension of at least 30 inches. Maintain the minimum dimensions from the top of the threshold to at least 70 inches above the shower drain outlet. Measure the shower from the centerline of the threshold (curb). You may install valves, showerheads, soap dishes, and grab bars that encroach into the minimum dimensions. You may install a fold-down seat in the shower if the minimum dimensions are maintained when the seat is up.

2. You may provide a shower with a finished minimum dimension of at least 25 inches if the finished area is at least 1,300 square inches.

3. Provide shower compartment access of at least 22-inch finished width.

4. Swing hinged shower doors out from the shower stall. Hinged doors may swing into the shower stall if they also swing out. Sliding shower doors are also allowed.

Water Supply Riser

1. Secure the pipe between the shower valve and the showerhead to the permanent structure. This provision applies whether the riser is visible or concealed. Securing the riser helps avoid leaks if the riser twists and becomes loose at joints.

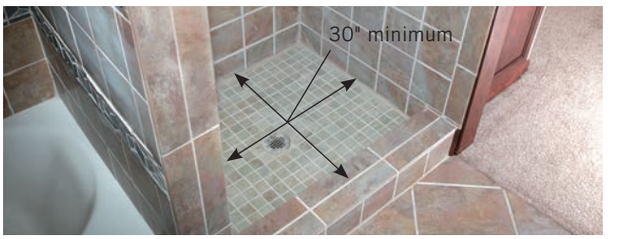
Shower Receptor Construction

1. You are not required to install a raised curb or threshold at the entrance to a shower. Showers designed for wheelchair access will not have a curb or threshold.

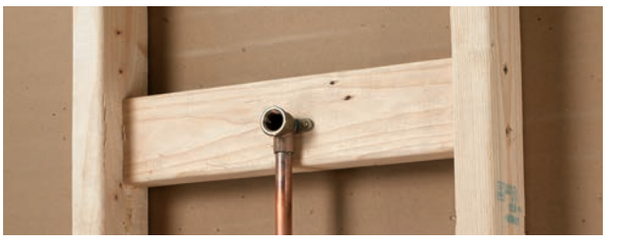
2. Install a shower curb or threshold (when used): (a) at least 1 inch below the sides and back of the receptor; and (b) at least 2 inches and not more than 9 inches above the top of the drain.

3. Slope the shower floor at least ¼ unit in 12 units (2-percent slope) and not more than ½ unit in 12 units.

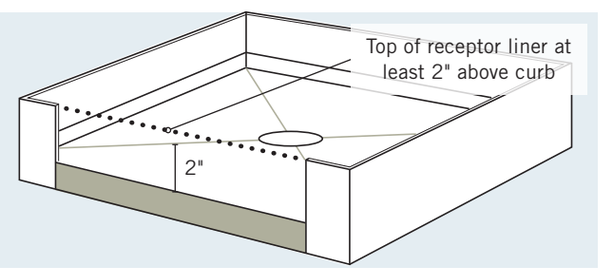
4. Use a flanged shower floor drain that provides a watertight seal at the floor.



A sufficiently large shower stall is more than a convenience—it is a safety issue.



Attaching the shower riser pipe to framing helps avoid water leaks caused when adjusting the showerhead loosens the pipe fittings.



Proper installation of a site-built shower receptor is critical to avoiding costly water leaks.

5. Use hot-mopped felt, sheet lead, sheet copper, approved plastic liner material, or approved trowel-applied liquid material when installing a site-built shower receptor. Plastic liners (such as chlorinated polyethylene and plasticized polyvinyl chloride) are the most common modern site-built liner materials.

6. Extend the lining material at least 2 inches beyond or around the rough jambs of the shower receptor. Extend the lining material at least 2 inches above the finished threshold or curb.

7. Attach the lining material to an approved backing. Nail or perforate the lining at least 1 inch above the finished threshold. Seal joints in plastic lining material according to manufacturer's instructions.

8. Install an approved flanged shower drain that is equipped with weep holes into the drain and is equipped with a flange that makes a watertight seal between the lining material and the drain.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:165

WATER SUPPLY BACKFLOW PREVENTION

An important part of the design and use of the drinking (potable) water supply system is preventing contamination of potable water. Contamination can occur when the potable water supply is intentionally or unintentionally connected to a contaminant source. A cross-connection is a connection between the potable water supply and a potential contaminant source. Backflow is when material (usually liquid) travels in the reverse of the intended direction within a cross-connection. Contamination occurs when contaminated material backflows into the potable water system through a cross-connection.

Some cross-connections are intended. Examples of intended cross-connections include toilet tank fill valves, automatic fill systems for swimming pools, and lawn irrigation systems. Some cross-connections are unintended. Examples of unintended cross-connections include spray hoses connected to a laundry tub faucet and garden hoses attached to chemical sprayers. In these examples, a sudden loss of water pressure in the potable water supply system or an increase in pressure at the contaminant source could allow a contaminant to be drawn back into the potable water system. If the liquid were weed killer in a spray bottle at the end of a garden hose, the weed killer could be drawn into the potable water system.

Backflow into the potable water system can occur by backpressure or by backsiphonage. Backpressure occurs when the pressure in the cross-connection source exceeds the pressure in the potable water supply system. Contaminated material is forced under pressure into the potable water system. Sources of backpressure include pumps, liquid storage tanks at a higher elevation than the cross-connection point, and thermal expansion from a heat source, such as a water heater. Backsiphonage occurs when the pressure in the potable water supply system falls below atmospheric pressure. Air pressure can force contaminated material into the potable water supply system or negative pressure in the potable water supply system can draw contaminated material into the potable water supply system.

The IRC requires protections of all potable water supply outlets and all intentional cross-connections by an air gap or by an approved backflow prevention device.

AIR GAP TERMS

Air gap: An air gap is the unobstructed distance between a water supply fixture outlet opening and the flood rim level of a receptor. Example: the vertical distance between a sink spout and the highest level that the water in the sink could reach without overflowing is the air gap.

Air gap distance measurement: Measure the air gap distance between the plumbing fixture outlet opening and the flood rim of the fixture or receptor. Measure the fixture outlet opening diameter without the aerator attached. Measure the vertical air gap distance with the aerator attached.

Air gap minimum distances: Provide an air gap distance based on the effective size of the fixture outlet opening. In most cases this distance is twice the fixture outlet opening diameter. Example: if a bathroom sink faucet outlet opening is ½", then the minimum vertical air gap between the faucet outlet opening and the flood rim of the sink is 1".

Most commercially available faucets are designed to provide the required minimum air gap distance.

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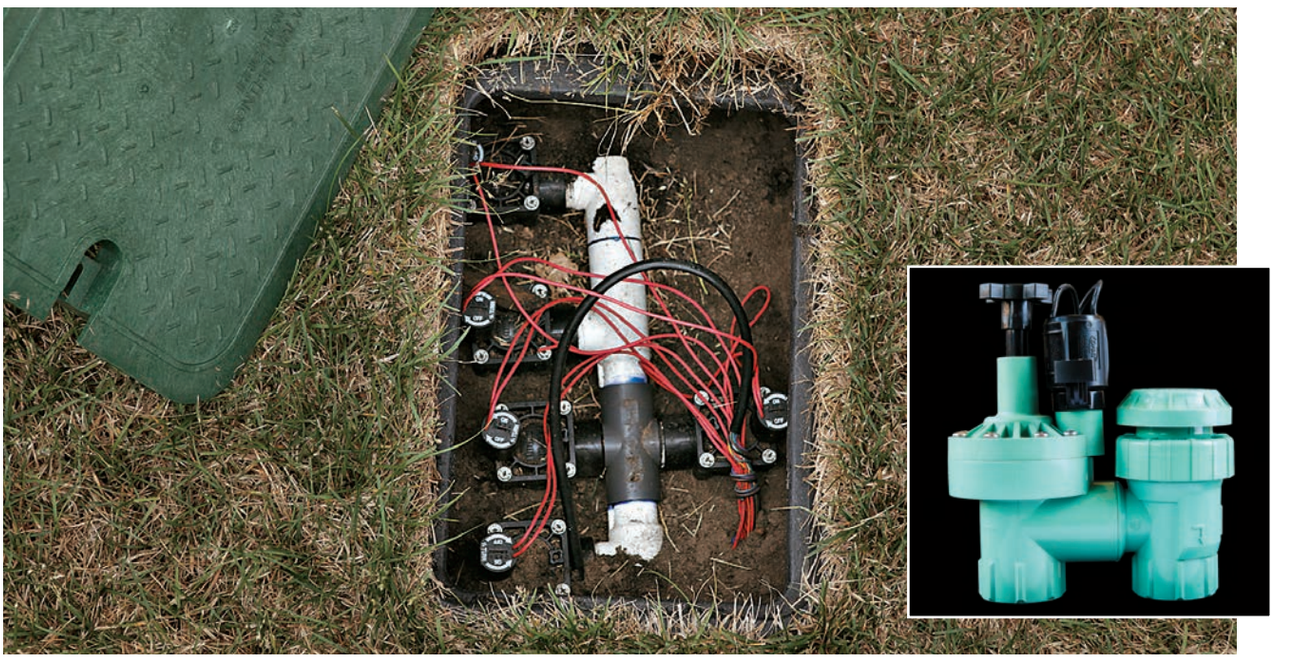
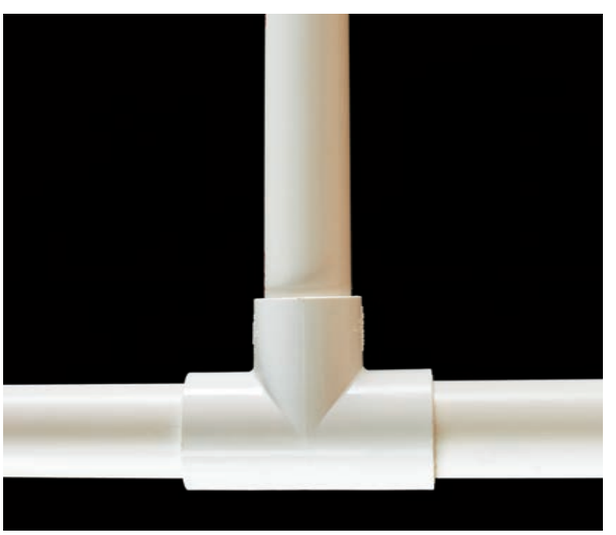
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:166

Irrigation Systems

1. Protect lawn irrigation system water connections by installing an atmospheric vacuum breaker, a pressure vacuum breaker, or a reduced pressure backflow preventer.
2. Do not install a valve downstream from an atmospheric vacuum breaker.
3. Install a reduced pressure backflow preventer if chemicals are introduced into the irrigation system.



VIOLATION! Pressure vacuum breakers are a common way to protect lawn irrigation systems. This manifold is missing a backflow preventer (inset photo) and is a code violation.



PVC supply tubing is a good choice for bringing water to a home irrigation system: ¾" inside diameter schedule 40 is shown here.

Sprinkler heads in many irrigation systems are tied into the water supply with thin riser flex pipes. The union is typically made with a barbed fitting.

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Page:167

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Page:168

Electrical System

Home wiring is a very popular do-it-yourself subject that is fundamentally hazardous. When it comes to electricity, mistakes and accidents do pose threats, including fire, injury, and death. Therefore, safety is the primary focus of the electrical code provisions.

In this chapter you will find many of the rules governing safe installation of electrical wires, electrical equipment—including conduit, electrical receptacles, switches, lights, and other fixtures. Use this information to inspect your wiring and make sure it all conforms to code. If it does not, or if you are unsure about it, have a professional electrician upgrade your electrical system.

In this chapter:

- Understanding Electrical Circuits
- Electrical Grounding & Bonding
- Electrical Branch Circuit Requirements
- Electrical Receptacle Installation
- Ground-Fault (GFCI) & Arc-Fault (AFCI) Protection
- Junction Boxes, Device Boxes & Enclosures
- Switch Installation
- Light Fixture Installation
- Satellite Dishes, Television & Radio Antennas
- Broadband Cable Wiring

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Page:169

DEFINITIONS OF ELECTRICAL TERMS

Accessible (readily): Electrical components are readily accessible if they can be reached quickly without moving or climbing over obstructions (such as pictures and work benches) and without using a portable ladder. Locks may be used to secure readily accessible components; however, the key or combination should be readily accessible to all occupants at all times. Panelboards and service disconnect equipment must be readily accessible in case circuits need to be shut off during an emergency.

Accessible (wires): Wires are accessible if they can be exposed without removing or damaging permanent parts of the building and if a person can reach them for inspection, repair, or maintenance. Examples: wires are accessible if they are behind suspended ceiling panels or if access requires opening a door, removing an access panel, or climbing a ladder. Wires are not accessible if you must cut drywall to expose the wires or if they are located in an area that cannot be reached for repair, inspection, or maintenance.

Bonding: Metallic components are bonded if they are physically and electrically connected together. Example: a bonding wire should connect a swimming pool motor and nearby metal parts of the electrical supply system. Example: metal conduit should be electrically and mechanically connected where it enters a panelboard cabinet.

Bonded metallic components are part of an electrically conductive path that will safely conduct current imposed by a ground fault. Example: when metal conduit containing a damaged wire becomes energized, this is a ground fault. A proper bonding connection will conduct the fault current on the conduit safely to the electrical panel and allow proper operation of the circuit breaker or fuse. Otherwise, a person touching the energized conduit could become the electrical circuit, and that person could receive a dangerous shock or the current flow could generate enough heat to start a fire.

Branch circuit: A branch circuit begins at a circuit breaker or fuse in a panelboard and conducts electricity to where it is used. A branch circuit can serve one device, such as an oven, or it can serve multiple devices, such as receptacles and light fixtures.

Cable: Any two or more wires contained in an insulating sheath or jacket. Most wire used in residential construction is actually a cable called nonmetallic cable and abbreviated NM. “Romex” is a common brand name belonging to one manufacturer of NM cable.

Grounded: The ground in an electrical system is the return path through which alternating current electricity flows to return to its source (the utility's transformer and ultimately to the power generating station). A grounded conductor is connected to the earth or to some body that serves as the earth. A grounded connection may be intentional (as in a circuit’s grounded conductor) or it may be unintentional (as in a ground fault).

Grounding electrode: A component in contact with the earth that provides the grounding connection for the electrical system. Common residential grounding electrodes include a copper rod driven at least 8' into the ground, a metal water service pipe, or a piece of reinforcing steel embedded in the footing.

Grounding wire: A grounding conductor, also called an equipment grounding conductor, connects electrical equipment to the grounding electrode system. This connection usually occurs at a grounding bus or terminal bar at the service equipment that is in turn connected to a grounding electrode. Grounding conductors are bare wires or may be covered with green insulation.

Grounded wire: A grounded conductor, broadly defined, is any conductor that is intentionally grounded. The common term for the grounded conductor in residential electrical systems is the “neutral” wire. The grounded conductor is a current-carrying conductor. You should treat it as such when working with electrical circuits. Grounded conductors are usually insulated with white or light gray insulation.

Grounding electrode wire: The grounding electrode conductor is a wire that connects the grounding electrode to the grounded conductors. In most residential electrical systems, the only connection between the grounding electrode conductor and the grounded conductors should occur at the service equipment.

Ground fault: A ground fault occurs when metal that is not normally energized becomes energized. Examples of a ground fault: (a) the hot (ungrounded) wire in a motor is damaged or disconnected and touches the motor’s case, energizing the case; (b) a screw penetrates the insulation of a hot (ungrounded) wire in an electrical panelboard and energizes the cabinet; (c) damaged insulation on a hot (ungrounded) wire allows the conductor to touch copper water pipe, energizing the pipe.

Location (damp): Damp locations are subject to moderate levels of moisture but are not subject to direct saturation by liquids. Examples of damp locations include covered porches and some basements. Many inspectors consider ceilings over showers and bathtubs as damp locations, but general codes do not specifically cite these as damp locations.

Location (wet): Wet locations are subject to direct contact with liquids or the elements. Examples of wet locations include exterior house walls not protected by a roof,

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:170

concrete and masonry in contact with the earth, and any components buried or in contact with the earth.

Multiwire branch circuit: A multiwire branch circuit is a three-wire branch circuit with two hot (ungrounded) wires and one neutral (grounded) wire. In residential electrical systems, the voltage between the two hot wires is 240 volts, and the voltage between the hot wires and the neutral wire is 120 volts. When a multiwire branch circuit is operating as intended, the current on the shared neutral wire is balanced. An indication that a multiwire branch circuit is not operating as intended is when some lights are dim and some are much brighter than normal. Split-wired receptacles that provide the required two 20-amp kitchen countertop receptacle circuits are one example of a multiwire branch circuit. Clothes dryer and range circuits are another example. Water heater and air conditioning condenser circuits are usually not multiwire branch circuits, because there is no neutral wire in the circuit.

Outlet: An outlet is a connection point where electricity is taken for use. An outlet could be a receptacle, a light fixture box, a junction box connected to an oven, or an air conditioning condenser disconnect box. Switch boxes, junction boxes, and panelboards are not outlets.

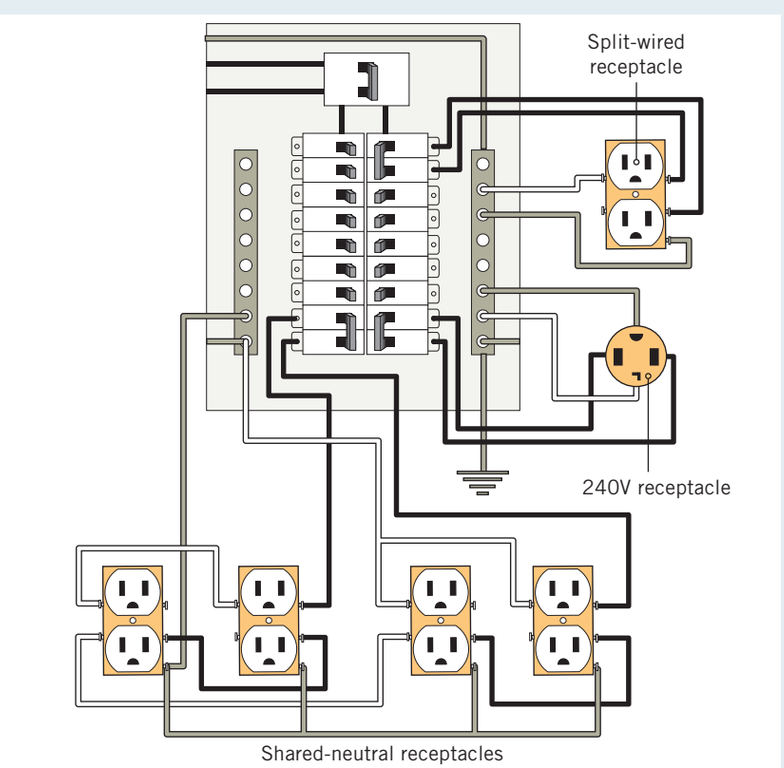
Overcurrent protection device: An overcurrent protection device automatically interrupts the flow of electricity if the current flowing through the device exceeds a design maximum amount. Common examples in residential electrical systems are fuses and circuit breakers.

Receptacle: A device into which a plug is inserted and through which electricity flows to equipment that uses electricity. Receptacles include the familiar single (one plug) and duplex (two plug) 120-volt devices and the 240-volt devices most often seen in laundry rooms to serve electric clothes dryers.

Service drop: The service drop describes overhead electrical wires beginning at the power pole and ending where the service drop wires connect to the service entrance wires. This is usually at the service point near the mast on the roof.

Service entrance wires: Service entrance wires run from the service point to the service equipment. Typically, the service entrance wires mark the point in your home wiring system where the equipment is the responsibility of the homeowner and not the utility company.

Ungrounded conductor: An ungrounded conductor is one that intentionally carries electricity. The common term for an ungrounded conductor in residential electrical systems is the "hot" or "live" wire or conductor. Ungrounded conductors are usually covered with red or black insulation.



Multiwire branch circuits.

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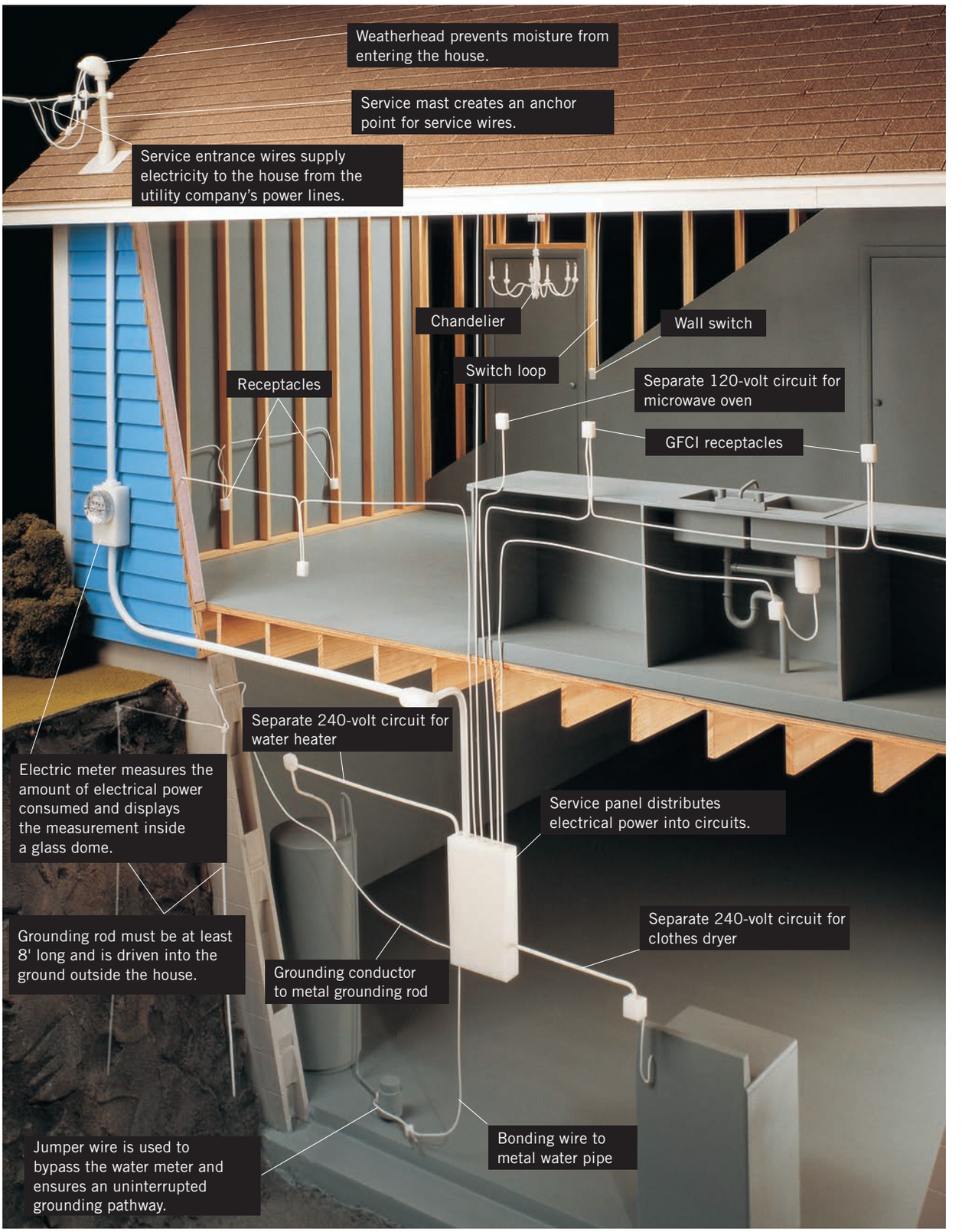
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:171

Typical Home Wiring System



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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:172

Understanding Electrical Circuits

An electrical circuit is a continuous loop. Household circuits carry current from the main service panel, throughout the house, and back to the main service panel. Several switches, receptacles, light fixtures, or appliances may be connected to a single circuit.

Current enters a circuit loop on hot wires and returns along neutral wires. These wires are color coded for easy identification. Hot wires are black or red, and neutral wires are white or light gray. For safety, most circuits include a bare copper or green insulated grounding wire. The grounding wire conducts current when wires or equipment are malfunctioning and helps reduce the chance of severe electrical shock. The service panel also has a bonding wire connected to any metal water pipes.

WIRING SAFETY

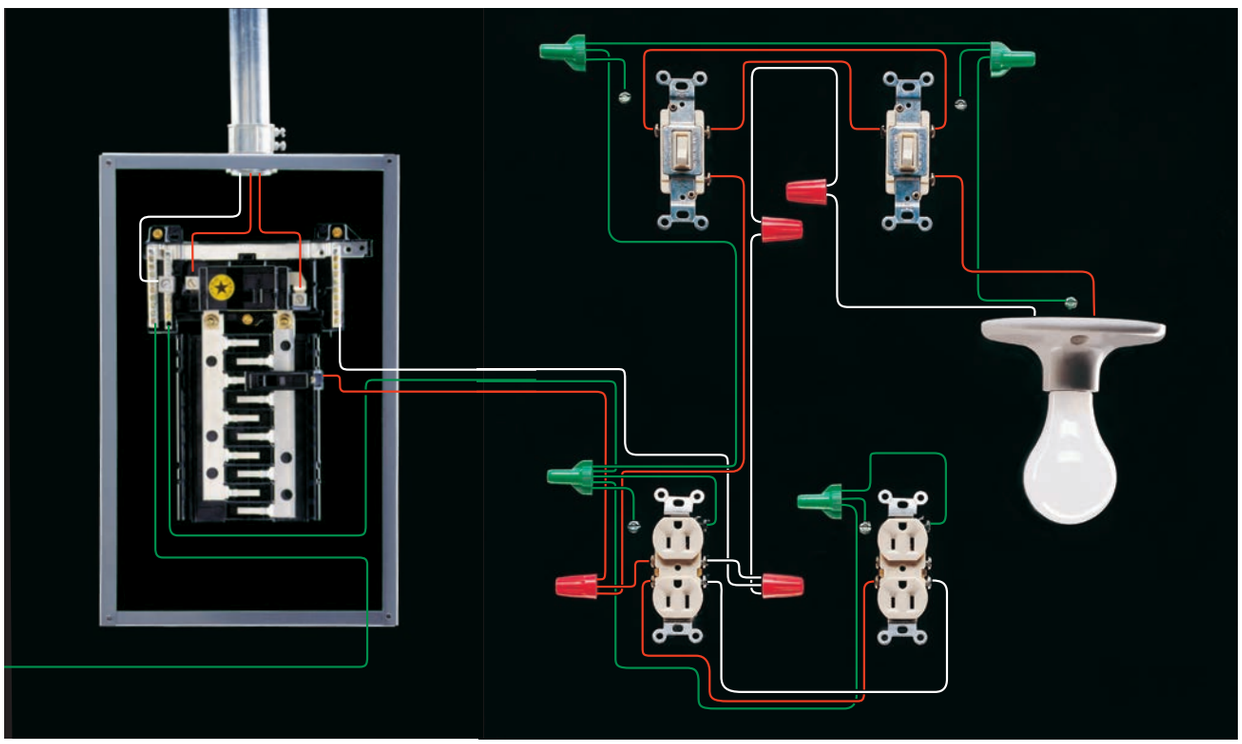
Safety should be the primary concern of anyone working with electricity. Although most household electrical repairs are simple and straightforward, always use caution and good judgment when working with electrical wiring or devices. Common sense can prevent accidents.

The basic rule of electrical safety is: Always turn off power to the area or device you are working on. At the main service panel or subpanel, remove the fuse or shut off the circuit breaker that controls the circuit you are servicing. Then check to make sure the power is off by testing for power with a voltage tester. Restore power only when the repair or replacement project is complete.

Follow the safety tips shown on these pages. Never attempt an electrical project beyond your skill or confidence level. Never attempt to repair or replace your main service panel or service entrance head. These are jobs for a qualified electrician and require that the power company shuts off power to your house.

If a circuit carries too much current, it can overload. A fuse or a circuit breaker protects each circuit in case of overloads.

Current returns to the service panel along a neutral circuit wire. Current then leaves the house on a large neutral service wire that returns it to the utility pole transformer.



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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:173

General Requirements

Minimum Service Current Capacity Requirements

1. Provide at least 100-amp service to a single family home.

2. Provide at least 60-amp service to an accessory structure. Exceptions to the 60-amp minimum service exist for one- and two-circuit 120-volt service to accessory structures.

3. You may use the following wire sizes as a feeder when the load at the accessory structure is limited to one or two 15- or 20-amp, 120-volt branch circuits: (a) use at least #10 AWG copper or #8 AWG aluminum wire if the accessory structure has not more than two 15 or 20 amp, 120 volt branch circuits; (b) use at least #14 AWG copper or #12 AWG aluminum if the accessory structure has only one 15 amp, 120 volt branch circuit and use at least the same size feeder wire as used for the branch circuit.

4. Provide an equipment grounding wire with the feeder wires, and refer to the grounding requirements section if there are at two or more branch circuits in the accessory structure.

Closure of Unused Openings

1. Close all openings in boxes, conduit bodies, and cabinets with material that provides protection equal to the original opening cover. This means using plastic or metal knockout covers. Tape and cardboard do not provide equal protection.

2. Recess metal knockout covers in non-metallic boxes and conduit bodies at least ¼ inch from the surface of the box or conduit body.

3. Cover open outlet boxes with a blank cover, a blank plate, or fixture canopy. Switch plates and receptacle plates do not provide complete closure for electrical boxes.

4. Ground metal covers and plates.

Identification of Circuits in Electrical Panels

1. Provide a legible and permanent marking or label that identifies the purpose of circuit breakers, fuses, and other equipment used to disconnect power from a circuit. Identify the circuit in enough detail that it can be distinguished from all other circuits. Example: do not identify a circuit as general lighting. Identify the specific rooms or outlets served by the circuit. A marking or label is not required if the purpose of the disconnecting equipment is self-evident. Use marking or labeling materials that will withstand the environment where the disconnecting equipment is located.

2. Locate the circuit identification on the face of the panelboard enclosure or on the inside panelboard door.

Prohibited Locations for Electrical Panels

1. Do not locate electrical panels and circuit breakers and fuses in clothes closets, bathrooms, over stairway steps, or in spaces designated for storage.

Cover open conduit knockouts in electrical boxes with an approved plastic or metal cap (inset).

Label each circuit in all electrical panels so that the purpose of each circuit is clear.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:174

Working Clearances around Electrical Panels

1. Inspect your electrical enclosures (cabinets) to make sure they conform to code. If not, hire a professional electrician to relocate it. The following rules apply to electrical enclosures (cabinets) that require access while interior parts are energized. Examples of these enclosures include electrical panels and subpanels, and air conditioner and furnace service-disconnect boxes.

2. Provide a clear working space around electrical enclosures that is at least 36 inches deep, at least 30 inches wide (or as wide as the enclosure if it is wider than 30 inches), and at least 78 inches high (or as high as the enclosure if it is higher than 78 inches). Measure the clear working space from any exposed energized parts or from the cover in front of covered energized parts.

3. The enclosure should have enough clearance that the enclosure door can be opened at least 90 degrees.

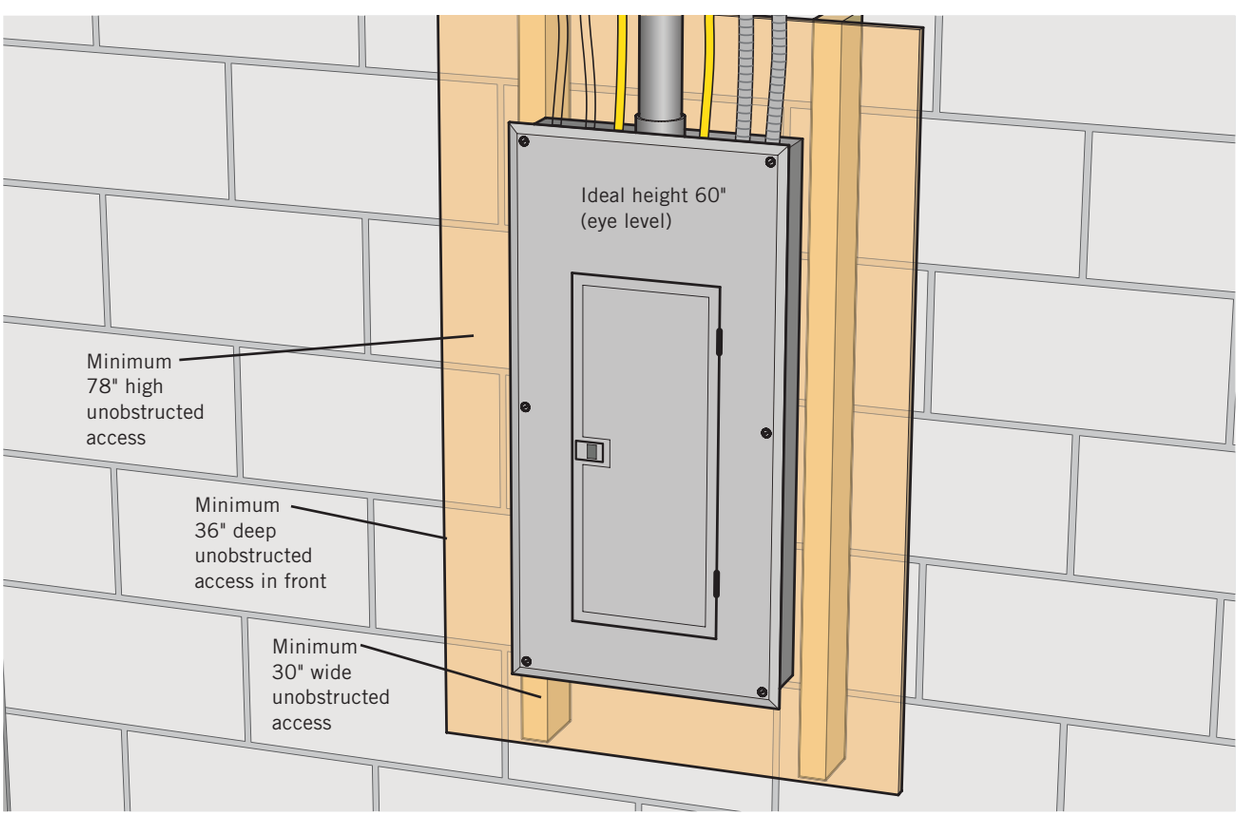
4. Do not locate equipment, pipes, and ducts that are not associated with the electrical system directly above or below an indoor enclosure from the floor to the ceiling or 6 feet above the enclosure, whichever is less.

5. Do not locate anything not associated with the electrical system directly above or below an outdoor enclosure from grade to 6 feet above the enclosure. Examples include hose bibbs, exhaust duct terminations, and appliance vents.

6. Provide access to the clear working space around the enclosure (cabinet). Do not block access with shelves, workbenches, or other difficult to move objects.

7. Install electrical panels and circuit breakers and fuses so that the circuit breaker handle or fuse is not more than 79 inches above the floor or ground when the center of the handle is in its highest position.

8. You may install electrical panels rated not more than 200 amps in existing buildings where the working space height is less than 78 inches. This does not apply to new construction.



Your equpment should include a safe space above, in front of, and below all electrical panels and similar electrical equipment. If your panel does not meet these standards, have it relocated by a professional.

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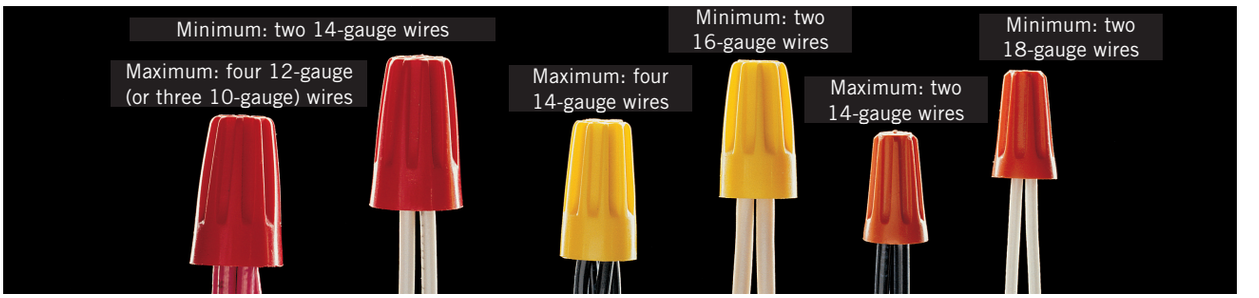
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:175



Use wire connectors rated for the wires you are connecting. Wire connectors are color-coded by size, but the coding scheme varies by manufacturer. The wire connectors shown above come from one major manufacturer. To ensure safe connections, each connector is rated for both minimum and maximum wire capacity. These connectors can be used to connect both conducting wires and grounding wires. Green wire connectors are used only for grounding wires.

Splicing Wires

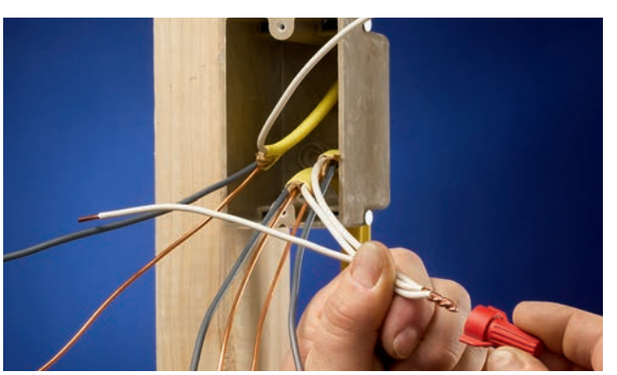
1. Splice (join) wires using only listed devices, such as appropriate-sized wire connectors. Use the wire connector according to manufacturer's recommendations regarding the minimum and maximum number and size of wires that the connector can accommodate.

2. Cover spliced wires with material equal to the original insulation. This does not include electrical tape or similar materials.

3. For splice wires that will be buried in the ground, use only devices listed for direct burial and install them according to manufacturer's instructions.

4. Provide access to spliced wires unless the splice and splicing device are specifically allowed to be concealed. Access is usually provided by an accessible, covered junction box.

5. Do not place wire splices in a raceway unless the raceway has a removable cover.



Twist wire connectors over the ends of individual conductors that have been stripped of insulation. Pre-twist wires together with pliers or linesmans' pliers (optional). Do not leave bare wire exposed beneath the bottom of the connector.

Push-in connectors are a relatively new product for joining wires. Instead of twisting the bare wire ends together, you strip off about ¾" of insulation and insert them into a hole in the connector. The connectors come with two to four holes sized for various gauge wires. These connectors are perfect for inexperienced DIYers, because they do not pull apart like a sloppy twisted connection can.

Splicing Aluminum & Copper Wires

1. Splice (join) aluminum and copper wires together using devices listed for splicing aluminum and copper wires. Look for a mark or label, such as AL/CU, on the device or on the package for assurance that the device is listed for splicing aluminum and copper wires. Some wire nuts sold for residential use are not listed for splicing aluminum and copper wires.

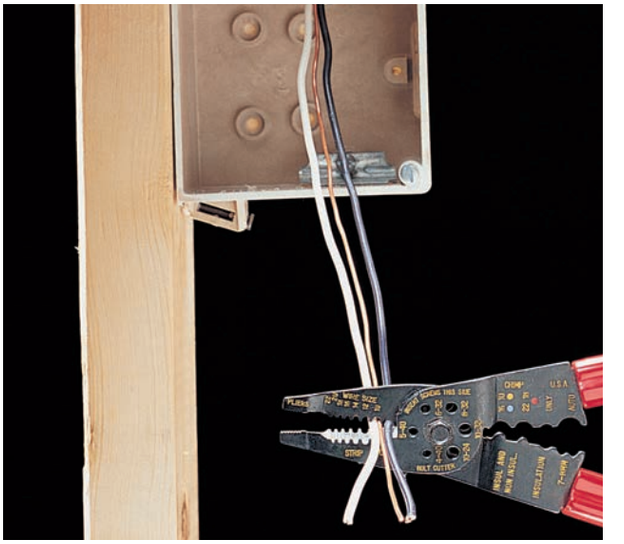
2. Use only inhibitors and antioxidant compounds that are approved for splicing aluminum and copper wires. These materials should not degrade or damage the wires, wire insulation, or equipment. Read and follow manufacturer's instructions.

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 176 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 176 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:176

Length of Wires Extending from Boxes

1. Extend wires at least 3 inches beyond the opening of any electrical box, junction, or switch point if the opening is less than 8 inches in any direction. This applies to most switch, receptacle, and light fixture mounting boxes used in residential electrical systems.

2. Extend wires at least 6 inches beyond where the wires emerge from the raceway or cable sheathing. Example: NM cable enters a single residential switch box with 1 inch of intact sheathing (outer cover). Begin the 6 inches measurement where the sheathing ends. The cable should extend at least 7 inches from the rear of the box. The NM cable should also extend at least 3 inches beyond the outside edge of the box.



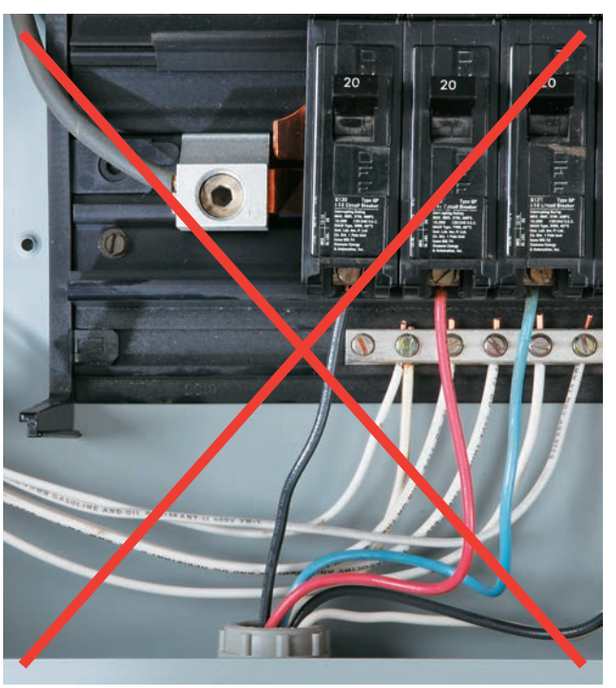
Extend wires past the box opening at least 3".

Connecting Wires to Terminals

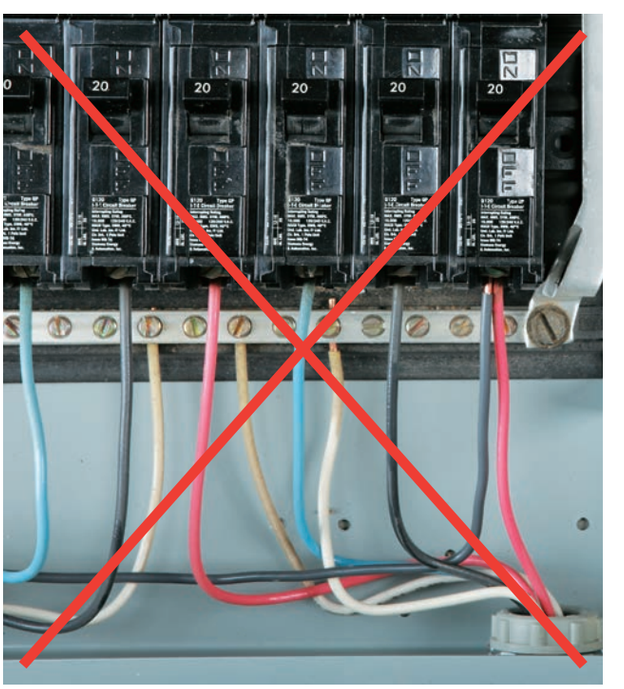
1. Remove insulation from wires and connect wires to terminals without damaging the wire. Do not connect damaged wires to terminals. Example: if you nick, damage, or cut strands from a stranded wire, cut the wire back to where it is full size and use the full, undamaged wire.

2. Connect more than one wire to a terminal only if the terminal is identified to accept multiple wires. Example: general codes require one wire per terminal for the grounded (neutral) wires and allow two or more same-gauge wires per terminal for the equipment grounding wires. Example: many circuit breakers allow only one hot (ungrounded) wire per circuit breaker terminal.

3. Connect aluminum wires to terminals only if the terminal is identified to accept aluminum wires.



VIOLATION! Do not connect multiple neutral or hot wires to a terminal (the neutral bus bar seen here has two neutral conductors connected to single terminal).



VIOLATION! Never connect multiple hot wires to the same terminal on circuit breakers or other electrical devices unless specifically allowed by the manufacturer.

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305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 177 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:177

Wire Color Codes

1. Use wires with white or gray insulation or wires with three white stripes on other than green insulation as neutral (grounded) wires.

2. Use wires with green insulation, or wires with green insulation and at least one yellow stripe as equipment grounding wires. You may use uninsulated (bare) wires as equipment grounding wires in most circuits.

3. You may use any color other than white, gray, or green as hot (ungrounded) wires. The common colors are red and black.

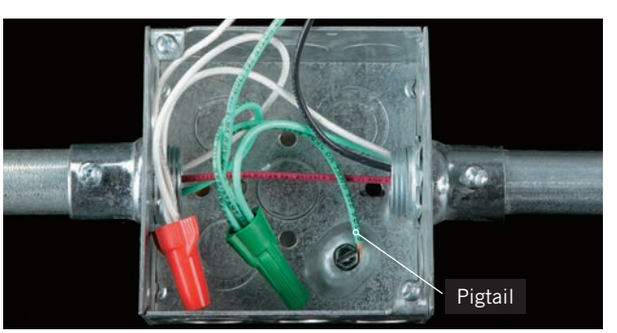
4. You may use a wire with white or gray insulation as a hot (ungrounded) wire if the wire is part of a cable (such as NM) and if you permanently mark it as a hot (ungrounded) conductor at all places where the wire is visible and accessible. This marking is usually done by wrapping the end of the wire with black or red electrical tape. The marking must encircle the insulation.

Neutral & Equipment Grounding Wire Continuity

1. Connect neutral (grounded) wires together in device boxes if the neutral wire is part of a multiwire branch circuit. Do not rely on any device, such as a receptacle or light fixture, to provide the connection for the neutral wire in a multiwire branch circuit.

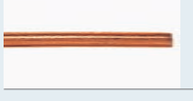
2. Connect equipment grounding wires together in all device boxes. Do not rely on any device, such as a receptacle or light fixture, to provide the connection for the equipment grounding wire in any circuit.

3. Install a wire (called a pigtail) between the connected wires and any device in the box.



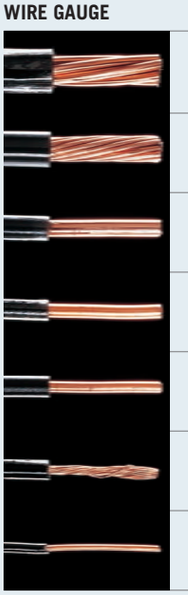
Use a pigtail when you need to connect multiple wires together and use one wire to connect to a terminal.

WIRE COLOR CHART

WIRE COLOR		FUNCTION
	White	neutral wire: at zero voltage in many, but not all, circuits
	Black	hot wire carrying current at full current & voltage
	Red	hot wire carrying current at full current & voltage
	White, Black markings	hot wire carrying current at full current & voltage
	Green	serves as a grounding pathway
	Bare copper	serves as a grounding pathway

Individual wires are color-coded to identify their function. In some circuit installations, the white wire serves as a hot wire that carries voltage. If so, this white wire may be labeled with black tape or paint to identify it as a hot wire.

WIRE SIZE CHART

WIRE GAUGE		WIRE CAPACITY & USE
	#6	55 amps; central air conditioner, electric furnace
	#8	40 amps; electric range, central air conditioner
	#10	30 amps; window air conditioner, clothes dryer
	#12	20 amps; light fixtures, receptacles, microwave oven
	#14	15 amps; light fixtures, receptacles
	#16	light-duty extension cords
	#18 to 22	thermostats, doorbells, security systems

Wire sizes (shown actual size) are categorized by the American Wire Gauge system. The larger the wire size, the smaller the AWG number. Amp ratings in this chart assume that the wires are contained in NM cable.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:178

Shut off power at the main electrical service panel before beginning any work. In some cases you may shut off individual circuits, but the safer precaution is always to throw the main breaker.

Service & Main Service Panel

Disconnecting Electrical Service

1. Provide equipment to disconnect all electrical service to a building using not more than six sets of switches or six sets of circuit breakers. The disconnecting equipment may be in one cabinet or in a group of cabinets in the same general location.

2. Label the service disconnecting equipment as such. The label must be permanent and clearly marked.

3. Use only service disconnecting equipment listed and labeled for that purpose. The electric meter and meter enclosure are not service equipment. Do not rely on removing the electric meter to disconnect electrical service.

4. The service disconnecting equipment should be installed in a readily accessible place where every building occupant has access.

5. The service disconnecting equipment may be located outside the building or inside the building as close as possible to where the service entrance conductors enter the building. Check with the local building official for information concerning your area. Fifteen feet is one typical maximum, but the distance may be less in some jurisdictions.

6. Service disconnecting equipment should not be located in bathrooms.

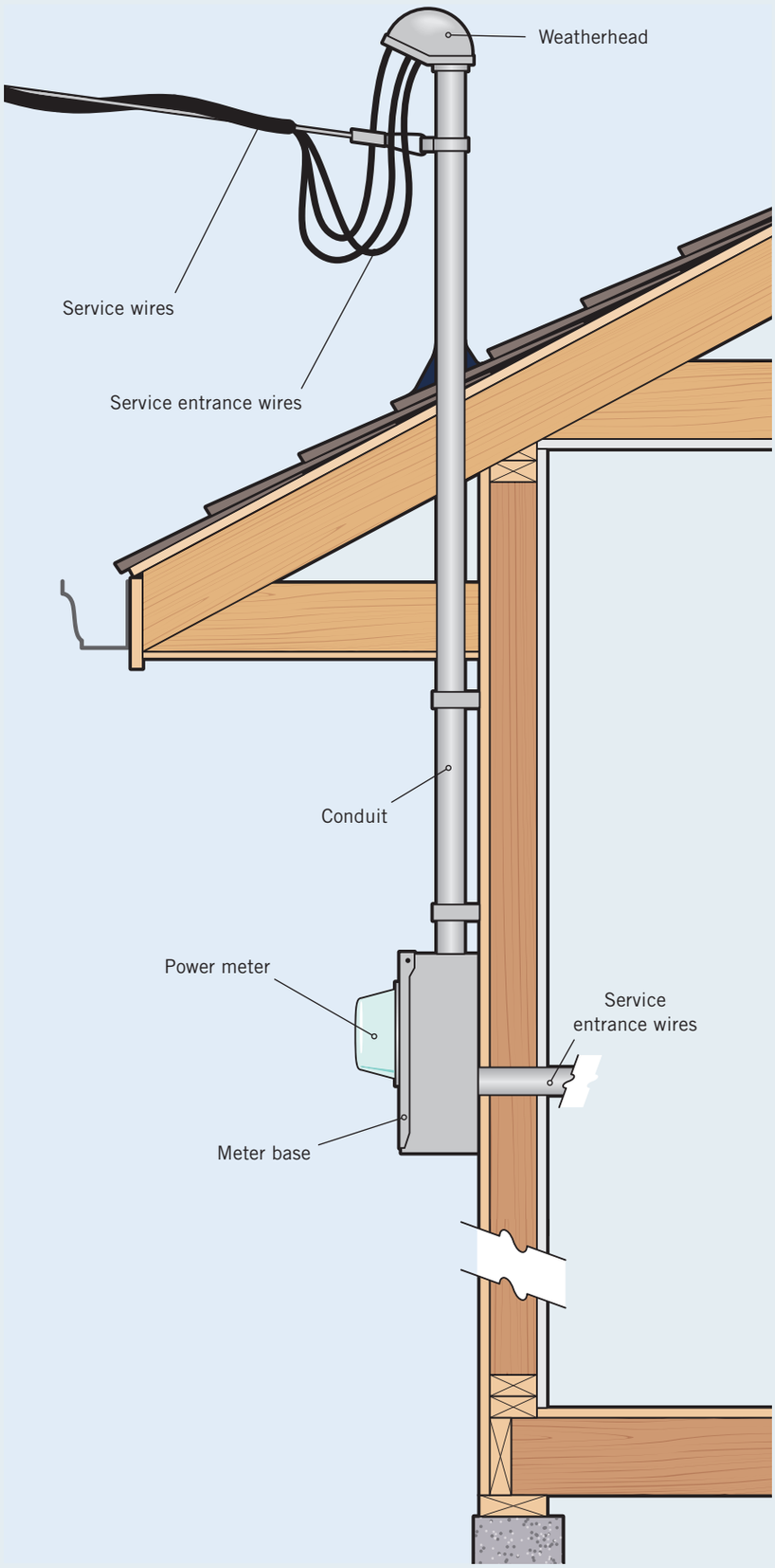
7. Service disconnecting switches or circuit breakers should not be installed more than 79 inches above the floor or ground.

A service disconnecting switch may be required when the main service panel is located too far from the point where the service entrance conductors enter the house.

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 179 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 179 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:179

IDENTIFYING YOUR SERVICE

Aboveground service. In this common configuration, the service wires from the closest transformer (called the service drop) are connected to the power distribution system in your house through a protective hood called a weatherhead. The service entrance wires are routed to a power meter that's owned by your utility company but housed in a base that may be your property. From the meter the entrance wires enter your house through the wall and are routed to the main service panel, where they are connected to the service equipment. Other aboveground configurations are allowed.



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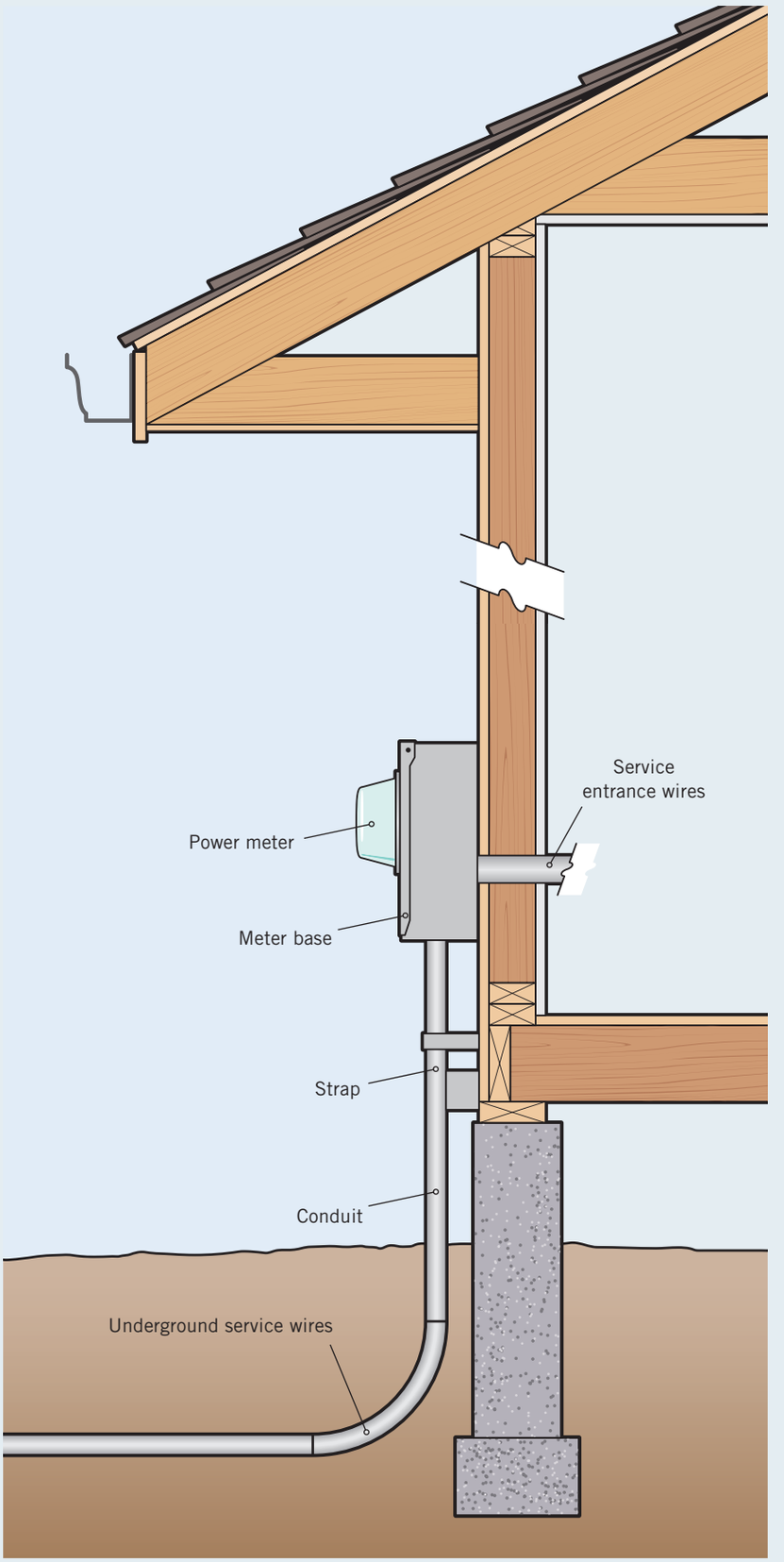
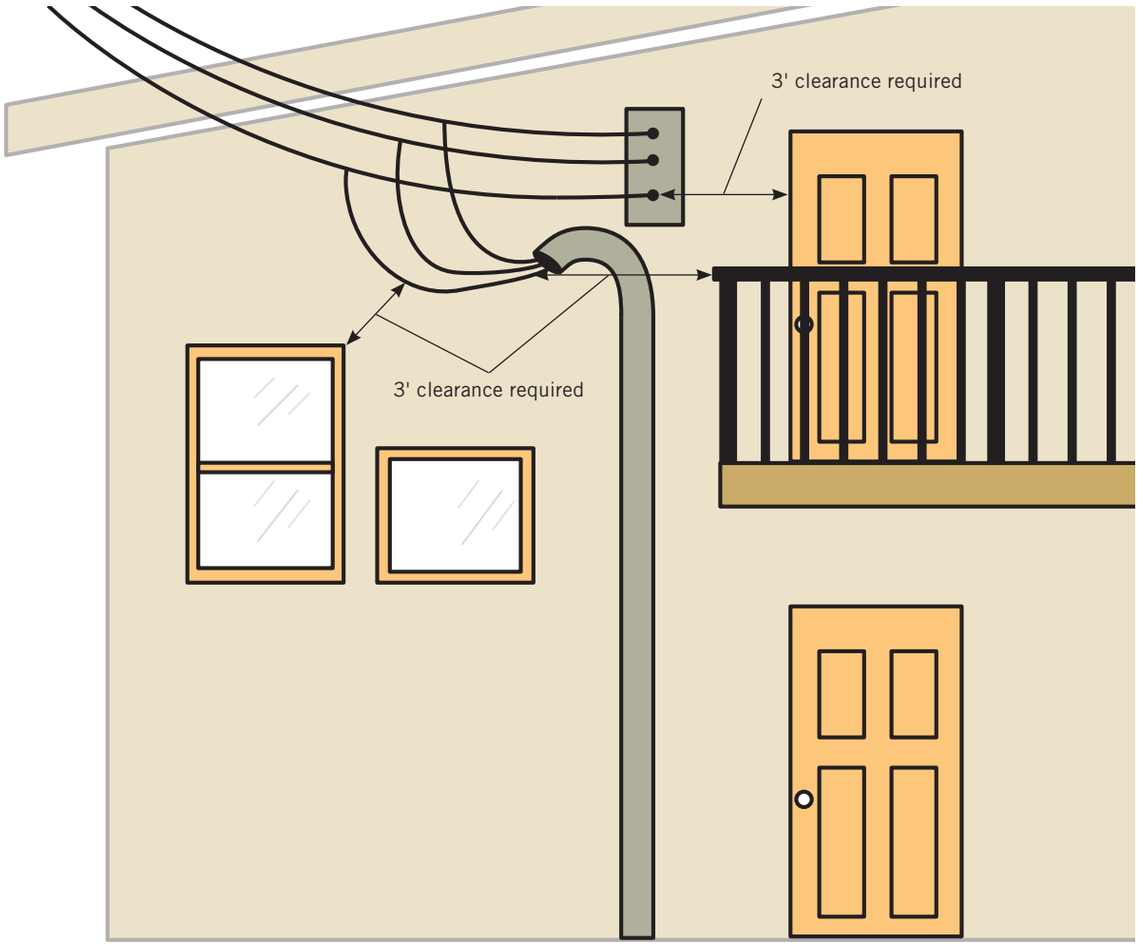
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:180



Underground service lateral. Increasingly, homebuilders are choosing to have power supplied to their new homes through underground service wires instead of an overhead service drop. Running the wires in the ground eliminates problems with power outages caused by ice accumulation or fallen trees, but it entails a completely different set of wire and conduit requirements. For the homeowner, however, the differences are minimal because the hookups are identical once the power service reaches the meter.

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 181 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 181 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:181

Inspect your service clearance to make sure individual service wires are not within 3' of doors, operable windows, and decks.



Overhead Service Drop Wire Clearances

1. Provide at least 3 feet of clearance between service drop and service entrance wires and porches, decks, stairs, ladders, fire escapes, balconies, sides of doors, and sides and bottoms of operable windows (not the tops of operable windows even if the top sash is operable). Clearance is required only to service drops and service entrance wires that consist of individual wires that are not protected by a raceway or outer jacket. This means that clearances are usually required for utility service drop wires and are not required for SE type service entrance cable and for wires or cables installed in conduit or tubing.

2. Provide at least 8 feet of vertical clearance between service drop wires and a roof not designed for regular pedestrian traffic, with a slope less than 4 inches in 12 inches. Access to such a roof would usually be by a ladder, through a window, or through a maintenance hatch.

3. You may reduce the 8-foot vertical clearance to at least 3 feet of vertical clearance if: (a) the voltage between wires is not more than (≤) 300 volts and (b) the roof is guarded or isolated; or if (c) the roof slope is at least 4 inches in 12 inches. Many residential service drops comply with this exception.

4. Provide at least 10 feet of vertical clearance between service drop wires and a roof designed for regular pedestrian traffic. Access to such a roof would usually be by stairs or by a door, and the roof edges would be protected by a guard.

5. Provide at least 18 inches of vertical clearance between service drop wires and a roof if: (a) the wires pass only over the overhang portion of the roof, and (b) not more than 6 feet of wire pass over not more than 4 lineal feet of roof surface measured horizontally, and (c) the wires enter a through-the-roof mast or terminate at an approved support.

6. Maintain all required clearances above the roof for at least 3 feet in all directions from the roof's edge.

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 182 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 182 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:182

Service Drop Clearance Aboveground

1. Measure the vertical clearance between service drop wires and the ground, walkway, driveway, or street beginning at the lowest point of the service drop wires and ending at the surface under the wire's lowest point. The lowest point of the service drop wires is often at the drip loop, but it could be at the point of attachment to the house or it could be where the wires enter the house.

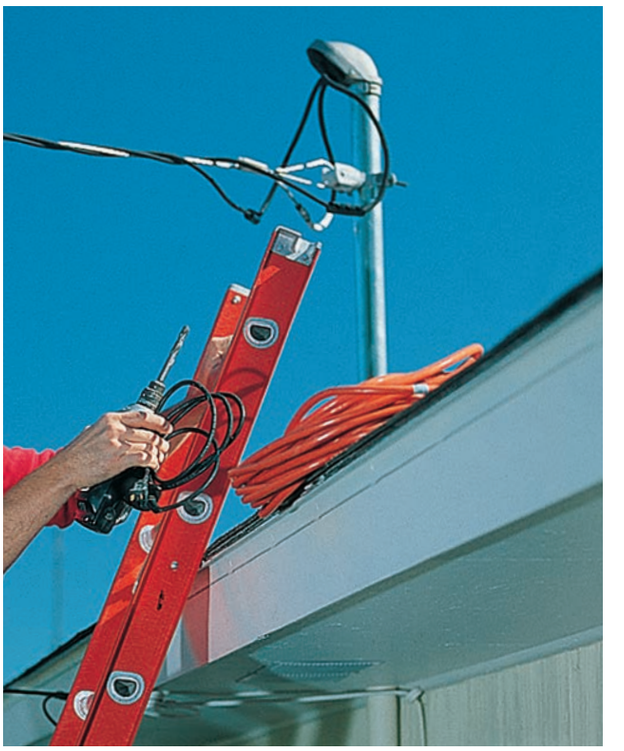
2. Provide at least 10 feet of vertical clearance between service drop wires and areas or sidewalks accessed by pedestrians only.

3. Provide at least 12 feet of vertical clearance between service drop wires and residential property and driveways.

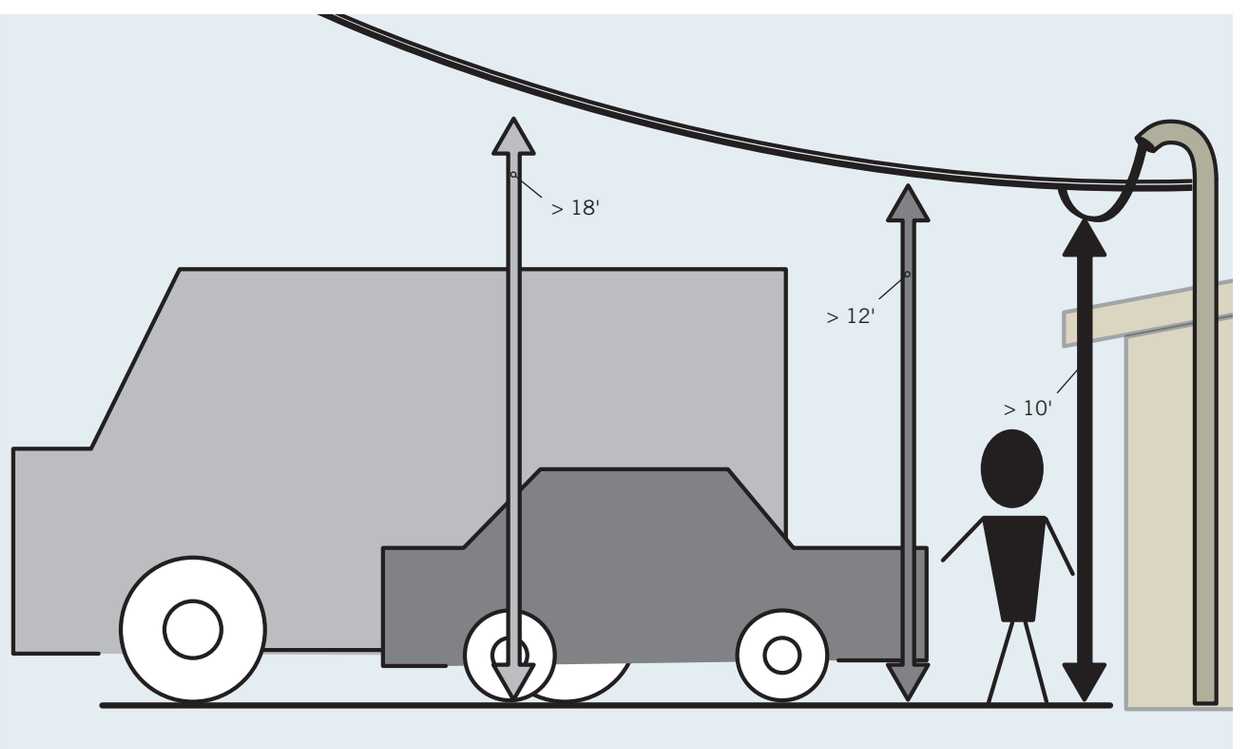
4. Provide at least 18 feet of vertical clearance between service drop wires and public streets, alleys, roads, or parking areas subject to truck traffic.

SAFETY TIP

If your electrical service entry does not conform to the codes, hire a professional to update it.



The service drop must occur at least 10' above ground level, and as much as 18' in some cases. Occasionally, this means that you must run the conduit for the service mast up through the eave of your roof and seal the roof penetration with a boot.



Safe clearance between service drop wires and the ground.

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 183 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 183 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:183

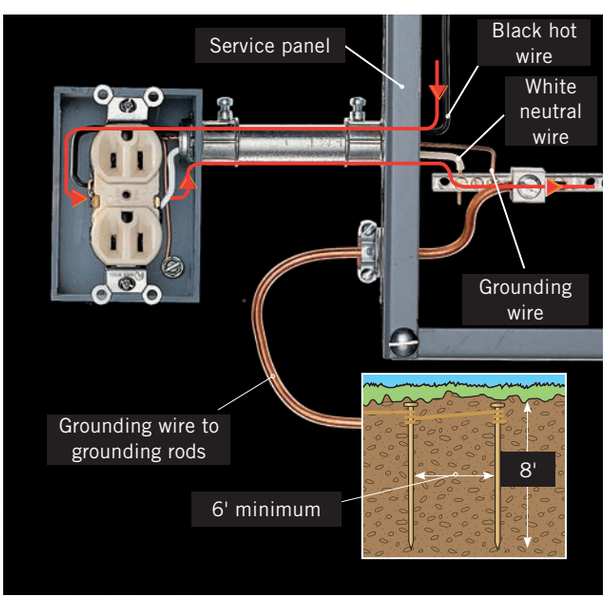
Electrical Grounding & Bonding

One of the important purposes of grounding and bonding can be summarized in this simple rule: Electricity wants to return to its source and will take all available paths to get there. When the electrical system is working as intended, electricity enters through the hot (ungrounded) wire, does its work, and returns to its source (usually the utility's transformer) through the neutral (grounded) wire.

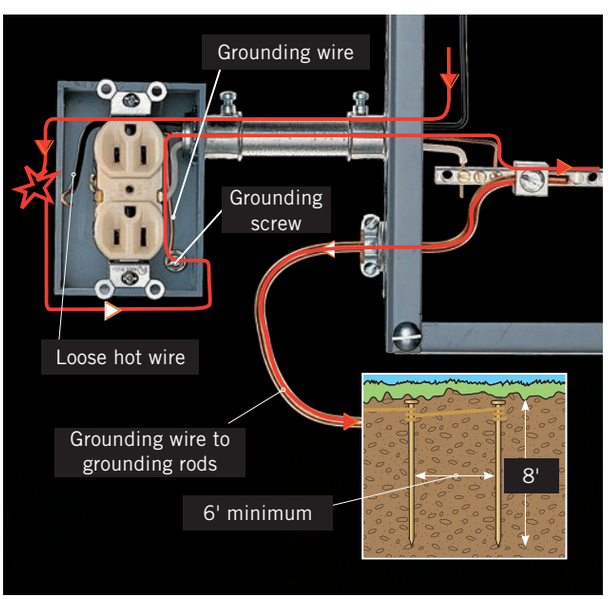
When electricity finds its way out of the intended path, things get dangerous. Example: a rat sits on copper water pipe and chews through the insulation on electrical cable exposing the hot (ungrounded) wire. After electrocuting the unfortunate rat, the exposed wire lands on the water pipe. If the water pipe is connected without electrical interruption to the electricity's source (through bonding), the electricity thinks that the water pipe is the neutral (grounded) wire and happily starts flowing through the water pipe. This is a ground fault. The electric current should quickly rise to the point where it trips a circuit breaker or blows a fuse, clearing the fault.

But what if the water pipe is not bonded? Perhaps a water softener has been added to the system, interrupting the electrical continuity of some or all of the water pipe. In our example, the water pipe is still energized, but there is no way for the electricity to return to its source; that is, until someone grabs a metal water faucet handle and is standing on the ground or on some conducting surface. At that time, the electricity finds its path to its source through the person. The person is injured or killed.

When trying to understand grounding and bonding, think like electricity. If metal can become energized, however unlikely that is, you must assume that it will become energized. Bonding metal together and connecting the metal to ground in an approved manner lets you, not the electricity, decide how electricity will flow in a fault condition.



Normal current flow: Current enters the electrical box along a black hot wire, then returns to the service panel along a white neutral wire.



Ground fault: Current is detoured by a loose wire in contact with the metal box. The grounding wire picks it up and channels it safely back to the main service panel where the circuit breaker trips or the fuse blows.

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 184 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 184 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:184

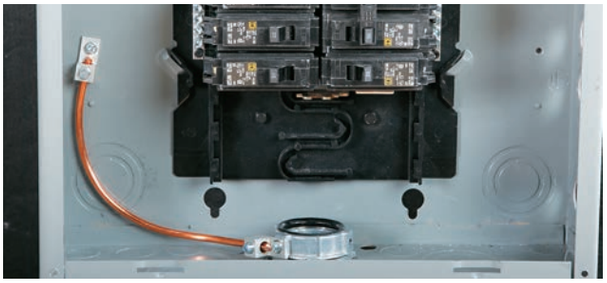
Inspect Electrical Panels for Proper Grounding

Grounding & Bonding at Service Panels & Subpanels

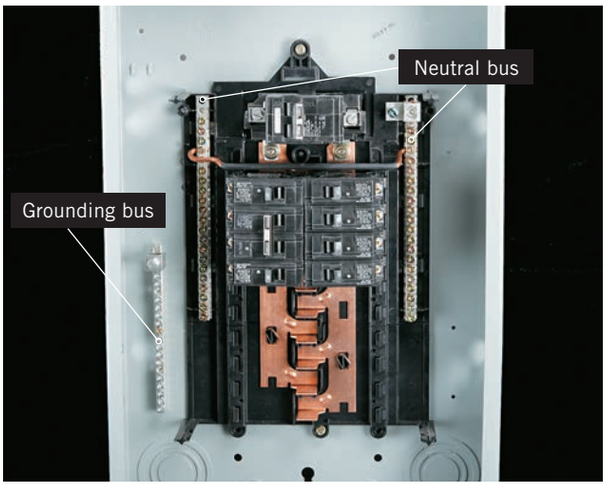
1. The neutral (grounded) wire should be connected to the grounding electrode wire at the nearest accessible point at or before the service equipment (main disconnect). The service equipment is usually the most convenient accessible grounding point, because the meter enclosure and points before it are usually locked or secured and not accessible. The grounding electrode wire connects the neutral (grounded) wire to a grounding electrode.

2. The neutral (grounded) wire should not be connected to ground at any other place downstream from the service equipment grounding point. An exception to this rule exists when two buildings are supplied by one electric service.

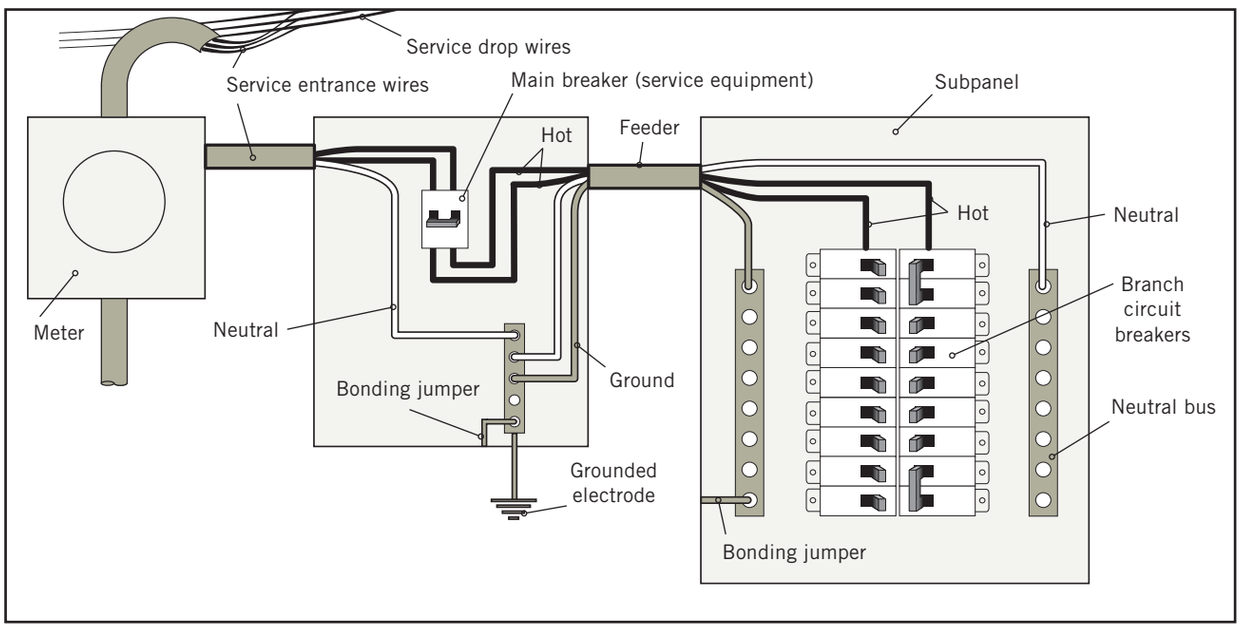
3. All metal parts of the electrical system should be connected to the neutral (grounded) wire. This includes service equipment and panelboard cases, any metal electrical conduit or tubing, and all metal pipes in the building (such as metal water and gas pipe).



Metallic conduit must be physically and electrically connected to panel cabinets. A bonding bushing may be required, in some cases, where all of a knockout is not removed.



The neutral and grounding wires should not be connected to the same bus in most subpanels. The grounding bus should be bonded to the subpanel cabinet. The neutral bus should not be bonded to the subpanel cabinet.



Parts of a common electrical service configuration.

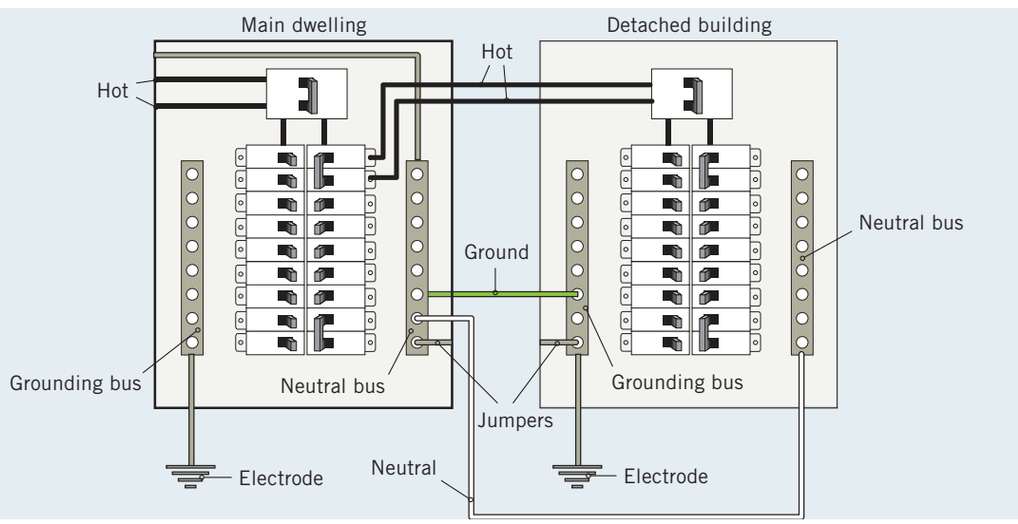
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 185 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 185 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:185

Service Grounding at Two Buildings Using Four-Wire Feeder

1. Use this procedure when installing a new feeder cable to a second building from the building with the primary electric service. (a) Install a feeder cable to the second building that contains an equipment grounding wire. Use a #10 copper equipment grounding wire for feeders above 20 amps to 60 amps or less. (b) Install a grounding electrode at both buildings. (c) Connect the feeder cable equipment grounding wire to the grounding electrode wire at the second building subpanel grounding bus. Connect all second building branch circuit equipment grounding wires to the grounding bus. (d) Bond the subpanel case to the grounding bus. (e) Connect the feeder cable neutral (grounded) wire to an isolated grounded bus at the second building subpanel. Do not connect the grounded bus to the subpanel case or to the grounding bus.

2. You are not required to use this procedure if there is only one branch circuit in the second building and if the new feeder cable for that one branch circuit contains an equipment grounding wire.

Wiring diagram for wiring a feeder from the main service panel to a subpanel in a separate building.



Grounding Electrodes & Electrode Wires

General Requirements

1. Every electrical service should be provided at least one approved type of grounding electrode. The most common grounding electrodes are underground metal water pipe, driven rod and pipe, and concrete encased.

2. All grounding electrodes that may be available at a building should be bonded together. General codes do not require that all possible types of grounding electrodes be installed. They require that if a grounding electrode is installed, it must be connected (bonded) to all other grounding electrodes and to the neutral (grounded) wire.

3. A bonding jumper at least as large as the grounding electrode wire should be used to connect (bond) the grounding electrodes. Bonding jumpers may be connected between grounding electrodes at any convenient point.

4. The grounding electrode wire may be connected at any convenient grounding electrode. Protect grounding electrode wires that are subject to physical damage with approved conduit or tubing, such as intermediate metallic conduit or PVC conduit.

5. Protect grounding electrode wires that are smaller than #6 AWG with approved conduit regardless of whether the wire is subject to physical damage.

6. Install a grounding electrode wire based on the size of the service entrance conductors. Most grounding electrode wires should be #6 or #8 copper.

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 186 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 186 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:186

7. Metal gas pipe should never be used as a grounding electrode.

Underground Water Pipe Electrodes

1. Use metal underground water pipe that is in contact with the ground for at least 10 feet as a grounding electrode. This includes all metal water pipe materials, such as copper and steel, and all metal water pipes, such as water service pipes, metal well casing pipe, and metal irrigation system pipes.

2. You must consider all underground water pipe that satisfies the previous conditions as a grounding electrode and connect (bond) underground water pipe to all other grounding electrodes.

3. Do not connect a grounding electrode wire to any interior metal water pipe at a point that is more than 5 feet from where the underground water pipe enters the building. Do not use any interior metal water pipe that is more than 5 feet from where the water pipe enters the building as a conductor for a grounding electrode. Example: do not connect the grounding electrode wire at a water heater cold water pipe if the pipe is more than 5 feet from where the water pipe enters the building.

4. Do not use underground metal water pipe as the only grounding electrode. Install at least one other type of grounding electrode and connect (bond) it to the underground metal water pipe.

5. Install bonding jumper wires around devices that might interrupt electrical continuity. Such devices include water meters, water pressure reducers, water softeners, and water filtration systems.

Rod & Pipe Electrodes

1. You may use metal pipe or conduit that is at least ¾ inch in diameter and at least 8 feet long as a grounding electrode. Use galvanized materials or other corrosion-resistant coating on iron and steel pipes.

2. You may use a stainless steel, zinc-coated or copper-coated steel, or copper rod that is at least ⅝-inch diameter and at least 8 feet long as a grounding electrode.

3. Do not use aluminum as rod and pipe electrodes.

4. Do not use one rod or pipe electrode as the only grounding electrode. Install at least one other grounding electrode of any approved type. Bond all grounding electrodes together. This provision does not apply if the rod or pipe electrode has a resistance to earth of not more than 25 ohms.

Concrete Encased Electrodes

1. You may use at least ½-inch-diameter reinforcing bar or at least #4 AWG bare copper wire as a concrete encased grounding electrode. The electrode material must be at least 20 feet long. Do not use reinforcing bar that is not electrically conductive or that is coated in non-conductive material.

2. Encase the reinforcing bar or wire in at least 2 inches of concrete. Place the bar or wire in either the horizontal or vertical part of the concrete that is in direct contact with the ground. Do not place a moisture barrier between the concrete and the ground.

3. You may use wire ties or similar means to connect (bond) reinforcing bars together to achieve the 20-foot minimum length.

4. Concrete encased electrodes are also called ufer grounding electrodes after the man who designed this grounding electrode system.

Grounding Electrode Wire Installation

Aluminum Grounding Electrode Wires

1. Do not use aluminum or copper-clad aluminum grounding electrode wires if the wire is in direct contact with masonry or the ground or if the wire is in a corrosive environment.

2. Do not install aluminum or copper-clad aluminum grounding electrode wires within 18 inches of the ground when the wire is installed outside.

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305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 187 1/10/18 11:47 AM
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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:187

Connecting Grounding Electrode Wires to the Electrode

1. Use one of the following methods to connect grounding electrode wires to grounding electrodes: (a) a pipe fitting, pipe plug, or other approved device screwed into a pipe or pipe fitting or (b) a listed bolted clamp made of cast bronze or brass or of plain or malleable iron.

2. You may use a listed metal strap ground clamp to connect indoor communications equipment grounding electrode wires to a grounding electrode.

3. Make accessible the connection point of grounding electrode wires and bonding jumpers to grounding electrodes. The connection point need not be accessible for buried or concrete encased grounding electrodes.

4. Clean grounding electrode wire connection points and all clamps and fittings of non-conductive materials, such as paint.

Connections around Equipment & Insulated Fittings

1. Install bonding jumpers around equipment such as water meters, pressure reducing valves, water softeners, water filtration equipment, dielectric fittings, and other equipment and fittings that interrupt the electrical continuity of metal piping.

2. Make bonding jumpers long enough to permit removal of the equipment and maintain electrical continuity.

Proper CSST bonding is very tricky to determine and has very high danger potential if incorrect. Have a qualified electrician determine if CSST in your house is properly bonded.

3. Use bonding jumpers that are at least the same wire size as the grounding electrode wire.

Metal Water Pipe Bonding

1. Connect (bond) interior metal water pipes to the service equipment enclosure, the neutral (grounded) wire at the service equipment, the grounding electrode conductor, or to any grounding electrode.

2. Use a bonding jumper or wire that is at least the same wire size as the grounding electrode wire.

3. Make the bonding connection point accessible.

Metal Gas Pipe Bonding

1. Connect (bond) interior metal gas pipes and other metal pipes to the service equipment enclosure, the neutral (grounded) wire at the service equipment, the grounding electrode conductor, or to any grounding electrode.

2. You may use the equipment grounding wire that serves the gas appliance as the bonding wire. Number 10 AWG copper wire is the largest equipment grounding wire for almost all residential branch circuits. This means that: (a) a separate bonding wire between the gas pipe and the service equipment is usually not necessary (although some jurisdictions require one anyway), and (b) #10 AWG copper wire is usually the largest required gas pipe bonding wire.

3. Make the bonding connection point accessible.

Bonding Corrugated Stainless Steel Gas Tubing

1. Install a #6 AWG copper bonding wire that is connected to a listed clamp on gas supply systems using corrugated stainless steel gas tubing (CSST). Limit the length of the wire to not more than 75 feet. This bonding connection is for lightning protection.

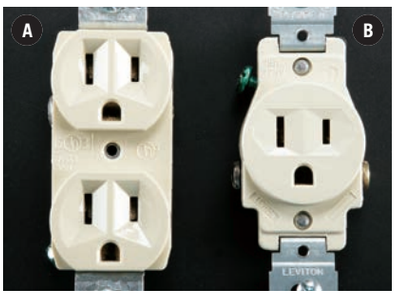
2. Install the bonding connection at the first length of steel or copper pipe before the CSST. This is usually at the gas meter or where the propane pipe enters the home.

3. Some CSST is arc-resistant and does not need a separate bonding connection. This CSST usually has a black jacket. Verify CSST bonding requirements using manufacturer's instructions and by contacting your building inspector.

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 188 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 188 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:188

Electrical Branch Circuit Requirements

Every electrical circuit has its limits. Among the more basic tasks in evaluating your existing wiring system or planning a system expansion is to identify which loads will be drawing from which circuits so you can establish what each circuit capacity will need to be. In addition to letting you plan the circuits wisely, specific load knowledge lets you create a more balanced service panel, lessening the chances that you'll trip breakers.



A duplex receptacle (A) contains two outlets. A single receptacle (B) contains one outlet.

Branch Circuit Load Limits

15-amp & 20-amp Circuits

1. Use only 15-amp and 20-amp, 120-volt circuits for multiple outlet branch circuits. A multiple outlet branch circuit has more than one light fixture and/or receptacle on the same circuit. One duplex receptacle counts as two receptacles. A circuit that serves one duplex receptacle is a multiple outlet branch circuit. This provision does not apply to a circuit that serves one single receptacle or one single light fixture.

2. Use only 120-volt branch circuits to supply residential light fixtures, receptacles for plug-and-cord connected loads not more than 1,440 watts, and motor loads less than .25 horsepower.

3. You may use either 120- or 240-volt branch circuits to supply one plug-and-cord connected or one permanently wired appliance rated more than 1,440 watts. This means that branch circuits rated more than 120 volts are effectively limited to serving a single receptacle or permanently wired fixed equipment.

4. Do not connect one or more fixed devices that in total exceed 50 percent of a multiple outlet branch circuit's amperage rating. Fixed devices do not include light fixtures. This means that all fixed devices (such as a permanently wired disposal or hot water circulating pump) on a multiple outlet branch circuit may not exceed 7.5 amps (about 900 watts) on a 15-amp multiple outlet branch circuit and may not exceed 10 amps (about 1,200 watts) on a 20-amp multiple outlet branch circuit.

30-amp Circuits

1. Do not connect one plug-and-cord device that exceeds 80 percent of a 30-amp branch circuit's amperage rating. This means that one device (such as a clothes dryer) may not exceed 24 amps (about 5,760 watts) on a 30-amp, 240-volt branch circuit.

2. Do not use a 30-amp branch circuit to serve loads other than a fixed device, such as a water heater, or a single plug-and-cord connected device, such as a welder.

SAFETY TIP

Always work with your local electrical inspector and an experienced wiring installer when adding electrical circuits.

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 189 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 189 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:189

Room Air Conditioner Circuits

1. Use wires that are rated at least 125 percent of a window or through-wall air conditioner's total rated current load if: (a) the air conditioner is connected to a receptacle by a plug-and-cord, (b) the air conditioner's total rated current load is shown on its nameplate (not just the individual motor load), (c) the air conditioner's total rated current load on the nameplate is not more than 40 amps and 250 volts, and (d) the branch circuit overcurrent protection device does not exceed the branch circuit wire ampacity rating and the ampacity rating of the receptacle. Example: a plug-and-cord connected room air conditioner's total rated current load is 17 amps. Use wires rated for 1.25 times 17 amps, which equals 21.25 amps (#10 copper wire).

2. Do not install a window or through-wall air conditioner on a 15- or a 20-amp multiple outlet branch circuit if the air conditioner's total rated current load is more than 50 percent of the branch circuit's rating (80 percent for dedicated circuits).

Kitchen Small Appliance Circuits

1. Provide at least two 20-amp, 120-volt branch circuits to serve only receptacles in the kitchen, pantry, breakfast and dining areas, and similar rooms. You may use the kitchen receptacle circuits to power a refrigerator, a wall clock, and the electrical requirements for gas cooking equipment. You may not use the kitchen branch circuits to supply light fixtures or other outlets in these rooms, and you may not use the kitchen branch circuits to supply outlets in other rooms or outside the house.

2. Provide a separate dedicated branch circuit for the kitchen range hood receptacle, if a range hood receptacle is installed. It is recommended, but not required, that this be a 20-amp, 120-volt branch circuit.

Air-conditioner load ratings can be found on the nameplate.

Bathroom Receptacle Circuit

1. Provide at least one 20-amp, 120-volt branch circuit to serve only receptacles located in the bathroom(s). You may not use the bathroom branch circuit to supply light fixtures or other outlets in the bathroom, and you may not use the bathroom branch circuit to supply outlets in other rooms.

2. You may provide each bathroom with its own dedicated 20-amp, 120-volt branch circuit. In this case, you may use the branch circuit to supply other bathroom outlets, such as light fixtures and exhaust fans.

Laundry Receptacle Circuit

1. Provide at least one 20-amp, 120-volt branch circuit to serve only receptacles located in the laundry area. You may not use the laundry branch circuit to supply light fixtures or other outlets in the laundry, and you may not use the laundry branch circuit to supply outlets in other rooms. Electric clothes dryers require a dedicated 240-volt, 30-amp circuit.

Garage Receptacle Circuit

1. Provide at least one 20-amp, 120-volt branch circuit to serve only receptacles located in the garage and readily accessible receptacles located outside the house. You may not use the garage receptacle branch circuit to supply light fixtures or other outlets in the garage, and you may not use the garage branch circuit to supply outlets in other areas inside or outside the house.

2. Provide at least one receptacle outlet for each vehicle storage bay in attached garages and in detached garages that are provided with power. General codes do not specify the type or rating of the receptacle.

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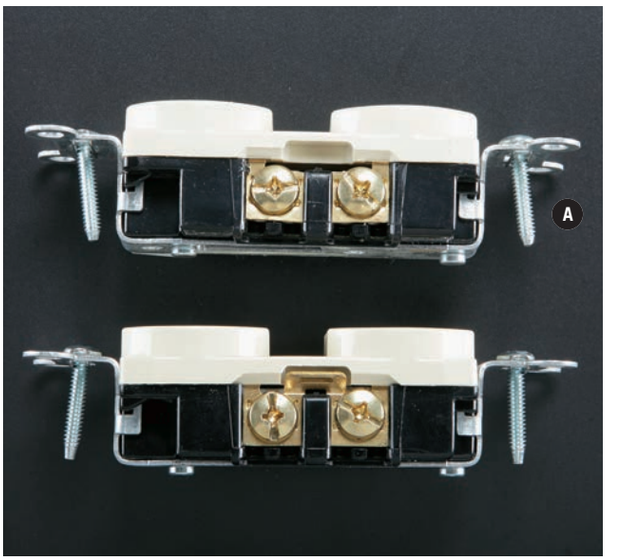
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 190 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:190

Multiwire Branch Circuits

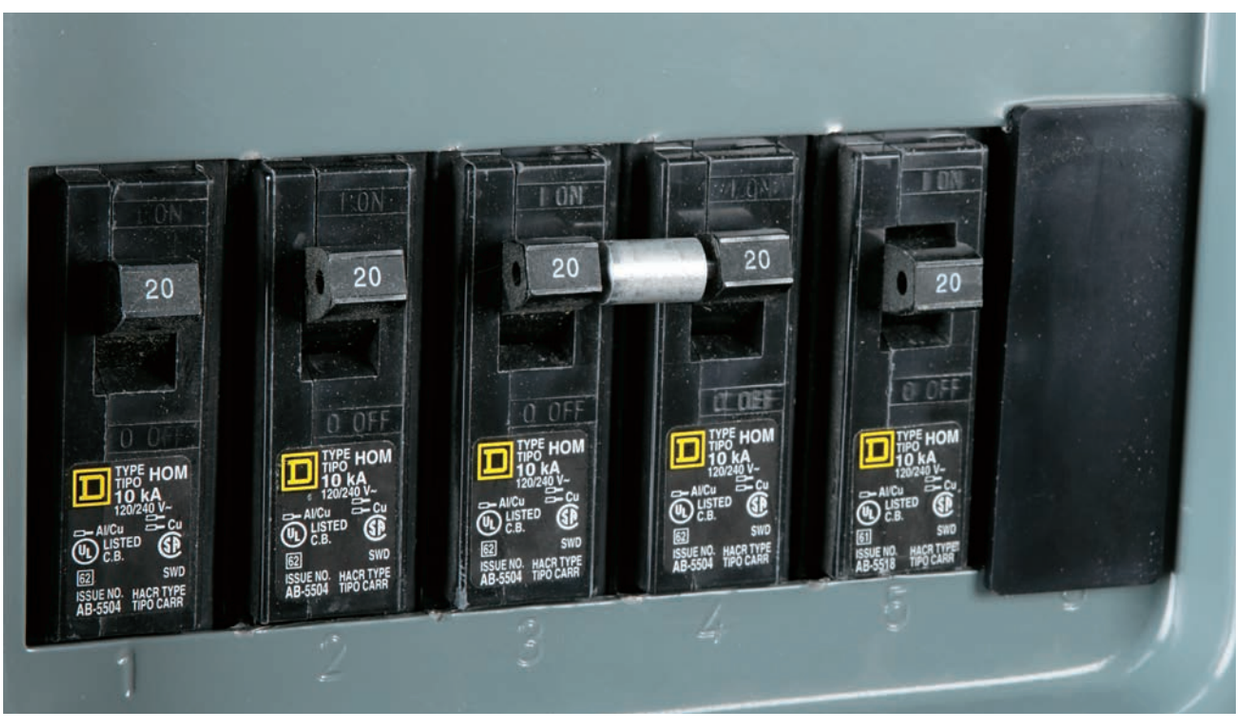
1. Run multiwire branch circuit wires from adjacent slots on the same panelboard. It is safer to originate a multiwire branch circuit from adjacent slots on the same side of the panelboard. This helps avoid overloading the shared neutral (grounded) wire.

2. Use a two-pole overcurrent device or two single pole devices that are connected by an approved handle tie to protect most multiwire branch circuits. Do not connect circuit breaker handles with nails, wires, or other unapproved handle tie substitutes.

3. Use wire ties or similar devices to group all ungrounded (hot) and grounded (neutral) wires of each multiwire branch circuit in the cabinet where the circuit originates.



The receptacle yoke is removed (A) when it is split-wired using a multiwire branch circuit.



Connect both handles of circuit breakers protecting a multiwire branch circuit with an approved handle tie.

QUANTITY OF RECEPTACLES ON A BRANCH CIRCUIT

A widely held belief exists that the IRC limits the number of receptacles on a residential branch circuit. This belief is incorrect. The IRC only requires that the number of branch circuits is sufficient to supply the connected load and that the load on any branch circuit does not exceed the IRC limits. This belief may come from restrictions on the number of outlets (both lights and receptacles) allowed for commercial electrical circuits. Commercial applications allow about 13 outlets on a 20-amp circuit and about 10 outlets on a 15-amp circuit. Wiring residential general lighting branch circuits based on these commercial outlet limits is often a good idea but is not required by the IRC.

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 191 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 191 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:191

Current Wiring Methods

Table 36 lists the wiring methods currently allowed in residential construction. **Note that certain wiring methods may not be used in certain applications.**

Approved Uses for Wiring Methods

1. Table 37 lists when a wiring method may be used in a specific application. Note that some wiring methods have restrictions or limitations shown by the following superscripts: (1) use less than 6 feet of LFC if the conduit walls are not reinforced, (2) insulate the neutral (grounded) wire unless the cable is used to supply other buildings on the same property, (3) insulate the neutral (grounded) wire, (4) use wires approved for wet locations and seal raceways to prevent water entry, (5) use materials listed as sunlight resistant, (6) protect metal raceways from corrosion, (7) use Schedule 80 RNC, (8) use materials listed as sunlight resistant if exposed to direct sunlight, (9) use less than 6 feet of conduit.

TABLE 36: CURRENT WIRING METHODS

WIRING METHOD	ABBREVIATION
Armored cable	AC
Electrical metallic tubing	EMT
Electrical nonmetallic tubing	ENT
Flexible metal conduit	FMC
Intermediate metal conduit	IMC
Liquidtight flexible conduit	LFC
Metal-clad cable	MC
Nonmetallic sheathed cable	NM
Rigid PVC conduit	RNC
Rigid metallic conduit	RMC
Service entrance cable	SE
Surface raceways	SR
Underground feeder cable	UF
Underground service cable	USE

TABLE 37: CURRENT WIRING METHODS ALLOWED USES

ALLOWED APPLICATION	AC	EMT	ENT	FMC	IMC RMC RNC	LFC[1]	MC	NM	SR	SE	UF	USE
Branch circuits	OK	OK	OK	OK	OK	OK	OK	OK	OK	OK[3]	OK	NO
Damp locations	NO	OK	OK	OK[4]	OK	OK	OK	NO	NO	OK	OK	OK
Direct burial	NO	OK[6]	NO	NO	OK[6]	OK	OK[6]	NO	NO	NO	OK	NO
Embedded in concrete below grade	NO	OK[6]	OK	NO	OK[6]	NO	NO	NO	NO	NO	NO	NO
Embedded in concrete in dry location	NO	OK	OK	NO	OK	NO	NO	NO	NO	NO	NO	NO
Embedded in masonry	NO	OK	OK	NO	OK[6]	OK	OK	NO	NO	NO	NO	NO
Embedded in plaster in dry location	OK	OK	OK	OK	OK	OK	OK	NO	NO	OK	OK	NO
Exposed not subject to damage	OK	OK	OK	OK	OK	OK	OK	OK	OK	OK	OK	OK
Exposed subject to damage	NO	NO	NO	NO	OK[7]	NO	NO	NO	NO	NO	NO	NO
Feeder	OK	OK	OK	OK	OK	OK	OK	OK	NO	OK[2]	OK	OK[2]
Fished in masonry voids	OK	NO	NO	OK	NO	OK	OK	OK	NO	OK	OK	NO
In masonry voids & cells in damp location or below grade	NO	OK[6]	OK	OK[4]	OK[6]	OK	OK	NO	NO	OK	OK	NO
In masonry voids & cells in dry location	OK	OK	OK	OK	OK	OK	OK	OK	NO	OK	OK	NO
Indoors (e.g., in stud walls)	OK	OK	OK	OK	OK	OK	OK	OK	OK	OK	OK	NO
Service entrance	NO	OK	OK[8]	OK[9]	OK	OK[9]	OK	NO	NO	OK	NO	OK
Wet locations & exposed to sunlight	NO	OK	OK[8]	OK[4]	OK	OK	OK	NO	NO	OK	OK[5]	OK[5]

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305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 192 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:192

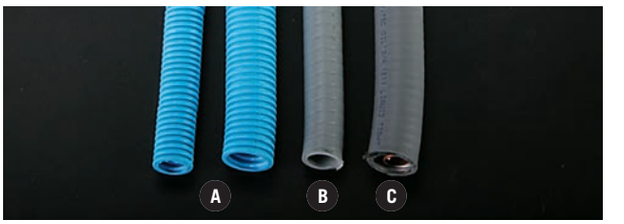
Rules for NM & UF Cable

1. Use Table 38 to determine the maximum ampacity and overcurrent protection of NM and UF cable. NM and UF cable is often referred to by the trade name *Romex*. This table applies to almost all branch circuit and feeder wiring in modern residential electrical systems. Example: the maximum rating for a circuit breaker protecting Number 12 copper wire is 20 amps.

Rigid metal conduit has threaded ends for making watertight connections with female-threaded fittings and couplings.

TABLE 38: NM & UF CABLE MAXIMUM AMPACITY

WIRE SIZE (AWG)	COPPER WIRE (AMPS)	ALUMINUM WIRE (AMPS)
14	15	--
12	20	15
10	30	25
8	40	30
6	55	40
4	70	55
3	85	65
2	95	75
1	110	85



Electrical nonmetallic tubing (A) may be used inside, and outside if it is rated as sunlight resistant. Liquid-tight flexible conduit can be non-metallic (B) or it can be metallic conduit with a non-metallic sheath (C).

Non-metallic sheathed cable is available in the most common gauges used in residential construction.

TABLE 39: MAXIMUM HOLE OR NOTCH SIZE IN STUDS & JOISTS

FRAMING MEMBER	MAXIMUM HOLE SIZE	MAXIMUM NOTCH SIZE
2 × 4 load-bearing stud	1 7/16" diameter	7/8" deep
2 × 4 nonload-bearing stud	2 1/8" diameter	1 7/16" deep
2 × 6 load-bearing stud	2 1/4" diameter	1 3/8" deep
2 × 6 nonload-bearing stud	3 5/16" diameter	2 3/16" deep
2 × 6 joists	1 7/8" diameter	7/8" deep
2 × 8 joists	2 3/8" diameter	1 1/4" deep
2 × 10 joists	3 1/16" diameter	1 1/2" deep
2 × 12 joists	3 3/4" diameter	1 7/8" deep

This framing member chart shows the maximum sizes for holes and notches that can be cut into studs and joists when running cables. When boring holes, there must be at least 5/8" of wood between the edge of a stud and the hole and at least 2" between the edge of a joist and the hole. Joists can be notched only in the end 1/3 of the overall span, never in the middle 1/3 of the joist.

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 193 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 193 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:193

NM & UF Cable Installation

1. Use NM and UF cable where the cable is not subject to physical damage. The term "subject to physical damage" is undefined and subject to interpretation. Your local building inspector will define what this means in your area. Locations that may be considered subject to physical damage include those within easy reach. Examples may include inside cabinets, in unfinished walls, and attached to finished walls below about 7 feet above the floor. Cable run in attics and crawlspaces is not usually considered subject to physical damage.

2. Protect NM and UF cable using RMC, IMC, EMT, or Schedule 80 RNC when the cable is subject to physical damage. Extend the protection at least 6 inches above the floor when the cable runs through the floor.

3. Protect NM and UF cable using nail guards or other approved physical protection when the cable is installed: (a) through holes, notches, or grooves that are closer than 1¼ inches to the edge of a stud or joist; (b) in notches and grooves in places such as drywall, plaster, and under carpet, unless the groove or notch is deeper than 1¼ inches; (c) through holes in metal framing (use grommets or bushings); and (d) parallel to the edge of a stud, joist, or furring strip when the cable is closer than 1¼ inches to the edge of the framing member.

4. Support NM, UF, AC, and MC cable every 4½ feet. Use wire staples or other approved fasteners to support vertical runs of NM, UF, AC, and MC cable. Staple the cable only on the flat edge. Note that wiring methods need not always be secured to be considered supported. Cable run across the tops of joists and truss chords is usually considered supported without being secured to the joists. Cable must be secured to be considered supported when it is run vertically and when it is run on the sides and bottoms of framing members.

5. Secure NM and UF cable not more than 8 inches from boxes and terminations that do not have cable clamps. This includes most plastic boxes. Secure NM and UF cable not more than 12 inches from boxes and terminations that have cable clamps. This includes most metal boxes. Measure the support distance from where the cable sheathing ends in the box, not from the box itself.

6. Use NM cable only in dry locations that are indoors and not within concrete or masonry that is exposed to the ground. Do not use NM cable in conduit that is buried in the ground. Buried conduit is considered a wet location. You may use UF cable in wet locations, including outdoors and underground if it is not subject to damage.

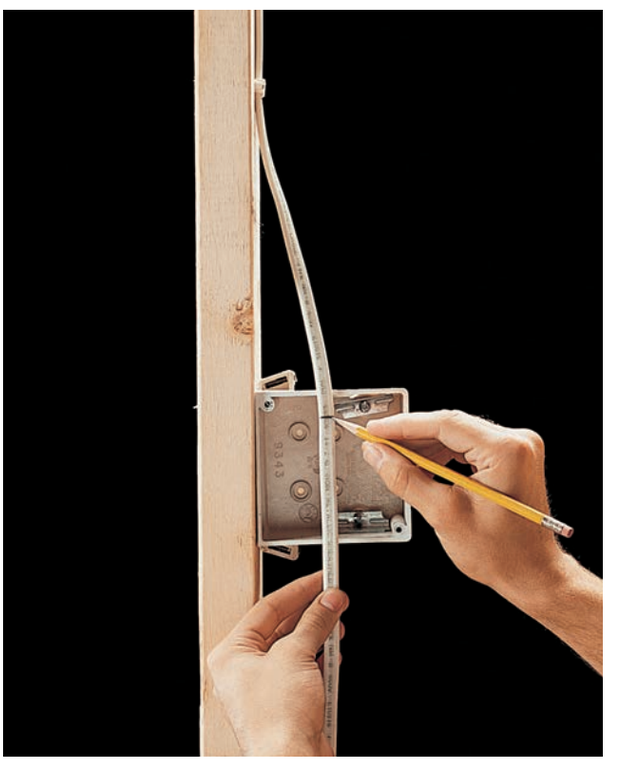
VIOLATION! Do not install NM and UF cable inside cabinets.

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 194 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 194 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:194

VIOLATION! Do not install NM and UF cable in exposed walls and ceilings. You may install NM and UF cable in exposed basement ceilings and attics under certain conditions.

VIOLATION! Do not install NM cable outdoors. Outdoors includes buried conduit. You may install UF cable outdoors if it is protected from physical damage.

Support NM and UF cable at least every 4½'. Cable on top of ceiling joists is considered supported.



Secure NM and UF cable within 8" from where the cable enters or leaves a plastic box. Measure from where the cable sheathing ends in the box, not from the edge of the box.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:195

Conduit & Tubing Installation

1. Apply the following installation requirements to EMT, IMC, RMC, ENT, FMC, LFC, and RNC: (a) limit the number of 90-degree bends between junction boxes to not more than four; (b) install bushings where conduit or tubing enters a box, fitting, or enclosure, unless the device provides equivalent protection against damage to any wires that may be pulled into the device; (c) remove rough edges from the ends of all conduit and tubing that may damage wires; (d) support EMT, IMC, and RMC not more than every 10 feet and within 3 feet of junction boxes or terminations; (e) support ENT not more than every 3 feet, unless the ENT is in an accessible ceiling, such as a drop ceiling, and if the distance between light fixtures is not more than 6 feet; and (f) support FMC and LFC not more than every 4½ feet and within 12 inches of junction boxes and terminations, unless the FMC and LFC is in an accessible ceiling, such as a drop ceiling, and if the distance between light fixtures is not more than 6 feet.

2. You may allow not more than 36 inches between the last support and a light fixture or other equipment that may need to be moved for service or replacement.

Wiring Support Requirements

1. Table 40 lists the on center support requirements for wiring methods. Note that some wiring methods have special requirements shown by the following superscripts: (1) support is not required in accessible ceilings, such as drop ceilings, if the distance between light fixtures is not more than 6 feet; (2) you may allow not more than 24 inches between the last support and a light fixture or other equipment that may need to be moved for service or replacement; (3) you may allow not more than 36 inches between the last support and a light fixture or other equipment that may need to be moved for service or replacement; (4) support NM and UF cable not more than 8 inches from boxes and terminations that do not have cable clamps. This includes most plastic boxes. Measure the support distance from where the cable sheathing ends in the box, not from the box itself; (5) support NM and UF cable not more than 12 inches from boxes and terminations that have cable clamps. This includes most metal boxes. (6) support RNC not more than 5 feet for conduit sizes between 1¼ and 2 inches.

TABLE 40: WIRING METHODS SUPPORT

	AC	MC	EMT IMC RMC	ENT	FMC LFC	NM UF	RNC	SE USE (SERVICE)	SE (BRANCH CIRCUIT OR INDOOR FEEDER)
MAXIMUM SUPPORT SPACING	4.5[1]	6[1]	10'	3[1]	4.5[1]	4.5'	3[6]	2.5'	4.5'
MAXIMUM SUPPORT DISTANCE TO BOX OR TERMINATION (INCHES)	12[1,2]	12[1,2]	36"	36"	12[1,3]	8[4]-12[5]	36"	12"	12"

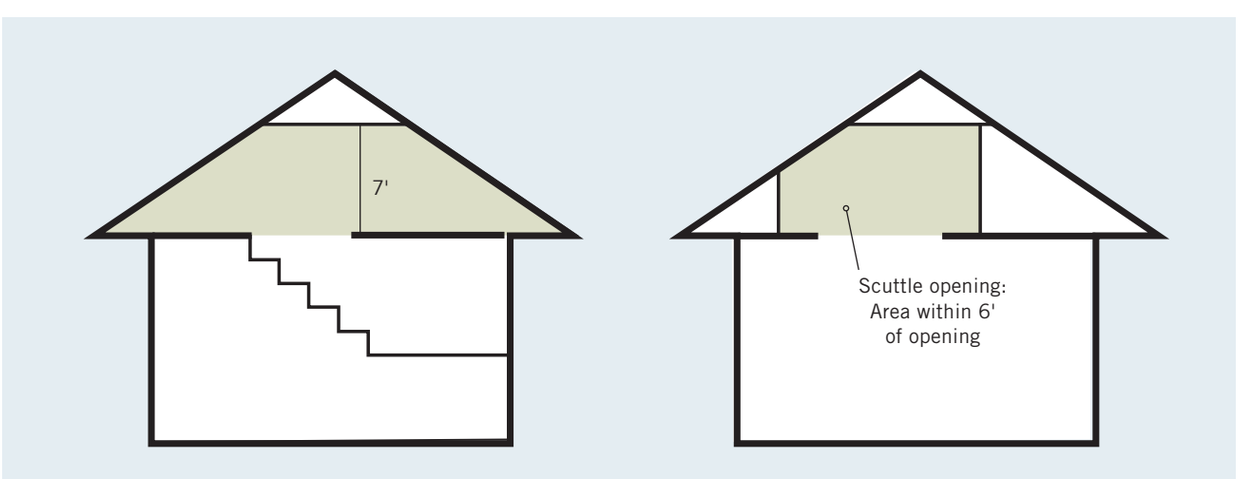
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 196 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 196 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:196

Use wood or other substantial guards to protect NM and UF cable installed perpendicular to rafters within the protection area.

Use wood or other substantial guards to protect NM and UF cable installed on top of ceiling joists within the protection area.

Wiring Protection in Attics

1. Protect electrical cables in accessible attics by using substantial guard strips that are at least as tall as the electrical cables when: (a) access to the attic is by permanent stairs or ladders (such as a pull-down attic ladder), and the cables are within 7 feet vertically from the top of attic floor joists or truss bottom chords, or the cables run across the face (shortest dimension) of rafters, studs, or truss webs or chords, or (b) access to the attic is by scuttle hole or similar opening and the cables described in (a) are within 6 feet horizontally from the nearest point of the attic access opening.
2. You need not protect electrical cables in accessible attics when the cables are installed: (a) running parallel to the edge of the framing and at least 1¼ inches from the edge of the framing or (b) in holes that are at least 1¼ inches from the edge of the framing.



Protect exposed NM and UF cable installed in accessible attics and within the shaded protection area.

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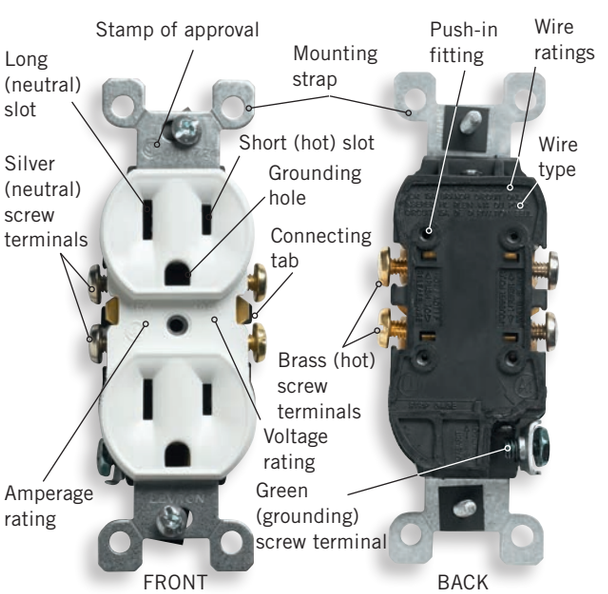
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 197 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:197

Electrical Receptacle Installation

Whether you call them outlets, plug-ins, or receptacles, these important devices represent the point where the rubber meets the road in your home wiring system. From the basic 15-amp, 120-volt duplex receptacle to the burly 50-amp, 240-volt appliance receptacle, the many outlets in your home do pretty much the same thing: transmit power to a load.

Learning the essential differences between receptacles does not take long. Amperage is the main variable, as each receptacle must match the amperage and voltage of the circuit in which it is installed. A 15-amp circuit should be wired with 15-amp receptacles; a 20-amp circuit needs 20-amp receptacles (identified by the horizontal slot that Ts into each tall polarized slot). A 20-amp multi-receptacle circuit may use either 15- or 20-amp receptacles. Receptacles for 240-volt service have unique slot configurations so you can't accidentally plug in an appliance that's not rated for the amperage in the circuit. Some receptacles can be wired using the push-in wire holes, but this is not recommended. Some receptacles provide built-in, ground-fault circuit protection, tripping the circuit breaker if there is a short circuit or power surge. These are easy to identify by reset and test buttons.



General Receptacle Installation Requirements

1. Use only grounding type (3-slot) when installing new receptacles in 15-amp and 20-amp branch circuits. You may replace existing 2-slot receptacles with a new 2-slot receptacle.

2. Mount receptacles in boxes that are recessed from the wall by seating the receptacle's extension ears at the top and bottom of the receptacle against the wall surface.

3. Mount receptacles in boxes that are flush with the wall by seating the receptacle's mounting yoke or strap against the box.

4. Do not allow the receptacle to move when a plug is inserted. This can, over time, cause wires to loosen, allow arcing, and cause a fire.

5. Install receptacle faceplates so that the plate completely covers the receptacle and so that the faceplate is flush against the wall. No gaps should exist between the receptacle and the faceplate or between the faceplate and the wall.

6. Install receptacles so that the face of the receptacle is either flush with or projects out from a nonmetallic faceplate.

7. Install receptacles so that the face of the receptacle projects out from a metallic faceplate at least (≥) 1/64 inch.

8. Install receptacles so that the wiring terminals are not exposed to physical contact.

Tamper-Resistant Receptacles

1. Install tamper-resistant receptacles in 120-volt, 15- and 20-amp general purpose branch circuits. These receptacles usually have an opening that moves to allow access to the receptacle. This requirement includes interior and exterior receptacles unless an exception applies. This requirement includes replacement of existing three-slot receptacles.

2. You do not need to install tamper-resistant receptacles if the receptacle: (a) is located more than 66 inches above the floor, (b) is part of a light

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 198 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 198 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:198

fixture or appliance, or (c) is a single or duplex dedicated appliance receptacle into which one or two not easily movable appliances will be plugged.

Non-Grounding Type Receptacles

1. You may replace a non-grounding type receptacle (2-slot) with another non-grounding type receptacle.

2. You may replace a non-grounding type receptacle (2-slot) with a grounding type receptacle (3-slot) if: (a) the replacement receptacle is a GFCI receptacle and (b) the cover plate is labeled "No Equipment Ground."

3. You may replace a non-grounding type receptacle (2-slot) with a grounding type receptacle (3-slot) if: (a) the replacement receptacle is supplied by a GFCI protected circuit and (b) the cover plate is labeled "GFCI Protected and No Equipment Ground."

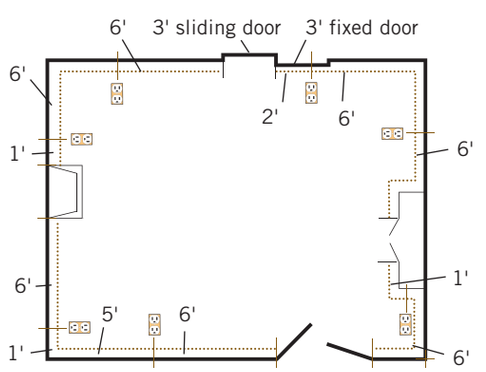
4. Use 1, 2, and 3 above only if no equipment grounding wire is available in the receptacle box. You must use a grounding type receptacle, and you must use the equipment grounding wire if it is available.

5. You may run an equipment grounding wire to the nearest box containing an equipment grounding wire if all hot, neutral, and grounding wires originate at the same panelboard.

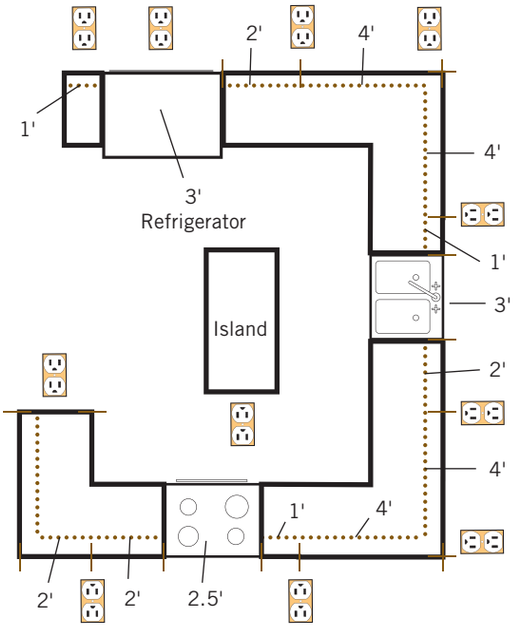
6. Do not connect the neutral wire to the receptacle grounding lug. These "bootleg grounds" are a dangerous code violation.

Receptacle Installation in Rooms

1. Apply the following provisions to receptacles in living rooms, family rooms, bedrooms, dens, sunrooms, recreation rooms, dining rooms, breakfast rooms, libraries, and similar living areas. Kitchens, bathrooms, hallways, garages, laundry rooms, and exterior receptacles have their own installation requirements.



Example of receptacle spacing requirements in a typical room. Measure receptacle spacing distance along the wall line. Install receptacles along partial height walls and along balcony guards in lofts and similar areas.



Example of countertop receptacle spacing in a typical kitchen.

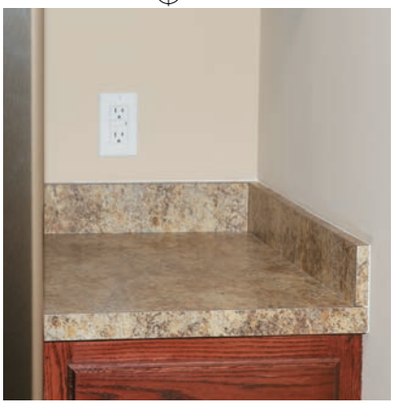
2. Install the required interior receptacles so that any point along a wall is not more than 6 feet from a receptacle. When measuring a wall, do not include operable doors, fireplaces, closet interiors, or similar openings, or fixed cabinets that do not have countertops or similar work surfaces. A wall begins at the edge of an opening and continues around any corners to the next opening. Walls include fixed (not sliding) panels in doors that are at least 2 feet wide. Walls include partial height walls that serve functions, such as room dividers, and walls that form breakfast bars and similar bar-type counters. Walls include guards and railings at balconies, raised floors, and other areas where furniture could be placed.

3. Locate floor receptacles intended to serve as required interior receptacles not more than 18 inches from the wall. You may install interior floor receptacles at any safe place, but you may count only receptacles not more than 18 inches from the wall among the required receptacles.

4. Install receptacles not more than 66 inches above the finished floor. You may install receptacles at any height, but you may count only receptacles not more than 66 inches above the finished floor among the required receptacles.

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 199 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 199 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:199

VIOLATION! Running a pigtail from the neutral terminal to the grounding screw on a receptacle is called a bootleg ground. It is usually done to make an ungrounded circuit appear to be grounded. It is very dangerous.



You must install receptacles behind a short run of countertop if it is at least 12" wide along a straight wall.

You must install receptacles behind a sink or cooking appliance if the countertop behind the sink or cooking appliance is at least 18" deep in a corner cabinet.

Kitchen Countertop Receptacle Installation

1. Install a GFCI protected receptacle at every kitchen countertop that is at least 12 inches wide.

2. Install kitchen countertop receptacles so that all points along the countertop wall are not more than 2 feet from a receptacle. A wall begins at the edge of an opening or appliance, and continues around any corners, and ends at the next opening or appliance. Include windows when measuring the wall unless the window is above a sink or cooking appliance.

3. Install receptacles behind a sink or cooking appliance located along a straight wall if the countertop behind the sink or cooking appliance is at least 12 inches wide. Install receptacles behind a sink or cooking appliance located along a wall corner if the countertop behind the sink or cooking appliance is at least 18 inches deep.

4. Install receptacles not more than 20 inches above the countertop. You may install receptacles at any height, but you may include only receptacles not more than 20 inches above the countertop among the required kitchen countertop receptacles.

5. Do not include among the required kitchen countertop receptacles: (a) receptacles located in appliance garages, (b) receptacles dedicated for a fixed-in-place appliance, or (c) receptacles not readily accessible for use by small appliances.

6. Do not install receptacles face up on work surfaces unless the receptacle is listed for this type of installation.

7. Locate the receptacle for the dishwasher in a space adjacent to the dishwasher, if installing a dishwasher receptacle. This does not apply to a hard-wired dishwasher outlet.

Kitchen Island & Peninsula Receptacles without a Sink or Cooking Appliance

1. Install at least one GFCI protected receptacle at every kitchen island and peninsula that measures at least 24 inches by at least 12 inches. Measure a peninsula from the interior connecting edge of the countertop.

2. Install kitchen countertop receptacles along any wall space above an island or peninsula countertop. Such wall space occurs when an island or peninsula is installed at a partial height wall.

3. You may install receptacles not more than 12 inches below an island or peninsula countertop if the countertop is flat and there is no wall space above the countertop or if the countertop is designed for access by the physically impaired. Do not install the required kitchen island or peninsula receptacle below a breakfast bar or other countertop that extends more than 6 inches beyond the supporting base.

Kitchen Island & Peninsula Receptacles with a Sink or Cooking Appliance

1. Install at least one GFCI protected receptacle not more than 24 inches from each side of a sink or cooking appliance installed in a kitchen island or peninsula.

2. Install receptacles behind a sink or cooking appliance if the countertop behind the sink or cooking appliance is at least 12 inches wide or at least 18 inches deep if the sink or cooking appliance is installed in a corner.

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 200 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 200 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:200

3. Install kitchen countertop receptacles along any wall space above an island or peninsula countertop. Such wall space occurs when an island or peninsula is installed at a partial height wall.

4. You many install receptacles not more than 12 inches below an island or peninsula countertop if the countertop is flat and there is no wall space or cabinet above the countertop.

5. Do not install receptacles face up on countertops or similar work surfaces.

Bathroom Sink Receptacles

1. Install at least one GFCI protected receptacle not more than 36 inches from the outside edge of each sink basin in a bathroom. You may install the receptacle along a wall adjacent to the sink.

2. Do not install receptacles face up on work surfaces.

Laundry Receptacles

1. Install at least one 20-amp, 120-volt receptacle in the laundry area. This required receptacle usually serves the clothes washing machine. The required laundry receptacle is in addition to any required garage or basement receptacle if the laundry is in the garage or basement.

2. Provide GFCI protection for all 15- and 20-amp, 120-volt receptacles in the laundry area. This includes any dedicated receptacle for the clothes washing machine.

Exterior Receptacles

1. Install at least one GFCI protected, 15- or 20-amp, 120-volt receptacle on the front and back exterior wall of every home. Locate the receptacle so that it is accessible from grade level and is not more than 78 inches above finished grade level.

2. Install at least one GFCI protected, 15- or 20-amp, 120-volt receptacle within the perimeter of any balcony, deck, or porch that: (a) is accessible from inside the home and (b) has a usable area of at least 20 square feet. Locate the receptacle not more than 78 inches above the balcony, deck, or porch.

Basement Receptacles

1. Install at least one GFCI protected, 15- or 20-amp, 120-volt receptacle in an unfinished basement. Install at least one GFCI protected receptacle in the unfinished part of a basement that is partially finished.

2. You are not required to provide GFCI protection to a receptacle that is dedicated to serving a fire or security alarm system.

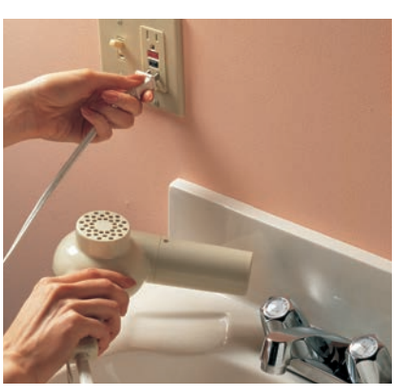
Garage & Accessory Building Receptacles

1. Install one GFCI protected, 15- or 20-amp receptacle for each motor vehicle parking space in an attached garage and in a detached garage that is supplied with electricity. Locate the receptacle not more than 66 inches above the floor. You are not required to supply electricity to detached garages and accessory buildings, but if you do you must install a receptacle. Accessory buildings include work sheds, storage sheds, tack sheds, barns, and similar buildings.

2. You may not serve any other outlets from the circuit serving garage receptacles except for readily accessible receptacles located outside the house. This means that garage lights and exterior lights and receptacles must be served by one or more separate circuits.

3. Do not connect other outlets to a receptacle circuit that is intended for charging an electric vehicle. These receptacle circuits are often 240 volts.

A GFCI protected receptacle must be installed within 36" of each bathroom sink basin.



An exterior-rated receptacle should be installed on both the front and back exterior walls of your house.

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305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 201 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:201

Ground-Fault (GFCI) & Arc-Fault (AFCI) Protection

Ground-Fault Location Requirements

1. Kitchen receptacles. Install ground-fault circuit-interrupter (GFCI) protection on all 120-volt receptacles that serve kitchen countertops. This does not include receptacles under the kitchen sink, receptacles located on kitchen walls that do not serve the countertop, and receptacles that are not within 6 feet of a sink.

2. Kitchen. Install GFCI protection on the outlets that supply dishwashing machines. This includes receptacles and hard-wired connections.

3. Bathroom receptacles. Install GFCI protection on all 120-volt receptacles located in bathrooms. This applies to all receptacles regardless of where they are located in the bathroom and includes receptacles located at countertops, inside cabinets, and along bathroom walls. This also applies to bathtubs and shower stalls that are not located in a bathroom. Install GFCI protection on all circuits serving electrically heated floors in bathrooms, kitchens, and around whirlpool tubs, spas, and hot tubs.

4. Garage and accessory building receptacles. Install GFCI protection on all 120-volt receptacles located in garages and grade-level areas of unfinished accessory buildings.

5. Exterior receptacles. Install GFCI protection on all 120-volt receptacles located outdoors. This

Ground-fault receptacles and circuit breakers detect unwanted current running between an energized wire and a grounded neutral wire.

A combination ARC-fault circuit breaker detects sparking (arcing) faults along damaged energized wires and detects these faults between wires. A branch ARC-fault circuit breaker only detects arcing faults between wires.

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 202 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 202 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:202

does not apply to receptacles that are dedicated for deicing equipment and are located under the eaves. This does apply to holiday lighting receptacles located under the eaves.

6. Basement receptacles. Install GFCI protection on all 120-volt receptacles located in unfinished basements. An unfinished basement is not intended as habitable space and is limited to storage and work space.

7. Crawl space outlets. Install GFCI protection on all 120-volt outlets and lights located in crawl spaces. Receptacles in crawl spaces are not required unless equipment requiring service is located there.

8. Sink receptacles. Install GFCI protection on all 120-volt receptacles that are located within 6 feet of the top inside edge of a sink. This includes wall, floor, and countertop receptacles.

9. Boathouse receptacles. Install GFCI protection on all 120-volt receptacles located in boathouses. Install GFCI protection on all 120-volt and 240-volt receptacles that serve boat hoists.

10. Spas, tubs, and other circuits requiring ground-fault protection. Install GFCI protection on all circuits serving spa tubs, whirlpool tubs, hot tubs, and similar equipment. Refer to the general codes for more information about receptacles serving these components.

11. Install GFCI circuit breakers and receptacles so that they are readily accessible.

Arc-Fault Location Requirements

1. Install a combination type or an outlet (receptacle) type arc-fault circuit-interrupter (AFCI) on all 15- and 20-amp, 120-volt branch circuits serving sleeping, family, dining, living, sun, and recreation rooms, kitchens, laundry areas, and parlors, libraries, dens, hallways, closets, and similar rooms and areas. This means that 15- and 20-amp, 120-volt branch circuits serving most interior spaces in a home are required to have AFCI protection. Note that garages, basements, utility and mechanical rooms, and exterior branch circuits are not included in this list, although local building officials may include these areas by interpretation.

2. You may provide AFCI protection for the entire branch circuit by installing a combination-type AFCI circuit breaker in the electrical panel where the branch circuit originates.

3. You may provide AFCI protection to a branch circuit using several different combinations of branch-circuit type AFCI circuit breakers and branch-circuit type AFCI receptacles. Refer to general codes or your local building inspector for details about these alternate methods.

4. Provide AFCI for branch circuits that are modified, replaced, or extended. You may use either of the following methods: (a) install a combination-type AFCI circuit breaker in the electrical panel where the branch circuit originates or (b) install a branch-circuit type AFCI receptacle at the first receptacle in the existing branch circuit.

5. Install AFCI circuit breakers and receptacles so that they are readily accessible.

Receptacles for whirlpool tubs must be GFCI protected and readily accessible

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 203 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 203 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:203

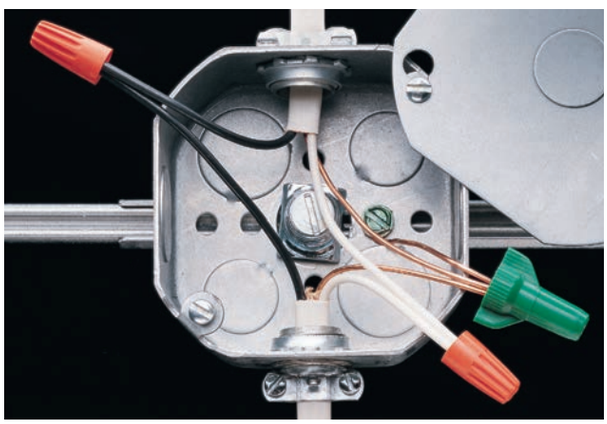
Junction Boxes, Device Boxes & Enclosures

All electrical boxes are available in different depths. A box must be deep enough so a switch or receptacle can be removed or installed easily without crimping and damaging the circuit wires. Replace an undersized box with a larger box using Table 42 the Electrical Box Fill Chart (see page 206) as a guide. **The NEC also says that all electrical boxes must remain accessible. Never cover an electrical box with drywall, paneling, or wall coverings.**

Non-Metallic Box Installation

1. Use non-metallic boxes with NM type cable or with non-metallic conduit or tubing. You may use non-metallic boxes with metallic conduit or tubing if you maintain the electrical continuity of the metallic conduit or tubing by installing a bonding jumper through the box. In many situations it is easier to use a metallic box with metallic conduit or tubing.

2. Extend NM cable sheathing at least ¼ inch into a non-metallic box knockout opening.



Box shape is related to function, as electrical fixtures are created to fit on boxes of a particular shape. Octagonal and round boxes generally are designed for ceiling mounting, while square and rectangular boxes are sized for single-pole, duplex, and other standard switch and receptacle sizes.

Do not support heavy light fixtures using only the light fixture electrical box. The eye hook supporting this chandelier is driven into the same ceiling joist to which the electrical box is mounted.

3. Secure NM cable, conduit, and tubing to each box. You may secure NM cable with cable clamps inside the box or with compression tabs provided where the cable enters the box. You do not need to secure NM cable to a standard single-gang box (2¼ by 4 inches) mounted in a wall or ceiling if you fasten the cable not more than 8 inches from the box and if the sheathing enters the box at least ¼ inch. Measure the 8 inches along the length of the sheathing, not from the outside of the box.

Light Fixture Box Installation

1. Use boxes designed for mounting light fixtures if a light fixture is to be mounted to the box. These boxes are usually 4-inch round or octagonal.

2. You may use other boxes to mount light fixtures on walls if the fixture weighs less than 6 pounds and is secured to the box using at least #6 screws.

3. Support light fixtures weighing at least 50 pounds independently from the light fixture box unless the box is labeled as being designed to support a heavier light fixture. You may use the light fixture box to support light fixtures weighing less than 50 pounds. Note that ceiling fans are not light fixtures.

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 204 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 204 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:204

Box Contents Limitations

1. Limit the number of wires, devices (such as switches and receptacles), and fittings in a box. This limitation is primarily based on the heat generated by the wires and devices in the box. The actual size of the box relative to its contents is a secondary consideration.

2. Use the cubic inch volume printed on the box or provided in the box manufacturer's instructions to determine box volume. Do not attempt to measure the box volume. Do not estimate box volume from the volume of similar size boxes. You will probably not get the same volume as provided by the manufacturer.

3. Use Table 41 to determine the volume units required by wires, devices, and fittings in a box.

Box Installation Tolerances

1. Install boxes in non-combustible material, such as masonry, drywall, plaster, or tile, so that the front edge is set back not more than ¼ inch from the finished surface.

2. Install boxes in walls and ceilings made of wood or other combustible material so that the box's front edge is flush with the finished surface or projects from the finished surface. You may use an extension ring, plaster ring, or similar device to extend the box to the finished wall surface. Mechanically secure the extension device to the box.

3. Cut openings for boxes in drywall and plaster so that the opening is not more than ⅛ inch from the perimeter of the box.

Boxes must be installed so the front edges are flush with the finished wall surface and the gap between the box and the wall covering is not more than ⅛".

TABLE 41: WIRE VOLUME UNIT

WIRE SIZE (AWG)	WIRE VOLUME
14	2.00 in.^{3}
12	2.25 in.^{3}
10	2.50 in.^{3}
8	3.00 in.^{3}
6	5.00 in.^{3}

VOLUME UNITS

Calculate the volume units required by wires, devices, and fittings based on the following definitions:

Volume units for current-carrying wires. Allow one volume unit for each individual hot (ungrounded) and neutral (grounded) wire in the box. Use Table 41 to determine the volume units of common wire sizes. Example: two pieces of #14/2 NM are in a box. Each piece of this cable contains one hot (ungrounded) and one neutral (grounded) wire and one grounding wire. From Table 41, each #14 wire uses 2.00 cu. in. in the box. The total volume units required by the hot (ungrounded) and neutral (grounded) wires is 8 cu. in.

Volume units for devices. Allow two volume units for each device (switch or receptacle) in the box. Base the volume units on the largest hot (ungrounded) or neutral (grounded) wire in the box. Example: NM cable size #14 and #12 are in a box. From Table 41, #14 wire uses 2.00 cu. in. and #12 wire uses 2.25 cu. in. Allow 4.5 cu. in. volume units (2 × 2.25 cu. in.) for each switch or receptacle in the box based on the volume of the larger #12 NM cable.

Volume units for grounding wires. Allow one volume unit for all grounding wires in the box. Base the volume unit on the largest hot (ungrounded) or neutral (grounded) wire in the box.

Volume units for clamps. Allow one volume unit for all internal cable clamps in the box, if any. Base the volume unit on the largest hot (ungrounded) or neutral (grounded) wire in the box.

Volume units for fittings. Allow one volume unit for all fittings in the box, if any. Base the volume unit on the largest hot (ungrounded) or neutral (grounded) wire in the box.

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 205 1/10/18 11:57 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 205 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:205

TABLE 42: ELECTRICAL BOX FILL CHART

BOX SIZE & SHAPE (If volume not labeled by manufacturer)	MAXIMUM NUMBER OF VOLUME UNITS PERMITTED (SEE NOTES BELOW)			
	14 AWG	12 AWG	10 AWG	8 AWG
JUNCTION BOXES				
4 × 1¼" R or O	6	5	5	4
4 × 1½" R or O	7	6	6	5
4 × 2⅛" R or O	10	9	8	7
4 × 1¼" S	9	8	7	6
4 × 1½" S	10	9	8	7
4 × 2⅛" S	15	13	12	10
4 11/16 × 1¼" S	12	11	10	8
4 11/16 × 1½" S	14	13	11	9
4 11/16 × 2⅛" S	21	18	16	14
DEVICE BOXES				
3 × 2 × 1½"	3	3	3	2
3 × 2 × 2"	5	4	4	3
3 × 2 × 2¼"	5	4	4	3
3 × 2 × 2½"	6	5	5	4
3 × 2 × 2¾"	7	6	6	4
3 × 2 × 3½"	9	8	7	6
4 × 2⅛ × 1½"	5	4	4	3
4 × 2⅛ × 1⅞"	6	5	5	4
4 × 2⅛ × 2⅛"	7	6	5	4

Notes:

- R = Round; O = Octagonal; S = Square or rectangular
- Each hot or neutral wire entering the box is counted as one volume unit.
- Grounding wires are counted as one volume unit in total—do not count each one individually.
- Raceway fittings and external cable clamps do not count. Internal cable connectors and straps count as one volume unit.
- Devices (switches and receptacles mainly) each count as two volume units.
- When calculating total volume units, any non-wire components should be assigned the gauge of the largest wire in the box.
- For wire gauges not shown here, contact your local electrical inspections office.

Box Support in Walls, Ceilings & Floors

1. Provide support for boxes that rigidly and securely fasten them in place. You may use nails or screws to support these boxes.

2. Protect screws inside boxes so that the threads will not damage the wires.

3. Wood braces used to support boxes must be at least 1 × 2 inches.

4. Use "cut-in" or "old work" retrofit boxes only if they have approved clamps or anchors that are identified for the location where they are installed.

Damp Locations

1. Install a receptacle box cover that is weatherproof when the cover is closed and a plug is not inserted into a receptacle located in a damp location. This applies to 15-amp and 20-amp receptacles. A damp area is protected from direct contact with water. Refer to the definition of damp location. You may use a receptacle cover suitable for wet locations in a damp location (see page 170).

2. Install a watertight seal between a flush-mounted receptacle and its faceplate. This will require a gasket or sealant between the finished surface (such as stucco, brick, or siding) and the faceplate.

Wet Locations

1. Install a receptacle box cover that is weatherproof when the cover is closed on any receptacle located in a wet location. This applies to 15-amp and 20-amp receptacles in any indoor or outdoor wet location. This applies regardless of whether or not a plug is inserted into the receptacle. Refer to the definition of wet location (see page 170).

2. Install a watertight seal between a flush-mounted receptacle and its faceplate. This will require a gasket or sealant between the finished surface (such as stucco, brick, or siding) and the faceplate.

Box Support by Raceways

1. Do not support any junction or device boxes using only conduit or tubing if the box volume is larger than 100 cubic inches.

2. Support boxes that do not contain switches, receptacles, or light fixtures by using at least two

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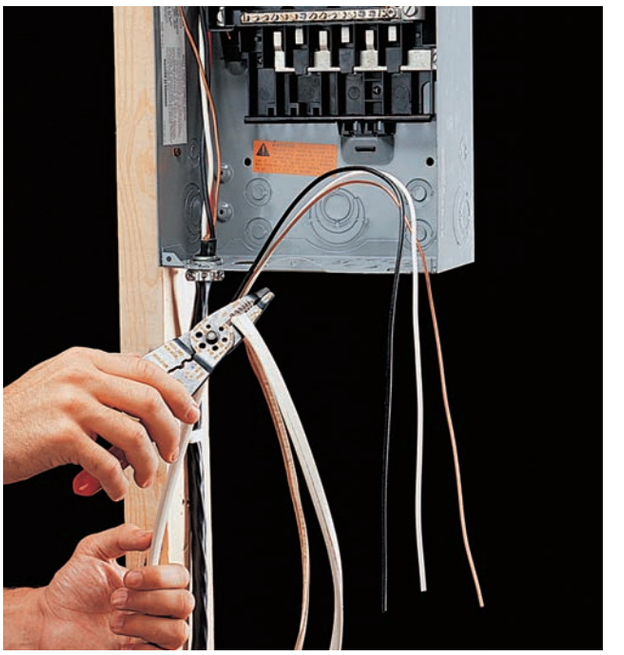
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:206

lengths of conduit threaded wrench-tight into the box. Secure the conduit not more than 3 feet from the box if the conduit enters from different sides of the box. Secure the conduit not more than 18 inches from the box if the conduit enters from the same side of the box. Example: if the conduit enters the box from the top and bottom of the box, then secure the conduit not more than 3 feet from the box. Example: if the conduit enters the box from only the top or only from the bottom, then secure the conduit not more than 18 inches from the box.

3. Support boxes that contain switches or receptacles or light fixtures by using at least two lengths of conduit threaded wrench-tight into the box. Secure the conduit not more than 18 inches from the box.

4. You may use RMC or IMC metal conduit to support light fixtures under certain conditions. Refer to the IRC for the exceptions.



Secure each cable to a cabinet using an approved cable clamp.

Conduit should not be used as the sole means to support a box.

Panel boxes, including the main service panel and subpanel boxes, also require the use of properly sized cable clamps wherever cables enter or exit the box.

Cables Secured to a Cabinet

1. Secure each individual cable to panelboard cabinets and to similar enclosures, unless the exception applies.

2. You may run NM cable into the top of a surface-mounted cabinet through an accessible rigid raceway under certain conditions. Refer to IRC Chapter 39 for the conditions.

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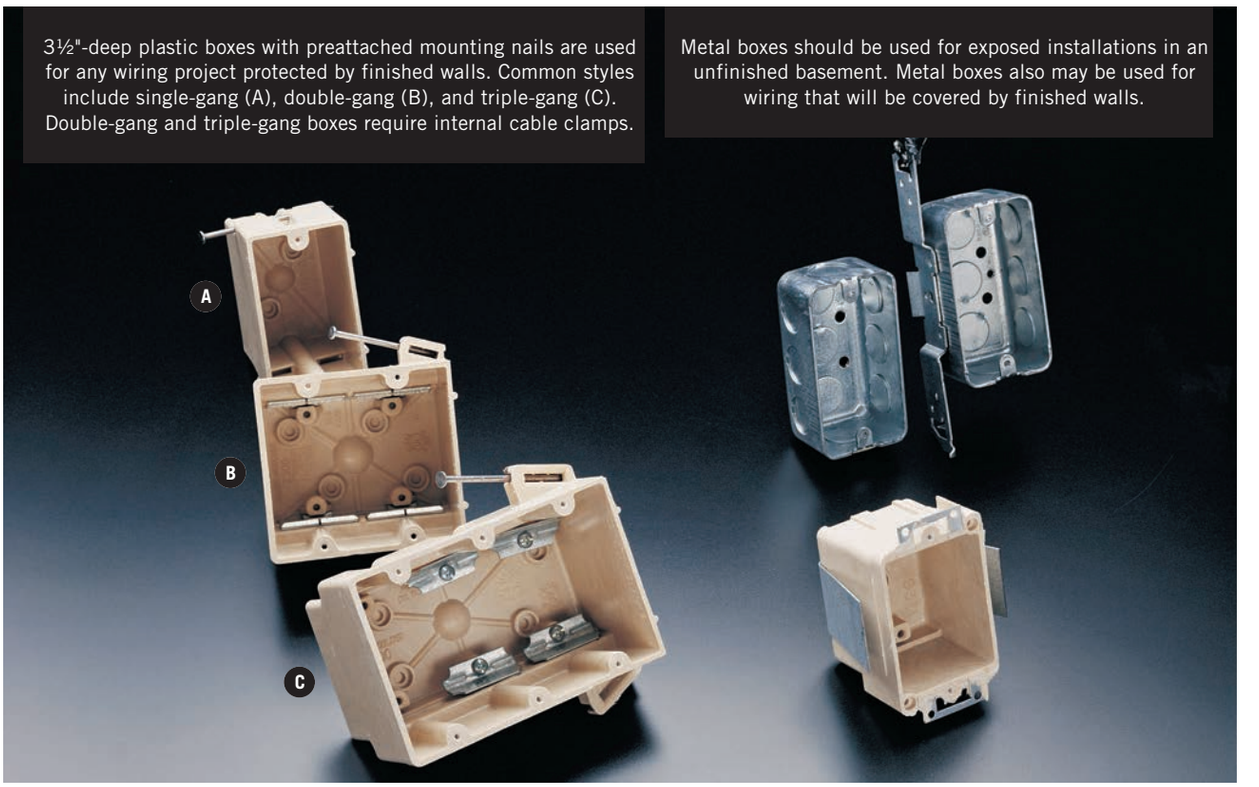
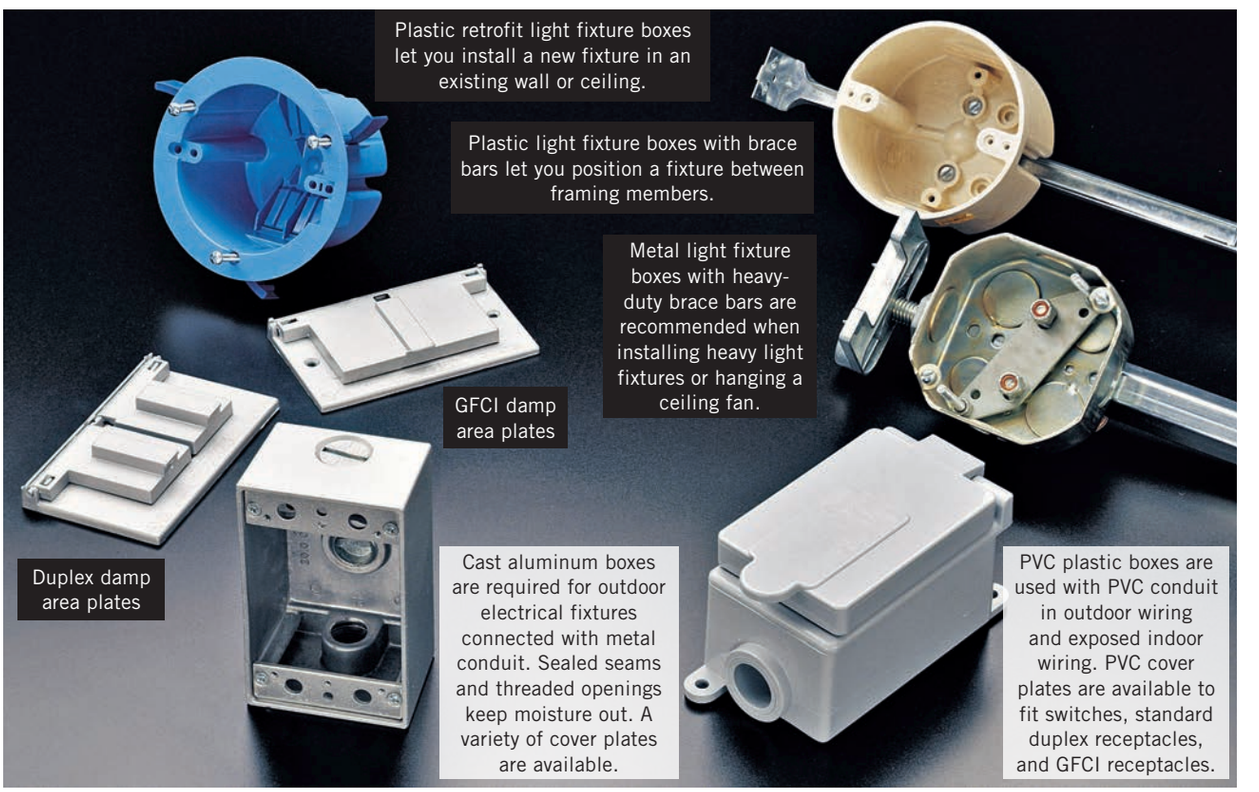
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:207

Electrical Box Types





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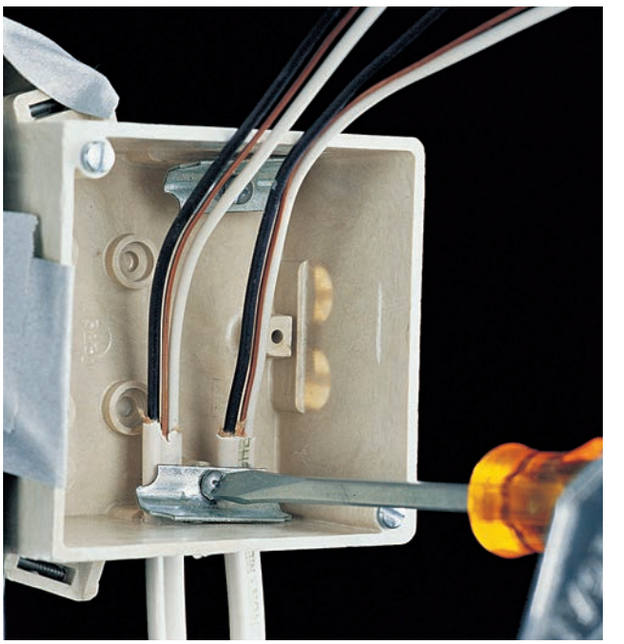
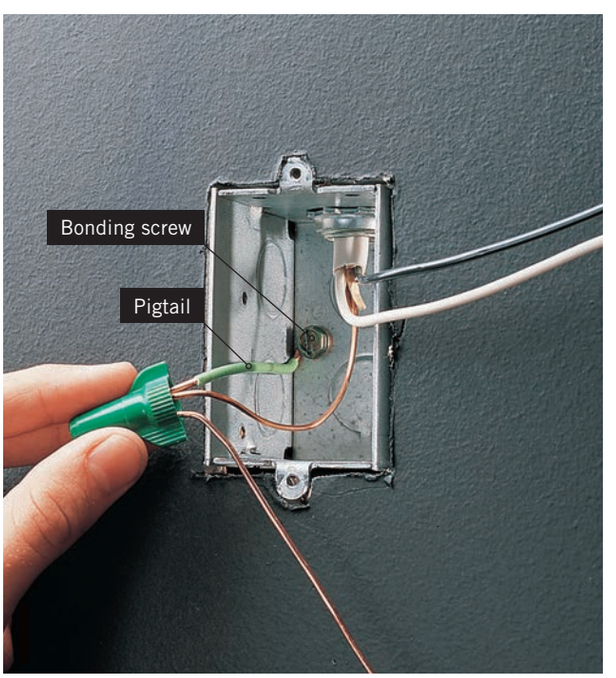
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:208

Box Installation Specifications

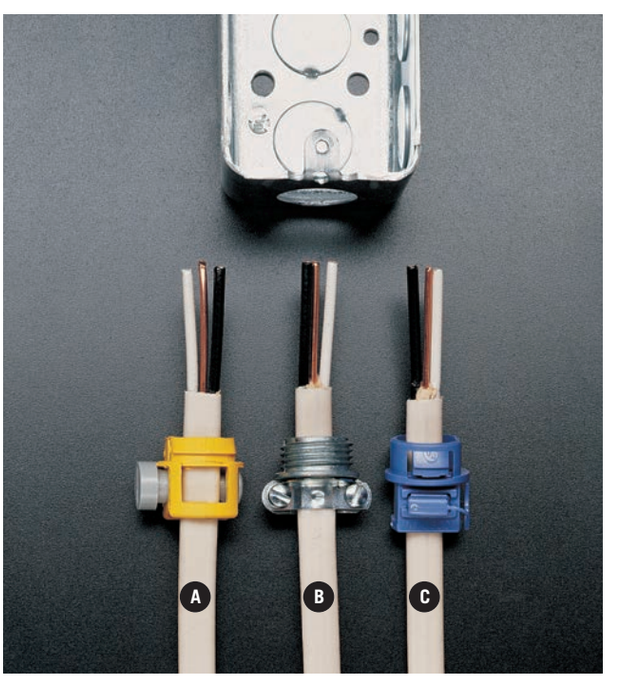
High-quality non-metallic boxes are rigid and don't contort easily. A variety of adapter plates are available, including single-gang (A), double-gang (B), light fixture (C), and junction box cover plate (D). Adapter plates come in several thicknesses to match different wall constructions.



Boxes larger than 2 × 4" and all retrofit boxes must have either compression tabs or internal cable clamps. After installing cables in the box, tighten cable clamps over the cables so they are gripped firmly, but not so tightly that the cable sheathing is crushed.



Metal boxes must be bonded to the circuit grounding system. Connect the circuit grounding wires to the box with a pigtail wire and wire connector (as shown) or with a grounding clip.



Cables entering a metal box must be clamped. A variety of clamps are available, including plastic clamps (A, C) and threaded metal clamps (B).

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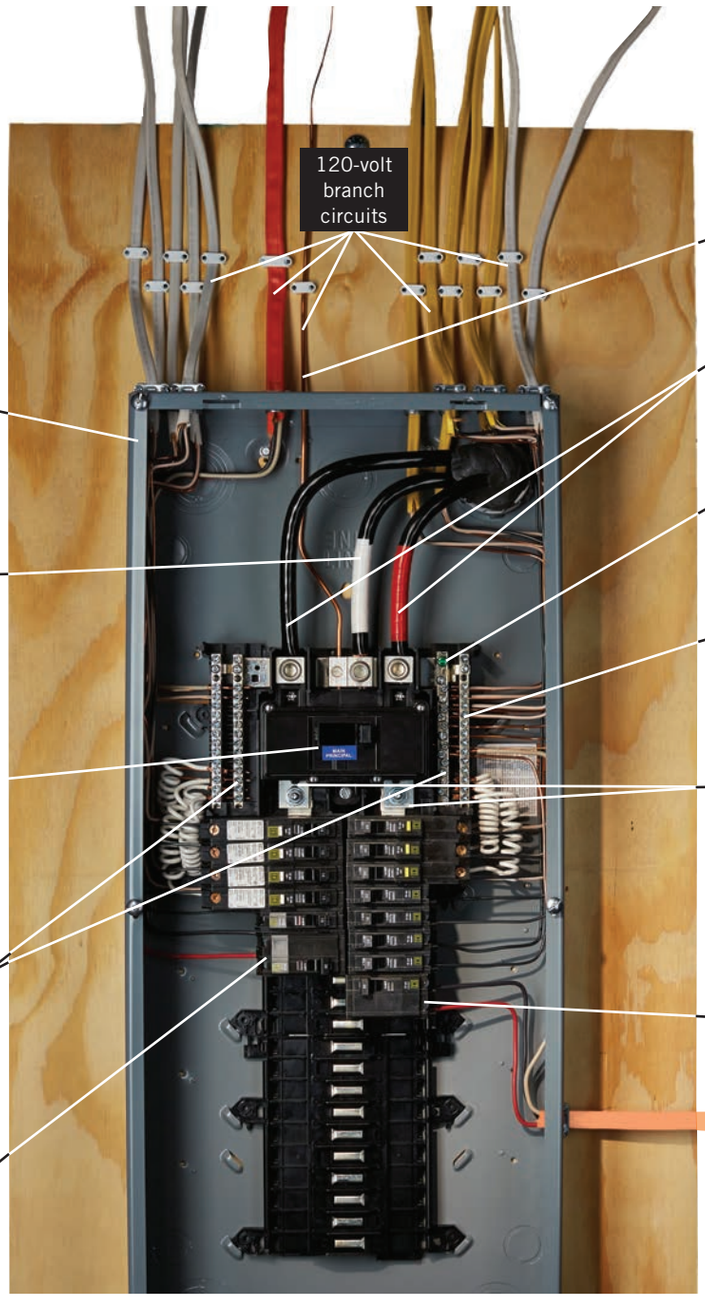
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:209

Circuit Breaker Panels

The circuit breaker panel is the electrical distribution center for your home. It divides the current into branch circuits that run throughout the house. Each branch circuit is protected by a circuit breaker or fuse that protects the wires from dangerous current overloads. When installing new circuits, the last step is to connect the wires to new circuit breakers at the panel. Follow basic safety procedures and always shut off the main circuit breaker and test for power before touching any parts inside the panel. Never touch the service wire lugs. If unsure of your own skills, hire an electrician to make the final circuit connections. (If you have an older electrical service with fuses instead of circuit breakers, always have an electrician make these final hookups.)



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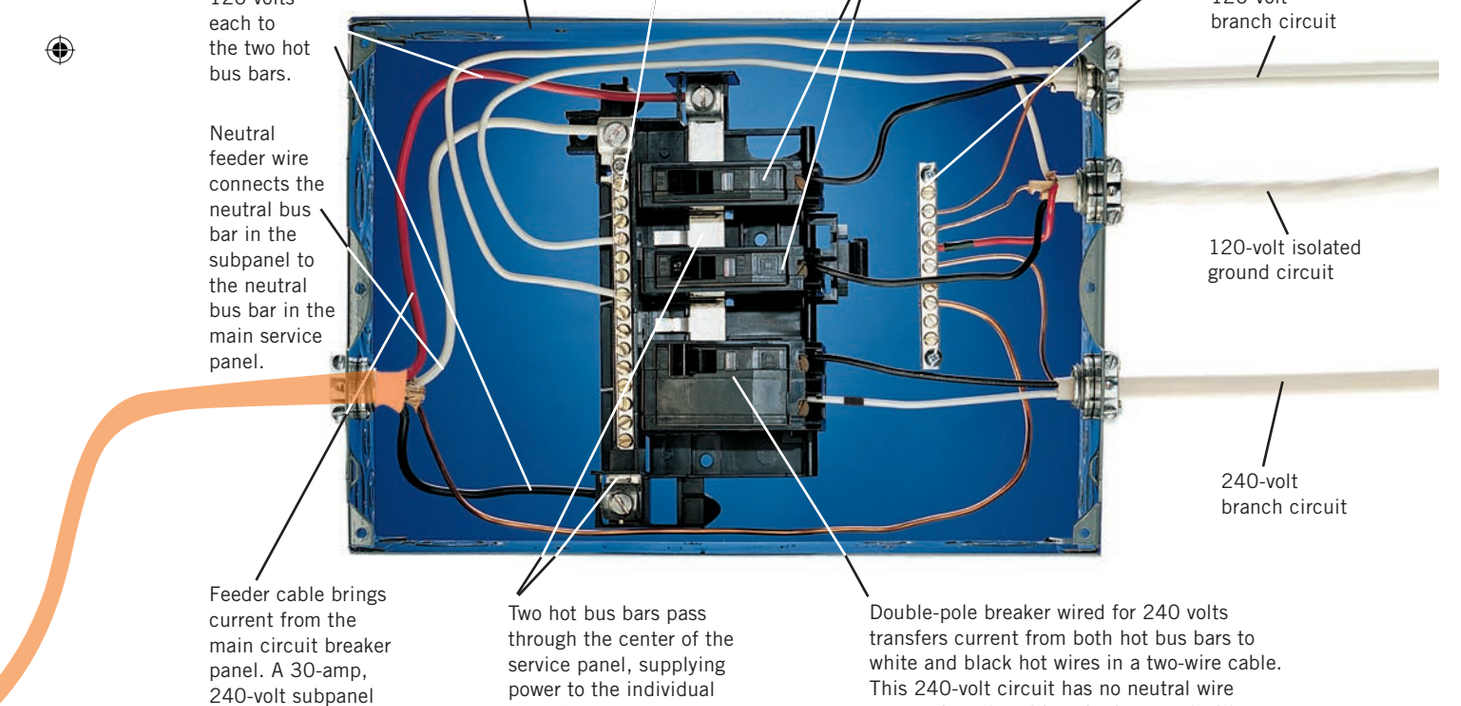
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:210

If a circuit breaker panel does not have enough open slots for new full-size circuit breakers, you may be able to install ½-height (slimline) circuit breakers. Otherwise, you will need to install a subpanel.

Before installing any new wiring, evaluate your electrical service to make sure it provides enough current to support both the existing wiring and any new circuits. If your service does not provide enough current, you will need to upgrade to a higher amp rating panel with enough extra breaker slots for the new circuits you want to install.

SAFETY WARNING

Never touch any parts inside a circuit breaker panel until you have checked for power. Circuit breaker panels differ in appearance, depending on the manufacturer. Never begin work in a circuit breaker panel until you understand its layout and can identify the parts.



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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:211

Switch Installation

Cover exposed electrical connections in timer boxes using the manufacturer-supplied cover.

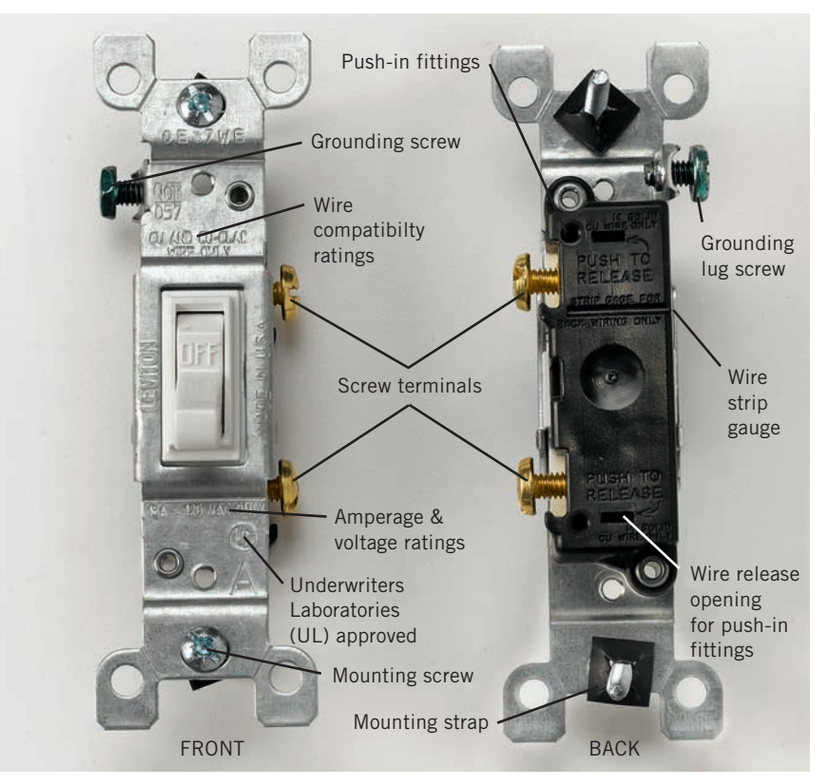
Switch Current Load Limitations

1. Do not use a switch in a circuit if the current load on the circuit exceeds the current rating of the switch. Example: a 15-amp snap switch may be overloaded if it switches ten 200-watt, 120-volt flood lights. Beware of overloads if the switch controls multiple high wattage flood lights or other high current draw equipment.

2. Use switches that are rated at least 80 percent of a motor's full load current rating.

3. Install switches that have at least the same current rating as the circuit breaker or fuse protecting the branch circuit when the switch controls plug-and-cord connected equipment either by switching the receptacle or by switching a permanently connected cord. Example: a switch controls half of a receptacle in a bedroom. If the branch circuit is 20 amps, the switch should be rated at 20 amps or more.

4. Run the grounded (neutral) wire of a general purpose branch circuit to the switch box when the switch controls lighting loads. Refer to the IRC for exceptions that may occur in some unusual conditions.



A typical 15-amp single pole switch seen front and back.

Three-way switches and four-way switches are required for circuits with fixtures controlled by multiple switches. A four-way switch is seen here. Note that ON and OFF are not indicated on the toggle because these settings can change based on which switch was used last.

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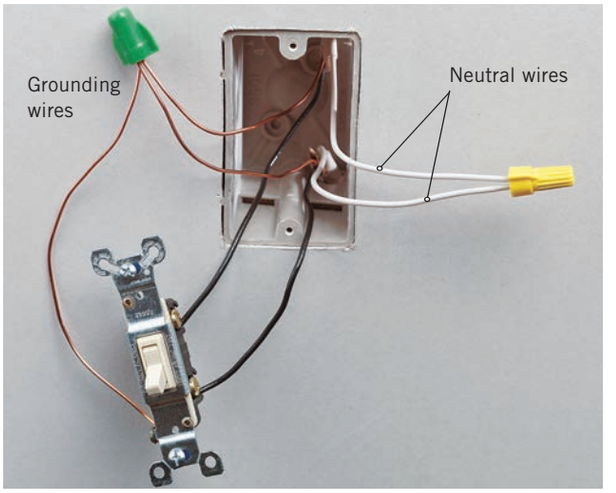
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:212



Connect the grounding wire to the switch grounding terminal when mounting the switch in a plastic box.

Switch Orientation

1. Install single-throw switches so that ON is in the up position when the device is installed vertically. You may install single-throw switches horizontally.

2. Use switches that clearly indicate whether the switch is in the ON or OFF position. This does not apply to three-way and four-way switches. This requirement is frequently waived when rocker type switches are used.

Timer Switches

1. Use timer switches with energized parts that are enclosed in the switch's case or enclose the timer switch in a cabinet or box.

2. Install a barrier to guard against contact with energized parts.

Switch Height

1. Locate switches not more than 79 inches above the finished floor or finished grade. Measure to the center of the handle when in the up position.

2. Locate switches in readily accessible places.

Grounding of Switches, Boxes & Faceplates

1. Ground metal boxes containing switches, the switches themselves (including dimmers and similar devices), and metal faceplates covering switches. Ground the switch by mounting the switch to a grounded metal box using metal screws or by connecting an equipment grounding wire to the switch. Connect switches to the equipment grounding wire when using non-metallic boxes.

2. You may replace an existing ungrounded switch with another ungrounded switch if the wiring method has no equipment grounding wire. Protect these ungrounded switches that are located not more than 8 feet vertically or 5 feet horizontally from the ground or from grounded metal objects by: (a) installing a non-combustible and non-conductive faceplate using nonmetallic screws or (b) using a switch with a non-metallic strap or yoke or (c) installing GFCI protection on the circuit.

Switches in Wet Locations

1. Enclose switches and circuit breakers installed in wet locations in a weatherproof cabinet or enclosure.

2. Do not locate switches in shower or tub spaces unless the switch is part of a listed tub or shower assembly.

Switch Mounting in Boxes

1. Mount switches in boxes that are recessed from the wall by seating the switch's extension ears at the top and bottom of the switch against the wall surface.

2. Mount switches in boxes that are flush with the wall by seating the switch's mounting yoke or strap against the box.

3. Do not allow the switch body to move when the switch is operated. This can, over time, cause wires to loosen, potentially causing arcing and a fire.

Switch Faceplate Installation

1. Install switch faceplates so that the plate completely covers the switch and so that the faceplate is flush against the wall. No gaps should exist between the switch handle and the faceplate or between the faceplate and the wall.

SWITCH ONLY HOT WIRES

Switch only the hot (ungrounded) wire unless the switch simultaneously disconnects all wires in the circuit. Maintain required wire color-coding throughout three-way and four-way circuits.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:213

Light Fixture Installation

Lights Required in Habitable Rooms

1. Install at least one switch-controlled light in every habitable room, kitchen, and bathroom. This light may be a switched (half-hot) receptacle in habitable rooms other than kitchens and bathrooms. In kitchens and bathrooms, the outlet must be a switched wall or ceiling lighting outlet. You may use lights controlled by occupancy sensors if the sensors have a manual override that allows switch control of the light.

Lights Required in Other Interior Spaces

1. Install at least one wall switch–controlled wall or ceiling light in every hallway, stairway, attached garage, and detached garage if the detached garage is provided with electricity.

2. Install at least one wall switch to control stairway lights if the stairs have at least (≥) 6 risers. Install a switch at: (a) each floor and (b) each landing that provides access to an interior or exterior entry opening.

Lights Required at Exterior Doors

1. Install at least one switch-controlled wall or ceiling light on the exterior side of every exterior door with grade level access. Exterior lights are not required at garage vehicle doors.

Lights Required in Attics, Crawlspaces & Basements

1. Install at least one light outlet in attics, crawlspaces, utility rooms, and basements if the area is used for storage or if it contains equipment that requires service. Locate the light outlet near any equipment that requires service.

2. Locate a switch for the light at the usual point of entry into the area. You may use a pull-chain-controlled light if the light is located at the usual point of entry into the area. This means that if the light is not at the entrance to the area, the light must be switched at the entrance.

Light Fixture Support

1. You may use a securely attached box to support light fixtures weighing less than 50 pounds. Note that ceiling fans are not considered light fixtures.

2. Do not use the screw shell of a light fixture to support anything that weighs more than 6 pounds or is more than 16 inches in any dimension.

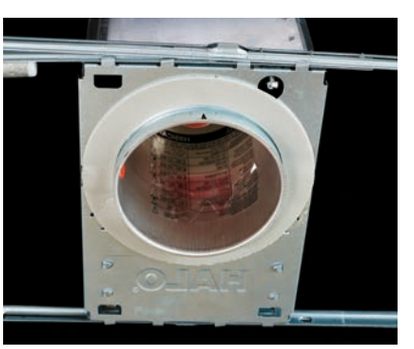
Recessed Lights

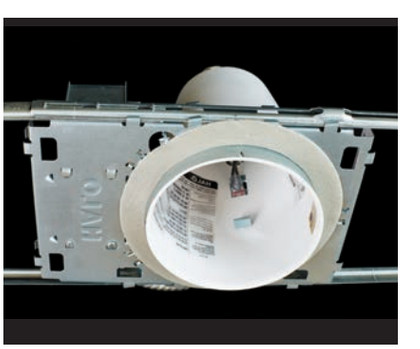
1. Use recessed lights that are labeled as being thermally protected. Thermal protection shuts off power to the light at high temperatures. Thermal protection is not required if the recessed light is made, labeled, and installed so that it functions as if it were thermally protected.

2. Use insulation contact (IC) rated recessed lights when the recessed parts are installed in an insulated attic. IC rated recessed lights may not require clearance to insulation or to combustible materials.

3. Provide at least 3 inches of clearance between insulation and recessed lights that are not labeled as being insulation contact (IC) rated. Do not install insulation above non-IC rated recessed lights.

Choose the proper type of recessed light fixture for your project. There are two types of fixtures: those rated for installation within insulation (left) and those which must be kept at least 3" from insulation (right). Self-contained thermal switches shut off power if the unit gets too hot for its rating. A recessed light fixture must be installed at least ½" from combustible materials.





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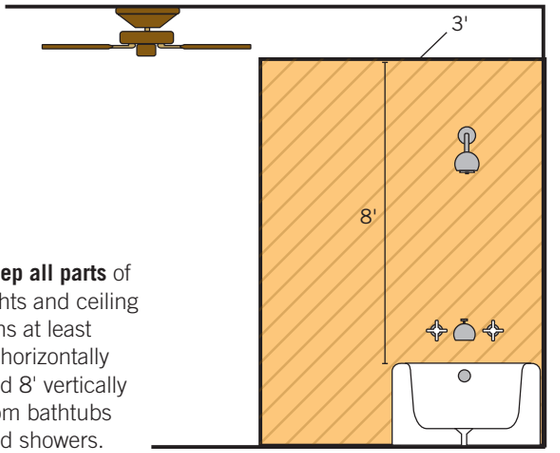
Page:214



Keep all parts of lights and ceiling fans at least 3' horizontally and 8' vertically from bathtubs and showers.

Lights in Wet & Damp Locations

1. Install lights in wet and damp locations so that water cannot enter or accumulate in the wiring or energized parts.

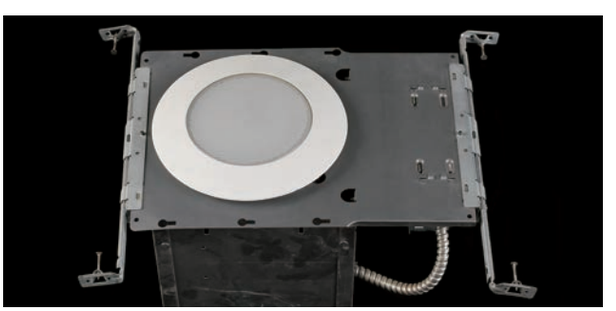
2. Use only lights labeled SUITABLE FOR WET LOCATIONS when installing lights that may be subject to direct contact with water. Refer to the definition of wet location (see page 170).

3. Use lights labeled either SUITABLE FOR WET LOCATIONS or SUITABLE FOR DAMP LOCATIONS when installing lights in damp locations. Refer to the definition of damp location (see page 170). Light fixtures, including ceiling fans, intended for indoors may not be installed in either wet or damp locations.

Ceiling Fans

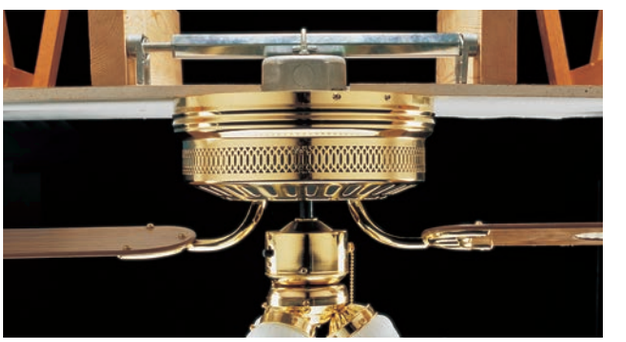
1. Support ceiling fans weighing not more than 70 pounds using boxes listed and labeled to support the fan.

2. Support ceiling fans weighing more than 70 pounds independently from the box.



Light fixtures installed in damp areas should be rated for moisture exposure.

Look for heavy-duty ceiling boxes that are specifically rated for ceiling fans and heavy light fixtures.



A sturdy metal brace with an integral box that is installed between ceiling joists can be used to support ceiling fans and heavy light fixtures.

Ceiling Fans & Lights Near Tubs & Showers

1. Install ceiling fans, cord-connected lights, lights suspended by cords, chains, or cables, and track lights so that no part of the light or fan falls within an exclusion zone measuring 3 feet horizontally from the base of the tub or shower stall threshold and 8 feet vertically from the top of the tub rim or shower stall threshold. Parts include fan blades, bulb enclosures, hanging chains, and other parts connected to or hanging from the light or fan.

2. Use light fixtures that are listed for damp locations if the fixture is: (a) located within the tub or shower area and (b) within 8 feet from the top of the tub rim or shower threshold.

3. Use light fixtures that are listed for wet locations if the fixture is: (a) located within the tub or shower area, (b) within 8 feet from the top of the tub rim or shower threshold, (c) subject to shower spray.

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Page:215

Closet Lights

Applicable Code Definltions for Closets:

Clothes closet: A space intended for storage of clothing, a clothes closet usually contains a horizontal rod for hanging clothing. This definition implies that this section does not apply to storage areas such as linen closets and pantries. As with all codes, application of this section depends on interpretation by the local building official.

Closet storage area: Clearances to light fixtures required by this IRC Section are between light fixtures and the closet storage area. The closet storage area is a space consisting of a hanging rod storage area and a shelf storage area. The required clearance applies to both areas. The clearances to light fixtures apply whether or not shelves or hanging rods are currently installed in the closet. This means that if a shelf or rod could be installed on a clothes closet wall, you must assume that one will be installed and that the clearances to light fixtures apply.

Hanging rod storage area: This area begins at the closet floor and ends 6 feet above the closet floor or at the highest hanging rod, whichever is higher. The hanging rod storage area includes all of the space within 24 inches horizontally from the back and sides of the closet walls.

Shelf storage area: This begins 6 feet above the closet floor or at the highest hanging rod, whichever is higher, and ends at the closet ceiling. The shelf storage area includes all of the space within 12 inches horizontally from the back and sides of the closet walls or within the width of the shelf, whichever is wider.

Light Fixture Clearances in Clothing Closets

1. Do not install any incandescent or LED light fixture in a clothes closet if any part of the lamp is exposed. This includes both surface mounted and recessed light fixtures. This includes incandescent light fixtures that have lamps such as compact fluorescent installed because the fluorescent lamp could be replaced with an incandescent lamp. This includes hanging light fixtures.

2. Provide at least 12 inches between surface mounted incandescent or LED light fixtures and the closest point of the closet storage area.

3. Provide at least 6 inches between recessed incandescent and LED light fixtures and the closest point of the closet storage area.

4. Provide at least 6 inches between fluorescent light fixtures and the closest point of the closet storage area.

5. You may install surface-mounted fluorescent and LED light fixtures within the closet storage area if the fixture is identified for use within the area.

Using Flexible Cords with Equipment

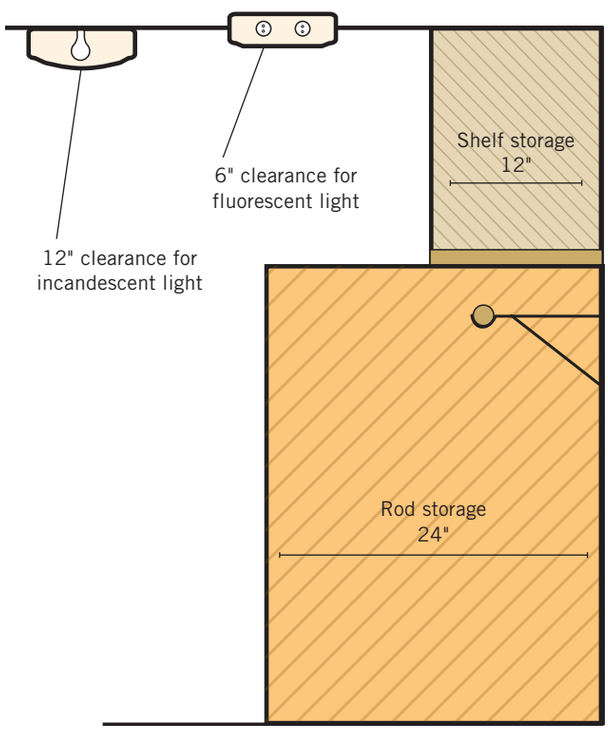
1. Use flexible cords only to connect an appliance to a receptacle and only if the appliance manufacturer's instructions allow connection by a flexible cord.

2. Do not run or conceal flexible cords in walls, ceilings, floors, or raceways.

3. Do not splice or tap flexible cords.

4. Provide power to flexible cords through an attachment plug. Do not hard-wire flexible cords directly to a power source.

5. Do not use flexible cords as a substitute for permanent wiring.



Closet hanging rod and shelf storage areas.

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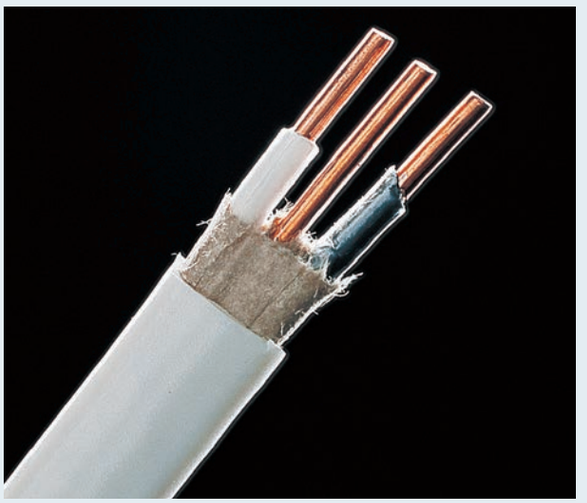
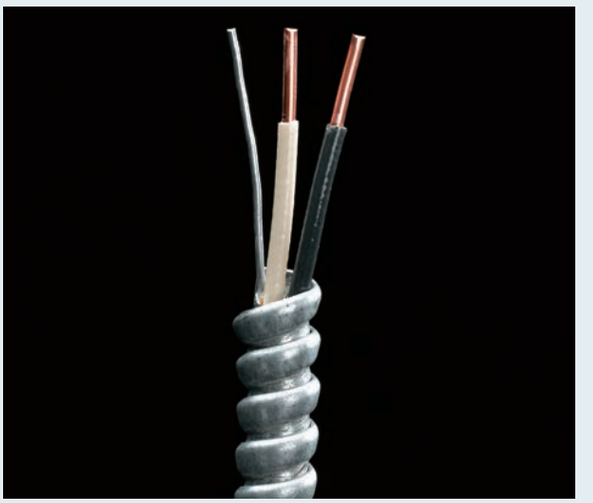
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:216

ELECTRIC EQUIPMENT GROUNDING

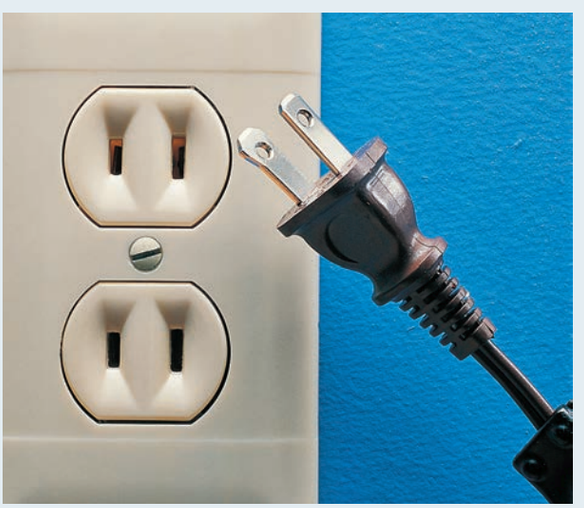
1. Ground metal parts in an electrical system including equipment cases, cabinets, boxes, conduit, tubing, light fixtures, and water pumps. Equipment cases include furnaces, air conditioning condensers, water heaters, dishwashers, and similar equipment.
2. You may ground metal parts in an electrical system by using any currently accepted wiring method that provides a mechanically and electrically continuous path to the service grounding connection. These methods include: (a) grounding wires contained in NM cable, (b) separate equipment grounding wires, and (c) metal conduit and tubing when the fittings at terminations are listed for grounding.
3. Do not use a separate earth ground as the only means of grounding equipment. Example: do not install a separate driven ground rod to ground an air conditioning condenser.
4. In older homes, the electrical wires do not have a separate grounding wire. Some people install a wire between the grounding screw of a grounded receptacle and the neutral terminal. This is not safe.



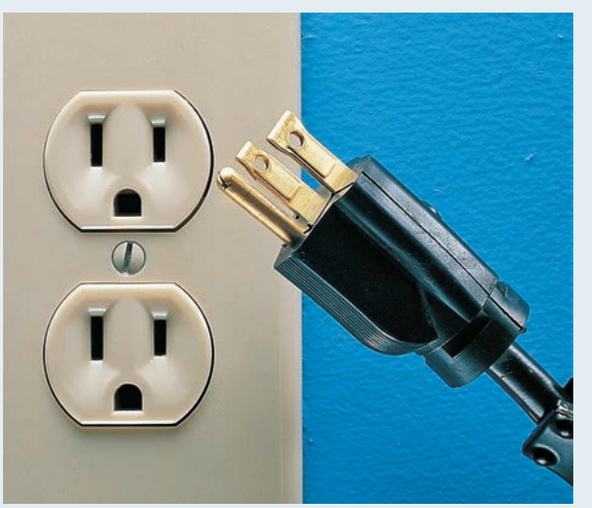
Modern NM (nonmetallic) cable, found in most wiring systems installed after 1965, contains a bare wire that provides grounding for receptacle and switch boxes.



Armored cable has a metal sheath that can serve as the grounding pathway.



Polarized receptacles have a long slot and a short slot. Used with a polarized plug, the polarized receptacle keeps electrical current directed for safety.



Three-slot receptacles are required by code for all new installations. They are usually connected to a standard two-wire cable with ground.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:217

Satellite Dishes, Television & Radio Antennas

This material applies to receiving antennas, such as satellite dishes, and traditional radio and television antennas. It does not apply to cable TV system wiring, and it does not apply to network-powered broadband communication system wiring. This material also applies to radio transmission antennas and towers, such as those used by amateur radio operators.

Antenna Prohibited Installation Locations

1. Do not attach or secure (guy) antennas to electric service entrance masts, poles that support electric power wires, plumbing vent pipes, or furnace vent pipes.

2. Do not attach or secure (guy) large antennas to chimneys, including framed and brick veneer chimneys. These chimneys are not designed to bear the loads imposed by large antennas. Consult a qualified contractor or chimney sweep before attaching or securing large antennas to chimneys.

3. Provide clearance between antennas and masts and electric power wires so that if the antenna falls, it is unlikely to fall on the electric power wires.

Antenna Wire & Cable Clearance to Electric Power Lines

1. Do not install outdoor, aboveground antenna wires and cables so that they cross over electric power wires. Avoid, if possible, installing outdoor, aboveground antenna wires that cross under electric power wires. Electric power wires include wires on overhead power poles, overhead service drop wires, and any electric power wires running between buildings.

2. Provide at least 2 feet of clearance between outdoor, aboveground antenna wires and cables and electric power lines that can swing freely.

3. Provide at least 4 inches between outdoor antenna wires and cables and most residential electric power wires when both are secured so that they cannot move.

4. Provide at least 12 inches of clearance between underground antenna wires and underground cables and electric power wires.

Television aerials and satellite dishes must be located well away from power lines. They should be properly grounded and protected against lightning strikes.

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305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 218 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:218

5. Provide at least a 2-inch clearance between indoor antenna wires and cables and indoor electric power wires.

Grounding Antennas, Masts, Wires & Cables

1. Install a ground/bonding wire between metal antenna masts, towers, and support poles and an approved grounding point. Metal antenna masts include the short metal mast commonly found on satellite dishes.

2. Install a grounding/bonding wire between the coaxial cable shield and an approved grounding/bonding point. You must ground/bond both the coaxial cable shield and any metal antenna mast.

3. Use at least #10 AWG copper wire or #17 copper clad steel wire as the grounding/bonding wire for receiving equipment only. You may use a #8 AWG aluminum or copper-clad aluminum grounding/bonding wire for receiving equipment only if it is not in contact with masonry, and is not installed in a corrosive environment, and is installed at least 18 inches above the ground at all points, including at the connection to the grounding/bonding point.

4. Use at least #10 AWG copper, bronze, or copper-clad steel as the grounding/bonding wires for transmitting/receiving stations. Use a larger wire if the lead-in wires are larger than #10 AWG. Insulation is not required on any grounding/bonding wire. You may use solid or stranded grounding/bonding wires for transmitting or receiving stations.

5. Run the grounding/bonding wire in as straight a line as possible to an approved grounding point.

SOURCE FOR THIS MATERIAL

The material in this section is based on the National Electrical Code (NEC)®, 2017 Edition. Most local building officials use the NEC as a supplement to or in place of the IRC when dealing with residential electrical issues. The IRC does not address antennas, so the NEC is usually the appropriate source for rules regarding installation of antennas and the wires that connect them to the receiving equipment. Verify with the local building official which version, if any, of the NEC is adopted in your area.

6. Connect the grounding/bonding wire(s) to one of the following approved grounding/bonding points: (a) the intersystem bonding connection terminal; (b) the building's grounding electrode, grounding electrode wire, or other metal part of the building grounding electrode system; (c) a metal water service pipe not more than 5 feet from where the water service pipe enters the building; (d) the service equipment cabinet or non-flexible metal service equipment raceway; or (e) the other system grounding/bonding connection described in the IRC.

7. Do not connect the antenna mast or coaxial cable to its own ground rod unless the ground rod is bonded to the building grounding electrode system using at least #6 AWG copper wire.

8. Secure and support the grounding/bonding wire by fastening it to the building or other substantial structure. Insulating supports are not required.

9. Protect the grounding/bonding wire if it is exposed to physical damage. Use a wiring method, such as metallic conduit, that is approved for use in physical damage environments.

10. Bond (connect) both ends of any metallic conduit and tubing used to protect the grounding/bonding wire to the bonding/grounding wire.

Grounding Wire Connection to the Grounding Point

1. Use a listed clamp, listed pressure connector, or other listed means to connect the grounding wire to the grounding point.

2. Install the listed connector so that it is both physically and electrically connected to the grounding point. This means removing paint, lacquer, rust, and other non-conductive material before attaching the listed connector to the grounding point.

3. Connect not more than one grounding wire to a listed connector unless the connector is listed to accept more than one wire.

4. Use a listed connector that is compatible with both the grounding point and the grounding wire material. Example: an iron or steel clamp is not compatible with a copper water pipe. Both materials will corrode over time.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:219

Broadband Cable Wiring

This material applies to network-powered broadband communication system wiring. These systems usually deliver television, telephone, Internet, and similar services. They operate at up to 150 volts and 100 watts. This material does not apply to standard cable TV system wiring, and it does not apply to satellite TV antenna wiring. Some new communication systems use fiber-optic cables. This article does not apply to fiber-optic cables.

Overhead Broadband Cable Clearance

1. Install outdoor, aboveground broadband communication cables above electric power wires whenever possible.

2. Avoid installing outdoor, aboveground broadband communication cables near electric power wires that can swing freely. Electric power wires include wires on overhead power poles, overhead service drop wires, and any electric power wires running between buildings. Provide at least 12 inches of clearance between outdoor, above-ground broadband communication cables and electric power lines that can swing freely. Increase clearance to at least 40 inches at the power pole.

3. Provide at least 4 inches between outdoor broadband communication cables and most residential electric power wires when both are secured so that they cannot move.

4. Measure the vertical clearance between overhead broadband cables and the ground, walkway, driveway, or street beginning at the lowest hanging point of the cables and ending at the surface under the lowest point.

5. Provide at least 9½ feet vertical clearance between broadband cables and finished grade, sidewalks, or platforms accessed by pedestrians only.

6. Provide at least 11½ feet vertical clearance between overhead broadband cables and residential property and driveways.

7. Provide at least 15½ feet vertical clearance between overhead broadband cables and public streets, alleys, roads, or parking areas subject to truck traffic.

8. Provide the same clearance between overhead broadband cables and swimming pools, spas, and hot tubs as for electrical wires.

9. Provide at least 8 feet vertical clearance between broadband cables and most low-slope roofs.

10. Provide at least 18 inches of vertical clearance between broadband cables and roof overhangs if not more than 4 feet of cable passes over the roof and if the cable terminates at a through-the-roof raceway or support. This is similar to clearances allowed for service drop wires.

11. Provide at least 3 feet vertical clearance between broadband cables and roofs with a slope of at least 4 inches in 12 inches.

LOW & MEDIUM POWER BROADBAND SYSTEM DEFINITION

Low power broadband systems operate at not more than 100 volts, and medium power systems operate at not more than 150 volts. Verify voltage rating and system classification with the broadband service provider. The operating voltage of the system affects how the cables are installed.

Broadband Cable Burial Depth

1. Bury broadband cables at least 18 inches deep when the cables are not covered by concrete or enclosed in conduit or other raceways. You may reduce the depth to at least 12 inches when the cables are under concrete residential driveways, patios, and similar concrete slabs. Refer to the NEC for burial depths when the cables are enclosed in conduit or raceways.

Grounding Broadband Cables

1. Install a copper (or other corrosion-resistant material) grounding/bonding wire at least

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305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 220 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:220

#14 AWG between the broadband cable shield and an approved grounding/bonding point.

2. Connect the grounding/bonding wire to the broadband cable shield at a point as close as possible to where the outside cable terminates outside the building. If the outside cable enters the building, make this connection at a point as close as possible to where the outside cable enters the building.

3. Run the grounding/bonding wire in as straight a line and as short a distance as possible from the broadband cable shield grounding/bonding connection point to an approved grounding/bonding point.

4. Limit the length of the grounding/bonding wire to not more than 20 feet. If the broadband cable shield ground/bonding point is more than 20 feet from an approved grounding point, you may install at least an 8-foot-long ground rod near where the cable enters the building and bond the ground rod to the electrical service grounding system using at least #6 AWG copper wire.

5. Connect the grounding/bonding wire(s) to one of the following approved grounding/bonding points in other than manufactured homes: (a) the intersystem bonding connection terminal; (b) the building's grounding electrode, grounding electrode wire, or other metal part of the building grounding electrode system; (c) a metal water service pipe not more than 5 feet from where the water service pipe enters the building; (d) the service equipment cabinet or non-flexible metal service equipment raceway; or (e) the other system grounding/bonding connection described in the IRC.

6. Connect the grounding/bonding wire(s) to one of the approved grounding/bonding points described above at manufactured homes if the home has service equipment or a grounded power disconnecting means located not more than 9 feet from the nearest wall of the home.

7. Connect the grounding/bonding wire(s) to the manufactured home's grounding electrode if the home does not have service equipment or a grounded power disconnecting means located not more than 9 feet from the nearest wall of the home. Use at least #6 AWG copper wire to make this connection.

8. Connect the broadband cable shield to the metal frame of the manufactured home if the grounding/bonding connection is made as described in #7 above. Use at least #12 AWG copper wire to make this connection.

9. Protect the grounding/bonding wire if it is exposed to physical damage. Use a wiring method, such as metallic conduit, that is approved for use in physical damage environments.

Broadband Cable & Electric Power Wire Separation

1. Do not run low-power or medium-power broadband cables in the same conduit, tubing, raceway, junction and device box, or enclosure with electric power wires unless an exception applies.

2. You may install low-power and medium-power broadband cables and electric power wires in the same cabinet or box when the electric power wires are intended to supply power to the broadband cable system, such as for an amplifier.

3. Separate indoor broadband cables and electric power wires by at least 2 inches.

4. Separation described in number 3 is not required if the electric power wires or broadband cables are enclosed in conduit, tubing, metal cable armor or if the electric power wires and cables are permanently separated from each other by a continuous non-conductive material.

5. Separation described in number 3 is not required if the electric power wires are contained in a jacket, such as with types NM, UF, and AC cable. This means that, in most cases, separation between broadband cables and electric power wires is required only when individual electric wires are installed in conduit or tubing.

6. Provide, if possible, at least 6 feet of separation between coaxial cables and any part of a lightning protection system.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:221

APPENDIX

Common Mistakes

An electrical inspector visiting your home might identify a number of situations that are not up to code. These situations may not be immediate problems. In fact, it is possible that the wiring in your home has remained trouble free for many years.

Nevertheless, any wiring or device that is not up to code carries the potential for problems, often at risk to your home and your family. In addition, you may have trouble selling your home if it is not wired according to accepted methods.

Most local electrical codes are based on the National Electrical Code (NEC), a book updated and published every three years by the National Fire Protection Agency. This code book contains rules and regulations for the proper installation of electrical wiring and devices. Most public libraries carry reference copies of the NEC.

All electrical inspectors are required to be well versed in the NEC. Their job is to know the NEC regulations and to make sure these rules are followed in order to prevent fires and ensure safety. If you have questions regarding your home wiring system, your local inspector will be happy to answer them.

While a book cannot possibly identify all potential wiring problems in your house, we have identified some of the most common wiring defects here and will show you how to correct them. When working on home wiring repair or replacement projects, refer to this section to help identify any conditions that may be hazardous.

Electrical inspectors are on the lookout for common mistakes. The following pages detail problems to avoid so you will pass inspection on the first try.

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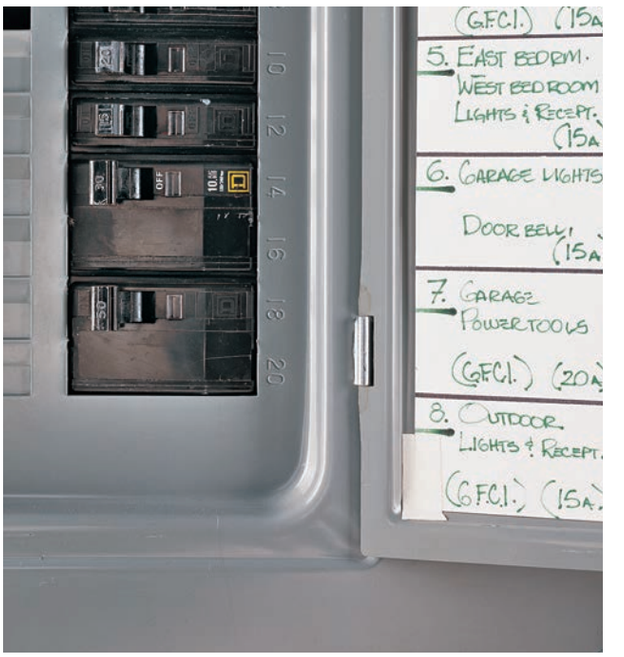
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:222

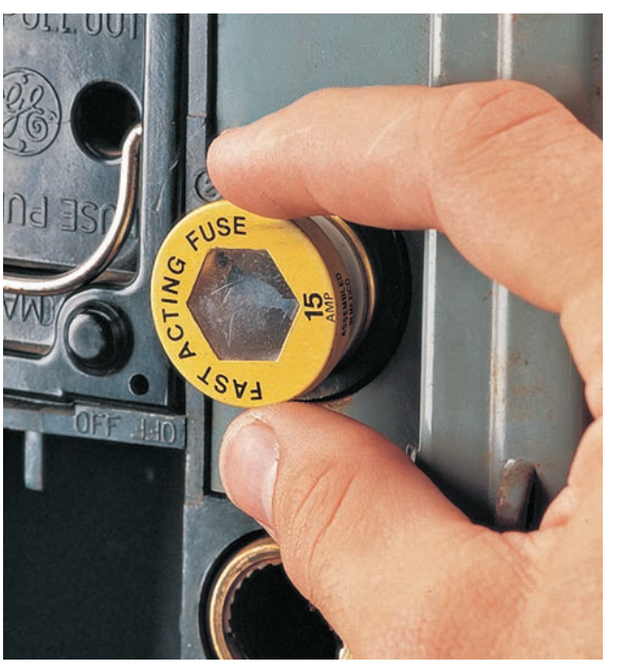
Service Panel Inspection

Problem: Rust stains are found inside the main service panel. This problem occurs because water seeps into the service head outside the house and drips down into the service panel.



Solution: Have an electrician examine the service head and the main service panel. If the panel or service wires have been damaged, new components must be installed.

Problem: This problem is actually a very old and very dangerous one. A penny or a knockout behind a fuse effectively bypasses the fuse, preventing an overloaded circuit from blowing the fuse. This is very dangerous and can lead to overheated wiring.



Solution: Remove the penny and replace the fuse. Have a licensed electrician examine the panel and circuit wiring. If the fuse has been bypassed for years, wiring may be dangerously compromised, and the circuit may need to be replaced.

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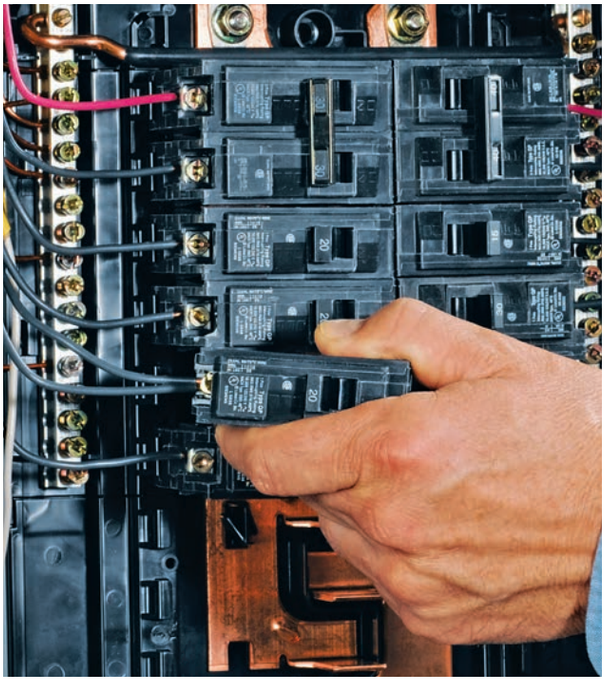
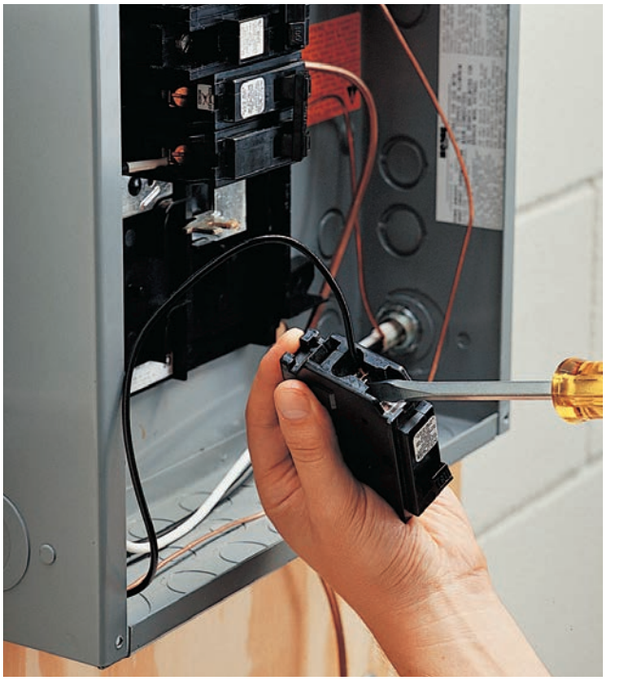
Page:223



Problem: Two wires connected to one single-pole breaker is a sign of an overcrowded panel and also a dangerous code violation unless the breaker is approved for such a connection.



Solution: If there is room in the panel, install a separate breaker for the extra wire. If the panel is overcrowded, have an electrician upgrade the panel or install a subpanel.

RECOGNIZING ALUMINUM WIRE

Solid-conductor aluminum wire was used in place of copper in many wiring systems installed beginning around 1964 and continuing until the late 1970s. Aluminum wire is identified by its silver color and by the AL stamp on the cable sheathing.

By the late 1960s, reports of house fires were traced to solid-conductor aluminum wire. Investigators discovered a couple of causes. One cause was aluminum's tendency to oxidize (rust), especially when connected to copper at switches, receptacles, and other wires. The other cause was that the aluminum wire being used until about 1972 tended to shrink and swell at a different rate than other materials. These problems increased heat at the connections and caused the fires.

By about 1974, the problems had been corrected and inventories of existing wire and devices had been depleted. The aluminum wire alloy was changed to reduce the shrink and swell problem. Switches and receptacles were changed to the CO/ALR type, which reduced the oxidation problem. By about 1980, though, solid-conductor aluminum wire had such a bad reputation that its use in the United States was minimal. It's unusual to find solid-conductor aluminum wire in houses built after about 1980, although some #8 AWG is being installed even today.

Here is some general advice about dealing with solid-conductor aluminum wiring. A qualified electrician who is familiar with the issues should work on wiring installed between 1964 and about 1974. The aluminum wire produced during this period may not be entirely safe even when connected to CO/ALR devices. Aluminum wire installed after 1974 should be safe when connected to CO/ALR devices; however, connecting aluminum wire to copper wire should only be done using connectors designed for this purpose.

You should not confuse solid-conductor aluminum wire with similar wire and with wire that looks similar but is not aluminum. Stranded aluminum wire continues to be used for large appliance circuits, feeders, and service entrance wires. It is safe when properly installed with anti-oxidant paste at terminals.

Copper-coated aluminum wire was produced in the 1970s. It is treated like aluminum wire but does not share the same problems. Copper-coated aluminum wire is uncommon. “Tin-coated” copper wire was installed mainly during the 1940s and 1950s. This wire looks like aluminum wire but is copper. This wire's safety may be questionable because of deterioration of its insulation, not because of the wire itself.

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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:224

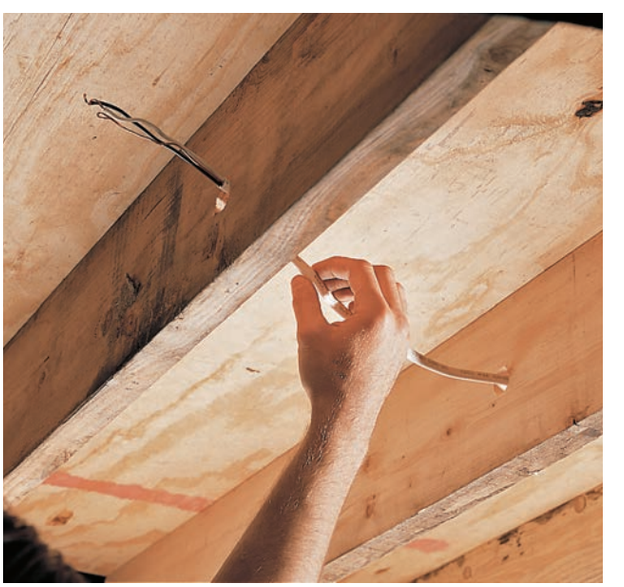
Inspecting the Bonding Jumper Wire

Problem: Grounding system jumper wire is missing or is disconnected. In most homes the grounding jumper wire attaches to water pipes on either side of the water meter.

Solution: Attach a jumper wire to the water pipes on either side of the water meter using pipe clamps. Use wire that is the same size and type as the grounding electrode wire.

Common Cable Problems

Problem: Cable running across joists or studs is attached to the edge of framing members. Electrical codes forbid this type of installation in exposed areas, such as unfinished basements or walk-up attics.



Solution: Protect cable by drilling holes in framing members at least 2" from exposed edges and threading the cable through the holes.

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C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:225

Problem: Cable running along joists or studs hangs loosely. Loose cables can be pulled accidentally, causing damage to wires.

Solution: Anchor the cable to the side of the framing members at least 1¼" from the edge using plastic staples. NM (non-metallic) cable should be stapled every 4½' and within 8" of each electrical box.

Problem: Cable threaded through studs or joists lies close to the edge of the framing members. NM (non-metallic) cable (shown cutaway) can be damaged easily if nails or screws are driven into the framing members during remodeling projects.

Solution: Install metal nail guards to protect cable from damage. Nail guards are available at hardware stores and home centers.

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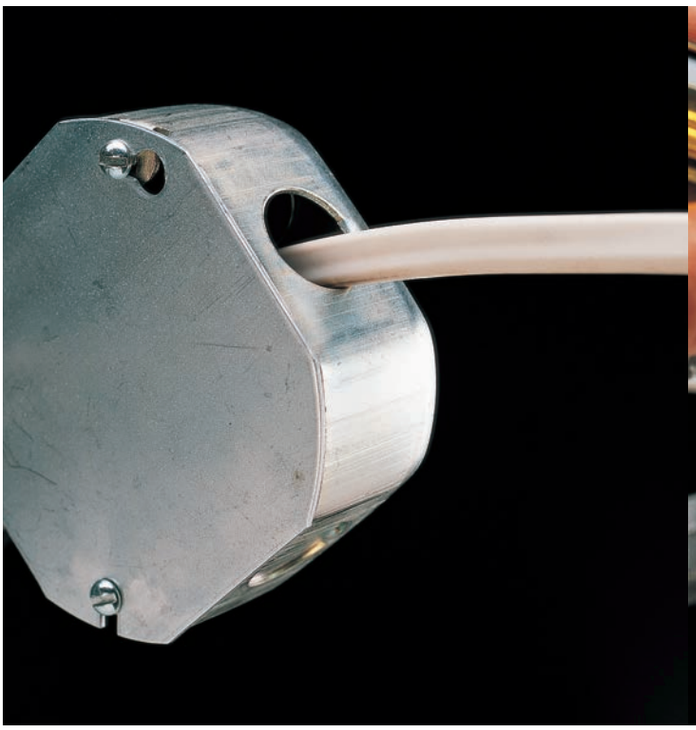
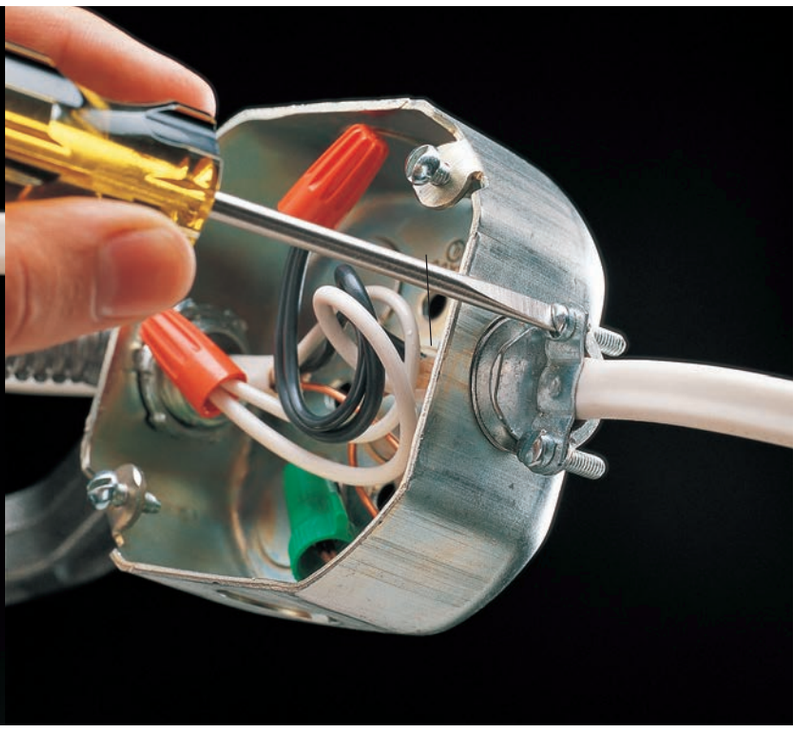
Page:226

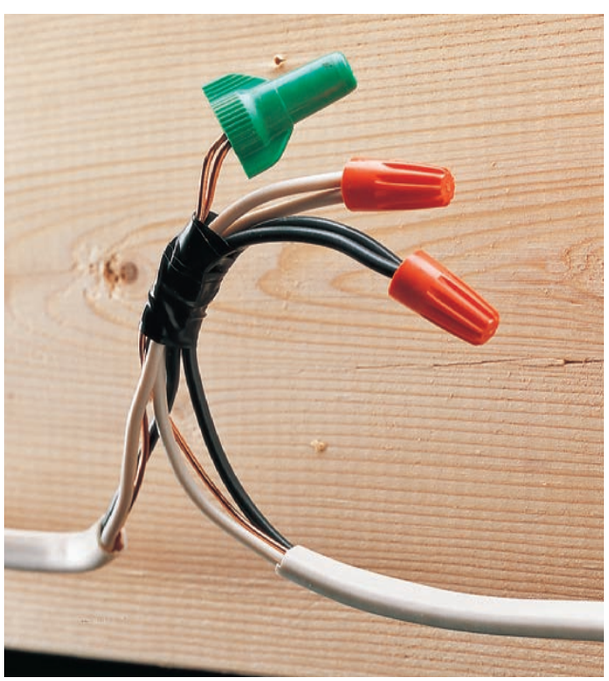




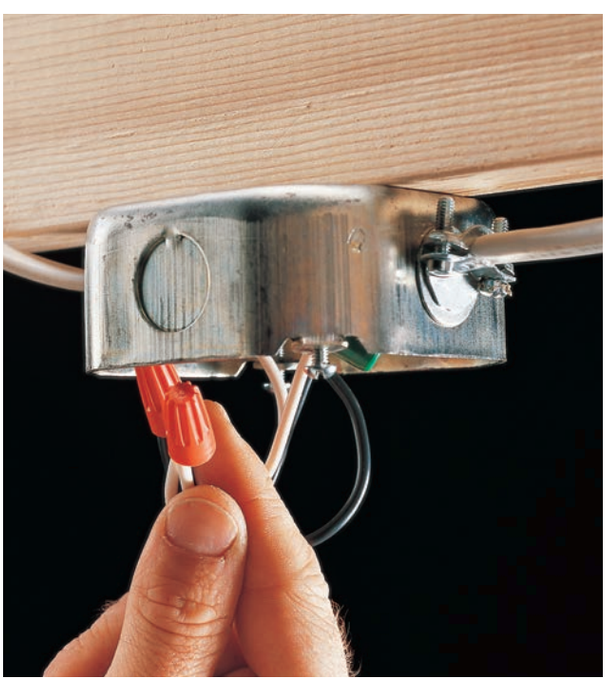
Problem: Unclamped cable enters a metal electrical box. Edges of the knockout can rub against the cable sheathing and damage the wires.

Solution: Anchor the cable to the electrical box with a cable clamp. Several types of cable clamps are available at hardware stores and home centers.

NOTE: With plastic boxes, clamps are not required if cables are anchored to framing members within 8" of the box.



Problem: Cables are spliced outside an electrical box. Exposed splices can spark and create a risk of shock or fire.



Solution: Bring installation up to code by enclosing the splice inside a metal or plastic electrical box. Make sure the box is large enough to accommodate the number of wires it contains.

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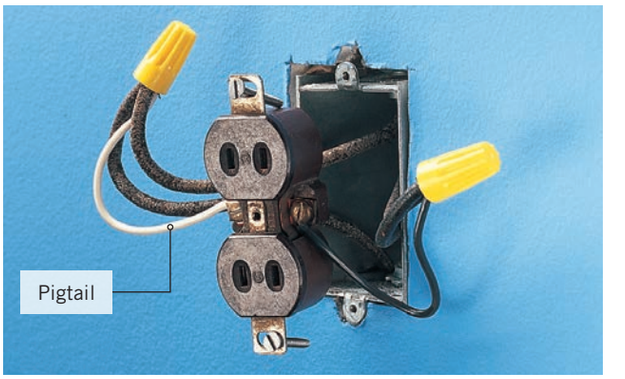
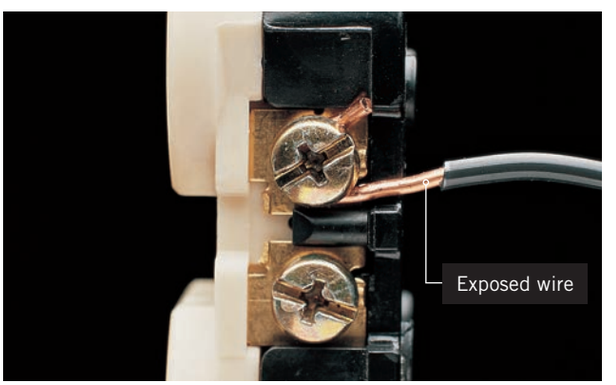
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:227

Checking Wire Connections

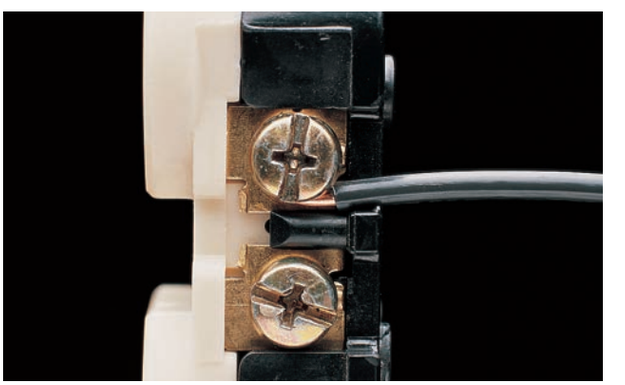
Problem: Two or more wires are attached to a single-screw terminal. This type of connection is seen in older wiring but is now prohibited by the NEC.



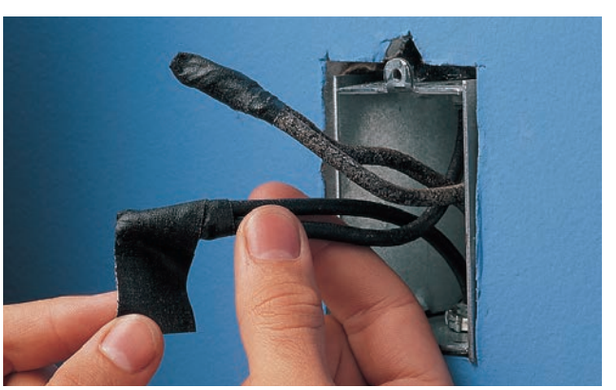
Solution: Disconnect the wires from the screw terminal, then join them to a short length of wire (called a pigtail) using a wire connector. Connect the other end of the pigtail to the screw terminal.



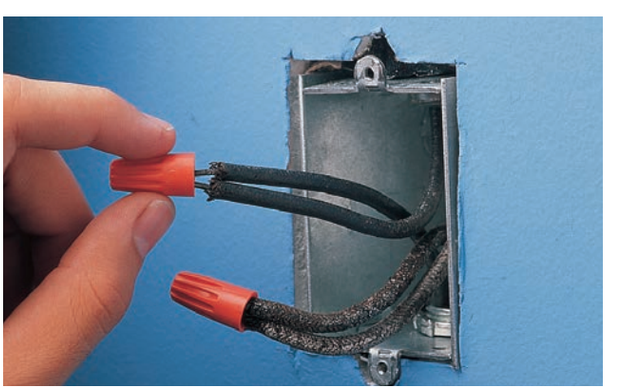
Problem: Bare wire extends past a screw terminal. Exposed wire can cause a short circuit if it touches the metal box or another circuit wire.



Solution: Clip the wire and reconnect it to the screw terminal. In a proper connection, the bare wire wraps completely around the screw terminal, and the plastic insulation just touches the screw head.

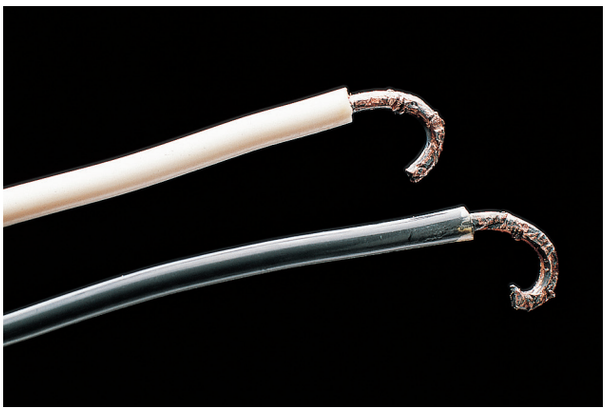


Problem: Wires are connected with electrical tape. Electrical tape was used frequently in older installations, but it can deteriorate over time, leaving bare wires exposed inside the electrical box.

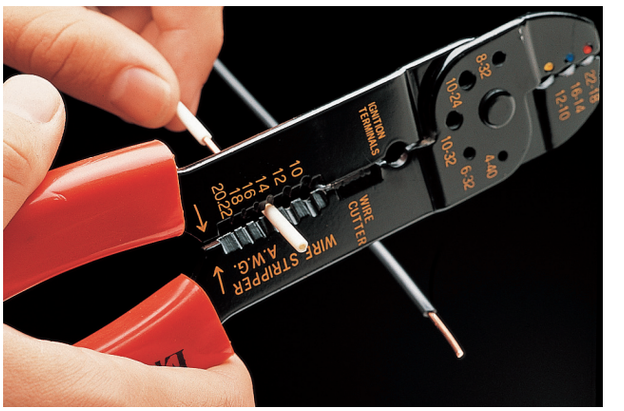


Solution: Replace electrical tape with wire connectors. You may need to clip away a small portion of the wire so the bare end will be covered completely by the connector.

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 228 1/10/18 11:58 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 228 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:228

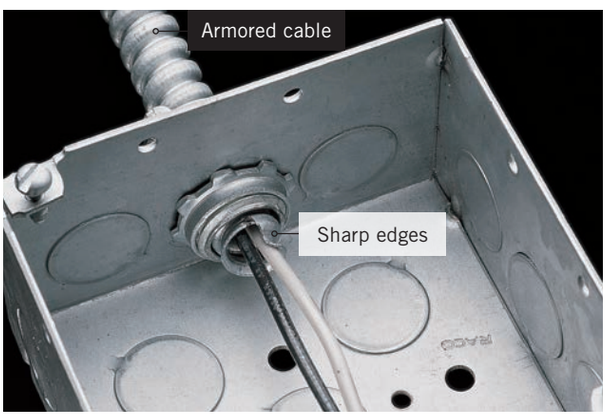


Problem: Nicks and scratches in bare wires interfere with the flow of current. This can cause the wires to overheat.

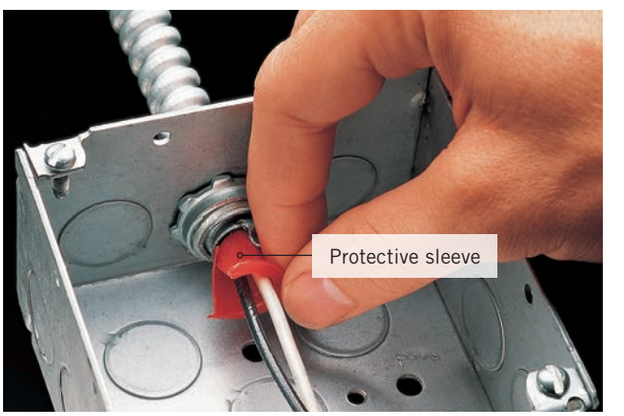


Solution: Clip away the damaged portion of the wire, then restrip about ¾" of insulation and reconnect the wire to the screw terminal.

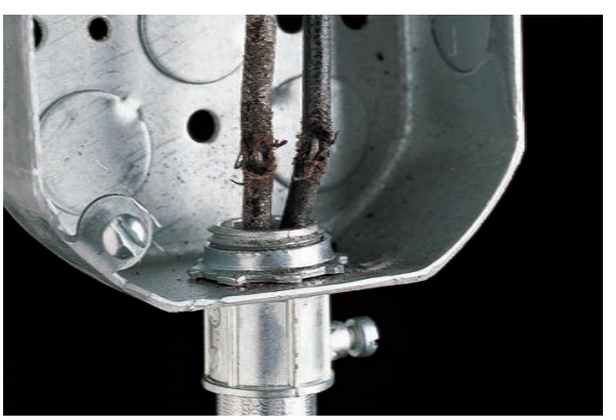
Electrical Box Inspection



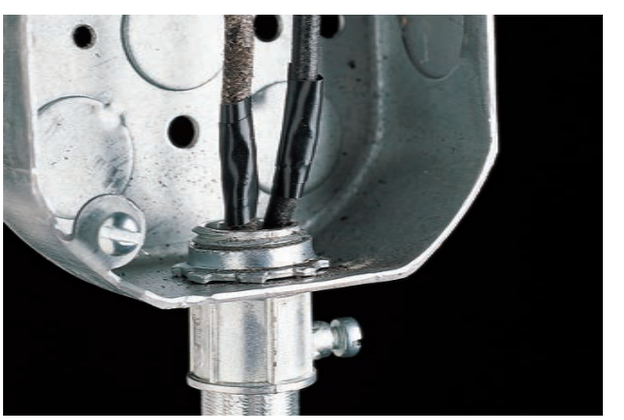
Problem: No protective sleeve on armored cable. Sharp edges of the cable can damage the wire insulation, creating a shock hazard and fire risk.



Solution: Protect the wire insulation by installing a plastic sleeve around the wires. Sleeves are available at hardware stores. Wires that are damaged must be replaced.



Problem: Insulation on wires is cracked or damaged. If damaged insulation exposes bare wire, a short circuit can occur, posing a shock hazard and fire risk.



Solution: Wrap damaged insulation temporarily with plastic electrical tape. Damaged circuit wires should be replaced by an electrician.

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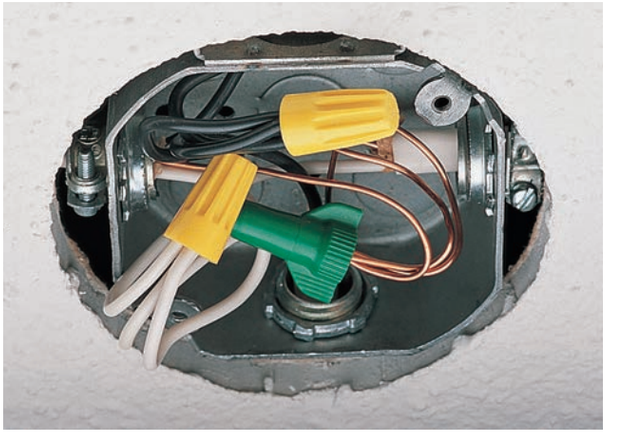
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:229



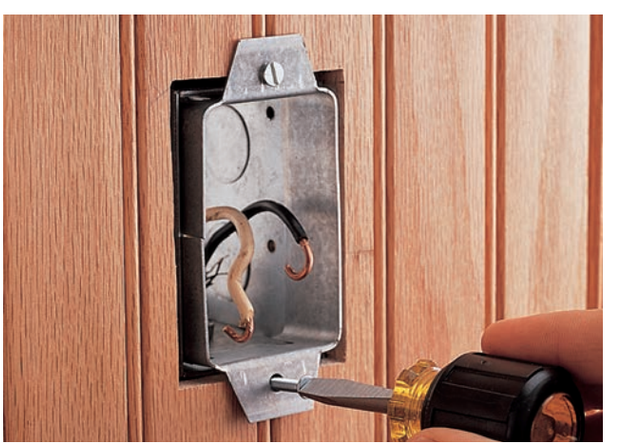
Problem: Open electrical boxes create a fire hazard if a short circuit causes sparks (arcing) inside the box.

Solution: Cover the open box with a solid metal cover plate, available at any hardware store. Electrical boxes must remain accessible and cannot be sealed inside ceilings or walls.

Problem: Short wires are difficult to handle. The NEC requires that each wire in an electrical box have at least 6" of workable length.

Solution: Lengthen circuit wires by connecting them to short pigtail wires using wire connectors. Pigtails can be cut from scrap wire but should be the same gauge and color as the circuit wires and at least 6" long.

Problem: A recessed electrical box is hazardous, especially if the wall or ceiling surface is made from a flammable material, such as wood paneling. The NEC prohibits this type of installation.



Solution: Add an extension ring to bring the face of the electrical box flush with the surface. Extension rings come in several sizes and are available at hardware stores.

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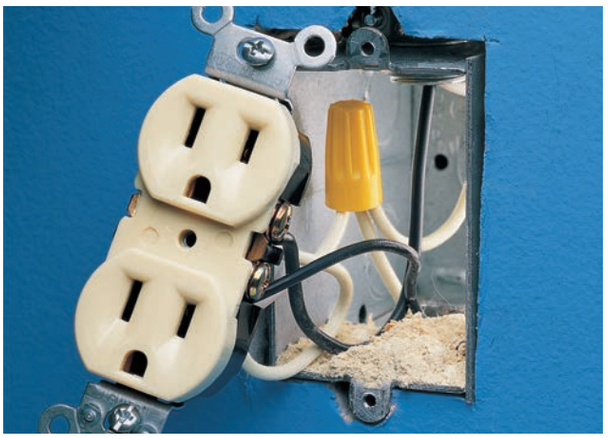
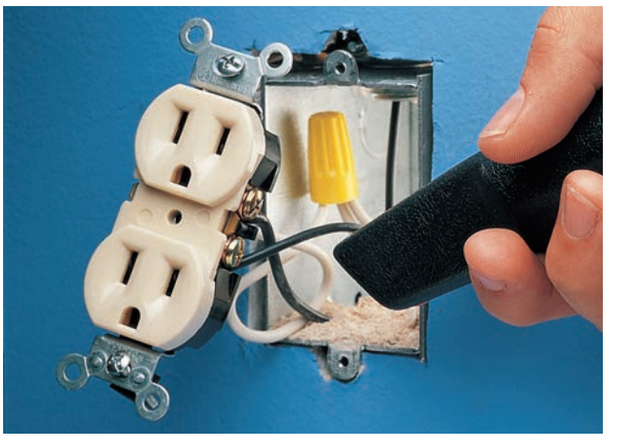
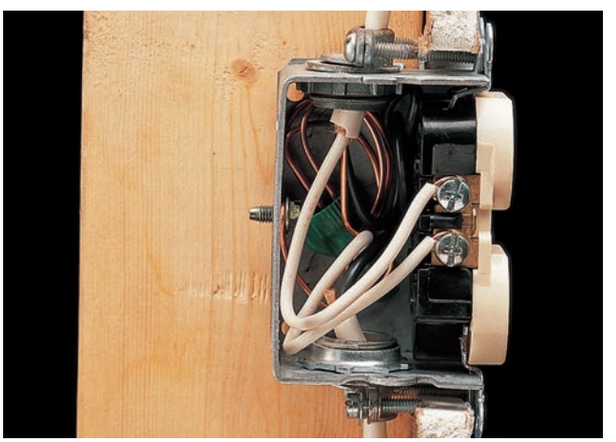
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 230 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:230



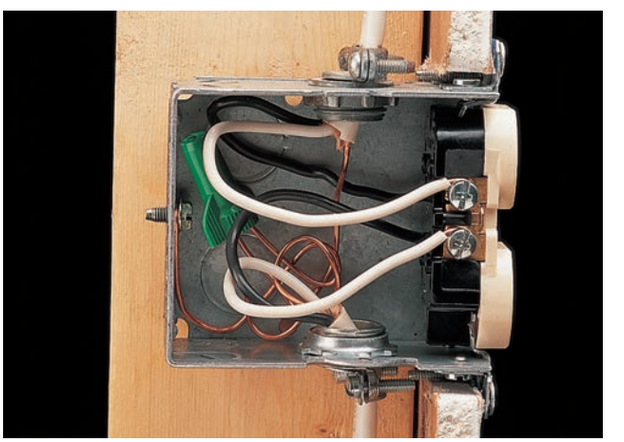
Problem: Open electrical boxes create a fire hazard if a short circuit causes sparks (dust and dirt in an electrical box can cause hazardous, high-resistance short circuits). When making routine electrical repairs, always check the electrical boxes for dust and dirt buildup.



Solution: Vacuum the electrical box clean using a narrow nozzle attachment. Make sure power to the box is turned off at the main service panel before vacuuming.



Problem: Crowded electrical box (shown cutaway) makes electrical repairs difficult. This type of installation is prohibited because heat in the box may cause a fire.



Solution: Replace the electrical box with a deeper electrical box.

Problem: Light fixture is installed without an electrical box. This installation exposes the wiring connections and provides no support for the light fixture.

Solution: Install an approved electrical box to enclose the wire connections and support the light fixture.

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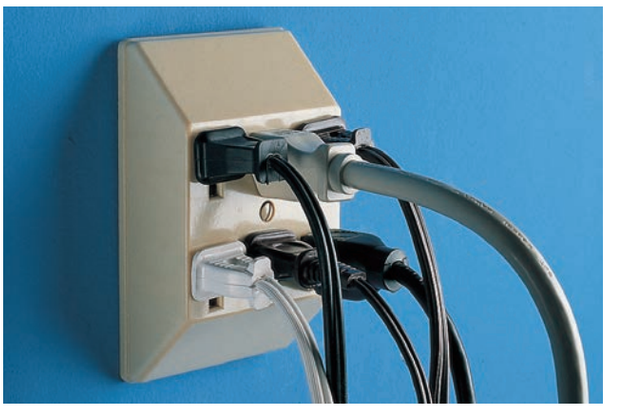
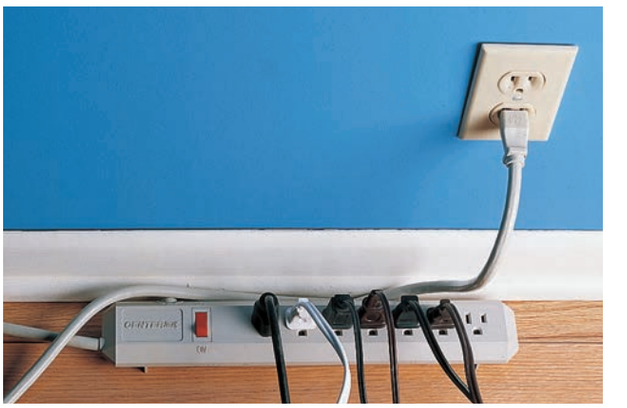
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:231

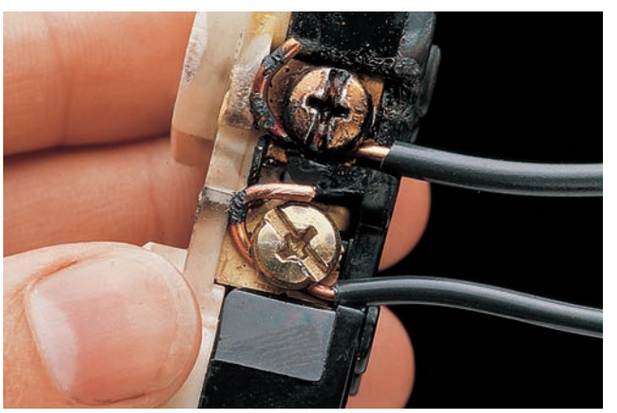
Inspecting Receptacles & Switches



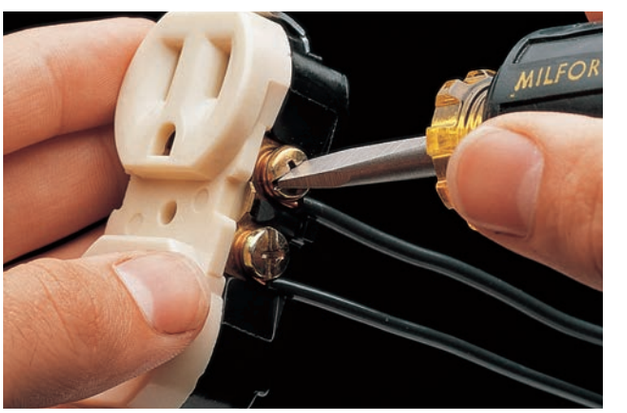
Problem: Octopus receptacle attachments used permanently can overload a circuit and cause overheating of the receptacle.



Solution: Use a multi-receptacle power strip with built-in overload protection. This is for temporary use only. If the need for extra receptacles is frequent, upgrade the wiring system.



Problem: Scorch marks near screw terminals indicate that electrical arcing has occurred. Arcing usually is caused by loose wire connections.



Solution: Replace the receptacle. Make sure wires are connected securely to screw terminals.

Problem: Exterior receptacle box allows water to enter the box when receptacle slots are in use.

Solution: Replace the old receptacle box with an in-use box that has a bubble cover to protect plugs from water while they are in the slots.

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 232 1/10/18 11:58 AM
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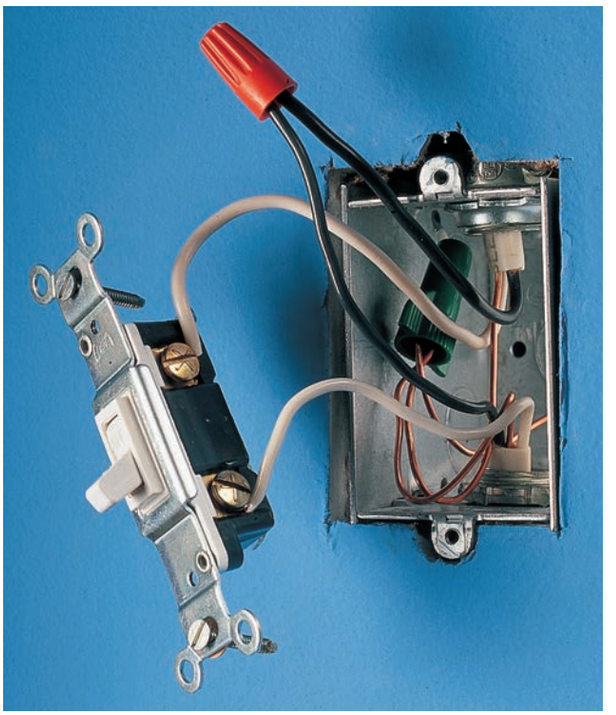
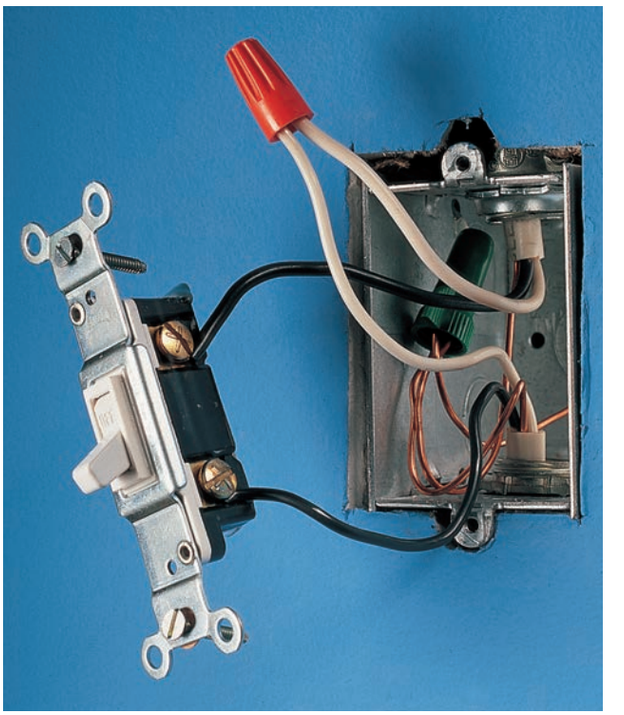
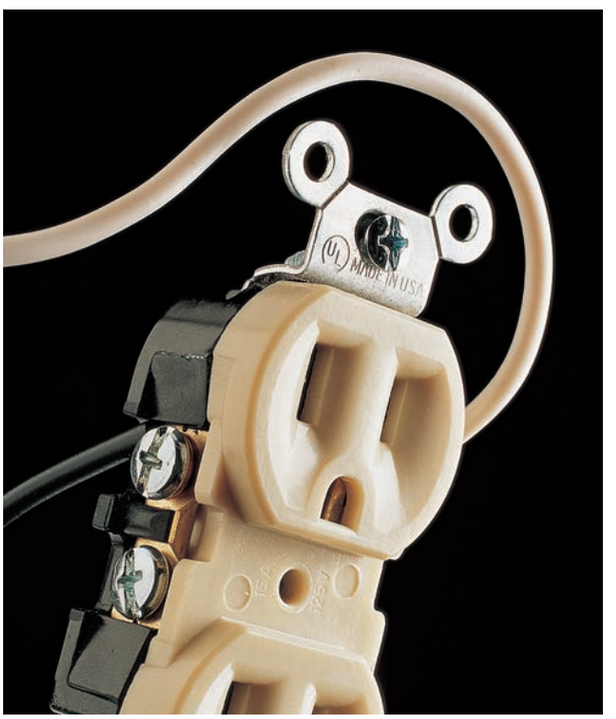
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:232



Problem: White neutral wires are connected to a switch. Although the switch appears to work correctly in this installation, it is dangerous because the light fixture carries voltage when the switch is off.



Solution: Connect the black hot wires to the switch, and join the grounded white wires together with a wire connector.



Problem: White neutral wires are connected to the brass screw terminals on the receptacle, and black hot wires are attached to silver screw terminals. This installation is hazardous because live voltage flows into the long neutral slot on the receptacle.

Solution: Reverse the wire connections so that the black hot wires are attached to brass screw terminals and white neutral wires are attached to silver screw terminals. Live voltage now flows into the short slot on the receptacle.

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 233 1/10/18 11:58 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 233 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:233

Measurement Conversions

ENGLISH TO METRIC

TO CONVERT:	TO:	MULTIPLY BY:
Inches	Millimeters	25.4
Inches	Centimeters	2.54
Feet	Meters	0.305
Yards	Meters	0.914
Square inches	Square centimeters	6.45
Square feet	Square meters	0.093
Square yards	Square meters	0.836
Ounces	Milliliters	30.0
Pints (US)	Liters	0.473 (Imp. 0.568)
Quarts (US)	Liters	0.946 (Imp. 1.136)
Gallons (US)	Liters	3.785 (Imp. 4.546)
Ounces	Grams	28.4
Pounds	Kilograms	0.454

TO CONVERT:	TO:	MULTIPLY BY:
Millimeters	Inches	0.039
Centimeters	Inches	0.394
Meters	Feet	3.28
Meters	Yards	1.09
Square centimeters	Square inches	0.155
Square meters	Square feet	10.8
Square meters	Square yards	1.2
Milliliters	Ounces	.033
Liters	Pints (US)	2.114 (Imp. 1.76)
Liters	Quarts (US)	1.057 (Imp. 0.88)
Liters	Gallons (US)	0.264 (Imp. 0.22)
Grams	Ounces	0.035
Kilograms	Pounds	2.2

Resources

Air Diffusion Council (ADC)
Flexible air ducts
847-706-6750
www.flexibleduct.org

American Concrete Institute
Document ACI 332
248-848-3800
www.concrete.org

American Society of Home Inspectors (ASHI)
Information and references
847-759-2820
www.ashi.org

American Wood Council
"Prescriptive Residential Deck Construction Guide"
202-463-2766
www.awc.org

Black & Decker Corporation
Power tools & accessories
800-544-6986
www.blackanddecker.com

International Association of Plumbing and Mechanical Officials (IAPMO)
Publishes *Uniform Plumbing Code®* and *Uniform Mechanical Code®*
909-472-4100
www.iapmo.org

International Code Council (ICC)
Develops residential and commercial building codes
Publishes *International Residential Code®*
888-422-7233
www.iccsafe.org

National Fire Protection Association (NFPA)
Publishes *National Electrical Code®* (NEC)
800-344-3555
www.nfpa.org

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305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 234 1/10/18 11:58 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 234 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:234

Index

aboveground exhaust duct construction, 38
aboveground service, 180, 182–183
ABS plastic pipe joints, 144
accessible (readily), 170
accessible (wires), 170
air, prohibited sources for return and outdoor, 117
air admittance valve, 126, 155
air conditioners. *See also* heating and air conditioning
  condensate disposal for, 114–115
  parts for central, 110
  room units, 190
air gaps, 166
air intake vents, 111
air movement requirements, 37
airtight construction, 119
aluminum wire, recognizing, 224
American Concrete Institute, 49
anchor bolts, 51
anchor straps, 51
antennas, 218–219
appliances
  chimney as vent for, 105
  circuits for, 190
  fuel-burning, 118–123
  HVAC, 110–115
  not requiring a vent, 123
  prohibited locations for, 111
arc-fault (AFCI) protection, 203
area requirements, 20
area wells, 31
armored cable, 217
attics
  access to, 95
  lights required in, 214
  storage in, 91
  wiring protection in, 197
Authority Having Jurisdiction (AHJ), 11
band board, 65
bars, 30
baseboard heating systems, 112
basements
  ceiling height for, 20
  concrete for, 50
  escape openings in, 30
  lights required in, 214
  receptacles in, 201, 203
bathrooms
  ceiling fans and lights near, 215
  circuits for, 190
  design standards for, 21
  receptacles in, 201, 202
  windows in, 35
bedroom floor joist spans, 62–63
bend (elbow), 140
bonding, 170, 184–188
bonding jumper wire, 225
bottom plate construction, 75
braced wall, 78
branch circuit
  definition of, 170
  load limits for, 189–191
  quantity of receptacles on, 191
  requirements for, 189–197
branch drain, 126
branch vent, 126
braze (brazing), 126
brick veneer, 103
bridging, 66
broadband cable wiring, 220–221
building departments, 11
building design and safety
  about, 19
  door and window hazards, 34–35
  egress doors, 32
  emergency escape openings, 30–31
  exterior doors, 33
  fire separations, 22–23
  habitable rooms, 20–21
  smoke and carbon monoxide alarms, 42–43
  stairways, 24–29
  ventilation and exhaust, 36–41
building drain, 126
building sewer, 126

cable
  common problems with, 225–227
  definition of, 170
  secured to cabinet, 207
carbon monoxide alarms, 42–43
ceiling fans, 215
ceiling height, minimum, 20–21
ceiling joist
  bearing on support, 88
  bridging and lateral support for, 88
  deflection for, 92
  nailing to rafter, 89–90
  notches and holes in, 88
  span definitions for, 91, 92
ceilings, fire separation and, 23
central air conditioner parts, 110
certificates of occupancy, 15
chimney crickets, 102
chimneys, 104–107
circuit breaker panels, 210–211
clay soil, 48
cleanout openings, 146–147
closed-cut valley flashing, 101
closet bend, 140
closet flange, 139, 140, 161
closet lights, 216
clothes dryer exhaust requirements, 40–41
clothes washing machines, 163
code compliance, 11
codes & permits, basics of, 8–17

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 235 1/10/18 11:58 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 235 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:235

cold water supply system, 131
collar ties, 88
combustion air
for fireplaces, 105
for fuel-burning appliances, 118–120
concrete, foundation, 50–51
concrete encased electrodes, 187
condensate disposal, 114–115
conduit and tubing installation, 196
connections and joints, drain and sewer pipe, 142–145
continuity, 29
corrugated stainless steel gas tubing, bonding, 188
coupling, 140
crawlspaces, 52–53, 203, 214
cripple wall framing, 77
cutoff valves, 136

damp locations, 206, 215
dead load, 46, 91
decks, 54–61
beams, 58
bracing, 61
flashing, 59
flooring, 60
footings, 56
guards and handrails, 60–61
joists, 56–58
posts, 58–59
stairs, 60
decorative chimney covers, 107
deflection of structural components, 46–47
device boxes, 204–211
discharge tubes, 114–115
dishwashing machines, 162
door hazards, 34–35
doors
exterior, 33, 214
how to flash, 85
lights required at, 214
downdraft ventilation, 39
draftstopping, 68
drainpipe, 126, 137
drip edge, 99
drip pans, 159
drop wire clearances, 182–183
ducts
combustion air, 119–120
construction of, 40
installation of HVAC, 116–117
length of, 40–41
sizing of HVAC, 114

edge spacing, 70
egress doors, 32
egress requirements, 30
egress wells, 31
egress windows, 30
elastomeric gaskets, 127, 138, 144, 145
electric equipment grounding, 217
electric radiant (baseboard) heating systems, 112
electrical boxes
inspection of, 229–231
length of wires extending from, 177
non-metallic, 204
specifications for, 209
supports for, 206–207
types of, 208
unclamped cable entering, 227
electrical branch circuit requirements, 189–197
electrical currents, understanding, 173–183
electrical panels
identification of circuits in, 174
inspecting for proper grounding, 185
prohibited locations for, 174
working clearances around, 175
electrical receptacle installation, 198–201
electrical rough-in inspection, 17
electrical service
disconnecting, 179
identifying, 180–181
electrical system
about, 169–172
broadband cable wiring, 220–221
electrical branch circuit requirements, 189–197
electrical grounding and bonding, 184–188
electrical receptacle installation, 198–201
ground-fault (GFCI) and arc-fault (AFCI) protection, 202–203
junction boxes, device boxes and enclosures, 204–211
light fixture installation, 214–217
satellite dishes, television and radio antennas, 218–219
switch installation, 212–213
understanding electrical circuits, 173–183
electrodes, grounding, 186–188
emergency escape openings, 30–31
enclosures, 204–211
endnailing, 70
environmental load, 46
exhaust, 36–41
exhaust fan labels, 37
exhaust hoods, 38
exterior components
about, 97
fireplaces and chimneys, 104–107
shingle roof-covering installation, 98–103
exterior doors, 33, 214
exterior receptacles, 201, 202–203
exterior stairways, 24, 25

facenailing, 70
factory-built fireplaces, 106–107
fall hazard rules, 34, 35
fasteners, roofing, 103
final inspections, 15
fire separation, 22–23
fireblocking, 82–83
fireplaces, 104–107
fire-rated doors, 22
fittings
definition of, 126
DMV, 140–142
for water supply lines, 133–134
fixture drain, 126–127
fixtures
definition of, 126
flow rate at, 132
flashing
roof, 101–103
for skylights, 102

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 236 1/10/18 11:58 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 236 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:236

vent, 150
wall penetration, 84–85
flexible cords, 197
flexible HVAC duct installation, 116–117
flexible water connectors, 134
floor joist openings, 66
floor joist span tables, 62–63
floor sheathing, 67
floor systems, 62–69
floor trusses, 68
food disposers, 163
footings
inspection of, 16
width and depth for, 49
forced air heating system, 111
foundation anchors, 51
foundation walls inspection, 16
foundations, 48–51
four-way switches, 212
FOUR-wire feeder, 186
framing inspection, 17
framing materials, wood nailing to, 71
freeze proof yard hydrant, 129
furnaces, 110
fuses, common problems with, 223

garage
appliances installed in, 113
concrete for, 50
definition of, 22
fire separation and, 22–23
receptacle circuits for, 190
receptacles in, 201, 202
gas fireplaces, 106
gas furnace parts, 110
gas pipe bonding, 188
girders, on supports, 64
grade plane, 10
grandfathering existing work, 13
gravel soil, 48
ground fault, 170, 184
grounded (definition), 170
grounded wire, 170
ground-fault (GFCI), 202–203
grounding, 184–188, 220–221
grounding electrode, 170
grounding electrode wire, 170, 186–188, 219
grounding wire, 170
grounding wire continuity, 178
guards, 28–29, 60–61
gypsum drywall, 23

habitable rooms, 20–21, 214. *See also individual rooms*
handrails, 28–29, 60–61
hardware
for decks, 54, 55
for joists, 65
headers, on supports, 64
headwalls, 103
hearth extension, 104
heat alarms, 42
heat producing devices, insulation clearance to, 95
heating and air conditioning
about, 109
combustion air for fuel-burning appliances, 118–120
in garage, 23
HVAC appliances, 110–115
HVAC duct installation, 116–117
inspection of, 17
vents for fuel-burning appliances, 121–123
high wind, 46
hip rafter framing, 86–87
home wiring system, 172
hose bibs, 136
hot water supply system, 131
house numbers, 33
hub, 127
hurricane ties/clips, 46, 57, 90

ice dams, 100
I-joists, 68
indirect waste receptor, 127
inlet, 140
inspections
of electrical boxes, 229–231
of electrical panels, 185
of electrical rough-in, 17
final, 15
of footings, 16
of foundation walls, 16
framing, 17
of heating and air conditioning, 17
overview of, 14–17
of plumbing rough-in, 17
of receptacles, 232–233
required, 15
of service panel, 223–224
of switches, 232–233
inspectors, working with, 11–12
installation instructions, 13
insulation clearance to heat producing devices, 95
intake openings, 37, 117
interior stairways, 24–29
intermediate spacing, 70
International Building Code (IBC), 9, 10
International Code Council (ICC), 8
International Energy Conservation Code (IECC), 9
International Fuel Gas Code (IFG), 9
International Mechanical Code (IMC), 9
International Plumbing Code (IPC), 9
International Residential Code (IRC), 7, 8, 9, 10
ionizing alarms, 42
irrigation systems, 167
island fixture vent, 154–155

jumper wire, 225
junction boxes, 204–211

kick-out flashing, 84, 103
kitchens. *See also individual appliances*
exhaust fan rates, 39
exhaust requirements, 38
receptacle installation, 200–202
kneewall areas, 20

laminated beam, 68
laminated glass, 34
landing, 24, 27–28, 32, 33
lateral load connector hardware, 55
laundry receptacle, 201

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 237 1/10/18 11:58 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 237 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:237

laundry receptacle circuits, 190
laundry tray, 127
ledger attachment, 55–56
light fixtures
  boxes for, 204
  common problems with, 231
  installation of, 214–215
lighting, for stairways, 24, 25
live loads, 29, 46–47, 91, 93
living area floor joist spans, 63
load-bearing walls
  floor joists under, 64
  stud size and spacing for, 73
loads, 46–47
local building codes, 8
local code amendments, 9
location (damp), 170
location (wet), 170–171
locks, 30, 32
lumber
  for decks, 54, 60
  nailing structural, 72

manufacturer's instructions, 13
masonry fireplace clearance, 104–105
measurement conversions, 234
microwave ovens, 39
mildew, 36
mistakes, common, 222–233
moisture, 36
mold, 36
multiwire branch circuit, 171, 191

nail guards, 226
nailing definitions, 70
National Electric Code (NEC), 9, 222
National Fire Protection Agency, 222
NM cable, 193–195, 217
non-grounding type receptacles, 199
nonload-bearing walls, stud size and spacing for, 74
nosing, 24, 27
notches and holes
  in ceiling joist, 88
  in joists and rafters, 68–69
  in joists and studs, 193
  in rafters, 69, 88
  in top plate, 75
  in wall studs, 76

O.C. (on center), 70
offset, 127
offset joints, 75
on-center spacking, 58
open risers, 26
OSB panel labels, 67
outdoor air, prohibited sources for, 117
outlet, 171
overcurrent protection device, 171

permit expiration, 15
permits, 14–15
pet doors, 22
photoelectric alarms, 42
pipe support, 135
pipes
  connections and joints between, 142–145
  drain and sewer, 138
  joints between different types, 145
  protecting, 136
  size reduction, 145
  slope of, 145
plate constructions, 75
plumbing rough-in inspection, 17
plumbing systems
  about, 125–129
  drain, waste and vent piping (DWV), 137–147
  home plumbing system, 130
  plumbing appliances and fixtures, 157–167
  plumbing traps, 156
  plumbing vents, 148–155
  water supply piping, 131–136
plywood labels, 67
point load, 46, 47
polarized receptacles, 217
post cap hardware, 59
pressure-reducing valve, 132
private inspectors, 12
pull-down stairs, 23
purlins, 87
PVC plastic pipe joints, 144–145

raceways, box support by, 206
radio antennas, 218–219
rafters
  bearing on support, 88
  bridging and lateral support for, 88
  ceiling joist nailed to, 89–90
  deflection for, 92
  notches and holes in, 69, 88
  span definitions for, 91, 93
  truss connection to walls and, 90
rain cap, 105
range hoods, 38, 39
receptacles
  definition of, 171
  inspecting, 232–233
  installation of, 198–201
  types of, 217
receptor (indirect waste), 127
recessed lights, 214
relief valves, 158
required inspections, 15
resources, 234
return air, prohibited sources for, 117
ridge framing, 86–87
ridgeboards, 86–87
rim joist connections, 57
riser, 24
riser height, 26
rod and pipe electrodes, 187
roof, vent height above, 123
roof deck type restriction, 98
roof flashing, 101–103
roof slope
  restrictions for, 98
  underlayment application for, 99–100
roof systems, 86–95
roof truss installation, 94
roofing fasteners, 103
rust stains, 223

saddle fitting, 128
safety, wiring, 173, 189, 211
safety glazing, 34–35
sandy gravel soil, 48
sandy soil, 48
sanitary tee, 141
satellite dishes, 218–219

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 238 1/10/18 11:58 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 238 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:238

seismic risk areas, 46
service clearance, 182
service current capacity requirements, minimum, 174
service drop, 171
service entrance wires, 171
service panel, 179
service panel inspection, 223–224
sewer pipe, 138
shield plate, 75
shingle roof-covering installation, 98–103
showers, 21, 165
silt soil, 48
sinks, 20, 21
site address, 33
skylights, 102
slip joint, 128, 139
smoke alarms, 42–43
snow loads, 91, 93
soil (plumbing term), 128
soil load-bearing capacities, 48
soil types, common, 48
solder (soldering), 128
solvent cement, 144
sone ratings, 37
spark arrestor, 105
splices, 176, 227
spread footing, 50
stack, 128
stack vent, 128
stairways, 24–29
  on decks, 60
  dimensions for, 25–26
  exterior, 24, 25
  guards for, 28–29
  headroom height for, 27
  landings for, 27–28
  lighting and switching for, 24–25
  terms for, 24
  width for, 25
  windows in, 35
standpipe, 129
staples as shingle fasteners, 103
state building codes, 8
steel pipe joints, 144
step flashing, 102
step footing, 50
stop-and-waste valve, 129
street fitting, 141
structural components
  about, 45–470
  crawlspaces, 52–53
  decks, 54–61
  floor systems, 62–69
  foundations, 48–51
  roof systems, 86–95
  wall penetration flashing, 84–85
  wall systems, 70–83
structural panel wall bracing, 78, 80, 82
subfloor, nailing one-piece, 72
support posts, 58
supports, for flooring system, 64–65
sweep, 141
switches
  inspecting, 232–233
  installation of, 212–213
  load limits for, 212
  for stairways, 24, 25

tailpiece, 129, 139
tamper-resistant receptacles, 198–199
tee, 141
television antennas, 218–219
tempered glass, 34–35
three-slot receptacles, 217
three-way switches, 212
timer switches, 213
toenailing, 70
toilets, 20, 21, 160–161
top plate construction, 75
transition cement, 144
transition duct, 41
traps, 129, 137, 148, 156
tread, 24
tread depth, 26
tread nosing, 27
tread slope, 27
trusses
  alteration and repair of, 94
  connection to walls, 90
  design and bracing requirements for, 94
  floor, 68
  installation tolerances for, 94
  roof, 94
tubs, 21
Type X drywall, 23

UF cable, 193–195
underground service lateral, 181
underground water pipe electrodes, 187
underlayment
  application of, 99–100
  specifications for, 99
ungrounded conductor, 171
Uniform Plumbing Code (UPC), 9
unused openings, closure of, 174

valley framing, 86–87
vent (plumbing term), 129
vent pipes, 137, 148–155
vent stack, 129
vent termination, 150–155
vents and ventilation, 36–41
  chimney as appliance vent, 105
  clearance for, 122
  connectors and fittings for, 121
  for crawlspaces, 52–53
  for fireplaces, 104
  for fuel-burning appliances, 121–123
  joints between, 123
  plumbing, 148–155
  slope of, 123
volume units, 205

wall bracing, 78–82
wall footing, 50
wall penetration flashing, 84–85
wall studs
  notches and holes in, 76
  size and spacing for, 73–75
wall systems, 70–83
walls, fire separation and, 23
waste, 129
waste tee, 163
water distribution pipes, 133–134
water flow, 132
water heaters, 157–159
water pipe bonding, 188
water pressure, 132
water supply backflow protection, 166
water supply riser, 165

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 239 1/10/18 11:58 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 239 1/10/18 11:47 AM
C M Y K Text
Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:239

water-hammer arrestors, 163
web-type trusses, 68
wet locations, 206, 213, 215
wet surfaces, safety glazing near, 35
wet vents, 153–154
whirlpool bathtubs (jetted baths), 164, 203
wind, high, 46
winder stair tread, 27
winder tread, 24
window hazards, 34–35
window wells, 31
windows
  above bathtubs and showers, 35
  fall hazard rules for, 35
  how to flash, 85
wire, recognizing aluminum, 224
wire connections, checking, 228
wire volume unit, 205
wires
  color codes for, 178
  connecting to terminals, 177
  size chart for, 178
  splicing, 176
wiring methods, 192–197
wiring safety, 173, 189, 211
wiring support requirements, 196
wood grades, in wall construction, 73
wood nailing
  definitions for, 70
  requirements for, 71–72
wood structural panel wall bracing, 82
wood-burning fireplace energy efficiency
  requirements, 105
woven valleys, 101
wye, 141

yard hydrant (freeze proof), 129

zoning ordinances, 10

305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 240 1/10/18 11:58 AM
305471 - B&D Codes for Homeowners 4th Edition Edition_168-240.indd 240 1/10/18 11:47 AM
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Title:305471 - B&D Codes for Homeowners 4th Edition Edition
Page:240

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4th Edition

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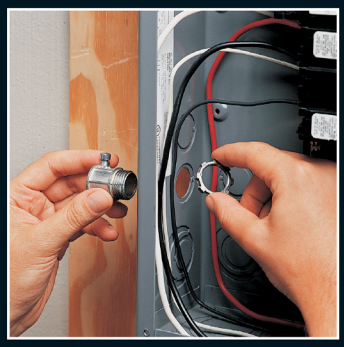
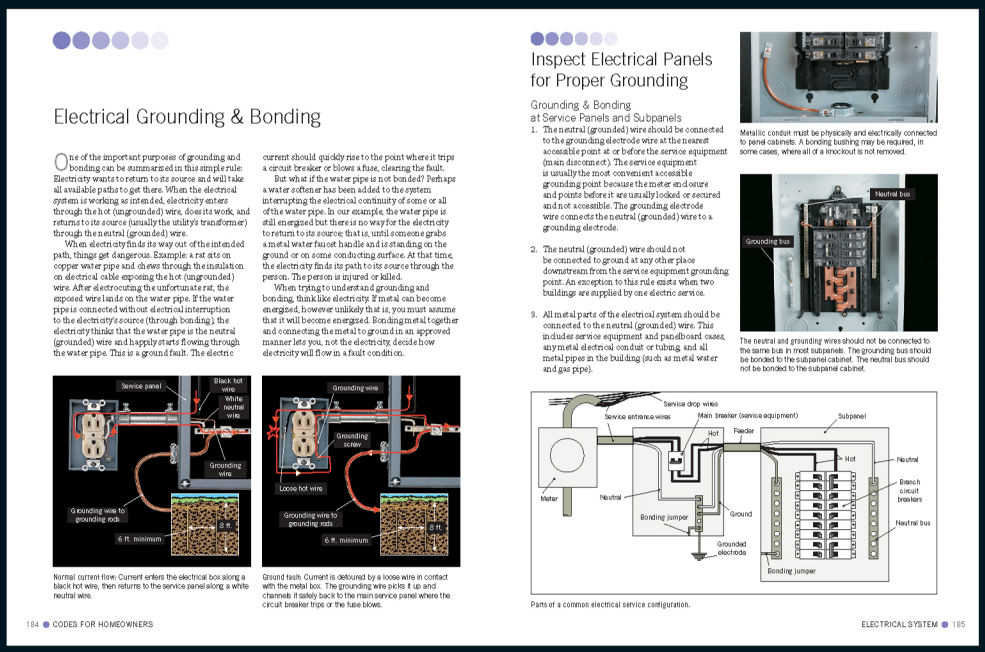
This DIY-friendly guidebook to residential codes gives you the information you need to understand and apply the electrical, plumbing, mechanical, and building codes that actually impact today's homeowners. Beyond simply reporting the codes, *BLACK+DECKER™ Codes for Homeowners* interprets them for you and presents them clearly, with helpful color photos and simple graphics. This edition is current with the 2017 National Electrical Codes, 2018 Uniform Plumbing Codes, and 2018 International Residential Codes. Written by national codes expert Bruce Barker and created under the supervision of BLACK+DECKER, *Codes for Homeowners* does what no other code book accomplishes: it makes codes and building standards simple to understand and visualize, so you will know your DIY projects are safe and will pass inspections.





Electrical Grounding & Bonding

One of the important purposes of grounding and bonding can be summarized in this simple rule: Electricity wants to return to its source and will take all available paths to get there. When the electrical system is working as intended, electricity enters through the hot (ungrounded) wire, does its work, and returns to its source (usually the utility's transformer) through the neutral (grounded) wire.

When electricity finds its way out of the intended path, things get dangerous. Example: a rat sits on copper water pipe and chews through the insulation on electrical cable exposing the hot (ungrounded) wire. After electrocuting the unfortunate rat, the exposed wire lands on the water pipe. If the water pipe is connected without electrical interruption to the electricity's source (through bonding), the electricity thinks that the water pipe is the neutral (grounded) wire and happily starts flowing through the water pipe. This is a ground fault. The electric current should quickly rise to the point where it trips a circuit breaker or blows a fuse, clearing the fault.

But what if the water pipe is not bonded? Perhaps a water softener has been added to the system interrupting the electrical continuity of some or all of the water pipe. In our example, the water pipe is still energized but there is no way for the electricity to return to its source; that is, until someone grabs a metal water faucet handle and is standing on the ground or on some conducting surface. At that time, the electricity finds its path to its source through the person. The person is injured or killed.

When trying to understand grounding and bonding, think like electricity. If metal can become energized, however unlikely that is, you must assume that it will become energized. Bonding metal together and connecting the metal to ground in an approved manner lets you, not the electricity, decide how electricity will flow in a fault condition.

Normal current flow. Current enters the electrical box along a black hot wire, then returns to the service panel along a white neutral wire.

Ground fault. Current is detoured by a loose wire in contact with the metal box. The grounding wire picks it up and channels it safely back to the main service panel where the circuit breaker trips or the fuse blows.

184 ● CODES FOR HOMEOWNERS

Inspect Electrical Panels for Proper Grounding

Grounding & Bonding at Service Panels and Subpanels

1. The neutral (grounded) wire should be connected to the grounding electrode wire at the nearest accessible point at or before the service equipment (main disconnect). The service equipment is usually the most convenient accessible grounding point because the meter enclosure and points before it are usually locked or secured and not accessible. The grounding electrode wire connects the neutral (grounded) wire to a grounding electrode.
2. The neutral (grounded) wire should not be connected to ground at any other place downstream from the service equipment grounding point. An exception to this rule exists when two buildings are supplied by one electric service.
3. All metal parts of the electrical system should be connected to the neutral (grounded) wire. This includes service equipment and panelboard cases, any metal electrical conduit or tubing, and all metal pipes in the building (such as metal water and gas pipe).

Metallic conduit must be physically and electrically connected to panel cabinets. A bonding bushing may be required, in some cases, where all of a knockout is not removed.

The neutral and grounding wires should not be connected to the same bus in most subpanels. The grounding bus should be bonded to the subpanel cabinet. The neutral bus should not be bonded to the subpanel cabinet.

Parts of a common electrical service configuration.

ELECTRICAL SYSTEM ● 185

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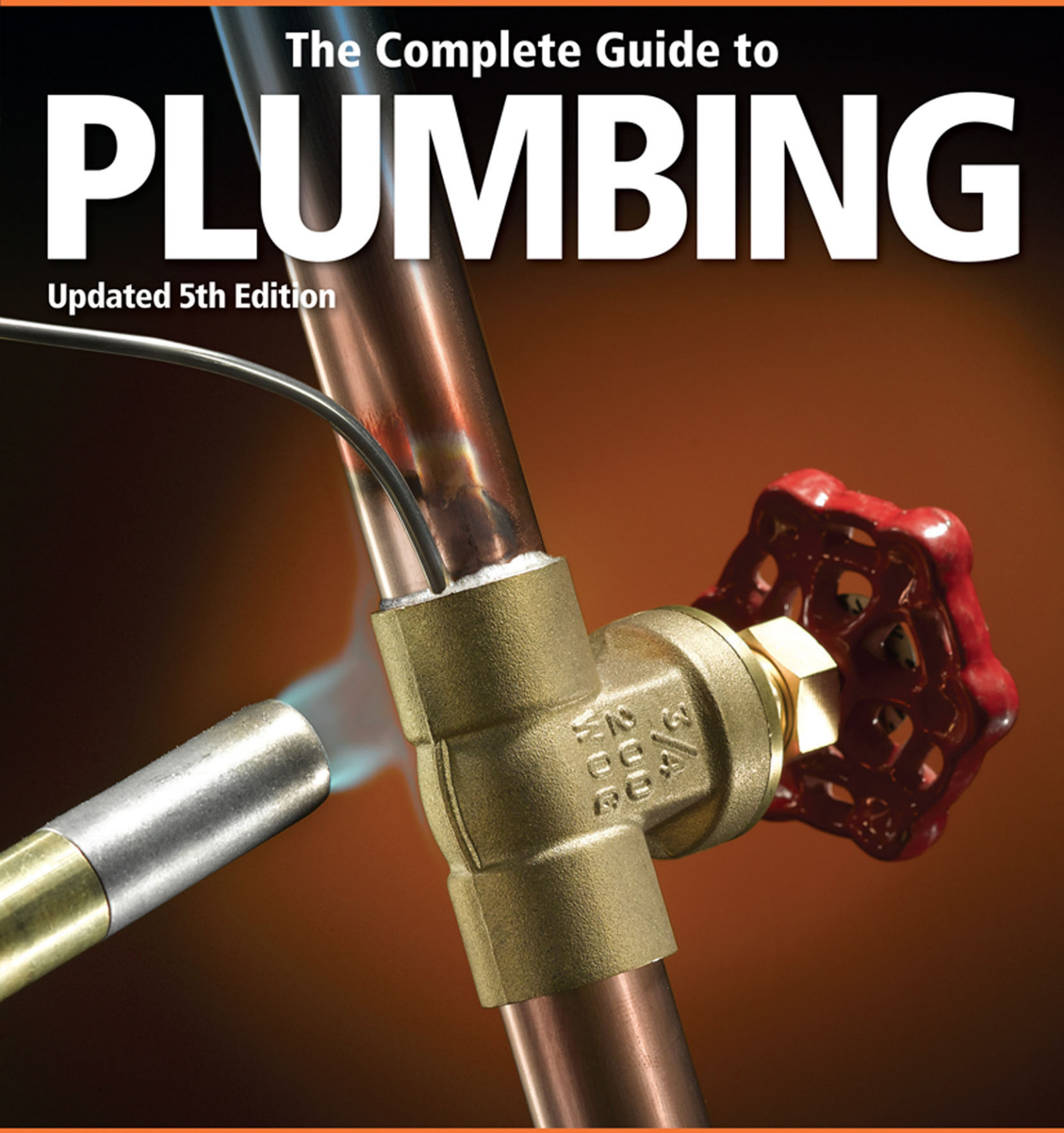

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#175 Dtp:225 Page:1

Contents

The Complete Guide to Plumbing

Introduction 7

The Home Plumbing System 8

Shutting Off the Water 12

Plumbing Fixtures 15

Toilets 16

Kitchen Faucets 22

Kitchen Drains & Traps 28

Dishwashers 32

Food Disposers 36

Water Heaters 42

Bathroom Faucets 54

Shower Kits 62

Custom Shower Bases 70

Alcove Bathtubs 78

3-Piece Tub Surrounds 86

Sliding Tub Doors 90

Jetted Tub 94

Bidets 102

Water Softeners 106

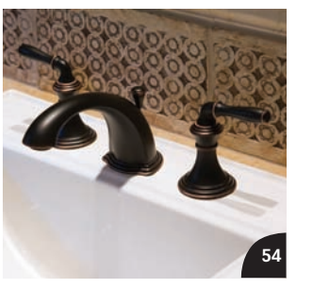
Hot Water Dispenser 110

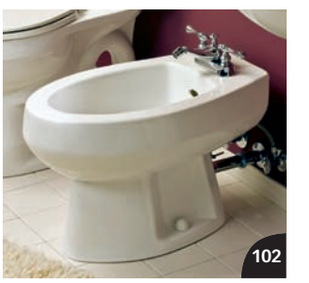
Icemaker 114

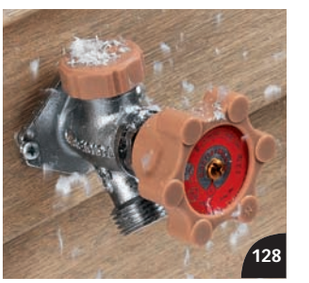
Pot Filler 120

Reverse-Osmosis Water Filters 122

Freezeproof Sillcocks 128







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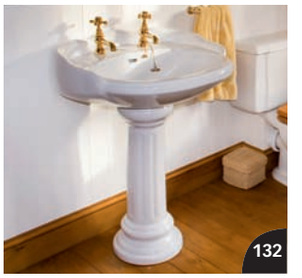
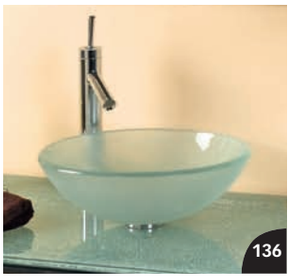
Contents (Cont.)





Pedestal Sinks 132

Wall-Hung Vanities 134

Vessel Sinks 136

Integral Vanity Tops 140

Kitchen Sinks 142

Standpipe Drains 144

Plumbing Installations 149

Installation Basics 150

Planning Plumbing Routes 154

Master Bath 158

Basement Bath 166

Half Bath 172

Kitchen 174

New Gas Lines 188

Plumbing Repairs 195

Common Toilet Problems 196

Clogged Toilets 210

Toilet Flanges 214

Toilet Drain Lines 216

Sink Faucets 218

Kitchen Sprayers 228

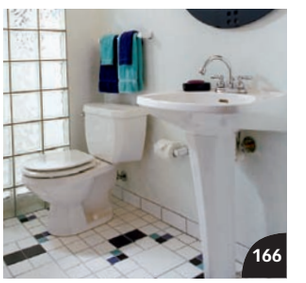
Fixing Leaky Tubs & Shower Faucets 232

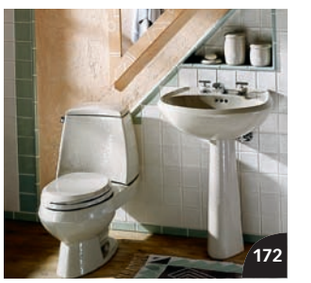
Single-Handle Tub & Shower Faucet with Scald Control 240

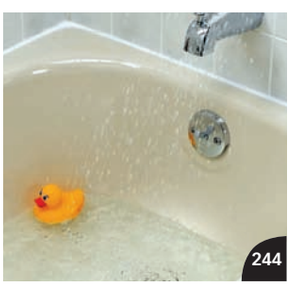
Tubs & Showers 244

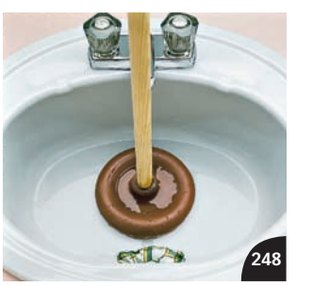
Sink Drains 248

Branch & Main Drains 250









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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
07-C67284 #175 Dtp:225 Page:4

Branch Drains & Vents 254

Main Stacks 258

Supply Pipes 264

Noisy Pipes 266

Plumbing Tools, Materials & Skills 269

Plumbing Tools 270

Plumbing Materials 274

Copper 276

Rigid Plastic Pipe 284

Working with Outdoor Flexible Plastic Pipe 288

Cross-Linked Polyethylene (PEX) 290

Galvanized Steel 298

Cast Iron 302

Pipe Fittings 306

Shutoff Valves 310

Valves & Hose Bibs 312

Compression Fittings 314

Gas Pipe Fittings 316

Appendix: Planning Your Project 318

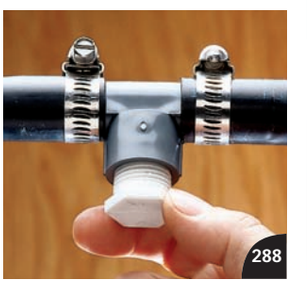
Testing New Plumbing Pipes 326

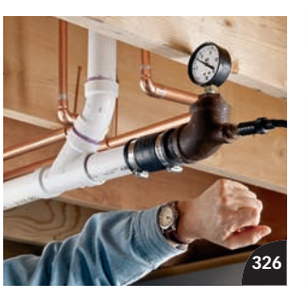
Glossary 328

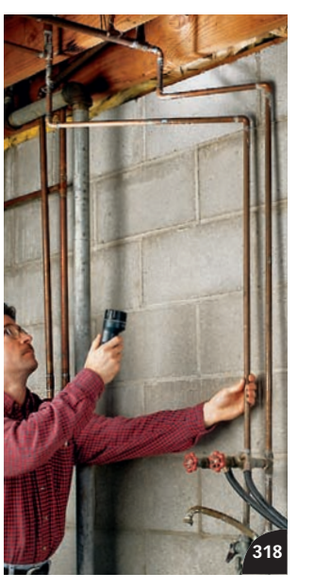
Metric Conversion Chart 329

Resources 330

Index 331







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Introduction

Of all the jobs that need doing around the house, plumbing repairs are the most likely to cause us to complain about the cost of hiring a pro. Not to disparage the good, valuable work of our professional plumbers, but how many times have you heard someone lament that they paid $80 just to have a washer replaced? The fact is, some plumbing repairs are extremely complicated and laborious, but others are really quite simple and entirely manageable. The reason you should own this book is that it will help you determine which projects you can take on yourself, and then it will show you exactly how to get the job done. So instead of lamenting that you paid an exorbitant fee for a simple job, you'll be boasting about how much you saved by doing it yourself.

For more than a decade, *Black & Decker's The Complete Guide to Plumbing* has been the leading plumbing manual for do-it-yourselfers. Now in its updated 5th edition, and nearing the milestone of one million copies sold, it is the clearest and most complete plumbing book you can own. From its easy-to-understand explanations of how modern plumbing works to its clear how-to photos of all of the most common home plumbing projects, this is the only plumbing book you'll need to become master of your home plumbing system.

This edition of *The Complete Guide to Plumbing* has been revised and updated to conform to national plumbing codes in effect from 2012 through 2015. It also includes plenty of all-new information and several projects that are relatively new to the home plumbing scene. For example, you'll find a complete step-by-step photo sequence that shows precisely how to install a tankless water heater. These on-demand plumbing appliances have exploded in popularity in recent years as homeowners have discovered that they no longer need to pay the energy costs required to keep 50 gallons of water hot even when it is not needed. Tankless water heaters are not cheap—the one we install here costs over $1,500—but by doing the installation yourself, you can have one for roughly the same cost as having a professional plumber install a traditional tank-type water heater.

Admittedly, most homeowners are not too likely to take on a plumbing project that is as ambitious as installing a tankless water heater—at least not until he or she has a few simpler projects checked off the bucket list. That's okay. Even if you do hire someone else to do the work, you should read through the project shown here first. There is no substitute for knowledge when you're reviewing a bid or inspecting someone else's work. In the meantime, you can build your skill set and save money and time by accomplishing some easier tasks. For example, it has been estimated that half of the home plumbing service calls involve problems with a toilet. Most of these can be remedied easily by replacing a flush valve or fill valve (pages 202 to 205) or clearing a clog with a closet auger (page 213). You need only to do one minor repair yourself to recover your investment in this book several times over. And you'll become a more self-sufficient homeowner.

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The Home Plumbing System

Because most of a plumbing system is hidden inside walls and floors, it may seem to be a complex maze of pipes and fittings. But spend a few minutes with us and you'll gain a basic understanding of your system. Understanding how home plumbing works is an important first step toward doing routine maintenance and money-saving repairs.

Water meters and main shutoff valves are located where the main water supply pipe enters the house. The water meter is the property of your local municipal water company. If the water meter leaks, or if you suspect it is not functioning properly, call your water company for repairs.

A typical home plumbing system includes three basic parts: a water supply system, a fixture and appliance set, and a drain system. These three parts can be seen clearly in the photograph of the cut-away house on the opposite page.

Fresh water enters a home through a main supply line (1). This fresh water source is provided by either a municipal water company or a private underground well. If the source is a municipal supplier, the water passes through a meter (2) that registers the amount of water used. A family of four uses about 400 gallons of water each day.

Immediately after the main supply enters the house, a branch line splits off (3) and is joined to a water heater (4). From the water heater, a hot water line runs parallel to the cold water line to bring the water supply to fixtures and appliances throughout the house. Fixtures include sinks, bathtubs, showers, and laundry tubs. Appliances include water heaters, dishwashers, clothes washers, and water softeners. Toilets and exterior sillcocks are examples of fixtures that require only a cold water line.

The water supply to fixtures and appliances is controlled with faucets and valves. Faucets and valves have moving parts and seals that eventually may wear out or break, but they are easily repaired or replaced.

Waste water then enters the drain system. It first must flow past a drain trap (5), a U-shaped piece of pipe that holds standing water and prevents sewer gases from entering the home. Every fixture must have a drain trap.

The drain system works entirely by gravity, allowing waste water to flow downhill through a series of large-diameter pipes. These drain pipes are attached to a system of vent pipes. Vent pipes (6) bring fresh air to the drain system, preventing suction that would slow or stop drain water from flowing freely. Vent pipes usually exit the house at a roof vent (7).

All waste water eventually reaches a main waste and vent stack (8). The main stack curves to become a sewer line (9) that exits the house near the foundation. In a municipal system, this sewer line joins a main sewer line located near the street. Where sewer service is not available, waste water empties into a septic system.

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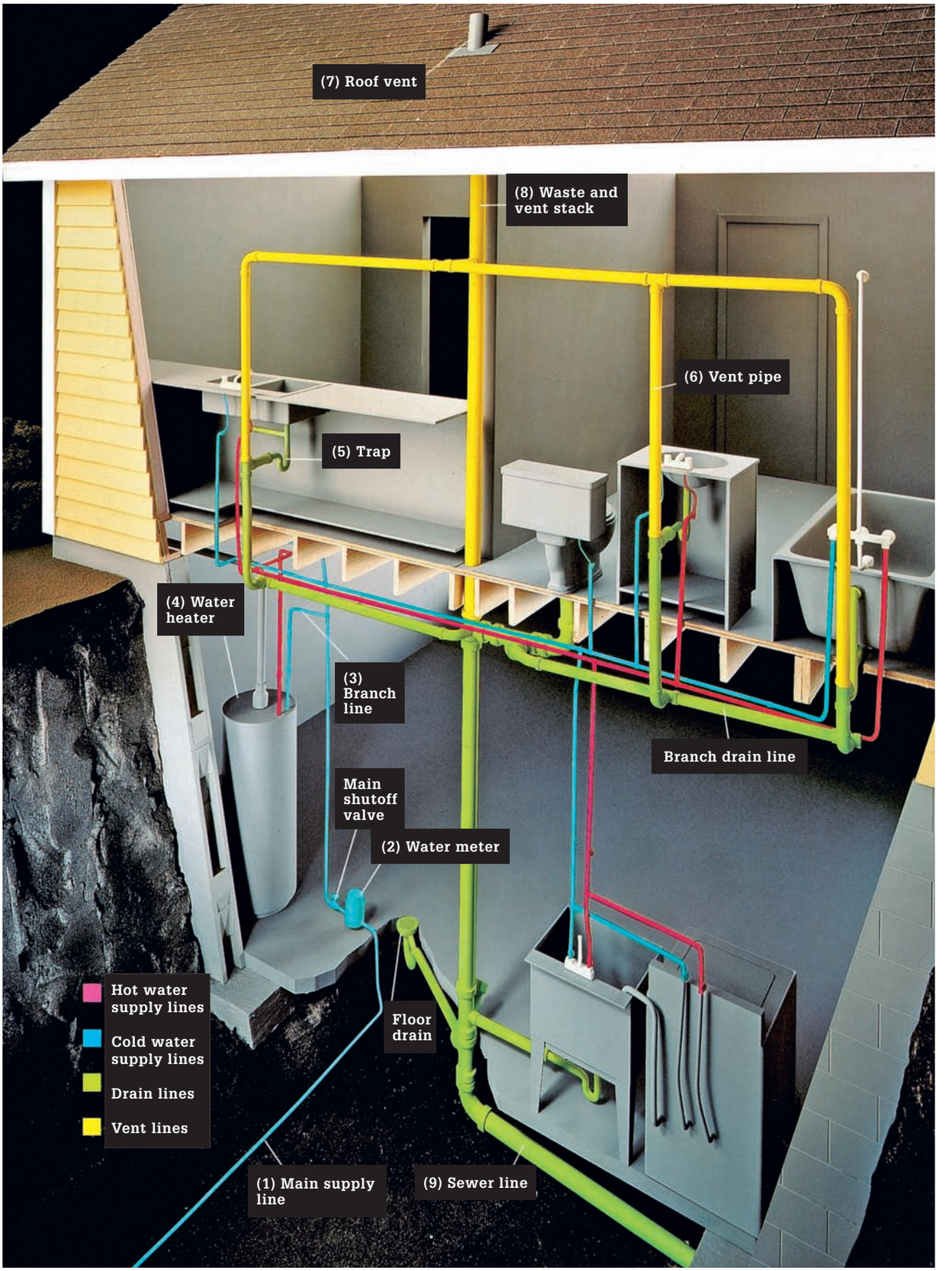

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Water Supply System

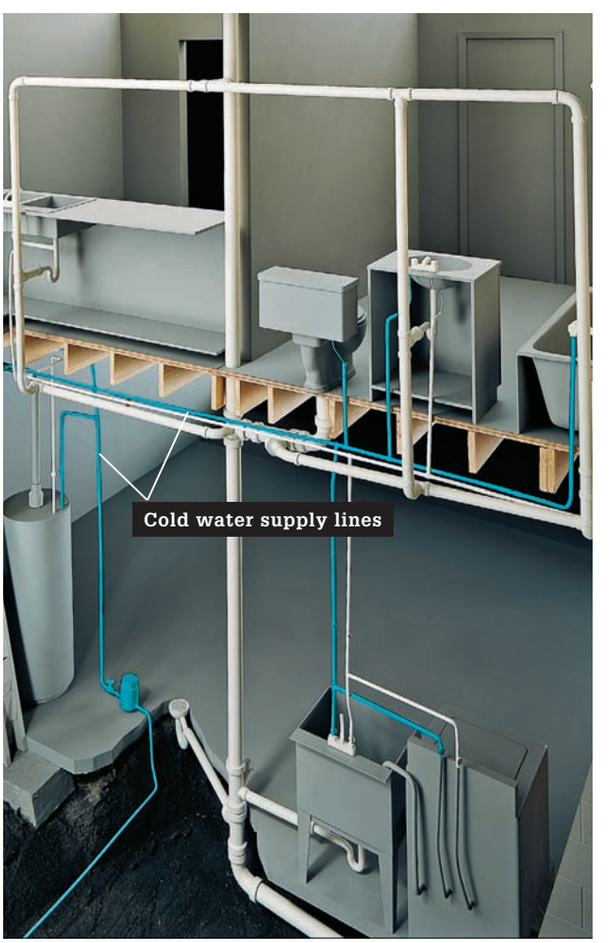
Water supply pipes carry hot and cold water throughout a house. In homes built before 1960, the original supply pipes were usually made of galvanized steel. Newer homes have supply pipes made of copper. Beginning in the 1980s, supply pipes made of rigid plastic (PVC or CPVC) became more commonplace, and the more recent plumbing innovations find PEX pipe widely used and accepted.

Water supply pipes are made to withstand the high pressures of the water supply system. They have small diameters, usually ½" to 1", and are joined with strong, watertight fittings. The hot and cold lines run in tandem to all parts of the house. Usually, the supply pipes run inside wall cavities or are strapped to the undersides of floor joists.

Hot and cold water supply pipes are connected to fixtures or appliances. Fixtures include sinks, tubs, and showers. Some fixtures, such as toilets or hose bibs, are supplied only by cold water. Appliances include dishwashers and clothes washers. A refrigerator icemaker uses only cold water. Tradition says that hot water supply pipes and faucet handles are found on the left-hand side of a fixture, with cold water on the right.

Because it is pressurized, the water supply system is occasionally prone to leaks. This is especially true of galvanized iron pipe, which has limited resistance to corrosion.

For some houses in older neighborhoods, the main supply line running from the street to the house is made of lead; this once posed a health hazard. Today, however, municipalities with lead pipes often add a trace amount of phosphate to the water, which coats the inside of the pipes and virtually eliminates leaching of lead into the water. If you are concerned about lead in your water, check with your local water supplier.



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Drain-Waste-Vent System

Drain pipes use gravity to carry waste water away from fixtures, appliances, and other drain openings. This waste water is carried out of the house to a municipal sewer system or septic tank.

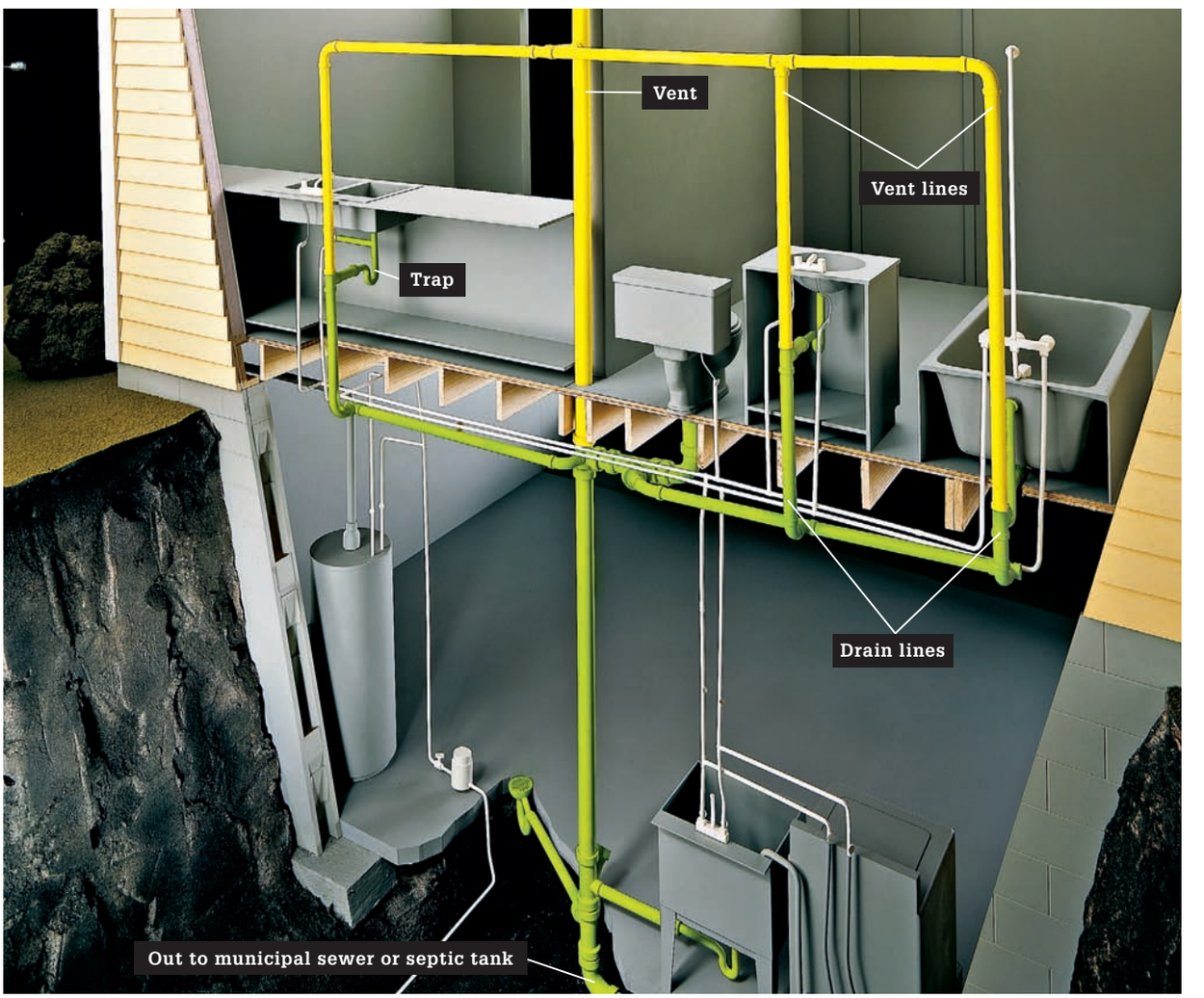
Newer drain pipes are plastic. In an older home, drain pipes may be cast iron, galvanized steel, copper, or lead. Because they are not part of the supply system, lead drain pipes pose no health hazard. However, lead pipes are no longer manufactured for home plumbing systems.

Drain pipes have diameters ranging from 1¼" to 4". These large diameters allow waste to pass through efficiently.

Traps are an important part of the drain system. These curved sections of drain pipe hold standing water, and they are usually found immediately after the drain tailpiece in the drain opening. The standing water of a trap prevents sewer gases from backing up into the home. Each time a drain is used, the standing trap water is flushed away and is replaced by new water.

In order to work properly, the drain system requires air. Air allows waste water to flow freely down drain pipes.

To allow air into the drain system, drain pipes are connected to vent pipes. All drain systems must include vents, and the entire system is called the drain-waste-vent (DWV) system. One or more vent stacks, located on the roof, provide the air needed for the DWV system to work.



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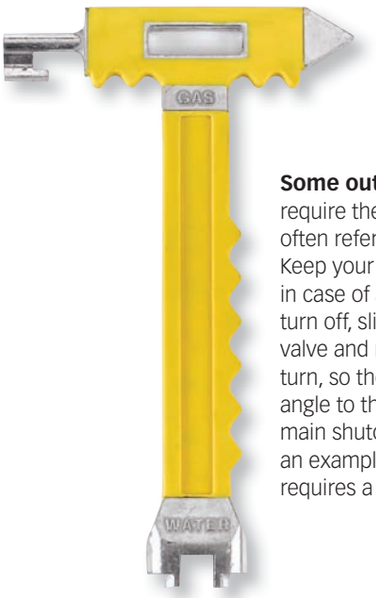
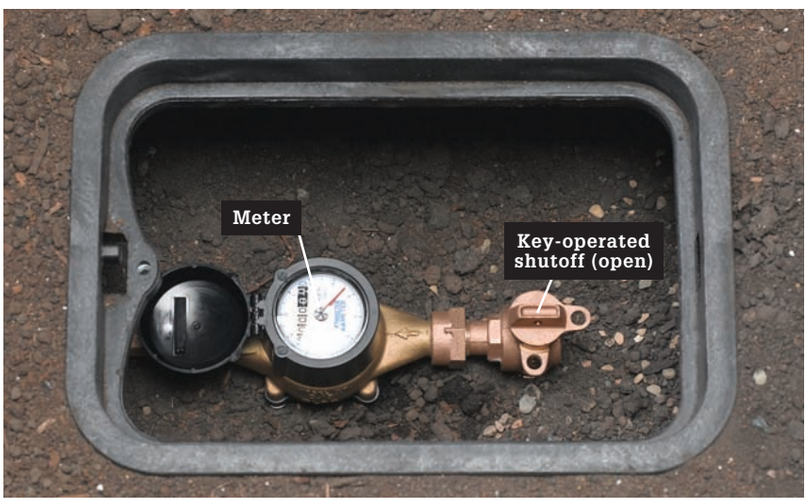
Shutting Off the Water

In case an emergency requires you to replace or repair a faucet, fixture, or appliance, knowing how to shut off the water is imperative. The photos on this page show the most common types of shutoffs. If you don't feel completely confident about finding your home's shutoff points or how to turn them off, contact your local water company for information.

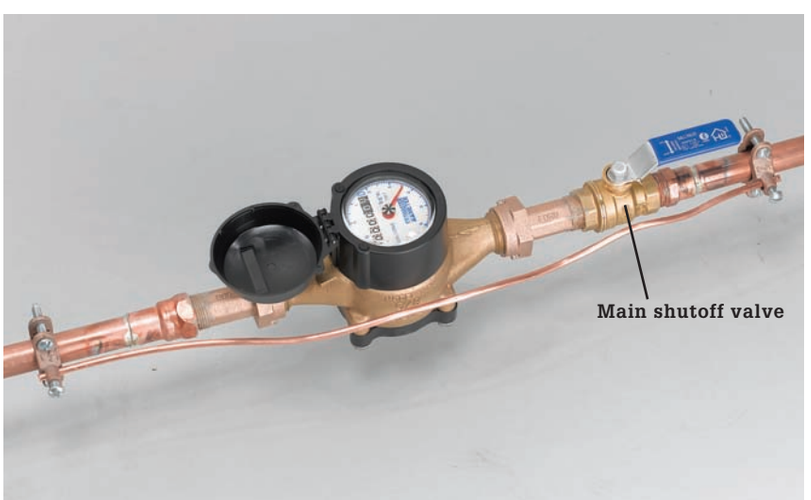
There are two basic types of valves, which shut off in two different ways. To turn off many older valves, rotate the handle clockwise (remember "lefty loosey; righty tighty") until it stops. To turn off many newer valves, rotate the handle one-quarter turn only.



Some outdoor shutoffs require the use of a special tool, often referred to as a "key." Keep your key within easy reach in case of an emergency. To turn off, slip the key over the valve and rotate one quarter turn, so the handle is at a right angle to the pipe. The outdoor main shutoff shown below is an example of a shutoff that requires a key.



An outdoor main shutoff may be as simple as an exposed valve that you turn by hand. Or it may be buried in a housing that is sometimes called a Buffalo box. In this example, both the meter and the main shutoff are housed in the Buffalo box; in other cases, the meter is located inside the house.



You may have an inside main shutoff, usually located near the point where the main supply pipe enters the house near the water meter. Many homes have both a Buffalo box and an indoor main shutoff. There may be a valve on each side of the meter; turn off either one of them to shut off water to the house.

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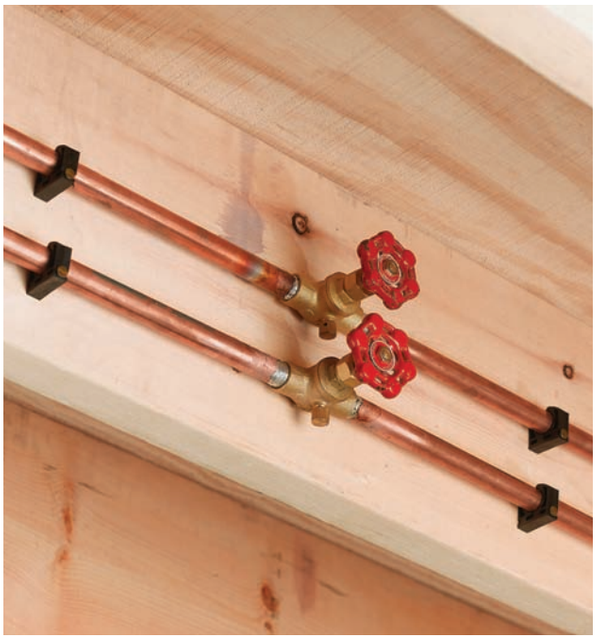
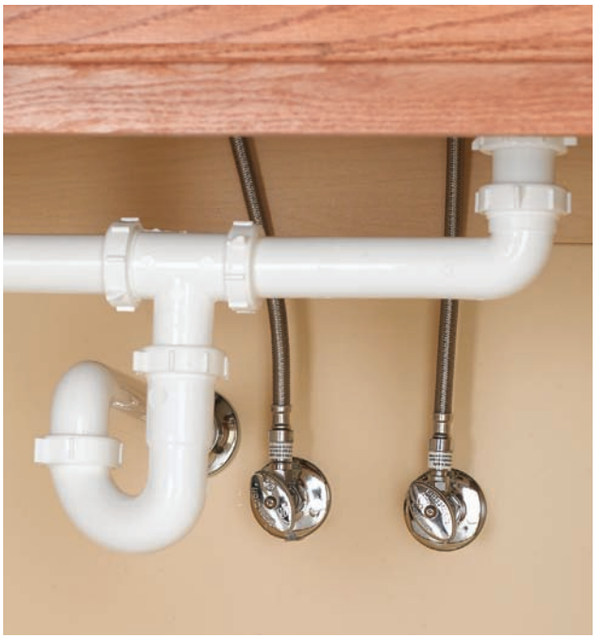


Partial-house shutoffs are often found in medium- to large-size homes. They control water flow to large areas of the house. They are found in pairs, one for hot and one for cold water. Turning off a pair of these may shut off water to a floor, or to an entire bathroom or kitchen.



Fixture shutoff valves, also called stop valves, control water to a specific faucet, toilet, or fixture. They are also usually found in pairs, one for hot and one for cold. However, toilets, icemakers, and other cold-water-only fixtures will have only one stop valve. If you live in an older home that lacks stop valves, it's a good idea to install them.

Although they are outlawed by many codes, your house may have small "saddle Tee" valves connected to tubes that supply water to icemakers, hot-water dispensers, and other fixtures that do not need full water pressure. Do not mistake the handle on a saddle valve for a shutoff.

Integral shutoffs are sometimes found on tub-and-shower faucets and other fixtures. This arrangement allows water to be turned off to the fixture only, so water remains available for the rest of the house.

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Plumbing Fixtures

Although it might be a bit of a stretch to refer to any aspect of plumbing as glamorous or fun, installing fixtures like sinks and showers is the heart of the plumbing pursuit. It is the aspect of plumbing we naturally think of first, and in many cases the payoff is almost instantaneous.

In this section you will find photos and step-by-step instructions for the plumbing fixture installations you, as a do-it-yourselfer, are most likely to attempt. The section with the most common fixture project by far is Toilets. From removal of the old unit to wrangling the new one into place, making all the hookups and even installing the seat, the entire project is laid out for you in full color photos. From there, you'll find a series of projects that move from kitchen to bath to laundry and back again, all shown in full detail.

In this chapter:

- Toilets
- Kitchen Faucets
- Kitchen Drains & Traps
- Dishwashers
- Food Disposers
- Water Heaters
- Bathroom Faucets
- Shower Kits
- Custom Shower Bases
- Alcove Bathtubs
- 3-Piece Tub Surrounds
- Sliding Tub Doors
- Jetted Tub
- Bidets
- Water Softeners
- Hot Water Dispenser
- Icemaker
- Pot Filler
- Water Filters
- Freezeproof Sillcocks
- Pedestal Sinks
- Wall-Hung Vanities
- Vessel Sinks
- Integral Vanity Tops
- Kitchen Sinks
- Standpipe Drain & Utility Sink

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Toilets

You can replace a poorly functioning or inefficient toilet with a high-efficiency, high-quality new toilet in just a single afternoon. All toilets made since 1996 have been required to use 1.6 gallons or less per flush, which has been a huge challenge for the industry. Today, the most evolved water-saving toilets have wide passages behind the bowl and wide (3") flush valve openings—features that facilitate short, powerful flushes. This means fewer second flushes and fewer clogged toilets. These problems were common complaints of the first generation of 1.6-gallon toilets and continue to beleaguer inferior models today. See which toilets are available at your local home center in your price range, then go online and see what other consumers' experiences with those models have been. New toilets often go through a "de-bugging" stage when problems with leaks and malfunctioning parts are more common. Your criteria should include ease of installation, good flush performance, and reliability. With a little research, you should be able to purchase and install a high-functioning, economical toilet that will serve you well for years to come.

Tools & Materials ▸

- Adjustable wrench
- Bucket and sponge
- Channel-type pliers
- Hacksaw
- Penetrating oil
- Pliers
- Putty knife
- Rubber gloves
- Screwdriver
- Supply tube
- Teflon tape
- Toilet seat bolts
- Toilet seat
- Towels
- Utility knife
- Wax ring without flange
- Wax ring with flange

Replacing a toilet is simple, and the newer models of water-saving toilets have overcome the performance problems of earlier models.

Gravity-assisted toilets are now designed with taller tanks and steeper bowl walls to increase the effects of gravity.

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Choosing a New Toilet

Toilets have changed in recent years. There's a toilet to fit every style. You can even buy a square or stainless-steel toilet, among many other new options. The new designs are efficient, durable, and less susceptible to clogs.

A toilet's style is partly affected by the way it's built. You have a number of options from which to choose:

Two-piece toilets have a separate water tank and bowl.

One-piece toilets have a tank and bowl made of one seamless unit.

Elongated bowls are roughly 2" longer than regular bowls.

Elevated toilets have higher seats, generally 18", rather than the standard 15".

You have a choice of two basic types of flush mechanisms: gravity- and pressure-assisted.

Gravity-assisted toilets allow water to rush down from an elevated tank into the toilet bowl. Federal law mandates that new toilets consume no more than 1.6 gallons of water per flush, less than half the volume used by older styles.

Pressure-assisted toilets rely on either compressed air or water pumps to boost flushing power.

Dual-flush systems feature two flush buttons on the top of the tank, allowing you to select either an 8-ounce flush for liquids or a 1.6-gallon flush for solids.

Two-piece toilets with a separate tank and bowl are much more common than one-piece models, and usually a lot less costly. The cheapest models are compact with a seat that is not as high above the floor as a full-size model. This can create access difficulty for some users. Round-bowl models usually cost less than models with a larger, elongated bowl.

Some high-end toilets are designed to get maximum pressure out of a small amount of water. Many employ narrower trapways (the path water travels through the bowl) in conjunction with large-diameter flush valves. Some models use as little as 1.2 gallons of water.

Pressure-assisted toilets are relatively expensive, but they can reduce your water usage significantly by eliminating multiple flushes. The flush mechanism of a pressure-assisted toilet boosts the flushing power by using either compressed air or water pumps.

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How to Remove a Toilet

Remove the old supply tube. First, turn off the water at the stop valve. Flush the toilet, holding the handle down for a long flush, and sponge out the tank. Use a wet/dry vac to clear any remaining water out of the tank and bowl. Unthread the coupling nut for the water supply below the tank using channel-type pliers.

Grip each tank bolt nut with a box wrench or pliers and loosen it as you stabilize each tank bolt from inside the tank with a large slotted screwdriver. If the nuts are stuck, apply penetrating oil to the nut and let it sit before trying to remove them again. You may also cut the tank bolts between the tank and the bowl with an open-ended hacksaw. Remove and discard the tank.

Remove the nuts that hold the bowl to the floor. First, pry off the bolt covers with a screwdriver. Use a socket wrench, locking pliers, or your channel-type pliers to loosen the nuts on the tank bolts. Apply penetrating oil and let it sit if the nuts are stuck, then take them off. As a last resort, cut the bolts off with a hacksaw by first cutting down through one side of the nut. Tilt the toilet bowl over and remove it.

Prying Up Wax Rings ▸

Removing an old wax ring is one of the more disgusting jobs you'll encounter in the plumbing universe (the one you see here is actually in relatively good condition). Work a stiff putty knife underneath the plastic flange of the ring (if you can) and start scraping. In many cases the wax ring will come off in chunks. Discard each chunk right away—they stick to everything. If you're left with a lot of residue, scrub with mineral spirits. Once clean, stuff a rag-in-a-bag in the drain opening to block sewer gas.

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How to Install a Toilet

Clean and inspect the old closet flange. Look for breaks or wear. Also inspect the flooring around the flange. If either the flange or floor is worn or damaged, repair the damage. Use a rag and mineral spirits to completely remove residue from the old wax ring. Place a rag-in-a-bag into the opening to block odors.

Installation Tip

If you will be replacing your toilet flange or if your existing flange can be unscrewed and moved, orient the new flange so the slots are parallel to the wall. This allows you to insert bolts under the slotted areas, which are much stronger than the areas at the ends of the curved grooves.

Insert new tank bolts (don't reuse old ones) into the openings in the closet flange. Make sure the heads of the bolts are oriented to catch the maximum amount of flange material. To firmly hold the bolts upright, slide on the plastic washers and press them down.

Remove the wax ring and apply it to the underside of the bowl, around the horn. Remove the protective covering. Do not touch the wax ring. It is very sticky. Remove the rag-in-a-bag. If you have an older 4-inch flange, place the ring on the flange rather than the toilet to make sure it is centered.

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Lower the bowl onto the flange, taking care not to disturb the wax ring. The holes in the bowl base should align perfectly with the tank bolts. Add a washer and tighten a nut on each bolt. Hand tighten each nut and then use channel-type pliers to further tighten the nuts. Alternate back and forth between nuts until the bowl is secure. Do not overtighten.

Install the flush valve. Some tanks come with a flush valve and a fill valve preinstalled. For models that do not have this, insert the flush valve through the tank opening and tighten a spud nut over the threaded end of the valve. Place a foam spud washer on top of the spud nut.

Adjust the fill valve as directed by the manufacturer to set the correct tank water level height and install the valve inside the tank. Hand tighten the nylon lock nut that secures the valve to the tank (inset photo) and then tighten it further with channel-type pliers.

With the tank lying on its back, thread a rubber washer onto each tank bolt and insert it into the bolt holes from inside the tank. Then, thread a brass washer and hex nut onto the tank bolts from below and tighten them to a quarter turn past hand tight. Do not overtighten.

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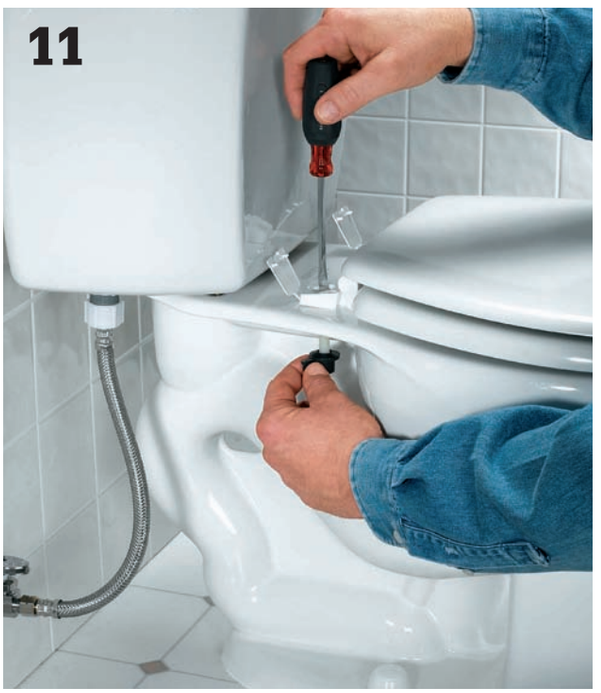
Position the tank on the bowl, spud washer on opening, bolts through bolt holes. Put a rubber washer, followed by a brass washer and a wing nut, on each bolt and tighten these up evenly.

You may stabilize the bolts with a large slotted screwdriver from inside the tank, but tighten the nuts, not the bolts. You may press down a little on a side, the front, or the rear of the tank to level it as you tighten the nuts by hand. Do not overtighten and crack the tank. The tank should be level and stable when you're done. Do not overtighten.

Hook up the water supply by connecting the supply tube to the threaded fill valve with the coupling nut provided. Turn on the water and test for leaks. Do not overtighten.



Attach the toilet seat by threading the plastic or brass bolts provided with the seat through the openings on the back of the rim and attaching nuts.

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Kitchen Faucets

Most new kitchen faucets feature single-handle control levers and washerless designs that rarely require maintenance. Additional features include brushed metallic finishes, detachable spray nozzles, or even push-button controls.

Connect the faucet to hot and cold water lines with easy-to-install flexible supply tubes made from vinyl or braided steel. If your faucet has a separate sprayer, install the sprayer first. Pull the sprayer hose through the sink opening and attach to the faucet body before installing the faucet.

Where local codes allow, use plastic tubes for drain hookups. A wide selection of extensions and angle fittings lets you easily plumb any sink configuration. Manufacturers offer kits that contain all the fittings needed for attaching a food disposer or dishwasher to the sink drain system.

Tools & Materials ▸

Adjustable wrench
Basin wrench or channel-type pliers
Hacksaw
Faucet
Putty knife
Screwdriver
Silicone caulk
Scouring pad
Scouring cleaner
Plumber's putty
Flexible vinyl or braided steel supply tubes
Drain components
Penetrating oil

Modern kitchen faucets tend to be single-handle models, often with useful features such as a pull-out head that functions as a sprayer. This Price Pfister model comes with an optional mounting plate that conceals sink holes when mounted on a predrilled sink flange.

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Choosing a New Kitchen Faucet

You'll find many options when choosing a new kitchen faucet. The best place to start the process is with your sink. In the past, most faucets were mounted directly to the sink deck, which had three or four predrilled holes to accommodate the faucets, spout, sprayer, and perhaps a liquid soap dispenser or an air gap for your dishwasher. Modern kitchen faucets don't always conform to this setup, with many of them designed to be installed in a single hole in the sink deck or in the countertop. If you plan to keep your old sink, look for a faucet that won't leave empty holes in the deck. Generally, it's best to replace like for like, but unfilled stainless sink holes can be filled with snap-in plugs or a soap dispenser.

The two most basic kitchen faucet categories are single-handle and two-handle. Single-handle models are much more popular now because you can adjust the water temperature easily with just one hand. Another difference is in the faucet body. Some faucets have the taps and the spout mounted onto a faucet body so the spacing between the tailpieces is preset. Others, called widespread faucets, have independent taps and spouts that can be configured however you please, as long as the tubes connecting the taps to the spouts reach. This type is best if you are installing the faucet in the countertop (a common way to go about it with new countertops such as solid surface, quartz, or granite).

In the past, kitchen faucets almost always had a remote pull-out sprayer. The sprayer was attached to the faucet body with a hose directly below the mixing valve. While this type of sprayer is still fairly common, many faucets today have an integral pull-out spout that is very convenient and less prone to failure than the old-style sprayers.

A single-handle, high arc faucet with traditional remote sprayer. The mounting plate is decorative and optional.

Single-handle faucets may require four holes, as does this model with its side sprayer and matching soap/lotion dispenser.

Two-handled faucets are less common, but remain popular choices for traditional kitchens. The gooseneck spout also has a certain elegance, but avoid this type if you have a shallow sink that's less than 8" deep.

A single-handle faucet with pull-out spray head requires only one hole in your sink deck or countertop—a real benefit if your sink is not predrilled or if it is an undermount model.

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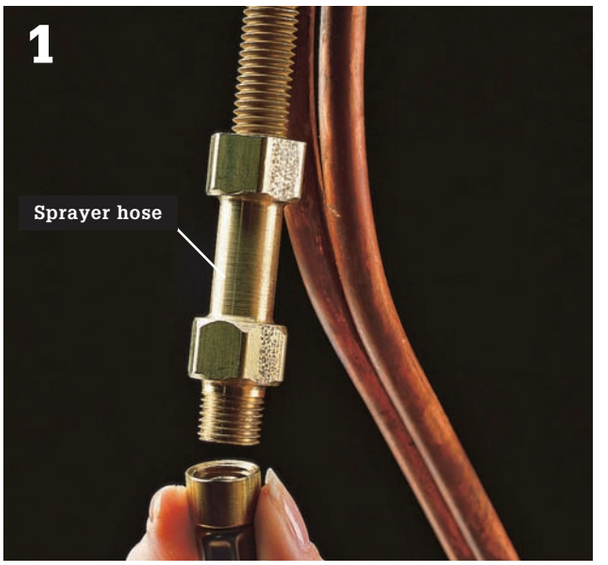
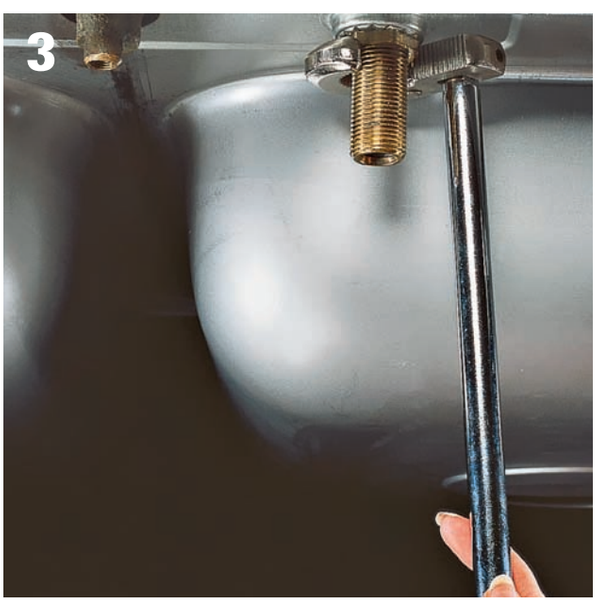
#175 Dtp:225 Page:23

How to Remove an Old Faucet



To remove the old faucet, start by clearing out the cabinet under the sink and laying down towels. Turn off the hot and cold stop valves and open the faucet to make sure the water is off. Detach the sprayer hose from the faucet sprayer nipple and unscrew the retaining nut that secures the sprayer base to the sink deck. Pull the sprayer hose out through the sink deck opening.

Spray the mounting nuts that hold the faucet or faucet handles (on the underside of the sink deck) with penetrating oil for easier removal. Let the oil soak in for a few minutes. If the nut is rusted and stubbornly stuck, you may need to drill a hole in its side, then tap the hole with a hammer and screwdriver to loosen it.



Unhook the supply tubes at the stop valves. Don't reuse old chrome supply tubes. If the stops are missing or unworkable, replace them. Then remove the coupling nuts and the mounting nuts on the tailpieces of the faucet with a basin wrench or channel-type pliers.

Pull the faucet body from the sink. Remove the sprayer base if you wish to replace it. Scrape off old putty or caulk with a putty knife and clean off the sink with a scouring pad and an acidic scouring cleaner like Bar Keeper's Friend®. *Tip: Scour stainless steel with a back and forth motion to avoid leaving unsightly circular markings.*

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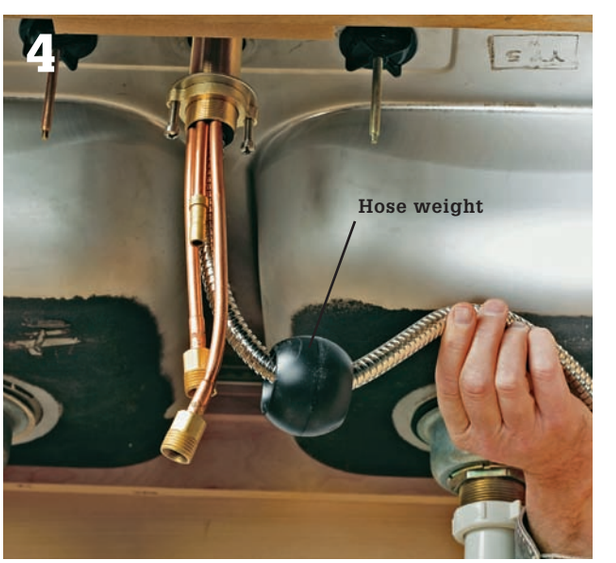
#175 Dtp:225 Page:24

How to Install a Pullout Kitchen Sink Faucet

Install the base plate (if your faucet has one) onto the sink flange so it is centered. Have a helper hold it straight from above as you tighten the mounting nuts that secure the base plate from below. Make sure the plastic gasket is centered under the base plate. These nuts can be adequately tightened by hand.

Retract the pullout hose by drawing it out through the faucet body until the fitting at the end of the hose is flush with the bottom of the threaded faucet shank. Insert the shank and the supply tubes down through the top of the deck plate.

Slip the mounting nut and washer over the free ends of the supply tubes and pullout hose, then thread the nut onto the threaded faucet shank. Hand tighten. Tighten the retainer screws with a screwdriver to secure the faucet.



Slide the hose weight onto the pullout hose (the weight helps keep the hose from tangling and it makes it easier to retract).

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#175 Dtp:225 Page:25

Connect the end of the pullout hose to the outlet port on the faucet body using a quick connector fitting.

Hook up the water supply tubes to the faucet inlets. Make sure the tubes are long enough to reach the supply risers without stretching or kinking.

Connect the supply tubes to the supply risers at the stop valves. Make sure to get the hot lines and cold lines attached correctly.

Attach the spray head to the end of the pullout hose and turn the fitting to secure the connection. Turn on water supply and test. *Tip: Remove the aerator in the tip of the spray head and run hot and cold water to flush out any debris.*

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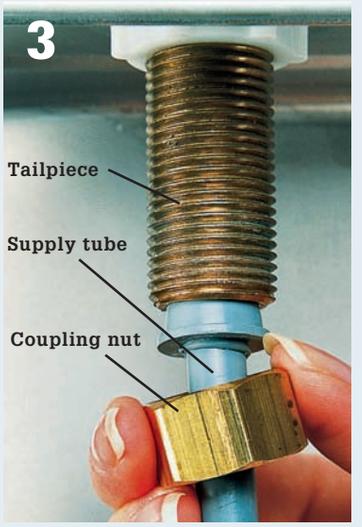
#175 Dtp:225 Page:26

Variation: One-Piece Faucet with Sprayer ▸

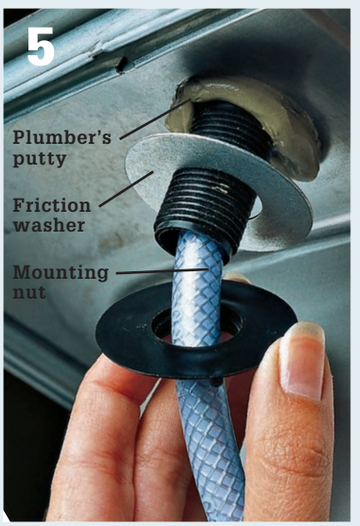
Thoroughly clean the area around the sink's holes. Slip the faucet's plastic washer onto the underside of the base plate. Press the faucet in place, and have a helper hold it in place while you work from below.

Slip a friction washer onto each tailpiece and then hand tighten a mounting nut. Tighten the mounting nut with channel-type pliers or a basin wrench. Wipe up any silicone squeeze-out on the sink deck with a wet rag before it sets up.

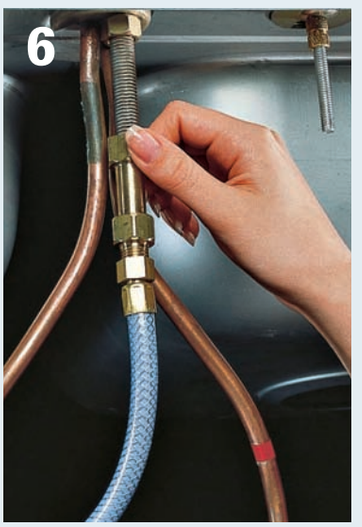


Connect supply tubes to the faucet tailpieces. Make sure the tubes you buy are long enough to reach the stop valves and that the coupling nuts will fit the tubes and tailpieces.

Apply a ¼" bead of plumber's putty to the underside of the sprayer base. With the base threaded onto the sprayer hose, insert the tailpiece of the sprayer through the opening in the sink deck.



From beneath, slip the friction washer over the sprayer tailpiece and then screw the mounting nut onto the tailpiece. Tighten with channel-type pliers or a basin wrench. Clean up any excess putty or caulk.



Screw the sprayer hose onto the hose nipple on the bottom of the faucet. Hand tighten and then give the nut one quarter turn with channel-type pliers or a basin wrench. Turn on the water supply at the shutoff, remove the aerator, and flush debris from the faucet.

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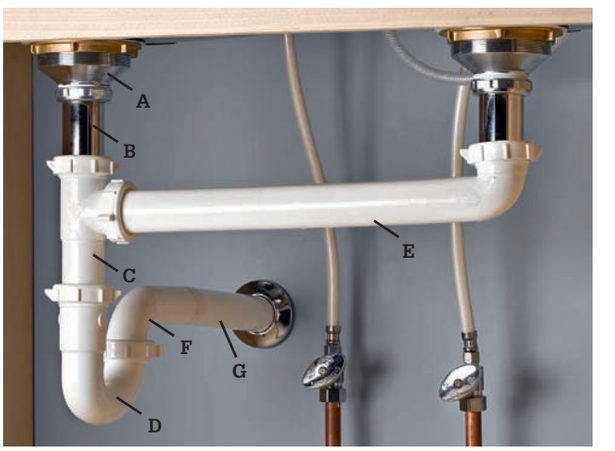
Kitchen Drains & Traps

Kitchen traps, also called sink drains or trap assemblies, are made of 1½-inch pipes (also called tubes), slip washers, and nuts, so they can be easily assembled and disassembled. Most plastic types can be tightened by hand, with no wrench required. Pipes made of chromed brass will corrode in time, and rubber washers will crumble, meaning they need to be replaced. Plastic pipes and plastic washers last virtually forever. All traps are liable to get bumped out of alignment; when this happens, they should be taken apart and reassembled.

A trap's configuration depends on how many bowls the sink has, whether or not you have a food disposer and/or a dishwasher drain line, and local codes. On this page we show three of the most common assembly types. T fittings on these traps often have a baffle, which reduces the water flow somewhat. On page 37 we show another type of installation that has separate traps for each of the bowls and no baffles, so water flows more freely. Check local codes to make sure your trap is compliant.

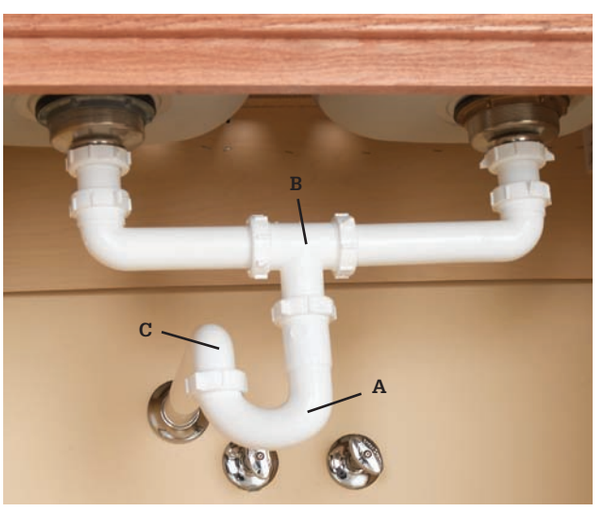
Tools & Materials

Flat screwdriver	Teflon tape
Spud wrench	Washers
Trap arm	Waste-T fitting
Mineral spirits	P-trap
Cloth	Saw
Strainer kit	Miter box
Plumber's putty	



Kitchen sink drains include a strainer body (A), tailpiece (B), waste T (C), P-trap (D), outlet drain line (E), trap arm (F), and wall stubout with coupling (G).

In this arrangement, the dishwasher drain hose (A) attaches to the food disposer (B), and a trap arm (C) leads from the disposer to the P-trap (D).



A "center tee" arrangement has a single P-trap (A) that is connected to a waste T (B) and the trap arm (C).

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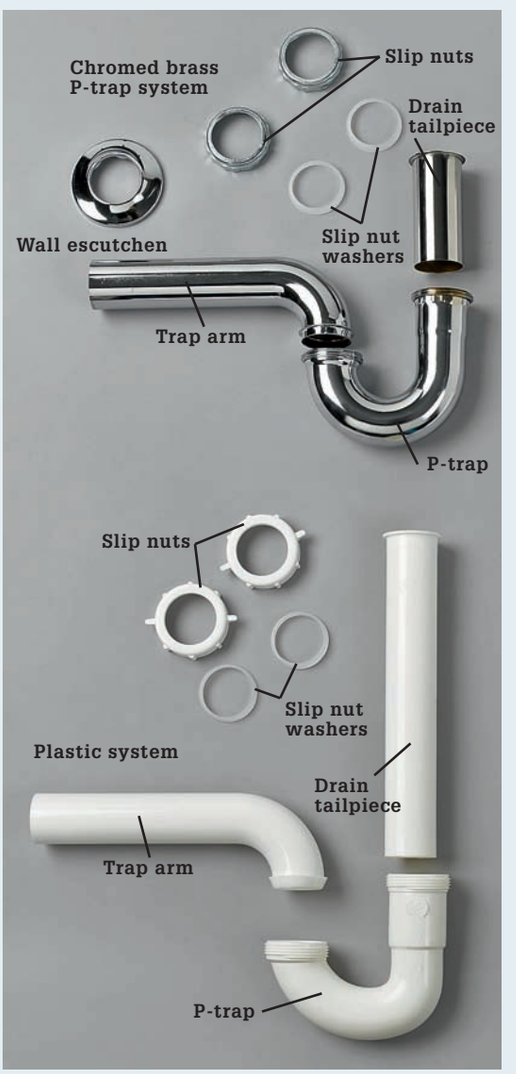
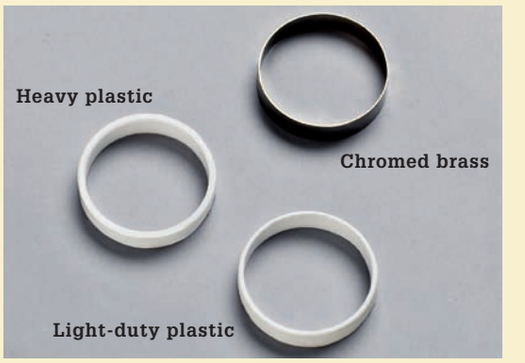
Drain Kits

Kits for installing a new sink drain include all the pipes, slip fittings, and washers you'll need to get from the sink tailpieces (most kits are equipped for a double bowl kitchen sink) to the trap arm that enters the wall or floor. For wall trap arms, you'll need a kit with a P-trap. Both drains normally are plumbed to share a trap. Chromed brass or PVC with slip fittings let you adjust the drain more easily and pull it apart and then reassemble if there is a clog. Some pipes have fittings on their ends that eliminate the need for a washer. Kitchen sink drains and traps should be 1½" o.d. pipe—the 1¼" pipe is for lavatories and doesn't have enough capacity for a kitchen sink.



Tips for Choosing Drains



Wall thickness varies in sink drain pipes. The thinner plastic material is cheaper and more difficult to obtain a good seal with the thicker, more expensive tubing. The thin product is best reserved for lavatory drains, which are far less demanding.

Slip joints are formed by tightening a male-threaded slip nut over a female-threaded fitting, trapping and compressing a beveled nylon washer to seal the joint.

Use a spud wrench to tighten the strainer body against the underside of the sink bowl. Normally, the strainer flange has a layer of plumber's putty to seal beneath it above the sink drain, and a pair of washers (one rubber, one fibrous) to seal below.

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How to Hook Up a Kitchen Sink Drain

If you are replacing the sink strainer body, remove the old one and clean the top and bottom of the sink deck around the drain opening with mineral spirits. Attach the drain tailpiece to the threaded outlet of the strainer body, inserting a nonbeveled washer between the parts if your strainer kits include one. Lubricate the threads or apply Teflon tape so you can get a good, snug fit.

Apply plumber's putty around the perimeter of the drain opening and seat the strainer assembly into it. Add washers below as directed and tighten the strainer locknut with a spud wrench (see photo, previous page) or by striking the mounting nubs at the top of the body with a flat screwdriver.

You may need to cut a trap arm or drain tailpiece to length. Cut metal tubing with a hacksaw. Cut plastic tubing with a handsaw, power miter saw, or a hand miter box and a backsaw or hacksaw. You can use a tubing cutter for any material. Deburr the cut end of plastic tubing with a utility knife.

Attach the trap arm to the male-threaded drain stubout in the wall, using a slip nut and beveled compression washer. The outlet for the trap arm should point downward. *Note: The trap arm must be lower on the wall than any of the horizontal lines in the set-up, including lines to dishwasher, disposer, or the outlet line to the second sink bowl.*

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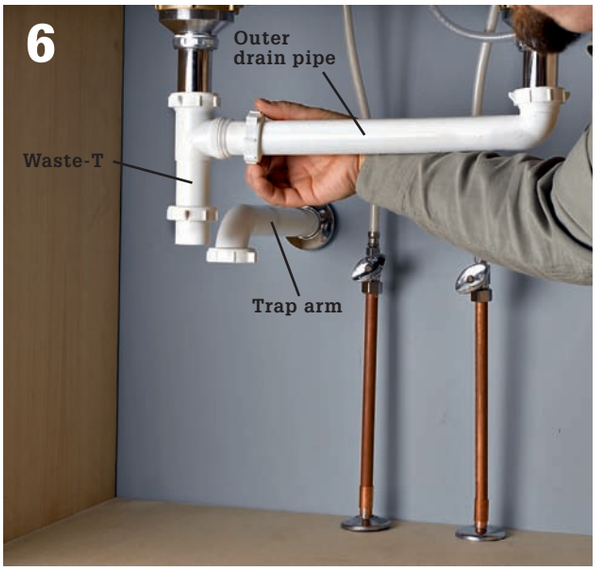
Attach a waste-T-fitting to the drain tailpiece, orienting the opening in the fitting side so it will accept the outlet drain line from the other sink bowl. If the waste-T is higher than the top of the trap arm, remove it and trim the drain tailpiece.



Join the short end of the outlet drain pipe to the tailpiece for the other sink bowl and then attach the end of the long run to the opening in the waste-T. The outlet tube should extend into the T ½"—make sure it does not extend in far enough to block water flow from above.

Attach the long leg of a P-trap to the waste-T and attach the shorter leg to the downward-facing opening of the trap arm. Adjust as necessary and test all joints to make sure they are still tight, and then test the system.

Variation: Drain in Floor ▸

If your drain stubout comes up out of the floor instead of the wall, you have an S-trap instead of a P-trap. This arrangement is illegal in many parts of the country, because a heavy surge of water can siphon the trap dry, rendering it unable to trap gases. However, if after draining the sink you run a slow to moderate stream of water for a few seconds, the trap will fill. An S-trap has two trap pipes that lead to a straight vertical pipe.

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Dishwashers

A dishwasher that's past its prime may be inefficient in more ways than one. If it's an old model, it probably wasn't designed to be very efficient to begin with. But more significantly, if it no longer cleans effectively, you're probably spending a lot of time and hot water pre-rinsing the dishes. This alone can consume more energy and water than a complete wash cycle on a newer machine. So even if your old dishwasher still runs, replacing it with an efficient new model can be a good green upgrade.

In terms of sizing and utility hookups, dishwashers are generally quite standard. If your old machine is a built-in and your countertops and cabinets are standard sizes, most full-size dishwashers will fit right in. Of course, you should always measure the dimensions of the old unit before shopping for a new one to avoid an unpleasant surprise at installation time. Also be sure to review the manufacturer's instructions before starting any work.

Tools & Materials ▸

Screwdrivers	Cable connector
Adjustable wrench	Teflon tape
2-ft. level	Hose clamps
⅝" automotive heater hose	Wire connectors
Automotive heater hose	Carpet scrap
4"-length of ½" copper tubing	Bowl

Replacing an old, inefficient dishwasher is a straightforward project that usually takes just a few hours. The energy savings begin with the first load of dishes and continue with every load thereafter.

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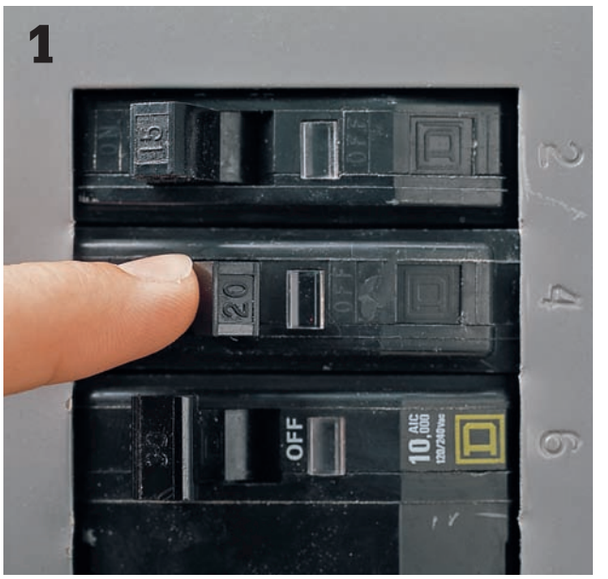
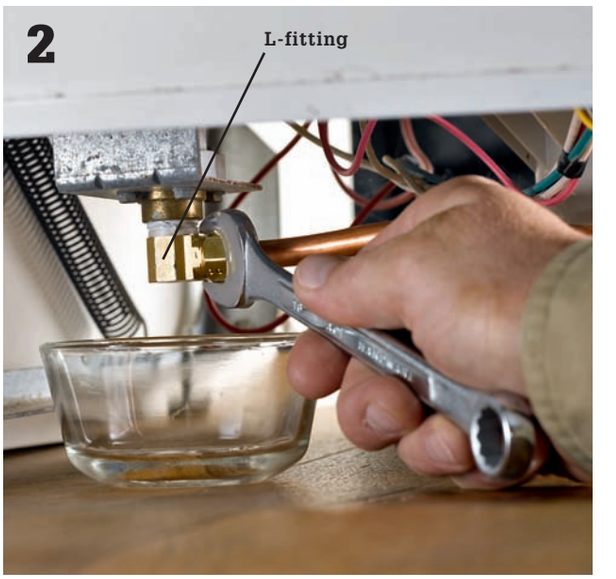
How to Replace a Dishwasher



Start by shutting off the electrical power to the dishwasher circuit at the service panel. Also, turn off the water supply at the shutoff valve, usually located directly under the floor.



Disconnect old plumbing connections. First unscrew the front access panel. Once the access panel is removed, disconnect the water supply line from the L-fitting on the bottom of the unit. This is usually a brass compression fitting, so just turning the compression nut counterclockwise with an adjustable wrench should do the trick. Use a bowl to catch any water that might leak out when the nut is removed.

Disconnect old wiring connections. The dishwasher has an integral electrical box at the front of the unit where the power cable is attached to the dishwasher's fixture wires. Take off the box cover and remove the wire connectors that join the wires together.

Disconnect the discharge hose, which is usually connected to the dishwasher port on the side of the garbage disposer. To remove it, just loosen the screw on the hose clamp and pull it off. You may need to push this hose back through a hole in the cabinet wall and into the dishwasher compartment so it won't get caught when you pull the dishwasher out.

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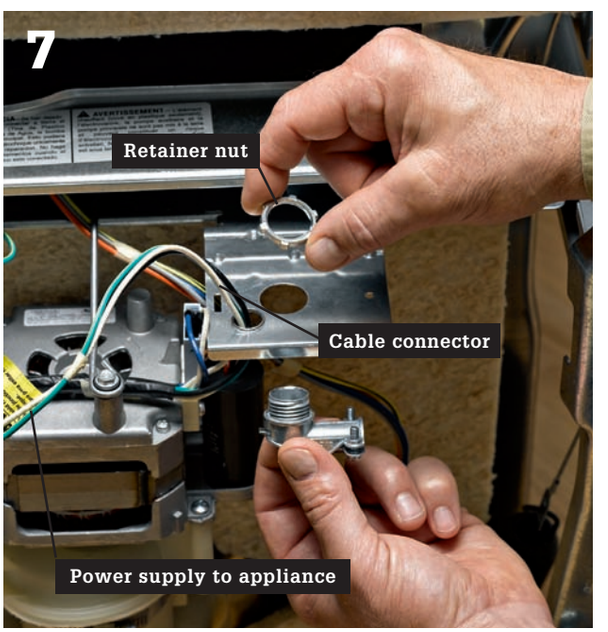
Detach the unit from the cabinets before you pull it out. Remove the screws that hold the brackets to the underside of the countertop. Then put a piece of cardboard or old carpet under the front legs to protect the floor from getting scratched, and pull the dishwasher out.

First, prepare the new dishwasher. Tip it on its back and attach the new L-fitting into the threaded port on the solenoid. Apply some Teflon tape or pipe sealant to the fitting threads before tightening it in place to prevent possible leaks.



Prepare for the wiring connections. Like the old dishwasher, the new one will have an integral electrical box for making the wiring connections. To gain access to the box, just remove the box cover. Then install a cable connector on the back of the box and bring the power cable from the service panel through this connector. Power should be shut off at the main service panel at all times.

Install a leveling leg at each of the four corners while the new dishwasher is still on its back. Just turn the legs into the threaded holes designed for them. Leave about ½" of each leg projecting from the bottom of the unit. These will have to be adjusted later to level the appliance. Tip the appliance up onto the feet and slide it into the opening. Check for level in both directions and adjust the feet as required.

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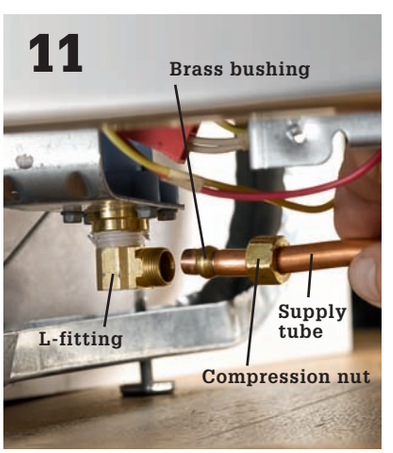
Once the dishwasher is level, attach the brackets to the underside of the countertop to keep the appliance from moving. Then pull the discharge hose into the sink cabinet and install it so there's a loop that is attached with a bracket to the underside of the countertop. This loop prevents waste water from flowing from the disposer back into the dishwasher. *Note: Some codes require that you install an air gap fitting for this purpose. Check with your local plumbing inspector.*

Push an adapter over the disposer's discharge nipple and tighten it in place with a hose clamp. If you don't have a disposer, replace one of the drain tailpieces with a dishwasher tailpiece, and clamp the discharge tube to its fitting.



Adjust the L-fitting on the dishwasher's water inlet valve until it points directly toward the water supply tubing. Then lubricate the threads slightly with a drop of dishwashing liquid and tighten the tubing's compression nut onto the fitting. Keeping the brass bushing between the nut and the L-fitting. Use an adjustable wrench and turn the nut clockwise.

Complete the electrical connections by clamping the cable and joining the wires with wire nuts, following manufacturer's instructions. Replace the electrical cover, usually by hooking it onto a couple of prongs and driving a screw. Restore power and water, and test. Replace the toe-kick.

Tube Choices

Note: Codes still allow copper supply tubes like the one shown, but a 4- to 5-ft. flexible dishwasher supply tube is a better choice if you are likely to be sliding the appliance in and out. A copper tube is less likely to burst, so it may be preferable in cases where the appliance is unlikely to be moved.

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Food Disposers

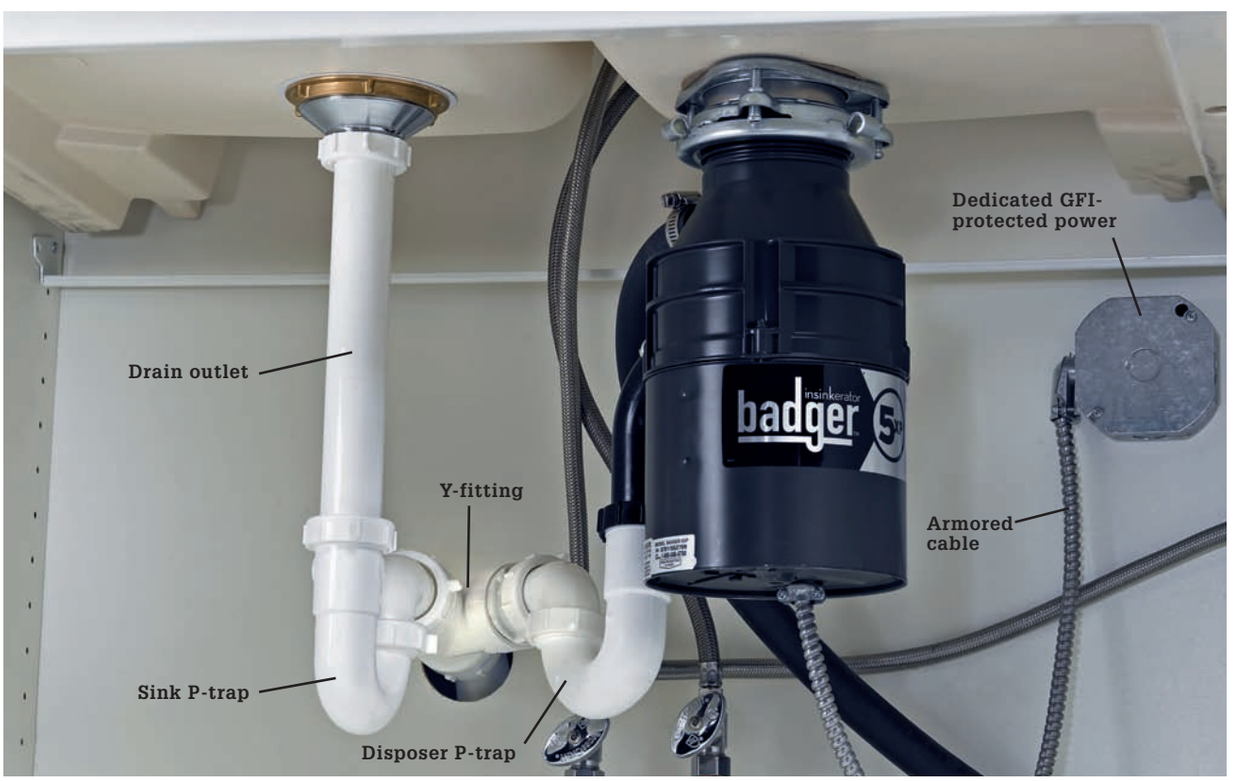
Food disposers are standard equipment in the modern home, and most of us have come to depend on them to macerate our plate leavings and crumbs so they can exit the house along with waste water from the sink drain. If your existing disposer needs replacing, you'll find that the job is relatively simple, especially if you select a replacement appliance that is the same model as the old one. In that case, you can probably reuse the existing mounting assembly, drain sleeve, and drain plumbing.

Disposers are available with power ratings between ⅓ and 1 HP (horsepower). More powerful models bog down less under load and the motors last longer because they don't have to work as hard. They are also costlier.

Choose a switch option that meets your family's safety needs. A "continuous feed" disposer may be controlled by a standard on-off switch on the wall. Another option is a disposer that stays on only when the switch is actively pressed. A "batch feed" disposer can turn on only when a lid is locked onto it, eliminating the possibility of harming fingers. Some models are controlled at the lid, without a wall switch. Continuous food disposers are the most common.

Tools & Materials ▸

Screwdriver	Putty knife
Channel-type pliers	Mineral spirits
Spud wrench (optional)	Plumber's putty
Hammer	Wire caps
Hacksaw or tubing cutter	Hose clamps
Kitchen drain supplies	Threaded Y-fitting
Drain auger	Electrical tape



A properly functioning food disposer that's used correctly can help reduce clogs. Some plumbers use separate P-traps for the disposer and the drain outlet tube as shown here. Others contend that configuring the drain line with a single P-trap minimizes the chance that a trap will have its water seal broken by suction from the second trap. See page 28, lower left.

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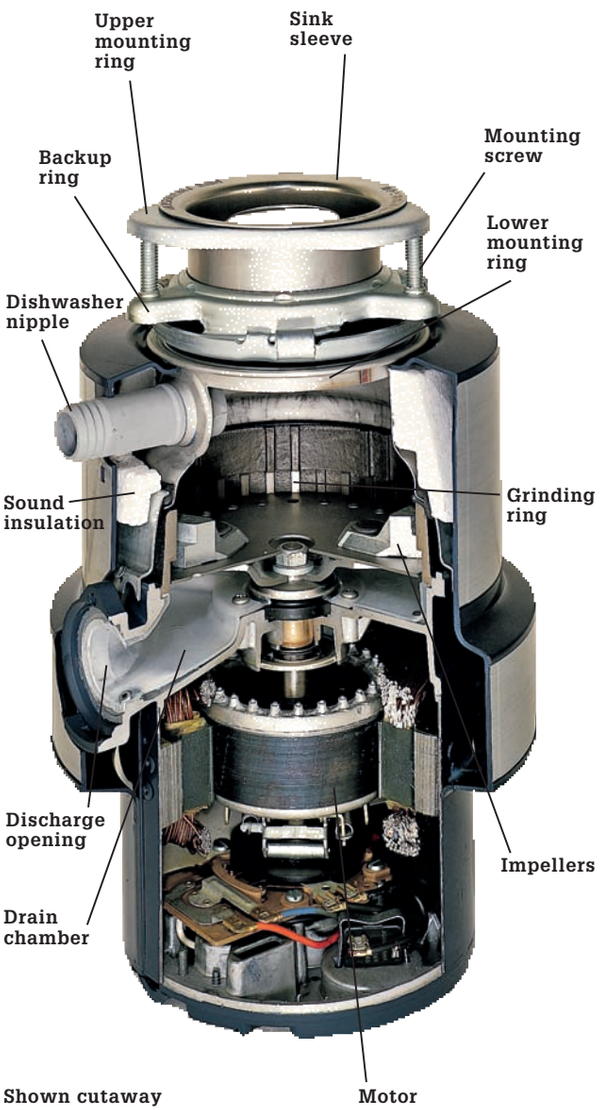
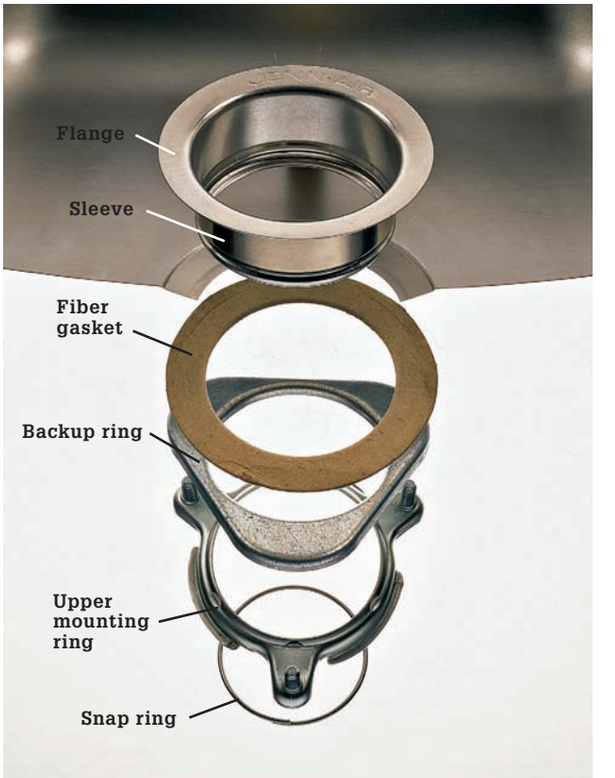
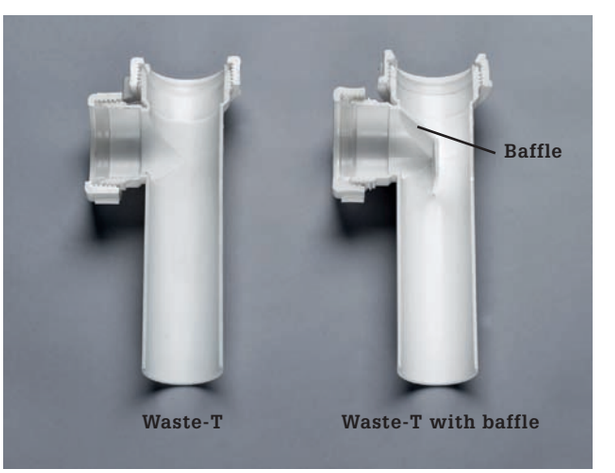


A food disposer grinds food waste so it can be flushed away through the sink drain system. A quality disposer has a ½ –horsepower, or larger, self-reversing motor. Other features to look for include foam sound insulation, a grinding ring, and overload protection that allows the motor to be reset if it overheats. Better food disposers have a 5-year manufacturer's warranty.



The disposer is attached directly to the sink sleeve, which comes with the disposer and replaces the standard sink strainer. A snap ring fits into a groove around the sleeve of the strainer body to prevent the upper mounting ring and backup ring from sliding down while the upper mounting ring is tightened against the backup ring with mounting screws. A fiber gasket compressor when the mounting screws are tightened to create a better seal under the flange.



Kitchen and drain tees are required to have a baffle if the tee is connected to a dishwasher or disposer. The baffle is intended to prevent discharge from finding its way up the drain and into the sink.

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How to Install a Food Disposer

Remove the old disposer if you have one. You'll need to disconnect the drain pipes and traps first. If your old disposer has a special wrench for the mounting lugs, use it to loosen the lugs. Otherwise, use a screwdriver. If you do not have a helper, place a solid object directly beneath the disposer to support it before you begin removal. *Important: Shut off electrical power at the main service panel before you begin removal. Disconnect the wire leads, cap them, and stuff them into the electrical box.*

Clear the drain lines all the way to the branch drain before you begin the new installation. Remove the trap and trap arm first.

Disassemble the mounting assembly and then separate the upper and lower mounting rings and the backup ring. Also remove the snap ring from the sink sleeve. See photo, previous page.

Press the flange of the sink sleeve for your new disposer into a thin coil of plumber's putty that you have laid around the perimeter of the drain opening. The sleeve should be well-seated in the coil.

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Slip the fiber gasket and then the backup ring onto the sink sleeve, working from inside the sink base cabinet. Make sure the backup ring is oriented the same way it was before you disassembled the mounting assembly.

Insert the upper mounting ring onto the sleeve with the slotted ends of the screws facing away from the backup ring so you can access them. Then, holding all three parts at the top of the sleeve, slide the snap ring onto the sleeve until it snaps into the groove.

Tighten the three mounting screws on the upper mounting ring until the tips press firmly against the backup ring. It is the tension created by these screws that keeps the disposer steady and minimizes vibrating.

Make electrical connections before you mount the disposer unit on the mounting assembly. Shut off the power at the service panel if you have turned it back on. Remove the access plate from the disposer. Attach the white and black feeder wires from the electrical box to the white and black wires (respectively) inside the disposer. Twist a small wire cap onto each connection and wrap it with electrical tape for good measure. Also attach the green ground wire from the box to the grounding terminal on your disposer.

(continued)

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:39

Knock out the plug in the disposer port if you will be connecting your dishwasher to the disposer. If you have no dishwasher, leave the plug in. Insert a large flathead screwdriver into the port opening and rap it with a mallet. Retrieve the knock-out plug from inside the disposer canister.

Hang the disposer from the mounting ring attached to the sink sleeve. To hang it, simply lift it up and position the unit so the three mounting ears are underneath the three mounting screws and then spin the unit so all three ears fit into the mounting assembly. Wait until after the plumbing hookups have been made to lock the unit in place.

Attach the discharge tube to the disposer according to the manufacturer's instructions. It is important to get a very good seal here, or the disposer will leak. Go ahead and spin the disposer if it helps you access the discharge port.

Attach a Y-fitting at the drain stubout. The Y-fitting should be sized to accept a drain line from the disposer and another from the sink. Adjust the sink drain plumbing as needed to get from the sink P-trap to one opening of the Y.

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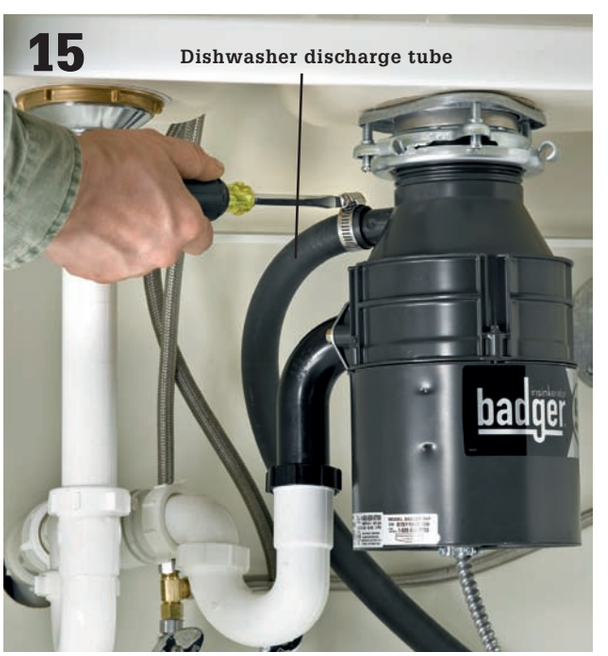
#175 Dtp:225 Page:40

Install a trap arm for the disposer in the open port of the Y-fitting at the wall stubout. Then, attach a P-trap or a combination of a tube extension and a P-trap so the trap will align with the bottom of the disposer discharge tube.

Spin the disposer so the end of the discharge tube is lined up over the open end of the P-trap and confirm that they will fit together correctly. If the discharge tube extends down too far, mark a line on it at the top of the P-trap and cut at the line with a hacksaw. If the tube is too short, attach an extension with a slip joint. You may need to further shorten the discharge tube first to create enough room for the slip joint on the extension. Slide a slip nut and beveled compression washer onto the discharge tube and attach the tube to the P-trap.



Connect the dishwasher discharge tube to the inlet port located at the top of the disposer unit. This may require a dishwasher hookup kit. Typically, a hose clamp is used to secure the connection.

Lock the disposer into position on the mounting ring assembly once you have tested to make sure it is functioning correctly and without leaks. Lock it by turning one of the mounting lugs until it makes contact with the locking notch.

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Water Heaters

Replacing a water heater is a relatively easy DIY plumbing task as long as it is a like-for-like replacement. In an ideal situation, you'd replace the old unit with one of the exact same size and make, and thereby avoid having to move any gas, water, or electrical lines. But if you choose to upgrade or downgrade in size, or perhaps replace an old electric water heater with a gas water heater that costs less to run, you'll find that relocating the necessary lines isn't that difficult.

It is a commonly held belief that a water heater should last around 10 years. The longevity depends on many factors, including initial quality, usage levels, maintenance diligence, and other miscellaneous factors such as hardness of water. While it is everyone's goal to get as much use out of our major appliances as possible, it is also undeniable that the best time to replace a water heater is before it leaks and fills your basement with water. It's a bit of a gamble, but once your old heater starts showing signs of wear and perhaps even acting up a bit, go ahead and make the change.

Water heaters for primary duty in residences range in size from 30 gallons to 65 gallons. For a family of four, a 40- or 50-gallon model should be adequate. While you don't want to run out of hot water every morning, you also don't want to pay to heat more water than you use. Base your choice on how well your current water heater is meeting your demand.

Follow local codes when choosing the pipe and fittings for both gas and water. Make sure there is a gas shutoff within 5 feet of the water heater. Also, there should be a union between the shutoff and the water heater, so pipes can be easily dismantled for service.

Water heaters typically last for at least 10 years, but once they start to show signs of aging, it's a good idea to replace them with a new, more efficient appliance.

Tools & Materials

Tubing cutter	Screwdriver	Discharge tube	Gas supply pipe and fittings
Hacksaw	MAPP torch kit	Garden hose	Copper soldering supplies
Pipe wrenches (2)	Appliance dolly	Drain pan	Leak detector solution
Adjustable wrench	Water heater	Pipe thread lubricant	Ball-type water shutoff valve
Channel-type pliers	T & P relief valve	Vent pipe elbow	

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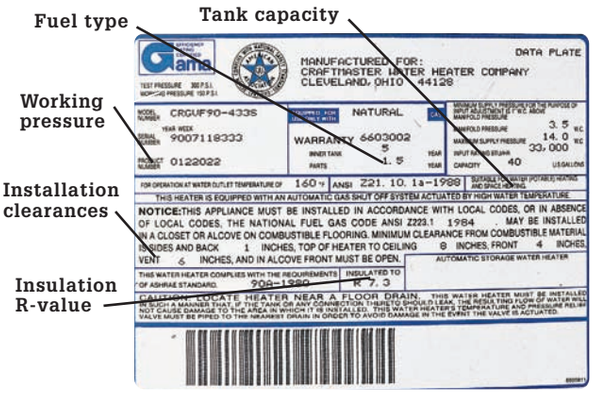
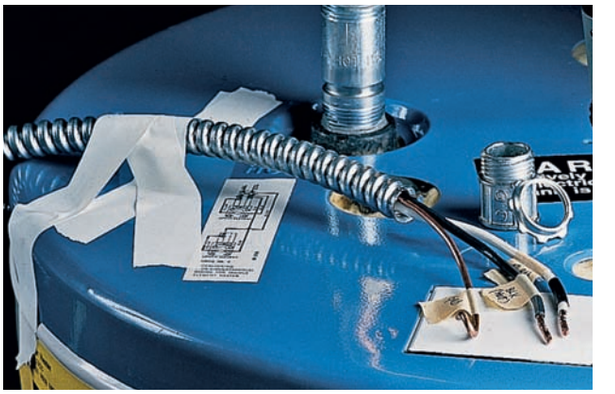
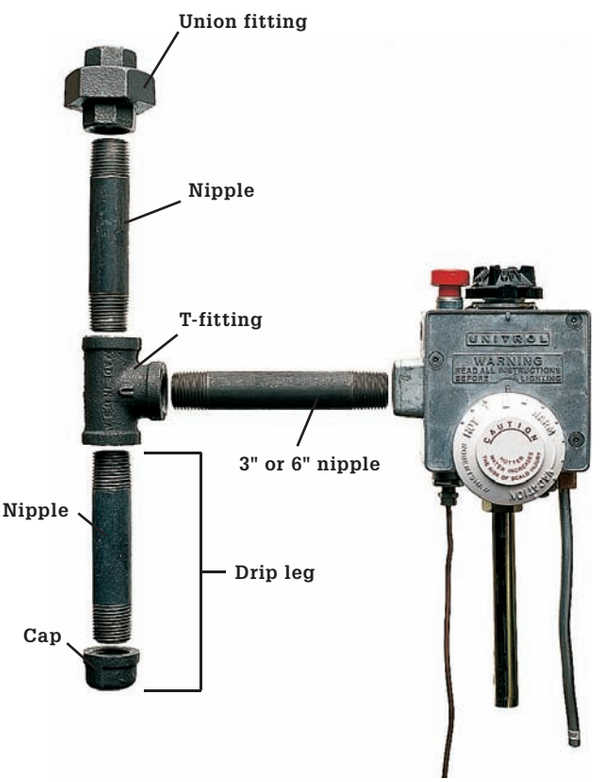


The nameplate on the side of a water heater lists tank capacity, insulation R-value, and working pressure (pounds per square inch). More efficient water heaters have an insulation R-value of 7 or higher. The nameplate for an electric water heater includes the voltage and the wattage capacity of the heating elements and thermostats. Water heaters also have a yellow energy guide label that lists typical yearly operating costs.



Use armored cable or wires housed in metal conduit to bring electrical power to electric water heaters. The armored cable or conduit should enter the top of the unit through a conduit clamp.



Use threaded black gas pipe to make the gas connection at the water heater. Other connectors, including flexible copper or stainless-steel connectors, are not allowed by some codes and are not as sturdy. The black pipe may be supplied by other pipe materials, such as soft copper. The basic construction involves three threaded nipples, a T-fitting, a cap, and a union to connect to the supply line.

If your house has soft copper gas supply lines, make sure this is allowed by local codes, and that they are made of gas-rated copper (which is thicker than standard copper tubing). Use a flare fitting to connect an additional threaded nipple from the black pipe assembly that connects to the water heater regulator. If you have black pipe supply lines, use a union fitting like the one in the previous photo.

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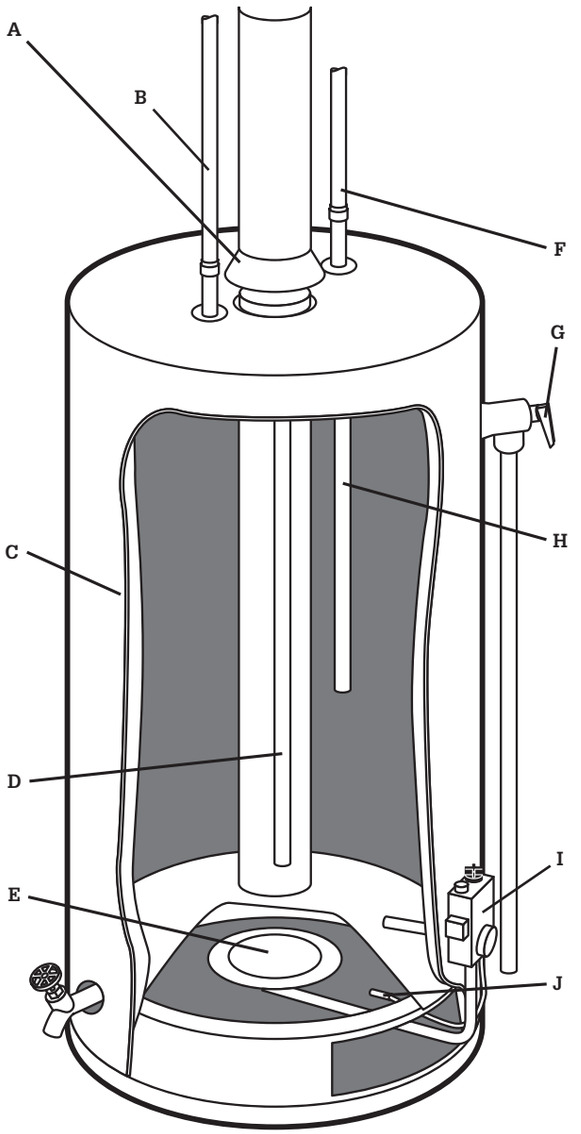
#175 Dtp:225 Page:43

GAS WATER HEATER

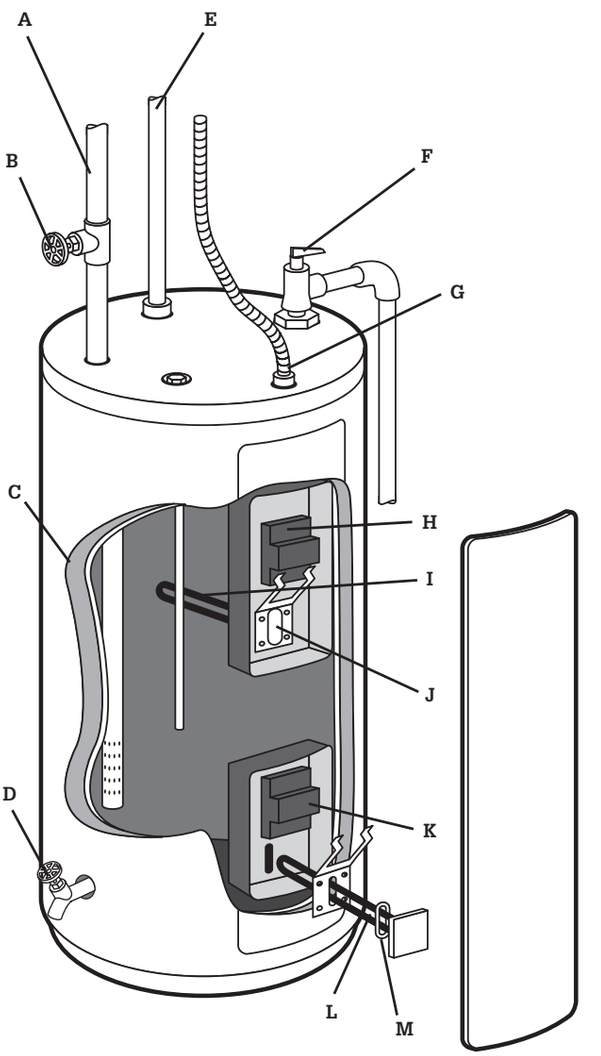
Gas water heater parts include:
(A) Flue
(B) Hot water outlet
(C) Tank
(D) Anode rod
(E) Gas burner
(F) Cold water inlet pipe
(G) Pressure-relief valve
(H) Dip tube
(I) Thermostat
(J) Thermocouple



Gas water heaters operate on either propane or natural gas and are generally very economical to run. They do cost a bit more than electric heaters up front. The following installation features a gas water heater. Check with your local building department to find out if homeowners are allowed to install gas appliances in your municipality.

ELECTRIC WATER HEATER

Electric water heater parts can include:
(A) Cold water inlet pipe
(B) Cold water inlet valve
(C) Insulation
(D) Draincock
(E) Hot water outlet pipe
(F) Pressure-relief valve
(G) Power cable
(H) High temperature thermostat
(I) Upper heating element
(J) Bracket
(K) Lower heating thermostat
(L) Lower heating element
(M) Gasket



Electric water heaters require 240-volt service, which might overload your service panel if you are replacing a gas heater with an electric model. Their primary advantage is that they are cheaper to purchase (but not to operate) and they do not require that you make gas connections.

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#175 Dtp:225 Page:44

How to Install a Gas Water Heater

Shut off the gas supply at the stopcock installed in the gas line closest to the water heater. The handle of the stopcock should be perpendicular to the gas supply pipe. Also shut off the water supply.

Drain the water from the old heater by hooking a garden hose up to the sillcock drain and running it to a floor drain. If you don't have a floor drain, drain the water into buckets. For your personal safety, wait until the water heater has been shut off for a couple of hours before draining it.

Disconnect the gas supply from the water heater. To do so, loosen the flare fitting with two wrenches or pliers in a soft copper supply line or loosen the union fitting with two pipe wrenches for black pipe supply lines (inset photo).

Disconnect the vent pipe from the draft hood by withdrawing the sheet metal screws connecting the parts. Also remove vent pipes up to and including the elbow so you may inspect them for corrosion buildup and replace if needed.

(continued)

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Cut the water supply lines. Prior to cutting, shut off the cold water supply either at the stop valve near the heater or at the water meter. Inspect the shutoff valve. If it is not a ball-type valve in new condition, replace it with a ball valve.

Install a Relief Valve ▸

Prepare the new water heater for installation. Before you put the water heater in place, add a T & P relief valve at the valve opening. Make sure to read the manufacturer's instructions and purchase the recommended valve type. Lubricate the threads and tighten the valve into the valve opening with a pipe wrench. *Note: The water heater shown in this sequence came with a T & P relief valve that's preinstalled.*

Remove the old water heater and dispose of it properly. Most trash collection companies will haul it away for $20 or $30. Don't simply leave it out at the curb unless you know that is allowed by your municipal waste collection department. A two-wheel truck or appliance dolly is a big help here. Water heaters usually weigh around 150 pounds.

Position the new unit in the installation area. If you have flooring you wish to protect from leaks, set the unit on a drip pan (available where water heater accessories are sold). The shallow pans feature a hose bib so you can run a drain line from the pan to a floor drain. If the water heater is not level, level it by shimming under the bottom with a metal or composite shim. Note that you'll need to shift the unit around a bit to have clearance for installing the water supply connectors (step 10).

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#175 Dtp:225 Page:46

Attach a discharge tube to the T & P relief valve. You may use either copper pipe or CPVC drain pipe. Cut the tube so the free end is 6" above the floor (some locales may allow 3" above the floor). If you have floorcoverings you wish to protect, add a 90-degree elbow and a copper drain tube that leads from the discharge tube to a floor drain.

Fabricate water connectors from lengths of copper tubing, threaded copper adaptors, and plastic-lined galvanized threaded nipples. Plastic-lined nipples (inset photo) reduce the corrosion that can occur when you join two dissimilar metals. Size the connector assemblies so they will end up just short of the cut copper supply tubing when the connectors are inserted into the water heater ports.

Install the connectors in the cold water inlet port (make sure you use the blue-coded lined nipple) and the hot outlet port (red-coded nipple) on top of the water heater. Lubricate the nipple threads and tighten with channel-type pliers. Slip a copper tubing repair coupling over each connector and reposition the unit so the supply pipes and connector tops align.

Join the connectors to the supply tubes with slip-fitting copper repair couplings. Be sure to clean and prime the parts first.

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001-049_28830.indd 47 7/26/12 11:34 AM
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#175 Dtp:225 Page:47

Reassemble the vent with a new elbow fitting (if your old one needed replacement, see step 4, page 45). Cut the duct that drops down from the elbow so it will fit neatly over the top flange of the draft hood.

Follow the manufacturer's instructions for configuring the vent; this varies from model to model. Attach the vertical leg of the vent line to the draft hood with ⅜" sheet metal screws. Drive at least three screws into each joint.

Install the parts for the black pipe gas connector assembly (see photo page 43). Use pipe dope to lubricate all joints. Attach a T-fitting to one end of a 3" nipple first and attach the other end of the nipple into the female-threaded regulator port. Attach a cap to another 6" nipple and then thread the other end into the bottom opening of the T-fitting to form a drip leg. Install a third nipple in the top opening of the T-fitting.

Connect the gas supply line to the open end of the gas connector. Use a union fitting for black gas pipe connections and a flare fitting for copper supply connections. See page 43 for more information on making these connections.

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001-049_28830.indd 48 7/26/12 11:34 AM
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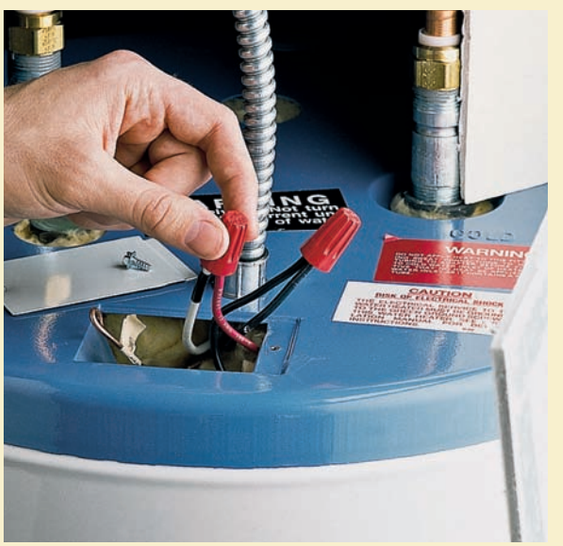
#175 Dtp:225 Page:48

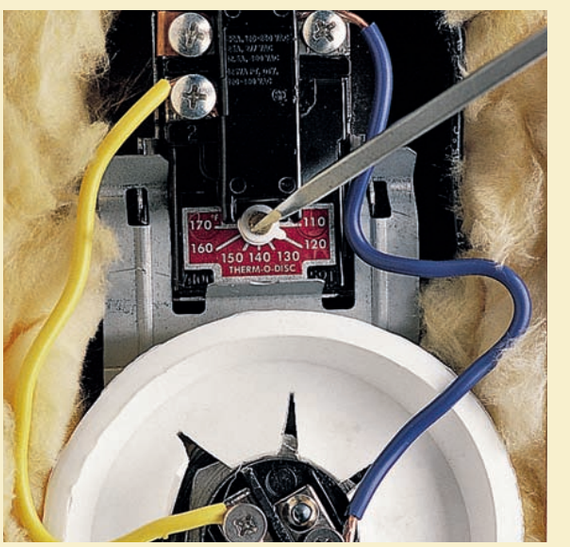
Test the connections. Turn on the gas supply and test the gas connections with testing solution (see page 317). Before turning on the water supply, make sure the tank drain valve is closed. Allow the tank to fill with water and then turn on a hot water faucet until water comes out (the water won't be hot yet, of course). Visually check all plumbing joints for leaks.

Light the pilot. This is usually a multi-step process that varies among manufacturers, but all new water heaters will have pilot-lighting instructions printed on a label near the water heater controls. Adjust the water temperature setting.

Tip: Hooking Up Electric Water Heaters ▸



The fuel supply connection is the only part of installing an electric water heater that differs from installing a gas heater, except that electric heaters do not require a vent. The feeder wires (240 volts) are twisted together with mating wires in the access panel located at the top of the unit.



Temperature adjustments on electric water heaters are made by tightening or loosening a thermostat adjustment screw located near the heating element. Always shut off power to the unit before making adjustment. In this photo you can see how close the live terminals for the heating element are to the thermostat.

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001-049_28830.indd 49
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Tankless Water Heater

A tankless water heater, as its name indicates, does not keep a tankful of hot water at all times. It heats water only when a hot-water faucet is opened, and so is also called an "on-demand" water heater. A tankless unit can cost a good deal more initially than a standard tank unit, but it typically saves enough in energy costs to pay back the investment within three to five years. Another advantage: you'll never run out of hot water.

Consult with your salesperson to choose a unit large enough to supply all the hot water you may simultaneously need. The model shown, for instance, is rated at nearly 200,000 BTUs and can supply up to 9.5 gallons per minute (GPM), supplying enough hot water for two or three faucets (including shower faucets) or appliances at a time. In addition to a whole-house unit like this, you may also purchase a smaller "point-of-use" unit to supply hot water for, say, a single bathroom. Many of these units are small enough to fit inside a cabinet.

The following pages show installing a gas-fired condensing tankless water heater, which is more efficient than non-condensing units. It requires running two PVC vent pipes out the wall or roof. You can also purchase an electric unit, which requires connecting to 240-amp electrical service box. An electric unit does not need to be vented outside.

This is a pretty ambitious project but within reach of a do-it-yourselfer with good plumbing skills. Consult with your local building department and get a permit before starting work. You will likely need to have the project inspected.

Tools & Materials ▸

- Tankless water heater with thermostat
- Drill with screwdriver bit and hole saw
- Channel-type pliers
- Pipe wrench
- Tubing cutter
- Saw for cutting PVC pipe
- Propane torch
- Level
- Electrical tools
- Pipe straps
- Screws
- PVC pipe
- PVC primer and cement
- Vent termination kit or roof jack with flashing
- Copper supply pipe
- Solder and flux
- Black gas pipe with pipe dope
- Shutoff valves for water and gas

Select a suitable location, perhaps right where the old tank unit was. It should be near the main cold-water supply pipe and a hot-water pipe leading to the house's faucets and appliances. You will need to run a gas line, and also run vent pipes out the wall or up through the roof. If there is no nearby electrical receptacle, plan to install one.

A tankless water heater can be installed near the old water heater's location to minimize new water and gas pipe runs. It takes up far less space than a standard tank heater. The unit shown on the following pages is a gas-fired condensing unit, which requires two vent pipes; non-condensing units have only one vent pipe. Vent pipes run outside the house at a downward slope. There are connections and valves for a gas supply, a cold-water supply, and a hot-water line to the house, and the unit can simply be plugged into a 120-volt electrical receptacle.

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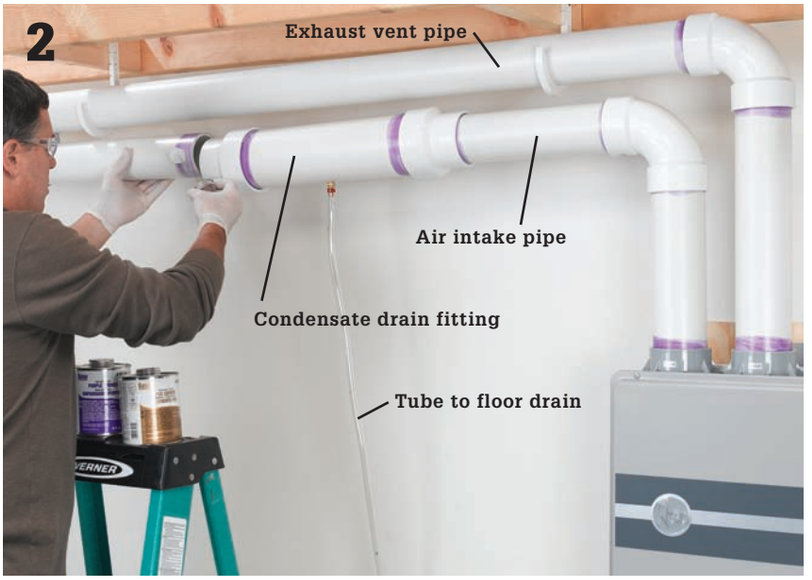
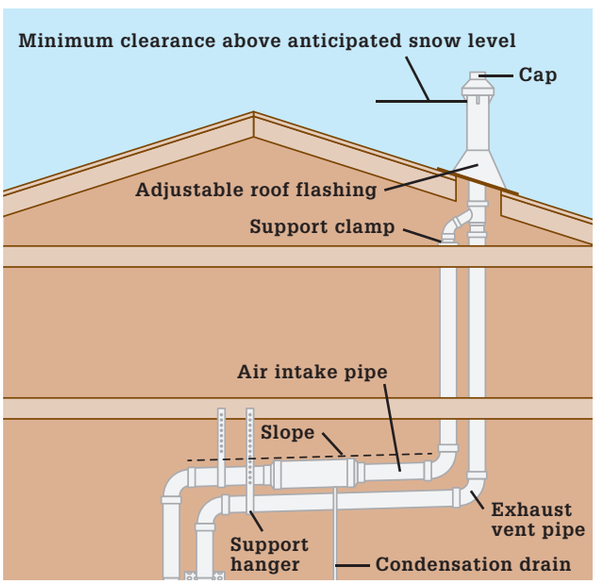
How to Install a Tankless Water Heater

Position the water heater away from combustible materials and where it can be easily accessed for servicing. Mount the unit securely to a wall using the brackets provided, driving screws into studs. If the wall is masonry, use masonry screws or lag screws with shields.



Plan the path for the exhaust vent pipe and the air intake pipes, which must exit the house at a code-approved location (if the exit location is a house wall, the distance from windows and eaves must meet code requirements). Cut PVC pipe and assemble with fittings, using primer and cement. On the air intake pipe, install a condensate drain fitting at a convenient point for running the drain tube to a floor drain.

Run the pipes out of the house. Make sure all horizontally run pipes slope slightly downward, and support pipes with straps. Using the parts from a "termination kit," cut two holes for the pipes, slip on interior flanges, and run the pipes through the flanges and out the wall. On the outside, attach a termination cap with screws, and caulk the edges.



If venting out a wall is not feasible, you may need to run the pipes up and out the roof. In this case, all horizontal runs should be sloped upward, so condensed water runs back into the water heater. In the attic, join the two pipes together with a Y-fitting. Run the pipe out the roof, slip on adjustable roof flashing, cut the pipe to the approved height above the roof, and add an approved cap to the top of the pipe.

(continued)

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Pro-Vision C M Y K (Text) (Ray)
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:51

Hook up the cold-water connections. If your house has copper piping, do not use heat to sweat pipes or fittings that are connected to the tankless heater, or you could damage internal parts. Buy the service valve kit made for your unit. Install a cold-water shutoff valve prior to the connection parts. Connect the cold-water parts. Allow them to cool (if you sweated copper), then connect to the unit's valve.

Turn on the valves to run cold water briefly through the unit, to be sure water flows freely. Close the unit's shutoff valve, then remove and clean the water heater's internal filter (inset). If there is a good deal of debris, repeat this process until the debris is gone.

Connect the other parts of the service valve kit. This includes another valve for the hot water, as well as a relief valve. Extend the relief valve's pipe down to a point near where it can run to a floor drain. Also run a drain tube from the unit to a floor drain or utility sink.

Connect to the house's hot-water line. Provide for a drain valve as shown, so you can drain the tank for service. As with the cold-water line (step 4), if the pipes are copper, do not heat any pipes or fittings while they are connected to the heater.

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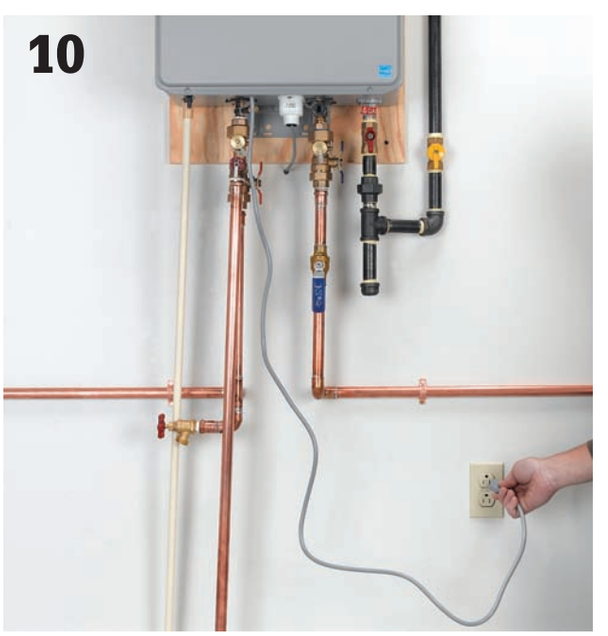
Pro-Vision C M Y K (Text) (Ray)
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:52

Hook up the gas connection. Working with black gas pipe, install a gas shutoff valve just below the unit, then install a union so you can easily disconnect the pipes for servicing. Connect the other pipes as shown; make sure to include a vertical drip nipple (to trap sediment). Turn on the gas, and test with leak detector solution to make sure there are no leaks.

Connect the thermostat. Connect two-wire thermostat cable to the unit (inset), and run it to a convenient location for controlling the water heater. Attach the thermostat's plate to the wall and run the cable through it. Attach the wires to the back of the thermostat's cover, and snap on the cover.



Test the water heater. Turn on the water supply and plug the unit into an electrical receptacle. Make sure you know which circuit breaker controls the water heater. When there is a demand for hot water (from a faucet or appliance), the water heater will turn on automatically and an electric spark will ignite the gas.

Program the thermostat. Turn off the gas and water to the water heater by closing the shutoff valves, and follow the manufacturer's instructions for setting the water temperature. Turning the temperature down will save energy costs, but a minimum temperature of 85°F is recommended to keep water safe from bacteria.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:53

Bathroom Faucets

One-piece faucets, with either one or two handles, are the most popular fixtures for bathroom installations.

"Widespread" faucets with separate spout and handles are being installed with increasing frequency, however. Because the handles are connected to the spout with flex tubes that can be 18" or longer, widespread faucets can be arranged in many ways.

Tools & Materials ▸

- Hacksaw or tin snips
- Channel-type pliers
- Pliers
- Basin wrench
- Adjustable wrench
- Screwdriver
- Plumber's putty
- Teflon tape
- Faucet kit
- Pipe joint compound
- Flexible supply tubes
- Heat-proof grease
- Loctite basin

Bathroom sink faucets come in two basic styles: the widespread with independent handles and spout (top); and the single-body, deck-mounted version (bottom).

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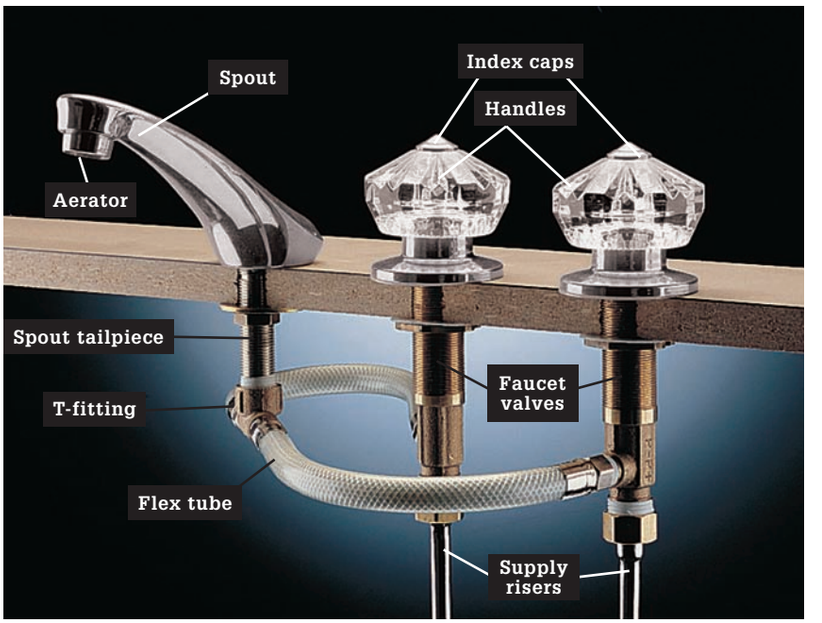
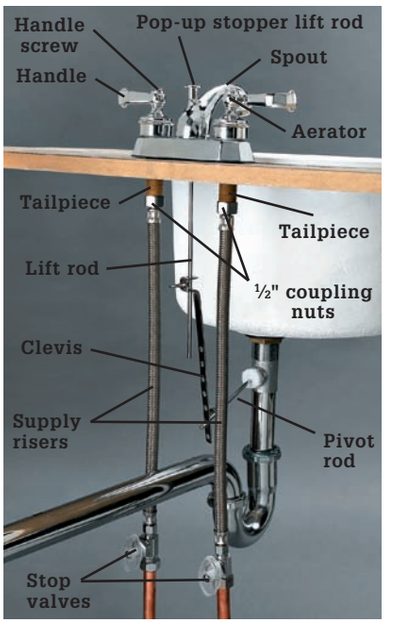
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:54

Bathroom Faucet & Drain Hookups

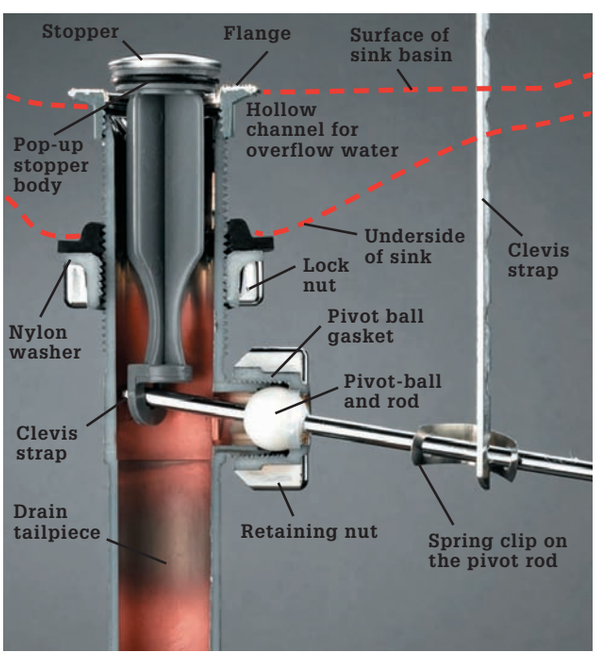


Widespread lavatory faucets have valves that are independent from the spout so they can be configured however you choose, provided that your flex tube connectors are long enough to span the distance.



Single-body lavatory faucets have both valves and the spout permanently affixed to the faucet body. They do not offer flexibility in configurations, but they are very simple to install.

The pop-up stopper fits into the drain opening so the stopper will close tightly against the drain flange when the pop-up handle is lifted up.



The linkage that connects the pop-up stopper to the pop-up handle fits into a male-threaded port in the drain tailpiece. Occasionally the linkage will require adjustment or replacement.

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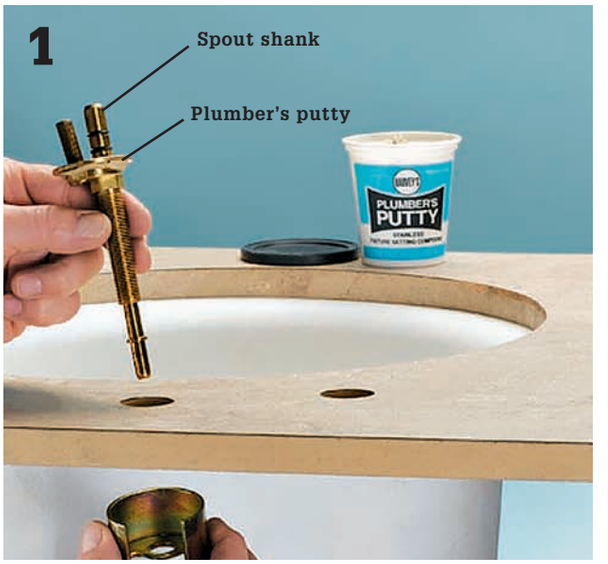
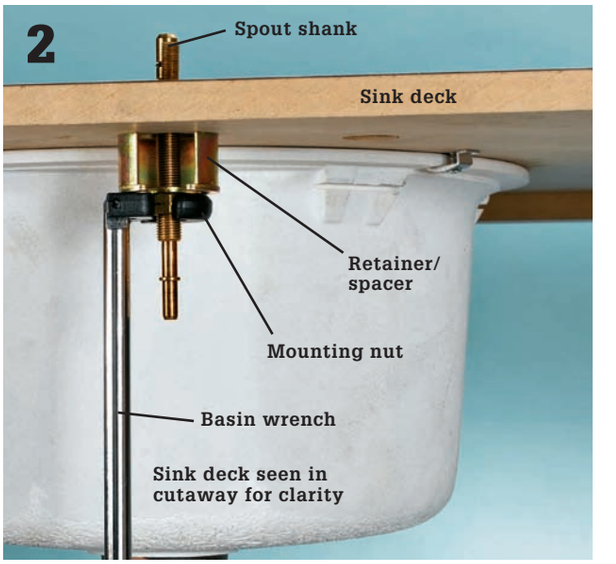
#175 Dtp:225 Page:55

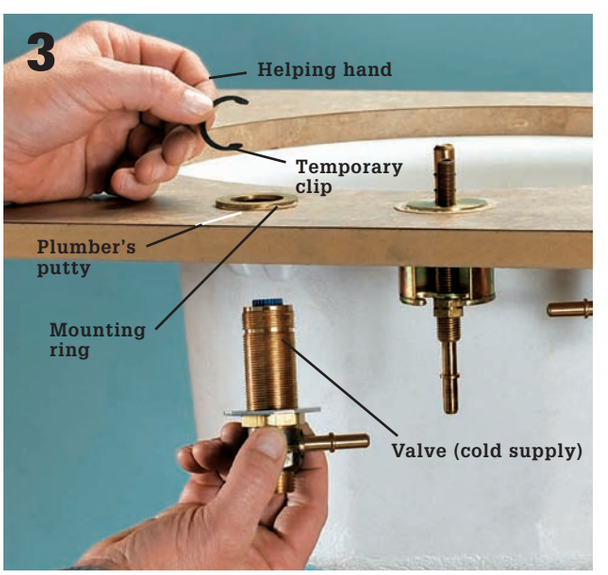
How to Install a Widespread Faucet



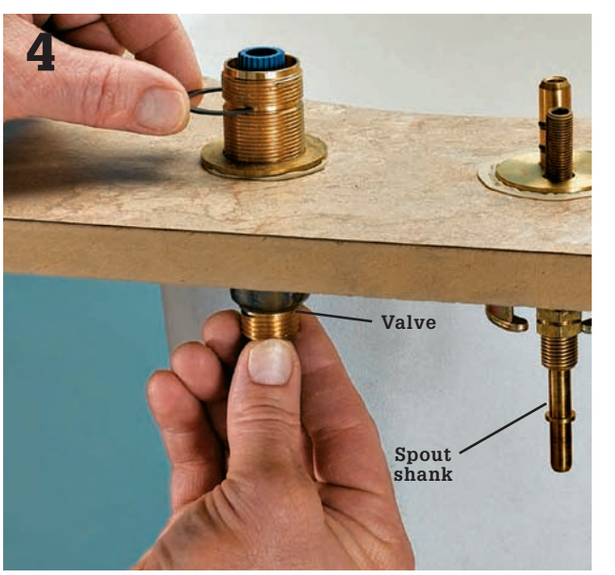
Insert the shank of the faucet spout through one of the holes in the sink deck (usually the center hole, but you can offset it in one of the end holes if you prefer). If the faucet is not equipped with seals or O-rings for the spout and handles, pack plumber's putty on the undersides before inserting the valves into the deck. *Note: If you are installing the widespread faucet in a new sink deck, drill three holes of the size suggested by the faucet manufacturer.*



In addition to mounting nuts, many spout valves for widespread faucets have an open-retainer fitting that goes between the underside of the deck and the mounting nut. Others have only a mounting nut. In either case, tighten the mounting nut with pliers or a basin wrench to secure the spout valve. You may need a helper to keep the spout centered and facing forward.



Mount the valves to the deck using whichever method the manufacturer specifies (it varies quite a bit). In the model seen here, a mounting ring is positioned over the deck hole (with plumber's putty seal) and the valve is inserted from below. A clip snaps onto the valve from above to hold it in place temporarily (you'll want a helper for this).



From below, thread the mounting nuts that secure the valves to the sink deck. Make sure the cold water valve (usually has a blue cartridge inside) is in the right-side hole (from the front) and the hot water valve (red cartridge) is in the left hole. Install both valves.

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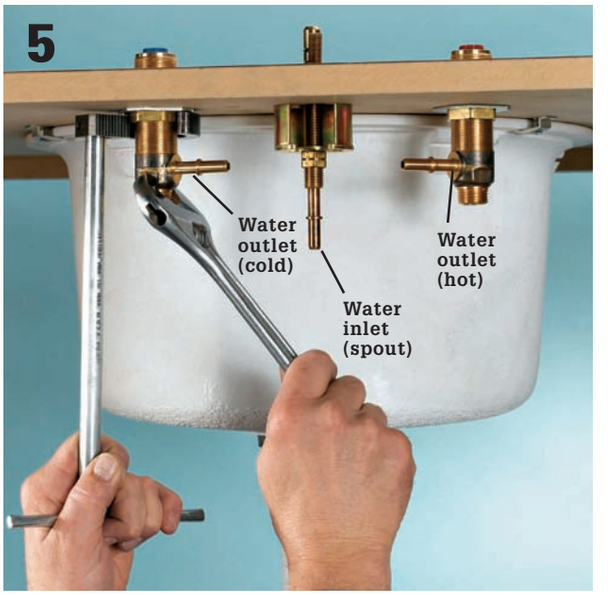
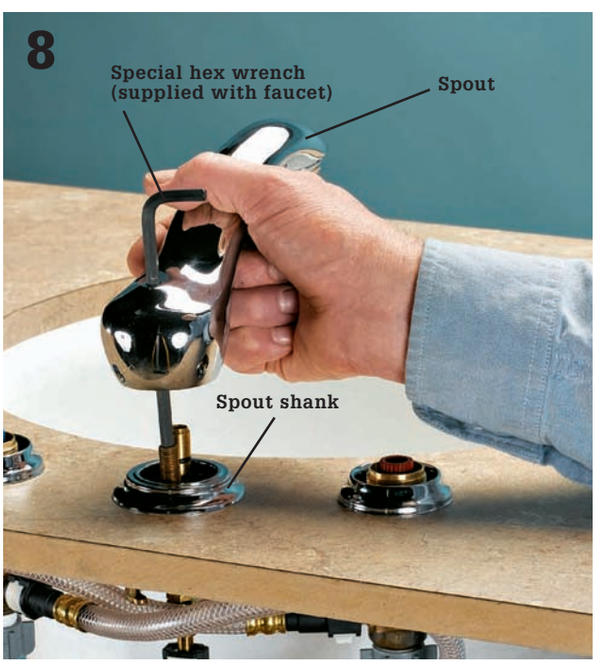
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:56



Once you've started the nut on the threaded valve shank, secure the valve with a basin wrench, squeezing the lugs where the valve fits against the deck. Use an adjustable wrench to finish tightening the lock nut onto the valve. The valves should be oriented so the water outlets are aimed at the inlet on the spout shank.

Attach the flexible supply tubes (supplied with the faucet) to the water outlets on the valves. Some twist onto the outlets, but others (like the ones above) click into place. The supply hoses meet in a T-fitting that is attached to the water inlet on the spout.

Attach flexible braided-metal supply risers to the water stop valves and then attach the tubes to the inlet port on each valve (usually with Teflon tape and a twist-on fitting at the valve end of the supply riser).



Attach the spout. The model shown here comes with a special hex wrench that is threaded through the hole in the spout where the lift rod for the pop-up drain will be located. Once the spout is seated cleanly on the spout shank, you tighten the hex wrench to secure the spout. Different faucets will use other methods to secure the spout to the shank.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:57

If your sink did not have a pop-up stopper, you'll need to replace the sink drain tailpiece with a pop-up stopper body (often supplied with the faucet). See page 60. Insert the lift rod through the hole in the back of the spout and, from below, thread the pivot rod through the housing for the clevis screw.

Attach the clevis strap to the pivot rod that enters the pop-up drain body, and adjust the position of the strap so it raises and lowers properly when the lift rod is pulled up. Tighten the clevis screw at this point. It's hard to fit a screwdriver in here, so you may need to use a wrench or pliers.

Attach the faucet handles to the valves using whichever method is required by the faucet manufacturer. Most faucets are designed with registration methods to ensure that the handles are symmetrical and oriented in an ergonomic way once you secure them to the valves.

Turn on the water supply and test the faucet. Remove the faucet aerator and run the water for 10 to 20 seconds so any debris in the lines can clear the spout. Replace the aerator.

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Pro-Vision C M Y K (Text) (Ray)
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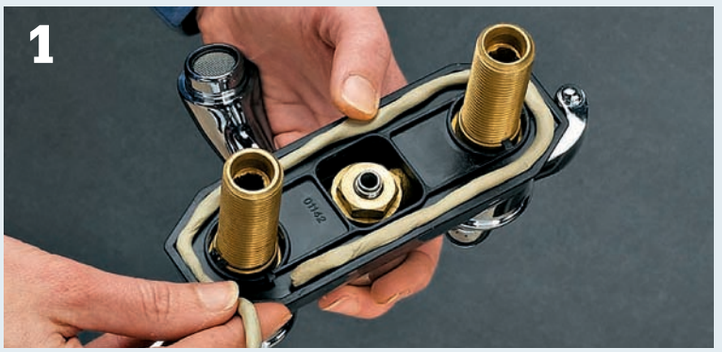
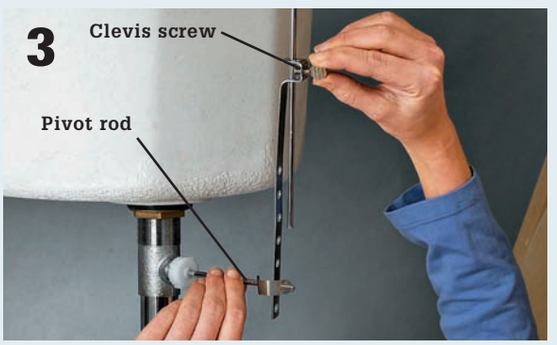
Variation: How to Install a Single-body Faucet ▸



High-quality faucets come with flexible plastic gaskets that create a durable watertight seal at the bottom of the faucet, where it meets the sink deck. However, an inexpensive faucet may have a flimsy-looking foam seal that doesn't do a good job of sealing and disintegrates after a few years. If that is the case with your faucet, discard the seal and press a ring of plumber's putty into the sealant groove on the underside of the faucet body.

Insert the faucet tailpieces through the holes in the sink. From below, thread washers and mounting nuts over the tailpieces, then tighten the mounting nuts with a basin wrench until snug. Put a dab of pipe joint compound on the threads of the stop valves and thread the metal nuts of the flexible supply risers to these. Wrench tighten about a half-turn past hand tight. Overtightening these nuts will strip the threads. Now tighten the coupling nuts to the faucet tailpieces with a basin wrench.



Slide the lift rod of the new faucet into its hole behind the spout. Thread it into the clevis past the clevis screw. Push the pivot rod all the way down so the stopper is open. With the lift rod also all the way down, tighten the clevis to the lift rod.

Grease the fluted valve stems with faucet grease, then put the handles in place. Tighten the handle screws firmly, so they won't come loose during operation. Cover each handle screw with the appropriate index cap—Hot or Cold.

Unscrew the aerator from the end of the spout. Turn the hot and cold water taps on full. Turn the water back on at the stop valves and flush out the faucet for a couple of minutes before turning off the water at the faucet. Check the riser connections for drips. Tighten a compression nut only until the drip stops.

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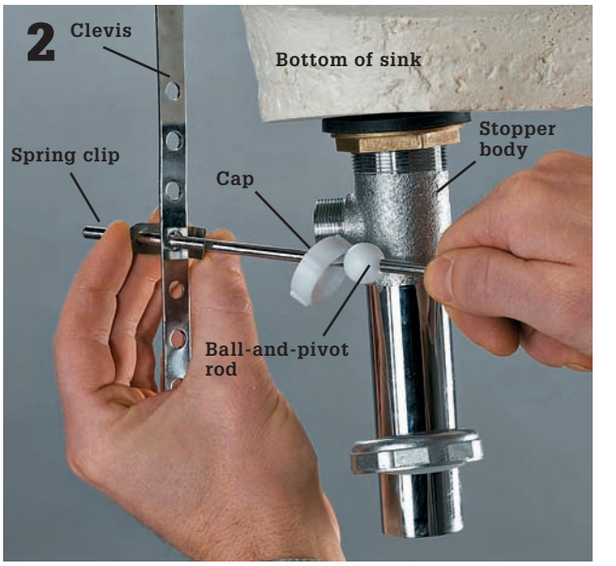
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:59

How to Install a Pop-up Drain

Put a basin under the trap to catch water. Loosen the nuts at the outlet and inlet to the trap J-bend by hand or with channel-type pliers and remove the bend. The trap will slide off the pop-up body tailpiece when the nuts are loose. Keep track of washers and nuts and their up/down orientation by leaving them on the tubes.



Unscrew the cap holding the ball-and-pivot rod in the pop-up body and withdraw the ball. Compress the spring clip on the clevis and withdraw the pivot rod from the clevis.

Remove the pop-up stopper. Then, from below, remove the lock nut on the stopper body. If needed, keep the flange from turning by inserting a large screwdriver in the drain from the top. Thrust the stopper body up through the hole to free the flange from the basin, and then remove the flange and the stopper body.

Clean the drain opening above and below, and then thread the locknut all the way down the new pop-up body, followed by the flat washer and the rubber gasket (beveled side up). Wrap three layers of Teflon tape clockwise onto the top of the threaded body. Make a ½"-dia. snake from plumber's putty, form it into a ring, and stick the ring underneath the drain flange.

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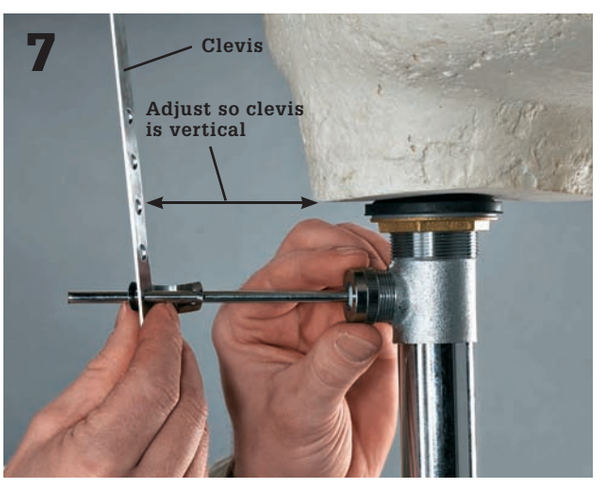
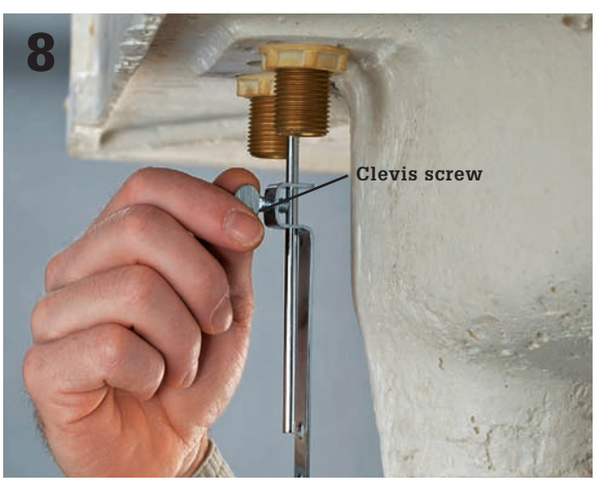
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:60

From below, face the pivot rod opening directly back toward the middle of the faucet and pull the body straight down to seat the flange. Thread the locknut/washer assembly up under the sink, then fully tighten the locknut with channel-type pliers. Do not twist the flange in the process, as this can break the putty seal. Clean off the squeezeout of plumber's putty from around the flange.

Drop the pop-up stopper into the drain hole so the hole at the bottom of its post is closest to the back of the sink. Put the beveled nylon washer into the opening in the back of the pop-up body with the bevel facing back.



Put the cap behind the ball on the pivot rod as shown. Sandwich a hole in the clevis with the spring clip and thread the long end of the pivot rod through the clip and clevis. Put the ball end of the pivot rod into the pop-up body opening and into the hole in the the stopper stem. Screw the cap on to the pop-up body over the ball.



Loosen the clevis screw holding the clevis to the lift rod. Push the pivot rod all the way down (which fully opens the pop-up stopper). With the lift rod also all the way down, tighten the clevis screw to the rod. If the clevis runs into the top of the trap, cut it short with your hacksaw or tin snips. Reassemble the J-bend trap.

Always Test Drain for Leaks

To make sure the sink will not leak, do a thorough test. Close the stopper and turn on the faucet to fill the bowl. Once full, open the stopper and look carefully beneath the sink. Feel the trap parts; they should be dry. If there is any indication of moisture, tighten trap parts as needed.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:61

Shower Kits

The fastest and easiest way to create a new shower in your bathroom is to frame in the stall area with lumber and drywall and then install a shower enclosure kit. Typically consisting of three fiberglass or plastic walls, these enclosure kits snap together at the corners and nestle inside the flanges of the shower pan (also called the receptor) to create nearly foolproof mechanical seals. Often, the walls are formed with shelves, soap holders, and other conveniences.

If you are on a tight budget, you can find extremely inexpensive enclosure kits to keep costs down. You can even create your own custom enclosure using waterproof beadboard panels and snap-together connectors. Or, you can invest in a higher grade kit made from thicker material that will last much longer. Some kits are sold with the receptor (and perhaps even the door) included. The kit shown here is designed to be attached directly to wall studs, but others require a backer wall for support. The panels are attached to the backer with high-tack panel adhesive.

Tools & Materials

- Tape measure
- Pencil
- Hammer
- Carpenter's square
- Screwdrivers
- Pipe wrench
- Level
- Strap wrench
- Adjustable wrench
- Pliers
- Drill/driver
- Center punch
- File
- Utility knife
- Hacksaw
- Masking tape
- Silicone caulk and caulk gun
- Shower enclosure kit
- Pan (receptor)
- Shower door
- Showerhead
- Faucet
- Plumbing supplies
- Panel adhesive
- Spud wrench
- Large-head roofing nails
- Jigsaw
- Duct tape
- Miter box

A paneled shower surround is inexpensive and easy to install. Designed for alcove installations, they often are sold with matching shower pans (called receptors).

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:62

How to Install a Shower Enclosure

Mark out the location of the shower, including any new walls, on the floor and walls. Most kits can be installed over wallboard, but you can usually achieve a more professional looking wall finish if you remove the wallcovering and floor covering in the installation area. Dispose of the materials immediately and thoroughly clean the area.

If you are adding a wall to create the alcove, lay out the locations for the studs and plumbing on the new wood sill plate. Also lay out the stud locations on the cap plate that will be attached to the ceiling. Refer to the enclosure kit instructions for exact locations and dimensions of studs. Attach the sill plate to the floor with deck screws and panel adhesive, making sure it is square to the back wall and the correct distance from the side wall.

Align a straight 2 × 4 right next to the sill plate and make a mark on the ceiling. Use a level to extend that line directly above the sill plate. Attach the cap plate at that point.

Install the 2 × 4 studs at the outlined locations. Check with a level to make sure each stud is plumb, and then attach them by driving deck screws toenail style into the sill plate and cap plate.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:63

Cut an access hole in the floor for the drain, according to the installation manual instructions. Drill openings in the sill plate of the wet wall (the new wall in this project) for the supply pipes, also according to the instructions.

Install a drain pipe and branch line and then trim the drain pipe flush with the floor. If you are not experienced with plumbing, hire a plumber to install the new drain line.

Install new supply risers as directed in the instruction manual (again, have a plumber do this if necessary). Also install cross braces between the studs in the wet wall for mounting the faucet body and shower arm.

If the supply plumbing is located in a wall (old or new) that is accessible from the non-shower side, install framing for a removable access panel.

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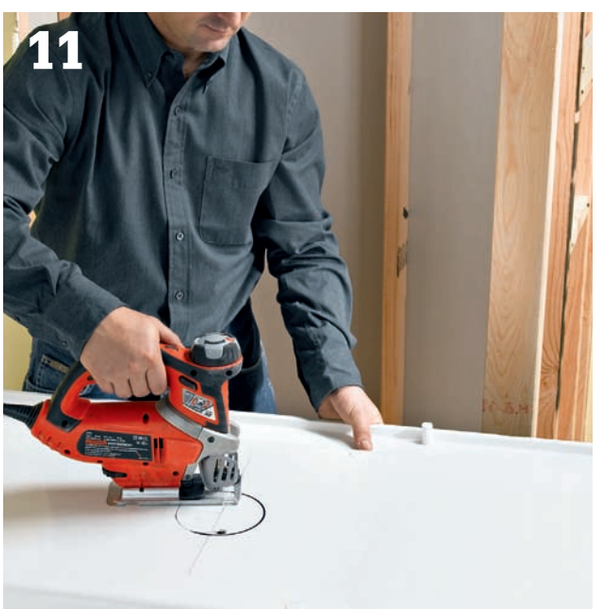
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:64

Attach the drain tailpiece that came with your receptor to the underside of the unit, following the manufacturer's instructions precisely. Here, an adjustable spud wrench is being used to tighten the tailpiece.

Option: To stabilize the receptor, especially if the floor is uneven, pour or trowel a layer of thinset mortar into the installation area, taking care to keep the mortar out of the drain access hole. Do not apply mortar in areas where the receptor has feet that are intended to make full contact with the floor.

Set the receptor in place, check to make sure it is level, and shim it if necessary. Secure the receptor with large-head roofing nails driven into the wall stud so the heads pin the flange against the stud. Do not overdrive the nails.



Lay out the locations for the valve hole or holes in the end wall panel that will be installed on the wet wall. Check your installation instructions. Some kits come with a template marked on the packaging carton. Cut the access hole with a hole saw and drill or with a jigsaw and fine-tooth blade. If using a jigsaw, orient the panel so the good surface is facing down.

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Pro-Vision C M Y K (Text) (Ray)
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:65

Position the back wall so there is a slight gap (about 1⁄32") between the bottom of the panel and the rim of the receptor—set a few small spacers on the rim if need be. Tack a pair of roofing nails above the top of the back panel to hold it in place (or, use duct tape). Position both end walls and test the fits. Make clip connections between panels (inset) if your kit uses them.

Remove the end wall so you can prepare the installation area for them. If your kit recommends panel adhesive, apply it to the wall or studs. In the kit shown here, only a small bead of silicone sealant on the receptor flange is required.

Reinstall the end panels, permanently clipping them to the back panel according to the kit manufacturer's instructions. Make sure the front edges of the end panels are flush with the front of the receptor.

Once the panels are positioned correctly and snapped together, fasten them to the wall studs. If the panels have predrilled nail holes, drive roofing nails through them at each stud at the panel tops and every 4" to 6" along vertical surfaces.

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Pro-Vision C M Y K (Text) (Ray)
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:66

Install wallcovering material above the enclosure panels and anywhere else it is needed. Use moisture-resistant materials, and maintain a gap of ¼" between the shoulders of the top panel flanges and the wallcovering.

Finish the walls and then caulk between the enclosure panels and the wallcoverings with tub and tile caulk.

Install the faucet handles and escutcheon and caulk around the escutcheon plate. Install the shower arm escutcheon and showerhead.

You can make an access panel out of plywood framed with mitered case molding, or buy a ready-made plumbing panel. Attach the panel to the opening created in step 8.

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Pro-Vision C M Y K (Text) (Ray)
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:67

How to Install a Hinged Shower Door

Measure the width of the shower opening. If the walls of the shower slope inward slightly before meeting the base, take your measurement from a higher point at the full width of the opening so you don't cut the door base too short. Cut the base piece to fit using a hacksaw and a miter box. File the cut ends if necessary to deburr them.

Identify which side jamb will be the hinge jamb and which will be the strike jamb according to the direction you want your hinged door to swing—an outward swing is preferred. Prepare the jambs for installation as directed in your instructions.

Place the base jamb on the curb of the shower base. If the joint where the wall meets the curb is sloped, you'll need to trim the corners of the base piece to follow the profile. Place a jamb carefully onto the base and plumb it with a level. Then, mark a drilling point by tapping a centerpunch in the middle of each nail hole in each jamb. Remove the jambs, drill pilot holes, and then attach the jambs with the provided screws.

Remove the bottom track and prepare the shower base curb for installation of the base track, following the manufacturer's directions. Permanently install the bottom track. Bottom tracks (not all doors have them) are usually attached to the side jambs or held in place with adhesive. Never use fasteners to secure them to curb.

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Pro-Vision C M Y K (Text) (Ray)
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:68

Working on the floor or another flat surface, attach the door hinge to the hinge jamb, if required. In most systems, the hinge is fitted over the hinge jamb after you attach it to the wall.

Attach the hinge to the door panel, according to the manufacturer's instructions. Attach any cap fitting that keeps water out of the jamb.

Fit the hinge jamb over the side jamb and adjust it as directed in your instruction manual. Once the clearances are correct, fasten the jambs to hang the door.

Install the magnetic strike plate and any remaining caps or accessories such as towel rods. Also attach the sweep that seals the passage, if provided.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:69

Custom Shower Bases

Building a custom-tiled shower base lets you choose the shape and size of your shower rather than having its dimensions dictated by available products. Building the base is quite simple, though it does require time and some knowledge of basic masonry techniques because the base is formed primarily using mortar. What you get for your time and trouble can be spectacular.

Before designing a shower base, contact your local building department regarding code restrictions and to secure the necessary permits. Most codes require water controls to be accessible from outside the shower and describe acceptable door positions and operation. Requirements like these influence the size and position of the base.

Choosing the tile before finalizing the design lets you size the base to require mostly or only full tiles. Consider using small tile and gradate the color from top to bottom or in a sweep across the walls. Or, use trim tile and listellos on the walls to create an interesting focal point.

Whatever tile you choose, remember to seal the grout in your new shower and to maintain it carefully over the years. Water-resistant grout protects the structure of the shower and prolongs its useful life.

Tools & Materials ▸

- Tape measure
- Circular saw
- Hammer
- Utility knife
- Stapler
- 2-ft. level
- Mortar mixing box
- Trowel
- Wood float
- Felt-tip marker
- Ratchet wrench
- Expandable stopper
- Drill
- Tin snips
- Torpedo level
- Tools & materials for installing tile
- 2 × 4 and 2 × 10 framing lumber
- Thinset mortar
- 16d galvanized common nails
- 15# building paper
- 3-piece shower drain
- PVC primer & cement
- Galvanized finish nails
- Galvanized metal lath
- Thick-bed floor mortar
- Latex mortar additive
- CPE waterproof membrane & preformed dam corners
- CPE membrane solvent glue
- CPE membrane sealant
- Cementboard & materials
- Utility knife
- Straightedge

Making a custom shower base gives you many options for the shape and size of your shower.

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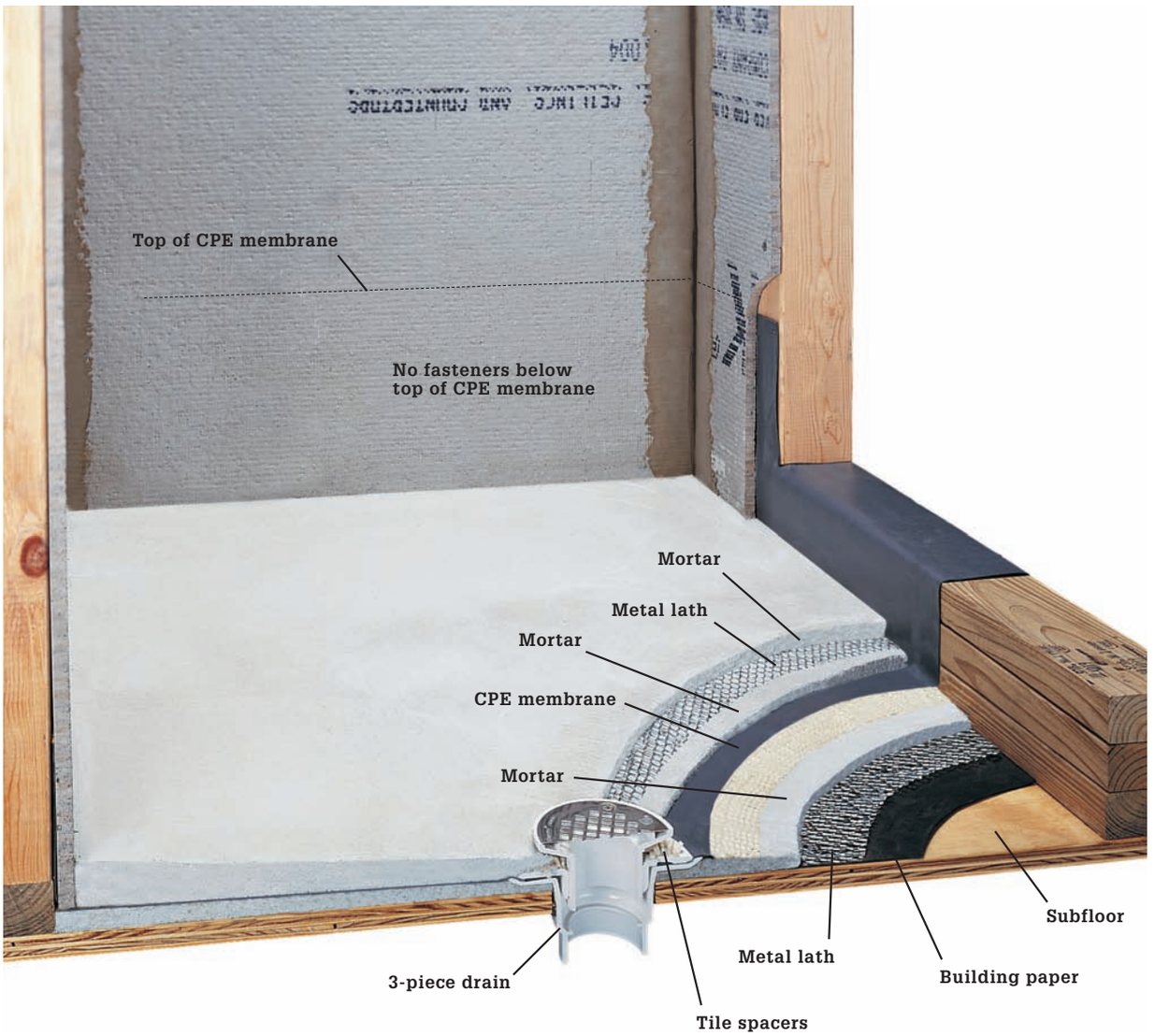
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:70

Cross-Section of a Shower Pan



A custom shower pan is a fairly intricate, multi-layed construction, but choosing to build one gives you the ultimate design flexibility.

Tips for Building a Custom Shower Base ▸

A custom-tiled shower base is built in three layers to ensure proper water drainage: the pre-pan, the shower pan, and the shower floor. A mortar pre-pan is first built on top of the subfloor, establishing a slope toward the drain of ¼" for every 12" of shower floor. Next, a waterproof chlorinated polyethylene (CPE) membrane forms the shower pan, providing a watertight seal for the shower base. Finally, a second mortar bed reinforced with wire mesh is installed for the shower floor, providing a surface for tile installation. If water penetrates the tiled shower floor, the shower pan and sloped pre-pan will direct it to the weep holes of the 3-piece drain.

One of the most important steps in building a custom-tiled shower base is testing the shower pan after the CPE membrane has been installed. This allows you to locate and fix any leaks to prevent costly damage.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:71

How to Build a Custom-tiled Shower Base

Remove building materials to expose subfloor and stud walls. Cut three 2 × 4s for the curb and fasten them to the floor joists and the studs at the shower threshold with 16d galvanized common nails. Also cut 2 × 10 lumber to size and install in the stud bays around the perimeter of the shower base. Install (or have installed) drain and supply plumbing.

Staple 15# building paper to the subfloor of the shower base. Disassemble the 3-piece shower drain and glue the bottom piece to the drain pipe with PVC cement. Partially screw the drain bolts into the drain piece, and stuff a rag into the drain pipe to prevent mortar from falling into the drain.

Mark the height of the bottom drain piece on the wall farthest from the center of the drain. Measure from the center of the drain straight across to that wall, then raise the height mark ¼" for every 12" of shower floor to slope the pre pan toward the drain. Trace a reference line at the height mark around the perimeter of the entire alcove, using a level.

Staple galvanized metal lath over the building paper; cut a hole in the lath ½" from the drain. Mix thinset mortar to a fairly dry consistency, using a latex additive for strength; mortar should hold its shape when squeezed (inset). Trowel the mortar onto the subfloor, building the pre-pan from the flange of the drain piece to the height line on the perimeter of the walls.

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Pro-Vision C M Y K (Text) (Ray)
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:72

Continue using the trowel to form the pre-pan, checking the slope using a level and filling any low spots with mortar. Finish the surface of the pre-pan with a wood float until it is even and smooth. Allow the mortar to cure overnight.

Measure the dimensions of the shower floor, and mark it out on a sheet of CPE waterproof membrane, using a felt-tipped marker (be sure to use a high-quality CPE shower liner; less-expensive PVC liners become brittle in time and can develop leaks). From the floor outline, measure out and mark an additional 8" for each wall and 16" for the curb end. Cut the membrane to size, using a utility knife and straightedge. Be careful to cut on a clean, smooth surface to prevent puncturing the membrane. Lay the membrane onto the shower pan.

Measure to find the exact location of the drain and mark it on the membrane, outlining the outer diameter of the drain flange. Cut a circular piece of CPE membrane roughly 2" larger than the drain flange, then use CPE membrane solvent glue to weld it into place and reinforce the seal at the drain.

Apply CPE sealant around the drain. Fold the membrane along the floor outline. Set the membrane over the pre-pan so the reinforced drain seal is centered over the drain bolts. Working from the drain to the walls, carefully tuck the membrane tight into each corner, folding the extra material into triangular flaps.

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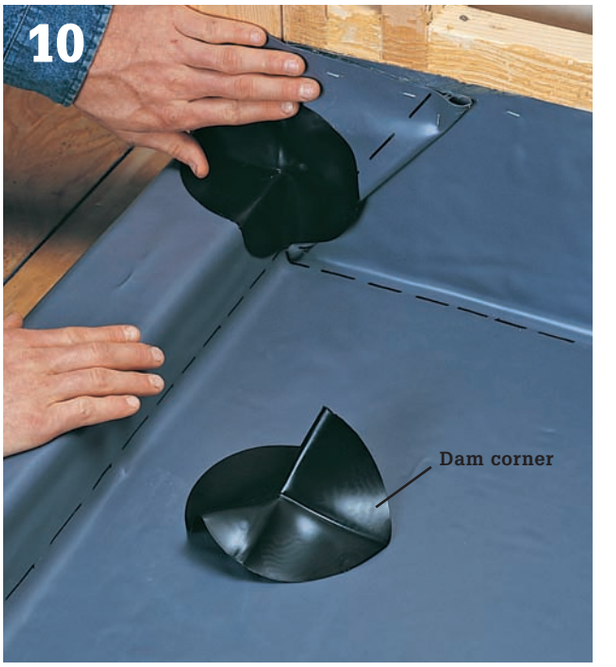
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:73

Apply CPE solvent glue to one side, press the flap flat, then staple it in place. Staple only the top edge of the membrane to the blocking; do not staple below the top of the curb, or on the curb itself.



At the shower curb, cut the membrane along the studs so it can be folded over the curb. Solvent glue a dam corner at each inside corner of the curb. Do not fasten the dam corners with staples.

At the reinforced drain seal on the membrane, locate and mark the drain bolts. Press the membrane down around the bolts, then use a utility knife to carefully cut a slit just large enough for the bolts to poke through. Push the membrane down over the bolts.

Use a utility knife to carefully cut away only enough of the membrane to expose the drain and allow the middle drain piece to fit in place. Remove the drain bolts, then position the middle drain piece over the bolt holes. Reinstall the bolts, tightening them evenly and firmly to create a watertight seal.

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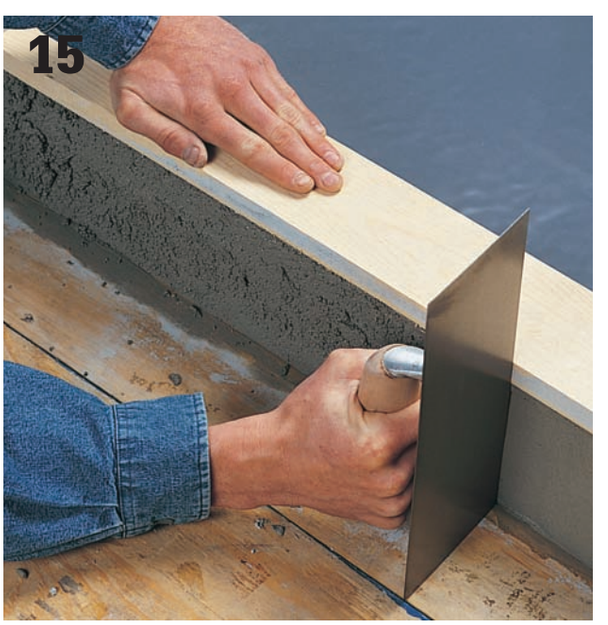
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:74

Test the shower pan for leaks overnight. Plug the drain and fill the shower pan with water, to 1" below the top of the curb. Mark the water level and let the water sit overnight. If the water level remains the same, the pan holds water. If the level is lower, locate and fix leaks in the pan using patches of membrane and CPE solvent.

Install cementboard on the alcove walls, using ¼" wood shims to lift the bottom edge off the CPE membrane. To prevent puncturing the membrane, do not use fasteners in the lower 8" of the cementboard. Cut a piece of metal lath to fit around the three sides of the curb. Bend the lath so it tightly conforms to the curb. Pressing the lath against the top of the curb, staple it to the outside face of the curb. Mix enough mortar for the two sides of the curb.



Apply thinset mortar to the edges of the curb, using a straight board as a guide. When the mortar has set, remove the board and apply thinset to the top of the curb.

Attach the drain strainer piece to the drain, adjusting it to a minimum of 1½" above the shower pan. On one wall, mark 1½" up from the shower pan, then use a level to draw a reference line around the perimeter of the shower base. Because the pre-pan establishes the ¼" per foot slope, this measurement will maintain that slope.

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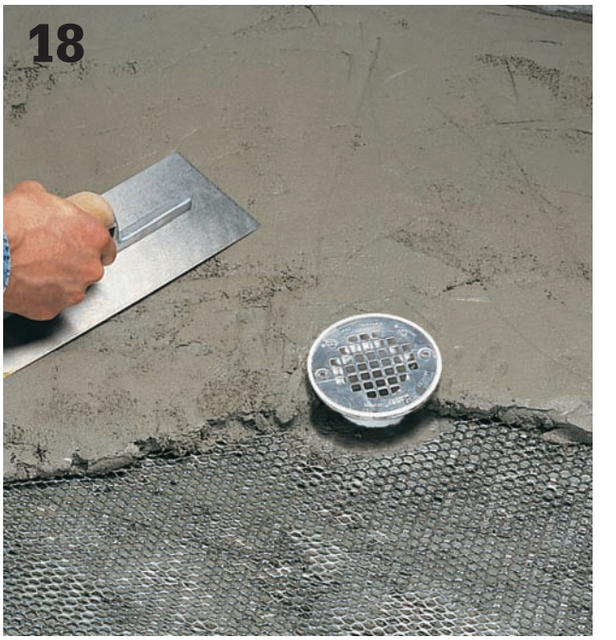
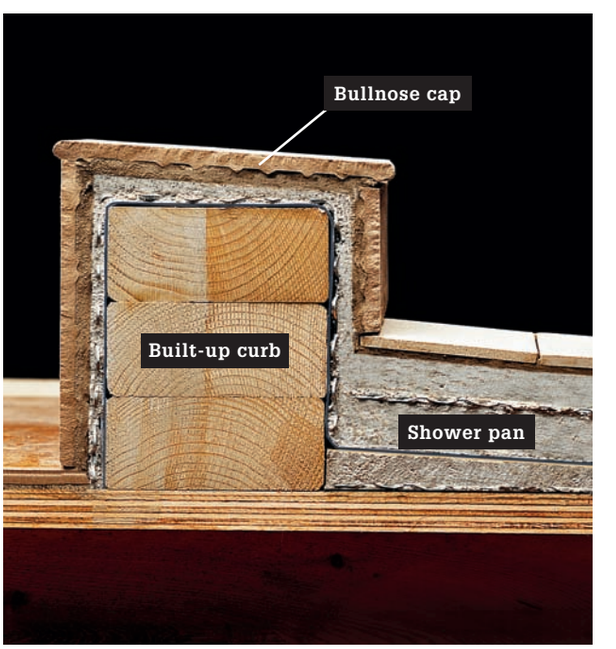
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:75

Spread tile spacers over the weep holes of the drain to prevent mortar from plugging the holes. Mix the floor mortar, then build up the shower floor to roughly half the planned thickness of this layer. Cut metal lath to cover the mortar bed, keeping it ½" from the drain (see photo in step 18).



Continue to add mortar, building the floor to the reference line on the walls. Use a level to check the slope, and pack mortar into low spots with a trowel. Leave space around the drain flange for the thickness of the tile. Float the surface until it is smooth and slopes evenly to the drain. When finished, allow the mortar to cure overnight before installing the tiles.

Install the tile. At the curb, cut the tiles for the inside to protrude ½" above the unfinished top of the curb, and the tiles for the outside to protrude ⅝" above the top, establishing a ⅛" slope so water drains back into the shower. Use a level to check the tops of the tiles for level as you work.



Option: Apply bullnose cap tiles to the top of the curb, sloping them toward the shower slightly. Make sure cap tiles overhang wall tiles.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:76

Design Suggestions

Textured surfaces improve the safety of tile floors, especially in wet areas such as this open shower. The shower area is designated effectively by a simple shift in color and size.

The raised curb on this open shower keeps most of the water headed toward the drain. But no matter, the entire bathroom is tiled, so stray droplets are no problem.

Mosaic tile, with its mesh backing and small shapes, often works well on curved walls such as the one that forms this shower. The rectangular shape of the individual mosaic tiles complements the shape of the post at the corner of the shower.

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Pro-Vision C M Y K (Text) (Ray)
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:77

Alcove Bathtubs

Most of our homes are equipped with an alcove tub (usually 60 inches long) that includes a tub surround and shower function. By combining the tub and the shower in one fixture, you conserve precious bathroom floorspace and simplify the initial installation. Plus, you only have one bathing fixture that needs cleaning.

But because tub/showers are so efficient, they do get a lot of use and tend to have fairly limited lifespans. Pressed steel tubs have enamel finishes that crack and craze; plastic and fiberglass tubs get grimy and stained; even acrylic and composite tubs show wear eventually (and as with other fixtures, styles, and colors change too). Fortunately, today's acrylic and fiberglass tubs have more durable finishes than those made a decade or two ago.

If you are not completely remodeling the bathroom, plan to make the new tub fit with its surroundings. For instance, if you have wall tiles, you'll need to remove some of them in order to remove and replace the tub. Make sure you can buy new tiles that exactly match the size and color of the existing tiles. Also check the width of the new tub; if it is narrower than the old tub, it may leave an untiled space on the floor that you will need to fill.

Plumbing an alcove tub is a relatively difficult job because getting access to the drain lines attached to the tub and into the floor is often very awkward. Although an access panel is required by most codes, the truth is that many tubs were installed without them or with panels that are too small or hard to reach to be of much use. If you are contemplating replacing your tub, the first step in the decision process should be to find the access panel and determine if it is sufficient. If it is not (or there is no panel at all), consider how you might enlarge it. Often, this means cutting a hole in the wall on the adjoining room and also in the ceiling below. This creates more work, of course, but compared to the damage caused by a leaky drain from a subpar installation, making an access opening is little inconvenience.

Tools & Materials ▸

Channel-type pliers	Shims
Hacksaw	Galvanized deck screws
Carpenter's level	Drain-waste-overflow kit
Pencil	1 × 3, 1 × 4, 2 × 4 lumber
Tape measure	
Saw	Galvanized roofing nails
Screwdriver	Galvanized roof flashing
Drill	Thinset mortar
Adjustable wrench	Tub & tile caulk
Trowel	Propane torch

By replacing a dingy old alcove tub with a fresh new one, you can make the tub and shower area as pleasant to use as it is efficient.

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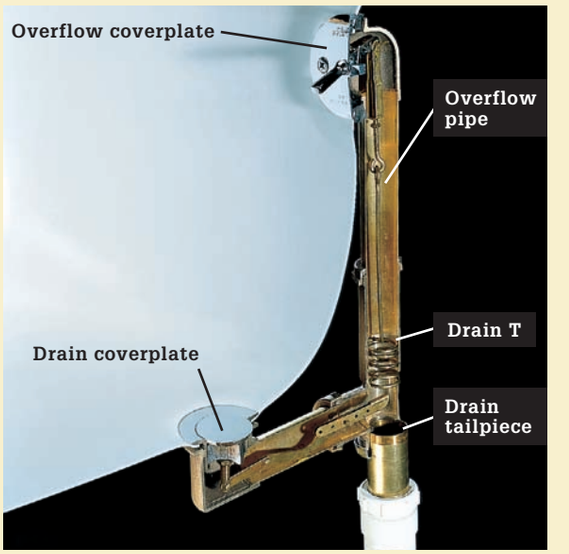
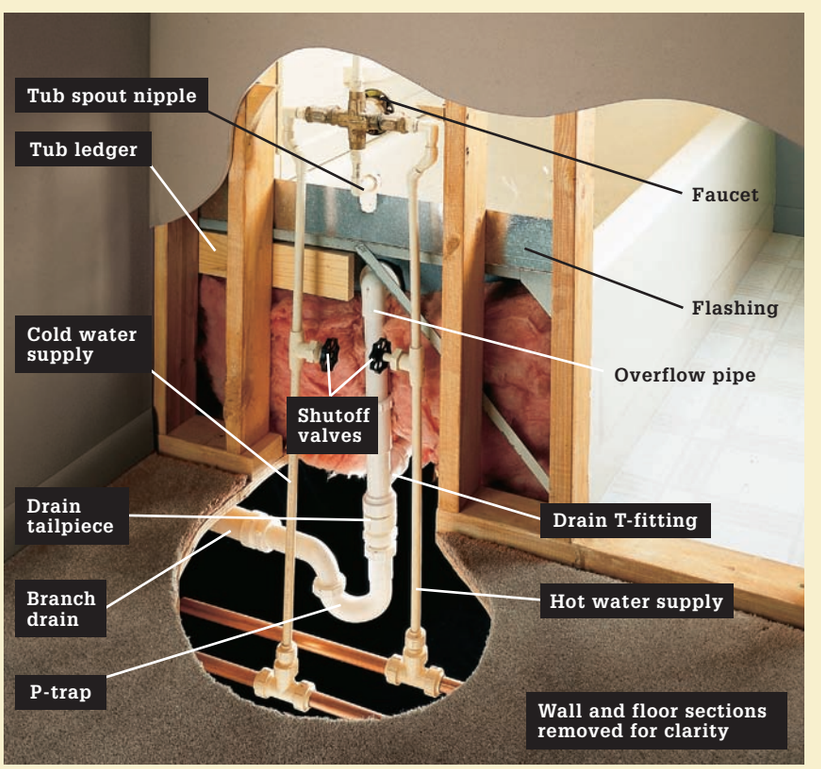
Pro-Vision C M Y K (Text) (Ray)
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:78

Tips for Installing Bathtubs ▸

Choose the correct tub for your plumbing setup. Alcove-installed tubs with only one-sided aprons are sold as either "left-hand" or "right-hand" models, depending on the location of the predrilled drain and overflow holes in the tub. To determine which type you need, face into the alcove and check whether the tub drain is on your right or your left.



A drain-waste-overflow kit with stopper mechanism must be purchased separately and attached after the tub is set. Available in both brass and plastic types, most kits include an overflow coverplate, an overflow pipe that can be adjusted to different heights, a drain T-fitting, an adjustable drain tailpiece, and a drain coverplate that screws into the tailpiece.



The supply system for a bathtub includes hot and cold supply pipes, shutoff valves, a faucet and handle(s), and a spout. Supply connections can be made before or after the tub is installed.

The drain-waste-overflow system for a bathtub includes the overflow pipe, drain T, P-trap, and branch drain. The overflow pipe assembly is attached to the tub before installation.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:79

How to Remove an Alcove Bathtub

Cut the old supply tubes, if you have access to them, with a reciprocating saw and metal cutting blade or with a hacksaw. Be sure to shut off the water supply at the stop valves first. Cut the shower pipe just above the faucet body and cut the supply tubes just above the stop valves.

Remove the faucet handles, tub spout, shower head and escutcheon, and arm. For the spout, check the underside for a set screw and loosen it if you find one. Then, insert a long screwdriver into the spout and turn the spout counterclockwise.

Remove the drain plug, working from the tub side. If the tub has a pop-up drain with linkage, twist the plug to disengage the linkage, and pull the plug and linkage out (inset). You may be able to use the handles of channel-type pliers to unscrew the flange, but a strainer wrench, also called a "dumbbell" tool, works better.

Remove the overflow coverplate (top photo) and then withdraw the pop-up drain linkage through the overflow opening (lower photo).

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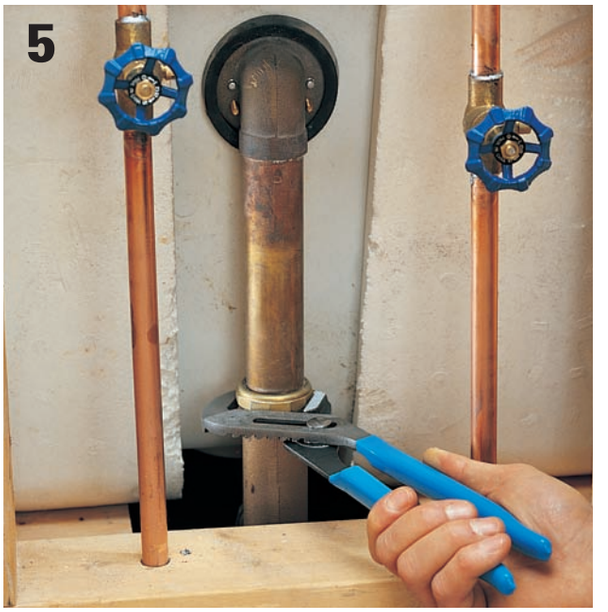
#175 Dtp:225 Page:80



Disconnect the overflow pipe from the drain assembly and remove both parts (your access may not be as unrestricted as seen here). If you need to cut the pipes, go ahead and do it. In most cases, it is difficult to maneuver the tub out with the DWO assembly still attached.

Cut the wall to a line about 6" above the tub rim. Alcove tubs are fastened to the wall studs with nails driven through or above a flange that protrudes up from the rim. You'll need to remove a bit of the wall covering so you can remove the fasteners.

If you can, pry out fasteners and then pull the tub away from the walls by levering between the back rim of the tub and the back wall of the alcove. If it resists, check for adhesive caulk or even flooring blocking the bottom of the apron. If needed, raise the tub and slide a pair of 1 × 4 runners under the skirt edge (inset photo) to make it easier to slide out.

Option: Cut stubborn tubs in half to wrangle them out of the alcove. This has the added benefit of making the tubs easier to get out the door, down the stairs, and into the dumpster. If the tub is cast iron, you won't be able to cut it, and because it's so heavy, removing it intact will be difficult. You can break it apart much easier, however, using a sledgehammer. Wear protective clothing and eyewear, and cover everything in the room with a dropcloth before you start swinging.

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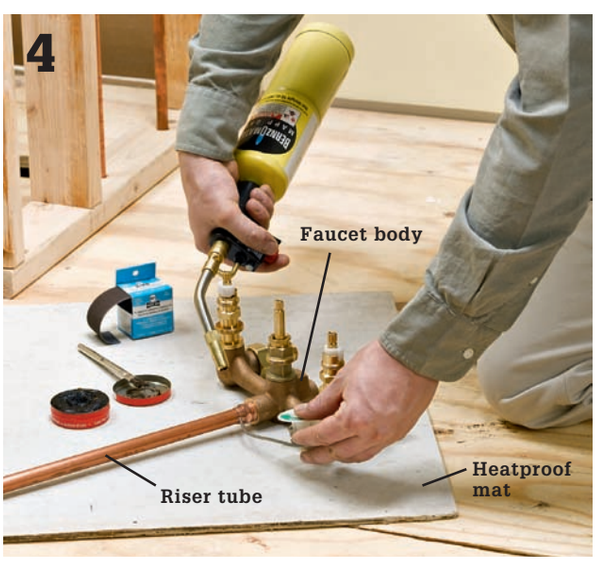
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:81

How to Install a New Alcove Tub

Prepare for the new tub. Inspect and remove old or deteriorated wall surfaces or framing members in the tub area. With today's mold-resistant wallboard products, it makes extra sense to go ahead and strip off the old alcove wallcoverings and ceiling down to the studs so you can replace them. This also allows you to inspect for hidden damage in the wall and ceiling cavities.

Check the subfloor for level—if it is not level, use pour-on floor leveler compound to correct it (ask at your local flooring store). Make sure the supply and drain pipes and the shutoff valves are in good repair and correct any problems you encounter. If you have no bath fan in the alcove, now is the perfect time to add one.

Check the height of the crossbraces for the faucet body and the showerhead. If your family members needed to stoop to use the old shower, consider raising the brace for the showerhead. Read the instructions for your new faucet/diverter and check to see that the brace for the faucet body will conform to the requirements (this includes distance from the surround wall as well as height). Adjust the brace locations as needed.



Begin by installing the new water supply plumbing. Measure to determine the required height of your shower riser tube and cut it to length. Attach the bottom of the riser to the faucet body and the top to the shower elbow.

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Pro-Vision C M Y K (Text) (Ray)
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:82

Attach the faucet body to the cross brace with pipe hanger straps. Then, attach supply tubing from the stop valves to the faucet body, making sure to attach the hot water to the left port and cold to the right port. Also secure the shower elbow to its cross brace with a pipe strap. Do not attach the shower arm yet.

Slide the bathtub into the alcove. Make sure tub is flat on the floor and pressed flush against the back wall. If your tub did not come with a tub protector, cut a piece of cardboard to line the tub bottom, and tape pieces of cardboard around the rim to protect the finish from shoes and dropped tools.

Mark locations for ledger boards. To do this, trace the height of the top of the tub's nailing flange onto the wall studs in the alcove. Then remove the tub and measure the height of the nailing flange. Measure down this same amount from your flange lines and mark the new ledger board location.

Install 1 × 4 ledger boards. Drive two or three 3"-galvanized deck screws through the ledger board at each stud. All three walls should receive a ledger. Leave an open space in the wet wall to allow clearance for the DWO kit. Measure to see whether the drain will line up with the tub's DWO. If not, you may need to cut and reassemble the drain.

(continued)

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:83

Install the drain-waste-overflow (DWO) pipes before you install the tub. Make sure to get a good seal on the slip nuts at the pipe joints. Follow the manufacturer's instructions to make sure the pop-up drain linkage is connected properly. Make sure rubber gaskets are positioned correctly at the openings on the outside of the tub.

Thread the male-threaded drain strainer into the female-threaded drain waste elbow. Wrap a coil of plumber's putty around the drain outlet underneath the plug rim first. Hand tighten only.

Attach the overflow coverplate, making sure the pop-up drain controls are in the correct position. Tighten the mounting screws that connect to the mounting plate to sandwich the rubber gasket snugly between the overflow pipe flange and the tub wall. Then, finish tightening the drain strainer against the waste elbow by inserting the handle of a pair of pliers into the strainer body and turning.

Working with a helper, place the tub in position, taking care not to bump the DWO assembly. If the DWO assembly does not line up with the drainpipe, remove the tub and adjust the drain location. Many acrylic, fiberglass, and steel tubs will have a much firmer feeling if they are set in a bed of sand-mix concrete. Check manufacturer's instructions, and pour concrete or mortar as needed. Set the tub carefully back in the alcove.

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Pro-Vision C M Y K (Text) (Ray)
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:84

Attach the drain outlet from the DWO assembly to the drain P-trap. This is the part of the job where you will appreciate that you spent the time to create a roomy access panel for the tub plumbing. Test the drain and overflow to make sure they don't leak. Also test the water supply plumbing, temporarily attaching the handles, spout, and shower arm so you can operate the faucet and the diverter.

Drive a 1½" galvanized roofing nail at each stud location, just over the top of the tub's nailing flange. The nail head should pin the flange to the stud. Be careful here—an errant blow or overdriving can cause the enameled finish to crack or craze. *Option: You may choose to drill guide holes and nail through the flange instead.*

Install the wallcoverings and tub surround (see pages 86–89 for a 3-piece surround installation). You can also make a custom surround from tileboard or cementboard and tile.

Install fittings. First, thread the shower arm into the shower elbow and attach the spout nipple to the valve assembly. Also attach the shower head and escutcheon, the faucet handle/diverter with escutcheon, and the tub spout. Use thread lubricant on all parts.

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Pro-Vision C M Y K (Text) (Ray)
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:85

3-Piece Tub Surrounds

No one wants bathroom fixtures that are aging or yellowed from years of use. A shiny new tub surround can add sparkle and freshness to your bathroom.

Tub surrounds come in many different styles, materials, and price ranges. Choose the features you want and measure your existing bathtub surround for sizing. Surrounds typically come in three or five pieces. A three-panel surround is being installed here, but the process is similar for five-panel systems.

Surface preparation is important for good glue adhesion. Plastic tiles and wallpaper must be removed and textured plaster must be sanded smooth. Surrounds can be installed over ceramic tile that is well attached and in good condition, but it must be sanded and primed. All surfaces must be primed with a water-based primer.

Tools & Materials ▸

Jigsaw	Adhesive
Hole saw	Screwdriver
Drill	Adjustable wrench
Measuring tape	Pry bar
Level	Hammer
Caulking gun	3-piece tub surround
Primer	

Three-piece tub surrounds are inexpensive and come in many colors and styles. The typical unit has two end panels and a back panel that overlap in the corners to form a watertight seal. They are formed from fiberglass, PVC, acrylic, or proprietary resin-based polymers. Five-piece versions are also available and typically have more features such as integral soap shelves and even cabinets.

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Pro-Vision C M Y K (Text) (Ray)
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:86

How to Install a 3-Piece Tub Surround

Remove the old plumbing fixtures and wallcoverings in the tub area. In some cases you can attach surround panels to old tileboard or even tile, but it is generally best to remove the wallcoverings down to the studs if you can, so you may inspect for leaks or damage.

Replace the wallcoverings with appropriate materials**,** such as water and mold-resistant wallboard or cementboard (for ceramic tile installations). Make sure the new wall surfaces are smooth and flat. Some surround kit manufacturers recommend that you apply a coat of primer to sheet goods such as greenboard to create a better bonding surface for the panel adhesive.

Test-fit the panels before you start; the tub may have settled unevenly or the walls may be out of plumb. Check the manufacturer's directions for distinguishing right and left panels. Place a panel in position on the tub ledge. Use a level across the top of the panel to determine if it is level. Create a vertical reference line to mark the edge of the panel on the plumbing end.

Test-fitting Tip ▸

Ensure a perfect fit by taping the surround panels to the walls in the tub area. Make sure the tops are level when the overlap seams are aligned and that you have a consistent ⅛" gap between the panel bottoms and the tub flange. Mark the panels for cutting if necessary and, once the panels have been removed, make any adjustments to the walls that are needed.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:87

Some kits are created to fit a range of bathtub dimensions. After performing the test fit, check the fitting instructions to see if you need to trim any of the pieces. Follow the manufacturer's instructions for cutting. Here, we had to cut the corner panels because the instructions advise not to overlap the back or side panel over the corner panels by more than 3". Cut panels using a jigsaw and a fine-tooth blade that is appropriate for cutting fiberglass or acrylic tileboard. The cut panels should be overlapped by panels with factory edges.

Measure and mark the location of the faucets**,** spout, and shower outlets. Measure in from the vertical reference line (made in step 3) and up from the top of the tub ledge. Re-measure for accuracy, as any cuts to the surround are final. Place the panel face-up on a sheet of plywood. Mark the location of the holes. Cut the holes ½" larger than the pipe diameter. If your faucet has a recessed trim plate (escutcheon), cut the hole to fit the recess. Using a hole saw or a jigsaw, cut out the plumbing outlets.

Install the plumbing end panel, test-fitting first. In this surround, the end panels are installed first. Apply adhesive to the back of the plumbing panel. Circle the plumbing outlet holes 1" from the edge. Follow the manufacturer's application pattern. Do not apply adhesive closer than 1" to the double-sided tape or the bottom edge of the panel.

Remove the protective backing from the tape. Carefully lift the panel by the edges and place against the corner and top of the tub ledge. Press firmly from top to bottom in the corner, then throughout the panel.

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Pro-Vision C M Y K (Text) (Ray)
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:88

Test-fit the opposite end panel and make any necessary adjustments. Apply the adhesive, remove the protective backing from the tape, and put in place. Apply pressure to the corner first from top to bottom, and then apply pressure throughout.

Apply adhesive to the back panel following the manufacturer's instructions. Maintain a 1" space between adhesive tape and the bottom of the panel. Remove protective backing from the tape. Lift the panel by the edges and carefully center between the two end panels. When positioned, firmly press in place from top to bottom.

Apply caulk to the bottom and top edges of the panels and at panel joints. Dip your fingertip in water and use it to smooth the caulk to a uniform bead.

Apply silicone caulk to escutcheons or trim plates and reinstall them. Allow a minimum of 24 hours for caulk and adhesive to dry thoroughly before using the shower or tub.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:89

Sliding Tub Doors

Curtains on your bathtub shower are a hassle. If you forget to tuck them inside the tub, water flows freely onto your bathroom floor. If you forget to slide them closed, mildew sets up shop in the folds. And every time you brush against them, they stick to your skin. Shower curtains certainly don't add much elegance or charm to a dream bath. Neither does a deteriorated door. Clean up the look of your bathroom, and even give it an extra touch of elegance, with a new sliding tub door.

When shopping for a sliding tub door, you have a choice of framed or frameless. A framed door is edged in metal. The metal framing is typically aluminum but is available in many finishes, including those that resemble gold, brass, or chrome. Glass options are also plentiful. You can choose between frosted or pebbled glass, clear, mirrored, tinted, or patterned glass. Doors can be installed on ceramic tile walls or onto a fiberglass tub surround.

Tools & Materials ▸

Measuring tape	Marker
Pencil	Masonry bit for tile wall
Hacksaw	Phillips screwdriver
Miter box	Caulk gun
Level	Masking tape
Drill	Silicone sealant & remover
Center punch	Tub door kit
Razor blade	Masking tape

A sliding tub door framed in aluminum gives the room a sleek, clean look and is just one of the available options. A model like this fits into a 60-inch alcove, so it can replace a standard tub, as long as you can provide access to the plumbing and an electrical connection.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:90

How to Install Sliding Tub Doors

Remove the existing door and inspect the walls. Use a razor blade to cut sealant from tile and metal surfaces. Do not use a razor blade on fiberglass surfaces. Remove remaining sealant by scraping or pulling. Use a silicone sealant remover to remove all residue. Remove shower curtain rods, if present. Check the walls and tub ledge for plumb and level.

Measure the distance between the finished walls along the top of the tub ledge. Refer to the manufacturer's instructions for figuring the track dimensions. For the product seen here, 3/16" is subtracted from the measurement to calculate the track dimensions.

Using a hacksaw and a miter box, carefully cut the track to the proper dimension. Center the track on the bathtub ledge with the taller side out and so the gaps are even at each end. Tape into position with masking tape.

Place a wall channel against the wall with the longer side out and slide into place over the track so they overlap. Use a level to check the channel for plumb, and then mark the locations of the mounting holes on the wall with a marker. Repeat for the other wall channel. Remove the track.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:91

Drill mounting holes for the wall channel at the marked locations. In ceramic tile, nick the surface of the tile with a center punch, use a ¼" masonry bit to drill the hole, and then insert the included wall anchors. For fiberglass surrounds, use a ⅛" drill bit; wall anchors are not necessary.

Apply a bead of silicone sealant along the joint between the tub and the wall at the ends of the track. Apply a minimum ¼" bead of sealant along the outside leg of the track underside.

Position the track on the tub ledge and against the wall. Attach the wall channels using the provided screws. Do not use caulk on the wall channels at this time.

Cut and install the header. At a location above the tops of the wall channels, measure the distance between the walls. Refer to the manufacturer's instructions for calculating the header length. For the door seen here, the length is the distance between the walls minus 1/16". Measure the header and carefully cut it to length using a hacksaw and a miter box. Slide the header down on top of the wall channels until seated.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:92

Mount the rollers in the roller mounting holes. To begin, use the second-from-the-top roller mounting holes. Follow the manufacturer's instructions for spacer or washer placement and orientation.

Carefully lift the inner panel by the sides and place the rollers on the inner roller track. Roll the door toward the shower end of the tub. The edge of the panel should touch both rubber bumpers. If it doesn't, remove the door and move the rollers to different holes. Drive the screws by hand to prevent overtightening.

Lift the outer panel by the sides with the towel bar facing out from the tub. Place the outer rollers over the outer roller track. Slide the door to the end opposite the shower end of the tub. If the door does not contact both bumpers, remove the door and move the rollers to different mounting holes.

Apply a bead of clear silicone sealant to the inside seam of the wall and wall channel at both ends and to the U-shaped joint of the track and wall channels. Smooth the sealant with a fingertip dipped in water.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:93

Jetted Tub

A jetted spa is basically a bathtub that recirculates water, air, or both to create an effect known as hydromassage. Hydromassage increases blood flow, relieves pressure on joints and muscles, and relieves tension. Interior hydromassage tubs usually have a water pump that blows a mixture of air and water through jets located in the tub body. Many include an integral water heater.

The product you'll see installed on these pages is a bit different. It is an air-jet tub: a relatively new entry in the jetted spa market that circulates only warm air, not water. This technology makes it safe to use bath oils, bubble bath, and bath salts in the spa. A model with no heater requires only a single 120-volt dedicated circuit. Models with heaters normally require either multiple dedicated 120-volt circuits or a 240-volt circuit.

Like normal bathtubs, jetted tubs can be installed in a variety of ways. Here, we install a drop-in tub (no nailing flange) in a three-wall alcove. This may require the construction of a new stub wall, like the short wall we plumbed as the wet wall for this installation. Unless you have a lot of wiring and plumbing experience, consider hiring professionals for all or parts of the project.

Tools & Materials ▸

- Plumbing tools
- Utility knife
- 4-foot level
- Square-edge trowel
- Drill or power driver
- Channel-type pliers
- Hacksaw
- Level
- Circular saw
- Drill
- Screwdriver
- Adjustable wrench
- Drain-waste-overflow assembly
- Rubber gaskets
- TFE paste or other thread lubricant
- Shims
- 1 × 4 lumber
- Plumber's putty
- 1½" galvanized deck screws
- 1" galvanized roofing nails
- Dry-set mortar
- Trowel
- Silicone caulk
- Jetted tub
- Faucet
- Plumbing supplies
- Joint compound

Air-jet tubs create massaging action, stirring the water with warm air. Air-jets eliminate concerns about stagnant water and bacteria that can remain in the pipes of whirlpool tubs that recirculate water.

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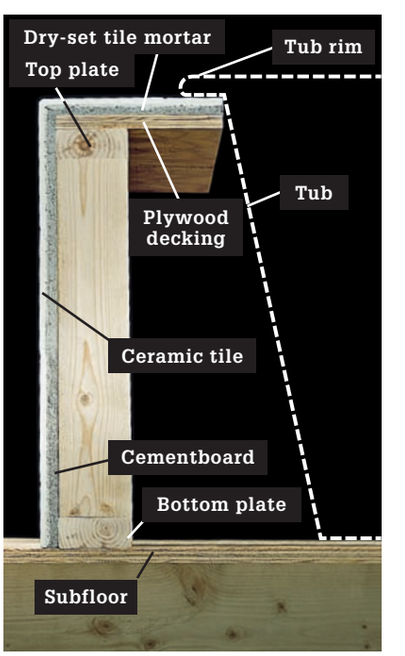
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:94

Tub Installation Options

Outdoor hot tubs can be inset into a deck or installed in a framed platform that can be built on just about any surface. Many hot tubs come preinstalled in a deck. The hot tub's bottom must rest on a very firm surface, such as a deck with beefed-up framing or a concrete pad.

Alcove tubs, whether jetted or not, are normally supported by ledgers attached to the side and back walls. The front apron on a jetted tub is removable so you can make hookups and access the tub plumbing.

A framed platform is built to support a drop-in style jetted tub in a corner or island application. The vertical panels installed on the sides of the structure should be easily removable for access to the plumbing and wiring of the tub.



A stub wall can be built to support one or more sides of the tub and is often used in conjunction with ledgers.

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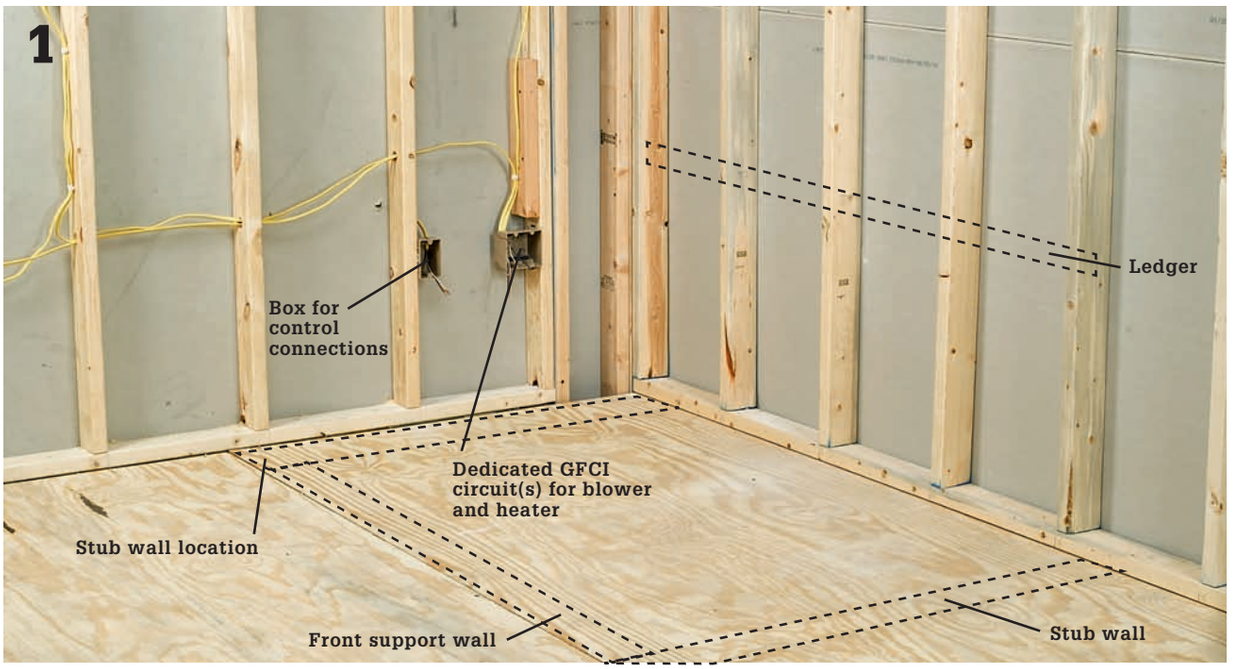
How to Install a Jetted Tub



Prepare the installation area for the jetted tub. Indicate the exact location where you'd like the tub installed as well as the planned wiring, water supply, and drain lines. Also plan for any wall-mounted tub controls, noting that wall-mounted ON/OFF switches or timers generally need to be installed at least 5 ft. away from the tub.

Lay out the locations for the drain, supply, and electrical lines, following the dimensions noted in your installation manual. Cut the drain opening in the subfloor making sure the ceneterpoint is exactly aligned with the drain hole in the tub. Cut out drain opening with a jigsaw.

Install a new branch drain line with P-trap for the tub. The P-trap should be centered in the drain cutout area so it will align precisely with the tub's drain tailpiece. The tub manufacturer will supply precise measurements; follow them closely.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:96

Build support framing as outlined in your installation manual, according to whichever type of installation you are undertaking. In this photo, a wet wall is being framed at the head area of the tub. An identically sized stub wall is installed in the corner to support the foot end of the tub. A third stub wall will be constructed to support the front of the tub after the tub is in place.

Install water supply risers with shutoff valves. Make sure to create or allow for an access panel so you can get at the supply and drain plumbing easily. Here, a section of the wallcovering on the room side of the wet wall will be removable. You also need to make sure you have ready access to the motor and pump for the jetted tub. On the model shown here, a removable front apron allows ample access.

Install a 1 × 4 cross brace in the stub wall cavity so you can secure the supply pipes with pipe straps.

Run new wiring circuits and install receptacles as required in your installation manual. You will need a permit for this part of the job. If you do not have significant experience with home wiring, hire a pro for the wiring. In most cases, you'll need a dedicated circuit for the pump and another (often 240-volt) for the motor, and perhaps even a third circuit for accessories and peripherals, such as lights.

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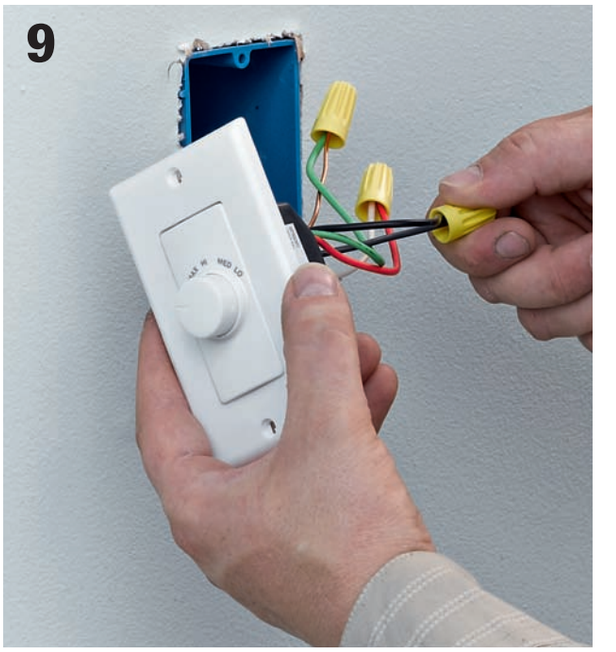
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:97

Prepare additional circuits as required for your tub. Here, a circuit is being run from the tub installation area to a remote wall switch that will regulate the air flow. Do as much of the wiring and plumbing installation as you can before the tub is in place.



Install wall controls as specified by the manufacturer. Check with your local inspections office. They may want to inspect your wiring and plumbing lines before the tub is installed.

Subfloor Prep ▸

Check the subfloor to make sure it is level. If you encounter a dip or low area (especially if it is in the area where the tub feet will rest) fill it with floor leveler compound (available at home centers and flooring stores). It is important that the tub be level or have a very slight slope toward the drain.

Attach the drain/overflow pipe assembly to the tub prior to installation, using rubber gaskets and pipe joint compound. Measure the distance the drain tailpiece will need to drop to connect with the drain trap and trim the tailpiece to fit (inset photo).

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:98

Secure the drain/overflow assembly by tightening the overflow coverplate and the drain strainer onto the assembly from inside the tub.

Slide or lower the tub into the installation area, taking care not to disturb the drain/overflow assembly. Make sure the drain tailpiece aligns exactly over the P-trap opening.

Check the tub for level. If it is not level, check to make sure it is resting cleanly on the subfloor all around. If needed, shim underneath one of the feet to level the tub. Do not shim under the apron if your tub has one that is already installed.

Secure the leveled tub in place as directed in your installation manual. Here, 2 × 4 blocks are screwed to the floor around the perimeter of the bathtub basin to create small curbs that prevent the tub from shifting. Build a 2 × 4 stub wall to support the front tub rim.

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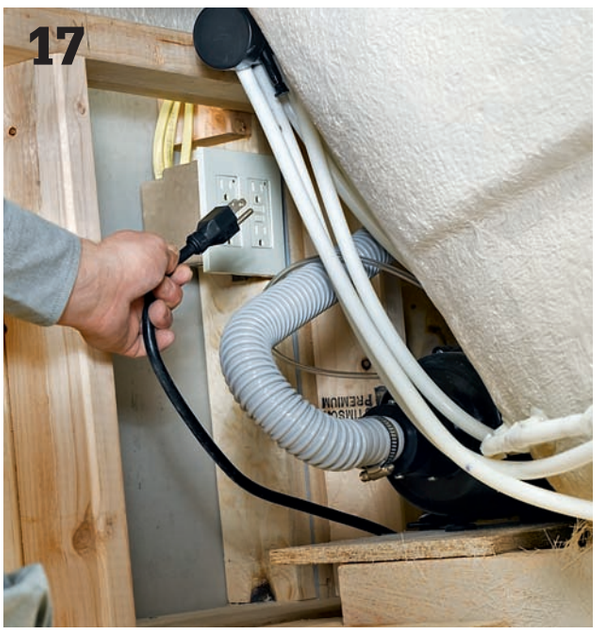
#175 Dtp:225 Page:99

Hook up the drain line by attaching the drain tailpiece to the P-trap in the floor. Use TFE paste or thread lubricant so you can get a good seal on the slip fitting.

Test the drain system to make sure it does not leak. Using a hose, first add a small amount of water and visually inspect the slip fittings and the area around the drain body. If it looks good, fill the tub up past the overflow line to make sure the overflow pipe seal does not leak. Drain the tub.



Make wiring hookups. Here, the hard work is already done and the blower and pump motors simply need to be plugged into their dedicated receptacles. If this unit had a heater, it would require an additional dedicated circuit. The blower motor also needs to be attached to the lead from the wall regulator installed in step 8.

Install wall panels around the tub area. If you will be installing wall tile, use cementboard. If you'll be installing a manufactured surround, mold-resistant drywall will do.

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#175 Dtp:225 Page:100

Install the wall surface materials, cutting holes for the spout and valves as needed.

Install the spout supply valves and hook them up to the supply risers. Tubs are not predrilled for faucets as sinks are, so you'll need to decide whether to drill holes for the valves in the tub rim using a step bit, or to mount the faucet in the platform or the rim of the support wall.

Attach the spout and the valve handles and test the supply system. To clear any debris from the lines, remove the spout aerator and run both hot and cold water for a minute or so.

Attach the removable front apron or replace the access panel covering. Then, fill the tub and have a nice, long soak.

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Bidets

Bidets are becoming ever more popular in the United States. Maybe that's because they can give an ordinary bathroom a European flare that so many of us find alluring. Go to Europe, Asia, or South America and you'll see how much people—both men and women—can come to rely on bidets. Some fans of this bathroom fixture think those who don't use bidets are unhygienic.

With the trend moving toward larger and more luxurious bathrooms, many Americans are becoming intrigued by this personal hygiene appliance. The standard model features hot and cold faucets, and either a movable nozzle located by the faucet handles or a vertical sprayer located near the front of the bowl. Most bidets are outfitted with a pop-up drain. You can also buy a combination toilet and bidet if space is an issue.

Installing a bidet is very much like installing a sink. The only difference is that the bidet can have the waste line plumbed below the floor, like a shower. But like sinks, bidets may have single or multiple deck holes for faucets, so be certain to purchase compatible components.

Tools & Materials

- Tape measure
- Drill
- Adjustable wrench
- Level
- Silicone sealant
- (2) ⅜" shut off valves
- (2) ⅜" supply lines
- P–trap
- Tubing cutter
- Plumber's putty
- Thread tape
- Bidet
- Bidet faucet

A bidet is a useful companion to a toilet, and it is a luxury item you and your family will appreciate. It's also a bit of a novelty you will enjoy sharing. For people with limited mobility, a bidet is an aide to independent personal sanitation.

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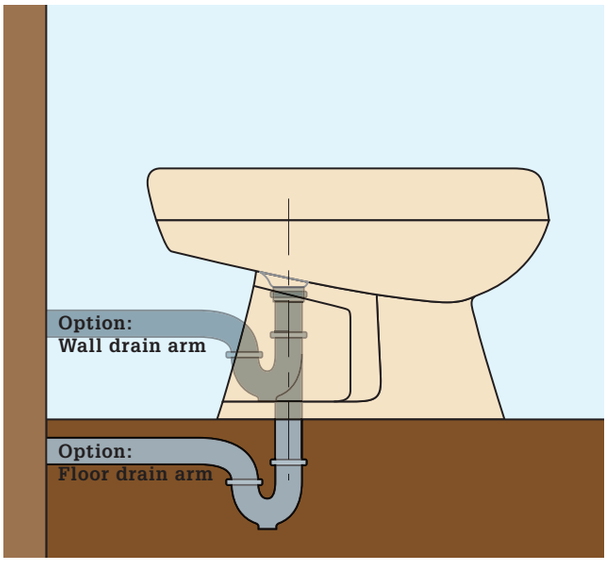
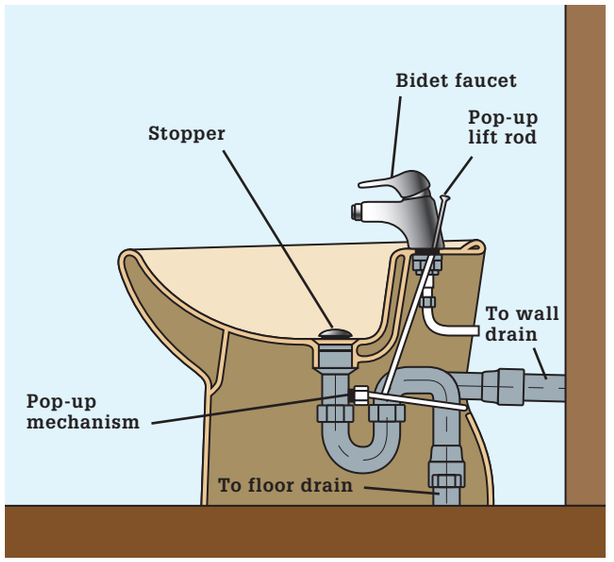
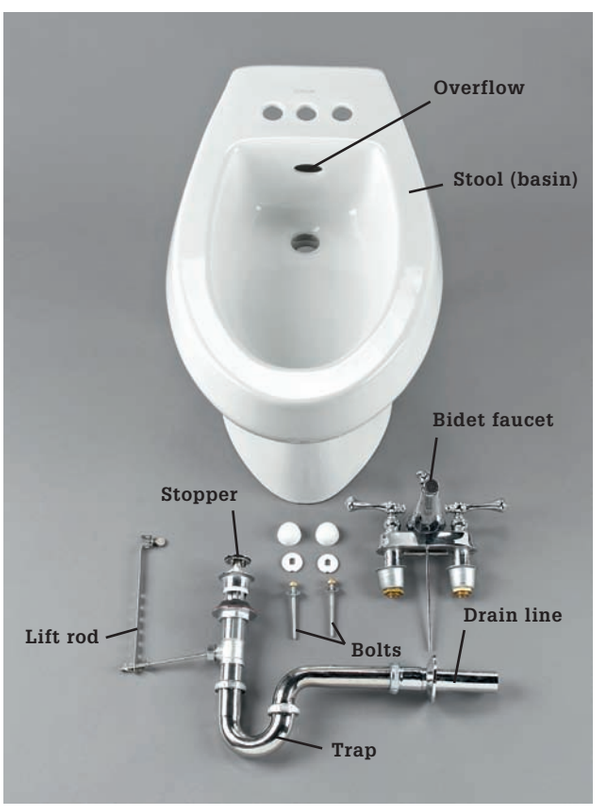




Bidet drains have more in common with sink drains than with toilet drains. Some even attach to a drain arm in the wall, with a P-trap that fits between the fixture drain tailpiece and the arm. Other bidets drain into a floor drain outlet with a trap that's situated between the tailpiece and the branch drain line.



A bidet requires a special faucet that allows you to mix hot and cold water to a temperature you find comfortable. It has a third knob to control the water pressure. The aerator and spout pivot to allow you to adjust the spray to a comfortable height.

You can get all the features of a bidet on your existing toilet with a number of aftermarket bidet seats. These seats feature heaters, sprayers, and dryers in basic or deluxe versions. Installation is easy and no additional space is needed.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:103

How to Install a Bidet

Rough-in supply and drain lines according to the manufacturer's specifications. If you do not have experience installing home plumbing, hire a plumber for this part of the job. Apply a coil of plumber's putty to the base of the bidet faucet, and then insert the faucet body into the mounting holes. Thread the washers and locknut onto the faucet body shank and hand tighten. Remove any plumber's putty squeeze-out.

Apply a roll of plumber's putty around the underside of the drain flange. Wrap the bottom ⅔ of the flange threads with three layers of Teflon tape. Make sure to wrap the tape clockwise so that tightening the nut will not bunch up the tape. Insert the flange in the drain hole, place the gasket and washer, and then thread the nut onto the flange. Do not fully tighten.

Install the pop-up drain apparatus according to the manufacturer's instructions.

Place the bidet in its final location, checking that supply and drain lines will be in alignment. Mark the locations of the two side-mounting holes through the predrilled holes on the stool and onto the floor.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:104

Remove the bidet and drill 3⁄16" pilot holes at the marks on the floor. Drive the floor bolts (included with the bidet basin) into the holes. Position the bidet so the floor bolts fit into the bolt holes in the base.

Connect the water supply risers to the bidet faucet using compression unions. Make sure to hook the hot and cold risers up to the correct ports on the faucet.

Hook up the drain line by attaching the P-trap to the drain tailpiece. The trap is then attached to a branch drain line coming out of the wall or floor in the same manner as a sink drain.

Remove the aerator so any debris in the supply line will clear and then turn on the water and open both faucets. Check for leaks in lines and fix, if found. Assemble the bolt caps and thread them onto the floor bolts. *Note: Do not dispose of paper in the bidet—return to the toilet to dry off after using the bidet for cleaning.*

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:105

Water Softeners

If your house has hard water coursing through its pipes, then you've got a couple of problems. Not only does your water do a poor job of dissolving soap, but you also have plenty of scale deposits on dishes, plumbing fixtures, and the inside of your water heater.

Softeners fix these problems by chemically removing the calcium and magnesium that are responsible for the hard water (usually described as over 17 grains of minerals per gallon). These units are installed after the water meter but before the water line branches off to appliances or fixtures, with one exception: Piping to outside faucets should branch off the main line before the softener because treating outside water is a waste of money.

Softeners come with an overflow tube and a purge tube to rinse out the minerals that are extracted from the water. These tubes should be attached to the floor drain or to a laundry sink basin, which is the better approach if the sink is close by

Know Your Types of Salt

Salt for water softeners comes in three basic types: rock salt, solar salt (crystals), and evaporated salt (pellets). Rock salt is a mineral that's mined from salt deposits. Solar salt is a crystalline residue left behind when seawater is evaporated naturally. It sometimes is sold as pellets or blocks. Evaporated salt is similar to solar salt, but the liquid in the brine is evaporated using mechanical methods. Rock salt is cheapest but leaves behind the most residue and therefore requires more frequent brine tank cleaning. Evaporated salt pellets are the cleanest and require the least maintenance.

Tools & Materials

Tape measure	Steel wool
Tubing cutter	Soldering flux
Propane torch	Solder
Slip-joint pliers	4"-thick concrete blocks

A modern water softener is a single appliance, with the softener resting on top of the salt storage tank.

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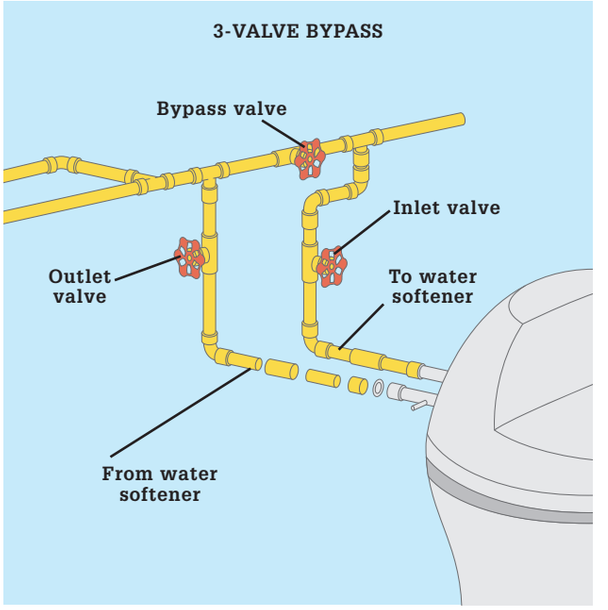
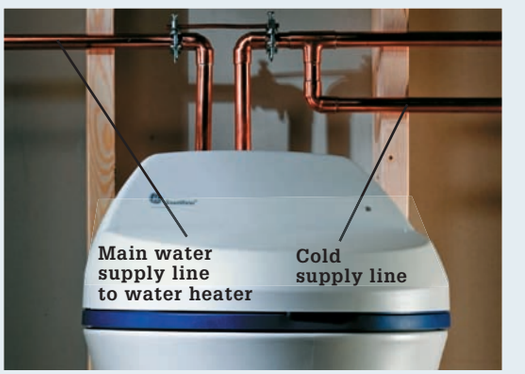


In some areas you are required to install a water softener with three valves, as shown. This arrangement allows you to bypass the water softener, so water can run to the house when the softener is disconnected.

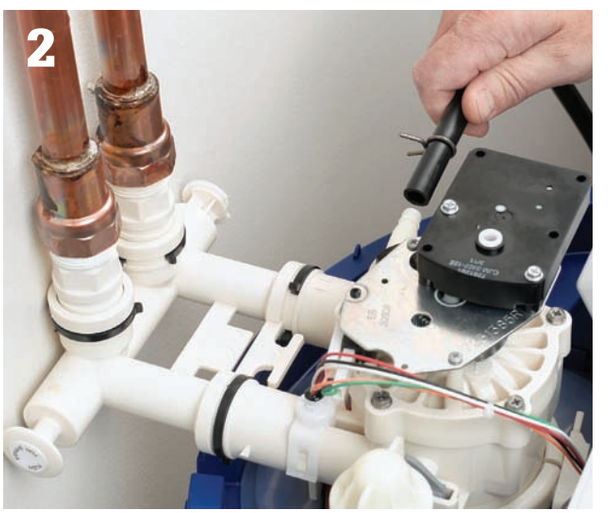
Softened Water

From your plumbing's point of view, the best water softening strategy is to position the softener close to the main, cold-only supply line (as seen here). Doing this results in both hot and cold water being softened. But because some homeowners object to the altered taste and increased salinity of softened water, the softener may be installed after the hot and cold lines have split from the main supply line. This way, the water may be softened immediately before it enters the heater, and the cold water remains unsoftened.



How to Install a Water Softener

The first step is to measure the distance between the bypass ports on the tank to the cold water supply line. Cut copper tubing to fit this space and solder appropriate fittings onto both ends.



Install the plastic tubing discharge tube on the head of the water softener following the manufacturer's directions.

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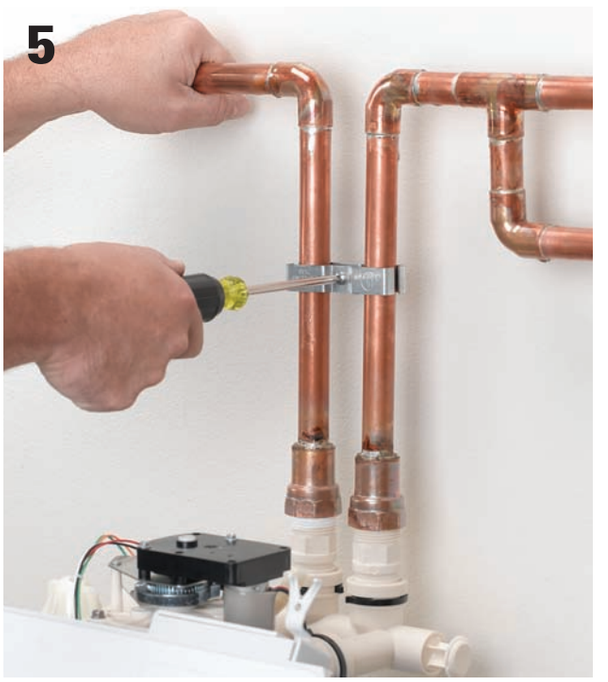
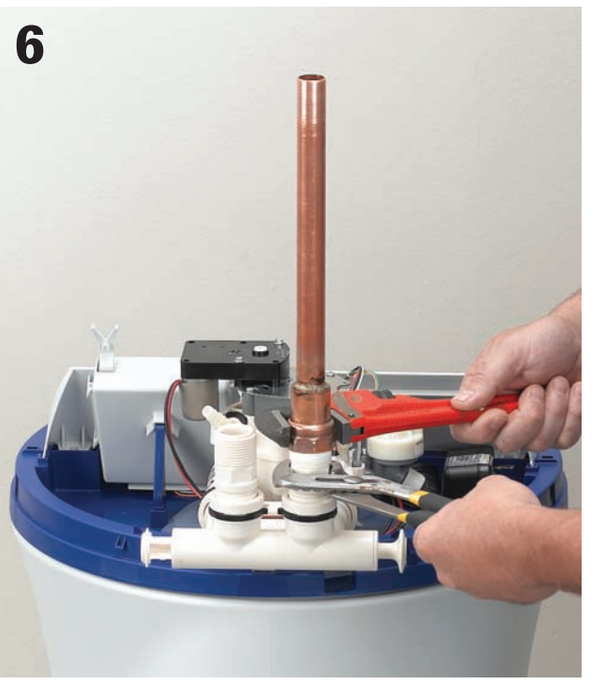
#175 Dtp:225 Page:107

The overflow tube is usually connected to the side of the softener's tank. Run this tube, along with the discharge tube, to a floor drain or a laundry sink.

Install the bypass valve in the softener's head. One side of the valve goes in the inlet port and the other fits into the outlet port. This valve is held in place with simple plastic clips or threaded couplings. *Note: Check local codes for bypass requirements.*



Attach the copper tubing that supplies the water to the bypass valve. For this unit, the joint is made with a male-threaded union that screws onto the bypass valve ports.



Use two wrenches to tighten the tube nuts, one holding the valve stable. Don't overtighten, or you may break plastic parts in the valve.

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#175 Dtp:225 Page:108

Connect the copper tubing from the softener to the water supply lines. Clean all fittings and pipes with steel wool. Then, apply soldering flux to the parts and solder them together with a propane torch. For more information on soldering copper, see page 278.

Run the tank overflow hose and the drain tube to a nearby floor drain or to a utility sink. The hoses should be secured so they don't flop around when water runs through them, and their ends must be at least 1½ inches above a drain.

Follow manufacturer's instructions to purge the air from the water softener. First run water with the valve in the bypass position, then pull the valve out so it is in the service position.

Turn on the water supply and make sure the installation works properly. If you see any leaks, fix them. Then add the water softening pellets to the top of the unit in the ratios explained on the package.

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Hot Water Dispenser

There are boxes and boxes of beverages and food that need only a trickle of hot water to achieve their destiny: coffee, tea, hot chocolate, instant soup, hot cereals, and just plain old hot water and lemon to name a few. And there's no faster way to get this hot water than with a hot water dispenser. These units are designed to fit in the spare hole on many kitchen sink decks. But, if you don't have one, you can replace your spray hose with the dispenser.

On-demand hot water is not only a convenience, it can help to conserve both energy and water.

Or, if you want to keep the hose, just drill an extra hole in your sink or countertop to accommodate the dispenser faucet.

Note: Installing this appliance requires both plumbing and wiring work. If you are unsure of your skills in these areas, hire a professional. (Be sure to check your local codes before starting.)

A dispenser requires an always-hot (unswitched) electrical receptacle under the sink. You could install a new receptacle with both plugs always hot, as shown in the steps, or the receptacle for the food disposer could be wired so that one plug (for the disposer) is controlled by a switch and the other (for the dispenser) is always hot.

Tools & Materials ▸

- Power drill with ¾"-dia. bit
- Utility knife
- Wire stripper
- Screwdrivers
- Adjustable wrench
- 14/2 NM electrical cable
- Flexible cable conduit
- Duplex electrical box
- Conduit box connector
- Switched receptacle
- Measuring tape
- Wire connectors
- Saddle valve
- Brass plug to fill spray hose port on kitchen faucet
- Teflon tape
- Hot water dispenser kit
- Cable connectors
- 15-amp circuit breaker (to match service panel breakers)
- Tubing cutter

Split and Switched Receptacle for Both Food Disposer and Hot-Water Dispenser ▸

There are several ways to split a receptacle so that one plug is hot and one is switched. Here, power enters the switch box first, and three-wire cable is run from the switch box to the receptacle box. Connect all the ground wires. At the receptacle box, remove the connecting tab between the two brass terminals; connect the red and black wires to the brass terminals; and connect the white (neutral) wire to the silver terminal. At the switch box, splice the white wires together; connect the red wire to one terminal; and connect the black wires to the other terminal via a pigtail.

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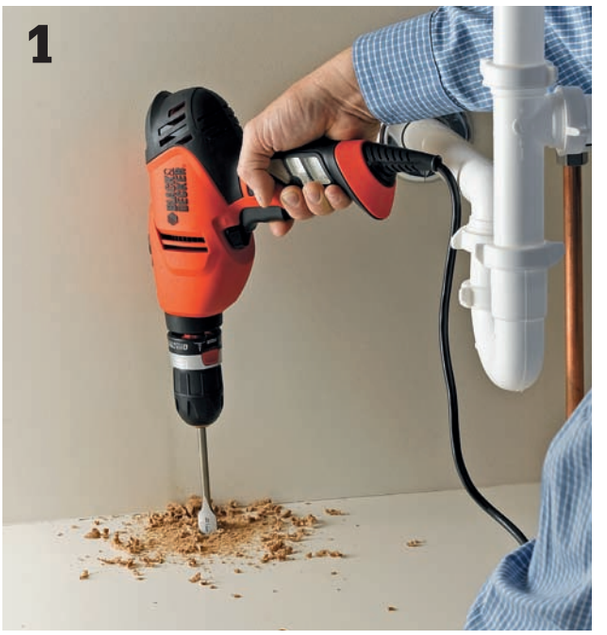
How to Install a Hot Water Dispenser



Drill an access hole for a new power cable (in flexible conduit) in the bottom of the sink compartment cabinet. Use a drill and a ¾"-dia. bit. Go into the basement and drill a hole up through the flooring that will align with the first hole (or make other arrangements to run circuit wire as you see fit).

Fish a 14/2 or 12/2 cable from the electric service panel up through the hole in the floor. Strip the sheathing from the cable with a utility knife. Also strip the insulation from the wires with a wire stripper. Do not nick the wire insulation.

Slide a piece of flexible conduit over the wires, so the wires are protected from the point they leave the cabinet floor to when they enter the electrical box. Attach the conduit to the box with a box connector so at least 8" of wire reaches into the box.

Install a receptacle. Mount a duplex metal box on the cabinet wall. Connect the ground wire to the receptacle's grounding terminal. Connect the black (hot) wire to the brass terminal, and the white (neutral) wire to the silver terminal. Mount the receptacle onto the box and add a coverplate.

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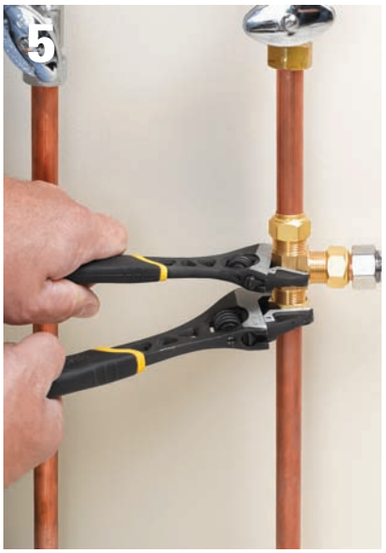

Tie into water supply. Water for the dispenser comes from the cold water supply line under the kitchen sink. Mount a Tee on this pipe, below its shutoff valve, by alternately tightening the Tee bolts on both sides with a wrench.

Determine the best place for the dispenser heater, usually on the back cabinet wall, so its pigtail plug will reach the switched receptacle. Screw its mounting bracket to the wall and hang the heater on this bracket.

To replace a spray hose with the dispenser faucet, remove the nut that holds the sprayer to the sink. Then remove the end of the hose from its port on the bottom of the faucet, using an adjustable wrench. This will free the hose so it can be pulled out from above the sink. Plug the spray hose part on the faucet.

The dispenser faucet is designed to fit into a standard sink hole. To install it, just squeeze its supply tubes together so they can fit into the hole, and drop it in place. The unit is held securely by a washer and locking screw that is tightened from below the sink.

Tie into water supply. Shut off the water and open nearby faucets to drain the pipe. Under the sink, cut into the cold-water pipe and install a compression or soldered Tee fitting. Install a compression stop valve onto the fitting. Tighten the nuts, shut off the valve, and turn the water back on to test for leaks.

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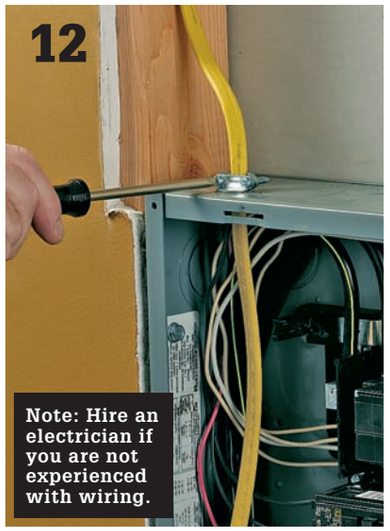
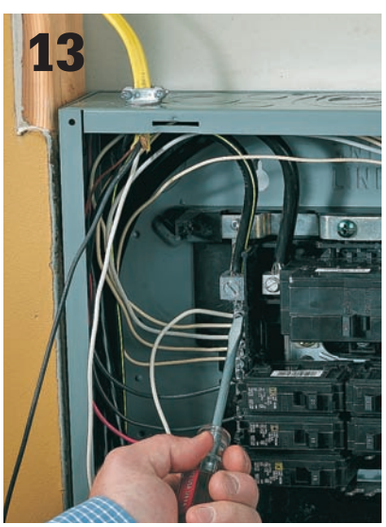
#175 Dtp:225 Page:112

Attach the two copper water tubes to the heater with compression fittings. Tighten them with a wrench. On the model seen here, the heater unit has three tubes. One supplies cold water to the heater, one supplies hot water to the faucet, and a third clear plastic hose acts as a vent and is attached to an expansion tank within the heater.

Slide the end of the plastic vent tube onto the nipple on top of the tank and attach it according to the manufacturer's instructions. On some models a spring clip is used for this job; other models require a hose clamp.



Install the heater power supply cable in the service panel. Begin by turning off the main power breaker. Then, remove the outside door panel and remove one of the knockout plates from the top or side of the box. Install a cable clamp inside this hole, push the cable through the clamp, and tighten the clamp to secure the cable.



Strip the sheathing from the cable inside the panel and remove the insulation from the ends on the black and white cable wires. Loosen a lug screw on the neutral bus bar and push the white wire under the lug. Attach the ground wire to the grounding bus bar. Tighten both these screws securely.

Loosen the lug screw on a standard 15-amp breaker and put the end of the black (hot) cable wire under this lug. Tighten the lug with a screwdriver. Then install the breaker in the hot bus bar by pushing it into place.

Once a new breaker is installed, the service panel cover has to be modified to fit over it. Break out the protective plate that covers the breaker position with pliers. Screw the cover to the panel, and turn on the main breaker. Turn on the water supply to the dispenser and plug it into the receptacle. Turn on the receptacle switch, wait fifteen minutes, and check that the system is working properly.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:113

Icemaker

Most expensive refrigerators come with icemakers as standard equipment, and practically every model features them as an option (a refrigerator with an icemaker usually costs about $100 more). It is also possible to purchase an icemaker as a retrofit feature for your old fridge.

Hooking up an existing icemaker to a cold-water supply involves drilling holes and connecting to a cold-water pipe. Most often, a pipe can be found in the basement below the kitchen, perhaps under the kitchen sink. To make the connection, some local codes allow the installation of a saddle Tee valve, but many do not, and a compression Tee valve is not difficult to install, as we show. In many kitchens the flexible line running from the valve to the fridge is copper, but plastic icemaker tubing is easier to install and less likely to kink or crack. To be sure everything fits, you can buy a connection kit from the refrigerator manufacturer.

Most icemakers either come preinstalled or are purchased as an accessory when you buy your new refrigerator. But if you have an older refrigerator with no icemaker and you'd like it to have one, all is not lost. Inspect the back of the unit, behind the freezer compartment. If your refrigerator has the required plumbing to support an icemaker, you will see a port or a port that is covered with backing. In that case, all you need to do is take the make and model information to an appliance parts dealer and they can sell you an aftermarket icemaker. Plan to spend $100 to $200.

A built-in icemaker is easy to install as a retrofit appliance in most modern refrigerators. If you want to have an endless supply of ice for home use, you'll wonder how you ever got along without one.

Tools & Materials

- Screwdrivers
- Nut drivers
- Needle-nose pliers
- Duct or masking tape
- Channel-type pliers
- Electric drill and assorted bits
- Icemaker kit (or icemaker tubing with ferrules and nuts)
- Open-end or adjustable wrench
- T-fitting (for supply tube)
- Putty knife
- Long ½"-inch drill bit
- Electrician's tape

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#175 Dtp:225 Page:114

How Icemakers Work ▸

An icemaker receives its supply of water for making cubes through a ¼" copper supply line that runs from the icemaker to a water pipe. The supply line runs through a valve in the refrigerator and is controlled by a solenoid that monitors the water supply and sends the water into the icemaker itself, where it is turned into ice cubes. The cubes drop down into a bin, and as the ice level rises, they also raise a bail wire that's connected to a shutoff. When the bin is full, the bail wire will be high enough to trigger a mechanism that shuts off the water supply.

Aftermarket automatic icemakers are simple to install as long as your refrigerator is icemaker ready. Make sure to buy the correct model for your appliance and do careful installation work—icemaker water supply lines are very common sources for leaks.

How to Connect an Icemaker

Locate a nearby cold-water pipe, usually in the basement or crawl space below the kitchen. Behind the refrigerator and near the wall, use a long ½-inch bit to drill a hole through the floor. Do not pull the bit out.

From below, fasten plastic icemaker tubing to the end of the drill bit by wrapping firmly with electrician's tape. From above, carefully pull the bit up, to thread the tubing up into the kitchen.

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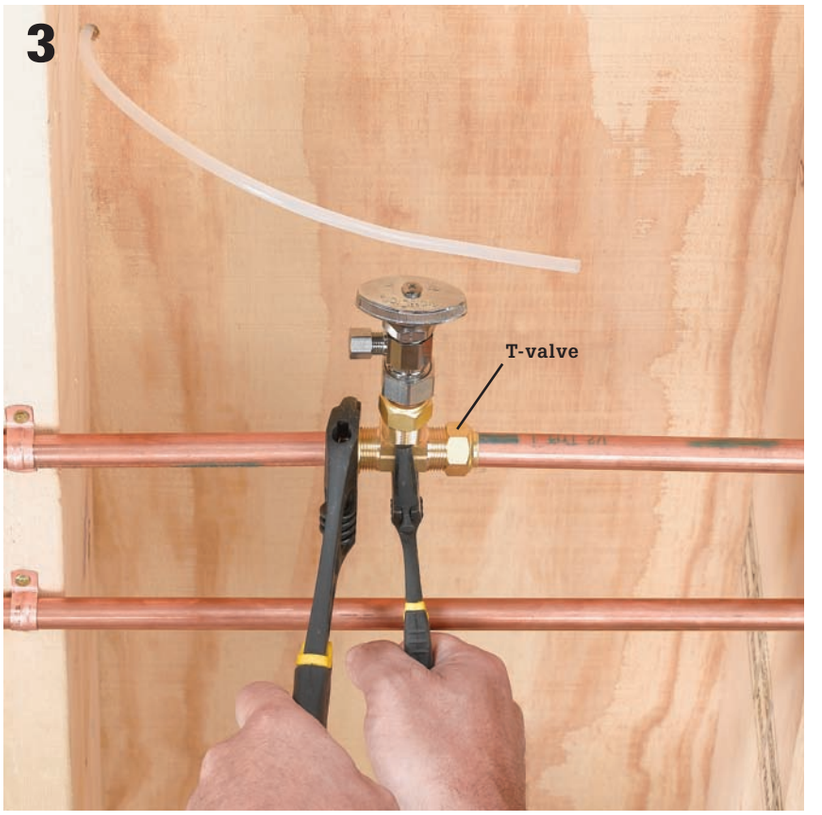
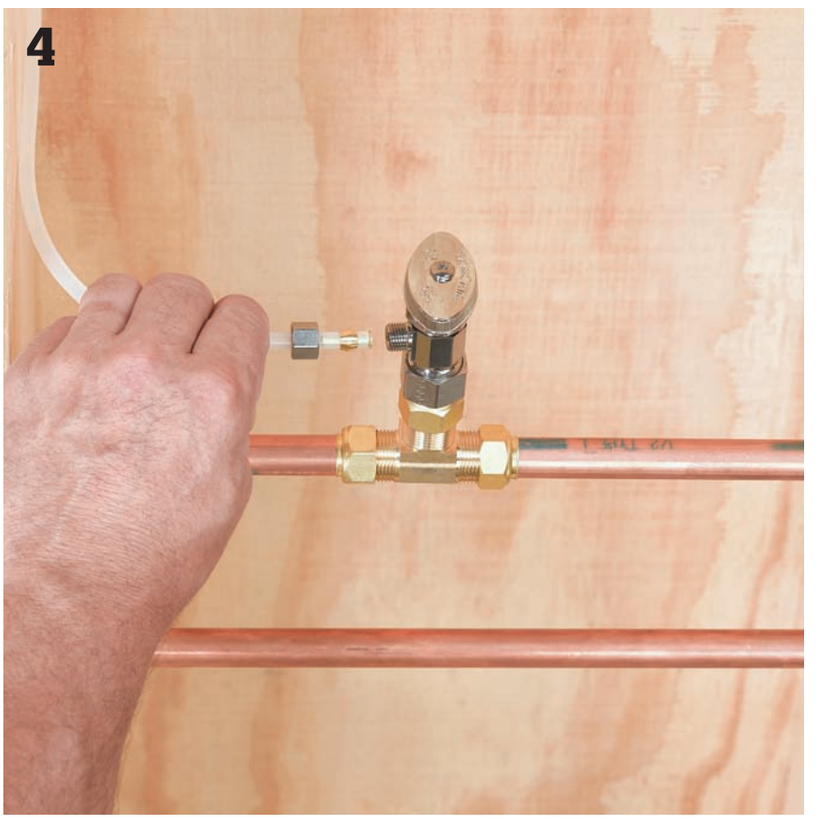


Shut off the water and open nearby faucets to drain the line. Cut into a cold-water pipe and install a compression Tee valve. Tighten all the nuts, close the valve and nearby faucets, and restore water to test for leaks.



Connect the tubing. Arrange the tubing behind the fridge so you have about 6 feet of slack, making it easy to pull the fridge out for cleaning. Cut the tubing with a knife. Slide on a nut and a ferrule. Insert the tubing into the valve, slide the ferrule tight against the valve, and tighten the nut. To finish the installation, connect the tubing to the refrigerator, using a nut and ferrule. Keep the tubing neatly coiled and kink-free for future maintenance.

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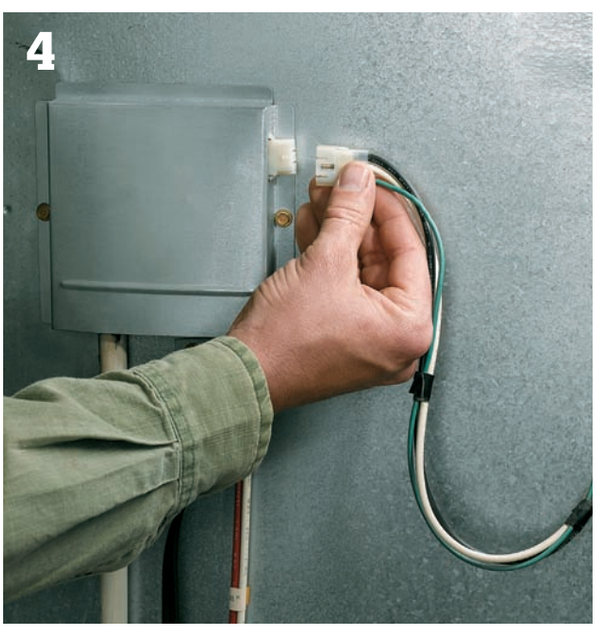
How to Install a New Icemaker

Remove all the contents from the refrigerator and freezer. Unplug the unit and pull it out from the wall. Open the freezer door and remove the icemaker cover plate (inset). On the back of the refrigerator, remove the backing or unscrew the icemaker access panel.

Install the tube assembly. Remove two insulation plugs to expose two openings, one for the water line and the other for a wiring harness. Install the water tube assembly (part of the icemaker kit) in its access hole; it has a plastic elbow attached to the plastic tube that reaches into the freezer compartment.

Hook up the harness. Icemaker kits usually come with a wiring harness that joins the icemaker motor inside the freezer box to the power supply wires. Push this harness through its access hole and into the freezer compartment. Then seal the hole with the plastic grommet that comes with the harness.



Join the end of the icemaker wiring harness to the power connector that was preinstalled on the back of the refrigerator. This connection should lay flat against the back. If it doesn't, just tape it down with some duct tape or masking tape.

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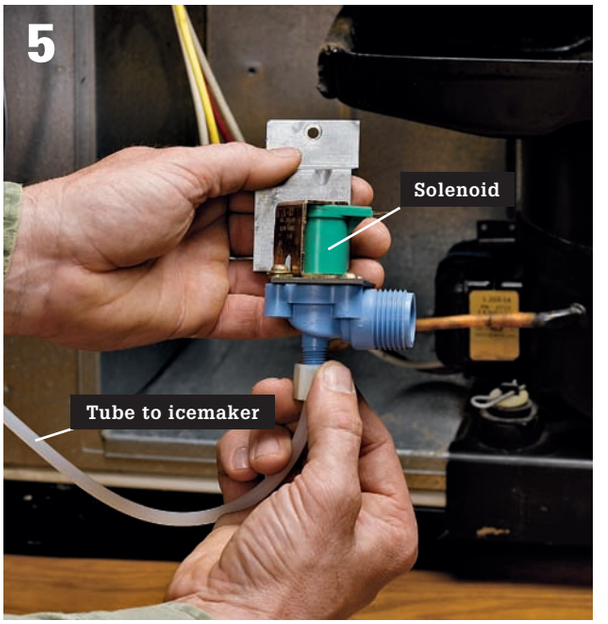
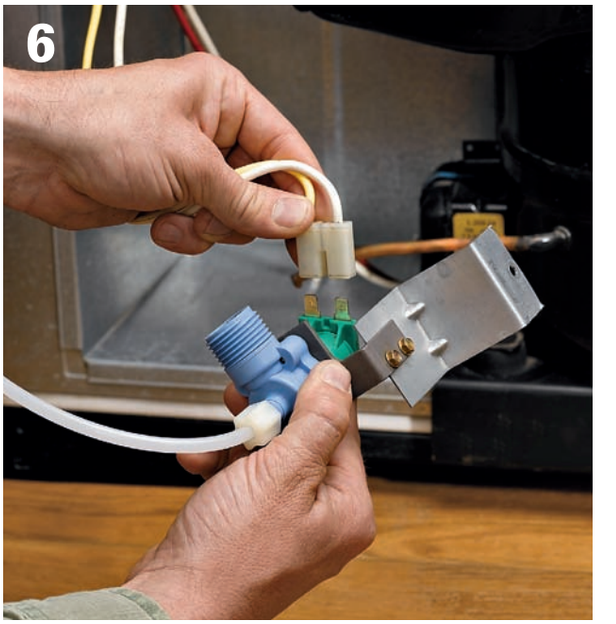
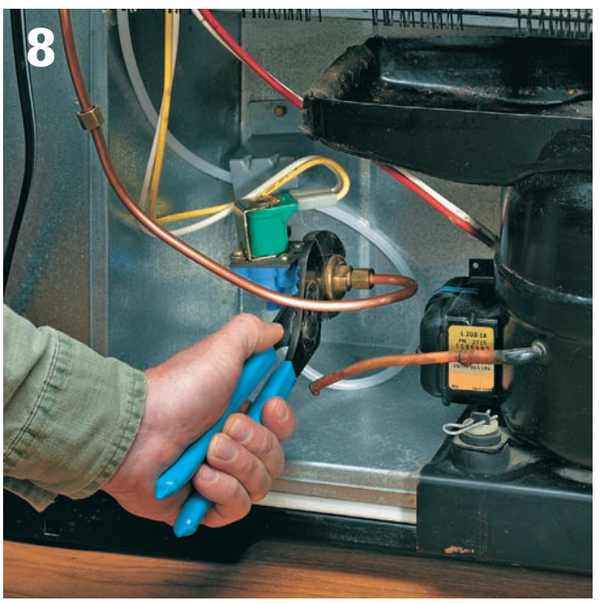


The water tube at the top of the refrigerator is attached to the solenoid that is mounted at the bottom with a plastic water line. To install the line, first attach it to the water tube, then run it down the back of the refrigerator and attach it to the solenoid valve with a compression fitting. This job is easier to do before you attach the solenoid assembly to the refrigerator cabinet.



The icemaker wiring harness comes with two snap connectors. One goes to the preinstalled wires on the refrigerator and the other is attached to the solenoid. Just push this second connector onto the brass tabs, usually at the top of the solenoid.

Attach the solenoid to a mounting bracket that should be installed on the cabinet wall at the bottom of the refrigerator. Mounting holes may be predrilled in the cabinet for this purpose. But if not, drill holes to match the bracket and the size of the screws. Then attach the bracket and make sure to attach the solenoid ground wire to one of these screws.



Install the water-inlet copper tube once the solenoid is mounted. Attach it by tightening the nut on one end with channel-type pliers. The other end of the tube is held to the refrigerator cabinet with a simple clamp. Make sure the end of this tubing is pointing straight up.

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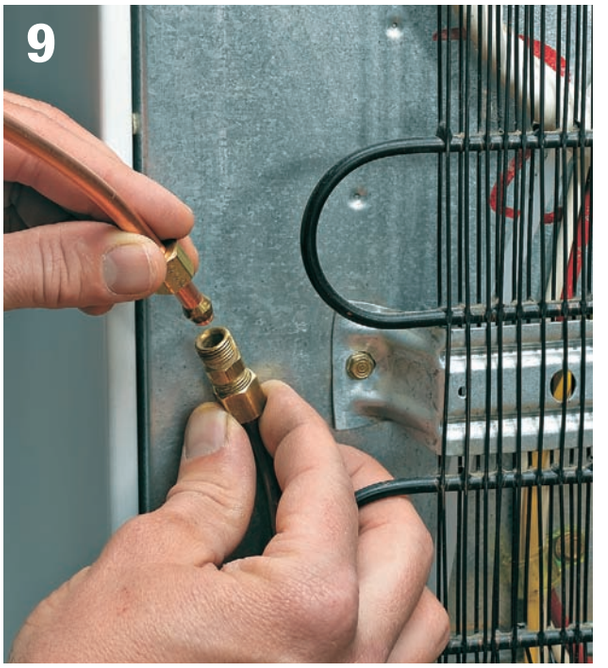
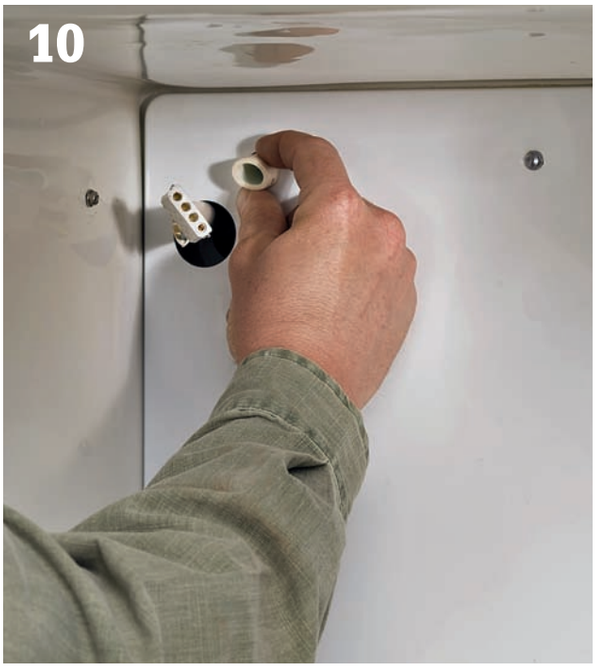


The end of the water-inlet tube is joined to the water supply tubing (from the house plumbing system) with a brass compression coupling. Tighten the compression nuts with an open-end or adjustable wrench.



From inside the freezer compartment, make sure the water tube and the wiring harness (from the back of the refrigerator) are free. If they are caught on the cabinet, loosen them until they are easily accessible.

Connect the wire harness to the plug on the icemaker unit. Also connect the water supply tube to the back of the icemaker with a spring clip or hose clamp.

Install the icemaker. Remove any small rubber caps that may be installed in the mounting screw holes with a narrow putty knife. Lift the unit and screw it to the freezer wall. The mounting bracket holes are usually slotted to permit leveling the unit. Plug in the refrigerator and test the icemaker.

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#175 Dtp:225 Page:119

Pot Filler

Kitchen design trends are moving ever closer to replicating commercial kitchens in the home. One example of this trend is the pot filler. A long-neck faucet that mounts to the wall behind or onto the counter beside the cooktop, a pot filler allows you to dispense water directly into large pots on the cooktop. This saves lugging pots of water from the sink to the stove.

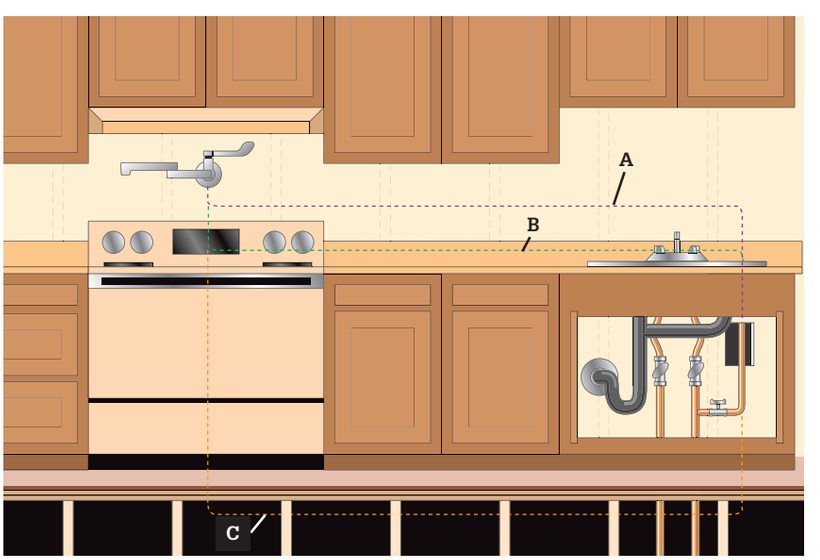
Although horizontally mounted models are available, most pot fillers are attached to the wall. Almost all are designed for cold water only. Some have two valves, one at the wall and another at the end of the spout. Other models can be turned on with a foot pedal for safe, hands-free use.

A pot filler will require code-approved supply pipe (½" in most cases) connected with a permanent union at another supply line or the main. The best time to run a new supply is during a remodel. But retrofitting a new supply line and mounting a pot filler is not too difficult as a standalone project. Using PEX supply pipe will make running the new supply line in finished walls easier (see pages 290 to 297 for cutting and fitting PEX).

A pot filler is a cold-water tap that you install above your cooktop so you can add water to large stock pots without having to carry a full pot of water around the kitchen.

Tools & Materials ▸

Hack saw	Pot filler	Reciprocating saw	Drywall patching materials
PEX tools	Protector plates	Drywall tools	
PEX pipe	PEX fittings	Pipe joint compound	



Plan the route for the new supply line. In most cases, you will enter the stud cavity of the wall and run a new line directly upward, past the backsplash height of the countertop (A). If the countertop backsplash is removable, avoid wallboard patching by installing the tubing behind the backsplash (B). You may also be able to run the supply line underneath the kitchen if there is an unfinished basement (C).

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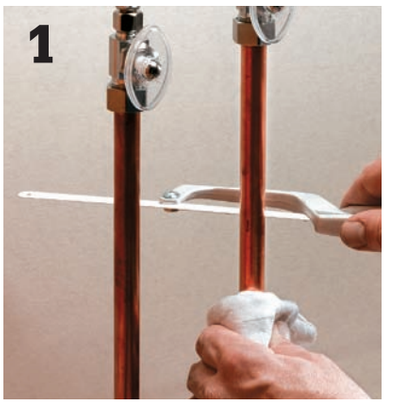
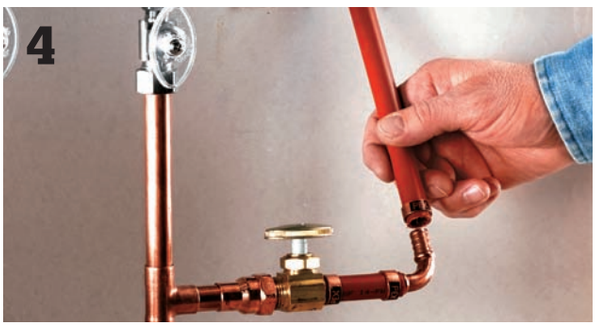
How to Install a Pot Filler



Shut off the water supply and locate the cold water supply riser at the kitchen sink. Cut into the riser and install a T-fitting, or replace the existing shutoff valve on the riser with a multiple-outlet shutoff valve, with an outlet for ½" supply pipe for the pot filler.

Plan the route for the new supply line beginning at the T-fitting and working toward the cooktop area. Determine the height of the new line and then snap chalklines from the sink to the cooktop. With the electrical power shut off, remove wall coverings 2" above and below the chalkline and at the location for the pot filler outlet. Make sure the location is high enough that the pot filler spout will clear your tallest stockpot.

Drill ¾" holes in the framing for the supply tubes. Install protector plates if the holes are within 1¼" of the stud edge. Run ½" PEX from the supply riser through the holes to the pot filler location (inset). Attach nailing plates to protect the pipes.



Attach the new PEX supply line to the T-fitting at the supply riser, installing an accessible shutoff valve on the new line.

At the cooktop, install the faucet union as specified by the manufacturer. Add blocking as needed. The pot filler installed here attaches to a drop-ear L-fitting, mounted to blocking. Apply pipe joint compound to the faucet inlet and thread it on to the L-fitting.

Cut and install the drywall patch. Fit the flange over the inlet. Apply pipe joint compound to the threads of the faucet body. Assemble and adjust the faucet according to the manufacturer's instructions. Test the faucet before refinishing the drywall.

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Reverse-Osmosis Water Filters

Not all water is created equal. Some water tastes better than other water. Some water looks better than other water. And some has more impurities. Because no one wants to drink bad water, the bottled water business has exploded over the past twenty years. Home filtration systems have also grown by leaps and bounds, in part because there are so many different types of filters available.

For example, sediment filters will remove rust, sand, and suspended minerals, like iron. A carbon filter can remove residual chlorine odors, some pesticides and even radon gas. Distillation filters can remove bacteria and organic compounds, while a traditional water softener can neutralize hard water. But many of the most toxic impurities, heavy metals like mercury, lead, cadmium, and arsenic are best

Reverse-osmosis filters can be highly effective for removing specific contaminants from drinking water. Because the filtration process wastes a lot of fresh water, it's a good idea to have your water professionally tested before investing in an RO system.

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removed with a reverse-osmosis (RO) system like the one shown here.

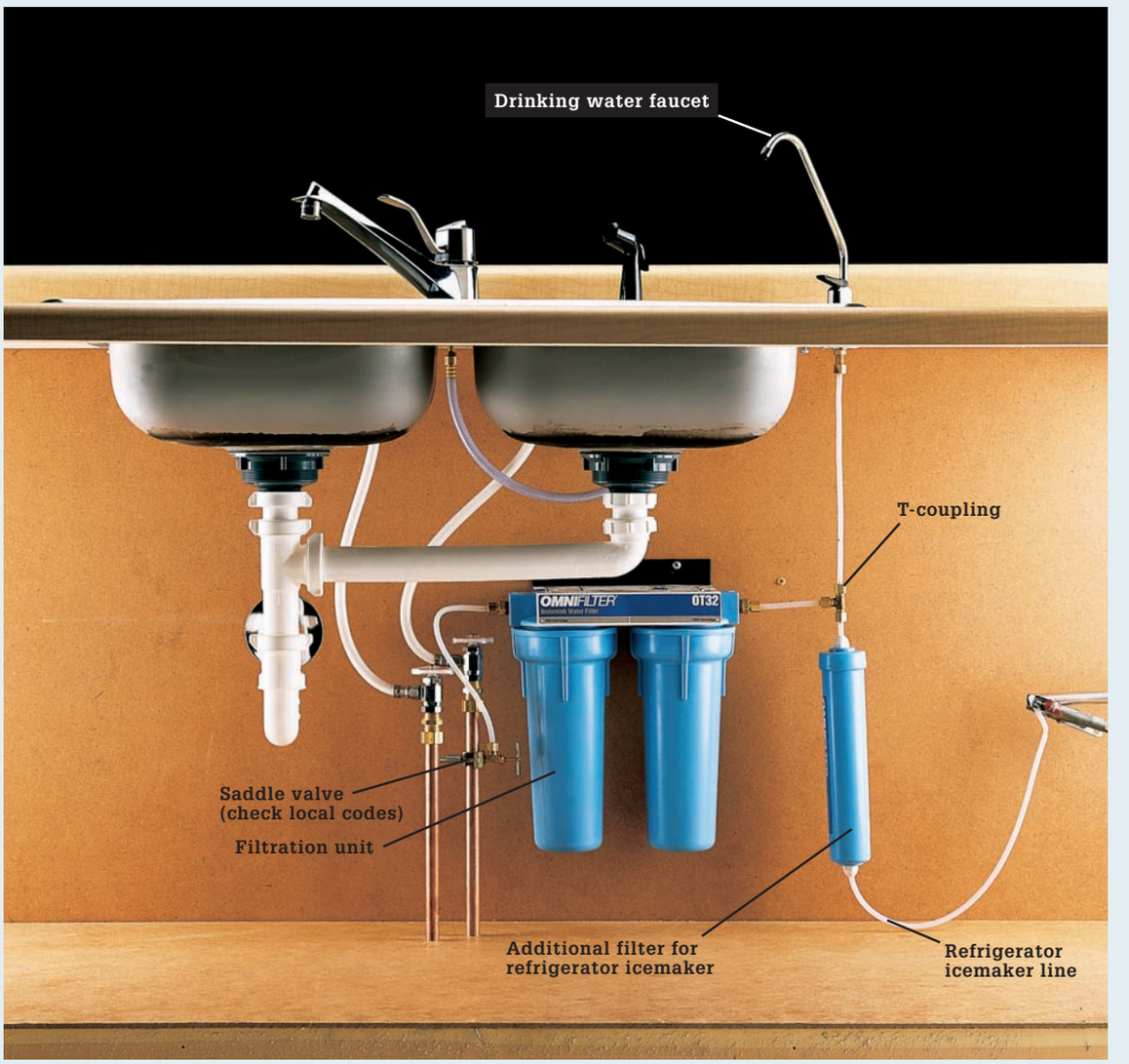
These filters are designed to treat cooking and drinking water. The system holds the treated water in a storage tank and delivers it to a sink-mounted faucet on demand. RO units feature multiple filter cartridges, in this case a pre-filter unit, followed by the RO membrane, and then a carbon post-filter.

Tools & Materials

- Plastic gloves
- Screwdrivers
- Electric drill
- Adjustable wrench
- Teflon tape
- Saddle valve
- Rubber drain saddle

Point-of-Use Filters

Point-of-use water filtration systems are typically installed in the sink base cabinet, with a separate faucet from the main kitchen faucet. The setup shown here has an extra filter to supply a nearby refrigerator icemaker.



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#175 Dtp:225 Page:123

How to Install a Reverse-Osmosis Water Filter

Install the RO membrane filter. It is shipped in a separate bag that is filled with anti-bacterial fluid. Wearing plastic gloves, remove the cartridge from the bag and install it in the filter unit. Make sure to touch only the ends of the cartridge when you handle it or you can damage the membrane.

Follow the manufacturer's instructions to establish the best location for the filter inside your kitchen sink cabinet. Drive mounting screws into the cabinet wall to support the unit.

Assemble the entire filtration system and then hang it on the cabinet wall. The best system layout may be to locate the filter on one wall and the storage tank on the opposite wall.

Attach valve to the side of the storage tank. Just wrap its threads a couple of times with Teflon tape and screw the valve into the tank. Finger tighten it, then turn it one more turn with an adjustable wrench.

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#175 Dtp:225 Page:124

Connect the filter to the tank with plastic tubing. Some units use a compression fitting; this one uses a push-type collar. Simply insert the hose into the collar until it stops. Pull back gently to make sure it is firmly attached.

Connect the water storage tank and faucet with plastic tubing. Here, a push-type compression fitting on the end of the tubing was used. To install it, push the end of the fitting over the bottom of the faucet shank until the fitting bottoms out.

The filter faucet comes with a jamb nut and sometimes a plastic spacer (as with this unit) that goes on the shank of the faucet before the jamb nut. After the nut is finger tight, snug it securely with an adjustable wrench.

Mount the faucet in the sink deck, following the manufacturer's instructions.

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#175 Dtp:225 Page:125

The water supply to the filter comes from the cold-water supply line that services the kitchen sink faucet. The easiest way to tap into the supply line is to replace the shutoff valve at the supply riser with a new valve containing an additional outlet for tubing.

Attach the filter supply tube to the port on the shutoff valve with a compression fitting. Push the end of the tubing onto the valve, then push the ferrule against the valve and thread the compression nut into place. Finger tighten it, then turn it one more full turn with a wrench.

The filter must also be tied into the drain system. The best way to do this is to replace the drain tailpiece with a new drain tailpiece that contains an auxiliary port.

Attach the tubing from the drain to the auxiliary port on the tailpiece. Finish up by turning on the water and checking the system for leaks. Be sure to filter and drain at least two tanks of water, to clean any contaminants from the system, before drinking the water.

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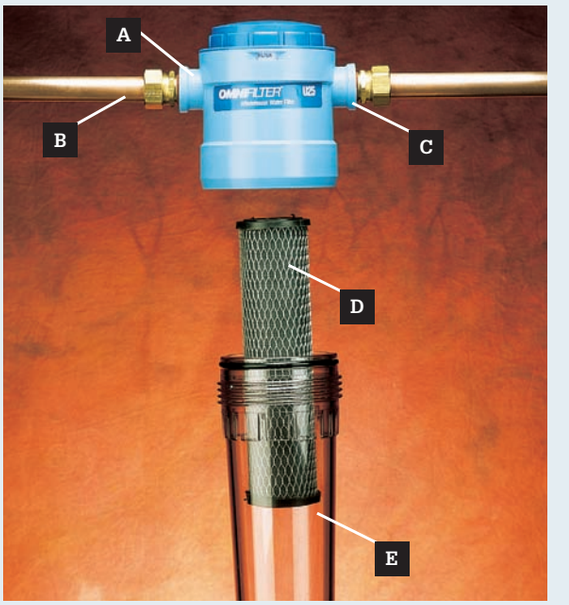
#175 Dtp:225 Page:126

Installing a Whole-House Water Filtration System ▸

A whole-house water filtration system is installed along the supply pipe carrying water to the house, located after the water meter, but before any other appliances in the pipe line. A whole-house system reduces the same elements as an undersink system and can also help reduce the iron flowing into the water softener, prolonging its life.

Always follow the manufacturer's directions for your particular unit. If your electrical system is grounded through the water pipes, make sure to install ground clamps on both sides of the filtration unit with a connecting jumper wire. Globe valves should be installed within 6" of the intake and the outtake sides of the filter.

Filters must be replaced every few months, depending on type of manufacturer. The filtration unit cover unscrews for filter access.



A whole-house water filtration system: (A) intake side, (B) supply pipe from the water meter pipe, (C) outtake side to the house supply pipe, (D) filter, and (E) filtration unit cover.

Shut off main water supply and turn on faucets to drain pipes. Position unit after water meter, but before any other appliances in supply pipe. Measure and mark pipe to accomodate the filtration unit. Cut pipe at marks with a pipe cutter. Join water meter side of pipe with intake side of unit, and house supply side of pipe with outtake side of unit. Tighten with a wrench.

Install a filter and screw filtration unit cover to bottom of the filtration unit. Attach a jumper wire to pipes on other side of unit, using pipe clamps. Open main water supply lines to restore the water supply. Allow faucets to run for a few minutes, as you check to make sure that the system is working properly.

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#175 Dtp:225 Page:127

Freezeproof Sillcocks

If you live in a part of the world where sub-freezing temperatures occur for extended periods of time, consider replacing your old sillcock (outdoor faucet) with a frost-proof model. In this project we show you how to attach the new sillcock using compression fittings, so no torch or molten solder is required. Before freezing weather arrives, be sure to disconnect the hose from a freeze-proof sillcock. If you don't, water that may remain in the hold and in the sillcock's shaft (or that may be created by condensation) may freeze and crack the shaft.

Compression fittings are ok to use in accessible locations, like between open floor joists in a basement. Your building code may prohibit their use in enclosed walls and floors. To see if your sillcock can be replaced according to the steps outlined here, see the facing page.

Tools & Materials

- Adjustable wrench
- Frost-proof sillcock
- Line level
- Silicone caulk
- Teflon tape
- Pipe joint compound
- Pipe wrench
- Tape measure
- ⅛-in. drill bit
- Screwdriver
- Threaded adapter
- #10 or #8 screws
- Tubing cutter
- 1⅛-inch spade bit
- 10d nails
- Board
- Electric drill

Did that outside faucet freeze again? Replace it with one that you never have to turn off in the winter.

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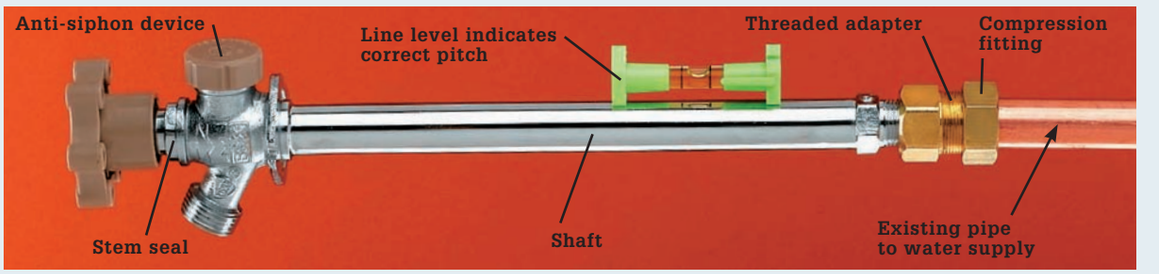
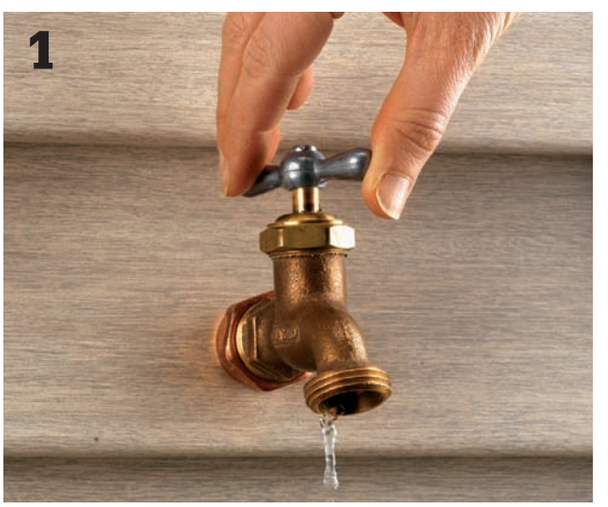
Anatomy of a Frost-proof Sillcock



The frost-proof sillcock shown here can stay active all winter because the stem washer turns off the water in the warm interior of the house. The shaft needs to be pitched slightly down toward the outside to allow water to drain from the shaft. This supply pipe is connected to the threaded adapter with a compression fitting, which is secured to the pipe with two wrenches. Do not use the steps that follow if any of the following apply:

- Your pipes are made from steel instead of copper.
- The length of the pipe from the sillcock to where you can comfortably work on it is greater than 12".
- The pipe has a valve or change of direction fitting within ten inches of the existing sillcock.
- The existing supply pipe is ⅝" outside diameter as measured with an adjustable wrench, and you are unable to make the hole in the wall bigger to accommodate the thicker shaft of the frost-proof sillcock. (For example, the hole is in a concrete foundation.)

How to Replace a Hose Bib with a Frost-proof Sillcock



Turn off the water to your outside faucet at a shutoff found inside the house or basement behind the faucet (see pages 12–13 if you have trouble turning off the water). Open the faucet and a bleeder valve on the shutoff to drain any remaining water from the pipe.

When you are sure the water flow has been stopped, use a tubing cutter to sever the supply pipe between the shutoff valve and the faucet. Make this first cut close to the wall. Tighten the tubing cutter onto the pipe. Both wheels of the cutter should rest evenly on the pipe. Turn the cutter around the pipe. The line it cuts should make a perfect ring, not a spiral. If it doesn't track right, take it off and try in a slightly different spot. When the cutter is riding in a ring, tighten the cutter a little with each rotation until the pipe snaps.

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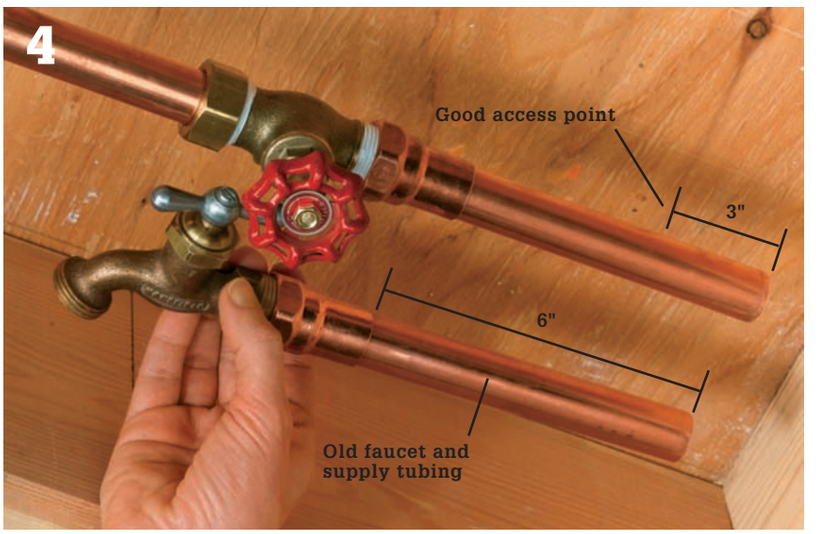
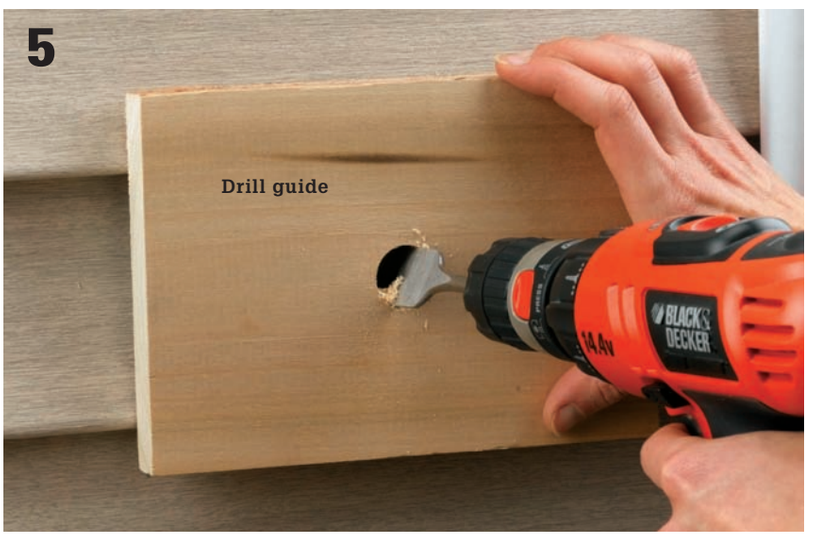
#175 Dtp:225 Page:129

Remove the screws, holding the flange of the old sillcock to the house, and pull it and the pipe stub out of the hole. Measure the outside diameter of the pipe stub. It should be either ⅝", which means you have ½" nominal pipe, or ⅞", which means you have ¾" nominal pipe. Measure the diameter of the hole in the joist. (If it's less than an inch, you'll probably need to make it bigger.) Measure the length of the pipe stub from the cut end to where it enters the sillcock. This is the minimum length the new sillcock must be to reach the old pipe. Record all this information.



Find a spot on the supply pipe where you have good access to work with a fitting and wrenches. The point of this is to help you select a new sillcock that is the best size for your project. In most cases, you'll have only two or three 6" to 12" shaft sizes to pick from. In the example above, we can see that the cut section of pipe is 6" long and the distance from the cut end to a spot with good access on the intact pipe is 3", so a new sillcock that's 9" long will fit perfectly.



If you need to replace old pipe with a larger diameter size, simplify the job of enlarging the sillcock entry hole into your home with a simple drill guide. First, drill a perpendicular 1⅛" diameter hole in a short board. From outside, hold the board over the old hole so the tops are aligned (you can nail or screw it to the siding if you wish). Run the drill through your hole guide to make the new, wider and lower hole in the wall.

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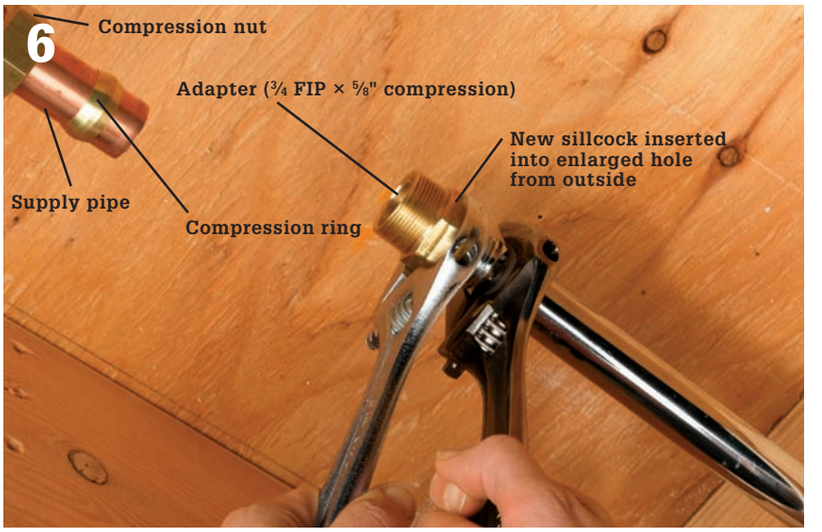
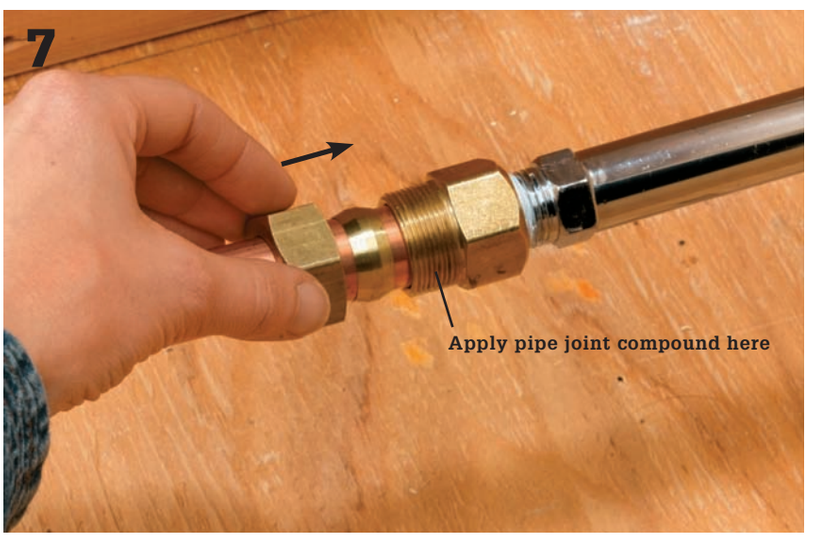


Insert the sillcock into the hole from the outside. Cut the supply pipe where it will meet the end of the sillcock. From the inside, wrap Teflon tape clockwise onto the threads of the sillcock. Stabilize the sillcock with one wrench and fully tighten the adapter onto the threaded sillcock with the other wrench.



Insert the end of the supply pipe into the adapter and pull them together. Spin the sillcock shaft so the faucet outside is oriented correctly (there should be a reference line on the bottom or top of the shaft). Apply pipe joint compound to the male threads on the adapter body. Hand thread the nut onto the adapter body. Stabilize the adapter body with one wrench, then tighten the compression nut with the other about two full turns past hand tight.

Turn the water back on. With the sillcock off and then on, check for leaks. Tighten the compression nut a little more if this union drips with the sillcock off. From outside the house, push the sillcock down against the bottom of the entry hole in the wall. Drill small pilot holes into the siding through the slots on the sillcock flange. Now, pull out on the sillcock handle in order to squeeze a thick bead of silicone caulk between the sillcock flange and the house. Attach the sillcock flange to the house with No. 8 or No. 10 corrosion-resistant screws.

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Pedestal Sinks

Pedestal sinks move in and out of popularity more frequently than other sink types, but even during times they aren't particularly trendy they retain fairly stable demand. You'll find them most frequently in small half baths, where their little footprint makes them an efficient choice. Designers are also discovering the appeal of tandem pedestal sinks of late, where the smaller profiles allow for his-and-hers sinks that don't dominate visually.

The primary drawback to pedestal sinks is that they don't offer any storage. Their chief practical benefit is that they conceal plumbing some homeowners would prefer not to see.

The sink is mounted onto the wall via a screw-attached metal bracket, and the pedestal is actually installed after the sink is hung and its purpose is only decorative. But other pedestal sinks (typically on the higher end of the design scale) have structurally important pedestals that do most or all of the bearing for the sink.

If you squeeze the plumbing tightly together, you may be able to hide the trap, stop valves, and supply tubes. Most of the time, however, at least some of these things will show. In that case, spend a bit more for classy-looking plumbing components.

Pedestal sinks are available in a variety of styles and are a perfect fit for small half baths. They keep plumbing hidden, lending a neat, contained look to the bathroom.

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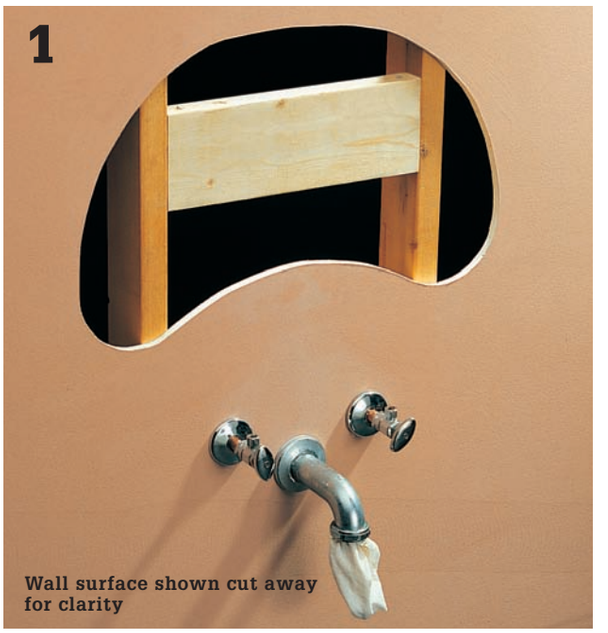
How to Install a Pedestal Sink



Install 2 × 6 blocking between the wall studs, behind the planned sink location where you will drive screws to mount the sink. Cover the wall with water-resistant drywall. Waste and supply lines may need to be moved, depending on the sink.

Set the basin and pedestal in position and brace it with 2 × 4s. Outline the top of the basin on the wall, and mark the base of the pedestal on the floor. Mark reference points on the wall and floor through the mounting holes found on the back of the sink and the bottom of the pedestal.

Set aside the basin and pedestal. Drill pilot holes in the wall and floor at the reference points, then reposition the pedestal. Anchor the pedestal to the floor with lag screws.

Attach the faucet, then set the sink on the pedestal. Align the holes in the back of the sink with the pilot holes drilled in the wall, then drive lag screws and washers into the wall brace using a ratchet wrench. Do not overtighten the screws.

Hook up the drain and supply fittings. Caulk between the back of the sink and the wall when installation is finished. You may choose to apply caulk between the sink and the wall, or between the bottom of the pedestal and the floor.

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#175 Dtp:225 Page:133

Wall-Hung Vanities

Think of a wall-mounted sink or vanity cabinet and you're likely to conjure up images of public restrooms where these conveniences are installed to improve access for floor cleaning. However, wall-hung sinks and vanities made for home use are very different from the commercial installations.

Often boasting high design, beautiful modern vanities and sinks come in a variety of styles and materials, including wood, metal, and glass. Some attach with decorative wall brackets that are part of the presentation; others look like standard vanities, just without legs. Install wall-hung sinks and vanities by attaching them securely to studs or wood blocking.

Tools & Materials

Studfinder	Level
Drill	Vanity

Today's wall-hung sinks are stylish and attractive, but they require mounting into studs or added blocking to keep them secure.

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#175 Dtp:225 Page:134

How to Install a Wall-Hung Vanity Base

Remove the existing sink or fixture and inspect the wall framing. Also determine if plumbing supply and waste lines will need to be moved to accommodate the dimensions of the new fixture. Locate the studs in the sink location with a stud finder.

Hold the sink or cabinet in the installation area and check to see if the studs align with the sink or sink bracket mounting holes. If they do, skip to step 3. If the studs do not align, remove the wallboard behind the mounting area. Install 2 × 6 blocking between studs at the locations of the mounting screws. Replace and repair wallboard.

Mark the locations of the mounting holes on the wall using a template or by supporting the sink or vanity against the wall with a temporary brace (made here from scrap 2 × 4s) and marking through the mounting holes.

Drill pilot holes at the marks. Have a helper hold the vanity in place while you drive the mounting screws. Hook up the plumbing (see pages 140 to 141).

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#175 Dtp:225 Page:135

Vessel Sinks

The vessel sink harkens back to the days of washstands and washbowls. Whether it's round, square, or oval, shallow or deep, the vessel sink offers great opportunity for creativity and proudly displays its style. Vessel sinks are a perfect choice for a powder room, where they will have high visibility.

Most vessel sinks can be installed on any flat surface—from a granite countertop to a wall-mounted vanity to an antique dresser. Some sinks are designed to contact the mounting surface only at the drain flange. Others are made to be partially embedded in the surface. Take care to follow the manufacturer's instructions for cutting holes for sinks and faucets.

A beautiful vessel sink demands an equally attractive faucet. Select a tall spout mounted on the countertop or vanity top or a wall-mounted spout to accommodate the height of the vessel. To minimize splashing, spouts should directly flow to the center of the vessel, not down the side. Make sure your faucet is compatible with your vessel choice. Look for a centerset or single-handle model if you'll be custom drilling the countertop—you only need to drill one faucet hole.

Tools & Materials

- Jigsaw
- Trowel
- Pliers
- Wrench
- Caulk gun and caulk
- Sponge
- Drill
- Vanity or countertop
- Vessel sink
- Pop-up drain
- P-trap and drain kit
- Faucet
- Phillips screwdriver

Vessel sinks are available in countless styles and materials, shapes, and sizes. Their one commonality is that they all need to be installed on a flat surface.

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Vessel Sink Options

This glass vessel sink embedded in a "floating" glass countertop is a stunning contrast to the strong and attractive wood frame anchoring it to the wall.

The natural stone vessel sink blends elegantly into the stone countertop and is enhanced by the sleek faucet and round mirror.

The stone vessel sink is complemented by the wall-hung faucet. The rich wood vanity on which it's perched adds warmth to the room.

Vitreous china with a glazed enamel finish is an economical and durable choice for a vessel sink (although it is less durable than stone). Because of the flexibility of both the material and the glaze, the design options are virtually unlimited with vitreous china.

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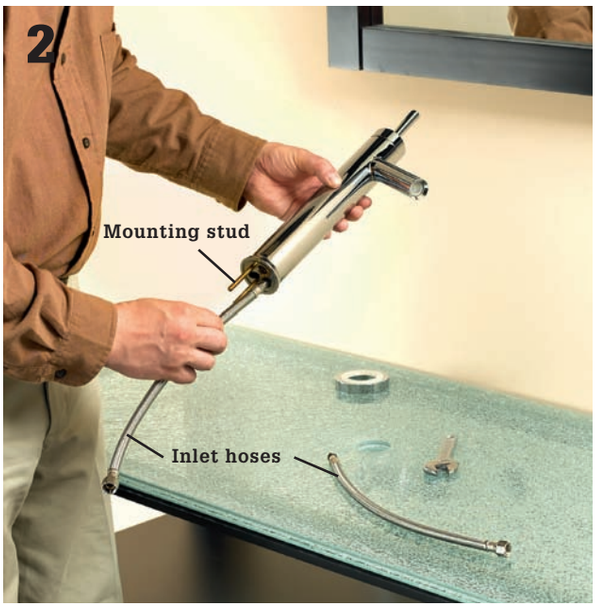
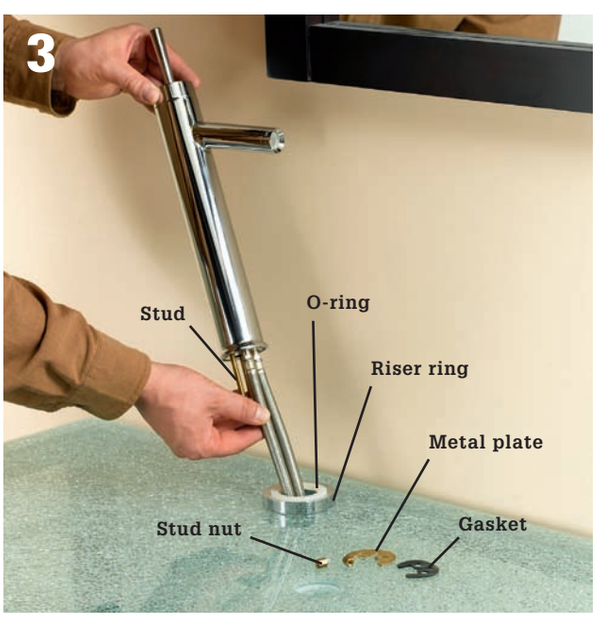
How to Install a Vessel Sink

Secure the vanity cabinet or other countertop that you'll be using to mount the vessel sink (see pages 140 to 141).



Begin hooking up the faucet. Insert the brass mounting stud into the threaded hole in the faucet base with the slotted end facing out. Hand tighten, and then use a screwdriver to tighten another half turn. Insert the inlet hoses into the faucet body and hand tighten. Use an adjustable wrench to tighten another half turn. Do not overtighten.



Place the riser ring on top of the O-ring over the faucet cutout in the countertop. From underneath, slide the rubber gasket and the metal plate over the mounting stud. Thread the mounting stud nut onto the mounting stud and hand tighten. Use an adjustable wrench to tighten another half turn.

To install the sink and pop-up drain, first place the small metal ring between two O-rings and place over the drain cutout.

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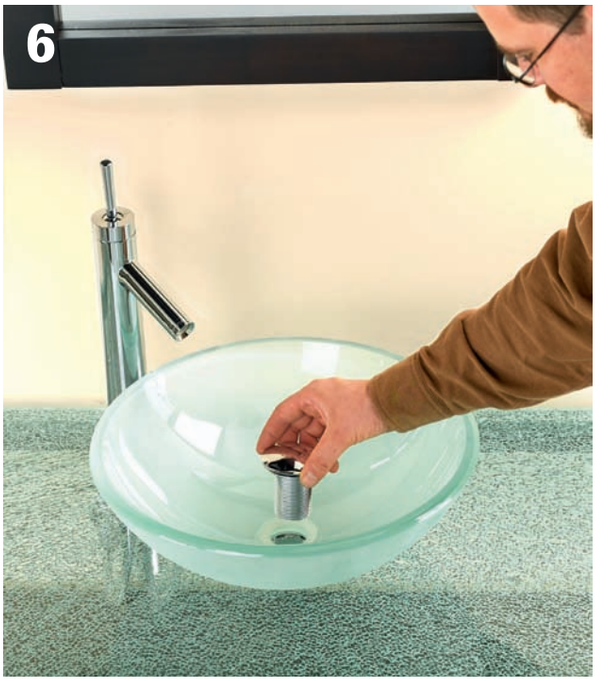
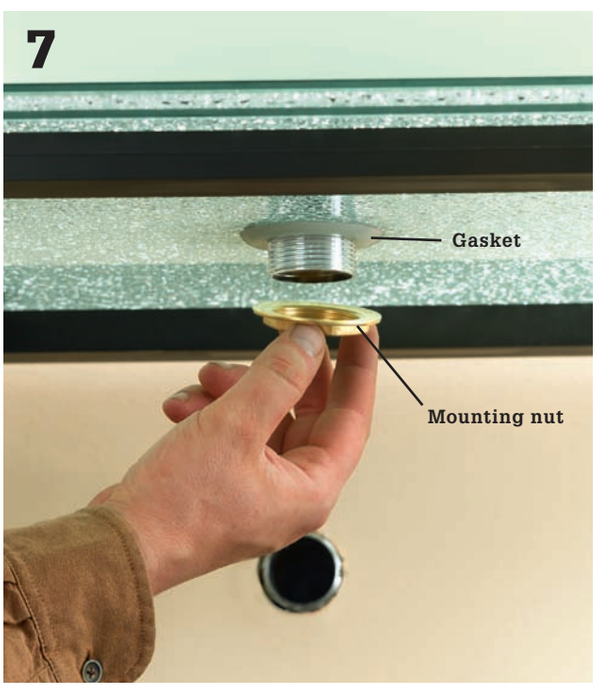
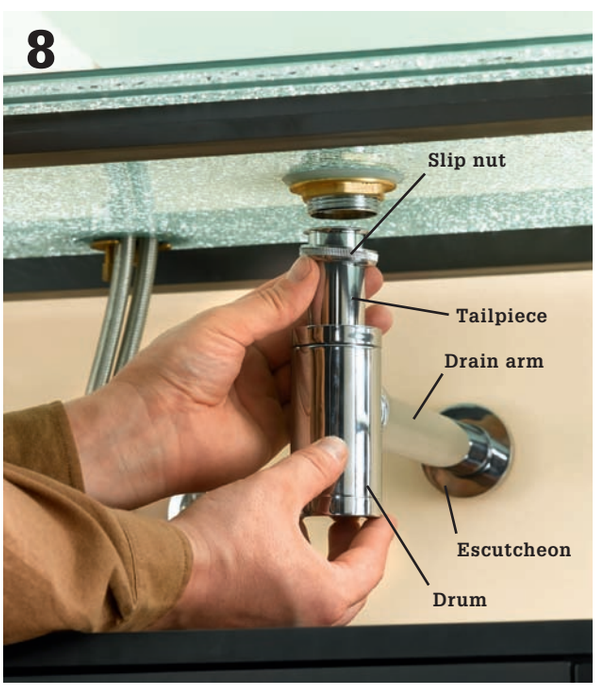
Place the vessel bowl on top of the O-rings. In this installation, the vessel is not bonded to the countertop.



Put the small rubber gasket over the drain hole in the vessel. From the top, push the pop-up assembly through the drain hole.



From underneath, push the large rubber gasket onto the threaded portion of the pop-up assembly. Thread the nut onto the pop-up assembly and tighten. Use an adjustable wrench or basin wrench to tighten an additional half turn. Thread the tailpiece onto the pop-up assembly.



Install the drum trap. Loosen the rings on the top and outlet of the drum trap. Slide the drum trap top hole over the tailpiece. Slide the drain arm into the side outlet, with the flat side of the rubber gasket facing away from the trap. Insert the drain arm into the wall outlet. Hand tighten the rings.

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Integral Vanity Tops

Most bathroom countertops installed today are integral (one-piece) sink-countertop units made from cultured marble or other solid materials, like solid surfacing. Integral sink-countertops are convenient, and many are inexpensive, and nowadays you can find them in a wide range of colors and styles.

Some remodelers and designers still prefer the distinctive look of a custom-built countertop with a self-rimming sink basin, which gives you a much greater selection of styles and colors. Install a self-rimming basin much as you would a self-rimming kitchen sink (pages 142–143).

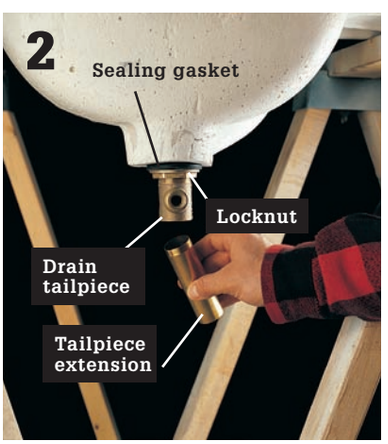
Tools & Materials

Pencil	Cardboard
Scissors	Masking tape
Carpenter's level	Plumber's putty
Screwdriver	Lag screws
Channel-type pliers	Tub and tile caulk
Ratchet wrench	Pipe dope
Basin wrench	

Integral sink-countertops are made in standard sizes to fit common vanity widths. Because the sink and countertop are cast from the same material, integral sink-countertops do not leak, and do not require extensive caulking and sealing.

How to Install a Vanity Cabinet

Set the sink-countertop unit onto sawhorses. Attach the faucet and slip the drain lever through the faucet body. Place a ring of plumber's putty around the drain flange, then insert the flange in the drain opening.



Thread the locknut and sealing gasket onto the drain tailpiece, then insert the tailpiece into the drain opening and screw it onto the drain flange. Tighten the locknut securely. Attach the tailpiece extension. Insert the pop-up stopper linkage.

Test-fit the top to see how much it will overhang on each side. Apply a layer of tub and tile caulk (or adhesive, if specified by the countertop manufacturer) to the top edges of the cabinet vanity, and to any corner braces.

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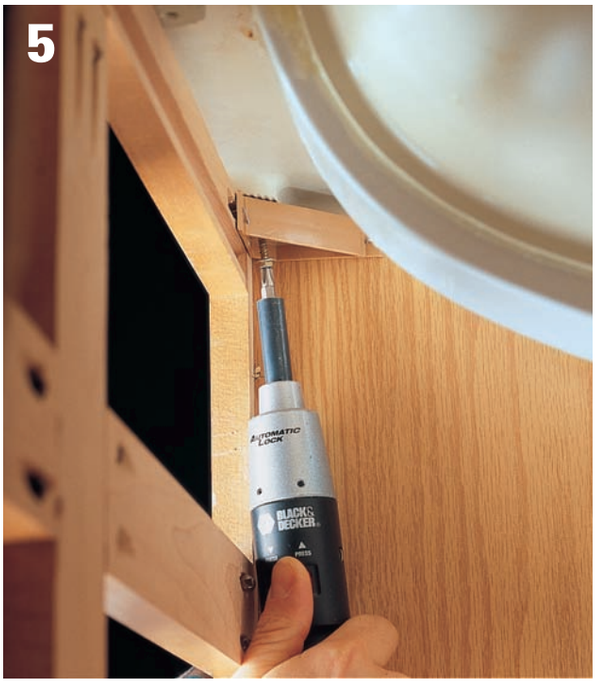
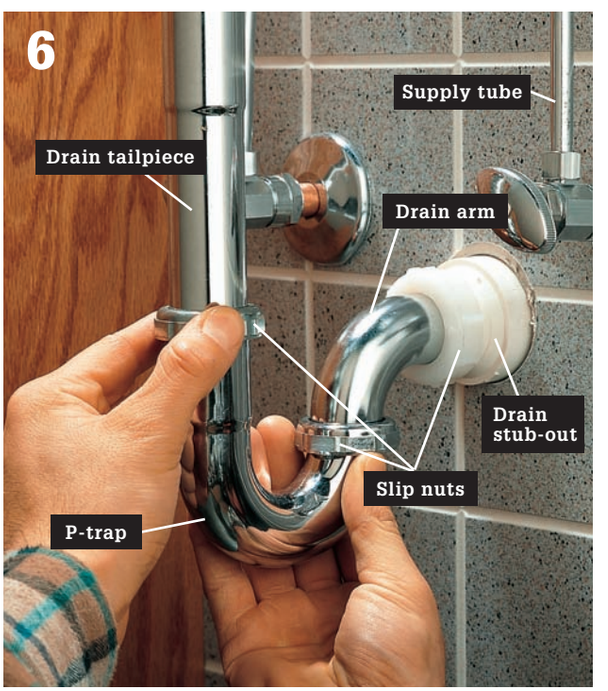
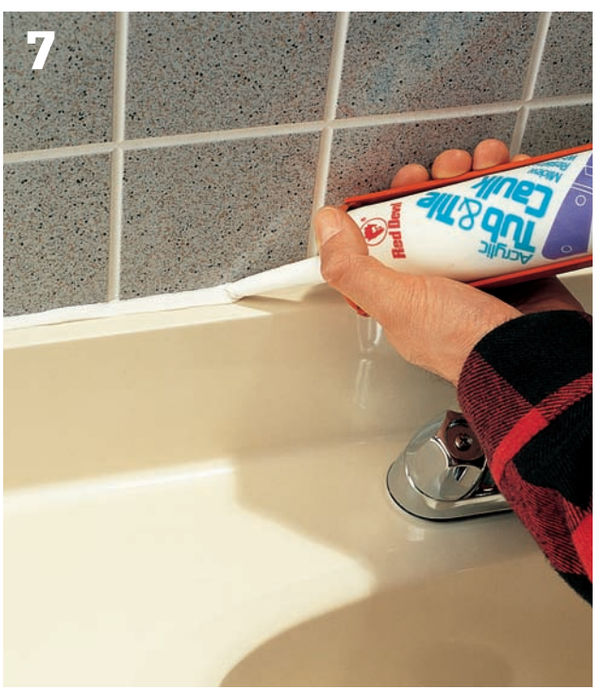
Center the sink-countertop unit over the vanity so the overhang is equal on both sides and the backsplash of the countertop is flush with the wall. Press the countertop evenly into the caulk.



Cabinets with corner braces: Secure the countertop to the cabinet by driving a mounting screw through each corner brace and up into the countertop. *Note: Cultured marble and other hard countertops require predrilling and a plastic screw sleeve.*



Attach the drain arm to the drain stub-out in the wall, using a slip nut. Attach one end of the P-trap to the drain arm, and the other to the tailpiece of the sink drain, using slip nuts. Connect supply tubes to the faucet tailpieces.



Seal the gap between the backsplash and the wall with tub and tile caulk.

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Kitchen Sinks

Most drop-in, self-rimming kitchen sinks are easily installed.

Drop-in sinks for do-it-yourself installation are made from cast iron coated with enamel, stainless steel, enameled steel, acrylic, fiberglass, or resin composites. Because cast-iron sinks are heavy, their weight holds them in place and they require no mounting hardware. Except for the heavy lifting, they are easy to install. Stainless steel and enameled-steel sinks weigh less than cast-iron and most require mounting brackets on the underside of the countertop. Some acrylic and resin sinks rely on silicone caulk to hold them in place.

If you are replacing a sink, but not the countertop, make sure the new sink is the same size or larger. All old silicone caulk residue must be removed with acetone or denatured alcohol, or else the new caulk will not stick.

Tools & Materials

- Caulk gun
- Spud wrench
- Screwdriver
- Sink
- Sink frame
- Plumber's putty or silicone caulk
- Mounting clips
- Jigsaw
- Pen or pencil

Shopping Tips

- When purchasing a sink, you also need to buy strainer bodies and baskets, sink clips, and a drain trap kit.
- Look for basin dividers that are lower than the sink rim—this reduces splashing.
- Drain holes in the back or to the side make for more usable space under the sink.
- When choosing a sink, make sure the predrilled openings will fit your faucet.

Drop-in sinks, also known as self-rimming sinks, have a wide sink flange that extends beyond the edges of the sink cutout. They also have a wide back flange to which the faucet is mounted directly.

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How to Install a Self-Rimming Sink

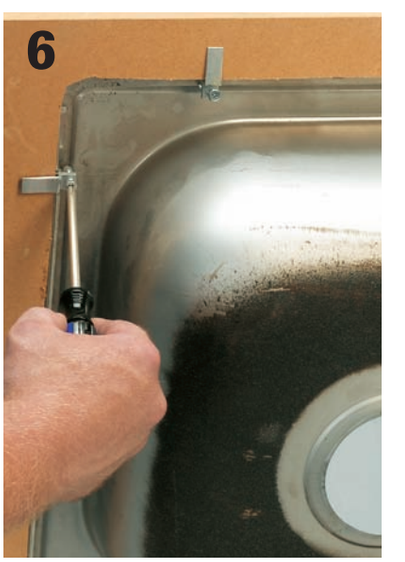
Invert the sink and trace around the edges as a reference for making the sink cutout cutting lines, which should be parallel to the outlines, but about 1" inside of them to create a 1" ledge. If your sink comes with a template for the cutout, use it.

Drill a starter hole and cut out the sink opening with a jigsaw. Cut right up to the line. Because the sink flange fits over the edges of the cutout, the opening doesn't need to be perfect, but as always you should try to do a nice, neat job.

Attach as much of the plumbing as makes sense to install prior to setting the sink into the opening. Having access to the underside of the flange is a great help when it comes to attaching the faucet body, sprayer, and strainer, in particular.

Apply a bead of silicone caulk around the edges of the sink opening. The sink flange most likely is not flat, so try and apply the caulk in the area that will make contact with the flange.

Place the sink in the opening. Try to get the sink centered right away so you don't need to move it around and disturb the caulk, which can break the seal. If you are installing a heavy cast-iron sink, it's best to leave the strainers off so you can grab onto the sink at the drain openings.



For sinks with mounting clips, tighten the clips from below using a screwdriver or wrench (depending on the type of clip your sink has). There should be at least three clips on every side. Don't overtighten the clips—this can cause the sink flange to flatten or become warped.

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Standpipe Drains

In many houses, the washing machine drain hose is hung loosely over the side of the utility sink, but this configuration is frowned upon by building codes. Instead, you should install a standpipe drain that allows the washing machine to drain directly into the utility sink's drain line. Standpipes with attached P-traps can be purchased at many home centers.

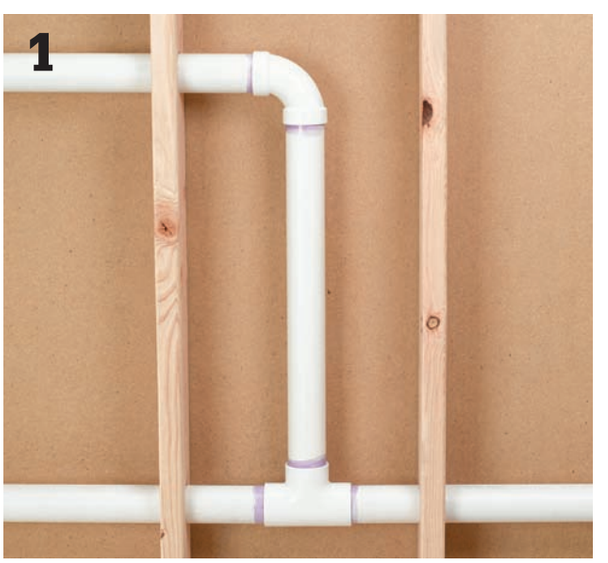
Tools & Materials ▸

Reciprocating saw	Pipe strap
Utility knife	Hose bibs
Waste Y-fitting	Solder
Primer & solvent glue	Threaded T-fittings
90° elbow	Torch
2" standpipe with trap	Sheet metal
2 × 4 backer	Teflon tape
2½" deck screws	Rubber supply hose
½" screws	

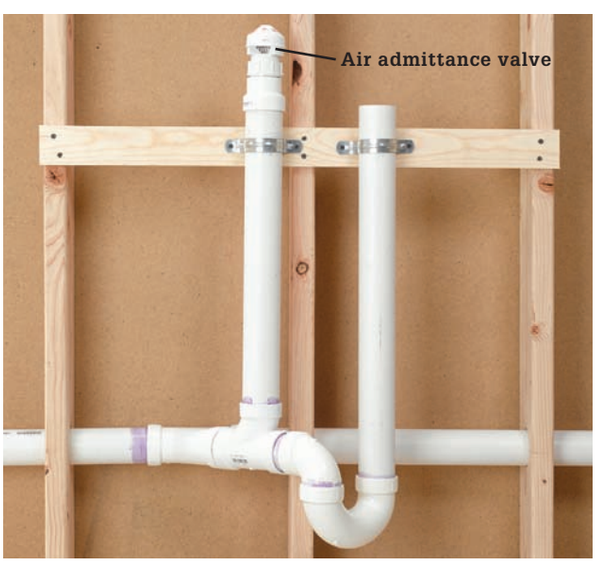
A washing machine with standpipe drain: washing machine drain hose (A), 2" standpipe drain with trap (B), waste line (C), utility sink drain pipe (D), hot and cold supply lines with hose bibs (E), rubber supply hoses to washing machine (F), and utility sink (G).

A 2"-pipe is required by most building codes. The top of the standpipe should be higher than the highest water level in the washing machine, but not shorter than 34". Hose bibs are installed in the hot and cold supply lines at the utility sink to provide the water supply to the washing machine.

How to Install a Washing Machine Standpipe Drain



Provide venting for the standpipe and/or the utility sink. Some locales allow you to install an unvented standpipe, but most building departments now require some sort of venting. See pages 8–11 for information on re-venting; in an extreme case, you may need to run a new vent up through the roof.



Option: Your building department may allow you to vent the standpipe by installing an air admittance valve (AAV). Consult with your inspector to be sure you locate the AAV in a code-approved manner. If you are installing a utility sink instead of a standpipe, you may be able to install an AAV onto the drain trap under the sink.

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Measure and mark the size and location of a waste Y-fitting in the drain line. Remove the marked section, using a reciprocating saz. Make cuts as straight as possible.

Use a utility knife to remove rough burrs on the cut ends of the pipe. Dry-fit the waste Y-fitting into the drain line to make sure it fits properly, then attach the Y-fitting using primer and solvent glue.

Dry-fit a 90° elbow and a 2" standpipe with trap to the waste Y-fitting. Make sure the standpipe is taller than the highest water level in the washing machine (a minimum of 34"). Solvent-glue all the pipes in place.

Attach a 2 × 4 backer behind the top of the standpipe for support, using 2½" deck screws. Fasten standpipe to the wood support, using a length of pipe strap and ½" screws. Insert the washing machine's rubber drain hose into the standpipe.

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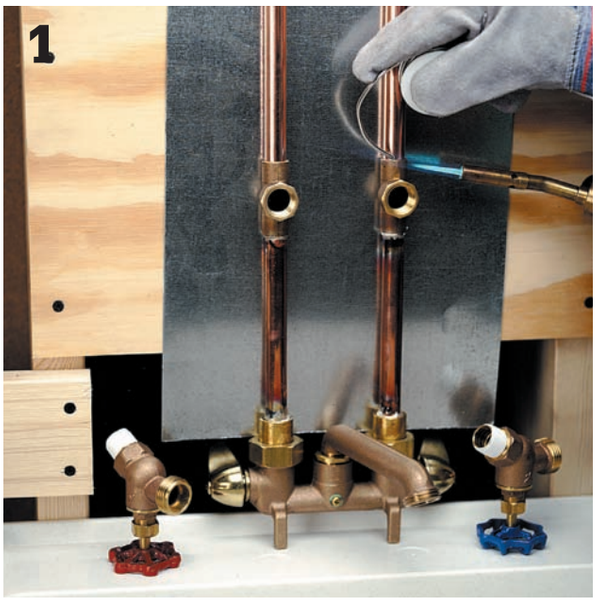
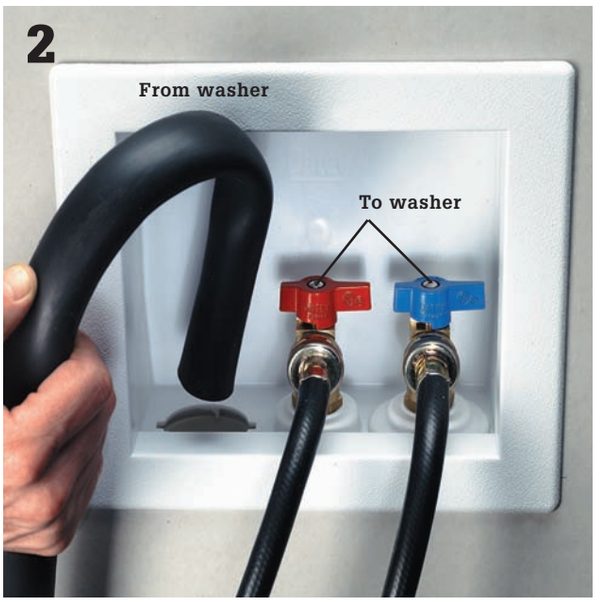
How to Hook Up a Washing Machine Box



Install hose bibs in the utility sink supply lines. Turn off water main and drain pipes. Cut into each supply pipe 6" to 12" from faucet. Solder threaded T-fittings into each supply line. Protect wood from torch flame with two layers of sheet metal. Wrap Teflon tape around threads of hose bibs, and screw them into T-fittings. Connect a rubber supply hose from each bib to the appropriate intake port on the washing machine.



Recessed washing machine boxes are available for finished utility rooms. The supply pipes and standpipe drain run to one central location. The washing machine's hose bibs, supply hoses, and drain hose must remain easily accessible.

Safe Washing Machine Water Supply

Washing machine hoses usually last a long time, but "usually" isn't good enough. Because a damaged hose may drip or even gush for a long time before it's discovered, especially in a room that's infrequently used, it is recommended that hoses be replaced every year or two.

For more peace of mind, consider two valve options. A self-adjusting valve eliminates constant pressure on the hoses, and so lengthens their life. It turns on only when the machine is being used. An automatic laundry shutoff valve removes water pressure on the hoses when the machine is not in use.

The self-adjusting valve shown is installed with the plumbing inside a wall, for a neat look. Remove drywall if there is any to expose the framing. Install the valve at the recommended height by nailing its adjustable wings to studs on each side. Run the supply pipes and the drain line between studs and attach to the valve, and test. Then apply drywall and add the cover plate.

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How to Install a Utility Sink

An inexpensive utility sink, sometimes unflatteringly referred to as a slop sink, should not be used for draining a washing machine; when the sink is full of water, dirty water can back up (flow back) into the washing machine. However, a big sink is handy for a variety of extra-dirty washing jobs, e.g., cleaning paint brushes, humidifiers, etc. An inexpensive sink may come with its own faucet and drain trap.

Assemble the sink. Work with the sink upside-down. For many models, the legs simply slip into slots at the corners.

Attach the trap. Turn the sink sideways and install the strainer body: apply a rope of plumber's putty to the underside of the flange, then tighten the nut on the underside of the sink. Assemble the drain trap. These plastic fittings can be tightened by hand.

Install and hook up the faucet. Turn the sink right-side-up and install the faucet in the sink's holes, run flexible supply lines to the hot and cold inlets, and tighten with a wrench. Drive screws through the holes in the legs to anchor the sink to the floor (below). If you have a concrete floor, you'll need a masonry bit and masonry screws.

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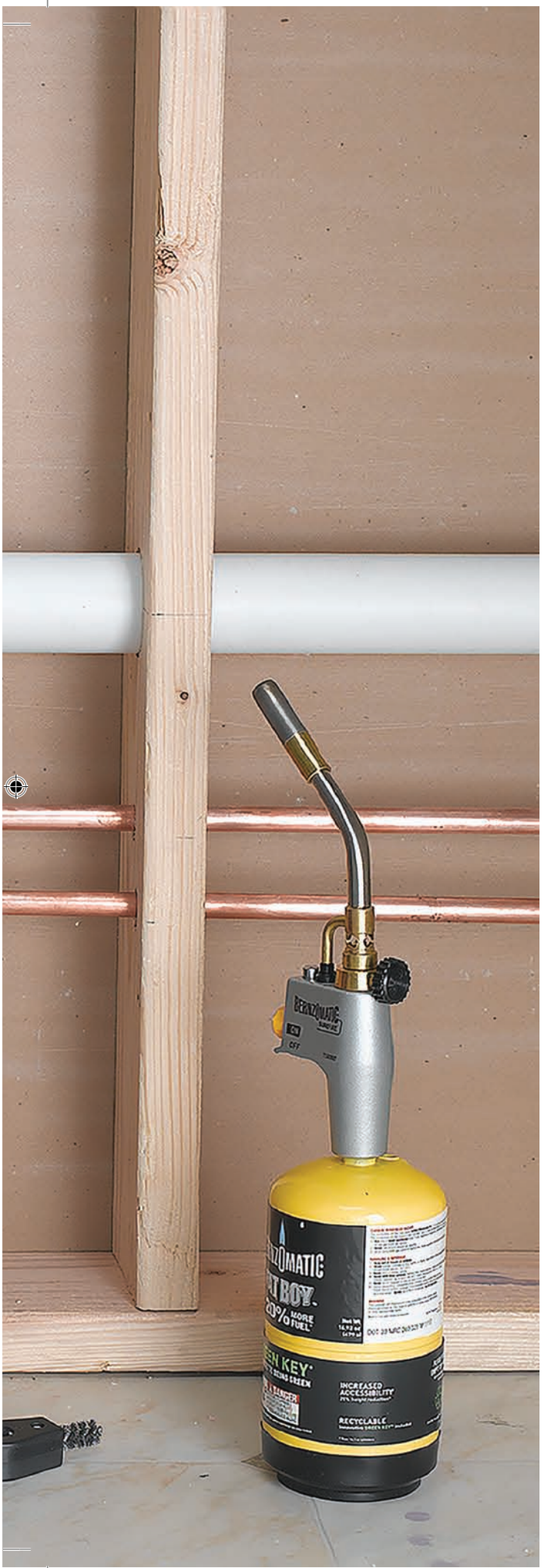
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:148



Plumbing Installations

Running new water supply and drain lines is an entirely different pursuit from hooking up fixtures, and in many ways it is more complicated. Because you are installing pipes where none existed before, the need to know all the applicable plumbing codes is critical (as opposed to simply making a one-for-one fixture swap-out). Great care also must be taken to cut new pipes to exactly the right length and make certain all joints are watertight and made with the correct fittings or products.

Choosing the best pipe materials for your job is an important part of the project. In most cases, the best advice is to use the same material that is already present. But you may choose to use a different material as long as you use the correct transition fittings. For example, if you're running a new supply line, you may choose PEX over copper because it is so fast and easy to install. Or, you may choose CPVC over copper for cost reasons.

In this chapter:

- Installation Basics
- Plumbing Routes
- Master Bath
- Basement Bath
- Half Bath
- Kitchen
- New Gas Lines

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:149
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Installation Basics

A major plumbing project is a complicated affair that often requires demolition and carpentry skills. Bathroom or kitchen plumbing may be unusable for several days while completing the work, so make sure you have a backup bathroom or kitchen space to use during this time.

To ensure that your project goes quickly, always buy plenty of pipe and fittings—at least 25% more than you think you need. Making several extra trips to the building center is a nuisance and can add many hours to your project. Always purchase from a reputable retailer that will allow you to return leftover fittings for credit.

The how-to projects on the following pages demonstrate standard plumbing techniques but should not be used as a literal blueprint for your own work. Pipe and fitting sizes, fixture layout, and pipe routing will always vary according to individual circumstances. When planning your project, carefully read all the information in the planning section. Before you begin work, create a detailed plumbing plan to guide your work and help you obtain the required permits. Don't depend on manufacturer specs to plan the installations of fixtures and the running of pipes; always check local codes. They may vary from the specs, and are generally more stringent.

Use 2 × 6 studs to frame "wet walls" when constructing a new bathroom or kitchen. Thicker walls provide more room to run drain pipes and main waste-vent stacks, making installation much easier.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:150

Installing New Plumbing

Use masking tape to mark the locations of fixtures and pipes on the walls and floors. Read the layout specifications that come with each sink, tub, or toilet, then mark the drain and supply lines accordingly. Position the fixtures on the floor, and outline them with tape. Measure and adjust until the arrangement is comfortable to you and meets minimum clearance specifications. If you are working in a finished room, prevent damage to wallpaper or paint by using self-adhesive notes to mark the walls.

Consider the location of cabinets when roughing in the water supply and drain stub-outs. You may want to temporarily position the cabinets in their final locations before completing the drain and water supply runs.

Install control valves at the points where the new branch supply lines meet the main distribution pipes. By installing valves, you can continue to supply the rest of the house with water while you are working on the new branches.

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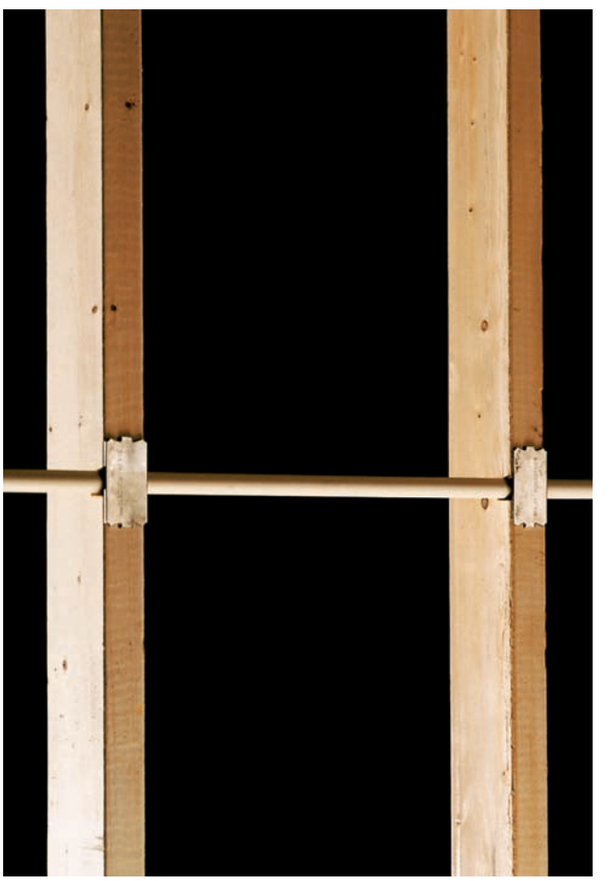
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:151

Maximum Hole & Notch Chart ▸

FRAMING MEMBER	MAXIMUM HOLE SIZE	MAXIMUM NOTCH SIZE
2 × 4 loadbearing stud	1 7/16" diameter	7/8" deep
2 × 4 non-loadbearing stud	2 1/2" diameter	1 7/16" deep
2 × 6 loadbearing stud	2 1/4" diameter	1 3/8" deep
2 × 6 non-loadbearing stud	3 5/16" diameter	2 3/16" deep
2 × 6 joists	1 1/2" diameter	7/8" deep
2 × 8 joists	2 3/8" diameter	1 1/4" deep
2 × 10 joists	3 1/16" diameter	1 1/2" deep
2 × 12 joists	3 3/4" diameter	1 7/8" deep

The framing member chart shows the maximum sizes for holes and notches that can be cut into studs and joists when running pipes. Where possible, use notches rather than bored holes, because pipe installation is usually easier. When boring holes, there must be at least 5/8" of wood between the edge of a stud and the hole, and at least 2" between the edge of a joist and the hole. Joists can be notched only in the end 1/3 of the overall span; never in the middle 1/3 of the joist. When two pipes are run through a stud, the pipes should be stacked one over the other, never side by side.

Create access panels so that in the future you will be able to service fixture fittings and shutoff valves located inside the walls. Frame an opening between studs, then trim the opening with wood moldings. Cover the opening with a removable plywood panel the same thickness as the wall surface, then finish it to match the surrounding walls.



Protect pipes from punctures if they are less than 1 1/4" from the front face of wall studs or joists by attaching metal protector plates to the framing members.

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Pro-Vision C M Y K (Text) (Ray)
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:152

Test-fit materials before solvent-gluing or soldering joints. Test-fitting ensures that you have the correct fittings and enough pipe to do the job, and can help you avoid lengthy delays during installation.

Support pipes adequately. Horizontal and vertical runs of DWV and water supply pipe must be supported at minimum intervals, which are specified by your local plumbing codes. A variety of metal and plastic materials are available for supporting plumbing pipes.

Use plastic bushings to help hold plumbing pipes securely in holes bored through wall plates, studs, and joists. Bushings can help to cushion the pipes, preventing wear and reducing rattling. Always use manufacturer-recommended bushings with metal wall studs (inset).

Install extra T-fittings on new drain and vent lines so that you can pressure-test the system when the building inspector reviews your installation. A new DWV line should have these extra T-fittings near the points where the new branch drains and vent pipes reach the main waste-vent stack.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:153

Planning Plumbing Routes

The first, and perhaps most important, step when replacing old plumbing is to decide how and where to run the new pipes. Since the stud cavities and joist spaces are often covered with finished wall surfaces, finding routes for running new pipes can be challenging.

When planning pipe routes, choose straight, easy pathways whenever possible. Rather than running water supply pipes around wall corners and through studs, for example, it may be easiest to run them straight up wall cavities from the basement. Instead of running a bathtub drain across floor joists, run it straight down into the basement, where the branch drain can be easily extended underneath the joists to the main waste-vent stack.

In some situations, it is most practical to route the new pipes in wall and floor cavities that already hold plumbing pipes, since these spaces are often framed to provide long, unobstructed runs. A detailed map of your plumbing system can be very helpful when planning routes for new plumbing pipes (page 157).

The most complicated part of new plumbing service is often the venting for the DWV system. All fixtures must be vented in a code-approved manner, and these codes are at times daunting to learn. See page 321 for more information on planning vent runs. Where possible, run vent lines through walls or up to the attic, to tie into existing vents. If that is not allowed, you may need to run a vent pipe up through the roof. In some cases you can use air admittance valves instead of vent pipes.

To maximize their profits, plumbing contractors generally try to avoid opening walls or changing wall framing when installing new plumbing. But the do-it-yourselfer does not have these limitations. Faced with the difficulty of running pipes through enclosed spaces, you may find it easiest to remove wall surfaces or to create a newly framed space for running new pipes.

On these pages, you will see some common methods used to create pathways for replacing old pipes with new plumbing.

Build a framed chase. A chase is a false wall created to provide space for new plumbing pipes. It is especially effective for installing a new main waste-vent stack. On a two-story house, chases can be stacked one over the other on each floor in order to run plumbing from the basement to the attic. Once plumbing is completed and inspected, the chase is covered with wallboard and finished to match the room.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
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Planning Pipe Routes

Use existing access panels to disconnect fixtures and remove old pipes. Plan the location of new fixtures and pipe runs to make use of existing access panels, minimizing the amount of demolition and repair work you will need to do.

Convert a laundry chute into a channel for running new plumbing pipes. The door of the chute can be used to provide access to control valves, or it can be removed and covered with wall materials, then finished to match the surrounding wall.

Run pipes inside a closet. If they are unobtrusive, pipes can be left exposed at the back of the closet. Or, you can frame a chase to hide the pipes after the installation is completed.

Remove suspended ceiling panels to route new plumbing pipes in joist cavities. Or, you can route pipes across a standard plaster or wallboard ceiling, then construct a false ceiling to cover the installation, provided there is adequate height. Most building codes require a minimum of 7 ft. from floor to finished ceiling.

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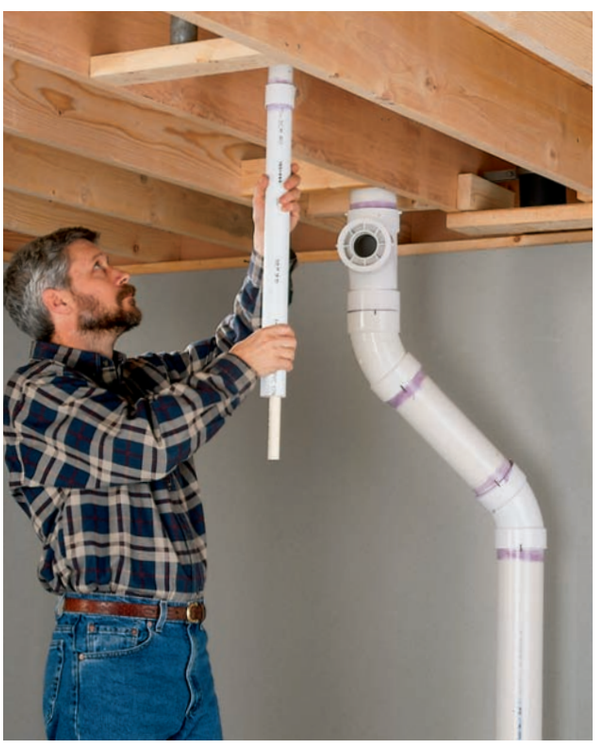
#175 Dtp:225 Page:155

Use a drill bit extension and spade bit or hole saw to drill through wall plates from unfinished attic or basement spaces above or below the wall.

Look for "wet walls." Walls that hold old plumbing pipes can be good choices for running long vertical runs of new pipe. These spaces are usually open, without obstacles such as fireblocks and insulation.



Probe wall and floor cavities with a long piece of plastic pipe to ensure that a clear pathway exists for running new pipe (left photo). Once you have established a route using the narrow pipe, you can use the pipe as a guide when running larger drain pipes up into the wall (right photo).

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:156

Remove flooring when necessary. Because replacing toilet and bathtub drains usually requires that you remove sections of floor, a full plumbing replacement job is often done in conjunction with a complete bathroom remodeling project.

Remove wall surfaces when access from above or below the wall is not possible. This demolition work can range from cutting narrow channels in plaster or wallboard to removing the entire wall surface. Remove wall surfaces back to the centers of adjoining studs; the exposed studs provide a nailing surface for attaching repair materials once the plumbing project is completed.

Create a detailed map showing the planned route for your new plumbing pipes. Such a map can help you get your plans approved by the inspector, and it makes work much simpler. If you have already mapped your existing plumbing system (pages 154 to 157), those drawings can be used to plan new pipe routes.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:157

Master Bath

A large bathroom has more plumbing fixtures and consumes more water than any other room in your house. For this reason, a master bath has special plumbing needs.

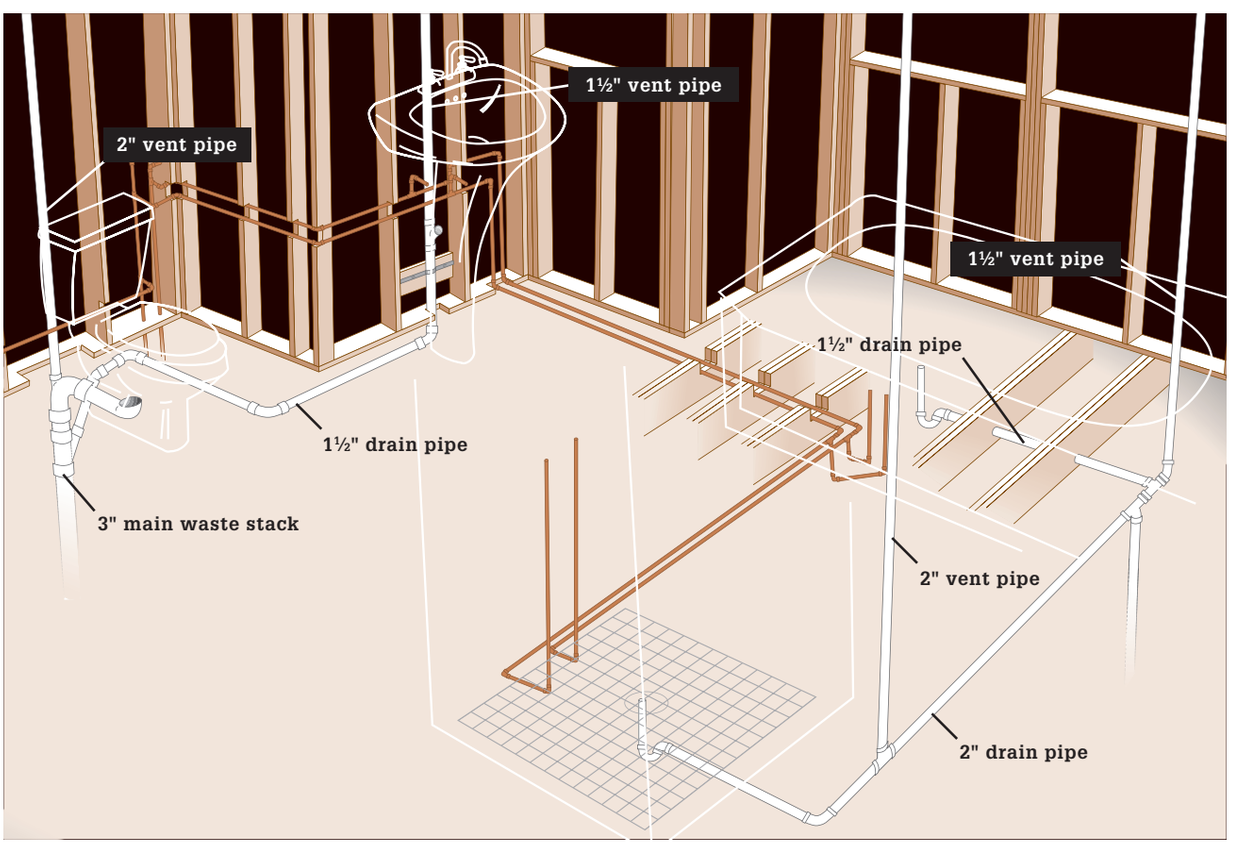
Frame bathroom "wet walls" with 2 × 6 studs, to provide plenty of room for running 3" pipes and fittings. If your bathroom includes a heavy whirlpool tub, you will likely need to strengthen the floor by installing "sister" joists alongside the existing floor joists underneath the tub. Check with your local codes.

For convenience, our project is divided into the following sequences:

- How to Install DWV Pipes for the Toilet & Sink (pages 159 to 161)
- How to Install DWV Pipes for the Tub & Shower (pages 162 to 163)
- How to Connect Drain Pipes to a Main Waste-Vent Stack (page 164)
- How to Install the Water Supply Pipes (page 165)

Our demonstration bathroom is a second-story master bath. We are installing a 3" vertical drain pipe to service the toilet and the vanity sink, and a 2" vertical pipe to handle the tub and shower drains. The branch drains for the sink and bathtub are 1½" pipes—for the shower, 2" pipe. Each fixture has its own vent pipe extending up into the attic, where they are joined together and connected to the main stack.

The pipe sizes and fittings described in this project will meet code in most areas. To ensure your inspector will be satisfied, however, consult your local codes.



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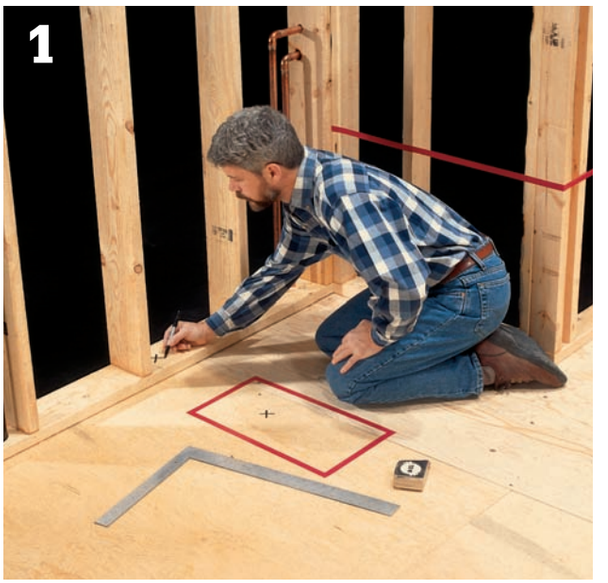
How to Install DWV Pipes for the Toilet & Sink



Use masking tape to outline the locations of the fixtures and pipe runs on the subfloor and walls. Mark the location for a 3" vertical drain pipe on the sole plate in the wall behind the toilet. Mark a 4½"-diameter circle for the toilet drain on the subfloor.

Cut out the drain opening for the toilet, using a hole saw. Mark and remove a section of flooring around the toilet area, large enough to provide access for installing the toilet drain and for running drain pipe from the sink. Use a circular saw with blade set to the thickness of the flooring to cut through the subfloor.

If a floor joist interferes with the toilet drain, cut away a short section of the joist and box-frame the area with double headers. The framed opening should be just large enough to install the toilet and sink drains.

To create a path for the vertical 3" drain pipe, cut a 4½" × 12" notch in the sole plate of the wall behind the toilet. Make a similar cutout in the double wall plate at the bottom of the joist cavity. From the basement, locate the point directly below the cutout by measuring from a reference point, such as the main waste-vent stack.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:159

Measure and cut a length of 3" drain pipe to reach from the bathroom floor cavity to a point flush with the bottom of the ceiling joists in the basement. Solvent-glue a 3" × 3" × 1½" Y-fitting to the top of the pipe, and a low-heel vent 90° fitting above the Y. The branch inlet on the Y should face toward the sink location; the front inlet on the low-heel should face forward. Carefully lower the pipe into the wall cavity.

Lower the pipe so the bottom end slides through the opening in the basement ceiling. Support the pipe with vinyl pipe strap wrapped around the low-heel vent 90° fitting and screwed to framing members.

Use a length of 3" pipe and a 4 × 3 reducing elbow to extend the drain out to the toilet location. Make sure the drain slopes at least ¼" per foot toward the wall, then support it with pipe strap attached to the joists. Insert a short length of pipe into the elbow so it extends at least 2" above the subfloor. After the new drains are pressure tested, this stub-out will be cut flush with the subfloor and fitted with a toilet flange.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:160

Notch out the sole plate and subfloor below the sink location. Cut a length of 1½" plastic drain pipe, then solvent-glue a waste-T to the top of the pipe and a sweep 90° elbow to the bottom. *Note: The distance from the subfloor to the center of the waste-T should be 14" to 18". The branch of the T should face out, and the discharge on the elbow should face toward the toilet location. Adjust the pipe so the top edge of the elbow nearly touches the bottom of the sole plate. Anchor it with a ¾"-thick backing board nailed between the studs.*

Dry-fit lengths of 1½" drain pipe and elbows to extend the sink drain to the 3" drain pipe behind the toilet. Use a right-angle drill to bore holes in joists, if needed. Make sure the horizontal drain pipe slopes at least ¼" per foot toward the vertical drain. When satisfied with the layout, solvent-glue the pieces together and support the drain pipe with vinyl pipe straps attached to the joists.

In the top plates of the walls behind the sink and toilet, bore ½"-diameter holes up into the attic. Insert pencils or dowels into the holes, and tape them in place. Enter the attic and locate the pencils, then clear away insulation and bore holes for the vertical vent pipes. Cut and install 2" vent pipes for the toilet and sink drain.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:161

How to Install DWV Pipes for the Tub & Shower

On the subfloor, use masking tape to mark the locations of the tub and shower, the water supply pipes, and the tub and shower drains, according to your plumbing plan. Use a jigsaw to cut out a 12" square opening for each drain, and drill 1"-diameter holes in the subfloor for each water supply riser.

If installing a large whirlpool tub, cut away the subfloor to expose the full length of the joists under the tub, then screw or bolt a second joist, called a sister, against each existing joist. Make sure both ends of each joist are supported by load-bearing walls.

In a wall adjacent to the tub, establish a route for a 2" vertical waste-vent pipe running from basement to attic. This pipe should be no more than 3½ ft. from the bathtub trap. Then, mark a route for the horizontal drain pipe running from the bathtub drain to the waste-vent pipe location. Cut 3"-diameter holes through the centers of the joists for the bathtub drain.

Cut and install a vertical 2" drain pipe running from basement to the joist cavity adjoining the tub location, using the same technique as for the toilet drain (steps 4 to 6, pages 159 to 160). At the top of the drain pipe, use assorted fittings to create three inlets: branch inlets for the bathtub and shower drains and a 1½" top inlet for a vent pipe running to the attic.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:162

Dry-fit a 1½" drain pipe running from the bathtub drain location to the vertical waste-vent pipe in the wall. Make sure the pipe slopes ¼" per foot toward the wall. When satisfied with the layout, solvent-glue the pieces together and support the pipe with vinyl pipe straps attached to the joists. If local codes require vents for each fixture, add a vent pipe and T-fitting.

Dry-fit a 2" drain pipe from the shower drain to the vertical waste-vent pipe near the tub. Install a solvent-glued trap at the drain location, cut a hole in the sole plate, and insert a 2" × 2" × 1½" vent T within 5 ft. of the trap. Make sure the drain is sloped ¼" per foot downward away from the shower drain. When satisfied with the layout, solvent-glue the pipes together.

Cut and install vertical vent pipes for the bathtub and shower, extending up through the wall plates and at least 1 ft. into the attic. These vent pipes will be connected in the attic to the main waste-vent stack. In our project, the shower vent is a 2" pipe, while the bathtub vent is a 1½" pipe. When you have completed all the DWV piping, cover large cutouts to sill plates with boards and stuff fiberglass insulation or use fire-rated foam insulation to create a fire stop.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:163

How to Connect Drain Pipes to a Main Waste-Vent Stack

In the basement, cut into the main waste-vent stack and install the fittings necessary to connect the 3" toilet-sink drain and the 2" bathtub-shower drain. In our project, we created an assembly made of a waste T-fitting with an extra side inlet and two short lengths of pipe, then inserted it into the existing waste-vent stack using banded couplings. Make sure the T-fittings are positioned so the drain pipes will have the proper downward slope toward the stack.

Dry-fit Y-fittings with 45° elbows onto the vertical 3" and 2" drain pipes. Position the horizontal drain pipes against the fittings, and mark them for cutting. When satisfied with the layout, solvent-glue the pipes together, then support the pipes every 4 ft. or as required by local codes with vinyl pipe straps. Make sure to maintain the proper ¼" per foot downward slope in all waste pipes.

How to Connect Vent Pipes to a Main Waste-Vent Stack

In the attic, cut into the main waste-vent stack and install a vent T-fitting, using banded couplings. The side outlet on the vent T should face the new 2" vent pipe running down to the bathroom. Attach a test T-fitting to the vent T. *Note: If your stack is cast iron, make sure to adequately support it before cutting into it (pages 302 to 304).*

Use elbows, vent T-fittings, reducers, and lengths of pipe as needed to link the new vent pipes to the test T-fitting on the main waste-vent stack. Vent pipes can be routed in many ways, but you should make sure the pipes have a slight downward angle to prevent moisture from collecting in the pipes. Support the pipes every 4 ft. or as required by local codes.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:164

How to Install the Water Supply Pipes

After shutting off the water, cut into existing supply pipes and install T-fittings for new branch lines. Notch out studs and run copper pipes to the toilet and sink locations. Use an elbow and female-threaded fitting to form the toilet stub-out. Once satisfied with the layout, solder the pipes in place.

Cut 1" × 4"-high notches around the wall, and extend the supply pipes to the sink location. Install reducing T-fittings and female-threaded fittings for the sink faucet stub-outs. The stub-outs should be positioned about 18" above the floor, spaced 8" apart. Once satisfied with the layout, solder the joints, then insert ¾" blocking behind the stub-outs and strap them in place.

Extend the water supply pipes to the bathtub and shower. In our project, we removed the subfloor and notched the joists to run ¾" supply pipes from the sink to a whirlpool bathtub, then to the shower. At the bathtub, we used reducing T-fittings and elbows to create ½" risers for the tub faucet. Solder caps onto the risers; after the subfloor is replaced, the caps will be removed and replaced with shutoff valves.

At the shower location, use elbows to create vertical risers where the shower wet wall will be constructed. The risers should extend at least 6" above floor level. Support the risers with a ¾" backer board attached between joists. Solder caps onto the risers. After the shower stall is constructed, the caps will be removed and replaced with shutoff valves.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:165

Basement Bath

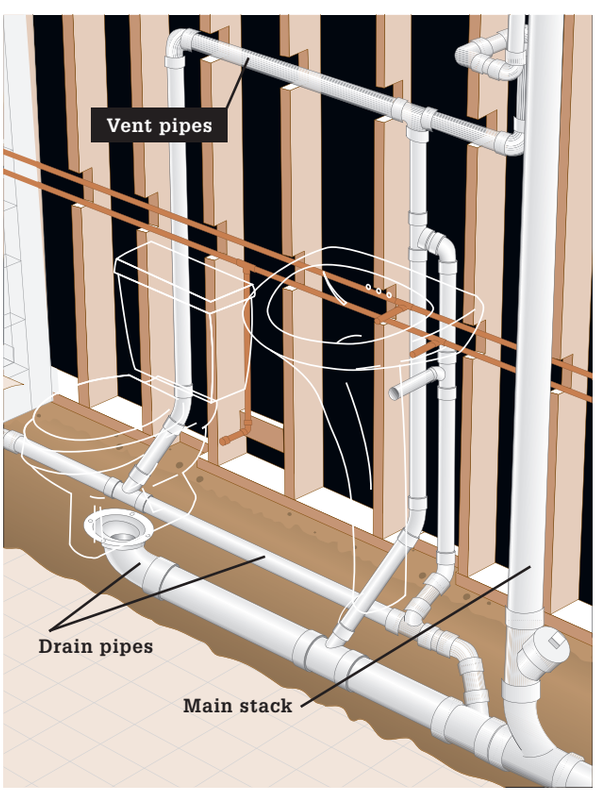
Adding a bathroom to an unfinished basement creates a host of new opportunities for finishing the rest of the space. With a convenient bathroom, you can much more easily justify a downstairs recreation room, a wine cellar, a home theater, or additional bedrooms. Many new homes are pre-plumbed with available stub-outs for plumbing at the time the house is built. More likely, you'll need to break up the concrete floor to install new drain and supply plumbing. This is exactly as much work as it sounds like, but with a jackhammer and some help, it is manageable.

Because horizontal plastic pipes cannot be encased in concrete, they must be laid in the granular fill beneath the concrete basement floor. Possible locations for the bathroom, therefore, are limited by how close the main sewer line is to the floor surface when it meets the main drain stack. Check local codes for other specific restrictions in your area.

Plan ahead for this project. Once you cut into the main waste-vent, there can be no drainage in the house until you have fully installed the new branch lines and sealed the joints. Make sure you have extra pipe and fittings on hand.

Sawing and jackhammering concrete (you'll have to do this to run the new pipe line) produces large quantities of dust. Use plastic sheeting to block off other portions of the basement, and wear approved particulate dust masks.

Our demonstration bathroom includes a shower, toilet, and pedestal sink arranged in a line to simplify trenching. A 2" drain pipe services the new shower and sink; a 3" pipe services the new toilet. The drain pipes converge at a Y-fitting joined to the existing main drain. The toilet and sink have individual vent pipes that meet inside the wet wall before extending up into the attic, where they join the main waste-vent stack.



Tools & Materials

Duct tape	2 × 4 lumber
Concrete	2 × 6 lumber
or circular saw	Duct tape
Cold chisel	Riser clamps
Hand maul	or plastic stack
Plastic sheeting	TY combo
Chalk line	Primer
Jackhammer	Solvent glue
Work & rubber gloves	Banded coupling
Eye & ear protection	Rags
Dust mask	Concrete
Plastic bags	Trowel
4-ft. level	Fiberglass insulation
Reciprocating saw	Power-actuated nailer

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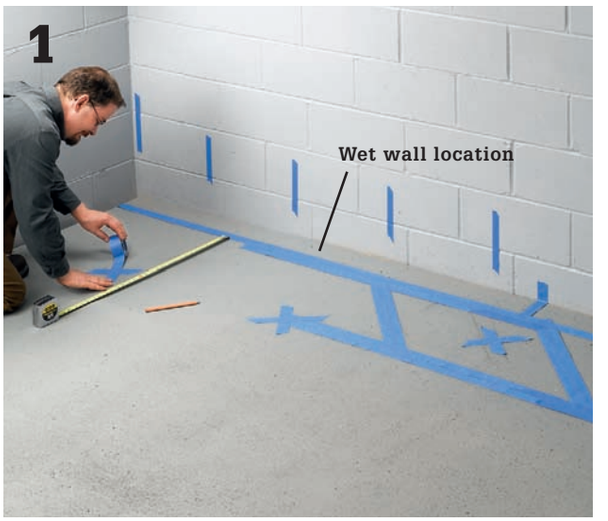
#175 Dtp:225 Page:166

How to Plumb a Basement Bath



Mark the proposed location of the basement bathroom on the basement floor, using tape. Include the walls, wet wall, and fixture locations. The easiest configuration is to install all the fixtures against the wet wall, which will contain the water supply and vents. The drain lines should run parallel to the wet wall in the most direct route to the main waste-vent stack. Mark the drain line location (typically around 6" out from the wet wall).

Cut out the area around the main stack. Use a concrete saw or a circular saw with a masonry blade to score a 24" × 24" square cutting line around the waste-vent stack. The cut should be at least 1" deep.

Remove concrete and dirt around the main stack. Using a cold chisel and hand maul, strike along the scored cutting lines to chip out the concrete around the main soil stack. If necessary, break up the concrete within the square so it can be removed. Take care not to damage the pipe. Excavate within the square to determine the depth of the sewer line where it meets the main stack. *Tip: Calculate the distance you want the new branch drain to run and multiply by ¼". Add the thickness of concrete floor to this number to find the minimum depth the sewer line must be to accommodate your layout plan. If you excavate an inch or two past this depth, there is no need to dig farther.*

Excavate the drainline trench. Enclose the work area with plastic sheeting to protect the rest of the house from concrete dust. Use a chalk line to lay out a 24"-wide trench centered over the new branch drain location. Score along the lines with a concrete saw or a circular saw with a masonry blade.

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#175 Dtp:225 Page:167

Use a jackhammer to break up the concrete in the trench, taking care not to damage any of the existing plumbing lines. Wear gloves, eye and ear protection, and a dust mask. Remove the concrete for disposal. Remove dirt (technically called granular fill) in the trench, starting at the main waste-vent stack.

Create a flat-bottomed trench that slopes toward the main stack at ¼" per foot. The soil will hold up the drain lines, so it is important to create an even surface. Use a hand tamper to tamp down the soil if it has been disturbed. Tape a 1" spacer to the end of a 4-ft. level to create a handy measuring tool for checking the proper slope. Set the soil aside to use for back fill.

Cut the drain line or main stack (depending on how deep the drain line is) using a reciprocating saw (or a snap cutter). Support the main waste-vent stack before cutting. Use a 2 × 4 and duct tape for a plastic stack, or riser clamps for a cast-iron stack. If cutting the horizontal drain line, cut as close as possible to the stack.

Cut into the stack above the cleanout and remove the pipe and fittings. Wear rubber gloves and have a large plastic bag and rags ready, as old pipes and fittings may be coated with sewer sludge. Remember that no waste water can flow in the house while the pipes are cut open. Turn off the water and drain toilets to prevent accidental use.

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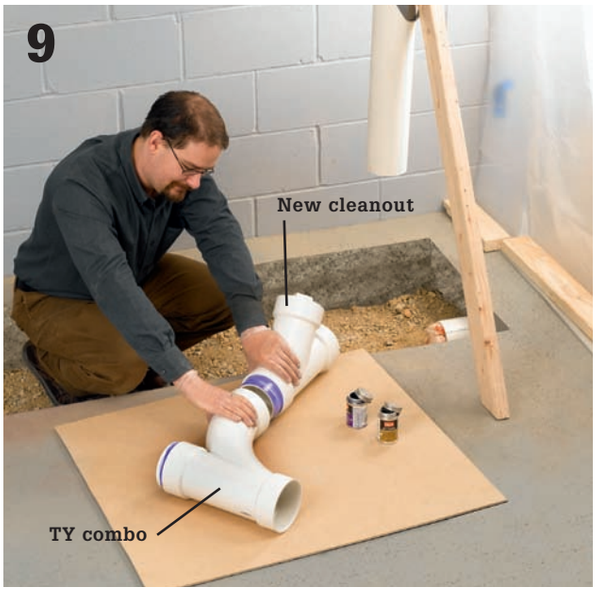
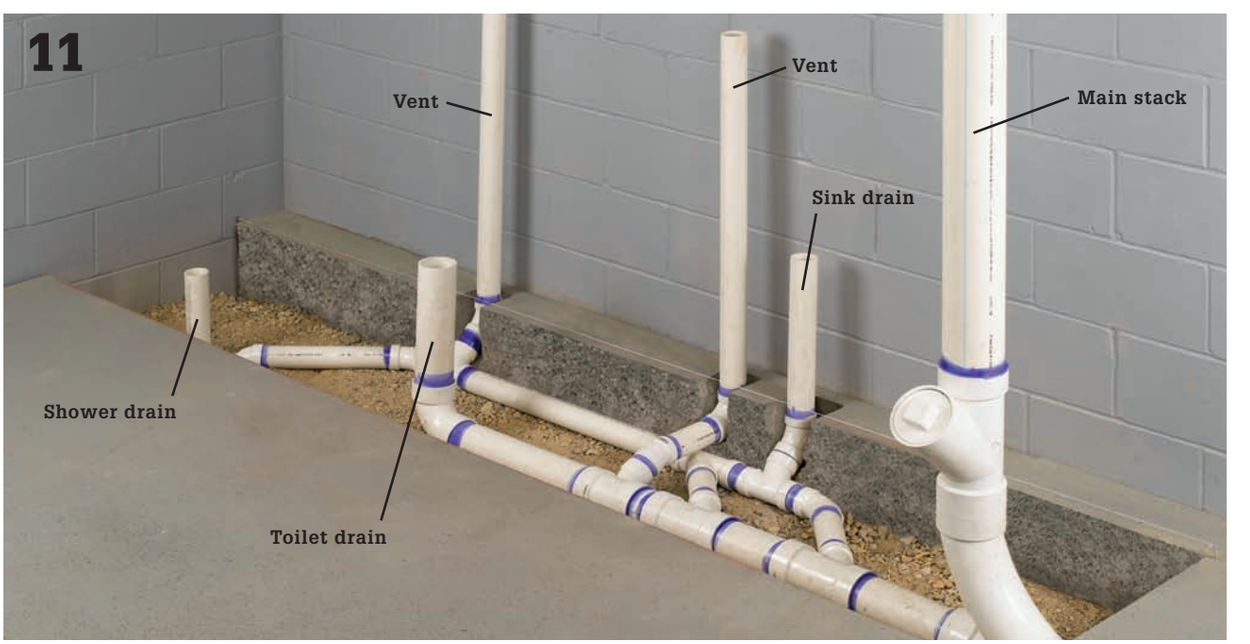


Cut and test-fit a new cleanout and long sweep TY combo assembly, dry-fitting it to the drain stack and the horizontal drain line to the street. Make any needed adjustments and then solvent-glue the fittings and new pipe into a single assembly.

Clean the outside of the old pipes thoroughly and apply primer. Also apply primer and solvent glue to the female surfaces of the union fittings in the assembly. Slide the fitting assembly over the primed ends of the drain stack and the drain line at the same time. This requires a little bit of play in one or both of the lines so you can manipulate the new assembly. If your existing pipes will not move at all, you'll need to use a banded coupling on the drain stack to seal the gap.



Cut and fit the components of the new drain line one piece at a time, starting at the stack. Use strings or boards to outline the wet wall, so vent placement is correct. Drain lines underground must be a minimum of 2". Use 3" × 2" reducing Ys to tie the shower drain line and the sink drain line into the toilet drain line. Install vertical drain and vent lines that are long enough to protrude well above the level of the finished floor.

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#175 Dtp:225 Page:169

Check for leaks by pouring water into each new drain pipe. If the joints appear sound, contact your building department and arrange for your inspection (you must do this prior to covering the pipes). Plug the pipe openings with rags to prevent sewer gas from escaping. *Note: Some local municipalities require an air test as well.*

Backfill around the pipes with the soil dug from the trench. Mix and pour new concrete to cover the trench, and trowel smooth. Allow the concrete to cure for 3 days. Some municipalities may require that isolation membrane be wrapped around vertical pipes where they will be surrounded by concrete—check with your local inspector.

Build the wet wall from 2 × 6 lumber. The sill plate should be pressure treated, but the other members may be untreated. Notch the sill plate so the vent pipes clear it easily. Use masonry anchors or concrete nails and a powder-actuated nailer to attach the plate.

Run 2" vent pipes through notches in the studs. Assemble with vent T and 90° fittings. The 2" pipes are larger than required, but using the same size as the drain lines eliminates the need for reducing fittings, and makes for less waste. The 90° fittings are typically less expensive than the vent elbows.

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#175 Dtp:225 Page:170

Route the vent pipe to a point beneath a wall cavity running from the basement to the attic. Or, if there is another vent line closer that you can tie into (not very likely), go ahead and do that.

Run vent pipe up through the floors above and either directly out through the roof or tie it to another vent pipe in the attic. Remove sections of wall surface as needed to bore holes for running the vent pipe through wall plates. Feed the vent pipe up into the wall cavity from the basement. Wedge the vent pipe in place while you solvent-glue the fittings. Support the vent pipe at each floor with plastic pipe hangers installed horizontally. Stuff fiberglass insulation into holes around pipes. Do not replace any wallcoverings until you have had your final inspection.

Install the water supply plumbing. Compared to the drain-vent plumbing, this will seem remarkably easy. Follow the instructions on page 165, but adjust the layout to conform to your fixtures.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:171

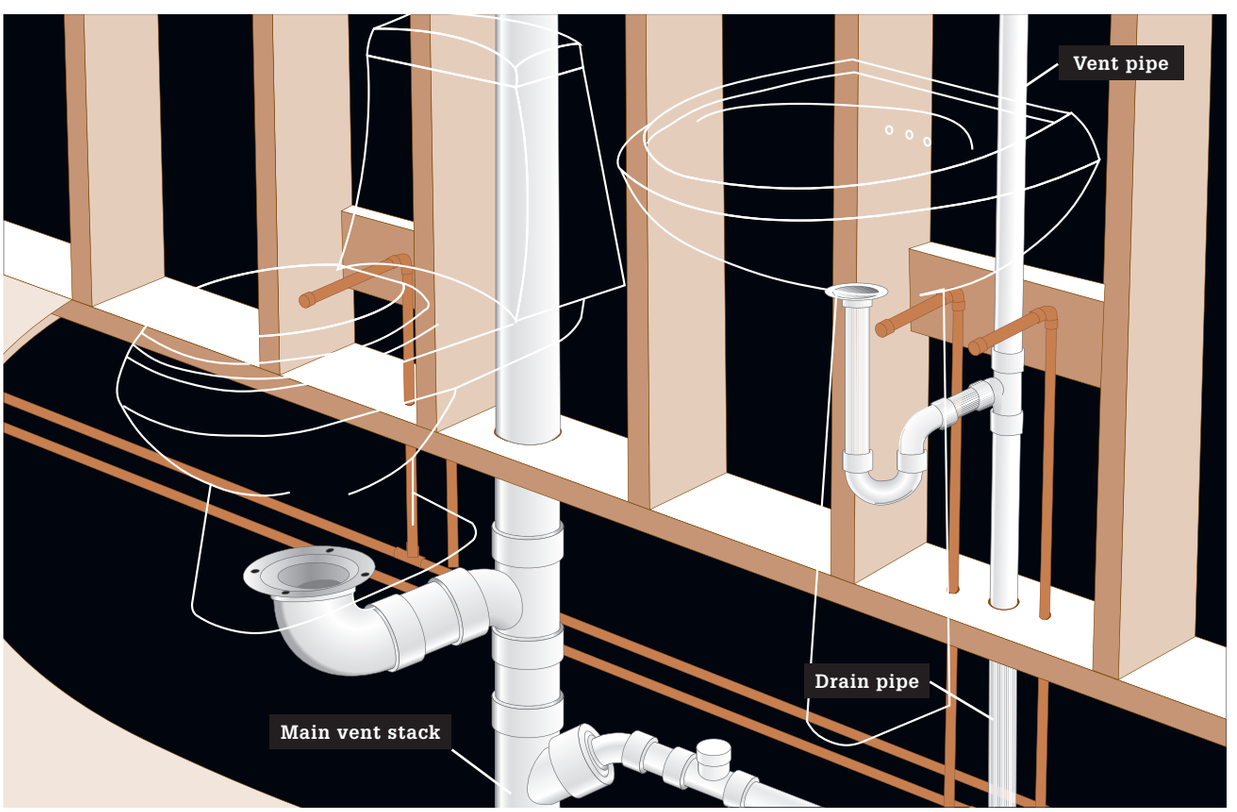
Half Bath

A first-story half bath is easy to install when located behind a kitchen or existing bathroom, because you can take advantage of accessible supply and DWV lines. It is possible to add a half bath on an upper story or in a location distant from existing plumbing, but the complexity and cost of the project may be increased considerably.

Be sure that the new fixtures are adequately vented. We vented the pedestal sink with a pipe that runs up the wall a few feet before turning to join the main stack. However, if there are higher fixtures draining into the main stack, you would be required to run the vent up to a point at least 6" above the highest fixture before splicing it into the main stack or an existing vent pipe. When the toilet is located within 6 ft. of the stack, as in our design, it requires no additional vent pipe.

The techniques for plumbing a half bath are similar to those used for a master bathroom. Refer to pages 158 to 165 for more detailed information.

In this half bath, the toilet and sink are close to the main stack for ease of installation, but are spaced far enough apart to meet minimum allowed distances between fixtures. Check your local code for any restrictions in your area. Generally, there should be at least 15" from the center of the toilet drain to a side wall or fixture, and a minimum of 21" of space between the front edge of the toilet and the wall.



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#175 Dtp:225 Page:172

How to Plumb a Half Bath

Locate the main waste-vent stack in the wet wall and remove the wall surface behind the planned location for the toilet and sink. Cut a 4½"-diameter hole for the toilet flange (centered 12" from the finished wall surface (usually, 12" from the bare studs). Drill two ¾" holes through the sole plate for sink supply lines and one hole for the toilet supply line. Drill a 2" hole for the sink drain.

In the basement, cut away a section of the stack and insert a waste T-fitting with a 3" side inlet for the toilet drain; below that, insert a 3" × 1½" reducing Y and 45, or a 3" × 1½" reducing TY combo for the sink. Install a closet bend and 3" drain pipe for the toilet, and install a 1½" drain pipe with a sweep elbow for the sink. Make sure to maintain the proper ¼" per foot slope of the drain pipes.

Tap into water distribution pipes with ¾" × ½" reducing T-fittings, then run ½" copper supply pipes through the holes in the sole plate to the sink and toilet. Support all pipes at 4-ft. intervals with strapping attached to joists.

Attach drop ear elbows to the ends of the supply pipes and anchor them to blocking installed between studs. Anchor the drain pipe to the blocking, then run a vertical vent pipe from the waste T-fitting up the wall to a point at least 6" above the highest fixture on the main stack. Then, route the vent pipe horizontally and splice it into the vent stack with a vent T.

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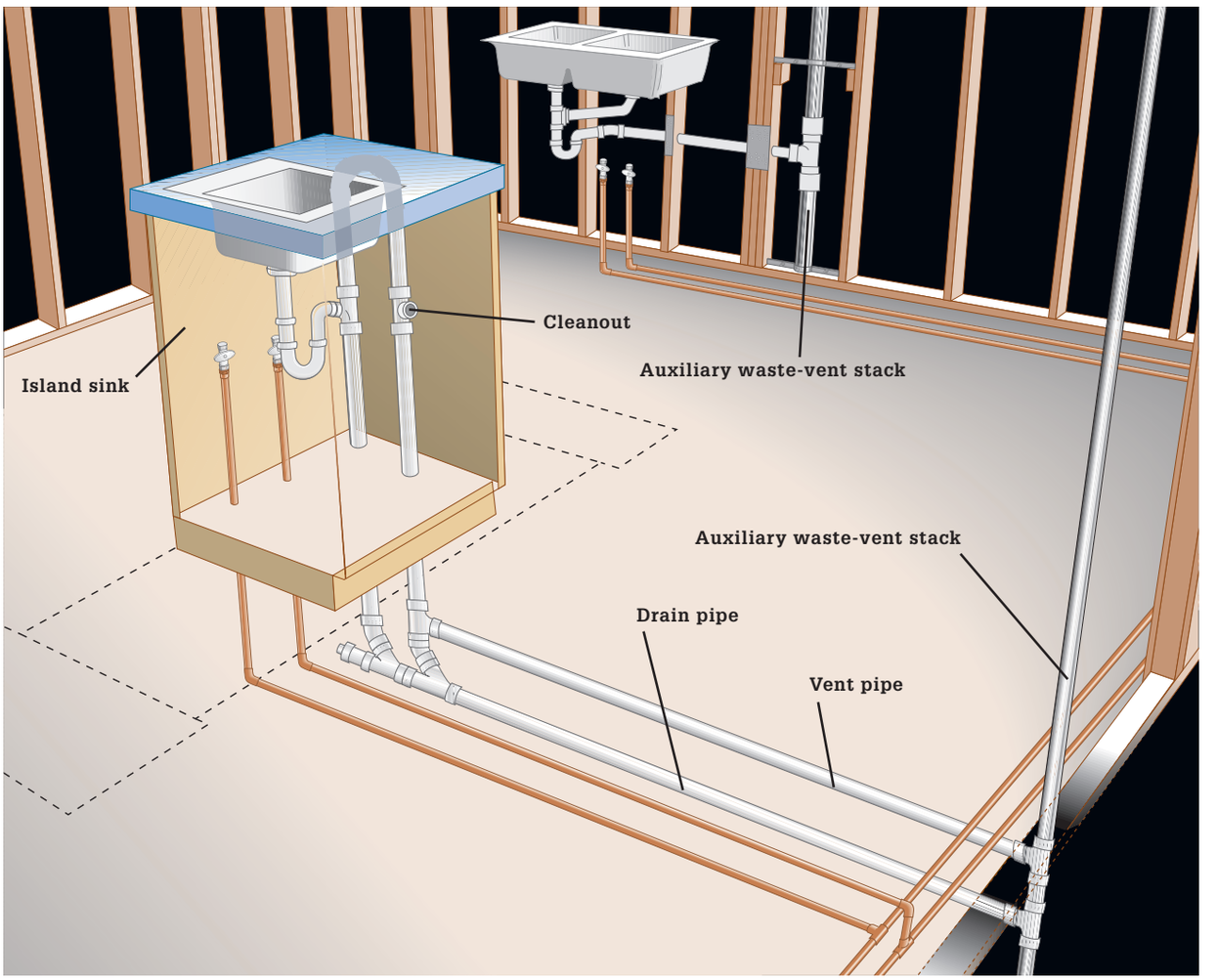
Kitchen

Plumbing a remodeled kitchen is a relatively easy job if your kitchen includes only a wall sink. If your project includes an island sink, however, the work becomes more complicated.

An island sink poses problems because there is no wall in which to run a vent pipe. An island sink requires either a complicated configuration known as a loop vent or a device called an air admittance valve (AAV), now approved by most codes. An AAV eliminates the need for a loop vent in most island sink installations. Check with the local plumbing inspector before designing an installation with an AAV or a loop vent.

For our demonstration kitchen, we divided the project into three phases:

- How to Install DWV Pipes for a Wall Sink (pages 176 to 178)
- How to Install DWV Pipes for an Island Sink (pages 179 to 185)
- How to Install New Supply Pipes (pages 186 to 187)



Our demonstration kitchen includes a double wall sink and an island sink. The 1½" drain for the wall sink connects to an existing 2" galvanized waste-vent stack; since the trap is within 3½ ft. of the stack, no vent pipe is required. The drain for the island sink uses a loop vent configuration connected to an auxiliary waste-vent stack in the basement.

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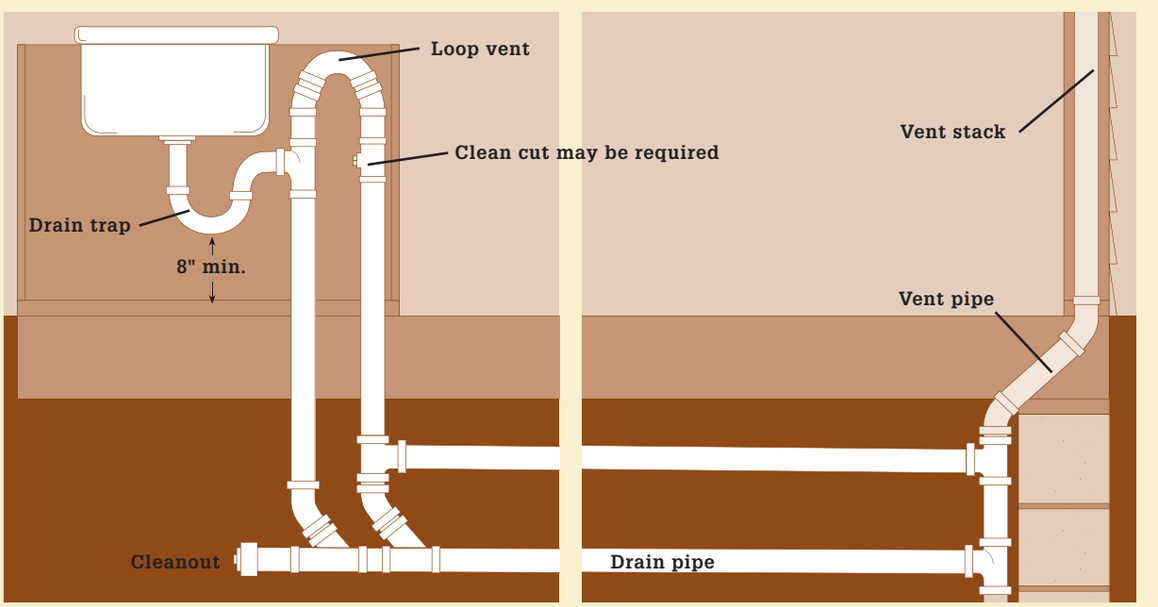
Tips for Plumbing a Kitchen ▸

Insulate exterior walls if you live in a region with freezing winter temperatures. Where possible, run water supply pipes through the floor or interior partition walls, rather than exterior walls.

Use existing waste-vent stacks to connect the new DWV pipes. In addition to a main waste-vent stack, most homes have one or more auxiliary waste-vent stacks in the kitchen that can be used to connect new DWV pipes.



Loop vents makes it possible to vent a sink when there is no adjacent wall to house the vent pipe. The drain is vented with a loop of pipe that arches up against the countertop and away from the drain before dropping through the floor. The vent pipe then runs horizontally to an existing vent pipe. In our project, we have tied the island vent to a vent pipe extending up from a basement utility sink. *Note: Loop vents are subject to local code restrictions. Always consult your building inspector for guidelines on venting an island sink.*

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How to Install DWV Pipes for a Wall Sink

Determine the location of the sink drain by marking the position of the sink and base cabinet on the floor. Mark a point on the floor indicating the position of the sink drain opening. This point will serve as a reference for aligning the sink drain stub-out.

Mark a route for the new drain pipe through the studs behind the wall sink cabinet. The drain pipe should angle ¼" per foot down toward the waste-vent stack.

Use a right-angle drill and hole saw to bore holes for the drain pipe. On non-loadbearing studs, such as the cripple studs beneath a window, you can notch the studs with a reciprocating saw to simplify the installation of the drain pipe. If the studs are loadbearing, however, you must thread the run though the bored holes, using couplings to join short lengths of pipe as you create the run.

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Measure, cut, and dry-fit a horizontal drain pipe to run from the waste-vent stack to the sink drain stub-out. Create the stub-out with a 45° elbow and 6" length of 1½" pipe. *Note: If the sink trap in your installation will be more than 3½ ft. from the waste-vent pipe, you will have to install a waste-T and run a vent pipe up the wall, connecting it to the vent stack at a point at least 6" above the lip of the sink.*

Remove the neoprene sleeve from a banded coupling, then roll the lip back and measure the thickness of the separator ring.

Attach two lengths of 2" pipe, at least 4" long, to the top and bottom openings on a 2" × 2" × 1½" waste-T. Hold the fitting alongside the waste-vent stack, then mark the stack for cutting, allowing space for the separator rings on the banded couplings.

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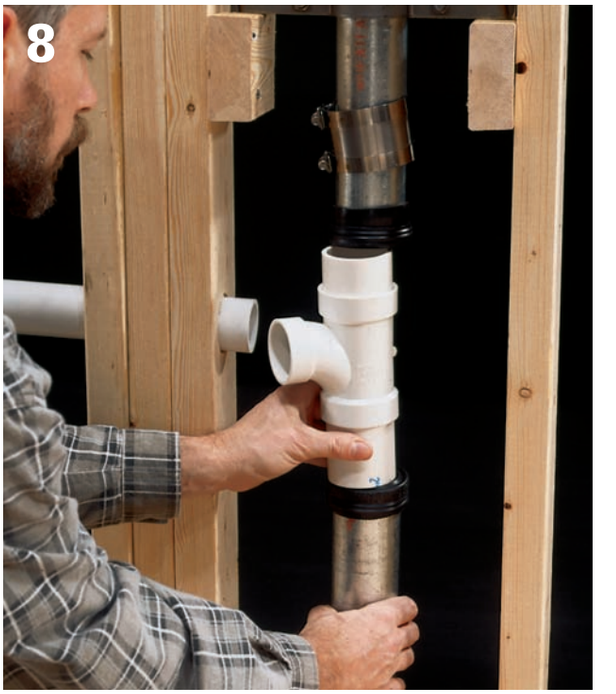
Use riser clamps and 2 × 4 blocking to support the waste-vent stack above and below the new drain pipe, then cut out the waste-vent stack along the marked lines, using a reciprocating saw and metal-cutting blade.



Slide banded couplings onto the cut ends of the waste-vent stack, and roll back the lips of the neoprene sleeves. Position the waste-T assembly, then roll the sleeves into place over the plastic pipes.

Slide the metal bands into place over the neoprene sleeves, and tighten the clamps with a ratchet wrench or screwdriver.

Solvent-glue the drain pipe, beginning at the waste-vent stack. Use a 90° elbow and a short length of pipe to create a drain stub-out extending about 4" out from the wall.

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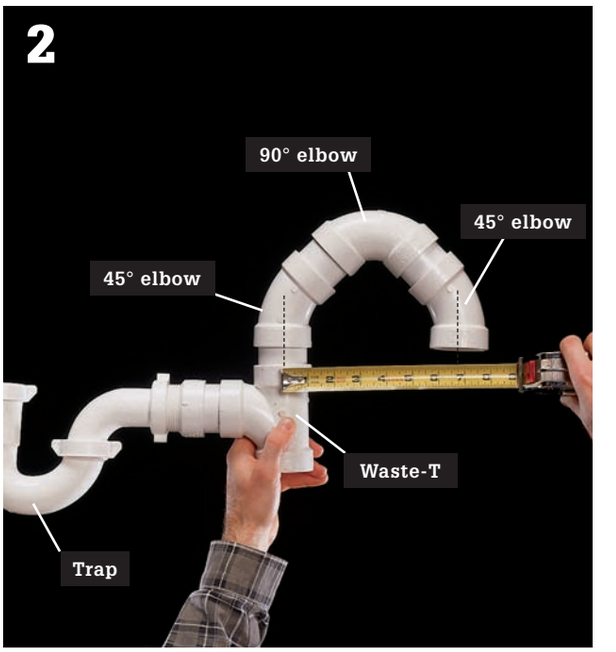
#175 Dtp:225 Page:178

How to Install DWV Pipes for an Island Sink

Position the base cabinet for the island sink, according to your kitchen plans. Mark the cabinet position on the floor with tape, then move the cabinet out of the way.



Create the beginning of the drain and loop vent by test-fitting a drain trap, waste-T, two 45° elbows, and a 90° elbow, linking them with 2" lengths of pipe. Measure the width of the loop between the centerpoints of the fittings.

Draw a reference line perpendicular to the wall to use as a guide when positioning the drain pipes. A cardboard template of the sink can help you position the loop vent inside the outline of the cabinet.

Position the loop assembly on the floor, and use it as a guide for marking hole locations. Make sure to position the vent loop so the holes are not over joists.

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#175 Dtp:225 Page:179

Use a hole saw with a diameter slightly larger than the vent pipes to bore holes in the subfloor at the marked locations. Note the positions of the holes by carefully measuring from the edges of the taped cabinet outline; these measurements will make it easier to position matching holes in the floor of the base cabinet.

Reposition the base cabinet, and mark the floor of the cabinet where the drain and vent pipes will run. (Make sure to allow for the thickness of the cabinet sides when measuring.) Use the hole saw to bore holes in the floor of the cabinet, directly above the holes in the subfloor.

Measure, cut, and assemble the drain and loop vent assembly with a cleanout on the vertical pipe that does not have a trap. Tape the top of the loop in place against a brace laid across the top of the cabinet, then extend the drain and vent pipes through the holes in the floor of the cabinet. The waste-T should be about 18" above the floor, and the drain and vent pipes should extend about 2 ft. through the floor.

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#175 Dtp:225 Page:180

In the basement, establish a route from the island vent pipe to an existing vent pipe. (In our project, we used the auxiliary waste-vent stack near a utility sink.) Hold a long length of pipe between the pipes, and mark for T-fittings. Cut off the plastic vent pipe at the mark, then dry-fit a waste T-fitting to the end of the pipe.

Hold a waste-T against the vent stack, and mark the horizontal vent pipe at the correct length. Fit the horizontal pipe into the waste-T, then tape the assembly in place against the vent stack. The vent pipe should angle ¼" per foot down toward the drain.

Fit a 3" length of pipe in the bottom opening on the T-fitting attached to the vent pipe, then mark both the vent pipe and the drain pipe for 45° elbows. Cut off the drain and vent pipes at the marks, then dry-fit the elbows onto the pipes.

Extend both the vent pipe and drain pipe by dry-fitting 3" lengths of pipe and Y-fittings to the elbows. Using a level, make sure the horizontal drain pipe will slope toward the waste-vent at a pitch of ¼" per foot. Measure and cut a short length of pipe to fit between the Y-fittings.

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#175 Dtp:225 Page:181

Cut a horizontal drain pipe to reach from the vent Y-fitting to the auxiliary waste-vent stack. Attach a waste-T to the end of the drain pipe, then position it against the drain stack, maintaining a downward slope of ¼" per foot. Mark the auxiliary stack for cutting above and below the fittings.

Cut out the auxiliary stack at the marks. Use the T-fittings and short lengths of pipe to assemble an insert piece to fit between the cutoff ends of the auxiliary stack. The insert assembly should be about ½" shorter than the removed section of stack.

Slide banded couplings onto the cut ends of the auxiliary stack, then insert the plastic pipe assembly and loosely tighten the clamps.

At the open inlet on the drain pipe Y-fitting, insert a cleanout fitting.

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#175 Dtp:225 Page:182

Solvent-glue all pipes and fittings found in the basement, beginning with the assembly inserted into the existing waste-vent stack, but do not glue the vertical drain and vent pipes running up into the cabinet. Tighten the banded couplings at the auxiliary stack. Support the horizontal pipes every 4 ft. with strapping nailed to the joists, then detach the vertical pipes extending up into the island cabinet. The final connection for the drain and vent loop will be completed as other phases of the kitchen remodeling project are finished.

After installing flooring and attaching cleats for the island base cabinet, cut away the flooring that covers the holes for the drain and vent pipes.

Install the base cabinet, then insert the drain and vent pipes through the holes in the cabinet floor, and solvent-glue the pieces together.

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Air Admittance Valves

The loop vent is approved by code in any jurisdiction and is a reliable way to vent your island sink. But in many parts of the country, you'll find another option that is far simpler, if not as time-tested: the air admittance valve (AAV). Invented in the 1970s, AAVs let the necessary amount of air enter a DWV system when water is draining, but they close when the line has emptied to keep sewer gases from escaping.

The advantage of AAVs is that you can install them to vent individual fixtures, reducing the amount of vent piping needed, as well as the number of roof penetrations. You can also install them on branch vent lines to service more than one fixture.

Be sure to check with your local building department before installing them anywhere. Any vent system containing AAVs also must have at least one standard vent outlet to the exterior of the building.

The first AAVs on the market were spring-activated, and you can still purchase these today through wholesale plumbing suppliers or the Internet. Later versions are gravity activated. In these AAVs, the valve is opened by negative line pressure in the drain line created by flushing or draining. When the valve opens, the pressure in the line equalizes.

AAVs can be installed into PVC systems like any other solvent-glued fitting. Always install AAVs according to the manufacturer's specification.

Shown cutaway

Air admittance valves are designed to allow air into the vent system when needed, but to keep it from exiting when the system should remain closed.

The original air admittance valves were spring loaded (right) but advancing technology is replacing these versions with gravity-activated AAVs (left). These older valves sometimes wear out, so it's a good idea to replace them with newer gravity-activated models.

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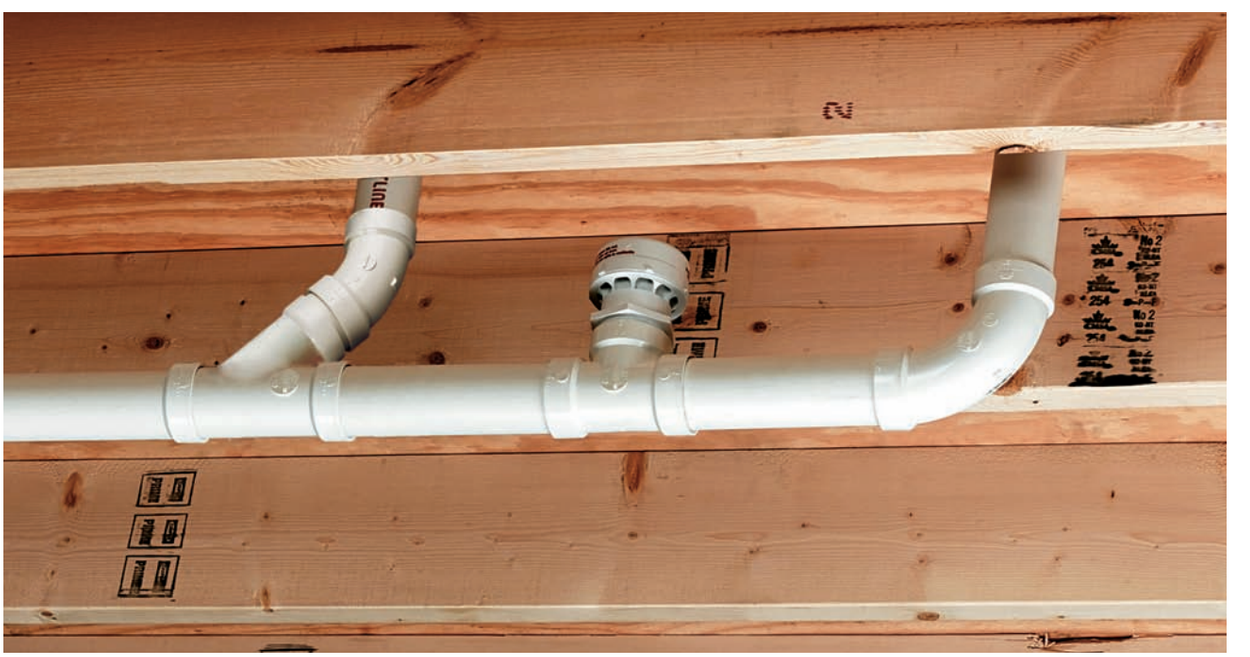
#175 Dtp:225 Page:184

Common AAV Applications

By installing an AAV in a plumbed kitchen island, you can do away with almost all of the complicated loop-vent plumbing. But be sure to check with your local plumbing inspector first. AAVs are allowed in all 50 states but not in some municipalities in selected states.

An AAV connected to the trap of an individual plumbing fixture can eliminate great amounts of vent-plumbing work. In many large public stadiums, for example, each bathroom fixture is vented with an AAV to cut down on the number of long vent runs.



An AAV can be installed on a branch drain servicing as many as six fixtures (check local code), as long as the DWV system has at least one outlet through the roof and outside of the building.

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How to Install New Supply Pipes

Drill two 1"-diameter holes, spaced about 6" apart, through the floor of the island base cabinet and the underlying subfloor. Position the holes so they are not over floor joists. Drill similar holes in the floor of the base cabinet for the wall sink.

Turn off the water at the main shutoff and drain the pipes. Cut out any old water supply pipes that obstruct new pipe runs, using a tubing cutter or hacksaw. In our project, we removed the old pipe back to a point where it was convenient to begin the new branch lines.

Dry-fit T-fittings on each supply pipe (we used ¾" × ½" × ½" reducing T-fittings). Use elbows and lengths of copper pipe to begin the new branch lines running to the island sink and the wall sink. The parallel pipes should be routed so they are between 3" and 6" apart.

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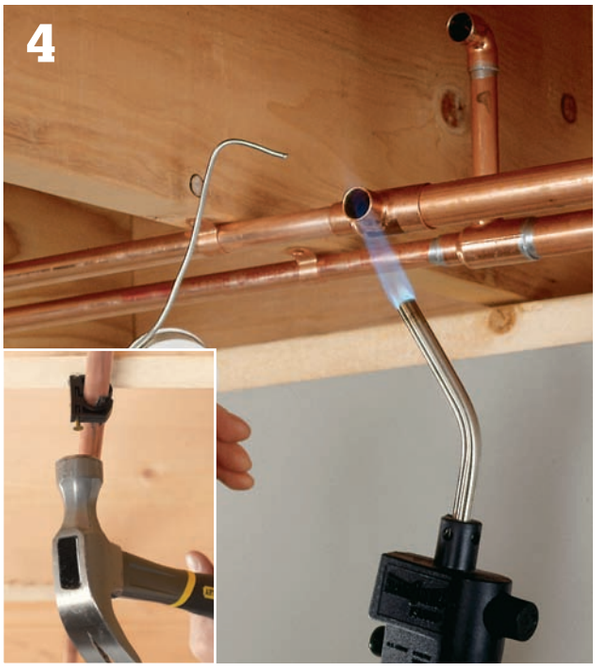

Solder the pipes and fittings together, beginning at the T-fittings. Support the horizontal pipe runs with copper pipe straps attached to the joists at least every 6 ft. (Check your local codes for specific strap spacing requirements.) A plastic Sioux strap (inset) holds the pipe away from the wood, minimizing noise when water is turned on and off.

Extend the branch lines to points directly below the holes leading up into the base cabinets. Use elbows and lengths of pipe to form vertical risers extending at least 12" into the base cabinets. Use a small level to position the risers so they are plumb, then mark the pipe for cutting.

Fit the horizontal pipes and risers together, and solder them in place. Install blocking between joists, and anchor the risers to the blocking with pipe straps.

Solder male-threaded adapters to the tops of the risers, then screw threaded shutoff valves onto the fittings.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:187

New Gas Lines

Do you want to enjoy the efficiency and control of cooking on a gas range, but your kitchen only supports an electric model? Or perhaps you've been meaning to move the range to improve the workflow. Would you like to add a supplementary gas water heater closer to your master bath? Are you planning to add a permanent heat source in your garage? Or do you simply want to save money by converting from electricity to gas fuel for a few of your major appliances? Any of these projects is within your grasp as long as your home already has natural gas service. You simply need to install a new branch gas line.

Installing a gas line isn't difficult, but it is dangerous and in many areas you simply aren't allowed to do it yourself. Please read the discussion of whether or not to tackle a gas-related project on pages 316 to 317 before you make your decision. Also refer to the basic materials and handling information in the same location.

If you choose to proceed with the new line installation, begin by mapping out where the new line will run and calculating what lengths of pipe and which fittings you will need. Begin at the supply pipe you'll be tying into and work forward. Also check with your local building department to find out which types of pipe are allowed and which types they recommend for your job.

The number of gas appliances a branch line can support is limited by the diameter of the branch and length of runs, so you'll need to know exactly which other appliances are serviced by the branch you're tying into and how much fuel they consume (see chart, next page). You will need to obtain a permit and have your work inspected, so it's good to involve the inspections department up front.

Running new pipe lines allows you to enjoy the practical and cost-savings benefits of natural gas in all areas of your home.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:188

Notes for Installing Gas Lines

- In most areas, a shutoff valve (usually a ball valve) must be accessible within 3 ft. of the appliance and in the same room.
- If you are relocating a line and cannot remove the existing branch supply line because of limited access, you will need to cap the gas stub out.
- If you live in an area that allows flexible copper or flexible stainless-steel connectors you will have more room for error in your measurements. If you must connect only using rigid black pipe, you may need to have some pipe lengths cut and threaded to fit.
- Most areas allow Type K and Type L copper tubing for installation in an LP gas or natural gas line. But always check with your local building department.
- Never use standard plumbing fittings with gas pipe. Use only gas-rated, cast brass stopcocks for smaller pipe (less than 3" dia.) and use gas-rated globe or gate valves for larger pipe.

Gas Consumption of Household Appliances

APPLIANCE	AVG. BTU'S PER HOUR	GAS CONSUMPTION PER HOUR*
50-gallon water heater	50,000	50 cu. ft.
Furnace	200,000	200 cu. ft.
Clothes dryer	35,000	35 cu. ft.
Range/oven	65,000	65 cu. ft.

*Based on output rate of 1,000 btu per cubic foot of fuel per hour. Your actual rate will likely differ. Check with your energy company.

Determine the flow rate for a branch line by adding the gas consumption per hour (use above data only if specific information is not printed on your appliance label) of each appliance. Although appliances may not run concurrently, it is advisable to select pipe size based on 100% flow rate. Note that distance traveled also plays an important role in selecting pipe size diameter (½", ¾", 1", 1¼", or 1½").

Horizontal pipe runs must be pitched downward slightly, either by using progressively thicker shims between pipe and the attachment surface, or by making progressively deeper cutouts in a support member, or drilling access holes that become progressively lower in joists.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:189

Tips for Running Gas Pipe ▸

Horizontal pipe runs should terminate in a drip nipple that drops from the end to capture moisture and impurities.

Make branch connections at the side or top of the pipe you are tying into. If you need to drop down or up, run a branch line at least 6" long straight out from the side of the pipe and then drop down or go up with a 90° union.

Protect pipes running in enclosed wall cavities with steel protector plates to stop nails or screws before they reach the pipe. Pipes in enclosed walls must be at least ½" in diameter.

Wrap the male pipe threads with gas-rated Teflon tape before joining to fittings. Wind the tape clockwise (as you face the hole in the pipe), and wrap two or three windings. Alternatively, apply pipe joint compound to the threads.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:190

How to Install a Branch Gas Line

Begin layout at the end of the run. Pull the appliance away from the wall slightly in the new location and mark the most convenient spot for the new gas line to enter the room. The easiest installation is up through the floor. Drill a hole through the floor and thread a wire through the hole to mark the location of the proposed gas line.

From the basement, locate the wire and determine whether the placement is feasible. Adjust the placement to work around joists or other supply lines if necessary. Drill a 1" hole up through the floor.

Turn off the gas at the gas meter, using an adjustable wrench. The valve does not have a stop, so it can rotate indefinitely. The gas is off when the bar is perpendicular to the pipe.

Disconnect the existing appliance. If a flexible stainless-steel connector was used, discard it, as they can only be installed once. Remove the gas stub-out or flexible copper line back to the supply line.

(continued)

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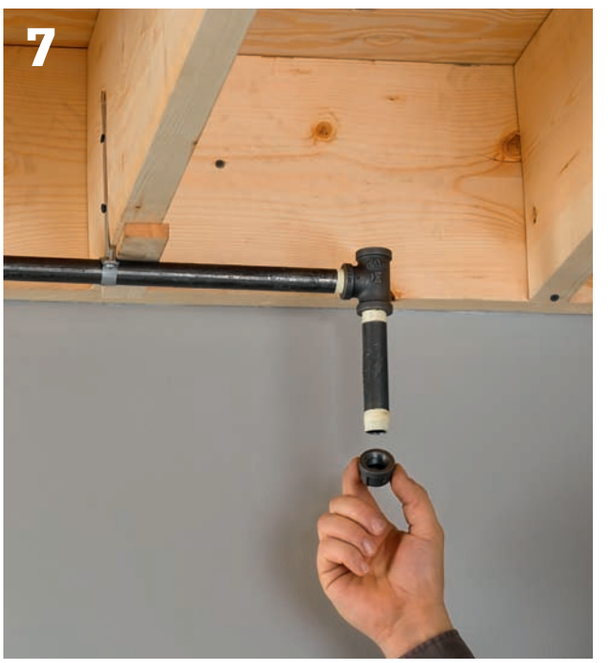
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:191

Begin fitting the new pipe. Apply pipe compound or gas-rate, yellow PTFE tape to all male threads. Hand tighten each joint, then tighten each pipe and fitting at least one turn before moving on to the next section. You may need to tighten more than one turn to get the proper alignment. Wipe any excess joint compound from the exposed threads.

Support pipe runs with pipe hangers rated for use with your pipe material. Make sure that the line has a slight downward slope from the source toward the appliance.



Install a T at the point where the pipe turns up to go through the floor. Connect a short nipple and a cap on the crossbar of the T pointing down. This creates a drip nipple to trap any moisture or impurities in the gas line. The drip nipple must be at least 3" long.

Push the riser stub-out pipe up through the hole in the floor. To prevent contamination, cover the end of the riser nipple with tape or plastic.

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#175 Dtp:225 Page:192

Attach an approved ¼"-turn gas valve to the riser stub-out. Apply pipe compound to the male threads. Use an adjustable wrench, not a pipe wrench, to tighten the valve onto the stubout. If desired, slip an escutcheon plate over the riser pipe before you attach the valve (you can also install a split plate later). With the valve off, restore gas to the line at the meter and test all joints with leak detector solution (see page 317).

Attach a male-threaded-to-flare adapter to the valve. Use two adjustable wrenches—one holding the valve in place and one tightening the fitting.

Attach the appliance connector tube to the valve. Make sure to buy a connector with ends that match the valve and the appliance port. In most cases, you may now use flexible stainless-steel connectors instead of soft copper tubing that requires flaring. But soft copper is allowed if you have the equipment to make a flare fitting joint (see page 276) and want to save a few dollars.

Hook up the appliance by attaching the other flare nut to the threaded gas inlet port on the appliance. Plug in the appliance's power cord. Turn on gas at the main meter and at the stop valve and test the flare fittings for leaks. Once you're certain all the joints are good, carefully slide the appliance into place.

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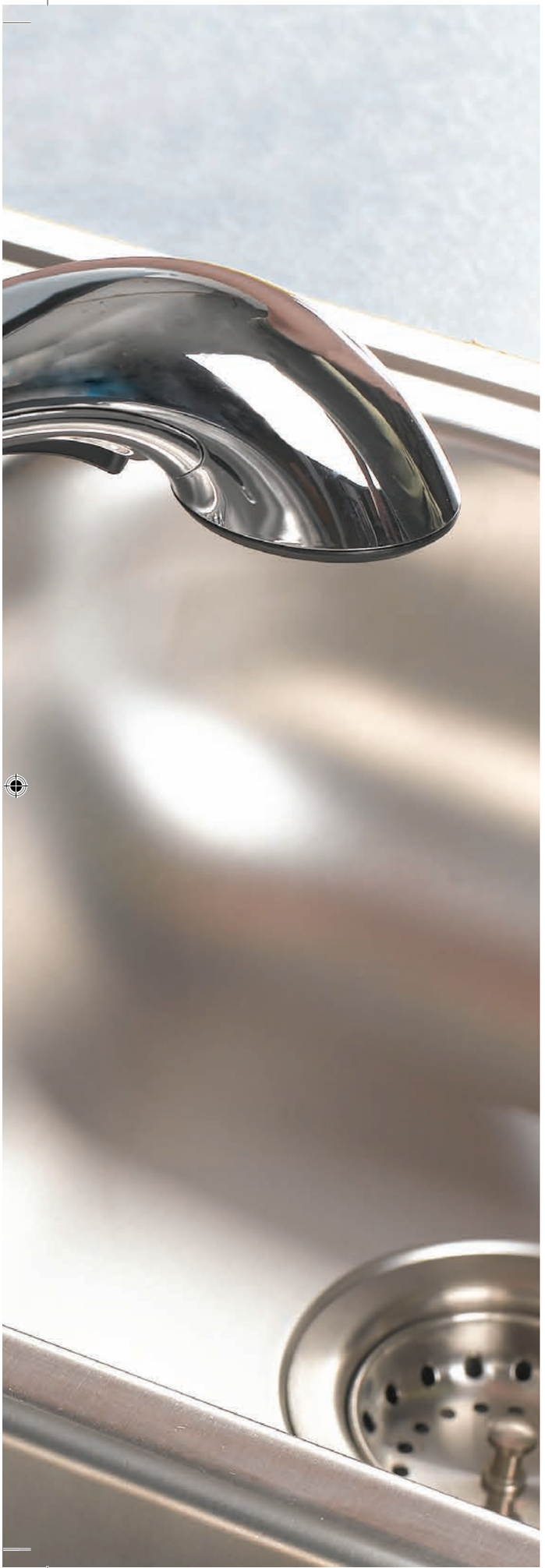

Plumbing Repairs

Making plumbing repairs is a good deal easier today than it was a generation ago. Back then, a leaky faucet was repaired by disassembling the valve and repacking it with messy string. Today, you simply remove the old cartridge and pop in a new one. In older times, if your toilet was running you replaced a rubber gasket or washer. Today, you're more likely to simply remove and replace the entire flush mechanism, which is actually a good deal easier to do than fixing one discreet piece of the mechanism. But convenience always comes at a price. Locating the correct replacement parts can get tricky, and instead of a cheap washer or bit of graphite string, you usually have to pay for the whole replacement parts package.

Faucets and drains are the parts of your plumbing system that are most likely to need repairs. Faucets leak or drip and drains clog. If you add these repairs to fixing toilet problems, you've covered almost everything you're likely to face. This chapter includes thorough information on these common repairs, as well as several that you're less likely to encounter—but in the event that you do, you'll be prepared.

In this chapter:

- Common Toilet Problems
- Toilet Flanges
- Toilet Drain Lines
- Sinks
- Sprayers & Aerators
- Leaky Plumbing
- Tubs & Showers
- Sink Drains
- Branch & Main Drains
- Branch Drains & Vents
- Main Stacks
- Supply Pipes
- Noisy Pipes

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
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Common Toilet Problems

A clogged toilet is one of the most common plumbing problems. If a toilet overflows or flushes sluggishly, clear the clog with a plunger or closet auger. If the problem persists, the clog may be in the main waste-vent stack (pages 250 to 251).

Most other toilet problems are fixed easily with minor adjustments that require no disassembly or replacement parts. You can make these adjustments in a few minutes, using simple tools (pages 270 to 272).

If minor adjustments do not fix the problem, further repairs will be needed. The parts of a standard toilet are not difficult to take apart, and most repair projects can be completed in less than an hour.

A recurring puddle of water on the floor around a toilet may be caused by a crack in the toilet base or in the tank. A damaged toilet should be replaced. Installing a new toilet is an easy project that can be finished in three or four hours.

A standard two-piece toilet has an upper tank that is bolted to a base. This type of toilet uses a simple gravity-operated flush system and can easily be repaired using the directions on the following pages. Some one-piece toilets use a complicated, high-pressure flush valve.

An older toilet may have a tank ball that settles onto the flush valve to stop the flow of water into the bowl. The ball is attached to a lift wire, which is in turn attached to the lift rod. A ballcock valve is usually made of brass, with rubber washers that can wear out. If the ballcock valve malfunctions, you might be able to find old washers to repair it, but replacing both the ballcock and the tank ball with a float-cup assembly and flapper is easier and makes for a more durable repair.

A modern float-cup valve with flapper is inexpensive and made of plastic, but is more reliable than an old ballcock valve and ball.

A pressure-assist toilet has a large vessel that nearly fills the tank. As water enters the vessel, pressure builds up. When the toilet is flushed, this pressure helps push water forcefully down into the bowl. As a result, a pressure-assist toilet provides strong flushing power with minimal water consumption.

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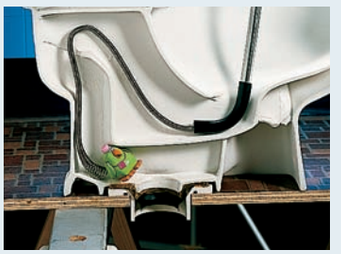
Problems & Repairs



PROBLEMS	REPAIRS
Toilet handle sticks or is hard to push.	1. Adjust lift wires (page 198). 2. Clean and adjust handle (page 201).
Handle must be held down for entire flush.	1. Adjust handle (page 201). 2. Shorten lift chain or wires (page 198). 3. Replace waterlogged flapper.
Handle is loose.	1. Adjust handle (page 201). 2. Reattach lift chain or lift wires to lever (page 198).
Toilet will not flush at all.	1. Make sure water is turned on. 2. Adjust lift chain or lift wires (page 198).
Toilet does not flush completely.	1. Adjust lift chain (page 201). 2. Adjust water level in tank (page 200). 3. Increase pressure on pressure-assisted toilet.
Toilet overflows or flushes sluggishly.	1. Clear clogged toilet (page 210). 2. Clear clogged main waste-vent stack (page 251).
Toilet runs continuously or there are phantom flushes.	1. Adjust lift wires or lift chain (page 198). 2. Replace leaky float ball (page 202). 3. Adjust water level in tank (page 200). 4. Adjust and clean flush valve (page 204). 5. Replace flush valve (page 204). 6. Replace flapper. 7. Service pressure-assist valve (page 204).
Water on floor around toilet.	1. Tighten tank bolts and water connections (pages 214–215). 2. Insulate tank to prevent condensation. 3. Replace wax ring (page 214). 4. Replace cracked tank or bowl (pages 18–21).
Toilet noisy when filling.	1. Open shutoff valve completely. 2. Replace ballcock and float valve. 3. Refill tube is disconnected.
Weak flush.	1. Clean clogged rim openings (page 210–213). 2. Replace old low-flow toilet.
Toilet rocks.	1. Replace wax ring and bolts (page 214). 2. Replace toilet flange (page 215).

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:197

Making Minor Adjustments

Many common toilet problems can be fixed by making minor adjustments to the handle and the attached lift chain (or lift wires).

If the handle sticks or is hard to push, remove the tank cover and clean the handle-mounting nut. Make sure the lift wires are straight.

If the toilet will not flush completely unless the handle is held down, you may have to remove excess slack in the lift chain.

If the toilet will not flush at all, the lift chain may be broken or may have to be reattached to the handle lever.

A continuously running toilet (page opposite) can be caused by bent lift wires, kinks in a lift chain, or lime buildup on the handle mounting nut. Clean and adjust the handle and the lift wires or chain to fix the problem.

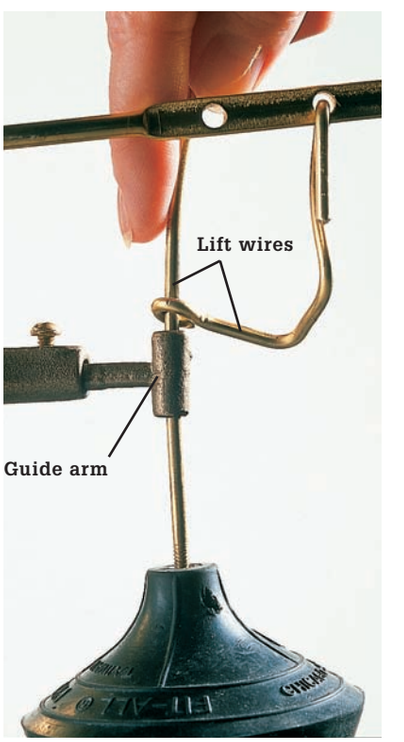
Tools & Materials ▸

Adjustable wrench	Screwdriver	Hacksaw	Small wire brush
Needlenose pliers	Scissors	Spray Lubricant	Vinegar

How to Adjust a Toilet Handle & Lift Chain (or Lift Wires)

Clean and adjust handle-mounting nut so handle operates smoothly. Mounting nut has reversed threads. Loosen nut by turning clockwise; tighten by turning counterclockwise. Remove lime buildup with a brush dipped in vinegar.

Adjust lift chain so it hangs straight from handle lever, with about ½" of slack. Remove excess slack in chain by hooking the chain in a different hole in the handle lever or by removing links with needlenose pliers. A broken lift chain must be replaced.



Adjust lift wires (found on older toilets without lift chains) so that wires are straight and operate smoothly when handle is pushed. A sticky handle often can be fixed by straightening bent lift wires. You can also buy replacement wires, or replace the whole assembly with a float cup.

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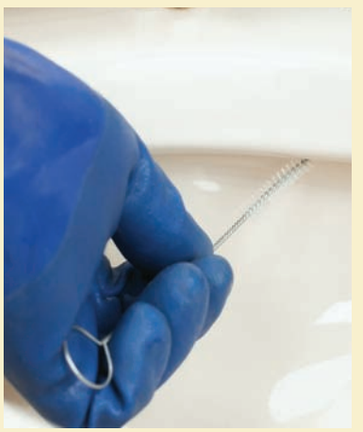
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:198

Quick Fixes ▸

Phantom flushes? Phantom flushes are weak flushes that occur without turning the handle. The flapper may not be completely sealing against the flush valve's seat. Make sure the chain is not tangled, and that the flapper can go all the way down. If that does not solve the problem, shut off water and drain the tank. If the problem persists, the flapper may need to be replaced.

Seat loose? Loose seats are almost always the result of loose nut on the seat bolts. Tighten the nuts with pliers. If the nut is corroded or stripped, replace the bolts and nuts or replace the whole seat.

Seat uncomfortably low? Instead of going to the trouble of raising the toilet or replacing it with a taller model, you can simply replace the seat with a thicker, extended seat.



Bowl not refilling well? The rim holes may be clogged; many toilets have small holes on the underside of the bowl rim, through which water squirts during a flush. If you notice that some of these holes are clogged, use a stiff-bristled brush to clear out debris. You may need to first apply toilet bowl cleaner or mineral cleaner.

Tank fills too slowly? The first place to check is the shutoff valve where the supply tube for the toilet is connected. Make sure it is fully open. If it is, you may need to replace the shutoff—these fittings are fairly cheap and frequently fail to open fully.

Toilet running? Running toilets are usually caused by faulty or misadjusted fill valves, but sometimes the toilet runs because the tank is leaking water into the bowl. To determine if this is happening with your toilet, add a few drops of food coloring to the tank water. If, after a while, the water in the bowl becomes colored, then you have a leak and probably need to replace the rubber gasket at the base of your flush valve.

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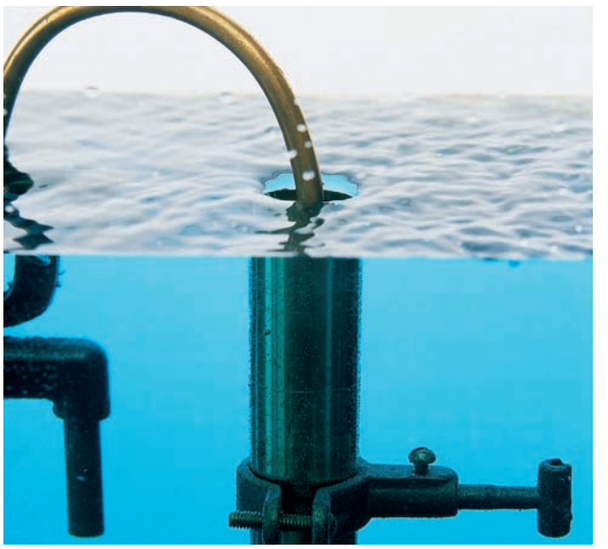
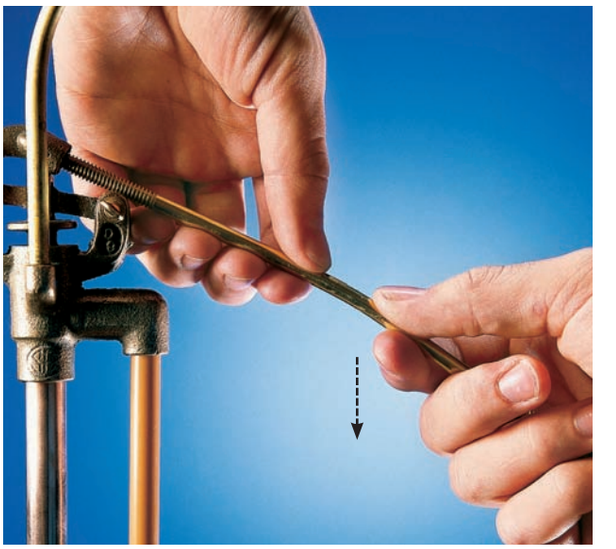
Reset Tank Water Level



Tank water flowing into the overflow pipe is the sound we hear when a toilet is running. Usually, this is caused by a minor misadjustment that fails to tell the water to shut off when the toilet tank is full. The culprit is a float ball or cup that is adjusted to set a water level in the tank that's higher than the top of the overflow pipe, which serves as a drain for excess tank water. The other photos on this page show how to fix the problem.



A ball float is connected to a float arm that's attached to a plunger on the other end. As the tank fills, the float rises and lifts one end of the float arm. At a certain point, the float arm depresses the plunger and stops the flow of water. By simply bending the float arm downward a bit, you can cause it to depress the plunger at a lower tank water level, solving the problem.

A diaphragm fill valve usually is made of plastic and has a wide bonnet that contains a rubber diaphragm. Turn the adjustment screw clockwise to lower the water level and counterclockwise to raise it.

A float cup fill valve is made of plastic and is easy to adjust. Lower the water level by pinching the spring clip with fingers or pliers and moving the clip and cup down the pull rod and shank. Raise the water level by moving the clip and cup upward.

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#175 Dtp:225 Page:200

What If the Flush Stops Too Soon?

Sometimes there is plenty of water in the tank, but not enough of it makes it to the bowl before the flush valve shuts off the water from the tank. Modern toilets are designed to leave some water in the tank, since the first water that leaves the tank does so with the most force. (It's pressed out by the weight of the water on top.) To increase the duration of the flush, shorten the length of the chain between the flapper and the float (yellow in the model shown).

The handle lever should pull straight up on the flapper. If it doesn't, reposition the chain hook on the handle lever. When the flapper is covering the opening, there should be just a little slack in the chain. If there is too much slack, shorten the chain and cut off excess with the cutters on your pliers.

If the toilet is not completing flushes and the lever and chain for the flapper or tank ball are correctly adjusted, the problem could be that the handle mechanism needs cleaning or replacement. Remove the chain/linkage from the handle lever. Remove the nut on the backside of the handle with an adjustable wrench. It unthreads clockwise (the reverse of standard nuts). Remove the old handle from the tank.

Unless the handle parts are visibly broken, try cleaning them with an old toothbrush dipped in white vinegar. Replace the handle and test the action. If it sticks or is hard to operate, replace it. Most replacement handles come with detailed instructions that tell you how to install and adjust them.

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#175 Dtp:225 Page:201

How to Replace a Fill Valve

Toilet fill valves wear out eventually. They can be repaired, but it's easier and a better fix to just replace them. Before removing the old fill valve, shut off the water supply at the fixture stop valve located on the tube that supplies water to the tank. Flush the toilet and sponge out the remaining water. Loosen the nut and disconnect the supply tube, then loosen and remove the mounting nut.

If the fill valve spins while you turn the mounting nut, you may need to hold it still with locking pliers. Lift out the fill valve. In the case of an old ballcock valve, the float ball will likely come out as well. When replacing an old valve like this, you will likely also need to replace the flush valve (see pages 204–205).

The new fill valve must be installed so the critical level ("CL") mark is at least 1" above the overflow pipe (see inset). Slip the shank washer on the threaded shank of the new fill valve and place the valve in the hole so the washer is flat on the tank bottom. Compare the locations of the "CL" mark and the overflow pipe.

Adjust the height of the fill valve shank so the "CL" line and overflow pipe will be correctly related. Different products are adjusted in different ways—the fill valve shown here telescopes when it's twisted.

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#175 Dtp:225 Page:202

Slip the valve's threaded end down through the tank. Push down on its shank (not the top) while tightening the locknut (inset). Hand tighten, then use a wrench to make an extra ¼ turn. Hook up the water supply tube, and tighten in the same way.

If the overflow pipe has a cap, remove it. Attach one end of the refill tube from the new valve to the plastic angle adapter and the other end to the refill nipple near the top of the valve. Attach the angle adapter to the overflow pipe. Cut off excess tubing with scissors to prevent kinking. *Warning: Don't insert the refill tube into the overflow pipe. The outlet of the refill tube needs to be above the top of the pipe for it to work properly.*

Turn the water on fully. Slightly tighten any fitting that drips water. Adjust the water level in the tank by squeezing the spring clip on the float cup with needlenose pliers and moving the cup up or down on the link bar. Test the flush.

Option: Newer diaphragm valves cost a bit more than float cups, but they boast quieter water flow. Install one the same way you would a float cup.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
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How to Replace a Flush Valve

Before removing the old flush valve, shut off the water supply at the fixture stop valve located on the tube that supplies water to the tank. Flush the toilet and sponge out the remaining water. To make this repair you'll need to remove the tank from the bowl. Start by unscrewing the water supply coupling nut from the bottom of the tank.

Unscrew the bolts holding the toilet tank to the bowl by loosening the nuts from below. If you are having difficulty unscrewing the tank bolts and nuts because they are fused together by rust or corrosion, apply penetrating oil or spray lubricant to the threads, give it a few minutes to penetrate, and then try again. If that fails, slip an open-ended hacksaw (or plain hacksaw blade) between the tank and bowl and saw through the bolt (inset photo).

Unhook the chain from the handle lever arm. Remove the tank and carefully place it upside-down on an old towel. Remove the spud washer and spud nut from the base of the flush valve using a spud wrench or large channel-type pliers. Remove the old flush valve.

Place the new flush valve in the valve hole and check to see if the top of the overflow pipe is at least 1" below the critical level line (see page 202) and the tank opening where the handle is installed. If the pipe is too tall, cut it to length with a hacksaw.

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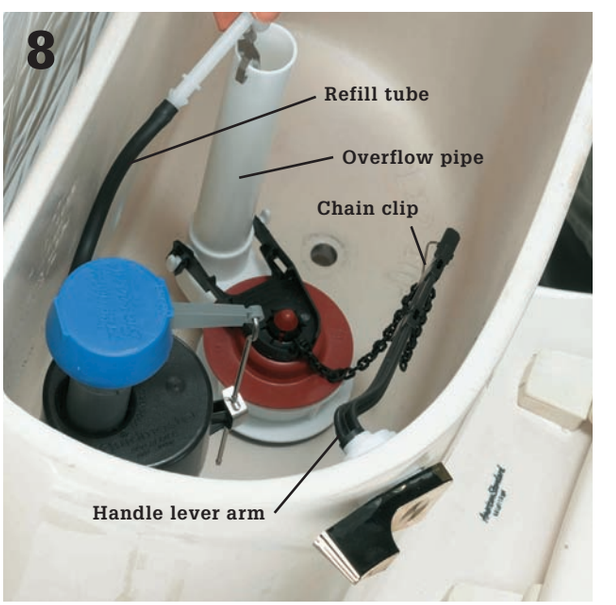
Position the flush valve flapper below the handle lever arm and secure it to the tank from beneath with the spud nut. Tighten the nut one-half turn past hand tight with a spud wrench or large channel-type pliers. Overtightening may cause the tank to break. Put the new spud washer over the spud nut, small side down.

With the tank lying on its back, thread a rubber washer onto each tank bolt and insert it into the bolt holes from inside the tank. Then, thread a brass washer and hex nut onto the tank bolts from below and tighten them to a quarter turn past hand tight. Do not overtighten.

With the hex nuts tightened against the tank bottom, carefully lower the tank over the bowl and set it down so the spud washer seats neatly over the water inlet in the bowl and the tank bolts fit through the holes in the bowl flange. Secure the tank to the bowl with a rubber washer, brass washer, and nut or wing nut at each bolt end. Press the tank to level as you hand-tighten the nuts. Hook up the water supply at the fill valve inlet.



Connect the chain clip to the handle lever arm and adjust the number of links to allow for a little slack in the chain when the flapper is closed. Leave a little tail on the chain for adjusting, cutting off remaining excess. Attach the refill tube to the top of the overflow pipe the same way it had been attached to the previous refill pipe. Turn on the water supply at the stop valve and test the flush. (Some flush valve flappers are adjustable.)

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:205

Dual-flush Valves

Though dual-flush valves for modern toilets were invented in Australia in the 1980s, they didn't become prominent worldwide until the 1990s when water-saving technology became easier to install and implement. A dual-flush valve allows you to make a half flush when a small amount of water will suffice; when you need a stronger flush, you can turn the handle in the other direction for a full flush. This can save plenty of water—and money—over the course of a year (see chart below).

A typical retrofit unit comes with both a flush valve and a fill valve, can be installed in most toilet tanks, and is extremely affordable—often not more than $50. Like most standard toilet valves, dual-flush valves rely on the force of gravity to achieve a clean and powerful flush, and although models from different manufacturers may vary in their installation and design, they all work to achieve the same purpose—a more water-efficient flush for the environmentally-minded and cost-savings savvy consumers. To use dual-flush technology, some units require you to pull up on the handle instead of down, while others are push-button activated. Stand-alone dual-flush valves can be purchased for home installation in a standard one-flush gravity-assisted toilet, or complete dual-flush-capable toilets can be purchased directly from manufacturers, and they come in a wide variety of styles and finishes to match most bathrooms.

Conserve water (and money) with the push of a button (inset). Dual-flush valves can be installed in most standard toilets.

Get with the (low) Flow

Gallons per flush (gpf)	Savings in gallons per year (gpy)
5.0	0
3.5	11,000 gpy from 5.0 gpf
1.6	25,300 gpy from 5.0 gpf to 1.6 gpf 14,100 gpy from 3.5 gpf to 1.6 gpf
1.28	27,700 gpy from 5.0 gpf to 1.28 gpf 16,500 gpy from 3.5 gpf to 1.28 gpf
1.0	29,000 gpy from 5.0 gpf to 1.0 gpf 18,600 gpy from 3.5 gpf to 1.0 gpf

Water savings based on an average household of four, each flushing 5.1 times a day, 365 days a year.
Source: WaterSense, see Resources, p. 330

Tools & Materials

- Dual-flush valve assembly
- Replacement gasket
- Hex nut
- Bolts
- Rubber washers
- Brass washers (if necessary)
- Screwdriver
- Teflon tape
- Channel-lock pliers
- Wax pencil
- Bucket
- Sponge
- Towel

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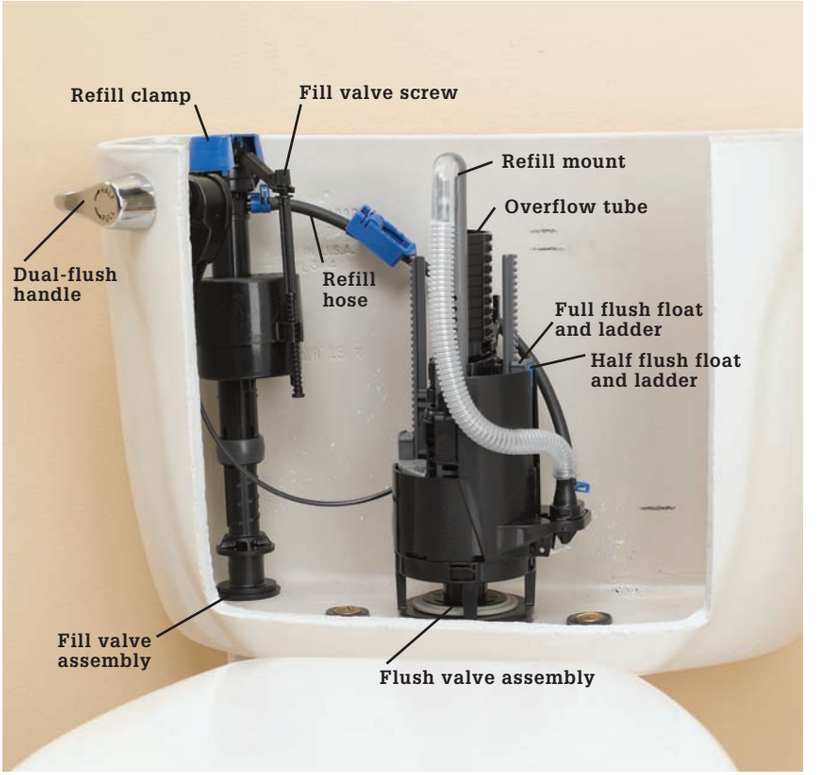

A dual-flush valve is easier to install than it looks. All the component pieces are seen on the left.

How to Install a Dual-flush Valve

Turn off the water supply. Remove the top of the tank and mark both the water level and the top of the overflow tube using a wax pencil. Remove the old assemblies, flush a single time, and mark the level of the remaining water in the bottom of the tank. Hold the toilet handle to flush once more, and remove excess water with a sponge.

Disconnect the supply line from behind the tank. Use channel-lock pliers to remove the lock nut from the valve shank, allowing excess water to drip into a bucket. Next, remove the tank after loosening the flush valve nuts. Remove the old gasket from the flush valve shank, but keep all the old parts together—they may still be needed.

(continued)

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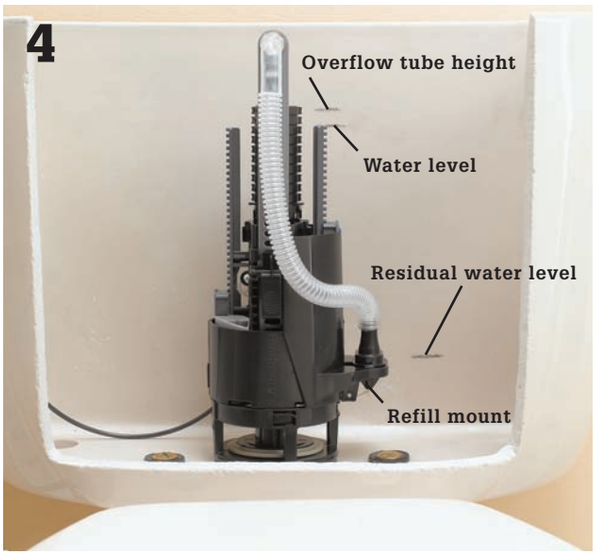
#175 Dtp:225 Page:207

After removing the flush valve lock nut from the new flush valve assembly, place the new flush valve assembly into the tank, ensuring it is level and comfortably seated atop the shank. Mark the height of the new overflow tube to match the height of the old tube recorded in step 1; cut the tube to match, removing the assembly from the tank if necessary. Removing the refill mount from the flush valve assembly (above) makes marking and cutting the tube easier.



Re-attach the refill mount, making sure it is low enough to fit inside the tank and high enough to clear the lid. Cut excess refill hose if necessary. To install the entire valve, hand-tighten the lock nut to the threaded shank. Do not over-tighten.

Reassemble the tank with bolts, rubber washers, brass washers, and a hex nut. Use the old rubber gasket if necessary and install the fill valve in much the same way as the flush valve; remove the fill valve lock nut and shank washer, and insert the valve onto the fill valve shank adjacent to the flush valve. The height of the fill valve must be approximately 3" greater than the flush valve; adjust as necessary by twisting the threaded shank in and out. When the desired height is reached, hand-tighten the fill valve lock nut to the shank.

The refill hose connects the dual valve assemblies; attach the refill hose from the fill valve to the nipple on the dual flush valve (inset), and ensure both ends are clear of the valve operations. If you need to change the orientation of the flush valve, release the base by turning the assembly counterclockwise until the tabs unlock, lift the valves out, and adjust as needed.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:208

Install the dual flush handle to the tank and hand-tighten the lever lock-nut. The nut is reverse-threaded, so be sure the tabs on the collar are oriented vertically and aligned with the handle's tabs. Reconnect and turn on the water supply, checking for leaks. Do not use plumber's putty or thread lubricants to seal the fittings, as they may damage the plastic nut. Teflon tape is a good alternative.

Adjusting the Flush and Tank Levels

If the water in the tank is uneven with the original high water mark from step 1, turn the screw near the top of the fill valve clockwise to increase the water level or counterclockwise to decrease it.

To adjust the level of half or full flushes, look to the flush valve assembly on the right; the higher float near the refill hose adjusts the half flush, while the opposing lower float on the other side of the assembly adjusts the full. Use a small amount of toilet paper and a test flush to gauge the amount of water used; if unsatisfied, adjust the appropriate flush by pulling out each float's stop, and raising or lowering each float to properly adjust the refill level. See the manufacturer's instructions, as the direction of adjustment to raise or lower the water level varies per manufacturer.

Adjusting the Refill Level in the Bowl

The refill tube connects both valve assemblies, and the roller clamp on the tube can be adjusted to monitor the level of water in the bowl. To adjust, add a gallon of water to the bowl and wait 10 minutes, then mark the water level with a wax pencil. Flush the toilet. If the refill valve is still running once the water mark has been reached, decrease the volume of water by moving the roller clamp toward zero. If there's not enough water, do the opposite, moving the clamp toward higher numbers. Continue adjusting until the water reaches the mark in the tank at the same time the valve turns off.

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#175 Dtp:225 Page:209

Clogged Toilets

The toilet is clogged and has overflowed. Have patience. Now is the time for considered action. A second flush is a tempting but unnecessary gamble. First, do damage control. Mop up the water if there's been a spill. Next, consider the nature of the clog. Is it entirely "natural" or might a foreign object be contributing to the congestion? Push a natural blockage down the drain with a plunger. A foreign object should be removed, if possible, with a closet auger. Pushing anything more durable than toilet paper into the sewer may create a more serious blockage in your drain and waste system.

If the tub, sink, and toilet all back up at once, the branch drainline that serves all the bathroom fixtures is probably blocked and your best recourse is to call a drain clearing service.

Tools & Materials

- Towels
- Closet auger
- Plunger with foldout skirt (force cup)

A blockage in the toilet bowl leaves flush water from the tank nowhere to go but on the floor.

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#175 Dtp:225 Page:210

The trap is the most common catching spot for toilet clogs, Once the clog forms, flushing the toilet cannot generate enough water power to clear the trap, so flush water backs up. Traps on modern 1.6-gallon toilets have been redesigned to larger diameters and are less prone to clogs than the first generation of 1.6-gallon toilets.

Not all plungers were created equal. The standard plunger (left) is simply an inverted rubber cup and is used to plunge sinks, tubs, and showers. The flanged plunger, also called a force cup, is designed to get down into the trap of a toilet drain. You can fold the flange up into the flanged plunger cup and use it as a standard plunger.

Drain Clearers

The home repair marketplace is filled with gadgets and gimmicks, as well as well-established products, that are intended to clear drains of all types. Some are caustic chemicals, some are natural enzymes, others are more mechanical in nature. Some help, some are worthless, some can even make the problem worse. Nevertheless, if you are the type of homeowner who is enamored with new products and the latest solutions, you may enjoy testing out new drain cleaners as they become available. In this photo, for example, you'll see a relatively new product that injects blasts of compressed CO_2 directly into your toilet, sink, or tub drain to dislodge clogs. It does not cause any chemicals to enter the waste stream, and the manufacturers claim the CO_2 blast is very gentle and won't damage pipes. As with any new product, use it with caution. But if a plunger or a snake isn't working, it could save you the cost of a house call.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:211

How to Plunge a Clogged Toilet

Plunging is the easiest way to remove "natural" blockages. Take time to lay towels around the base of the toilet and remove other objects to a safe, dry location, since plunging may result in splashing. Often, allowing a very full toilet to sit for twenty or thirty minutes will permit some of the water to drain to a less precarious level.

Force Cups ▸

A flanged plunger (force cup) fits into the mouth of the toilet trap and creates a tight seal so you can build up enough pressure in front of the plunger to dislodge the blockage and send it on its way.

There should be enough water in the bowl to completely cover the plunger. Fold out the skirt from inside the plunger to form a better seal with the opening at the base of the bowl. Pump the plunger vigorously half-a-dozen times, take a rest, and then repeat. Try this for four to five cycles.

If you force enough water out of the bowl that you are unable to create suction with the plunger, put a controlled amount of water in the bowl by lifting up on the flush valve in the tank. Resume plunging. When you think the drain is clear, you can try a controlled flush, with your hand ready to close the flush valve should the water threaten to spill out of the bowl. Once the blockage has cleared, dump a five-gallon pail of water into the toilet to blast away any residual debris.

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How to Clear Clogs with a Closet Auger

Place the business end of the auger firmly in the bottom of the toilet bowl with the auger tip fully withdrawn. A rubber sleeve will protect the porcelain at the bottom bend of the auger. The tip will be facing back and up, which is the direction the toilet trap takes.

Closet Augers

A closet auger is a semirigid cable housed in a tube. The tube has a bend at the end so it can be snaked through a toilet trap (without scratching it) to snag blockages.

Rotate the handle on the auger housing clockwise as you push down on the rod, advancing the rotating auger tip up into the back part of the trap. You may work the cable backward and forward as needed, but keep the rubber boot of the auger firmly in place in the bowl. When you feel resistance, indicating you've snagged the object, continue rotating the auger counterclockwise as you withdraw the cable and the object.

Fully retract the auger until you have recovered the object. This can be frustrating at times, but it is still a much easier task than the alternative—to remove the toilet and go fishing.

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#175 Dtp:225 Page:213

Toilet Flanges

If your toilet rocks, it will eventually leak. The rocking means that the bolts are no longer holding the toilet securely to the floor. If you have tightened the bolts and it still rocks, it is possible that a bolt has broken a piece of the flange off and is no longer able to hold. Rocking might also be because an ongoing leak has weakened the floor and it is now uneven. Whatever the reason, a rocking toilet needs to be fixed.

If your flange is connected to cast-iron piping, use a repair flange. This has a rubber compression ring that will seal the new flange to the cast-iron pipe.

Tools & Materials

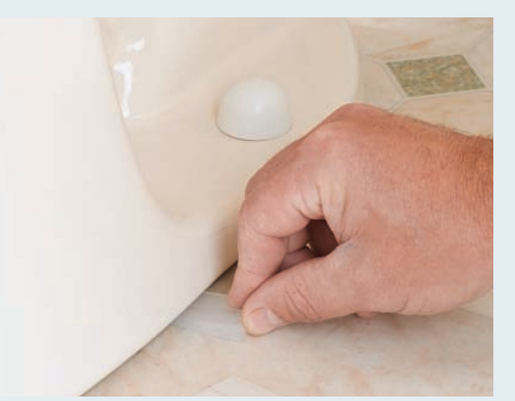
- Drill
- Wrench
- Internal pipe cutter
- Solvent-glue
- #10 stainless-steel flathead wood screws
- Marker

Use a flange repair kit for a quick fix to a broken flange. The new flange piece from the kit is simply screwed to the floor after it has been oriented correctly over the broken flange.

Toilets that rock often only need to have the nuts on the closet bolts tightened. But if you need to tighten the bolts on an ongoing basis, you very likely have a problem with the closet flange.

Toilet Shims

If the toilet is wobbly because of an uneven floor, shims may solve the problem. (Do not install shims if the toilet leaks at the base; they will not solve that problem.) Slip two or more plastic toilet shims under the toilet until it is stabilized. Press the shims with only medium pressure; don't force them too hard. Cut the exposed portions of the shims with a utility knife.



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How to Replace a PVC Closet Flange

Begin by removing the toilet and wax ring. Cut the pipe just below the bottom of the flange using an internal pipe cutter (inset, available at plumbing supply stores). Remove the flange.

If your flange is attached to a closet bend, you will need to open up the floor around the toilet to get at the horizontal pipe connecting the bend to the stack to make the repair. If it is connected to a length of vertical plastic pipe, use a repair coupling and a short length of pipe to bring the pipe back up to floor level. Glue the new pipe into the repair coupling first and allow it to set. Clean the old pipe thoroughly before gluing.

Cut the replacement pipe flush with the floor. Dry-fit the new flange into the pipe. Turn the flange until the side cut-out screw slots are parallel to the wall. (Do not use the curved keyhole slots, as they are not as strong.) Draw lines to mark the location of the slots on the floor.

Prime and solvent-glue the pipe and flange, inserting the flange slightly off the marks and twisting it to proper alignment. Secure the flange to the floor with #10 stainless-steel flathead wood screws.

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Toilet Drain Lines

If your existing toilet drain line is heavily deteriorated, replace it. You will also need to replace the drain line if you are relocating and replacing the main drain stalk or if you are moving the toilet to a different spot in the bathroom.

Replacing a toilet drain is sometimes a troublesome task, mostly because the cramped space makes it difficult to route the large, 3" or 4" pipe. You likely will need to remove flooring around the toilet and wall surface behind the toilet.

Replacing a toilet drain may require framing work, as well, if you find it necessary to cut into joists in order to route the new pipes. When possible, plan your project to avoid changes to the framing members.

Tools & Materials

Drill	Pipe
Circular saw	Exterior-grade plywood
Reciprocating saw	Screws

Replacing a toilet drain usually requires that you remove flooring and wall surface to gain access to the pipes.

How to Replace a Toilet Drain Line

Remove the toilet, then unscrew the toilet flange from the floor and remove it from the drain pipe. You can also use an internal pipe cutter to cut plastic drain pipe (see previous page, top left).

Cut away the flooring around the toilet drain along the center of the floor joists, using a circular saw with the blade set to a depth ⅛" more than the thickness of the subfloor. The exposed joist will serve as a nailing surface when the subfloor is replaced.

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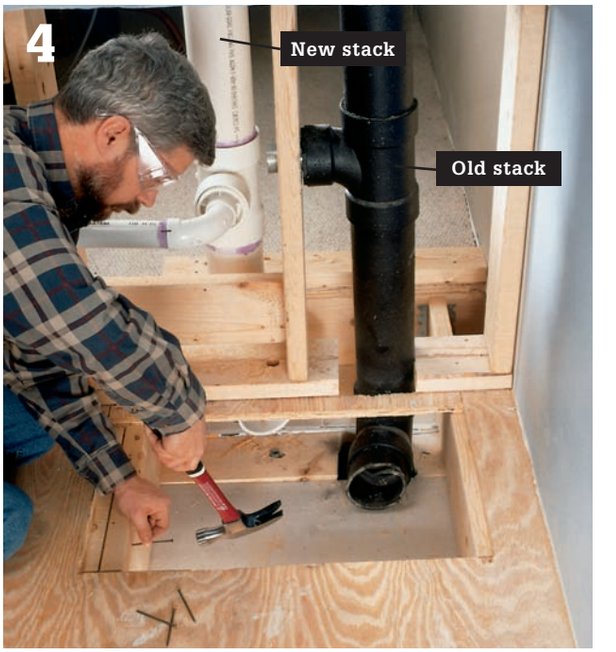
Cut away the old closet bend as close as possible to the old waste-vent stack, cutting first with a grinder equipped with a metal-cutting blade, then finishing with a reciprocating saw.



If a joist obstructs the route to a new waste-vent stack, cut away a section of the floor joist. Install double headers and metal joist hangers to support the ends of the cut joist.

Create a new toilet drain running to the waste-vent stack, using a closet bend and a straight length of pipe. Position the drain so there will be at least 15" of space between the center of the bowl and side wall surfaces when the toilet is installed. Make sure the drain slopes at least ¼" per ft. toward the stack, then support the pipe with plastic pipe strap attached to framing members. Insert a 6" length of pipe in the top inlet of the closet bend; once the new drain pipes have been tested, this pipe will be cut off with a handsaw and fitted with a toilet flange.

Cut a piece of exterior-grade plywood to fit the cutout floor area, and use a jigsaw to cut an opening for the toilet drain stub-out. Position the plywood, and attach it to joists and blocking with 2" screws.

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Sink Faucets

It's not surprising that sink faucets leak and drip. Any fitting that contains moving mechanical parts is susceptible to failure. But add to the equation the persistent force of water pressure working against the parts, and the real surprise is that faucets don't fail more quickly or often. It would be a bit unfair to say that the inner workings of a faucet are regarded as disposable by manufacturers, but it is safe to say that these parts have become more easy to remove and replace.

The older your faucet, the more likely you can repair it by replacing small parts like washers and O-rings. Many newer faucets can be repaired only by replacing the major inner components, like a ceramic disk or a cartridge that encapsulates all the washers and O-rings that could possibly wear out.

The most important aspect of sink faucet repair is identifying which type of faucet you own. In this chapter we show all of the common types and provide instructions on repairing them. In every case, the easiest and most reliable repair method is to purchase a replacement kit with brand-new internal working parts for the model and brand of faucet you own.

Tools & Materials

- Pliers
- Needlenose pliers
- Heatproof grease
- Channel-type pliers
- Utility knife
- White Vinager
- Old toothbrush
- Tape measure
- Repair kit (exact type varies)
- Teflon tape
- Screwdrivers
- Pipe joint compound
- Plumber's putty
- Rag

Eventually, just about every faucet develops leaks and drips. Repairs can usually be accomplished simply by replacing the mechanical parts inside the faucet body (the main trick is figuring out which kind of parts your faucet has).

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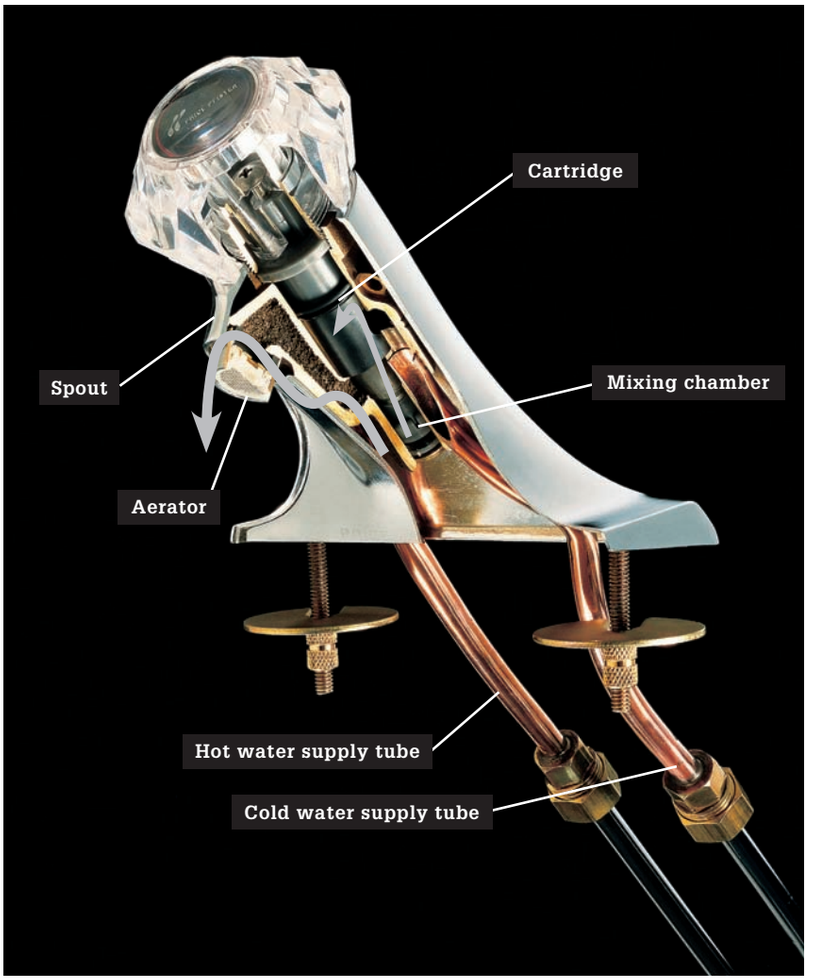

All faucets, no matter the type, have valves that move many thousands of times to open and close hot- and cold-water ports. These valves—or the rubber or plastic parts that rub against other parts when the faucet is being adjusted—wear out in time. Depending on the faucet, you may be able to fix the leak by cleaning or replacing small parts, such as washers or O-rings; or you may need to buy a repair kit and replace a number of parts; or the only solution may be to replace a self-enclosed "cartridge" that contains all the moving parts.

Common Problems and Repairs

PROBLEMS	REPAIRS
Faucet drips from the end of the spout or leaks around the base.	1. Identify the faucet design (page 220), then install replacement parts, using directions on the following pages.
Old worn-out faucet continues to leak after repairs are made.	1. Replace the old faucet (pages 23 to 27).
Water pressure at spout seems low, or water flow is partially blocked.	1. Clean faucet aerator (page 227). 2. Replace corroded galvanized pipes with copper.
Water pressure from sprayer seems low, or sprayer leaks from handle.	1. Clean sprayer head (page 231). 2. Fix diverter valve (page 229).
Water leaks onto floor underneath faucet.	1. Replace cracked sprayer hose (page 229). 2. Tighten water connections, or replace supply tubes and shutoff valves (pages 186 to 187). 3. Fix leaky sink strainer (pages 248 to 249).
Hose bib or valve drips from spout or leaks around handle.	1. Take valve apart and replace washers and O-rings (pages 221 to 222).

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Identifying Your Faucet and the Parts You Need

A leaky faucet is the most common home plumbing problem. Fortunately, repair parts are available for almost every type of faucet, from the oldest to the newest, and installing these parts is usually easy. But if you don't know your make and model, the hardest part of fixing a leak may be identifying your faucet and finding the right parts. Don't make the common mistake of thinking that any similar-looking parts will do the job; you've got to get exact replacements.

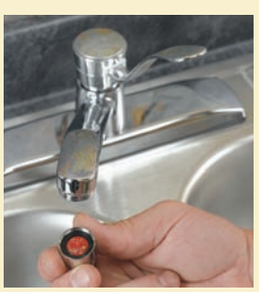
There are so many faucet types that even experts have trouble classifying them into neat categories. Two-handle faucets are either compression (stem) or washerless two-handle. Single-handle faucets are classified as mixing cartridge; ball; disc; or disc/cartridge.

A single-handle faucet with a rounded, dome-shaped cap is often a ball type. If a single-handle faucet has a flat top, it is likely a cartridge or a ceramic disc type. An older two-handle faucet is likely of the compression type; newer two-handle models use washerless cartridges. Shut off the water, and test to verify that the water is off. Dismantle the faucet carefully. Look for a brand name: it may be clearly visible on the baseplate, or may be printed on an inner part, or it may not be printed anywhere. Put all the parts into a reliable plastic bag and take them to your home center or plumbing supply store. A knowledgeable salesperson can help you identify the parts you need.

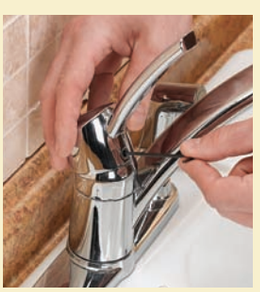
If you cannot find what you are looking for at a local store, check online faucet sites or the manufacturers' sites; they often have step-by-step instruction for identifying what you need. Note that manufacturers' terminology may not match the terms we use here. For example, the word "cartridge" may refer to a ceramic-disc unit.

Most faucets have repair kits, which include all the parts you need, and sometimes a small tool as well. Even if some of the parts in your faucet look fine, it's a good idea to install the parts provided by the kit, to ensure against future wear.

Repair Tips



If water flow is weak, unscrew the aerator at the tip of the spout. If there is sediment, then dirty water is entering the faucet, which could damage the faucet's inner workings.



To remove handles and spouts, work carefully and look for small screw heads. You often need to first pry off a cap on top, but not always. Parts may be held in place with small setscrews.

Cleaning and removing debris can sometimes solve the problem of low water flow, and occasionally can solve a leak as well.

Apply plumber's grease (also known as faucet grease or valve grease), to new parts before installing them. Be especially sure to coat rubber parts like O-rings and washers.

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#175 Dtp:225 Page:220

Compression Faucets

A compression faucet has a stem assembly that includes a retaining nut, threaded spindle, O-ring, stem washer, and stem screw. Dripping at the spout occurs when the washer becomes worn. Leaks around the handle are caused by a worn O-ring.

Pry off the cap on top of the handle and remove the screw that holds the cap onto the stem. Pull the handle up and out. Use an adjustable wrench or pliers to unscrew the stem and pull it out.

If the handle is stuck, try applying mineral cleaner from above. If that doesn't work, you may need to buy a handle puller. With the cap and the hold-down screw removed, position the wings of the puller under the handle and tighten the puller to slowly pull the handle up.

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Remove the screw that holds the rubber washer in place, and pry out the washer. Replace a worn washer with an exact replacement—one that is the same diameter, thickness, and shape.

Replace any O-rings. A worn O-ring can cause water to leak out the handle. Gently pry out the old O-ring and reinstall an exact replacement. Apply plumber's grease to the rubber parts before reinstalling the stem.

If washers wear out quickly, the seat is likely worn. Use a seat wrench to unscrew the seat from inside the faucet. Replace it with an exact duplicate. If replacing the washer and O-ring doesn't solve the problem, you may need to replace the entire stem.

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Washerless Two-handle Faucet

Almost all two-handle faucets made today are "washerless." Instead of an older-type compression stem, there is a cartridge, usually with a plastic casing. Many of these cartridges contain ceramic discs, while others have metal or plastic pathways. No matter the type of cartridge, the repair is the same; instead of replacing small parts, you simply replace the entire cartridge.

Remove the faucet handle and withdraw the old cartridge. Make a note of how the cartridge is oriented before you remove it. Purchase a replacement cartridge.

Install the replacement cartridge. Clean the valve seat first and coat the valve seat and O-rings with faucet grease. Be sure the new cartridge is in the correct position, with its tabs seated in the slotted body of the faucet. Re-assemble the valve and handles.

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One-Handle Cartridge Faucets

Single-handle cartridge faucets like this work by moving the cartridge up and down and side to side, which opens up pathways to direct varying amounts of hot and cold water to the spout. Moen, Price-Pfister, Delta, Peerless, Kohler, and others make many types of cartridges, some of which look very different from this one.

To remove the spout, pry off the handle's cap and remove the screw below it. Pull the handle up and off. Use a crescent wrench to remove the pivot nut.

Lift out the spout. If the faucet has a diverter valve, remove it as well. Use a screwdriver to pry out the retainer clip, which holds the cartridge in place.

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#175 Dtp:225 Page:224

Remove the cartridge. If you simply pull up with pliers, you may leave part of the stem in the faucet body. If that happens, replace the cartridge and buy a stem puller made for your model.

Gently pry out and replace all O-rings on the faucet body. Smear plumber's grease onto the new replacement cartridge and the new O-rings, and reassemble the faucet.

Here is one of many other types of single-handle cartridges. In this model, all the parts are plastic except for the stem, and it's important to note the direction in which the cartridge is aligned. If you test the faucet and the hot and cold are reversed, disassemble and realign the cartridge.

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Ball Faucets

The ball-type faucet is used by Delta, Peerless, and a few others. The ball fits into the faucet body and is constructed with three holes (not visible here)—a hot inlet, a cold inlet, and the outlet, which fills the valve body with water that then flows to the spout or sprayer. Depending on the position of the ball, each inlet hole is open, closed, or somewhere in-between. The inlet holes are sealed to the ball with valve seats, which are pressed tight against the ball with springs. If water drips from the spout, replace the seats and springs. Or go ahead and purchase an entire replacement kit and replace all or most of the working parts.

Remove the old ball and cam after removing the faucet handle and ball cap. Some faucets may require a ball faucet tool to remove the handle. Otherwise, simply use a pair of channel-type pliers to twist off the ball cap.

Pry out the neoprene valve seals and springs. Place thick towels around the faucet. Slowly turn on the water to flush out any debris in the faucet body. Replace the seals and springs with new parts. Also replace the O-rings on the valve body. You may want to replace the ball and cam, too, especially if you're purchasing a repair kit. Coat all rubber parts in faucet grease, and reassemble the faucet.

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Disc Faucets

Disc-type faucets are the most common single-handle faucets currently being made. A pair of ceramic discs encased in a cylinder often referred to as a "cartridge" rub together as they rotate to open ports for hot and cold water. The ceramic discs do wear out in time, causing leaks, and there is only one solution—replace the disc unit (or "cartridge"). This makes for an easy—through comparatively expensive—repair.

Other Cartridges ▸

Many modern cartridges do not have seals or O-rings that can be replaced, and some have a ball rather than a ceramic disk inside. For the repair, the cartridge's innards do not matter; just replace the whole cartridge.

Replace the cylinder with a new one, coating the rubber parts with faucet grease before installing the new cylinder. Make sure the rubber seals fit correctly in the cylinder openings before you install the cylinder. Assemble the faucet handle.

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Kitchen Sprayers

If water pressure from a sink sprayer seems low, or if water leaks from the handle, it is usually because lime buildup and sediment have blocked small openings inside the sprayer head. To fix the problem, first take the sprayer head apart and clean the parts. If cleaning the sprayer head does not help, the problem may be caused by a faulty diverter valve. The diverter valve inside the faucet body shifts water flow from the faucet spout to the sprayer when the sprayer handle is pressed. Cleaning or replacing the diverter valve may fix water pressure problems.

Whenever making repairs to a sink sprayer, check the sprayer hose for kinks or cracks. A damaged hose should be replaced.

If water pressure from a faucet spout seems low, or if the flow is partially blocked, take the spout aerator apart and clean the parts. The aerator is a screw-on attachment with a small wire screen that mixes tiny air bubbles into the water flow. Make sure the wire screen is not clogged with sediment and lime buildup. If water pressure is low throughout the house, it may be because galvanized steel water pipes are corroded. Corroded pipes should be replaced with copper (pages 276 to 283).

Tools & Materials ▸

- Screwdriver
- Channel-type pliers
- Needlenose pliers
- Small brush
- Vinegar
- Universal washer kit
- Heatproof grease
- Replacement sprayer hose

Kitchen sprayers are very convenient and, in theory, quite simple. Yet, they break down with surprising regularity. Fixing or replacing one is an easy job, however.

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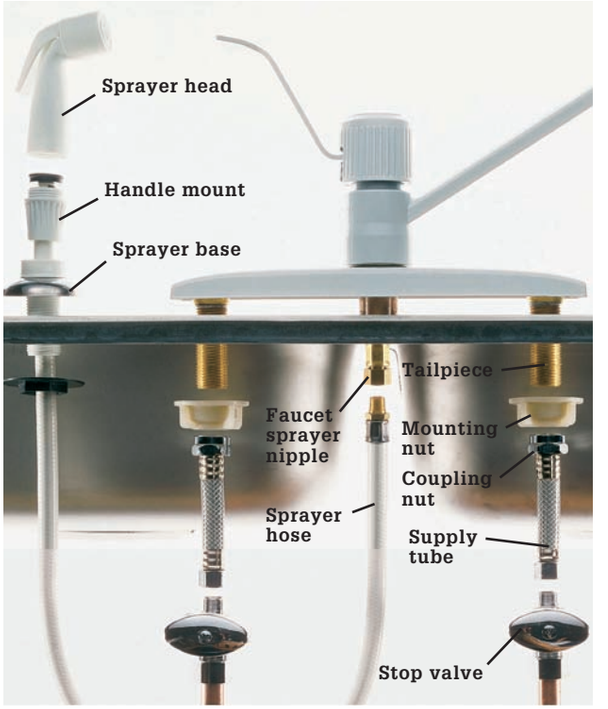
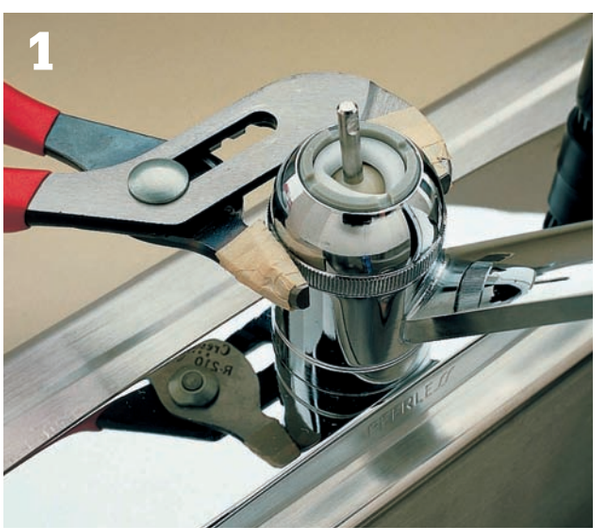


The standard sprayer hose attachment is connected to a nipple at the bottom of the faucet valve. When the lever of the sprayer is depressed, water flows from a diverter valve in the faucet body out to the sprayer. If your sprayer stream is weak or doesn't work at all, the chances are good that the problem lies in the diverter valve.

Sprayer heads can be removed from the sprayer hose, usually by loosening a retaining nut. A sprayer's head can get clogged with minerals. Unscrew the sprayer from the hose and remove any parts at its tip. Soak it in mineral cleaner, and use a small brush to open any clogged orifices.

How to Repair a Sprayer



Shut off the water at the stop valves and remove the faucet handle to gain access to the faucet parts. Disassemble the faucet handle and body to expose the diverter valve. Ball-type faucets like the one shown here require that you also remove the spout to get at the diverter.

Locate the diverter valve, seen here at the base of the valve body. Because different types and brands of faucets have differently configured diverters, do a little investigating beforehand to try and locate information about your faucet. The above faucet is a ball type.

(continued)

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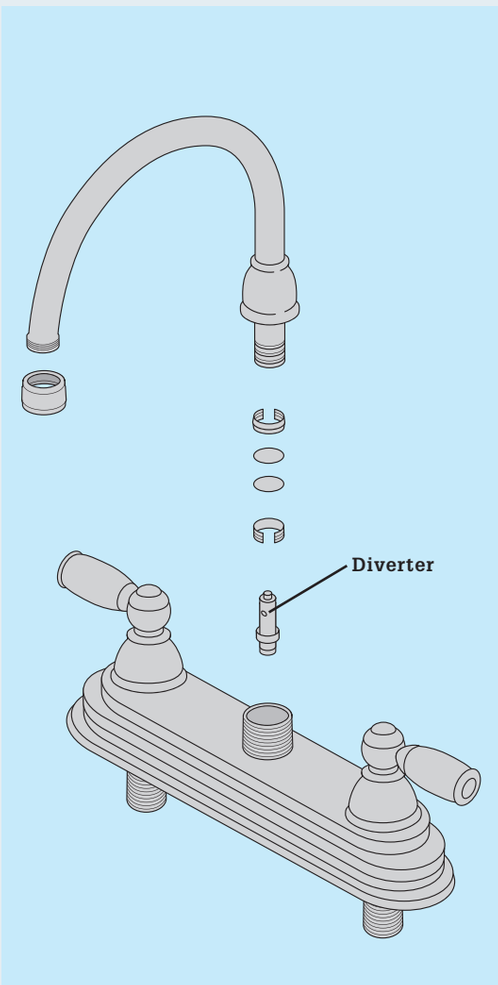
Pull the diverter valve from the faucet body with needlenose pliers. Use a toothbrush dipped in white vinegar to clean any lime buildup from the valve. If the valve is in poor condition, bring it to the hardware store and purchase a replacement.

Coat the washer or O-ring on the new or cleaned diverter valve with faucet grease. Insert the diverter valve back into the faucet body. Reassemble the faucet. Turn on the water and test the sprayer. If it still isn't functioning to your satisfaction, remove the sprayer tip and run the sprayer without the filter and aerator in case any debris has made its way into the sprayer line during repairs.

Finding the Diverter on a Two-Handle Faucet ▸

On a two-handle faucet, the diverter is usually located in a vertical position just under the spout. Remove the spout. You may need to use longnose pliers to pull out the diverter. Try cleaning out any debris. If that does not restore operation, replace the valve.



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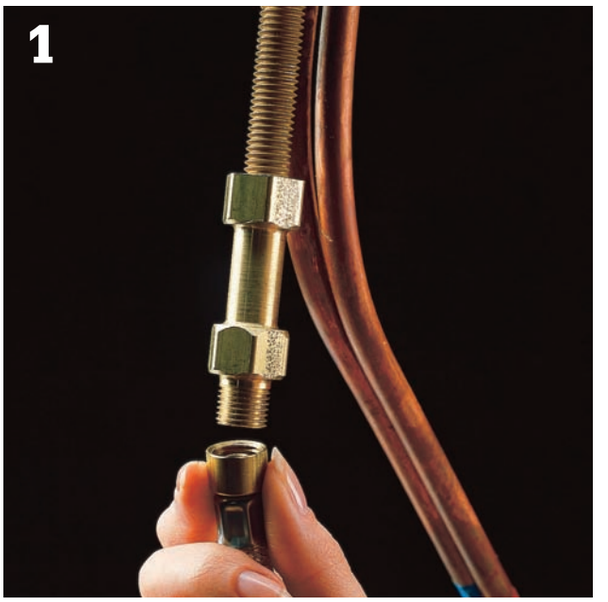
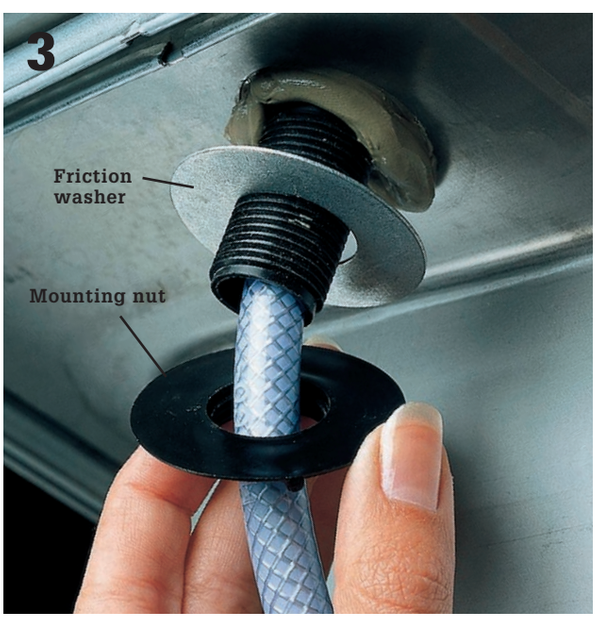
How to Replace a Kitchen Sprayer

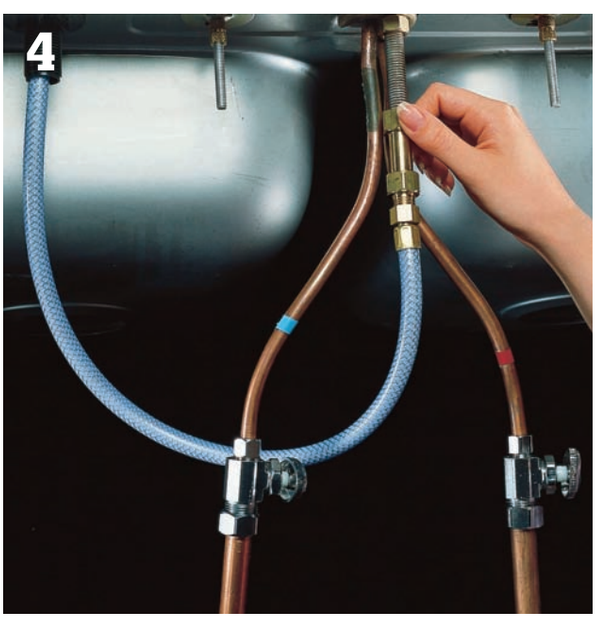


To replace a sprayer hose, start by shutting off the water at the shutoff valves. Clear out the cabinet under your sink and put on eye protection. Unthread the coupling nut that attaches the old hose to a nipple or tube below the faucet spout. Use a basin wrench if you can't get your channel-type pliers on the nut.

Unscrew the mounting nut of the old sprayer from below and remove the old sprayer body. Clean the sink deck and then apply plumber's putty to the base of the new sprayer. Insert the new sprayer tailpiece into the opening in the sink deck.



From below, slip the friction washer up over the sprayer tailpiece. Screw the mounting nut onto the tailpiece and tighten with a basin wrench or channel-type pliers. Do not overtighten. Wipe away any excess plumber's putty.



Screw the coupling for the sprayer hose onto the hose nipple underneath the faucet body. For a good seal, apply pipe joint compound to the nipple threads first. Tighten the coupling with a basin wrench, turn on the water supply at the shutoff valves, and test the new sprayer.

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Fixing Leaky Tubs & Shower Faucets

Tub and shower faucets have the same basic designs as sink faucets, and the techniques for repairing leaks are the same as described in the faucet repair section of this book (pages 218 to 227). To identify your faucet design, you may have to take off the handle and disassemble the faucet.

When a tub and shower are combined, the showerhead and the tub spout share the same hot and cold water supply lines and handles. Combination faucets are available as three-handle, two-handle, or single-handle types (next page). The number of handles gives clues as to the design of the faucets and the kinds of repairs that may be necessary.

With combination faucets, a diverter valve or gate diverter is used to direct water flow to the tub spout or the showerhead. On three-handle faucet types, the middle handle controls a diverter valve. If water does not shift easily from tub to showerhead, or if water continues to run out the spout when the shower is on, the diverter valve probably needs to be cleaned and repaired (pages 229 to 230).

Two-handle and single-handle types use a gate diverter that is operated by a pull lever or knob on the tub spout. Although gate diverters rarely need repair, the lever occasionally may break, come loose, or refuse to stay in the up position. To repair a gate diverter set in a tub spout, replace the entire spout.

Tub and shower faucets and diverter valves may be set inside wall cavities. Removing them may require a deep-set ratchet wrench.

If spray from the showerhead is uneven, clean the spray holes. If the showerhead does not stay in an upright position, remove the head and replace the O-ring.

To add a shower to an existing tub, install a flexible shower adapter. Several manufacturers make complete conversion kits that allow a shower to be installed in less than one hour.

Tub/shower plumbing is notorious for developing drips from the tub spout and the showerhead. In most cases, the leak can be traced to the valves controlled by the faucet handles.

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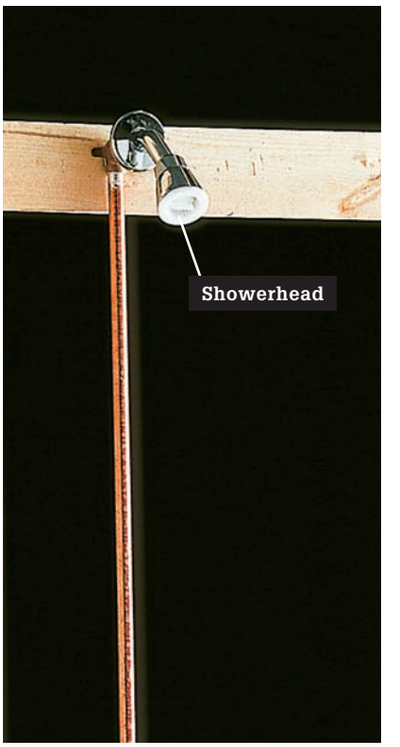
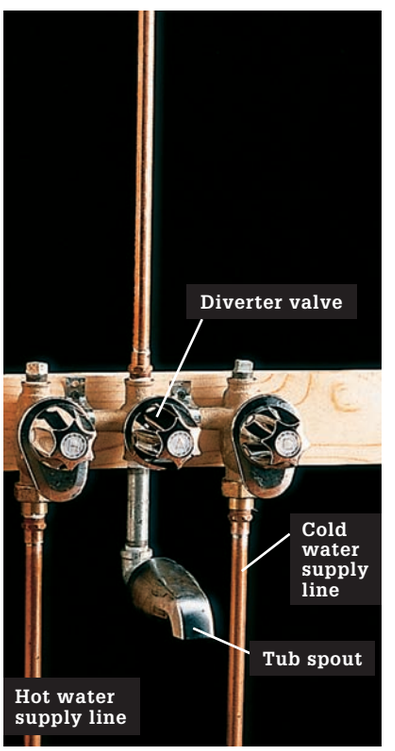
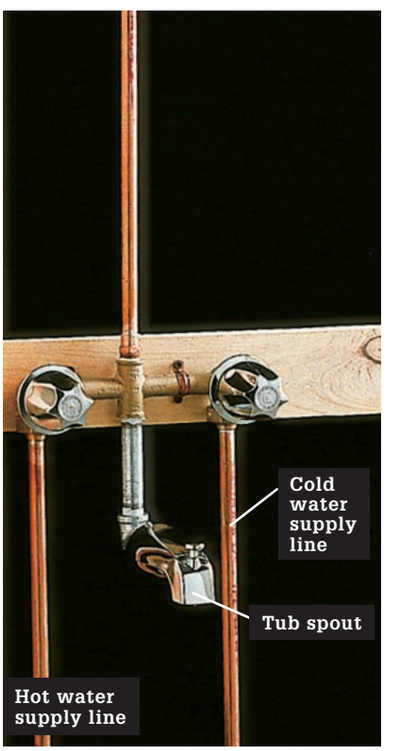
Tub & Shower Combination Faucets

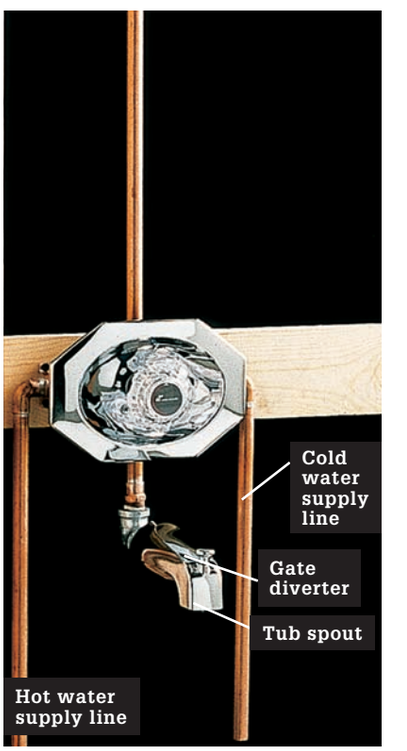




Three-handle faucet (page 234) has valves that are either compression or cartridge design.



Two-handle faucet (page 236) has valves that are either compression or cartridge design.



Single-handle faucet (pages 238 to 239) has valves that are cartridge, ball-type, or disc design.

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Fixing Three-handle Tub & Shower Faucets

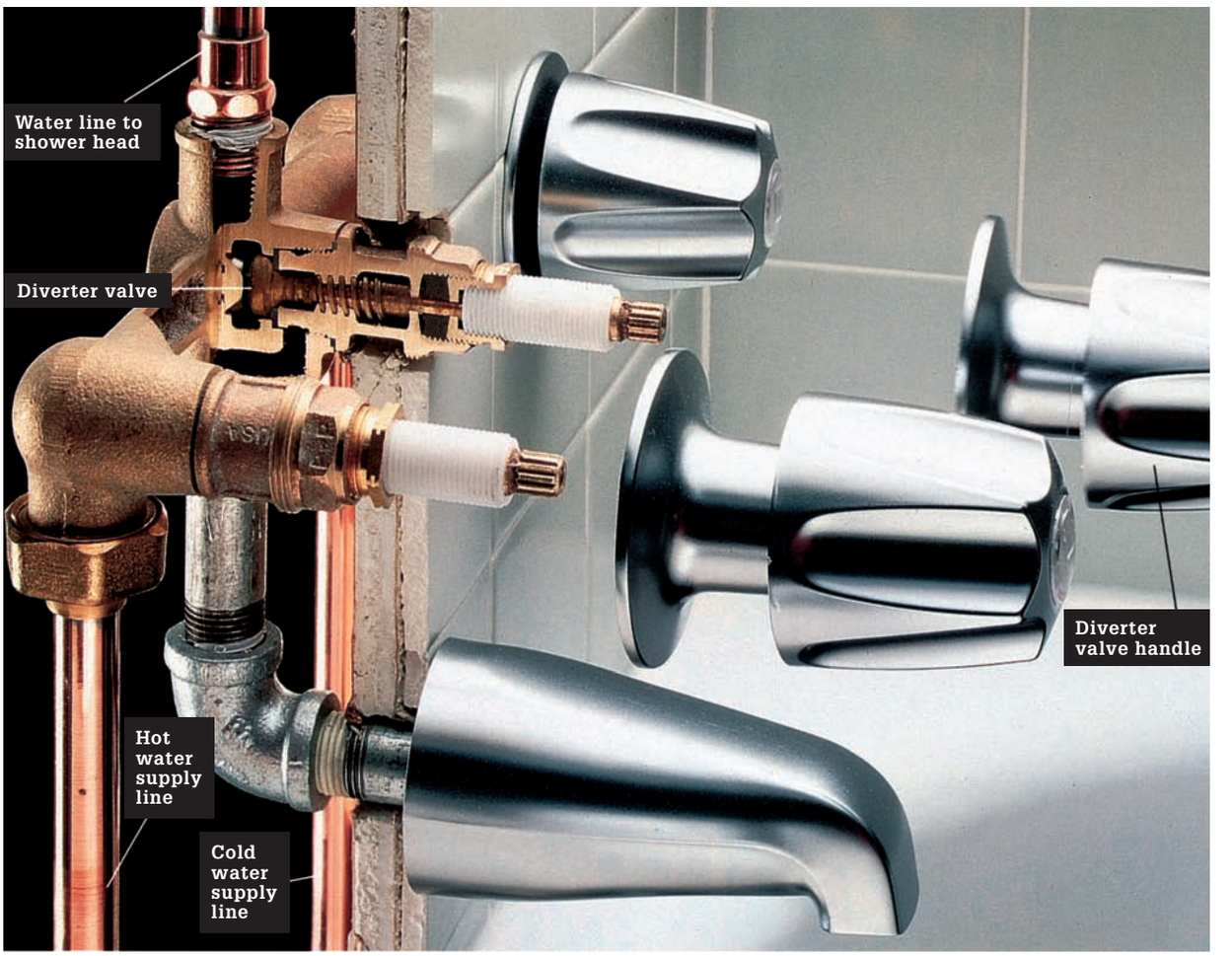
A three-handle faucet type has two handles to control hot and cold water, and a third handle to control the diverter valve and direct water to either a tub spout or a shower head. The separate hot and cold handles indicate cartridge or compression faucet designs. To repair them, refer to page 235.

If a diverter valve sticks, if water flow is weak, or if water runs out of the tub spout when the flow is directed to the showerhead, the diverter needs to be repaired or replaced. Most diverter valves are similar to either compression or cartridge faucet valves. Compression-type diverters can be repaired, but cartridge types should be replaced.

Remember to turn off the water before beginning work.

Tools & Materials

- Screwdriver
- Adjustable wrench or channel-type pliers
- Deep-set ratchet wrench
- Small wire brush
- Replacement diverter cartridge or universal washer kit
- Faucet grease
- Vinegar



A three-handle tub/shower faucet has individual controls for hot and cold water plus a third handle that operates the diverter valve.

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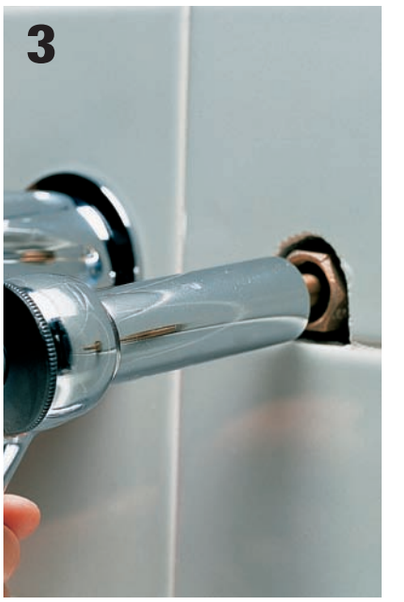
How to Repair a Compression Diverter Valve

Remove the diverter valve handle with a screwdriver. Unscrew or pry off the escutcheon.

Remove bonnet nut with an adjustable wrench or channel-type pliers.



Unscrew the stem assembly, using a deep-set ratchet wrench. If necessary, chip away any mortar surrounding the bonnet nut.

Remove brass stem screw. Replace stem washer with an exact duplicate. If stem screw is worn, replace it.

Unscrew the threaded spindle from the retaining nut.

Clean sediment and lime buildup from nut, using a small wire brush dipped in vinegar. Coat all parts with faucet grease and reassemble diverter valve.

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Fixing Two-handle Tub & Shower Faucets

Two-handle tub and shower faucets are either cartridge or compression design. They may be repaired following the directions on pages 221 to 223. Because the valves of two-handle tub and shower faucets may be set inside the wall cavity, a deep-set socket wrench may be required to remove the valve stem.

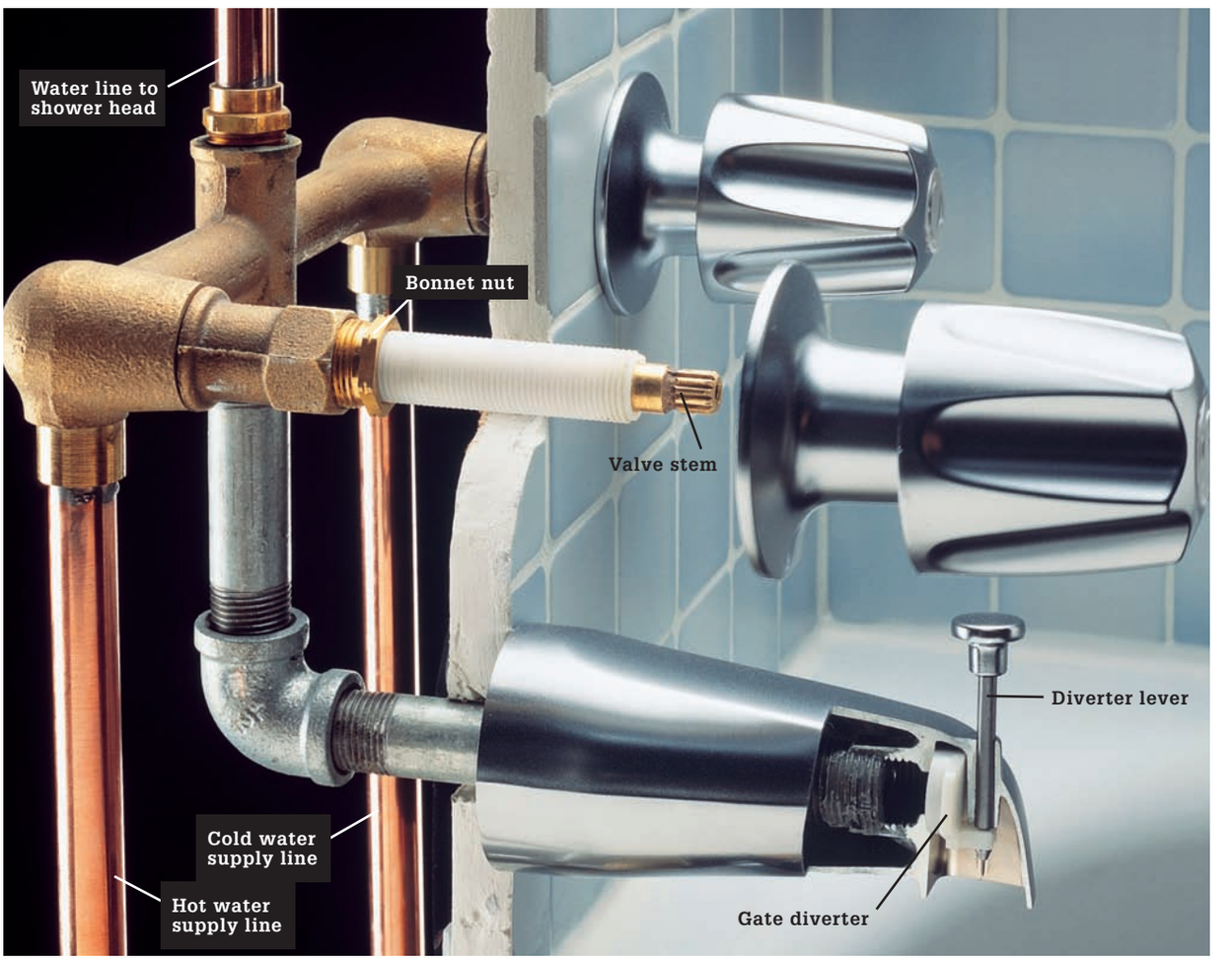
Two-handle tub and shower designs have a gate diverter. A gate diverter is a simple mechanism located in the tub spout. A gate diverter closes the supply of water to the tub spout and redirects the flow to the shower head. Gate diverters seldom need repair. Occasionally, the lever may break, come loose, or refuse to stay in the up position.

If the diverter fails to work properly, replace the tub spout. Tub spouts are inexpensive and easy to replace.

Remember to turn off the water before beginning any work.

Tools & Materials ▸

- Screwdriver
- Allen wrench
- Pipe wrench
- Channel-type pliers
- Small cold chisel
- Ball-peen hammer
- Deep-set ratchet wrench
- Masking tape or cloth
- Pipe joint compound
- Replacement faucet parts, as needed



A two-handle tub/shower faucet can operate with compression valves, but more often these days they contain cartridges that can be replaced. Unlike a three-handled model, the diverter is a simple gate valve that is operated by a lever.

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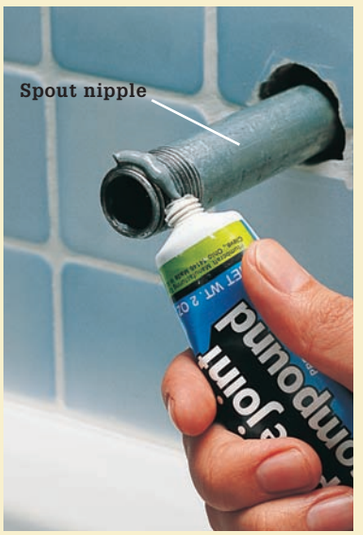
Tips on Replacing a Tub Spout

Check underneath tub spout for a small access slot. The slot indicates the spout is held in place with an Allen screw. Remove the screw, using an Allen wrench. Spout will slide off.

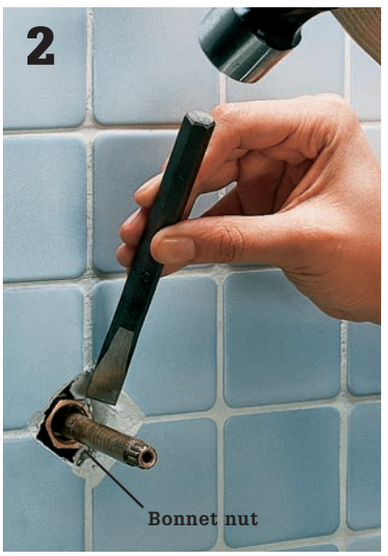
Unscrew faucet spout. Use a pipe wrench, or insert a large screwdriver or hammer handle into the spout opening and turn spout counterclockwise.



Spread pipe joint compound on threads of spout nipple before replacing spout. If you have a copper pipe or a short pipe, buy a spout retrofit kit, which can attach a spout to most any pipe.

How to Remove a Deep-set Faucet Valve

Remove handle and unscrew the escutcheon with channel-type pliers. Pad the jaws of the pliers with masking tape to prevent scratching the escutcheon.



Chip away any mortar surrounding the bonnet nut using a ball-peen hammer and a small cold chisel.

Unscrew the bonnet nut with a deep-set ratchet wrench. Remove the bonnet nut and stem from the faucet body.

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Fixing Single-handle Tub & Shower Faucets

A single-handle tub and shower faucet has one valve that controls both water flow and temperature. Single-handle faucets may be ball-type, cartridge, or disc designs.

If a single-handle control valve leaks or does not function properly, disassemble the faucet, clean the valve, and replace any worn parts. Use the repair techniques described on page 226 for ball-type, or page 227 for ceramic disc. Repairing a single-handle cartridge faucet is shown on the opposite page.

Direction of the water flow to either the tub spout or the showerhead is controlled by a gate diverter. Gate diverters seldom need repair. Occasionally, the lever may break, come loose, or refuse to stay in the up position. Remember to turn off the water before beginning any work; the shower faucet shown here has built-in shutoff valves, but many other valves do not. Open an access panel in an adjoining room or closet, behind the valve, and look for two shutoffs. If you can't find them there, you may have to shut off intermediate valves or the main shutoff valve.

Tools & Materials

- Screwdriver
- Adjustable wrench
- Channel-type pliers
- Replacement faucet parts, as needed

A single-handle tub/shower faucet is the simplest type to operate and to maintain. The handle controls the mixing ratio of both hot and cold water, and the diverter is a simple gate valve.

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How to Repair a Single-handle Cartridge Tub & Shower Faucet

Use a screwdriver to remove the handle and escutcheon.

Turn off water supply at the built-in shutoff valves or the main shutoff valve.

Unscrew and remove the retaining ring or bonnet nut using adjustable wrench.

Remove the cartridge assembly by grasping the end of the valve with channel-type pliers and pulling gently.

Flush the valve body with clean water to remove sediment. Replace any worn O-rings. Reinstall the cartridge and test the valve. If the faucet fails to work properly, replace the cartridge.

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Single-Handle Tub & Shower Faucet with Scald Control

In many plumbing systems, if someone flushes a nearby toilet or turns on the cold water of a nearby faucet while someone else is taking a shower, the shower water temperature can suddenly rise precipitously. This is not only uncomfortable; it can actually scald you. For that reason, many one-handle shower valves have a device, called a "balancing valve" or an "anti-scald valve," that keeps the water from getting too hot.

The temperature of your shower may drastically rise to dangerous scalding levels if a nearby toilet is flushed. A shower fixture equipped with an anti-scald valve prevents this sometimes dangerous situation.

How to Adjust the Shower's Temperature

To reduce or raise the maximum temperature, remove the handle and escutcheon. Some models have an adjustment screw, others have a handle that can be turned by hand.

To remove a balancing valve, you may need to buy a removal tool made for your faucet. Before replacing, slowly turn on water to flush out any debris; use a towel or bucket to keep water from entering inside the wall.

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Fixing & Replacing Showerheads

If spray from the showerhead is uneven, clean the spray holes. The outlet or inlet holes of the showerhead may get clogged with mineral deposits. Showerheads pivot into different positions. If a showerhead does not stay in position, or if it leaks, replace the O-ring that seals against the swivel ball.

A tub can be equipped with a shower by installing a flexible shower adapter kit. Complete kits are available at hardware stores and home centers.

A typical showerhead can be disassembled easily for cleaning and repair. Some showerheads include a spray adjustment cam lever that is used to change the force of the spray.

Tools & Materials ▸

- Adjustable wrench or channel-type pliers
- Pipe wrench
- Drill
- Glass and tile bit
- Mallet
- Screwdriver
- Masking tape
- Thin wire (paper clip)
- Faucet grease
- Rag
- Replacement O-rings
- Masonry anchors
- Flexible shower adapter kit (optional)

How to Clean & Repair a Showerhead

Unscrew the swivel ball nut, using an adjustable wrench or channel-type pliers. Wrap jaws of the tool with masking tape to prevent marring the finish. Unscrew collar nut from the showerhead.

Clean outlet and inlet holes of showerhead with a thin wire. Flush the head with clean water.

Replace the O-ring, if necessary. Lubricate the O-ring with faucet grease before installing.

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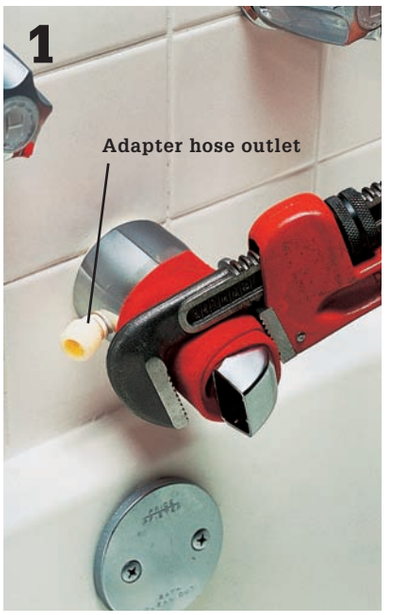
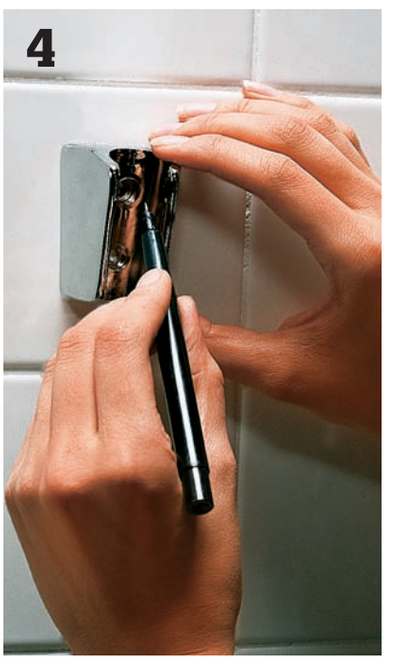
How to Install a Flexible Shower Adapter



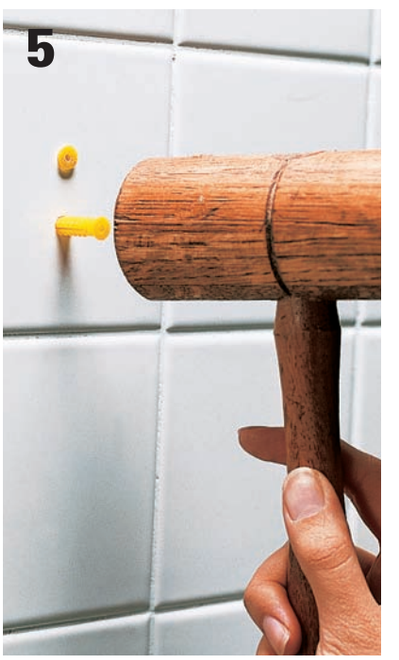
Remove old tub spout (page 237). Install new tub spout from kit, using a pipe wrench. New spout will have an adapter hose outlet. Wrap the tub spout with a rag to prevent damage to the chrome finish.

Attach flexible shower hose to the adaptor hose outlet. Tighten with an adjustable wrench or channel-type pliers.

Determine location of showerhead hanger. Use hose length as a guide and make sure showerhead can be easily lifted off hanger.



Mark hole locations. Use a glass and tile bit to drill holes in ceramic tile for masonry anchors.



Insert anchors into holes and tap into place with a wooden or rubber mallet.

Fasten showerhead holder to the wall and hang showerhead.

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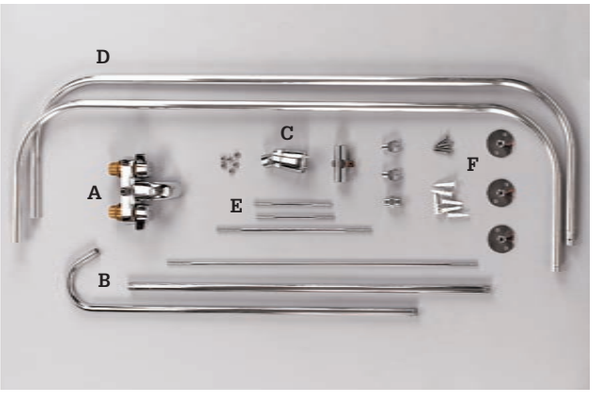
Variation: Shower Conversion Kit



A packaged kit for adding a shower to your tub features a faucet with diverter (A), shower riser plumbing (B), showerhead (C), and a frame for the shower curtain (D) that mounts on the wall and ceiling with threaded rods (E), and fasteners and fittings (F).

Remove the old tub faucet and replace it with the new diverter-type faucet from the kit. Fit the assembled shower riser into the top of the faucet and hand-tighten. Apply Teflon tape to the threads before making the connection. This assembly includes one straight and one curved section, joined by a coupling. The top, curved pipe includes a connector to a wall brace. Shorten the straight section using a tubing cutter to lower the showerhead height, if desired. Slip the compression nut and washer onto the bottom end of the shower riser and attach the riser to the top of the faucet, hand-tightening for the time being.

With a helper, assemble the curtain frame, securing with setscrews. Hold the frame level and measure to the ceiling to determine the ceiling brace pipe length. Cut the pipe and complete the ceiling brace assembly. Set the shower riser to the desired height and connect the brace to the wall (ensure strong connections by driving the mounting screws into a wall stud and ceiling joist, if possible.)

After the curtain frame is completely assembled and secured, tighten the faucet connection with a wrench. Full-size shower kits require one shower curtain on each side of the curtain frame. The hooks seen here feature roller bearings on the tops so they can be operated very smoothly with minimal resistance.

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Tubs & Showers

Tub or shower not draining? First, make sure it's only the tub or shower. If your sink is plugged, too, it may be a coincidence or it may be that a common branch line is plugged. A sure sign of this is when water drains from the sink into the tub. This could require the help of a drain cleaning service, or a drum trap that services both the sink and tub needs cleaning.

If the toilet also can't flush (or worse, water comes into the tub when you flush the toilet), then the common drain to all your bathroom fixtures is plugged. Call a drain cleaning service. If you suspect the problem is only with your tub or shower, then read on. We'll show you how to clear drainlines and clean and adjust two types of tub stopper mechanisms. Adjusting the mechanism can also help with the opposite problem: a tub that drains when you're trying to take a bath.

As with bathroom sinks, tub and shower drain pipes may become clogged with soap and hair. The drain stopping mechanisms can also require cleaning and adjustment.

Tools & Materials

Phillips screwdriver	Toothbrush
Plunger	Needlenose pliers
Scrub brush	Dishwashing brush
White vinegar	Faucet grease

Maintenance Tip

Like bathroom sinks, tubs and showers face an ongoing onslaught from soap and hair. When paired, this pesky combination is a sure-fire source of clogs. The soap scum coagulates as it is washed down the drain and binds the hair together in a mass that grows larger with every shower or bath. To nip these clogs in the bud, simply pour boiling hot clean water down the drain from time to time to melt the soapy mass and wash the binder away.

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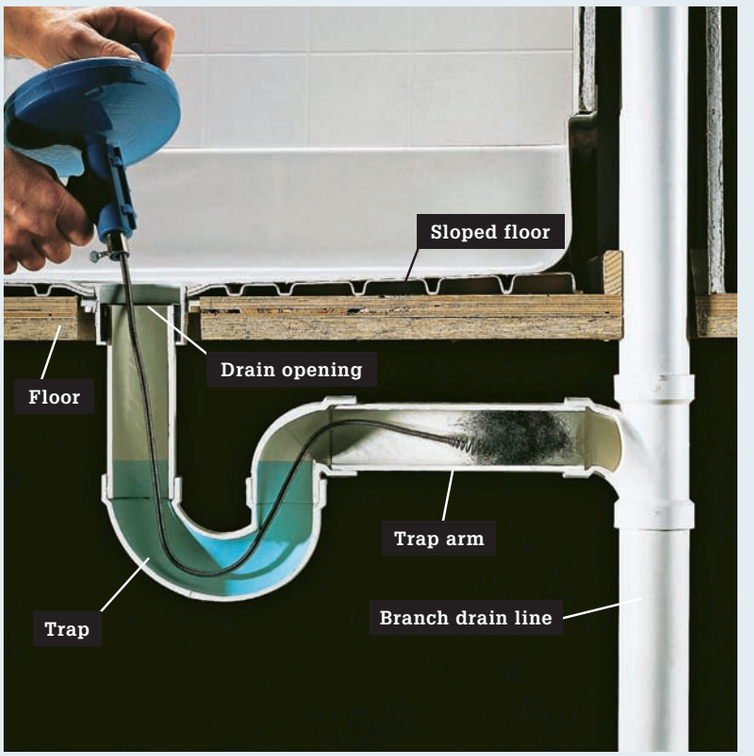
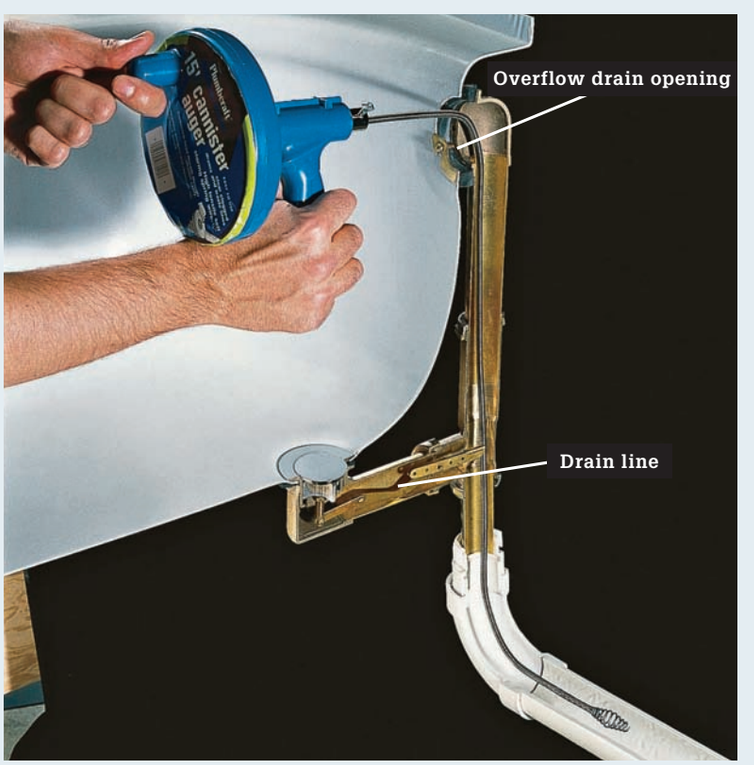
Using Hand Augers ▸



On shower drains, feed the head of a hand-crank or drill-powered auger in through the drain opening after removing the strainer. Crank the handle of the auger to extend the cable and the auger head down into the trap and, if the clog is farther downline, toward the branch drain. When clearing any drain, it is always better to retrieve the clog than to push it farther downline.



On combination tub/showers, it's generally easiest to insert the auger through the overflow opening after removing the coverplate and lifting out the drain linkage. Crank the handle of the auger to extend the cable and the auger head down into the trap and, if the clog is farther downline, toward the branch drain. When clearing any drain, it is always better to retrieve the clog than to push it farther downline.

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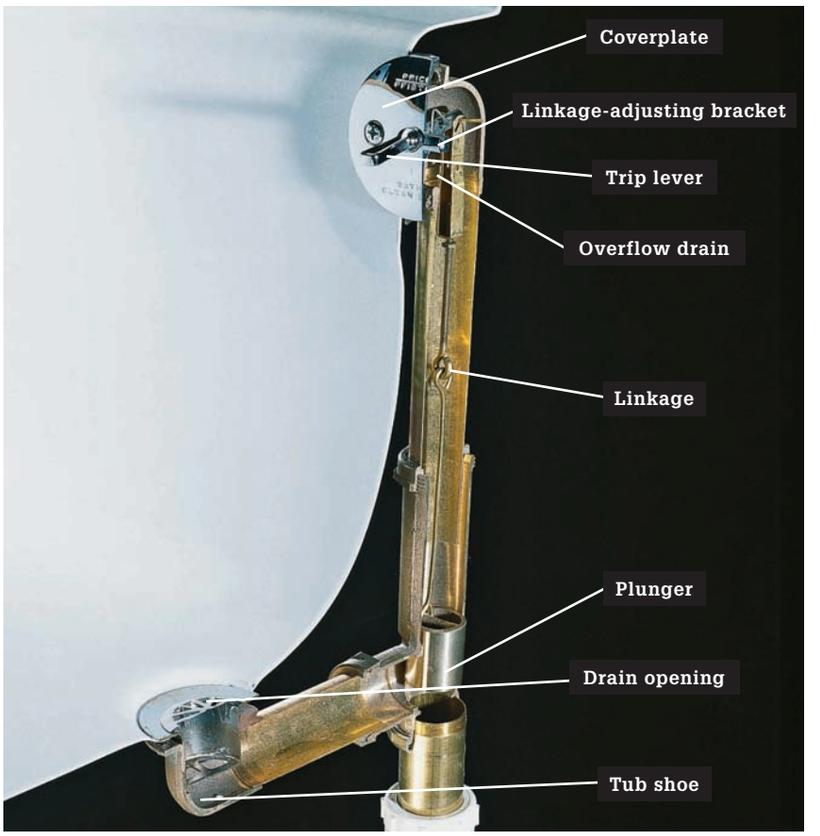
How to Fix a Plunger-Type Drain



A plunger-type tub drain has a simple grate over the drain opening and a behind-the-scenes plunger stopper. Remove the screws on the overflow coverplate with a slotted or Phillips screwdriver. Pull the coverplate, linkage, and plunger from the overflow opening.

Clean hair and soap off the plunger with a scrub brush. Mineral buildup is best tackled with white vinegar and a toothbrush or a small wire brush.

Adjust the plunger. If your tub isn't holding water with the plunger down, it's possible the plunger is hanging too high to fully block water from the tub shoe. Loosen the locknut with needlenose pliers, then screw the rod down about ⅛". Tighten the locknut down. If your tub drains poorly, the plunger may be set too low. Loosen the locknut and screw the rod in an ⅛" before retightening the locknut.

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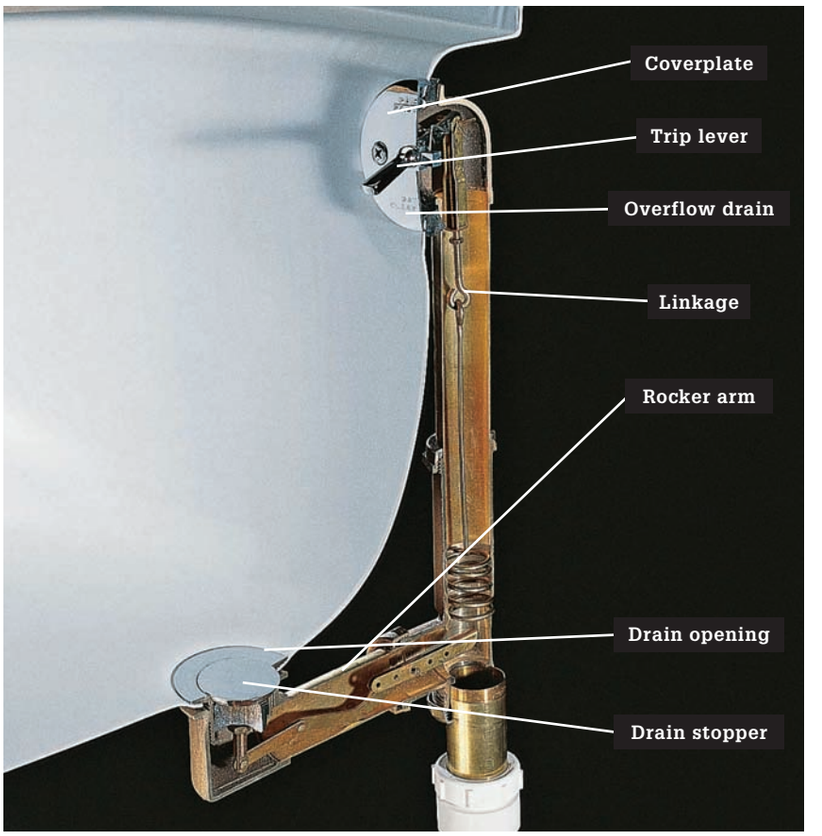
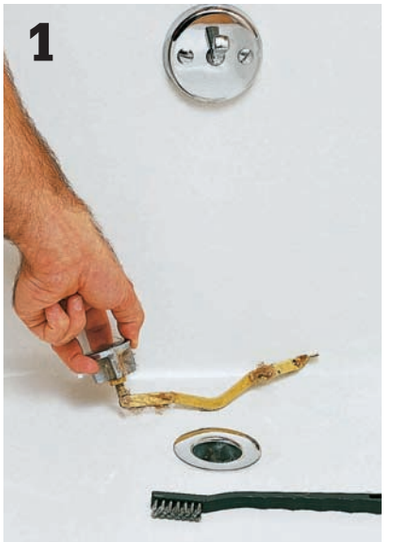
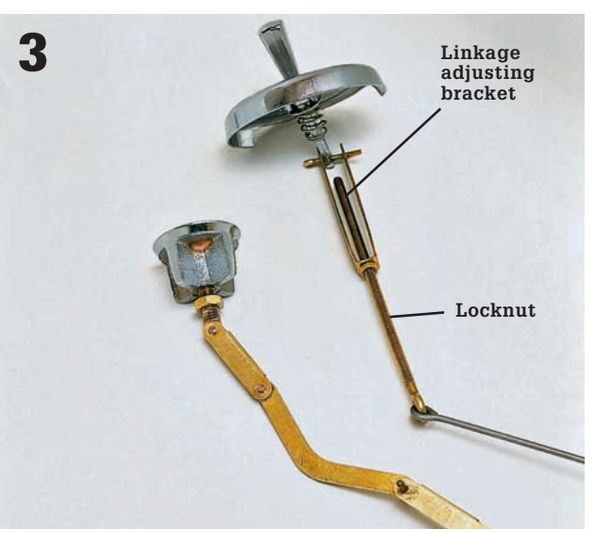
How to Fix a Pop-up Drain





Raise the trip lever to the open position. Pull the stopper and rocker arm assembly from the drain. Clean off soap and hair with a dishwashing brush in a basin of hot water. Clean off mineral deposits with a toothbrush or small wire brush and white vinegar.

Remove the screws from the cover plate. Pull the trip lever and the linkage from the overflow opening. Clean off soap and hair with a brush in a basin of hot water. Remove mineral buildup with white vinegar and a wire brush. Lubricate moving parts of the linkage and rocker arm mechanism with faucet grease.



Adjust the pop-up stopper mechanism by first loosening the locknut on the lift rod. If the stopper doesn't close all the way, shorten the linkage by screwing the rod ⅛" farther into the linkage-adjusting bracket. If the stopper doesn't open wide enough, extend the linkage by unscrewing the rod ⅛". Tighten the locknut before replacing the mechanism and testing your adjustment.

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Sink Drains

Every sink has a drain trap and a fixture drain line. Sink clogs usually are caused by a buildup of soap and hair in the trap or fixture drain line. Remove clogs by using a plunger, disconnecting and cleaning the trap (this page), or using a hand auger (page 249).

Many sinks hold water with a mechanical plug called a pop-up stopper. If the sink will not hold standing water, or if water in the sink drains too slowly, the pop-up stopper must be cleaned and adjusted (page 247).

Tools & Materials ▸

Plunger	Rag
Channel-type pliers	Bucket
Small wire brush	Replacement gaskets
Screwdriver	Teflon tape
Flashlight	

Clogged lavatory sinks can be cleared with a plunger (not to be confused with a flanged force-cup). Remove the pop-up drain plug and strainer first, and plug the overflow hole by stuffing a wet rag into it, allowing you to create air pressure with the plunger.

How to Clear a Sink Trap

Place bucket under trap to catch water and debris. Loosen slip nuts on trap bend with channel-type pliers. Unscrew nuts by hand and slide away from connections. Pull off trap bend.

Dump out debris. Clean trap bend with a small wire brush. Inspect slip nut washers for wear and replace if necessary. Reinstall trap bend and tighten slip nuts.

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How to Clear a Kitchen Sink

Plunging a kitchen sink is not difficult, but you need to create an uninterrupted pressure lock between the plunger and the clog. If you have a dishwasher, the drain tube needs to be clamped shut and sealed off at the disposer or drainline. The pads on the clamp should be large enough to flatten the tube across its full diameter (or you can clamp the tube ends between small boards).

If there is a second basin, have a helper hold a basket strainer plug in its drain or put a large pot or bucket full of water on top of it. Unfold the skirt within the plunger and place this in the drain of the sink you are plunging. There should be enough water in the sink to cover the plunger head. Plunge rhythmically for six repetitions with increasing vigor, pulling up hard on the last repitition. Repeat this sequence until the clog is removed. Flush out a cleared clog with plenty of hot water.

How to Use a Hand Auger at the Trap Arm

If plunging doesn't work, remove the trap and clean it out (see previous page). With the trap off, see if water flows freely from both sinks (if you have two). Sometimes clogs will lodge in the T-fitting or one of the waste pipes feeding it. These may be pulled out manually or cleared with a bottlebrush or wire. When reassembling the trap, apply Teflon tape clockwise to the male threads of metal waste pieces. Tighten with your channel-type pliers. Plastic pieces need no tape and should be hand tightened only.

If you suspect the clog is downstream of the trap, remove the trap arm from the fitting at the wall. Look in the fixture drain with a flashlight. If you see water, that means the fixture drain is plugged. Clear it with a hand-crank or drill-powered auger (see page 272).

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Branch & Main Drains

If using a plunger or a hand auger does not clear a clog in a fixture drain line, it means that the blockage may be in a branch line, the main waste-vent stack, or the sewer service line.

First, use a hand-crank or drill-powered auger to clear the branch drain line closest to any stopped-up fixtures. Branch drain lines may be serviced through the cleanout fittings located at the end of the branch. Because waste water may be backed up in the drain lines, always open a cleanout with caution. Place a bucket and rags under the opening to catch waste water. Never position yourself directly under a cleanout opening while unscrewing the plug or cover.

If using an auger on the branch line does not solve the problem, then the clog may be located in a main waste-vent stack. To clear the stack, run an auger cable down through the roof vent. Make sure that the cable of your auger is long enough to reach down the entire length of the stack. If it is not, you may want to rent or borrow another auger. Always use extreme caution when working on a ladder or on a roof.

If no clog is present in the main stack, the problem may be located in the sewer service line. Locate the main cleanout, usually a Y-shaped fitting at the bottom of the main waste-vent stack. Remove the plug and push the cable of a hand auger into the opening.

Some sewer service lines in older homes have a house trap. The house trap is a U-shaped fitting located at the point where the sewer line exits the house. Most of the fitting will be beneath the floor surface, but it can be identified by its two openings. Use a hand auger to clean a house trap.

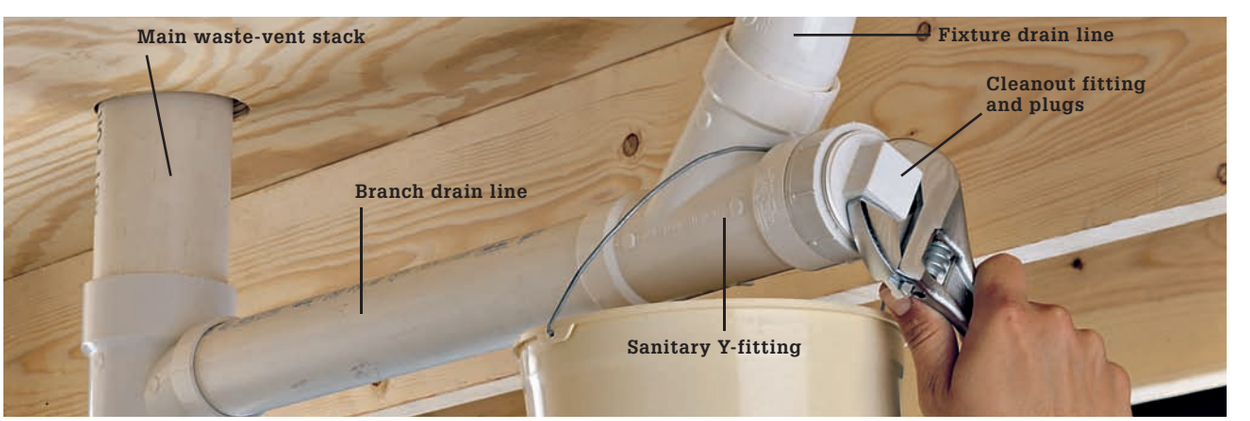
If the auger meets solid resistance in the sewer line, retrieve the cable and inspect the bit. Fine, hair-like roots on the bit indicate the line is clogged with tree roots. Dirt on the bit indicates a collapsed line.

Use a power auger to clear sewer service lines that are clogged with tree roots. Power augers (page 272) are available at rental centers. However, a power auger is a large, heavy piece of equipment. Before renting, consider the cost of rental and the level of your do-it-yourself skills versus the price of a professional sewer cleaning service. If you rent a power auger, ask the rental dealer for complete instructions on how to operate the equipment.

Always consult a professional sewer cleaning service if you suspect a collapsed line.

Tools & Materials ▸

- Adjustable wrench or pipe wrench
- Hand auger
- Cold chisel
- Ball-peen hammer
- Bucket
- Ladder
- Phillips screwdriver
- Rags
- Penetrating oil
- Cleanout plug (if needed)
- Pipe joint compound
- Electrical drum auger
- Gloves
- Teflon Tape



Clear a branch drain line by locating the cleanout fitting at the end of the line. Place a bucket underneath the opening to catch waste water, then slowly unscrew the cleanout plug with an adjustable wrench. Clear clogs in the branch drain line with a hand auger.

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How to Clear a Branch Drain Line

Clear the main waste and vent stack by running the cable of a hand-crank or drill-powered auger down through the roof vent. Always use extreme caution while working on a ladder or roof.

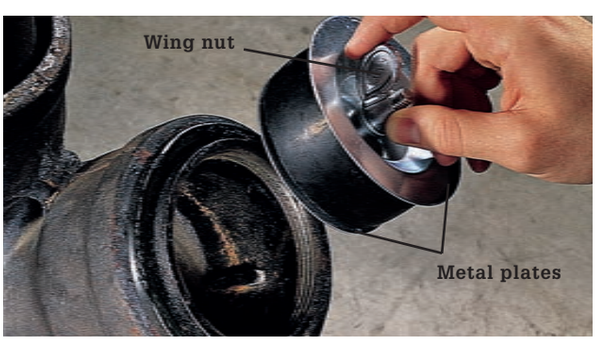
Clear the house trap in a sewer service line using a hand auger. Slowly remove only the plug on the "street side" of the trap. If water seeps out the opening as the plug is removed, the clog is in the sewer line beyond the trap. If no water seeps out, auger the trap. If no clog is present in the trap, replace the street-side plug and remove the house-side plug. Use the auger to clear clogs located between the house trap and main stack.

How to Replace a Main Drain Cleanout Plug

Remove the cleanout plug, using a large wrench. If the plug does not turn out, apply penetrating oil around the edge of the plug, wait 10 minutes, and try again. Place rags and a bucket under fitting opening to catch any water that may be backed up in the line.

Remove stubborn plugs by placing the cutting edge of a cold chisel on the edge of the plug. Strike the chisel with a ball-peen hammer to move plug counterclockwise. If the plug does not turn out, break it into pieces with the chisel and hammer. Remove all broken pieces.

Replace the old plug with a new plug. Apply pipe joint compound to the threads of the replacement plug and screw into the cleanout fitting.



Alternate: Replace the old plug with an expandable rubber plug. A wing nut squeezes the rubber core between two metal plates. The rubber bulges slightly to create a watertight seal.

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#175 Dtp:225 Page:251

How to Power-Auger a Floor Drain

Remove the cover from the floor drain using a slotted or Phillips screwdriver. On one wall of the drain bowl you'll see a cleanout plug. Remove the cleanout plug from the drain bowl with your largest channel-type pliers. This cleanout allows you to bypass the trap. If it's stuck, apply penetrating oil to the threads and let it sit a half an hour before trying to free it again. If the wrench won't free it, rent a large pipe wrench from your home center or hardware store. You can also auger through the trap if you have to.

Power Auger Large Lines

If you choose to auger a larger line, you may find yourself opening a cleanout with 10 or 20 vertical feet of waste water behind it. Be careful. The cap may unexpectedly burst open when it's loose enough, spewing noxious waste water uncontrollably over anything in its path, including you! Here are some precautions:

Whenever possible, remove a trap or cleanout close to the top of the backed-up water level. Run your auger through this. Make sure the auger and its electric connections will not get wet should waste water spew forcefully from the cleanout opening.

Use the spear tool on the power auger first, to let the water drain out through a smaller hole before widening it with a larger cutting tool. If you are augering through a 3" or 4" cleanout, use three bits: the spear, a small cutter, and then a larger cutter to do the best job.

Rent an electric drum auger with at least 50 feet of ½-inch cable. The rental company should provide a properly sized, grounded extension cord, heavy leather gloves, and eye protection. The auger should come with a spear tool, cutter tool, and possibly a spring tool suitable for a 2-inch drainline. Attach the spearhead first (with the machine unplugged).

Wear close-fitting clothing and contain long hair. Place the power auger machine in a dry location within 3 ft. of the drain opening. Plug the tool into a grounded, GFI-protected circuit. Wear eye protection and gloves. Position the footswitch where it is easy to actuate. Make sure the FOR/REV switch is in the Forward position (inset photo). Hand feed the cleaning tool and some cable into the drain or cleanout before turning the machine on.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:252

Stationary power augers (as opposed to pistol-grip types) are controlled by a foot pedal called an actuator so you can turn the power on and off hands-free.

With both gloved hands on the cable, depress the foot actuator to start the machine. Gradually push the rotating cable into the drain opening. If the rotation slows or you cannot feed more cable into the drain, pull back on the cable before pushing it forward again. Don't force it. The cable needs to be rotating whenever the motor is running or it can kink and buckle. If the cleaning tool becomes stuck, reverse it, back the tool off the obstruction, and switch back to Forward.

Gradually work through the clog by pulling back on the cable whenever the machine starts to bog down and push it forward again when it gains new momentum. Never let the cable stop turning when the motor is running. When you have broken through the clog or snagged an object, withdraw the cable from the line. Manually pull the cable from the drain line while continuing to run the drum Forward. When the cleaning tool is close to the drain opening, release the foot actuator and let the cable come to a stop before feeding the last 2 or 3 ft. of cable into the drum by hand.

After clearing the drain pipe, run the auger through the trap. Finish cleaning the auger. Wrap Teflon tape clockwise onto the plug threads and replace the plug. Run hot water through a hose from the laundry sink or use a bucket to flush remaining debris through the trap and down the line.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:253

Branch Drains & Vents

In our demonstration project, we will replace branch drains for a bathtub and vanity sink. The tub drain will run down into the basement before connecting to the main waste-vent stack, while the vanity drain will run horizontally to connect directly to the stack.

A vent pipe for the bathtub runs up into the attic, where it will join the main waste-vent stack. The vanity sink, however, requires no secondary vent pipe, since its location falls within the critical distance of the new waste-vent stack.

Tools & Materials

- Reciprocating saw or jigsaw
- Drain pipe
- Riser clamps
- Solvent glue
- Marker
- Metal protector plates
- Vent elbow

Remove old pipes only where they obstruct the planned route for the new pipes. You will probably have to remove drain and water supply pipes at each fixture location, but the remaining pipes usually can be left in place. A reciprocating saw with metal-cutting blade works well for this job.

How to Replace Branch Drains

Establish a route for vertical drain pipes running through wall cavities down into the basement. For our project, we cut away a section of the wall sole plate in order to run a 1½" bathtub drain pipe from the basement up to the bathroom.

From the basement, cut a hole in the bottom of the wall, below the opening you cut. Measure, cut, and insert a length of drain pipe up into the wall to the bathroom. A length of flexible CPVC pipe can be useful for guiding the drain pipe up into the wall. For very long pipe runs, you may need to join two or more lengths of pipe with couplings as you insert the run.

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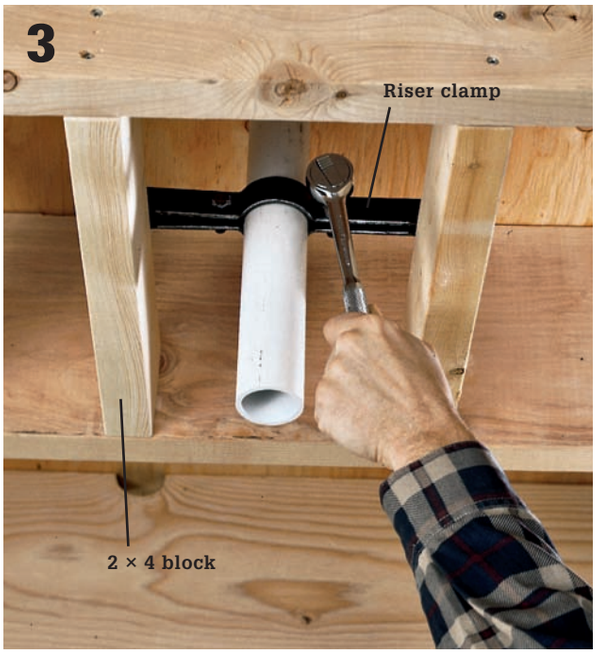

Secure the vertical drain pipe with a riser clamp supported on 2 × 4 blocks nailed between joists. Take care not to overtighten the clamps, which can damage the pipe.

Install a horizontal pipe from the waste T-fitting on the waste-vent stack to the vertical drain pipe. Maintain a downward slope toward the stack of ¼" per ft., and use a Y-fitting with 45° elbow to form a cleanout where the horizontal and vertical drain pipes meet.

Solvent-glue a waste T-fitting to the top of the vertical drain pipe. For a bathtub drain, as shown here, the T-fitting must be well below floor level to allow for the bathtub drain trap. You may need to notch or cut a hole in floor joists to connect the drain trap to the waste-T.

From the attic, cut a hole into the top of the bathroom wet wall, directly above the bathtub drain pipe. Run a 1½" vent pipe down to the bathtub location, and solvent-glue it to the waste-T. Make sure the pipe extends at least 1 ft. into the attic.

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#175 Dtp:225 Page:255

Remove wall surfaces as necessary to provide access for running horizontal drain pipes from fixtures to the new waste-vent stack. In our project, we ran 1½" drain pipe from a vanity sink to the stack. Mark the drain route on the exposed studs, maintaining a ¼" per ft. downward slope toward the stack. Use a reciprocating saw or jigsaw to notch out the studs.

Secure the old drain and vent pipes with riser clamps supported by blocking attached between the studs.

Remove the old drain and water supply pipes, where necessary, to provide space for running the new drain pipes.

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#175 Dtp:225 Page:256

Using a sweep elbow and straight length of pipe, assemble a drain pipe to run from the drain stubout location to the waste T-fitting on the new waste-vent stack. Use one 45° and one 90° elbow and a short length of pipe to create a stubout extending at least 2" out from the wall. Secure the stubout to a ¾" backer board attached between studs.

Protect the drain pipes by attaching metal protector plates over the notches in the studs. Protector plates prevent drain pipes from being punctured when wall surfaces are replaced.

In the attic, use a vent elbow and straight length of pipe to connect the vertical vent pipe from the tub to the new waste-vent stack.

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#175 Dtp:225 Page:257

Main Stacks

Although a main waste-vent stack rarely rusts through entirely, it can be nearly impossible to join new branch drains and vents to an old cast-iron stack. For this reason, plumbing contractors sometimes recommend replacing the iron stack with plastic pipe during a plumbing renovation project.

Be aware that replacing a main waste-vent stack is not an easy job. You will be cutting away heavy sections of cast iron, so working with a helper is essential. Before beginning work, make sure you have a complete plan for your plumbing system and have designed a stack that includes all the fittings you will need to connect branch drains and vent pipes. While work is in progress, none of your plumbing fixtures will be usable. To speed up the project and minimize inconvenience, do as much of the demolition and preliminary construction work as you can before starting work on the stack.

Because main waste-vent stacks may be as large as 4" in diameter, running a new stack through existing walls can be troublesome. To solve this problem, our project employs a common solution: framing a chase in the corner of a room to provide the necessary space for running the new stack from the basement to the attic. When the installation is completed, the chase will be finished with wallboard to match the room.

Tools & Materials

- Riser clamps
- Cast-iron snapcutter
- Reciprocating saw
- Rag
- Plumb bob
- PVC plastic pipe
- Waste-vent pipe
- Solvent glue
- Ladder
- Vent T
- Pry bar
- Roofing cement
- Rubber gasket flashing nails

A new main waste-vent stack is best installed near the location of the old stack. In this way, the new stack can be connected to the basement floor cleanout fitting used by the old cast-iron stack.

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#175 Dtp:225 Page:258

How to Replace a Main Waste-Vent Stack

Secure the cast-iron waste-vent stack near the ceiling of your basement, using a riser clamp installed between the floor joists. Use wood blocks attached to the joists with 3" wallboard screws to support the clamp. Also clamp the stack in the attic, at the point where the stack passes down into the wall cavity. *Warning: A cast-iron stack running from basement to attic can weigh several hundred pounds. Never cut into a cast-iron stack before securing it with riser clamps above the cut.*

Use a cast-iron snap cutter or a reciprocating saw (page 272) to sever the stack near the floor of the basement, about 8" above the cleanout, and near the ceiling, flush with the bottom of the joists. Have a helper hold the stack while you are cutting out the section. *Note: After cutting into the main stack, plug the open end of the pipe with a cloth to prevent sewer gases from rising into your home.*

Nail blocking against the bottom of the joists across the severed stack. Then, cut a 6"-diameter hole in the basement ceiling where the new waste-vent stack will run using a reciprocating saw. Suspend a plumb bob at the centerpoint of the opening as a guide for aligning the new stack.

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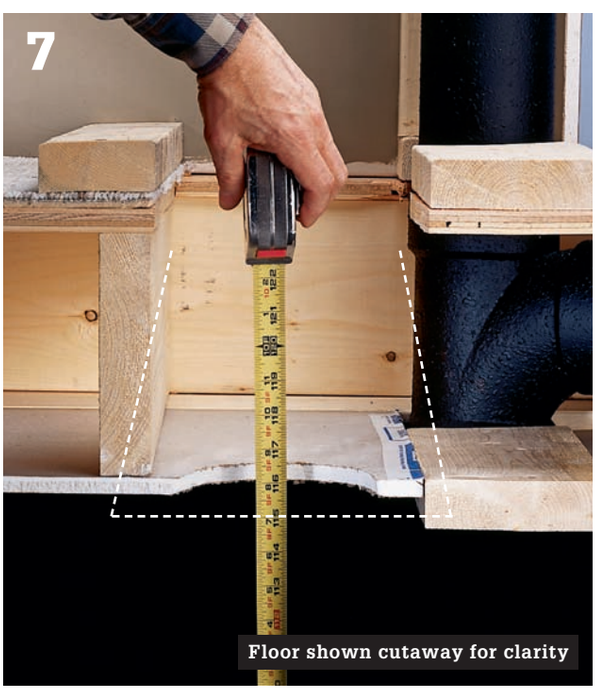
Attach a 5-ft. segment of PVC plastic pipe the same diameter as the old waste-vent stack to the exposed end of the cast-iron cleanout fitting, using a banded coupling with neoprene sleeve.

Dry-fit 45° elbows and straight lengths of plastic pipe to offset the new stack, lining it up with the plumb bob centered on the ceiling opening.

Dry-fit a waste T-fitting on the stack, with the inlets necessary for any branch drains that will be connected in the basement. Make sure the fitting is positioned at a height that will allow the branch drains to have the correct ¼" per ft. downward slope toward the stack.



Determine the length for the next piece of waste-vent pipe by measuring from the basement T-fitting to the next planned fitting in the vertical run. In our project, we installed a T-fitting between floor joists, where the toilet drain was connected.

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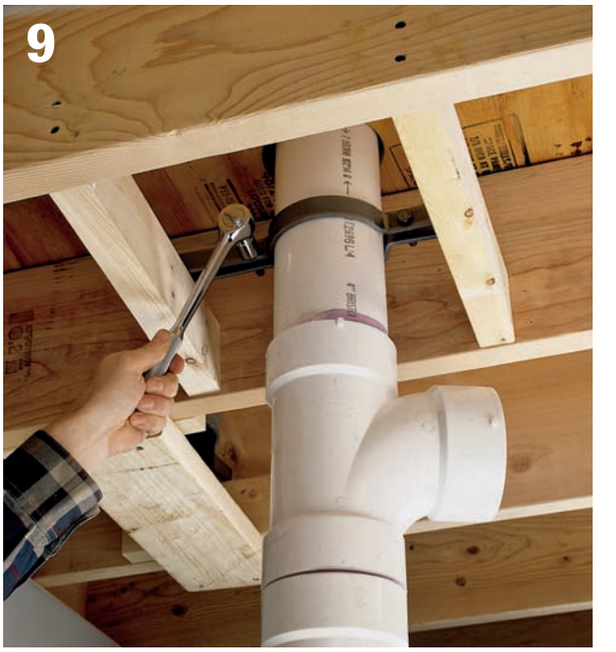
Cut a PVC plastic pipe to length, raise it into the opening, and dry-fit it to the T-fitting. *Note: For very long pipe runs, you may need to construct this vertical run by solvent-gluing two or more segments of pipe together with couplings.*



Check the length of the stack, then solvent-glue all fittings together. Support the new stack with a riser clamp resting on blocks attached between basement ceiling joists.

Attach the next waste T-fitting to the stack. In our demonstration project, the waste-T lay between floor joists and was used to connect the toilet drain. Make sure the waste-T is positioned at a height that will allow for the correct ¼" per ft. downward slope for the toilet drain.

Add additional lengths of pipe, with waste T-fittings installed where other fixtures will drain into the stack. In our example, a waste-T with a 1½" bushing insert was installed where the vanity sink drain was attached to the stack. Make sure the T-fittings are positioned to allow for the correct downward pitch of the branch drains.

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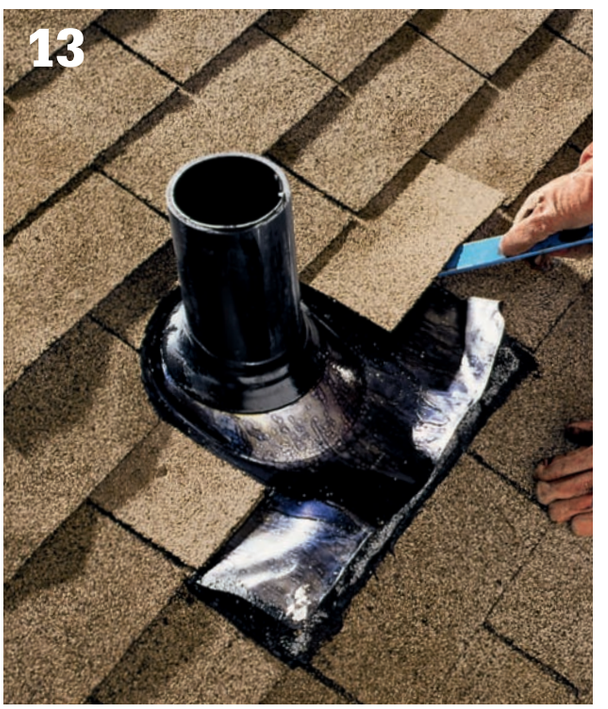
Cut a hole in the ceiling where the waste-vent stack will extend into the attic, then measure, cut, and solvent-glue the next length of pipe in place. The pipe should extend at least 1 ft. up into the attic.



Remove the roof flashing from around the old waste-vent stack. You may need to remove shingles in order to accomplish this. *Note: Always use caution when working on a roof. If you are unsure of your ability to do this work, hire a roof repair specialist to remove the old flashing and install new flashing around the new vent pipe.*

In the attic, remove old vent pipes, where necessary, then sever the cast-iron soil stack with a cast-iron cutter, and lower the stack down from the roof opening with the aid of a helper. Support the old stack with a riser clamp installed between joists.

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Solvent-glue a vent T with a 1½" bushing in the side inlet to the top of the new waste-vent stack. The side inlet should point toward the nearest auxiliary vent pipe extending up from below.

Finish the waste-vent stack installation by using 45° elbows and straight lengths of pipe to extend the stack through the existing roof opening. The new stack should extend at least 1 ft. through the roof, but no more than 2 ft.

How to Flash a Waste-Vent Stack

Loosen the shingles directly above the new vent stack, and remove any nails, using a flat pry bar. When installed, the metal vent flashing will lie flat on the shingles surrounding the vent pipe. On its upper half, shingles will lie on top of the flashing; the lower half of the flashing will rest on top of the shingles. Apply roofing cement to the underside of the flashing.

Slide the flashing over the vent pipe, and carefully tuck the base of the flashing up under the shingles. Press the flange firmly against the roof deck to spread the roofing cement, then anchor it with rubber gasket flashing nails. Reattach loose shingles as necessary.

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Supply Pipes

When replacing old water supply pipes, we recommend that you use Type M rigid copper or PEX. Use ¾" pipe for the main distribution pipes and ½" pipes for the branch lines running to individual fixtures.

For convenience, run hot and cold water pipes parallel to one another, between 3" and 6" apart. Use the straightest, most direct routes possible when planning the layout, because too many bends in the pipe runs can cause significant resistance and reduce water pressure.

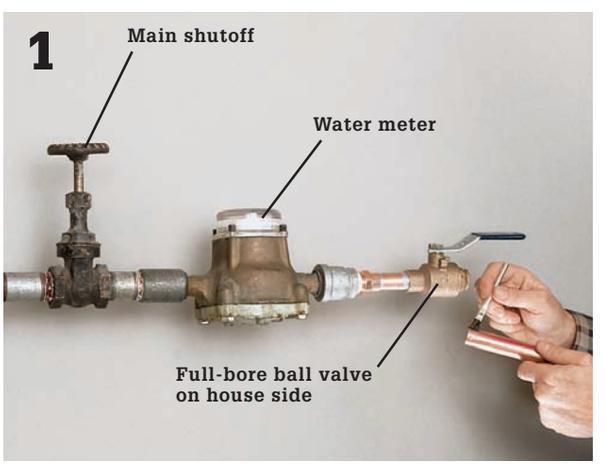
It is a good idea to remove old supply pipes that are exposed, but pipes hidden in walls can be left in place unless they interfere with the installation of the new supply pipes.

Tools & Materials

Male-threaded adapter	Copper pipes
Full-bone control valve	T-fittings

Support copper supply pipes at least every 10 ft. along vertical runs and 6 ft. along horizontal runs (check local codes). Always use copper or plastic support materials with copper; never use steel, which can interact with copper and cause corrosion.

How to Replace Water Supply Pipes



Shut off the water on the street side of the water meter, then disconnect and remove the old water pipes from the house side. Solder a ¾" male-threaded adapter and full-bore control valve to a short length of ¾" copper pipe, then attach this assembly to the house side of the water meter. Extend the ¾" cold-water distribution pipe toward the nearest fixture, which is usually the water heater.

At the water heater, install a ¾" T-fitting in the cold-water distribution pipe. Use two lengths of ¾" copper pipe and a full-bore control valve to run a branch pipe to the water heater. From the outlet opening on the water heater, extend a ¾" hot water distribution pipe. Continue the hot and cold supply lines on parallel routes toward the next group of fixtures in your house.

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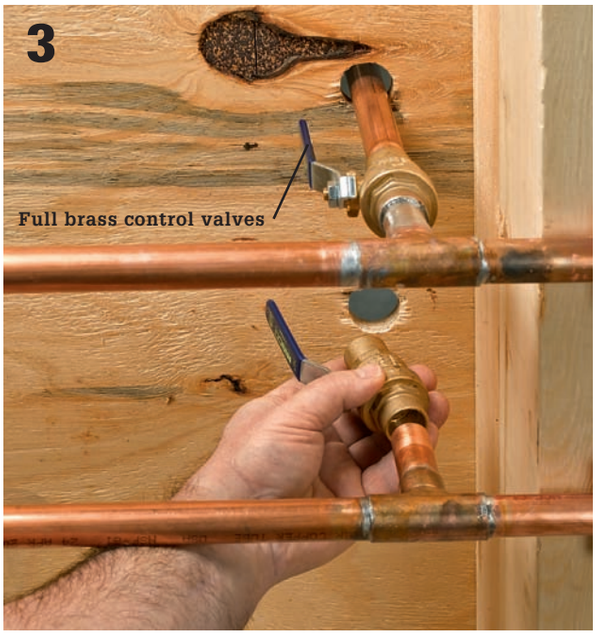
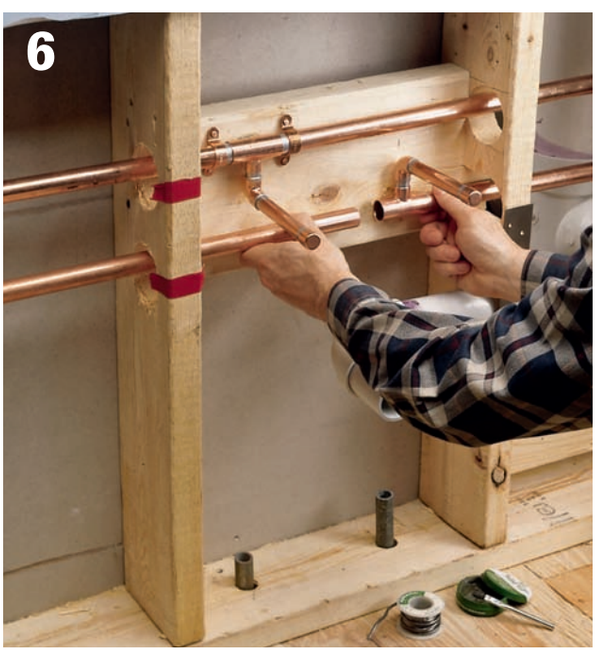


Establish routes for branch supply lines by drilling holes located in stud cavities. Install T-fittings, then begin the branch lines by installing brass control valves. Branch lines should be made with ¾" pipe if they are supplying more than one fixture; ½" if they are supplying only one fixture.

Extend the branch lines to the fixtures. In our project, we ran ¾" vertical branch lines up through the framed chase to the bathroom. Route pipes around obstacles, such as a main waste-vent stack, by using 45° and 90° elbows and short lengths of pipe.

Where branch lines run through studs or floor joists, drill holes or cut notches in the framing members, then insert the pipes. For long runs of pipe, you may need to join two or more shorter lengths of pipe, using couplings as you create the runs.



Install ¾" to ½" reducing T-fittings and elbows to extend the branch lines to individual fixtures. In our bathroom, we installed a hot and cold stubout for the bathtub and sink, and a cold-water stubout for the toilet. Cap each stubout until your work has been inspected and the wall surfaces have been completed.

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Noisy Pipes

Pipes can make a loud banging noise when faucets are turned off or when valves on washing machines (or other automatic appliances) shut abruptly. The sudden stop of flowing water traps air and creates a shock wave, called water hammer, that slams through the water supply system. Some pipes may knock against wall studs or joists, creating additional noise.

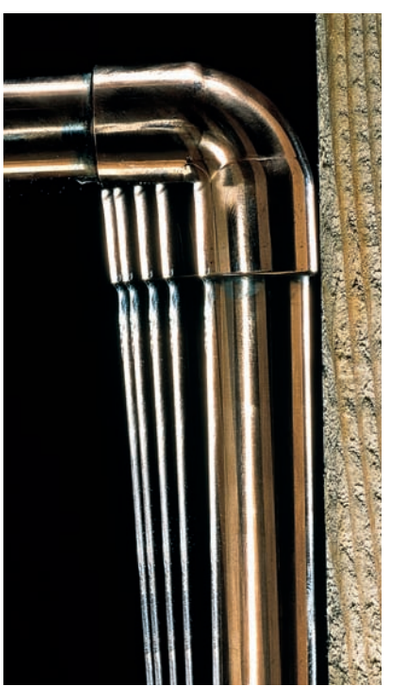
Water hammer can be more than an annoyance. The shockwave can cause damage and eventually failure in pipes and fittings. If a pressure-relief valve on your water heater leaks, it may not be a faulty valve, but a pressure surge in the supply system.

You can eliminate water hammer by installing a simple device called a water hammer arrester in the supply line. Inexpensive point-of-use arresters are small enough to be installed easily near the noisy valve or appliance (the closer the better). They can be positioned horizontally or vertically or at an angle without any change in effectiveness. Unlike with old-style air chambers, water cannot fill a water hammer arrester, so they should be effective for the life of the system.

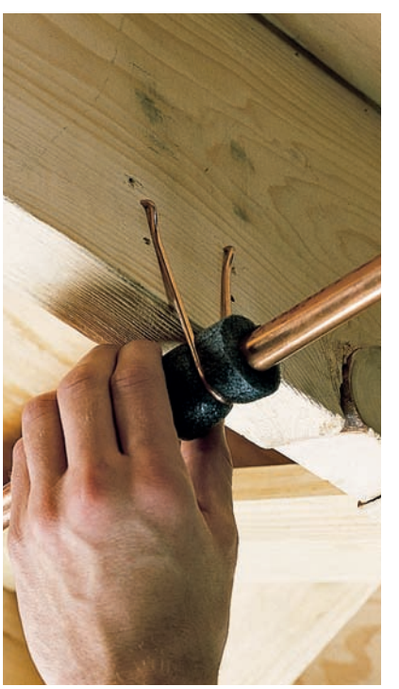
Pipes that bang against studs or joists can be quieted by cushioning them with pieces of pipe insulation. Make sure pipe hangers are snug and that pipes are well supported.

Tools & Materials

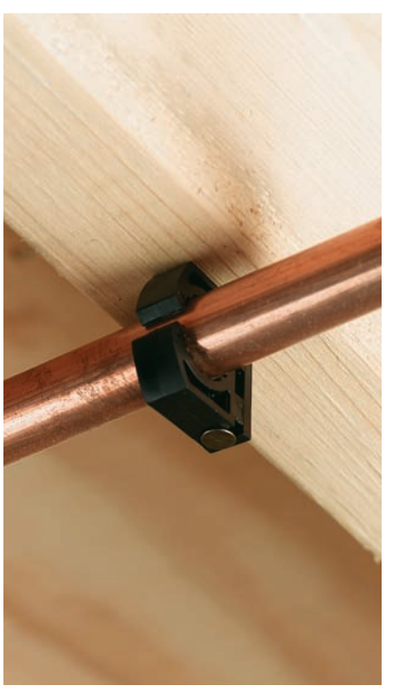
- Reciprocating saw or hacksaw
- Propane torch (for sweating copper)
- Pipe wrenches (for galvanized steel)
- Adjustable wrench
- Foam rubber pipe insulation
- Pipe and fittings, as needed
- Utility knife
- Teflon tape



Clattering pipes can be a major annoyance, but they also should alert you of a problem with the supply system.



Loose pipes may bang or rub against joist hangers, creating noise. Use pieces of foam rubber pipe insulation to cushion pipes.



A "Sioux strap" holds pipe away from a framing member. Just snap the strap on and drive a nail.

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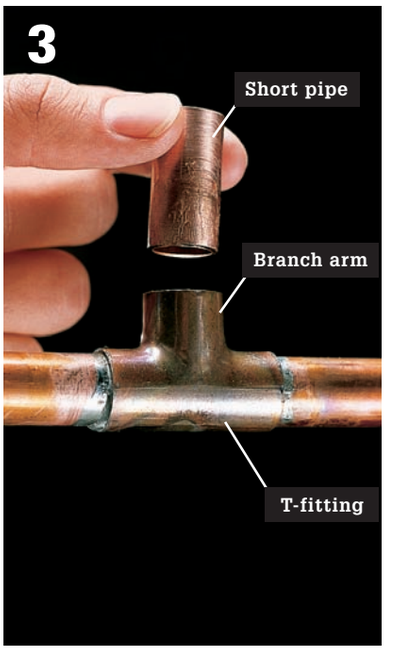
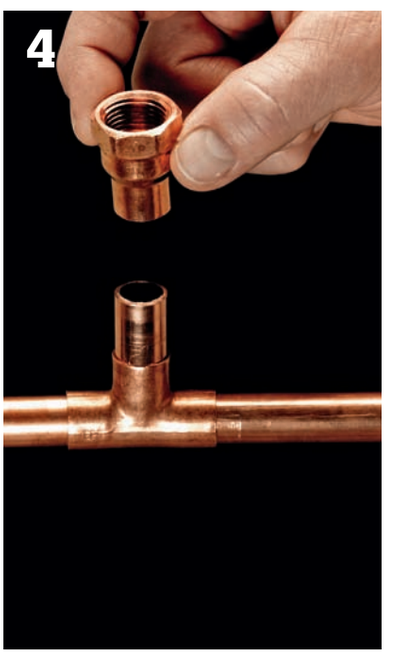
How to Install a Water Hammer Arrester

Shut off the water supply and drain the pipes. Use a tubing cutter or reciprocating saw to cut out a section of horizontal pipe long enough for a T-fitting.

Install a T-fitting as close to the valve as possible.



Install a short piece of pipe in the branch arm of the T-fitting. This short pipe will be used to attach a threaded fitting.



Install a threaded fitting. Use a fitting recommended by the manufacturer of your arrester.

Wrap the threads of the arrester in Teflon tape. Thread the arrester onto the fitting by hand. Tighten by holding the fitting with one adjustable wrench and turning the arrester with the other. Do not overtighten. Turn the water on and check for leaks.

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Plumbing Tools, Materials & Skills

Most home plumbing projects can be completed using a fairly inexpensive set of tools. (An exception: If you run PEX pipe, you will need to invest in a fairly pricy crimper.) So don't hesitate to buy a high-quality tool even if it costs a bit more. Some tools, like a basin wrench or spud wrench, get used seldom but are usually worth their modest price even if you only use them once. Large and expensive tools, such as a power drain auger, can be rented.

The type of plumbing material you employ has a profound effect on how you do the job. Plastic pipes are joined by solvent weld, while copper sweated and pieces of PEX are joined with crimping rings. Each type of material carries with it a small army of fittings and adapters and handling tools. Here, you'll see how to match the parts correctly.

Finally, good work comes down to good technique and patience. We can't teach you patience, but here we show you the techniques you'll need to become an accomplished home plumber.

In this chapter:

- Plumbing Tools
- Plumbing Materials
- Copper
- Rigid Plastic Pipe
- Outdoor Flexible Plastic Pipe
- Cross-Linked Polyethylene (PEX)
- Galvanized Steel
- Cast Iron
- Pipe Fittings
- Shutoff Valves
- Valves & Hose Bibs
- Compression Fittings
- Flare Fittings
- Gas Pipe Fittings

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Plumbing Tools

Many plumbing projects and repairs can be completed with basic hand tools you probably already own. Adding a few simple plumbing tools will prepare you for all the projects in this book. Specialty tools, such as a snap cutter or appliance dolly, are available at rental centers. When buying tools, invest in quality products.

Always care for tools properly. Clean tools after using them, wiping them free of dirt and dust with a soft rag. Prevent rust on metal tools by wiping them with a rag dipped in household oil. If a metal tool gets wet, dry it immediately, and then wipe it with an oiled rag. Keep toolboxes and cabinets organized. Make sure all tools are stored securely.

Caulk gun & all purpose caulk

Utility knife

Head lamp

Non-contact volt meter

Wire brush

Hacksaw

Cold chisel

Ratchet wrench and sockets

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#175 Dtp:225 Page:270

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:271

Drill-powered auger is stronger than a hand-crank auger for removing larger pipe obstructions. This auger can be cranked by hand or attached to a standard ⅜-inch power drill.

Force cup clears drain clogs with water and air pressure. The force cup is used for toilet bowls. The flange usually can be folded up into the cup for use as a standard plunger.

Pipe wrench has a movable jaw that adjusts to fit a variety of pipe diameters. Pipe wrench is used for tightening and loosening pipes, pipe fittings, and large nuts. Two pipe wrenches often are used together to prevent damage to pipes and fittings.

Spud wrench is specially designed for removing or tightening large nuts that are 2" to 4" in diameter. Hooks on the ends of the wrench grab onto the lugs of large nuts for increased leverage.

Blow bag, sometimes called an expansion nozzle, is used to clear drains. It attaches to a garden hose and removes clogs with large spurts of water. The blow bag is best used on floor drains.

Plastic tubing cutter works like a gardener's pruners to cut flexible plastic pipes quickly.

Tubing cutters make straight, smooth cuts in plastic and copper pipe. A tubing cutter usually has a triangular blade for removing burrs from the insides of pipes.

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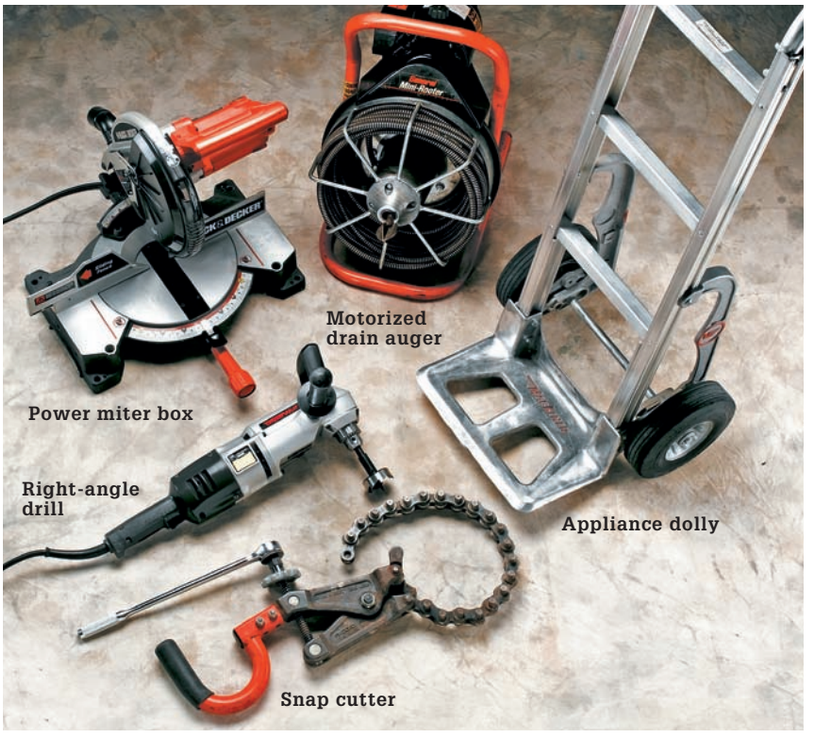
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:272

Closet auger is used to clear toilet clogs. It is a slender tube with a crank handle on one end of a flexible auger cable. A special bend in the tube allows the auger to be positioned in the bottom of the toilet bowl. The bend is usually protected with a rubber sleeve to prevent scratching the toilet.

MAPP torch (left) is used for soldering fittings to copper pipes. Light the torch quickly and safely using a spark lighter.

Flame-resistant pad helps keep wood and other underlying materials safe from the torch's flame.



Rental tools may be needed for large jobs and special situations. A power miter saw makes fast, accurate cuts in a wide variety of materials, including plastic pipes. A motorized drain auger clears tree roots from sewer service lines. Use an appliance dolly to move heavy objects like water heaters. A snap cutter is designed to cut tough cast-iron pipes. The right-angle drill is useful for drilling holes in hard-to-reach areas.

Power hand tools can make any job faster, easier, and safer. Cordless power tools offer added convenience. Use a cordless ⅜" power drill for virtually any drilling task.

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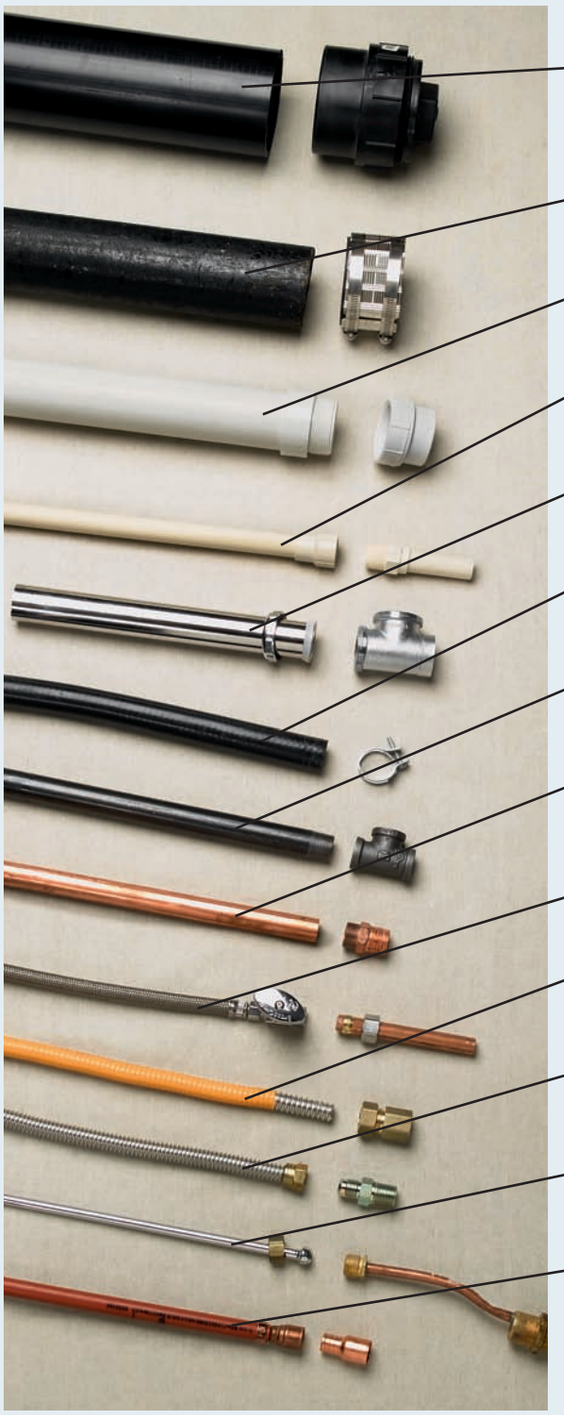
Plumbing Materials

Common Pipe & Tube Types



BENEFITS & CHARACTERISTICS

ABS (acrylonitrile butadiene styrene) was once approved for use in DWV systems. Most local codes now prohibit ABS for new installations, but in some cases it can be added to pre-existing ABS DWV systems.

Cast iron is strong but hard to work with. Repairs should be made with plastic pipe, if allowed.

PVC (polyvinyl chloride) is rigid plastic that resists heat and chemicals. Lightweight tubes and heavier Schedule 40.

CPVC (chlorinated polyvinyl chloride) rigid plastic is inexpensive and withstands high temperature and pressure.

Chromed brass has an attractive shiny surface and is used for drain traps where appearance is important.

PE (polyethylene) plastic is a black or bluish flexible pipe sometimes used for main water service lines as well as irrigation systems.

Black pipe (iron pipe) generally is threaded at the ends to accept female-threaded fittings. Not for potable water.

Rigid copper is used for water supply pipes. It resists corrosion and has smooth surfaces for good water flow.

Braided metal is used for water supply tubes that connect shutoff valves to fixtures.

Flexible stainless-steel (protective coated) connectors are used to attach gas appliances to supply stopcocks.

Flexible stainless-steel (uncoated) connectors are used to attach gas appliances to supply stopcocks

Chromed copper supply tube is used in areas where appearance is important. Easy to bend and fit.

PEX (cross-linked polyethylene) is flexible and is approved by major building codes for water supply.

Flexible copper tubing (not shown) bends easily and requires fewer couplings than rigid copper.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:274

COMMON USES	LENGTHS	DIAMETERS	FITTING METHODS	TOOLS USED FOR CUTTING
Pipes; drain traps	Sold by linear ft.	2", 3", 4"	Glue and plastic	Miter box or hacksaw
Main drain-waste-vent stack	5 ft., 10 ft.	3", 4"	Banded neoprene couplings	Snap cutter or hacksaw
Drain & vent pipes; drain traps	10 ft., 20 ft.; or sold by linear ft.	1¼", 1½", 2", 3", 4"	Solvent glue and/or plastic fittings	Tubing cutter, miter box, or hacksaw
Hot & cold water supply pipes	10 ft.	⅜", ½", ¾", 1"	Solvent glue and plastic fittings, or with compression fittings	Tubing cutter, miter box, or hacksaw
Valves & shutoffs; drain traps, supply risers	Lengths vary	1¼", ½", ¾", 1¼", 1½"	Compression fittings, or with metal solder	Tubing cutter, hacksaw, or reciprocating saw
Outdoor cold water supply pipes	Sold in coils of 25 to hundreds of ft.	¼" to 1"	Rigid PVC fittings and stainless steel hose	Ratchet-style plastic pipe cutter or miter saw
Gas supply pipe	Sold in lengths up to 10 ft.	¾", 1"	Threaded connectors	Hacksaw, power cutoff saw or reciprocating saw with bi-metal blade
Hot & cold water supply pipes	10 ft., 20 ft.; or sold by linear ft.	⅜", ½", ¾", 1"	Metal solder or compression fittings	Tubing cutter, hacksaw, or jigsaw
Supply tubes	12" or 20"	⅜"	Compression coupling or compression fittings	Do not cut
Gas ranges, dryers, water heaters	36" or 48"	⅝", ½" (OD)	Compression coupling	Do not cut
Gas ranges, dryers, water heaters	36" or 48"	⅝", ½" (OD)	Compression coupling	Do not cut
Supply tubing	12", 20", 30"	⅜"	Brass compression fittings	Tubing cutter or hacksaw
Water supply, tubing for radiant floors	Sold in coils of 25 ft. to hundreds of ft.	¼" to 1"	Crimp fittings	Tubing cutter
Gas supply; hot & cold water supply	30-ft., 60-ft. coils; or by ft.	¼", ⅜", ½", ¾", 1"	Brass flare fittings, solder, compression fittings	Tubing cutter or hacksaw

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:275

Copper

Copper is an ideal material for water supply pipes. It resists corrosion and has smooth surfaces that provide good water flow. Copper pipes are available in several diameters (page 274), but most home water supply systems use ½" or ¾" pipe. Copper pipe is manufactured in rigid and flexible forms.

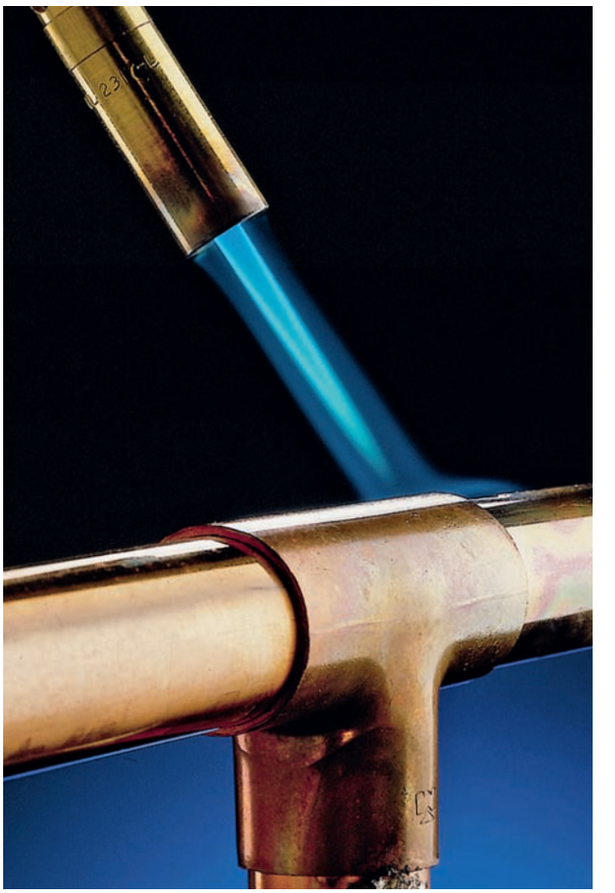
Rigid copper, sometimes called hard copper, is approved for home water supply systems by all local codes. It comes in three wall-thickness grades: Types M, L, and K. Type M is the thinnest, the least expensive, and a good choice for do-it-yourself home plumbing.

Rigid Type L usually is required by code for commercial plumbing systems. Because it is strong and solders easily, Type L may be preferred by some professional plumbers and do-it-yourselfers for home use. Type K has the heaviest wall thickness and is used most often for underground water service lines.

Flexible copper, also called soft copper, comes in two wall-thickness grades: Types L and K. Both are approved for most home water supply systems, although flexible Type L copper is used primarily for gas service lines. Because it is bendable and will resist a mild frost, Type L may be installed as part of a water supply system in unheated indoor areas, like crawl spaces. Type K is used for underground water service lines.

A third form of copper, called DWV, is used for drain systems. Because most codes now allow low-cost plastic pipes for drain systems, DWV copper is seldom used.

Copper pipes are connected with soldered, compression, or flare fittings (see chart below). Always follow your local code for the correct types of pipes and fittings allowed in your area.



Soldered fittings, also called sweat fittings, often are used to join copper pipes. Correctly soldered fittings (pages 278 to 280) are strong and trouble-free. Copper pipe can also be joined with compression fittings (pages 314 to 315) or flare fittings (page 316). See chart below.

Copper Pipe & Fitting Chart ▸

Fitting Method	RIGID COPPER Type M	RIGID COPPER Type L	RIGID COPPER Type K	FLEXIBLE COPPER Type L	FLEXIBLE COPPER Type K	General Comments
Soldered	yes	yes	yes	yes	yes	Inexpensive, strong, and trouble-free fitting method. Requires some skill.
Compression	yes	not applicable		no	no	Makes repairs and replacement easy. More expensive than solder. Best used on flexible copper.
Flare	no	no	yes	yes	yes	Use only with flexible copper pipes. Usually used as a gas-line fitting. Requires some skill.

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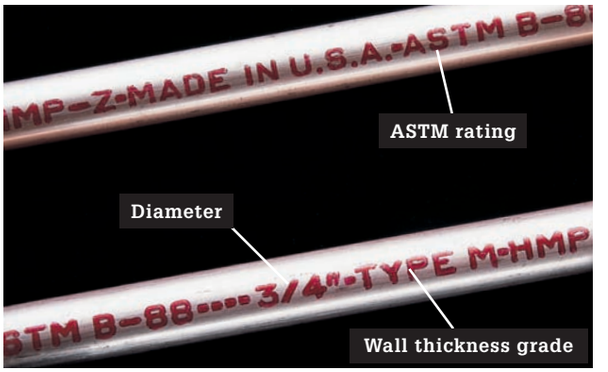
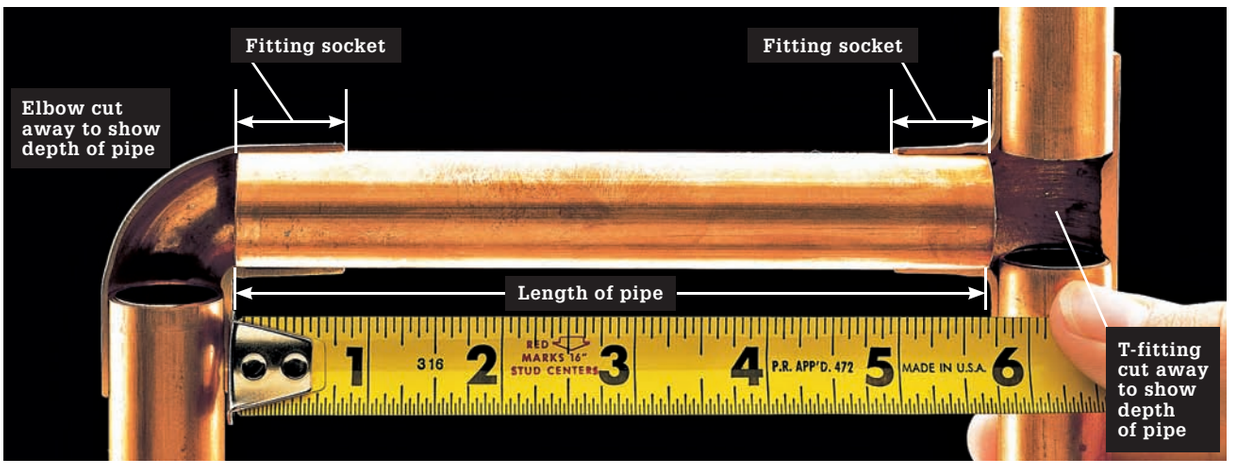


Grade stamp information includes the pipe diameter, the wall-thickness grade, and a stamp of approval from the ASTM (American Society for Testing and Materials). Type M pipe is identified by red lettering, Type L by blue lettering.

Bend flexible copper pipe with a coil-spring tubing bender to avoid kinks. Select a bender that matches the outside diameter of the pipe. Slip bender over pipe using a twisting motion. Bend pipe slowly until it reaches the correct angle, but not more than 90º.

Specialty tools and materials for working with copper include: flaring tools (A), emery cloth (B), coil-spring tubing bender (C), pipe joint compound (D), soldering paste (flux) (E), lead-free solder (F), wire brush (G), flux brush (H), compression fitting (I), flare fitting (J).



Find the length of copper pipe needed by measuring between the bottom of the copper fitting sockets (fittings shown in cutaway). Mark the length on the pipe with a felt-tipped pen.

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Cutting & Soldering Copper

The best way to cut rigid and flexible copper pipe is with a tubing cutter. A tubing cutter makes a smooth, straight cut, an important first step toward making a watertight joint. Remove any metal burrs on the cut edges with a reaming tool or round file.

Copper can be cut with a hacksaw. A hacksaw is useful in tight areas where a tubing cutter will not fit. Take care to make a smooth, straight cut when cutting with a hacksaw.

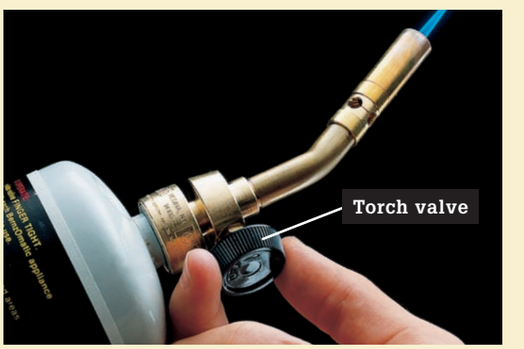
A soldered pipe joint, also called a sweated joint, is made by heating a copper or brass fitting with a propane torch until the fitting is just hot enough to melt metal solder. The heat draws the solder into the gap between the fitting and pipe to form a watertight seal. A fitting that is overheated or unevenly heated will not draw in solder. Copper pipes and fittings must be clean and dry to form a watertight seal.

Tools & Materials

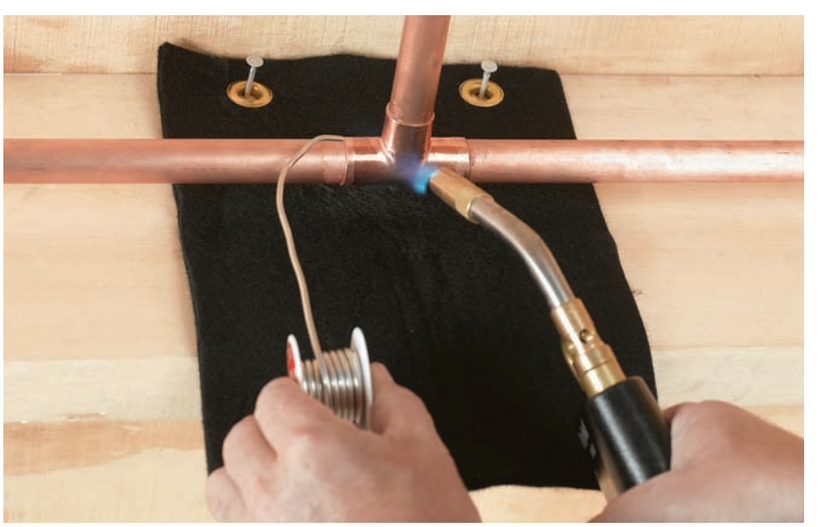
- Tubing cutter with reaming tip (or hacksaw and round file)
- Wire brush
- Flux brush
- Propane torch
- Spark lighter (or matches)
- Round file
- Cloth
- Adjustable wrench
- Channel-type pliers
- Copper pipe
- Copper fittings
- Emery cloth
- Soldering paste (flux)
- Sheet metal
- Lead-free solder
- Rag

Soldering Tips

Use caution when soldering copper. Pipes and fittings become very hot and must be allowed to cool before handling.



Prevent accidents by shutting off propane torch immediately after use. Make sure valve is closed completely.



Protect wood from the heat of the torch flame while soldering. Use an old cookie sheet, two sheets of 26-gauge metal, or a fiber shield, as shown.

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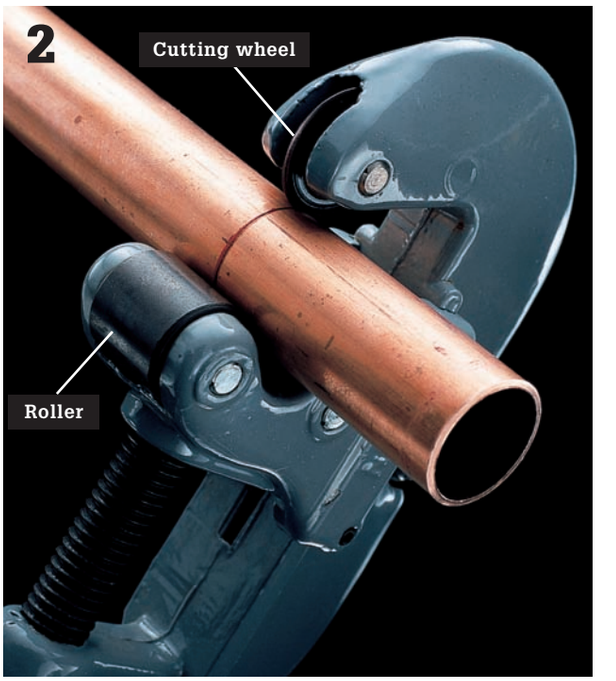
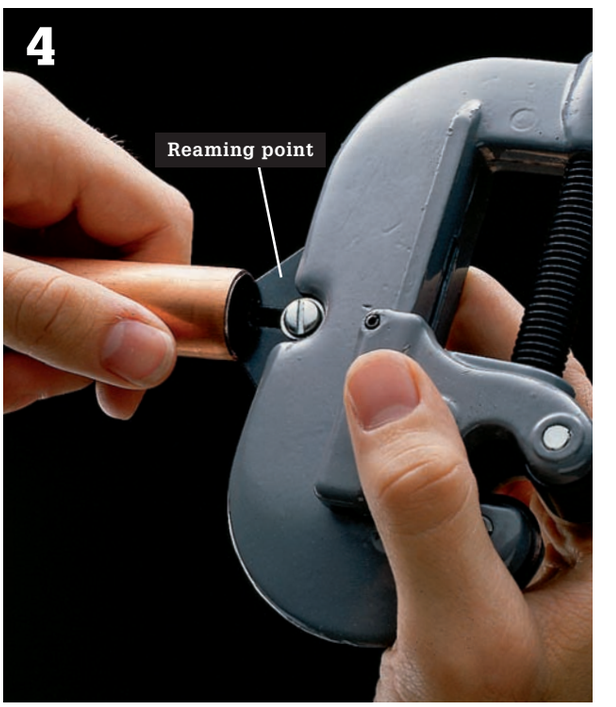
How to Cut Rigid & Flexible Copper Pipe

Place the tubing cutter over the pipe and tighten the handle so that the pipe rests on both rollers and the cutting wheel is on the marked line.



Turn the tubing cutter one rotation so that the cutting wheel scores a continuous straight line around the pipe.

Rotate the cutter in the opposite direction, tightening the handle slightly after every two rotations, until the cut is complete.



Remove sharp metal burrs from the inside edge of the cut pipe, using the reaming point on the tubing cutter, or a round file.

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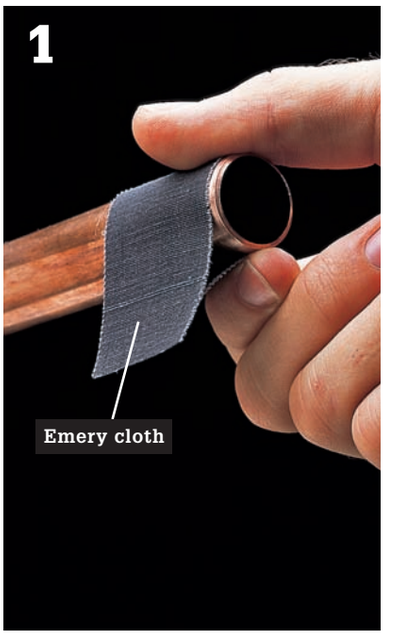
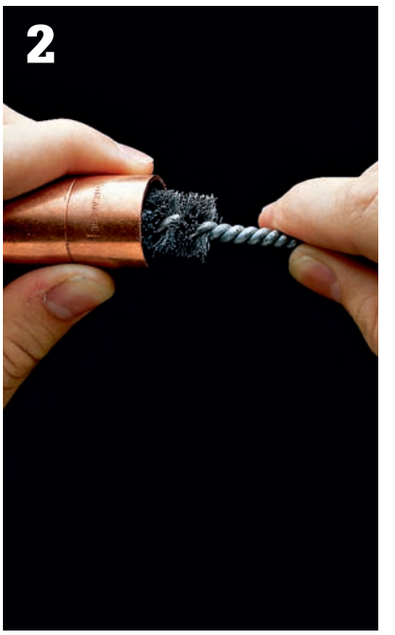
How to Solder Copper Pipes & Fittings



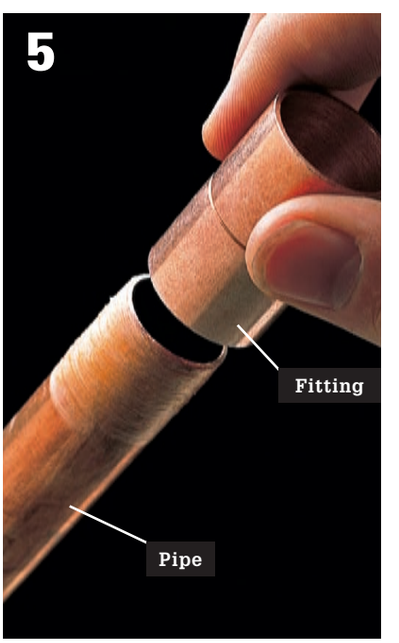
Clean the end of each pipe by sanding with emery cloth. Ends must be free of dirt and grease to ensure that the solder forms a good seal.



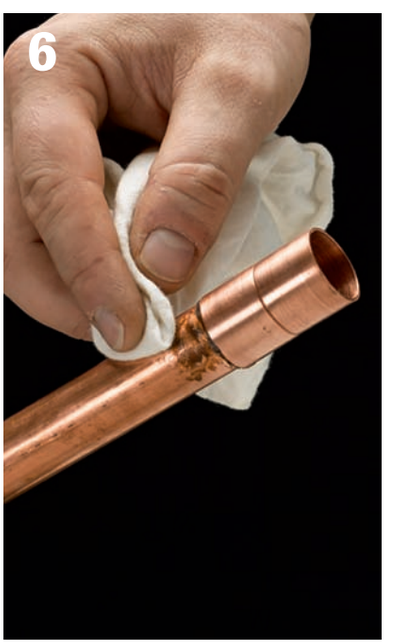
Clean the inside of each fitting by scouring with a wire brush or emery cloth.

Apply a thin layer of soldering paste (flux) to end of each pipe, using a flux brush. Soldering paste should cover about 1" of pipe end.

Apply a thin layer of flux to the inside of the fitting.



Assemble each joint by inserting the pipe into the fitting so it is tight against the bottom of the fitting sockets. Twist each fitting slightly to spread soldering paste.



Use a clean dry cloth to remove excess flux before soldering the assembled fitting.

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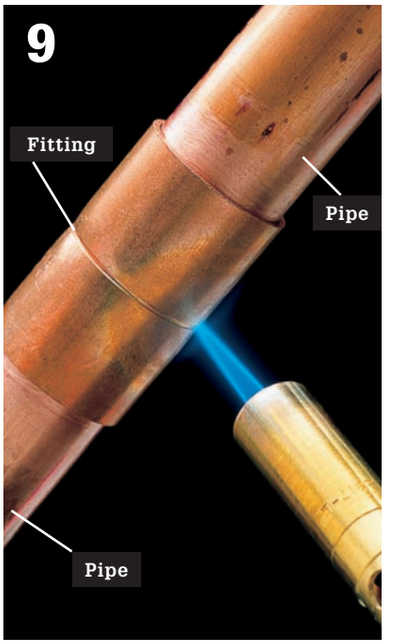
#175 Dtp:225 Page:280

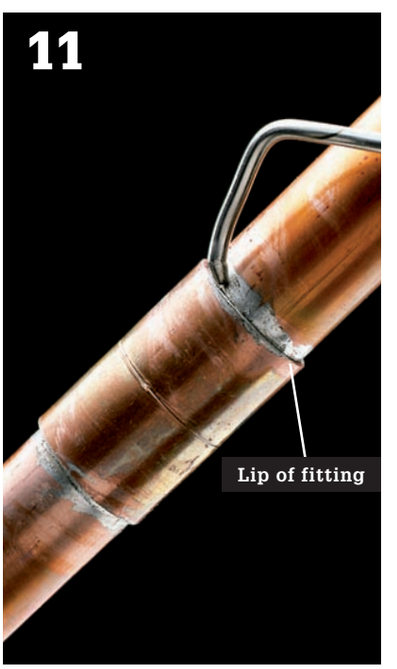
Prepare the wire solder by unwinding 8" to 10" of wire from spool. Bend the first 2" of the wire to a 90º angle.

Open the gas valve and trigger the spark lighter to ignite the torch. Adjust the torch valve until the inner portion of the flame is 1" to 2" long.



Move the torch flame back and forth and around the pipe and the fitting to heat the area evenly.

Heat the other side of the copper fitting to ensure that heat is distributed evenly. Touch solder to pipe. Solder will melt when the pipe is at the right temperature.



When solder melts, remove the torch and quickly push ½" to ¾" of solder into each joint. Capillary action fills the joint with liquid solder. A correctly soldered joint should show a thin bead of solder around the lips of the fitting.

Allow the joint to cool briefly, then wipe away excess solder with a dry rag. *Caution: Pipes will be hot. If joints leak after water is turned on, disassemble and resolder.*

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
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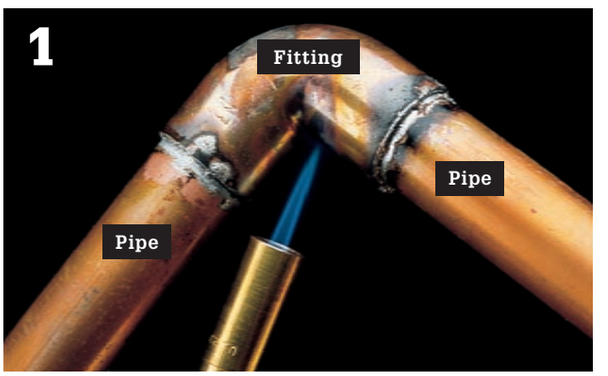
How to Solder Brass Valves

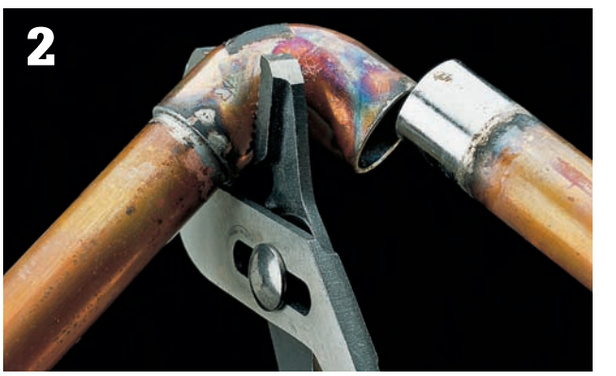
Valves should be fully open during all stages of the soldering process. If a valve has any plastic or rubber parts, remove them prior to soldering.

To prevent valve damage, quickly heat the pipe and the flanges of the valve, not the valve body. After soldering, cool the valve by spraying with water.

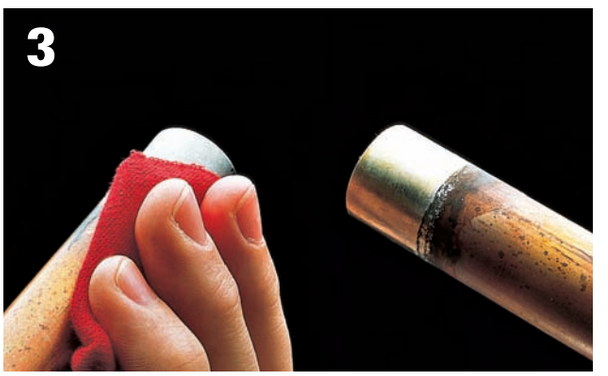
How to Take Apart Soldered Joints



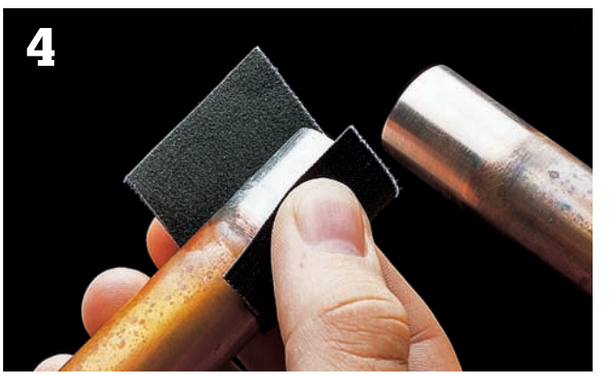
Turn off the water and drain the pipes by opening the highest and lowest faucets in the house. Light your torch. Hold the flame tip to the fitting until the solder becomes shiny and begins to melt.



Use channel-type pliers to separate the pipes from the fitting.



Remove old solder by heating the ends of the pipe with your torch. Use a dry rag to wipe away melted solder quickly. *Caution: Pipes will be hot.*



Use emery cloth to polish the ends of the pipe down to bare metal. Never reuse fittings.

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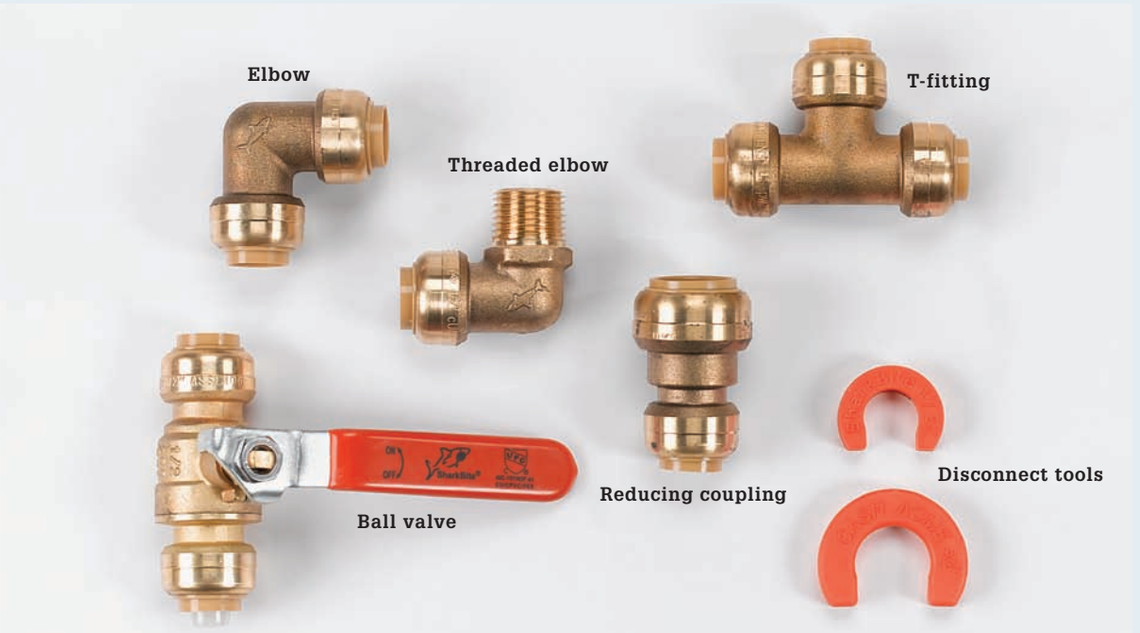
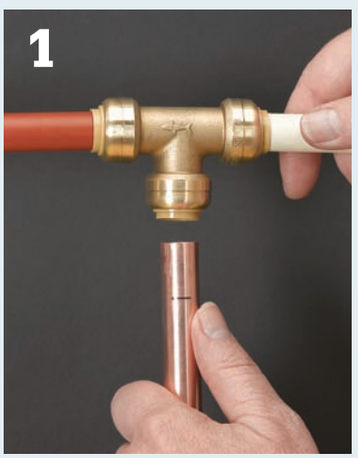
#175 Dtp:225 Page:282

Push Fittings ▸

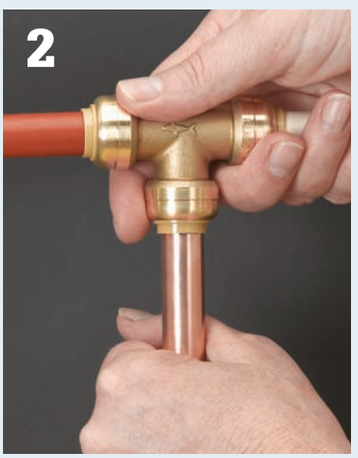
Push fittings make water supply connections about as easy as possible. They are expensive, so you won't want to use them for all connections on a large installation. But even professional plumbers use them in tight spots where sweating or welding would be difficult. They are also an ideal material for making a quick repair.



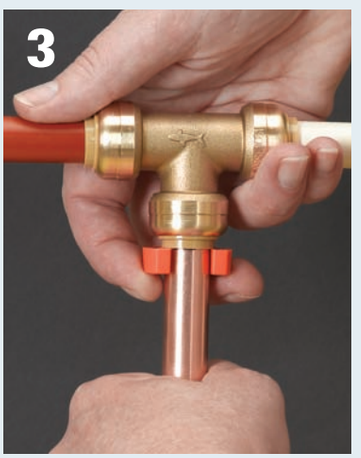
Push fittings are available as couplings tees, elbows, and even shutoff valves. They connect to hard copper, CPVC, and PEX pipe, but not to PVC or galvanized or black steel pipe. In most areas they are approved for use inside covered walls.



Cut the pipe square, and remove any burrs and rough edges. Draw a mark 1" from the cut end.



Push the pipe into the fitting an inch or so until you hear it click. Tug to make sure you have a strong connection. It may not seem like it, but the connection is indeed watertight and durable. You may rotate it to the desired position.



To remove a pipe from a push fitting, slip the disconnect tool over the pipe, slide it over the fitting, and press against the fitting's release collar as you pull the pipe out.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:283

Rigid Plastic Pipe

Cut rigid ABS, PVC, or CPVC plastic pipes with a tubing cutter or with any saw. Cuts must be straight to ensure watertight joints.

Rigid plastics are joined with plastic fittings and solvent glue. Use a solvent glue that is made for the type of plastic pipe you are installing. For example, do not use ABS solvent on PVC pipe. Some solvent glues, called "all-purpose" or "universal" solvents, may be used on all types of plastic pipe.

Solvent glue hardens in about 30 seconds, so test-fit all plastic pipes and fittings before gluing the first joint. For best results, the surfaces of plastic pipes and fittings should be dulled with emery cloth and liquid primer before they are joined.

Liquid solvent glues and primers are toxic and flammable. Provide adequate ventilation when fitting plastics, and store the products away from any source of heat.

Plastic grip fittings can be used to join rigid or flexible plastic pipes to copper plumbing pipes.

Tools & Materials

- Tape measure
- Felt-tipped pen
- Tubing cutter (or miter box or hacksaw)
- Utility knife
- Channel-type pliers
- Gloves
- Plastic pipe
- Fittings
- Emery cloth
- Plastic pipe primer
- Solvent glue
- Rag
- Petroleum jelly

Solvent welding is a chemical bonding process used to permanently join PVC pipes and fittings.

Primer and solvent glue are specific to the plumbing material being used. Do not use all-purpose or multi-purpose products. Light to medium body glues are appropriate for DIYers as they allow the longest working time and are easiest to use. When working with large pipe, 3 or 4 inches in diameter, buy a large-size can of cement, which has a larger dauber. If you use the small dauber (which comes with the small can), you may need to apply twice, which will slow you down and make connections difficult. (The smaller can of primer is fine for any other size pipe, since there's no rush in applying primer.) Cement (though not primer) goes bad in the can within a month or two after opening, so you may need to buy a new can for a new project.

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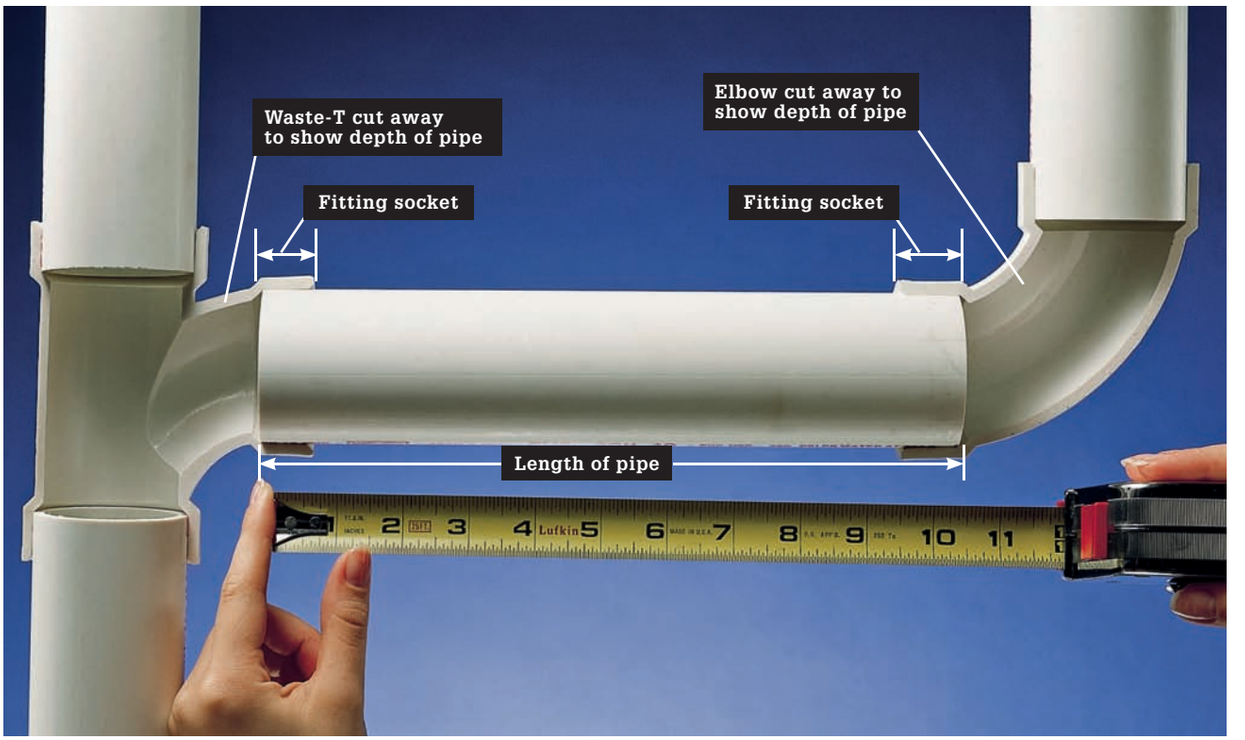
How to Cut Rigid Plastic Pipe



Find the length of plastic pipe needed by measuring between the bottoms of the fitting sockets (fittings shown in cutaway). Mark the length on the pipe with a felt-tipped pen.

Plastic tubing cutters do a fast, neat job of cutting. You'll probably have to go to a professional plumbing supply store to find one, however. They are not interchangeable with metal tubing cutters.

The best cutting tool for plastic pipe is a power miter saw with a fine tooth woodworking blade or a plastic-specific blade.

A ratcheting plastic-pipe cutter can cut smaller diameter PVC and CPVC pipe in a real hurry. If you are plumbing a whole house you may want to consider investing in one. They also are sold only at plumbing supply stores.

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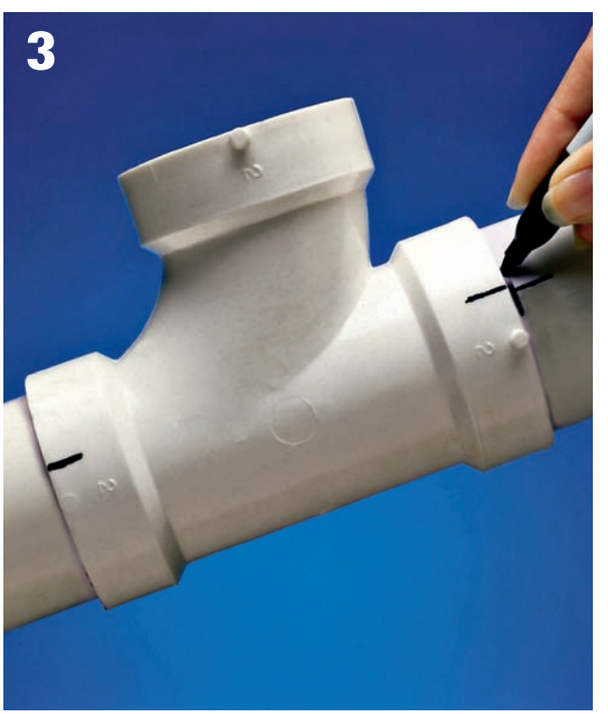
#175 Dtp:225 Page:285

How to Solvent-Glue Rigid Plastic Pipe

Remove rough burrs on cut ends of plastic pipe, using a utility knife or deburring tool (inset).

Test-fit all pipes and fittings. Pipes should fit tightly against the bottom of the fitting sockets.



Mark the depth of the fitting sockets on the pipes. Take pipes apart. Clean the ends of the pipes and fitting sockets with emery cloth.

Apply a light coat of plastic pipe primer to the ends of the pipes and to the insides of the fitting sockets. Primer dulls glossy surfaces and ensures a good seal.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:286

Solvent-glue each joint by applying a thick coat of solvent glue to the end of the pipe. Apply a thin coat of solvent glue to the inside surface of the fitting socket. Work quickly: solvent glue hardens in about 30 seconds.

Quickly position the pipe and fitting so that the alignment marks are offset by about 2". Force the pipe into the fitting until the end fits flush against the bottom of the socket.

Spread solvent by twisting the pipe until the marks are aligned. Hold the pipe in place for about 20 seconds to prevent the joint from slipping.

Wipe away excess solvent glue with a rag. Do not disturb the joint for 30 minutes after gluing.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:287

Working with Outdoor Flexible Plastic Pipe

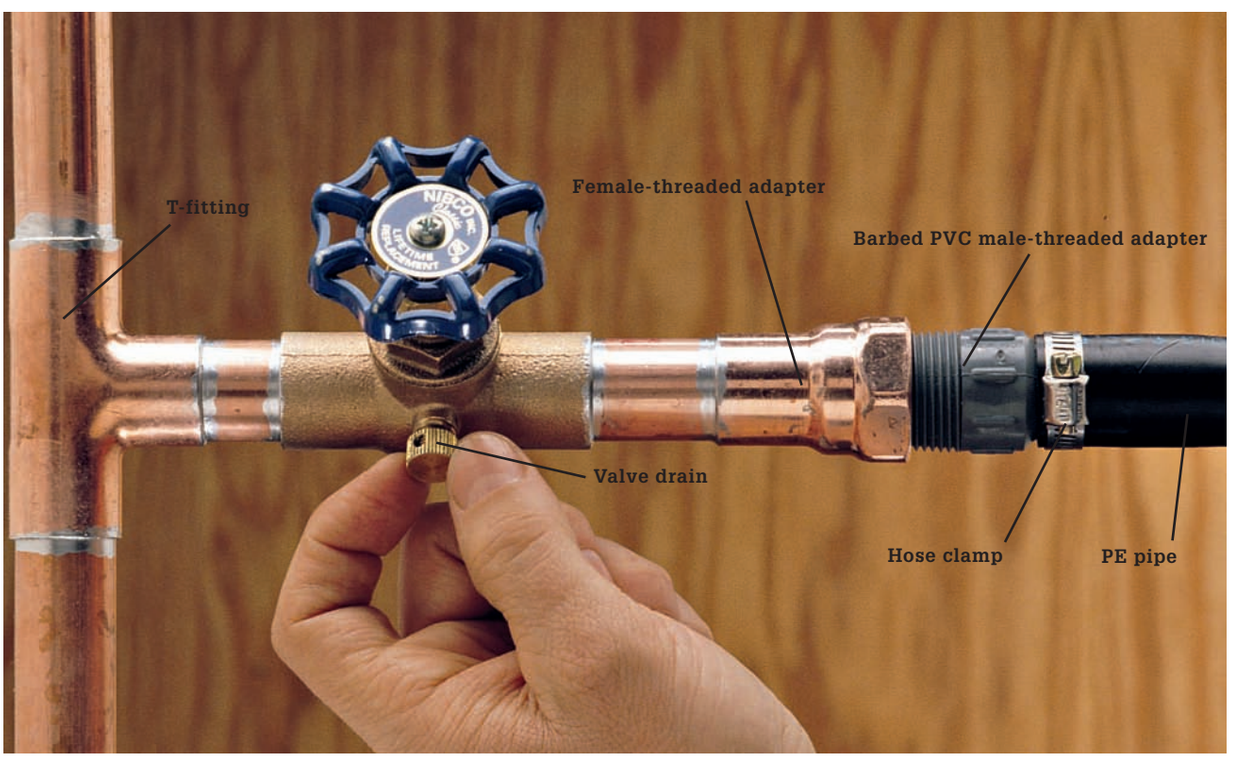
Flexible PE (polyethylene) pipe is used for underground cold water lines. Very inexpensive, PE pipe is commonly used for automatic lawn sprinkler systems and for extending cold water supply to utility sinks in detached garages and sheds.

Unlike other plastics, PE is not solvent-glued, but is joined using "barbed" rigid PVC fittings and stainless-steel hose clamps. In cold climates, outdoor plumbing lines should be shut off and drained for winter.

Tools & Materials

Tape measure	Flexible pipe
Tubing cutter	Fittings
Screwdriver or wrench	Hose clamps
Pipe joint compound	Utility knife

Connect lengths of PE pipe with a barbed PVC fitting. Secure the connection with stainless steel hose clamps.



Connect PE pipe to an existing cold water supply pipe by splicing in a T-fitting to the copper pipe and attaching a drain-and-waste shutoff valve and a female-threaded adapter. Screw a barbed PVC male-threaded adapter into the copper fitting, then attach the PE pipe. The drain-and-waste valve allows you to blow the PE line free of water when winterizing the system.

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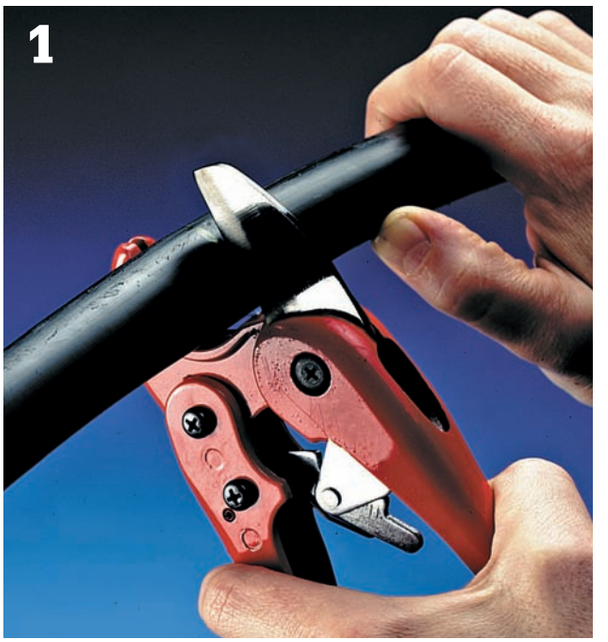
#175 Dtp:225 Page:288

How to Cut & Join Outdoor Flexible Plastic Pipe



Cut flexible PE pipe with a plastic tubing cutter, or use a miter box or sharp knife. Remove any rough burrs with a utility knife.

Fit stainless-steel hose clamps over the ends of the flexible pipes being joined.

Option: To ensure a tighter fit, dab some pipe joint compound onto the barbs so they are easier to slide into the flexible plastic pipe. Apply pipe joint compound to the barbed ends of the T-fitting. Work each end of PE pipe over the barbed portions of the fitting and into position.

Slide the band clamps over the joint ends. Hand tighten each clamp with a screwdriver or wrench.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:289

Cross-Linked Polyethylene (PEX)

Cross-linked polyethylene (PEX) is growing quickly in acceptance as a supply pipe for residential plumbing. It's not hard to understand why. Developed in the 1960s but relatively new to the United States, this supply pipe combines the ease of use of flexible tubing with the durability of rigid pipe. It can withstand a wide temperature range (from subfreezing to 180°F); it is inexpensive; and it's quieter than rigid supply pipe.

PEX is flexible plastic (polyethylene, or PE) tubing that's reinforced by a chemical reaction that creates long fibers to increase the strength of the material. It has been allowed by code in Europe and the southern United States for many years, but has won approval for residential supply use in most major plumbing codes only recently. It's frequently used in manufactured housing and recreational vehicles and in radiant heating systems. Because it is so flexible, PEX can easily be bent to follow corners and make other changes in direction. From the water main and heater, it is connected into manifold fittings that redistribute the water in much the same manner as a lawn irrigation system.

For standard residential installations, PEX can be joined with very simple fittings and tools. Unions are generally made with a crimping tool and a crimping ring. You simply insert the ends of the pipe you're joining into the ring, then clamp down on the ring with the crimping tool. PEX pipe, tools, and fittings can be purchased from most wholesale plumbing suppliers and at many home centers. Coils of PEX are sold in several diameters from ¼" to 1". PEX tubing and fittings from different manufacturers are not interchangeable. Any warranty coverage will be voided if products are mixed.

Tools & Materials ▸

- Tape measure
- Felt-tipped pen
- Full-circle crimping tool
- Go/no-go gauge
- Tubing cutter
- PEX pipe
- Manifolds
- Protector plates
- PEX fittings
- Utility knife
- Plastic hangers
- Crimp ring

PEX pipe is a relatively new water supply material that's growing in popularity in part because it can be installed with simple mechanical connections.

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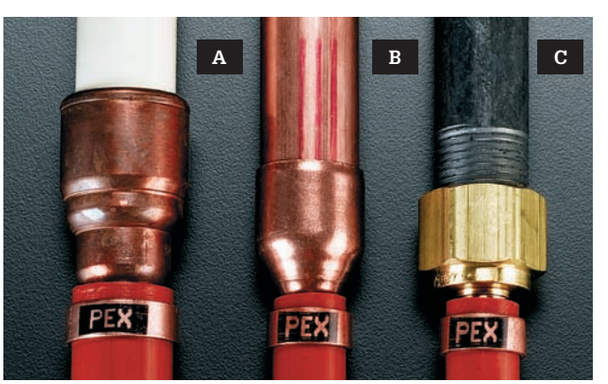
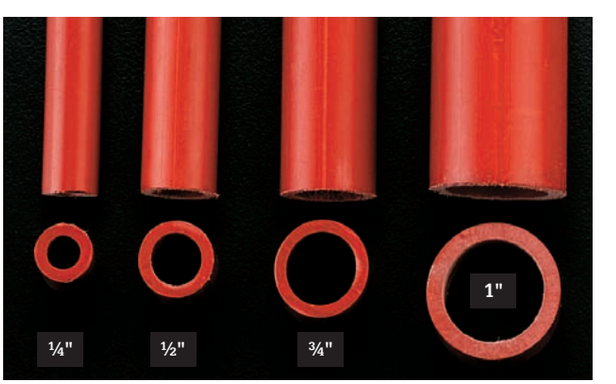
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:290

PEX Tools & Materials

Specialty tools for installing PEX are available wherever PEX is sold. The basic set includes a full-circle crimping tool (A), a tubing cutter (B), and a go/no-go gauge (C) to test connections after they've been crimped. Competing manufacturers make several types of fittings, with proprietary tools that only work with their fittings. The tools and fittings you use may differ from those shown on these pages.



PEX is connected to other water supply materials with transition fittings, including CPVC-to-PEX (A), copper-to-PEX (B), and iron-to-PEX (C).



Generally, you should use the same diameter PEX as is specified for rigid supply tubing, but in some "home run" installations (see next page) you can use ⅜" PEX where ½" rigid copper would normally be used.

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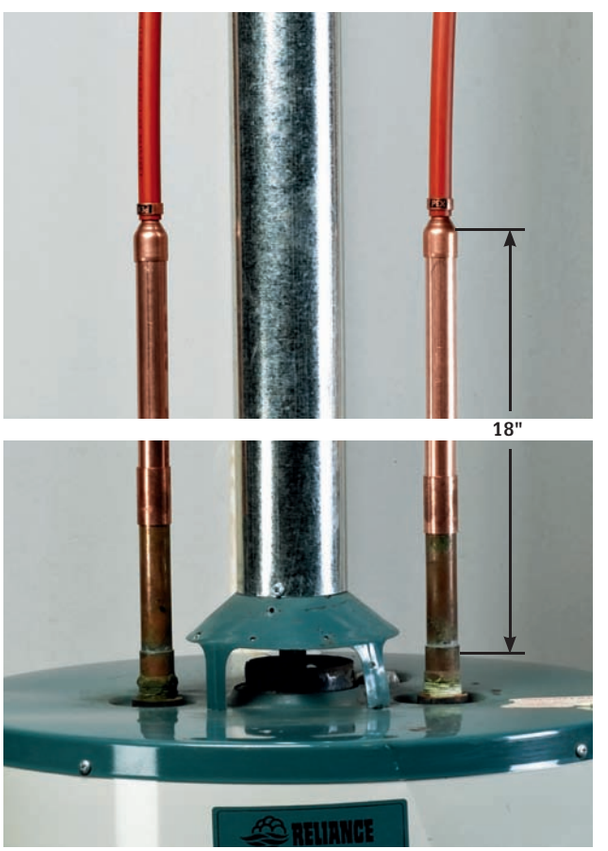
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:291

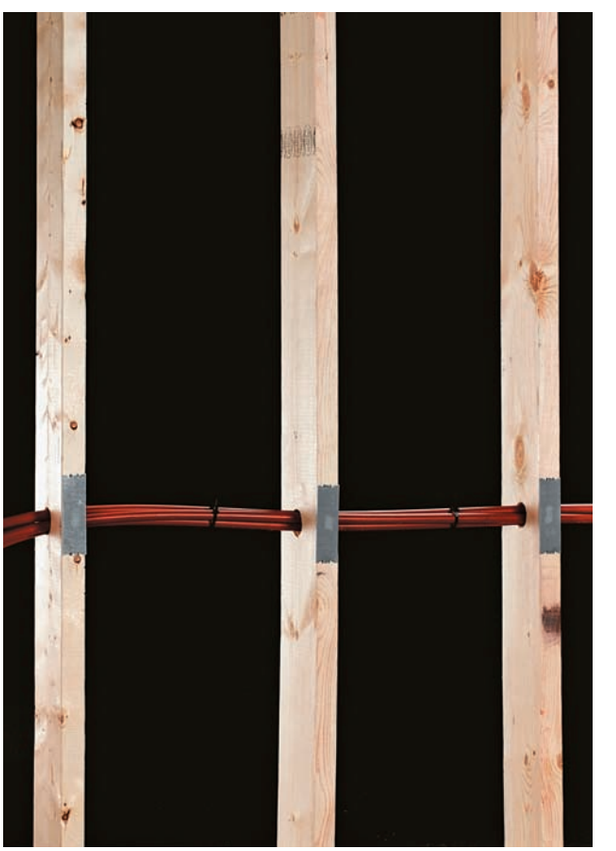
PEX Installation

Check with your local plumbing inspector to verify that PEX is allowed in your municipality. PEX has been endorsed by all major plumbing codes in North America, but your municipality may still be using an older set of codes. Follow the guidelines below when installing PEX:

- Do not install PEX in above-ground exterior applications because it degrades quickly from UV exposure.
- Do not use PEX for gas lines.
- Do not use plastic solvents or petroleum-based products with PEX (they can dissolve the plastic).
- Keep PEX at least 12" away from recessed light fixtures and other potential sources of high heat.
- Do not attach PEX directly to a water heater. Make connections at the heater with metallic tubing (either flexible water-heater connector tubing or rigid copper) at least 18" long; then join it to PEX with a transition fitting.
- Do not install PEX in areas where there is a possibility of mechanical damage or puncture. Always fasten protective plates to wall studs that house PEX.
- Always leave some slack in installed PEX lines to allow for contraction and in case you need to cut off a bad crimp.
- Use the same minimum branch and distribution supply-pipe dimensions for PEX that you'd use for copper or CPVC, according to your local plumbing codes.
- You can use push fittings to join PEX to itself or to CPVC or copper. See page 283.



Do not connect PEX directly to a water heater. Use metal connector tubes. Solder the connector tubes to the water heater before attaching PEX. Never solder metal tubing that is already connected to PEX lines.



Bundle PEX together with plastic ties when running pipe through wall cavities. PEX can contract slightly, so leave some slack in the lines.

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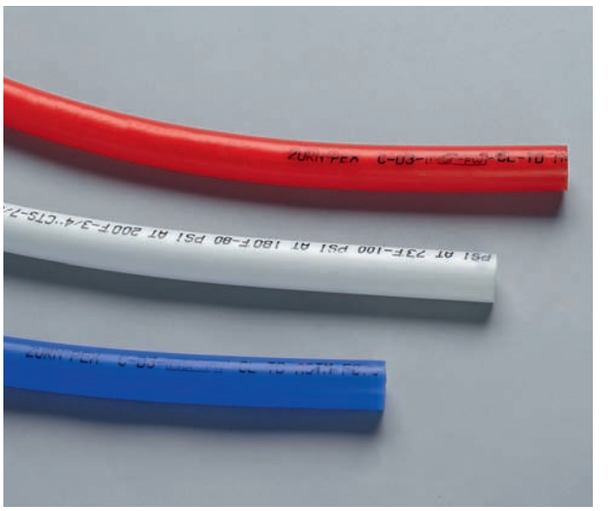
Buying PEX



Color coding is a practice many PEX manufacturers have embraced to make identification easier. Because the material is identical except for the color, you can buy only one color (red is more common) and use it for both hot and cold supply lines.

PEX combines the flexibility of plastic tubing with the durability of rigid supply pipe. It is sold in coils of common supply-pipe diameters.

The PEX Advantage

PEX supply tubing offers a number of advantages over traditional rigid supply tubing:

- Easy to install. PEX does not require coupling joints for long runs or elbows and sweeps for turns. The mechanical connections do not require solvents or soldering.
- Easy to transport. Large coils are lightweight and much easier to move around than 10-ft. lengths of pipe.
- Good insulation. The PEX material has better thermal properties than copper for lessened heat loss.
- Quiet. PEX will not rattle or clang from trapped air or kinetic energy.
- Good for retrofit jobs. PEX is easier to snake through walls than rigid supply tubing and is compatible with copper, PVC, or iron supply systems if the correct transition fittings are used. If your metal supply tubes are used to ground your electrical system, you'll need to provide a jumper if PEX is installed in midrun. Check with a plumber or electrician.
- Freeze resistance. PEX retains some flexibility in sub-freezing conditions and is less likely to be damaged than rigid pipe, but it is not frostproof.

General Codes for PEX

PEX has been endorsed for residential use by all major building codes, although some municipal codes may be more restrictive. The specific design standards may also vary, but here are some general rules:

- For PEX, maximum horizontal support spacing is 32" and maximum vertical support spacing is 10 ft.
- Maximum length of individual distribution lines is 60 ft.
- PEX is designed to withstand 210°F water for up to 48 hours. For ongoing use, most PEX is rated for 180 degree water up to 100 pounds per square inch of pressure.
- Directional changes of more than 90 degrees require a guide fitting (see page 307).

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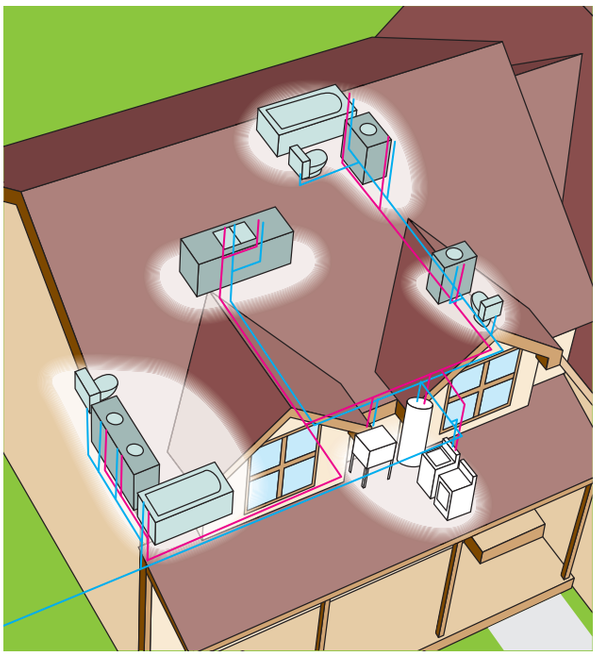
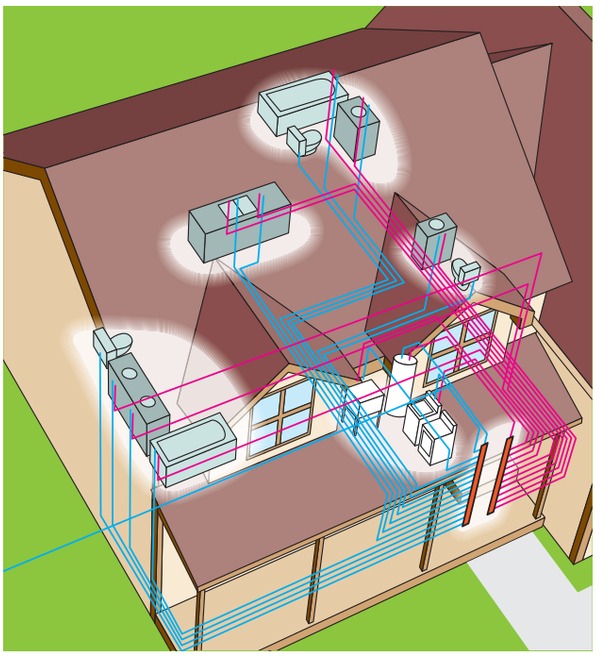
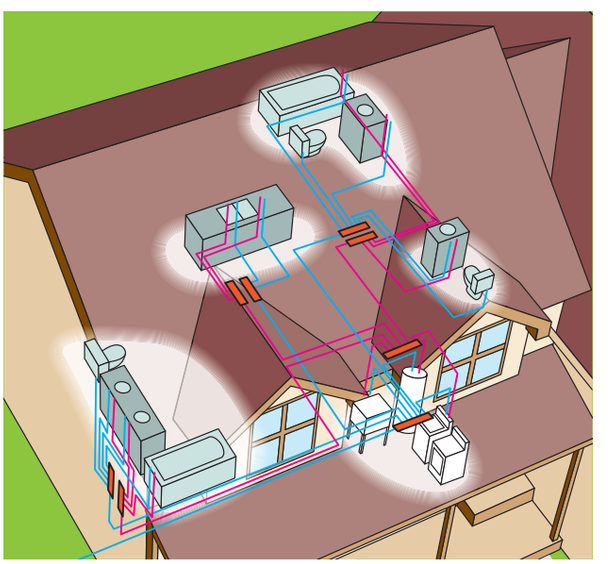
System Designs



Trunk-and-branch systems are configured in much the same way as a traditional rigid copper or PVC supply systems. A main supply line (the trunk line) carries water to all of the outlets via smaller branch lines that tie into the trunk and serve a few outlets in a common location.



Home run systems rely on one or two central manifolds to distribute the hot and cold water very efficiently. Eliminating the branch fittings allows you to use thinner supply pipe in some situations.



Remote manifold systems are a hybrid between traditional trunk-and-branch systems and home run systems. Instead of relying on just one or two manifolds, they employ several smaller manifolds downline from a larger manifold. Each smaller manifold services a group of fixtures, as in a bathroom or kitchen.

Choosing a PEX System

- For maximum single-fixture water pressure: Trunk and branch
- For economy of materials: Trunk and branch or remote manifold
- For minimal wait times for hot water (single fixture): Home run
- For minimal wait times for hot water (multiple fixtures used at same approximate time): Trunk and branch or remote manifold
- For ease of shutoff control: Home run
- For lowest number of fittings and joints: Home run

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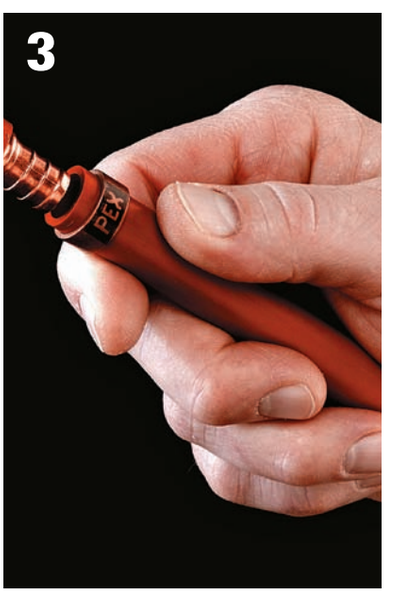
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:294

How to Make PEX Connections

Cut the pipe to length, making sure to leave enough extra material so the line will have a small amount of slack once the connections are made. A straight, clean cut is very important. For best results, use a tubing cutter.

Inspect the cut end to make sure it is clean and smooth. If necessary, deburr the end of the pipe with a sharp utility knife. Slip a crimp ring over the end.



Insert the barbed end of the fitting into the pipe until it is snug against the cut edges.Position the crimp ring so it is ⅛" to ¼" from the end of the pipe, covering the barbed end of the fitting. Pinch the fitting to hold it in place.

Align the jaws of a full-circle crimping tool over the crimp ring and squeeze the handles together to apply strong, even pressure to the ring.

Test the connection to make sure it is mechanically acceptable, using a go/no-go gauge. If the ring does not fit into the gauge properly, cut the pipe near the connection and try again.

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#175 Dtp:225 Page:295

How to Plumb a PEX Water-Supply System

Install copper manifolds (one for hot and one for cold) in an accessible location central to the fixtures. The manifold should have one outlet for each supply line it will support (fixtures that require hot and cold supply will need a separate outlet for each). Run supply lines from the water heater and water main to the copper manifolds. Connect the supply pipes to the manifolds with crimp fittings.

A manifold may be attached vertically or horizontally, but it must be anchored with correctly sized hangers screwed to the framing members.

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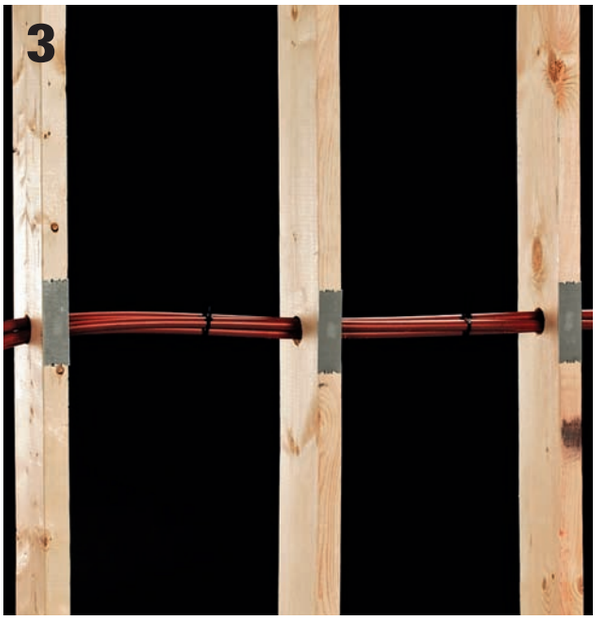
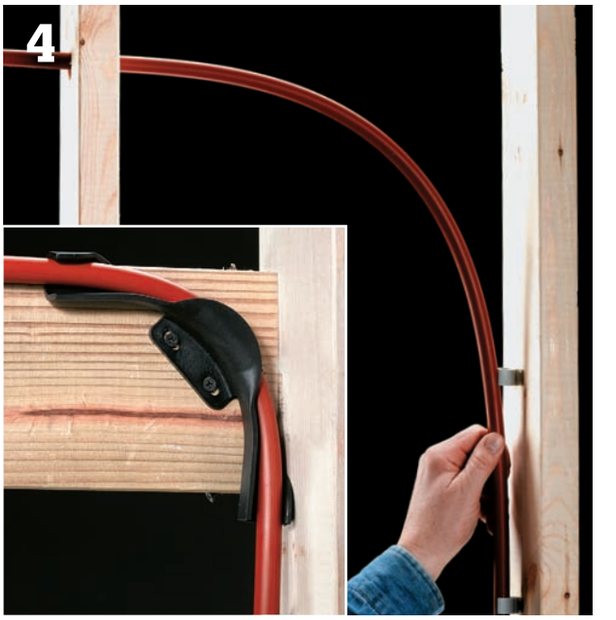


Starting at each fixture (and leaving at least 12" of extra pipe exposed), run appropriately sized PEX through holes in the framing to the manifolds. Pipes may be bundled together loosely with plastic ties. Protect the line with a nailing plate at each stud location. Be sure to leave some slack in the supply lines.



Support the pipe with a plastic hanger near every floor or ceiling and midway up vertical runs. Also use hangers to guide pipe near the beginnings and ends of curves and near fittings. Use a plastic guide for sharp curves (inset). Do not bend PEX so sharply that it kinks.

Cut each branch supply line to length (leave some extra in case you need to recrimp). Install shutoff valves for each outlet (most manifolds come with preattached valves). Connect the PEX branch supply lines to the shutoff valves. Label each pipe. Use a short length of PEX and a plug to seal any unused outlets (inset).

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:297

Galvanized Steel

Galvanized steel pipe often is found in older homes, where it is used for water supply and small drain lines. It can be identified by the zinc coating that gives it a silver color and by the threaded fittings used to connect pipes.

Glavanized steel pipes and fittings will corrode with age and eventually must be replaced. Low water pressure may be a sign that the insides of galvanized pipes have a buildup of rust or other minerals. Blockage usually occurs in elbow fittings. Never try to clean the insides of galvanized steel pipes. Instead, remove and replace them as soon as possible.

Glavanized steel pipe and fittings are available at hardware stores and home improvement centers. Always specify the interior diameter (I.D.) when purchasing galvanized pipes and fittings. Pre-threaded pipes, called nipples, are available in lengths from 1" to 1 ft. If you need a longer length, have the store cut and thread the pipe to your dimensions.

Old galvanized steel can be difficult to repair. Fittings are often rusted in place, and what seems like a small job may become a large project. For example, cutting apart a section of pipe to replace a leaky fitting may reveal that adjacent pipes are also in need of replacement. If your job takes an unexpected amount of time, you can cap off any open lines and restore water to the rest of your house. Before you begin a repair, have on hand nipples and end caps that match your pipes.

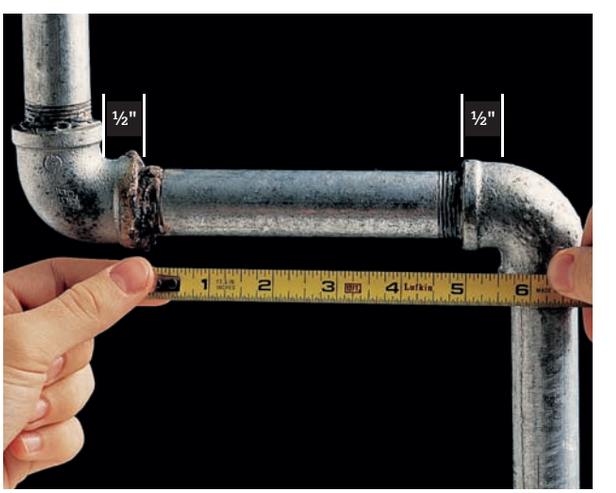
Taking apart a system of galvanized steel pipes and fittings is time-consuming. Disassembly must start at the end of a pipe run, and each piece must be unscrewed before the next piece can be removed. Reaching the middle of a run to replace a section of pipe can be a long and tedious job. Instead, use a special three-piece fitting called a union. A union makes it possible to remove a section of pipe or a fitting without having to take the entire system apart.

Note: Galvanized steel is sometimes confused with "black iron." Both types have similar sizes and fittings. Black iron is used only for gas lines.

Tools & Materials ▸

- Tape measure
- Reciprocating saw with metal-cutting blade or a hacksaw
- Pipe wrenches
- Propane torch
- Wire brush
- Nipples
- End caps
- Union fitting
- Pipe joint compound
- Replacement fittings (if needed)

Galvanized pipe was installed in homes for both gas and water supply pipes until the middle part of the last century. Although it is not used for new installations today, it can still be repaired easily using simple tools and techniques.



Measure the old pipe. Include ½" at each end for the threaded portion of the pipe inside fitting. Bring overall measurement to the store when shopping for replacement parts.

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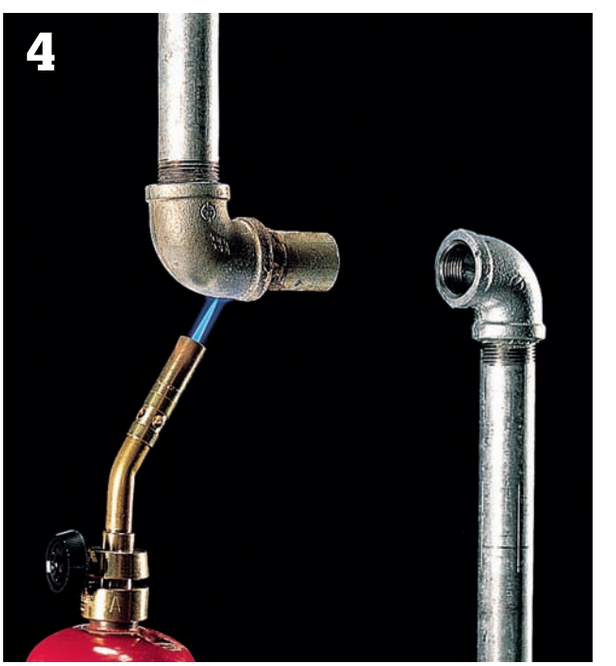
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:298

How to Remove & Replace a Glavanized Steel Pipe

Cut through galvanized steel pipe with a reciprocating saw and a metal-cutting blade or with a hacksaw.

Hold the fitting with one pipe wrench, and use another wrench to remove the old pipe. The jaws of the wrenches should face opposite directions. Always move the wrench handle toward the jaw opening.

Remove any corroded fittings using two pipe wrenches. With the jaws facing in opposite directions, use one wrench to turn fitting and the other to hold the pipe. Clean the pipe threads with a wire brush.



Heat stubborn fittings with a torch to make them easier to remove. Apply flame for 5 to 10 seconds. Protect wood and other flammable materials from heat, using a double layer of sheet metal.

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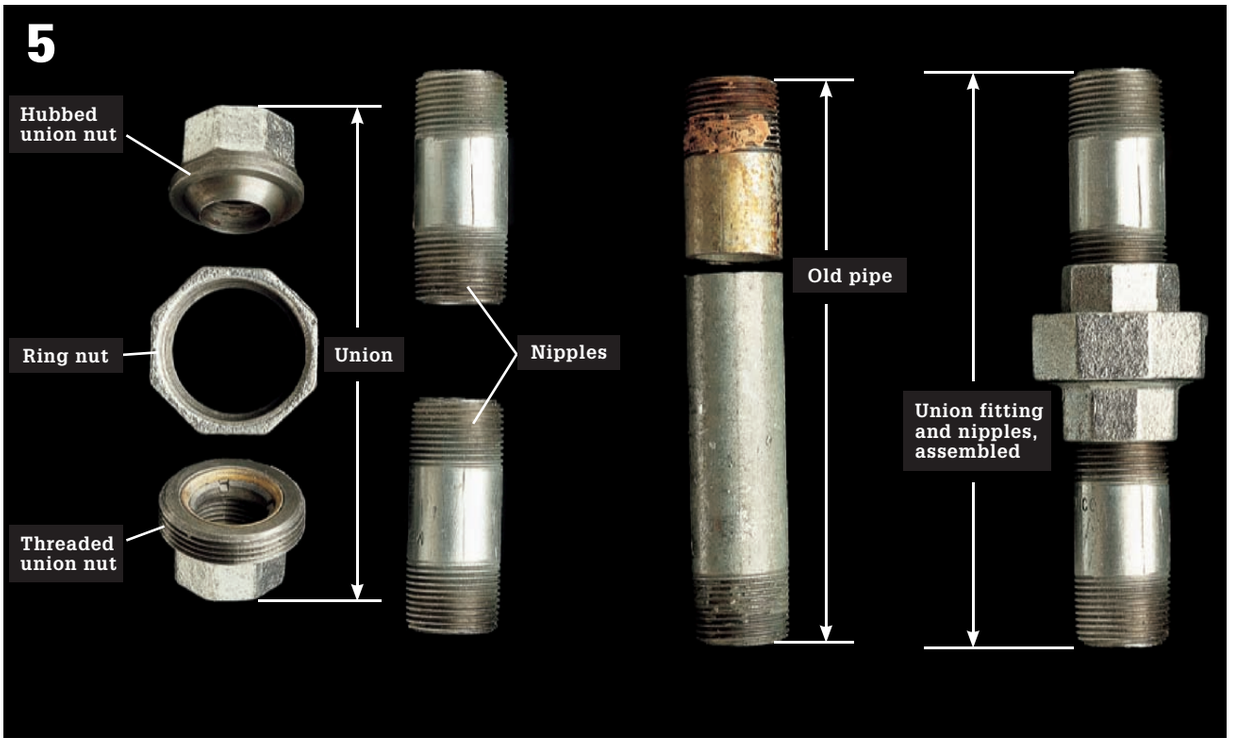
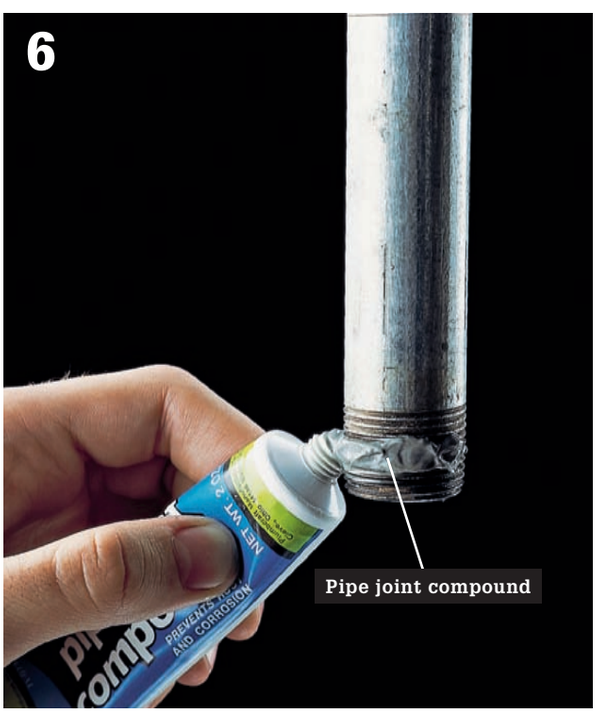


Replace a section of galvanized steel pipe with a union fitting and two threaded pipes (nipples). When assembled, the union and nipples must equal the length of the pipe that is being replaced.



Apply a bead of pipe joint compound or pipe tape around the threaded ends of all pipes and nipples. Spread the compound evenly over the threads with your fingertip.

Screw new fittings onto pipe threads. Tighten fittings with two pipe wrenches, leaving them about one-eighth turn out of alignment to allow assembly of the union.

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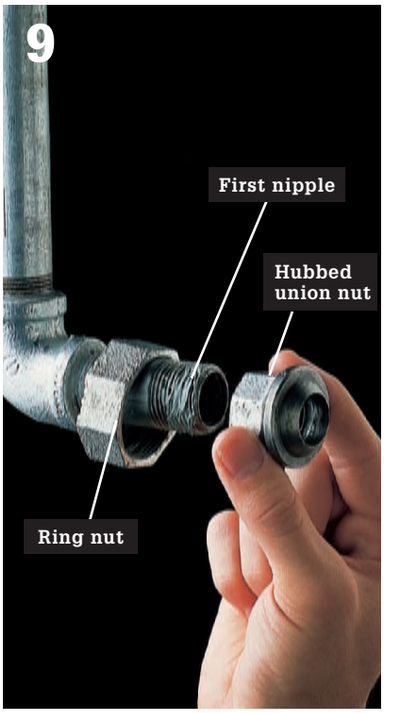
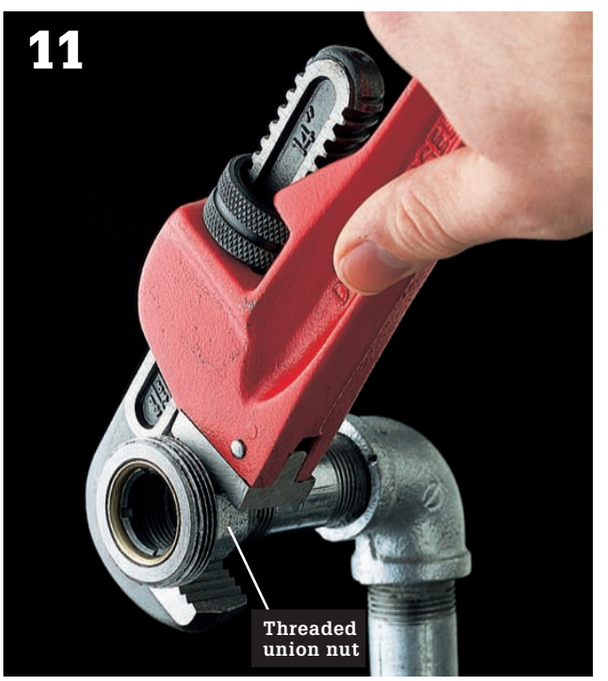
#175 Dtp:225 Page:300

Screw the first nipple into the fitting, and tighten with a pipe wrench.

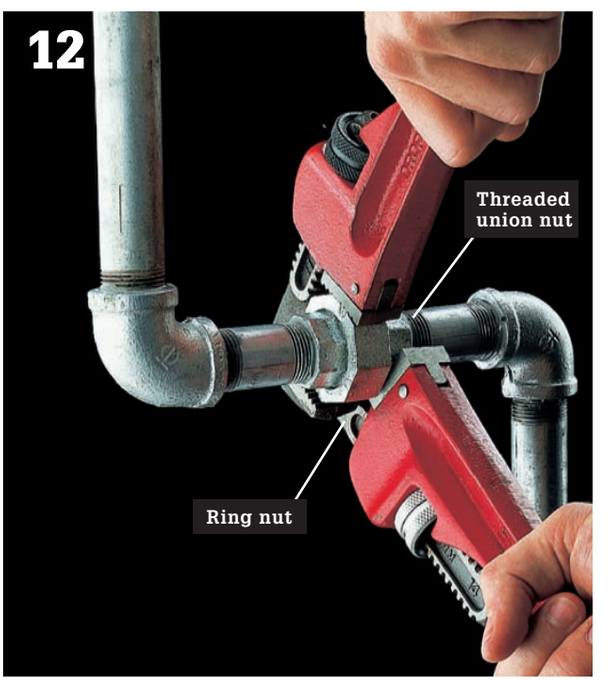


Slide a ring nut onto the installed nipple, then screw the hubbed union nut onto the nipple and tighten with a pipe wrench.

Screw the second nipple onto the other fitting. Tighten with a pipe wrench.



Screw the threaded union nut onto the second nipple. Tighten with a pipe wrench. Turn pipes into alignment, so that the lip of the hubbed union nut fits inside the threaded union nut.



Complete the connection by screwing the ring nut onto the threaded union nut. Tighten the ring nut with pipe wrenches.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
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Cast Iron

Cast-iron pipe often is found in older homes, where it is used for large DWV pipes, especially the main stack and sewer service lines. It can be identified by its dark color, rough surface, and large size. Cast-iron pipes in home drains usually are 3" or more in diameter.

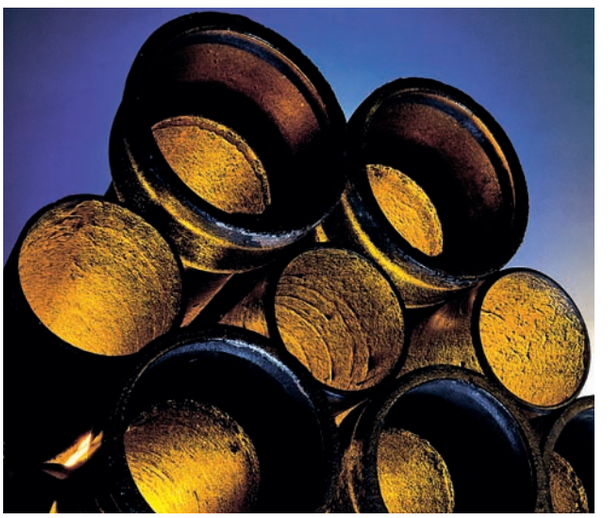
Cast-iron pipes may rust through or hubbed fittings (below) may leak. If your house is more than 30 years old, you may find it necessary to replace a cast-iron pipe or joint.

Cast iron is heavy and difficult to cut and fit. For this reason, leaky cast-iron pipe usually is replaced with PVC of the same diameter. PVC can be joined to cast iron easily, using a banded coupling (below).

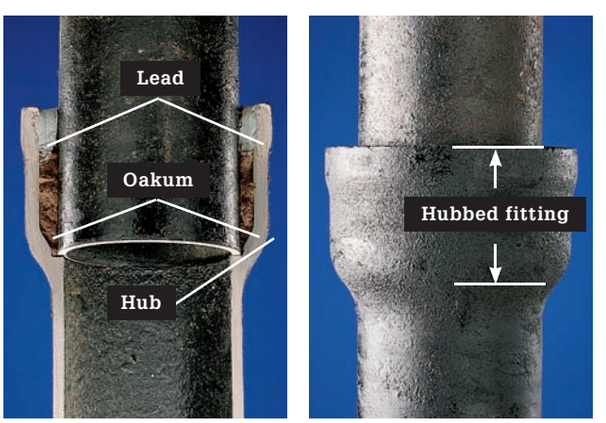
Tools & Materials ▸

Tape measure	Screwdriver
Chalk	Riser clamps or strap hangers
Adjustable wrenches	Two wood blocks
Reciprocating saw (or rented snap cutter)	2½" wallboard screws
Ratchet wrench	Banded couplings
	Plastic replacement pipe

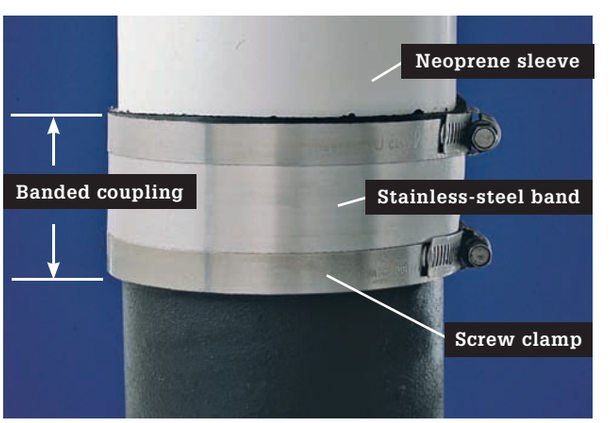
Snap cutters are the traditional tool of choice for cutting cast iron (see page 307), but today's variable-speed reciprocating saws do the job easily and safely. Use a long metal-cutting blade and set the saw at low speed. Wear eye and ear protection when cutting cast iron pipe.



Cast-iron pipe was used almost exclusively for drain systems until the introduction of heavy-duty PVC drain pipes. It is tough to work with and in most cases replacing it makes sense.



Hubbed fittings (shown cutaway, left) were used to join cast-iron pipe. Hubbed pipe has a straight end and a flared end. The straight end of one pipe fits inside the hub of the next pipe. In the old days, joints were sealed with packing material (oakum) and lead. Repair leaky joints by cutting out the entire hubbed fitting and replacing with plastic pipe.



Banded couplings may be used to replace leaky cast iron with a PVC or ABS plastic pipe. The new plastic pipe is connected to the remaining cast-iron pipe with a banded coupling. Banded coupling has a neoprene sleeve that seals the joint. Pipes are held together with stainless steel bands and screw clamps.

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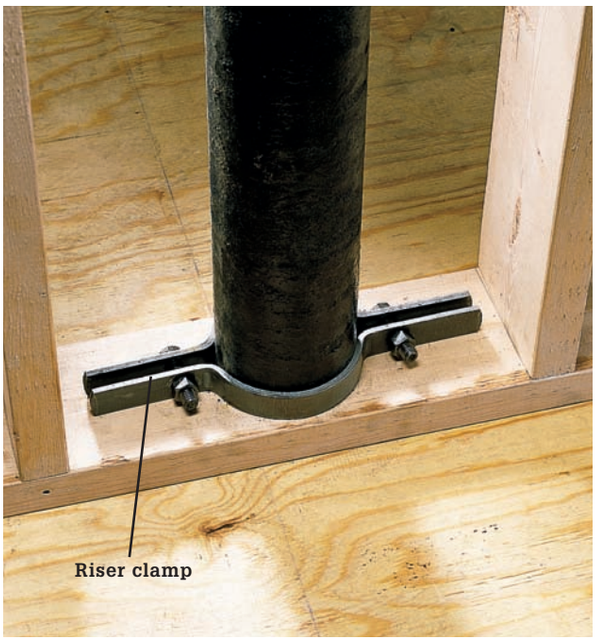
Cutting Cast-Iron Pipe

Before cutting a horizontal run of cast-iron drain pipe, make sure it is supported with strap hangers every 5 ft. and at every joint connection.

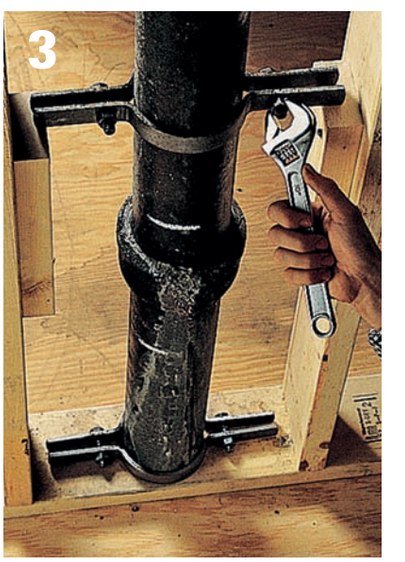


Before cutting a vertical run of cast-iron pipe, make sure it is supported at every floor level with a riser clamp. Never cut through pipe that is not supported.

How to Remove & Replace a Section of Cast-Iron Pipe

Use chalk to mark cut lines on the cast-iron pipe. If replacing a leaky hub, mark at least 6" on each side of hub.

Support lower section of pipe by installing a riser clamp flush against the bottom plate or floor.



Support the upper section of pipe by installing a riser clamp 6" above the pipe section to be replaced. Attach wood blocks to the studs with 2½" deck screws, so that the riser clamp rests on tops of blocks.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:303

Wrap the chain of the snap cutter around the pipe, so that the cutting wheels are against the chalkline.

Tighten the chain and snap the pipe according to the tool manufacturer's directions.

Repeat cutting at the other chalkline. Remove cut section of pipe.

Cut a length of PVC plastic pipe to be ½" shorter than the section of cast-iron pipe that has been cut away.

Slip a banded coupling and a neoprene sleeve onto each end of the cast-iron pipe.

Make sure the cast-iron pipe is seated snugly against the rubber separator ring molded into the interior of the sleeve.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:304

Fold back the end of each neoprene sleeve until the molded separator ring on the inside of the sleeve is visible.

Position the new plastic pipe so it is aligned with the cast-iron pipes.

Roll the ends of the neoprene sleeves over the ends of the new plastic pipe.

Slide stainless-steel bands and clamps over the neoprene sleeves.

Tighten the screw clamps with a ratchet wrench or screwdriver.

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Pipe Fittings

Use the photos on these pages to identify the plumbing fittings specified in the project how-to directions found in this book. Each fitting shown is available in a variety of sizes to match your needs. Always use fittings made from the same material as your pipes.

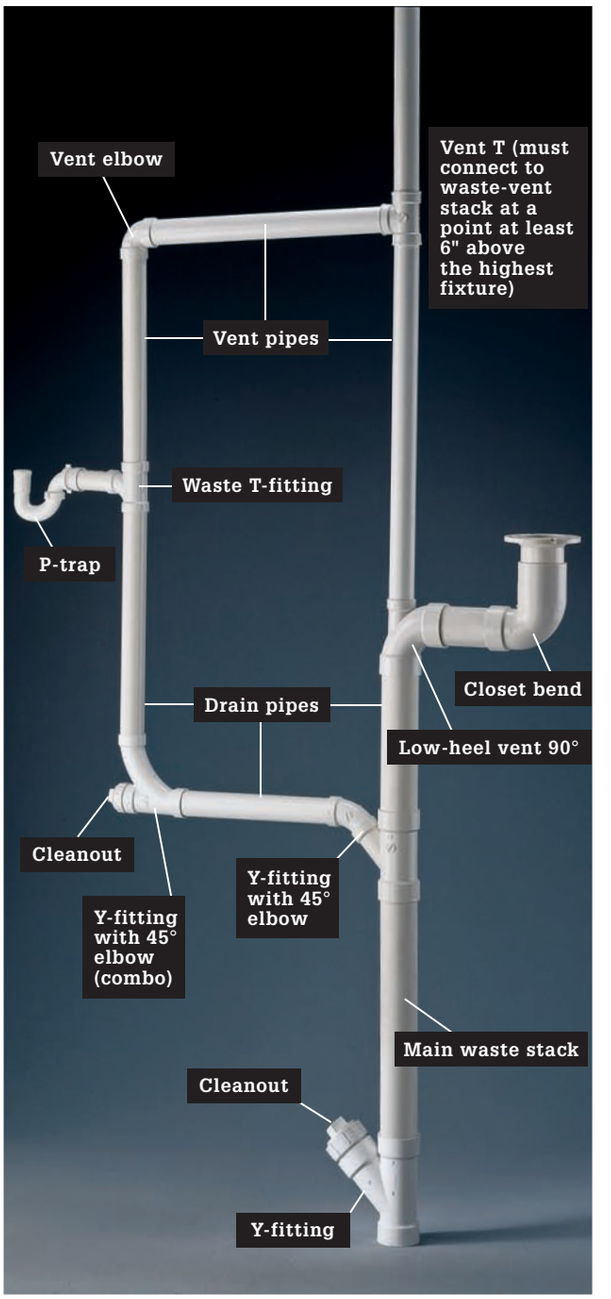
Pipe fittings come in a variety of shapes to serve different functions within the plumbing system. DWV fittings include:

Vents: In general, the fittings used to connect vent pipes have very sharp bends with no sweep. Vent fittings include the vent T and vent 90° elbow. Standard drain pipe fittings can also be used to join vent pipes.

Horizontal-to-vertical drains: To change directions in a drain pipe from the horizontal to the vertical, use fittings with a noticeable sweep. Standard fittings for this use include waste T-fittings and 90° elbows. Y-fittings and 45° and 22½° elbows can also be used for this purpose.

Vertical-to-horizontal drains: To change directions from the vertical to the horizontal, use fittings with a very pronounced, gradual sweep. Common fittings for this purpose include the long-radius T-Y-fitting and some Y-fittings with 45° elbows.

Horizontal offsets in drains: Y-fittings, 45° elbows, 22½° elbows, and long sweep 90° elbows are used when changing directions in horizontal pipe runs. Whenever possible, horizontal drain pipes should use gradual, sweeping bends rather than sharp turns.



Basic DWV tree shows the correct orientation of drain and vent fittings in a plumbing system. Bends in the vent pipes can be very sharp, but drain pipes should use fittings with a noticeable sweep. Fittings used to direct falling waste water from a vertical to a horizontal pipe should have bends that are even more sweeping. Your local plumbing code may require that you install cleanout fittings where vertical drain pipes meet horizontal runs.

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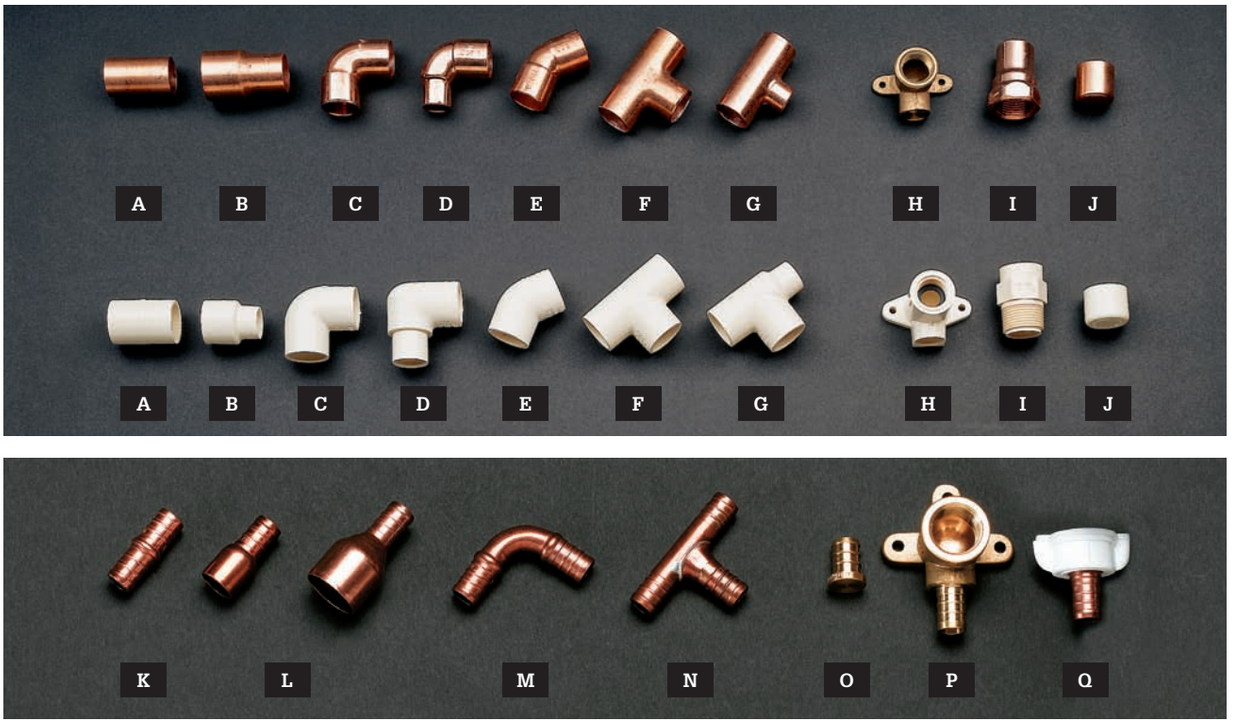
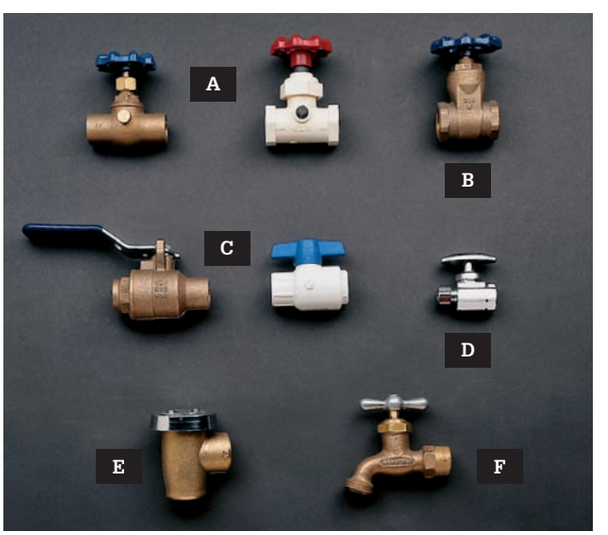
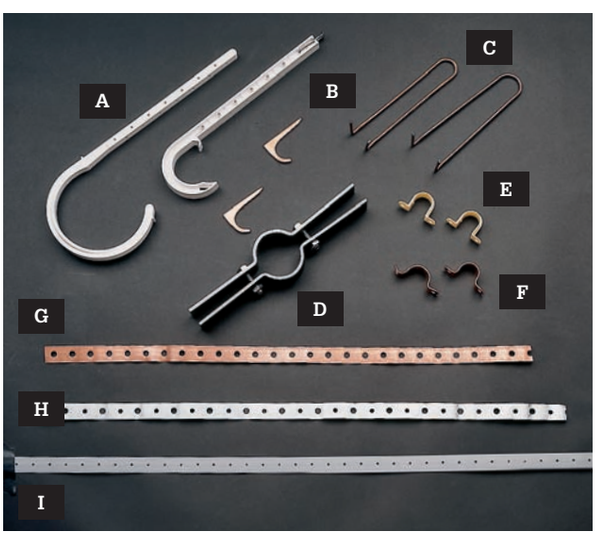


Water supply fittings are available for copper (top), CPVC plastic (center), and PEX (bottom). Fittings for CPVC and copper are available in many shapes, including: unions (A), reducers (B), 90º elbows (C), reducing elbows (D), 45º elbows (E), T-fittings (F), reducing T-fittings (G), drop-ear elbows (H), threaded adapters (I), and caps (J). Common PEX fittings (bottom) include unions (K), PEX-to-copper unions (L), 90º elbows (M), T-fittings (N), plugs (O), drop-ear elbows (P), and threaded adapters (Q). Easy-to-install push fittings are also available; see page 283.



Water supply valves are available in brass or plastic and in a variety of styles, including: drain-and-waste valves (A), gate valve (B), full-bore ball valves (C), fixture shutoff valve (D), vacuum breaker (E), and hose bib (F).



Support materials for pipes include: plastic pipe hangers (A), copper J-hooks (B), copper wire hangers (C), riser clamp (D), plastic pipe straps (E), copper pipe straps (F), flexible copper, steel, and plastic pipe strapping (G, H, I). Do not mix metal types when supporting metal pipes; use copper support materials for copper pipe, and steel for steel and cast-iron pipes.

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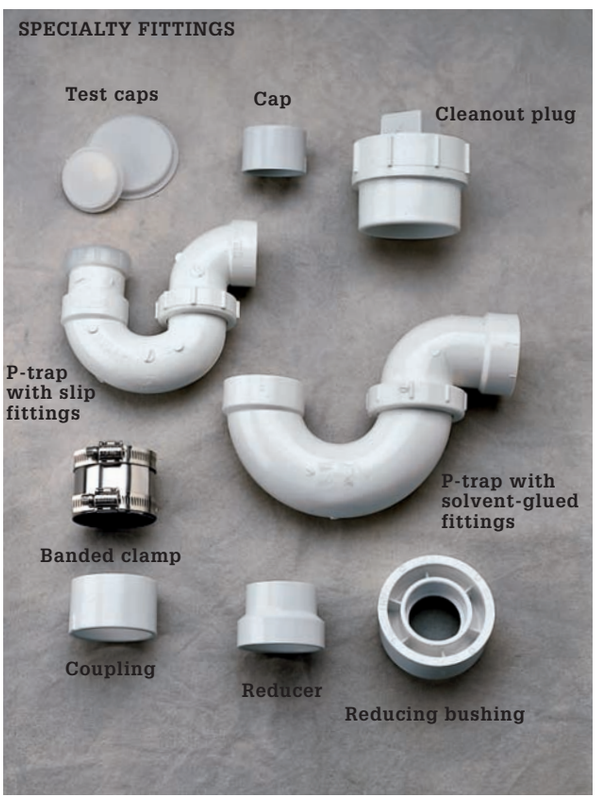

Fittings for DWV pipes are available in many configurations, with openings ranging from 1¼" to 4" in diameter. When planning your project, buy plentiful numbers of DWV and water supply fittings from a reputable retailer with a good return policy. It is much more efficient to return leftover materials after you complete your project than it is to interrupt your work each time you need to shop for a missing fitting.

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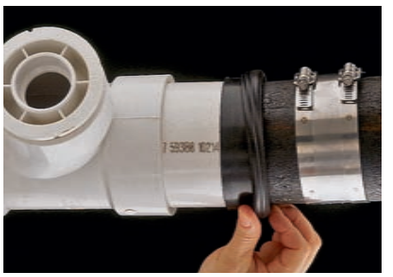
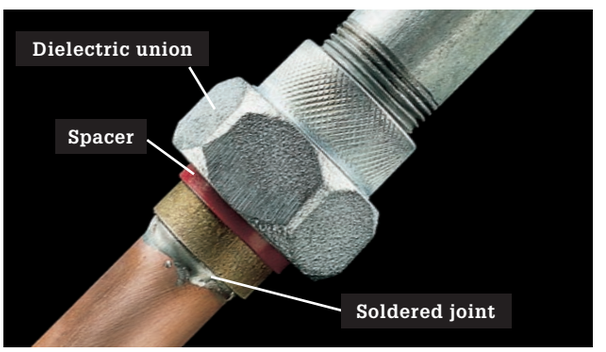
How to Use Transition Fittings

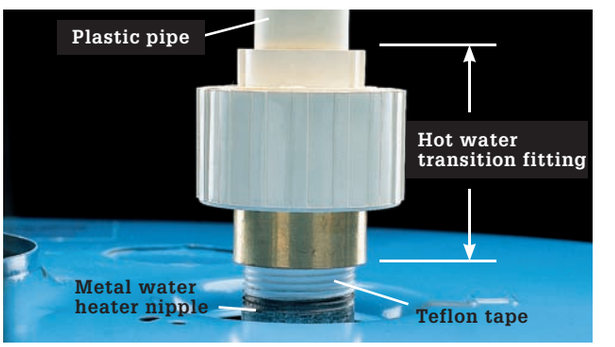


Connect plastic to cast iron with banded couplings. Rubber sleeves cover ends of pipes and ensure a watertight joint.

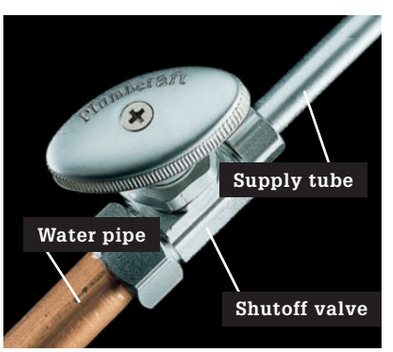
Make transitions in DWV pipes with rubber couplings. The two products shown here (Mission-brand fittings, see Resources page 330) can be used to connect pipes of different materials, as well as same-material pipes that need a transition.



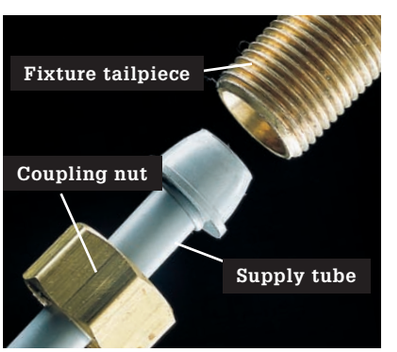
Connect copper to galvanized steel with a dielectric union. A dielectric union is threaded onto iron pipe and is soldered to copper pipe. A dielectric union has a plastic spacer that prevents corrosion caused by an electrochemical reaction between dissimilar metals.



Connect metal hot water pipe to plastic with a hot water transition fitting that prevents leaks caused by different expansion rates of materials. Metal pipe threads are wrapped with Teflon tape. Plastic pipe is solvent-glued to fitting.



Connect a water pipe to any fixture supply tube, using a shutoff valve.



Connect any supply tube to a fixture tailpiece with a coupling nut. The coupling nut compresses the bell-shaped end of the supply tube against the fixture tailpiece.

Specialty supply fittings can be used to supply portable water fixtures such as icemakers and hot water dispensers. The John-Guest Speed-Fit fitting shown here (see Resources, page 330) is designed to connect to clear tubing or the manufacturer's proprietary plastic supply tubing.

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Shutoff Valves

Worn-out shutoff valves or supply tubes can cause water to leak underneath a sink or other fixture. First, try tightening the fittings with an adjustable wrench. If this does not fix the leak, replace the shutoff valves and supply tubes.

Shutoff valves are available in several fitting types. For copper pipes, valves with compression-type fittings (page 315) are easiest to install. For plastic pipes, use grip-type valves. For galvanized steel pipes, use valves with female threads.

Older plumbing systems often were installed without fixture shutoff valves. When repairing or replacing plumbing fixtures, you may want to install shutoff valves if they are not already present.

Tools & Materials ▸

Hacksaw	Felt-tipped pen
Tubing cutter	Shutoff valves
Adjustable wrench	Supply tubes
Tubing bender	Pipe joint compound

Shutoff valves allow you to shut off the water to an individual fixture so it can be repaired. They can be made from durable chromed brass or lightweight plastic. Shutoff valves come in ½" and ¾" diameters to match common water pipe sizes.

Supply tubes are used to connect water pipes to faucets, toilets, and other fixtures. They come in 12", 20", and 30" lengths. PB plastic and chromed copper tubes are inexpensive. Braided steel and vinyl mesh supply tubes are easy to install.

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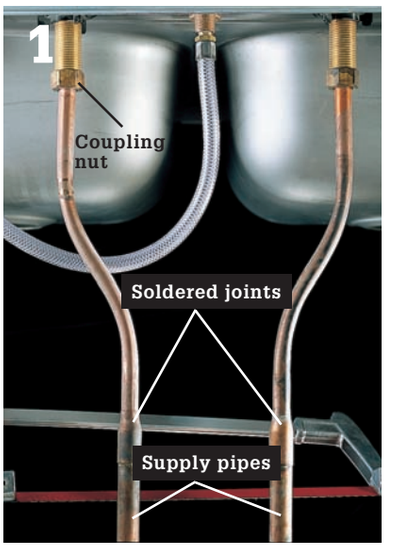
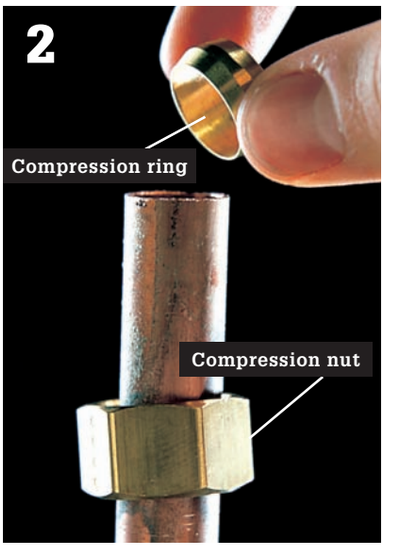
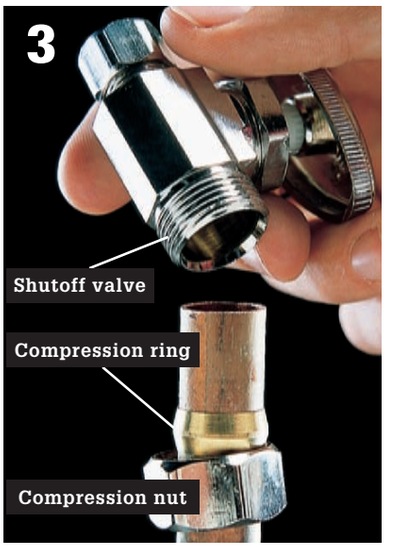
How to Install Shutoff Valves & Supply Tubes



Turn off water at the main shutoff valve. Remove old supply pipes. If pipes are soldered copper, cut them off just below the soldered joint, using a hacksaw or tubing cutter. Make sure the cuts are straight. Unscrew the coupling nuts and discard the old pipes.



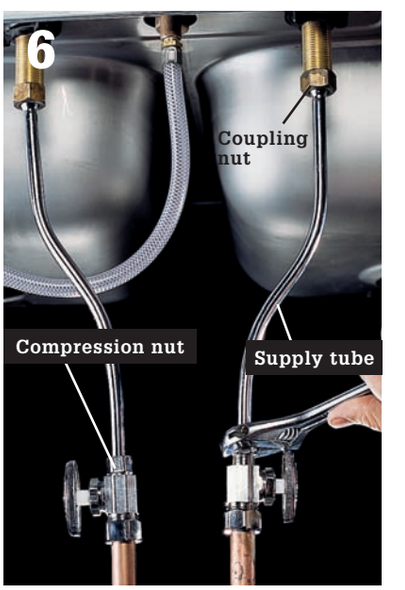
Slide a compression nut and a compression ring over the copper water pipe. Threads of the nut should face the end of the pipe.



Apply pipe joint compound to the threads of the shutoff valve or compression nut. Screw the compression nut onto the shutoff valve and tighten with an adjustable wrench.

Bend chromed copper supply tube to reach from the tailpiece of the fixture to the shutoff valve, using a tubing bender. Bend the tube slowly to avoid kinking the metal.

Position the supply tube between fixture tailpiece and the shutoff valve, and mark the tube to length. Cut the supply tube with a tubing cutter (page 272).



Attach the bell-shaped end of the supply tube to the fixture tailpiece with a coupling nut, then attach the other end to the shutoff valve with compression ring and nut. Tighten all fittings with an adjustable wrench.

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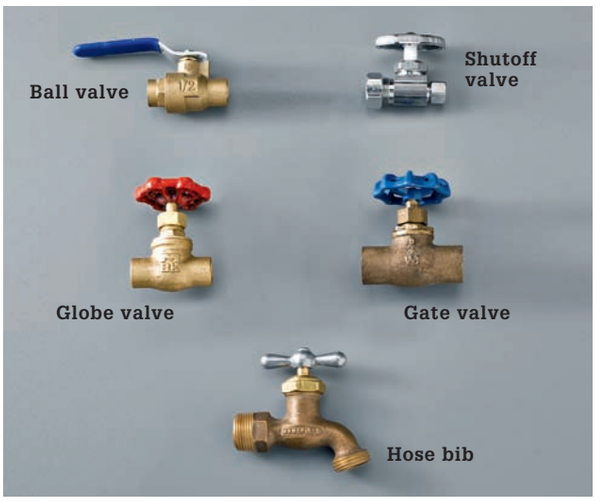
Valves & Hose Bibs

Valves make it possible to shut off water at any point in the supply system. If a pipe breaks or a plumbing fixture begins to leak, you can shut off water to the damaged area so that it can be repaired. A hose bib is a faucet with a threaded spout, often used to connect rubber utility or appliance hoses.

Valves and hose bibs leak when washers or seals wear out. Replacement parts can be found in the same universal washer kits used to repair compression faucets. Coat replacement washers with faucet grease to keep them soft and prevent cracking.

If you have the opportunity to replace a shutoff valve, install a ball valve, which has proved itself to be the most reliable type.

Remember to turn off the water before beginning work.



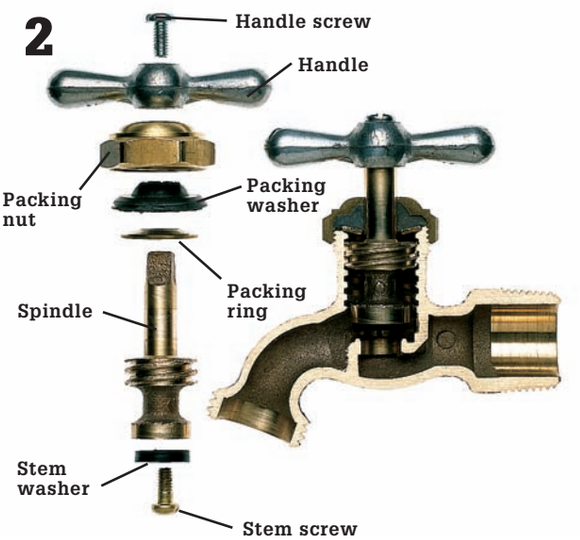
With the exception of chromed shutoff valves that are installed at individual fixtures (see previous pages), valves and hose bibs are heavy-duty fittings, usually with a brass body they are installed in-line to regulate water flow. Gate valves and globe valves are similar and are operated with a wheel-type handle that spins. Ball valves are operated with a handle much like a gas pipe stopcock and are considered by pros to be the most reliable. Hose bibs are spigots with a threaded end designed to accept a female hose coupling.

Tools & Materials

Screwdriver	Universal washer kit
Adjustable wrench	Faucet grease

How to Fix a Leaky Hose Bib

Remove the handle screw and lift off the handle. Unscrew the packing nut with an adjustable wrench.



Unscrew the spindle from the valve body. Remove the stem screw and replace the stem washer. Replace the packing washer and reassemble the valve.

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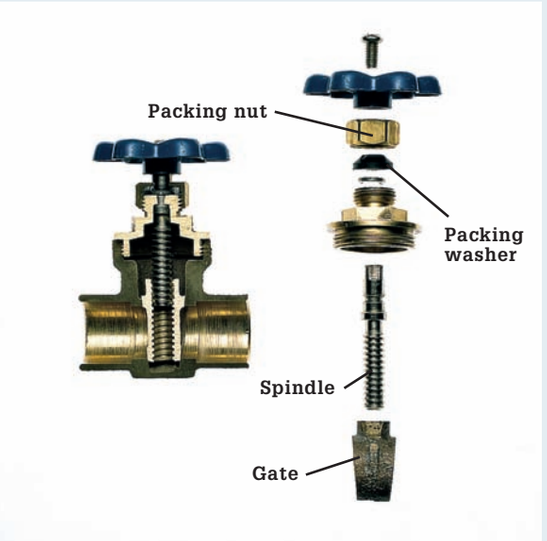
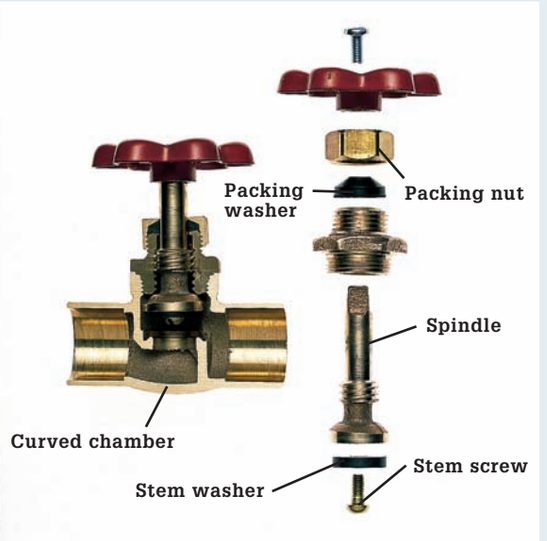
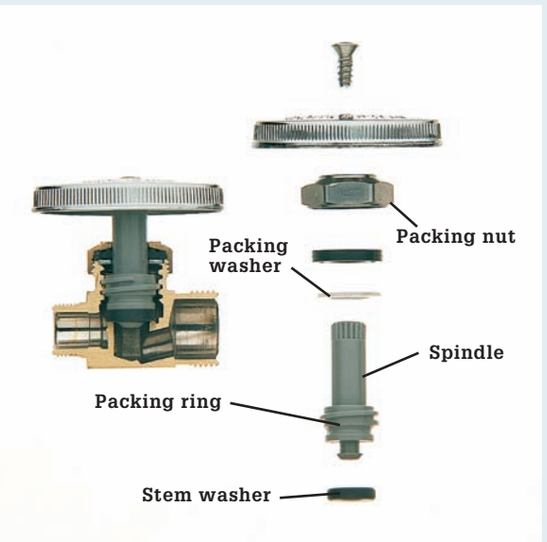
Common Types of Valves



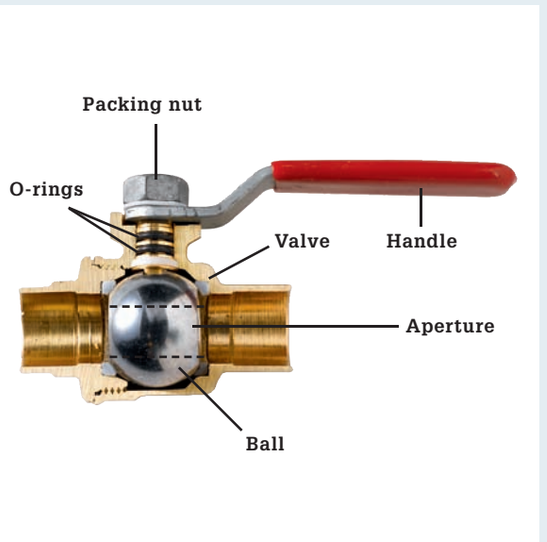
Gate valve has a movable brass wedge, or "gate," that screws up and down to control water flow. Gate valves may develop leaks around the handle. Repair leaks by replacing the packing washer or packing string found underneath the packing nut.



Globe valve has a curved chamber. Repair leaks around the handle by replacing the packing washer. If valve does not fully stop water flow when closed, replace the stem washer.



Shutoff valve controls water supply to one or more fixtures. A shutoff valve has a plastic spindle with a packing washer and a snap-on stem washer. Repair leaks around the handle by replacing the packing washer. If a valve does not fully stop water flow when closed, replace the stem washer. Shutoff valves with multiple outlets are available to supply several fixtures from a single supply.



Ball valve contains a metal ball with an aperture (or controlled hole) in the center. The ball is controlled by a handle. When the handle is turned the hole is positioned parallel to the valve (open) or perpendicular (closed).

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
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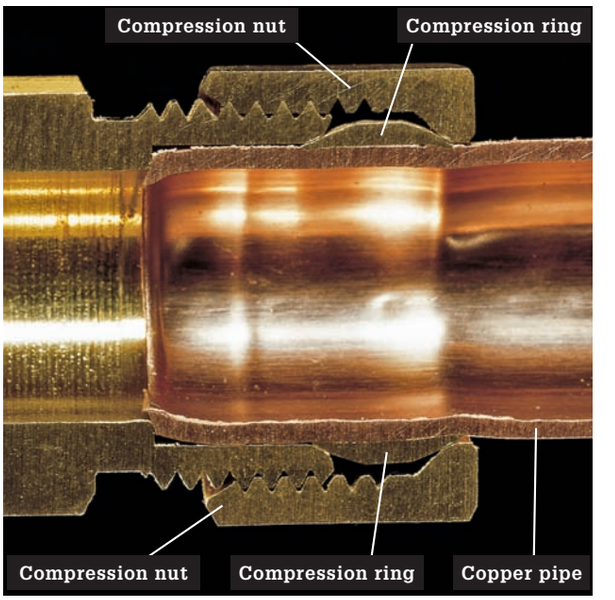
Compression Fittings

Compression fittings are used to make connections that may need to be taken apart. Compression fittings are easy to disconnect and are often used to install supply tubes and fixture shutoff valves. Use compression fittings in places where it is unsafe or difficult to solder, such as in crawl spaces.

Compression fittings are used most often with flexible copper pipe. Flexible copper is soft enough to allow the compression ring to seat snugly, creating a watertight seal. Compression fittings also may be used to make connections with Type M rigid copper pipe.



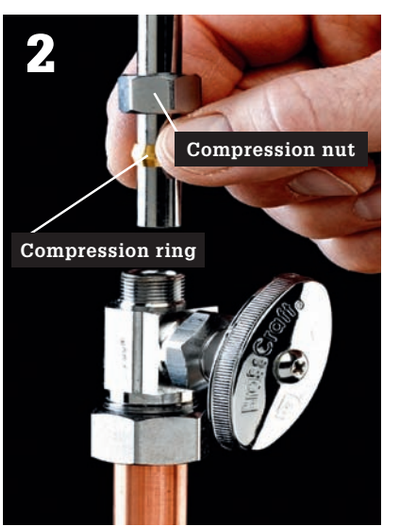
Compression fitting (shown in cutaway) shows how threaded compression nut forms seal by forcing the compression ring against the copper pipe. Compression ring is covered with pipe joint compound before assembling to ensure a perfect seal.

Tools & Materials

- Felt-tipped pen
- Tubing cutter or hacksaw
- Adjustable wrenches
- Brass compression fittings
- Pipe joint compound or Teflon tape

How to Attach Supply Tubes to Fixture Shutoff Valves with Compression Fittings

Bend flexible copper supply tube and mark to length. Include ½" for portion that will fit inside valve. Cut tube.



Slide the compression nut and then the compression ring over the end of the pipe. The threads of the nut should face the valve.

Apply a small amount of pipe joint compound to the threads. This lubricates the threads.

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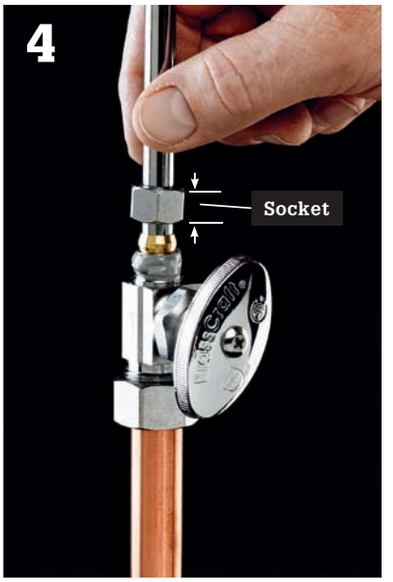
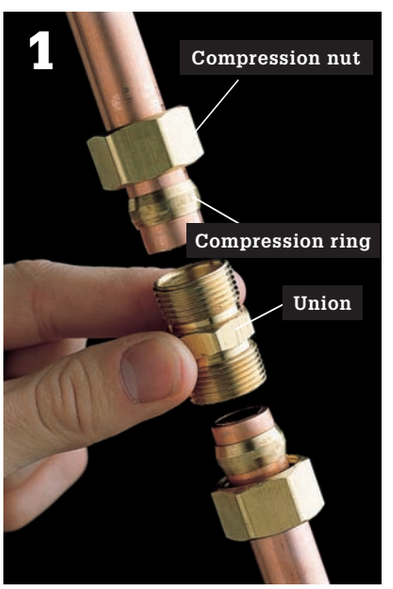


Insert the end of the pipe into the fitting so it fits flush against the bottom of the fitting socket.

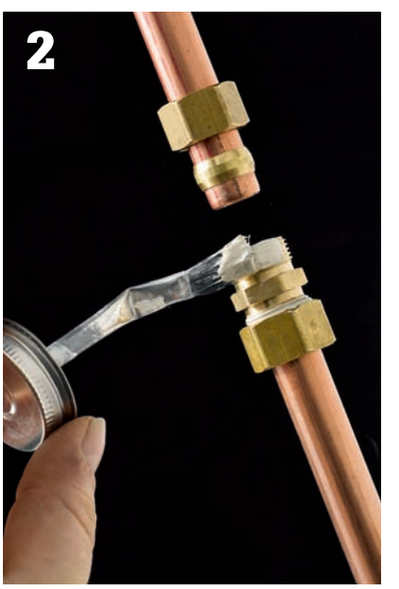
Slide the compression ring and nut against the threads of the valve. Hand tighten the nut onto the valve.

Tighten the compression nut with adjustable wrenches. Do not overtighten. Turn on the water and watch for leaks. If the fitting leaks, tighten the nut gently.

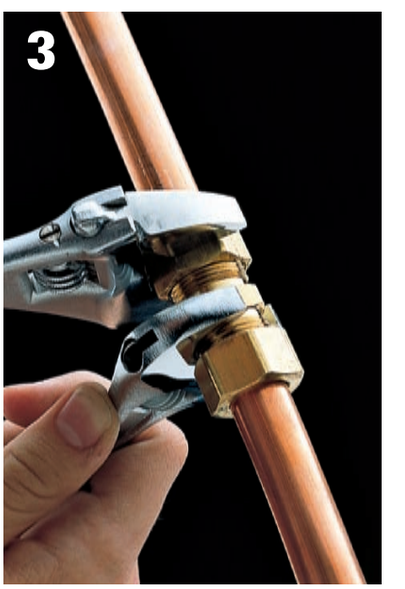
How to Join Two Copper Pipes with a Compression Union Fitting



Slide compression nuts and rings over the ends of pipes. Place a threaded union between the pipes.



Apply a layer of pipe joint compound or Teflon tape to the union's threads, then screw compression nuts onto the union.



Hold the center of the union fitting with an adjustable wrench and use another wrench to tighten each compression nut one complete turn. Turn on the water. If the fitting leaks, tighten the nuts gently.

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Gas Pipe Fittings

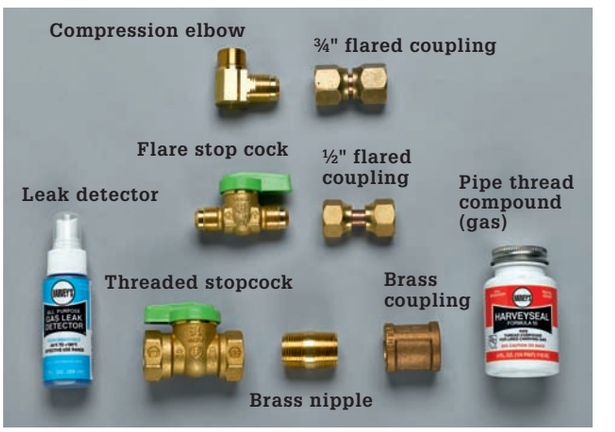
Few word combinations strike more fear into the hearts of liability lawyers than "do-it-yourself" and "gas." Of course there is good reason for this, as working with gas pipe and making gas hookups carry extremely high potential for catastrophe if errors are made. And that is why many municipalities insist that only licensed professionals may install or service gas lines and appliances. If your municipality is one of these, follow the law and keep your hands off the gas. It simply is not worth the risk of doing it yourself.

If your area allows ambitious homeowners to work on their own gas lines and appliances, you should still take some extra time considering whether you really ought to call a professional. If you do decide to proceed, follow all safety precautions to the letter and be very, very careful.

Technically, working with gas pipe is not too different from working with water supply tubing or DWV pipe. For home fuel, gas comes in two forms: natural gas, which is delivered via a pipeline, and liquefied petroleum gas (LP gas), which is stored in a refillable tank or "bottle" at the property. Appliances cannot use these gases interchangeably, though conversion kits are available. Make sure your appliance matches the type of gas you have available.

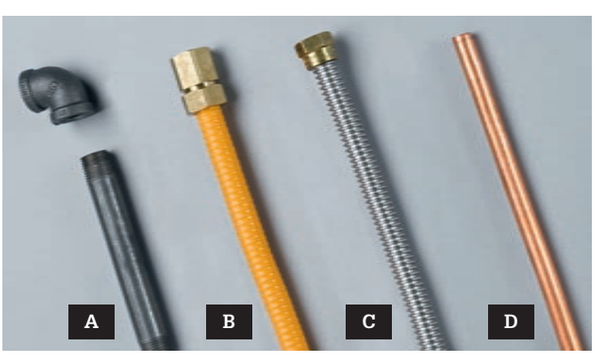
Tools & Materials

- Adjustable wrench
- Gas pipe thread compound
- Leak detector solution
- Teflon tape

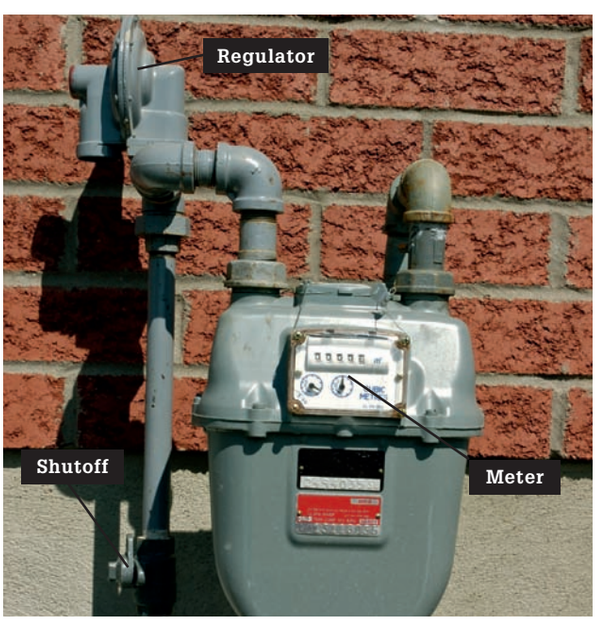


Gas valves and fittings may look similar to those used for water, but use only gas-rated valves and fittings for gas installations. Valves feature quarter-turn on to off and are available with threaded or flare connections. Fittings are available in many sizes measured by outside diameter (O.D.). Fittings can be either are threaded or flared and male or female. Thread compound and leak detector solution are important parts of the gas plumbing tool kit.

Parts of a Gas Delivery System



Black steel pipe (A) is the traditional material for gas piping and is acceptable everywhere. Corrugated stainless steel tubing is coated with PVC (B). Because it is flexible, fewer connections need to be made and the possibility for leaks is diminished. Some areas may not allow this piping. Flexible pipe (C) is often used for connecting appliances to supply lines. Soft copper (D) may be used for gas in some areas, but is not allowable for gas lines in other jurisdictions.



A natural gas meter has a pressure regulator and shutoff valve. The shut off valve is activated with a special gas shutoff wrench, or an adjustable wrench.

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#175 Dtp:225 Page:316

Working with Black Pipe

Working with black pipe is virtually the same as working with galvanized pipe (See pages 298 to 301). The pipe used must be new or, if reused, used previously only for gas fittings.

Black pipe threads are cut in a tapered manner referred to as National Pipe Taper (NPT). The diameter of the male-threaded pipe is smaller at the end. This is why it is easier to thread a fitting on initially, but gets more difficult with each turn. MPT and FPT refer to male and female threads cut to this standard.

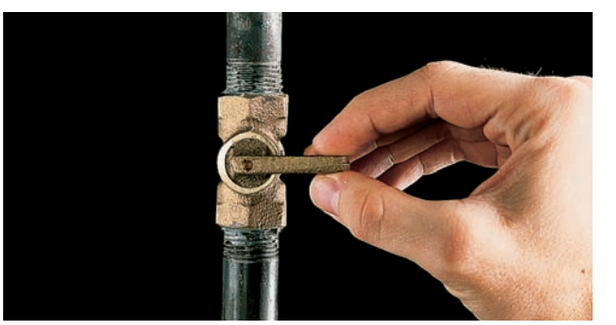
All threads should have pipe joint compound applied before being fitted and all joints must be tested with leak detector solution once the installation is complete. Pipe compounds may be gray, thick paste, or white PTFE (Teflon) paste. You may also use yellow PTFE tape. White PTFE tape that's commonly used for waterlines and hookups is not acceptable for gas line use.

After completing an installation and turning the gas on, each connection must be checked for leaks. Use leak detecting solution sprayed around each joint. If gas is leaking, the solution will bubble and foam. Do not use detergent as a leak detector—it contains corrosive chemicals that may degrade the connection. Tightening the leaky joint will mean that all subsequent joints need to be tightened, not loosened, to accommodate the new alignment. Loosening will potentially create more leaks.

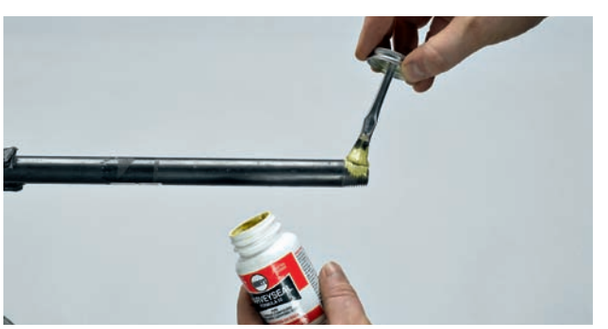
Black pipe is available in a wide variety of threaded lengths. Shorter lengths are referred to as nipples. If you can't make the standard lengths work for your application, most pipe retailers have thread cutting machines and will cut and thread pipe to length, usually for a fee.

Black pipe fittings include Ts, reducers, elbows with two female-threaded ends, street elbows with a male- and a female-threaded end, couplings, and caps.

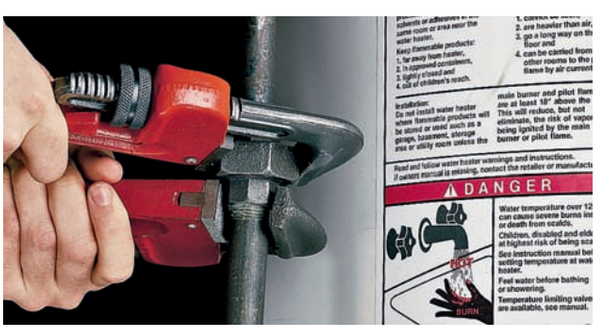
Apply leak detector solution to each joint after you've restored the gas flow to make sure there are no leaks. Leaking gas will cause bubbles in the solution. Do not use ordinary soap—it can lead to corrosion of the metal around the seal.



Shut off the gas by turning the handle of the nearest in-line stopcock so it is perpendicular to the gas line.



Apply an approved gas pipe thread compound liberally all over the threads.



After hand tightening, turn the fitting or pipe at least one full turn to tighten. In order to achieve the proper alignment, you may tighten up to two full turns, but do not overtighten. Use one pipe wrench to stabilize the fixed pipe or fitting, while using the second wrench to tighten the movable pipe or fitting.

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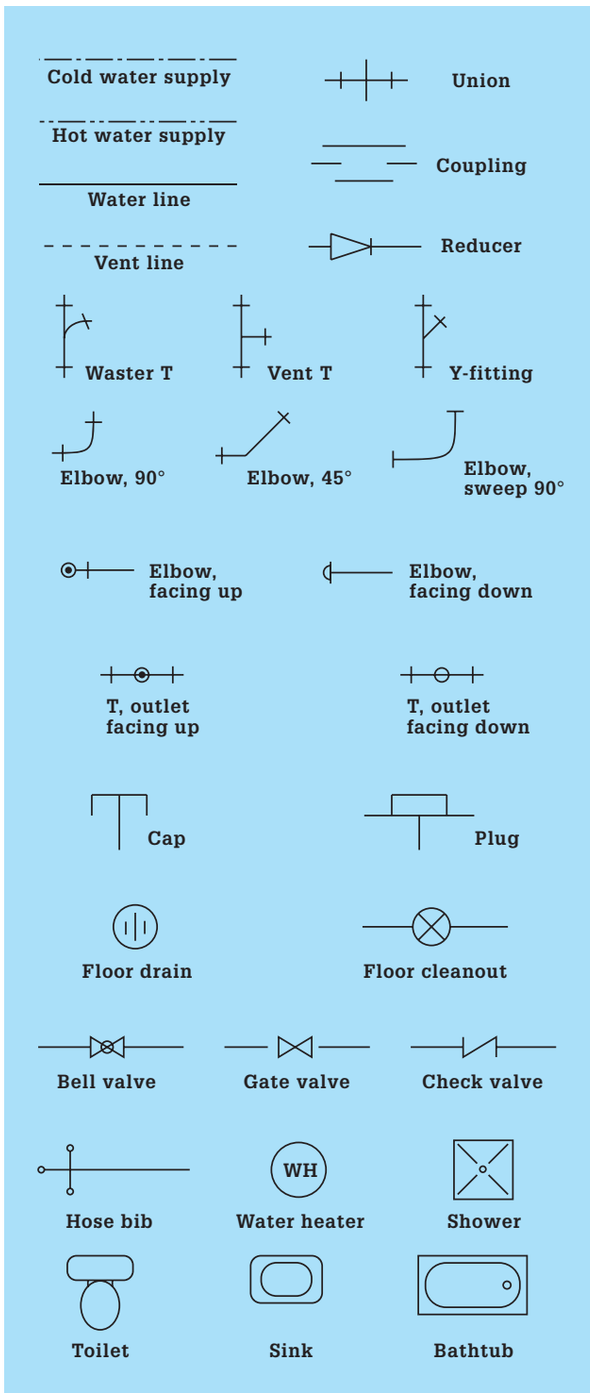
APPENDIX: Planning Your Project

Start planning by drawing maps. Mapping your home's plumbing system is a good way to familiarize yourself with the plumbing layout and can help you when planning plumbing renovation projects. With a good map, you can envision the best spots for new fixtures and plan new pipe routes more efficiently. Maps also help in emergencies, when you need to locate burst or leaking pipes quickly.

Draw a plumbing map for each floor on tracing paper, so you can overlay floors and still read the information below. Make your drawings to scale and have all plumbing fixtures marked. Fixture templates and tracing paper are available at drafting supply stores.

Snoop around your basement for clues about the locations of supply, drain, vent, and gas pipes in your walls.



Use standard plumbing symbols on your map to identify the components of your plumbing system. These symbols will help you and your building inspector follow connections and transitions more easily.

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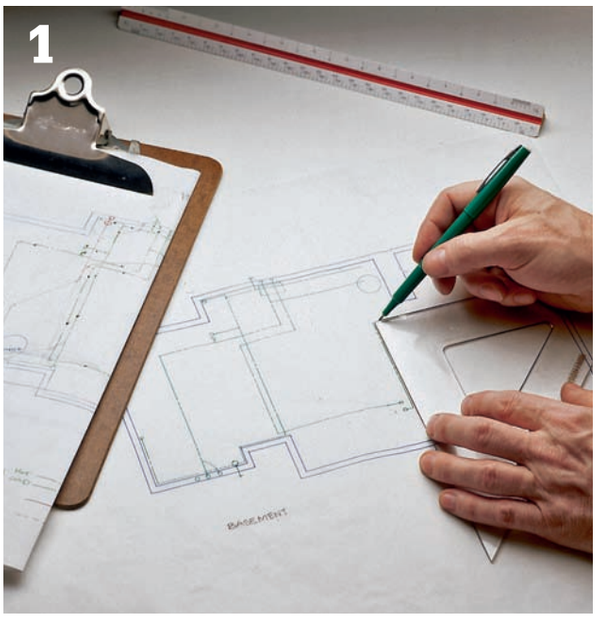
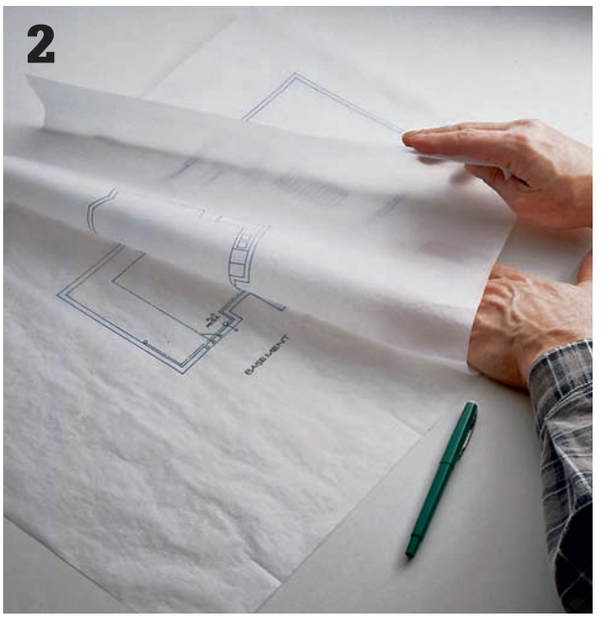
How to Map Your Plumbing System

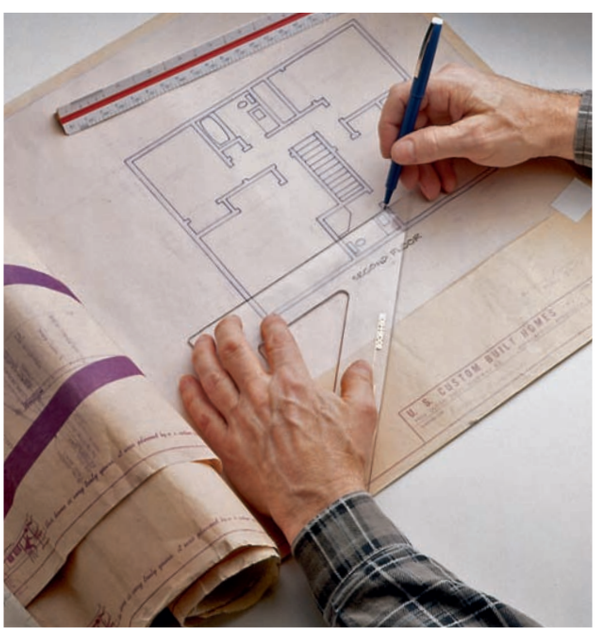


Draw a floorplan for the basement. The drawing should be scaled, legible, and accurate. Note the plumbing features using the symbols on the previous page.



Draw the first floor on a separate piece of transparent drafting paper, using the same scale that you used for the basement. Draw separate floorplans for any additional floors.

Overlay upper-floor diagrams onto the first-floor map, and mark the location of pipes—generally they will extend directly up from fixtures below. If first-story and second-story fixtures are not closely aligned, the supply pipes follow an offset route in wall or floor cavities. By overlaying the maps, you can see the relation and distance between fixtures and accurately estimate pipe routes.



Option: Use floor plans of your house to create your plumbing map. Convert the general outlines for each story to tracing paper. The walls can be drawn larger than scale to fit all the plumbing symbols you will map, but keep overall room dimensions and plumbing fixtures to scale. Be sure to make diagrams for basements and attic spaces as well.

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Understanding Plumbing Codes

The plumbing code is the set of regulations that building officials and inspectors use to evaluate your project plans and the quality of your work. Codes vary from region to region, but most are based on the National Uniform Plumbing Code, the authority we used in the development of this book.

Code books are available for reference at bookstores and government offices. However, they are highly technical, difficult-to-read manuals. More user-friendly for do-it-yourselfers are the variety of code handbooks available at bookstores and libraries. These handbooks are based on the National Uniform Plumbing Code but are easier to read and include many helpful diagrams and photos.

Plumbing code handbooks sometimes discuss three different plumbing "zones" in an effort to accommodate variations in regulations from state to state. The states included in each zone are listed below.

Zone 1: Washington, Oregon, California, Nevada, Idaho, Montana, Wyoming, North Dakota, South Dakota, Minnesota, Iowa, Nebraska, Kansas, Utah, Arizona, Colorado, New Mexico, Indiana, Wisconsin, parts of Texas.

Zone 2: Alabama, Arkansas, Louisiana, Tennessee, North Carolina, Mississippi, Georgia, Florida, South Carolina, parts of Texas, parts of Maryland, parts of Delaware, parts of Oklahoma, parts of West Virginia.

Zone 3: Virginia, Kentucky, Missouri, Illinois, Michigan, Ohio, Pennsylvania, New York, Connecticut, Massachusetts, Vermont, New Hampshire, Rhode Island, New Jersey, parts of Delaware, parts of West Virginia, parts of Maine, parts of Maryland, parts of Oklahoma.

Remember that your local plumbing code always supersedes the national code. Local codes may be more restrictive than the national code. Your local building inspector is a valuable source of information and may provide you with a convenient summary sheet of the regulations that apply to your project.

The plumbing inspector is the final authority when it comes to evaluating your work. By visually examining and testing your new plumbing, the inspector ensures that your work is safe and functional.

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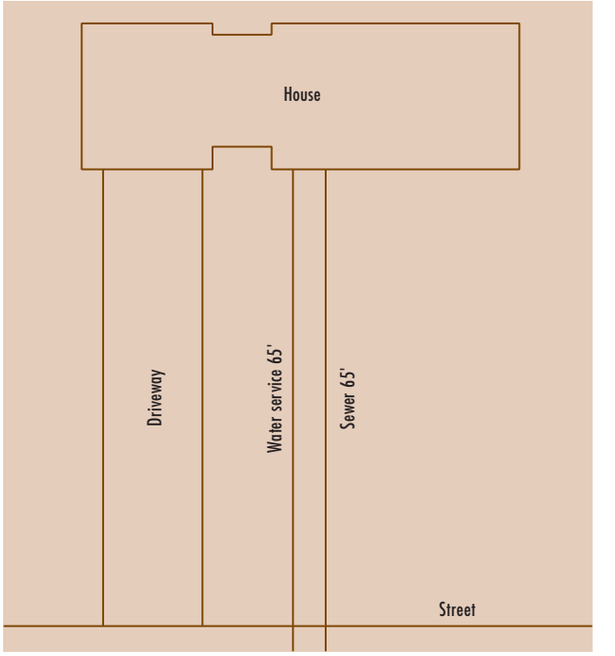
#175 Dtp:225 Page:320

GETTING A PERMIT

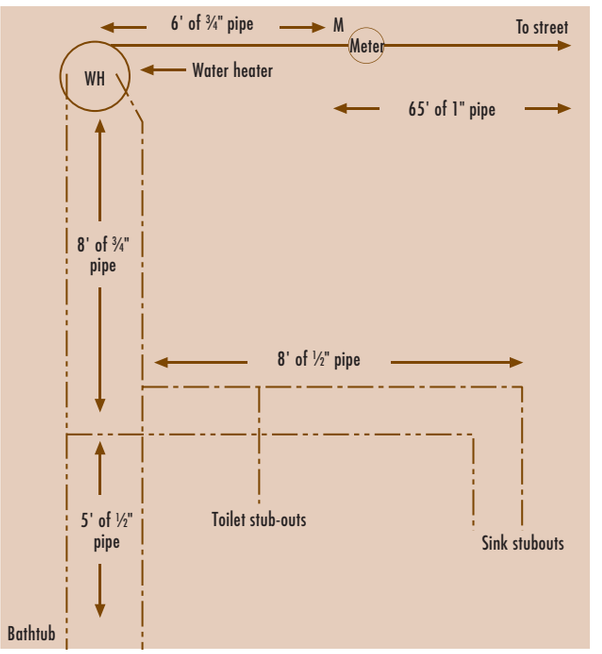
To ensure public safety, your community requires that you obtain a permit for most plumbing projects, including most of the projects demonstrated in this book.

When you visit your city building inspection office to apply for a permit, the building official will want to review three drawings of your plumbing project: a site plan, a water supply diagram, and a drain-waste-vent diagram. These drawings are described on this page. If the official is satisfied that your project meets code requirements, he or she will issue you a plumbing permit, which is your legal permission to begin work. The building official also will specify an inspection schedule for your project. As your project nears completion, you will be asked to arrange for an inspector to visit your home while the pipes are exposed to review the installation and ensure its safety.

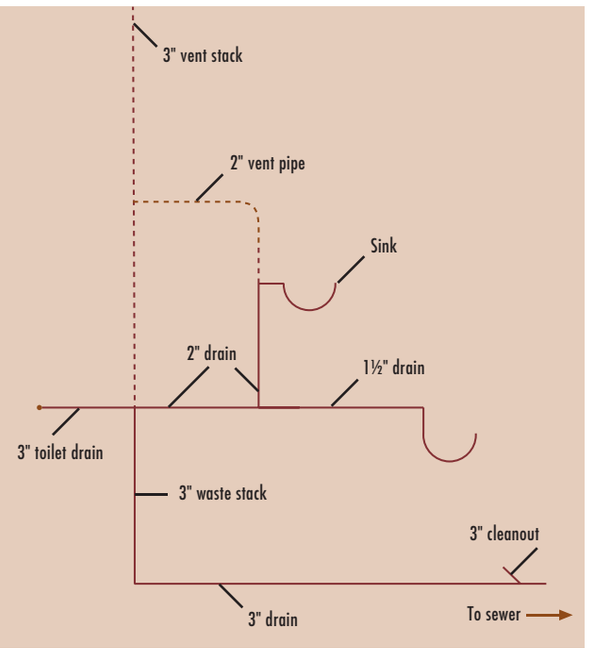
Although do-it-yourselfers often complete complex plumbing projects without obtaining a permit or having the work inspected, we strongly urge you to comply with the legal requirements in your area. A flawed plumbing system can be dangerous, and it can potentially threaten the value of your home.



The site plan shows the location of the water main and sewer main with respect to your yard and home. The distances from your foundation to the water main and from the foundation to the main sewer should be indicated on the site plan.



The supply riser diagram shows the length of the hot and cold water pipes and the relation of the fixtures to one another. The inspector will use this diagram to determine the proper size for the new water supply pipes in your system.



A DWV diagram shows the routing of drain and vent pipes in your system. Make sure to indicate the lengths of drain pipes and the distances between fixtures. The inspector will use this diagram to determine if you have properly sized the drain traps, drain pipes, and vent pipes in your project.

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#175 Dtp:225 Page:321

Sizing for Water Distribution Pipes

FIXTURE	UNIT RATING
Toilet	3
Vanity sink	1
Shower	2
Bathtub	2
Dishwasher	2
Kitchen sink	2
Clothes washer	2
Utility sink	2
Sillcock	3

SIZE OF SERVICE PIPE FROM STREET	SIZE OF DISTRIBUTION PIPE FROM WATER METER	MAXIMUM LENGTH (FT.)—TOTAL FIXTURE UNITS					
		40	60	80	100	150	200
¾"	½"	9	8	7	6	5	4
¾"	¾"	27	23	19	17	14	11
¾"	1"	44	40	36	33	28	23
1"	1"	60	47	41	36	30	25
1"	1¼"	102	87	76	67	52	44

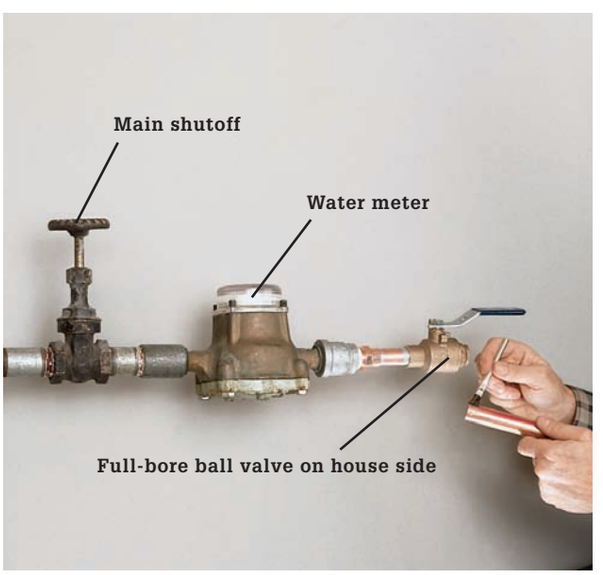
Water distribution pipes are the main pipes extending from the water meter throughout the house, supplying water to the branch pipes leading to individual fixtures. To determine the size of the distribution pipes, you must first calculate the total demand in "fixture units" (above, left) and the overall length of the water supply lines, from the street hookup through the water meter and to the most distant fixture in the house. Then, use the second table (above, right) to calculate the minimum size for the water distribution pipes. Note that the fixture unit capacity depends partly on the size of the street-side pipe that delivers water to your meter.

Sizes for Branch Pipes & Supply Tubes

FIXTURE	MIN. BRANCH PIPE SIZE	MIN. SUPPLY TUBE SIZE
Toilet	½"	⅜"
Vanity sink	½"	⅜"
Shower	½"	½"
Bathtub	½"	½"
Dishwasher	½"	½"
Kitchen sink	½"	½"
Clothes washer	½"	½"
Utility sink	½"	½"
Sillcock	¾"	N.A.
Water heater	¾"	N.A.

Branch pipes are the water supply lines that run from the distribution pipes toward the individual fixtures. Supply tubes are the vinyl, chromed copper, or braided tubes that carry water from the branch pipes to the fixtures. Use the chart above as a guide when sizing branch pipes and supply tubes.

Valve Requirements



Full-bore gate valves or ball valves are required in the following locations: on both the street side and house side of the water meter; on the inlet pipes for water heaters and heating system boilers. Individual fixtures should have accessible shutoff valves, but these need not be full-bore valves. All sillcocks must have individual control valves located inside the house.

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#175 Dtp:225 Page:322

Modifying Water Pressure

Pressure-reducing valve (shown above) is required if the water pressure coming into your home is greater than 80 pounds per square inch (psi). The reducing valve should be installed near the point where the water service enters the building. A booster pump may be required if the water pressure in your home is below 40 psi.

Preventing Water Hammer

Water hammer arresters may be required by code. Water hammer is a problem that may occur when the fast-acting valves on washing machines or other appliances trap air and cause pipes to vibrate against framing members. The arrester works as a shock absorber and has a watertight diaphragm inside. It is mounted to a T-fitting installed near the appliance (see pages 306–307).

Anti-Siphon Devices

Vacuum breakers must be installed on all indoor and outdoor hose bibs and any outdoor branch pipes that run underground. Vacuum breakers prevent contaminated water from being drawn into the water supply pipes in the event of a sudden drop in water pressure in the water main. When a drop in pressure produces a partial vacuum, the breaker prevents siphoning by allowing air to enter the pipes.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:323

Drain cleanouts make your DWV system easier to service. In most areas, the plumbing code requires that you place cleanouts at the end of every horizontal drain run. Where horizontal runs are not accessible, removable drain traps will suffice as cleanouts.

PIPE SUPPORT INTERVALS

Type of pipe	Vertical-run support interval	Horizontal-run support interval
Copper	10 ft.	6 ft.
PEX	5 ft.	3 ft.
CPVC	10 ft.	3 ft.
PVC	10 ft.	4 ft.
Steel	12 ft.	10 ft.
Iron	15 ft.	5 ft.

Minimum intervals for supporting pipes are determined by the type of pipe and its orientation in the system. See page 40 for acceptable pipe support materials. Remember that the measurements shown above are minimum requirements; local code may require supports at closer intervals.

Fixture Units & Minimum Trap Size

FIXTURE	FIXTURE UNITS	MIN. TRAP SIZE
Shower	2	2"
Vanity sink	1	1¼"
Bathtub	2	1½"
Dishwasher	2	1½"
Kitchen sink	2	1½"
Kitchen sink*	3	1½"
Clothes washer	2	1½"
Utility sink	2	1½"
Floor drain	1	2"

*Kitchen sink with attached food disposer

Minimum trap size for fixtures is determined by the drain fixture unit rating, a unit of measure assigned by the plumbing code. *Note: Kitchen sinks rate 3 units if they include an attached food disposer, 2 units otherwise.*

Sizes for Horizontal & Vertical Drain Pipes

PIPE SIZE	MAXIMUM FIXTURE UNITS FOR HORIZONTAL BRANCH DRAIN	MAXIMUM FIXTURE UNITS FOR VERTICAL DRAIN STACKS
1¼"	1	2
1½"	3	4
2"	6	10
2½"	12	20
3"	20	30
4"	160	240

Drain pipe sizes are determined by the load on the pipes, as measured by the total fixture units. Horizontal drain pipes less than 3" in diameter should slope ¼" per foot toward the main drain. Pipes 3" or more in diameter should slope ⅛" per foot. *Note: Horizontal or vertical drain pipes for a toilet must be 3" or larger.*

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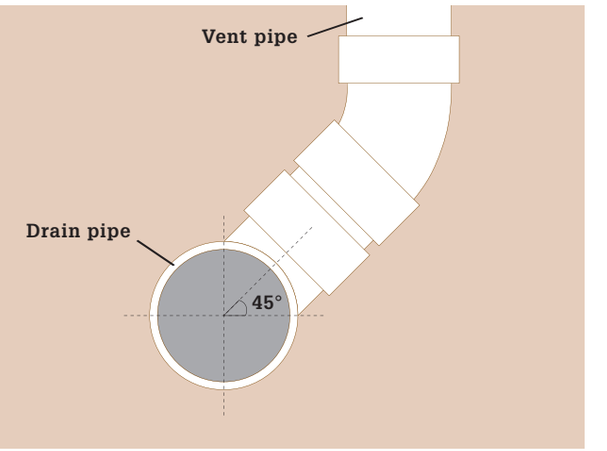
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:324

Vent Pipe Sizes, Critical Distances

SIZE OF FIXTURE DRAIN	MINIMUM VENT PIPE SIZE	MAXIMUM CRITICAL DISTANCE
1¼"	1¼"	2½ ft.
1½"	1¼"	3½ ft.
2"	1½"	5 ft.
3"	2"	6 ft.
4"	3"	10 ft.

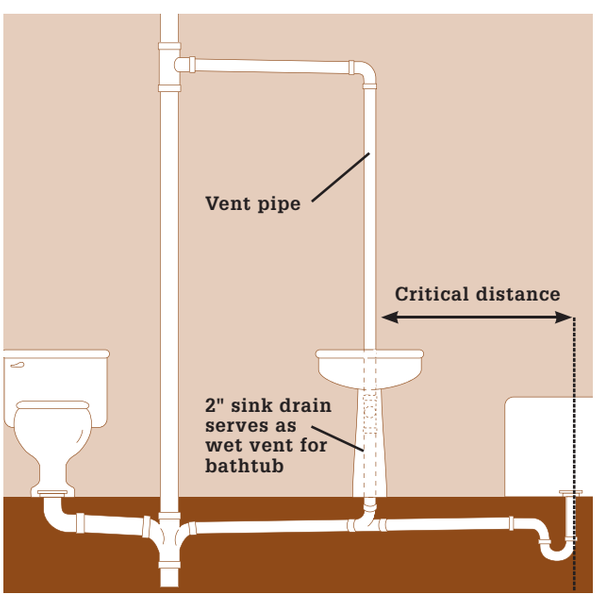
Vent pipes are usually one pipe size smaller than the drain pipes they serve. Code requires that the distance between the drain trap and the vent pipe fall within a maximum "critical distance," a measurement that is determined by the size of the fixture drain. Use this chart to determine both the minimum size for the vent pipe and the maximum critical distance.

Vent Pipe Orientation to Drain Pipe



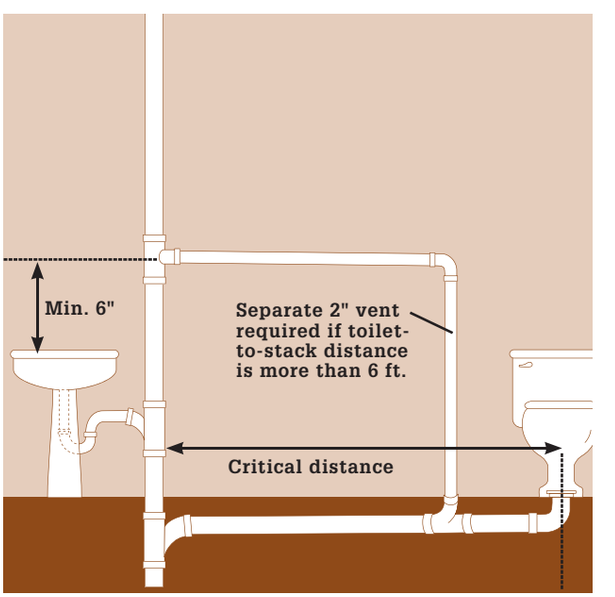
Vent pipes must extend in an upward direction from drains, no less than 45º from horizontal. This ensures that waste water cannot flow into the vent pipe and block it. At the opposite end, a new vent pipe should connect to an existing vent pipe or main waste-vent stack at a point at least 6" above the highest fixture draining into the system.

Wet Venting



Wet vents are pipes that serve as a vent for one fixture and a drain for another. The sizing of a wet vent is based on the total fixture units it supports (opposite page): a 3" wet vent can serve up to 12 fixture units; a 2" wet vent is rated for 4 fixture units; a 1½" wet vent, for only 1 fixture unit. *Note: The distance between the wet-vented fixture and the wet vent itself must be no more than the maximum critical distance (chart above).*

Auxiliary Venting



Fixtures must have an auxiliary vent if the distance to the main waste-vent stack exceeds the critical distance (chart above). A toilet, for example, should have a separate vent pipe if it is located more than 6 ft. from the main waste-vent stack. This secondary vent pipe should connect to the stack or an existing vent pipe at a point at least 6" above the highest fixture on the system.

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#175 Dtp:225 Page:325

Testing New Plumbing Pipes

When the building inspector comes to review your new plumbing, he or she may require that you perform a pressure test on the DWV and water supply lines as he or she watches. The inspection and test should be performed after the system is completed but before the new pipes are covered with wallboard. To ensure that the inspection goes smoothly, it is a good idea to perform your own pretest, so you can locate and repair any problems before the inspector visits.

The DWV system is tested by blocking off the new drain and vent pipes, then pressuring the system with air to see if it leaks. At the fixture stub-outs, the DWV pipes can be capped off or plugged with test balloons designed for this purpose. The air pump, pressure gauge, and test balloons required to test the DWV system can be obtained at tool rental centers.

Testing the water supply lines is a simple matter of turning on the water and examining the joints for leaks. If you find a leak, you will have to drain the pipes, then remake the faulty joints.

A pressure gauge and air pump are used to test DWV lines. The system is first blocked off at each fixture and at points near where the new drain and vent pipes connect to the main stack. Air is then pumped into the system to a pressure of 5 pounds per square inch (psi). To pass inspection, the system must hold this pressure for 15 minutes.

How to Test New DWV Pipes

Insert a test balloon into the test T-fittings at the top and bottom of the new DWV line, blocking the pipes entirely. *Note: Ordinary T-fittings installed near the bottom of the drain line and near the top of the vent line are generally used for test fittings.*

Block toilet drains with a test balloon designed for a closet bend. Large test balloons may have to be inflated with an air pump.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:326

Cap off the remaining fixture drains by solvent-gluing test caps onto the stub-outs. After the system is tested, these caps are simply knocked loose with a hammer.

At a cleanout fitting, insert a weenie—a special test balloon with an air gauge and inflation valve. Attach an air pump to the valve on the weenie and pressurize the pipes to 5 psi. Watch the pressure gauge for 15 minutes to ensure that the system does not lose pressure.

If the DWV system loses air when pressurized, check each joint for leaks by rubbing soapy water over the fittings and looking for active bubbles. When you identify a problem joint, cut away the existing fitting and solvent-glue a new fitting in place, using couplings and short lengths of pipe.

After the DWV system has been inspected and approved by a building official, remove the test balloons and close the test T-fittings by solvent-gluing caps onto the open inlets.

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:327

Glossary

Access panel — Opening in a wall or ceiling that provides access to the plumbing system

Air admittance valve — A valve that allows air into a drain line in order to facilitate proper draining. Often used where traditional vent pipe would be difficult to install.

Appliance — Powered device that uses water, such as a water heater, dishwasher, washing machine, whirlpool, or water softener

Auger — Flexible tool used for clearing obstructions in drain lines

Ballcock — Valve that controls the water supply entering a toilet tank

Blow bag — Expanding rubber device that attaches to a garden hose; used for clearing floor drains

Branch drain line — Pipe that connects additional lines to a drain system

Branch line — Pipe that connects additional lines to a water supply system

Cleanout — Cover in a waste pipe or trap that provides access for cleaning

Closet auger — Flexible rod used to clear obstructions in toilets

Closet bend — Curved fitting that fits between a closet flange and a toilet drain

Closet flange — Ring at the opening of a toilet drain, used as the base for a toilet

Coupling — Fitting that connects two pieces of pipe

DWV — Drain, waste, and vent; the system for removing water from a house

DWV stack — Pipe that connects house drain system to a sewer line at the bottom and vents air to outside of house at the top

Elbow — Angled fitting that changes the direction of a pipe

Fixture — Device that uses water, such as a sink, tub, shower, sillcock, or toilet

Flapper (tank ball) — Rubber seal that controls the flow of water from a toilet tank to a toilet bowl

Flux (soldering paste) — Paste applied to metal joints before soldering to increase joint strength

Hand auger (snake) — Hand tool with flexible shaft, used for clearing clogs in drain lines

Hose bib — Any faucet spout that is threaded to accept a hose

I.D. — Inside diameter; plumbing pipes are classified by I.D.

Loop vent — A special type of vent configuration used in kitchen sink island installations

Main shutoff valve — Valve that controls water supply to an entire house; usually next to the water meter

Motorized auger — Power tool with flexible shaft, used for clearing tree roots from sewer lines

Nipple — Pipe with threaded ends

O.D. — Outside diameter

Plumber's putty — A soft material used for sealing joints between fixtures and supply or drain parts

Reducer — A fitting that connects pipes of different sizes

Riser — Assembly of water supply fittings and pipes that distributes water upward

Run — Assembly of pipes that extends from water supply to fixture, or from drain to stack

Saddle valve — Fitting clamped to copper supply pipe, with hollow spike that punctures the pipe to divert water to another device, usually a dishwasher or refrigerator icemaker

Sanitary fitting — Fitting that joins DWV pipes; allows solid material to pass through without clogging

Shutoff valve — Valve that controls the water supply for one fixture or appliance

Sillcock — Compression faucet used on the outside of a house

Soil stack — Main vertical drain line, which carries waste from all branch drains to a sewer line

Solder — Metal alloy used for permanently joining metal (usually copper) pipes

T-fitting — Fitting shaped like the letter T used for creating or joining branch lines

Trap — Curved section of drain, filled with standing water, that prevents sewer gases from entering a house

Union — Fitting that joins two sections of pipe but can be disconnected without cutting

Vacuum breaker — Attachment for outdoor and below-ground fixtures that prevents waste water from entering supply lines if water supply pressure drops

Wet vent — Pipe that serves as a drain for one fixture and as a vent for another

Y-fitting — Fitting shaped like the letter Y used for creating or joining branch lines

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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:328

Metric Conversion Chart

Lumber Dimensions

NOMINAL - U.S.	ACTUAL - U.S. (IN INCHES)	METRIC
1 × 2	¾ × 1½	19 × 38 mm
1 × 3	¾ × 2½	19 × 64 mm
1 × 4	¾ × 3½	19 × 89 mm
1 × 5	¾ × 4½	19 × 114 mm
1 × 6	¾ × 5½	19 × 140 mm
1 × 7	¾ × 6¼	19 × 159 mm
1 × 8	¾ × 7¼	19 × 184 mm
1 × 10	¾ × 9¼	19 × 235 mm
1 × 12	¾ × 11¼	19 × 286 mm
1¼ × 4	1 × 3½	25 × 89 mm
1¼ × 6	1 × 5½	25 × 140 mm
1¼ × 8	1 × 7¼	25 × 184 mm
1¼ × 10	1 × 9¼	25 × 235 mm
1¼ × 12	1 × 11¼	25 × 286 mm

NOMINAL - U.S.	ACTUAL - U.S. (IN INCHES)	METRIC
1½ × 4	1¼ × 3½	32 × 89 mm
1½ × 6	1¼ × 5½	32 × 140 mm
1½ × 8	1¼ × 7¼	32 × 184 mm
1½ × 10	1¼ × 9¼	32 × 235 mm
1½ × 12	1¼ × 11¼	32 × 286 mm
2 × 4	1½ × 3½	38 × 89 mm
2 × 6	1½ × 5½	38 × 140 mm
2 × 8	1½ × 7¼	38 × 184 mm
2 × 10	1½ × 9¼	38 × 235 mm
2 × 12	1½ × 11¼	38 × 286 mm
3 × 6	2½ × 5½	64 × 140 mm
4 × 4	3½ × 3½	89 × 89 mm
4 × 6	3½ × 5½	89 × 140 mm

Metric Conversions

TO CONVERT:	TO:	MULTIPLY BY:
Inches	Millimeters	25.4
Inches	Centimeters	2.54
Feet	Meters	0.305
Yards	Meters	0.914
Square inches	Square centimeters	6.45
Square feet	Square meters	0.093
Square yards	Square meters	0.836
Ounces	Milliliters	30.0
Pints (U.S.)	Liters	0.473 (Imp. 0.568)
Quarts (U.S.)	Liters	0.946 (Imp. 1.136)
Gallons (U.S.)	Liters	3.785 (Imp. 4.546)
Ounces	Grams	28.4
Pounds	Kilograms	0.454

TO CONVERT:	TO:	MULTIPLY BY:
Millimeters	Inches	0.039
Centimeters	Inches	0.394
Meters	Feet	3.28
Meters	Yards	1.09
Square centimeters	Square inches	0.155
Square meters	Square feet	10.8
Square meters	Square yards	1.2
Milliliters	Ounces	.033
Liters	Pints (U.S.)	2.114 (Imp. 1.76)
Liters	Quarts (U.S.)	1.057 (Imp. 0.88)
Liters	Gallons (U.S.)	0.264 (Imp. 0.22)
Grams	Ounces	0.035
Kilograms	Pounds	2.2

Counterbore, Shank, & Pilot Hole Diameters

SCREW SIZE	COUNTERBORE DIAMETER FOR SCREW HEAD (IN INCHES)	CLEARANCE HOLE FOR SCREW SHANK (IN INCHES)	PILOT HOLE DIAMETER HARD WOOD (IN INCHES)	PILOT HOLE DIAMETER SOFT WOOD (IN INCHES)
#1	.146 (9/64)	5/64	3/64	1/32
#2	1/4	3/32	3/64	1/32
#3	1/4	7/64	1/16	3/64
#4	1/4	1/8	1/16	3/64
#5	1/4	1/8	5/64	1/16
#6	5/16	9/64	3/32	5/64
#7	5/16	5/32	3/32	5/64
#8	3/8	11/64	1/8	3/32
#9	3/8	11/64	1/8	3/32
#10	3/8	3/16	1/8	7/64
#11	1/2	3/16	5/32	9/64
#12	1/2	7/32	9/64	1/8

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07-C67284 #175 Dtp:225 Page:329

Resources

American Standard
800 442 1902
www.americanstandard-us.com

General Electric
www.ge.com

Hakatai
888 667 2429
www.hakatai.com
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International Assoc. of Plumbing & Mechanical Officials
909 472 4100
www.iapmo.org

International Code Council
800 284 4406
www.iccsafe.org

John Guest Co.
Speedfit push-in fittings
www.johnguest.com

Joseph Hansa
Consultant

Kleer Drain
www.kleerdrain.com

Kleve Inc.
952 941 4211
www.kleveheating.com

Kohler
800 4 KOHLER
www.kohlerco.com

National Kitchen & Bathroom Assoc. (NKBA)
800 843 6522
www.nkba.com

Plumbing and Drainage Institute
978 557 0720
www.pdionline.org

Price Pfister
800 624 2120
www.pricepfister.com

Swanstone
800 325 7008
www.swanstone.com

The Faucet Shoppe
Chicago, Illinois
Adam & Ryan Chamlin
www.thefaucetshoppe.com

Toto
800 350 8686
www.totousa.com

Water Sense
www.SaveWaterAmerica.com

World Plumbing Council
+44 17 08 47 27 91
email: secretariat@worldplumbing.org
www.worldplumbing.org

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Pro-Vision C M Y K (Text) (Ray)
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:330

Index

A

ABS plastic pipes. *see* Rigid plastic pipes
Adjustable wrenches, 271
Aerators, 228
Air admittance valve (AAV), 174, 184–185
Anti-scald valve, 240
Anti-siphon devices, 323
Appliances
  description of, 8
  gas consumption of, 189
  new gas lines for, 188–193
  water supply system and, 10
  see also individual appliances
Augers
  description of, 272–273
  using, 213, 245, 249, 252–253
Auxiliary venting, 325

B

Balancing valve, 240
Ball faucets, 220, 226
Ball valves, 312, 313
Basement bathrooms, 166–171
Basin wrenches, 271
Bathrooms
  basement, 166–171
  bidets, 102–105
  drains, 55, 60–61
  faucets
    hookups, 55
    installing single-body, 59
    installing widespread, 56–58
    overview of, 54
  half, 172–173
  master
    installing DWV pipes for toilet and sink, 159–161
    installing DWV pipes for tub and shower, 162–163
    overview of, 158
  see also Showers; Sinks; Toilets; Tubs
Bathtubs. *see* Tubs
Bidets
  installing, 104–105
  overview of, 102–103
Black pipe, 317
Blow bags, 272
Branch drain lines
  clearing, 250–251
  home plumbing system and, 8, 9
  replacing, 254–257

C

Cabinets, vanity, 140–141
Cartridge faucets
  description of, 220
  one-handle, 224–225
  single-handle tub and shower, 238–239
  two-handle tub and shower, 236
  washerless two-handle, 223
Cast iron pipe
  cutting, 303
  overview of, 302
  removing, 303–304
  replacing, 304–305
Caulk gun, 270
Channel-type pliers, 271
Chisels, 270
Closet augers, 213, 273
Closet flanges (toilet), 214–215
Codes
  permits and, 321
  PEX and, 293
  understanding, 320–321
Cold chisels, 270
Compression faucets, 220, 221–222
Compression fittings, 314
Copper pipes
  compression union fittings and, 315
  cutting, 278–279
  joints, 282
  overview of, 276–277
  soldering, 278, 280–281
  types of, 276
CPVC plastic pipes. *see* Rigid plastic pipes
Cross-linked polyethylene (PEX) pipes
  advantages of, 293
  buying, 293
  choosing, 294
  general codes and, 293
  installing, 292
  making connections with, 295
  materials for, 291
  overview of, 290
  plumbing a water supply system with, 296–297
  system designs and, 294
  tools for, 291
Crystals (salt), 106

D

Disc faucets, 220, 227
Discharge hoses (dishwasher), 33–35
Dishwashers, 32–35
Diverter valves, 228–230, 232, 235
Doors, 68–69, 90–93
Drain tees, 37
Drain traps, 8, 9
Drains
  bathroom
    fixing tub and shower, 244–247
    hookups, 55
    pop-up, 60–61, 247
    toilets and, 216–217
  branch
    clearing, 250–251
    replacing, 254–257
  cleanouts, 324
  fittings for, 306
  fixing
    kitchen, 249
    plunger-type, 246
    pop-up, 247
    tub and shower, 244–247
  floor, 31, 252–253
  installing pop-up, 60–61
  kitchen
    choosing, 29
    fixing, 249
    hooking up, 30–31
    kits for, 29
    overview of, 28
  main, 250–251
  sink, 248–249
  standpipe, 144–145
  types of, 306
Drain-waste-overflow kits, 79
Drain-waste-vent (DWV) system
  auxiliary venting, 325
  basic tree, 306
  branch drain lines
    clearing, 250–251
    replacing, 254–257

302-336_28830.indd 331 7/26/12 1:04 PM
302-336_28830.indd 331 7/26/12 12:56 PM
Pro-Vision C M Y K (Text) (Ray)
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:331

description of, 8
diagram of, 321
fittings for, 308
home plumbing system and, 9, 11
island sinks and, 179–183
main waste-vent stack
clearing, 250–251
connecting drain pipes to, 164
connecting vent pipes to, 164
flashing, 263
overview of, 258
replacing, 259–263
replacing cleanout plug, 251
planning routes for, 154
testing new pipes for, 326–327
toilets and sinks and, 159–161
tubs and showers and, 162–163
vent fittings for, 306
wall sinks and, 176–178
wet venting, 325
Drill-powered augers, 272
Drills, 273
Dual-flush systems, 17, 206–209

E

Electric water heaters, 42–43, 44, 49
Elevated toilets, 17
Elongated toilet bowls, 17
Evaporated salt, 106
Expansion nozzles, 272

F

Faucets
ball, 220, 226
bathroom
drain hookups and, 55
overview of, 54
single-body, 59
widespread, 56–58
cartridge, 220
cartridges for, 227
common problems and repairs, 219
compression, 220, 221–222
disc, 220, 227
home plumbing system and, 8
identifying, 220
kitchen
choosing, 23
installing, 25–27
overview of, 22
removing, 24
one-handle cartridge, 224–225
outdoor, 128–131
overview of, 218–219
pot fillers, 120, 121
repair tips for, 220
repairing, 232, 234–239
replacing deep-set valve, 237
single-handle tub and shower
repairing, 238–239
with scald control, 240
three-handle tub and shower, 234–235
two-handle, washerless, 223
two-handle tub and shower, 236–237
see also Sinks
Files, 271
Fittings
compression, 314–315
gas pipe, 316–317
types of, 274–275, 306–308
using transition, 309
Fixtures
home plumbing system and, 8, 10
minimum trap sizes for, 324
shutoff valves for, 13
Flame-resistant pads, 273
Flanges (toilet), 214–215
Flexible PE (polyethylene) pipe, 288, 289
Flush valves
dual, 206–209
replacing, 204–205
Food disposers
installing, 38–41
overview of, 36–37
split receptacles and, 110
Force cups, 272
Framing member chart, 152
Freezeproof sillcocks, 128–129

G

Galvanized steel pipe
overview of, 298
removing, 299
replacing, 300–301
Gas consumption, 189
Gas lines
fittings for, 316
installing a branch line, 191–193
notes for installing, 189
overview of, 188, 316
tips for running, 190
Gas water heaters, 42–43, 44, 45–49
Gate diverters, 232, 236, 238
Gate valves, 313
Globe valves, 313
Gravity-assisted toilets, 17

H

Hacksaws, 270
Half bathrooms, 172–173
Hand augers, 245, 249
Hand tools, 270–272
Head lamps, 270
Home plumbing system, description of, 8–11
Hose bibs, 129, 312
Hot tubs, outdoor, 95
Hot water dispenser, 110–113
Hydromassage, 94

I

Icemakers
connecting, 115–116
installing new, 117–119
overview of, 114–115
Island sinks, 179–183

J

Jetted tubs
installation options, 95
installing, 96–101
overview of, 94

K

Kitchens
air admittance valve (AAV) and, 174, 184–185
drains and traps, 28–31
faucets, 22–27
installing DWV pipes for, 174–183
installing new supply lines for, 186–187
overview of, 174
sinks
clearing, 249
clearing traps, 248
installing, 143
installing new supply lines for, 186–187
island, 179–183
overview of, 142
sprayers, 228–231
tips for plumbing, 175
Knives, 270

L

Lead, 10
Leaks
faucets and, 219
gas, 317
testing for, 61
Levels, 271

302-336_28830.indd 332 7/26/12 1:04 PM
302-336_28830.indd 332 7/26/12 12:56 PM
(Text) (Ray)
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:332

Loop vents, 174, 175, 184

M

Main drain cleanout plugs, 251
Main waste-vent stack
  clearing, 251
  connecting to, 164
  flashing, 263
  overview of, 258
  replacing, 259–263
MAPP torch, 273
Master bathrooms
  connecting DWV pipes to main waste-vent stack, 164
  installing DWV pipes for toilet and sink, 159–161
  installing DWV pipes for tub and shower, 162–163
  installing water supply pipes for, 165
  overview of, 158
Materials, overview of, 274–275
Maximum hole and notch chart, 152
Minimum trap sizes, 324
Motorized drain auger, 273

N

National Uniform Plumbing Code, 320
Needlenose pliers, 271
Non-contact volt meter, 270

O

On-demand water heaters, 50–53
One-handle cartridge faucets, 224–225
One-piece faucets, 54
One-piece toilets, 17
Outdoor flexible plastic pipe, 288–289

P

Pedestal sinks, 132–133
Pellets (salt), 106
Permits, 321
PEX
  advantages of, 293
  buying, 293
  choosing system, 294
  general codes and, 293
  installing, 292
  making connections with, 295
  materials for, 291
  overview of, 290
  plumbing a water supply system with, 296–297
  system designs and, 294
  tools for, 291
Pipe wrenches, 272
Pipes
  cast iron, 302–305
  connecting to main waste-vent stack, 164
  copper
    compression union fittings and, 315
    cutting, 278–279
    joints, 282
    overview of, 276–277
    soldering, 278, 280–281
    types of, 276
  fittings for, 306–308
  galvanized steel, 298–301
  gas
    fittings for, 316
    installing branch lines, 191–193
    notes on, 189
    overview of, 188
    tips for running, 190
  installing DWV
    for island sink, 179–183
    for toilets and sinks, 159–161
    for tubs and showers, 162–163
    for wall sink, 176–178
  installing water supply, 165
  noisy, 266–267
  outdoor flexible plastic, 288–289
  PEX
    advantages of, 293
    buying, 293
    choosing system, 294
    general codes and, 293
    installing, 292
    making connections with, 295
    materials for, 291
    overview of, 290
    plumbing a water supply system with, 296–297
    system designs and, 294
    tools for, 291
  replacing water supply, 264–265
  rigid plastic, 284–287
  routes for, 154–157
  sizing for, 322, 324, 325
  supply, 10, 264–265
  support intervals for, 324
  support materials for, 307
  testing new, 326–327
  types of, 274–275
  vent, 325
Plastic pipes
  outdoor flexible, 288–289
  rigid, 284–287
Plastic tubing cutters, 272
Pliers, 271
Plumbing basics
  home system, 8–11
  installation basics, 150–153
  planning routes, 154–157
Plumbing codes, understanding, 320–321
Plumbing symbols, 318
Plumbing system, mapping, 318–319
Plungers, 211, 212, 272
Plunger-type drains, fixing, 246
Point-of-use filters, 123
Pop-up drains, 60–61
Pot fillers, 120–121
Power augers, 250, 252–253
Power drills, 273
Power tools, 272–273
Pressure-assisted toilets, 17
Project planning
  codes and permits, 320–321
  mapping plumbing system, 319
  overview of, 318
  pipe, supply tube, and vent requirements, 322, 324, 325
  testing new pipes, 326–327
  valve requirements, 322
  venting, 325
  water hammers and, 323
  water pressure and, 322
Propane torches, 273
Push fittings, 283
Putty knives, 271
PVC plastic pipes. *see* Rigid plastic pipes

R

Ratchet wrenches, 270
Reciprocating saws, 273
Rental tools, 273
Reverse-osmosis water filters, 122–126
Right-angle drill, 273
Rigid plastic pipes, 284–287
Rock salt, 106
Roof vent, 8

S

Salts, 106
Saws, 273
Screwdrivers, 271
Seat wrenches, 271
Septic system, 8

302-336_28830.indd 333 7/26/12 1:04 PM
302-336_28830.indd 333 7/26/12 12:56 PM
(Text) (Ray)
Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:333

Sewer line, 8, 9
Shower pans, 71
Showers
bases
building, 72–76
design suggestions for, 77
overview of, 70
pan cross-section, 71
tips for building, 71
conversion kit, 63–67, 243
enclosure kits for, 62
faucets
fixing single-handle, 238–239
fixing three-handle, 234–235
fixing two-handle, 236–237
types of, 232–233
fixing drains, 244–247
flexible adapters for, 242
hinged door for, 68–69
installing DWV pipes for, 162–163
repairing, 244
showerheads and, 241–242
temperature and, 240
Shutoff valves
attaching supply tubes to, 314–315
description of, 313
installing, 311
overview of, 310
types of, 12–13
Sillcocks, freezeproof, 128–131
Single-body faucets, 59
Single-handle faucets, 233, 238–240
Sinks
clearing trap and, 248
drains, 244, 248
faucets
ball, 226
cartridges for, 227
common problems and repairs, 219
compression, 221–222
disc, 227
identifying, 220
one-handle cartridge, 224–225
overview of, 218–219
repair of, 220
two-handle, 230
washerless two-handle, 223
installing DWV pipes for, 159–161
integral vanity tops, 140–141
island, 179–183
kitchen
clearing, 248–249
installing, 143
installing new supply lines for, 186–187
overview of, 142
maintenance tip for, 244
pedestal, 132–133
self-rimming, 142–143
utility, 147
vessel, 136–139
wall, 176–178
wall-hung vanities, 134–135
see also Faucets
Slip joints, 29
Snap cutters, 273
Softened water, 107
Solar salt, 106
Soldering, 278, 280–282
Solvent glues, 284, 286–287
Spas
installation options, 95
installing, 96–101
overview of, 94
Sprayers, 27, 228–229, 231
Spud wrenches, 272
Standpipe drains, 144–145
Stop valves, 13
Stoppers. *see* Pop-up drains
Strainer wrenches, 271
S-trap, 30–31
Supply pipes, 10, 264–265
Supply tubes, 311, 322

T

T fittings, 28, 30–31
Tankless water heaters, 50–53
Tape measures, 271
T-fittings, 306
Three-handle faucet, 233, 234–235
Tile, shower bases and, 70, 72–77
Toilets
adjusting handle and lift chain/wires, 198
choosing, 17
clearing with closet auger, 213
clogged, 210, 212
common problems and repairs, 196–197, 199, 201
drain clearers and, 211
drain lines for, 216–217
dual-flush systems, 17
flanges for, 214–215
gravity-assisted, 17
installing, 19–21
installing DWV pipes for, 159–161
overview of, 16
pressure-assisted, 17
removing, 18
replacing fill valves, 202–203
replacing flush valves, 204–205
resetting tank water level, 200
rocking, 214
shims for, 214
Tools, overview of, 270–273
Transition fittings, 309
Trap arms, 249
Traps
clearing sink, 248
clogged toilets and, 211
importance of, 11
kitchen drain and, 30–31
minimum sizes for, 324
using hand augers on arm, 249
see also Drains
Tubing cutters, 272
Tubs
alcove
installation tips for, 79
installing, 82–85
overview of, 78
removing, 80–81
drains, fixing, 244–247
drain-waste-overflow kits for, 79
faucets
overview of fixing, 232
repairing, 232–243
single-handle, 233, 238–239, 240
three-handle, 233, 234–235
two-handle, 233, 236–237
installing DWV pipes for, 162–163
jetted, 94–101
overflow kit for, 79
repairing, 244, 246–247
shower conversion kits and, 243
sliding doors for, 90–93
spouts, 237
3-piece, 86–89
Two-handle faucets, 233, 236–237
Two-handle faucets, washerless, 223
Two-piece toilets, 17

U

Utility knives, 270

V

Vacuum breakers, 307, 323
Valves
dual-flush, 206–209
home plumbing system and, 8
overview of, 312
replacing fill, 202–203

302-336_28830.indd 334 7/26/12 1:04 PM
302-336_28830.indd 334 7/26/12 12:56 PM
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Job:07-28830 Title:CPi-TheC GtoPlumbing5thEdn
#175 Dtp:225 Page:334

replacing flush, 204–205
requirements for, 322
shutoff, 310–311
soldering, 282
types of, 313
water supply, 307
Vanities
integral tops, 140–141
wall-hung, 134–135
Vent fittings, 306
Vent pipes
connecting, 164
drain-waste-vent (DWV) system and, 11
home plumbing system and, 8, 9
Venting requirements, 325
Vents. *see* Drain-waste-vent (DWV) system
Vessel sinks
installing, 138–139
options for, 137
overview of, 136

W

Wall-hung vanities, 134–135
Washerless two-handle faucets, 223
Washing machines, 144–146
Waste water, 8
see also Drain-waste-vent (DWV) system
Water dispenser, hot, 110–113
Water filters
point-of-use, 123
reverse-osmosis, 122–126
whole-house, 127
Water hammer arresters, 266–267, 323
Water heaters
home plumbing system and, 8, 9
installing, 45–49
overview of, 42–44
tankless, 50–53
types, 44
Water meter, 8, 9
Water pressure, modifying, 323
Water softeners, 106–109
Water supply system
attaching shutoff valves to, 314–315
description of, 8, 10
fittings for, 307
installing pipes for, 165, 186–187
pipes. *see* pipes
tube sizes, 322
valves for, 307
Water usage, 8
Wax rings, removing, 18
Wet venting, 325
Wet walls, 156
see also Bathrooms
Whole-house water filtration systems, 127
Widespread faucets
installing, 56–58
overview of, 54, 55
Wire brushes, 270
Wrenches, 271–272

Y

Y-fittings, 306

302-336_28830.indd 335 7/26/12 1:04 PM
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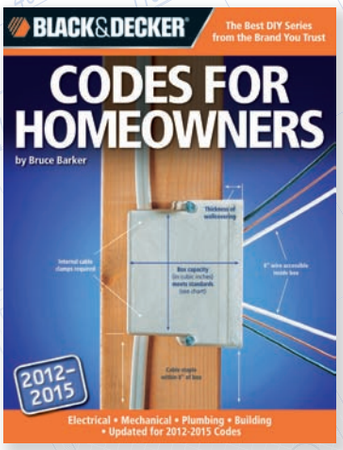

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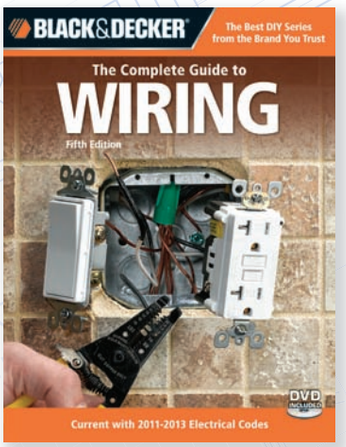

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Thank you, Mom and Dad, for everything. You've been wonderful role models, tireless cheerleaders, and the finest parents imaginable. I'm sure you still have the receipt for that original set of encyclopedias. Maybe we can find the salesman, and sell him one of mine!

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Contents

Foreword ix

Preface xi

Acknowledgments xiii

Real Estate Terms: Numbers 1

Real Estate Terms: From A–Z 3

Appendix A 125 Terms All Buyers and Sellers Should Know 449

Appendix B 105 Words for Landlords, Tenants, and their Agents 453

Appendix C 100 Tax Terms Important to Real Estate 455

Appendix D 80 Slang Expressions Used by Real Estate Insiders 457

Appendix E 77 Words Important to Developers 461

Appendix F 60 Useful Ideas for Analyzing Investments 463

Appendix G 50 Words to Important Residential Real Estate Agents 465

Appendix H 50 Federal Laws and Widespread State Laws that Affect Real Estate 467

Appendix I 20 Ways to Hold Real Estate 469

Appendix J Symbols and Abbreviations 471

Appendix K Common Land Measurements and Conversions 477

About the Authors 479

Online Access to Additional Real Estate Tools 480

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Foreword

Real Estate is a fascinating subject. It is absolutely captivating when you begin to understand it. With this book, Denise and Bill Evans have given the reader the primary tools of a great education in real estate, and an opportunity to share in our wonderful and exciting industry. Their encyclopedia includes not just definitions of the lingo of the real estate community, but also examples to put the language into understandable context. Many of the entries include practical advice about opportunities, pitfalls, and related concepts. This book is a terrific educational achievement that provides immense value for the real estate novice and the seasoned professional alike.

What gives me the right to say all this? I've been active in real estate for over 50 years, including work in construction, government, corporate America, and private legal practice.

As a young man, I needed to work during the "down times," finishing up undergraduate school at UCLA in June 1955 and waiting to go into the service in 1956. I found employment in the heavy earth-moving construction business in the fast-paced housing construction and office-industrial developments of southern California. I saw first-hand the real world application of important real estate principles. In February 1959, I returned from active duty as an Air Force pilot to Orange County, California and started UCLA Law School the following September. Still intrigued with the real estate industry, I returned to the construction business part-time during the first year of law school. After completing law school and passing the bar exam in 1962, I joined an Orange County law firm that had a significant portion of its work in the real estate field.

In June of 1969 I was appointed Chief Deputy Commissioner of Corporations by Ronald Reagan, who was governor of California at the time. Because of my extensive real estate experience, I was, along with the Commissioner, responsible for drafting rules for real estate syndications in California. These rules were substantially adopted by the SEC and NASD.

In 1972, at the end of my term, I returned to private practice in Orange County, again concentrating on real estate–related matters. In 1982 I was contacted by the Century 21 real estate brokerage franchise to prepare a business plan for Century 21 to sell real

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estate syndication interests through the Century 21 brokerage offices nationwide, in each of the nine Century 21 regions.

Bill Evans was recommended to me as someone who could prepare, plan, and manage the training for the real estate syndications licensing program. Previously, Bill had been responsible for other real estate training programs throughout the southeastern United States, but this was his first national platform. He rose to the occasion, writing the textbooks and traveling the United States to conduct week-long courses, primarily to residential agents with no prior commercial real estate or securities experience. Over the course of 18 months, he took the program from absolutely nothing to successful real estate syndication licensing of over 700 candidates, which included their completion of a national securities exam. Miraculously, he found time to get married to Denise, and she eventually forgave me for keeping Bill on the road so much.

Since that time, we've each gone on to other endeavors outside Century 21, but we've all stayed active in real estate. Denise and Bill Evans are a great team in all their real estate related endeavors. I am confident that this book will herald another team victory.

James L. Kelly

Former President of Century 21
Real Estate Securities Corporation

Preface

This work started out as a simple dictionary, an attempt to explain complicated real estate and finance concepts in everyday language. Somewhere along the way we discovered that definitions were often not enough. People needed to know about related issues, sometimes a little practical advice, and places to look on the Internet for more in-depth treatment.

And so, the little dictionary grew to this encyclopedia. We hope you find it useful in your everyday life, and a much-used resource for refining your understanding of real estate in the United States.

Up until the final day allowed by the publisher, we were adding new words. There will always be new words, new ways to use old words, and fresh perspectives on tried-and-true concepts. On the other hand, we can't print new versions of the encyclopedia every week. That's why we're really excited about the commitment McGraw-Hill has made to this project, and to the maintenance of a Web site dedicated to the encyclopedia.

The Web site will contain real estate–related tools such as forms, formulas, and links to valuable Web sites. It will also provide new words and expanded definitions as those become available.* This book will grow as we grow. Please feel free to share your comments with us by sending an e-mail to dle@deniselevans.com.

*Take advantage of this additional information by going to mhprofessional.com/reencyclopedia.

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Acknowledgments

We would like to thank Dianne Wheeler and McGraw-Hill for making this exciting new project possible. There is a tremendous risk in publishing a work of this stature, in a fresh new format not yet tried by any other company. They believed in us, made available their top people to provide editorial and production assistance, and committed to a Web site for this book before they had seen the first draft. Thank you for the vote of confidence. We look forward to seeing you gratified to learn it was well-placed.

Thank you, also, to J. Barry Mason, Dean of the Culverhouse College of Commerce and Business Administration at the University of Alabama, for making the resources available to us so we could research this encyclopedia. We appreciate all of his confidence and support, and the nurturing and supportive environment he has encouraged in the entire College among students, faculty, and staff.

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THE COMPLETE REAL ESTATE ENCYCLOPEDIA

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Numbers

80–10–10 mortgage A type of mortgage arrangement with 80 percent of the purchase price paid by a first mortgage, 10 percent paid by a second mortgage, and the final 10 percent in down payment; sometimes used in order to avoid having a 90 percent first mortgage and the required private mortgage insurance premiums.

203(b) loan Standard FHA-insured fixed-interest rate mortgage loans for one- to four-family residential properties. The loan program features the ability to have down payments as low as 3 percent and to finance closing costs as part of the loan. There are limitations on the maximum size loan that can qualify. The limitations change over time and by geographic area. The comparable adjustable-rate program is called a 251 loan.

203(k) loan Also called a HUD rehabilitation and repair loan, it is an FHA-insured loan obtained through independent lenders. Single-family to four-unit residential properties are eligible, as well as mixed-use properties with certain ratios of residential to commercial uses. Rehab money can be used for normal repairs or improvements, or to convert a single-family home to a multifamily dwelling (up to four units) or the reverse. Homes that have been demolished, or will be razed as part of the rehab, are eligible as long as some of the foundation structure remains. The maximum loan amount is 110 percent of the value of the property after rehab. (Do not confuse this type of loan with HUD's property improvement loan, also called a Title I loan.)

203(n) loan FHA-insured loan for the purchase of a unit in a cooperative apartment building. [Program details are similar to that of a 203(b) loan.]

234(c) loan FHA-insured loan for the purchase of a condominium unit. If the unit is in a building converted from apartments to condos, no insurance will be provided unless (1) the conversion was more than one year earlier, (2) the potential buyer was a tenant before conversion, or (3) the conversion is supported by a tenant's organization that represents a majority of the households in the project. Eighty percent of FHA-insured mortgages in the project must be to owner-occupants. [Otherwise, it is similar to the 203(b) program.]

234(d) loan An FHA-insured loan for the construction or rehabilitation of housing projects intended to be sold as condominium units.

245 loan An FHA-insured loan program also called the graduated payment mortgage. It allows home purchasers to begin with low monthly mortgage payments and then steadily increase them over the next 5 to 10 years, when they will remain constant.

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245(a) loan FHA-insured loan program also called Growing Equity Mortgage (GEM) Insurance.

251 loan A standard FHA-insured mortgage loan for one- to four-family residential properties at adjustable interest rates. The comparable fixed-rate program is called a 203(b) loan.

501(c)(3) A charitable organization, named after Internal Revenue Code, Section 501(c)(3), which gives such organizations tax-exempt status.

1031 exchange (pronounced "ten thirty-one exchange") From Section 1031 of the Internal Revenue Code, the ability to exchange like-kind property and defer paying taxes on the gain realized. Under normal circumstances, if a party purchases Blackacre for $10,000 and then exchanges it for $100,000 in cash, there is a gain of $90,000 on which income taxes must be paid. But, because of §1031, if Blackacre is exchanged for like-kind property, then the gain is realized (meaning it occurs) but is not recognized (meaning no tax is due at that time).

The property given up is called the relinquished property, and the property received is called the replacement property. After the exchange, the basis in the relinquished property becomes the basis in the replacement party. In other words, the $10,000 purchase price for Blackacre, called the basis, becomes the basis of the replacement property. When the replacement property is sold later for $150,000, the gain would be $150,000 less $10,000, not $150,000 less $100,000. That is true unless you do another 1031 exchange at that time. There is currently no limit on the number of exchanges you can do in a lifetime.

The properties must be qualifying use properties, meaning that they have or will be held for income production (rental) or investment, or used in a trade or business. Personal residences and vacation homes are not qualifying properties.

Swapping properties is a very handy tax tool, but it is relatively rare to find property owners who want to exchange properties at a simultaneous closing. As a result, the IRS allows the use of a fiction, a type of like-kind property proxy. In the fiction, the owner of Blackacre may sell it for cash, but the money must be placed in the hands of a qualified intermediary to hold. It is said the taxpayer can never have his or her fingerprints on the cash—not to spend, not to borrow against, nothing. The taxpayer then has 45 days to identify a replacement property and complete a form with the identification information. After that, the taxpayer has a short time to close on the replacement property, for which the funds in the hands of the qualified intermediary may be used. If all this is done exactly right, the taxes will be deferred.

[This entry does not allow enough space for all the technicalities of a 1031 exchange. Specific details of a 1031 exchange can be found at the IRS Web site (www.irs.gov), "Publication 544, Sales and Other Dispositions of Assets" and "Form 8824, Like-Kind Exchanges" (PDF).]

1099 The IRS form for reporting payments made to independent contractors or interest earned on investments or bank accounts. The person completing the form supplies copies to the party receiving the payments and to the IRS and state and local taxing authorities. If one's tax return does not disclose income reported on a 1099, there is a high likelihood of an audit. Real estate agents typically receive 1099s from their brokers for commissions earned during the prior year.

A

AAA tenant (pronounced "triple-A tenant" but written as AAA tenant) Commercial tenant with the best possible credit rating and the least likely possibility of default. Owners can secure better selling prices or better financing terms if they have such tenants in their property.

abandonment An intentional surrender, disclaimer, or termination of ownership with no stated intention regarding who the next owner should be. Legally requires some external evidence of an intention to abandon; simply neglecting property will not suffice. Differs from surrender, which requires that someone accept the property, and from forfeiture, which is unintentional loss of property. Abandoned property will generally revert to someone with a prior claim, such as an abandoned leasehold reverting to the landlord or an abandoned easement reverting to the landowner. Sometimes abandoned property will escheat to the state.

abatement A reduction or decrease. Local governments sometimes offer tax abatements to new businesses in order to attract them to the area. Commercial leases usually have clauses denying rent abatement if the leased property is partially destroyed and then rebuilt and made usable again.

able to purchase Financially capable of gaining access to the necessary funds to complete a purchase. Real estate brokers with a written listing agreement are usually entitled to a commission if they produce a buyer who is "ready, willing, and able" to acquire the subject property at the asking price, even if the seller then refuses to go through with the sale.

abnormal sale In appraisals, a sale that is not typical of the market at that place and time. Such a sale may be the result of family transactions, ignorance of true values, threat of foreclosure, or other unusual events and will not be used to determine the value of the property being appraised.

abode Residence, home, domicile.

above building standard Typically refers to items not included in a landlord's construction work letter. A new tenant can usually negotiate the landlord's agreement to pay for all construction expenses necessary to customize space to building standard, which might be hollow doors, inexpensive carpet, 2 ft $\times$ 4 ft ceiling tiles, and fluorescent light fixtures, depending on the building. Anything above building standard must generally be paid by the tenant.

abrogate Withdraw, rescind, revoke, or cancel. Common usage implies an act done in a one-sided or high-handed manner, but this is not necessary to the definition.

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absentee owner One who does not personally occupy or manage their property.

absolute auction A sale will be to the highest bidder, regardless of the amount bid. Common wisdom among auctioneers is that a property advertised as being sold at absolute auction will attract more bidders and higher bidding prices than one advertised with even a low minimum acceptable bid, or reserve price.

absolute net lease Also called a triple net lease, in which the tenant pays rent plus all costs of ownership, such as insurance, real estate taxes, repairs, cleaning, and utilities.

absolute net rent Rent payments that are pure income to the landlord, because they are not reduced by any operating expenses. When an owner quotes a figure as absolute net rent, it is a clue that the tenant will also have to pay all insurance, real estate taxes, repairs, cleaning, and utilities in addition to the monthly rent.

absolute title A title to real estate without any competing claims such as IRS liens, prior mortgages, leases, easements, or spousal claims. A lender will usually require either clear title in the borrower, or waivers by other parties, so the lender will have absolute title if it has to foreclose. Also called clear title.

absorption rate The rate at which vacant space is leased or purchased over a specified period of time. The absorption rate for commercial property is usually expressed in square feet per year; residential property is quoted in units (homes) per year.

abstract deed Colloquial expression used to refer to the original deed from the government to the first private owner of a parcel of land. Other times, it is meant to describe a deed that recites all former owners and their dates of acquisition. Sometimes purchasers who request an abstract deed mean to communicate that they want title insurance or a title opinion in addition to the deed. Technically, there is no legal instrument called an abstract deed. (When you encounter this expression, ask questions in order to determine what is meant.)

abstract of title Synopsis of all prior owners and important claimants to property, with the date and origin of their rights and date and manner of termination, together with all current owners, lienholders, easements, or other such claims against the property.

abut Next to, touching, contiguous. Typically arises in the context of whether property owners have a duty to clean snow, ice, and debris from the sidewalks abutting their property.

A/C Shorthand for air conditioning.

accelerate To demand the full amount due under a contract even though the original agreement allowed payments over time. Almost all promissory notes and leases have acceleration clauses in the event of default. If it were not for such clauses, the lender or landowner could be required to file separate lawsuits when each payment was missed, or wait until the end of the term and sue for all at once.

accelerated amortization Making additional mortgage payments so as to reduce the principal amount of the debt more quickly than originally contemplated in the parties' agreement.

accelerated cost recovery system (ACRS) A method of tax accounting in which the IRS simplified the rules for depreciation of property. It has been replaced by the modified accelerated cost recovery system (MACRS), but you will still encounter references to ACRS.

accelerated depreciation Depreciation methods that allow larger deductions in early years, trailing off to smaller deductions in later years. It is the opposite of straight-line depreciation, in which equal amounts are depreciated every year. Accelerated depreciation is not allowed for real property, but may be employed for certain components, such as fencing, security systems, carpet, or windows. The most common types of accelerated depreciation encountered in real estate are double declining balance, also called 200 percent declining balance, and the alternative 150 percent declining balance method.

> **Example:** *Carpeting in residential rental properties may be depreciated over 5 years. Assuming $10,000 worth of carpeting is installed in an apartment building, this is each year's depreciation using the different methods:*

	Straight Line	150% Declining	200% Declining
Year 1	$2,000	$3,000	$4,000
Year 2	2,000	2,100	2,400
Year 3	2,000	2,000	2,000
Year 4	2,000	2,000	1,600
Year 5	2,000	900	0

acceleration clause The clause in a promissory note or lease that allows immediate demand, upon default, for all sums due over the entire term.

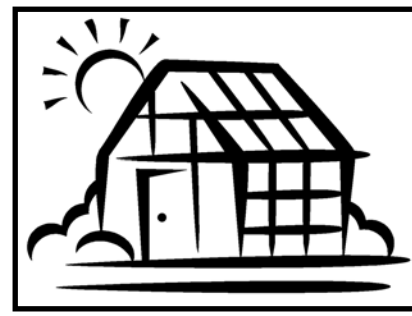
acceptance (1) The act of receiving something with the intention of retaining it. Transfer of title to real estate requires acceptance of the title. (One cannot secretly deed a toxic waste site to an enemy in hopes that the Environmental Protection Agency will make that person handle the cleanup.) (2) The act of agreeing to the terms and conditions of an offer, creating a contract by virtue of the acceptance.

Access Board An independent federal agency that develops and maintains design criteria for buildings and other improvements, transit vehicles, telecommunications equipment, and electronic and information technology. It also enforces accessibility standards that cover federally funded facilities. The Access Board's Web site is www.access-board.gov.

accessibility (1) Evaluation of the convenience of a property relative to the people who will be using it. May refer to ingress and egress for customers or lack of obstructions for persons with disabilities. (2) Important component in pricing surveying services. The more difficult the terrain and the less accessible the site; the more expensive the fee.

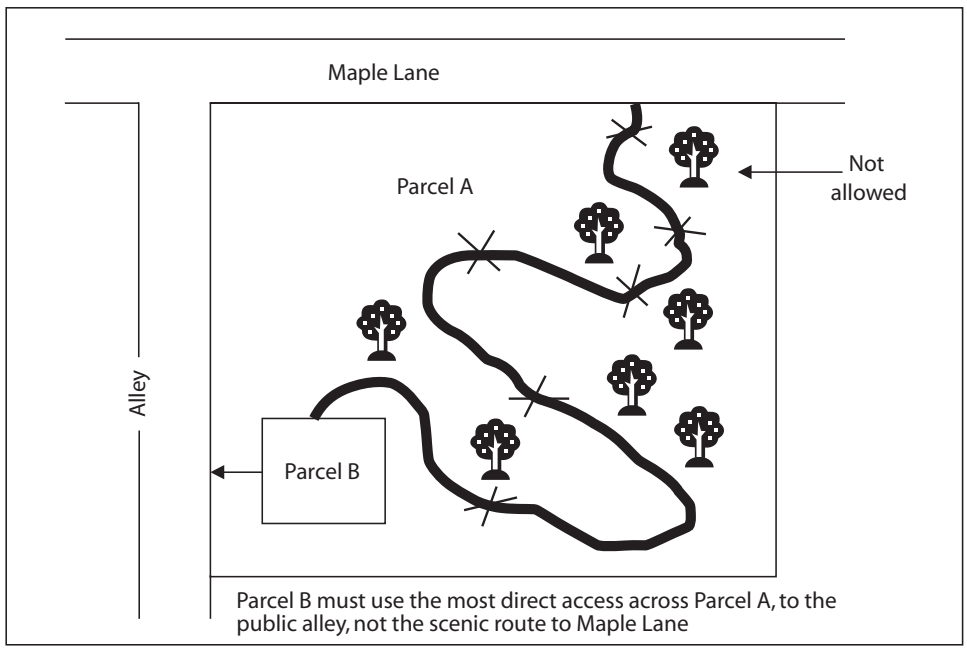
accession The right to own things that become a part of something you already own. When a tenant adds built-in cabinetry or other fixtures to a building, they become the property of the landlord by virtue of accession. Also frequently encountered in the realm of riparian (water) rights, such as new land created by dry river beds or retreating tidal lands.

accessory building A secondary structure that exists for the benefit of the main building, such as a tool shed or a detached garage. When drafting an offer to purchase real estate, you should be sure to include accessory buildings in your description. Otherwise, easily movable sheds and other structures not permanently affixed to the soil might be removed before closing.



A greenhouse is an accessory building.

access right The right of owners to get to or from their property. Legally, no land may be landlocked. Therefore, if a parcel is cut off from all public roads and there are no easements for ingress and egress, then the owner may bring suit and have a court declare an easement of necessity over the land of another. (This is one of the rare times when private individuals are able to bring condemnation actions and force another to give them property rights.)



Parcel B must use the most direct access across Parcel A, to the public alley, not the scenic route to Maple Lane

Example: *Parcel B is landlocked, but the owner is entitled to access rights to public roads and may force the owner of parcel A to provide an ingress and egress easement. The easement must be via the most direct route to the nearest public road, without being unduly burdensome on parcel A. The owner of parcel B may not force the owner of parcel A to provide a scenic route.*

accommodating party A third party who holds money or other property for a short period of time in order to facilitate a tax-free exchange under Section 1031 of the IRS Code. The third party is called a qualified intermediary in the tax regulations.

Example: *Jack sells his office building to Jill for $400,000. Jill pays the money to Larry Lawyer, who keeps it in his escrow account. Larry is the accommodating party. When Jack meets the timing requirements of Section 1031 and wants to buy an apartment building for $1,000,000, Larry will write a check to the seller for $400,000 and Jack will pay the remaining $600,000. In common language, Jack can't have his fingerprints on the money, so an accommodating party is necessary.*

accommodation party One who signs a promissory note even though he or she receives no direct economic benefit from it. Typically, a financially strong party who must add his or her name to the transaction or the true borrower would not qualify for the loan. There is a widespread and mistaken belief among accommodation parties that they simply signed their name but will not be held responsible if the loan goes into default. This is incorrect; they will be held liable for the full amount of the loan if there is a default. (*Do not confuse with accommodating party.*)

Accredited Rural Appraiser (ACR) A designation granted by the American Society of Farm Managers and Rural Appraisers (www.asfmra.org).

accretion The addition of land through natural causes, such as gradual silting. You will often see accretion used to also describe the addition of land because of receding waters, but this is more properly called dereliction.

accrual method An accounting method in which income is counted when it is earned (whether you receive the money at that time or not) and expenses are counted when incurred (whether you pay the bill at that time or not). It is the opposite of the cash method, in which income is counted when money is received and expenses are counted when the bills are paid. Most businesses use the accrual method because it allows income, and the expenses associated with generating that income, to be accounted for in the same period. (Many small businesses use the cash method because it's easier.)

accrue To accumulate; grow. A $100,000 loan at 7 percent interest accrues interest at the rate of $7,000 per year, or $19.18 per day. The mortgage holder on a property being sold will typically tell the closing company a payoff amount accurate as of the anticipated closing date, with a daily accrual for each day closing is delayed.

accrued but unpaid Money that has been earned, such as interest on a mortgage loan, but not yet collected.

accrued depreciation The total depreciation claimed, to date, on a property. It is an entry on the balance sheet and is supposed to properly reflect that the property is becoming less valuable with the passage of time. Realistically, in the case of real estate, the property is usually becoming more valuable each year. As a result, you may have a book value of $200,000 but a fair market value of $2,000,000.

accrued interest For every day that a loan remains unpaid by the borrower, it earns interest that must be paid to the lender. This process of earning interest with each passing day is called accrual, and the money earned is called accrued interest. It may not be payable until the first day of the next month, but it has already been fully earned by the lender. See also *nonaccrual*.

accumulated depreciation Also called *accrued depreciation*.

acknowledge To accept responsibility for something. In real estate, it means to sign an instrument in front of a notary public, who will certify that the signer stated the signature was an act of free will.

acknowledgment A declaration by one signing an instrument, usually a deed, mortgage, or will, that their signature was free and voluntary. The declaration must be made before an authorized person, usually a notary public, but may also be designated court officials or others named by statute.

ACM See *asbestos containing material*.

acquisition The act of obtaining ownership of something. It may occur through derivative acquisition—procured from another who previously owned the thing—or though original acquisition, which is new creation such as land made when the ocean recedes.

acquisition cost The price and all related expenses of obtaining property; may include closing expenses, survey, inspections, and paying off adverse claimants.

acquisition, development, and construction (ADC) loan A loan made to allow a developer to buy land, install infrastructure such as streets and sewers, and build improvements. Because the value of the collateral depends on the development process adding significant value, these are considered somewhat risky loans. As a result, lenders limit the number of ADC loans they extend. A loan turndown from one lender may not be a stamp of disapproval for the project, but simply that lender's inability to extend any more ADC loans until others are paid off or converted to permanent financing.

acquisition loan A loan made to acquire a property, also called a purchase money loan. In bankruptcy law, acquisition lenders receive some special priorities and benefits not granted to other creditors.

acre Historically, the amount of land a yoke of oxen could plow in one day; today, a quantity of land containing 43,560 square feet. An acre can be any shape. Especially in the case of commercial properties, land values are usually expressed in terms of price per square foot rather then price per acre.

Example: *If you know that a 16-acre parcel recently sold for $10,000,000, you calculate the price per foot as follows:*

16 acres × 43,560 square feet per acre = 696,960 square feet
$10,000,000 ÷ 696,960 feet = $14.35 per square foot

acreage zoning Zoning intended to reduce residential density by requiring large building lots.

acre-foot A quantity of water, sand, or minerals equal to a volume 1 foot high over one hypothetical acre of land. It arises in the context of pricing water for irrigation purposes, estimating the value of minerals in place under the soil, and estimating numbers of fish per acre-foot of water.

ACRS See *accelerated cost recovery system*.

action to quiet title See *quiet title action*.

active participation An IRS term relating to passive activity losses that can be deducted only against passive activity income, not against ordinary income. Rental activities are always passive, unless you are a real estate professional. There is a small loophole—if you or your spouse actively participated in a passive rental real estate activity, you can still deduct up to $25,000 in rental activity losses from ordinary income. As a result, taxpayers are eager to prove they have active participation in their real estate investments so that large depreciation expenses, for example, can shelter income from other sources. Active participation can be shown if you make bona fide management decisions such as approving new tenants, deciding rental terms, approving expenditures, and similar activities. (See IRS Publication 925, "Passive Activity and At-Risk Rules" at the IRS Web site www.irs.gov.)

active remediation Engaging in some affirmative action to remove contaminants from soil or water. The alternative is passive remediation, which is usually accomplished by normal flushing processes occurring over time.

active solar heating Method of heat that relies upon the sun to heat either air or liquids in a solar collector, and then distribute that heat throughout the structure. Contrast with passive solar heat.

Act of God An act caused exclusively by the violence of Nature, without any intervention from humans. Many contracts contain clauses relieving the parties of responsibility if an Act of God delays or makes impossible the performance of the contract. Examples include earthquakes, floods, hurricanes, lightning, tidal waves, tornadoes. (With current controversy over the effects of global warming, and with allegations that deficiencies in the New Orleans levee system caused the massive flooding in 2005, we can expect renewed litigation concerning flooding as an Act of God or of humans.)

actual age In appraisal, the true age of a property, as opposed to its effective age. A building might have an actual age of 25 years but an effective age of 3 years because of massive renovations made 3 years earlier. A house with six small children in the family might have an actual age of 2 years and an effective age of 18 years.

actual damages Losses or injuries for which the law allows compensation as a means of reimbursement; used also to refer to the money awarded by a court as that compensation. Contrast with nominal damages, which would award $1, but recognize that the plaintiff's rights have been violated even though no economic, physical, or emotional harm occurred. Contrast also with punitive damages, which are not intended to compensate the victim but to punish the aggressor.

Actual damages may be

- Direct damages—those that flow directly and naturally from the wrong
- Consequential damages—those that flow from some consequence of the wrong

Example: *Able agrees to purchase Baker's house. As a result of that contract, Baker agrees to buy a new condo under construction and pays a nonrefundable $5,000 reservation fee. Able then defaults and refuses to purchase Baker's house, even though Able has no justifiable reason for doing so. Two weeks later the stock market crashes, and Baker counts himself lucky when he is able to sell his house for $40,000 less than the original contract price. But, Baker is now unable to purchase the condo and loses his $5,000. Under the right circumstances, Able could be liable to Baker for actual damages consisting of the $40,000 difference in the two sale prices (direct damages) and for the loss of the $5,000 earnest money (consequential damages—more indirect and less predictable) and for punitive damages.*

actual eviction Removing someone from property either by force or by legal process. Contrast with constructive eviction, in which property is rendered unusable because of some action or inaction of the landlord.

actual notice Commonly means notice expressly and directly given to a person and received by that person. In legal documents, however, a requirement for actual notice may be satisfied through express notice or implied notice, but not by constructive notice. Express notice is given by actual delivery of the information to the person charged. Implied notice is satisfied if the person has sufficient facts available to cause him or her to ask further questions and thereby receive express notice. Constructive notice occurs when someone is charged by law with making inquiries such as would cause him or her to learn of facts giving rise to implied notice.

actual possession The physical occupancy or control of property by someone. Contrast with constructive possession in which the law assumes possession because of legal rights to the property.

Example: *One who has a deed to 40 acres of land, but uses only 1 acre for a house and yard, is said to have actual possession of 1 acre and constructive possession of the other 39 acres.*

actual value The true market value of a property if it were offered for sale at a particular time to a buyer with sufficient information about the property to make an informed decision. Contrast with book value, which is the original purchase price, plus capital expenditures, minus depreciation. Contrast also with perceived value based on fraud.

ADA See *Americans with Disabilities Act*.

ADC loan See *acquisition, development, and construction loan*.

add-back The amount added to the principal balance of a loan because the monthly payments are insufficient to pay all currently accrued interest; may be encountered with variable-rate, fixed-payment loans.

addendum Something added as an attachment to a form contract, before contract execution; generally used to cover the particular circumstances of that transaction. Real estate contracts may have addenda (plural of addendum) to cover requirements relative to financing contingencies, property inspections, disclosure of the possible presence of lead-based paint in structures built before 1978, and other variables. Especially for properties with lengthy legal descriptions, an addendum will generally be used for the legal description of the property, rather than squeezing it into the small space available on the form. Contrast with amendment, which is an attachment added after contract execution in order to modify or expand upon the original contract.

additional charge mortgage A mortgage instrument that recites on its face that it is used to secure present and future debts by the borrower to the lender. It serves to put new lenders on notice that the equity in the property may decrease in the future, as a result of additional money being advanced by the first lender. See *future advances mortgage* and *anaconda mortgage*.

additional rent Amounts due under a lease in addition to the originally agreed upon base rent. Leases usually characterize all sums due to a landlord, including late fees, collection costs, and property damage, as additional rent. This gives the landlord some legal advantages as far as declaring a default, obtaining an eviction, and collecting sums due. Examples could include the tenant's share of property maintenance and insurance expenses and a retail tenant's obligation to pay a percentage of gross income in addition to base rent.

additional first-year depreciation Also called bonus depreciation. An IRS provision that allows taxpayers to take more than the ordinary depreciation in the first year a property is placed in use. (After the 9/11 attacks, taxpayers could deduct up to one-half of the basis of their property in the first year. Ordinarily, only $^{1}/_{39}$ or $^{1}/_{28}$ of the basis could be deducted in the first year. Similarly, in the wake of the devastating 2005 hurricane year, some taxpayers could take additional first-year depreciation equal to one-half of the basis.) In addition, taxpayers may take larger than normal depreciation for some property, called Section 179 property, even it if results in effectively expensing the entire purchase price in the current year.(For more information, visit the IRS Web site www.irs.gov.)

add-on interest An interest calculation sometimes used to avoid state usury laws (prohibitions against excessive interest) or to gain the equivalent of a prepayment penalty not otherwise allowed by law. The interest for the entire term of the loan is calculated as if no payments will be made until the loan matures. The total interest is added to the principal, and the borrower then makes equal monthly payments over the term of the loan. Even though the borrower reduces the outstanding principal balance with each payment, he or she is still paying interest on the whole amount borrowed. If the borrower prepays the loan, a calculation called the rule of 78s results in a disguised prepayment penalty.

Example: *The difference between 8 percent simple interest and 8 percent add-on interest for a $25,000 loan paid monthly for 4 years is*

Simple interest monthly payments	=	*$610.32*
Simple interest total interest paid	=	*$3,586.62*
Add-on interest monthly payments	=	*$687.50*
Total add-on interest paid	=	*$8,000.00*

adequate consideration See *consideration*.

adequate public facilities ordinances (APFO) A local law controlling growth by requiring completion of infrastructure—roads, sanitary and storm sewers, waterlines, and schools—prior to, or at the same time as, new private development that will need those services. Approvals for new subdivisions or commercial properties may be withheld until regulatory authorities deem there are adequate public facilities.

adhesion contract A contract that is so grossly one-sided that courts will not enforce it, or will not enforce specific terms deemed to be unconscionable or oppressively unfair, especially if the consumer has no other choices in the marketplace.

adjacent Nearby, but not necessarily touching; implies properties separated by a natural barrier such as a river, or by a street, but not separated by another property. Properties that touch each other are legally said to be adjoining rather than adjacent, but common usage includes such properties as within the definition of adjacent.

Adjacent to my property	
Maple Street	
My property	Adjoins my property

adjoining Touching, as in properties that are not separated by any natural or human-made barrier nor by any other property. Contrast with adjacent, which means nearby, but not necessarily touching.

adjudication A formal declaration by a court, addressing all issues raised by the parties.

Example: *The court's adjudication declared the seller in default, ordered the seller to execute a deed to the buyer, and further assessed attorney's fees and costs against the seller.*

adjunction Adding something to property in such a manner that it loses its independent identity.

Example: *Personal property consisting of boards and nails will become part of the real estate by adjunction when they are used to build an addition to a house.*

adjustable mortgage loan See *adjustable-rate mortgage*.

adjustable-rate mortgage (ARM) An instrument granting a security interest in real property as collateral for a promissory note with interest rates that change from time to time, as specified in the note. The note should contain

- An initial rate, or the first interest rate to be charged.
- A reference number, called the index, to be used in calculating future interest rates. As the index increases or decreases, the loan interest rate will increase or decrease by the same amount.
- The index could be the Federal Reserve overnight funds rate plus a certain percentage, it could be the prime rate charged by CitiBank to its most credit-worthy customers (CitiBank Prime), or any number of other indices. You want to avoid any adjustable-rate note with references to vague generalities such as "market rate" or rates charged by small unknown lenders.
- A statement regarding the frequency at which the rate may change. Commercial loans typically change every time the index changes. Consumer loans usually change only once or twice a year.
- A statement regarding the maximum amount the interest may increase each time, called a periodic cap. (Consumer loans usually have periodic caps, but not commercial loans.)
- A statement regarding the maximum amount the interest may increase over the lifetime of the loan, called a lifetime cap. (Consumer loans usually have a lifetime cap around 5 percent; commercial loans usually do not have any lifetime caps.)

Many adjustable-rate mortgages for home loans have a conversion clause allowing (or even requiring) change to a fixed rate of interest after a specified period of time, usually 5 or 7 years. This gives the homeowner the ability to lock in a fixed rate without having to go through the trouble and expense of a refinance.

One type of adjustable-rate mortgage is the fixed-payment, adjustable-rate loan. With it, the consumer pays the same amount each month, even if interest rates rise to the point that the payment does not pay the currently accruing interest. The unpaid interest is added to the principal of the loan. In such a situation, the loan is said to be negatively amortizing, meaning the principal balance grows larger each month rather than smaller.

adjusted basis A tax and accounting term referring to the original acquisition cost of a property, with the following adjustments:

- Depreciation, which reduces the basis
- Capitalized closing costs, which increase the basis
- Capital improvements, such as a new roof, which increase the basis

The difference between the adjusted basis and the ultimate sale price of a property will be the taxable profit on the sale. The adjusted basis is an extremely important tax concept, and one which it is important to master in order to comfortably evaluate properties.

adjusted sales price In an appraisal, the answer obtained when the sales price of a comparable property is adjusted for factors that make it different from the property being appraised.

> **Example:** *Property A is being appraised, and property B is a similar property that sold recently. Property B has some features that property A does not. The sale price of property B would probably be lower if it, too, lacked that feature, so a downward adjustment is made. Likewise, property B lacks some features present in property A. If property B had those features, it would have sold for a higher price, so an upward adjustment is made in property B's sale price.*

Example: Adjusted Sales Price Calculations

	A	B	Adjustments
Sale price	—	$175,000	
Garage	Yes	No	+$40,000
Pool	No	Yes	−$25,000
Brick	Yes	No	+$8,000
Adjusted sale price of B			$198,000

adjusted tax basis See *adjusted basis*.

adjustments Closing: Debits and credits to the purchase price of a property because of items to be paid by the seller or the buyer. All adjustments should be reflected on a settlement statement. (The settlement statement used in home sales is a form, called a HUD–1, created by the Department of Housing and Urban Development.). In appraisal: See *adjusted sales price*.

administrative expenses Compensation to management for operating or building a property; may include salaries and professional fees. Contrast with operating expenses, reserves for losses, and reserves for repairs.

administrator A person appointed by a court to manage and distribute the estate of someone who has died without a will. Sometimes, the term refers to a male occupying that position, with a female being called an administratrix. Contrast with executor (male or gender-neutral) and executrix (female), who are persons named by a will to manage and distribute one's estate.

administrator's deed A deed executed by one appointed by a court to administer another's estate; usually for someone who died without a will.

administratrix Older term meaning a female appointed by a court to administer the estate of another, usually someone who died without a will. The male position was called an administrator. (Today, the term administrator is considered gender-neutral.)

administrivia Slang term meaning the nondeal points contained in small print in documents written by lawyers, especially seemingly nonsensical items such as "The masculine shall include the feminine and the singular shall include the plural."

ADR See *asset depreciation range*.

adult One who has gained the age of majority, usually 18 or 21 depending on the state. Sometimes, younger people can take legal steps to remove the "disabilities of nonage," after which they will be treated as legal adults even though under the requisite age. Only adults have the legal capacity to enter into contracts or sell property. Minors may own real estate, but, because of the inability to enter contracts, they cannot effectively manage it, obtain a mortgage, or sell the property. If such actions should prove necessary, the child's legal guardian will usually have to ask a court for permission for the proposed action. The court will then appoint a guardian ad litem to represent the child's interests, in case the guardian has a conflict of interest or clouded judgment.

ad valorem tax Literally means "according to the value." A tax placed upon property and calculated with reference to the value of the property. Ad valorem taxes usually have a super-priority, so that a sale for unpaid taxes will transfer title into the buyer, free and clear of any mortgages or other liens. On the other hand, lienholders are generally given the right to redeem property from tax sales, and regain all rights simply by reimbursing the purchaser for the sale price plus accrued interest.

advance In construction financing, to disburse money from the allowable total amount of a loan in order to pay bills currently due, or to pay the builder or developer according to a previously agreed upon schedule of payments. Typically, a certain percentage will be advanced upon approval of plans and drawings, another amount at completion of all clearing and grubbing, at the end of final grading, when the structure is in the black (the roof decking has been completed), and then again at completion and final inspection.

advance payment annuity A regular payment made at the beginning of each month, year, or other period. It is relevant to real estate because many financial calculations, such as those possible in Microsoft Excel or on a financial calculator, require entry of different formulas depending on whether you are solving for an advance payment annuity (also called an annuity due) or an ordinary annuity. Any time you want to solve an equation that involves a payment received at the beginning of a period, such as rent, you use the format for advance payment annuity. Any time you want to solve an equation that involves a payment received at the end of a period, such as mortgage payments, you use the format for ordinary annuity.

adverse claim A claim against real property that is inconsistent with the purported owner's full ownership rights.

adverse financial change condition In a loan commitment, a clause that allows the lender to cancel the commitment without penalty if the borrower's financial condition changes for the worse before loan funding.

adverse possession Sometimes called squatter's rights; method of acquiring title to real estate when the true owner has neglected to assert his or her own rights for a specified period of time.

Commonly arises in the context of boundary line disputes. The next most common occurrence is when there is some technical defect in the title which can't be cured with a corrective deed because the person who must sign has disappeared, is dead, or refuses to sign. If one actually occupies property without permission, in an open and notorious manner, that is exclusive and hostile, and the true owner takes no action to dispossess the claimant, then the actual owner will be forever barred from asserting any rights to the property. The requirement of hostility does not mean there must be animosity between the parties, but simply that the adverse possessor claims ownership of the property, and therefore is legally hostile to any other claimants. The lack of permission refers to the absence of a lease or other such agreement granting possession but not necessarily title. The required time period, called the holding period, may vary from 10 to 20 years.

By law, one cannot adversely possess against the government.

> **Example:** *Seth and Rose are next-door neighbors and the best of friends. Seth erects a fence on what he believes to be their boundary line. For the next 10 years (or 20, depending on the jurisdiction) he mows the lawn up to the fence. Rose believes the fence marks the boundary between their two properties, but she is mistaken. Rose then sells her property to Greg, who orders a survey. The survey reveals that 20 feet of Emma's land is on Seth's side of the fence. In a lawsuit over the property line, Seth will usually claim that Greg's surveyor is mistaken and will also claim that even if the survey is correct, Seth has gained title to the 20 feet by virtue of adverse possession. It was Emma's responsibility to know the true location of her property lines. If she did not assert her rights during the 10- or 20-year time period, she, and all others coming after her, lose those rights.*

aesthetic value A premium attached to the value of property because of its physical appearance or the scenic views that may be enjoyed from the property; the artistic worth of something, rather than its practical value.

aesthetic zoning Zoning regulations that require new construction to conform to certain architectural and landscaping requirements. Examples include prohibitions against metal buildings, requirements that retaining walls be hidden behind shrubberies or trees, and restrictions on the location of off-street parking. Failure to investigate aesthetic zoning requirements can result in a project going substantially over-budget and possibly becoming economically disastrous.

affiant A person who makes a written statement under oath by way of an affidavit.

affidavit A written statement signed by the person making the statement—the affiant—and sworn to as true and accurate.

affirm Confirm, ratify, positively acknowledge as correct. One may affirm a statement in an affidavit. Witnesses may affirm that all testimony to be given will be true and accurate.

affirmative lending Obligation placed upon federally chartered lenders by virtue of the Community Reinvestment Act, and upon state-chartered lenders by similar state legislation. Requires lenders to exert efforts to match the demographic character of their loan portfolios to the demographic character of the community in which they operate.

affirmative marketing program A voluntary program designed by the U.S. Department of Housing and Urban Development in order to further its fair housing goals. This program seeks to involve builders, developers, lenders, and the real estate industry in a wide variety of cooperative enterprises to improve communication, focus, and sensitivity. Signatories are contractually bound to abide by the requirements of the plan. Many local governments have their own versions of an affirmative marketing program. Developers may agree to be bound by the master plan, or they must present and obtain approval of their own plan before construction permits will be granted.

affordability index See *housing affordability index*.

affordable housing Housing for people whose income is a certain percentage below the median income for an area, as determined by the U.S. Department of Housing and Urban Development (HUD). National and local governments provide incentives and cash assistance to developers to build new affordable housing or rehabilitate older apartment buildings or other projects and offer housing at rates deemed affordable for the area.

Currently, HUD has three affordable housing programs. They are

1. HOME. Provides grants to state and local governments to fund their programs to meet the housing needs of low-income and very low income families.
2. SHOP. Provides funds to nonprofit organizations to acquire home sites and develop or improve the systems for delivery of sweat equity and volunteer-based homeownership programs for low-income families.
3. HOZ. Provides funds for communities to reclaim vacant and blighted areas and create home ownership zones of mixed income, pedestrian friendly neighborhoods.

after acquired property clause A clause in a mortgage that "scoops up," as additional collateral, property acquired after the original loan. The intent is to protect the lender in case the borrower has a defective title to the property at the time of the loan, but later cures those defects and gains full legal title. It is also intended to gain a security interest in contiguous land purchased later, and having some practical relationship to the mortgaged land. (In practice, the clause is usually buried in the fine print and allows lenders to increase the value of their collateral when that was never the original intent of the parties.)

after-tax cash flow A financial analysis of an income-producing property to determine cash benefits to the owner after paying all expenses, mortgage payments, and taxes, and after deducting

amounts that must be taken into income for tax purposes, but which have not yet been collected. If the tax savings from depreciation or other tax shelters will result in tax losses, thus reducing taxes that must be paid on other income, then those savings are added back in, just as if they were additional income. The intent is to discover the amount of money that can be deposited in the bank at the end of each year.

Analysis of a Property Management Company for One Year

Financial Items	Profit	Cash Flow	After-Tax Cash Flow
Total billings	$80,000	$80,000	$80,000
Outstanding receivables as yet unpaid	N/A	(22,000)	(22,000)
Labor expenses	(35,000)	(35,000)	(35,000)
Office equipment depreciation	(4,000)	N/A	N/A
Loan principal payments	N/A	(6,000)	(6,000)
Loan interest payments	(1,200)	(1,200)	(1,200)
Net taxable income	39,800	N/A	N/A
Taxes on income	(9,154)	N/A	(9,154)
Net cash flow	N/A	15,800	N/A
Net cash flow after taxes	N/A	N/A	6,646
After-tax income	$30,646	N/A	N/A

N/A = not applicable.

after-tax equity yield Methods of financial analysis for an equity position in real estate, being the net return rate on an investment after deducting expenses, interest, and taxes.

> **Example:** *An investor buys a property with $100,000 down (equity) and $400,000 in financing. The investor receives $7,000 in cash flow each year, after paying income taxes on money earned from the investment. After 5 years, the investor sells the property and receives $150,000 after deducting mortgage balance, taxes, and sale costs. The investor received a return of the original $100,000 and a sale profit of $50,000 upon sale, plus the $35,000 received over the course of 5 years, for a total of $85,000.*

After quantifying the various components, one then calculates yield by using any of several formulas, such as cash-on-cash and internal rate of return.

after-tax income Income after deducting taxes. After-tax income is not the same thing as after-tax cash flow. The major difference between the two will usually occur because depreciation is a deduction from income but not cash flow. You don't write a check for depreciation. The other major difference arises because you write a check for mortgage principal payments, which reduces cash flow, but you can't deduct it, so it does not reduce taxable income.

Difference between After-Tax Income and After-Tax Cash Flow		
	After-Tax Income	**After-Tax Cash Flow**
Total rents	$10,000	$10,000
Operating expenses	(1,000)	(1,000)
Depreciation	(1,500)	N/A (not a cash item)
Mortgage interest	(1,000)	(1,000)
Mortgage principal	N/A (not deductible)	(500)
Subtotals	6,500	7,500
Taxes	(1,820)	(1,820)
Final number	$4,680	$5,680

N/A = not applicable.

after-tax proceeds from resale The amount of money left for the investor upon a sale after deducting all sale costs and taxes. This is the money available for reinvestment in another property.

agency A relationship in which the principal gives an agent the right to act on the principal's behalf and to exercise some business judgment and discretion. Agents owe very high degrees of loyalty, good faith, and confidentiality to their principals, often expressed as fiduciary obligations. Except for the agency coupled with an interest, agency relationships automatically terminate when the principal dies or becomes incapacitated. Agents do not have to receive payment for their services, and the agency agreement does not have to be in writing unless it relates to transferring an interest in real estate. The consequence is that many people enter into principal-agent relationships almost accidentally, being unaware of the responsibilities and obligations each has to the other.

- There is a great variety of agency relationships that arise in a number of ways. All states have statutes regulating real estate agents and defining their duties and responsibilities, but this is by no means the exclusive method of defining the relationship or its obligations.
- Agency by estoppel arises when a principal allows someone to engage in such activities that the public is justified in believing the person is acting as an agent, even if the person had no such authority. This becomes important when someone makes commitments he or she had no authority to make, and an innocent third party, relying on those commitments, suffers an injury. The principal will not be allowed to avoid the commitment by claiming the supposed agent had no authority, because the law will impose an agency by estoppel.
- Exclusive agency is a real estate sales relationship in which the owner of property grants a particular agent the exclusive right to market the property and secure buyers, but the owner retains the right to sell the property himself or herself and pay no commission at all. Contrast with an open listing, in which the owner agrees to pay a commission to any real

estate professional who brings a buyer to the closing table. Contrast also with an exclusive right to sell agreement, in which not only does the agent have an exclusive agency, but even if the owner sells the property, the agent receives a commission.

- General agency occurs when the agent is empowered to do all acts in connection with a particular trade, business, or employment. Contrast with special agency, in which the agent is authorized to conduct a single transaction or series of transactions not involving a continuing relationship. Real estate agents are special agents.
- Agency by ratification arises when one purports to act on behalf of a principal, without true authority, but the principal later learns of the act, ratifies it, and agrees to be bound. Requires some proof that the principal made a conscious decision to ratify the act. Contrast with agency by estoppel, in which the principal becomes bound because of his or her negligence, not because of any conscious decision.
- Agency coupled with an interest is a special relationship that arises when the agent also has an interest in the property with which he or she is dealing. This agency will not automatically terminate upon the death of the principal.
- Types of real estate agency:
  - A listing agent represents the seller of a property.
  - A selling agent works with the buyer, but may be a subagent of the seller or an agent of the buyer. Real estate agents must disclose which party they are representing, before someone accidentally reveals any confidential information.
  - A dual agent is supposed to represent both the buyer and seller, but this is virtually impossible for one person to do. The status arises most often when one real estate agent in an office represents the seller and another real estate agent in the same office represents the buyer; then the broker is technically considered a dual agent. In such situations the broker must take care that each agent not reveal confidential information to the other.
  - A transaction agent is technically no agent at all, but is simply a facilitator who uses superior knowledge of real estate customs and practices to assist buyers and sellers.

agency disclosure State laws that require agents to disclose which party to a transaction they are representing. Some states also require agents to disclose all agency relationships offered by their firm.

agent One who acts on behalf of a principal in an agency relationship. See *agency* for an extended discussion.

aggrieved party A party who has suffered a wrong or an injury; one who has a grievance or a complaint against another.

agreed boundary A doctrine that allows adjoining landowners to agree regarding the location of the true boundary line between themselves, if the line is in doubt. An oral agreement as to the location of the true boundary line is usually enforceable, despite statute of frauds laws that require all contracts relative to real estate to be in writing. In contrast, an oral agreement to compromise a boundary line, perhaps to "split the difference" and establish it someplace in the middle between two conflicting opinions, must be in writing to be enforceable.

agreement of sale Typically refers to any real estate sales contract. In a few states, however, the term refers specifically to a type of seller financing also called a bond for title, land sale contract, or contract for deed. In that instance, the seller retains legal title to the property until the purchaser has made all payments over the term of the financing period. At the end, if there has been no default, the seller executes a deed to the buyer. This device is often used in high-risk financing situations because it can often avoid legal protections given to the buyer in the event of foreclosure or bankruptcy.

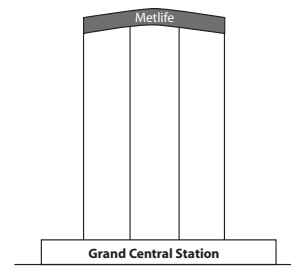
Agricultural Foreign Investment Disclosure Act A law requiring foreign persons with an interest in more than one acre of agricultural land to report their ownership to the U.S. Secretary of Agriculture, using form FSA 153. The law is only one of a number of mechanisms for monitoring foreign investment in the United States, its effect on pricing Americans out of the market, and its concentration of critical resources into foreign hands. (For more information, go to the U.S. Department of Agriculture Web site www.usda.gov and search for "FSA 153.")

agricultural use exemption In ad valorem taxes, an exemption that allows agricultural land to be valued at its current usage, rather than the possibly much more expensive highest and best use valuation. Oftentimes, the appraised value is then further reduced by a certain percentage to reach an assessed value, upon which the taxes are based. (Many say this is done as an incentive to maintain green spaces and agricultural land rather than developing it in order to generate money to pay extremely high real estate taxes. Others say the exemption is a result of powerful agricultural and timber lobbies.)

AIDS Acquired immunodeficiency syndrome. Persons who are HIV-positive, or who have AIDS, are protected from discrimination by the Americans with Disabilities Act (ADA) and other federal and state legislation. This extends to decisions to buy, rent, or sell. Further, in many states it is considered a violation of privacy to reveal that a former tenant or owner was HIV-positive or suffered from AIDS.

AIDS Housing Opportunity Act Legislation passed in 1990 to provide state and local governments with the resources and incentives to devise long-term comprehensive strategies for meeting the housing needs of persons with AIDS and the families of such persons.

air rights Historically, property owners owned to the center of the earth and to the top of the heavens, which included the right to all the air above the property and the right to exclude trespassers from that air. Until the invention of aircraft, the matter typically arose only in disputes over the right to remove tree limbs extending over one's property. Today, aircraft constantly trespass into property owner's air space and violate their air rights. As an accommodation to modern technology, courts allow reasonable trespasses to air rights. Airports and governments frequently purchase air rights adjacent to an airport, called avigation easements, to provide glide paths for aircraft. (Because of the scarcity of prime real estate near city centers, many local governments are investigating and implementing plans to lease air rights above transit hubs to developers, for building hotels and other such projects.)



The 58-story MetLife building in New York City is built in air rights above Grand Central Station

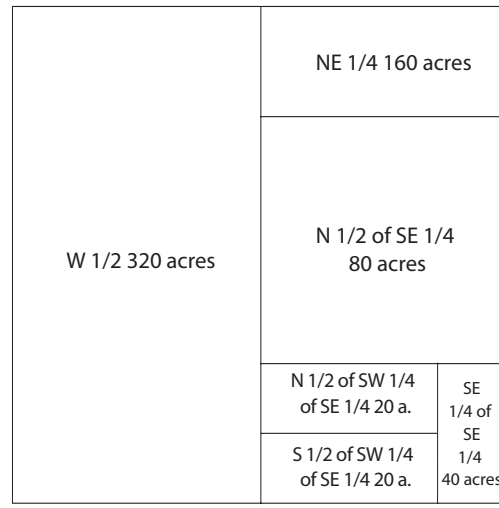
air space A three-dimensional slice of property above ground level. People who own condominiums own the rights to a specific air space.

ALDA See *Asset Conservation, Lender Liability and Deposit Insurance Act of 1996*.

alienation The act of transferring ownership or some partial interest in real property from one person to another. Voluntary alienation occurs when one executes a deed or a lease. Involuntary alienation occurs when there is a foreclosure, tax sale, or condemnation.

alienation by devise Occurs when property passes by virtue of a will, and alienation by descent occurs when it passes by intestate succession in the absence of a will.

aliquot parts subdivision Method of describing large parcels of lands as being entire sections, or regular percentages of sections. Under the public land survey system employed in most southern and western states, the states were divided into townships containing 6 square miles each. Townships were subdivided into 36 sections, and each section had 640 acres. Smaller parcels are described in terms such as quarters or halves of sections. All townships and sections are numbered, so it is fairly easy to identify a particular parcel of land by reference to its section township number, section number, and then its quadrant within the section.



Subdividing a Section

alley A path between buildings or behind buildings, usually with walls on both sides.

alligator property Derogatory slang term referring to a property with negative cash flows that eat up large amounts of investor cash.

all-inclusive deed of trust A purchase money deed of trust which is secondary to the seller's deed of trust to its own lender, which remains in place rather than being paid off at the time of sale. Now largely extinct because almost all commercial lenders have loan clauses allowing them to accelerate the note and demand all sums due immediately when a sale occurs. As a result, it is now virtually impossible to sell property without paying off the first mortgage or deed of trust, unless one engages in some type of fraud in order to prevent the lender from discovering the property has been sold. (Similar to a wraparound mortgage, but used in states that employ deeds of trust rather than mortgages.)

allodial system A system of real property law in which individuals may fully own all the rights associated with property and dispose of that property as they wish. The system had been evolving for many centuries, but the theory and the term were first clearly articulated by Thomas Jefferson in 1774, when he argued against an attempted land grab by King George III and used the theory to provide one of the supports for the American Revolutionary War. Contrast the allodial system with the

feudal system, in which the sovereign owned all land and could grant usage rights to others, but those rights were revocable at will.

allowance An accounting term used to describe entries on a profit and loss statement for expenses that might become necessary in the future. Examples include an allowance for bad debt, in which a certain percentage of income is deducted because of the likelihood it will be uncollectible.

Alpha Sigma Gamma A national real estate honorary for college students participating in real estate education programs. It is sponsored by the American Real Estate Society (www.aresnet.org/ASG/index.htm).

all-risks policy An insurance policy that covers all perils except those specifically excluded in writing. Mortgage lenders typically require an all-risks policy on their collateral.

alluvium The material deposited on land by virtue of the process of accretion. The accretion process occurs when rivers or other waters deposit silt and mud on land, and thus create more land; the silt and mud making up the new land is called alluvium.

ALTA See *American Land Title Association*. The acronym is usually pronounced as a word—"all tuh"—and used to describe a particular type of survey or other requirements imposed by the lender at a real estate closing, for example, "The mortgage lender will require an ALTA survey." Although this expression is common, there is no such thing as "an" ALTA survey. There are various ALTA requirements for a survey, some or all of which might be demanded by a lender.

alterations Physical changes to a property. Tenants are usually prohibited from making any alterations to the leased property. Disputes arise over whether something constitutes an alteration, or mere decoration or even repair.

alternative investments See *specialty investments*.

alternative minimum tax Tax reform enacted in 1969 as a result of the increasing financial burden of the Vietnam War. It was designed to impose a flat tax upon wealthy individuals who used all available tax shelters and loopholes in order to avoid paying any taxes at all. The treasury secretary at the time, Joseph Barr, warned against a taxpayer revolt once it became widely known that the country had 155 citizens who made over $200,000 per year but paid no income taxes at all, and 20 of them were actually millionaires! His predictions were accurate; more people wrote their congresspersons to complain about the 155 "tax cheats" than wrote to complain about the Vietnam War.

To remedy the situation, Congress revised the Internal Revenue Code so that complex calculations must be performed as if certain tax preference items were not deductible and then a minimum tax imposed on that figure so that "wealthy" individuals would pay their fair share of the tax burden. The problem with the system is that it is not indexed for inflation, so a 1969's wealthy individual is today's typical two-income middle-class family. The New York Times predicts that, by the year 2010, nearly 30 million taxpayers will have to pay the alternative minimum tax. There is increasing pressure to abolish the tax entirely, or to revise it to provide relief for middle-class Americans.

alternative mortgage instrument Any mortgage other than a fixed-rate, fixed-term, fully amortizing mortgage.

alternative workspace Various concepts relating to novel uses of space, including:

- Telecommuting. Working at home or on the road, with a computer network and possibly video links to a central office.
- Hoteling. Using office space on an as-needed basis via reservations, like a hotel room.
- Hot desking. In which telecommuters come into the office and use any available office or cubicle, without the need for reservations.
- Office sharing.
- Open office plans.

amendment A change to an agreement; an attachment added after contract execution in order to modify or expand upon the original contract.

amenities Particular features that add to the value of a property, such as a whirlpool tub and steam shower in a house, or swimming pool and tennis courts in a condominium project.

American Bankers Association A trade organization for officers of commercial banks (www.aba.com).

American Institute of Architects A professional association for architects, designers, and developers (www.aia.org).

American Institute of Real Estate Appraisers A professional organization formerly associated with the National Association of REALTORS®. It merged with the Society of Real Estate Appraisers in 1991 to form the Appraisal Institute (www.appraisalinstitute.org). It awards two designations, the MAI (Member, Appraisal Institute) and SRA (Senior Residential Appraisal) to members who have completed rigorous experience and testing requirements. In common parlance, an MAI appraisal, being one performed by someone with the MAI designation, is supposed to be more accurate and more reliable than one prepared by a licensed appraiser without the MAI designation.

American Land Title Association An association founded in 1907 as the trade association for the abstract and title insurance industry (www.alta.org).

American Motel Hotel Brokers Network An association for real estate brokers who specialize in hotels, motels, resorts, casinos, bed and breakfasts, and assisted living facilities (www.amhbnetwork.com).

American National Standards Institute, Inc. Founded in 1918, the organization (www.ansi.org) promulgates and oversees the implementation of a wide variety of standards, from acoustical devices to building measurements to livestock production. It also accredits programs that assess conformance to the ISO 9000 (quality) and ISO 1400 (environmental) management systems.

American Planning Association A professional organization of regional and urban planners (www.planning.org).

American Real Estate and Urban Economics Association An organization of scholars and practitioners concerned with the economic analysis of real estate activities. The association publishes Real Estate Economics, the oldest academic journal concentrating on the real estate industry. The organization's Web site, www.areuea.org, includes a searchable database of article abstracts.

American Real Estate Society Describes itself as an "association of real estate thought leaders… dedicated to producing and disseminating knowledge related to real estate decision making and the functioning of real estate markets." Membership is open to anyone with an interest in real estate research. The society's Web site is www.aresnet.org.

American Society of Appraisers A professional organization of appraisers (www.appraisers.org). It offers testing and accreditation in all appraisal disciplines, including

- Appraisal review and management
- Business valuation
- Gems and jewelry
- Machinery and technical specialties
- Real property
- Personal property

American Society of Farm Managers and Rural Appraisers Founded in 1929 as an association of farm managers; it added rural appraisers in 1936. It confers the designation ARA (Accredited Rural Appraiser). The organization's Web site is www.asfmra.org.

American Society of Home Inspectors (ASHI) A professional organization for home inspectors, founded in 1976. It is North America's oldest and largest professional society of home inspectors. The organization's Web site is www.ashi.com.

American standard Shorthand for measurement methods used by the Building Owners and Managers Association and adopted by the American National Standards Institute Inc. (ANSI) so that there is uniformity in measuring and calculating office space.

Americans with Disabilities Act (ADA) A federal law that grants civil rights protections to individuals with disabilities. It guarantees equal opportunity for individuals with disabilities in public accommodations, employment, transportation, state and local government services, and telecommunications.

- Real estate: The Act is most relevant in its provisions regarding public accommodation. Responsibility for compliance is placed on both landlords and tenants, as well as other property owners. Many commercial leases allocate the burden of ADA compliance so that the tenant must pay for any alterations or improvements necessary to bring a property into compliance.
- Places of public accommodation: These include a wide range of entities, such as restaurants, hotels, theaters, doctors' offices, pharmacies, retail stores, museums, libraries, parks, private schools, and day care centers. Private clubs and religious organizations are exempt.

- Accessibility for existing properties: Steps must be taken to remove barriers, if it can be done easily and without much expense. The evaluation of the expense depends on the size and financial strength of the entity.
- Accessibility requirements when a property undergoes alteration or renovation: For example, if during renovations a doorway is being relocated, the new doorway must be wide enough to meet the new construction standard for accessibility. When alterations are made to a primary function area, such as the lobby of a bank or the dining area of a cafeteria, an accessible path of travel to the altered area must also be provided. The bathrooms, telephones, and drinking fountains serving that area must also be made accessible. These additional accessibility alterations are only required to the extent that the added accessibility costs do not exceed 20 percent of the cost of the original alteration.
- Accessibility in new construction: The ADA requires that all new construction of places of public accommodation, as well as of "commercial facilities" such as office buildings, be accessible. Elevators are generally not required in facilities under three stories or with fewer than 3,000 square feet per floor, unless the building is a shopping center or mall; the professional office of a health care provider; a terminal, depot, or other public transit station; or an airport passenger terminal.
- Litigation: Private individuals may bring lawsuits to obtain injunctive relief to force compliance with the ADA and recover their attorneys' fees for the litigation, but may not obtain money damages. Citizens may also file complaints with the United States attorney general, who is authorized to bring lawsuits in cases of general public importance or where a pattern of discrimination is alleged. The suit can ask for money damages and civil penalties.
- The official ADA Web site is www.usdoj.gov/crt/ada/.

AMI See *alternative mortgage instrument*.

AML See *adjustable mortgage loan*.

amortization (1) In mortgages, the gradual payment of a loan, in full, by making regular payments over time of principal and interest so there is a $0 balance at the end of the term. (2) In accounting, refers to the process of spreading expenses out over a period of time rather than taking the entire amount in the period the expense occurred. For example, some real estate closing expenses may be deducted on one's taxes in the current year, but others must be amortized over the life of the mortgage loan and only a small percentage deducted each year.

amortization schedule A report that usually shows the principal and interest allocation of each monthly payment during the first year, the total principal and interest paid in each subsequent year, and the total interest that will be paid over the life of a loan. Download a template for creating loan amortization reports by going to the Microsoft Excel Web site at http://office.microsoft.com/en-us/templates.

Loan principal amount	$175,000.00	Annual loan payments	$13,971.36
Annual interest rate	7.000%	Monthly payments	$1,164.28
Loan period in years	30	Interest in first calendar year	$12,193.68
First year of loan	2007	Interest over term of loan	$244,140.80
First month of loan	January	Sum of all payments	$419,140.80

Year	Month	Beginning Balance	Payment	Interest	Cumulative Principal	Cumulative Interest	Ending Balance
2007	Jan	$175,000.00	$1,164.28	$1,020.83	$143.45	$1,020.83	$174,856.55
	Feb	$174,856.55	$1,164.28	$1,020.00	$287.73	$2,040.83	$174,712.27
	Mar	$174,712.27	$1,164.28	$1,019.15	$432.86	$3,059.98	$174,567.14
	Apr	$174,567.14	$1,164.28	$1,018.31	$578.83	$4,078.29	$174,421.17
	May	$174,421.17	$1,164.28	$1,017.46	$725.65	$5,095.75	$174,274.35
	June	$174,274.35	$1,164.28	$1,016.60	$873.33	$6,112.35	$174,126.67
	Jul	$174,126.67	$1,164.28	$1,015.74	$1,021.87	$7,128.09	$173,978.13
	Aug	$173,978.13	$1,164.28	$1,014.87	$1,171.28	$8,142.96	$173,828.72
	Sep	$173,828.72	$1,164.28	$1,014.00	$1,321.56	$9,156.96	$173,678.44
	Oct	$173,678.44	$1,164.28	$1,013.12	$1,472.72	$10,170.08	$173,527.28
	Nov	$173,527.28	$1,164.28	$1,012.24	$1,624.76	$11,182.32	$173,375.24
	Dec	$173,375.24	$1,164.28	$1,011.36	$1,777.68	$12,193.68	$173,222.32

Year	Beginning Balance	Payment	Principal	Cumulative Principal	Cumulative Interest	Ending Balance
2008	$173,222.32	$13,971.36	$1,906.07	$3,683.75	$24,258.97	$171,316.25
2009	$171,316.25	$13,971.36	$2,043.97	$5,727.72	$36,186.36	$169,272.28
2010	$169,272.28	$13,971.36	$2,191.73	$7,919.46	$47,965.98	$167,080.54

anaconda mortgage A mortgage containing a clause saying it secures the debt originally intended by the parties, and all future debts that may become due and owing in the future. Such clauses are sometimes called dragnet clauses or Mother Hubbard clauses. The effect is that a borrower with multiple loans—real estate, automobile, line of credit, checking account overdraft protection, business—may find that the lender will require all sale proceeds when the property is sold, even though the borrower might have substantial equity under the terms of the specific note originally secured by the mortgage. Debtors find themselves squeezed to death, like being encircled by an anaconda snake. The courts disfavor such clauses and usually refuse to enforce them unless there is some relationship among the debts and some specific reference in later loan documents to the earlier anaconda clause. Despite that, it is recommended that you ask mortgage lenders to delete the clause from their instrument before you sign.

anchor tenant A major department store or chain store located in a shopping center so as to attract customers who will then shop at the smaller, satellite stores; sometimes referred to as a traffic generator or magnet store.

- Because of the critical importance of that traffic to the smaller tenants, wise shopping center owners in a position to negotiate terms will prohibit the anchor from going dark, meaning vacating its space. Otherwise, the anchor could move to a more desirable location, continue paying the rent for the old property, but effectively cause most of the other tenants to go out of business and default on their leases because of the lack of traffic. Unfortunately, important anchor tenants usually have the clout to refuse to sign a lease with such terms.
- Anchor tenants often reserve the right to dictate the selection of the satellite tenants and to prohibit ones which might be incompatible with their core philosophies (such as liquor stores) or who might compete with their merchandise sales.
- A related term is shadow anchor, used when a small shopping center wants to communicate that an important traffic generator is next door or directly across the street. An ad might read, "Subject property shadow anchored by Wal-Mart to the east and Target to the west."

ancient lights doctrine Early English doctrine holding that one could not build a structure so as to block the sunlight from a neighbor's window. Despite the abundance of available land in this country, Americans love of high-rise architecture, coupled with a general unwillingness to expand private property rights to contiguous spaces, means that the concept never really caught on here. One exception occurs when a neighbor builds a spite fence for a malicious purpose to obstruct light; the courts will order removal of the fence. Recently, some courts are revisiting the doctrine and allowing application, especially as it relates to the use of solar-powered equipment. Such courts reason that public policy now disfavors unbridled development and favors use of alternative energy sources.

ancillary tenant A shopping center tenant that occupies smaller space and is less important than an anchor tenant. See *satellite tenant*.

angel investors See *venture capital*.

animal unit A unit of measurement indicating the ability of land to support range animals. Generally, a 1,000-pound animal grazing 26 pounds of dry forage per day (a mature cow or equivalent) is equal to one animal unit. Livestock grazing permits are usually expressed in terms of animal units per area or total animal unit months.

annexation The process of joining property to another. Arises in two contexts: (1) Personal property is annexed to real property, becoming a part of it, and must remain if the property is sold or if a leasehold interest comes to an end. (2) Local governments expand their jurisdictional limits and tax bases by annexing property. The process is usually accomplished through local ballot and is generally hotly contested by groups of property owners who do not want to lose their independence or see an increase in property taxes.

annual bumps Slang for annual increases in such items as rent or operating expenses.

annual cap An agreed-upon limit on the amount an adjustable-rate mortgage may increase the interest rate each year. Consumer mortgages usually have annual caps; commercial mortgages usually do not.

annual debt service The total of all principal and interest payments made over the course of a year. This figure provides one of the analytical tools for mortgage lenders of income-producing properties, who compare net annual income of the property to annual debt service on the proposed mortgage to arrive at a debt service coverage ratio. Acceptable ratios depend on the particular industry and on lending market conditions at the time.

annual mortgage constant The amount of annual debt service compared to the principal amount of a loan and then expressed as a dollar amount.

Annual debt service ÷ Mortgage principal = Annual mortgage constant

The constant tells you the total principal and interest payments per year per $100 of debt. (Before the widespread availability of simple financial calculators and computer spreadsheet templates, figures obtained from annual mortgage constant tables were the only quick and reliable way to calculate mortgage payments.)

annual percentage rate (APR) Usually different from the quoted interest rate or face rate on a promissory note, the annual percentage rate is a creation of the federal Truth in Lending Act, which requires that certain loan expenses be treated as if they were additional interest paid over the life of the loan, and then a new interest rate calculated based on that assumption. The intent was to force standardization in calculating the cost of obtaining credit, so that consumers could shop wisely and make informed decisions without fear of hidden charges making credit more expensive than anticipated. In reality, there is no real consensus or practical guidance about the necessity to include or ability to exclude many loan charges from the APR calculations, resulting in continued widespread confusion about the cost of credit.

Annual Percentage Rate	Finance Charge	Amount Financed	Total of Payments
The cost of your credit as a yearly rate.	The dollar amount the credit will cost you.	The amount of credit provided to you on your behalf.	The amount you will have paid after you have made all payments as scheduled.
8.69%	**$227,087**	**$125,000**	**$352,087**

Sample disclosures required by the Truth in Lending Act for a $125,000 loan for 30 years at a quoted interest rate of 7.25% but a higher APR because of prepaid interest points and other charges

annuity A sum of money received on a regular basis as one of a series of fixed payments. Real property is sometimes sold in exchange for a private annuity. The buyer guarantees a fixed monthly income to the seller for the seller's lifetime. The seller, of course, is gambling he or she will live much longer than anyone could expect, and thus ultimately receive far more than the property was worth.

The buyer is gambling that the seller will die sooner as opposed to later, and the buyer will have a windfall. Wise sellers will include a clause guaranteeing a minimum term for payments, even if they must be made to their estate or heirs. See *advance payment annuity* and *ordinary annuity*.

annuity due See *advance payment annuity*.

anticipation, principle of In appraisal, the concept that the value of property today is equal to the value of future income, discounted to present value. Discounting rests on the assumption that the right to receive $1 in the future is not worth $1 today, but something less than $1.

anticipatory breach An affirmative statement or action indicating that a party has no intention of honoring his or her contractual commitments. This is important because one cannot ordinarily bring a lawsuit until there has been an actual breach of a contract. For tactical or other reasons, it may be important to avoid delays. If there has been an anticipatory breach, the aggrieved party may bring suit immediately.

antideficiency legislation Laws in some states that protect consumers from deficiency judgments after foreclosure of a purchase-money mortgage on residential real estate. The lender may take the real property in satisfaction of the debt. If the property is worth less than the debt at that time, the lender suffers the loss and may not sue the borrower for the difference.

antitrust laws State and federal laws designed to encourage competition and discourage or prohibit monopolies. Relevant in the real estate context because of the somewhat monopolistic power of local real estate boards, their ability to admit or exclude members, the possibility of de facto (informal) price fixing relative to real estate commissions, and their control of the Multiple Listing Service® database of properties offered for sale. This is an exceptionally complex area of law. (For more information, visit the Department of Justice Web site at www.usdoj.gov/atr/overview.html and the National Association of REALTORS® antitrust pages at www.realtor.org/libweb.nsf/pages/fg704.)

APA See *American Planning Association*.

apartment (building) A building with multiple residential tenants.

APFO See *adequate public facilities ordinances*.

APN See *assessor parcel number*.

APP Shorthand for appreciation.

appeals board A local board empowered to overturn decisions of a permitting, zoning, taxing, or other regulatory authority. Before embarking on any possibly contested activity in these areas, such as a zoning change request, it is extremely important to determine the name and requirements of the correct appeals board, should it become necessary to ask for reversal of a decision. Many boards have very limited and technical grounds for appeal that, if known in advance, can be factored into tactical decisions at the level below. In addition, the time limits for filing appeals are generally extremely short.

application fee A fee charged by a lender, ostensibly for the time and trouble involved in processing a loan request, analyzing available data, and calculating what terms and conditions to offer. In reality, this view is a holdover from the days when consumers went to lenders, hat in hand, to plead for money. In today's very competitive lending market, where virtually every television show includes at least one mortgage lender as an advertiser, it is ludicrous to think that a consumer would pay someone for the opportunity to review a loan request. This fee will usually be waived upon request; it is simply another source of profit for the lender.

apportion To divide into parts. Co-owners of property may decide to apportion maintenance costs among themselves, according to the percentage of ownership enjoyed by each. Buyers and sellers usually apportion real estate taxes so that the portion earned by local government before closing, but not yet paid because not yet due, will be paid by the seller in the form of a credit against the purchase price. When the property tax bill is later received by the buyer, he or she will pay the entire bill in full, but will have already received the equivalent of reimbursement through the credit at closing.

apportionment Division into parts. Typically used when deciding how to allocate expenses relative to oil and gas leases, and when deciding that portion of the income of a company or utility that was earned in a particular state and thus subject to state income taxes. See *apportion*.

appraisal The process of developing an opinion about a property's value. That opinion is supposed to reflect what a willing buyer would pay a willing seller after reasonable exposure to the marketplace, with neither buyer nor seller operating under any sort of duress or pressure. An appraisal is generally required when property is financed, and should be required before a real estate agent attempts to market anything significantly different from properties commonly and frequently sold in the marketplace. It may not be necessary to obtain an appraisal of a four-bedroom ranch house in a good school zone, but some assistance may be needed in arriving at a price to market an 11,000 square foot ski-lodge-type home in a small town.

- There are three common approaches to estimating the fair market value of a property. They are comparison, cost, and income.
- The comparison approach to appraisal seeks to obtain information about recent sales of comparable properties. It would be highly unlikely for the properties to be identical, so the appraiser will make adjustments in the sale price of the other comparable properties—called comps for short—in order to calculate what the sale price might have been if it were identical to the subject property. For example, if the subject property had no garage, but the comp had a two-car garage, the appraiser might subtract $50,000 from the sale price of the comp. The appraiser might then add $30,000 because the subject property has a finished attic providing more livable square footage, and another $15,000 because the subject property is brick while the comp is wood frame needing new paint. A residential appraiser will typically use three comps, commercial appraisers will employ more because it's generally difficult to find truly comparable properties, resulting in a large number of adjustments. The more adjustments, the more likely error will creep into the calculations. At the end of the process, the appraiser will have a value based on the comparison approach.

- Cost approach. This approach uses an estimate of the reproduction or replacement cost of the improvements, less depreciation, plus land value. The reproduction cost is the amount necessary to build exactly the same building. Replacement costs are those necessary to build an improvement with substantially the same usefulness using today's materials and techniques, but not necessarily the same exact characteristics.
- Income approach. This approach assumes that the value of the real estate is directly related to the value of the income generated by that real estate, such as shopping centers, apartments, and office buildings. The appraiser will calculate a net operating income (NOI) for the property by taking all possible income over the course of a year, and then subtracting operating expenses, insurance, real estate taxes, reserves for bad debts, a certain percentage for anticipated vacancies, and sometimes a certain dollar amount for the value of the owner's management and supervision. The bottom line number, the NOI, is then capitalized by dividing it by a certain percentage. That percentage rate is supposed to reflect the return an investor would expect on his or her money taking into consideration all the variables associated with the property. Variables could include the strength of the tenants, the likelihood of default, the remaining term on the leases, the prospect of future rent increases built into the leases, the likelihood of lease renewals at the expiration of current terms, the cost of financing to purchase the property, the availability of other investment sources and their rates of return, and other such factors. If a property had an NOI of $100,000 and a capitalization rate (cap rate for short) of 10 percent, then you divide $100,000 by 0.1 and arrive at a value of $1,000,000. Increasing the cap rate to 11 percent decreases the value to $909,090. Decreasing the cap rate to 9 percent increases the value to $1,111,111.
- Integration. Sometimes the appraiser will have to employ several methods in order to account for different aspects of the property. An income-producing property might include additional acreage for future development. The appraiser would value the current improvements using the income approach, and the surplus or excess land using the comparable approach.
- Reconciliation. At the end of the analysis, the appraiser will take all methods employed, as appropriate to the property, and reconcile the differing values into one value. This will then be the appraised value of the property.

appraisal review A report that comments on the completeness and accuracy of an appraisal report. Lenders frequently employ in-house review appraisers as a check on the accuracy and honesty of third-party appraisals.

appraiser One who performs appraisals of real or personal property. The various associations and organizations for real estate appraisers include:

- Appraisal Institute (www.appraisalinstitute.org). Offers the designation MAI, among others.
- National Association of Independent Fee Appraisers (NAIFA) (www.naifa.com). Founded in 1961.

- National Association of Master Appraisers (NAMA) (www.masterappraisers.org). Founded in 1982. It offers three designations: Master Residential Appraiser; Master Farm and Land Appraiser, and Master Senior Appraiser.
- National Association of Real Estate Appraisers (NAREA) (www.iami.org/NAREA/home.cfm). Founded in 1966.
- National Association of Review Appraisers and Mortgage Underwriters (NARA/MU) (www.iami.org/NARA/home.cfm). Founded in 1975.
- National Society of Real Estate Appraisers (www.nareb.com/affiliates/society_appraisers.shtml).
- American Society of Farm Managers and Rural Appraisers (www.asfmra.org).

appreciation The process of increasing in value. As a practical matter, although the IRS allows taxpayers to depreciate real property improvements as if they were becoming less valuable over time and will eventually be worthless, real property generally appreciates over time with proper maintenance and repair.

appreciation return Expressed as a percentage, the return generated by the appreciation of a property or portfolio over the period of analysis.

appropriation (1) Taking private land for public use, as by condemnation. (2) Taking public property for private use, such as using water from a navigable river for irrigation purposes. (3) Legislatively designating government funds for a project.

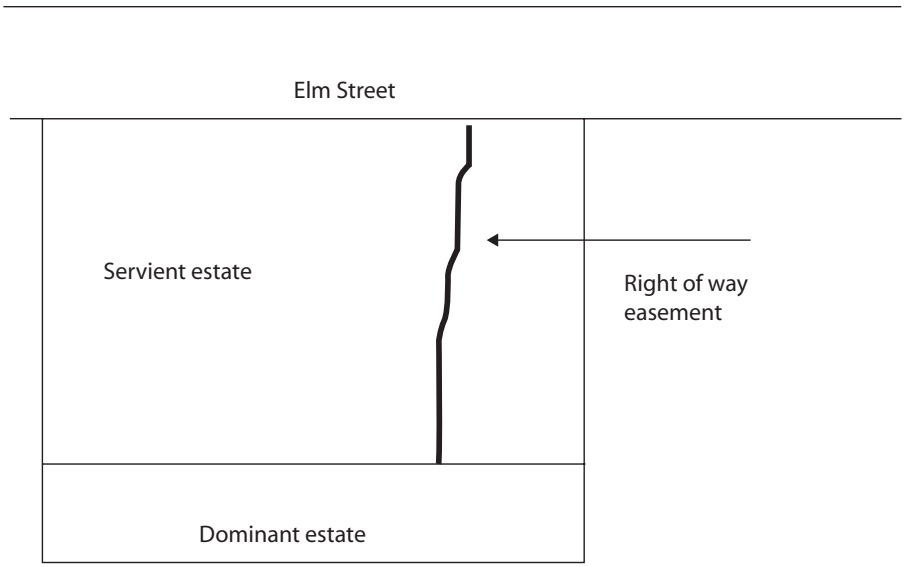
appurtenance That belonging to something of greater importance. Contracts usually describe a main structure and add a catchall for all appurtenances. (See figure on page 34.)

- In real estate law, easements, or the right to use another's property, may be appurtenant or in gross.
- If appurtenant, then the easement belongs to what is called the dominant estate (property) and passes to new owners for all time until the easement is abandoned. For example, an easement for ingress and egress over another's property is an easement appurtenant. The property that enjoys the easement is the dominant estate, and the property over which one may travel is called the servient estate. A sale of the dominant estate automatically includes a transfer of the easement, because it is appurtenant.
- Contrast with an easement in gross, which might be a right to park one's antique car at a friend's house and gain ingress and egress for purposes of using the car. This easement is personal and not tied to any particular real estate.
- This is a tricky area of the law that generally requires the assistance of a lawyer specializing in complex real estate issues. The seminal case on the subject is the 1850 English case of Ackroyd v. Smith.

APR See *annual percentage rate*.

ARA See *Accredited Rural Appraiser*.

arable Able to be cultivated.



arbitrage The simultaneous purchase in one market and sale in another market of a commodity, security, or monies, in the expectation of making a profit on price differences in the differing markets. Generally thought of as involving foreign currency exchanges, in which one enters contracts to buy euros and sell yen and hopefully make money in a moment in time when the exchange rates work out in one's favor (this is highly risky).

arbitraries Shortened property descriptions used in title plants for indexing real properties, rather than the sometimes lengthy, technically accurate, surveyor's descriptions. Also called arbs.

arbitration A method of nonjudicial or alternative dispute resolution (ADR) which long existed at common law but has recently gained renewed vigor because of the Federal Arbitration Act and the U.S. Supreme Court's pronouncements that the Act applies to all disputes involving matters in interstate commerce. Virtually every construction contract, architectural agreement, and mortgage loan document today contains an arbitration clause and is deemed to involve interstate commerce because of the nationwide impact of those industries. The American Arbitration Association maintains a Web site at www.adr.org.

The process relies upon aggrieved parties agreeing to one or more disinterested persons hearing their complaints and defenses and then coming to a conclusion establishing the rights and responsibilities of the parties and their damages, if any. In theory, at least, the arbitrators are skilled and knowledgeable in the particular field of the dispute and allowed to factor into their decisions their own knowledge and experiences. This is in contrast to the modern jury system, in which the law seeks to obtain a jury absolutely ignorant of any details of the industry or dispute, and willing to come to a conclusion based solely on the evidence presented by the lawyers.

- Pros. The process is usually much more informal than a traditional trial, allowing a leveling of the playing field when consumers attempt to represent themselves against lawyers

representing the other side. In some markets, for some types of disputes, you can reach a hearing and resolution faster and more cheaply than in the court system. For others, a shortage of trained arbitrators for complex cases means the dispute might actually take longer. There are no formal rules of evidence, and the arbitrator simply factors in issues such as hearsay when deciding how much weight to give evidence, rather than excluding it entirely. Discovery is usually very limited in consumer cases so that extensive time and money is not spent searching for documents to produce, attending depositions, and other such matters. The final judgment is confidential and not publicly reported anywhere unless it is a money judgment not paid within the required time period, in which case the winner may record his or her arbitration award in the public records and attempt to enforce it.

- Cons. As a practical matter the arbitration award cannot be appealed or overturned, even if the arbitrator made obvious mistakes of law that directly resulted in a wrong decision. There are exceptions, but they are exceedingly technical, generally disfavored by appellate courts, and usually require a level of sophistication at the hearing level not enjoyed by most consumers. That is because, for most of the few allowable grounds of appeal, you must know those grounds and all their technicalities in advance and make tactical decisions at the hearing level that will preserve your rights to appeal. This lack of appellate rights was considered a trade-off for the ability to have an arbitrator knowledgeable about your field and supposedly able to reach a more fair decision than a jury. In reality, this rarely works out.

architecture The science and art of structural design and construction supervision.

Architectural and Transportation Barriers Compliance Board The former name of the Access Board.

architectural drawings Project drawings provided by the architect, typically showing the floor plan; elevations (views of the various sides of the structure); finish schedules; and details of moldings, cabinetry, doors, and other such matters necessary for the builder to order the proper materials for construction. It typically does not include engineering drawings for heating and air conditioning, electrical, audiovisual, telecommunications, security, waste management or plumbing systems, or landscaping plans and topographical details. All such plans, obtained from other professionals, are typically combined with the architectural drawings into a set of working drawings.

area A measurement of the square footage contained within certain boundaries.

ARELLO See *Association of Real Estate License Law Officials.*

ARES See *American Real Estate Society*.

AREUEA See *American Real Estate and Urban Economics Association.*

Argus A computer program widely used among real estate investors to analyze portfolio performance and purchase opportunities. It is becoming increasingly important for graduates of business schools to have working knowledge of the Argus software if they want to secure employment with

large institutional owners and managers of real estate. (For more information go to Realm Web site at www.realm.com.)

ARM See *adjustable-rate mortgage*.

arm's-length transaction A transaction in which the parties have equal bargaining strength in order to protect their individual interests and are not related or involved in some other type of relationship that would tend to call into question the fervor with which they attempt to protect their interests. If the IRS determines that a sale of real estate was not an arm's-length transaction for fair market value, it may deem part of the value of the property as a gift, which could result in gift taxes.

arrears (1) Being past due on a debt. (2) Paid at the end of the period rather than the beginning. Rent is usually paid in advance, at the beginning of the month for the coming month. Interest is usually paid in arrears, at the beginning of the month for interest accrued during the prior month. Real estate taxes are usually paid in arrears.

arterial street Designed to carry traffic through an area as quickly and efficiently as possible in order to reach another destination. One might not want to locate a retail business on an important arterial street, because there would be limited ability for commuters to exit the artery and shop at the retail establishment. Arterial streets are designed for the benefit of the city as a whole, rather than the communities through which they pass. See *feeder road*.

artificial intelligence The ability of a computer program to evaluate data and make decisions according to parameters set out in the software. Automated underwriting software is a type of artificial intelligence. The increasingly popular AVM—automated valuation model—uses artificial intelligence and related property data to create appraisals for lenders and for the IRS.

artificial person A legal entity that is granted some of the rights and responsibilities of a natural person, such as corporations that may enter into contracts, partnerships that may sue and be sued, and church associations that may hold title to real estate. Almost all artificial persons enjoy the same rights and responsibilities as each other.

ASA See *American Society of Appraisers*.

asbestos A mineral fiber once commonly used for its fire-retarding and insulation properties. It was widely employed in insulation, roofing, floor tiles, household products, and appliances. After extensive studies, the Environmental Protection Agency determined that asbestos caused lung and stomach cancer in people exposed to it over long periods of time. If real property contains asbestos in it, most lenders will require removal, or a firm commitment for removal, before they will fund any loans to buy or renovate the property. Real estate agents are required to disclose the presence of asbestos on property, if known. Asbestos removal is generally accomplished by specially trained and licensed asbestos abatement contractors.

asbestos containing material (ACM) Under Environmental Protection Agency regulations, any material containing more than 1 percent asbestos. There are different regulatory requirements depending on whether the ACM is friable or nonfriable.

as-built drawing Not infrequently, the owner or contractor of a building under construction will make field modifications to the original architectural or engineering drawings. Ideally, all such modifications should be noted on one set of plans set aside for that purpose. At the completion of the project, the respective professionals will be asked to generate a new set of drawings showing the actual construction details, rather than original designs, so that future work can be planned and executed in a knowledgeable manner with reference to what already exists in the property. In the alternative, long after a building has been constructed, the owner may employ professionals to prepare plans showing all details of the building and its various systems. Both of these result in as-built drawings.

as is In its current condition without any guarantees by the seller.

as-is value An estimate of the value of real property in its current condition, which may be depressed because of necessary repairs and maintenance.

ASHI See *American Society of Home Inspectors*.

assemblage The process of putting together the purchase, or options for the purchase, of several small parcels from multiple owners in order to create a larger parcel of land. The goal is to obtain enough land for a particular development in mind, or to conduct the assemblage as a speculative venture, in order to sell the larger parcel for more money than it cost to purchase the smaller parcels. This increase in value due to the assemblage is called plottage value.

assessed value The value of real property for the purposes of calculating property taxes and other similar charges such as school taxes and fire district dues; the tax appraiser will establish a fair market value for the property. The assessed value is then frequently calculated as a specific percentage of the appraised value. Oftentimes the percentage will vary depending on the use of the property and any applicable exemptions. In some states, for example, property is assessed at 20 percent of its fair market value. Persons residing on their property, and claiming a homestead exemption, may be entitled to an assessment of 10 percent of fair market value.

Example: Assessed Value of Real Property at 310 Main Street

Appraised value	$370,000	
Assessment ratio of 10% for owner-occupied residential properties, results in assessed value	$37,000	
Tax rate of 2% of assessed value	$7,400	
Taxes due		$7,400

assessment (1) The official valuation of property for tax purposes. (2) A one-time charge made against property owners for each one's pro rata share of the expense of repairs or improvements to be enjoyed by all of them in common, such as a condo association assessment to replace a roof, or a local government assessment to pave a dirt road. (3) Determination of the value of property in a condemnation case.

assessor A public official charged with maintaining the property tax rolls and the accuracy of the appraised and assessed value of properties.

assessor parcel number (APN) A number assigned by the local assessor in order to identify a particular property. Often used in real estate contracts until a more detailed legal description can be obtained, because each parcel has its own unique APN; deemed to be more reliable than a street address.

asset Something of value. On a balance sheet or personal financial statement, assets will include the following items, typically arranged in order according to the ease with which they can be converted into cash:

- Cash and equivalents
  - Cash on hand
  - Cash in banks
  - Marketable securities
- Receivables
  - Accounts receivable
  - Less reserves for bad debts
- Furniture, fixtures, and equipment
- Fine art
- Real property
- General intangibles
  - Stock in closely held corporations
  - Intellectual property rights
  - Goodwill

When lenders examine balance sheets, they generally assume that individuals and small businesses overvalue the furniture, fixtures, and equipment and the general intangibles. Large entries for cash and equivalent assets will overcome a poor credit rating 9 times out of 10.

Asset Conservation, Lender Liability and Deposit Insurance Act of 1996 An amendment to the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) made in response to mortgage lender anxiety regarding statutory language that might make lenders liable for cleanup of contaminated sites, simply by virtue of their mortgage interest or as the result of a foreclosure. The amendments protect lenders from liability, preforeclosure, unless they participated in the contamination. It also shields them after a foreclosure, but only if they sell the property at the earliest practicable, commercially reasonable, time.

asset cost recovery system (ACRS) See *accelerated cost recovery system*, which is the correct name for an outdated tax accounting methodology abbreviated as ACRS. Unfortunately, one often encounters this method erroneously described as "asset cost recovery system."

asset depreciation range (ADR) An elective depreciation method allowed by the IRS after 1970 and before 1981. It had over 100 classes of property from which to choose appropriate depreciation periods. The entire system was a hotbed of taxpayer versus IRS controversy, so it was replaced by the

ACRS system in 1981, and then by the MACRS in 1987. One still encounters the ADR in literature, but it no longer exists.

asset management The umbrella name for all phases and areas of expertise in the acquisition, management, leasing, operation, and eventual sale of real property assets.

assign To transfer one's property rights or contract rights to another. In the context of real property, an assignment is commonly used in three circumstances: (1) An investor signs a contract to purchase real property and reserves the right to assign that contract to some business entity to be created in the future, but still owned or controlled by the same investor. (2) An investor wishes to purchase property anonymously because of fears the owner will increase the asking price if he or she knew the identity of the true purchaser. As a result, the investor employs a straw man to sign the purchase contract, and the contract is then assigned to the ultimate purchaser. (3) A speculative purchaser of condominium units or other property to be built in the future will sign a purchase contract for a fixed price, in the expectation that prices will increase dramatically by the time construction is completed. At that time the speculator may then assign their (below-market price) contract to another for a substantial profit.

assignee One to whom a contract or lease has been assigned. See *assign*.

assignment of lease Transferring all rights in a lease to real property to another. Leases typically contain prohibitions against assignment without landlord approval, but the approval may not be unreasonably withheld. Reasonable grounds may include a change in the creditworthiness of the tenant, an increase in the burden placed upon the property by the new tenant because of additional parking demands, or incompatibility with other tenants such as a liquor store coming into a small shopping center of family-oriented businesses. When a tenant assigns its lease, it remains liable for the entire lease term unless the landlord agrees to a novation, which is a declaration that the old lease is void and the landlord has entered into a direct relationship with the assignee.

assignment of rents Additional collateral usually required by lenders for commercial properties. The lender may wish to take some step short of foreclosure if there is a default. By virtue of the assignment of rents, the lender may exercise its rights to contact all tenants and advise them to pay their rent directly to the lender rather than to the landlord borrower.

assignor A person making an assignment.

associate broker A real estate classification used in some states to describe someone who has obtained his or her broker's license and is thereby legally capable of heading a real estate office, but who works as a salesperson under the supervision and control of the lead broker, usually called the qualifying broker or a managing broker.

Associated Builders and Contractors (ABC) A national trade association representing contractors, subcontractors, materials suppliers, and related firms. The organization's Web site is www.abc.org.

Associated General Contractors of America (AGCA) A trade association for general contractors; established in 1918 after Woodrow Wilson expressed a need for such an organization. The organization's Web site is www.agc.org.

Association of Real Estate License Law Officials (ARELLO) This association was organized in 1929 to facilitate the exchange of information and cooperation among regulators and policy makers in the area of real property. Today, the ARELLO mission statement is to "Support jurisdictions in the administration and enforcement of real estate license laws to promote and protect the public interest." Their Web site, www.arello.org, includes a consumer section with links to consumer protection agencies and to a database for checking whether persons selected by you have current real estate licenses in their jurisdiction.

assumable loan A loan that can be taken over by a purchaser, who may then continue making payments in the same amount, at the same interest rate, for the remaining term of the loan.

History and background: Before the high interest rates and banking crises of the 1980s, most mortgage loans were freely assumable if the purchaser paid a small assumption fee. Problems arose when interest rates skyrocketed to nearly 20 percent, creating a lively market in people wishing to assume old 6 and 7 percent loans rather than obtain new purchase money loans at 20 percent. The lending industry also began to see a high percentage of non-credit-worthy purchasers, unable to obtain financing on their own, assuming loans. This all seemed good for consumers, but it was bad for lenders. Caught in the squeeze, many went under in the giant banking and savings and loan debacles of the era. To prevent future interest rate squeezes, and future underwriting disasters, lenders introduced a new loan clause called the due on sale clause. It stated that if the underlying property were sold or otherwise conveyed, the entire note would be due and payable immediately, even if it had not matured and there had never been a single default or late payment. California led the way of states antagonistic to this attempted infringement on consumer rights and outlawed the enforceability of due on sale clauses. The federal government, facing gigantic cash losses as a result of its lending industry bailouts, was strongly in favor of due on sale clauses so the current crisis would not repeat itself in the future. It passed legislation preempting states laws in the case of all federally chartered or federally insured (FDIC) financial institutions. The new law stated that due on sale clauses were enforceable and state laws to the contrary did not apply. The ability to assume mortgage loans is now effectively dead.

Today, some loans are still characterized as assumable, but the purchaser must meet all underwriting requirements necessary for an original loan, and the interest rate can usually be increased to market rates. In a true loan assumption, the original borrower remains liable on the promissory note, in addition to the purchaser of the property.

assumptions and limiting conditions A recital of the assumptions on which an appraisal is based. These typically include matters such as: the appraisal is an accurate reflection of the value of the property, but only if there are no hidden defects, there are no boundary line problems, factual information obtained from others is correct, zoning allows the current or anticipated future use, and other such matters.

at-risk rules IRS rules limiting the deductibility of some losses, which are not allowed to exceed the amount the taxpayer has at risk, meaning the total of cash contributions and liability on promissory notes. Under certain circumstances, nonrecourse loans secured by real property but not by the

individual's guarantee or endorsement may still satisfy the at-risk rules. (For more guidance, go to IRS Web site www.irs.gov and download IRS Publication 925, "Passive Activity and At Risk Rules.")

attached housing Housing that is attached to each other on at least one side. Contrast with detached housing, which is best exemplified by the traditional suburban home.

attachment The legal process of seizing real or personal property for the payment of nonmortgage debts such as tax liens or judgments.

attest To witness by observation and signature, as one who attests that another has signed a real estate contract. Contrast with acknowledgment, in which the signer states he or she signed the document voluntarily, and then a notary public or other such individual affixes his or her signature and seal as evidence of hearing the acknowledgment and witnessing the signing.

attorn The act of a tenant formally agreeing to become the tenant of a new landlord, but for the same property. Usually occurs when there has been a sale or foreclosure of the leased property. The new owner will want to obtain an attornment in order to cut off defenses and claims the tenant might have against the old landlord, and to prevent the old landlord from muddying the waters by making claims for rent, even though no longer owning the real estate.

attorney-in-fact A person authorized to act for another under a properly executed power of attorney.

attorney's opinion of title The written opinion of an attorney regarding the identity of all current title owners, lienholders, and possible claimants to a particular parcel of land. Although lenders always require title insurance, which will pay off claims if the title opinion turns out to be inaccurate, many cash purchasers are content with simply the attorney's opinion of title. If other persons then assert claims in the future, the purchaser may suffer loss of the property, with the only recourse being to sue the attorney for malpractice, a difficult and expensive process and one further complicated by the general inability to find lawyers willing to sue other lawyers.

attornment See *attorn*.

attractive nuisance A concept in tort law holding that if a person creates or allows a condition to exist on his or her property that a reasonably prudent person would know presents a danger to children, then that person must take steps to protect children of tender years from the condition, especially if it is something known to be attractive to small children. Liability can also be imposed if someone creates such a condition on someone else's property or even in a public place. Examples would be a swimming pool on one's own property, a rope swing installed by a private individual over a pond in a public park, or even an old refrigerator dumped by the side of the road in a rural area, but which could trap and suffocate children inside. Many courts hold that an artificial body of water, such as a pool, is an attractive nuisance but a natural one, such as a pond, is not.

auction A sales technique in which real or personal property is offered for sale and bidders make oral offers in varying amounts until one is accepted. Frequently used for involuntary transfers of real estate, such as foreclosures and tax sales. In some states, foreclosure auctioneers must be licensed. Where property is offered by the owner voluntarily for auction sale, the fine print in the auction terms usually contains a provision for a buyer's premium. The amount of the winning bid is automatically increased by the stated amount, and that percentage is used to pay the auctioneer's fees.

automated mortgage underwriting Loan processing that is entirely or predominantly performed by computers using artificial intelligence, without human assistance or intervention. The computer has a complex set of instructions to follow depending on the data input by the consumer or by a data entry clerk, including ordering credit reports and other financial data and evaluating all borrower information against predetermined profiles for acceptable lending requirements.

automated valuation model (AVM) Originally a computerized method of estimating large numbers of property values in an efficient, if not entirely accurate, manner; frequently used by tax appraisers to periodically reappraise properties for purposes of real estate taxes. A disgruntled property owner may appeal the valuation and present evidence the computer made a mistake in that particular instance. Today, AVM artificial intelligence has progressed to the level of respectability that lenders use it to appraise property for mortgage loan purposes and the IRS uses it to evaluate a taxpayer's assets.

automatic stay A bankruptcy provision that stops all creditor actions, including foreclosures, immediately upon a debtor's filing for bankruptcy protection. There is then a breathing period during which no creditor action may take place. Afterward, a creditor may ask the court for permission to proceed, called a request to lift the automatic stay. To be successful, it must prove that neither the debtor, nor any other creditors, will be prejudiced if foreclosure or repossession is allowed to continue.

average downtime An estimate of the length of time a leasehold property will remain on the market after the expiration of one lease term and before the commencement of a new tenant's lease.

average free rent The number of months typically given as free rent in order to provide incentives for a tenant to vacate their old premises and move to new ones without being liable for double rent during the overlapping terms, or to provide competitive incentives for new tenants to rent in one building rather than another.

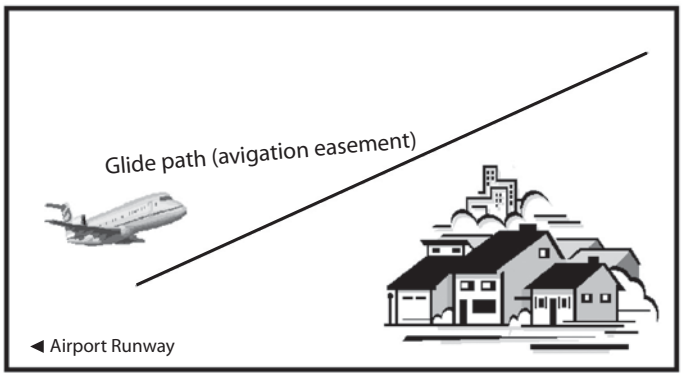
average rate of return One way of measuring an investment's profitability. To calculate, one takes the total net earnings, divides by the total number of years the investment was held, and then divides that answer by the investment's initial acquisition cost.

> **Example:** *Rainer spent $800,000 to buy an apartment building. After deducting all operating expenses, real estate taxes, and insurance, she receives $65,000 in the first year, $71,000 in the second year, $69,000 in the third year, and $70,000 in the fourth year. The total net earnings are $275,000. Divide that number by the 4 years being analyzed, to reach $68,750 as an average*

annual return. Divide $68,750 by the initial $800,000 investment to calculate the average rate of return of 8.59 percent.

Drawback: The procedure does not take into account the time value of money. The $65,000 received in the first year was more valuable than the $70,000 received in the fourth year, because the $65,000 could have been invested to earn still more money.

avigation easement An easement obtained by airport authorities, through purchase or condemnation, and used to provide clear access for low-flying aircraft on the glide path.



Avigation easement for a glide path for departing aircraft.

avulsion A sudden and perceptible loss or addition to property as a result of the action of water either taking soil from one property and leaving it on another, or by virtue of a river or other running water changing the course of its bed. The rule is that boundary lines described with reference to the midpoint of the stream will remain at the midpoint of the old stream, and not the midpoint of the new stream. This is because of the sudden nature of the change, so that people may reasonably notice and mark the location of the old stream bed as a matter of reference.

axial growth A growth pattern for cities, which typically expand outward along major arteries such as interstate highways or other controlled access roads. The population centers will appear star shaped, or like spokes in a wheel, when viewed from above.

B

bachelor apartment A small rental dwelling unit that combines living and bedroom spaces into one room (and, sometimes, kitchen space as well). (Do not confuse with single-room occupancy, which generally has shared cooking or bathroom facilities.)

back-end ratio One method of analyzing a borrower's ability to meet underwriting requirements for a home loan. This method takes into account existing long-term debt of the applicant, plus the payments on the requested loan, in order to arrive at a percentage of income that will be devoted to debt service. Lenders typically like to see ratios below 36 percent of take-home pay. Contrast with front-end ratio, which compares only the requested loan against take-home pay.

Example: Back-End Ratio

Monthly take-home pay	$3,600
Auto loan payments	$480
Mortgage loan payments	$790
Total long-term debt	$1,270
Ratio of debt to take-home pay	35.28%
Back-end ratio	35.28%

backfill In construction and excavation work, to fill something with additional dirt. When building foundation walls or retaining walls, one excavates a space large enough to build the walls and provide a comfortable work space, and then backfills with additional rock and dirt afterward.

back taxes Unpaid property taxes, which remain a lien on property even after it is sold to another; could result in a forced sale.

back-to-back lease One type of rental concession in commercial leases; encountered in markets with large amounts of vacant space on the market and no real prospect of filling the space with new entrants. As a result, landlords must resort to "stealing" tenants from each other. They will offer a back-to-back lease, agreeing to pay the tenant's rent at their old space until the expiration of the term, if the tenant will immediately vacate and move to the new space. In a strong rental market, a landlord may wish to attract a particularly desirable tenant from another building even though the landlord's vacant space could easily be filled from current market demand. In such a situation, the landlord will offer to buy out the entire current lease, paying a

lump sum to the owner of the other building. The other building owner is generally motivated to accept the lump-sum payment, because he or she anticipates renting the vacant space to a new tenant fairly quickly and thereby gaining a cash windfall in the form of the buyout price.

backup contract An offer to purchase that is accepted by the seller but is contingent on a prior contract failing to proceed to closing.

bad title Title to real estate that has some defects or problems that prevent the owner from conveying the property free and clear of any liens or adverse claims.

bailment A legal relationship is which a person (bailor) surrenders control of personal property to another (bailee), but with the agreement that the goods will be returned or accounted for upon request. Bailees are not insurers of goods and are responsible only for their own negligence in carrying out the terms of the bailment agreement, not for any third-party theft or vandalism, unless the bailees specifically represented they would protect the goods against third parties. Warehouse operations are typically bailments, as are records storage businesses. Most self-storage facilities, in which consumers retain their own lock, are not bailments.

balance, principle of In appraisal, the concept that there is an ideal balance of factors for the development of real estate, such as will produce the greatest value.

> **Example:** *A 10-acre parcel may be capable of being divided into a community of small garden homes with a profit margin of $10,000 each, but the legal fees and time spent for zoning changes and the costs of street and other infrastructure improvements may decrease the total project profitability to $250,000, thus affecting the value of the land. The developer may be able to build three luxury homes, instead, for a total profit of $500,000.*

balance sheet A semi-itemized listing of all assets and liabilities of a person or a company in order to arrive at a net worth, which is the difference between the assets and the liabilities. Most lenders require a balance sheet as part of the loan application process. Short-term debt, which will be paid off in one year or less, is treated by lenders in a different manner than long-term debt when calculating their various ratios to determine loan eligibility. As a result, consumers would be well advised to separate the two types of debt when completing a balance sheet form provided by the lender.

Example:

Assets:	
Cash and equivalents	*$23,400*
Marketable securities	*87,300*
Real property, nonhomestead	*312,000*
Primary residence	*209,000*
Art and collections	*19,000*
Vehicles	*42,000*
Furniture and accessories	*48,000*
Total assets	*$740,700*

Liabilities:	
Line of credit balance	*$11,000*
Credit cards	*2,500*
Mortgages, nonhomestead	*118,000*
Mortgage, primary residence	*92,000*
Accrued and unpaid taxes	*13,000*
Total liabilities	*$236,500*
Net worth	*$504,200*
Liabilities and net worth	*$740,700*

One of the primary weaknesses of a standard balance sheet is that it does not reflect any contingent liabilities—matters which may become liabilities in the future, but then again, may simply disappear. These are things like loans guaranteed for children, the results of pending litigation, and penalties and interest that may be imposed at the end of a current tax audit. In accounting, such matters are noted in footnotes. Some mortgage application forms specifically ask about contingent liabilities, and others do not. Obviously, the rosy picture presented in the preceding example balance sheet would change markedly if the owner disclosed involvement in a multimillion dollar lawsuit for which there was no insurance coverage, and which might result in a judgment in the future.

balcony A platform that projects from a wall, usually surrounded by some sort of guard structure to prevent falls.

balloon mortgage A real estate loan with monthly payments as if the loan would be paid in full over a period of time, usually 30 years, but the entire principal balance is due in a much shorter time, usually 5 or 7 years. This is a method for lenders to offer fixed-rate mortgages at rates very competitive with adjustable-rate mortgages, but without the risk that interest rates will rise dramatically in 6 to 10 years or longer, leaving the lender with a low-interest-rate investment in a high-return world. Balloon mortgages are usually quoted as something similar to "6.5 percent interest on a 30-year am [short for amortization] with 5-year balloon." Also called partially amortized loan.

balloon payment The full principal amount due at the end of a balloon mortgage.

BANANA A derogatory term; acronym for Build Absolutely Nothing Anywhere Near Anybody. Much stronger than NIMBY—Not In My Back Yard.

band of investment An appraisal method used to arrive at a capitalization rate for the valuation of income-producing property. Appraisers determine the net operating income from a property, and then divide that figure by a number, called the cap rate or capitalization rate, in order to arrive at a property value. Conceptually, that value represents what an investor would pay to receive an income equal to that of the property. (The net operating income is fairly easy to calculate, but what cap rate do you use? There are no tables or standards. The appraiser must choose a figure that is justifiable.)

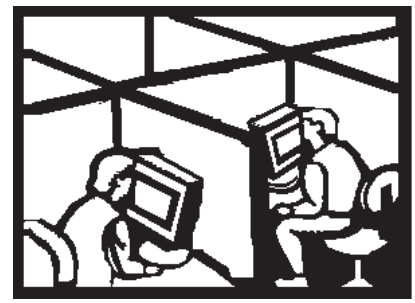
The band of investment method considers the interest rates currently available in the marketplace to finance the particular property. In commercial markets, interest rates may vary significantly

depending on which lenders are trying to add what particular property types to their loan portfolios in order to achieve an optimum mix. After deciding on the property loan interest rate, the appraiser then calculates the amount of equity the purchaser would have to pay at closing, and what reasonable investors would expect for a percentage return on their equity each year. These two percentages are then blended according to the percentage of debt and percentage of equity typically seen when financing such properties. The blended number is the cap rate the appraiser will use to help determine value.

bank An institution empowered by law to receive deposits, cash checks or drafts, discount commercial paper, make loans, and issue promissory notes payable to the bearer, known as bank notes. American commercial banks fall into two categories: (1) federally chartered and (2) state chartered. Federally chartered banks come under the regulatory and auditing supervision of the United States Comptroller of the Currency. State-chartered banks come under the control of the appropriate state banking authority. Typically the FDIC will audit state-chartered banks and the comptroller's office will audit federally chartered banks.

Bank Insurance Fund The new name of the former fund of the Federal Deposit Insurance Corporation (FDIC). The FDIC is still alive and kicking, only the fund has changed names.

bank partitions Cubicles; floor-fastened room partitions approximately 5 feet high, so named because they are common in banks.



bank rate See discount rate.

bankruptcy A common expression used to mean insolvency, being a condition in which one's liabilities exceed one's assets, or in which current cash flow is not sufficient to meet current debts. As a result of the condition, the debtor may take advantage of protections afforded by the Bankruptcy Code. Immediately upon filing, the law imposes an automatic stay which prohibits all collection activities. Over time, the stay may be lifted so that collection may resume, but the law does allow a breathing spell to allow the debtor and attorney to analyze their options. The Code underwent dramatic changes in November of 2005, with the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). Bankruptcy is now a much less consumer-friendly place than it used to be, and it places greater demands on bankruptcy lawyers. Some pertinent aspects of bankruptcy law are noted here.

- Chapter 7 bankruptcy. A case brought under Chapter 7 of the Code, with a goal of liquidating all assets, paying all liabilities as far as the money will go, and then obtaining a discharge and a fresh start. Some debts cannot be discharged at all, such as judgments for money damages for fraud, payroll withholding taxes, intentional damage, domestic obligations, and other items. In addition, because of past credit card abuses with debtors maxing out their credit cards and then filing for bankruptcy, there is now increased scrutiny of purchases prior to bankruptcy. Suspect purchases will be denied discharge. Debtors

requesting Chapter 7 relief must complete government-approved credit counseling before filing, and may be forced to enter Chapter 13, rather than Chapter 7, if a "means test" determines they have the ability to repay some debts over time.

- Chapter 11. Commonly called reorganization, this is designed for businesses or for individuals who exceed the financial limitations for Chapter 13 eligibility. Businesses will continue operations and propose a plan to meet their obligations, or a plan to sell the business as a going concern rather than liquidate assets. The plans usually contemplate the sale of some assets, forgiveness of some debt, and a generous repayment schedule over time. Things rarely work out well for the debtor, and the vast majority of Chapter 11 cases either result in the largest lender owning the company at the end, or the company changing its plan to one of liquidation. Just because the goal is liquidation does not mean the debtor must convert to Chapter 7; they are said to be in a "liquidating 11."
- Chapter 13. Commonly called wage earners bankruptcy, but this is misleading, because anyone with regular income from some source may take advantage of the chapter. There are financial limitations for eligibility that, if exceeded, will result in the debtor taking advantage of Chapter 11 instead of Chapter 13. The debtor must complete government-approved credit counseling before being allowed to file. Once in Chapter 13, the debtor proposes a plan for repayment of debts, with payments stretching over 3 to 5 years. At the end of the time, if all agreements under the plan have been met, and if the person completes all required financial education, the debtor receives a discharge.
- Bankruptcy and real estate:
  1. Filing stops all foreclosure activities until and unless the lender is able to lift the automatic stay and obtain court approval to proceed. In some states where a debtor may redeem property after a foreclosure sale, the bankruptcy will enable the debtor to do so by making payments, rather than by paying the full cash price ordinarily required for a redemption.
  2. Transfers of real estate within the recent past may be reversed if they are for less than full value and deemed to be a fraud against creditors, even if there was no fraudulent intent.
  3. Listing agreements to sell property may be terminated, or cancelable, depending on the chapter.
  4. Tenants may reject burdensome lease obligations and secure early termination of their leases.
  5. Commercial lenders, who typically require that collateral be held in a single-asset entity, may be able to successfully argue against a plan of reorganization and force a foreclosure.
  6. Other lenders opposed to a Chapter 11 plan of reorganization may be forced to accept it in a procedure called the cram-down.

bargain and sale deed A deed that contains only the name of the seller, the name of the buyer, a recital of consideration, a description of the property, and words of conveyance is a bargain and sale deed. In it, the seller makes no warranties regarding good title or any other matters, but simply sells

to the purchaser whatever interest the seller might have had. Typically used in two situations: (1) When the seller obtained the property by law and is not in a position to make warranties because of lack of knowledge and lack of prior control. This would include deeds by administrators of estates, deeds from the IRS after a tax sale, or deeds from a lender after a foreclosure. (2) The second frequent instance is when someone is asked to sign a deed in order to clear up title defects that might or might not have given the seller some rights in the property. The seller is willing to give up any rights he or she might have but is not willing to issue any warranties that he or she owned anything at all. See *quitclaim deed*.

bargain purchase option A right granted to a lessee, typically under a personal property lease such as for office equipment, but it could be a real property lease. The right, called the option, gives the lessee the ability to buy the property, at the end of the lease term, for a price substantially less than fair market value. The inclusion of a bargain purchase option in a lease contract is an indication that the contract is really a disguised seller-financing arrangement. As a result, "rent" payments previously written off in their entirety may be disallowed by the IRS because some portion of the rent was really payment of principal on a loan. In addition, under Sarbanes-Oxley, public companies may have to post such arrangements as liabilities on the company's balance sheets, contrary to prior custom and practices.

base and meridian On May 7, 1785, Congress adopted the rectangular system of surveying properties, now called the public land survey system. It is based on a rectangular system of imaginary lines running across the country. The baselines run east and west, and the meridian lines run north and south. Properties are described by reference to the principal meridian and the baseline that controls that area.

base (expense) year In commercial leases, the year used as a measure of a tenant's obligation to pay the pro rata share of ever-increasing building expenses over time. The rent for the first year is usually calculated by the landlord so as to pay currently known building expenses and provide a profit. This is usually the base year. As expenses increase over time, the amount they exceed the expenses of the base year is the figure the landlord uses to calculate the tenant's pro rata share of the expenses.

baseline East-west lines in the public land survey system, part of the baseline and meridian line components. Each principal meridian has a baseline. Properties in the principal meridian's area are described by their bearing east or west of the meridian and north or south of the baseline.

base period The point in time that serves as a reference for calculating financial and economic data. The base period value is usually set at 1.0 or 100, called the benchmark, for purposes of comparison, and then all other periods are either greater or less than the benchmark.

base rent The minimum periodic rent specified in a lease. Additions could include the tenant's share of common area maintenance (CAM—pronounced as a word), share of building operating expenses, and percentage rent based on gross retail or food sales.

basis A tax and accounting term referring to the original acquisition cost of a property; used to determine annual depreciation deductions and eventual gain or loss upon the disposition of the property. This concept is fundamental to almost all real estate analysis and real property tax planning, and an important one to master. Some of the key concepts are

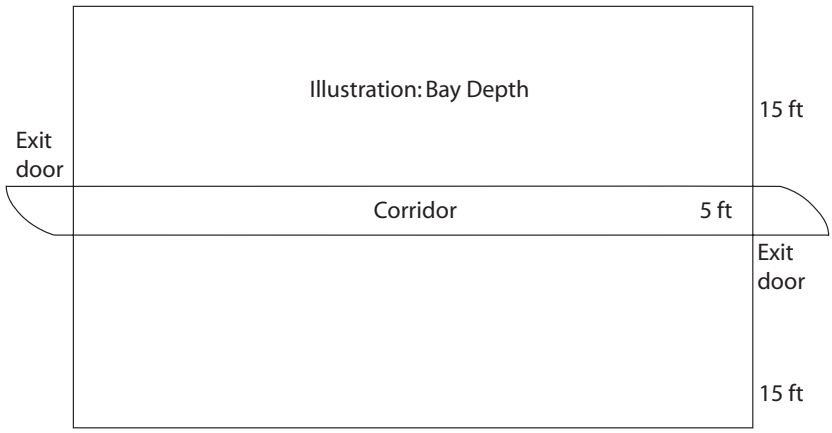
- The basis may be increased by adding some acquisition and closing costs. Many taxpayers would prefer to write off those costs as deductible expenses, but that is not allowed.
- The basis may be increased as you make capital expenditures for the benefit of the property. Usually a capital expenditure is something that adds value above and beyond the slight increase experienced when things are repaired.
- The basis is decreased each year as you deduct depreciation expenses on your taxes.
- Property acquired by gift will have the same basis the donor had, plus any capital improvements made by the donee, plus any gift taxes paid by the donor.
- Property acquired by inheritance will receive a stepped-up basis valued as of the date of death or a date 6 months afterward, depending on which election is selected. While this may be good for the heir, it might be bad for the estate to value property at a high value and be required to pay estate taxes.
- Property acquired by virtue of a 1031 exchange will have the same basis as the property sold. If this doesn't make sense, refer to definition for 1031 exchange, which is too long to include here.
- The basis must be allocated between land and improvements. Land cannot be depreciated for tax purposes, but improvements can. There is no precise formula, and taxpayers are expected to use good faith in their allocation rather than setting artificially high improvement values in order to maximize depreciation deductions.
- Most consumers do not currently track the basis in their homes, nor the capital improvements such as a new roof, swimming pool, or new garage. This is because current tax code provisions allow individuals up to $250,000 in gain ($500,000 for married persons) on the sale of their personal residence without incurring any tax liability. However, the apparent large size of this number could easily be eroded by inflation, and Congress could easily change the tax laws.

basis point A unit of measure used in finance, it is $^{1}/_{100}$ of 1 percent. Commercial lenders will typically quote rates as a certain number of basis points above an index, such as LIBOR (London InterBank Overnight Rate) or 10-year Treasury bonds. A fee of 50 basis points for a $3,000,000 loan is a fee of $^{50}/_{100}$ of 1 percent, or $^{1}/_{2}$ of 1 percent on $3,000,000, being $15,000.

basket loan Financial institutions are heavily regulated regarding the types of loans they can make and the mixture of the types of allowable loans in the total portfolio. They are allowed to make a very small percentage of loans that would otherwise be prohibited for one reason or another. Such loans are scooped into the miscellaneous basket. The term "basket" is used in a wide variety of circumstances in law, finance, and general business dealings, and always refers to some sort of conceptual container filled with small items.

bay (1) The smallest rentable tenant space in a strip center, usually defined by the front and rear exterior walls and fire walls at either side. (2) An unfinished area between rows of columns or load-bearing walls. (3) Loading areas in warehouse or industrial space. Ascertaining the number of bays necessary and available is usually critically important when working with buyers or potential tenants of such space.

bay depth Represents the distance from the building's corridor wall to the outside window of the building. The bay depth will be a critical limitation when configuring space for the most efficient use. Because of the waste factor when bay depths result in larger than necessary offices, for example, a building with cheap per-square-foot rental rates but inefficient bay depths may be more expensive than one with higher rental rates but a more compatible design. In the diagram, the bay depth is 15 feet.



bay window An arrangement of three or more windows that project outward from the exterior wall.

bearer instrument A security that does not include the name of the owner or payee. Anyone in possession of the instrument may present it and receive payment.

bearing wall A wall that helps support the weight of the upper floors and roof. See *load-bearing wall*.

bedrock The solid rock under soil.

bedroom community An area consisting primarily of commuter residences and small local establishments—grocery, laundry, limited dining, and other similar businesses catering to residents—but no large employers. Also called a dormitory town.

before-and-after rule A rule of damages holding that the measure of damage to a thing is the difference between the value before the injury and the value after the injury. In a real estate

context, this often arises in a condemnation case for eminent domain purposes. The government must compensate a property owner for the value of the property taken, but must also pay damages if the remaining property has been injured because of the loss of the other piece.

before-tax cash flow The amount of money generated by an investment after collection of all revenues and payment of all bills, but without any deductions for depreciation or other noncash items, and before calculation of income tax consequences. An important figure in analyzing any investment, because properties with high depreciation expenses may show tax losses but positive cash flows. In the alternative, a property that requires expensive financing for acquisition or operation may show good net income figures for accounting and tax purposes, but have a negative cash flow requiring the owner to supplement the property with money from other sources.

below-market interest rate (BMIR) Government-subsidized interest rate concessions offered to spur development, usually in a particular market segment, such as low-income housing, or in particular market areas, such as parts of the country heavily damaged by natural disasters. In the housing industry, the borrower is generally required to pass along the savings to consumers in the form of lower rents.

benchmark A permanent reference mark, usually set in concrete or iron and used to establish the elevation above sea level or certain corners in a surveying system. All other measurements in the area should be checked for accuracy relative to the nearest benchmark, preferably against several nearby benchmarks to establish redundancy.

beneficiary A person who receives the benefits from something although perhaps not the legal owner of the thing. In real estate, the term is usually encountered in the context of a trust, in which a trustee holds what is called bare legal title to the property, but the property itself and all sums gained from the property are held for the beneficiary. Care should be taken when buying, selling, or leasing property that involves a beneficiary, and, if at all possible, one should gain the beneficiary's signature even though it is not technically required. Otherwise, you could find yourself in the middle of litigation between the trustee and the beneficiary if the beneficiary claims the actions taken were illegal and not authorized.

benefit-of-the-bargain rule A rule of damages that says if a person has been defrauded, that person may recover the difference between the actual value of the property and the value the property would have if it had been as represented.

benefits In eminent domain cases, the concept of "benefit" comes into play because property owners may receive an enhancement in the value of their remaining property after the condemnation. If the enhancement is special to them, or only a very few owners, rather than the general betterment enjoyed by the public at large by the anticipated improvements, then any condemnation award to them may be reduced by the amount of the benefits.

> **Example:** *Ken owns 5 acres of land near an eight-lane city thoroughfare. The only thing preventing him from having valuable road frontage is a 2-foot-deep strip of land still owned by Elsie. This is the only land remaining to Elsie after successive road widenings over the years. The city*

decides to widen the road again and takes all the rest of Elsie's land and a 15-foot-deep strip of Ken's land. The city is liable to Ken for the 15-foot sliver, but Ken suddenly has 5 acres of extremely valuable road frontage property. Ken probably won't receive a check from the city because of the special benefits he received from the condemnation.

bequeath To leave personal property to another in a will. The word devise is used when referring to real property left by will.

bequest A gift of personal property made by will.

berm A small ledge or shoulder of dirt with some type of vegetation, designed to control water runoff, hide something unsightly such as a power substation, or provide a noise-control buffer between busy streets and residential areas.

betterment An improvement to real estate.

BFP See *bona fide purchaser*.

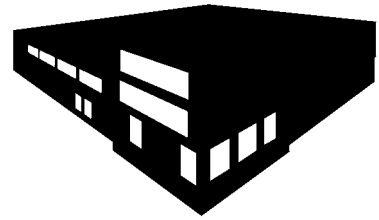
biannual Occurring twice a year. Contrast with biennial, which means occurring every 2 years. If an adjustable-rate mortgage provides for rate changes biannually or biennially, it's important to know the difference.

bid (1) An offer to purchase at a specific price, usually at an auction or foreclosure. (2) An offer to complete specified work for a certain price, usually presented in the context of a request for sealed bids to complete government work.

bid bond A type of bond required in some government construction projects. If required, it must be filed at the same time as the bid. This protects the agency in the event the bidder fails or refuses to enter into a contract after being offered it or withdraws the bid before the award. The bonding company will then pay the agency the difference between the defaulting low bid and the next highest bid, whose bidder will be given the contract.

bid shopping The practice of a general contractor estimating the cost for subcontractors in order to prepare a bid for construction work, and then attempting to induce those same subcontractors to lower their price below the estimate.

biennial Occurring every 2 years. Contrast with biannual, which means occurring twice a year. (It's important to know the difference if an adjustable-rate mortgage provides for rate changes biannually or biennially.)



big box (1) Large square or rectangular building with ample parking, suitable for a wide variety of retail tenants. (2) Regular users of such space, such as Wal-Mart, Target, or Home Depot. An example of usage is, "I'm working with a big box and need to find 12 to 16 acres to buy. Do you have anything?"

bilateral contract A contract in which each party promises to do something in return for the other's promise. If either party breaks its promise, the other may sue. This is the most common type of contract. A real estate purchase contract is a bilateral contract—the seller promises to sell, and the buyer promises to buy. Contrast with a unilateral contract, in which one party has an obligation but the other does not. Option contracts are unilateral contracts—the seller is obligated to sell if the buyer decides to buy, but the buyer is not obligated to buy at all.

bill of assurance A name used in some states to describe the total collection of restrictive covenants that apply to a neighborhood.

bill of sale A written instrument used to transfer ownership of personal property. Many buyers insist on a general bill of sale, in addition to a deed, to ensure that all property intended to pass in the sale actually does so. Some states have held that certain real estate–related interests are actually personal property, and attempted sales via deed were void.

binder (1) Money given as earnest money for an oral contract to purchase real estate, to bind the parties until such time as they can complete the necessary written contract. (2) A written instrument giving immediate casualty coverage for property, even though the insured may not have paid a premium or received a policy. (3) A temporary contract of title insurance in which the insurer agrees to issue a final policy if certain exceptions, such as prior mortgage liens, are removed at or before closing.

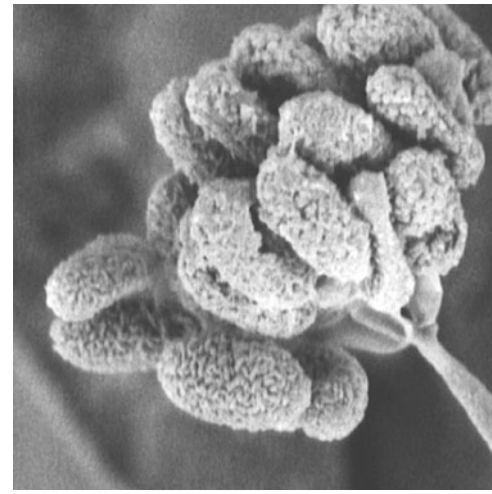
biometrics Increasingly popular building security system technology that relies on automated identification of physical characteristics such as fingerprints or retinal scans in order to determine access rights. The technology and the cost have both reached the point that consumer-level biometric security devices are available, such as for use in self-storage facilities and residences. Access codes, keys, and electronic cards are becoming outdated. Developers should bear this in mind when designing new construction and spend a minor amount of extra money necessary for wiring to accommodate biometric systems.

bird dog Someone who regularly furnishes sales leads to another, but does not actually handle any of the selling. Successful real estate agents usually have many bird dogs.

biweekly loan A loan that calls for payments every 2 weeks, rather than once a month.

Blackacre Mythical property used as an example in nearly all explanations of legal concepts relating to real estate, such as, "If A owns an undivided $^1/_2$ interest in Blackacre… ." If more properties are needed, use Greenacre, and then Whiteacre.

black mold Refers to Stachybotrys chartarum, called stachy for short, a greenish black mold that can grow in parts of a structure exposed to constant moisture. The fungus can produce toxins harmful or even fatal to humans and has been identified in the sick building syndrome. There are some very dark dematiaceous hyphomycetes that look very similar; confirmation of stachy must be made after miscroscope examination. This is an area of widespread litigation and should be a cause of concern to both buyers and sellers of real estate. (For more information, visit the Web site of the Centers for Disease Control and Prevention at www.cdc.gov/mold/stachy.htm.)



Black's Guide A data source for office buildings in certain major markets, providing tenant and other information. Its primary competitor is CoStar. (For more information visit the Black's Guide Web site at www.blacksguide.com.)

blacktop The asphalt paving used on many roads, and also the process of paving the road.

blanket A single mortgage instrument covering two or more properties. It is most often encountered in property intended for development, with partial lien releases given as lots are sold and part of the sale proceeds used to pay down the loan. Contrast with cross-collateralization, in which two or more properties, each with their own mortgages, include the other properties as additional collateral.

bleeding a project (1) In construction, charging excessive development and construction oversight fees, renting one's own equipment to the project at inflated prices, and perhaps putting family members on the payroll in order to bleed off as much money as possible. (2) In rental property management, refusing to make ordinary repairs and replacements in order to take as much cash flow as possible from the project, but with a resulting rapid deterioration of the property. In an area of limited consumer choices, such as communities with high concentrations of low-income housing, the landlord almost never suffers the consequences of this type of decision.

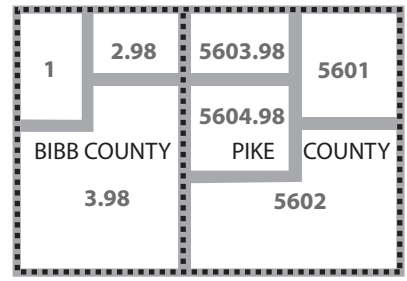
blighted area A declining area suffering from seriously decreasing property values and not likely to recover without some outside intervention. More than simply a market slip, a blighted area can be identified by deteriorating buildings, increased crime rates, and decreased occupancies.

blind ad An advertisement that does not include the identity of the person placing the ad, only a phone number or a post office box number. They are popular with employers placing help wanted ads in order to identify someone to replace a soon-to-be-fired employee. Blind ads are illegal in most states for real estate brokers or agents, who must not only identify themselves in all ads, but include enough information to alert the public of their status as a real estate professional.

block An area bounded by perimeter streets. Many subdivision descriptions employ a subdivision name, and then a block number and a lot number to identify particular properties. The numbers are assigned when the subdivision developer files its plat plan with local authorities.

blockbusting An illegal and discriminatory practice in which someone stampedes another into selling or granting a listing contract by trading on fears the neighborhood is changing with respect to race, sex, religion, color, disability, family status, or ancestry of the inhabitants. (For more detailed information, visit the U.S. Housing and Urban Development Web site at www.hud.gov and search on the term "blockbusting.") See panic peddling.

block numbering area (BNA) A small, relatively permanent statistical subdivision within a county, generally containing 2,500 to 8,000 people and having readily identifiable borders. Similar to census tracts, but differing only in the local versus federal source of the data used to create the maps. Mapped and numbered by the U.S. government, which provides demographic information at www.census.gov. Third-party resellers of demographic information extrapolate from the census tract data into more personalized demographic areas.



Blue book: Any number of pocket-sized reference books on a wide variety of topics. The ones most relevant to real estate are The Blue Book of Building and Construction (www.thebluebook.com), The Apartment Blue Book (www.apartmentbluebook.com), and The Realty Blue Book.

blue laws Laws that prevent the transaction of certain business on Sundays, prohibit the sale of alcoholic beverages any day of the week; and/or place severe limitations on the manner and hours of sale of alcoholic beverages. These laws originated in colonial New England and were printed on blue paper. It is important to know and understand all local blue laws in a market area because, for example, many national restaurant chains will not open locations where Sunday liquor sales are prohibited.

blueprint A detailed set of plans used as a guide for construction. Because of the economies of a very inexpensive method of creating and copying such plans, they were formerly characterized by white lines on blue paper.

blue-sky laws A popular name for state securities laws intended to protect investors and aid them in making informed buying decisions rather than taking the word of a smooth-talking salesperson who "promises the sky."

blue stake When a utility company (telephone, gas, electric, cable TV, sewer, or water, etc.) comes to the job site and locates and spray paints the ground and/or installs little flags or blue stakes to show where their service is located underground. See *utility notification*.

blue top In excavating and in road construction, the practice of marking the desired final grade with a stake topped by blue fibers. The heavy equipment operator continues to move dirt until only the blue tops show above the ground.

B-note investors In commercial real estate financing, purchasers of the subordinate tranches, or second and third mortgages. If a borrower defaults, the B-note investors will suffer losses before the investment-grade tranches. As a result, such investors scrutinize deals more thoroughly, charge higher interest rates commensurate with their increased risk, and typically retain powers to protect themselves somewhat in the event of default. These rights include

- The right to approve modifications to the agreement
- The right to insist on foreclosure in the event of default
- Certain limited cure rights to keep a loan current and avoid foreclosure

board-foot A measure of lumber 1 foot square by 1 inch thick, being 144 cubic inches. In valuing timber land, it is usually important to calculate the number of board-feet that can be harvested from the standing timber. Often, however, timber is now sold by the pound rather than the board-foot.

board of directors The governing body of an organization, charged with establishing policy and with taking steps to see that the policies are implemented. Except in small corporations or associations, the board typically does not involve itself in day-to-day business activities, those being more properly the role of the president. Many corporations have executive boards with true legal responsibilities, and advisory boards of largely ceremonial function designed to reward contributors, create strategic alliances, or gain expert insights into limited areas on an as-needed basis.

- In the real estate context, a director who acts as a broker in real estate transactions involving corporate property cannot accept a commission unless the board specifically authorizes it, even if the president previously granted the approval and would otherwise have had such authority to hire a third party.
- Lenders have legal limitations on the sizes of loans they can extend to their own directors. Large developers should consider this before accepting board positions.
- The board of directors in a cooperative apartment enjoys tremendous power in the approval of new members and in decisions to evict current members.
- The board of directors of a condominium association is charged with making sure the community always has adequate insurance. Because of the shared nature of ownership in the common areas, inadequate insurance could result in the imposition of liability on individual unit owners for an accident in a common area. Failure to maintain the proper level of insurance could subject board members to liability.

board of equalization A local government board charged with the responsibility of ensuring equal property tax assessments. Normally, a property owner appeals to the board of equalization if dissatisfied with the tax assessment notice received for the year.

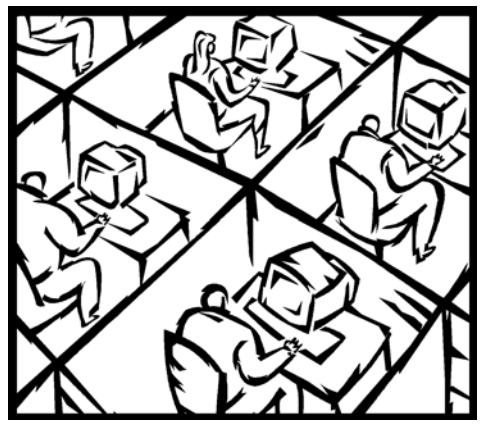
board of REALTORS® A local association comprised of real estate professionals who are members of the National Association of REALTORS® (www.realtor.org and www.realtor.com) and the local or state board of REALTORS®.

board of zoning appeals A local board empowered to overturn decisions of a zoning authority. Before embarking on any possibly contested activity in these areas, such as a zoning change request, it is extremely important to find out the name and requirements of the correct appeals board, should it become necessary to ask for reversal of a decision. Many boards have very limited and technical grounds for appeal that, if known in advance, could have been factored into tactical decisions at the level below. In addition, the time limits for filing appeals are generally short. See *appeals board*.

Boeckh Building Valuation Manual A reference book that provides guidance for the replacement costs (substantially similar utility, but not identical methods of construction) or reproduction costs (identical) for various types of buildings. (For more information go to the Marshall & Swift/Boeckh Web site at www.msbinfo.com.)

boilerplate A term used to refer to standard language appearing in almost all mortgages, leases, sale agreements, and other contracts. Important rights can be signed away by language lurking in the boilerplate; it is important to read all contracts thoroughly and not to skip anything.

boiler room A lead-generating system usually characterized by large groups of people working in cubicles making cold calls to consumers in order to gauge interest in real estate investments, insurance products, refinance offers, or any number of other products. The leads are then sold to professionals for follow-up. Sometimes, the boiler room operation also engages in high-pressure sales techniques, which has lead many states to pass legislation allowing a cooling off period within which to reject and void any contracts entered into as a result of such tactics.



bollard A pillar or post, usually consisting of a metal pipe anchored in concrete and then filled with concrete, placed near building corners, loading docks, entrance doors, and gas pumps in order to protect them from automobiles; may be left natural, painted, or covered with plastic bollard covers.

BOMA See *Building Owners and Managers Association*.

BOMA measurements Standards offered by the Building Owners and Managers Association for determining leaseable square footage and other such measurements. Many have been adopted by the American National Standards Institute, Inc. (ANSI).

bona fide purchaser (BFP) One who purchases property in good faith and for a valuable consideration without knowledge, actual or constructive, of the seller's title defects. Under certain circumstances, BFPs may retain the property free and clear of the claims of others. (As a practical matter, it is difficult to be a BFP of real property because of the constructive notice provided by public filings of almost all real estate–related claims.)

bond A certificate that provides evidence of a debt or obligation.

bond for title A method of selling and financing real estate; also called a land sale contract or a contract for sale. The owner signs a contract agreeing to transfer the property to the buyer after the buyer makes all required regular payments over a certain period of time. Unlike a mortgage, the seller avoids many problems associated with foreclosure and possibly bankruptcy if there is a default. The practice is looked upon with disfavor by courts, which typically try to find ways to convert the relationship in some sort of equitable mortgage, and thus grant the consumer protections afforded by the law.

bonus depreciation Additional depreciation deductions allowed by the IRS under certain circumstances and possibly in certain areas. After the devastating effect of the 9/11 attacks, business owners were allowed to take a first-year depreciation deduction of up to 50 percent of the basis of property placed in service between specified dates. This was in contrast to the normal deduction of 3.63 or 2.56 percent for real property, depending on whether it was commercial or residential rental. Again, after the 2005 hurricane season, the IRS allowed the same bonus depreciation for property placed in service in specifically named Gulf Opportunity Zone counties in the affected states.

book cost The acquisition cost of a property as reflected on the books and records of a company.

book depreciation The amount of depreciation expenses deducted for a property on the books and records of a company. Book depreciation may be charged at a faster or slower rate than allowed by the IRS, in order to provide management with a realistic view of the gradually diminishing value of the company's assets.

book value The value of an asset as reflected on the books and records of a company, taking into account the original book cost of acquisition and then deducting depreciation expenses charged over the years and adding capital expenditures. Book value rarely bears any relationship to the true value of assets.

boomerangers Generation-X aged persons who return home to live with their parents after being unable to find jobs that will provide adequate compensation to support them as well as their parents did.

boot (1) Money or other property that is not like-kind and is given to make up the difference in value between two properties exchanged in a like-kind exchange under Section 1031 of the Internal Revenue Code. If a gain would otherwise be recognized on the transaction, except for the intervention of the 1031 vehicle, then gain must be recognized and taxes paid to the extent of the value of the boot. (2) Especially in Texas, it is common among property developers to require some type of boot to show that more than money is involved in their business transactions.

> **Example:** *A seller might agree to sell prime property for $12,000,000, but only if the buyer throws in a particularly handsome bronze statue sitting on his desk.*

bootstrap financing A funding expansion from internal sources, such as reducing expenses in the budget, collecting rents or other receivables more aggressively, delaying payments to vendors, or preselling units.

boring tests Tests conducted to determine the soil's load-bearing ability to support a building or other improvement, and the size of the footings necessary. Also called compaction tests.

bottom feeder A derogatory term for someone who buys distressed properties; one who profits from the misfortunes or poor management of others.

bottom-fishing The strategy of offering ridiculously low prices for large numbers of properties because of the expectation that, statistically, someone is bound to "bite" and accept an offer.

bottomland Lowlands located in a valley or other low area near rivers, streams, or bodies of water prone to flooding. Bottomland was especially prized by farmers at one time because of the constant deposit of nutrient-rich soils.

boundary The perimeter of a property as fixed in the legal property description. Boundary line disputes are common, emotional, and often end up in years of litigation and sometimes mayhem. If one is buying property in a subdivision, it is advisable to have the seller locate and point out the markers at the corners of the property. These may or may not be consistent with fence lines, shrubberies, driveways, or even structures built on the wrong side of the boundary. If buying nonsubdivision property, employ the services of a licensed professional surveyor to determine the proper boundary.

boundary line disputes Probably the most common type of lawsuit involving real estate, because it is the type least likely to result in settlement before trial. Problems generally arise as a result of some or all of the following four factors:

1. Formerly unsurveyed property owned by amicable neighbors passes into the hands of an outsider who orders a survey and discovers the boundary lines are in different places than previously thought.
2. Formerly amicable neighbors who did not care about a 10- or 20-foot discrepancy in boundary lines suddenly care when oil or gas is discovered under the land, or the property becomes so valuable that it is being sold by the square foot rather than by the acre.
3. Advances in surveying technology would have placed a property corner in a different location than the original surveyor placed it, and when this is discovered, the neighbors go to court.
4. Someone mistakenly builds a house or other improvement with a portion located on a neighbor's land. Words are exchanged regarding tearing down the trespassing improvement, and the parties resort to the court system to solve their differences.

There are very specific rules for resolving boundary line disputes:

1. Advances in technology make no difference because the property corners are where the original surveyor placed them according to his or her own state-of-the-art technology for the time, not at the absolutely accurate location according to today's technology.

2. If there are mistakes in the description, courts follow a hierarchy of things to consider and things to ignore if there is a conflict among descriptions within a deed.
3. If someone innocently builds an improvement that encroaches on another's land, most courts will figure out a way to either give the property to the encroacher or will order the other person to sell a minimal amount of land to the encroacher.

B-paper Home mortgages for consumers with poor credit or other disabilities that prevent them from obtaining the best possible interest rates, percentage of financing, or other terms. The promissory notes are generally at high rates of interest commensurate with the higher risk of default assumed by the lender. The B-paper industry was largely unregulated for many years, but has now come under increasing scrutiny and even class action litigation because of widespread predatory abuses. On the other hand, the industry is predominantly honest and does fill a void in the home mortgage market, enabling millions of responsible persons to enjoy the benefits of homeownership.

branch office Any secondary or ancillary place of business. Most states require branch offices of real estate companies to have their own broker-in-charge or qualifying broker, legally responsible for activities at that branch.

breach of contract A violation of some or all of the terms of a contract. Most contracts spell out specific remedies in the event of breach, but include a basket granting any and all other remedies allowed at law or equity. Some states have statutes making defaulting parties liable for the attorneys' fees of the other side; other states do not have such laws and attorneys' fees are recoverable only if that right is granted in the contract.

- In a real estate context, some purchase contracts provide that a breaching buyer will lose his or her earnest money but not be responsible for any other damages. If not so specified as a limitation on damages, then a breaching buyer is fully responsible for all the seller's damages, which could include losses when the property is sold for a lesser amount, costs of remarketing the property, attorneys' fees, and possibly even consequential damages such as the seller's loss of opportunity to purchase something else. In extremely rare circumstances, the seller can obtain an injunction forcing the defaulting buyer to proceed with the purchase.
- If the seller defaults, the buyer may apply for an injunction to order the seller to proceed with the sale. This unusual remedy is because the law says that real property is so unique that money damages can never compensate one for its loss—only the property itself will suffice. Despite that, buyers may waive this remedy of specific performance and seek damages instead. Under some circumstances they may receive both.

breakdown method In appraisal, the process of dividing depreciation into separate components, assigning a weight to each one, and then arriving at a depreciated value of the property. This has nothing to do with book depreciation or tax depreciation, but is instead intended to calculate the true current value of the improvements. The three types of property depreciation are:

1. Physical depreciation. What is the condition of the improvement?

2. Functional obsolescence. Loss of value because of physical factors other than deterioration, such as a poor floor plan, a one-car garage instead of a two-car garage, or high ceilings and multiple windows creating heating and cooling problems.
3. Economic obsolescence. Loss of value because of factors outside the property, such as noise pollution from nearby highways or an airport.

break-even point In any project, the point at which revenue will be sufficient to pay all required expenses and debt service. Most industries have generally recognized rules of thumb for the appropriate break-even point. For apartments, it might be 80 percent occupancy, for self-storage it might be 55 percent occupancy, and for business center space it might be 75 percent occupancy. Most construction lenders require that a project at least reach the break-even point before construction lending can be converted to fixed-rate and lower-rate permanent financing. If preparing a pro forma for a project and your break-even point is dramatically different from the rule of thumb for your industry, it may be time to check your assumptions or your math.

bricks and mortar A popular expression for a physical location, as opposed to intangible assets or even cyberspace.

bricks, clicks, and flips Retail stores that have physical locations, Internet sale sites, and strong catalog sales. (A variant of "bricks and clicks" and "clicks and mortar.")

bridge loan A short-term loan intended to bridge the gap between other transactions. (1) Temporary financing obtained at the end of a construction loan period but before permanent financing can be arranged. (2) A loan obtained by a home buyer when the equity from an existing home is necessary to provide the down payment for a new home, but the buyer has been unable to sell his or her old home as of that time (frequently offered by employers who transfer employees to new cities).

bring-down search An additional title search to make sure nothing adverse has been recorded in the real estate records since the time of the original search and the recording of the deed or mortgage. This time period is known as the gap.

British thermal unit (BTU) A unit of measure of heat, used in rating the capacity of air conditioning and heating equipment. One BTU is the amount of energy necessary to raise the temperature of 1 pound of water by 1 degree Fahrenheit.

broker An agent employed to make bargains and contracts for compensation. In the real estate industry, a broker does not make contracts and bind his or her principal but, instead, acts as an intermediary between buyers and sellers.

- The broker-in-charge or qualifying broker in an office is responsible for setting office policies, supervising agents in the execution of their legal responsibilities, and complying with all regulatory requirements. All contracts with consumers are with the broker, who is the only one legally permitted to enter into such relationships. The broker may then delegate

some responsibilities to agents or other licensed salespersons, but does not thereby relieve himself or herself of liability.

- Brokers have fiduciary responsibilities to their principals, called clients. They must exercise honesty, integrity, care, and skill in carrying out their duties. All other persons, called customers, are owed the duty of honesty.
- The broker must submit all written offers to the principal as soon as received and may not hold any offer while waiting for a more attractive one.
- All earnest monies coming into the possession of the broker must be deposited into an escrow account as soon as possible according to the instructions of the offer, but it may hold a check, undeposited, in a file if the offer states the check may not be deposited until the offer is accepted.
- All client monies, such as from property management activities, must be maintained in an escrow account and cannot be comingled with the broker's other funds.

brokerage A real estate activity devoted to assisting buyers and/or sellers in the purchase of real property. In smaller communities, brokerage activities are conducted on a type of general practitioner basis. In larger communities, brokers generally specialize in certain price ranges or types of residential properties; or some combination of office buildings, retail space, food service, industrial, warehouse, farms and lands, or development land.

broker-in-charge See *broker*.

broker price opinion (BPO) In most states, only a licensed appraiser is authorized to offer a professional opinion as to the value of a property. Often, though, a real estate broker will be asked to offer an opinion regarding the price to ask when marketing a property. This is a fine distinction, but perfectly legal, as long as labeled as such. BPOs are frequently obtained by out-of-state lenders seeking to work out a sale of a distressed property.

broom clean Containing no debris. Most apartment leases require that the premises be left broom clean.

brownfields According to the Environmental Protection Agency, "a brownfield is a property, the expansion, redevelopment, or reuse of which may be complicated by the presence or potential presence of a hazardous substance, pollutant, or contaminant." The EPA's Brownfields program (initiated in 1995) supplies local grants to support revitalization efforts by funding environmental assessment, cleanup, and job-training activities.

brownstone A row house built of reddish-brown sandstone; usually refers to one built in the nineteenth century, in a large city, with a narrow profile facing the street.

BTU See *British thermal unit*.

BTXE Toxic chemicals typically found as soil contaminants at former gas station or other petroleum-handling sites. Short for benzene, toluene, xylene, and ethylbenzene.

bubble A period of rapid expansion and price increases, followed by a market slowdown and contraction. Many analysts claim a real estate bubble exists in some cities characterized by a price growth of more than 30 percent per year. Other analysts disagree. (For housing cost information in various states and cities, see the Office of Federal Housing Oversight Web site at www.ofheo.gov, and click on House Price Index.)

budget (1) An itemized list of expected income and expenses over a period of time. (2) An estimate of particular monetary needs, such as a capital budget for construction or a development budget for construction and business ramp up to break even.

budget mortgage Typically a residential mortgage, one that requires monthly payments for real estate taxes and insurance in addition to principal and interest payments.

buffer zone (1) A transitional area between two areas of different zoning or characteristic land use. (2) Green space or other open or natural areas providing privacy and noise pollution control for a subdivision.

builders and sponsors profit and risk allowance (BSPRA) An amount above the cost of constructing apartments that is allowed to be included in the project costs for purposes of determining the maximum loan amount in certain government-sponsored programs; generally calculated as 10 percent of the project development cost, less the cost of the land.

builders risk insurance Fire, liability, and extended coverage protection to cover the risks encountered when a building is under construction.

builder warranty A guarantee offered by the builder on the quality of construction.

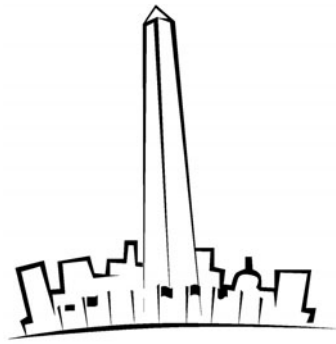
building codes Regulations established by local governments to specify minimum building standards for foundations, structural support, electrical and plumbing systems, fire retardation, accessibility, safety for small children and others, fire escapes, numbers of exits, numbers of parking places, and many other areas concerned with the health and safety of the population. The most widely employed building code is the standard known as the International Building Code. Some local governments still employ the Southern Building Code. (For more information go to the International Code Council Web site at www.iccsafe.org.)

building efficiency ratio The proportion of leasable space in a building to the total space.

Building Energy Conservation Code As a part of the National Energy Policy Act of 1992, Congress required that states incorporate energy-efficient requirements into their building codes for commercial buildings. Details regarding model codes may be obtained from United States Department of Energy Web site at www.energycodes.gov or a local building inspection office.

building height The total height from the bottom of the ground floor to the highest structure or decoration on the roof. Local building codes or airport avigation easements may place restrictions on building height.

Example: *The Washington, D.C., building height restriction states that no building may be more than 20 feet taller than the width of the street in front of it, but exceptions may be granted for spires, towers, domes, minarets, pinnacles, and engineering structures such as ventilation shafts.*



building inspection A physical review of a property in the various stages of construction, to ensure the builder has complied with all requirements of the local building codes. Failure to pass a particular inspection may halt progress until the condition has been corrected. For example, no construction may proceed on a building until it has passed its foundation inspection. The local inspections department will not issue a certificate of occupancy (C/O) until the property has passed fire marshall review and any other inspections that may be required in the locale. In order to provide de facto enforcement of the rule prohibiting occupancy without a C/O, many utility companies will not provide permanent service without proof that one has been issued and will disconnect temporary service at the end of the originally anticipated completion date.

building line A setback line; the closest a building may be allowed to come to the property boundary line. Building lines may be set by local government or by subdivision building restrictions.

building loan agreement A loan to finance construction. Funding is made either at preestablished stages or at completion, or upon submission and approval of invoices evidencing construction bills.

Building Owners and Managers Association (BOMA) This professional organization (www.boma.org) is made up of persons who own or manage buildings, primarily office buildings.

building permit Written permission from local government to proceed with construction, substantial repair, demolition, or sign erection on real property. The permit process serves several purposes:

- Revenue generation through permitting fees
- Early identification of potential problems, such as the need for historical district approvals
- Entry of the project into a tracking system to ensure code compliance through periodic inspections
- Estimation of the anticipated cost of the project, in order to assist local government with analysis of building and development trends
- Initiation of steps that will ultimately ensure all subcontractors have business licenses and correctly report their income for the year

(Developers typically include contingencies in their purchase contracts to allow for difficulties in obtaining building permits. Especially with large projects, which require extensive plan review before issuance of a permit, the permitting process can take many months.)

building restrictions Zoning or subdivision restrictions on the size or type of building that can be erected.

building standard A particular style and quality of building materials, finishes, and accessories used in a specific commercial building. Office leases will generally include a construction allowance or build-out allowance to complete space according to a tenant's space design and using building standard materials. If the tenant desires a better quality, the tenant may usually pay for the difference in cost and obtain it. The phrase also comes into play in circumstances when the landlord has agreed to be responsible for replacing all building standard lightbulbs in the leased space. If building standard is fluorescent, and the tenant has incandescent bulbs in spaces such as conference rooms, then the tenant will have to pay for replacement of those bulbs. This can be a significant expense.

build-out Improvements to leased space to make it usable for a particular tenant's needs.

built-ins Appliances, machinery, and other equipment installed as part of a building rather than left freestanding. Built-ins are considered fixtures, and fixtures are considered real estate. A contract to sell real estate automatically carries with it an obligation to leave all fixtures in place and included in the sale. There is usually a great deal of controversy over the exact nature of something as a built-in or not, such as a high-end refrigerator surrounded by custom cabinetry and with matching door insert panels. If in doubt, specifically list all appliances, machinery, and other such questionable items in the purchase contract.

built to suit An arrangement in which a property owner agrees to construct a building according to a tenant's exact specifications, and then to lease the property to the tenant, preferably on a long-term basis.

bulk sale Transfer of all or substantially all the assets of a business. Some states have bulk sales laws requiring notice to creditors before any such sales, so that a debtor may not liquidate all assets, pocket the money, and leave creditors holding the bag.

bulk zoning Zoning designed to control density and overcrowding.

bullet loan A loan with a 5- to 10-year term, no amortization, and the entire principal balance due at the end.

bundle A package of shingles. Normally, there are three bundles per square and 27 shingles per bundle. Most roofing contractors charge by the square or by the bundle.

bundle of rights theory A concept describing all the rights capable of ownership in real property. The bundle may be broken, and only some of the rights transferred and others retained, or they may be transferred to different people.

burden of proof In court, the responsibility to come forward with credible evidence that a thing happened or did not happen. Normally, the party who complains about a wrongdoing has the burden of proof. In some circumstances, primarily under federal laws related to discrimination, the aggrieved party need only make an allegation of wrongful behavior and the defendant has the burden of proof that his or her behavior was reasonable under the circumstances. The burden of proof may be set at different levels for various types of litigation. For example:

- When contesting a property tax valuation, the owner must generally prove that the assessment was manifestly excessive, clearly erroneous, or confiscatory. This burden of proof is very high, much more than required to show the assessment was simply inaccurate.
- Housing discrimination cases involve a three-step process that moves the burden of proof back and forth. Under what is called the McDonnell Douglas test, plaintiffs have the burden of showing they are a member of a protected minority; they applied for and were qualified to rent or purchase property; and they were rejected and the housing or rental opportunity remained available afterward. That creates a presumption of discrimination, which shifts the burden to the defendants to prove they had legitimate, nondiscriminatory reasons for their actions. If successful, the burden shifts back to the plaintiffs to prove by a preponderance of the evidence (meaning, "more likely than not") that the offered reason was a pretext and there really was a discriminatory purpose.

Bureau of Land Management An agency of the U.S. Department of the Interior, charged with the care, custody, and management of all land owned by the U.S. government, comprising approximately 261 million acres. It also maintains current and historical information regarding land ownership and use, maintains a geospatial (GIS) data clearinghouse, and manages and provides access to the public land survey system, also called the rectangular survey system employed in surveying real property. (The Bureau of Land Management Web site is at www.blm.gov.)

burned-out tax shelter An investment that has exhausted most of its tax-sheltering benefits. For properties taking advantage of bonus depreciation of up to 50 percent for the first year placed in use, the shelter can be burned out by year 2.

business center An office arrangement providing individual offices for local representatives of large companies, professionals, and small-business persons, with sharing of lobby space, conference rooms, support staff, telecommunications services, office equipment, and other amenities. Formerly called executive suites and shared offices. The industry trade organization is the Office Business Center Association International (www.obcai.org).

business day A standard day for conducting business, excluding government holidays and weekends. Various notices required in real estate contracts, leases, or other agreements may have deadlines based on the passage of a certain number of days, or of business days. To count days, you start with the day after the triggering event, and count that as day 1.

business interruption insurance Insurance that provides benefits if business is interrupted while repairs are conducted after an insurable loss.

business park A development designed for warehouse, office or light-industrial use, with generous landscaping and open spaces.

business value The intangible value of a business, over and above the value of the land, improvements, fixtures, receivables, and cash. Intangibles may consist of goodwill, franchise value, and proprietary systems and procedures.

buyback agreement A provision in a contract requiring the seller to buy the property back for a stated price if certain conditions are met within a specified period of time. One wishing to purchase an existing automobile dealership may purchase the land first, with a buyback agreement requiring seller repurchase if the purchaser is unable to obtain manufacturer approval for transfer of the dealership itself.

buy down To reduce the interest on a mortgage loan by paying discount points in order to buy down the rate. For residential loans, it rarely makes sense for borrowers to buy down their rate. In order to evaluate, ask for the amount of the monthly principal and interest payments with and without the reduced rate. Subtract the lower number from the larger number. This is the amount of your monthly savings. Divide your monthly savings into the price for the buy down. This provides the number of months you must pay on the mortgage before you will have saved enough money to pay for the discount points. Finally, ask yourself, "Do I realistically think I will own this property for that length of time?" If not, then do not pay the points.

buyer's broker An agency relationship in which the broker represents the buyer rather than the seller. This is typical in commercial real estate transactions, but relatively rare in residential real estate brokerage. For residential brokerage, most agents "working with" buyers are actually subagents of the seller.

buyer's market A market with more properties for sale than can reasonably be expected to be purchased by the available demand. As a result, sellers will have to compete against each other to attract buyers and will usually do so by lowering prices.

buyout (1) Securing the removal of tenants from a building by paying cash incentives for the early termination of their leases. Owners may desire to buy out tenants in order to rehab the property to attract a better quality of tenant at higher rates; in order to sell the property to an owner-occupier; or to remove an objectionable tenant causing problems but not technically in default. (2) Securing the release of a tenant from lease obligations in another building so the tenant can rent in the owner's building. The other building's owner may permit the buyout if he or she believes the departing tenant can be replaced fairly quickly, thereby gaining a large windfall profit from the buyout payment.

buy-sell agreement An agreement among partners or shareholders describing the circumstances and terms of sale if one or more wish to exit the arrangement or wish to sell their shares to an outsider.

bylaws Regulations by which an organization conducts its governance activities. They typically provide for the timing and method of elections and regular meetings, number of directors and other officers, methods and notice necessary for special elections or meetings, number of votes required for different types of actions, establishment of standing committees, and a grant of authority to organize other committees, powers of the board, officers, and various committees. The developer of

a subdivision or condominium project typically creates the first set of bylaws and appoints the initial board of directors.

by operation of law A method of acquiring rights in real estate without any specific intention or even knowledge on the part of the owner. Spouses may gain rights through homestead, dower (widow's rights), curtesy (widower's rights), or community property statutes.

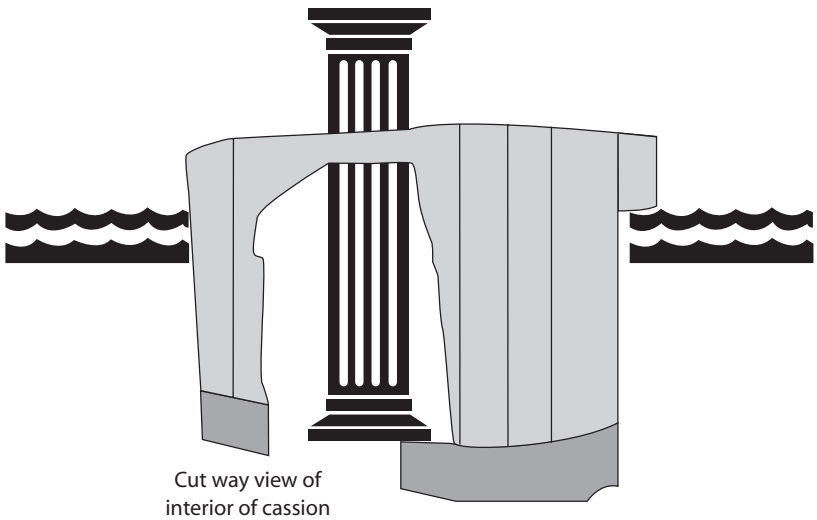
C

CAD (1) See *cash available for distribution*. (2) See *central appraisal district*. (3) See *computer-aided design*.

cadastral (1) A legal map for recording ownership of the various parcels of land within a jurisdiction. (2) The United States Cadastral System program within the U.S. Department of the Interior Bureau of Land Management, responsible for surveying and related activities. (For more information go to the Bureau's Web site at www.blm.gov.)

CAI See *Community Association Institute.*

caisson A casing or cylinder used to sink shafts into wet or unstable ground, or a watertight structure within which construction is conducted under water. Often used in bridge building; sometimes used in commercial construction.



Cut way view of interior of cassion

call option See *call provision*.

call provision A clause in a loan instrument that gives the lender the right to accelerate the debt upon the occurrence of certain conditions. These might include filing for bankruptcy (illegal, but it's in all the promissory notes anyway), reduction in value of the collateral, occupancy levels dropping

below certain minimum levels in income-producing properties, or the catchall clause "whenever the lender deems itself insecure." As a practical matter, it would be an unwise lender who relies solely on the "deeming itself insecure" clause, because such action almost always results in litigation in which a jury, usually of the borrower's peers, gets to decide if it was reasonable under the circumstances for the lender to panic.

CAM See *common area maintenance*.

cancellation clause A clause in a contract or lease that allows one or either party to cancel it upon the happening of certain named events other than a default. It is most often encountered: (1) in the lease for a single-tenant commercial building or house, allowing the landlord to cancel the lease upon sale to another owner who wishes to occupy the property rather than use it as an investment, and (2) in a commercial lease for a small-space user who might stand in the way of expansion by a larger tenant. Well-negotiated leases include a provision for some sort of compensation to the tenant if this happens.

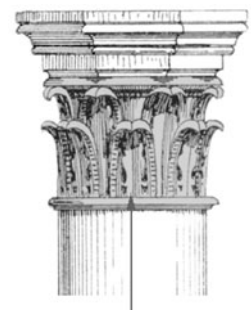
cantilever A beam or overhanging architectural element that is supported at only one end. The most common examples are bay windows and swimming pool diving boards. The most famous example is a balcony that seems to be suspended in the air above a waterfall at Frank Lloyd Wright's architectural masterpiece, Fallingwater, in Pennsylvania (www.paconserve.org/fallingwaterhome.htm).

cap A ceiling on the adjustments that can be made in the payments or interest rate of an adjustable-rate loan.

capacity The legal ability of parties to enter into contracts.

- Full capacity. Having unlimited ability to enter into binding contracts of all types.
- Limited capacity. Having the ability to enter into binding contracts for certain things, such as a minor's contracts for necessities, but also having the ability to disaffirm other contracts upon reaching legal age, for example.
- No capacity. Having no ability to enter into contracts, such as one who has been adjudicated as mentally incompetent.

capital (1) In architecture, the top part of a column. (2) In finance: (a) All the accumulated goods, possessions, and assets used for the production of income and wealth. (b) The amount invested in business.



Corinthian capital.

capital asset (1) All property held by a taxpayer except inventory or goods in process. (2) All property except that held for resale to others in the ordinary course of business.

capital calls A call for additional equity investment by shareholders or partners in order to fund cash shortfalls in development or operations, or to compensate for the falling value of noncash assets and the need to increase cash so that liabilities do not exceed assets.

capital expenditure Money spent on capital improvements, being those that change the nature of property, extend its useful life, or otherwise improve it beyond the natural improvement to be expected with routine repairs and maintenance. This is an important concept because capital expenditures must be added to the basis and depreciated slowly over time, while noncapital expenditures for repairs may be deducted entirely in the current year on one's taxes.

capital gain The taxable gain recognized from the sale of a capital asset. It is the difference between the sale price of the property and the adjusted basis. Tax laws routinely offer preferential treatment for long-term capital gains on property held for a certain period of time before sale. Capital gains may be offset by capital losses.

capital improvement See *capital expenditure*.

capitalization rate Usually called a cap rate, it is a number used in order to estimate the value of an income-producing property. There are no cap rate tables, no firm standards, and no universal formulas for arriving at one. Cap rates change frequently, depending on market demand for particular types of properties, lender appetite for particular types of loans, and prevailing interest rates. Most commercial real estate brokers, appraisers, and lenders know a range of cap rates for different types of properties. One divides the annual net operating income by the cap rate to arrive at a value. High-quality multi-tenant medical offices might sell for cap rates of 7 percent, and rundown apartment buildings with high turnover might sell for a cap rate of 13 percent. If both of them had gross rents of $300,000 per year with operating expenses of $60,000, then each would have a net operating income (NOI) of $240,000. By dividing the cap rate into the NOI, the medical offices would have a value of $240,000 ÷ 0.07, or $3,428,571. Using the same formula for the apartments, but the higher cap rate, $240,000 ÷ 0.13 gives a value of $1,846,153. It seems counterintuitive at first, but the higher the cap rate, the lower the value.

capitalize (1) In finance: (a) To add an expenditure to the basis of property. (b) To provide funding to an enterprise. (c) To book something as an asset and depreciate it rather than writing off the money spent as an expense. (When one "cooks the books" for a business, extensive repairs might be capitalized as improvements in order to make the enterprise appear more valuable than it is in reality. This approach runs counter to the normal taxpayer desire to treat all repairs as expenses in order to gain maximum tax deductions in the current year.) (2) In appraisal, to estimate the present value of an income stream from a business or property.

capitalized closing costs A taxpayer may write off as deductible expenses some of the closing costs associated with the purchase of property or the acquisition of a loan. Others must be deducted proportionately over the term of the loan, so that if the loan is for 30 years, $^{1}/_{30}$ may be deducted each year. Still others must be capitalized, meaning treated as additional money spent on the purchase price when it comes time to calculate the gain on a later sale of the same property.

Tax Deductions for Home Purchase Expenses

	Deduct in Current Year	Amortize over Loan Term	Capitalize
Loan origination fee for primary home purchase	✓		
Buyer-paid loan discount points for primary home purchase	✓		
Seller-paid loan discount points for primary home (but only if the seller doesn't deduct them also)	✓		
Any of the above three, but for secondary home		✓	
Prepaid interest	✓		
Property tax prorates	✓		
Title insurance for owner			✓
Survey			✓
Legal fees for closing			✓
Recordation fees and transfer taxes			✓
Normal seller expenses you agree to pay, like real estate commission, back taxes, and unpaid assessments or dues			✓

For more information, consult IRS Publications 530 (Tax Information for First Time Homeowners), 523 (Selling Your Home), 587 (Business Use of Your Home), and 936 (Home Mortgage Interest Deduction) available at www.irs.gov or by calling 800-829-3676.

capitalized value of future income The value today of the right to receive income in the future. The concept rests on the principle that no one would pay $120 today for the right to receive $120 one year from today. Neither would anyone pay $120 today for the right to receive $10 per month over the next 12 months. Add to that the idea that relative risk affects a person's decision making. You might place $120 in an FDIC-insured savings account today, in order to receive $140 in one year. But, would you pay $120 to an out-of-work student, in exchange for her promise to pay you $140 in one year? Probably not. These two concepts—the time value of money and the evaluation of risk—are at the heart of discounting. Discounting is the basic tool for reaching a capitalized value of future income. See *present value* or *discounted cash value*.

capitalized value of property The acquisition cost of the property, plus expenses of acquisition and improvement. The choice between adding an item to the capitalized value or writing it off as an expense in the current year is one of the critically important decisions of any business or investment property. It is important to have a grasp of the hard-and-fast rules and an understanding of the gray areas.

capital loss A loss recognized upon the sale of a capital asset. It is the difference between the sale price of the property and the adjusted basis. Just like capital gains, capital losses can be either short

term or long term. Long-term capital losses may be set off against long-term capital gains. Short-term capital losses may be set off against short-term capital gains; one may not recognize a capital loss on the sale of a personal residence.

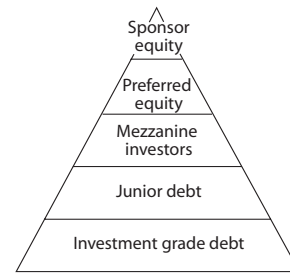
capital markets The markets in which equity is raised and long-term loans (over one year) are originated and traded. These include the stock market, the bond market, and the primary market. The primary market is any market in which the original issuer receives money, such as an investment house that purchases all securities for an original issue and then resells them on the stock market. Short-term debt instruments, for one year or less, are sold in the money markets, not the capital markets.

capital recapture Return of the principal invested in a property, normally expressed as a dollar amount over a period of time.

capital recovery See *recapture rate*.

capital stack A description of the totality of capital invested in a project, including pure debt, hybrid debt, and equity. The stack is described as containing the most risk at the top, traveling down the stack to the position with the least risk. Higher positions in the stack expect higher returns for their capital because of the higher risk. Lenders and equity stakeholders are highly sensitive to their position in the stack. Typically, the stack is arranged as follows.

1. Sponsor equity
2. Preferred equity
3. Mezzanine investors (hybrid debt and equity)
4. Second and other junior mortgages
5. Investment-grade first mortgages



Capital stack.

capital structure See *capital stack*.

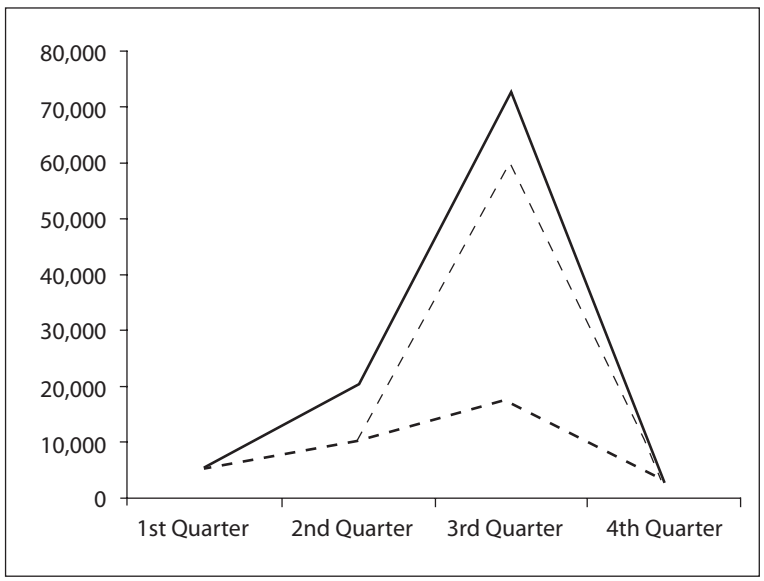
cap rate See *capitalization rate*.

capture rate The sales or leasing rate of a project, which is usually compared to similar projects in the marketplace. There are various measurements, depending on the size of the units being sold or leased. When referring to commercial real estate space for lease, the capture rate might be expressed as an average number of square feet leased per month, quarter, or year. When referring to small space with short rental terms, such as self-storage or business center space, the expression is also used to communicate the number of units rented versus the number of inquiries per month, or sometimes the number of units rented versus the number of physical visits to the property per month. All these measurements allow management to compare its success to others in the marketplace and to make adjustments in pricing, advertising, or possibly even sales personnel as a result. They also allow management to make decisions about future development, in order to accurately anticipate the length of time it will take a project to reach stabilized occupancy or, the alternative, to break even.

Example: *The following table shows capture rates of square feet of space rented in each of the quarters of the past year, for three different buildings.*

Square Feet of Space Leased, per Quarter, in Three Different Buildings

Quarter	Building A	Building B	Building C
1st	5,000	0	500
2nd	10,000	0	10,000
3rd	18,000	42,000	12,500
4th	2,000	0	500



A quick glance at the chart shows that tenants seem to sign the most leases in the third quarter, although the negotiating process probably starts much earlier.

caravan A group inspection tour of newly listed properties by local real estate agents; a field trip to view the competition's listings.

carport/car porch An open-air roofed structure used to house vehicles at a residence. Contrast with a garage, which must be completely enclosed.

carry-back financing Seller financing through the vehicles of a second mortgage, a wraparound mortgage, or a bond for title.

carrying charges Costs incurred in owning property up until completion of a development, as opposed to the actual development expenses themselves. Carrying charges must be capitalized and

then amortized, or expensed, over the next 10 years as tax deductions. Examples include interest accrued on development loans, and property taxes.

carryover basis In tax accounting, the retention of an earlier basis (adjusted acquisition cost) in property even though the property has changed hands. This happens most often in two instances: (1) Someone acquires property by gift. The basis is the same as it was in the hands of the donor, adjusted upward for any gift taxes paid by the donor. (2) In a 1031 exchange, in which like-kind property is exchanged for other like-kind property in a sort of perfectly legal accounting sleight of hand, the basis in property acquired is the same as the basis in the property given up, even though both might currently have substantially different fair market values.

carve-out An area of personal liability in an otherwise nonrecourse loan. A lender may be willing to accept property as sufficient collateral for a loan, without requiring personal liability on the part of the corporate or individual borrower in case there is a default and the collateral is insufficient to pay the debt. The exceptions, or carve-outs, are for things outside the ability of the lender to analyze during underwriting, such as borrower fraud or environmental claims.

cash available for distribution (CAD) Encountered in REIT (real estate investment trust) and large corporation accounting, it is cash from operations after payment of all expenses and a reserve for taxes, repairs, and reasonably anticipated capital expenditures.

cash equivalent (1) In finance, assets easily converted to cash. Lenders like to see large percentages of assets held in cash and cash equivalents rather than tied up in real estate or stock in small corporations. (2) In appraisal, the conversion of a sales price with favorable or unfavorable financing terms into the equivalent price if the consideration had been all cash. A seller might demand an above-market price for a property but be willing to hold the financing at below-market rates, for example. Such a transaction would require analysis for the cash equivalent sales price.

cash flow (1) Noun: The cash available from an investment after receipt of all revenues and after payment of all bills. (2) Verb: The process of creating cash flow, as in "I think that property will start to cash flow in about a year." A property can have positive cash flow (good) or negative cash flow (usually bad). Cash flow is not the same thing as profitability. A property can be profitable, meaning gross income less expenses, depreciation, and interest on debts results in a positive number. That same property can have a negative cash flow because of the need to pay principal payments on loans or expend money for something that represents a capital expenditure, like a new roof.

cash flow mortgage A loan workout tool in which all, or nearly all, of the cash flow from a property is used to service the debt for some period of time, even though this amount may be less than the amount originally expected by the lender.

cashier's check An official check issued by a bank with itself as the drawer. Contrast with a certified check, which is one drawn on the bank customer's account, with the customer as drawer, but certified as good by the bank. Closing companies usually require a cashier's check for the purchaser's portion of all closing costs and purchase money. A cashier's check can be the subject

of a stop-payment order. Because of widespread forgery of cashier's checks, many closing companies will not complete closing until funds are actually collected and in the closing company's escrow account.

cash method An accounting method employed by individuals for preparation of their taxes, and often used by small businesses. Income is counted when the money is actually received by the taxpayer, and expenses are counted during the period in which they are actually paid. Contrast with the accrual method, in which income is counted when it is earned, whether or not it results in money during that period, and expenses are counted when they are incurred, regardless of when they are actually paid. Cash method accounting can dramatically skew financial statements, making properties appear profitable solely as a result of holding bills and not paying them until another period.

cash-on-cash A tool for investment analysis, being a comparison of the cash flows taken from a property over some period, usually a year, as compared to the original cash investment.

cash-on-cash return See *cash-on-cash*.

cash out To liquidate an asset.

cash-out refinance To refinance a property in an amount sufficient to pay off existing debt and provide cash to the owner. Because this is not a taxable event, it is a widespread way for investors to realize benefits from the growth in their assets without having to sell them.

cash purchase A property acquisition with no financing. Even without a financing contingency, it is important for real estate contracts to specify if there will be a cash purchase or a financed purchase, because the two represent vastly different responsibilities on the part of the closing company.

cash throw-off Same as the noun version of cash flow, but rarely used. It is common, however, to say that a property is "throwing off cash."

castle, man's home as A concept rooted in English common law, from the case of *Anonymous*, King's Bench, 1506, reported at Year Book, 21, H.VII 39, pl. 50, holding that a person was entitled to defend his premises against intruders because "a man's house is his castle and his defense, and where he has a peculiar right to stay."

categorical taking A government regulation that deprives a property owner of all economically beneficial use of his or her property, and, as a result, constitutes a regulatory taking such as would justify requiring the government to pay the property owner for the loss.

caveat emptor Means "buyer beware." The legal doctrine followed in some states that sellers of real property are not required to disclose any defects except those inherently dangerous and not easily discoverable by the purchaser. Contrast with seller disclosure states that affirmatively mandate written disclosure of a wide variety of named deficiencies, plus anything else that might be deemed a property defect.

caveats Warnings. Frequently encountered in real estate disclosures or contracts with the words "to the best of the Seller's knowledge" or "but without aid of a structural engineer."

CBD See *central business district*.

CCA chromated copper arsenate; a pesticide that is forced into wood under high pressure to protect it from termites, other wood-boring insects, and decay caused by fungus.

CCIM See *Certified Commercial Investment Member*.

C-corporation A typical corporation that pays taxes on its income at the corporate level and then the shareholders are taxed on dividends distributed to them. Contrast with S-corporation, which has no taxes at the corporate level.

CCR See *conditions, covenants, and restrictions*.

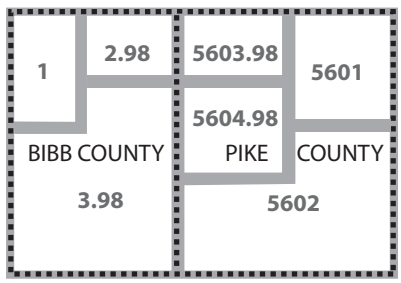
CD See *certificate of deposit*.

cease and desist An order from a government authority requiring one to stop engaging in some activity, such as construction without a proper permit. If issued from a court, it would be called an injunction.

ceiling (1) The uppermost surface of a room or space. When a lease makes all improvements "below ceiling" the responsibility of the tenant, one must ask if "ceiling" means the concrete bottom of the floor above, or if it means the suspended grid system with ceiling tiles. The space in between the two is called the plenum. All the wiring, plumbing, and ductwork go through the plenum, so the choice of which surface is the "ceiling" could mean a substantial difference in tenant responsibilities. (2) An upper limit on something, such as the IRS ceiling of $1,000,000 worth of home mortgage debt for which one can deduct mortgage interest.

cemetery lots A special land use designation authorized by statute. In many states, cemetery lots are exempt from real property taxes.

census tract A small, relatively permanent statistical subdivision within a county, generally containing 2,500 to 8,000 people and readily identifiable borders. Similar to block numbering areas (BNAs), but differing only in the local versus federal source of the data used to create the maps. Mapped and numbered by the U.S. government, which provides demographic information at www.census.gov. Third-party resellers of demographic information extrapolate from the census tract data into more personalized demographic areas.



central appraisal district (CAD) Employed when multiple entities are entitled to assess taxes based on the value of real property located within their shared borders. In order to avoid inconsistencies in appraisals and duplication of expenses, the multiple entities will organize and share the expenses of a central appraisal district.

central business district (CBD) Typically the downtown section of a city, generally containing the finance, real estate, insurance, and legal headquarters for the city.

Century 21 page A slang expression derived from the real estate franchise firm Century 21; describes a Web site that exists for no other purpose than to redirect you to another site. Web sites are often referred to as "real estate."

CERCLA See *Comprehensive Environmental Response Compensation and Liability Act*.

certificate of completion A document issued by an architect, engineer, or other qualified inspector attesting that the project has been completed in conformity with all plans and specifications; usually required before the construction lender will fund the final payment due under a construction loan.

certificate of deposit (CD) A receipt for money deposited in a financial institution.

certificate of discharge Also called a waiver of tax lien. An IRS release of tax lien so that property can be sold or foreclosed. (For more information go to the IRS Web site www.irs.gov and see Form 4422, "Application for Certificate Discharging Property Subject to Estate Tax Lien"; Form 783, "Instructions on How to Apply for a Certificate of Discharge of Property from Federal Tax Lien" (non-estate tax); and Form 786, "Instructions for Preparing Notice of Non-judicial Sale of Property & Application for Consent to Sale.")

certificate of eligibility A certificate issued by the regional Department of Veterans Affairs in order to indicate a person's eligibility for a VA loan.

certificate of estoppel See *estoppel*.

certificate of insurance A document issued by an insurance company to certify the extent and limits of coverage. Usually required by landlords as evidence a tenant is in compliance with lease requirements to maintain certain minimum levels of property and liability insurance. Also required by general contractors as proof the subcontractors have adequate insurance.

certificate of no defense Same as estoppel certificate. See *estoppel*.

certificate of occupancy (C/O) Almost always referred to simply as a "C.O." A document issued by a local government certifying that a structure has passed all required inspections and is ready for occupancy. It is always required at the completion of any construction when repairs require a construction permit. It is also often required when a property changes character from residential to commercial, even if no construction takes place, and is sometimes required before issuance of a new business license when a property changes hands. As a de facto method of enforcement, many utility companies will not permit service until receipt of a valid certificate of occupancy.

certificate of reasonable value (CRV) A document issued by the Department of Veterans Affairs as a prerequisite for a VA loan; it is based on an approved appraisal. It establishes the maximum value of the property for VA purposes and, as a result, the maximum size of the VA loan.

certificate of satisfaction A document filed in the public records certifying that a recorded lien on real property has been paid in full.

certificate of title A document issued by an attorney or title company certifying the status of title to real property and the absence or presence of title defects, liens, and adverse claimants. This is not the same as title insurance, because the preparer is liable only for negligence in the event of mistakes.

certified check A check drawn on the bank customer's account, with the customer as the drawer and the check certified by the bank as payable.

Certified Commercial Investment Member (CCIM) A designation awarded by the Commercial Investment Real Estate Institute after a member completes education, experience, and testing requirements. (For more information go to the Web site of the CCIM Institute at www.ccim.com.)

Certified General Appraiser An appraiser qualified to appraise any type of property, under rules adopted by the Appraisal Foundation (www.appraisalfoundation.org).

certified historic structure As defined by the IRS for purposes of the rehabilitation tax credit (popularly known as the historic preservation tax credit), any building, portion of a building, bridge, ship, railroad car, dam, or any other structure that is either listed in the National Register of Historic Places or located in a registered historic district and certified by the U.S. Department of the Interior as being historically significant to the district.

certified home inspector A home inspector certified under state licensing or certification programs.

Certified Property Manager (CPM) A professional designation awarded by the Institute of Real Estate Management (IREM) (www.irem.org), which is affiliated with the National Association of REALTORS®.

Certified Residential Appraiser A state certification for residential appraisers.

Certified Residential Broker (CRB) A designation awarded by the Council of Real Estate Brokerage Managers (www.crb.com), which is affiliated with the National Association of REALTORS®.

Certified Residential Specialist (CRS) A designation awarded by the Council of Residential Specialists (www.crs.com), which is affiliated with the National Association of REALTORS®.

cestui que trust (pronounced "seh tee kuh trust") The beneficiary of a trust.

chain A unit of measurement formerly used in surveying and still seen in deeds with old property descriptions. One chain equals 66 feet.

chain of title The history of all owners and lien holders of real property, together with the dates of their acquisition and the nature of their title, going all the way back to the first deed out of the government.

change order A written order from the owner, architect, engineer, or other authorized person to depart from previously agreed upon plans and specifications for construction. Change order

management is a critical aspect of any construction job, as change orders frequently change the cost of the job, usually in an amount in excess of what might otherwise be expected. Many subcontractors bid jobs at break-even prices in order to secure the work, confident that numerous change orders will provide the profit necessary.

> **Example:** *An electrician might contract to perform all wiring and electrical work for a home for $2,000. Additional outlets added by change order might be billed at $65 each, even though the additional labor and materials might amount to only $5 each.*

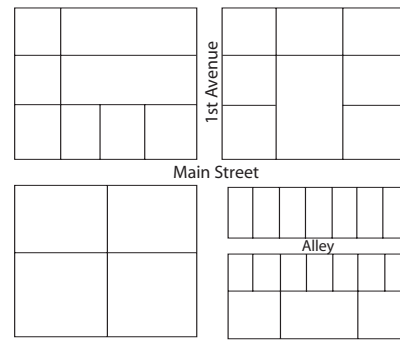
charge off To discontinue accounting for some or all of a promissory note and its accrued interest as an asset of the lender. If a loan is partially or totally uncollectible, then it is partially or totally worthless and cannot constitute an asset. This is an accounting function only; the lender may still pursue collection activities and then rebook the money as a cash asset when and if there is a recovery.

chattel Tangible personal property.

chattel mortgage A security interest in tangible personal property.

Check 21 Shorthand for the Check Clearing for the 21st Century Act; legislation that allows faster processing of checks by financial institutions by allowing them to process images rather than physical pieces of paper. The law also allows the creation of substitute checks that are processed immediately.

checkerboard development A traditional subdivision design with straight streets at right angles to each other and houses on evenly sized square or rectangular lots. Contrast with *cluster development*.



choice of law clause Frequently employed by a national company with real estate relationships in many states, the clause will state that the law of the company's headquarters will control any disputes between the parties. This is because the lawyers back at headquarters know their own law and know how to write contracts to protect themselves. If all their nationwide contracts were interpreted under the laws of the different states, it could be chaotic. Choice of law clauses are usually accompanied by forum shopping clauses, which specify which state's courts will hear disputes between the parties.

chronologic age The actual age of a thing, rather than its effective age.

circulation Areas in an office space that are used to travel between offices, cubicles and the like; hallways and corridors.

cistern A container for the collection of rainwater. Many historic homes had gutters and downspouts that routed all water into a cistern beneath the house to be used as a water source for cooking, cleaning, and in the event of fire.

civil law A system of laws with its origins in Roman and French statutes rather than the judicial decisions of English common law. See *common law*.

Civil Rights Act of 1866 Passed after the Civil War, this Act declared that all persons born in the United States were citizens of the United States without regard to race, color, or previous condition of servitude. All citizens were entitled to enter into and enforce contracts, and to buy, sell, lease, inherit, and pass by inheritance real and personal property. It prohibited discrimination in housing, but provided no enforcement mechanism other than private lawsuits. It was not until 102 years later, with the passage of the Civil Rights Act of 1968, that antidiscrimination laws could be truly enforced through federal actions.

Civil Rights Act of 1964 On November 27, 1963, newly sworn-in President Lyndon Johnson called for the passage of a new civil rights bill, as a tribute to the late President John F. Kennedy, who had been assassinated only weeks earlier. The resulting bill was signed into law on July 7, 1964, with a stated purpose: "To enforce the constitutional right to vote, to confer jurisdiction upon the district courts of the United States to provide injunctive relief against discrimination in public accommodations, to authorize the Attorney General to institute suits to protect constitutional rights in public facilities and public education, to extend the Commission on Civil Rights, to prevent discrimination in federally assisted programs, to establish a Commission on Equal Employment Opportunity, and for other purposes." It has come to be identified with halting discrimination in public accommodations—restaurants, hotels, and other public facilities.

Civil Rights Act of 1968 Expanded upon prior civil rights acts, especially the Civil Rights Act of 1866 and the Civil Rights Act of 1964. The Act was passed one week after the assassination of Dr. Martin Luther King. One improvement was the provision of federal solutions to aid in stopping discrimination. Title VIII of the Civil Rights Act of 1968 is also known as the Fair Housing Act. Additional information is available at the Web site of the U.S. Department of Justice, Civil Rights Division, www.usdoj.gov/crt/crt-home.html.

claim A demand, as of right.

Claritas A commercial provider of market research and demographic data (www.claritas.com). When marketing commercial real estate, it is common for the agent to obtain 1-, 3-, and 5-mile-radius demographic information regarding population density, median household income, and median home price for the most recent census survey with estimates of current data and projections of future data.

class (building) Subjective evaluation of the desirability of an office building based on its age, amenities, maintenance, and design. There are no hard-and-fast rules, and evaluations may change for a virtually identical building in two different markets. The classification is independent of the location; one commonly encounters comments such as "It's a class B property in a class A location," meaning a less desirable building happily situated at a great location and thus able to command higher rents than might otherwise be expected.

class A building A building of high-quality and well-designed with above-average finishes and features and the ability to attract first-class investors and tenants. New tenants typically offered a build-out allowance to customize their space.

class B building A building of good quality but without any extras; may have been designed as a no-frills building or may be a former class A building that has become dated in its design and finishes but is still well maintained. New tenants may be offered a build-out allowance, but it is typically sufficient only to repaint walls and replace floor coverings.

class C building An affordable office space with average to below-average maintenance. New tenants typically take space "as is," although carpets might be shampooed before occupancy.

Clean Water Act Legislation originally enacted in 1972, and amended several times since then, that establishes comprehensive national policies for water quality management. The laws are enforced by the Environmental Protection Agency (www.epa.gov).

clearance letter Also called a wood infestation report, provided by a licensed termite inspection company and attesting the absence of any evidence of active termite infestation. (This letter is a requirement of most lenders before closing may take place.)

clear-cutting The process of removing all vegetation from a site when harvesting timber, rather than cutting only the marketable trees. Some states require immediate reforestation of clear-cut timber lands. Purchasers of timbered land should be careful to word contracts so as to include the timber. In many states, once an owner signs a contract to sell timber, it ceases to become part of the real estate, is converted to personal property, and is not automatically covered under a sale contract for real property.

clearing and grubbing The stage of development in which vegetation is cleared from land (clearing) and a root rake or similar device employed to remove roots remaining in the soil (grubbing). The next stage is cutting and filling.

clear span The horizontal distance between supporting pillars, columns, or walls, being the maximum possible distance clear of obstacles. Especially when working with industrial properties, it is important to know the existing or required clear spans for clients.

clear-span facility A building, most often a warehouse or airplane hanger, with vertical columns on the outside edges of the structure and a clear span for the entire interior area.

clear title Good title; marketable title; title to real property without any defects, liens, mortgages or adverse claimants.

client The person to whom an agent owes duties of integrity, confidentiality, loyalty, and hard work. Contrast with customer, who is owed the duty of honesty.

close corporation A corporation comprised of a small number of individuals who contribute to the success of the business operations. Also called closely held corporation. Stock in close

corporations is typically sale-restricted, so that shares must be first offered to the corporation or to the other shareholders before they can be sold to outsiders. Sale restrictions must be noted on the face of stock certificates, putting buyers on notice that an attempted sale may be void if all requirements have not been met.

closed-end mortgage A mortgage loan in which all sums have been funded at closing. Contrast with open-end mortgage, in which the principal balance may increase over time. A home loan is typically a closed-end mortgage; a construction loan is typically an open-end mortgage.

closely held corporation See *close corporation*.

closing The process of obtaining all necessary signatures, making all required disclosures, and collecting and disbursing all monies in order to transfer title to real estate, execute a mortgage, or both. Closings are regulated by the Real Estate Settlement and Procedures Act.

closing agent The person who performs a closing. The closing agent is typically not an agent of either party or of the lender, but simply the person entrusted to carry out all nonconflicting instructions from all parties.

closing company A company or firm that conducts real estate closings, also called settlements. The closing company does not represent any party to the transaction, but merely ensures that all documents are properly signed and all monies collected and disbursed according to the parties' contract.

closing costs Technically, only those fees and expenses necessary to close a sale or a mortgage, such as document preparation, the fee for the actual closing itself, and perhaps overnight delivery charges. In common language, though, the phrase has come to mean all expenses associated with a closing with the exception of the actual purchase price of the property and any lender fees. Rather than specifying that a buyer and seller will share closing costs equally, the better practice would be to spell out all anticipated expenses and the allocation for payment.

Examples of potential expenses include

- Preparation of closing documents
- Deed preparation
- Expenses associated with clearing title defects, such as preparation of affidavits or quit-claim deeds
- Title inspection
- Owners' title insurance
- Lender's title insurance
- Lender-required policy endorsements
- Deed recordation fees
- Mortgage recordation fees
- Transfer taxes (which can be sizable in the case of the New York mansion tax, for example)
- Closing agent fees
- Transfer fees imposed by condos, homeowners associations, or co-op boards

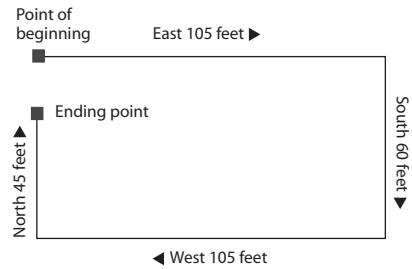
- Listing agent's commission
- Selling agent's commission
- Cost of wood infestation report and clearance letter
- Cost of survey
- Cost of appraisal
- Cost of required inspections
- Escrow fees
- Prepayment penalties
- Prorated real estate taxes, insurance, and/or dues

closing date The date on which the seller delivers the deed to the buyer and the buyer pays the agreed-upon consideration. Purchase contracts typically specify a closing date no later than a certain number of days or no later than a certain date. If closing does not take place on or before the designated date, then the party causing the delay is in default. As a practical matter, unless the contract recites specifically that "time is of the essence," then closing may usually be delayed several days without penalty or loss. In a seller's market, however, the better practice is to ensure that closing takes place by the agreed-upon date, or the buyer will risk loss of the property and sale to someone else.

closing protection letter Additional title insurance coverage insuring the lender against losses caused by errors or infidelity of the closing attorney or the closing agents in the handling of the transaction.

closing statement Written itemization accounting for all funds changing hands at a real estate or mortgage loan closing.

closure In a metes-and-bounds legal description of land, the necessity that the various calls and distances culminate at the point of beginning, so the shape described is "closed." If the shape is not closed and the property description is inaccurate in some regard, then the transaction violates the statute of frauds and the transfer is void. The drawing to the right is of a property description without closure.



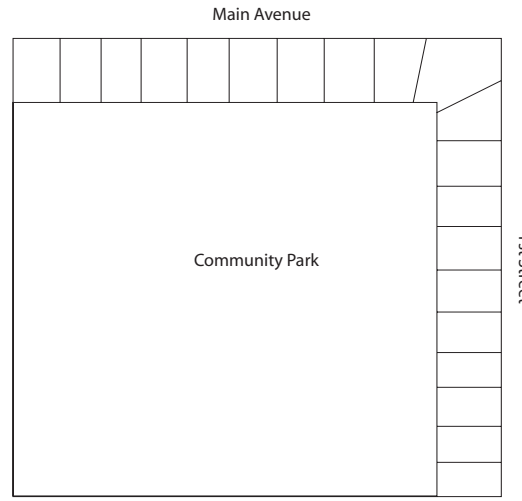
This property description has no closure.

closure document A document written by a state environmental protection agency certifying that a previous environmental hazard no longer bears further scrutiny because it has been remediated.

cloud on title Something that appears on its face to constitute a defect in title or a claim against property, but which may be cleared through the execution of affidavits, quitclaim deeds, or corrective deeds, or by means of a lawsuit called an action (or bill) to quiet title.

cluster development A subdivision planning design in which housing is clustered together on relatively small lots with a larger amount of common area shared by all; also called open space development and conservation subdivision. Requires some sort of homeowners association with the ability to assess dues in order to maintain the common area. Contrast with *checkerboard development*.

cluster zoning Zoning that specifies housing density for an entire area overall, leaving a developer free to use some space for high-density housing such as apartments or garden homes, and other space for low-density estate-sized lots. Contrast with traditional zoning ordinances that specify the same density for each and every lot within an area.



CMA See *comparative market analysis*.

CMBS See *collateralized mortgage backed securities*.

CMO See *collateralized mortgage obligation*.

CMO REIT A real estate investment trust that specializes in collateralized mortgage obligations.

C/O See *certificate of occupancy*.

cobroker See *cooperating broker*.

code (1) Any systematic collection of laws, regulations, or rules. (2) Shorthand for any of the various building codes, such as, for example, "This historic property has been updated and meets all current code requirements."

code of ethics Any written system of standards and ethical considerations for the persons bound. All state real estate licensing organizations have their own codes of ethics; most are based on that of the National Association of REALTORS®, which is available at www.realtor.org/mempolweb.nsf/pages/code?opendocument.

COFI See *cost of funds index*.

coinsurance A method of dividing financial responsibility for a loss between the owner and the insurance company. Coinsurance clauses exist within insurance contracts as a type of penalty for an owner who decides to gamble about the size of any potential loss and insure property for less than the full value in order to keep premiums low. They usually provide that an owner may not collect full policy limits for a loss unless the property has been insured to at least 80 percent of its value.

COLA (pronounced like the beverage) See *cost-of-living adjustment*.

cold call To make unsolicited contact with persons for the purpose of making a sale. In real estate, new agents will often cold call entire neighborhoods in an attempt to obtain listings.

cold canvass See *cold call*.

collapsible corporation A former tax-planning tool allowing conversion of ordinary income to capital gains through the vehicle of a corporation set up and then quickly "collapsed" by a sale or exchange of the stock or a liquidation. Today, the vehicle has been largely penalized out of existence by the IRS. If the corporation is collapsed and the stock sold within 3 years of formation, sale proceeds will be treated as ordinary income although such a holding period would otherwise qualify for capital gains treatment. See also *thin corporation*.

collateral Security for a debt.

collateral heir An heir who is not in a direct line from a decedent, but born from a collateral line, such as brothers and sisters, aunts and uncles, or cousins. Relevant in the context of intestate succession, being the order of distribution of property when one dies without a will. Contrast to lineal heirs.

collateralized mortgage obligation (CMO) A security or bond backed (collateralized) by a pool of mortgages. The issuer of the security segmented the cash flow in such a manner that it could create bonds with maturities at differing dates and appeal to a broad spectrum of investors. Today, the CMO has largely been replaced by the REMIC—real estate mortgage investment conduit—although the terms are often used interchangeably.

collateralized mortgage backed securities (CMBS) Derivative investments created by aggregating mortgage loans into pools and then selling interests, much like bonds, which entitle owners to payments over time until the debt is finally retired. (Note: Commercial mortgage backed securities, a specialized type of collateralized mortgage backed securities, are also known as CMBSs.) The concept is best understood by reference to the various parties involved:

- A loan originator, such as a commercial bank, mortgage banker, or insurance company originates mortgage loans.
- An investment bank acts as an intermediary and sponsors the conduit by purchasing the commercial mortgage loans and warehousing them until they are ready to be converted to securities.
- A rating agency rates the underlying mortgages as AAA, AA, A, BBB, and so on down to CCC, with AAA to BBB being classified as investment-grade and BB downward classified as below investment grade.
- The same investment bank previously mentioned now separates the mortgages into tranches, or classes, of bonds depending on their ratings. The tranches are then offered for sale as securities backed by the entire mortgage pool. One might buy investment-grade tranches, but they are backed by all the loans, not just the investment-grade loans.
- Investors purchase the securities. Investment-grade tranches are usually purchased by insurance companies, pension funds, mutual funds, money managers, and commercial banks. Below-investment-grade tranches are sold to real estate investment funds or CMBS servicing entities.
- A servicer collects mortgage payments, monitors delinquencies and defaults, engages in workout procedures or initiates foreclosure, and handles all accounting and reporting, paying over monies periodically to the trustee for distribution to the investors.

- The trustee, who represents the trust that holds legal title to the mortgages for the benefit of the certificate holders, pays out money to investors according to the terms of their securities. The most common arrangement is the "waterfall" payment, in which class A bond holders receive principal and interest payments in the early years, while class B and class C holders will receive only interest. After a fairly short predetermined period of time, the class A bond holders will have been paid in full, and their bonds will be retired. At that point, the class B holders will begin to receive principal in addition to interest, but the class C holders will still receive only interest. When class B holders have been paid in full, class C holders will begin receiving principal payments. As a result, the class C holders will suffer if there are significant defaults and not enough money to pay everyone in full. For that reason, class C holders generally receive a higher return on their investment.

colonia Residential areas along the United States side of the border with Mexico and that may lack some of the most basic living necessities, such as potable water and sewer systems, electricity, paved roads, and safe and sanitary housing. The Environmental Protection Agency estimates there are more than 1,300 colonia in Texas and New Mexico alone.

color of title The appearance of title to real property, such as a deed that turns out to be defective. Important because those with color of title are given more rights than those who have no color of title, but a mere possessory or other such claim.

Color of Title Act This act, 43 U.S.C. §1068, authorizes the secretary of the interior to issue a patent—original deed from the government—to a person who has occupied a certain area of land for at least 20 years with color of title, under circumstances that would otherwise constitute adverse possession if it were not for the rule prohibiting adverse possession against the government. The occupier is able to tack his or her possession on to that of his or her ancestor or grantor, in order to arrive at a cumulative time of 20 years or more.

commencement of work The readily observable date on which work commences on a construction project. This date is important in the context of mechanics' and materialmen's liens for unpaid construction bills, because the date of the lien is effectively backdated to the date of commencement of work, even though there may not have been a failure to pay bills until many months later. In many states, if there is a lien filed, and the commencement of work occurred before the construction mortgage was recorded, then the lienholder is in a first lien position and the construction lender is in second place, comparable to having a second mortgage rather than a first mortgage.

commerce clause of the constitution Article I, Section 8, Clause 3 of the United States Constitution. This clause empowers Congress "to regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." The commerce clause has provided the most powerful tool available to the federal government for spreading its legislative and regulatory reach into the lives of everyday Americans.

commercial bank A financial institution authorized to receive both time (savings accounts, CDs) and demand (checking accounts) deposits, to make loans of various types, to engage in trust

services, to issue letters of credit, to accept and pay drafts, to rent safety deposit boxes, and to engage in similar activities and ventures.

commercial creep The gradual encroachment of commercial real estate into residential areas.

Commercial Investment Real Estate Institute A professional organization, which is an affiliate of the National Association of REALTORS®; specializing in commercial real estate and offering the designation CCIM—Certified Commercial Investment Member. The name of the institute has now been changed to the CCIM Institute (www.ccim.org), but the old name is still frequently encountered.

commercial lease A lease of space for nonresidential purposes.

commercial leasehold insurance Insurance to cover the payment of rent in the event a tenant defaults.

commercial lender An entity that routinely loans money as part of its core business. Contrast with a seller who loans money as part of a real estate transaction, or private investors who loan money sporadically as a good opportunity presents itself.

commercial mortgage backed securities (CMBS) Collateralized mortgage backed securities with an underlying pool of commercial (non-residential) loans. See also *collateralized mortgage backed securities.*

commercial mortgage banker A banker who specializes in originating commercial mortgage loans.

commercial mortgage loan A loan secured by a mortgage on real estate that has a business or investment purpose.

commercial property Property designed for use as offices, retail space, or wholesale, hospitality, or similar uses. Contrast with multifamily residential (apartments), residential development, or industrial property.

commercial real estate Typically refers to office or retail space, or multifamily residential properties such as apartments. May include industrial real estate, but sometimes the phrase is meant to exclude industrial properties and must be read in context.

Commercial Real Estate Women (CREW) A national organization (www.crewnetwork.org) founded in 1989 with the goals of "advancing the success of women in commercial real estate" and "achieving parity in opportunity, influence and power in the industry."

commingle (also spelled co-mingle) It is illegal for real estate brokers to combine (or commingle) clients' funds with the broker's business funds in one account, even if all monies are accurately accounted for and there have been no other improprieties. Client funds do not have to be separated from each other, but can all be commingled in one escrow account.

commission The compensation paid to a real estate broker for services rendered in connection with a sale, exchange, or lease of property. In order to be entitled to a commission, the broker must

have a written contract for the services and must be licensed in the state. Generally the commission is fully earned if the broker produces a buyer who is ready, willing, and able to close at the terms specified in the listing agreement. This is true even if the seller elects not to accept the offer and withdraws the property from the market or increases the price.

Commission rates. Commissions are negotiated independently between the parties. Setting commission rates in advance by local real estate boards or other organizations is a violation of federal law. Most listing agreements now contain a disclaimer advising that commissions are separately negotiated on a case-by-case basis.

Sales commission amounts. Typically expressed as a percentage of the gross sales price of the property, usually ranging from 6 to 10 percent, although higher and lower percentages may be negotiated.

Leasing commissions. Compensation paid to an agent upon lease execution. It is usually calculated as a certain percentage of the total anticipated rent payments, up to a 5-year term.

Example: *If the leasing commission is 4 percent on a 5-year lease at $12,000 per month, then multiply $12,000 by 60 months to arrive at $720,000 and the broker is paid 4 percent, or $28,800. The parties may negotiate a lesser percentage for a term longer than 5 years, to be paid at the 5-year anniversary date.*

Leasing commissions—lump sum. Sometimes negotiated to be equal to one or two month's rent, or even a certain amount per square foot. The drawback to this method is that the broker is compensated the same for a 3-year lease as for a 10-year lease.

Leasing commissions—payment over time. Occasionally, leasing agents prefer to receive their commissions as each payment of rent is made, rather than in a lump sum at lease signing. The effect is to provide a guaranteed income for many years.

commissioner An officer charged with the administration of laws or regulations pertaining to a particular subject matter, such as a real estate commissioner. A directory may be found at the Web site of the Association of Real Estate License Law Officials (ARELLO) at www.arello.com.

commission rates See *commission*.

commission splits Listing brokers will typically split their commission with the selling broker—the person who provides the buyer for the property. One should always inquire, however, because some brokers refuse to split commissions, preferring to find their own buyers and keep 100 percent of the commission rather than work with other brokers in the area.

commitment (loan) An agreement by a lender to extend a loan on certain terms and conditions and by a certain date. Language making the "commitment" subject to credit approval or underwriting are not true commitments at all, but merely quotes.

common area maintenance (CAM) ("CAM" is pronounced as a word) Costs required for a tenant's pro rata share of the upkeep of common areas and amenities such as the parking lot, external lighting, trash removal, and street cleaning. When obtaining quotes for retail space or office space, one

should always ask about tenant CAM expenses, because a lower per-square-foot rental rate at one location may be offset by high CAM expenses.

common areas (1) In leaseholds, the area over which the landlord retains exclusive control and liability, such as stairwells and hallways. (2) In condominiums, all property except for the specific condominium units themselves. Common areas are owned by all condo owners in common with each other, except that access may be restricted for plumbing, electrical, and other such areas, or it may be semirestricted so that all condo owners own a portion of your balcony, but you are the only one entitled to use it.

common enemy rule A rule of water management and rights followed in some states. It holds that excessive rainwater is a common enemy that damages property at random. Uphill property owners can take any steps to protect their land from the water, even if it causes damage to the property of others further down the hill. The downhill property owners are supposed to protect their own land, because water is the common enemy and everyone has to provide their own protection. Today, most states have modified rules that require everyone to act reasonably under the circumstances in order to protect their own property and avoid damaging the property of others.

common law A law derived from common usage, ancient customs, or the pronouncements and interpretations of courts. Contrast with code law, or civil law, which relies on statutory enactments for the articulation of rights and responsibilities, and then judicial interpretation of those statutes. English law, and almost all American law, is based on common law. The law in France is based on the Napoleonic code, and the law in Louisiana is based on that code also. (Because of the completely different underpinnings of Louisiana law, it is rare to find a lawyer or real estate agent outside the state who will offer an opinion regarding real estate law within the state.) When reading definitions of words, one should pay attention to whether the definition recites "at common law" or "at civil law."

Community Association Institute An umbrella association for condo associations, homeowners associations, and other community groups, providing information on management, governance, and legal issues. It estimates that 57 million Americans lived in association-governed communities in 2006. The Web site of the Community Association Institutes is at www.caionline.org.

community property Property owned by a husband and wife, each owning an undivided one-half interest by virtue of the marital relationship and not by virtue of any deed or other document of specific intent. There are exceptions for family property inherited from one side or the other. The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington.

Community Reinvestment Act (CRA) An act passed by Congress in 1977 to encourage financial institutions to meet the credit needs of the communities in which they operate, including low- and moderate-income neighborhoods. Compliance is monitored via regular audits, and a poor record of CRA compliance is taken into consideration when the financial institution applies for deposit facilities, including mergers and acquisitions.

One may find a financial institution's rating for CRA compliance by visiting the Web sites of the various regulatory agencies that track compliance. A financial institution may appear on one list but not others, depending on which agency has responsibility for that bank and its CRA compliance. The possibilities are

Federal Reserve Board (www.federalreserve.gov)
FDIC (www.fdic.gov)
Office of Comptroller of the Currency (www.occ.treas.gov)
Office of Thrift Supervision (www.ots.treas.gov)

community shopping center A shopping center of approximately 100,000 to 300,000 square feet and 20 to 70 retail spaces, designed for a mixture of retailers and food service establishments with a high convenience factor for a market area radius of 3 to 6 miles. Usually situated on 10 to 40 acres, with at least one anchor tenant; anchor(s) typically comprise 40 to 60 percent of the gross leasable space.

compaction The process of compressing soil used to fill the low areas in a parcel of land. Developers typically obtain soil compaction reports before beginning development, but care must be taken to test more than the typical 6-foot depth. It is a common practice for excavating companies and unscrupulous landowners to use substandard fill material, such as tree trunks and other vegetation that will eventually decompose and reduce volume, and then properly compact only the top 6 feet of fill. Over time, the property will settle, possibly resulting in severe structural problems.

compaction tests See *boring tests*.

comortgagor An additional borrower with some interest in the real property that is the subject of the mortgage.

comparables In an appraisal, recently sold or leased properties similar to the property under analysis, such that a review of the sales prices of the comps will assist in determining a value of the subject property. The properties need not be identical, as long as they are reasonably similar and the appraiser can make adjustments for features that differ. These may include property amenities, age of the improvements, traffic counts and market area, time and conditions of the sale, and anything else recognized by the market as having value.

comparative market analysis (CMA) An analysis of the value of property by taking only a very few market indicators, such as price per square foot for land or price per unit for apartments, and then extrapolating to the property under analysis. This does not constitute an appraisal, but may give prospective sellers a basis for setting a sales price for listing purposes.

comparative negligence A legal theory in some states that evaluates the negligence of a wrongdoer against any negligence of the injured party that contributed to its injuries, and then assigns a pro rata responsibility for the harm suffered.

> **Example:** *If a property owner allows a loose step to remain unrepaired, and a guest loses his or her balance and falls, the property owner has been negligent. If, however, the guest was*

intoxicated, a jury might decide the guest was 25 percent responsible for the injuries. In such a case, the jury will calculate a dollar value for the injury and associated expenses and will then reduce it by 25 percent in order to arrive at an award.

Contrast with contributory negligence, which denies any award at all if the injured party was at all negligent under the circumstances.

comparative unit method An appraisal technique in which direct and indirect costs are totaled and then divided by an appropriate unit to obtain a cost per unit.

Examples include

- Land compared on a value per square foot
- Land compared on a value per front-foot
- Self-storage facilities compared on a value per unit
- Hotels compared on a value per room

comparison method See *market comparison approach*.

compensation (1) Payment for goods or services. (2) Damages necessary to restore an injured party to his or her position before the wrongdoing. (3) In eminent domain, payment to property owners for the value of the property taken and any damage caused to the value of the remaining property.

compensatory damages Damages intended to compensate the injured party for the harm suffered. Contrast with punitive damages to punish the wrongdoer, and nominal damages awarded to recognize that a right was violated or a duty breached, but no harm done.

competent (1) Duly qualified; having sufficient ability or authority. (2) Having the legal ability to testify about a particular subject. In real estate, the concept is important because property owners are usually competent to testify about the value of their property before a loss and the value of their property after a loss. In other words, it is not legally necessary to hire an appraiser to testify, although it is prudent as a practical matter.

competitive market analysis See *comparative market analysis*.

complete appraisal An older term rendered obsolete by the July 1, 2006, changes to the Uniform Standards of Professional Appraisal Practice, but still frequently encountered. The term used to mean an appraisal that did not resort to using any of the departure provisions of the old rules. Previously, all clients had to be provided with a complete appraisal unless the client signed off and approved a limited appraisal noting specific appraisal methods not employed because they were perhaps not relevant to the specific property. Today, the new scope of work rule allows the appraiser to choose the analytical methods necessary to meet the client's objectives and the scope of work, but the client does not have to approve the methodology.

completion bond A fidelity bond posted by a contractor or developer to guarantee that a particular project will be completed according to plans and specifications, on time, and without any liens incurred as a result of unpaid bills to subcontractors and suppliers; usually required as a condition of

performing government work. It provides more coverage than a simple performance bond, which ensures that one party will perform if the other will perform, usually by payment. The completion bond is independent of any underlying contracts and any defenses to those contracts.

compliance inspection (1) An inspection by a government official to ensure that a building or project complies with all relevant building codes and zoning regulations. (2) An inspection by the representative of a lender to ensure that all lending institution requirements have been met as a prerequisite to a loan or as a condition of funding advances on a construction or development loan.

component building A building made of prefabricated components that are then delivered to the construction site and assembled. In housing, the modular home is an example, although a manufactured home that is assembled elsewhere and delivered to the site would not be a component building. Components could include tilt-up concrete walls popular with commercial construction, and structural insulated wall and roof panels (providing rigidity, sheathing, insulation, wire chases, and sometimes even outside and inside finishes all in one product) for residential construction. The ultimate component building is an apartment building of self-contained apartment rectangles built elsewhere and then stacked together like children's building blocks.

component depreciation A former practice of separating a building into its various components—walls, roof, etc.—and then depreciating each component separately, some more rapidly than others, in order to generate large tax deductions. (This is no longer allowed by the IRS, except in a modified form called cost allocation.)

compound interest The process of charging, or earning, interest on interest. Interest accrued in prior periods is added to the principal, and then interest in the current period is calculated on the total.

> **Example:** *If you saved $100 per month, starting at age 25, at an earnings rate of 5 percent per annum, you would have $144,959 by age 65, only $48,000 of which would be money you contributed. To perform your own calculations, use the following formula to create a Microsoft Excel spreadsheet:*
>
> *=FV(Interest Rate, Number of Years, Savings per Year)*–1*

For Interest Rate enter the cell address where you will note the interest rate you expect to earn; for Number of Years enter the cell address where you enter the number of years you expect to save the same amount each year; and for Savings per Year enter the cell address where you will enter the amount you expect to save each year.

	A						
1	0.05						
2	40						
3	1,200						
4	=FV(A1,A2,A3)*–1						

Comprehensive Environmental Response Compensation and Liability Act (CERCLA) Federal laws passed in 1980 and known commonly as the Superfund. The law imposes strict liability for cleaning up environmentally contaminated land—one's liability does not depend on any fault or responsibility, but simply on one's status as any of the following:

- A past or current owner of a facility
- A past or current operator of a facility (such as a tenant or property manager)
- A generator of hazardous substances
- A transporter of hazardous substances

Because of potential cleanup liability for the actions of previous owners, it is essential that any purchaser of commercial property investigate a property history for evidence of manufacturing processes, petroleum-related businesses such as gas stations, dry-cleaning plants, transmission repair shops, and any number of other activities. In the alternative, one may order a Phase I Environmental Report from a licensed engineer. As a practical matter, most lenders will require the report as a condition of providing funds for purchase.

At one time, there was some confusion over a mortgage lender's potential exposure to liability by virtue of possibly being considered an "operator" when involved in management decisions during a loan workout. There was also great fear about lender liability after foreclosure, when the financial institution became an "owner." This has largely been cleared up through CERCLA amendments providing limited lender immunity provided there is appropriate due diligence before credit extension. Due diligence is usually resolved through requiring a Phase I Environmental Report from a licensed engineer, and then a Phase II report if the Phase I report indicates any suspicious evidence. After foreclosure, the lender can avoid liability if it takes steps to sell the property as soon as possible.

When selling or buying property, it is important for the sales documents to include a provision allocating financial responsibility in the case cleanup is necessary in the future. Parties may not disclaim responsibility under CERCLA, but they may contractually agree regarding who will bear the ultimate cost of a cleanup.

For more information regarding this complex subject, visit the Superfund pages of the Environmental Protection Agency Web site at www.epa.gov/ebtpages/cleasuperfund.html.

comps Shorthand for comparable properties, used in appraisal.

computer-aided design (CAD) The use of computer software to assist in performing standard architectural and engineering design services. Products range from the most basic shareware home design and landscaping software to sophisticated systems with three-dimensional flyover and walk-through capabilities, project budgeting, and timeline creation.

computerized loan origination (CLO) A computerized network of major lenders that uses artificial intelligence to evaluate loan application data entered online by agents and determine loan eligibility and terms. HUD has approved the procedure as long as there is full disclosure of the fee, multiple lenders are displayed on the screen to give borrowers freedom of choice, and the fee charged is a dollar amount rather than a percentage of the loan.

concession (1) A discount, rebate, or abatement. Lease concessions may consist of free rent, below-market rent, a larger than normal build-out allowance, reserved parking, 5-year anniversary renovation allowance, or any number of other economic incentives to induce one to lease in a particular building. When investigating the purchase of an income-producing property, one should examine each and every lease in its entirety to determine the existence of any lease concessions that would adversely affect an economic analysis of the property, and one should also obtain estoppel certificates from tenants so that there are no agreements outside the terms of the written leases. (2) A business that operates within the confines of another business or on another property, but usually without a lease. Examples include a shoe-shine concession at the airport, the hot-dog concession at the ball park, or the designer fragrance concession in a department store.

concession burnoff The process of rent concessions becoming less frequent, smaller, or both, so that the market sees growth in overall rental rates because of the discontinuance of temporary concessions, not because of a true increase in market rates.

conciliation agreement A settlement or compromise agreement between a regulatory agency and an individual or entity charged with violating rules, regulations, or laws. The agreement evidences an acknowledgment of past wrongdoing and an intention to correct the consequences of the past actions and to desist from future violations.

concurrent ownership Ownership by two or more parties at the same time. The most common examples of concurrent ownership are

- Tenants in common
- Joint tenants with right of survivorship
- Tenants by the entireties
- Community property interests
- Tenants in common with cross-contingent remainders

condemnation (1) A proceeding to obtain private property for public use through the exercise of the government's rights of eminent domain. Historically considered possible only for public improvement projects such as roads, schools, and courthouses, the landmark U.S. Supreme Court case of *Kelo v. City of New London*, 125 S.Ct. 2655 (June 23, 2005) held that local government could condemn land belonging to one private party in order to convey it to another private party as part of an economic development plan to increase government revenues, add jobs, and improve the quality of life in a depressed area.

In a condemnation case, the government will order an appraisal of the property and then offer the owner the appraised price, or perhaps a negotiated amount in excess of the appraisal but taking into account the savings realized by not having to litigate the issue. If the property owner does not accept, the government must escrow the amount of money determined by its appraisal and may then proceed with condemnation of the property. The parties may then go to court to contest the amount of the required award, but the contest will not prevent or delay condemnation of the property.

Specialized tax rules apply whether property is condemned, sold to the government under threat of condemnation, or sold to a third party under reasonable fear of impending condemnation (see IRS Publication 544 at www.irs.gov). Taxpayers may defer income realized in a condemnation award by purchasing replacement property within 2, 3, or 5 years, depending on the particular circumstances.

Payments to cover the costs of relocating are not part of the condemnation award and are not taxable income. Severance damages awarded because of damage caused to the remaining property are not part of the condemnation award. The amount of damages will reduce the basis in the remaining property. If it reduces the basis to $0, then any excess must be reported as gain, but taxation can be deferred.

(2) A decision by local government that property owned by another is no longer safe and must be repaired or demolished. It is not a defense that the owner is making no use of the property and is not exposed to any danger, so long as the public at large may be exposed to danger. If the owner fails to make the necessary repairs or take any other action, the government authority may conduct the demolition itself and place a lien upon the property for the costs of demolition.

condemnee One whose property is condemned.

condemnor One who condemns property.

condition A future and uncertain event that determines whether or not there will be a contractual obligation or liability. Conditions may be express or implied, possible or impossible, lawful or unlawful, affirmative or negative, precedent or subsequent, positive or negative, and, finally, single, copulative, or disjunctive. Each type of condition has different legal consequences.

Examples of the most common types encountered in real estate are

- Express. If the purchaser cannot obtain financing, the purchaser may cancel the contract.
- Implied. If the seller burns down the house the day before closing, the purchaser may cancel the contract.
- Lawful. If the broker produces a buyer willing and able to pay the asking price, the seller will pay a commission of 6 percent of that price.
- Unlawful. If the broker produces a buyer willing and able to pay at least $125,000, the broker will be paid all the purchase price in excess of $125,000.

conditional commitment An agreement by a lender to extend a loan with specified terms, but only if certain conditions are met, such as retention of occupancy rates at a certain level until the time of closing, securing of key man insurance for an important manager-owner, release from a contingent liability that might impair the borrower's financial condition, or any number of other conditions.

conditional offer An offer to buy real estate conditioned on the occurrence of one or more things before the purchaser is obligated to buy. Examples include zoning changes or the ability to secure a contiguous property.

conditional sales contract (1) A sales contract in which the buyer is given possession and use of the item sold, but the seller retains legal title until all payments have been made in full. Equipment leases for a term of years, at the end of which the buyer pays $1 to buy the property, have been characterized by the IRS as conditional sales contracts rather than true leases. As a result, the taxpayer is not allowed to deduct the full lease payments each year, but only an amount equal to the depreciation available if the property had been purchased for cash, plus an allocation for interest. This amount is usually less than the annual lease payment. (2) If pertaining to real estate, commonly called a bond for title, land sale contract, or contract for deed.

conditional use permit (CUP) (pronounced "cup") A permit granted to a property owner to make use of real property in a manner allowed under current zoning regulations, but only in accordance with conditions to be applied by the zoning authority. Houses of worship may be allowed in areas zoned for residential use, but the applicant may be required to obtain a conditional use permit that can be predicated on size, off-street parking availability, indirect nighttime lighting, and other such factors determined on a case-by-case basis. Contrast with variance, in which the property owner is given permission to use the property in a manner inconsistent with current zoning regulations.

conditions, covenants, and restrictions (CC&Rs) Rules incorporated by reference into the deeds of condominiums and individual lots in subdivisions with homeowners associations and/or restrictive covenants. The CC&Rs set out restrictions on the use of property, and even on the behavior of residents.

condo cowboys A derogatory term among condominium developers used to refer to inexperienced persons with little training, experience, or capital, but who decide to engage in condo construction or conversion. Such people often ignore established methods and principles of development and marketing, frequently encounter financial difficulties requiring additional financing at high interest rates, and then dump units on the marketplace with little or no profit margin but with the net effect of forcing down prices in the entire market.

condominium A system of ownership in a multiunit development allowing individual ownership of some areas and common ownership of all other areas. The identifying feature is the legality that common areas (entrance, hallways, elevators, swimming pool, parking, etc.) are owned by all members of the community in common with each other, rather than being owned by a separate corporation or association. Residential condominium projects may be multistory apartment-style residences or may resemble traditional detached housing or garden home communities.

condominium conversion The process of converting a building with tenants, or a cooperative building with tenant-shareholders, into a community of individual owners of specified units and common owners of all common areas. Many states have laws protecting tenants in a building scheduled for conversion. Protections may include lengthy notice periods regarding the plans to convert, prohibitions against drastic rent increases designed to force tenant flight from the building, an exclusive period during which only the tenant may purchase the unit before exposure to the general market, and special protections for the elderly and disabled.

condominium declaration The document that establishes the legal existence of the condominium project and the ability to divide airspace into horizontal layers of ownership. The condominium declaration must be filed with the designated public official for the state or county where the land is located.

condominium owners association An association that automatically includes as members all persons who own condominium units in a defined project. Unlike subdivisions, in which the homeowners association often owns the common lands, the condominium owners association does not own the common areas—the unit owners own them in common with each other. The association does enforce the provisions of the covenants, conditions, and restrictions and manages the financial, legal, and maintenance business of the community.

condotel A relatively recent concept involving a melding of a resort hotel with condominium ownership. Initially became popular after September 11, 2001, when it became difficult to obtain financing of more than 50 percent of the cost of acquisition or development of a hotel property. To raise the additional necessary capital, developers sold individual units to investors and users, with the promise to rent the units to hotel guests and pay over profits to the individual owners. In recent years the practice has become less common with regular hotels, but remains strong with resort developments. The Securities and Exchange Commission, and several plaintiffs' law firms, have recently taken the position that such relationships involve the sale of securities, thereby requiring registration, disclosure, adherence to strict accounting standards, and many other requirements.

conduit A metal pipe through which electric wiring is run. Building codes often require that all electric wiring for commercial buildings must be in conduit and securely attached to the ceiling, not suspended from dropped-ceiling supports or other building components.

conduit financing A method of providing loan money through a debt instrument that blends features of a traditional pass-through mortgage security and a bond. Traded on Wall Street as securities known as REMICs—real estate mortgage investment conduits. For real estate borrowers, the single most important feature of conduit financing is the very large prepayment penalty imposed on all such transactions. The success of the entire securitization process depends upon trustee receipt of regular monthly income for distribution to bondholders according to a prearranged schedule. If a borrower pays off the loan early, that loan will no longer earn any interest, which affects the money available for payment to investors. In order to compensate, the trustee will have to go out into the marketplace and purchase an investment to replace the mortgage paid off. That investment may cost a premium price, so the prepayment penalty is used to offset the premium.

conduit tax treatment Income passing through an entity without taxation at that level, but only at the recipient's level. A subchapter S-corporation, a partnership, and a limited liability company are all examples. Contrast with a C-corporation, which pays income taxes on profits and then uses after-tax dollars to pay dividends to shareholders, who pay taxes on the dividends.

confirmation of sale A court approval of a sale by a trustee, executor, administrator, guardian, or bankruptcy trustee. Sales contracts by such persons are always specified as contingent on court approval.

confiscation Seizure of private property by the government without compensation to the owner, usually as a consequence of the owner being convicted of a crime.

conflict of interest A situation that presents the possibility of having to choose which side in a transaction will receive the better service, deal, terms, or representation. The conflict may be choosing between two other parties, such as an agent attempting to represent both buyer and seller in a particular transaction, or it may be between the party and another, such as a real estate broker wishing to purchase property listed with that same broker. Rules regarding handling conflicts of interest generally provide a solution through full disclosure to all parties involved or withdrawal from the situation entirely.

conforming loan A loan that meets the underwriting requirements necessary for sale to Fannie Mae (FNMA—Federal National Mortgage Association) or Freddie Mac (FHLMC—Federal Home Loan Mortgage Corporation). There is nothing derogatory about a nonconforming loan; it may be too large, it may be for a property flipped within the prior 90 days, or any number of other disqualifying reasons besides creditworthiness or value of collateral.

conformity principle An appraisal principle holding that the more a property's components are in harmony with the surrounding properties or components, the more they contribute to value.

> **Example:** *A 5,000-square-foot home with a three-car garage and an inground pool is more valuable in a neighborhood filled with similar properties than it would be in a neighborhood of 2,500-square-foot homes with two-car garages and no pools.*

congregate housing Also called supported housing, with private living quarters and shared dining and social areas. Housing for the elderly and disabled is generally congregate housing, as are dorm rooms for students.

consent decree A judgment in which the defendant agrees to take some action, or to cease doing something the plaintiff deemed objectionable, but without admitting any wrongdoing.

consequential damages (1) Damages that do not flow directly from some wrong, injury, or taking. A buyer who refuses to proceed to closing for no legal reason may be liable for the seller's *direct* damages of the difference between the agreed-upon purchase price and the price ultimately obtained for the property, or the interest on the money if the sums are identical, plus any additional costs of marketing. The buyer might also be liable for the seller's *consequential* damages consisting of its loss of earnest money on another property, but only if the buyer knew the seller was depending on the closing to fund money for the seller's new home. (2) In a condemnation award, consequential damages are those suffered when the remaining property is injured because of the loss of the condemned property. A farmer's fields may be too small for efficient cultivation by large machinery after the county condemns enough land for roads to cross through the fields. A storekeeper's business may suffer as a consequence of its parking lot being taken for construction of a fire station.

conservation easement A voluntary restriction on land preventing development on the property in order to retain its natural condition. The restriction will remain on the property for all subsequent

property owners unless it can be successfully removed by court order or by agreement of all affected parties. See *easement*.

conservation subdivision A housing development where homes are clustered together on smaller lots to preserve the surrounding natural area or farmland, which is often then owned and managed by the community.

conservator A guardian, receiver, or other protector appointed by a court to manage the assets of someone suffering from a permanent or temporary disability that prevents the person from managing his or her own affairs. A person need not be adjudged mentally incompetent to have a conservator appointed, and the appointment does not disqualify the person from entering into contracts, making or changing wills, or any other such legal rights.

consideration An act or a promise given by one person in exchange for an act or a promise from the other. The values do not have to be equal, and it has been said that one may promise to give a barleycorn in exchange for the promise to deed a castle, and it will be sufficient. It is a common misperception that earnest money is the component that makes a real estate contract enforceable. In reality, the promise to buy, and the promise to sell, is sufficient consideration. Consideration is an essential element for contract enforcement.

Consideration substitutes. Sometimes the law will permit enforcement of a contract even though one side or the other did not give consideration, if there was an allowed consideration substitute. The most common one is detrimental reliance, in which one person promises to do a thing gratuitously and another worsens his or her position in reliance on that promise. Under ordinary circumstances this would be a mere promise to make a gift, and unenforceable. Because of the detrimental reliance, however, it may become an enforceable contract.

Adequate consideration. If this is required by law, the consideration must be reasonably close to the value of the thing promised or exchanged.

Good consideration. The consideration is based on natural duty and affection or a moral obligation, such as property sold for "love and affection."

Consideration of support. It is not uncommon for elderly parents to transfer property to their children "in consideration of care and support." In most states, such transfers are voidable if the care and support are not forthcoming.

consideration of support See *consideration*.

consignment The practice of accepting possession of goods for another with the intention of selling the goods and remitting payment to the owner, less any agreed-upon fees. Ownership of the goods remains at all times in the consignor, not in the shopkeeper (consignee). Landlords may not obtain liens in the goods, and lenders may not gain security interests under blanket liens, if they have been put on notice that the party engages in the sale of consigned goods.

consolidated metropolitan statistical area (CMSA) See *metropolitan area*.

consolidation loan A new loan that pays off two or more existing loans or indebtednesses, usually resulting in lower payments. Home equity lines of credit are often marketed as consolidation loans, urging consumers to pay off high-interest-rate credit cards and automotive debt for lower-interest-rate, tax-deductible, mortgage debt. While the practice does reduce monthly payments significantly, it replaces relatively short term debt with long-term debt and results in higher total interest payments over time.

constant The annual payment required to pay the principal and interest due on a $1 loan for a specified repayment term at a specified interest rate. Before the widespread availability of computers and extremely affordable financial calculators, it was common to use mortgage constant tables to calculate monthly payments. One would refer to the table for the proper loan term, such as 30 years, and then within that table find the loan constant for the anticipated interest rate. See the following example. The constant is the monthly payment on $1. To find out your own monthly payment, you multiply the constant by the number of dollars in your loan, and the answer is what your monthly payments would be.

Example:

Monthly Loan Constants for a 30-Year Mortgage Loan

Interest Rate (%)	Constant
5.00	0.00537
5.25	0.00552
5.50	0.00568
5.75	0.00584
6.00	0.00600
6.25	0.00616
6.50	0.00632
6.75	0.00649
7.00	0.00665
7.25	0.00682
7.50	0.00699
7.75	0.00716
8.00	0.00734
8.25	0.00751
8.50	0.00769
8.75	0.00787
9.00	0.00805
9.25%	0.00823
9.50	0.00841
9.75	0.0085

If the loan is $145,000 for 30 years at 6.75 percent interest, then

$$0.00649 \times 145{,}000 = \$941.05$$

constructed wetlands A system of artificially created marshy-type areas of vegetation with frequent flooding, designed to treat wastewater through natural biological processes. The Environmental Protection Agency is a strong proponent of this method of cleaning water and has many additional resources on its Web site at www.epa.gov; search on "constructed wetlands."

construction allowance As a leasing incentive, an amount budgeted for a tenant to spend on improvements to the space leased. When one is engaged in negotiations, care should be taken to define the tenant's obligations and the landlord's obligations with reference to the construction allowance. Also called tenant improvements allowance or TI for short.

> **Example:** *If the lease gives the tenant responsibility for all improvements "below ceiling," then the considerable cost of adding or replacing ceiling tiles and light fixtures must be borne by the landlord and will not be deducted from the construction allowance. One should also negotiate the disposition of any unused construction allowance dollars and provide for their use as a credit against future rent or for them to be retained by the landlord in the account of the tenant and used at some point in the future for rehab expenses such as replacing worn carpet or repainting internal corridors.*

construction contract A contract for construction services. A good one should contain the following information:

- The names of the parties
- The contractor's registration number
- A general description of the work to be performed
- A statement of the quality, such as "standard practices of the trades"
- A set of blueprints and engineering plans
- A set of specifications
- A description of responsibilities for oversight and management
- A timetable
- A fixed price for the work or a formula such as time and materials
- Definitions of terms, such as "time to exclude/include commuting time"
- The process for pricing and approving change orders
- Payment schedules
- The process to be used for dispute resolution
- Remedies in the event of default
- The terms of any warranties

construction loan A loan originated for the purposes of providing payment for construction work or subdivision development. See also *building loan agreement*.

construction to permanent loan A construction loan with provision for automatic conversion to a fully amortizing permanent loan upon completion of construction.

constructive eviction The circumstance arising when, through no fault of the tenant, the premises are rendered unusable for the purposes for which they were leased, resulting in the de facto

equivalent of an eviction. The concept is available as a defense for consumer tenants breaking their leases and vacating the premises as a result of claimed constructive eviction. It is not generally available to commercial tenants.

constructive fraud A breach of some duty that results in a tendency to deceive others, with no requirement of a showing of intention to deceive or moral wrongdoing. A broker may be charged with constructive fraud if that person had a duty to disclose a known dangerous defect and failed to do so.

constructive notice Notice that is deemed to have been received by a person, whether or not the person actually received it.

- All citizens are presumed to have constructive notice of the law.
- All persons have constructive notice of the contents of documents recorded in the public real estate records.
- The owner of property has constructive notice of any persons in actual possession of the property and claiming adversely to the owner.

constructive possession Legally considered to be in possession of property even though not physically occupying it or using it in any manner. If one has a house on 40 acres of land, but rarely ventures outside the house and yard, one is in actual possession of the house and yard and in constructive possession of the remainder of the 40 acres.

constructive receipt An IRS concept that the unrestricted right to receive money is the same as actually receiving it for purposes of calculating income. This has nothing to do with accrual methods of accounting versus cash methods of accounting, but, rather, with timing of depositing checks and similar concepts.

Consumer Credit Protection Act See *Truth-in-Lending Act*.

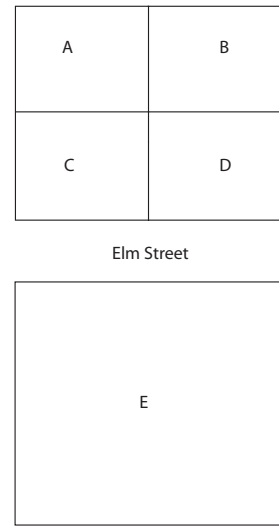
consumer mortgage Usually a home mortgage loan, but sometimes also refers to mortgages on rental houses.

consumer price index (CPI) A Bureau of Labor Statistics' (www.bls.gov/cpi/) inflation calculator; it is the most widely known index for measuring economic performance and inflation in the United States. The CPI measures and compares the total cost of a statistically determined "typical market basket" of goods and services consumed by U.S. households against the cost for the same goods and services consumed in the base period 1982–1984. The contents of the "market basket" are determined by the Consumer Expenditure Survey of about 10,000 families and their spending habits over a period of time.

contamination A condition of impurity resulting from mixture with a foreign substance.

contiguous Next to, actually touching, at something greater than a point. The identification of contiguous parcels is important in the following circumstances:

- In adverse possession, a party in actual possession of property that has a defective deed is considered in constructive possession of the remainder of the parcel, but not of contiguous parcels, even if described in the same deed.
- Bankrupt debtors may claim homestead rights in contiguous parcels of land and are not limited to the single parcel on which their home sits, assuming other legal requirements are met.
- Under the Uniform Land Security Interest Act (model legislation not necessarily passed by all states) a mortgage lender's after acquired property clause is unenforceable except as to contiguous property.



Parcel C is contiguous to parcels A and D, but only adjacent to parcels B and E. But, in some jurisdictions, if the corners of the properties touch, this is sufficient to make the properties "contiguous."

contingency clause A clause that allows cancellation of a contract without penalty if a certain described thing happens (e.g., an inspection report reveals necessary repairs estimated to cost in excess of $1,000) or fails to happen (e.g., failure to obtain satisfactory financing). A contingency clause contains a condition for contract performance.

contingent liability A liability that is not currently a liability but may become one upon the happening of some future event. If a father guarantees the student housing lease of his son, then the son is liable for the rent but the father may become liable if the son defaults. Other common contingent liabilities are guarantees of the debts of others, potential adverse judgments in litigation, and currently contested tax liabilities or audits. Lenders sometimes request a list of all contingent liabilities when evaluating a borrower's financial strength.

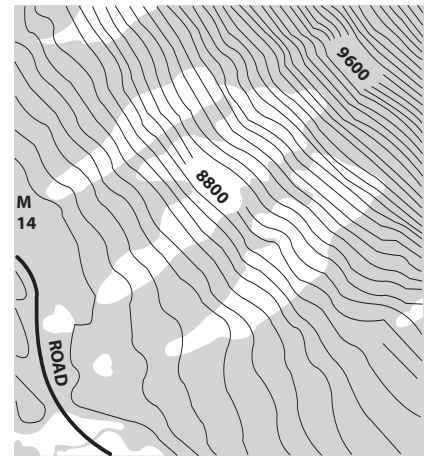
contingent offer See *conditional offer*.

continuing care retirement community See *life-care facility*.

continuous occupancy clause A clause frequently contained in the lease of a shopping center anchor tenant requiring it to remain open and in business for the entire term of its lease. The anchor is important not just because of its own rent payments, but also because it attracts customers who will shop at the other retail establishments in the center. If the anchor goes dark by moving out, all the remaining tenants will suffer, causing a possible domino effect of defaults.

continuous operations clause Similar to a continuous occupancy clause, but with better drafting. The continuous operations clause in the lease of a shopping center anchor tenant requires the tenant to remain open at a contractually defined level of operations sufficient to generate the traffic flow necessary to attract ample customers for the other shopping center tenants.

contour map A map that displays the hills and dales of a site as determined by a topographical survey. The contours of the land are represented by curved lines along which the height above sea level is relatively constant. The map will contain a linear scale indicating the dimensions of the site, and a contour scale indicating the elevation difference between contour lines, such as 5 feet. Lines that are widely spaced indicate a slow change in elevation; lines that are closely spaced indicate a rapid change in elevation.



contract A legally enforceable agreement. Its requirements are

- Competent parties
- Subject matter
- Legal consideration
- Mutuality of agreement (also called "meeting of the minds")
- Mutuality of obligation

As a general rule, oral contracts are enforceable unless they relate to real estate or are incapable of performance within one year, guarantee the debts of another, or are evidenced by some writing signed by the person sought to be charged ("This is to confirm our agreement…") There are other exceptions, but they are not relevant here. It is often difficult to enforce oral contracts because the parties usually have differing recollections of the exact terms of the agreement.

contract for deed See *bond for title*.

contract for purchase or sale A contract for the sale of real property. There is no one form for this purpose, although local boards of REALTORS® typically draft model contracts for customization and use by their members.

contractor One who supplies labor and materials to provide services in connection with the construction of an improvement on real estate. General contractors must typically be licensed by the state. An exception is made for property owners who act as their own general contractors or for general contractors of projects below a certain dollar limit.

contractor grade Usually an inexpensive quality of building materials; it is generally equated with the cheapest components possible.

contract price A tax term used in the calculation of gain realized on an installment sale. It is the selling price, minus any mortgage debt assumed by the buyer, plus the excess of any such liens collected in addition to the seller's equity in the property.

contract rate The face rate of the interest on a promissory note; typically the interest rate quoted, as opposed to the federally mandated calculation of annual percentage rate (APR) which treats certain prepaid loan costs as additional interest.

contract rent The rent stipulated in a lease. Contrast with *economic rent*.

contribution (1) An appraisal principle that says the value of an improvement is the amount it adds to the value of the property as a whole, not the value of the improvement standing alone in a void. A backyard workshop in a prestigious neighborhood might not add any value at all and could be considered an eyesore detracting from value, but might be worth $10,000 in a different neighborhood. (2) A legal principle holding that if a judgment is collected against one who was held guilty of negligence, assault, defamation, fraud, or some other tort, then that person may obtain a contribution from others against whom the same judgment was rendered, for their proportionate share of the judgment. Likewise, persons jointly liable for a debt, such as partners or cotenants, are responsible to pay their share to the other if one pays the entire amount.

contributory negligence A legal theory of negligence followed in some states (often called "contrib." for short). Under this theory, if someone was guilty of negligence that caused injury to another person, but the injured person was also negligent in any manner at all that contributed to his or her injuries, then there will be no recovery.

> **Example:** *If a contractor built a deck with supports in the soil instead of in concrete, the contractor would be guilty of negligence. If the homeowner routinely left a hose dripping at the base of one of the supports, leaching out the soil and rotting the wood, the homeowner would also be guilty of negligence. If the deck collapsed, then in a contributory negligence state the homeowner would not be allowed to recover any damages at all from the contractor. In a comparative negligence state, the homeowner's recovery would be reduced, but not eliminated.*

controllable expenses Real estate expenses one may manage and keep as low as practical under the circumstances. For an office building, controllable expenses would be things like janitorial services, office personnel, and, to a limited extent, electricity. The most common noncontrollable expense is real estate taxes. Most contracts or leases will define what they mean by controllable expenses, without regard to what the common understanding of the phrase might be. The phrase is important because many commercial leases require tenants to pay their pro-rata share of increases in building expenses each year. Wise tenants will negotiate an upper limit on the contributions; wise landlords will insist that the "cap" apply only to controllable expenses.

controlled business arrangement (CBA) A business arrangement recognized under the Real Estate Settlement and Procedures Act (RESPA) allowing a real estate brokerage office to provide financing, title insurance, and hazard insurance through the vehicle of subsidiary companies that operate within the brokerage office. Restrictions include the requirement that written disclosure of the affiliation be made to consumers, an estimated charge for the services is provided, consumers are free to obtain the services elsewhere, and referral fees are not charged among the various subsidiary companies.

control premium An amount paid to gain enough ownership interest to control a corporation or other entity. This would typically be an amount in excess of the simple fair market value of the shares sought to be purchased; used in business valuation calculations.

convenience center An open shopping center with fewer than half a dozen stores offering day-to-day necessities, such as basic groceries, dry cleaners, liquor stores, and video rental stores.

convenience store (C-store) A retail store that sells daily purchase items such as milk and beverages and impulse purchase items such as snacks and small gifts, usually in conjunction with gasoline sales. Convenience stores are attractive investments because the IRS allows rapid depreciation over a 15-year time period rather than the normal 39-year period required of typical commercial real estate.

conventional home Also called a stick-built home; a home built on-site, as opposed to a manufactured home (built elsewhere) or a modular home (components built elsewhere and assembled on-site).

conventional loans A mortgage loan without government participation in the form of insurance (such as the FHA) or guarantee (such as the VA).

conversion (1) The process of changing a property into condominium ownership. (2) Wrongfully taking property of another, or denying that person access to his or her property. If a self-storage facility overlocks a tenant unit in the mistaken belief the rent is past due, when in reality the rent was credited to the wrong person's account, then the facility is guilty of conversion.

conversion clause (1) A clause in a mortgage loan that allows the borrower to convert from an adjustable-rate mortgage to a fixed-rate mortgage, or that allows the borrower to convert from interest-only construction financing to a lower interest rate and usually fully amortizing permanent financing. (2) A clause sometimes seen in leases and real estate sales contracts providing that any personal property left on the premises after lease expiration or after real estate closing may be discarded or retained, as the real estate owner desires, and will not constitute a conversion. (In other words, the owner has no responsibility to keep the property in a safe place and/or attempt to return it to the former occupant.)

convertible ARM An adjustable-rate mortgage loan that the borrower may convert to a fixed-interest rate during a predetermined time period, at an interest rate calculated according to a formula set out in the note.

convey To transfer title to real estate to another.

cooling off period A time period within which a person may change his or her mind about a contractual agreement and cancel it without penalty. The right must be granted within the contract itself or by virtue of consumer protection statutes because it does not exist at common law.

co-op (1) Short for cooperative apartment, being a method of owning real estate in which a corporation owns a building and related facilities and persons who buy stock in the building are entitled

to rent a particular unit, called a proprietary lease, at rates significantly below market rents. (2) An arrangement between two real estate agents for the sale of a property and splitting of the commission, usually as a result of one agent having the listing with the owner and another agent bringing the buyer to the closing table.

cooperating broker A broker who agrees to split a real estate commission with another broker in return for services rendered in connection with a particular piece of real property.

cooperative apartment See *co-op*.

core-based statistical area (CBSA) A concept developed by the federal Office of Management and Budget in order to standardize geographic and population descriptions so that data from one federal agency may be reliably related to data from another federal agency without having to recheck definitions used by each agency. In the Year 2000 census definitions by the United States Census Bureau, a core-based statistical area is a functional region based around an urban center of at least 10,000 persons. These definitions replace the Year 1990 census definitions of metropolitan area, metropolitan statistical area, and consolidated metropolitan statistical area, although the older terms are still used in common parlance. CBSAs are further grouped as follows:

- Metropolitan statistical area. Contains at least one urbanized area of 50,000 people or more.
- Micropolitan statistical area. Contains at least one urbanized area and a population of 10,000 to 50,000 people.
- Metropolitan divisions. Divisions in metropolitan statistical areas with a single core of 2.5 million people or more.
- New England city and town areas (NECTAs). Geographic areas defined by cities and towns in New England, but still segregated according to the 50,000 people per size cutoff.

core factor In an office building, the percentage of common area space such as lobbies, restrooms, and corridors as compared to the total net rentable square footage in the building. See *loss factor*.

CORENET Global An association of corporate real estate executives and related professionals, organized in 2002 by the merger of the International Development Research Council (IDRC) and the National Association of Corporate Real Estate Executives (NACORE). The Web site for CORENET Global is at www.corenetglobal.org.

core space In an office building, the common area space such as lobbies, restrooms, and corridors.

corner influence The effect on the value of real estate by its proximity to the intersection of two streets.

corner of Main and Main The most important intersection in a community or in a downtown office area. Some drug store chains have a simple site-selection preference for the "corner of Main and Main," no matter what the cost.

corporation A legal entity created by filing documents with the local secretary of state, commissioner of corporations, or similar official. It may have as few as one shareholder, must begin life with

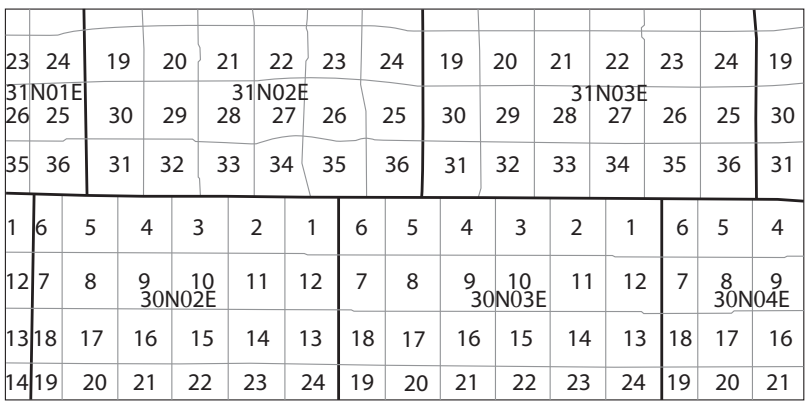
some minimal amount of assets gained as a result of the shareholder(s) paying for shares of stock, may be stipulated as having a limited life span or perpetual existence until formally dissolved, and may be designated as having the powers to do only limited types of things or anything allowed by law. The entity thus created will enjoy all the rights and responsibilities of natural persons, including owning and renting real estate, and suing or being sued in the courts. The IRS allows corporations to be segregated into three main types for tax accounting purposes:

1. **S-corporation.** A small corporation that is allowed to file information returns only. It pays no taxes on its income but, instead, sees all income taxed to the shareholders according to their pro rata share of the corporation.
2. **C-corporation.** Any corporation that does not meet the limitations for an S-corporation, or one that otherwise qualifies for S-corporation status but elects to be treated as a C-corporation. The corporation files its own tax returns, pays taxes on income, and then distributes dividends to shareholders who pay taxes on the dividends.
3. **501(c)(3) corporation.** A not-for-profit corporation authorized by Section 501(c)(3) of the Internal Revenue Code, which files an information tax return but pays no taxes.

corporeal Tangible real or personal property; things you can touch. Contrast with incorporeal property such as easements (a right to use, but not a right to, property) and goodwill.

correction deed A deed executed to correct some defect in the original, such as the misspelling of a name or a mistake in a property description. Correction deeds are usually exempt from transfer taxes imposed by the recording authority.

correction lines Provisions in the public land survey system made to correct for the curvature of the earth; one cannot have perfect rectangles over a curved surface. Every fourth township line (24 miles apart) is used as a correction line on which the spaces between the east and west range lines are corrected to a full and proper 6 miles. The effect is that the grid lines do not match up until they meet at the principal meridian.



correlation A former appraisal term, replaced by reconciliation.

correlative water right A theory of riparian rights—water rights—that holds an owner who has rights in a common source of water is entitled to take only a reasonable amount of water for the beneficial use of the land. Contrast with appropriative rights, in which the owner has the exclusive right to take all the water for the beneficial use of the land.

cosigner A person who signs a promissory note in such a capacity that he or she has equal and primary liability with another. Contrast with a guarantor, who is liable only if the original obligor defaults. A cosigner must list the promissory note as a liability on financial statements; a guarantor has only contingent liability which may never ripen into full liability.

cost allocation depreciation A tax method of depreciating property by separating a functional unit—such as an office complex—into allowable components that may be depreciated over a shorter time period than otherwise permitted for the whole. For example, nonresidential real property improvements must be depreciated over 39 years. One may allocate the cost of some components, such as fencing, lighting, security systems, and carpet into categories that can be depreciated over 5 or 7 years, providing larger tax deductions.

cost approach An appraisal method that estimates the cost to reproduce or replace an improvement and then subtracts an amount for depreciation to reach the current condition of the property. Of the three approaches—comparison to comparable properties, capitalization of income, and cost—cost is the one deemed least reliable overall, but most necessary in the case of unusual properties with no realistic probability of a tenant.

CoStar A commercial provider of information about commercial real estate in most major markets across the United States and the United Kingdom. The information provided includes the ability to take a virtual drive down a designated street; to see street-level views of all the properties; and to click through to obtain information regarding ownership, management, vacancy rates, tenant information, lease expirations, and asking rents. Other information includes a property listing service, data regarding sales prices of properties, and advertising services for real estate firms. The CoStar Web site is at www.costar.com.

cost basis The original cost of a property. After increases for capital improvements made over the years, and decreases for depreciation deductions or involuntary conversions such as condemnation, the number becomes one's adjusted basis.

cost-benefit analysis A decision-making tool that evaluates all the hard-dollar and economic consequence costs associated with pursuing a course of conduct against all the hard-dollar and economic consequence benefits reasonably to be expected from that decision, and comparing the two to see if they make economic sense.

> **Example:** *Riverdale Apartments is experiencing increased competition because of the abundance of new apartment projects being built nearby. In order to compete more effectively, it is considering adding a sophisticated security system with Web cameras allowing residents to monitor gate access; areas around the buildings; and common areas such as the laundry room, swimming pool, and playground. The hard costs of $270,000 can be partially defrayed by*

charging rental rates $15 per month higher than other properties. Spread across 200 apartments, this results in an additional income of $36,000 per year. In addition, the system is anticipated to result in the ability to retain occupancies at 95 percent rather than an expected short-term drop to 75 percent until the new apartment buildings fill up and begin charging market rents in about 2 years. Calculations may attach a value of $36,000 per year to this consideration. Finally, the security system will result in significant insurance premium reductions amounting to $20,000 per year. The total short-term economic benefit is $92,000 per year for 2 years and $56,000 per year each year afterward (without adjusting for inflation or the cost of money). As a result, the initial $270,000 investment can be recouped in about 3½ years and will show a profit afterward. After completing this cost-benefit approach, management will probably decide to spend the money for the improvements.

cost of funds index (COFI) A yield index based on the cost of funds to savings & loan institutions in the San Francisco Federal Home Loan Bank district. It is one of the indexes commonly used to set the rate of adjustable-rate mortgages.

cost-of-living adjustment (COLA) A change in payments, such as rent in subsidized housing, based on a change in the index that measures inflation.

cost-of-living index An indicator of the current price level for goods and services as compared to a base year. The base year is always set at a value of 1.0 or 100. As the cost of living increases (inflation), the number will increase, so that a cost of living index of 150 means things cost 50 percent more than they did in the base year. As the cost of living decreases (recession or depression) the number will decrease, so that a cost of living index of 93 means things cost only 93 percent of what they cost in the base year. The consumer price index is one such cost of living index.

cost-plus-percentage contract A compensation method for a construction project, in which the contractor is paid a specified percentage over and above construction costs. This percentage may be pure profit to the contractor, or it may be the contractor's gross compensation from which must be paid general overhead expenses such as clerical help, phone lines, and general business insurance. It is important to determine the difference, because if the contractor expects the percentage to be pure profit, then normal business operating expenses will have to be accounted for somewhere in the construction contract as expenses.

cost recovery A tax concept commonly called depreciation, but technically different in ways that don't matter to most taxpayers. The explanation is that depreciation is a calculation determined by starting with the acquisition cost of a property and then subtracting the anticipated salvage value when the property's useful life is over. That number is then divided by the number of years one can reasonably assume the property will have a useful life. The resulting figure is the annual depreciation for the property. Because of constant arguments, audits, and litigation over the correct salvage value and the correct useful life for various properties, the IRS replaced the whole depreciation system with the cost recovery system that assigns a useful life to various classes of property, assumes the property will be worthless at the end, and then allows deductions over the course of the useful life.

cost to cure The amount of money necessary to remedy something that is depressing the value of real property. If the cost to cure a parking lot filled with potholes is $12,000, but the current parking lot condition depresses the value of the property by $20,000, then the defect is said to be curable.

cotenancy A form of property ownership in which two or more persons or entities own undivided interests. The interests do not always have to be in equal shares.

Council of Real Estate Brokerage Managers An affiliate of the National Association of REALTORS®; it confers the Certified Real Estate Brokerage Manager (CRB) designation. The Web site of the Council is www.crb.com.

Council of Residential Specialists An affiliate of the National Association of REALTORS®; it confers the designation Certified Residential Specialist (CRS). The Web site of the Council is www.crs.com.

counseling A relatively new career within the real estate industry that involves providing independent and unbiased advice on a variety of real estate–related issues. Membership in the Counselors of Real Estate (www.cre.org) is by invitation only. Another trade organization is the National Association of Counselors (http://nac.lincoln-grad.org/).

counselor One who provides counseling services.

Counselors of Real Estate (CRE) See *counseling*.

counteroffer An offer that differs from the previous offer in some significant detail. A counteroffer rejects the prior offer by operation of law, and instead makes a new offer that must either be accepted or rejected by the other party.

Example: *A seller offers to sell her home "as is" for $250,000.*

- A buyer offers to buy the home for $240,000, but the seller must replace the roof and recarpet the house (counteroffer)
- The seller replies that she will sell for $235,000 "as is" (another counteroffer).
- The buyer replies that he will pay $210,000 "as is" (another counteroffer).
- The seller sees things going downhill and says, "Wait, wait, I accept your first counteroffer of $240,000 and I will repair the roof and carpet." However, the seller cannot do this, because that offer no longer exists and cannot be accepted.

county A political subdivision within a state. It is usually the largest government body within the state. In Louisiana, the equivalent is called a parish.

coupon book Formerly, a booklet given to investors with coupons that were clipped out and mailed in to receive that period's income. This was the source of the expression "coupon clipper," meaning a person of leisure with investment income. Today, a coupon book is the booklet given to mortgage borrowers, containing coupons with account and payment information, to be mailed in with monthly mortgage payments.

court An organ of government belonging to the judicial department and charged with resolving disputes among parties. Courts generally have jurisdictional requirements providing that only certain disputes among described parties for certain amounts of money may be heard. If you file your grievance in the wrong court, you may be prejudiced when the case is dismissed for lack of jurisdiction and the time period during which to file in the proper court has expired.

covenant An agreement. For example, one can make a "covenant not to compete" a provision of a business sale, or one can write a restrictive covenant regarding the use of real property into the real estate records, which binds all owners whether it is contained in their specific deed or not.

covenants, the usual The use of this expression in a real estate contract refers to the seller's obligation regarding the type of deed the seller will execute. The three usual choices are a general warranty deed, a special warranty deed, or a quitclaim deed. The general warranty deed gives assurances and promises regarding the quality of the title being transferred; a special warranty deed merely promises that the seller has not done anything to injure the title, but makes no promises about other parties and their possible claims; while a quitclaim deed merely transfers any interest the seller might have, not that the seller is saying he or she owned anything at all. As a general rule, courts have construed contract language requiring execution of a deed "with the usual covenants" to mean a general warranty deed with the covenants of seisin, right to convey, against encumbrances, quiet enjoyment, warranty, and further assurances.

CPI See *consumer price index*.

CPM See *Certified Property Manager*.

CRA See *credit reporting agency* and *Community Reinvestment Act*.

cradle-to-the-grave management A phrase used to describe the Resource Conservation and Recovery Act, which is a federal law establishing a system for managing hazardous wastes in an environmentally sound manner from the point of origin to the point of final disposal.

cram down A bankruptcy tool used by debtors to force creditors to agree to a plan of reorganization in Chapter 11. If the requisite minimum number of votes have been obtained to approve a plan of reorganization, and if the plan provides better protections or payments to the nonconsenting creditors than they would receive in a liquidation, then the court may "cram down" the plan and all will be bound by its terms.

CRE See *Counselor of Real Estate*.

creative financing Any financing arrangement other than the traditional one of obtaining a loan from a commercial lending institution.

credit (1) In finance, the availability of money. (2) In accounting, a liability or equity entered on the right side of the page in double-entry accounting. The concept is confusing to most consumers because an accounting "credit" does not mean more "stuff" such as property or money; it merely indicates the side of the page on which the entry is posted. The other entry is called a debit.

credit bid The amount a lender can bid at a foreclosure sale under one of its mortgages, representing the total of all amounts due under the promissory note.

credit bureau See *credit reporting agency*.

credit enhancement A method of reducing the risk of extending credit to a borrower. It can include requiring collateral, a stand-by letter of credit, a comaker, a guarantor, or any other means.

credit history An individual's history and experience regarding repayment of loans and use of revolving credit such as credit cards.

credit life insurance Insurance that pays to a lender the full principal balance of a loan in the event of the death of the borrower. It is illegal for a lender to require credit life insurance (or credit disability insurance) as a condition of making a loan.

credit limit The maximum loan amount a person may receive on a particular instrument or from a particular lender. A revolving line of credit might have a credit limit of $50,000. Banks have limits on the amount of credit they can extend to single borrowers, based on the size of the bank, and limits on the credit they can extend to officers and directors.

creditor One who is owed a debt.

credit rating service See *credit reporting agency*.

credit report A history of all information on file at a credit reporting agency about a particular individual or business. By law, consumers are entitled to receive one free credit report per year from each of the three major credit reporting agencies—Experian, Equifax, and TransUnion, but may request and pay for as many as they choose. Requesting one's own credit report does not decrease the score. You may obtain a copy of your report by going to the official Web site at www.annualcreditreport.com or calling 1–877–322–8228. (Beware: The Web site www.freecreditreport.com is not the official, federally mandated Web site.)

credit reporting agency (CRA) An organization that maintains credit history information and sells reports and scores to authorized credit grantors. Regulated by the Federal Trade Commission under the requirements of the Fair Credit Reporting Act.

credit scoring The process of rating potential borrowers based on their overall credit history, current debts, and frequency of application for credit. The most commonly used score, by far, is the FICO score.

credit tenant A national or large regional tenant with excellent credit. Although local tenants may also have excellent credit, oftentimes better than their national counterparts, only the larger companies are called credit tenants. A lender will offer more attractive financing terms for a development with a certain amount of space preleased or currently leased to credit tenants.

credit union A nonprofit organization in which qualified persons may make deposits and obtain loans. Formerly, membership was strictly defined so as to limit it to persons in a particular industry

or trade organization, but those rules are now largely obsolete. Bankers believe that credit unions enjoy an unfair advantage in the marketplace by virtue of paying no income taxes as a result of their nonprofit status. The lack of any income tax expenses allows the credit unions to offer somewhat higher rates on deposits and somewhat lower rates on loans.

CREW network See *Commercial Real Estate Women*.

crib Slang for one's dwelling place.

cross-collateralization The process of tying two or more mortgages together so that the security of one note stands as security for the other notes. A step often taken in a debt workout after default so that the creditor may enhance the amount of collateral available for a debt and also increase the hostage value of property, thereby discouraging any plans the debtor might have to simply turn in the keys and abandon mortgaged property to the creditor.

cross-defaulting clause A provision in many mortgages that a default in any mortgage on the property, or any loan by the same lender to the same borrower, will constitute a default in the one containing the clause, even if all note payments are current on that particular mortgage. Used as a method for early triggering of remedies before things are allowed to deteriorate to a point that could seriously impair the value of the collateral.

> **Example:** *A borrower may default on a second mortgage but not suffer foreclosure because the second mortgage holder believes the property has insufficient equity to make it worthwhile. Technically, this does not affect the first mortgage lender, but is a good indication of worsening financial conditions and possible cessation of routine property maintenance by the borrower, possible insurance cancellations, potential lawsuits from other creditors which might force a bankruptcy, and other matters generally unpleasant to contemplate by the first mortgage holder. It may be preferable to declare a default immediately and proceed to foreclosure rather than wait until the borrower misses payments on the first mortgage.*

CRS See *Certified Residential Specialist*.

CRV See *certificate of reasonable value*.

C2P See *construction to permanent loan*.

CTL Shorthand for credit tenant lease. See *credit tenant*.

cubic yard A measurement used to measure concrete, gravel, or earth. It measures 3 ft × 3 ft × 3 ft, which is equivalent to 27 cubic feet. Usually shortened to simply "yard," as in "It will take 12 yards of dirt to fill that hole."

culvert A waterway for rainwater or other runoff; may be a ditch or a pipe. If ditches along the side of a road channel runoff, then property owners must install culverts under driveways in order to prevent the formation of dams. One must usually obtain highway or road department permission to install a culvert because the location will generally be in a road right-of-way.

curable depreciation Depreciation that can be cured at a cost less than the value that will be added.

curb appeal The subjective evaluation of the aesthetic appeal of a house or other building, as viewed from the street.

cure rights In bankruptcy, the right to fix a default so that a creditor cannot pursue its remedies. For example, a debtor may file for bankruptcy moments before foreclosure, stop the foreclosure, and then propose a plan to cure the default and past due sums. Usually the plan involves small monthly payments over the course of several years. Of course, it is not enough to cure the default, the debtor must also stay current on future obligations, but bankruptcy will sometimes allow for a renegotiation of those obligations.

current use See *highest and best use*.

curtail schedule See *amortization schedule*.

curtesy The right of a husband to some interest in his deceased wife's real estate, even if the wife died without a will or left all property to another in her will. The same rights granted to a widow in her deceased husband's property are called dower. As a result of these rights, mortgage lenders may require a spouse to sign a mortgage instrument giving security in the real estate, even though the spouse has not signed the promissory note and so has no personal liability to repay the debt. Many states have abolished the ancient rights of dower and curtesy.

curtilage The enclosed space of ground and buildings immediately surrounding a dwelling, or a conceptual amount of space reasonably attached to the use of a dwelling. This is an important concept in law enforcement in determining whether (a) an area is within the curtilage and thus searchable under a search warrant for the dwelling, (b) an officer's presence in an area for surveillance purposes is within the curtilage and thus an unlawful entry, and (c) despite the determination of (a) and (b), there is no expectation of privacy in garbage left within the curtilage for pickup, so it may be searched without a warrant.

cut and fill The process of contouring land to more easily develop it, accomplished after clearing and grubbing.

cyberpark A large area of land where computer and technology companies are concentrated, or that has been constructed with a high-tech communications infrastructure such as loop redundancy, fiber optics, and perhaps even belowground network bunkers of reinforced concrete.

D

damages Compensation for an injury for which the law provides a remedy. Following are highlights of some of the law of damages as it relates to real property:

- The measure of damages to property is the difference in the value of the thing before the injury and after the injury. The cost to make repairs is usually not a valid measure of damages.
- Parties may not contractually agree to a penalty for default, such as late completion of a construction project. Penalties are illegal. Parties may, however, agree that the damages for default will be difficult to measure exactly, so they will agree to liquidated damages in a certain agreed-upon amount. This is the reasoning behind contracts that allow retention of the earnest money if the buyer defaults.
- In breach of contract cases, injured parties are required to take such actions as are reasonable to minimize their damages and will be denied any damages at all if they do not take such mitigation steps. If a tenant breaches a lease, the landlord must try to release the premises to another, and the value of any damages will be diminished by the value of the new lease.
- Consequential damages, which are damages not as a direct result of the wrong, but flowing from some of the consequences of the wrong, are recoverable only if the wrongdoer had some reason to know of the consequences. A person who allows something unsafe to remain on the premises (such as a wet floor) may be responsible for the injury to a guest who slips and falls. However, the person may not be liable for the consequential damages when the guest becomes addicted to pain medication.
- Punitive damages are intended to punish the wrongdoer and deter future similar conduct. Because of the preponderance of multimillion-dollar punitive damage jury verdicts in recent years, the United States Supreme Court has recently held that excessive punitive damages are a violation of the "cruel and unusual punishment" clause of the Constitution, and so may be reviewed in the federal court system and set aside even though the original lawsuit was brought in a state court system.
- Treble damages are allowed under many federal statutes rather than allowing the jury to calculate punitive damages.
- Damages received for personal bodily injury are not income and not taxable; other types of damages may be taxable depending on what they represent.
- Damages are recoverable for emotional distress. The addition of a claim for emotional distress is often enough to trigger an insurance company defense of a lawsuit. Although there may not be insurance coverage for an award, it will pay for the lawyers.

Davis-Bacon Act A federal law requiring certain minimum levels of wages for all workers involved in construction on federal projects or federally funded projects. The purpose was to give local contractors an opportunity to participate in government contracts, even though out-of-town contractors might have access to cheaper labor and would therefore enjoy a competitive advantage in bidding. The other purpose was to prevent contractors from paying lower wages than currently prevailing in the local marketplace, thereby reducing wages for the entire area. The Act is looked upon as one favoring unions, although that was not the intent. In fact, the Act had an unsavory beginning, introduced by Representative Bacon in 1927 as a reaction to a contractor who hired poor black laborers from Alabama to build a veterans hospital in Bacon's district of Long Island. The Act does not require payment of union wages, merely payment of wages consistent with those prevailing in the community. Today, the Act is still alive and well, and garnered tremendous public support when President Bush attempted to temporarily suspend it for contractors working in hurricane-damaged parts of the country.

d/b/a (Also written as "dba.") Means "doing business as." Some states require dba registration with a central office, and others do not.

DBH Means "diameter breast-high"; the diameter of a tree at a point 4 1/2 feet above the ground.

Many homeowners associations prohibit cutting trees of a certain DBH on one's own land, unless the property owner receives prior approval.

When selling timber, purchasers generally need to know the average DBH for the trees. The information is also necessary to calculate tonnage of timber, which is the more modern way of pricing, rather than calculating board-feet.

DCR See *debt coverage ratio*.

DDA See *demand deposit account*.

dead load The weight of a building, not counting the occupants and furnishings.

dead man's statute A law of evidence employed in many states. One version says that a witness may not testify about oral statements made by a decedent (someone who has died) if the effect of the testimony would be to make the decedent's estate larger or smaller, even if the witness would not benefit one way or the other. Another version says witnesses cannot testify about statements made by a decedent if the witness would benefit from those alleged statements. (Be sure to clearly understand which is being used in a specific case.)

dealer In tax law, persons who buy and sell property for their own account, whether that property consists of silver spoons, trading cards, or real estate. Investors want to avoid dealer status because:

- Gains on sales are treated as ordinary income rather than the more favorably treated capital gains, no matter how long you hold a particular piece of property.
- Dealers have to pay self-employment taxes on their income.

- Dealers cannot take advantage of installment sales provisions that allow others to pay taxes over time, as they receive installment payments from the purchaser. Dealers must pay income taxes on the entire profit, even if they receive payments over many years.

dealer status See also *dealer*. Determined by the intent of the party. The courts have arrived at several areas they will examine in order to determine intent. The most significant are

1. Taxpayer's purpose for the acquisition and sale
2. Number and frequency of real estate sales
3. Duration of ownership
4. Time spent by taxpayer in promoting the sale
5. Use of outside brokers in making the sale
6. Extent of taxpayer improvements to the property

debenture An unsecured note or bond.

debit (1) On a closing statement for a real estate sale, an item that is charged to a party. (2) In accounting, an entry that appears on the left side of the page. It is the opposite of a credit. In accounting, a credit does not necessarily indicate more money and a debit does not necessarily indicate less money or an expense.

debt An obligation to pay another.

debt capital Money borrowed on a long-term basis and used to purchase an investment such as real property.

debt coverage ratio (DCR) The ratio of net operating income compared to annual debt service, which includes principal and interest payments. The ratio is used by lenders to evaluate loans on income-producing property. A ratio of 1.2 or better will usually support the extension of credit.

Example:

Annual revenues	=	*$100,000*
– Annual operating expenses	=	*50,000*
= Net operating income	=	*50,000*

Annual debt service on proposed loan = 11,000

$50,000 ÷ $11,000 = DCR of 4.54

debt/equity ratio The ratio of mortgage debt to the owner's equity in the property. Typical home mortgage lenders require a debt/equity ratio of 80 percent—meaning they will loan up to 80 percent of the value of the home. Higher ratios can be obtained by purchasing private mortgage insurance. Commercial lenders have varying requirements depending on particular market circumstances at the time.

debtor (1) One who owes a debt. (2) In bankruptcy, the person who requests protection under the bankruptcy laws.

debtor in possession (DIP) (To pronounce the abbreviation always say each letter; it is not pronounced as a word.) In bankruptcy, a Chapter 11 debtor who remains in possession of his or her property and continues to operate a business or sell the property. The DIP must still obtain court approval for nonroutine transactions but is able to conduct business, receive monies, and pay bills, including a reasonable salary for the debtor. Contrast with the situation in which a bankruptcy trustee is appointed; in this case the trustee is then in control of all assets of the debtor.

debt relief The forgiveness of a legal obligation, in whole or in part. In real estate, it occurs most frequently when a mortgage lender agrees to accept a deed to the property rather than go through a foreclosure, and further agrees to accept the property as full payment for the loan, even though it is not worth the full amount of the loan. In such a situation the borrower has received debt relief and must report that as income for tax purposes. There is a loophole: if the debtor was insolvent immediately before the debt relief, and insolvent immediately after the debt relief, then he or she need not declare income to the extent of the insolvency.

> **Example:**
>
> *The debtor owes $125,000 on his home and 20,000 on credit cards. The debtor's only asset is his home, which is worth $110,000.*
>
> *Netting assets and liabilities before the debt relief results in the debtor being insolvent by $35,000.*
>
> *After giving the home to the bank and receiving forgiveness of the balance of the mortgage loan, the debtor now still has credit card debt of $20,000 and no assets at all. The debtor is insolvent by $20,000.*
>
> *Because the debtor is still insolvent, and the debt relief did not cure his condition of insolvency, there is no taxable income.*

See also Publication 17, "Your Federal Income Tax," Chapter 12, "Other Income," available at the IRS Web site, www.irs.gov.

debt service The amount necessary to make principal and interest payments on a loan. It does not include amounts collected each month as a reserve for insurance or real estate taxes and does not include payments for private mortgage insurance.

debt service constant See *mortgage constant*.

debt service ratio The ratio of debt payments to disposable income; used in evaluating one's eligibility for a mortgage loan. National averages, calculated quarterly for every year since 1980, are provided at the Web site of the Federal Reserve Board, www.federalreserve.gov/releases/housedebt/default.htm.

debt to equity ratio See *debt/equity ratio*.

decedent One who has died. The legal subject "decedent's estates" deals with all the law related to the collection, preservation, and disposition of property formerly belonging to a decedent.

declaration The legal document a condominium developer must file in order to create the vehicle for condominium ownership. All states have fairly similar laws setting out the requirements for what must be in the declaration. They are sometimes called uniform condominium acts or horizontal property acts.

declaration of condominium ownership See *declaration*.

declaration of homestead A document signed by a homeowner and filed with the tax assessor's office in order to take advantage of homestead exemptions reducing real estate taxes.

declaration of restrictions A document filed in the real estate records of the county where property is located, and incorporated by reference into the deeds of every property located within the described area, setting out the rules and regulations pertaining to those properties. It is commonly used to spell out restrictive covenants in neighborhoods, such as minimum building size, setback lines, prohibitions against home-based businesses, and restrictions against boats or motor homes parked in view of the street.

declaration of trust A written statement that one who holds the legal title to property does so in trust for another, being the beneficiary.

decree Technically, the judgment of a court of equity. Today, states have abolished the distinctions between courts of law, which followed fairly strict rules of law and awarded damages to injured parties, and courts of equity, which generally tried to do what was fair and just (equitable) and issued decrees to people ordering them to do something, or to stop doing something. Causes of action are grounded in law or equity, but the same court and same judge now hear everything.

decree of foreclosure and sale An announcement by a court establishing the amount of a mortgage debt and ordering the foreclosure of the property to pay the debt; employed in states that must follow judicial foreclosure in order for a lender to sell mortgaged property.

dedicated circuit An electric circuit that serves only one appliance (e.g., a dishwasher) or a series of electric heaters or smoke detectors. It is an important point of lease negotiations to agree upon the number and size, in amps, of dedicated circuits to be provided to a tenant. Most leases of large and modern office buildings contain restrictions on the electrical load a tenant can place upon the building.

dedication An owner's gift of land, or an interest in land such as a right-of-way, for the public's use, coupled with the public's acceptance of the gift by making use of it. A dedication may be express, as when the owner specifically states an intention of dedicating land for a park. Alternatively, a dedication may be implied because of the owner's conduct and the reasonable conclusions to be drawn from that conduct. When one sees news stories about protestors attempting to block development of a valuable vacant lot previously kept clean and mowed by neighbors and used by children as a park, one is seeing an attempt to have a court declare that the owner made an implied dedication for the public use.

deed A written document properly signed, acknowledged, and delivered, and bearing a description of specific property and words of conveyance for that property.

deed books Records containing copies of recorded deeds and other instruments affecting title to land located within the jurisdiction.

deed indented See *indenture deed*.

deed in lieu of foreclosure An instrument transferring title to real property to a mortgage lender without the necessity of going through the foreclosure process. Called the deed in lieu (pronounced "loo") for short, the procedure is attractive to lenders because of the speed, lack of any defenses, and removal of anxiety about last-minute borrower bankruptcy. It is attractive to borrowers because there is no foreclosure to appear on the credit records. There is some risk to the lender if there are intervening liens, because a deed in lieu transfers title to property subject to the effect of any junior liens. Usually a foreclosure destroys other liens, if they were recorded after the mortgage or deed of trust.

deed of reconveyance A method of extinguishing lender's rights in real property in a state that uses the deed of trust procedure rather than the mortgage procedure.

deed of trust A security instrument used to grant rights in real property to a lender. It is used in some states; other states use mortgages to accomplish the same goal. With a deed of trust, title to the property is transferred to a trustee, who holds it in trust for the borrower's benefit until such time as the loan has been paid in full. At that time, the trustee will transfer legal title back to the borrower by way of a deed of reconveyance. If there is a default and foreclosure, it is the trustee who conveys the property to another.

deed poll A deed signed only by the grantor. This is the typical type of deed, but one rarely hears it called a poll deed or deed poll. Contrast with a deed indented, also called an indenture deed, which contained promises, representations, or warranties by both the seller and purchaser and so required both signatures. The documents were distinguished because the deed poll had a "polled" or clean-cut edge, while the deed indented had an indented or jagged edge.

deed restriction A provision placed in a deed restricting or limiting the use of the property in some manner. It may include subdivision or similar restrictions common to many properties in the neighborhood, or it may be something personal to the grantor such as a requirement that the purchaser resell to the seller before offering to anyone else.

deed to secure debt A type of mortgage used in a few states; the title to the property is transferred to the lender until the debt is paid in full. Contrast with deed of trust which is employed in states called title theory states, and with true mortgages which are employed in states called lien theory states. The deed to secure debt is a hybrid of the two theories.

de facto In fact, in actuality, as things are really done. The phrase is used to express a state of affairs or condition that might not be technically legal, but which has the same effect as the legal condition. Here are two examples:

- When an apartment complex allowed the power to be disconnected for nonpayment and failed to secure a reconnection, it amounted to a de facto eviction of all the tenants (also called a constructive eviction).

- The IRS has ruled that a long-term lease of property with the right to purchase for $1 at the end of the term is not a true lease, but a de facto installment sale.

defamation of title Wrongfully causing some cloud—problem—to be placed on the title of another, such as a lender failing to satisfy a mortgage that has been paid in full.

default The failure to meet one's obligations in a timely manner. There are several important concepts relating to defaults in the real estate field:

- Leases and mortgages often differentiate between monetary defaults, such as failure to pay money when due, and nonmonetary defaults such as a failure to provide proof of insurance or copies of monthly financial statements. If so, there will be different notice provisions and grace periods for each.
- Unless a sale contract contains language that "time is of the essence," or one party has made the other aware that time is critical, then a court will ordinarily award a purchaser a reasonable amount of time to complete closing, even if it is past the contract date.
- Some states have statutes allowing collection of attorneys' fees when there has been a default in the contract. Other states require specific language in the contract allowing for collection of attorneys' fees.

default point The total revenues necessary from a project to pay all the bills with nothing left over—the point at which $1 more in revenues creates a profit and $1 less forces one to default on paying creditors unless additional capital is injected into the project. See *break-even point*.

defeasance The process of legal title being transferred back to a borrower once all payments and other requirements in a mortgage loan have been completed.

defeasance fee A prepayment penalty; in a commercial loan, money that must be paid to the lender when a mortgage is paid off earlier than the specified maturity date.

defeasible fee A real property title that can be revoked or undone upon the happening of a named event. (The whole area of real estate law, regarding things that might happen in the future to grant or take away title to property, is called future interests. The rules are exceptionally complex and not often encountered in the real world.)

defect in title A recorded instrument that would prevent a grantor from giving good or clear title to property.

defendant The party sued in an action at law. Contrast actions in equity, in which the party sued is called a respondent. Today, these distinctions are largely irrelevant, but they may be encountered when reading old legal decisions.

deferred charges An accounting and tax concept in which nontangible costs that are expected to provide value over a number of years are booked as assets and then reduced each year by a pro rata amount as they are charged to expenses.

Example:

Acme Inc. pays a broker $75,000 to negotiate a 10-year lease on very favorable terms.

Year 1, day 1: Acme writes a check for $75,000 and books an asset for $75,000.

Year 1, day 2: Acme enters an expense for $7,500 (one-tenth of the total amount) and reduces the asset by $7,500. The net result is that, at the end of year 1, Acme has $75,000 missing from its bank account, but this is balanced by an asset of $67,500 and an expense of $7,500.

Years 2 through 10: Continue the same process as year 1, day 2 until the deferred charge is finally $0 and the last $7,500 is expensed.

If you do not properly account for such deferred charges on your taxes, you risk an audit, disallowance of expenses, penalties, and interest.

deferred commission A real estate commission paid at a later date or over time. See *residual*.

deferred exchange The correct name for a real estate transaction which is often erroneously called a tax-free exchange. See *1031 exchange*.

deferred gain In a tax-deferred exchange, the amount of gain that escapes current taxation and is deferred until a later date, when the replacement property is sold. See *1031 exchange*.

deferred maintenance A physical deterioration of a property due to lack of periodic repairs, routine maintenance, and necessary replacements. Commenting that a property has deferred maintenance issues is a polite way of saying it appears shabby and needs work.

deferred payments Payments to be made at some point in the future. Some leases have deferred payment provisions rather than free-rent concessions. With deferred rent payments, the tenant pays no rent for the first 3 to 12 months, but then will pay higher-than-market rent for the balance of the lease term as the tenant makes payments on the rent that accrued in the early months.

deficiency The amount due on a mortgage loan after adding all expenses of foreclosure and accrued interest to the principal balance of the loan and then deducting the sale price or lender-bid price for the property. The balance remaining, if any, may be collected by the lender by means of taking a deficiency judgment, unless prohibited by law or contract. Deficiency judgments may be collected just like any other judgment, through seizure of other assets or garnishment. There are two circumstances when a lender may not collect any deficiency:

1. In states with consumer protection statutes that outlaw deficiencies on first mortgages on a borrower's principal residence.
2. With mortgage loans designated as nonrecourse, meaning the lender and borrower agreed in advance that the property would stand for the debt and there would be no deficiency allowed in the event of foreclosure.

deficiency judgment A lawsuit and judgment against a debtor for the remaining balance due on a promissory note after giving credit for any repossessed or foreclosed collateral.

> **Example:** *Sarah has a mortgage for $200,000 on her home. She defaults on her loan, and the bank forecloses. The bank sells the home at a foreclosure auction to a third party who bids only $160,000 because the home has been allowed to deteriorate and needs many repairs. Sarah still owes the bank $40,000 unless she lives in a state that does not allow deficiencies on home loans. The bank may sue Sarah and obtain a judgment for $40,000, called a deficiency judgment.*

definition of value In a formal appraisal, the bottom line—the statement with the appraiser's estimate of value, after all calculations, comparisons, and reconciliations.

delayed (tax-free) exchange See *1031 exchange*.

delinquency rate The number of loans with delinquencies divided by the total number of loans; also calculated alternatively as the total principal balances of loans with delinquencies divided by the total principal balances of all loans. Commercial lenders look at historical and current delinquency rates for differing types of properties—apartments, office buildings, warehouses, and others—as part of the analysis for the interest rates and terms they will offer on a particular loan.

delinquent Past due.

delivery The transfer of possession from one person to another. Deeds and leases require delivery before they are effective. Delivery does not depend on manual transfer, but does depend on the intent of the parties. Deeds are delivered when placed within the possession or control of the grantee in such a manner that the grantor cannot regain possession or control.

demand deposit account A checking account. One may demand payment of the money on deposit without penalty. Contrast with a certificate of deposit, in which one must pay a penalty if the money is withdrawn early.

demand loan A loan that states it is due upon demand, rather than on any certain date or upon the happening of a certain event. For purposes of calculating the statute of limitations within which to sue on a demand loan, it is treated as if demand were made and default occurred on the very first day the loan was made, even if that did not truly happen in fact.

de minimis PUD A planned unit development (PUD) in which the common areas have minimal value; a no-frills project.

de minimis settlement A settlement agreement between the Environmental Protection Agency (EPA) and a property owner who may be technically liable for cleanup under the strict liability provisions of the Superfund, but who did not create nor contribute to the contamination and who acquired the property without knowing or having reason to know of the earlier contamination. Although a de minimis settlement is always a possibility, the EPA is by no means required to offer such a deal, so it is truly "buyer beware." See *CERCLA*.

demise A transfer of an interest in real property for a certain number of years, for life, or at will. This is why leases often refer to "the demised premises." The use of the word demise in an instrument automatically triggers the grantor's liability for the warranty of quiet enjoyment.

demised premises The property leased. See *demise*.

demising partition or wall A wall separating two tenants or separating a tenant's space from a corridor or other common area space.

demographic Pertaining to characteristics of the population, such as race, age, household income, median home price, and number of inhabitants per household. The U.S. Census Bureau (www.census.gov) collects a wealth of demographic data.

Example: *Families without insurance, 2003 and 2004:*

	2003			2004		
Family Income	**Total (in millions)**	**Number Uninsured (in millions)**	**Percent Uninsured**	**Total (in millions)**	**Number Uninsured (in millions)**	**Percent Uninsured**
All	288,280	44,961	15.6%	291,155	45,820	15.7%
Less than $250,000	73,881	19,603	26.5	73,012	19,437	26.6
$25,000 to $49,999	74,278	13,221	17.8	73,791	13,565	18.4
$50,000 to $74,999	53,672	6,018	11.2	54,982	6,373	11.6
$75,000 or more	86,449	6,119	7.1	89,371	6,445	7.2

demography A study of the characteristics of people living in an area.

demolition A destruction and removal of some or all of an existing structure. The process of demolishing something is usually shortened to the verb *demo*, as in, "We're going to demo that space next week to prepare it for the next tenant." A demolition usually requires a permit from the same local government agency that issues construction permits.

demolition clause A clause that allows landlords to cancel a lease in the event they decide to demolish the building.

density In zoning, the number of things allowed per unit of land, such as number of houses, occupants, or families per acre.

Department of Housing and Urban Development (HUD) Created as a cabinet-level agency in 1965, the stated mission of HUD (www.hud.gov) is "to increase homeownership, support community development and increase access to affordable housing free from discrimination. To fulfill this mission, HUD will embrace high standards of ethics, management and accountability and forge new partnerships—particularly with faith-based and community organizations—that leverage resources and improve HUD's ability to be effective on the community level."

The most common HUD-related activities are

- Acquisition and sale of all FHA-insured homes that are foreclosed on
- Involvement in moderate-income and low-income housing
- Removing barriers to minority ownership of homes
- Community planning and development
- Native American housing

Department of the Interior (DOI) A department of the federal government, established in 1849 to take charge of the country's internal affairs. Lightheartedly referred to as the "department of everything else" at one time, it was originally responsible for all affairs not handled by the Department of Foreign Affairs (now the State Department), Treasury Department, and War (now Defense) Department. Today, it is responsible for Indian affairs, national parks, wildlife management, and surface mining, to name a few areas. More information is available at its Web site, www.doi.gov, which includes Webcams for several national parks and the city of Washington, D.C.

Department of Veterans Affairs (VA) Established on March 15, 1989, to replace the former Veterans Administration, it is currently the second largest of the 15 Cabinet departments and is headed by the secretary of veterans affairs. It provides a wide variety of programs, including guarantees of mortgage loans received by eligible veterans.

departure provision An older term rendered obsolete by the July 1, 2006, changes to the Uniform Standards of Professional Appraisal Practice (USPAP), but it is still frequently encountered. It refers to the ability of an appraiser to render less than a complete appraisal in certain limited situations and only if the person reading the appraisal would not be misled or confused. Omissions might include particular appraisal methods deemed unreliable or impractical under the circumstances.

depletion An accounting and tax term referring to deductions made to account for land becoming less valuable because of the removal of natural resources, including timber and geothermal deposits of hot water or hot rocks.

Examples of items eligible for the IRS depletion allowance under 26 U.S.C. §613(b) are

Borax	Marble	Carbon dioxide
Mollusk shells	Clay	Oil and gas
Coal	Potash	Copper
Sand	Gold	Silver
Granite	Shale	Gravel
Slate	Iron	Stone
Iron ore	Sulfur	Limestone
Timber		

For more information, see Publication 535, "Business Expenses," Chapter 10, "Depletion," available at the IRS Web site, www.irs.gov.

deposit Money paid to ensure performance under a written or oral contract. Many states require that lease and other such deposits be maintained in escrow accounts and earn interest which must be paid to the party when the deposit is refunded. All real estate brokers must place earnest money deposits in escrow accounts. One must carefully examine the particular contract language relative to deposits in order to determine the circumstances under which they may be withheld from the depositor.

Deposit Insurance Fund An entity under the control of the Federal Deposit Insurance Corporation, with two subfunds called the Bank Insurance Fund and the Savings Association Insurance Fund. Depositors are insured to the extent of $100,000 of deposits per depositor per insured institution. Bank customers who buy securities offered by the financial institution do not receive insurance for those securities. By law, one should see prominently displayed on all such literature: "Not Insured by FDIC."

deposition Out-of-court testimony under oath by a witness or other party either during the pendency of a lawsuit or in order to preserve evidence in the event of a lawsuit. The testimony is recorded and transcribed by a court reporter, and the deponent (the person giving the deposition testimony) then signs the transcript to confirm that it is a true and accurate record of the questions asked and the answers given. Deposition testimony is admissible in court under some circumstances if the deponent is unavailable to testify. Especially when dealing with elderly persons, if there is some dispute over title to real property or the effects of adverse possession, it is good practice to obtain deposition testimony.

Depository Institutions Deregulation and Monetary Control Act of 1980 Federal legislation that accomplished phenomenal deregulation of federally chartered financial institutions, leading to state deregulation so that state-chartered financial institutions could compete with their federal cousins. Regulation Q phased out the former limits on interest that could be paid on deposits. Many analysts say that the resulting unbridled competition for depositors' money, leading to a bidding war to gain depositors, drove financial institutions to make ever riskier loans in order to obtain the high interest rates necessary to service the deposits. According to such analysts, this legislation was one of the primary factors in the savings and loan crash, the banking crisis, and the FDIC bailout of the mid to late 1980s.

depreciable basis See *basis*.

depreciable life See *accelerated cost recovery system*.

depreciable real estate Property capable of supporting depreciation deductions. As a general rule of thumb, improvements may be depreciated but land may not. Land may be depleted, however, if minerals are extracted.

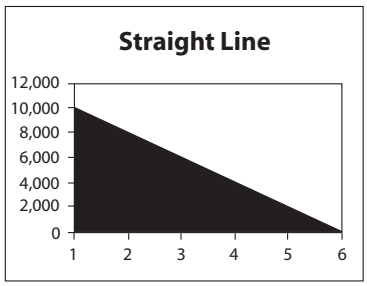
depreciated cost See *book value*.

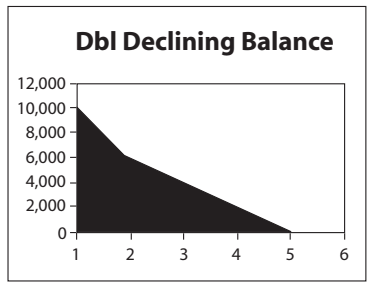
depreciation (1) In accounting, the process of deducting some portion of the acquisition cost of property over time, as an expense against income, to reflect the fact that the property is becoming

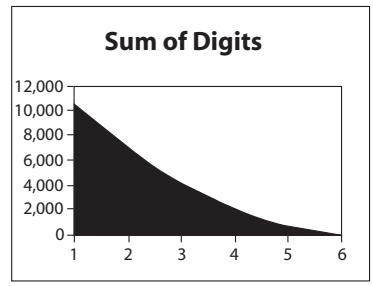
less valuable and will eventually require replacement. One cannot allow a $3,000,000 building to remain on the books for 35 years as an asset at the same value and then, suddenly one year, demolish the building, write off $3,000,000 against income for that particular year, and then construct another building or move. (2) In appraisal, a reduction in the calculations for the reproduction cost of an improvement, in order to arrive at a value of the improvement in its current state, not as it would be if it were reproduced and brand new.

depreciation methods Various accounting tools for calculating depreciation. The most common is the straight-line method, in which equal pro rata shares are deducted each year until one reaches $0 or a salvage value, as the circumstances may warrant. The second most common is the double-declining balance method. Some accountants still use the sum-of-the-years-digits method, although this is no longer allowed for tax purposes.

Example: *Following are three graphs representing the depreciating value of a $10,000 asset with a useful life of 5 years and a salvage value of $0, using the three different methods.*







depreciation recapture A tax law provision that some depreciation expenses taken on real property must be "recaptured" upon a sale of the asset and taxes paid at ordinary income rates rather than capital gains rates. Ordinarily, property held for more than one year and then sold will qualify for capital gains tax rates, which are lower than ordinary income tax rates.

There are two exceptions in which some or all of the gain must be taxed at ordinary income rates:

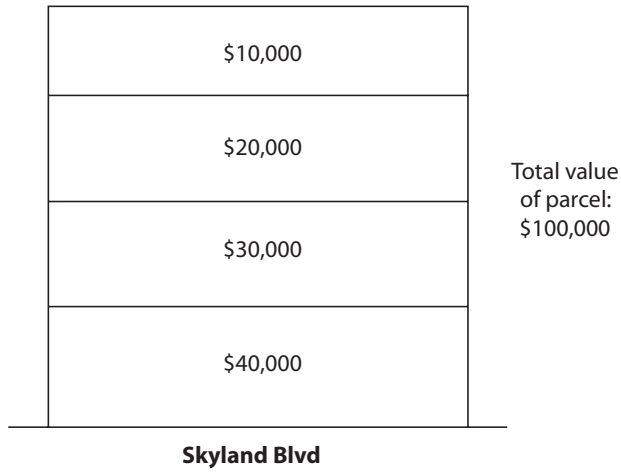
1. If depreciation was taken on personal property, that portion of the gain that is equal to total depreciation taken over the years will be taxed at ordinary income rates.
2. If accelerated depreciation was taken on real property (see *depreciation methods* for an explanation), then that portion of the gain represented by the difference between straight-line depreciation and the accelerated depreciation will be taxed at ordinary income rates.

depth The distance between the front and the rear property line of a lot. Because local government rights-of-way for streets and sidewalks may exceed the actual width of the pavement, the lot depth may be less than the visible yard.

depth tables In a tax assessment appraisal, a set of tables that evaluate the relative value of artificially defined slices of property as one proceeds at greater depths from the street frontage. The first, and most simple, table is the 4–3–2–1 table. It describes the front quarter of a parcel as representing 40 percent of the total value, the next quarter as representing 30 percent of the value, the next

quarter as representing 20 percent of the value, and the rearmost quarter as representing 10 percent of the value. Commercial appraisers consider the use of depth tables unreliable.

Example: *Here is an example of a depth table.*



deraign To prove ownership of land; to trace the chain of title.

dereliction The gradual receding of water to leave dry land.

derivative acquisition See *acquisition*.

derivative investments Investments that rely on the performance of underlying assets in order to establish value and return profits.

descent A method of acquiring real property, when the prior owner dies without a will and the laws of intestate succession determine the person or persons who will acquire title by descent.

description The information in a deed that will precisely identify the land being conveyed, in such a manner that it cannot be confused with any other land. It is not appropriate to use a street address or a tax parcel identification number in a deed, except as additional information to aid in the description. There are three predominant types of description:

- Metes and bounds. Includes an independently verifiable starting point, distances of lines and directions, and angles between lines.
- Aliquot parts. Uses portions of one or more sections (640 acres), half sections (320 acres), quarter sections (160 acres), or quarter-quarter sections (40 acres).
- Subdivision plat. Makes reference to subdivision plats, such as "Lot 9, Block 3 according to the plat or map of Sunny Acres as recorded in the County records at Plat Book 182, Page 79."

designated broker See *principal broker*.

detached housing Homes with freestanding walls not shared with any other house. Contrast with row house, duplex, or townhome.

determinable fee See *future interest* and *fee simple determinable*.

detrimental reliance Taking an action or failing to take an action because of a representation made by another person that turned out to be untrue.

> **Example:** *Jake called his mortgage company to find out the remaining balance due on his home loan. The lender sent Jake a letter advising him the payoff was $28,312. The sum was small enough that Jake decided to sell his car to pay off the home loan, quit his job, and take a year off to write a novel. After he sent the money in, the mortgage company advised him that it had made a mistake and the payoff was really $48,312, so he needed to pay an additional $20,000 to satisfy the mortgage. A court may apply the theory of estoppel against the mortgage company and force it to satisfy the loan without any additional money, because Jake had detrimental reliance on the mortgage company's representations.*

developer One who transforms raw land into improved real estate.

developer profit The increase in value caused by the efforts of a developer.

development The process of improving raw land.

development impact fee See *impact fees*.

development loan A loan used to develop real property, which includes not just construction of the improvements, but also excavation work, infrastructure such as storm sewers and roads, and the holding costs of the property until such time as it can be sold or can support fully amortizing permanent financing. Contrast with a construction loan, for building improvements only.

devise A transfer of real property by virtue of the provisions in a will. Contrast with descent, which is a transfer by virtue of statutory provisions controlling ownership of real estate when one dies without a will.

devisee A person who inherits real property by virtue of provisions in a will.

diffused surface waters Water that comes from rain, melting snow, or underground springs and that spreads over the surface of the land. The concept is important because

1. Applicable local environmental laws may require developers to provide siltation and erosion control for diffused surface waters traveling over disturbed land.
2. In some states, called common enemy states, property owners may do what they want with diffused surface waters—impound them and deny water to lower landowners, or dam one's own land to prevent a watershed and cause flooding to the upper landowners.

3. In other states, using the civil law rule, property owners may not dam diffused surface waters to the damage of upper owners, nor may they impound diffused surface waters and deny water to lower property owners.
4. Still other states use the common enemy rule for urban land and the civil law rule for rural land.

diluvion The gradual washing away of soil along a watercourse. Contrast with accretion, the gradual adding of soil to land along a watercourse.

DINK An abbreviation for "dual income, no kids." A slang expression for a particular income market.

dinosaur pen A traditional mainframe computer room complete with raised floor, special power, and its own ultraheavy air conditioning.

DIP See *debtor in possession*.

direct capitalization Dividing the net operating income of a property by a selected capitalization rate to arrive at a value. Contrast with *yield capitalization*.

direct costs Construction costs that are readily identifiable, such as labor, materials, and construction management fees. Contrast with indirect or soft costs which cover an allocation for overhead plus all expenses spent away from the construction site, such as legal, accounting, permitting, and construction period interest. Sometimes called hard costs.

direct endorsement A mechanism that allows HUD-approved lending institutions to approve FHA mortgage insurance themselves, without having to submit paperwork to HUD and wait for approvals.

directional growth The direction in which a city or town seems to be growing. This is important in appraisal and in making decisions to purchase speculative real estate to hold for later sale or development.

direct participation program (DPP) An investment vehicle that allows parties to directly participate in the cash flows and tax benefits of the underlying property, without requiring any active management by the investor. The investment will be shares of a partnership, a subchapter S-corporation, a limited liability company, or some other entity that files an informational return with the IRS but does not itself have any taxable income or deductible losses.

direct reduction mortgage A mortgage loan in which at least a portion of each month's payment is used to reduce the principal balance of the loan—there is a direct reduction of the principal balance, resulting in next month's interest being smaller. When a borrower makes a fixed payment each month according to a fully amortizing loan schedule, the entire loan balance will eventually be paid by the anticipated maturity date. That is the most common type of direct reduction mortgage, but a wide variety of other options is possible.

direct sales comparison approach Formerly known as the market data approach, this is an appraisal method in which the property being appraised is compared to sales of similar properties in order to arrive at a value. The appraiser identifies the comparable properties as being similar in

time and somewhat similar in size, quality, use, and amenities, among other considerations. The appraiser then makes adjustments to the sales price of the comps, based on how they differ from the specific property.

> **Example:** *A home with a three-car garage might be reduced by $25,000 in order to make it comparable to the subject home with a two-car garage. After making the adjustments, the appraiser then reconciles all the comparables to arrive at an opinion of value for the subject property.*

disbursement Payment of money.

discharge in bankruptcy The release of a debtor from the payment of any and all debts except those specifically approved by a bankruptcy court.

disclaimer (1) The refusal or rejection of a right, as a disclaimer of an inheritance of environmentally contaminated property. (2) The limitation of a warranty or responsibility.

disclosure statement (1) Also called the Reg-Z box, information required by Regulation Z of the federal Truth in Lending Act. (2) Any other federally required or state-required document designed to inform consumers of rights, responsibilities, or property defects.

Annual Percentage Rate	Finance Charge	Amount Financed	Total of Payments
The cost of your credit at a yearly rate	The dollar amount the credit will cost you	The amount of credit provided to you or on your behalf	The amount you will have paid after you have made all payments as scheduled
A%	**$B**	**$C**	**$D**

A: The annual cost of the loan, as a percentage. Usually higher than the quoted interest rate because of the additional cost of prepaid interest and other finance charges.
B: If all payments are made on time, and the loan is paid in full over its expected term, "B" is the total of all interest, prepaid interest, and mortgage insurance payments over the life of the loan.
C: The loan you applied for, less prepaid interest and other up-front finance charges such as commitment fees, origination fees, or mortgage insurance premiums paid up front.
D: The total of all payments (principal, interest, and mortgage insurance) if the loan is paid in full over the entire term.

Disclosure is required by the Truth in Lending Act.

discount To sell at a reduced value, such as selling a $100,000, 30-year, 8 percent mortgage for $90,000 in order to raise immediate cash.

discount broker A real estate broker who offers limited services in return for a commission rate lower than what is generally available in the marketplace. The most common service offered is listing a property on a multiple listing service, but all prospective buyers are then referred directly to the owner.

discounted cash flow Also known as a present value analysis; an approach to analysis of an income-producing property by calculating the present value of a future income stream with the use of a discount rate. The two most common methods are the internal rate of return method and the present value method.

discounting The appraisal method of computing the value of an income-producing property by calculating the present value of anticipated cash flows.

discount points Mortgage fees charged by the lender and treated as additional interest above the face rate in the promissory note in order to obtain an effective rate higher than the stated rate. One point is equal to 1 percent of the loan.

discount rate The rate at which the Federal Reserve loans money to lenders to cover short-term cash needs, usually for overnight loans. Increases or decreases in the discount rate almost always signal similar increases or decreases in bank loan rates to customers, even though the two are not directly tied to each other.

discrimination (1) The act of making generalized distinctions among groups of people or things without inquiry into the specific characteristics of individuals within the group. This includes illegal discrimination such as that based on race, color, sex, age, disability, religion, or family status (protected classifications) and legal discrimination such as a builder's bias for or against local subcontractors. Federal and state laws prohibit denying or discouraging housing or credit choices for persons in protected classifications. (2) The unintentional but still illegal effect of barring certain groups of people from access to housing, credit, goods, or services because of their race, color, sex, age, disability, religion, or family status. This is called disparate impact. An example would be a prohibition against tenants having animals in their units, which would work a hardship to the sight-impaired who rely on guide dogs. (3) Specific federal laws addressing discrimination include the

- Americans with Disabilities Act
- Fair Housing Act provisions of the Civil Rights Act of 1964
- Equal Credit Opportunity Act

disintermediation The situation that exists when depositors withdraw their savings from financial institutions and invest the money directly in the marketplace, usually because they can obtain a higher yield even though also running a higher risk of losing their money.

disparate impact A legal doctrine in discrimination cases whereby the plaintiff demonstrates a type of discrimination that is perhaps not intentional, but which has the effect of barring certain

citizens from full access to rights, property, or experiences. The courts may examine a policy that appears neutral on its face but which has a different (disparate) impact on a protected class than others. Once a plaintiff in a lawsuit proves that a disparate impact exists, the defendant must then prove there is a valid and nondiscriminatory reason for the statistical imbalance.

disposal field The area where wastewater from a septic tank drains into specially prepared ground for further purification.

disposition costs The seller's expenses of sale.

dispossess proceeding One name for the legal proceeding commonly known as an eviction.

disseisin The wrongful deprivation of possession of real property; a wrongful eviction.

dissolution A termination, as of an agreement, contract, corporation, or partnership.

Distinguished Real Estate Instructor (DREI) A designation granted by the Real Estate Educators Association (www.reea.org).

distraint The legal right of a landlord to obtain a court order and seize tenants' possessions to pay for back rent.

distressed property Real property that suffers a reduction in its market price because of pressures operating on the owner, such as threatened foreclosure, divorce, settlement of an estate, or fear of economic changes that might decrease the value.

distressed sale The sale of real property under circumstances creating great urgency on the part of the seller, such as impending foreclosure, divorce, relocation to another city, or any other such pressure.

distribution real estate The modern term for industrial real estate, because most industrial operations today involve assembling components and/or distributing goods rather than the old smokestack manufacturing uses.

divided interest An interest in some portion of the bundle of rights in real estate, such as a leasehold interest or a remainder interest. (This does not mean a particular percentage of interest or a cotenancy.)

doc-in-a-box A popular term for a neighborhood or other retail-type medical office specializing in walk-in patients.

dock-high building An industrial building with loading docks at the height of a delivery truck, opening to a floor at the same height.

dockominium Condominium ownership of a boat slip or dock. The owner sometimes obtains a deed to the small parcel of land under the water and has the right to use the common elements

consisting of the docks and perhaps some storage space, bathroom facilities, parking, and other such things. The concept is still relatively new and is meeting legal challenges from people claiming that it is inconsistent with doctrines of public trust and riparian rights. According to opponents, navigable waters are not subject to private ownership and, as a result, no one can sell condo-type rights in a boat slip upon the waters. (Before investing in a dockominium, it might be wise to check out the status of this emerging area of the law.)

documentary evidence Traditionally, evidence in the form of written papers or documents. Today, many government agencies, such as the IRS, accept printed versions of electronic documents when regulations require documentary evidence. See also *Uniform Electronic Transactions Act*.

documentary letter of credit Used somewhat like cashier's checks, but with more safeguards. The typical documentary letter of credit will allow payment to a vendor upon the vendor's presentation of the letter and certain documents, such as proof the goods were placed on board a vessel for shipment to the United States.

Dodge, F.W. A company that provides a wide variety of reports and services relevant to the construction industry. Its Web site is at www.fwdodge.construction.com.

dog Slang for an undesirable property.

domicile The place of one's principal residence.

dominant tenement (or estate) Land that benefits from an easement that burdens another property, called the servient tenement.

donee One who receives a gift.

donor One who gives a gift.

dormitory town See *bedroom community*.

dotal property An archaic term meaning the property the wife brings into a marriage in order to assist her husband in setting up the household.

double declining balance An accounting method employed to approximate the situation of an asset losing value (depreciating) more rapidly in the early years after acquisition and then more slowly in later years.

double escrow A process of flipping a property in a simultaneous closing. If anybody defaults, then everybody defaults.

double-load corridor A building design in which there are apartments or other individual units on both sides of a passage corridor. Contrast with single-load corridor.

double taxation A situation said to exist when a corporation must pay taxes on income, make dividend payments to shareholders on after-tax dollars, and then the shareholders must again pay taxes on the dividends. This is the situation with normal corporations, called C-corporations, that do not qualify for S-corporation (small corporation) status. S-corporations file reports allocating pro rata shares of all income to the individual shareholders, who then pay taxes on that number. The corporation itself does not pay any taxes.

dower A widow's rights in the real property of her deceased husband. The similar right of a widower in his deceased wife's property is called curtesy. Many states have abolished these rights and replaced them with a more generic homestead right or surviving spouse's share.

down payment The balance of the purchase price for property after credits for money contributed by lenders. See *equity*.

downzoning The process of changing the zoning on a parcel to a use that is less intensive than formerly allowed. Property once zoned for multifamily residential use might be downzoned to single-family residential use.

dragnet clause A clause in a mortgage loan that spreads a dragnet, which, in fishing, is a large net dragged across an area in order to capture everything it encounters. Similarly, a mortgage dragnet clause attempts to capture as much as possible for the lender. There are three types; some or all may appear in a mortgage loan. One seeks to make all debts of the borrower includable in the mortgage so that even a checking account overdraft may be deducted from sale proceeds when the property is sold. Another type attempts to extend the mortgage to other properties acquired by the borrower at a later date. In addition, a dragnet clause can provide that default in any other loans will constitute a default in the mortgage loan, even if the mortgage payments are current. Courts disfavor dragnet clauses and tend to scrutinize them very carefully in order to limit their reach, or sometimes they even find them unenforceable. If opposed to a dragnet clause in a promissory note or mortgage, one should request its deletion.

drainage rights Legal principles regarding the ability of a property owner to divert the natural flow of water onto another property. Whether it is allowed or not depends on the state, sometimes on whether the land is urban or rural, or on what's reasonable under the circumstances.

draw (1) A request that a lender advance funds under a construction or other future-advances loan. (2) A periodic request by a contractor or subcontractor for a portion of the contract price for a job, usually according to the percentage of completion of the work and the cost of materials and labor.

DREI See *distinguished real estate instructor*.

dresser drawer title See *trunk title*.

drill track A segment of rail track that connects various individual industrial spurs to the main railway. When negotiating for the purchase or lease of industrial property, one should make sure there are provisions for a drill track, which usually requires easements over the properties of other owners.

drive-by appraisal A value estimate made without examining the interior of a property. There is nothing inherently wrong with such an appraisal, as long as it is disclosed.

Drug Enforcement Act Relevant to real estate as it allows seizure of real property if illegal drug activities take place on it. Innocent owners may successfully contest the seizure after expending large sums of money to lawyers to prove that the owner had no involvement and no knowledge of the drug activity or took steps to stop the illegal activity but was unsuccessful. (The lesson for property owners is that if you are suspicious about drug-related activity in your apartments or other properties, you cannot take a "live and let live" approach to the problem.)

dry closing A closing that is completed except for the disbursement of money and delivery of documents. Often used when a buyer delivers a personal check at the closing and the closing company must wait until the funds are collected in order to complete closing.

dry hole clause A provision in an oil and gas lease that specifies rent payments in the event of a dry well.

dry in To install black roofing felt (tar paper) on a roof. When completed, one says the building is "in the dry" or "in the black."

dry mortgage A nonrecourse mortgage, in which the lender looks solely to the property for recovery in the event of default and has no rights to sue the borrower for a deficiency judgment if the property is worth less than the loan balance at the time of foreclosure.

Dryvit A brand name for a particular exterior insulation and finish system (EIFS) that resembles stucco. There has been extensive class-action litigation as a result of claimed deficiencies in the system as a whole, not just the Dryvit brand. Unfortunately, Dryvit has come to be synonymous with the entire industry, much the same as Xerox for copiers and Kleenex for facial tissues.

drywall Also called wallboard or gypsum board, it is a panel of gypsum covered on both sides with paper and used as the primary wall material in home construction. Commonly also called by a particular brand name, Sheetrock.

dual agency A relationship in which an agent represents two principals—clients—who may have competing interests. Most often encountered when one agent in a real estate company has a listing on a property and represents the seller, and another agent has a buyer-agency relationship with a buyer interested in the same property. Technically speaking, the managing broker is the agent of both parties and acts as a dual agent.

dual contract The illegal and unethical practice of providing two different sets of contracts for the same transaction—usually one at an inflated price so that 80 or 90 percent financing will, in actuality, pay 100 percent of the true purchase price. This practice constitutes fraud.

due care A legal concept meaning just, proper, and sufficient care under the circumstances. It is the care that would be taken by a reasonable person. For example, tenants are required to take due care of leased property and not use a barbecue grill in the living room.

due diligence The process of investigating all facts, conditions, rules, laws, regulations, financial considerations, or any other such matters as would affect one's decision to purchase property. The various types of investigations as would comprise due diligence will vary from property to property. With the purchase of a home, it might include nothing more than a home inspection, termite report, and a review of any restrictive covenants. When purchasing raw land for development, it could include zoning issues, possible environmental contamination, surveys, soil compaction studies, analysis of cost to develop versus value when completed, and so on as far as the imagination can go.

due-on-sale clause A clause in almost all mortgage loans providing that the entire balance of the loan will be due and payable if the property is sold, even if all payments are current and there has never been a default; effectively destroyed former widespread ability to assume mortgages. The clause allows lenders to control their interest rate exposure in a rising market, so they are not left with a portfolio full of low-interest-rate loans in an era of high interest rates. It also allows lenders to fully investigate any purchaser and make independent underwriting decisions about that purchaser and whether to extend a loan or not. A due-on-sale clause is not enforceable against someone who inherits property from a relative and intends to live in that property as a principal residence. See also *assumable loan*.

dummy A straw man, as when a developer desires to purchase a number of properties in order to assemble them and build a shopping center but is afraid that owners will increase their asking prices if they know the true name of the buyer. Owners sell to the dummy, who then transfers to the developer.

duplex A building separated into two homes.

durable lease A lease with an annual rent and a term "for as long as the grass grows or the water runs." In most states, leases over 20 years in length must be recorded or they are void for their period beyond 20 years, and leases longer than 99 years are void for any longer periods, even if properly recorded.

durable power of attorney A power of attorney instrument gives one person—the attorney in fact—the power to act for another in a general manner for all things, or for specifically listed things or areas described in the power. The power ceases as soon as the person granting it—the principal—dies or becomes legally incompetent. A durable power of attorney is different, in that it continues even though the principal becomes incompetent, but still terminates upon death. Used by many elderly people to allow children to manage their affairs in the event of mental disability, but without the stigma, expense, and court oversight of a formal declaration of incompetence and appointment of a guardian.

duress Unlawful pressure, force, or threats by one person against another. If one is the victim of duress, then any contract or agreement entered into as a result of the duress is void. The operative word in the definition is "unlawful." Many people claim economic duress when a lender, for example, threatens foreclosure unless a borrower signs a new loan agreement with onerous terms, a high

interest rate, and large fees for attorneys and other expenses. Usually, if the lender had the right to foreclose, then the threats cannot be unlawful and duress does not exist.

Dutch auction An auction in which the asking price is lowered gradually until someone is willing to pay at that level, and the property is then sold to that person. Contrast with the typical auction practice in which the auctioneer asks a high price, lowers it until someone places a bid, and then the auctioneer attempts to obtain higher bids to increase the price from there.

duty to disclose The legal responsibility of a seller, broker, or agent to tell a potential buyer about a defect in the premises. Some states have laws requiring disclosure of certain named and described conditions in addition to anything else that might constitute a defect.

dwelling A place of habitation.

dwelling defense In most states, people are allowed to use some degree of force to protect their dwelling and the inhabitants. They may not set traps for intruders, and they are usually entitled to use only the force reasonably necessary under the circumstances to deter the intruder. Some states allow deadly force, however, without any requirement that the home occupant first attempt to escape, or "otherwise avoid using force with complete safety." The defense is based on 500-year-old English court decisions that one's home is one's castle and entitled to defense. See *castle—man's home as*.

DWV (drain-waste-vent) The section of a plumbing system that carries water and sewer gases out of a home.

E

early occupancy If agreed among the parties, the ability of a purchaser to take possession of property before closing. Under some circumstances, a buyer who takes early occupancy may be considered as assuming the risk of loss if there is a fire or other destruction of the property. In other words, the buyer may be obligated to proceed to closing at the full purchase price, even if the seller has no insurance coverage.

earnest money A deposit of money made by the purchaser of real estate. It can serve the following purposes:

- It shows evidence of economic resources and the probable ability to proceed to closing.
- It provides hostage value because of the usual contract provision that seller may retain the earnest money in the event of default.
- It may allow enforcement of a contract that might be defective on purely technical grounds. For example, some states allow enforcement of an oral real estate contract when there has been partial performance by the payment of earnest money. This occurs often, as when a buyer submits a written offer for property and an earnest money check. The seller makes a verbal counteroffer, and the buyer verbally accepts. The seller deposits the check. No one ever thinks to prepare a new written contract for signatures. Standing alone, this is an oral contract that is unenforceable under the Statute of Frauds.

earnest money contract A real estate purchase contract with a provision for earnest money.

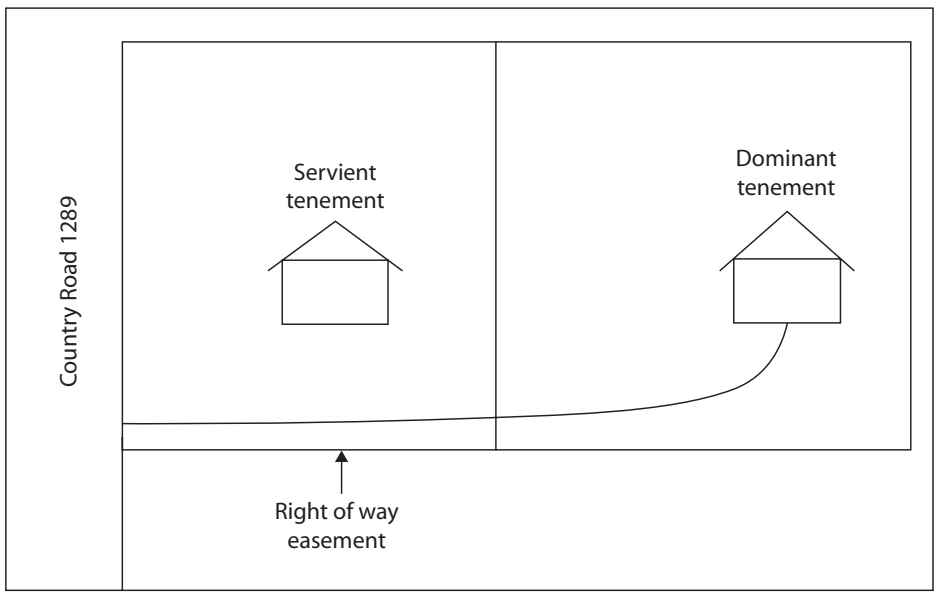
earnings before interest, taxes, depreciation, and amortization (EBITDA) (pronounced "ee-bit-dah") Net earnings of a business before deductions for interest, taxes, or depreciation. It often provides the standard for purchase of income-producing properties or going-concern businesses, with buyers and sellers conducting negotiations in terms of multiples of EBITDA, such as an offer to buy at "seven times EBITDA."

earthquake strap A metal strap used to secure gas water heaters to the framing or foundation of a house; intended to reduce the chances of having the water heater fall over in an earthquake and cause a gas leak.

easement A nonpossessory right to use another's property. Easements may be created by express words of grant in a written document, by prescription (unrestricted usage over time resulting in property rights), or by necessity, as when the law will force the grant of ingress and egress rights for landlocked property.

- Easements are said to be appurtenant or in gross. If appurtenant, then the easement benefits one property and burdens another one. The property being benefited is called the dominant estate, dominant tenement, or dominant hereditament—they all mean much the same thing. The one with the burden is called the servient estate, tenement, or hereditament.
- Easements appurtenant stay with the land, no matter who owns it or how many times the land changes hands. An example is a right-of-way easement.
- If the easement is in gross, then it is personal to someone and does not benefit a particular property. A common example is a power line easement. The easement stays in effect no matter who owns the land burdened by the easement, but typically expires with the death of the owner of the easement.
- An easement may not unduly burden the property.

Example: *A right-of-way easement may have been originally granted so one farmer could cross the property of another to reach another field. Later, one farm is sold to someone who plans to build a 250-home subdivision and use the right-of-way as the construction entrance. Courts will not allow this.*



easement by necessity The legal ability of a property owner to use a right-of-way over the lands of another because the owner's property is landlocked and has no direct access to any public roads. Generally, the right-of-way must be a route that places the least burden on the other property, even if it is inconvenient for the landlocked property owner. See *easement*.

EBITDA (pronounced ee-bit-dah) See *earnings before interest, taxes, depreciation, and amortization*.

echo boomers Children of baby boomers; a distinct demographic with identifiable buying habits.

economic feasibility See *feasibility study*.

economic life The period of time during which an improvement has value in excess of its salvage value; the useful life span of an improvement.

economic obsolescence A factor that reduces the value of an improvement because of something external to the property itself. A well-built and well-maintained house may suffer economic obsolescence because it is located on one acre of land in the middle of a fast-food area on a major suburban road. The improvement—the house—no longer has any value at all. In this example, though, that hardly matters because the land is worth vastly more than the original homeowners ever dreamed.

economic rent The rent reasonably to be anticipated in the marketplace as opposed to the actual rent. For an investor familiar with economic rents in an area, there are usually many opportunities to buy properties at values based on contract rents, and then raise the rents and realize immediate growth in equity and the ability to refinance for amounts in excess of the original purchase price. Also called market rent.

effective age The apparent age of an improvement rather than its actual age.

effective gross income The anticipated gross income from a rental property after deducting an estimated amount for vacancies and bad debt.

effective interest rate The actual interest rate of a loan, regardless of the face interest rate or the rate quoted. See *annual percentage rate*.

effective procuring cause The broker who first obtains the serious attention of a buyer and brings the parties together.

effective rental rate True rent, after taking into account rent concessions; usually expressed as a dollar amount per square foot. Some parts of the country quote rents as dollars per foot per month; others use dollars per foot per year.

> **Example:** *If 5,000 square feet of office space normally rents for $20 per foot per year, but the landlord gives 6 months' free rent on a 5-year lease, then the effective rental rate is calculated as follows:*
>
> *5,000 feet × $20 per foot = $100,000 per year*
>
> *6 months free rent = $0*
>
> *4.5 years paid rent @ $100,000 per year = $450,000*
>
> *$450,000 paid rent spread over a 5-year term = $90,000 per year effective rent*
>
> *$90,000 effective rent ÷ 5,000 feet = $18 per foot effective rental rate*

effective yield A calculation of the return on an investment that considers the price paid, the time held, and the interest received.

efficiency apartment A small apartment with living, sleeping, and cooking areas all contained in one room.

efficiency ratio The ratio of leasable space to gross space in a building. When planning a building, it is important to balance the need to maximize the efficiency ratio in order to lease the maximum amount of space possible, against the aesthetic need to have wide corridors and open spaces.

efflux The expiration of a prescribed period of time, such as the end of a lease.

egress An exit.

EIFS See *exterior insulation and finish system*.

ejectment A legal action to restore possession of property to the party entitled to it.

ekistics The science of how people settle land areas, including urban development.

elasticity The ability of the real estate market to respond to price increases over a fairly short period of time.

elderly housing Housing occupied by persons 62 or older, or housing designed and marketed for persons 55 and older. Under the Fair Housing Act, elderly housing does not have to be made available to families.

election of remedies The necessity that injured parties make a selection of only one method of being compensated for their loss, rather than collecting multiple times in different ways. For example, if a certain lender behavior is a violation of the Equal Credit Opportunity Act and of local laws, the borrower may recover damages under one law, but not under both. In addition, some courts hold that when a seller breaches a contact to sell real estate, the buyer must choose between suing for damages or suing to force the seller to proceed with the sale. This does not prevent parties from suing for as many different theories as their lawyer can imagine, but they can have only one remedy at the end of the trial. (The concept of election of remedies is similar to the concept of double jeopardy—one can't be punished twice for the same wrong.)

elective share The ability of a surviving spouse to elect to take a specified percentage of the decedent's estate rather than the amount left by the will. Most states make some sort of provision so that a surviving spouse cannot be completely disinherited. The vehicle may be the common law rights of curtesy (the widower's share) or dower (the widow's share). Because of archaic concepts about the relative needs of surviving spouses, dower and curtesy did not provide the same benefits to husbands as to wives. As a result, many states passed statutes modifying the rules or even completely abolishing them in favor of a statutory scheme. The statutory system usually allows a surviving spouse to elect between taking what was provided in the will or taking a certain preset percentage of the decedent's estate.

electric lateral The trench or area in the yard where the electric service line (from a transformer or pedestal) is located, or the work of installing the electric service to a home.

electrical rough Work performed by the electrical contractor after the plumber and heating contractor are finished; normally the installation of all electric wires. The electrical contractor usually receives a substantial payment on its contract price at the completion of the electrical rough. Contrast with *electrical trim*.

electrical trim Work performed by the electrical contractor when the house is nearing completion. The electrician installs all plugs, switches, light fixtures, smoke detectors, appliance "pig tails," and bath ventilation fans and wires the furnace and "makes up" the electric house panel. The electrician does all work necessary to get the home ready to pass the municipal electrical final inspection.

electronic signature A method of sending identity verification over the Internet, usually through the use of a personal identification number (PIN).

eleemosynary corporation A nonprofit corporation. Also called a 501(c)(3) corporation.

elevation An orthographic (flattened; nonperspective) drawing of the various faces of a building, component, or improvement, showing examples of relevant details and something to indicate scale. One may have elevations of each side of a building, usually with a person standing nearby to illustrate scale; elevations of cabinets in kitchens or offices; or elevations of a storm sewer system showing a representation of the incline.

eluviation The movement of soil caused by excessive water within the soil.

emancipated minor (1) A child who is under the age of majority—18 or 21, depending on the jurisdiction—but who has taken advantage of state laws and obtained a court order to remove the disabilities of nonage and be declared a legal adult. As a result, such a child may enter into enforceable contracts and may, if not disallowed in the emancipation order, be allowed to sell real property. There is a difference of opinion among states about whether an emancipation order in one state will be given effect in another state. In other words, a child who has been emancipated in New York may or may not be allowed to enter into contracts or sell real property in another state. (2) A minor child may become emancipated from his or her parents when the child marries or enters the military service. The parents no longer have any rights or responsibilities concerning the child, but the child still may not enter enforceable contracts or sell real property until he or she has reached the legal age of majority or has obtained a court order removing the disabilities of nonage, as described earlier.

emblement A growing crop. Emblements are personal property and do not automatically pass with the land when a deed is executed. See also *fructus industriales*.

emerging markets A loosely defined term generally referring to countries with relatively stable governments, developing economies, and an increasing ability to spend money on consumer goods.

eminent domain The power of government to take land for the public good with the payment of just compensation. See *condemnation*.

empty nesters People whose children have matured, left the home, and established homes of their own. This demographic segment generally has disposable income, homes with large amounts

of equity, and a desire to change living arrangements either by going smaller, by moving to a completely different locale, or by the addition of a second home.

encapsulate To remediate hazardous waste by surrounding it, such as spraying a special coating on asbestos.

encroachment The trespass of an improvement upon the land of another.

encumber To place a burden or a charge upon property. Commonly used to mean placing a mortgage, but may include other liens, easements, covenants, and restrictions. The burden is called an encumbrance.

Endangered Species Act A federal law originally intended to protect endangered species on federal land, but expanded to include protections wherever found, including private property. The existence of a protected species on one's land may prevent development or dramatically increase the expenses. This is not considered a condemnation, so there is no government compensation.

end cap In a strip shopping center (long and rectangular with large amounts of road frontage), the retail space at either end is called the end cap. Chain restaurants usually desire freestanding space, but will accept end cap. Any establishment requiring a drive-through window, such as a fast-food restaurant, dry cleaning store, or bank, will need end-cap space.

end loan (1) A permanent mortgage financing placed after construction financing. (2) A loan to buy stock in a cooperative apartment so one may rent a particular unit under a proprietary lease.

end money An amount of money held in reserve in case project costs exceed estimates in a development. Called over-and-above money in FHA rental housing projects.

endorsement (also spelled indorsement) Placing one's signature on the back of a check or other negotiable instrument in order to transfer ownership to another. Endorsers warrant payment of the instrument unless they sign with the additional words "without recourse."

energy efficient home tax credit IRS income tax credits granted when a taxpayer installs energy-saving components in a residence. The amount of credit varies with the type and cost of the particular equipment or features. Contractors who build new homes are eligible for some of the credits. For more information, see IRS Publication 553, "Highlights of 2005 Tax Changes," at www.irs.gov.

enhancement An increase; a betterment.

enjoin To issue an order from a court commanding one to take some action or cease some action. See *injunction*.

enterprise zone An area with the availability of tax incentives, grant money, or low-cost loans offered by local government in order to assist in revitalization.

entertainment complex A shopping center that features theaters, restaurants, amusements, and related retail stores.

entire tenancy A sole possession by one person. See *tenancy in severalty*.

entitlement (1) To be owed something under the law, such as federal entitlement programs. (2) That portion of a VA-guaranteed loan that protects the lender in case the veteran defaults.

entity A legally created person as opposed to a natural person. May include corporations, partnerships, limited liability companies, associations, joint ventures, real estate investment trusts (REITs), and traditional trusts.

entrants Newcomers; people who enter a market.

entrepreneur One who assumes risk in order to combine knowledge, capital, and resources to create a venture that will hopefully return a profit.

entry for marriage in speech An ancient court order (writ) to recover land given to a man in consideration of his promise to marry a woman, but if he did not marry the woman within a reasonable time, married another woman, or entered the priesthood, he was obligated to return the land.

environmental assessment A study of land to determine if there are any factors such as would possibly give rise to concerns about hazardous materials, protected species, historic remains, or other such factors.

environmental impact statement A written report containing an analysis of the ecology and general environment of an area, together with projections regarding how that will change during construction of the project and after completion and public usage. These statements were originally required by the National Environmental Policy Act of 1969, but only for federal projects. Today, most state and local governments require these statements for all large projects and selected smaller ones. The vast collection of federal environmental impact statements, for projects ranging from Alaska to Antarctica, may be accessed online at the Web site for the Transportation Library of Northwestern University, nucat.library.northwestern.edu.

environmental obsolescence Same as *economic obsolescence*.

Environmental Protection Agency (EPA) A U.S. government agency established in 1970 to coordinate all federal activities relative to safeguarding the nation's air, water, and land from dangerous substances. Its oversight includes research, monitoring, standard setting, and enforcement matters.

The EPA Web site at www.epa.gov offers information regarding all programs, educational tools, enforcement actions, and current and pending legislation.

The most significant programs from a real estate perspective are the

- Clean Water Act
- Comprehensive Environmental Response, Compensation and Liability Act (CERCLA)
- Resource Conservation and Recovery Act

environmental site assessment (ESA) A report by an environmental engineer or other qualified professional regarding the existence of any environmental hazards or concerns.

EOY Abbreviation for "end of year."

EPA See *Environmental Protection Agency*.

epitome An abstract of title in book form.

Equal Credit Opportunity Act A federal law that ensures all consumers and businesses are given an equal chance to obtain credit, assuming they meet legitimate and legal underwriting guidelines. Enforcement is by a number of different agencies depending on the identity of the credit grantor. The FTC may bring an enforcement action against retail stores, utilities, and small loan companies, to name a few. The Office of the Comptroller of the Currency would be responsible for bank violations. No agency will intervene in private disputes, but it will monitor the patterns of violation and could make a decision to take action. Private individuals who believe they have been victims of a violation may bring private or class-action lawsuits against offenders. Among other things, it is illegal to

- Discourage an applicant because of sex, marital status, age, race, or national origin, or because they receive public assistance
- Ask an applicant to reveal his or her sex, race, national origin, or religion, except that it may ask that this information be voluntarily revealed in connection with a mortgage loan in order to compile statistics to assist the government in making sure discrimination does not take place
- Inquire about an applicant's plans to have or raise children
- Ask if an applicant receives alimony or child support, unless the applicant intends to rely on that income in order to qualify for the extension of credit
- Consider sex, marital status, race, national origin, or religion in making a decision to grant credit
- Consider whether you have a phone listing in your own name, although a creditor may consider whether you have a phone or not
- Consider the race of people in the neighborhood where the applicant wants to buy, refinance, or improve a house with borrowed funds
- Refuse to consider public assistance income the same as any other income
- Refuse to consider alimony or child support the same as any other income

It is not illegal to consider military status, citizenship, or sexual orientation, although specific state laws may extend protections to such groups. For more information, visit the FTC Web site at www.ftc.gov.

equal dignities rule A rule of law that if a contract must be in writing in order to satisfy the Statute of Frauds, then the authority of an agent to enter into such a contract must also be in writing.

equalization board A state or county agency responsible for ensuring consistency and fairness in real property tax assessments.

Equifax One of the three major credit reporting bureaus. It maintains a Web site at www.equifax.com. The other two bureaus are Experian and TransUnion. See also *Fair Credit Reporting Act*.

equitable conversion A doctrine commonly applied when death intervenes between the signing of a contract regarding real property and the actual closing. The purchase money and the real property are converted, or changed, into each other for purposes of determining the rights of heirs and surviving spouses. If a will left all personal property to one child and all real property to another, and the seller of real estate died before closing, then that particular parcel of property would be treated as if closing had taken place before death and the cash received, so that the child inheriting personal property would take the sale proceeds.

equitable lien A lien or charge on property arising because of some technical defect in a legal instrument such as a mortgage or because a court determines that the lien is only fair and just under the circumstances after considering all the facts.

equitable mortgage The declaration by a court that an instrument by which one is to pay money to another and, as a result, receive title to real property when all payments have been completed is in reality a mortgage, and the parties will be treated as if they had all the rights and responsibilities of a mortgage relationship. The exception is if an innocent third party buys the property; then the equitable mortgagor—the person making the payments—cannot recover the property but may only sue the seller for damages. See also *equitable lien*.

equitable ownership Describes the rights of a trust beneficiary in property, as opposed to the legal ownership resting in the name of the trustee.

equitable servitude A restriction on the use of land that runs with the land. It is often asserted when there is no writing and no legal document imposing any restrictions. Proponents will argue that the restriction is fair and just under the circumstances. If a court agrees with them, then an order will be issued describing the servitude and binding the land to it.

equitable theory of mortgages An operative theory in states that treat mortgages as instruments granting security rights to a lender, but legal title remains with the borrower at all times. These are called lien theory states. In lien theory states, lenders must usually resort to judicial foreclosure and obtain a court order authorizing sale of the property to satisfy a debt. The alternative is the title theory of mortgages and title theory states, in which the borrowers transfer legal title to the

lender, who holds it in trust for the borrower under a deed of trust. Foreclosure in such states is nonjudicial because the lender already has the legal title. Some states are called hybrid theory states and transfer title to the lender in an instrument called a mortgage rather than a deed of trust but allow nonjudicial foreclosures.

equitable title (1) The interest held by one who has agreed to purchase property but has not yet closed. (2) The title held by a trust beneficiary, because the trustee has legal title but the law recognizes the beneficiary as having rights. See also *equitable conversion*.

equity (1) The difference between the value of a property and the mortgage debt on it is said to be the equity. Under federal law, when one's equity in property reaches 22 percent of the value of the property—when the mortgage has been reduced to 78 percent of the value of the property—then private mortgage insurance is supposed to be automatically cancelled if it is in place. (2) The ability of a court to do what's fair under the circumstances, without regard to many of the technical requirements of the law. Because real estate has always enjoyed a protected status in the courts, it is usually easier to obtain equitable relief when real property is involved. As an example, in a boundary line dispute there might be no legal theory to find in favor of a property owner who accidentally builds part of his house on his neighbor's land. Nevertheless, almost no court will require the property owner to tear down the encroaching part of the house. Instead, the court will usually "do equity" and require the landowner to sell, and the house owner to buy, the small amount of land necessary to fix the problem.

equity buildup The gradual increase in a person's equity in property because of the monthly payments of principal that reduce a loan amount.

equity dividend The annual cash flow that an equity investor receives.

equity loan A line of credit secured by the equity in the borrower's home. It is open ended, meaning the borrower may take advances, pay down the line to reestablish it, and then take advances against it as needed; usually renewed on an annual basis, with adjustable interest rates tied to the lender's prime rate. (Often called a HELOC—home equity line of credit.)

equity of redemption The rights a mortgage borrower has to reclaim property after default and before foreclosure. It is a right in real estate and may be transferred by deed, but a bill of sale of the right to another will be unenforceable. Contrast with *right of redemption*.

equity REIT A real estate investment trust (REIT) with underlying investments in income-producing properties. Contrast with a mortgage REIT that invests in mortgages, but not physical properties.

equity participation See *participating mortgage*.

equity sharing loan See *participating mortgage*.

equity stripping A term applied to a variety of sleight-of-hand practices, most often:

- Offering to assist homeowners facing foreclosure through buying their home and then selling it back to them, usually at rates and on terms guaranteed to result in default and loss of all equity

- Protecting assets from creditors by encumbering the equity with loans from friendly creditors, such as relatives, who won't foreclose if you miss a few payments

equity yield rate The rate of return on the equity portion of an investment, taking into account the periodic cash flow after debt service and before taxes, plus proceeds from a sale.

erosion The slow wearing away by natural forces such as water and wind.

errors and omissions (E&O) insurance Insurance that protects against malpractice. Especially when working with a buyer's broker, who has a high degree of responsibility to anticipate problems and warn the client, one should ask for proof of E&O insurance before hiring a real estate professional.

escalation clause A clause in any of a wide variety of contractual or real property arrangements that allows one party to increase the price upon the happening of certain specified events. Long-term leases often have rent increases at 3- to 5-year intervals, with the adjustment being a certain stated amount, a percentage of then-current market rents, or an increase based on some index with the first year of the lease representing the benchmark and against which the index is measured.

> **Example:** *The parties agree that rent will increase in 5 years in the same proportion as the consumer price index (CPI) in 5 years bears to the current consumer price index. If the rent today is $4,000 per month and the CPI is 179, and in 5 years the CPI is 192, then the new rent is calculated at follows:*
>
> $192 \div 179 = 1.0726\%$
>
> $\$4{,}000 \times 1.0726\% = \$4{,}290.40$ *per month*

Other escalation clauses are used to increase the interest rate in a loan when there has been a default and to increase rent when a tenant remains in possession after expiration of its term.

escalator clause See *escalation clause*.

escalator mortgage See *adjustable-rate mortgage*.

escape clause A clause that allows one party or the other to cancel a contract without penalty upon the happening of certain described events or conditions. The most common ones in real estate are the ability to cancel a purchase contract if the buyer cannot secure acceptable financing or if the buyer cannot sell his or her own home.

escarpment A long, steep face of rock or dirt.

escheat The reversion of property to the state because of the lack of anyone to inherit it.

escrow The process in which money and/or documents are held in trust by a disinterested third party who will consummate the instructions of the parties as expressed in their contracts. The third party is called the escrow agent. The escrow agreement usually contains a clause providing that if the parties disagree about something and are unable to resolve their differences, the escrow

company will pay all money on hand into court in an action called an interpleader, name the disputing parties as defendants, disclaim any interest of its own in the property except for reimbursement for costs and expenses of bringing the interpleader action, and then let the parties battle it out in court. This effectively takes the escrow company out of the middle of any disputes and avoids liability on its part.

escrow account (1) A separate bank account for keeping money that is the property of others. Attorneys and real estate agents are required to keep escrow accounts for client money and not commingle client money with their own funds. (2) An accounting entry by a mortgage lender showing the amount on hand from the borrower's monthly budget loan payments to pay real estate taxes and insurance when those bills become due.

escrow agent A person or firm who agrees to hold funds for others and disburse them according to lawful instructions.

escrow analysis With a budget loan, the mortgage lender's annual analysis of funds collected each month from the borrower for insurance and real estate taxes, the amount actually expended for those bills at year end, and the amount the monthly payments must increase or possibly decrease in the next year to provide the appropriate level of funds to pay the next year's bills.

escrow closing See *closing*.

escrow payment That portion of the monthly payments in a budget loan that will be accumulated by the lender and then used to pay insurance and real estate taxes.

estate (1) All the property of a person who has died. (2) The degree, quantity, nature, and extent of legal interest that a person has in real and personal property. The most common estates are

1. In fee simple absolute. This is the greatest degree of ownership possible, in which a person owns all rights to a property and may freely dispose of them to purchasers or heirs.
2. At sufferance. In this type of estate a tenant continues to retain possession past the expiration of the lease.
3. At will. A tenant is put into possession by the owner of land, but the possession may be terminated at the will of the owner.
4. By the entirety. This is a joint estate held by two persons who are married to each other at the time of creation and which cannot be destroyed by either one of them or by the creditors of the other. In some states, a divorce court may not even divide the property, but the parties must agree on its disposition.
5. For life. In this estate, someone has an interest in property that lasts only as long as some life named or described in the granting instrument.
6. For years. This is typically a lease.
7. In remainder. In this type of estate a person takes property after the death of a person with a defining life in a life estate.
8. In reversion. That portion of an estate that remains in a grantor who transfers less than full ownership of a property. For example, if the owner of property transfers a life estate

to another, the owner retains an estate in reversion and will regain full ownership when the life tenancy ends. If that future interest were also transferred to another, it would be called a remainder, but since it is retained by the grantor it is called a reversion.

9. In severalty. This term can be confusing, because it means the opposite of our common understanding of the word "several." An estate in severalty is an estate owned by one person, alone.

estate tax A tax imposed on the value of the estate of a decedent. The conceptual justification is premised on a peculiarly American notion that it is undesirable for generations to accumulate wealth by passing it to each other in a manner similar to that of English aristocracy and that each generation should make its own mark and earn its own way. As a result, it is considered advantageous to remove wealth from each generation by way of estate taxes and use the money for the common good. For details, see Publication 554, "Survivors, Executors and Administrators" available at the IRS Web site, www.irs.gov.

estoppel A doctrine that stops one from denying facts or taking a course of action because it would be unfair under the circumstances. It may be because someone else relied on former statements regarding the facts or because someone else relied upon a situation allowed to exist by a party, so that the party cannot now be allowed to change that situation. The concept commonly arises in three situations:

1. Before the sale of an income-producing property, the tenants sign estoppel certificates acknowledging they have no claims against the landlord, no defenses to any of the terms or conditions of their lease, and no outside or "side" agreements varying the terms of the lease. After the sale, the tenant cannot claim otherwise, even if all parties agree that there has been
   a wrong done to the tenant by the prior landlord and the tenant would otherwise be able to cancel the lease if it were not for the estoppel certificate.
2. A subdivision with restrictive covenants grows lax in the enforcement of them and permits many violations over the years regarding, for example, parking boats and motor homes in
   driveways. If one buys a home in the subdivision and keeps a motor home in the driveway,
   the principle of estoppel will prevent the homeowners association from suddenly deciding
   to enforce that particular covenant.
3. A government employee tells someone one thing, and it later turns out to be wrong. The citizen has already taken action on the incorrect information. In most circumstances, courts will not allow estoppel against a government or government agency.

estoppel by deed A legal concept that comes into play when someone deeds real property to another, even though not having title at the time—usually due to a technical defect. When the sellers later gain legal title through clearing up the technical defect or otherwise, they cannot claim the property as their own because of estoppel by deed.

estoppel certificate See *estoppel*.

estovers The right or privilege of a tenant to take so much from the land as is necessary for support, such as the right to cut timber for heating.

et con From the Latin et conjunx, meaning "and husband." Used in deeds and deed records. Also called et vir.

et ux From the Latin et uxor, meaning "and wife." Used in deeds and deed records. Usage arose in the 1300s in England, when wives had no legal identity and therefore were not named in legal instruments. Despite the dramatic change in circumstances today, one still sees deed references to "John Jones et ux…"

et vir Latin for "and man," it is often used interchangeably with "et con" to mean "and husband."

evaluation A study of potential property uses, but not value.

eviction The process of denying possession to a tenant. It may be one of the following:

- Actual, as when the landlord obtains a court order that the tenant vacate the premises or have his or her goods and person removed by law enforcement officials.
- Constructive, as when the landlord allows a condition to continue that renders the premises, or a part of the premises, incapable of possession and enjoyment.

evidence of title Proof that one has title to property; may be deeds, court orders, probate estate proceedings, or Torrens certificates.

examination of title The process of investigating title to real estate, usually confined to recent records.

exception (1) Estates or described lands specifically spelled out in a deed as not passing to the grantee. (2) Liens and claims specifically excluded from the coverage of a title insurance policy. (3) Liens and claims specifically excluded from a contract of sale.

excess land Land taken by eminent domain in a condemnation proceeding, but which is greater than the amount actually needed for the project in mind. A government may condemn excess land because the portion remaining after the amount actually needed may be rendered completely useless. In such a circumstance, the authority would have to pay for the condemned land and pay damages for the loss in value of the remaining land. It may be cheaper to simply take all the land and then attempt to sell the excess, especially if there are several excess parcels that are contiguous to each other.

excess rent A contract rent that is in excess of current market rents. In a bankruptcy proceeding, a bankrupt tenant may renegotiate a lease in order to remove the excess rent.

exchange Parties may exchange like-kind properties and not pay any income taxes at the time of the exchange but, instead, defer them until the later sale of the exchanged property. See *1031 exchange*.

exclusionary zoning Zoning that has the effect of excluding persons protected by law from discrimination.

exclusive agency Same as exclusive agency listing.

exclusive agency listing A relationship with a seller of real estate in which a broker has the exclusive right to list the property and receive a commission except that if the owner sells the property to one not obtained by the listing agent or its advertising and marketing efforts, then the owner need not pay a commission. Contrast with *exclusive right to sell listing*.

exclusive right to sell listing A relationship with a seller of real estate in which a broker has the exclusive right to list and to sell the property, so that even if the owner sells to his or her child, with no involvement whatsoever from the broker, the broker is still entitled to a commission. This is done to avoid disputes over who procured a particular buyer. Sellers who wish to exclude certain persons from the effect of the agreement should describe them, such as "except for the following named potential buyers …" or "except for sales to family members related in the third degree… ." Contrast with *exclusive agency listing*.

exculpatory clause (1) A clause in a mortgage that allows the borrower to surrender the property to a lender without any further personal liability for a deficiency. (2) A clause in a trust instrument or in a will excusing the trustee or executor from liability when powers are exercised in error but in good faith.

execute To complete, as by signing a contract or signing and delivering a deed.

executed contract A contract that has been fully performed by all sides; contrast with *executory contract*.

executive suite An older term for a business center, a business arrangement granting no leasehold interests but allowing persons to enjoy the use of office space with a sharing of amenities such as conference rooms, lobby, phone system, copiers, and network facilities, as well as a sharing of clerical, support help, and facilities and personnel management.

executor One named in a will to fulfill the wishes of a decedent regarding the disposition of assets. Today, the word refers to both males and females serving in that capacity. At one time, executor referred only to males, and the female was called an executrix.

executory contract A contract under which one or more parties has not yet completed their performance.

executory interest A general term used to describe all future interests other than reversions or remainders; an interest that will shift from one owner to another or spring into being upon the happening of some event in the future.

executrix An older term meaning a female executor.

exemplary damages The same thing as punitive damages. See *damages*.

expansion option A right granted by the landlord to the tenant where the tenant has the option to add more space to the premises according to the terms of the option, which may contain restrictions as to the time, proximity, and rental rate, or the restriction that the option is available only if another named or described tenant fails to exercise its expansion option first.

expense ratio A comparison of the operating expenses to potential gross income of a property in order to obtain a ratio that can be compared to other similar properties. In this manner, the owner may receive advance warning that rents are below market or expenses are too high. In addition, a potential buyer familiar with the ratios for similar properties may be forewarned if there is an unusually small ratio in a property under consideration. This could be the result of a seller not spending the proper sums to maintain and manage property, a seller performing its own maintenance without booking any expenses that might be incurred after the buyer takes over the property, or the seller omitting expenses. Purchasers interested in buying self-managed and maintained property will generally estimate a reasonable maintenance and management expense, and then reevaluate the estimated net income and the asking price in light of that information.

expenses The cost of maintaining property or generating income.

expense stop In a commercial lease, a provision that annual rent escalations due to increasing building operating expenses will be stopped, or capped, at a certain amount of increase per year or over the lifetime of the lease.

Experian One of the three major credit reporting agencies. The other two are TransUnion and Equifax. The Web site for Experian is at www.experian.com. See also *Fair Credit Reporting Act*.

expire To end; to die.

exposure (1) In finance, the amount that one may lose in an investment; the potential loss, which could be the capital invested plus any personal liability on loans in excess of the value of the property securing the loans. (2) In the market, the process of making a property known to the marketplace as available for sale or lease. (3) Physically, the direction of an improvement; for example, "The southern exposure of the house had all the best views."

express condition See *condition*.

express notice The actual delivery of information to a party. Contrast with *constructive notice* and *implied notice*.

express warranty Specific promises made by a party regarding the quality of something sold and the remedial actions that will be taken if the property sold does not conform with the promises.

expropriation The seizure of private property for public use by condemnation.

ex-situ Off-site; most commonly used in the context of ex-situ remediation of contaminated soil, which means removing the soil and replacing it with clean soil.

extended coverage Insurance that covers specific risks not covered in a normal policy.

extender clause A clause in a listing agreement that says the broker may be entitled to a commission after the expiration of the listing period if a buyer originally procured during the period later buys the property within a certain time span afterward, usually 6 months. When hiring a new broker after no success with an earlier one, an owner should always disclose a copy of the former contract and advise both brokers, in writing, that if there are any disputes as to claims for commission, the brokers must share rather than the owner being liable for double commission payments.

extension An agreement to defer the time for doing an act or for termination of a lease.

extension option An agreed-upon continuation of occupancy under the same conditions, as opposed to a renewal, which implies new terms or conditions. In a lease, it is a right granted by the landlord to the tenant whereby the tenant has the option to extend the lease for an additional period.

exterior insulation and finish system A cement-based synthetic material that resembles stucco and is used in the same way. It is usually abbreviated as EIFS. One widely known manufacturer is Dryvit.

external obsolescence Same as *economic obsolescence*.

eye appeal See *curb appeal*.

F

facade The front of a building; what one sees from the street. Sometimes a building is constructed of metal, but the facade is brick or some other attractive treatment. Zoning regulations, subdivision restrictions, and historic district requirements may specify particular building facades.

facade easement Typically, rights granted to historic groups so they can maintain control over the appearance of the exterior of a building.

face interest rate The interest rate shown on the face of a promissory note and used to calculate the monthly payments on a loan. In order to help borrowers compare apples to apples when shopping for a lender, the federal Truth in Lending Act requires lenders to reveal an annual percentage rate which includes the "face interest rate" plus the value of some closing costs and prepaid expenses.

face value The value of an instrument (promissory note, bond, stock, etc.) as stated on the face of the instrument. The face value does not always equal the market value.

> **Example:** *A 5-year-old mortgage note with a face value of $100,000 and an amortization term of 20 years at 2.8 percent interest is worth far less than $100,000 for two reasons: (1) The principal balance is now a little under $80,000. (2) Why would anyone invest even $80,000 to earn 2.8 percent interest when he or she can get better returns in the marketplace? For both reasons, an investor would pay much less than the $100,000 face value to buy the mortgage.*

facilitator Someone who helps out in a real estate transaction but owes no responsibilities to the buyer, the seller, the lender, or the borrower. A facilitator in a real estate transaction might contact a home inspector, arrange for a survey, assist with removing underwriting problems on a mortgage loan, and explain the computations for the buyers' and sellers' costs at closing. When working with people in a real estate or mortgage loan transaction, it is extremely important to ask them to disclose, in writing, their exact role and their responsibilities to you. Someone you might assume to be your agent, with the responsibility to work for your best interests, might actually be only a facilitator, with little or no responsibilities.

facilities management Taking care of what's called the physical plant of a property—repairs, maintenance, security, janitorial, groundskeeping, etc. Formerly this was considered a janitorial-type career choice. Today, with rapidly changing technology, environmental concerns, government regulations, terror-related security issues, and other such matters, a career in facilities management is

seen as a white collar, high-dollar choice. For more information go to the FMLink Group Web site at www.fmlink.com.

factory-built home Generally, a home that is largely built someplace else and then shipped to a site for completion and/or simple installation. Mobile homes (also called manufactured housing) generally come to mind first, although the term also includes modular homes, panelized homes, and log-cabin kit homes.

Fair Credit Reporting Act A federal law intended to remedy abuses by credit reporting agencies. The law is enforced by the Federal Trade Commission, which maintains information on its Web site, www.ftc.gov. Generally, the law prohibits reporting erroneous or outdated credit information. The following adverse information cannot be reported:

- Civil suits, civil judgments, or arrest records older than 10 years or the statute of limitations, whichever is longer;
- Paid tax liens older than 7 years. (Note: Credit reporting bureaus and the Federal Trade Commission take the position that unpaid tax liens can be reported forever. This seems to be against the plain language of the statute.)
- Accounts placed for collection more than 7 years ago. When in doubt, the FTC assumes that an account will be placed for collection 180 days after it first becomes delinquent.
- Anything else, other than crimes, older than 7 years.

An important exception allows reporting of older information if the consumer is applying for a loan of $150,000 or more, life insurance with a face value of $150,000 or more, or a job with an annual salary of $75,000 or more.

Consumers may obtain one free credit report per year from each of the three major credit reporting agencies—Equifax, TransUnion, and Experian—by going to their centralized site of www.annualcreditreport.com.

(Beware of firms promising to "clean up your credit" for a fee. Many times, they employ illegal tactics that involve you committing fraud or perjury. The Federal Trade Commission has been very aggressive in suing such services.)

Fair Debt Collection Practices Act A federal law designed to curb abuses in the debt collection industry. The law applies to debt collectors, who are defined as persons or companies who collect debts for another. If you owe money to Smith's Marina and Mr. Smith himself or one of his employees contacts you to collect the money owed, that person is not a debt collector under the Act because they are trying to collect money due to themselves, not money due to a third party.

Generally speaking, collectors cannot call you before 8 a.m. or after 9 p.m. They can't threaten you with arrest, bodily harm, or public exposure as a "deadbeat." They can't imply they are connected with law enforcement. Collectors cannot harass you with repeated phone calls on the same day. They can't call you at work if you tell them you are not allowed to receive such calls at work.

Consumers may sue and collect damages and attorneys' fees for violations of the Fair Debt Collection Practices Act. (It may be found at 15 USC §1601 and subsequent sections.) You must file suit within one year of the violation.

Fair Housing Act A federal law originally passed in 1968. The law prohibits discrimination by landlords, real estate agents, municipalities, lenders, and homeowners' insurance companies, if the discriminatory practices make housing unavailable to people because of race or color, religion, sex, national origin, family status, or disability. Discrimination includes such things as steering, redlining, and imposing greater requirements on some groups than on others. Limited accessibility that makes housing practically unavailable for persons with disabilities is a form of discrimination. Housing providers may not unreasonably limit the number of people living in a unit or restrict families to only certain areas of a complex. It is, however, legal to limit a project to people over 55, as allowed by the Housing for Older Persons Act of 1995. The many faces of discrimination are varied and sometimes subtle. It is recommended that all persons involved in real estate become thoroughly familiar with the law.

The Department of Justice may file civil or criminal actions for violations. Individuals who have been discriminated against may file a complaint with the Department of Housing and Urban Development or file suit in state or federal court. There is currently a thriving litigation industry in consumer protection groups using individuals to attempt obtaining housing, lending, or insurance and then suing under the Act when they encounter discrimination. (More information may be found at the Web site for the Department of Housing and Urban Development, www.hud.gov/offices/fheo/index.cfm, and at 42 USC §3601 and subsequent sections.)

Fair Isaac Company (FICO) score A credit score, based on the name of the company that wrote the software that calculates the scores.

fair market value The amount that a willing buyer would pay a willing seller for property after reasonable exposure to the marketplace.

false advertising Advertising that contains blatantly false or misleading statements, whether intentional or not. False advertising may be grounds for rescission, or cancellation, of a contract, and it may also provide the basis for an award of compensatory and punitive damages.

FAMC See *Federal Agricultural Mortgage Corporation*.

familial status Under the Fair Housing Act, a protected class of people who live in a household with one or more persons under the age of 18 years and are the parent, legal guardian, or custodial adult for the minor. The concept includes pregnant women and people attempting to gain custody of a minor. Except for elderly housing, one may not discriminate against someone on the basis of familial status.

family Traditionally, people who are related by blood or marriage. The term can mean many different things depending on the circumstances. Most statutes have a section devoted to "definitions" that will tell you the intended definition of words used in the law. For example, the concept of

what constitutes a family may be important in zoning cases for single-family housing or apartment restrictions against non-family members living in the apartment with the tenant.

family limited partnership (FLP) A special type of limited partnership recognized by some states as an estate planning tool. A donor establishes a family limited partnership and then transfers into it property expected to appreciate in value over the years. The donor then makes gifts of small percentages of the partnership to children or other family members. The gifts are small enough to escape gift taxes and may be doubled if the donor makes the first gift to the spouse, and then each of them makes gifts each year. As the property grows in value, the appreciation belongs to the person receiving the gifted shares and so is not in the donor's estate at death.

Fannie Mae A popular name for Federal National Mortgage Association.

Farm and Land Institute Now known as the REALTORS® Land Institute.

farm area A specific geographic area or condominium complex receiving intense marketing efforts from a real estate agent in order to obtain listings. The agent specializes in the area, learning everything there is to know. Over time, communities will always have agents identified with particular parts of town, such as "Myra the lake lady" or "Lyman the land man."

farm assets All the assets of a ranch or farm, including the residence, outbuildings, barns, irrigation systems, trees, and fencing. Farm assets receive special treatment under the Internal Revenue Code if there is sale, exchange, or lease. Farmers are also exempt from the requirements to pay quarterly estimated taxes. (See Publication 225, "Farmer's Tax Guide" at the IRS Web site, www.irs.gov.)

Farm Credit Administration (FCA) An independent agency (www.fca.gov) responsible for regulating and examining banks in the Farm Credit System, including Farmer Mac. It is funded through assessments made against the FCS institutions.

Farm Credit Council A federated trade association representing the Farm Credit System.

Farm Credit System The oldest government-sponsored enterprise (GSE) (www.farmcredit-ffcb.com) in the country, created in 1916. It is a nationwide network of borrower-owned lending institutions and affiliated service entities that makes loans to agricultural and rural borrowers. The members do not take deposits. The funds for loans are obtained through the issuance of Farm Credit debt securities on a worldwide basis in the domestic and global capital markets.

Farmer Mac A nickname for the Federal Agricultural Mortgage Corporation (FAMC).

Farmers Home Administration (FmHA) A federal agency that formerly operated under the United States Department of Agriculture (USDA). The Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994 replaced FmHA with USDA Rural Development.

fashion/specialty centers Shopping centers devoted to retail and dining establishments attractive to a higher-end, fashion-oriented concept. They usually contain 80,000 to 250,000 square feet of space on 5 to 25 acres, with a primary trade area of 5 to 15 miles.

fastrack construction Construction that begins before all plans and specifications have been completed. For example, the builder may have full architectural and structural engineering drawings sufficient to pour footings and a concrete pad, before the electrical plans have been completed.

FCA See *Farm Credit Administration*.

FDIC See *Federal Deposit Insurance Corporation*.

feasibility study An analysis of the marketplace to determine if it is economically practical and desirable to develop a particular project. Contrast with a market analysis, which merely identifies whether a defined market or trade area desires what you propose to build. A market study determines demand for the real estate development; a feasibility study determines whether that demand is willing to pay what the project will cost, plus a profit.

> **Example:** *The demand for first-class office space in downtown Elm City exceeds the available space. There are no vacancies, and potential tenants must take space in the suburbs or settle for less desirable space downtown. The market analysis determines that a market exists for a new midrise office building. The feasibility study then analyzes all acquisition and construction costs, the length of time until a new building would be at break-even occupancy, the cost of funds for construction financing, and the expenses of operating such a building. According to the feasibility study, the building would have to command rents in the range of $28 to $30 per square foot per year in order to be a viable project. Current market rents downtown for similar space range between $19 and $23 per square foot per year.*

This constitutes the feasibility study—what will it cost, what must I charge, what will the market pay? The portion of the study that asks "What will the market pay" is the portion with the most risk, the most in need of salesmanship when one is talking to lenders and investors, and the truest test of a seasoned developer with good instincts. In the preceding example, the market may very well respond positively to a new building with rental rates significantly higher than anything else downtown. On the other hand, it might not. One has to choose, in the end, after all the analysis has been completed.

Federal Agricultural Mortgage Corporation (FAMC) Commonly called Farmer Mac (www.farmermac.com), it is one of the system entities in the Farm Credit System. Its purpose is to attract new capital for the financing of agricultural real estate and to provide liquidity to agricultural lenders.

Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994 Federal legislation passed in order to streamline and modernize the Department of Agriculture.

Federal Deposit Insurance Corporation (FDIC) An independent agency (www.fdic.gov) created by Congress in 1933. It supervises banks, insures deposits up to $100,000 per depositor per institution, and acts as a receiver and liquidator for failed banks.

Federal Emergency Management Agency (FEMA) Formerly an independent federal agency that became part of the Department of Homeland Security on March 1, 2003. FEMA's mission statement

is to "lead the effort to prepare the nation for all hazards and effectively manage federal response and recovery efforts following any national incident." FEMA (www.fema.gov) also initiates proactive mitigation activities, trains first responders, and manages the National Flood Insurance Program.

Federal Financial Institutions Examination Council A federal interagency body (www.ffiec.gov) that establishes uniform standards and reporting requirements for the examination and auditing of financial institutions supervised by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

Federal Home Loan Banks (FHLBanks) The largest source of residential mortgage and community development credit in the United States. This group consists of a regional cooperative of 12 FHLBanks, each with its own president and board of directors. Its primary business consists of FHLBank Advances, which are low-cost loans made to member institutions. This gives those members the liquidity to make mortgage loans. The FHLBanks (www.fhlbanks.com) regenerate their own liquidity by selling debt consisting of consolidated bonds with maturities of one year or more, and consolidated discount notes which mature within 360 days.

Federal Home Loan Mortgage Corporation A stockholder-owned corporation chartered by Congress in 1970 to assist home mortgage lenders with a steady flow of money. Called Freddie Mac (www.freddiemac.com) for short, it buys home mortgages from loan originators such as local financial institutions and then sells mortgage backed securities and debt securities. In order to realize one of its goals, to stabilize the mortgage industry, Freddie Mac has transformed the industry by standardizing mortgage documents, introducing automated underwriting, creating the market for conventional mortgage backed securities, and leading the fight against unfair and predatory lending practices. Its primary competitor is Fannie Mae; both are regulated by the Office of Federal Housing Enterprise Oversight in HUD.

Federal Housing Administration (FHA) Created by Congress in 1934 and later added to the Department of Housing and Urban Development's (HUD) Office of Housing in 1965. The FHA (www.fha.gov) says it is the only government agency that is entirely self-supporting and receives no taxpayer funds at all. It provides mortgage insurance on loans made by FHA-approved lenders, making those loans risk-free for the originators.

Federal Housing Finance Board (FHFB) Regulates the 12 Federal Home Loan Banks.

Federal Insurance Administration (FIA) A federal agency that administers several insurance programs, including flood insurance.

Federal Land Bank The former name for institutions established by Congress in 1917 in order to provide long-term mortgage credit to farmers and ranchers, and later to rural home buyers. The Federal Land Banks merged with the Federal Intermediate Credit Banks after the Agricultural Credit Act of 1987. It is now known as a Farm Credit Bank.

federally chartered banks Financial institutions authorized and regulated by the federal government rather than the state government. They have the word "national" in their name, or the initials

"N.A." at the end. Supervision is by the Office of the Comptroller of the Currency (OCC) at www.occ.treas.gov.

federally related transaction (FRT) FDIC regulations define the term as "any real estate-related financial transaction entered into on or after August 9, 1990, that the Board or any regulated institution engages in, contracts for, or regulates." FDIC regulations require an appraiser for any FRT except those under $250,000 and other narrowly defined exceptions.

Federal National Mortgage Association (FNMA) Popularly known as Fannie Mae. A former government agency that was privatized in 1968, Fannie Mae's mandate is to increase the availability and affordability of homeownership for low-, moderate- and middle-income Americans. It does this by purchasing mortgages in the secondary market and then selling and insuring securities comprised of packages of mortgages. These are usually single-class mortgage backed securities known as Fannie Mae MBS. Contrast with multiclass mortgage backed securities described under *real estate mortgage investment conduit* (REMIC). The association's Web site is www.fanniemae.com; shares in the company are traded on the New York Stock Exchange as FNM.

Federal Reserve System Often called "the Fed," it is the central bank of the United States, created in 1913. It regulates credit through the interest rates it charges for short-term loans to financial institutions, supervises and regulates banking institutions, and provides advisory services to the government. Funding comes from interest on investments, fees for services to depository institutions, and interest on loans. The public usually comes into contact with the Fed in two ways: When the Federal Reserve chairman announces interest rate changes for loans to member financial institutions, almost all financial institutions change their interest rates within days afterward. In this way, the Fed controls the cost of credit to consumers. Additionally, it provides a central clearinghouse for checks drawn on different banks across the nation, making it possible for your bank in your home town to give you credit for a check drawn on another bank on the other side of the country.

federal rule for condemnations A method of appraising property taken by the federal government via condemnation under its rights of eminent domain. It is employed when less than an entire parcel is taken. The entire parcel is given a value as it would be before condemnation. Then the parcel to be taken is subtracted, and the remaining parcel appraised. The difference is the condemnation award. This differs from the method used by most states, which value the property condemned and then award damages for the decrease in value suffered by any leftover property. See *before-and-after rule*.

Federal Savings and Loan Insurance Corporation (FSLIC) A former quasi-governmental agency that provided insurance for deposits at savings and loan institutions. FSLIC (pronounced fizz-lick) went bankrupt in the 1980s banking crisis, and was replaced by the Savings Association Insurance Fund, administered by the FDIC.

federal tax lien A lien or encumbrance upon all of a taxpayer's real property located in the county where the lien is filed. Tax liens may be for unpaid income taxes, or for the 100 percent penalty assessed against controlling shareholders when their small corporations do not pay withholding

taxes for employees. Lenders who foreclose on real estate must send notices to the IRS regarding impending foreclosures, or the property will still be subject to the tax lien after the foreclosure, even if the lien was filed after the mortgage and would ordinarily be destroyed by the foreclosure. (For more information, go to the IRS Web site, www.irs.gov, and search on "IRC 7425 notice.")

Federal Trade Commission (FTC) Created in 1914, the FTC (www.ftc.gov) was the successor to the old Bureau of Corporations. It was formed in response to widespread concerns about monopolies and their impact on consumers.

Today, it is comprised of three bureaus:

1. Bureau of Consumer Protection. Created to protect consumers from unfair, deceptive, or fraudulent practices. It enforces a variety of consumer protection laws enacted by Congress. It also maintains the consolidated consumer Web site (www.consumer.gov) with information and links to over 170 government agencies.
2. Bureau of Competition. The antitrust arm.
3. Bureau of Economics. Helps the FTC evaluate the economic impact of its various policies.

fee appraiser One who furnishes appraisals of real property for a fee. Contrast with review appraiser, who is typically an employee of a financial institution or institutional investor and who reviews the work of fee appraisers.

feeder road See *arterial street*.

fee simple The maximum possible interest (estate) one can possess in real property is the fee simple absolute. It is unlimited as to duration, transferability, and descendability to heirs. Lesser types of fee simple estates include the fee simple defeasible and the fee simple determinable, both of which may result in loss of the property upon the happening of some event in the future.

fee simple defeasible An interest in real property that may be defeated upon the happening of a certain described event. In other words, someone must take an action in order for the estate to come to an end.

> **Example:** *"I grant Blackacre to First Methodist Church 'so long as' (or 'while' or 'during the period') the property is used for religious services." If the property ceases to be used for religious purposes, then the grantor or the grantor's heirs have a reasonable amount of time to declare their rights and retake possession of the property. If they do nothing, they eventually lose their rights and the property stays with First Methodist Church, to do as it chooses with it. Contrast with* fee simple determinable, *which is an automatic termination.*

fee simple determinable An interest in real property that will automatically terminate upon the happening of a certain described event.

> **Example:** *"I grant Blackacre to First Methodist Church 'for so long as it is used as' (or 'but only if the property is used for') a church." When the property ceases being used for the purpose granted, then title automatically reverts back to the grantor or the grantor's heirs. It is said that the grantor retains a possibility of reverter. Contrast with* fee simple defeasible.

fee tail An ancient form of ownership and restriction on land, in which property could pass only to members of the direct male line of a family, and when a time came when there were no direct male members to inherit, the property reverted to the state.

felony A crime that carries the possibility of a sentence in excess of one year. Violation of some real estate laws is classified as a felony.

FEMA See *Federal Emergency Management Agency*.

feng shui The art and science of placing buildings and specifying the use of components, finishes, and furniture in such a manner as to create harmony and balance.

feudal system An ancient system of land ownership. Under old English common law, the king owned all lands. All other people were mere tenants, who enjoyed possession solely by virtue of the goodwill of the overlord above them. By the seventeenth century the system was replaced by the allodial system we know today.

FF&E See *furniture, fixtures, and equipment*.

FHA See *Federal Housing Authority*.

FHA approved An activity, development, lender, or construction method which meets all requirements of the FHA and will qualify for FHA-insured mortgage loans.

FHA insured A single-family or multifamily mortgage loan that is insured by the Federal Housing Authority. If the borrower defaults, the FHA will either pay the lender the insurance proceeds, up to the balance remaining on the loan after foreclosure, or it will pay the loan in full and take an assignment of the collateral.

FHFB See *Federal Housing Finance Board*.

FIA See *Federal Insurance Administration*.

fiber to the curb An important amenity in a development; the existence of fiber-optic cable from the phone company's central office to the edge of the development, so that all properties within may make use of advanced telecommunications services.

fictitious company name A trade name or assumed name for a company, rather than the actual legal name of the person or entity that owns the business. Many states require fictitious party filings so that consumers and others may determine the true ownership of a business simply by knowing the trade name.

fidelity bond A special insurance policy that covers losses caused by dishonest employees. Property management companies and others with employees who handle money belonging to clients should generally obtain fidelity bonds. Also called a surety bond.

fiduciary A person who enjoys a relationship of trust or confidence with respect to another such that the law will impose greater than normal responsibilities on the fiduciary for honesty, integrity, candor, and scrupulous good faith even if it means sacrificing the interests of the fiduciary. Typical fiduciaries include attorneys, real estate agents representing principals, trustees, and guardians. Because of the fiduciary relationship between an agent and principal, it is difficult to understand the concept of dual agency, in which the broker may represent both the buyer and seller. A seller's fiduciary must keep all the client's information confidential, not volunteer anything unless absolutely required by law, and attempt to gain the highest possible price for the property. A buyer's fiduciary must ferret out all secrets, volunteer all information regarding anything at all that might affect property values, recommend the most thorough home inspectors, and attempt to obtain the lowest possible price for a property. These positions are extremely difficult to reconcile in one person.

fiduciary obligations Very high responsibilities of care, concern, representation, and confidentiality owed by one in a special relationship to another. An agent owes fiduciary obligations to the principal, who is also called the client.

field fit The practice of taking measurements for building components as an improvement is undergoing construction, rather than relying on precise written plans and specifications. Sometimes small amounts of field fitting are necessary, as when tolerances can vary by fractions of an inch. Other times, although the practice is widespread and commonplace, it is not recommended.

file To place a document in the public records. All such documents are time and date stamped when received; this is important because the priority of deeds and of liens is usually on a race-to-the-courthouse, first-to-file basis. In many states, if a judgment is recorded against a seller only minutes before a deed to the buyer is recorded, then the buyer's new property is subject to the lien, which must be paid or the judgment creditor may execute and take the property and sell it for satisfaction of the debt.

filled land An area where the grade—the level of the land—has been raised, preferably by depositing clay, soil, rock, and gravel and then compacting the fill at regular intervals as the grade is raised. Less ideal, but more common in areas with little regulatory oversight, is the practice of dumping tree stumps and other vegetation, covering them with 6 feet or so of clay, and then compacting only the top 6 feet. The property will pass most compaction studies, which bore down only 6 feet. In time, however, the vegetation will rot, the land will settle, and the owner will see potholes and foundation cracks.

final injunction A court order entered after trial on all issues, directing that the losing party take some action or stop doing something. If the losing party disputes the decision, it may appeal. Contrast with a temporary restraining order, which is a court order intended to be effective for a very short time until there can be a hearing. Contrast also with a preliminary injunction, which is a court order intended to be effective only until there can be a full trial, usually several years later.

finance charge The total of all direct and indirect costs associated with obtaining credit.

finance fee A charge by a mortgage broker to cover costs and expenses associated with placing a loan. With VA and FHA loans, the fee is limited to 1 percent of the amount financed. Other loans vary between one-half of 1 percent and 3 percent depending on the competition to obtain loans, credit risk, and other such business factors. The fee is generally negotiable. See *origination fees*.

financial institution An organization that obtains money from deposits and earns money from loans.

Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) (pronounced "fie-ree-ah") Federal legislation passed in 1989 in response to the banking and savings and loan crisis, the FDIC bailout, and the bankruptcy of the Federal Savings and Loan Insurance Corporation (FSLIC). It reorganized much of the oversight and regulatory framework for financial institutions and created the Resolution Trust Corporation (now defunct) to receive and liquidate assets from failed financial institutions.

financial management rate of return (FMRR) A method of evaluating the performance of a real estate investment, FMRR is a modified version of the internal rate of return tool. FMRR uses two different rates for its calculations: (1) the cost of capital rate to discount future negative cash flows back to the present (in other words, what would it cost you to borrow the money to cover losses in future years?) and (2) a specified reinvestment rate for compounding future positive cash flows to the end of the projection period (in other words, what if you took your profits and reinvested them at a certain rate, how would they grow?)

financial privacy rules See *Gramm-Leach-Bliley Act*.

financial purchase A buying decision that involves insurance or other financial products, such as a home mortgage.

financial statement A semi-itemized list of the assets and liabilities of a person or entity as of a point in time, and the revenues and expenses over a representative month or over a period of time such as one year. Do not confuse with *financing statement*.

financing Borrowing money to buy property. See *leverage*.

financing statement A document filed in the public records; gives notice that a secured party claims a security interest in certain described goods and other personal property owned by a named debtor. It is also called a UCC-1 after the form provided by the Uniform Commercial Code. The purpose of the statement is to put other creditors, or purchasers, on notice that the security interest exists and will remain on the property even if sold and even if another creditor loans money against the same property. The financing statement does not give the security interest; it merely provides notice of the existence of a security agreement. If a creditor fails to obtain a signed security agreement, the financing statement will be useless. (Do not confuse with *financial statement*.)

finder's fee A fee for finding someone to buy, sell, or rent real estate. It is illegal in most states unless the finder is a licensed real estate broker or agent. There is some question about whether

existing tenants may receive small gifts or rent credits for referring new tenants. The states that allow this limit the compensation or gift to something minimal.

finish-out allowance See *tenant improvement allowance*.

fire insurance A type of property insurance covering losses caused by fire and by damage caused in putting out the fire. Premiums will often depend on proximity to a fire station (within 5 miles is best), the rating of the fire department (all volunteer personnel with minimum equipment up to full-time personnel with all equipment), proximity to a fire hydrant, and method of construction of the property.

fireproof Having all surfaces covered with a noncombustible material such as concrete or brick. Contrast with *fire resistant*.

fire resistant Able to withstand exposure to a fire of a specified intensity for a specified period of time, usually 1, 2, or 4 hours. Contrast with *fireproof*.

fire sprinkler system A system for the delivery of water to locations registering a certain heat and to surrounding areas. Local building codes sometimes change the requirements for fire sprinkler systems, requiring larger sprinkler heads than before. Even if a property has a sprinkler system in place, you will need to check the pressure, the size of the heads, and any other matters required by local law in order to ensure that the system will be in compliance.

fire-stop Obstructions placed in open areas above a ceiling in order to stop a fire that could otherwise easily spread to all parts of a building.

fire wall A fire-resistant wall required by local health and safety codes. Depending on the particular code adopted, a property owner may need to erect fire walls between every 3,000 square feet of space, between spaces rented by separate tenants or owned by separate condo owners, and along exterior walls within a certain distance of a property line. The code will detail the hours of fire retardant required under different circumstances. Doors allowing passage through fire walls must be fire doors.

firm commitment A lender's unqualified and irrevocable promise to grant a loan for a specified amount, which may be a firm amount or a certain percentage of the appraised value. The commitment will also specify the interest rate, term, and collateral. For commercial mortgages, the borrower should ask that the firm commitment include a statement of anticipated legal fees and other fees and expenses and, if possible, negotiate an upper limit to attorneys' fees.

FIRREA See *Financial Institutions Reform, Recovery and Enforcement Act*.

first-generation space Office space in a new building. First-generation space lacks walls, floor covering, ceiling tiles, and lighting; it has never been built-out. When comparing tenant improvement allowances among buildings under consideration for leasing office space, it is important to note if the space is first generation or second generation, because the build-out will typically be much

more expensive in first-generation space. Even if second-generation space has to be completely reconfigured, there will still be some savings by the ability to reuse doors and light fixtures.

first mortgage A real estate loan made to the borrower and recorded in the public records by the lender, before any other mortgages.

first refusal, right of The right to buy or rent real property if and when the owner decides to sell or lease. The owner is under no obligation to ever sell or lease, though. Contrast this with an option, in which the the person who wants to buy or lease (optionee) has a legal right to require the owner (optionor) to sell or lease, but the optionee does not have any obligation to buy or lease. With a right of first refusal, control is in the owner. With an option, control is in the other person.

Care should be taken when drafting a right of first refusal. The parties should specify an expiration date, a price or method of calculating the price, and what happens if the purchaser-lessee declines to buy or lease at a particular point: Does the right of first refusal end, or does it continue to the next time?

The parties should give particular thought and attention to describing the triggering event. What gives rise to the ability to exercise the right of first refusal? Is it the owner merely soliciting offers, or must there be a bona fide offer from a third party before the party will be notified and given the first opportunity to buy or lease? What if the owner dies? Does the party have a right to buy the property before it passes to the heirs?

first-year depreciation See *additional first-year depreciation*.

fiscal year Accounting year. Many companies use accounting years ending on June 30 or September 30, rather than the calendar year ending on December 31.

fixed assets Items on a company's balance sheet—the tangible property used in the business and not for resale; would include buildings, furniture, fixtures, equipment, and land.

fixed bid A firm price for completing a job.

fixed expenses Expenses that continue at relatively stable levels, month after month or year after year, regardless of occupancy levels, retail sales, or other areas of revenue, including property rent or depreciation, some minimal level of personnel expenses, and some minimal level of utilities. Contrast with variable expenses, which are more or less directly tied to revenue; as revenues increase, so will the expenses.

fixed lease See *gross lease*.

fixed-rate loan A certain percentage rate of interest that will not change over the life of the loan. Contrast with adjustable-rate loan or mortgage.

fixed-rate mortgage See *fixed-rate loan*.

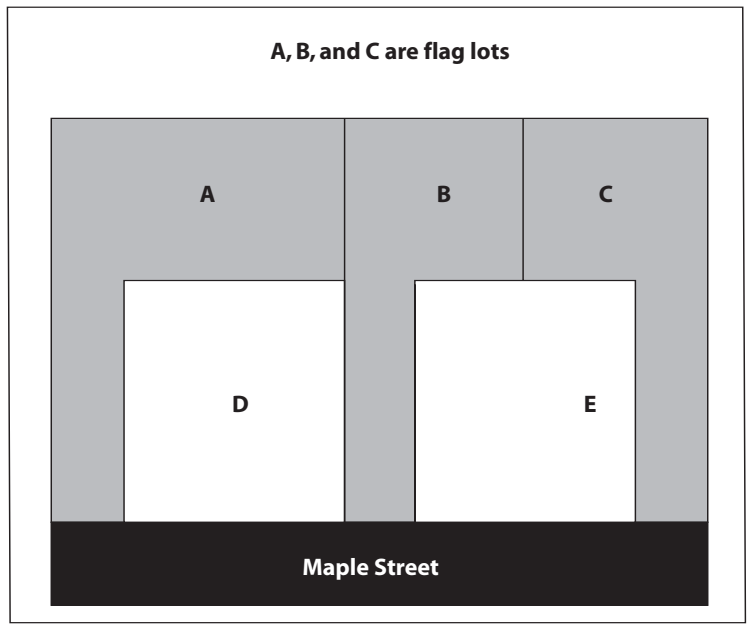
fixed-term mortgage A real estate loan for a definite period of time, such as 15 or 30 years.

fixer-upper Usually a polite way of describing a property in need of extensive repairs, renovations, or cosmetic improvement.

fixture An item of personal property that becomes part of the real property.

fixturing period A time period before a lease begins, when the tenant is allowed access to make improvements, deliver furniture, install phone systems, and other such matters.

flag lot A parcel of land shaped like a flag, with a narrow strip providing access to a public street or waterway and the bulk of the property containing no frontage. When planned, it is a way to maximize property density without having to install additional streets. Some jurisdictions require subdivision platting and approval for any project that includes building additional streets. Flag lots are a way around the platting laws.



flat An apartment.

flat-fee broker One who charges a set fee rather than a percentage of the sale price of a property. Flat-fee brokers typically offer unbundled services, or no-frills services, and almost always exclude any services connected with showing property, handling negotiations, responding to consumer inquiries, or assisting with closing.

For a flat fee, one may usually obtain some combination of the following:

- Listing on the local multiple listing service
- Yard signs and subdivision entrance signs

- An assigned phone number with voice mail for callers
- Placement on a Web site
- Packages of forms, instructions, videos, or DVDs
- A personal consultation for a specified time period
- An initial walk-through inspection with recommendations

flat lease See *gross lease*.

flat-rate tax A tax calculated as a certain percentage of income, with all persons paying the same percentage.

flexible payment mortgage A mortgage with payments that are allowed to vary, but which will always be sufficient to pay the loan over a certain amortizing period. An adjustable-rate mortgage is one example, and a graduated payment mortgage is another.

flex space Originally, industrial space that could be configured as needed for offices, manufacturing, assemblage, or warehousing. Today, the term usually refers to flexible office arrangements such as movable walls, offices shared by different people during different time slots, or any number of other flexible arrangements.

flip To buy low and sell high in a fairly short period of time; sometimes associated with predatory practices such as securing an option on property about to be foreclosed and then exercising that option only if able to find a purchaser who will pay enough to generate a profit. In the meantime, the consumer cannot sell to anyone else.

- Condo flipping is accomplished through buying reservation rights in condos to be built in the future, and then selling those rights, not the actual condo, shortly before project completion. There are many Web sites devoted to nationwide markets for condo flipping.
- House flipping usually refers to the practice of buying a home at a price substantially below market because of the need for repairs and then making the renovations and selling in a short period of time, at a substantial profit. Acquisition and renovation is typically financed with a mortgage note due in six months. The practice is risky for those unfamiliar with construction, because delays can be catastrophic.

float (1) The amount of movement in a variable-rate mortgage, as in "the loan can float 1 percent per year or a maximum of 5 percent in a lifetime." (2) The period of time after a check is deposited but before the funds have been collected or credited. If a depositor receives credit immediately, even though it may take several days for the maker's bank to transfer funds to the depositor's bank, then the depositor takes advantage of the float because it has use of the money. If a depositor does not receive credit for several days, but the bank has already received its money from the maker's bank, then the bank takes advantage of the float.

floating lien Sometimes refers to the lien of an anaconda mortgage that attaches to additional property acquired after a mortgage loan is originated. More properly refers to a lien on goods or inventory that change constantly, as in financing for a retail establishment. The lien floats among

items as they come into the store and are available for sale, detaching itself as the goods are sold to consumers.

floating rate A loan interest rate that is not fixed and does not have specified times for increase or decrease, but which floats and changes as the index changes.

floating zone A land area described in the text of zoning regulations but not placed on the zoning map until a developer applies for rezoning.

flood insurance The popular name for the National Flood Insurance Program (www.floodsmart.gov) administered by the Mitigation Division of the Federal Emergency Management Agency. Flood insurance is intended as an alternative to disaster assistance, by providing better assistance at cheaper net costs to the government. Policies are available in three forms: dwelling (most homes), general property (apartments and businesses), and residential condominium association. They cover structural damage; furnaces, water heaters, and air conditioners; flood debris cleanup; and floor surfaces such as carpeting and tile.

flood insurance rate maps Maps maintained by the Mitigation Division of the Federal Emergency Management Agency. They locate and describe areas having a 1 percent risk of flooding in any given year. They can be viewed online at the FEMA's Map Service Center Web site, http://msc.fema.gov.

flood plain Any normally dry land that is susceptible of being covered by water from any natural source.

flood-prone area An area that has a 1 percent probability of flooding in any given year. Although popularly known as an area that will flood sometime in a 100-year period, this characterization is technically inaccurate.

floor Other than the obvious, refers to the bottom of something. Variable-rate mortgages may provide a minimum interest rate, called a floor, even if the rate would otherwise be less if the index dropped. Percentage leases with rent partially based on gross revenues might have a minimal amount, or floor payment.

floor area ratio The ratio of floor space in a building to lot size; used in zoning regulations to restrict the size of buildings.

floor duty The practice of assigning responsibilities to real estate agents for spending time in the office in order to be available for walk-in customers or general phone inquiries not directed to a particular agent.

floor joists Horizontal boards laid on edge and resting on the beams that provide the main support for the floor. The subflooring is nailed to the joists, and then the flooring is installed. It is increasing common to use engineered floor joists—wood and binding material rather than traditional lumber—in order to gain strength and stability.

floor load (1) The weight per square foot that the floors in a building can support, if the weight is evenly distributed. (2) The weight per square foot of a particular piece of equipment or machinery that will be installed in a building, frequently regulated in leases so as not to exceed a stated amount.

floor loan The minimum amount a lender will fund on an approved loan, with the balance payable if and when the borrower meets certain conditions, such as minimum occupancy levels or preleasing. If the borrower fails to meet the requirements, the borrower will have to secure gap financing or mezzanine financing in the interim, which can be extremely expensive.

floor plan Architectural drawings showing the layout of the floor(s) in a building, locations of load-bearing walls and/or required fire walls, dimensions for all walls, locations and swings (inward, outward, which side the hinges are on) for all doors, and locations of windows.

flyspecking A slang expression for reviewing every word, every comma that might make a difference between dependent and independent clauses, every pronoun and its antecedents (does "he" refer to the grantor or the grantee in a sentence, for example), and sketching every property description in every deed in a chain of title to make sure the same land is always described and the description makes an enclosed parcel. Comes from the expression "picking the flyspecks out of the pepper," which is an exceptionally tedious job.

FMHA See *Farmers' Home Administration*.

FNMA See *Federal National Mortgage Association*.

folio In some states, refers to the page number of the book in which real estate documents are recorded.

foot-candle A measure of light intensity. One foot-candle is the illumination measured on a surface one foot from the source of one candle. Many worker-safety regulations specify the minimum foot-candles of light required in work areas. Zoning variances for commercial properties near residential areas might place a restriction on the maximum foot-candles of lighting after a certain hour at night.

footing A concrete support for a wall, chimney, or pillar, usually wider than the structure being supported and intended to distribute the weight evenly over a larger surface area. Local building codes will specify minimum footing size for various buildings, although the better practice is to employ a structural engineer to determine the proper size, which may be in excess of the minimums.

footprint The area of land physically occupied by a building, including its square footage and shape.

forbearance The act of restraining from exercising a right.

1. Typically encountered in leases and other contracts specifying that a forbearance by one party who fails to declare a default when entitled shall not entitle the other party to rely on future forbearances and will not constitute a waiver of any rights.

2. After a loan default, lenders will sometimes enter into formal forbearance agreements with borrowers, agreeing not to foreclose if the borrowers will agree to a new payment plan, pay all attorneys' fees associated with drafting the agreement, usually agree to a higher interest rate and more collateral, and almost always agree to waive any and all claims against the lender.

forced sale An involuntary sale resulting from foreclosure, execution on a judgment, partition action by a cotenant wanting to sell the property and divide the money, or a divorce proceeding. See *distressed sale*.

force majeure Something outside the control of parties to a contract and which could not have been foreseen or planned for. Usually found in construction contracts, suspending the time limits in the event of a force majeure. It can include Acts of God, such as tornadoes and hurricanes, or acts of humans, such as a strike, terrorist attack, or other such disruptive event.

foreclosure The destruction of a borrower's rights in mortgaged property, except as may be allowed under statutes giving a post-foreclosure right of redemption. The foreclosure process varies among states, but generally segregates into judicial foreclosures and nonjudicial foreclosures.

- Judicial foreclosures involve filing a petition with a court, asking that court to enter an order as to the amount due under a mortgage loan, and then granting the lender permission to sell the property and apply the proceeds to the debt.
- Nonjudicial foreclosures are accomplished by providing some sort of public notice of the default and scheduled auction of the mortgaged property, and then carrying out the auction process.
- Some states allow a statutory right of redemption after foreclosure. This gives the borrower, and sometimes other creditors of the borrower, a certain amount of time to redeem the property by paying the foreclosure purchaser the full amount of the purchase price plus interest at a rate defined in the statute. This is different from the equity of redemption.
- The term equity of redemption means all rights of the borrower before foreclosure, but which are extinguished at foreclosure. If the borrower has any rights after foreclosure, they are granted by specific statutes giving a right of redemption.
- Some states have consumer protection statutes to guard against predatory purchasers taking advantage of foreclosure panic on the part of homeowners.
- If a borrower deeds the mortgaged property to the lender in order to avoid a foreclosure, that is called a deed in lieu of foreclosure. It is a risky route for the lender because all liens remain on the property, even those that might have been cleared off by a foreclosure.
- In most states, if a foreclosure sale does not bring enough money to satisfy the debt, the lender may sue the borrower for something called a deficiency judgment. Exceptions occur in states that limit that right when the debt is a first mortgage on the borrower's primary residence. Another exception would be if the borrower has negotiated a nonrecourse mortgage that insulates it from any personal liability.
- A foreclosure obliterates the rights of the owner (except as noted previously) and virtually all creditors who might have filed claims after the mortgage was foreclosed. This includes second mortgages, if the first mortgage is being foreclosed.

The five major categories of parties who may still have claims on property after a foreclosure are

1. Those who hold mortgages or have other claims which were filed before the mortgage that was foreclosed.
2. The IRS, if the foreclosing lender did not give it the proper notice required by federal law.
3. Those holding mechanics' and materialmen's liens, which might be for work started on the property before the mortgage was taken, but perfected by filing documents after the mortgage was recorded.
4. Local or state governments to which real estate taxes are due.
5. A bankruptcy trustee, who may set aside a foreclosure under the proper circumstances.

foreign corporation Any corporation organized under the laws of another state or country. Foreign corporations may sue and be sued in the courts of a state only if they are registered and licensed in that state. Normally, if a foreign corporation does business in a state without registration, it may not use the courts of the state to sue the defaulting party.

foreign investment in real estate The U.S. government closely tracks foreign investment in many critical sectors of the U.S. economy, including banking, technology, and real estate. Foreign investors seeking real estate opportunities may gain information at the Web site of the Association for Foreign Investors in Real Estate, www.afire.org. The U.S. Department of Commerce, Bureau of Economic Analysis (www.bea.gov), requires annual reports from all foreign direct investors in U.S. business enterprises, including real estate.

Foreign Investment in Real Property Tax Act (FIRPTA) A federal law designed to assist in the collection of income taxes when foreign owners and investors sell real property or shares in entities that own real property.

Purchasers are required to withhold 10 percent of the sales price unless either of the following occurs:

1. The IRS is asked to calculate the exact taxes that would be due, in which case that amount will be withheld.
2. The purchaser will use the property as a residence and the selling price is less than $300,000.

Purchasers must report the withholding on IRS Form 8288 or 8288-A and must report and pay over the money within 20 days after purchase. If purchasers do not withhold, they may be liable for the taxes themselves. Almost all real estate closings today require the seller's signature on what's called the FIRPTA affidavit, stating that the seller is not a foreign person. (For more information, see Publication 515, "Withholding of Tax on Nonresident Aliens and Foreign Entities," available at the IRS Web site, www.irs.gov.)

forfeiture The loss of rights to something as a result of a failure to perform an obligation. Courts often view forfeitures as penalties, which are illegal. As a result, one who is buying property under a bond for title and will receive a deed only when all payments have been made may be protected from a forfeiture if there is a default after a substantial amount of money has already been paid.

forgery A counterfeit signature or instrument. A forged deed is void and gives no rights, even to innocent purchasers for value. If title insurance was purchased by an owner, however, that owner may make a claim for compensation, or the title insurance company may take steps to buy out any competing claims.

formaldehyde A colorless liquid with a distinctive odor, classified as a volatile organic compound because it can be emitted as a gas from certain solids and liquids, even at room temperature. Almost every building component contains formaldehyde in some amount. It is used as a component in glues and adhesives, and in paints and other coatings. Some claim it is a cause of sick building syndrome.

form contract There is no such thing. Consumers often request a form contract for a real estate sale, lease, or other transaction, thinking to obtain some universally recognized, perhaps government-approved document with a few blanks for variables such as parties' names. Office supply stores, local associations of realtors, books in law libraries, and computers in real estate offices may all have forms that are in widespread use, but each is capable of negotiation and customization. One should never rely on a form to protect one's rights—every document should be read in its entirety, even the boring parts that seem like boilerplate, and changed as necessary.

formosan termite See *termite bond*.

fortress mall A shopping mall of superior quality, with at least one fashion department store, at least four anchors having minimum sales of $500 per square foot, and surrounded by a "moat" consisting of acres of parking. The goal is to capture consumers inside the fortress, where they will remain to conduct all their shopping and dining. Still a strong market segment, but seeing erosion by the newer lifestyle malls.

forum shopping clause A clause in an agreement specifying the state and county where any disputes will be heard. All states have rules regarding jurisdiction, meaning the ability of particular courts of the state (circuit, district, probate, justice of the peace) to hear particular disputes and to issue orders that are binding on the parties. All states have rules regarding venue, meaning the county in which a dispute must be heard. Forum shopping clauses alter the normal rules. They are frequently included by financially strong parties who are afraid of the whims of local lawyers, judges, and juries and would prefer that disputes are handled in their own backyard. Such clauses will be upheld where reasonable under the circumstances.

The contractual agreement to a particular forum does not necessarily mean that forum's law will apply. Choice of law is another totally different concept. Many contracts with forum shopping clauses also have choice of law clauses stating that the law of a certain state will control any disputes.

foundation inspection An examination of the support for a building to make sure it is sufficient for the size and weight of the building and the character of the soil under it. Also, the examination of an existing building to discover evidence of any defects in the foundation, such as cracks in exterior walls or sinkholes.

fourplex A small apartment building containing four residences. Many FHA loan programs are available for fourplexes.

four quadrants of the real estate capital markets An expression describing the following:

1. Private equity. Direct, private, real estate investments
2. Public equity. REITS and other publicly traded vehicles
3. Private debt. Whole loan mortgages
4. Public debt. Collateralized mortgage backed securities and other similar vehicles

four-three-two-one rule One appraisal method that says commercial property of uniform depth and with road frontage has 40 percent of its value in the front quarter of the parcel, 30 percent in the next quarter, 20 percent in the next quarter, and 10 percent in the rear quarter.

fractional interest Some interest in real estate less than the entire bundle of rights.

franchise (1) A contractual relationship whereby one party (franchisee) is entitled to use the trade name, image, procedures, and trade secrets of another (franchisor) usually in return for paying an initial purchase price and a percentage of gross revenues over the period of the arrangement. In most instances, there is a separate fee for the franchisee's share of national and regional advertising campaigns. Real estate franchises include Century 21, RE/MAX, and ERA. (2) A government grant of some privilege, such as the ability to operate as a corporation or the ability to sell drinks and sandwiches in the county courthouse.

fraud A deceitful practice. Fraud consists of a misrepresentation of a material fact that is relied upon by another party to his or her detriment. There is no requirement that the misrepresentation be intentional. The thing misrepresented must be a fact; it is very difficult to prove fraud when one fails to fulfill his or her obligations but had good intentions in the beginning.

There are three types of fraud:

1. Intentional fraud. Punitive damages may be assessed for this type of fraud.
2. Negligent fraud. As when one makes a statement recklessly but without any intention to deceive, and someone relies on that statement and is injured when it turns out to be false. One example would be a real estate agent telling a buyer that all appliances are new when, in reality, the agent didn't know but thought they looked new. Depending on the degree of recklessness involved, this type of fraud may or may not support punitive damages.
3. Innocent fraud. As when one takes steps to confirm facts but is perhaps mistaken or given mistaken information, and then relays that information to someone else who relied on it and was injured.

The Statute of Frauds is a rule that says certain contracts must be in writing, including contracts having to do with real estate. It has nothing to do with fraud, per se, except to protect against possible fraud by requiring a writing.

Freddie Mac See *Federal Home Loan Mortgage Corporation*.

free and clear title Title to real property that is absolute without any liens, mortgages, adverse claims, or other encumbrances.

freehold An estate in land for life or in fee. The duration of the interest is undeterminable. The estate may end at some point in the future, but no one can predict the date of termination. Best understood by reference to its opposite, which is a leasehold.

free market system auction An auction process used by the Federal National Mortgage Association (Fannie Mae) to accept bids from approved lenders as to the amount, price, and terms of existing mortgages those lenders desire to sell to Fannie Mae. Once Fannie Mae decides how much it can spend to buy mortgages, it notifies the winning bidders, who have a certain amount of time within which to deliver the mortgages. The servicing agent continues to service the loans and receives a fee from Fannie Mae.

friable Crumbly, brittle. When asbestos is friable, it is hazardous.

frontage The length of a property line along a road, street, waterway, or important amenity such as a state park.

front-ending Doing something in advance of the economically prudent time, taking into consideration all risks. Local governments may front-end the streets in a project and require the developer to build all of them, even though the rearmost lots might never sell. Metropolitan development boards might front-end incentives and pay them to a developer in advance, in order to help defray start-up costs, rather than the more normal method of giving tax breaks over time.

front-end ratio A mortgage qualification calculation prepared by taking the proposed monthly mortgage payments, plus real estates taxes and insurance, and dividing that number by the borrower's gross monthly income without reduction for taxes.

> **Example:** *Steve makes $4,000 per month. The mortgage for a home he would like to buy would result in payments of $1,100 per month. His front-end ratio is $1,100 ÷ $4,000 = 27.5%. This is an acceptable ratio for lenders, who would prefer to keep it at 29 percent or lower.*

front foot A method of describing or pricing commercial real estate by the number of feet of road frontage the parcel has. The drawback is that there is no widely recognized standard for depth, so a property selling for $1,500 per front foot might be half the depth of one selling for $2,400 a front foot, but no one can tell just from the price.

front-loading See *front-ending*.

front money Cash needed to start a development, as opposed to borrowed funds. See *seed money*.

frost line The depth of frost penetration into the soil. It varies from area to area, depending on the soil quality in a particular location, but can average 3 to 4 feet below the surface. Building foundations should penetrate below the frost line in order to avoid the shifting caused by frost heaving.

Many local building codes allow an exception with the use of a frost-protected shallow foundation, which uses insulation and drainage techniques to raise the frost line to just below the surface.

frost-protected shallow foundation A construction method that uses insulation and drainage to artificially raise the frost line of soil to a level that allows relatively short—shallow—foundations. In cold climates, building foundations must extend below the frost line to a depth of soil that does not freeze. Freezing causes soil to heave upward and then sink back again, shifting everything on top of the soil. It does not result in a very stable building base unless one takes steps to prevent soil movement.

FRT See *federally related transactions*.

fructus industriales The fruits of industry, meaning crops and other annual plants that must be sown each year in order to produce. At common law, these things were considered the tenant's, who could make claim for them at the end of a tenancy. The terms fructus naturales and fructus industriales are not representative of modern agribusiness or ranching, but come from a time before the industrial revolution.

fructus naturales The fruits of nature, meaning things produced by nature without the help of humans, such as fruits, wool, offspring of animals, and milk. At common law, these things did not belong to a tenant, who could not make any claim for them at the end of a tenancy. The terms fructus naturales and fructus industriales are not representative of modern agribusiness or ranching, but come from a time before the industrial revolution.

FSLIC See *Federal Savings and Loan Insurance Corporation*.

FTC See *Federal Trade Commission*.

full capacity Able to enter into contracts without any disabilities at all, such as would be attributable to age or mental abilities.

full disclosure A requirement to reveal all information relevant to a transaction. Some states have full disclosure laws requiring transmittal of property condition information to buyers.

full reconveyance A mortgage concept used in title theory states, where the borrower transfers title to the real property to another, usually a trustee, and is entitled to full reconveyance, or a return of the legal title, when the debt has been paid in full.

full service In connection with a lease, this indicates that the landlord provides janitorial, parking lot cleaning, and waste removal services, but the tenant may have to pay for these services through its pro rata portion of the building maintenance expenses. Contrast with *full-service gross lease*.

full-service gross lease A lease requiring the landlord to provide and pay for all maintenance, upkeep, repairs, janitorial services, waste removal, utilities, insurance, taxes, and other operating expenses for a property in return for a fixed periodic rent from the tenant.

fully amortizing loan A loan calling for periodic payments that include some amount of interest and some amount of principal reduction, such that, at the end of the loan term, the entire principal amount of the loan plus all accrued interest will have been paid in full.

functional obsolescence A loss of value from all factors within a property except for physical deterioration. This may include a poor floor plan, the lack of a garage, high ceilings that dramatically increase heating costs, or the lack of central air conditioning in the South. Contrast with economic obsolescence (factors outside the property that depress its value) and physical obsolescence (deterioration).

funding (a loan) The act of a lender paying money under a loan.

funding fee (1) A fee charged to the borrower by the Veterans Administration for guaranteeing a loan. (2) A fee charged by lenders as additional profit, and which may be negotiated downward.

funds from operations A measure of the profitability of any business, but particularly a real estate investment trust. It is net income without downward adjustments for depreciation or amortization and without considering any extraordinary revenues such as from the sale of an asset.

furniture, fixtures, and equipment (FF&E) All the property at a location, except for the real property itself. Usually referred to by the initials only (FF&E). Lenders will often take security interests in the FF&E of a business borrower, in addition to a mortgage on the real property, so as not to encounter a possible post-default battle over what was covered by their lien.

future-advances mortgage A real estate loan that contemplates some portion being funded—advanced—at the beginning of the loan, usually for a purchase of property. The amount advanced is not the full allowable amount under the loan so that future monies may be obtained as necessary for construction, renovation, or other uses in or for the property.

future interest Interest in land in which the possession and enjoyment are deferred until a future date.

FY Fiscal year, as in FY07.

G

GAAP (pronounced "gap") Generally accepted accounting principles declared by the Financial Accounting Standards Board (FASB).

gain The profit on the sale of an asset. One may *realize* gain, as when property is taken in condemnation, but not *recognize* gain for tax purposes until a later date. When reading tax advice, it is extremely important to differentiate between these two concepts, as authors sometimes assume that all readers understand the difference.

game theory The science of evaluating the relationships among parties and the optimal choices for participants in any given situation. Game theory is an important tool in negotiating. Two frequently encountered game theory models are the prisoner's dilemma and chicken.

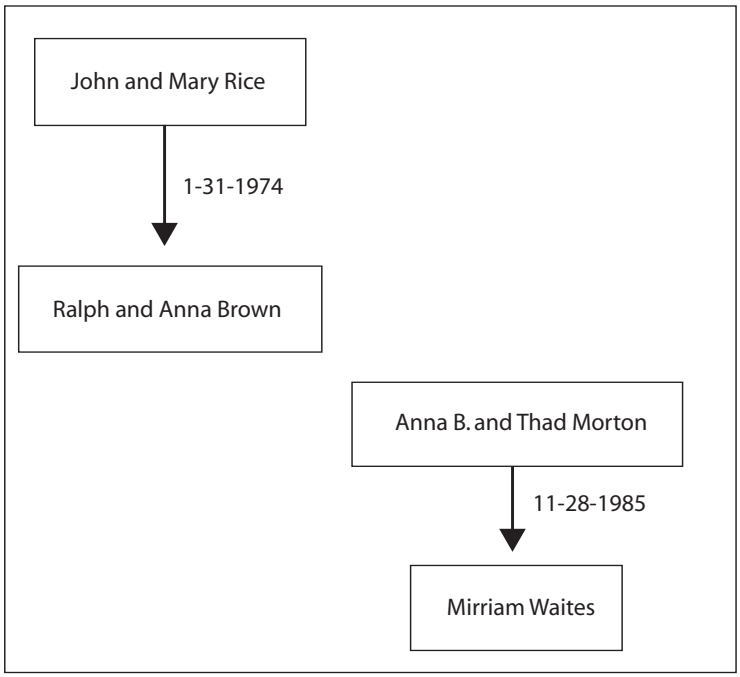
- The prisoner's dilemma model involves parties trusting each other to make the best choice for all, without prearranging their plans, rather than making the best choice for an individual. This is seen in the real estate world in quoting commissions, which involves informal, nonverbal negotiations among real estate agents. Although there is no price fixing going on, all brokers understand that if they cooperate and refuse to lower prices, they will all make a good living. If one or a few lower commission rates in order to capture a lot more business, those few will do well until all brokers lower their prices and get into a price war, after which all will do poorly.
- Chicken is the "sport" of two cars racing against each other, head-on, with the first one to swerve being labeled chicken and losing the match. The best way to win a game of chicken is to remove your ability to swerve and to let the other side know that you no longer have any freedom to move—no freedom of negotiation, in other words. For example, the common use of the chicken theory is to tell a seller that you do not have, and cannot borrow, enough money to meet the asking price. The seller will have to reduce the price, or you will have to find another property.

gap A time period when an additional title search is being conducted to determine if any adverse findings have occurred since the original title search and the recording of the deed or mortgage.

gap financing A loan that covers the difference between the construction loan and the permanent financing. See *bridge loan*.

gap in title A break in the chain of title, as when one finds a deed into party A, and then later a deed out of party B, with never any more claims or deeds from party A.

Example: *You see a deed into Ralph and Anna Brown in 1974, but no deed out of their names. On the other hand, the same property suddenly has a deed in 1985 from "Anna B. and Thad Morton" to Mirriam Waites, but you can't find a deed into Anna B. and Thad Morton. This is a gap in title. Most likely, Ralph Brown died and his widow, Anna Brown, married Thad Morton, but you will need additional research to clarify this.*



garage mahal A slang expression for an opulent parking garage.

garnishee A party who owes money or holds property belonging to the judgment debtor.

garnishment A process involving three parties:

- Judgment creditor. The party who takes a judgment against a debtor (can also be the IRS or a state's Department of Revenue).
- Judgment debtor. The party who owes the debt.
- Garnishee A party who owes money or holds property belonging to the judgment debtor.

In this legal process, the judgment creditor obtains a court order requiring the garnishee to turn over funds or property to the judgment creditor instead of to the true owner, the judgment debtor. The most common garnishments are against employers, requiring them to withhold a portion of wages and salary and pay it to the creditor rather than to the employee. The second most common garnishment is against a bank, ordering it to turn over bank account funds to the judgment creditor or the IRS.

gated community A fenced and gated community of homes. Most local governments require public access to all roads maintained by the government. As a result, gated communities must usually assess homeowners in order to maintain their own roads.

gatekeeper A slang expression to describe the person you must persuade or impress just to get your proposal in front of a decision maker.

gazump An action by a seller to increase the purchase price of goods or property after the buyer is emotionally invested but immediately before the paperwork is signed. Contrast with *gazunder*.

gazunder An action by a buyer to lower the offer for goods or property after the seller has already mentally spent the purchase money and is emotionally invested in a sale at that time, but immediately before the paperwork is signed. Contrast with *gazump*.

GC General contractor. Also can be written as G/C.

general agency See *agency*.

general agent See *agency*.

general and administrative expenses Usually a pro rated portion of general overhead, charged to a particular project although not capable of segregation into goods or services provided for that project. An example could be the cost of paper, toner, office equipment maintenance contracts, phone lines, and office space.

general bill of sale A document transferring ownership of personal property to another. There are no particular requirements, so long as someone can identify the parties involved and the thing being sold. It is not necessary to spell out the amount paid, but it is usually a good idea to include it.

> **Example:** *"John Jones sells to Lydia Lang, for $200, one 10x15 foot hard plastic portable shed located at 135 Elm Street, Pleasant, New York."*

general contractor One who is responsible for construction of a building or other improvement for an owner or a developer. Most states have educational, experience, and insurance requirements as a condition of obtaining a general contractor's license. They also prohibit unlicensed persons from constructing improvements for another unless the project is under a certain specified size. The trade association is the Associated General Contractors of America (www.agc.org), established in 1918. You may check licensing requirements and the status of local contractors at www.contractors-license.org, maintained by the Craftsman Book Company.

general lien A lien that attaches to all property of a debtor located within the area where the lien was recorded. Judgments and IRS liens are general liens, which may be satisfied from the sale of any property found. Contrast with specific lien, which is upon specifically described property only.

generally accepted accounting principles (GAAP) (pronounced "gap") Established by the Financial Accounting Standards Board (FASB), these are the guidelines for proper accounting practices.

general partner One who may enter into contracts for a partnership, is liable for all partnership debts, is entitled to vote on all partnership affairs, and is entitled to a pro rata share of all partnership profits. The general partner may be an individual or a corporation. A partnership may be comprised entirely of general partners, or it may have one or a few general partners with the remainder of the investors being limited partners.

general partnership A partnership in which all partners are general partners. Contrast with *limited partnership*.

General Services Administration (GSA) A government agency established in 1949 with the passage of the Federal Property and Administrative Services Act, consolidating several earlier agencies. The GSA's areas of responsibility are public buildings, federal supply, and national archives and records. It has been responsible for establishing the Federal Citizen Information Center in Pueblo, Colorado; bringing the government into the credit card age for employee expenses; and creating www.firstgov.gov, the official portal for all government Web sites. The GSA Web site is at www.gsa.gov, which is the starting point for all inquiries regarding surplus property sales and auctions.

general warranty deed An instrument transferring ownership of real property, and which warrants—promises—that the seller has good title with no adverse claimants and that the seller will defend the title against other parties should that prove necessary. Contrast with *special warranty deed,* which simply promises that the seller has not done anything to cause a problem with the title. Contrast also with *quitclaim deed*, which makes no promises at all, but simply transfers any interest the seller might have, if anything.

gentrification The informal process of revitalizing an older and deteriorated neighborhood into more upscale homes owned by more affluent occupants. The first step is usually taken by young professionals seeking affordable housing in an urban setting, who immediately begin using disposable income to upgrade their properties. Their efforts attract other like-minded home buyers. Eventually the neighborhood reaches a point where the existing homeowners can afford to sell their properties and buy elsewhere, but they can't afford to pay the increasing property taxes. The process gains momentum at that point, with former apartment buildings being converted to condos, single-family residences undergoing complete renovations, and the entire neighborhood changing to middle class or upper-middle class. It is controversial, with some claiming it destroys the ethnicity and integrity of many older neighborhoods, all in the guise of ethnocentric notions of "improvement."

geodetic survey system A national coordinate system for mapping the lands, waters, coastlines, and even the ionosphere. Geodetic coordinates are indispensable for routing transportation and delivery of goods, locating underground utility equipment for repairs, excavating, and restoration of the earth's surface. The entire Internet depends on global positioning system (GPS) clocks for the precise timing necessary to avoid instant, perpetual gridlock. Without the spatial coordinates supplied by the geodetic survey system, which are necessary for minute adjustments in the delivery of time

information, the Internet, the financial sector, and a host of other necessary sectors of our economy would be in the Dark Ages.

geographic information system (GIS) A computer mapping program in which land characteristics and/or demographic information may be revealed and printed as color-coded overlays.

gerbil tube Slang for a glass-enclosed pedestrian overpass connecting two buildings.

ghetto A term with its origins in eastern Europe, used to designate the part of town occupied by Jewish citizens. Now the term ghetto is used to describe any urban area suffering significant deterioration, often predominated by one or a very few ethnic or racial groups. Disputes often arise regarding whether lenders, insurers, and other service providers are engaged in illegal discrimination when they redline these neighborhoods, or whether they are assessing risks based on the quality of the infrastructure and not on any judgments regarding the inhabitants.

GI Bill Now called the Montgomery GI Bill, it offers support for veterans seeking postsecondary education.

gift causa mortis A gift in contemplation of death. This was an important term at one time because the IRS required such gifts, made within 3 years of death, to be included in the gross estate for estate tax purposes. You will still encounter the word, but the legal significance is no longer important because such property is no longer included in the estate.

gift deed A deed with love and affection as the consideration, but nothing else of generally accepted monetary value.

gift letter A letter provided to a lender or government agency stating that money to be used as the down payment for a home loan was a gift and not a loan from the donor.

gift tax A federal tax that must be paid by a donor. The tax is based on the value of lifetime gifts made to others except in the following situations:

- For the base year of 2004, one can make gifts of up to $11,000 of cash or property per year to each recipient without incurring gift taxes; spouses may give up to $22,000 per year to each recipient. After 2004, there is a cost-of-living adjustment. This is an important aspect of estate planning. See *family limited partnership* for details.
- Tuition or medical expenses paid directly to the educational or medical institution are not counted as gifts, regardless of the relationship with the student or patient.
- Gifts to spouses are not taxable; there are no dollar limits.
- Gifts to political organizations or charities are not taxable.

For more information, see Publication 950, "Introduction to Estate and Gift Taxes," available at the IRS Web site, www.irs.gov.

GI loan GI is a slang term for armed services personnel—"government issue." A GI loan is a loan program for armed services personnel. See *Veterans Administration*.

Ginnie Mae A corporation formed in 1968 and placed under the control of the Department of Housing and Urban Development (HUD). Ginnie Mae makes no loans, nor does it buy or sell mortgages. Instead, it guarantees pools of federally insured or federally guaranteed loans. It is almost never called by its true name, which is the Government National Mortgage Association (GNMA) (www.ginniemae.gov).

going-concern value The value of a business in operation, taking into account the goodwill and the value of the income, in addition to hard assets, such as real estate and equipment. When appraising a project to develop income-producing property, the appraiser will usually provide two numbers—one for the project on the day of completion, with no tenants, and one when it reaches stabilized occupancy and is a going concern. Lenders who take mortgages on income-producing property with intensive management aspects—such as hospitality properties—usually obtain a going-concern rider for the title insurance so that coverage will be increased above the value of the real property.

going dark A slang expression for a retail store closing its doors and discontinuing operations at a particular site. Many shopping center and strip center leases prohibit an anchor store—the one that draws traffic to the center and assists the smaller stores with business—from going dark. Without the clause, the anchor store would be able to move to another location, close operations at the old location but continue paying rent, and effectively destroy the business of all other tenants because of the reduction in traffic.

going-in capitalization rate A total obtained by dividing a project's first year's net operating income by the purchase price or development cost.

gold plating Including unnecessarily expensive items in a construction or renovation project to justify a large budget or a substantial rent increase.

good and marketable title A title to real estate, free of any liens or adverse claims.

good and merchantable title See *good and marketable title*.

good consideration Usually signifies something founded on moral obligation or affection for the value necessary to support an enforceable contract. Many deeds will recite they are in consideration of love and affection. This is good consideration, and is sufficient, but it is not valuable consideration.

good faith Honesty.

good-faith estimate An initial estimate of expected closing costs, net proceeds to seller, gross cash required of buyer, or loan expenses. By virtue of various state and federal laws, a seller's real estate agent may be required to provide a good-faith estimate of net seller proceeds to accompany every offer; the closing company may be required to provide a good-faith estimate of closing expenses to the buyer, and a lender may be required to provide a good-faith estimate of loan costs to a borrower.

good funds Collected funds in a bank account and usable immediately by the owner of the account.

good title See *good and marketable title*.

goodwill An intangible asset consisting of the public esteem in which a business is held. When a business is sold, the difference between the value of the hard assets and the value of the income stream is often attributed to goodwill. One may not depreciate goodwill, but it can be amortized over 15 years because of its inclusion in the IRS definition of Section 197 intangibles.

Government Accountability Office (GAO) An investigative arm of Congress, formerly called the General Accounting Office. Members of Congress may request a wide variety of reports, analyses, and raw data, which is supplied in a nonpartisan manner by the GAO. It also recommends actions to be taken by Congress as a result of findings in the reports. Its Web site, www.gao.gov, contains an excellent search engine to find reports on housing, financial services, and natural resources, to name a few topics.

A few interesting reports related to real estate include

- ''Financial Institutions: Issues Regarding the Tax-Exempt Status of Credit Unions" (important because credit unions usually offer lower interest rates because of their tax-exempt status, but banks are crying "no fair" over the situation.)
- ''Real Estate Brokerage: Various Factors May Affect Price Competition"
- ''Title Insurance: Preliminary Views and Issues for Further Study"
- ''Catastrophe Risk: U.S. and European Approaches to Insure Natural Catastrophe and Terrorism Risks"
- ''Consumer Protection: Federal and State Agencies Face Challenges in Combating Predatory Lending"
- ''Residential Care Facilities Mortgage Insurance Program: Opportunities to Improve Program and Risk Management"
- ''Public Housing: Information on the Roles of HUD, Public Housing Agencies, Capital Markets, and Service Organizations"
- ''Elderly Housing: Federal Housing Programs and Supportive Services"

Government National Mortgage Association (GNMA) Almost always referred to by its popular name—see *Ginnie Mae*.

government patent The original deed out of the government and into the first private individual to own a particular parcel of land. A thorough title search will trace the title of real property all the way back to a government patent.

Government Printing Office (GPO) The federal government's primary, centralized resource for gathering, cataloging, providing, authenticating, and preserving published information in all its forms. It maintains a 1.5 million square foot facility in Washington D.C. for processing, printing,

and distribution of materials. Unless one knows the specific government agency responsible for particular materials, GPO's Web site, www.gpo.gov, is the best place to start any search regarding laws, regulations, procedures, forms, advice, or virtually anything else prepared by or collected for the U.S. government.

government rectangular survey system See *public land survey system*.

government-sponsored enterprise (GSE) One of a group of financial services organizations created by the government. Some are owned by the federal government, some are owned by private individuals, and some are owned by corporations that use their services. All of them enjoy exceptionally low loan rates and exceptionally high sales prices for their bonds and other debt instruments because of the implicit backing of the U.S. government. They include

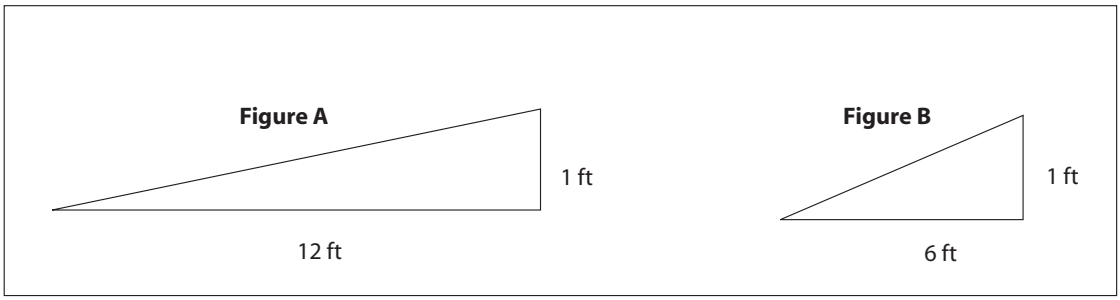
- Federal Home Loan Banks. Owned by over 8,000 community financial institutions that use the services of the FHLBs.
- Federal Home Loan Mortgage Corporation (Freddie Mac). A stockholder-owned, publicly traded corporation listed on the New York Stock Exchange as FRE.
- Federal National Mortgage Association (Fannie Mae). A stockholder-owned, publicly traded corporation listed on the New York Stock Exchange as FNM.
- Government National Mortgage Association (Ginnie Mae). A wholly owned (by the government) corporation within the Department of Housing and Urban Development.
- Farm Credit Bank. Federally chartered and borrower-owned financial institutions.
- Federal Agricultural Mortgage Association (Farmer Mac). A stockholder-owned, publicly traded corporation listed on the New York Stock Exchange as AGM.
- Student Loan Marketing Corporation (Sallie Mae). A stockholder-owned, publicly traded corporation listed on the New York Stock Exchange as SLM.

government survey method See *public land survey system*.

GO-Zone Certain named states and counties in the southern United States, as designated in the Gulf Opportunity Zone Act of 2005. This legislation was passed by Congress in the wake of the devastating 2005 hurricane season to provide tax benefits in hurricane-ravaged areas. Among other benefits, improved property purchased and put into use after August 25, 2005, and before January 1, 2009, may have 50 percent of the value of the improvements depreciated in the first year. In addition, demolition expenses may be written off as expenses rather than capitalized, and the Section 179 expense limits were increased dramatically. Neither the properties, nor the investors, need to have suffered any hurricane damage. The program is similar to the now-defunct Liberty Zone tax benefits enacted after 9/11. For more information, see Publication 4492, "Information for Taxpayers Affected by Hurricanes Katrina, Rita and Wilma," available at the IRS Web site, www.irs.gov.

grace period The allotted time during which a payment can be made without penalty and without entry upon credit records as delinquent or in default.

Grade (1) A designated ground level. (2) To change the contours of land.



Gradient The slope, or change in elevation, of land or improvements such as a pipe or a road. It is expressed as the ratio of inches (or feet) of rise or fall over a specified distance. It is similar to the concept of pitch in roofing. Figure A (above) has a gradient of 1:12 because the grade increases by 1 foot over a distance of 12 feet. Figure B has a gradient of 1:6.

Graduate REALTORS® Institute (GRI) An education program developed by the National Association of REALTORS® (www.realtor.org) and offered through state REALTOR® boards. Members may earn the designation after completion of 90 hours of coursework.

graduated payment mortgage A home loan structured to provide lower payments in the early years, growing as the homeowners' financial situation hopefully improves. The FHA-insured graduated payment mortgage plan is called a 245 loan. (Do not confuse with the FHA-insured 245(a) program, called a growing equity mortgage.)

graduated rental lease A commercial lease that offers low rental rates in the early months or years, increasing over time to reach market rates. Sometimes the later rents are greater than market rates, as when the low early rent must be recouped in later years; usually offered as an incentive to secure tenants for a new building or one suffering the recent departure of an exceptionally large tenant. Other times it is offered when a large tenant vacates but continues paying rent for the unexpired term of the lease—the old tenant will make an arrangement with the landlord and effectively subsidize the new tenant's rent for some period of time.

Gramm-Leach-Bliley Act Contains privacy provisions regarding consumers' financial information. Financial institutions are required to provide information to their customers regarding information-gathering and information-sharing practices. Consumers may opt out if they do not want their information shared with nonaffiliated third parties.

grandfathering An expression used to describe a statutory or contractual willingness to allow some activities or former rights to continue even though not technically allowed under current conditions. For example, downtown zoning regulations no longer allow gas stations in the area, but Fred's Fuel was doing business before the zoning laws went into effect, so it is grandfathered and can stay in business.

grand list A name for tax rolls in the New England states.

granny flat A slang expression for accessory apartments in areas of single-family zoning; also called mother-in-law apartments or maid's quarters, they may or may not be allowed under zoning regulations.

grant The act of conveying title to real estate via a voluntary transfer. In some states, use of the words "grant, bargain, and sell" in a deed automatically incorporates some or all of the typical deed warranties. (See *warranty deed*.) In order to avoid the consequences of such statutes, if a grantor wishes to convey title without any warranties, it should use a quitclaim deed or the words "bargain, sell, and quitclaim" rather than "grant, bargain, and sell."

grantee A person who receives the title of real estate via a deed.

grantor A person who gives title to real estate via a deed.

grantor-grantee index A method of tracing ownership of real property. Before widespread use of computer databases, all deeds in the abstract system of recording were recorded in deed books, but indexed in grantor-grantee indexes and grantee-grantor indexes. These are large books divided into alphabetical sections such as "Aa through Ad," "Ae through Al," and so on. Each deed was recorded by the grantor's name and then by the grantee's name in the appropriate section of the index. Depending on the volume of transactions over time, an index book might contain entries for a few or for many years.

gratuitous agent An agent who acts without compensation, but who still owes full fiduciary responsibilities to his or her principal.

grave dancer See *bottom feeder*.

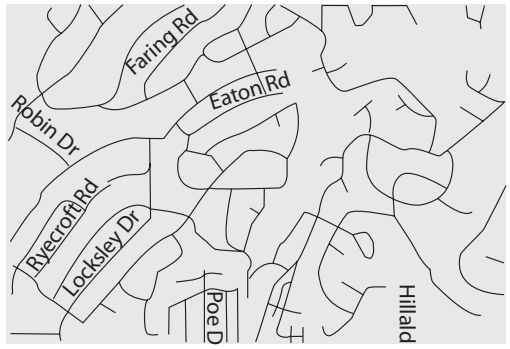
greater fool theory An investing theory that supports buying overvalued property in a hot market because a greater fool will come along and buy it from you at a profit. Like the game of musical chairs, the greater fool theory breaks down when one misjudges when the music will stop and there won't be enough fools (chairs) to go around.

greenbelt An area of natural vegetation around a development, intended to provide a buffer and natural setting. It may be required by zoning or restrictive covenants or may be simply an aesthetic choice.

green space A natural area in or around a development, intended to provide buffer, noise control, recreational use, and/or wildlife refuge, all in order to enhance the quality of life in and around the development.

GRI See *Graduate REALTORS® Institute*.

Gridiron system.



Street hierarchy system.

gridiron Used to describe the numbered rectangular street and avenue system once popular with urban planners. For example, 101 1st Avenue would be on 1st Avenue, between 1st Street and 2nd Street. Contrast with the *street hierarchy system* (above), which is a more disorganized street system consisting of neighborhoods with very limited entrances and exits, and streets with names rather than numbers.

grid system See *gridiron*.

gross area A term that must be defined with each use; sometimes it means the total heated and cooled floor area of a building, measuring from the exteriors of all walls and including all floors. Other times it is used to signify space measured from the inside of the exterior walls.

gross income The total revenue of a business or individual before deduction for expenses, allowances, depreciation, or other adjustments.

gross income multiplier A rule of thumb for evaluating the reasonableness of an asking price. One compares the monthly or annual gross income to the asking price and evaluates how that compares to typical ratios for similar properties. For example, some investors will not pay more than 100 times the monthly gross income for a property. If a house rents for $900 per month, the investor will pay $90,000 but no more. The method is not a good indication of value and would never be employed by an appraiser, but it has its uses as a preliminary qualifier or disqualifier of properties.

gross lease A lease for a set amount of rent each month, with the landlord paying all expenses of the property and its management. It is the typical form of lease for residential properties. Contrast with a net lease in which the tenants reimburse the landlord for some or all of the expenses of ownership and management. (Net leases are common in commercial transactions.)

gross leasable area (GLA) A total amount of floor space available for rental to tenants; typically encountered in the retail development industry, although it also applies to office space.

gross potential income The total rent possible from a property if it were 100 percent leased at market rates (with no deductions for bad debt,) plus ancillary income such as from laundry machines and late fees. Contrast with *gross potential rental income*.

gross potential rental income The total rent possible from a property if it were 100 percent leased at market rates (with no deductions for bad debt,) but does not include ancillary income like laundry machines or late fees.

gross rent multiplier See *gross income multiplier*.

gross square footage The total number of square feet of a building, measuring from the outside of the exterior walls and including all floors. The term is generally encountered in an institutional setting where the ratio of head count to gross square footage of buildings is important for determining capacity and the need to construct more buildings.

gross up To artificially increase operating expenses in a project for accounting purposes in order to calculate each tenant's pro rata share of those expenses. Most commercial leases provide that actual operating expenses will be increased—grossed up—to what they would be if the project were 95 percent leased. That figure is then divided among the tenants according to their pro rata share of expenses, as determined by their pro rata share of leased space.

ground area See *footprint*.

ground lease A long-term lease of land in which the tenant will erect improvements at its own expense. Not a desirable arrangement from the tenant's point of view, but sometimes the only way to gain access to extremely valuable real estate in an excellent location. The owner may be unwilling to sell, or the owner may have received the property by gift or deed (such as a church or university) and be prohibited from selling for some period of time. At the end of the lease term, the improvements become the property of the landowner.

ground rent The rent paid under a ground lease.

groundwater Water below the earth's surface, saturating soil and rock at the level of the water table and below. It supplies approximately 35 percent of the drinking water in the country and, as such, is a source of much concern for the Environmental Protection Agency. If one purchases a property with contaminants, and those contaminants have leached into the groundwater, then remediation will usually be required before development can proceed.

group boycott An illegal practice in which two or more real estate brokers or agents refuse to cooperate and split commissions with another one, usually a discount broker.

group home A residence for a group of persons with similar special needs, such as developmentally challenged adults or abused women with small children.

growing equity mortgage (GEM) A home loan arrangement in which the payments are increased each year by a specific amount, with the additional money credited to additional principal

reduction. As a result, the loan is paid in full earlier than the normal amortization period. The FHA-insured GEM program is called a 245(a) loan.

grow your own buyer strategy When seeking out occupants for a single-tenant building, searching for one that is likely to desire purchasing the building in 3 to 5 years.

GSE See *government-sponsored enterprise*.

guarantee The act itself, or also the document, whereby one agrees to pay a debt if the principal obligor does not. Under common law, creditors had to exhaust their remedies against a debtor before pursuing a guarantor. Today, almost all guarantee instruments contain clauses allowing the creditor to seek payment directly from the guarantor if there has been a default by the debtor. Guarantee agreements must be in writing to be enforceable. Usually, there must be some consideration passing to the guarantor unless the instrument creating the obligation (note, lease) is signed at the same time as the guarantee, in which case the law assumes the guarantor has some interest in the transaction.

guardian A person who operates under court supervision and handles the affairs of a party—the ward—who is incapable of doing so. Wards may be minor children or those adjudged incompetent. Guardians may execute deeds on behalf of their wards. In some states, a guardian may not place a mortgage on property owned by the ward, nor may the guardian buy property subject to a mortgage.

guide meridians Lines placed every 24 miles in the public land survey system in order to correct for the earth's curvature. Meridian lines are imaginary lines running north and south. They cannot be parallel because the earth curves as it approaches the poles. As a result, they cannot be a uniform 6 miles apart, as they should be. The guide meridians correct for this.

Gulf Opportunity Zone Act of 2005 See *GO-Zone*.

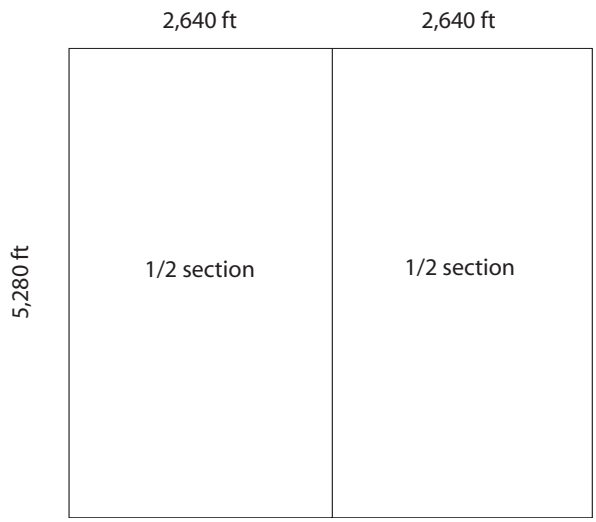
H

habendum clause The part of a deed that begins with the words "to have and to hold" and that defines the quantity of estate granted, such as "to have and to hold for and during her natural life and thereafter to grantor." This example gives a life estate to the grantee and a remainder to the grantor.

habitable Living quarters capable of being occupied without danger to health or safety and in a manner generally consistent with minimum living conditions for the community. Many states require landlords to provide habitable dwellings to tenants.

half section See *public land survey system* for a full explanation.

> **Example:** *A section of land is 1 square mile, being 5,280 feet on each side and containing 640 acres. A half section can be the north or south half, or it can be the east or west half, but it can't be an arbitrary 320 acres somewhere in the middle. A half section would have one side of 5,280 feet and the other side of 2,640 feet.*

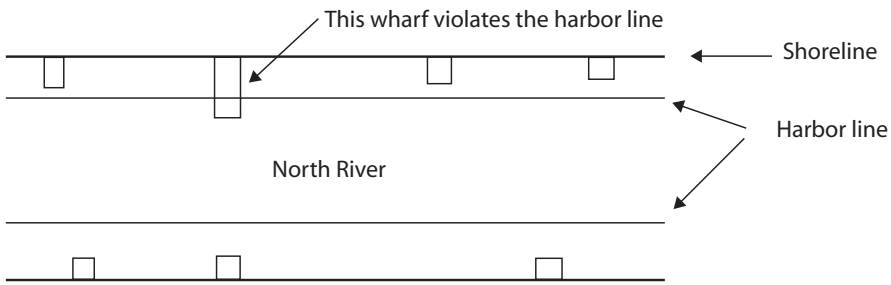


handicap The Fair Housing Act prohibits discrimination on the basis of a handicap. A handicap has been defined as having the same meaning as disability. Persons with disabilities are persons with mental or physical impairments that substantially limit one or more major life activities. The term mental or physical impairment may include conditions such as blindness, hearing impairment,

mobility impairment, HIV infection, mental retardation, alcoholism, drug addiction, chronic fatigue, learning disability, head injury, and mental illness. The term major life activity may include seeing, hearing, walking, breathing, performing manual tasks, caring for one's self, learning, speaking, or working. The Fair Housing Act also protects persons who have a record of such an impairment or are regarded as having such an impairment.

handyman's special In real estate advertising, generally indicates a building with substantial deterioration and in need of extensive repairs beyond normal paint-up/fix-up aesthetic improvements.

harbor line Also called the navigable line, it is an arbitrary line set by local authorities for the farthest extent wharves and other structures may intrude into the rivers and other waterways so as not to interfere with navigation.



hard costs See *direct costs*.

hazard insurance A form of property insurance that protects against physical damage to property, such as by fire or tornado.

hazardous substance Generally defined as a substance posing imminent and substantial danger to public health and welfare or the environment. The Superfund hazardous substances are specifically defined by inclusion lists within the following legislation:

- Comprehensive Environmental Response, Compensation and Liability Act (CERCLA)
- Clean Water Act
- Resources Conservation and Recovery Act
- Clean Air Act
- Toxic Substances Control Act

hearing A legal proceeding conducted by an administrative agency in order to take testimony and arguments for or against a proposed action. Parties may have attorneys present but are not required to do so. Unlike the court system, most agencies permit corporations to appear through an officer or majority shareholder, without requiring an attorney.

heavy industry A concept usually important in zoning regulations, where it will be defined for the particular purposes of those laws. In common parlance, heavy industry is usually understood as that requiring extensive capital investment in land and machinery and thus not easily relocated. This is

contrasted with light industry, which is usually more labor intensive and relatively easy to move. Other times, the term "heavy industry" is intended to convey an image of severe environmental impact through normal operations.

hectare A land measurement under the metric system, equal to 10,000 square meters, or roughly 2.471 acres.

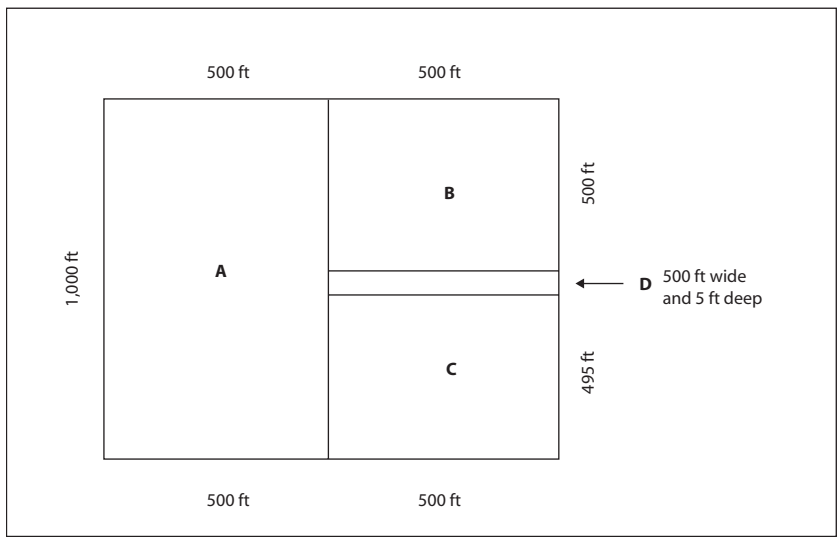
height, building Generally held to be the height from the street to the surface of a flat roof or the average height of a pitched roof, without taking into account roof structures, air handling equipment, antennas, or satellite dishes. The term is most often significant when attempting to meet zoning restrictions, which usually contain their own definitional sections. If so, then it is irrelevant what the general public considers as the true measurement of building height; the method of measurement specified in the statute will control.

heir One who inherits property.

heirs and assigns Because of peculiarities in old English common law, these words when used in a deed, "To Harry Smith, his heirs and assigns," indicate an intention to transfer the maximum possible estate in land.

hereditament Any real or personal property that may be inherited. It would not include a life estate in oneself—meaning a right to land during one's own life but no longer—because that obviously can't be inherited. The word had more importance under older English law because of the ability to place a greater variety of restrictions on land than is possible today. It is often encountered in wills, leaving "all my lands, tenements and hereditaments to my daughter… ." As a practical matter, only the word "hereditament" is necessary because it includes the other two.

hiatus A break or gap. In discussions of land, an area of land that lies between two parcels but appears from legal descriptions and public records to not be a part of either.



> **Example:** *A parcel 1,000 feet by 1,000 feet has been divided. In writing the deeds, though, parcel C's description started at the southeast corner and proceeded northward only 495 feet rather than the full 500 feet necessary to meet the boundary with parcel B. The missing 5 feet is the hiatus. A court might hold that property C's grantor still owns the 5-foot parcel, or it might reform the deed, or it might find that the owner of parcel B adversely possessed the 5-foot parcel.*

hidden defect (1) A title defect that is not obvious from examining the public records, such as a forgery. (2) A defect in property that is not observable by the untrained eye and must be disclosed by the seller or seller's agent if known.

hidden risk See *hidden defect*.

highest and best use In public appraisal and tax appraisal, that use of land which would be the most economically advantageous over a given period of time, while at the same time being legally, financially, and physically possible. A 5-acre residential estate within minutes of downtown Houston would have a highest and best use if it were developed for offices, and therefore should be appraised with that use in mind. Many property tax laws allow exemptions and appraisal at current use rather than highest and best use.

high-rise A concept with no fixed definition except as contained within specific fire codes or building codes. In commercial real estate, it is generally understood by reference to what it is not. It is not a low-rise, which is a one- or two-story structure. It is not a midrise, which could be anything between three and six, perhaps eight stories high, depending on the community. A high-rise is anything taller than a midrise. The meaning of high-rise in Asheville, North Carolina, will be different than that in New York City or Chicago.

high-water mark The line on shore marked by the reach of the medium tide and which usually determines the boundary between private property and public property. Some jurisdictions limit private property to the shoreline, which is the highest reach of the waves inward to the land.

historic cost The cost of a structure when it was first built. Contrast with original cost, which is the price paid by the current owner.

historic district A designation given by local government to particular parts of town deemed historically significant or containing a large concentration of older buildings considered worthy of preservation in an historically accurate condition. Properties located in historic districts are usually the subject of dramatically increased scrutiny by planning and zoning authorities. The approval of an historic board may be required before a building permit for repairs or renovations for these properties is issued. Many are also eligible for federal historic preservation credits.

historic preservation credits A common name given to the IRS concept of rehabilitation tax credits, allowing tax credits equal to 10 percent of the cost of renovation, reconstruction, and restoration of buildings placed in service before 1936. A larger credit, 20 percent, is allowed for certified historic structures. There is a special increase for properties in the Gulf Opportunity Zone (named counties

suffering hurricane damage in the 2005 hurricane season) with 13 percent allowed for pre–1936 buildings and 26 percent for certified historic structures. The properties do not need to have suffered any hurricane damage, as long as they are in the specifically named states and counties. See Form 3468, "Investment Credit," and the attached instructions, available at the IRS Web site, www.irs.gov.

holdback Retainage; amounts withheld from payment until certain goals have been reached.

> **Example:** *A lender holds back funding the balance of a loan until stabilized occupancy has been reached, or a homeowner holds back the final 10 percent of a construction contract price until after completion of all inspections.*

holder in due course A party who acquires possession of an instrument (usually a check, promissory note, or installment sale contract) after giving value for it, in good faith, and without notice that there are any defenses; the holder in due course takes free of any claims. It was common at one time for health clubs, home improvement companies, vinyl siding installers, and many others to provide financing for their customers. The company would then sell the promissory notes to a holder in due course. When the consumer complained of high-pressure sales tactics, services inferior to those represented, or shoddy workmanship and refused to continue making payments, the holder in due course would sue and win a judgment because it was not subject to any defenses against the original party. State legislation has now exempted purchasers of consumer contracts from holder in due course status, so that defenses good against the original party are also good against the purchaser of the paper. There is still a very lively industry in buying consumer paper, but purchasers now include clauses making the purchase with recourse, meaning that if the consumer asserts any defenses, the original contracting party must buy the paper back and deal with the consumer directly.

hold-harmless clause A contract provision that if one party is harmed, injured, subjected to claims, sued, or has a judgment against it, the other party to the contract will reimburse the first party for all such costs, expenses, and claims. It is a common clause in commercial leases, because the law imposes liability on both owners and occupiers of land for a wide variety of injuries caused by defects in or on the property. By the time an innocent landlord, tenant, or other party to a contract is able to obtain a dismissal of charges as to them, the bills for legal fees could amount to many tens of thousands of dollars. To control this situation, landlords usually require hold-harmless clauses from tenants. On the other hand, if the tenant has the superior bargaining position, the tenant will refuse to indemnify the landlord and, in addition, require the landlord to indemnify the tenant! Also called an indemnity clause.

holding company A company that owns or controls another company.

holding costs See *carrying charges.*

holding period (1) A time period important in the law of adverse possession, with its own peculiar rules for calculation. See *adverse possession* for more information. (2) A period of time one owns property, important in tax law for determining tax rates and benefits and for disallowance of some benefits.

Examples:

- Property exchanged in a 1031 exchange by related parties has a 2-year holding period before it can be sold; otherwise there will be adverse tax consequences.
- Banks have a 21-day holding period before sending taxpayer bank deposits to the IRS pursuant to a garnishment.
- Property sold after a holding period of 1 year or less will result in short-term capital gains or losses.
- Property sold after a holding period of more than 1 year will result in long-term capital gains or losses.
- Property sold after a holding period of more than 5 years will result in super-long-term capital gains or losses.
- Property acquired by inheritance will be treated as if it were held for longer than 1 year.

holdout A property owner who refuses to sell to a developer who is purchasing a number of separate parcels in order to put them together—an assemblage—for development. Sometimes the practice results in an offer vastly in excess of market price, because the holdout controls the success of the entire project. Other times, developers go back to the drawing board and redesign the project, leaving the holdout with no offer at all and what could turn into very unpleasant living conditions due to being surrounded by parking lots and 24-hour high-intensity lighting. Developers often avoid the problem by purchasing options rather than properties, so that if a critical property owner refuses to sell, the developer can abandon the entire project with a minimal expenditure.

holdover tenant A tenant who remains in possession of leased premises beyond the expiration of a lease term. Most commercial leases, and many residential leases, provide that a holdover tenant will be responsible for rent in an amount 125 to 200 percent greater than current market rents, but accepting the rent does not sacrifice any of the landlord's rights to obtain an eviction. (State laws may place a cap on the amount of increased rent charged to consumers.)

holiday A day set apart for commemorating an important event. The term is used often in contracts and leases when computing time, as when a certain number of days are allowed for an action, but if the due date falls on a weekend or holiday, it will be the next business day. Leases, in particular, limit delivery of certain services, such as heating and air conditioning, on weekends and holidays. The better practice is for the contract or lease to define the holidays meant by it. In the absence of such a definition, holidays will usually include federal holidays, when federal offices are closed, and may include state holidays when state offices are closed, if different.

holographic will A will written by the testator's hand but bearing no witness signatures. Regular wills must be witnessed, and the testator and all witnesses must sign in the presence of each other; otherwise the will is void. The holographic will is an exception recognized by some states. Contrast with nuncupative will, which is an *oral* will made shortly before death before witnesses and later reduced to writing by them.

home cooking A slang expression indicating the fear held by out-of-state or out-of-town defendants in a lawsuit that they will not receive a fair trial because of jury prejudice or because

judges will not accord out-of-town lawyers the same credibility and leniency granted to local lawyers. This is the reason for most forum shopping clauses in contracts between local persons and large, usually nationwide, companies. The forum shopping clause requires any lawsuits to be brought in the other party's jurisdiction, thus presumably giving them the advantage of home cooking.

home equity conversion mortgage (HECM) An FHA-insured reverse mortgage loan allowing persons to borrow money against the equity in their home with no repayment usually necessary until after death. The money may be taken in one lump sum, or in payments over time.

The important elements are

- The borrower and any other current owners of the home must be aged 62 or over and live in the home as their principal residence.
- The home must be a single-family residence in a one- to four-unit building, a condominium, or part of a planned unit development (PUD). Some manufactured housing is eligible, but cooperative apartments are not.
- The home must be at least 1 year old and must meet HUD minimum standards, except that the HECM can be used to make necessary repairs.
- Applicants must discuss the program with a HUD-approved counselor before making any decision.
- Repayment in full is due (1) when the last surviving borrower dies, (2) when the home is sold, (3) when the borrowers permanently move elsewhere or fail to live in the home for 12 months, or (4) if there is a default in mortgage terms, such as failing to pay property taxes or keep the property insured or allowing it to deteriorate below HUD minimum standards.

home equity line of credit (HELOC) A revolving credit line secured by a mortgage on the borrower's residence. The borrower may draw down the loan—obtain funds—and then repay the principal later and restore the full borrowing ability for the maximum amount of the loan. The loan is often for amounts represented by the surplus above the first mortgage up to 125 percent of the appraised value of the home. These are high-risk loans because a foreclosure after default will not provide a sale price high enough to pay off the HELOC. As a result, the loans carry fairly high interest rates and, despite widespread advertising for 125 percent loans, only the most credit-worthy borrowers are able to secure the maximum loans. IRS rules allow the deduction of the interest on up to $100,000 of home equity line of credit debt.

home improvement loan A loan to make improvements on one's principal or secondary residence; may be a home equity line of credit or a traditional loan in a fixed amount. Both are secured by a second mortgage on the property.

home inspection Usually a professional, third-party inspection of a home prior to purchase in order to discover defects and report them to the purchaser.

home loan See *mortgage*.

Home Mortgage Disclosure Act A federal law requiring lenders with federally related loans to report the number of mortgage loan applications and the number of actual mortgage loans in different parts of their service areas. The Act is designed to shed light on discriminatory practices and thereby eliminate them. Reports are available on the Web site of the Federal Financial Institutions Examination Council, www.ffiec.gov/hmda.

home office An area of one's residence used for office purposes. Home offices may be eligible for tax benefits—see *home office tax deduction*. Some states allow real estate brokers to maintain their principal office in their homes under certain circumstances.

home office tax deduction The ability to deduct a portion of the cost and upkeep of a home because of the use of some space for business purposes. Generally,

- You must use some portion of the home regularly and exclusively as your principal place of business, or a place where you meet with clients, or
  - If using some structure separate from your home, you must merely use it in connection with your business.
  - If you are an employee, the use of a portion of your home for business must be for the convenience of your employer, not for your own convenience.
- The space must be used exclusively for business, but it does not have to be separated by walls or other partitions from other space.
- The deduction will be calculated using a percentage determined by comparing the space used for business purposes with the total space in the home. For example, a 150-square-foot room in a 3,000-square-foot house, or 150/3,000, will equate to 5 percent.
- Direct expenses used for work, materials, or repairs only in the business portion of the home are fully deductible; indirect expenses used for the entire home, such as utilities, cleaning, insurance, and real estate taxes can be deducted in a pro rata amount as determined from the percentage of space; unrelated expenses for nonbusiness parts of the home, such as painting other rooms, landscaping maintenance, or pool care are not deductible.
- Your use of home office business deductions cannot result in a business loss that will shelter other income.

For more information, see Publication 587, "Business Use of Your Home," available at the IRS Web site, www.irs.gov.

homeowners association An organization of the homeowners in a subdivision or a group of related subdivisions. In order to have the ability to collect dues and enforce rules, the association must be created by a legal document that was drawn up and filed before the first lot or home is sold, or by a legal document signed by 100 percent of the property owners and then filed in the public records.

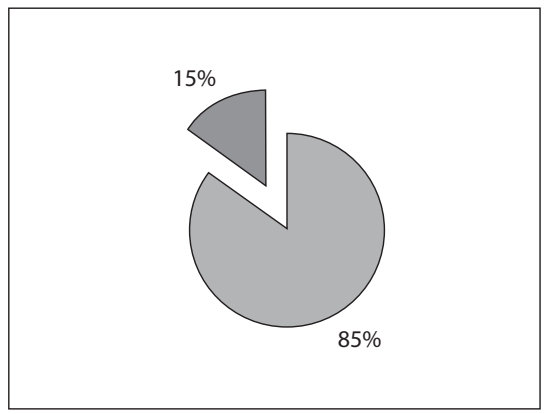
- The associations sometimes own common areas. They also enforce restrictive covenants for the subdivision, such as setback lines, prohibitions against parking motor homes in driveways, restrictions on home-based businesses, and even architectural and landscaping

restrictions. Often, one cannot cut trees, paint a house, add a porch, or make any other changes without first submitting detailed plans to an architectural review committee.

- The associations generally collect monthly dues in an amount barely sufficient to pay for common area maintenance and an annual party. Maintenance could be as minor as buying new flowers for the entrance or as pervasive as maintaining private roads in a gated community; siltation control and dredging for a private lake; costs of a security system and/or guard; and the care and upkeep of swimming pools, tennis courts, and other recreational facilities. In the absence of a fund for attorneys' fees, or the ability to assess additional dues for attorneys' fees in order to take rule breakers to court, the result is that rules generally go unenforced except as may be possible through peer pressure.
- Most homeowners associations have the right to impose fines and to place liens on property and force a sale if the fines are not paid, but this route is rarely successful without long and expensive litigation. Usually, the liens remain in place until the property is eventually sold, and then they are collected, but this has little deterrent value when trying to stop current rule violations.

homeownership rate The ratio of owner-occupied units to total residential units in a specified area.

Example: *For an area with 20,000 units, 17,000 of them are owner-occupied and 3,000 are occupied with renters. This means that the ratio of owner-occupied units is 85 percent and the ratio of rentals is 15 percent.*



homeowner's insurance policy An insurance policy tailored for most homeowners with a package of coverages and endorsements designed to address most risks. Usually includes coverage for the main structure, a certain percentage of that in additional coverage for outbuildings, a certain percentage of additional coverage for contents, reimbursement for rental expenses and cleanup costs in the event of significant loss, and liability coverage in case anyone else is injured on the property as a result of a condition or defect of the property.

Homeowners Protection Act of 1998 (HOPA) Legislation passed in response to abuses in the private mortgage insurance (PMI) industry. Home purchasers who wish to borrow more than 80 percent of the purchase price of their property must usually purchase private mortgage insurance, which pays the lender in the event of default and a foreclosure. The purchaser pays the premiums through additional fees added to the monthly mortgage payment. Once the loan is paid to an amount less than 80 percent of the purchase price or the fair market value, there should be no need for the insurance. Despite this, PMI companies would continue to collect insurance premiums. The Act requires PMI companies to notify borrowers of their right to cancel the insurance when the loan is no more than 80 percent of the value of the home, and it requires them to automatically cancel the insurance when the loan is no more than 78 percent of the value of the home. The value is based on the purchase price or can be based on a recent appraisal if the borrower is willing to order and pay for an appraisal. There are exceptions to the cancellation rules, primarily when there has been a history of loan delinquencies. Also called PMI Cancellation Act.

homeowners' warranty program An insurance program offered by a subsidiary of the National Association of Home Builders. If purchased, the policy provides the buyer of a new home with a 10-year warranty against named physical defects.

home rule The power granted to local governments to pass ordinances regulating matters particularly local in nature. Some states have limited home rule, so matters that would seem to be local in nature must still be submitted to statewide referenda for approval and passage.

homestead The dwelling house and adjoining land forming the permanent residence of the head of household. Under modern law, a person's homestead is given a very specific definition within each state's statutes and is then granted protections from creditors and against excessive real estate taxes. The term homestead may also apply to the rights granted to a widow or widower to use real property for their remaining lives if they elect to take advantage of homestead laws rather than provisions made in a will. The protections may be unlimited, only up to a certain dollar value of equity, or limited in area. Each state's laws are different, and homestead may be defined differently in the various statutes within a state.

homogenous The same. The value of property in a homogenous neighborhood is relatively easy to determine because of ample evidence regarding recent sales of comparable sites.

HOPA See *Homeowners Protection Act of 1998*.

Horizontal Property Acts Name given by some jurisdictions to their statutes regulating the creation of condominiums.

hostile possession See *adverse possession*.

hotel A concept that seems relatively straightforward, as a place where people rent rooms for the night. Local business codes, tax laws, and zoning ordinances will all have their own definitions, however, contained within particular statutes. If in doubt regarding whether a particular use will be considered a hotel, one should refer to the appropriate laws.

house In real estate jargon, generally indicates a detached dwelling on a parcel of its own land.

house fluffer A decorator who recommends improvements and renovations designed to maximize a home's sale price.

house poor Also called land poor; a situation in which all of one's wealth is in the home (or land) and there is very little cash or income to pay for anything other than necessities.

house rules Everyday-conduct rules adopted by a condominium association to cover things such as hours of pool usage, number of allowable guest parking places, prohibitions against drying towels on balcony railings, and other such matters.

housing affordability index Developed by the National Association of REALTORS® to track the financial ability of consumers to buy homes. Many state organizations publish similar indices for their local markets. The benchmark is 100, sometimes expressed as 1.0. It means that a family earning the median income has exactly enough money to qualify for a mortgage to buy a median-priced home in that market. It assumes a 20 percent down payment, and that mortgage payments will not exceed 25 percent of income. A figure less than 100, or less than 1.0, means that the median income family cannot afford the median house. A greater figure means the median income family can afford a home more expensive than the median home. When a trend line is declining, it indicates that housing is becoming less affordable. Upwardly trending numbers mean housing is becoming more affordable. National figures may be obtained by going to the National Association of REALTORS® Web site, www.realtor.org, and clicking on Research, then Housing Statistics, and then Housing Affordability Index.

housing code A local ordinance that establishes minimum health and safety levels for existing housing. Contrast with building codes, which address new construction.

housing completions A statistic tracked by the U.S. Census Bureau (www.census.gov) and by many local real estate and builder organizations. It indicates the number of new homes made ready for occupancy within a certain time period, usually one month and one year.

housing counseling agency A nonprofit organization that provides advice and credit counseling to individuals wishing to purchase housing. Many low-income loan programs require completion of a housing counseling course as a condition of obtaining the loan.

housing finance agency A state or local organization that provides housing assistance through low-interest mortgage loans to qualifying buyers, including loans to fund down payment and closing costs due after the application of traditional mortgage money.

housing for the elderly Any project specifically designed for persons 55 years or older and marketed to that demographic group. Housing for the elderly is exempt from Fair Housing laws prohibiting discrimination against families.

housing permit See *building permit*.

housing starts A statistic tracked by the U.S. Census Bureau (www.census.gov) and by many local real estate and builder organizations; indicates the number of new homes on which construction has started within a certain time period, usually one month and one year.

housing stock The total number of dwelling units in a defined area.

Howey rule A rule of securities law articulated by the Supreme Court in the case of Howey v. Securities and Exchange Commission. The Howey company sold real estate interests in orange groves that it managed. As a practical matter, one could not buy the real estate and make any profit from it unless Howey handled all the details of cultivation, harvesting, and marketing. The SEC claimed Howey was selling "investment contracts" and therefore had to register with the SEC. The Supreme Court agreed.

The Howey rule, as it has come to be called, says that an investment contract is

1. A contract, transaction, or scheme whereby one person invests his or her money
2. in a common enterprise
3. led to expect profits solely from the efforts of a third party.

HUD The United States Department of Housing and Urban Development. This federal cabinet-level department has a wide variety of responsibilities, including

- Enforcing fair housing laws
- Assisting community development through block grants, loan guarantees, and disaster recovery assistance
- Regulating Fannie Mae and Freddie Mac
- Supporting health care through providing mortgage insurance for hospitals, nursing homes, and assisted living facilities
- Aiding Native Americans with specialized housing programs
- Educating citizens about hazards such as lead paint
- Overseeing the Federal Manufactured Housing Program
- Providing public housing assistance
- Making available housing counseling
- Administering a number of mortgage insurance programs for multifamily housing
- Providing mortgage insurance for single-family houses
- Handling witness relocation for people who have testified about crimes in their public or assisted housing buildings

HUD-Code home A manufactured home. The word "code" refers to the HUD regulation requiring all manufactured homes built after 1976 to meet the minimum requirements of the HUD Code, as contrasted with local building codes, which usually don't apply to manufactured housing.

HUD–1 form *See closing statement*.

hundred percent commission A real estate office arrangement in which the qualifying or managing broker keeps none of the real estate commission earned by the office, but instead pays 100 percent to the agent who secured the listing, the buyer, or the tenant. The broker makes his or her

own money by competing against the agents, contrary to the typical practice in most other real estate offices. The broker also charges each agent a monthly fee to cover office space, advertising, and operating expenses and to provide a profit to the broker. This is in contrast to the more widespread practice in which commissions are paid to the broker, who is the only person legally authorized to enter into an agency agreement with another. The broker then splits the commission, paying some portion to the agent actually responsible for the work performed to earn the money.

hundred percent location Refers to the best location with the highest land value.

HVAC Heating, ventilation, and air conditioning.

hybrid mortgage A mortgage that combines the benefits of an adjustable-rate mortgage and a fixed-rate mortgage, such as adjustable rates in the early years and then an automatic conversion to fixed rates after a stated period of time. For example, the 5/25 (adjustable for 5 years and fixed for 25) and the 7/23.

hypothecate To give a security interest in specific real or personal property while retaining possession of the property. Contrast with a pawnshop, in which one surrenders possession of the security, or a loan against negotiable securities such as stocks and bonds, which could be sold by the borrower if the lender did not require possession in itself.

hypothetical condition A condition that does not currently exist in fact but has some probability of existing in the future. An appraisal may determine the value of property in its current condition, and then also determine a value based on a hypothetical condition, such as a state's plans to build a new highway exit at the property.

I

idem sonans Sounding the same, or alike. The rule of idem sonans is that absolute accuracy in spelling names is not required in a deed or other legal document, so long as the spellings sound the same and there is no intent to deceive. Without the rule, typographical errors in a deed would result in title not passing, creating a nightmare in writing title insurance and in litigation over competing claims.

Example: *Jayne Smith is idem sonans with Jane Smith.*

illiquidity (1) The condition of having insufficient cash to meet anticipated requirements, such as a business loan that is turned down because of the borrower's illiquidity, not because of problems with the borrower's credit rating or the value of the collateral. (2) The relative ease with which an asset can be converted to cash. The more difficult, the more illiquid the asset is.

impact fees Fees imposed by local government on new construction projects in order to compensate the government for the increased costs of delivering services. Impact fees can sometimes be extremely high, having the result of chilling development.

implied agency An agency relationship that arises out of the conduct of the parties and the impressions they give to the world, rather than because of a written or oral agreement. It is extremely rare to have an implied agency in real estate because of the rule that real estate contracts must be in writing, so agency relationships regarding real estate must also be in writing.

implied authority A principal grants the agent implied authority when there is an implied agency. See *implied agency*.

implied condition A provision not specifically spelled out in a contract, but considered an important underlying assumption of the parties. In most states, there is an implied condition in a new home sales contract that the home will be habitable and can be safely occupied in relative comfort with working hot and cold water with no leaks, a working sanitary sewer system, operational heating, and relative security from intruders.

implied contract A contract that arises out of the actions of the parties rather than any express words or writings by them. For example, when one names a price for a service and another accepts that service without any comment about the price, there is an implied contract to pay the quoted price. Almost all real estate transactions must have a written contract, by law, to be enforceable. Only the major terms need be in writing, however—the parties, a description of the property, a

description of the estate granted (forever, for life, lease for years, etc.), and the consideration. Minor terms may be determined by reference to the actions of the parties, and so can be the subject of an implied contract.

implied easement An easement recognized by the law, although not expressly agreed upon by the parties or their predecessors in title. This situation usually arises when the owner of a parcel of land sells a portion to someone else. At the time of the sale, there might have been common roads, irrigation, or other uses. After the sale, courts will sometimes recognize an implied easement allowing all owners of the sold parcel to continue to enjoy those uses that technically belong to the other parcel, such as a right-of-way easement or an easement to use water from a lake or stream. This should not be confused with an easement of necessity, which generally requires that there be no other method of ingress or egress, for example. The better practice is to identify such matters ahead of time and include them in the purchase agreement and deed. Unfortunately, these issues usually arise long after the amicable relationship between the original seller and purchaser has deteriorated or the land has changed ownership and conflict results.

implied listing A listing agreement for the sale of property that arises out of the conduct of the parties, rather than any express written or oral contract between them. If there were an implied listing, then the listing broker would be entitled to the normal and customary commission available in the marketplace. As a practical matter, most states require listing agreements to be in writing to be enforceable and many states subject brokers to disciplinary action for entering into unwritten listing agreements.

implied notice A situation in which the law considers someone as having notice of a particular fact because they knew of sufficient other facts such as would cause a reasonable person to make inquiries and then gain additional knowledge.

> **Example:** *Zack finds a house he wants to buy. The owners live out of town, but every time Zack visits the house to review and inspect it, he sees evidence that someone is living in the house. Despite that, he signs a contract to buy the house, goes through with the closing, and is surprised when the current tenants tell him they have a 5-year lease on the property. Zack had implied notice of this fact. When he saw evidence of occupancy, he should have asked more questions and is not entitled to simply sit in ignorance and hope everything works out for the best.*

implied warranty of habitability (1) A legal doctrine that imposes on a landlord the obligation to make leased premises ready for occupancy in a safe, healthy, and nonhazardous condition and with the minimal amenities necessary for the provision of heat and water, although not including the utilities themselves. Many states have passed uniform landlord tenant laws, changing the implied warranty into an expressly articulated and defined legal obligation of the landlord. (2) State law may also imply similar warranties for new home builders.

impound account See *escrow account*.

improved land Land that has some improvement from its natural state, such as grading, added structures, planted timber, or crops.

improvements Valuable additions to land intended to increase its value.

imputed interest A common term for the IRS expression "unstated interest" or sometimes "original issue discount." It applies to the situation in which a promissory note calls for no interest or insufficient interest under the circumstances. In an audit, the IRS will calculate an interest rate, impute that to the transaction, and declare each year's imputed interest as additional income to the lender, on which the lender must pay income taxes, penalties, and interest. (The rules are found at 26 U.S.C. §1273, 1274 and 483.)

imputed notice The concept that notice to one person will be considered notice to another in a special relationship to the first person. For example, notice to an attorney is the same as notice to the attorney's client. In circumstances allowing oral contracts (usually not the case with real estate), if a seller makes an offer and a buyer accepts that offer via a communication to the seller's agent, then the acceptance makes a binding contract as of that moment. The seller cannot withdraw the offer before actually learning of the acceptance, because the contract has already been formed when the agent received the notice.

inactive license A mechanism under some state real estate licensing laws for a real estate agent to withdraw his or her name from licensing under any broker and hold the license in an inactive status until the agent is ready to return to active practice with the same, or another, broker. While on inactive status, the agent may not engage in activities requiring a real estate license and may not accept compensation for buying, selling, or referring buyers or sellers. Normally the inactive licensee is able to pay a smaller licensing fee and is relieved of some or all continuing education requirements during the inactive status.

inchoate Incomplete, impartial, not completed. Inchoate property rights include mechanics' and materialmen's liens, which come into possibility when work is commenced on a property but might never ripen into actual existence if all bills are paid for the work.

inclusionary zoning Zoning that requires inclusion of low- or moderate-income housing in new residential developments.

income (1) For IRS purposes, income is never precisely defined, but it apparently includes all moneys received from any sources unless specifically excluded by some IRS Code provision. (2) In business, all the revenues derived from the business, less all expenses. Many people use the word income interchangeably with revenues, but revenue implies a gross figure without deductions, and income implies an amount after expenses.

income and expense report See *financial statement*.

income approach A method of valuing real property by determining the net operating income over the useful life of the property and then translating that number to the present value via a discount rate. The present-value concept depends on the assumption that $1 today is worth more than 10 cents a year for the next 10 years, because of the purchasing power of the $1 to buy other investments that will yield a return over the next 10 years, and because of the effects of inflation, which

decreases the amount of goods or services $1 will buy over the years. In order to compensate for these considerations, one would say that the value of 10 cents a year for the next 10 years is worth less than $1 today. How much less is the art and science of discounting.

income averaging A tax tool formerly given to all taxpayers and now available for just a few classes, such as farmers and fishermen. It allows taxpayers to average their income over 3 years and pay taxes on the average income, rather than no taxes one year and then high taxes at a high bracket in the next year, for example. (Calculated on Schedule J of IRS Form 1040.)

income capitalization approach See *income approach*.

income limits The maximum amount a family can earn and still be eligible for certain government housing assistance programs.

income-producing property Whether or not it actually produces a profit, a property that is intended to generate rental or other revenues for the owner.

income property Property purchased for the income it generates, such as rents.

income statement See *financial statement*.

income stream A steady flow of money from a property. When evaluating the property, one has to evaluate the strength and durability of the income stream.

> **Example:** *Is the tenant a national tenant with good financial strength, excellent prospects for continued health, and a 20-year lease on the property with rent adjustments annually to reflect cost-of-living increases, or is the tenant a start-up business with a 1-year lease in an area already saturated with similar businesses? Those two income streams are markedly different from each other.*

income tax A tax on income. A simple concept, but one that requires thousands of pages of IRS statutes, regulations, revenue rulings, and court interpretations to explain. See the IRS Web site at www.irs.gov.

incompetent Legally not able to make decisions, enter into contracts, or execute wills. This may be a result of a permanent mental impairment, as when one is declared non compos mentis or incompetent, or it may be for temporary reasons, such as a minor child's inability to make binding contracts.

incorporate To form a corporation by filing documents in the appropriate state authority, which may be one's own state or a corporation-friendly state such as Delaware. Once having formed the corporation, one must pay annual franchise taxes to the state for the privilege of existing as an artificial entity, and one must observe all the forms and conventions of corporate existence. In other words, the sole shareholder cannot form a corporation and then never have meetings, never sign documents in the corporate name, take all corporate money for personal use without accounting for it on the books and records of the corporation, and generally behave as if the corporation did not

exist. If the shareholder(s) behave as if the corporation does not exist, then creditors may be able to *pierce the corporate veil* and seize assets of the individual shareholders.

incorporation by reference A method of including all the terms of one document into another document without having to spell everything out. Deeds will frequently make reference to restrictive covenants on file in the real estate records at a certain book and page number and incorporate them by reference into the deed itself. In that manner, any purchaser of the land is bound by the restrictive covenants, without getting into arguments about whether or not they had constructive notice because of the public filing. A renewal lease may be a one- or two-page instrument incorporating the original lease by reference, with the exception of changes to the rental rate and the term.

incorporeal rights Property rights that are inheritable but not tangible or visible, such as easements, licenses, mining claims, and franchises.

increment A portion, as of property or time. Developers build subdivisions in phases or increments, completing one section in order to gauge market demand before starting another section. Lawyers bill in minimum increments of 6, 10, 15, or 30 minutes depending on the particular lawyer and local custom, so a 3-minute phone call might be billed as any of these time increments.

incubator space Office, industrial, or high-tech space usually owned or managed by a local government development board and intended to provide an economical and supportive environment for new business start-ups. The rental rates are usually below market, there is some sharing of services and amenities, and mentoring services are provided. The new business is usually kicked out of the nest after it reaches a certain volume of business or after it achieves a previously approved and agreed upon business plan.

incumbrance Same as encumbrance. See *encumber*.

incurable obsolescence See *functional obsolescence*.

indemnification The process of shifting a loss from one party to another either because of an express agreement by the parties or because the law requires it under the circumstances.

> **Example:** *A purchaser of real estate discovers the property is subject to a lien that was placed against it prior to sale and pays the lien in order to avoid foreclosure; then the purchaser is entitled to indemnification, or reimbursement, from the prior owner who breached the warranties in the deed.*

indemnity clause See *hold-harmless clause*.

indenture deed A deed in which the buyer and seller bind themselves to certain obligations, such as an agreement that any liability for environmental cleanup expenses will be paid by the buyer and not the seller. Under ordinary circumstances, only the seller need sign a deed, because only the seller has any obligations regarding transferring good title. Leases are often called indentures, because they are a conveyance of an interest in real estate with both parties having continuing obligations.

The name indenture deed comes from ancient times, when such deeds were torn in half in an indented or jagged manner and could be proved by matching the two pieces.

independent appraisal An appraisal conducted by a disinterested person.

independent contractor One who is hired to reach a certain goal or perform a certain task, but who has the ability and the right to determine the methods and times for reaching that goal or task, so long as it is not illegal and is within the limits of the contract. This is an important concept because

1. Employers must take withholding taxes and pay matching taxes for employees but not independent contractors. The IRS has significantly tightened the definition of independent contractor so that most work relationships do not qualify. Under certain circumstances, real estate agents have been held to be employees for tax purposes.
2. If an independent contractor is negligent or commits an intentional tort, then the person who hired the contractor is not generally liable for the resulting damage. If an employee did the same thing, the employer would be liable so long as the employee was acting within the line and scope of his or her employment, which is usually a fairly easy hurdle for plaintiffs' lawyers to overcome.
3. An exception exists for the general rule of nonliability for the actions of an independent contractor, and that is in the area of real estate brokerage. Most real estate agents are independent contractors working for the broker. Real estate licensing laws, however, usually hold the broker responsible for the actions of agents.

index (1) A statistical indicator that measures changes in the economy in general or in particular areas. An example is the cost-of-living index. (2) A reference point against which measurements are taken for purposes of making future adjustments. An adjustable-rate mortgage might begin with an interest rate of 6 percent and provide that it will increase or decrease in a like percentage as the increase or decrease between today's quoted price for 10-year U.S. Treasury bonds and the price on the loan's annual anniversary date. We would say that 10-year T-bonds are the index.

Some leading loan indices include

- Wall Street Journal prime
- Federal discount rate
- Fed funds rate
- 11th District Cost of Funds
- 10-year Treasuries
- One-year LIBOR

index lease A lease that makes some or all of the rent dependent upon calculations with reference to some index, such as the cost-of-living index or the whole price index.

index loan See *adjustable-rate mortgage*.

index rate See *index*.

indicated value The bottom line in an appraisal; the appraiser's opinion of the current value of real propertyafter reconciliation of all methods and approaches to appraising the property.

indirect costs Costs of construction not directly related to the sticks and bricks. Examples include

- Real estate taxes
- Administrative costs
- Professional fees
- Insurance
- Lease-up expenses

individual retirement account (IRA) A retirement savings program entitling the individual to deduct contributions from gross income for purposes of calculating income taxes. The contributions are said to be from before-tax dollars.

Generally speaking, first-time home buyers can withdraw up to $10,000 from their IRA or Roth-IRA accounts, penalty free, in order to pay qualified home purchase expenses such as a down payment. Spouses can withdraw up to $20,000. There's a lifetime limit, though. Once you use up your distribution "free passes," you can't put the money back in your account and then use it again in the future. (For more information, see Tax Topic 428, "Roth IRA Distributions," and Publication 590, "Individual Retirement Accounts," available at the IRS Web site, www.irs.gov.)

indorsement See *endorsement*.

industrial broker One who specializes in industrial properties, also commonly called distribution properties.

industrial park An area zoned for industrial use. Often developed by local industrial development boards in order to provide low-cost real estate with shared rail lines or other amenities to attract employers to an area.

industrial property (1) Property designed for or used by companies or persons for manufacturing, warehousing, or assemblage of components. (2) In zoning, environmental, and building codes, the term "industrial property" will be defined within the statutes or codes for the specific purposes of those laws. The phrase may include uses not typically considered industrial and may exclude uses normally considered industrial.

in-fill development Property development within the boundaries of an area rather than moving outward and contributing to sprawl. The concept carries with it connotations of demolition of older buildings in order to make way for new construction, usually with a greater height and/or increased densities, rather than simply finally getting around to developing vacant land. In-fill development generally takes place in older neighborhoods outside the central business district but inside the ring of modern suburbs.

inflation A loss in the purchasing power of money. Inflation is generally measured by the consumer price index.

inflation guard An insurance policy endorsement that automatically increases coverage over time in order to keep up with the effects of inflation.

information reporting Reports provided to the IRS but which do not carry with them any liability for income taxes from the reporting entity. Partnerships and subchapter S-corporations must file information returns, closing agents must report real property purchase price information regarding the seller (Form 1098), and real estate brokers must report earnings of their agents (Form 1099).

☐ CORRECTED (if checked)

RECIPIENT'S/LENDER'S name, address, and telephone number	* **Caution:** *The amount shown may not be fully deductible by you. Limits based on the loan amount and the cost and value of the secured property may apply. Also, you may only deduct interest to the extent it was incurred by you, actually paid by you, and not reimbursed by another person.*	OMB No. 1545-0901 2006 Form **1098**	**Mortgage Interest Statement**
RECIPIENT'S federal identification no. / PAYER'S social security number	1 Mortgage interest received from payer(s)/borrower(s)* $		**Copy B For Payer** The information in boxes 1, 2, and 3 is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if the IRS determines that an underpayment of tax results because you overstated a deduction for this mortgage interest or for these points or because you did not report this refund of interest on your return.
PAYER'S/BORROWER'S name	2 Points paid on purchase of principal residence $		
Street address (including apt. no.)	3 Refund of overpaid interest $		
City, state, and ZIP code	4		
Account number (see instructions)			

Form **1098** (keep for your records) Department of the Treasury - Internal Revenue Service

informed consent Consent given after being provided with fair and full disclosure of all the facts necessary to make an intelligent decision after weighing the relative pros and cons of the situation and the possibility of realistic alternatives. Real estate agents may sometimes represent both buyers and sellers in the same transaction if all parties agree after informed consent.

infrastructure The basic amenities and services that must be in place for a particular activity or pursuit. The infrastructure in a subdivision would consist of roads; storm sewers; and mechanisms for the transmission of water, waste products, electricity, telecommunications, and possibly natural gas. References to the infrastructure of a community might also include basic services, such as fire and police protection, schools, and libraries.

ingress A way of entry.

in gross See *appurtenance*.

inheritance tax See *estate tax*.

in-house sale One in which the listing broker also brought the buyer to the closing table. There is no other broker involved, and no one is entitled to a share of the commission except as the broker and the agent working for the broker may have agreed to between themselves.

initial interest rate In an adjustable-rate mortgage, the first interest rate charged.

injunction A court order requiring a party to do something, or to stop doing something, until further notice. If the party fails to perform according to the injunction, then the party will be required to appear in court, defend his or her actions, and show cause why he or she should not be held in contempt of court. If held in contempt, the party may be ordered to pay a fine, may be jailed until the contempt is cured, or could suffer both consequences.

Injunctions come in three varieties:

1. Temporary restraining order (TRO). Usually obtainable with little or no notice to the defendant, sometimes as quickly as within an hour or so if the complaining party can convince a judge that there is immediate risk of irreparable harm if the restraining order is not issued.
2. Preliminary injunction. Usually issued after a TRO, if the judge decides that an injunction should remain in effect until such time as there can be a full trial on the merits of the case. Failure to obtain a TRO does not mean a judge will not issue a preliminary injunction; it simply means the judge did not agree with the plaintiff's evaluation of the necessity for urgent action.
3. Final injunction. The final order issued by a court after it has heard all the evidence and legal arguments for and against the injunction. The order is a final order, from which the parties may appeal.

inner city Technically refers to the densely populated area just outside the central business district, but usually connotes a blighted area near the city center.

innocent misrepresentation See *fraud*.

innocent purchaser for value See *bona fide purchaser*. The words "for value" are sometimes added to bona fide purchaser, also, in order to emphasize the requirement for valuable consideration as opposed to mere "good consideration," which might consist of love and affection.

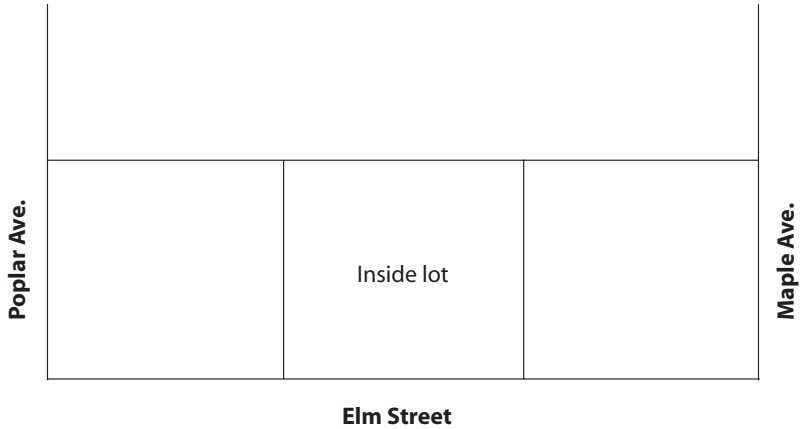
in perpetuity Forever.

inquiry notice That legal notice presumed to exist when a person is in command of sufficient facts as would cause a reasonable person to make further inquiries.

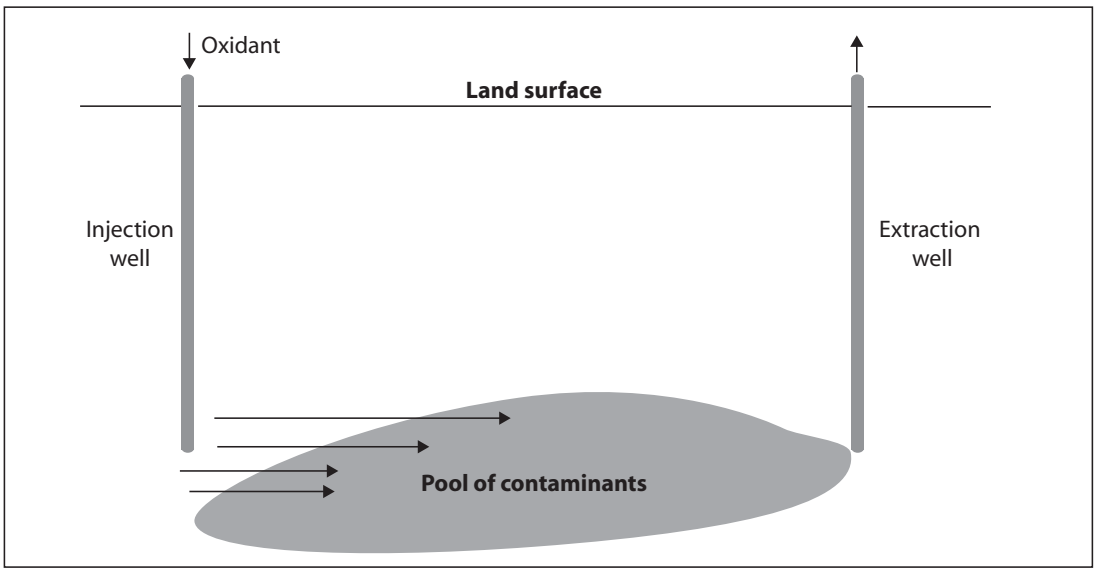
> **Example:** *If one buys real property and knows that it is occupied by someone other than the seller, then the buyer has an obligation to make inquiries to find out the character of the rights of the occupant, whether the occupant has a long-term lease, no lease at all, or is claiming title to the property as his or her own. But, having failed to make any inquiry, the purchaser cannot make a claim against the seller if the occupant claims rights in the property.*

in rem Meaning "against the thing." Lawsuits regarding title to real estate, or claims against real estate, are said to be in rem, so they must be filed in the state and county where the property is located.

inside lot Any subdivision lot except the corner lots.



in situ In place, on-site, such as EPA provisions for remediation in situ of contaminants rather than a requirement the contaminated soil be excavated and disposed of in an approved facility. To illustrate, the following is a diagram showing the process of chemical oxidation as an in situ solution to contamination.



Source: EPA.

insolvent The condition that exists when (1) one's liabilities are greater than assets, so that a complete liquidation even at fair market value would not pay all debts, or (2) one's current income is not sufficient to pay current bills, resulting in the need to contribute more cash to the organization or default on some payments.

installment contract A contract providing for payment of the purchase price to the seller over time. Installment contracts are given favorable treatment by the IRS (www.irs.gov), which allows the seller to declare gain only as the seller receives principal payments each year, rather than requiring the seller to immediately take into income the entire gross amount of the purchase price. Interest is counted as income in the year paid.

installment note A promissory note requiring payments over some period of time. Contrast with a single-pay loan, in which all principal and interest are due at maturity.

installment sale See *installment contract*.

Institute of Real Estate Management (IREM) An affiliate of the National Association of REALTORS®, this association (www.irem.org) is devoted to the needs of multifamily and commercial property managers.

institutional investor A large corporate investor in real estate and real estate securities, such as a pension fund, university, or insurance company.

institutional lender A federal- or state-regulated entity that loans money.

institutional lender financing Loan funds provided by a federal- or state-regulated entity that loans money as one of its core business activities. Contrast with seller financing, and with private investors who loan money for particular projects.

institutional property A zoning category authorizing schools, hospitals, and nursing homes.

instrument A written legal document.

insulation disclosure Also called the R-value rule, a Federal Trade Commission (FTC) requirement that persons selling new houses must disclose in their sales contracts the type, thickness, and R-value of the insulation installed in the house. Failure to make the required disclosure constitutes a deceptive trade practice and subjects the party to fines by the FTC.

insurable interest A right or interest in property or in the life of another that would cause the person to suffer a monetary loss if injury came to the property or to the other person. One must have an insurable interest in order to buy insurance, because the insurance is intended to compensate one for a loss.

insurable title A real estate title that can be insured by a title insurance company.

insurance A commercial contract agreeing to compensate one for loss in the event of specifically named or described risks.

insurance binder Evidence of property insurance coverage. Some insurance agents will bind coverage before receipt of payment for the premium. Lenders usually require proof that the premium has been paid for one year.

intangible property Something that is nonphysical, noncurrent, and exists only in connection with something else. Business goodwill is intangible property—it does not exist by itself; it cannot be seen, touched, smelled, or heard; and it cannot be sold separately from something else, because even the goodwill built up in a particular business name cannot be sold separately from the name. Intangible property is usually exempt from property taxes.

intelligent building A building equipped with the telecommunications infrastructure to easily and economically adapt to changing conditions through the use of automated control systems for heating, air conditioning, ventilation, lighting, power, and a variety of health, safety, and security conditions. Contrast with *smart home*, which usually refers to home automation systems that can be controlled by a centralized panel or device, or by dialing in to the control panel from outside the home.

intentional fraud A misrepresentation of a material fact which is intended to deceive another, does actually deceive another, and which causes harm to the one deceived. The law allows punitive damages. See also *fraud*.

interest Sums paid or earned for the use of money.

interest deductions The IRS allows various interest payments on loans secured by real property to be deducted: Some of these deductions are as follows:

- For business loans, 100 percent of the interest paid each year is a deductible expense.
- For homeowners, the interest on up to $1,000,000 of combined primary and secondary residence home mortgage debt can be deducted.
- Home equity line of credit interest is deductible up to the interest attributable to $100,000 of debt.
- Interest on loans to buy stock in a cooperative building are deductible within the same limits as home interest.
- Co-op apartment owners may deduct their pro rata share of mortgage interest on underlying debt on the building.

For more information see Publication 936, "Home Mortgage Interest Deduction," at the IRS Web site, www.irs.gov.

interest in property The extent of ownership in property.

interest-only loan A loan on which one pays periodic interest payments without any reduction in principal, and the entire principal balance is due and payable upon maturity of the note.

interest-only securities (IOs) Instruments created from collateralized mortgage obligations from which the monthly interest payments have been stripped out and converted into securities.

interest rate The cost of borrowing money, expressed as a percentage per year of the money borrowed.

interest rate cap In an adjustable-rate mortgage, a ceiling on the amount the interest rate may increase during any described period, such as one year, or over the lifetime of the loan.

interim financing A short-term loan arranged in order to buy time until something changes. At the end of the original construction loan period, a developer may wish to seek interim financing rather than permanent financing because of an expectation that interest rates will fall in the future, or because the developer's plans have changed and the property will be sold rather than retained. The problem with permanent financing and many development projects is the existence of very large prepayment penalties—one cannot simply refinance when interest rates go down or simply pay off the loan when there is a sale. A borrower may also seek interim financing because the borrower's financial strength, or that of income-producing property serving as collateral, is not currently sufficient to justify attractive financing terms.

interim use A use for property until it can be put to its highest and best use. Land that is not quite ready for development because of insufficient population densities may be used as a sales lot for manufactured housing, for example. An empty freestanding department or discount store might be used as a flea market.

interlocutory decree A court order that is provisional, temporary, or not final. Interlocutory decrees are usually not appealable unless one obtains permission from the court.

intermediate theory state See *hybrid theory state.*

intermediation The normal flow of money into financial institutions in the form of deposits, which are then loaned out to earn income. Contrast with disintermediation, which occurs when depositors take their money out of financial institutions because they can earn more money, relatively risk free, in other investments.

internal rate of return The annual rate of earnings on an investment equates the value of cash returns with the cash invested, taking into consideration the power of compounding interest. The following formula requires a trial-and-error method for solution. The fallacy with the method is its assumption that all cash flows are reinvested at the internal rate of return.

$$0 = CF_0 + \frac{CF_1}{(1+r)^1} + \frac{CF_2}{(1+r)^2} + \frac{CF_3}{(1+r)^3} + \frac{CF_n}{(1+r)^n}$$

Using this formula, CF is the cash flow in each period, with one subpart of the formula for each investment year until you reach *n*, the final year of the investment. You have to solve for R, the annual rate, by trial and error.

Internal Revenue Service (IRS) A bureau within the United States Department of the Treasury, the IRS is charged with the responsibility of collecting the taxes imposed by Congress. In furtherance of that responsibility, it provides a wealth of resources to assist law-abiding persons in understanding and complying with the complicated tax laws of the country. An excellent search engine at the IRS

Web site, www.irs.gov, gives access to thousands of online publications, forms, instructions, and even internal IRS manuals.

International Code Council A membership association (www.iccsafe.org) that develops the codes used in the construction of residential and commercial buildings.

International Council of Shopping Centers A global trade association (www.icsc.org) of the shopping center industry.

International Facility Management Association A global association (www.ifma.org) for facilities management. The organization defines facilities management as "a profession that encompasses multiple disciplines to ensure functionality of the built environment by integrating people, place, process and technology."

interpleader A legal proceeding in which one holding money and making no claim to it, but unsure as to which of several claimants should receive the money, pays the money into court. This is the normal route taken by an escrow agent or someone else holding earnest money when the buyer and seller both demand the earnest money. The escrow company will name both the buyer and seller as defendants; ask that it be reimbursed out of the money for its costs, usually a small attorney's fee and a court filing fee; and that it be allowed to exit from the fight. The buyer and seller then battle over the funds.

interrogatories A set of written questions by one party in a lawsuit to another party in the lawsuit, which must be answered under oath.

interstate A concept with many different interpretations depending on which federal law is being considered. Usually relevant in determining if an activity has a sufficient connection to interstate commerce, and thus the Commerce Clause of the Constitution, to warrant federal intrusion or oversight of the activity. Article I, Section 8, Clause 3 of the United States Constitution is known as the Commerce Clause and empowers the United States Congress "To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." Representative areas of federal power may include

- Matters *in* interstate commerce
- Matters *affecting* interstate commerce
- Agencies and instrumentalities of interstate commerce
- Local laws that discriminate against interstate commerce
- Crimes that interfere with or obstruct interstate commerce

Interstate Land Sales Full Disclosure Act A federal law passed in response to abuses in the sale and development of large subdivision projects. Developers often took large deposits or even sold lots and then did not begin development for many years. The law requires registration of the subdivision with the federal government and mandates certain disclosures and rescission (contract cancellation) periods to consumers. Subdivisions of less than various size limits or those that will be completed within specified time limits are exempt, as are subdivisions in states certified as having substantially similar laws.

interval ownership Also called time-share ownership, in which a person shares ownership of property but is entitled to exclusive possession only for a particular time period each year.

inter vivos branch A theory that is applied to transactions entered into during one's lifetime. Some legal principles have differing rules depending on whether property was disposed of during the owner's lifetime or by provisions in the owner's will. The rule that applies for lifetime transactions is called the inter vivos branch of the rule.

inter vivos trust A trust established during the granting party's lifetime, rather than by virtue of the party's will.

intestate Without a will. All states have laws specifying the rules of intestate succession, or who will receive property, and in what shares, when someone dies without a will. If there is no one to inherit, then the property escheats to the state.

intestate succession The order of distribution of property when one dies without a will.

intrinsic value An appraisal term meaning an intangible value based on a property's proximity to certain features and amenities, such as good schools, health care, and shopping.

inventory (1) The total listings controlled by a real estate broker. (2) The total property for sale or lease in a defined area. (3) Property held for sale in the ordinary course of business or to be used in the manufacture of goods held for sale. (4) An itemized listing of personal property.

inverse condemnation A lawsuit brought against a government agency because of some action claimed to have damaged property to such a degree as to amount to a condemnation, even though there was no official exercise of the right of eminent domain and no compensation offered or paid to the property owner. This situation often comes up when governments increase the level or degree of regulation of property in such a manner as to make it economically incapable of development and thus worthless to the owner.

investment analysis A study of the potential return on a real estate investment to the owner, without reference to a potential sales price but strictly limited to the earnings and investment returns on the property. There are several different methods of analysis, some of which might be appropriate for particular properties and others not, or some of which are easier to use and favored by investors. The most common methods include

- Cash-on-cash return
- Payback period
- Internal rate of return

investment contract "Any contract, transaction or scheme whereby a person invests money in a common enterprise and is led to expect profits solely from the efforts of the promoter or third party," is the definition used by the Securities and Exchange Commission (SEC). Investment contracts related to real estate come within the definition. Nationwide litigation is currently under way to say

that purchases of units in hotel condominiums—condotels—are also investment contracts. If something qualifies, it is possibly subject to registration, reporting, and disclosure requirements imposed by the SEC.

investment-grade property A term used to describe property felt to be of sufficient size and quality to be an attractive purchase target by one of the large institutional portfolios, such as retirement funds or insurance companies.

investment interest An IRS phrase meaning the interest incurred on debt for an income-producing property. Investment interest is deductible only to the extent of investment income; you can't use investment interest to shelter other income. Unused investment interest may be carried over to subsequent years.

investment life cycle The time period from acquisition of an investment to its final disposition.

investment property Property held for the production of income or for an increase in value, as opposed to property held as a personal residence, use in a business, used for pleasure, or held in inventory.

investment value The value of property to a particular investor, aside from the property's general market value. Often encountered when a person sells appreciated real estate and must identify another property to purchase within 45 days in order to take advantage of the 1031 tax exchange vehicle for deferring taxes. Because of the short time limits, that investor is willing to pay a higher price than someone else, because the investor must buy something in order to avoid paying income taxes on the earlier sale.

investor One who uses his or her money to purchase property in the expectation of earning periodic cash flows from the property, making a profit on the eventual resale of the property, or both.

involuntary alienation Loss of property for nonpayment of debts, such as foreclosure, tax sale, or execution on a judgment.

involuntary conversion An IRS term meaning the involuntary loss of property through destruction or condemnation. The event can be a tax loss or a tax gain, depending on any proceeds received as a result of the involuntary conversion. If there is a gain, the taxes can be deferred. See *condemnation*.

involuntary lien A lien on real estate that results without the property owners' voluntary cooperation in the placement of the lien. Examples include tax liens and judgment liens. Contrast with a mortgage, which is voluntary.

ironclad agreement A mythical contract that can't be broken—like the Loch Ness Monster, often reported but never confirmed. As a practical matter, there is no agreement that can't be broken if the parties have sufficient resources, well-qualified legal talent, and plenty of time.

irrevocable Not capable of being revoked. An offer to sell at a certain price can be revoked at any time before acceptance. An irrevocable offer to sell cannot be revoked, but it should always have an expiration date.

ISO 14000 Refers to a series of voluntary standards for implementation and auditing of environmental controls previously agreed upon by a community or required by statute. The term is internationally recognized. In the United States, the Environmental Protection Agency (EPA) refers to the standards as Voluntary Environmental Management Systems/ISO 14001.

J

jeopardy (1) Danger, hazard, peril. Mortgaged property is said to be in jeopardy because it might be taken by foreclosure. (2) Subjected to the possibility of criminal punishment, including fines. The constitutional protection against double jeopardy has been held to apply to fines, such as might be levied against a company for violation of housing discrimination laws.

joint and several liability Having full liability for the whole of a debt or injury. Comakers on promissory notes have joint and several liability, so that the lender may collect the entire amount due from only one borrower and is not limited to collecting one-half from each borrower. The following usually have joint and several liability unless required otherwise by a specific state law or contractual agreement:

- Partners in a general partnership
- Taxes owed by husbands and wives who file joint returns
- Multiple persons who commit one wrong and injure another
- Tenants under one lease, such as roommates
- Cosigners on promissory notes
- Cosigners on guarantee agreements

joint ownership Ownership of property by two or more people or entities. It includes tenants in common, joint tenants with right of survivorship, tenants by the entireties, and community property interests.

joint tenancy A short version of the term "joint tenants with right of survivorship." A method of taking title to real property; commonly used by husbands and wives, or by others, as an estate planning tool. The parties each own a fractional share and, at the same time, own the whole of the property. If a joint tenant dies, the others do not inherit that tenant's share, but simply see the removal of an obstacle in the way of taking everything. This is a subtle point, but it is the heart of the estate planning tool—no one inherits anything as a result of the death of the other joint tenant(s). As a result, the property does not pass through probate and cannot be used to satisfy claims against the estate of the decedent. However,

- The property may be includable in one owner's estate for purposes of calculating estate taxes. The rules are different depending on whether the parties were married or not.

- A joint tenancy may be destroyed if one owner transfers his or her interest to a third party. If that happens, the new owner becomes a tenant in common, not a joint tenant. If there were originally more than two joint tenants, the remaining ones may still be joint tenants as to each other's interest.

joint venture A legal entity somewhat similar to a partnership, except that its purpose is the pursuit of a single transaction for the mutual benefit of both joint venturers. Each joint venturer has equal rights of direction and control. For tax purposes, the joint venture is treated as a partnership and must file a partnership tax return.

judge-made law Legal decisions by appellate courts that are binding on all future generations unless overruled by a later appellate court, but which are directly contradictory to specific statutes or earlier case authority. This happens rather often in real estate law, much of which arose out of peculiarities of life in the Middle Ages and before. When faced with a situation that would result in a seemingly unfair conclusion under applicable principles of law, the judges sometimes simply change the law.

judgment An order of a court.

judgment creditor One who has obtained a judgment against another. The original claim did not have to arise out of a debt—it could have been an automobile accident, a promissory note, an award in a divorce case, or anything at all.

judgment debtor One who has had a judgment rendered against him or her. The original claim did not have to arise out of a debt—it could have been an automobile accident, a promissory note, an award in a divorce case, or something similar.

judgment, foreign A judgment taken in another state. Once the judgment has been entered and becomes final in the other state, it may be domesticated—filed of record—in any other state where the debtor may have property. The judgment debtor may not relitigate the original issues at that time, unless there are very extraordinary circumstances.

judgment in rem A judgment against property, rather than against a person. One example would be a judgment establishing a right-of-way easement in favor of one property and over another property. The judgment binds all people to the extent of their interaction with the property.

judgment lien A lien on all property of a judgment debtor as a result of the entry of a judgment, the failure to appeal, and the filing of some document in the public records as evidence of the judgment.

judgment-proof Having no assets out of which a judgment may be satisfied. In some states, a judgment debtor may have substantial assets, but they are legally beyond the reach of creditors. In other states, judgments can remain liens against property for as long as 20 years. Today's judgment-proof debtor may be wealthy in 5 or 10 years and have assets that can be seized at that time.

judicial foreclosure A foreclosure mechanism used in some states. An action must be filed with a court to begin the foreclosure process. The court will then fix the amount of the debt and order foreclosure of the property.

judicial landmark A tool available in some states for marking court-established boundary line corners after a lawsuit between contiguous property owners. The applicable statute will usually specify a certain size monument, such as a concrete block at least 12 inches per side; a depth at which it should be buried; and a requirement for an engraved notation that indicates that it is a judicial landmark, the date set, and the name of the surveyor setting the landmark.

jumbo mortgage A loan in an amount greater than the size limits for Fannie Mae or Freddie Mac purchase. The loans must remain in the lender's portfolio or be sold to other investors. Because the loans cannot be sold easily, some banks charge a higher interest rate for them.

junior lien or mortgage Refers to the priority of payment if a property must be liquidated to satisfy the debts against it. The first recorded lien or mortgage will be paid first out of sale proceeds, up to the entire amount of the debt, including principal, interests, legal fees, and expenses. If there is any money remaining, junior lienholders (which include junior mortgages) will be paid in full in the order of their priority until the money runs out.

junk fees A popular term for lender fees and expenses that are disguised additional profit. They are usually relatively small, but can add up to significant income if enough borrowers pay them. Sample junk fees are loan processing, document handling, fund maintenance, review appraisal, underwriting review, and other such items.

jurisdiction Power. The concept that a court or government authority may exercise control over a person or property because of the location of the property, the activities of a person within a geographic area, or a person's request for assistance from that authority, thereby voluntarily subjecting themselves to jurisdiction.

jury trial, right to In many states, there is no right to a jury trial on disputes relating to real property. This is because of rules with their roots in English courts dating back to the time of the Norman invasion in 1066. Before making any litigation decisions based on what you think a jury of your peers would decide, be sure to see if you are entitled to a jury.

just compensation A requirement of the United States Constitution that no owner be deprived of private property without payment of a value which is fair to the owner, and fair to the taxpayers who must pay the compensation. This concept forms the basis of eminent domain law and condemnations.

just title A title that seemed to be proper and legal, although defective in some regard. In some states, persons with a defective title may gain full title to the property if they use the property for a certain period of time, claim it as their own, and have such title such as would give rise to a good-faith belief that the property was theirs.

K

Kelo One of the most important real estate cases of modern history, *Kelo v. City of New London* tested the limits of the government's right to condemn private property for public use, and concluded with the United States Supreme Court granting wide latitude to local government.

> The issue involved a desire by the city of New London, Connecticut, to condemn 90 acres of private property and offer it to a developer as part of a larger urban revitalization plan. Historically, eminent domain has been used to build roads, schools, and public buildings. In the Kelo case, the overall development plans called for a resort hotel and conference center, retail space, residences, and a new state park.
>
> The case finally ended up in the United States Supreme Court. On June 23, 2005, Justice Stephens wrote the majority opinion, finding in favor of the city of New London. Justice Stephens said that local governments should be given wide latitude in local condemnation cases. "The city has carefully formulated a development plan that it believes will provide appreciable benefits to the community, including, but not limited to, new jobs and increased tax revenue." Under the particular facts of the Kelo case, the condemnation was for a permissible public purpose and not a private purpose.

There have been two types of backlash to the *Kelo* decision.

> Many local governments immediately passed laws prohibiting the use of eminent domain for private development. The Supreme Court decision left open the likelihood that such laws would be constitutional and, in fact, practically invited states to pass new laws.
>
> Small towns across America began plans to condemn undeveloped property owned by Wal-Mart within their borders. City leaders and citizens claimed it would be for the public good, because a Wal-Mart store where planned would be a blight on the community, much the same as the 90 acres in New London was considered a blight. (At this writing, it is too early in the judicial process to see where this will go.)

key tenant See *anchor tenant*.

kickback An illegal fee or rebate paid to someone in order to gain that person's decision or recommendation for the award of business. Under the Real Estate Settlement and Procedure Act (RESPA), federal law prohibits kickbacks to real estate agents from mortgage companies.

kiosk A small, freestanding retail location within the confines of another business or in the common areas of a shopping center. Kiosks represent a method of significantly expanding real estate income without raising rents or building more space. The term is sometimes used to denote only self-service locations, with the attended sites called carts. (For more information see the Web site of the Self Service and Kiosk Association, www.selfservice.org.)

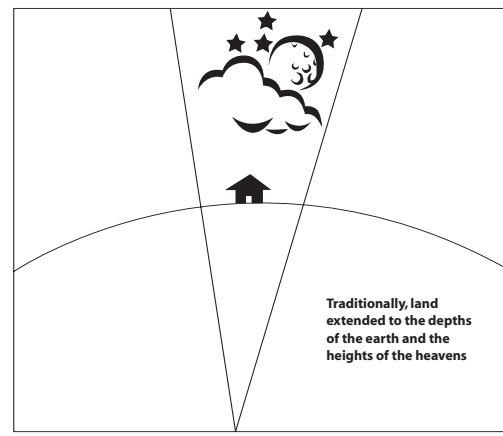
kit homes Structures that arrive as prefabricated components to be erected on-site. Includes the familiar log cabin kits, geodesic dome houses, and post and beam houses.

L

laches A doctrine of equity, or fairness, holding that people cannot sleep on their rights and then, after the passage of time and possibly the intervening claims of other people, suddenly demand that the law fix everything. The concept is similar to a statute of limitations, except that it has no fixed time period and is totally dependent on the particular circumstances of a case.

> **Example:** *Ruby plants 10 pecan trees on the wrong side of her property line with Jake. Jake knew this when the first shovel of dirt was turned, but he remained silent. Seven years later Ruby begins harvesting pecans to supplement her income, but Jake sues her and claims the pecans belong to him. Most likely the court will rule that Jake's claims are barred by laches and Ruby may harvest pecans until the trees stop bearing.*

land In the law, the surface of the earth, descending down in a cone shape to the center of the world and upward to the heavens, along with all natural things thereon, such as minerals, water, vegetation, and rights to the air. This is less than the concept of real property, which includes land but also all rights in and to land or its use, and all artificial things attached to the land.



land bank Land purchased and held for future development.

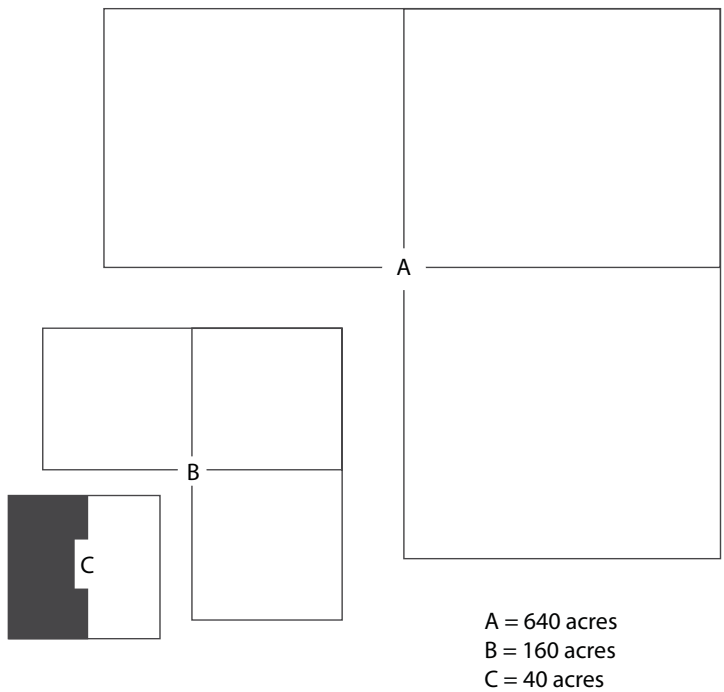
land contract Also called a bond for title, land sale contract or contract for deed. It is a financing arrangement for real property, in which the seller holds the financing and the legal title and does not give the buyer a deed until all payments have been made in full. For many people with the inability to secure financing, it is the only practical way for them to own a home. The practice is perilous, though, and could result in the loss of the property, and substantial money spent over the years, simply because of one late payment.

land court A specialized court to hear real estate matters. The details vary from state to state.

land description Any instrument granting or relinquishing rights in real estate must contain a description of the real estate. The description must be precise enough so that a stranger, relying only on the writing in the instrument and perhaps some training as a surveyor, could go out in the world

and locate the exact piece of property covered by the instrument. That being said, it is not at all uncommon for old deeds to recite, "Starting at the midpoint of the old logging road, thence proceed 500 feet, more or less, to a stream. . . ." Allowances are made for such descriptions if one can determine the boundaries with other evidence. It is not acceptable, however, to describe real property by a street address, by a tax assessor's parcel identification number, or as something similar to "one acre of land near the north end of Joe Jones's property." Acceptable land descriptions appear in one of three ways:

1. Subdivision lot and block number, as recorded on a master plat in the local real estate records.
2. Metes and bounds, which includes a recognized starting point and then gives the angle and direction of turns, and the length of lines, for the various sides of the property until returning to the beginning.
3. Aliquot part, which starts with a particularly described 640-acre section, and then describes particular fractions of that section to arrive at the description of the parcel.



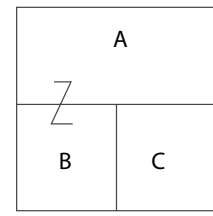
Example of an aliquot part.

The diagram "explodes" out the relevant quarters of each square, to make it easier to follow the description. We start with the largest parcel, which is a section—labeled "A" on the drawing. It contains 640 acres. The part in which we are interested is the southwest (SW) quarter (1/4) of the section—labeled "B" on the drawing. Within B, we are interested in that SW 1/4—labeled "C". Within C, we are interested in the west half (shaded black in the drawing). Putting all the pieces together, we would name the particular section according to the government numbering system,

and then start with the smallest piece and work our way backward to the whole. In this case, the description is, "The W 1/2 of the SW 1/4 (C) of the SW 1/4 (B) of Section 8 (A)." If a section is 640 acres, then B must be one-fourth of that, or 160 acres. C is one-fourth of that, or 40 acres, and the black part is 20 acres.

land economics (1) The study of land use, natural resources, public utilities, housing, and urban land issues. (2) A prestigious journal, Land Economics has been published since 1925 by the University of Wisconsin Press (www.jstor.org/journals/00237639.html).

land grant A grant of public lands by the government, usually for roads, railroads, or agricultural colleges.



land hook A method of indicating on a survey map the existence of contiguous parcels with the same ownership. In the diagram, the symbol connecting parcel A to parcel B is called the "land hook." It may also show the connection of properties across public roads or waterways.

land lease See *ground lease*.

landlocked Without access to public streets or roads. The owner of property that is landlocked may file suit to obtain an easement by necessity across another's land, but it must be a route that places the least burden on the other property.

landlord The owner of property rented to another. The landlord's interest is called a reversionary interest, while the tenant's interest is possessory.

landlord tax stop See *tax stop*.

landlord-tenant code See *Uniform Residential Landlord and Tenant Act*.

landlord-tenant law A general name given to the area of law that concerns itself with the creation of leasehold estates, the rights and responsibilities of the parties afterward, and the termination of the estates.

landmark In surveying, a permanent feature on the land, used as a reference point. If it is necessary to remove a landmark for development or other purposes, the best practice would be to contact the local government engineer or mapping office and ask that a witness monument be set in the place of the former landmark. (Some states require this by law.)

land measurement conversion (1) Most often necessary when translating acreage measurements into square feet, because as land becomes more valuable people begin quoting prices in terms of dollars per square foot rather than dollars per acre. There are 43,560 square feet to an acre. (2) Older deeds often contain descriptions with property lines expressed as "chains" or "rods," which must be converted to feet and inches to be meaningful today. Tables and calculators are available online at www.onlineconversion.com to perform virtually any type of measurement conversion. This Web site is privately maintained through voluntary contributions.

land poor Having substantial real estate assets but little cash. It historically referred to agricultural land, but it no longer has that restricted definition.

land sale contract See *land contract*.

land, tenements, and hereditaments In keeping with attorneys' practice of using three words when one will usually suffice, you often see the expression "land, tenements, and hereditaments" in real estate instruments. It is meant to describe all the rights capable of being owned and enjoyed. Land is the dirt and everything natural under it, attached to it, and the air above. Tenements are any structures attached to the land, and hereditaments are any interests in real estate capable of being inherited.

land trust A trust in which land is the only asset. See *trust*.

land-use intensity system (LUIS) A concept that certain uses of land share common characteristics as far as population densities and traffic generation, and that the best method of zoning or imposing development restrictions is with regard to those characteristics. Densities are controlled by reference to floor area ratio, open space ratio, livability space ratio, and/or recreational space ratio.

> **Example:** *Rather than zone separate areas for office use, multifamily residential use, and retail use, one LUIS zoning area might permit all three, since all three involve large numbers of people in small spaces needing multilane roads with separate turn lanes and synchronized traffic control devices.*

land-use plan A plan submitted by a developer to local planning or zoning authorities as a condition of obtaining a demolition or a construction permit.

land-use regulation A system of government-enforced restrictions on the development and uses of properties. Well-planned regulations should complement each other, although in the real world there is often overlapping of jurisdictions and conflicting laws. The primary vehicles of land-use regulation are

1. Federal and state government environmental protections for species, types of habitats, erosion control, siltation, etc.
2. Preemption by federal agencies for specific purposes, such as Federal Aviation Administration (FAA) restrictions on building heights near airports
3. Federal and state highway restrictions regarding signage and curb cuts
4. Federal and state tax incentives or tax burdens for particular uses of property
5. State health department regulations regarding sanitary waste disposal
6. State and local historic preservation laws
7. Local zoning ordinances
8. Local building codes
9. Local fire department regulations regarding safety issues
10. Subdivision restrictions

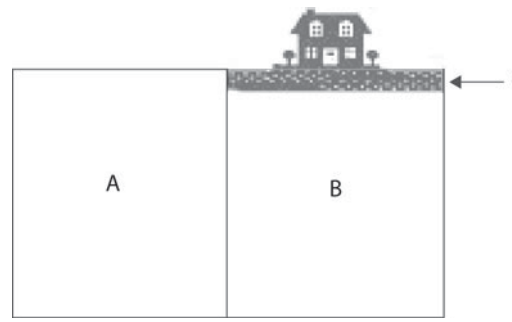
larger parcel A concept relevant in condemnation cases in order to determine if the taking of land by eminent domain has caused damage to the larger parcel. Usually the concept is limited to one piece of property out of which a portion is taken by eminent domain, but courts have described the larger parcel as including noncontiguous properties.

Example: *A resort community has a golf course one-half mile away. If the golf course were taken by eminent domain, its loss would certainly affect the value of the resort community as a whole. Damages attributable to the loss in value of the larger parcel are called severance damages.*

late charge A fee to compensate a lender for the additional administrative expenses and general inconvenience suffered when payments are not received on time. If the late charge is excessive, the courts will construe it as a penalty, and penalties are illegal. Many industries have had to reduce their customary late charges because of class-action litigation resulting in millions of dollars of refunds and reimbursement for attorneys' fees.

latent defects Real property defects not discoverable by reasonable and customary inspection. If known to the seller, or to the real estate broker representing the seller, then each of them has an obligation to reveal such defects to a prospective purchaser.

lateral and subjacent support All property is entitled to support from the sides (lateral support) and from underneath (subjacent support). In the diagram, A owns the surface of the land and all the mineral rights underneath. C owns the surface rights only, because the mineral rights were sold to B, many years ago. A may not dig a strip mine and slice down the property line many feet, because B's and C's land would crumble at the edges and fall into the strip mine. A has a duty of lateral support to B and to C. By the same token, B cannot carelessly dig deep mines and cause the surface to cave in, because B owes the duty of subjacent support to C.



law day (1) An old term meaning the date an obligation was due. (2) May 1 of each year, a special day first recognized by President Eisenhower in 1958 in order to provide a date to reflect upon and celebrate the rule of law in our country.

lawful condition See *condition*.

lawful interest The maximum interest rate allowed by law. Any amount higher is called usury and is illegal. Contrast with *legal rate of interest*, which is the amount set by state law when the parties fail to establish a contractual rate.

law of capture Under this theory, a landowner does not own migratory substances (such as oil and gas) under the land but does have the exclusive right to drill for, produce, or in some other manner gain possession of the substances. Contrast with *unitization*.

lead A heavy metal shown to cause learning disabilities, behavioral problems, seizures, and even death in children. The Environmental Protection Agency (EPA) estimates that 3 to 4 million children

had elevated lead levels in their blood in 1978. The number has now been reduced to several hundred thousand, but elevated lead levels in blood is still the leading environmentally induced illness in children.

Federal law that went into effect in 1996 requires sellers and landlords of properties built before 1978 (when lead-based paint became illegal) to do the following before any contract or lease becomes final:

1. Provide a copy of the EPA booklet, "Protect Your Family from Lead in Your Home."
2. Disclose any known information concerning lead-based paint or lead-based paint hazards.
3. Provide any records and reports on lead-based paint and/or lead-based paint hazards.
4. Include an attachment to the contract or lease (or language inserted in the lease itself) that includes a lead warning statement and confirms that the seller or landlord has complied with all notification requirements.
5. Provide home buyers a 10-day period to conduct a paint inspection or risk assessment for lead-based paint or lead-based paint hazards.

lead lender Most often, a lender who originates a loan and then sells part of the loan to another financial institution—called the participant—but remains in control of the relationship with the borrower. Sometimes, the originating lender will also sell the "lead position" and will simply retain a passive, participation interest in the loan.

leakage A measure of retail sales lost by a community to a competitive market, indicating the need for more retail development in an area.

leaking underground storage tank (LUST) An underground tank that is leaking or spilling hazardous fluids into the soil or groundwater. In 1986 Congress established the Leaking Underground Storage Tank (LUST) Trust Fund to

- Oversee cleanups by responsible parties
- Enforce cleanups by recalcitrant parties
- Pay for cleanups at sites where the owner or operator is unknown, unwilling, or unable to respond or which require emergency action.

lease An oral or written agreement transferring the right to exclusive use and possession of property for some period of time. Some important lease concepts are

- The normal requirement that all contracts having to do with real estate must be in writing does not apply to contracts that are capable of performance in one year or less. In most states, an oral lease for less than one year is enforceable; an oral lease for a longer period is not.
- A tenant is not relieved of responsibility to pay rent if the premises are damaged, destroyed, or partially or totally unusable unless the lease allows it, or unless consumer protection laws applicable to residential leases allow it.
- If a tenant transfers the entire remaining term of a lease to someone else, that is an assignment. If a tenant transfers less than the remaining term, that is a sublease. Either way, the

original tenant is still fully responsible for complying with all lease terms, even if the new one does not. In most states, a landlord may require its approval before assignment or subletting, but may not unreasonably withhold its approval.

- A tenant's interest under a lease may be insured, in addition to coverage for the contents. The interest may also be mortgaged, although that would be extremely unusual except in the case of valuable improvements built on leased land under a long-term lease.

leased fee The name given to the landlord's rights in real estate after the landlord signs a lease with a tenant. It consists of the right to receive rental payments and the right to retake possession of the premises at the end of the lease term—the reversionary right.

leasehold A name given to the tenant's rights in real estate after signing a lease. The leasehold estate is classified as a less-than-freehold estate.

leasehold estate The interest a tenant has to possess and use property by virtue of a lease.

leasehold improvements Improvements made by tenants to leased premises. The cost must be depreciated over a 39-year term, even if the lease will last only 5 years. At the end of the lease term, the tenants then write off on their taxes all the remaining undepreciated balance. For a short period of time between November 2004 and January 1, 2006, leasehold improvements could be depreciated over 15 years rather than 39. (Beware of tax advice indicating this is still the law.)

leasehold interest The interest a tenant has to possess and use property by virtue of a lease.

lease option A contractual arrangement in which the tenant is given the right to buy the leased property under certain circumstances. An option is a right to buy, even if the seller later changes his or her mind and does not wish to sell to anyone at all. Contrast with a right of first refusal, which is the right to buy if and when the owner ever decides to sell.

Persons negotiating the terms of a lease option should consider the following:

1. Do you mean to grant an option or a right of first refusal? Be specific; call it by the right name and then describe what happens if the landlord wishes to sell to someone else.
2. What are the earliest and the latest dates on which the option can be exercised?
3. If the option can be exercised any time during the lease term, does it continue if there is a renewal or an extension of the lease? Renewals are new leases. Extensions are continuations of old leases.
4. Can the tenant sell the option to someone else without also assigning the lease to someone else? If not, may the tenant at least sell the option to another entity in which the tenant (or specifically named person) is a controlling or 100 percent shareholder?
5. Will the price be set in the agreement, will the parties agree to a fair market value (usually a bad idea because of the almost certainty of arguments), or will the parties agree to a formula that employs some index that is independent and easily verifiable?
6. What events will allow the option to be terminated by the landlord, even if the lease continues? This could be late payment of rent, the tenant's failure to cure a nonmonetary default after notice by the landlord, or any other factors the parties may negotiate.

lease-purchase agreement An installment sale. The tenant sometimes pays a higher-than-market rent for the property, with a portion of the monthly payment earmarked as rent, another portion as principal payments, and another portion as interest.

Landlords should not rely on a lease-purchase agreement as a mechanism to keep all payments and bypass foreclosure if there is a default by the tenant. Courts are very antagonistic to such forfeitures. By planning ahead and classifying the different aspects of the monthly payments, you can avoid the possibility of a court deciding things for you or the IRS deciding how to treat the income.

lease-up The time period for a newly available property to attract tenants and reach stabilized occupancy.

leasing commission See *commission*.

legal age The age at which a minor may enter into binding contracts.

legal description See *land description* and *boundary line disputes*.

legal name One's first name given at birth and one's last name, or family name. It is good practice, but not required, to include a full middle name and, for married women taking their husband's name, their former surname or "maiden name," usually preceded by the word "nee," meaning "born."

legal notice Bringing something to another's attention in a legally recognized method. What is required under the circumstances may depend on specific provisions in a contract or lease between the parties. It may depend on what is the standard custom or practice in a geographic, professional, or other community. It may depend on laws that say, for example, all persons are deemed to have notice of anything appearing in the real estate records and/or all things appearing in the legal sections of the newspaper classified ads. If in doubt about the proper way to give notice, give it in all ways you can imagine. (If in doubt about whether you have received legal notice, assume you have if you know about the fact, however you came to know about it.)

legal rate of interest The rate of interest set by state law in the absence of an agreement by the parties. It is usually the same rate established for interest on judgments. Contrast with *lawful interest*.

lender One who advances money to another in the expectation of receiving repayment of the money plus a fee for the use of the money, called interest.

lender liability An area of the law devoted to various theories of wrongdoing by financial institutions in their relationships with third parties, not just borrowers.

lessee A tenant; the person or entity entitled to possession under a lease.

less-than-freehold estate The technical definition includes many real estate interests rarely seen any more. Today, the term largely refers to leasehold interests. For sake of historical reference, a less-than-freehold estate is any estate in land or improvements which is capable of determination as to its length or duration. Contrast with a *freehold* estate, which is inheritable or is measured by a lifespan.

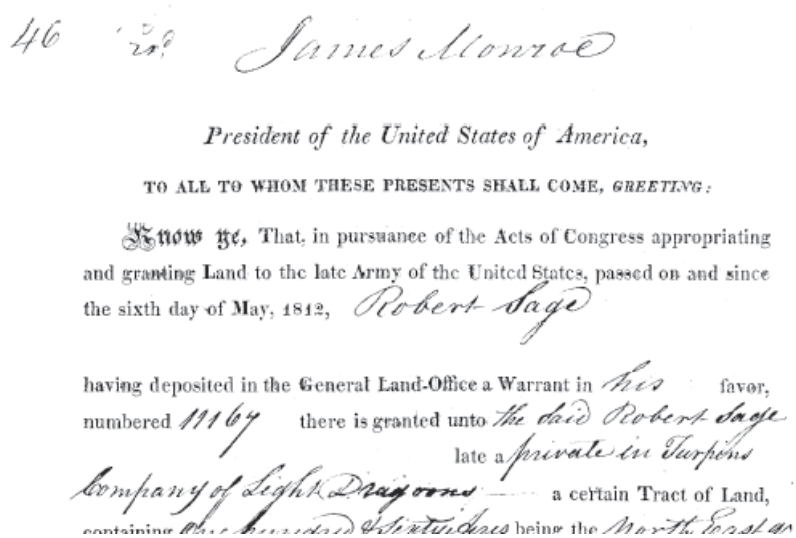
let To rent out.

letter of attornment A notice from a landlord to a tenant that the property has been sold and which directs the tenant to pay rent to the new owner.

letter of credit (LOC) (Pronounce each letter of the abbreviation; it is not pronounced as a word.) An instrument issued by a bank or other financial institution (issuer) agreeing that it will pay money to another (beneficiary), on behalf of the bank's customer (account party), upon the happening of certain named events. There is usually an issuance fee of 1 to 2 percent of the face amount of the LOC. Modern banking regulations require the same underwriting as for a commercial loan. The LOC will set out the exact prerequisites to be met before the bank will issue payment. These usually include a particular time and place to present the original letter of credit and the exact documents that must accompany the letter. Some states still follow the old "strict compliance" rule holding that any deviation from the instructions, no matter how minor, will justify the bank in refusing to pay. Others follow a "substantial compliance" rule, so that minor typographical or syntax errors in the presenting documents will not justify nonpayment. See also the two types of letters of credit: *documentary letter of credit* and *standby letter of credit*.

letter of intent (LOI) A signed document between parties setting out the deal points on which they agree and leaving for later negotiation the minutia over which the lawyers will argue. In the absence of any limiting language in the LOI, it can be construed as a binding contract between the parties. Usually, however, the LOI will recite that it is only an expression of interest regarding the parties' mutual intent, that the parties have not reached an agreement regarding any terms or provisions of a contract, and the LOI is neither a contract, nor an offer capable of acceptance, nor evidence of a contract, but merely the current status of negotiations that might possibly lead to a contract.

letter of patent A legal document transferring ownership out of the government—federal or state—to a private individual. The following sample is an excerpt from a patent out of the United States to Robert Sage, on May 6, 1812, for 160 acres of land, signed by President James Monroe.


46 No. James Monroe

President of the United States of America,

TO ALL TO WHOM THESE PRESENTS SHALL COME, *GREETING:*

Know ye, That, in pursuance of the Acts of Congress appropriating and granting Land to the late Army of the United States, passed on and since the sixth day of May, 1812, Robert Sage

having deposited in the General Land-Office a Warrant in his favor, numbered 11167 there is granted unto the said Robert Sage late a Private in Turpins Company of Light Dragoons a certain Tract of Land, containing one hundred & sixty acres being the North East

letter report (1) A short appraisal report with only the property description and characteristics, valuation, and recommendation, but without all the area information and without details regarding the method of reaching the valuation. (2) A report by a title company regarding the condition of the title on a particular date, but without issuing any insurance.

letter ruling A written statement from the IRS to a particular taxpayer, containing an interpretation of tax law as it applies to that taxpayer's situation. Letter rulings are issued in response to a request from a taxpayer and are not binding on the IRS as it relates to other cases.

level-payment mortgage A mortgage note with periodic payments in equal amounts. Usually, a fully amortizing mortgage, with each payment including some portion for principal reduction and some portion for currently accrued interest, so that at the end of the agreed-upon term the note will be paid in full. The concept is not restricted to fully amortizing mortgages, though, and may include payments made according to an amortization schedule but with the entire balance due at an earlier date, or simply payments in a fixed amount with the entire balance due in 3, 5, or 10 years, or whatever the parties agree to.

leverage The effect borrowed money has on an investment; the concept of borrowing money to buy an asset that will appreciate in value, so that the ultimate sale will return profits on the equity invested and on the borrowed funds.

> **Example:** *Mark and Amy each have $100,000 to invest. They can buy rental houses for $100,000 per house and collect rent of $1,100 per month for each house. At the end of 5 years, they will be able to liquidate and sell their houses for $150,000 each. Amy uses leverage and Mark does not.*

Mark	Amy
Buys one house for $100,000 cash	Buys five houses with $20,000 down for each one
Mortgage debt: $0	Mortgage debt: $400,000 at 6%
Monthly rental income: $1,100	Monthly rental income: $5,500
	Subtract monthly interest: $2,000
	Net monthly income: $3,500
Total rent income over 5 years: $66,000	Total net rental income over 5 years: $210,000
Total sales profit: $50,000	Total sales profit after paying off mortgages: $250,000
Total money from investment: $66,000 + $50,000 = $116,000	Total money from investment: $210,000 + $250,000 = $460,000

leverage, negative or positive Negative leverage occurs when the cost of borrowing money is greater than the return a party makes on an equity investment. This could occur with an adjustable-rate mortgage on a commercial investment during a time of rapidly rising interest rates. Construction loans, and development loans, are usually at adjustable rates of interest and do not have any ceilings or limits on the interest rate. Positive leverage occurs when the cost of money is less than the return on an investment.

levy (1) To assess. One may levy a tax or fine, which means to impose it. (2) To seize or collect, as when a creditor levies on assets by execution.

liability (1) A debt or obligation. (2) A potential loss, such as a poorly trained, poorly supervised real estate agent who may be a liability.

LIBOR (pronounced "lie-bore") London Interbank Offered Rate. The rate that European banks use to charge interest to each other on large loans. LIBOR is used as an index for many commercial loans in the United States, rather than a reference to the prime rate. Often quoted as something similar to "135 basis points over 1-year LIBOR," so that if LIBOR on 1-year loans is currently at 5.66 percent, then the quoted loan rate for the customer will be 5.66 percent plus 1.35 percent, or 7.01 percent.

license An authorization for a particular person or entity to do some act on the land or property of another. Licenses are revocable at will, grant no exclusivity, and are not assignable. The one who receives the license is the licensee; the one who grants it is the licensor.

license laws Particular state laws having to do with qualifications, licensing, and oversight of real estate or other professionals within the state in order to (1) ensure minimal levels of expertise, (2) promulgate enforceable standards to protect consumers from fraud, abuse, or negligence, and (3) provide mechanisms for self-policing of the industry. One can check the license status of any purported real estate broker or agent by going to the Web site of the Association of Real Estate License Law Officials, www.arello.org, and clicking on License Registration Verification.

lien A legally enforceable claim on the property of another as a result of a debt or obligation. It may be voluntary, such as a mortgage, or involuntary, such as a tax lien. It may be general, such as a judgment lien on all property within a county, or specific, such as a mortgage lien on the described property. One of the most important concepts in lien law is the priority among competing liens if property is insufficient to pay all claims or if the owner files for bankruptcy. The general rules are as follows (however, there may be local variations among the various states):

1. The first lien to be recorded is paid first, and so on in the order of recordation.
2. A statutory lien, such as a mechanics' and materialmen's lien, may be given artificial priority even though recorded after another lien.
3. Lien priority may be reshuffled if a debtor files for bankruptcy. The rules are too complex to examine here.
4. Lien-stripping takes place in bankruptcy when an asset is not worth as much as the accumulated liens placed upon it. Junior lienholders are stripped out and turned into unsecured creditors. Even mortgage liens may be reduced in amount, if the real estate is not worth as much as the loan balance.
5. A landlord's *statutory* lien for unpaid rent can be avoided, or set aside, by a bankruptcy trustee, but a landlord's *contractual* lien cannot be avoided unless lien-stripping comes into play.

lien-stripping See *lien*.

lien-theory states States that treat a mortgage solely as a security interest in real property, with title to the property retained by the borrower. Contrast with title theory states, in which the actual title to the property passes to the creditor, who then has an obligation to reconvey it to the debtor when the loan has been paid in full. Contrast also with hybrid theory, a mixture of the two.

life and safety systems See *life-support systems*.

life-care facility A residential development offering varying levels of housekeeping support, medical care, and community dining for senior citizens. Also called a continuing care retirement community, the concept allows residents to remain on campus but in differing residency styles, as they age and their needs change. Residents may begin in a garden home indistinguishable from other homes in the community at large, progress to something similar to a hotel suite with community dining, and then perhaps to bedridden full-time nursing care. Frequently a person will purchase a housing unit and then also pay monthly dues to cover communal services for the rest of their life. The American Association of Homes and Services for the Aging, www.aahsa.org, has additional information and directories.

life cycle The various phases of a project—predevelopment, development, leasing, operating, and rehabilitation.

life estate The right to use and enjoy real estate for a limited time measured by someone's life—either the owner of the life estate or someone else. Often used as an estate planning tool so that elderly people can sell their property or give it to relatives, but still retain the right to continue living in it.

> **Example:** *Mary Smith, who is 85 years old, has a life estate in Blackacre, but it's for the life of 10–year-old Ashley Brown. As a result, Mary and her heirs will be able to use the property until Ashley dies, hopefully some time in the distant future.*

life-of-loan cap The maximum amount an adjustable-rate mortgage can increase. If the initial interest rate is 6.5 percent with adjustments allowed every 3 months, but there is a life-of-loan cap of 5 percent, then the highest interest rate that can be charged will be 6.5 percent plus 5 percent, or 11.5 percent. Also called "lifetime cap."

life safety systems See *life-support systems*.

lifestyle mall A shopping mall concept that first became popular in the late 1990s. The term was copyrighted in May 1997 by Memphis, Tennessee, developers Poag & McEwen Co. The lifestyle mall features an open-air architecture, typically high-end retailers, may or may not include anchor stores, and has a large concentration of dining and entertainment facilities. The properties are usually well landscaped and offer outdoor artwork, music, and trams or trolleys for on-site transportation. It is intended to support a "shopping as entertainment" mindset and has become highly popular in affluent communities.

life-support systems The fire alarms, smoke detectors, sprinklers, exit lights, hoods, portable fire extinguishers, and other such warning and protection systems in commercial buildings. Most

recently, halon (nonwater) fire-extinguishing systems became an important component, because of the need to protect sophisticated computer and telecommunications equipment in the event of a fire. Industry leaders are now calling for inclusion of protections, or at least warnings, for chemical and biological contaminants associated with possible terrorist attacks. Sometimes called life safety systems.

life tenant One who has a life estate in a property, being the right to enjoy the property for a period of time measured by that person's life or some other designated person's life. The rest of the bundle of rights is called a reversion or remainder interest. Life tenants may sell, gift, or will their property to another, but when the defining life comes to an end, so do the rights of those other people. At that point, the remainderman may take possession of the property and enjoy it fully.

> **Example:** *Aunt Esther, who is 80 years old, sells her farm to Acme Agribusiness. She retains a life estate, measured by the life of her 40-year-old nephew, Mark. Esther dies two days later, with a will that leaves everything she owned to Texas A&M University. Mark has no rights in the property; he's just a measuring life. Texas A&M may use the farm until Mark's death, at which time it will pass to Acme Agribusiness.*

lifetime cap See *life-of-loan cap*.

lifting clause A provision in a second, third, or other junior mortgage that allows the liens ahead of it to be paid off and refinanced for the same or a lesser amount, without sacrificing their priority in lien positions. Without this clause, investors with second mortgages could never refinance the first ones because, the instant the first mortgage was paid off, the second lienholder would immediately advance to first position.

lift the automatic stay In bankruptcy, all collection activities by creditors must cease as soon as the creditor receives notice of the bankruptcy proceeding. This is called the automatic stay. Creditors may proceed with foreclosure or repossession of collateral only if they obtain permission from the bankruptcy judge to do so. That request is called a request to lift automatic stay, the process is called lifting the stay.

lifting the stay See *lift the automatic stay*.

light and air At English common law, property owners were entitled to light and air if they had "ancient windows" through which they had historically enjoyed such things. If an adjoining property owner erected a tall fence, or built a pigsty and fouled the air, this was a violation of what came to be called the ancient lights doctrine. American courts initially followed the doctrine and then rejected it when it seemed to stand in the way of development and "progress."

The landmark case in this country involved two resort hotels in Florida, one of which planned an expansion that would cast the other's pool, cabana, and sunbathing area into the shadows. The court refused to find any rights in light and air and allowed the expansion to continue. Today, especially as regards rights to sunlight for solar energy collection, American courts are reexamining the principles of rights to air and light, and finding ways to enforce them.

light industry A term usually encountered in the context of zoning regulation, with local statutes or ordinances providing their own definitions. Generally, however, light industry is understood to mean that which is more labor intensive and less machinery intensive than heavy industry. Light industry usually consists of nonpolluting users with moderate energy demands engaged in assembling products, sewing, baking, or cleaning.

like-kind exchange Under IRS regulations, property held for productive use in a trade or business or for investment that is exchanged solely for similar property. Any real estate (except your personal residence) is considered like-kind to any other real estate. Encountered in the context of a 1031 exchange, if you sell a piece of real estate, and then buy another piece within certain strict time limits and following very specific rules, then you will not have to pay income taxes on the first sale. Taxes will be paid when you sell the second property, unless you do another 1031 exchange. In that case, tax payment will be delayed again. See also *1031 exchange*.

> **Example:** *In real estate, all real estate except one's personal residence(s) is considered "like kind" to all other real estate. City property is "like kind" to farm property; unimproved real estate is "like kind" to improved real estate. On the other hand, shares in a REIT are not considered real estate for the purposes of a like-kind exchange. In addition, a long-term lease of less than 30 years is not considered real estate, and a life estate expected to last less than 30 years is not considered real estate, for purposes of these rules. (For more information, see Publication 544, "Sales and Other Dispositions of Assets," available at the IRS Web site, www.irs.gov.)*

limitations of actions Rules for the time limits after which one may not file a lawsuit on particular theories of recovery. Also called statutes of limitations, all states have legislation specifying the time limits. As an example, one state may say that claims for negligence must be brought within 1 year of accrual of the cause of action, claims for fraud within 1 year of discovery of the fraud, claims for breach of contract within 6 years of the breach, and claims for the recovery of land within 10 years of the trespass or other wrong to land. A cause of action accrues when the wrongful conduct has occurred and you have suffered a harm.

> **Example:** *A carpenter does a poor job building some stairs, but you have no way of knowing until the stairs collapse 5 years later. Then the cause of action for negligence accrued when the stairs fell, causing injury to you or to your property. In this situation, you would have one year from that date to file a suit. If you discover the problem earlier, your cause of action is for breach of contract, for breach of the warranty to perform in a good and workmanlike manner.*

limited appraisal An outdated expression due to the July 1, 2006, amendments to the Uniform Standards of Professional Appraisal Practice (USPAP). Real estate appraisals typically use three separate approaches to arrive at various values, and then the appraiser reconciles the approaches to reach one opinion of value. The approaches are income approach, comparable sales approach, and the cost-to-rebuild approach. In a limited appraisal, one or more of the approaches might have been omitted. (There is nothing shoddy about this.) Raw land cannot have a cost-to-rebuild analysis, for example. Under older standards, an appraiser would be required to specify that the appraisal was

limited and then designate the appropriate departure rule. Today, appraisers are allowed more latitude, as long as they and the client have a clear understanding of the scope of the work requested. The term limited appraisal is no longer necessary.

limited capacity See *capacity*.

limited common elements In a condominium project, individual owners own the airspace within their exterior walls, the ceiling, and the floor of their unit. Everything else is owned in common with all other owners in the project. The theory requires some modification because things like balconies, front doors, and windows really provide benefit for only specific unit owners. There may also be assigned parking places, boat slips, or storage lockers. Such things are called limited common elements and must be defined in the condominium documents.

limited equity condominium Government-subsidized homeownership of condominiums. Low-income consumers are allowed to buy such condos at below-market prices with little or no down payment and very low interest rate financing. When ready to sell, they must sell to other qualified low-income consumers, at a predetermined price that takes into account general inflation, but not rapidly increasing real estate prices in the area.

limited liability company A cross between a corporation and a partnership, the limited liability company must be created by documents filed in the same place as corporations. This type of organization enjoys much of the informality of a partnership, the tax benefits of a partnership with all income taxed at the shareholder level but not at the company level (see *double taxation*), and the limited liability granted to corporate shareholders, who cannot be held personally liable for a corporate debt or transgressions. Be aware, however, that members of a limited liability company may well be safe from contractual claims against the company, but most claims for negligence or wrongdoing will include some theory of personal liability against the members also.

> **Example:** *A claim against a limited liability company may be for its negligence in allowing mud and water to remain on the floor, leading to a customer slipping and falling and sustaining back injuries. The plaintiff in such a case may claim the individual members were also personally liable for their failure to develop policies and procedures to keep the floors clean or because they were also the employees and had personal responsibility to mop the floors.*

limited partners Persons who invest in a limited partnership upon the condition that their maximum exposure to liability, if the venture is unsuccessful, is the loss of their investment. Contrast with *general partner*.

limited partnership A partnership agreement in which one person acts as the general partner, with unlimited liability for all partnership debts, and all other investors have a status similar to stockholders. Such people, called limited partners, may lose their investment if there is a loss to the project, but no creditor may reach their personal assets. The vehicle was much more popular before tax law changes took away most of the tax advantages of real property syndications.

limited power of appointment A power granted by will, authorizing the recipient to choose who among a group of named or described persons may receive property.

limited power of attorney The authority granted to another under a written power of attorney, specifying or describing the particular acts the attorney in fact may do, and no others. Contrast with a general power of attorney, which allows all things the person could do himself or herself. Limited powers are usually given to do things like transfer stock, obtain information from the IRS or Social Security Administration, sign all documents necessary for a real estate closing, or other such tasks.

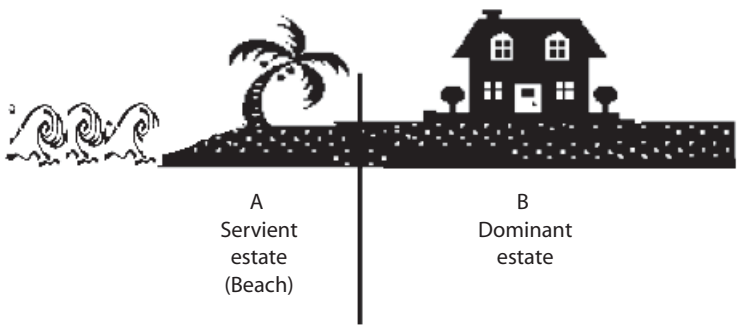
limited referral agent A real estate agent who refers leads to others in the office in return for a referral fee, but does not actually work the listings or assist a buyer with finding properties.

limited service broker A real estate broker who offers less than all the traditional brokerage services. Typically, the limited service broker provides sellers with listings on the local multiple listing service, and perhaps some advice and yard signs, in exchange for a flat fee that is fully earned whether the property sells or not.

lineal heirs Descendants in a direct line, such as children and grandchildren.

line of credit A revolving loan issued by a financial institution; it may be secured by a mortgage or other collateral, or unsecured. The borrower may draw down the line, up to the maximum limits, at any time and pay interest each month. If the principal is repaid during the time period of the line, then the maximum amount or any lesser amount may be drawn down again. Lines of credit are typically for one year, and then extended from year to year afterward. If a borrower draws down the maximum amount and then does not repay any of the principal, the lender will eventually refuse to renew the note and may require payment in full or conversion to an amortizing loan with regular monthly payments that will eventually pay it in full. Lines of credit are best used by persons with reliable income arriving at sporadic times or by persons awaiting the sale of an asset but needing cash in the meantime.

line-of-sight easement An easement to preserve a view. The owners of the servient estate may not do anything on their property that would obstruct the line of sight of the dominant estate.



link A surveying measurement still seen in older deeds or in deeds using descriptions from earlier times. A link is 7.92 inches. See *land measurement conversion*.

liquid asset An asset that is cash or can be converted to cash on very short notice.

liquidated damages Damages agreed upon in advance by contracting parties. The parties will recite that if one or the other breaches the contract, it will be difficult to determine damages at that time. This is often true in situations where construction is delayed and a business cannot open on time or homeowners cannot take possession of their home when anticipated. Liquidated damages are used in a wide variety of cases, though, not just construction contracts. The parties will agree to an amount of damages, or a method of calculating damages, such as a certain amount per day. Most real estate sale contracts stipulate the earnest money deposit as the amount of liquidated damages. The catch with this system is that courts will not enforce penalties, which are illegal. If the liquidated damages do not bear some relationship to reality and the probable damages suffered by the innocent party, then courts will recharacterize them as penalties (completely unenforceable) or will reduce them to an amount deemed reasonable under the circumstances.

liquidity The ability of a person or company to readily and easily obtain cash from its assets in order to meet obligations or make purchases.

lis pendens A document recorded in the real estate records, putting all people on notice that a lawsuit has been filed that will affect title to the described property. If someone buys the property after the filing of the lis pendens notice, then that person takes it subject to any claims that might prove successful in the lawsuit.

listing A written agency agreement between a property owner and a licensed real estate broker, authorizing the broker to market the property, solicit offers for its purchase or lease, and engage in negotiations pursuant to the owner's instructions. It imposes fiduciary responsibilities on the broker, who owes duties of care, loyalty, and confidence to the property owner.

Important concepts include

- Most state licensing laws require listing agreements to be in writing.
- The most common type of listing agreement is an exclusive right to sell, under which the broker receives a commission even if the owner sells the property to a relative.
- Some brokers offer exclusive right to list contracts, giving the owner the right to sell to anyone without paying a commission, but no other real estate broker may earn a commission directly from the owner, only as a cooperating broker paid by the listing broker.
- Most states require a definite termination date in the listing agreement, which may be renewed by mutual agreement of the parties.
- Most states prohibit net listings, in which the owner agrees to pay the broker all sums received over a certain minimum amount wanted by the owner.
- Some listing agreements have a clause entitling the broker to the agreed-upon compensation if the property sells within a certain time period—usually 6 months—after listing expiration, but to someone introduced to the property by the broker during the listing period.

listing agent The real estate agent who obtained a listing contract from a property owner, authorizing the broker for whom the agent works to market and solicit offers to buy the owner's property on specified terms and conditions. See also *listor*.

listing agreement See *listing*.

listing broker The real estate broker who enters into an agreement with a property owner to market and solicit offers to buy the owner's property.

listing contract See *listing*.

listor The real estate agent who obtained a listing agreement for his or her broker. Technically, only the qualifying broker, managing broker, or similar statutorily designated person for a real estate company, may enter into listing agreements. The broker will then split any commission with the listor in an agreed-upon amount ranging from 25 percent to as much as 100 percent.

littoral land Land bordering an ocean, sea, or lake. Contrast *riparian land*, which is land bordering a river or stream.

littoral rights The rights of landowners who own land bordering an ocean, sea, or lake. Generally speaking, the rights consist of the ability to take fish from the water, to build structures such as piers for a limited distance into the water, and the right to use so much of the water, for irrigation and other purposes, as is allowed under state law and local regulations.

livability space ratio See *land-use intensity system*.

live load The amount of additional weight that can be safely added to a building without structural failure or stress. It includes furniture, equipment, and people. Contrast with *dead load*.

livery of seisin A term that hasn't been used in centuries but is still encountered in real estate literature. It was an ancient ceremony for transferring ownership of land to another by means of the delivery of possession—called "livery of seisin."

lives in being Persons who will be alive at the time a transfer of real estate takes place. Under highly technical and infrequently encountered rules of real estate having to do with something called the *Rule Against Perpetuties*, certain time limits start to run by reference to lives in being. If a gift of real estate is made in a will, then the time limit is measured by the persons alive at the time the will is effective—when the testator dies—not when the will is first signed.

living trust A trust that goes into effect during the lifetime of the person who created it, called the settlor. Contrast with a will that goes into effect after the settlor's death, called a "testamentary trust." See *inter vivos trust*.

load-bearing wall See *bearing wall*.

loan application process The creation and transmittal of all information a lender might find necessary to assist it in reaching a decision to loan money to a borrower or not. At a minimum, the process usually consists of

- A list of assets and liabilities
- Current cash flows showing a present ability to repay the loan, or pro forma projections showing future income sufficient to repay the loan, such as if the loan proceeds will be used to buy income-producing property
- A Social Security number and present address so that the lender can obtain a credit score

Depending on the complexity of the purpose for the loan, or the handicaps a borrower must overcome because of a poor credit score, the process can become much more complex. All lenders have their own specialized requirements and procedures; even individual loan officers within an organization may have differing requirements for the process.

loan broker See *mortgage broker*.

loan commitment In real estate, a formal promise by a lender to loan up to a specified amount of money, depending on the appraised value of the collateral, with additional details regarding the interest rate, term of the loan, property on which mortgage will be taken, and a date on which the commitment will expire.

loan constant See *constant*.

loan correspondent (1) One who originates a loan. (2) One who services the loan by collecting payments from the borrower, disbursing funds to investors or the mortgage owner, monitoring insurance status and real estate tax payments, and handling phone calls and inquiries from the borrower.

loan officer An employee of a financial institution, charged with the responsibility of generating loan business for his or her employer and assisting in all details necessary to complete the loan application process. Sometimes the loan officer also monitors the relationship with the borrower after the loan closes; other times this is taken over by someone else.

loan pool See *collateralized mortgage backed securities*.

loan servicing See *servicing*.

loan-to-value (LTV) ratio The relationship between the principal amount of a loan and the appraised value of the property serving as security. A loan of $80,000 on a property appraised at $100,000 is an 80 percent LTV. Residential mortgages with an LTV of 80 percent or less qualify for FHA insurance; if the ratio is higher, then borrowers may be required to obtain private mortgage insurance. Generally speaking, the higher the LTV, the higher the interest rate will be because the lender has assumed more risk. Those risks are as follows: (1) When there is little equity in the property, it has a low hostage value; the borrower is more likely to default and walk away from the property because the borrower has little to lose. (2) At foreclosure, the property may not bring a

price sufficient to pay off the principal balance of the loan, much less the accrued interest and costs of foreclosure.

lobby To work for or against the passage of legislation. Currently, the two strongest lobbies in the real estate industry are the National Association of REALTORS® and the American Bankers Association. They are squared off on opposite sites of legislation that would give financial institutions the right to offer real estate brokerage services.

local improvement district A mechanism for property owners with common concerns to band together and assess themselves for purely local improvements such as sidewalk repair, neighborhood park rehabilitation, irrigation, and flood control. The local improvement districts must be authorized by state law and follow specific state procedures for formation, governance, and the issuance of bonds to finance the projects.

locally unwanted land uses Halfway homes for prisoners, waste disposal sites, electric power plants, and other things generally considered good but in someone else's part of town.

locational obsolescence See *external obsolescence*.

location intelligence Generally refers to the use of computer-aided mapping and demographic tools, including market characteristics, locations of competitors, traffic counts, zoning, growth characteristics, and other such data important to site selection.

lockbox (1) A special box placed on the door of homes listed for sale, with a key to the property inside the box. The box is accessed via a code or a key, available only to licensed real estate agents. (2) An arrangement whereby customers of a business send their payments to a PO box which is actually controlled by the business's lender rather than the business. The lender takes all receipts, pays itself any loan payments and fees, and then remits the balance to the business.

locked-in interest rate An agreement by a lender to grant a particular interest rate on a loan that is funded by the expiration date. For consumers, the lock-in is sometimes free, sometimes there is a charge, and sometimes the initial lock-in is free but any extensions will require payment of a fee. On commercial loans, there is almost always a commitment fee for an interest rate lock.

lock-in clause A clause in a promissory note that prohibits prepayment.

lock-in period (1) The period of time during which a loan may not be prepaid. (2) The period of time during which a lender will guarantee a certain interest rate on a loan to be extended by it in the future.

London Interbank Offered Rate See *LIBOR*.

long-term capital gain A gain on the sale of an asset held for more than one year. Currently long-term capital gains enjoy reduced tax rates over those imposed on short-term capital gains.

long-term debt Technically, that portion of any debt that will come due after 1 year from the current date. A newly made 30-year mortgage would have 1 year of payments posted to short-term debt on the accounting books of the borrower, and 29 years posted to long-term debt. In

common parlance, though, it is simply any debt with a maturity greater than 1 year from the time of making.

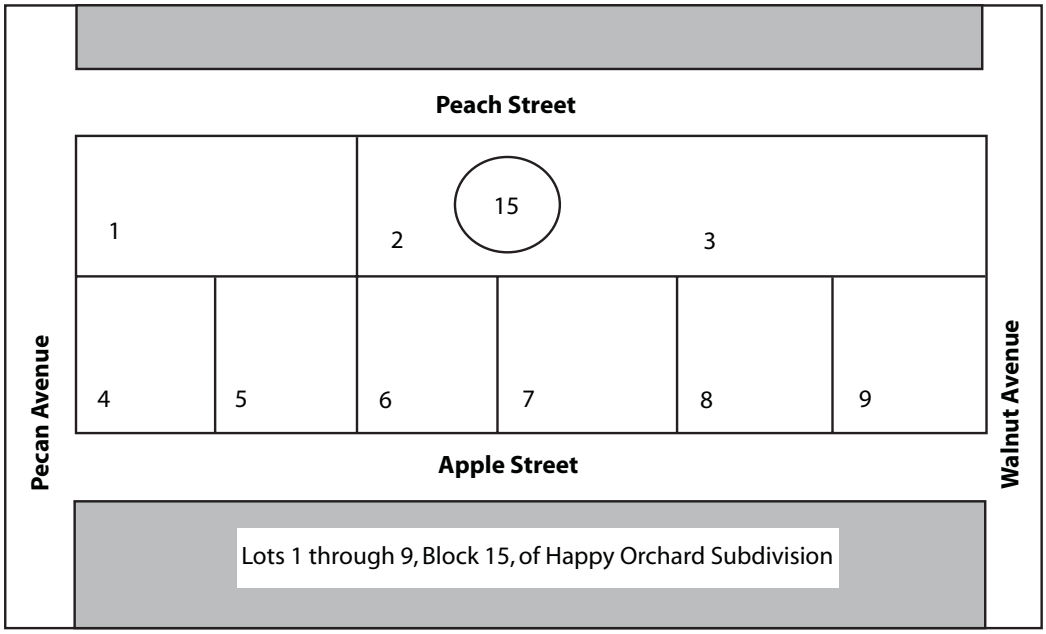
long-term loss Losses on real property sold more than one year after purchase. Compare with long-term capital gains, which are profits earned on real property sold more than one year after purchase. Long-term losses must be deducted against long-term gains.

loss factor The ratio between the total square footage not available for lease in a building and the total square footage in a building. When comparing rents among buildings, be aware that owners may account for the loss factor differently. Some may quote a per-square-foot rate for usable space—the space you can count as "yours." This may be higher than another's quote for a rate per square foot of rentable space—the space you can count as "yours" plus your share of the loss factor. For example, a building has 50,000 square feet, but only 40,000 square feet may be rented to tenants. The remaining 10,000 square feet is devoted to the lobby, elevators, corridors, and utility rooms. Then the loss factor is 10,000/50,000 or 20 percent.

loss payee A person entitled to payment from an insurance policy, even if the person is not the insured. For property insurance, the mortgage lender is usually the first loss payee and will be paid to the extent of the principal balance of its loan, with the remainder of the money to the homeowner. Lenders may waive payment if there is an insured loss and allow payment to the borrower to make repairs. In the alternative, it may accept payment and then disburse funds as repairs are made, as a method of making sure the insurance money goes back into the property.

lost-grant doctrine One theory underpinning adverse possession and prescription, that one who occupies and uses property for the required period of time really had good title, or grant, at one time in the past, but the documents have been lost. (1) This is important in determining exactly when someone gains title by adverse possession. Was it from the date of first possession, at the date the statute of limitations expired, or the date of a court's order recognizing the successful adverse possession? Using the lost grant doctrine, title is effective on the date of first possession. (2) This doctrine is used to get around statutes prohibiting adverse possession against the government. Courts will say there was no adverse possession; someone must have just lost the original deed.

> **Example:** *In the case of normal adverse possession, Tootsie and Ben are adjoining property owners who are arguing over a strip of land that each claims. Ben cuts down the trees on the strip of land. Tootsie claims they were her trees and sues for damages. She claims her survey is the correct one and, even if it were not, she has adversely possessed the land for 20 years and it is now her land. Ben claims his survey is the correct one. If the court rules that Ben's survey is the correct one, but Tootsie has adversely possessed the land, when did Tootsie gain title? If it was at the time of the court ruling, then Ben could not be liable for cutting the trees because they didn't belong to Tootsie at the time he cut them. But, because of the lost-grant doctrine, courts will treat the trees as if they had always belonged to Tootsie, so Ben is liable.*



lot, block, and subdivision A method of identifying property within a platted subdivision. The developer files a map, or plat (see above), with local authorities. It shows the exact legal description of the entire parcel of land, and then shows how the developer will install streets, number the blocks within the subdivision, and number the lots within each block.

love and affection The usual recited consideration when there has been a gift of real estate to a family member or other loved one. Love and affection is good consideration under applicable statutes, but it is not valuable consideration. Important concepts include the following:

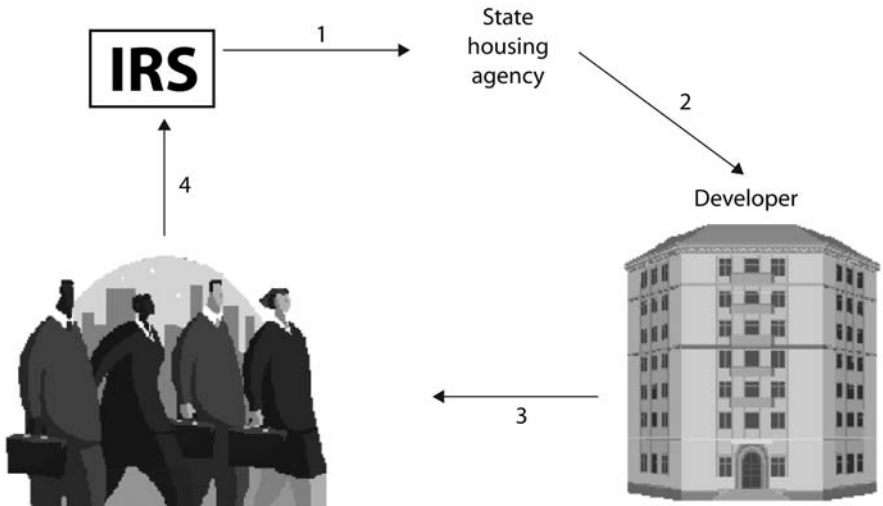
- A transfer of land to a child for love and affection during the parent's lifetime will often be deemed an advancement under the parent's will and can reduce the amount the child will inherit under the will.
- Love and affection will support a deed and make it valid, but it is not sufficient consideration so as to make a contract enforceable. In other words, a contract to transfer real estate upon love and affection is not enforceable; a deed with recited consideration of love and affection cannot be set aside.
- One who takes property for a consideration of love and affection cannot be a bona fide purchaser for value, because the consideration is only *good*, it is not *valuable*.

low-income housing (1) Generically, any housing that is limited to occupancy by persons whose family income does not exceed certain preset maximum levels. (2) For purposes of special tax incentives provided to persons who build or rehabilitate "qualified low income housing projects," the IRS defines the term as (a) any project in which 20 percent or more of the units are both rent restricted and occupied by persons whose income is 50 percent or less of the area median

gross income or (b) one in which 40 percent or more of the units are both rent restricted and occupied by persons whose income is 60 percent or less of the area median gross income.

low-income housing limited partnerships Partnerships formed to take advantage of the tax credits offered for investing in low-income housing.

low-income housing tax credits A package of allowed tax credits issued by the IRS to state housing agencies. The IRS has formulas for determining the size of credits issued to each state. The state housing agency then reviews applications from developers who wish to build or rehabilitate low-income housing and receive the benefit of the tax credits. If approved, the state agency will then award a certain amount of tax credits to the developer, who may use them on its federal income taxes.



Low-income housing tax credits: where they go.
1. IRS gives credits to state housing agency
2. State housing agency awards credits to developer applicant
3. Developer passes credits through to its investors
4. Investors "spend" credits with IRS to reduce their taxes

low-rise Usually a one- to four-story commercial building. The meaning changes depending on custom and usage in a particular market.

LTV See *loan-to-value ratio*.

LULUs See *locally unwanted land uses*.

lump-sum payment A payment of all principal and interest at the maturity of a promissory note.

LUST See *leaking underground storage tank*.

L/V See *loan–to-value ratio*.

M

Maes, the Used generically to refer to Maggie Mae, Fannie Mae, Sallie Mae, Ginnie Mae, and Munie Mae.

Maggie Mae Common name for Mortgage Guaranty Insurance Corporation (www.mgic.com). It is the leading provider of private mortgage insurance for loans in excess of an 80 percent loan to value. It also purchases, pools, and then sells interests in sub- and no-performing mortgage debt, and it purchases and services charged-off consumer debt such as unpaid credit cards and Chapter 13 bankruptcies.

magnet store See *anchor tenant*.

Magnusson-Moss Act A federal law passed in 1975, governing disclosures in connection with written warranties on consumer goods, including goods attached to or installed on real property. It does not require warranties, but if one is given, (1) the title of the document must clearly state whether it is a full warranty (imposing no conditions on the buyer, such as routine maintenance every 3 months) or a limited warranty (requiring the borrower to meet certain requirements, that can be spelled out in the body of the warranty itself); (2) the warranty must disclose certain information about the coverage of the warranty, explained in an easy-to-read and concise manner; (3) the warranty must be available where the goods are sold so that consumers can read it before buying. It is unlawful to disclaim the implied warranty of merchantability. It is also unlawful to say that use of unauthorized parts or repair services will automatically void the warranty.

MAI Member, Appraisal Institute; a designation awarded to appraisers who meet stringent educational, testing, and experience requirements imposed by the Appraisal Institute.

maid's quarters See *granny flat*.

mailbox rule A rule of contract law that says if an offer is made in such a manner that it would be reasonable to assume that another person would accept the offer by placing a letter or other writing in the mail, then acceptance is deemed to have occurred when the writing was placed in the mail, not when it was received by the person making the offer. For example, this is important when a property owner offers, in writing, to sell a particular property for a specified sum. The potential purchaser decides to accept the offer and mail the acceptance to the owner. Before the owner receives the letter, but after it is mailed, the owner decides to withdraw the offer and takes the property off the market or increases the price. In this example, the owner cannot do so because the purchaser has

already accepted the offer; it cannot be withdrawn. There is now a contract; there is no longer an offer capable of revocation.

maintenance The care and upkeep of a building to keep it in roughly the same condition as when it was first built, except for natural changes in the patina of finishes.

maintenance fee Another name for a condo association fee and homeowners association fee, and sometimes used to describe the rent charged to a co-operative apartment owner.

majority The age at which a person is able to enter into legally binding contracts in a particular state.

maker The person who executes a promissory note.

malfeasance Doing an act that is wrongful. Contracts will often have default clauses for a party's malfeasance, misfeasance, or nonfeasance. Malfeasance is a wrongful act, misfeasance is a proper act done in a wrongful manner, and nonfeasance is the failure to act when one had a duty to act.

management agreement A contract between the owner of income-producing property and another, who will manage the property. Management companies offer a wide variety of services and fee schedules, some charging a percentage of collected rents in return for a package of services and others charging a different fee for minimal services and then a menu of extras for varying charges. There is often a minimal monthly fee. (Always determine if there are additional charges for any of the services.)

Services can include some or all of the following:

- Collection of rents
- Leasing space to new tenants
- Collection activities including evictions
- Management of on-site personnel such as resident managers (who may be the employee of the property owner or the employee of the management company)
- Management of outside repair and maintenance service providers
- In-house repair and maintenance services
- Preparation and filing of all tax reports, such as rent taxes
- Payment of all or some bills
- Physical property inspections
- Periodic reporting of the property condition, revenues, and expenses
- Periodic recommendations regarding changes to the property or rental rates
- Brokerage services for the acquisition of additional properties or the sale of existing properties.

mandamus In the nature of an appeal, mandamus is a command from a court ordering a government authority, or a lower court official, to do some act that is within their power to do and they are supposed to do without exercising any discretion. One would appeal a decision to deny a building

permit for construction with minor or inconsequential variances from code requirements. However, one would seek mandamus if the permitting office acknowledged that all requirements had been met, but still refused to issue the permit. The decision of proper remedy—mandamus or appeal—is highly technical, and the wrong choice could result in the loss of all rights to reverse a decision.

manufactured housing Housing that is manufactured off-site and then installed on real property with minimal assemblage except as pertains to the various sections of a double-wide or a triple-wide home. All such housing manufactured since 1976 must meet a sort of national building code established by HUD for the industry. The industry trade association is the Manufactured Housing Institute (www.manufacturedhousing.org).

marginal land Land with little immediate usefulness because of problems with access, water control, topography, environmental restrictions, or other such factors.

marginal release A method of noting the satisfaction of a mortgage or other lien by making a notation in the margin of the recorded instrument.

marginal tax rate The percentage of income that must be paid to the IRS for a particular range of incomes, called tax brackets. As one's income increases, the marginal tax rate increases but only for that portion of one's income within the higher bracket. Portions of income within the lower brackets are taxed at the lower marginal tax rates.

marital deduction For estate tax and gift tax purposes, the 100 percent deduction granted for assets passing to spouses.

market A defined area from which one's customers may be drawn. The market size and boundaries will depend on the product offered (student housing, self-storage, estate lots for custom homes, professional offices for attorneys, etc.). A market can be defined in various ways. For example, it can be defined

1. By a radius from a certain point, such as the market within a 1-, 3-, or 5-mile radius of a development
2. By reference to natural boundaries consumers will not typically cross for goods and services, such as a highway, a particular city street, or even a bridge.
3. As an entire city
4. As all persons of a particular type within a city

An accurate description of one's market is essential to any development planning in order to assess the competition already existing in the market and the need for additional entrants. Market identification and description is also important for advertising and marketing services. (For example, there is no point in spending a large budget on citywide print advertising in newspapers and local magazines if your market lives and works within 3 miles of your location.)

marketable title Clear title to real estate without any liens, encumbrances, or adverse claims such as would be considered defects. A power line easement is technically an encumbrance, but most

would not consider it such an impediment as to prevent marketable title unless the property was zoned for residential use and the power line easement covered so much of the lot that property became unbuildable.

market comparison approach A method of appraising property by analyzing the prices of similar properties sold in the recent past and then making adjustments based on differences among the properties and the relative age of the other sale. More properly called the direct sales approach. See also *comparables*. The other two methods are the cost approach and the income approach.

market cycle A period of time during which real estate prices increase steadily and then level off or decrease.

market data Information about a defined geographic area or demographic (college graduates, young families, retirees, etc.) and the timing, characteristics, total volume, and individual size of buying activity within that area or group.

market data approach A former term for the direct sales comparison method of appraisal.

marketing period A measure of time between listing property for sale and closing. The average marketing period in an area is a good indication of the strength or weakness of the seller's market.

market rent See *economic rent*.

market rental rates Rents that are relatively consistent with other rents in the same area for comparable properties. For example, in downtown Metro City, the market rental rate for class A office space is $42 per square foot per year, with a tenant improvement allowance of $25 per square foot on a 5-year lease.

market value There are many different definitions of market value, depending on the organization finding it necessary to write a definition. Most definitions include the following: the price that would be paid by a motivated buyer to a motivated seller after a property's exposure to a marketplace of equally capable buyers, each with full information about the property and the market place and neither operating under any sort of outside influences.

Mark-to-Market program As used by the Department of Housing and Urban Development, a HUD program to eliminate higher than market rental rates for low-income housing owned by private developers. There was nothing wrong with this, originally. HUD wanted to encourage developers to build such housing, so it offered to subsidize the rents and pay developers the difference between the income-based rents paid by the tenants and a developer-set unit rent that could be higher than local market conditions. If developers could receive above-market rents and income guaranteed by HUD, anyone would naturally start building lots of low-income housing. Now, however, the properties have been enjoying above-market rents for many years, and HUD wants it to end. The Mark-to-Market program is a staged termination of those incentives, requiring low-income housing facilities to charge market rents, and no higher.

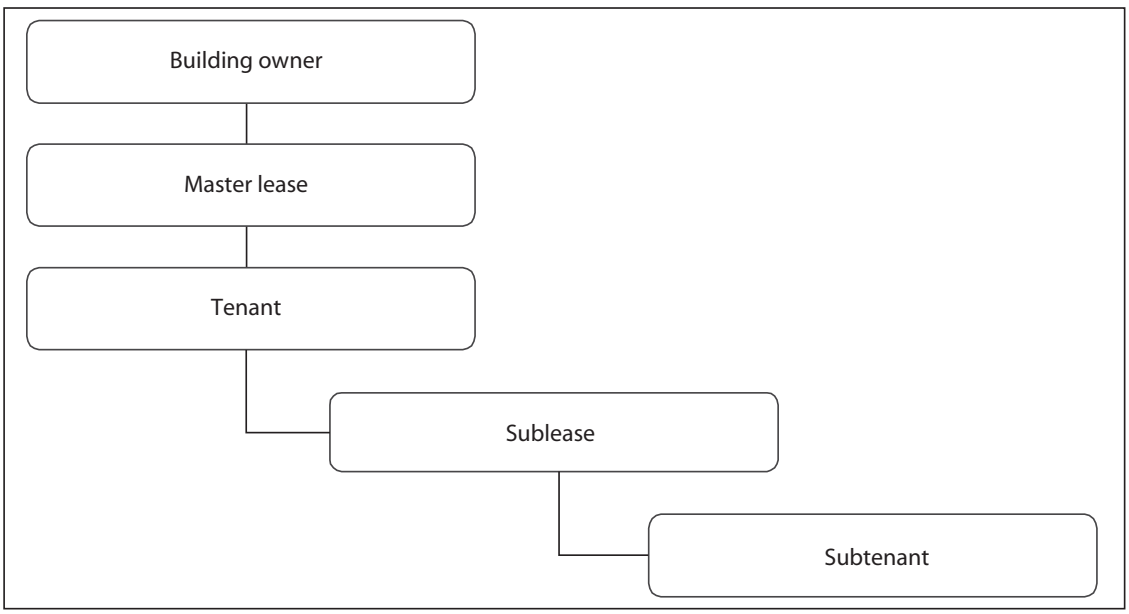
marriage benefit The concept that married persons enjoy a de facto tax benefit not given to other couples because the married filing jointly tax rates are lower than the ones for single persons.

married, filing jointly The ability of husbands and wives to file a joint tax return that allows them to aggregate their incomes into one total and pay taxes at a somewhat lower rate than if a single person earned the same amount of income. It is not necessary that both spouses earn income.

master (1) Employer-employee law is sometimes called master-servant law. (2) A person appointed by a court to perform a specific function, such as to sell real estate that is in dispute or to assist with evidentiary issues or other duties. (The practice is rare in federal court, but very common in some state courts.)

master deed A document used by condominium developers to record the project; its division into condominium ownership; and the grant of common areas to the condominium owners. Also called the declarations, the condominium declaration, or the declaration of condominium. (Do not confuse with *master's deed*.)

master lease A lease between the owner of property and its direct tenant, with all other leases subject to the first one. A tenant may sublease or assign part or all of its space on its own terms and conditions, but the parties will always be bound by the master lease because they are subordinate to it.



master's deed A deed from a judicial officer given as a result of a foreclosure, a tax sale, or sometimes a divorce, depending on the state and its customs. Do not confuse with *master deed*.

material fact Any fact that is relevant to a reasonable person making a decision. For example,

- Real estate agents must disclose material facts known to them about the condition of property.
- Some facts, although they may be material, cannot be disclosed unless the seller gives his or her permission, such as the fact that the seller or a prior owner or occupant of the property was HIV-positive or had AIDS.
- Legally actionable fraud is a misrepresentation of a material fact. If there was a misrepresentation, but the fact was not material, there is no liability for fraud.

materialman See *mechanics' and materialmen's liens*.

maturity The date on which the remaining balance of a promissory note is due.

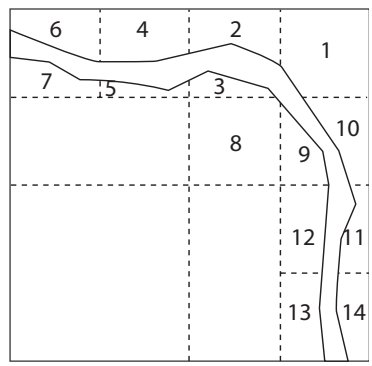
McMansion A derogatory term for a large house on a small lot; the term is intended to give a sense of uniformity and pretension. Also called starter castle.

mean The average of a set of numbers. Contrast with median, which is the middle figure in a set of numbers, and mode, which is the value that appears most often in a set of numbers.

Example: *A survey of home values in a neighborhood of nine houses obtained the following values:*

House	Value
1	$139,000
2	139,000
3	139,500
4	139,750
5	139,850
6	140,000
7	140,500
8	140,800
9	169,000

The mean, or average, is the total of all values divided by 9, or $143,044. The median is the middle number when the numbers are all arranged from highest to lowest, which would be house 5, or $139,850. The mode is $139,000, because it is the number that appears most often.



meander line An artificial line placed on a survey to describe the meandering course of a river or stream that forms a boundary of property. The use of a meander line indicates that the

boundary is the waterway and changes if the waterway changes. If the surveyor does not use a meander line, then the boundary line is fixed and constant.

measurements See *land measurement conversion*.

measuring life The person whose life span determines the duration of a life tenant's entitlement to possess and use real property. Typically, property is given or left by will to someone to use "for and during their natural lifetime" and then the document specifies who gets the property afterward. In the typical case, the life tenant is also the measuring life; when the life tenant dies, the right to use the property also dies at the same time.

> **Example:** *A different variety of life tenancy might give property "to Alice and her heirs, for and during the lifetime of Nate," with Nate being a baby born two days earlier. Nate is the measuring life. When Nate dies, Alice or her heirs will cease to have any interest in the property. It does not matter if Nate dies one week later or 100 years later, the life estate ends when he dies. At the end of the measuring life, the property passes to a previously specified remainderman.*

mechanics' and materialmen's liens Statutory liens granted in some states to specifically describe persons who provide goods or services contributing to the improvement of real property under a contract with the owner or the owner's representative, such as a general contractor. Such a lien will attach in favor of subcontractors even if the owner paid the general contractor, but the general contractor did not pay the subcontractors. It can take priority over a mortgage if the work was started before the mortgage was recorded, even if the lien document was not filed until after the mortgage was filed. Most statutes grant a very short time after nonpayment for the lien documents to be filed, or the lien will be lost. After that, one claiming under the lien must promptly take steps to foreclose the lien, or it will be lost. Property owners may protect themselves in some states by posting notices of nonresponsibility on the property, advising all subcontractors and vendors that they must look only to the general contractor for payment. A commercial service (Wallace W. Lien, P.C.) provides access to the lien laws for all 50 states at its Web site, www.lienlaw.com.

median The middle number of a series. See also *mean*, which includes examples.

median cut A break in the concrete or landscaped dividing area separating opposite lanes of traffic, enabling persons to turn at that location. The placement of median cuts is extremely important when looking for locations for retail establishments. If it is not easy for the public to turn into a place of business and to leave from that place of business, they will not shop there.

mediation An alternative dispute resolution (ADR) process in which a trained person assists disputants in coming to a solution that will be the best one under the circumstances for all involved. It is not binding, but many courts are now imposing mandatory diversion to mediation and a requirement that the parties negotiate in good faith to reach a settlement. Failure to settle may subtly impact a judge's decision regarding the party most at fault in a dispute. The American Arbitration Association, which also offers mediation services, maintains a Web site at www.adr.org.

meeting of the minds A requirement for the formation of a valid and enforceable contract is that the parties must agree to the same thing. If there is a mutual mistake of fact regarding one of

the critical elements of a contract, there has been no meeting of the minds and the contract may be set aside.

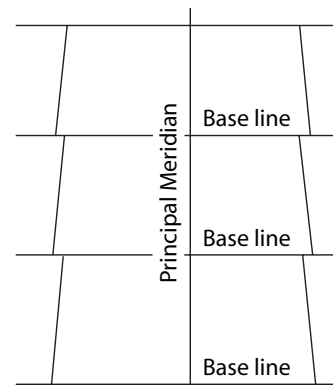
megalopolis A densely populated urban area that sprawls across two or more large, independent cities. The photo is a night-time satellite image showing population concentrations in megalopolis areas in the United States.

Examples include the Bos-Wash megalopolis from Boston to Washington, D.C., with an estimated population in excess of 41 million people; Chi-Pitts from Chicago to Pittsburgh; and San-San from San Francisco to San Diego. The largest megalopolis in the world is the 1,200-mile Taiheiyo Belt in Japan.

menace (1) A threat of violence used to secure a contract. Such a contract can be set aside, just as a contract secured by duress. (2) A threat of violence to another, such as a trespasser. Some state statutes allow the use of force to protect one's home, but do not include the ability to menace another in order to protect one's home.

merchantable title See *marketable title*.

merger (1) With regard to corporations, a legal joining together of two or more corporations into one entity or an entity with common ownership. A horizontal merger occurs between or among competitors, and a vertical merger occurs when suppliers, shippers, retailers, and such in a common industry join together. (2) With regard to real estate: (a) The joining of two or more interests in real estate into one owner, so that the separate interests, or estates, disappear. If a property owner with a right-of-way easement over her neighbor's land then purchases the neighbor's land, the easement is extinguished. If she then sells her first property to another, the new owner cannot now claim the benefit of the old right-of-way easement, because it was merged into land ownership. (b) The concept that a real estate contract becomes merged into the deed, so that provisions in the contract, but not in the deed, are not enforceable. This is almost always a question of intent, which means a jury gets to decide. The better course is to specify in the contract that all representations and warranties and all promises and agreements survive the deed. (c) The concept that negotiations are merged into a final contract and cannot be used to vary the terms of the contract.



meridian One of the imaginary lines running north and south and used by surveyors for reference in locating and describing land. Each area has a principal meridian as the reference for all other lines. Because of the curvature of the earth, though, meridian lines cannot remain an equal distance apart, because they converge as

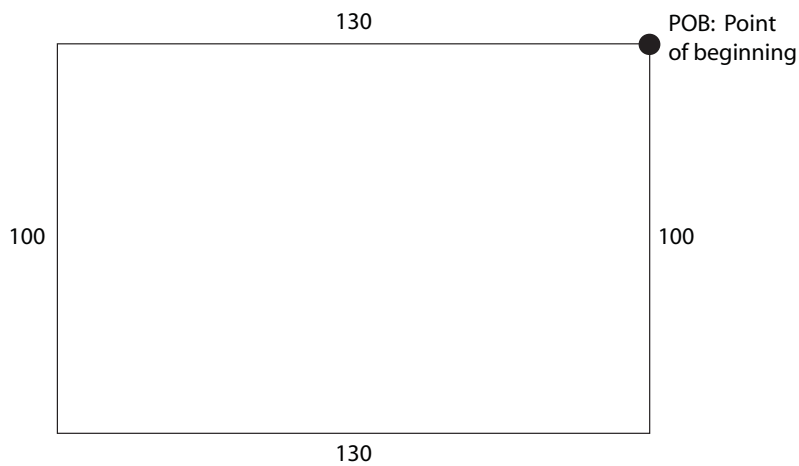
they approach the North Pole. As a result, correcting lines, called guide lines, are run at 24-mile intervals. The correcting lines break and then re-form at each base line. See also *public land survey system*.

mesne profits Damages due from one who is in wrongful possession of property, usually measured by the fair market rental of the property during the time period of the wrongful possession. This is damage for the possession itself; not damage for injuries to the property such as cutting down trees, destroying carpet, or flooding the basement. If the trespasser made improvements to the property, in good faith and believing himself or herself entitled to possession, then the value of the improvements may be used to set off any judgment for mesne profits.

messuage A house and the surrounding land and buildings used by it; the term is encountered in older laws granting a widow the right of quarantine after her husband's death, being the ability to use the mansion and messuage for a certain period of time until her other rights are settled.

metes and bounds A method of describing real property by starting with some universally recognized point, usually a specified corner of a 640-acre section but sometimes a monument. The description then specifies turning in a certain direction—northwest or southeast, for example—and at a certain angle, such as 35 degrees. The description will then specify the distance one should proceed at that direction and angle for one of the property lines, before making a turn. The process continues until the entire parcel is described and one has returned to the beginning point.

> **Example:** *Beginning at the Northwest corner of Section 16, Township 19 South, Range 10 West, being the Point of Beginning (POB) thence proceed southerly along said section line for a distance of 100 feet to a point; thence turn 90 degrees 0 minutes west and proceed for a distance of 130 feet to a point; thence turn 90 degrees 0 minutes north and proceed for a distance of 100 feet to a point; thence turn 90 degrees and 9 minutes east and proceed for a distance of 130 feet to the POB, containing 0.229 acres, more or less.*



metroplex See *megalopolis*.

metropolitan area (1) Generally, any area in or around a city. (2) A concept developed by the federal Office of Management and Budget (OMB) in order to standardize the descriptions of geographical areas so that comparisons of data among various federal agencies could be on an apples-to-apples basis; all data regarding a particular metropolitan area would apply to the same geographical area and the same population density and profile. Today, the concept is called core-based statistical areas, which include metropolitan statistical areas and micropolitan statistical areas. One may find statistical information about each at the Web site of the U.S. Census, www.census.gov/population/www/estimates/aboutmetro.html.

- Metropolitan statistical areas contain at least one urbanized area of 50,000 people or more.
- Micropolitan statistical areas contain at least one urbanized area and a population of 10,000 to 50,000 people.

metropolitan division See *metropolitan area*.

metropolitan statistical area See *metropolitan area*.

mezzanine financing A hybrid of debt and equity funding. Usually shortened to "mezz financing." The provider loans money on a second or even third mortgage basis and may either take an ownership interest in addition or may reserve the right to take over an ownership interest if the loan is not paid on time and in full. The loans are generally extended in emergency situations, such as to buy property quickly before bank lending can be arranged, or to engage in expansion activities and "grow" a company out of a cash crunch that is preventing it from securing a conventional loan. Because of the subordinate nature of the debt, the risky nature of the activities being funded by the money, and the lack of time to perform due diligence, mezz lenders usually want a high return on their money, in the 20 to 30 percent range.

mezzanine investors Persons or companies who advance money to a business and receive, in return, a combination of promissory notes and preferential ownership shares in the business. Just as the mezzanine is the balcony-type partial floor of a building, between the ground floor and the second floor, so too a mezzanine investor occupies the middle ground with more risk than the first and second mortgage lenders, but not as much risk as the owners and other investors. See also *capital stack*.

MGIC See *Maggie Mae*.

micropolitan statistical area See *metropolitan area*.

midrise Usually a four- to seven-story building, although definitions vary among markets. Contrast with *low-rise* and *high-rise*.

military protections and benefits There are a number of protections and benefits for current and former members of the armed services, the reserves, and the national guards. They include

- The Homeowners Assistance Program for military personnel stationed at or near a military installation scheduled for closure or realignment. It is administered by the U.S. Corps of Engineers, which may purchase homes, reimburse persons for losses on the sale of their homes, or pay off mortgages if such markets are depressed. See the Web site for the Savannah District of the U.S. Corps of Engineers, www.sas.usace.army.mil/hapinv/index.html, for details.
- The Soldiers and Sailors Civil Relief Act, passed by Congress at the start of World War II, requires automatic reduction of home mortgage interest rates to 6 percent under certain circumstances and a variety of other protections from eviction, lapse of life insurance, garnishments, and lawsuits. See the entry for *Soldiers and Sailors Civil Relief Act* for details.
- Mortgage guarantees by the Veterans Administration.
- The GI Bill (www.gibill.com), now called the Montgomery GI Bill, which offers support for veterans seeking postsecondary education.

mill One-tenth of one cent, or $0.001. Ad valorem (property) taxes are usually expressed in terms of a certain number of mills. A rate of 12.4 mills means that a property assessed for $100,000 would have ad valorem taxes of 12.4 (rate) × 0.001 (mill) × $100,000 (assessed value) for a tax of $1,240.

mineral rights The right to take things beneath the soil. One may sell land and mineral rights separately from each other, which works a severance of the interests. In some states, sand, gravel, and clay are not considered minerals, even if they exist below the surface. One frequently contentious issue is whether a grant of mineral rights includes the ability to take them by strip mining or other open-air operations, such as quarrying. (The answer differs from state to state and also depends on the precise language of the deed.)

minimum lot area A zoning ordinance specifying the smallest size lot on which something can be built. Sometimes, the restriction may be because of health department requirements for septic tanks, requiring a minimum of one acre.

minimum property requirements An FHA requirement that a mortgage loan be secured by a property that is livable, soundly built, and suitably located as to the site and neighborhood. If the property does not meet the standards, the FHA may require repairs before providing funding.

minimum rent The smallest amount of rent due from a tenant with a variable rental rate, such as a rent calculated as a certain percentage of gross sales, with a minimum rent of a certain amount per month.

mini-warehouse A term sometimes used interchangeably with self-storage by consumers, but with differing meanings in zoning statutes. Typically, a mini-warehouse is defined as small storage space of 200 to perhaps 1,000 square feet, designed for commercial customers, while self-storage

would be something of 25 to 200 square feet and designed for storage of household goods by consumers. Each zoning regulation will provide its own definition.

minor A person who has not yet reached the age of majority required to enter into binding contracts.

misfeasance An action that was legal and proper, but which was performed in an improper manner. A real estate agent who innocently deposits an earnest money check in the real estate company's business account instead of the escrow account, but who does not spend the money or use it in any manner, is probably guilty of a misfeasance. If the agent spent the money, that would be malfeasance, or doing something improper and illegal. If the agent put the check in a desk drawer and did not deposit it in any account, that would be nonfeasance, or the failure to take an action when the law required that some act be done.

misrepresentation See *fraud*.

mitigation of damages A legal principle that those who are injured by a breach of contract have a duty to take all steps necessary to decrease their damages, rather than simply sitting idly by and suing the defaulting party for all sums due under the contract. A landlord has a duty to mitigate its damages and find another tenant for property, with the defaulting tenant to be given credit for the value of the replacement lease.

mixed use The use of real property for more than one type of use, such as residential property and small offices in close proximity. The modern trend of land use is toward mixed use.

MLS Short for multiple listing service. A service whereby real estate brokers agree to make information about their listed properties available to each other and to split a commission with any other broker who provides the buyer. Most local boards require an exclusive listing agreement with a broker as a prerequisite for placement in the multiple listing service.

- At one time, this exclusive access to information about properties currently on the market, and historical information regarding selling prices of former properties, gave real estate brokers tremendous advantages over nonmembers and over consumers trying to sell property without the assistance of a broker. Today, with easy access to information on the Internet, including limited MLS information at the Web site of the National Association of REALTORS® (www.realtor.com), consumers are able to negotiate more competitively.
- The Antitrust Division of the Department of Justice has been scrutinizing MLS agreements that exclude brokers who are not members of the local board of REALTORS® (associated with the National Association of REALTORS®) or brokers who accept limited-services agreements.

mobile home See *manufactured housing*.

modular housing A type of housing in which the components are manufactured elsewhere and then assembled at the building site. It allows the construction of semicustom or even custom homes at very economical prices. The industry's trade association is the Modular Building Systems Association (www.modularhousing.com). The above photo is of a custom, modular home.

month-to-month tenancy A leasehold interest that is terminable at the expiration of any given month, although state consumer protection statutes may require the landlord, the tenant, or both to give one month's notice before termination. Oral leases are assumed to be month-to-month, because the tenant pays rent one month at a time. If a tenant remains in possession of property at the expiration of a typical 6-month or 1-, 3- or 5-year lease, courts in the various states are divided in their opinions regarding whether the new arrangement is a month-to-month tenancy or a renewal for a like term as the original lease, not exceeding 1 year.

monument A physical object, either natural or artificial, used by surveyors as a reference point. It may be a concrete block, iron pin, rod, stone marker, or other such thing set in place in order to bear witness to the reference point, or it may be a tree, bridge, river, or fence.

moral turpitude Under all real estate licensing laws, as with other professions, a real estate license can be denied or it can be revoked if a person is guilty of a crime of moral turpitude. There are many definitions, including baseness, vileness, depravity; contrary to accepted and customary rules, depraved or vicious motives, or acts done contrary to justice, honesty, modesty, or good morals. An examination of the various licensing statutes shows that the term is rather free-floating and is intended to convey a sense that if the commission of a particular crime bears a reasonable and substantial relationship to the qualifications, functions, or duties of a real estate broker, then it is a crime of moral turpitude.

moratorium A temporary cessation. Usually encountered in real estate when a local government suspends issuance of building permits in a particular area because, for example, the existing water line or sewer line capacity will not accommodate new growth.

more or less Words used in a deed description to indicate that the given size or dimensions of the property may not be precisely as stated. Without such words, a parcel that differs in size from

the representations could result in the rescission—setting aside—of a deed because of a mutual mistake of fact.

mortgage A written document that provides a lender with rights in real property as collateral for a loan. The loan itself is evidenced by a promissory note, which is a written promise to repay money on certain terms and conditions. In common language, people refer to the whole relationship with the real estate lender as a mortgage, and you will see references in writing to "mortgage interest rates." Technically, though, the reference should be to "mortgage loan interest rates."

- In some states, the security instrument is called a deed of trust. The property owner actually deeds the property to a third party, who holds the naked legal title in trust for the owner and will reconvey (retransfer) it when the debt has been paid in full. If there is a default and foreclosure, the trustee will convey the property to the successful bidder. Such states usually allow nonjudicial foreclosures.
- In other states, the instrument called a mortgage creates only a lien on real property. The borrower is called the mortgagor, and the lender is called the mortgagee. In order to foreclose, the lender usually has to obtain court permission to conduct a sale. These are called judicial foreclosures.
- In a very few states, called hybrid states, the instrument called a mortgage transfers legal title to the lender itself. The title is extinguished when the debt has been paid in full. The lender may take advantage of nonjudicial foreclosure.
- If foreclosure nets less money than is owed on the note with all interest and costs of collection, then the lender can usually sue the borrower in state court for the balance, called a deficiency. Exceptions occur if the note provided that it was nonrecourse, meaning without any personal liability by the borrower, or if state laws prohibit deficiency judgments for first mortgages on a consumer's principal residence.
- In some states, a debtor has a grace period after foreclosure within which to buy the property back for the amount of the winning bid price plus interest at the legal rate for that state. These rights of redemption may also be extended to junior lienholders and even unsecured creditors, who may wish to invest the money necessary for redemption because they believe they can sell at a profit and recoup their losses.

mortgage backed security (MBS) See *collateralized mortgage backed securities*.

mortgage banker One who is not an institutional lender (bank, credit union, etc.) but who loans their own funds for mortgage financing. The mortgage banker might borrow the money on a line of credit, in order to fund the loans, but it is still responsible for providing the cash. Contrast with a mortgage broker, who acts only as an intermediary.

mortgage broker One who acts as an intermediary between borrowers and lenders, but who is not personally involved in underwriting, funding, or servicing the loans.

Mortgage Guaranty Insurance Corporation (MGIC) See *Maggie Mae*.

mortgage lender A person or company that loans money and takes a security interest in real property. The lender can provide more than just real estate loans, but it is referred to as the mortgage lender when someone is talking about a real estate loan.

mortgage REIT A real estate investment trust (REIT) that purchases mortgage debts as investments, rather than income-producing property. Contrast with equity REITs, which invest in office buildings, hospitals, apartments, and other real properties, but not mortgages.

mortmain Literally means "dead hand." Originally referred to statutes passed in England in 1279 and 1290 to prevent transfers of property to the Church, which would keep the land in its "dead hand" forever and prevent the king from ever realizing any tax income from it. In modern times, mortmain statutes invalidated deathbed gifts to charities, upon the theory that the recipient may have been guilty of undue influence by promises of a rosy hereafter, making the gift suspicious. Today, most such statutes have been repealed. (Unhappy heirs wishing to contest last-minute charitable gifts may use the general theory of undue influence to make their case.)

most-favored-tenant clause A clause in a lease promising an existing tenant the same concessions as may be granted to future tenants, for a specified period of time. Frequently encountered when a new building wishes to secure a large tenant, but that tenant wants to wait and see if the concession package gets any better with the passage of time. As a compromise, the landlord will agree that future tenants will never receive a better deal than the existing one. As a practical matter, the first large tenant in a building will almost always receive the best deal, so the clause is in the nature of a "feel-good clause."

Mother Hubbard clause See *anaconda mortgage*.

mother-in-law apartment See *granny flat*.

multifamily residential property Properties consisting of five or more connected dwelling units.

multiple listing service See *MLS*.

municipal mortgage enhancement (Munie Mae) A Fannie Mae program in which its mortgage backed securities are exchanged for the underlying mortgage on a tax-exempt multifamily project, thereby enabling the developer to obtain loan money at the lowest possible rate.

Munie Mae See *municipal mortgage enhancement*.

muniment of title (1) A legal document evidencing title to real property. (2) Under the muniment of title doctrine, when parties have litigated the title to real property, the loser cannot take a second bite of the apple, sue the next owners, and thereby attempt to regain title.

N

NAEBA See *National Association of Exclusive Buyer Agents*.

naked title Bare legal title to property, carrying with it none of the benefits of ownership. Usually the title held by a trustee, with the beneficiary holding equitable title.

nanoacre Related to real estate only because space on a computer board is referred to as real estate. A nanoacre is about 2 square millimeters, or 0.003 square inches.

NAR See *National Association of REALTORS®*.

narrative report A self-contained appraisal report.

NAREB See *National Association of Real Estate Brokers*.

National Association of Exclusive Buyer Agents (NAEBA) Established in 1995 as an organization for brokers and real estate agents who represent buyers. In the normal situation, the listing agent represents the seller, and most other agents "working with buyers" act as subagents for the seller. The situation is not well understood by the public. The NAEBA Web site is at www.naeba.org.

National Association of Real Estate Brokers (NAREB) A national trade association with a Mission Statement "to bring together the nation's minority professionals in the real estate industry to promote the meaningful exchange of ideas about our business and how best to serve our clientele." The NAREB Web site is at www.nareb.com.

National Association of REALTORS® (NAR) The largest real estate organization in the world, with over 850,000 members in all 50 states plus Washington, D.C.; Guam; Puerto Rico; and the Virgin Islands. The association promotes ethical standards, educational growth, professionalism, and the effective use of modern tools and technology. It has positioned itself as "The Voice for Real Estate," a theme it adopted in 1989 and has followed since that time. It maintains a Web site primarily for members at www.realtor.org and another devoted to consumers at www.realtor.com.

REALTOR

National Conference of Commissioners on Uniform State Laws Founded in 1892 to study the laws of the various states, recommend areas that should have uniform laws around the nation, and then write laws that may serve as models for legislation by the individual states. The current real

estate–related laws written and proposed by the National Conference of Commissioners on Uniform State Laws (www.nccusl.org) include topics on landlord-tenant law, condominiums, conservation easements, residential time-shares, and nonjudicial foreclosure.

National Flood Insurance Program A federal program allowing people to purchase flood insurance. It is administered by the Federal Insurance Administration (FIA), which is a branch of the Federal Emergency Management Agency (FEMA). See *flood insurance*.

National Trust for Historic Preservation A private, nonprofit organization (www.nationaltrust.org) dedicated to saving historic places and revitalizing America's communities. Each year it publishes a list of the country's most endangered places. For 2006, one of the top 11 most endangered places was a descriptive locale rather than a specific place. It was the corner of Main and Main, being the heart of downtown urban life and the hottest, most desirable redevelopment site for demolition of older buildings and construction of chain stores.

natural disaster Any destructive activity not caused by human forces or interventions, including hurricanes, tornadoes, flooding, and volcanic eruptions, to name a few.

natural person An individual, as opposed to an artificial person like a corporation, partnership, or association.

natural vacancy rate The normal, average, or traditional percentage of rental properties in a community that are not leased or occupied.

navigable line That portion of a river that can accommodate boat traffic in safety.

navigable waters According to the Code of Federal Regulations section dealing with the U.S. Army Corps of Engineers (www.usace.army.mil/), which is given jurisdiction over them, navigable waters are "those waters that are subject to the ebb and flow of the tide and/or are presently used, or have been used in the past, or may be susceptible for use to transport interstate or foreign commerce. A determination of navigability, once made, applies laterally over the entire surface of the water body, and is not extinguished by later actions or events which impede or destroy navigable capacity." Property owners wishing to build boat piers or other structures extending into navigable waters must obtain a permit from the Department of the Army.

NECTAs See *New England city and town areas*.

negative amortization The situation that exists when one's monthly loan payments are insufficient to completely pay currently accrued interest. The unpaid interest is added to the principal balance. Rather than the normal situation of a principal balance becoming smaller with a fully amortizing loan, this situation results in a larger balance, hence the name negative amortization. It occurs most often when a borrower has a variable-rate loan but with fixed monthly payments for a short period of time.

negative cash flow Having insufficient cash to pay all operating expenses of a business or an investment. The situation is common with new developments and is solved by the developer using its own money to help pay bills or, more often, by borrowing enough money in the development loan to cover cash shortfalls until the project reaches stabilized occupancy and the break-even point.

negative easement (1) A prohibition of some activity on a property, so as to enhance the value or enjoyment of another property. For example, a beach-front property might have a building-height restriction so that inland property owners can enjoy an unobstructed view of the ocean. (2) Subdivision covenants and restrictions on the use of land are sometimes called reciprocal negative easements. For example, the restriction that no property may have fences around the front yard enhances the value of all properties because of the open nature of the community.

negative equity loans Government-insured mortgage loans for up to 125 percent of the value of the property. The money may be used only for improvements to the property.

negative leverage See *leverage*.

negligence A breach in the performance of a legal duty, proximately resulting in harm to another. Central to the concept of negligence is the problem of determining the exact duty owed. For example, does one owe any duties of care regarding the condition of property so as not to injure trespassers? If there is no duty, there can be no negligence, no matter how sloppy and careless the act.

negligent fraud A false statement of a material fact, made without any intention to deceive, but upon which someone else relies to their detriment and is injured. An example would be a real estate agent telling a buyer that all the appliances are new when, in reality, the agent didn't know, but thought they looked new.

negligent waste See *waste*.

negotiable instrument A document signed by the maker or drawer, containing an unconditional promise to pay a certain sum of money on demand or at a definite time to the bearer or to order but without any other promise, order, obligation, or power. (See the Uniform Commercial Code, Article 3.)

negotiation (1) Under the Uniform Commercial Code, it is a voluntary or involuntary transfer of possession of a negotiable instrument by someone other than the issuer, to another, who thereby becomes a holder. (2) More commonly, it is the art and science of bringing two or more parties to an agreement that each views as delivering at least some of his or her goals.

When negotiating in real estate, keep some of these thoughts in mind:

- Price and terms (amount of earnest money, contingencies, time to close, what personal property stays behind, seller financing, etc.) are like two ends of a street. The closer you get to one, such as the price you want to pay, the further you are away from the other, such as the ability to also obtain seller financing. (Common wisdom says you can negotiate price or terms, but not both. That is not true, but they do tend to have an impact on each other.)
- The better armed you are with facts, the more likely you will succeed in your negotiations. If you think a price is too high, be prepared to give examples of similar properties that sold recently for lower prices. You may learn about features making the subject property more valuable. The seller may drop the price. You may find that, while you think the price is high, it is actually below market compared to similar properties.

- In commercial lease negotiations, there is always a certain amount of money the landlord is willing to spend—the deal money. It might be spent in the way of rent concessions, renovation of the leased property, or real estate commissions. Rent concessions consist of free rent for some time or reduced rent for the entire time. Free or reduced rent that is paid back later in the lease is not a true rent concession and shouldn't reduce the amount of available deal money. Learning about other rent concessions in the marketplace, and the amount of leasing commissions typically paid by a particular landlord, will give you a good idea of how to calculate the deal money. (The easiest negotiation in leasing is to tell the landlord how you want the deal money spent. After that, the measure of a good negotiator is how much more you can get.)
- Learn everything you can about the person or company on the other side. Negotiation is not always about reaching an agreement on price. Many times it is discovering and meeting unspoken goals or needs of the other party.
- Don't bid against yourself. If your offer is rejected, wait for a counteroffer.
- Never be embarrassed by a low offer if you think that's what the property is worth. It is far more common than you would think for properties to have asking prices well above what the owners are willing to accept. See *bottom-fishing*.
- In negotiations over specific wording of a written contract or lease, draw a red "X" on the first page of each version as it is rejected, but keep all rejected versions in a safe place. It may become important later—even years later if there is a lawsuit—to reconstruct what terms were discussed and rejected by the parties.
- Be aware that written negotiations, even by e-mail, can be interpreted as an enforceable contract under some circumstances. All writings, even e-mail messages, should contain a line saying, "For negotiation purposes only." See *Uniform Electronic Transactions Act* and *Statute of Frauds*.
- Letters of intent can be construed as binding contracts. If you want to avoid this, say so in the LOI. If you want the LOI to be a binding contract as to its deal terms, with details to be worked out later, say that. But, the devil is in the details, as they say, so be prepared to find contract or lease language particulars that become deal breakers. If your LOI is a binding contract, then you may find a court deciding the other contract terms for you.
- Be aware that popular word processing programs may keep track of all changes to a document. If you send that document file to someone else, that person may be able to click a menu item and view all your changes, thereby being able to track your thoughts. If in doubt regarding this feature, click on the Help button for your program and enter "track changes," "compare documents," or similar words.

neighborhood shopping center Generally a straight-line strip center with a grocery store anchor, sometimes a drugstore, and other small retailers. It caters to shoppers in the immediate neighborhood for convenience items, such as laundry, hair and nail care, video rental, tanning salons, mail and package stores, and gift items.

net annual income Income after payment of taxes.

net income Operating income after deduction of all expenses. See *net operating income*.

net income figures Loosely defined as a listing of after-tax income from various sources.

net lease A lease in which the tenant pays rent plus some portion of the maintenance and operating expenses of a property. The term triple net lease means the tenant pays all expenses associated with the property—maintenance, repairs, insurance, and real estate taxes. Beyond that, though, the expression net lease has no particular definition regarding the tenant's exact responsibilities. Every lease will be different and should be scrutinized for exact tenant expenses. One should always obtain a detailed list of expenses that are within the landlord's control, such as office overhead and salaries. Otherwise, expenses may increase dramatically merely because the owner's son-in-law, for example, has been given a high-paying job for mowing the lawn each week.

net listing An arrangement in which a property owner pays the listing real estate agent all purchase price proceeds over and above a minimum figure required by the owner. Because the real estate agent is usually the one to recommend an asking price to the owner, the practice is very susceptible to abuse. As a result, it is illegal in some states.

net-net-net lease See *triple net lease*.

net operating income (NOI) The foundation of almost all analyses of income-producing property such as apartments, office buildings, and retail space. The number is the result of taking all rental and other revenues from the property and then subtracting all reasonably necessary operating expenses. Loan payments do not count as expenses for purposes of the NOI. If you, as the owner, pay yourself a salary of $100,000 a year but your job could be filled by someone at $35,000 a year, it is legitimate to make that downward adjustment in the expenses when presenting figures to a potential purchaser or lender. On the other hand, if you take no salary, do all the office work, make all repairs, and mow the lawn, then you will have to estimate what those expenses would be if a third party owned the project and enter that number as an imputed expense.

Example:

Difference between Cash Flow and Net Operating Income				
	Real Numbers: Annual		**Used to Calculate NOI: Annual**	
Revenues		+$250,000		+$250,000
Utilities		−2,000		−2,000
Maintenance crew	Self:	0	Reasonable third-party expense	−32,000
Office personnel	Spouse:	−100,000	Reasonable third-party expense	−40,000
Taxes and insurance		−20,000		−20,000
Loan payments		−24,000	Not relevant	0
	Cash flow =$104,000		NOI =$156,000	

net present value An analytical tool for evaluating whether or not to purchase an investment. The tool does not tell you if an investment is good or bad; it tells you if the investment will meet your predetermined objectives or not.

Example of Net-Present-Value Calculations

A, B, and C each have $100,000 to spend on a rental house. By the end of year 1, whoever buys the house will have earned $9,000 in rent after paying all expenses, and the owner will then sell the house and earn $103,000 after paying all closing expenses. Each of them has different requirements for their investments. A would like to earn a 4.5% return, B would like to earn 12%, and C would like to earn 13%. Whose investment needs will be met by buying the rental house?

	A	**B**	**C**
	4.5%	**12%**	**13%**
Initial investment	$100,000	$100,000	$100,000
Cash income from rent by end of year 1	9,000	9,000	9,000
Cash income from asset sale at end of year 1	103,000	103,000	103,000
Total year 1 income	112,000	112,000	112,000
Present value of year 1 income at the selected discount rate	107,177	100,000	99,114
Net present value, or the difference between present value and necessary investment of $100,000	7,177	0	(886)*
	Buy	Buy	Don't buy

A's net present value is positive, which means the investment will exceed A's requirements. B's net present value is 0, which means the investment will exactly meet B's requirements. C's net present value is negative, which means the investment will not meet C's requirements.

*The parentheses indicate a negative number, in this case −$886.

- Critical to defining your objectives is setting the equivalent of an interest rate you would like to earn on your initial cash investment. This is called the discount rate. The discount rate may change from investment to investment, depending on your assessment of the risk. The safest investment is an FDIC-insured savings account, but it returns the lowest interest rate. You, the investor, decide what rate you would like to earn. You use the net-present-value tool to calculate whether a particular investment will earn the rate you want.

- Having said all that, the official definition of net present value is as follows: using a preselected discount rate, net present value is the present value of all cash incomes, less the present value of all cash outflows (including initial investment). If this is not clear, it will become so with the example below.
- If the net present value is 0 or a positive number, the investor should go forward. If the answer is negative for the discount rate selected, then the investment should not be made because it will not meet the investor's objectives, not because it is a "bad investment" in the ordinary sense of that phrase.
- The Excel formula for present value is

  =pv(rate, cashflow, cashflow, cashflow)

  ''Rate" is the cell with the interest rate the investor would like to earn. Each of the "cashflow" entries is a cell address for cash flows by the end of each year, such as year 1, year 2, year 3, and so on. If an asset is sold in a particular year, the net sales price (after expenses of the sale) is entered as part of the cash flow for that year. One flaw of the system is that it assumes all cash flows are received at year-end, when they are really received over time, but that is usually a relatively minor problem.

net return rate All the profits from a property, including the profit on a resale, as compared to the initial investment.

net usable acre/net usable feet The portion of a property that is usable for ordinary purposes. If 5 acres of land slopes downward dramatically into a ravine, the listing agent might say the price is $12 per square foot, but $20 per net usable foot.

net worth The financial value of a person or company after adding all assets and subtracting all liabilities.

New England city and town areas (NECTAs) Areas defined by the U.S. Census Bureau with reference to traditional city and town designations in the six New England states.

new town In keeping with the expression "all things old are new again," modern residential development is focusing on a small-town atmosphere called the new town concept. It includes sidewalks and community parks plus offices, retail, places of worship, and schools within the project itself and usually within walking distance of residential areas. It may even include some home-above-retail or home-above-office concepts and satellite offices for government services such as license renewal.

NIMBY A derogatory term; an acronym for "not in my backyard." It is intended to convey the sense that people are generally in favor of socially desirable programs such as half-way houses for felons, or unsavory but largely necessary uses such as waste disposal sites, as long as they are located in or near someone else's neighborhood.

no bid When a property with a Veterans Administration (VA) guarantee goes into foreclosure, the VA must perform an analysis regarding whether it would be cheaper to pay the guarantee amount or to buy the house from the servicer and then sell the house itself. When it chooses to pay the guarantee amount, it is called a no bid.

no buy, no pay clause A clause in a real estate listing contract that excuses the seller from paying a real estate commission if the broker produces a buyer who is ready, willing, and able to purchase the listed property for the asking price, but the seller changes his or her mind and refuses to sell at all, or refuses to sell to that particular buyer. Without such an unusual clause, the broker has earned the commission when he or she produced such a buyer, and the owner will have to pay even though the owner declines to sell the property.

no deal, no commission clause See *no buy, no pay clause*.

no further action letter Written confirmation from an environmental oversight board that a property requires no remediation for possible contaminants.

NOI See *net operating income*.

nominal consideration A token payment or promise given in exchange for something else of greater value. Courts will usually not "look behind the value of consideration," and even a nominal consideration (such as $1) will support a contract and make it enforceable. It will also support a deed, so that it cannot be set aside.

nominal interest rate The stated interest rate in a note, which may differ from the true (effective) interest rate because of discounting or fees.

nominal partner One who lends his or her name to a venture or business and appears to be a partner, but in truth is not. Care should be taken because nominal partners may be held liable for partnership debts and liabilities, especially if someone can prove they would not have done business with the partnership but for their mistaken belief that the nominal partner was a true partner.

nominee One who is designated to act for another in a limited sense. It could be a trustee, an agent, or a straw man.

nonaccrual The actions of a lender making a change in how a loan is accounted on its books. Normally, the lender will treat itself as receiving income as interest comes due—accrues—on the loan. Under normal circumstances, the lender can expect to actually receive the cash in a very short period of time afterward. When a borrower defaults and does not pay its interest, and the default continues for several months, the lender will reach the point where it begins to doubt if it will ever receive the cash for the interest that is accruing. At that point, it does not make business sense and, in fact, might be against federal regulations, to keep acting as if the lender were receiving income. As a result, the lender places the loan on nonaccrual, and stops posting income from the loan. This is a bookkeeping and accounting action only. It does not mean the lender will not attempt to collect every nickel of money due to it.

nonassumption clause See *due-on-sale clause*.

noncapital expenditures Money spent on repairs, supplies, payroll, and other operating expenses.

noncategorical taking In an inverse condemnation case, a property owner complains that government regulations have rendered his or her property worthless, thus amounting to condemnation under eminent domain powers and therefore entitling the owner to compensation. There are two approaches to analyzing the taking—a categorical taking or a noncategorical taking. The noncategorical taking standard starts by finding the property has not been rendered economically useless. That being said, the courts must engage in complex analyses and balancing of interests across a wide variety of factors, including the extent to which the regulation interferes with reasonable investment-backed expectations of the property owner. See also *categorical taking*.

noncompetition clause (1) A contract provision usually required by a buyer when purchasing a business. It prohibits the seller from engaging in a similar business in competition with the buyer. Courts will usually enforce such agreements if they are reasonable in a geographical area and time period. For example, Jack sells his property management business to Irene and agrees he will not open another property management firm anywhere in the same county for the next 3 years. In this way, Irene can be sure she will not lose existing or potential clients to Jack, and she will receive the full benefit of her bargain. (2) Some noncompetition clauses are designed to prevent employees from working for competitors. Courts disfavor such clauses. Most likely, if Irene wanted her employees to agree not to work for any other property management company in town, such a clause would be unenforceable.

nonconforming use The use of a property in a manner that was permitted at one time but that now violates a zoning or other restriction. The use is allowed to continue—is grandfathered—as a nonconforming use. Depending on the particular laws of the jurisdiction, a nonconforming use may not be allowed to continue after a sale, long-term lease, substantial destruction of the property, or abandonment for a period of time.

nondisclosure The failure to reveal a fact, whether or not there is an intention to conceal that fact. A person may be liable for nondisclosure if they had a duty to disclose, such as the duty to reveal latent (hidden) property defects.

nondisturbance clause (1) A mortgage term that guarantees leases will be allowed to continue uninterrupted if there is a foreclosure. (2) A clause in a mineral lease or sale of mineral interests that the buyer will not disturb the surface in its operations.

no-doc loan Short for "no document" loan, it typically covers three situations in which borrowers cannot or will not provide the documentation typically necessary to evaluate their ability to pay back a loan: (1) a borrower who has regular self-employment income but no tax forms from an employer, (2) wealthy individuals with complex financial lives showing large tax losses every year but an amazing ability to live lavish lifestyles (also called no-ratio loans), and (3) wealthy people with substantial assets but who want maximum privacy and refuse to supply any documentation. All three groups are going to pay high interest rates as a result of their lack of documentation.

nonfeasance A failure to act when the law required an action. Real estate brokers are supposed to deposit earnest money checks as soon as possible. If the broker neglects to deposit the check, he or

she is guilty of a nonfeasance, even if there was no improper motive and no misuse of the funds. Likewise, if local fire codes require fire extinguishers in the hallways of an office building, and the owner fails to install them, it is guilty of nonfeasance and may be liable for injuries and damages if there is a fire. Contrast with misfeasance, which is doing a legal and proper thing but in an improper manner, and malfeasance which is doing something improper or unlawful.

nonfreehold estates Any interest in land without seisin. Historically, the nonfreehold estates were everything except the fee simple, fee tail, and life estate. Today, it usually refers to a lease.

nonhomogeneic A term used to describe real property; no two are alike.

nonjudicial foreclosure A foreclosure under a power of sale in a mortgage. It enables the lender to give the appropriate notices required under state law and then sell the mortgaged property to the highest bidder, which could be the lender itself.

nonperforming loan Under banking regulations, a loan that is more than 90 days past due, that has been placed on nonaccrual, or that is current on its payments but being handled as a workout.

nonprofit corporation A corporation formed for a nonprofit purpose, such as charitable, educational, political, social, or trade organizations. Usually called a 501(c)(3) corporation after Section 501(c)(3) of the Internal Revenue Code. All such corporations with tax-exempt status are required to file annual reports with the IRS on Form 990. You may view the tax deductibility of contributions and past 990 forms for particular organizations free of charge at the Web site for Philanthropic Research, Inc., www.guidestar.org. See also *eleemosynary corporation*.

nonpublicly traded REIT See *private REIT*.

nonrecourse loan A loan that includes no personal liability for the borrower. The lender has agreed that the collateral is sufficient and, if there is a foreclosure and the property brings less than the amount due under the loan, then the lender will suffer the loss and not sue the borrower. Even nonrecourse loans typically have carve-outs imposing personal liability on the borrower if there are environmental problems or the borrower is guilty of some sort of fraud.

nontraded REIT See *private REIT*.

no-ratio loans See *no-doc loans*.

normal wear and tear That amount of physical deterioration that occurs with normal use of a property as contemplated by the parties. It could be dramatically different between a day-care facility and an upscale clothing store. Most commercial leases require the tenant to return the premises in like condition as when rented, normal wear and tear excepted. Consumer protection laws in many states prohibit withholding a tenant's deposit if there is only normal wear and tear to the premises. The best practice is to define the term in the lease. For example, "Normal wear and tear shall mean the necessity to shampoo carpets and paint walls, but not the necessity to replace carpet or repair walls for anything larger than a small picture hanger."

notary public A person authorized by law to take oaths and witness signatures on documents. In some states, the notary must post a fidelity bond. In some states, notaries must keep complete logs of all documents notarized and the type of identification provided by the party signing the instrument.

note See *promissory note*.

notice See *legal notice*.

notice of assessment A notice sent to property owners advising them of the current assessed valuation of their property for real estate tax purposes. The assessed value is usually based on a formula that starts with the fair market value and then decreases it to reach an assessed value. Property owners normally have a specific period of time within which to contest their assessments and should not be complacent just because the assessed value is less than the fair market value.

notice of completion A notice typically given by contractors performing construction or improvement work for state or local governments; advising of the completion of the work and the necessity to file any liens within the required time period afterward. Many times the notice will run in the legal section of the local newspaper, although there may be a central location for filing them.

notice of default A written notice sometimes required by state law or sometimes required within particular leases, promissory notes, or other contracts, advising the defaulting party of the existence of the default and a time period within which to cure it. Most documents require no notice of monetary default, although the better practice is to require it just in case checks are lost or misplaced. Notices of nonmonetary default would include matters such as failure to maintain insurance, subleasing space without the landlord's approval, or any number of other things prohibited under the parties' agreements.

notice of nonresponsibility An official notice by property owners that they are not responsible for debts incurred to improve property, and that vendors and subcontractors must look solely to the general contractor for payment. Proper posting of the notice prevents the imposition of mechanics' and materialmen's liens in the event the general contractor does not pay the subcontractors or the suppliers.

notice-race statute A law in some states that establishes the relative priority of claims when deeds or mortgages are not recorded in the public records in the chronological order in which they were executed. It provides that if a second mortgage lender provides money to a property owner without notice that there is already a first mortgage on the property, and the second mortgage lender records its mortgage before the first mortgage is recorded (usually because of some accident or oversight), then the second mortgage lender will have the first lien on the property.

> **Example** *Ralph borrows $140,000 from Big Lender to buy a home. He signs a mortgage. Big Lender makes a mistake and files the mortgage in the wrong county in Ralph's state. This has the same effect as not filing at all. A year later, Ralph borrows $25,000 from Easy Internet Loans. It takes a mortgage and files it in the right place. Two days later Ralph takes the cash*

and disappears. In a notice-race state, Easy Internet Money may foreclose on the property and take the first $25,000 in proceeds from the sale. The balance will go to Big Lender, who will usually not see enough money to pay the loan in full. Contrast with pure-race statutes *and* pure-notice statutes.

notice to quit A legal notice to a tenant to vacate the premises; one of the steps in an eviction process.

novation The substitution of a new contract, debt, or obligation for an existing one. Usually encountered when a tenant assigns the lease to another, or when a new building owner requires all existing tenants to execute novation agreements. The effect is to extinguish all obligations under the old agreements and replace them with the new obligations.

nuisance An activity that arises from the unreasonable, unwarranted, or unlawful use of one's own property resulting in an obstruction or injury to another property owner or to the public and producing such material annoyance, inconvenience, and discomfort that the law will presume resulting damage. It may consist of noise, smoke, odors, pollution, vibration, interference with rights of passage, maintaining an offensive business, discharge of water, or maintaining a building in a manner that makes it unsafe for others because of falling debris or because of rats or vermin. (Do not confuse with *attractive nuisance*, a theory of negligence liability for maintaining features attractive to children but likely to harm them.)

null and void Having no legal effect.

nuncupative will An oral will stated by the testator before witnesses shortly before the testator's death and reduced to writing by the witnesses shortly after death. Such wills are unenforceable in many states. Contrast with *holographic will*, which is one prepared entirely in the testator's handwriting but without any witnesses.

O

OAR See *overall capitalization rate*.

obligee A party to whom an obligation is owed. A lender is an obligee.

obligor A party who owes an obligation. A borrower is an obligor.

obsolescence A loss in value of an improvement because something makes it undesirable or no longer useful, even though it might be structurally sound.

- Functional obsolescence occurs because of factors within a property, such as a poor floor plan or lack of modern amenities. A three-bedroom, one-bathroom house with a one-car garage would generally be considered as suffering from functional obsolescence.
- Economic obsolescence, also called environmental obsolescence and external obsolescence, occurs because of factors outside a property. Examples include construction of an airport near a residential area or a change in highway access leaving a retail area stranded.

OC3 The next level of telecommunications requirements for offices and distribution centers. Previously, users wanted local T1 access for broadband needs, with speeds greater than the more familiar digital subscriber line (DSL) service. Even T3, equivalent to 28 T1s, is now sometimes inadequate for intensive voice and data needs. Today, fiber-optic OC3 (optical carrier 3) is the minimum requirement for sophisticated shoppers, with speeds of up to 155 megabytes per second, or the equivalent of 84 T1s or three T3s.

OC12 High-speed data provisioning at speeds up to 622 megabytes per second, equivalent to 414 T1s. See *OC3*.

OC48 High-speed provisioning at speeds up to 2.5 gigabytes per second. It is most often used by large enterprises or as an Internet service provider (ISP) backbone. See *OC3*.

occupancy agreement An agreement that allows a buyer to take possession of property prior to closing on the purchase. Except for the most unusual of circumstances, it is usually a poor idea because of the risks involved if the sale falls through.

occupancy certificate See *certificate of occupancy*.

occupancy level See *occupancy rate*.

occupancy permit See *certificate of occupancy*.

occupancy rate The ratio of rented property to the total available for rent. It is the flip side of the vacancy rate. Occupancy rates may be calculated by number of units, number of square feet, or by dollar value of rentals, also called the economic occupancy rate.

Example: *A 10-unit apartment complex has the following units and occupancies:*

Style	Number of Units	Size each (ft^2)	Rent each	Number Rented	Number Vacant
One bedroom	4	1,000	$800	3	1
Two bedroom	4	1,200	$1,000	4	0
Studio	2	600	$700	1	1
Totals	10	10,000 sq feet of space available for rent	$8,600 total possible monthly rental income	8	2

Occupancy rate by number of units: 8 units are rented out of a total of 10 possible = 80% occupancy.

Occupancy rate by square footage: 8,400 square feet are rented (3 @ 1,000 feet; 4 @ 1,200 feet; 1 @ 600 feet) out of a possible 10,000 square feet = 84% occupancy.

Economic occupancy: a monthly income of $7,100 (3 @ $800; 4 @ $1,000; 1 @ $700) out of a possible $8,600 = 82.5% occupancy.

occupancy report See *rent roll*.

Occupational Safety and Health Administration (OSHA) (pronounced as a word) A federal agency within the Department of Labor, OSHA (www.osha.gov) performs workplace inspections, engages in education and partnership to improve workplace safety, and enforces compliance with workplace safety standards. It is a common misperception that OSHA has the right to conduct surprise inspections of the workplace, including construction sites. In reality, OSHA may inspect only what it is given permission to inspect, or the particular portion of the premises described with particularity in a search warrant.

OEA See *operating and easement agreement*.

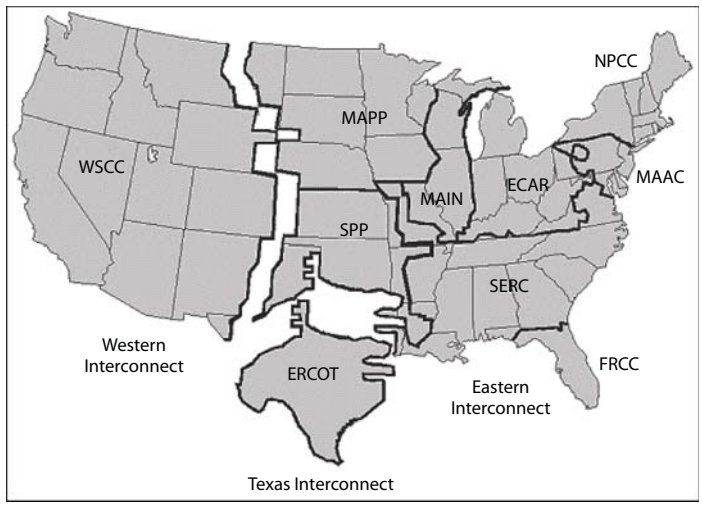
off-balance sheet lease See *operating lease*.

offer A commitment to do some act, usually to buy or sell something, upon specified terms which, if accepted, would create an enforceable contract. The person making the offer is the offeror; the person receiving it is the offeree. Some important concepts include

- An offer may be withdrawn at any time before it is accepted, unless the offer by its terms stated it would be irrevocable for a specified period of time or other conditions.

- The mailbox rule states that if an offer is made via the mail, or if an offer does not limit acceptance to some vehicle other than the mail, then it may be accepted by mail. If so, then acceptance is effective when it is placed in the mail, not when received by the offeror. As a result, the offer may not be withdrawn once acceptance has been placed in the mail.
- The Uniform Computer Information Transactions Act provides that e-mail offers are accepted when the return e-mail has been received by the offeror, not when it is sent.
- Some states have held that fax transmissions of acceptance are effective when faxed.
- An offer that is "accepted," but with changes in some of the terms or conditions, is a counteroffer and is not an acceptance. A counteroffer is a new offer that must be accepted or rejected. The old offer may not be resurrected at that point.
- A property auctioned without reserve is an offer that may not be withdrawn. Unless specified otherwise, all auctions are presumed to be with reserve and the property may be withdrawn at any time before acceptance.
- Upon receiving an offer from a potential purchaser, an agent is obligated to transmit it to the client as soon as possible, even if the agent thinks it is a poor offer that will not be accepted. Further, an agent may not retain an offer until receipt of another, in order to present them together, unless the client has given specific instructions to act in that manner.

off-grid Property that has no commercially available electricity. It is "off the power grid." There are three power grids in the United States: the Eastern Interconnect, Western Interconnect, and Texas Interconnect.



Courtesy U.S. Diesel Engines.

office building A building used primarily for office space.

Office Business Center Association A trade association (www.obcai.org) for owners and managers of business centers, also called executive suites and shared tenant services. See also *business center*.

Office of Federal Housing Enterprise Oversight (OFHEO) An independent entity (www.ofheo.gov) established in 1992 within HUD. It provides oversight for Fannie Mae and Freddie Mac and is funded through assessments against those two corporations.

Office of Interstate Land Sales Registration Oversees implementation of the 1968 Interstate Land Sales Full Disclosure Act, with provisions similar to securities laws. The Act requires registration of subdivisions with 100 or more nonexempt lots and the provision of a Property Report Disclosure Document to each purchaser. The most common exemption is for improved lots, either with habitable structures completed when offered for sale or to be completed within two years. For more information go the HUD Web site, www.hud.gov.

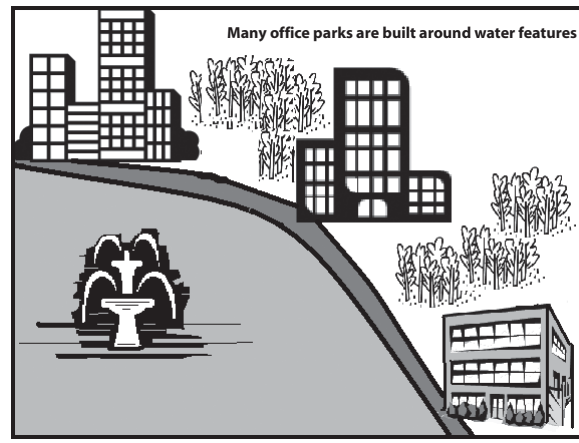
Office of Management and Budget A White House office (www.whitehouse.gov/omb) charged with assisting the president in preparation of the federal budget and supervising its administration. It also evaluates the effectiveness of agency programs, policies, and procedures.

Office of Property Disposal A part of the Public Building Service of the General Services Administration. The Office of Property Disposal (www.propertydisposal.gsa.gov) handles the disposal of all surplus federal property, including real estate.

Office of Real Property Management Provides asset management, analysis, and reporting of government real property holdings, and regulatory oversight and recommendations. Part of the General Services Administration (www.gsa.gov).

Office of Thrift Supervision (OTS) A primary regulator of federal- and state-chartered savings associations. OTS (www.ots.treas.gov) was established as a bureau of the Department of the Treasury in 1989.

office park A development designed specifically to attract office users, usually with scenic views, walking trails and restaurants, multiple entrances to ease traffic flow, and preferably at least one median cut and a traffic light to facilitate left turns out of the property in the evenings.


Many office parks are built around water features

off-site costs Construction expenses that are incurred away from the construction site. Examples include the cost of bringing in utilities, storm and sanitary sewer lines, and roads.

off-site improvements Development improvements that are not located on the lots being sold. Examples include roads and street lighting.

off-street parking The necessity to provide parking places on one's own property, rather than using city streets. Many zoning ordinances establish a minimum number of off-street parking places depending on the zoning and on the particular use of a structure on the property.

OFHEO See *Office of Federal Housing Enterprise Oversight*.

oil and gas lease An arrangement granting the right to explore for and extract oil and gas and possibly related minerals. Some important concepts are

- Oil and gas are considered minerals, but the law pertaining to them is different from solid minerals because oil and gas are said to be "fugitive" and capable of traveling from place to place to the lands of different owners.
- Because of the fugitive nature of gas and oil, it is possible for one person to drill many wells on his or her property and effectively drain the gas and oil from all surrounding lands. As a result, many states have laws enforcing pooling of interests or unitization if the property owners cannot agree on a fair way to cooperate in production. Such laws have been held constitutional.
- Because oil and gas are considered such important natural resources, most states with significant deposits heavily regulate exploration, drilling, production, and the rights of various parties to contractual arrangements. (Such legislation must be read into contracts between the parties.)
- Leases fall into two broad categories: "or" leases and "unless" leases. "Or" leases obligate the lessee to drill or to pay "delay rentals," but if the lessee does neither, there is not an automatic termination of the lease. By contrast, the "unless" lease says that if the lessee does not drill by a certain time, the lease will terminate unless the lessee pays delay rentals. Nonpayment and nonproduction will result in forfeiture.
- Rent under the lease is generally paid in the form of royalty payments; lessors generally reserve a one-eighth royalty interest.
- A lease on a pooled tract of land may provide for offset royalties, meaning that if no well is drilled on the subject land, but one is drilled within a certain distance of the land, then the lessor will still be entitled to royalty payments based on the production of the other well.

OILSR See *Office of Interstate Land Sales Registration*.

once a mortgage, always a mortgage A maxim signifying the rule that an instrument originally intended as a security instrument cannot be converted to a deed. It has reference to the practice of amending a mortgage to give up a right of redemption or an equity of redemption and thereby give permanent legal title to the lender. Parties may accomplish the same result, but they must do so in a separate legal instrument with its own consideration and the passage of title as of that date and time. Otherwise, the lender must foreclose to obtain full legal title.

one-hundred percent location The best spot in an urban area, where the land values and the rents are the highest.

on-site On the property itself, such as an on-site manager for an apartment complex or on-site waste management for a large subdivision.

open and notorious In the theory of adverse possession, parties who do not have legal title to property may gain it if they use the property in a certain manner for specified periods of time and the true owner does nothing to stop them. See *adverse possession*, generally. One of the requirements is that the possession be open and notorious. This means such acts upon land as are consistent with the ordinary and customary uses of the land and which would alert the true owner that someone is claiming rights to the property. Adverse possessors may not furtively sneak upon land and leave behind subtle indications of their presence—they must act as if the land were theirs and behave accordingly.

open-end fund An investment fund that does not have a finite life, continually accepts new investor capital, and makes new property investments.

open-end mortgage A mortgage loan that may allow future advances as the value of the property increases, up to a certain percentage of loan-to-value. The legal problem with this arrangement occurs when loan 1 is an open-end mortgage, lender 2 loans money to the borrower and takes a second mortgage, and then lender 1 advances additional money under its open-end mortgage. If there is a foreclosure or bankruptcy, and not enough money to pay everyone, in what order are the loans paid? The answer depends on the borrower's state, the precise language of the open-end mortgage, and/or whether lender 2 gave notice to lender 1 of the new loan. See *future advances mortgage*. Do not confuse with an *open mortgage*.

open house In residential real estate sales, an opportunity for prospective home buyers to tour a home offered for sale, or a model home, during a time period when it will be open for all visitors. Shoppers trying to refine their ideas regarding housing needs should not hesitate to attend open houses—they are not wasting the agent's time. Real estate agents and brokers welcome opportunities to tell prospective buyers about other properties if the present one is not appropriate and are also eager to assist prospective sellers who are just checking out the market and possible prices to ask for their own homes.

open housing The opportunity for housing units to be purchased or leased without discrimination on the basis of race, gender, family status, or any of the other prohibited classifications. The 1866 Civil Rights Act and the 1968 Civil Rights Act did not take the place of local open-housing legislation, which may provide for even greater protections. On the other hand, the constitutional rights of property owners must be recognized under local open-housing laws. The typical battleground for state open-housing laws relates to statutes prohibiting discrimination based on marital status, and the conflict caused with landlords who refuse to rent to unmarried couples for religious reasons.

open listing An offer by a property owner to pay a commission to any real estate broker who brings a buyer to the closing table. Rather than pay a 7 percent commission to a listing broker, with the listing broker then splitting that commission with the broker who provides the buyer, an open listing will agree to pay the entire 7 percent to any broker who brings the buyer.

open mortgage A mortgage that may be prepaid at any time without penalty. Do not confuse with an *open-end mortgage*. Further, an *open mortgage clause* does not have anything to do with an open mortgage.

open mortgage clause An insurance clause providing that the mortgagee (lender) will be paid in the event of a loss "as its interest may appear." This is far less protection to the lender than a union mortgage clause, which stipulates that the policy will be payable to the mortgagee unless it, or its agents, were the cause of the loss. In other words, if the homeowner burns the house to the ground and no insurance is payable to the homeowner as a result, then the lender with only an open mortgage clause will also receive nothing, but a lender with a union mortgage clause will still be paid.

open space Land that is intentionally left undeveloped as an amenity for a project.

open the kimono A slang expression used to describe revealing all one's financial and other confidential information to a suitor who has expressed an interest in purchasing a company or some of its assets. The danger, of course, is gauging whether the suitor is serious or merely engaging in a spectator sport.

operating and easement agreement (OEA) An agreement between a shopping center developer or owner and usually major tenants regarding matters outside the formal lease.

operating budget A good-faith estimate regarding the size and sources of future income, and the amounts and types of future expenses necessary for the day-to-day operation of a business or project. Contrast with a capital budget, which is an estimate of the capital needs of a project, such as new equipment, unusual repairs, additional property, or other such matters.

operating capital See *working capital*.

operating expense escalation An increase in rent because a clause in the tenant's lease provides that as the building operating expenses increase above what they were in a base year, the tenant will pay its pro rata share of those increased expenses. Wise tenants negotiate an expense stop in order to place a ceiling on the escalations. Landlords are reluctant to agree because they generally have no control over real estate taxes or insurance premiums. As a result, tenants will typically put a cap on controllable expenses. Were it not for such restrictions, unscrupulous landlords could employ a large staff of overpaid relatives to perform work on the property and pass that expense on to all the tenants. Whether or not such practices would be attackable on the grounds of a lack of good faith

would depend on the landlord's facially reasonable explanation for the practice and on the relative skill of each party's lawyers.

operating expense ratio The ratio between operating expenses and potential gross income. Such ratios will generally be similar among properties or businesses in the same geographical area with the same or similar characteristics. Knowledge of such ratios allows a developer or entrepreneur to create a pro forma estimate of future income and expenses for a new business. It also allows a property owner to conduct a reality check of its own operations, to see if its own operating expense ratios are consistent with those of other properties in the local marketplace. (An operating expense ratio that is higher than expected may be an indication of inefficiency, embezzlement, or pricing one's goods and services too cheaply.)

operating expenses Necessary expenses for the normal day-to-day running of a business or income-producing property. It does not include financing expenses, depreciation, or capital expenditures.

operating income See *net operating income*.

operating lease An important accounting and income tax concept having to do with the determination of whether a lease (usually of personal property, but sometimes of real property) is a true lease, or whether it is a disguised lending arrangement. The operating lease is the true lease, and 100 percent of the payments are treated as expenses for accounting purposes and tax deductibility purposes. Sometimes called an off-balance sheet lease, meaning not that the lease is hidden or disguised, but it appears on the profit and loss statement rather than the balance sheet. Contrast with *capital lease*. In order to qualify as an operating lease, the transaction must meet the following requirements:

- The lease term is less than 75 percent of the estimated economic life of the equipment.
- The present value of lease payments is less than 90 percent of the equipment's fair market value.
- The lease cannot contain a bargain purchase option (i.e., purchase option for less than the fair market value).
- Ownership is retained by the lessor during and after the lease term.

operating leverage The phenomenon of inflation leading to increased income and expenses each year, at the same time that financing (leverage) expenses remain the same if the borrower has fixed-rate financing. The result is that cash flows increase over time.

operating statements Financial statements regarding the cash flow of a business.

operation of law The application of rights and responsibilities because of a person or property's status, relationships, location, or other such factors independent of one's express agreement to assume responsibilities or another's express agreement to grant rights. Here are some examples of things that happen by operation of law:

- When a premises owner takes possession of mislaid personal property, he or she becomes a gratuitous bailee with a duty to use ordinary care to return the property to the true owner.
- The death of the principal terminates an agency relationship.
- Bankruptcy of the principal terminates an agency relationship.
- Joint tenancies with rights of survivorship are severed when one joint tenant transfers his or her interest or a creditor seizes his or her interest.
- In some states, when property has been dedicated to public usage, such as a park, and that usage is abandoned or relinquished, the property reverts back to the original grantor or his or her heirs.
- Title to real property is said to be acquired by operation of law when it is acquired by adverse possession, by intestate succession (descent), or by virtue of another's will (devise).
- A domicile by operation of law is an assigned domicile for persons who are incapable of making legal choices, such as minor children and persons declared mentally incompetent.
- Title to condemned property taken under a power of eminent domain passes on the day the condemnation declaration is filed, whether or not the parties have agreed upon a price or the former owner has signed any documents.
- A gift made in contemplation of death is automatically revoked if the donor recovers or if the donee dies before the donor.
- A will leaving property to one's spouse is considered revoked in some states if the parties obtain a divorce.

opinion of title A letter, certificate, or other writing containing a report regarding title to real property and all encumbrances upon it, as of a certain date and time. The opinion of title is not the same thing as title insurance. If the preparer, usually an attorney, makes a mistake, then one's only recourse is to sue for malpractice.

opportunistic investment strategy A strategy characterized by targeting underperforming and/or undermanaged properties, or properties that are temporarily depressed, and then using high degrees of leverage (borrowed funds) to acquire the property, hold it for a short period of time, and then sell it at an expected profit of at least 20 percent.

opportunity cost The value of the opportunity given up in order to take advantage of the one you decide to take. The classic opportunity cost evaluation is the "rent or buy decision." If a person buys a home, the person gives up the opportunity to invest the down payment money in something else. Because mortgage payments and maintenance costs are usually higher than rent, the new homeowner must also spend more money each month rather than investing it. On the other hand, the analysis must take into account tax savings because of the deductibility of home mortgage interest payments. Conducting an analysis of opportunity costs in the "rent versus buy" situation might cause one to buy immediately, buy later, or decide not to buy at all for the foreseeable future. Ginnie Mae has an excellent rent versus buy calculator at www.ginniemae.gov.

option The right to purchase or lease property for an agreed-upon price. The person who owns the property is called the optionor and is the one who grants the option. The recipient is called the optionee. The optionee has the right to take advantage of the opportunity, but does not have the obligation to do so.

option contract A contract granting an option.

option risk All American consumer mortgage loans give the borrower the option to pay the loan off early, usually because of a sale of the property or because the borrower decided to refinance. This is bad news for the investors who purchased that mortgage as part of a pool, because now the income stream they intended to purchase has ended. The investor's risk, that the prepayment option may be exercised and the income stopped, is called the option risk and sometimes the prepayment risk.

option to purchase See *option*.

oral contract A verbal agreement that is enforceable unless it falls within the Statute of Frauds. The problem with most oral contracts is not one of technical enforceability; it is one of proof. Unless both parties to a dispute have a clear recollection of the exact terms of the contract, and they are both truthful, a jury will have to decide whether a contract exists and the terms of that contract.

oral lease See *month-to-month tenancy*.

ordinances Municipal laws.

ordinary and necessary business expenses An IRS term limiting the deductibility of expenses to those that are ordinary and necessary. Excessive compensation to insiders may be re-classed as only partially ordinary and necessary, with the balance treated as dividends, which are not deductible.

ordinary annuity A series of equal payments, made at the end of each payment period. Contrast with *annuity due*, which is a series of equal payments made at the beginning of each period. A mortgage payment is an ordinary annuity, because the payment is made after a month's worth of interest has accrued. Rent payments are annuities due, because payment is made in advance at the beginning of each month. The difference is important for proper formula entries in financial calculators, or for Excel, as the formula is slightly different if the payments are ordinary annuities or annuities due.

ordinary income Income subject to full or ordinary taxation rates. Contrast with *capital gains*.

ordinary loss A loss that is deductible against ordinary income on one's taxes.

ORE, OREO Other real estate, other real estate owned; a lender's portfolio of properties on which it has foreclosed.

orientation Positioning of a structure on a site. Decisions regarding orientation should take into account prevailing winds, solar energy and passive solar heating through windows, the impact of the setting sun on afternoon workers, views, and any other relevant factors.

original cost The cost to the current owner. Contrast with historic cost, which is the original construction cost.

original equity An amount of cash originally invested by a property owner.

original face value The principal amount due on a mortgage at its inception.

original issue discount See *imputed interest*.

originate To make; all the steps necessary to attract a potential borrower, process a loan request, prepare all necessary paperwork, and place the loan on the books of the lender.

origination fees Charges to a borrower to cover the costs of originating a loan.

orphan lot A subdivision lot that is unbuildable at the current market value of homes (for some reason or another). The lot may be too steep and site work too expensive for current development. Or the lot could have a power line easement crossing the middle, with overhead lines, so that no structure can ever be built under the lines. As land and home values increase, investors search for orphan lots that may become economically viable under new market conditions.

orthographic A three-dimensional image represented in two dimensions with no perspective, as if the original were truly flat. Architectural drawings of elevations—the different sides of a building—have no perspective detail but are orthographic. Many local tax assessor's offices and online property information services include orthographic aerial or satellite photographs of properties, corrected for the earth's curvature.

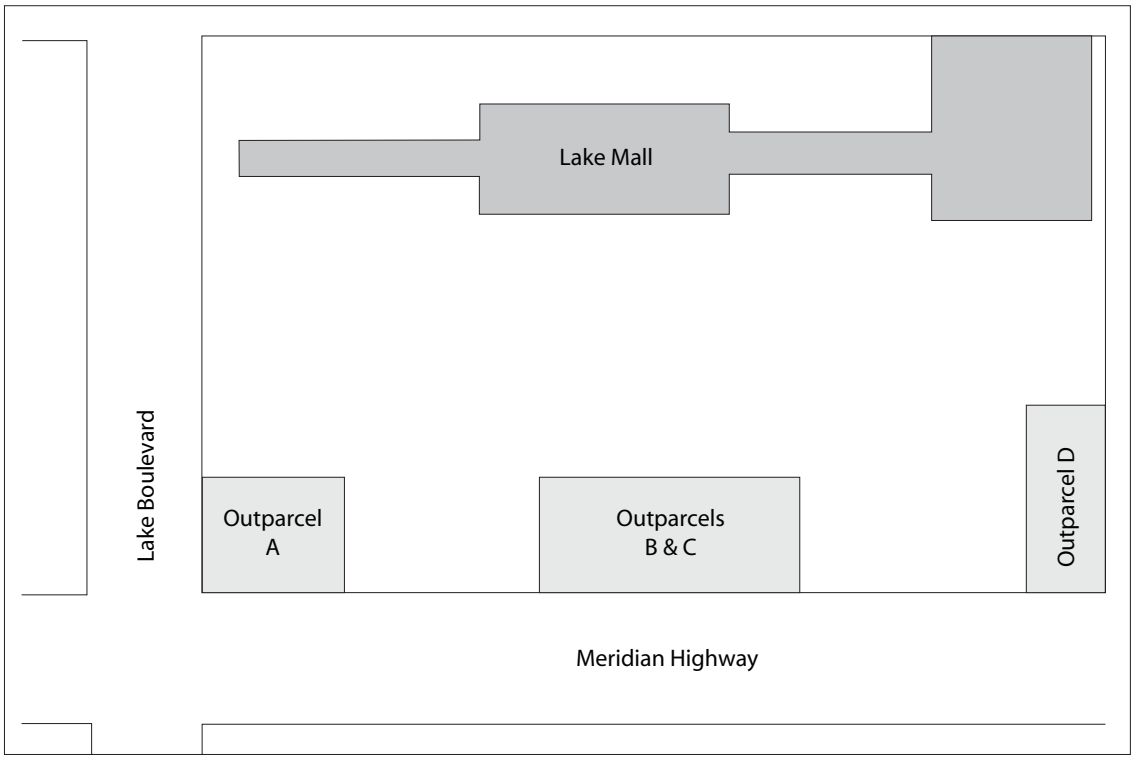
orthos See *orthographic*.

OSHA See *Occupational Safety and Health Administration*.

ostensible authority The illusion of having the authority to act as an agent on behalf of a principal. It can be created because the agent gives that impression and the principal does nothing to correct the misperception, or because the principal itself creates that impression in others. Either way, the principal will be bound by the actions of the agent if a court finds that ostensible authority existed.

other people's money (OPM) A common expression used when talking about the multiplying effect of using borrowed funds to purchase property rather than paying all cash. Investors will say, "I'm using OPM for the deal."

outlet center A shopping center devoted to discount outlets for brand name manufacturers. They are most often located in rural areas or tourist locations. If rural, the market can be drawn from a radius as large as 200 miles, although a 25- to 75-mile market area is more common.



outparcel (1) A small lot at the outer edge of a shopping center, usually reserved for later sale to a fast-food outlet or chain restaurant; also called a pad site. Many important mall tenants will reserve some control over outparcel development by virtue of agreements in their operating and easement agreement with the mall owner. (2) A small lot the original developer could not obtain when purchasing a large site for a shopping center. The problem with outparcels is the impact future development will have on existing mall tenants, who may find visibility obstructed with new construction, common area maintenance expenses increased because of dramatically increased lighting requirements, and parking problems if the outparcel customers use mall parking places. (See example above.)

outstanding balance The amount owed on a debt, as of a particular date. Title companies will obtain an outstanding balance for liens on property being sold, as of the anticipated date of closing, with a daily accrual for additional interest due each day the closing is delayed.

overage Additional rent for retail stores, based on a percentage of gross sales.

overall capitalization rate (1) Sometimes referred to as the "going-in capitalization rate." It is the first year's net operating income divided by the acquisition cost of the property. (2) In appraisal, it is the proper discount rate to account for the timing and amounts of all future cash flows from an income-producing property.

overall rate of return (OAR) See *overall capitalization rate*.

over-and above money Money that is held in reserve in case a project goes over budget. Also called end money.

overbuilding A situation that occurs when the rate of construction is faster than the market can absorb new construction. Developers often cannot anticipate the amount of competition until it is too late. The lead time between placing land under contract with a lengthy due diligence period to the first signs of excavation or construction that would alert people of new development can be as long as a year on small projects. The typical market cycle is a period of perceived need for "product"—offices, houses, malls, whatever—and then a seeming explosion of new projects "coming out of the ground" almost simultaneously. By the time developers see the signs of large numbers of competing projects, it is too late to back out of their own plans. As a result, all projects go full steam ahead and hope that something other than price will differentiate them from competitors, allowing the current project to fill up quickly while competitors go begging. This hope is usually misguided, and a price war results.

overimprovement Erecting improvements at prices that are out of proportion to the land value or to the area. Each market will have its own rules of thumb regarding ideal ratios of land cost to improvement construction costs.

override (1) A carve-out from oil and gas lease royalty payments, usually a gross dollar amount per barrel of oil or per cubic foot of gas without diminution for costs of extraction. The override may be payable to the broker on the deal, to the attorney, or to some person other than the lessor with the mineral rights. (2) A name given to a clause, in a real estate listing contract, that requires payment of a commission to the listing broker if a buyer introduced to the property by the broker purchases the property within a certain time period after the listing agreement expires. The clause is to protect the broker for sales activities at the very end of the listing period that do not come into fruition until later. It also serves to protect the broker from buyers who learn about the property from the broker, take the broker's time in securing additional information and property inspections, and then attempt to time their offers until after the listing expiration in the hopes the seller will accept a lower price because then the seller does not have to pay a commission from the sale proceeds.

Overseas Private Investment Corporation A federal agency (www.opic.gov) established in 1971 to assist American businesses desiring to invest overseas. It provides medium- to long-term funding for projects in developing countries and emerging markets, including housing, hotels, airports, and natural resource extraction. It also provides political risk insurance for currency inconvertibility, expropriation, and political violence. The corporation is self-funding through fees for services and uses no taxpayer money.

owner financing A seller of real property holding a first or second mortgage for some or all of the purchase price.

owner-occupant An owner of real property who also uses that property for his or her own business purposes. The truism is that owner-occupants will pay a higher price for real property than investors, because owner-occupants have limited choices for an ideal location, while investors may place their money anywhere. Contrast with an investor, who owns property in order to derive rental income from it.

owner of record The person recorded on public real estate records as the owner of real property. The term is sometimes defined to mean the person reflected on the tax assessor's rolls. The exact definition is important when dealing with statutes that require notice to the owner of record of real property. An example is a tax sale statute with such a notice provision. If notice is given to the wrong person, the tax sale may be set aside even if the statutory time period for objection has passed.

owners and occupiers (owners and occupants) Parties who own real property or occupy it in some legally permitted status, such as a tenant. There are a wide variety of responsibilities imposed on owners and occupants, such as compliance with the Americans with Disabilities Act. Other than such statutory requirements, the area of law concerned with duties of owners and occupiers is called premises liability. The most frequent application of the duties is in slip and fall cases. The duty of care owed to people coming on the property will usually depend on the status of those people as invitees, licensees, or trespassers. Some states merge invitees and licensees into something called entrants, who are lawfully on property, versus trespassers who should not be on the property. A few states impose the same standard of care as to all persons on real property, being a duty of reasonable care under the circumstances.

- An invitee is a person who enters upon property at the express or implied invitation of the owner in order to conduct some business with the owner or engage in some activity the owner conducts or permits to be conducted on the property. The owner and the occupier of property owe a duty to protect invitees against all known dangers and any dangers that should have been discoverable with reasonable care.
- A licensee is a person who has permission to enter on property, but for the person's own purposes rather than that of the owner. Typically, social guests are classed as licensees. In most states, owners and occupiers owe a licensee the duty of reasonable or due care; in some states the only duty is to refrain from wanton, willful, or reckless conduct.
- A trespasser is a person who does not have permission to enter on property. Owners and occupiers owe the duty to not set traps for trespassers and not to willfully or wantonly injure them.

ownership form See *title*.

ownership in severalty See *tenancy in severalty*.

ownership rights to realty One who owns real property in fee simple has the right to possession, enjoyment, control, and disposition of the property.

owner's title policy Title insurance that protects the owner against loss if there is an adverse claim against the owner's property and that provides legal counsel to defend against adverse claimants.

Typically, the mortgage lender will require a mortgagee's policy that will protect it, but the owner fails to specify that he or she also wants an owner's policy. The increased premium is usually negligible. If there is a mortgagee's policy but no owner's policy, and if there is an adverse claim to the property that is found to be good and not defeatable, the title insurance will pay off the mortgage lender to the full amount of its loan, but the owner will receive nothing and suffer the loss of its equity.

P

package mortgage A mortgage that includes financing for real estate and for personal property. The plan is usually promoted as beneficial to consumers because it allows them to buy appliances, for example, at low mortgage interest rates and pay just a small amount each month, as compared to typical finance or credit card companies that charge higher interest rates and provide shorter terms for payoff, leading to higher monthly payments. Promoters also tell consumers that with a package mortgage, interest payments for appliances are deductible from taxes, while finance company or credit card interest is not deductible.

Example: *The following table compares $3,000 worth of appliances financed by a package mortgage, a typical credit card, and a finance company.*

Appliances Financed in Package Mortgage versus Other Choices

	Package Mortgage	Finance Company	Credit Card
Amount financed	$3,000	$3,000	$3,000
Interest rate	7%	20%	15%
Term	30 years	3 years	3 years
Payments	$19.96	$111.49	$104.00
Total interest paid by end of 3 years	$620.50	$1,103.64	$744.00
Unpaid balance at end of 3 years	$2,901.94	$0	$0
Total interest at end of 5 years	$1,021.68		
Total interest at end of 10 years	$1,969.69		
Total payments by end of term	$7,185.60	$4,103.64	$3,744.00

Remember: The package mortgage and finance company will both require additional filing fees for the security interest in the appliances; you will not have that expense with a credit card. Calculate your own tax deductions using the highest rate you'll have to pay. Do the deductions compensate for the higher total interest paid?

pad site (1) A freestanding parcel at a shopping center; generally leased or sold to financial institutions, fast-food outlets, or chain restaurants. Also called an outparcel. (2) A space rented for placement of a manufactured home.

paid-but-unaccrued Money paid in advance, before it has been earned or accrued. The person paying the money may be entitled to a refund.

paint-to-paint Expression used to describe ownership in a condominium building. The condo owner does not own the exterior walls of the unit, only from the interior paint and inward.

paired sales An appraisal technique used to find the value of a particular feature within a property, such as a two-car garage. If the appraiser can find two recently sold houses that are virtually identical except that one has a two-car garage and one does not, these are called paired sales. If the two-car garage is the only significant difference in the two, then the difference in the sale price must be attributable to the garage. In that manner, one may assign a value to a two-car garage. As a result, when employing the comparable sales method of appraising a house, the appraiser may confidently assign values to the various features that differ in the house under consideration from the houses that sold recently.

panelized home A home built of preformed panels. A series of rectangular panels arrive at the job site and are put together to form the exterior of the home. Sometimes the panels have exterior siding and interior wiring in place already; other times they do not.

panic peddling The illegal practice of inducing people in a neighborhood to sell their homes because of fears that minorities are, or will be, buying homes there.

P&I Abbreviation for principal and interest, being the two components of all payments under an amortizing mortgage loan.

P&L An abbreviation for a profit and loss statement.

paper Slang for promissory notes. If a seller is willing to provide some or all of the financing for a property, the seller would say, "I'm willing to hold some paper." Lenders who specialize in loans to borrowers with less-than-ideal credit histories are said to specialize in B paper.

paper profit (1) An increase in the value of real property, so one has a profit on paper even though the property has not been sold. (2) The profit from an income-producing property that has an accounting profit on which the owner has to pay income taxes, but that has a negative cash flow requiring cash infusion from the owner in order to pay bills. This can occur if debt service payments are high, because only the interest portion is a deductible expense, even though the owner must write checks for interest and principal. It can also happen if customers or tenants are not paying their bills on time, so that the receivables are large, or if the property owner must expend large sums of money making upgrades or repairs that must be capitalized rather than written off as expenses.

paper the file (1) To document one's own file regarding all events, meetings, who said what, who did what, and anything else, because of a fear that there will be a problem in the future and it will be important to reconstruct exactly what happened. Warning: Papering the file preparatory to firing a real estate agent who might claim discrimination is also discrimination if the broker does not routinely paper everyone's file. (2) Providing every possible projection and all research, analysis, maps, drawings, and photographs to a lender for a commercial loan application. One cynical school of thought says this comforts lenders and makes a loan more likely. Others say that the complicated

financial analyses required of lending personnel will be easier with a wide array of data from which to choose, thus speeding up the approval process.

parcel A piece of real property with its own distinct legal description.

parcel register The abstract index for a property registered in the Torrens system of land registration.

pari passu In equal portions. Used to describe distributions to creditors if they will each take a pro rata share of a debtor's assets.

parking ratio The number of parking places per some other variable. Landlords will sometimes offer a certain number of reserved parking places per thousand square feet of leased space. Zoning regulations may require a certain number of off-street parking places per apartment, per thousand square feet of office space, or per employee.

parol evidence A rule that parol (oral) evidence will not be admissible to vary the terms of a written contract. On the other hand, if some term of the written contract is ambiguous on its face, then parol evidence is admissible to explain that term. Under the Uniform Commercial Code, if the contract has to do with the sale of goods, more latitude is granted to explain or supplement the contract by parol evidence of typical business practices. Much less latitude is given with real estate contracts.

partial interest Ownership of some portion of the ownership rights to real estate, such as mineral rights.

partially amortizing loan A loan with periodic payments of interest and principal, but for a shorter term than necessary to pay the principal balance in full at that rate. Partially amortizing loans have a balloon payment at some point, requiring repayment in full or through refinancing.

partial release A mortgage lender's release of its lien from only some portion of the land mortgaged. Usually encountered in subdivision development. The lender and the developer will have a prearranged ratio for division of proceeds from the sale of each parcel.

partial taking A condemnation of only part of a parcel of land. Often, if there is a partial taking, then the condemning authority will also have to pay damages for the decrease in value to the remaining portion. For example, if the partial taking resulted in the city gaining most of a store's parking lot, then the store itself will probably suffer a loss of revenues because customers can't find parking. The property not taken will have decreased in value because of the partial taking.

partial write-down See *write-down*.

participating mortgage An older term that is still sometimes encountered; it is a mortgage in which the lender takes a share of the profits during operations and on the sale of the property. Today, this would most frequently be called mezzanine financing.

participation The practice of a lead lender selling portions of a loan to other lenders, called participants. It may be done because the loan is larger than the regulatory limits for the lead lender, or because the loan is very attractive but rather risky, so several lenders will pool their efforts and spread the risk. FDIC regulations that went into effect on January 1, 2002, dramatically changed the structure and accounting for many participations. Formerly, lead banks could agree to repurchase a bad loan from a participant. As a result, it was easier to sell shares to other banks because the participants had no risk. Today, such a repurchase agreement will cause the transaction to be treated as a loan from the participant to the lead, rather than a sale, with the result that the lead may be in violation of banking regulations regarding loan size.

parties In litigation, the various people or companies with grievances or defenses that wish to be heard by the court. Types of parties include

- Plaintiff. Files the lawsuit.
- Defendant. The person the suit is against.
- Counterplaintiff. A defendant who has claims against the plaintiff.
- Counterdefendant. The plaintiff who is also sued by the defendant.
- Cross-claimants. Defendants who sue each other.
- Third-party defendants. When a defendant decides someone else should be added to the lawsuit because the defendant has claims against that person and it is all related to the same dispute. (Typically occurs when the defendant seeks indemnity from another.)

partition The division of real property into separate parcels for joint owners who no longer wish to own the property together. If possible, a court must physically divide the property into shares of equal value and quality. If not possible, the court will order a sale of the property with the proceeds to be split among the owners. Partition actions are encountered most often when an owner of real property dies without a will but with several heirs. If they cannot agree on a disposition of the property, it will be partitioned. In the alternative, investors will often buy an undivided interest from a minority heir for very little money and then petition a court for partition. Usually the investor will be able to buy the property at the partition auction, because none of the other owners can afford to purchase the whole. The strategy is not intended to obtain a bargain price for property, because the court will usually order an appraisal and prohibit any owner from buying at a price less than the appraised value. Rather, the practice is intended to force property onto the market even though some or most of the other owners have no desire to sell.

partition auction An auction held when co-owners want to divide property they own in common but cannot agree on a physical division into parcels. As a result, the property is auctioned and the sales proceeds are split among them according to their percentage of ownership. Any co-owner is free to bid at the auction, but usually must bid an amount at least equal to the appraised value of the property.

partnership A legal relationship between two or more persons, each of whom may act as an agent for the partnership and legally bind it and the other partners.

party wall A wall built on the line between two properties and necessary for the support of structures built on either side of the property line. Each owner owns the one-half of the party wall on his

or her own property and has a support easement in the one-half on the other person's property. Neither person can demolish the one-half of the wall on his or her own property because that would damage the neighbor's building. Townhomes usually share party walls.

passive activity An IRS phrase meaning two different things: (1) A trade or business activity in which the taxpayer does not materially participate during the year. (2) A rental activity, even if the taxpayer does materially participate in it, unless the taxpayer is a real estate professional. One wants to avoid something being characterized as a passive activity, because that limits the deductions that can be taken on tax returns.

There are many ways to satisfy the material participation test and avoid characterization as a passive activity. The most common one is by working in the business for more than 500 hours a year. To be a real estate professional, you must work more than 750 hours a year in the real estate trades or businesses, and that must be more than one-half of the personal services you provide for the year for all trades or businesses.

passive activity expenses Generally consists of mortgage interest on a loan used to acquire an investment classified as a passive activity under IRS regulations.

passive activity income Income earned from a passive activity. The IRS segregates certain types of income and expenses so that passive activity expenses are deductible only from passive activity income. If expenses are greater than income, the taxpayer may not use additional deductions to shelter other income (such as regular payroll income), but must carry the losses forward and use them in a future year. As a general rule, there are two types of passive activities:

1. Trade or business activities in which the taxpayer does not materially participate (less than 500 hours, generally) during the year.
2. Rental activities, even if the taxpayer does participate in them, except for the following:
   a. The taxpayer is a real estate professional.
   b. The rental is a dwelling the taxpayer uses for more than 14 days per year or 10 percent of the days the dwelling was available for rental, whichever is greater.
   c. Taxpayers may deduct up to $12,500 in losses ($25,000 if married) from passive activities if they or their spouse actively participated in it. There is a phaseout for various income levels.
   d. Low-income housing credits are available up to a maximum of $25,000.

(The rules are extremely complicated, and there are many exceptions. For further information see Publication 925: "Passive Activity and At-Risk Rules" and Tax Topics 425: "Passive Activities—Losses and Credits" at the IRS Web site www.irs.gov.)

passive activity loss The situation when expenses are greater than income from a passive activity.

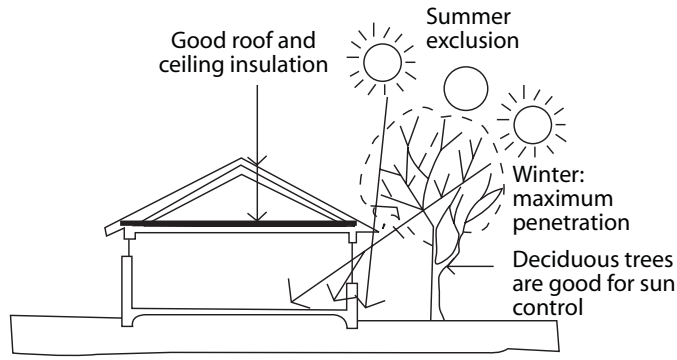
passive income See *passive activity income*.

passive income generator (PIG) The name given to an investment offered to taxpayers who have excess passive activity losses and need some passive activity income to offset the losses. (Be careful

of any investment touted as a PIG—if the only reason for an investment is the tax benefits it might produce, then the investment should be made with great caution.)

passive investor One who does not actively participate in a trade or business. Generally, a passive investor may not take advantage of certain tax deductions, such as the Section 179 deduction allowing the full deductibility of some capital expenditures—up to certain dollar limits—in the current year rather than the normal method of capitalizing and then depreciating them.

passive solar heating Design features in a structure allowing it to maximize the use of sunlight to heat interior spaces, but without any mechanical devices to distribute that heat throughout the building. Contrast with *active solar heating*.



pass-through certificates (or securities) Interests in a pool of mortgages sold to investors.

pass-throughs Landlord operating expenses that can be billed to tenants, either as part of their obligation to pay a pro rata share of operating expenses, their obligation to pay a pro rata share of common area maintenance, or a particular tenant's obligation to pay for goods and services benefiting only that tenant.

patent The first transfer of title out of the government to a private individual or company.

payback period An estimate of the time that will be necessary for an investor to recoup the initial investment. It is used to compare investments that might have different initial capital requirements.

payment Funds given to another in exchange for goods or services or as reimbursement for money loaned. A mortgage payment may consist of interest only; it could be a combination of principal and interest; or it could also include sums for real estate taxes, property insurance, and/or private mortgage insurance. In order to use Microsoft Excel to calculate your monthly principal and interest payment for a mortgage, do the following:

1. In cell A1, place the annual interest rate.
2. In cell A2, place the number of months of the loan to fully amortize it.
3. In cell A3, place the principal amount of the loan.
4. In cell A4, write the following formula exactly:
   =pmt(A1/12,A2,A3)
5. Cell A4 will calculate your monthly payment.

payment cap A limit on the allowable increase of mortgage payments under an adjustable-rate mortgage. The typical horror story used to illustrate this principle envisions interest rates increasing dramatically so that a capped payment is no longer sufficient to pay accrued interest, much less any

principal reductions. In such a situation, the accrued but unpaid interest is added to the principal, making the loan grow larger over time rather than smaller. In most of the real world, loans with payment caps also have interest rate caps, so it is contractually impossible for interest rates to climb to an amount causing negative amortization.

payoff The amount necessary to pay a loan in full, with all accrued interest and fees and the prepayment penalty, if applicable. Payoff figures are usually provided to a closing company as correct on a given day. If closing is delayed, the lender has also provided a per diem charge to increase the payoff for every day of delay.

PCBs (1) Polychlorinated biphenyls. (2) Pollution control bond.

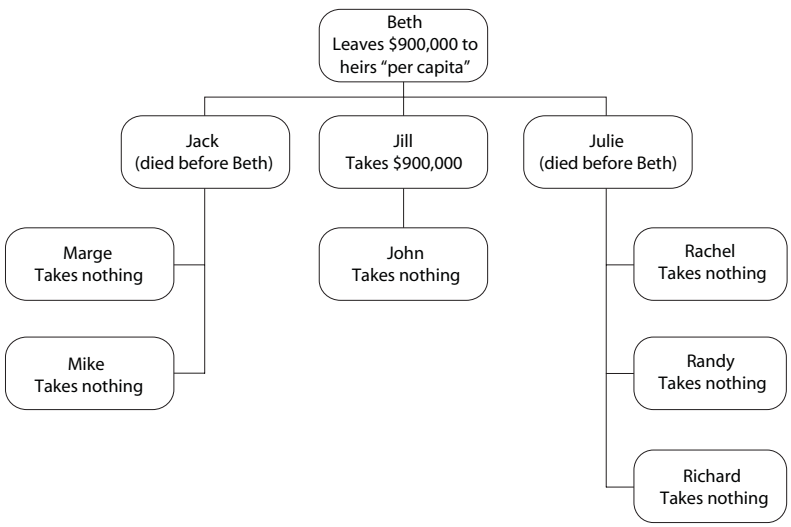
penalty A payment required as a result of breaking the law or sometimes for breaching the terms of a contract. Most contract drafters assiduously avoid the term because private penalties are not enforceable. Instead, contract drafters use the terms liquidated damages, delay payments, or late fees. Even the prepayment penalty is really not a penalty but compensation to a lender for the loss of income suffered when a loan is paid off earlier than the terms allow.

pencil out A slang expression for a rough analysis of the viability of an investment.

penthouse Originally, a home built on the roof of a high-rise building, giving the occupant complete privacy. By definition, each building could have only one penthouse. Today, the word is used for any number of apartments or condos on the topmost floors of a building, usually finished out in a very luxurious manner.

per annum Each year.

per capita Per head; per person. The term is most often encountered in estate planning, where assets may be left to heirs, per capita. In a per capita distribution, a predeceased heir's portion is shared equally among other heirs at the same level.



Example: *Beth leaves $900,000 to her heirs, per capita. She has three children, but two of them die before her. Each child would have received $300,000 if alive. Because the gift was per capita, the money is divided among only the children who survived Beth. In the following diagram, one child will receive the entire $900,000. The grandchildren—children of the predeceased children—receive nothing. Contrast with per stirpes, in which the share belonging to predeceased heirs would go to their own heirs. Using per stirpes distribution in the example, Jill takes only $300,000, Jack's children share $300,000, and Julie's children share $300,000.*

percentage lease A lease that requires rent payments based on a percentage of the gross sales of the tenant. It is common with retail leases and food and beverage leases. Most contain a minimum payment clause so that if gross sales drop below a certain level the rent will be the minimum payment rather than a percentage of sales.

percentage of debt The ratio of debt secured by property as compared to the value of the property. Most home loans start out with debt equal to 80 percent of the value of the home.

percentage of equity The ratio of equity in a property (the difference between the value of property and the debt secured by that property) as compared to the total value of the property. Most home loans start out with equity equal to 20 percent of the value of the home.

percolation test A test to determine the drainage characteristics of soil. Drainage is essential to the proper functioning of a septic tank waste disposal system. Usually called a "perc test."

per diem charge In mortgage loans, the amount of interest earned by the lender for each day the loan remains unpaid. For purposes of such calculations, some promissory notes define a year as containing 360 days; others define a year as containing 365 days.

> **Example:** *For a 365-day year, if one borrows $100,000 at 7 percent interest for one year, $7,000 in interest will be due at the end of the year. The per diem is $7,000 ÷ 365 = $19.18. Disregarding late charges, for each day the borrower is late in paying the loan, the borrower will owe an additional $19.18. For a 360-day year, for the same loan, the per diem is $7,000 ÷ 360 = $19.44.*

per door A common method of referring to the number of units in an apartment complex. One might say, "The annual maintenance expenses for my apartment projects generally run in the range of $150 per door."

perfect (pronounced with the emphasis on the second syllable, not the first) To complete all steps necessary to establish a security interest in property that will take priority over later lenders. As between a lender and a borrower, a mortgage is effective and enforceable even if it is never recorded in the real estate records. If a third party, such as another lender, loans money to the debtor and records its own mortgage, then the second lender will have first rights in the property. The recordation of the mortgage, or of a UCC–1 for personal property, is called perfecting a security interest. Note: The UCC–1 is named for the Uniform Commercial Code form used to record notice of a security interest in personal property.

perfecting title Curing title defects in real property.

performance In contracts, the substantial completion of all duties and responsibilities. Note: The exact meaning of the word "substantial" is the cause of much litigation in contract law.

performance bond An insurance policy often required on government construction projects. If the contractor does not perform the work it contracted to do, the insurance company will either hire someone else to complete the job or will pay off the resulting damages, up to policy limits. Sometimes it is inaccurately called a performance and completion bond. Technically, liability under a performance bond is contingent on the contracting party paying according to the terms of its construction contract. Contrast with completion bond, where the contracting party does not have to pay anything to the insurance company, even though it might have been obligated to pay the contractor. As a result, most bonds are performance bonds and it is very difficult to obtain a completion bond.

performing loan As defined by the Federal Financial Institutions Examination Council, a loan that is less than 90 days past due, has not been placed on nonaccrual, or is not in workout status.

performing nonperforming loan A loan on which all payments are made on time but the collateral has decreased in value so that it is no longer sufficient to support the loan. FDIC regulations require the lender to classify the loan as nonperforming. In such a situation, the lender will require additional collateral or will demand payment in full.

periodic cash flow See *cash flow*.

periodic estate A lease with a definite period of duration.

periodic tenancy A tenant's right to possess and use property for periods defined by the amount of rent paid. If rent is paid on a monthly basis, then the tenancy continues month to month as the tenant chooses to stay and the landlord chooses to continue accepting rent. If the tenant pays rent on an annual basis, for an entire year at a time, then the tenancy continues on a year-to-year basis. Consumer protection laws define the amount of notice necessary to terminate a periodic tenancy for residential properties. Usually, the landlord must give 10 days notice for a week-to-week tenancy and 60 days notice for a month-to-month tenancy.

period of redemption See *right of redemption*.

perks (1) Slang for perchloroethylene or tetrachloroethylene. These chemicals, used in dry cleaning, are highly toxic and will contaminate soil and groundwater. When buying property on or near the site of a present or former dry-cleaning plant, the investor should be concerned about the presence of perks and should order the appropriate tests to determine the existence and extent of contamination. (2) Slang for perquisites, meaning nonmonetary benefits. In commercial leasing, building perks might include a fitness club open only to employees of building tenants.

perk test Proper pronunciation, but technically spelled "perc test"; a percolation test.

permanent lender One who makes permanent loans on real property. Contrast with construction lender or bridge lender. In the field of commercial properties, many permanent lenders

include large prepayment penalties in their loan documents. (Unlike consumer lending, which includes no prepayment penalties, the choice of a permanent lender for a commercial loan can have long-lasting adverse consequences.)

permanent mortgage A mortgage for an extended period of time, usually 10 to 25 years.

permeability The measure of a material's ability to transmit liquids. The passage of soil contaminants into groundwater increases as soil permeability increases. On the other hand, in situ remediation—removal or decomposition—of groundwater contamination is easier as permeability increases. For a color map of the United States showing the relative permeability of soils across the country, see the Web site page of the Environmental Protection Agency at www.epa.gov/iwi/1999sept/iv20_usmap.html.

permit A document issued by a government authority giving permission to proceed with some action. In real estate, one may need some or all of the following permits, to name a few:

- A demolition permit before destroying a structure
- An excavation permit before doing site work
- An environmental permit for erosion and siltation control on land about to be disturbed
- A utility disturbance permit to move utility lines
- A construction permit for construction
- A health permit for an on-site waste management system
- A health permit for removal of asbestos-containing building components
- A highway department permit for on-site signage visible from state or federal highways
- An occupancy permit before a structure can be used

perpetuity Never ending; forever. A legal principle called the rule against perpetuities says that transfers of interests in land must vest, if at all, within lives in being plus a gestational period and 21 years, or they are void.

perquisites Special nonmonetary benefits, often offered by landlords in order to attract new tenants. Examples include reserved parking places for company executives, an exercise club for tenants or employees, or free high-speed Internet service.

person Legally, any natural or artificial person, which would include corporations, partnerships, associations, and limited liability companies. If it is important to distinguish among the "persons" who may do something or who are prohibited from doing something, relevant contracts, leases, or statutes will usually define the term.

personal assistant An unlicensed assistant in a real estate office who may work under the supervision of a licensed broker or agent, but who is prohibited from doing anything that specifically requires a license under applicable state law.

personal liability The responsibility of a person to pay a debt or other obligation. If an individual signs a promissory note, that individual usually has full personal liability for the debt. An exception is

the unusual situation of a nonrecourse individual loan, in which the lender agrees to look only to the collateral for recovery in the event of default. Some states protect consumers from liability for a first mortgage loan on a personal residence, and require that the lender must be satisfied with taking the home by foreclosure, but may not sue for a deficiency. If a corporation signs a promissory note, the individual shareholders will not have personal liability unless they signed a guarantee agreement or unless the lender is successful with an alternate legal theory such as "piercing the corporate veil."

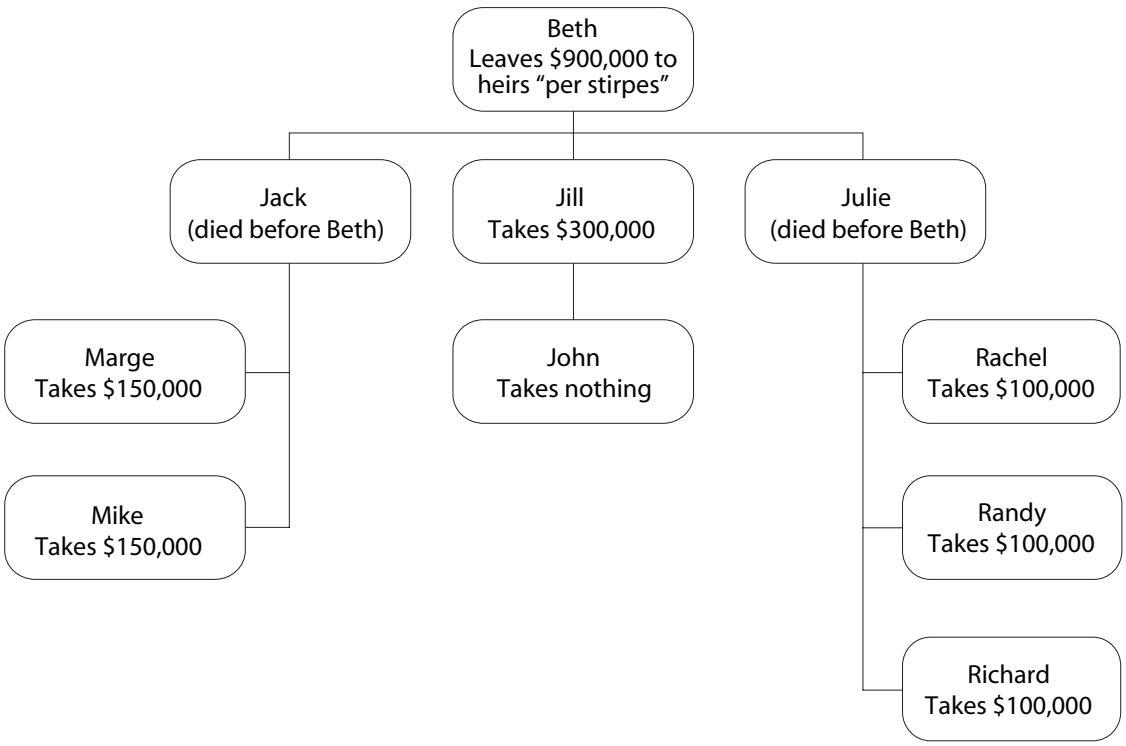
personal property Any property except for real property. Personal property may consist of physical objects, or it may be intangibles such as copyrights, patents, or securities. Personal property is also called personalty.

personal residence One's customary and normal place of habitation, as claimed for voting and income tax purposes.

personalty See *personal property*.

per stirpes A method of distributing an estate when one of the beneficiaries dies before the testator. The predeceased beneficiary's share is divided equally among that person's own heirs.

> **Example:** *Beth leaves $900,000 to her heirs, per stirpes. She has three children, but two of them die before her. Each child would have received $300,000 if alive. For the children who died*



first, each one's $300,000 share will be split equally among their own children. Grandchild John receives nothing, because his mother was still alive to receive her gift. Contrast with per capita, in which all members of a generational class take equal shares.

petitioner A person who files a complaint in an equity court, such as a divorce court, or who requests relief from an administrative body. In many states, all persons who initiate lawsuits are now called plaintiffs.

phantom income Reportable or taxable income that does not generate cash flows to pay the taxes on the income. A disclosure that "taxable income may exceed economic income" is the clue that an investor may receive phantom income.

Phase I Environmental Site Assessment Investigation of real property to determine the possibility of contamination, based on visual observation and property history, but no physical testing. Under new Environmental Protection Agency regulations that went into effect on November 1, 2006, a Phase I, as it is called for short, will be mandatory for all investors who wish to take advantage of CERCLA defenses that will shield them from liability for future cleanup, should that prove necessary. The new Phase I rules, called "All Appropriate Inquiry" or AAI, also require more investigation than previously mandated. Investors can expect to see dramatic price increases over prior experiences.

Phase II Environmental Site Assessment Investigation of real property through physical samplings and analyses to determine the nature and extent of contamination and, if indicated, a description of the recommended remediation method.

Phase III Environmental Site Assessment Design and implementation of a plan of remediation for a contaminated site, together with all necessary reports demonstrating successful remediation.

phase out To bring to an end in stages. Typically encountered with tax benefits that are phased out—decreased or diminished—over the course of several years.

physical depreciation or deterioration A loss of value in an appraised property because of all causes of age and the action of the elements.

physical life The time period during which a real property improvement can be expected to remain in existence. Contrast with *useful life*.

physical obsolescence The deterioration of a property due to wear and tear or abuse.

piggyback loan A combination of a construction loan and a permanent loan commitment.

piercing the corporate veil A theory used to reach the assets of individual shareholders when there is a judgment against a corporation but the corporation has no assets to satisfy the judgment. In general, if the shareholders operated a business in complete disregard of the corporate form, meaning they never had shareholder meetings, never voted on anything, never used the corporate name on stationary or paperwork, commingled personal funds and corporate funds, and

generally behaved as if the corporation did not exist, then a court will impose personal liability for corporate debts.

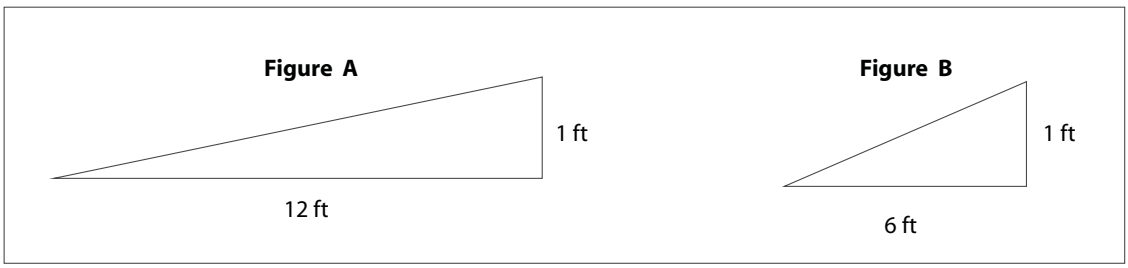
pipeline (1) A system for carrying fluids or gases. (2) A popular expression for things that are in process. For example, "There are over 10,000 condo units in the pipeline, in various stages of construction or conversion." Or "I'm not worried about apartment move-outs this summer because I have a number of prospects in the pipeline."

pipeline risk A slang expression for the risk a lender takes when it makes a loan commitment at a certain interest rate, but knowing that before the loan closes interest rates might increase.

pipestem lot See *flag lot*.

pitch The slope of a roof, sidewalk, or other surface. The Americans with Disabilities Act has specific requirements for the pitch of access ramps leading to building entrances.

> **Example:** *Figure A has a 1:12 pitch because the slope rises 1 foot for every 12 feet of distance. Figure B has a 1:6 pitch.*



PITI A mortgage loan term for principal, interest, taxes, and insurance.

placed in service The date when property was first made available for its intended purpose. This concept is extremely important for tax purposes. Most tax benefits depend on proper determination of when an improvement was first placed in service.

plaintiff The person who files a lawsuit. See also *petitioner*.

planned unit development (PUD) A project or subdivision that has individually owned parcels and homes, together with recreational or landscaping elements owned by a homeowners association and managed for the mutual benefit of all homeowners.

planning commission A government agency or an appointed group of citizens with varying degrees of responsibility regarding the use of land within a jurisdictional limit. Some commissions have the authority to make decisions regarding permitted uses and variances from permitted uses. Some commissions are merely advisory in order to provide citizen input into the process. The authorizations and the delegations of authority for a particular commission will determine the extent of its powers.

plat A plan or survey map of a parcel of land. Developers file subdivision plats showing block and lot numbers, the dimensions and locations of individual lots, and the dimensions and locations of dedicated streets. Legal descriptions for properties within the subdivision are then made by reference to the recorded plat, such as "Lot 2, Block 3 of Harper Downs II as recorded in Plat Book 213, Page 82, of the Judge of Probate of Jefferson County, Alabama."

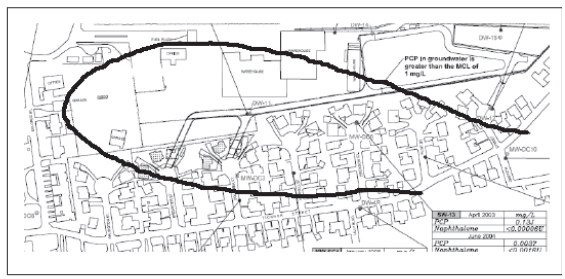
pledged account mortgage A mortgage loan program in which money is placed in a savings account and the interest earned on the account is used to subsidize interest payments in the early years. It allows a borrower to buy property with much less equity while still enjoying a relatively low interest rate. The downside is for the person who put up the pledged account, because the money is at risk in the event of default, and it is not earning any interest for the investor.

pledged asset mortgage A mortgage loan program allowing a purchaser to grant a security interest in other assets rather than having to liquidate them to pay a down payment. It allows the borrower to continue receiving income and other benefits from those assets, and also avoids the possibility of the borrower having to pay income taxes on sale proceeds if the assets had to be sold to make a down payment.

> **Example:** *Fannie Mae has three pledged asset mortgage programs: (1) 30 percent of the purchase price in pledged assets from a family member results in 100 percent financing and no PMI insurance; (2) a 10 percent pledge by a family member, with certain borrower income and other requirements, results in the borrower needing to pay at least 3 percent of the combined purchase price and closing costs, and PMI is required; and (3) a 10 percent self-pledge by the borrower will gain 100 percent financing with PMI required.*

plot plan A diagram showing the anticipated placement of improvements on real property, employed as part of the approval process.

plottage value The increased value of land due to assembling small parcels into something larger capable of development. Also called assemblage value.



A plume of groundwater contamination. (Source: EPA.)

plume Contaminated groundwater that flows and spreads from a single source.

PMI See *private mortgage insurance*.

PMI Cancellation Act See *Homeowners Protection Act of 1998*.

pocket card A card issued by a state real estate licensing authority for each licensed salesperson. Many states require licensed professionals to have the card in their possession at all times.

pocket listing A private agreement between a property owner and a broker, in which the owner agrees to pay a commission if the broker produces a buyer, but there is no listing agreement, no obligation to market the property, and no signage or advertising.

point of beginning In a metes and bounds description, the starting corner of the property.

point of entry The place where water service enters private property. If there is a leak on the homeowner side of the point of entry, the homeowner must pay a plumber to fix it and is responsible for payment of all water usage attributable to the leak. If the leak is on the water company side of the point of entry, the water company must make the repair and the homeowner cannot be charged for the cost of leaking water.

points Charges in connection with a mortgage, calculated with reference to the amount of the loan. One point is equal to one percent of the loan. A fee of three points on a $100,000 loan is $3,000.

- See *discount points* for an explanation of the use of this device to reduce the interest rate on a loan.
- Origination points are the same as *origination fees*, and are charges to cover lender or mortgage broker expenses and profit.

pollution control bond A tax-exempt security issued by a state, certain agencies or authorities, a local government, or a development corporation in order to finance the construction of air or water pollution control facilities or sewage or solid waste disposal facilities in accordance with federal law. These bonds are backed by the credit of the pollution control entity, not the issuer.

polychlorinated biphenyls (PCBs) Highly toxic synthetic chemicals.

pool A group of mortgage loans used as security for a bond issue. See *collateralized mortgage backed securities*.

portable mortgage A new product first offered in 2003 and still relatively rare; it allows a borrower to move a mortgage from property to property as he or she sells and then buys new homes. This saves significant loan and closing fees. Interest rates are somewhat higher than conventional loans, the borrower must have nearly perfect credit, and the savings decrease the longer the time period is between sales.

portfolio A group of investment assets.

portfolio loan A mortgage loan the financial institution keeps in its own portfolio rather than selling on the secondary market.

positive cash flow See *cash flow*.

positive leverage See *leverage*.

possession Exercising dominion or control over property. There are two varieties of real property possession. Actual possession occurs when property is in the immediate physical control and

occupancy of a party. Constructive possession exists as to the whole of a property when someone is in actual possession of a part.

possessory interest The right to immediate use and occupancy of property.

possibility of reverter See *reverter, possibility of*.

postforeclosure redemption rights In some states, the right to repurchase one's own property after it has been foreclosed, by paying the full bid price plus interest within a defined time period. Sometimes, creditors of the former owner also have the same rights.

potential gross income The maximum rental income possible from a property without vacancy or credit losses.

potentially responsible parties (PRPs) Under federal law, persons who may be responsible for the cleanup of a contaminated site, either because they were an owner, operator, transporter, or disposer of waste products for that site. The Environmental Protection Agency looks for evidence of the identity of potentially responsible parties by reviewing documents, performing a site investigation, conducting interviews, using "information request letters" to gather information, and by performing title searches. (PRPs are not limited to the persons who caused the contamination, but may include all subsequent owners or occupiers of the property.)

power center A shopping center that dominates its market; it usually has several anchor tenants.

power of attorney A document executed by one person (the principal) authorizing another to act as his or her agent and on his or her behalf for any legal purposes or for specifically defined tasks. The agent is called an attorney in fact.

power of sale A mortgage or deed of trust clause granting the lender the right to sell mortgaged property in the event of a default.

power of termination See *reentry (deeds)*.

preapproval The practice of obtaining lender approval for a mortgage loan up to a certain specified amount and then shopping for an appropriate property.

predatory lending Strictly speaking, it consists of loaning money to consumers in the hope and expectation they will default and the lender will be able to take the collateral. Modern usage has expanded the term to include any lending practices that rely on a consumer's lack of sophistication, or gullibility, for the imposition of unnecessarily high interest rates, large lending fees, or both. HUD maintains a Web site for researching reports of predatory lending, and resources for persons who believe they have been victims of predatory lending: www.hud.gov/offices/hsg/sfh/pred/predlend.cfm.

predecessors in title All those who owned a parcel of real property before the current owner.

preexisting use See *nonconforming use*.

prefabricated components Ready-to-attach sections of buildings, such as structural insulated panels, tilt-up concrete walls, or roof trusses.

preferred equity Corporate shares of stock that have greater rights than normal shares. Owners of preferred equity may be entitled to dividends—income—when there is not enough money to pay all shareholders. If the company is liquidated and all assets sold, preferred equity holders will receive their predetermined share before other equity holders.

prelease To secure tenants for a property before it is completed and ready for occupancy.

preliminary injunction A court order that orders a party to do something, or to refrain from doing something, until such time as the court decides otherwise after a full trial on all issues. Contrast with *temporary restraining order* and with *final injunction*.

preliminary title report The initial title report showing the current owners of real property and all liens and encumbrances on the property. It is not title insurance.

premises Land and improvements, generally, but the definition depends on context, case authority, and statutory description. Premises may be narrowed to one room if a search warrant gives the right to search certain described premises. It could be the entire house and surrounding 160 acres under other circumstances.

premises liability Responsibilities placed upon owners and occupiers of property to keep the premises in a reasonably safe condition so as not to injure persons coming on the property. The term is descriptive of a field of law; lawyers might specialize in construction litigation, lender liability cases, or premises liability lawsuits, for example. Some states have different standards of care depending on whether one must guard against injury to licensees, invitees, or trespassers. See *owners and occupiers*.

premium (1) An amount paid for an insurance policy. (2) An advance payment of several months or even years of rent to a landlord. (3) The value of a mortgage in excess of its face value. For example, if a $100,000 mortgage cannot be prepaid and is bearing interest at 10 percent when prevailing interest rates are only 6 percent, an investor might pay more than $100,000 to buy the mortgage because of the high return.

prepaid expenses Expenses that represent goods or services delivered over a period of time, but which are paid in a lump sum at the beginning of that time period. If one paid $12,000 for an insurance premium on property for one year, that $12,000 would be entered on the accounting records as a $12,000 asset called prepaid insurance expense. Each month the property owner would reduce the asset account by $1,000 and show a corresponding $1,000 expense for that month for insurance. At the end of the year, the prepaid expense account would be $0 and the books and records would show $12,000 worth of total insurance expenses. When conducting the due diligence to purchase an income-producing property, the potential buyer should inquire about the handling of expenses for which the seller receives bills only a few times a year. Sometimes, such expenses never show up on

the monthly profit and loss statements, but are artificially placed in something called the thirteenth month accounting period.

prepaid interest An interest paid in advance of the time it is earned, as with discount points. Prepaid interest is not tax deductible unless all the following specific requirements are met:

1. The loan is secured by the taxpayer's primary residence.
2. Paying discount points is an established business practice in the area.
3. The points paid were not more than customarily charged in the area.
4. The taxpayer uses the cash method of accounting.
5. The points were not a substitute for normally itemized expenses such as the appraisal fee, survey fee, property taxes, and attorneys' fees.
6. The funds provided at closing by the buyer and by the seller, if applicable, were at least equal to the points (in other words, you didn't roll the points into the loan).
7. The loan is used to buy or build the primary residence.
8. The points were computed as a percentage of the loan.
9. The settlement statement (HUD–1) clearly shows the item as points.

prepaids A word used to describe items that must be prepaid at closing, such as one year's property insurance premium.

prepayment clause A loan provision allowing the borrower to pay the loan in full before the maturity date without penalty, or to make principal reductions faster than originally envisioned by the parties. Consumer mortgages all have prepayment clauses. Large, commercial loans typically prohibit prepayment.

prepayment option See *prepayment clause*.

prepayment penalty A fee paid to the lender for the privilege of paying off a loan earlier than originally agreed upon by the parties. In commercial lending, this is called the defeasance fee and is the amount necessary for the loan manager to take the proceeds of the borrower's payoff, plus the prepayment penalty, and go out in the marketplace to buy an investment with the same return and the same maturity. (Usually that investment will be a government bond.)

prepayment privilege See *prepayment clause*.

prepayment risk See *option risk*.

prepayments See *prepaids*.

preplanning An early stage of real estate development. The term has different meanings to different people, so one should not make any assumptions when hearing that a development is in preplanning. It may mean that stage when the project is under consideration, but before any money has been expended on research or due diligence. It may mean that stage before generation of any site plans or architectural plans, but after expenditure of significant sums for due diligence and research.

prequalify To estimate the most expensive home a borrower can afford to buy with the assets, income, and expected loan amount and terms for which the borrower might be eligible.

presale A sale of improved properties before they are built; common with condos and subdivisions. Presales are binding contracts. If the construction is completed, the buyer must purchase the property. Defaulting purchasers could risk more than the loss of their earnest money or their reservation fee. Under certain circumstances they could be liable for additional damages if the market takes a downturn and the property cannot be sold for a sum equal to or greater than the presale price.

prescription The loss of rights because of a failure to assert them over a lengthy period of time. This is similar to a statute of limitations, but the time period is not established by statute, but by court interpretation and the particular circumstances of the case.

present value Today's value for income to be received in the future. Two factors affect the analysis: (1) the perceived risk that one might receive nothing at all in the future, or a smaller amount than expected, and (2) the potential income from alternative investments that could be purchased if one were paid the present value for a future income stream. (Discounting is the mathematical calculation used to arrive at present value.)

present value of annuity See *ordinary annuity*.

present value of one The value today of an amount to be received in the future, based on a compound interest rate.

preservation district A zoning district designed to protect areas that are sensitive to change, either because of environmental concerns, historic preservation, or scenic areas. There is usually a heightened degree of government oversight for development or renovation of these areas.

pretax income Income from an investment before income taxes. If there are significant tax advantages to an investment, such as low-income housing credits or bonus depreciation, the after-tax income will sometimes be larger than the pretax income.

price An amount of money exchanged for something of value.

price fixing An agreement among competitors to charge roughly the same price as each other, denying consumers a meaningful choice in the marketplace. The practice is illegal under the Sherman Antitrust Act. In the real estate area, the most famous application of this principle has to do with real estate commissions and the complaint that local REALTOR® association members agreed to all charge the same rate. It is the reason for the disclaimer that appears on most real estate company form listing contracts and purchase contracts, "The commission is negotiated among the parties and is not set by…."

primary distribution See *public offering*.

primary lease The lease between a landlord and a direct tenant. Contrast with a *sublease*, which is between the tenant and a subtenant.

primary market Any market in which the original issuer receives money, such as an investment house that purchases all securities for an original issue and then resells them on the stock market. Also called the *loan origination market*. Contrast with *secondary market*, where mortgages are pooled and then sold to others.

primary metropolitan statistical area (PMSA) Now obsolete but still encountered in trade literature. The term was adopted by the U.S. Census Bureau in 1990, as part of a hierarchy that started with something called a metropolitan area (MA). The MA included metropolitan statistical areas (MSA), consolidated metropolitan statistical areas, and primary metropolitan statistical areas (PMSAs). The entire hierarchy was changed in 2000, with the new concept being a core-based statistical area, which includes metropolitan statistical areas and micropolitan statistical areas. For historical reference, a PMSA consisted of two or more communities that would qualify by themselves to be an MSA (1 million or more inhabitants) but that were so closely tied together economically that they should be treated as one unit.

primary mortgage market The portion of the mortgage market that originates loans and then either keeps them or sells them on the secondary market.

prime To come before another creditor in terms of priority of payment should there be insufficient assets to pay all creditors. A first mortgage holder primes a second mortgage holder, who primes a later judgment creditor, who primes a general unsecured creditor. Filing for bankruptcy reshuffles the deck, as the bankruptcy trustee primes large categories of creditors.

prime contractor See *general contractor*.

prime rate Traditionally defined as the rate of interest charged by a financial institution to its best customers. In reality, many commercial loans are quoted in terms of "prime minus one quarter," for example, which indicates there are better rates than prime. In addition, many lenders offer rates based on the London Interbank Offered Rate (LIBOR), resulting in interest rates less than prime. Today, prime rate is often just a published rate by a financial institution, called its prime rate whether it is the lowest offered rate or not.

prime tenant Usually the largest, most important tenant in a shopping center or office building.

principal (1) One who has permitted or instructed another—called an agent—to act on his or her behalf and according to his or her instructions. (2) One who is primarily liable for an obligation, as

opposed to a surety, who is secondarily liable. (3) With a promissory note, the principal is the unpaid balance of the funds borrowed, not including any interest or other fees. (4) In a trust, the property of the trust that generates income. Principal can be real property or personal property.

principal and interest payment The typical mortgage loan payment includes all accrued interest on the principal balance and some reduction of the principal; the borrower pays principal and interest. Only the interest portion of the payment is deductible on the borrower's taxes.

principal balance That portion of the original loan amount which remains unpaid. It does not include accrued interest or fees.

principal broker A name given in some states to the responsible party in a real estate office; sometimes called the managing broker or the qualifying broker. It is the person legally authorized to enter into agency contracts with consumers, and the person legally responsible for supervising the agents who work under that supervision.

principal, interest, taxes, and insurance payment Usually a consumer mortgage loan arrangement that allows the borrower to pay small amounts each month toward anticipated annual expenses for taxes and insurance. The lender keeps the tax and insurance portions of the payment in an escrow account, ready to pay the bills when they come due. If the borrower sells his or her home before the taxes or insurance are due, the borrower may be entitled to a refund of monies in the escrow account.

principal limit The maximum lifetime amount an elderly borrower can take out on a reverse mortgage. Calculation of the principal limit is a formula that uses the age of the youngest borrower, the maximum claim amount (the lesser of the house's appraised value or the FHA's maximum loan amount for houses in the area), and the expected average mortgage interest rate.

principal meridian One of the imaginary lines running north and south, used as references for the public land survey system. There are 37 principal meridians in the United States. Each one has a name, and the names are used to distinguish the various surveys that eventually made up the public land survey system.

principal-only securities (POS) Collateralized mortgage obligations issued by the Government National Mortgage Association (Ginnie Mae) that have been stripped out into bonds based only on interest payments (interest-only securities) and those based solely on principal payments (principal-only securities).

principal residence The place one declares as his or her primary domicile; the address used on a driver's license, for voting, and for income taxes. The choice of a principal residence can make a difference regarding liability for income taxes, estate taxes, creditors' rights, homestead exemptions, and other such legal and economic consequences.

principle of balance See *balance, principle of*.

prior appropriation theory A theory of water use that holds that the first user of water has the unrestricted right to take it, even if it works to the detriment of the neighbors. Contrast with *reasonable use theory*.

priority An order of payment of creditors if there are insufficient assets to pay all creditors.

privacy law There is no single statute called the privacy law; however, a variety of statutes attempt to protect the privacy of citizens. They include as follows:

- The Buckley-Pell Amendment to the Family Educational Rights and Privacy Act denies federal funds to educational institutions that do not maintain the confidentiality of student records.
- The government may not obtain bank records without first informing the account holder and giving the account holder an opportunity to protest, by virtue of the Privacy Act of 1974, found at 5 U.S.C. §552a.
- Privacy of medical records and health information is guaranteed under the Health Insurance Portability and Accountability Act of 1996, typically called HIPAA (pronounced "hip-uh" for short). See 42 U.S.C. §3201.

private covenant See *covenant*.

private letter ruling An official IRS decision regarding how it will treat a transaction contemplated by the particular taxpayer who requested the private letter ruling. Private letter rulings are binding on the IRS for that one taxpayer, but other taxpayers are not entitled to rely on the position articulated in the ruling. Another taxpayer with an identical fact situation could find the IRS taking a completely different position.

private mortgage insurance (PMI) Insurance to cover a lender's risk if it extends a loan for more than 80 percent of the fair market value (or purchase price, whichever is less) of property. Usually, the borrower pays the premiums for the PMI insurance. See also *Homeowners Protection Act of 1998*, which is popularly called the PMI Cancellation Act.

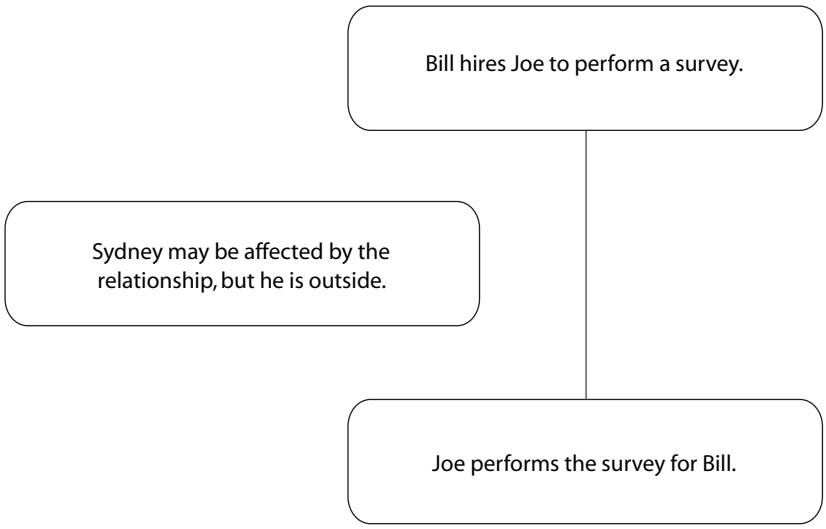
private offering An investment offered to a small group of investors. Section 4(2) of the federal Securities Act exempts from registration "transactions by an issuer not involving any public offering." What qualifies as "not involving any public offering" is complicated and differs depending on a wide variety of circumstances. Generally, Regulation D (Rules 501 through 508) provides a safe harbor. If the issuer follows the rules for the circumstances described in Regulation D, then the issuer won't get in trouble.

private REIT A real estate investment trust that is not traded on the national stock exchanges. Investments typically last for a set time period, usually 10 to 12 years. At the end, investors cash out through an initial public offering, a merger, or a liquidation. The investment usually lacks the liquidity of a publicly traded REIT—it is often difficult to redeem the shares or sell to a third party. Also called unlisted REIT, nontraded REIT, and nonpublicly traded REIT.

private sector A portion of the economy composed of businesses and households, but excluding government.

privity of possession (1) In successive possession of property, one possessor after another without a break. It is an important concept in adverse possession, which requires possession of property for a certain period of time before gaining title. Possessors who cannot meet the time period requirements are allowed to tack (combine) their time with earlier possessors who were in privity. (2) Having a direct contractual relationship between parties.

> **Example:** *If Joe surveys land for Bill, then Bill and Joe have privity. If neighboring property owner Sydney is unhappy with the results of the survey, he cannot sue Joe for breach of contract or failure to perform the survey properly, because there is no privity between Joe and Sydney. Other legal theories may get around that problem, but not a breach-of-contract action.*



probate To prove the validity of a will. Probate courts generally oversee decedents' estates, the payment of bills, and the distribution of assets. Some states have exemptions for small estates, which may avoid probate. Other states have no exemptions. Probate will need to be opened in every state in which a decedent owns assets, including real estate, unless there is a specific state exemption.

proceeds from resale See *resale proceeds*.

procuring cause A broker is considered the procuring cause of a sale and is entitled to a commission if the broker's efforts are the foundation on which negotiations resulting in a sale are begun.

producing cause See *procuring cause*.

profit and loss statement A semi-itemized list of all revenues and expenses of a person or company over a stated period of time, such as one month, one quarter, or one year. The items on the list are generally broad categories, but the selection of categories is a matter of personal preference for most small businesses. As a general rule, one should design a profit and loss statement so that it gives a snapshot of important revenue categories and the expenses associated with those particular revenues.

profit a prendre A right to take substances from the soil of another.

profit margin The difference between the cost of a unit (house, subdivision parcel, condominium) including a pro rata share of all overhead and other such expenses, as compared to the sales price for that unit.

pro forma See *pro forma statement*.

pro forma statement Anticipated revenues and expenses of a business. Development projects will include a pro forma statement (pro forma for short) for each month or quarter until the project reaches stabilized occupancy, and then a separate pro forma for a representative 12 months at stabilized occupancy. Many developers prepare three pro formas for every project: best case, worst case, and most likely case.

progressive tax A tax that imposes a greater burden on the wealthy than on those with low incomes because the tax rate percentage increases as one's income or assets increase. Income taxes and estate taxes are progressive taxes. Contrast with a regressive tax, such as sales tax, that charges the same percentage to all taxpayers but results in a heavier burden to low-income citizens.

progress payments Payments to a contractor or developer based on the stage of completion of the project.

projection A forecast of future trends in a business, based on past experiences or on other currently available data. A projection that senior housing needs will increase at 12 percent per year for the next 5 years may form the basis for a pro forma profit and loss statement for development of a retirement community.

projection period The time period of a projection. It might be the next 5 years, it could be the life span of a real estate development from breaking ground to selling out all properties, or it could be one year from today. The projection period is always defined when making projections.

promissory note A binding contract—promise—to pay a definite sum of money to someone upon specified terms and conditions.

property Any tangible or intangible thing that is or may be owned by someone.

property condition addendum or clause A clause in a real estate purchase contract permitting the buyer to cancel the contract without penalty or loss of the earnest money if an inspection reveals defects. Wise sellers will insert a basket clause, specifying that minimal defects, such as those that would cost no more than $500 to repair, may not be grounds for cancellation and that anything estimated to cost between $501 and $2,000 (or wherever the seller's comfort level is) may be repaired by the seller within a reasonable time and the contract may not be cancelled.

property depreciation See *depreciation*.

property description See *land description*.

property line The boundary line between two properties.

property management See *management agreement*.

property report A summary of facts about undeveloped land that must be given to purchasers of nonexempt properties under the Interstate Land Sales Full Disclosure Act.

property tax See *ad valorem tax*.

proportional tax A tax that charges the same percentage of income, regardless of the amount of income; also called a flat-rate tax.

proprietary lease In a cooperative apartment, residents buy shares of stock in a corporation that owns the apartment building. They then rent a particular unit from the corporation, under a document called a proprietary lease.

proprietorship Ownership. Those who own their own business in their own personal name, without a corporation or partnership or other such business structure, is said to have a sole proprietorship.

pro rata Proportionate to one's interests or claims. In bankruptcy, unsecured creditors will receive their pro rata portion of any money left after paying secured creditors, attorneys' fees, and costs of administration. If the unsecured claims total $1,000,000, and the money left for distribution is $10,000, then each creditor will receive 1 cent for each dollar of their claim.

prorate The process of determining the pro rata portions. In real estate, the term comes up frequently at a closing, when allocating certain property expenses. Usually real estate taxes are paid in arrears and homeowners association dues are paid in advance. The new owner will pay 100 percent of the real estate tax bill when it is presented after the closing, but a portion of that bill represents time periods when the seller owned the property. Likewise, the seller will have already paid the association dues for the month, but will own the property for only a portion of the month. At closing, these expenses are prorated between the buyer and seller. The buyer will receive a credit for the accrued-but-unpaid property taxes. The seller will receive a credit for the paid-but-unaccrued association dues.

prospect A person who has indicated some interest in buying and who appears to have the desire and the ability to purchase. Contrast with suspect, who is someone identified as possibly having an interest in buying, but who has not yet been contacted or has not yet given any evidence of interest.

prospective appraisal A licensed professional appraiser's estimate of the value a property will have after certain conditions come to pass. Before lending development money for a project, lenders will require a prospective appraisal of the completed project.

prospectus A legal document describing something that is being offered for sale, with all disclosures required by applicable state and federal laws.

proximate cause The primary or moving cause of an injury.

proxy A person who stands in the place of another. (1) Normally used in the context of a shareholder granting permission for another shareholder or board member to vote his or her shares of stock. (2) In bankruptcy, creditors may give their proxies to other creditors, to the trustee, or to the debtor's attorney to vote for or against a plan of reorganization. (3) Marriage by proxy is still allowed in a very few states, in which someone stands in for the bride or the groom in the wedding ceremony, usually because one party is in the military service and deployed to a combat area.

PRPs See *potentially responsible parties*.

public auction See *public sale*.

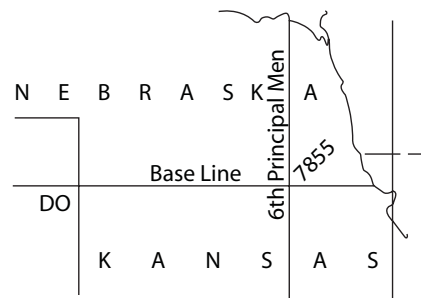
public domain (1) Land belonging to the government and not reserved for a specific use. (2) Things belonging to all persons to share, use, and enjoy, such as music and literature for which the copyrights have expired or ideas that are freely exchanged in the public domain.

public housing Housing owned and operated by the government, usually for rental to low-income families. Contrast with low-income housing, which is privately owned but government supported through a variety of incentives.

public lands Land owned by central or local government in trust for its citizens. Most federal lands are managed by the following agencies, depending on a grant of jurisdiction to each:

- Bureau of Land Management (www.blm.gov)
- U.S. Fish and Wildlife Service (www.fws.gov)
- U.S. Forestry Service (www.fs.fed.us)
- National Park Service (www.nps.gov)
- National Oceanic and Atmospheric Administration (www.noaa.gov)
- Bureau of Reclamation (www.usbr.gov)
- U.S. Army Corps of Engineers (www.usace.army.mil)

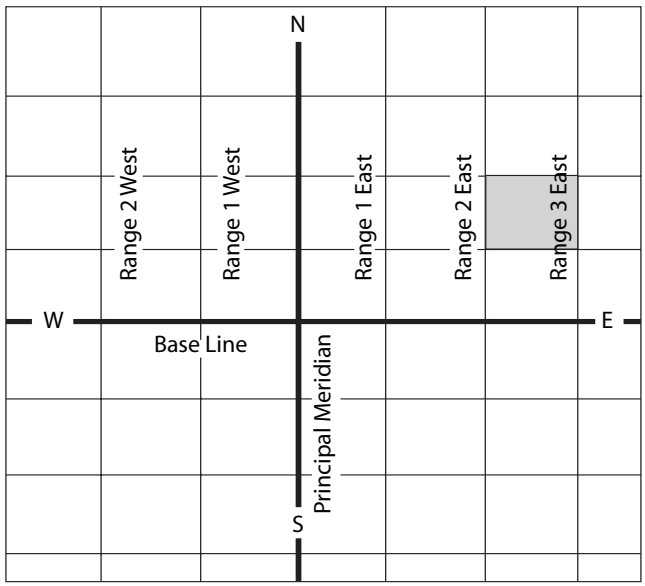
public land survey system (PLSS) A way of subdividing and describing land in most of the United States. Texas, Hawaii, and most of the original 13 states are not described by the PLSS. The system starts with a principal meridian, which is a north-south line. There are 37 principal meridians in the United States. Each principal meridian has a base line that runs east and west through it.



Land is described as being east or west of the principal meridian, and north or south of the range line associated with that meridian. Land is typically divided into 6-mile-square townships. Townships are described with reference to their principal meridian and base line.

Example: *A township "2 North, Range 3 East, Mount Diablo Meridian" would mean the township is in the*

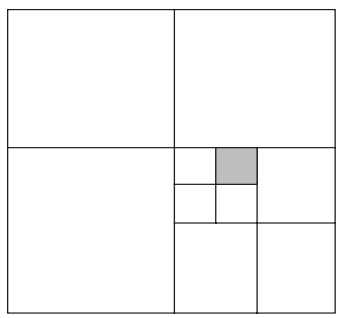
second tier north of the base line, and the third column east of the Mount Diablo Principal Meridian.



Each township is then divided into 36 sections. Each section is 1 mile square and contains approximately 640 acres, making allowance for unsophisticated measuring tools employed at the time of creation.

6	5	4	3	2	1
7	8	9	10	11	12
18	17	16	15	14	13
19	20	21	22	23	24
30	29	28	27	26	25
31	32	33	34	35	36

Sections may be further subdivided into quarter-sections (160 acres), quarter-quarter sections (40 acres), or any other mathematical subdivision. The gray square in the figure on the bottom right might be described as "the northeast quarter of the northwest quarter of the southeast quarter of Section 14, Township 2 North, Range 3 East of the 6th Meridian.



public offering (1) Offering of new securities to the investing public after registration with the Securities and Exchange Commission. (2) A sealed-bid auction where oil sands rights are sold to the highest bidder. (3) A requirement by some governments, educational institutions, and others that property declared as surplus must be offered to the public for purchase before being sold in a private sale. Also called a primary distribution.

public record Federal, state, or local records that are available for inspection by the public. In real estate, it refers to the

practice of filing copies of all real estate documents in a central depository, where they are indexed and preserved for viewing by members of the public.

public sale An auction of property after notice to the public. Notice requirements will vary depending on the reason for the sale.

public sector That portion of the economy consisting of the government and corporations owned by the government. Contrast with *private sector*.

public street Any street, road, or way dedicated to public use. Most cities have strict requirements for roads built by developers and then dedicated to public use.

PUD See *planned unit development*.

puffing An expression of opinion regarding positive traits and superior qualities of a property, but not intended as a statement of fact.

punch list The list of completion, correction, and repair items necessary after construction has been completed on a project and before acceptance by the owner, tenant, or purchaser. The item can be as minor as, "Switch plate in master bathroom is not straight," to things as important as, "All the carpet is the wrong color."

pur autre vie Literally, "for another life." An ownership interest in land, but only for a period of time measured by the lifetime of a named person.

purchase agreement See *contract for purchase or sale*.

purchase contract See *contract for purchase or sale*.

purchase money mortgage (1) A mortgage loan used to purchase real estate. It may be seller-financing, institutional lender financing, or any other type, as long as the loan proceeds were used to purchase the property. Some states prohibit lenders from suing borrowers on purchase money mortgages if a foreclosure sale does not result in enough money to pay the debt in full. (2) Sometimes used to refer to a purchase money security interest in personal property. Personal property security interests are sometimes called chattel mortgages, hence the expression purchase money mortgage. (3) In bankruptcy, the debtor may not keep normally exempt assets without paying the creditor if the creditor has a purchase money security interest.

purchase option See *option*.

purchase price The contractually agreed upon price for a property, before credits, adjustments, or concessions.

pure debt An obligation to repay money, but without any sharing of profits or increases in value. Most mortgages are pure debt; the lender does not own any part of the property nor does the lender receive any profits from the property.

pure notice statute Refers to recordation statutes that say, as between competing claimants to real property or to liens on real property, priority is given to a subsequent claimant who takes its interest without notice of the prior interest. Contrast *pure race statute* and *notice-race statute*.

pure race statute Refers to recordation statutes that provide that the first lender, lienholder, or purchaser to record their instrument take precedence over all others, even if when they were recording they had knowledge of prior claims that were simply unrecorded. It is a race to the courthouse to record. Contrast *pure notice statute* and *notice-race statute*.

Q

QLIP See *qualified leasehold improvement property*.

quadraplex An apartment building with four units. Also called fourplex.

qualified buyer One who is actively seeking property to purchase and has the financial ability to complete a purchase. If a seller refuses to sell property to a qualified buyer procured by a real estate broker during the listing period, then the seller will be liable for payment of the full commission unless there is a no-buy, no-pay clause.

qualified intermediary A person or entity permitted to hold funds in a 1031 exchange, which is a vehicle for selling a property and buying a replacement property, thereby deferring payment of taxes until sale of the second property. Anyone may be a qualified intermediary as long as that person does not fit the description of a disqualified person. Disqualified persons are those who are the agent of the taxpayer at the time of the exchange or who acted as an agent for the seller at any time in the 2 years prior to the exchange. See *1031 exchange* for the mechanics of the transaction.

qualified leasehold improvement property (QLIP) An IRS term meaning any improvement made or to be made by a tenant-taxpayer to the interior part of nonresidential real property more than 3 years old, in space occupied exclusively by the tenant. For QLIPs placed in service after August 27, 2005, and before January 1, 2009, in the GO-Zone (hurricane damaged states and counties), 50 percent of the cost of the QLIP may be taken as a depreciation deduction in the first year, rather than the $^{1}/_{39}$ deduction allowed under normal tax law.

qualified real estate professional An outdated IRS term related to the passive activity rules. See *real estate professional*, which is the modern term.

qualifying broker In some states, the person legally responsible for a real estate office, the training and supervision of all licensed real estate persons in the office, and the one who must sign all agreements with clients. Also called broker in charge or managing broker. See *broker*.

qualifying ratio The maximum ratio of debt to income that will still allow a borrower to qualify for a loan. Lenders use two different ratios. The front-end ratio compares housing costs to income. The back-end ratio compares all consumer debt to income. Each lender has its own preferred ratios, which are usually dictated by demands placed by the secondary market or by loan guarantors such as the Veterans Administration. The numbers are not secret, but they change too often to include in a book. Be sure to ask a lender about its qualifying ratios and what exactly is included in the numbers.

quantity survey An appraisal method used to calculate the reproduction cost of a structure by quantifying all materials, labor and overhead necessary to reproduce it.

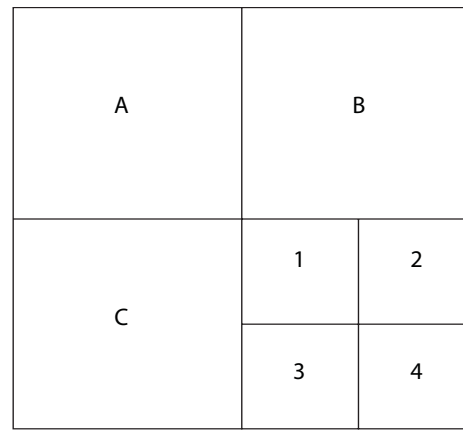
quantum meruit (pronounced like "merit") Means "as much as he deserves." It is the principle that if someone has benefited from the work and goods of another, but without a formal contract, then the one supplying the labor or materials is entitled to a reasonable compensation as long as they did not lead the other to believe it would be free. The theory arises often in construction projects, which seem to have a high percentage of people working on a handshake and an implied understanding of the normal fees in the area.

quarantine An ancient right of widows to enjoy their deceased husband's home and property for a period of time after death and before allocation of the widow's other common law rights. Today, the concept has been codified in many state probate codes, which grant an allowance to the widow during the pendency of the estate probation.

quarter One-fourth of a year. For 2007, January, February, and March would be written as 1Q07; April, May, and June would be 2Q07, and so on.

quarter-quarter section A parcel of land described by starting with a 640-acre section, dividing it into quarters, and then dividing one of the quarters into fourths again. It has a size of 40 acres. In the figure, 1, 2, 3, and 4 are each quarter-quarter sections. A, B, and C are quarters, of 160 acres each. See *public land survey system*.

quarter section A parcel of land described by starting with a 640-acre section and then dividing it into four equal quarters, each with 60 acres. In the figure, A, B, and C are all quarter sections, and 1, 2, 3, and 4 together make a quarter section. See *public land survey system*.



quash To annul, vacate, void, abate, dispel, or overthrow. One quashes an indictment, a rebellion, or fears that a zoning variance will ruin the neighborhood. Use of the word "squash" instead of "quash" is inappropriate.

quiet enjoyment The right to enjoy leased or owned property without disturbance. The covenant of quiet enjoyment is one of the typical warranties made in deeds and leases. Some states will not find a breach unless there has been an actual or constructive eviction of the owner or tenant. Other states are more lenient. Most controversy arises in the context of landlord-tenant disputes, in which the landlord has done something the tenant views as damaging to the tenant's business. Examples include extremely noisy construction on the floor above for an extended period of time; barricades erected in front of a tenant café's entrance, or the landlord failing to furnish heat.

quiet title action A court action to determine the true owner of real property when there is a dispute among parties or when there might be an adverse claim by parties who cannot be found.

It is common in the case when a prior owner might have been the cause of a technical title defect, but the prior owner has died and no one can find the prior owner's heirs. In such a case, the purported owner will file a quiet title action and publish notices requiring anyone with claims to come forward or be forever barred.

quitclaim deed A deed with no warranties at all. The grantor conveys anything it might own at the moment, but makes no representations or warranties it owns anything. It is the normal vehicle for clearing up title defects.

quit title suit See *quiet title action*.

quotient verdict One in which jurors cannot agree on an award, such as for a contested condemnation. They agree to each write down the amount they think should be awarded, and then someone takes the average of all those numbers. By agreement among themselves, the jury awards the average amount to the plaintiff. (Quotient verdicts are illegal and may be set aside if the jurors were foolhardy enough to leave their slips of paper and calculations in the jury room when they depart.)

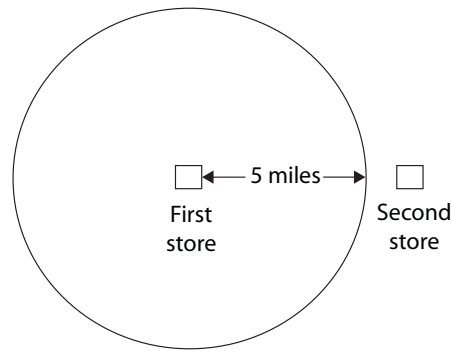
R

race to the courthouse In a pure race state, the first party to file a deed, mortgage, or other instrument will take priority—will be given effect—before instruments filed afterward. As a result, a situation sometimes arises when there is a possibility of competing claims, such as a spouse or creditor who wants to file a claim against property before it is sold to another. In such situations, there is a race to the courthouse to file first—before anyone else.

racial steering See *steering*.

rack rate Slang for rent at full asking price with only the minimal build-out or other allowances usually quoted to prospects. No concessions.

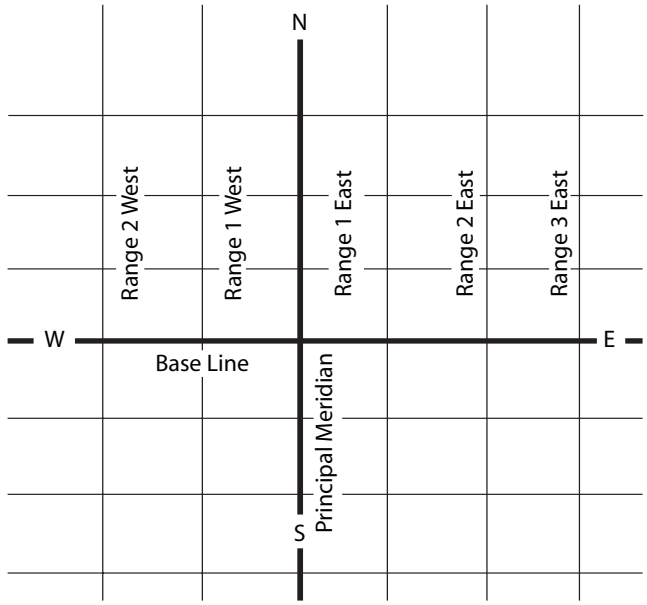
radius clause A shopping center lease clause that prevents a tenant from opening another store within a certain radius of the current shopping center. The purpose is to prevent a competitor from duplicating the landlord's tenant mix in a nearby mall. In the drawing, a 5-mile radius clause would not prohibit the second store, even though they probably have overlapping market areas. Most courts require the restriction to be reasonable in duration and geographical area in order to be enforceable. Contrast with *reverse radius clause*.



radon Colorless, odorless gas that occurs naturally due to the breakdown of minerals in the earth. It tends to become trapped in our modern, nearly air-tight homes. Since there has been some correlation between radon and lung cancer, the EPA recommends levels no higher than 4 picocuries per liter (pCi/L), although generally acceptable levels are in the range of 4 to 8 pCi/L. The EPA Web site at www.epa.gov has information on testing for radon and reducing it.

RAM Short for reverse annuity mortgage. See *reverse mortgage*.

range A division of land in the public land survey system. Each range line is approximately 6 miles apart and is identified according to its distance east or west from the principal meridian for the area. Range 1 West is in the column immediately west of the principal meridian for the area. See *public land survey system*.



RAP See *remedial action plan*.

rate guarantee See *locked-in interest rate*.

rate improvement mortgage A fixed-rate mortgage with one opportunity, at a time of the borrower's choosing but in the early years of a loan, to reduce the rate to market interest at that time. The loan will then continue at the new interest rate, which cannot be changed again.

rate of return The ratio between the earnings and the cost of an investment.

rate of return of investment See *recapture rate*.

rating agency A company that evaluates the creditworthiness and strength of other companies and assigns a score to them, such as A, AA, and so on.

raw land Land with no improvements, no infrastructure, and no grading or site development.

RBC See *risk-based capital requirements*.

ready, willing, and able One who has the desire and the ability to act. If an owner has an exclusive right to sell listing contract with a broker, and the broker produces a buyer who is ready, willing, and able to buy, but the seller refuses to sell, the broker has earned the commission.

real estate Land and everything above and below the soil.

real estate agent See *agent*.

real estate board See *board of REALTORS®*

real estate broker See *broker*.

Real Estate Brokerage Managers Council See *Council of Real Estate Brokerage Managers*.

real estate commission See *commission*.

real estate contract See *agreement of sale*.

Real Estate Educators Association (REEA) A professional organization (www.reea.org) dedicated to its mission statement of providing "resources and opportunities for professional development to individuals and organizations involved in Real Estate education to better serve their customer base."

Real Estate Information Professionals Association (REIPA) A national trade association (www.reipa.org) for professionals and corporations involved in providing real estate and public record information in the United States. It has spearheaded the drive to deal with standards in automated valuation model (AVM) technology, which is being used more and more by home lenders for property evaluation, rather than traditional appraisals.

real estate information system (REIS) A computerized system for tracking property location, description, ownership, and any other information considered important by the entity creating the system. Today, almost any major and midsize city in the United States has online REIS access for property taxes, past and current property ownership, and recent sales prices.

real estate investment trust (REIT) Congress passed the Real Estate Investment Trust Act of 1960 to allow small investors to pool their money into real estate investments and receive the same benefits as wealthier Americans who were able to purchase real property directly. REITs are special corporations that must invest only in real estate and must distribute at least 90 percent of their net income in the form of dividends, 95 percent before 1999. In exchange, they are allowed to escape any income tax liability at the corporate level.

Many people describe REITs as real estate mutual funds, which is conceptually true except for one big difference: REITS are closed-ended funds, meaning investors cannot demand redemption of their shares, but can only trade them on the open market. With a real estate mutual fund (REMF) investors may demand redemption from the fund, even if the public market isn't buying. There is a wide variety of REITs:

- Overall, they are either equity REITs that invest in property or mortgage REITs that invest in mortgages.
- They are not allowed to operate high-management properties like hospitals or hotels, but they can hire outside companies for the management.
- REITs generally specialize in one of the following sectors: retail, health care, lodging, industrial, office, residential, or specialty (self-storage centers, restaurant properties, etc.). Some diversify across several sectors.
- Some are publicly traded on the stock exchanges, some are private, and some are unlisted. Unlisted REITS are also called non-exchange traded REITS; they file reports with the SEC but do not trade on the national stock exchanges. Private REITS do not file any reports with the SEC and are not traded on any national stock exchange.

real estate mortgage investment conduit (REMIC) An entity that holds a fixed pool of mortgages and issues multiple classes of mortgage backed securities. All interests must be classified as regular or residual. Regular interests are entitled to principal and interest income, through bonds, stock, or some other vehicle. Residual interests provide income that is less certain. There are almost 50 different classes of certificates, all with varying rights and risks. The Freddie Mac Web site has an excellent discussion of all available certificate types at www.freddiemac.com/mbs/docs/remic_glossary.pdf.

real estate mutual fund (REMF) Similar to a REIT but with technical differences that make the REMF like any other mutual fund. The REMF invests in real estate assets, including REITs and REOCs and pays dividends to investors. A REMF is open ended, meaning investors may demand that their shares be redeemed and can then cash out and pursue other investments.

real estate operating company (REOC) A publicly traded company that specializes in real estate investments but does not meet the strict requirements to be a REIT, particularly the requirement to pay at least 90 percent of net income out to investors. As a result of the ability to retain funds, REOCs can invest in expansion opportunities.

real estate owned (REO) Foreclosure property held by a lender.

real estate professional Usually refers generically to a trained and licensed person who makes his or her living in some aspect of buying, selling, or managing real estate. The IRS has a specific definition applicable to whether one is exempt from the passive activity rules. For IRS purposes, a real estate professional is any person who meets the following requirements:

1. More than half of the personal services the taxpayer performed in all trades or businesses during the tax year were performed in real property trades or businesses in which he or she materially participated.
2. The taxpayer performed more than 750 hours of services during the tax year in real property trades or businesses in which he or she materially participated.

real estate salesperson See *sales associate.*

real estate securities Various methods for people to invest in real estate without having to buy land and/or buildings. Some of the various methods are the following:

- Bonds for a particular project. One of the earliest issuers was the American Real Estate Company, organized in 1888 with $100,000 worth of capital, it issued almost $15 million in bonds and certificates with installment payments to purchasers. It went bankrupt soon after the 1914 market downturn.
- Stock in a corporation that owns a particular building or project. Early development pioneers sold stock in buildings to be constructed, thus largely eliminating the need to borrow construction money.
- In the 1950s, real estate syndication emerged, with limited partnership interests being offered to the public. They were popular for a few years and then interest waned.

- By 1960, Congress authorized creation of real estate investment trusts (REITs) which would produce favorable tax advantages for investors. Most early REITs were mortgage REITs (ownership of mortgages) rather than equity (ownership of property) investments.
- In the 1980s limited partnerships and syndications became popular again as large, nationwide firms entered the picture as underwriters and promoters. Passage of dramatic tax law changes in 1986 took away many of the tax incentives for this vehicle, leading to its near demise.
- In the 1990s, investment in equity-REITs took off, with that becoming the predominant real estate security for investors.
- Today, tenancy in common investments (TICs) are the favored medium.

Real Estate Settlement Procedures Act (RESPA) A federal consumer protection statute supervised and enforced by the Department of Housing and Urban Development (HUD). First passed in 1974, it requires various disclosures in order to help consumers make more informed decisions when shopping for settlement (real estate closing) services. It also seeks to eliminate kickbacks and referral fees, which unnecessarily increase the costs of certain settlement services. It applies to mortgage loans on single-family housing, duplexes, triplexes, and four-plexes (generally described as "one- to four-family residential property"), whether the loan is for a purchase, refinance, property improvement, or home equity line of credit.

- When borrowers apply for a purchase loan, they must be given a special information booklet regarding various real estate settlement services, a good-faith estimate of settlement costs, and a mortgage servicing disclosure statement regarding whether the lender will service the loan or transfer it to another.
- There must be an affiliated business arrangement disclosure whenever a closing company recommends a particular attorney, appraiser, surveyor or others if that third party is not independent from the closing company. The closing company cannot require use of a particular third party, but the *lender* can do so in order to protect its interests.
- The settlement agent must provide the consumer with the HUD–1 Settlement Statement, which clearly shows all receipts, all disbursements, all credits and charges, and all fees in connection with the transaction. The borrower may request to see the HUD–1 one day before closing.
- Loan servicing companies must supply an annual escrow statement to borrowers at least once a year. It summarizes all escrow account activity for taxes, insurance, and other escrow items.
- If the loan servicing is transferred, the borrower must be given a servicing transfer statement at least 15 days before the effective date, including a toll-free number and address for the new servicer. If the borrower makes timely payments to the old servicer during the first 60 days after transfer, the borrower cannot be penalized.
- Kickbacks and referral fees for settlement service business involving federally insured loans are prohibited, with civil and criminal penalties for violation.

- Sellers may not specify the buyer use a particular title insurance company, either directly or indirectly, as a condition of sale. Buyers may sue a seller who violates this provision and receive an amount equal to three times all charges made for title insurance.
- Escrow deposit payments cannot be excessive. Lenders may require borrowers to pay no more than one-twelfth of the total annual disbursements each month, plus a cushion that cannot exceed one-sixth of the total disbursements for the year.

real estate tax See *ad valorem tax*.

realized gain A tax concept meaning the taxpayer has received a profit—a gain—on the sale of real property, but, for various policy reasons codified into the Internal Revenue Code, the IRS chooses not to *recognize* the gain and, as a result, requires no payment of taxes at that time. The reason could be because the taxpayer took advantage of a 1031 exchange, because the gain was from the sale of a home and was less than the current exclusions, or because the property was taken by eminent domain and the proceeds reinvested within the required time period.

real property See *property*.

real property trades or business Under the Internal Revenue Code, losses from passive activities have limited deductibility unless one is a real estate professional. The test for a real estate professional is whether the person spends the required amount of time in real property trades or businesses. With that background in mind, the expression includes development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operations, or management and brokerage of real estate.

realtist A member of the National Association of Real Estate Brokers (www.nareb.com), comprised primarily of minority brokers and salespersons.

REALTOR® A member of the National Association of REALTORS® (www.realtor.org).

REALTORS® Land Institute (RLI) An affiliate of the National Association of REALTORS®; it focuses on brokerage of farms and ranches, undeveloped tracts of land, transitional and development land, subdivision and wholesaling of lots, and site selection and assemblage of parcels. (Originally named the Farm and Land Institute.) The RLI Web site is at www.rliland.com.

realty See *real estate*.

reappraisal lease A lease in which the rent is adjusted based on an independent appraisal of the value of the property; frequently seen with long-term ground leases.

reasonable consent In most leases, a landlord's reasonable consent is required before the tenant may make an assignment of the lease or sublet to another tenant. The concept is naturally vague, as it must cover a wide variety of circumstances. It is intended to be understood by its negative—the landlord must have a stated reason for withholding consent, and, considering all the circumstances, that reason cannot be arbitrary, foolish, unfair, illegal, or unethical.

reasonable time A fair and just amount of time to complete an act or fulfill a contract, taking into consideration all the circumstances. Unless a contract provides that time is of the essence, then the parties will be given a reasonable time after a due date within which to comply.

reasonable use theory Riparian owners (owners of land located beside a river or stream) may make reasonable use of the water flowing past their land for either natural or artificial wants, but may not use it in such a manner as to affect the quality or quantity of water available to downstream owners. Contrast with *prior appropriation theory*.

reassessment Reviewing or updating the value estimates of real property for the purpose of calculating ad valorem taxes.

rebate (1) A refund. (2) A kickback. Kickbacks from settlement providers are illegal under the Real Estate Settlement and Procedures Act.

rebuttable presumption A law of evidence that something will be considered true (the presumption) until it is proven untrue (rebutted). When a rebuttable presumption has been created, it normally shifts the burden of proof to a different party than would normally have it. For example,

- In some jurisdictions, if a bankrupt debtor company owns only one asset, and that asset was transferred to the company shortly before it filed for bankruptcy, then there is a rebuttable presumption that the transfer was fraudulent and intended to isolate that one asset and its creditors from other assets belonging to the original owner. The debtor must prove the transfer was not fraudulent, rather than the creditor being required to prove it was fraudulent.
- In some states, when spouses take property as joint tenants with rights of survivorship, but one spouse provided all the money for the purchase, there is a rebuttable presumption that a gift was intended to the other spouse. As a result, if the one providing the money wishes the whole of the property upon divorce, and the state is not a community property state, then the paying spouse has the burden of proving it did not intend a gift to the nonpaying spouse.
- If there is a boundary line dispute and one party destroys evidence, such as tearing down a fence or removing markers or pins, there is a rebuttable presumption that the evidence would have been adverse to the party who destroyed the evidence.

recapture (tax) Same as *depreciation recapture*.

recapture clause (1) A clause in a lease setting out conditions under which the landlord may recapture the premises even without a default by the tenant. A common usage occurs when the tenant wishes to sublease or assign its space for a profit—the new occupant will pay a higher rental rate than the tenant is paying to the landlord. In such a circumstance, the landlord will want to recapture the space and rent it directly to the new tenant or it will want to share in the lease profits. (2) A clause in a statute that provides exceptions to an exception. For example, one clause in the Clean Water Act grants an exception to the requirement to obtain a permit. But, the recapture clause "recaptures" the permit requirement under certain limited circumstances.

recapture of depreciation Same as *depreciation recapture*.

recapture rate In appraisal, used to describe the rate of recovery of an investment in a wasting asset—one that becomes less valuable because it is used up, like an oil lease.

recasting Renegotiating a loan in the face of an impending or actual default. See *workout*.

receivables Money due from tenants or clients. Receivables are listed as an asset on the balance sheet. One can have a profit on paper, because all the rent charged to tenants counts as income, whether collected or not. One can also have a large amount of assets and be worth a lot of money, on paper, because unpaid rents—receivables—are listed as an asset. At the same time everything looks rosy on paper, you can be going broke because tenants are not paying their rent, you don't have any hope of ever collecting the past-due receivables, and there is no money to pay the bills.

(Remember this when reviewing financial information for a rental property: you must see the balance sheet and the financial statements at the same time to figure out what is really happening.)

Sample Balance Sheet Showing Assets		
Assets:		
	Current Assets	
	Cash on hand	500
	Cash in banks	4,500
	Receivables	28,000
	Fixed Assets	
	Furniture and equipment	16,000
	Land and buildings	200,000
	Total Assets	249,000

recession Technically, two successive quarters of falling gross domestic product as judged by the National Bureau of Economic Research, a private nonprofit, nonpartisan research organization founded in 1920. Commonly, a time of general economic slowdown.

reciprocal negative easements Another name for *restrictive covenants*.

reciprocity A mutual agreement to accept another's judgment on a matter. Some states offer reciprocity of real estate licensing, so that an agent or broker licensed in one state may become licensed in another without meeting the minimum education, testing, or apprenticeship requirements.

recital Statements of fact, usually appearing at the beginning of contracts and leases. Usually the recitals start with the word, "Whereas …" Most attorneys and almost all parties give very little

thought to the recitals, but they can be critically important. The recitals are the facts considered important in the formation of the agreement. They may be as innocuous as a statement that the tenant is a corporation duly organized and existing under the laws of the state of California, for example. They can also include such things as specific representations made by each party to the other. If there is a later dispute about the parties' intentions, or whether a misrepresentation was material or not, reference to the recitals can often make the difference in the dispute.

reclamation (1) The process of converting unusable lands to beneficial use, such as reclamation of strip mine sites, swamps, and gullies. (2) A bankruptcy remedy allowing a vendor who sold goods on credit to one who filed bankruptcy shortly afterward to reclaim those goods and obtain their return from the bankrupt buyer, but only if the buyer was insolvent at the time of receipt and the seller makes demand for reclamation within 10 days of the buyer's receipt.

recognized gain That portion of a sale profit that is taxable. When a person has a gain on the sale of property, it is said the person realizes gain. Under certain beneficial tax provisions, the seller may not have to pay taxes because the gain is not recognized at that time—the IRS chooses to ignore it for one reason or another. Normally, all gain is recognized unless it falls within one of the exceptions allowing deferral until a later date, such as a 1031 exchange, or excluded completely, such as sale of a principal residence for less than the ceiling amount of gain.

reconciliation In appraisal, the process of considering values calculated from the various appraisal methods and weighting the strength to be given to each approach in order to arrive at a final value for the property.

reconfiguration Changing the physical layout of something, such as a work space, a golf course, or the sizes and layouts of rooms in a hotel.

reconveyance When a mortgage debt is retired, the lender conveys (transfers) the property back to the borrower in a title state.

recording Entering something into the real estate or probate records so that it serves as constructive notice of its contents to all the world. Many jurisdictions have specialized requirements before they will admit documents to recording, such as the name and address of the person who prepared the document, the book and page numbers of the source of title for the property, and prohibitions against strike-through marks or other editorial revisions apparent on the face of the document. See the sample recording information that appears to the right.

2006 16959
Recorded in the above
DEED Book & Page
08-02-2006 03:33:57 PM
Source of Title: 1998 / 13964
W. Hardy McCollum - Probate Judge
Tuscaloosa County, Alabana
Book/Pg: 2006/16958
Term/Cashier: SCAN2 / hazeln
Tran: 6B30. 458511.552066
Recorded: 08-02-2006 15:34:09

DFE Deed Tax	13.50
PJF Probate Judge Fee	2.00
REC Recording Fee	6.00
SOT Source of Title	1.00

Total Fees: $ 22.50 Page

recording acts State statutes that govern the official recording of deeds and other real estate documents and the effects of such recording as to creditors, subsequent purchasers, and other interested parties. There are three varieties of recording statutes:

1. Notice acts provide that a person with notice of an unrecorded instrument is barred from claiming priority over it, as of the date the person received notice.
2. Race acts ("race to the courthouse") provide that the first person to record takes priority, even if that person had notice of a prior unrecorded instrument.
3. Race-notice acts provide that the first to record without notice of a prior unrecorded instrument has the better rights.

recording fee A fee charged by the office that accepts real estate–related documents for recordation. The term is used generically and is meant to include the actual recording fee, the transfer taxes, the indexing fees, and other such related costs.

record owner See *owner of record*.

recourse (1) The ability of a lender to demand payment from a borrower if the collateral is insufficient to pay the debt in full, or even if the lender chooses not to attempt foreclosure of the collateral. (2) The requirement that the seller of a promissory note repurchase it if the borrower defaults.

> **Example:** *Vic's Vinyl Siding agrees to install siding on Nellie's house in exchange for her agreement to pay $300 a month over the next 5 years, for a total of $18,000. Nellie signs a promissory note with those payments, and a mortgage. Vic does the work and then sells the note and mortgage to Quick Cash Company, with recourse, for $10,000. Three days later the siding falls off the house and Nellie refuses to make any more payments. Under federal law, she can refuse to pay Quick Cash Company even though her dispute is with Vic's Vinyl Siding. Because the sale was with recourse, Quick Cash can force Vic to repay the $10,000 to them and take back Nellie's promissory note and mortgage. Nellie and Vic may then battle over the quality of the work.*

recovery fund A fund maintained by many state real estate commissions to assist in compensating victims who have suffered as a result of a breach of a real estate agent's or broker's responsibilities but were unable to recover because there was no insurance and no discoverable assets. The fund is typically maintained by dues from agents and brokers.

recreational lease (1) Separate ownership of recreational facilities at a condominium project or planned unit development, with the owner leasing their use to the residents. (2) Leasing of land for recreational purposes such as hunting, fishing, snow sports, and motor sports. It is a method of keeping land largely natural and still enjoying some sort of income.

rectangular survey See *public land survey system*.

reddendum clause A deed clause that reserves something for the grantor, such as a life estate. Contrast with *habendum clause*, which describes the quality and quantity of the estate conveyed.

redeem (1) In mortgages, to cure a default by paying all past-due sums and penalties after receiving notice of default, but before acceleration. (2) To exercise the post-foreclosure right of

redemption, if allowed. (3) Under federal law, the IRS has 120 days after foreclosure to purchase property on which it had a lien—to redeem the property. (It rarely does this, and would only do so if it believed it could sell the property at a profit large enough to justify the time and trouble.)

redeemable rent Under lease with a purchase option and the ability to use a predetermined amount of the rent as payment on the purchase price, the payment portion is called redeemable rent.

redeemable ground rents Homeowners sometimes own their house, but must rent the land on which the house sits—called a ground lease. This is fairly common in Maryland and some other states. The homeowner may deduct redeemable rent paid for the ground lease, the same as mortgage interest, but only if

1. The ground lease, including renewal periods, is for more than 15 years.
2. The lease can be freely assigned.
3. The homeowner has a present or future right to end the lease and buy the land at a specified price.
4. The lessor's interest in the land is primarily a security interest to protect the rental payments to which he or she is entitled.

redemption, equity of See *equity of redemption*.

redemption rights See *right of redemption*.

redevelop To rebuild after substantial demolition of the old structure.

redevelopment agency A government subdivision created to improve blighted, depressed, deteriorated, or otherwise economically depressed areas; to assist property owners displaced by redevelopment; and to issue bonds or other instruments necessary to fund the programs. Goals are normally accomplished in partnership with private developers.

red herring A proposed prospectus that has been filed with the Securities and Exchange Commission (SEC) but not approved by it. Its purpose is to determine the extent of public interest in an issue while it is being reviewed by the SEC. Called a red herring because of the red ink around the border of the front page.

rediscount rate An interest rate charged by the Federal Reserve to member banks who borrow money. See *discount rate* (also called bank rate).

redline prints Blueprints with changes marked in red ink. At the completion of construction, the redline prints should be combined into as-built drawings.

redlining Commonly used to communicate an illegal practice of refusing to make loans or sell insurance in certain areas. In reality, the practice is common and is legal, but only if the disqualifying criteria do not include race, religion, gender, family status, disability, or ethnic origin, or some disguised criteria intended to discriminate on those grounds. Many insurance companies will not sell insurance in entire states viewed as being plaintiff-friendly with outrageous jury awards. This is a form of permissible redlining.

reentry (deeds) Sometimes called the power of termination, or the right of entry, it is the retained right of a grantor who conveys property subject to a condition to subsequently enter and retake the property when the condition has been broken. An example would be a deed to the city of particular land "on condition that it be used for a school and for no other purposes." If the city uses the property for something else, the land does not automatically go back to the grantor, but the grantor has the right to retake the property—the right of reentry—should the grantor choose to do so.

- Even if the grantee or subsequent purchasers mortgage the property, the grantor still has the right to reenter and regain the property free and clear of any liens or claims, including the mortgage.
- The right of reentry can be exercised only by the grantor and his or her heirs, but not by third parties such as creditors of the grantor.
- Some states hold that the right cannot be transferred to others by the grantor during his or her lifetime.
- Some states require the holder of a right of reentry to file a statement in the real estate records regarding that specific right, rather than simply rely on deed language as sufficient notice to the world.

reentry (leases) The right of a landlord to enter premises upon a breach and retake possession. Contrast with *reversion*, which is the right the landlord has in premises at the expiration of a lease.

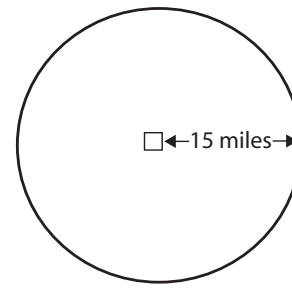
referral Recommending a particular broker to someone. Brokers may legally pay referral fees, but only to other brokers.

refi Shorthand for *refinance*.

refinance Obtain a new loan to pay off an older one.

reformation A legal action to correct an instrument to comply with the intentions of the parties. If the grantor in a deed will not agree to sign a corrective deed, it may be necessary for the buyer or a subsequent owner to file a reformation action.

regional shopping center In common language, a large shopping center that draws customers from outside the part of town where it is located. According to the International Council of Shopping Centers, it is one with general merchandise including a high percentage of fashion stores, with 400,000 to 800,000 square feet of space sitting on 40 to 100 acres and two or more anchor tenants taking up 50 to 70 percent of the available space. The typical market area is a radius of 5 to 15 miles, or approximately 80 to 700 square miles.



registered agent for service See *resident agent*.

registrar A person charged with maintaining official records, such as deeds and mortgages.

regression (1) A statistical technique for creating a mathematical equation to explain the relationship between known variables so that the model can be used to predict other variables when one

has insufficient data. Multiple regression analysis is the basis of computerized automatic valuation models (AVM) employed instead of appraisals by many mortgage lenders. (2) An appraisal principle that if properties of relatively unequal value are located near each other, the one with the lower value will depress the value of the other. (3) A withdrawal of the sea from the land due to an uplift of the land or a drop in sea level.

regressive taxation A tax burden that falls more heavily on those with low income. Contrast with *progressive tax* and *proportional tax*. Sales taxes are regressive taxes if imposed on all sales, because the straight percentage imposed on all sales takes away a higher percentage of a low-income household's available income. Some states attempt to lessen the regressive effect of sales taxes by exempting purchases of food and medicine. In the following table, the low-income household spends almost 5 percent of its disposable income on sales taxes, because all income after paying for housing must go to buy things that are taxable.

Comparison of Effects of Sales Taxes

	Low-Income Family	High-Income Family
Income	$15,000	$150,000
Housing costs	7,200	48,000
Taxable purchases	7,800	36,000
Sales taxes @ 9%	702	3,240
Percentage of income spent on sales taxes	4.68%	2.16%

Regulation D (Reg D) A Securities and Exchange Commission regulation that can apply to real estate investments that constitute a security. Reg D provides two types of limited offering exemptions from the registration requirements of federal securities laws, neither of which are dependent on the nature or sophistication of the purchaser. The first exemption is for offerings of up to $1 million and an unlimited number of purchasers; the other is for offerings of up to $5 million to a limited number of investors. It also allows exemptions for private offerings to accredited investors or to a small number of sophisticated investors. Even if an offering is exempt under Reg D, the company must still file a Form D with the SEC, providing the names and addresses of the company's owners and stock promoters. If investors are offered a Reg D investment, they should check with the SEC (publicinfo@sec.gov) to see if a form is on file; the lack of a Reg D form may be a warning of possible illegality in the investment. (These are important safe harbors to the real estate investor and developer because sales of interests in real estate–related businesses can constitute securities. The full text may be found at 17 CFR 230.504 through 506, retrievable at the U.S. Government Printing Office Web site at www.gpoaccess.gov/cfr/retrieve.html.)

Regulation CC ("Reg Double C") A federal banking regulation regarding the availability of funds and collection of checks, Reg CC sets limits for the length of time a financial institution may place a hold on the use of funds after a check has been deposited to an account. People commonly think

funds must be available immediately if checks are drawn on local financial institutions, but that is not true. Large checks, such as are often received for real estate transactions, may have a hold time as long as 7 days for local checks, except that the first $5,000 must be made available on the first business day.

Other than the deposits described in the following list, checks drawn on local institutions must be credited on the second business day after deposit, and checks drawn on nonlocal institutions must be credited on the fifth day after deposit. A local institution is one in the same check processing region. The financial institution may increase the hold times for large deposits or for any number of factors causing it reasonable concern. The deposits described in the following list must be made available for withdrawal on the first business day after deposit except that items 3 through 7 can be made available on the second day after being deposited if the deposit is to one of the financial institution's own ATM machines, or on the fifth day after deposit if made to any other ATM machine:

1. Electronic payments
2. U.S. Treasury Department checks
3. Cash
4. U.S. Postal Service money orders
5. Federal Reserve and Federal Home Loan Bank checks
6. State or local government checks
7. Cashier's, teller's, or certified checks
8. Checks drawn on an account at the same financial institution

Regulation Q A federal law having to do with interest on bank deposits. Today, it provides that banks cannot pay interest on demand deposit accounts—checking accounts.

Regulation Z A regulation issued by the Board of Governors of the Federal Reserve System in order to assist in implementation of the Truth in Lending Act. It requires certain disclosures regarding the cost of credit and rights of rescission (discussed at length under *rescind*). Additional disclosures must be made for *reverse mortgages*, discussed within that topic. The disclosure box appearing on all consumer promissory notes is called the Reg Z Box (see the diagram).

Annual Percentage Rate	**Finance Charge**	**Amount Financed**	**Total of Payments**
The cost of your credit at a yearly rate	The dollar amount the credit will cost you	The amount of credit provided to you or on your behalf	The amount you will have paid after you have made all payments as scheduled
A%	**$B**	**$C**	**$D**

Regulatory Information Service Center A centralized Web site (www.reginfo.gov) for research on all federal government regulations and deregulatory actions.

regulatory taking A legal theory that a particular government regulation has so adversely affected the value of real property as to amount to a condemnation of the property, for which the owner is entitled to compensation. There are two varieties: categorical and noncategorical takings. In order to establish a case of categorical taking, the Supreme Court has held that the property owner must show (1) that the land-use regulation does not substantially advance legitimate state interests, and (2) that it denies an owner all economically viable uses of his or her land. These are both heavy burdens to overcome. A noncategorical taking does not require elimination of all economically viable uses of property, but does require a case-by-case analysis of the regulation regarding its character and nature, the severity of its economic impact, and the degree of interference with the property owner's reasonable investment-backed expectations.

rehab Short for *rehabilitate*.

rehabilitate To restore a structure to good condition after deterioration.

rehabilitation tax credit Credits against income taxes for expenses associated with the renovation, restoration, or reconstruction of certain buildings. The credit is 10 percent of the expenses for buildings placed in service before 1936, and 20 percent for certified historic structures. For properties located in the GO-Zone (certain named states and counties suffering 2005 hurricane damage) the credit was increased to 13 and 26 percent, respectively, for expenses incurred after August 27, 2005, and before January 1, 2009.

Reilly's law of retail gravitation Proposed by William J. Reilly in 1931, it says that people in a larger city will travel farther to shop than people in a smaller city. Reilly created a formula for calculating the precise point of geographical equilibrium between two nearby trade areas—the point at which one-half of the population shops in either trade area. Its weakness is that it assumes no natural or human-made boundaries. Modern retail theory recognizes that populations will usually not cross boundaries—such as major highways, bridges, or even some streets—in order to shop on the other side, even if more convenient than perceived "local" choices.

reinvestment rate When analyzing the value of an income-producing property, it is the rate an investor is assumed to be able to earn on intermediate cash flows. The number is necessary for inclusion in the formula for the financial management rate of return.

> **Example:** *Ryan owns two rental houses. After payment of all expenses and debt service, Ryan has cash flows of $300 per month, which is a 15 percent return on his money. The internal rate-of-return analysis for these properties assumes that Ryan will take his entire $300 per month and reinvest that money in something else at the same 15 percent rate he is earning on the apartments. The formula assumes a reinvestment rate of 15 percent, which is highly unlikely. The financial management rate-of-return formula still assumes Ryan will reinvest the entire $300 per month, but allows the person doing the analysis to pick a reinvestment rate. If Ryan puts the $300 per month in a savings account earning 2.5 percent, then his reinvestment rate is 2.5 percent.*

REIS See *real estate information system*.

reissue rate A discount given by a title insurance company when the prior policy on the same property was from the same title company. In some markets, even competitor companies will offer a reissue rate if the property purchaser can provide a copy of the prior title policy, thus saving some work for the current company.

REIT See *real estate investment trust*.

related party transactions A business deal, transaction, or conveyance among parties that have a special relationship with each other, either through family ties, related corporations, or other possibilities. Related party transactions require certain regulatory disclosures in order to avoid the appearance (or the actuality) of wrongful insider conduct. In addition, the IRS disallows or limits tax benefits if the underlying transaction is between related parties, because of the possibility of manipulation.

relation back doctrine (1) The principle that something done today will be treated as if it were done earlier. A document held in escrow and then delivered later will be treated as if delivered when it was put into escrow. This is not because the escrowee is the agent of the person receiving delivery, but because of the doctrine of relation back. This is an important distinction when someone dies after escrow, but before delivery, because agencies are automatically terminated upon death. (2) Some jurisdictions follow a relation back doctrine regarding lawsuits, so that if the plaintiff sues the defendant on a breach of contract claim for some transaction between the parties (normally a 4- to 6-year statute of limitations) and the defendant has negligence claims against the plaintiff arising out of the same transaction (normally a 1- to 2-year statute of limitations), then the defendant may assert his or her claims even though the time limit may have otherwise expired.

release See *release of lien*.

release clause A mortgage clause that allows a partial release of some of the collateral when the borrower pays off a portion of the loan. Typically found in subdivision development mortgages, because the development lender must release its lien in order for the purchaser-homeowner to secure his or her own first mortgage financing.

release of lien A recordable document showing that a lender, judgment creditor, the IRS, or other secured creditor no longer claims a lien upon real property.

reliction A gradual withdrawal of waters, leaving dry land. Riparian owners (owners of land located beside a river or stream), and sometimes littoral owners (owners of land at the edges of lakes and ponds), have the right to any new land caused by reliction. Some states hold that a sudden reliction creating large quantities of land results in the land being owned by the state. See also *dereliction*.

Religious Land Use and Institutionalized Persons Act of 2000 Federal legislation that prohibits any government from imposing or implementing a land-use regulation in a manner that imposes a substantial burden on the religious exercise of a person, including a religious assembly or institution,

unless the government demonstrates that imposition of the burden on that person, assembly, or institution (1) is in furtherance of a compelling governmental interest and (2) is the least restrictive means of furthering that compelling governmental interest.

relinquished property The first property transferred in a 1031 exchange. The property received is called the replacement property.

relocation clause A lease clause that allows the landlord to move a tenant to another location within the building, usually to accommodate the entry of a new tenant requiring a large quantity of space or for the expansion of an existing tenant. Tenants requiring site-specific locations, such as retail tenants next to a particular anchor, or office tenants with ground-floor space needs, usually negotiate the deletion of a building's standard relocation clause. If the clause is present, landlords typically pay for all expenses of the move but may not pay for new stationery, change-of-address notifications, or business interruption unless these items are negotiated and included in the lease.

relocation exception An exception to the Housing and Urban Development (HUD) regulation denying FHA insurance to properties flipped in less than 90 days, and requiring additional documentation for properties purchased and then sold within 91 to 180 days after initial purchase. The exception is for properties purchased by an employer or relocation agency in connection with the transfer of an employee who needs to sell his or her home in order to relocate.

relocation network A group of independent real estate brokers that agree to cooperate and exchange information regarding potential customers moving into their various geographical areas.

relocation service: A company that assists with advice and possibly handling of the details of a move, usually to another city. Most commercial relocation services contract with employers in order to assist transferred employees. Services may include packing, moving, and unpacking services; purchase of the employee's old home; and assistance with finding a new home. Free services are provided by many specialty support groups.

remainder An estate in property that takes effect at the termination of a life estate. One may transfer property to another for their lifetime or for the lifetime of a third party. The named person who defines the duration of the life estate is called the measuring life. The person who has the life estate is called the life tenant. When the measuring life ends, even if the life tenant is still alive, the person who owns the remainder is entitled to the full possession and enjoyment of the property. The interests may be contingent remainders, vested remainders, or vested remainders subject to divestiture. The rules of construction are complicated.

> **Example:** *A clause in a will leaving property to an only child for life, and then the remainder to grandchildren alive at the time of the child's death, creates a contingent remainder in the grandchildren until they are born, and then vested remainders as they are born, but subject to divestiture if they die before their parent, the testator's child. One should seek legal counsel well versed in specialty real estate law if setting up or interpreting life estates and remainders.*

remaining balance See *outstanding balance*.

remaining economic life The number of years between the date of an appraisal and the date a property improvement will cease to have any economic value, even if it will still be structurally sound. A solidly built parking deck with short ceiling heights, narrow lanes, and tight turning radii might have a limited remaining economic life because most modern cars, particularly trucks and SUVs, cannot use the deck.

remaining term An amount of time left before a loan matures or before a lease expires.

remedial action plan (RAP) A plan required by the Environmental Protection Agency for cleanup of hazardous waste sites.

remediation The process of cleaning up environmentally contaminated sites. It may be active, which requires some human intervention, or it may be passive and accomplished through the normal processes of nature. It may be ex situ, in which contaminated material is removed, or in situ, which relies on cleaning mechanisms in place on the property. Processes can include mechanical, chemical, thermal, magnetic separation, manual separation, use of biologic agents, or flushing, to name a few.

REMF See *real estate mutual fund*.

REMIC See *real estate mortgage investment conduit*.

remodel To change the appearance or utility of a building.

rendering A drawing or painting showing a perspective view of a building, also called a rendition. Contrast with *elevation*, which shows only a two-dimensional view of one or more faces of a building.

> **Example:** *At their simplest levels, Figure A is a rendering and Figure B is the east elevation, both of the same house.*

Figure A

Figure B

rendition (1) A report generally required of businesses, listing their personal property subject to property taxes. The system relies on honest and accurate reporting, because personal property is not as easily discovered and valued as real property. Cheats may be discovered through the services of tax ferrets. (2) Another name for a rendering.

renegotiate An agreement to revise the terms of a contract. Promissory notes, mortgages, leases, and other contracts can typically be renegotiated if failure to do so will result in default and that default would be economically disadvantageous to the other party. This power to renegotiate is exemplified by the old saying referring to loans from small banks, "If you owe the bank $10,000, they own you. If you owe the bank $1,000,000, you own them." A debtor in bankruptcy can force renegotiation of onerous contract terms, such as a long-term lease at above-market rental rates.

renegotiated-rate mortgage (RRM) Sometimes called a rollover mortgage, it is a type of balloon mortgage. The interest remains fixed for some period of time, usually 3 to 5 years. At the end, the parties may renegotiate the interest rate and, if they come to an agreement, the lender will change the rate with a minimum of fees and expenses. If they do not agree, the borrower is free to move the loan, but may not choose to simply keep the existing loan and its terms in place.

renewal lease The lease term after tenants exercise their renewal option. See *renewal option* for more in-depth treatment.

renewal option A right that may be given to a tenant to continue in the leased space at the expiration of the current lease, on specified terms and conditions. A renewal is a new lease agreement. Contrast to an *extension*. The difference is important because

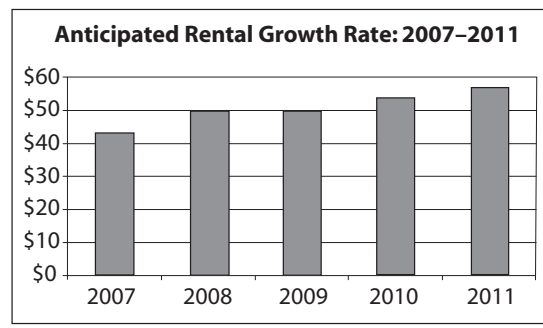
1. Oral agreements to extend a lease may be enforceable under the Statute of Frauds, but oral agreements to renew may be unenforceable unless there is some writing evidencing the agreement.
2. A previously agreed upon rental rate for a renewal would indicate adjustment of the base period for the tenant's share of operating expenses to the renewal year, while the same rental rate for an extension would indicate use of the original base year. If the tenant must pay a pro rata share of building operating expenses in excess of what they were in year 1 (first lease year) versus what they were in year 6 (first renewal year), it could amount to a significant amount of money each month.

renewal probability The average percentage of tenants in a building that are expected to renew at market rental rates at the expiration of their current leases. The figure is used to estimate leasing-related costs and downtime.

renovate To repair and upgrade, with a sense of changing something. Contrast with rehabilitate or restore, which imply keeping the same general character and appearance. Differences among the words are important when making modifications to historic structures, because renovation may not be allowed. A property owner's imprecise use of terminology regarding his or her plans could result in unintentional animosity by neighbors and historic preservation commissions.

rent Payment for the privilege of possessing space one does not own.

rental growth rate The expected trend in market rental rates over the period of projection, expressed as an annual percentage increase. In the chart, rents are expected to be at $43 a foot for 2007, climb rapidly to $50 a foot for 2008 because of a lack of new buildings coming online, remain at $50 a foot during 2009 because of the opening of new buildings, and then climb moderately afterward.



rental income Money collected from tenants for the use of space. On financial statements, money collected as late fees, from the use of laundry machines, or as forfeited deposits (unless credited to rent) should not be included in rental income but should be listed separately or under "miscellaneous income."

rental pool An arrangement in which condo owners or other such ownerships in a large community agree to make their units available for rental by a common leasing agent or property manager according to the good business judgment of that agent and then to all share in the overall revenues and expenses according to a predetermined formula. The arrangement may constitute a security under federal securities laws and require registration and appropriate disclosures.

rental rate The periodic charge per unit for the use of property. The rental rate may be a certain amount per square foot per year (even though paid monthly), per square foot per month, per room, per apartment, or any number of other variations.

rent concession See *concession*.

rent control Laws that regulate the rent that can be charged for space. Rent-control laws were originally enacted as emergency measures after World Wars I and II, because many returning service personnel emigrated to urban centers. This caused housing shortages and dramatic rent increases, with a resulting increase in evictions. Today, rent control is seen as a legitimate exercise of a government's police power and usually does not require an emergency situation. The state of New York differentiates between rent-controlled apartments and rent-stabilized apartments because of the dates of differing legislation. Rent-controlled apartments are still operating under laws enacted in 1947. They require that the tenant have continuously occupied the apartment since before July 1, 1971. As those apartments vacate, they become rent-stabilized under other legislation, or they become decontrolled under some circumstances.

rent escalation See *escalation clause*.

rent-free period A sometimes misleading term indicating a landlord concession regarding a period of time during which the tenant will not have to pay any rent. It is truly rent-free if the uncollected rent is not rolled into the back end of the lease or otherwise recaptured over the term of the tenancy. If the tenant must pay the rent, but simply at another time and in smaller increments, then it is more properly called deferred rent. Even landlords often misuse the two words, so persons shopping for space should specifically inquire about the free-rent versus deferred-rent issue when receiving quotes.

rent multiplier See *gross rent multiplier*.

rent roll A list of tenants, usually including the lease expiration date and rental rate for each one.

December Rent Roll: Fernwood Apartments

Tenant	Apartment	Lease Start	Lease End	Rent
Anderson, John	F	1/1/2005	12/31	$900
Chabannes, Norbert	A	6/1/2000	5/30	$1,000
Freeman, Larry	B	11/1/2005	10/31	$1,100
Lucas, Patricia	E	4/1/2003	3/31	$990
Malone, Paulette	C	6/1/2004	5/31	$1,050
Woodruff, Joseph	D	9/1/2006	8/31	$1,100

rent stabilization See *rent control*.

rent strike A group of tenants banding together and refusing to pay rent until necessary repairs have been made to a building. Typically, the rent is paid into an escrow account or into a court clerk's office in conjunction with a lawsuit against the landlord.

rent-up period The time it takes new properties to reach stabilized occupancy.

REO See *real estate owned*.

REOC See *real estate operating company*.

reorientation A change in direction or focus of a business in response to changing market conditions or in order to attract a different market.

repair and retreatment bond If available, an agreement by a pest control company that if a property has been treated and continuously protected by it against termites or other wood-destroying insects, but an infestation occurs and results in damage, the company will repair all damage and eradicate all such insects, at no charge to the property owner, with the possible exception of a deductible.

repairs Work to return a property to its former condition without extending its life. Repairs are fully deductible on the current year's tax returns.

replacement cost (1) In appraisal, the cost to erect a new building substantially similar to the current one. (2) In insurance, the cost to purchase a new item substantially similar to the one damaged, destroyed, or stolen. Contrast with *fair market value*.

replacement property A property received in a 1031 exchange. The first property given up is the relinquished property.

replacement reserve An amount of money set aside because building components or equipment will wear out in a relatively short time and need to be replaced. Replacement reserves can be a mere accounting entry as a phantom expense item reducing net operating income each month, or it can be money actually deposited into an account and earmarked for replacements. If the money

is set aside into a separate account, any contract for the purchase of that property or business should include a clause addressing who gets the money—the purchaser or seller. When purchasing a condo or co-op, or a home in a planned unit development, the buyer should make sure there are adequate cash replacement reserves for the future. If not, then repairs will not be made or they will be made only after assessments against all owners.

replacement value protection Insurance that will provide payments to replace insured goods, whatever that cost might be, rather than insurance in the amount of the current fair market value of the used goods. This could be important for personal property protection, but also for building insurance. Especially with historic homes built of high-quality durable materials with a great deal of hand-crafted and decorative detail, the replacement value could be far in excess of the fair market value.

replevin A type of lawsuit to recover personal property, such as when a landlord takes possession of leased property due to a default and refuses to return personal property located on the premises.

repo Slang for repossess.

reporting requirements IRS requirements that certain transactions or financial information be reported to it, even if there are no tax consequences. Settlement agents are required to report sales or exchanges of all real property, or a statement of exemption. If there is no settlement agent, the order of responsibility is attorney, title company, mortgage lenders, and real estate brokers. The IRS also requires reporting returns for partnerships, S-corporations, and limited liability companies, even though none of those entities has to pay taxes; instead, individual members report their share of income and losses.

repose, statute of See *statute of limitations*.

repossession The actions of a lender to take possession of personal property in which it has a security interest, or the actions of a landlord to take possession of leased premises after default. Repossession may be by court order, or it may be self-help, as when the automobile repo person takes a car in the dead of night. Self-help repossession is generally allowed unless prohibited by specific consumer protection statutes, but it must be accomplished without a breach of the peace. Some courts define "breach of the peace" as shouting, threats of violence, or any sort of public disturbance. Others hold that repossession in the face of the debtor's oral statements to cease and desist is a breach of the peace, but that does not preclude the creditor from returning later to attempt repossession when the debtor is not present.

reproduction cost The cost of exactly duplicating an improvement as of a certain date. Contrast with replacement cost. An example is an historic building with high coffered ceilings and deep solid-maple crown molding that has been converted to office space with a drop-in grid ceiling that hides the older details. The reproduction cost would include the cost to build a structure with the same high ceilings and the same crown molding. The replacement cost might be the cost to build a structure with normal 8-foot ceilings constructed of ceiling tiles.

repurchase agreement An agreement to buy something back from the purchaser. This is encountered most often in two situations: (1) The thing purchased turns out to be less valuable than originally thought, such as when someone buys a promissory note, or a partial interest in a promissory note, and the obligor then defaults. (2) Especially with condominium units in facilities specializing in elder care, the seller of the units will agree to buy them back at a preestablished price if the owner dies or becomes so disabled as to require nursing home or similar care.

request for proposal (RFP) Ideally, a tightly written list of requirements and specifications upon which contractors, vendors, or service providers are invited to place bids. The goal is to write the specifications in such a manner that bids can be compared equally, without making adjustments among them. For example, an RFP for floor covering might specify the exact maker and pattern name for a carpet, or it might specify a generic carpet of a certain weight, with or without a pattern, and with or without a pad of a specified thickness. It would include scale drawings of the space to be carpeted so that waste could be calculated, and it would include special instructions such as the need for installation to take place between certain dates or over a weekend.

request for qualifications In a public sector–private sector partnership for development or redevelopment of property, a call by the government entity in charge for submission of the qualifications of those interested in being involved in the partnership.

resale price In a projection regarding the performance of a real estate investment, it is the anticipated price the property will bring upon eventual sale at a point in time.

resale proceeds Upon the sale of real property, the money remaining after payment of expenses of the sale, any mortgage debt on the property, and sometimes after payment of income taxes. The term is imprecise and is usually defined in context. Under some programs administered by the Department of Housing and Urban Development, property owners who received assistance for their home purchase must reimburse HUD for some of the resale proceeds.

rescind To withdraw or undo. The act itself is called rescission. If a party has a right of rescission, the party may rescind a transaction. Important rescission rights include the following:

- Under the Truth-in-Lending Act, consumers may rescind a loan transaction if the lender failed to provide all required disclosures.
- Certain state laws give homeowners the right to rescind sales contracts for properties in danger of foreclosure.
- Most states still allow insurance companies to rescind policies if there was a fraud in the representations made to secure the policy.
- A contract may be rescinded if there was fraud in the inducement, meaning a fraud with the underlying transaction and not with the nature of the contract or document signed.
- Under the Truth-in-Lending Act, consumers refinancing their principal residence or taking out a home equity line of credit may, with certain exceptions, rescind the loan within 3 business days and not owe any interest or fees.

rescission See *rescind*.

Research Institute for Housing America A nonprofit organization (www.housingamerica.org) that is a division of the Mortgage Bankers Association. It provides research grants for projects regarding expanding rental opportunities and homeownership for the underserved.

reservation The retention of some right by the grantor in a deed. Grantors may reserve a life estate, the mineral interests, or a right-of-way across the property, for example. Reservations appear in the reddendum clause of a deed.

reserved water rights doctrine Holds that when the United States withdraws land from the public domain and reserves it for a private purpose, it also withdraws all water rights necessary to support the purpose, including the rights to groundwater if other waters are inadequate. This includes Indian lands and lands owned in the Territories before statehood. The U.S. may sell or assign those rights to others. The reservation allows the government (or persons to whom it sells those rights) to prevent upstream owners from taking water, even if otherwise allowed under state law. Assignees of federal reserved water rights enjoy greater protections and privileges than other citizens of the state. Whether or not there was a reservation is a question of federal law and must be determined in federal court.

reserve for bad debt An expense item on a profit and loss statement for the current period's pro rata share of anticipated annual credit losses due to unpaid bills or defaulting tenants.

reserve for credit and collections See *reserve for bad debt*.

reserve for losses An accounting entry made to set aside a fund for payment of possible future liabilities as a result of litigation or similar claims. If a tenant is injured after falling from a defective balcony at an apartment, that tenant might sue for damages. The apartment complex might have liability insurance, but there could be a very large deductible. If there is no doubt about the fall, no doubt about the landlord's liability, and the only issue is regarding the size of the check to the tenant, the landlord knows he or she will eventually have to pay up to the deductible limits for the injury. As a result, the landlord will probably set aside a reserve for losses in that amount.

reserve fund A physical fund with money for anticipated future needs. A reserve fund should appear on a company's or property's balance sheet as an actual bank account, earmarked for a particular use.

reserve price The price below which auctioned property will not be sold. If a property is advertised with reserve, then the owner may withdraw it from auction at any time before sale. If it is advertised without reserve, then the seller must go through with the auction.

reserves See *reserve fund*.

residence The place where one lives.

resident agent A name given in some states to the person authorized by law to accept service of process (lawsuits, for example) for a corporation or other artificial person. There are many commercial services that will provide this service for companies. Also called "registered agent for service."

residential Pertaining to housing. Many tax laws and consumer protection statutes turn on whether a property is residential or not.

residential broker A real estate broker who specializes in single-family homes. A broker who specializes in multifamily residential, such as apartments, is usually called a commercial broker.

Residential Communities Initiative A Department of Defense program to upgrade housing for military personnel by partnering with private industry for renovation, construction, and management.

residential development The preparation of land and infrastructure for dwelling places and may also include construction of the dwellings.

residential mortgage A loan secured by real property used for a personal residence or dwelling.

residential property (1) In real estate brokerage, commonly used to signify an owner-occupied residence, even though a rental house is technically a residential property. (2) For tax purposes, any rental property in which at least 80 percent of the income is from dwelling units. Residential property enjoys a 27.5-year depreciation period, while normal commercial property must be depreciated over 39 years.

Residential Sales Council See *Council of Residential Specialists*.

residential service contract An insurance policy that will cover repair or replacement of major home systems, such as plumbing, heating, air conditioning, or electrical. Either the buyer or seller can purchase the contract, although sellers usually do so as an incentive for a buyer to purchase that property rather than another.

resident manager A person who supervises an apartment complex or self-storage facility while living on the premises. The practice usually provides excellent management and early detection of problems, but can have some drawbacks, including the possible need to go through an eviction proceeding if the manager is fired or quits and refuses to leave the dwelling. In addition, there may be overtime pay issues if the manager is "on call" for emergencies outside normal business hours. From a psychological standpoint, some resident managers report burnout because, even during their off-hours, they are never truly free of the tenants and the need to interact with them.

residual (1) An amount remaining from an investment after payment of all operating expenses, debt service, reserve funds, and income taxes. The residual remains for payment to the investor. (2) The value of leased personal property at the end of the lease term. Under an operating lease, a lessee may be given the right to purchase the property for the previously agreed upon residual value. Car leases, copier leases, and heavy equipment leases all work on this principle.

residuary Everything not specifically mentioned in a will. After all named and described gifts have been made, whatever is left is in the residuary. If the will makes no provision for the residuary, that portion of the estate will pass by intestate succession.

Resolution Trust Corporation (RTC) A corporation that no longer exists, but had a major impact on U.S. real estate markets. The RTC was formed in the wake of the banking and thrift crisis and bailouts of the mid to late 1980s. As lending institutions were declared insolvent and closed by their various regulatory agencies, the Federal Deposit Insurance Corporation (FDIC) or the Federal Savings and Loan Insurance Corporation (FSLIC, pronounced "fizz-lick") arranged for payments to depositors and then took over the assets of the failed institutions. The assets could include performing and non-performing loans, real estate, vehicles, equipment, furniture, and often rare and expensive artwork and accessories. The task of managing and liquidating the assets proved too much, so the government created the RTC to take over those functions. The mandate of the RTC was to liquidate assets, including real estate, as quickly as possible, even if a higher price might be obtained by holding the assets and managing sales over a longer period of time. Billions of dollars of real estate came into the hands of the RTC. The real estate was then sold, often for pennies on the dollar, and as a result many real estate markets were seriously depressed and took years to recover.

Resource Conservation and Recovery Act (RCRA) (pronounced "rick-rah") A federal law that establishes a system for managing hazardous wastes in an environmentally sound manner from the point of origin to the point of final disposal, called cradle-to–the-grave management. It also promotes resource recovery and waste minimization. The Act gives citizens the right to file suit against violators to enforce its provisions, and the right to file suit against the Environmental Protection Agency administrator to require enforcement of the rules. More information is available at the EPA Web site at www.epa.gov.

RESPA See *Real Estate Settlement Procedures Act*.

respondeat superior One of the many methods of finding someone vicariously liable for the wrongful actions of another. It is the legal theory that an employer is responsible for the negligent or wrongful acts of its employees performed within the line and scope of their employment, and a principal is responsible for the negligent or wrongful acts of its agent performed within the line and scope of its agency. It is not a theory of contract law—meaning who has authority to bind whom—but rather a theory of tort law and injuries to persons or property. It is extremely rare to find a case in which a property owner has been held liable for the wrongful conduct of its broker. More often, brokers have been accountable for actions of their salespersons.

restatement of laws Works prepared by the American Law Institute (www.ali.org) in order to set out the law on various subjects with commentary regarding changes and anticipated growth. The Restatement of the Law of Agency, for example, is not itself law, but may become so when a court refers to a rule in the restatement and adopts that rule of conduct or interpretation within the state. Other restatements related to real estate include

- Restatement of the Law of Contracts
- Restatement of the Law of Property
- Restatement of the Law of Trusts

restore To return a structure to its original appearance, although the use of modern and updated materials may be employed.

restraining order See *temporary restraining order*.

restraint on alienation A restriction on the ability to transfer real property, such as a gift of land to a church or university with the requirement that it not be sold for 99 years. Restraints on alienation are generally disfavored by the law and will only be enforced if they are reasonable in scope and duration.

restricted appraisal report A report in which the information that forms the basis of the appraisal is not included within the document itself, but is available for reference should that prove necessary.

restriction A limitation on the use of property, usually contained in the deed, in restrictive covenants appearing in the real estate records, or by virtue of local ordinances.

restrictive covenant A deed restriction. See *covenant*.

resulting trust A trust that is implied by law as necessary to carry out the true intentions of the parties involved. It typically arises when one transfers legal title to another for various reasons, but both parties intended the grantor to retain all benefits from the property. If an elderly person transferred her home to a child as an estate planning tool, but continued to live in the residence, the law would not allow the child to sell the home and keep the proceeds. It would, instead, impose a resulting trust. Contrast with a *constructive trust*.

retail anthropology The study of consumers' shopping habits in order to choose the best locations for new retail sites and the best designs for the development itself and for the space within each store.

retail gravitation The ability of a shopping center to draw business away from other shopping areas. See also *Reilly's law of retail gravitation*.

retail installment contract A contract that provides compensation for consumer goods or services by making payments over time, usually at a high interest rate.

retail investor An individual investor who buys securities through a stockbroker on online service. Contrast with *institutional investor*.

retail property A zoning classification that allows stores or shopping centers.

retainage Money withheld and not paid until completion of a project and inspection of the goods or services provided. Typically, 10 percent of a construction contract price will be withheld until final inspection.

retaining wall A support to prevent collapse of earth embankments. Many local governments have landscaping requirements to disguise retaining walls over a certain height and restrictions on the materials that can be used for retaining walls.

retaliatory eviction A landlord's refusal to allow a tenant to remain after the tenant has made a good-faith complaint about the landlord, the property, or the landlord's manner of management. (This is illegal in many states.)

retention pond A human-made pond where storm water is directed and retained until it can be absorbed into the water table or slowly released without flooding downstream property owners. The modern trend is to prefer absorption into the natural water table, so many local governments impose retention pond requirements as a condition of development, even if storm sewer facilities are available. Many modern office park water features, such as small lakes with fountains, are government-required retention ponds.

retire (a debt) To pay off a loan.

retreatment bond An agreement by a pest control company that it will not charge to eradicate an infestation, usually by termites, if insects appear between regularly scheduled treatments.

retrospective appraisal The estimated value of property at some point in the past; may be necessary to value a gift.

return on equity See *equity dividend*.

return on investment (ROI) A generic term to define a number of analytical tools for measuring the financial benefits of an investment, including cash-on-cash, internal rate of return, equity dividend, and financial management rate of return.

revaluation or reevaluation See *reassessment*.

revaluation clause See *reappraisal lease*.

revaluation lease See *reappraisal lease*.

revenue The total rent, sales, or earnings of a company. When negotiating for the purchase of income-producing property, be sure to inquire about the seller's definition of revenue rather than make the assumption that the seller is using the correct terminology to describe figures supplied to you. Contrast with *income*.

revenue ruling Advice from the IRS national office regarding application of the law to a particular fact situation on which a taxpayer has requested guidance. Any taxpayer may rely on a revenue ruling as guidance for similar conduct, but courts are not bound by them if a court thinks the IRS was wrong. Contrast with *private letter rulings* (also called letter rulings) which issue from a local IRS office and which can be relied upon only by the taxpayer to whom the letter was addressed. Contrast also with a *technical advice memorandum* issued under different rules but still binding on the IRS only as regards one particular taxpayer.

revenue stamps Stamps affixed to deeds and some other real estate documents as evidence of payment of the appropriate recording or transfer taxes.

reverse annuity mortgage See *reverse mortgage*.

reverse exchange A tax-deferred exchange in which the taxpayer acquires the replacement property before selling the relinquished property. See *1031 exchange*. (It is far more common to sell a property and then begin looking for a replacement property to take advantage of Section 1031 of the Internal Revenue Code.)

reverse leverage A situation in which the interest rate on a mortgage is so high that one cannot obtain any financial benefits from a property because of the debt service.

reverse mortgage A financial tool that allows senior homeowners to withdraw money from the equity in their home in a lump sum, or in payments over time, in the form of a loan that is not payable until after the last spouse dies or the homeowners cease using the home full time. Because this is a loan transaction, federal truth-in-lending laws require certain disclosures to the homeowners before they enter into such a transaction. They include, among other things, the following:

- An itemization of the loan charges, appraised value of the home, and age of the youngest borrower.
- All advances to and for the benefit of the consumer, including annuity payments that the consumer will receive from an annuity that the consumer purchases as part of the reverse mortgage transaction.
- Any additional compensation to the lender, such as the right to share in the increase in value of the home.
- The assumed annual appreciation of the home at 0, 4, and 8 percent per year.
- The assumed loan period of 2 years, one based on the actuarial life expectancy of the home owner, and one based on the actuarial life expectancy times 1.4 (in case the homeowner beats the odds and lives longer than expected).
- All other normal disclosures required in any consumer lending transaction (see *Regulation Z*).

reverse radius clause In a shopping center lease, a clause that prevents the center owner from buying or building another one nearby and thus providing competition for the tenant's customers.

reverse redlining Another name for predatory lending. The lender does not refuse to do business inside the redlined area, but instead targets the residents for predatory lending practices.

reversion The interest retained by a grantor after transferring some of its interests but not all. A landlord transfers some of its interests when it executes a lease; the right retained is the reversion. Also called a reversionary interest. Contrast with *right of reentry*.

reversionary factor The mathematical factor that indicates the present worth of one dollar to be received in the future. It is the same as the *present value of one*.

reversionary interest See *reversion*.

reversionary value The value of property at the expiration of a certain time period.

reverter, possibility of The interest retained by a grantor after transferring a determinable fee (one that will automatically end on a specified event, such as "to Mary until her thirtieth birthday or marriage, whichever comes first) or an estate in fee simple conditional (available in only some states, it says that a gift to A "and the heirs of his body" retains a possibility of reverter in the grantor because A might never have any heirs of his body).

review appraiser Usually an employee of a lender or institutional purchaser, the review appraiser is responsible for checking the reports of fee appraisers to make sure they have been properly prepared and documented and do not seem out of line with the review appraiser's own estimate of property value.

revocation A cancellation of a power or authority, such as a power of attorney or an agency.

RevPAR (revenue per available room) A value used to compare investments in comparable hospitality facilities. It is the total room revenue for the period divided by the average number of available rooms.

rezoning To change the permitted uses of property within an area. If only one property is rezoned, it is called spot zoning. When property is rezoned, then all future owners can use it for any purpose allowed by the zoning classification. Contrast with *variance*, which allows one particular use not otherwise allowed by the zoning regulations.

RFP See *request for proposal*.

RFQ See *request for qualifications*.

Rho Epsilon At one time a national organization of real estate clubs for students at colleges and universities. Today, there is no longer a central headquarters or a coordinating entity, but there are many local Rho Epsilon real estate clubs at schools of higher education. See also *Alpha Sigma Gamma*, which is the national real estate honor society open to college seniors.

rider (1) An amendment or attachment to a contract. (2) Commonly used to indicate additional terms or coverages for standard insurance contracts.

right of contribution See *contribution*.

right of entry See *reentry (deeds)*.

right of first offer; right of first opportunity If specifically granted in the lease, the tenant's right to obtain additional space in the building or in the office park, or to buy the building if the landlord agrees. Unlike a right of first refusal, an offer from a third party is not required in order to trigger the right. The landlord may simply advise the tenant that space is available, or that the building is for sale, and solicit an offer. If the tenant does not make an offer, or if the offer is unacceptable, the right terminates as to that space.

right of first refusal The right to match a third-party's offer and purchase property if it is offered for sale. The owner has no obligation to sell to anyone, however. The term "right of first refusal" is

often used interchangeably with option, but an owner who grants an option is obligated to sell if the recipient of the option chooses to exercise it. Contrast *right of first offer*.

right of prospect See *views, right to*.

right of redemption The statutory right to redeem property either after it has been set for foreclosure or sometimes after the foreclosure itself. Postforeclosure redemption rights typically belong to the borrower, to any other persons with interests in the property, and to creditors of the borrower. It gives such persons the right to buy the property from the foreclosure purchaser, even if the purchaser was the lender, for the foreclosure price plus accrued interest at a statutorily set rate. The right of redemption may extend as long as one year in some states.

right of survivorship The right to enjoy full and undivided ownership of property after the death of another. It may apply to real property, or to personal property, including bank accounts. In real estate, the right is incidental to an estate called joint tenancy or sometimes joint tenancy with right of survivorship. The estate can be destroyed in most states if one of the joint owners, without the knowledge or consent of the others, conveys (transfers) his or her interest to someone else. The purchaser does not enjoy a right of survivorship with the other remaining joint tenants, but has only an undivided interest that will pass to his or her heirs upon death.

right-of-way (1) The right to use another's land for ingress or egress, which is a type of easement. (2) Either deeded rights or easement rights in the government for public roads, streets, and highways. Government rights-of-way may extend for many feet outside the paved boundary or even beyond the shoulder of the road. Typical rights-of-way are measured from 30 to 50 feet from the centerline of the road and may be larger if the government secured enough land for future road widening. (Before building, excavating, or even planting trees along the side of a road, one should check with the local road department for right-of-way measurements.)

Right to Financial Privacy Act Guarantees that a bank customer will be given notice and an opportunity to object before bank records will be revealed to the government. There are some exceptions for things such as drug trafficking. (Do not confuse with the Financial Privacy Rules of the Financial Modernization Act of 1999, which protects disclosure of information to nongovernment entities, such as other companies wishing to sell goods and services to the bank customer.)

riparian owner One who owns land along a river, stream, or other watercourse. Contrast with *littoral owner*. Often, riparian is used to signify all things having to do with water, rather than in its technically accurate sense. As a result, care should be taken to read in context when the word is encountered.

riparian rights Rights pertaining to the use of water in, on, near, or flowing over land. The most common rights are the right to a reasonable use of the water, the right to use the shoreline and have access to the water, the right to any land formed by accretion or relication, the right to have the water flow to the land without obstruction, the limited right to build piers in the water, and the right to catch fish, although the land owner does not own the fish. Although the word "riparian" typically

applies to rivers and streams but not lakes, the expression "riparian rights" generally means to imply any rights having to do with water, including surface runoff.

risk Uncertainty regarding the possibility of loss.

risk of loss Responsibility for damage to improvements, typically after signing a contract for sale and before closing takes place. States that have adopted the Uniform Vendor and Purchaser Risk Act place the risk of loss on the seller. As a result, if the property is damaged before closing, the buyer may cancel the contract, recover all sums paid, and not have any liability, provided the buyer has not taken possession. Contracts may, of course, vary the terms of the uniform law, and not all states have adopted it.

risk-free rate An interest rate on the safest investments, which would generally be short-term federal government obligations or savings accounts in amounts less than the FDIC insurance limits.

risk management A systematic approach to identifying insurable and noninsurable risks, evaluating the risk of loss versus the cost of insurance, and minimizing the possibility of loss through well-planned and regularly followed systems and procedures. Especially in construction, which typically has the very highest premiums for workers' compensation insurance, well-planned and well-executed risk management programs can result in significant savings on premiums.

risk-based capital requirement Evaluation of the capital adequacy of a financial institution according to the amount of risk attached to each type. One dollar in cash is much less risky than an unsecured promissory note for $1 from a con artist. Everything in between is a matter of degree. That is the premise that forms the basis of risk-based capital requirements. The Board of Governors of the Federal Reserve System sets the requirements for American financial institutions. This impacts the sizes and types of real estate loans financial institutions are willing to make. Internationally, the Basel II Accord provides guidelines for measuring risk when evaluating capital.

risk versus reward A financial analysis comparing the potential gains from a project or property against the potential losses. The greater the risk, the greater the reward should be.

Robert's Rules of Order Rules for the conduct of meetings in an orderly manner. First used in 1876 by American army officer Henry Martyn Robert, who was asked to preside over a church meeting and discovered that neither he, nor anyone else, knew a proper or consistent way to conduct meetings. Today, almost all organizations, including those for condominiums, co-op apartments, homeowners groups, and others, adopt Robert's Rules of Order in their bylaws. (The official Web site at www.robertsrules.com warns that the earliest editions of the Rules are no longer copyright protected, and so may be found in reprint, masquerading as current editions.)

rod A linear unit of measurement equal to $16^1/_2$ feet.

rollback A retroactive claim for a higher ad valorem (property tax) rate when property is sold or put to a higher use than the one for which it was assessed. The rollback period can be as great as 10 prior years of recalculated taxes.

Example: *Farmer Brown owns 100 acres of land at the corner of a busy road used by almost all commuters in the area. The land is worth at least $200,000 an acre, but because of state law favorable to agricultural uses, it is appraised for tax purposes at only $10,000 an acre. Farmer Brown sells the land to Doris Developer, who is surprised when the real estate tax bill comes due a few months later and there is a rollback for 5 years. Doris will owe 5 years of prior real estate taxes calculated on an appraised value of $200,000 per acre. In all likelihood, Farmer Brown had an innocent-sounding clause in his sales contract that said, "The parties will prorate real estate taxes as of the date of closing, except that seller shall not be responsible for any increase in taxes as a result of the sale." Without the clause, if they had simply agreed to pro-rate taxes (as most form contracts provide), then Farmer Brown might have to reimburse Doris Developer for over four years, worth of the taxes.*

rollover home sale An older income tax concept referring to the ability of homeowners to defer payment of taxes on the sale of their principal residence if the money were rolled over into a new residence. Today, taxpayers may exclude from income up to $250,000 of gain ($500,000 for married persons) on the sale of a principal residence, with no necessity that they buy another one.

rollover loan (1) A construction loan that automatically converts to permanent financing upon completion of construction. (2) A loan from a person's own retirement plan that continues into a new retirement plan if one changes jobs. (3) Short-term loans (as short as 14 days) that automatically renew if not paid, but incur substantial fees in connection with the renewal. The most common type is the payday advance loan.

rollover risk The risk that a tenant will not renew the lease.

roof rights; roof rental A lease of space on building rooftops for satellite dishes or other telecommunications equipment. It can be a significant source of additional income, which is why building tenants are now finding it difficult to include roof rights within their space lease at no additional charge.

root deed The first undisputably error-free, claim-free conveyance in a chain of title. In many jurisdictions, it is the first deed (the patent) out of the government into a private owner. Other states have statutes that cure any title defects that are older than a certain number of years. In such states, the root deed is the first deed older than the cutoff period.

row house See *town house*.

royalty Compensation for the use of property, usually copyrighted material or minerals, including oil and gas. Payment is generally calculated as a percentage of receipts and may be paid in cash or in kind.

RRM See *renegotiated-rate mortgage*.

rule against perpetuities See *perpetuity*.

rule in Shelley's case An ancient rule of law designed to plug a loophole used in the fourteenth century to avoid paying the historic equivalent of estate taxes. The rule involved a transfer of land to A for life and then to A's heirs. Worded in that way, A's heirs did not take by inheritance; they took

by virtue of the original deed. As a result, no inheritance tax was due. This is common estate planning stuff today, but it was fairly revolutionary in the 1300s in England. The word "heirs" could not be defined until A died, so no one had any real rights in the property until A died. As a result, A could do whatever he or she wanted with the property and no one could complain. The rule in Shelley's case said that, in such an instance, the transfer to A for life was really completely to A, not just for his or her life. A had all rights to the property, and there were no remainder interests. When A died, the heirs had to pay the inheritance tax. Virtually all states have abolished the rule in Shelley's case. Some have abolished its application in all instruments, some only in wills, and some only in deeds. An understanding of the rule in Shelley's case is the hallmark of one knowledgeable about obscure points of real estate law.

rule of 5 A rule of thumb used by subdividers to estimate development costs. Generally, one-fifth goes to land acquisition; one-fifth to site improvement, engineering, and legal; one-fifth to miscellaneous charges such as loan interest; and two-fifths to advertising, administration, commissions, and profit.

rule of 72s A quick calculation of the approximate time it would take money to double when earning compound interest. Divide 72 by the interest rate to obtain the approximate answer.

Example:

Time Needed for an Investment to Double at Various Interest Rates

Interest rate	**4.5%**	**6%**	**7.5%**	**9%**
Math	72/4.5	72/6	72/7.5	72/9
Approximate years to double	16	12	9.6	8
Actual years to double	15.5	11.5	9.25	7.75

rule of 78s A method for computing the refund due when a borrower wants to pay off an add-on interest loan at an earlier time than the maturity date. The reason there would be any refund at all is because all the interest is calculated up front, for the entire loan, and then paid in equal monthly installments. If the loan is repaid early, some portion of the interest has not been earned, but it has already been paid. Use of the rule of 78s results in the lender "earning" more of the interest than one might otherwise think. To calculate, you need to use a fraction that changes every month. For the first month, the numerator (top number) is the number of months remaining in the loan. The denominator (bottom number) is the sum of the digits for the number of months of the original loan. If the loan is for 1 year, then you add $1 + 2 + 3 + 4 + \ldots + 11 + 12 = 78$. For the first month, with 12 months remaining in the loan, the fraction is $^{12}/_{78}$. According to the method, $^{12}/_{78}$ of the interest has been earned in the first month, or 15.38 percent. You might think that only $^{1}/_{12}$ of the interest—8.33 percent—has been earned, since only one month has passed, but that's the way the rule of 78s works—to the lender's advantage. The next month, you change the numerator by adding the number of remaining months (11) to last month's numerator of 12. The numerator is then $11 + 12 = 23$, so $^{23}/_{78}$ of the interest has been earned, or 29.48 percent. For month 3, the numerator is $10 + 23$, and so on.

Example: *Danielle buys a used car for $6,000 and finances it with the dealer for one year at 18 percent interest. The dealer adds $6,000, plus the $1,080 for one year's interest, to arrive at $7,080. Then the dealer divides that number by 12 to arrive at Danielle's monthly payment of $590. Of that number, $90 is the add-on interest. The following table shows what Danielle's interest refund would be if she paid off the loan in full in each of the following months after buying the car. (The rule of 78s is a common term used with car loans; it is rarely used with real estate loans.)*

Month	Months Remaining	Interest Paid	% of Interest Earned	$ of Interest Earned	Refund
1	12	$90	12/78	$13.85	$76.15
2	11	90	23/78	26.53	63.47
3	10	90	33/78	38.08	51.92
4	9	90	42/78	48.47	41.53
5	8	90	50/78	57.60	32.40
6	7	90	57/78	65.77	24.23
7	6	90	63/78	72.70	17.30
8	5	90	68/78	78.46	11.54
9	4	90	72/78	83.07	6.93
10	3	90	75/78	86.54	3.46
11	2	90	77/78	88.85	1.15
12	1	90	78/78	90.00	0

run with the land Passes with the transfer of the land. Covenants and easements run with the land. They are binding on the land—and through the land, binding on the owners. This is true even if subsequent owners do not agree or have no knowledge of the easement or covenant.

rural Concerning the country. Contrast with *urban* or *suburban*.

rurban areas A term coined in the early 1970s by French philosopher Henri Lefebvre; meant to describe areas that combined intensive agricultural uses with suburban living sites and some industrialization. In much of the world except the United States, it is used generally to describe areas that derive economic benefit from the nearby city, but which maintain the ability for people to grow foodstuffs on their own land for personal consumption and minor amounts of sales in the city. In the United States, it is meant to be synonymous with exurban—another component of suburban sprawl, being estate-sized lots usually with ancillary country clubs, located past the suburbs and before the country.

R-value A measure of the heat conductivity of material. The higher the R-value, the better the insulating qualities. The Federal Trade Commission, in something called the R-Value Rule, requires certain disclosures regarding insulation. Among other things, new home sellers must put the following in every sales contract: the type, thickness, and R-value of the insulation that will be installed in each

part of the house. Failure to make the required disclosures amounts to a deceptive trade practice and is punishable by fines. For full text of the rule, see 16 CFR 460 available at the Government Printing Office Web site at www.gpo.gov.

R-Value Rule Also called "insulation disclosure." See *R-value*.

R/W See *right-of-way*.

Rylands v. Fletcher A very famous case that should be known and understood by all real estate developers. It was the precursor of the doctrine that a property owner is strictly liable for all damages caused by abnormally dangerous things and activities on his or her land, without any need to show negligence, contractual responsibility, or any neglect or omission at all. In this 1865 English case, Rylands was building a pond to supply water for his mill. During excavation, his engineers discovered five abandoned and filled mine shafts in the bed of the pond site. They seemed unimportant. Upon completion of the pond, the shafts started filling in with water. Shortly afterward the water burst through the abandoned shafts and traveled underground until it flooded Fletcher's mines. Fletcher sued, but Rylands defended by saying he had done nothing wrong, that it was a freak accident, and, anyway, it was all the engineers' fault for not investigating further. The court held Rylands liable, stating that if one brings upon his land something that will cause injury if it escapes, then he is strictly liable for the consequences if it does escape.

S

safe harbor A system of rules that, if followed exactly, will provide protection from the effects of other laws. For example, in a 1031 like-kind exchange, the use of a qualified intermediary and compliance with strict IRS deadlines will result in the ability to avoid paying taxes at the time of a sale. This is the safe harbor from normal tax liability rules. There are other ways to complete a like-kind exchange without paying taxes, but the seller embarks upon those uncharted waters at its own peril. A very slight miscalculation could result in the imposition of large taxes, penalties, and interest at a later date.

safe rate The interest rate obtainable from relatively risk-free investments, such as U.S. Government Treasury Bonds.

sale leaseback The simultaneous purchase of a piece of property and the lease of the same property back to the former owner. This practice is common with professional associations, such as doctors and lawyers, who wish for a core group of senior partners to own the real estate despite the entrance and exit of other partners in the business. Other times, banks or other owners with long-term plans will sell their property to investor groups and sign long-term leases.

sale pending A term used by real estate brokers to indicate that a contract has been signed but not yet proceeded to closing.

sales associate A licensed real estate agent who works under the supervision of a qualifying or managing broker.

sales commission amounts Typically a percentage of the gross sales price of the property, although some brokers are now offering flat-fee commission structures for minimal services, with add-on fees for additional services selected from a menu of items. It is illegal for any organization or group to establish a standard commission rate, because that would amount to price-fixing. Individual brokers may decline to accept any listing for less than a certain minimum commission level or percentage, though. The average commission for a home sale is in the range of 4 to 7 percent, except that a more difficult property might require a commission as high as 10 percent in order to interest a broker. Commercial, industrial, and farm and land properties typically have higher commissions, but there may be complex formulas for calculating them, rather than a simple percentage of the sale price.

sales comparison approach See *market comparison approach*.

sales contract See *agreement of sale*.

sales kit A package of materials about a listed property and the area in which it is situated.

salesperson See *sales associate*.

sales price The contractually agreed upon price for real estate.

Sallie Mae Popular name for Student Loan Marketing Association. This organization has nothing to do with real estate, but it is defined here because there is sometimes confusion with all the other "Maes" that are related to real estate finance—Fannie Mae, Ginnie Mae, Maggie Mae, and Munie Mae.

S&L See *savings and loan association*.

salvage value The estimated value a property will have at the end of its useful life. (1) It is an important consideration when demolishing a structure in order to build a new one. Especially with older buildings, architectural components such as molding, trim, doors and hardware, windows, and even antique brick can command a very high price. (2) It was important at one time for income tax depreciation, but there is now a different system in place, the modified cost recovery system, which does not rely upon establishing a salvage value.

sandwich lease The lease that exists between a tenant and subtenant when one subleases space.

SARA See *Superfund Amendments and Reauthorization Act*.

Sarbanes-Oxley Act of 2002 (SOX) Also known as the Public Company Accounting Reform and Investor Protection Act of 2002. This Act is a federal law that was passed in response to the major accounting scandals and resulting corporate crashes in the beginning years of the twenty-first century. The law imposes enhanced accounting and disclosure standards on public companies, including REITs. In particular, the balance-sheet treatment of real estate values to reflect economic obsolescence, potential contamination, and short-term lease expirations with key tenants are critical issues. It has an indirect impact on private companies because many insurers and lenders are imposing the same requirements on all customers. Further, an exit strategy that depends on selling real estate assets to public companies will need to implement SOX-compliant controls early to facilitate due diligence and obtain the highest price.

satellite city A self-supporting city planned within the natural growth pattern of another major city. It is intended to stop urban sprawl, supply an alternate mini central business district, and provide high-speed (preferably mass-transit) access between the major city and its satellites.

satellite tenant Any tenant except the anchor tenants in a shopping center; usually a national or local tenant occupying smaller space.

satisfaction of mortgage The process of making a notation in the public records that a mortgage debt has been paid in full and is no longer a lien upon the described real estate. When paying off a loan, one should make sure the lender records the satisfaction information. Failure to do so could

result in later title problems for the owner as he or she attempts to hurriedly obtain the satisfaction in time for a closing. It can also subject the lender to a cause of action for slander of title.

satisfaction piece The instrument that provides notice of the satisfaction of a mortgage.

save-harmless clause See *hold-harmless clause* or *indemnity clause*.

savings and loan association A financial institution that specializes in consumer deposits and residential mortgages.

savings bank Originally organized under individual state supervision as a vehicle for cash workers to deposit their earnings. The industry remained small until the mid–1980s, when savings banks became a federally chartered alternative to the savings and loan associations, whose insurance fund was bankrupt. Savings banks could be protected under the Bank Insurance Fund of the FDIC.

SBA See *Small Business Administration*.

scale The relationship between measurements on a plan or map and the dimensions of the physical object represented. One inch might represent 10 feet or 10 miles. Topographic maps contain two scales, one for distance and one for change in elevation.

scenic easement A voluntary, but permanent and legally enforceable restriction on the use of land that maintains it in a more-or-less natural state. See *easement*.

schematics (1) Preliminary drawings prepared in order to obtain regulatory approval of plans for construction or development. They lack the details necessary to actually build the project because the project may not go forward at all, or because the details may change dramatically after regulatory approval is conditioned on certain changes. (2) Final electrical plans showing locations and types of all fixtures, switches, outlets, junction boxes, and load centers, together with labeling of circuits and identification of elements on each circuit.

scienter Knowledge regarding the wrongful nature of an act. Some criminal or civil penalty statutes require scienter, and some do not. For example, the shareholders of a small corporation are liable for the 100 percent IRS penalty if the treasurer fails to pay over employee withholding taxes, whether or not the shareholders knew of the practice. One may be liable for discriminatory housing advertising, without a showing of scienter, if ads show all-white human models and target advertising media not likely to be viewed by nonwhites.

scire facias sur mortgage Foreclosure. In some states, foreclosure proceedings are started by a judicial writ (scire facias) requiring the debtor to appear in court and show cause why there should not be proceedings upon the mortgage (sur mortgage). See *judicial foreclosure*.

scope of appraisal An explanation of the work done to complete an appraisal, including physical inspection of the site and comparable properties, industry research for standard ratios, operating incomes and expenses, and other such matters.

scope of authority The boundaries of an agent's ability to take actions in furtherance of the objectives of the agent's principal, or client. Those same boundaries will also impose liability on the principal if the agent does something wrongful, without knowledge or approval by the principal, but within the scope of the agent's authority. (1) In most states, a purchaser of real estate must take steps to determine the scope of the agent's authority to bind its client-seller; otherwise the purchaser deals with the agent at its own peril. (2) The owner of real estate may be liable if its sales or leasing agent engages in discriminatory or other wrongful conduct that is within the scope of the agent's authority. (3) The owner of real estate may be liable if the agent fails to disclose unsafe conditions known to the seller and the agent, but concealed by the agent from the buyer.

scope of employment The actions taken by an employee in furtherance of the employer's business objectives or the employee's job description. Wrongful conduct within the scope of employment will subject the employer to liability, even if it had no knowledge of the wrong and had specific rules prohibiting such behavior.

> **Example:** *A receptionist who places minority callers on "hold" for long periods of time before transferring them to an apartment leasing agent, but who transfers white callers immediately, is engaging in discriminatory behavior that is within the scope of his or her employment as a receptionist. Answering calls and making decisions to transfer those calls is within the scope of employment. How people make decisions within the scope of their employment can result in liability to the employer. If, in this example, the receptionist shot and killed a minority applicant entering the reception area, that would not be within the scope of employment for a receptionist, although it might be for a security guard.*

scope of work Under the July 1, 2006, changes to the Uniform Standards of Professional Appraisal Practice (USPAP), the phrase means the type and extent of research work an appraiser performs to develop the results for an assignment. Under prior requirements, all clients had to be provided with a complete appraisal unless the client signed off and approved a limited appraisal noting specific departure rules. Today, the new Scope of Work Rule allows the appraiser to choose the analytical methods necessary to meet the client's objectives, but the client does not have to approve the methodology.

Scope of Work Rule A July 2006 amendment to the Uniform Standards of Professional Appraisal Practice (USPAP) which changed the emphasis of rules already in place and removed some technical requirements formerly necessary for appraisals. The Rule provides that for each appraisal, appraisal review, and appraisal consulting assignment, an appraiser must

- Identify the problem to be solved
- Determine and perform the scope of work necessary to develop credible assignment results
- Disclose the scope of work in the report

S-corporation See *subchapter S-corporation*.

scrape A slang expression for a property with improvements that should be bulldozed because they detract from the value of the land. Example: "That old shopping center is a scrape."

scrivener One who drafts a document. Under the "doctrine of scrivener's error," parties may correct a deed, mortgage, or other instrument by the use of oral evidence that the draftsperson made a mistake and did not express the intention of the parties. By virtue of the parol evidence rule, such testimony would ordinarily not be allowed.

seal (1) An embossed impression created by a metal die pressed upon paper. A notary public seal, a corporate seal, or a government agency seal are all proof that the signature of that person is genuine and authorized, because they would not otherwise have access to the embosser to create the seal. (2) Originally, an impression made in wax upon a contract. It took the place of reciting consideration, having a signature, or having witnesses for the contract. Today, some statutes allow certain symbols, such as the initials "l.s." to take the place of a seal, transforming a standard contract into one "under seal." Where still recognized, contracts under seal may have a longer statute of limitations than others.

seasoned loan A loan that has been paid on time for a sufficient amount of time to give a lender the reasonable belief that it will continue in a like manner.

SEA street A road that uses street edge alternatives.

SEC See *Securities and Exchange Commission*.

secondary easement A voluntary but legally enforceable restriction on land that is necessary in order to assist in the rights granted under another easement. This is typically encountered in the context of one's ability to enter on the land of another to maintain a right-of-way easement. It is sometimes difficult to repave a road while remaining only on the road—the easement—so a secondary easement is necessary.

secondary financing See *junior lien* or mortgage.

secondary market A general description for the sale and purchase of financial instruments. The New York Stock Exchange is a secondary market for shares of stock. Although there is not a similar central exchange vehicle, trading in existing mortgages is also called the secondary market.

secondary mortgage market The market for the purchase and sale of existing mortgage loans as long-term investments. Fannie Mae purchases many mortgages, as do other private investment groups. See *collateralized mortgage backed securities, REMIC, Fannie Mae*, and *collateralized mortgage obligation*.

second bite of the apple A second chance at an argument or negotiation previously lost. The law typically frowns upon second bites of the apple and does not allow them. For example, in a dispute over the breach of a real estate sales contract, the unhappy purchaser may not sue for damages, lose, and then file another lawsuit for specific performance to enforce the terms of the contract.

second-generation space A term typically applied to office space that has had a prior tenant and so has some improvements that are reusable by a subsequent tenant, such as some walls, doors,

ceiling treatments, and light fixtures. Contrast with first-generation space, which has never been customized for a tenant and consists of wide-open space with support columns, concrete flooring, and the concrete bottom of the floor above.

second home A residence that is not one's principal residence. The IRS allows mortgage interest deductions for up to two residences.

second mortgage A mortgage (or deed of trust) that is placed on property after another mortgage. Typically, the first mortgage provides security for the loan used to finance the bulk of the purchase price. The second mortgage could be seller financing for some portion of the purchase price, a home equity line of credit, construction cost overruns, or any other reason. In a foreclosure, no money can be paid to the second mortgage holder until all principal, interest, and expenses of the first mortgage have been paid in full. This results in a greater risk that the second mortgage lender might not receive payment of its debt, so it usually charges a higher interest rate than the first.

secret profit The practice of real estate agents making money on the sale of their client's real estate above the amount paid as a commission. This typically occurs when an agent recommends a sale to a friend, relative, or a corporation in which the agent owns an interest, and then the agent profits on a resale or development of the property. Secret profits violate the fiduciary responsibilities owed to the client, making the agent liable for punitive damages, payment of the profit to the client, and possible loss of the agent's real estate license.

section (federal code) A particularly numbered subpart of some federal law. The text of any federal law may be found by going to the Office of the Law Revision Counsel at uscode.house.gov and clicking on "Search the U.S. Code." Laws written as, for example, "26 U.S.C. Section 121," "26 U.S.C. §121," or sometimes "U.S.C.A." or "U.S.C.S." consist of a "title" (26 in the example) and a "section" (121 in the example). Entering the appropriate title and section will bring up the text of the law. See also *U.S.C.*

section (of land) A section is a specific area of land measuring 1 square mile. See *public land survey system*.

Section 8 housing Low- and moderate-income housing subsidized by the federal Department of Housing and Urban Development. There are two primary methods of subsidy: (1) Tenant-based subsidies consist of rental vouchers and rental certificates that are portable—the tenant can use them for any approved rental housing offered by landlords willing to participate in the programs. The program certificates may also be used to assist with mortgage payments under current rules. (2) Project-based subsidies consist of housing complexes that offer reduced rental rates to qualifying applicants, usually as a condition of the developer receiving tax credits, low-interest-rate loans, and high loan-to-value ratios for mortgage lending.

Section 121 (26 U.S.C. §121) The Internal Revenue Code section that addresses taxable income upon the sale of a principal residence. An unmarried individual may exclude up to $250,000 of gain from income; married persons filing joint returns may exclude up to $500,000 of gain. The taxpayer

must have owned and occupied the property for at least 2 of the prior 5 years and this exclusion can be used as frequently as every 2 years. For many Americans, this ability to buy a home, fix it up, sell it in 2 years for a large profit, and then do it all over again is their primary investment vehicle and "savings account." As a result, statistics regarding the low level of savings in the United States are somewhat misleading. To find the law's text, see the instructions at *Section (federal code)*.

Section 167 (26 U.S.C. §167) The Internal Revenue Code section that addresses depreciation deductions. To find the law's text, see the instructions at *Section (federal code)*.

Section 1031 (26 U.S.C. §1031) The Internal Revenue Code section that addresses tax-deferred exchanges, also called like-kind exchanges. See *1031 exchange*. To find the law's text, see the instructions at *Section (federal code)*.

Section 1221 (26 U.S.C. §1221) The Internal Revenue Code section that defines a capital asset by explanation of things that are not capital assets. To find the law's text, see the instructions at *Section (federal code)*.

Section 1223 (26 U.S.C. §1223) The Internal Revenue Code section that defines the various holding periods for property, important in determining tax benefits. To find the law's text, see the instructions at *Section (federal code)*.

Section 1245 (26 U.S.C. §1245) The Internal Revenue Code section that establishes rules regarding gains and losses on certain depreciable property, including real property. It is important because it contains definitions for something called "Section 1245 property." This, in turn, is important in other tax laws defining benefits available for Section 1245 property. To find the law's text, see the instructions at *Section (federal code)*.

Section 1245 property Under IRS statutes and regulations, depreciable real and personal property.

sector theory A land-use theory that says development tends to grow along transportation corridors outward from the city, forming wedge-shaped areas that follow the path of least resistance and most economy.

Securities and Exchange Commission (SEC) A federal agency charged with the supervision of publicly traded securities and the protection of the public from fraud, manipulation, and other abuses. Real estate may constitute the primary or most important assets of many publicly traded companies such as REITs. In addition, the direct sale of interests in real estate may qualify as a sale of a security and subject one to SEC registration and oversight. As a general matter, certain persons must register with the SEC and certain investment vehicles must be registered with the SEC. On any given transaction, one or the other may be exempt but not both. The SEC has four divisions:

1. Division of Corporation Finance, which oversees disclosure of important information to the public
2. Division of Market Regulations, which regulates the participants in the securities markets, such as broker-dealers and stock exchanges

3. Division of Investment Management, which regulates the $15 trillion investment management industry, including mutual funds.
4. Division of Enforcement, which investigates possible violations of securities laws, conducts civil enforcement actions, and works closely with law enforcement when it appears there has been criminal activity

securitization The process of taking many individual assets and combining them into a group, or pool, so that investors may buy interests in the pool rather than in the individual assets. The creation of collateralized mortgage backed securities is one example. The process increases the number of possible investors due to the ability to sell shares in the pool at relatively modest prices. In addition, because of the high degree of predictability inherent in large groups of things, the process of securitization increases predictability, lowers risk, and therefore increases value.

> **Example:** *On a single flip of a coin, how much would you bet that the coin would land heads up? On 20,000 flips of a coin, how much would you bet that it would land heads up fifty percent of the time, give or take two percent? This is a fundamental concept of securitization.*

security (1) Property that serves as collateral for a debt, such that defaulting on the debt will result in the creditor seizing and selling the property. (2) Under what has come to be known as "the modified Howey rule," an investment contract or other instrument commonly known as a security is defined as "an investment in a common venture premised on a reasonable expectation of profit to be derived from the entrepreneurial or managerial efforts of others." This definition includes many real estate investments that, if not specifically exempted under some provision of federal law, are susceptible to SEC regulation and oversight for the investment itself, the persons marketing the investment, or both. The Howey rule arose out of a Supreme Court case interpreting sales of interests in an orange grove in Florida—a real estate sale arrangement held to be a security.

security agreement A contract that grants a creditor a lien in personal property belonging to the debtor. Every state has passed some version of the Uniform Commercial Code, Article Nine, which addresses security agreements and their consequences. A mortgage lender will often require a separate security agreement and UCC–1, which is the document filed in the public records to provide evidence of a security agreement. Lenders do this so that if there is later a default and argument regarding whether specific additions to the real estate constitute real or personal property, the lender is covered both ways. Formerly known as a chattel mortgage.

security deposit Money required to be paid to a landlord or to service providers in order to protect them against possible default. The law varies from state to state regarding the following questions: Must the deposit be kept in a separate account from the operating account? Must it earn interest? May it be used to pay for damage to the property, or just default in the payment of rent? How much money can a landlord require? How soon does it have to be refunded? Most states maintain excellent Web sites with information about consumer protection laws, including landlord-tenant law and the requirements related to security deposits.

security instrument A generic name for something that gives a creditor rights in property for the protection of a debt from the borrower. It may include a security agreement for personal property, or a mortgage or a deed of trust on real property.

security interest Rights in property, voluntarily granted by a borrower to a lender, so that the property may serve as collateral for a loan and be subject to seizure and sale in the event of default.

seed money The amount of money necessary to begin a real estate development prior to the acquisition of any financing. It will cover the costs of market studies, feasibility studies, loan application expenses, and accounting and legal fees. Also called front money.

see-through building A new office building with a high vacancy rate. As a result, many floors have never been built-out, so they contain no interior walls. At night, with the lights on, one can literally see through the building to the other side.

seisin The possession of real property by one who claims to own a freehold interest, which is generally everything except a leasehold interest.

seized To have seisin, as in "He was seized of certain real property described as…."

self-amortizing mortgage See *fully amortizing loan*.

self-contained appraisal report According to the Appraisal Standards Board requirements for Uniform Standards of Professional Appraisal Practice (USPAP) it is an appraisal report that should contain all information significant to the solution of the appraisal problem. The emphasis is upon the word "significant"; the appraiser need not include *all* information.

self-employment tax A federal tax similar to the Social Security and Medicare taxes deducted and matched by employers. It is equal to 15.3 percent of net earnings from self-employment and must be calculated on Schedule SE and reported on Form 1040. Real estate agents, brokers, mortgage brokers, and all other self-employed individuals are required to pay self-employment taxes. (See Tax Topic 554, "Self-Employment Tax" and Publication 334, "Tax Guide for Small Business," at the IRS Web site, www.irs.gov.)

self-help Refers to the ability of a creditor to take steps to gain control of property currently in the possession and control of a debtor. Self-help repossession of personal property is generally allowed if it can be done without breaching the peace. Self-help eviction is generally frowned upon and may expose the landlord to liability in damages to the tenant. The time-honored but illegal practice of removing a tenant's front door in order to "paint" it is a form of self-help eviction.

seller financing The practice of a seller of real property holding some or all of the debt necessary to purchase the property. It is widely believed that seller financing is the last resort of borrowers who cannot obtain financing elsewhere, and the last resort of owners who cannot sell their property without offering it to buyers who cannot obtain financing. In reality, many property owners prefer to finance the sale of their properties, thereby earning a better rate of return on their money than if they obtained cash and then attempted to invest that cash in the marketplace. By the same token, many purchasers are able to secure somewhat cheaper mortgage loan interest rates than generally available in the marketplace if a seller will hold the financing.

seller's market A market in which there is very little desirable property for sale and a multitude of buyers attempting to purchase. Sellers can afford to demand low commission rates from agents who

are hungry for listings, refuse to negotiate the price, and refuse to allow contract contingencies. Contrast with *buyer's market*.

selling broker or agent The one who provides the buyer for a piece of property. The other side of the transaction is the listing agent, who provided the seller.

sell the paper A slang expression meaning to sell mortgage notes on the secondary market or to another investor.

semiannual Occurring twice each year. Same as *biannual*.

senior mortgage See *first mortgage*.

Senior Residential Appraiser (SRA) A designation granted by the Appraisal Institute. An SRA may refer to himself or herself as a member of the Appraisal Institute, but may not use the designation MAI, which, confusingly, stands for Member, Appraisal Institute. An MAI must meet more rigorous education, testing, and experience requirements than an SRA.

sensitivity analysis Use of spreadsheets to analyze an income-producing property or a development project, and then changing key assumptions in order to view the changes this causes. The creation of a best-case, worst-case, and most-likely-case pro forma is one type of sensitivity analysis.

separate property Property owned by either spouse before marriage, or inherited by one or the other after marriage. Contrast with *community property*. In other states, a divorce court will take into consideration the separate nature of property when making decisions to divide property or award alimony. One tricky aspect of the separate property issue is the interest in minerals, oil and gas, crops, timber, or postmarital improvements on or under separate land. Such interests do not always carry with them the separate property characterization.

septic system An on-site system for the disposal of wastewater.

sequestration order A court order authorizing the seizure of personal property, or the rents or other income from real property, to be kept in safety under court supervision pending the outcome of litigation between the parties. The order is usually issued only when the creditor can prove that the debtor intends to fraudulently remove or spitefully damage the property to the detriment of the creditor. Normally the creditor requesting the order must post a bond in order to reimburse the debtor for his or her damages if it later turns out that the order was wrongfully entered.

service of process Completion of all legal requirements to give official notice to a person regarding a lawsuit filed against that person. After service of process, the defendant will have a certain number of days to file an answer. It is critical to determine the correct service date and to keep track of the deadline to file an answer, which could be as short as 14 days in most states. Failing to file an answer will result in a default judgment in which the court will give the person filing the suit—the plaintiff—everything that person asked for, no questions asked. When the judgment becomes final and not appealable, after the passage of another period of time, the plaintiff may begin efforts to seize any real or personal property he or she can find to satisfy the judgment.

service release premium The commission a lender pays a loan broker in return for placing a loan with that lender rather than another. Also called yield spread premium.

servicing Providing management, oversight, payment receipt, property insurance monitoring, and all other functions related to ongoing loan activities after origination. Most loan originators sell the servicing to third-party companies.

servient estate See *servient tenement*.

servient tenement Property upon which an easement exists in order to benefit another property, called the dominant tenement. Also called servient estate.

set-aside letter A letter from a lender stating that funds have been "set aside" to pay for specific improvements. It is sometimes given to the contractor of a financially troubled project advising that the lender will set aside money to fund completion, even though there may be problems with the owner. It is also sometimes given to a local government authority as a condition of issuing subdivision development approval. The set-aside letter from the lender guarantees availability of funds to complete common areas of the development. The developer may obtain a commercial bond to achieve the same results, but the set-aside letter may be cheaper.

setback The distance between the edges of property and improvements located on the property. Local governments and subdivisions usually have minimum setback requirements for aesthetic and for safety reasons.

set off To deduct debts from each other. Oftentimes defaulting debtors will claim that they have not paid their obligations because of a right of setoff against injuries suffered as a result of wrongdoing by the creditor. Lenders with bank deposits in the name of their borrower may set off the bank account against the mortgage debt if there is a default.

settlement See *closing*. See also *Real Estate Settlement Procedures Act*.

settlement date Closing date.

settlement statement See *closing statement*.

settling Movement of an improvement because of movement in the soil supporting the improvement. It could be caused by compaction of the soil, erosion of pockets due to underground streams or springs, or the aftereffects of frost heave pushing frozen ground upward and then settling back.

settlor The person who establishes a trust.

sever To separate, as when the mineral interests are severed from the surface rights in real property.

severally This is one of those words that means the exact opposite of what you might guess. It means individually, although you might think it has something to do with several people. It is most

often encountered in two situations. Property may be owned severally, or "in severalty" meaning that there is one owner with no co-owners. In addition, one might see legal liability expressed as "jointly and severally," such as roommates who sign a lease together. They are both liable for the entire rent (jointly), and they are each individually liable for the entire rent (severally). If there is a default, the landlord may sue both of them and collect from whoever has money, or the landlord may choose to sue only one tenant and collect the entire amount from that one tenant, not simply one-half of the debt.

severalty Sole ownership of real property.

severance damages The compensation to a property owner after the government takes some portion of real property by condemnation under its eminent domain rights and, as a result, causes a decrease in value to the remaining property.

> **Example:** *Annie's Corner Grocery received a $135,000 condemnation award when the city took one-half of the grocery's parking lot in order to expand the library, and an additional $200,000 in severance damages because the grocery store itself was now much less valuable with the smaller parking lot.*

sewer A system for the transmission of storm water to a controlled discharge point or for the transmission of sanitary wastewater to a treatment facility.

shadow anchor Understood with reference to an anchor store, which is a retail store that generates a great deal of traffic and attracts business to the shopping center in which it is located. A nearby shopping center would say it is shadow anchored by the same store—the anchor is nearby, but not part of the same center.

shall When used in a contract, lease, mortgage, or statute, it means that the thing is required; it must be done. Shall implies a complete lack of discretion. Contrast with *should*.

shared appreciation mortgage (SAM) A mortgage arrangement that virtually disappeared for many years and is now making a reappearance. The borrower receives a lower interest rate on the mortgage loan in exchange for agreeing to pay the lender some of the profits when the property is sold. Every agreement will be different, but one example would be a reduction of one-half of 1 percent in the interest rate in return for 20 percent of the profit from a sale. Under IRS Revenue Ruling 83–51, the shared appreciation paid to the lender when the property is sold will be deductible interest in the year in which it is paid, but only if the lender is paid in cash, not via a refinance of the mortgage.

shared equity mortgage A mortgage loan in which the lender pays a portion of the equity for the borrower and in return receives a portion of the increase in value of the property when it is sold. It is most commonly seen today in use with public programs that assist first-time home buyers; the practice is intended to discourage flipping in a rapidly rising real estate market. The longer the homeowner keeps the property, the lower the percentage of equity that must be shared with the lender.

shared tenant service provider A short-term, small office space on flexible terms with bundled services such as telecommunications, secretarial support, meeting rooms, and other business necessities. Also called business center or executive suite.

shareholders See *stockholders*.

sharing the market uplift An expression used to describe a recapture clause in a lease, allowing the tenant to sublease space at a profit in an escalating rental market, but with the necessity to share some or all of the profit with the landlord.

Shelley's case, rule in See *rule in Shelley's case*.

shell lease A lease for unfinished space, typically for retail or distribution purposes, with the tenant to make all improvements to the property. Sometimes called a dark shell lease.

sheriff's deed A deed from a court after an execution on real property to satisfy the judgment obtained by a creditor.

Sherman Antitrust Act One of the antitrust laws designed to encourage competition and discourage monopolies.

shopping center According to the International Council of Shopping Centers (www.icsc.org), "a group of retail or other commercial establishments that is planned, developed, owned and managed as single property. On-site parking is provided. The center's size and orientation are generally determined by the market characteristics of the trade area served by the center."

shoreline The mean high-water mark dividing water from land.

short form A one- or two-page instrument with important deal points sufficient for recording, so that a lengthier document need not be placed in the public records.

short rate The relatively higher insurance premium rate charged for coverage when one cancels a policy earlier than originally agreed upon. Rather than receiving a pro rata refund of the unearned premium, the property owner receives a smaller amount.

short sale In real estate, the lender's agreement to release its lien upon property so that the property can be sold, even though the sale price will not generate enough money to pay off the loan. Investors who specialize in purchasing preforeclosure properties will often negotiate a short sale price with the lender as part of their strategy. Oftentimes, the lender will agree to forgive the balance of the mortgage debt.

short-term capital gain or loss A gain or loss on the sale of real estate or other capital assets that were held for one year or less. Disregard advice that short-term capital gains are for holding periods of less than one year; a holding period of exactly one year is still short term. To calculate the holding period, start counting on the day following the date of acquisition; the day of sale is considered part of the holding period. Short-term capital gains are netted against short-term

capital losses. If the net result is a gain, it is taxed at ordinary income rates, not the more favorable long-term capital gain rates.

short-term debt That portion of debt that is payable within one year. Consumers typically include only debts maturing in one year in their schedule of short-term debts. Businesses usually segregate debt into the current year's portion of all debt, with the balance, if any, categorized as long-term debt. When completing a form financial statement for a lender, it is important to find out that lender's definition of short-term debt. Placing debts in the wrong category could result in a failure to meet certain critical ratios, and denial of the loan.

should In a lease, mortgage, contract, or statute, it is language of recommendation rather than something that is required. Contrast with *shall*.

show-cause order A judicial or government agency order to appear before it and present evidence regarding why a specific order should not issue from that authority. When one is charged with violation of an injunction prohibiting certain actions on real property, for example, the order is to appear and show cause why the defendant should not be held in contempt of court.

shut-in royalty In oil and gas leases, a royalty paid to keep a lease in effect, even though there is no oil or gas production.

sick building syndrome A combination of symptoms—rashes, respiratory problems, fatigue, headaches—that appear when one is in a building or a portion of a building and diminish when one is away from the building. The symptoms cannot be traced to any single cause, but they typically manifest in office buildings and very rarely in residential properties. Contrast with a *building-related illness*, which can be traced to a particular source, such as Legionnaires' disease.

side letters (leases) Written agreements that vary the terms of a lease. All contracts for the purchase of income-producing property should provide for full review of leases and any side letters before closing.

siding Materials used to clad the outside of building walls. Siding is not structural and does not support the roof or upper floors. It may include wood, brick, shingles, vinyl, and other materials. Many zoning regulations stipulate the types of siding that must be used, or cannot be used, for buildings in particular zone classifications. For example, metal siding may be prohibited in certain residential areas.

sight line An imaginary line extending from an observation point to a view beyond that. Many neighborhood restrictions prohibit obstruction of sight lines to scenic views.

signature elevator link A fancy elevator, such as the glass ones that ascend and descend on the exterior of buildings.

silent partner A partnership investor without any voting power or authority. See *limited partnership*.

silent second (1) A second mortgage placed on a home, usually in favor of the seller, so that a purchaser can buy the home even without a sufficient down payment. They are called silent because the first lender does not know about the second mortgage and might not have approved the first mortgage if it had known the borrower did not have enough money for a down payment. (2) Shared equity second mortgage programs offered by some state housing assistance authorities. The housing authority loans money to a qualifying moderate-income home purchaser, with repayment due only when the home is sold or refinanced. This is called the silent second, meaning an invisible second mortgage. The housing authority then shares in the profits due to the increase in value. Sometimes there are restrictions requiring sale only to another qualifying moderate-income home buyer.

simple interest Interest on the principal balance of a loan or debt, but without compounding due to also charging interest on past-due and unpaid interest.

simple loss payable clause See *open mortgage clause*.

simple majority Fifty-one percent of the voting members or shares. Contrast with *supermajority*.

simulate To create an artificial environment or circumstance that closely resembles reality so that people may test their predictions about behavior or practice their skills. One may purchase simulation software to help new real estate agents learn how to interact with buyers and sellers or house-flipping simulation software to learn the tricks and perils of that process.

Simultaneous Death Act A law enacted in most states providing that when persons die at the same time or perhaps within a described number of hours of each other, and one or both would inherit from the other if only they had survived, then each will be treated as if he or she had died before the other. As a result, property does not pass through one estate briefly and then into another estate.

simultaneous death clause Usually in wills made by husbands and wives, the clause says that if one does not survive the other by a certain time limit, usually 6 months, their properties will be disposed of in an alternative manner specified in the will.

single agency The practice of representing only one side in a real estate purchase rather than engaging in dual agency.

single-asset entity (SAE) See *single-purpose entity*.

single-family housing Relatively freestanding dwelling units, but may include townhomes that share a common wall. The exact definition will be important for zoning purposes and for some loan programs that are restricted to single family housing. In each instance, the law or program itself will have a definition of the word for their particular purposes.

single load corridor A hallway that has apartments, condo units or offices on only one side.

single pay loan Usually a short-term loan with all principal and interest due at maturity. There are no monthly interest payments. It is the typical loan for a house flip, with a quick purchase, rehab, and

resale anticipated within 6 months. May also be used for a bridge loan made when an old home has not yet sold but a new home must be purchased, with the bridge loan being payable in full when the old home sells.

single-purpose entity (SPE) A limited liability company or corporation that holds title to real estate and owes money to a lender as the result of a mortgage on the property, but which has no other assets or liabilities. The SPE will usually lease the property to another company, comprised of the same owners. That second company then executes leases to tenants, hires a management company or provides for necessary services, and generally incurs all liabilities associated with managing the property. This structure is usually required by a lender as a condition of extending a mortgage loan. It insulates the collateral from claims of other creditors. If the second company must file for bankruptcy because it is not able to pay creditors, that does not stop the lender from foreclosing unless the SPE also files for bankruptcy. If the SPE files for bankruptcy, it is much easier for the lender to lift the automatic stay and proceed with foreclosure because it has the only vote for issues such as approving a plan of reorganization under Chapter 11 (see *bankruptcy*). If there were many creditors, consisting of the janitorial service, utilities, tenants, and others, then those other creditors could force the mortgage lender to acquiesce in a plan of reorganization that is not in the lender's best interests. That process is called a cram-down. With only one creditor, the mortgage lender, there is no chance of a cram-down. (Do not confuse with a *special-purpose entity*, also abbreviated as SPE, which is much broader than a single-purpose entity.) Also called a single-asset entity (SAE).

single-room occupancy (SRO) A type of housing in which residents have a private bedroom, but share other communal features such as a kitchen, bathrooms, or entertainment areas. It may be very-low-income housing, student housing, or elder housing. Some very expensive condo and co-op projects include SRO space set aside for domestic help employed within the buildings, because the employees could not otherwise afford to live near where they work.

sinking fund Money set aside in a special account to which regular contributions are made by way of additional money and/or interest on the money, with the plans that by a specified date the fund will be sufficient for a particular purpose. Prospective homeowners may set up a sinking fund for a house down payment, and companies usually establish sinking funds to pay off bonds.

SIOR See *Society of Industrial and Office REALTORS®*.

site A property location. Typically refers to one planned for development, but does not necessarily have such a restrictive meaning.

site assessment See *environmental site assessment*.

site-built home A home built primarily at the location where it will be inhabited. The extreme opposite is a manufactured home, which is built elsewhere and simply moved to the location. Modular homes are more of a gray area because components are built elsewhere and then assembled at the house site.

site improvements Any alterations or additions to land that enhance its utility or value.

site plan A drawing that shows the boundaries of a parcel of land, the topography, important landscape elements that impact design (such as a large oak tree), and the placement of all anticipated major improvements, including buildings, roads and driveways, storm and sanitary sewer lines, and utility connections.

site selection The process of choosing the best location for an anticipated use. Large national chain retailers and restaurants typically have very specific criteria regarding demographic profiles and densities, traffic counts, access and proximity to competitors, and amount of land required. Smaller companies usually piggyback on those requirements or simplify them dramatically. One rule of thumb for site selection says that a prospective retail site from which one can see a McDonald's and a branch bank is a good site. Persons skilled in the complex statistical and mathematical calculations and projections necessary for some industries are able to command high salaries. Also called location intelligence.

siting Establishing placement of future improvements upon land so as to make the best use of whatever features are important. These might include using existing contours, vegetation, and routes of access. Items that might need to be contemplated are prevailing winds, solar energy or satellite access needs, and desirable and/or objectionable views and zoning regulations.

situs Location.

skin in the game An expression reputed to have been coined by investor Warren Buffett, referring to a situation in which high-ranking insiders use their own money to buy stock in the company they are running. Most often, it refers to a lender aversion to 100 percent financing, even if the property is worth well more than the loan, because the lender wants the owner or developer to "have some skin in the game" and some equity to lose if the deal goes bad.

sky lease Lease of air rights above land.

skyscraper A multistory building with a steel skeleton that supports the weight of the building.

slab A building foundation of poured concrete, lacking a basement or crawl space.

slander of title See *defamation of title*.

slant drilling A method of drilling for oil and gas from an adjacent property.

sleeper note See *single pay loan*.

slip and fall cases A generic type of litigation referring to injuries sustained when someone fails to maintain his or her property in a safe and clean condition. Many states differentiate among types of persons when evaluating the duty of care owed by an owner or occupier of property. For such states, legal responsibility for the injury may depend on whether the injured party was an invitee, a licensee, or a trespasser. See *owners and occupiers* for a description of the various parties and responsibilities to them.

slum A heavily populated urban area with widespread and massive deterioration of buildings and infrastructure, a lack of meaningful social or police services, and an exceptionally high degree of poverty, unemployment, and crime.

small-bay retail Businesses with a size of 1,000 to 2,500 square feet, such as nail salons, video stores, sandwich shops, and other similar tenants.

Small Business Administration (SBA) A federal government agency created in 1953 to "aid, counsel, assist and protect… the interests of small business concerns," including real estate–related industries. It provides training and counseling and financial assistance through loans and guarantees. The SBA (www.sba.gov) also negotiates small business set-asides with federal agencies requiring outside goods and services, meaning that a certain predetermined percentage of those contracts will be awarded to small businesses.

small claims court A court of limited jurisdiction, meaning it will not hear disputes larger than a certain dollar amount. It is usually intended to be fast, informal, and not dependent on technical rules of procedure or evidence that would give an advantage to persons with lawyers. Matters pertaining to title to real estate, rights of occupancy under leases, or requests for injunctions normally cannot be heard in small claims courts, but suits for real estate commissions, collection of unpaid rent, or minor property damage would be appropriate. Normally the losing party may appeal to a somewhat higher court and automatically obtain a completely new trial. Most states allow corporate officers or employees to represent the corporation in small claims court, even though this technically constitutes practicing law.

smart building A building that includes the most modern telecommunications amenities generally available in the marketplace, allowing occupants easy access to bandwidth and switching services. Do not confuse with *intelligent building*, which is one able to sense its environment and make heating, cooling, lighting, health, and safety decisions without human input.

smart home Usually refers to home automation systems that can be controlled by a centralized panel or device or by dialing in to the control panel from outside the home.

SMSA See *standard metropolitan statistical area*.

societal marketing concept The idea that a real estate project has an impact on more than just the people who will use the project and must be marketed to the collective satisfaction of the entire community of neighbors and regulators.

Society of Industrial and Office REALTORS® (SIOR) An association (www.sior.com) of industrial and commercial real estate professionals, including brokers, corporate executives, lenders, and educators. It is affiliated with the National Association of REALTORS®.

soft costs Construction costs that cannot be visibly seen, such as professional fees for architects, surveyors, engineers, lawyers, and accountants; government fees and permits; utility hookup fees; and construction period interest and loan fees.

soft market A real estate market characterized by more sellers or lessors than buyers or tenants.

soft money (1) A slang expression for creative financing techniques that involve no cash changing hands, such as seller financing. (2) Money invested in a real estate acquisition or development that is written off as an expense rather than added to the basis to increase equity.

soil bank A former federal government program that paid landowners to keep their agricultural lands fallow—unfarmed—for 5 to 10 years in order to prevent overproduction in specified commodities. Today, many of the same functions are administered by the Conservation Reserve Program of the Farm Service Agency (www.fsa.usda.gov).

soil boring tests Tests performed by a geotechnical engineer by drilling holes into the soil in order to determine some or all of the following: (1) ability of the soil to support structures on the surface with or without additional assistance from footings, piers, and other aids; (2) permeability of the soil to determine whether it will percolate sufficiently for an on-site septic system; (3) discover and monitor leakage from underground storage tanks or the presence of other contaminants.

soils engineer A licensed professional who is responsible for determining the soil's load-bearing capacity, sizes and depths of footings, groundwater levels, presence of any contaminants, and advice regarding fill and compaction preparatory to construction. Also called a geotechnical engineer.

solar easement The right to prevent an adjoining landowner from building a structure that will block the sunlight and diminish the effectiveness of solar energy features on one's own property. Such easements are normally voluntary and agreed upon between the property owners, but they may be imposed by a court of law under the proper circumstances.

solar heating A system using the energy of the sun to heat a structure. Active solar heating uses some type of motor to move heat; passive solar heating relies on the design of the structure itself to move the heat. Use of solar heating can result in tax credits. For more information, see "Notice 2006–27" at the IRS Web site, www.irs.gov.

Soldiers and Sailors Civil Relief Act (SSCRA) A federal law providing protections for persons who may be handicapped by active military service. Protection is extended to active-duty military personnel (and sometimes their dependents), and to reservists and members of the National Guard who are called up to active federal services. Benefits of the Act include the ability to request interest rate reductions on all debt incurred before entering military service, including mortgage debt but excluding student loans; stop eviction proceedings if the monthly rent is under a preset amount; terminate a residential lease without penalty if the lease was entered into before active military duty; and delay civil lawsuits such as collection cases, bankruptcy, foreclosure, child custody, paternity, and divorce proceedings until after the service member is able to attend proceedings.

sole proprietorship Ownership of a business by an individual rather than a partnership, corporation, or limited liability company.

solid waste All types of waste material, not necessarily contaminants.

SOX See *Sarbanes-Oxley Act of 2002*.

space planning Configuring the interior of a building for the optimum use of interior spaces in order to meet the needs of the owner or occupant. It is usually a good idea to meet with a space planner before designing a building or leasing space because a good planner can minimize the square footage necessary for one's needs, thus saving expenses.

space pocket A portion of leased premises set aside to accommodate future growth on the part of the tenant. Typically, no rent is due on the pocketed area until the earlier of actual use or a specified future date.

SPE Either a *Single-Purpose Entity* or a *Special-Purpose Entity*. These two are not the same thing.

spec Speculative; built without a purchaser or a tenant, but in anticipation of securing one when the project is completed.

spec house A residence built without a particular buyer in mind or under contract, but designed to appeal to the maximum market possible. Spec houses are typically built in an inexpensive manner, but with decorative finishes commensurate with the tastes of the target market. For example, an upper-bracket spec home might have a marble entryway, but wire shelves in the closets, inexpensive lighting and plumbing fixtures, and other contractor-grade materials.

special agent Someone employed to represent another person—the principal—in a clearly defined and limited activity. A real estate broker hired to sell a property is a special agent.

special assessment A charge to property owners in order to pay for some improvement benefiting all assessed owners in common. Local government sometimes makes special assessments to pay for road or sewer work. More commonly, condo associations and neighborhood associations will levy special assessments for the repair or expansion of recreational or other community amenities, or for structural repairs such as a new roof or road repaving.

special assessment district A specifically defined geographical area of property owners who have requested some public improvement and agreed to pay for that improvement through pro rata charges levied against owners within the district.

special benefits The improvement in value certain properties experience after condemnation proceedings under the government's eminent domain authority. They are different from the general community benefits enjoyed because of the improvements planned after condemnation.

> **Example:** *The city condemns a 100-foot-wide strip of land for road building. As a result, formerly landlocked property now has valuable road frontage. It has received a special benefit.*

special conditions See *contingency clause*.

special-purpose entity (SPE) Usually a limited liability company formed in order to separate profits, losses, and risks from the corporation that created it. The most spectacular example of the use of special-purpose entities was Enron, which used SPEs to siphon off losses and "cook the

books." The use of SPEs is legitimate and necessary in many circumstances, though. (Do not confuse with *single-purpose entity*, also abbreviated as SPE, which is more specialized and is typically a lender requirement before it will extend mortgage financing on large projects.) Also called special-purpose vehicle.

special-purpose property Real property improvements that are designed in such a customized way that they are usable only by a limited number of owners or occupants. An automobile dealership is a special-purpose property. It would be extremely expensive to convert the dealership to some other use.

special-purpose vehicle See *special-purpose entity*.

specialty investments Property types that are not considered conventional institutional-grade real estate investments. Examples include congregate care facilities, self-storage facilities, mobile homes, timber, agriculture, and parking lots.

specialty shopping center A shopping center devoted to a particular market segment. The most common type has upscale fashion and home accessory stores. It may or may not have an anchor, but usually does have a number of restaurants for the "shopping as entertainment" market segment. Another type caters to certain demographic groups, such as a shopping center with largely Hispanic-themed merchandise and restaurants, and a high percentage of Hispanic shop owners.

special-use permit Local government permission to use property in a certain manner allowed under applicable zoning regulations, but only after a case-by-case analysis of the intended use and the issuance of the special-use permit. For example, a group home intended for two, three, or four adults who are developmentally challenged might be a permitted use in an R–1 residentially zoned area, but the regulations might require a special-use permit. This allows authorities to assure themselves regarding the existence of safeguards and assistance for the residents and to limit densities of such facilities so that one area or another does not tend to a high concentration of group homes.

special-use valuation For purposes of ad valorem (real estate) taxes, and for estate taxes, property may sometimes be valued at its current use rather than the highest and best use. This is called special-use valuation, as opposed to fair market value. Most often, this special consideration is granted for agricultural land, so that farmers and their families are not forced to sell their land because they are unable to pay the taxes that might be imposed if the property were valued as a potential subdivision development, industrial park, or shopping center, as examples.

special warranty deed A deed that provides warranties against the consequences of any actions by the grantor, but makes no representations, warranties, or promises regarding what title defects might exist because of the actions of prior owners. Contrast with *general warranty deed*.

specifications The detailed requirements for some or all aspects of a construction or development project. For example, cabinet specifications might detail the type and quality of wood for the doors, drawer bottoms, and cabinet fronts and sides; full-extension or limited-extension drawer

glides capable of supporting certain weights; the type and thickness of paint or other finishes; and the quality and type of hinge and pull hardware.

specific performance A court order requiring one to comply with the terms of his or her contract rather than the typical legal remedy of paying monetary damages for breach of contract. Real estate is considered unique, and the theory is that a buyer can never take money damages, go out into the marketplace, and replace the property when a seller defaults. As a result, the law gives to the buyer of real estate the remedy of specific performance. Under very exceptional circumstances a court has been known to grant specific performance to a seller and force a buyer to go forward with purchasing real estate.

speculation Investment decisions based on the hope and expectation there will be a profit, but no firm evidence that this will be the case. As a general rule, the more speculative the venture, the greater the reward should be, commensurate with the risk taken.

spendable income Gross salary minus taxes, housing costs, and savings.

spite fence A high fence erected between neighbors, for no other reason than to obstruct one's light, air, and view. The law will sometimes force a party to remove a spite fence, even though property owners normally have no rights to light, views, or air from across an adjoining property.

split-rate capitalization Estimating the value of income-producing property using more than one discount rate because of differences in lease expirations or tenant quality.

spoliation of evidence The destruction of evidence necessary for pending or contemplated litigation. The practice is illegal under common law and under Sarbanes-Oxley (SOX) regardless of the motives or intention of the party responsible for maintaining the evidence.

> **Example:** *Landlord Larry has a problem tenant who constantly complains about various unsafe conditions at a 6-year-old apartment complex, attributing them to poor design and construction. The tenant threatens to file suit if Larry does not fix all the defects and give the tenant 6 months free rent. Two days later, as she does on the same date every year, Larry's assistant destroys all noncurrent files more than 5 years old. This includes many of the original development and construction records for the complex. SOX probably does not apply because the apartment complex is not owned by a publicly traded company, but Larry is more than likely guilty of common law spoliation of evidence.*

sponsor equity The cash investment by the owners of a project.

spot zoning Changing the zoning for a particular parcel of property in order to allow uses not ordinarily permitted under the regular zoning for that area. This is a very unusual step; the more common method of reaching the same goal would be to grant a variance for a particular owner for a specific use. In an area zoned for residential use, local government might grant a variance so that a parcel can be used for a doctor's office. With spot zoning, that parcel's zoning would be changed to General Business or something similar, and any business permitted under such zoning could operate on the parcel.

spread (1) The difference between the asking price and an offer. For example, if the seller was asking $1.5 million but the offer was only $1.2 million, the spread would be $300,000. (2) The difference between the cost of money and the earning rates.

> **Example:** *A mortgage banker is able to borrow money at 7 percent interest because of its excellent credit and high net worth. It then loans that money out on moderately risky ventures at 15 percent interest. The spread is 8 percent.*

spreading agreement A separate agreement spreading the reach of a mortgage to other properties and sometimes even to other borrowers or lenders. It was once common in New York, in particular, to use spreading agreements rather than executing new mortgages because of the ability to thereby avoid paying large mortgage recordation fees. Such loopholes have largely been closed, however.

sprinkler system A system of overhead pipes, valves, heads, and sensors that will cause the release of water if a fire develops. Under most building codes, certain types of structures are required to have sprinkler systems. If present, but not required, the owner may usually have fewer fire walls, greater occupancy levels, and/or fewer exits and greater distances between exits.

spur track A segment of railroad line connected to the main line at only one end. Contrast with *drill track*.

square footage The area of a space measured in feet. A rectangular parcel of land 100 feet wide by 150 feet deep is $100 \times 150 = 1{,}500$ square feet. For buildings, the measurements are usually taken at the outside walls. Leased space is measured in usable or in rentable square feet, which differ from each other. Usable square feet consist of the space capable of being occupied by the tenant. Rentable square feet may include a percentage add-on, such as ten percent increase over usable square feet, so that the tenant is paying rent on its proportionate share of the common areas in addition to its own space. Space is generally quoted as a certain number of square feet, "more or less." This is because there have been successful lawsuits for fraud against real estate agents who represented that, for example, a house contained 2,050 square feet when it really measured out to only 2,000 square feet—a difference of one large closet.

square footage of living area The heated and cooled space in a dwelling, except that a heated garage is generally not included.

square foot method The practice of estimating the cost of construction work by reference to the number of square feet in a structure. For example, houses of a certain quality might cost $100 per square foot to build. One might obtain a wide variety of bids for subcontracting work, such as plumbing and painting, because of the ability of some subcontractors to review plans and calculate the labor, materials, overhead, and profit necessary for them to accept the job, while others use a simple square footage method and hope that it all works out okay.

square yard A space that measures out to the equivalent of a square 1 yard (3 feet) wide by 1 yard long. There are 9 square feet to a square yard. Most real estate measurements are in acres, square feet, or cubic yards, rather than square yards.

squatter's rights See *adverse possession*.

SRA See *Senior Residential Appraiser*.

SRO See *single-room occupancy*.

stabilized income The income from a property once it reaches stabilized occupancy.

stabilized occupancy The occupancy levels reached by a new property after the initial lease-up period, and that are reasonably expected to continue into the future with the proper marketing, management, and maintenance. Conventional wisdom says that stabilized occupancies in excess of 90 or 95 percent are not good, but merely indicate a failure to charge enough rent.

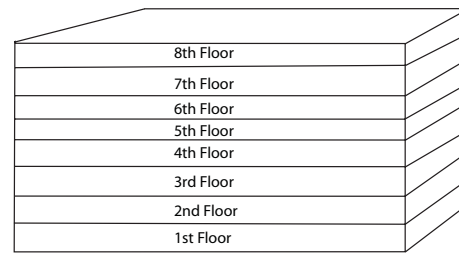
stabilized value The value of a property after it reaches stabilized occupancy. Most appraisals of property to be developed include one value for the day the project opens its doors and then a separate stabilized value.

Stachybotrys chartarum See *black mold*.

stacking plan A two-dimensional representation of a building showing the general shape of the building and the space availability and tenants on each floor, for use as a marketing piece on a Web site. Management may have its own version that includes color coding for lease expiration dates, current rental rates, and target rental rates.

Example: *Stacking plan for an office building.*

Floor	Tenants				
8	Columbia Spectrum Mgmt 15,035 sf		Great American Title 3,140 sf		Vacant 2,866 sf
7	Friedman & Fuller 4,825 sf	VTEL 2,276 sf	Equifax 5,340 sf	MetLife 6,022 sf	Vacant 2,578 sf
6	Network Equipment Technologies 21,041 sf				
5	Interoffice of Tysons 21,041 sf				
4	Westbourne Investments 1,389 sf		Americredit 1,137 sf	Adobe 7,965 sf	FCEDA 10,550 sf
3	Pharmaceutical Research 4,766 sf		N.E.T. Federal 5,592 sf	Wiltel 8,098 sf	CalNet 2,585 sf
2	Charles Schwab 4,260 sf	Flinn & Beagan 2,241 sf		Transgeneral 3,498 sf	Scitor 4,210 sf
1	Cassidy & Pinkard 6,261 sf	Accustaff 2,000 sf	Dictaphone 4,385 sf	Phillips 13,812 sf	



stagflation A slang expression for a period of stagnation and inflation.

staging Redecorating a home, including the use of rented furniture and accessories, to make it appear more attractive to potential buyers.

stakeholder Anyone who might be affected by a decision; anyone who has a "stake" in the outcome of a situation. Local government decisions are typically made with reference to the stakeholders in the community, which could include nearby property owners, employers, employees, tenants, lenders, and community service programs.

standard depth The depth of a lot considered normal for appraisal purposes. For residential appraisal, 100 feet is considered the standard depth.

standard metropolitan statistical area (SMSA) A former U.S. Census Bureau term outdated since 2000, but still sometimes encountered as referring to a large city and its economically related environs. See *metropolitan area*.

standard mortgage clause A clause in a fire and casualty insurance policy providing additional coverage for the mortgage lender and also providing that the lender's rights to recover proceeds will not be compromised if the borrower is guilty of wrongdoing relative to the insured loss. Also called a union mortgage clause. Contrast with an *open mortgage clause*.

> **Example:** *Ted cannot make his mortgage payments and fears foreclosure, so he burns down his house to collect the insurance proceeds. Unfortunately, his neighbor saw the whole thing and alerted the police. Ted will not be able to collect any insurance money, but his mortgage lender will because it was not involved in the wrongdoing.*

standard of care The duties and responsibilities expected of people by virtue of their status, their relationship with another person, or the situation in which they find themselves. Real estate licensing boards establish standards of care for their members regarding duties of honesty, integrity, disclosure, and professionalism. A property owner may have differing standards of care relative to persons on his or her property, depending on whether those persons are licensees, invitees, or trespassers.

standard practices of the trade(s) The way in which construction work is normally done by the average professional in the field in that general locale. Most construction contracts include a clause holding the contractor and subcontractors to the standard practices of the trades. Unfortunately, most property owners don't know what that means until it is too late. The better practice is to have a detailed set of specifications and to delete the standard practices clause. For example, standard practices may indicate the use of plastic electrical outlet boxes, but a property owner might prefer to pay the additional $1 or $2 each to have metal ones.

standby commitment A lender's promise to make funds available to a borrower for a specified period of time. Different from a line of credit because the standby does not contemplate a revolving relationship in which the borrower obtains money, repays some or all of it, and then has that same amount of credit available again for new borrowings. The standby is intended to be drawn down and then repaid according to normal promissory note terms. The most typical use is when a developer needs a takeout loan—permanent financing that will "take out" the construction loan—in order to obtain a construction loan. Rather than lock in possibly high interest rates and prepayment penalties for permanent financing, the developer will pay a fee for a standby commitment. When the project is completed, the developer can then elect to fund under the standby and then wait and see if interest rates drop or if it will sell the project rather than retain it, or proceed with permanent financing.

standby fee A fee charged for a standby commitment.

standby letter of credit Usually shortened to standby or to LOC. It is the agreement by a lender to disburse funds to a third party if the lender's customer defaults on its obligations to that third party (called the beneficiary).

Rather than pay a large security deposit for a lease, a tenant might offer the landlord a standby letter of credit (LOC) issued by the tenant's bank. For all but the most exceptionally credit-worthy customers, the bank will usually require cash collateral in the form of a certificate of deposit or comparable asset.

The issuance fee is generally in the range of 1/2 to 2 percent per year for the issuance of the standby, which should be less than the money earned by the cash collateral.

The LOC will usually specify the exact manner in which the beneficiary must collect funds, such as presentation of the original LOC at a certain branch location to a particular officer at that location, accompanied by a statement regarding the customer's default. Normally, the statement must be worded exactly in the manner specified within the body of the LOC and any paraphrasing at all will result in denial of payment. The LOC will also have a date and time of expiration.

Landlords (or anyone else) accepting standby letters of credit should be aware that the law in this area is very precise in its requirements. In many states, minor errors in wording the documents presented in order to collect on a letter of credit might result in the bank's legally justifiable refusal to pay. Presenting documents to the wrong person, or at the wrong location, could result in refusal to pay. That refusal might not be curable because of the expiration of the time limits within which to make the claim. The better practice is to pay a lawyer with good malpractice insurance to review the documents and prepare the request for payment.

standing Having a sufficient stake in the outcome of a dispute so as to justify a court in believing that the party will vigorously defend or pursue the rights at issue in litigation. The concept of standing used to be very narrow, so that if a property owner contracted for selective cutting of timber, but the timber company clear-cut and left a devastated wasteland behind, only the property owner could sue for damages because he or she was the only one with standing. Today, the concept has been expanded and would probably include adjoining landowners and even public interest groups who would be recognized as having standing and the ability to sue the timber company.

standing timber Timber that has not been cut or sold. Standing timber is considered part of the real estate. In some states, once a landowner signs a contract to sell the timber, it becomes personal property even if it has not yet been cut. As a result, a sale of the real property after the timber contract will not include the timber.

stapled stock A relationship between a real estate investment trust (REIT) that owns real property, such as a hotel, and a standard corporation that leases or manages that property, ostensibly for a profit. But the arrangement is set up so the stockholders are the same for the REIT and for the operating company—the stocks are "stapled" together. As a result, they hypothetically do not care which company makes what size profit, as long as the aggregate profit is an acceptable number. There is

one problem: the REIT profits are not taxable at the corporate level, but the corporation profits are taxed. As a result, the ideal situation would be for the operating company to pay exceptionally high rent, forcing it to just barely break even every year and owe no taxes, while the REIT collects high rents, makes large profits, and pays no taxes. Of course, distributions to shareholders are taxed as income to the shareholders for either entity. The practice was once widespread but now represents a now-closed loophole that is seldom encountered except for older transactions. It is necessary to understand the concept, however, because there are always novel arrangements attempting to accomplish the same goals and that describe themselves as similar to stapled stock.

Starker transaction Named for T. J. Starker, who successfully claimed the benefit of IRS like-kind exchange and tax-deferral rules even though there was a significant time lapse between selling one property and buying the replacement property. Section 1031 of the Internal Revenue Code establishes a safe harbor for similar transactions, guaranteeing the IRS will not contest a delayed exchange if all parties follow the rules exactly. See *1031 exchange*.

starter castle A derogatory expression for a large house on a small lot, generally considered pretentious and often containing minimal furniture and accessories because all disposable income must go toward the mortgage payments. Also called a McMansion.

starter home A home that is smaller than the typical homes in an area, and thus less expensive and easier for first-time home buyers to acquire.

starts See *housing starts*.

state rule One method of calculating compensation for condemnation of property under a government's eminent domain powers, it calculates the value of the land taken, the damages caused to any property not taken, and the special benefits enjoyed by the remaining property as a result of the condemnation. The numbers are all combined in the calculations to arrive at an award amount. Contrast with the federal method, which is a straight before-and-after analysis: the difference in the value of the entire parcel before condemnation and the value of the remainder after condemnation is the award.

statute A law enacted by a state or by the federal government.

Statute of Frauds A statute setting out certain contracts that are not enforceable within the state. The most significant provisions for real estate purposes are those that require almost all contracts and transfers related to real estate to be in writing and all guarantee agreements to be in writing. This does not mean there must be a formal "contract" or "agreement" signed by all parties. The Statute is usually satisfied if there is some writing signed by the party sought to be held liable.

> **Example:** *A letter from Sam Seller to Betty Buyer says, "Dear Betty, I'm glad you like the home so much. Your offer of $150,000 was more than I was expecting, so I'll be out shopping for a new home while you get ready for closing. I'm looking forward to seeing you again at the end of the month; do you mind terribly if I don't move out until a day or two afterward? Warmest regards, Sam." This might be sufficient to allow Betty to enforce a sale contract.*

Even a combination of e-mails, read together, could suffice for Statute of Frauds purposes in some states. See also Uniform Electronic Transactions Act.

statute of limitations State and federal laws that place a time limit on the ability to make certain claims in a lawsuit. The various statutes are usually fairly clear and might provide 6 years for breach of contract, 2 years for negligence, and 10 years for rights to real property. The part that causes all the litigation is the question of "when does the time period start to run?" As a general rule of thumb, the clock starts ticking when there has been a harm that would give rise to the ability to sue. If a stairway is erected improperly in year 1, but there is no way to know this until it collapses in year 5, then the statute of limitations begins to run in year 5.

statute of repose See *statute of limitations*.

Statute of Uses A statute passed in England during the reign of King Henry VIII and expressly or by implication adopted by all American states. Formerly, one could not create an estate in land that would begin in the future. After the statute, such estates were granted legal recognition. One often sees frequent references to the Statute of Uses although it is seldom a point of contention between parties. However, as recently as 2003 the issue was raised in a California case in the context of determining rights of various parties in a trust.

statutory dedication The granting of public rights in roads, parks, or other improvements by virtue of recording a subdivision plat on which the developer indicates those areas dedicated to the public use.

statutory foreclosure See *judicial foreclosure*.

statutory lien A charge or claim upon property that arises by virtue of specific statutes that address the relationship between the property owner and the party given the ability to place the lien. A mechanics' and materialmen's lien is a statutory lien; a mortgage is a voluntary lien; and a lease giving the landlord rights in property located in the leased premises is a contractual lien. In bankruptcy, statutory liens are not enforceable but contractual and voluntary liens are. As a result, even if state statutes grant a landlord's lien, for example, the better practice is to also include those rights in the lease itself.

statutory right of redemption A right given in some states for mortgage debtors to repurchase their property after foreclosure and before expiration of the allowed time period. The same rights are also sometimes given to spouses and other creditors of the debtor. In order to redeem, the former owner must pay the full bid price at the foreclosure, plus interest. Under some statutes, the right can be lost if the property owner does not vacate the foreclosed property within a certain time period after receiving notice from the purchaser. Rights of redemption may be bought and sold.

stay, automatic In bankruptcy, the requirement that all creditor collection activities must cease immediately upon receiving notice the debtor has filed for bankruptcy protection. There is generally a breathing spell during which nothing may happen. Afterward, the creditor may apply to the court to lift the automatic stay and allow collection proceedings, usually foreclosure, to go forward.

steering The illegal practice of limiting housing choices, and thereby engaging in discrimination, through a variety of subtle and not-so-subtle techniques. An agent working with minority buyers is guilty of steering when he or she fails to provide information about houses within the buyers' price range that are located in predominantly white neighborhoods.

step-in-the-dark rule A rule of contributory negligence that says those who enter property in the dark, without first determining if there are any dangers in or upon the property, are not entitled to recover damages from the property owner if they suffer injury or damage.

step loan A type of adjustable-rate mortgage under which the interest increases in one or sometimes two steps only, combining some of the best features of a fixed-rate loan and an adjustable-rate loan.

stepped-up basis Under current tax law, a tax benefit granted to one who inherits real property, allowing an increase in basis up to the fair market value of the property as of the date of death. Normally, a person receiving a gift has the same basis in the property as the donor.

> **Example:** *If Mary buys a parcel of land for $10,000 and then 20 years later gives it to Jamie, Jamie's basis is $10,000. If Jamie sells the land, the taxable gain is the difference between the sales price, which could be many millions of dollars, and the $10,000 basis. If, however, Jamie received the same property under Mary's will, the property will be valued as of the date of death (or 6 months afterward, depending on which election is selected) and that value will be Jamie's basis. As a result, if the property is worth $1,000,000 on the date of Mary's death and Jamie sells it for $1,000,000, Jamie has no taxable gain. Mary's estate, on the other hand, could have a sizable estate tax it will have to pay. Efforts to repeal estate taxes are usually accompanied by less well-publicized compromises to also repeal the stepped-up basis rules.*

step-up lease See *graduated rental lease*.

stigma A negative impression of property because of real or perceived problems. The most common stigma is associated with property that has remained on the market for whatever time period is locally considered "too long." Potential buyers usually think there must be some problem with the property that they might or might not be able to recognize and economically cure, so they avoid such properties. Another common stigma is a commercial property, usually with a restaurant tenant, that has experienced high turnover. The reason might be that the tenants had insufficient financial resources to survive until the break-even point, but the property soon acquires a stigma as a bad location for restaurants. To some extent, the stigma can become a self-fulfilling prophecy if the community fails to patronize any business at that location because of the stigma. Despite that, there are tremendous opportunities for investors who target stigmatized properties and can successfully overcome the bad reputation.

stipulations The terms of a written contract.

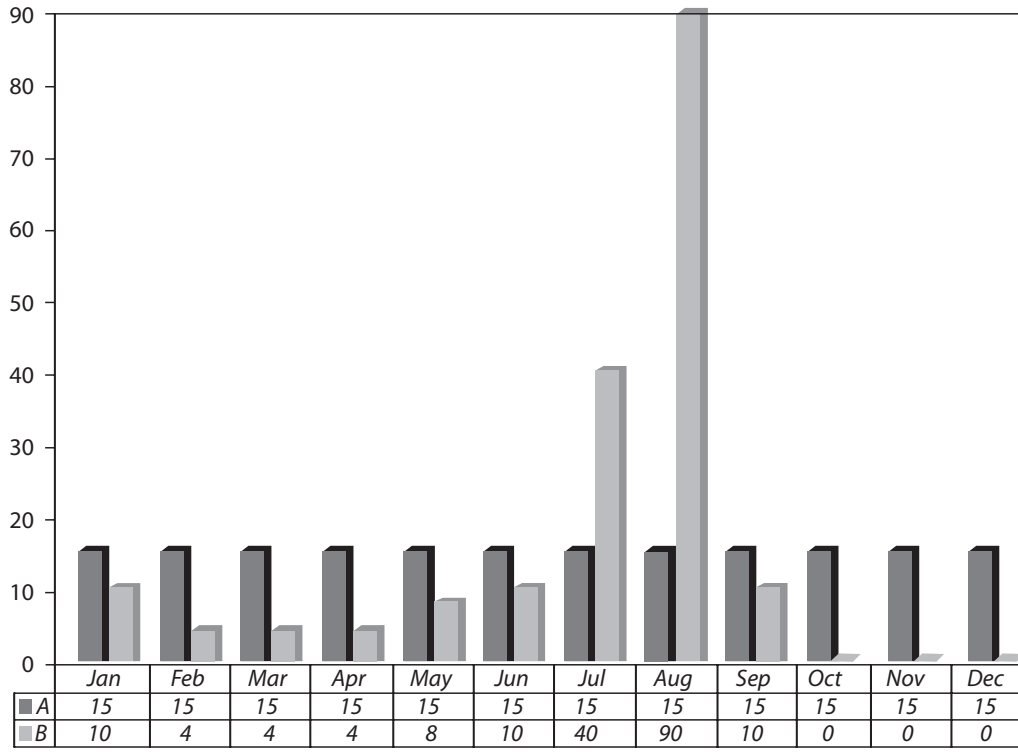
stirpes See *per stirpes*.

stockholders Persons who own shares of a corporation. As a matter of convention, persons who own shares in large, publicly traded corporations are called stockholders and persons who own shares of small, subchapter S-corporations are called shareholders. Technically, though, the two names are interchangeable.

stop clause See *expense stop*.

straight lease See *gross lease*.

straight-line To estimate evenly spaced, and regularly increasing, rents or other revenues from a project, although reality may be a little more irregular. In the graph, A (the dark columns) shows a straight-line projection for apartment lease-up over the course of the year. The B columns show a more realistic projection based on an expectation that students will largely fill the apartments in July and August with a small percentage of other rentals coming at various times.



straight-line depreciation A method of accounting for the gradual loss in value of an asset over time by predicting that the asset's value will decline in equal amounts each year over a specified number of years. The method is also used for tax purposes as an expense allowed each year for the supposed loss in value of an asset, even though it might actually be increasing in value. See *depreciation*.

straw man One who purchases real property in his or her own name and then holds it for sale to the person who supplied the money for the sale, the intended ultimate purchaser. The technique is often used when a well-known developer, or even a large local property owner such as a hospital or university, wishes to conceal its identity so sellers do not raise their prices.

street edge alternatives Streets and roads with swales—shallow ditches—lined with rocks and filled with soil and plants to increase absorption and reduce storm-water runoff into nearby streams or ponds. Contrast with the typical curbs and gutters spilling into a storm sewer system.

street hierarchy system A local government system of classifying streets in order to determine widths, traffic control devices, building setback lines, and other factors. The most common classifications are

- Principal thoroughfare, usually more than 5 miles long and connecting freeways and other major roads, with daily traffic counts in excess of 30,000 vehicles
- Thoroughfare, usually more than 3 miles long and connecting freeways and other major roads, with daily traffic counts in excess of 20,000 vehicles
- Collector, usually 1 to 2 miles long, connecting thoroughfares and local streets, with daily traffic counts in excess of 5,000 vehicles
- Local, usually less than 1 mile long, servicing neighborhoods and accommodating on-street parking and pedestrian traffic, with low traffic counts

strict liability The liability of a property owner or occupier for injury to others despite the lack of any fault or wrongdoing by the owner or occupier. Typically, when people engage in an inherently dangerous activity on land, such as blasting rock, they are responsible for damage to adjoining property or to persons injured by the blast. This is true even if an independent contractor was responsible for the work and even if everything was done exactly as it should have been done using all possible safeguards and protections and the injury was the result of a freak accident.

strip center An attached row of stores or service outlets managed as a coherent retail entity, with on-site parking usually located in front of the stores. It may be configured in a straight line or have an L or U shape. There are no enclosed walkways linking the stores. The tenants offer a narrow range of goods and services usually targeted to a local neighborhood.

structural inspection An evaluation by an engineer of the structural integrity of an improvement or a building foundation.

structural insulated panels A modular and energy-efficient method of construction that uses large sheets of rigid foam material sandwiched between sheets of plywood. Sometimes the exterior siding material is also attached to the plywood, as is the interior finish wall material. The system is used for economy construction and luxury construction, both, depending on the quality of the interior and exterior finishes, the thickness of the foam layer, and the quality of the plywood. Typically spaces are precut for windows and doors and chases are predrilled for electrical wiring.

structure Any constructed improvement to a site.

Student Loan Marketing Association See *Sallie Mae*.

subagency An agent who operates under the authority of another agent. Typically, the listing broker has the direct agency relationship with the seller of real property. Other real estate brokers may attempt to sell the same property and act as a subagent for the seller rather than acting as the agent for the buyer.

subchapter S-corporation A corporation just like any other, but that meets certain IRS requirements and is therefore eligible for specifically described tax benefits. IRS Form 2553 must be filed in a timely manner, though. If this type of corporation is elected, there are almost no taxes to the corporation on earned income, although there are some narrow exceptions. Instead, the income is taxed directly to the shareholders according to their percentage of ownership in the corporation. In order to qualify, the corporation must have no more than 100 shareholders, none of which may be another corporation or a non-U.S. citizen.

subcontractor One who performs services under the supervision of a general contractor. Also called a "sub."

subdivide To separate property into smaller parcels for sale or borrowing purposes. People normally think of a subdivision as related to development of a residential area, but the definition is not that restrictive.

> **Example:** *A seller wishing to sell only a portion of a parcel of real property may have to apply for subdivision approval before the sale, including assignment of a new tax parcel identification number. Borrowers sometimes subdivide property so that a mortgage will be on only a specific improvement, such as a house, and the land reasonably necessary to support that improvement, rather than have a mortgage encumber more land than is necessary.*

subdivision Popularly refers to a residential neighborhood developed as an integrated whole and with a specific identity.

subdivision lot and block number The subdivision plat identification for a particular parcel of land (lot) and the numbered block in which it is located.

subflooring The plywood or other solid base nailed directly to the floor joists and on which carpeting or other finish flooring is attached.

subjacent A property that is contiguous to another, but at a lower level.

subject property The property under discussion.

subject to Refers to the practice of purchasing real property on which there is an existing mortgage and, rather than paying off or assuming the mortgage, simply allowing it to remain on the property in the original owner's name. Purchasers buying property subject to a mortgage should make sure the loan does not have a due-on-sale clause and that it is not enforceable in the particular circumstances, and they should take whatever steps are necessary to ensure that monthly mortgage payments are made on time.

sublease The relationship created when a tenant rents some or all of its premises to another for some or all of the remaining term of the original tenant's lease. Technically, if the tenant transfers all of its interest, that is an assignment. If the tenant retains some of the space, or some of the time under the lease, that is a sublease. At all times, the tenant remains liable under its lease with the building owner.

sublet See *sublease*.

submarket A small geographical area that is clearly identifiable, at least to local residents, and that contains the logical users of specific goods and services being offered to the public. Submarkets will vary depending on the businesses defining them.

> **Example:** *In Houston, Texas, the Highway 290 submarket may define the customers for billboard advertising. Off 290, the Cypress submarket may define customers for a shopping center, and in Cypress, Enchanted Valley may define the submarket for a convenience store.*

submittal notice A written notice by a broker to a seller regarding the identity of a person to whom the property has been shown. This is important in order to register prospective buyers in case there is a dispute with another broker in an open listing situation and in case the listing broker is entitled to a commission if a prospect secured during the listing period buys the property within a certain time limit after expiration of the listing.

subordinate To agree to place one's mortgage or other interests in a junior position relative to another. See *subordinated ground lease* and *subordinated mortgage*.

subordinated classes Those classes of collateralized mortgage backed securities that have the lowest priority to receive payments from the underlying mortgage loans, and thus the highest risk and the highest rate of return.

subordinated ground lease An agreement by a property owner in a ground lease situation to allow the tenant's construction lender to have superior rights to the land. The ground lease tenant often builds improvements on the rented land. If those improvements are made with borrowed money, the lender can take a mortgage only on what the tenant owns—the lease rights, not the land itself. If the lender forecloses on the leaseheld interest, it must continue paying rent to the property owner or risk loss of the lease and the improvements. This is generally unacceptable to a lender. It will require the property owner to put the land up as additional collateral for the loan—subordinate the ground lease to the mortgage. In other words, if the lender forecloses, it may take the land and the improvements. Property owners who agree to subordinated ground leases generally obtain higher-than-market rent for their land, to compensate for their increased risk.

subordinated mortgage A mortgage lien that might have been filed first, but which is agreed among the parties to be treated as a junior lien and inferior to the rights of another mortgage.

subprime loan A loan at higher interest rates because the borrower does not qualify, for credit or income reasons, for the best rates.

subrogation The substitution of one party for another. Insurance companies typically have rights of subrogation, so if the insurer pays the property owner for a loss, such as a house fire, and then discovers that loss was the fault of a third party, the insurance company may sue and recover from the third party.

subsidized housing Residential dwellings that receive some form of government assistance.

subsidy Benefits granted to persons or groups in order to encourage behavior or outcomes deemed important to society. Rent subsidies encourage construction of adequate affordable housing because the owner can be ensured of an income stream as long as the housing meets government requirements. The same subsidy encourages better consumer choices because of the availability of affordable alternatives. Tax credits to contractors for energy-efficient construction are subsidies to encourage the use of energy-efficient alternatives.

substandard housing Residential structures that do not meet local health and safety requirements.

substantial completion The point at which a construction contract has been completed to the point that the owner or tenant may use the property in the manner in which it was intended, even though some work may remain undone. As used in leases for the start date of rent, construction loans for the maturity of the loan, and construction contracts defining the timing of draw schedules, the term may be defined someplace else in the document. That definition, if it exists, will control the rights and responsibilities of the parties, even if the definition is completely different from the normal understanding of the parties.

substitute trustee The naming of a successor trustee under a deed of trust for real property. Typically, the lender does not name a substitute trustee until immediately before foreclosure. A review of local real estate records for substitute trustee filings may give advance notice of opportunities to invest in foreclosure properties.

substitution In appraisal, the principle that the value of property may be determined by examining the sales prices of similar properties sold in the past. The theory is that a buyer would be indifferent to the substitution and either property would be acceptable.

subsurface rights See *mineral rights*.

suburb An outlying residential area some distance from a city's core.

successor in interest An owner of property after the one being described.

> **Example:** *Jim executed a mortgage on property that was never paid off, but which never showed up in title searches until recently, despite the fact the property had been sold several times. All of Jim's successors in interest were in danger of losing their property to a foreclosure by the mortgage holder.*

successor trustee Under a deed of trust, a person or company called a trustee holds the title to the mortgaged property. If that trustee resigns, another one, called the successor trustee, must be appointed.

summary appraisal report A written appraisal report with a minimum of detail. Contrast with a *self-contained appraisal report*.

summary possession See *eviction*.

sum-of-the-years digits depreciation An accounting method of describing the loss in value of an asset over time, sometimes used for personal property that tends to lose more of its value in the early years and then level off.

sunset clause A provision in a sales contract that sets a date for closing and after which the contract will be unenforceable except for provisions related to damages or earnest money refund or retention.

superadequacy A component of real estate that is not necessary to the current or anticipated use and so adds no value. In an office building, a private luxury bathroom with a whirlpool tub and steam shower, installed off the office of the president of the company, could be deemed a superadequacy.

superfund See *CERCLA*.

Superfund Amendments and Reauthorization Act (SARA) Amendments to the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA) that placed greater emphasis on state and citizenry involvement and coordination, increased focus on human health problems from contamination, and put in place greater enforcement mechanisms.

supermajority A specified number of votes greater than a 51 percent simple majority. Some condo association bylaws, corporation bylaws, or neighborhood association rules require a supermajority for certain actions, such as making special assessments or amending the bylaws. The rules for the organization will specify the size of the supermajority, which can be anything from 67 to 95 percent.

superpriority The rights of certain creditors of a bankrupt debtor to receive payment before others that would seem to have superior claims to money or assets; typically granted when a creditor provides much-needed financing after the filing of the bankruptcy petition. Attorneys and bankruptcy trustees have a de facto superpriority because they will always be paid from estate assets before any other creditors.

superstructure That portion of a building or other structure that is aboveground.

supply and demand An economic principle that says the price is determined by the point where supply equals demand. As supplies increase and purchasers have more choices of housing or commercial spaces, sellers and landlords will begin to compete on the basis of price and prices will come down. As demand increases and there are insufficient properties in the market to meet the demand, purchasers will begin bidding up the prices or sellers will raise prices until they meet some price resistance.

supported housing See *congregate housing*.

suprariparian Upstream; describes the relative position of two properties that border a river or stream. The one that is upstream, in the direction against the current, is the suprariparian property. In some states, suprariparian owners may not take so much of the water from the stream or river as to deny its use to those downstream.

surety One who guarantees the performance of another. Contrast with a simple guarantee, which is an agreement to pay money if another does not pay money due. A surety, on the other hand, may have to pay money or undertake the responsibility to complete a project.

surety bond See *fidelity bond*.

surface rights The right to use and modify the surface of land. Normally, one who has mineral rights may make use of the surface in furtherance of those rights, but may not destroy the value of the surface.

surplus funds The situation in which a foreclosure sale results in more money than is necessary to pay off the mortgage loan plus all expenses and costs of foreclosure.

surrender The cancellation of a lease or other contract by mutual agreement of the parties.

surrogate court In some states, the name given to the probate court that has jurisdiction to supervise the administration of a decedent's estate.

survey The process by which land is located with reference to commonly agreed upon landmarks or other points of reference, and then measured out for all of its boundaries, including distances and direction-and-degree of turns. Surveys will typically note any indicia of property lines, even if inaccurate, including fence lines and marks left by prior surveyors. A topographic survey will also include land contours. An as-built survey will include all improvements upon the property with their placement and dimensions.

surveyor A licensed professional who prepares surveys.

surviving spouse's share The ability of spouses to choose to disregard the will left by their deceased husband or wife and, instead, to take a portion of the estate as specified by the state's laws. The provision for a surviving spouse's share is intended to prevent spouses from being disinherited and left destitute.

survivorship The right of a joint tenant to attain full ownership rights upon the death of other joint tenants. It is sometimes important to understand that the survivor does not acquire the rights of predeceased joint tenants; rather the deaths of the other tenants remove obstacles to full ownership by the survivor.

suspect A person identified as possibly having an interest in buying, but who has not yet been contacted or has not yet given any evidence of interest. Contrast with a *prospect*, who has indicated some interest in buying and who appears to have the desire and the ability to purchase.

suspense account In accounting, a temporary "parking place" for entries one does not know how to classify.

> **Example:** *An apartment project receives a cash rent payment left in its mailbox. There is no indication of the name of the tenant, so the manager cannot post the payment to any particular account. Because of the software accounting system, however, the manager cannot create a deposit slip for the payment unless there is a tenant account. To solve the problem, the manager posts the payment to the suspense account, where it will stay temporarily until someone can find out the tenant's name.*

sustainable site design Landscaping plans using plants either native to the area or tolerant of local weather conditions and thus requiring a minimum of water and chemical management for diseases and pests.

sweat equity An increase in the value of property due to the rehabilitation and renovation efforts of the owner, usually acting as his or her own general contractor, subcontractor, and laborer.

sweetener Something extra included in a transaction to make it more palatable to the other side. For example, Farmer Brown might agree to mow the fields for 5 years if Roberta Rider agrees to buy 10 acres of his land for a horse farm.

sweetheart contract A contract entered into by related parties who do not negotiate aggressively for the best terms and conditions and which usually has the effect of costing a third party more money than would otherwise be necessary under the circumstances. At one time it was common for developers to retain title to recreational amenities in a subdivision or condo project and charge high rents for their usage. This has largely been regulated out of existence, but such sweetheart contracts always seems to arise in some other guise.

swing loan A short-term loan that allows homeowners to buy a new home even though their old one has not yet sold.

SYD See *sum-of-the-years digits depreciation*.

syndicate A method of selling real property in which a sponsor—the syndicator—sells interests to investors. At one time limited partnerships were the preferred vehicle. Today tenant-in-common properties (TICs) are extremely popular.

synthetic lease A transaction that appears as a long-term lease from an accounting standpoint but as a loan from a tax standpoint. In the past, such transactions were booked as leases in order to remove loan liabilities from the balance sheets of companies. The company did not have to disclose the duration of the long-term leases, simply the amount of annual lease expenses. Now, the Sarbanes-Oxley Act requires publicly traded companies to disclose the true nature of such off-balance sheet transactions. Unfortunately, many such synthetic leases included both real and personal property. Today, perhaps 10 years after they were originated, the transaction must be reported as a loan liability; the real property posted as an asset at its current value; and the personal property, now practically worthless, posted at its value. The result has been huge losses posted to corporate balance sheets because of the accounting corrections.

T

table funding A lending method employed when a loan originator does not have access to the money necessary to make loans and then hold them until it has enough to sell on the secondary market. As a result, the originator forms a relationship with a lender who provides the funds for closing and immediately takes an assignment of the loan. This is called table funding. Under regulations of the Department of Housing and Urban Development, table-funded loans must disclose service release premiums—profit received by the originator—on the loan closing settlement statement. Loans sold on the secondary market do not have to make those disclosures.

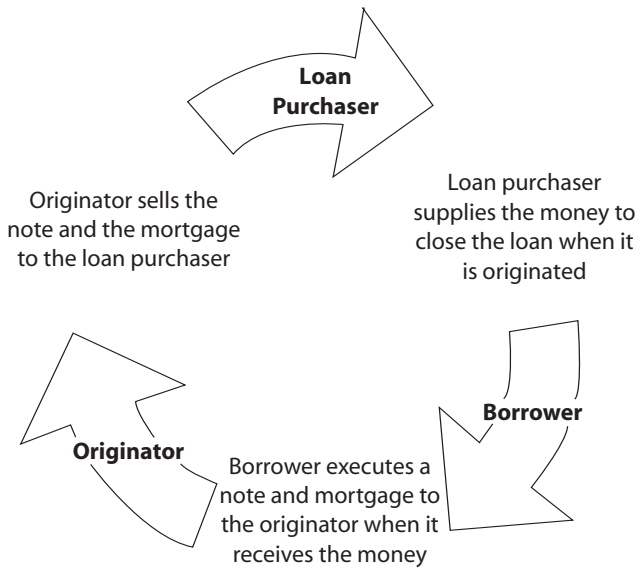
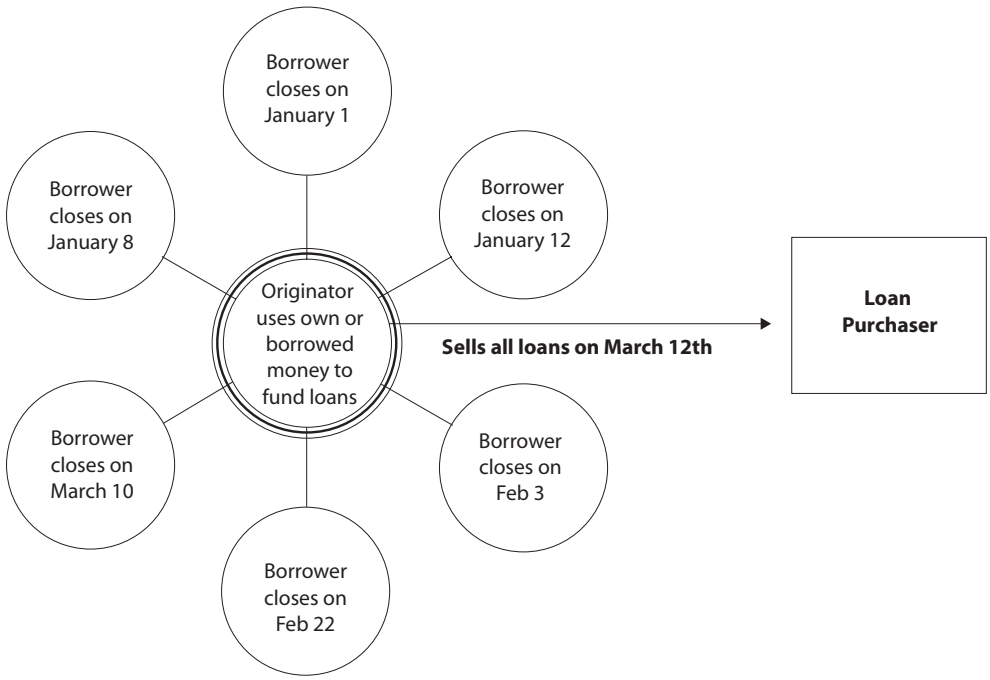


Table funding—everything occurs on the same day.



A typical (non-table funded) loan transaction.

tack To add one time period onto another. When parties are in adverse possession of real property, the possession must be uninterrupted and last for 10 to 20 years before the true owner will be prohibited from trying to regain the property. A current possessor can tack his or her time together with the time of prior possessors in order to accumulate the requisite number of years.

take (1) A generic term meaning to acquire title by whatever means, such as by deed, by will, by purchase, or by gift, to name a few. (2) A common expression for a condemnation under the power of eminent domain.

take down To receive money from a loan. A developer or contractor will usually take down its loan in planned stages.

take-out commitment A binding agreement by a lender to provide permanent financing at the expiration of the construction financing, if certain conditions have been met. These usually include minimum occupancy levels for an income-producing property.

tangible personal property That which can be seen, touched, and moved, such as equipment, furniture, and vehicles. Contrast with intangible personal property, which includes goodwill, copyrights, and accounts receivable.

tangible property Real estate plus tangible personal property.

targeted affordable housing A Freddie Mac (www.freddiemac.com) multifamily lending program.

taxable income Gross revenues minus almost all operating expenses, depreciation, loan interest, and a few other minor items. Some business expenses, such as entertainment, are not fully deductible.

tax and insurance escrow A fund maintained by a lender when a borrower makes monthly payments toward the annual property tax and insurance bills. See *PITI*.

tax avoidance Perfectly legal and ethical strategies for reducing taxes to the lowest possible number. Contrast with *tax evasion*.

tax base The assessed value of all the property within a taxing jurisdiction. Local governments are always extremely sensitive to the size of the tax base and the need to increase it, and will often offer incentives to developers who will increase the sales taxes in the area, increase the tax base through additional improved properties, or increase the tax base through redevelopment and increased property values.

tax benefit rule A rule that if one receives a tax benefit from an item in a prior year because of a deduction, such as for an uninsured casualty loss or a bad debt write-off, and then recovers the money in a subsequent year, the money must be counted as income in the subsequent year.

> **Example:** *Acme Inc. suffers a fire a few days after completion of a building that cost $500,000 to build. The building is a total loss. Acme's insurance company refuses to pay the claim, suspecting arson. Acme writes off the $500,000 loss as an expense on its taxes and sues the insurance company. Five years later Acme wins the lawsuit and receives an award of $500,000. The money must be reported as income because it was expensed in the earlier year. If it had never been written off, it would not be income when the judgment was recovered.*

tax bounty hunter See *tax ferret*.

tax bracket The highest marginal tax rate to which a person or estate will be subject. Income taxes and estate taxes are calculated as a percentage of adjusted gross income, but the percentage increases as income increases. One's income is divided into brackets with an upper and lower limit to each bracket; the income within the bracket is taxed at its appropriate percentage rate, and then the next bracket is taxed at a higher percentage rate. See *marginal tax rate*.

tax certificate When a property is sold for delinquent real estate taxes, the purchaser usually receives only a tax certificate. It is not a deed, nor does it transfer title to the property into the purchaser. Rather, it is a right to receive a deed when the statutory time period passes but only if the property owner has not paid all past-due taxes plus interest and costs.

tax court A specialized federal court established to hear taxpayer claims opposing tax deficiencies assessed by the Internal Revenue Service. There are no juries in the United States Tax Court, but on the plus side, the taxpayer does not have to pay the IRS before filing suit. If a jury is desired, the taxpayer can contest the same issues in the United States District Court for the taxpayer's district, but

only to claim a refund. In other words, the party has to pay the taxes first, and then file suit in District Court. If you pay your money, you get a jury. No money, no jury.

tax credit A direct reduction against income tax liability. Credits reduce taxes dollar-for-dollar. Common tax credits include

1. Earned income credit, used to assist low-income taxpayers.
2. Saver's tax credit, for contributions to qualified retirement plans by low-income individuals.
3. Child-related credits for child- and dependent-care expenses, adoption expenses, and the child tax credit.
4. Education credits, particularly the Hope credit and the lifetime learning credit.
5. Credits for the elderly or disabled.
6. Mortgage credit certificate programs by some state and local governments may be used for tax credits on federal income taxes.
7. Work opportunity credits (for businesses).
8. Rehabilitation credits.

Contrast with a tax deduction, which merely reduces income on which taxes are calculated.

tax deduction An expense allowed as a reduction of taxable income. The most common individual deductions are for home mortgage interest, ad valorem and sales taxes, moving expenses associated with a job, charitable giving, and health-care costs. Virtually all expenses associated with income-producing property are deductible, including noncash expenses such as depreciation. Virtually all operating expenses for a business are deductible, except that capital expenditures (a new roof, expansion of building, purchase of equipment) must be capitalized and depreciated over time unless falling within the Section 179 limits. Section 179 lets a taxpayer deduct as expenses certain things that would otherwise have to be capitalized.

tax deed A deed issued to the successful purchaser at an auction for unpaid real estate taxes, but only after passage of a predetermined period of time during which the owner may reclaim the property by paying all past-due taxes, expenses of sale, and interest. See also *tax certificate*.

tax-deferred exchange See *1031 exchange*.

tax depreciation See *depreciation*.

tax evasion The use of fraud or other illegal means to hide income or reduce taxes. Contrast with *tax avoidance*.

tax exemption A reduction in the assessed rate of real property for purposes of calculating ad valorem taxes. Properties used for religious purposes usually have a 100 percent reduction, resulting in no tax liability. Additional exemptions might be granted for other uses, such as for a personal residence, timberland, or conservation land. One must generally apply for exemptions; they are not granted automatically.

tax ferret A person who assists property tax collectors, for a fee. Also known as a tax bounty hunter.

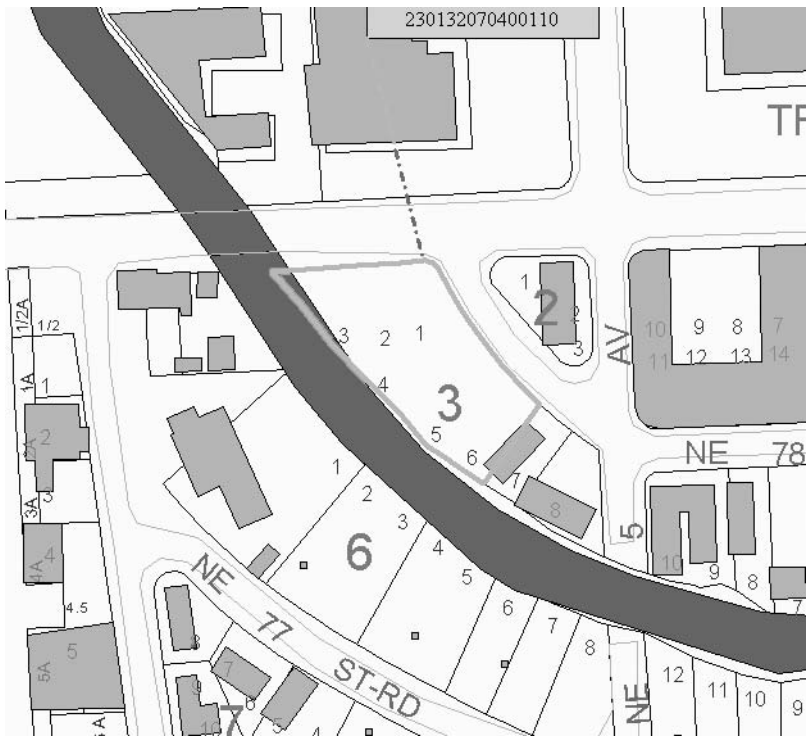
tax foreclosure See *tax certificate, tax deed*, and *tax sale*.

tax-free exchange A common term for a tax-deferred exchange. It is not tax free; one pays the taxes at a later date. See *1031 exchange*.

tax home A person's principal place of business or employment. Used for determining if travel expenses are deductible, because they are from the tax home to other business locations, or if they are simply nondeductible commuting expenses from the residence to the tax home.

tax lien (1) A statutory claim on specific real property for ad valorem or other property taxes; the lien is automatic and nothing regarding a particular property needs to be filed. The tax lien has priority over all other liens—even a mortgage filed before the taxes became due. (2) A claim on all real property of a taxpayer within a certain geographical area, usually a county or parish, because of unpaid federal or state taxes. The lien attaches when the lien documents are filed with the local recording office, and not before. Even though an IRS lien does not take priority over a prior-recorded mortgage, a mortgage lender who fails to give proper foreclosure notice to the IRS may find the property still subject to the lien, even after foreclosure.

tax maps An official document showing the locations and parcel identification numbers for all property located within an ad valorem (property) tax jurisdiction. Today, many tax maps are maintained online for easy search by citizens, either through a commercial service such as eMapsPlus (www.emapsplus.com) or by the local tax assessor or tax mapping office.



tax on sale of home See *Section 121*.

tax preference items Certain types of income or deductions that are used to calculate the alternative minimum tax. The most common item related to real estate is the depreciation deduction.

tax rate The percentage used to calculate various taxes.

tax redemption (1) The act of a property owner paying all delinquent real estate taxes, plus expenses and accrued interest after a tax sale but before final issuance of a tax deed to the sale purchaser, and thereby regaining all rights to the property. (2) In some jurisdictions, another name for a tax certificate is a tax redemption certificate. It is the document given to a successful tax sale purchaser, and entitles the purchaser to receive a tax deed after a preset period of time unless the owner pays all taxes before that time expires.

tax roll A list of all real property parcels located within a taxing jurisdiction, with the names of the owners or those receiving the tax bills, assessed value of properties, and tax amounts due.

tax sale A public sale because of unpaid property taxes. In most jurisdictions, the successful purchaser receives only a tax certificate, which will entitle the purchaser to ask for a tax deed after the passage of the time period specified in that state.

tax shelter An investment that generates paper losses or tax credits that may be used to offset other income and thus reduce taxes.

tax stop A clause in a lease that stops the escalation of tax expenses for either the landlord or the tenant. (1) A tenant tax stop would put an upper limit on the taxes a tenant must reimburse to a landlord under a net lease or triple-net lease. (2) A landlord tax stop would require the tenant to reimburse the landlord if property taxes in any year exceed a certain amount.

tax year The accounting year selected by a taxpayer for purposes of determining annual taxable income. A new company may select any tax year it desires—July 23 through July 22, for example—and need not use the standard individual tax year of January 1 through December 31.

TDR See *transferable development rights*.

teaser rate A below-market rate for the initial period of an adjustable-rate mortgage. It is intended to attract borrowers to this type of loan. Interest usually adjusts to market rates or even somewhat higher on the first allowed adjustment date.

technical advice memorandum (TAM) A written interpretation of tax law as it relates to a specific problem posed by a specific taxpayer. The question must regard a closed transaction—a dispute over the treatment of something done in the past, not a request for advice on how to proceed in the future. Only an IRS district director or the chief of a local Appeals Office may request a TAM, which is then written by the National Office. TAMs are binding on the IRS for only the transaction at hand. Other taxpayers who use the TAM as guidance for their own actions do so at their own risk, because the IRS may take the opposite position the next time. Contrast with a *private letter ruling*, which has

the same effect but the guidance comes from the local office and the advice relates to a future transaction. Contrast also with a *revenue ruling*, which is often issued in response to a particular taxpayer problem but which may be used by all other taxpayers as authority for their actions.

temporary restraining order (TRO) (Pronounce each of the letters, not as a word.) A court order issued upon application of someone claiming that a state of emergency exists, a defendant must be ordered to desist some action, or a defendant must be ordered to take some action, otherwise irreparable harm will result and the simple recovery of money damages afterward will not be adequate to compensate the plaintiff. Because of the unique nature of real estate and the protections historically granted to it, TROs are usually sought in order to stop developers from cutting trees, clearing land, building or destroying dams, or other such matters.

- The temporary restraining order is a type of injunction.
- Normally the application must be made under oath and must be accompanied by a bond in an amount set by the court. The bond is supposed to provide a fund out of which a defendant may be reimbursed if it later appears that the temporary restraining order was wrongful.
- The TRO may be issued without notice to the other side and without giving the other side an opportunity to argue against it, if certain technical requirements are met. The judge issuing the TRO must set the matter down for hearing on a preliminary injunction within a very short period of time, and notice of the hearing must be given to the other side. At that hearing, the judge will either grant the preliminary injunction or dissolve the TRO. If the judge grants the preliminary injunction, the matter will be set for trial regarding the propriety of a permanent injunction. A judge may determine that there is no emergency, dissolve the TRO, but still set the matter for trial regarding a permanent injunction or money damages.

tenancy The right of possession to real property; may refer to a leasehold interest or any ownership interest.

tenancy at sufferance A tenancy established when one who was originally in lawful possession of property refuses to leave once the tenancy expires.

tenancy at will A landlord-tenant relationship that arises because of some defect in a written lease or because the parties intended to execute a lease but, for some reason, never did. It continues for as long as both parties desire it to continue, usually on a month-to-month basis. Many consumer protection statutes require a minimum of 30 days notice before termination of a tenancy at will. (Do not confuse with a periodic tenancy, which may be from month to month and terminable upon a 30-day notice, but which was never intended to be anything more than a lease for an indefinite time.)

tenancy by the entireties An estate in land allowed in some states and available only to husbands and wives. Each owns an undivided interest in the whole. When one dies, the survivor takes everything. Unlike a joint tenancy, however, a tenancy by the entireties cannot be destroyed and

converted into a tenancy in common when one person attempts to sell his or her interest to an outsider. In addition, creditors of just one spouse may not execute on that interest. Any disposition or mortgage of the property requires both signatures to be valid. (In most states, even most judges may not divide the property or order it to be sold.)

tenancy for life See *life estate*.

tenancy for years A leasehold interest for a fixed term, which may be month to month. The more proper term is a periodic tenancy. Do not confuse with a tenancy at will, which is usually a month-to-month tenancy that arose because of some defect in the originally planned lease between the parties.

tenancy in common Joint ownership of an undivided interest in real property with one or more other people, corporations, or other entities. Tenants in common may each sell their shares to outsiders. If a tenant dies, that tenant's share goes to his or her heirs or as directed in a will. Contrast with *joint tenancy*, sometimes called joint tenancy with right of survivorship, in which one's death causes the cessation of any interest, leaving the survivors to have undivided interests in the property. See also *tenant-in-common properties*, which are a specialized investment vehicle using the tenancy-in-common concepts.

tenancy in severalty Ownership of one property by one person. That one person may own more than one property, but each property is owned "in severalty."

tenant (1) One who leases real property. (2) One who has an estate in land, such as a joint tenant with right of survivorship.

tenant improvement (TI) allowance A negotiated sum a landlord is willing to spend to customize space for the needs of a particular tenant. For second-generation space—that with walls, doors, ceiling tiles, lighting, and electrical already in place because of a prior tenant—the offered TI allowance will typically be enough to replace worn carpets and wallpaper, paint walls, freshen up some cabinetry, and move a minor number of walls and doors. For first-generation space—brand new space—the TI allowance is often insufficient to complete construction with even the most inexpensive quality of components. Construction expenses in excess of the TI allowance must be paid by the tenant.

tenant improvements Improvements to leased space for the benefit of a nonresidential tenant.

tenant-in-common properties (TICs) (pronounced as a word) Rarely called by its full name. See *TICs*.

tenant mix The type and quality of the tenants in a commercial property. Institutional investors typically prefer a mixture of credit tenants from the national, regional, and local levels.

tenant reimbursements Amounts paid by a tenant to a landlord as reimbursement for operating expenses, taxes, and insurance, if required by the lease.

tenant representative A real estate broker or agent who represents tenants in locating and negotiating space for lease. Typically, the commission is paid by the landlord and is a percentage of the gross value of the lease. If the commission is 4 percent and the rent is $5,000 a month for 5 years, then the gross rent is $5,000 × 12 (months per year) × 5 years = $300,000. The commission would be 4 percent of that, or $12,000.

tenant tax stop See *tax stop*.

tender An offer to perform a contract, with the present ability to do so. The term is important when parties dispute the amount due on a debt. Usually, the debtor tenders payment in full, but the payment is refused by the creditor because of an assertion that more is due and the creditor will not accept a partial payment. Because there was a tender, if it is later determined the debtor's calculations were accurate, the debtor will owe no additional interest, costs, fees, or expenses.

tenements (1) A common expression for apartment buildings in advanced stages of disrepair, located in a generally deteriorated part of town. (2) In its broadest sense, anything permanent that may be the subject of an interest. It is more than just land, but includes all real property that is the subject of a freehold interest and so excludes leases. See *land, tenements, and hereditaments* for differences among the words.

tenure A time period, as in the tenure of a lease.

tenure in land The manner in which one enjoys rights or possession, such as a leasehold interest or a fee simple interest.

tenure monthly advance reverse mortgage A specialized reverse mortgage in which payments continue as long as the owner occupies the property, even if the payments exceed the value of the property.

term The life of a loan.

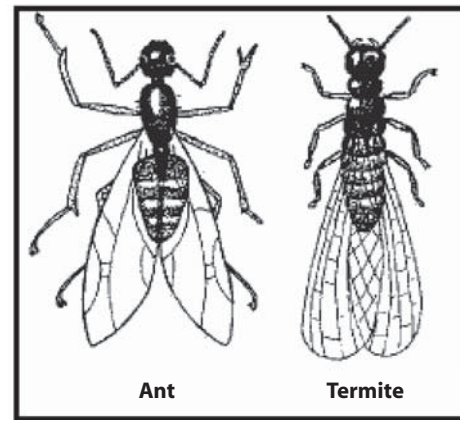
term, amortization The number of years over which a loan will be completely paid by regular monthly payments of principal and interest. Terms of 20, 25, and 30 years are common with residential mortgages. New regulations allow terms as long as 50 years. Especially in commercial real estate, it is very common to have amortization terms longer than loan terms. A lender may offer a "10-year loan on a 30-year am" which means the regular monthly payments will pay the loan in full by the end of 30 years, but the entire loan balance will be due at the end of 10 years.

terminal value The remaining value of property at the end of a certain designated period.

terminate To end. (1) For leases, this term implies an ending before the natural expiration time, as by default. When reviewing leases, pay close attention to the rights and responsibilities "upon termination" or "at expiration," because these are two completely different circumstances. (2) For partnerships, it means the end of the partnership business and affairs, although that might technically be before formal dissolution of the partnership. (3) Under the Uniform Commercial Code, it means legally ending a contract, without default by either side.

termination date Although the verb "to terminate" in a lease usually implies an ending before the natural expiration, termination date is sometimes used to mean the natural ending date of a lease.

termite bond An insurance policy issued by a pest control company. There are two varieties. The most common is a retreatment bond, which will pay all costs and expenses of eradication and retreatment if termites are discovered. Less common today is the repair and retreatment bond, which will also pay for any repairs necessitated by termite damage. Virtually every bond today excludes Formosan termites from their coverage. The Formosan termite is a particularly voracious termite that exists in large colonies and eats practically anything.



termite clause A provision in a sales contract that allows a buyer to obtain a termite inspection, also called a wood infestation report, and either cancel the contract or require the seller to eradicate and repair as a condition of closing if termites are discovered.

term loan A loan with a maturity date but no amortization. One pays the interest monthly, quarterly, or annually, as required by the lender, but the principal is not due until maturity. Term loans of short duration, usually less than one year, may be set up as single pay loans. In that case, principal and all accrued interest are paid at maturity.

term monthly advance reverse mortgage A specialized reverse mortgage plan in which the payments are for a specified term; usually employed by homeowners who do not expect to live very much longer. The advantage over a regular reverse mortgage is the ability to receive larger monthly payments.

terotechnology A study of costs associated with an asset throughout its life cycle, using analytical tools such as internal rate of return, present value, and discounted cash flow. The results are used to better manage the property.

testament Originally, an instrument that provided for the disposition of personal property after death. Today, it is simply another word for a will, as in "last will and testament."

testamentary trust A trust created by one's last will and testament.

testator The decedent who leaves a will. The feminine form used to be called "testatrix," but today testator includes male and female.

testatrix See *testator*.

testimonium clause The clause in a deed that says, "In witness whereof, the parties to these presents have set their hands and seals on this the ___ day of _____, _____." It is the clause that identifies the grantor(s) and establishes the date of signing.

theme or festival center A shopping center designed to appeal primarily to tourists, sometimes with unified architectural themes, entertainment, dining, and merchandise. Examples include Pier 39 in San Francisco, Jax Brewery on the riverfront in New Orleans, and Faneuil Hall Marketplace in Boston.

thin corporation A corporation with large debts to its shareholders and very little equity. In such a situation, the IRS may reclassify the debt as equity investment, meaning payments to shareholders do not include tax-deductible interest but are, instead, dividend payments. Thinly capitalized corporations are used for a variety of sophisticated tax planning vehicles.

thinly capitalized See *thin corporation*.

thin market A market in which there are few sales, making it difficult for people to purchase a property or to find comparable sales for an appraisal.

third-party beneficiary contract A contract formed between two parties, but some or all of the contract is for the benefit of a third party who owes no obligations under the contract. The classic third-party beneficiary contract is a life insurance policy, which is intended to benefit a survivor. In real estate, the concept frequently comes up as aggrieved individuals attempt to claim they are third-party beneficiaries of contracts among property owners, surveyors, appraisers, or developers and therefore are entitled to sue for breach of contract.

> **Example:** *Linda wants to obtain a home equity loan. The bank hires an appraiser to determine the value of her home. The appraiser finds that Linda has no equity, and the property has actually declined in value since she purchased it 5 years earlier. Linda is turned down for her loan request. She sues the appraiser for negligence and for breach of his contractual obligations to perform his job in a good and professional manner. The court dismisses all claims because the appraiser did not owe any duty to Linda, so there could be no negligence. In addition, she was not a party to the contract between the bank and the appraiser, so there could be no breach of contract. Finally, she was not a third-party beneficiary because the contract was not for her benefit, but for the bank's protection. (Like the insanity defense in criminal law, the third-party beneficiary theory is often employed, but seldom successful.)*

thirteenth-month accounting period An accounting method that does not seek to make annual corrections or adjustments during any particular month or quarter, because that would skew the financial reporting for that particular period. Instead, an artificial month is created, being the thirteenth month. Bad debts, other write-offs, and income from unusual activities are all booked in the thirteenth month and then flow through for year-end accounting purposes. (Do not confuse with thirteenth-period accounting, which uses 13 periods per year, each with 4 weeks, for a total of 52 weeks or 1 year.)

TICs (tenant in common properties) Almost always pronounced as a word and very rarely called "tenant in common properties." Investment vehicles that allow persons to buy fractional shares of real estate interests directly, rather than shares of stock, bond certificates, or other intermediate ownership mechanisms. The property may be a high-rise office building on the other side of the country, a retail center, a triple-net lease from a national drugstore chain, oil or gas wells, or any other investment properties. Because of securities and tax law limitations, no more than 35 investors may be

involved to jointly own the properties. It allows them to invest in high-quality property that would ordinarily be outside their budgets—most properties that are "tic-ified" cost $30 million or more.

The industry has grown from virtually nothing in 2002—when an IRS ruling clarified the status of such an investment—to many billions of dollars of properties today. An investor has the ability to invest in a TIC as a replacement property in a 1031 exchange.

tie-in contract A contract in which a vendor conditions the sale of a desirable product on the purchaser's willingness to also buy a less desirable product. The products are said to be tied to each other. The definition includes lenders, who might express a willingness to loan money for a development project at very attractive interest rates and terms, but only if the developer will purchase a piece of foreclosed real estate in the lender's inventory. The slang expression for this practice is called trash for cash. It is illegal under banking regulations and under the Sherman Antitrust Act.

tier A row of townships extending east and west. See *public land survey system*.

Tier I, II, III, or IV data center Facilities for the secure maintenance of data computers for government, industry, health care, and finance. Each increase in a tier level represents increased redundancy (duplication of equipment), reliability, power paths, and availability. A Tier IV data center must be able to withstand one unanticipated worst-case scenario with no interruption in service. Because of rigorous site prerequisites for a Tier IV facility, such as distances from certain risk factors, it can be extremely difficult to find an appropriate property for a user.

timber investment management organization (TIMO) A group that aids institutional investors in locating and managing timberland. The industry grew after legislation in the 1970s that encouraged institutional investors to diversify their portfolios. A 2002 study by Yale's Program on Private Forest Certification showed that approximately $14.4 billion of timberland was managed by TIMOs.

time is of the essence An expression that often appears in contracts and leases. It is intended to nullify the typical rule that one may have a reasonable amount of time after passage of a deadline in order to do the thing required. If the writing contains a time is of the essence clause, then failure to perform by the deadline will be a noncurable default.

time-price differential The difference between the purchase price of a property and the higher total price paid if the purchase is financed. The Truth in Lending Act requires disclosure of the time-price differential in an installment sale contract.

time-share ownership The right to use property for an interval of time each year. See *time-sharing and time-shares*.

time-sharing and time-shares A temporal division of possessory rights in real property, typically allowing one the use of resort property for a limited time each year. "Owners" may have deeded rights to the real estate with fixed or floating periods of possession, or they may have only a license or other such right-to-use, but no ownership. The rights may be limited in duration, expiring after 5 or 10 years. Many time-share communities offer exchange programs, allowing one to use their time

at a different resort than the one of their purchase. Besides the original acquisition price, owners are responsible for their share of the annual dues and unusual expenses. The resale market is limited, so the economic evaluation of a decision to buy should not depend on the ability to recover the purchase price, much less a profit, at some time in the future.

There is currently some regulatory confusion among states and the federal government regarding exactly how time-share interests should be treated. Before developing a time-share project, one should check with local authorities to see if any of the following are required: securities registration with the state Securities Department, subdivision platting, condominium registration, and/or real estate license needed for sales of interests.

title (1) All the elements that create the highest legal right to own, possess, use, control, enjoy, and dispose of real property or an inheritable right or interest in it. (2) The rights of ownership recognized and protected by the law.

title by estoppel See *estoppel by deed*.

title insurance A policy issued by an insurance company to cover defects in legal title to real property, including liens and other adverse claimants. All institutional lenders (everyone except individuals and small private lenders) require title insurance in connection with their loans. One may buy the basic, no-frills policy or add riders for additional protection and higher premiums. (The standard title insurance policy written for closing protects only the lender; owners should request owner coverage in addition.)

Commercial borrowers comparing lending costs among providers should inquire about the standard riders required by each lender: a large number of riders can dramatically increase closing costs and may make the difference in a decision between two lenders. Riders (also called endorsements), can address some of the following:

- Inflation
- Problems with restrictions, encroachments, and minerals
- Zoning problems
- Separate tax parcel problems if the tax parcel includes land in addition to that being mortgaged
- Losses if it turns out the land does not abut a public street
- Last dollar coverage, meaning that if the loan is secured by real property and personal property, borrower payments will be treated as if made to personal property first, so that the lender's real property title insurance is not reduced simply by virtue of loan payments
- Usury, so that if a court rules that the mortgage is invalid because the note's interest rate is too high and violates state usury laws, the title insurance will pay the lender
- Environmental protection, in case a government authority files an environmental protection lien that gains priority over the mortgage
- Going-concern value measure of damages for an operating business, rather than simply the value of the real estate measure of damages

Title I (one) loan A HUD loan insurance program for light to moderate home improvement loans up to $25,000 for single-family residences, and up to $12,000 per unit, with a total cap of $60,000, for multifamily properties. The loans may be repaid over 20 years at market interest rates. This is not a subsidized-interest program, although some local communities do offer interest subsidies in connection with Title I loans. Eligible borrowers include owners, purchasers under a contract for sale, or tenants with at least 6 months left on their lease. [Do not confuse with HUD's 203(k) loan, also called a HUD rehabilitation and repair loan.]

title I look-alike loan Same as a Title I loan, except privately funded without government insurance, and the money can be used for other things beside home improvements.

title plant A collection of information about the ownership and lien history of property, filed according to geographical location rather than by owners' names. The use of a title plant makes it very easy to research the history of ownership of land.

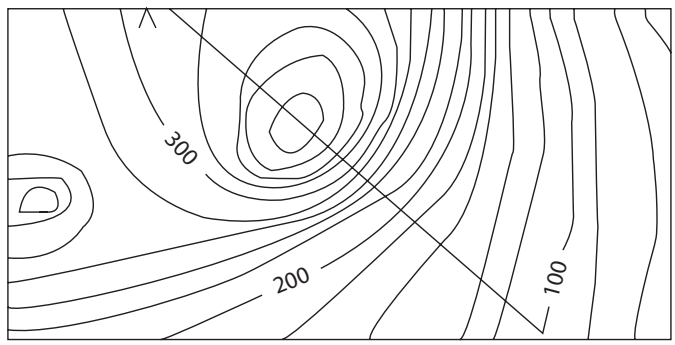
title search A review of all recorded documents that affect title to a particular piece of real property. Ideally, a title search should proceed all the way backward to the original patent (deed) out of the government into the first private owner, or to the root deed, which is the first deed before a statutorily enacted cutoff date for claims.

title theory of mortgages See *title-theory states*.

title-theory states Those states in which mortgages are treated as passing legal title to the lender, with the borrower having equitable title. Typically title-theory states employ a deed of trust instrument rather than something called a mortgage. If the borrower pays the debt in full, then the lender reconveys the property to the borrower. Contrast with *lien theory states* and with *hybrid theory states*.

tolling A suspension of a statute of limitations time period. In adverse possession, the time period may be tolled while the record owner is a minor child and unable to bring a lawsuit to oust trespassers in possession of his or her property. Parties in disputes often contractually agree to toll all applicable statutes of limitations while they pursue negotiations; otherwise a rapidly approaching expiration date would force them into litigation just to avoid loss of valuable rights.

topo Short for topographic map.



topographic map A map that shows the contours of the land via a two-dimensional drawing with multitudes of contour lines showing changes in elevations. Each map has its own scale. The contour lines indicate a change in elevation by the scale amount. For example, each line might represent a 1-foot change in elevation. The distance between the lines can be computed by reference to the distance scale. For example, 1 inch might equal 50 feet. Two contour lines that are 1 inch apart would indicate a grade of 1 foot over the course of 50 feet, which is very gentle. The closer the lines on the topographic map, the steeper the incline. (See figure on bottom of page 414.)

topography The contours of land—such as flat, rolling, or steep.

topping off A ceremony to celebrate the completion of a building. It is a custom to attach a tree branch to the highest point on the roof at that time. All decision makers and management-level people involved in the project, including lenders, professionals, ownership, important prelease tenants, and construction and development personnel are usually invited to the ceremony, and each are given a complimentary hard hat customized with the name of the building and the date of the ceremony.

tornado bait A slang expression for a mobile home park.

Torrens certificate An instrument issued by the registrar of legal titles in a state that employs the optional Torrens system for title registration. The certificate operates much like a car title, listing the name of the owner and any mortgage or deed of trust liens, plus any other liens or encumbrances.

Torrens registration The process of first entering a property into the optional land registration system known as the Torrens system. For the states and counties that offer this as an alternative to the more traditional abstract method, registration begins as a lawsuit. The property owner sets out all the evidence showing his or her entitlement to the property and any mortgages or other liens against the property. The owner must disclose other persons who might have a claim to the same property. Those persons receive notice of the suit. There is usually also a method of public notice in case other claimants wish to assert their rights. Normally, no other claimant disputes the title and the court orders issuance of a Torrens certificate. If there is a dispute, the lawsuit will proceed just like any other suit, with a trial and a decision.

Torrens system An optional system for registering title to real property and all claims and encumbrances against the property; available in only a few states. See also *Torrens certificate* and *Torrens registration*.

tort A legally recognized wrong for which the law provides a remedy. The wrong may be negligent; it might be one of the intentional torts such as defamation, assault, battery, trespass, conversion (broadly, acts that amount to theft), or false imprisonment (preventing someone from leaving a place); or it might be something that can combine elements of negligence, recklessness, or intentional conduct, such as fraud or nuisance. The modern trend of legal theory is to expand concepts of tort liability. As a result, older decisions that find in favor of a property owner, for example, and against

someone injured on the property may no longer be reliable when you are trying to determine rules of conduct and the limits of responsibilities. The better practice is to do all things reasonable and fair under the circumstances, regularly consult with insurance advisors regarding risk management practices, keep informed regarding litigation trends in your industry, and always maintain adequate insurance coverage.

total assets The sum of all cash, investments, furniture, fixtures, equipment, receivables, intangibles, and any other items of value owned by a person or a business entity.

total inventory A sum of the square footages of particular types of properties within a defined area, regardless of whether vacant or rented.

total return The sum of periodic income and property appreciation.

town house or townhome A residential construction type that includes dwelling units with no side yards, but which share a common wall and sometimes common roof structures, sidewalks, and/or driveways with the units on either side. Each property owner has an easement in the shared portion on the other side of the line. A common wall cannot be partially removed, for example, because it would damage the support for the other property, and a common driveway cannot be partially removed because it supplies the access to the others' parking court or garage. See also *party wall*.

township (1) Primarily in the northeast, a jurisdictional and geographical area within a county. (2) A division within the public land survey system.

toxic mold See *black mold*.

tract A parcel of real estate; usually refers to a large area of land.

tract house A house that is substantially similar to all other houses in a subdivision.

trade fixtures Personal property attached to a structure and used in a business. Normally, fixtures become part of the real estate and cannot be removed by a tenant. Trade fixtures, however, are recognized as a part of the business itself, not the real estate, and so may be removed at the expiration of the lease term. Despite that, many leases specifically provide that any tenant improvements paid by the landlord must remain on the property, even if they are trade fixtures.

trade-in The practice of a developer purchasing a buyer's existing home in order to facilitate purchase of one in the developer's new subdivision. Industry groups have asked the Department of Housing and Urban Development (HUD) for exemption of the practice from the FHA antiflipping regulations that deny FHA insurance if a house is purchased and then resold within 90 days, but HUD has been resistant to the idea.

trade libel The intentional disparagement of a property or a business. The statements must be false and must result in monetary loss in order to give rise to a cause of action.

traditional zoning ordinance Zoning that specifies the same density for each and every lot within an area.

traditionary evidence An exception to the hearsay rule. One may use evidence regarding traditions, reputation, and oral histories in order to establish ancient boundaries of land when there are no living witnesses to testify regarding the original parties' intentions.

traffic counts Statistics regarding the number of vehicles that pass a given point during a 24-hour period. Traffic counts are an important component of site selection for most national companies. There is a science to reading traffic counts, because annual numbers, by themselves, can be deceptive.

trailing twelve Shorthand for "trailing 12 months of financials," meaning profit and loss information for a property or business for the past 12 months. Also written as the abbreviation "ttm."

tranche A class of securities. Collateralized mortgage backed securities are usually divided into tranches according to seniority and risk.

transaction broker A real estate broker or agent who acts as an intermediary for the exchange of information and negotiations regarding the sale or lease of real estate and who may offer marketing and advertising services, but who does not represent either party in the relationship. Transaction brokerage is allowed only when state legislatures specifically provide for its use.

transferable development rights (TDR) A zoning and land planning tool often used to preserve undeveloped or culturally significant areas. Typically, the local government will identify an area it wants to retain in a natural state, such as farmland, called the sending area. Government will also identify an area in need of development, usually through rehabilitation, called the receiving area. To meet those two goals—preservation one place, development in another—government will buy development rights from the farmers, for example. The farmers will agree to restrict their land so it cannot be developed. In return, they will receive something in the nature of credits that allow zoning variances in the receiving area. The farmer may sell those credits to a developer who wishes to build or renovate something in the receiving area. The farmer gets cash, the developer gets its variance, some land is preserved, and other land is rehabilitated, all with a minimum of bureaucratic involvement along each step of the way.

transfer certificate of title Used in the Torrens system, it is a duplicate Torrens certificate of title. The owner of property receives a duplicate certificate; the original is retained by the registrar and recorded. When the property is sold, the purchaser receives the transfer certificate of title, which is surrendered to the registrar in order to complete issuance of a new Torrens certificate listing the new owner.

transfer tax A state or local tax imposed when title is transferred from one owner to another.

transit-oriented development Development around destinations near public transportation centers, with mixtures of housing, employment, shopping, dining, and entertainment all within walking distance of transit nodes.

TransUnion One of the three major credit reporting bureaus. The other two are Experian and Equifax. The TransUnion Web site is at www.transunion.com. See also *Fair Credit Reporting Act*.

trash for cash See *tie-in contract*.

treble damages A court award of damages in an amount three times greater than some proven value such as actual damages. It is intended as a punishment to a wrongdoer. Most government regulations that grant to the public the right to sue if there is a violation also grant the right to receive treble damages.

trespass The unlawful interference with someone's personal or property rights. In a lawsuit, the property owner does not need to prove physical damage to the property in order to recover monetary damages, because the damage is to the exclusive ownership and possessory rights of the owner. However, modern courts do require some evidence that the trespass was intentional; older law did not differentiate between intentional and accidental trespass. In many states, the duty of care a property owner has to avoid unsafe conditions that might harm persons coming on the property is much less for a trespasser than for those who are invited.

triple-A tenant A commercial tenant with excellent credit, extremely low sensitivity to temporary market downturns, and, ideally, national name recognition. Banks are generally included within the examples of triple-A tenants despite the lack of a national platform, because their financial strength and prestige make them very desirable tenants.

triple-net lease A lease that requires the tenant to pay all costs and expenses associated with ownership of the property, including taxes, insurance, repairs, and maintenance. Contrast with *gross lease*.

TRO See *temporary restraining order*.

trophy building A status symbol, landmark building with distinctive design features and the very best construction and finishes. It generally has widespread name recognition and is considered a prestigious address. Since 9/11, the allure of trophy buildings has waned among some tenants, who view the real estate as a mixture of trophy and target.

trunk title When an owner fails to record a deed, but instead keeps it in a trunk at home, in a dresser drawer, or such, there is nothing in the public records to evidence the owner's right to the property. If necessary for a real estate closing, the owner will have to produce the original of the instrument. In the title insurance industry, such persons are said to have trunk title or sometimes dresser drawer title.

trust The practice of one party holding legal title to real property or other assets for the benefit of someone else, called the beneficiary. The one with the legal title is called the trustee. The person or entity that set up the trust is called the trustor. Trusts are extremely important in tax and estate planning but should almost never be established without the assistance of a tax attorney

who is well skilled in the area. A very slight deviation from the format acceptable to the IRS could prove disastrous.

trust account A bank account specially designated to hold funds that belong to others. Real estate brokers and attorneys are required to maintain separate trust accounts for client money and for escrowed funds.

trustee's deed The instrument that transfers legal title to a purchaser after a foreclosure in a state that uses deeds of trust rather than mortgages. See also *deed of trust*.

trustee's sale A foreclosure in a state that uses deeds of trust as a vehicle for granting rights in real property to be used as collateral for a loan.

Truth in Lending Act Title I of the Consumer Credit Protection Act. It is a federal law that requires lenders to make certain disclosures to potential borrowers within 3 days after receipt of a written loan application. A final disclosure statement is provided at the time of loan closing. The disclosure is required to be in a specific format and must include the following information:

1. Name and address of creditor
2. Amount financed
3. Itemization of amount financed (optional, if a good-faith estimate is provided)
4. Finance charge
5. Annual percentage rate (APR)
6. Variable-rate information
7. Payment schedule
8. Total of payments
9. Demand feature
10. Total sales price
11. Prepayment policy
12. Late payment policy
13. Security interest
14. Insurance requirements
15. Certain security interest charges
16. Contract reference
17. Assumption policy
18. Required deposit information

truth in lending laws Various provisions of the Truth in Lending Act and sometimes state laws with similar requirements.

Truth in Negotiations Act (TINA) A public law enacted for the purpose of providing for full and fair disclosure by contractors in the conduct of negotiations with the government. The most significant provision included in TINA is the requirement that contractors submit certified cost and pricing data for larger contracts.

turnkey project Construction and furnishing of an improvement to the customized requirements and specifications of a buyer to the degree that the new owner need only turn the key in the lock and start business. The concept may include hiring and training all necessary staff positions, letting contracts for routine maintenance needs, and/or leasing a property up to stabilized occupancy. Contrast with *built to suit*.

turnover rate The rate at which tenants or clients depart and are replaced.

U

UCC See *Uniform Commercial Code*.

UETA See *Uniform Electronic Transactions Act*.

ULI See *Urban Land Institute*.

underground storage tank A tank maintained below ground level and holding liquids, usually petrochemicals or waste. The Environmental Protection Agency (EPA) registers and regulates underground storage tanks unless there is an approved state or tribal program in place. The EPA maintains an excellent Web site (www.epa.gov/oust) with information about regulations, cleanup, assistance for development of abandoned gas stations, and links to all individual state programs and resources.

underimprovement A structure that is less than the highest and best use for a property. A residence sitting on 1 acre of land on a major retail street is an underimprovement; the property would be more valuable with a fast-food restaurant.

underlying mortgage The first mortgage in a wraparound mortgage arrangement.

undersecured loan A loan in which the collateral is not worth as much as the debt.

underwater A popular expression for a property with a debt larger than its value. You will sometimes encounter prime properties for lease, rather than for sale, because the property is underwater. The owners cannot afford to sell, because a sale at market value would require them to bring cash to the closing table to pay off the debt.

underwrite (1) To evaluate the risk of a situation, as in loan underwriting to determine the borrower's financial strength, ability to repay the debt in the event of an interruption of cash flow, and willingness to repay the debt as evidenced by the borrower's credit score or credit history. (2) To guarantee a sale, such as an investment banker who underwrites the sale of securities and will purchase any that do not sell on the open market. (3) To assume liability, such as an insurance company that underwrites a policy.

undeveloped land See *raw land*.

undisclosed agency The failure of an agent to disclose that he or she is working for another, called the principal. Most states require real estate agency disclosure before a person reveals any confidential information.

> **Example:** *Ralph asks his next-door neighbor, real estate agent Beronda, to help him find a house. Beronda agrees, but she must disclose to Ralph that she will work as a subagent for the sellers (the typical situation) and will not be Ralph's agent. She will owe Ralph only the duty of honesty and no other duties.*

undivided interest Ownership that is shared with other co-owners, but not as to any particularly identifiable portion of the whole.

undue influence A theory used to set aside contracts, wills, or deeds. It is any improper method of persuasion used to overcome the will of another and induce that person to do something he or she would not otherwise do. Success in using the theory usually depends on proof that someone used his or her position of trust and confidence to overcome the will of a person in a weakened, infirm, or psychologically distressed state.

unearned increment The amount by which land increases in value because of generally improving conditions in the area, not because of any particular efforts by the property owner. The concept is important to a social theory made popular in the late 1800s by American journalist Henry George, but which still maintains broad appeal. Proponents, often called "Georgists" support the return of the unearned increment to society, in the form of large taxes on that portion of the increase in value of real estate. The concept is diametrically opposed to the current system of long-term capital gains tax breaks, which allow a property owner to retain more of the unearned increment, not less.

unencumbered property Real estate with no other liens, claims, easements, leases, or anything at all that would diminish free and clear title.

Uniform Commercial Code (UCC) A system of laws governing commercial transactions such as sales of goods, banking, the taking of security interests in personal property, documents of title regarding personal property, and letters of credit. The word "uniform" is misleading because all states have their own customized versions of the UCC. The UCC is important to real property because many real estate transactions involve a component that includes personal property.

Link to each state's version of the UCC by going to Cornell University's excellent legal resources site at www.law.cornell.edu/uniform/ucc.html. See also *uniform laws*.

Uniform Electronic Transactions Act (UETA) An attempt to bring commerce into the twenty-first century by recognizing the importance of electronic documents and by providing rules for granting legal effect to them and protecting against abuses. Many states passed local versions of the UETA; some apply to real estate and some do not. The federal version is called the Electronic Signatures in Global and National Commerce Act (E-Sign). It governs in the absence of state laws, or when state laws are inconsistent with E-Sign. The critical issue in real estate is whether an exchange of e-mails or e-mailed documents may satisfy the Statute of Frauds requirement that almost all contracts related to real estate must be in writing. This issue is still unsettled and controversial. See also *uniform laws*.

uniform laws A misleading term, because it seems to imply a nationwide system of laws, when really it refers to model legislation that may be adopted by individual states with or without

local revisions. There is a great variety of uniform laws, which may be found at the Web site of the organization responsible for discussing and drafting them—the National Conference of Commissioners on Uniform State Laws (NCCUSL) (www.nccusl.org).

Uniform Residential Appraisal Report (URAR) A standard form for reporting the value of a residence, required by most major lenders and secondary market purchasers in order to simplify the underwriting and review process.

Uniform Residential Landlord and Tenant Act Legislation governing the rights and responsibilities of residential landlords and tenants. Currently, some version of the law has been passed by many states. As a general matter, the laws

- Standardize and simplify the eviction process
- Require the tenant to pay rent into court during the pendency of an eviction if it is contested
- Limit the amount of any security deposits
- Provide for prompt repayment of security deposits
- Require certain minimal conditions of habitability
- Impose penalties for breach of the provisions.

See also *uniform laws*.

Uniform Settlement Statement The real estate closing form required by the Real Estate Settlement Procedures Act (RESPA) in order to account for all funds received, all disbursements made, and all expenses and all credits at closing. The form is more commonly known as a HUD–1.

Uniform Standards of Professional Appraisal Practice (USPAP) Requirements of the Appraisal Foundation (www.appraisalfoundation.org) regarding appraisal ethics, record keeping, methodology, research, reporting, and client interaction. The Standards have undergone recent revisions simplifying the appraisal process and conforming its practices to modern realities.

unilateral contract A contract that is binding on one party but only if the other party chooses to take advantage of it. An option contract is the classic unilateral contract. A property owner (optionor) will give another party (optionee) the right to purchase property, but the optionee is not obligated to purchase if it chooses not to.

unimproved land See *raw land*.

unincorporated association A group of two or more persons who band together for a common purpose or goal, but without the formality of creating a corporation or partnership. Many religious groups function as unincorporated associations. The rules differ among states, but a deed to or from an unincorporated association may have specialized requirements to be legal.

union mortgage clause See *standard mortgage clause*.

unities A concept having to do with joint ownership of property. The four unities are interest, possession, time, and title. Joint tenancy with right of survivorship requires all four unities—the owners

must have obtained their rights from the same deed, must have undivided possession, and the same use over the same period of time.

unitization A system for controlling proliferation of oil and gas wells. Originally, property owners with oil or gas under their land would each dig one or more wells on their property and try to capture as much as they could of the underlying pool, which drained from many properties. One response was the passage of unitization laws by state governments, establishing spacing restrictions on wells and a sharing of profits and expenses among all the owners of the underground pool.

unlisted REIT See *private REIT*.

unrealized gain The current increase in fair market value of a property, which is unrealized because the property has not been sold. Contrast with *unrecognized gain*, which is a tax concept.

unrecognized gain A gain on the transfer of real property, but for which there is no current tax consequence because of various provisions of the Internal Revenue Code, such as the ability to reinvest proceeds and defer taxes until a sale of the replacement property. See *1031 exchange*.

unrecorded deeds Deeds that are not recorded with the public official given responsibility for maintenance of real estate records. An unrecorded deed is perfectly legal and passes title from the seller (grantor) to the purchaser (grantee) just like a recorded deed. The problem occurs if there is some event after the transfer, such as the grantor's bankruptcy, grantor's sale or mortgage of the same property to another, or tax or judgment liens against the grantor. If the deed was not recorded, other parties may be able to successfully claim the property, including a bankruptcy trustee who may seize the property and sell it to satisfy the grantor's debts.

unsecured creditors Persons owed money by a debtor, but who have no collateral as security for the debts owed to them.

unsecured loan A loan without collateral.

unstated interest See *imputed interest*.

upper bracket A slang term describing a home for affluent persons; refers to people with income at the highest bracket of the income tax rates.

upset price See *reserve price*.

URAR See *Uniform Residential Appraisal Report*.

urban area (1) As used by the U.S. Census Bureau, the term refers to all areas that are urban. Since the 2000 census, that includes urban clusters and urbanized areas. An urban cluster is a densely settled territory with more than 2,500 people but less than 50,000. An urbanized area is one "consisting of a central place(s) and adjacent territory with a general population density of at least 1,000 people per square mile of land area that together have a minimum residential population of at least 50,000 people." (2) The Census Bureau's definition of "urban area" has changed several times in the past. If

researching a particular subject that uses the term, it may be important to find the definition in effect at the time the book or article was written. (3) In popular speech, any densely populated area of a city or town.

urban cluster See *urban area*.

urbanized area See *urban area*.

Urban Land Institute A nonprofit organization (www.uli.org) that provides research services and publications on land use and development.

urban renewal Redevelopment of deteriorated and underutilized urban properties, often through the provision of tax incentives, low-interest-rate bond money for loans, and government investment in infrastructure improvements such as roads and public parks in order to spur development.

urban sprawl A derogatory term for the spread of suburban developments, typically along relatively narrow strips of land following major arteries or highways.

usable area In commercial leasing, it is the amount of space that can be utilized by tenants within the walls defining their rented space. Contrast with rentable area, which is an artificial measurement of a tenant's usable area plus a tenant's pro rata portion of the common areas. When quoting rent per square foot, landlords usually base the rent on rentable area, not on usable area.

U.S.C. This is the abbreviation for United States Code. Any reference to, for example, 26 U.S.C. §1273, means Title 26 of the United States Code and section 1273 of that Title. This format is considered the official citation. There are several publishers of the United States Code. An alternate citation might be seen as 26 U.S.C.S. §1273 (United States Code Service, published by Lawyers Cooperative Service and containing cross references to legal aids from the same publisher, including LexisNexis) or 26 U.S.C.A. §1273 (United States Code Annotated, published by West Publishing Company and containing cross references to legal aids from the same publisher, including Westlaw.) To find the complete text of United States Code Sections, visit the Web site of the U.S. Government Printing Office, www.gpoaccess.gov/uscode/index.html. See also *section (federal code)* for an alternate, but still official, Web site for research.

useful life (1) In accounting and taxation, the time period over which an asset is depreciated. (2) In appraisal, the time period during which one can expect a positive cash flow from a property.

U.S. Government survey system See *public land survey system*.

USPAP See *Uniform Standards of Professional Appraisal Practice*.

UST An abbreviation for "underground storage tank."

usury An interest rate higher than allowed by state law. The limits usually vary depending on the size of the loan, the term, the use of the money, and/or the status of the borrower as a consumer or

other type of borrower. The consequences of usury may range from a reduction of the interest rate, loss of all interest completely, or even civil fines or penalties.

utility easement A right to use another's property for purposes of laying water and sewer lines, gas lines, or bringing in electric or telecommunications services.

utility notification See *blue stake*.

utility stop A cap on the utility expenses used to calculate a tenant's pro rata share of building operating expenses. It may be desired as a lease term by a small-space user who does not wish to assist in paying the power bills for a large user with seemingly excessive utility needs disproportionate to the space it is occupying.

V

VA See *Veterans Administration*. (It is now called the Department of Veterans Affairs.)

vacancy and collection allowance When preparing a pro forma estimate of future performance of an investment, the vacancy and collection allowance is an estimate of the amount by which gross scheduled rents should be decreased to account for vacancies and for rents that will be uncollectible. A typical number to use is 5 percent of the gross scheduled rent. Some analysts include rent concessions, or discounts, in the vacancy and collection allowance figure; others prefer to list rent concessions as a separate expense item so management can track how much it is willing to give away in concessions and match that against how much it actually has to spend for concessions.

> **Example:** *An apartment complex has 10 units renting for $800 per month. It caters to students and sometimes has vacancies during the summer months. The owner is willing to give away $1,500 a year in free rent, reduced rent, or other concessions. The owner anticipates next year will look like this:*

Gross scheduled rent		$96,000
Less V&C allowance		(4,800)
Total anticipated revenue		$91,200
Maintenance expenses	(3,600)	
Concessions	(1,500)	
Other marketing expenses	(1,000)	
Insurance	(8,000)	
Real estate taxes	(11,000)	
Total expenses		($25,100)
Net operating income		$66,100

vacancy factor See *vacancy rate*.

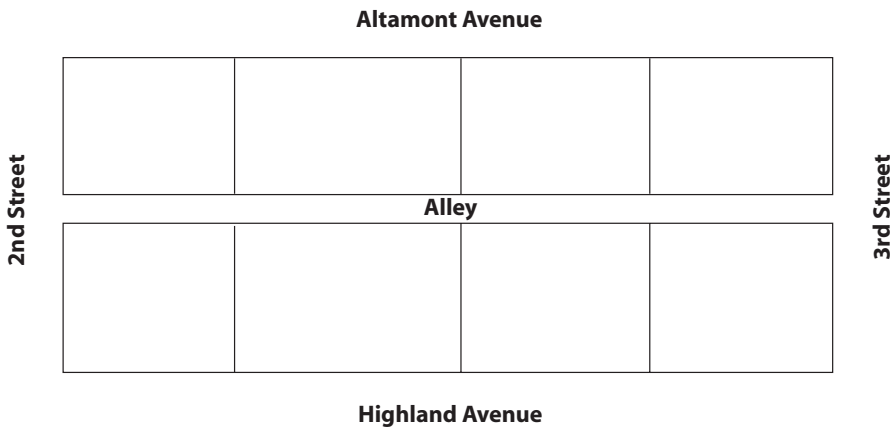
vacancy rate The ratio of vacancies to total available rentals, over a particular period of time. There are three primary methods of calculating the vacancy rate: by number of units, square footage, or dollars of rental income. Beyond that, the calculations can be for a moment in time—a particular month—or for experience over the course of a year. Economic vacancy, which is the dollar value of

vacancies rather than the number of units or square footage of floor space, is the most accurate indicator of the vacancy rate. When reviewing pro forma projections or past financial records, one must ascertain which method was used to calculate vacancies, however, because each method will result in a different rate unless all units are the same size and rent for exactly the same amount. See Example at *occupancy rates* for an explanation of the various calculations.

vacant land Land not being used at the present time but that may have utilities and infrastructure in place. Contrast with *raw land*.

vacate (1) To move out. (2) To release and give up, such as a city agreeing to vacate a public street and return it to private ownership. (3) To set aside, such as a judge vacating a previously entered order.

> **Example:** *At one time residents needed an alley behind their homes so the coal trucks could make deliveries for home heating fuel. Today, there is no longer any need for truck deliveries behind the homes; the residents petition the city for an order vacating the alley and giving the land to adjoining landowners.*



vacation home A second home used for recreational purposes. Mortgages for vacation homes generally have higher interest rates than those for primary residences because, if there is any economic difficulty, the property owner is more likely to stop making payments on a vacation home than on a primary residence. Vacation home mortgage interest is deductible the same as for a primary residence, but under current tax law there is a $1,000,000 cap on the amount of debt generating deductible interest. The sale of a principal residence will not result in current income taxes if the gain is less than $250,000 for single persons or $500,000 for married people, but this exclusion does not apply to vacation homes. If the vacation home is used for rental income, there are limitations on your personal usage if you want to deduct rental expenses, including depreciation.

valid Having legal force.

VA loan or mortgage A home loan guaranteed by the Department of Veterans Affairs (www.homeloans.va.gov/elig2.htm) (known as the Veterans Administration before 1989), which will pay the lender up to certain limits if the borrower defaults. In some instances, the VA will decide to purchase the home from the lender after default and attempt resale, calculating that the profits from a resale will make the transaction cheaper than paying off the loan. By law, it is required to do this analysis on all defaulted loans. Eligibility for a VA guarantee is complicated and depends on the borrower's dates, length, and type of service; whether the borrower is currently active in the military; whether the borrower is in the National Guard or the Reserves; and the number of months the borrower was in peacetime or combat service.

valuable consideration Any type of promise, benefit, or relinquishment of a right given by a party in order to receive something else in return, and which will result in a contract being legally enforceable. A contract to sell a home in consideration of love and affection is *good* consideration, but not *valuable* consideration. Good consideration is sufficient to prevent a deed from being set aside, but it is insufficient to enforce a contract.

valuation (1) The process of estimating the worth of something. (2) The estimated worth given to something.

value The worth of all rights arising from ownership of property.

value before and after taking A rule used in federal condemnation cases. When the government takes only part of a piece of property, it values the entire parcel before the taking and then it separately appraises the portion remaining after condemnation. The difference in the two numbers is the amount of the award to the property owner. Contrast with the method used by many states, which value the property taken, add any severance damage caused to the remaining property, and subtract any special benefits gained by the remaining property as a result of the condemnation. In an ideal world, both approaches would result in the same number.

value in exchange The value of property if one were to exchange it for goods and services.

value in use The worth of a property as it is currently being used. A convenience store allowed to remain in business in a zoning area that no longer allows convenience stores has a high value in use because there can be no nearby competition. A house on the side of a major street in a retail area would have a value in use much lower than its highest and best use as a retail site.

value per square foot A method of pricing land when it becomes very valuable. Rather than quote $1,176,120 per acre, which is a bit awkward, value will be expressed as $27 per square foot in this example. There are 43,560 square feet per acre: $27 × 43,560 = $1,176,120.

vanilla building A building suitable for a wide variety of uses and brand names, rather than one with a distinctive architectural style or use such as a Taco Bell or a car dealership.

variable expenses Property operating expenses that increase and decrease in relatively direct proportion to changes in occupancy. It is important to differentiate between fixed expenses and variable expenses because the fixed expenses must be met every month, no matter what the occupancies. In preparing a pro forma analysis for a new project, one will usually calculate fixed expenses starting with month 1 and continuing unchanged until perhaps another employee must be added to the payroll. Variable expenses, however, are always calculated as dependent on lease-up and tied to each month's occupancy figures if the pro forma is a spreadsheet.

variable interest rate A loan interest rate that changes as some outside factor, preferably one not within the control of the lender, changes. Commonly seen in adjustable-rate mortgages.

variable maturity mortgage A mortgage loan with a variable interest rate but a fixed monthly payment. As interest rates increase or decrease, less or more of the payment each month will be used to pay the principal rather than interest. As a result, the maturity of the note will change over time.

variable payment plan Any loan that contemplates changes in payments, either because of a variable interest rate, graduated payments increasing principal reductions as one's income increases, or some other type of flexibility in the loan.

variable-rate mortgage (VRM) A precursor to the modern adjustable-rate home mortgage (ARM), and still used in the area of commercial mortgages. With a variable-rate mortgage, the interest rate on the loan changes whenever the index rate changes. The monthly payments usually change every month, also. Most construction loans are variable-rate mortgages. The ARM differs because the interest rate changes at predetermined intervals, such as once a year or once every 6 months.

variance Permission to use a property in a manner that does not meet current zoning requirements. In order to gain a variance, the property owner usually has to show a hardship on the property—not on the owner—if the requested use is not allowed. It is considered a hardship if the property will otherwise remain vacant or if a structurally sound improvement must be demolished to allow some other use. Buyers with a signed purchase contract can usually petition for a variance; this is commonly one of the steps in a due diligence plan that must be completed in a satisfactory manner before the buyer will purchase property.

vendee Buyer. Contrast with *donee*, who receives property by gift, and *devisee*, who receives property under a will.

vendee's lien A lien against real property for the earnest money deposit paid on a contract of purchase. Not enforceable in all states.

vendor Seller. Contrast with *donor*, who transfers property by gift, and *testator*, who transfers property under a will.

vendor's lien See *purchase money mortgage*.

venire The total pool of people summoned for jury duty.

venture capital A common name given to money raised for investment in high-risk enterprises. Venture capital firms may specialize by industry and/or by stage—seed money for start-ups, mid-stage firms on the brink of success but needing additional capital, or successful firms capable of expansion to a regional or nationwide platform. There is a National Venture Capital Association (www.nvca.org). Sometimes called angel investors.

verbal Oral. Verbal contracts are enforceable unless they fall within the Statute of Frauds.

- Verbal wills, called *nuncupative wills,* are usually not enforceable.
- Verbal statements made by someone before death, and which would have the effect of increasing or decreasing that person's estate, will usually not be allowed into evidence by virtue of the dead man's statute.
- A verbal agreement regarding the location of the true boundary line between property owners is often enforceable; a verbal agreement to compromise the line between two property owners is usually not enforceable.

verification A sworn statement before a notary public, or other person authorized to take oaths, that the contents of a document are accurate. Contrast with *acknowledgment*, which is simply confirmation that one's signature was knowingly and willingly placed on an instrument.

vertical development The philosophy that increasing population density for an area requires construction of taller and taller buildings. Especially since 9/11 and the perceived vulnerability of skyscrapers, vertical development in its traditional form does not enjoy the widespread and enthusiastic support it once did. Today, notions of building down into the earth are gaining acceptance in vertical development planning, as are more sophisticated notions of horizontal development making better use of space.

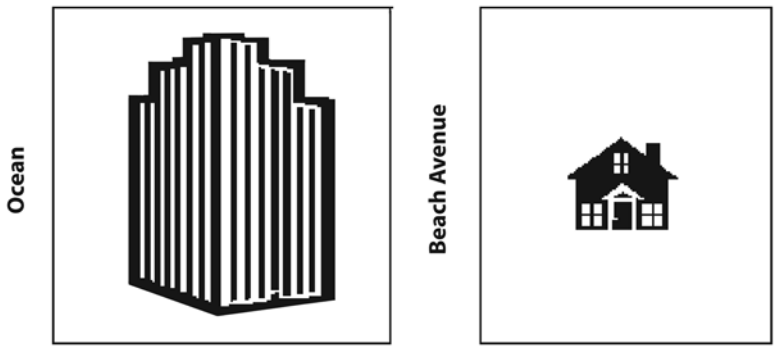
vertical merger A merger between companies that supply different goods or services but in a common industry.

vest To give immediate rights in property, even if possession or enjoyment will be delayed until later. The question of when property rights vest is critical to future interests, taxation, and creditors' rights.

Veterans Administration A former name for the current Department of Veterans Affairs. The Department was established in March 15, 1989.

vicarious liability The legal principle that persons who are in a position to control the actions of another will be held liable for any injuries caused by that other person. Liability does not rely on proving there was improper training, instructions, control, or supervision. Rather, it is imposed merely because of the relationship between the parties. Respondeat superior is one type of vicarious liability. In real estate, the concept is most often encountered in claims against an employer (construction contractor, property manager, and sometimes even real estate brokers) for the discriminatory actions of an employee.

views, right to The theory that one is entitled to a particular view, as of the ocean or something else scenic. Such rights may be granted by particular language in an easement. In the absence of such language, courts are very reluctant to find that any property owner has an inherent right to a view across another's land to something considered of aesthetic value. Also called visual rights or a right of prospect. In the following example, unless local ordinances or zoning provide otherwise, the homeowner cannot prevent construction of the condo project on the grounds it will obstruct the homeowner's view of the ocean. Under some circumstances, though, if the tall building were a government office, school, or some other public structure, the homeowner might be entitled to compensation for the loss of the view, under eminent domain and condemnation theories.



violation Something prohibited by law.

virtual office An arrangement with a phone answering and mail receipt company that may or may not also provide meeting rooms, administrative support, and telecommunications services. The practice is popular with small entrepreneurs and with large-corporation employees who live and work in markets that do not need, or will not support, traditional office space with rent, furniture, equipment, and support staff personnel expenses. A step up from the virtual office, but less demanding than conventional office space, is the relatively recent phenomenon of the business center.

visual rights See *views, right to*.

voice over IP (VoIP) Technology that allows voice, videophone, cell phone, Internet, and office network traffic to all be usable with the same instrument—a telephone.

The following scenario describes use of VoIP in a real estate office:

A single phone instrument can awaken you in the mornings, read to you your most important voice mail and e-mail messages, respond to voice commands for handling those messages, and tell you your schedule for the day. As you make cellular calls before reaching the office, the phone downloads any new information from the office network, including appointments made by your assistant, who has constant real-time access to your calendar. Incoming calls will carry with them not only caller ID,

but full contact information from the office computer, including histories and notes regarding prior calls with the same person. While speaking to the caller, you can e-mail to them photographs or any other information on file at the office. Once you reach the office, the phone will sense your proximity to the network and automatically switch from cellular service to office wireless service, enabling you to take full-size video calls with links to all branch offices or the main office, plus links to special video kiosks set up at shopping malls, new subdivisions, or college campuses.

If you are a real estate sales or leasing agent, people will be able to enter a kiosk, call you and take a virtual tour of all properties meeting their criteria, and then narrow the choices to the few that warrant a personal visit.

The uses of VoIP are limitless and will completely revolutionize how we think about interacting with other people and with information. Because of its growing importance, offices and residential areas unable to accommodate the bandwidth requirements will find themselves at an extreme disadvantage. Today, all real estate decisions must be made with one eye on the IRS and one eye on the telecommunications possibilities and limitations.

void Without any legal effect from the very beginning. Sometimes written as "void ab initio." A contract by one who has been judged mentally incompetent is void. Contrast with voidable, which is something able to be set aside, should the party so chose.

voidable Capable of being set aside and rendered not enforceable, but not inherently without legal effect. Contracts made by minor children are voidable when they reach the age of majority, but are not automatically void. Contrast with *void*.

voidable preference In bankruptcy law, the notion that a transfer of property within a certain time period before filing for bankruptcy may be set aside, because it takes property out of the bankruptcy estate and may diminish the money available for unsecured creditors. There does not have to be any showing of fraudulent or dishonest intent.

voluntary alienation A transfer of real property through one's intentional actions. Contrast with *involuntary alienation*, such as a foreclosure.

voluntary lien An agreement to allow the use of specific property as collateral for a debt. Contrast with *involuntary lien*.

voucher system A method of disbursing money from a construction loan. The developer or the general contractor (general) will give vouchers to subcontractors (subs) or suppliers as they are entitled to payment under their own contracts. The voucher certifies that the work has been performed properly, or the supplies are free from defect and accurate in price and amount delivered. The subs or the suppliers then take their vouchers to the construction lender, who writes checks to them. The drawback is that it is management intensive for the lender, who is usually operating on such tight margins that it can't afford the administrative staff to service a voucher system. The more common system is the draw system, in which the general receives large chunks of money on a prearranged draw schedule and then disburses them to subs and suppliers.

vulture capitalist (1) A person or firm who accumulates cash and commitments for cash in order to take advantage of an anticipated temporary plunge in real estate values. At the proper time, the vulture capitalist will buy virtually every distressed property it can acquire, to resell when the market returns. (2) A derogatory term applied to venture capitalists, some of whom have a reputation of investing in a business in the hopes it will fail, at which point the venture capitalist takes over the assets and liquidates them at a profit.

W

wage earners' bankruptcy Same as Chapter 13 bankruptcy. See *bankruptcy*.

waiver The voluntary relinquishment of a known right, remedy, claim, or privilege.

waiver of tax lien See *certificate of discharge*.

walk-through inspection An inspection by a buyer or a tenant prior to taking possession, typically to determine that all repairs or improvements have been completed in a proper manner.

ward See *guardian*.

warehouse A commercial storage building. Zoning regulations and building codes may place restrictions on the placement and construction styles of warehouses. See *bailment* for the rights and responsibilities of parties.

warehouse fee A charge to a borrower when a mortgage banker or other small lender must borrow money on a short-term basis in order to loan money on mortgage loans. If the interest rate on the short-term loan is too large to make money on the spread, the mortgage banker will charge a warehouse fee to cover its costs until it can assemble enough loans in its virtual warehouse and sell them to someone else, making enough money to pay off its short-term loans.

warehousing The practice by a loan originator of packaging large numbers of loans for sale on the secondary market.

warranty An express or implied promise arising out of a contract or a transfer of interests in real estate. An express warranty would be a manufacturer's warranty that an appliance will be defect free for 12 months. The "warranty of fitness for a particular use and purpose" is an implied warranty, imposed by the law, that a product will be safe if used in the manner in which it is intended. The contents of written warranties on consumer products are covered by the federal Magnusson-Moss Act, passed in 1975. It includes goods attached to or installed on real property. See also *warranty deed*.

warranty deed A deed containing promises by the seller regarding the quantity and quality of title being transferred to the buyer and some of the responsibilities of the seller if the warranties are breached. A special warranty deed gives assurances that the seller has not done anything to diminish the title but makes no promises about things that happened before the seller took title or

things that are outside the seller's control. A general warranty deed gives the most protection to a buyer, and includes both present and future covenants as follows:

- Present covenants:
  - Seisin, meaning the seller (grantor) has legal title
  - Right to convey, meaning there are no restrictions on the right to convey
  - Against encumbrances, meaning there are no other claims such as liens, easements, or other similar matters
- Future covenants:
  - Covenant of warranty, being a promise to indemnify the grantee for any damage suffered as a result of the title being defective. Some courts require an actual dispossession of the grantee before the covenant comes into play, and others do not. Some allow the attorneys' fees paid by the grantee as an element of damage, and others do not.
  - Quiet enjoyment, that grantee will be able to enjoy the estate without adverse claims from other parties.
  - Further assurances, that grantor will take any steps necessary in the future to defend the title or perfect grantee's title if there is a technical defect and a corrective deed required, for example.

warranty of habitability An implied promise, meaning one imposed by the law and not specifically agreed to by the parties, that the premises will be suitable for habitation in a safe and sanitary manner. It is a change from the old common law rule of caveat emptor, meaning the buyer takes at his or her own risk. The warranty applies to landlords and has been held to apply to sellers of new homes and sometimes to sellers of used homes. (Consumer protection statutes and disclosure statutes in some states expand upon the implied warranty.)

waste An abusive or destructive use of property by someone who is entitled to possession but who does not have complete ownership rights, such as a tenant, mortgage borrower, or a joint owner. Waste is more than normal wear and tear and implies neglect or misconduct. Contrast with *trespass*, which is damage by one who is not entitled to possession. There are three types of waste:

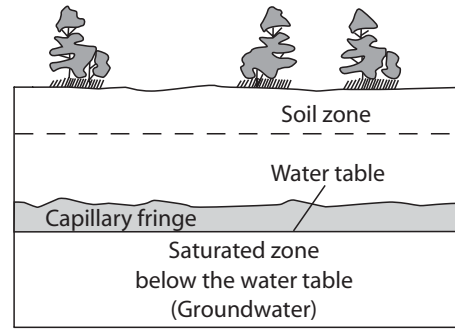
1. Voluntary waste (also called affirmative waste) is an intentional change to property resulting in damage to the property.
2. Permissive waste (also called negligent waste) is a failure to maintain property, so that it deteriorates in value.
3. Ameliorative waste occurs when the changes increase the value of the property. In some jurisdictions, a court will still award damages because the owner is entitled to have its property remain in the same condition, without being subjected to others' opinions regarding whether it was improved or not. Other jurisdictions refuse to allow damages, finding that the owner has been benefited by the actions.

wasting asset An asset that is depleted or used up over time, such as oil and gas, minerals under the earth, or timberland. Wasting assets may give rise to income tax depletion deductions, similar to the better-known depreciation deductions.

water line capacity The volume of water capable of being transmitted by particular sizes of pipes, expressed as gallons per minute. When making zoning decisions, or considering requests for variances, local boards must always consider the water line capacity of the existing infrastructure and whether or not the lines in place will accommodate the anticipated water needs, or if it will be necessary to lay new lines.

water rights See *riparian rights* (surface waters, rivers, and streams) and *littoral rights* (oceans, lakes, and other large bodies of water).

water table The upper limit of the saturated area of the earth containing groundwater. The water table will be at varying depths depending on location and time of year.



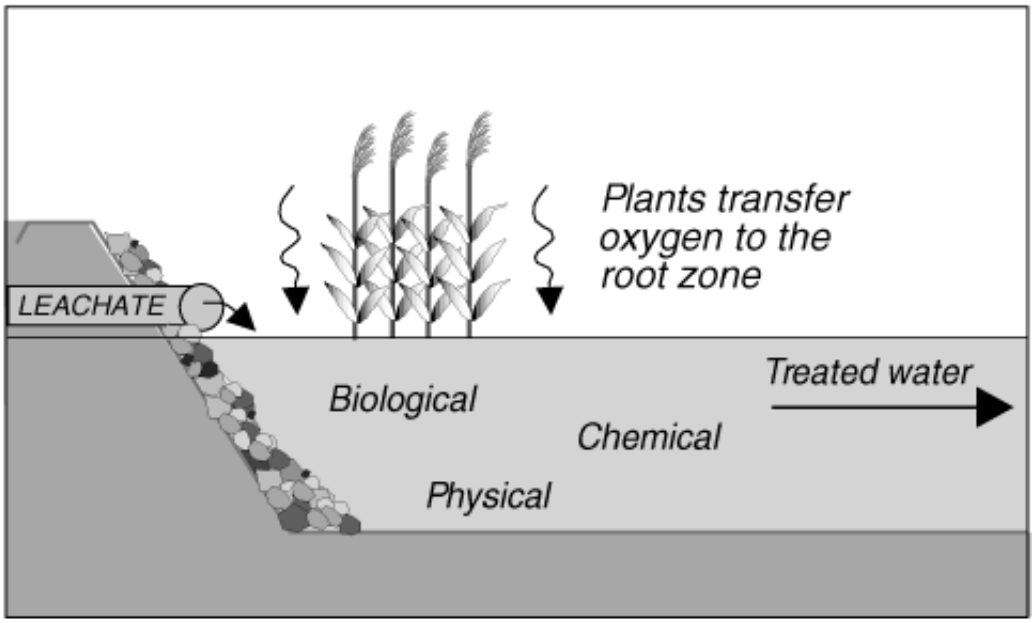
Source: EPA.

waters of the United States All navigable waters within the United States. The Army Corps of Engineers attempted to expand the definition to include wetlands and waterways that drained into navigable waters, thus allowing it to require permits from property owners under many circumstances. In the landmark decision of *Rapanos v. United States,* the Supreme Court decided, on June 19, 2006, that "The phrase the waters of the United States includes only those relatively permanent, standing or continuously flowing bodies of water 'forming geographic features' that are described in ordinary parlance as 'streams,' 'oceans, rivers, [and] lakes'… and does not include channels through which water flows intermittently or ephemerally, or channels that periodically provide drainage for rainfall."

wear and tear Physical deterioration of property as a result of normal usage and aging.

Webcam A camera with an assigned Internet protocol (IP) address, reachable by persons on the Internet and in possession of the IP address or a Web link. Webcams with remotely controlled pan and zoom features are becoming an important tool for the marketing of commercial properties, especially when potential buyers or tenants may come from anywhere in the nation or the world.

wetlands (1) Land normally saturated with water, such as swamps or marshes. Wetlands are now recognized as an important component of wildlife preservation, water purification, and protection against hurricanes. The federal government currently has no centralized wetlands protection program; the primary vehicle for preservation is the Clean Water Act as administered by the Environmental Protection Agency. Many states do have comprehensive wetlands management programs, however, and care should be taken to review all relevant laws before purchasing property that might be construed as wetlands. (2) An alternative wastewater management system is called constructed wetlands; it makes use of natural cleaning systems found in wetlands. The following diagrammed system, called the subsurface flow system, can handle discharges up to 10,000 gallons a day—enough for a small community.



Source: U.S. Geological Survey.

wharfing out The right to exclusive use of submerged lands by virtue of erecting a wharf over them.

white elephant Like the legendary white elephants of India, a property that is expensive to maintain, doesn't return any particular value, and can't realistically be sold to anyone else.

wholly destroyed In leases and insurance policies employing the term, it means an improvement that is no longer usable for its purpose in any part, not a complete obliteration of all pieces and components.

widow's election In some states a widow may claim a portion of her husband's estate, even if she is intentionally excluded from his will. Normally it is the amount she would take by statute if the husband had died intestate—without a will.

wild deed Also called a thin air deed, one which appears in the real estate records with a grantor who has never before had recorded title, usually to a grantee who is never heard of again. Unless the state has a statute voiding any claims under such a wild deed after a certain period of time, the effect is to so thoroughly cloud the title that a suit to quiet title will be necessary to bar any future claimants under the wild deed.

will An instrument by which a person directs the disposition of assets after death. At one time the term will referred to disposition of real property, and a testament was a disposition of personal property, hence the expression "last will and testament." Today, will covers all properties. See also *holographic will* (handwritten), *nuncupative will* (oral), *intestate succession* (dying without a will), and *escheat* (dying with no will and no heirs).

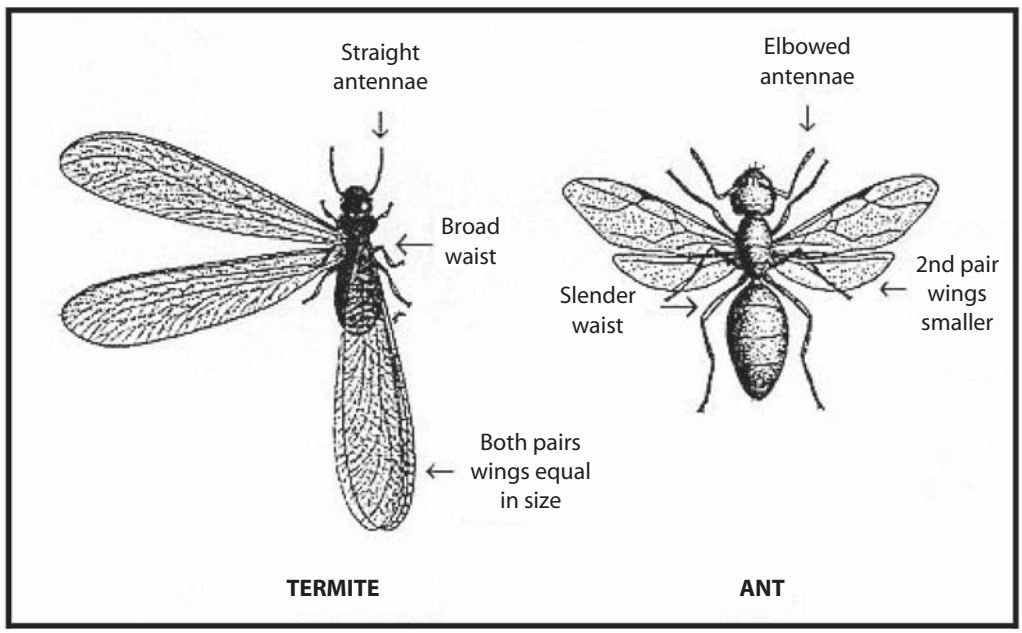
willing buyer See *ready, willing, and able*.

without recourse Words sometimes written on the back of a check when one endorses the check over to another. It has the legal effect of preventing recovery of the money from the endorser in case the check is returned as "not sufficient funds" (NSF) or for any other reason. It would be imprudent for anyone to accept a two-party check with the words without recourse written on the back.

witness monument A permanent marker used to establish the location of boundary lines or the quarter-quarter section and larger-area corners in the public land survey system.

Women's Council of Realtors (WCR) Founded in 1938 as an affiliate of the National Association of REALTORS®, the WCR (www.wcr.org) promotes networking, education, and professional development for women with careers in real estate.

wood-destroying insect Termites, post beetles, carpenter ants, and carpenter bees. Millipedes are technically wood decomposers, but may be included under some circumstances. Home purchase contracts generally require the property to be free from wood-destroying insects. Most termite policies exclude from coverage Formosan termites—a particularly voracious and practically indestructible termite working its way northward from New Orleans and other southern coastal cities. The Pest Control Canada Web site at www.pestcontrolcanada.com is one of the best for identification and further information about wood-destroying insects and other pests, plus there is an opportunity to submit photos of your own unidentified pests in order to ask for assistance.



wood infestation report A report required by almost all lenders of residential mortgages. The report identifies any signs of current or past infestation by wood-destroying insects, and may include reports of mold or water damage. Ideally, the report will state that there is no current wood infestation.

worker's compensation laws A statutory arrangement granting employers protection from lawsuits by injured employees, in return for granting employees the right to recover specified amounts for injuries, even if due to the employee's own negligence. Most states require employers with a certain minimum number of employees to maintain worker's compensation insurance. Historically, the concept has been thought inapplicable to real estate agents, who were considered independent contractors rather than employees. Recently, though, cases in New Jersey and in Virginia have ruled that real estate agents were employees for purposes of the worker's compensation statutes in those states.

working capital The difference between cash and other quick assets (current assets) and current liabilities.

Example:

Statement of Working Capital as of January 1, 20____

Assets		**Liabilities**	
Current		Current	
Cash	$1,000	Payables	$1,200
Receivables	$4,000	90-day note	$1,000
		Bad debt reserve	$200
Total current assets	$5,000	Total current liabilities	$3,200
Fixed		Long term	
Land	$15,000	Mortgage	$22,000
Buildings	$45,000	Equity	$45,800
Equipment	$6,000		
Total assets	$71,000	Total liabilities and equity	$71,000

The working capital consists of the difference between the total current assets and the total current liabilities: $5,000 – $3,200 = $1,800. The bad debt reserve is an artificial number selected by management, based on prior experiences, regarding the amount of accounts receivable that will not be collected during the current period, or perhaps at all.

working drawings Surveying, topographic, architectural, and engineering plans used in the field to construct improvements, and on which any changes are noted as the work is performed. At the end of the project, the working drawings are then submitted to the persons who originally created them in order to incorporate all changes into a final set of as-built drawings.

working mortgage A Fannie Mae product employing electronic payment and mortgage terms synchronized with a borrower's schedule of payroll deposits. Whether a borrower is paid weekly, or twice monthly, mortgage payments can be calculated for that time period and automatically deducted from the borrower's bank account on the day after electronic deposit of the paycheck. It assists the borrower with a more levelized budgeting process and will lead to a faster payoff of the loan because of the effective addition of one payment period each year and the decreased amount of time on which interest is paid.

workout The process of working with a lender to explore alternatives to foreclosure or bankruptcy after a default. This may involve the lender receiving additional collateral, lengthening the term of the loan, writing down part of the principal balance, providing minor additional lending to make the repairs necessary to sell the property at its best price, or any number of negotiated terms and conditions. One of the keys to a mutually beneficial workout solution is for all parties to be well educated regarding the consequences of bankruptcy. One example is the ability of a bankruptcy court to reduce the principal balance of a mortgage loan under certain circumstances. It is also wise for borrowers to understand the limitations of bankruptcy, however, so they don't take an imprudently aggressive stance with their lender.

worthier title doctrine (1) At common law, if a testator devised (left by will) exactly the same interest in land that an heir would take by descent (laws applicable when there wasn't a will), then the heir would be considered as having taken title by descent rather than devise. Descent was considered the worthier title. The doctrine has its roots in English feudal law and certain rights that passed by land if it were inherited, but not if it were gained "by purchase," which included "by will." Today, most states have overruled this portion of the doctrine or ignored it as irrelevant. It does still sometimes arise in the context of adverse possession and calculation of holding periods. (2) A second portion of the doctrine is called the inter vivos branch; it is still alive and well, although rarely encountered because it is a somewhat exotic theory. This branch holds that a gift by A to a trust for A's lifetime, with the property then given to A's heirs after A's death, is a gift to A's heirs by the worthier title of descent rather than by a lifetime gift. The practical implications are that the heirs have no rights to anything until A dies, so that if an heir has creditors, there is nothing for the creditors to seize until A dies. If it were not for the doctrine, A's heirs would have a remainder interest during A's lifetime, which would be subject to seizure by creditors.

wraparound mortgage A largely extinct financing tool involving a seller leaving its first mortgage in place while selling the property to another and holding the financing. The new mortgage "wrapped around" the old mortgage, so that the buyer made payments to the seller, who then deducted enough to make payments to the original mortgage lender. The practice has been rendered obsolete by the widespread use of the due-on-sale clauses in mortgage loans, making the entire principal balance of the loan due when the property is sold, whether or not there has been a default. There are a few circumstances when a *due-on-sale clause* is not enforceable (see that entry for details), providing an opportunity for wraparound mortgages.

write-down (1) To reduce the value of an asset on the books and records of a company because of a decrease in value of that asset. Because of the mechanics of double-entry bookkeeping, writing down an asset has the consequence of reducing income for that time period. The timing of write-downs is therefore critical because of the impact on taxable income, earnings reported to shareholders, asset value, earnings reported to lenders, and other instances. Large companies will often write down assets in a quarter that is already disappointing, in an attempt to get all the bad news over with at the same time. (2) A lender's agreement to accept less than the full principal balance of a loan, usually in recognition of the fact that it won't collect the full balance anyway.

write-off To take an asset entirely off the books because it no longer has any value. If an accrual-basis taxpayer has taken money into income when bills were sent out to customers, but then some of the bills became uncollectible, the taxpayer may write off the uncollectible ones as a deduction against income. Financial institutions are required to write off loans when they become delinquent by a certain amount.

writ of certiorari A request that a higher court hear arguments that a lower court ruled improperly on some or all issues in a lawsuit. The higher court does not have to honor the request and therefore frequently "denies cert." This is different from an appeal, which must at least be heard by the higher court, even though the court may ultimately rule against the person who filed the appeal.

- In the federal court system, trial occurs at the level of the United States District Court. If one is unhappy with the outcome, one has the right to appeal to the United States Circuit Court with authority over the district court. If again unhappy with the outcome, one petitions the United States Supreme Court for a writ of certiorari.
- The writ orders the Circuit court to certify the record and send it up to the Supreme Court for review. The same system is used in most state courts, to some extent.
- The denial of a writ of certiorari, often called a "denial of cert," does not mean the higher court agrees with the ruling of the lower court. Rather, it usually means the issues presented are not important enough, in the opinion of the higher court, to warrant its consideration. The vast majority of cases are rejected.
- Cert may be granted but limited to one or a few issues. An example appears here.

CERTIORARI GRANTED

04-607 LABORATORY CORP. OF AMERICA V. METABOLITE LABORATORIES, ET AL.

The petition for a writ of certiorari is granted limited to Question 3 presented by the petition.

writ of ejectment See *ejectment*.

writ of execution The vehicle for seizing property in order to satisfy a judgment. The rules are different in every state but can be determined by inquiring at the clerk's office where one ordinarily files lawsuits.

X

xeriscaping Landscaping that uses plants and elements requiring little or no water. The xeriscaping movement is gaining momentum among environmentally conscious corporations making choices for their office landscaping.

Y

yard of concrete One cubic yard, or a volume 3 feet wide by 3 feet long by 3 feet high. One yard of concrete will cover 80 square feet at the $3^1/_2$ inch depth required for a sidewalk or a garage floor.

yield A measurement of the rate of earnings for an investment.

yield capitalization A method of converting future income from an investment into present value by discounting each year's income using an appropriate discount rate or by using one overall rate that reflects the investment.

yield maintenance premium A prepayment penalty designed to replace lost income to investors if one of the loans in a collateralized mortgage backed security is paid off early, thereby effectively stopping any future interest income.

yield spread premium See *service release premium*.

yield to maturity (YTM) The internal rate of return of an investment, taking into consideration all incomes and expenses and their timing.

YTM See *yield to maturity*.

Z

zero cost loan A popular advertising hype for a mortgage loan with no costs to the borrower. The reality is that the borrower pays a higher than normal interest rate on the loan. The normal loan expenses, including the profit to all the intermediaries, are paid out of the higher yield. This could result in dramatically increased overall mortgage costs.

> **Example:** *The table shows a $150,000 loan at 7.5 percent interest on a 30-year amortization with the borrower paying all closing costs and expenses and a $150,000 loan at 8.5 percent interest with no costs at closing.*

	7.5%	**8.5%**
Loan amount	$150,000	$150,000
Closing costs	$3,000	0
Monthly payment	$1,048.82	$1,153.37
Interest paid over 5 years	$54,855.12	$62,437.57
Lifetime interest paid	$227,575.20	$265,213.20
Total interest and closing costs	$230,575.20	$265,213.20

The $3,000 in closing costs you "saved" with Option 2 cost you $34,638 in additional interest over 30 years. Even if you sell after year 5, the $3,000 in closing costs you saved cost you $7,582.45 in additional interest.

zero lot line A type of construction in which the building sits directly on the property lines. It is usually prohibited by setback requirements in local zoning or in deed restrictions.

zone condemnation The demolition of entire areas for new construction.

zone theory In the law of trespass as it relates to flights over one's land, the theory is that a property owner has a lower zone of effective possession which should not be invaded by the government or others, but flights in the zone above that are permissible. Traditionally, property owners owned all to the middle of the earth and up to the far reaches of the heavens. Without the zone theory, every aircraft in the skies would be trespassing on someone's property.

zoning The regulation of the uses of property; the density of populations employing those uses; and the kinds, sizes, and proportions of structures that can be erected on property. Zoning was first

put into place in New York City in 1916 as a reaction against the construction of the Equitable Building, because its 41-story height cast shadows over neighboring residences and affected people's quality of life. The concept soon caught on and was enacted by nearly every city and town in America as a function of their police power. Today, Houston, Texas, is the only major American city with no zoning regulations at all.

- A current use of property that is no longer permitted after a zoning change may be allowed to continue for some period of time. Purchasers of such properties should make sure the use will still be allowed, if that is important. Purchasers of nearby properties should not make assumptions about zoning merely because of what already exists nearby.
- Zoning variances—permission for nonconforming uses—are typically granted only if it would be a hardship on the property to do otherwise. An economic hardship on the owner is irrelevant. Hardship is usually found only when the property has no other practical use other than the one planned and there is a need in the community for that use.
- Zoning variances, when granted, usually contain some requirements not otherwise demanded of other property owners, including such things as facade renovation of an older building, the necessity for off-street parking, or any number of other demands.
- Euclidean zoning, also known as building block zoning, is the most common. It is named for the town of Euclid, Ohio, which provided the test case for Supreme Court review and confirmation as constitutional. Land is divided into specific geographical districts with permitted uses within each type of district. Districts are usually designated R1 for single-family residential, R2 for two-family homes, R3 for multifamily, and so on. Its proponents like the long history of interpretation and the ease of implementation. Its critics say it lacks flexibility and fossilizes outdated theories of land-use planning.
- Performance zoning uses goal-oriented criteria to establish guidelines for the intensity of land use and the impact on infrastructure and on surrounding areas. It employs four major concepts: open-space ratio, impervious surface ratio (roads and parking lots), floor area ratio, and density. Zoning districts have descriptions such as wilderness districts, agricultural districts, and development districts. Proponents like the flexibility, but critics say the system is too complicated.
- Incentive zoning is a rewards-based system that seeks to encourage development to meet a city's needs. The system starts with standard restrictions on building size and height and occupancy densities, and then offers bonuses if developers will include needed amenities such as low-income housing, transit access, or beautification features. By agreeing to the bonus items, the developer may increase the densities or gain other variances.
- Design-based zoning is used in newer mixed-use urban planning models. It concentrates on building design and compatibility in an area rather than specific uses. Zoning districts might be called traditional neighborhood, suburban neighborhood, or transit-oriented development.

zoning variance Permission to conduct a particular activity on real property even though in violation of applicable zoning restrictions for the area. Variances are typically granted only after public

notice and a hearing on the subject, and then only if it would be a hardship on the property to disallow the variance. An economic hardship on the owner is irrelevant. Hardship is usually found only when the property has no practical use other than the one planned, and there is a need in the community for that use.

Appendix A

125 Terms All Buyers and Sellers Should Know

(See also List of Consumer Protection Laws and List of Tax Laws that Affect Real Estate)

1. Adjustable rate mortgage
2. Agency
3. All-risks policy
4. Amortization
5. Annual percentage rate
6. Arbitration
7. Back end ratio
8. Balloon mortgage
9. Bargain and sale deed
10. Boundary line dispute
11. Breach of contract
12. Buyer's broker
13. Caveat emptor
14. CC&R
15. Clearance letter
16. Closing costs
17. Commissions
18. Contingency clause
19. Conforming loan
20. Covenants, the usual
21. Credit report
22. Curb appeal
23. Deed of trust
24. Disclosure statement
25. Discount broker
26. Discount points
27. Distressed property
28. Double escrow
29. Dry closing
30. Dual agency
31. Due on sale clause
32. Durable power of attorney
33. Duty to disclose
34. Early occupancy
35. Earnest money
36. Escrow
37. Exclusive agency listing
38. Exclusive right to sell listing
39. Extender clause
40. Facilitator
41. Fair Credit Reporting Act
42. First refusal, right of

(*Cont.*)

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43. Fixed rate loan
44. Flat fee broker
45. Flip
46. Flood insurance
47. Foreign Investment in Real Property Tax Act (FIRPTA)
48. Form contract
49. Formosan termite
50. Fraud
51. Front end ratio
52. Full disclosure
53. General warranty deed
54. Gift letter
55. Good-faith estimate
56. Grantee
57. Grantor
58. Greater fool theory
59. Homeowners' association
60. Homestead
61. HUD–1 form
62. Impound account
63. Individual retirement account (IRA)
64. Installment contract
65. Insulation disclosure
66. Joint ownership
67. Junk fees
68. Latent defects
69. Lead
70. Lease option
71. Lease purchase agreement
72. Limited service broker
73. Loan application process
74. Loan commitments
75. Mailbox rule
76. Mechanics' and materialmen's liens
77. MLS
78. Mortgage
79. Net listing
80. No buy, no pay clause
81. No-doc loan
82. No-ratio loan
83. Occupancy agreement
84. Open house
85. Open listing
86. Option
87. Owners title policy
88. Percolation test
89. Portable mortgage
90. Private mortgage insurance (PMI)
91. Property condition addendum or clause
92. Proprietary lease
93. Pro-rate
94. Quitclaim deed
95. Regulation CC
96. Reissue rate
97. Replacement value insurance
98. RESPA
99. Right of first offer; right of first opportunity
100. Right of first refusal
101. Risk of loss
102. Sale-leaseback
103. Severalty
104. Sheriff's deed
105. Single asset entity (SAE)
106. Special warranty deed
107. Staging

(*Cont.*)

108. Statute of Frauds
109. Subchapter S corporation
110. Sunset clause
111. Tax certificate
112. Tax deed
113. Teaser rate
114. Tenancy by the entireties
115. Tenancy in common
116. Tenancy in severalty
117. Tenant-in-common properties (TICs)
118. Time is of the essence
119. Time-sharing/timeshares
120. Title insurance
121. Torrens registration
122. Trunk title
123. Walk-through inspection
124. Warranty deed
125. Zero cost loan

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Appendix B

105 Words for Landlords, Tenants, and their Agents

1. AAA tenant
2. Absolute net lease
3. Absorption rate
4. Actual eviction
5. ADA
6. Additional rent
7. Anchor tenant
8. Annual bumps
9. Assignment of lease
10. Attorn
11. Back to back lease
12. Base (expense) year
13. Base rent
14. Bay depth
15. Broom clean
16. Building efficiency ratio
17. Building standard
18. Business center
19. CAM
20. Cancellation clause
21. Class A (or B or C) building
22. Concession burnoff
23. Construction allowance
24. Constructive eviction
25. Continuous occupancy clause
26. Continuous operations clause
27. Controllable expenses
28. Core factor
29. Credit tenant
30. Dark store
31. Deferred commission
32. Demising partition or wall
33. Discrimination
34. Disparate impact
35. Dock high building
36. Effective rental rate
37. Efficiency ratio
38. End cap
39. Escalation clause
40. Eviction
41. Expansion option
42. Expense stop
43. Extension option
44. First generation space

(*Cont.*)

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45. Fixturing period
46. Flex space
47. Full service
48. Going dark
49. Graduated rental lease
50. Gross lease
51. Gross up
52. Handicap
53. Hold harmless clause
54. Holdover tenant
55. Implied warranty of habitability
56. Index lease
57. Intelligent building
58. Lease
59. Leasehold improvements
60. Letter of credit
61. Letter of intent
62. Life support systems
63. Loss factor
64. Master lease
65. Mitigation of damages
66. Month-to-month tenancy
67. Most favored tenant clause
68. Net lease
69. Normal wear and tear
70. Notice to quit
71. Operating expense escalation
72. Pass-throughs
73. Percentage lease
74. Rack rate
75. Radius clause
76. Reappraisal lease
77. Reasonable consent
78. Recapture clause
79. Redeemable rent
80. Relocation clause
81. Renewal option
82. Renewal probability
83. Rental growth rate
84. Rent control
85. Rent-free period
86. Rent roll
87. Rent strike
88. Retaliatory eviction
89. Sandwich lease
90. Satellite tenant
91. Section 8 housing
92. Security deposit
93. Sharing the market uplift
94. Shell lease
95. Sky lease
96. Stabilized occupancy
97. Surrender
98. Tenancy at sufferance
99. Tenancy at will
100. Tenant improvement (TI) allowance
101. Tenant mix
102. Trade fixtures
103. Triple-A tenant
104. Turnover rate
105. Uniform Residential Landlord and Tenant Act

Appendix C

100 Tax Terms Important in Real Estate

1. 501(c)(3)
2. 1031 Exchange
3. 1099
4. Accommodating party
5. Accrued depreciation
6. Active participation
7. Additional first-year depreciation
8. Adjusted basis
9. Ad valorem tax
10. After tax cash flow
11. Alternative minimum tax
12. Arm's length transaction
13. At-risk rules
14. Bargain purchase option
15. Basis
16. Bonus depreciation
17. Boot
18. Burned-out tax shelter
19. Capital gain
20. Capitalized closing costs
21. Capital loss
22. Carryover basis
23. Certificate of discharge
24. Conditional sales contract
25. Conduit tax treatment
26. Constructive receipt
27. Cost allocation depreciation
28. Cost recovery
29. Dealer
30. Dealer status
31. Debt relief
32. Deferred gain
33. Depletion
34. Depreciation methods
35. Depreciation recapture
36. Energy efficient home tax credit
37. Estate tax
38. Family limited partnership
39. Federal tax lien
40. Gift tax
41. GO-Zone
42. Gulf Coast Opportunity Act
43. Historic preservation credits
44. Holding period

(*Cont.*)

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45. Home office tax deduction
46. Imputed interest
47. Income averaging
48. Independent contractor
49. Individual retirement account
50. Information reporting
51. Installment contract
52. Interest deductions
53. Investment interest
54. Involuntary conversion
55. Letter ruling
56. Like-kind exchange
57. Long term capital gain
58. Long term capital loss
59. Low income housing tax credits
60. Marital deduction
61. Modified accelerated cost recovery system
62. Operating lease
63. Ordinary and necessary business expenses
64. Passive activity
65. Passive activity income
66. Passive investor
67. Phantom income
68. Placed in service
69. Prepaid interest
70. Private letter ruling
71. Qualified leasehold improvement property
72. Qualified intermediary
73. Real estate professional
74. Realized gain
75. Real property trades or business
76. Recognized gain
77. Redeemable ground rents
78. Rehabilitation tax credit
79. Related party transactions
80. Revenue ruling
81. Reverse exchange
82. S-corporation
83. Section 121
84. Section 167
85. Section 1031
86. Section 1221
87. Section 1223
88. Section 1245
89. Starker transaction
90. Stepped-up basis
91. Taxable income
92. Tax avoidance
93. Tax benefit rule
94. Tax credit
95. Tax deduction
96. Tax evasion
97. Tax lien
98. Tax preference items
99. Technical Advice Memorandum (TAM)
100. Thin corporation

Appendix D

80 Slang Expressions Used by Real Estate Insiders

It doesn't matter how much you know about a topic, if you don't use the right "insider's language," you'll be dismissed as a spectator—someone who knows all the rules but has never really played the sport. Learn these 80 bits of "jargon" used in the real estate industry, and you'll be recognized as someone who "talks the talk" and can therefore probably "walk the walk." It's all about credibility. You either have it or you don't. Next to each word is a short-hand definition. Refer to the main Encyclopedia content to find out more.

1. **Administrivia**: seemingly useless language in a document
2. **Alligator property**: a bad deal that's eating up your money
3. **Anaconda mortgage**: one that covers ALL debts with that lender, past and future
4. **Annual bumps**: rent increases
5. **BANANA**: Build Absolutely Nothing Anywhere Near Anyone
6. **Big box**: large square building use by Wal-Mart, Target, Kmart, etc.
7. **Bird dog**: someone who sends you leads
8. **Blackacre**: the example property name always used by lawyers
9. **Boomerangers**: baby boomers' children who come back home to live
10. **Bootstrap financing**: creative financing without a formal lender
11. **Bottom-fishing**: shopping for properties at disgracefully low prices
12. **Bricks and mortar**: having a physical presence, not solely Internet-based
13. **Bricks, clicks, and flips**: having stores, Web sites, and catalogues
14. **Bullet loan**: one that will be due in full in a few years
15. **Burned out tax shelter**: real estate that doesn't have any tax benefits any more
16. **CBD**: Commercial Business District; downtown
17. **Century 21 page**: home web page that pops you over to a new page
18. **Condo cowboys**: condo developers who don't know what they're doing
19. **C-Store**: convenience store

(*Cont.*)

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20. **Corner of Main and Main**: middle of downtown
21. **Cram down**: bankruptcy court order forcing terms that make creditors unhappy
22. **Crib**: home
23. **Cyberpark**: business park with a lot of high-tech companies
24. **Dark store**: large retail store that's still paying rent but closed the doors at that location
25. **DINK**: Dual Income, No Kids
26. **Dinosaur pen**: a room for high-speed, high-heat computers
27. **Doc-In-A-Box**: retail medical offices for minor emergencies
28. **Dockominium**: cross between a condo and a dock: ownership of a dock
29. **Dog**: crummy property with bad problems, like toxic waste or steep ravines
30. **Dresser drawer title**: deed that stays in a dresser drawer instead of being recorded
31. **Dry mortgage**: mortgage loan with no personal liability for borrower
32. **Dummy**: straw man; someone who fronts for another, secret, buyer
33. **Echo boomers**: children of baby boomers
34. **Empty nesters**: baby boomers whose children have grown up and moved out
35. **Equity Stripping**: (1) buying foreclosures at deep discounts or (2) hiding assets
36. **Fleas**: the things that are bad about "dog" properties
37. **Flyspecking**: checking and re-checking every tiny thing about a document or title
38. **Garage mahal**: pretentious garage architecture
39. **Gatekeeper**: the person who keeps you from getting to the decision maker
40. **Gazump**: increasing the sales price after someone agrees to buy but before contract signing
41. **Gazunder**: decreasing offer after someone agrees to sell but before contract signing
42. **Gerbil tube**: enclosed walkway that connects buildings
43. **Going dark**: large retailer closing its doors but continuing to pay rent
44. **Gold plating**: padding expenses or financials
45. **Granny flat**: apartments within homes, such as over garage, in basement
46. **Greater fool theory**: even if you pay too much, someone else will pay more
47. **Gross up**: artificially increase building expenses to a calculated level
48. **Home cooking**: out of town lawyers and parties getting the shaft from locals
49. **House fluffer**: decorator who makes a house look pretty so it will sell more quickly
50. **House poor**: having a big house, but no cash
51. **Ironclad agreement**: no such thing. Any agreement can be successfully broken
52. **LULUs**: Locally Unwanted Land Uses
53. **McMansion**: pretentious house that looks like all the other pretentious houses
54. **NFL city**: city with an NFL franchise; supposedly has good demographics
55. **NIMBY**: Not In my Back Yard
56. **Open the kimono**: reveal all financial information to a supposed buyer
57. **Paint-to-paint**: what you own in a condo—the insides of the outer walls
58. **Paper**: mortgage notes

(*Cont.*)

59. **Paper the file**: generate lots of analyses, spreadsheets, charts and photos for a loan application
60. **Pipeline**: what's coming along right now in the way of prospects, apartments, condos, etc.
61. **Pipeline risk**: lender worry that interest rates will increase after a firm loan commitment
62. **Rack rate**: quoted rent rate, ignoring discounts that might be available
63. **Sandwich lease**: a sublease
64. **Scrape**: a property suitable only for bulldozing and redevelopment
65. **Second bite of the apple**: getting a second chance with a different set of arguments
66. **Seed money**: start up cash before obtaining any loans
67. **See-through building**: new building with no tenants
68. **Skin in the game**: investor/developer with some cash at risk; not 100% financing
69. **Stagflation**: stagnant inflation
70. **Starter castle**: pretentious home built with really cheap components and methods
71. **Sweat equity**: increase in value due to hard work
72. **Tax ferrets**: people who rat out tax cheats
73. **Tornado bait**: mobile home
74. **Trash for cash**: forcing you to buy shoddy stuff in addition to the good stuff you really want
75. **Trunk title**: deed kept in a trunk instead of being recorded
76. **Underwater**: property with more debt than the property is worth
77. **Upper bracket**: making lots of money
78. **Vanilla building**: plain building that could have any brand of tenant
79. **Vulture capitalist**: someone waiting for a crash so they can buy properties very cheaply
80. **White elephant**: property you can't get rid of because it's too nice and can't be afforded

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Appendix E
77 Words Important to Developers

1. ADC loan
2. Adequate public facilities ordinances
3. Adverse financial change condition
4. Aesthetic zoning
5. Air rights
6. Annexation
7. As-built drawings
8. Assemblage
9. Bankruptcy
10. Basket loan
11. Bay depth
12. Bid bond
13. Bid shopping
14. Biometrics
15. Builder's risk insurance
16. Capital stack
17. Carrying charges
18. Carve out
19. Cash out refinance
20. Claritas
21. Completion bond
22. Conditional use permit
23. CoStar
24. Defeasance clause
25. Diffused surface waters
26. End cap
27. Feasibility study
28. Field fit
29. Flag lot
30. Floating zone
31. Floor loan
32. Footprint
33. Four quadrants of the real estate capital markets
34. Front ending
35. Front money
36. Future advances mortgage
37. Gap financing
38. Height, building
39. Holdback
40. Holdout
41. Impact fees
42. Inclusionary zoning
43. Indirect costs
44. In-fill development
45. Infrastructure
46. Interim use
47. Inverse condemnation

(*Cont.*)

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48. Joint and several liability
49. Jury, right to trial by
50. Kelo
51. Key lot
52. Land use intensity
53. Land use regulation
54. Location intelligence
55. Mechanics and materialmens lien
56. Median cut
57. Moratorium
58. Operating and easement agreement
59. Outparcel
60. Overbuilding
61. Overseas Private Investment Corporation
62. Performance bond
63. Phase I
64. Phase II
65. Plottage value
66. Potentially responsible party
67. Prime rate
68. Pro forma statement
69. Progress payments
70. Public land survey system
71. Radius clause
72. Reilly's Law of Retail Gravitation
73. Retail anthropology
74. Retention pond
75. Rylands v. Fletcher
76. Schematics
77. Zoning variance

Appendix F

60 Useful Ideas for Analyzing Investments

1. 4-3-2-1 rule
2. Advance payment annuity
3. After-tax cash flow
4. After-tax equity yield
5. After-tax income
6. After-tax proceeds from resale
7. Appreciation return
8. Average downtime
9. Average free rent
10. Average rate of return
11. Balance sheet
12. Before-tax cash flow
13. Break-even point
14. Building efficiency ratio
15. Cap rate
16. Capitalized value of future income
17. Capture rate
18. Cash flow
19. Cash flow before taxes
20. Cash-on-cash
21. Cost-benefit analysis
22. Debt coverage ratio
23. Debt/equity ratio
24. Debt service coverage ratio
25. Discounted cash flow
26. EBITDA
27. Economic rent
28. Effective gross income
29. Effective rental rate
30. Elasticity
31. Equity yield rate
32. Expense ratio
33. Financial management rate of return
34. Going in capitalization rate
35. Gross income
36. Gross income multiplier
37. Gross operating income
38. Gross potential income
39. Gross rent multiplier
40. Internal rate of return
41. Loan-to-value ratio
42. Marginal tax rate
43. Negative amortization
44. Negative cash flow

(*Cont.*)

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45. Negative leverage
46. Net operating income
47. Net present value
48. Net usable acre
49. Occupancy rate
50. Operating expense ratio
51. Ordinary annuity
52. Parking ratio
53. Payback period
54. Potential gross income
55. Present value
56. Reinvestment rate
57. Renewal probability
58. Rental growth rate
59. Rental income
60. Stabilized occupancy

Appendix G

50 Words Important to Residential Real Estate Agents

1. Ad valorem tax
2. ALTA
3. Artificial intelligence
4. Assessed value
5. Attractive nuisance
6. Automated mortgage underwriting
7. Automated valuation model
8. Black mold
9. Blockbusting
10. B-paper
11. Broker price opinion (BPO)
12. Bubble
13. Comparables
14. Computerized loan origination
15. Conditional offer
16. Distressed property
17. Double escrow
18. Dry closing
19. Easement
20. Fee Simple
21. Fiduciary
22. First refusal, right of
23. Form contract
24. Good-faith estimate
25. Gratuitous agent
26. Group boycott
27. Implied agency
28. Implied listing
29. Independent contractor
30. Limited referral agent
31. Mailbox rule
32. Metes and bounds
33. Open listing
34. Option
35. Package mortgage
36. Panic peddling
37. Parol evidence
38. Pocket listing
39. Price fixing
40. Procuring cause
41. Prospect vs. suspect
42. Qualified buyer
43. Radon
44. Ready, willing, and able
45. Recovery fund
46. Rescind
47. Secret profit
48. Steering
49. Submittal notice
50. Undisclosed agency

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Appendix H

50 Federal Laws, and Widespread State Laws that Affect Real Estate

1. AIDS Housing Opportunity Act
2. Adequate public facilities ordinances (APFO)
3. Agricultural Foreign Investment Disclosure Act
4. Americans With Disabilities Act
5. Antitrust laws
6. Arbitration
7. Building Energy Conservation Code
8. Check 21
9. Civil Rights Act of 1866
10. Civil Rights Act of 1964
11. Civil Rights Act of 1968
12. Clean Water Act
13. Color of Title Act
14. Community Reinvestment Act (CRA)
15. Comprehensive Environmental Response Compensation & Liability Act (CERCLA)
16. Consumer Credit Protection Act
17. Davis-Bacon Act
18. Endangered Species Act
19. Equal Credit Opportunity Act
20. Fair Credit Reporting Act
21. Fair Debt Collection Practices Act
22. Fair Housing Act
23. Federal Housing Administration (FHA)
24. Federal Trade Commission
25. Foreign investment in real estate
26. Foreign Investment in Real Property Tax Act (FIRPTA)
27. Gramm-Leach-Bliley Act
28. Home Mortgage Disclosure Act
29. Homeowners' Protection Act of 1998 (HOPA)
30. Howey Rule
31. Interstate Land Sales Full Disclosure Act
32. Occupational Safety and Health Administration (OSHA)
33. Magnusson Moss Act
34. PMI Cancellation Act
35. Privacy laws (see topic for various laws)
36. Private Property Rights Implementation Act of 2006
37. Real Estate Settlement Procedures Act (RESPA)

(*Cont.*)

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38. Regulation CC
39. Regulation Z
40. Religious Land Use and Institutionalized Persons Act of 2000
41. Residential Communities Initiative
42. Right to Financial Privacy Act
43. R-Value Rule
44. Sarbanes Oxley Act of 2002 (SOX)
45. Sherman Antitrust Act
46. Soldiers and Sailors Civil Relief Act (SSCRA)
47. Statute of Frauds
48. Truth in Lending Act (TLA)
49. Truth in Negotiations Act (TINA)
50. Uniform Landlord Tenant Act

Appendix I
20 Ways to Hold Real Estate

1. Community property
2. Condominium
3. Cooperative apartment
4. Corporation
5. General partnership
6. Interval ownership
7. Joint tenants with right of survivorship
8. Joint venture partners
9. Lease
10. Leasehold interest
11. Life estate
12. Limited liability company
13. Limited partnership
14. Ownership in severalty
15. Remainder interest
16. Tenants by the entireties
17. Tenants in common
18. Tenants in common with cross contingent remainders
19. TIC properties
20. Trust

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Appendix J
Symbols and Abbreviations

Δ defendant
Π plaintiff
§ section
¶ paragraph
© copyright
® registered
~ approximately
± more or less
≤ less than or equal to
≥ more than or equal to
≠ not equal to
< less than
> more than
= (double underline) total of above

A

AAA triple a
ABA American Bankers Association
ABC Associated Builders and Contractors
A/C air conditioning
ACM asbestos containing material
ACRS accelerated cost recovery system
ADA Americans with Disabilities Act
ADC acquisition, development, and construction loan
ADR asset depreciation range
AGCA Associated General Contractors of America
AI artificial intelligence
AIA American Institute of Architects
AIDS acquired immunodeficiency syndrome
ALDA Asset Conservation, Lender Liability and Deposit Insurance Act of 1996
ALTA American Land Title Association
Alt/min alternative minimum tax
AMI alternative mortgage instrument
AML adjustable mortgage loan
AMT alternative minimum tax
ANSI American National Standards Institute, Inc.
APA American Planning Association
APFO adequate public facilities ordinances
APN assessor parcel number
APP appreciation
APR annual percentage rate
ARA Accredited Rural Appraiser
ARELLO Association of Real Estate License Law Officials
ARES American Real Estate Society
AREUEA American Real Estate and Urban Economics Association
ARM adjustable-rate mortgage
ASA American Society of Appraisers

(*Cont.*)

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ASFMRA American Society of Farm Managers and Rural Appraisers

ASHI American Society of Home Inspectors

ASREC American Society of Real Estate Counselors

AVM automatic valuation model

B

BANANA build absolutely nothing anywhere near anybody

BFP bona fide purchaser

BIF Bank Insurance Fund

BLM Bureau of Land Management

BMIR below market interest rate

BNA block numbering area

BOMA Building Owners and Managers Association

BOY beginning of year

BPO broker price opinion

BSPRA builders and sponsors profit and risk allowance

BTU British thermal unit

BTXE benzene, toluene, xylene, and ethylbenzene

C

CAD cash available for distribution

CAD central appraisal district

CAD computer aided design

CAI Community Association Institute

CAM common area maintenance

CBA controlled business arrangement

CBD central business district

CBSA core-based statistical area

CCA chromated copper arsenate

CCIM Certified Commercial Investment Member

CCR conditions, covenants and restrictions

CD certificate of deposit

CERCLA Comprehensive Environmental Response Compensation and Liability Act

CLO computerized loan origination

CMA comparative market analysis

CMBS collateralized mortgage backed securities; sometimes commercial mortgage backed securities

CMO collateralized mortgage obligation

CMSA consolidated metropolitan statistical area

CO or **C/O** certificate of occupancy

COFI cost of funds index

COLA cost of living adjustment

CPI consumer price index

CPM Certified Property Manager

CRA Community Reinvestment Act

CRA credit reporting agency

CRB Certified Residential Broker

CRE Counselors of Real Estate

CREW Commercial Real Estate Women

CRS Certified Residential Specialist

CRV certificate of reasonable value

C-store convenience store

CUP conditional use permit

CWA Clean Water Act

D

D defendant

DBH diameter breast high

(*Cont.*)

DCR debt coverage ratio

DDA demand deposit account

DINK dual income, no kids

DIP debtor in possession

DOI Department of the Interior

DPP direct participation program

DREI Distinguished Real Estate Instructor

DWV drain-waste-vent

E

EBITDA earnings before interest, taxes, depreciation and amortization

EIFS exterior insulation and finish system

E&O errors and omissions insurance

EOY end of year

EPA Environmental Protection Agency

F

FAMC Federal Agricultural Mortgage Corporation

FCA Farm Credit Association

FDIC Federal Deposit Insurance Corporation

FEMA Federal Emergency Management Agency

FF&E furniture, fixtures and equipment

FFIEC Federal Financial Institutions Examination Council

FHA Federal Housing Administration

FHFB Federal Housing Finance Board

FIA Federal Insurance Administration

FICO Fair Isaac Company score

FIRPTA Foreign Investment in Real Property Tax Act

FIRREA Financial Institutions Reform, Recovery and Enforcement Act

FLP family limited partnership

FmHA Farmers Home Administration

FMRR financial management rate of return

FMV fair market value

FNMA Federal National Mortgage Association

FRT federally related transaction

FSLIC Federal Savings and Loan Insurance Corporation

FTC Federal Trade Commission

FY fiscal year

G

GAAP generally accepted accounting principles

GAO Government Accountability Office

G/C and **GC** general contractor

GEM growing equity mortgage

GIS geographic information system

GLA gross leasable area

GNMA Government National Mortgage Association

GPI gross potential income

GPO Government Printing Office

GPRI gross potential rental income

GRI Graduate REALTORS® Institute

GRM gross rent multiplier

GSA General Services Administration

GSE government-sponsored enterprise

H

HECM home equity conversion mortgage

HELOC home equity line of credit

HOPA Homeowners Protection Act of 1998

HUD United States Department of Housing and Urban Development

HUD-1 settlement statement

HVAC heating, ventilation and air conditioning

(*Cont.*)

I

ICSC International Council of Shopping Centers

IFMA International Facilities Management Association

ILSFDA Interstate Land Sales Full Disclosure Act

IRA Individual Retirement Account

IREM Institute of Real Estate Management

IRR internal rate of return

IRS Internal Revenue Service

L

LIBOR London Interbank Offered Rate

LLC limited liability company

LLP limited liability partnership

LOC letter of credit

LOI letter of intent

LTV loan-to-value ratio

LUIS land use intensity system

LULU locally unwanted land use

LUST leaking underground storage tank

L/V loan-to-value ratio

M

MAI Member, Appraisal Institute

MBS mortgage backed security

MGIC Mortgage Guaranty Insurance Corporation

MLS multiple listing service

M&M mechanics and materialmen

MSA metropolitan statistical area

N

NAEBA National Association of Exclusive Buyer Agents

NAR National Association of REALTORS®

NAREB National Association of Real Estate Brokers

NECTA New England city and town area

NIMBY not in my back yard

NNN triple net lease

NOI net operating income

NPV net present value

O

OAR overall capitalization rate

OEA operating and easement agreement

OFHEO Office of Federal Housing Enterprise Oversight

OILSR Office of Interstate Land Sales Registration

OMB Office of Management and Budget

OPM other people's money

ORE owned real estate; other real estate

OSHA Occupational Safety and Health Administration

OTS Office of Thrift Supervision

P

P plaintiff

PCB polychlorinated biphenyls

PCB pollution control board

P&I principal and interest

PIG passive activity generator

PITI principal, interest, taxes and insurance

P&L profit and loss

PLSS public land survey system

PMI private mortgage insurance

PMSI primary metropolitan statistical area

POS principal only securities

PRP potentially responsible party

(*Cont.*)

PUD planned unit development

PV present value

R

RAM reverse annuity mortgage

RAP remedial action plan

RCRA Resource Conservation and Recovery Act

REEA Real Estate Educators Association

REIPA Real Estate Information Professionals Association

REIS real estate information system

REIT real estate investment trust

REMF real estate mutual fund

REMIC real estate mortgage investment conduit

REO real estate owned

REOC real estate operating company

RESPA Real Estate Settlement Procedures Act

RevPAR revenue per available room

RFP request for proposal

RFQ request for qualifications

RLI REALTORS® Land Institute

ROI return on investment

RRM renegotiated rate mortgage

RTC Resolution Trust Corporation

R/W right of way

S

SAE single asset entity

SAM shared appreciation mortgage

SARA Superfund Amendments and Reauthorization Act

SBA Small Business Administration

SEA street edge alternatives

SEC Securities and Exchange Commission

SH shareholders; stockholders

SIOR Society of Industrial and Office REALTORS®

SIP structural insulated panel

S/L statute of limitations

S&L savings and loan association

SMSA standard metropolitan statistical area

SOX Sarbanes-Oxley Act of 2002

SPE single purpose entity

SPE special purpose entity

SRA Senior Residential Appraiser

SRO single room occupancy

SSCRA Soldiers and Sailors Civil Relief Act

SYD sum of the years digits

T

TAM technical advice memorandum

TDR transferable development right

TI taxable income

TI tenant improvements

TIC tenant in common property

TILA Truth in Lending Act

TIMO timber investment management organization

TINA Truth in Negotiations Act

TRO temporary restraining order

U

UCC Uniform Commercial Code

UCC-1 financing statement

UETA Uniform Electronic Transactions Act

ULI Urban Land Institute

URAR Uniform Residential Appraisal Report

(*Cont.*)

USPAP Uniform Standards of Professional Appraisal Practice

UST underground storage tank

V

VA Department of Veterans' Affairs

VRM variable rate mortgage

W

WCR Women's Council of REALTORS®

WOR without recourse

Y

YTM yield to maturity

Appendix K

Common Land Measurements and Conversions

Author note: Land measurements and conversion tables are available online at www.onelineconversion.com to perform virtually any conversion.

1 mile = 80 chains
= 320 rods
= 1760 yards
= 5280 feet

16 $^1/_2$ feet = 1 rod, perch, or pole

1 chain = 100 inches
= 66 feet,
= 100 links
= 4 rods

1 link = 7.92 inches

25 links = 1 rod

4 rods = 1 chain

144 square inches = 1 square foot

9 square feet = 1 square yard

30 $^1/_4$ square yards = 1 square rod

160 square rods = 1 acre

10,000 square links = 1 square chain

10 square chains = 1 acre

1 acre = 208,708 feet by 208,708 feet

1 acre = 43,560 square feet

1 acre = 4,840 square yards

1 acre = 160 square rods

640 acres = 1 square mile or 1 section

36 square miles or sections = 1 township

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Denise L. Evans received her law degree from the University of Alabama and is licensed to practice law in the state of Texas, where she specialized in real estate and banking litigation. When she returned to Alabama, she entered commercial real estate, and has been active in various aspects of that field for almost twenty years. Today, she is a commercial real estate broker, adjunct professor in real estate at the Culverhouse College of Commerce and Business Administration at the University of Alabama, and the author of several real estate books. She is married to her coauthor, O. William "Bill" Evans. She founded and is active in her local chapter of CREW, the national organization devoted to women in commercial real estate.

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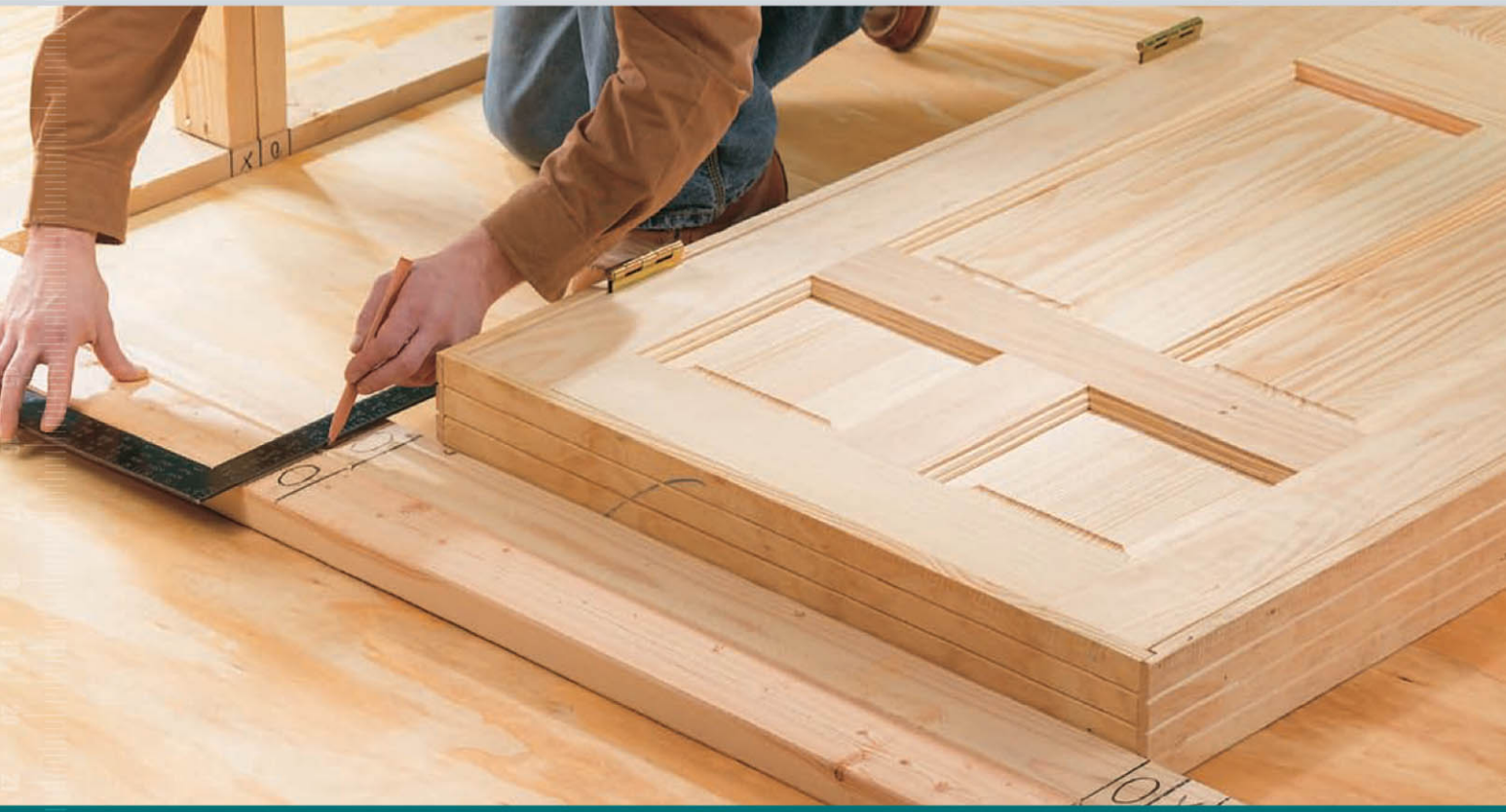
HOME SKILLS

Carpentry



AN INTRODUCTION TO SAWING, DRILLING, SHAPING & JOINING WOOD

HOME SKILLS

Carpentry

AN INTRODUCTION TO SAWING, DRILLING, SHAPING & JOINING WOOD

COOL SPRINGS PRESS
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MINNEAPOLIS, MINNESOTA

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(Fogra 39)Job:04-30427 Title:MBI-HomeSkills Carpentry
#175 Dtp:225 Page:1

CONTENTS

Tools, Materials & Skills

Introduction 4

Prying Tools 7

Tape Measurers 10

Handsaws 18

Hammers 20

Clamps & Vises 24

Sharpening Chisels & Plane Blades 26

Planes & Surface Forming Rasps 28

Jigsaws 30

Circular Saws 32

Straightedge Guides 38

Power Miter Saws 39

Table Saws 47

Drills & Bits 53

Sanders 56

Pneumatic Nailers 60

Powder-Actuated Tools 64

Routers 66

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(Fogra 39)Job:04-30427 Title:MBI-HomeSkills Carpentry
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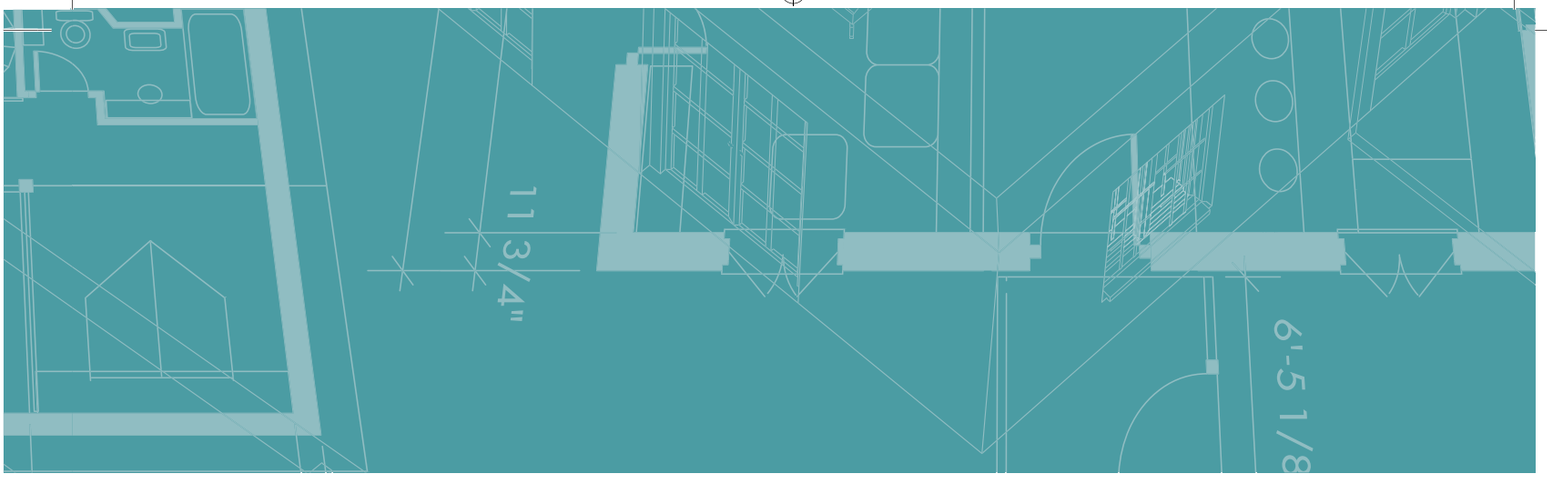

Basic Carpentry

Lumber 70

Plywood & Sheet Goods 74

Trim Moldings 76

Nails 78

Screws & Other Hardware 80

Glues & Adhesives 82

Workshop

Storage Strategies 110

Pegboard 114

Sawhorses 118

Workbench 120

Anatomy of a House

Partition Walls 90

Door Frames for Prehung Doors 94

Framing a Window 96

Door & Window Casings 100

Base Molding 106

References

Reference Charts 126

Index 127

001-031_30427.indd 3 4/10/13 4:22 PM
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(Fogra 39)Job:04-30427 Title:MBI-HomeSkills Carpentry
04-C68867 #175 Dtp:225 Page:3

Introduction

FUNDAMENTAL CARPENTRY SKILLS are a real must-have for anyone who wants to be moderately self-sufficient. On the easy end are the projects that stump so many but are so rudimentary—assembling a pre-fab shelving unit, hanging artwork, or easing a stuck door. With your collection of basic carpentry tools and an understanding of how to use them correctly, you will know which tool to use, how to locate studs, and how to sand or plane a door so it stops sticking.

Beyond the basics is a whole world of carpentry that you can do yourself. From birdhouses, doghouses, and sheds to your own house, knowing how to measure, cut, shape, assemble, and secure lumber, trim, and sheet goods is priceless. Even if you never attempt a major construction project like building partition walls, it is beneficial to know what the skeleton of your home looks like.

Throughout the book are Skillbuilder exercises. These are little activities to help you learn how to use a tool or material. If you didn't spend your childhood in the garage experimenting with every piece of scrap wood and every tool, you need to spend some playtime experimenting and developing skills. The more you practice on small projects, the better your big, serious projects will turn out. Remember, you may need to experience failure with tools and materials to understand how to achieve success.

Homeskills: Carpentry is a valuable resource on your road to self-reliance. Here you will find all the most common carpentry tools—photographs so you know what they look like, buying tips so you know what to look for, and technique tips to perfect your methodology. Use this book as a launch point to adventures in home repair and home improvem-ent, or use it as a handy reference to augment your hardware knowledge.

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(Fogra 39)Job:04-30427 Title:MBI-HomeSkills Carpentry
#175 Dtp:225 Page:4

TOOLS, MATERIALS & SKILLS

Prying Tools 7

Tape Measures 10

Plumb Bobs, Chalk Lines & Stud Finders 12

Levels 14

Squares 16

Handsaws 18

Hammers 20

Clamps & Vises 24

Sharpening Chisels & Plane Blades 26

Planes & Surface-forming Rasps 28

Jigsaws 30

Circular Saws 32

Straightedge Guides 38

Power Miter Saws 39

Table Saws 47

Drills & Bits 53

Sanders 56

Pneumatic Nailers 60

Powder-Actuated Tools 64

Routers 66

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001-031_30427.indd 5 4/10/13 4:22 PM

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(Fogra 39)Job:04-30427 Title:MBI-HomeSkills Carpentry
#175 Dtp:225 Page:5

You absolutely do not need pneumatic tools to be a home carpenter—but don't let them intimidate you. They are actually a lot of fun to use.

IF YOU WANT YOUR PROJECTS TO LOOK THEIR best, they need to be level, plumb, true, and square. Achieving this state requires the proper tools—and attention to detail. Fortunately, measuring tools are some of the least expensive tools to purchase. At minimum, your toolbox should contain a tape measure, torpedo level, and a Speed square, and probably a studfinder. Plumb bobs and chalklines are necessary for framing and other larger construction jobs. Longer levels and various types of squares will come in handy as you build your skills.

Cutting accurately is as important as measuring accurately. A variety of hand and power tools are available to cut and shape wood. The circular saw is a power tool that most home carpenters should own. A good hand saw or two can also come in handy. Both power miters and table saws get less expensive every year.

Of course, once cut, all that lumber needs to be assembled. Hammers and power drills/drivers are also on the must-have list. Not all hammers are created the same, so we show you what to look for.

When acquiring your tool collection, purchase the highest quality you can afford. Sure, those hundred-piece tool kits for $19.99 are a great deal, but are they a good value? When the screwdriver bends on the first hard twist or the hammerhead flies off the handle on the first dry day, you will wish you had spent a bit more wisely.

One way to economize is to look for used tools at garage sales. Many hand tools have a lifespan of decades, and many older tools were built to last. For power tools, look for reconditioned models offered by the manufacturer. If you have handy relatives, they might be an excellent resource for secondhand tools. Many do-it-yourselfers upgrade their tools regularly. They may be happy to give you their old torpedo level if you ask.

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#175 Dtp:225 Page:6

Demolition is an important part of many carpentry projects. And just like building, it's all about the tools.

PRYING TOOLS

Prying tools are an essential part of any carpenter's tool arsenal, because many carpentry projects start with the removal of existing materials. With the right tools, you can often remove nails without damaging the lumber, so that it can be used again.

Pry bars are available in many sizes. Choose quality pry bars forged from high-carbon steel in a single piece. Most pry bars have a curved claw at one end for pulling nails and a chisel-shaped tip at the opposite end for other prying jobs. You can improve leverage by placing a wood block an inch or two away from the material you're trying to pry loose.

A quality prying tool is an essential part of any homeowner's tool kit. A flat prybar like the one seen here (sometimes called a wonderbar) is a very useful tool.

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#175 Dtp:225 Page:7

Prying tools include wrecking bars for heavy demolition work, cat's paws for removing nails, and a brad puller. Flat bars are made of flattened steel and come in a variety of sizes for light- and heavy-duty use.

Use the right tool for the job. A wrecking bar, sometimes called a crowbar, is a rigid tool for demolition and heavy prying jobs. As its name implies, it is good for wrecking. If you are removing trim, use a thin, flat pry bar. The claw on a claw hammer is meant for light-duty nail removal. If you will be pulling many nails, use a one piece flat bar or cat's paw so you don't ruin your hammer.

A cat's paw has a sharpened claw for removing stubborn nails. Use a hammer to drive the claw into the wood under the nail head, then lever the tool to pull up the nail.

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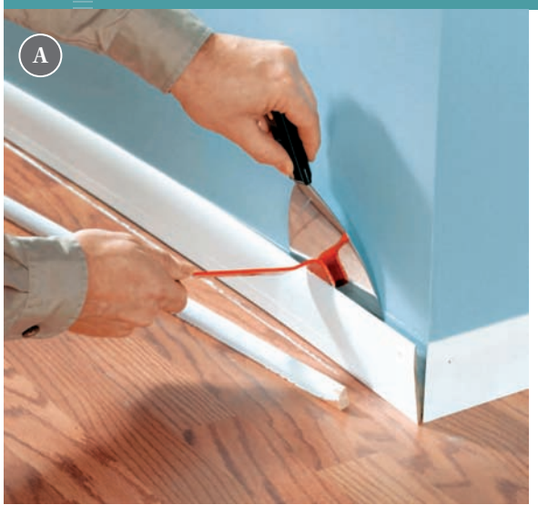
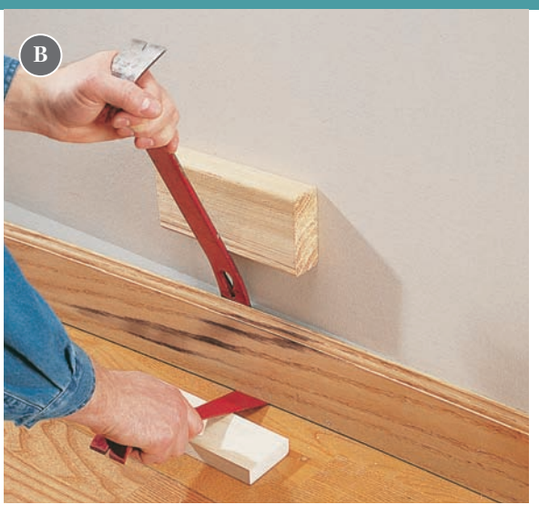
REMOVING TRIM MOLDINGS





A Trim moldings are often layered composites. Begin by removing the base shoe or outermost layer first. Use a wide drywall or putty knife to initiate the prying and make room for a flat pry bar.

B Use large flat scraps of wood to protect wall and floor surfaces from damage. For base trim, which may be nailed both into the wall and the floor, insert one bar beneath the trim and work the other between the base and the wall. Force the pry bars in opposing directions to work the molding away from the wall.

C Remove nails from trim by using an end nippers to grab the pointed end of the nail and pull the nail through the back side of the trim. This causes the least amount of damage to the front face of the trim. Use the rounded head of the end nippers to "roll" the nail out of the molding.

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#175 Dtp:225 Page:9

TAPE MEASURES

The first step in any carpentry project is the taking of accurate measurements. Even though it seems big, buy a 25-foot steel tape measure with a ¾-inch-wide blade for general use. Most tape measures are retractable, so the tape returns easily. Make sure your tape has a locking mechanism, so you can keep it extended to a desired length. A belt clip is also essential.

Wider tapes normally have a longer standout—the distance a tape can be extended before it bends under its own weight. A long standout is an extremely useful feature when you're measuring without a partner to support the far end of the tape. Open a tape in the store and extend it until it bends. It should have a standout of at least 7 feet.

Tape measures are commonly set in 1⁄16-inch increments along the top edge and 1⁄32-inch increments for the first six inches across the bottom. Select one with numbers that are easy to read. "Easy reader" tapes feature a fractional readout for people who have difficulty reading a measurement calibrated with dash marks. Most tape measures feature numbers that are marked or labeled every 16 inches for easy marking of studs. A high-quality tape measure also has a two- or three-rivet hook to control the amount of play in the tape, ensuring your measurements are as accurate as possible.

Buy a 25-ft. retractable steel tape for general carpentry projects. If you are working on a large project like a deck, patio, or retaining wall, consider purchasing a 50-ft. reel-type tape.

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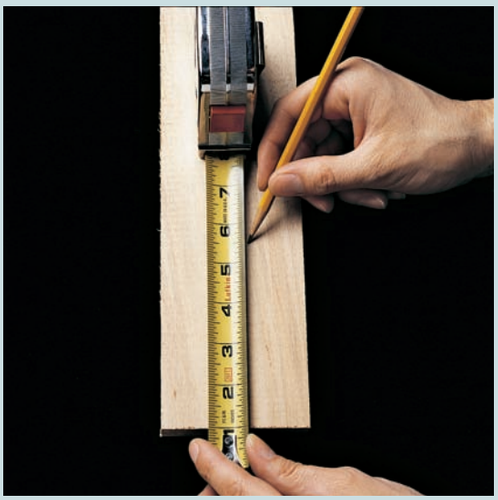
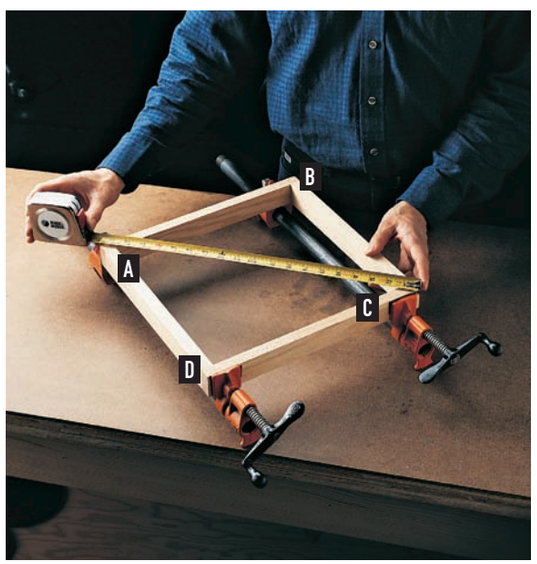
Skillbuilder



The end hook on a tape measure has between 1/16 and 1/8" of play so that the hook pushes in for taking an inside measurement and pulls out for taking an outside edge measurement. The hook end should not be used when an extremely accurate measurement is required. For precise measurements, use the 1" mark as your starting point (called burying an inch), then subtract 1" from your reading. Using the hook end, measure 5" from the end of a board. Then measure by burying an inch (shown).

Use only one tape measure, if possible, while working on a project. If you must work with two tapes, make sure they record the same measurement. Different tape measures do not always measure equally. A slight difference in the end hooks can create an error of 1/16" or more between two tapes, even if they are of the same brand and style.



Check for square when building frames, boxes, cabinets, drawers, and other projects where fit is important. Hold a tape measure across the diagonals of the workpiece (A-C, B-D). The measurements will be identical if the workpiece is square.

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#175 Dtp:225 Page:11

PLUMB BOBS, CHALK LINES & STUD FINDERS

The plumb bob is a simple, yet extremely precise tool used to establish a line that is plumb—or exactly vertical. Plumb bobs are commonly used to find marking points to position a sole plate when building a wall. Plumb refers to a hypothetical line running to the exact center of the earth. Think of it as a line that is exactly perpendicular to a level surface.

The chalk line is a tool used to mark straight lines on flat surfaces for layout or to mark sheet goods and lumber for cutting. Typical chalk lines contain 50 to 100 feet of line wound up in a case filled with chalk. Always tap the box lightly to fully coat the line with chalk before pulling it out. To mark a line, extend it from the case, pull it taut, and snap it using the thumb and forefinger. Chalk lines have a crank that is used to reel in the line when the job is complete and a locking mechanism to help keep the line taut during marking.

Most of today's chalk lines (sometimes called chalk boxes) double as plumb bobs for general use (see photos, opposite page, bottom). A chalk box isn't quite as accurate as a plumb bob for establishing a vertical line. However, if you don't own a plumb bob, using a chalk box is an easy alternative.

Studfinders are battery-powered electronic devices that analyze wall density. They can help you locate wall framing and even electrical wires, depending on the model.

Tip

When driving nails or screws into studs, the fastener must not penetrate more than 1" into the stud. Why? Electrical and plumbing lines run through the middle of studs. The finish layer of drywall is ½" thick on walls, so a 1¼" fastener is the safest length.

Buy powdered chalk refills of blue or red chalk. In most cases blue is a better choice because it is less permanent. Red is used mostly by professionals whose lines need to be visible for inspectors.

Use a studfinder to locate wall studs or ceiling blocking. These devices locate the edges of framing so you can determine the center of studs and joists.

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#175 Dtp:225 Page:12

Skillbuilder

Practice this skill in a closet, finished garage, or basement where rows of holes won't be noticed. Use the studfinder to find a stud. Mark the edges of the stud, then confirm framing locations by driving a finish nail through the wall in a line between and beyond the marks. To find neighboring studs, measure from the center point of the confirmed stud in 16" or 24" intervals. Use the nail to verify. This exercise also acquaints you with the feeling of driving a nail through wall finish into a stud (good) or through wall finish into air (bad).

To snap a chalk line over a very short distance, pin the string down with the edge of your palm, then use your thumb and forefinger on the same hand to snap the line. When snapping lines to mark stud locations, make sure you snap over the center of the studs, so you will know where to drive screws or nails.

To position a sole plate, hang a plumb bob (or chalk box, as shown) from the edge of the top plate so that it nearly touches the floor. When it hangs motionless, mark the floor directly below the point of the plumb bob. Repeat the process at each end of the new wall space to determine the proper sole plate position.

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LEVELS

Levels are essential to virtually every carpentry project. They help you build walls that are perfectly vertical (plumb), shelves, countertops, steps that are level, and roofs that incline at a correct and consistent pitch.

Take care of your levels. Unlike some other tools that can be tossed into a tool bucket without damage, a level is a finely tuned instrument that is easily broken. Before you buy a level, test it on a level surface to make sure the vials are accurate (opposite page).

Most levels contain one or more bubble gauges—sealed vials with a single small air bubble suspended in fluid—that indicate the level's orientation in space at any moment. As the level is tilted, the bubble shifts its position inside the vial to reflect the change. This type of level is sometimes referred to as a spirit level because of the use of alcohol inside the gauge. There are also several types of electronic levels that offer digital readouts instead of using a bubble gauge.

Skillbuilder

Use your level to level all the appliances in your house. Many appliances have threaded leveling feet that screw in and out. Remember, righty tighty (clockwise), lefty loosey (counter-clockwise). However, that's if you are on the screw side facing the receiver. Since you will be looking down onto the lifter feet, if you want to elevate twist clockwise, and to lower twist counter-clockwise. Level the appliances front to back and side to side.

Most carpenter's levels contain three gauges: one for checking level (horizontal orientation), one for plumb (vertical orientation), and one for 45° angles. Some levels include pairs of gauges with opposing curves to improve readability.

Laser levels project highly accurate beams of light around rooms or along walls. Many styles automatically establish their own level orientation.

You should own at least two levels: a 2-foot carpenter's level for checking studs, joists, and other long construction surfaces, and a 8 to 9" torpedo level that is easy to carry in a tool belt and is perfect for checking shelves and other small workpieces. A 4-ft. version of the carpenter's level is most useful for framing projects.

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(Fogra 39)Job:04-30427 Title:MBI-HomeSkills Carpentry
#175 Dtp:225 Page:14

Battery-powered digital levels represent the latest advance in level design. Digital levels provide very accurate digital readouts, so you don't have to trust your eye when judging bubble position within a vial. Digital levels also measure slope and offer rise/run ratios, which are useful when building stairs. The electronic components are contained in a module that can be used alone as a torpedo level or inserted into frames of varying lengths.

Laser levels project a beam of light to create a level line all around a room or for level lines of longer lengths. A laser can eliminate the need for snapping chalk reference lines.

Make sure your level is accurate. Hold one side of the level against a flat, even surface (top photo), mark the location, and read the bubble gauge carefully. Pivot the level 180° (bottom photo) and read the gauge again. Next, flip the level over and read the gauge. The bubble should give the same reading each time. If not, adjust the mounting screws to calibrate the bubble, or buy a new level.

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(Fogra 39)Job:04-30427 Title:MBI-HomeSkills Carpentry
#175 Dtp:225 Page:15

SQUARES

Squares come in many shapes and sizes, but they are all designed with one general purpose: to help you mark lumber and sheet goods for cutting.

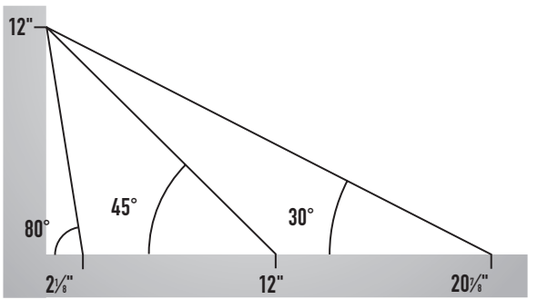
A drywall T-square is large—it has a 4-foot arm so that you can make or mark straight cuts across a sheet of drywall or other sheet goods. A try square is great for marking crosscuts on 2 × 4s, but it is fixed, not adjustable like a combination square. A rafter square (also speed square) or a framing square is best for marking angles on rafters. Using the right tool will make your work more efficient and improve the accuracy of your cuts.

Familiarize yourself with the different types of squares and their uses so you can choose the right tool for the job.

A drywall T-square simplifies the task of marking and cutting straight lines on sheets of drywall. The top of the T hooks over the edge of the drywall, while the leg is used as a straightedge. A T-square is also handy for marking cutting lines on plywood and other sheet goods. Some models have an adjustable T that can be set to common angles.

Tip

If you are only going to buy one square, buy a large 10" or 12" polyethylene rafter square. They are inexpensive and very handy for marking and making crosscuts, the most common carpentry cuts you will make.



A framing square is commonly used to mark right angles on sheet goods and other large surfaces, but it can also be used to establish other angles by using different measurements along the body (long arm) and the tongue (short arm). The tool has gradations marked in tiny increments, and many come with detailed tables to help you make angles.

Common Framing Square Angles

Angle	Tongue	Body
30°	12"	20⅞"
45°	12"	12"
60°	12"	61⁵⁄₁₆"
70°	12"	4⅜"
75°	12"	3⁷⁄₃₂"
80°	12"	2⅛"

The chart above shows the markings to use on the framing square to obtain commonly required angles. If you want to make a line at a 30° angle, mark the workpiece at 12" on the tongue and 20⅞" on the body, and connect the marks with a straight line.

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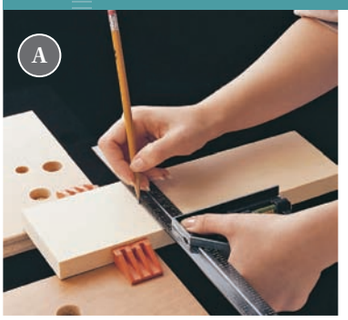
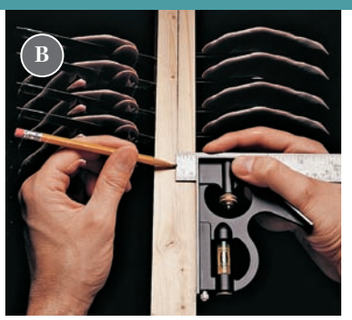
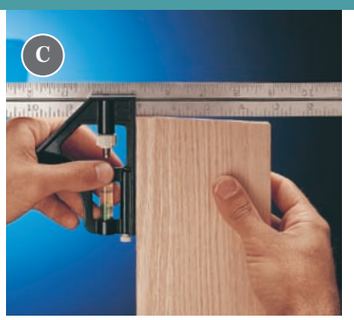
USING A COMBINATION SQUARE





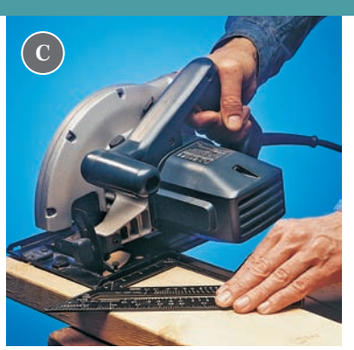


A To mark a board for crosscutting, hold the square against the edge of the workpiece with the head locked, then use the edge of the blade to guide your pencil. Use the handle's 45° edge to mark boards for miter cuts.

B To mark a line parallel to the edge of a board, lock the blade at the desired measurement, then hold the tip of the pencil along the end of the blade as you slide the tool along the workpiece. This is useful when marking reveal lines on window and door

C To check for square, set the blade of a square flush with the end of the workpiece (and set the head flush with one edge). If the end is a true 90°, there will not be a gap between the blade and the workpiece.

USING A RAFTER SQUARE



A To mark angle cuts, position the rafter square's pivot point against the edge of the workpiece, and set the tool so the desired angle marking is aligned with the same edge. Scribe a line to mark the angle on the workpiece. Flip the tool over to mark angles in the opposite direction.

B To mark crosscuts, place a rafter square's raised edge flush with one edge of the board, and use the perpendicular edge to guide your pencil. On wide boards, you'll need to flip the square to the board's other edge to extend the line across the board.

C To guide a circular saw when making crosscuts, first align the blade of the saw with your cutting line. As you cut, hold the raised edge of the square against the front edge of the workpiece and the perpendicular edge flush with the foot of the saw.

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HANDSAWS

It's possible that you could do almost all your carpentry projects using a circular saw, power miter saw, or jigsaw and never miss a handsaw. However, there are times when using a handsaw is easier, more convenient, and produces better results. Handsaws also provide the do-it-yourselfer a cost-effective alternative to the higher price of power tools.

For every power saw available today, there is a handsaw available that was originally used to make the same type of cut.

There are many differences between handsaws. When you shop for a saw, look for one that's designed for the type of cutting you plan to do. Differences in handle design and the number, shape, and angle (set) of the teeth make each saw work best for specific applications.

For general carpentry cuts, use a crosscut saw with 8 to 10 teeth per inch. Crosscut saws have pointed teeth designed to slice through wood on the forward stroke and to deepen the cut and remove sawdust from the kerf on the back stroke.

Always use a handsaw for its intended purpose. Misuse of a handsaw will only damage the tool, dull the blade, or lead to injury.

When saw blades become dull, take them to a professional blade sharpener for tuning. It's worth the extra cost to ensure the job is done right.

Making a cutout by hand requires a saw with a narrow, tapered blade that fits into confined spaces. Use a keyhole saw for making cutouts in plywood, paneling, and other thin materials and a drywall saw for making fixture cutouts in drywall.

Handsaws are less important today than they were a couple of generations ago. But keeping a few at hand is a good idea. A basic set includes a hacksaw, a coping saw, and a crosscut saw (preferably one that fits in your toolbox). A backsaw and miter box will expand your skills.

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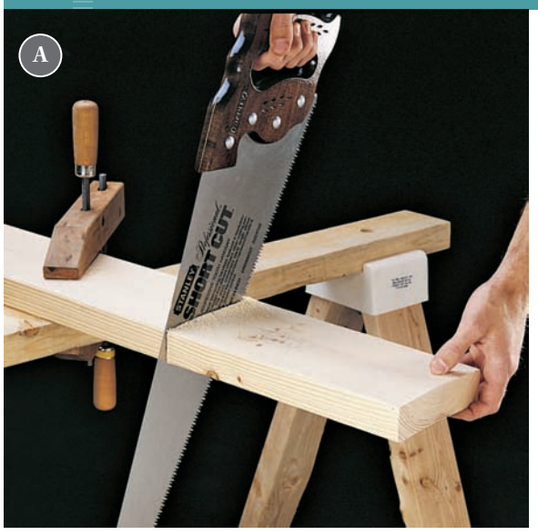
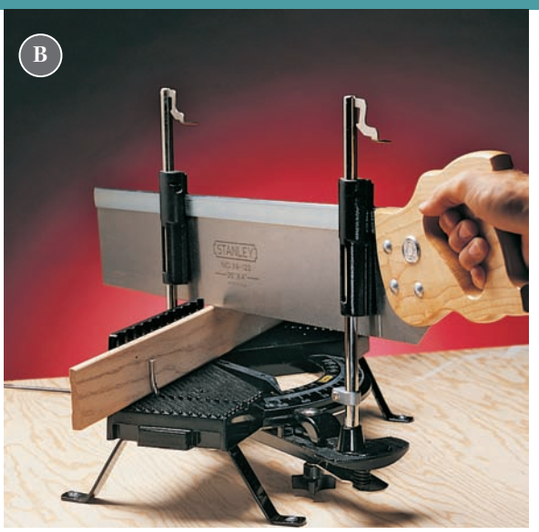
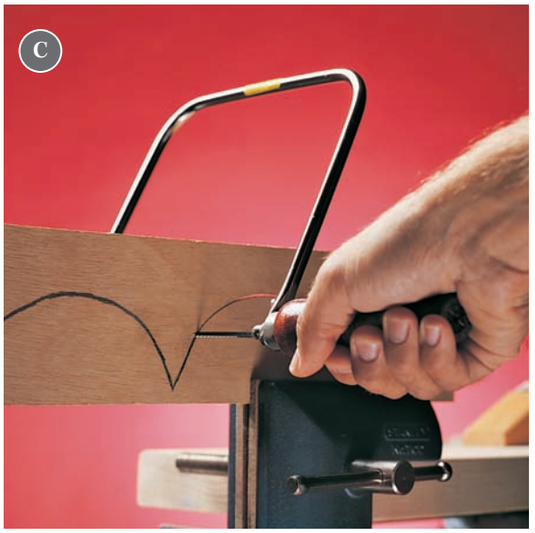
CHOOSING THE RIGHT HANDSAW







A A crosscut saw comes in handy for single-cut projects or in confined spaces where power tools won't fit. At the end of a cut, saw slowly, and support waste material with your free hand to prevent splintering.

B A backsaw with a miter box cuts precise angles on moldings and other trim. Clamp or hold the workpiece in the miter box and make sure the miter box is securely fastened to the work surface.

C A coping saw has a thin, flexible blade designed to cut curves. It is also essential for making professional-looking joints in trim moldings. The blade of a coping saw breaks easily when under heavy use, so have extra blades on hand.

D A hacksaw has a flexible, fine-tooth blade designed to cut metal. Carpenters use hacksaws to cut plumbing pipe or to cut away stubborn metal fasteners. To avoid breaking the blade, make sure the blade is stretched tightly in the frame before cutting.

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#175 Dtp:225 Page:19

HAMMERS

The standard hammer is a 16-ounce, curved-claw finish hammer. It is designed for driving, setting, and pulling nails. Choose a hammer with a smooth finish, a high-carbon steel head, and a quality handle made of hickory, fiberglass, or solid steel. Less expensive steel handles often have hollow cores that are not as efficient at transmitting force to the head. This is a tool that needs to feel comfortable, so heft all the finish hammers available before purchasing.

Straight-claw framing hammers—usually with a 20-ounce or heavier head—are used for framing walls and other heavy-duty tasks. The extra weight helps drive large nails with fewer swings. Most framing hammers are too heavy for finish carpentry, where control is of primary importance.

A mallet with a non-marking rubber or plastic head is the best tool for driving chisels without damaging the tools. Mallets are also useful for making slight adjustments to a workpiece without marring the surface of the wood.

A sledgehammer or maul is effective for demolishing old construction or adjusting the position of framing members.

Framing hammers vary in size, length, and handle material. Handle types include fiberglass, solid steel, hollow core, and wood. Hammers typically range in length from 14 to 18". Most framing hammers have a head weighing at least 20 oz., but lighter and heavier models are available. Some heads feature a waffle pattern across the face that increases the hammer's hold on the nail for more efficiency and accuracy. Framing hammers have straight claws for prying boards.

A hammer is not a one-size-fits-all tool. For most homeowners, a finishing hammer with a claw will be the hammer most often used, but it's beneficial to have on hand a mallet, sledgehammer, and large framing hammer if you will be tackling large carpentry projects.

Skillbuilder

Buy a box of 2" common or box nails. Grab some scrap 2× lumber (construction sites have lots of these) and facenail the pieces together. Drive lots and lots of nails, from both sides. Drive the nails with the lumber on a solid surface (cement floor). Drive the nails with the lumber on a springy surface (upholstered furniture). Notice a difference? Use the nail-encrusted boards as a doorstop.

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#175 Dtp:225 Page:20

Use a sledgehammer to demolish wall framing and to drive spikes and stakes. Sledgehammers vary in weight from 2 to 20 lbs., and in length from 10 to 36".

A mallet with a rubber or plastic head drives woodworking chisels. A soft mallet will not damage fine woodworking tools.

The strongest wooden tool handles have wood grain that runs parallel to the tool head (left). Handles with the grain running perpendicular to the tool head (right) are more likely to break. Check the end grain before buying a new tool or tool handle. Tool handles that are cracked or loose should be replaced. Wood handles absorb more shock than fiberglass or metal.

A new hammer may have a very smooth face that tends to slip off the heads of nails. Rough up the face with sandpaper to increase friction between the hammer and the nail. You can also use fine sandpaper to remove wood resins and nail coatings that build up on the face of your hammers. For finish hammering, you may want to stick with a smooth-face hammer.

Pulling Nails with a Hammer

To pull nails with a claw hammer, place a block of wood under the hammer head for added leverage and to avoid damage to the workpiece. If you are pulling large nails or many nails, use a pry bar or cat's paw.

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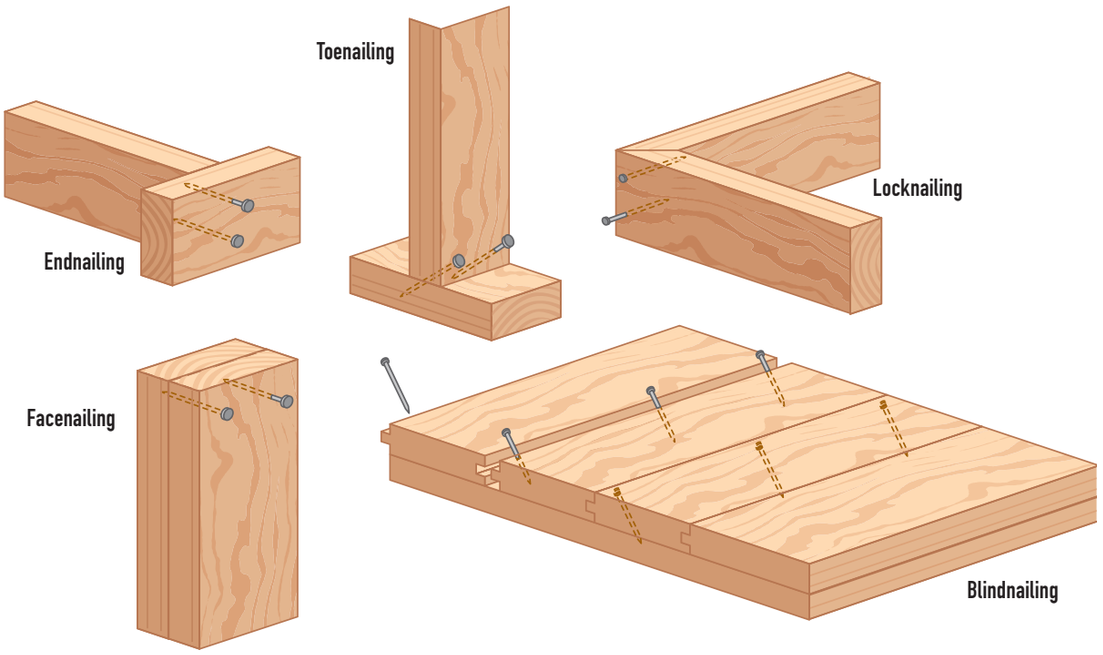
#175 Dtp:225 Page:21

DRIVING NAILS WITH A HAMMER

Hold the hammer with a relaxed grip: Take advantage of the hammer's momentum and weight by releasing your wrist at the bottom of the swing as if you were throwing the head of the hammer onto the nail. Hit the nail squarely on the head, repeating the motion until the nail head is flush with the work surface.

To set a finish nail below the surface, position the tip of a nail set on the nail head and strike the other end with a hammer.



Use the proper nailing technique for the task. Endnailing is used to attach perpendicular boards when moderate strength is required. Toenail at a 45° angle for extra strength when joining perpendicular framing members. Facenail to create strong headers for door and window openings. Blindnail tongue-and-groove boards to conceal nails, eliminating the need to set nails and cover them with putty before painting or staining. Locknail outside miter joints in both directions on trim projects to prevent gaps from developing as the trim pieces dry.

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#175 Dtp:225 Page:22

Use a screwdriver or screw bit that closely matches the screw head. A tip that's too big or too small will damage the screw and the driver, and it will make the screw hard to remove later. This screwdriver is too small for the screw—the blades should fit all the way into the screw head.

SCREWDRIVERS

Every carpenter should own several Phillips and slotted screwdrivers. Even though the drill-mounted screw bit has become the standard for large projects, screwdrivers are still essential for a variety of carpentry tasks. Look for quality screwdrivers with hardened-steel blades and handles that are easy to grip. Other features to look for include insulated handles to protect against electrical shock and oxide-coated tips for a strong hold on screw heads. For working in tight spots, a screwdriver with a magnetic head can also be helpful.

Cordless power screwdrivers save time and effort. For small projects, they are an inexpensive alternative to a cordless drill or screw gun. Most models include a removable battery pack and charger, so you can keep one battery in the charger at all times. Cordless power screwdrivers have a universal ¼" drive and come with a slotted bit and a #2 Phillips bit. Other bits, such as Torx and socket bits are also available.

Other driving options include square-drive and Torx-drive screws. Square-drive screwdrivers are gaining popularity because square-drive screws are difficult to strip. Torx-drivers are used on electronics, tools, and automotive applications.

Common screwdrivers include: slot screwdriver with insulated handle, Phillips screwdriver with insulated handle and oxide tip for better control, spiral ratchet driver with interchangeable bits, offset screwdriver for driving in tight places, and cordless power screwdriver with battery pack and pivoting shaft.

Skillbuilder

Using #8 by 1¼" Phillips head wood screws and a scrap of 2× lumber, drive a screw (by hand) without drilling a pilot hole. Then drill 1/16", 3/32", ⅛", 5/32", and 3/16" pilot holes. Drive a screw into each hole. Notice that it is difficult to drive the screw so that it is flush with the wood surface. That's because wood screws have a shank and a straight taper. Drill a 5/32" to a depth to match the screw shank. Then extend that hole with a 1/16" bit. This is called countersinking. Drive a screw into this hole and it is easier to make the head flush. Special countersink-pilot hole drill bits are available to repeat this process as one step. Bugle head screws countersink themselves, as they have no shank and a fluted head. See page 55 Common Drill Bits for more information on drilling.

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#175 Dtp:225 Page:23

CLAMPS & VISES

Vises and clamps are used to hold workpieces in place during cutting or other tasks and to hold pieces together while glue sets.

Your workbench should include a heavy-duty carpenter's vise. For specialty clamping jobs, a wide variety of clamps are available, including C-clamps, locking pliers, handscrews, web clamps, or ratchet-type clamps.

For clamping wide stock, use pipe clamps or bar clamps. The jaws of pipe clamps are connected by a steel pipe. The distance between the jaws is limited only by the length of the pipe.

Use handscrews to hold materials together at various angles while glue is drying. Handscrews are wooden clamps with two adjusting screws. The jaws won't damage wood surfaces.

Use C-clamps for clamping jobs from 1 to 6". To protect workpieces, place scrap wood blocks between the jaws of the clamp and the workpiece surface.

Use ratchet-type clamps to clamp a workpiece quickly and easily. Large ratchet-type clamps can span up to 4 ft. and can be tightened with one hand while supporting the workpiece with the other hand.

Hold large workpieces with pipe clamps or bar clamps. Bar clamps are sold with the bars. Pipe clamp jaws are available to fit ½" or ¾" diameter pipe of any length.

Mount a sturdy bench vise on the end of your workbench to hold workpieces securely. Select a vise that adjusts easily and has a minimum jaw opening of about 4".

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CHISELS

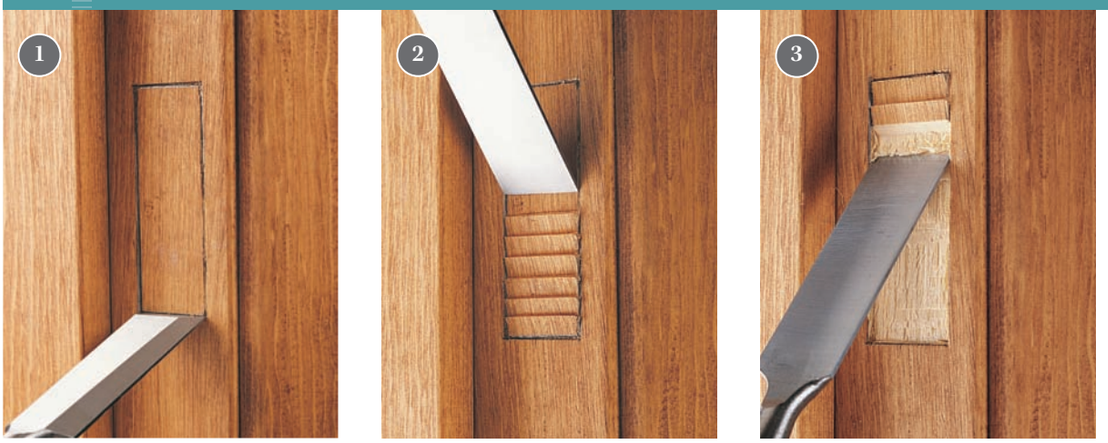
A wood chisel consists of a sharp steel blade beveled on one face and set in a wood or plastic handle. It cuts with light hand pressure or when the end of the handle is tapped with a mallet. A wood chisel is often used to cut hinge and lock mortises.

When creating deep cuts, make several shallow cuts instead of one deep cut. Forcing a chisel to make deep cuts only dulls the tool and can damage the workpiece.

Sharpen the blades of your chisels often (see following pages). Chisels are easier and safer to use and produce better results when they are sharp.

Types of chisels include (from left to right): a framing chisel, used for rough trimming of lumber; a mortise chisel, for framing hinge and lock mortises; a small wood chisel, for light-duty wood carving; cold chisel that is made of solid steel and is used for cutting through metal; and a mason's chisel, for cutting stone and masonry.

CHISELING A MORTISE



1 Cut the outline of the mortise. Hold the chisel bevel-side-in and tap the butt end lightly with a mallet until the cut has reached the proper depth.

2 Make a series of parallel depth cuts ¼" apart across the mortise, with the chisel held at a 45° angle. Drive the chisel with light mallet blows to the handle.

3 Pry out waste chips by holding the chisel at a low angle with the beveled side toward the work surface. Drive the chisel using light hand pressure.

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SHARPENING CHISELS & PLANE BLADES

It is a good idea to sharpen chisels and plane blades before each use, even if the tools are brand new. The factory edges on new blades are sharpened by machine and are not as sharp as hand-sharpened blades.

Sharpening a tool blade is a two-step process. First, the tool is rough-ground on an electric bench grinder, then it is finish-honed on a fine-grit sharpening stone. If you do not have a bench grinder, you can use a coarse-grit sharpening stone to rough-grind the blade.

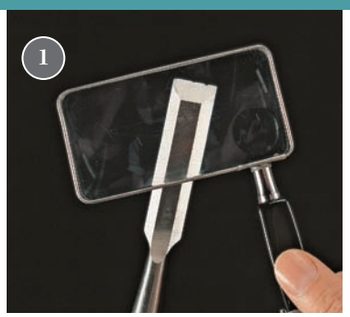
Tools & Materials

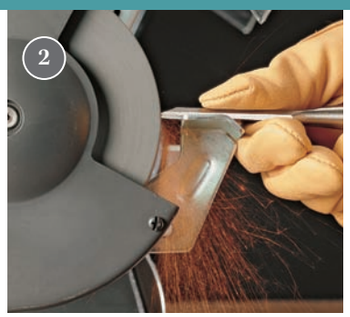
- Bench grinder or coarse-grit sharpening stone
- Work gloves
- Fine-grit sharpening stone
- Cup of water
- Light machine oil

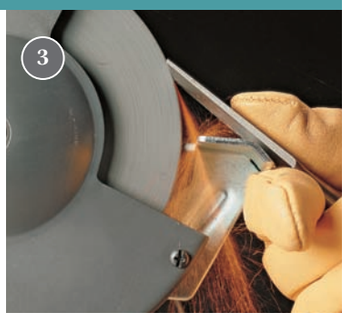
Tip: Sponge Bath

One way to keep the blade cool when grinding is to hot-glue a piece of sponge to the back of the blade near the cutting edge. Dip the blade in water. The sponge holds water against the back of the blade to draw off heat. When the sponge gets warm, wet it again.

SHARPENING CHISELS & PLANE BLADES ON A GRINDER







1 Inspect the cutting edge for nicks. Before the blade can be honed on a sharpening stone, any nicks in the steel must be completely removed by grinding.

2 Grind off nicks, using a bench grinder with a medium-grit wheel. Hold the tool on the flat portion of the tool rest, with the beveled side facing up. Hold the tip against the wheel and move it from side to side. Make sure the cutting edge remains square, and cool the blade frequently in water.

3 Rough-grind the cutting edge by turning the blade so that the beveled side is down. Rest the blade on the angled portion of the tool rest. Move the blade from side to side against the wheel to grind the tip to a 20° bevel, checking often with an angle gauge. Cool the metal frequently in water while grinding.

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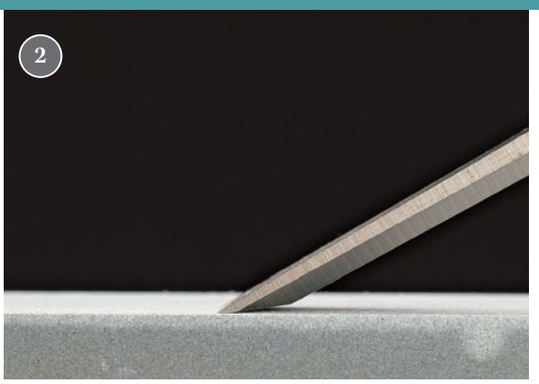
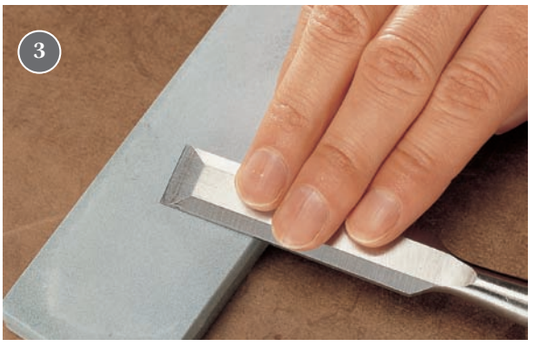
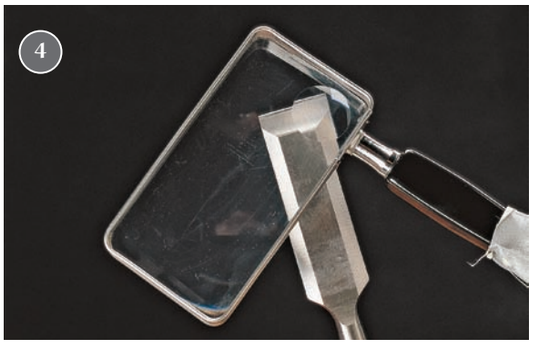
SHARPENING A BLADE BY HAND







1 Finish-hone the cutting edge on a fine-grit sharpening stone. Place a few drops of light machine oil on the stone to lubricate the steel and to float away grit and filings. Hold the blade at a 25° angle so the bevel is flat against the stone. Draw it several times across the stone, lifting it away after each pass. Wipe the stone often with a clean rag, and apply oil after each wiping.

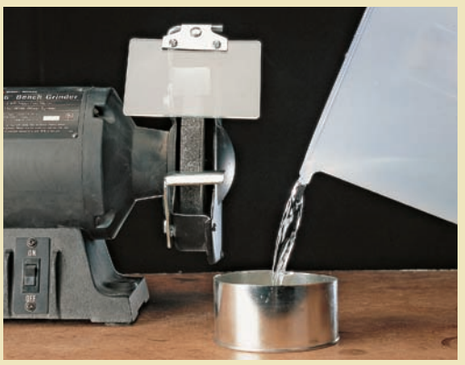
2 Put a "micro-bevel" on the blade by lifting it slightly so only the tip touches the stone. Draw the blade two or three times across the stone, until a slight burr can be felt along the back of the blade.

3 Turn the blade over. Holding the blade flat, draw it across the stone one or two times to remove the burr.

4 Examine the cutting edge of the blade. The fine micro-bevel should be about 1/16" wide. The micro-bevel gives the chisel its razor-sharp edge.

Tip: Keep Your Temper

Keep a container of cool water close by when grinding a tool blade. Dip the blade in water frequently to prevent heat from ruining the temper of the steel. When the beads of water on the blade evaporate, it should be dipped again.



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PLANES & SURFACE-FORMING RASPS

Common carpentry planes include: a jack plane, for trimming framing lumber, doors, and other large workpieces; a power planer, for removing lots of material quickly; a block plane, for shaving material from trim and other narrow workpieces; and surface-forming rasps, for trimming flat or curved surfaces.

Planes are designed for removing shavings of material from lumber when a saw would cut off too much material and sanding would remove too little. A hand plane consists of a razor-sharp cutting blade, or iron, set in a steel or wood base. Adjusting the blade requires some trial and error. After making an adjustment, test the plane on a scrap piece before using it on your workpiece. Usually, the shallower the blade is set, the better the plane cuts.

The blade on a surface-forming rasp can't be adjusted, but interchangeable blades are available for fine and rough work. Surface-forming rasp blades have a series of holes stamped in the metal, so shavings seldom become clogged in the tool's blade.

If you plan on planing many large workpieces, consider purchasing a power planer. A power planer does the job more quickly than a hand plane and with equally fine results.

Use a block plane for common jobs, like trimming end grain, planing the edges of particleboard and plywood, and trimming laminates.

Skillbuilder

Buy a short 1 × 4 pine board, poplar board, and maple or oak board. (Yes, expensive!). Clamp the pine into a vise. Operate the plane so the wood grain runs "uphill" ahead of the plane. Grip the toe knob and handle firmly, and plane with long, smooth strokes. To prevent overplaning at the beginning and end of the board, called dipping, press down on the toe knob at the beginning of the stroke and bear down on the heel at the end of the stroke. Try planing the other direction. Repeat with the other two boards. Try planing on the face of the board—you will need to secure it below the surface of the wood so it doesn't move and the plane can move freely.

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To change power planer blades, remove the screws and gib bars that hold the blades in place and carefully remove the dull blade. Wear gloves to protect your hands. For double-edged blades, flip the blade to the fresh edge and reinstall. Tighten the gib screws securely.

Turn the planer's cutting depth dial to set the amount of material you'll remove with each pass. Limit cutting depth to ⅛" or less to prevent overloading the motor and to ensure a smooth cut.

Draw layout lines on your workpiece to mark the amount of material you need to plane away. Make repeated passes with the planer until it reaches the layout lines. Keep an eye on your layout lines as you work to make sure the planer removes material evenly.

Power Planer Overview

Traditional hand planes are still used by both carpenters and woodworkers, but it takes practice to sharpen, adjust, and use them properly. If you're not experienced with hand planes, a power planer may be a better choice for your carpentry projects. It's much easier to set up and operate, and it will generally plane away material more quickly than a hand plane.

Typical power planers have two narrow blades mounted in a cylindrical-shaped cutterhead. The cutterhead spins at high speeds to provide the planing action. Power planer blades are made of carbide, which stays sharp much longer than a conventional steel plane blade. When the blades dull, they do not need to be resharpened. Instead, you simply remove them from the cutterhead and replace. Most power planers have double-edged blades, so you have a second sharp edge to use before it's necessary to buy new blades.

To use a power planer, set the depth of cut by turning a dial on the front of the tool. This raises the front portion of the planer's sole to expose the cutters. Limit your cutting depth to not more than ⅛" on softwood and 1⁄16" on hardwoods like oak or maple. If possible, connect the planer to a dust bag or shop vacuum to collect the planer shavings; these tools make considerable debris quickly. Start the planer and slide it slowly along the wood to make the cut, keeping the sole of the tool pressed firmly against the workpiece. Push down on the front of the planer as you begin the cut, then transfer pressure to the rear of the planer as you reach the end of the cut. If you are planing both across the grain and along it, make the cross-grain passes first, then finish up with long-grain passes. This will allow you to plane away any tearout or chipping that occurs on the cross-grain passes.

As you make each pass, apply more hand pressure on the front of the tool to begin, then transfer pressure to the rear as you end the cut. Slide the tool smoothly and slowly so the motor doesn't labor in the cut.

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JIGSAWS

The jigsaw is a very good portable power tool for cutting curves and internal cutouts. The cutting capacity of a jigsaw depends on its power and the length of its blade stroke. Choose a saw rated to cut 2-inch-thick softwood and ¾-inch-thick hardwood stock. Many jigsaws have a pivoting baseplate that can be locked so you can make bevel cuts as well.

A variable-speed jigsaw is the best choice, because different blade styles require different cutting speeds for best results. In general, faster blade speeds are used for cutting with coarse-tooth blades and slower speeds with fine-tooth blades.

Jigsaws vibrate more than other power saws because of the up-and-down blade action. However, top-quality jigsaws have a heavy-gauge steel baseplate that reduces vibration to help you hold the saw tightly against the workpiece for better control.

Because jigsaw blades cut on the upward stroke, the top side of the workpiece may splinter. If the wood has a good side to protect, cut with this surface facing downward.

Jigsaw blades come in an array of designs for cutting different materials. Choose the right blade for the job. With fine-tooth blades that have 14 or more teeth per inch, set the saw at a low speed. Coarse blades require faster blade speeds.

Do not force blades. Jigsaw blades are flexible and may bend or break if forced. Move the saw slowly when cutting bevels or tough material like knots in wood.

Skillbuilder

Buy a 2 × 4 ft. ½" piece of plywood. Use a compass or various round shapes to trace circles on the board ranging from 2" to 10". Drill a ¼" hole along the inside edge of the line, but not crossing to the outside. Insert the jigsaw into the hole and cut out the circle. Cut out a circle with the workpiece clamped to a solid surface. Cut out another circle without clamping. When you have cut out all the holes, add legs to your holey board and use it as a bean bag toss game!

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Make plunge cuts by tipping the saw so the front edge of the baseplate is held firmly against the workpiece. Start the saw, and slowly lower it to a horizontal position, letting the blade gradually cut through the workpiece.

Cut metals with a fine-tooth metal-cutting blade and select a slow blade speed. Support sheet metals with thin plywood to eliminate vibration. Use emery paper or a file to smooth burred edges left by the blade.

The jigsaw is designed to cut curves, but tight curves can cause the blade to bind. An easy way to avoid this problem is to make a series of relief cuts through the surrounding waste material and up to the curved cutting line. This way you can break up a tight curve into smaller sections rather than one long cut.

Tip

To get the best possible cut with a jigsaw, clamp your workpiece securely to a solid work station. Even though the saw is meant to be held with one hand, it usually works better to use both hands for guidance. And remember, don't force it!

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CIRCULAR SAWS

A portable circular saw has become the most frequently used cutting tool for do-it-yourselfers. With the right set of blades, you can use a circular saw to cut wood, metal, plaster, concrete, or other masonry materials. An adjustable baseplate lets you set the blade depth for your workpiece, and it also pivots from side to side for bevel cuts.

Most professional carpenters use a 7¼-inch-blade circular saw. For home carpentry, 7¼-inch-blade and 6½-inch-blade models are the most popular. A smaller blade means a smaller, lighter saw body, but bear in mind that a smaller saw is usually less powerful and is limited when cutting bevel cuts or material that is thicker than 2× stock.

Cordless circular saws have 5⅜-inch-wide blades—wide enough to cut through sheet goods or to make square cuts on 2× lumber. Cordless models are useful in situations where a power cord gets in the way. However, most cordless circular saws aren't powerful enough to be the primary cutting tool for big projects.

Because circular saw blades cut in an upward direction, the top face of the workpiece may splinter. To protect the finished side of the workpiece, mark measurements on the back side and place the good side down for cutting.

Get the most out of your saw by inspecting your blade regularly and changing it as needed (page 34). You can also improve your results with a straightedge guide (page 38), which makes it easier to cut long stock precisely.

Common types of circular saws include: (A) 7¼"-blade, standard-drive saw. Standard-drive circular saws are the most popular choice among do-it-yourselfers and are widely used by professional carpenters. This model has a sawdust-release pipe that connects to a collection bag. (B) 7¼"-blade, worm-drive saw. Some carpenters prefer the worm-drive saw for heavy-duty cutting. Worm-drive saws offer more torque at any given speed. As a result, they are less likely to slow, bind, or kick back when subjected to a heavy load. (C) 6½"-blade, standard-drive saw. Do-it-yourselfers looking for a lightweight saw may want to consider a standard-drive saw with a 6½" blade. This model has a convenient window for an easy view of the line while cutting. (D) 5⅜"-blade, cordless trim saw. Cordless trim saws are convenient for cutting trim and other thin stock, especially when the work site is outdoors or away from an electrical receptacle.

Tip

Using your circular saw to cut masonry is possible, but probably not the best idea. If you need to cut masonry (pavers, concrete, stone) rent a dedicated masonry wet saw. A wet saw uses a small stream of water to make the cutting easier and keep down the dust. A masonry saw has the power to handle this tough material.

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Circular Saw Blade Options

To get full use from your circular saw, you'll need an assortment of blades designed for specific cutting tasks. Your collection should include at least one general-purpose combination blade with carbide teeth. In addition to cutting wood and sheet material, you can also use a circular saw to cut masonry and thin metal with the appropriate abrasive blade. Here are the main types of circular saw blades:

- Remodeling blade: Designed to make both ripcuts and crosscuts in construction lumber that may also be embedded with nails or screws. It will have a low tooth count and tall shoulders behind the teeth to prevent them from cutting too aggressively or breaking on metal. It's a good choice for opening wall cavities or removing exterior or floor sheathing.
- Ripping/general framing blade: Higher tooth counts than a remodeling blade, usually ranging from 16 to 24 teeth. A suitable blade for fast rip cuts in construction plywood and general crosscuts in framing lumber. Fewer teeth will produce more splintering, so this is not a blade for finish cutting.
- General-purpose blade: The workhorse blade of most circular saws, these blades will have 30 to 40 teeth and are good choices for fast, semi-smooth wood cutting in any direction.
- Fine crosscutting blade: A 40- to 60-tooth blade designed to make smooth crosscuts in veneered plywood with minimal splintering.
- Masonry or metal-cutting blade: A toothless blade made of special abrasives for cutting cinder block, concrete, and both ferrous and non-ferrous metal. Be sure to wear a dust mask when using these blades; abrasive particles and masonry dust are hazardous to breathe.

Tip

You can keep a blade in good condition and prolong its life by using it only for the material it's designed to cut and cleaning it when the teeth become dirty. Wipe the blade with kerosene or blade cleaner and steel wool, then dry the blade and coat it with silicone spray or machine oil to prevent rust. Replace blades that are dull or have cracked or missing teeth.

Skillbuilder

Use a combination or rafter square to mark 45° miters across the faces of four 2 × 4 or 2 × 6 pieces of lumber to make four equal-length pieces. The miters need to be opposing, not parallel. Make the miter cuts. Glue, clamp, and locknail or screw the pieces together to make a square. You've made a heavy duty picture frame! Repeat the process, except this time set the saw blade at 45° and bevel across the ends of the boards. Assemble these pieces into a square. If your measuring and cutting were accurate, your squares should actually be square. For future reference, miter usually means cutting an angle across the face (broad side) of a piece, and bevel means shaving or cutting along an edge or end of a board.

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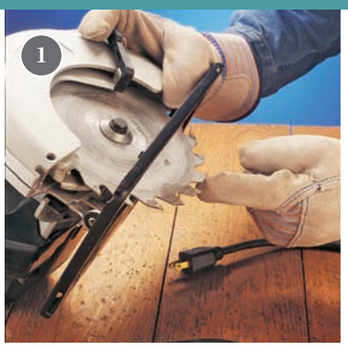
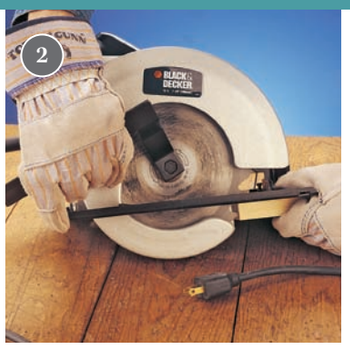
SETTING THE BLADE DEPTH

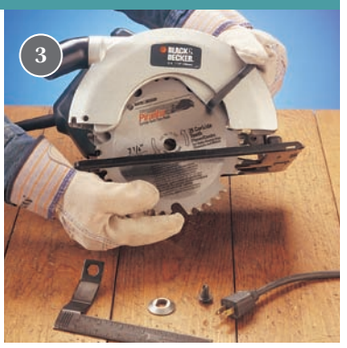
1 The blade on a circular saw does not move when you set the blade depth. Instead, on most circular saws, the saw baseplate pivots up and down, changing the amount of blade that is exposed. Unplug the saw, then pull out the depth adjustment lever and slide it up or down to adjust the blade depth.

2 Pull up on the blade guard lever to expose the blade, then position the blade flush with the edge of the workpiece to check the setting. The blade should extend beyond the bottom of the workpiece by no more than the depth of a saw tooth. Release the knob to lock the blade. Note: Some saws have a baseplate that drops rather than pivots. When the knob is pulled out, the entire baseplate can be moved up or down.

CHANGING A CIRCULAR SAW BLADE







1 Unplug the saw and inspect the blade, wearing gloves to protect your hands. Replace the blade if you find worn, cracked, or chipped teeth. Remove the blade for cleaning if sticky resin or pitch has accumulated.

2 To loosen the blade, first depress the arbor lock button or lever to lock the blade in position, then loosen the bolt with a wrench and slide the bolt and washer out of the assembly. On older models with no arbor lock, insert a wood block between the blade and baseplate to keep the blade from turning as you loosen the bolt.

3 Install a new blade. Or, if the old blade is soiled but in otherwise good condition, clean and reinstall it. Use the directional markings on the side of the blade as a guide when attaching a blade. Insert the bolt and washer, then tighten the bolt with a wrench until the bolt is snug. Do not overtighten.

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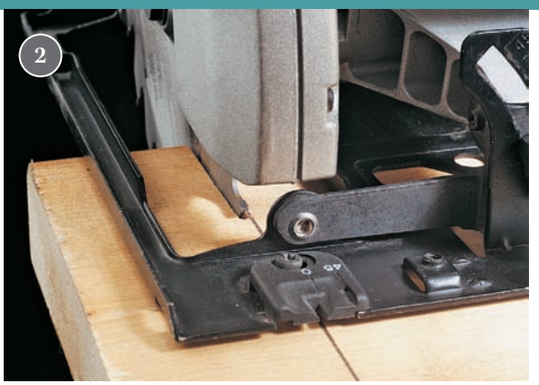
MAKING CROSSCUTS



1 Secure the workpiece with clamps and position the baseplate with the blade approximately 1" from the edge. Align the guide mark with the cutting line. The saw will remove a small amount of material on each side of the blade. If your project requires exact cuts, make your first cut in the waste area. You can make a second pass with the saw, as necessary, to remove more material.

2 While holding the saw with two hands, squeeze the trigger and guide the blade into the workpiece, following the cutting line with the guide mark and applying steady pressure as you push the saw forward. The guide mark on every saw is different. If you will be cutting material with someone else's saw, make a few practice cuts to familiarize yourself with the new saw.

MAKING PLUNGE CUTS

1 Support the workpiece by clamping it down on sawhorses. Clamp a 2 × 4 on the edge as a guide. Retract the blade guard and position the saw so the front edge of the foot, not the blade, is against the workpiece.

2 Hold the saw with two hands as you make the cut. Start the saw, and slowly lower the blade into the workpiece, keeping the baseplate against the 2 × 4.

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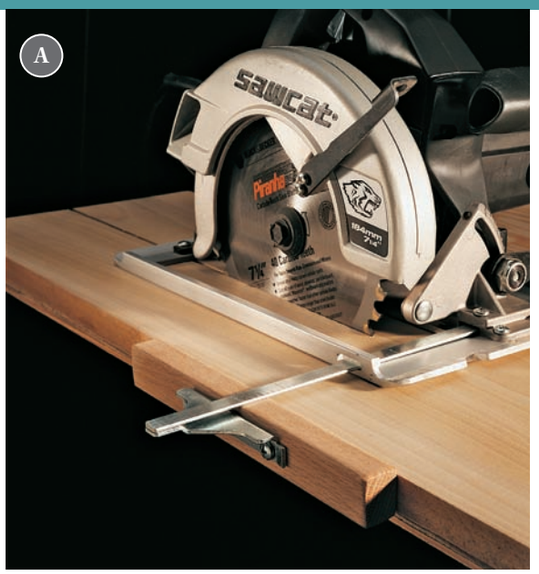
MAKING RIP CUTS



A Attach a commercial straightedge guide to the baseplate of your circular saw. Generally, straight-cutting guides that mount to the saw are accurate enough but they are not precise. For maximum precision, try clamping cutting guides to your work surface.

B It's much safer to cut up full-sized, heavy sheets of plywood with a circular saw than a table saw. Lay the sheet over several pieces of framing lumber to provide room for the blade underneath. Set the blade depth so the teeth protrude about ¼" below the plywood. Once the sheets are cut into manageable sizes, you can make finish cuts on the table saw. Clamp a straightedge guide to the workpiece.

Tips for Circular Saw Success

Circular saws are powerful, heavy, and potentially dangerous. To get the best possible results, take the time to use the saw correctly. Use a stable base to saw on, and clamp the workpiece down so it does not move. Do not hold a piece of wood against your thigh and saw off the end! Not only are you endangering your limbs, you will not get a quality cut.

Maintaining a steady travel speed is important. When making long rip cuts, make sure both sides of the material are supported so the blade does not get pinched. Make sure you have the room to maneuver during the cut, and that the cord is long enough to make the cut.

Finally, circular saws are noisy dust makers--protect your eyes, nose, and ears.

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MAKING BEVEL CUTS

Tip

Copy existing angles with a T-bevel. Transpose the cutting line to your workpiece and adjust the angle of your circular saw to cut on the line.

1 Loosen the bevel adjustment knob and slide the knob to the required setting. Some models have a setscrew for common angles such as 90° (no bevel) and 45°. Tighten the knob.

2 Position the baseplate of your saw on the workpiece. As you cut, sight down the blade to ensure it remains aligned with the cutting line on the waste side of the workpiece.

CUTTING DADOES

1 To cut dadoes with a circular saw, set the blade depth to ⅓ the desired depth of the dado, and mark the outside edges where you want the dado. Secure the workpiece with a clamp and cut the outside lines using a straightedge. Make several parallel passes between the outside cuts, every ¼".

2 Clean out the material between the kerfs with a wood chisel. To avoid gouging the workpiece, apply hand pressure or tap the chisel with the bevel side up using a mallet. For more information on chisels, see page 25.

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STRAIGHTEDGE GUIDES

Making straight and accurate rip cuts or cutting long sheets of plywood or paneling is a challenge. Even the best carpenter can't always keep the blade on the cutline, especially over a longer span. A straightedge guide or jig solves the problem. As long as you keep the saw's baseplate pressed against the cleat as you make the cut, you're assured of a straight cut on your workpiece.

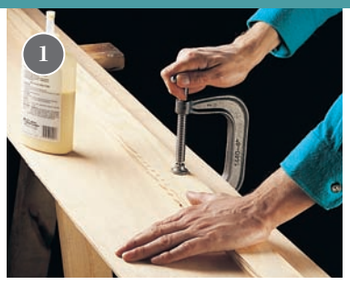
For accurate cutting, the cleat must have a perfectly straight edge. Ask at the lumber yard if they will cut the cleat using their panel saw.

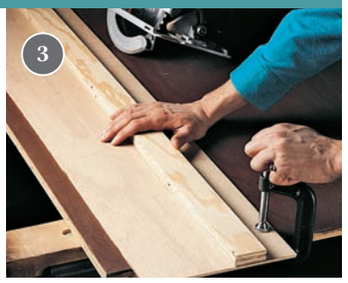
Tools & Materials

- C-clamps
- Pencil
- Circular saw
- ¼" finish plywood base (12 × 96")
- ¾" plywood cleat (2 × 96")
- Carpenter's glue

A straightedge guide overcomes the difficulty of making square rip cuts and other square cuts on long workpieces. The guide's flat edge ensures that any cuts made with it will be flat as well.

BUILDING A STRAIGHTEDGE GUIDE





1 Apply carpenter's glue to the bottom of the ¾" plywood cleat, then position the cleat on the ¼" plywood base, 3" from one edge. Clamp the pieces together until the glue dries.

2 Position the circular saw with its wide foot tight against the ¾" plywood cleat on the wide side of the plywood. Cut away the excess portion of the plywood base with a single pass of the saw to create a square, flat edge. Repeat on the other side with the narrow foot.

3 To use the guide, position it on top of the workpiece, so the guide's flat edge is flush with the cutting line on the workpiece. Clamp the guide in place with C-clamps. Typically you will only use the wide side, but at times you may need to use the narrow side.

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POWER MITER SAWS

Power miter saws are versatile, portable tools that are used to cut angles in trim, framing lumber, and other narrow stock.

The blade assembly of a power miter saw swivels up to 45° in either direction, allowing it to make straight, mitered, and beveled cuts. However, when the assembly is turned to a 45° angle, the cutting depth is considerably shortened.

If you are considering buying or renting a power miter saw for a specific project, such as building a deck, don't assume that every saw will have the capacity to cut wider boards at a 45° angle. Ask the salesperson about the maximum cutting capacity for each saw at a 45° angle, and make sure the saw you choose can make clean cuts through the stock you use most frequently.

A compound miter saw (opposite page, top) has a second pivot point on the blade assembly that makes it possible to cut a bevel and miter angle at the same time. This option is useful when cutting cove moldings. See page 46, for more information about compound miter cuts.

The biggest limitation of a power miter saw is cutting extra-wide stock. A sliding compound miter saw (opposite page, bottom) eliminates this limitation. The entire blade assembly is mounted on a sliding carriage, giving the saw a much greater cutting capacity than a standard or compound miter saw. For tips on cutting extra-wide boards without a sliding compound miter saw, see page 44.

The power miter saw has evolved from a new and relatively rare tool just a generation ago into the workhorse tool found in most home workshops today. It combines speed, accuracy, and fast set-up time, and as it's become more popular, it's become quite affordable.

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A compound miter saw cuts bevels and miters at the same time. The miter and bevel scales make it easy to set the saw quickly for precise angles. Before cutting, make sure the material is flush with the guide fence. Otherwise, the angle you cut will be incorrect. Extension arms provide a safe way to hold longer materials in place. Some models also offer stock clamps that secure workpieces to the saw table. Always remove debris or small wood scraps that may be blocking the kerf board before beginning any cut, and remember to empty the dust collection bag regularly.

A sliding compound miter saw has all the components of a regular compound miter saw, with the addition of a sliding blade assembly that makes it possible to cut much wider stock.

Skillbuilder

Repeat the Skillbuilder exercise from the circular saw section (page 33) using the miter saw instead.

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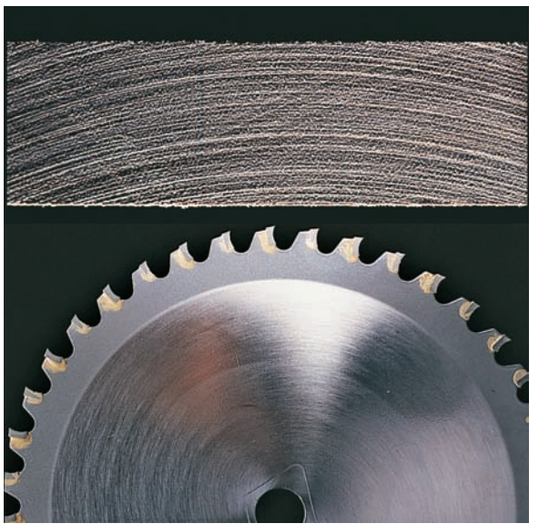
Power Miter Saw Blades & Their Applications

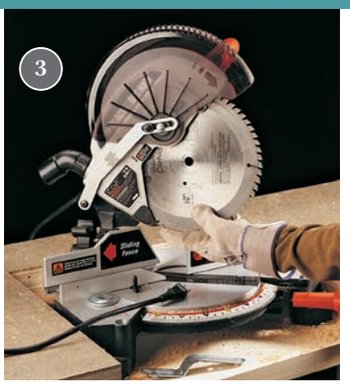
The quality of the cut produced by a power miter saw depends on the blade you use and the speed at which the blade is forced through the workpiece. Let the motor reach full speed before cutting, then lower the blade assembly slowly for the best results.

A 16-tooth carbide-tipped blade cuts quickly and is good for rough-cutting framing lumber.



A 60-tooth carbide-tipped blade makes smooth cuts in both softwoods and hardwoods. It is a good all-purpose blade for general carpentry work.

CHANGING THE BLADE ON A POWER MITER SAW



1 Unplug the saw and inspect the blade; check for dull or damaged teeth.

2 If the blade is dull or is the wrong type for the material you want to cut, depress the arbor lock button and turn the arbor nut on the blade clockwise to remove it.

3 When the nut is free, carefully remove the blade and slide the new blade into position. Tighten the arbor nut until snug. Do not overtighten the nut.

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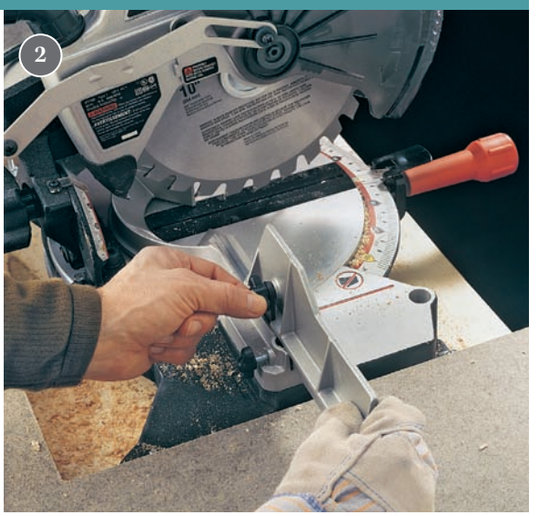
SETTING UP A POWER MITER SAW



1 Anchor the saw to a stationary workbench, using C-clamps. To support long moldings or other stock, build a pair of blocks the height of the saw table, using 1× lumber. Align the blocks with the saw fence and clamp them to the workbench.

2 Position the adjustable fence to support the workpiece, then tighten the fence clamp.

Option: Consider building a cutting table with a recessed area the same depth as the saw bed. The table will support longer stock, eliminating the need for support arms.

Option: Rent or buy a portable power miter saw table for extensive cutting of long stock. Or, use a portable workbench and a roller-type support stand to support your saw and workpieces.

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#175 Dtp:225 Page:42

CUTTING WITH A POWER MITER SAW

A It's easy to make precise crosscuts on a miter saw with this simple procedure. First, lower the blade so the edges of the teeth meet your cutting line. Make sure the blade will cut on the waste side of the line.

B Hold the workpiece securely against the saw table and fence, and raise the motor arm to its highest position. Start the saw and pivot the blade slowly into the wood to make the cut.

C To cut multiple pieces of stock to the same length, clamp a stop block to your support table at the desired distance from the blade. After cutting the first piece, position each additional length against the stop block and the fence to cut pieces of equal length.

D Lock the saw assembly in the down position when storing or moving it or when you won't be using it for a long period of time.

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#175 Dtp:225 Page:43

CUTTING EXTRA-WIDE BOARDS

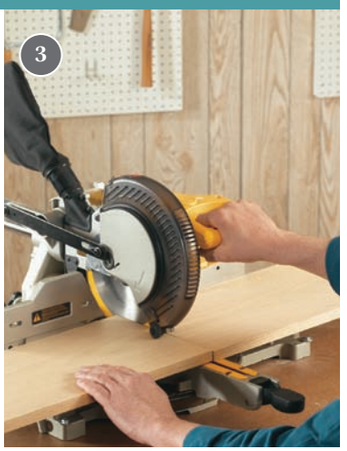
Blade guard removed for clarity

Blade guard removed for clarity

1 Make a full downward cut. Release the trigger and let the blade come to a full stop, then raise the saw arm.

2 Turn the workpiece over and carefully align the first cut with the saw blade. Make a second downward cut to finish the job.

USING A SLIDING MITER SAW



1 Sliding miter saws will cut with a plunge stroke, like a conventional miter saw. For wide workpieces, however, the saw's sliding arm allows it to also cut on a push stroke. First pull the saw toward yourself and align the blade with the cutting line. Start the saw to begin the cut, pivoting the blade down into the workpiece.

2 Push the blade carriage forward slowly until the workpiece has been cut through. Do not force the cut or the saw may kick back.

3 Once the piece is cut in two, stop the saw and wait until the blade stops before lifting it out of the workpiece.

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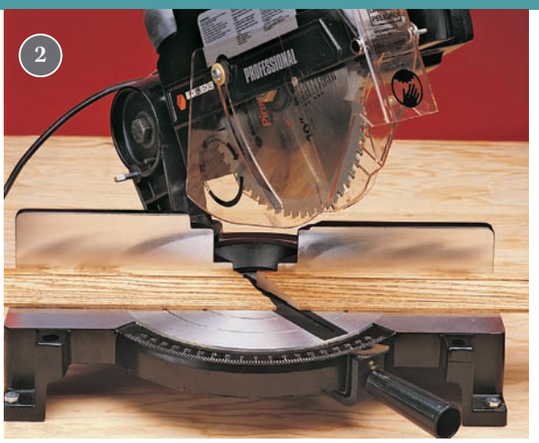
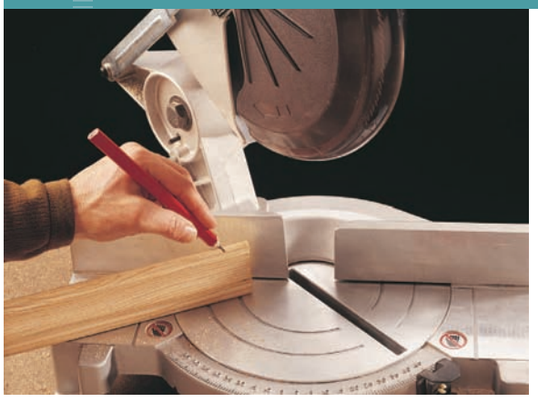
MITER-CUTTING CASE MOLDINGS



1 Mark cutting lines on each piece of molding or other material you plan to cut. On window and door casings, mark a line across the front face of the piece as a reference for the cutting direction. Remember: Only the beginning of the cutting line should actually be used to line up the saw blade. The freehand line across the face of the molding is a directional reference only.

2 Lay door and window casing stock flat on the saw bed and set the blade to match the cutting line. If you have a compound saw, set the bevel adjustment to 0°. Hold the casing with your hand at a safe distance from the blade, leaving the waste piece unsecured.

CUTTING BASEBOARDS



Mark a cutting line along the top edge of baseboards to indicate the starting point and direction for each cut. Baseboards and moldings that run the length of a wall are cut by standing the stock on-edge against the saw fence.

Join molding pieces for longer spans by mitering the ends at 45° angles. The mitered joint (scarf) cannot open up and show a crack if the wood shrinks.

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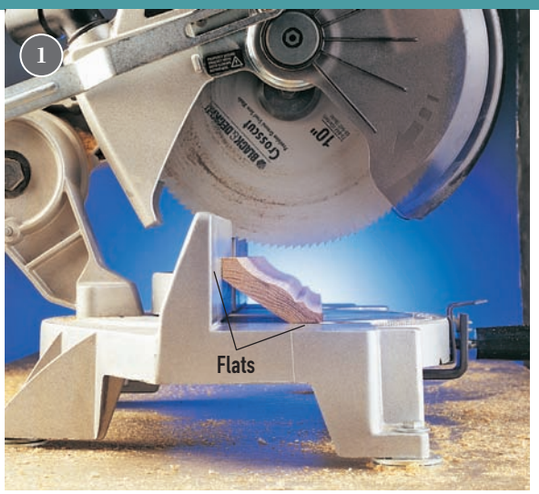
MAKING COMPOUND MITER CUTS



1 On a non-compound miter saw, cove moldings must be positioned at an angle for cutting. Position the molding upside-down so the flats on the back of the molding are flush with the saw bed and fence.

2 Set the blade at 45° and cut the molding. To cut the molding for an adjoining wall, swivel the miter saw to the opposite 45° setting, and make a cut on the second piece that will fit with the first piece to form a corner.

Option

To miter cove molding on a compound miter saw, lay the molding flat on the saw bed and set the miter and bevel angles. For cove moldings, the standard settings are 33° (miter) and 31.62° (bevel). On many saws, these settings are highlighted for easy identification. If the walls are not perpendicular, you will need to experiment to find the correct settings.

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#175 Dtp:225 Page:46

TABLE SAWS

For any serious do-it-yourself carpenter, a table saw is one of the most useful of all tools. Table saws make miter, rip, cross, and bevel cuts. They can also produce dadoes, dovetails, rabbets, and tenon joints for countless carpentry projects.

Several handmade accessories can improve your results and minimize the risk of injury when using a table saw. Pushsticks (page 49) make it easier to push stock through the blade's path while keeping your hands at a safe distance. Featherboards help keep your stock flat against the rip fence and table during cutting.

If you want to add a table saw to your workshop but don't have the money or enough space for a full-sized model, consider buying a portable table saw. Although they are smaller, these saws have most of the capabilities of a full-sized table saw.

For general carpentry work, use a combination blade. If you plan to do a lot of ripping or crosscutting and want the most accurate cuts possible, switch to a blade that's designed exclusively for that purpose.

The table saw is a versatile, highly accurate cutting tool. With virtually unlimited jigs and accessories available, such as this taper-cutting jig, there are very few cuts a table saw cannot make.

Safety Tip

Using a table saw requires extra caution because of the exposed position of the blade. Remember that your hands and fingers are vulnerable, even with a safety guard in place. Read the owner's manual for specific instructions on how to operate your saw. In the following photos, the blade guard and splitter have been removed for clarity.

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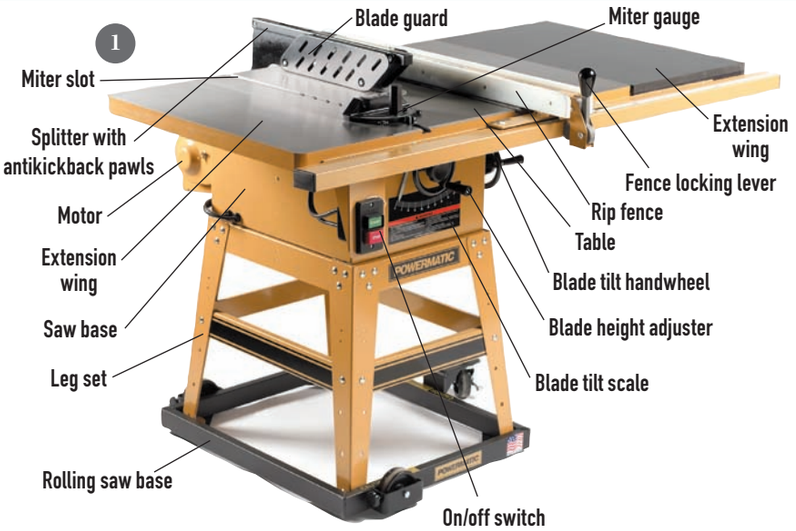
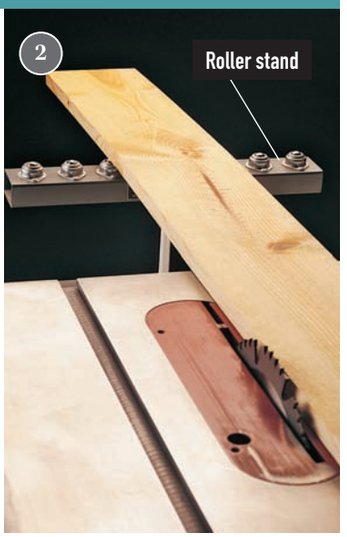
USING A TABLE SAW

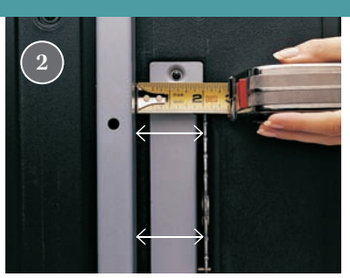


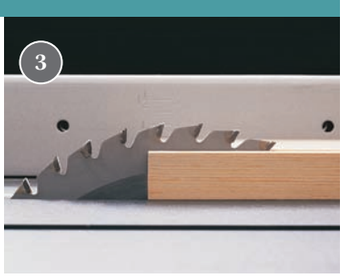


1 Learn what the parts and accessories of a table saw do before operating one. This contractor table saw includes: blade guard; rip fence, for aligning the cutting line on the workpiece with the blade; blade height adjuster and bevel angle scale; on/off switch; bevel tilt adjuster; and miter gauge, for setting miter angles.

2 Use a roller stand to hold long pieces of stock at the proper height when cutting them on a table saw. A roller stand allows you to slide the material across the table without letting the workpiece fall to the floor.

SETTING UP A TABLE SAW





1 Check the vertical alignment of a table saw blade by adjusting the bevel to 0° and holding a try square against it. The blade and square must be flush. If not, adjust the blade according to the instructions in the owner's manual.

2 Check the horizontal blade alignment by measuring the distance between the blade and the rip fence at both ends of the blade. If the blade is not parallel to the fence, it may cause binding or kickback. Adjust the saw according to the owner's manual.

3 Set the blade so it extends no more than ½" above the surface of the workpiece. This minimizes strain on the motor and produces better cutting results.

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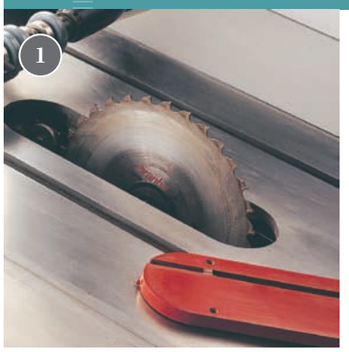
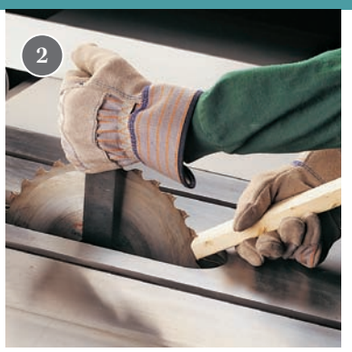
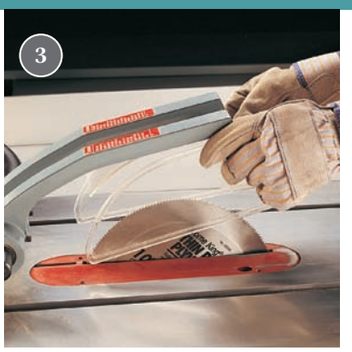
CHANGING A TABLE SAW BLADE





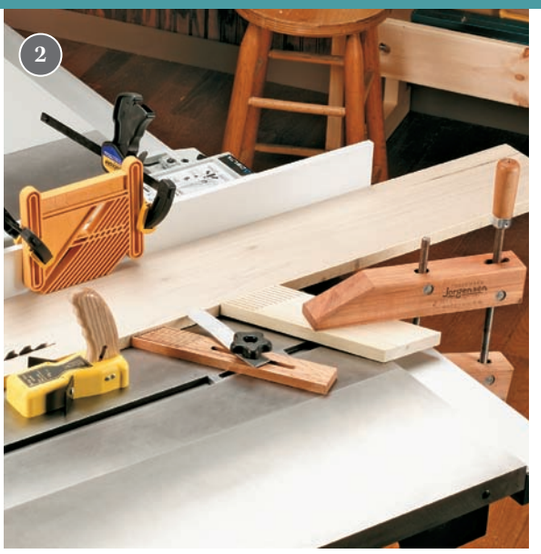


1 Unplug the table saw. Remove the blade guard and the table insert, then turn the blade height adjustment knob clockwise to raise the blade to its maximum height

2 Wearing gloves, hold the blade stationary with a piece of scrap wood. Loosen and remove the arbor nut. (An arbor wrench is supplied with most saws).

3 Carefully remove the old blade, and install the new blade so the teeth curve toward the front of the saw. Don't overtighten the arbor nut. Replace the table insert and the blade guard.

USING PUSHSTICKS & FEATHERBOARDS



1 Pushsticks are essential safety items during rip cuts. They keep your hands clear of the blade.

2 Featherboards in various styles hold workpieces against the saw table or rip fence. They're especially useful for ripping long stock, where control can be difficult. Never use them on the outfeed side of the blade.

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RIP-CUTTING WITH A TABLE SAW

1 Start a rip cut by standing to the left of the workpiece, placing your left leg against the corner of the saw with your hip touching the front fence rail.

2 Feed the workpiece into the blade with your right hand while pressing the board against the fence with your left hand.

3 As you near the end of the cut, use a pushstick to feed the board past the blade.

4 When the board is cut in two, a waste piece will be left next to the blade. Don't reach for it by hand. Turn the saw off.

5 With the workpiece clear of the blade, use the pushstick to slide the waste piece away from the blade.

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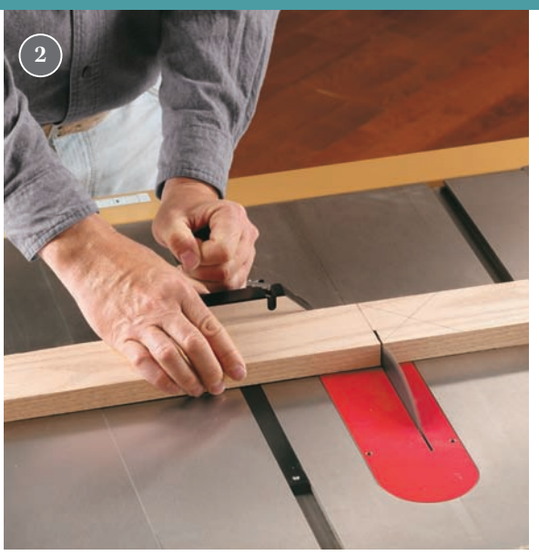
CROSSCUTTING WITH A TABLE SAW



1 Align the blade carefully with the layout line before starting the saw and making the cut.

2 With the workpiece held firmly against the miter gauge, slide both past the blade to make the cut. Stand behind the miter gauge so your body is clear of the waste piece.

3 Push the miter gauge past the blade until the workpiece is cut in two and the workpiece is clear.

4 Slide the waste piece away from the blade with a pushstick. If it is too small to reach easily, turn off the saw first. Do not remove short waste pieces by hand with the saw running.

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#175 Dtp:225 Page:51

Using a Table Saw to Rip Sheet Goods

A table saw is a good choice for making clean, accurate cuts in plywood. Generally, it will produce better results than a circular saw. However, full-sized sheets of plywood can be unwieldly to handle and hard to lift up onto the saw table. The safest approach for cutting up large sheets is to cut them into smaller pieces first with a circular saw. Smaller sections will be much easier and safer to maneuver over the saw. Use extreme caution if a table saw is your only option for cutting up a full-sized sheet. To set up the cut, position a sturdy roller stand or shop table behind the saw to catch the plywood as it exits the blade. Make sure the outfeed support is slightly shorter than the saw table height to keep it from catching on workpieces during cutting. Install a general-purpose or fine-cutting blade. Set the blade height about ¼" higher than the plywood's thickness, and lock down the rip fence clamp.

Start the saw and tip the sheet up onto the saw table, making sure a long edge is flush against the rip fence. Stand along the opposite edge of the sheet near the back corner and push it into the blade. When the cut is underway, walk the sheet slowly into the blade and move around behind it to support the rear edge. Keep your hands clear as you complete the cut, pushing the section against the rip fence all the way past and clear of the blade. Turn off the saw and wait for the blade to stop before removing the workpieces.

RIPPING SHEET GOODS ON A TABLE SAW

1 If a plywood panel is too large to handle easily, cut it into smaller pieces with a circular saw first. Cut just outside the final layout lines so you can make the finish cuts on the table saw.

2 Start the cut by standing behind the rear corner of the sheet and pushing with your right hand. Keep the material pressed firmly against the rip fence with your left hand. Slowly walk the sheet into the blade.

3 As the cut progresses, move your body behind the sheet to support the rear edge. Eventually, your right hand should push the material between the fence and blade all the way through the cut.

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#175 Dtp:225 Page:52

DRILLS & BITS

The power drill is one of the most popular and versatile power tools. Thanks to a host of improvements in its design, today's drills have many more functions than just drilling holes. Most have variable speed and reverse, making them convenient for driving and removing screws, nuts, and bolts, as well as for drilling, sanding, and stirring paint. A keyless chuck makes it easy to swap bits or quickly convert a drill into a grinder, sander, or paint mixer. Newer models allow you to adjust the drill's clutch for drilling or for driving into various materials, so the clutch will automatically disengage before screw heads strip or sink too far into the material.

Drills are commonly available in ¼-inch, ⅜-inch, and ½-inch sizes. The size refers to the maximum diameter of the bits and other accessories that the drill will accept. A ⅜-inch drill is standard for carpentry projects because it accepts a wide variety of bits and accessories and runs at a higher speed than ½-inch models.

Cordless technology has made drills more portable than ever. But it's important to understand the strengths of corded and cordless designs before deciding which one you should own. Most cordless drills operate at slower speeds and with less torque than corded models. Yet, cordless models are convenient because they allow up to several hours of operation between charges and eliminate the need for extension cords. Top-of-the-line cordless drills generate about 1,200 rpm. Corded drills weigh significantly less because they don't require battery packs, and some operate at more than 2,000 rpm. For most jobs, a cordless drill's slower speed is not a problem, but as the battery wears down, drilling becomes difficult and more of a strain on the motor. Spare battery packs can offset this problem. If you own both types of drills, keep your corded model on hand as a backup.

Shopping for Drills

When shopping for a drill, remember that the most powerful tool is not necessarily the best one for the job. This is especially true of cordless drills, because higher voltage ratings usually require heavier batteries. A more powerful cordless model is useful for heavy-duty drilling, when extra power will allow you to drill holes in thick timbers or masonry more quickly and easily. For driving screws and for light-duty drilling, a medium-voltage cordless model or a corded drill is a better choice. A drill in the 12- to 14.4-volt range is usually sufficient for most tasks. Try out several drills so you can compare the feel of the tools under load.

You'll also appreciate having two battery packs to minimize waiting for recharging. Most good-quality cordless drills come with one-hour chargers.

Drills include: (A) Clutch adjustment dial, (B) Variable speed switch, (C) Screw bit holder, (D) Keyless chuck, (E) Trigger lock and reversing switch, (F) Voltage rating, (G) Battery pack.

Skillbuilder

Using a cordless drill with an adjustable clutch, drive a series of drywall or deck screws fully into scrap lumber. Drive the first screw with the clutch set at the lowest setting. Increase the clutch setting with each screw until you reach the highest. Drive a screw with the clutch set on drill. If you have a corded variable speed drill, repeat the same exercise with the corded drill. Notice how the lack of a clutch leads to stripping out more screwheads.

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Corded drills are still widely available because they can generate lots of torque and operate at speeds of 2,000 rpm or more. If you want a fast, powerful, lightweight drill, a corded drill may be the right tool for you.

A hammer drill combines the rotary motion of a conventional drill with the impact action of a hammer. It can drill holes in masonry much faster than a regular drill. Hammer drills can also be set for rotary motion only, making them useful for general drilling applications.

Drill bits include: a magnetic drive guide, twist bit set, screwdriver and nut driver set, plug cutter, glass and tile bits, spade bit set, hole saw bits, and adjustable counterbore bit. These accessories are often sold with a drill or are available separately.

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#175 Dtp:225 Page:54

COMMON DRILLING TOOLS

A An auger bit is designed with a screw-like tip and deep threads. It bores raceway holes for wiring quickly and easily by self-feeding through the wood.

B Twist bits are used for general hole boring. In hardwood, drill a pilot hole first. The extra step will prevent binding and splintering as the larger bit cuts through the wood.

C Use an adjustable counterbore bit to drill pilot, countersink, and counterbore holes with one action. Loosen the setscrew to match the bit to the size and shape of the screw.

D Drill holes for door knobs and cylinders with a hole saw. To prevent the door from splintering, drill until the hole saw pilot (mandrel) just comes through the other side of the door. Complete the hole from the opposite side.

E A spade bit is used for larger diameter holes in wood. Use a backerboard when drilling holes in hardwood and finish plywood or any time you want to prevent blemishes. A backerboard placed on the bottom of the workpiece prevents splintering as the bit breaks through.

F Remove a broken screw by drilling a pilot hole in the top of the screw and removing it with a properly sized, reverse-thread extracting bit.

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#175 Dtp:225 Page:55

SANDERS

Power sanding tools shape and smooth wood and other building materials in preparation for painting and finishing. Carpenters also use them for removing small amounts of material. Finish sanders (opposite page, top) are best for light to medium sanding and for achieving very smooth surfaces. Belt sanders (opposite page, bottom left) are suitable for most work involving rough, fast removal of material. For very small, intricate, or contoured areas, sand by hand with folded sandpaper or a sanding block, or use drill-mounted sanding accessories (opposite page, bottom right).

When sanding a rough workpiece that requires a fine finish, begin sanding with a lower-grit sandpaper. Slowly move up to a higher grit to achieve the finish you want. Medium sanding jobs normally consist of three sanding steps: coarse, medium, and fine.

Sanding is painstaking work. Take your time and do it right the first time. If you attempt to cut corners when sanding a project, you will see it in the end result.

Tip

Sanders create airborne particles of material. Consider buying a sander that has a dust collection bag, and always wear a dust mask and eye protection.

Use a power sander to remove unwanted material and create a smooth finish. This random-orbit sander is used in general applications that require medium to heavy sanding. The orbital motion combines a circular pattern with side-to-side motion. Unlike disc sanders, random orbit sanders leave no circular markings, and there's no need to follow the grain of the wood. Sanding discs are available with hook-and-loop fasteners or pressure-sensitive adhesive. Sponge applicators and accessories are also available for buffing.

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Finish sanders are designed for jobs that require medium- to light-duty sanding to achieve a fine finish. Types of finish sanders include: (A) 3-in-1 sander for finish sanding, medium material removal, and detail work; (B) traditional finish sander for finishing larger areas; (C) palm sander for detail work; and (D) detail sander for smaller-scale finish work and easy corner access. The palm sander is also ideal for polishing and scrubbing jobs when fitted with the appropriate accessories.

Remove material from large areas quickly with a belt sander. Disposable belts are available ranging from 36 (extra-coarse) to 100 (fine) grit. Most belt sanding is done with the grain. However, sanding across the grain is an effective way to remove material from rough-hewn lumber.

Sanding accessories for power drills include (clockwise from top right): disc sander for fast sanding, sanding drums, and flap sanders to smooth contoured surfaces.

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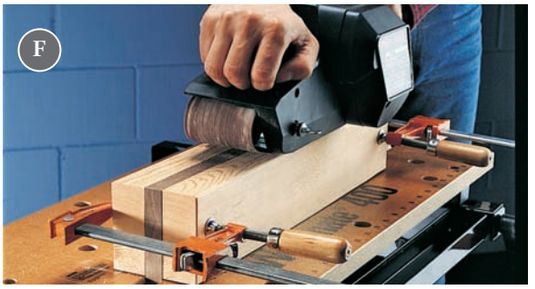
USING SANDERS



A Sanding station. A disk sander's flat table and miter gauge make it helpful for sanding edges flat and square. Tip the miter gauge to refine angled workpieces, such as mitered trim. For best accuracy, sand up to a marked layout line.

B Drum sander. It's possible to sand broad curves using a belt or random-orbital sander, but use a drum sander mounted in a drill press or power drill for sanding tight curves.

C Clean sandpaper with a stiff-bristle brush to remove sawdust and grit that can clog the sandpaper and reduce its effectiveness.

D It's often faster to start heavy stock removal with a coarse rasp, then switch to a sander when most of the stock is filed away. A rasp will not create airborne sawdust, so it is also a cleaner tool to use. Wear gloves if you need to hold the rasp by the blade. Notice that a rasp cuts on the push stroke only.

E A sanding block is helpful for smoothing flat surfaces. For curved areas, wrap sandpaper around a folded piece of scrap carpeting or 2 × 4.

F When sanding the edge of a board with a belt sander, clamp it between two pieces of scrap lumber to prevent the belt sander from wobbling and rounding off the edges.

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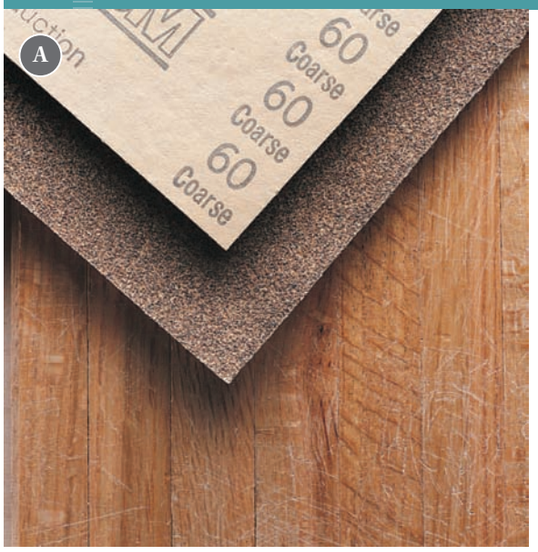
SELECTING THE PROPER SANDPAPER



A Use 60-grit coarse sandpaper on hardwood flooring and to grind down badly scratched surfaces.

B Use 100-grit sandpaper for initial smoothing of wood. Move the sander in the direction of the wood grain to achieve the smoothest surface.

C Use 150-, then 180-grit fine sandpaper to put a smooth finish on wood surfaces. Fine sandpaper will prepare wood surfaces for staining or smooth drywall joints.

D Use 220-grit extra-fine sandpaper to smooth stained wood before staining. Use 400-grit and higher sandpaper between coats of varnish.

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PNEUMATIC NAILERS

Nail guns use compressed air, other gas, or a battery to drive nails into wood. The air-powered—or pneumatic—nail guns offer many advantages over hand-nailing, for both novices and professional carpenters alike. For one, the guns are simple and efficient to use. Rather than swinging a hammer several times to drive and set a nail, a nail gun completes the whole task in one trigger squeeze. Position the gun's tip where you want the nail to be, press down the safety on the nailing tip, and squeeze the trigger to fire the nail. The process is the same, whether you're driving a tiny brad or a 3-inch framing nail. Most professional carpenters use nail guns because large framing or trim carpentry jobs can be completed in much less time than hand-nailing.

Nail guns will help improve your nailing accuracy. You'll never need to worry about a glanced hammer blow denting the wood or bending a nail. Air nailers never miss the nail head. As long as you choose the correct nails for the application and set the air compressor pressure properly, a pneumatic nailer will drive and set nails reliably, time after time.

Nail guns are made in various sizes to suit different carpentry applications. Framing nailers are designed to drive large-shank nails through framing lumber. Brad nailers drive smaller, casing-sized nails for installing trim moldings. Roofing nailers tack shingles in place using long coils of collated nails, sometimes with washers on the shanks. There are even nail guns made for attaching metal joist hanger hardware and strapping. Most styles are available for rent if you only need a nail gun for occasional projects.

When using a nail gun, you'll usually need a tank-style air compressor to supply the air. Set the air pressure correctly for the gun you're using. Most nailers require around 60 to 100 psi of continuous pressure to operate. Use the correct style and sizes of nails for the gun—some nail styles are not interchangeable from one nailer to the next. Also, add a few drops of nail gun oil into the air nozzle to lubricate the internal drive mechanism if your gun requires it. Always wear ear and eye protection when operating a nail gun.

Unlike some other pneumatic tools, nail guns don't require a large air compressor or high volume of air to operate properly. A 4-gallon compressor is generally adequate. Compressors are made in several styles, including single tank, twin-tank, and pancake varieties. Some are equipped to power more than one nailer at a time.

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Framing nailers are ideal for assembling wall, floor, and roof framework. They're the largest nail guns for home carpentry, capable of driving 2 to 4" framing nails.

Brad nailers are designed for attaching baseboard, wall moldings, and window and door casings. Some styles have angled magazines that make it easier to work in tight spaces and corners.

Coil roofing nailers install shingles or wall sheathing quickly and easily. The round magazine stores longer clips of nails than a straight magazine for improved efficiency. These guns can be fired repeatedly by holding the trigger and tapping the gun along the work surface.

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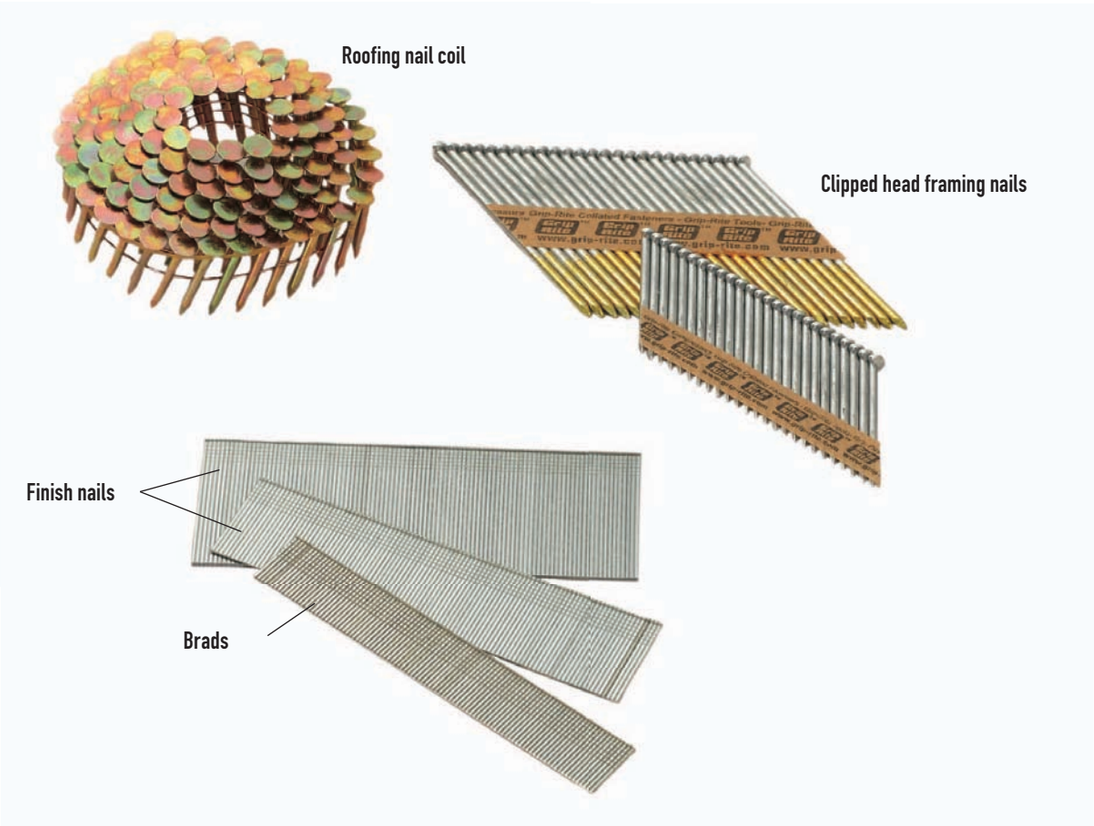

Pneumatic nails are made in a variety of styles, sizes, and compositions to suit specific tasks. Clips are either straight or angled, and framing nail heads can be round or clipped. You can buy uncoated or galvanized nails as well as nails designed for use with treated lumber or marine applications.

To prepare a nail gun for use, slide a clip of nails down into the slot in the magazine and close the cover. Add a few drops of oil into the air hose nozzle, if necessary, before each use.

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#175 Dtp:225 Page:62

Drive a nail by positioning the gun's nailing tip where you want the nail to be and pushing the safety tip against the workpiece. Hold the gun firmly and squeeze the trigger. Lift the gun off to re-engage the safety.

Adjust the air compressor's regulator to achieve the recommended air pressure for the gun you're using. Incorrect air pressure will cause the nailer to either overdrive the nails or stop them short of setting properly.

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#175 Dtp:225 Page:63

POWDER-ACTUATED TOOLS

Occasionally, your carpentry projects may involve fastening wood to metal or concrete, such as attaching wall sole plates to concrete floors. You may even need to fasten metal plumbing straps or conduit clips to steel I-beams. In these situations, you could use hardened screws for fastening, but that involves lots of tedious drilling and usually a few broken or stripped screw heads. An easier alternative is to use small charges of gunpowder to drive hardened nails into metal or concrete with a powder-actuated nail gun.

Powder-actuated nailers look and work a bit like a pile driver or handgun. A steel barrel holds specially designed, hardened nails called drive pins. The nails are equipped with a plastic sleeve to keep them centered in the barrel. Driving force is delivered by a small gunpowder charge, called a power load, which looks like a rifle shell with a crimped tip. The power loads fit into a magazine behind the barrel on the tool. Squeezing the tool's trigger, or hitting the end with a hammer (depending on the tool style), activates a firing pin that ignites the gunpowder. The expanding gasses drive a piston against the nail at great force. Powder-actuated nailers can drive only one fastener at a time, but some styles will hold a clip of multiple power loads for faster operation.

Power loads are made in a range of color-coded calibers to suit different nailing applications and drive pin sizes. Follow the manufacturer's recommendations carefully to choose the correct load and fastener for your task. Generally, the safest method is to start with the lowest energy load that will work for your nailing situation and see if it's sufficient to fully drive the nail. Use the next stronger load, if necessary.

Powder-actuated nailers are easy to use for do-it-yourselfers and safe for indoor projects, provided you wear hearing and eye protection and follow all manufacturer's instructions. Most home centers sell the nail guns and supplies, or you can rent these tools.

Powder-actuated nailers offer the quickest and easiest method for fastening framing to block and concrete.

Powder-actuated nail guns (PATs) are designed in two styles. Plunger types are activated by hitting the end of the shaft with a hammer, while trigger styles function like a handgun. With either type, the barrel must be depressed against the work surface to release a safety before a drive pin can be fired.

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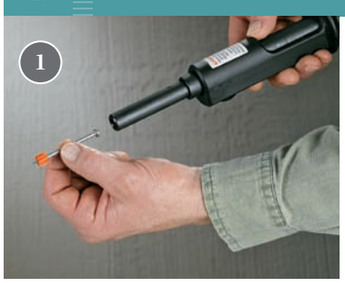
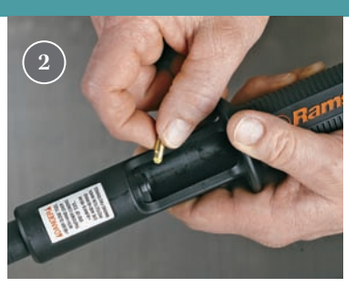
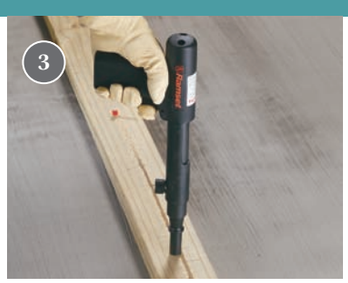
Powder loads contain various amounts of gunpowder inside a crimped shell. Color coding ensures that you're using the right amount of charge for your drive pin size and the materials you're fastening together. Follow the color charts carefully, starting with a low-powder charge.

PATs use hardened nails, called drive pins, in a range of sizes. A plastic finned sleeve centers the drive pin in the tool barrel.

USING A POWDER-ACTUATED TOOL







1 To prepare a PAT for use, slide a drive pin into the barrel first. Push it in until the nail tip is flush with the end of the barrel. Be sure there's no powder load in the magazine.

2 Slide the magazine open and insert a powder load into the barrel. A rim on the load shell ensures that it can only be loaded one way. Close the magazine.

3 Press the end of the barrel firmly against the work surface to release the safety. Squeeze the trigger or strike the end of the tool sharply with a hammer to fire the drive pin. Once the pin is fired, slide open the magazine to eject the spent load shell.

Tip

Occasionally, your first powder load selection won't completely set the nail. In these situations, use a hand maul to drive it in the rest of the way. Choose a stronger powder load for driving subsequent fasteners.

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ROUTERS

Among workshop tools, the router is the undisputed king of versatility. With a router, you can cut, shape edges, build joints, create decorative inlays, and even drill holes. More research and development goes into router innovations each year than virtually any other woodworking tool. And for all these various capabilities, routers don't cost a fortune. A good-quality router is worth every cent you pay.

The two main types of routers for general workshop use are fixed-base and plunge. A third type, called a trim router, is a much smaller tool primarily used to trim plastic laminate.

Fixed-base routers are the standard-issue tools of the router family. They have a motor that's adjusted up or down on its base and is fixed in place for the routing operation. Standard fixed-base models range in power from 1½ to 2¼ horsepower and are suitable for most handheld and table routing jobs. Large fixed-base tools, with 3 horsepower or more, are called heavy-duty, or production, routers and are used for heavy work with large bits. They also make excellent table routers.

Plunge routers have a special base that allows the motor to travel up and down while under power. This feature lets you plunge the spinning router bit down into the workpiece, move the tool sideways for a horizontal cut, then retract the bit from the wood at the end of the cut. Plunge routers can do everything standard fixed-base routers can do but are especially useful for inside cuts, such as mortises.

The plunge router (left) and fixed base router (right) are the two main types of routers for general workshop use. A trim router (center) is smaller and used primarily for trimming plastic laminate.

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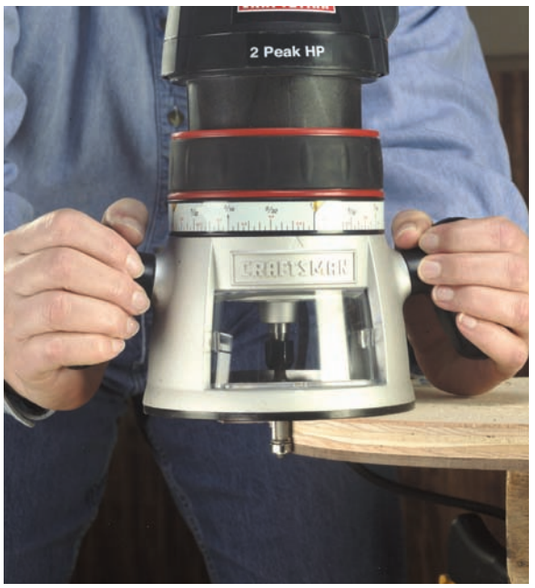
#175 Dtp:225 Page:66

Router Kits. Many manufacturers now make router kits that consist of a motor and both plunge (left) and fixed (right) bases.

Plunge Routers. For some router operations, like cutting hinge mortises or template routing, a plunge router offers more convenience than a fixed-base router.



A flush-trimming bit with a bottom bearing rides along a template placed below the workpiece.

To cut a dado with a router, use a straight bit the same diameter as the dado width. Clamp a guide block to the work piece and make the cut in several passes of increasing depth.

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#175 Dtp:225 Page:67

BASIC CARPENTRY

Lumber.....70

Plywood & Sheet Goods.....74

Trim Moldings.....76

Nails.....78

Screws & Other Hardware.....80

Glues & Adhesives.....82

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(Fogra 39)Job:04-30427 Title:MBI-HomeSkills Carpentry
#175 Dtp:225 Page:68

OBVIOUSLY, ADDING A SECOND floor to your home is an advanced project that most homeowners are not going to attempt. However, finishing a basement is a fairly common do-it-yourself project. To do so you'll need to know how to build a partition wall, frame a door, and perhaps trim a window. All it takes is a set of clear instructions, a little patience, and practice.

The medium of carpentry is lumber, so it is good to know what is available and how to use it. Dimensional lumber, sheet goods, and trim are all covered in the following chapter. In addition, the fasteners and adhesives needed to put it all together are shown.

Contact your local building inspector to see if your project requires a permit.

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LUMBER

Lumber for structural applications such as walls, floors, and ceilings is usually milled from strong softwoods and is categorized by grade, moisture content, and dimension.

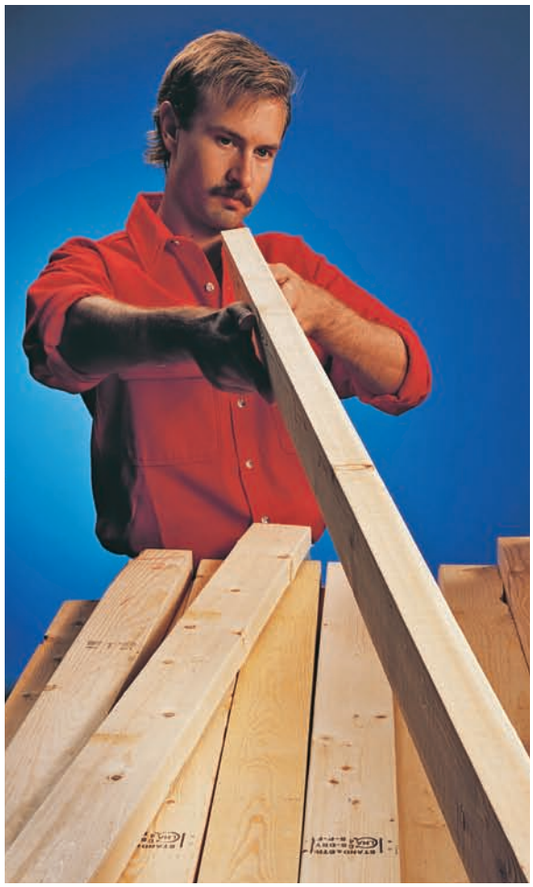
Grade: Characteristics such as knots, splits, and grain slope affect the strength of the lumber and determine the grade (chart, opposite page).

Moisture content: Lumber is also categorized by moisture content. S-DRY (surfaced dry) is the designation for lumber with a moisture content of 19 percent or less. S-DRY lumber is the least likely to warp or shrink and is a good choice for framing walls. S-GRN (surfaced green) means the lumber contains a moisture content of 19 percent or more.

Exterior lumber: Lumber milled from redwood or cedar is naturally resistant to decay and insect infestation and is a good choice for exterior applications. The most durable part of a tree is the heartwood, so specify heartwood for pieces that will be in contact with the ground.

Treated lumber: Lumber injected with chemicals under pressure is resistant to decay and is generally less expensive than decay-resistant heartwoods such as redwood and cedar. For outdoor structures like decks, use treated lumber for posts and joists and more attractive redwood or cedar for decks and railings.

Dimension lumber: Lumber is sold according to its nominal size, such as 2 × 4. Its actual size (chart, page 73) is smaller. Always use actual sizes for measuring and estimating.



Check lumber visually before buying it. Take the time to choose the boards with the fewest defects, even if they will be hidden behind wall surfaces.

The Steel-Framing Alternative

Lumber is not the only material available for framing walls. Metal studs and tracks offer an attractive—if less common—choice for new construction. Steel-framed walls can be installed faster than wood stud walls—the parts are attached by crimping and screwing the flanges—and the channels are precut to accommodate electrical and plumbing lines. Steel framing is also lighter in weight, easy to recycle, fireproof, and comparable in price to lumber. If you are interested in using steel framing for a new wall in a wood-framed home, consult a professional for information about electrical, plumbing, and load-bearing safety precautions. Steel framing is available at most home centers.

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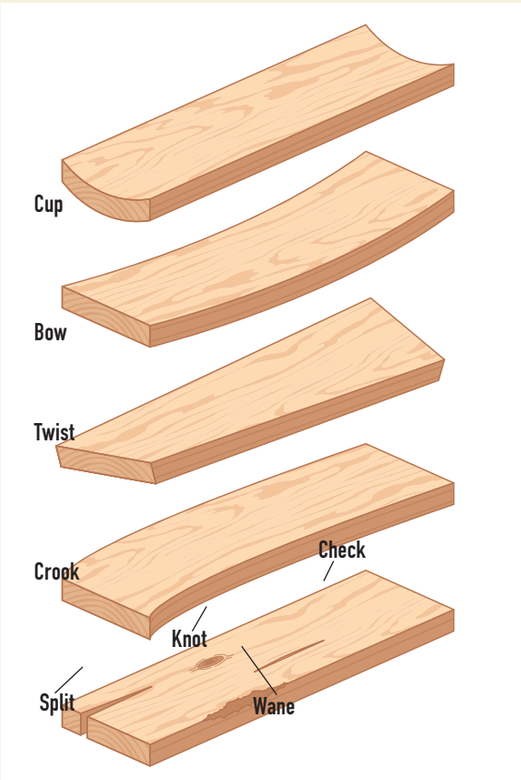
#175 Dtp:225 Page:70

LUMBER GRADING CHART

Much of today's lumber is still fairly wet when it is sold, so it's hard to predict how it will behave as it dries. But a quick inspection of each board at the lumberyard or home center will help you disqualify flawed boards. Lumber that is cupped, twisted, or crooked should not be used at full length. However, you may be able to cut out good sections for use as blocking or other short framing pieces. If a board is slightly bowed, you can probably flatten it out as you nail it. Checks, wanes, and knots are cosmetic flaws that seldom affect the strength of the board. The exception is a knot that is loose or missing. In this case, cut off the damaged area. Sections with splits should also be cut off. Splits are likely to spread as the wood dries.

Grade	Description, uses
Clear	Free of knots and defects
SEL STR or Select Structural	Good appearance, strength, and stiffness
1, 2, 3	1, 2, 3 grades indicate knot size
CONST or Construction	Both grades used for general framing
STAND or Standard	Good strength and serviceability
STUD or Stud	Special designation used in any stud application, including load-bearing walls
UTIL or Utility	Economical choice for blocking and bracing



Grade stamps provide valuable information about a piece of lumber. The lumber's grade is usually indicated by the largest number stamped on the wood. Also stamped on each piece of lumber are its moisture content, species, and lumber mill of origin.

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#175 Dtp:225 Page:71

SELECTING THE RIGHT LUMBER FOR A PROJECT

Picking the right wood for a project is a decision that will affect the durability and attractiveness of the final product. Some woods are more prone to warping than others, some are more resistant to decay, and some are superior when it comes to accepting a coat of paint. Matching styles and wood varieties will help to create a common theme throughout your home.

Lumber sizes such as 2 × 4 are nominal dimensions, not actual dimensions. The actual size of lumber is slightly smaller than the nominal size. When it is originally milled, lumber is cut at the nominal size; however, the boards are then planed down for a smoother finish, producing the actual dimensions you buy in the store. See the chart on the opposite page for nominal and actual dimensions.

Softwood	Description	Uses
Cedar	Easy to cut, holds paint well. Heartwood resists decay.	Decks, shakes, shingles, posts, and other decay-prone surfaces.
Fir, larch	Stiff, hard wood. Holds nails well. Some varieties are hard to cut.	Framing materials, flooring, and subflooring.
Pine	Lightweight, soft wood with a tendency to shrink. Holds nails well. Some varieties resist decay.	Paneling, trim, siding, and decks.
Redwood	Lightweight, soft wood that holds paint well. Easy to cut. Heartwood resists decay and insect damage.	Outdoor applications, such as decks, posts, and fences.
Treated lumber	Chemically treated to resist decay. Use corrosion-resistant fasteners only. Wear protective eye wear and clothing to avoid skin, lung, and eye irritation.	Ground-contact and other outdoor applications where resistance to decay is important.

Hardwood	Description	Uses
Birch	Hard, strong wood that is easy to cut and holds paint well.	Painted cabinets, trim, and plywood.
Maple	Heavy, hard, strong wood that is difficult to cut with hand tools.	Flooring, furniture, and countertops.
Poplar	Soft, light wood that is easy to cut with hand or power tools.	Painted cabinets, trim, tongue-and-groove paneling, and plywood cores.
Oak	Heavy, hard, strong wood that is difficult to cut with hand tools.	Furniture, flooring, doors, and trim.
Walnut	Heavy, hard, strong wood that is easy to cut.	Fine woodwork, paneling, and mantelpieces.

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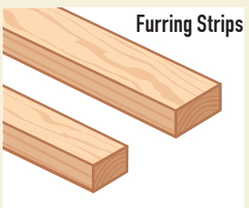
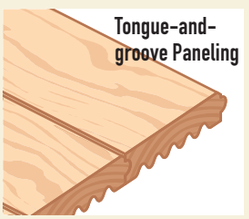
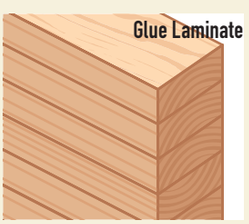
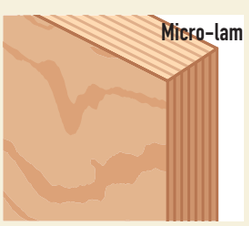
(Fogra 39)Job:04-30427 Title:MBI-HomeSkills Carpentry
#175 Dtp:225 Page:72

Type	Description	Common Nominal Sizes	Actual Sizes
	Used in framing of walls, ceilings, floors, rafters, structural finishing, exterior decking, fencing, and stairs.	1 × 4 1 × 6 1 × 8 2 × 2 2 × 4 2 × 6 2 × 8	¾" × 3½" ¾" × 5½" ¾" × 7¼" 1½" × 1½" 1½" × 3½" 1½" × 5½" 1½" × 7¼"
	Used in framing of walls, ceilings, floors, rafters, structural finishing, exterior decking, fencing, and stairs.	1 × 2 1 × 4	¾" × 1½" ¾" × 2½"
	Used in wainscoting and full-length paneling of walls and ceilings.	5/16" × 4 1 × 4 1 × 6 1 × 8	Varies, depending on milling process and application.
	Used in trim, shelving, cabinetry, and other applications where a fine finish is required.	1 × 4 1 × 6 1 × 8 1 × 10 1 × 12	¾" × 3½" ¾" × 5½" ¾" × 7½" ¾" × 9½" ¾" × 11½"
	Composed of layers of lumber laminated to form a solid piece. Used for beams and joists.	4 × 10 4 × 12 6 × 10 6 × 12	3½" × 9 3½" × 12 3½" × 9 3½" × 12
	Composed of thin layers glued together for use in joists and beams.	4 × 12	3½" × 11⅜"

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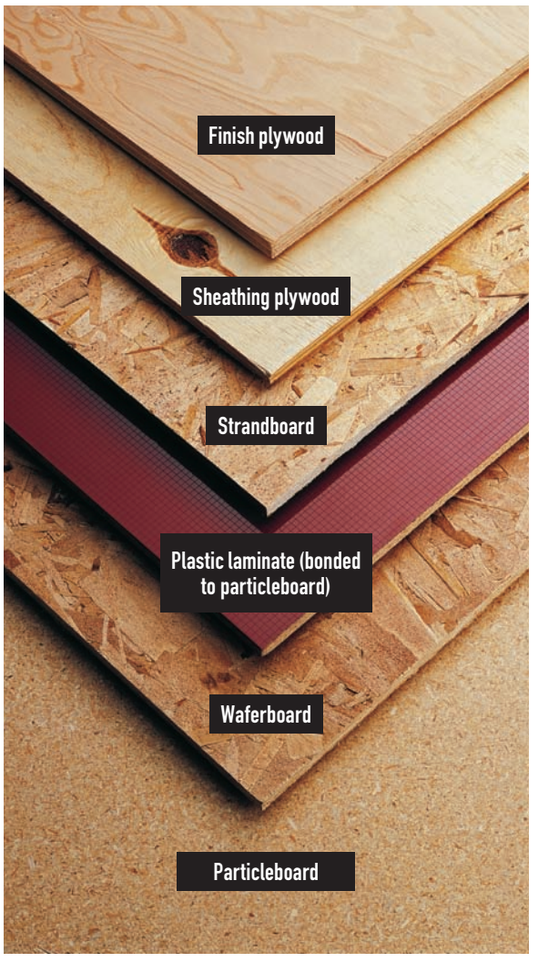
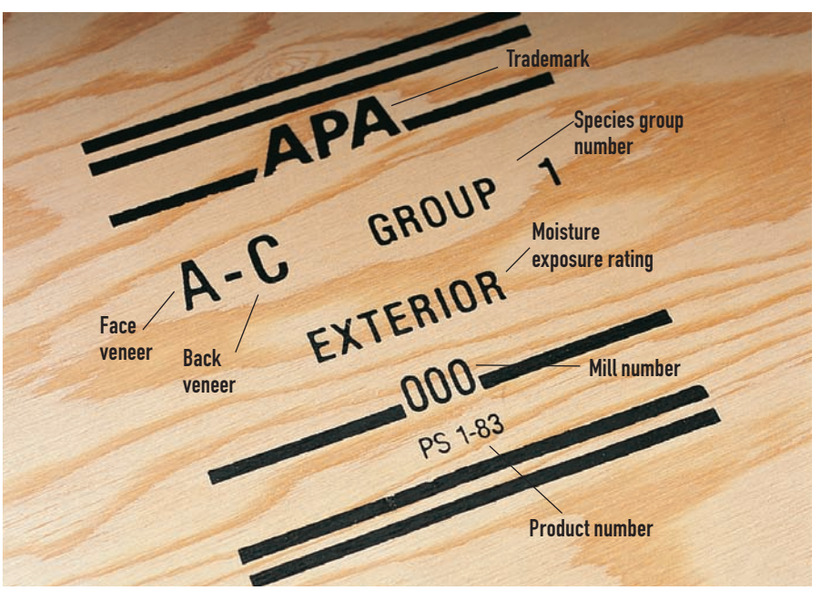


PLYWOOD & SHEET GOODS

There are many different types of sheet goods, but plywood is the most widely used. Plywood is an extremely versatile sheet material that is made up of thinly sliced layers or plies of wood. Plywood is available in thicknesses ranging from 3⁄16" to ¾" and is graded A through D, depending on the quality of the wood in its outer plies. It is also graded for interior or exterior usage. Classifications for plywood are based on the wood species used for the face and back veneers. Group 1 species are the strongest and stiffest, Group 2 is the next strongest.

Finish plywood is graded either A-C, meaning it has a finish-quality wood veneer on one side and a utility-grade ply on the other side, or A-A, indicating it has a finish veneer on both sides.

Sheathing plywood is graded C-D with two rough sides and features a bond between plies that is waterproof. Plywood rated EXPOSURE 1 is for use where some moisture is present, and plywood rated EXTERIOR is used in applications that are permanently exposed to weather. Sheathing plywood also carries a thickness rating and a roof and floor span index, which appear as two numbers separated by a diagonal slash. The first number, for roofing application, indicates the maximum spacing



The finish plywood grading stamp shows the grade of face and back veneers, species group number, and a moisture exposure rating. Mill numbers and product numbers are for the manufacturer's use.

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for rafters. The second number specifies the joist spacing when plywood is used for subflooring. Some plywood is stamped "sized for spacing." This means that the actual dimensions are slightly smaller than 4 × 8 feet to allow space for expansion between sheets after installation.

Plastic laminates make durable surfaces for countertops and furniture. Plastic laminates are sometimes bonded to particleboard for use in shelving, cabinets, and countertops.

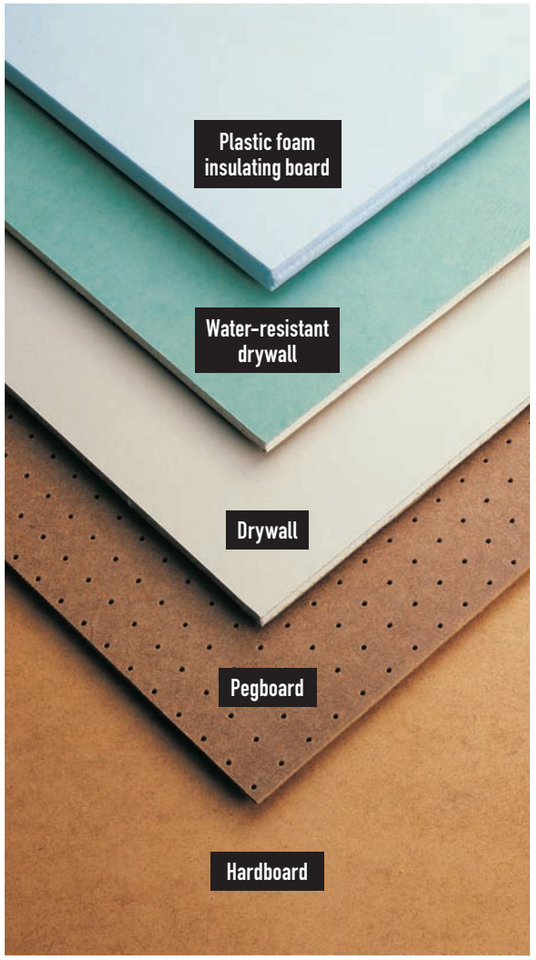
Strand-, particle-, and waferboard are made from waste chips or inexpensive wood species and are used for shelving and floor underlayment.

Foam insulating board is lightweight and serves as insulation for basement walls.

Water-resistant drywall is used behind ceramic wall tiles and in other high-moisture areas.

Drywall, also known as wallboard, Sheetrock, and plasterboard, comes in panels 4-feet wide, 2-, 4-, 8-, 10-, or 12-feet long, and in ⅜-inch, ½-inch, and ⅝-inch thicknesses.

Pegboard and hardboard are made from wood fibers and resins bonded together under high pressure and are used for tool organization with a workbench and as shelf backing.



The sheathing plywood grading stamp shows thickness, roof or floor span index, and exposure rating, in addition to the manufacturer's information.

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TRIM MOLDINGS

Trim moldings give character and definition to many carpentry projects. In addition, you can sometimes use them to cover up carpentry mistakes, such as hiding small gaps in wall corners when the drywall hasn't been cut perfectly.

It's important to measure and cut moldings precisely so that when installed, they fit together snugly without gaps. Predrilling moldings is recommended, especially when hardwoods such as oak are used. Predrilling makes hand nailing easier, reduces splitting during installation, and makes it easier to set nails cleanly. There's no need to predrill when using a pneumatic nail gun.

Most moldings should be painted or stained before installation. Cove moldings and wainscoting can be purchased with a factory coat of white paint. Pine and poplar are good choices if you plan to paint. For stained surfaces, use a hardwood with a pleasing grain, such as oak.

Tip

Use the same wood species whenever possible in selecting trim materials for walls, doors, and windows. Even when painted, oak shows a distinct grain pattern that painted poplar does not have.

Decorative moldings give a finished appearance to walls, doors, windows, and cabinets.

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Trim moldings are both functional and decorative. They can be used to conceal gaps at the base and around the sides of a carpentry project, to hide the edges of plywood surfaces, or simply to add visual interest to the project. Moldings are available in dozens of styles, but the samples shown here are widely available at all home improvement centers.

Synthetic trim moldings, available in many styles, are less expensive than hardwood moldings. Synthetic moldings are made of wood composites (A) or rigid foam (B) covered with a layer of melamine.

Baseboard molding (C) is used to trim the bottom edge of a wall along the floor line. Choosing molding that matches the baseboard elsewhere in your home helps your project fit in with its surroundings.

Hardwood strips (D) are used to construct face frames for carpentry projects and to cover unfinished edges of plywood shelves. Maple, oak, and poplar strips are widely available in 1 × 2, 1 × 3, and 1 × 4 sizes.

Crown moldings (E, F) cover gaps between the top of a wall and the ceiling. They can also add a decorative accent to other projects.

Cove molding (G) is a simple, unobtrusive trim for covering gaps.

Ornamental moldings, including spindle and rail (H) and embossed moldings (I, J), give a distinctive look to many projects.

Door-edge molding (K), also called cap molding, is only available in specialty stores in some areas. It is used with finish-grade plywood to create panel-style doors and drawer faces.

Shelf-edge molding (L), also called base cap molding, provides a decorative edge to plywood shelves or can be used to create a wider baseboard molding.

Base-shoe molding (M) covers gaps around the top, bottom, and sides of a wall. Because it bends easily, base-shoe molding works well to cover irregular gaps caused by uneven walls and loose floors.

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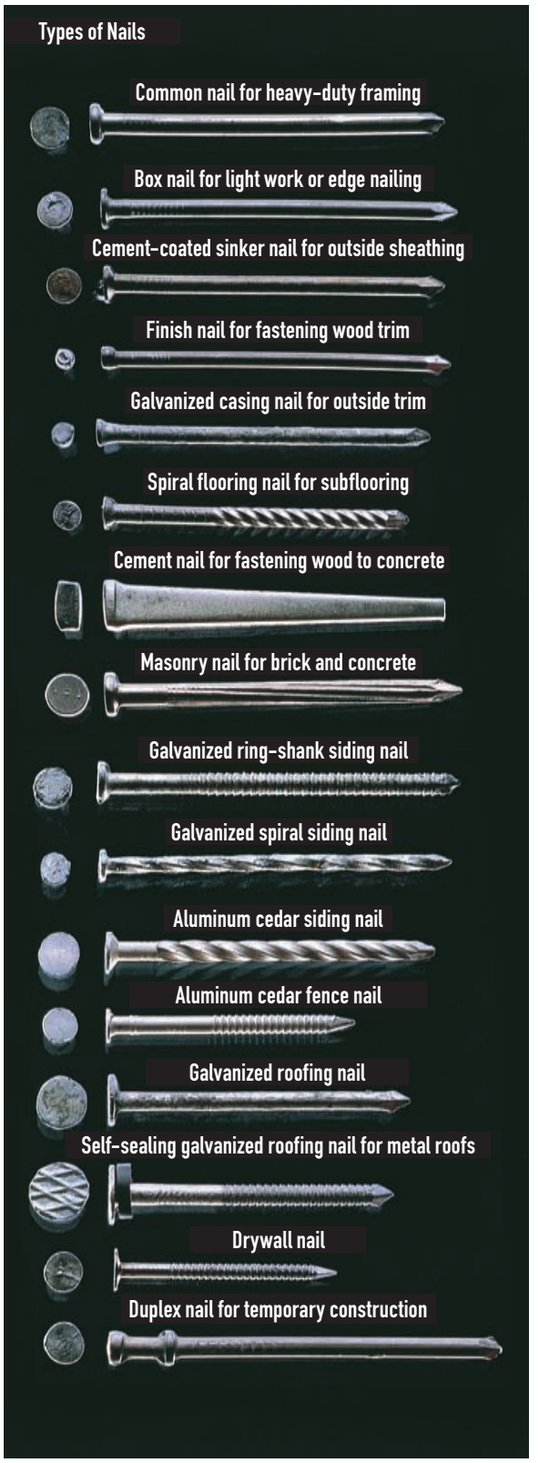
NAILS

The wide variety of nail styles and sizes makes it possible to choose exactly the right fastener for each job. Nails are identified by their typical purpose, such as casing, flooring, or roofing nails; or by a physical feature, such as galvanized, coated, or spiral. Some nails come in both a galvanized and non-galvanized version. Use galvanized nails for outdoor projects and non-galvanized indoors. Nail lengths may be specified in inches or by numbers from 4 to 60 followed by the letter "d," which stands for "penny" (see "Nail Sizes," opposite page).

Some of the most popular nails for carpentry projects include:

- Common and box nails for general framing work. Box nails are smaller in diameter, which makes them less likely to split wood. Box nails were designed for constructing boxes and crates, but they can be used in any application where thin, dry wood will be nailed close to the edge of the piece. Most common and box nails have a cement or vinyl coating that improves their holding power.
- Finish and casing nails, which have small heads and are driven just below the work surface with a nail set. Finish nails are used for attaching moldings and other trim to walls. Casing nails are used for nailing window and door casings. They have a slightly larger head than finish nails for better holding power.
- Brads, or small wire nails sometimes referred to as finish nails. They are used primarily in cabinetry, where very small nail holes are preferred.
- Flooring nails, which are often spiral-shanked for extra holding power to prevent floorboards from separating or squeaking. Spiral flooring nails are sometimes used in other applications, such as installing tongue-and-groove paneling on ceilings.
- Galvanized nails, which have a zinc coating that resists rusting. They are used for outdoor projects.
- Drywall nails, once the standard fastener for drywall, are less common today because of the development of Phillips-head drywall screws that drive quickly with a screw gun or drill and offer superior holding power (page 80).



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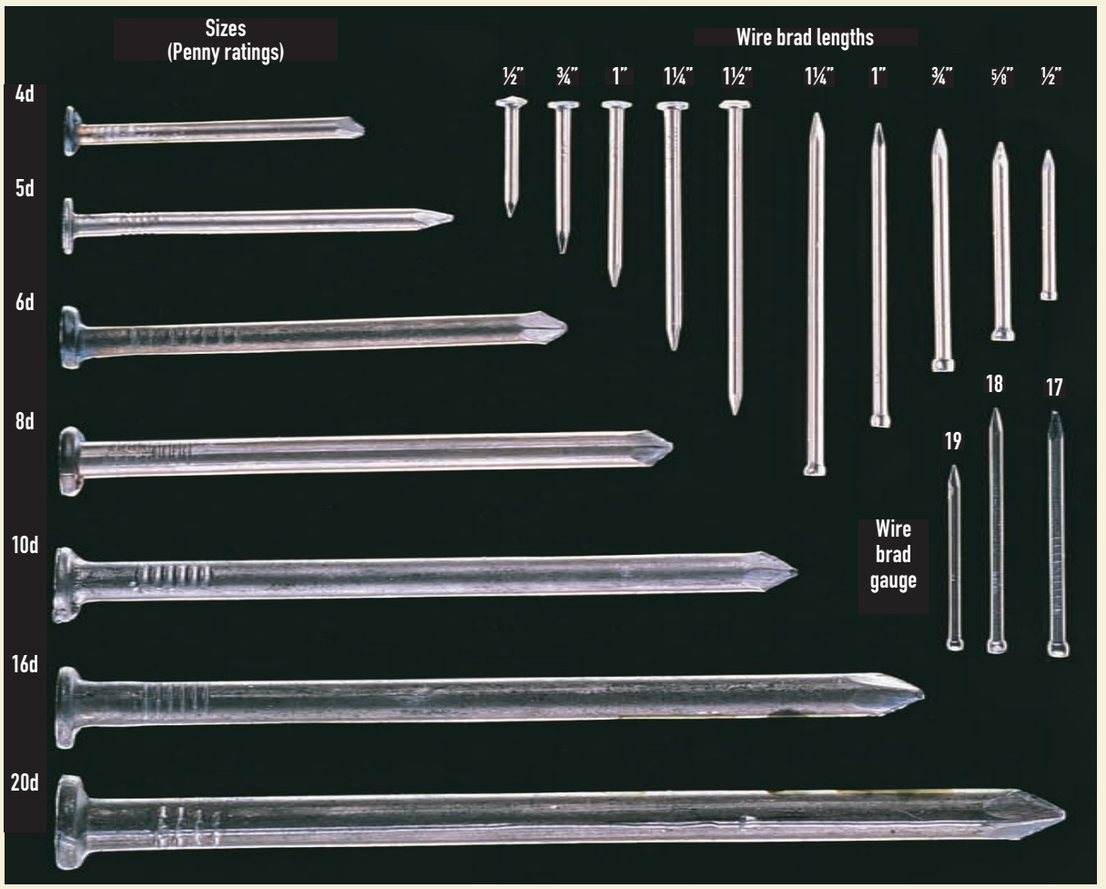
NAIL SIZES



The pennyweight scale that manufacturers use to size nails was developed centuries ago as an approximation of the number of pennies it would take to buy 100 nails of that size. The range of nail types available today (and what they cost) is much wider, but the scale is still in use. Each pennyweight refers to a specific length (see chart, below), although you will find slight variations in length from one nail type to the next. For example, box nails of a given pennyweight are roughly ⅛" shorter than common nails of the same weight.

Estimating Nail Quantities

Estimate the number of nails you'll need for a project, then use the chart to determine approximately how many pounds of nails to purchase.

Note: Sizes and quantities not listed are less common, although they may be available through some manufacturers.

Nails per lb.											
Pennyweight	2d	3d	4d	5d	6d	7d	8d	10d	12d	16d	20d
Length (in.)	1	1¼	1½	1⅝	2	2⅛	2½	3	3¼	3½	4
Common	870	543	294	254	167		101	66	61	47	29
Box	635	473	406	236	210	145	94	88	71	39	
Cement-coated			527	387	293	223	153	111	81	64	52
Finish	1350	880	630	535	288		196	124	113	93	39
Masonry			155	138	100	78	64	48	43	34	

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#175 Dtp:225 Page:79

SCREWS & OTHER HARDWARE

The advent of the screw gun and numerous types of driver bits for drills have made screws a mainstay of the carpentry trade. With literally hundreds of different screws and types of fastening hardware available, there is a specific screw for almost every job. But, for most carpentry jobs you will only need to consider a few general-purpose types. Although nails are still preferred for framing jobs, screws have replaced nails for hanging drywall, installing blocking between studs, and attaching sheathing and flooring. Screws are also used to attach a workpiece to plaster, brick, or concrete, which requires an anchoring device (opposite page, top).

Screws are categorized according to length, slot style, head shape, and gauge. The thickness of the screw body is indicated by the gauge number. The larger the number, the larger the screw. Large screws provide extra holding power; small screws are less likely to split a workpiece. There are various styles of screw slot, including Phillips, slotted, and square. Square-drive screwdrivers are increasing in popularity because they grip the screw head tightly, but Phillips head screws are still the most popular.

Most screws are now designed to be driven with a power screwdriver. They don't require pilot holes in soft wood, and the bugle-shaped heads allow the screws to countersink themselves. Use drywall screws for general-purpose, convenient fastening indoors. Deck screws are corrosion-resistant screws made specifically for outdoor use. Use deck screws with the correct coating for the lumber being used.

Easily recognizable by their bugle-shaped heads, drywall screws are designed to dimple the surface of the drywall without ripping the facing paper.

Use protector plates where wires or pipes pass through framing members and are less than 1¼" from the edge. The plates prevent drywall screws or nails from puncturing wires or pipes.

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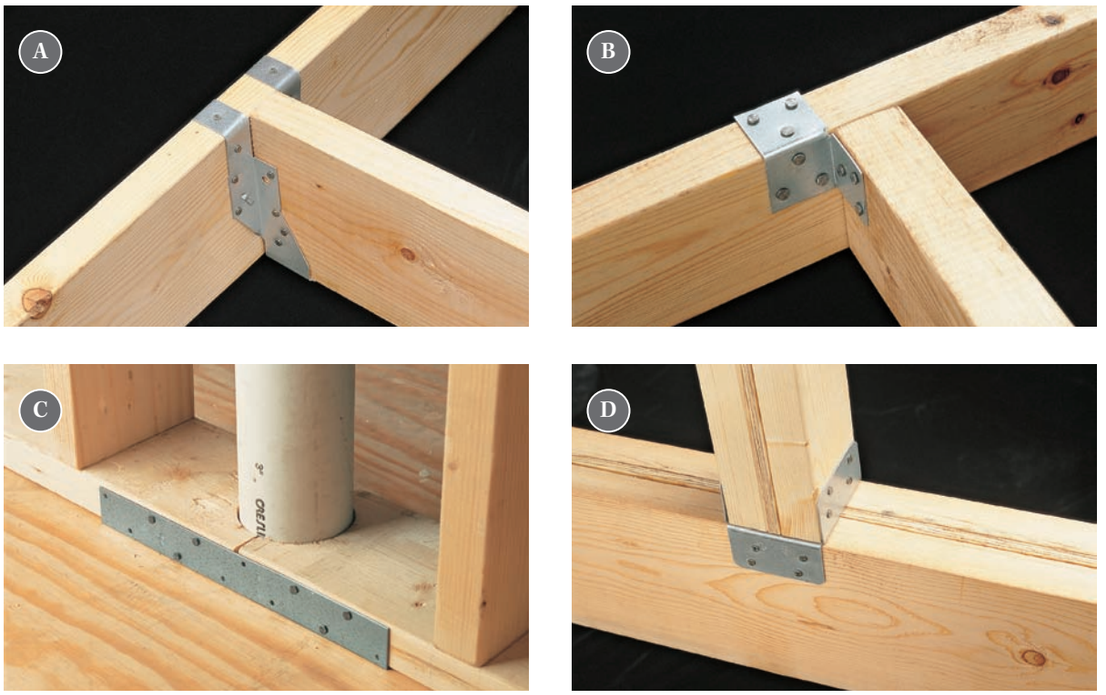
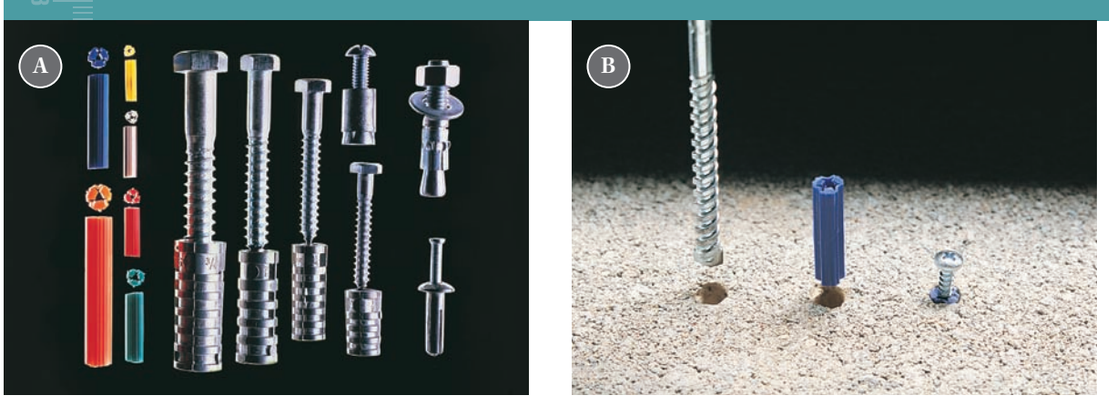


Metal framing connectors may be required in some communities, especially in areas prone to high winds or earthquakes. Metal joist hangers (A), stud ties (B), connector straps (C), and post-and-beam saddles (D) all provide extra reinforcement to structural joints. Wood joints made with metal connectors are stronger than toenailed joints. Metal connectors must be installed with approved fasteners.

USING MASONRY & WALL ANCHORS



A Use wall anchors to attach hardware or lumber to plaster, concrete, or brick. Choose an anchor that is equal in length to the thickness of the wall's surface material. Plastic plugs are used for anchoring in hollow walls.

B To install a wall anchor, drill a pilot hole equal in diameter to the plastic anchor. Insert the anchor in the hole and drive it flush with the wall surface. Insert the screw and tighten it; as the anchor expands, it will create a tight grip.

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GLUES & ADHESIVES

When used properly, glues and adhesives can be stronger than the materials they hold together. Use hot glue in lightweight woodworking projects, carpenter's glue for wood joints, and carpentry adhesive for preliminary installation of thin panels and lumber. Panel adhesive, a thinner formula that can be applied from a tube or with a brush, is used to install paneling, wainscoting, and other lightweight tongue-and-groove materials. Masonry adhesive is used for securing top courses of interlocking blocks.

Caulks are designed to permanently close joints, fill gaps in woodwork, and hide subtle imperfections. Different caulks are made of different compounds and vary greatly in durability and workability. Most caulk is applied with a caulk gun, but some types are available in squeeze tubes for smaller applications. While silicone caulks last longer, many are not paintable and are difficult to smooth out. Latex caulks are less durable than silicone, but are much easier to work with, especially when used to hide gaps. Caulks are available for bond to masonry, glass, tile, metals, wood, fiberglass, and plastic. Read the label carefully to choose the right caulk for the job.

Carpentry adhesives include (clockwise from top right): clear adhesive caulk, for sealing gaps in damp areas; waterproof construction adhesive, for bonding lumber for outdoor projects; multi-purpose adhesive, for attaching paneling and forming strong bonds between lumber pieces; electric hot glue gun and glue sticks, for bonding small decorative trim pieces on built-ins; wood glues and all-purpose glue, for many woodworking projects.

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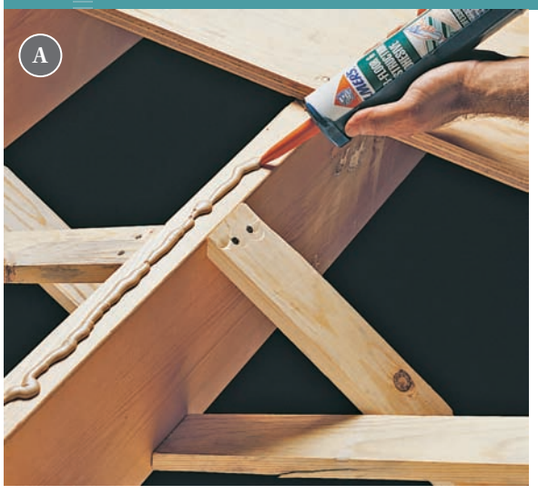
USING ADHESIVES AND GLUES



A Strengthen floors and decks and reduce squeaks with joist and deck adhesive. For outdoor applications, make sure you choose a waterproof adhesive.

B Construction adhesive adds strength to carpentry and woodworking joints. It also has two advantages over glue. It has high initial tack, so parts don't slide apart, and it retains some flexibility after drying.

C Exterior-grade construction adhesive fortifies the bond between wood structural members and the masonry house foundation. Additional fasteners, such as powder-actuated nails, are still needed.

D Specialty molding and trim glue has a thicker formulation than standard wood glue to resist running and dripping on vertical surfaces. It is tackier than regular glue, which helps hold ceiling trims in place when they are positioned, creating a small amount of time for you to fasten them with nails.

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#175 Dtp:225 Page:83

ANATOMY OF A HOUSE

Partition Walls 90

Door Frames for Prehung Doors 94

Framing a Window 96

Door & Window Casings 100

Base Molding 106

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#175 Dtp:225 Page:84

Anatomy Details

Many remodeling projects, like adding new doors or windows, require that you remove one or more studs in a load-bearing wall to create an opening. When planning your project, remember that new openings require a permanent support beam called a header, above the removed studs, to carry the structural load directly.

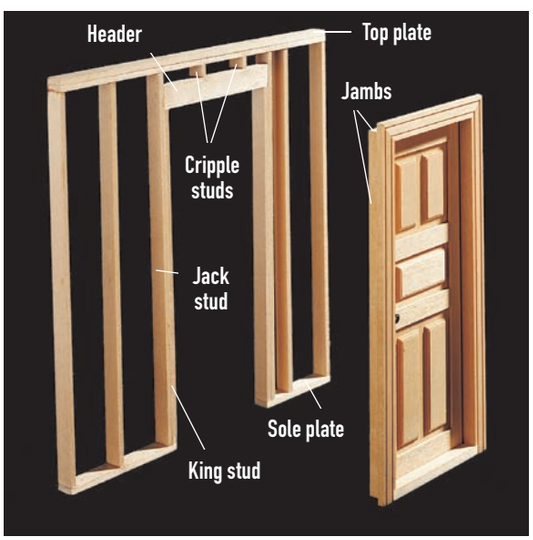
The required size for the header is set by local building codes and varies according to the width of the rough opening. For a window or door opening, a header can be built from two pieces of 2-inch dimensional lumber sandwiched around ⅜-inch plywood (chart, right).

When a large portion of a load-bearing wall (or an entire wall) is removed, a laminated beam product can be used to make the new header.

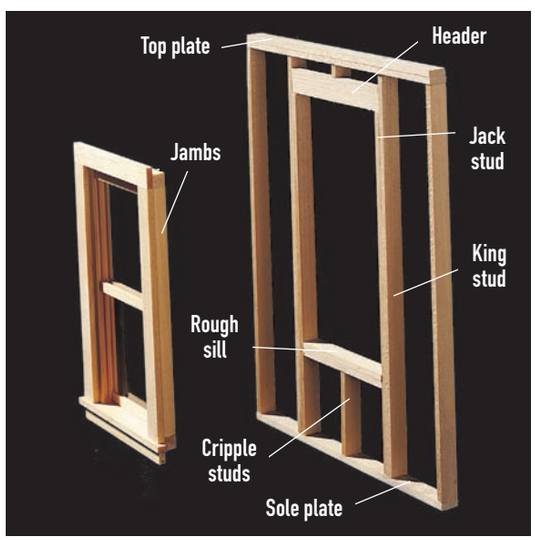
Recommended Header Sizes

Rough Opening WIdth	Recommended Header Construction
Up to 3 ft.	⅜" plywood between two 2 × 4s
3 ft. to 5 ft.	⅜" plywood between two 2 × 6s
5 ft. to 7 ft.	⅜" plywood between two 2 × 8s
7 ft. to 8 ft.	⅜" plywood between two 2 × 10s

If you will be removing more than one wall stud, make temporary supports to carry the structural load until the header is installed.



Door opening: The structural load above the door is carried by cripple studs that rest on a header. The ends of the header are supported by jack studs (also known as trimmer studs) and king studs that transfer the load to the sole plate and the foundation of the house. The rough opening for a door should be 1" wider and ½" taller than the dimensions of the door unit, including the jambs. This extra space lets you adjust the door unit during installation.



Window opening: The structural load above the window is carried by cripple studs resting on a header. The ends of the header are supported by jack studs and king studs, which transfer the load to the sole plate and the foundation of the house. The rough sill, which helps anchor the window unit but carries no structural weight, is supported by cripple studs. To provide room for adjustments during installation, the rough opening for a window should be 1" wider and ½" taller than the window unit, including the jambs.

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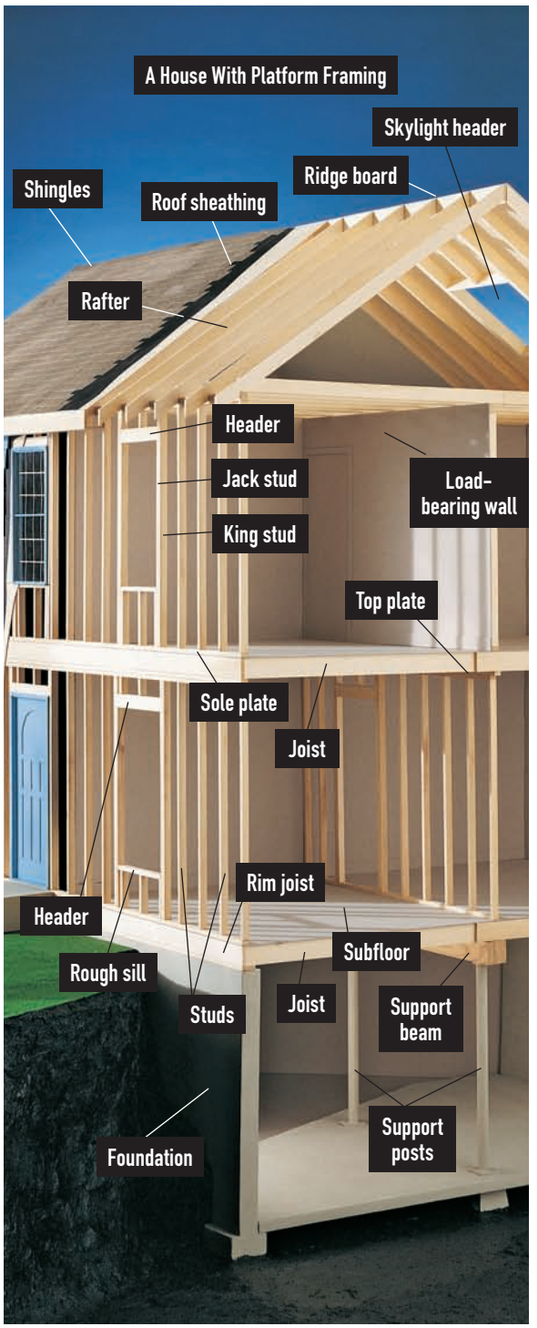

BEFORE YOU START A do-it-yourself carpentry project, you should familiarize yourself with a few basic elements of home construction and remodeling. Take some time to get comfortable with the terminology of the models shown on the next few pages. The understanding you will gain in this section will make it easier to plan your project, buy the right materials, and clear up any confusion you might have about the internal design of your home.

If your project includes modifying exterior or load-bearing walls, you must determine if your house was built using platform- or balloon-style framing. The framing style of your home determines what kind of temporary supports you will need to install while the work is in progress. If you have trouble determining what type of framing was used

Platform Framing

Platform framing (photos, above and left) is identified by the floor-level sole plates and ceiling-level top plates to which the wall studs are attached. Most houses built after 1930 use platform framing. If you do not have access to unfinished areas, you can remove the wall surface at the bottom of a wall to determine what kind of framing was used in your home.

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#175 Dtp:225 Page:86

in your home, refer to the original blueprints, if you have them, or consult a building contractor or licensed home inspector.

Framing in a new door or window on an exterior wall normally requires installing a header. Make sure that the header you install meets the requirements of your local building code, and always install cripple studs where necessary.

Floors and ceilings consist of sheet materials, joists, and support beams. All floors used as living areas must have joists with at least 2 × 8 construction.

There are two types of walls: load-bearing and partition. Load-bearing walls require temporary supports during wall removal or framing of a door or window. Partition walls carry no structural load and do not require temporary supports.

Balloon Framing

Balloon framing (photos, right and above) is identified by wall studs that run uninterrupted from the roof to a sill plate on the foundation, without the sole plates and top plates found in platform-framed walls (page 88). Balloon framing was used in houses built before 1930, and it is still used in some new home styles, especially those with high vaulted ceilings.

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Framing Options for Window & Door Openings (new lumber shown in yellow)

Using an existing opening avoids the need for new framing. This is a good option in homes with masonry exteriors, which are difficult to alter. Order a replacement unit that is 1" narrower and ½" shorter than the rough opening.

Framing a new opening is the only solution when you're installing a window or door where none existed or when you're replacing a unit with one that is much larger.

Enlarging an existing opening simplifies the framing. In many cases, you can use an existing king stud and jack stud to form one side of the new opening.

Wall Anatomy

Load-bearing walls carry the structural weight of your home. In platform-framed houses, load-bearing walls can be identified by double top plates made from two layers of framing lumber. Load-bearing walls include all exterior walls and any interior walls that are aligned above support beams.

Partition walls are interior walls that do not carry the structural weight of the house. They have a single top plate and can be perpendicular to the floor and ceiling joists but are not aligned above support beams. Any interior wall that is parallel to floor and ceiling joists is a partition wall.

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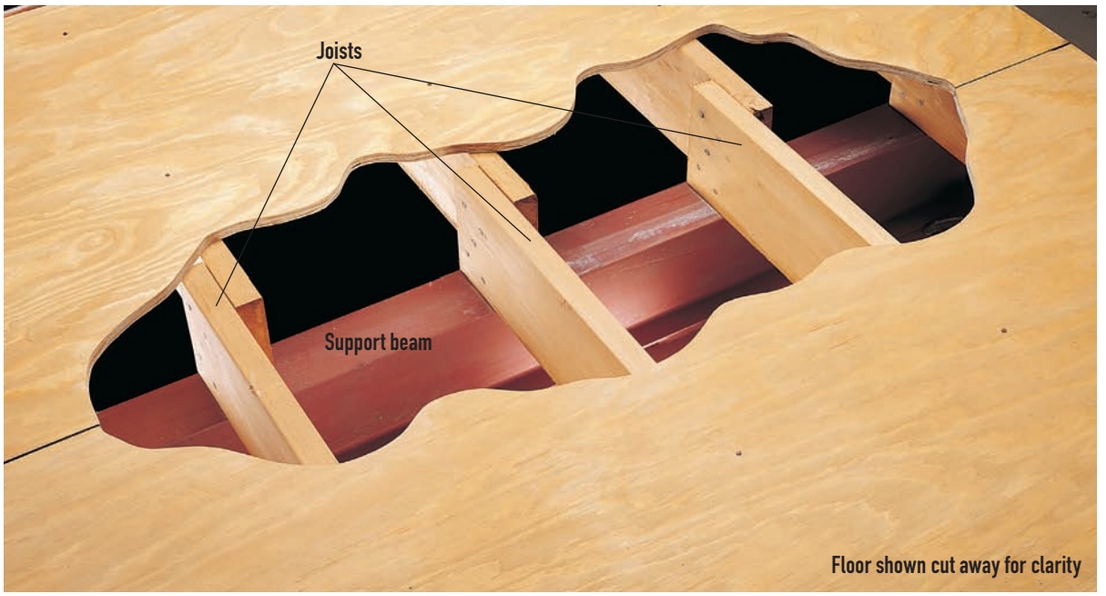
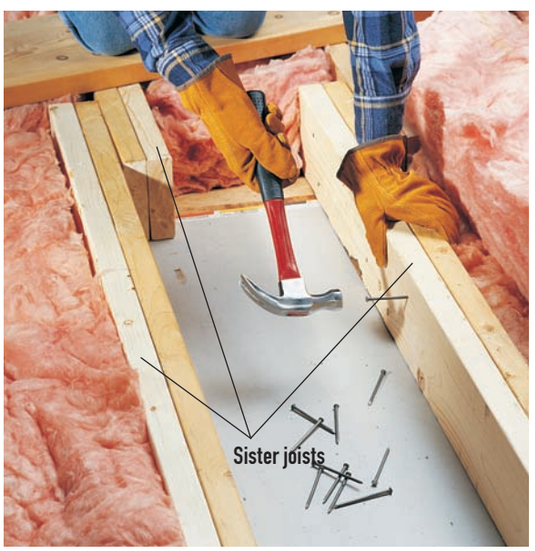
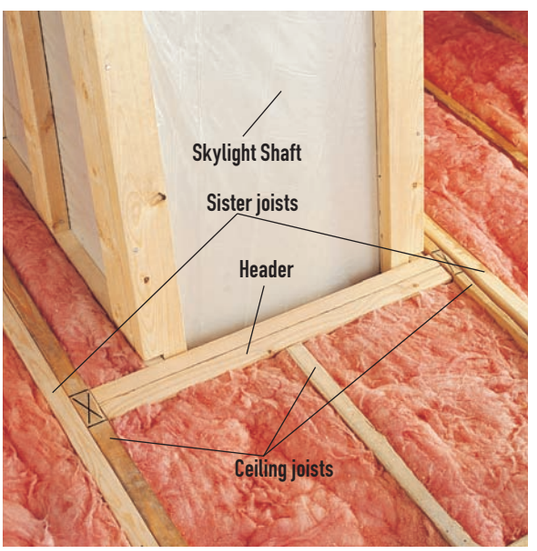
Floor & Ceiling Anatomy



Joists carry the structural load of floors and ceilings. The ends of the joists rest on support beams, foundations, or load-bearing walls. Rooms used as living areas must be supported by floor joists that are at least 2 × 8 in size. Floors with smaller joists can be reinforced with sister joists.



Floors with 2 × 6 joists, like those sometimes found in attics, cannot support living areas unless a sister joist is attached alongside each original joist to strengthen it. This often is necessary when an attic is converted to a living area.



Sister joists also are used to help support a header when ceiling joists must be cut, such as when framing a skylight shaft.

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#175 Dtp:225 Page:89

Partition Walls

Tools & Materials

- Protective eyewear
- Chalk line
- Circular saw
- Framing square
- Plumb bob
- Powder-actuated nailer
- T-bevel
- 2 x 4 lumber
- Blocking lumber
- 16d and 8d common nails
- Concrete fasteners
- Drywall screws

A typical partition wall consists of top and bottom plates and 2 × 4 studs spaced 16" on-center. Use 2 × 6 lumber for walls that will hold large plumbing pipes (inset).

PARTITION WALLS ARE non-load-bearing walls typically built with 2 × 4 lumber, but they can also be built with 3⅝-inch steel studs. Walls holding plumbing pipes can be framed with 2 × 6 lumber. On a concrete floor, use pressure-treated lumber for the bottom plates.

This project involves building a wall in place, rather than framing a complete wall on the floor and tilting it upright, as in new construction. The build-in-place method allows for variations in floor and ceiling levels and is generally much easier for remodeling projects.

If your wall will include a door or other opening, see pages 94 to 99. Check the local building codes for requirements about fireblocking in partition walls. And after your walls are framed and the mechanical rough-ins are completed, install metal protector plates where pipes and wires run through framing members.

Nail guns will help improve your nailing accuracy. You'll never need to worry about a glanced hammer blow denting the wood or bending a nail. Air nailers never miss the nail head. As long as you choose the correct nails for the application and set the air compressor pressure properly, a pneumatic nailer will drive and set nails reliably, time after time.

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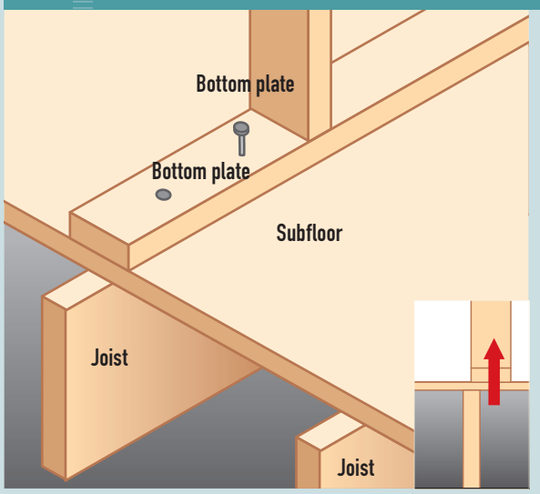
#175 Dtp:225 Page:90

VARIATIONS FOR FASTENING TOP PLATES TO JOISTS

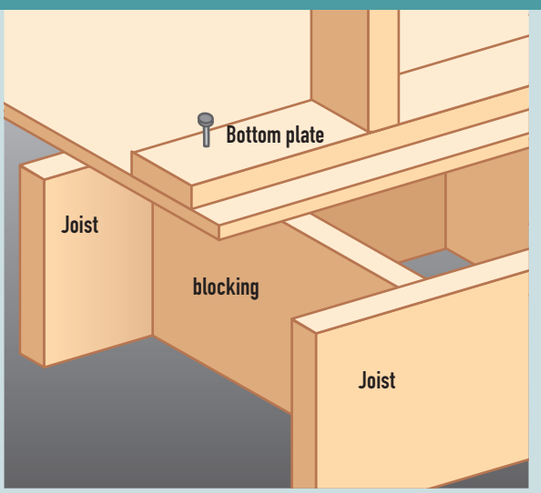
When a new wall is perpendicular to the ceiling or floor joists above, attach the top plate directly to the joists, using 16d nails.

When a new wall falls between parallel joists, install 2 × 4 blocking between the joists every 24". If the new wall is aligned with a parallel joist, install blocks on both sides of the wall, and attach the top plate to the joist (inset).

VARIATIONS FOR FASTENING BOTTOM PLATES TO JOISTS



If a new wall is aligned with a joist below, install the bottom plate directly over the joist or off-center over the joist (inset). Off-center placement allows you to nail into the joist but provides room underneath the plate for pipes or wiring to go up into the wall.



If a new wall falls between parallel joists, install 2 × 6 or larger blocking between the two joists below, spaced 24" on center. Nail the bottom plate through the subfloor and into the blocking.

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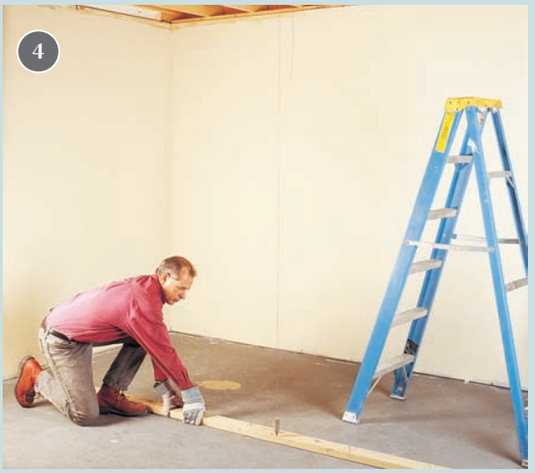
BUILDING PARTITION WALLS



1 Mark the location of the leading edge of the new wall's top plate, then snap a chalk line through the marks across the joists or blocks. Use a framing square, or take measurements, to make sure the line is perpendicular to any intersecting walls. Cut the top and bottom plates to length.

2 Set the plates together with their ends flush. Measure from the end of one plate, and make marks for the location of each stud. The first stud should fall 15 ¼" from the end; every stud thereafter should fall 16" on center. Thus, the first 4 × 8-ft. drywall panel will cover the first stud and "break" in the center of the fourth stud. Use a square to extend the marks across both plates. Draw an X at each stud location.

3 Position the top plate against the joists, aligning its leading edge with the chalk line. Attach the plate with two 16d nails driven into each joist. Start at one end, and adjust the plate as you go to keep the leading edge flush with the chalk line.

4 To position the bottom plate, hang a plumb bob from the side edge of the top plate so the point nearly touches the floor. When it hangs motionless, mark the point's location on the floor. Make plumb markings at each end of the top plate, then snap a chalk line between the marks. Position the bottom plate along the chalk line, and use the plumb bob to align the stud markings between the two plates.

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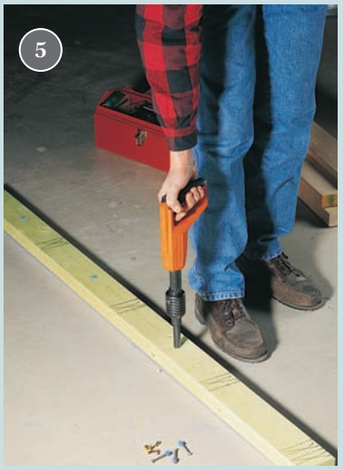
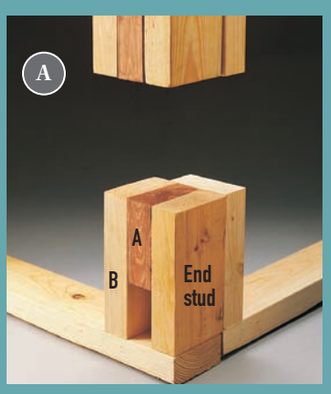


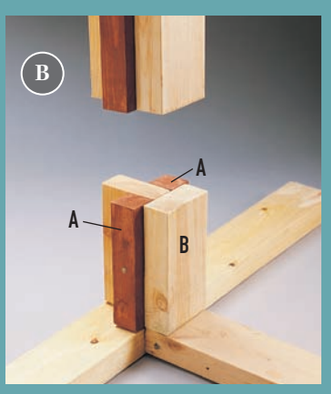
5 Fasten the bottom plate to the floor. On concrete, use a powder-actuated nailer or masonry screws, driving a pin or screw every 16". On wood floors, use 16d nails driven into the joists below.

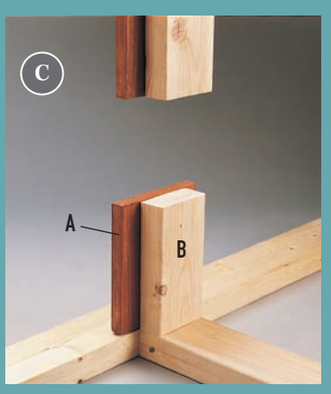
6 Measure between the plates for the length of each stud. Cut each stud so it fits snugly in place but is not so tight that it bows the joists above. If you cut a stud too short, see if it will fit somewhere else down the wall.

7 Install the studs by toenailing them at a 60° angle through the sides of the studs and into the plates. At each end, drive two 8d nails through one side of the stud and one more through the center on the other side.

Framing Corners (shown in cutaways)







A L-corners: Nail 2 × 4 spacers (A) to the inside of the end stud. Nail an extra stud (B) to the spacers. The extra stud provides a surface to attach drywall at the inside corner.

B T-corner meets stud: Fasten 2 × 2 backers (A) to each side of the side-wall stud (B). The backers provide a nailing surface for drywall.

C T-corner between studs: Fasten a 1 × 6 backer (A) to the end stud (B) with drywall screws. The backer provides a nailing surface for drywall.

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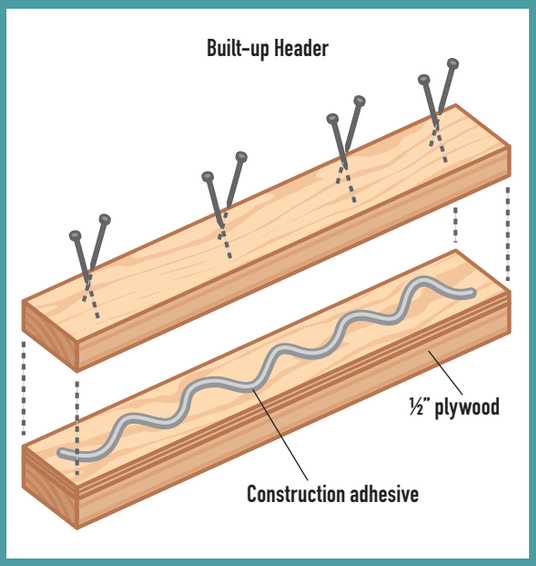
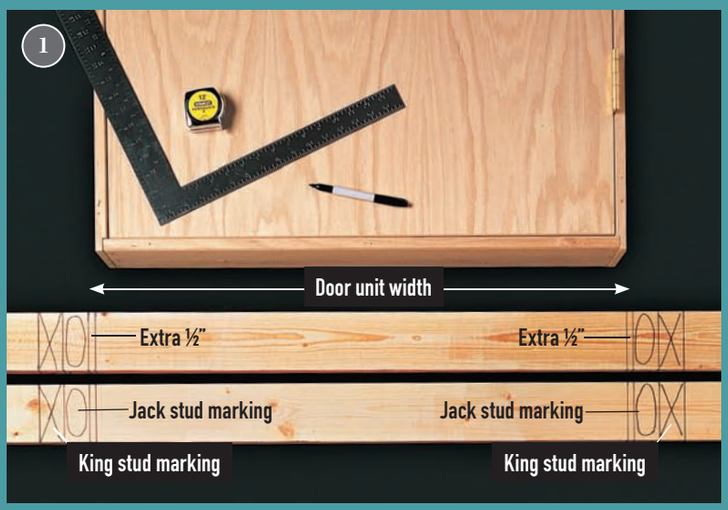
Door Frames for Prehung Doors



Door frames for prehung doors start with king studs that attach to the top and bottom plates. Inside the king studs, jack studs support the header at the top of the opening. Cripple studs continue the wall-stud layout above the opening. The dimensions of the framed opening are referred to as the rough opening.

In non-load-bearing walls, the header may be a 2 × 4 laid flat. A built-up header is constructed of two 2× pieces of lumber glued and screwed around a piece of ½" plywood.

FRAMING FOR PREHUNG DOORS



1 To mark the layout for the door frame, measure the width of the door unit along the bottom. Add 1" to this dimension to determine the width of the rough opening (the distance between the jack studs). This gives you a ½" gap on each side for adjusting the door frame during installation. Mark the top and bottom plates for the jack and king studs.

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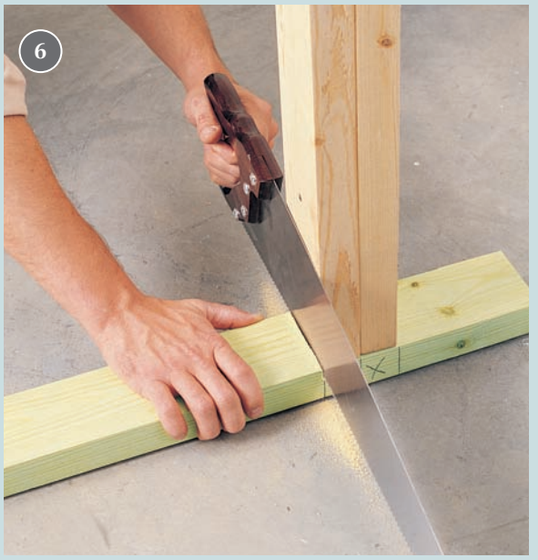

2 After you've installed the wall plates (see page 92), cut the king studs and toenail them in place at the appropriate markings.

3 Measure the full length of the door unit, then add ½" to determine the height of the rough opening. Using that dimension, measure up from the floor and mark the king studs. Cut a 2 × 4 header to fit between the king studs. Position the header flat, with its bottom face at the marks, and secure it to the king studs with 16d nails.

4 Cut and install a cripple stud above the header, centered between the king studs. Install any additional cripples required to maintain the 16" on-center layout of the standard studs in the rest of the wall.

5 Cut the jack studs to fit snugly under the header. Fasten them in place by nailing down through the header, then drive 10d nails through the faces of the jack studs and into the king studs, spaced 16" apart.

6 Saw through the bottom plate so it's flush with the inside faces of the jack studs. Remove the cut-out portion of the plate. If you're finishing the wall with drywall, hang the door after the drywall is installed.

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Framing a Window

Tools & Materials

Tape measure
Pencil
Combination square
Hammer
Level
Circular saw
Handsaw
Pry bar
Nippers
Drill
Reciprocating saw
Stapler
Nail set
Caulk gun
10d common nails
5d galvanized roofing nails
Shims
2× lumber
⅛" plywood
Building paper
Drip edge
10d galvanized casing nails
8d casing nails
Fiberglass insulation
Paintable silicone caulk

MANY WINDOWS MUST be custom-ordered several weeks in advance. To save time, you can complete the interior framing before the window unit arrives, but be sure you have the exact dimensions of the window unit before building the frame. Do not remove the outside wall surface until you have the window and accessories and are ready to install them.

Follow the manufacturer's specifications for the rough opening size when framing for a window. The listed opening usually is 1-inch wider and ½-inch taller than the actual dimensions of the window unit. The following pages show techniques for woodframe houses with platform framing.

If your house has balloon framing (built before the 1930s) consult a professional.

If your house has masonry walls or if you are installing polymer-coated windows, you may want to attach your window using masonry clips instead of nails.

Tip

Most garages don't have windows—partly for security and partly because of the expense. This is a great project for adding windows to a garage to allow natural light into your work space while building your carpentry skills.

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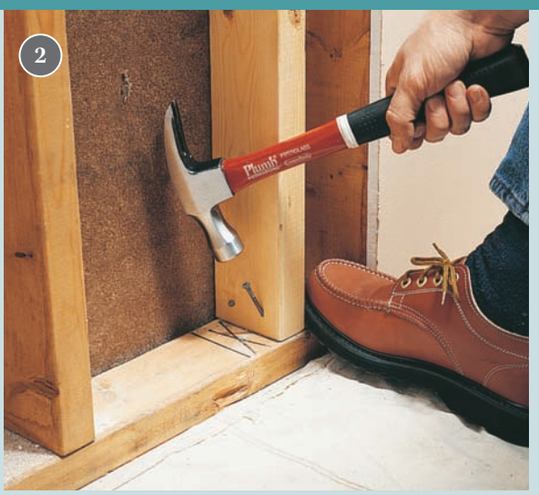
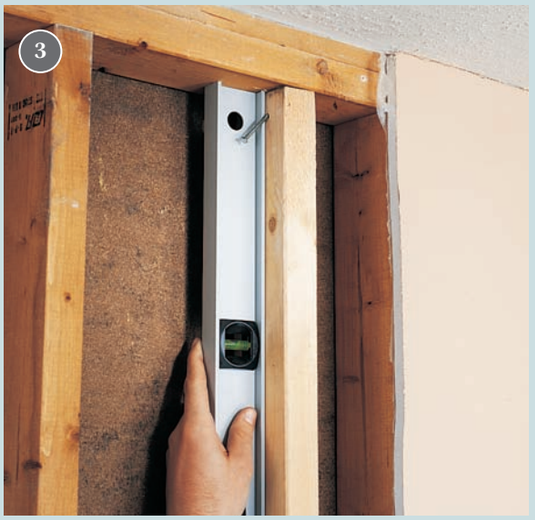
FRAMING A WINDOW OPENING





1 Prepare the project site and remove the interior wall surfaces. Measure and mark the rough opening width on the sole plate. Mark the locations of the jack studs and king studs on the sole plate. Where practical, use the existing studs as king studs.

2 Measure and cut the king studs, as needed, to fit between the sole plate and the top plate. Position the king studs and toenail them to the sole plate with 10d nails.

3 Check the king studs with a level to make sure they are plumb, then toenail them to the top plate with 10d nails.

4 Measuring from the floor, mark the top of the rough opening on one of the king studs. This line represents the bottom of the window header. For most windows, the recommended rough opening is ½" taller than the height of the window frame.

continued

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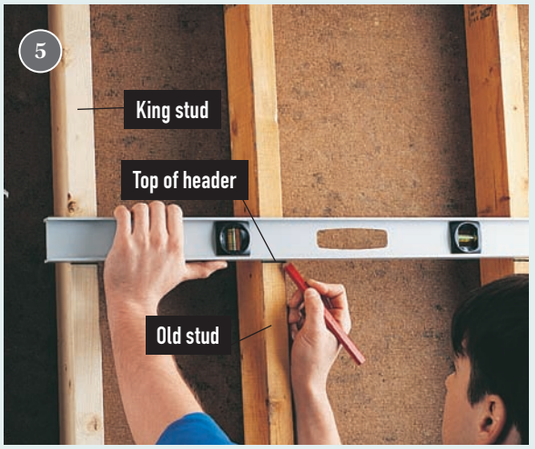

5 Measure and mark where the top of the window header will fit against the king stud. The header size depends on the distance between the king studs. Use a carpenter's level to extend the lines across the old studs to the opposite king stud.

6 Measure down from header line and mark the double rough sill on the king stud. Use a carpenter's level to extend the lines across the old studs to the opposite king stud. Make temporary supports (page xx) if removing more than one stud.

7 Set a circular saw to its maximum blade depth, then cut through the old studs along the lines marking the bottom of the rough sill and along the lines marking the top of the header. Do not cut the king studs. On each stud, make an additional cut about 3" above the sill cut. Finish the cuts with a handsaw.

8 Knock out the 3" stud sections, then tear out the old studs inside the rough opening, using a pry bar. Clip away any exposed nails, using nippers. The remaining sections of the cut studs will serve as cripple studs for the window.

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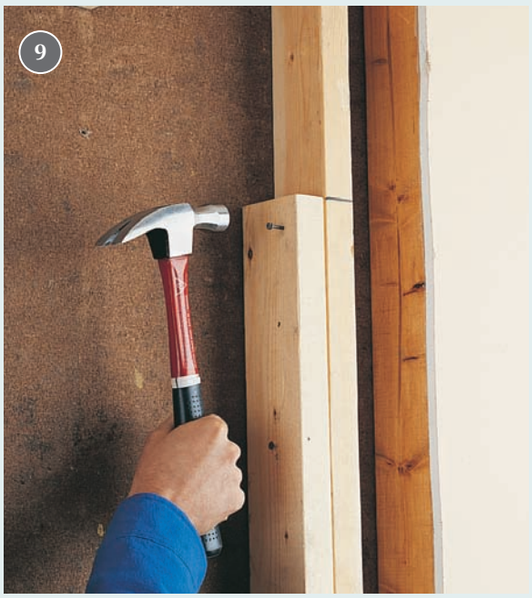

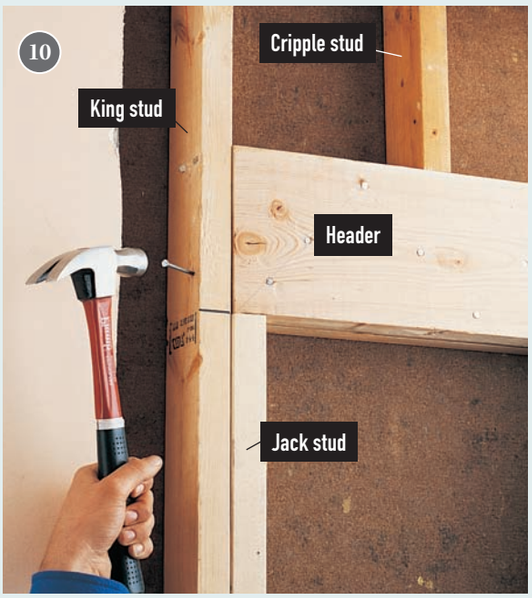

9 Cut two jack studs to reach from the top of the sole plate to the bottom header lines on the king studs. Nail the jack studs to the king studs with 10d nails driven every 12". Note: On a balloon-framed house, the jack studs will reach to the sill plate.

10 Position the header on the jack studs, using a hammer to tap it into place if necessary. Attach the header to the king studs, jack studs, and cripple studs using 10d nails.

11 Build the rough sill to reach between the jack studs by nailing a pair of 2 × 4s together. Position the rough sill on the cripple studs, and nail it to the jack studs and cripple studs with 10d nails.

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Door & Window Casings

DOOR AND WINDOW CASINGS PROVIDE AN attractive border around doors and windows. They also cover the gaps between door or window jambs and the surfaces of surrounding walls. Install door and window casings with a consistent reveal between the inside edges of the jambs and casings, making sure the casings are level and plumb.

In order to fit casings properly, the jambs and wallcovering must lie in the same plane. If either protrudes, the casings will not lie flush. To solve this problem, you'll need to remove some material from whichever surface is protruding.

Tools & Materials

- Tape measure
- Pencil
- Combination square
- Nail set
- Level
- Straightedge
- Power miter saw or miter box and backsaw
- Hammer
- Casing materials
- 4d and 6d finish nails
- Wood putty

Options for Installing Door & Window Casings

Add corner blocks, also known as rosettes, at the ends of the head casing. Attach the corner blocks once the side casings are in place, then cut the head casing to fit. Set the nails, using a nailset, after all pieces are installed.

Backband molding can dress up butted window casings. Install the back band around the perimeter of the window, mitering the joints at the corners. Nail the back band in place with 4d finish nails or pneumatic brads.

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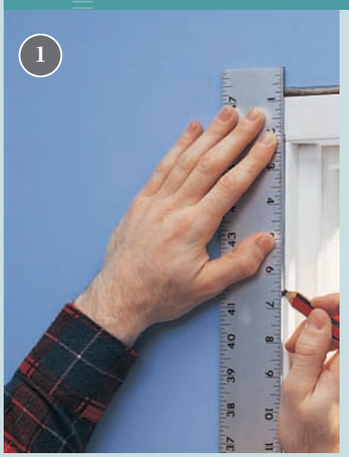
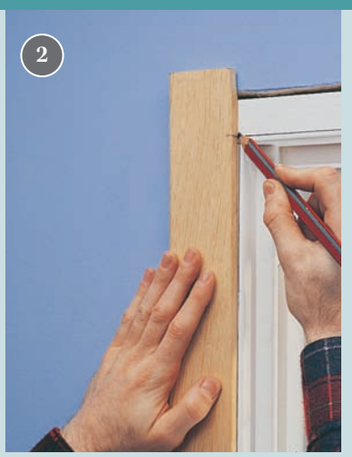
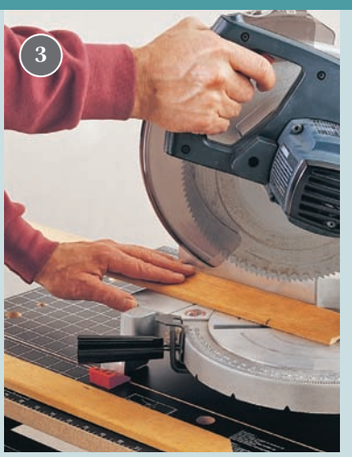
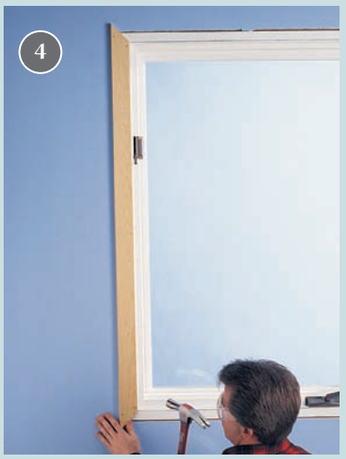
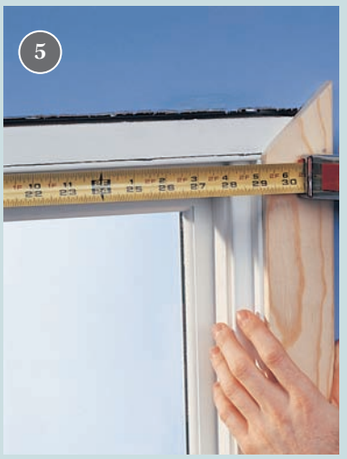
INSTALLING MITERED CASING ON DOORS & WINDOWS

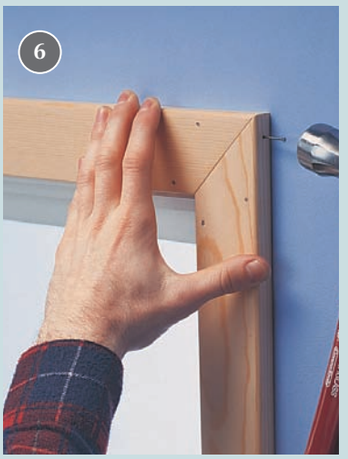












1 On each jamb, mark a reveal line ⅛" from the inside edge. The casings will be installed flush with these lines. On double-hung windows, the casings are usually installed flush with the edge of the jambs, so no reveal line is needed.

2 Place a length of casing along one side jamb, flush with the reveal line. At the top and bottom of the molding, mark the points where horizontal and vertical reveal lines meet. (When working with doors, mark the molding at the top only).

3 Make 45° miter cuts on the ends of the moldings. Measure and cut the other vertical molding piece using the same method.

4 Drill pilot holes spaced every 12" to prevent splitting, and attach the vertical casings with 4d finish nails driven through the casings and into the jambs. Drive 6d finish nails into framing members near the outside edge of the casings.

5 Measure the distance between the side casings, and cut top and bottom casings to fit, with ends mitered at 45°. If the window or door unit is not perfectly square, make test cuts on scrap pieces to find the correct angle of the joints. Drill pilot holes and attach with 4d and 6d finish nails.

6 Locknail the corner joints by drilling pilot holes and driving 4d finish nails through each corner, as shown. Drive all nail heads below the wood surface, using a nail set, then fill the nail holes with wood putty.

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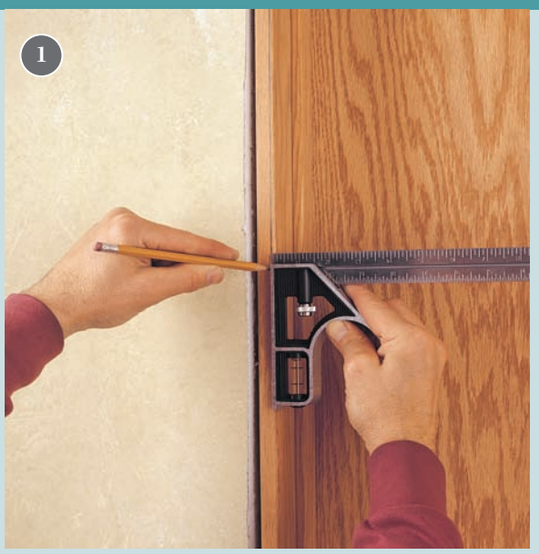
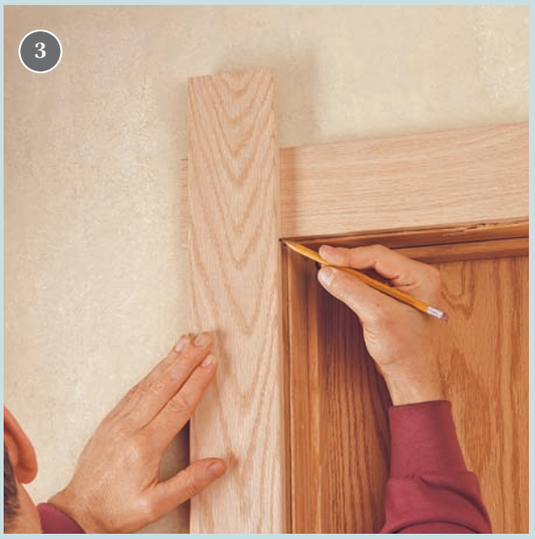
INSTALLING BUTTED DOOR CASINGS





1 On each jamb, mark a reveal line ⅛" from the inside edge. The casings will be installed flush with these lines.

2 Cut the head casing to length. Mark the centerpoint of the head casing and the centerpoint of the head jamb. Align the casing with the head jamb reveal line, matching the centerpoints so that the head casing will either align with the outer edges or extend evenly beyond both side jamb casings. Nail the casing to the wall at stud locations and at the jamb.

3 Hold the side casings against the head casing and mark them for cutting, then cut the side casings to fit.

4 Align the side casings with the side jamb reveal lines, then nail the casings to the jambs and framing members. Set the nails, using a nail set. Fill the nail holes with wood putty.

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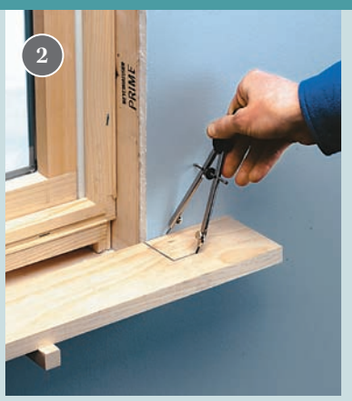
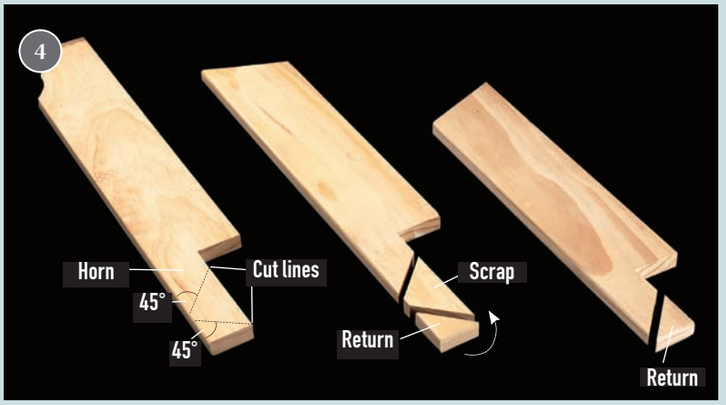
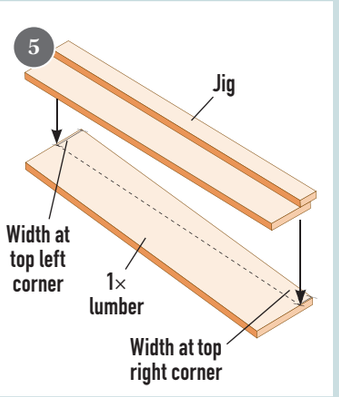
INSTALLING STOOL & APRON WINDOW TRIM







1 Cut the stool to length, with several inches at each end for creating the horn returns. With the stool centered at the window and tight against the drywall, shim it to its finished height. At each corner, measure the distance between the window frame and the stool, then mark that dimension on the stool.

2 Open a compass so it touches the wall and the tip of the rough opening mark on the stool, then scribe the plane of the wall onto the stool to complete the cutting line for the horn.

3 Cut out the notches for the horn, using a jigsaw or a sharp handsaw. Test-fit the stool, making any minor adjustments with a plane or a rasp to fit it tightly to the window and the walls.

4 To create a return at the horn of the stool, miter-cut the return pieces at 45° angles. Mark the stool at its overall length and cut it to size with 45° miter cuts. Glue the return to the mitered end of the horn so the grain wraps around the corner. Note: Use this same technique to create the returns on the apron (step 13), but make the cuts with the apron held on edge, rather than flat.

5 Where extensions are needed, cut the head extension to its finished length—the distance between the window side jambs plus the thickness of both side extensions (typically 1× stock). For the width, measure the distance between the window jamb and the finished wall at each corner, then mark the measurements on the ends of the extension. Use a straightedge to draw a reference line connecting the points. Build a simple cutting jig, as shown.

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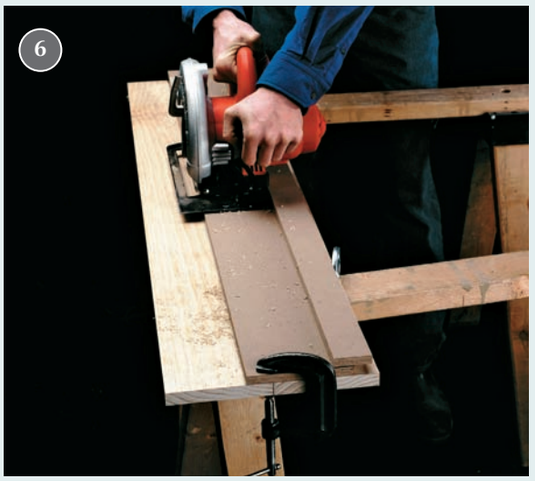

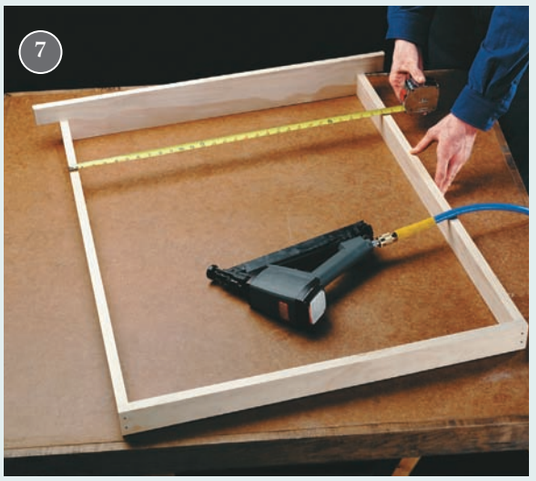

6 Clamp the jig on the reference line, then rip the extension to width using a circular saw; keep the baseplate tight against the jig and move the saw smoothly along the cut. Reposition the clamp when you near the end of the cut. Cut both side extensions to length and width, using the same technique as for the head extension (step 5).

7 Build a box frame with the extensions and stool, using 6d finish nails and a pneumatic nailer. Measure to make sure the box has the same dimensions as the window jambs. Drive nails through the top of the head extension into the side extensions and through the bottom of the stool into side extensions.

8 Apply wood glue to the back edge of the frame, then position it against the front edge of the window jambs. Use wood shims to adjust the frame, making sure pieces are flush with window jambs. Fasten the frame at each shim location, using 8d finish nails driven through pilot holes. Loosely pack insulation between framing members and extensions.

9 On the edge of each extension, mark a ¼" reveal at the corners, the middle, and the stool. Place a length of casing along the head extension, aligned with the reveal marks at the corners. Mark where the reveal marks intersect, then make 45° miter cuts at each point. Reposition the casing at the head extension, and attach using 4d finish nails at the extensions and 6d finish nails at the framing members.

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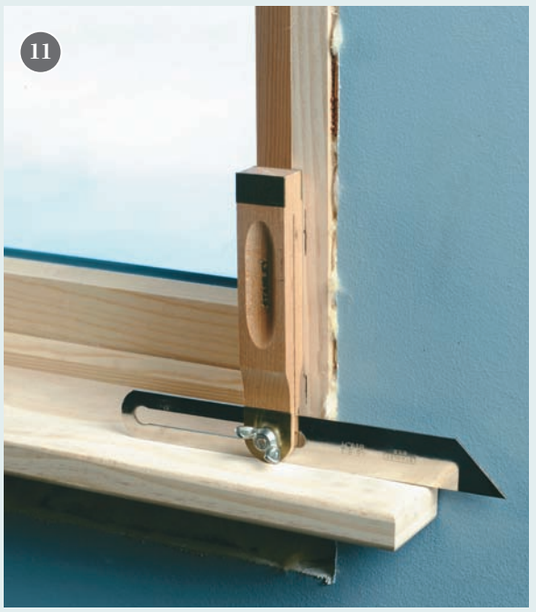

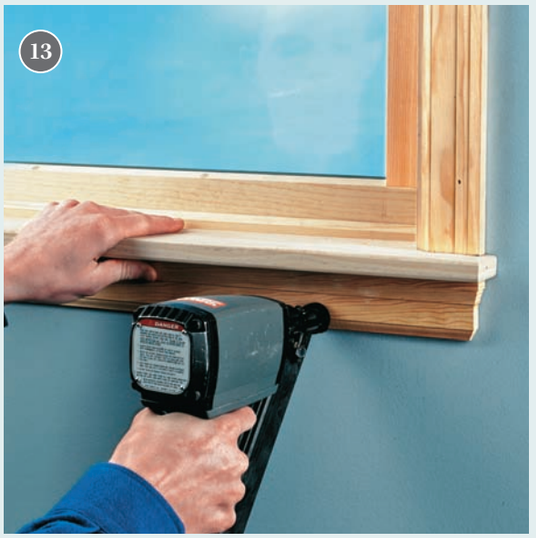

10 Cut the side casings to rough length, leaving the ends slightly long for final trimming. Miter one end at 45°. With the pointed end on the stool, mark the height of the side casing at the top edge of the head casing.

11 To get a tight fit for side casings, align one side of a T-bevel with the reveal, mark the side extension, and position the other side flush against the horn. Transfer the angle from the T-bevel to the end of the casing, and cut the casing to length.

12 Test-fit the casings, making any final adjustments with a plane or rasp. Fasten the casing with 4d finish nails at the extensions and 6d finish nails at the framing members.

13 Cut the apron to length, leaving a few inches at each end for creating the returns (step 4). Position the apron tight against the bottom edge of the stool, then attach it using 6d finish nails driven every 12".

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#175 Dtp:225 Page:105

Base Molding

BASEBOARD TRIM IS INSTALLED TO CONCEAL the joint between the finished floor and the wallcovering. It also serves to protect the drywall at the floor. Installing plain, one-piece baseboard such as ranch-style base or cove base is a straightforward project. Outside corner joints are mitered, inside corners are coped, and long runs are joined with scarf cuts.

The biggest difficulty to installing base is dealing with out-of-plumb and nonsquare corners. However, a T-bevel makes these obstacles easy to overcome.

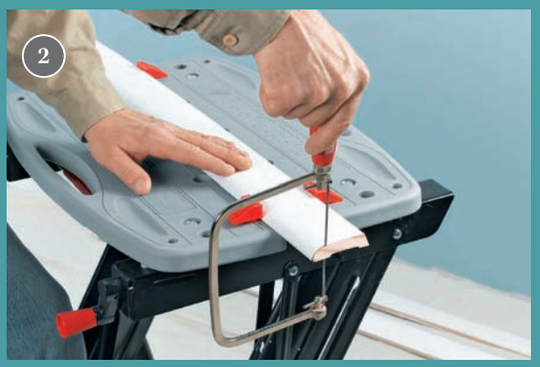
Plan the order of your installation prior to cutting any pieces and lay out a specific piece for each length of wall. It may be helpful to mark the type of cut on the back of each piece so you don't have any confusion during the install.

Locate all studs and mark them with painter's tape 6 inches higher than your molding height. If you need to make any scarf joints along a wall, make sure they fall on the center of a stud. Before you begin nailing trim in place, take the time to pre-finish the moldings. Doing so will minimize the cleanup afterward.

Tools & Materials

- Pencil
- Tape measure
- Power miter saw
- T-bevel
- Coping saw
- Metal file set
- Pneumatic finish nail gun & compressor
- Moldings
- Pneumatic fasteners
- Carpenter's glue
- Finishing putty

INSTALLING ONE-PIECE BASE MOLDING



1 Measure, cut, and install the first piece of baseboard. Butt both ends into the corners tightly. For longer lengths, it is a good idea to cut the piece slightly oversized (up to 1/16" on strips over 10 ft. long) and "spring" it into place. Nail the molding in place with two nails at every stud location.

2 Cut the second piece of molding oversized by 6" to 10" and cope-cut the adjoining end to the first piece. Fine-tune the cope with a metal file and sandpaper. Dry-fit the joint, adjusting it as necessary to produce a tight-fitting joint.

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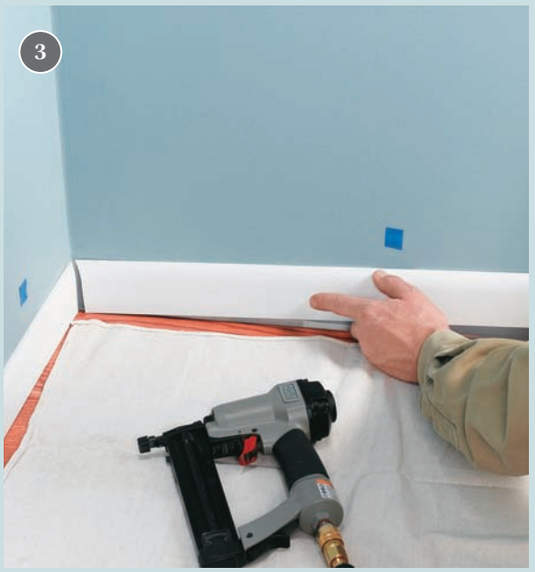

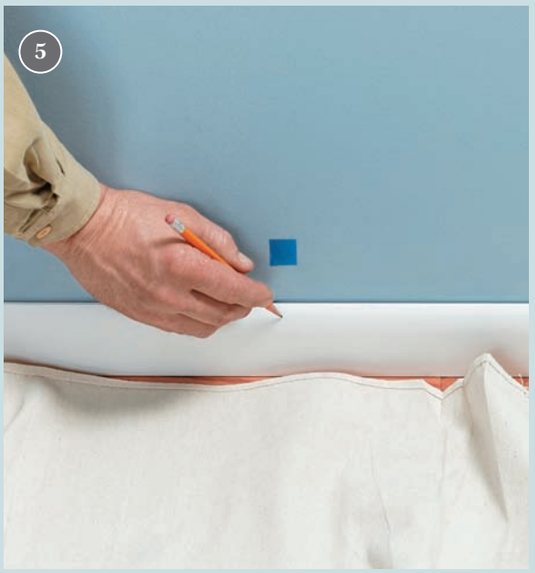

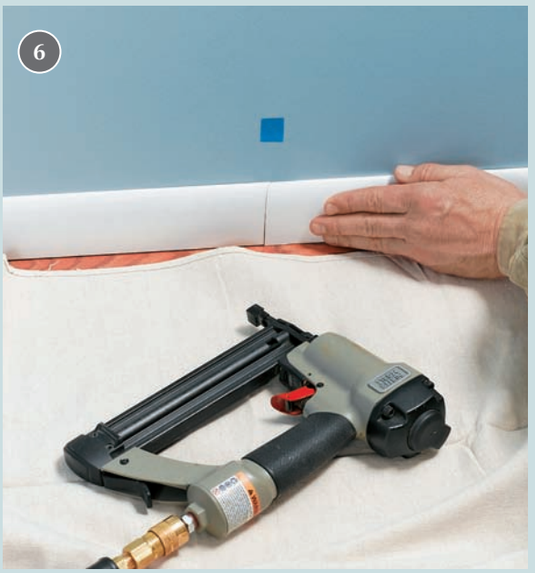

3 Check the corner for square with a framing square. If necessary, adjust the miter cut of your saw. Use a T-bevel to transfer the proper angle. Cut the second piece (coped) to length and install it with two nails at each stud location.

4 Adjust the miter angle of your saw to cut the adjoining outside corner piece (3). Test-fit the cut to ensure a tight joint (inset photo). Remove the mating piece of trim and fasten the first piece for the outside corner joint.

5 Lay out any scarf joints by placing the piece in position so that the previous joint is tight and then marking the center of a stud location nearest the opposite end. Set the angle of your saw to a 30° angle and cut the molding at the marked location.

6 Nail the third piece in place, making sure the outside corner joint is tight. Cut the end of the fourth piece to match the scarf joint angle and nail it in place with two nails at each stud location. Add the remaining pieces of molding, fill the nail holes with putty, and apply a final coat of finish.

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(Fogra 39)Job:04-30427 Title:MBI-HomeSkills Carpentry
#175 Dtp:225 Page:107

WORKSHOPS

Storage Strategies..... 110

Pegboard..... 114

Sawhorses..... 118

Workbench..... 120

096-128_30427.indd 108 4/10/13 4:32 PM
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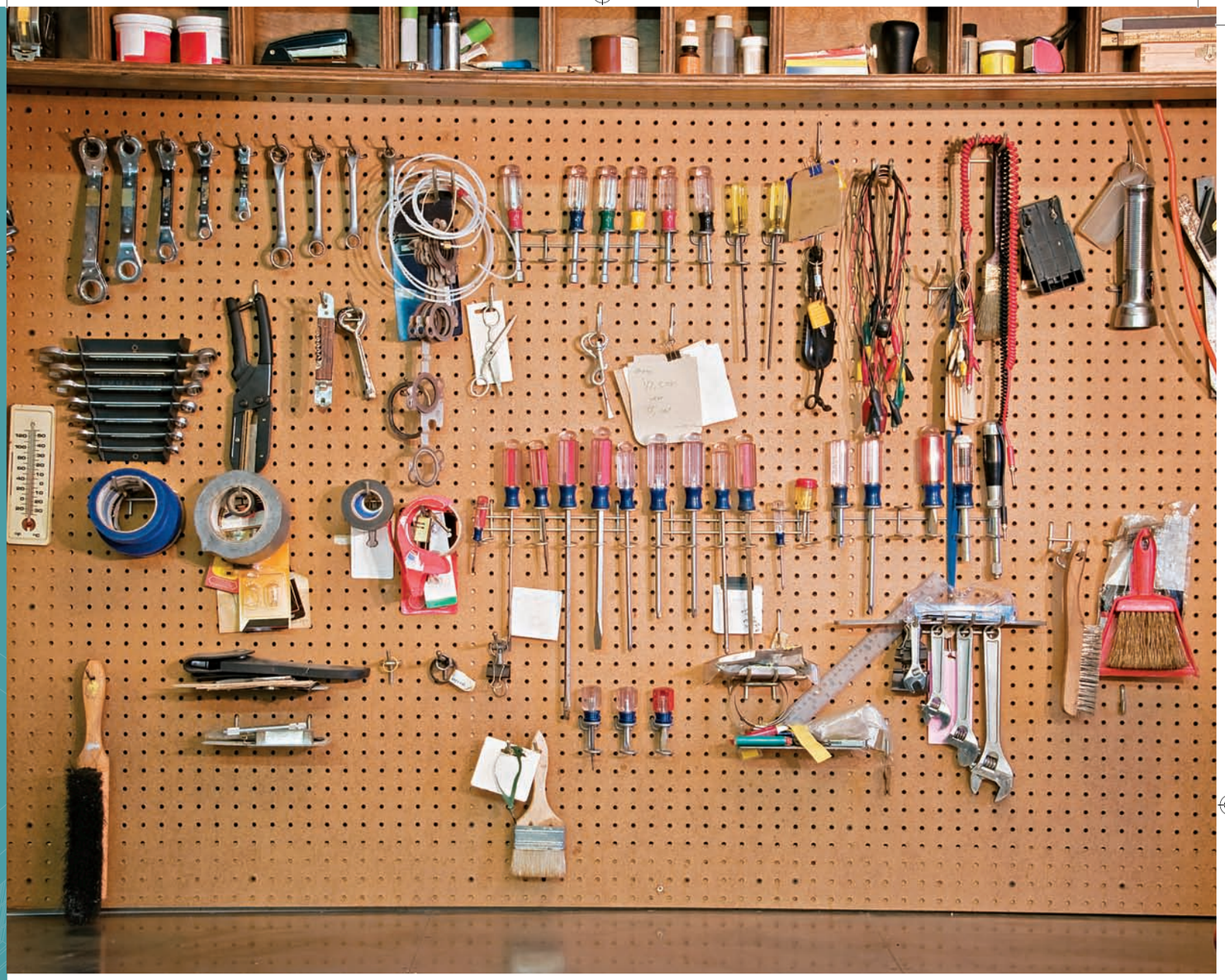

ONCE YOU BEGIN to acquire tools and materials for carpentry projects, you will find that organization is a must. Lumber and sheet goods are bulky, and you will probably have leftover pieces that you want to keep—but where? This section gives you pointers on where and how.

Using pegboard is a classic way of organizing that still works great as an infinitely adjustable storage system. Nicely framed pegboard will enhance any shop space.

Work surfaces are also important. A pair of heavy duty sawhorses and a piece of plywood make a great temporary table. Directions for building the sawhorses are included, and are a good practice project for developing your new carpentry skills.

A sturdy workbench, if you have the room, is a complement to any garage or basement. Plans for a sturdy, durable, and simple to build workbench are included.

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#175 Dtp:225 Page:109

STORAGE STRATEGIES

Your stored tools and supplies should be well organized, easy to access, and out of the way. This is the best way to ensure your work surfaces are clean and ready for the next phase of a project. Depending on the type of work you do, you'll probably need plenty of open space to facilitate large projects as needed, or to temporarily reconfigure the shop to accommodate materials that need to be cut down to a manageable size, etc. If this requires the use of shared spaces—for example, making room in the garage by pulling the car into the driveway—it helps to have tools and work surfaces that are easily moved or can be set up and knocked down quickly.

Here are some of the key strategies that help make an integrated shop work with its surroundings:

For storage, think volume, not just floor space. Shelving units that rise from floor to ceiling make better use of floor space than shelves that stop at a convenient, reachable height. The upper shelves can be filled with seldom-used items. Also look for opportunities where overhead storage can help keep the floor area and work surfaces clear. Open stud cavities in an unfinished garage or utility room offer free space for small shelves or long, thin material stored on end.

For work that involves multiple stages or tool operations, plan for mobility and adaptability. Work benches, materials racks, and even large stationary tools can be outfitted with heavy-duty locking casters so you can roll them out when you need them and roll them back when you're done. You can build your own caster bases or shop around for compatible manufactured versions. Some power tools are designed for use with specific portable bases or come with their own folding stands, so check with the manufacturers of your tools.

Plan workstations for double duty: a permanent bench or work table is already taking up floor space, so why not use the space above and below for storage? For example, a lumber rack above a saw table makes it easy to grab stock as you go. Rolling carts or pull-out bins and drawers beneath a bench can hold other tools plus blades or bits for the station's main tool. Small woodworking shops can save space by combining a saw table or extension wing with a router table.

Consider using outdoor spaces for work and storage. Rolling tool bases and portable workstations simplify setup outdoors. Cutting sheet goods (especially MDF and particleboard) outdoors helps keep dust down in garage shops and simplifies transport of materials into basement workspaces. A simple lean-to shed built against the back wall of the house or garage is a great way to keep materials out of the elements and out of the way. A permanent outdoor workbench made with weather-resistant materials is handy for rough-cutting materials or finishing projects in nice weather. Here are some other tips for saving space in a small shop:

- Cover garage or basement walls with plywood for hanging tools, bins, or cabinets wherever you need them. Paint the plywood a light color for better light reflection.
- Store lumber, sheet goods, and other large materials on a rolling cart or rack for easy access and to facilitate unloading and transport from your vehicle.
- Build custom cubbies or shelving for storing frequently used equipment, like portable power tools, without their bulky cases. Incorporate tote-away boxes or sliding trays for blades, bits, and accessories.
- Keep a trash barrel or bin underneath one or both ends of workstations for discarding scrap material as you work.
- In a basement shop, store clamps and similar devices by clamping them to the floor joists above (secure bar clamps to only one joist; clamping across joists can pull them together, thus releasing other clamps)
- For a lightweight, portable work table, use a hollow-core door finished with polyurethane (or other varnish) laid over foldup metal sawhorses.

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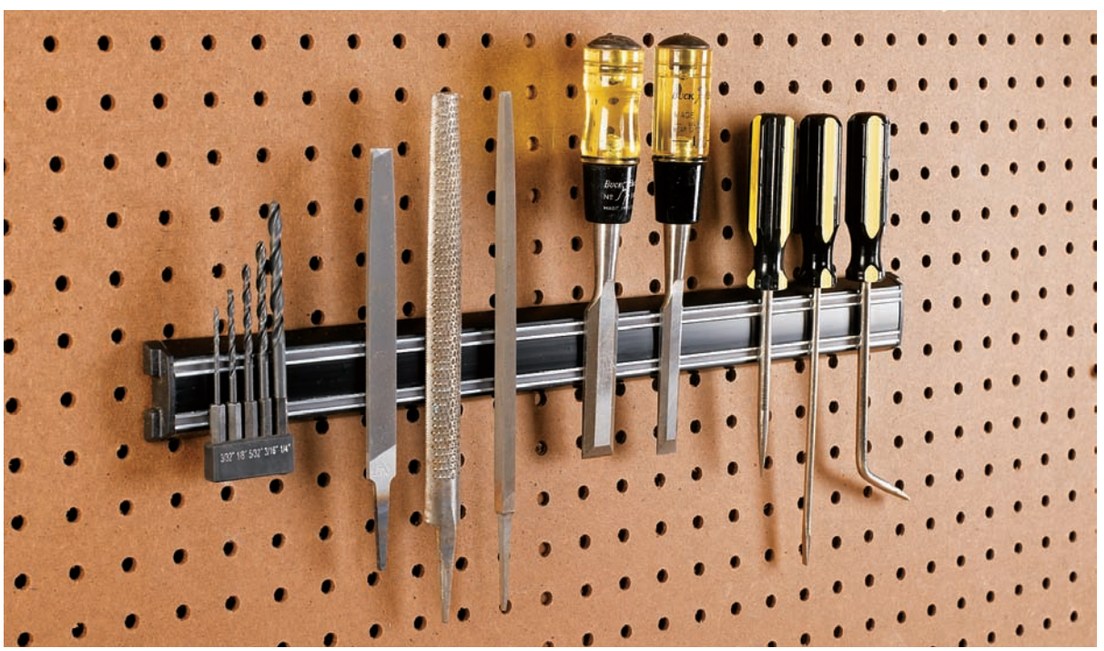
#175 Dtp:225 Page:110

A utility shop. This compact shop area was made with inexpensive utility cabinets and a plywood work top.

You can build this space-saving lumber rack with a few 2 × 4 studs and some steel pipe: drill matching holes in all of the studs, then fasten one to the side of every other garage-wall stud. Add a plywood shelf or two for storing small pieces. Don't use garage wall studs as the pipe supports; the holes would weaken the studs too much.



Magnetic bar strips, typically used for holding knives in the kitchen, are just as handy for storing chisels, files, awls, and other metal tools in the workshop.

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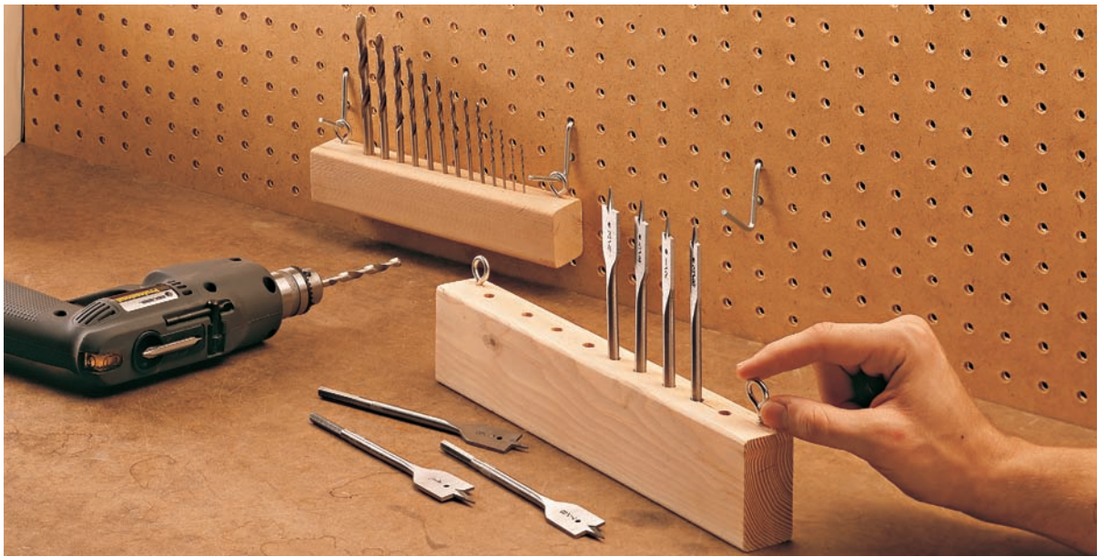
(Fogra 39)Job:04-30427 Title:MBI-HomeSkills Carpentry
#175 Dtp:225 Page:111

Lengths of plastic plumbing pipe or cardboard carpet-roll tubes make a safe and handy home for dowels, rods, and fine trim pieces. Gang the cylinders together with strapping or duct tape to create a freestanding storage unit.

Build a Bench Buddy. Create more storage space by attaching pieces of pegboard to the sides of the workbench with drywall screws and finish washers.



Metal drill and router bits have finely honed cutting edges that can be ruined if the bits bump against each other inside a toolbox or workbench drawer. To protect tool bits from damage, make a storage block by boring holes in a scrap piece of lumber. Attach screw eyes to the top of the block so it can be stored on pegboard hooks and taken down when a bit is needed.

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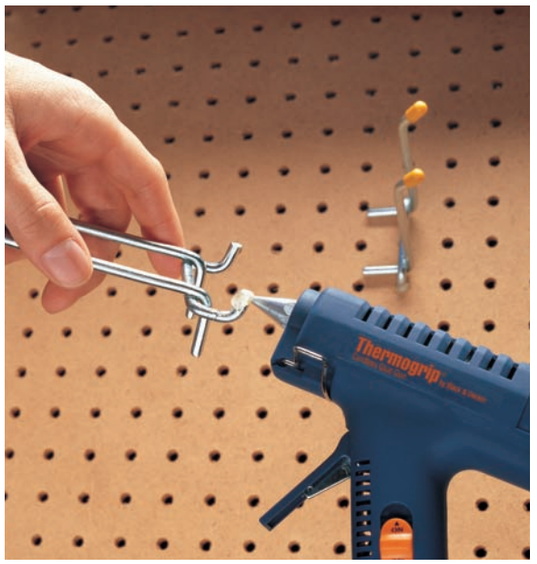
Add storage space in an unfinished utility area by covering the studs with panels of pegboard. These panels are ideal for storing drywall framing squares, levels, garden tools, and other large items.



Pegboard hooks frequently fall out when an item is removed. End this aggravating problem by gluing the hooks to the pegboard with a hot glue gun. If you need to reposition the pegboard hooks, heat them for a few seconds with a heat gun until the glue softens.

Store long materials in the space between open ceiling joists in an unfinished utility area. Attach ¾" plywood furring strips across the joists with 2½" drywall screws or lag screws. Space the strips no more than 36" apart to provide adequate support. Make sure to avoid any electrical cables or fixtures located between the ceiling joists. Some homeowners attach boards across the bottom of the ceiling joists to make out-of-the-way storage shelves for small cans and other shop items.

Skillbuilder

Use leftover pieces of plywood or 1" lumber to build sturdy storage boxes for heavy hardware. Assemble the boxes with 1¼" drywall screws and glue. Try to build each box the exact same size. Organize the storage boxes on utility shelves for easy access. If you wish, attach metal handles to the boxes.

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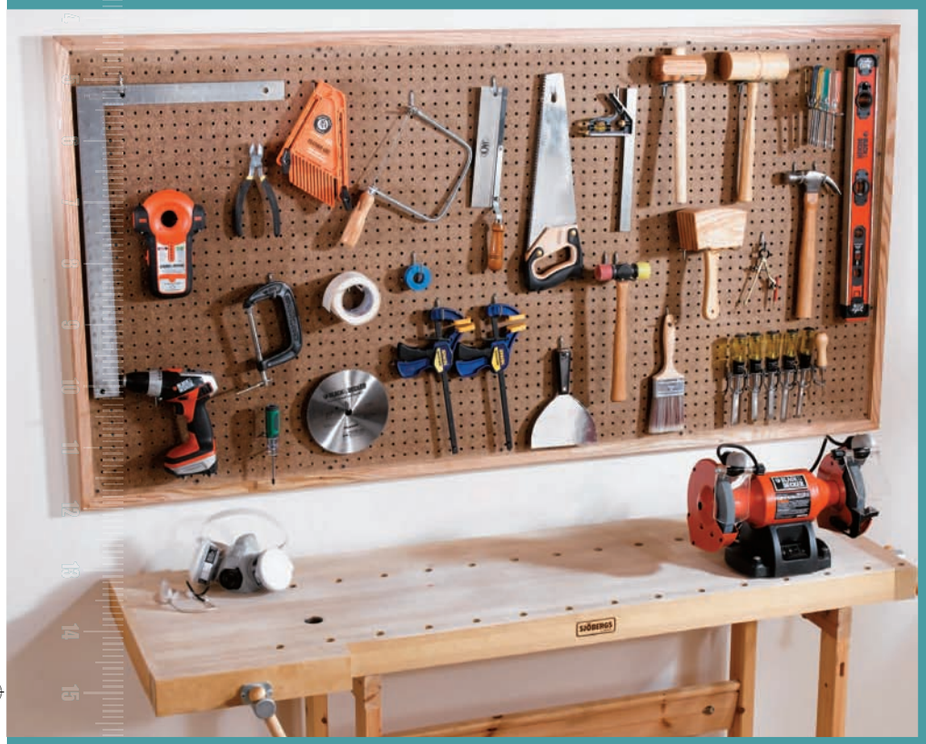
#175 Dtp:225 Page:113

Pegboard



Tools & Materials

- Work gloves
- Eye protection
- Tape measure
- Level
- Circular saw or jigsaw
- Drill with bits
- Stud finder
- Clamps
- 1 × 2" furring strips
- Caulk gun
- Drywall screws (1", 2½")
- Panel adhesive
- Picture frame molding (optional)
- Paint roller
- Varnish or primer and paint
- Pegboard

Pegboard systems are classic storage solutions for garages and other utility areas. Outfitted with a variety of hangers, they offer flexibility and convenience when used to store hand tools and other small shop items.

PEGBOARD, ALSO CALLED perforated hardboard or perfboard, is one of the simplest and least expensive storage solutions for hanging tools and other lightweight objects. When mounted to the wall and outfitted with metal hooks, pegboard provides a convenient way to keep items from getting lost in the back of a drawer or the bottom of a tool chest. Pegboard also makes it easy to change the arrangement or collection of your wall-hung items, because you can reposition the metal hooks any way you like without measuring, drilling holes, or hammering nails into the wall. In fact, pegboard has served as a low-cost storage option for so long that there are a multitude of different hooks and brackets you can buy to accommodate nearly anything you want to hang. Any home center will carry both the pegboard and the hooks.

You need to install pegboard correctly to get the most value from it. If your garage walls have exposed studs, you can simply screw pegboard to the studs. The empty bays between the studs will provide the necessary clearance for inserting the hooks. On a finished wall, however, you'll need to install a framework of furring strips behind the pegboard to create the necessary clearance and provide some added stiffness. It's also a good idea to build a frame around your pegboard to give the project a neat, finished appearance.

If your garage tends to be damp, seal both faces of the pegboard with several coats of varnish or primer and exterior paint; otherwise it will absorb moisture and swell up or even delaminate.

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#175 Dtp:225 Page:114

PEGBOARD & HANGER HARDWARE STYLES

Hanger hardware comes in many shapes and sizes, from the basic J for hanging a single tool to double-prong hangers for hammers and even shelf standards. You can buy assorted hangers in kits or stock up on the type you're likely to use the most.

Two common thicknesses for pegboard hangers are ⅛"-dia. and 3⁄16"-dia., both of which fit into standard pegboard hole configurations. The thicker the hanger, the more it can handle. Both types rely on the mechanical connection with the pegboard and can fail if the holes in the board become elongated. The pegboard must have furring strips on the back side to create a recess for the hangers.

Pegboard is a single-purpose sheet good material. It is used to create a wall surface with storage functionality (occasionally it may be used as a cabinet back where ventilation is desired). Although it comes in ⅛"-thick panels, avoid them in favor of ¼" thick material. Most larger home centers carry it unfinished and in prefinished white. Wood grain and other decorative panels can be found, and you can also buy metal pegboard panels. The standard size holes are ¼" dia. and spaced in a 1" on center grid.

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#175 Dtp:225 Page:115

INSTALLING A PEGBOARD STORAGE SYSTEM

1 Cut your pegboard panel to size if you are not installing a full sheet (most building centers sell 2 × 4 ft. and 4 × 4 ft. panels in addition to the standard 4 × 8 ft.) If you are cutting with a circular saw, orient the panel face up to prevent tearout on the higher-grade face. If cutting with a jigsaw, the good face of the panel should be down. If possible, plan your cuts so there is an even amount of distance from the holes to all edges.

2 Cut 1 × 2 furring strips to make a frame that is attached to the back side of the pegboard panel. The outside edges of the furring strips should be flush with the edges of the pegboard. Because they will be visible, cut the frame parts so the two side edge strips run the full height of the panel (36" here). Cut a couple of filler strips to fill in between the top and bottom rails.

3 Attach the furring strips to the back of the panel using 1" drywall screws and panel adhesive. Drive the screws through countersunk pilot holes in the panel face. Do not drive screws through the predrilled pegboard holes. Use intermediate furring strips to fill in between the top and bottom. These may be fastened with panel adhesive alone.

Option

Make a frame from picture frame molding and wrap it around the pegboard to conceal the edge grain and the furring strips. If you can't find picture frame molding with the correct dimensions, mill your own molding by cutting a ⅜"-wide by 1"-deep rabbet into one face of 1 × 2 stock.

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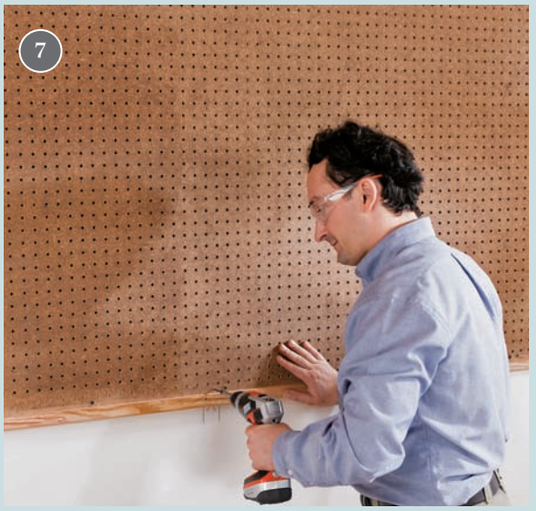
(Fogra 39)Job:04-30427 Title:MBI-HomeSkills Carpentry
#175 Dtp:225 Page:116



4 Paint or top coat the pegboard. You can leave the pegboard unfinished, if you prefer, but a coat of paint or varnish protects the composite material from nicks and dings and hardens it around the hole openings so the holes are less likely to become elongated. A paint roller and short-nap sleeve make quick work of the job.

5 Locate and mark wall studs if your garage wall has a wall covering. Make sure the marks extend above and below the pegboard location so you can see them once the pegboard is positioned on the wall.

6 Tack the pegboard and frame to the wall in the desired location. Drive one 2½" screw partway through the top frame at the center of the pegboard. Place a long level on the top of the pegboard and adjust it to level using the screw as a pivot point.

7 Drive a drywall screw through the top and bottom frame rails at each wall stud location. Drill countersunk pilot holes first. Double-check for level after driving the first screw. Insert hangers as desired.

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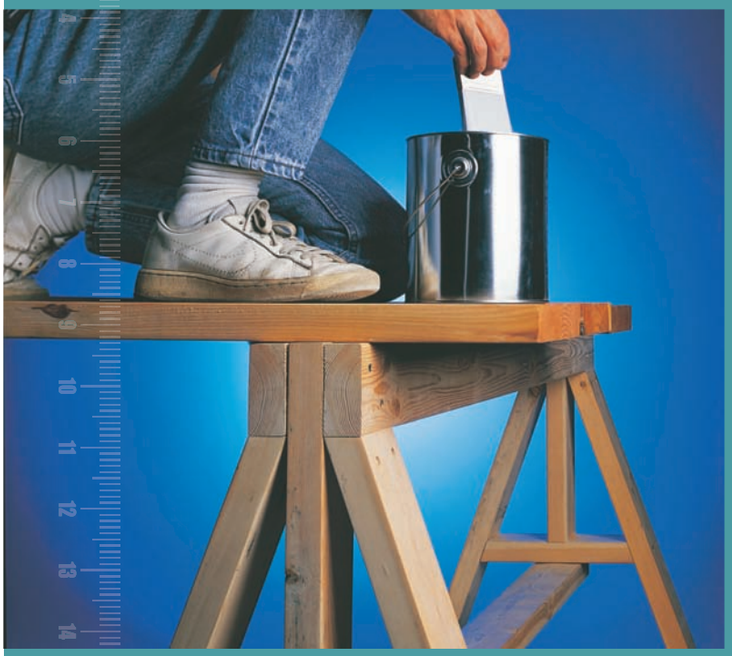
(Fogra 39)Job:04-30427 Title:MBI-HomeSkills Carpentry
#175 Dtp:225 Page:117

Sawhorses



For scaffolding, place straight 2 × 10s or 2 × 12s across a pair of heavy-duty sawhorses.

Tools & Materials (for one sawhorse)

Circular saw
Tape measure
Screw gun or cordless screwdriver
(4) 8-ft. 2 × 4s
2½" drywall screws
(2) Vertical braces, 15 ½"
(2) Top rails, 48"
(1) Bottom brace, 48"
(2) Horizontal braces, 11 ¼"
(4) Legs, 26"

SAWHORSES PROVIDE a stable work surface to support materials during marking and cutting. They can also form the base for temporary scaffolding to use while installing drywall or ceiling panels. A wide top is best for supporting large loads. Small break-down sawhorses are a good choice if storage space is limited.

Easy-storing Sawhorse Options

Light-duty metal sawhorses can be folded and hung on the workshop wall when they are not in use.

Buy brackets made from fiberglass or metal, and cut a 48" top rail and four 26" legs from 2 × 4s. Disassemble sawhorses for storage.

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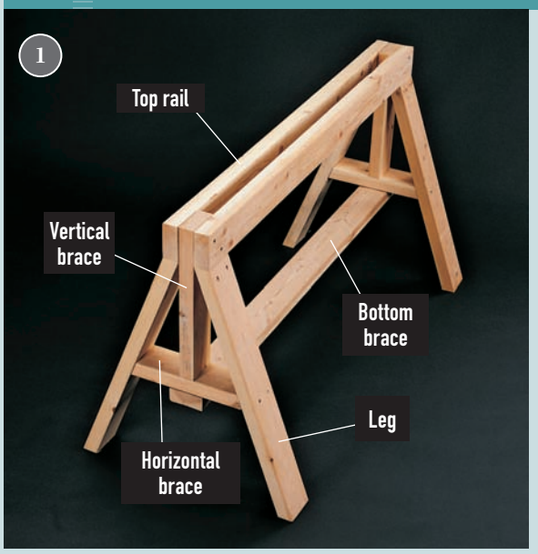
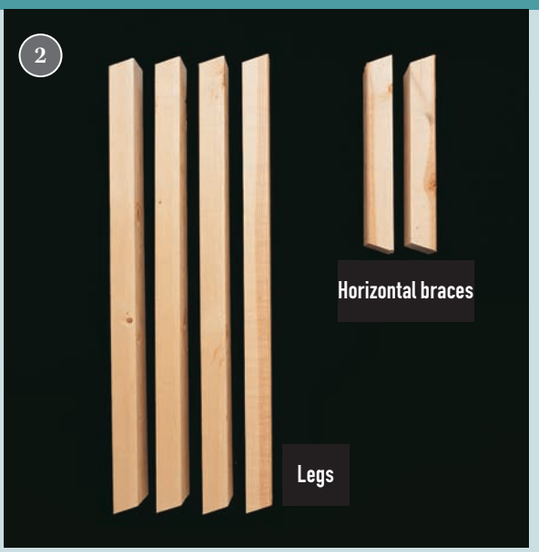
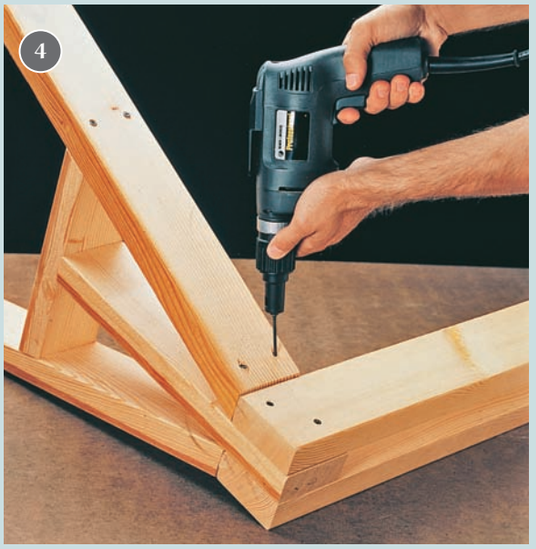
#175 Dtp:225 Page:118

BUILDING A HEAVY-DUTY SAWHORSE







1 Measure and cut the vertical braces, top rails, and bottom brace to the lengths specified in the Material List (opposite page) using a tape measure and a circular saw.

2 Set a circular or miter saw to a 17° bevel angle. (Bevel cuts will match the angle shown above.) Cut the ends of the horizontal braces with opposing angles. Cut the ends of the legs with similar angles.

3 Attach the top rails to the vertical braces, as shown, using 2½" drywall screws.

4 Attach the horizontal braces to the vertical braces, using 2½" drywall screws. Attach a pair of legs to the horizontal braces and then to the brace at each end. Complete the sawhorse by attaching the bottom brace to the horizontal braces.

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(Fogra 39)Job:04-30427 Title:MBI-HomeSkills Carpentry
#175 Dtp:225 Page:119

Workbench

THIS WORKBENCH has heavy-duty legs to support big loads and a sturdy double-layer top to withstand pounding. Cover the top with a hardboard surface that can be removed when it becomes damaged. Build a shelf below the work surface for storing power tools. If desired, mount an all-purpose vise on top of the workbench.

Tools & Materials

- Circular saw
- Carpenter's square
- Drill and bits, including screwdriver bits
- Ratchet or adjustable wrench
- Hammer
- Nail set
- Drywall screws (1⅝", 2½", and 3")
- Lag screws (1½" and 3")
- 4d finish nails
- (6) 8-ft. 2 x 4s
- (1) 5-ft. 2 x 6
- (1) 4 x 8-ft. sheet of ¾" plywood
- (1) 4 x 8-ft. sheet of ½" plywood
- (1) 4 x 8-ft. sheet of ⅛" hardboard

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WORKBENCH CUTTING DIAGRAM

Cutting List

Key	Pieces	Size and Description
A	1	⅛" hardboard top, 24 × 60"
B	2	¾" plywood top, 24 × 60"
C	4	2 × 4 crosspieces, 21"
D	4	2 × 4 legs, 19 ¾"
E	4	2 × 4 legs, 34 ½"
F	4	2 × 4 legs, 7 ¾"

Key	Pieces	Size and Description
G	3	2 × 4 braces, 54"
H	1	2 x 6 front (top) brace, 57"
I	1	½" plywood shelf, 14 × 57"
J	1	½" plywood shelf back, 19 ¼" × 57"
K	1	1 × 4 backstop, 60"

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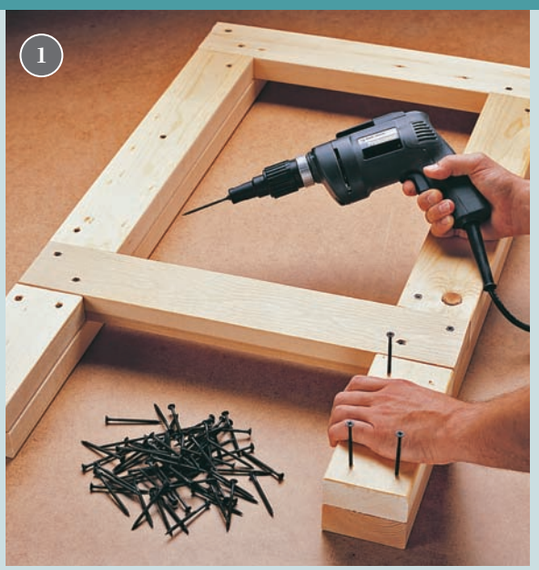
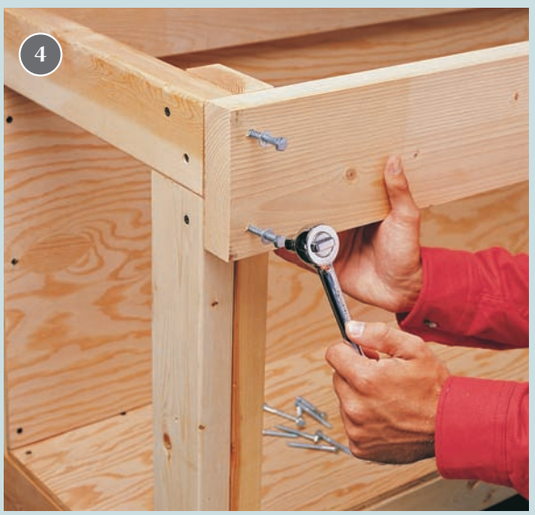
#175 Dtp:225 Page:121

BUILDING A WORKBENCH





1 Cut two pieces of C, D, E, and F for each end of the bench. Assemble them with 2½" drywall screws.

2 Attach both 2 × 4 rear braces (G) inside the back legs of the assembled ends using 2½" drywall screws.

3 Attach the 2 × 4 front lower brace (G) inside the front legs of the assembled ends. Secure the bottom shelf (I) and workbench back (J) to the assembled 2 × 4 frame using 2½" drywall screws.

4 Drill pilot holes and join the 2 × 6 front upper brace (H) outside the front legs with 3" lag screws.

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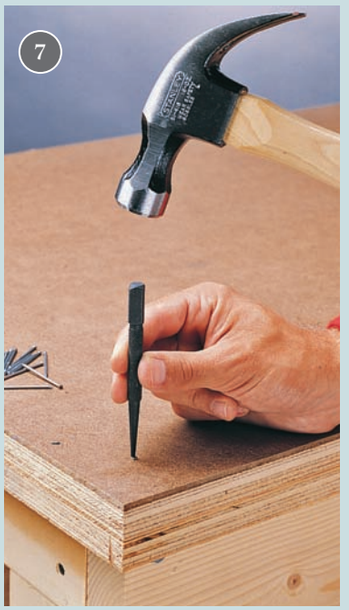
(Fogra 39)Job:04-30427 Title:MBI-HomeSkills Carpentry
#175 Dtp:225 Page:122



5 Center the bottom layer of the ¾" plywood work surface (B) on top of the frame. Align the plywood with the back edge, draw a reference line for driving the nails, and fasten it in place with 4d nails.

6 Align the bottom and top layers of the plywood work surface (B), and draw a reference line at least ½" closer to the edge to avoid the nails in the first layer. Drive 3" drywall screws through both layers and into the bench frame.

7 Nail the hardboard work surface (A) to the plywood substrate with 4d finish nails. Set the nails below the surface.

8 Position the vise at one end of the bench. On the bench top, mark holes for the vise base. Bore ¼" pilot holes into the bench top.

9 Attach the vise with 1½" lag screws. Attach the backstop (K) to the back of the bench top with 2½" drywall screws.

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(Fogra 39)Job:04-30427 Title:MBI-HomeSkills Carpentry
#175 Dtp:225 Page:123

Reference Charts

Metric Equivalent

Inches (in.)	1/64	1/32	1/25	1/16	1/8	1/4	3/8	2/5	1/2	5/8	3/4	7/8	1	2	3	4	5	6	7	8	9	10	11	12	36	39.4
Feet (ft.)																								1	3	3 1/12
Yards (yd.)																									1	1 1/12
Millimeters (mm)	0.40	0.79	1	1.59	3.18	6.35	9.53	10	12.7	15.9	19.1	22.2	25.4	50.8	76.2	101.6	127	152	178	203	229	254	279	305	914	1,000
Centimeters (cm)							0.95	1	1.27	1.59	1.91	2.22	2.54	5.08	7.62	10.16	12.7	15.2	17.8	20.3	22.9	25.4	27.9	30.5	91.4	100
Meters (m)																								.30	.91	1.00

Converting Measurements

To Convert:	To:	Multiply by:
Inches	Millimeters	25.4
Inches	Centimeters	2.54
Feet	Meters	0.305
Yards	Meters	0.914
Miles	Kilometers	1.609
Square inches	Square centimeters	6.45
Square feet	Square meters	0.093
Square yards	Square meters	0.836
Cubic inches	Cubic centimeters	16.4
Cubic feet	Cubic meters	0.0283
Cubic yards	Cubic meters	0.765
Pints (U.S.)	Liters	0.473 (Imp. 0.568)
Quarts (U.S.)	Liters	0.946 (Imp. 1.136)
Gallons (U.S.)	Liters	3.785 (Imp. 4.546)
Ounces	Grams	28.4
Pounds	Kilograms	0.454
Tons	Metric tons	0.907

To Convert:	To:	Multiply by:
Millimeters	Inches	0.039
Centimeters	Inches	0.394
Meters	Feet	3.28
Meters	Yards	1.09
Kilometers	Miles	0.621
Square centimeters	Square inches	0.155
Square meters	Square feet	10.8
Square meters	Square yards	1.2
Cubic centimeters	Cubic inches	0.061
Cubic meters	Cubic feet	35.3
Cubic meters	Cubic yards	1.31
Liters	Pints (U.S.)	2.114 (Imp. 1.76)
Liters	Quarts (U.S.)	1.057 (Imp. 0.88)
Liters	Gallons (U.S.)	0.264 (Imp. 0.22)
Grams	Ounces	0.035
Kilograms	Pounds	2.2
Metric tons	Tons	1.1

Liquid Measurement Equivalents

1 Pint	= 16 Fluid Ounces	= 2 Cups
1 Quart	= 32 Fluid Ounces	= 2 Pints
1 Gallon	= 128 Fluid Ounces	= 4 Quarts

Metric Plywood Panels

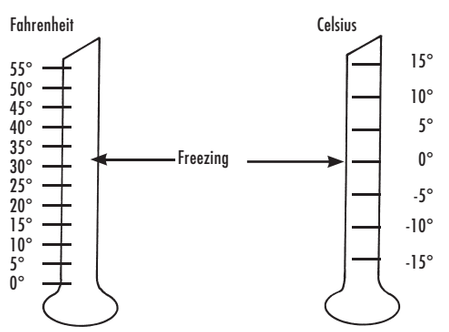
Metric plywood panels are commonly available in two sizes: 1,200 mm × 2,400 mm and 1,220 mm × 2,400 mm, which is roughly equivalent to a 4 × 8-ft. sheet. Standard and Select sheathing panels come in standard thicknesses, while Sanded grade panels are available in special thicknesses.

Standard Sheathing Grade		Sanded Grade	
7.5 mm	(5/16 in.)	6 mm	(4/17 in.)
9.5 mm	(3/8 in.)	8 mm	(5/16 in.)
12.5 mm	(1/2 in.)	11 mm	(7/16 in.)
15.5 mm	(5/8 in.)	14 mm	(9/16 in.)
18.5 mm	(3/4 in.)	17 mm	(2/3 in.)
20.5 mm	(13/16 in.)	19 mm	(3/4 in.)
22.5 mm	(7/8 in.)	21 mm	(13/16 in.)
25.5 mm	(1 in.)	24 mm	(15/16 in.)

Converting Temperatures

Convert degrees Fahrenheit (F) to degrees Celsius (C) by following this simple formula: Subtract 32 from the Fahrenheit temperature reading. Then, multiply that number by 5/9. For example, 77°F - 32 = 45. 45 × 5/9 = 25°C.

To convert degrees Celsius to degrees Fahrenheit, multiply the Celsius temperature reading by 9/5. Then, add 32. For example, 25°C × 9/5 = 45. 45 + 32 = 77°F.



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Pro-Vision C M Y K (Text) (Ray)
(Fogra 39)Job:04-30427 Title:MBI-HomeSkills Carpentry
#175 Dtp:225 Page:124

Lumber Dimensions

Nominal-U.S.	Actual-U.S. (in inches)	Metric
1 × 2	¾ × 1½	19 × 38 mm
1 × 3	¾ × 2½	19 × 64 mm
1 × 4	¾ × 3½	19 × 89 mm
1 × 5	¾ × 4½	19 × 114 mm
1 × 6	¾ × 5½	19 × 140 mm
1 × 7	¾ × 6¼	19 × 159 mm
1 × 8	¾ × 7¼	19 × 184 mm
1 × 10	¾ × 9¼	19 × 235 mm
1 × 12	¾ × 11¼	19 × 286 mm
1¼ × 4	1 × 3½	25 × 89 mm
1¼ × 6	1 × 5½	25 × 140 mm
1¼ × 8	1 × 7¼	25 × 184 mm
1¼ × 10	1 × 9¼	25 × 235 mm
1¼ × 12	1 × 11¼	25 × 286 mm

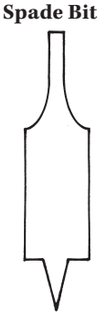
Nominal-U.S.	Actual-U.S. (in inches)	Metric
1½ × 4	1¼ × 3½	32 × 89 mm
1½ × 6	1¼ × 5½	32 × 140 mm
1½ × 8	1¼ × 7¼	32 × 184 mm
1½ × 10	1¼ × 9¼	32 × 235 mm
1½ × 12	1¼ × 11¼	32 × 286 mm
2 × 4	1½ × 3½	38 × 89 mm
2 × 6	1½ × 5½	38 × 140 mm
2 × 8	1½ × 7¼	38 × 184 mm
2 × 10	1½ × 9¼	38 × 235 mm
2 × 12	1½ × 11¼	38 × 286 mm
3 × 6	2½ × 5½	64 × 140 mm
4 × 4	3½ × 3½	89 × 89 mm
4 × 6	3½ × 5½	89 × 140 mm

Drill Bit Guide

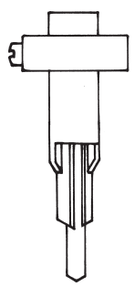
Twist Bit

Self-piloting

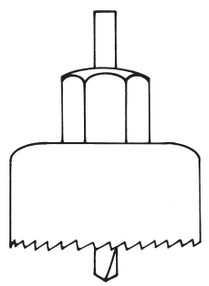
Spade Bit



Adjustable Counterbore



Hole Saw



Counterbore, Shank & Pilot Hole Diameters

Screw Size	Counterbore Diameter for Screw Head	Clearance Hole for Screw Shank	Pilot Hole Diameter	
			Hard Wood	Soft Wood
#1	.146 9⁄64	5⁄64	3⁄64	1⁄32
#2	¼	3⁄32	3⁄64	1⁄32
#3	¼	7⁄64	1⁄16	3⁄64
#4	¼	⅛	1⁄16	3⁄64
#5	¼	9⁄64	5⁄64	1⁄16
#6	5⁄16	5⁄32	3⁄32	5⁄64
#7	5⁄16	5⁄32	3⁄32	5⁄64
#8	⅜	11⁄64	⅛	3⁄32
#9	⅜	11⁄64	⅛	3⁄32
#10	⅜	3⁄16	⅛	7⁄64
#11	½	3⁄16	5⁄32	9⁄64
#12	½	7⁄32	9⁄64	⅛

Abrasive Paper Grits – (Aluminum Oxide)

Very Coarse	Coarse	Medium	Fine	Very Fine
12-36	40-60	80-120	150-180	220-600

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096-128_30427.indd 125 4/10/13 4:25 PM
Pro-Vision C M Y K (Text) (Ray)
(Fogra 39)Job:04-30427 Title:MBI-HomeSkills Carpentry
#175 Dtp:225 Page:125

Index

A
adhesives, 82–83

B
balloon framing, 87
base molding, installing, 106–107
baseboards, 106–107
    cutting, 45
bench buddy, building, 112
bevel cuts, 37
bits, 53–55, 112, 125
blades
    care of, 33
    changing, 34, 41, 49
    for miter saws, 41
    setting depth of, 34
    sharpening, 26
butted door casings, installing, 102

C
case moldings, miter-cutting, 45
casings. See under doors; windows
ceilings, 89
chalk lines, 12–13
chiseling mortises, 25, 27
chisels, 25–27
    sharpening, 26
circular saws, 32–38
clamps, 24
compound miter cuts, 46
conversions
    metric, 124
    temperature, 124
corners, framing, 93
crosscuts, 35, 51
cutting
    bevel cuts, 37
    compound miter cuts, 46
    crosscuts, 35, 51
    dadoes, 37
    plunge cuts, 35
    with power miter saw, 43
    rip cuts, 36, 52
    with table saw, 51
    wide boards, 44

D
dadoes, cutting, 37
demolition, 7
doors
    casings for, 100–102
    framing for, 94–95
    openings for, 85, 88
drills, 53–55

F
featherboards, 49
floors, 89
framing
    balloon, 87
    platform, 86
    steel, 70
framing corners, 93

G
glues, 82–83
grading chart, lumber, 71
grinders, 26

H
hammers, 20–21
handsaws, 18–19
header sizes, 85

J
jigsaws, 30–31
joists, 89, 91

L
levels, 14–15
liquid measurement
    equivalents, 124
load-bearing walls, 88
lumber
    dimensions, 124
    grading chart, 71
    overview, 70–73
    selecting, 72
    storage, 111

M
masonry
    anchors for, 81
    cutting, 32
metric conversions, 124
miter cuts, compound, 46
mitered casing, installing, 101
molding
    base, 106–107
    case, 45
    trim, 9, 76–77, 112
mortise, chiseling, 25, 27

N
nails
    driving, 20, 22
    pulling, 21
    quantity, 79
    sizes, 79
    types, 78

096-128_30427.indd 126 4/10/13 4:32 PM
096-128_30427.indd 126 4/10/13 4:25 PM
Pro-Vision C M Y K (Text) (Ray)
(Fogra 39)Job:04-30427 Title:MBI-HomeSkills Carpentry
#175 Dtp:225 Page:126

P
partition walls, 88, 90–93
    building, 92–93
pegboard, 112, 113, 114–117
pegboard storage system,
    installing, 116–117
planes, 28–29
    sharpening, 26
platform framing, 86
plumb bobs, 12
plunge cuts, 35
plywood, 74–75, 124
pneumatic nailers, 60–63
powder-actuated tools, 64–65
power miter saws, 39–46
prying tools, 7–8
pushsticks, 49

R
rip cuts, 36, 52
routers, 66–67

S
sanders, 56–59
sandpaper, 59, 125
sawhorses, building, 118–119
saws
    circular, 32–38
    handsaws, 18–19
    jigsaws, 30–31
    power miter, 39–46
    sliding miter, 44
    table, 47–52
screwdrivers, 23
screws, 80–81
sharpening, 26
sheet goods, 52, 74–75
Skillbuilders
    drills, 53
    driving nails, 20
    levels, 14
    miter saws, 40
    planing, 28
    sawing, 30
    screwdrivers, 23
    squares, 33
    storage, 113
    studs, 13
    tape measures, 11
sliding miter saws, cutting with, 44
squares, 16–17
steel framing, 70
stool and apron window trim,
    installing, 103–104
storage
    building bench buddy, 111
    building lumber rack, 111
    ideas for, 111–113
    installing pegboard system,
        116–117
    overview of, 110
straightedge guides, building, 38
stud finders, 12
surface-forming rasps, 28

T
table saws, 47–52
tape measures, 10–11
temperature conversions, 124
Tips
    circular saws, 36
    cutting masonry, 32
    grinding, 26, 27
    jigsaws, 30
    powder-actuated tools, 65
    sanders, 56
    saw blades, 33
    squares, 16
    studs, 12
    table saws, 47
    trim moldings, 76
trim moldings
    overview, 76–77
    removing, 9
    storage, 112

V
vises, 24

W
walls
    load-bearing, 88
    partition, 88, 90–93
wide boards, cutting, 44
windows
    casings for, 100–101, 103–105
    framing for, 96–99
    openings for, 85, 88
workbenches, building, 120–123

096-128_30427.indd 127 4/10/13 4:32 PM
096-128_30427.indd 127 4/10/13 4:25 PM
(Text) (Ray)
(Fogra 39)Job:04-30427 Title:MBI-HomeSkills Carpentry
#175 Dtp:225 Page:127

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The techniques shown in this book are general techniques for various applications. In some instances, additional techniques not shown in this book may be required. Always follow manufacturers' instructions included with products, since deviating from the directions may void warranties. The projects in this book vary widely as to skill levels required: some may not be appropriate for all do-it-yourselfers, and some may require professional help.

Consult your local building department for information on building permits, codes, and other laws as they apply to your project.

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04-C68867 #175 Dtp:225 Page:128

CARPENTRY

TEACHES YOU ALL THE SKILLS YOU NEED TO BECOME YOUR VERY OWN HOME CARPENTER

At the core of every DIYer is the ability to work with wood. In the home, the garage, or the backyard, carpentry skills will prove useful time and time again—it is the ultimate foundational craft of the do-it-yourselfer. With *HomeSkills: Carpentry*, you can embark on the fun process of building your DIY skillset by learning the basics of working with wood and wood products. You'll see how to assemble your starter toolbox and small workshop, and we'll give you a crash course in how to use tools correctly. Finally, we'll share step-by-step instructions for accomplishing some of the most common home carpentry projects: building your own workbench or setup table, hanging a door, building an interior stud wall, working with plywood and sheet goods, and a score of other practical tasks. Accompanied by 350 detailed photographs, this one-stop how-to book will have you well on your way to becoming a home carpenter.

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HOME SKILLS

Landscaping

HOW TO USE PLANTS, STRUCTURES & SURFACES TO TRANSFORM YOUR YARD

HOME SKILLS

Landscaping

HOW TO USE PLANTS, STRUCTURES & SURFACES TO TRANSFORM YOUR YARD

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JOB:04-30438 Title:Home Skill Landscaping
#175 Dtp:228 Page:1

CONTENTS

Introduction 4

Landscape Design & Materials

Landscape Design 7

Green Landscapes 14

Landscape Materials 16

Estimating Materials 26

Tools 27

Planting & Water Management Projects

Landscape Beds & Edging 30

Rigid Paver Edging 32

Freeform Paver Edging 33

Concrete Curb Edging 34

Wood Edging 36

Planting Trees & Shrubs 38

Windbreaks 40

Mulch Beds 42

Rain Garden 44

Xeriscape 48

Drip Irrigation 52

In-Ground Sprinkler System 54

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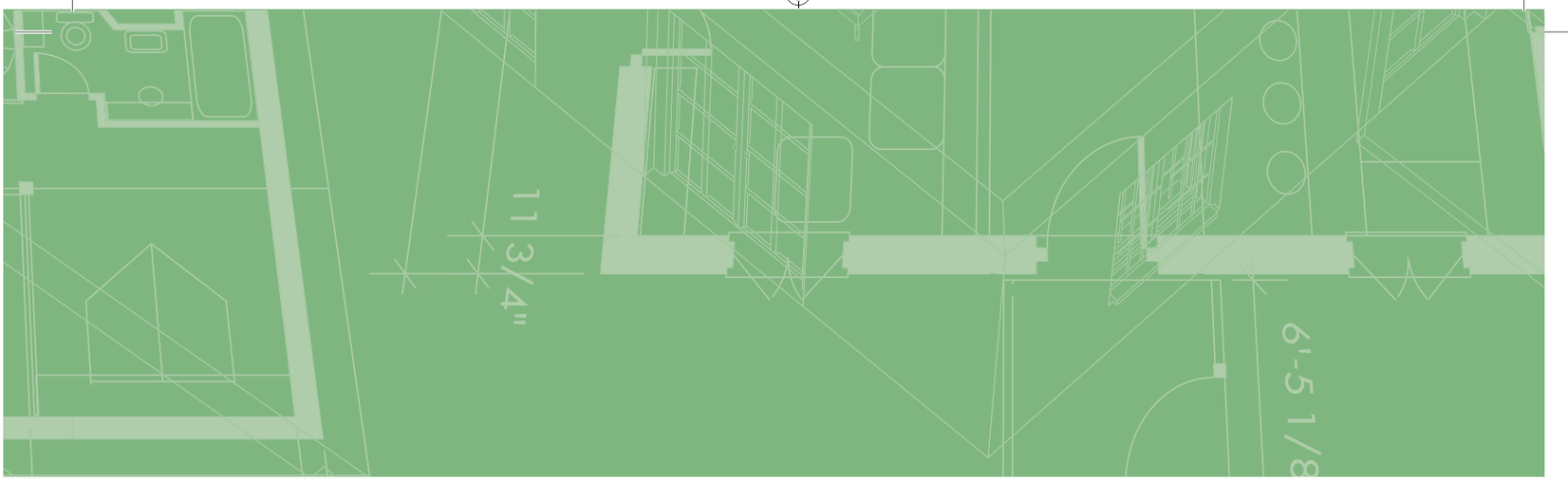
#175 Dtp:228 Page:2



Building Projects

Design & Layout for Walkways & Steps .. 60

Sandset Brick Walkway 64

Flagstone Walkway 70

Simple Gravel Path 72

Pebbled Stepping Stone Path 78

Timber Garden Steps 81

Flagstone Garden Steps 85

Fence Design & Layout 92

Fenceline Layout 97

Wood Panel Fence 103

Split Rail Fence 109

Vinyl Panel Fence 113

Dry Stone Wall 117

Interlocking Block Retaining Wall 120

Resources

Metric Conversions 126

Index 127

001-057_30438.indd 3 4/13/13 12:02 PM
aping JOB:04-30438 Title:Home Skill Landscaping
'age:2 Pro-Vision C M Y K (Ray) (Text) #175 Dtp:228 Page:3

Introduction

MOST HOMEOWNERS already do basic upkeep on their yards, but how about really doing some landscaping? We are all spending a bit more time at home, investing more in our homes than ever before. Our yards present a whole other realm of projects to keep us busy.

The great aspect about landscaping is that there are so many projects you can do yourself with only basic skills and no landscaping background. Most landscaping projects require a little advance planning and a lot of sweat, the perfect combination for a do-it-yourself newbie. And, a huge bonus is that landscaping is very forgiving—you can make mistakes and often no one will be the wiser!

HomeSkills: Landscaping has all the information you need to make your first forays into the rewarding activity of beautifying your yard and landscape. *HomeSkills: Landscaping* shows you how to draw a map of your yard to aid in planning and design and what materials are available for your projects. You can use this book to take your yard and make it into the outdoor retreat you deserve. Or, make a high maintenance yard into a low-maintenance dream. Convert a high-water-usage lawn into a low-use landscape. Build walkways and steps to make your yard more accessible and useable and a fence to make it more private or provide a backdrop for plantings.

So let's get started! It's time to dig in and get your hands dirty with some of the easiest, yet most rewarding home improvement projects you can tackle.

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JOB:04-30438 Title:Home Skill Landscaping
#175 Dtp:228 Page:4

LANDSCAPE DESIGN & MATERIALS

Landscape Design.....7

Green Landscapes 14

Landscape Materials.....16

Estimating Materials.....26

Tools 27

001-057_30438.indd 5 4/13/13 12:02 PM

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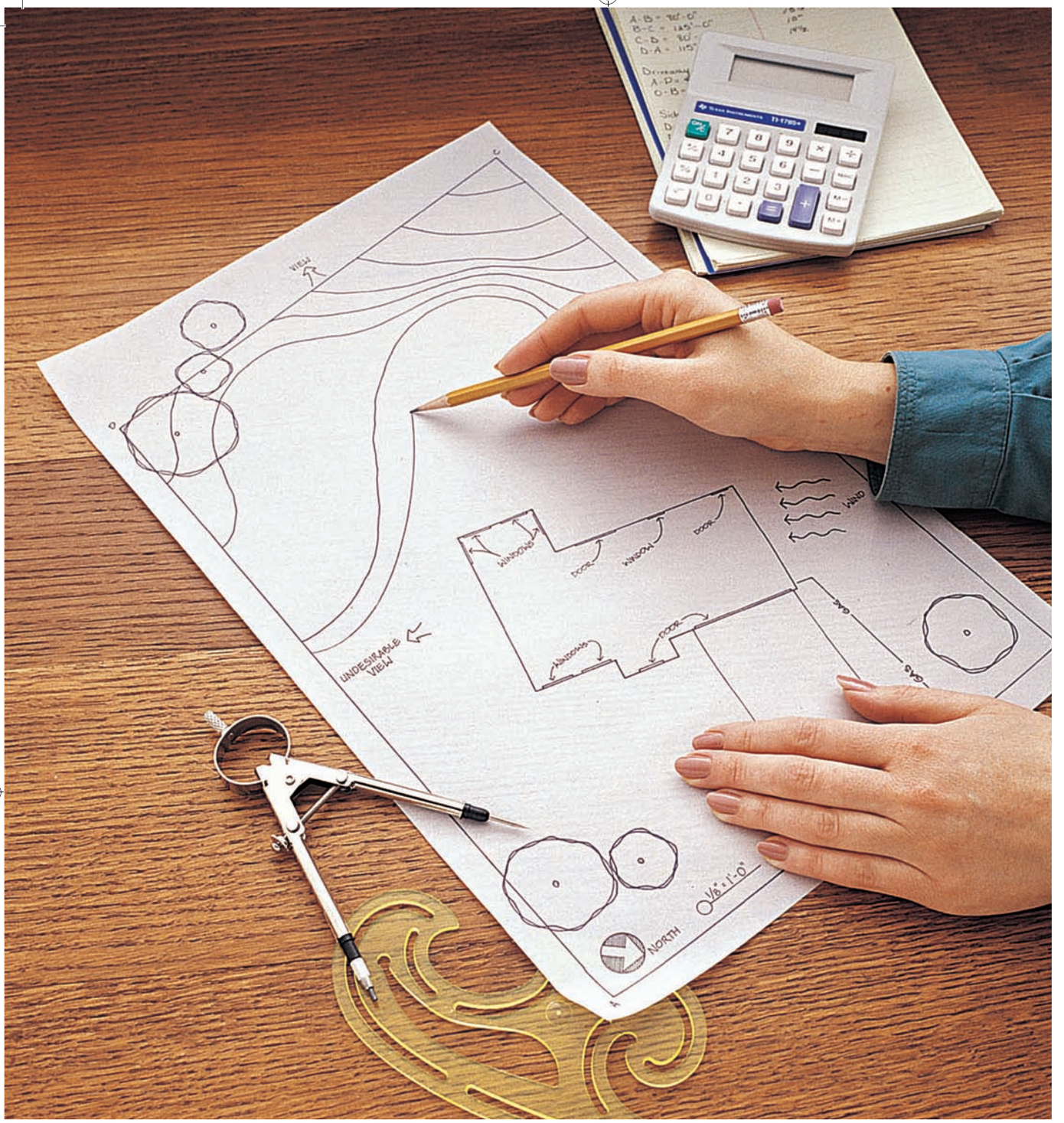

WHEN IT COMES TO DESIGN AND MATERIALS, it's a good idea to work things out on paper, when mistakes and miscalculations can be corrected with an eraser and time is the only investment. Mapping out your yard with dimensions and adding structures on paper is invaluable for working up an accurate materials list and estimating costs. Though many landscaping materials are relatively inexpensive, total project costs may become a factor when choosing one style or material over another. This chapter shows you exactly how to create an accurate site map of your yard, including slopes and irregular features. Even if you aren't handy with paper and pencil, you can still create this type of plan. Also covered are the materials you are likely to see when you go to your local lumberyard, stone yard, or garden center and the tools you will need on hand for the projects covered.

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JOB:04-30438 Title:Home Skill Landscaping
#175 Dtp:228 Page:6

LANDSCAPE DESIGN

Before you dig into the projects in this book, take the time to brainstorm and make a wish list of how you imagine your outdoor space could look. If your goal is to create an outdoor room, consider what elements you'll want to include to accomplish this. Now, get out a scratch pad and begin making some rough drawings of your dream landscape. Think big picture, not project-by-project. Each feature we'll teach you to build complements another project, and you'll find as you build that you want to keep adding more elements to your outdoor space. There's no limit! But, you'll want to take this grand plan in stages, which is why your first task is to create a priority list and start with defining, foundation elements: patios, fences, retaining walls.

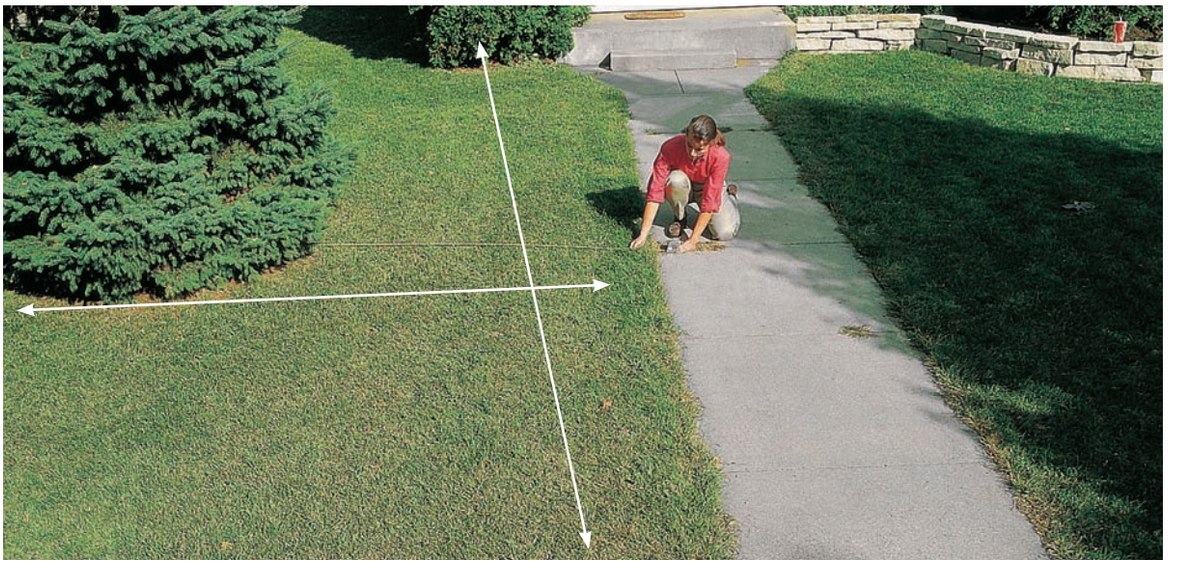
Now that you have an idea of how various projects will fit into your overall landscape design, you'll want to focus on the task at hand. While not all landscape projects require a detailed plan, drawings will help you navigate complicated projects with many steps. Here, we'll show you how to survey your yard, draw a site map, sketch bubble plans, draw a landscape design, and create a working drawing you can take to the field—your back yard, that is.

Tip

Measuring your yard doesn't have to be done with precise surveying equipment, but it is very helpful to spend some time with a tape measure before you begin drawing plans. These measurements provide the information you need to create all other landscape drawings. Good measurements are also essential for projects where building permits are required.

Make a rough sketch of your yard, then make measurements that are as accurate as possible. Some landscape projects require digging, so contact your local utility companies to mark the locations of any underground power, gas, or communications lines. If the property boundaries aren't clear, you may also need to contact your county surveyor's office to come and mark the precise boundary lines for you. This can be very important if your landscaping plans will include a fence or garden wall that adjoins the property line.

Straight lines and square corners are easy enough to measure and mark, but it can be a bit harder to



Measure the position of all the features of your yard, relative to the property lines. This work may require a helper and a long tape measure.

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Use the survey measurements to create a rough drawing of your yard.

precisely locate features that have irregular shapes, or features that are angled in relation to the main property lines. In this case, you can use a method called triangulation to determine precise positions. On a square lot, for example, you can determine the location of a large tree most accurately by measuring the distance to the tree from two corners of the property.

On a yard with significant slopes, make cross-section drawings, called elevations, to indicate the vertical rise of the landscape. Elevations are drawings that show the landscape as viewed from the side. They'll be important for planning fence, garden wall, or retaining wall projects.

Using your survey measurements and the rough sketch,

Convert all the measurements you made in the survey to scale measurements. Then outline your yard by drawing the straight boundaries to scale.

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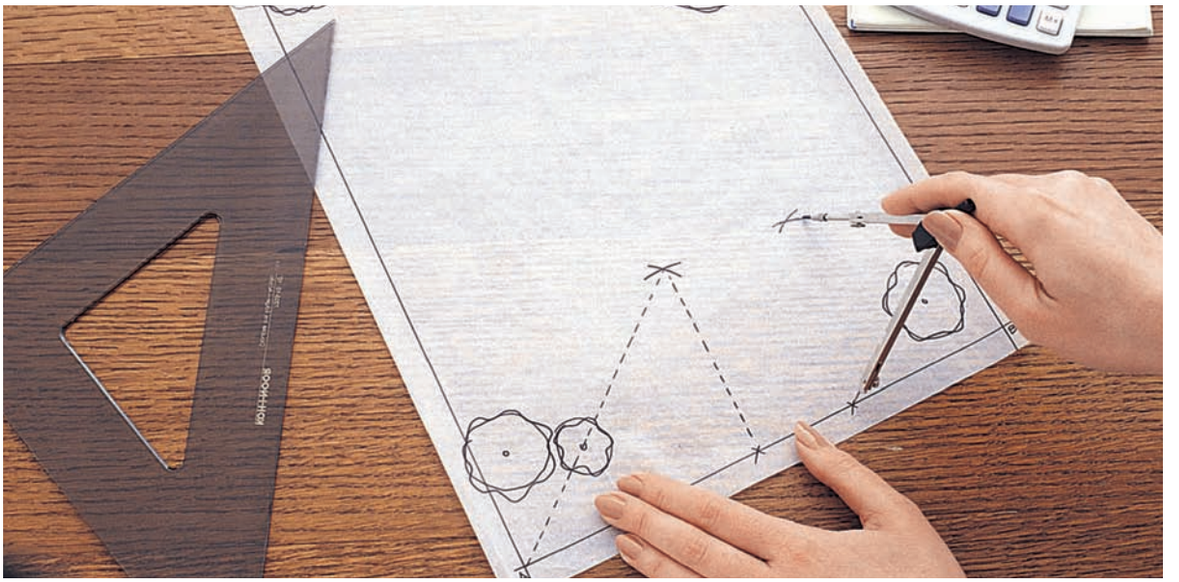
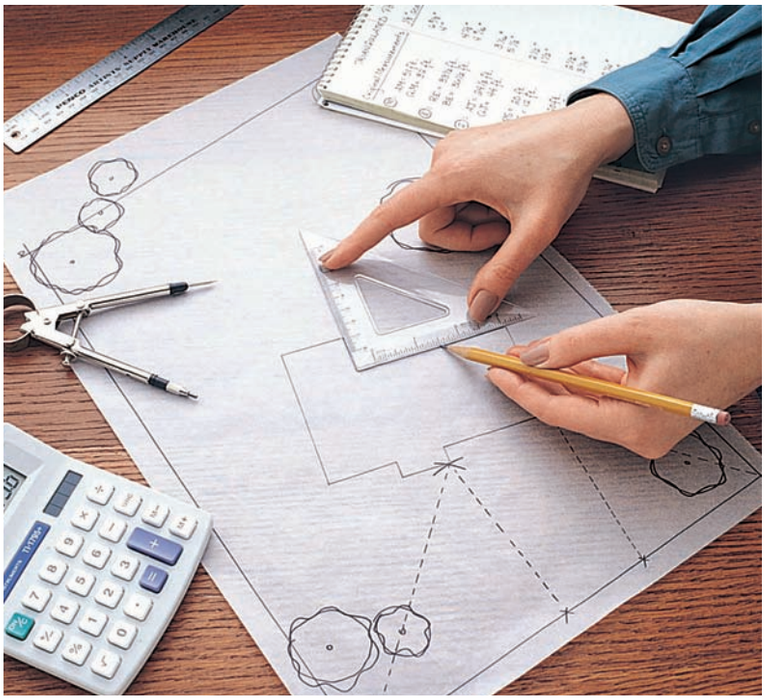


Where you triangulated measurements from property corners, set a compass to the scale measurements, then draw arcs on the drawing. Where the arcs intersect is the precise location of the triangulated measurements.

you'll now create a more accurate and precise drawing of your yard, called a site map. The site map is an overhead view of your yard, drawn to scale. It is the basis for the finished landscape design. This is nothing more than a drawing that shows the basic permanent features of your yard. It will include the property lines and all buildings on the site, as well as other permanent structures, like driveways or large trees.

A scale of ⅛ inch = 1 foot is a good scale to use for site maps and landscape plans. At this scale, you can map a yard as big as 60 × 80 feet on a standard sheet of paper, or an 80 × 130-foot yard on a 11 × 17-inch sheet of paper. If your yard is bigger than this, you can tape several sheets together.



Use a plastic triangle and ruler to mark the edges and corners of all structures within the boundaries of your yard.

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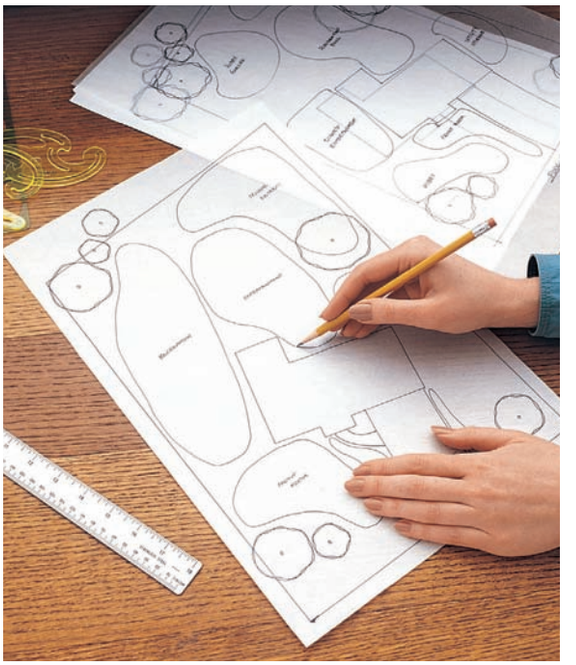
Sketching Bubble Plans

Bubble plans are rough sketches in which you play with different ideas for arranging features within your overall yard. They are a great way to test out different ideas before committing to them. You might, for example, draw your yard with a patio positioned in different locations to see how it feels in relationship to your deck and garden beds.

Draw lots of variations of your ideas, and feel free to play with ideas that seem a little extreme. Professional designers sometimes go through dozens of ideas before settling on one that will eventually turn into a final landscape design.

The place to start is with lots of photocopies of the site map you've created. Or, you can use tracing paper to play with bubble plan ideas. Tracing paper is available at art supply stores.

Make sure to include the other members of your household in this important planning step. They'll be enthusiastic about the work if you've included everyone in the planning process.



Sketch the landscape features you're considering on a photocopy or tracing paper copy of your site map. Feel free to experiment; it costs nothing to dream.

You can test different bubble plans in your yard by outlining features with stakes and string. You can use cardboard cutouts to represent stepping-stones and walkways.

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Creating a Landscape Design

Once your bubble plan experiments have yielded a plan you like, it's time to turn it into a formal landscape design. The landscape design will serve as a road map for your future landscape. It's particularly helpful if you have a big landscape renovation planned that will take several seasons to complete.

The landscape design can be a chance to have some artistic fun. You can illustrate your design in color, if you want. You may have a few false starts, so it will help to have several copies of your final site map when you begin.

The key to a professional-looking design is to use smooth flowing lines rather than straight lines and sharp angles. Aim for a feeling of continuous flow through the different areas of your landscape. In the final design, the boundaries of the spaces should resemble the rounded flowing lines of your bubble plan.

On a fresh copy of your site map, outline the hardscape features, including patio or deck surfaces, fences, walls, hedges, garden areas, and pathways.

Add symbols and textures for any remaining elements, then use colored pencils to finish the design.

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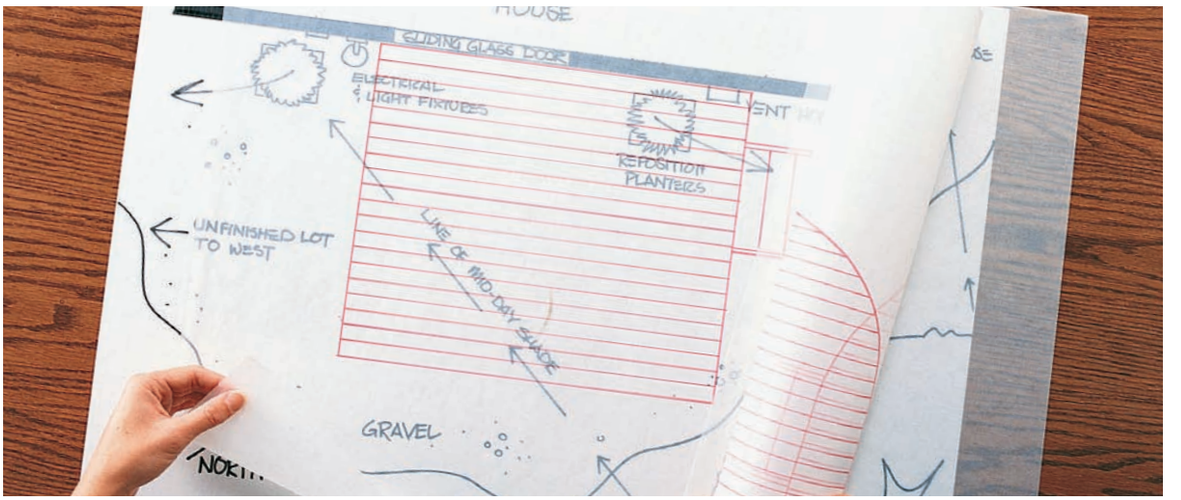
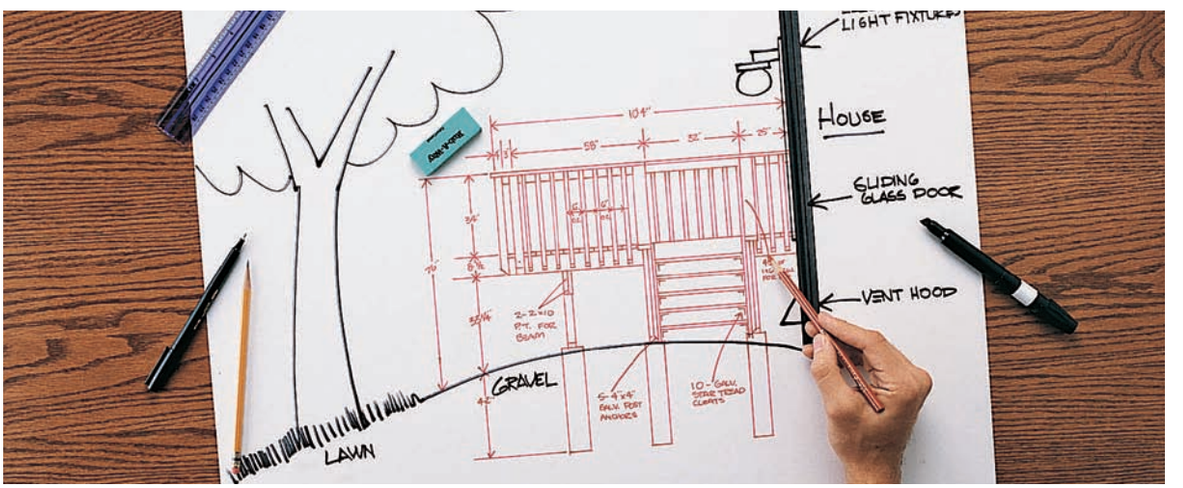
Creating Working Drawings

The final step of this planning process is the starting point for the actual projects you'll find on the pages of this book. Working drawings are individual plans for specific projects within your overall landscape. If you happen to be working from a pre-existing plan, such as a deck or gazebo blueprint, you may not need to make your own drawings. If you're designing your own project, though, making working drawings is what will let you estimate materials and organize your steps.

Working plans serve the same function for landscape construction as blueprints do for builders creating a house. The working plan is a bare-bones version of a plan drawing that includes only the measurements and specifications needed to actually create the project.



On an enlargment of your landscape design, or using tracing paper, make a more detailed overhead view of the specific project, showing structural measurements.



Create detailed plan and elevation drawings for your project. List all dimensions on the drawing, and indicate size, type, and quantities of lumber and hardware needed.

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Building Codes and Utilities

Before you can even begin drawing plans for your fence, wall, or gate, you need to research local building codes. Building codes will tell you if a building permit and inspection are needed for a project. Some code requirements are designed to protect public safety, while others help preserve aesthetic standards. For example, in most communities the stringers (horizontal cross pieces) of a picket fence must face inward, toward your house.

Codes may dictate what materials can be used, maximum heights for structures, depths for concrete footings and posts, and setback distance or how far back a fence or wall must be from property lines, streets, or sidewalks. Setback distance is usually 6 to 12 inches and is especially important on a corner lot, since a structure could create a blind corner. A fence or wall may be built directly above a property line if agreed by both neighbors who share ownership of the fence.

If you find a fence, wall, or gate design that appeals to you, but does not meet local ordinances, the municipal authorities may be willing to grant a variance, which allows you to compromise the strict requirements of the code. This normally involves a formal appeal process, approval of neighbors, and perhaps a public hearing.

Another thing to consider as you plan your project is the placement of any utility lines that cross your property. At no cost, utility companies will mark the exact locations and depths of buried lines so you can avoid costly and potentially life-threatening mistakes. In many areas, the law requires that you have this done before digging any holes. Even if not required by law in your area, this step is truly necessary.

A fence, wall, or gate on or near a property line is as much a part of your neighbors' landscapes as your own. As a simple courtesy, notify your neighbors of your plans and even show them sketches; this will help to avoid strained relationships or legal disputes. You may even decide to share labor and expenses, combining resources for the full project or on key features that benefit you both.

Call 811 before you dig.
Call Before You Dig will contact your electric, phone, gas, and water utilities, and cable television vendor to send out a representative to mark the exact locations of underground utility lines.

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GREEN LANDSCAPES

As any backyard gardener knows, getting things to grow involves a great deal of trial and error—and also time, money, patience, and even wonder: How can it be that your next-door neighbor has more perfect tomatoes than she knows what to do with when all you can produce is a handful of mealy specimens each year? It could be her soil or her technique, but most likely the difference is that her backyard's microclimate is a better environment for growing tomatoes.

In the bigger picture, this imbalance occurs not just across the globe but also from county to county. Yet, you can visit any garden center in, say, Colorado, and find a huge selection of plants that evolved not on the Western plains but in coastal climates or even the dampest regions of Scotland. These plants may survive in the dry Colorado air with enormous amounts of irrigation and probably lots of chemicals, but it begs the question: Why fight nature?

Choosing plants that are well-adapted to the local climate (and your yard's microclimate) is the first step in creating a green landscape, both literally and figuratively. In many regions, this also means limiting the amount of conventional grass because of its insatiable thirst for water. The next step is to look for ways to use water more efficiently and for collecting free water when Mother Nature provides it.

When it comes to the manufactured elements of the landscape, the basic precepts of green building apply: Choose renewable, recyclable, and healthful materials such as recycled-plastic decking and locally produced mulch. Also consider permeable paving in place of concrete and asphalt to keep storm runoff in the ground instead of loading up the sewer system with water and all the yard and driveway chemicals it brings with it. In this illustration you'll find some of the features in a well-planned, low-maintenance landscape.

Tip

Don't have a green thumb? Master Gardeners are advanced gardeners who have taken coursework and usually have years of experience in your area. In order to maintain their Master Gardener designation they volunteer at events, community education centers, and Q & A sessions. Find one by asking at your local university extension service.

A green yard tends to look very natural and very at-home in its surroundings. It should be populated with native plants that don't require heroic efforts to thrive and it should require little or no watering or chemical fertilization. Ideally, a green yard also has a positive impact on your home and property by providing valuable shade or preventing soil erosion.

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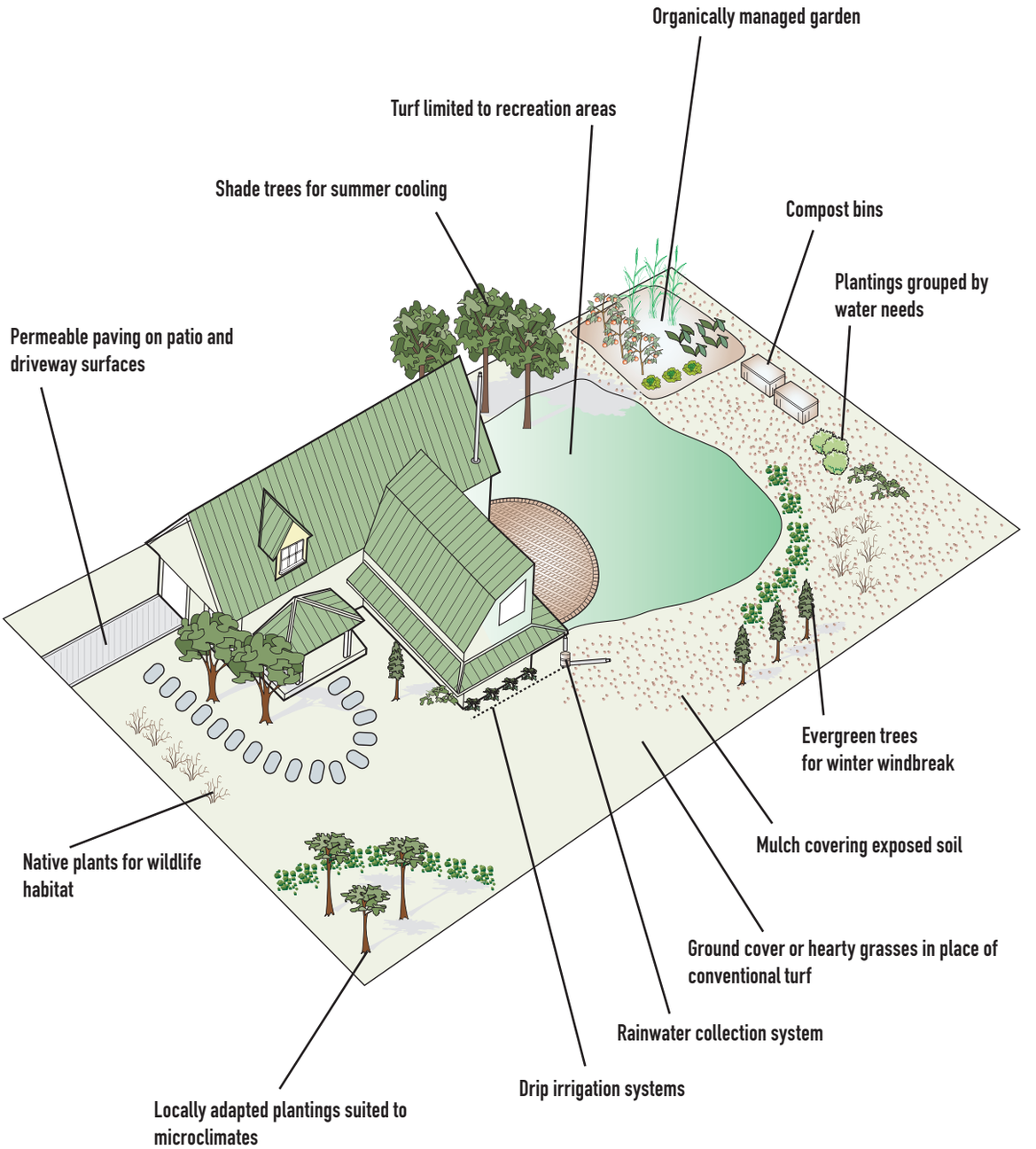
ELEMENTS OF A GREEN YARD



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LANDSCAPE MATERIALS

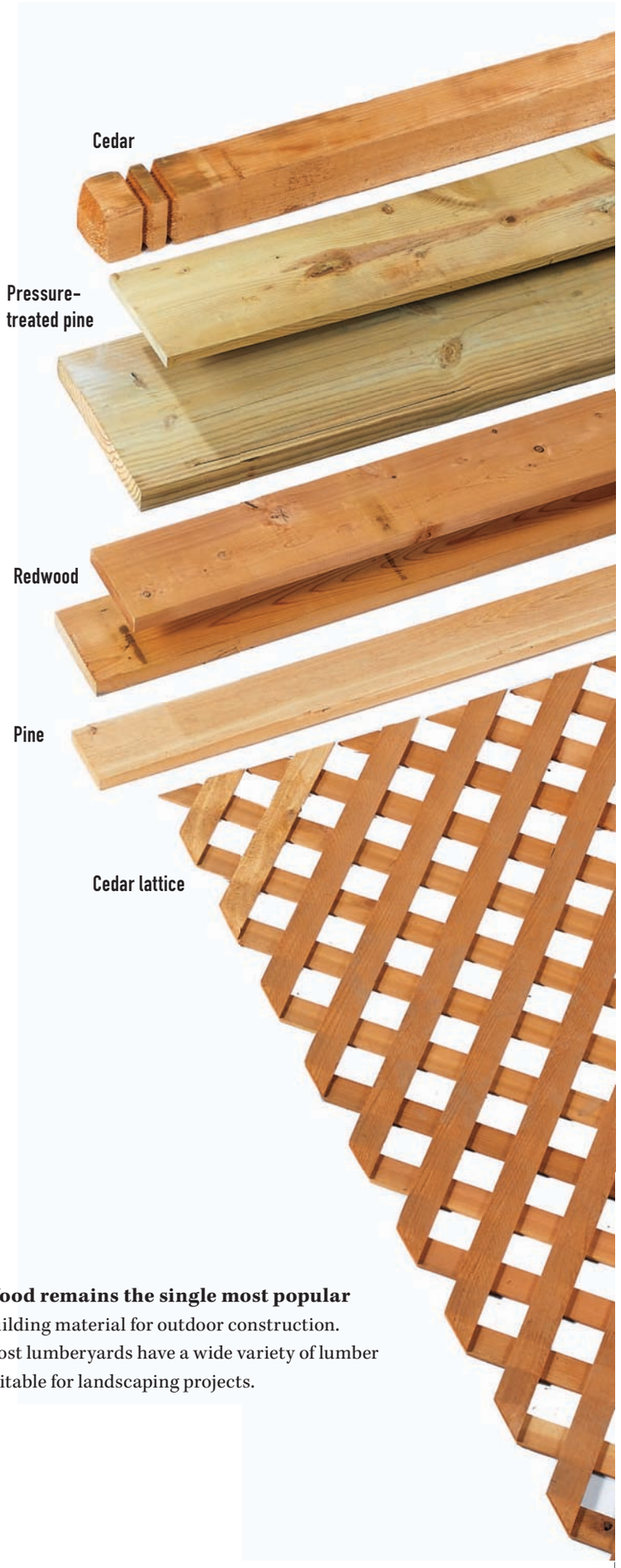
As with most building projects, choosing the right materials for your landscape is really a question of priorities. What do you value most highly—appearance, durability, ease of maintenance, or cost? Your decision will most likely involve a combination of all of these factors along with a few compromises.

From natural to manufactured, the range of materials available today for landscape projects offers many options. You may choose materials that blend with your existing yard and architectural features, or you may go another direction entirely, such as preferring a brand-new element for your yard because it adds a bit of contrast and panache.

Wood and Vinyl

Wood is still the most commonly used material for fences and is really the only one that allows for custom designs and details as it is ultimately workable. For outdoor applications your best choices are woods that are naturally rot- and bug-resistant, like cedar, redwood, or cypress, or you can choose pine that has been pressure treated with chemicals to prevent rot. Unfortunately, the pressure treated lumber is not as attractive, but it is much less expensive.

Local climate conditions may also impact your choices. Wood will degrade more quickly in high moisture areas. Under desert conditions, wood may last much longer. If termites are a local problem, then treated lumber or vinyl is a necessity.



Wood remains the single most popular building material for outdoor construction. Most lumberyards have a wide variety of lumber suitable for landscaping projects.

Tip

Contact with the ground or moist surfaces speeds the rotting of wood. To avoid ground contact, use concrete footings with metal stand-offs to anchor wood fence posts.

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Pressure-treated lumber stamps list the type of preservative and the chemical retention level, as well as the exposure rating and the name and location of the treating company.

Cedar grade stamps list the mill number, moisture content, species, lumber grade, and membership association. Western red cedar (WRC) or incense cedar (INC) for decks should be heartwood (HEART) with a maximum moisture content of 15% (MC15).

Plastic materials (right) such as PVC vinyl and fiberglass reinforced plastic (FRP) are generally used in applications such as fencing and lawn edging. Many styles and sizes are available, and they are strong, versatile, and require no maintenance. Some fence materials are sold as kits, making installation easy.

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Stone and Concrete

Natural stone offers beautiful color, interesting texture, and great durability, making it one of the very best building materials for outdoor construction. Although it is more expensive than many other materials, if it fits in your budget, you're not likely to regret choosing stone. It is a good choice for edging, walls, walkways, ponds, fountains, and waterfalls. Natural stone is also used to accent flowers and plants creating depth in garden areas (this is a great way to use stone if you can't afford huge amounts of it).

Each type of stone offers a distinctive look, as well as a specific durability and workability. The nature of your project will often dictate the best form of stone to use. When shopping for stone, describe your project to the supplier and ask him or her to suggest a stone that meets your needs.

Fieldstone, sometimes called river rock, is used to build retaining walls, ornamental garden walls, and rock gardens. When split into smaller pieces, fieldstone can be used in projects with mortar. When cut into small pieces, or quarried stone, fieldstone is called cobblestone, a common material in walks and paths.

Ashlar, or wall stone, is quarried granite, marble, or limestone that has been smooth-cut into large blocks, ideal for creating clean lines with thin mortar joints. Cut stone works well for stone garden walls, but because of its expense, its use is sometimes limited to decorative wall caps.

Flagstone is large slabs of sedimentary rock with naturally flat surfaces. Limestone, sandstone, slate, and shale are the most common types of flagstone. It is usually cut into pieces up to 3 inches thick, for use in walks, steps, and patios. Smaller pieces—less than 16 inches square—are often called steppers.

Rubble is irregular pieces of quarried stone, usually with one split or finished face. It is widely used in wall construction.

Fieldstone is stone gathered from fields, dry riverbeds, and hillsides. It is used in wall construction.

Flagstone consists of large slabs of quarried stone cut into pieces up to 3" thick. It is used in walks, steps, and patios.

Tip

A stone yard is a great place to get ideas and see the types of stone that are available. This stone yard includes a display area that identifies different types of stone and suggests ways they can be used.

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Manufactured stone is designed to resemble natural stone, but because it's more uniform it is easier to install and generally costs less. Concrete products are being offered in more styles all the time, giving you a lot of flexibility to build distinctive projects that are also reasonably priced.

Concrete paver slabs, available in several shapes and sizes, are used for laying simple walkways and patios. They're available in a standard finish, a smooth aggregate finish, or can be colored and molded to resemble brick or cobblestone. Concrete paver slabs are relatively inexpensive and quite easy to work with. They're usually laid in a bed of sand and require no mortar. Their surface is sometimes finished so the smooth gravel aggregate is exposed, but they are also available in plain pavers and colored slabs.

Paver bricks resemble traditional kiln-dried clay bricks but are more durable and easier to install. Paver bricks come in many colors and shapes and are ideal for paving patios, walkways, and driveways. Many varieties are available in interlocking shapes that can be combined with standard bricks to create decorative patterns, such as herringbone and basket weave. Edging blocks are precast in different sizes for creating boundaries to planting areas, lawns, loose-fill paths, and retaining walls.

Tip

Veneer stone is natural or manufactured stone cut or molded for use in nonload-bearing, cosmetic applications, such as facing exterior walls or freestanding concrete block walls.

Concrete products for landscaping are available in a wide range of colors, sizes, and shapes.

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Loose Materials

Loose materials for patios and walkways encompass a wide range of natural elements, from gravel to wood chips to small river stones. You can use a loose material by itself to create a simple patio or path surface or use it as infill between an arrangement of heavier materials, such as flagstone or large, concrete stepping pavers. In contrast to the solidity and permanence of traditional paving, loose materials have a casual, summery feel. Walking over a pathway of crushed stone or wood chips can feel like a stroll down a country lane or a walk through the woods. As a primary surface, loose materials offer several practical advantages. They drain well, are forgiving of uneven ground, and can be replenished and graded with a rake for a quick facelift. They also tend to be much less expensive than most other paving options and couldn't be easier to install. In a typical installation, start with a bed of compacted gravel and cover it with landscape fabric to inhibit weed growth and separate the gravel base from the surface material. Then, spread out the surface material a few inches thick, compact it if necessary, and you're done! For simpler applications, such as a lightly traveled garden path, you can often skip the gravel base and lay the landscape fabric right over leveled and tamped soil. In most cases, it's best to include a raised edging of some kind to contain the materials and maintain the shape of the paved surface.

Loose materials can work well on their own or as a complement to surrounding elements. In this landscape, buff-colored gravel serves as both a primary surface and an infill material for a stepping stone path. The natural look of the gravel provides a nice contrast to the formal paver walkway and patio.

Selecting Loose Materials

Because different loose materials can have very different textures and properties, it's important to choose the right surface for the application. Here's a look at some of the most popular materials for patios and walkways:

Decomposed granite

Decomposed granite: A popular choice for level patios, paths, and driveways, decomposed granite (DG) can be compacted to a relatively smooth, flat, hard surface. DG consists of small pieces of granite ranging in size from sand-size grains to a quarter inch—this size variation is the reason this material is so compactable. DG is available in various natural shades of gray, brown, and tan. Due to its gritty, sandy finish that can stick to your shoes, DG is not a good choice for surfaces that receive heavy traffic directly to and from the house.

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JOB:04-30438 Title:Home Skill Landscaping
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Crushed stone

Pea gravel and crushed stone include a broad range of gravel, from fairly fine textures to very coarse. Pea gravel is small- to medium-sized rounded stone. Crushed stone typically consists of coarse, jagged pieces in various sizes, generally larger than pea gravel. Many types of gravel are compactable, but usually less so than DG.

River Rock

Smoothed and rounded by water or machines, river rock ranges from small stones to baseball-sized (and larger) rocks. These smooth surfaces make it more comfortable to walk on than jagged gravel but it is also less compactable and easily displaced underfoot. Larger stones are difficult to walk on and are more suitable for infill and accent areas than for primary paving surfaces.

Wood chips

Wood chips and mulch are commonly used as groundcover in planting beds, gardens, and flowerbeds. Most types are soft and springy underfoot, and many can be used for light-traffic paths and even children's play areas. Wood chips come in a wide variety of grades, colors, and textures. In general, finely chopped and consistent materials are more expensive and more formal in appearance than coarse blends. The term mulch is often used interchangeably with wood chips but can also describe roughly chopped wood and other organic matter that's best suited for beds and ground cover. Most loose material made of wood needs some replenishing every two to four years.

Both stone and wood loose materials are typically sold in bulk at landscape and garden centers and by the bag at home centers. Buying in bulk is often much less expensive for all but the smallest jobs. Landscape and garden suppliers typically offer bulk deliveries for a reasonable flat fee. Due to the variance in terminology and appearance of loose materials, be sure to visit the supplier and take a look at the materials you're buying firsthand, so you know exactly what to expect.

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Concrete & Mortar

Poured concrete is used for driveways, walkways, and patios because of its exceptional strength. Although it is sometimes criticized for its bland appearance, concrete in modern use is often tinted or given a surface finish that lets it simulate brick pavers or flagstone at a fraction of the cost. Concrete can also be formed into curves and other shapes, such as edging, ponds, or fountains. Setting fence posts is the most common use of concrete for do-it-yourself landscapers. Mortar is used for laying brick and mortared stone walls.

Bagged concrete mix comes in many formulations. The selection you're likely to encounter varies by region and by time of year, but the basic products most home centers stock include: all-purpose concrete (A, C) for posts, footings, and slabs; sand mix (B) for topping and casting; Portland cement (D) for mixing with aggregate, sand, and water to make your own concrete; high/early concrete (E) for driveways and other projects that demand greater shock and crack resistance; fast-setting concrete (F) for setting posts and making repairs; specialty blends for specific purposes, such as countertop mix (G), which comes premixed with polyester fibers and additives that make it suitable for countertops.

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Mortar Mixes: Type N, a medium-strength mortar for above-grade outdoor use in nonload-bearing (freestanding) walls, barbeques, chimneys, and tuck-pointing (A); refractory mortar, a calcium aluminate mortar that is resistant to high temperatures, used for mortaring around firebrick in fireplaces and barbeques (B); Type S, a high-strength mortar for outdoor use at or below grade, typically used in foundations, retaining walls, driveways, walks, and patios (C); mortar tint for coloring mortar (D); and you'll need water for mixing mortar so a hose is needed (E) (a sprayer attachment is needed later to clean the surface).

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JOB:04-30438 Title:Home Skill Landscaping
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Hardware & Fasteners

Although they're rarely visible, the metal spikes, screws, nails, bolts, and other hardware items can be crucial to a successful landscaping project.

The chemicals now used in pressure-treated lumber may require metal connectors specially designed to withstand the corrosive effect of these chemicals. Specifically, manufacturers suggest that metal connectors used with pressure-treated lumber be galvanized with a hot-dip process rather than a mechanical zinc plating. Triple-dipped, hot-dipped galvanized fasters are the best.

Cedar, redwood, and cypress will stain if galvanized fasteners are used. If you will be letting the wood weather, or will be using a clear sealer or a light stain, use specially coated hardware or stainless steel fasteners. If you will be painting, the fasteners only need to be corrosion resistant. Stainless can also be used with pressure-treated lumber. The disadvantage of stainless steel is the expense. Do not use aluminum fasteners with pressure-treated lumber.

There are a number of head-driving options available for exterior-rated screws. Square and Torx-drive screws will not slip while fastening like Phillips heads. Posi-drive screws are very popular because they combine Phillips and square-drive heads, giving you a choice of which to use.

Estimating & Ordering Materials

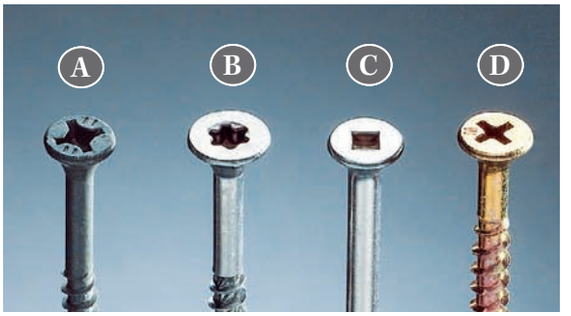
Even with small projects, it's important to take careful measurements and estimate accurately. Landscaping materials are bulky and are expensive and time consuming to transport, so accurate estimating will save you time and money.

Begin compiling a materials list by reviewing the scale drawing of your building plans (pages 10 to 11), then use the information here to estimate materials. Once you have developed a materials list, add 10 percent to the estimate for each item to allow for waste and small oversights.

The cost of your project will depend upon which building materials you choose. You can save money by choosing materials that are readily available in your area. This is particularly true of natural stone products. Choosing stone that is quarried locally is far less expensive than exotic stone transported long distances. Lumber, metal, and plastics can also vary widely in price, depending on where they're milled or manufactured.

Most of what you need is available at large, general-purpose home centers, but for landscaping projects you may want to buy some materials from specialty retailers. A large concrete project, for example, will be cheaper if you buy ready-mix concrete instead of bagged concrete mix from your home center.

If you plan on working with specialty or alternative materials, such as vinyl fencing or composite decking, many home centers will have a select range of styles and sizes on hand but can also order specialty materials for you.



Head styles for exterior screws include: Posi-drive (A), torx (B), square drive (C), and phillips (D).

Tip

A cordless drill can make landscape projects like fencing move much more quickly. If you are using treated lumber, which is made heavy and wet from the treatment, you will need a more powerful drill/driver than what you need for untreated lumber.

If you are installing landscape timbers, you will need a powerful drill and an extra long drill bit to drill the holes for the spikes.

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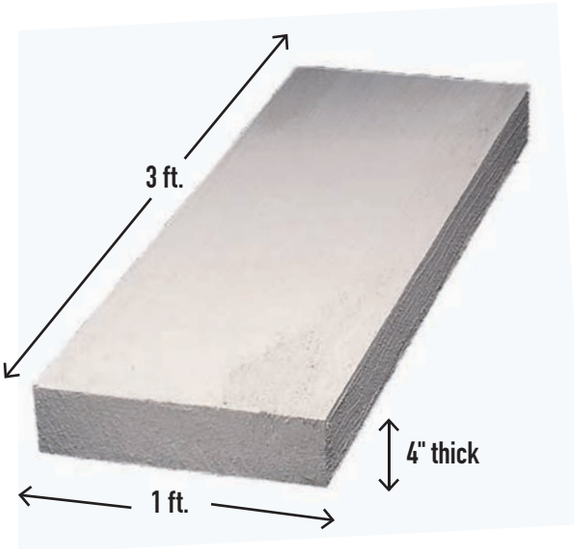
A contractor's calculator can convert measurements and estimate concrete volume. The calculator isn't very expensive and will relieve you of complex math conversions. It's also handy for estimating fencing materials and paint coverage.



To estimate concrete volume, measure the width and length of the project in feet, then multiply the dimensions to get the square footage. Measure the thickness in feet (4" thick equals ⅓ ft.), then multiply the square footage times the thickness to get the cubic footage. For example, 1 ft. × 3 ft. × ⅓ ft. = 1 cu. ft. Twenty-seven cubic feet equals 1 cubic yard.

Local brick and stone suppliers will often help you design your project and advise you about estimating materials, local building codes, and climate considerations.

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JOB:04-30438 Title:Home Skill Landscaping
#175 Dtp:228 Page:25

ESTIMATING MATERIALS

Sand, gravel, topsoil (2" layer)	surface area (sq. ft.) ÷ 100 = tons needed
Standard brick pavers for walks (2" layer)	surface area (sq. ft.) × 5 = number of pavers needed
Standard bricks for walls and pillars (4 × 8")	surface area (sq. ft.) × 7 = number of bricks needed (single-brick thickness)
Poured concrete (4" layer)	surface area (sq. ft.) × .012 = cubic yards needed
Flagstone	surface area (sq. ft.) ÷ 100 = tons needed
Interlocking block (2" layer)	area of wall face (sq. ft.) × 1.5 = number of blocks needed
Ashlar stone for 1-ft.-thick walls	area of wall face (sq. ft.) ÷ 15 = tons of stone needed
Rubble stone for 1-ft.-thick walls	area of wall face (sq. ft.) ÷ 35 = tons of stone needed
8 × 8 × 16" concrete block for freestanding walls	height of wall (ft.) × length of wall (ft.) × 1.125 = number of blocks needed

AMOUNT OF CONCRETE NEEDED (CU. FT.)

Number of 8"-diameter footings	Depth of footings (ft.)			
	1 ft.	2 ft.	3 ft.	4 ft.
2	¾	1½	2¼	3
3	1	2¼	3½	4½
4	1½	3	4½	6
5	2	3¾	5¾	7½

CONCRETE COVERAGE

Volume	Thickness	Surface coverage
1 cu. yd.	2"	160 sq. ft.
1 cu. yd.	3"	110 sq. ft.
1 cu. yd.	4"	80 sq. ft.
1 cu. yd.	5"	65 sq. ft.
1 cu. yd.	6"	55 sq. ft.
1 cu. yd.	8"	40 sq. ft.

DRY INGREDIENTS FOR SELF-MIX

Amount of concrete needed (cu. ft.)	94-lb. bags of portland cement	Cubic feet of sand	Cubic feet of gravel	60-lb. bags of premixed dry concrete
1	⅙	⅓	½	2
2	⅓	⅔	1	4
3	½	1 ½	3	6
4	¾	1 ¾	3 ½	8
5	1	2 ¼	4 ½	10
10	2	4 ½	9	20

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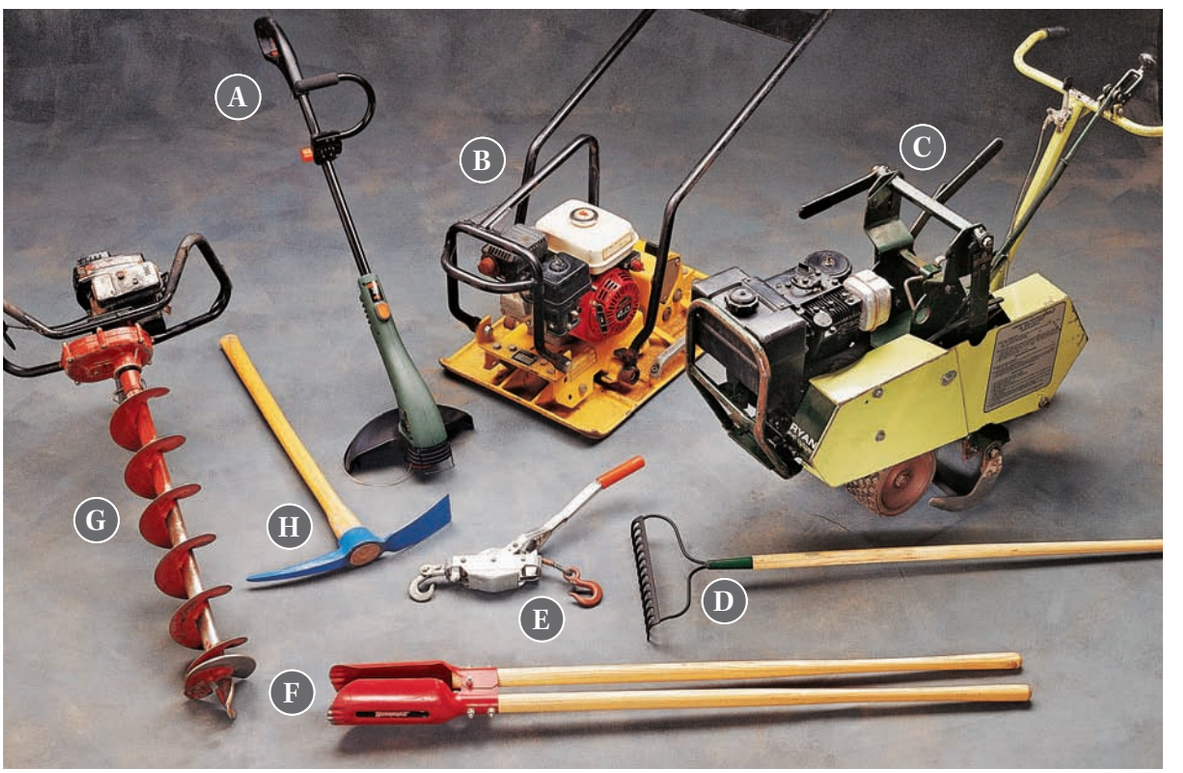
TOOLS

The landscaper's tool shed contains a range of basic hand tools, larger specialty tools, masonry tools, and power tools. As you take on projects in this book, you'll gradually expand your everyday tool box to a well-rounded collection that could easily fill a shed. You may not want to purchase every tool, and that's where rental centers come in handy. Many landscape supply and hardware stores also have equipment available for rent. If you'll use the equipment one time, or on a very limited basis, this is the most cost-effective way to acquire the tools you need without investing heavily in equipment that will sit unused 99 percent of the time.

Metal tools should be made from high-carbon steel with smoothly finished surfaces. Hand tools should be well-balanced and have tight, comfortably molded handles. Pick up the tool. How does it feel? Ergonomics are a big deal because you'll be spending lots of time handling your basic tools. Consider the length of the shaft on shovels, landscape rakes, etc. You can find adjustable options that allow you to "size" the equipment to suit your body.

Tip

For tools you decide to purchase, invest in the best you can afford. Estate sales often have good quality tools for less—and if the handle is ruined, replacements are available.



Specialty tools for landscape and yard work include: weed trimmer for clearing light brush (A), power tamper for compacting soil and subbase material (B), power sod cutter (C), garden rake or bow rake (D), come-along manual winch to assist in moving heavy objects (E), post-hole digger (F), gas-powered auger (G), pick axe (H).

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Hand tools include: caulk gun (A), tape measure (B), chalk line (C), compass (D), garden hose (E), bow saw (F), plumb bob (G), combination square (H), speed square (I), pressure sprayer (J), mason's line (K), square and round shovels (M), garden rake (N), posthole digger (O), hoe (P), carpenter's level (Q), framing square (R), putty knife (S), wood chisel (T), awl (U), socket wrench set (V), hammer (W), rubber mallet (X), pruning shears (Y), metal shears (Z), bar clamps (AA), and pipe clamps (BB).

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JOB:04-30438 Title:Home Skill Landscaping
#175 Dtp:228 Page:28

PLANTING & WATER MANAGEMENT PROJECTS

Landscape Beds & Edging 30
Rigid Paver Edging 32
Freeform Paver Edging 33
Concrete Curb Edging 34
Wood Edging 36
Planting Trees & Shrubs 38
Windbreaks 40
Mulch Beds 42
Rain Garden 44
Xeriscape 48
Drip Irrigation 52
In-Ground Sprinkler System 54

001-057_30438.indd 29 4/13/13 12:02 PM
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Landscape Beds & Edging

Tools & Materials

Landscape fabric (optional)
Soil amendments
Mulch
Plants
Hose
Spade
Shovel

Freeform planting beds within a landscaped yard provide borders, definition, and visual relief.

LANDSCAPE BEDS DRESS UP a plain, green yard and provide supple ground for growing perennials, annuals, vegetables, or whatever greenscape you choose to plant. Use your imagination! Beds can be dug to create borders in an outdoor living room, or they may be positioned as "islands" in a sea of green back yard. The shape, size, and location of a landscape bed is really up to you. Then just add edging to add a polished look to any landscape bed, walkway, or patio area. You can trim a bed with brick, natural stone, timber, or neat-and-clean black plastic edging. Edging serves the practical purpose of containment, keeping surface material in place so it doesn't drift off into the yard. Aesthetically speaking, it creates a visual border and provides an opportunity to incorporate hardscape into a landscape design.

Create Landscape Beds

Planting areas should occupy 40 to 50 percent of your total open yard area, so don't skimp. Of course, you'll add time to your gardening duties, but more beds means less mowing.

Before digging, use your site map to decide where you will place landscape beds. Don't get boxed into linear designs. Experiment with kidney-shaped beds, or beds that seem to flow like a creek with curved edges. Build in border beds that separate outdoor living spaces, such as a patio, from the rest of the yard. Beds also provide privacy when placed along a property line and planted with screening varieties, such as evergreens.

Once you decide on bed location and shape, check the soil quality of the area by conducting a soil test. That way you can add the correct soil amendments to be sure you're giving plants the best foundation for growth. Most soil will require amending, and you can do so with organic substances, including: sphagnum peat, wood chips, grass clippings (if you do not use lawn chemicals), straw, or compost. Remember, amendments are mixed into the soil and mulch is placed on the soil, after planting.

In the project shown here, you'll create a landscape bed with curved edges by using a garden hose to outline the bed shape. This bed features plastic edging, which is installed before amending soil. You can choose any number of edging materials (see pages 32 to 37) for this project. As always, before you dig, call your local utilities hotline first.

Tip

Choose low-maintenance shrubs and perennials that blossom like clockwork each season. Your nursery can help you with good choices for your area. Go on a weekday afternoon when they aren't swamped with weekend shoppers.

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INSTALLING A LANDSCAPE BED

1 Use a garden hose to outline the planned garden bed area. Remove the ground cover inside the area with a spade.

2 Dig a trench around the perimeter of the bed using a spade. Place plastic lawn edging into the trench and secure it by driving edging stakes into the bottom lip.

3 Till amendments into the soil with a spade and shovel. Test the design and layout of the plants. Install landscape fabric over the entire area, if desired, to inhibit weed growth.

4 Install plant material. Apply a 2 to 3" layer of mulch over the entire surface. Leave 1 to 2" of clearance for tree trunks and woody ornamentals to prevent insects and pests from attacking them.

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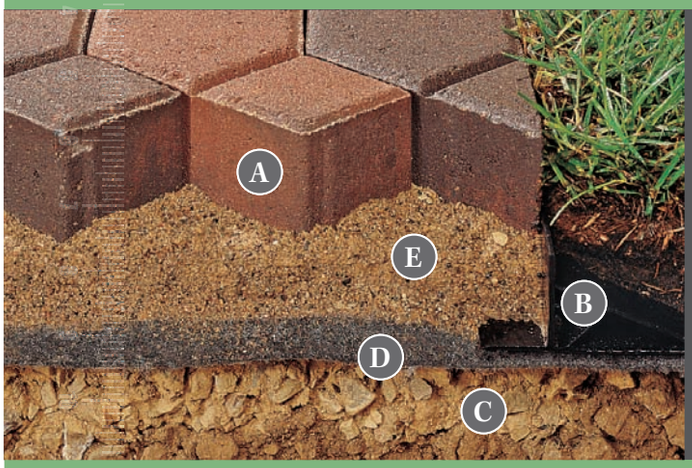
Rigid Paver Edging



A Brick pavers
B Rigid plastic edging
C Compactable gravel subbase
D Landscape fabric
E Sand

Tools & Materials

Landscape fabric (optional)
Soil amendments
Mulch
Plants
Hose
Spade
Shovel

Rigid plastic edging installs easily and works well for both curved and straight walkways made from paving stones or brick pavers set in sand.

CHOOSE HEAVY-DUTY EDGING that's strong enough to contain your surface materials. If your patio or walkway has curves, buy plenty of notched, or flexible, edging for the curves. Also, buy 12-inch-long galvanized spikes: one for every 12 inches of edging plus extra for curves.

Invisible edging is so named for its low-profile edge that stops about halfway up the side edges of pavers. The exposed portion of the edging is easily concealed under soil and sod or groundcover.

INSTALLING RIGID PAVER EDGING

1 Set the edging on top of a compacted gravel base covered with landscape fabric. Using your layout strings as guides, secure the edging with spikes driven every 12" (or as recommended by the manufacturer). Along curves, spike the edging at every tab, or as recommended.

2 Cover the outside of the edging with soil and/or sod after the paving is complete. Tip: On two or more sides of the patio or path, you can spike the edging minimally, in case you have to make adjustments during the paving. Anchor the edging completely after the paving is done.

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Freeform Paver Edging

Brick set on long edges

Brick soldier edging

Brick set on faces perpendicular to the walkway edge

Brick set on faces parallel to the walkway edge

Tools & Materials

- Flat shovel
- Rubber mallet
- 2 × 4 (about 12" long)
- Bricks
- Hand tamper
- Garden spade
- Work gloves
- Gravel
- Landscape fabric
- Eye protection

BRICK EDGING CAN BE LAID in several different configurations (see below): on-end with its edge perpendicular to the paved surface; on its long edges; or laid flat, either parallel or perpendicular to the walkway edge.

INSTALLING BRICK PAVER EDGING

1 Excavate the edge of the patio or walkway site using a flat shovel to create a clean, vertical edge. The edge of the soil (and sod) will support the outsides of the bricks. For edging with bricks set on-end, dig a narrow trench along the perimeter of the site, setting the depth so the tops of the edging bricks will be flush with the paving surface (or just above the surface for loose materials).

2 Set the edging bricks into the trench after installing the gravel subbase and landscape fabric. If applicable, use your layout strings to keep the bricks in line and to check for the proper height. Backfill behind the bricks with soil and tamp well as you secure the bricks in place. Install the patio surface material. Tap the tops of the bricks with a rubber mallet and a short 2 × 4 to level them with one another.

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Concrete Curb Edging

Concrete edging draws a sleek, smooth line between surfaces in your yard and is especially effective for curving paths and walkways.

Tools & Materials

- Rope or garden hose
- Excavation tools
- Mason's string
- Hand tamp
- Maul
- Circular saw
- Drill
- Concrete mixing tools
- Margin trowel
- Wood concrete float
- Concrete edger
- 1 × 1 wood stakes
- ¼" hardboard
- 1" wood screws
- Fiber-reinforced concrete
- Acrylic concrete sealer
- Eye and ear protection

POURED CONCRETE EDGING IS PERFECT for curves and custom shapes, especially when you want a continuous border at a consistent height. Keeping the edging low to the ground (about one inch above grade) makes it work well as a mowing strip, in addition to a patio or walkway border. Use fiber-reinforced concrete mix, and cut control joints into the edging to help control cracking.

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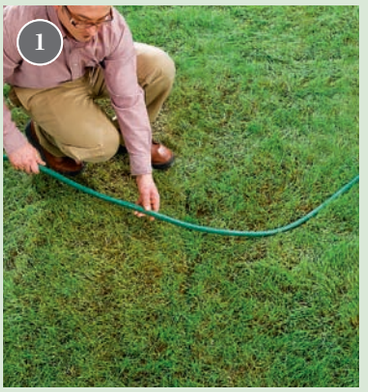
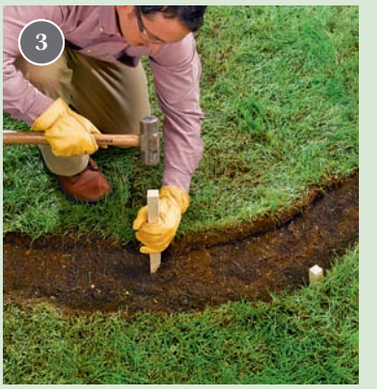
INSTALLING CONCRETE CURB EDGING





1 Lay out the contours of the edging using a rope or garden hose. For straight runs, use stakes and mason's string to mark the layout. Make the curb at least 5" wide.

2 Dig a trench between the layout lines 8" wide (or 3" wider than the finished curb width) at a depth that allows for a 4"-thick (minimum) curb at the desired height above grade. Compact the soil to form a flat, solid base.

3 Stake along the edges of the trench, using 1 × 1 × 12" wood stakes. Drive a stake every 18" along each side edge.

4 Build the form sides by fastening 4"-wide strips of ¼" hardboard to the insides of the stakes using 1" wood screws. Drill pilot holes to prevent the stakes from splitting. Bend the strips to follow the desired contours.

5 Add spacers inside the form to maintain a consistent width. Cut the spacers from 1 × 1 to fit snugly inside the form. Set the spacers along the bottom edges of the form at 3-ft. intervals.

6 Fill the form with concrete mixed to a firm, workable consistency. Use a margin trowel to spread and consolidate the concrete.

7 Tool the concrete: once the bleed water disappears smooth the surface with a wood float. Using a margin trowel, cut 1"-deep control joints across the width of the curb at 3-ft. intervals. Tool the side edges of the curb with an edger. Allow to cure. Seal the concrete, as directed, with an acrylic concrete sealer, and let it cure for 3 to 5 days before removing the form.

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JOB:04-30438 Title:Home Skill Landscaping
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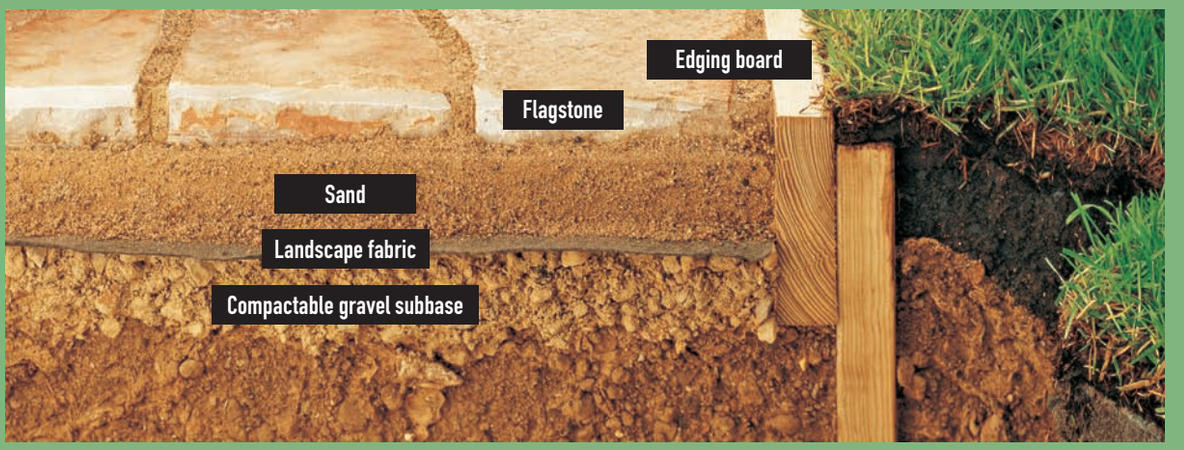
Wood Edging

Tools & Materials

Excavation tools
Circular saw
Compactable gravel
Drill
2× lumber for edging
2 × 4 lumber for stakes
Wood preservative
Landscape fabric
Sand
2½" galvanized deck screws
Eye and ear protection

Lumber or timber edging can be used with any patio surface material. Here, this lumber edging is not only decorative, it also holds all of the loose material in place.

PRESSURE-TREATED LANDSCAPE OR CEDAR TIMBERS make attractive, durable edging form beds or walkways that are easy to install. Square-edged timbers are best for geometric pavers like brick and cut stone, while loose materials and natural flagstone look best with rounded or squared timbers. Choose the size of timber depending on how bold you want the border to look.



Wood edging is a popular choice for simple flagstone or paver walkways and for patios with a casual look.

DIMENSION LUMBER MAKES FOR AN INEXPENSIVE EDGING MATERIAL and a less-massive alternative to landscape timbers; 2 × 4 or 2 × 6 lumber works well for most patios and walkways. Use only pressure-treated lumber rated for ground contact or all-heart redwood or cedar boards to prevent rot. For the stakes, use pressure-treated lumber, since they will be buried anyway and appearance is not a concern.

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JOB:04-30438 Title:Home Skill Landscaping
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INSTALLING TIMBER EDGING

1 During the site excavation, dig a perimeter trench for the timbers so they will install flush with the top of the patio or walkway surface (or just above the surface for loose material). Add the compacted gravel base, as required, including a 2 to 4" layer in the perimeter trench. Cut timbers to the desired length using a reciprocating saw with a long wood-cutting blade, a circular saw, or a handsaw.

2 Drill ½" holes through each timber, close to the ends and every 24" in between. Cut a length of ½"-diameter (#4) rebar at 24" for each hole using a reciprocating saw and metal-cutting blade. Set the timbers in the trench and make sure they lie flat. Use your layout strings as guides for leveling and setting the height of the timbers. Anchor the timbers with the rebar, driving the bar flush with the wood surface.

INSTALLING LUMBER EDGING

1 Excavate the project site, and dig a perimeter trench for the boards so they will install flush with the top of the surface (or just above the surface for loose material). Add the gravel base, as required, including a 2 to 4" layer of gravel in the trench. Cut the edging boards to length, and seal the ends with wood preservative. Cut 2 × 4 stakes about 16" long. Set the edging boards in the trench and drive a stake close to the ends of each board and every 24" in between.

2 Fasten the boards to the stakes with pairs of 2½" deck screws. Where boards meet at corners and butt joints, fasten them together with screws. Use your layout strings as guides for leveling and setting the height of the edging. Backfill behind the edging to support the boards and hide the stakes.

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JOB:04-30438 Title:Home Skill Landscaping
#175 Dtp:228 Page:37

Planting Trees & Shrubs

Tools & Materials

Shovel
Garden hose
Utility knife
Long stake
Tree
Peat moss

Trees and shrubs are packaged three different ways for sale: with a bare root, container-grown, and balled-and-burlapped. Bare root specimens (left) are the most wallet-friendly, but you must plant them during the dormant season, before growing begins. Container-grown plants (center) are smaller and take years to achieve maturity, but you can plant them any time—preferably during spring or fall. Balled-and-burlapped specimens (right) are mature and immediately fill out a landscape. They are also the most expensive.

Tip

Don't destroy your investment before it is in the ground—protect the branches, foliage, and roots from wind and sun damage during transport.

TREES AND SHRUBS are structural elements that provide many benefits to any property. Aside from adding structural interest to a landscape, they work hard to provide shade, block wind, and form walls and ceilings of outdoor living areas. Whether your landscape is a blank canvas or you plan to add trees and shrubs to enhance what's already there, you'll want to take great care when selecting what type of tree you plant, and how you plant it.

A substantially sized tree might be your greatest investment in plant stock, which is more reason to be sure you give that tree a healthy start by planting it correctly. Timing and transportation are the first issues you'll consider. The best time to plant is in spring or fall, when the soil is usually at maximum moistness and the temperature is moderate enough to allow roots to establish. When loading and unloading, lift by the container or root ball, not the trunk. You may decide to pay a nursery to deliver specimens if they are too large for you to manage, or if you are concerned about damaging them en route to your property.

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JOB:04-30438 Title:Home Skill Landscaping
#175 Dtp:228 Page:38

PLANTING A BALLED-AND-BURLAPPED TREE

1 Use a garden hose to mark the outline for a hole that is at least two or three times the diameter of the root ball. If you are planting trees with shallow, spreading roots (such as most evergreens) rather than a deep taproot, make the hole wider. Dig no deeper than the height of the rootball.

2 Amend some of the removed soil with hydrated peat moss and return the mixture to build up the sides of the hole, creating a medium that is easy for surface roots to establish in. If necessary (meaning, you dug too deep) add and compact soil at the bottom of the hole so the top of the rootball will be slightly above grade when placed.

3 Place the tree in the hole so the top of root ball is slightly above grade and the branches are oriented in a pleasing manner. Cut back the twine and burlap from around the trunk and let it fall back into the hole. Burlap may be left in the hole—it will degrade quickly. Non-degradable rootball wrappings should be removed.

4 Backfill amended soil around the rootball until the soil mixture crowns the hole slightly. Compress the soil lightly with your hands. Create a shallow well around the edge of the fresh soil to help prevent water from running off. Water deeply initially and continue watering very frequently for several weeks. Staking the tree is wise, but make sure the stake is not damaging the roots.

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Windbreaks

Tools & Materials

Shovel
Garden hose
Utility knife
Trees
Soil amendments (as needed)

A stand of fast-growing trees, like these aspens, will create an effective windbreak for your property just a few years after saplings are planted.

WIND SAPS heat from homes, forces snow into burdensome drifts, and can damage more tender plants in a landscape. To protect your outdoor living space, build an aesthetically pleasing wall—a "green" wall of tress and shrubs—that will cut the wind and keep those energy bills down. Windbreaks are commonly used in rural areas where sweeping acres of land are a runway for wind gusts. But even those on small, suburban lots will benefit from strategically placing plants to block the wind.

Essentially, windbreaks are plantings or screens that slow, direct, and block wind from protected areas. Natural windbreaks are comprised of shrubs, conifers, and deciduous trees. The keys to a successful windbreak are: height, width, density, and orientation. Height and width come with age. Density depends on the number of rows, type of foliage, and gaps. Ideally, a windbreak should be 60 to 80 percent dense. (No windbreak is 100 percent dense.) Orientation involves placing rows of plants at right angles to the wind. A rule of thumb is to plant a windbreak that is ten times longer than its greatest height. And keep in mind that wind changes direction, so you may need a multiple-leg windbreak.

Tip

If you live in a rural area, contact your local university extension service for windbreak plans for your area. Also, bulk tree seedlings are available from organizations like the Arbor Day Foundation for very low cost. Of course, seedlings will take longer to mature than saplings, but if you are planting hundreds of trees it might be worth the wait.

Windbreak Benefits

Windbreaks deliver multiple benefits to your property.:

Energy conservation: reduce energy costs from 20 to 40 percent.

Snow control: single rows of shrubs function as snow fences.

Privacy: block a roadside view and protect animals from exposure to passers-by.

Noise control: muffle the sound of traffic or neighbors.

Aesthetic appeal: improve your landscape and increase the value of your property.

Erosion control: prevent dust from blowing; roots work against erosion.

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JOB:04-30438 Title:Home Skill Landscaping
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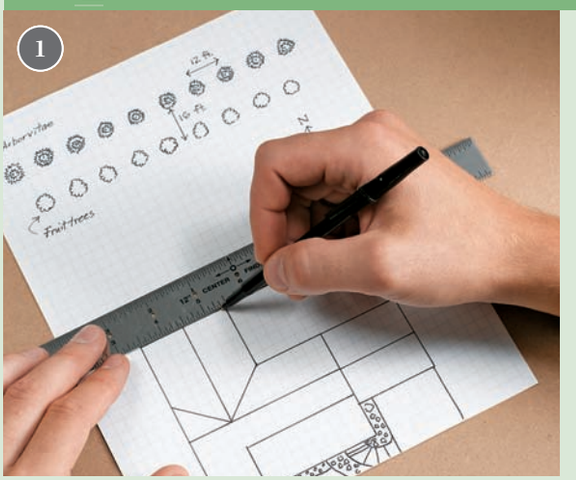
PLANTING WINDBREAKS



1 Before you pick up a shovel, draw a plan of your windbreak, taking into consideration the direction of the wind and location of nearby structures. Windbreaks can be straight lines of trees or curved formations. They may be several rows thick, or just a single row. If you only have room for one row, choose lush evergreens for the best density. Make a plan.

2 Once you decide on the best alignment of trees and shrubs, stake out reference lines for the rows. For a three-row windbreak, the inside row should be at least 75 ft. from buildings or structures, with the outside row 100 to 150 ft. away. Within this 25 to 75 ft. area, plant rows 16 to 20 ft. apart for shrubs and conifers and no closer than 14 ft. for deciduous trees. Within rows, space trees so their foliage can mature and eventually improve the density.

3 Dig holes for tree root balls to the recommended depth (see pages 38 to 39). Your plan should arrange short trees or shrubs upwind and taller trees downwind. If your windbreak borders your home, choose attractive plants for the inside row and buffer them with evergreens or dense shrubs in the second row. If you only have room for two rows of plants, be sure to stagger the specimens so there are no gaps.

4 Plant the trees in the formation created in your plan. Follow the tree and shrub planting techniques on page 39.

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Mulch Beds

Mulch comes in many varieties, but most is made from shredded wood and bark. Because it is an organic material it breaks down and requires regular refreshing.

Mulches

Organic:
Compost
Lawn clippings (free of chemicals)
Leaves
Wood chips or shavings
Bark
Manure

Synthetic and Stone:
Recycled rubber mulch
Stone or brick
Landscape fabric

MULCH IS THE DRESSING on a landscape bed, but its benefits run deeper than surface appeal. Mulch protects plant and tree roots, prevents soil erosion, discourages weed growth, and helps the ground retain moisture. You can purchase a variety of mulches for different purposes. Synthetic mulches and stones are long-lasting, colorful, and resist erosion. They'll never break down. Organic mulches, such as compost and wood chips, will decompose over time.

No matter what type of mulch you choose, application technique is critical. If you spread it too thick it may become matted down and can trap too much moisture. Too thin, it can wash away to reveal bare spots. If it is unevenly applied it will appear spotty.

Consider timing before you apply mulch. The best time to mulch is mid- to late-spring, after the ground warms up. If you apply mulch too soon, the ground will take longer to warm up and your plants will suffer for it. You may add more mulch during the summer to retain water, and in the winter to insulate soil. (As weather warms, lift some of the mulch to allow new growth to sprout.) Spring is prime mulching time.

Tip

If you have a dog, avoid using the cocoa hull mulch. Some dogs will eat it, and it contains the same dangerous-to-dog chemicals as chocolate.

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JOB:04-30438 Title:Home Skill Landscaping
#175 Dtp:228 Page:42

LANDSCAPING WITH MULCH

1 Remove weeds from the bed and water plants thoroughly before applying mulch. For ornamental planting beds it often is a good idea to lay strips of landscape fabric over the soil before mulching.

2 Working in sections, scoop a pile of material from the load (wheelbarrow or bag) and place the piles around the landscape bed.

3 Spread mulch material to a uniform 1" thickness to start. Do not allow mulch to touch tree trunks or stems of woody ornamentals. Compost can double as mulch and a soil amendment that provides soil with nutrients. If you don't make your own compost, you can purchase all-natural products such as Sweet Peet.

Option:
Help contain the mulch in a confined area by installing flexible landscape edging.

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JOB:04-30438 Title:Home Skill Landscaping #175 Dtp:228 Page:43

Rain Garden

Tools & Materials

Shovels
Rakes
Trowels
Carpenter's level
Small backhoe (optional)
Tape measure
Wood stakes, at least 2 ft. long
String
6 ft. 2 × 4 board (optional)

Rain gardens provide a valuable habitat for birds and wildlife, and these purposeful landscape features also enhance the appearance of your yard.

A RAIN GARDEN COLLECTS AND FILTERS water run-off, which prevents flooding and protects the environment from pollutants carried by urban stormwater. In fact, when a rain garden is installed and planted properly, it looks like any other landscape bed on a property. (There are no ponds or puddles involved.) The difference is, a rain garden can allow about 30 percent more water to soak into the ground than a conventional lawn.

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JOB:04-30438 Title:Home Skill Landscaping
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Though a rain garden may seem like a small environmental contribution toward a mammoth effort to clean up our water supply and preserve aquifers, collectively they can produce significant community benefits. For instance, if homeowners in a subdivision each decide to build a rain garden, the neighborhood could avoid installing an unsightly retention pond to collect stormwater run-off. So you see, the little steps you take at home can make a big difference.

Most of the work of building a rain garden is planning and digging. If you recruit some helpers for the manual labor, you can easily accomplish this project in a weekend. As for the planning, give yourself good time to establish a well-thought-out design that considers the variables mentioned here. And as always, before breaking ground, you should contact your local utility company or digging hotline to be sure your site is safe.

Preparing the Land

Soil is a key factor in the success of your rain garden because it acts as a sponge to soak up water that would otherwise run off and contribute to flooding, or cause puddling in a landscape. Soil is either sandy, silty, or clay-based, so check your yard to determine what category describes your property. Sandy soil is ideal for drainage, while clay soils are sticky and clumpy. Water doesn't easily penetrate thick, compacted clay soils, so these soils need to be amended to aerate the soil body and give it a porous texture that's more welcoming to water run-off. Silty soils are smooth but not sticky and absorb water relatively well, though they also require amending. Really, no soil is perfect, so you can plan on boosting its rain garden potential with soil amendments. The ideal soil amendment is comprised of: washed sharp sand (50%); double-shredded hardwood mulch (15%); topsoil (30%); and peat moss (5%). Compost can be substituted for peat moss.

While planning your rain garden, give careful consideration to its position, depth, and shape. Build it at least 10 feet from the house, and not directly over a septic system. Avoid wet patches where infiltration is low. Shoot for areas with full or partial sun that will help dry up the land, and stay away from large trees. The flatter the ground, the better. Ideally, the slope should be less than a 12% grade.

Residential rain gardens can range from 100 to 300 square feet in size, and they can be much smaller, though you will have less of an opportunity to embellish the garden with a variety of plants. Rain gardens function well when shaped like a crescent, kidney, or teardrop. The slope of the area where you're installing the rain garden will determine how deep you need to dig. Ideally, dig four to eight inches deep. If the garden is too shallow, you'll need more square footage to capture the water run-off, or risk overflow. If the garden is too deep, water may collect and look like a pond. That's not the goal.

Finally, as you consider the ideal spot for your rain garden—and you may find that you need more than one—think about areas of your yard that you want to enhance with landscaping. Rain gardens are aesthetically pleasing, and you'll want to enjoy all the hard work you put into preparing the land and planting annuals and perennials.

Tip: Before you Dig

Determine the best place for your rain garden by answering the following questions:

- Where does water stand after a heavy rain?
- What is the water source? (drainpipe, run-off from a patio or other flat surface, etc.)
- What direction does water move on your property?
- Where could water potentially enter and exit a rain garden?
- Where could a rain garden be placed to catch water from its source before it flows to the lowest point on the property?
- Do you need more than one rain garden?

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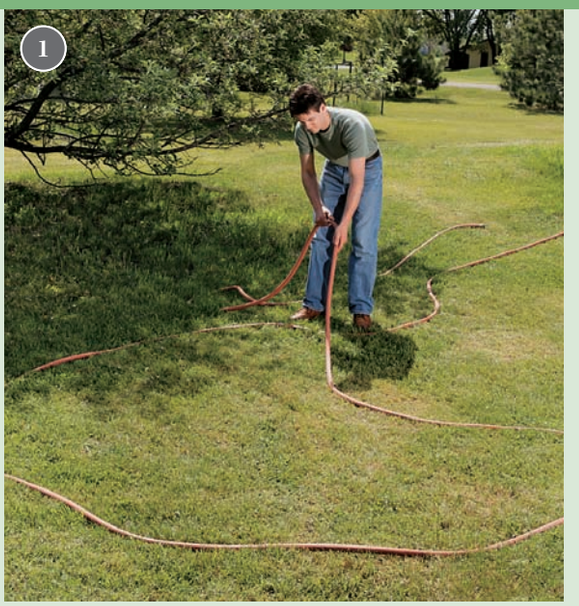
BUILDING A RAIN GARDEN



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JOB:04-30438 Title:Home Skill Landscaping
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1 Choose a site, size, and shape for the rain garden, following the design standards outlined on the previous two pages. Use rope or a hose to outline the rain garden excavation area. Avoid trees and be sure to stay at least 10 ft. away from permanent structures. Try to choose one of the recommended shapes: crescent, kidney, or tear drop.

2 Dig around the perimeter of the rain garden and then excavate the central area to a depth of 4 to 8". Heap excavated soil around the garden edges to create a berm on the three sides that are not at the entry point. This allows the rain garden to hold water in during a storm.

3 Dig and fill sections of the rain garden that are lower, working to create a level foundation. Tamp the top of the berm so it will stand up to water flow. The berm eventually can be planted with grasses or covered with mulch.

4 Level the center of the rain garden and check with a long board with a carpenter's level on top. Fill in low areas with soil and dig out high areas. Move the board to different places to check the entire garden for level. Note: If the terrain demands, a slope of up to 12% is okay. Then, rake the soil smooth.

5 Plant specimens that are native to your region and have a well-established root system. Contact a local university extension or nursery to learn which plants can survive in a saturated environment (inside the rain garden). Group together bunches of 3 to 7 plants of like variety for visual impact. Mix plants of different heights, shapes, and textures to give the garden dimension. Mix sedges, rushes, and native grasses with flowering varieties. The plants and soil cleanse stormwater that runs into the garden, leaving pure water to soak slowly back into the earth.

6 Apply double-shredded mulch over the bed, avoiding crowns of new transplants. Mulching is not necessary after the second growing season. Complement the design with natural stone, a garden bench with a path leading to it, or an ornamental fence or garden wall. Water a newly established rain garden during drought times—as a general rule, plants need 1 in. of water per week. After plants are established, you should not have to water the garden. Maintenance requirements include minor weeding and cutting back dead or unruly plant material annually.

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JOB:04-30438 Title:Home Skill Landscaping
#175 Dtp:228 Page:47

Xeriscape

Xeriscaping is associated with sand, cacti, and arid climates, but the basic idea of planting flora that withstands dry conditions and makes few demands on water resources is a valid goal in any area.

XERISCAPING, IN A NUTSHELL, is waterwise gardening. It is a form of landscaping using drought-tolerant plants and grasses. How a property is designed, planted, and maintained can drastically reduce water usage if xeriscape is put into practice. Some think that xeriscaping will become a new standard in gardening as water becomes a more precious commodity and as homeowners' concern for the environment elevates.

Several misconceptions about xeriscaping still exist. Many people associate it with desert cactus

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JOB:04-30438 Title:Home Skill Landscaping
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and dirt, sparsely placed succulents and rocks. They are convinced that turf is a four-letter word and grass is far too thirsty for xeriscaping. This is not true. You can certainly include grass in a xeriscape plan, but the key is to incorporate turf where it makes the most sense: children's play areas or front yards protected from foot traffic. Also, your choice of plants expands far beyond prickly cactus. The plant list, depending on where you live, is long and varied.

The Seven Principles of Xeriscape

Keep in mind these foundational principles of xeriscape as you plan a landscape design. First begin by finding out what the annual rainfall is in your area. What time of year does it usually rain? Answering these questions will help guide plant selection. Now look at the mirco-environment: your property. Where are there spots of sun and shade? Are there places where water naturally collects and the ground is boggy? What about dry spots where plant life can't survive? Where are trees, structures (your home), patios, walkways, and play areas placed? Sketch your property and figure these variables into your xeriscape design.

Also, carefully study these seven principles and work them into your plan.

1. Water conservation: Group plants with similar watering needs together for the most efficient water use. Incorporate larger plantings that provide natural heating and cooling opportunities for adjacent buildings. If erosion is a problem, build terraces to control water runoff. Before making any decision, ask yourself: How will this impact water consumption?
2. Soil improvement: By increasing organic matter in your soil and keeping it well aerated, you provide a hardy growing environment for plants, reducing the need for excess watering. Aim for soil that drains well and maintains moisture effectively. Find out your soil pH level by sending a sample away to a university extension or purchasing a home kit. This way, you can properly amend soil that is too acidic or alkaline.
3. Limited turf areas: Grass isn't a no-no, but planting green acres with no purpose is a waste. The typical American lawn is not water-friendly—just think how many people struggle to keep their lawns green during hot summers. If you choose turf, ask a nursery for water-saving species adapted to your area.
4. Appropriate plants: Native plants take less work and less water to thrive. In general, drought-resistant plants have leaves that are small, thick, glossy, silver-grey, or fuzzy. These attributes help plants retain water. As a rule, hot, dry areas with south and west exposure like drought-tolerant plants; while north- and east-facing slopes and walls provide moisture for plants that need a drink more regularly. Always consider a plant's water requirements and place those with similar needs together.
5. Mulch: Soil maintains moisture more effectively when its surface is covered with mulch such as leaves, coarse compost, pine needles, wood chips, bark, or gravel. Mulch will prevent weed growth and reduce watering needs when it is spread three inches thick.
6. Smart irrigation: If you must irrigate, use soaker hoses or drip irrigation (see page 52). These systems deposit water directly at plants' roots, minimizing run-off and waste. The best time to water is early morning.
7. Maintenance: Sorry, there's no such thing as a no-maintenance lawn. But you can drastically cut your outdoor labor hours with xeriscape. Just stick to these principles and consider these additional tips: 1) plant windbreaks to keep soil from drying out (see page 40); 2) if possible, install mature plants that require less water than young ones; 3) try "cycle" irrigation where you water to the point of seeing run-off, then pause so the soil can soak up the moisture before beginning to water again.

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JOB:04-30438 Title:Home Skill Landscaping
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1 Plan the landscape with minimal turf, grouping together plants with similar water requirements. Refer to the Seven Principles of Xeriscape as you sketch. Always consider your region's climate, and your property's microclimate: rainfall, sunny areas, shady spots, wind exposure, slopes (causing run-off), and high foot-traffic zones.

2 Divide your xeriscape landscape plan into three zones. The oasis is closest to a large structure (your home) and can benefit from rain runoff and shade. The transition area is a buffer between the oasis and arid zones. Arid zones are farthest away from structures and get the most sunlight. These conditions will dictate the native plants you choose.

3 Plant in receding layers by installing focal-point plants closest to the home (or any other structure), choosing species that are native to the area. As you get farther away from the home, plant more subtle varieties that are more drought-tolerant.

4 As you plant beds, be sure to group together plants that require more water so you can efficiently water these spaces.

5 Incorporate groundcover on slopes, narrow strips that are difficult to irrigate and mow, and shady areas where turf does not thrive. Install hardscape such as walkways, patios, and stepping-stone paths in high foot-traffic zones.

6 Mulch will help retain moisture, reduce erosion, and serves as a pesticide-free weed control. Use it to protect plant beds and fill in areas where turf will not grow.

7 Plant turf sparingly in areas that are easy to maintain and will not require extra watering. Choose low-water use grasses adapted for your region. These may include Kentucky Bluegrass, Zoysia, St. Augustine, and Buffalo grass.

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Drip Irrigation

Tools & Materials

Drip irrigation kit
Tubing punch
Extra fittings, as needed

Drip irrigation systems offer many different types of fittings, including the spray head shown here. Because they precisely direct water exactly where it's needed, drip systems waste very little water. A thick layer of mulch around plants will help keep soil moist.

PLANTS LOVE DEEP, long drinks of water, and this can best be accomplished through water-saving drip irrigation. Rather than dousing plant beds with a hit of water, which can pool on the surface and run off rather than sinking down to feed roots, drip irrigation's misty spray or gurgling drip (depending on the system) take time to feed plants slowly. Not a drop of water is wasted, making this method the most "green" way to water plant beds that require such maintenance.

Irrigation Equipment

Some of the things you'll need include: Emitters (A), Sprayer stakes (B), Crimp (C), Filter housing and filter (D), Key punch (E), Tee fitting (F), Coupler (G), Pressure-reducer (H). **Basic kits come** with only a few components, but can be augmented with pieces purchased "a la carte." You'll also need a punch for piercing the tubing and "goof plugs" for repairing errant punches.

Tubing for drip irrigation is thin-wall flexible polyethylene or polyvinyl, typically ¼" or ½" in diameter. Internal diameters can vary from manufacturer to manufacturer, so it's a good idea to purchase pipe and fittings from a single source.

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JOB:04-30438 Title:Home Skill Landscaping
#175 Dtp:228 Page:52

INSTALLING A DRIP IRRIGATION SYSTEM

1 Connect the system's supply tube to a water source, such as a hose spigot or a rainwater system. If you tap into your household water supply, use a pressure gauge to check water pressure. If pressure exceeds 50 pounds per square inch (psi), install a pressure-reducing fitting before attaching the feeder tube. A filter should also be attached to the faucet before the feeder tube.

2 At garden bed locations, begin installing drip emitters every 18". You can also purchase ½" PE tubing with emitters preinstalled. If you use this tubing, cut the feeder tube once it reaches the first bed, and attach the emitter tubing with a barbed coupling. Route the tubing among the plants so that emitters are over the roots.

3 For trees and shrubs, make a branch loop around the tree. Pierce the feed tube near the tree and insert a T-fitting. Loop the branch around the tree and connect it to both outlets on the T-fitting. Use ¼" tubing for small trees, ½" for larger specimens. Insert emitters in the loop every 18".

4 Use micro sprayers for hard-to-reach plants. Sprayers can be connected directly to the main feeder line or positioned on short branch lines. Sprayers come in a variety of spray patterns and flow rates; choose one most appropriate for the plants to be watered.

5 Potted plants and raised beds can also be watered with sprayers. Place stake-mounted sprayers in the pots or beds. Connect a length of ¼" tubing to the feeder line with a coupler, and connect the ¼" line to the sprayer.

6 Once all branch lines and emitters are installed, flush the system by turning on the water and letting it flow for a full minute. Then, close the ends of the feeder line and the branch lines with figure-8 end crimps. Tubing can be left exposed or buried under mulch.

Tip

For a fast-drip irrigation solution, use a soaker hose with tiny holes. You can snake the hose through a landscape bed or bury it under mulch. Cut the hose to a desired length and use end caps or hose fittings, as needed. These hoses have a 2- to 3-inch watering width.

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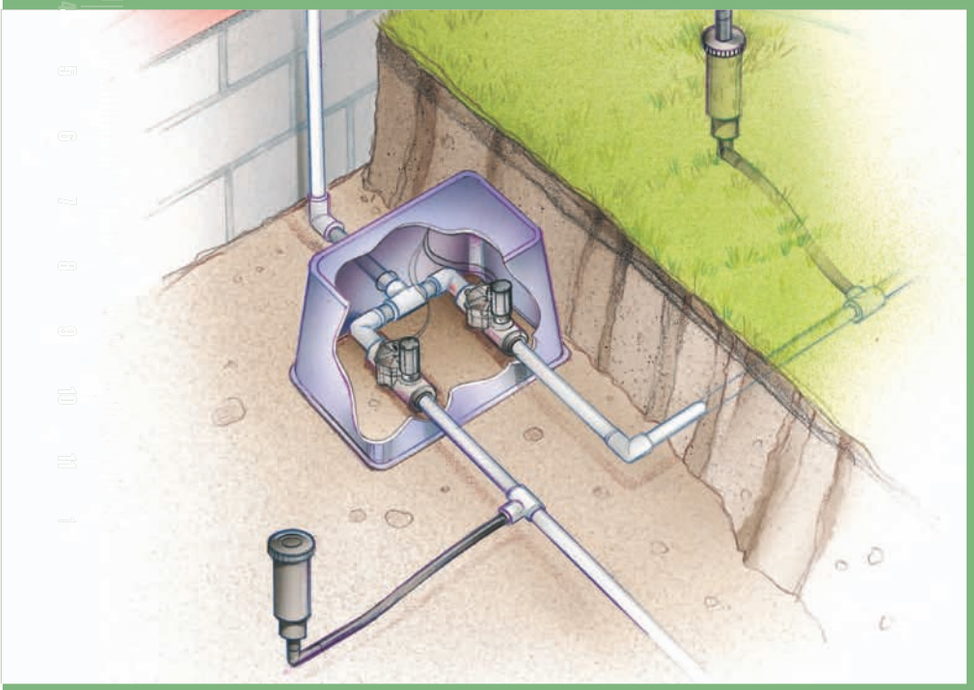
Pro-Vision C M Y K (Ray) (Text)

In-Ground Sprinkler System



Tools & Materials

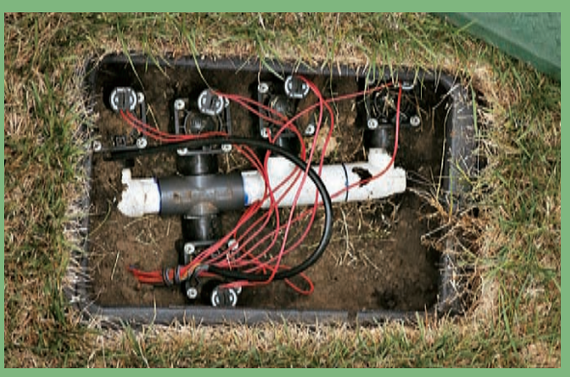
- Bucket
- Stopwatch
- Pressure valve
- Drill with 1" bit
- Shovel
- Utility knife
- Compression T-fitting
- PVC pipe
- PVC valves & fittings
- PVC solvent glue
- Antisiphon fitting
- Irrigation manifold with control module & controller
- Wooden stakes & string
- PVC or PE irrigation pipe
- T-fittings & L-fittings
- Irrigation risers
- Irrigation heads

Water from the house supply (or sometimes an external source such as a river and pump) enters a manifold in the irrigation system and is apportioned out to a network of sprinkler heads from the manifold.

SPRINKLER SYSTEMS offer a carefree means of keeping your lawn and garden green. Home improvement centers and landscaping retailers sell kits as well as individual components for installing in-ground systems. Installing a system can take a bit of time, but it's not at all difficult. The most challenging part of the job might be tapping into your home's plumbing system. If you're unsure of your abilities here, you can install everything but the final hookups, then hire a plumber to tap into the plumbing system.

For larger yards, design a sprinkler system with several zones, each serviced by a separate feeder pipe. Water is distributed to these zones at a manifold connected to the main supply line.

A variety of timers are available for automating any irrigation system. More expensive models will control as many as 16 different zones, and may have rain sensors that prevent the system from operating if it is raining. The instructions will vary depending on the type of timer and accessory you buy, but all operate in largely the same way: the timer plugs into an ordinary receptacle, and sends its control signals to the manifold valves through low-voltage wires.



The manifold for a sprinkler system typically is buried in a shallow box in the yard and covered with an easily removed lid.

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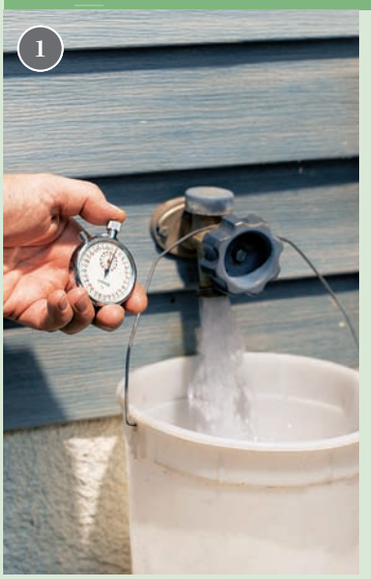
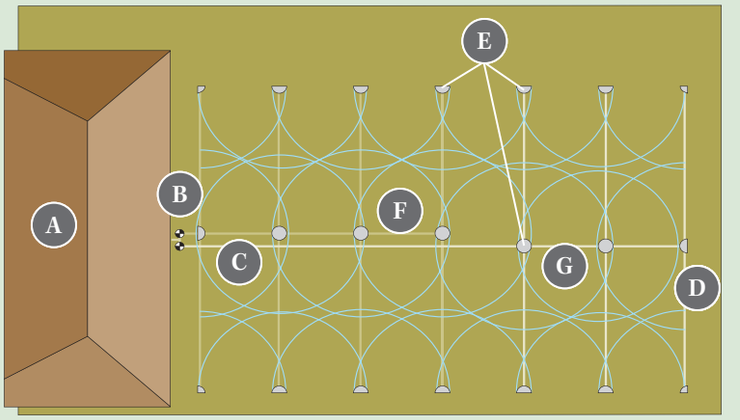
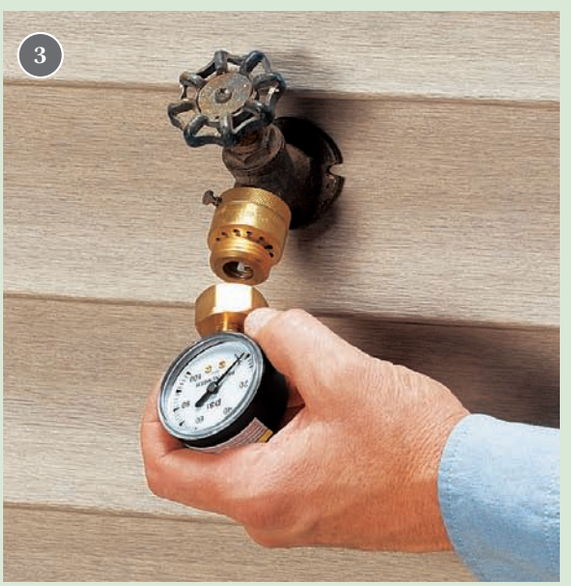
DESIGNING AN IN-GROUND SPRINKLER SYSTEM





House (A), Valve manifold (B), Sprinkler line (PVC pipe) (C), Sprinkler line (PE pipe) (D), Sprinkler heads (E), Circuit 1 (F), Circuit 2 (G)



Tip

Before beginning an irrigation system project, check with your local building department. You may need a permit. Also check local requirements regarding backflow prevention or anti-siphon devices. Before you dig trenches, call your utility company to have any utility lines marked.

1 To measure the flow rate of your water service, set a gallon bucket under an outdoor spigot. Open the faucet all the way and record the amount of time it takes to fill the bucket. To calculate the gallons per minute (GPM), divide 60 by the number of seconds it took to fill the gallon bucket. So, if it took 6 seconds, then 60 ÷ 6 equals 10 GPM. This number will determine the size of your manifold and feeder pipe.

2 Make a sketch showing layout of sprinkler heads. Follow manufacturer's instructions for overlapping head spray patterns. Keep heads at least 6" from sidewalks, driveways, and buildings. Next, mark the irrigation manifold location and create zones for your sprinkler heads. Locate the manifold near the water meter. Zones are individual runs of PVC or PE supply pipe the same size as your water main. Turns and changes of elevation can reduce efficiency, so try to design zones with few turns or rises.

3 Now measure the pressure of your water system. Make sure all faucets in the house are off. Attach a pressure valve to any faucet in the system and open its valve all the way. Record the reading.

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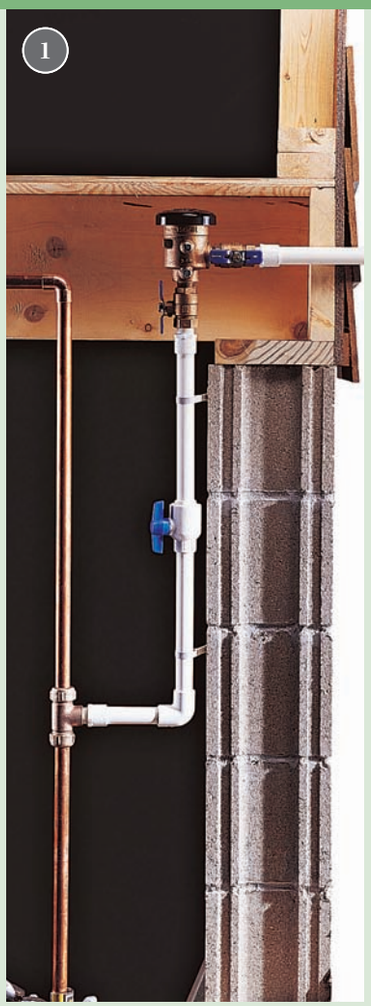
INSTALLING A SPRINKLER SYSTEM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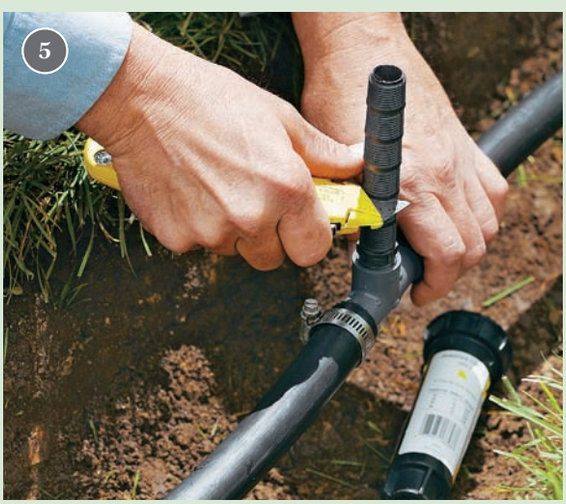
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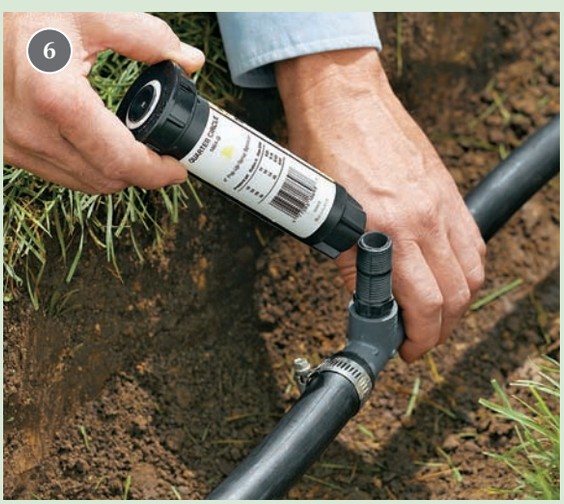
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JOB:04-30438 Title:Home Skill Landscaping
#175 Dtp:228 Page:56

1 Tap into your water supply. Shut off the water at the main shutoff valve. On the downstream side of your water meter, install a compression T-fitting. To supply the irrigation system, you will need to run PVC pipe to the manifold location. At a convenient location inside the house, install a gate valve with bleed in the line. Outside, dig a 10" trench leading to the manifold location. Drill a 1" hole through the sill directly above the trench, and route the pipe through the hole and down to the trench, using an L-fitting. You may also need to install a backflow prevention or an anti-siphon device between the main and the irrigation manifold; check local code.

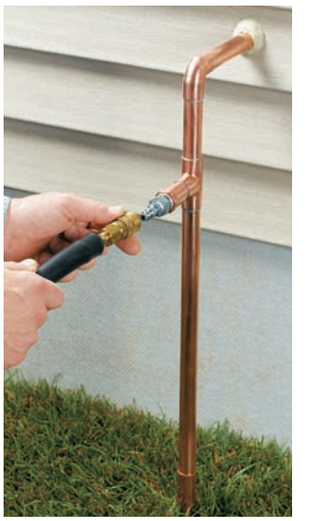
2 Choose a manifold with as many outlets as you have zones. The manifold shown here has two zones. Assemble the manifold as directed (some come preassembled, others are solvent-glued) and set it in the hole. Connect the supply pipe from the house to the manifold with an automated control module. Install the controller on the house near the supply pipe (inset) and run the included wires under the supply pipe from the valves to control module.

3 Mark the sprinkler locations. Use stakes or landscape flags to mark the sprinkler locations and then mark the pipe routes with spray paint or string. Once all the locations are marked, dig the trenches. In nonfreezing climates, trenches can be as little as 6". In freezing climates, dig trenches at least 10" deep. Renting a trencher can speed the job considerably. Set the sod aside so you can replace it after the sprinklers are installed.

4 Lay the pipe. Work on one zone at a time, beginning at the manifold. Connect the first section of PVC or PE pipe (PE shown) to the manifold outlet with solvent glue for PVC, or a barbed coupler and pipe clamps for PE (shown). At the first sprinkler location, connect a T-fitting with a female-threaded outlet for the riser. Continue with the next run of PE to the next sprinkler location. Install T-fittings at each sprinkler location. At the end of each zone, install an L-fitting for the last sprinkler.

5 Install the risers for the sprinkler heads. Risers come in a variety of styles. The simplest are short, threaded pipe nipples, but flexible and cut-to-fit risers are also available. Use a riser recommended by the manufacturer for your sprinkler head. For pop-up heads, make sure the nipple is the correct length for proper sprinkler operation.

6 Once all the risers are in place, flush the system. Turn on the water and open the valves for each zone one at a time, allowing the water to run for about a minute or until it runs clear. After the system is flushed, begin installing the sprinkler heads. Thread the heads onto the risers and secure them in place with earth. Make sure the heads are vertical (stake the risers if necessary). Fill in the rest of the trenches and replace the sod.



Tip

In freezing climates, the system needs to be drained with compressed air before winter. Install the fitting downstream of any anti-siphon valves but before the manifold. In the fall, close the irrigation system's shutoff valve and open any drain valves. At the manifold, open one zone's valve and blow air into the zone until no water comes out. Repeat for each zone.

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aping JOB:04-30438 Title:Home Skill Landscaping
ge:56 Pro-Vision C M Y K (Ray) (Text) #175 Dtp:228 Page:57

BUILDING PROJECTS

Design & Layout for Walkways & Steps 60

Sandset Brick Walkway 64

Flagstone Walkway 70

Simple Gravel Path 72

Pebbled Stepping Stone Path 78

Timber Garden Steps 81

Flagstone Garden Steps 85

Fence Design & Layout 92

Fenceline Layout 97

Wood Panel Fence 103

Split Rail Fence 109

Vinyl Panel Fence 113

Dry Stone Wall 117

Interlocking Block Retaining Wall 120

058-128_30438.indd 58 4/13/13 3:57 PM
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Pro-Vision C M Y K (Ray) (Text)
JOB:04-30438 Title:Home Skill Landscaping
#175 Dtp:228 Page:58

A LANDSCAPE OF PLANTS, trees, and shrubs is really only a partial landscape. The hardscape—walkways, steps, walls, or fences—guides the eye, demarks boundaries, provides backdrop, and allows for easy access. Small and large yards can benefit from thoughtful inclusion of each of these aspects. A pathway guides visitors to your yard, moving them through the beautiful plantings you have added to your outdoor living area. Fences and walls not only mark boundaries between in and out for privacy and security, they can also provide a contrasting backdrop for plantings or support for vines. Fences also serve as screens to block unsavory elements from view. A retaining wall can help control erosion and provide more level ground for living spaces and planting areas. A decorative low rock wall can provide seating while setting off patio areas from the yard.

Because the hardscape can tend to be more expensive and labor intensive than some aspects of the vegetative landscape, it is even more important to plan these projects carefully before beginning. Fences and walls on property boundaries are governed by local building codes and respect for neighbors. Make certain to check in with both neighbors and your local governing agency for appropriateness of your project.

To help with planning, begin a list of hardscape elements you observe in your neighborhood and whether you find them appealing or not. Online image searches of walkways, walls, and fences will provide you with more ideas than you may know what to do with.

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Design & Layout for Walkways & Steps

As an important part of a home's curb appeal, a primary walkway should be styled to complement the house exterior and street-side landscaping.

Secondary walkways can be a blend of practicality and decoration. A gentle curve here and there adds interest without slowing travel too much.

A tertiary path can be as rustic or creative as you like. It can serve as an invitation to stroll through a garden or an access path for tending plants—or both.

Tools & Materials

- Stakes
- Mason's string
- Maul
- Plate compactor
- Compactable gravel
- Excavation tools
- Line level
- ¾" rope
- Marking paint
- Lumber (1 × 2, 1 × 4, 2 × 4)
- Level
- Drill and drill bit
- Cardboard
- Screws
- Eye and ear protection
- Work gloves

DESIGNING AND PLANNING a new walkway starts with a careful assessment of how the path will be used. Landscape designers commonly group outdoor walkways into three main categories, according to use and overall design goals.

The first is a primary walkway: a high-traffic path used by household members and visitors, such as a walkway between the street and the home's main entry door. A main path should provide the quickest and easiest route from point A to point B. Any unnecessary twists and turns are likely to be cross-cut by walkers, leaving you with a less manicured path through the yard. To allow two people to walk side-by-side, a main path should be 42 to 48 inches wide. Surface materials should be durable, slip-resistant, and easy to shovel (if you live in a snowy climate), such as poured concrete, pavers, or flat stones.

A secondary walkway typically connects the house to a patio or outbuilding or a patio to a well-used area in the yard. A comfortable width for single-person travel is 24 to 36 inches. Surfaces should be flat and level underfoot and provide good drainage and slip-resistance in all seasons.

The third type, a tertiary path, is informal, perhaps nothing more than a line of stepping stones meandering through a flower garden or a simple gravel path leading to a secluded seating area. Design tertiary paths for a comfortable stride, with a minimum width of 12 to 16 inches.

Once you've established the design criteria for your walkway or path, spend some time testing the size and configuration of the route to be sure it will meet your needs. See page 82 for a set of stairs for your walkway or landscape.

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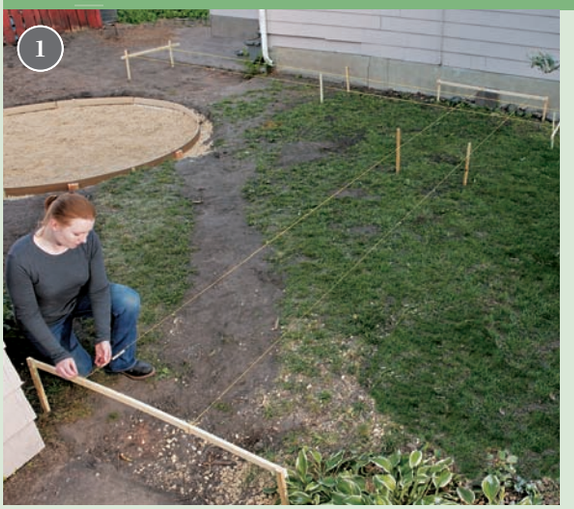
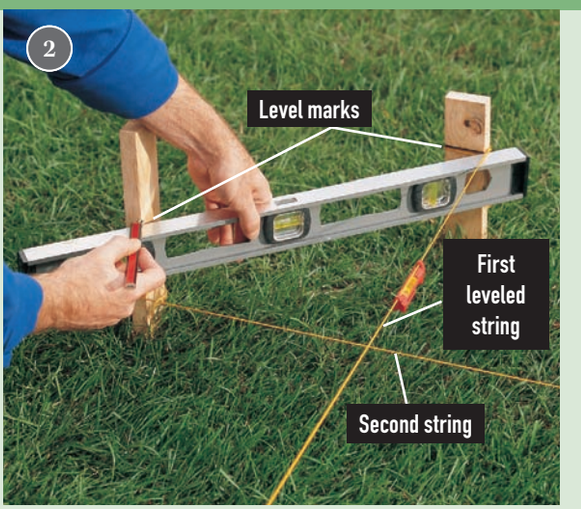
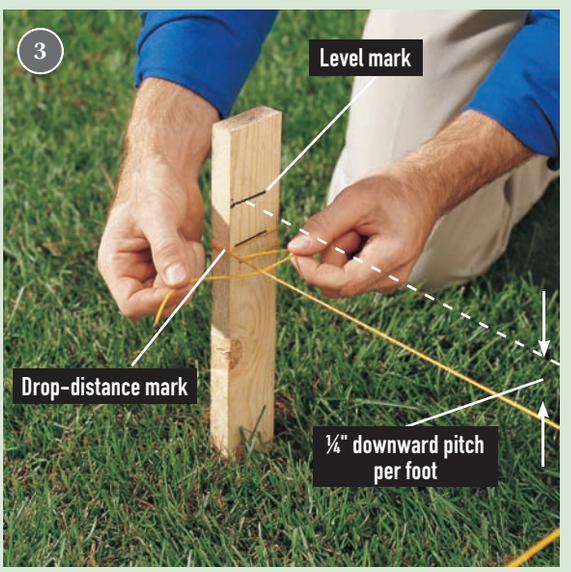
LAYING OUT A STRAIGHT WALKWAY







1 Use temporary stakes and mason's string to plan the walkway layout. Drive stakes at the ends of each section and at any corners, then tie the strings to the stakes to represent the edges of the finished path. Run a second set of strings 6" outside the first lines.

2 Set up a new string layout to mark the precise borders of the finished walkway. Along the high edge of the walkway, set the strings to the finished surface height. Use a line level to make sure the strings are level. Tip: For 90° turns, use the 3-4-5 technique to set the strings accurately at 90°.

3 Set the border strings lower for the slope. The finished surface follows a downward slope of ¼" per foot on the opposite side of the walkway. Use a homemade slope gauge to set the height of the strings (see step 3, page 62).
Fine-tune the gravel base to follow the slope setting, and prepare for the sand bed and/or surface material.

4 Excavate the area within the string lines. First, cut sod along the inside edge of the second string line. Remove all grass and plantings from the excavation area. Add the gravel subbase.

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LAYING OUT CURVING OR IRREGULAR WALKWAYS

1 Experiment with different sizes and shapes for the walkway using two lengths of ¾" braided rope or a garden hose. To maintain a consistent width, cut spacers from 1 × 2 lumber and use them to set the spacing between the rope outlines.

2 Mark the ground with marking paint, following the final outline of the ropes. Excavate the area 6" beyond the marked outline (or as required for your choice of edging). If desired, you can set up a string layout to guide the installation of the gravel subbase (see page 61).

3 Create a slope gauge for checking the slope of your gravel base, edging, or surface material. Tape a level and a drill bit to a straight 2 × 4 that's a little longer than the width of the walkway. The slope should be ¼" per foot: for a 2-ft. level, use a ½"-dia. bit or spacer; for a 4-ft. level, use a 1"-thick spacer. The slope is correct when the level reads level.

Tip

To plan a simple stepping stone path, cut pieces of cardboard to roughly the same size as an average stone you're using. Lay out the pieces in the desired route, then walk along the "stones" to make sure the spacing is comfortable for walking with a casual stride. Leave the test pieces in place to guide the excavation and/or stone setting.

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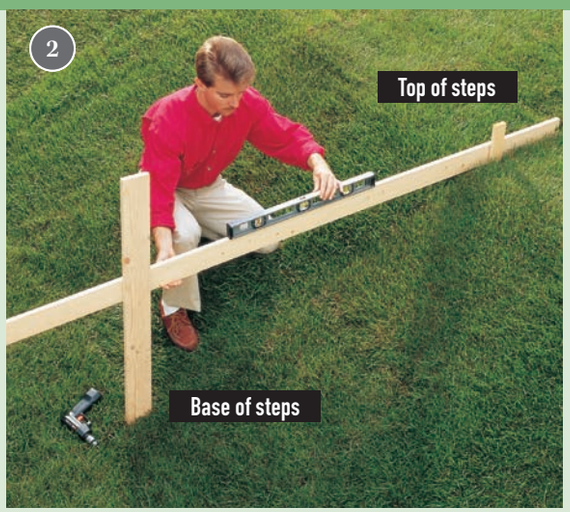
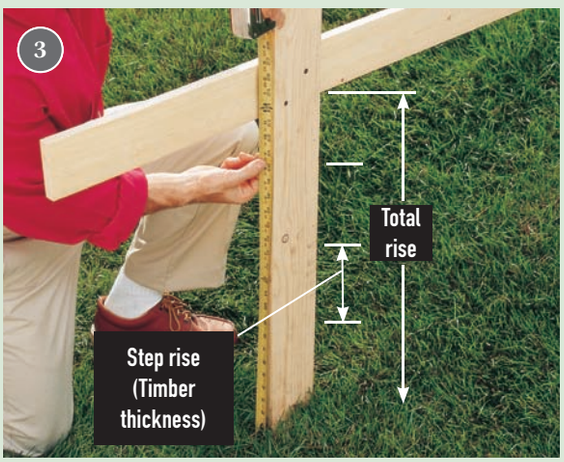
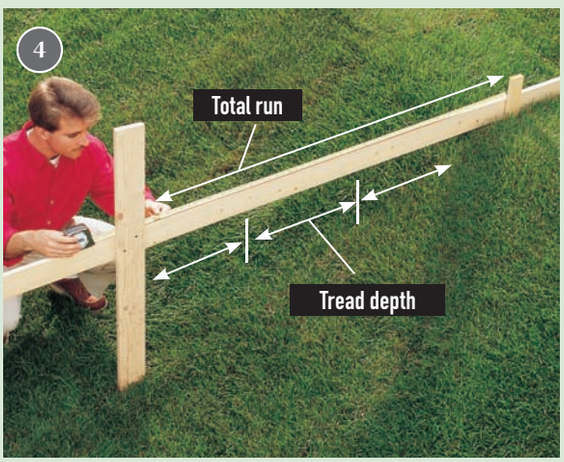
PLANNING LANDSCAPE STEPS







1 Landscape steps are best with a riser height (vertical dimension) of 6" or less and a tread depth (horizontal dimension) of 11" or more. Plan to build each tread with a downward slope of ¼" per foot from back to front. Complete the following steps to calculate the tread and riser dimensions for your steps.

2 Drive a tall stake into the ground at the base of the stairway site. Adjust the stake so it is perfectly plumb. Drive a shorter stake at the top of the site. Position a long, straight 1 × 4 or 2 × 4 against the stakes, with one end touching the ground next to the top stake. Adjust the 1 × 4 so it is level, then attach it to the stakes with screws. For long spans, use a mason's string instead of a board.

3 Measure from the ground to the bottom of the 1 × 4 to find the total rise of the stairway. Divide the total rise by the desired riser height to find the number of steps you need. If the result contains a fraction, drop the fraction and divide the rise by the whole number to find the exact riser dimension.

4 Measure along the 1 × 4 between the stakes to find the total horizontal run of the stairway. Divide the total run by the number of steps to find the depth of each step tread. If the depth is less than 11", revise the step layout to extend the depth of the treads.

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JOB:04-30438 Title:Home Skill Landscaping
#175 Dtp:228 Page:63

Sandset Brick Walkway

A curving brick walkway can be as much a design statement as a course for easy travel. Curves require more time than straight designs, due to the extra cutting involved, but the results can be all the more stunning.

Tools & Materials

- Tape measure
- ¾" braided rope
- Marking paint
- Excavation tools
- Plate compactor
- Mason's string
- Stakes
- Hand tamp
- 2- or 4-ft. level
- Drill bits
- Rubber mallet
- Straightedge
- Trowel
- Masonry saw
- Push broom
- 1 × 2 lumber
- Compactable gravel
- Straight 2 × 4
- Duct tape
- Coarse sand
- Landscape fabric
- Landscape staples
- Brick paver units
- Plastic patio edging
- ⅛" hardboard
- Paver joint sand
- Eye and ear protection
- Work gloves
- 12" galvanized spikes
- Maul

SANDSET BRICK IS A GOOD CHOICE of material for a walkway for the same reasons that make it a great patio surface—it's easy to work with, it lends itself equally well to traditional paving patterns and creative custom designs, and it can be installed at a leisurely pace because there's no mortar or wet concrete involved. The timeless look of natural clay brick is especially well-suited to walkways, where the rhythmic patterns of geometric lines create a unique sense of movement that draws your eye down the path toward its destination.

In this walkway project, all of the interior (field) bricks are arranged in the installation area and then the curving side edges of the walk are marked onto the set bricks to ensure perfect cutting lines. After the edge bricks are cut and reset, border bricks are installed followed by rigid paver edging to keep everything in place. This is the most efficient method for installing a curving path. Straight walkways can follow the standard process of installing the edging and border bricks (on one or both sides of the path, as applicable) before laying the field brick, as is done in the brick patio project.

With standard brick, you'll need to set the gaps with spacers cut from ⅛" hardboard, as shown in this project.

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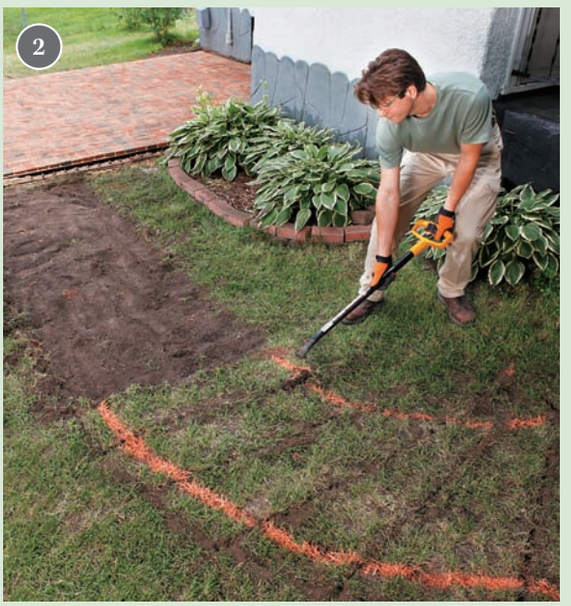
INSTALLING A SANDSET BRICK WALKWAY



1 Lay out the walkway curved edges using ¾" braided rope (or use mason's strings for straight sections). Cut 1 × 2 or 2 × 2 spacers to the desired path width and then place them in-between the ropes for consistent spacing. Mark the outlines onto the ground along the inside edges of the ropes with marking paint.

2 Excavate the area 6" outside of the marked lines along both sides of the path. Remove soil to allow for a 4"-thick subbase of gravel, a 1" layer of sand, and the thickness of the brick pavers (minus the height of the finished paving above the ground). The finished paving typically rests about 1" aboveground for ease of lawn maintenance. Thoroughly tamp the area with a plate compactor.

3 Spread out an even layer of compactable gravel—enough for a 4"-thick layer after compaction. Grade the gravel to follow a downward slope of ¼" per foot (most long walkways slope from side to side, while shorter paths or walkway sections can be sloped along their length). Use a homemade slope gauge to screed the gravel smooth and to check the slope as you work (see step 3 in Laying Out Curved Walkways). Tamp the subbase thoroughly with the plate compactor, making sure the surface is flat and smooth and properly sloped.

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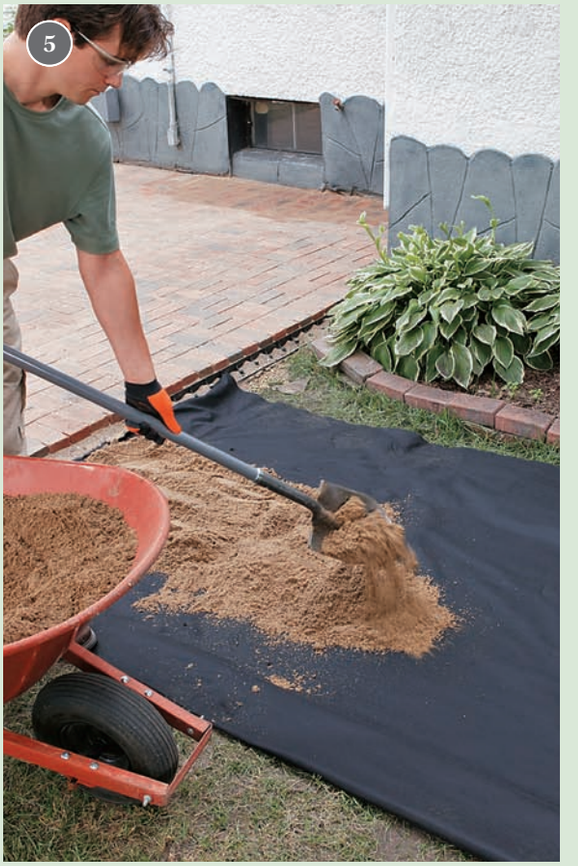

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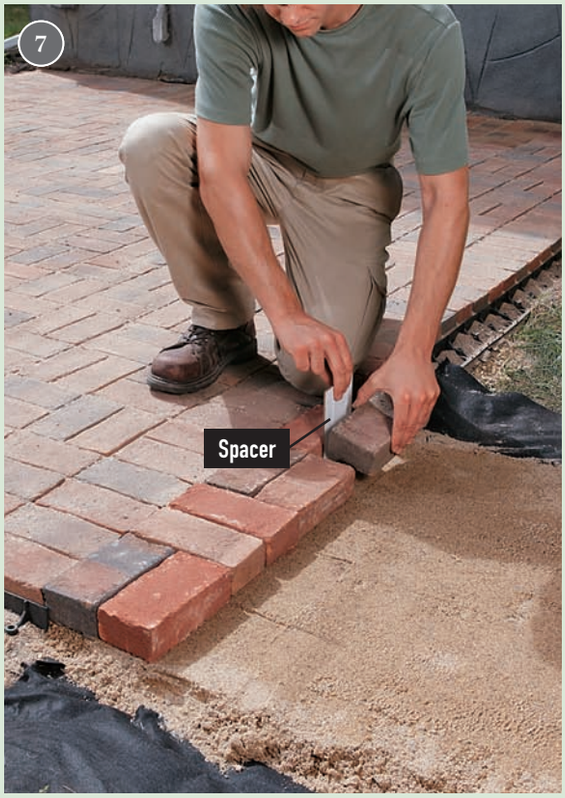

4 Cover the gravel base with professional-grade landscape fabric, overlapping the strips by at least 6". If desired, tack the fabric in place with landscape staples.

5 Spread a 1"-layer of coarse sand over the landscape fabric. Screed the sand with a board so it is smooth, even, and flat.

6 Tamp the screeded sand with a hand tamper or a plate compactor. Check the slope of the surface as you go.

7 Begin the paving at one end of the walkway, following the desired pattern. Use ⅛"-thick hardboard spacers in-between the bricks to set the sand-joint gaps. Tip: It's best to start the paving against a straightedge or square corner. If your walkway does not connect to a patio or stoop, set a temporary 2 × 4 with stakes at the end of the walkway to create a straight starting line.

8 Set the next few courses of brick, running them long over the side edges. With the first few courses in place, tap the bricks with a rubber mallet to bed them into the sand.

Option:

If your walkway includes long straight sections between curves, set up guidelines with stakes and mason's strings to keep the ends of the courses straight as you pave.

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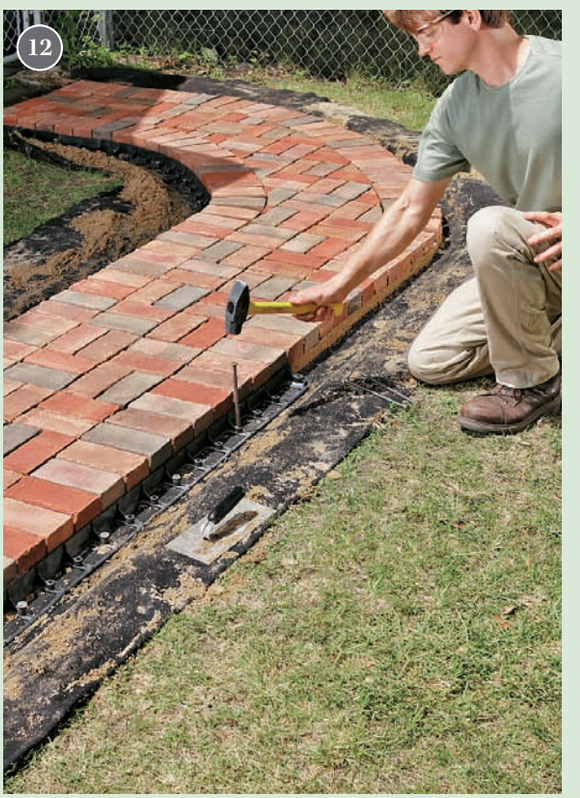

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9 Lay out the curved edges of the finished walkway using ¾" braided rope . Adjust the ropes as needed so that the cut bricks will be roughly symmetrical on both edges of the walkway. Also measure between the ropes to make sure the finished width will be accurate according to your layout. Trace along the ropes with a pencil to mark the cutting lines onto the bricks.

10 Cut the bricks with a rented masonry saw (wet saw), following the instructions from the tool supplier. Make straight cuts with a single, full-depth cut. Curved cuts require multiple straight cuts made tangentially to the cutting line. After cutting a brick, reset it before cutting the next brick.

11 Align the border bricks (if applicable) snug against the edges of the field paving. Use a straightedge or level to make sure the border units are flush with the tops of the field bricks. Set the border bricks with a rubber mallet. Dampen the exposed edges of the sand bed, and then use a trowel to slice away the edge so it's flush with the paving.

12 Install rigid paver edging (bendable) or other edge material tight against the outside of the walkway.

13 Fill and tamp the sand joints one or more times until the joints are completely filled. Sweep up any loose sand.

14 Soak the surface with water and let it dry. Cover the edging sides with soil and sod or other material, as desired.

Variation:

Cut field bricks after installing the edging. Mark each brick for cutting by holding it in position and drawing the cut line across the top face.

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Flagstone Walkway

Flagstone walkways combine durability with beauty and work well for casual or formal landscapes.

Tools & Materials

Excavation tools
Circular saw with masonry blade
Power drill
Masonry chisel
Maul
Rubber mallet
Landscape fabric
Sand
2 × 6 pressure-treated lumber
Deck screws
Compactable gravel
Flagstone pavers
Eye and ear protection
Work gloves

NATURAL FLAGSTONE is an ideal material for creating landscape floors. It's attractive and durable and blends well with both formal and informal landscapes. Although flagstone structures are often mortared, they can also be constructed with the sand-set method. Sand-setting flagstones is much faster and easier than setting them with mortar.

There are a variety of flat, thin sedimentary rocks that can be used for this project. Home and garden stores often carry several types of flagstone, but stone supply yards usually have a greater variety. Some varieties of flagstone cost more than others, but there are many affordable options. When you buy the flagstone for your project, select pieces in a variety of sizes from large to small. Arranging the stones for your walkway is similar to putting together a puzzle, and you'll need to see all the pieces laid out.

The following example demonstrates how to build a straight flagstone walkway with wood edging. If you'd like to build a curved walkway, select another edging material, such as brick or cut stone. Instead of filling gaps between stones with sand, you might want to fill them with topsoil and plant grass or some other ground cover between the stones.

Tip

Make a flagstone patio to match your flagstone walkway. All the same steps, just make sure the slope is away from house for good drainage.

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BUILDING A FLAGSTONE WALKWAY

1 Lay out, excavate, and prepare the base for the walkway. Form edging by installing 2 × 6 pressure-treated lumber around the perimeter of the pathway. Drive stakes on the outside of the edging, spaced 12" apart. The tops of the stakes should be below ground level. Drive galvanized screws through the edging and into the stakes.

2 Test-fit the stones over the walkway base, finding an attractive arrangement that limits the number of cuts needed. The gaps between the stones should range between ⅜ and 2" wide. Use a pencil to mark the stones for cutting, then remove the stones and place them beside the walkway in the same arrangement. Score along the marked lines with a circular saw and masonry blade set to ⅛" blade depth. Set a piece of wood under the stone, just inside the scored line. Use a masonry chisel and maul to strike along the scored line until the stone breaks.

3 Lay overlapping strips of landscape fabric over the walkway base and spread a 2"-layer of sand over it. Make a screed board from a short 2 × 6, notched to fit inside the edging. Pull the screed from one end of the walkway to the other, adding sand as needed to create a level base.

4 Beginning at one corner of the walkway, lay the flagstones onto the sand base. Repeat the arrangement you created in step 2, with ⅜- to 2"-wide gaps between stones. If necessary, add or remove sand to level the stones, then set them by tapping them with a rubber mallet or a length of 2 × 4.

5 Fill the gaps between the stones with sand. (Use topsoil if you're going to plant grass or ground cover between the stones.) Pack sand into the gaps, then spray the entire walkway with water to help settle the sand. Repeat until the gaps are completely filled and tightly packed with sand.

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Simple Gravel Path

Loose materials can be used as filler between solid surface materials, like flagstone, or laid as the primary ground cover, as shown here.

Tools & Materials

- Mason's string
- Hose or rope
- Marking paint
- Excavation tools
- Garden rake
- Plate compactor
- Sod stripper or power sod cutter
- Wood stakes
- Lumber (1 × 2, 2 × 4)
- Straight 2 × 4
- Edging
- Spikes
- Professional-grade landscape fabric
- Compactable gravel
- Dressed gravel
- Eye and ear protection
- Work gloves
- Circular saw
- Maul

LOOSE-FILL GRAVEL PATHWAYS are perfect for stone gardens, casual yards, and other situations where a hard surface is not required. The material is inexpensive, and its fluidity accommodates curves and irregular edging. Since gravel may be made from any rock, gravel paths may be matched to larger stones in the environment, tying them in to your landscaping. The gravel you choose need not be restricted to stone, either. Industrial and agricultural byproducts, such as cinder and ashes, walnut shells, seashells, and ceramic fragments may also be used as path material.

For a more stable path, choose angular or jagged gravel over rounded materials. However, if your preference is to stroll throughout your landscape barefoot, your feet will be better served with smoother stones, such as pea gravel. With stone, look for a crushed product in the ¼ to ¾" range. Angular or smooth, stones smaller than that can be tracked into the house, while larger materials are uncomfortable and potentially hazardous to

Tip

Do not use gravel paths near plants and trees that produce messy fruits, seeds, or other debris that will be difficult to remove from the gravel. Organic matter left on gravel paths will eventually rot into compost that will support weed growth. Use a leaf blower to clean light organic material from gravel or wood chip paths.

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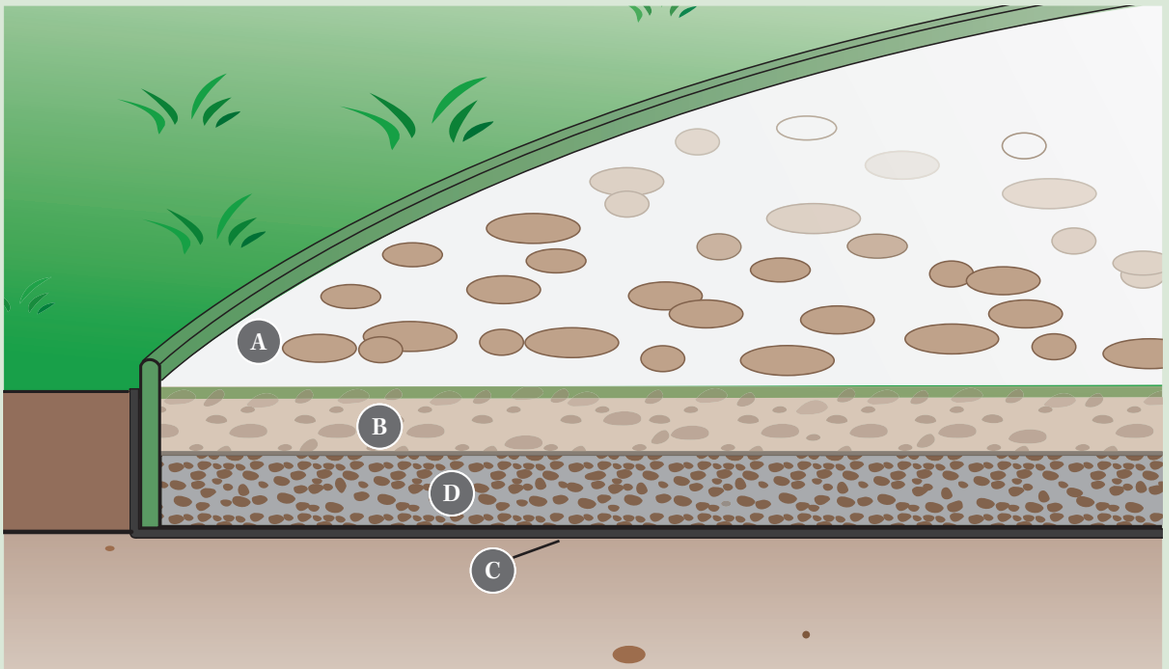

Staked metal edging separates dirt from gravel (A), 2+ inches of gravel forms the walking surface (B), landscape fabric overlaps edging to keep out roots and rhizomes (C), 2+ inches of paver base forms a bed for the walking surface pathway (D).

walk on. If it complements your landscaping, use light-colored gravel, such as buff limestone. Visually, it is much easier to follow a light pathway at night because it reflects more moonlight.

Stable edging helps keep the pathway gravel from migrating into the surrounding mulch and soil. When integrated with landscape fabric, the edge keeps invasive perennials and trees from sending roots and shoots into the path.

A base of compactable gravel under the surface material keeps the pathway firm underfoot. For best results, embed the surface gravel material into the paver base with a plate compactor. This prevents the base from showing through if the gravel at the surface is disturbed. An underlayment of landscape fabric helps stabilize the pathway and blocks weeds, but if you don't mind pulling an occasional dandelion and are building on firm soil, it can be omitted.

Tip: Make a Spacer Gauge

To ensure that the edges of the pathway are exactly parallel, create a spacer bar and use it as a guide to install the edging. Start with a piece of 2 × 4 that's a bit longer than the path width. Near one end, cut a notch that will fit snugly over the edging. Trim the spacer so the distance from the notch to the other end is the planned width of the pathway.

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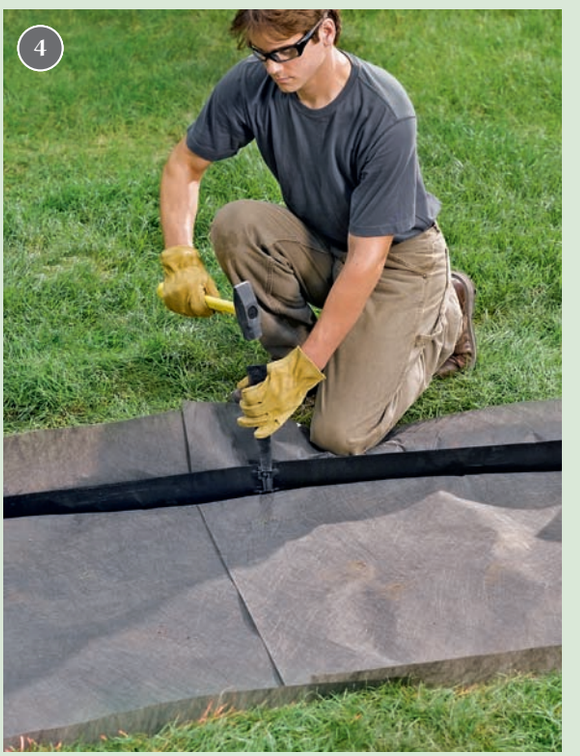
CREATING A GRAVEL PATHWAY



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1 Lay out one edge of the path excavation. Use a section of hose or rope to create curves, and use stakes and string to indicate straight sections (see pages 60 to 63 for detailed steps on designing and laying out a walkway). Cut 1 × 2 spacers to set the path width and establish the second pathway edge; use another hose and/or more stakes and string to lay out the other edge. Mark both edges with marking paint.

2 Remove sod in the walkway area using a sod stripper or a power sod cutter (see option, below). Excavate the soil to a depth of 4 to 6". Measure down from a 2 × 4 placed across the path bed to fine-tune the excavation. Grade the bottom of the excavation flat using a garden rake. Note: If mulch will be used outside the path, make the excavation shallower by the depth of the mulch. Compact the soil with a plate compactor.

3 Lay landscaping fabric from edge to edge, lapping over the undisturbed ground on either side of the path. On straight sections, you may be able to run parallel to the path with a single strip; on curved paths, it's easier to lay the fabric perpendicular to the path. Overlap all seams by 6".

4 Install edging over the fabric. Shim the edging with small stones, if necessary, so the top edge is ½" above grade (if the path passes through grass) or 2" above grade (if it passes through a mulched area). Secure the edging with spikes. To install the second edge, use a 2 × 4 spacer gauge that's been notched to fit over your edging.

5 Stone or vertical-brick edges may be set in deeper trenches at the sides of the path. Place these on top of the fabric also. You do not have to use additional edging with paver edging, but metal (or other) edging will keep the pavers from wandering.

Option

Use a power sod cutter to strip grass from your pathway site. Available at most rental centers and large home centers, sod cutters excavate to a very even depth. The cut sod can be replanted in other parts of your lawn.

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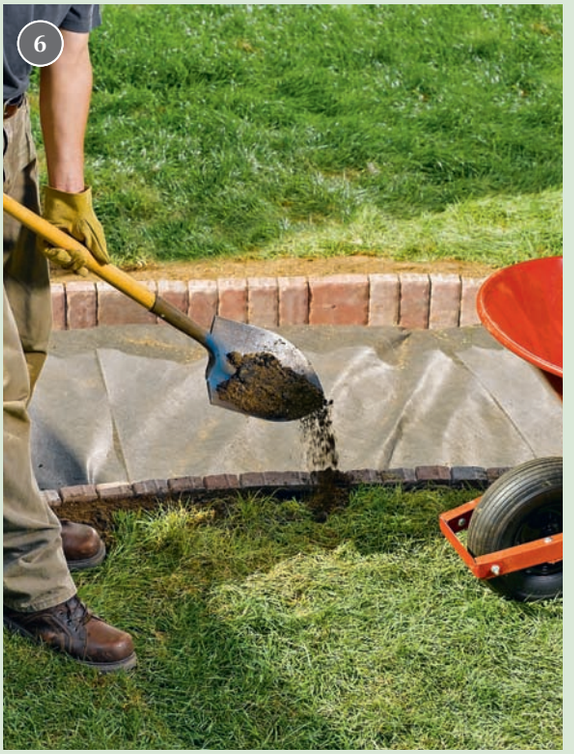

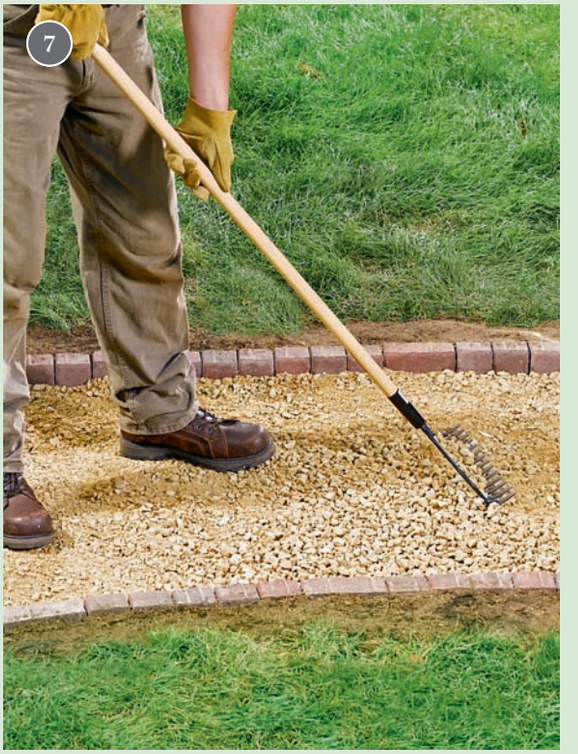

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6 Trim excess fabric, then backfill behind the edging with dirt and tamp it down carefully with the end of a 2 × 4. This secures the edging and helps it to maintain its shape.

7 Add a 2- to 4"-thick layer of compactable gravel over the entire pathway. Rake the gravel flat. Then, spread a thin layer of your surface material over the base gravel.

8 Tamp the base and surface gravel together using a plate compactor. Be careful not to disturb or damage the edging with the compactor.

9 Fill in the pathway with the remaining surface gravel. Drag a 2 × 4 across the tops of the edging using a sawing motion to level the gravel flush with the edging.

10 Set the edging brick flush with the gravel using a mallet and 2 × 4.

11 Tamp the surface again using the plate compactor or a hand tamper. Compact the gravel so it is slightly below the top of the edging. This will help keep the gravel from migrating out of the path.

12 Rinse off the pathway with a hose to wash off dirt and dust and bring out the true colors of the materials.

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Pebbled Stepping Stone Path

Stepping stones blend beautifully into many types of landscaping, including rock gardens, ponds, flower or vegetable gardens, or manicured grass lawns.

Tools & Materials

- Mason's string
- Hose or rope
- Marking paint
- Sod stripper
- Excavation tools
- Hand tamp
- Wood stakes
- 1 × 2 lumber
- Straight 2 × 4
- Edging
- Landscape fabric
- Coarse sand
- Thick steppers or broad river rocks with one flat face
- ¼ to ½" pond pebbles
- 2½"-dia. river rock
- Eye and ear protection
- Work gloves
- Level
- Rake

A STEPPING STONE PATH is both a practical and appealing way to traverse a landscape. With large stones as foot landings, you are free to use pretty much any type of fill material in between. You could even place stepping stones on individual footings over ponds and streams, making water the temporary infill that surrounds the stones. The infill does not need to follow a narrow path bed, either. Steppers can be used to cross a broad expanse of gravel, such as a Zen gravel panel or a smaller graveled opening in an alpine rock garden.

Stepping stones in a path serve two purposes: they lead the eye, and they carry the traveler. In both cases, the goal is rarely fast, direct transport, but more of a relaxing stroll that's comfortable, slow-paced, and above all, natural. Arrange the stepping stones in your walking path according to the gaits and strides of the people that are most likely to use the pathway. Keep in mind that our gaits tend to be longer on a utility path than in a rock garden.

Sometimes steppers are placed more for visual effect, with the knowledge that they will break the pacing rule with artful clusters of stones. Clustering is also an effective way to slow or congregate walkers near a fork in the path or at a good vantage point for a striking feature of the garden.

In the project featured here, landscape edging is used to contain the loose infill material (small aggregate), however a stepping stone path can also be effective without edging. For example, setting a series of steppers directly into your lawn and letting the lawn grass grow between them is a great choice as well.

Tip:

Select beefy stones (minimum 2½ to 3½" thick) with at least one flat side. Thinner stepping stones tend to sink into the pebble infill. Stones that are described as stepping stones usually have two flat faces. For the desired visual effect on this project, we chose steppers and 12 to 24" wide fieldstones with one broad, flat face (the rounded face is buried in the ground, naturally).

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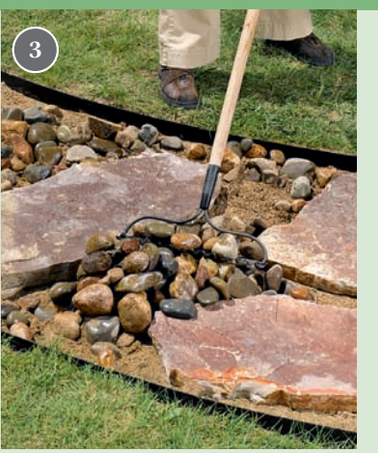
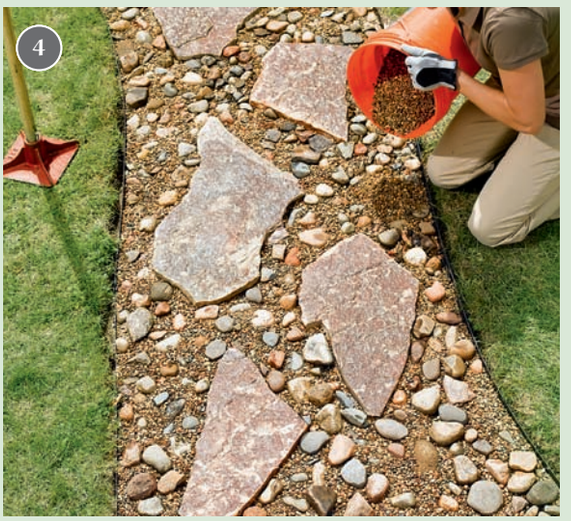
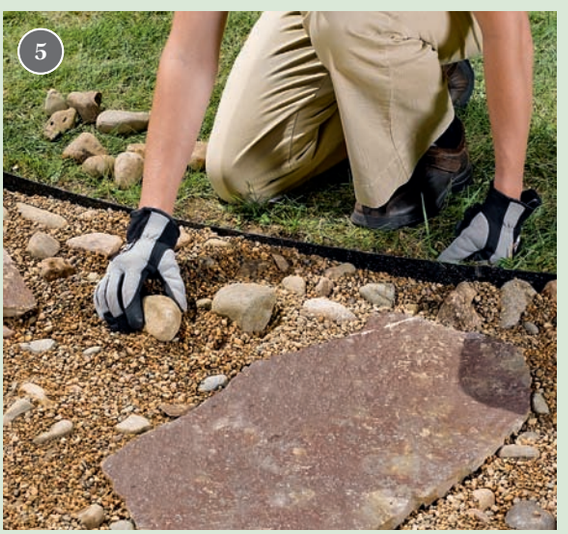
MAKING A PEBBLED STEPPING STONE PATH







1 Excavate and prepare a bed for the path as you would for the gravel pathway (see page 72), but use coarse building sand instead of compactable gravel for the base layer. Screed the sand flat so it's 2" below the top of the edging. Do not tamp the sand. Tip: Low-profile plastic landscape edging is a good choice because it does not compete with the pathway.

2 Moisten the sand bed, then position the stepping stones in the sand, spacing them for comfortable walking and the desired appearance. As you work, place a 2 × 4 across three adjacent stones to make sure they are even with one another. Add or remove sand beneath the steppers, as needed, to stabilize and level the stones.

3 Pour in a layer of larger infill stones (2"-dia. river rock is seen here). Smooth the stones with a garden rake. The infill should be below the tops of the stepping stones. Reserve about ⅓ of the larger diameter rocks.

4 Add the smaller infill stones that will migrate down and fill in around the larger infill rocks. To help settle the rocks, you can tamp lightly with a hand tamper, but don't get too aggressive—the larger rocks might fracture easily.

5 Scatter the remaining large infill stones across the infill area so they float on top of the other stones. Eventually, they will sink down lower in the pathway and you will need to lift and replace them selectively to maintain the original appearance.

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VARIATIONS

Move from a formal space to a less orderly area of your landscape by creating a pathway that begins with closely spaced steppers on the formal end and gradually transforms into a mostly-gravel path on the casual end, with only occasional clusters of steppers.

Combine concrete stepping pavers with crushed rock or other small stones for a path with a cleaner, more contemporary look. Follow the same basic techniques used on page 79, setting the pavers first, then filling in-between with the desired infill material(s).

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Timber Garden Steps

Here we use gravel (small aggregate river rock), a common surface for paths and rock gardens, for the tread surfaces. Other tread surfaces include bricks, cobbles, and stepping stones. Even large flagstones can be fit to the tread openings.

Tools & Materials

- Marking paint
- Mason's string
- Level
- Excavation tools
- Hand tamp
- Circular saw
- Speed square
- Framing square
- Drill and ⅜" bit with long shaft
- Sledgehammer
- Wood stakes
- Compactable gravel
- 2 × 4 lumber
- Landscape timbers
- ⅜" landscape spikes
- Gravel

TIMBERFRAMED STEPS provide a delightfully simple and structurally satisfying way to manage slopes. They are usually designed with shallow steps that have long runs and large tread areas, that can be filled with a variety of materials. Two popular methods are shown here—gravel and with poured concrete. Other tread surfaces you might consider are bricks, cobbles, and stepping stones. Even large flagstones can be cut to fit the tread openings.

Timber steps needn't follow the straight and narrow, either. You can vary the lengths of the left and right returns to create swooping helical steps that suggest spiral staircases. Or, increase the length of both returns to create a broad landing on which to set pots or accommodate a natural flattening of the slope. Want to soften the steps? Use soil as a base near the sides of the steps and plant herbs or ground cover. Or for a spring surprise, plant daffodils under a light pea gravel top dressing at the edges of the steps.

Timber steps don't require a frost footing, because the wooden joints flex with the earth rather than crack like solid concrete steps would. However, it's a good idea to include some underground anchoring to keep loose muddy soil from pushing the steps forward. To provide long-term stability, the gravel-filled steps shown here are secured to a timber cleat at the base of the slope, while the concrete-filled steps are anchored at the base with long sections of pipe driven into the ground.

Designing steps is an important part of the process. Determine the total rise and run of the hill and translate this into a step size that conforms to this formula: 2× (rise) + run = 26". Your step rise will equal your timber width, that can range from approximately 3½" (for 4 × 4 timbers or 4 × 6 on the flat) to 7¼" or 7½" (for 8 × 8 timbers). See page 63 for more help with designing and laying out landscape steps. As with any steps, be sure to keep the step size consistent so people don't trip.

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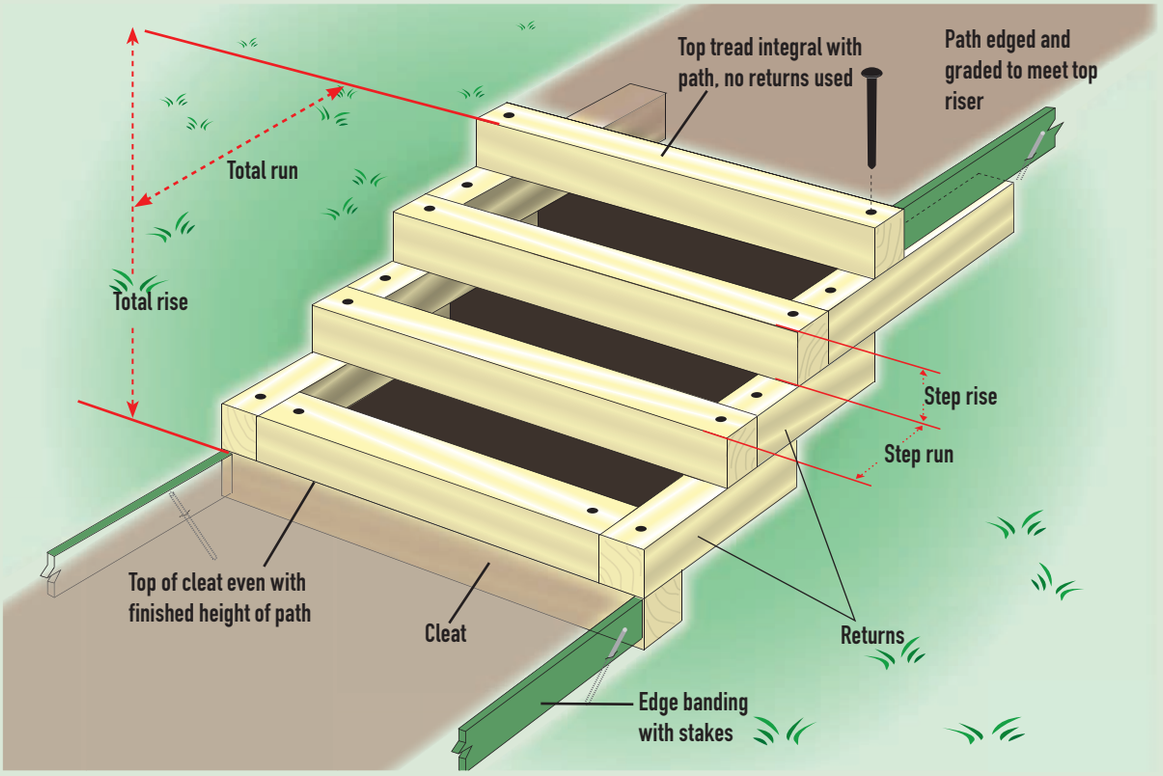
Construction Details: Timber Step Frames



Tip: Cutting Timbers

Large landscape timbers (6 × 6" and bigger) can be cut accurately and squarely with a circular saw, even though the saw's cutting capacity isn't big enough to do the job completely. First, draw cutting lines on all four sides of the timber using a speed square as guide. Next, cut along the line on all four sides with the saw set for maximum blade depth. Finally, use a hand saw to finish the cut. For most DIYers, this will yield a straighter cut than saws that can make the cut in one pass, such as a reciprocating saw.

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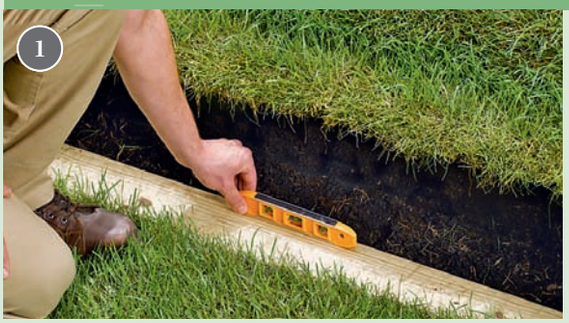
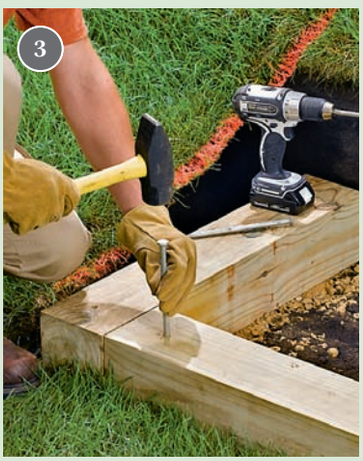
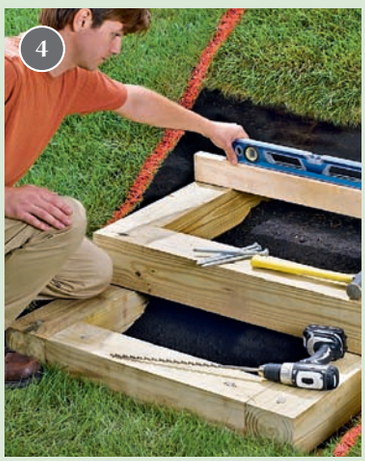
BUILDING TIMBER & GRAVEL GARDEN STEPS







1 Install and level the timber cleat: mark the outline of the steps onto the ground using marking paint. Dig a trench for the cleat at the base of the steps. Add 2 to 4" of compactable gravel in the trench and compact it with a hand tamp. Cut the cleat to length and set it into the trench. Add or remove gravel beneath the cleat so it is level and its top is even with the surrounding ground or path surface.

2 Create trenches filled with tamped gravel for the returns (the timbers running back into the hill, perpendicular to the cleat and risers). The returns should be long enough to anchor the riser and returns of the step above. Dig trenches back into the hill for the returns and compact 2 to 4" of gravel into the trenches so each return will sit level on the cleat and gravel.

3 Cut and position the returns and the first riser. Using a 2 × 4 as a level extender, check to see if the backs of the returns are level with each other and adjust by adding or removing gravel in the trenches. Drill four ⅜"-dia. holes and fasten the first riser and the two returns to the cleat with spikes.

4 Excavate and add tamped gravel for the second set of returns. Cut and position the second riser across the ends of the first returns, leaving the correct unit run between the riser faces. Note that only the first riser doesn't span the full width of the steps. Cut and position the returns, check for level, then pre-drill and spike the second riser and returns to the returns below.

5 Build the remaining steps in the same fashion. As you work, it may be necessary to alter the slope with additional excavating or backfilling (few natural hills follow a uniform slope). Add or remove soil as needed along the sides of the steps so that the returns are exposed roughly equally on both sides. Also, each tread should always be higher than the neighboring ground.

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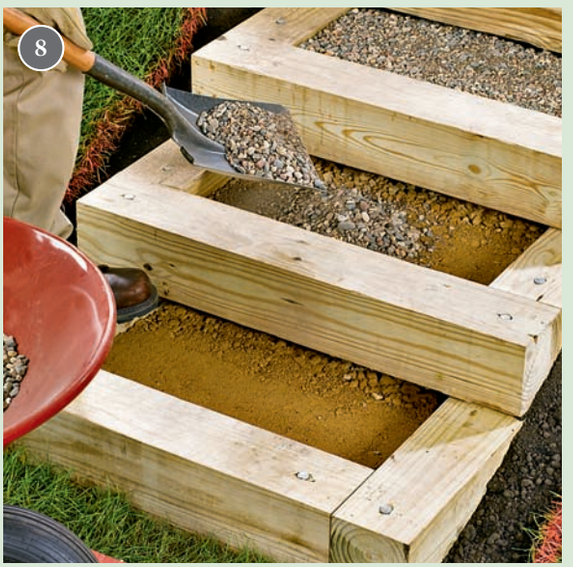

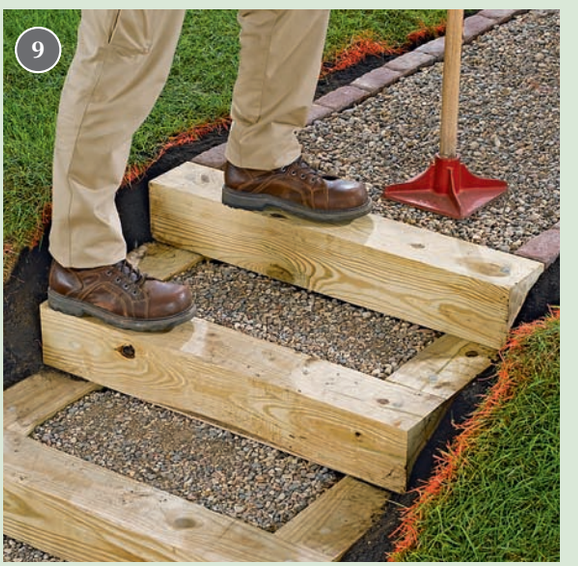

6 Install the final riser. Typically, the last timber does not have returns because its tread surface is integral with the path or surrounding ground. The top of this timber should be slightly higher than the ground. As an alternative, you can use returns to contain pathway material at the top of the steps.

7 Lay and tamp a base of compactable gravel in each step tread area. Use a 2 × 4 as a tamper. For proper compaction, tamp the gravel in 2" or thinner layers before adding more. Leave about 2" of space in each tread for the surface material.

8 Fill up the tread areas with gravel or other appropriate material. Irregular crushed gravel offers maximum surface stability, while smooth stones, like the river rock seen here, blend into the environment more naturally and feel better underfoot than crushed gravel and stone.

9 Create or improve pathways at the top and bottom of the steps. For a nice effect, build a loose-fill walkway using the same type of gravel that you used for the steps. Install a railing, if desired or if required by the local building code.

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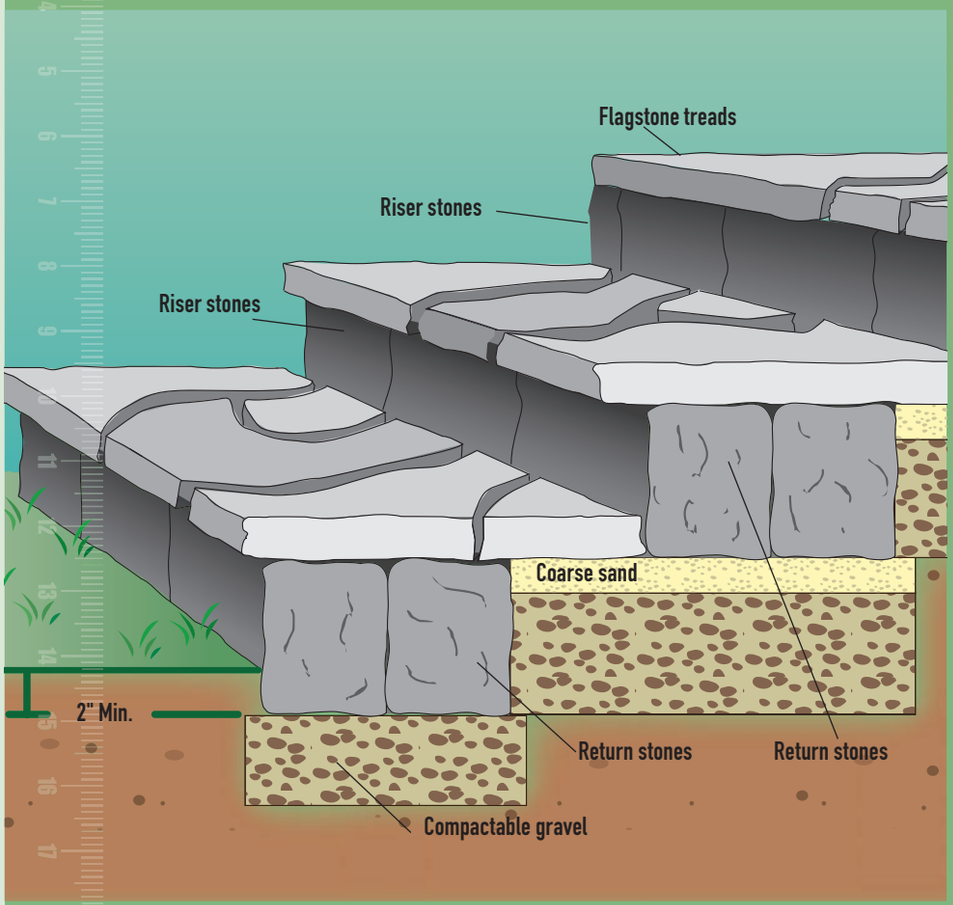
Flagstone Garden Steps



Tools & Materials

- Tape measure
- Mason's string
- Marking paint
- Line level
- Torpedo level
- 4-ft. level
- Excavation tools
- Maul
- Hand tamp
- Wood stakes
- Lumber (2 × 4, 4× 4)
- Straight 2 × 4
- Landscape fabric
- Compactable gravel
- Coarse sand
- Wall stone
- Flagstone
- Stone chisels
- Stone and block adhesive
- Rubber mallet
- Eye and ear protection
- Work gloves
- Small brush
- Banker box
- Spade
- Granite or polymeric sand

FLAGSTONE STEPS are perfect structures for managing natural slopes. Our design consists of broad flagstone treads and blocky ashlar risers, commonly sold as wall stone. The risers are prepared with compactable gravel beds on which the flagstone treads rest. For the project featured here, we purchased both the flagstone and the wall stone in their natural split state (as opposed to sawn). It may seem like overkill, but you should plan on purchasing 40 percent more flagstone, by square foot coverage, than your plans say you need. The process of fitting the stones together involves a lot of cutting and waste.

The average height of your risers is defined by the height of the wall stone available to you. These rough stones are separated and sold in a range of thicknesses (such as 3 to 4 inches), but hand-picking the stones helps bring them into a tighter range. The more uniform the thicknesses of your blocks, the less shimming and adjusting you'll have to do. (Remember, all of the steps must be the same size, to prevent a tripping hazard.) You will also need to stock up on slivers of rocks to use as shims to bring your risers and returns to a consistent height; breaking and cutting your stone generally produces plenty of these.

Flagstone steps work best when you create the broadest possible treads: think of them as a series of terraced patios. The goal, once you have the stock in hand, is to create a tread surface with as few stones as possible. This generally means you'll be doing quite a bit of cutting to get the irregular shapes to fit together. For a more formal look, cut the flagstones along straight lines so they fit together with small, regular gaps.

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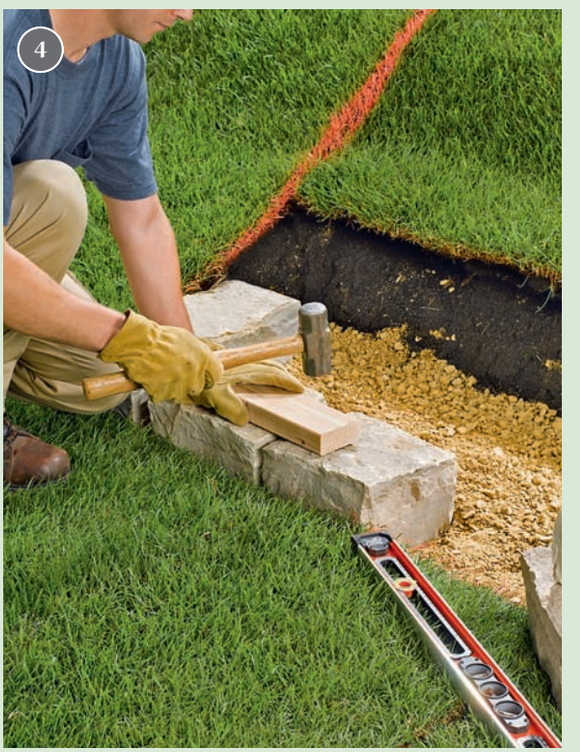
BUILDING FLAGSTONE GARDEN STEPS



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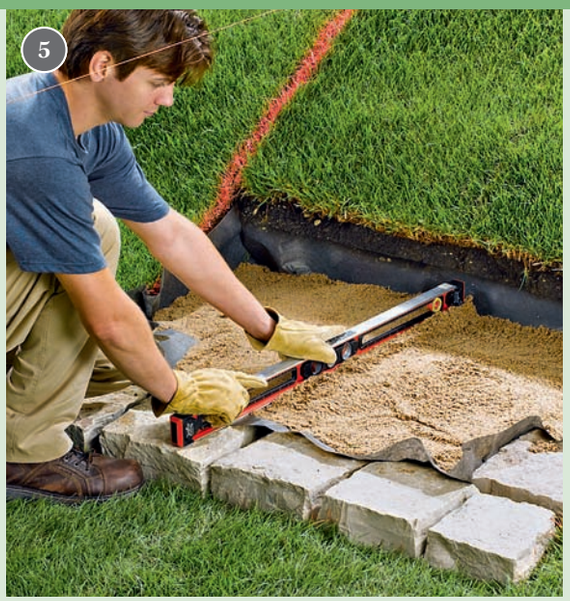

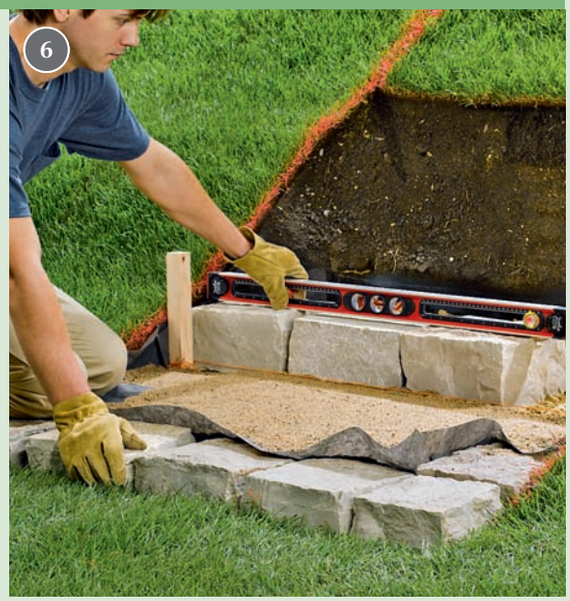

1 Measure the height and length of the slope to calculate the rise and run dimensions for each step (see page 63 for help with designing and laying out steps). Plot the footprint of your steps on the ground using marking paint. Purchase wall stones for your risers and returns in a height equal to the rise of your steps. Also buy flagstone (with approx. 40% overage) for the step treads.

2 Begin the excavation: for the area under the first riser and return stones, dig a trench to accommodate a 4"-layer of gravel, plus the thickness of an average flagstone tread. For the area under the back edge of the first step's tread and the riser and return stones of the second step, dig to accommodate a 4"-layer of gravel, plus a 1"-layer of sand. Compact the soil with a 2 × 4 or 4 × 4.

3 Add a layer of compactable gravel to within 1" of the planned height and tamp. Add a top layer of compactable gravel and level it side to side and back to front. This top layer should be a flagstone's thickness below grade. This will keep the rise of the first step the same as the following steps. Leave the second layer of gravel uncompacted for easy adjustment of the riser and return stones.

4 Set the riser stones and one or two return stones onto the gravel base. Level the riser stones side to side by adding or removing gravel as needed. Level the risers front to back with a torpedo level. Allow for a slight up-slope for the returns (the steps should slope slightly downward from back to front so the treads will drain). Seat the stones firmly in the gravel with a hand maul, protecting the stone with a wood block.

5 Line the excavated area for the first tread with landscape fabric, draping it to cover the insides of the risers and returns. Add layers of compactable gravel and tamp down to within 1" of the tops of the risers and returns. Fill the remainder of the bed with sand and level it side to side with a 2 × 4. Slope it slightly from back to front. This layer of sand should be a little above the first risers and returns so that the tread stones will compact down to sit on the wall stones.

6 Set the second group of risers and returns: first, measure the step/run distance back from the face of your first risers and set up a level mason's string across the sand bed. Position the second-step risers and returns as you did for the first step, except these don't need to be dug in on the bottom because the bottom tread will reduce the risers' effective height.

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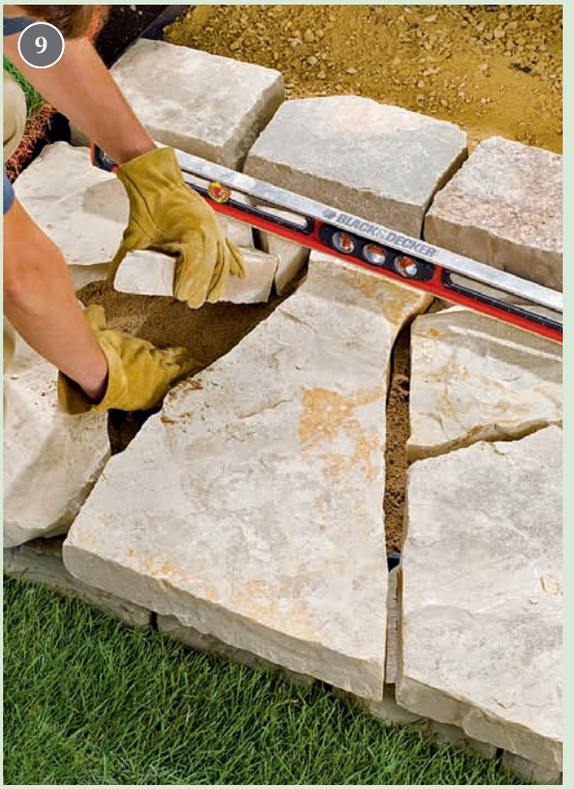

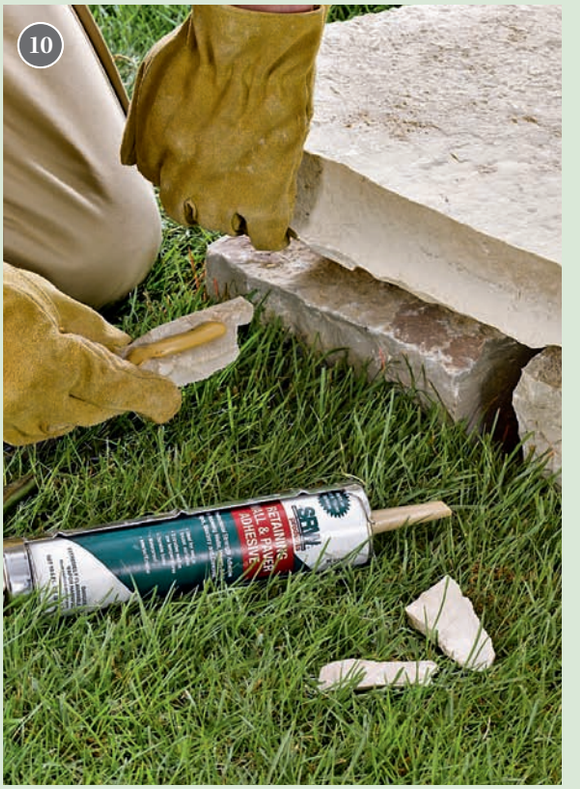

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7 Fold the fabric over the tops of the risers and trim off the excess. Set the flagstone treads of the first step like a puzzle, leaving a consistent distance between stones. Use large, heavy stones with relatively straight edges at the front of the step, overhanging the risers by about 2".

8 Fill in with smaller stones near the back. Cut and dress stones where necessary using stone chisels and a maul or mason's hammer. Finding a good arrangement takes some trial and error. Strive for fairly regular gaps, and avoid using small stones as they are easily displaced. Ideally, all stones should be at least as large as a dinner plate.

9 Adjust the stones so the treads form a flat surface. Use a level as a guide, and add wet sand under thinner stones or remove sand from beneath thicker stones until all the flags come close to touching the level and are stable.

10 Shim between treads and risers with thin shards of stone. (Do not use sand to shim here). Glue the shards in place with block and stone adhesive. Check each step to make sure there is no path for sand to wash out from beneath the treads. You can settle smaller stones in sand with a mallet, but cushion your blows with a piece of wood.

11 Complete the second step in the same manner as the first. The bottoms of the risers should be at the same height as the bottoms of the tread on the step below. Continue building steps to the top of the slope. Note: The top step often will not require returns.

12 Fill the joints between stones with sand by sweeping the sand across the treads. Use coarse, dark sand such as granite sand, or choose polymeric sand, which resists washout better than regular builder's sand. Inspect the steps regularly for the first few weeks and make adjustments to the heights of stones as needed.

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FLAGSTONE STEP VARIATIONS

Pave the slope. Sometimes the best solution for garden steps is simply to lay some broad, flat rocks down on a pathway more or less as you find it. Make some effort to ensure that the surface of each rock is relatively flat and safe to walk on. Do not use this approach on steep slopes (greater than 2 in 12) or in heavily traveled areas.

These terraces are made from large flagstone steppers supported by stacked riser stones. They function as steps in managing the slope, but they look and feel more like a split-level patio. For a natural look and the best visual effect, terrace-type steps should mimic the topography of your yard.

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Cut-limestone blocks that are roughly uniform in size are laid in a step formation to create a stately passageway up this small hill. A hand-formed mortar cap adorns the sides of the outdoor stairway for a more finished appearance.

Stacked slabs cannot be beat for pure simplicity, longevity, and ease of maintenance. The initial cost is high, and stacking stones that weigh several hundred pounds (or more) does require professionals with heavy equipment. But once these lovely garden steps are in place they'll stay put for generations with hardly any attention beyond a simple hosing off.

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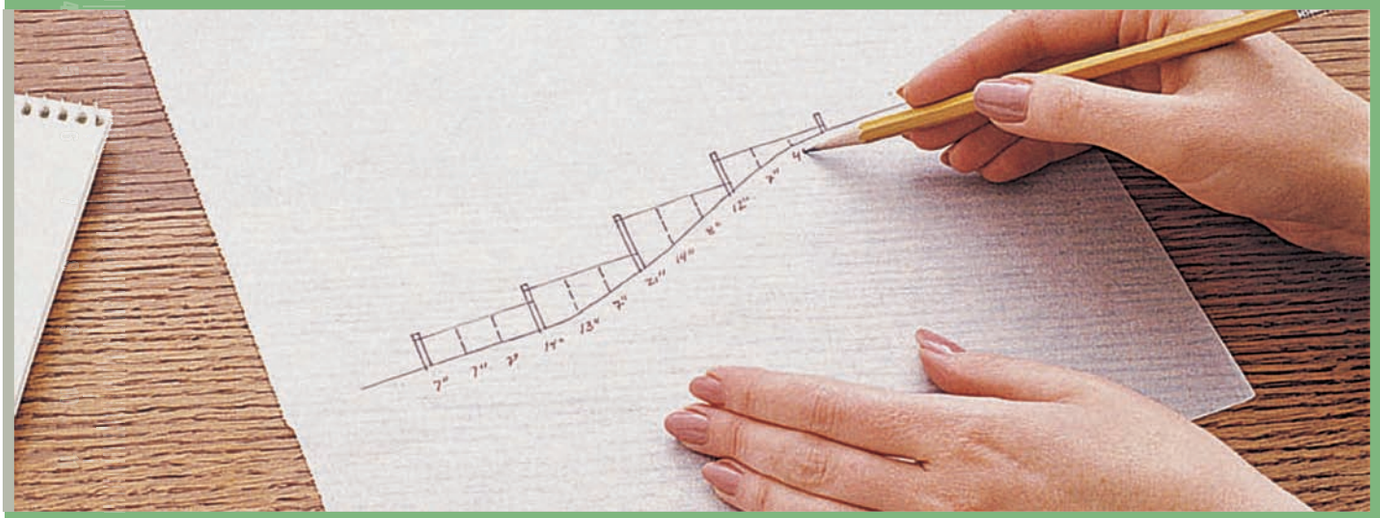
Fence Design & Layout



Use the elevation drawing described in the Landscape Design & Materials chapter to determine layouts and materials needed for fences and walls that run over uneven terrain.

Good plans make it possible to complete a project efficiently. Plotting fence, wall, and gate locations on paper makes it much easier to determine a realistic budget, make a materials list, and develop a realistic work schedule.

Tip

Don't start drawing onto your site plan right away. Make a number of photocopies that you can draw on, and save the original as a master copy.

Along with your site map, an elevation chart may be helpful if you have significant slope to contend with. On a copy of the site map, locate and draw the fence or wall layout. Consider how to handle obstacles like large rocks and trees or slopes. Be sure you take into account local setback regulations and other pertinent building codes.

As you begin to plot your new fence or wall, you'll need to do a little math. To determine the proper on-center spacing for fence posts, for example, you divide the length of the fence into equal intervals—six to eight foot spacing is typical. If your calculations produce a remainder, don't put it into one odd-sized bay. Instead, distribute the remainder equally among all the bays or between the first and last bay (unless you are installing prefab panels).

If you plan to use prefabricated fence panels, post spacing becomes more critical. If you'd like to install all your posts at once (the most efficient strategy), you'll need to add the width of the post to the length of the panel plus an extra half-inch for wiggle room in your plan. But most fence panel manufacturers suggest that you add fence posts as you go so you can locate them exactly where the panels dictate they need to be.

If you're making a plan for building a wall, be sure to plan enough space around the wall itself for footings that are at least twice as wide as the wall they will support. Carefully plot each corner and curve, and allow plenty of space between the footings and obstacles such as trees or low-lying areas where water may collect.

Once you've worked out the details and decided on a final layout, convert the scale dimensions from the site map to actual measurements. From this information, draw up a materials estimate, adding 10 percent to compensate for errors and oversights.

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Handling Slope

It's considerably easier to build a fence or garden wall when the ground is flat and level along the entire length of the proposed site line. But few landscapes are entirely flat. Hills, slight valleys, or consistent downward grades are slope issues to resolve while planning your fence. There are two common ways to handle slope: contouring and stepping.

With a contoured fence, the stringers are parallel to the ground, while the posts and siding are plumb to the earth. The top of the fence maintains a consistent height above grade, following the contours of the land. Most pre-assembled panel fences cannot be contoured, since the vertical siding members are set square to the stringers. Picket fence panels may be "racked" out of square for gentle contouring. Vinyl fence sections generally permit contouring.

Each section of a stepped fence is level across the top, forming the characteristic steps as the ground rises or falls. Stepped fences appear more structured and formal. Pre-assembled panels may be stepped to the degree their bottoms can be trimmed for the slope, or that additional siding (such as kick boards) can be added to conceal gaps at the tall end of the step. Stepped custom-built fences are more work than contoured fences since vertical siding boards must be trimmed to length individually and post heights may vary within a layout.

Solid planning and careful execution allow you to turn a sloped yard into a positive design factor when you build your fence or wall project.

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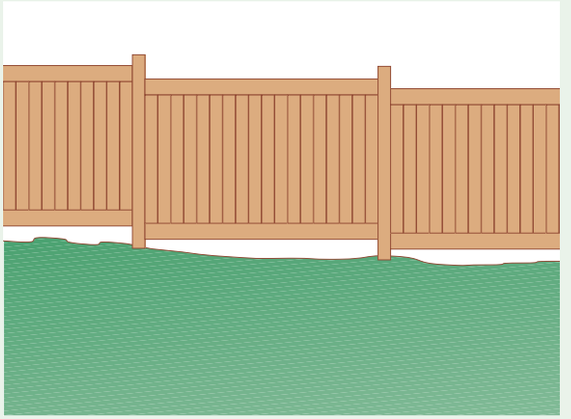
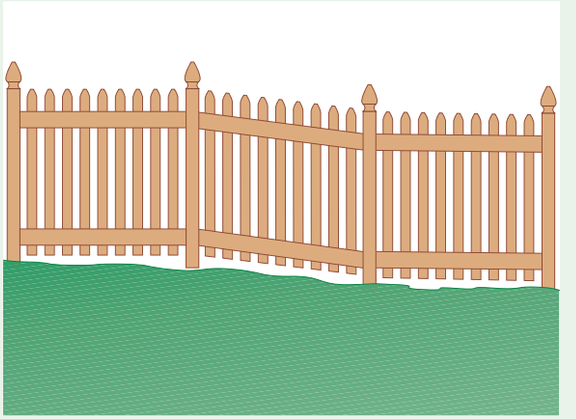
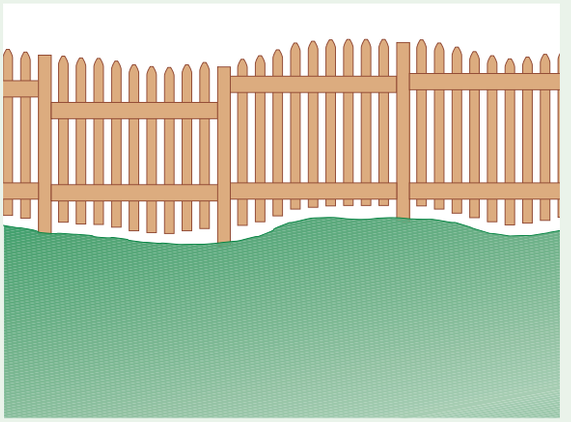
Strategies for Managing Slope



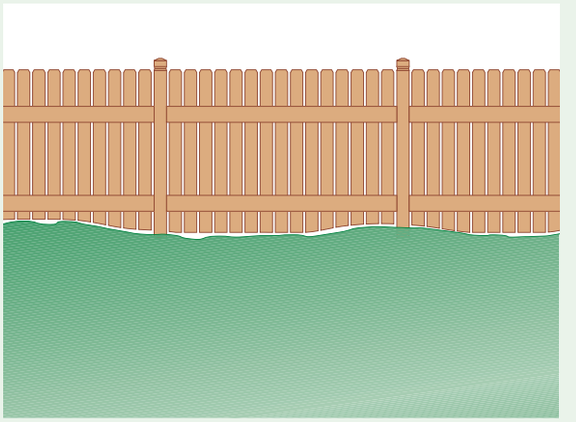
Stepped panels are horizontal, maintaining an even height between posts. A good strategy for pre-built panel systems, stepping fences is the only way to handle slope when working with panels that cannot be trimmed, racked, or otherwise altered.



Racking a panel involves manipulating a simple fence panel by twisting it out of square so the stringers follow a low slope while the siding remains vertical. Stockade and picket panels are good candidates for this trick, but the degree to which you can rack the panels is limited. If the siding is connected to stringers with more than one fastener at each joint, you'll need to remove some fasteners and replace them after racking the panel.



Contouring creates a more casual, natural-looking fence. Each individual siding board is set the same distance from the ground below and allowed to extend to full height without trimming. The resulting top of the fence will mimic the ground contour.



Bottom trimming creates a level fenceline with a baseline that follows the slope and contour of the land. On low slopes you can use this technique and trim the siding boards on pre-made panels that have open bottoms (in some cases you can raise the bottom stringer). Bottom trimming is best for site-built board and stringer fences, however.

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Contoured Fences

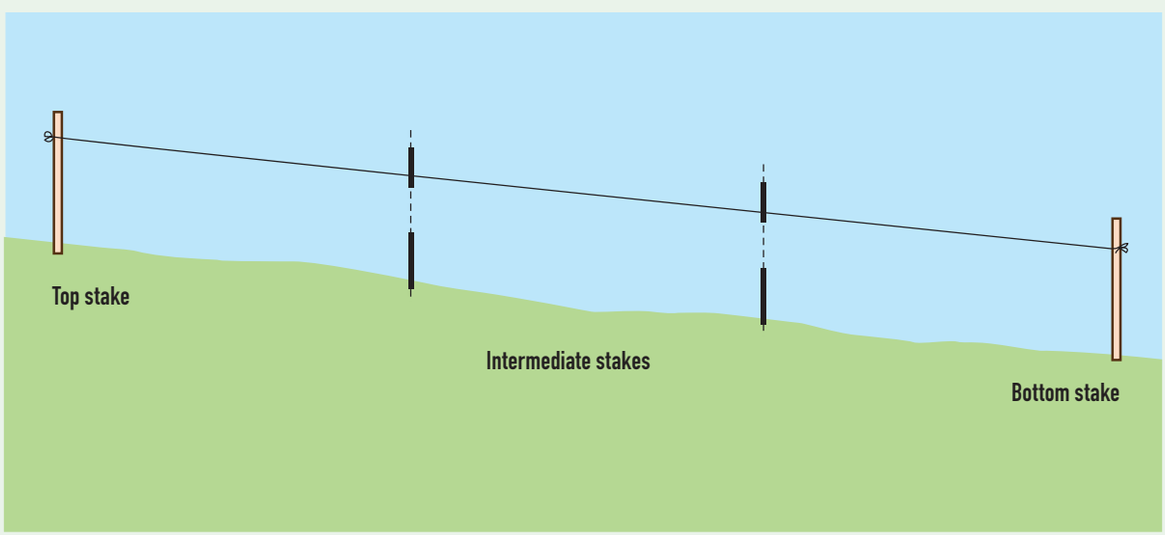
A contoured fence rolls along with the terrain, maintaining a consistent height above the ground as it follows the land. Picket fences and others with individual siding work best for contouring. There are multiple tactics you can use to build a contoured fence. The scenario described below involves setting all your posts, installing stringers, trimming posts to uniform height above the top stringer and then adding the picket siding.

Begin the contoured fence layout by running a string between batter boards or stakes located at the ends and corners of the fenceline, adding intermediate batter boards or stakes as needed to keep the string roughly parallel with the grade. Mark the post centers at regular distances (usually six or eight feet) on the string. Don't forget to allow for the posts when measuring. Drop a plumb bob at each post mark on the string to determine posthole locations. Mark these locations with a piece of plastic pegged to the ground or by another method of your choosing.

Align, space, and set the posts (if appropriate for your fence type). Attach the lower stringers between posts. If you are using metal fence rail brackets, bend the lower tab on each bracket to match the slope of the stringer. Each stringer should follow the slope of the ground below as closely as possible while maintaining a minimum distance between the highest point of the ground and the bottom of the stringer. This distance will vary from fence to fence according to your design, but 12 inches is a good general rule.

Install all of the lower stringers and then install the upper stringers parallel to the lower ones. Make sure to maintain an even spacing between the stringers. Establish the distance from the upper stringer to the post tops and then measure this distance on each post. Draw cutting lines and trim the post tops using a circular saw and a speed square clamped to the post as a guide.

Make a spacer that's about the same width as the siding boards, with a height that matches the planned distance from the ground to the bottom of each siding board. Set the spacer beneath each board as you install it. You'll also want a spacer to set the gap between siding boards. Install the siding and add post caps.



Slope Option 1: Contour Contoured fences can follow ground with either a regular slope or an irregular slope. Place a stake at the beginning and end of the fenceline and at each corner. Add intermediate stakes to maintain spacing when the slope changes.

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Stepped Fences

A stepped fence retains its shape and configuration regardless of changes in slope. The effect of the stepping up or down of whole panels is to create a more formal appearance, but it also lets you avoid cutting premade fence panels. The sacrifice is that you often end up with very tall fence posts and you may need to add filler wood between panel bottoms and irregular dips in the ground.

The following stepping technique works over slopes of a consistent grade. If the grade changes much, bracket each new slope with its own stake or pair of batter boards, as in the illustration on the previous page. Treat the last post of the first run as the first post of the second run and so on.

Alternatively, step each section independently, trimming the post tops after the siding is set. The scenario below describes a flat cap stringer, which some fences use to create a smooth top. If this is not needed on your fence, simply measure down the appropriate distances to position the inset or face-mounted stringers.

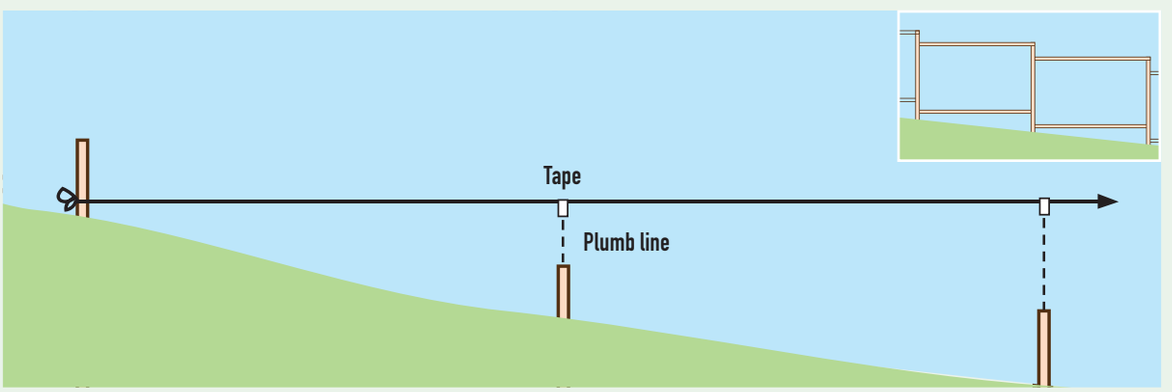
Begin the stepped fence layout by using mason's string and stakes or batter boards to establish a level line that follows the fenceline. Measure the length of the string from end stake to end stake. This number is the run. Divide the run into equal segments that are between 72 and 96". This will give you the number of sections and posts (number of sections plus one). Measure from the ground to the string at both end stakes. The difference between the two measurements is the rise of the slope. Divide the rise by the number of fence sections on the slope to find the stepping measurement.

Measure and mark the post locations along the level string with permanent marker "Vs" on tape. Drop a plumb bob from each post location mark on the string. Mark the ground with a nail and a piece of bright plastic.

Set the first post at one end and the next one in line. Mark the trim line for cutting to height and run a level string from the cutting line to the next post. Measure up (or down) from the string for the step size distance. Adjust marks if necessary before cutting the posts.

Repeat until you reach the end of the fenceline. Avoid creating sections that will be too tall or too short. The bottom stringer should remain at least four inches above grade.

Cut all posts and then attach stringers or panels so the distance from the tops of the posts to the stringers is consistent.



Slope Option 2: Stepping Stepped fences (inset) can be installed on either regular or irregular slopes. To plan the fence, run a mason's string between stakes or batter boards at the high end and the low end of the fenceline; measure the distance from the string to the ground at both ends, then calculate the difference between measurements to find the total rise. Divide this amount by the number of fence sections to determine the stepping measurement for each fence panel. On irregular slopes, the amount of drop will vary from section to section.

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Fenceline Layout

Use a pair of wood stakes and mason's string to plot the rough location of your fence or wall. Then, for greater accuracy, install batter boards to plot the final location.

Tools & Materials

- Stakes & mason's string
- Line level
- Tape measure (2)
- Level
- Circular saw
- Hammer
- Masking tape
- Work gloves
- Eye and ear protection
- Pencil
- Spray paint
- Hand maul
- 1 × 4, 2 × 4 lumber
- Permanent marker
- Screw gun
- Screws

FENCE INSTALLATIONS BEGIN with plotting the fenceline and marking post locations. Make a site map and carefully measure each post location. The more exact the posthole positions, the less likely it is that you'll need to cut stringers and siding to special sizes.

For walls, determine the outside edges of the footings along the entire site. Then plot right angles to find the ends and inside edges of the footings.

Laying out a fence or wall with square corners or curves involves a little more work. The key for these techniques is the same as for plotting a straight fenceline: measure and mark accurately. This will ensure proper spacing between the posts and accurate dimensions for footings, which will provide strength and support for each structure.

Laying out a straight fence

Determine your exact property lines. Plan your fenceline with the locally required setback (usually 6 to 12 inches from the property line). Draw a site map. It should take all aspects of your landscape into consideration, with the location of each post marked. Referring to the site map, mark the fenceline with stakes at each end or corner-post location.

Drive a pair of wood stakes a couple of feet beyond each corner or end stake. Screw a level crossboard across the stakes six inches up from the ground on the highest end of the fence run. Draw a mason's string from the first batter board down the fenceline. Level the line with a line level and mark the height of the line against one stake of the second batter board pair. Attach a level batter board to these stakes at this height and tie the string to the crossboard so it is taut.

To mark gates, first find the on-center spacing for the gateposts. Combine the width of the gate, the clearance necessary for the hinges and latch hardware, and the actual width of one post. Mark the string with a "V" of masking tape to indicate the center point of each gatepost.

To mark remaining posts, refer to your site map, and then measure and mark the line post locations on the string with marks on masking tape. Remember that the marks indicate the center of the posts, not the edges.

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INSTALLING BATTER BOARDS

1 To install batter boards, drive a pair of short wood stakes a couple of feet beyond each corner or end of the rough planned fenceline. Screw a level crossboard across one pair of stakes, about 6" up from the ground on the higher end of the fence run. Loosely tie a mason's string to the middle of the crossboard.

2 Stretch the mason's line from the batter board to the second pair of stakes at the opposite end or corner of the run. Draw the string tight, and level it with a line level. Mark the string's position onto one of the stakes. Fasten a crossboard to the second pair of stakes so it is level and its top is aligned with the mark on the stake. Tie the mason's line to the center of the crossboard.

3 Measure out from the starting points of the fenceline and mark post locations directly onto the layout lines using pieces of masking tape (don't forget to allow for the widths of your posts—see opposite page).

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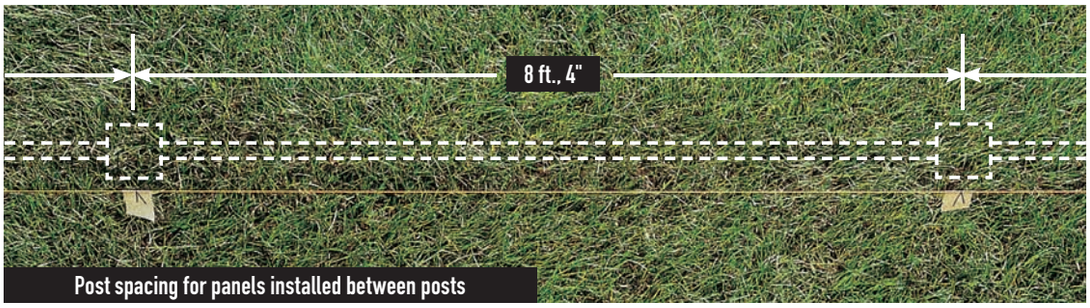
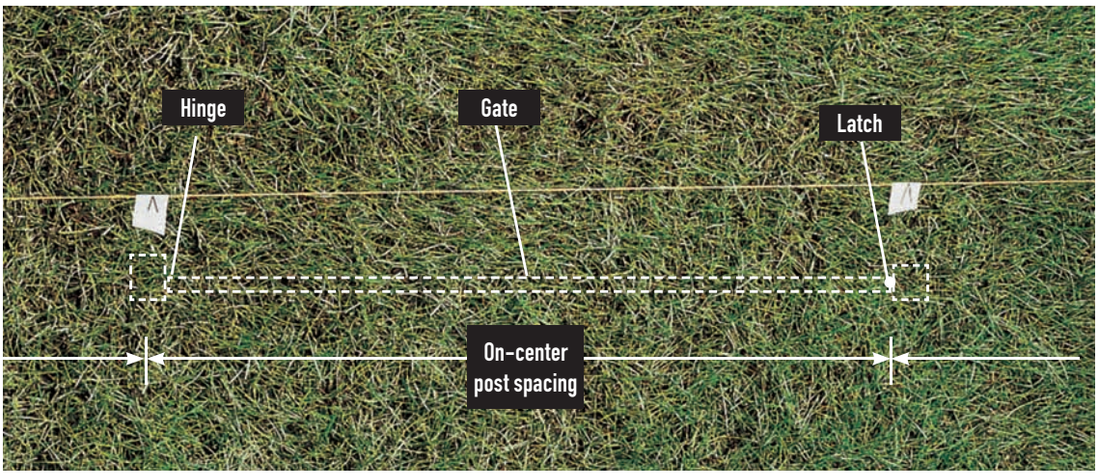
Tip: Spacing for Line Posts and Gate Posts



Post spacing for panels installed between posts

Post spacing for panels attached to faces of posts

If your fence panels will be installed between fence posts (top photo) and you are using 4 × 4 wood posts, add 4" to the length of the fence panels and use that distance as the on-center span between posts (the 4 × 4 posts are actually only 3½" wide but the extra ½" created by using the full 4" dimension will create just the right amount of "wiggle room" for the panel). If panels will be attached to the post faces, add ½" to the actual panel width to determine post spacing.



To find the on-center spacing of gate posts, add the gate width, the clearance needed for hinge and gate hardware, and the actual diameter of one post.

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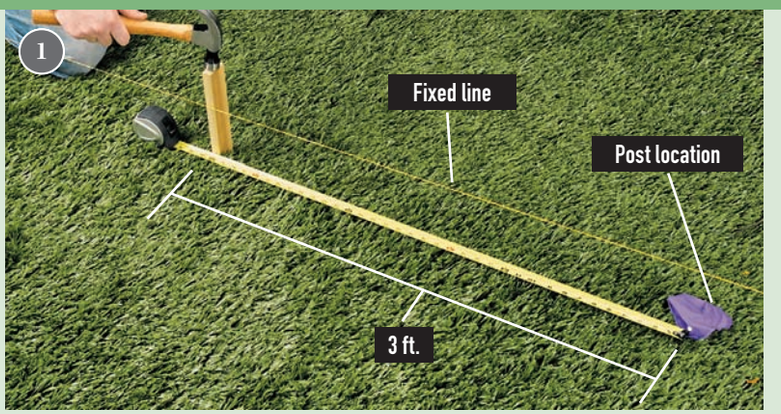
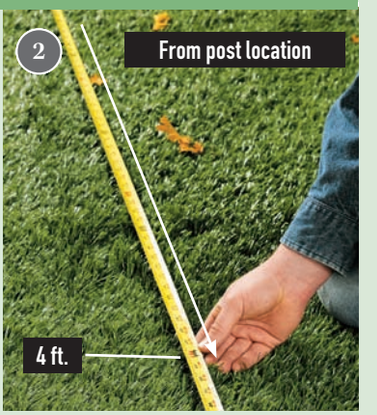
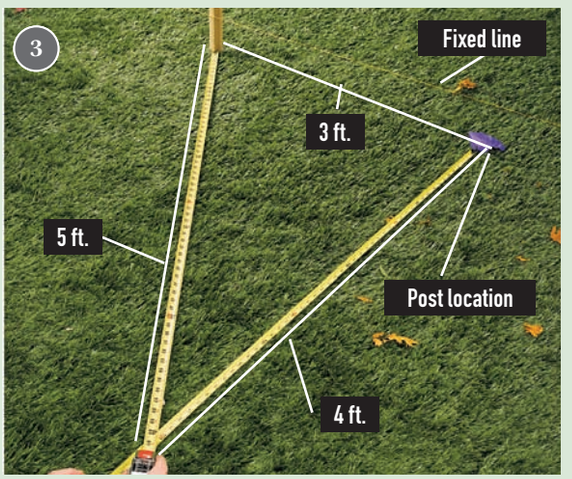
Right Angles

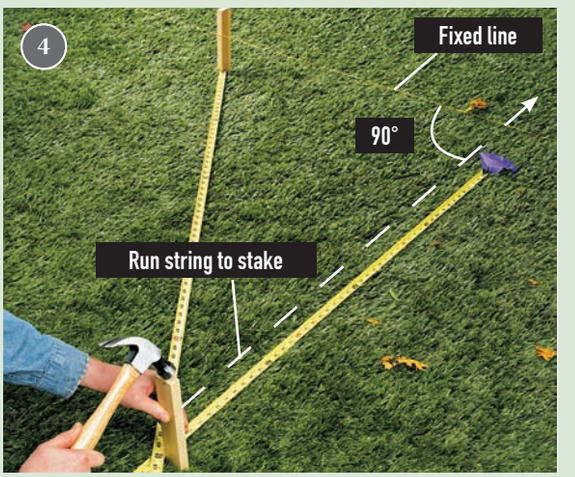
If your fence or wall will enclose a square or rectangular area, or if it joins a building, you probably want the corners to form 90 degree angles. There are many techniques for establishing a right angle when laying out an outdoor project, but the 3-4-5-triangle method is the easiest and most reliable. It is a simple method of squaring your fence layout lines, but if you have the space use a 6-8-10 or 9-12-15 triangle. Whichever dimensions you choose, you'll find it easier to work with two tape measures to create the triangle.

LAYING OUT A RIGHT ANGLE









1 Drive a pair of stakes along a known fenceline and run a line that crosses the corner post location (this line should stay fixed as a reference while you square the crossing line to it). Drive a stake 3 ft. out from the corner post location, on the line you don't want to move. You will adjust the other line to establish the right angle.

2 Draw one tape measure from the post location roughly at a right angle to the fixed line. Draw the tape beyond the 4 ft. mark and lock it.

3 Angle the second tape measure from the 3-ft. stake toward the 4 ft. mark on the first tape measure. The two tapes should intersect at 5 ft. and 4 ft.

4 Drive a stake at the point where the tape measure marks intersect. Run a line for this stake to another stake driven past the corner post location to establish perpendicular layout lines. The string tied to the second stake should pass directly over the post location.

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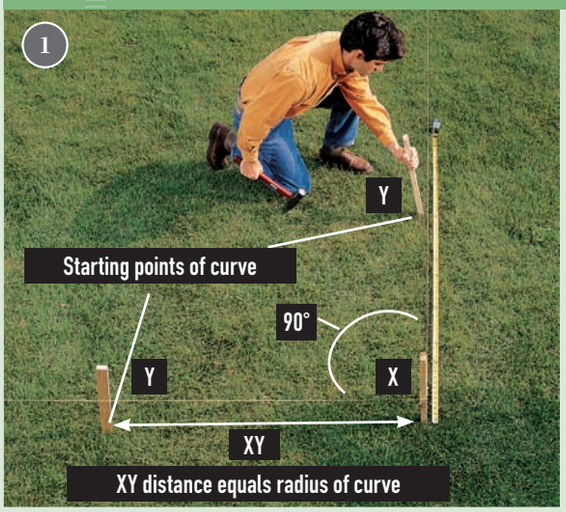
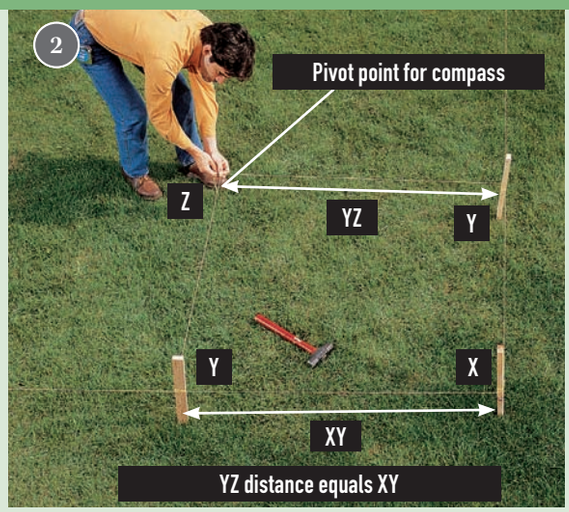
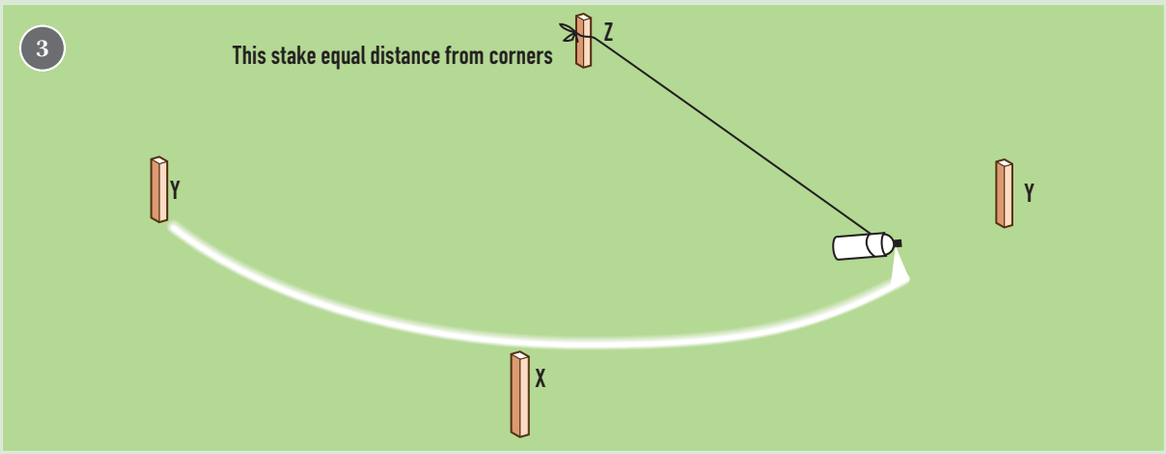
Curves

A curve in a fenceline or wall must be laid out evenly for quality results. One easy way to accomplish this is to make a crude compass by tying one end of a string around a can of marking paint and tying the other end to a wood stake, as shown in step 3 below. The radius of the curve should equal the distance from the compass' pivot stake to the starting points of the curve, so make sure to tie the string to this length.

LAYING OUT A CURVE







1 Plot a right angle at the corner of the outline, using the 3-4-5 method. Measure and drive stakes equidistant from the outside corner to mark the starting points for the curve (labeled "Y" here).

2 Tie a mason's string to each Y stake, and extend the strings back to the corner stake (2). Hold the strings tight at the point where they meet. Then, pull the strings outward at the meeting point until they are taut. Drive a stake at this point to create a perfect square. This stake (labeled "Z" here) will be the pivot point for your string compass.

3 Mark the curve: Tie a mason's string to the pivot point (Z) and to a can of marking paint. When the string is held taut, the can's spray nozzle should be even with the stakes at the start of the curve (Y). Keeping the string taut, spray the ground in a smooth arc, extending the curve between the two Y stakes.

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Setting Posts

Taking the time to make sure posts are vertical and positioned precisely is perhaps the most important aspect of a successful fence building project.

Even among professional landscapers you'll find widely differing practices for setting fence posts. Some take the always-overbuild approach and set every post in concrete that extends a foot past the frostline. Others prefer the impermanence, adjustability, and drainage of setting posts in packed sand or gravel. some treat the post ends before setting the posts, others don't bother. The posts may be set all at once, prior to installing the stringers and siding; or, they may be set one at a time in a build-as-you-go approach. Before deciding which approach is best for your situation, it's a good idea to simply walk around your neighborhood and see how the posts for similar fences are installed, then assess which posts seem to be holding up the best.

Another area of dispute is at which point in the process posts should be cut to length (height). While there are those who advocate cutting all posts before installation and then aligning them in the ground before setting them (especially when installing chain link), the most reliable method is to trim the posts to height with a circular saw or handsaw after they are set in the ground and the concrete has set. Here are some additional thoughts to help you decide how to set your posts:

- Tamped earth and gravel post setting have been increasing the life span and stability of posts for thousands of years by keeping the immediate surroundings of the post drier and firmer.
- The shallow, dish-shaped concrete footing breaks all the rules, but is often the only footing that works in very loose sandy soils. Check with local fence contractors to make sure it's right for your area.
- Hybrid footings help stabilize posts in deep freezing soils. Quick-set concrete mix may be poured into the hole dry, followed by water (or not, according to local custom—soil moisture is sometimes sufficient to harden the concrete).
- Common posts are set high enough to be trimmed down to their final height. Posts with precut mortises (such as split rail fence posts) or finials need to be set to the final height in the hole.
- Dig holes two times the post thickness for sandset or gravel-set and closer to three times the diameter if concrete-set.
- For long-term strength and stability, set all gate posts and end posts in concrete.

The most reliably long-lasting wood posts are pressure-treated with chemicals and labeled for ground contact. species that are naturally rot resistant are unfortunately less so today than in yesteryear.

Once you've plotted your fenceline with batter boards and string, mark and dig the postholes. remove the string for digging, but leave the batter boards in place; you will need these for aligning the posts when you set them.

As a general rule, posts should be buried at a minimum depth equal to ⅓ of the total post length (e.g., a post for a six-foot-tall fence will be approximately nine feet long, with three feet buried in the ground). Check with your city's building department for the post depth and burial method required by the local Building Code. Posts set in concrete should always extend below the frost line.

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Wood Panel Fence

Building with wood fence panels is a great time-saver and allows you to create a more elaborate fence than you may be able to build from scratch.

PREFABRICATED FENCE PANELS take much of the work out of putting up a fence, and (surprisingly) using them is often less expensive than building a board and stringer fence from scratch. They are best suited for relatively flat yards, but may be stepped down on slopes that aren't too steep.

Fence panels come in many styles, ranging from privacy to picket. Most tend to be built lighter than fences you'd make from scratch, with thinner wood for the stringers and siding. When shopping for panels, compare quality and heft of lumber and fasteners as well as cost.

Purchase panels, gate hardware, and gate (if you're not building one) before setting and trimming your posts. Determine also if panels can be trimmed or reproduced from scratch for short sections.

The most exacting task when building a panel fence involves insetting the panels between the posts. This requires that preset posts be precisely spaced and perfectly plumb. In our inset panel sequence, we set one post at a time as the fence was built, so the attached panel position can determine the spacing, not the preset posts.

An alternative installation to setting panels between posts is to attach them to the post faces. Face-mounted panels are more forgiving

Tools & Materials

- Pressure-treated cedar or redwood 4 × 4 posts
- Prefabricated fence panels
- Corrosion-resistant fence brackets or panel hangers
- Post caps
- Corrosion-resistant deck screws (1", 3½")
- Prefabricated gate & hardware
- Wood blocks
- Colored plastic
- Tape measure
- Plumb bob
- Masking tape
- Stakes and mason's string
- Clamshell digger or power auger
- Gravel
- Hand tamp
- Level
- 2 × 4 lumber
- Circular saw, hand saw, or reciprocating saw
- Concrete
- Drill
- Line level
- Clamps
- Scrap lumber
- Shovel
- Hammer
- Speed square
- Eye and ear protection
- Work gloves
- Permanent marker
- Hinges (3)

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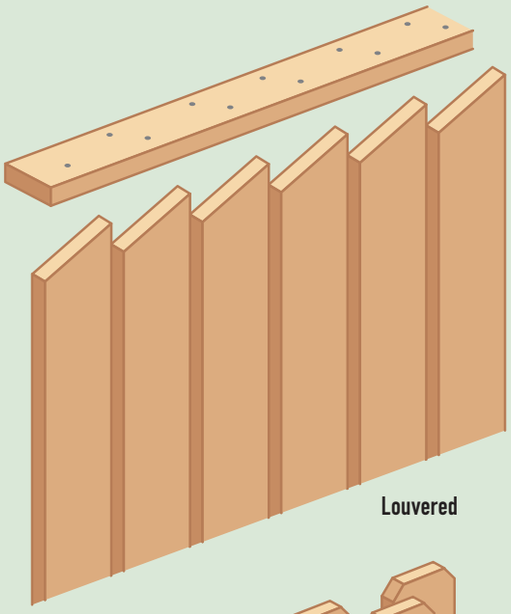
of preset posts, since the attachment point of stringers doesn't need to be dead center on the posts.

Wood fence panels usually are constructed in either six- or eight-foot lengths. Cedar and pressure treated pine are the most common wood types used in making fence panels, although you may also find redwood in some areas. Generally, the cedar panels cost one-and-a-half to two times as much for similar styles in pressure-treated lumber.

When selecting wood fence panels, inspect every board in each panel carefully (and be sure to check both sides of the panel). These products are fairly susceptible to damage during shipping.

PANEL BOARD PATTERN VARIATIONS



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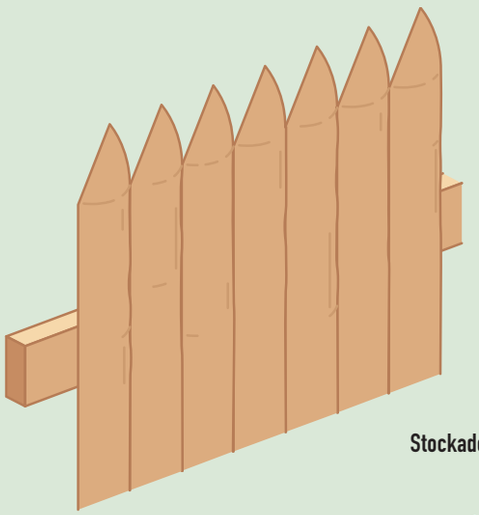
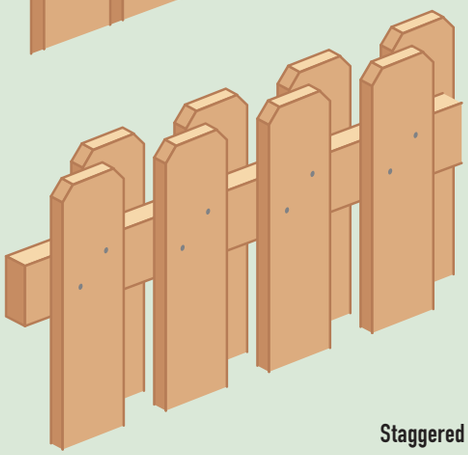
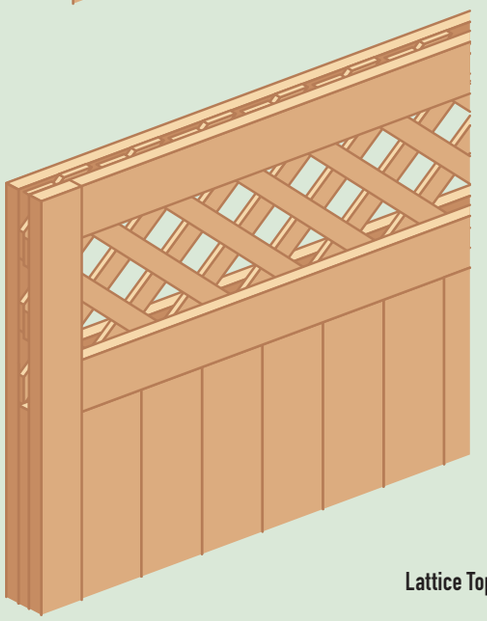


Stockade



Staggered Board



Lattice Top

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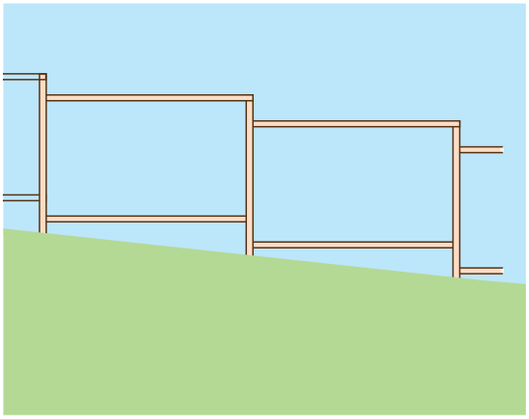
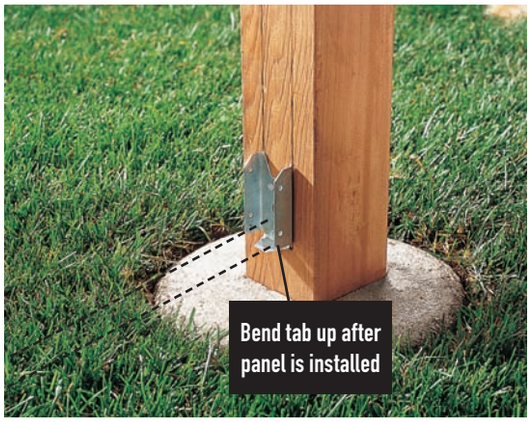
Tips for Installing Fence Panels



On a sloped lot, install the panels in a step pattern, trying to keep a consistent vertical drop between panels. It is difficult to cut most preassembled panels, so try to plan the layout so only full-width panels are used.



Metal fence panel hangers make quick work of hanging panels and offer a slight amount of wiggle room if the panel is up to ½" narrower than the space between posts.

With some panel styles, the best tactic is to flatten the lower tab after attaching it to the post and then bend it up or down against the panel frame once the panel is in place.

Setting all of the posts in concrete at one time and then installing the panels after the concrete sets has advantages as well as disadvantages. On the plus side, this approach lets you pour all of the concrete at the same time and provides good access so you can make absolutely certain the posts are level and plumb. On the downside, if the post spacing is off even a little bit, you'll need to trim the panel (which can be tricky) or attach a shim to the post or the panel frame (also tricky). Most panel manufacturers recommend installing the posts as you go.

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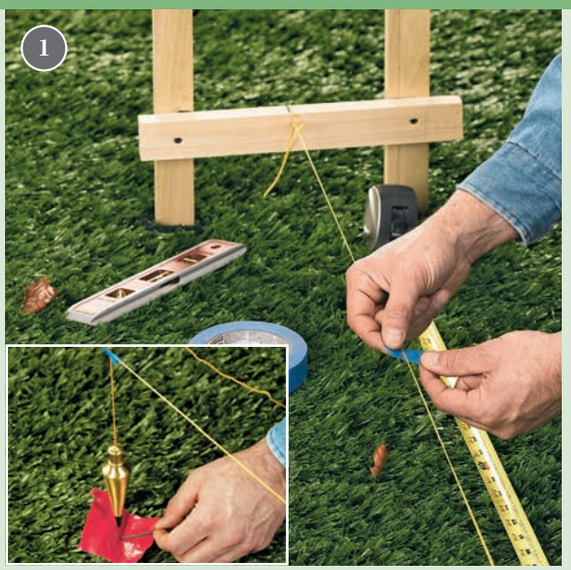
BUILDING A WOOD PANEL FENCE



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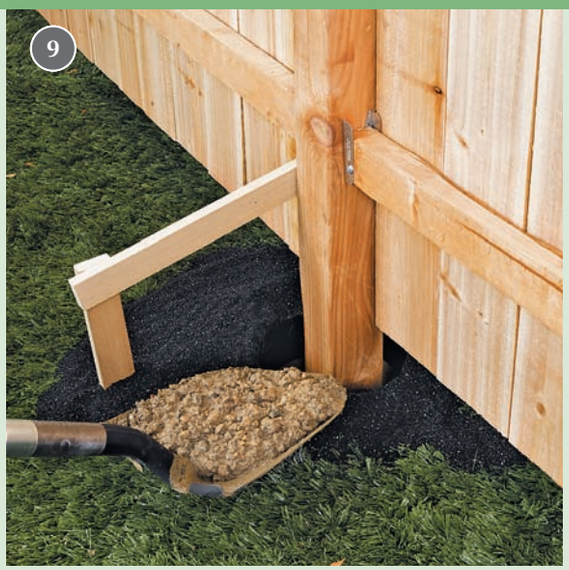

1 Lay out the fenceline, and mark the posthole locations with colored plastic (inset). Space the holes to fit the fence panels, adding the actual post width (3½" for 4 × 4 posts) plus ¼" for brackets to the panel length. Tip: For stepped fences, measure the spacing along a level line, not along the slope.

2 Dig the first posthole for a corner or end post using a clamshell digger or power auger. Add 6" of gravel to the hole, and tamp it flat. Set, plumb, and brace the first post with cross bracing.

3 Dig the second posthole using a 2 × 4 spacer to set the distance between posts (cut the spacer to the same length as the stringers on the preassembled fence panels).

4 Fill the first posthole with concrete or with tamped soil and gravel. Tamp the concrete with a 2 × 4 as you fill the hole. Let the concrete set.

5 Install the stringer brackets onto the first post using corrosion-resistant screws or nails. Shorter fences may have two brackets, while taller fences typically have three. Note: The bottom of the fence siding boards should be at least 2" above the ground when the panel is installed.

6 Set the first panel into the brackets. Shim underneath the free end of the panel with scrap lumber so that the stringers are level and the panel is properly aligned with the fenceline. Fasten the panel to the brackets with screws or nails.

7 Mark the second post for brackets. Set the post in its hole and hold it against the fence panel. Mark the positions of the panel stringers for installing the brackets. Remove the post and install the stringer brackets, as before.

8 Reset the second post, slipping the ends of the panel stringers into the brackets. Brace the post so it is plumb, making sure the panel remains level and is aligned with the fenceline. Fasten the brackets to the panel with screws or nails.

9 Anchor the second post in concrete. After the concrete sets, continue building the fence, following steps 5 to 8. Option: You can wait to fill the remaining postholes with concrete until all of the panels are in place.

10 Attach the post caps after trimming the posts to their finished height (use a level mason's line to mark all of the posts at the same height). Install the gate, if applicable; see next page.

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#175 Dtp:228 Page:107

INSTALLING A PREFAB GATE

1 To install a prefabricated gate, attach three evenly spaced hinges to the gate frame using corrosion-resistant screws.

2 Follow the hardware manufacturer's directions, making sure the hinge pins are straight and parallel with the edge of the gate. Position the gate between the gate posts so the hinge pins rest against one post. Shim the gate to the desired height using wood blocks set on the ground. Make sure there is an even gap (reveal) between the gate and the latch post, and then fasten the hinges to the hinge post with screws (inset).

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Split Rail Fence

A split rail fence looks great as a garden backdrop or a friendly boundary line. The rough-hewn texture and traditional wood joints are reminiscent of homesteaders' fences built from lumber cut and dressed right on the property.

Tools & Materials

- Mason's string
- Shovel
- Clamshell digger or power auger
- Digging bar (with tamping head) or 2 × 4
- Level
- Reciprocating saw or handsaw
- Tape measure
- Stakes
- Soil
- Nails
- Precut split rail fence posts and rails
- Compactable gravel
- Plastic tags
- Lumber and screws for cross bracing
- Wheelbarrow
- Line level
- Shovel
- Eye and ear protection
- Work gloves

THE SPLIT RAIL, or post and rail, fence is essentially a rustic version of the post and board fence style and is similarly a good choice for a decorative accent, for delineating areas, or for marking boundaries without creating a solid visual barrier. Typically made from split cedar logs, the fence materials have naturally random shaping and dimensions, with imperfect details and character marks that give the wood an appealing hand-hewn look. Natural weathering of the untreated wood only enhances the fence's rustic beauty.

The construction of a split rail fence couldn't be simpler. The posts have holes or notches (called mortises) cut into one or two facets. The fence rails have trimmed ends (called tenons) that fit into the mortises. No fasteners are needed. Posts come in three types to accommodate any basic configuration: common posts have through mortises, end posts have half-depth mortises on one facet, and corner posts have half-depth mortises on two adjacent facets. The two standard fence styles are two-rail, which stand about three feet tall, and three-rail, which stand about four feet tall. Rails are commonly available in eight- and ten-feet lengths.

In keeping with the rustic simplicity of the fence design, split rail fences are typically installed by setting the posts with tamped soil and gravel instead of concrete footings (frost heave is generally not a concern with this fence, since the joints allow for plenty of movement). This comes with a few advantages: the postholes are relatively small, you save the expense of concrete, and it's much easier to replace a post if necessary. Plan to bury about a third of the total post length (or 24 inches minimum). This means a three-foot-tall fence should have 60-inch long posts. If you can't find long posts at your local home center, try a lumberyard or fencing supplier.

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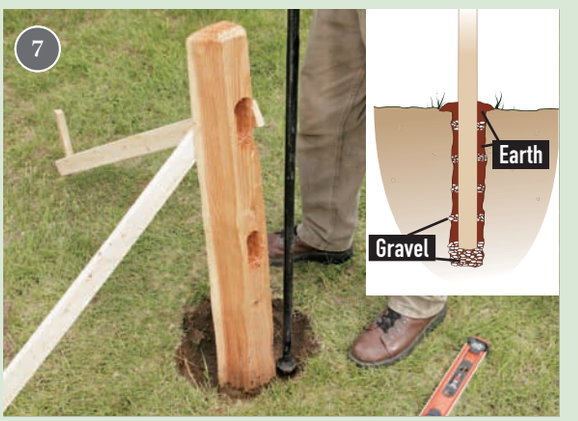
BUILDING A SPLIT RAIL FENCE



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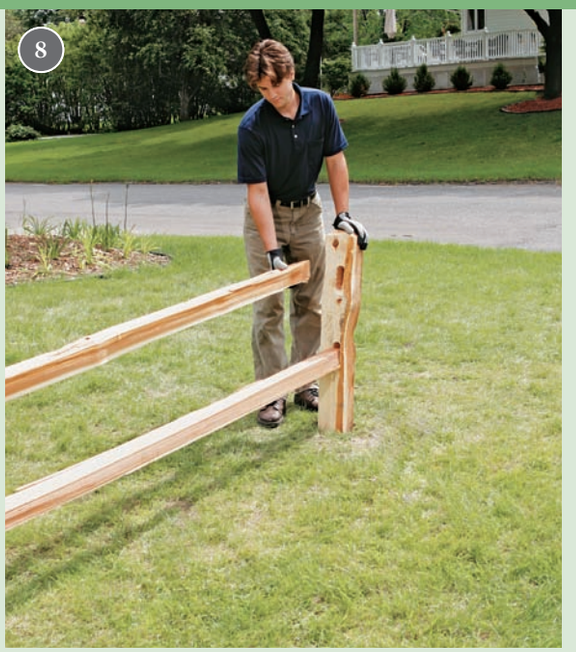

1 Determine the post spacing by dry-assembling a fence section and measuring the distance between the post centers. Be sure the posts are square to the rails before measuring.

2 Set up a string line using mason's string and stakes to establish the fence's path, including any corners and return sections. Mark each post location along the path using a nail and plastic tag.

3 Dig the postholes so they are twice as wide as the posts and at a depth equal to ⅓ the total post length plus 6". Because split posts vary in size, you might want to lay out the posts beforehand and dig each hole according to the post size.

4 Add 6" of drainage gravel to each posthole. Tamp the gravel thoroughly with a digging bar or a 2 × 4 so the layer is flat and level.

5 Set and measure the first post. Drop the post in its hole, and then hold it plumb while you measure from the ground to the desired height. If necessary, add or remove gravel and re-tamp to adjust the post height.

6 Brace the post with cross bracing so it is plumb. Add 2" of gravel around the bottom of the post. Tamp the gravel with a digging bar or 2 × 4, being careful not to disturb the post.

7 Fill and tamp around the post, one layer at a time. Alternate between 4" of soil and 2" of gravel (inset), tamping each layer all the way around the post before adding the next layer. Check the post for plumb as you work. Overfill the top of the hole with soil and tamp it into a hard mound to help shed water.

8 Assemble the first section of fence by setting the next post in its hole and checking its height. Fit the rails into the post mortises, and then brace the second post in place. Note: Set all the posts at the same height above grade for a contoured fence.

9 Secure the second post by filling and tamping with alternate layers of gravel and soil, as with the first post. Repeat steps 5 through 9 to complete the fence. Tip: Set up a mason's string to help keep the posts in a straight line as you set them.

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Variation

For a fence that remains level across the top, set up a level mason's line strung between two installed fence posts or between temporary supports. Set all of the posts so their tops are just touching the line.

Tip: Custom Details

Custom-cut your rails to build shorter fence sections. Cut the rails to length using a reciprocating saw and long wood blade or a handsaw (be sure to factor in the tenon when determining the overall length). To cut the tenon, make a cardboard template that matches the post mortises. Use the template to mark the tenon shape onto the rail end, and then cut the tenon to fit.

Gates for split rail fences are available from fencing suppliers in standard and custom-order sizes. Standard sizes include 4 ft. for a walk-through entrance gate and 8 or 10 ft. for a drive-through gate. For large gates, set the side posts in concrete footings extending below the frost line.

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Vinyl Panel Fence

Vinyl fencing is now available in a wide range of traditional designs, including picket, post and board, open rail, and solid panel. Color options are generally limited to various shades of white, tan, and gray.

Tools & Materials

- Mason's string
- Shovel
- Clamshell digger or power auger
- Circular saw
- Drill
- Tape measure
- Hand maul
- Line level
- Post level
- Clamps or duct tape
- Concrete tools
- Stakes
- 2 × 4 lumber
- Vinyl fence materials (with hardware, fasteners, and decorative accessories)
- Pea gravel
- Concrete
- Pressure-treated 4 × 4 (for gate, if applicable)
- PVC cement or screws (optional)
- Work gloves
- Post caps
- Eye and ear protection

THE BEST FEATURES of vinyl fencing are its resilience and durability. Vinyl fencing is made with a form of tough, weather-resistant, UV-protected PVC (polyvinyl chloride), a plastic compound that's found in numerous household products, from plumbing pipe to shower curtains. A vinyl fence never needs to be painted and should be guaranteed for decades not to rot, warp, or discolor. So if you like the styling of traditional wood fences, but minimal maintenance is a primary consideration, vinyl might just be your best option. Another good option is wood composite fencing, which comes in fewer styles than vinyl but is environmentally friendly and can replicate the look of wood fencing.

Installing most vinyl fencing is similar to building a wood panel fence. With both materials, it's safest to set the posts as you go, using the infill panels to help you position the posts. Accurate post placement is critical with vinyl, because many types of panels cannot be trimmed if the posts are too close together. Squeezing the panel in can lead to buckling when the vinyl expands on hot days, while setting the posts too far apart results in unsightly gaps.

Given the limited workability of most vinyl panels, this fencing tends to work best on level or gently sloping ground. Keep in mind that installation of vinyl fences varies widely by manufacturer and fence style.

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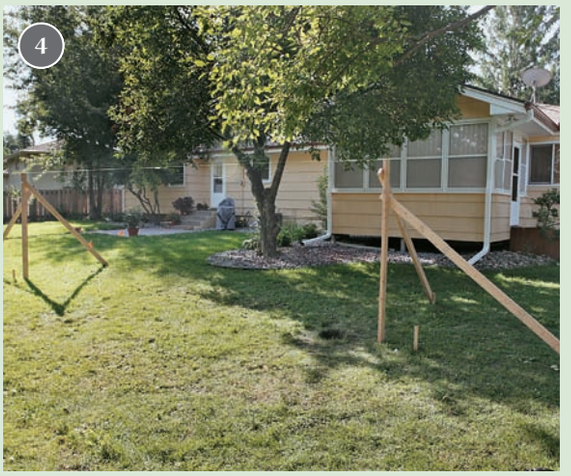
INSTALLING A VINYL PANEL FENCE



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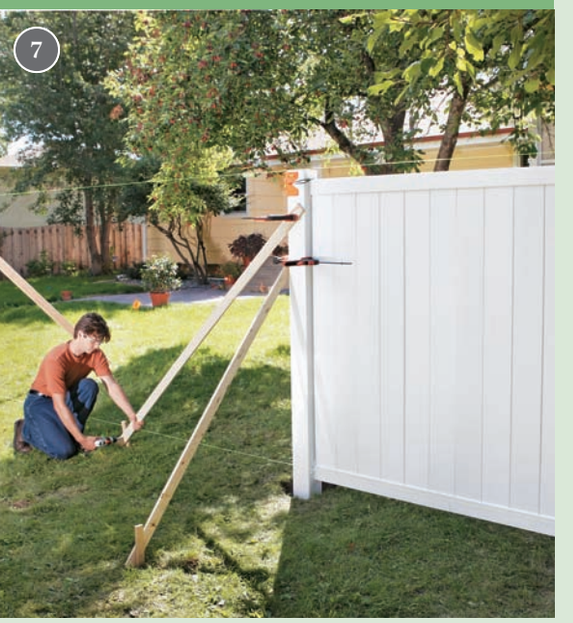

1 Lay out the first run of fence with stakes and mason's string. Position the string so it represents the outside or inside faces of the posts (you'll use layout strings to align the posts throughout the installation). Mark the center of the first post hole by measuring in from the string half the post width.

2 Dig the first posthole, following the manufacturer's requirements for diameter and depth (improper hole dimensions can void the warranty). Add 4 to 6" (or as directed) of pea gravel to the bottom of the hole and tamp it down so it is flat and level using a 2 × 4 or 4 × 4.

3 Attach the fence panel brackets to the first post using the provided screws. Dry-fit a fence panel into the brackets, then measure from the top of the post to the bottom edge of the panel. Add 2" (or as directed) to represent the distance between the fence and the ground; the total dimension is the posts' height above the ground.

4 Set up a post-top string to guide the post installation. Using the post height dimension, tie a mason's string between temporary 2 × 4 supports so the string is centered over the post locations. Use a line level to make sure the string is level. Measure from the string to the ground in several places to make sure the height is suitable along the entire fence run.

5 Set the first post. Drop the post in its hole and align it with the fenceline string and height string. Install cross bracing to hold the post perfectly plumb. Tip: Secure bracing boards to the post with spring-type clamps or duct tape. Fill the posthole with concrete and let it set completely.

6 Determine the second post's location by fitting a fence panel into the brackets on the first post. Mark the ground at the free edge of the panel. Measure out from the mark half the post width to find the center of the post hole (accounting for any additional room needed for the panel brackets).

7 Complete the fence section. Dig the hole for the second post, add gravel, and tamp as before. Attach the panel brackets to the second post, set the post in place, and check its height against the string line. Assemble the fence section with the provided screws (inset). Confirm that the fence panel is level. Brace the second post in place (as shown) and anchor it with concrete. Repeat the same layout and construction steps to build the remaining fence sections.

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8 Add the post caps. Depending on the product, caps may be installed with PVC cement or screws, or they may be fitted without fasteners. Add any additional decorative accessories, such as screw caps, to complete the installation.

9 Hang the gate using the provided hardware. Fasten the hinges to the gate panel with screws. Position the gate in line with the infill fence panels, and screw the hinges to the hinge post. Install the latch hardware onto the gate and latch post. Close the gate, position the gate stops against the gate rails, and fasten the stops to the latch post with screws.

Reinforce the hinge post with a pressure-treated 4 × 4 inserted inside the post. Set the post in concrete following the same steps used for fence sections. Check carefully to make sure the post is plumb, as this will ensure the gate swings properly. Install the latch post according to the manufacturer's specified dimension for the gate opening.

Tip: Cutting Panels

Cut panels for short runs on solid-panel fencing (if straight along the top) per manufacturer's recommendations.

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Dry Stone Wall

Tools & Materials

Mason's string and stakes
Compactable gravel
Ashlar stone
Capstones
Mortar mix
Trowel
Stiff-bristle brush
Work gloves
Protective footwear

It is easiest to build a dry stone wall with ashlar—stone that has been split into roughly rectangular blocks. Ashlar stone is stacked in the same running-bond pattern used in brick wall construction; each stone overlaps a joint in the previous course. This technique avoids long vertical joints, resulting in a wall that is attractive and also strong.

STONE WALLS are beautiful, long-lasting structures that are surprisingly easy to build, provided you plan carefully. A low stone wall can be constructed without mortar using a centuries-old method known as dry laying. With this technique, the wall is actually formed by two separate stacks that lean together slightly. The position and weight of the two stacks support each other, forming a single, sturdy wall. A dry stone wall can be built to any length, but its width must be at least half of its height.

You can purchase stone for this project from a quarry or stone supplier, where different sizes, shapes, and colors of stone are sold, priced by the ton. The quarry or stone center can also sell you Type M mortar—necessary for bonding the capstones to the top of the wall.

Building dry stone walls requires patience and a fair amount of physical effort. The stones must be sorted by size and shape. You'll probably also need to shape some of the stones to achieve consistent spacing and a general appearance that appeals to you.

To shape a stone, score it using a circular saw outfitted with a masonry blade. Place a mason's chisel on the score line and strike with a maul until the stone breaks. Wear safety glasses when using stonecutting tools.

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BUILDING A DRY STONE WALL

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1 Lay out the wall site using stakes and mason's string. Dig a 6"-deep trench that extends 6" beyond the wall on all sides. Add a 4" crushed stone sub-base to the trench, creating a "V" shape by sloping the sub-base so the center is about 2" deeper than the edges.

2 Select appropriate stones and lay the first course. Place pairs of stones side by side, flush with the edges of the trench and sloping toward the center. Use stones of similar height; position uneven sides face down. Fill any gaps between the shaping stones with small filler stones.

3 Lay the next course, staggering the joints. Use pairs of stones of varying lengths to offset the center joint. Alternate stone length, and keep the height even, stacking pairs of thin stones if necessary to maintain consistent height. Place filler stones in the gaps.

4 Every other course, place a tie stone every 3 ft. You may need to split the tie stones to length. Check the wall periodically for level.

5 Mortar the capstones to the top of the wall, keeping the mortar at least 6" from the edges so it's not visible. Push the capstones together and mortar the cracks in between. Brush off dried excess mortar with a stiff-bristle brush.

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Interlocking Block Retaining Wall

Interlocking concrete block is the only retaining wall material that comes ready to install. With little or no cutting, you can build a wall with straight lines, curves, or steps, or have it conform to a slope on one or both ends.

Tools & Materials

- Wheelbarrow
- Shovel
- Line level
- Hand tamper
- Tamping machine (available for rent)
- Small maul
- Masonry chisel
- Eye and ear protection
- Work gloves
- 4-ft. level
- Tape measure
- Caulk gun
- Circular saw with masonry cutting blade
- Stakes
- Mason's string
- Landscape fabric
- Compactable gravel
- Perforated drain pipe
- Coarse backfill material
- Construction adhesive
- Excavation tools
- Interlocking block
- Flour or marking paint

SLOPING AREAS of a yard may be fun for the kids to play on, but they can certainly limit your usable space for amenities like patios and gardens. When you need more flat ground or simply want to reshape nature's contours a bit, a low retaining wall is the answer. Retaining walls cut into a slope—and in some cases, replace the slope—bridging the upper and lower levels while adding more useable area to both.

Low retaining walls can be built with a variety of materials, including landscape timbers, natural stone, and poured concrete. But by far the most popular material for do-it-yourself projects is interlocking concrete block made specifically for retaining walls. This block requires no mortar—most types are simply stacked in ordered rows—and it has flanges (or pins) that automatically set the batter for the wall (the backward lean that most retaining walls have for added strength). Interlocking block is available at home and garden centers and landscape suppliers. Most types have roughly textured faces to mimic the look of natural stone.

Due to the structural factors involved, the recommended height limit for do-it-yourself retaining walls is three feet. Anything higher is best left to a professional. As walls get taller, the physical stresses involved and resulting potential problems rise dramatically. Retaining walls of any size may be governed by the local Building Code; contact your city's building department to learn about construction specifications and permit requirements.

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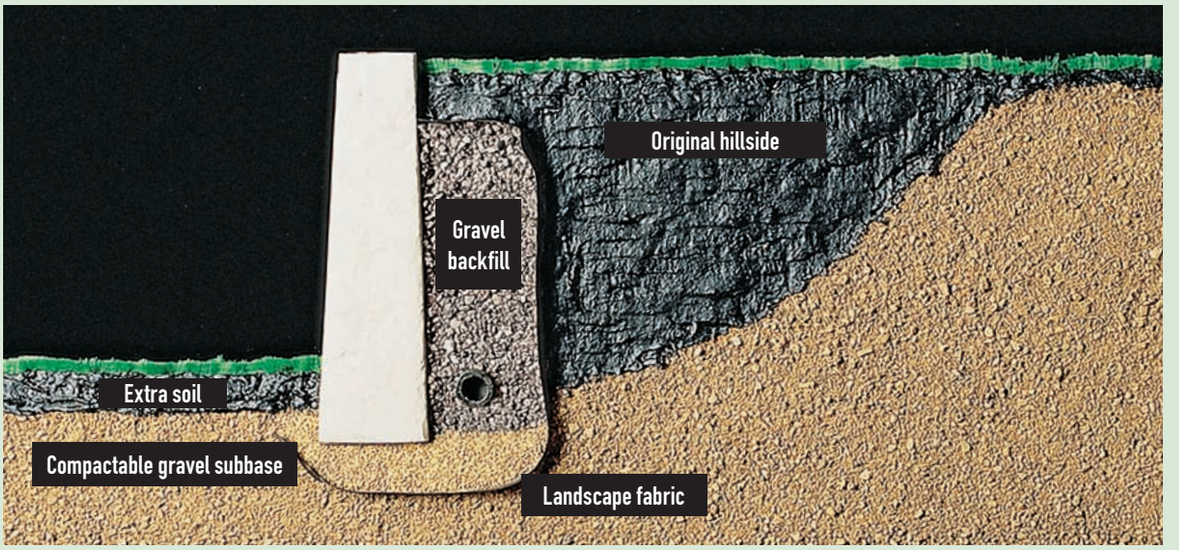
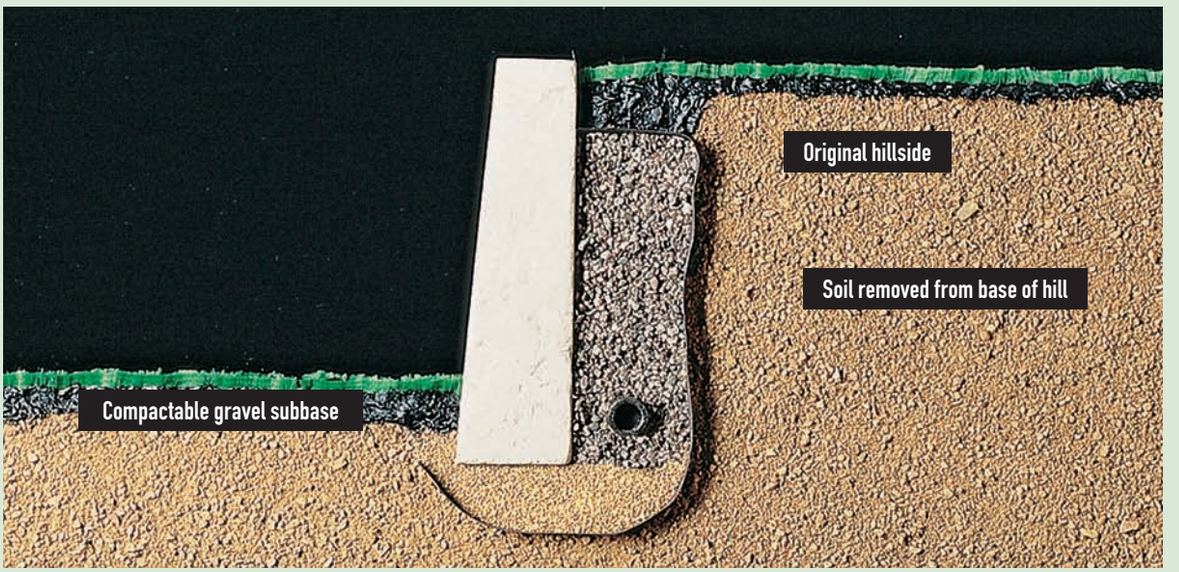
Options for Positioning a Retaining Wall

Structural features for all retaining walls include: a compactable gravel subbase to make a solid footing for the wall, crushed stone backfill, a perforated drain pipe to improve drainage behind the wall, and landscape fabric to keep the loose soil from washing into and clogging the gravel backfill. There are a couple different ways you can position a retaining wall on your slope:



(A) Increase the level area above the wall by positioning the wall well forward from the top of the hill. Fill in behind the wall with extra soil, which is available from sand-and-gravel companies.



(B) Keep the basic shape of your yard by positioning the wall near the top of the hillside. Use the soil removed at the base of the hill to fill in near the top of the wall.

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Tips for Building Retaining Walls

Backfill with crushed stone and install a perforated drain pipe about 6" above the bottom of the backfill. Vent the pipe to the side or bottom of the retaining wall, where runoff water can flow away from the hillside without causing erosion.

Make a stepped trench when the ends of a retaining wall must blend into an existing hillside. Retaining walls are often designed so the ends curve or turn back into the slope.

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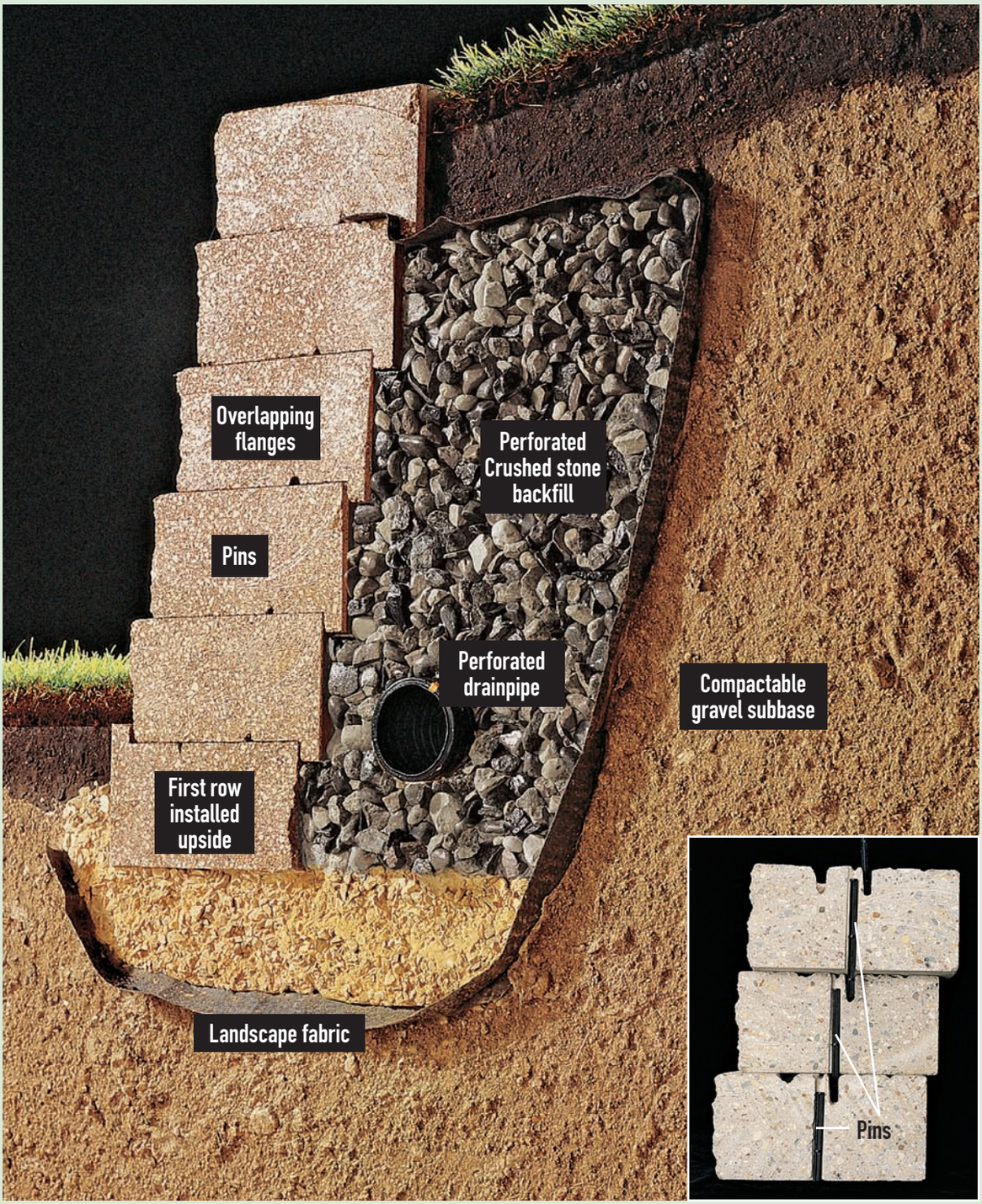

Interlocking wall blocks do not need mortar. Some types are held together with a system of overlapping flanges that automatically set the backward pitch (batter) as the blocks are stacked, as shown in this project. Other types of blocks use fiberglass pins (inset).

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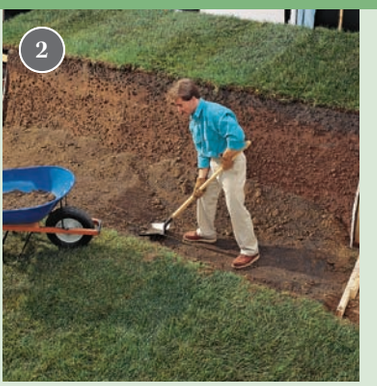
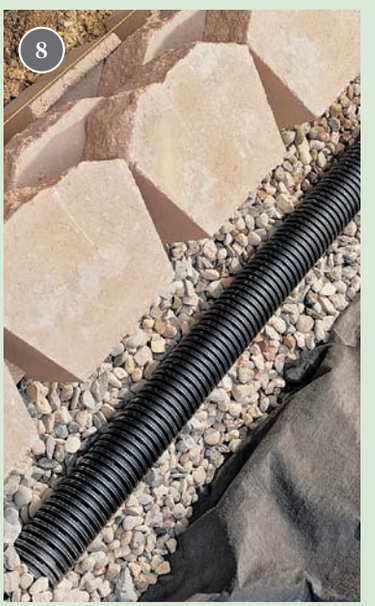
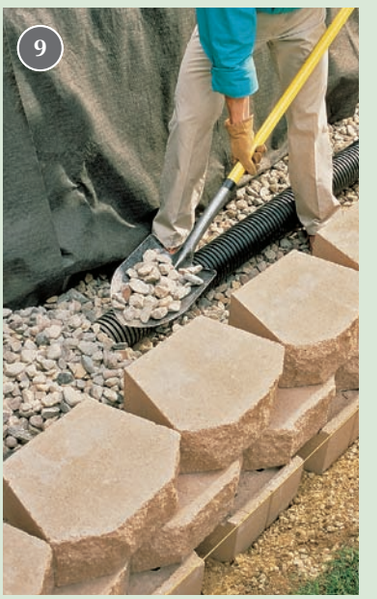
BUILDING A RETAINING WALL USING INTERLOCKING BLOCK







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#175 Dtp:228 Page:124

1 Excavate the hillside, if necessary. Allow 12" of space for crushed stone backfill between the back of the wall and the hillside. Use stakes to mark the front edge of the wall. Connect the stakes with mason's string, and use a line level to check for level.

2 Dig out the bottom of the excavation below ground level, so it is 6" lower than the height of the block. For example, if you use 6"-thick block, dig down 12". Measure down from the string in multiple spots to make sure the bottom base is level.

3 Line the excavation with strips of landscape fabric cut 3 ft. longer than the planned height of the wall. Make sure all seams overlap by at least 6".

4 Spread a 6" layer of compactable gravel over the bottom of the excavation as a subbase and pack it thoroughly. A rented tamping machine, or jumping jack, works better than a hand tamper for packing the subbase.

5 Lay the first course of block, aligning the front edges with the mason's string. (When using flanged block, place the first course upside down and backward.) Check frequently with a level and adjust, if necessary, by adding or removing subbase material below the blocks.

6 Lay the second course of block according to manufacturer's instructions, checking to make sure the blocks are level. (Lay flanged block with the flanges tight against the underlying course.) Add 3 to 4" of gravel behind the block, and pack it with a hand tamper.

7 Make half-blocks for the corners and ends of a wall, and use them to stagger vertical joints between courses. Score full blocks with a circular saw and masonry blade, then break the blocks along the scored line with a maul and chisel.

8 Add and tamp crushed stone, as needed, to create a slight downward pitch (about ¼" of height per foot of pipe) leading to the drain pipe outlet. Place the drain pipe on the crushed stone, 6" behind the wall, with the perforations face down. Make sure the pipe outlet is unobstructed. Lay courses of block until the wall is about 18" above ground level, staggering the vertical joints.

9 Fill behind the wall with crushed stone, and pack it thoroughly with the hand tamper. Lay the remaining courses of block, except for the cap row, backfilling with crushed stone and packing with the tamper as you go.

10 Before laying the cap block, fold the end of the landscape fabric over the crushed stone backfill. Add a thin layer of topsoil over the fabric, then pack it thoroughly with a hand tamper. Fold any excess landscape fabric back over the tamped soil.

11 Apply construction adhesive to the top course of block, then lay the cap block. Use topsoil to fill in behind the wall and to fill in the base at the front of the wall. Install sod or plants, as desired.

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Metric Conversions

Metric Equivalent

Inches (in.)	1/64	1/32	1/25	1/16	1/8	1/4	3/8	2/5	1/2	5/8	3/4	7/8	1	2	3	4	5	6	7	8	9	10	11	12	36	39.4
Feet (ft.)																								1	3	3 1/12
Yards (yd.)																									1	1 1/12
Millimeters (mm)	0.40	0.79	1	1.59	3.18	6.35	9.53	10	12.7	15.9	19.1	22.2	25.4	50.8	76.2	101.6	127	152	178	203	229	254	279	305	914	1,000
Centimeters (cm)							0.95	1	1.27	1.59	1.91	2.22	2.54	5.08	7.62	10.16	12.7	15.2	17.8	20.3	22.9	25.4	27.9	30.5	91.4	100
Meters (m)																								.30	.91	1.00

Converting Measurements

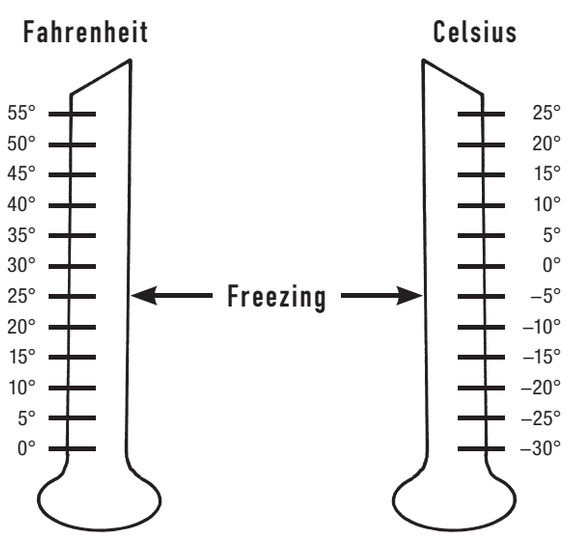
To Convert:	To:	Multiply by:
Inches	Millimeters	25.4
Inches	Centimeters	2.54
Feet	Meters	0.305
Yards	Meters	0.914
Miles	Kilometers	1.609
Square inches	Square centimeters	6.45
Square feet	Square meters	0.093
Square yards	Square meters	0.836
Cubic inches	Cubic centimeters	16.4
Cubic feet	Cubic meters	0.0283
Cubic yards	Cubic meters	0.765
Pints (U.S.)	Liters	0.473 (Imp. 0.568)
Quarts (U.S.)	Liters	0.946 (Imp. 1.136)
Gallons (U.S.)	Liters	3.785 (Imp. 4.546)
Ounces	Grams	28.4
Pounds	Kilograms	0.454
Tons	Metric tons	0.907

To Convert:	To:	Multiply by:
Millimeters	Inches	0.039
Centimeters	Inches	0.394
Meters	Feet	3.28
Meters	Yards	1.09
Kilometers	Miles	0.621
Square centimeters	Square inches	0.155
Square meters	Square feet	10.8
Square meters	Square yards	1.2
Cubic centimeters	Cubic inches	0.061
Cubic meters	Cubic feet	35.3
Cubic meters	Cubic yards	1.31
Liters	Pints (U.S.)	2.114 (Imp. 1.76)
Liters	Quarts (U.S.)	1.057 (Imp. 0.88)
Liters	Gallons (U.S.)	0.264 (Imp. 0.22)
Grams	Ounces	0.035
Kilograms	Pounds	2.2
Metric tons	Tons	1.1

Converting Temperatures

Convert degrees Fahrenheit (F) to degrees Celsius (C) by following this simple formula: Subtract 32 from the Fahrenheit temperature reading. Then mulitply that number by 5/9. For example, 77°F - 32 = 45. 45 × 5/9 = 25°C.

To convert degrees Celsius to degrees Fahrenheit, multiply the Celsius temperature reading by 9/5, then add 32. For example, 25°C × 9/5 = 45. 45 + 32 = 77°F.



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JOB:04-30438 Title:Home Skill Landscaping
#175 Dtp:228 Page:126

Index

Brick walkway, installing, 64–69
Bubble plans, sketching, 10
Building codes, 13

Call Before You Dig, 13
Concrete curb edging, installing, 34–35

Drip irrigation systems, installing, 50–51

Edging
  concrete, curb edging installation, 34–35
  landscape timber, installing, 36
  lumber, installing, 37
  pavers
    freeform installation, 33
    rigid installation, 32
Environmentally friendly landscaping
  overview, 14–15
  rain gardens
    about, 45
    planting, 46–47
  xeriscapes
    creating, 50–51
    principles of, 48–49

Fences
  hanging prefab gates, 108
  laying out
    about, 92
    batter board installation, 98
    contoured fences, 95
    curves, 101
    managing slope and, 93–94
    right angles, 100
    spacing line/gate posts, 99
    stepped fences, 96
    straight fences, 97
  setting posts, 102
  split rail
    about, 109
    building, 110–11
    variations, 112
  vinyl panel fencing
    about, 113
    installing, 114–16
  wood panel
    about, 103–4
    building, 106–7
    hanging prefab gates, 108
    installation tips, 105
    styles of, 104
  See also Walls
Flagstone
  steps
    about, 85
    building, 86–89
    variations, 90–91
  walkways
    building, 70–71
Flower beds. *See* Landscape beds
Freeform paver edging, installing, 33

Garden beds. *See* Landscape beds
Gates
  hanging prefab, 108
  vinyl fencing and, 115
Gravel pathways
  about, 72–73
  creating, 74–77
Green yards
  elements of, 14–15
  rain gardens
    about, 45
    planting, 46–47
  xeriscapes
    creating, 50–51
    principles of, 48–49

Irrigation
  drip systems
    installing, 51–52
  in-ground sprinkler systems
    about, 54
    designing, 55
    installing, 56–57

Landscape beds
  installing, 31
  planning, 30
Landscape design
  bubble plans, 10
  creating formal, 11
  measuring the yard, 7–9
  rough ideas, 7
  working drawings, 12
Landscape materials. *See* Materials
Landscape timber
  cutting, 82
  edging, installing, 36
  steps with gravel
    building, 83–84
    construction details, 82
Lumber, edging, installing, 37

Master Gardeners, 14
Materials
  concrete and mortar, 22–23
(Materials, continued)
  estimating, 25–26
  hardware and fasteners, 24
  loose materials, 20–21
  ordering, 24–25
  stone and concrete, 18–19
  wood and vinyl, 16–17
Measuring yards, 7–9
Mulch
  about, 42
  landscaping with, 43

Pavers
  freeform edging, installing, 33
  rigid paver edging, installing, 32

Rain gardens
  about, 45
  planting, 46–47
Retaining walls
  about, 120
  building with interlocking block, 123–25
  options for positioning, 121
  tips for building, 122
Rigid paver edging, installing, 32

Shrubs
  about, 38
  balled-and-burlapped, planting, 39
  windbreaks, planting, 40–41
Spacer gauges, making, 73
Split rail fences
  about, 109
  building, 110–11
  variations, 112
Sprinkler systems, in-ground
  about, 54
  designing, 55
  installing, 56–57
Steps
  flagstone
    about, 85
    building, 86–89
    variations, 90–91
  landscape timber and gravel
    building, 83–84
    construction details, 82
  planning, 63
  See also Walkways

Tools, 26–27
Trees
  about, 38
  balled-and-burlapped, planting, 39
  windbreaks, planting, 40–41
Triangulation, 7–9

Utilities, 13

Vinyl panel fencing
  about, 113
  cutting, 115
  installing, 114–16

Walkways
  about, 59–60
  brick, sandset, installing, 64–69
  curved/irregular, laying out, 62
  flagstone, building, 70–71
  gravel pathways
    about, 72–73
    creating, 74–77
  stepping stones
    pebbled, making, 78–79
    pebbled variations, 80
    tips, 62
  straight, laying out, 61
  See also Steps
Walls
  dry stone
    about, 117
    building, 118–19
  retaining
    about, 120
    building with interlocking block, 123–25
    options for positioning, 121
    tips for building, 122
  See also Fences
Water
  conserving, xeriscapes, 48–51
  drip irrigation systems, installing, 51–52
  green landscapes and, 14
  rain gardens, 45–47
Windbreaks, planting, 40–41
Wood panel fences
  about, 103–4
  building, 106–7
  hanging prefab gates, 108
  installation tips, 105
  styles of, 104
Working drawings, 12

Xeriscapes
  creating, 50–51
  principles of, 48–49

Yards, measuring, 7–9

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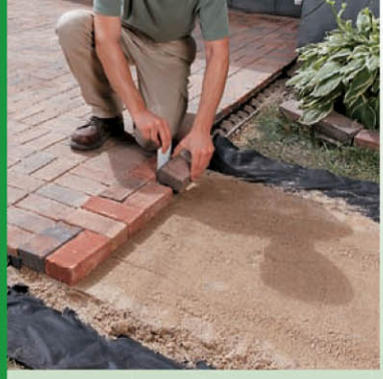

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#175 Dtp:225 Page:1

CONTENTS

Introduction 4

The Home Plumbing System

Plumbing Tools 10
Plumbing Materials 14
Copper 16
Rigid Plastic Pipe 24
Outdoor Flexible Plastic Pipes 28
Cross-Linked Polyethylene (PEX) 30
Galvanized Steel 38
Pipe Fittings 42
Shutoff Valves 46
Valves & Hose Bibs 48
Compression Fittings 50

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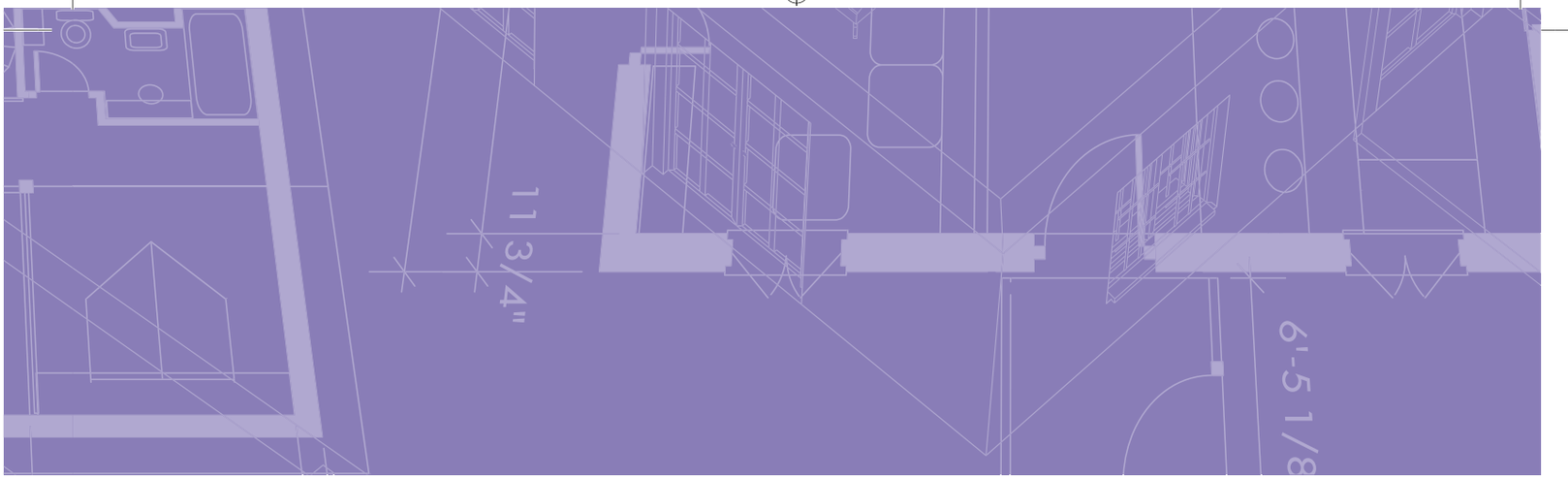
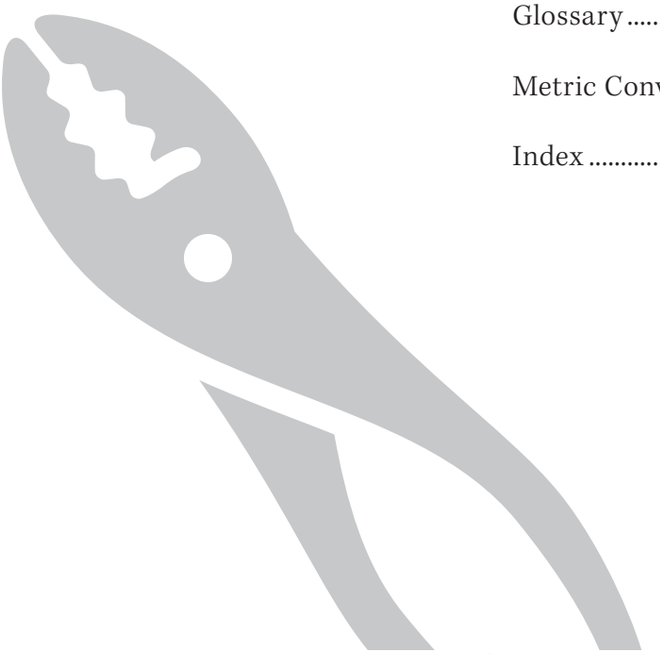


Plumbing Repairs & Projects

Toilets 54
Kitchen Faucets 70
Bathroom Faucets 80
Kitchen Drains & Traps 88
Dishwashers 94
Food Disposers 98
Icemakers 104
Tub & Shower Faucets 110
Tub & Shower Drains 120

References

Glossary 124
Metric Conversions 125
Index 126



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#175 Dtp:225 Page:3

Introduction

EVERY HOMEOWNER SHOULD have a good basic understanding of the plumbing system in their home. *HomeSkills: Plumbing* guides you through the layout of the standard plumbing system, the materials used, both past and present, the tools necessary for repairs and projects, and numerous projects and repairs you can easily accomplish.

The plumbing system, like the electrical system, may seem deeply mysterious at first glance. How does this seemingly jumbled assortment of pipes (especially in an older home that may have been updated many times) make any sense. You will see that it actually does make a good deal of sense.

While not as dangerous as the electrical system, improperly installing or repairing plumbing systems can cause serious damage to your home through water leakage. It is important to follow current code and building practices to assure a dry, functional installation.

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#175 Dtp:225 Page:4

THE HOME PLUMBING SYSTEM

Plumbing Tools 10

Plumbing Materials 14

Copper 16

Rigid Plastic Pipe 24

Outdoor Flexible Plastic Pipe 28

Cross-Linked Polyethylene (PEX) 30

Galvanized Steel 38

Pipe Fittings 42

Shutoff Valves 46

Valves & Hose Bibs 48

Compression Fittings 50

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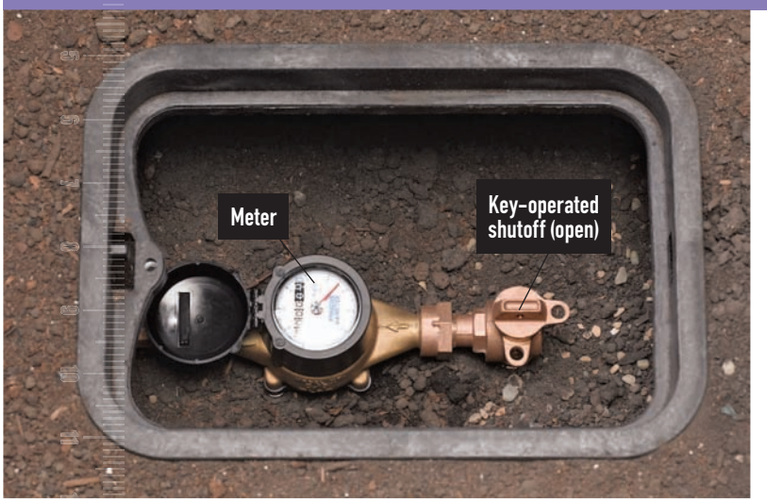
The Home Plumbing System



An outdoor main shutoff may be as simple as an exposed valve that you turn by hand. Or it may be buried in a housing that is sometimes called a Buffalo box. In this example, both the meter and the main shutoff are housed in the box; in other cases, the meter is located inside the house.

BECAUSE MOST OF a plumbing system is hidden inside walls and floors, it may seem to be a complex maze of pipes and fittings. But the information in this book will help you gain a basic understanding of your system. Understanding how home plumbing works is an important first step toward doing routine maintenance and money-saving repairs.

A typical home plumbing system includes three basic parts: a water supply system, a fixture and appliance set, and a drain system. These three parts can be seen clearly in the photograph of the cut-away house on the opposite page.

Fresh water enters a home through a main supply line (1). This fresh water source is provided by either a municipal water company or a private underground well. If the source is a municipal supplier, the water passes through a meter (2) that registers the amount of water used. A family of four uses about 400 gallons of water each day.

Immediately after the main supply enters the house, a branch line splits off (3) and is joined to a water heater (4). From the water heater, a hot water line runs parallel to the cold water line to bring the water supply to fixtures and appliances throughout the house. Fixtures include sinks, bathtubs, showers, and laundry tubs. Appliances include water heaters, dishwashers, clothes washers, and water softeners. Toilets and exterior sillcocks are examples of fixtures that require only a cold water line.

The water supply to fixtures and appliances is controlled with faucets and valves. Faucets and valves have moving parts and seals that eventually may wear out or break, but they are easily repaired or replaced.

Waste water then enters the drain system. It first must flow past a drain trap (5), a U-shaped piece of pipe that holds standing water and prevents sewer gases from entering the home. Every fixture must have a drain trap.

The drain system works entirely by gravity, allowing waste water to flow downhill through a series of large-diameter pipes. These drain pipes are attached to a system of vent pipes. Vent pipes (6) bring fresh air to the drain system, preventing suction that would slow or stop drain water from flowing freely. Vent pipes usually exit the house at a roof vent (7).

All waste water eventually reaches a main waste and vent stack (8). The main stack curves to become a sewer line (9) that exits the house near the foundation. In a municipal system, this sewer line joins a main sewer line located near the street. Where sewer service is not available, waste water empties into a septic system.

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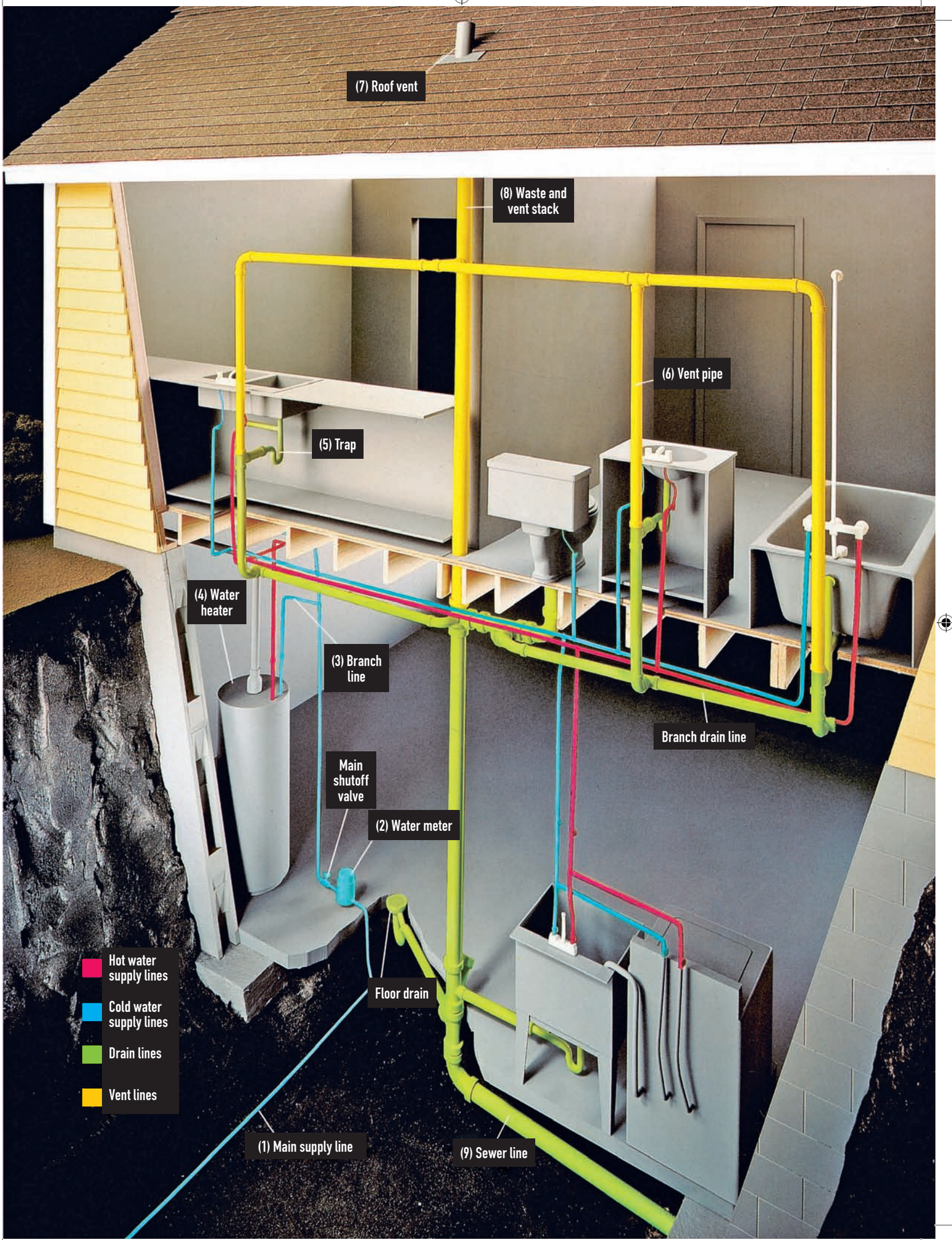

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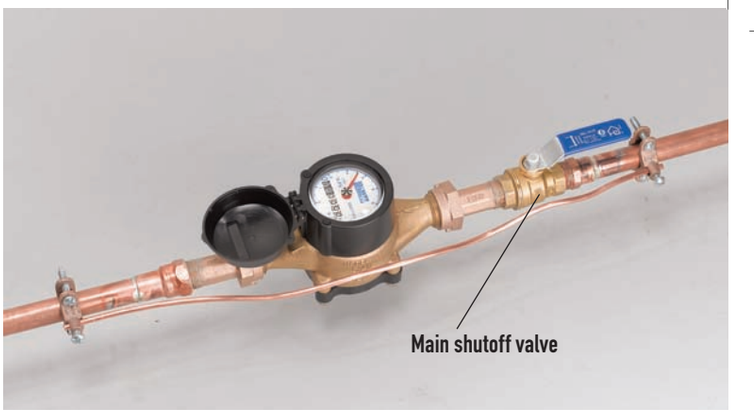
You may have an inside main shutoff, usually located near the point where the main supply pipe enters the house near the water meter. There may be valves on each side of the meter; turn off either one of them to shut off water to the house. The copper grounding wire is an important part of the electrical system and should never be removed.



Water Supply System

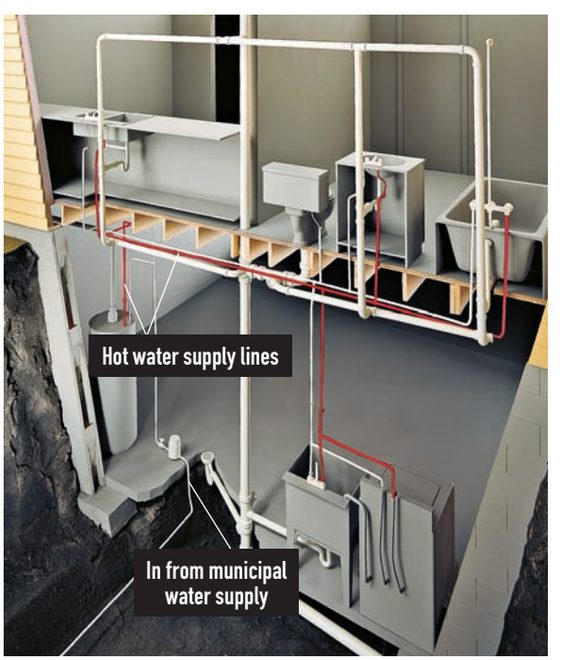
Water supply pipes carry hot and cold water throughout a house. In homes built before 1960, the original supply pipes were usually made of galvanized steel. Newer homes have supply pipes made of copper. Beginning in the 1980s, supply pipes made of rigid plastic (PVC or CPVC) became more commonplace, and the more recent plumbing innovations find PEX pipe widely used and accepted.

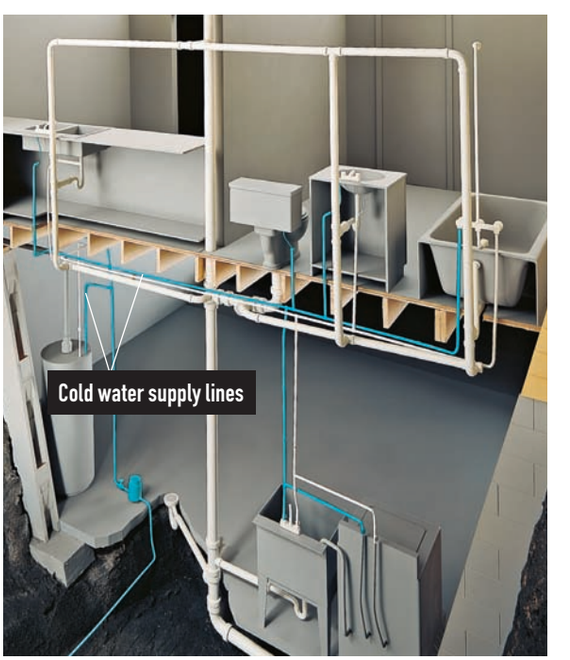
Water supply pipes are made to withstand the high pressures of the water supply system. They have small diameters, usually ½" to 1", and are joined with strong, watertight fittings. The hot and cold lines run in tandem to all parts of the house. Usually, the supply pipes run inside wall cavities or are strapped to the undersides of floor joists.

Hot and cold water supply pipes are connected to fixtures or appliances. Fixtures include sinks, tubs, and showers. Some fixtures, such as toilets or hose bibs, are supplied only by cold water. Appliances include dishwashers and clothes washers. A refrigerator icemaker uses only cold water. Tradition says that hot water supply pipes and faucet handles are found on the left-hand side of a fixture, with cold water on the right.

Because it is pressurized, the water supply system is occasionally prone to leaks. This is especially true of galvanized iron pipe, which has limited resistance to corrosion.

For some houses in older neighborhoods, the main supply line running from the street to the house is made of lead; this once posed a health hazard. Today, however, municipalities with lead pipes often add a trace amount of phosphate to the water, which coats the inside of the pipes and virtually eliminates leaching of lead into the water. If you are concerned about lead in your water, check with your local water supplier.





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Drain-Waste-Vent System

Drain pipes use gravity to carry waste water away from fixtures, appliances, and other drain openings. This waste water is carried out of the house to a municipal sewer system or septic tank.

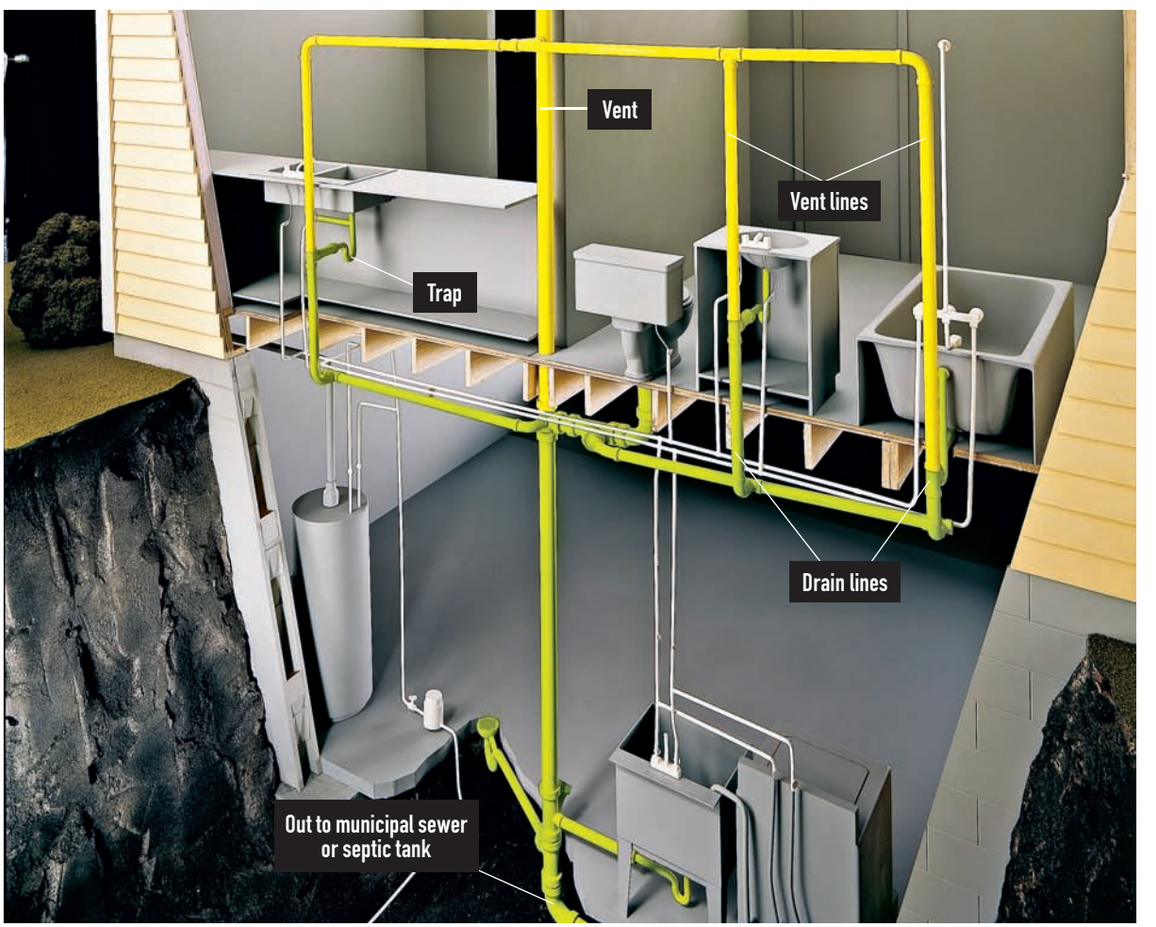
Newer drain pipes are plastic. In an older home, drain pipes may be cast iron, galvanized steel, copper, or lead. Because they are not part of the supply system, lead drain pipes pose no health hazard. However, lead pipes are no longer manufactured for home plumbing systems.

Drain pipes have diameters ranging from 1¼" to 4". These large diameters allow waste to pass through efficiently.

Traps are an important part of the drain system. These curved sections of drain pipe hold standing water, and they are usually found immediately after the drain tailpiece in the drain opening. The standing water of a trap prevents sewer gases from backing up into the home. Each time a drain is used, the standing trap water is flushed away and is replaced by new water.

In order to work properly, the drain system requires air. Air allows waste water to flow freely down drain pipes.

To allow air into the drain system, drain pipes are connected to vent pipes. All drain systems must include vents, and the entire system is called the drain-waste-vent (DWV) system. One or more vent stacks, located on the roof, provide the air needed for the DWV system to work.



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PLUMBING TOOLS

Many plumbing projects and repairs can be completed with basic hand tools you probably already own. Adding a few simple plumbing tools will prepare you for all the projects in this book. Specialty tools, such as a snap cutter or appliance dolly, are available at rental centers. When buying tools, invest in quality products.

Always care for tools properly. Clean tools after using them, wiping them free of dirt and dust with a soft rag. Prevent rust on metal tools by wiping them with a rag dipped in household oil. If a metal tool gets wet, dry it immediately, and then wipe it with an oiled rag. Keep toolboxes and cabinets organized. Make sure all tools are stored securely.

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Drill-powered auger is stronger than a hand-crank auger for removing larger pipe obstructions. This auger can be cranked by hand or attached to a standard ⅜" power drill.

Force cup clears drain clogs with water and air pressure. The force cup is used for toilet bowls. The flange usually can be folded up into the cup for use as a standard plunger.

Pipe wrench has a movable jaw that adjusts to fit a variety of pipe diameters. Pipe wrench is used for tightening and loosening pipes, pipe fittings, and large nuts. Two pipe wrenches often are used together to prevent damage to pipes and fittings.

Spud wrench is specially designed for removing or tightening large nuts that are 2" to 4" in diameter. Hooks on the ends of the wrench grab onto the lugs of large nuts for increased leverage.

Blow bag, sometimes called an expansion nozzle, is used to clear drains. It attaches to a garden hose and removes clogs with large spurts of water. The blow bag is best used on floor drains.

Plastic tubing cutter works like a gardener's pruners to cut flexible plastic pipes quickly.

Tubing cutters make straight, smooth cuts in plastic and copper pipe. A tubing cutter usually has a triangular blade for removing burrs from the insides of pipes.

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Closet auger is used to clear toilet clogs. It is a slender tube with a crank handle on one end of a flexible auger cable. A special bend in the tube allows the auger to be positioned in the bottom of the toilet bowl. The bend is usually protected with a rubber sleeve to prevent scratching the toilet.

MAPP torch (left) is used for soldering fittings to copper pipes. Light the torch quickly and safely using a spark lighter.

Flame-resistant pad helps keep wood and other underlying materials safe from the torch's flame.

Rental tools may be needed for large jobs and special situations. A power miter saw makes fast, accurate cuts in a wide variety of materials, including plastic pipes. A motorized drain auger clears tree roots from sewer service lines. Use an appliance dolly to move heavy objects like water heaters. A snap cutter is designed to cut tough cast-iron pipes. The right-angle drill is useful for drilling holes in hard-to-reach areas.

Power hand tools can make any job faster, easier, and safer. Cordless power tools offer added convenience. Use a cordless ⅜" power drill for virtually any drilling task.

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#175 Dtp:225 Page:13

Common Pipe & Tube Types

Benefits & Characteristics

ABS (acrylonitrile butadiene styrene) was once approved for use in DWV systems. Most local codes now prohibit ABS for new installations, but in some cases it can be added to pre-existing ABS DWV systems.

Cast iron is strong but hard to work with. Repairs should be made with plastic pipe, if allowed.

PVC (polyvinyl chloride) is rigid plastic that resists heat and chemicals. Lightweight tubes and heavier Schedule 40.

CPVC (chlorinated polyvinyl chloride) rigid plastic is inexpensive and withstands high temperature and pressure.

Chromed brass has an attractive shiny surface and is used for drain traps where appearance is important.

PE (polyethylene) plastic is a black or bluish flexible pipe sometimes used for main water service lines as well as irrigation systems.

Black pipe (iron pipe) generally is threaded at the ends to accept female-threaded fittings. Not for potable water.

Rigid copper is used for water supply pipes. It resists corrosion and has smooth surfaces for good water flow.

Braided metal is used for water supply tubes that connect shutoff valves to fixtures.

Flexible stainless-steel (protective coated) connectors are used to attach gas appliances to supply stopcocks.

Flexible stainless-steel (uncoated) connectors are used to attach gas appliances to supply stopcocks

Chromed copper supply tube is used in areas where appearance is important. Easy to bend and fit.

PEX (cross-linked polyethylene) is flexible and is approved by major building codes for water supply.

Flexible copper tubing (not shown) bends easily and requires fewer couplings than rigid copper.

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(Fogra 39)Job:04-30437 Title:MBI-HomeSkills Plumbing
#175 Dtp:225 Page:14

Common Uses	Lengths	Diameters	Fitting Methods	Tools Used for Cutting
Pipes; drain traps	Sold by linear ft.	2", 3", 4"	Glue and plastic	Miter box or hacksaw
Main drain- waste-vent stack	5 ft., 10 ft.	3", 4"	Banded neoprene couplings	Snap cutter or hacksaw
Drain & vent pipes; drain traps	10 ft., 20 ft.; or sold by linear ft.	1¼", 1½", 2", 3", 4"	Solvent glue and/or plastic fittings	Tubing cutter, miter box, or hacksaw
Hot & cold water supply pipes	10 ft.	⅜", ½", ¾", 1"	Solvent glue and plastic fittings, or with compression fittings	Tubing cutter, miter box, or hacksaw
Valves & shutoffs; drain traps, supply risers	Lengths vary	1¼", ½", ¾", 1¼", 1½"	Compression fittings, or with metal solder	Tubing cutter, hacksaw, or reciprocating saw
Outdoor cold water supply pipes	Sold in coils of 25 to hundreds of ft.	¼" to 1"	Rigid PVC fittings and stainless steel hose	Ratchet-style plastic pipe cutter or miter saw
Gas supply pipe	Sold in lengths up to 10 ft.	¾", 1"	Threaded connectors	Hacksaw, power cutoff saw or reciprocating saw with bi-metal blade
Hot & cold water supply pipes	10 ft., 20 ft.; or sold by linear ft.	⅜", ½", ¾", 1"	Metal solder or compression fittings	Tubing cutter, hacksaw, or jigsaw
Supply tubes	12" or 20"	⅜"	Compression coupling or compression fittings	Do not cut
Gas ranges, dryers, water heaters	36" or 48"	⅝", ½" (OD)	Compression coupling	Do not cut
Gas ranges, dryers, water heaters	36" or 48"	⅝", ½" (OD)	Compression coupling	Do not cut
Supply tubing	12", 20", 30"	⅜"	Brass compression fittings	Tubing cutter or hacksaw
Water supply, tubing for radiant floors	Sold in coils of 25 ft. to hundreds of ft.	¼" to 1"	Crimp fittings	Tubing cutter
Gas supply; hot & cold water supply	30-ft., 60-ft. coils; or by ft.	¼", ⅜", ½", ¾", 1"	Brass flare fittings, solder, compression fittings	Tubing cutter or hacksaw

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#175 Dtp:225 Page:15

COPPER

Copper resists corrosion and has smooth surfaces that allow good water flow. Copper pipes are available in several diameters, but most home water supply systems use ½-inch or ¾-inch pipe. Copper pipe is manufactured in rigid and flexible forms.

Rigid copper, sometimes called hard copper, is approved for home water supply systems by all local codes. It comes in three wall-thickness grades: Types M, L, and K. Type M is the thinnest, the least expensive, and a good choice for do-it-yourself home plumbing.

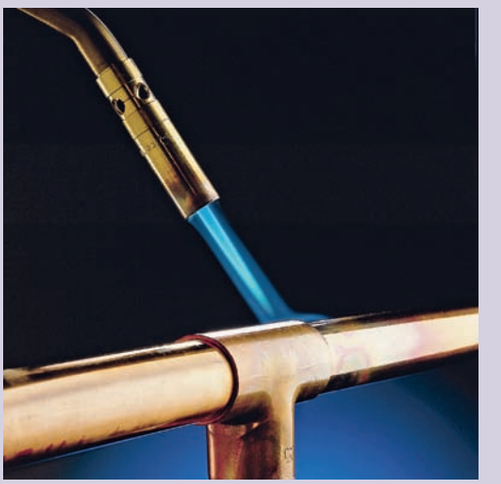
Rigid Type L usually is required by code for commercial plumbing systems. Because it is strong and solders easily, Type L may be preferred by some professional plumbers and do-it-yourselfers for home use. Type K has the heaviest wall thickness and is used most often for underground water service lines.

Flexible copper, also called soft copper, comes in two wall-thickness grades: Types L and K. Both are approved for most home water supply systems, although flexible Type L copper is used primarily for gas service lines. Because it is bendable and will resist a mild frost, Type L may be installed as part of a water supply system in unheated indoor areas, like crawl spaces. Type K is used for underground water service lines.

A third form of copper, called DWV, is used for drain systems. Because most codes now allow low-cost plastic pipes for drain systems, DWV copper is seldom used.

Skillbuilder

Practice makes perfect. If you have never soldered copper pipe before, practice sweating a few fittings onto a short sections of pipe before beginning an installation. This will acquaint you with process in a low stress setting.



Copper pipes are connected with soldered, compression, or flare fittings (see chart below). Always follow your local code for the correct types of pipes and fittings allowed in your area.

Soldered fittings, also called sweat fittings, often are used to join copper pipes. Correctly soldered fittings are strong and trouble-free. Copper pipe can also be joined with compression fittings or flare fittings. See chart below.

Copper Pipe & Fitting Chart

Fitting Method	Rigid Copper Type M	Rigid Copper Type L	Rigid Copper Type K	Flexible Copper Type L	Flexible Copper Type K	General Comments
Soldered	Yes	Yes	Yes	Yes	Yes	Inexpensive, strong, and trouble-free fitting method. Requires some skill.
Compression	Yes	Not Applicable		No	No	Makes repairs and replacement easy. More expensive than solder. Best used on flexible copper.
Flare	No	No	Yes	Yes	Yes	Use only with flexible copper pipes. Usually used as a gas-line fitting. Requires some skill.

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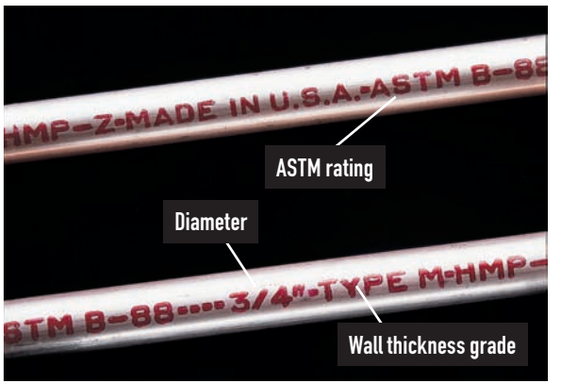
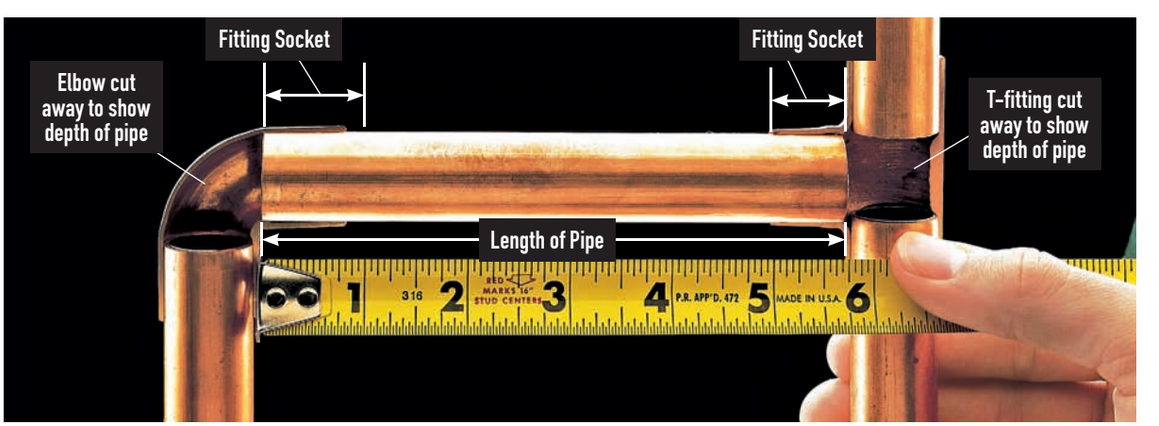
#175 Dtp:225 Page:16



Grade stamp information includes the pipe diameter, the wall-thickness grade, and a stamp of approval from the ASTM (American Society for Testing and Materials). Type M pipe is identified by red lettering, Type L by blue lettering.

Bend flexible copper pipe with a coil-spring tubing bender to avoid kinks. Select a bender that matches the outside diameter of the pipe. Slip bender over pipe using a twisting motion. Bend pipe slowly until it reaches the correct angle, but not more than 90º.

Specialty tools and materials for working with copper include: flaring tools (A), emery cloth (B), coil-spring tubing bender (C), pipe joint compound (D), soldering paste (flux) (E), lead-free solder (F), wire brush (G), flux brush (H), compression fitting (I), flare fitting (J).



Find the length of copper pipe needed by measuring between the bottom of the copper fitting sockets (fittings shown in cutaway). Mark the length on the pipe with a felt-tipped pen.

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#175 Dtp:225 Page:17

Cut & Solder Copper

The best way to cut rigid and flexible copper pipe is with a tubing cutter. A tubing cutter makes a smooth, straight cut, an important first step toward making a watertight joint. Remove any metal burrs on the cut edges with a reaming tool or round file.

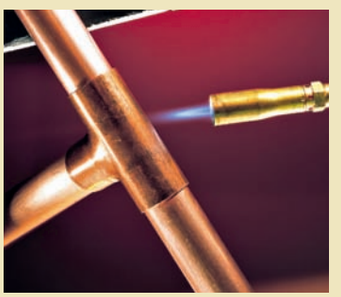
Copper can be cut with a hacksaw. A hacksaw is useful in tight areas where a tubing cutter will not fit. Take care to make a smooth, straight cut when cutting with a hacksaw.

A soldered pipe joint, also called a sweated joint, is made by heating a copper or brass fitting with a propane torch until the fitting is just hot enough to melt metal solder. The heat draws the solder into the gap between the fitting and pipe to form a watertight seal. A fitting that is overheated or unevenly heated will not draw in solder. Copper pipes and fittings must be clean and dry to form a watertight seal.

Tip

Never light a propane torch with a match. Ignition of the torch usually results in a small fire ball which will easily burn your fingers. A spark lighter keeps your hands and clothing at a safe distance.

Tips for Safe Soldering



Use caution when soldering copper. Pipes and fittings become very hot and must be allowed to cool before handling.

Prevent accidents by shutting off propane torch immediately after use. Make sure valve is closed completely.

Protect wood from the heat of the torch flame while soldering. Use an old cookie sheet, two sheets of 26-gauge metal, or a fiber shield, as shown.

Tools & Materials

Tubing cutter with reaming tip (or hacksaw and round file)
Wire brush
Flux brush
Propane torch
Spark lighter
Round file
Cloth
Adjustable wrench
Channel-type pliers
Copper pipe
Copper fittings
Emery cloth
Soldering paste (flux)
Sheet metal
Lead-free solder
Rag

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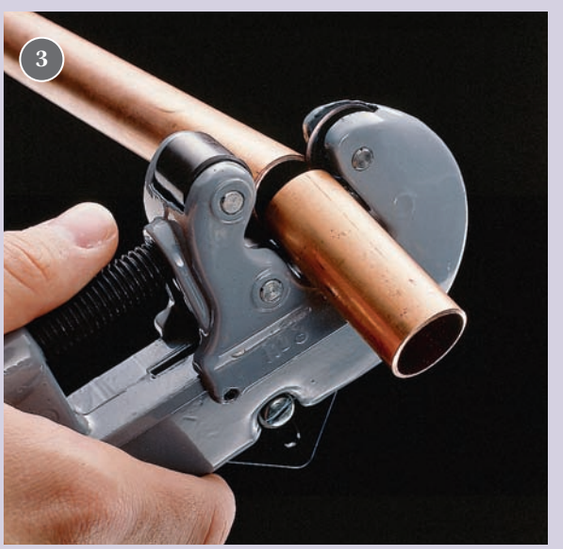
CUTTING RIGID & FLEXIBLE COPPER PIPE



1 Place the tubing cutter over the pipe and tighten the handle so that the pipe rests on both rollers and the cutting wheel is on the marked line.

2 Turn the tubing cutter one rotation so that the cutting wheel scores a continuous straight line around the pipe.

3 Rotate the cutter in the opposite direction, tightening the handle slightly after every two rotations, until the cut is complete.

4 Remove sharp metal burrs from the inside edge of the cut pipe using the reaming point on the tubing cutter or a round file.

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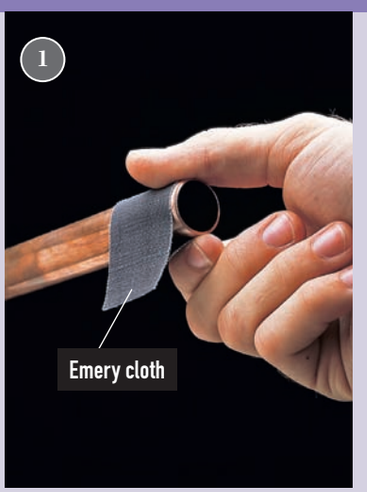
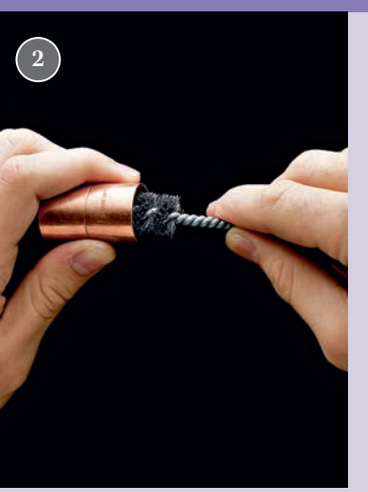
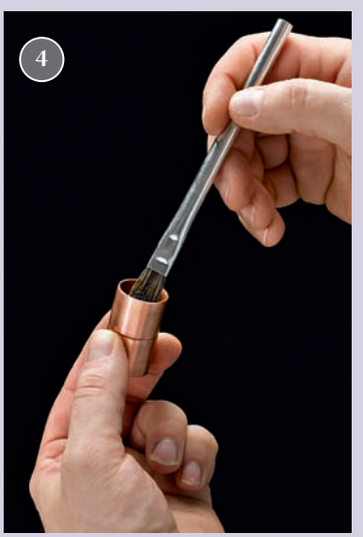
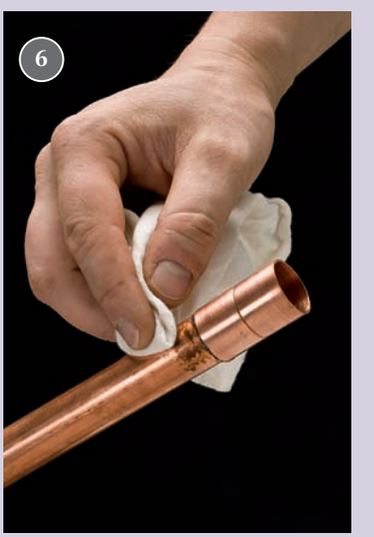
SOLDERING COPPER PIPES & FITTINGS









1 Clean the end of each pipe by sanding with emery cloth. Ends must be free of dirt and grease to ensure that the solder forms a good seal.

2 Clean the inside of each fitting by scouring with a wire brush or emery cloth.

3 Apply a thin layer of soldering paste (flux) to the end of each pipe, using a flux brush. Soldering paste should cover about 1" of pipe end.

4 Apply a thin layer of flux to the inside of the fitting.

5 Assemble each joint by inserting the pipe into the fitting so it is tight against the bottom of the fitting sockets. Twist each fitting slightly to spread soldering paste.

6 Use a clean dry cloth to remove excess flux before soldering the assembled fitting.

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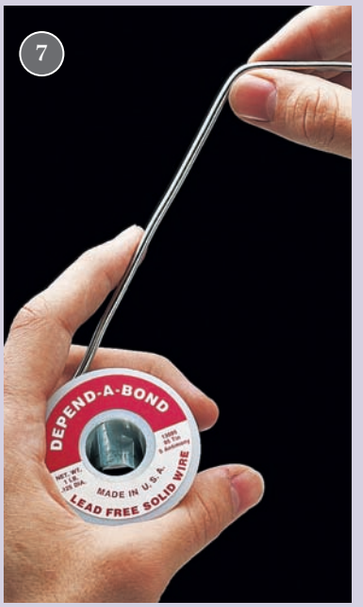

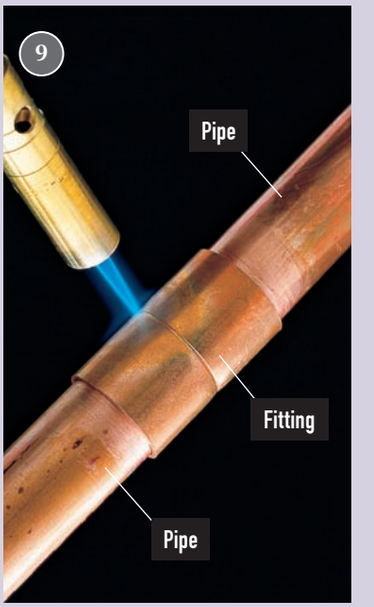

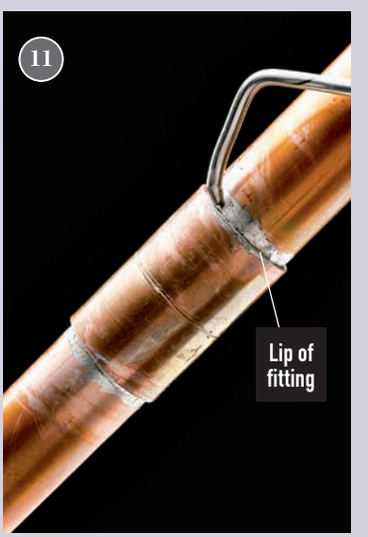

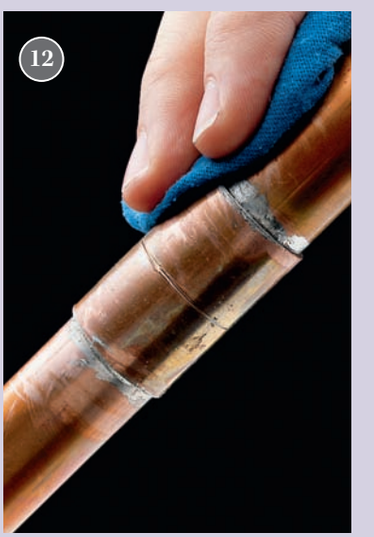

7 Prepare the wire solder by unwinding 8" to 10" of wire from the spool. Bend the first 2" of the wire to a 90° angle.

8 Open the gas valve and trigger the spark lighter to ignite the torch. Adjust the torch valve until the inner portion of the flame is 1" to 2" long.

9 Move the torch flame back and forth and around the pipe and the fitting to heat the area evenly.

10 Heat the other side of the copper fitting to ensure that heat is distributed evenly. Touch the solder to the pipe. The solder will melt when the pipe is at the right temperature.

11 When the solder melts, remove the torch and quickly push ½" to ¾" of solder into each joint. Capillary action fills the joint with liquid solder. A correctly soldered joint should show a thin bead of solder around the lips of the fitting.

12 Allow the joint to cool briefly, then wipe away excess solder with a dry rag. Caution: Pipes will be hot. If joints leak after water is turned on, disassemble and resolder.

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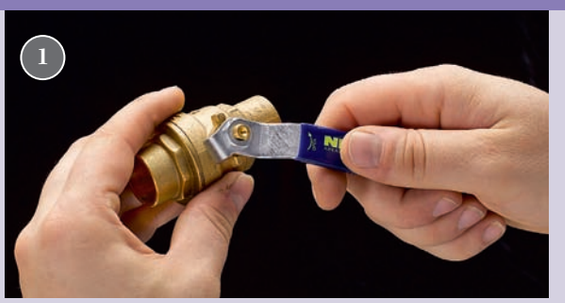
#175 Dtp:225 Page:21

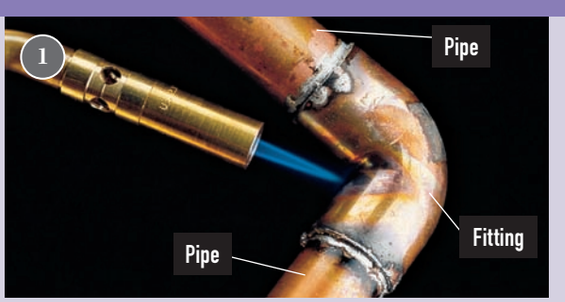
SOLDERING BRASS VALVES

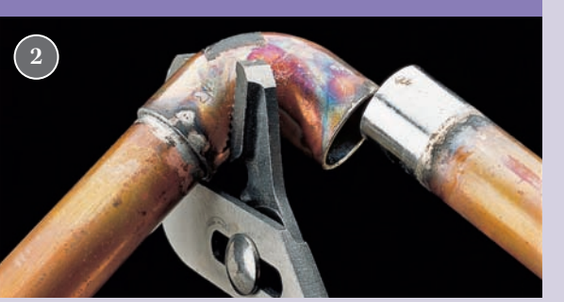


1 Valves should be fully open during all stages of the soldering process. If a valve has any plastic or rubber parts, remove them prior to soldering.

2 To prevent valve damage, quickly heat the pipe and the flanges of the valve, not the valve body. After soldering, cool the valve by spraying with water.

DISMANTLING SOLDERED JOINT BLADES





1 Turn off the water and drain the pipes by opening the highest and lowest faucets in the house. Light your torch. Hold the flame tip to the fitting until the solder becomes shiny and begins to melt.

2 Use channel-type pliers to separate the pipes from the fitting.

3 Remove old solder by heating the ends of the pipe with your torch. Use a dry rag to wipe away melted solder quickly. Caution: Pipes will be hot.

4 Use emery cloth to polish the ends of the pipe down to bare metal. Never reuse fittings.

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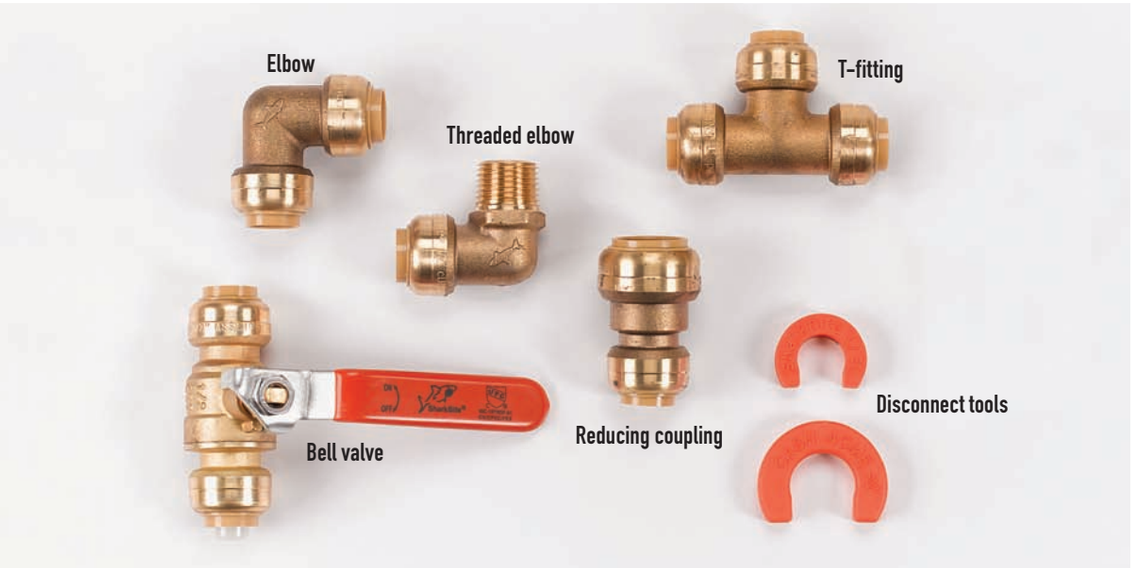
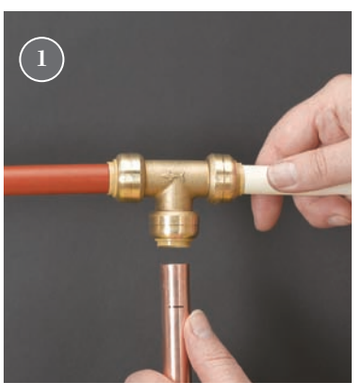
#175 Dtp:225 Page:22

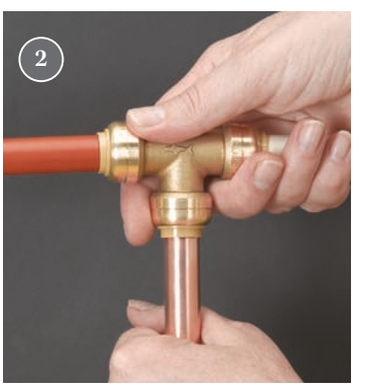
PUSH FITTINGS

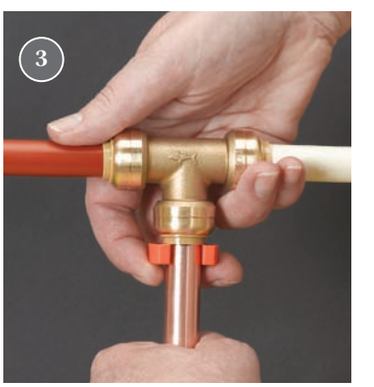
Push fittings make water supply connections about as easy as possible. They are expensive, so you won't want to use them for all connections on a large installation. But even professional plumbers use them in tight spots where sweating or welding would be difficult. They are also an ideal material for making a quick repair.



Push fittings are available as couplings tees, elbows, and even shutoff valves. They connect to hard copper, CPVC, and PEX pipe, but not to PVC or galvanized or black steel pipe. In most areas they are approved for use inside covered walls.







1 Cut the pipe square, and remove any burrs and rough edges. Draw a mark 1" from the cut end.

2 Push the pipe into the fitting an inch or so until you hear it click. Tug to make sure you have a strong connection. It may not seem like it, but the connection is indeed watertight and durable. You may rotate it to the desired position.

3 To remove a pipe from a push fitting, slip the disconnect tool over the pipe, slide it over the fitting, and press against the fitting's release collar as you pull the pipe out.

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#175 Dtp:225 Page:23

RIGID PLASTIC PIPE

Cut rigid ABS, PVC, or CPVC plastic pipes with a tubing cutter or with any saw. Cuts must be straight to ensure watertight joints.

Rigid plastics are joined with plastic fittings and solvent glue. Use a solvent glue that is made for the type of plastic pipe you are installing. For example, do not use ABS solvent on PVC pipe. Some solvent glues, called "all-purpose" or "universal" solvents, may be used on all types of plastic pipe.

Solvent glue hardens in about 30 seconds, so test-fit all plastic pipes and fittings before gluing the first joint. For best results, the surfaces of plastic pipes and fittings should be dulled with emery cloth and liquid primer before they are joined.

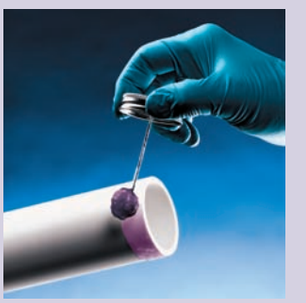
Liquid solvent glues and primers are toxic and flammable. Provide adequate ventilation when fitting plastics, and store the products away from any source of heat.

Plastic grip fittings can be used to join rigid or flexible plastic pipes to copper plumbing pipes.

Primer and solvent glue are specific to the plumbing material being used. Do not use all-purpose or multi-purpose products. Light to medium body glues are appropriate for DIYers as they allow the longest working time and are easiest to use. When working with large pipe, 3 or 4 inches in diameter, buy a large-size can of cement, which has a larger dauber. If you use the small dauber (which comes with the small can), you may need to apply twice, which will slow you down and make connections difficult. (The smaller can of primer is fine for any other size pipe, since there's no rush in applying primer.) Cement (though not primer) goes bad in the can within a month or two after opening, so you may need to buy a new can for a new project.

Skillbuilder

Before you begin a plastic pipe project, take some time to practice the priming and cementing process. Once you apply the cement, you have a limited time to assemble. Buy some pipe and fittings and practice the solvent-gluing steps. It might seem expensive, but you need to understand the materials before undertaking a project.



Tools & Materials

- Tape measure
- Felt-tipped pen
- Tubing cutter (or miter box or hacksaw)
- Utility knife
- Channel-type pliers
- Gloves
- Plastic pipe
- Fittings
- Emery cloth
- Plastic pipe primer
- Solvent glue
- Rag
- Petroleum jelly

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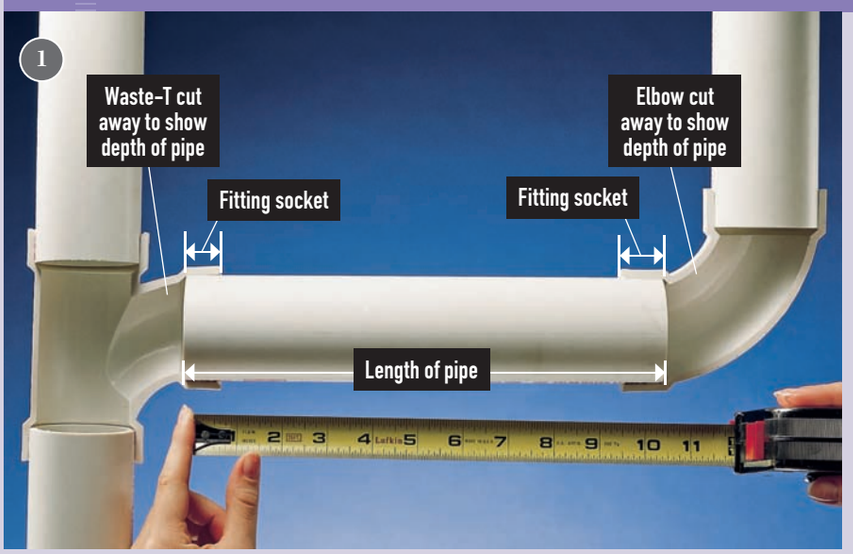
CUTTING RIGID PLASTIC PIPE



1 Find the length of plastic pipe needed by measuring between the bottoms of the fitting sockets (fittings shown in cutaway). Mark the length on the pipe with a felt-tipped pen.

2 Plastic tubing cutters do a fast, neat job of cutting. You'll probably have to go to a professional plumbing supply store to find one, however. They are not interchangeable with metal tubing cutters.

3 The best cutting tool for plastic pipe is a power miter saw with a fine tooth woodworking blade or a plastic-specific blade.

4 A ratcheting plastic-pipe cutter can cut smaller diameter PVC and CPVC pipe in a real hurry. If you are plumbing a whole house you may want to consider investing in one. They also are sold only at plumbing supply stores.

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#175 Dtp:225 Page:25

USING SOLVENT-GLUE ON RIGID PLASTIC PIPE

1 Remove rough burrs on cut ends of plastic pipe using a utility knife or deburring tool (inset).

2 Test-fit all pipes and fittings. Pipes should fit tightly against the bottom of the fitting sockets.

3 Mark the depth of the fitting sockets on the pipes. Take pipes apart. Clean the ends of the pipes and fitting sockets with emery cloth.

4 Apply a light coat of plastic pipe primer to the ends of the pipes and to the insides of the fitting sockets. Primer dulls glossy surfaces and ensures a good seal.

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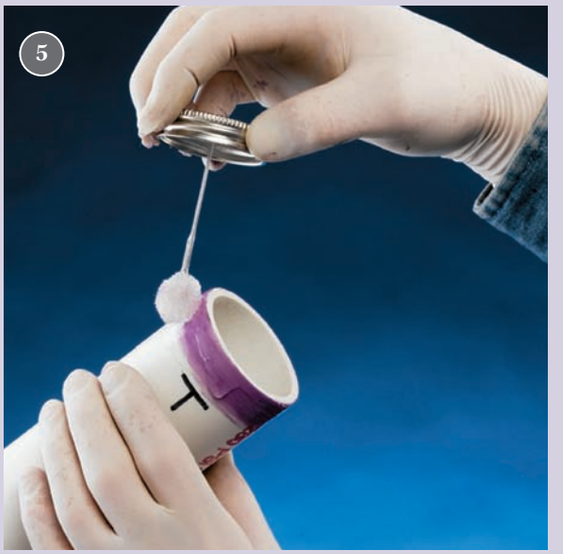

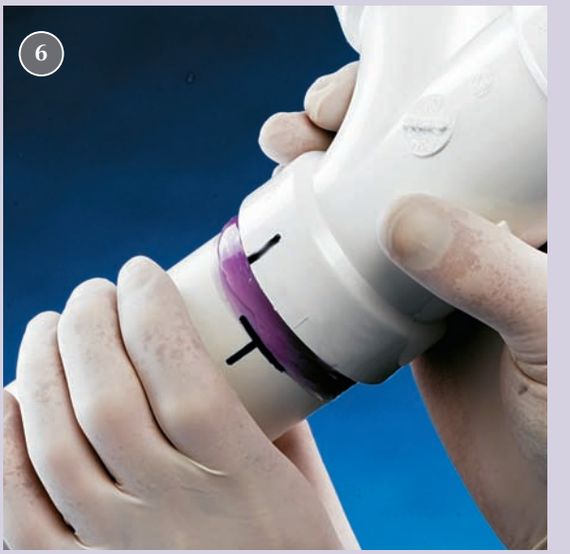

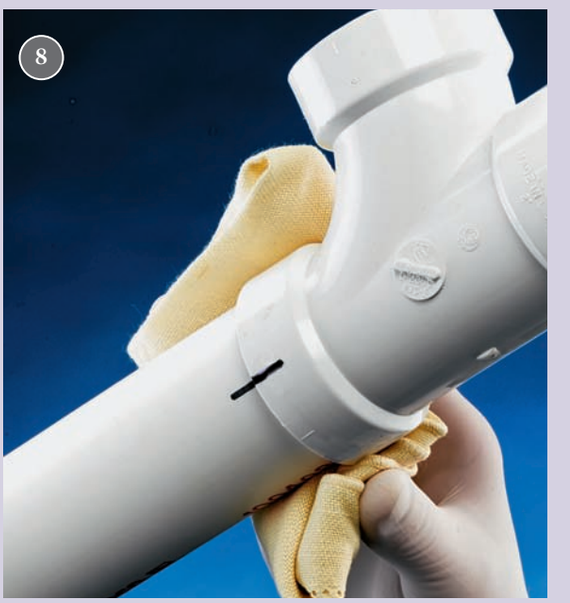

5 Solvent-glue each joint by applying a thick coat of solvent glue to the end of the pipe. Apply a thin coat of solvent glue to the inside surface of the fitting socket. Work quickly: solvent glue hardens in about 30 seconds.

6 Quickly position the pipe and fitting so that the alignment marks are offset by about 2". Force the pipe into the fitting until the end fits flush against the bottom of the socket.

7 Spread solvent by twisting the pipe until the marks are aligned. Hold the pipe in place for about 20 seconds to prevent the joint from slipping.

8 Wipe away excess solvent glue with a rag. Do not disturb the joint for 30 minutes after gluing.

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#175 Dtp:225 Page:27

OUTDOOR FLEXIBLE PLASTIC PIPE

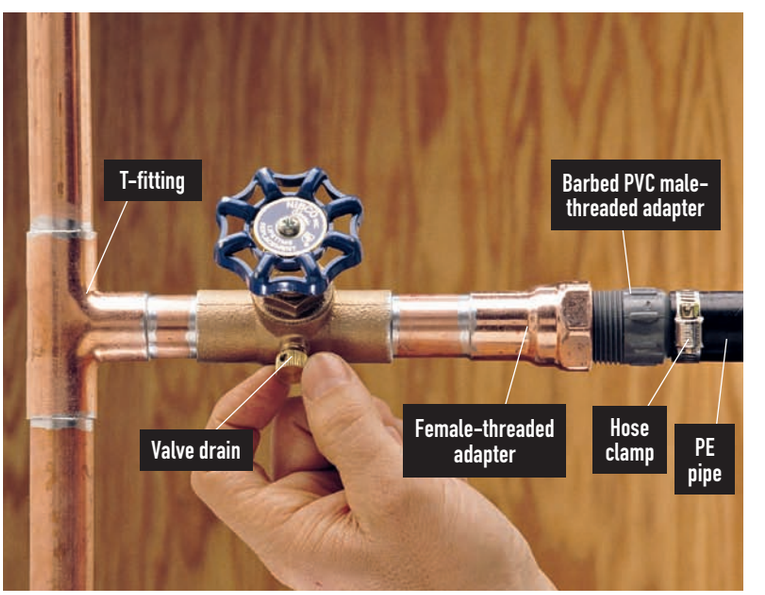
Flexible PE (polyethylene) pipe is used for underground cold water lines. Very inexpensive, PE pipe is commonly used for automatic lawn sprinkler systems and for extending cold water supply to utility sinks in detached garages and sheds.

Unlike other plastics, PE is not solvent-glued, but is joined using "barbed" rigid PVC fittings and stainless-steel hose clamps. In cold climates, outdoor plumbing lines should be shut off and drained for winter.

Connect lengths of PE pipe with a barbed PVC fitting. Secure the connection with stainless steel hose clamps.

Tools & Materials

- Tape measure
- Tubing cutter
- Screwdriver or wrench
- Pipe joint compound
- Flexible pipe
- Fittings
- Hose clamps
- Utility knife



Connect PE pipe to an existing cold water supply pipe by splicing in a T-fitting to the copper pipe and attaching a drain-and-waste shutoff valve and a female-threaded adapter. Screw a barbed PVC male-threaded adapter into the copper fitting, then attach the PE pipe. The drain-and-waste valve allows you to blow the PE line free of water when winterizing the system.

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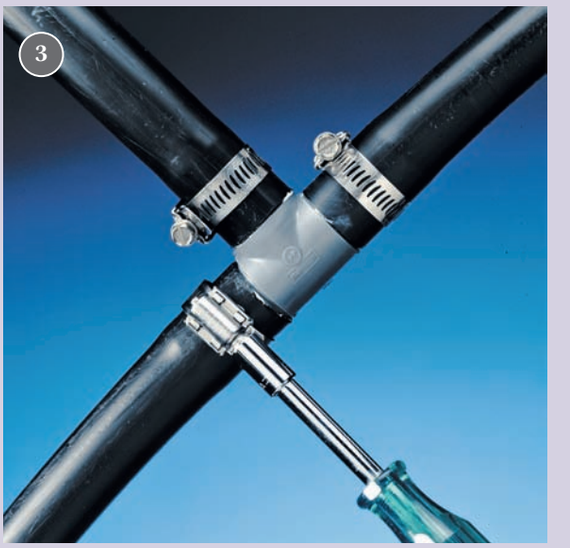
(Fogra 39)Job:04-30437 Title:MBI-HomeSkills Plumbing
#175 Dtp:225 Page:28

CUTTING & JOINING OUTDOOR FLEXIBLE PLASTIC PIPE

Option

To ensure a tighter fit, dab some pipe joint compound onto the barbs so they are easier to slide into the flexible plastic pipe. Apply pipe joint compound to the barbed ends of the T-fitting. Work each end of PE pipe over the barbed portions of the fitting and into position.



1 Cut flexible PE pipe with a plastic tubing cutter, or use a miter box or sharp knife. Remove any rough burrs with a utility knife.

2 Fit stainless-steel hose clamps over the ends of the flexible pipes being joined.

3 Slide the band clamps over the joint ends. Hand tighten each clamp with a screwdriver or wrench.

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(Fogra 39)Job:04-30437 Title:MBI-HomeSkills Plumbing
#175 Dtp:225 Page:29

CROSS-LINKED POLYETHYLENE (PEX)

Cross-linked polyethylene (PEX) is growing quickly in acceptance as a supply pipe for residential plumbing. It's not hard to understand why. Developed in the 1960s but relatively new to the United States, this supply pipe combines the ease of use of flexible tubing with the durability of rigid pipe. It can withstand a wide temperature range (from subfreezing to 180°F); it is inexpensive; and it's quieter than rigid supply pipe.

PEX is flexible plastic (polyethylene, or PE) tubing that's reinforced by a chemical reaction that creates long fibers to increase the strength of the material. It has been allowed by code in Europe and the southern United States for many years, but has won approval for residential supply use in most major plumbing codes only recently. It's frequently used in manufactured housing and recreational vehicles and in radiant heating systems. Because it is so flexible, PEX can easily be bent to follow corners and make other changes in direction. From the water main and heater, it is connected into manifold fittings that redistribute the water in much the same manner as a lawn irrigation system.

For standard residential installations, PEX can be joined with very simple fittings and tools. Unions are generally made with a crimping tool and a crimping ring. You simply insert the ends of the pipe you're joining into the ring, then clamp down on the ring with the crimping tool. PEX pipe, tools, and fittings can be purchased from most wholesale plumbing suppliers and at many home centers. Coils of PEX are sold in several diameters, from ¼-inch to 1-inch. PEX tubing and fittings from different manufacturers are not interchangeable. Any warranty coverage will be voided if products are mixed.

Tools & Materials

Tape measure	Manifolds
Felt-tipped pen	Protector plates
Full-circle crimping tool	PEX fittings
Go/no-go gauge	Utility knife
Tubing cutter	Plastic hangers
PEX pipe	Crimp ring

PEX pipe is a relatively new water supply material that's growing in popularity in part because it can be installed with simple mechanical connections.

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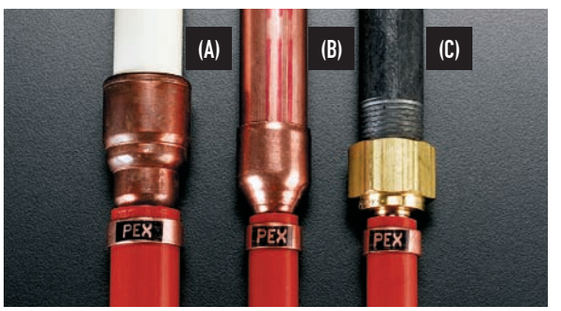
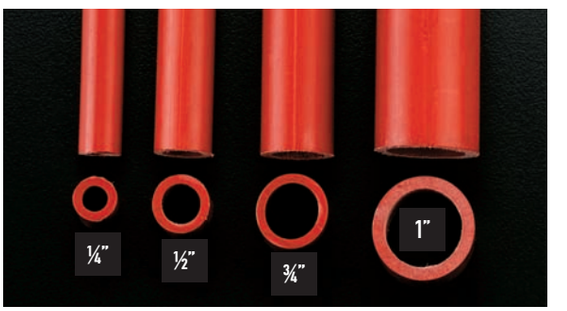
Specialty tools for installing PEX are available wherever PEX is sold. The basic set includes a full-circle crimping tool (A), a tubing cutter (B), and a go/no-go gauge (C) to test connections after they've been crimped. Competing manufacturers make several types of fittings, with proprietary tools that only work with their fittings. The tools and fittings you use may differ from those shown on these pages.



PEX is connected to other water supply materials with transition fittings, including CPVC-to-PEX (A), copper-to-PEX (B), and iron-to-PEX (C).



Generally, you should use the same diameter PEX as is specified for rigid supply tubing, but in some "home run" installations (see page 36) you can use ⅜" PEX where ½" rigid copper would normally be used.

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#175 Dtp:225 Page:31

PEX INSTALLATION

Check with your local plumbing inspector to verify that PEX is allowed in your municipality. PEX has been endorsed by all major plumbing codes in North America, but your municipality may still be using an older set of codes. Follow the guidelines below when installing PEX:

- Do not install PEX in above-ground exterior applications because it degrades quickly from UV exposure.
- Do not use PEX for gas lines.
- Do not use plastic solvents or petroleum-based products with PEX (they can dissolve the plastic).
- Keep PEX at least 12 inches away from recessed light fixtures and other potential sources of high heat.
- Do not attach PEX directly to a water heater. Make connections at the heater with metallic tubing (either flexible water-heater connector tubing or rigid copper) at least 18 inches long; then join it to PEX with a transition fitting.
- Do not install PEX in areas where there is a possibility of mechanical damage or puncture. Always fasten protective plates to wall studs that house PEX.
- Always leave some slack in installed PEX lines to allow for contraction and in case you need to cut off a bad crimp.
- Use the same minimum branch and distribution supply-pipe dimensions for PEX that you'd use for copper or CPVC, according to your local plumbing codes.
- You can use push fittings to join PEX to itself or to CPVC or copper.

Do not connect PEX directly to a water heater. Use metal connector tubes. Solder the connector tubes to the water heater before attaching PEX. Never solder metal tubing that is already connected to PEX lines.

Bundle PEX together with plastic ties when running pipe through wall cavities. PEX can contract slightly, so leave some slack in the lines.

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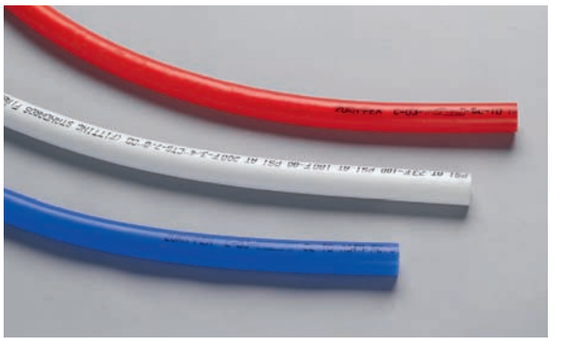
Buying PEX



Color coding is a practice many PEX manufacturers have embraced to make identification easier. Because the material is identical except for the color, you can buy only one color (red is more common) and use it for both hot and cold supply lines.

PEX combines the flexibility of plastic tubing with the durability of rigid supply pipe. It is sold in coils of common supply-pipe diameters.

The PEX Advantage

PEX supply tubing offers a number of advantages over traditional rigid supply tubing:

- Easy to install. PEX does not require coupling joints for long runs or elbows and sweeps for turns. The mechanical connections do not require solvents or soldering.
- Easy to transport. Large coils are lightweight and much easier to move around than 10-ft. lengths of pipe.
- Good insulation. The PEX material has better thermal properties than copper for lessened heat loss.
- Quiet. PEX will not rattle or clang from trapped air or kinetic energy.
- Good for retrofit jobs. PEX is easier to snake through walls than rigid supply tubing and is compatible with copper, PVC, or iron supply systems if the correct transition fittings are used. If your metal supply tubes are used to ground your electrical system, you'll need to provide a jumper if PEX is installed in midrun. Check with a plumber or electrician.
- Freeze resistant. PEX retains some flexibility in sub-freezing conditions and is less likely to be damaged than rigid pipe, but it is not frostproof.

General Codes for PEX

PEX has been endorsed for residential use by all major building codes, although some municipal codes may be more restrictive. The specific design standards may also vary, but here are some general rules:

- For PEX, maximum horizontal support spacing is 32" and maximum vertical support spacing is 10 ft.
- Maximum length of individual distribution lines is 60 ft.
- PEX is designed to withstand 210°F water for up to 48 hours. For ongoing use, most PEX is rated for 180 degree water up to 100 pounds per square inch of pressure.
- Directional changes of more than 90 degrees require a guide fitting (see page 45).

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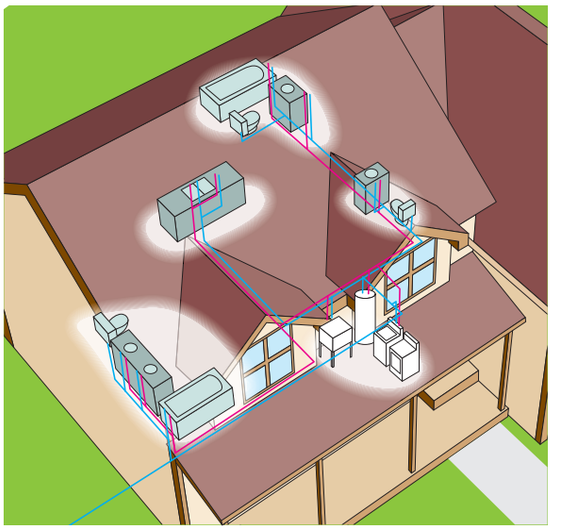
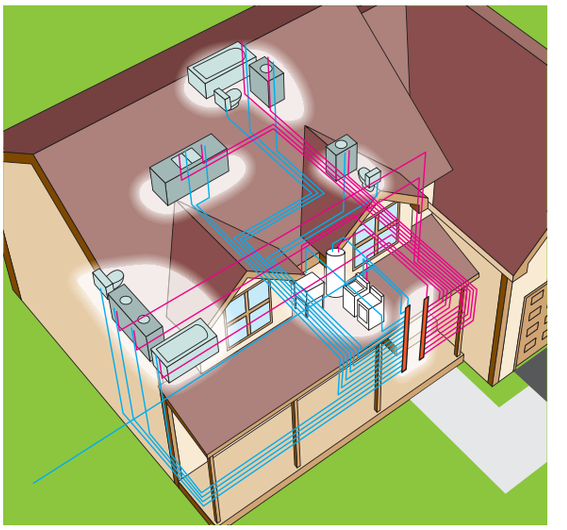
#175 Dtp:225 Page:33

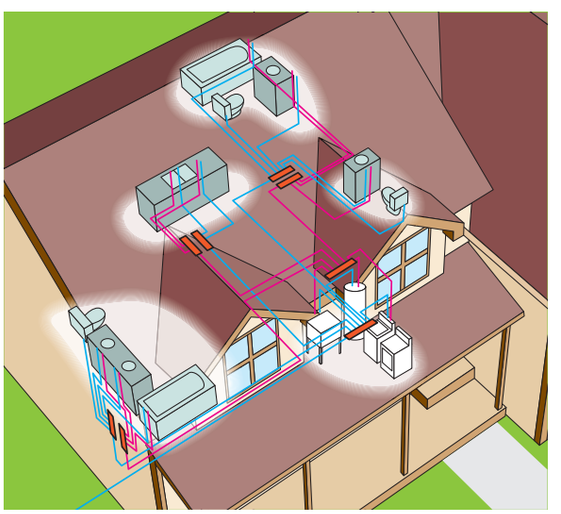
PEX System Designs



Trunk-and-branch systems are configured in much the same way as a traditional rigid copper or PVC supply systems. A main supply line (the trunk line) carries water to all of the outlets via smaller branch lines that tie into the trunk and serve a few outlets in a common location.



Home run systems rely on one or two central manifolds to distribute the hot and cold water very efficiently. Eliminating the branch fittings allows you to use thinner supply pipe in some situations.



Remote manifold systems are a hybrid between traditional trunk-and-branch systems and home run systems. Instead of relying on just one or two manifolds, they employ several smaller manifolds downline from a larger manifold. Each smaller manifold services a group of fixtures, as in a bathroom or kitchen.

Choosing a PEX System

- For maximum single-fixture water pressure: Trunk and branch
- For economy of materials: Trunk and branch or remote manifold
- For minimal wait times for hot water (single fixture): Home run
- For minimal wait times for hot water (multiple fixtures used at same approximate time): Trunk and branch or remote manifold
- For ease of shutoff control: Home run
- For lowest number of fittings and joints: Home run

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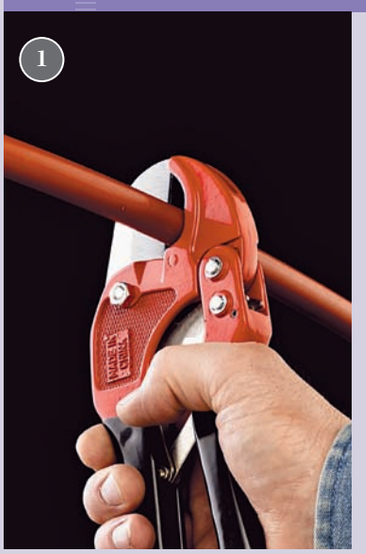
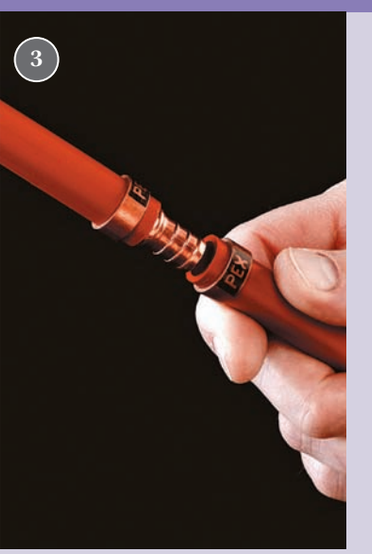
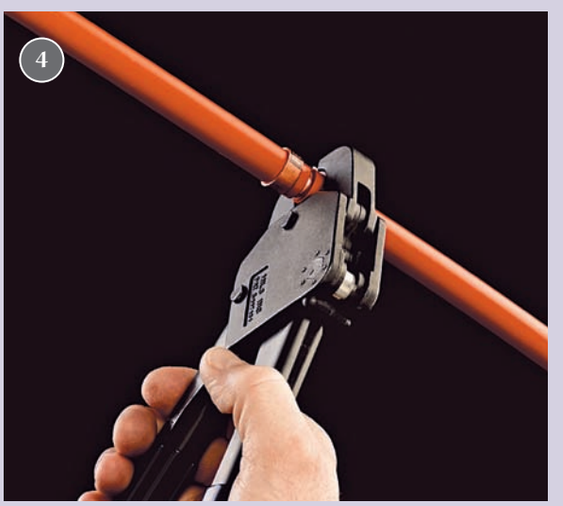
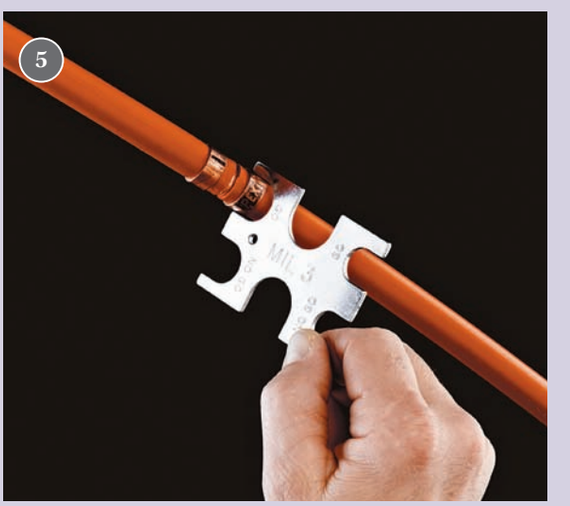
MAKING PEX CONNECTIONS









1 Cut the pipe to length, making sure to leave enough extra material so the line will have a small amount of slack once the connections are made. A straight, clean cut is very important. For best results, use a tubing cutter.

2 Inspect the cut end to make sure it is clean and smooth. If necessary, deburr the end of the pipe with a sharp utility knife. Slip a crimp ring over the end.

3 Insert the barbed end of the fitting into the pipe until it is snug against the cut edges.Position the crimp ring so it is ⅛" to ¼" from the end of the pipe, covering the barbed end of the fitting. Pinch the fitting to hold it in place.

4 Align the jaws of a full-circle crimping tool over the crimp ring and squeeze the handles together to apply strong, even pressure to the ring.

5 Test the connection to make sure it is mechanically acceptable, using a go/no-go gauge. If the ring does not fit into the gauge properly, cut the pipe near the connection and try again.

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1 Install copper manifolds (one for hot and one for cold) in an accessible location central to the fixtures. The manifold should have one outlet for each supply line it will support (fixtures that require hot and cold supply will need a separate outlet for each). Run supply lines from the water heater and water main to the copper manifolds. Connect the supply pipes to the manifolds with crimp fittings.

2 A manifold may be attached vertically or horizontally, but it must be anchored with correctly sized hangers screwed to the framing members.

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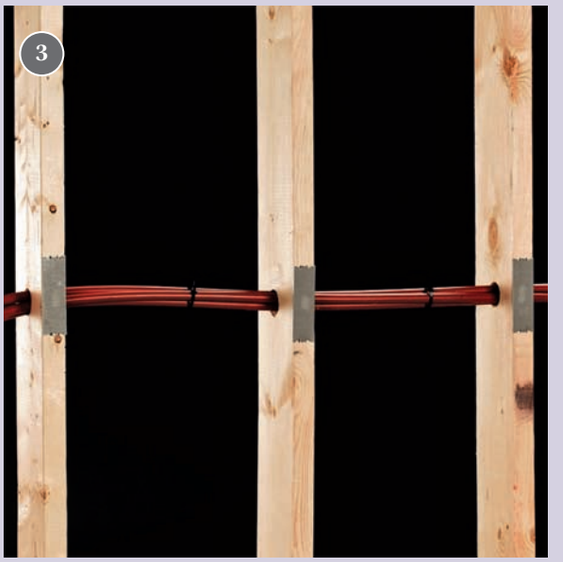

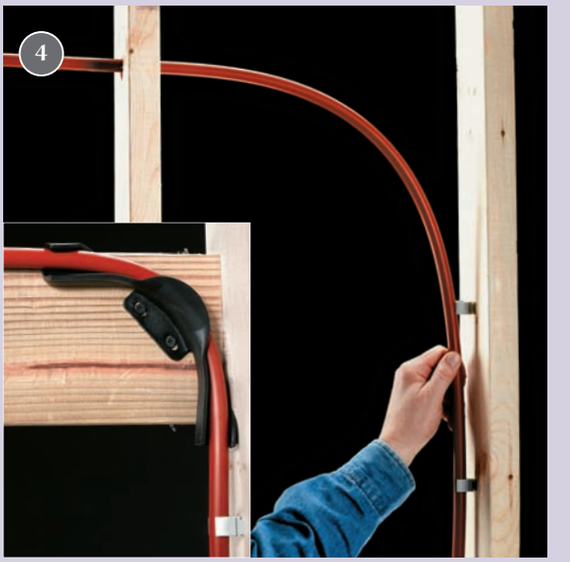

3 Starting at each fixture (and leaving at least 12" of extra pipe exposed), run appropriately sized PEX through holes in the framing to the manifolds. Pipes may be bundled together loosely with plastic ties. Protect the line with a nailing plate at each stud location. Be sure to leave some slack in the supply lines.

4 Support the pipe with a plastic hanger near every floor or ceiling and midway up vertical runs. Also use hangers to guide pipe near the beginnings and ends of curves and near fittings. Use a plastic guide for sharp curves (inset). Do not bend PEX so sharply that it kinks.

5 Cut each branch supply line to length (leave some extra in case you need to recrimp). Install shutoff valves for each outlet (most manifolds come with preattached valves). Connect the PEX branch supply lines to the shutoff valves. Label each pipe. Use a short length of PEX and a plug to seal any unused outlets (inset).

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GALVANIZED STEEL

Galvanized steel pipe is often found in older homes, where it is used for water supply and small drain lines. It can be identified by the zinc coating that gives it a silver color and by the threaded fittings used to connect pipes.

Glavanized steel pipes and fittings will corrode with age and eventually must be replaced. Low water pressure may be a sign that the insides of galvanized pipes have a buildup of rust or other minerals. Blockage usually occurs in elbow fittings. Never try to clean the insides of galvanized steel pipes. Instead, remove and replace them as soon as possible.

Glavanized steel pipe and fittings are available at hardware stores and home improvement centers. Always specify the interior diameter (I.D.) when purchasing galvanized pipes and fittings. Pre-threaded pipes, called nipples, are available in lengths from 1 inch to 1 foot. If you need a longer length, have the store cut and thread the pipe to your dimensions.

Old galvanized steel can be difficult to repair. Fittings are often rusted in place, and what seems like a small job may become a large project. For example, cutting apart a section of pipe to replace a leaky fitting may reveal that adjacent pipes are also in need of replacement. If your job takes an unexpected amount of time, you can cap off any open lines and restore water to the rest of your house.

Tip

Galvanized steel is sometimes confused with "black iron." Both types have similar sizes and fittings. Black iron is used only for gas lines.

Tools & Materials

- Tape measure
- Reciprocating saw with metal-cutting blade or a hacksaw
- Pipe wrenches
- Propane torch
- Wire brush
- Nipples
- End caps
- Union fitting
- Pipe joint compound
- Replacement fittings (if needed)

Before you begin a repair, have on hand nipples and end caps that match your pipes.

Taking apart a system of galvanized steel pipes and fittings is time-consuming. Disassembly must start at the end of a pipe run, and each piece must be unscrewed before the next piece can be removed. Reaching the middle of a run to replace a section of pipe can be a long and tedious job. Instead, use a special three-piece fitting called a union. A union makes it possible to remove a section of pipe or a fitting without having to take the entire system apart.

Galvanized pipe was installed in homes for both gas and water supply pipes until the middle part of the last century. Although it is not used for new installations today, it can still be repaired easily using simple tools and techniques.

Measure the old pipe. Include ½" at each end for the threaded portion of the pipe inside fitting. Bring overall measurement to the store when shopping for replacement parts.

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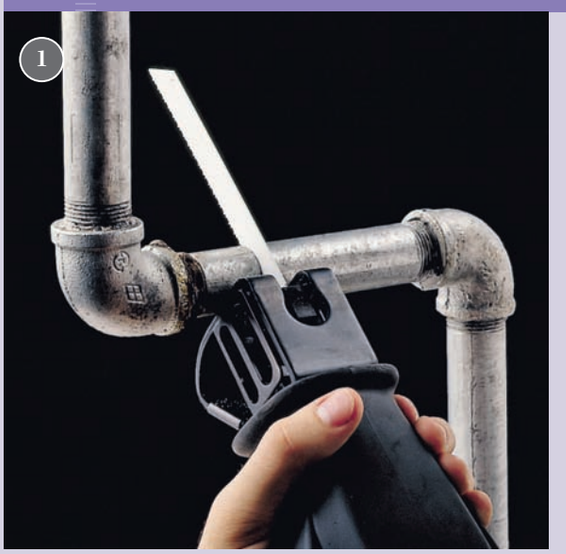
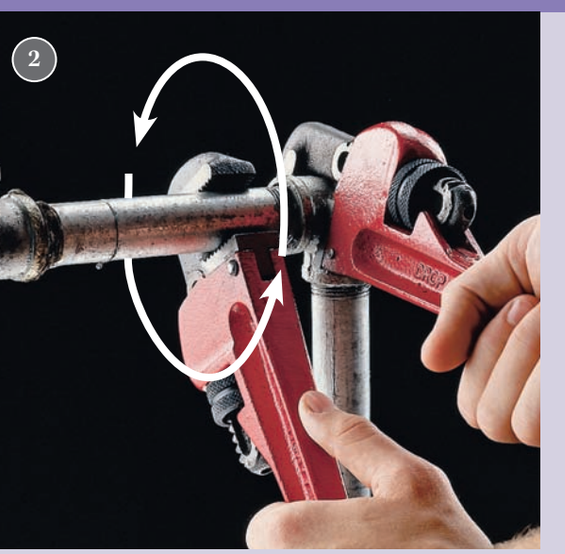
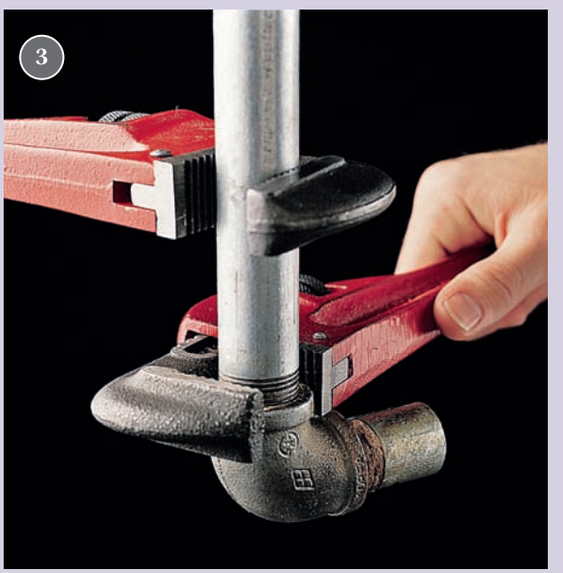
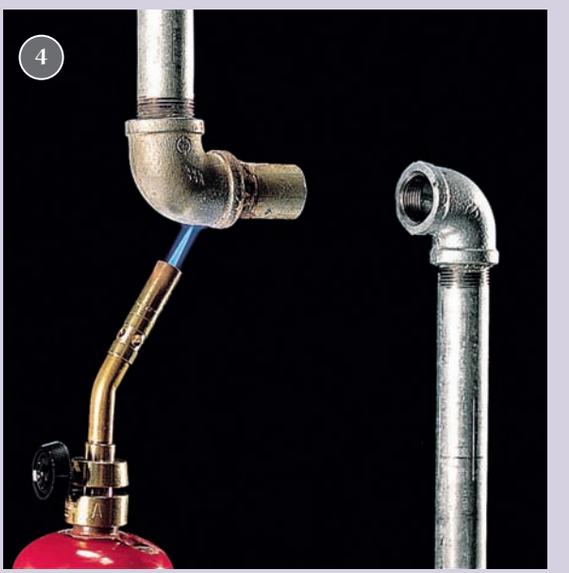
REMOVING & REPLACING A GALVANIZED STEEL PIPE









1 Cut through galvanized steel pipe with a reciprocating saw and a metal-cutting blade or with a hacksaw.

2 Hold the fitting with one pipe wrench, and use another wrench to remove the old pipe. The jaws of the wrenches should face opposite directions. Always move the wrench handle toward the jaw opening.

3 Remove any corroded fittings using two pipe wrenches. With the jaws facing in opposite directions, use one wrench to turn fitting and the other to hold the pipe. Clean the pipe threads with a wire brush.

4 Heat stubborn fittings with a torch to make them easier to remove. Apply the flame for 5 to 10 seconds. Protect wood and other flammable materials from heat using a double layer of sheet metal.

continued

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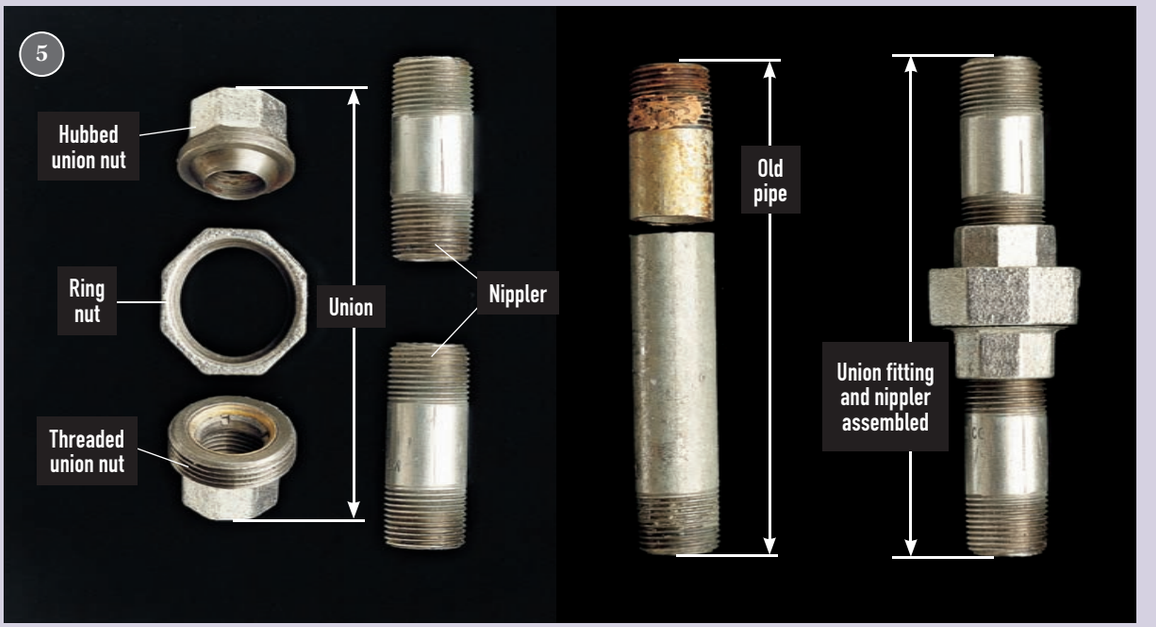
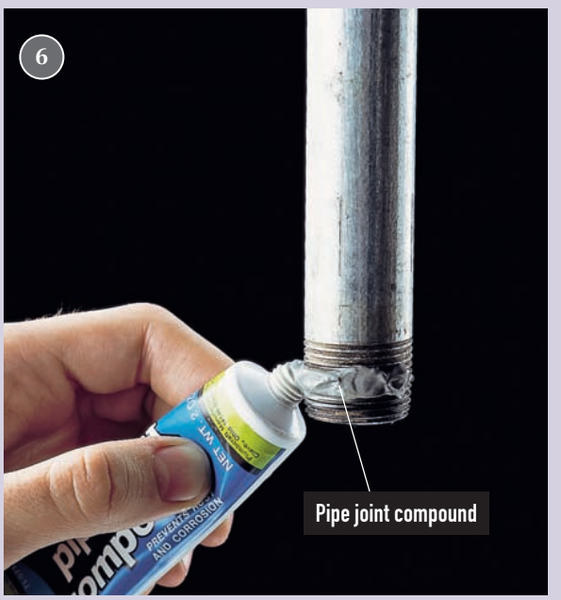
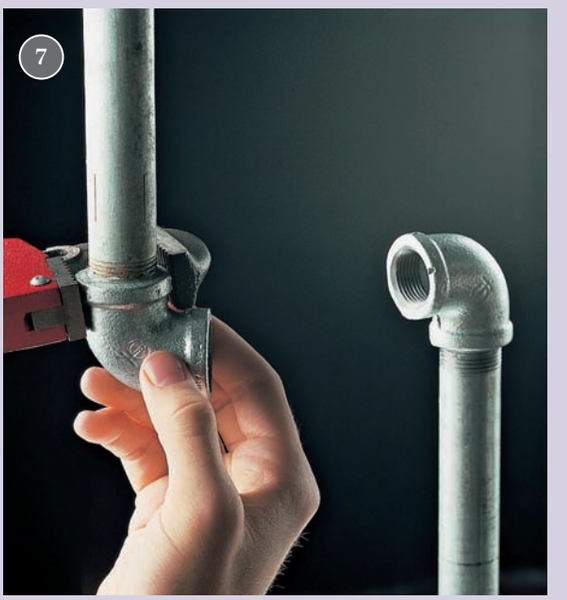
#175 Dtp:225 Page:39







5 Replace a section of galvanized steel pipe with a union fitting and two threaded pipes (nipples). When assembled, the union and nipples must equal the length of the pipe that is being replaced.

6 Apply a bead of pipe joint compound or pipe tape around the threaded ends of all pipes and nipples. Spread the compound evenly over the threads with your fingertip.

7 Screw new fittings onto pipe threads. Tighten fittings with two pipe wrenches, leaving them about one-eighth turn out of alignment to allow assembly of the union.

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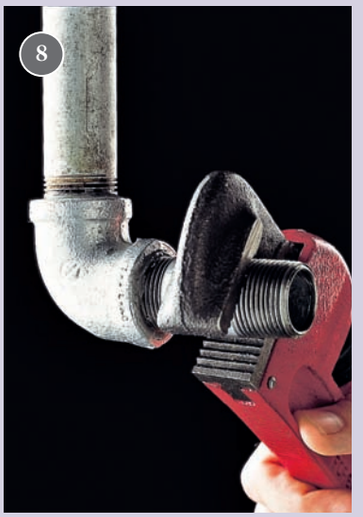

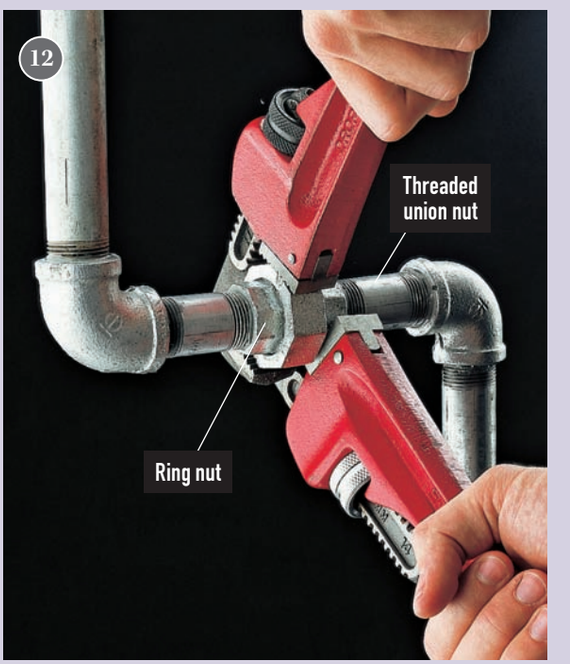

8 Screw the first nipple into the fitting, and tighten with a pipe wrench.

9 Slide a ring nut onto the installed nipple, then screw the hubbed union nut onto the nipple and tighten with a pipe wrench.

10 Screw the second nipple onto the other fitting. Tighten with a pipe wrench.

11. Screw the threaded union nut onto the second nipple. Tighten with a pipe wrench. Turn pipes into alignment, so that the lip of the hubbed union nut fits inside the threaded union nut.

12 Complete the connection by screwing the ring nut onto the threaded union nut. Tighten the ring nut with pipe wrenches.

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#175 Dtp:225 Page:41

PIPE FITTINGS

Use the photos on these pages to identify the plumbing fittings specified in the project how-to directions found in this book. Each fitting shown is available in a variety of sizes to match your needs. Always use fittings made from the same material as your pipes.

Pipe fittings come in a variety of shapes to serve different functions within the plumbing system. DWV fittings include:

Vents: In general, the fittings used to connect vent pipes have very sharp bends with no sweep. Vent fittings include the vent T and vent 90° elbow. Standard drain pipe fittings can also be used to join vent pipes.

Horizontal-to-vertical drains: To change directions in a drain pipe from the horizontal to the vertical, use fittings with a noticeable sweep. Standard fittings for this use include waste T-fittings and 90° elbows. Y-fittings and 45° and 221/2° elbows can also be used for this purpose.

Vertical-to-horizontal drains: To change directions from the vertical to the horizontal, use fittings with a very pronounced, gradual sweep. Common fittings for this purpose include the long-radius T-Y-fitting and some Y-fittings with 45° elbows.

Horizontal offsets in drains: Y-fittings, 45° elbows, 221/2° elbows, and long sweep 90° elbows are used when changing directions in horizontal pipe runs. Whenever possible, horizontal drain pipes should use gradual, sweeping bends rather than sharp turns.

Basic DWV tree shows the correct orientation of drain and vent fittings in a plumbing system. Bends in the vent pipes can be very sharp, but drain pipes should use fittings with a noticeable sweep. Fittings used to direct falling waste water from a vertical to a horizontal pipe should have bends that are even more sweeping. Your local plumbing code may require that you install cleanout fittings where vertical drain pipes meet horizontal runs.

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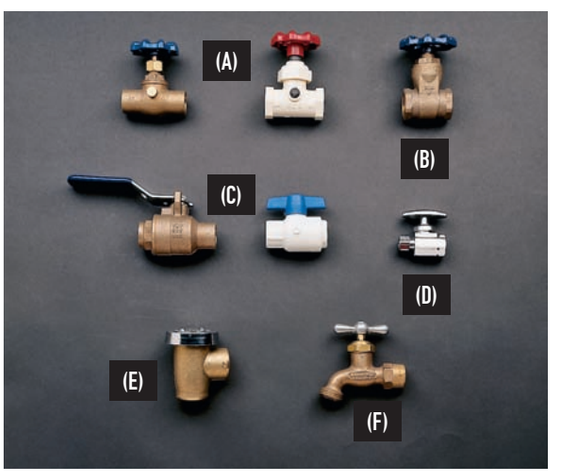
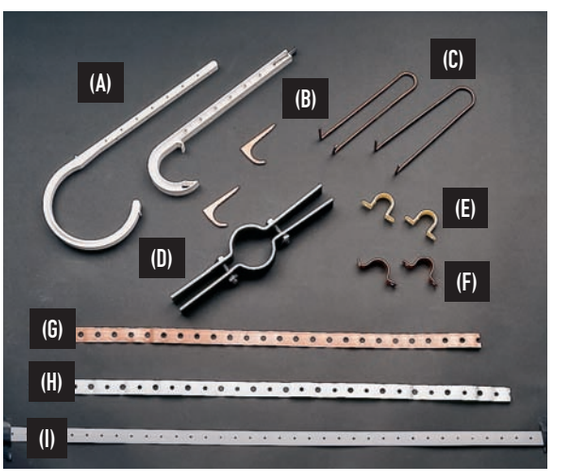
(Fogra 39)Job:04-30437 Title:MBI-HomeSkills Plumbing
#175 Dtp:225 Page:42

Water supply fittings are available for copper (top), CPVC plastic (center), and PEX (bottom). Fittings for CPVC and copper are available in many shapes, including: unions (A), reducers (B), 90º elbows (C), reducing elbows (D), 45º elbows (E), T-fittings (F), reducing T-fittings (G), drop-ear elbows (H), threaded adapters (I), and caps (J). Common PEX fittings (bottom) include unions (K), PEX-to-copper unions (L), 90º elbows (M), T-fittings (N), plugs (O), drop-ear elbows (P), and threaded adapters (Q). Easy-to-install push fittings are also available.



Water supply valves are available in brass or plastic and in a variety of styles, including: drain-and-waste valves (A), gate valve (B), full-bore ball valves (C), fixture shutoff valve (D), vacuum breaker (E), and hose bib (F).



Support materials for pipes include: plastic pipe hangers (A), copper J-hooks (B), copper wire hangers (C), riser clamp (D), plastic pipe straps (E), copper pipe straps (F), flexible copper, steel, and plastic pipe strapping (G, H, I). Do not mix metal types when supporting metal pipes; use copper support materials for copper pipe, and steel for steel and cast-iron pipes.

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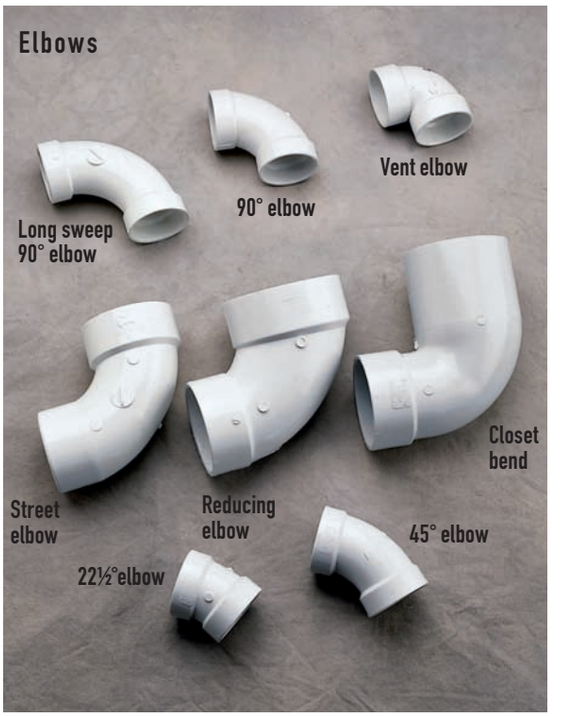
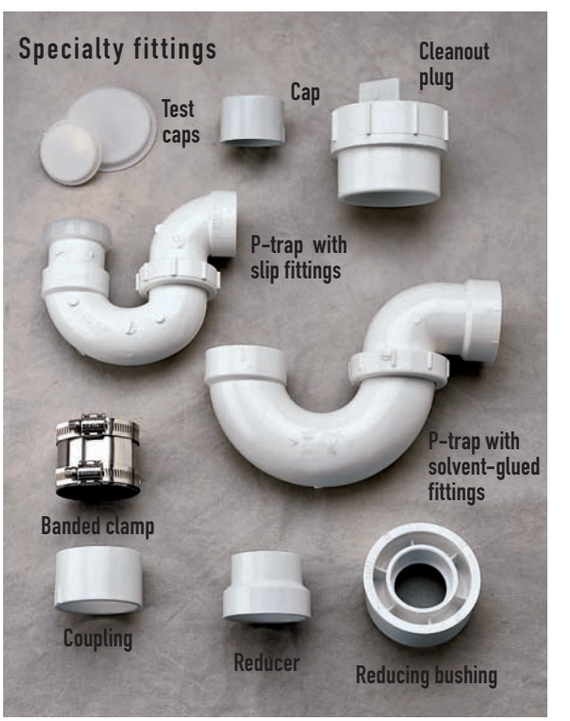
#175 Dtp:225 Page:43





Fittings for DWV pipes are available in many configurations, with openings ranging from 1¼" to 4" in diameter. When planning your project, buy plentiful numbers of DWV and water supply fittings from a reputable retailer with a good return policy. It is much more efficient to return leftover materials after you complete your project than it is to interrupt your work each time you need to shop for a missing fitting.

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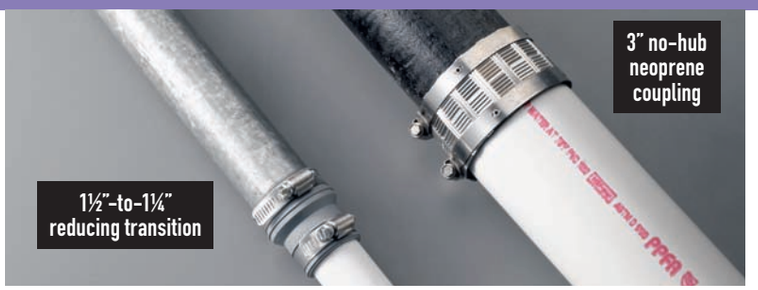
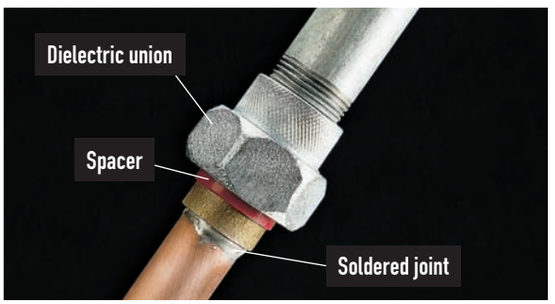
#175 Dtp:225 Page:44

USING TRANSITION FITTINGS

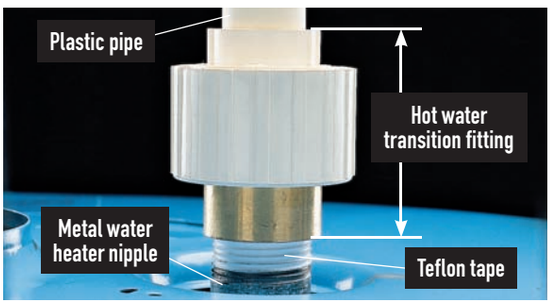
Connect plastic to cast iron with banded couplings. Rubber sleeves cover ends of pipes and ensure a watertight joint.



Make transitions in DWV pipes with rubber couplings. The two products shown here can be used to connect pipes of different materials, as well as same-material pipes that need a transition.

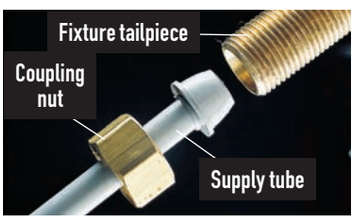


Connect copper to galvanized steel with a dielectric union. A dielectric union is threaded onto iron pipe and is soldered to copper pipe. A dielectric union has a plastic spacer that prevents corrosion caused by an electrochemical reaction between dissimilar metals.



Connect metal hot water pipe to plastic with a hot water transition fitting that prevents leaks caused by different expansion rates of materials. Metal pipe threads are wrapped with Teflon tape. Plastic pipe is solvent-glued to fitting.

Connect a water pipe to any fixture supply tube using a shutoff valve.



Connect any supply tube to a fixture tailpiece with a coupling nut. The coupling nut compresses the bell-shaped end of the supply tube against the fixture tailpiece.

Specialty supply fittings can be used to supply potable water fixtures such as icemakers and hot water dispensers. The John-Guest® Speed-Fit® fitting shown here is designed to connect to clear tubing or the manufacturer's proprietary plastic supply tubing.

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#175 Dtp:225 Page:45

SHUTOFF VALVES

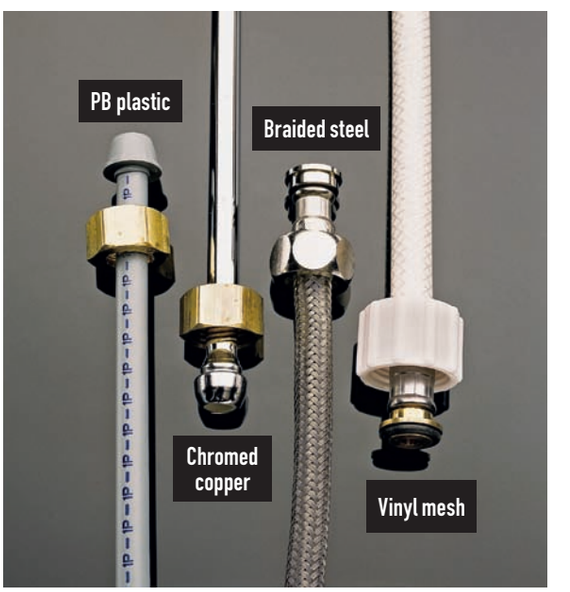
Worn-out shutoff valves or supply tubes can cause water to leak underneath a sink or other fixture. First, try tightening the fittings with an adjustable wrench. If this does not fix the leak, replace the shutoff valves and supply tubes.

Shutoff valves are available in several fitting types. For copper pipes, valves with compression-type fittings are easiest to install. For plastic pipes, use grip-type valves. For galvanized steel pipes, use valves with female threads.

Tools & Materials

- Hacksaw
- Tubing cutter
- Adjustable wrench
- Tubing bender
- Felt-tipped pen
- Shutoff valves
- Supply tubes
- Pipe joint compound

Shutoff valves allow you to shut off the water to an individual fixture so it can be repaired. They can be made from durable chromed brass or lightweight plastic. Shutoff valves come in ½" and ¾" diameters to match common water pipe sizes.



Supply tubes are used to connect water pipes to faucets, toilets, and other fixtures. They come in 12", 20", and 30" lengths. PB plastic and chromed copper tubes are inexpensive. Braided steel and vinyl mesh supply tubes are easy to install.

Tip

Older plumbing systems often were installed without fixture shutoff valves. When repairing or replacing plumbing fixtures, you may want to install shutoff valves if they are not already present.

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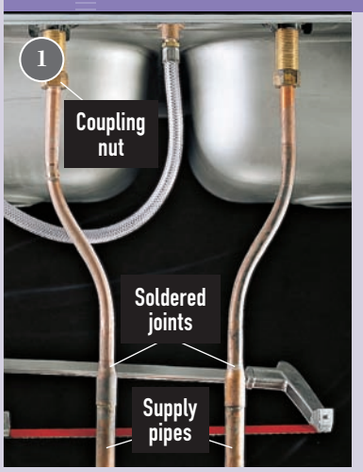
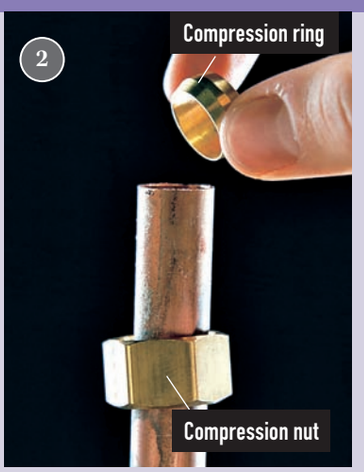
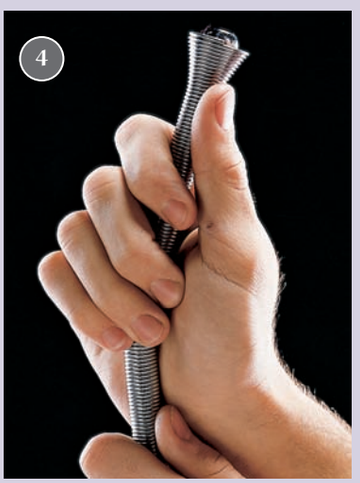
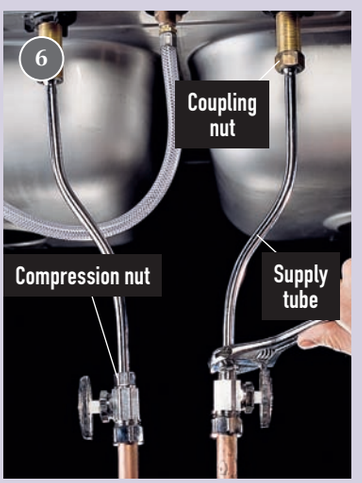
INSTALLING SHUTOFF VALVES & SUPPLY TUBES









1 Turn off water at the main shutoff valve. Remove old supply pipes. If pipes are soldered copper, cut them off just below the soldered joint using a hacksaw or tubing cutter. Make sure the cuts are straight. Unscrew the coupling nuts and discard the old pipes.

2 Slide a compression nut and a compression ring over the copper water pipe. Threads of the nut should face the end of the pipe.

3 Apply pipe joint compound to the threads of the shutoff valve or compression nut. Screw the compression nut onto the shutoff valve and tighten with an adjustable wrench.

4 Bend chromed copper supply tube to reach from the tailpiece of the fixture to the shutoff valve using a tubing bender. Bend the tube slowly to avoid kinking the metal.

5 Position the supply tube between the fixture tailpiece and the shutoff valve, and mark the tube to length. Cut the supply tube with a tubing cutter (page 14).

6 Attach the bell-shaped end of the supply tube to the fixture tailpiece with a coupling nut, then attach the other end to the shutoff valve with compression ring and nut. Tighten all fittings with an adjustable wrench.

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#175 Dtp:225 Page:47

VALVES & HOSE BIBS

Valves make it possible to shut off water at any point in the supply system. If a pipe breaks or a plumbing fixture begins to leak, you can shut off water to the damaged area so that it can be repaired. A hose bib is a faucet with a threaded spout, often used to connect rubber utility or appliance hoses.

Valves and hose bibs leak when washers or seals wear out. Replacement parts can be found in the same universal washer kits used to repair compression faucets. Coat replacement washers with faucet grease to keep them soft and prevent cracking.

Tip

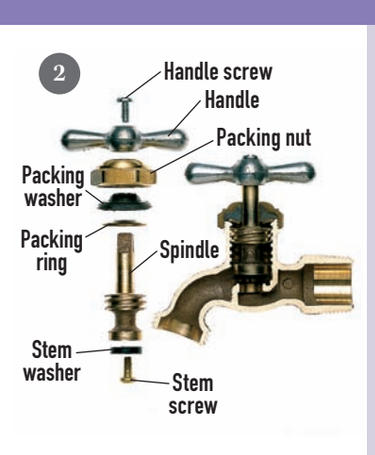
If you have the opportunity to replace a shutoff valve, install a ball valve, which is most reliable type.

Tools & Materials

- Screwdriver
- Adjustable wrench
- Universal washer kit
- Faucet grease

With the exception of chromed shutoff valves that are installed at individual fixtures (see previous pages), valves and hose bibs are heavy-duty fittings, usually with a brass body that are installed in-line to regulate water flow. Gate valves and globe valves are similar and are operated with a wheel-type handle that spins. Ball valves are operated with a handle much like a gas pipe stopcock and are considered by pros to be the most reliable. Hose bibs are spigots with a threaded end designed to accept a female hose coupling.

FIXING A LEAKY HOSE BIB



1. Turn off the water to the hose bib before beginning work. Remove the handle screw and lift off the handle. Unscrew the packing nut with an adjustable wrench.
2. Unscrew the spindle from the valve body. Remove the stem screw and replace the stem washer. Replace the packing washer and reassemble the valve.

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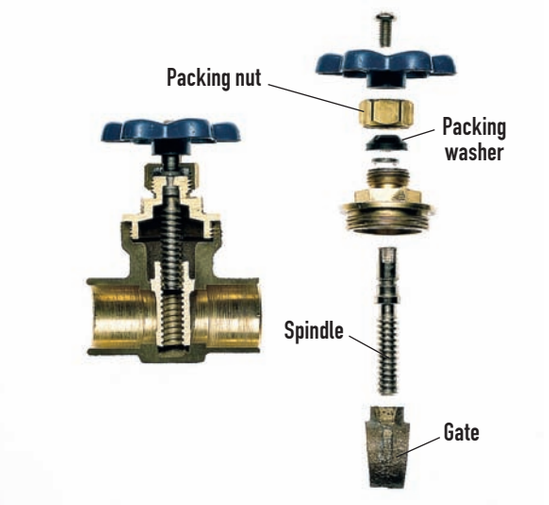
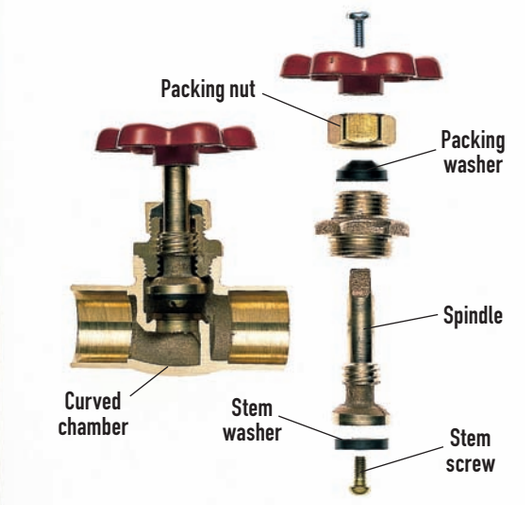
#175 Dtp:225 Page:48

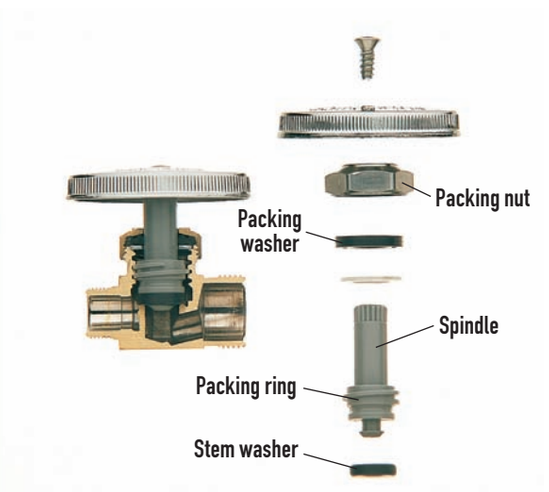
COMMON TYPES OF VALVES



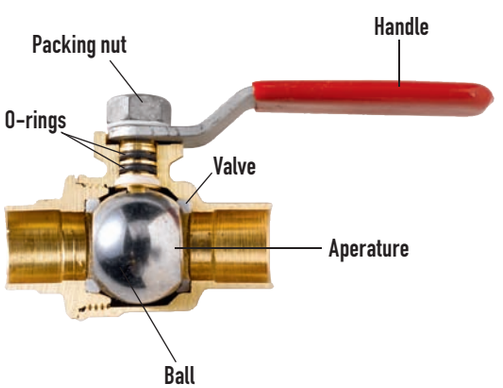
A gate valve has a movable brass wedge, or "gate," that screws up and down to control water flow. Gate valves may develop leaks around the handle. Repair leaks by replacing the packing washer or packing string found underneath the packing nut.



A globe valve has a curved chamber. Repair leaks around the handle by replacing the packing washer. If the valve does not fully stop water flow when closed, replace the stem washer.



A shutoff valve controls water supply to one or more fixtures. A shutoff valve has a plastic spindle with a packing washer and a snap-on stem washer. Repair leaks around the handle by replacing the packing washer. If a valve does not fully stop water flow when closed, replace the stem washer. Shutoff valves with multiple outlets are available to supply several fixtures from a single supply.



A ball valve contains a metal ball with an aperture (or controlled hole) in the center. The ball is controlled by a handle. When the handle is turned the hole is positioned parallel to the valve (open) or perpendicular (closed).

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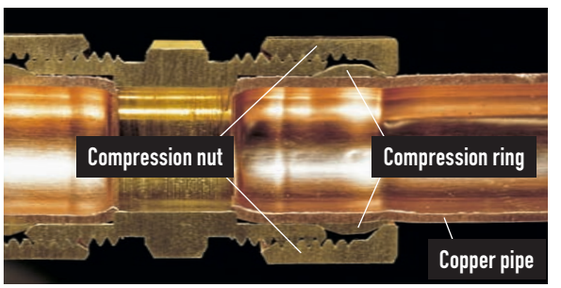
#175 Dtp:225 Page:49

COMPRESSION FITTINGS

Compression fittings are used to make connections that may need to be taken apart. Compression fittings are easy to disconnect and are often used to install supply tubes and fixture shutoff valves. Use compression fittings in places where it is unsafe or difficult to solder, such as in crawl spaces.

Compression fittings are used most often with flexible copper pipe. Flexible copper is soft enough to allow the compression ring to seat snugly, creating a watertight seal. Compression fittings also may be used to make connections with Type M rigid copper pipe.

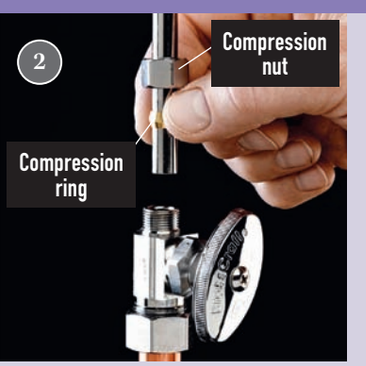


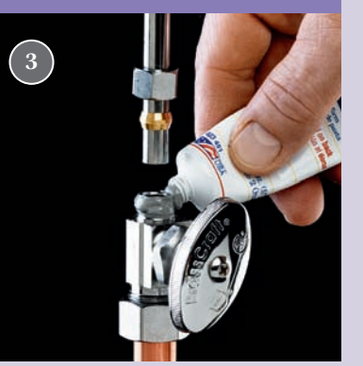
Compression fitting (shown in cutaway) shows how a threaded compression nut forms a seal by forcing the compression ring against the copper pipe. The compression ring is covered with pipe joint compound before assembling to ensure a perfect seal.

Tools & Materials

- Felt-tipped pen
- Tubing cutter or hacksaw
- Adjustable wrenches
- Brass compression fittings
- Pipe joint compound or Teflon tape

ATTACHING SUPPLY TUBES TO FIXTURE SHUTOFF VALVES WITH COMPRESSION FITTING





1 Bend the flexible copper supply tube and mark to length. Include ½" for the portion that will fit inside the valve. Cut the tube.

2 Slide the compression nut and then the compression ring over the end of the pipe. The threads of the nut should face the valve.

3 Apply a small amount of pipe joint compound to the threads. This lubricates the threads.

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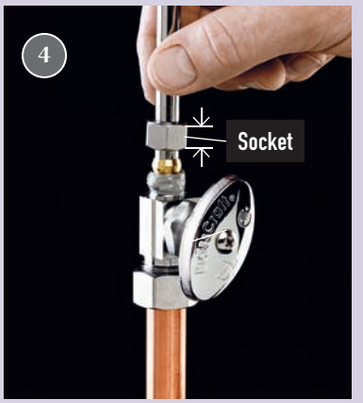
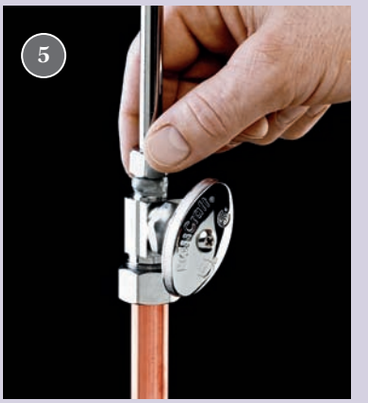
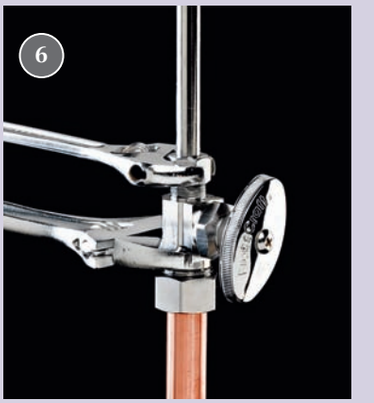




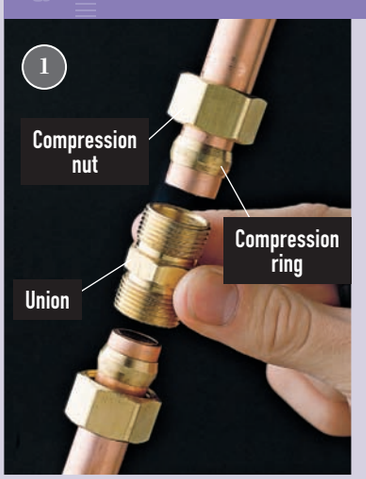


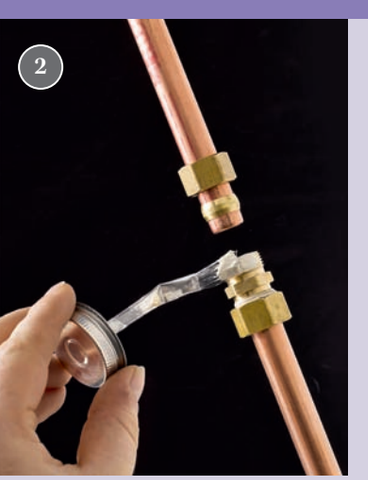
4 Insert the end of the pipe into the fitting so it fits flush against the bottom of the fitting socket.

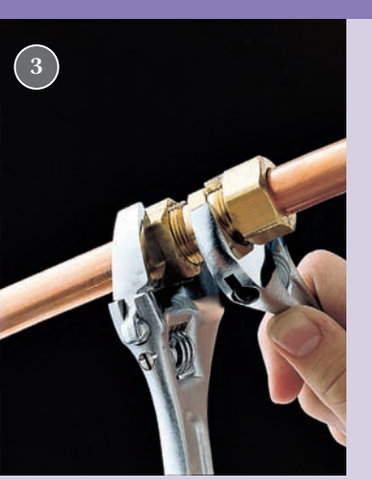
5 Slide the compression ring and nut against the threads of the valve. Hand tighten the nut onto the valve.

6 Tighten the compression nut with adjustable wrenches. Do not overtighten. Turn on the water and watch for leaks. If the fitting leaks, tighten the nut gently.

JOINING TWO COPPER PIPES WITH A COMPRESSION UNION FITTING







1 Slide compression nuts and rings over the ends of pipes. Place a threaded union between the pipes.

2 Apply a layer of pipe joint compound or Teflon® tape to the union's threads, then screw compression nuts onto the union.

3 Hold the center of the union fitting with an adjustable wrench and use another wrench to tighten each compression nut one complete turn. Turn on the water. If the fitting leaks, tighten the nuts gently.

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(Fogra 39)Job:04-30437 Title:MBI-HomeSkills Plumbing
#175 Dtp:225 Page:51

PLUMBING REPAIRS AND PROJECTS

Toilets 54

Kitchen Faucets 70

Bathroom Faucets 80

Kitchen Drains & Traps 88

Dishwashers 94

Food Disposers 98

Icemakers 104

Tub & Shower Faucets 110

Tub & Shower Drains 120

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(Fogra 39)Job:04-30437 Title:MBI-HomeSkills Plumbing
#175 Dtp:225 Page:52

Plumbing Repairs and Projects

FOR THE HOMEOWNER, THE TOILET IS TYPICALLY the most problematic plumbing fixture. As a child you may have watched in horrific fascination as the water rose menacingly up to the rim of the toilet, then flowed over. Whether due to a "natural" clog, or a toy, an overflowing toilet is not something that can wait for the plumber to arrive. And you don't need a plumber. Fixing toilets, sinks, and faucets is easy, once you understand the tools, techniques, and logic necessary.

All the information needed for fixing or replacing toilets, faucets, sink drains, and tub and shower fixtures is included here. Also covered are dishwashers, disposers, and ice makers, the three most common water-based kitchen appliances that need servicing or replacement.

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(Fogra 39)Job:04-30437 Title:MBI-HomeSkills Plumbing
#175 Dtp:225 Page:53

Toilets

Replacing a toilet is simple, and the newer models of water-saving toilets have overcome the performance problems of earlier models.

Gravity-assisted toilets are now designed with taller tanks and steeper bowl walls to increase the effects of gravity.

Tools & Materials

- Adjustable wrench
- Bucket and sponge
- Channel-type pliers
- Hacksaw
- Penetrating oil
- Pliers
- Putty knife
- Rubber gloves
- Screwdriver
- Supply tube
- Teflon tape
- Toilet seat bolts
- Toilet seat
- Towels
- Utility knife
- Wax ring without flange
- Wax ring with flange

YOU CAN REPLACE A POORLY functioning or inefficient toilet with a high-efficiency, high-quality new toilet in just a single afternoon. All toilets made since 1996 have been required to use 1.6 gallons or less per flush, which has been a huge challenge for the industry. Today, the most evolved water-saving toilets have wide passages behind the bowl and wide (3") flush valve openings—features that facilitate short, powerful flushes. This means fewer second flushes and fewer clogged toilets. These problems were common complaints of the first generation of 1.6-gallon toilets and continue to beleaguer inferior models today. See which toilets are available at your local home center in your price range, then go online and see what other consumers' experiences with those models have been. New toilets often go through a "de-bugging" stage when problems with leaks and malfunctioning parts are more common. Your criteria should include ease of installation, good flush performance, and reliability. With a little research, you should be able to purchase and install a high-functioning, economical toilet that will serve you well for years to come.

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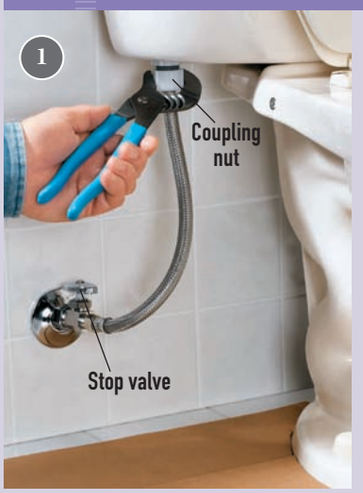
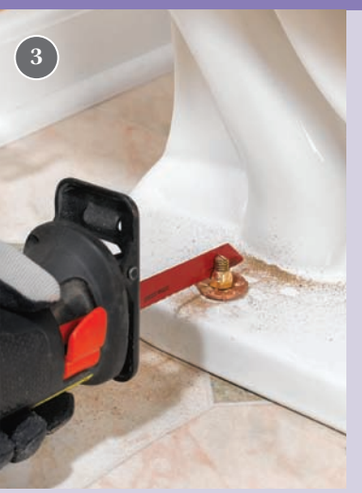
REMOVING A TOILET





1 Remove the old supply tube. First, turn off the water at the stop valve. Flush the toilet, holding the handle down for a long flush, and sponge out the tank. Use a wet vac to clear any remaining water out of the tank and bowl. Unthread the coupling nut for the water supply below the tank using channel-type pliers.

2 Grip each tank bolt nut with a box wrench or pliers and loosen it as you stabilize each tank bolt from inside the tank with a large slotted screwdriver. If the nuts are stuck, apply penetrating oil to the nut and let it sit before trying to remove them again. You may also cut the tank bolts between the tank and the bowl with an open-ended hacksaw. Remove and discard the tank.

3 Remove the nuts that hold the bowl to the floor. First, pry off the bolt covers with a screwdriver. Use a socket wrench, locking pliers, or your channel-type pliers to loosen the nuts on the tank bolts. Apply penetrating oil and let it sit if the nuts are stuck, then take them off. As a last resort, cut the bolts off with a hacksaw by first cutting down through one side of the nut. Tilt the toilet bowl over and remove it.

Prying Up Wax Rings

Removing an old wax ring is one of the more disgusting jobs you'll encounter in the plumbing universe (the one you see here is actually in relatively good condition). Work a stiff putty knife underneath the plastic flange of the ring (if you can) and start scraping. In many cases the wax ring will come off in chunks. Discard each chunk right away—they stick to everything. If you're left with a lot of residue, scrub with mineral spirits. Once clean, stuff a rag in a plastic bag into the drain opening to block sewer gas.

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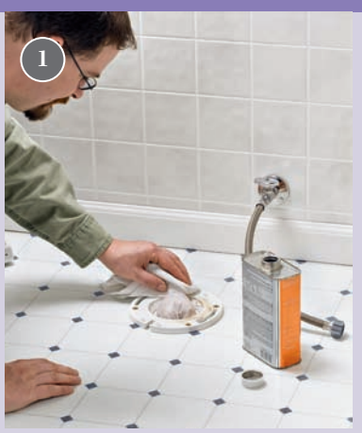
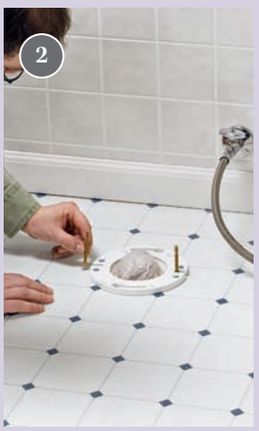
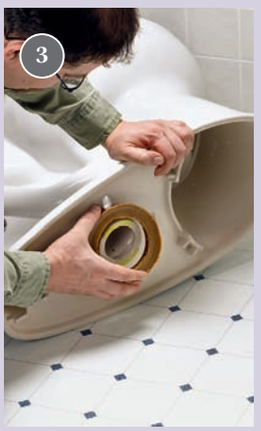
INSTALLING A TOILET



Tip

If you will be replacing your toilet flange or if your existing flange can be unscrewed and moved, orient the new flange so the slots are parallel to the wall. This allows you to insert bolts under the slotted areas, which are much stronger than the areas at the ends of the curved grooves.





1 Clean and inspect the old closet flange. Look for breaks or wear. Also inspect the flooring around the flange. If either the flange or floor is worn or damaged, repair the damage. Use a rag and mineral spirits to completely remove residue from the old wax ring. Place a rag-in-a-bag into the opening to block odors.

2 Insert new tank bolts (don't reuse old ones) into the openings in the closet flange. Make sure the heads of the bolts are oriented to catch the maximum amount of flange material. To firmly hold the bolts upright, slide on the plastic washers and press them down.

3 Remove the wax ring and apply it to the underside of the bowl, around the horn. Remove the protective covering. Do not touch the wax ring. It is very sticky. Remove the rag-in-a-bag. If you have an older 4-inch flange, place the ring on the flange rather than the toilet to make sure it is centered.

4 Lower the bowl onto the flange, taking care not to disturb the wax ring. The holes in the bowl base should align perfectly with the tank bolts. Add a washer and tighten a nut on each bolt. Hand tighten each nut and then use channel-type pliers to further tighten the nuts. Alternate back and forth between nuts until the bowl is secure. Do not overtighten.

5 Install the flush valve. Some tanks come with a flush valve and a fill valve preinstalled. For models that do not have this, insert the flush valve through the tank opening and tighten a spud nut over the threaded end of the valve. Place a foam spud washer on top of the spud nut.

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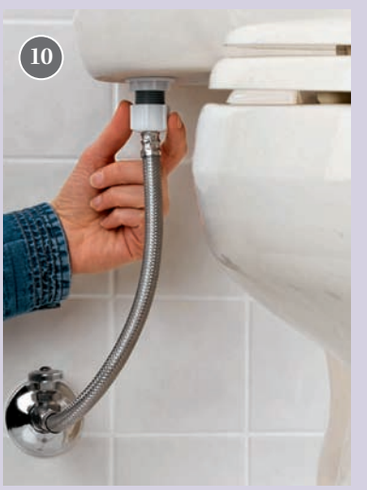

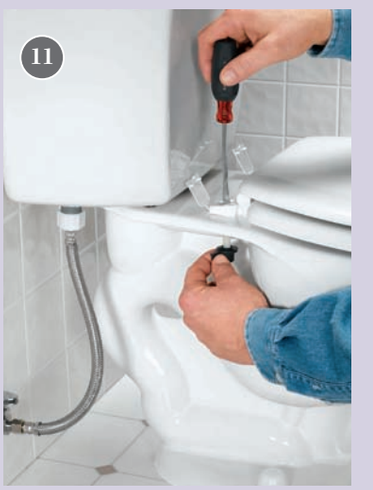

6 Adjust the fill valve as directed by the manufacturer to set the correct tank water level height and install the valve inside the tank. Hand tighten the nylon lock nut that secures the valve to the tank (inset photo) and then tighten it further with channel-type pliers.

7 With the tank lying on its back, thread a rubber washer onto each tank bolt and insert it into the bolt holes from inside the tank. Then, thread a brass washer and hex nut onto the tank bolts from below and tighten them to a quarter turn past hand tight. Do not overtighten.

8 Position the tank on the bowl, spud washer on opening, bolts through bolt holes. Put a rubber washer, followed by a brass washer and a wing nut, on each bolt and tighten these up evenly.

9 You may stabilize the bolts with a large slotted screwdriver from inside the tank, but tighten the nuts, not the bolts. You may press down a little on a side, the front, or the rear of the tank to level it as you tighten the nuts by hand. Do not overtighten and crack the tank. The tank should be level and stable when you're done. Do not overtighten.

10 Hook up the water supply by connecting the supply tube to the threaded fill valve with the coupling nut provided. Turn on the water and test for leaks. Do not overtighten.

11 Attach the toilet seat by threading the plastic or brass bolts provided with the seat through the openings on the back of the rim and attaching nuts.

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#175 Dtp:225 Page:57

COMMON TOILET PROBLEMS

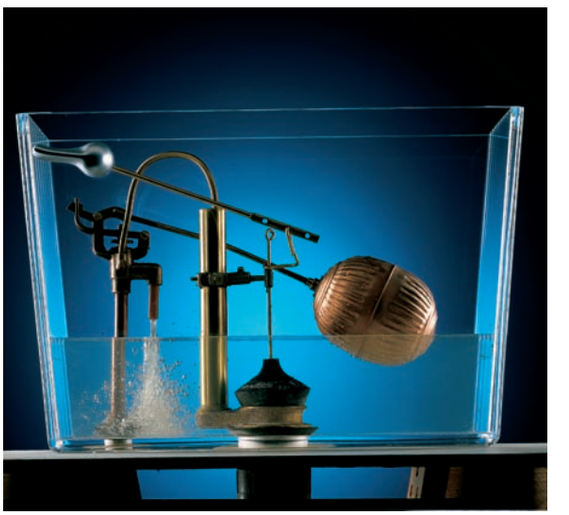
A clogged toilet is one of the most common plumbing problems. If a toilet overflows or flushes sluggishly, clear the clog with a plunger or closet auger. If the problem persists, the clog may be in the main waste-vent stack.

Most other toilet problems are fixed easily with minor adjustments that require no disassembly or replacement parts. You can make these adjustments in a few minutes, using simple tools.

If minor adjustments do not fix the problem, further repairs will be needed. The parts of a standard toilet are not difficult to take apart, and most repair projects can be completed in less than an hour.

A recurring puddle of water on the floor around a toilet may be caused by a crack in the toilet base or in the tank. A damaged toilet should be replaced. Installing a new toilet is an easy project that can be finished in three or four hours.

A standard two-piece toilet has an upper tank that is bolted to a base. This type of toilet uses a simple gravity-operated flush system and can easily be repaired using the directions on the following pages. Some one-piece toilets use a complicated, high-pressure flush valve.



An older toilet may have a tank ball that settles onto the flush valve to stop the flow of water into the bowl. The ball is attached to a lift wire, which is in turn attached to the lift rod. A ballcock valve is usually made of brass, with rubber washers that can wear out. If the ballcock valve malfunctions, you might be able to find old washers to repair it, but replacing both the ballcock and the tank ball with a float-cup assembly and flapper is easier and makes for a more durable repair.

A modern float-cup valve with flapper is inexpensive and made of plastic, but is more reliable than an old ballcock valve and ball.

A pressure-assist toilet has a large vessel that nearly fills the tank. As water enters the vessel, pressure builds up. When the toilet is flushed, this pressure helps push water forcefully down into the bowl. As a result, a pressure-assist toilet provides strong flushing power with minimal water consumption.

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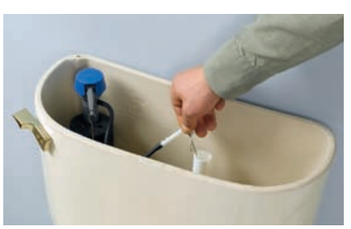
PROBLEMS & REPAIRS



Problems	Repairs
Toilet handle sticks or is hard to push.	1. Adjust lift wires. 2. Clean and adjust handle.
Handle must be held down for entire flush.	1. Adjust handle. 2. Shorten lift chain or wires. 3. Replace waterlogged flapper.
Handle is loose.	1. Adjust handle. 2. Reattach lift chain or lift wires to lever.
Toilet will not flush at all.	1. Make sure water is turned on. 2. Adjust lift chain or lift wires.
Toilet does not flush completely.	1. Adjust lift chain. 2. Adjust water level in tank. 3. Increase pressure on pressure-assisted toilet.
Toilet overflows or flushes sluggishly.	1. Clear clogged toilet. 2. Clear clogged main waste-vent stack.
Toilet runs continuously or there are phantom flushes.	1. Adjust lift wires or lift chain. 2. Replace leaky float ball. 3. Adjust water level in tank. 4. Adjust and clean flush valve. 5. Replace flush valve. 6. Replace flapper. 7. Service pressure-assist valve.
Water on floor around toilet.	1. Tighten tank bolts and water connections. 2. Insulate tank to prevent condensation. 3. Replace wax ring. 4. Replace cracked tank or bowl.
Toilet noisy when filling.	1. Open shutoff valve completely. 2. Replace ballcock and float valve. 3. Refill tube is disconnected.
Weak flush.	1. Clean clogged rim openings. 2. Replace old low-flow toilet.
Toilet rocks.	1. Replace wax ring and bolts. 2. Replace toilet flange.

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(Fogra 39)Job:04-30437 Title:MBI-HomeSkills Plumbing
#175 Dtp:225 Page:59

Making Minor Adjustments

Many common toilet problems can be fixed by making minor adjustments to the handle and the attached lift chain (or lift wires).

If the handle sticks or is hard to push, remove the tank cover and clean the handle-mounting nut. Make sure the lift wires are straight.

If the toilet will not flush completely unless the handle is held down, you may have to remove excess slack in the lift chain.

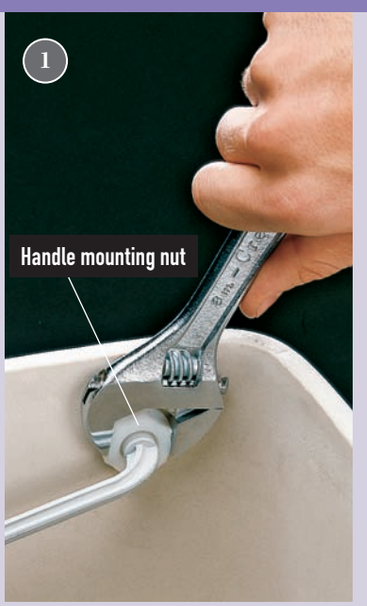
If the toilet will not flush at all, the lift chain may be broken or may have to be reattached to the handle lever.

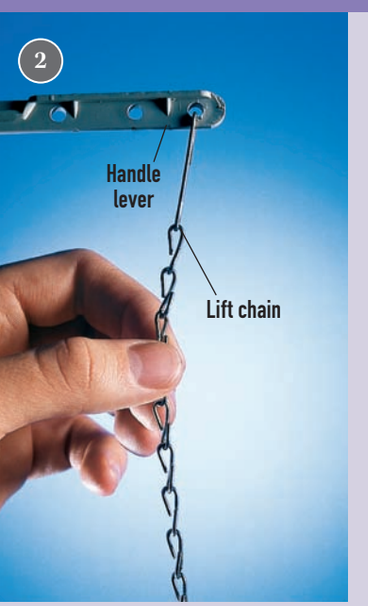
Tools & Materials

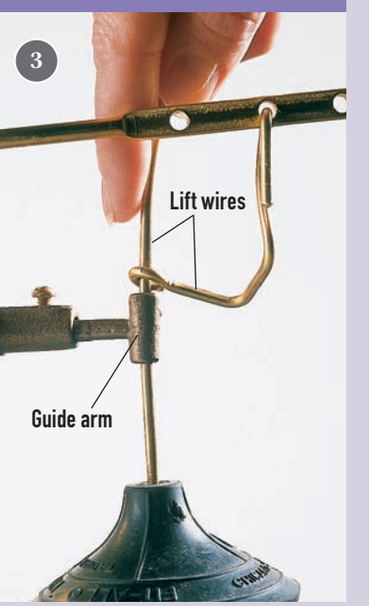
- Adjustable wrench
- Needlenose pliers
- Screwdriver
- Scissors
- Hacksaw
- Spray Lubricant
- Small wire brush
- Vinegar

A continuously running toilet (page opposite) can be caused by bent lift wires, kinks in a lift chain, or lime buildup on the handle mounting nut. Clean and adjust the handle and the lift wires or chain to fix the problem.

ADJUSTING A TOILET HANDLE & LIFT CHAIN (OR LIFT WIRES)







1 Clean and adjust handle-mounting nut so handle operates smoothly. Mounting nut has reversed threads. Loosen nut by turning clockwise; tighten by turning counterclockwise. Remove lime buildup with a brush dipped in vinegar.

2 Adjust lift chain so it hangs straight from handle lever, with about ½" of slack. Remove excess slack in chain by hooking the chain in a different hole in the handle lever or by removing links with needlenose pliers. A broken lift chain must be replaced.

3 Adjust lift wires (found on older toilets without lift chains) so that wires are straight and operate smoothly when handle is pushed. A sticky handle often can be fixed by straightening bent lift wires. You can also buy replacement wires, or replace the whole assembly with a float cup.

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#175 Dtp:225 Page:60

QUICK FIXES

Phantom flushes? Phantom flushes are weak flushes that occur without turning the handle. The flapper may not be completely sealing against the flush valve's seat. Make sure the chain is not tangled, and that the flapper can go all the way down. If that does not solve the problem, shut off water and drain the tank. If the problem persists, the flapper may need to be replaced.

Seat loose? Loose seats are almost always the result of loose nut on the seat bolts. Tighten the nuts with pliers. If the nut is corroded or stripped, replace the bolts and nuts or replace the whole seat.

Seat uncomfortably low? Instead of going to the trouble of raising the toilet or replacing it with a taller model, you can simply replace the seat with a thicker, extended seat.

Bowl not refilling well? The rim holes may be clogged; many toilets have small holes on the underside of the bowl rim, through which water squirts during a flush. If you notice that some of these holes are clogged, use a stiff-bristled brush to clear out debris. You may need to first apply toilet bowl cleaner or mineral cleaner.

Tank fills too slowly? The first place to check is the shutoff valve where the supply tube for the toilet is connected. Make sure it is fully open. If it is, you may need to replace the shutoff—these fittings are fairly cheap and frequently fail to open fully.

Toilet running? Running toilets are usually caused by faulty or misadjusted fill valves, but sometimes the toilet runs because the tank is leaking water into the bowl. To determine if this is happening with your toilet, add a few drops of food coloring to the tank water. If, after a while, the water in the bowl becomes colored, then you have a leak and probably need to replace the rubber gasket at the base of your flush valve.

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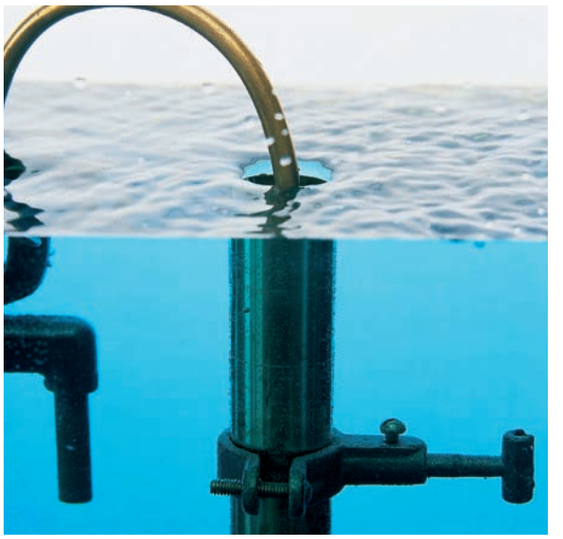
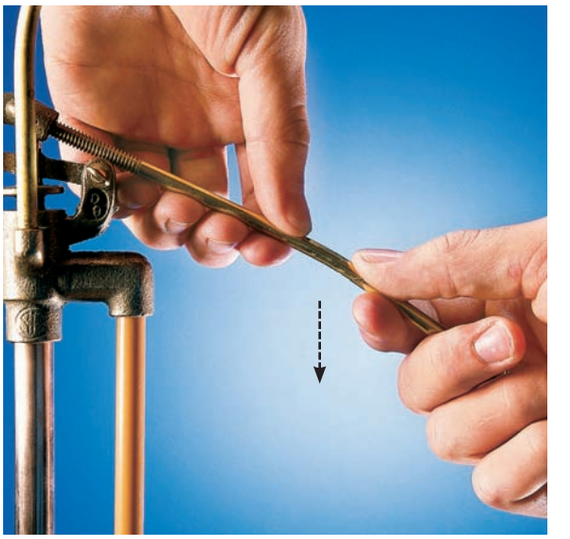
#175 Dtp:225 Page:61

Reset Tank Water Level



Tank water flowing into the overflow pipe is the sound we hear when a toilet is running. Usually, this is caused by a minor misadjustment that fails to tell the water to shut off when the toilet tank is full. The culprit is a float ball or cup that is adjusted to set a water level in the tank that's higher than the top of the overflow pipe, which serves as a drain for excess tank water. The other photos on this page show how to fix the problem.



A ball float is connected to a float arm that's attached to a plunger on the other end. As the tank fills, the float rises and lifts one end of the float arm. At a certain point, the float arm depresses the plunger and stops the flow of water. By simply bending the float arm downward a bit, you can cause it to depress the plunger at a lower tank water level, solving the problem.

A diaphragm fill valve usually is made of plastic and has a wide bonnet that contains a rubber diaphragm. Turn the adjustment screw clockwise to lower the water level and counterclockwise to raise it.

A float cup fill valve is made of plastic and is easy to adjust. Lower the water level by pinching the spring clip with fingers or pliers and moving the clip and cup down the pull rod and shank. Raise the water level by moving the clip and cup upward.

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#175 Dtp:225 Page:62

What If the Flush Stops Too Soon?

Sometimes there is plenty of water in the tank, but not enough of it makes it to the bowl before the flush valve shuts off the water from the tank. Modern toilets are designed to leave some water in the tank, since the first water that leaves the tank does so with the most force. (It's pressed out by the weight of the water on top.) To increase the duration of the flush, shorten the length of the chain between the flapper and the float (yellow in the model shown).

The handle lever should pull straight up on the flapper. If it doesn't, reposition the chain hook on the handle lever. When the flapper is covering the opening, there should be just a little slack in the chain. If there is too much slack, shorten the chain and cut off excess with the cutters on your pliers.

If the toilet is not completing flushes and the lever and chain for the flapper or tank ball are correctly adjusted, the problem could be that the handle mechanism needs cleaning or replacement. Remove the chain/linkage from the handle lever. Remove the nut on the backside of the handle with an adjustable wrench. It unthreads clockwise (the reverse of standard nuts). Remove the old handle from the tank.

Unless the handle parts are visibly broken, try cleaning them with an old toothbrush dipped in white vinegar. Replace the handle and test the action. If it sticks or is hard to operate, replace it. Most replacement handles come with detailed instructions that tell you how to install and adjust them.

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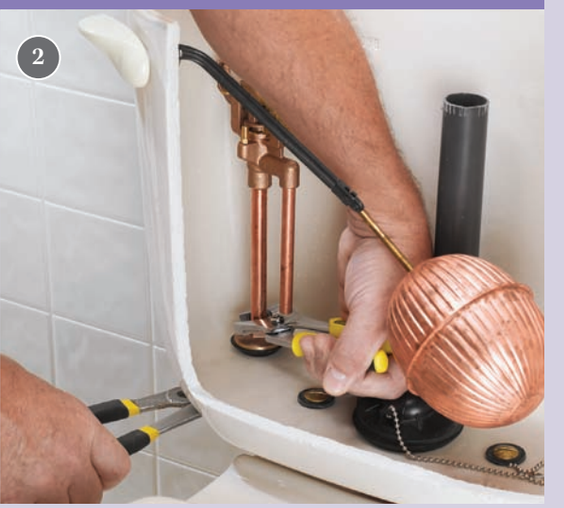
REPLACING A FILL VALVE



1 Toilet fill valves wear out eventually. They can be repaired, but it's easier and a better fix to just replace them. Before removing the old fill valve, shut off the water supply at the fixture stop valve located on the tube that supplies water to the tank. Flush the toilet and sponge out the remaining water. Loosen the nut and disconnect the supply tube, then loosen and remove the mounting nut.

2 If the fill valve spins while you turn the mounting nut, you may need to hold it still with locking pliers. Lift out the fill valve. In the case of an old ballcock valve, the float ball will likely come out as well. When replacing an old valve like this, you will likely also need to replace the flush valve (see pages 68-69).

3 The new fill valve must be installed so the critical level ("CL") mark is at least 1" above the overflow pipe (see inset). Slip the shank washer on the threaded shank of the new fill valve and place the valve in the hole so the washer is flat on the tank bottom. Compare the locations of the "CL" mark and the overflow pipe.

4 Adjust the height of the fill valve shank so the "CL" line and overflow pipe will be correctly related. Different products are adjusted in different ways—the fill valve shown here telescopes when it's twisted.

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#175 Dtp:225 Page:64

Tip

Newer diaphragm valves cost a bit more than float cups, but they boast quieter water flow. Install one the same way you would a float cup.

5 Slip the valve's threaded end down through the tank. Push down on its shank (not the top) while tightening the locknut (inset). Hand tighten, then use a wrench to make an extra ¼ turn. Hook up the water supply tube, and tighten in the same way.

6 If the overflow pipe has a cap, remove it. Attach one end of the refill tube from the new valve to the plastic angle adapter and the other end to the refill nipple near the top of the valve. Attach the angle adapter to the overflow pipe. Cut off excess tubing with scissors to prevent kinking. Warning: Don't insert the refill tube into the overflow pipe. The outlet of the refill tube needs to be above the top of the pipe for it to work properly.

7 Turn the water on fully. Slightly tighten any fitting that drips water. Adjust the water level in the tank by squeezing the spring clip on the float cup with needlenose pliers and moving the cup up or down on the link bar. Test the flush.

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#175 Dtp:225 Page:65

REPLACING A FLUSH VALVE

1 Before removing the old flush valve, shut off the water supply at the fixture stop valve located on the tube that supplies water to the tank. Flush the toilet and sponge out the remaining water. To make this repair you'll need to remove the tank from the bowl. Start by unscrewing the water supply coupling nut from the bottom of the tank.

2 Unscrew the bolts holding the toilet tank to the bowl by loosening the nuts from below. If you are having difficulty unscrewing the tank bolts and nuts because they are fused together by rust or corrosion, apply penetrating oil or spray lubricant to the threads, give it a few minutes to penetrate, and then try again. If that fails, slip an open-ended hacksaw (or plain hacksaw blade) between the tank and bowl and saw through the bolt (inset photo).

3 Unhook the chain from the handle lever arm. Remove the tank and carefully place it upside-down on an old towel. Remove the spud washer and spud nut from the base of the flush valve using a spud wrench or large channel-type pliers. Remove the old flush valve.

4 Place the new flush valve in the valve hole and check to see if the top of the overflow pipe is at least 1" below the critical level and the tank opening where the handle is installed. If the pipe is too tall, cut it to length with a hacksaw.

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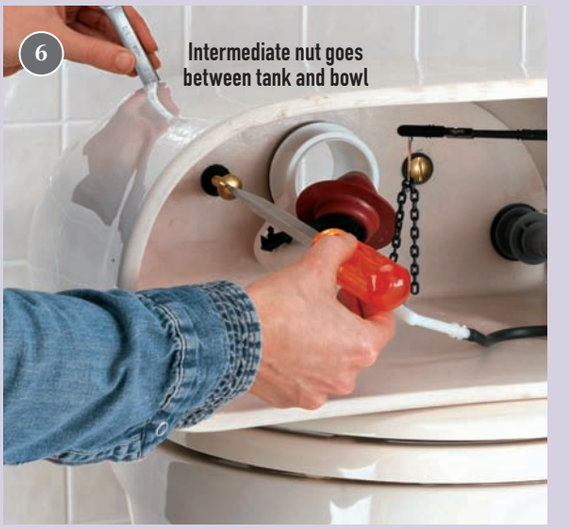

5 Position the flush valve flapper below the handle lever arm and secure it to the tank from beneath with the spud nut. Tighten the nut one-half turn past hand tight with a spud wrench or large channel-type pliers. Overtightening may cause the tank to break. Put the new spud washer over the spud nut, small side down.

6 With the tank lying on its back, thread a rubber washer onto each tank bolt and insert it into the bolt holes from inside the tank. Then, thread a brass washer and hex nut onto the tank bolts from below and tighten them to a quarter turn past hand tight. Do not overtighten.

7 With the hex nuts tightened against the tank bottom, carefully lower the tank over the bowl and set it down so the spud washer seats neatly over the water inlet in the bowl and the tank bolts fit through the holes in the bowl flange. Secure the tank to the bowl with a rubber washer, brass washer, and nut or wing nut at each bolt end. Press the tank to level as you hand-tighten the nuts. Hook up the water supply at the fill valve inlet.

8 Connect the chain clip to the handle lever arm and adjust the number of links to allow for a little slack in the chain when the flapper is closed. Leave a little tail on the chain for adjusting, cutting off remaining excess. Attach the refill tube to the top of the overflow pipe the same way it had been attached to the previous refill pipe. Turn on the water supply at the stop valve and test the flush. (Some flush valve flappers are adjustable.)

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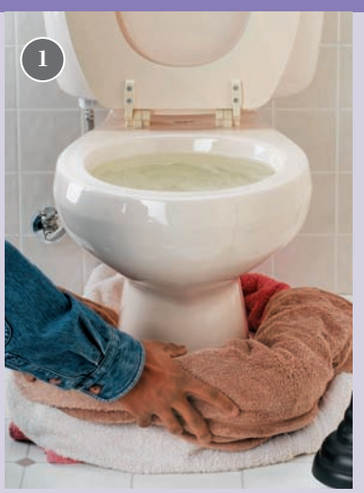
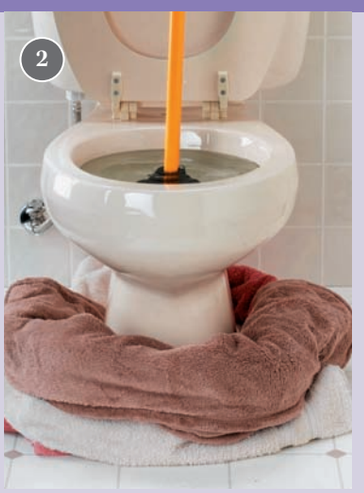
PLUNGING A CLOGGED TOILET





1 Plunging is the easiest way to remove "natural" blockages. Take time to lay towels around the base of the toilet and remove other objects to a safe, dry location, since plunging may result in splashing. Often, allowing a very full toilet to sit for twenty or thirty minutes will permit some of the water to drain to a less precarious level.

2 There should be enough water in the bowl to completely cover the plunger. Fold out the skirt from inside the plunger to form a better seal with the opening at the base of the bowl. Pump the plunger vigorously half-a-dozen times, take a rest, and then repeat. Try this for four to five cycles.

3 If you force enough water out of the bowl that you are unable to create suction with the plunger, put a controlled amount of water in the bowl by lifting up on the flush valve in the tank. Resume plunging. When you think the drain is clear, you can try a controlled flush, with your hand ready to close the flush valve should the water threaten to spill out of the bowl. Once the blockage has cleared, dump a five-gallon pail of water into the toilet to blast away any residual debris.

Force Cups

A flanged plunger (force cup) fits into the mouth of the toilet trap and creates a tight seal so you can build up enough pressure in front of the plunger to dislodge the blockage and send it on its way.

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#175 Dtp:225 Page:68

CLEARING CLOGS WITH A CLOSET AUGER

1 Place the business end of the auger firmly in the bottom of the toilet bowl with the auger tip fully withdrawn. A rubber sleeve will protect the porcelain at the bottom bend of the auger. The tip will be facing back and up, which is the direction the toilet trap takes.

2 Rotate the handle on the auger housing clockwise as you push down on the rod, advancing the rotating auger tip up into the back part of the trap. You may work the cable backward and forward as needed, but keep the rubber boot of the auger firmly in place in the bowl. When you feel resistance, indicating you've snagged the object, continue rotating the auger counterclockwise as you withdraw the cable and the object.

3 Fully retract the auger until you have recovered the object. This can be frustrating at times, but it is still a much easier task than the alternative—to remove the toilet and go fishing.

Closet Augers

A closet auger is a semirigid cable housed in a tube. The tube has a bend at the end so it can be snaked through a toilet trap (without scratching it) to snag blockages.

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#175 Dtp:225 Page:69

Kitchen Faucets

Tools & Materials

- Adjustable wrench
- Basin wrench or channel-type pliers
- Hacksaw
- Faucet
- Putty knife
- Screwdriver
- Silicone caulk
- Scouring pad
- Scouring cleaner
- Plumber's putty
- Flexible vinyl or braided steel supply tubes
- Drain components
- Penetrating oil

Modern kitchen faucets tend to be single-handle models, often with useful features such as a pull-out head that functions as a sprayer. This Pfister model comes with an optional mounting plate that conceals sink holes when mounted on a predrilled sink flange.

MOST NEW KITCHEN FAUCETS feature single-handle control levers and washerless designs that rarely require maintenance. Additional features include brushed metallic finishes, detachable spray nozzles, or even push-button controls.

Connect the faucet to hot and cold water lines with easy-to-install flexible supply tubes made from vinyl or braided steel. If your faucet has a separate sprayer, install the sprayer first. Pull the sprayer hose through the sink opening and attach it to the faucet body before installing the faucet.

Where local codes allow, use plastic tubes for drain hookups. A wide selection of extensions and angle fittings lets you easily plumb any sink configuration. Manufacturers offer kits that contain all the fittings needed for attaching a food disposer or dishwasher to the sink drain system.

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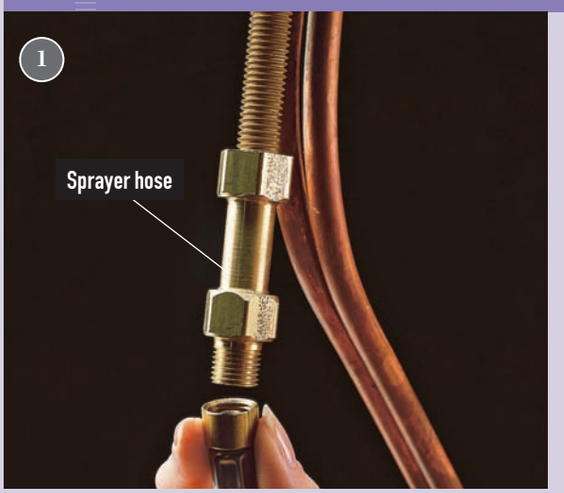
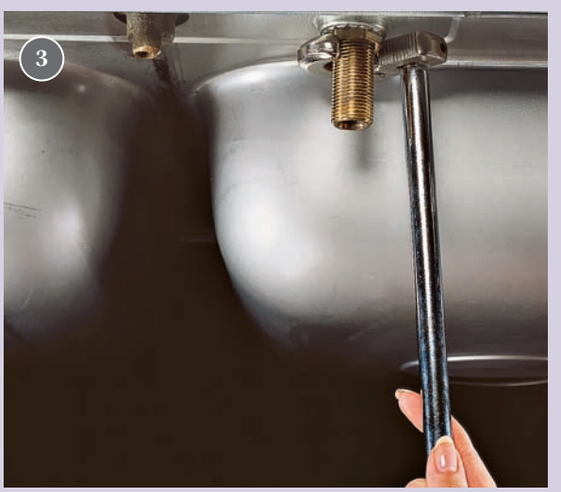
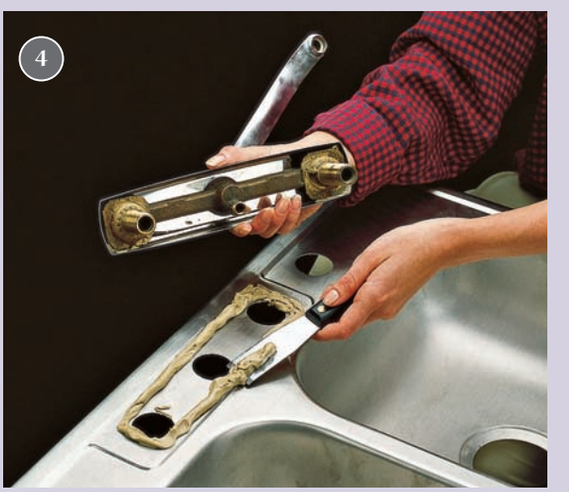
REMOVING AN OLD FAUCET







1 To remove the old faucet, start by clearing out the cabinet under the sink and laying down towels. Turn off the hot and cold stop valves and open the faucet to make sure the water is off. Detach the sprayer hose from the faucet sprayer nipple and unscrew the retaining nut that secures the sprayer base to the sink deck. Pull the sprayer hose out through the sink deck opening.

2 Spray the mounting nuts that hold the faucet or faucet handles (on the underside of the sink deck) with penetrating oil for easier removal. Let the oil soak in for a few minutes. If the nut is rusted and stubbornly stuck, you may need to drill a hole in its side, then tap the hole with a hammer and screwdriver to loosen it.

3 Unhook the supply tubes at the stop valves. Don't reuse old chrome supply tubes. If the stops are missing or unworkable, replace them. Then remove the coupling nuts and the mounting nuts on the tailpieces of the faucet with a basin wrench or channel-type pliers.

4 Pull the faucet body from the sink. Remove the sprayer base if you wish to replace it. Scrape off old putty or caulk with a putty knife and clean off the sink with a scouring pad and an acidic scouring cleaner like Bar Keepers Friend. Tip: Scour stainless steel with a back-and-forth motion to avoid leaving unsightly circular markings.

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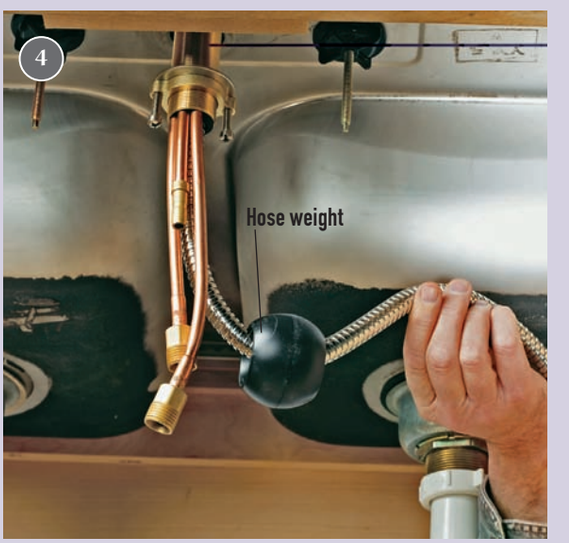
INSTALLING A PULLOUT KITCHEN SINK FAUCET



1 Install the base plate (if your faucet has one) onto the sink flange so it is centered. Have a helper hold it straight from above as you tighten the mounting nuts that secure the base plate from below. Make sure the plastic gasket is centered under the base plate. These nuts can be adequately tightened by hand.

2 Retract the pullout hose by drawing it out through the faucet body until the fitting at the end of the hose is flush with the bottom of the threaded faucet shank. Insert the shank and the supply tubes down through the top of the deck plate.

3 Slip the mounting nut and washer over the free ends of the supply tubes and pullout hose, then thread the nut onto the threaded faucet shank. Hand tighten. Tighten the retainer screws with a screwdriver to secure the faucet.

4 Slide the hose weight onto the pullout hose (the weight helps keep the hose from tangling and it makes it easier to retract).

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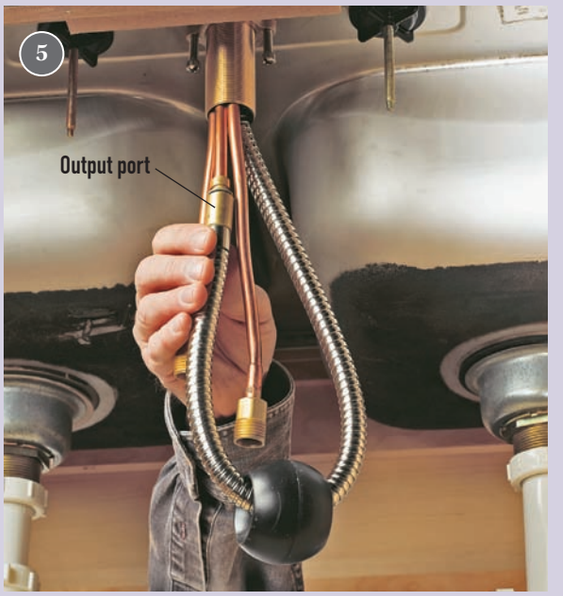

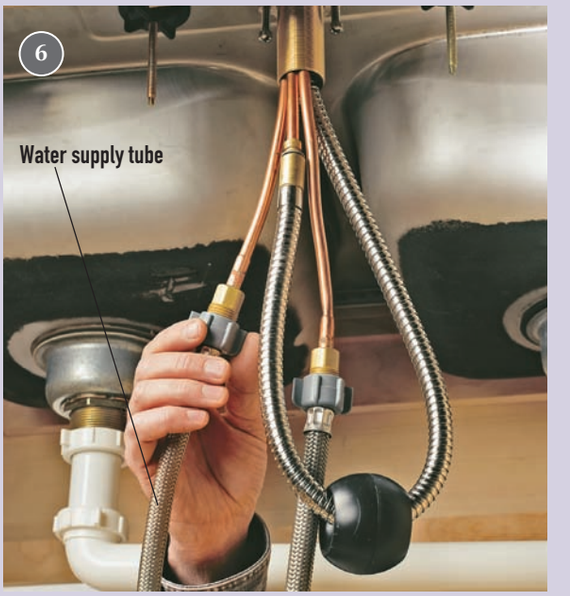

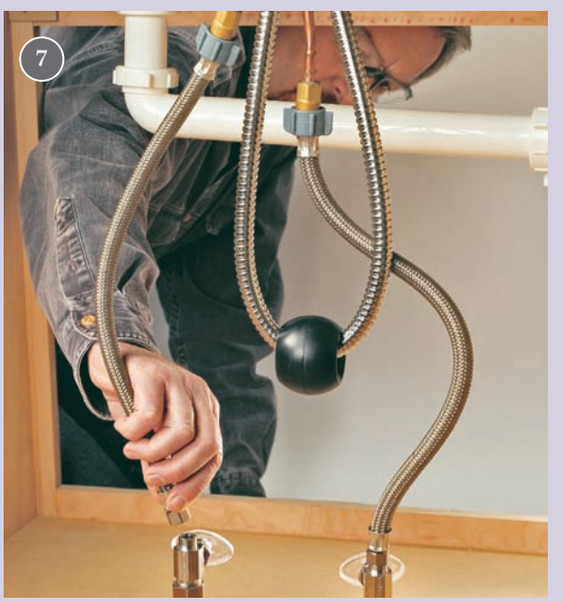

5 Connect the end of the pullout hose to the outlet port on the faucet body using a quick connector fitting.

6 Hook up the water supply tubes to the faucet inlets. Make sure the tubes are long enough to reach the supply risers without stretching or kinking.

7 Connect the supply tubes to the supply risers at the stop valves. Make sure to get the hot lines and cold lines attached correctly.

8 Attach the spray head to the end of the pullout hose and turn the fitting to secure the connection. Turn on water supply and test. Tip: Remove the aerator in the tip of the spray head and run hot and cold water to flush out any debris.

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Identifying Your Faucet and the Parts You Need

A leaky faucet is the most common home plumbing problem. Fortunately, repair parts are available for almost every type of faucet, from the oldest to the newest, and installing these parts is usually easy. But if you don't know your make and model, the hardest part of fixing a leak may be identifying your faucet and finding the right parts. Don't make the common mistake of thinking that any similar-looking parts will do the job; you've got to get exact replacements.

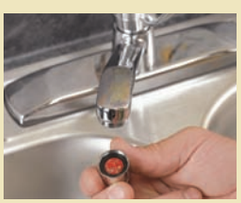
There are so many faucet types that even experts have trouble classifying them into neat categories. Two-handle faucets are either compression (stem) or washerless two-handle. Single-handle faucets are classified as mixing cartridge; ball; disc; or disc/cartridge.

A single-handle faucet with a rounded, dome-shaped cap is often a ball type. If a single-handle faucet has a flat top, it is likely a cartridge or a ceramic disc type. An older two-handle faucet is likely of the compression type; newer two-handle models use washerless cartridges. Shut off the water, and test to verify that the water is off. Dismantle the faucet carefully. Look for a brand name: it may be clearly visible on the baseplate, or may be printed on an inner part, or it may not be printed anywhere. Put all the parts into a reliable plastic bag and take them to your home center or plumbing supply store. A knowledgeable salesperson can help you identify the parts you need.

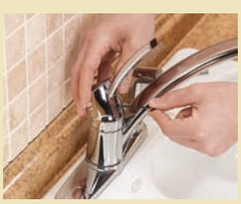
If you cannot find what you are looking for at a local store, check online faucet sites or the manufacturers' sites; they often have step-by-step instructions for identifying what you need. Note that manufacturers' terminology may not match the terms we use here. For example, the word "cartridge" may refer to a ceramic-disc unit.

Most faucets have repair kits, which include all the parts you need, and sometimes a small tool as well. Even if some of the parts in your faucet look fine, it's a good idea to install the parts provided by the kit, to ensure against future wear.

Repair Tips



If water flow is weak, unscrew the aerator at the tip of the spout. If there is sediment, then dirty water is entering the faucet, which could damage the faucet's inner workings.



To remove handles and spouts, work carefully and look for small screw heads. You often need to first pry off a cap on top, but not always. Parts may be held in place with small setscrews.

Cleaning and removing debris can sometimes solve the problem of low water flow, and occasionally can solve a leak as well.

Apply plumber's grease (also known as faucet grease or valve grease), to new parts before installing them. Be especially sure to coat rubber parts like O-rings and washers.

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#175 Dtp:225 Page:74

Compression Faucets

A compression faucet has a stem assembly that includes a retaining nut, threaded spindle, O-ring, stem washer, and stem screw. Dripping at the spout occurs when the washer becomes worn. Leaks around the handle are caused by a worn O-ring.

Pry off the cap on top of the handle and remove the screw that holds the cap onto the stem. Pull the handle up and out. Use an adjustable wrench or pliers to unscrew the stem and pull it out.

If the handle is stuck, try applying mineral cleaner from above. If that doesn't work, you may need to buy a handle puller. With the cap and the hold-down screw removed, position the wings of the puller under the handle and tighten the puller to slowly pull the handle up.

If washers wear out quickly, the seat is likely worn. Use a seat wrench to unscrew the seat from inside the faucet. Replace it with an exact duplicate. If replacing the washer and O-ring doesn't solve the problem, you may need to replace the entire stem.

Remove the screw that holds the rubber washer in place, and pry out the washer. Replace a worn washer with an exact replacement—one that is the same diameter, thickness, and shape.

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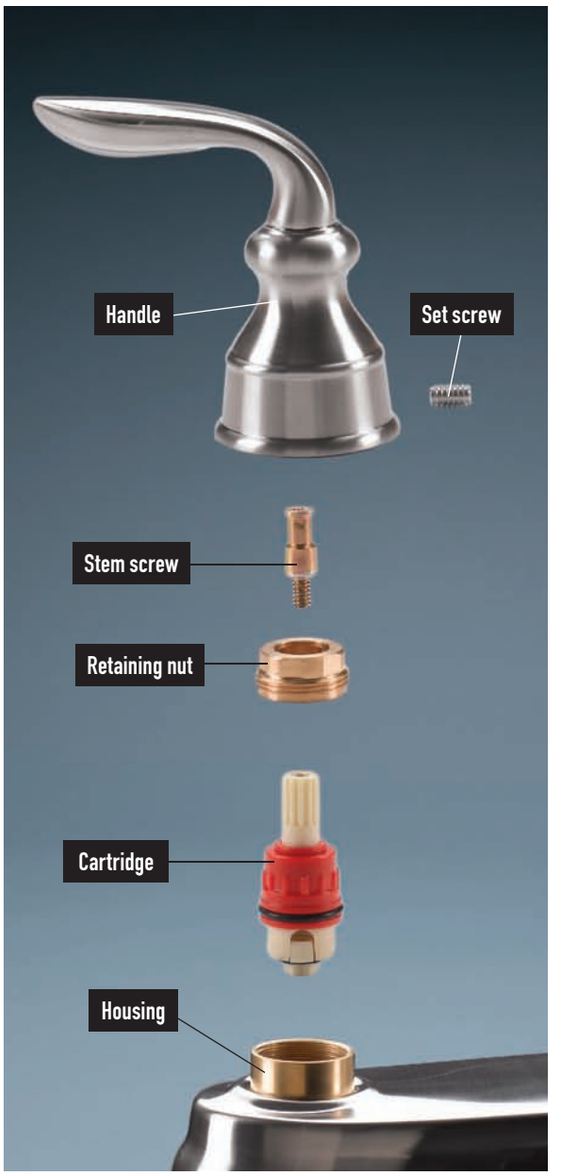
Washerless Two-handle Faucet



Almost all two-handle faucets made today are "washerless." Instead of an older-type compression stem, there is a cartridge, usually with a plastic casing. Many of these cartridges contain ceramic discs, while others have metal or plastic pathways. No matter the type of cartridge, the repair is the same; instead of replacing small parts, you simply replace the entire cartridge.

Remove the faucet handle and withdraw the old cartridge. Make a note of how the cartridge is oriented before you remove it. Purchase a replacement cartridge.

Install the replacement cartridge. Clean the valve seat first and coat the valve seat and O-rings with faucet grease. Be sure the new cartridge is in the correct position, with its tabs seated in the slotted body of the faucet. Re-assemble the valve and handles.

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#175 Dtp:225 Page:76

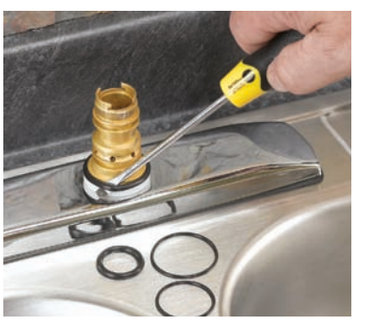
One-Handle Cartridge Faucets

Single-handle cartridge faucets like this work by moving the cartridge up and down and side to side, which opens up pathways to direct varying amounts of hot and cold water to the spout. Moen, Price-Pfister, Delta, Peerless, Kohler, and others make many types of cartridges, some of which look very different from this one.

To remove the spout, pry off the handle's cap and remove the screw below it. Pull the handle up and off. Use a crescent wrench to remove the pivot nut.

Lift out the spout. If the faucet has a diverter valve, remove it as well. Use a screwdriver to pry out the retainer clip, which holds the cartridge in place.

Remove the cartridge. If you simply pull up with pliers, you may leave part of the stem in the faucet body. If that happens, replace the cartridge and buy a stem puller made for your model.



Gently pry out and replace all O-rings on the faucet body. Smear plumber's grease onto the new replacement cartridge and the new O-rings, and reassemble the faucet.

Repair Tips

Here is one of many other types of single-handle cartridges. In this model, all the parts are plastic except for the stem, and it's important to note the direction in which the cartridge is aligned. If you test the faucet and the hot and cold are reversed, disassemble and realign the cartridge.

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#175 Dtp:225 Page:77

Ball Faucets

The ball-type faucet is used by Delta, Peerless, and a few others. The ball fits into the faucet body and is constructed with three holes (not visible here)—a hot inlet, a cold inlet, and the outlet, which fills the valve body with water that then flows to the spout or sprayer. Depending on the position of the ball, each inlet hole is open, closed, or somewhere in-between. The inlet holes are sealed to the ball with valve seats, which are pressed tight against the ball with springs. If water drips from the spout, replace the seats and springs. Or go ahead and purchase an entire replacement kit and replace all or most of the working parts.

Remove the old ball and cam after removing the faucet handle and ball cap. Some faucets may require a ball faucet tool to remove the handle. Otherwise, simply use a pair of channel-type pliers to twist off the ball cap.

Pry out the neoprene valve seals and springs. Place thick towels around the faucet. Slowly turn on the water to flush out any debris in the faucet body. Replace the seals and springs with new parts. Also replace the O-rings on the valve body. You may want to replace the ball and cam, too, especially if you're purchasing a repair kit. Coat all rubber parts in faucet grease, and reassemble the faucet.

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#175 Dtp:225 Page:78

Disc Faucets

Disc-type faucets are the most common single-handle faucets currently being made. A pair of ceramic discs encased in a cylinder often referred to as a "cartridge" rub together as they rotate to open ports for hot and cold water. The ceramic discs do wear out in time, causing leaks, and there is only one solution—replace the disc unit (or cartridge). This makes for an easy—through comparatively expensive—repair.

Replace the cylinder with a new one, coating the rubber parts with faucet grease before installing the new cylinder. Make sure the rubber seals fit correctly in the cylinder openings before you install the cylinder. Assemble the faucet handle.

Other Cartridges

Many modern cartridges do not have seals or O-rings that can be replaced, and some have a ball rather than a ceramic disk inside. For the repair, the cartridge's innards do not matter; just replace the whole cartridge.

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#175 Dtp:225 Page:79

Bathroom Faucets

Tools & Materials

- Hacksaw or tin snips
- Channel-type pliers
- Pliers
- Basin wrench
- Adjustable wrench
- Screwdriver
- Plumber's putty
- Teflon tape
- Faucet kit
- Pipe joint compound
- Flexible supply tubes
- Heat-proof grease
- Loctite basin

Bathroom sink faucets come in two basic styles: the widespread with independent handles and spout (top); and the single-body, deck-mounted version (left).

ONE-PIECE FAUCETS, WITH EITHER ONE or two handles, are the most popular fixtures for bathroom installations.

"Widespread" faucets with separate spout and handles are being installed with increasing frequency, however. Because the handles are connected to the spout with flex tubes that can be 18" or longer, widespread faucets can be arranged in many ways.

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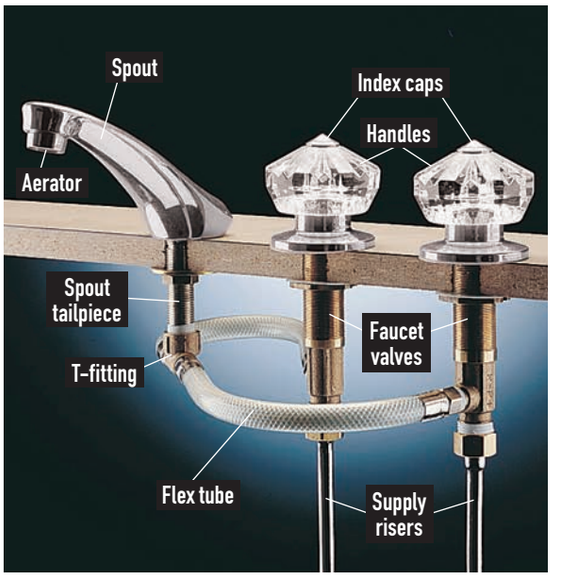
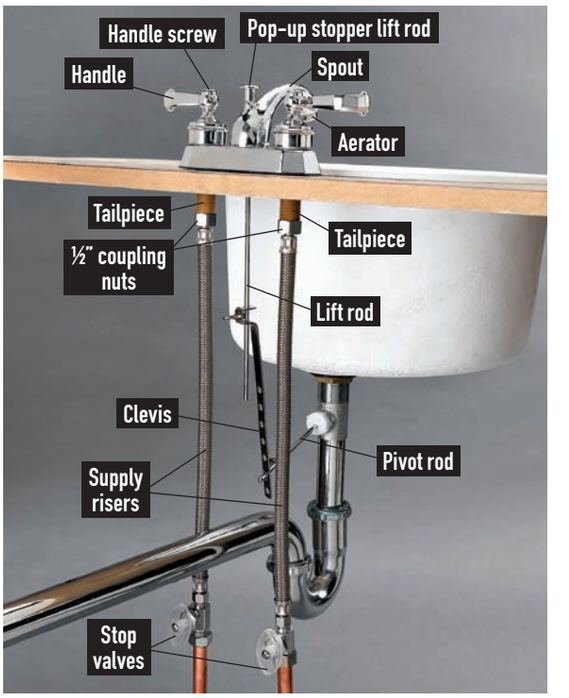
Bathroom Faucet & Drain Hookups

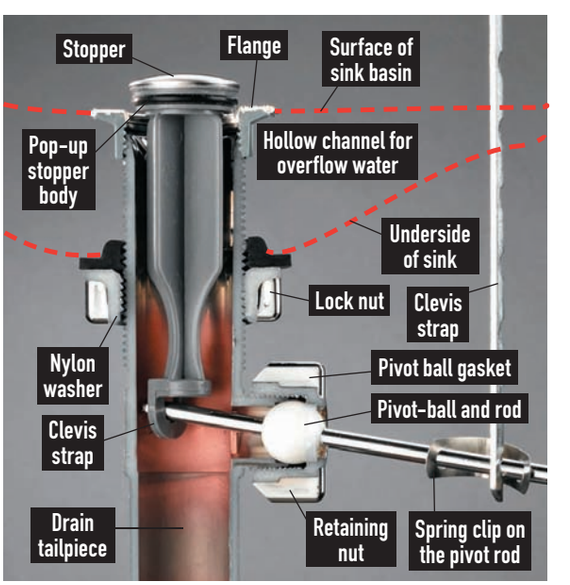


Widespread lavatory faucets have valves that are independent from the spout so they can be configured however you choose, provided that your flex tube connectors are long enough to span the distance.



Single-body lavatory faucets have both valves and the spout permanently affixed to the faucet body. They do not offer flexibility in configurations, but they are very simple to install.

The pop-up stopper fits into the drain opening so the stopper will close tightly against the drain flange when the pop-up handle is lifted up.



The linkage that connects the pop-up stopper to the pop-up handle fits into a male-threaded port in the drain tailpiece. Occasionally the linkage will require adjustment or replacement.

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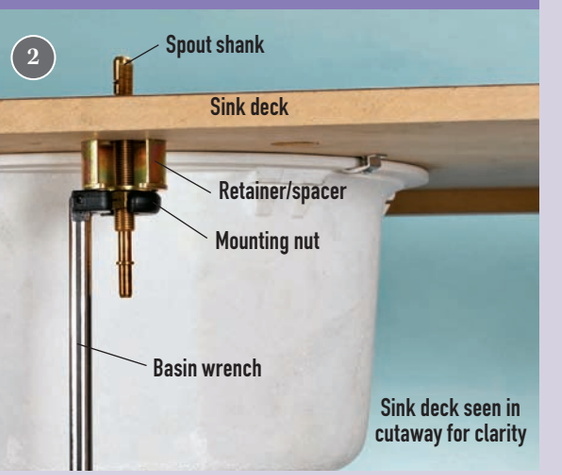
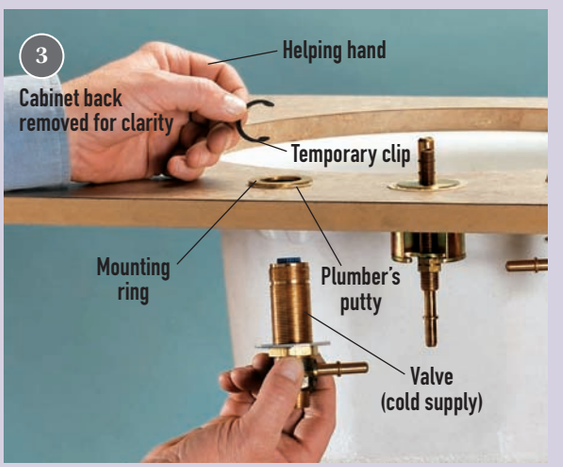
INSTALLING A WIDESPREAD FAUCET





1 Insert the shank of the faucet spout through one of the holes in the sink deck (usually the center hole, but you can offset it in one of the end holes if you prefer). If the faucet is not equipped with seals or O-rings for the spout and handles, pack plumber's putty on the undersides before inserting the valves into the deck. If you are installing the widespread faucet in a new sink deck, drill three holes of the size suggested by the faucet manufacturer.

2 In addition to mounting nuts, many spout valves for widespread faucets have an open-retainer fitting that goes between the underside of the deck and the mounting nut. Others have only a mounting nut. In either case, tighten the mounting nut with pliers or a basin wrench to secure the spout valve. You may need a helper to keep the spout centered and facing forward.

3 Mount the valves to the deck using whichever method the manufacturer specifies (it varies quite a bit). In the model seen here, a mounting ring is positioned over the deck hole (with plumber's putty seal) and the valve is inserted from below. A clip snaps onto the valve from above to hold it in place temporarily (you'll want a helper for this).

4 From below, thread the mounting nuts that secure the valves to the sink deck. Make sure the cold water valve (usually has a blue cartridge inside) is in the right-side hole (from the front) and the hot water valve (red cartridge) is in the left hole. Install both valves.

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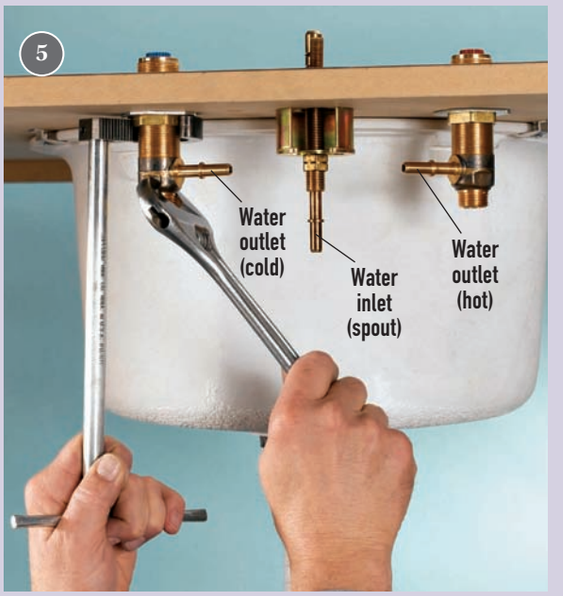

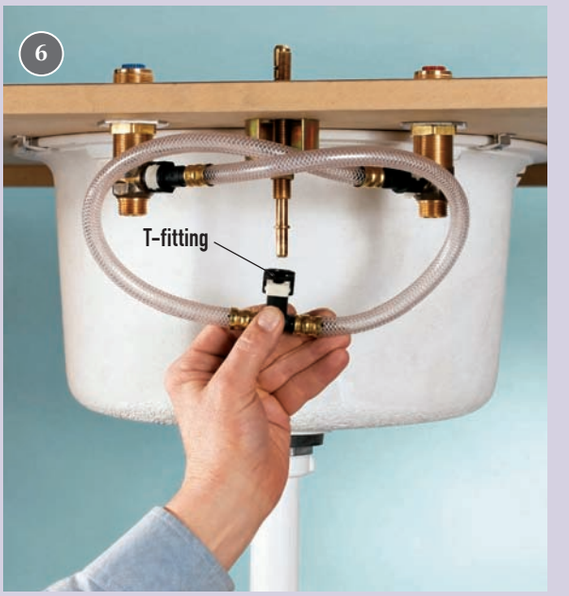

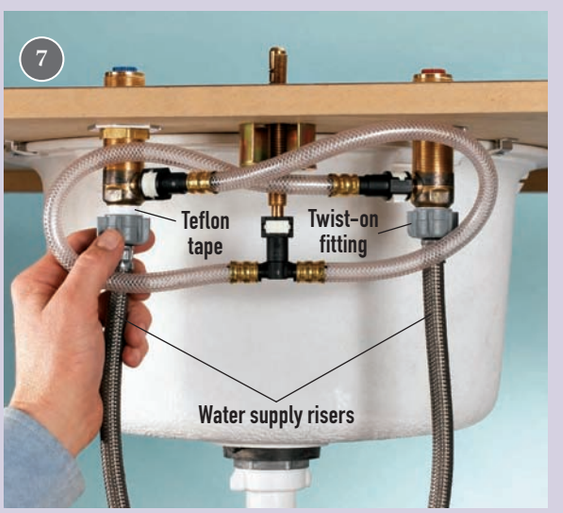

5 Once you've started the nut on the threaded valve shank, secure the valve with a basin wrench, squeezing the lugs where the valve fits against the deck. Use an adjustable wrench to finish tightening the lock nut onto the valve. The valves should be oriented so the water outlets are aimed at the inlet on the spout shank.

6 Attach the flexible supply tubes (supplied with the faucet) to the water outlets on the valves. Some twist onto the outlets, but others (like the ones above) click into place. The supply hoses meet in a T-fitting that is attached to the water inlet on the spout.

7 Attach flexible braided-metal supply risers to the water stop valves and then attach the tubes to the inlet port on each valve (usually with Teflon tape and a twist-on fitting at the valve end of the supply riser).

8 Attach the spout. The model shown here comes with a special hex wrench that is threaded through the hole in the spout where the lift rod for the pop-up drain will be located. Once the spout is seated cleanly on the spout shank, you tighten the hex wrench to secure the spout. Different faucets will use other methods to secure the spout to the shank.

Continued

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#175 Dtp:225 Page:83

9 If your sink did not have a pop-up stopper, you'll need to replace the sink drain tailpiece with a pop-up stopper body (often supplied with the faucet). Insert the lift rod through the hole in the back of the spout and, from below, thread the pivot rod through the housing for the clevis screw.

10 Attach the clevis strap to the pivot rod that enters the pop-up drain body, and adjust the position of the strap so it raises and lowers properly when the lift rod is pulled up. Tighten the clevis screw at this point. It's hard to fit a screwdriver in here, so you may need to use a wrench or pliers.

11 Attach the faucet handles to the valves using whichever method is required by the faucet manufacturer. Most faucets are designed with registration methods to ensure that the handles are symmetrical and oriented in an ergonomic way once you secure them to the valves.

12 Turn on the water supply and test the faucet. Remove the faucet aerator and run the water for 10 to 20 seconds so any debris in the lines can clear the spout. Replace the aerator.

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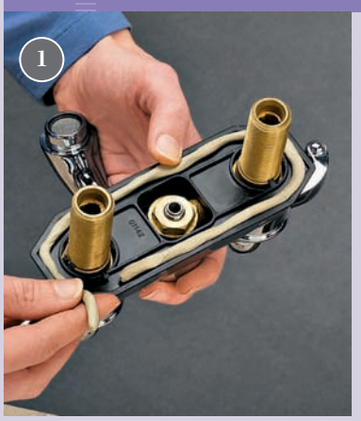
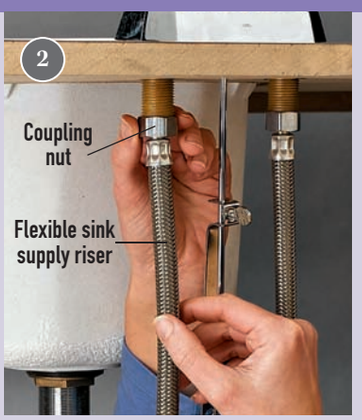
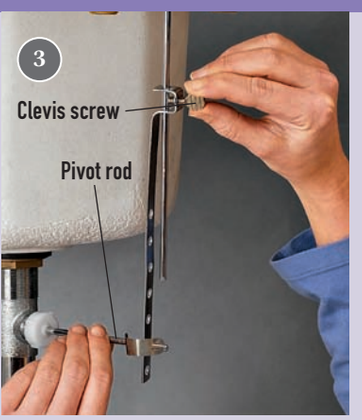
VARIATION: INSTALLING A SINGLE-BODY FAUCET







1 High-quality faucets come with flexible plastic gaskets that create a durable watertight seal at the bottom of the faucet, where it meets the sink deck. However, an inexpensive faucet may have a flimsy-looking foam seal that doesn't do a good job of sealing and disintegrates after a few years. If that is the case with your faucet, discard the seal and press a ring of plumber's putty into the sealant groove on the underside of the faucet body.

2 Insert the faucet tailpieces through the holes in the sink. From below, thread washers and mounting nuts over the tailpieces, then tighten the mounting nuts with a basin wrench until snug. Put a dab of pipe joint compound on the threads of the stop valves and thread the metal nuts of the flexible supply risers to these. Wrench tighten about a half-turn past hand tight. Overtightening these nuts will strip the threads. Now tighten the coupling nuts to the faucet tailpieces with a basin wrench.

3 Slide the lift rod of the new faucet into its hole behind the spout. Thread it into the clevis past the clevis screw. Push the pivot rod all the way down so the stopper is open. With the lift rod also all the way down, tighten the clevis to the lift rod.

4 Grease the fluted valve stems with faucet grease, then put the handles in place. Tighten the handle screws firmly, so they won't come loose during operation. Cover each handle screw with the appropriate index cap—Hot or Cold.

5 Unscrew the aerator from the end of the spout. Turn the hot and cold water taps on full. Turn the water back on at the stop valves and flush out the faucet for a couple of minutes before turning off the water at the faucet. Check the riser connections for drips. Tighten a compression nut only until the drip stops. Replace the aerator.

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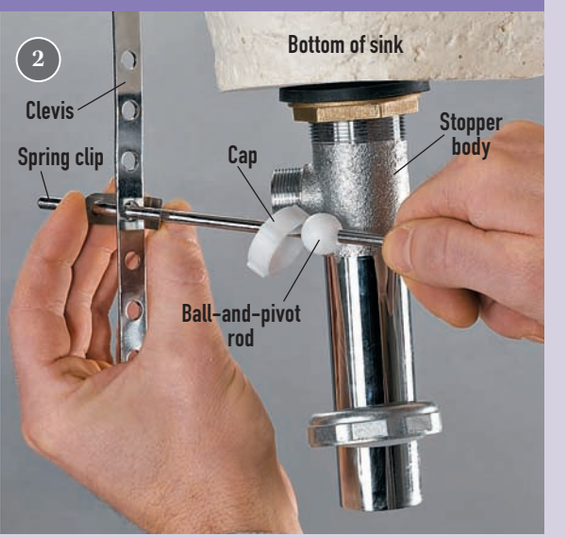
INSTALLING A POP-UP DRAIN



1 Put a basin under the trap to catch water. Loosen the nuts at the outlet and inlet to the trap J-bend by hand or with channel-type pliers and remove the bend. The trap will slide off the pop-up body tailpiece when the nuts are loose. Keep track of washers and nuts and their up/down orientation by leaving them on the tubes.

2 Unscrew the cap holding the ball-and-pivot rod in the pop-up body and withdraw the ball. Compress the spring clip on the clevis and withdraw the pivot rod from the clevis.

3 Remove the pop-up stopper. Then, from below, remove the lock nut on the stopper body. If needed, keep the flange from turning by inserting a large screwdriver in the drain from the top. Thrust the stopper body up through the hole to free the flange from the basin, and then remove the flange and the stopper body.

4 Clean the drain opening above and below, and then thread the locknut all the way down the new pop-up body, followed by the flat washer and the rubber gasket (beveled side up). Wrap three layers of Teflon tape clockwise onto the top of the threaded body. Make a ½"-dia. snake from plumber's putty, form it into a ring, and stick the ring underneath the drain flange.

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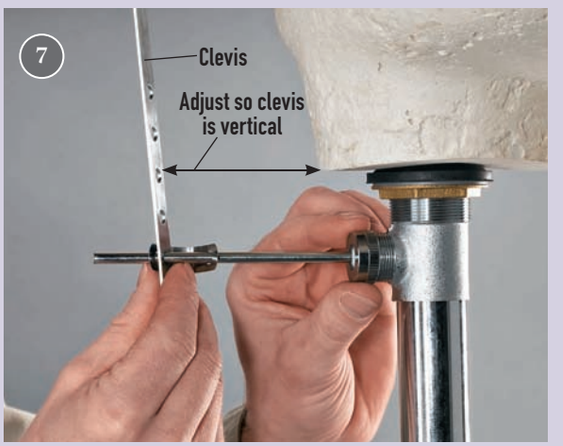

5 From below, face the pivot rod opening directly back toward the middle of the faucet and pull the body straight down to seat the flange. Thread the locknut/washer assembly up under the sink, then fully tighten the locknut with channel-type pliers. Do not twist the flange in the process, as this can break the putty seal. Clean off the squeezeout of plumber's putty from around the flange.

6 Drop the pop-up stopper into the drain hole so the hole at the bottom of its post is closest to the back of the sink. Put the beveled nylon washer into the opening in the back of the pop-up body with the bevel facing back.

7 Put the cap behind the ball on the pivot rod as shown. Sandwich a hole in the clevis with the spring clip and thread the long end of the pivot rod through the clip and clevis. Put the ball end of the pivot rod into the pop-up body opening and into the hole in the stopper stem. Screw the cap on to the pop-up body over the ball.

8 Loosen the clevis screw holding the clevis to the lift rod. Push the pivot rod all the way down (which fully opens the pop-up stopper). With the lift rod also all the way down, tighten the clevis screw to the rod. If the clevis runs into the top of the trap, cut it short with your hacksaw or tin snips. Reassemble the J-bend trap.

Always Test Drain for Leaks

To make sure the sink will not leak, do a thorough test. Close the stopper and turn on the faucet to fill the bowl. Once full, open the stopper and look carefully beneath the sink. Feel the trap parts; they should be dry. If there is any indication of moisture, tighten trap parts as needed.

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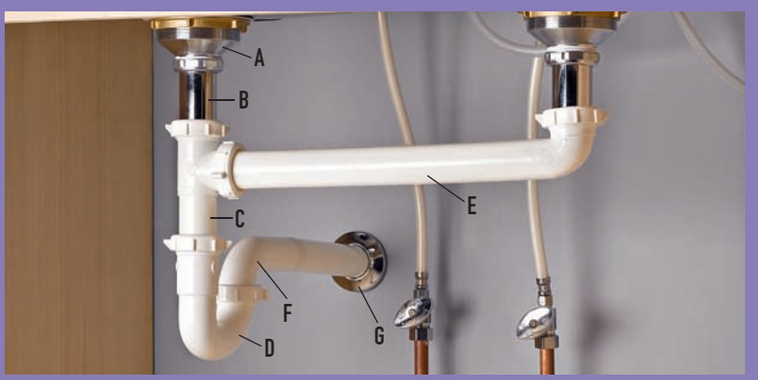
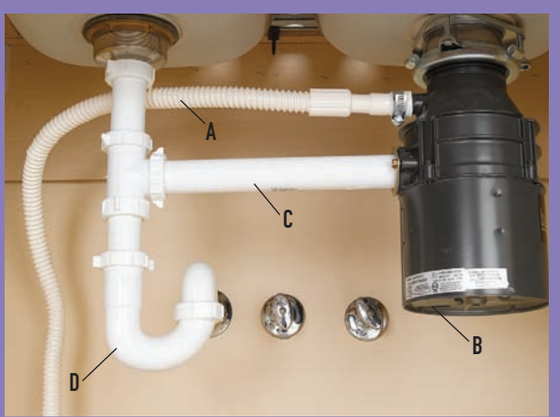
Kitchen Drains & Traps



Kitchen sink drains include a strainer body (A), tailpiece (B), waste-T (C), P-trap (D), outlet drain line (E), trap arm (F), and wall stubout with coupling (G).

Tools & Materials

- Flat screwdriver
- Spud wrench
- Trap arm
- Mineral spirits
- Cloth
- Strainer kit
- Plumber's putty
- Teflon tape
- Washers
- Waste-T fitting
- P-trap
- Saw
- Miter box



In this arrangement, the dishwasher drain hose (A) attaches to the food disposer (B), and a trap arm (C) leads from the disposer to the P-trap (D).

A "center tee" arrangement has a single P-trap (A) that is connected to a waste T (B) and the trap arm (C).

KITCHEN TRAPS, ALSO CALLED sink drains or trap assemblies, are made of 1½-inch pipes (also called tubes), slip washers, and nuts, so they can be easily assembled and disassembled. Most plastic types can be tightened by hand, with no wrench required. Pipes made of chromed brass will corrode in time, and rubber washers will crumble, meaning they need to be replaced. Plastic pipes and plastic washers last virtually forever. All traps are liable to get bumped out of alignment; when this happens, they should be taken apart and reassembled.

A trap's configuration depends on how many bowls the sink has, whether or not you have a food disposer and/or a dishwasher drain line, and local codes. On this page we show three of the most common assembly types. T fittings on these traps often have a baffle, which reduces the water flow somewhat. Check local codes to make sure your trap is compliant.

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#175 Dtp:225 Page:88

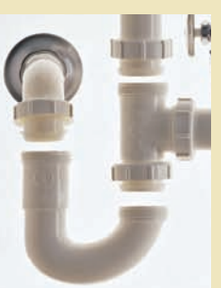
Tip: Drain Kits

Kits for installing a new sink drain include all the pipes, slip fittings, and washers you'll need to get from the sink tailpieces (most kits are equipped for a double bowl kitchen sink) to the trap arm that enters the wall or floor. For wall trap arms, you'll need a kit with a P-trap. Both drains normally are plumbed to share a trap. Chromed brass or PVC with slip fittings let you adjust the drain more easily and pull it apart and then reassemble if there is a clog. Some pipes have fittings on their ends that eliminate the need for a washer. Kitchen sink drains and traps should be 1½" o.d. pipe—the 1¼" pipe is for lavatories and doesn't have enough capacity for a kitchen sink.

Tips for Choosing Drains

To make sure the sink will not leak, do a thorough test. Close the stopper and turn on the faucet to fill the bowl. Once full, open the stopper and look carefully beneath the sink. Feel the trap parts; they should be dry. If there is any indication of moisture, tighten trap parts as needed.

Wall thickness varies in sink drain pipes. The thinner plastic material is cheaper and more difficult to obtain a good seal than with the thicker, more expensive tubing. The thin product is best reserved for lavatory drains, which are far less demanding.



Slip joints are formed by tightening a male-threaded slip nut over a female-threaded fitting, trapping and compressing a beveled nylon washer to seal the joint.

Use a spud wrench to tighten the strainer body against the underside of the sink bowl. Normally, the strainer flange has a layer of plumber's putty to seal beneath it above the sink drain, and a pair of washers (one rubber, one fibrous) to seal below.

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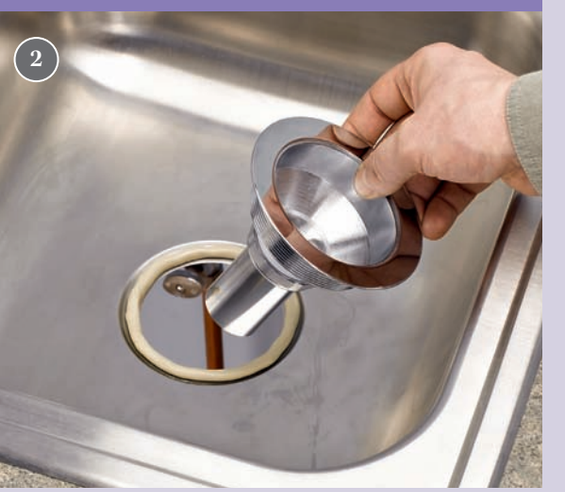
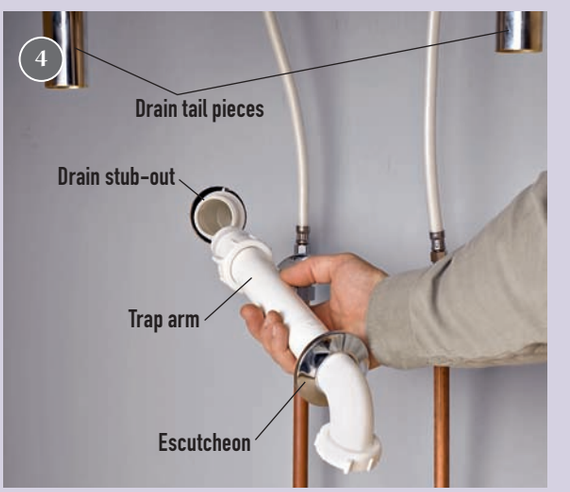
HOOKING UP A KITCHEN SINK DRAIN





1 If you are replacing the sink strainer body, remove the old one and clean the top and bottom of the sink deck around the drain opening with mineral spirits. Attach the drain tailpiece to the threaded outlet of the strainer body, inserting a nonbeveled washer between the parts if your strainer kits include one. Lubricate the threads or apply Teflon tape so you can get a good, snug fit.

2 Apply plumber's putty around the perimeter of the drain opening and seat the strainer assembly into it. Add washers below as directed and tighten the strainer locknut with a spud wrench (see photo, previous page) or by striking the mounting nubs at the top of the body with a flat screwdriver.

3 You may need to cut a trap arm or drain tailpiece to length. Cut metal tubing with a hacksaw. Cut plastic tubing with a handsaw, power miter saw, or a hand miter box and a backsaw or hacksaw. You can use a tubing cutter for any material. Deburr the cut end of plastic tubing with a utility knife.

4 Attach the trap arm to the male-threaded drain stubout in the wall, using a slip nut and beveled compression washer. The outlet for the trap arm should point downward. Note: The trap arm must be lower on the wall than any of the horizontal lines in the set-up, including lines to dishwasher, disposer, or the outlet line to the second sink bowl.

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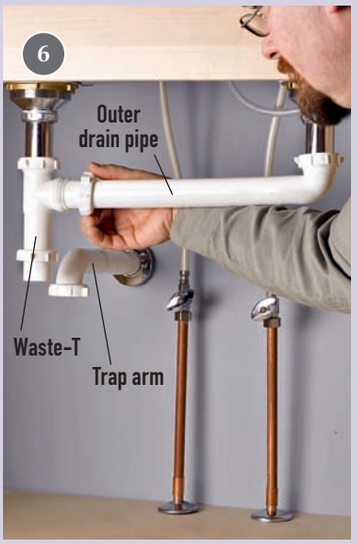
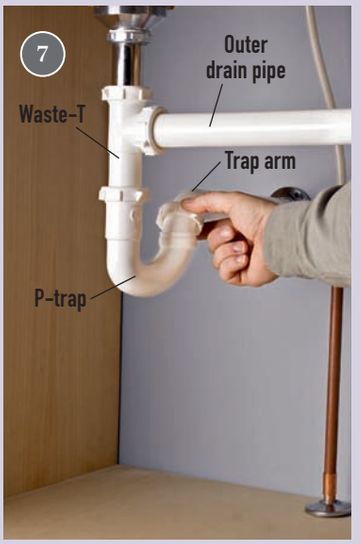




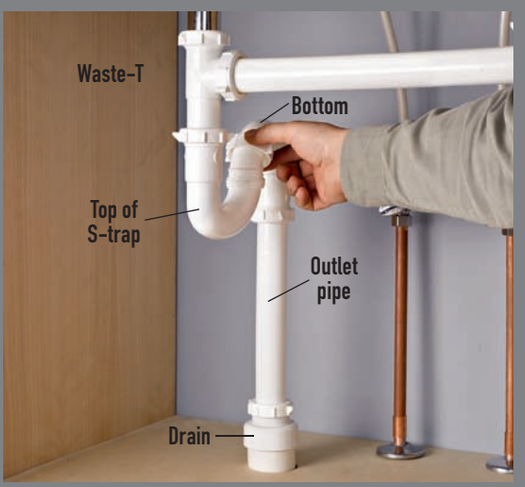
5 Attach a waste-T-fitting to the drain tailpiece, orienting the opening in the fitting side so it will accept the outlet drain line from the other sink bowl. If the waste-T is higher than the top of the trap arm, remove it and trim the drain tailpiece.

6 Join the short end of the outlet drain pipe to the tailpiece for the other sink bowl and then attach the end of the long run to the opening in the waste-T. The outlet tube should extend into the T ½"—make sure it does not extend in far enough to block water flow from above.

7 Attach the long leg of a P-trap to the waste-T and attach the shorter leg to the downward-facing opening of the trap arm. Adjust as necessary and test all joints to make sure they are still tight, and then test the system.

Variation: Drain in Floor

If your drain stubout comes up out of the floor instead of the wall, you have an S-trap instead of a P-trap. This arrangement is illegal in many parts of the country, because a heavy surge of water can siphon the trap dry, rendering it unable to trap gases. However, if after draining the sink you run a slow to moderate stream of water for a few seconds, the trap will fill. An S-trap has two trap pipes that lead to a straight vertical pipe.



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CLOGGED SINK DRAINS

Every sink has a drain trap and a fixture drain line. Sink clogs usually are caused by a buildup of soap and hair in the trap or fixture drain line. Remove clogs by using a plunger, disconnecting and cleaning the trap or using a hand auger.

Many sinks hold water with a mechanical plug called a pop-up stopper. If the sink will not hold standing water, or if water in the sink drains too slowly, the pop-up stopper must be cleaned and adjusted.

Tools & Materials

- Plunger
- Channel-type pliers
- Small wire brush
- Screwdriver
- Flashlight
- Rag
- Bucket
- Replacement gaskets
- Teflon tape

Clogged lavatory sinks can be cleared with a plunger (not to be confused with a flanged force-cup). Remove the pop-up drain plug and strainer first, and plug the overflow hole by stuffing a wet rag into it, allowing you to create air pressure with the plunger.

CLEARING A SINK TRAP

1 Place bucket under trap to catch water and debris. Loosen slip nuts on trap bend with channel-type pliers. Unscrew nuts by hand and slide away from connections. Pull off trap bend.

2 Dump out debris. Clean trap bend with a small wire brush. Inspect slip nut washers for wear and replace if necessary. Reinstall trap bend and tighten slip nuts.

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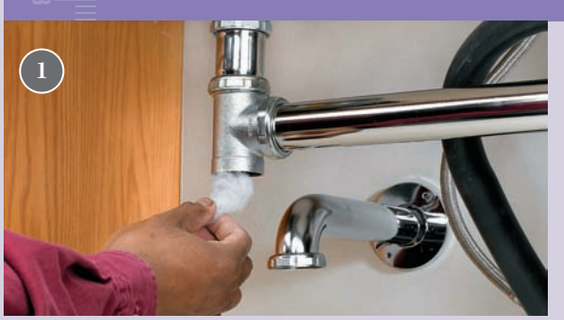
#175 Dtp:225 Page:92

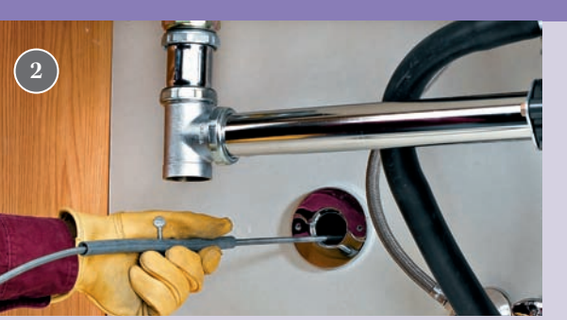
CLEARING A KITCHEN SINK

1 Plunging a kitchen sink is not difficult, but you need to create an uninterrupted pressure lock between the plunger and the clog. If you have a dishwasher, the drain tube needs to be clamped shut and sealed off at the disposer or drainline. The pads on the clamp should be large enough to flatten the tube across its full diameter (or you can clamp the tube ends between small boards).

2 If there is a second basin, have a helper hold a basket strainer plug in its drain or put a large pot or bucket full of water on top of it. Unfold the skirt within the plunger and place this in the drain of the sink you are plunging. There should be enough water in the sink to cover the plunger head. Plunge rhythmically for six repetitions with increasing vigor, pulling up hard on the last repetition. Repeat this sequence until the clog is removed. Flush out a cleared clog with plenty of hot water.

USING A HAND AUGER AT THE TRAP ARM





1 If plunging doesn't work, remove the trap and clean it out (see previous page). With the trap off, see if water flows freely from both sinks (if you have two). Sometimes clogs will lodge in the T-fitting or one of the waste pipes feeding it. These may be pulled out manually or cleared with a bottlebrush or wire. When reassembling the trap, apply Teflon tape clockwise to the male threads of metal waste pieces. Tighten with your channel-type pliers. Plastic pieces need no tape and should be hand tightened only.

2 If you suspect the clog is downstream of the trap, remove the trap arm from the fitting at the wall. Look in the fixture drain with a flashlight. If you see water, that means the fixture drain is plugged. Clear it with a hand-crank or drill-powered auger.

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#175 Dtp:225 Page:93

Dishwashers

Tools & Materials

Screwdrivers
Adjustable wrench
2-ft. level
⅝" automotive heater hose
Automotive heater hose
4"-length of ½" copper tubing
Cable connector
Teflon tape
Hose clamps
Wire connectors
Carpet scrap
Bowl

Replacing an old, inefficient dishwasher is a straightforward project that usually takes just a few hours. The energy savings begin with the first load of dishes and continue with every load thereafter.

A DISHWASHER THAT'S PAST its prime may be inefficient in more ways than one. If it's an old model, it probably wasn't designed to be very efficient to begin with. But more significantly, if it no longer cleans effectively, you're probably spending a lot of time and hot water pre-rinsing the dishes. This alone can consume more energy and water than a complete wash cycle on a newer machine. So even if your old dishwasher still runs, replacing it with an efficient new model can be a good green upgrade.

In terms of sizing and utility hookups, dishwashers are generally quite standard. If your old machine is a built-in and your countertops and cabinets are standard sizes, most full-size dishwashers will fit right in. Of course, you should always measure the dimensions of the old unit before shopping for a new one to avoid an unpleasant surprise at installation time. Also be sure to review the manufacturer's instructions before starting any work.

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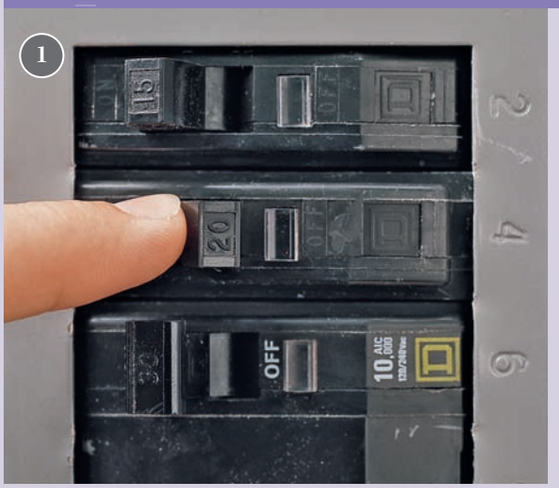
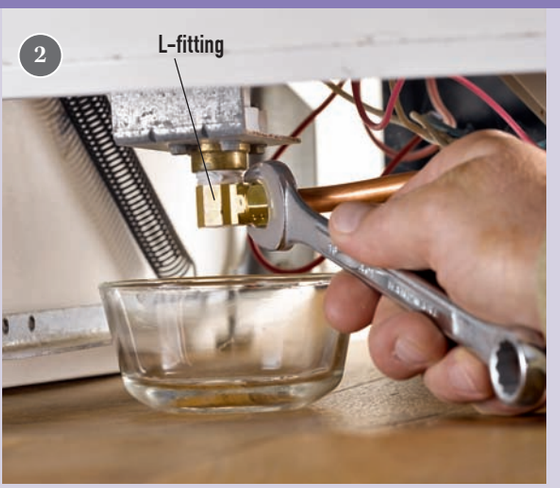
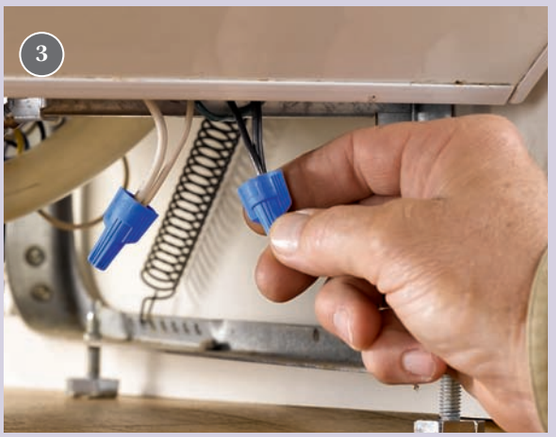
REPLACING A DISHWASHER







1 Start by shutting off the electrical power to the dishwasher circuit at the service panel. Also, turn off the water supply at the shutoff valve, usually located directly under the floor.

2 Disconnect old plumbing connections. First unscrew the front access panel. Once the access panel is removed, disconnect the water supply line from the L-fitting on the bottom of the unit. This is usually a brass compression fitting, so just turning the compression nut counterclockwise with an adjustable wrench should do the trick. Use a bowl to catch any water that might leak out when the nut is removed.

3 Disconnect old wiring connections. The dishwasher has an integral electrical box at the front of the unit where the power cable is attached to the dishwasher's fixture wires. Take off the box cover and remove the wire connectors that join the wires together.

4 Disconnect the discharge hose, which is usually connected to the dishwasher port on the side of the garbage disposer. To remove it, just loosen the screw on the hose clamp and pull it off. You may need to push this hose back through a hole in the cabinet wall and into the dishwasher compartment so it won't get caught when you pull the dishwasher out.

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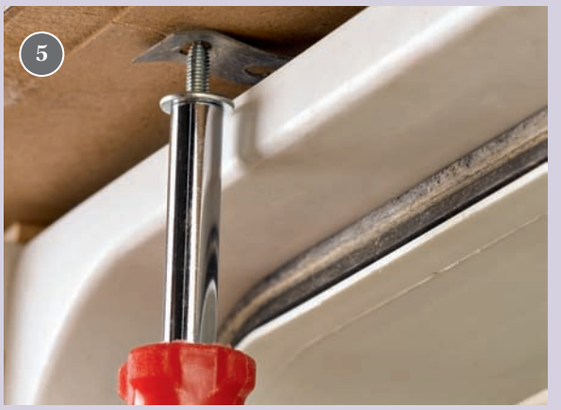

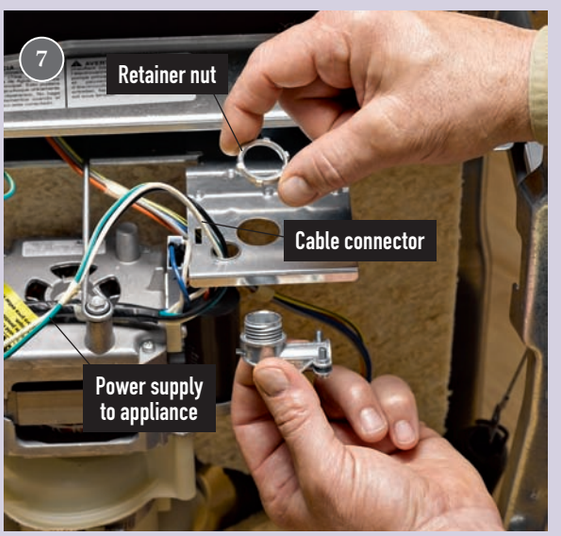

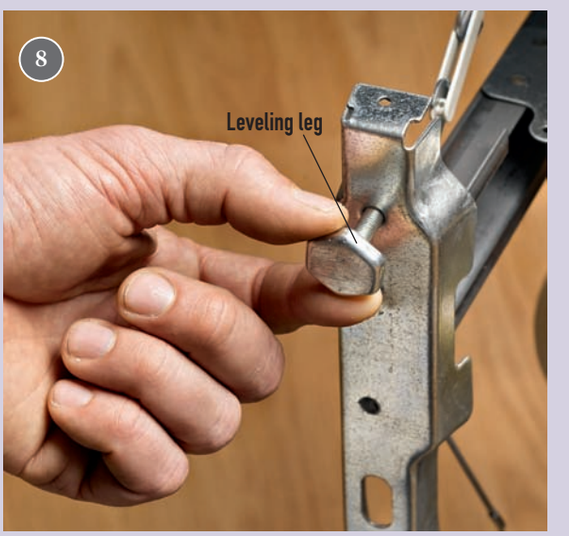

5 Detach the unit from the cabinets before you pull it out. Remove the screws that hold the brackets to the underside of the countertop. Then put a piece of cardboard or old carpet under the front legs to protect the floor from getting scratched, and pull the dishwasher out.

6 First, prepare the new dishwasher. Tip it on its back and attach the new L-fitting into the threaded port on the solenoid. Apply some Teflon tape or pipe sealant to the fitting threads before tightening it in place to prevent possible leaks.

7 Prepare for the wiring connections. Like the old dishwasher, the new one will have an integral electrical box for making the wiring connections. To gain access to the box, just remove the box cover. Then install a cable connector on the back of the box and bring the power cable from the service panel through this connector. Power should be shut off at the main service panel at all times.

8 Install a leveling leg at each of the four corners while the new dishwasher is still on its back. Just turn the legs into the threaded holes designed for them. Leave about ½" of each leg projecting from the bottom of the unit. These will have to be adjusted later to level the appliance. Tip the appliance up onto the feet and slide it into the opening. Check for level in both directions and adjust the feet as required.

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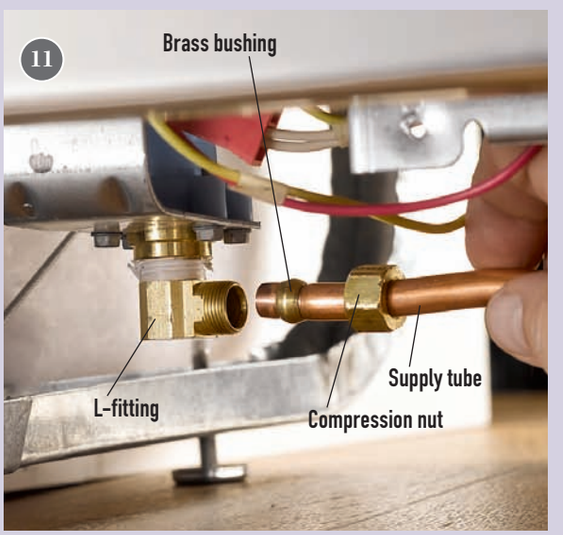
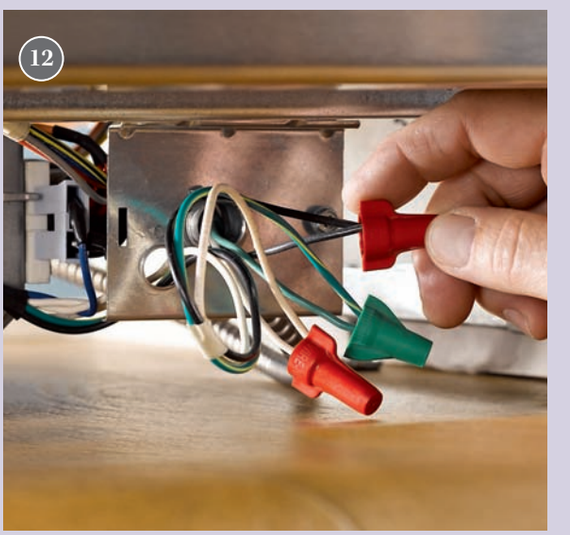
#175 Dtp:225 Page:96

Tip: Tube Choices

Codes still allow copper supply tubes like the one shown, but a 4- to 5-ft. flexible dishwasher supply tube is a better choice if you are likely to be sliding the appliance in and out. A copper tube is less likely to burst, so it may be preferable in cases where the appliance is unlikely to be moved.





9 Once the dishwasher is level, attach the brackets to the underside of the countertop to keep the appliance from moving. Then pull the discharge hose into the sink cabinet and install it so there's a loop that is attached with a bracket to the underside of the countertop. This loop prevents waste water from flowing from the disposer back into the dishwasher. Note: Some codes require that you install an air gap fitting for this purpose. Check with your local plumbing inspector.

10 Push an adapter over the disposer's discharge nipple and tighten it in place with a hose clamp. If you don't have a disposer, replace one of the drain tailpieces with a dishwasher tailpiece, and clamp the discharge tube to its fitting.

11 Adjust the L-fitting on the dishwasher's water inlet valve until it points directly toward the water supply tubing. Then lubricate the threads slightly with a drop of dishwashing liquid and tighten the tubing's compression nut onto the fitting. Keeping the brass bushing between the nut and the L-fitting. Use an adjustable wrench and turn the nut clockwise.

12 Complete the electrical connections by clamping the cable and joining the wires with wire nuts, following manufacturer's instructions. Replace the electrical cover, usually by hooking it onto a couple of prongs and driving a screw. Restore power and water, and test. Replace the toe-kick.

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#175 Dtp:225 Page:97

Food Disposers

Tools & Materials

- Screwdriver
- Channel-type pliers
- Spud wrench (optional)
- Hammer
- Hacksaw or tubing cutter
- Kitchen drain supplies
- Drain auger
- Putty knife
- Mineral spirits
- Plumber's putty
- Wire caps
- Hose clamps
- Threaded Y-fitting
- Electrical tape

A properly functioning food disposer that's used correctly can help reduce clogs. Some plumbers use separate P-traps for the disposer and the drain outlet tube as shown here. Others contend that configuring the drain line with a single P-trap minimizes the chance that a trap will have its water seal broken by suction from the second trap.

FOOD DISPOSERS ARE standard equipment in the modern home, and most of us have come to depend on them to macerate our plate leavings and crumbs so they can exit the house along with waste water from the sink drain. If your existing disposer needs replacing, you'll find that the job is relatively simple, especially if you select a replacement appliance that is the same model as the old one. In that case, you can probably reuse the existing mounting assembly, drain sleeve, and drain plumbing.

Disposers are available with power ratings between 1/3 and 1 HP (horsepower). More powerful models bog down less under load and the motors last longer because they don't have to work as hard. They are also costlier.

Choose a switch option that meets your family's safety needs. A "continuous feed" disposer may be controlled by a standard on-off switch on the wall. Another option is a disposer that stays on only when the switch is actively pressed. A "batch feed" disposer can turn on only when a lid is locked onto it, eliminating the possibility of harming fingers. Some models are controlled at the lid, without a wall switch. Continuous food disposers are the most common.

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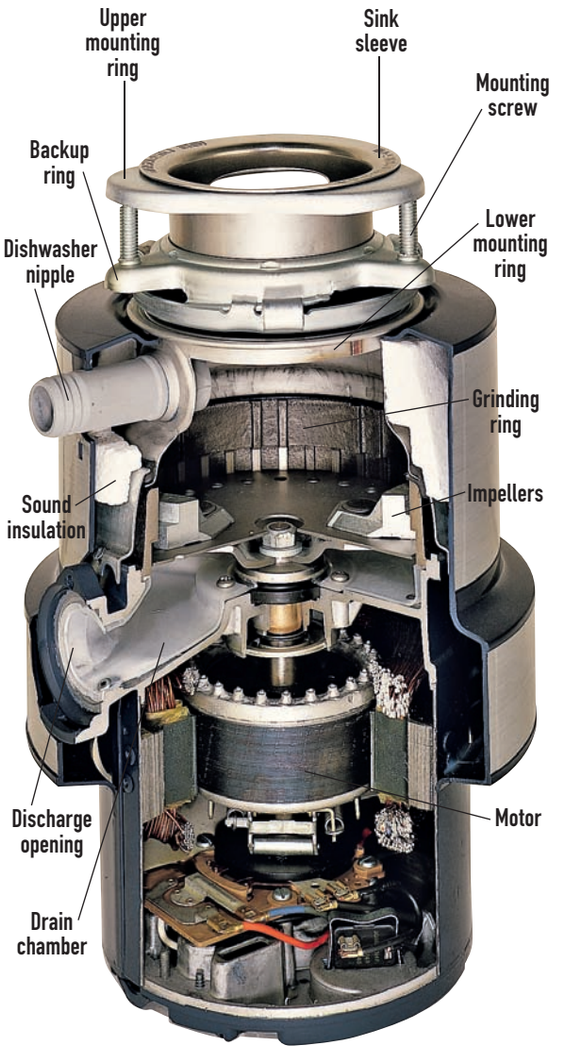
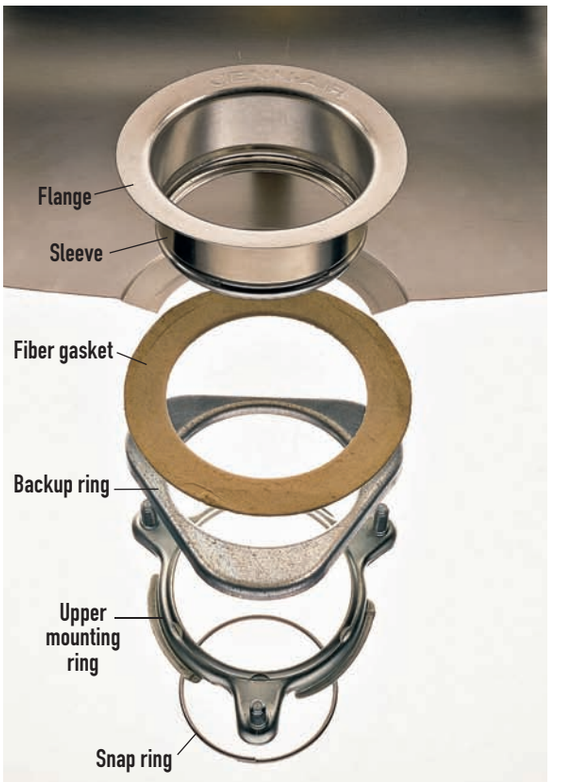
Shown cutaway

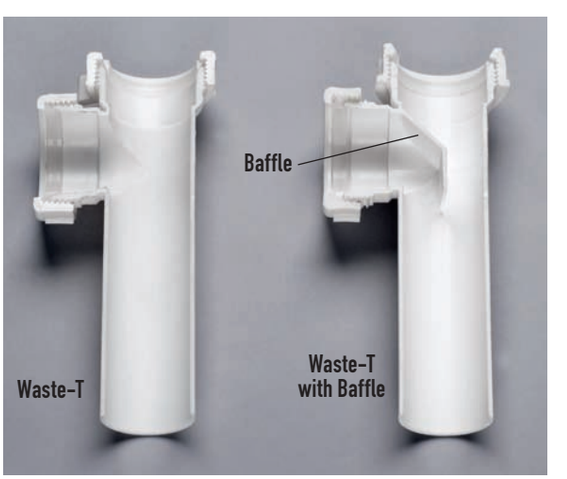


A food disposer grinds food waste so it can be flushed away through the sink drain system. A quality disposer has a ½ –horsepower, or larger, self-reversing motor. Other features to look for include foam sound insulation, a grinding ring, and overload protection that allows the motor to be reset if it overheats. Better food disposers have a 5-year manufacturer's warranty.

Kitchen and drain tees are required to have a baffle if the tee is connected to a dishwasher or disposer. The baffle is intended to prevent discharge from finding its way up the drain and into the sink.



The disposer is attached directly to the sink sleeve, which comes with the disposer and replaces the standard sink strainer. A snap ring fits into a groove around the sleeve of the strainer body to prevent the upper mounting ring and backup ring from sliding down while the upper mounting ring is tightened against the backup ring with mounting screws. A fiber gasket compresses when the mounting screws are tightened to create a better seal under the flange.



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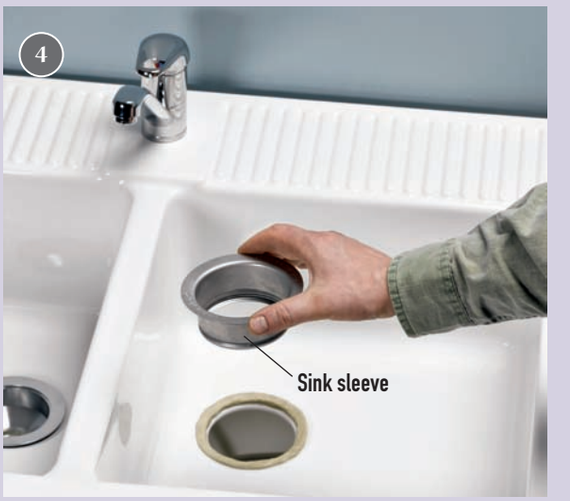
INSTALLING A FOOD DISPOSER



1 Remove the old disposer if you have one. You'll need to disconnect the drain pipes and traps first. If your old disposer has a special wrench for the mounting lugs, use it to loosen the lugs. Otherwise, use a screwdriver. If you do not have a helper, place a solid object directly beneath the disposer to support it before you begin removal. Important: Shut off electrical power at the main service panel before you begin removal. Disconnect the wire leads, cap them, and stuff them into the electrical box.

2 Clear the drain lines all the way to the branch drain before you begin the new installation. Remove the trap and trap arm first.

3 Disassemble the mounting assembly and then separate the upper and lower mounting rings and the backup ring. Also remove the snap ring from the sink sleeve. See photo, previous page.

4 Press the flange of the sink sleeve for your new disposer into a thin coil of plumber's putty that you have laid around the perimeter of the drain opening. The sleeve should be well-seated in the coil.

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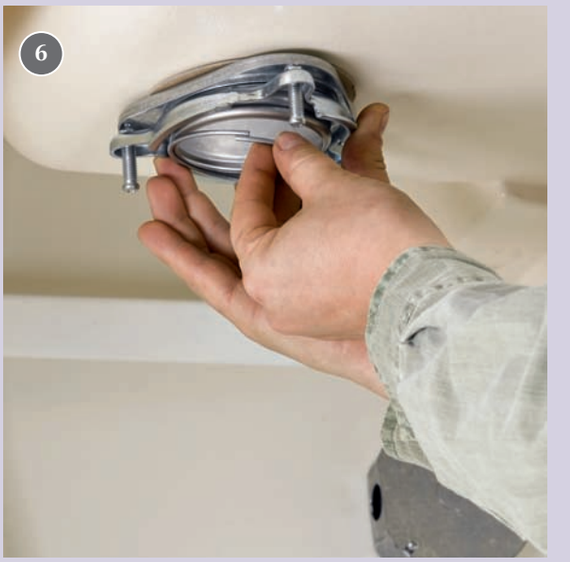

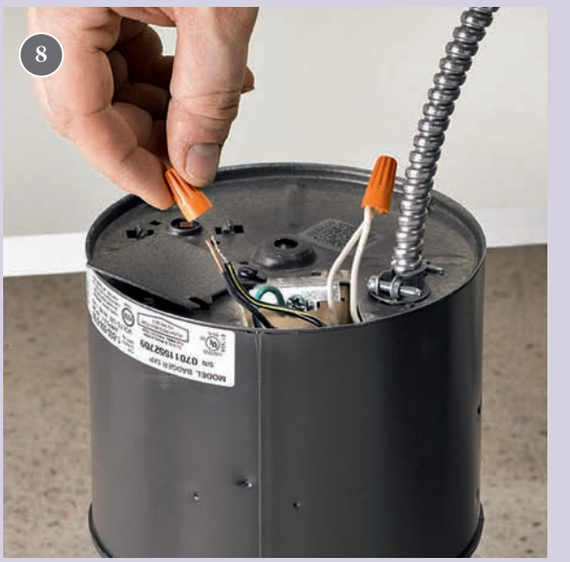

5 Slip the fiber gasket and then the backup ring onto the sink sleeve, working from inside the sink base cabinet. Make sure the backup ring is oriented the same way it was before you disassembled the mounting assembly.

6 Insert the upper mounting ring onto the sleeve with the slotted ends of the screws facing away from the backup ring so you can access them. Then, holding all three parts at the top of the sleeve, slide the snap ring onto the sleeve until it snaps into the groove.

7 Tighten the three mounting screws on the upper mounting ring until the tips press firmly against the backup ring. It is the tension created by these screws that keeps the disposer steady and minimizes vibrating.

8 Make electrical connections before you mount the disposer unit on the mounting assembly. Shut off the power at the service panel if you have turned it back on. Remove the access plate from the disposer. Attach the white and black feeder wires from the electrical box to the white and black wires (respectively) inside the disposer. Twist a small wire cap onto each connection and wrap it with electrical tape for good measure. Also attach the green ground wire from the box to the grounding terminal on your disposer.

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9 Knock out the plug in the disposer port if you will be connecting your dishwasher to the disposer. If you have no dishwasher, leave the plug in. Insert a large flathead screwdriver into the port opening and rap it with a mallet. Retrieve the knock-out plug from inside the disposer canister.

10 Hang the disposer from the mounting ring attached to the sink sleeve. To hang it, simply lift it up and position the unit so the three mounting ears are underneath the three mounting screws and then spin the unit so all three ears fit into the mounting assembly. Wait until after the plumbing hookups have been made to lock the unit in place.

11 Attach the discharge tube to the disposer according to the manufacturer's instructions. It is important to get a very good seal here, or the disposer will leak. Go ahead and spin the disposer if it helps you access the discharge port.

12 Attach a Y-fitting at the drain stubout. The Y-fitting should be sized to accept a drain line from the disposer and another from the sink. Adjust the sink drain plumbing as needed to get from the sink P-trap to one opening of the Y.

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#175 Dtp:225 Page:102

13 Install a trap arm for the disposer in the open port of the Y-fitting at the wall stubout. Then, attach a P-trap or a combination of a tube extension and a P-trap so the trap will align with the bottom of the disposer discharge tube.

14 Spin the disposer so the end of the discharge tube is lined up over the open end of the P-trap and confirm that they will fit together correctly. If the discharge tube extends down too far, mark a line on it at the top of the P-trap and cut at the line with a hacksaw. If the tube is too short, attach an extension with a slip joint. You may need to further shorten the discharge tube first to create enough room for the slip joint on the extension. Slide a slip nut and beveled compression washer onto the discharge tube and attach the tube to the P-trap.

15 Connect the dishwasher discharge tube to the inlet port located at the top of the disposer unit. This may require a dishwasher hookup kit. Typically, a hose clamp is used to secure the connection.

16 Lock the disposer into position on the mounting ring assembly once you have tested to make sure it is functioning correctly and without leaks. Lock it by turning one of the mounting lugs until it makes contact with the locking notch.

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#175 Dtp:225 Page:103

Icemakers

Tools & Materials

- Screwdrivers
- Nut drivers
- Needle-nose pliers
- Duct or masking tape
- Channel-type pliers
- Electric drill and assorted bits
- Icemaker kit (or icemaker tubing with ferrules and nuts)
- Open-end or adjustable wrench
- T-fitting (for supply tube)
- Putty knife
- Long ½"-inch drill bit
- Electrician's tape

A built-in icemaker is easy to install as a retrofit appliance in most modern refrigerators. If you want to have an endless supply of ice for home use, you'll wonder how you ever got along without one.

MANY REFRIGERATORS COME with icemakers as standard equipment, and practically every model features them as an option (a refrigerator with an icemaker usually costs about $100 more). It is also possible to purchase an icemaker as a retrofit feature for your old fridge.

Hooking up an existing icemaker to a cold-water supply involves drilling holes and connecting to a cold-water pipe. Most often, a pipe can be found in the basement below the kitchen, perhaps under the kitchen sink. To make the connection, some local codes allow the installation of a saddle Tee valve, but many do not, and a compression Tee valve is not difficult to install, as we show. In many kitchens the flexible line running from the valve to the fridge is copper, but plastic icemaker tubing is easier to install and less likely to kink or crack. To be sure everything fits, you can buy a connection kit from the refrigerator manufacturer.

Most icemakers either come preinstalled or are purchased as an accessory when you buy your new refrigerator. But if you have an older refrigerator with no icemaker and you'd like it to have one, all is not lost. Inspect the back of the unit, behind the freezer compartment. If your refrigerator has the required plumbing to support an icemaker, you will see a port or a port that is covered with backing. In that case, all you need to do is take the make and model information to an appliance parts dealer and they can sell you an aftermarket icemaker. Plan to spend $100 to $200.

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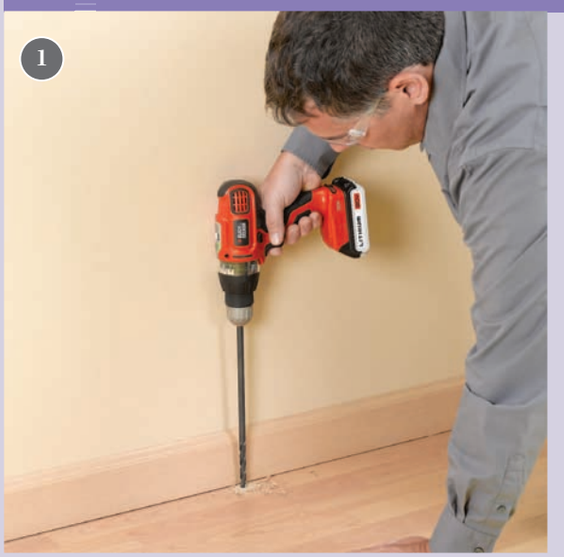
#175 Dtp:225 Page:104

How Icemakers Work

An icemaker receives its supply of water for making cubes through a ¼" copper supply line that runs from the icemaker to a water pipe. The supply line runs through a valve in the refrigerator and is controlled by a solenoid that monitors the water supply and sends the water into the icemaker itself, where it is turned into ice cubes. The cubes drop down into a bin, and as the ice level rises, they also raise a bail wire that's connected to a shutoff. When the bin is full, the bail wire will be high enough to trigger a mechanism that shuts off the water supply.

Aftermarket automatic icemakers are simple to install as long as your refrigerator is icemaker ready. Make sure to buy the correct model for your appliance and do careful installation work—icemaker water supply lines are very common sources for leaks.

CONNECTING AN ICEMAKER



1 Locate a nearby cold-water pipe, usually in the basement or crawl space below the kitchen. Behind the refrigerator and near the wall, use a long ½" bit to drill a hole through the floor. Do not pull the bit out.

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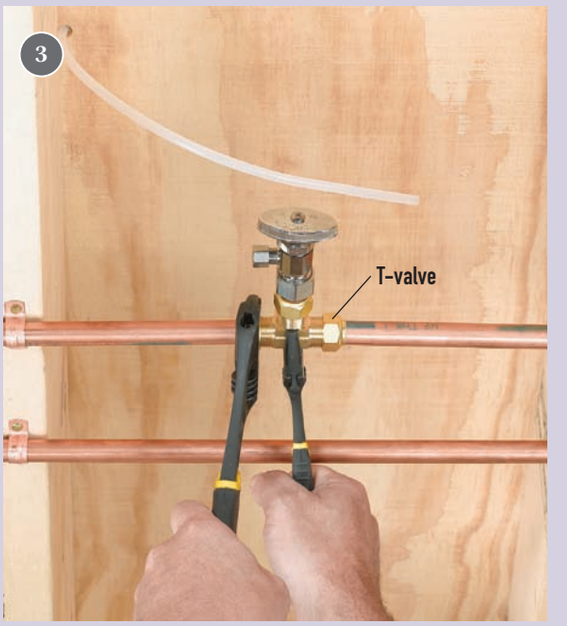

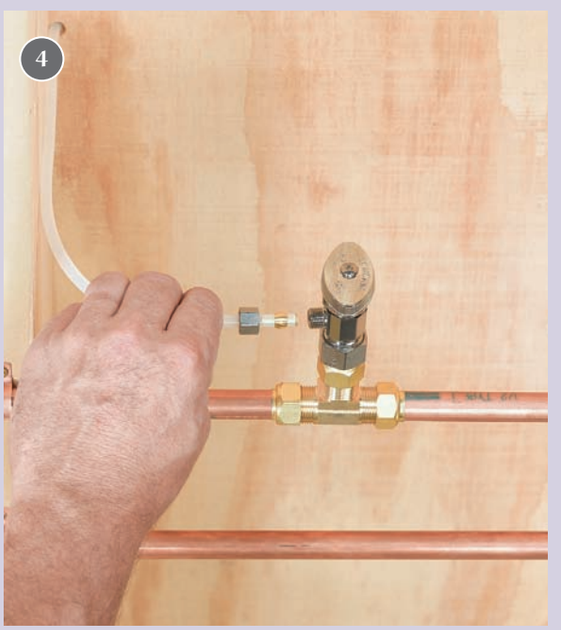

2 From below, fasten plastic icemaker tubing to the end of the drill bit by wrapping firmly with electrician's tape. From above, carefully pull the bit up, to thread the tubing up into the kitchen.

3 Shut off the water and open nearby faucets to drain the line. Cut into a cold-water pipe and install a compression Tee valve. Tighten all the nuts, close the valve and nearby faucets, and restore water to test for leaks.

4 Connect the tubing. Arrange the tubing behind the fridge so you have about 6 ft. of slack, making it easy to pull the fridge out for cleaning. Cut the tubing with a knife. Slide on a nut and a ferrule. Insert the tubing into the valve, slide the ferrule tight against the valve, and tighten the nut. To finish the installation, connect the tubing to the refrigerator using a nut and ferrule. Keep the tubing neatly coiled and kink-free for future maintenance.

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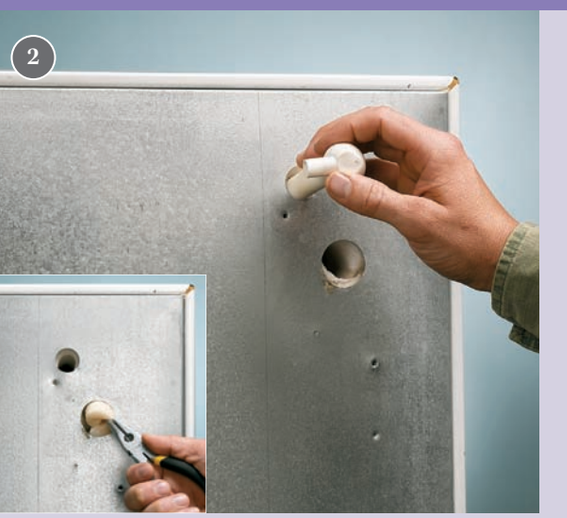
INSTALLING A NEW ICEMAKER



1 Remove all the contents from the refrigerator and freezer. Unplug the unit and pull it out from the wall. Open the freezer door and remove the icemaker cover plate (inset). On the back of the refrigerator, remove the backing or unscrew the icemaker access panel.

2 Install the tube assembly. Remove two insulation plugs to expose two openings, one for the water line and the other for a wiring harness. Install the water tube assembly (part of the icemaker kit) in its access hole; it has a plastic elbow attached to the plastic tube that reaches into the freezer compartment.

3 Hook up the harness. Icemaker kits usually come with a wiring harness that joins the icemaker motor inside the freezer box to the power supply wires. Push this harness through its access hole and into the freezer compartment. Then seal the hole with the plastic grommet that comes with the harness.

4 Join the end of the icemaker wiring harness to the power connector that was preinstalled on the back of the refrigerator. This connection should lay flat against the back. If it doesn't, just tape it down with some duct tape or masking tape.

continued

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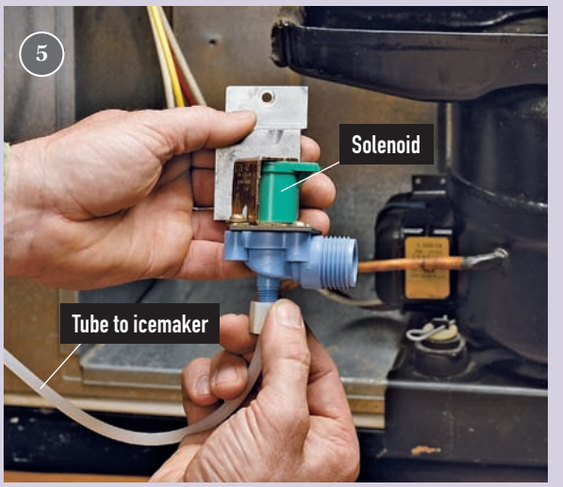

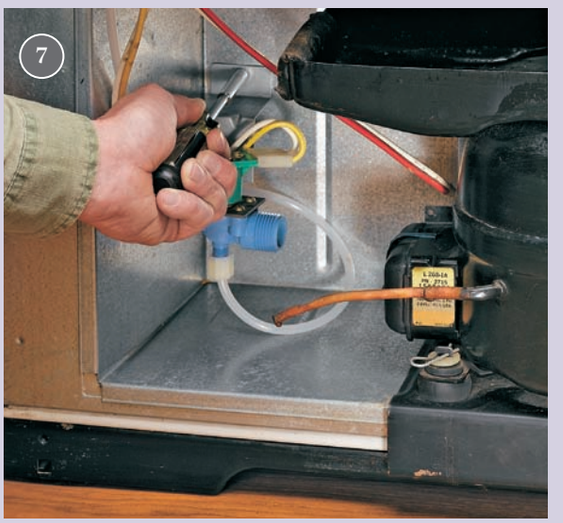

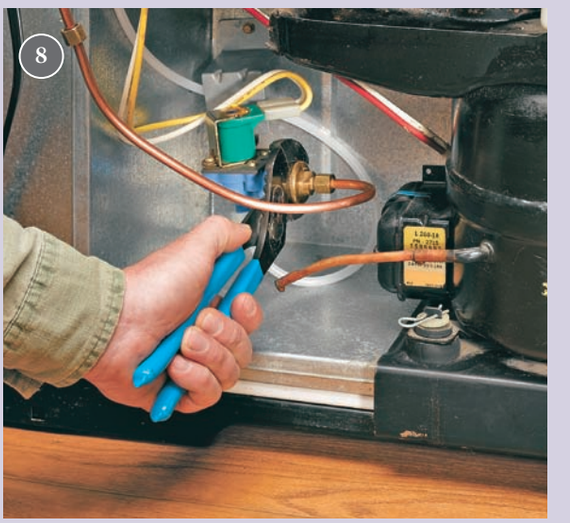

5 The water tube at the top of the refrigerator is attached to the solenoid that is mounted at the bottom with a plastic water line. To install the line, first attach it to the water tube, then run it down the back of the refrigerator and attach it to the solenoid valve with a compression fitting. This job is easier to do before you attach the solenoid assembly to the refrigerator cabinet.

6 The icemaker wiring harness comes with two snap connectors. One goes to the preinstalled wires on the refrigerator and the other is attached to the solenoid. Just push this second connector onto the brass tabs, usually at the top of the solenoid.

7 Attach the solenoid to a mounting bracket that should be installed on the cabinet wall at the bottom of the refrigerator. Mounting holes may be predrilled in the cabinet for this purpose. But if not, drill holes to match the bracket and the size of the screws. Then attach the bracket and make sure to attach the solenoid ground wire to one of these screws.

8 Install the water-inlet copper tube once the solenoid is mounted. Attach it by tightening the nut on one end with channel-type pliers. The other end of the tube is held to the refrigerator cabinet with a simple clamp. Make sure the end of this tubing is pointing straight up.

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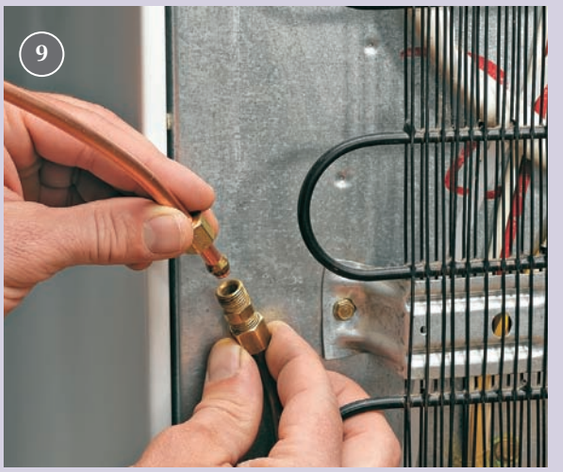

9 The end of the water-inlet tube is joined to the water supply tubing (from the house plumbing system) with a brass compression coupling. Tighten the compression nuts with an open-end or adjustable wrench.

10 From inside the freezer compartment, make sure the water tube and the wiring harness (from the back of the refrigerator) are free. If they are caught on the cabinet, loosen them until they are easily accessible.

11 Connect the wire harness to the plug on the icemaker unit. Also connect the water supply tube to the back of the icemaker with a spring clip or hose clamp.

12 Install the icemaker. Remove any small rubber caps that may be installed in the mounting screw holes with a narrow putty knife. Lift the unit and screw it to the freezer wall. The mounting bracket holes are usually slotted to permit leveling the unit. Plug in the refrigerator and test the icemaker.

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#175 Dtp:225 Page:109

Tub & Shower Faucets

Tools & Materials

Screwdrivers
Nut drivers
Needle-nose pliers
Duct or masking tape
Channel-type pliers
Electric drill and assorted bits
Icemaker kit (or icemaker tubing with ferrules and nuts)
Open-end or adjustable wrench
T-fitting (for supply tube)
Putty knife
Long ½"-inch drill bit
Electrician's tape

Tub/shower plumbing is notorious for developing drips from the tub spout and the showerhead. In most cases, the leak can be traced to the valves controlled by the faucet handles.

TUB AND SHOWER FAUCETS have the same basic designs as sink faucets, and the techniques for repairing leaks are the same as described in the faucet repair section of this book (pages xx to xx). To identify your faucet design, you may have to take off the handle and disassemble the faucet.

When a tub and shower are combined, the showerhead and the tub spout share the same hot and cold water supply lines and handles. Combination faucets are available as three-handle, two-handle, or single-handle types. The number of handles gives clues as to the design of the faucets and the kinds of repairs that may be necessary.

With combination faucets, a diverter valve or gate diverter is used to direct water flow to the tub spout or the showerhead. On three-handle faucet types, the middle handle controls a diverter valve. If water does not shift easily from tub to showerhead, or if water continues to run out the spout when the shower is on, the diverter valve probably needs to be cleaned and repaired.

Two-handle and single-handle types use a gate diverter that is operated by a pull lever or knob on the tub spout. Although gate diverters rarely need repair, the lever occasionally may break, come loose, or refuse to stay in the up position. To repair a gate diverter set in a tub spout, replace the entire spout.

Tub and shower faucets and diverter valves may be set inside wall cavities. Removing them may require a deep-set ratchet wrench.

If spray from the showerhead is uneven, clean the spray holes. If the showerhead does not stay in an upright position, remove the head and replace the O-ring.

To add a shower to an existing tub, install a flexible shower adapter. Several manufacturers make complete conversion kits that allow a shower to be installed in less than one hour.

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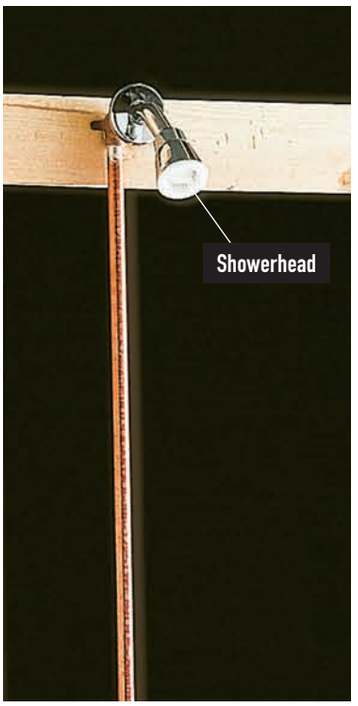
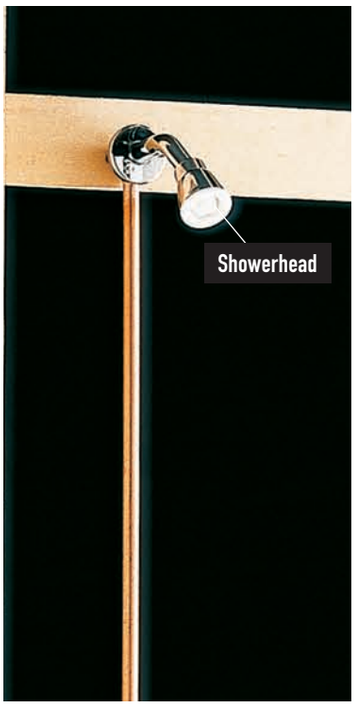
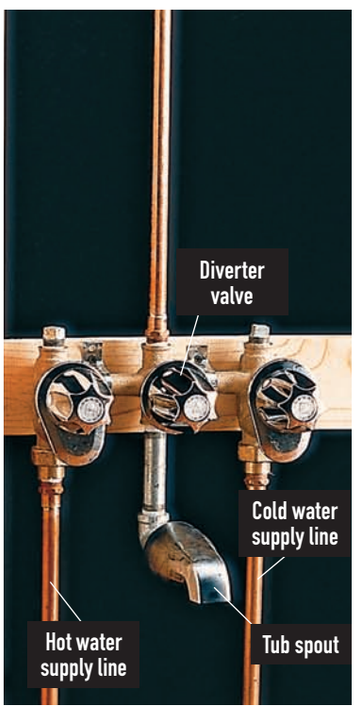
Tub & Shower Combination Faucets

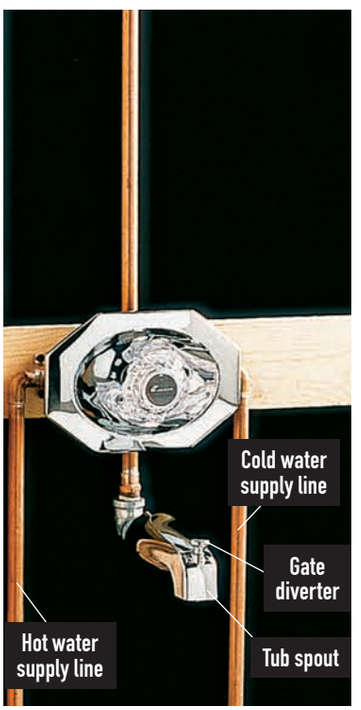






Three-handle faucet has valves that are either compression or cartridge design.

Two-handle faucet has valves that are either compression or cartridge design.



Single-handle faucet has valves that are cartridge, ball-type, or disc design.

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#175 Dtp:225 Page:111

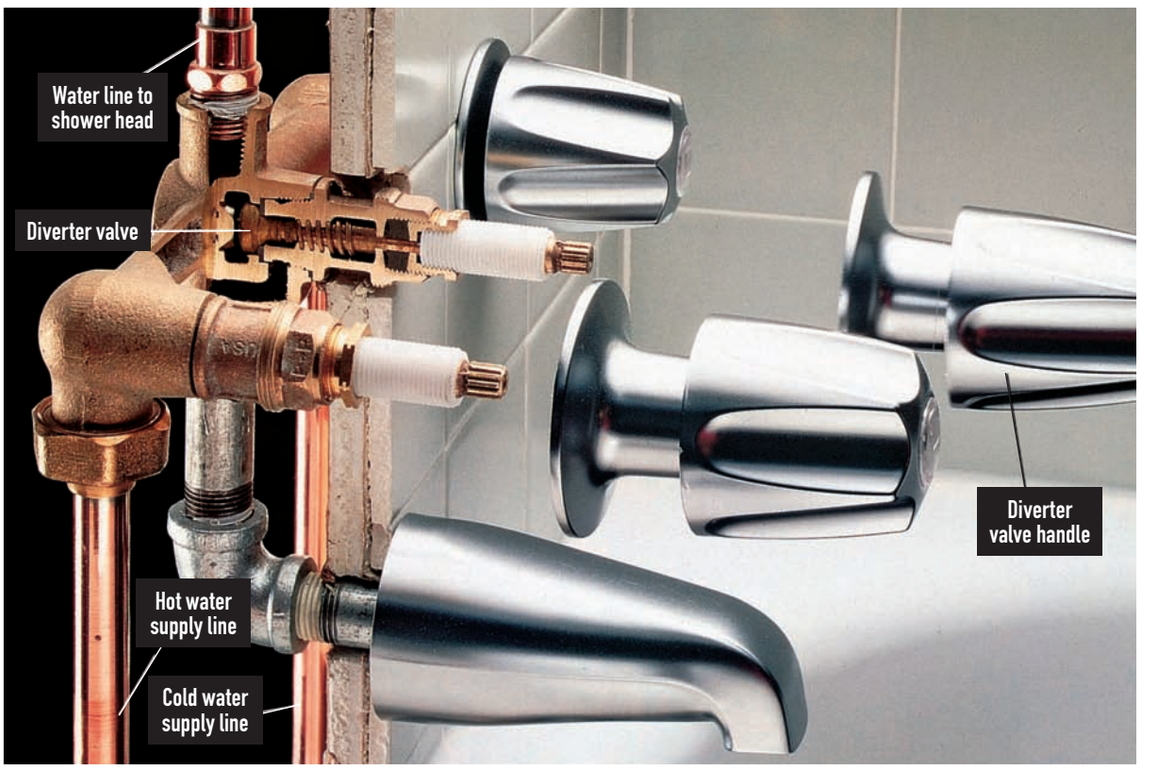
Repair Three-handle Tub & Shower Faucets

A three-handle faucet type has two handles to control hot and cold water, and a third handle to control the diverter valve and direct water to either a tub spout or a shower head. The separate hot and cold handles indicate cartridge or compression faucet designs.

If a diverter valve sticks, if water flow is weak, or if water runs out of the tub spout when the flow is directed to the showerhead, the diverter needs to be repaired or replaced. Most diverter valves are similar to either compression or cartridge faucet valves. Compression-type diverters can be repaired, but cartridge types should be replaced.

Tools & Materials

- Screwdriver
- Adjustable wrench or channel-type pliers
- Deep-set ratchet wrench
- Small wire brush
- Replacement diverter cartridge or universal washer kit
- Faucet grease
- Vinegar



A three-handle tub/shower faucet has individual controls for hot and cold water plus a third handle that operates the diverter valve.

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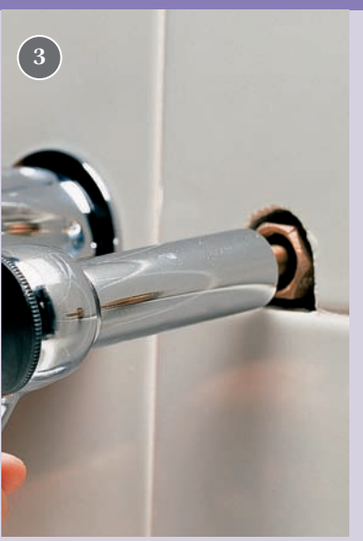
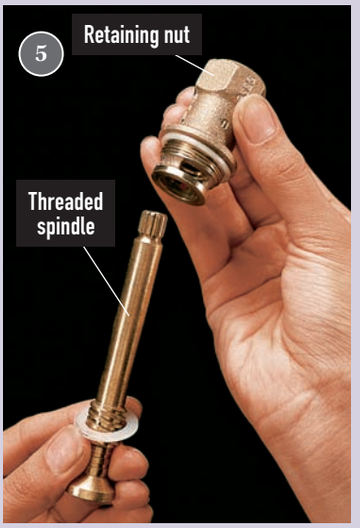
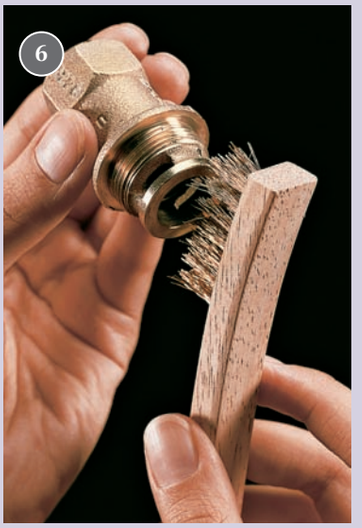
REPAIRING A COMPRESSION DIVERTER VALVE







1 Remember to turn off the water before beginning work. Remove the diverter valve handle with a screwdriver. Unscrew or pry off the escutcheon.

2 Remove bonnet nut with an adjustable wrench or channel-type pliers.

3 Unscrew the stem assembly, using a deep-set ratchet wrench. If necessary, chip away any mortar surrounding the bonnet nut.

4 Remove the brass stem screw. Replace the stem washer with an exact duplicate. If the stem screw is worn, replace it.

5 Unscrew the threaded spindle from the retaining nut.

6 Clean sediment and lime buildup from the nut using a small wire brush dipped in vinegar. Coat all parts with faucet grease and reassemble the diverter valve.

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Repair Two-handle Tub & Shower Faucets

Two-handle tub and shower faucets are either cartridge or compression design. Because the valves of two-handle tub and shower faucets may be set inside the wall cavity, a deep-set socket wrench may be required to remove the valve stem.

Two-handle tub and shower designs have a gate diverter. A gate diverter is a simple mechanism located in the tub spout. A gate diverter closes the supply of water to the tub spout and redirects the flow to the shower head. Gate diverters seldom need repair. Occasionally, the lever may break, come loose, or refuse to stay in the up position.

If the diverter fails to work properly, replace the tub spout. Tub spouts are inexpensive and easy to replace.

Tools & Materials

- Screwdriver
- Allen wrench
- Pipe wrench
- Channel-type pliers
- Small cold chisel
- Ball-peen hammer
- Deep-set ratchet wrench
- Masking tape or cloth
- Pipe joint compound
- Replacement faucet parts, as needed

A two-handle tub/shower faucet can operate with compression valves, but more often these days they contain cartridges that can be replaced. Unlike a three-handled model, the diverter is a simple gate valve that is operated by a lever.

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#175 Dtp:225 Page:114

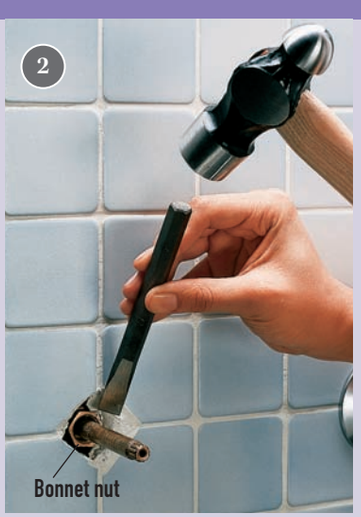
Tips on Replacing a Tub Spout

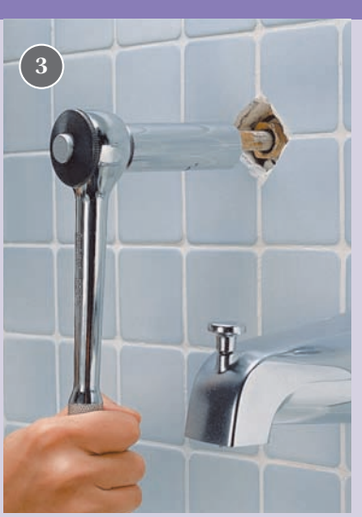
Check underneath tub spout for a small access slot. The slot indicates the spout is held in place with an Allen screw. Remove the screw using an Allen wrench. Spout will slide off.

Unscrew faucet spout. Use a pipe wrench, or insert a large screwdriver or hammer handle into the spout opening and turn spout counterclockwise.

Spread pipe joint compound on threads of spout nipple before replacing spout. If you have a copper pipe or a short pipe, buy a spout retrofit kit, which can attach a spout to most any pipe.

REMOVING A DEEP-SET FAUCET VALVE





1 Remember to turn off the water before beginning any work. Remove the handle and unscrew the escutcheon with channel-type pliers. Pad the jaws of the pliers with masking tape to prevent scratching the escutcheon.

2 Chip away any mortar surrounding the bonnet nut using a ball-peen hammer and a small cold chisel.

3 Unscrew the bonnet nut with a deep-set ratchet wrench. Remove the bonnet nut and stem from the faucet body.

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Repair Single-handle Tub & Shower Faucets

A single-handle tub and shower faucet has one valve that controls both water flow and temperature. Single-handle faucets may be ball-type, cartridge, or disc designs.

If a single-handle control valve leaks or does not function properly, disassemble the faucet, clean the valve, and replace any worn parts. Use the repair techniques described on page 80 for ball-type, or page 81 for ceramic disc. Repairing a single-handle cartridge faucet is shown on the opposite page.

Direction of the water flow to either the tub spout or the showerhead is controlled by a gate diverter. Gate diverters seldom need repair. Occasionally, the lever may break, come loose, or refuse to stay in the up position. Remember to turn off the water before beginning any work; the shower faucet shown here has built-in shutoff valves, but many other valves do not. Open an access panel in an adjoining room or closet, behind the valve, and look for two shutoffs. If you can't find them there, you may have to shut off intermediate valves or the main shutoff valve.

Tools & Materials

Screwdriver
Adjustable wrench
Channel-type pliers
Replacement faucet parts, as needed

A single-handle tub/shower faucet is the simplest type to operate and to maintain. The handle controls the mixing ratio of both hot and cold water, and the diverter is a simple gate valve.

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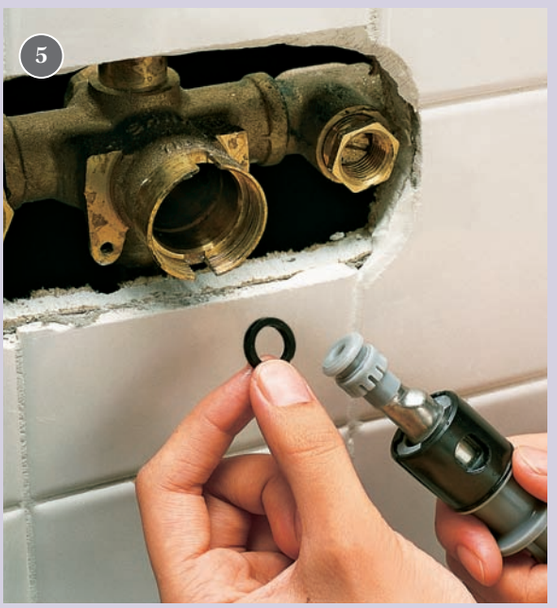
#175 Dtp:225 Page:116

REPAIRING A SINGLE-HANDLE CARTRIDGE TUB & SHOWER FAUCET



1 Use a screwdriver to remove the handle and escutcheon.

2 Turn off water supply at the built-in shutoff valves or the main shutoff valve.

3 Unscrew and remove the retaining ring or bonnet nut using adjustable wrench.

4 Remove the cartridge assembly by grasping the end of the valve with channel-type pliers and pulling gently.

5 Flush the valve body with clean water to remove sediment. Replace any worn O-rings. Reinstall the cartridge and test the valve. If the faucet fails to work properly, replace the cartridge.

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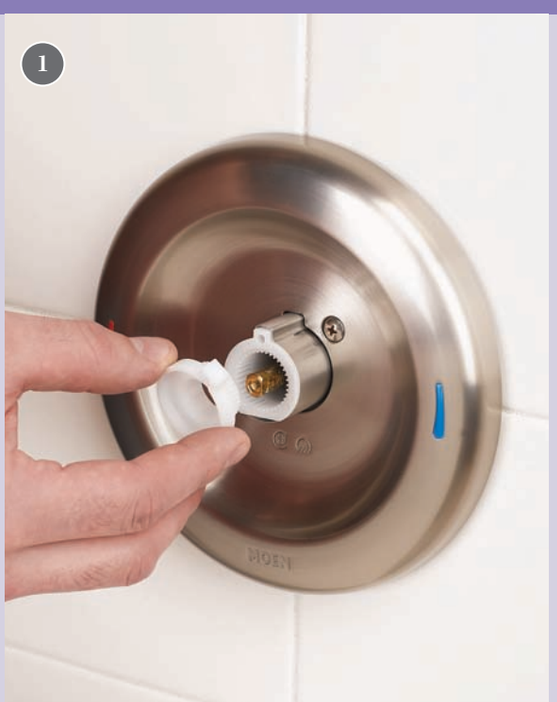
(Fogra 39)Job:04-30437 Title:MBI-HomeSkills Plumbing
#175 Dtp:225 Page:117

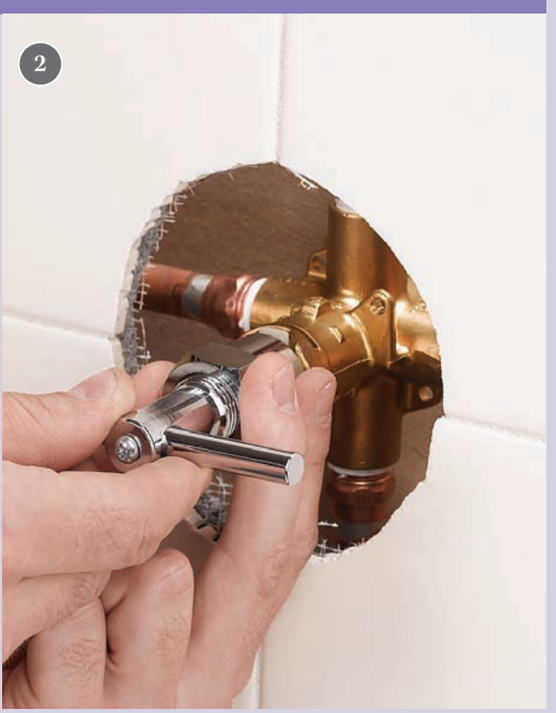
Single-Handle Tub & Shower Faucet with Scald Control

In many plumbing systems, if someone flushes a nearby toilet or turns on the cold water of a nearby faucet while someone else is taking a shower, the shower water temperature can suddenly rise precipitously. This is not only uncomfortable; it can actually scald you. For that reason, many one-handle shower valves have a device, called a "balancing valve" or an "anti-scald valve," that keeps the water from getting too hot.

The temperature of your shower may drastically rise to dangerous scalding levels if a nearby toilet is flushed. A shower fixture equipped with an anti-scald valve prevents this sometimes dangerous situation.

ADJUSTING THE SHOWER'S TEMPERATURE





1 To reduce or raise the maximum temperature, remove the handle and escutcheon. Some models have an adjustment screw, others have a handle that can be turned by hand.

2 To remove a balancing valve, you may need to buy a removal tool made for your faucet. Before replacing, slowly turn on water to flush out any debris; use a towel or bucket to keep water from entering inside the wall.

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#175 Dtp:225 Page:118

Fix & Replace Showerheads

If spray from the showerhead is uneven, clean the spray holes. The outlet or inlet holes of the showerhead may get clogged with mineral deposits. Showerheads pivot into different positions. If a showerhead does not stay in position, or if it leaks, replace the O-ring that seals against the swivel ball.

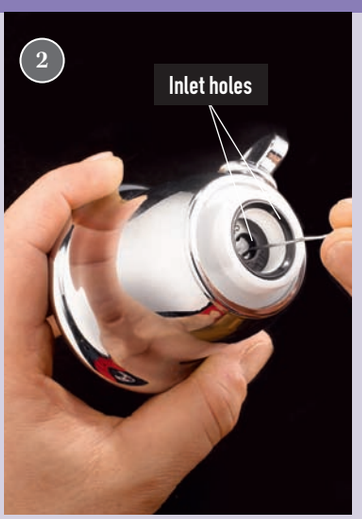
A tub can be equipped with a shower by installing a flexible shower adapter kit. Complete kits are available at hardware stores and home centers.

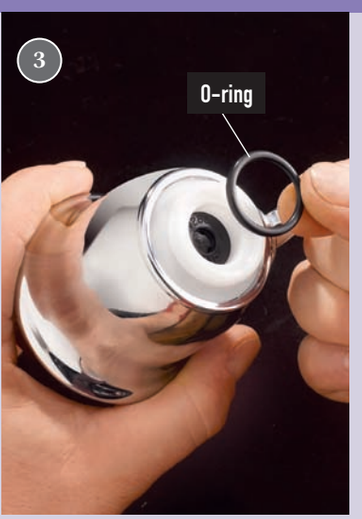
Tools & Materials

- Adjustable wrench or channel-type pliers
- Pipe wrench
- Drill
- Glass and tile bit
- Mallet
- Screwdriver
- Masking tape
- Thin wire (paper clip)
- Faucet grease
- Rag
- Replacement O-rings
- Masonry anchors
- Flexible shower adapter kit (optional)

A typical showerhead can be disassembled easily for cleaning and repair. Some showerheads include a spray adjustment cam lever that is used to change the force of the spray.

CLEANING & REPAIRING A SHOWERHEAD





1 Unscrew the swivel ball nut, using an adjustable wrench or channel-type pliers. Wrap jaws of the tool with masking tape to prevent marring the finish. Unscrew the collar nut from the showerhead.

2 Clean outlet and inlet holes of showerhead with a thin wire. Flush the head with clean water.

3 Replace the O-ring, if necessary. Lubricate the O-ring with faucet grease before installing.

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(Fogra 39)Job:04-30437 Title:MBI-HomeSkills Plumbing
#175 Dtp:225 Page:119

Tub & Shower Drains

Tools & Materials

Phillips screwdriver
Plunger
Scrub brush
White vinegar
Toothbrush
Needlenose pliers
Dishwashing brush
Faucet grease

As with bathroom sinks, tub and shower drain pipes may become clogged with soap and hair. The drain stopping mechanisms can also require cleaning and adjustment.

TUB OR SHOWER NOT DRAINING? First, make sure it's only the tub or shower. If your sink is plugged, too, it may be a coincidence or it may be that a common branch line is plugged. A sure sign of this is when water drains from the sink into the tub. This could require the help of a drain cleaning service, or a drum trap that services both the sink and tub needs cleaning.

If the toilet also can't flush (or worse, water comes into the tub when you flush the toilet), then the common drain to all your bathroom fixtures is plugged. Call a drain cleaning service. If you suspect the problem is only with your tub or shower, then read on. We'll show you how to clear drainlines and clean and adjust two types of tub stopper mechanisms. Adjusting the mechanism can also help with the opposite problem: a tub that drains when you're trying to take a bath.

Maintenance Tip

Like bathroom sinks, tubs and showers face an ongoing onslaught from soap and hair. When paired, this pesky combination is a sure-fire source of clogs. The soap scum coagulates as it is washed down the drain and binds the hair together in a mass that grows larger with every shower or bath. To nip these clogs in the bud, simply pour boiling hot clean water down the drain from time to time to melt the soapy mass and wash the binder away.

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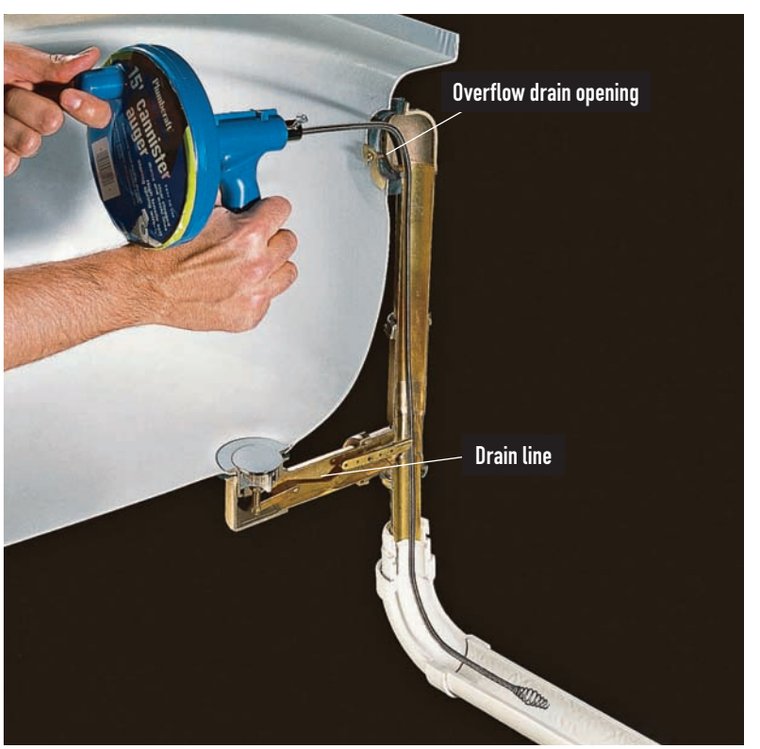
#175 Dtp:225 Page:120

USING HAND AUGERS

On shower drains, feed the head of a hand-crank or drill-powered auger in through the drain opening after removing the strainer. Crank the handle of the auger to extend the cable and the auger head down into the trap and, if the clog is farther downline, toward the branch drain. When clearing any drain, it is always better to retrieve the clog than to push it farther downline.



On combination tub/showers, it's generally easiest to insert the auger through the overflow opening after removing the coverplate and lifting out the drain linkage. Crank the handle of the auger to extend the cable and the auger head down into the trap and, if the clog is farther downline, toward the branch drain. When clearing any drain, it is always better to retrieve the clog than to push it farther downline.

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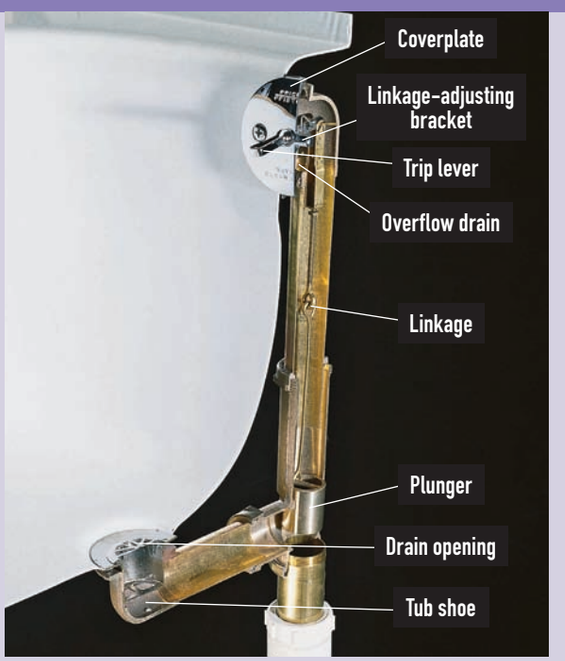
#175 Dtp:225 Page:121

FIXING A PLUNGER-TYPE DRAIN



1 A plunger-type tub drain has a simple grate over the drain opening and a behind-the-scenes plunger stopper. Remove the screws on the overflow coverplate with a slotted or Phillips screwdriver. Pull the coverplate, linkage, and plunger from the overflow opening.

2 Clean hair and soap off the plunger with a scrub brush. Mineral buildup is best tackled with white vinegar and a toothbrush or a small wire brush.

3 Adjust the plunger. If your tub isn't holding water with the plunger down, it's possible the plunger is hanging too high to fully block water from the tub shoe. Loosen the locknut with needlenose pliers, then screw the rod down about ⅛". Tighten the locknut down. If your tub drains poorly, the plunger may be set too low. Loosen the locknut and screw the rod in ⅛" before retightening the locknut.

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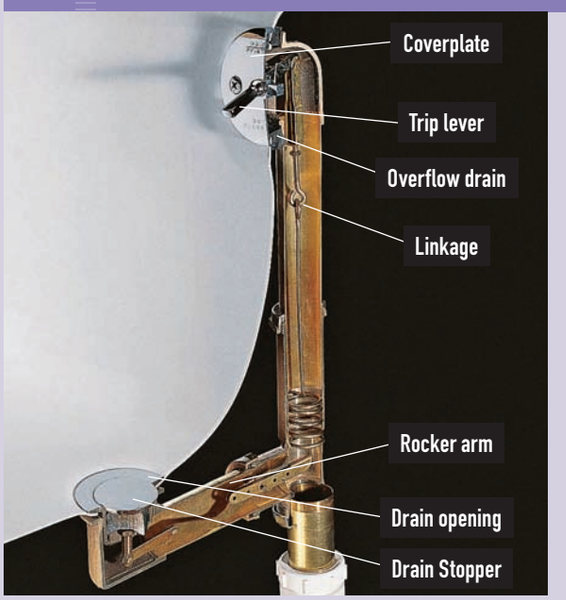
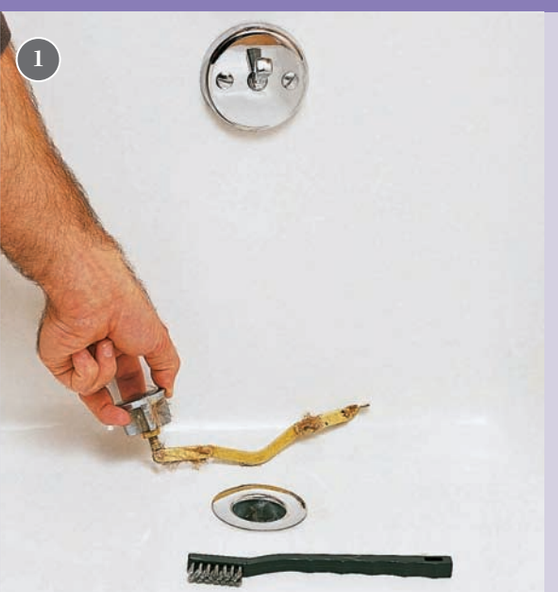
#175 Dtp:225 Page:122

FIXING A POP-UP DRAIN





1 Raise the trip lever to the open position. Pull the stopper and rocker arm assembly from the drain. Clean off soap and hair with a dishwashing brush in a basin of hot water. Clean off mineral deposits with a toothbrush or small wire brush and white vinegar.

2 Remove the screws from the cover plate. Pull the trip lever and the linkage from the overflow opening. Clean off soap and hair with a brush in a basin of hot water. Remove mineral buildup with white vinegar and a wire brush. Lubricate moving parts of the linkage and rocker arm mechanism with faucet grease.

3 Adjust the pop-up stopper mechanism by first loosening the locknut on the lift rod. If the stopper doesn't close all the way, shorten the linkage by screwing the rod ⅛" farther into the linkage-adjusting bracket. If the stopper doesn't open wide enough, extend the linkage by unscrewing the rod ⅛". Tighten the locknut before replacing the mechanism and testing your adjustment.

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(Fogra 39)Job:04-30437 Title:MBI-HomeSkills Plumbing
#175 Dtp:225 Page:123

Glossary

Access panel — Opening in a wall or ceiling that provides access to the plumbing system

Air admittance valve — A valve that allows air into a drain line in order to facilitate proper draining. Often used where traditional vent pipe would be difficult to install.

Appliance — Powered device that uses water, such as a water heater, dishwasher, washing machine, whirlpool, or water softener

Auger — Flexible tool used for clearing obstructions in drain lines

Ballcock — Valve that controls the water supply entering a toilet tank

Blow bag — Expanding rubber device that attaches to a garden hose; used for clearing floor drains

Branch drain line — Pipe that connects additional lines to a drain system

Branch line — Pipe that connects additional lines to a water supply system

Cleanout — Cover in a waste pipe or trap that provides access for cleaning

Closet auger — Flexible rod used to clear obstructions in toilets

Closet bend — Curved fitting that fits between a closet flange and a toilet drain

Closet flange — Ring at the opening of a toilet drain, used as the base for a toilet

Coupling — Fitting that connects two pieces of pipe

DWV — Drain, waste, and vent; the system for removing water from a house

DWV stack — Pipe that connects house drain system to a sewer line at the bottom and vents air to outside of house at the top

Elbow — Angled fitting that changes the direction of a pipe

Fixture — Device that uses water, such as a sink, tub, shower, sillcock, or toilet

Flapper (tank ball) — Rubber seal that controls the flow of water from a toilet tank to a toilet bowl

Flux (soldering paste) — Paste applied to metal joints before soldering to increase joint strength

Hand auger (snake) — Hand tool with flexible shaft, used for clearing clogs in drain lines

Hose bib — Any faucet spout that is threaded to accept a hose

I.D. — Inside diameter; plumbing pipes are classified by I.D.

Loop vent — A special type of vent configuration used in kitchen sink island installations

Main shutoff valve — Valve that controls water supply to an entire house; usually next to the water meter

Motorized auger — Power tool with flexible shaft, used for clearing tree roots from sewer lines

Nipple — Pipe with threaded ends

O.D. — Outside diameter

Plumber's putty — A soft material used for sealing joints between fixtures and supply or drain parts

Reducer — A fitting that connects pipes of different sizes

Riser — Assembly of water supply fittings and pipes that distributes water upward

Run — Assembly of pipes that extends from water supply to fixture, or from drain to stack

Saddle valve — Fitting clamped to copper supply pipe, with hollow spike that punctures the pipe to divert water to another device, usually a dishwasher or refrigerator icemaker

Sanitary fitting — Fitting that joins DWV pipes; allows solid material to pass through without clogging

Shutoff valve — Valve that controls the water supply for one fixture or appliance

Sillcock — Compression faucet used on the outside of a house

Soil stack — Main vertical drain line, which carries waste from all branch drains to a sewer line

Solder — Metal alloy used for permanently joining metal (usually copper) pipes

T-fitting — Fitting shaped like the letter T used for creating or joining branch lines

Trap — Curved section of drain, filled with standing water, that prevents sewer gases from entering a house

Union — Fitting that joins two sections of pipe but can be disconnected without cutting

Vacuum breaker — Attachment for outdoor and below-ground fixtures that prevents waste water from entering supply lines if water supply pressure drops

Wet vent — Pipe that serves as a drain for one fixture and as a vent for another

Y-fitting — Fitting shaped like the letter Y used for creating or joining branch lines

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#175 Dtp:225 Page:124

Metric Conversions

Metric Equivalent

Inches (in.)	1/64	1/32	1/25	1/16	1/8	1/4	3/8	2/5	1/2	5/8	3/4	7/8	1	2	3	4	5	6	7	8	9	10	11	12	36	39.4
Feet (ft.)																								1	3	3 1/12
Yards (yd.)																									1	1 1/12
Millimeters (mm)	0.40	0.79	1	1.59	3.18	6.35	9.53	10	12.7	15.9	19.1	22.2	25.4	50.8	76.2	101.6	127	152	178	203	229	254	279	305	914	1,000
Centimeters (cm)							0.95	1	1.27	1.59	1.91	2.22	2.54	5.08	7.62	10.16	12.7	15.2	17.8	20.3	22.9	25.4	27.9	30.5	91.4	100
Meters (m)																								.30	.91	1.00

Converting Measurements

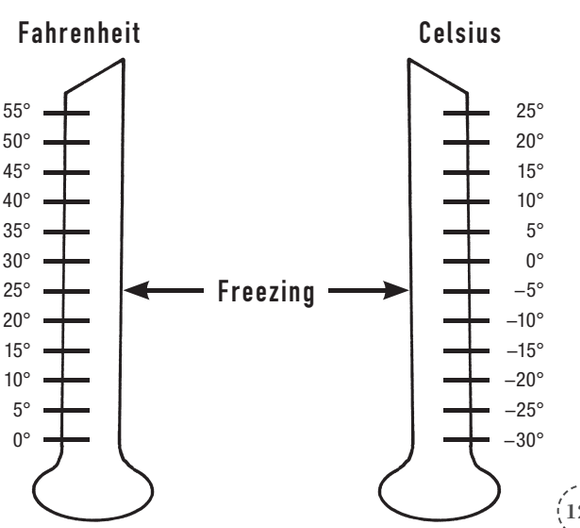
To Convert:	To:	Multiply by:
Inches	Millimeters	25.4
Inches	Centimeters	2.54
Feet	Meters	0.305
Yards	Meters	0.914
Miles	Kilometers	1.609
Square inches	Square centimeters	6.45
Square feet	Square meters	0.093
Square yards	Square meters	0.836
Cubic inches	Cubic centimeters	16.4
Cubic feet	Cubic meters	0.0283
Cubic yards	Cubic meters	0.765
Pints (U.S.)	Liters	0.473 (Imp. 0.568)
Quarts (U.S.)	Liters	0.946 (Imp. 1.136)
Gallons (U.S.)	Liters	3.785 (Imp. 4.546)
Ounces	Grams	28.4
Pounds	Kilograms	0.454
Tons	Metric tons	0.907

To Convert:	To:	Multiply by:
Millimeters	Inches	0.039
Centimeters	Inches	0.394
Meters	Feet	3.28
Meters	Yards	1.09
Kilometers	Miles	0.621
Square centimeters	Square inches	0.155
Square meters	Square feet	10.8
Square meters	Square yards	1.2
Cubic centimeters	Cubic inches	0.061
Cubic meters	Cubic feet	35.3
Cubic meters	Cubic yards	1.31
Liters	Pints (U.S.)	2.114 (Imp. 1.76)
Liters	Quarts (U.S.)	1.057 (Imp. 0.88)
Liters	Gallons (U.S.)	0.264 (Imp. 0.22)
Grams	Ounces	0.035
Kilograms	Pounds	2.2
Metric tons	Tons	1.1

Converting Temperatures

Convert degrees Fahrenheit (F) to degrees Celsius (C) by following this simple formula: Subtract 32 from the Fahrenheit temperature reading. Then mulitply that number by 5/9. For example, 77°F - 32 = 45. 45 × 5/9 = 25°C.

To convert degrees Celsius to degrees Fahrenheit, multiply the Celsius temperature reading by 9/5, then add 32. For example, 25°C × 9/5 = 45. 45 + 32 = 77°F.



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Pro-Vision C M Y K (Text) (Ray)
(Fogra 39)Job:04-30437 Title:MBI-HomeSkills Plumbing
#175 Dtp:225 Page:125

Index

Bathroom faucets
- components, 81
- installing
  - pop-up drains, 86–87
  - single-body faucets, 85
  - widespread faucets, 82-84

Bathrooms
- clogs in common drain, 120
- *See also* Bathroom faucets; Bathtubs; Tub and shower faucets

Bathtubs
- adjusting shower temperature, 118
- drains
  - repairing plunger-type, 122
  - repairing pop-up, 123
- removing deep-set faucet valves, 115
- replacing tub spouts, 115
- showerheads
  - repairing/replacing, 119
- unclogging
  - hand augers, 121
- *See also* Tub and shower faucets

Black iron pipe, 38

Brass valves, soldering, 22

Compression fittings
- connecting shutoff valves with, 50
- joining copper pipes with, 51

Copper pipes
- bending, 17
- cutting, 18–19
- finding length needed, 17
- joining with compression fittings, 51
- pipe and fitting chart, 16
- rigid vs. flexible, 16
- soldering, 16, 18, 20-22
- tools for, 17

Cross-linked polyethylene (PEX) pipe
- buying, 33
- choosing PEX systems, 34
- connecting, 30, 35
- installing, 32
- plumbing codes and, 33
- plumbing PEX systems, 36–37
- tools for, 31

Dishwashers, replacing, 94–97

Diverter valves, repairing, 113

Drain-waste-vent systems
- components of, 8–9
- fittings for, 42, 44

Fittings. *See* Pipe fittings

Food disposers
- choosing, 98
- components, 99
- installing, 100–3

Galvanized steel pipe
- about, 38
- measuring, 38
- removing and replacing, 39–41

Garbage disposals. *See* Food disposers

Hose bibs, repairing leaky, 48

Icemakers
- about aftermarket, 104–5
- connecting, 106–7
- installing new, 107–9

Kitchen drains
- choosing, 89
- connecting, 89, 90
- connecting floor drains, 91
- unclogging, 92
- unclogging traps, 92
- unclogging with hand auger, 93
- *See also* Food disposers

Kitchen faucets
- identifying type of, 74
- installing pullout faucets, 72–73
- removing, 71
- repairing
  - ball faucets, 78
  - compression faucets, 75
  - disc faucets, 79
  - one-handle cartridge faucets, 77
  - tips for, 74
  - washerless two-handle faucets, 76

Kitchens. *See* Dishwashers; Food disposers; Icemakers; Kitchen drains; kitchen faucets; Kitchen sinks

Kitchen sinks
- clearing with a hand auger, 93
- drains
  - choosing, 89
  - connecting, 89, 90–97
  - floor drains, 91
  - unclogging, 92
- plunging, 93
- traps
  - unclogging, 92
- *See also* Food disposers; Kitchen faucets

Kitchen traps. *See* Kitchen drains

Main shutoff valves, 6–7

PE (polyethylene) pipe
- connecting, 28–29
- cutting, 29

098-128_30437.indd 126 4/12/13 4:38 PM
098-128_30437.indd 126 4/12/13 4:30 PM
Pro-Vision C M Y K (Text) (Ray)
(Fogra 39)Job:04-30437 Title:MBI-HomeSkills Plumbing
#175 Dtp:225 Page:126

Pipe fittings
compression fittings
connecting shutoff valves with, 50
joining copper pipes with, 51
for drain-waste-vent systems, 42, 44
transition fittings
connecting, 45
for water supply systems, 43
Pipes
types of, 14–15
See also Copper pipes; Galvanized steel pipe; Plastic pipe
Pipe support, for water supply systems, 43
Plastic pipe
Cross-linked polyethylene (PEX)pipe
buying, 33
choosing PEX systems, 34
connecting, 30, 35
installing, 32
plumbing codes and, 33
plumbing PEX systems, 36–37
tools for, 31
PE (polyethylene) pipe
connecting, 28
cutting, 29
rigid
cutting, 24–25
solvent-gluing, 24, 26–27
Polyethylene (PEX) pipe. *See* Cross-linked polyethylene (PEX) pipe
Push fittings, connecting, 23

Shower faucets. *See* Tub and shower faucets
Showers
adjusting shower temperature, 118
drains
repairing plunger-type, 122
repairing pop-up, 123
removing deep-set faucet valves, 115
replacing tub spouts, 115
showerheads
repairing/replacing, 119
unclogging
hand augers, 121
See also Tub and shower faucets
Shutoff valves
installing, 47
main, 6–7
for toilets, 61
types of, 46, 49
Sinks. *See* Bathroom faucets; Kitchen faucets
Soldering
brass valves, 22
copper pipe, 16, 18, 20–21
Steel pipe. *See* Galvanized steel pipe
Supply tubes
installing, 47
types of, 46
Support materials, for water supply systems, 43

Toilets
common problems, 58–59
components of, 58
diagnosing running, 61
diagnosing short flushing, 63
fill valves
replacing, 64–65
flappers, 61
flush valves
replacing, 66–67
handles and lift chains
adjusting, 60
high efficiency and gravity-assisted, 54
installing, 56–57
loose seats, 61
removing, 55
resetting tank level, 62
seats
replacing, 61
shutoff valves
replacing, 61
unclogging
closet augers, 69
plunging, 68
unclogging rim holes, 61
Tools, for plumbing projects, 10–13, 17, 31
Transitions fittings, connecting, 45
Tub and shower faucets
repairing
compression diverter valves, 113
overview, 110
single-handle, 116–18
three-handle, 112
two-handle, 114
types of, 110–11

Valves
repairing
ball valves, 49
gate valves, 49
globe valves, 49
hose bibs, 49
shutoff valves, 49
soldering
brass valves, 22
types of, 48–49
for water supply systems, 43

Water supply systems, 7
pipe fittings for, 43
support materials for, 43
valves for, 43
Wax rings, removing, 55, 56

098-128_30437.indd 127 4/12/13 4:38 PM
098-128_30437.indd 127 4/12/13 4:30 PM
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NOTICE TO READERS

For safety, use caution, care, and good judgment when following the procedures described in this book. The publisher cannot assume responsibility for any damage to property or injury to persons as a result of misuse of the information provided.

The techniques shown in this book are general techniques for various applications. In some instances, additional techniques not shown in this book may be required. Always follow manufacturers' instructions included with products, since deviating from the directions may void warranties. The projects in this book vary widely as to skill levels required: some may not be appropriate for all do-it-yourselfers, and some may require professional help.

Consult your local building department for information on building permits, codes, and other laws as they apply to your project.

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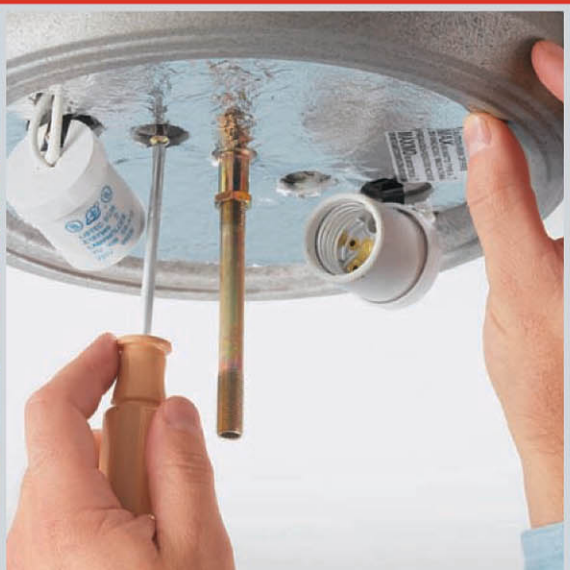
HOME SKILLS

Wiring

FIX YOUR OWN LIGHTS, SWITCHES, RECEPTACLES, BOXES, CABLES & MORE



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#175 Dtp:225 Page:1

CONTENTS

Introduction 4

Working with Wiring

Wiring Safety 7
How Electricity Works 9
Understanding Electrical Circuits 14
Grounding & Polarization 16
Home Wiring Tools 18
Wire & Cable 20
NM Cable 28
Conduit 36
Work with Conduit 38
Electrical Boxes 40
Install Boxes 46
Electrical Panels 54
Wall Switches 62
Types of Wall Switches 64
Testing Switches 70
Receptacle Wiring 74
GFCI Receptacles 80
Testing Receptacles 84

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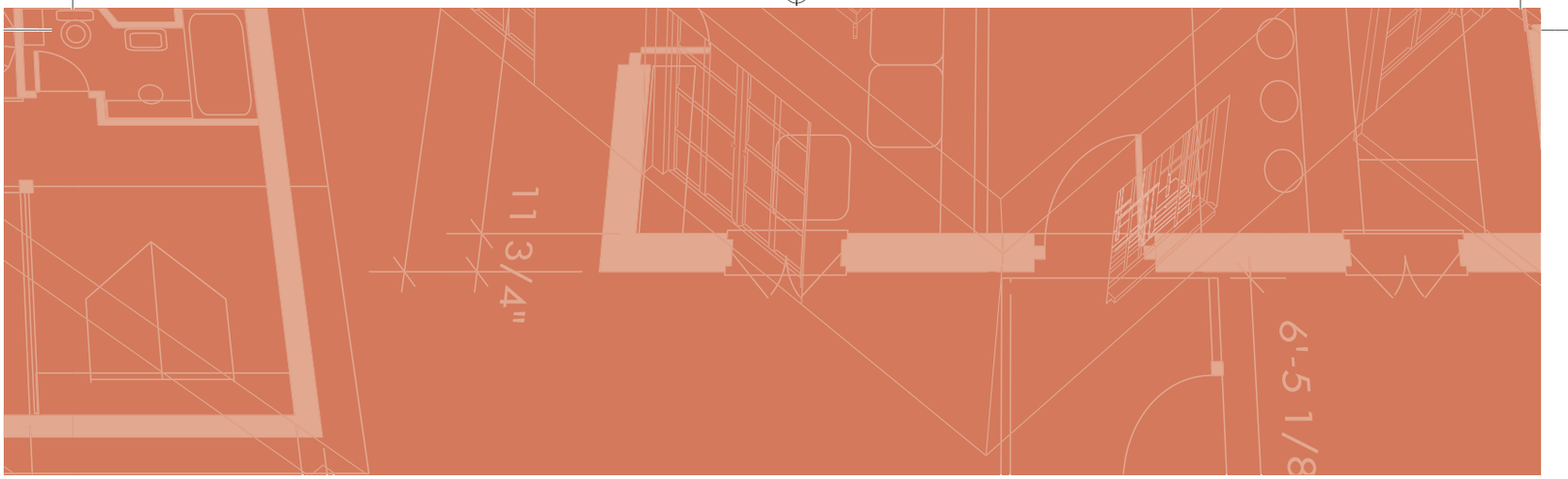

Wiring Projects

GFCI & AFCI Breakers 92

120/240-Volt Dryer Receptacles 94

120/240-Volt Range Receptacles 95

Ceiling Lights 96

Recessed Ceiling Lights 100

Hard-wired Smoke & CO Detectors 104

Baseboard Heaters 106

Ceiling Fans 110

Repairing Light Fixtures 114

Repairing Fluorescent Lights 118

Resources

Highlights of the National Electrical Code 124

Metric Conversions 126

Index 127

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#175 Dtp:225 Page:3

Introduction

THE ELECTRICAL SYSTEM in your home may seem like a complicated, mysterious beast, ready to breathe fire or deliver shocks at any time. It is somewhat complicated, and in an older home it may actually be a dangerous beast, but the system itself is mostly straightforward. Even if you never intend to attempt a wiring project more complicated than changing out a ceiling fixture, it is important to understand how the electrical system in your home works. *HomeSkills: Wiring* explains the current standards in home wiring and explains how to test and evaluate your home's system.

Illustrations of all the most common types of electrical cables, receptacles, and switches are provided, with explanations of how they function. You will learn why it is important to update a service panel or install AFCI protection. You will learn what it means to blow a fuse or trip a circuit, how to remedy the problem, and whether something should be done as a longer-term solution.

Detailed directions for installing in either new construction or finished areas are given. Most wiring tasks do not require high levels of skill. They do, however, require a great deal of attention to the details of meeting the current codes which protect us from dangerous and costly misuse of wiring. Safety is very important when dealing with something as powerful as electricity. Hundreds of people die each year from electrocution, or from fires started by improper wiring. Make sure that your wiring project is safe and appropriate by getting a permit and having your work inspected.

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#175 Dtp:225 Page:4

WORKING WITH WIRING

Wiring Safety 7
How Electricity Works 9
Understanding Electrical Circuits 14
Grounding & Polarization 16
Home Wiring Tools 18
Wire & Cable 20
NM Cable 28
Conduit 36
Work with Conduit 38
Electrical Boxes 40
Install Boxes 46
Electrical Panels 54
Wall Switches 62
Types of Wall Switches 64
Testing Switches 70
Receptacle Wiring 74
GFCI Receptacles 80
Testing Receptacles 84

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(Fogra 39)Job:04-30439 Title:MBI-HomeSkills Wiring
#175 Dtp:225 Page:5

Knowing which tools are safest to use is one of the keys to successful work. Touchless circuit testers let you diagnose voltage without exposing wires.

THE ONLY WAY you can possibly manage home wiring projects safely is to understand how electricity works and how it is delivered from the street to the outlets in your home.

The most essential quality to appreciate about electricity is that the typical amounts that flow through the wires in your home can be fatal under certain conditions if you contact it directly. Sources estimate that up to 1,000 people are electrocuted accidentally in the U.S. every year. In addition, as many as 500 die in fires from electrical causes. Home wiring can be a very satisfying task for do-it-yourselfers, but if you don't know what you're doing or are in any way uncomfortable with the idea of working around electricity, do not attempt it.

This chapter is intended to explain the fundamental principles behind the electrical circuits that run through our homes. It also includes some very basic tips for working safely with wiring, and it details the essential tools you'll need for the job. For the beginner it should be considered mandatory reading. Even if you have a good idea of electrical principles, take some time to review the material. A refresher course is always useful.

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WIRING SAFETY

Safety should be the primary concern of anyone working with electricity. Although most household electrical jobs are simple and straightforward, always use caution and good judgment when working with electrical wiring or devices. Common sense can prevent accidents.

Safety Tip

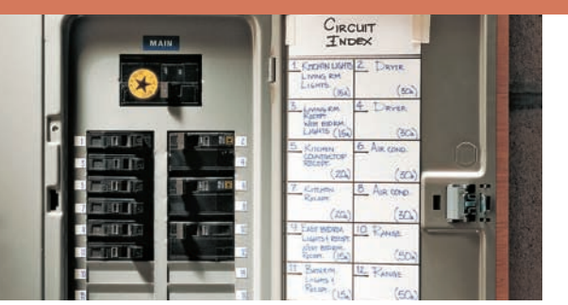
Always test a live circuit with the voltage tester to verify that the tester is working before you rely on it. Restore power only when the repair or replacement project is complete.

The basic rule of electrical safety is: Always turn off power to the area or device you are working on. At the main service panel, remove the fuse or shut off the circuit breaker that controls the circuit you are servicing. Then check to make sure the power is off by testing for power with a voltage tester.

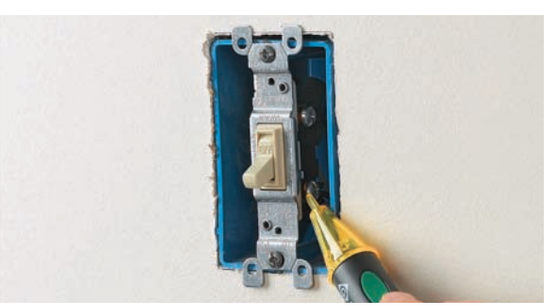
Follow the safety tips shown on these pages. Never attempt an electrical project beyond your skill or confidence level. Never attempt to repair or replace your main service panel or service entrance head. These are jobs for a qualified electrician and require that the power company shut off power to your house.

TIPS FOR WORKING WITH ELECTRICITY

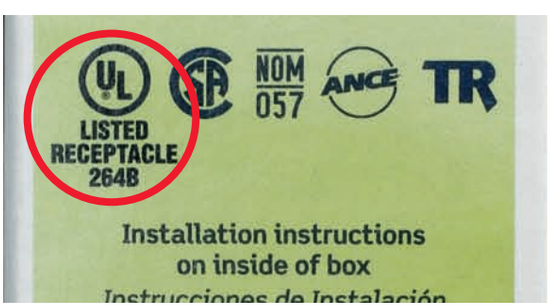
Shut power OFF at the main service panel or the main fuse box before beginning any work.



Create a circuit index and affix it to the inside of the door to your main service panel. Update it as needed.



Confirm power is OFF by testing at the outlet, switch, or fixture with a voltage tester.



Use only UL-approved electrical parts or devices. These devices have been tested for safety by Underwriters Laboratories.

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#175 Dtp:225 Page:7

Wear rubber-soled shoes while working on electrical projects. On damp floors, stand on a rubber mat or dry wooden boards.

Use fiberglass or wood ladders when making routine household repairs near the service mast.

Extension cords are for temporary use only. Cords must be rated for the intended usage.

Breakers and fuses must be compatible with the panel manufacturer and match the circuit capacity.

Never alter the prongs of a plug to fit a receptacle. If possible, install a new grounded receptacle.

Do not penetrate walls or ceilings without first shutting off electrical power to the circuits that may be hidden.

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HOW ELECTRICITY WORKS

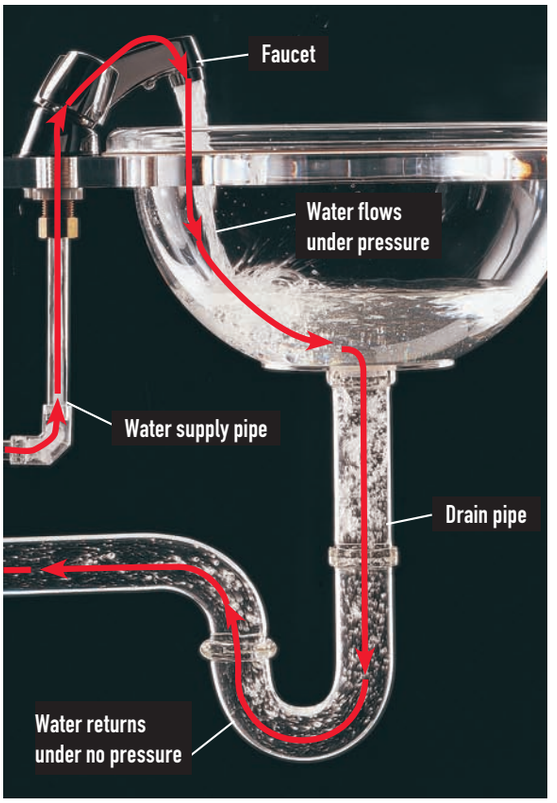
A household electrical system can be compared with a home's plumbing system. Electrical current flows in wires in much the same way that water flows inside pipes. Both electricity and water enter the home, are distributed throughout the house, do their "work," and exit.

In plumbing, water first flows through the pressurized water supply system. In electricity, current first flows along hot wires. Current flowing along hot wires also is pressurized. The pressure of electrical current is called voltage.

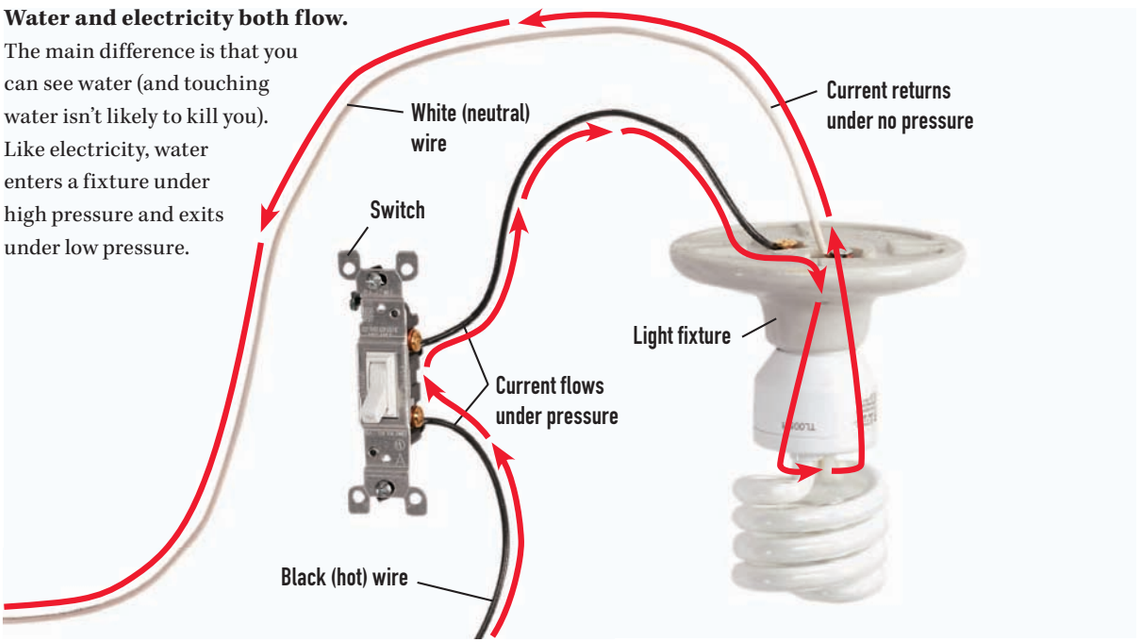
Large supply pipes can carry a greater volume of water than small pipes. Likewise, large electrical wires carry more current than small wires. This current-carrying capacity of wires is called amperage.

Water is made available for use through the faucets, spigots, and showerheads in a home. Electricity is made available through receptacles, switches, and fixtures.

Water finally leaves the home through a drain system, which is not pressurized. Similarly, electrical current flows back through neutral wires. The current in neutral wires is not pressurized and is said to be at zero voltage.



Water and electricity both flow. The main difference is that you can see water (and touching water isn't likely to kill you). Like electricity, water enters a fixture under high pressure and exits under low pressure.



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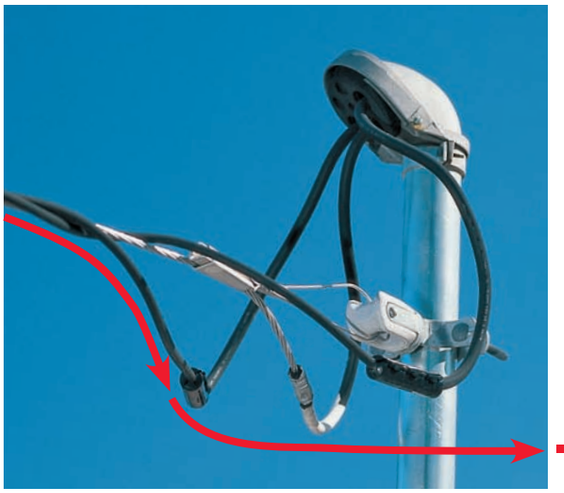
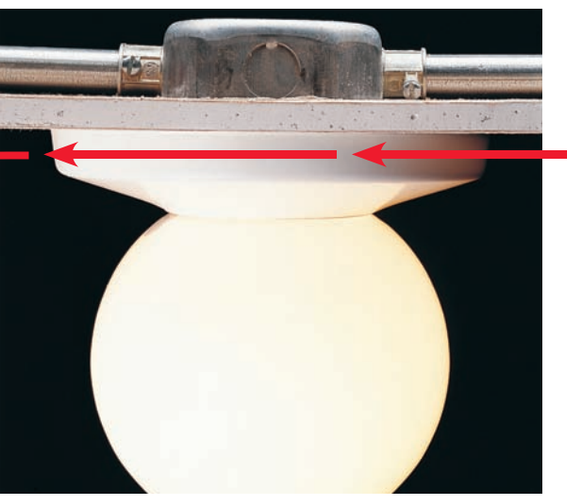
Parts of the Electrical System



The service mast is the metal pole and weatherhead that create the entry point for electricity into your home. The mast is supplied with three wires carrying 240 volts and originating from the nearest transformer.

The electric meter measures the amount of electrical power consumed. It is usually attached to the side of the house, and connects to the service mast. A thin metal disc inside the meter rotates when power is used. The electric meter belongs to your local power utility company. If you suspect the meter is not functioning properly, contact the power company.

A grounding wire connects the electrical system to the earth through a metal grounding rod driven next to the house, eliminating shock hazards from equipment and metallic objects.



Light fixtures attach directly to a household electrical system. They are usually controlled with wall switches. The two common types of light fixtures are incandescent and fluorescent.

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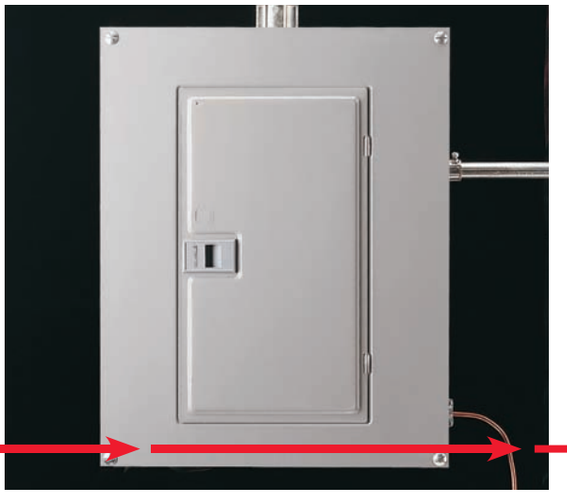
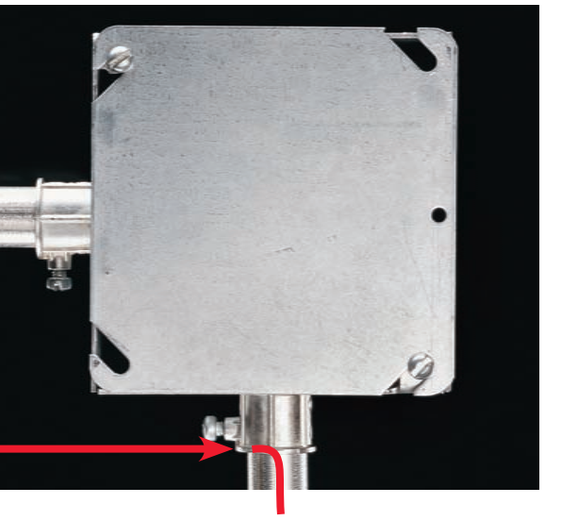
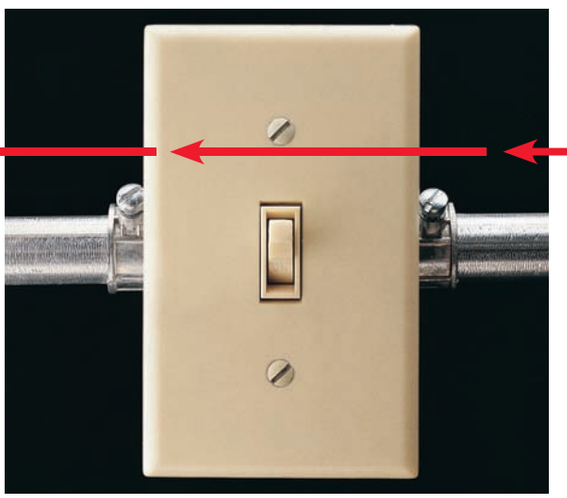


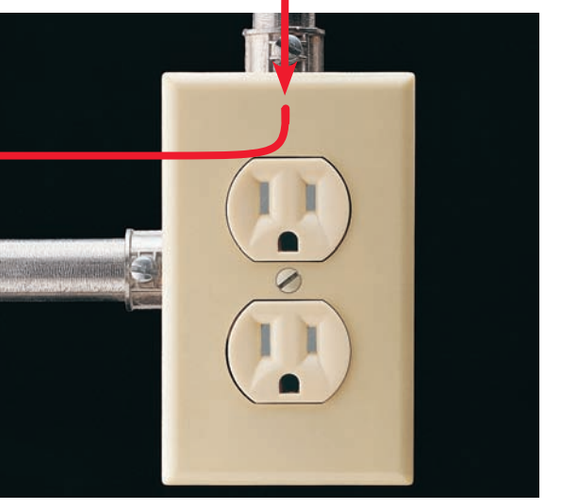
The main service panel, in the form of a fuse box or breaker box, distributes power to individual circuits. Fuses or circuit breakers protect each circuit from short circuits and overloads. Fuses and circuit breakers also are used to shut off power to individual circuits while repairs are made.



Electrical boxes enclose wire connections. According to the National Electrical Code, all wire splices or connections must be contained entirely in a covered plastic or metal electrical box.



Switches control electrical current passing through hot circuit wires. Switches can be wired to control light fixtures, ceiling fans, appliances, and receptacles.



Receptacles, sometimes called outlets, provide plug-in access to electrical power. A 120-volt, 15-amp receptacle with a grounding hole is the most typical receptacle in wiring systems installed after 1965. Most receptacles have two plug-in locations and are called duplex receptacles.

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Glossary of Electrical Terms

Ampere (or amp): Refers to the rate at which electrical power flows to a light, tool, or appliance.

Armored cable: Two or more wires that are grouped together and protected by a flexible metal covering.

Box: A device used to contain wiring connections.

BX: See armored cable (Bx is the older term).

Cable: Two or more wires that are grouped together and protected by a covering or sheath.

Circuit: A continuous loop of electrical current flowing along wires or cables.

Circuit breaker: A safety device that interrupts an electrical circuit in the event of an overload or short circuit.

Conductor: Any material that allows electrical current to flow through it. Copper wire is an especially good conductor.

Conduit: A metal or plastic pipe used to protect wires.

Continuity: An uninterrupted electrical pathway through a circuit or electrical fixture.

Current: The movement of electrons along a conductor.

Duplex receptacle: A receptacle that provides connections for two plugs.

Feed wire: A conductor that carries 120-volt current uninterrupted from the service panel.

Fuse: A safety device, usually found in older homes, that interrupts electrical circuits during an overload or short circuit.

Greenfield: Materials used in flexible metal conduit. See armored cable.

Grounded wire: See neutral wire.

Grounding wire: A wire used in an electrical circuit to conduct current to the earth in the event of a short circuit. The grounding wire often is a bare copper wire.

Hot wire: Any wire that carries voltage. In an electrical circuit, the hot wire usually is covered with black or red insulation.

Insulator: Any material, such as plastic or rubber, that resists the flow of electrical current. Insulating materials protect wires and cables.

Junction box: See box.

Meter: A device used to measure the amount of electrical power being used.

Neutral wire: A wire that returns current at zero voltage to the source of electrical power. Usually covered with white or light gray insulation. Also called the grounded wire.

Non-metallic sheathed cable: NM cable consists of two or more insulated conductors and, in most cases, a bare ground wire housed in a durable PVC casing.

Outlet: See receptacle.

Overload: A demand for more current than the circuit wires or electrical device was designed to carry. Usually causes a fuse to blow or a circuit breaker to trip.

Pigtail: A short wire used to connect two or more circuit wires to a single screw terminal.

Polarized receptacle: A receptacle designed to keep hot current flowing along black or red wires, and neutral current flowing along white or gray wires.

Power: The result of hot current flowing for a period of time. Use of power makes heat, motion, or light.

Receptacle: A device that provides plug-in access to electrical power.

Romex: A brand name of plastic-sheathed electrical cable that is commonly used for indoor wiring. Commonly known as NM cable.

Screw terminal: A place where a wire connects to a receptacle, switch, or fixture.

Service panel: A metal box usually near the site where electrical power enters the house. In the service panel, electrical current is split into individual circuits. The service panel has circuit breakers or fuses to protect each circuit.

Short circuit: An accidental and improper contact between two current-carrying wires, or between a current-carrying wire and a grounding conductor.

Switch: A device that controls electrical current passing through hot circuit wires. Used to turn lights and appliances on and off.

UL: An abbreviation for Underwriters Laboratories, an organization that tests electrical devices and manufactured products for safety.

Voltage (or volts): A measurement of electricity in terms of pressure.

Wattage (or watt): A measurement of electrical power in terms of total energy consumed. Watts can be calculated by multiplying the voltage times the amps.

Wire connector: A device used to connect two or more wires together. Also called a wire nut.

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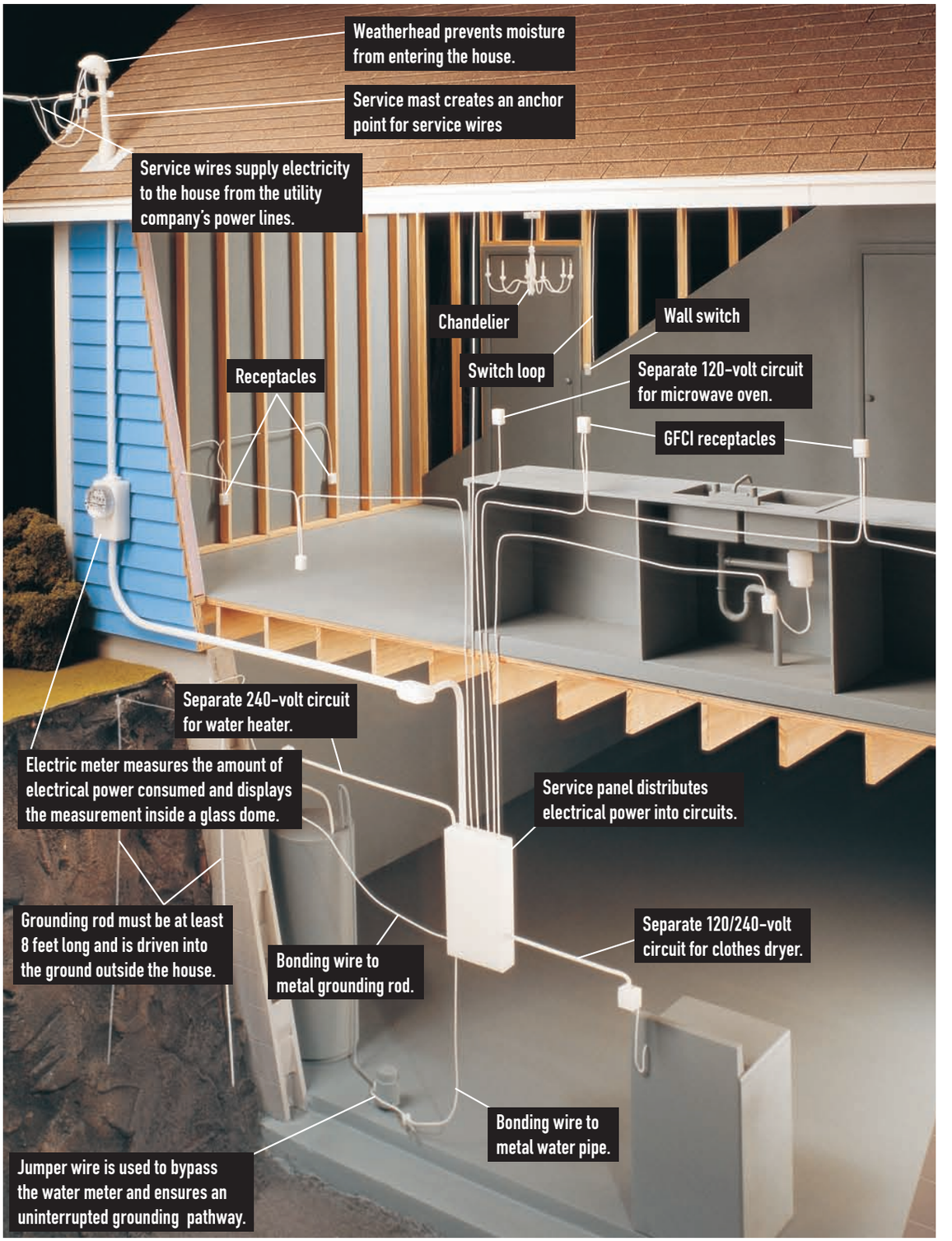
Major Features of Home Wiring



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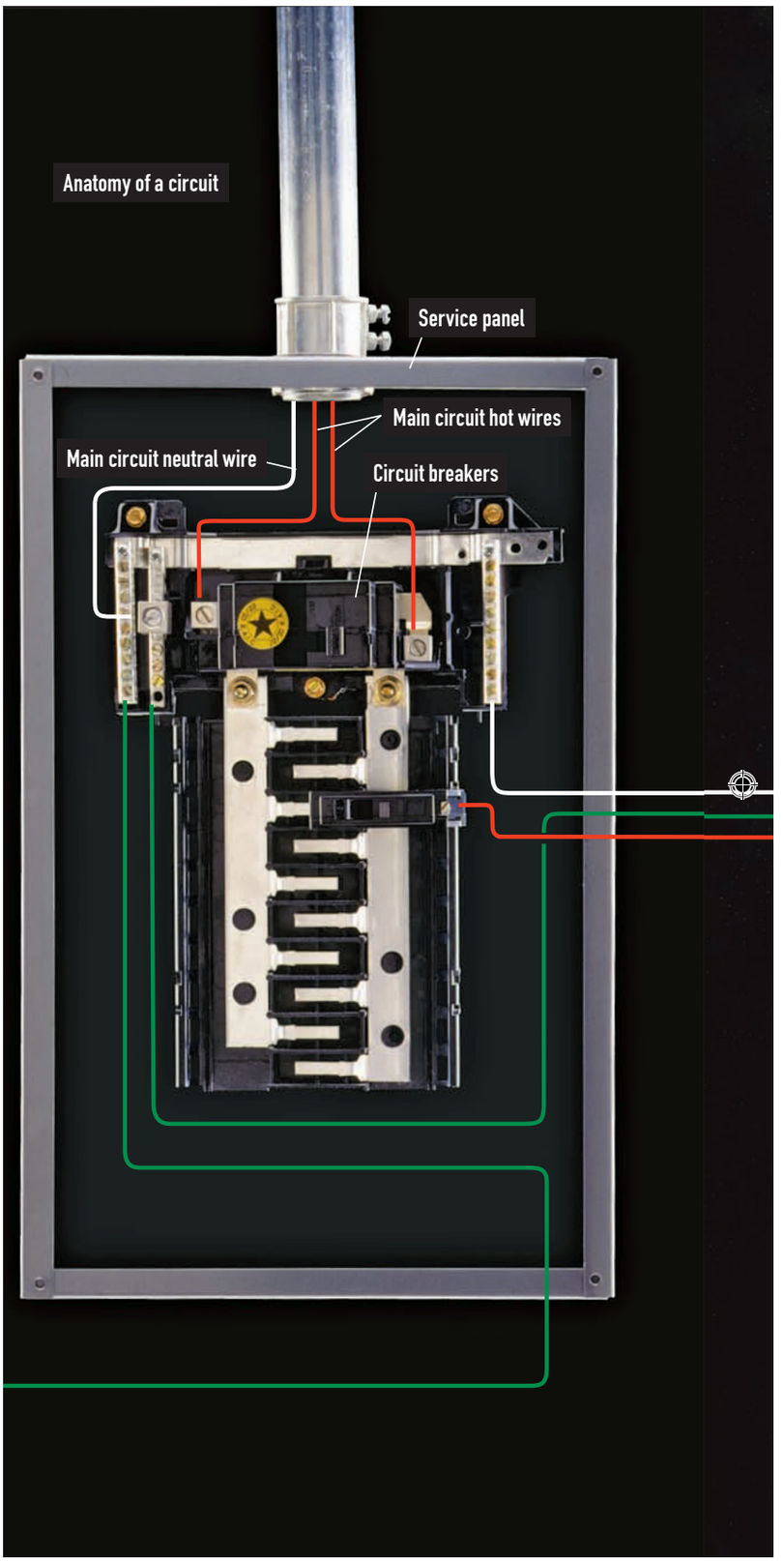
UNDERSTANDING ELECTRICAL CIRCUITS

An electrical circuit is a continuous loop. Household circuits carry power from the main service panel, throughout the house, and back to the main service panel. Several switches, receptacles, light fixtures, or appliances may be connected to a single circuit.

Current enters a circuit loop on hot wires and returns along neutral wires. These wires are color coded for easy identification. Hot wires are black or red, and neutral wires are white or light gray. For safety, most circuits include a bare copper or green insulated grounding wire. The grounding wire conducts current in the event of a ground fault, and helps reduce the chance of severe electrical shock. The service panel also has a grounding wire connected to a metal water pipe and metal grounding rod buried underground.

If a circuit carries too much power, it can overload. A fuse or a circuit breaker protects each circuit in case of overloads.

Current returns to the service panel along a neutral circuit wire. Current then becomes part of a main circuit and leaves the house on a large neutral service wire that returns it to the utility pole transformer.



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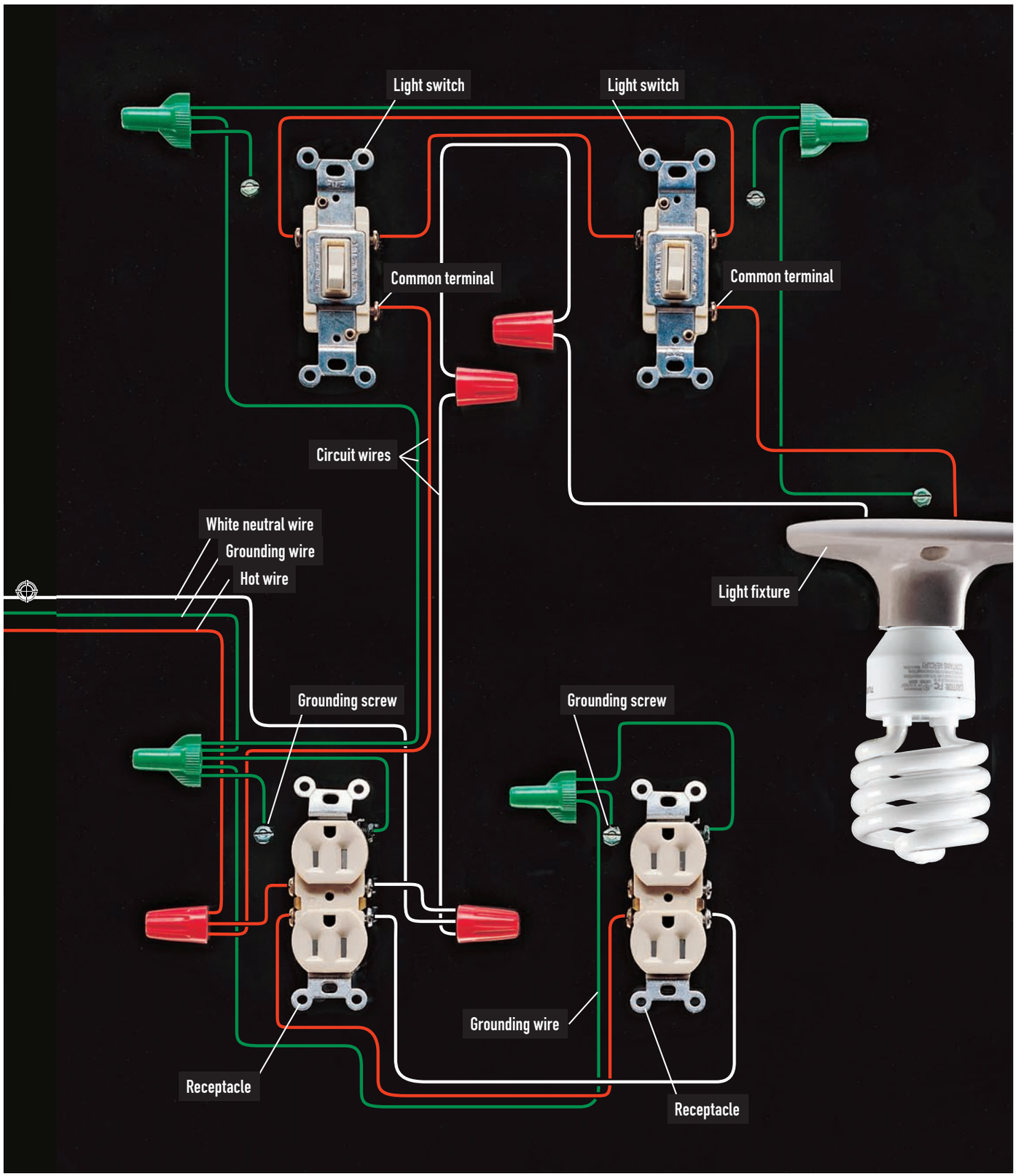

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GROUNDING & POLARIZATION

Electricity always seeks to return to its source and complete a continuous circuit. In a household wiring system, this return path is provided by white neutral wires that return current to the main service panel. From the service panel, current returns along a neutral service wire to a power pole transformer.

A grounding wire provides an additional return path for electrical current. The grounding wire is a safety feature. It is designed to conduct electricity if current seeks to return to the service panel along a path other than the neutral wire, a condition known as a ground fault.

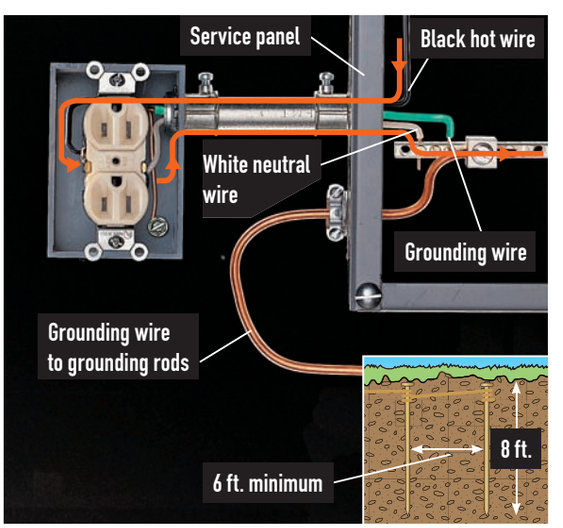
A ground fault is a potentially dangerous situation. If an electrical box, tool, or appliance becomes short-circuited and is touched by a person, the electrical current may attempt to return to its source by passing through that person's body.

However, electrical current prefers the path of least resistance. A grounding wire provides a safe, easy path for current to follow back to its utility transformer. If a person touches an electrical box, tool, or appliance that has a properly installed grounding wire, any chance of receiving a severe electrical shock is greatly reduced.

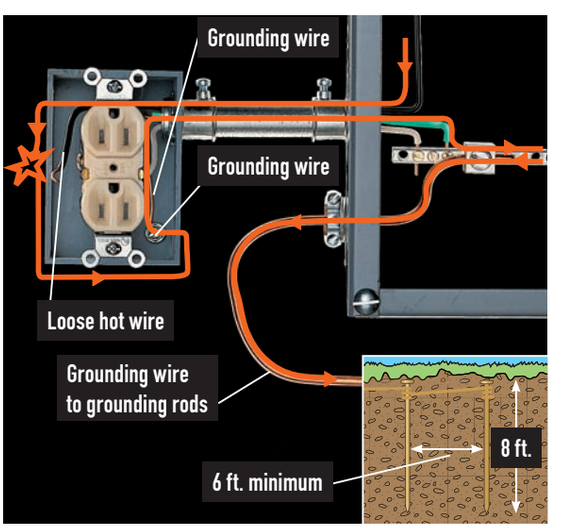
In addition, household wiring systems are required to be connected directly to the earth. This helps to ensure that all equipment and metallic objects are held at Earth's potential (zero volts) to eliminate shock hazards. A short circuit can also occur when a hot and a neutral conductor come in contact. When your electrical system is functioning properly, the fuses or circuit breaker will de-energize the circuit to clear the fault.

Grounding of the home electrical system is accomplished by wiring the household electrical system to a metal cold water pipe and metal grounding rods that are buried in the earth.

After 1920, most American homes included receptacles that accepted polarized plugs. The two-slot polarized plug and receptacle was designed to keep hot current flowing along black or red wires, and neutral current flowing along white or gray wires.



Normal current flow: Current enters the electrical box along a black hot wire, then returns to the service panel along a white neutral wire. Any excess current passes into the earth via a grounding wire attached to grounding rods or a metal water pipe.



Short circuit: Current is detoured by a loose wire in contact with the metal box. The grounding wire picks it up and channels it safely back to the main service panel. There, it returns to its source along a neutral service cable or enters the earth via the grounding system.

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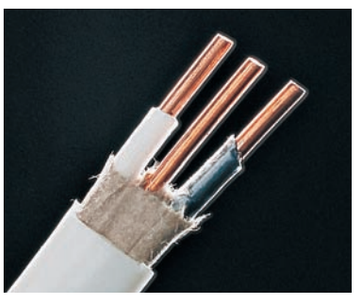
#175 Dtp:225 Page:16

Armored cable and metal conduit, widely installed in homes during the 1940s, provided a true grounding path. When connected to metal junction boxes, it provided a metal pathway back to the service panel.

Modern cable includes a green insulated or bare copper wire that serves as the grounding path. This grounding wire is connected to all three-slot receptacles and metal boxes to provide a continuous pathway for any ground faulted current. By plugging a three-prong plug into a grounded three-slot receptacle, people are protected from ground faults that occur in appliances, tools or other electric devices.

Use a receptacle adapter to plug three-prong plugs into two-slot receptacles, but use it only if the receptacle connects to a grounding wire or grounded electrical box. Adapters have short grounding wires or wire loops that attach to the receptacle's coverplate mounting screw. The mounting screw connects the adapter to the grounded metal electrical box.



Modern NM (nonmetallic) cable, found in most wiring systems installed after 1965, contains a bare copper wire that provides grounding for receptacle and switch boxes.

Armored cable is sold pre-installed in a flexible metal housing. BX, Greenfield, and MC are three common types. Metal-clad cable Type MC is shown here. It contains a green insulated ground wire along with black and white conductors.

Polarized receptacles have a long slot and a short slot. Used with a polarized plug, the polarized receptacle keeps electrical current directed for safety.

Three-slot receptacles are required by code for new homes. They are usually connected to a standard two-wire cable with ground.

Receptacle adapter allows three-prong plugs to be inserted into two-slot receptacles. The adapter can be used only with grounded receptacles, and the grounding loop or wire of the adapter must be attached to the coverplate mounting screw of the receptacle. Use of these adapters is generally discouraged.

Double-insulated tools have non-conductive plastic bodies to prevent shocks caused by short circuits. Because of these features, double-insulated tools can be used safely with ungrounded receptacles.

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#175 Dtp:225 Page:17

HOME WIRING TOOLS

To complete the wiring projects shown in this book, you need a few specialty electrical tools as well as a collection of basic hand tools. As with any tool purchase, invest in good-quality products when you buy tools for electrical work. Keep your tools clean, and sharpen or replace any cutting tools that have dull edges.

The materials used for electrical wiring have changed dramatically in the last 20 years, making it much easier for homeowners to do their own electrical work.

Tip

Electrical tape is never actually used to splice or repair electrical wires. If you see electrical tape used on any wiring in your home without a wire cap, the problem needs to be corrected immediately by re-making the connection with a cap.

Hand tools you'll need for home wiring projects include: Stud finder/laser level (A) for locating framing members and aligning electrical boxes; Tape measure (B); Cable ripper (C) for scoring NM sheathing; Standard (D) and Phillips (E) screwdrivers; Utility knife (F); Side cutters (G) for cutting wires; Channel-type pliers (H) for general gripping and crimping; Linesman pliers (I) combine side cutter and gripping jaws; Needlenose pliers (J); Wire strippers (K) for removing insulation from conductors.

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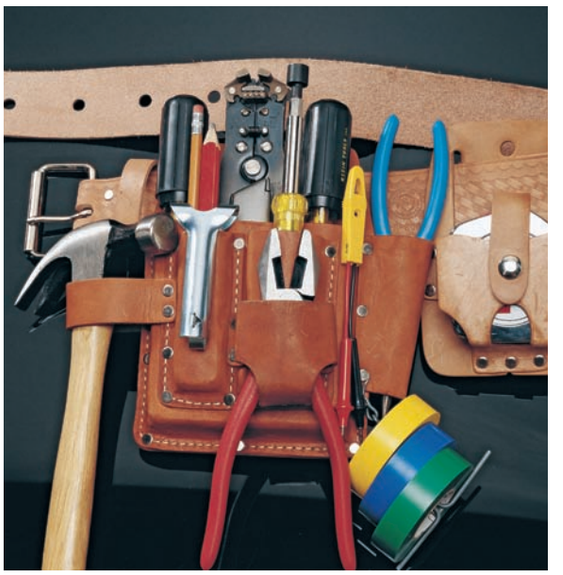

Use a tool belt to keep frequently used tools within easy reach. Electrical tapes in a variety of colors are used for marking wires and for attaching cables to a fish tape.

A fish tape is useful for installing cables in finished wall cavities and for pulling wires through conduit. Products designed for lubrication reduce friction and make it easier to pull cables and wires.

Diagnostic tools for home wiring use include: Touchless circuit tester (A) to safely check wires for current and confirm that circuits are dead; Plug-in tester (B) to check receptacles for correct polarity, grounding, and circuit protection; Multimeter (C) to measure AC/DC voltage, AC/DC current, resistance, capacitance, frequency, and duty cycle (model shown is an auto-ranging digital multimeter with clamp-on jaws that measure through sheathing and wire insulation).

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#175 Dtp:225 Page:19

WIRE & CABLE

Wires are made of copper, aluminum, or aluminum covered with a thin layer of copper. Solid copper wires are the best conductors of electricity and are the most widely used. Aluminum and copper-covered aluminum wires require special installation techniques.

A group of two or more wires enclosed in a metal, rubber, or plastic sheath is called a cable (photo, opposite page). The sheath protects the wires from damage. Metal conduit also protects wires, but it is not considered a cable.

Individual wires are covered with rubber or plastic vinyl insulation. An exception is a bare copper grounding wire, which does not need an insulation cover. The insulation is color coded (chart, left) to identify the wire as a hot wire, a neutral wire, or a grounding wire.

In most wiring systems installed after 1965, the wires and cables are insulated with plastic vinyl. This type of insulation is very durable and can last as long as the house itself.

Before 1965, wires and cables were insulated with rubber. Rubber insulation has a life expectancy of about 25 years. Old insulation that is cracked or damaged can be reinforced temporarily by wrapping the wire with plastic electrical tape. However, old wiring with damaged insulation should be inspected by a qualified electrician to make sure it is safe.

Wires must be large enough for the amperage rating of the circuit (chart, right). A wire that is too small can become dangerously hot. Wire sizes are categorized according to the American Wire Gauge (AWG) system. To check the size of a wire, use the wire stripper openings of a combination tool as a guide.

Wire Color Chart

Wire Color		Function
	White	Neutral wire carrying current at zero voltage.
	Black	Hot wire carrying current at full voltage.
	Red	Hot wire carrying current at full voltage.
	White, black markings	Hot wire carrying current at full voltage.
	Green	Serves as a grounding pathway.
	Bare copper	Serves as a grounding pathway.

Individual wires are color-coded to identify their function. In some circuit installations, the white wire serves as a hot wire that carries voltage. If so, this white wire may be labeled with black tape or paint to identify it as a hot wire.

Wire Size Chart

Wire Gauge		Wire Capacity and Use
	#6	60 amps, 240 volts; central air conditioner, electric furnace.
	#8	40 amps, 240 volts; electric range, central air conditioner.
	#10	30 amps, 240 volts; window air conditioner, clothes dryer.
	#12	20 amps, 120 volts; light fixtures, receptacles, microwave oven.
	#14	15 amps, 120 volts; light fixtures, receptacles.
	#16	Light-duty extension cords.
	#18 to 22	Thermostats, doorbells, security systems.

Wire sizes (shown actual size) are categorized by the American Wire Gauge system. The larger the wire size, the smaller the AWG number.

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#175 Dtp:225 Page:20

Knob and tube wiring, so called because of the shape of its porcelain insulating brackets, was common before 1940. Wires are covered with a layer of rubberized cloth fabric, but have no additional protection.

Metal-clad (MC) armored cable has been around since the 1920s. Early versions had no grounding function, but existed solely to protect the wires that were threaded into it. Later armored cable products either had ground wire twisted in with the flexible metal cover or relied on the metal cover itself for connecting to ground. Modern MC contains an insulated ground wire along with the conductors.

Metal conduit was installed during the middle of the 20th century as a way to protect hot and neutral conductors. The conduit itself often was employed for connecting to ground. Modern conduit (both metal and PVC) should be filled with insulated THHN conductors, including an insulated ground wire.

Early NM (nonmetallic) cable was used from 1930 until 1965. It features a rubberized fabric sheathing that protects individual wires. NM cable greatly simplified installations because separate wires no longer had to be pulled by hand through a conduit or armored cable. Early NM cable had no grounding wire.

NM (nonmetallic) cable was developed around 1930. The first version had rubberized sheathing that degraded rapidly and had no ground wire. Modern versions with a hard PVC shell came onto the market in the 1960s. Sheathing is now color-coded by gauge (the yellow seen here is 12 AWG).

UF (underground feeder) cable has wires embedded in a solid-core plastic vinyl sheathing and includes a bare copper grounding wire. It is designed for installations in damp conditions, such as buried circuits.

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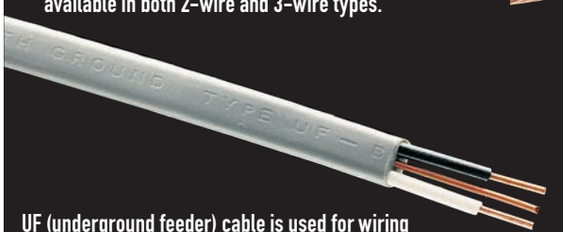
#175 Dtp:225 Page:21

NM (nonmetallic) sheathed cable should be used for most indoor wiring projects in dry locations. NM cable is available in a wide range of wire sizes, and in either "2-wire with ground" or "3-wire with ground" types. NM cable is sold in boxed rolls that contain from 25 to 250 ft. of cable.

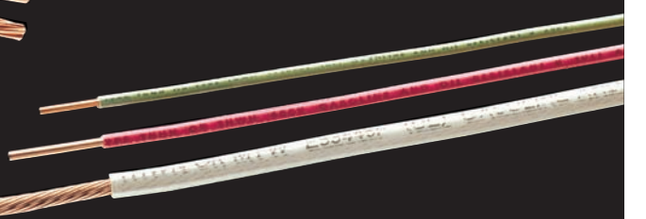
Large-appliance cable, also called SER cable, is used for kitchen ranges and other 50-amp or 60-amp appliances that require 8-gauge or larger wire. It is similar to NM cable, but each individual conducting wire is made from fine-stranded copper wires. Large-appliance cable is available in both 2-wire and 3-wire types.



UF (underground feeder) cable is used for wiring in damp locations, such as in an outdoor circuit. It has a white or gray solid-core vinyl sheathing that protects the wires inside. It also can be used indoors wherever NM cable is allowed.

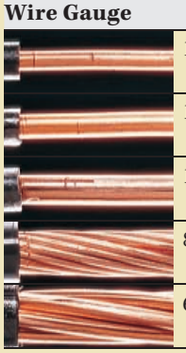
Coaxial cable is used to connect cable television jacks. Coaxial cable is available in lengths up to 25 ft. with preattached F-connectors (A). Or you can buy bulk cable (B) in any length.

THHN/THWN wire can be used in all conduit applications. Each wire, purchased individually, is covered with a color-coded thermoplastic insulating jacket. Make sure the wire you buy has the THHN/THWN rating. Other wire types are less resistant to heat and moisture than THHN/THWN wire.



Telephone cable is used to connect telephone outlets. Your phone company may recommend four-wire cable (shown below) or eight-wire cable, sometimes called four-pair. Eight-wire cable has extra wires that are left unattached. These extra wires allow for future expansion of the system.

Tips for Working with Wire

Wire Gauge		Ampacity	Maximum Wattage Load
	14-gauge	15 amps	1440 watts (120 volts)
	12-gauge	20 amps	1920 watts (120 volts) 3840 watts (240 volts)
	10-gauge	30 amps	2880 watts (120 volts) 5760 watts (240 volts)
	8-gauge	40 amps	7680 watts (240 volts)
	6-gauge	50 amps	9600 watts (240 volts)

Wire "ampacity" is a measurement of how much current a wire can carry safely. Ampacity varies according to the size of the wires, as shown at left. When installing a new circuit, choose wire with an ampacity rating matching the circuit size. For dedicated appliance circuits, check the wattage rating of the appliance and make sure it does not exceed the maximum wattage load of the circuit.

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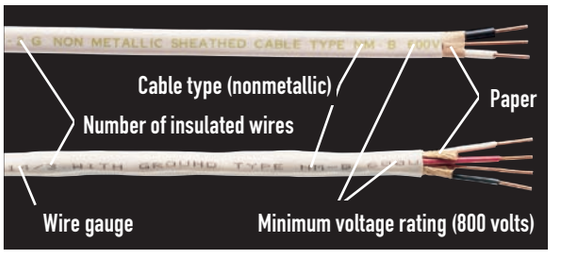
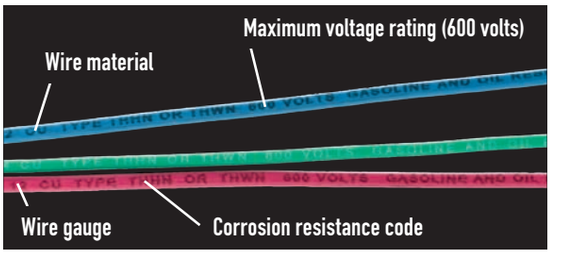
Reading NM (Nonmetallic) Cable



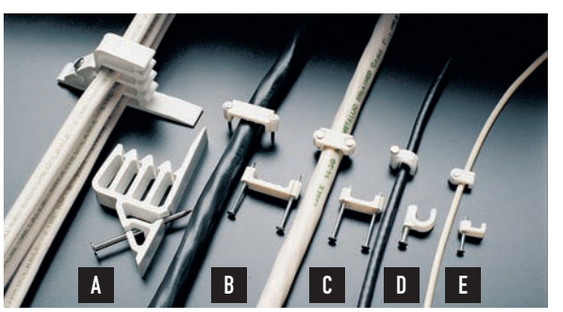
NM (nonmetallic) cable is labeled with the number of insulated wires it contains. The bare grounding wire is not counted. For example, a cable marked 14/2 G (or 14/2 WITH GROUND) contains two insulated 14-gauge wires, plus a bare copper grounding wire. Cable marked 14/3 WITH GROUND has three 14-gauge wires plus a grounding wire. NM cable also is stamped with a maximum voltage rating, as determined by Underwriters Laboratories (UL).

Reading Unsheathed, Individual Wire



Unsheathed, individual wires are used for conduit and raceway installations. Wire insulation is coded with letters to indicate resistance to moisture, heat, and gas or oil. Code requires certain letter combinations for certain applications. T indicates thermoplastic insulation. H stands for heat resistance and two Hs indicate high resistance (up to 194° F). W denotes wire suitable for wet locations. Wire coded with an N is impervious to damage from oil or gas.

Use wire connectors rated for the wires you are connecting. Wire connectors are color-coded by size, but the coding scheme varies according to manufacturer. The wire connectors shown above come from one major manufacturer. To ensure safe connections, each connector is rated for both minimum and maximum wire capacity. These connectors can be used to connect both conducting wires and grounding wires. Green wire connectors are used only for grounding wires.



Use plastic cable staples to fasten cables. Choose staples sized to match the cables. Stack-It® staples (A) hold up to four 2-wire cables; ¾" staples (B) for 12/2, 12/3, and all 10-gauge cables; ½" staples (C) for 14/2, 14/3, or 12/2 cables; coaxial staples (D) for anchoring television cables; bell wire staples (E) for attaching telephone cables.

Push-in connectors are a relatively new product for joining wires. Instead of twisting the bare wire ends together, you strip off about ¾" of insulation and insert them into a hole in the connector. The connectors come with two to four holes sized for various gauge wires. These connectors are perfect for inexperienced DIYers because they do not pull apart like a sloppy twisted connection can.

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STRIPPING NM SHEATHING & INSULATION

1 Measure and mark the cable 8 to 10" from end. Slide the cable ripper onto the cable, and squeeze tool firmly to force cutting point through plastic sheathing.

2 Grip the cable tightly with one hand, and pull the cable ripper toward the end of the cable to cut open the plastic sheathing.

3 Peel back the plastic sheathing and the paper wrapping from the individual wires.

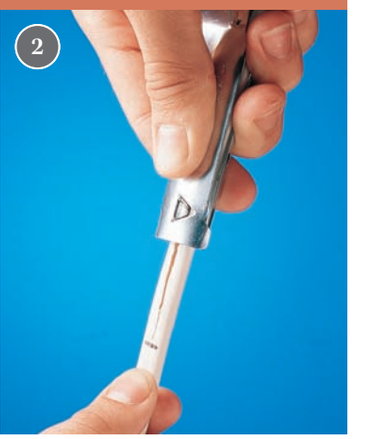
4 Cut away the excess plastic sheathing and paper wrapping, using the cutting jaws of a combination tool.

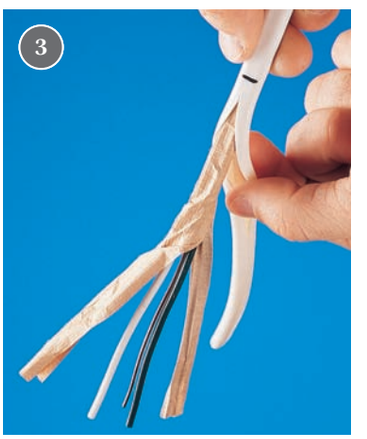
5 Cut individual wires as needed using the cutting jaws of the combination tool. Leave a minimum of 6" of wire running past the edge of the box.

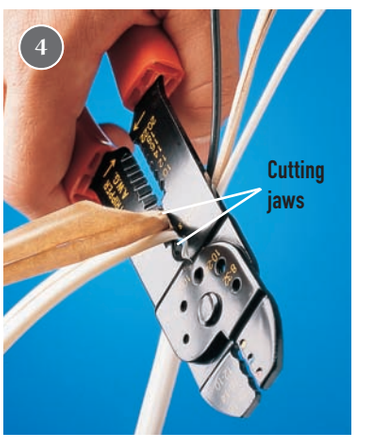
6 Strip insulation for each wire, using the stripper openings. Choose the opening that matches the gauge of the wire, and take care not to nick or scratch the ends of the wires.

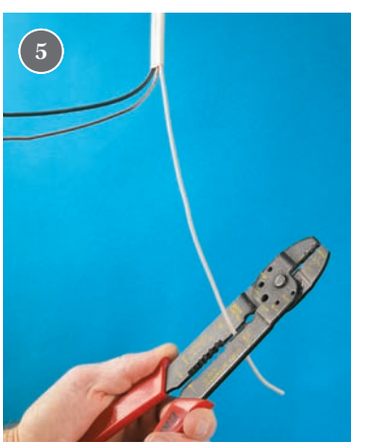
Tip

It's a good idea to practice stripping wire and cable before you strip wire you have installed.









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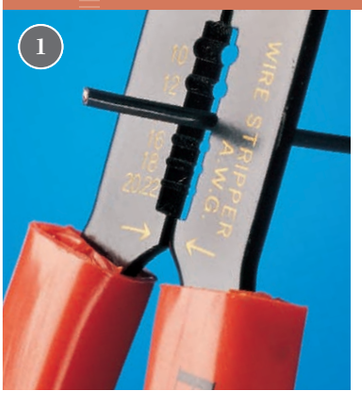
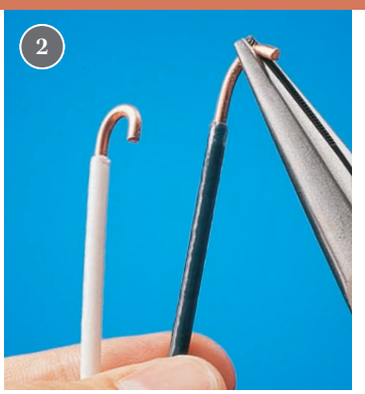
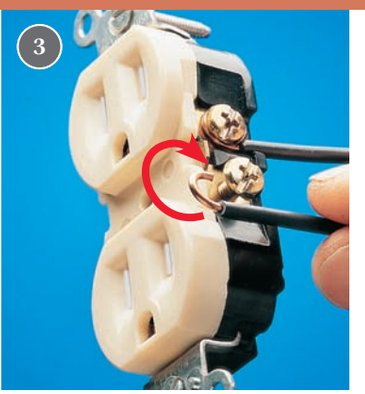
CONNECTING WIRES TO SCREW TERMINALS







1 Strip about ¾" of insulation from each wire using a combination tool. Choose the stripper opening that matches the gauge of the wire, then clamp the wire in the tool. Pull the wire firmly to remove plastic insulation.

2 Form a C-shaped loop in the end of each wire using a needlenose pliers or the hole of the correct gauge in a pair of wire strippers. The wire should have no scratches or nicks.

3 Hook each wire around the screw terminal so it forms a clockwise loop. Tighten screw firmly. Insulation should just touch head of screw. Never place the ends of two wires under a single screw terminal. Instead, use a pigtail wire (page 27).

CONNECTING WIRES WITH PUSH-INS

1 Mark the amount of insulation to be stripped from each wire using the strip gauge on the back of the switch or receptacle. Strip the wires using a combination tool (step 1, above). Never use push-in fittings with aluminum wiring.

2 Insert the bare copper wires firmly into the push-in fittings on the back of the switch or receptacle. When inserted, wires should have no bare copper exposed. Note: Although push-in fittings are convenient, most experts believe screw terminal connections (above) are more dependable.

3 Remove a wire from a push-in fitting by inserting a small nail or screwdriver in the release opening next to the wire. Wire will pull out easily.

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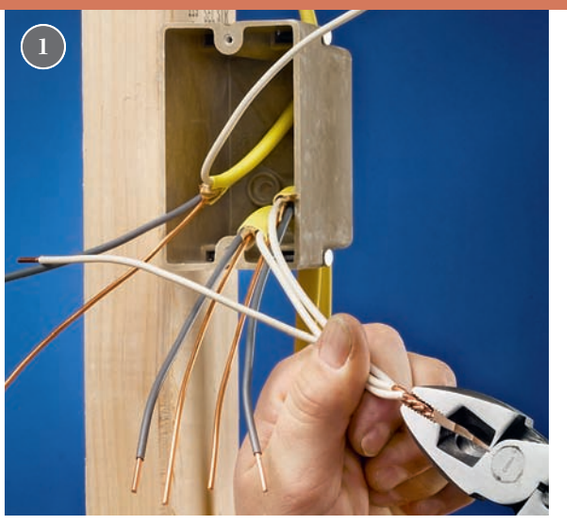
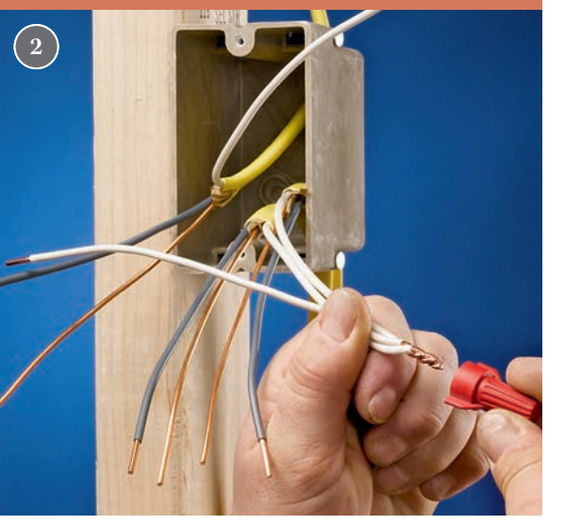
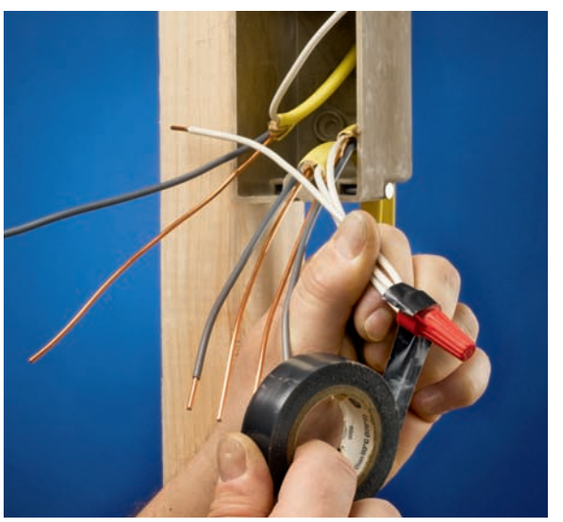
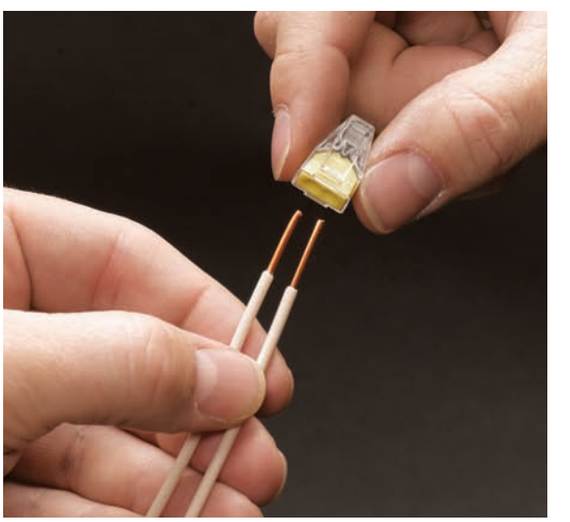
JOINING WIRES WITH A WIRE CONNECTOR









1 Ensure power is off and test for power. Grasp the wires to be joined in the jaws of a pair of linesman's pliers. The ends of the wires should be flush and they should be parallel and touching. Rotate the pliers clockwise two or three turns to twist the wire ends together.

2 Twist a wire connector over the ends of the wires. Make sure the connector is the right size (see page 23). Hand-twist the connector as far onto the wires as you can. There should be no bare wire exposed beneath the collar of the connector.

Option: Reinforce the joint by wrapping it with electrician's tape. By code, you cannot bind the wire joint with tape only, but it can be used as insurance. Few professional electricians use tape for purposes other than tagging wires for identification.

Option: Strip ¾" of insulation off the ends of the wires to be joined, and insert each wire into a push-in connector. Gently tug on each wire to make sure it is secure.

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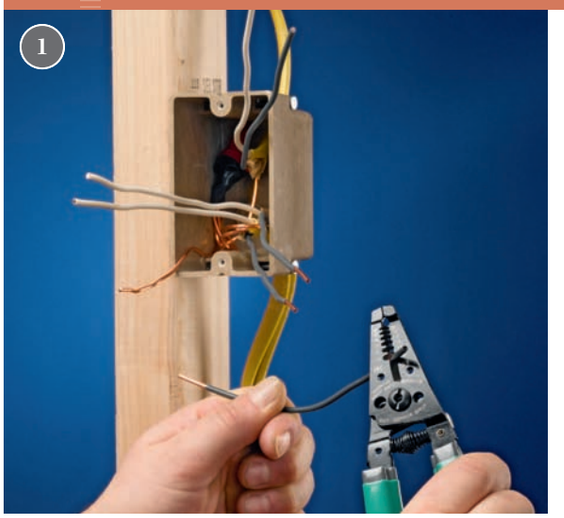
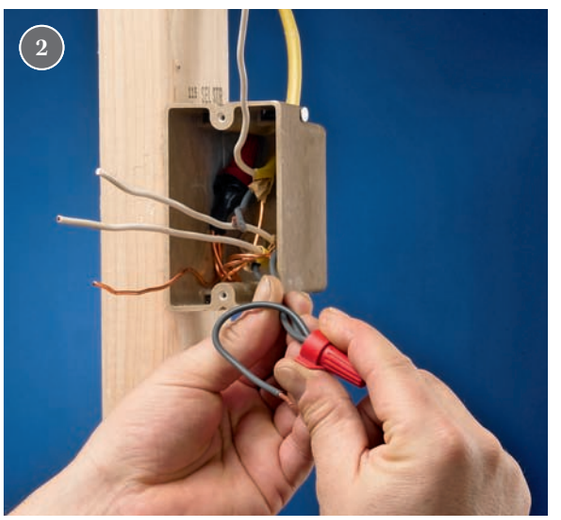
PIGTAILING WIRES

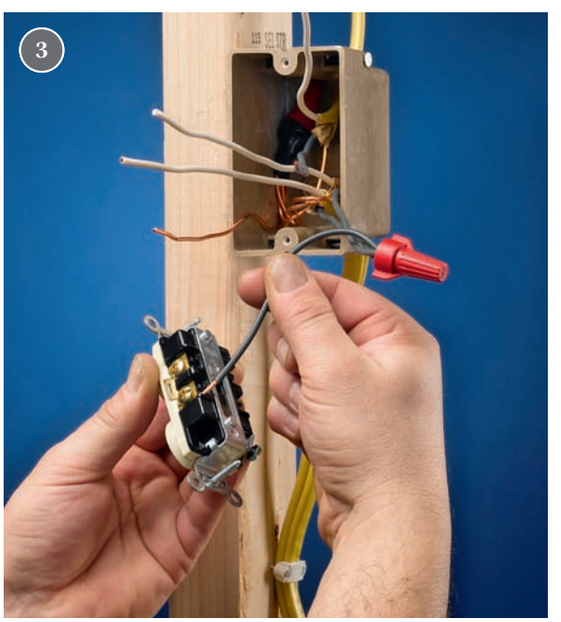


1 Cut a 6" length from a piece of insulated wire the same gauge and color as the wires it will be joining. Strip ¾" of insulation from each end of the insulated wire.

2 Join one end of the pigtail to the wires that will share the connection using a wire nut (see previous page).

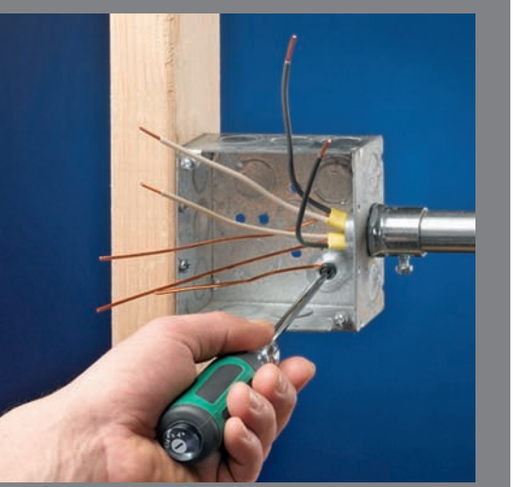
3 Connect the pigtail to the appropriate terminal on the receptacle or switch. Fold the wires neatly and press the fitting into the box.





Alternative:

If you are pigtailing to a grounding screw or grounding clip in a metal box, you may find it easier to attach one end of the wire to the grounding screw before you attach the other end to the other wires.



Tip

Pigtailing is done mainly to avoid connecting multiple wires to one terminal, which is a code violation.

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(Fogra 39)Job:04-30439 Title:MBI-HomeSkills Wiring
#175 Dtp:225 Page:27

NM CABLE

NM cable is used for all indoor wiring projects except those requiring conduit. Cut and install the cable after all electrical boxes have been mounted. Refer to your wiring plan to make sure each length of cable is correct for the circuit size and configuration.

Cable runs are difficult to measure exactly, so leave plenty of extra wire when cutting each length. Cable splices inside walls are not allowed by code. When inserting cables into a circuit breaker panel, make sure the power is shut off.

After all cables are installed and all the ground wires spliced, call your electrical inspector to arrange for the rough-in inspection. Do not install wallboard or attach light fixtures and other devices until this inspection is done.

Tools & Materials

- Drill
- Bits
- Tape measure
- Cable ripper
- Combination tool
- Screwdrivers
- Needlenose pliers
- Hammer
- Fish tape
- NM cable
- Cable clamps
- Cable staples
- Masking tape
- Electrical tape
- Grounding pigtails
- Wire connectors
- Eye and ear protection

Pulling cables through studs is easier if you drill smooth, straight holes at the same height. Prevent kinks by straightening the cable before pulling it through the studs. Use plastic grommets to protect cables on steel studs (inset).

Framing Member	Maximum Hole Size	Maximum Notch Size
2 × 4 loadbearing stud	1 7/16" diameter	7/8" deep
2 × 4 non-loadbearing stud	2 1/2" diameter	1 7/16" deep
2 × 6 loadbearing stud	2 1/4" diameter	1 3/8" deep
2 × 6 non-loadbearing stud	3 5/16" diameter	2 3/16" deep
2 × 6 joists	1 1/2" diameter	7/8" deep
2 × 8 joists	2 3/8" diameter	1 1/4" deep
2 × 10 joists	3 1/16" diameter	1 1/2" deep
2 × 12 joists	3 3/4" diameter	1 7/8" deep

This framing member chart shows the maximum sizes for holes and notches that can be cut into studs and joists when running cables. When boring holes, there must be at least 1 1/4" of wood between the edge of a stud and the hole, and at least 2" between the edge of a joist and the hole. Joists can be notched only in the end 1/3 of the overall span; never in the middle 1/3 of the joist. If 1 1/4" clearance cannot possibly be maintained, you may be able to satisfy code by installing a metal nail plate over the point of penetration in the stud.

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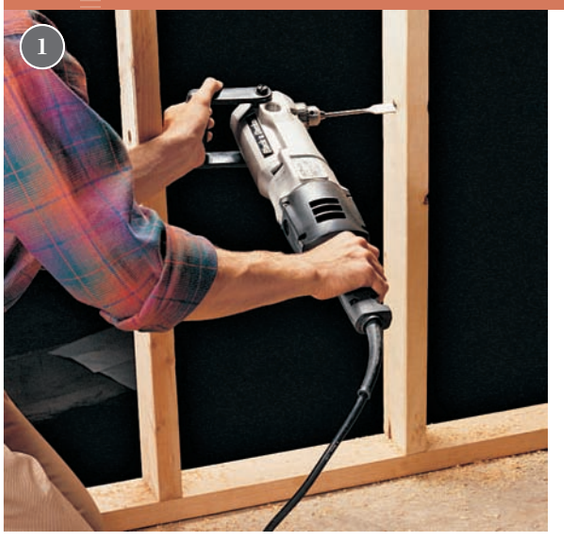
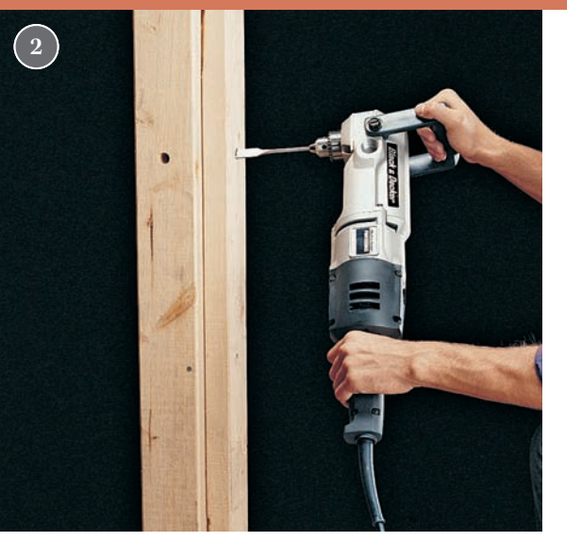
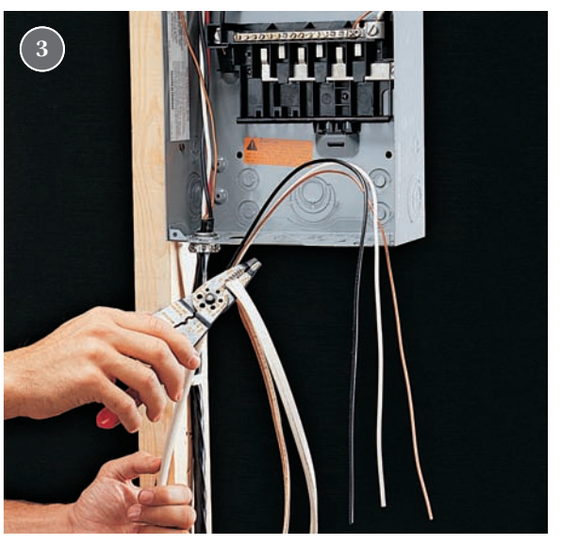
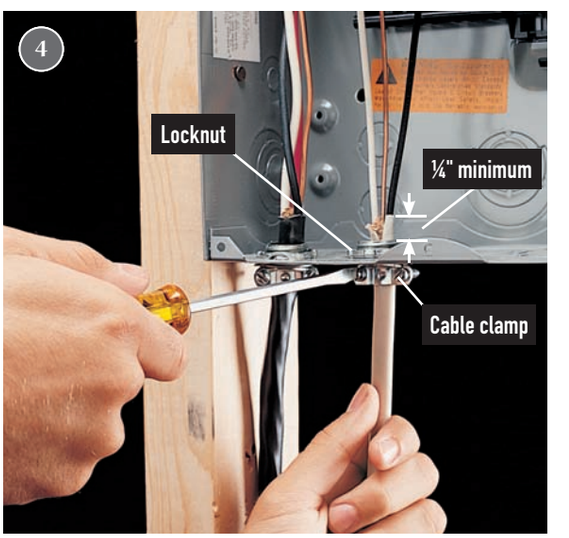
#175 Dtp:225 Page:28

INSTALLING NM CABLE









1 Drill ⅝" holes in framing members for the cable runs. This is done easily with a right-angle drill, available at rental centers. Holes should be set back at least 1¼" from the front face of the framing members.

2 Where cables will turn corners (step 6, page 30), drill intersecting holes in adjoining faces of studs. Measure and cut all cables, allowing 2 ft. extra at ends entering the breaker panel and 1 ft. for ends entering the electrical box.

3 Shut off power to circuit breaker panel. Use a cable ripper to strip cable, leaving at least ¼" of sheathing to enter the circuit breaker panel. Clip away the excess sheathing.

4 Open a knockout in the circuit breaker panel using a hammer and screwdriver. Insert a cable clamp into the knockout, and secure it with a locknut. Insert the cable through the clamp so that at least ¼" of sheathing extends inside the circuit breaker panel. Tighten the mounting screws on the clamp so the cable is gripped securely but not so tightly that the sheathing is crushed.

continued

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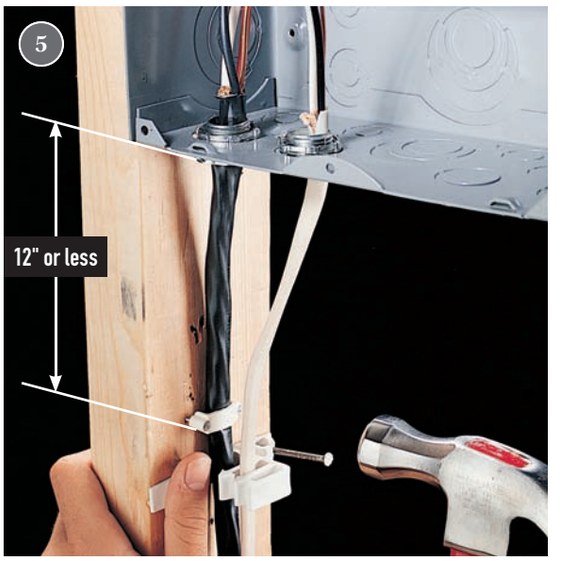
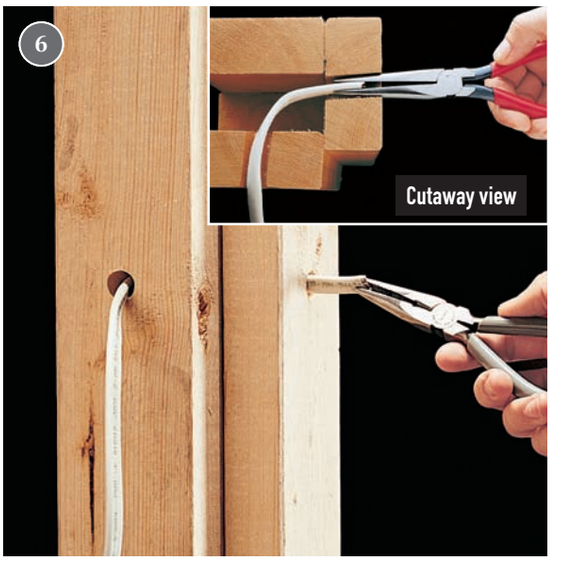
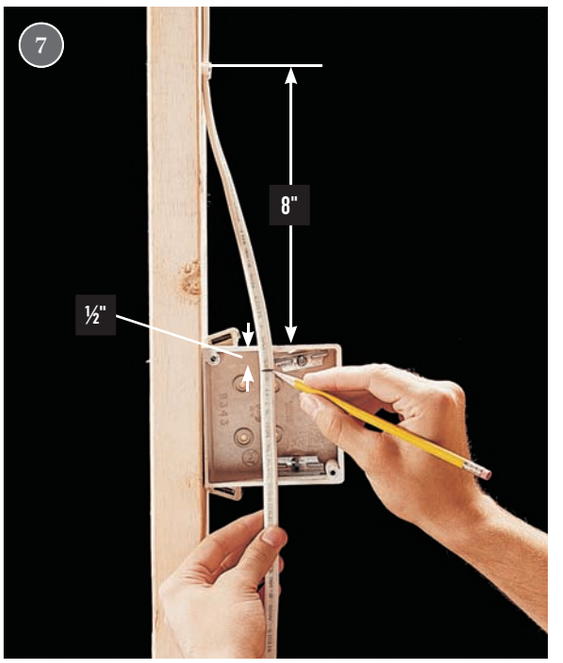
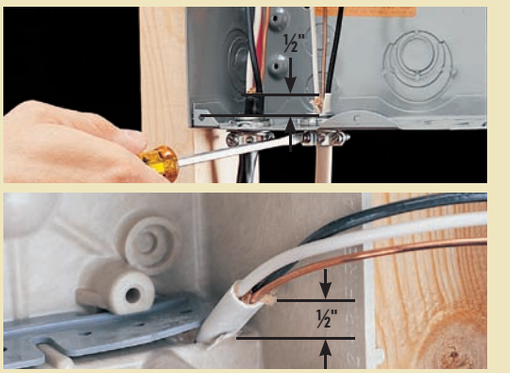






Tip



Different types of boxes have different clamping devices. Make sure cable sheathing extends ½" past the edge of the clamp to ensure that the cable is secure and that the wire won't be damaged by the edges of the clamp.

5 Anchor the cable to the center of a framing member within 12" of the circuit breaker panel using a cable staple. Stack-It® staples work well where two or more cables must be anchored to the same side of a stud. Run the cable to the first electrical box. Where the cable runs along the sides of framing members, anchor it with cable staples no more than 4 ft. 6 in. apart.

6 At corners, form a slight L-shaped bend in the end of the cable and insert it into one hole. Retrieve the cable through the other hole using needlenose pliers (inset).

7 Staple the cable to a framing member 8" from the box. Hold the cable taut against the front of the box, and mark a point on the sheathing ½" past the box edge. Remove sheathing from the marked line to the end using a cable ripper, and clip away excess sheathing with a combination tool. Insert the cable through the knockout in the box.

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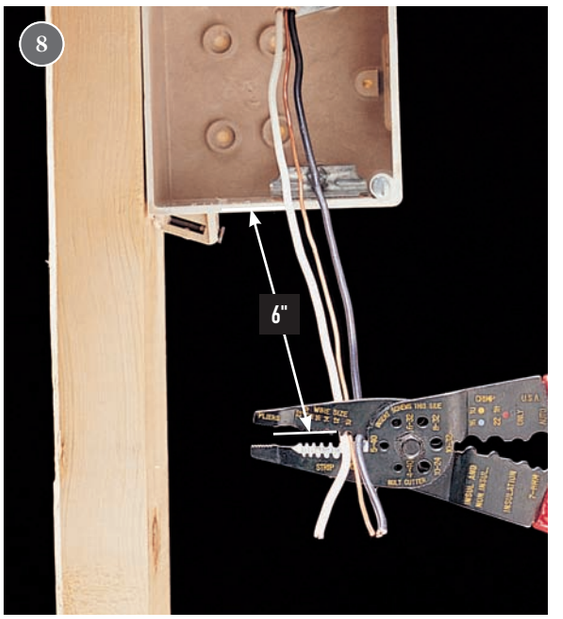
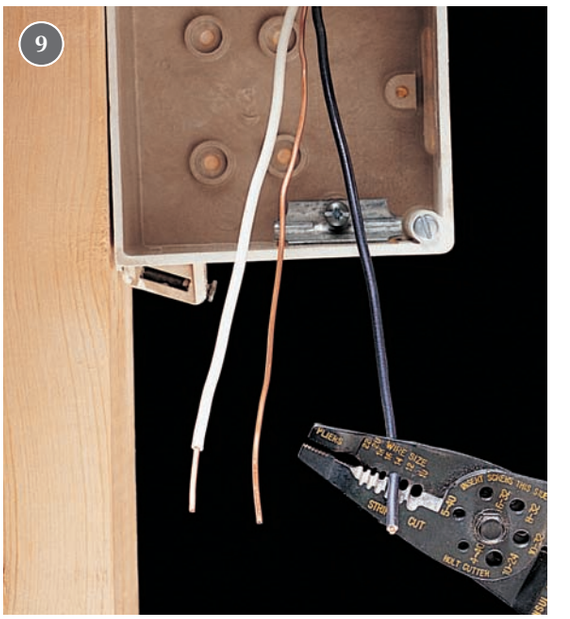
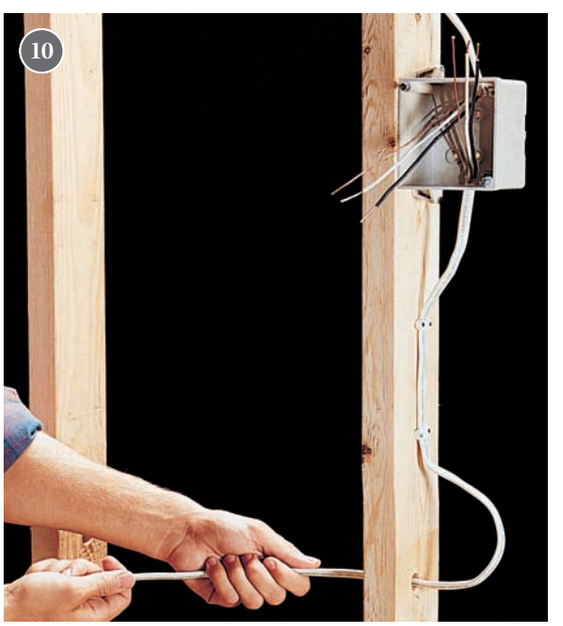
#175 Dtp:225 Page:30







8 As each cable is installed in a box, clip back each wire so that at least 6" of workable wire extends past the front edge of the box.

9 Strip ¾" of insulation from each circuit wire in the box using a combination tool. Take care not to nick the copper.

10 Continue the circuit by running cable between each pair of electrical boxes, leaving an extra 1 ft. of cable at each end.

11 At metal boxes and recessed fixtures, open knockouts, and attach cables with cable clamps. From inside fixture, strip away all but ¼" of sheathing. Clip back wires so there is 8" of workable length, then strip ¾" of insulation from each wire.

continued

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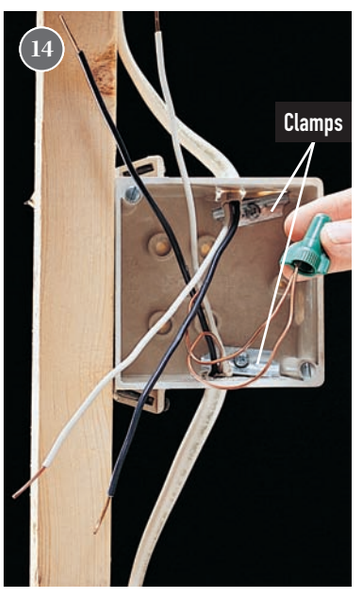

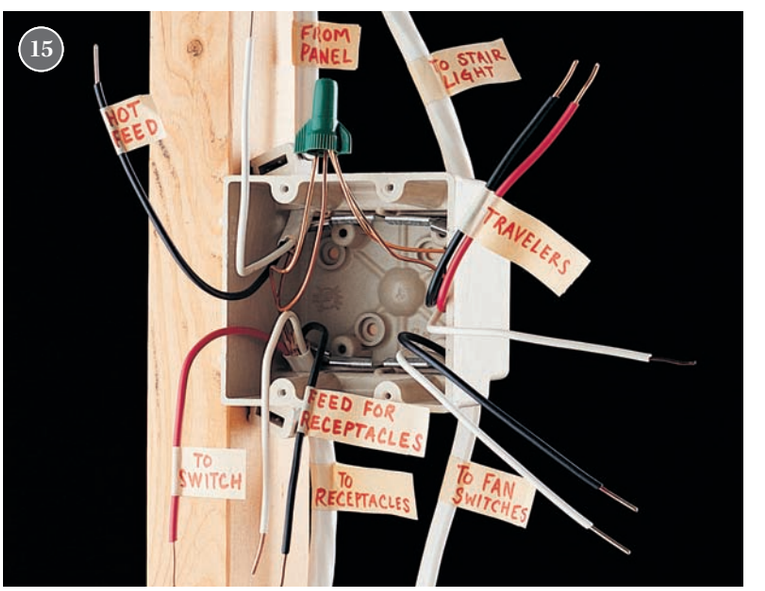

12 For a surface-mounted fixture like a baseboard heater or fluorescent light fixture, staple the cable to a stud near the fixture location, leaving plenty of excess cable. Mark the floor so the cable will be easy to find after the walls are finished.

13 At each recessed fixture and metal electrical box, connect one end of a grounding pigtail to the metal frame using a grounding clip attached to the frame (shown above) or a green grounding screw.

14 At each electrical box and recessed fixture, join grounding wires together with a wire connector. If the box has internal clamps, tighten the clamps over the cables.

15 Label the cables entering each box to indicate their destinations. In boxes with complex wiring configurations, also tag the individual wires to make final hookups easier. After all cables are installed, your rough-in work is ready to be reviewed by the electrical inspector.

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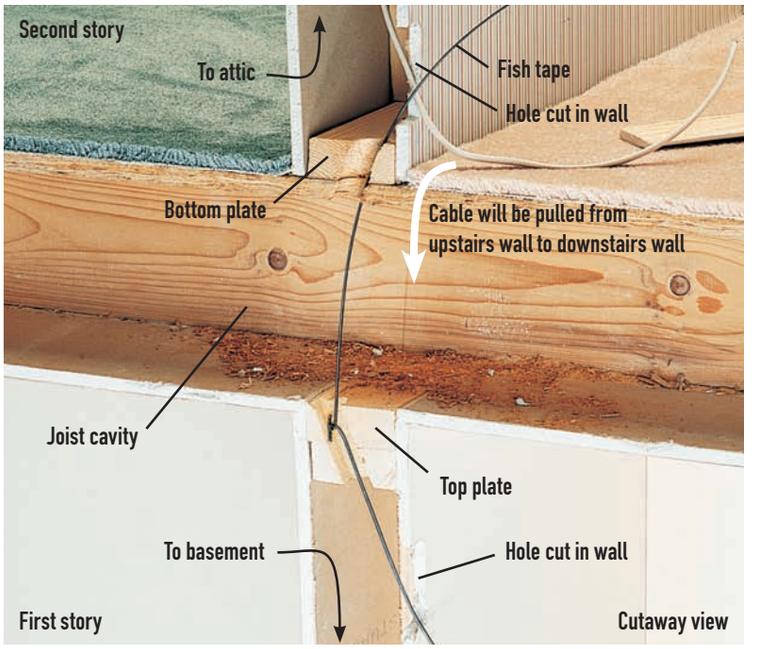
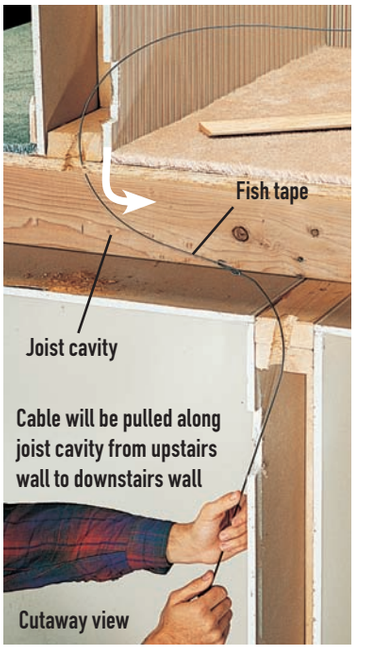
#175 Dtp:225 Page:32

Run Cable Inside Finished Walls





If there is no access space above and below a wall, cut openings in the finished walls to run a cable. This often occurs in two-story homes when a cable is extended from an upstairs wall to a downstairs wall. Cut small openings in the wall near the top and bottom plates, then drill an angled 1" hole through each plate. Extend a fish tape into the joist cavity between the walls and use it to pull the cable from one wall to the next. If the walls line up one over the other (left), you can retrieve the fish tape using a piece of stiff wire. If walls do not line up (right), use a second fish tape. After running the cable, repair the holes in the walls with patching plaster or wallboard scraps and taping compound.

If you don't have a fish tape, use a length of sturdy string and a lead weight or heavy washer. Drop the line into the stud cavity from above, then use a piece of stiff wire to hook the line from below.

Use a flexible drill bit, also called a bell-hanger's bit, to bore holes through framing in finished walls.

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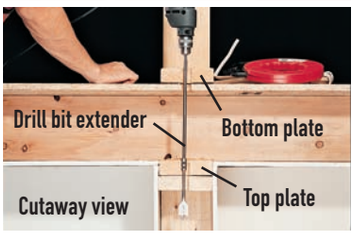
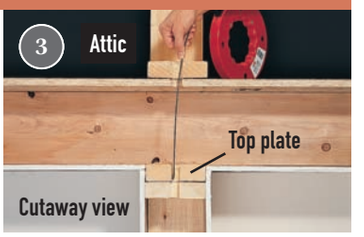
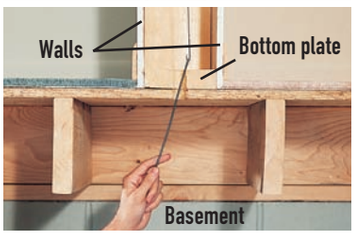
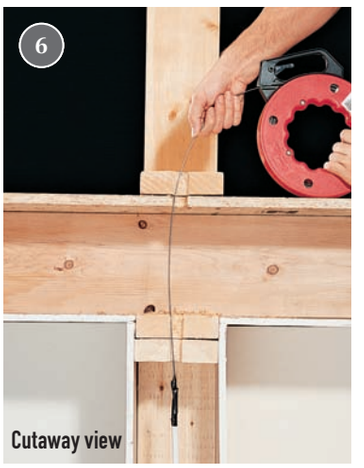
#175 Dtp:225 Page:33

RUNNING NM CABLE INSIDE A FINISHED WALL









1 From the unfinished space below the finished wall, look for a reference point, like a soil stack, plumbing pipes, or electrical cables, that indicates the location of the wall above. Choose a location for the new cable that does not interfere with existing utilities. Drill a 1" hole up into the stud cavity.

2 From the unfinished space above the finished wall, find the top of the stud cavity by measuring from the same fixed reference point used in step 1. Drill a 1" hole down through the top plate and into the stud cavity using a drill bit extender.

3 Extend a fish tape down through the top plate, twisting the tape until it reaches the bottom of the stud cavity. From the unfinished space below the wall, use a piece of stiff wire with a hook on one end to retrieve the fish tape through the drilled hole in the bottom plate.

4 Trim back 2" of sheathing from the end of the NM cable, then insert the wires through the loop at the tip of the fish tape.

5 Bend the wires against the cable, then use electrical tape to bind them tightly. Apply cable-pulling lubricant to the taped end of the fish tape.

6 From above the finished wall, pull steadily on the fish tape to draw the cable up through the stud cavity. This job will be easier if you have a helper feed the cable from below as you pull.

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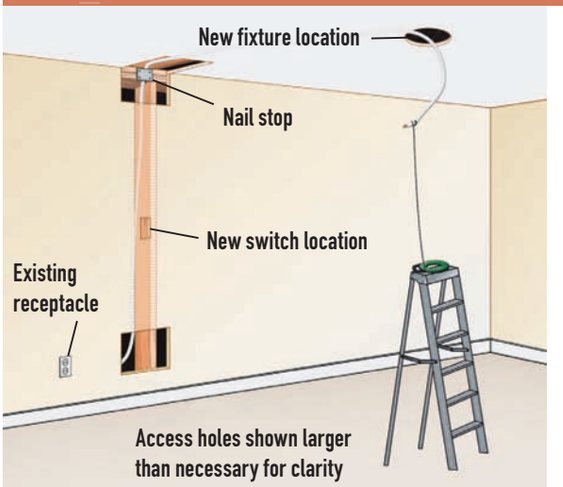
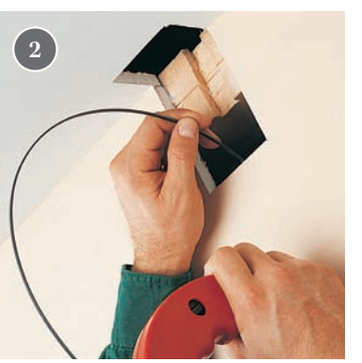
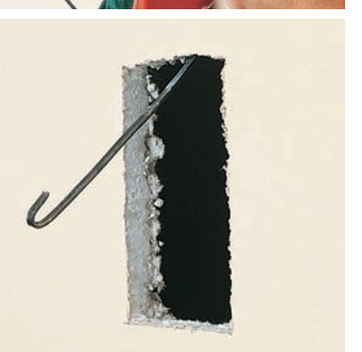
#175 Dtp:225 Page:34

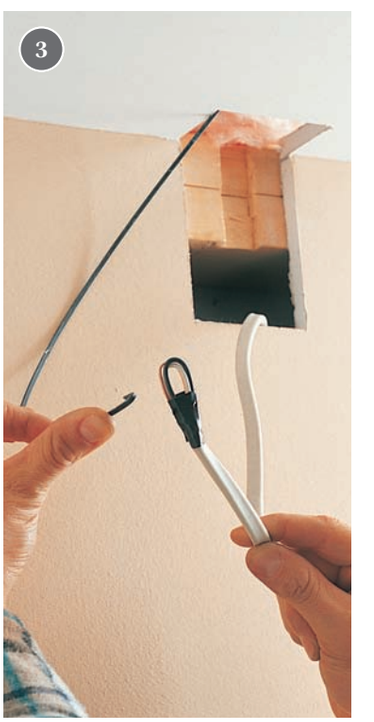
INSTALLING NM CABLE IN FINISHED CEILINGS



If you don't have access to a ceiling from above, you can run cable for a new ceiling fixture from an existing receptacle in the room up the wall and into the ceiling without disturbing much of the ceiling. To begin, run cable from the receptacle to the stud channel that aligns with the ceiling joists on which you want to install a fixture. Be sure to plan a location for the new switch. Remove short strips of drywall from the wall and ceiling. Make a notch in the center of the top plates, and protect the notch with metal nail stops. Use a fish tape to pull the new cable up through the wall cavity and the notch in top plates. Next, use the fish tape to pull the cable through the ceiling to the fixture hole. After having your work inspected, replace the drywall and install the fixture and switch.







1 Plan a route for running cable between electrical boxes (see illustration above). Remove drywall on the wall and ceiling surface. Where cable must cross framing members, cut a small access opening in the wall and ceiling surface; then cut a notch into the framing with a wood chisel.

2 Fish a cable from the existing receptacle location up to the notch at the top of the wall. Protect the notch with a metal nail stop.

3 Fish the cable through the ceiling to the location of the new ceiling fixture.

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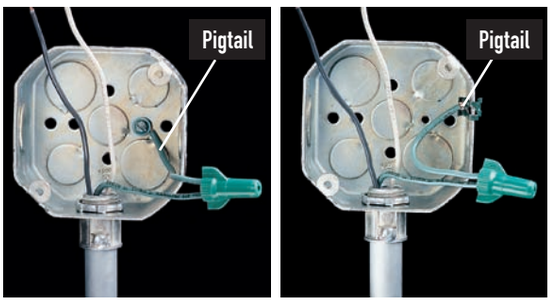
#175 Dtp:225 Page:35

CONDUIT

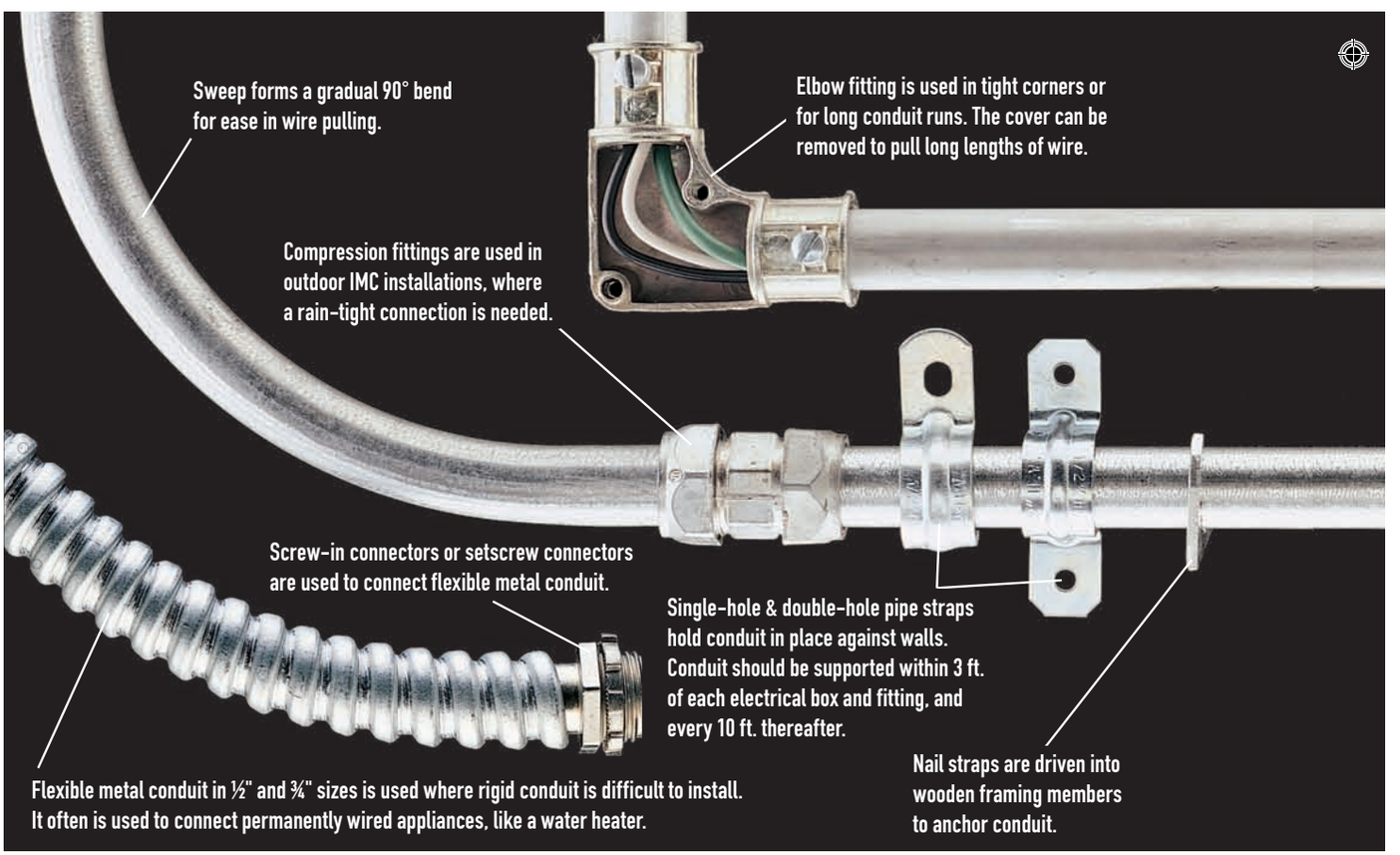
Electrical wiring that runs in exposed locations must be protected by rigid tubing called conduit. For example, conduit is used for wiring that runs across masonry walls in a basement laundry and for exposed outdoor wiring. THHN/THWN wire normally is installed inside conduit, although UF or NM cable can also be installed in conduit.

There are several types of conduit available, so check with your electrical inspector to find out which type meets code requirements in your area. Conduit installed outdoors must be rated for exterior use. Metal conduit should be used only with metal boxes, never with plastic boxes.

At one time, conduit could only be fitted by using elaborate bending techniques and special tools. Now, however, a variety of shaped fittings are available to let a homeowner join conduit easily.



Electrical Grounding in Metal Conduit: Install a green insulated grounding wire for any circuit that runs through metal conduit. Although code allows the metal conduit to serve as the grounding conductor, most electricians install a green insulated wire as a more dependable means of grounding the system. The grounding wires must be connected to metal boxes with a pigtail and grounding screw (left) or grounding clip (right).



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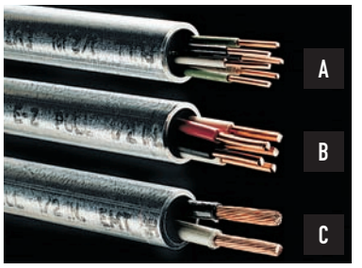
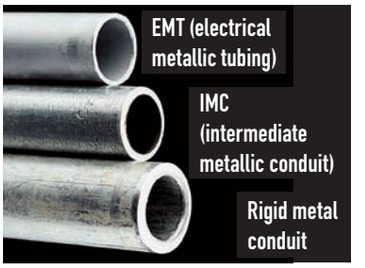
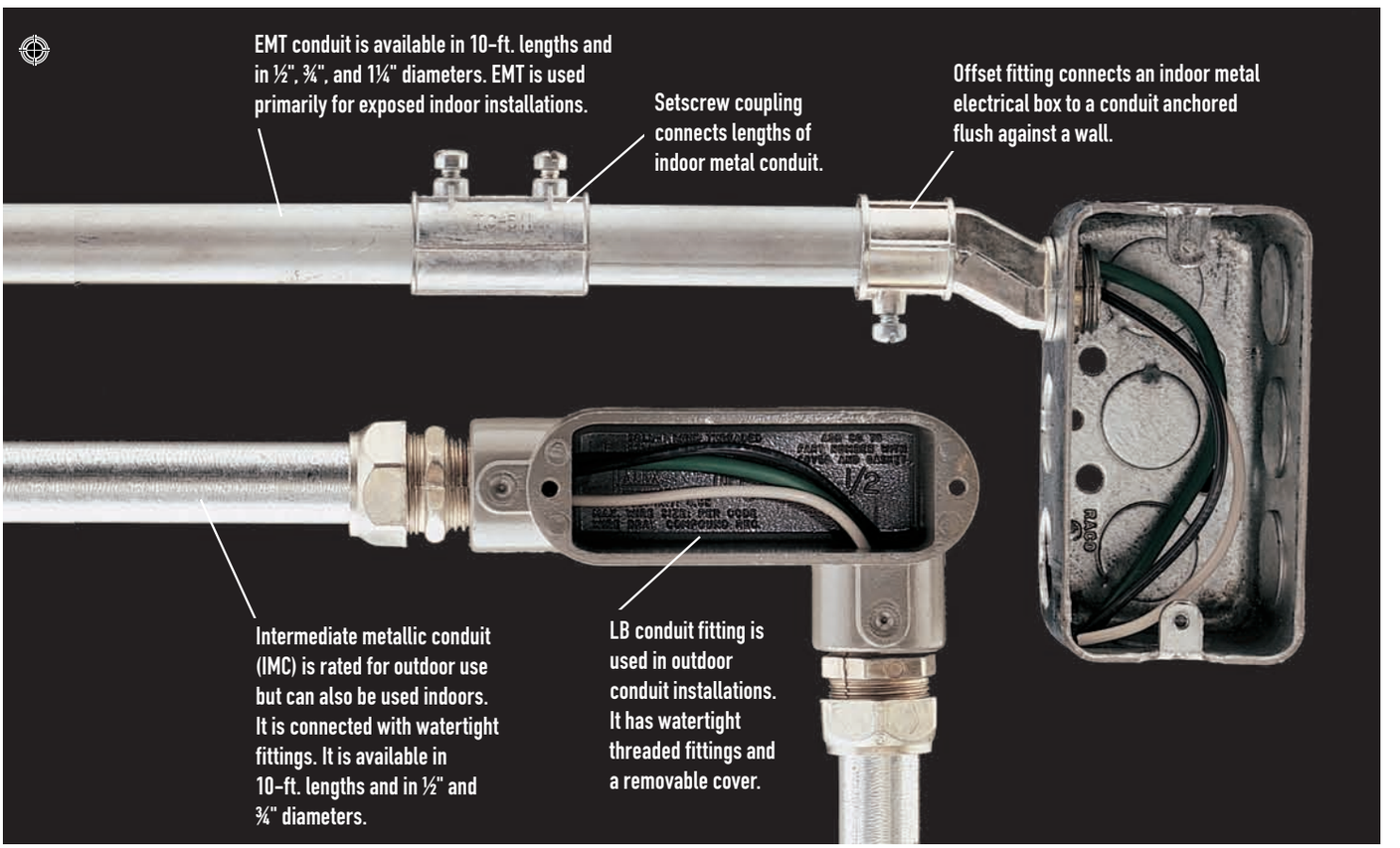


Fill Capacity: Conduit ½" in diameter can hold up to six 14-gauge or 12-gauge thhn/thwn wires (A), five 10-gauge wires (B), or two 8-gauge wires (C). Use ¾" conduit for greater capacity. Local codes may vary—check with your electrical inspector.



Metal Conduit: EMT is lightweight and easy to install. IMC has thicker galvanized walls and is a good choice for exposed outdoor use. Rigid metal conduit provides the greatest protection for wires, but it is more expensive and requires threaded fittings. EMT is the preferred metal conduit for home use.

Plastic Conduit: Plastic PVC conduit is allowed by many local codes. It is assembled with solvent glue and PVC fittings that resemble those for metal conduit. When wiring with PVC conduit, always run a green grounding wire.



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Conduit types used most in homes are EMT (electrical metallic tubing), IMC (intermediate metallic conduit), RNC (rigid nonmetallic conduit), and flexible metal conduit. The most common diameters by far are ½" and ¾", but larger sizes are stocked at most building centers.

Nonmetallic conduit fittings typically are solvent welded to nonmetallic conduit, as opposed to metal conduit, which can be threaded and screwed into threaded fittings or attached with setscrews or compression fittings.

A thin-wall conduit bender is used to bend sweeps into EMT or IMC conduit.

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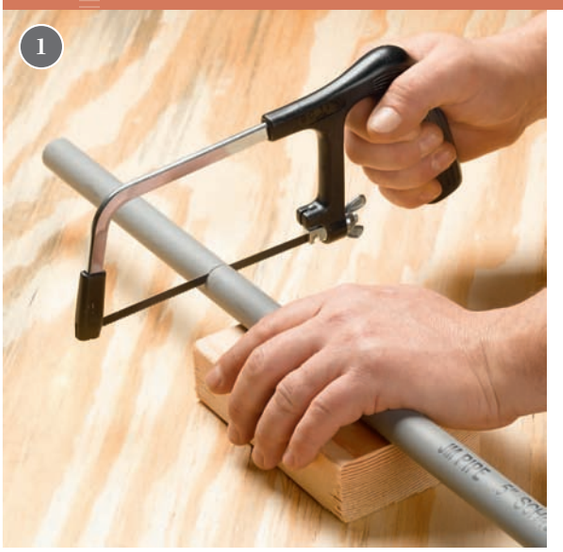
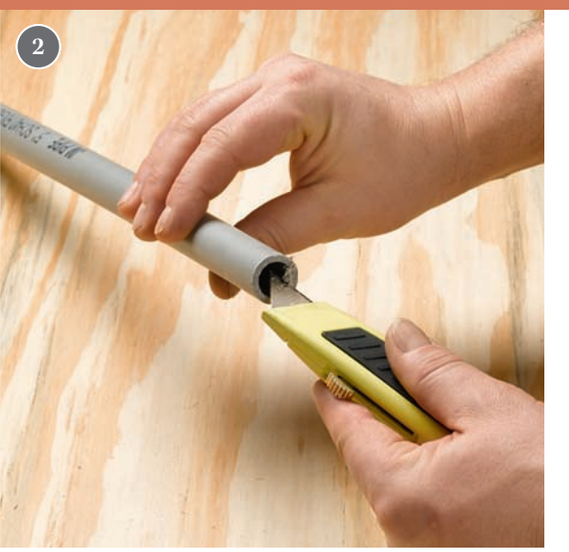
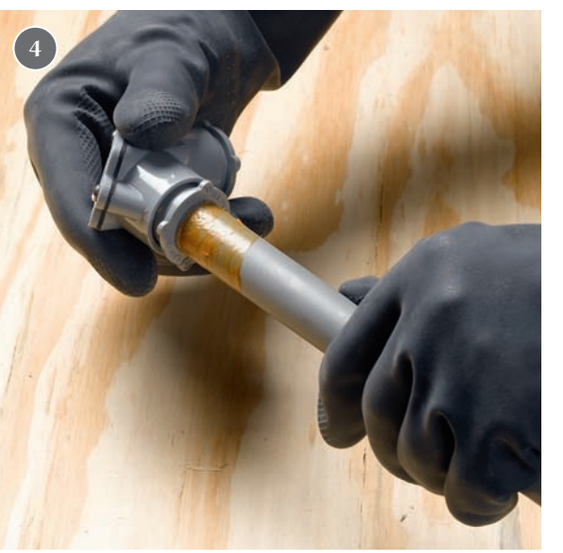
MAKING NONMETALLIC CONDUIT CONNECTIONS







1 Cut the rigid nonmetallic conduit (RNC) to length with a fine-tooth saw, such as a hacksaw. For larger diameter (1½" and above), use a power miter box with a fine-tooth or plastic cutting blade.

2 Deburr the cut edges with a utility knife or fine sandpaper such as emery paper. Wipe the cut ends with a dry rag. Also wipe the coupling or fitting to clean it.

3 Apply a coat of PVC cement to the end of the conduit and to the inside walls of the coupling (inset). Wear latex gloves to protect your hands. The cement should be applied past the point on the conduit where it enters the fitting or coupling.

4 Insert the conduit into the fitting or coupling and spin it a quarter turn to help spread the cement. Allow the joint to set undisturbed for 10 minutes.

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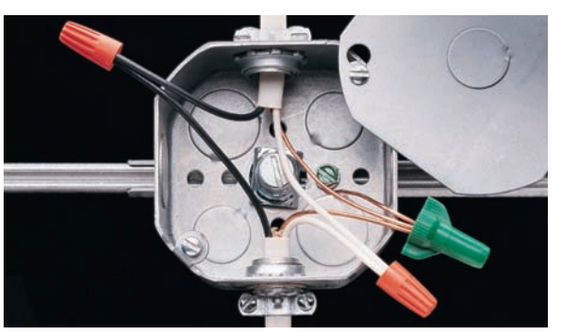
ELECTRICAL BOXES

The National Electrical Code requires that wire connections and cable splices be contained inside an approved metal or plastic box. This shields framing members and other flammable materials from electrical sparks.

Electrical boxes come in several shapes. Rectangular and square boxes are used for switches and receptacles. Rectangular (2 × 3") boxes are used for single switches or duplex receptacles. Square (4 × 4") boxes are used any time it is convenient for two switches or receptacles to be wired, or "ganged," in one box, an arrangement common in kitchens or entry hallways. Octagonal electrical boxes contain wire connections for ceiling fixtures.

All electrical boxes are available in different depths. A box must be deep enough so a switch or receptacle can be removed or installed easily without crimping and damaging the circuit wires. Replace an undersized box with a larger box using the Electrical Box Chart (right) as a guide. The NEC also says that all electrical boxes must remain accessible. Never cover an electrical box with drywall, paneling, or wallcoverings.



Octagonal boxes usually contain wire connections for ceiling fixtures. Cables are inserted into the box through knockout openings and are held with cable clamps. Because the ceiling fixture attaches directly to the box, the box should be anchored firmly to a framing member. Often, it is nailed directly to a ceiling joist. However, metal braces are available that allow a box to be mounted between joists or studs. A properly installed octagonal box can support a ceiling fixture weighing up to 35 pounds. Any box must be covered with a tightly fitting cover plate, and the box must not have open knockouts.

Electrical Box Fill Chart

BOX SIZE AND SHAPE	MAXIMUM NUMBER OF CONDUCTORS PERMITTED (SEE NOTES BELOW)			
	18 AWG	16 AWG	14 AWG	12 AWG
Junction Boxes				
4 × 1¼" R or O	8	7	6	5
4 × 1½" R or 0	10	8	7	6
4 × 2⅛" R or O	14	12	10	9
4 × 1¼" S	12	10	9	8
4 × 1½" S	14	12	10	9
4 × 2⅛" S	20	17	15	13
4 11/16 × 1¼" S	17	14	12	11
4 11/16 × 1½" S	19	16	14	13
4 11/16 × 2⅛" S	28	24	21	18
Device Boxes				
3 × 2 × 1½"	5	4	3	3
3 × 2 × 2"	6	5	5	4
3 × 2 × 2¼"	7	6	5	4
3 × 2 × 2½"	8	7	6	5
3 × 2 × 2¾"	9	8	7	6
3 × 2 × 3½"	12	10	9	8
4 × 2⅛ × 1½"	6	5	5	4
4 × 2⅛ × 1⅞"	8	7	6	5
4 × 2⅛ × 2⅛"	9	8	7	6

Notes:

- R = Round; O = Octagonal; S = Square or rectangular
- Each hot or neutral wire entering the box is counted as one conductor.
- Grounding wires are counted as one conductor in total—do not count each one individually.
- Raceway fittings and external cable clamps do not count. Internal cable connectors and straps count as either half or one conductor, depending on type.
- Devices (switches and receptacles mainly) each count as two conductors.
- When calculating total conductors, any nonwire components should be assigned the gauge of the largest wire in the box.
- For wire gauges not shown here, contact your local electrical inspections office.

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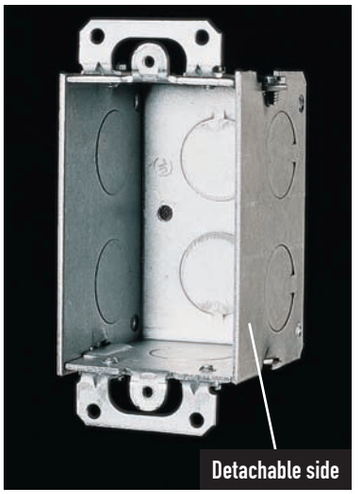
Common Electrical Boxes

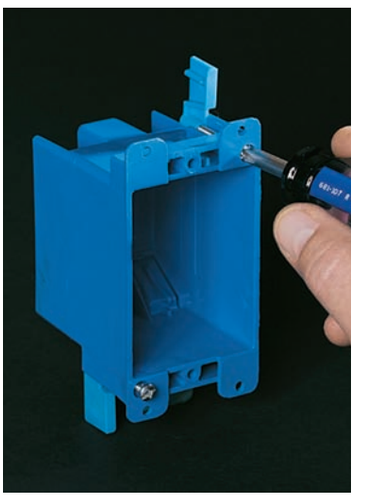


Rectangular boxes are used with wall switches and duplex receptacles. Single-size rectangular boxes (shown above) may have detachable sides that allow them to be ganged together to form double-size boxes.

Square 4 × 4" boxes are large enough for most wiring applications. They are used for cable splices and ganged receptacles or switches. To install one switch or receptacle in a square box, use an adapter cover.

Braced octagonal boxes fit between ceiling joists. The metal braces extend to fit any joist spacing and are nailed or screwed to framing members.

Outdoor boxes have sealed seams and foam gaskets to guard a switch or receptacle against moisture. Corrosion-resistant coatings protect all metal parts. Code compliant models include a watertight hood.



Retrofit boxes can be installed to upgrade older boxes or to allow you to add new additional receptacles and switches. One type (above) has built-in clamps that tighten against the inside of a wall and hold the box in place.

Plastic boxes are common in new construction. They can be used only with NM (nonmetallic) cable. The box may include preattached nails for anchoring it to framing members. Wall switches must have grounding screws if installed in plastic boxes.

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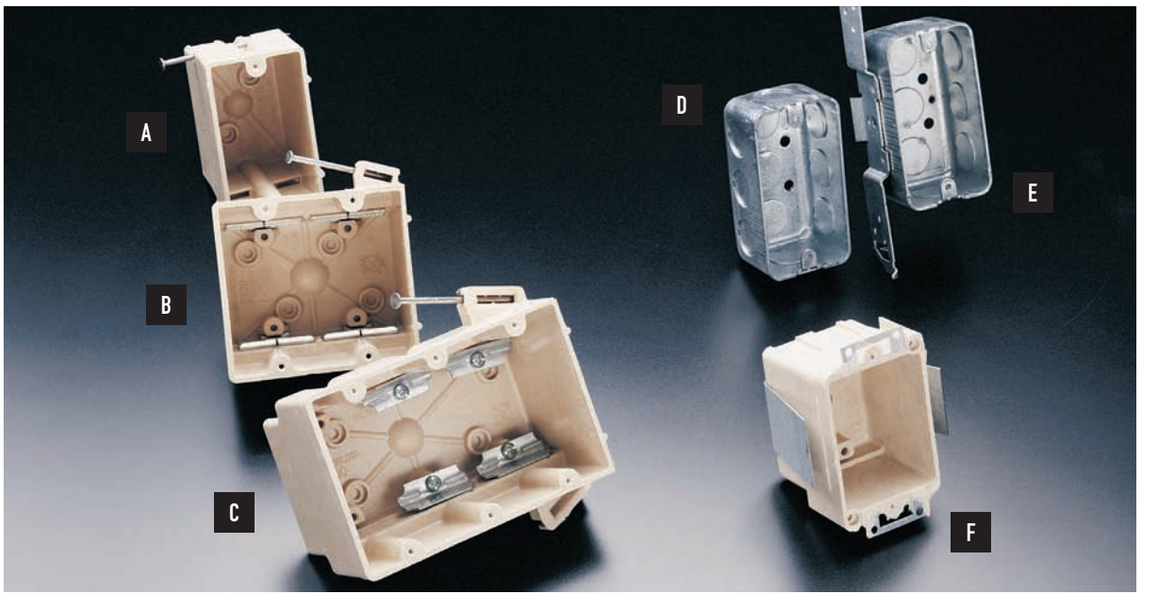
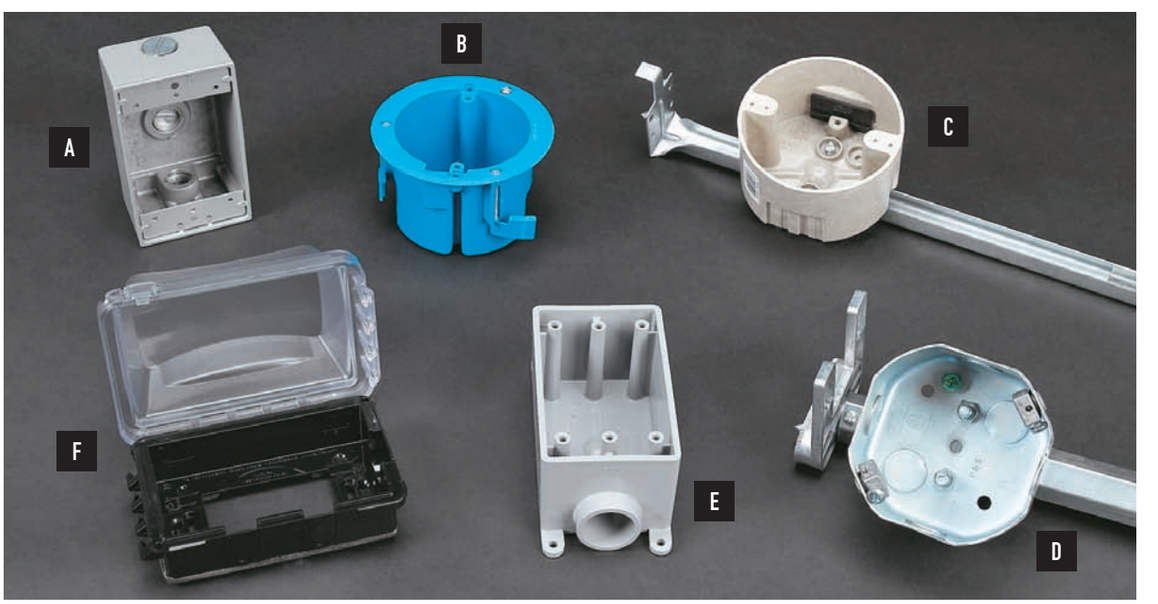


3½"-deep plastic boxes with preattached mounting nails are used for any wiring project protected by finished walls. Common styles include single-gang (A), double-gang (B), and triple-gang (C). Double-gang and triple-gang boxes require internal cable clamps. Metal boxes (D) should be used for exposed indoor wiring, such as conduit installations in an unfinished basement. Metal boxes (E) also can be used for wiring that will be covered by finished walls. Plastic retrofit boxes (F) are used when a new switch or receptacle must fit inside a finished wall. Use internal cable clamps.



Additional electrical boxes include: Cast aluminum box (A) for use with outdoor fixtures, including receptacles that are wired through metal conduit. These must have in-use covers if they house receptacles; retrofit ceiling box (B) used for light fixtures; light-duty ceiling fan box (C) with brace that spans ceiling joists; heavy-duty retrofit ceiling fan box (D) designed for retrofit; PVC box (E) for use with PVC conduit in indoor or outdoor setting; wall-mounted in-use cover (F) for exterior receptacle.

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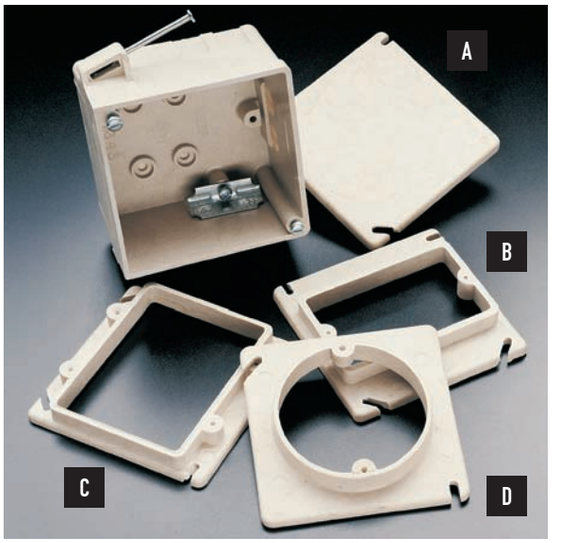
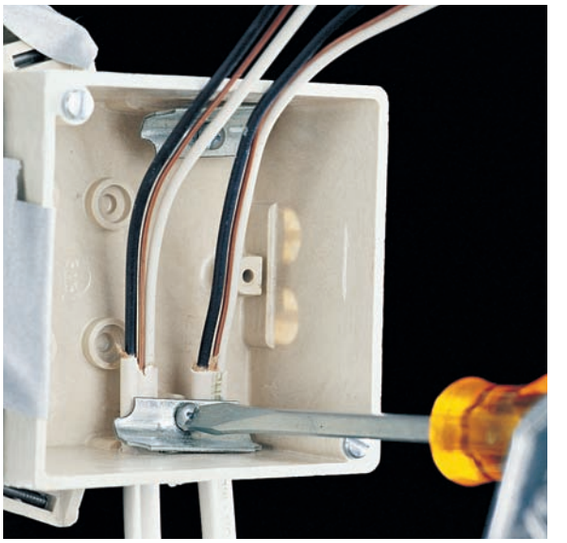
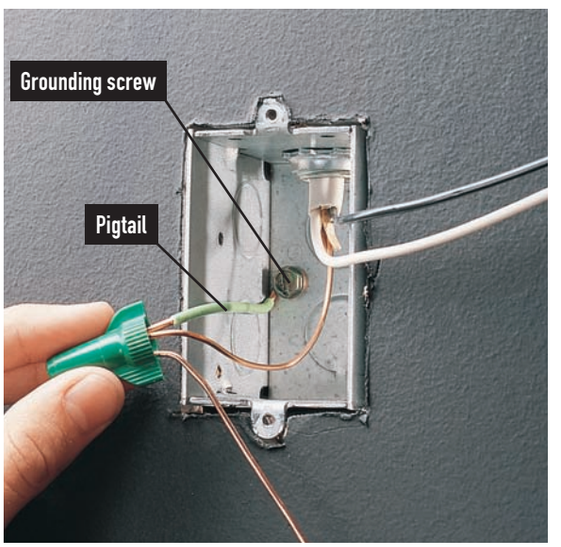
Box Specifications



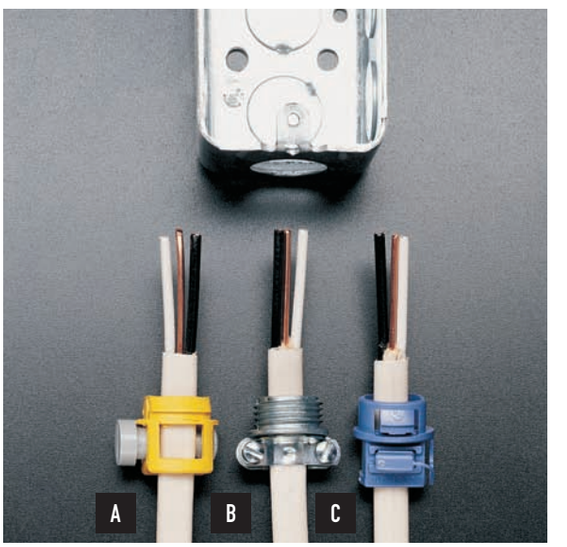
High-quality nonmetallic boxes are rigid and don't contort easily. A variety of adapter plates are available, including junction box cover plate (A), single-gang (B), double-gang (C), and light fixture (D). Adapter plates come in several thicknesses to match different wall constructions.



Boxes larger than 2 × 4" and all retrofit boxes must have internal cable clamps. After installing cables in the box, tighten the cable clamps over the cables so they are gripped firmly, but not so tightly that the cable sheathing is crushed.



Metal boxes must be grounded to the circuit grounding system. Connect the circuit grounding wires to the box with a green insulated pigtail wire and wire connector (as shown) or with a grounding clip (page 32).



Cables entering a metal box must be clamped. A variety of clamps are available, including plastic clamps (A, C) and threaded metal clamps (B).

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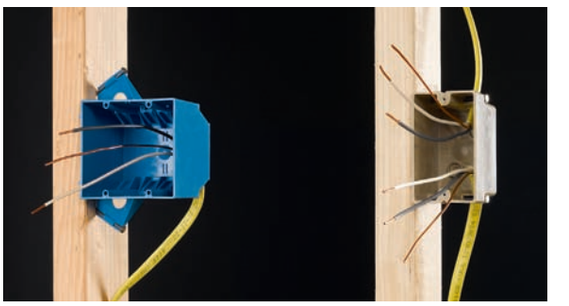
Nonmetallic Boxes

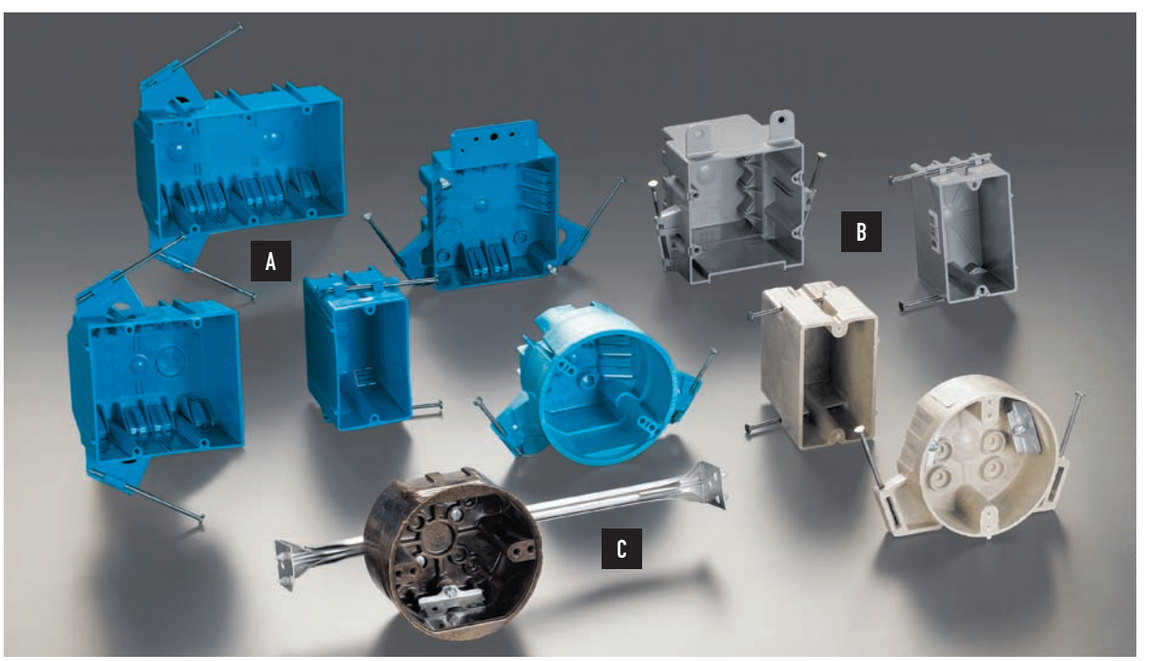
Nonmetallic electrical boxes have taken over much of the do-it-yourself market. Most are sold prefitted with installation hardware—from metal wings to 10d common nails attached at the perfect angle for a nail-in box.

In addition to cost and availability, nonmetallic boxes hold a big advantage over metal boxes in that their resistance to conducting electricity will prevent a sparking short circuit if a hot wire contacts the box. Nonmetallic boxes generally are not approved for exposed areas, where they may be susceptible to damage. Their lack of rigidity also allows them to compress or distort, which can reduce the interior capacity beyond code minimums or make outlets difficult to attach.

Low cost is the primary reason that blue PVC nail-in boxes are so popular. Not only are they inexpensive, they also feature built-in cable clamps so you may not need to buy extra hardware to install them. The standard PVC nail-in box is prefitted with a pair of 10d common nails for attaching to exposed wall studs. These boxes, often called handy boxes, are too small to be of much use (see fill chart, page 40).



The bulk of the nonmetallic boxes sold today are inexpensive blue PVC. You can also purchase heavier-duty fiberglass or thermoset plastic models that provide a nonmetallic option for installing heavier devices.



Nonmetallic boxes for home use include: Single-gang, double-gang, triple gang, and quad boxes (A); thermoset and fiberglass boxes for heavier duty (B); round fixture boxes (C) for ceiling installation (nail-in and with integral metal bracket).

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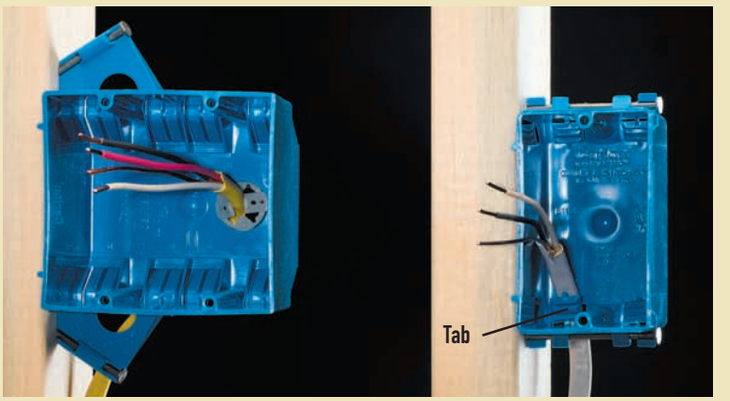
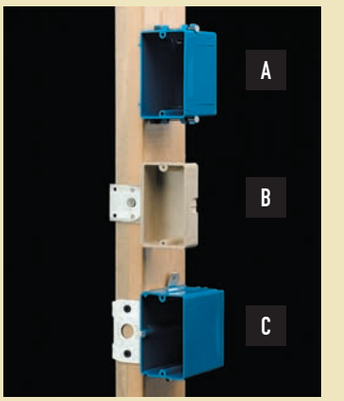
Tips for Working with Nonmetallic Boxes



Do not break off the tabs that cover cable entry holes in plastic boxes. These are not knockouts as you would find in metal boxes. In single-gang boxes (right), the pressure from the tab is sufficient to secure the cable as long as it enters with sheathing intact and is stapled no more than 8" from the box. On larger boxes (left), you will find traditional knockouts intended to be used with plastic cable clamps that resemble metal cable clamps. Use these for heavier gauge cable and cable with more than three wires.



Nail-in boxes (A) are prefitted with 10d nails that are attached perpendicular to the face of single-gang boxes and at an inward angle for better gripping power on larger boxes. Side-mount boxes (B) feature a nailing plate that is attached to the front of the stud to automatically create the correct setback; adjustable side-mount boxes (C) are installed the same way but can be moved on the bracket.

Distortion can occur in nonmetallic boxes when nails or other fasteners are overdriven or installed at improper angles, or when the semiflexible boxes are compressed into improperly sized or shaped openings. This can reduce the box capacity and prevent devices and faceplates from fitting.

Integral ribs cast into many nonmetallic boxes are used to register the box against the wall studs so the front edges of the box will be flush with the wall surface after drywall is installed. Most are set for ½" drywall, but if your wall will be a different thickness you may be able to find a box with corresponding ribs. Otherwise, use a piece of the wallcovering material as a reference.

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INSTALL BOXES

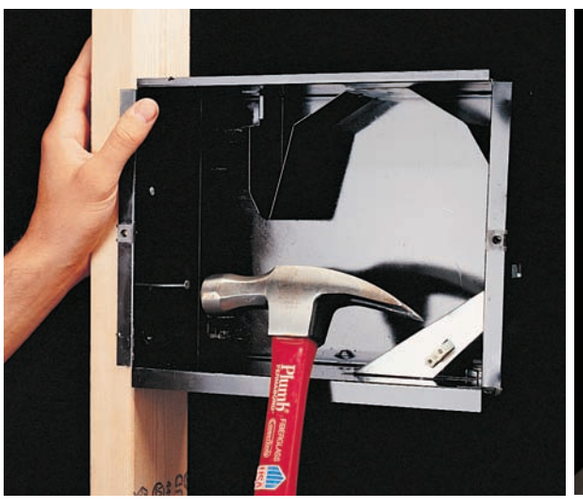
Install electrical boxes for receptacles, switches, and fixtures only after your wiring project plan has been approved by your inspector. Use your wiring plan as a guide, and follow electrical code height and spacing guidelines when laying out box positions.

Always use the deepest electrical boxes that are practical for your installation. Using deep boxes ensures that you will meet code regulations regarding box volume and makes it easier to make the wire connections.

Some electrical fixtures, like recessed light fixtures, electric heaters, and exhaust fans, have built-in wire connection boxes. Install the frames for these fixtures at the same time you are installing the other electrical boxes.

Electrical boxes in adjacent rooms should be positioned close together when they share a common wall and are controlled by the same circuit. This simplifies the cable installations and also reduces the amount of cable needed.

Fixtures That Do Not Need Electrical Boxes



Recessed fixtures that fit inside wall cavities have built-in wire connection boxes and require no additional electrical boxes. Common recessed fixtures include electric blower-heaters (left), bathroom vent fans (right), and recessed light fixtures. Install the frames for these fixtures at the same time you are installing the other electrical boxes along the circuit. Surface-mounted fixtures like electric baseboard heaters (pages 106 to 109) and under-cabinet fluorescent lights also have built-in wire connection boxes. These fixtures are not installed until it is time to make the final hookups.

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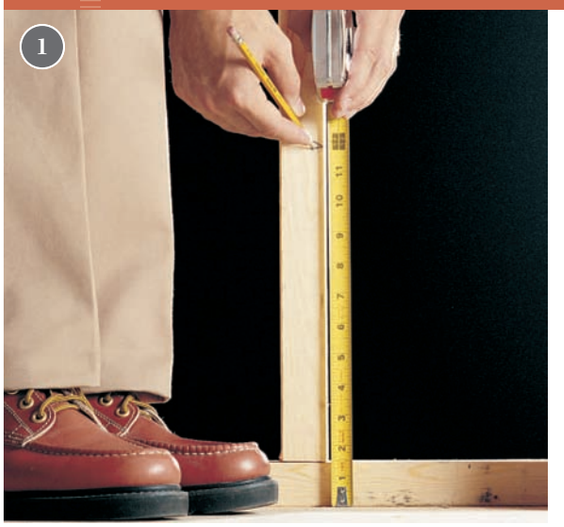
INSTALLING ELECTRICAL BOXES FOR RECEPTACLES



1 Mark the location of each box on studs. Standard receptacle boxes should be centered 12" above floor level. GFCI receptacle boxes in a bathroom should be mounted so they will be about 10" above the finished countertop.

2 Position each box against a stud so the front face will be flush with the finished wall. For example, if you will be installing ½" wallboard, position the box so it extends ½" past the face of the stud. Anchor the box by driving the mounting nails into the stud.

3 If installing square boxes, attach the adapter plates before positioning the boxes. Use adapter plates that match the thickness of the finished wall. Anchor the box by driving the mounting nails into the stud.

4 Open one knockout for each cable that will enter the box, using a hammer and screwdriver. Always introduce the new cable through the knockout that is farthest way from the wall stud.

5 Break off any sharp edges that might damage vinyl cable sheathing by rotating a screwdriver in the knockout.

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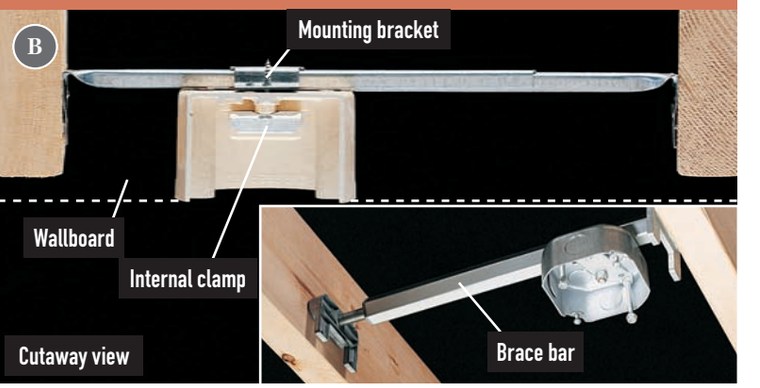
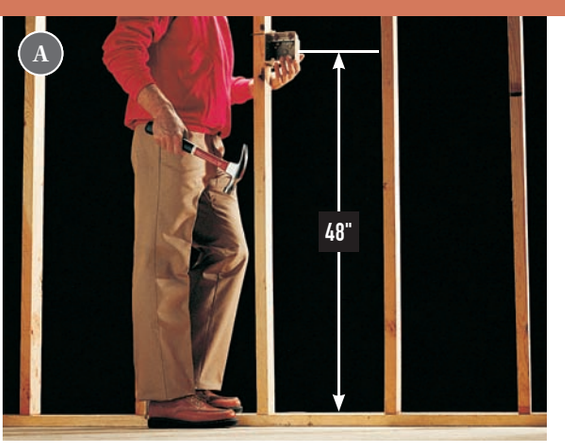
INSTALLING BOXES FOR LIGHT FIXTURES

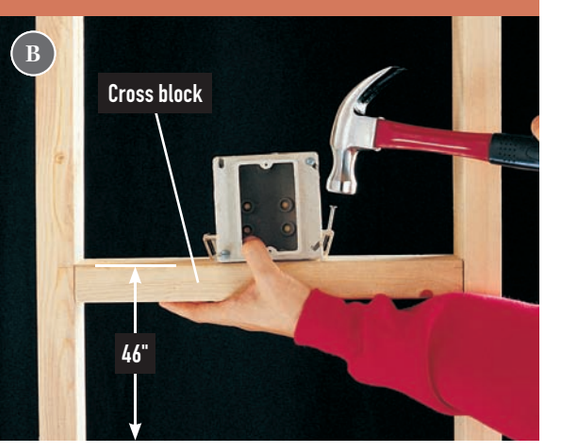


A Position the light fixture box for a vanity light above the frame opening for a mirror or medicine cabinet. Place the box for a ceiling light fixture in the center of the room. Position each box against a framing member so the front face will be flush with the finished wall or ceiling, then anchor the box by driving the mounting nails into the framing.

B To position a light fixture between joists, attach an electrical box to an adjustable brace bar. Nail the ends of the brace bar to joists so the face of the box will be flush with the finished ceiling surface. Slide the box along the brace bar to the desired position, then tighten the mounting screws. Use internal cable clamps when using a box with a brace bar. Note: For ceiling fans and heavy fixtures, use a metal box and a heavy-duty brace bar rated for heavy loads (inset photo).

INSTALLING BOXES FOR SWITCHES





A Install switch boxes at accessible locations, usually on the latch side of a door, with the center of the box 48" from the floor. The box for a thermostat is mounted at 48" to 60". Position each box against the side of a stud so the front face will be flush with the finished wall, and drive the mounting nails into the stud.

B To install a switch box between studs, first install a cross block between studs, with the top edge 46" above the floor. Position the box on the cross block so the front face will be flush with the finished wall, and drive the mounting nails into the cross block.

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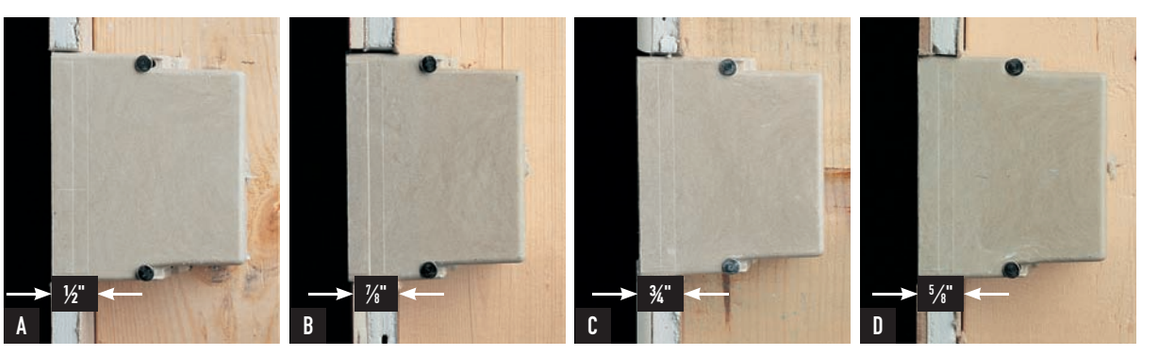
#175 Dtp:225 Page:48

LOCATING ELECTRICAL BOXES

Heights of electrical boxes vary depending on use. In the kitchen shown here, boxes above the countertop are 45" above the floor, in the center of 18" backsplashes that extend from the countertop to the cabinets. All boxes for wall switches also are installed at this height. The center of the box for the microwave receptacle is 72" off the floor. The centers of the boxes for the range and food disposer receptacles are 12" off the floor, but the center of the box for the dishwasher receptacle is 6" off the floor.

Typical Wallcovering Thickness



Consider the thickness of finished walls when mounting electrical boxes against framing members. Code requires that the front face of boxes be flush with the finished wall surface, so how you install boxes will vary depending on the type of wall finish that will be used. For example, if the walls will be finished with ½" wallboard (A), attach the boxes so the front faces extend ½" past the front of the framing members. With ceramic tile and wall board (B), extend the boxes ⅞" past the framing members. With ¼" Corian® over wallboard (C), boxes should extend ¾"; and with wallboard and laminate (D), boxes extend ⅝".

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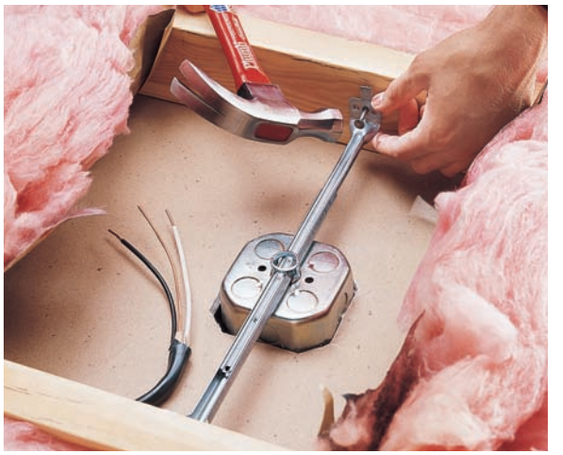
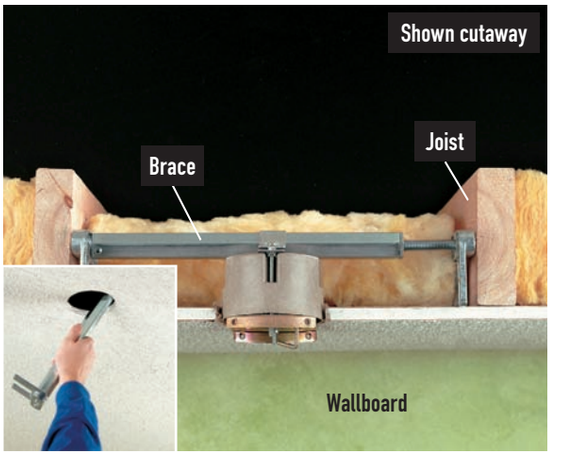
#175 Dtp:225 Page:49

Ceiling Boxes

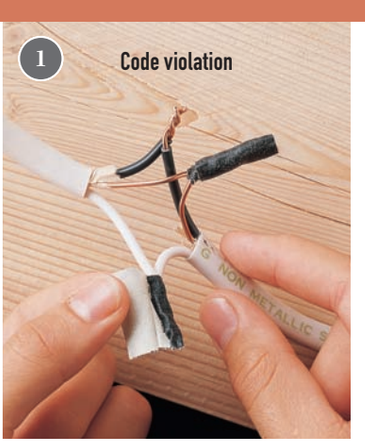


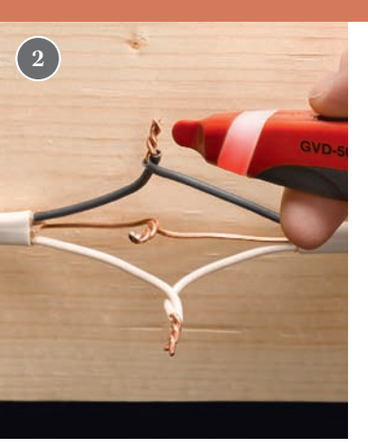


Ceiling boxes for lights are generally round or octagonal in shape to fit typical lamp mounting plates. The easiest way to install one is by nailing the brace to open ceiling joists from above. If the ceiling is insulated, pull the insulation away from the box if the fixture you're installing is not rated IC for insulation contact.

A heavy-duty brace is required for anchoring boxes that will support heavy chandeliers and ceiling fans. A remodeling brace like the one seen here is designed to install through a small cutout in the ceiling (inset photo).

INSTALLING A JUNCTION BOX





1 Turn off power to circuit wires at the main service panel. Carefully remove any tape or wire connectors from the exposed splice. Avoid contact with the bare wire ends until the wires have been tested for power.

2 Test for power. The tester should not glow. If it does, the wires are still hot. Shut off power to the correct circuit at the main service panel. Disconnect the illegally spliced wires.

3 Open one knockout for each cable that will enter the box, using a hammer and screwdriver.

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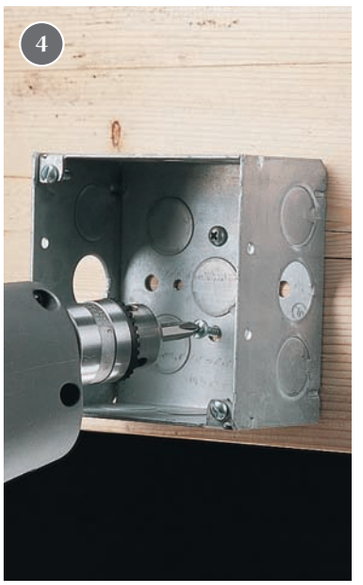

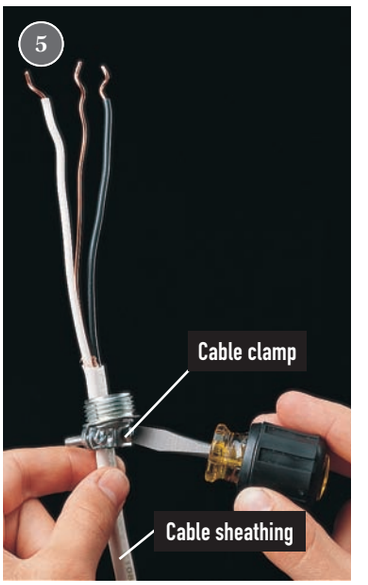

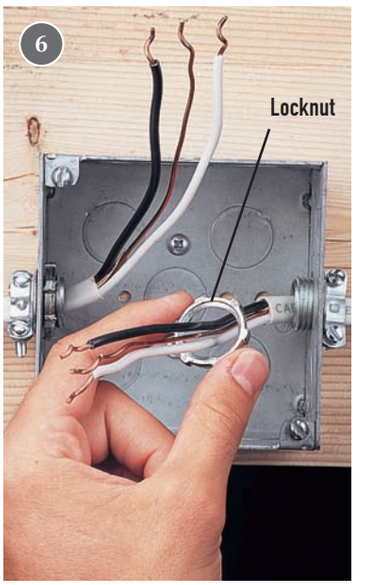

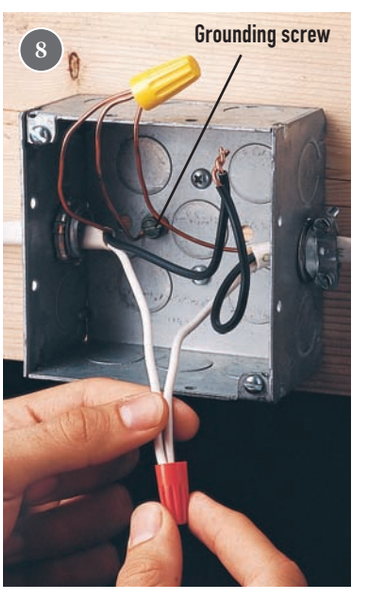

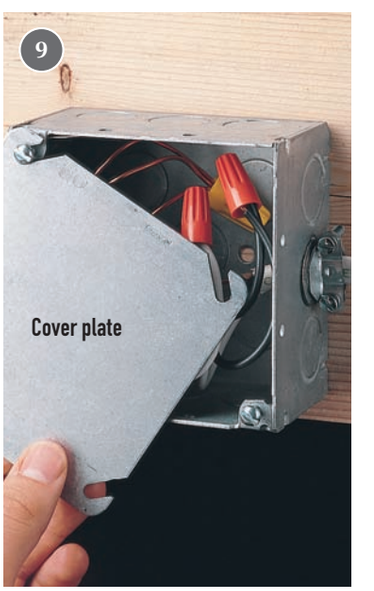

4 Anchor the electrical box to a wooden framing member using screws or nails.

5 Thread each cable end through a cable clamp. Tighten the clamp with a screwdriver. See if there is any slack in the cables so you can gain a little extra cable to work with.

6 Insert the cables into the electrical box, and screw a locknut onto each cable clamp.

7 Tighten the locknuts by pushing against the lugs with the blade of a screwdriver.

8 Use wire connectors to reconnect the wires. Pigtail the copper grounding wires to the green grounding screw in the back of the box.

9 Carefully tuck the wires into the box, and attach the cover plate. Turn on the power to the circuit at the main service panel. Make sure the box remains accessible and is not concealed by finished walls or ceilings.

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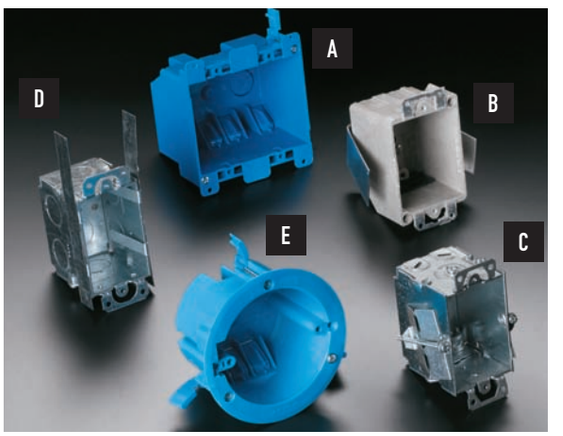
Install Pop-in Retrofit Boxes

Attaching an electrical box to a wall stud during new construction is relatively easy. The task becomes complicated, however, when you're working in finished walls during remodeling or repair. In most cases, it's best to use an electronic stud finder, make a large cutout in the wall, and attach a new box directly to a framing member or bracing (and then replace and refinish the wall materials). But there are occasions when this isn't possible or practical and you just need to retrofit an electrical box without making a large hole in the wall. You also may find that an older switch or receptacle box is too shallow to accommodate a new dimmer or GFCI safely. These situations call for a pop-in retrofit box (sometimes called an "old work" box).

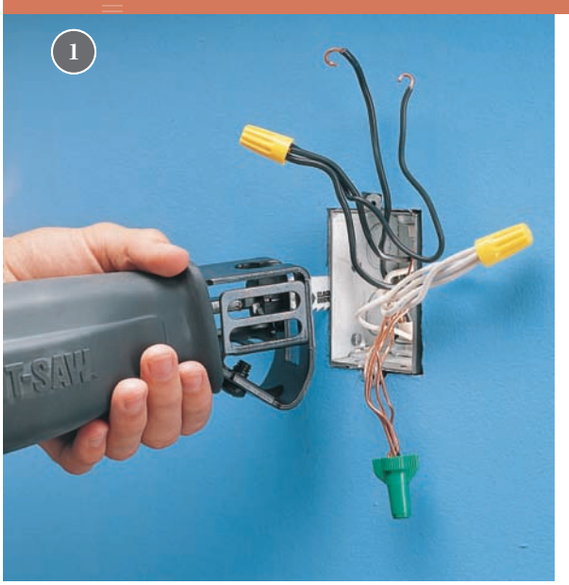


Tools & Materials

- Screwdriver
- Pencil
- String
- Electrical tape
- Wallboard saw
- Template (if provided)
- Plastic or metal pop-in box
- Eye protection

Pop-in boxes for remodeling come in variety of styles. For walls, they include plastic retrofit boxes with flip-out wings (A), metal or plastic boxes with compression tabs or brackets (B), metal retrofit boxes with flip-out wings (C), and metal boxes with bendable brackets, also known as F-straps, (D). For ceilings, plastic fixture boxes with flip-out wings (E) are available.

REMOVING AN ELECTRICAL BOX



1. To install a dimmer switch or GFCI receptacle, you may have to replace an old, overcrowded box. Shut off power and remove the old switch or receptacle. Identify the location of nails holding the box to the framing member and cut the nails with a hacksaw or reciprocating saw with a metal blade inserted between the box and the stud.
2. Bind the cable ends together and attach string in case they fall into the wall cavity when the old box is removed. Disconnect the cable clamps and slide the old box out. Install a new pop-in box (see next page).

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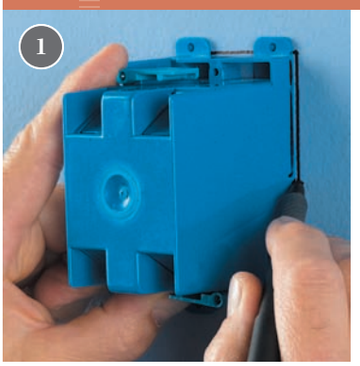
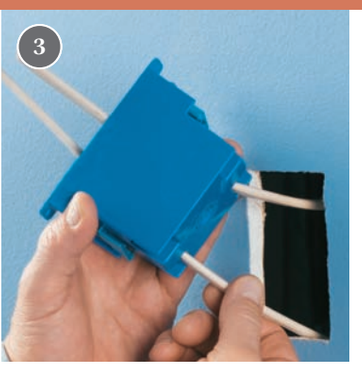
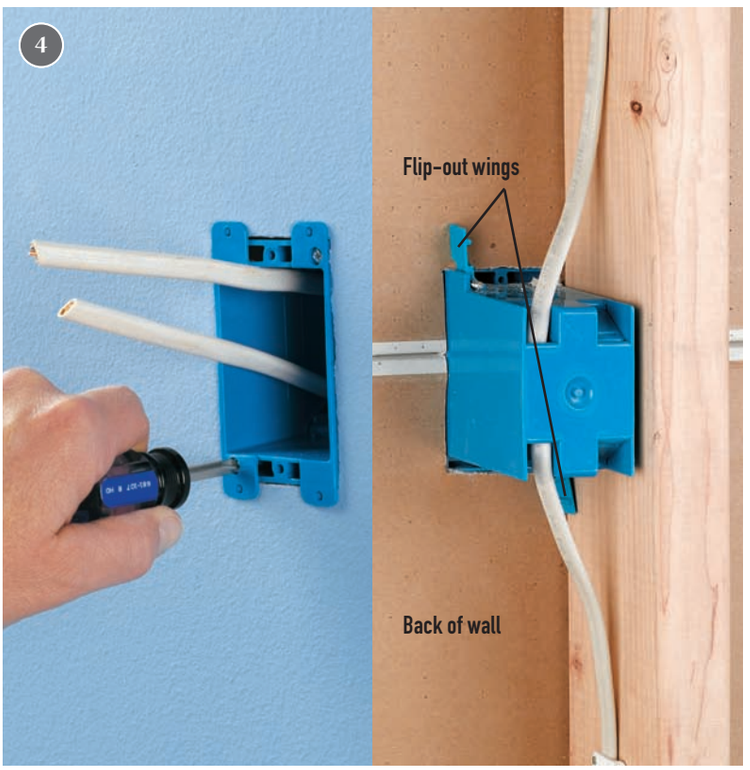
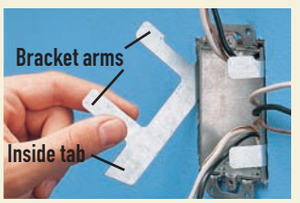
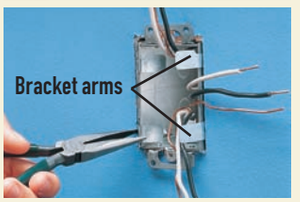
INSTALLING A POP-IN BOX











Variation: Feed cable into the new box and secure it in the opening after clamping the cables. With this pop-in box, bracket arms are inserted at the sides of the box (top) and then bent around the front edges to secure the box in the opening (bottom).

1 Use a template to trace a cutout for the box at the intended location. If no template is provided, press the pop-in box against the wall surface and trace its front edges (but not the tabs on the top and bottom).

2 Puncture the wallboard with the tip of a wallboard saw or by drilling a small hole inside the lines, and make the cutout for the box.

3 Pull NM cable through a knockout in the box (no cable clamp is required with a plastic box; just be sure not to break the pressure tab that holds the cable in place).

4 Insert the box into the cutout so the tabs are flush against the wall surface. Tighten the screws that cause the flip-out wings to pivot (right) until the box is held firmly in place. Connect the switch or receptacle that the box will house.

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ELECTRICAL PANELS

Every home has a main service panel that distributes electrical current to the individual circuits. The main service panel usually is found in the basement, garage, or utility area, and can be identified by its metal casing. Before making any repair to your electrical system, you must shut off power to the correct circuit at the main service panel. The service panel should be indexed (page 7) so circuits can be identified easily.

Service panels vary in appearance, depending on the age of the system. Very old wiring may operate on 30-amp service that has only two circuits. New homes can have 200-amp service with 30 or more circuits. Find the size of the service by reading the amperage rating printed on the main fuse block or main circuit breaker.

Regardless of age, all service panels have fuses or circuit breakers that control each circuit and protect them from overloads. In general, older service panels use fuses, while newer service panels use circuit breakers.

In addition to the main service panel, your electrical system may have a subpanel that controls some of the circuits in the home. A subpanel has its own circuit breakers or fuses and is installed to control circuits that have been added to an existing wiring system.

The subpanel resembles the main service panel but is usually smaller. It may be located near the main panel, or it may be found near the areas served by the new circuits. Garages and basements that have been updated often have their own subpanels. If your home has a subpanel, make sure that its circuits are indexed correctly.

When handling fuses or circuit breakers, make sure the area around the service panel is dry. Never remove the protective cover on the service panel. After turning off a circuit to make electrical repairs, remember to always test the circuit for power before touching any wires.

The main service panel is the heart of your wiring system. As our demand for household energy has increased, the panels have also grown in capacity. Today, a 200-amp panel is considered the minimum for new construction.

Tip

Every house should have a properly labeled service panel. This makes it much easier to find a circuit that has been tripped. If the same circuit is regularly tripped, you are either overloading the circuit, or there is a problem with the wiring or the circuit breaker.

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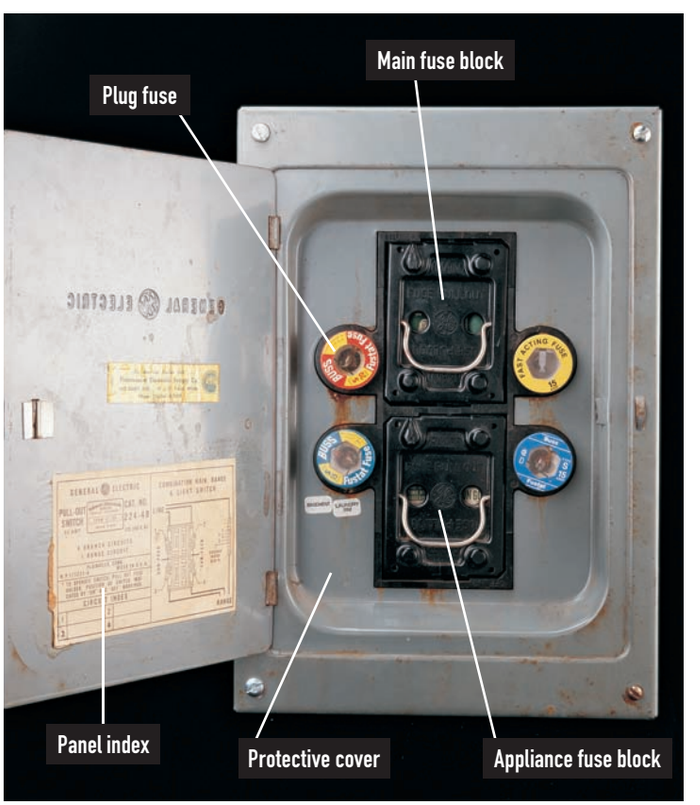
A circuit breaker panel providing 100 amps or more of power is common in wiring systems installed during the 1960s and later. A circuit breaker panel is housed in a gray metal cabinet that contains two rows of individual circuit breakers. The size of the service can be identified by reading the amperage rating of the main circuit breaker, which is located at the top or bottom of the main service panel.

A 200-amp service panel is now the minimum standard for all new housing. It is considered adequate for a medium-sized house with no more than three major electric appliances. However, larger houses with more electrical appliances often are equipped with a 400-amp service panel.

To shut off power to individual circuits in a circuit breaker panel, flip the lever on the appropriate circuit breaker to the OFF position. To shut off the power to the entire house, turn the main circuit breaker to the OFF position.



A 60-amp fuse panel often is found in wiring systems installed between 1950 and 1965. It usually is housed in a gray metal cabinet that contains four individual plug fuses, plus one or two pull-out fuse blocks that hold cartridge fuses. This type of panel is regarded as adequate for a small, 1,100-sq. ft. house that has no more than one 240-volt appliance. Many homeowners update 60-amp service to 100 amps or more so that additional lighting and appliance circuits can be added to the system. Home loan programs also may require that 60-amp service be updated before a home can qualify for financing.

To shut off power to a circuit, carefully unscrew the plug fuse, touching only its insulated rim. To shut off power to the entire house, hold the handle of the main fuse block and pull sharply to remove it. Major appliance circuits are controlled with another cartridge fuse block. Shut off the appliance circuit by pulling out this fuse block.

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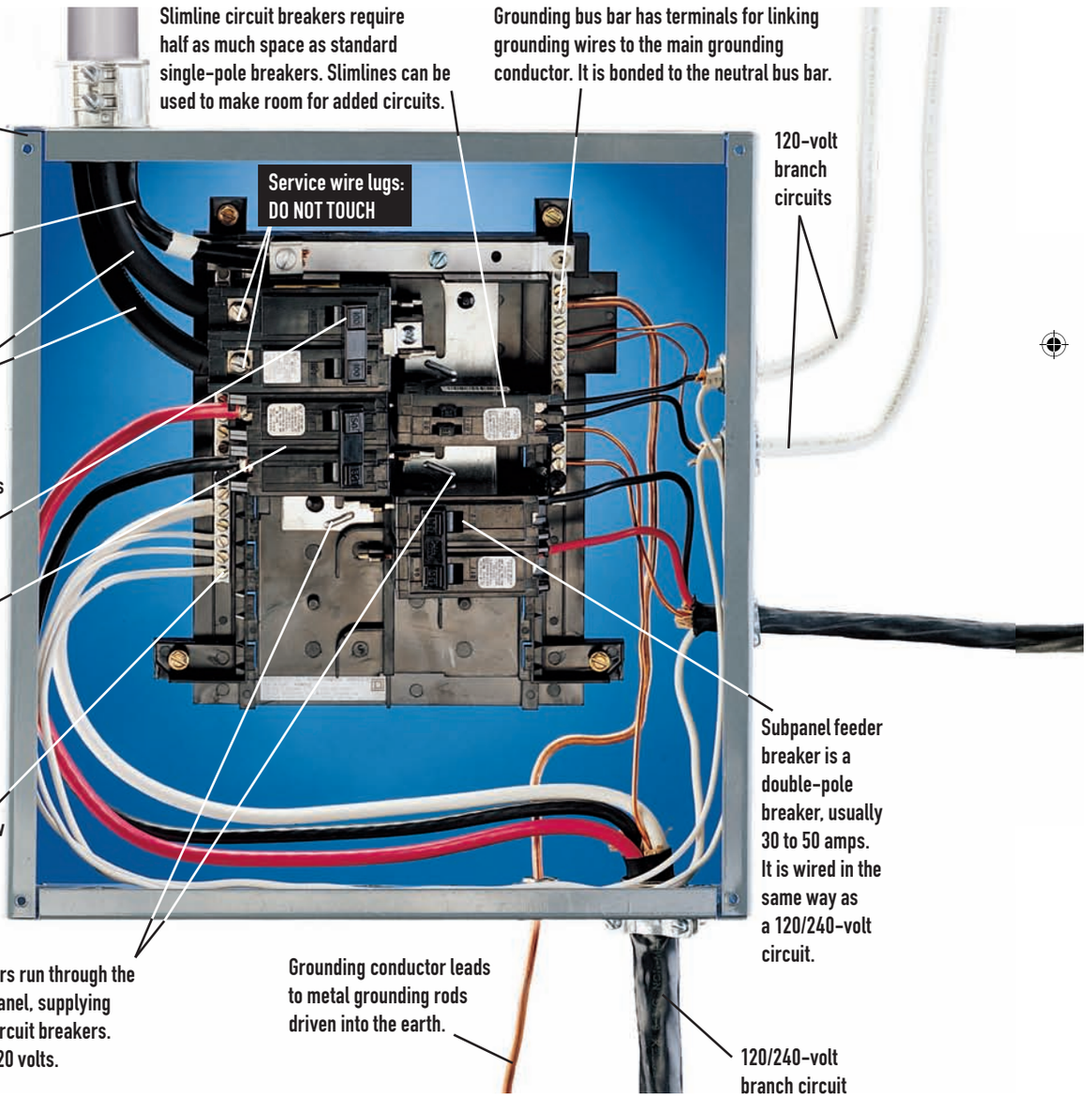
Circuit Breaker Panels

The circuit breaker panel is the electrical distribution center for your home. It divides the current into branch circuits that are carried throughout the house. Each branch circuit is controlled by a circuit breaker that protects the wires from dangerous current overloads. When installing new circuits, the last step is to connect the wires to new circuit breakers at the panel. Working inside a circuit breaker panel is not dangerous if you follow basic safety procedures. Always shut off the main circuit breaker and test for power before touching any parts inside the panel, and never touch the service wire lugs. If unsure of your own skills, hire an electrician to make the final circuit connections. (If you have an older electrical service with fuses instead of circuit breakers, always have an electrician make these final hookups.)



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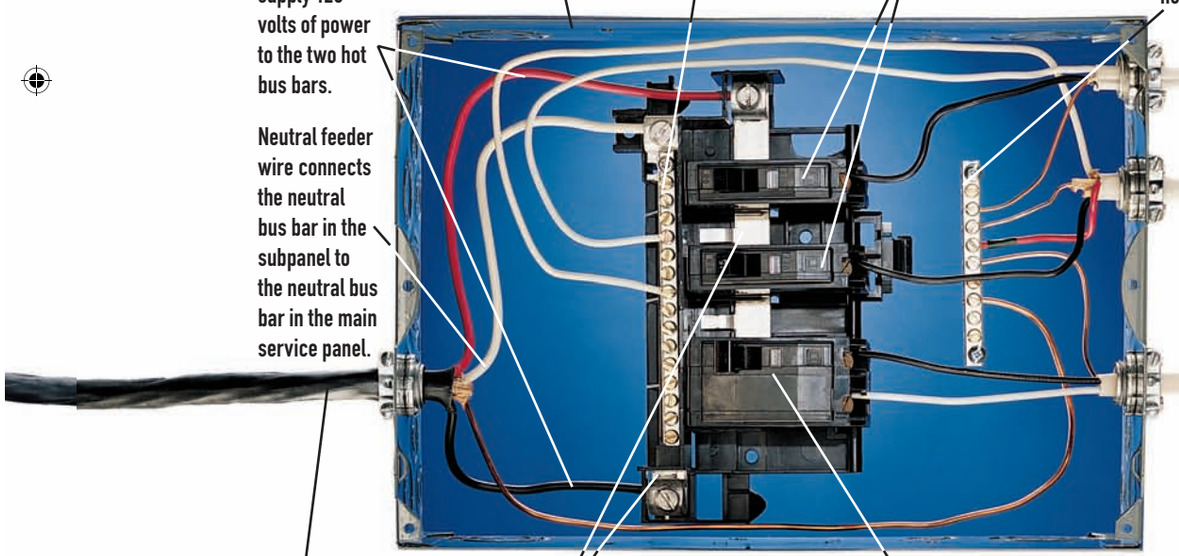
If the main circuit breaker panel does not have enough open slots to hold new circuit breakers, install a subpanel. This job is well within the skill level of an experienced do-it-yourselfer, although you can also hire an electrician to install the subpanel.

Before installing any new wiring, evaluate your electrical service to make sure it provides enough current to support both the existing wiring and any new circuits. If your service does not provide enough power, have an electrician upgrade it to a higher amp rating. During the upgrade, the electrician will install a new circuit breaker panel with enough extra breaker slots for the new circuits you want to install.

Safety Warning

Never touch any parts inside a circuit breaker panel until you have checked for power. Circuit breaker panels differ in appearance, depending on the manufacturer. Never begin work in a circuit breaker panel until you understand its layout and can identify the parts.



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Fuses & Circuit Breakers

Fuses and circuit breakers are safety devices designed to protect the electrical system from short circuits and overloads. Fuses and circuit breakers are located in the main service panel.

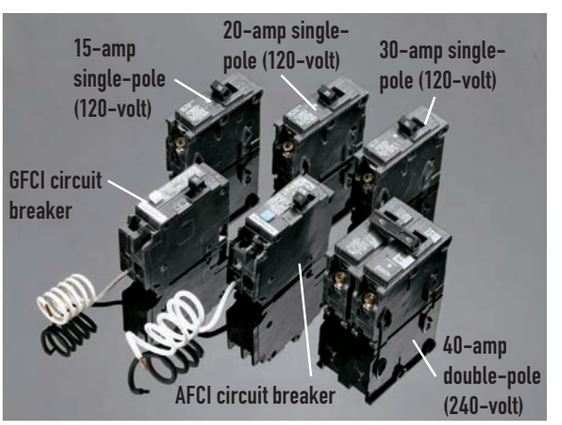
Most service panels installed before 1965 rely on fuses to control and protect individual circuits. Screw-in plug fuses protect 120-volt circuits that power lights and receptacles. Cartridge fuses protect 240-volt appliance circuits and the main shutoff of the service panel.

Inside each fuse is a current-carrying metal alloy ribbon. If a circuit is overloaded, the metal ribbon melts and stops the flow of power. A fuse must match the amperage rating of the circuit. Never replace a fuse with one that has a larger amperage rating.

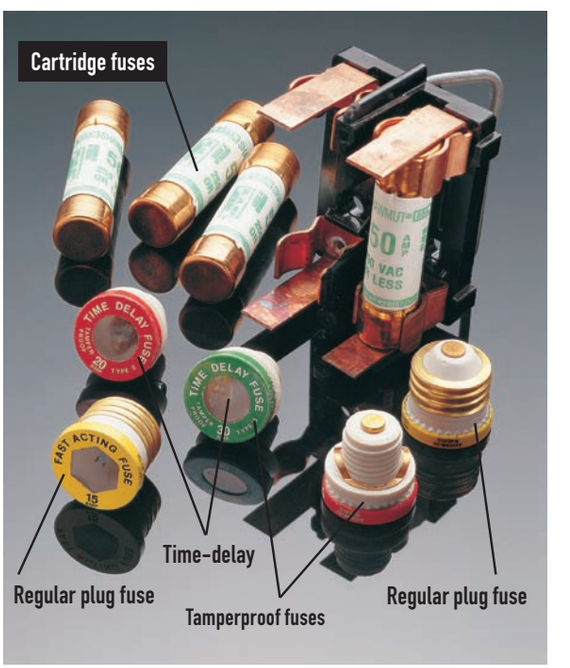
In most service panels installed after 1965, circuit breakers protect and control individual circuits. Single-pole circuit breakers protect 120-volt circuits, and double-pole circuit breakers protect 240-volt circuits. Amperage ratings for circuit breakers range from 15 to 100 amps.

Each circuit breaker has a permanent metal strip that heats up and bends when voltage passes through it. If a circuit is overloaded, the metal strip inside the breaker bends enough to "trip" the switch and stop the flow of power. Circuit breakers are listed to trip twice. After the second trip they weaken and tend to nuisance trip at lower currents. Replace breakers that have tripped more than twice—they may fail. Worn circuit breakers should be replaced by an electrician.

When a fuse blows or a circuit breaker trips, it is usually because there are too many light fixtures and plug-in appliances drawing power through the circuit. Move some of the plug-in appliances to another circuit, then replace the fuse or reset the breaker. If the fuse blows or the breaker trips again immediately, there may be a short circuit in the system. Call a licensed electrician if you suspect a short circuit.



Circuit breakers are found in the majority of panels installed since the 1940s. Single-pole breakers control 120-volt circuits. Double-pole breakers rated for 20 to 60 amps control 240-volt circuits. Ground-fault circuit interrupter (GFCI) and arc-fault circuit interrupter (AFCI) breakers provide protection from shocks and fire-causing arcs for the entire circuit.



Fuses are used in older service panels. Plug fuses usually control 120-volt circuits rated for 15, 20, or 30 amps. Tamper-proof plug fuses have threads that fit only matching sockets, making it impossible to install a wrong-sized fuse. Time-delay fuses absorb temporary heavy power loads without blowing. Cartridge fuses control 240-volt circuits and range from 30 to 100 amps.

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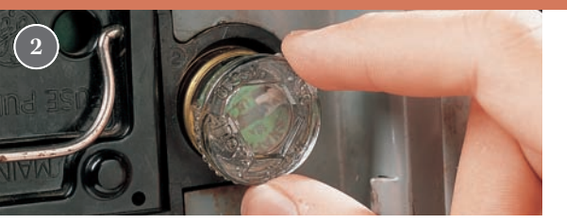
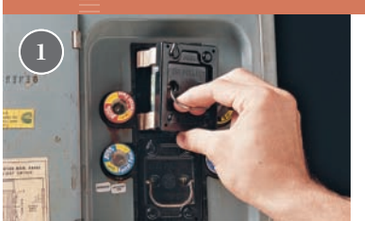
IDENTIFYING & REPLACING A BLOWN PLUG FUSE

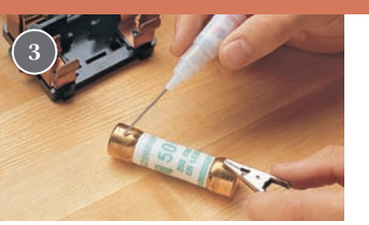


1 Locate the blown fuse at the main service panel. If the metal ribbon inside is cleanly melted (right), the circuit was overloaded. If window is discolored (left), there was a short circuit.

2 Unscrew the fuse, being careful to touch only the insulated rim of the fuse. Replace it with a fuse that has the same amperage rating.

REMOVING, TESTING & REPLACING A CARTRIDGE FUSE



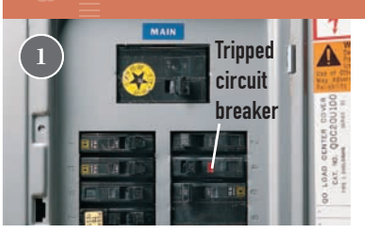


1 Remove cartridge fuses by gripping the handle of the fuse block and pulling sharply.

2 Remove the individual cartridge fuses from the block using a fuse puller.

3 Test each fuse using a continuity tester. If the tester glows, the fuse is good. If not, install a new fuse with the same amperage rating.

RESETTING A CIRCUIT BREAKER



1 Open the service panel and locate the tripped breaker. The lever on the tripped breaker will be either in the OFF position, or in a position between ON and OFF.

2 Reset the tripped circuit breaker by pressing the circuit breaker lever all the way to the OFF position, then pressing it to the ON position.

3 Test AFCI and GFCI circuit breakers by pushing the TEST button. The breaker should trip to the OFF position. If not, the breaker is faulty and must be replaced by an electrician.

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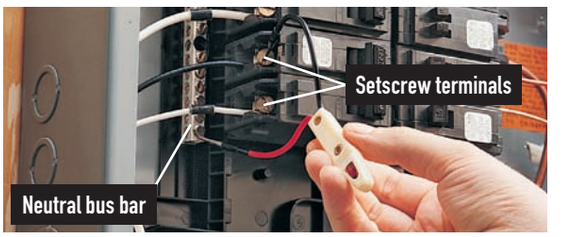
#175 Dtp:225 Page:59

Connecting Circuit Breakers

The last step in a wiring project is connecting circuits at the breaker panel. After this is done, the work is ready for the final inspection.

Circuits are connected at the main breaker panel, if it has enough open slots, or at a circuit breaker subpanel. When working at a subpanel, make sure the feeder breaker at the main panel has been turned off, and test for power (photo, right) before touching any parts in the subpanel.

Make sure the circuit breaker amperage does not exceed the ampacity of the circuit wires you are connecting to it. Also be aware that circuit breaker styles and installation techniques vary according to manufacturer. Use breakers designed for your type of panel. For most rooms in a home, in addition to the kitchen, basement, and bathroom, an AFCI breaker needs to be installed.

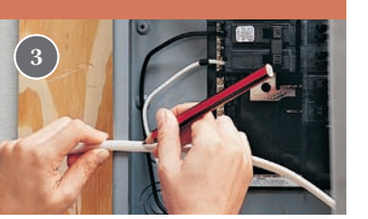


Test for current before touching any parts inside a circuit breaker panel. With main breaker turned off but all other breakers turned on, touch one probe of a neon tester to the neutral bus bar, and touch the other probe to each setscrew on one of the double-pole breakers (not the main breaker). If tester does not light for either setscrew, it is safe to work in the panel. Note: Touchless circuit testers are preferred in most situations where you are testing for current because they're safer. But in some instances you'll need a tester with individual probes to properly check for current.

Tools & Materials

Screwdriver	Pencil	Cable ripper	Pliers	Single- and double-pole circuit breakers
Hammer	Combination tool	Circuit tester	Cable clamps	

CONNECTING CIRCUIT BREAKERS



1 Shut off the main circuit breaker in the main circuit breaker panel (if you are working in a subpanel, shut off the feeder breaker in the main panel). Remove the panel cover plate, taking care not to touch the parts inside the panel. Test for power (photo, top).

2 Open a knockout in the side of the circuit breaker panel using a screwdriver and hammer. Attach a cable clamp to the knockout.

3 Hold cable across the front of the panel near the knockout, and mark sheathing about ½" inside the edge of the panel. Strip the cable from the marked line to the end using a cable ripper. (There should be 18 to 24" of excess cable.) Insert the cable through the clamp and into the service panel, then tighten the clamp.

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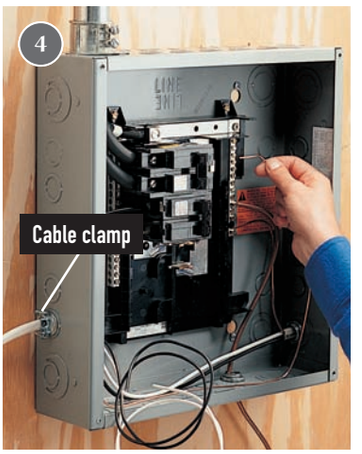

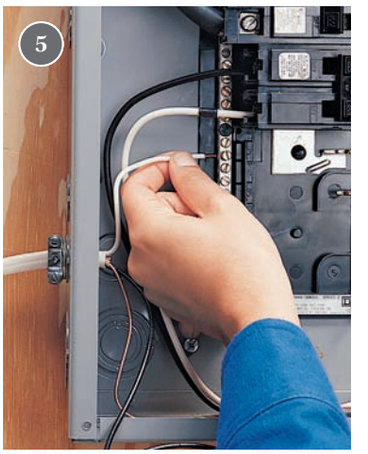

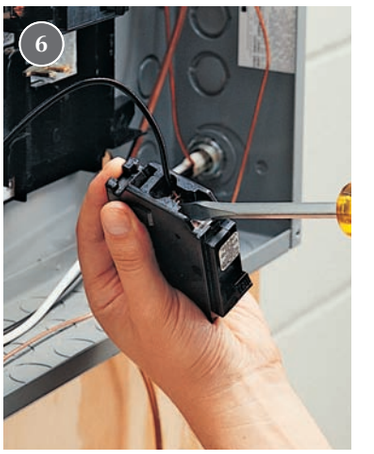

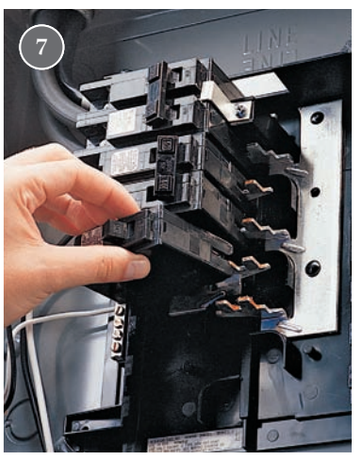

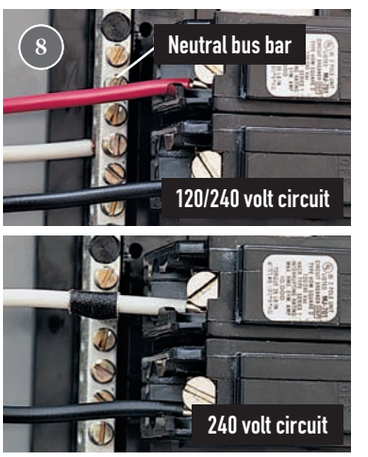

4 Bend the bare copper grounding wire around the inside edge of the panel to an open setscrew terminal on the grounding bus bar. Insert the wire into the opening on the bus bar, and tighten the setscrew. Fold excess wire around the inside edge of the panel.

5 For 120-volt circuits, bend the white circuit wire around the outside of the panel to an open setscrew terminal on the neutral bus bar. Clip away excess wire, then strip ½" of insulation from the wire using a combination tool. Insert the wire into the terminal opening, and tighten the setscrew.

6 Strip ½" of insulation from the end of the black circuit wire. Insert the wire into the setscrew terminal on a new single-pole circuit breaker, and tighten the setscrew.

7 Slide one end of the circuit breaker onto the guide hook, then press it firmly against the bus bar until it snaps into place. (Breaker installation may vary, depending on the manufacturer.) Fold excess black wire around the inside edge of the panel.

8 120/240-volt circuits (top): Connect red and black wires to the double-pole breaker. Connect white wire to the neutral bus bar, and grounding wire to the grounding bus bar. For 240-volt circuits (bottom), attach white and black wires to the double-pole breaker, tagging white wire with black tape. There is no neutral bus bar connection on this circuit.

9 Remove the appropriate breaker knockout on the panel cover plate to make room for the new circuit breaker. A single-pole breaker requires one knockout, while a double-pole breaker requires two knockouts. Reattach the cover plate, and label the new circuit on the panel index.

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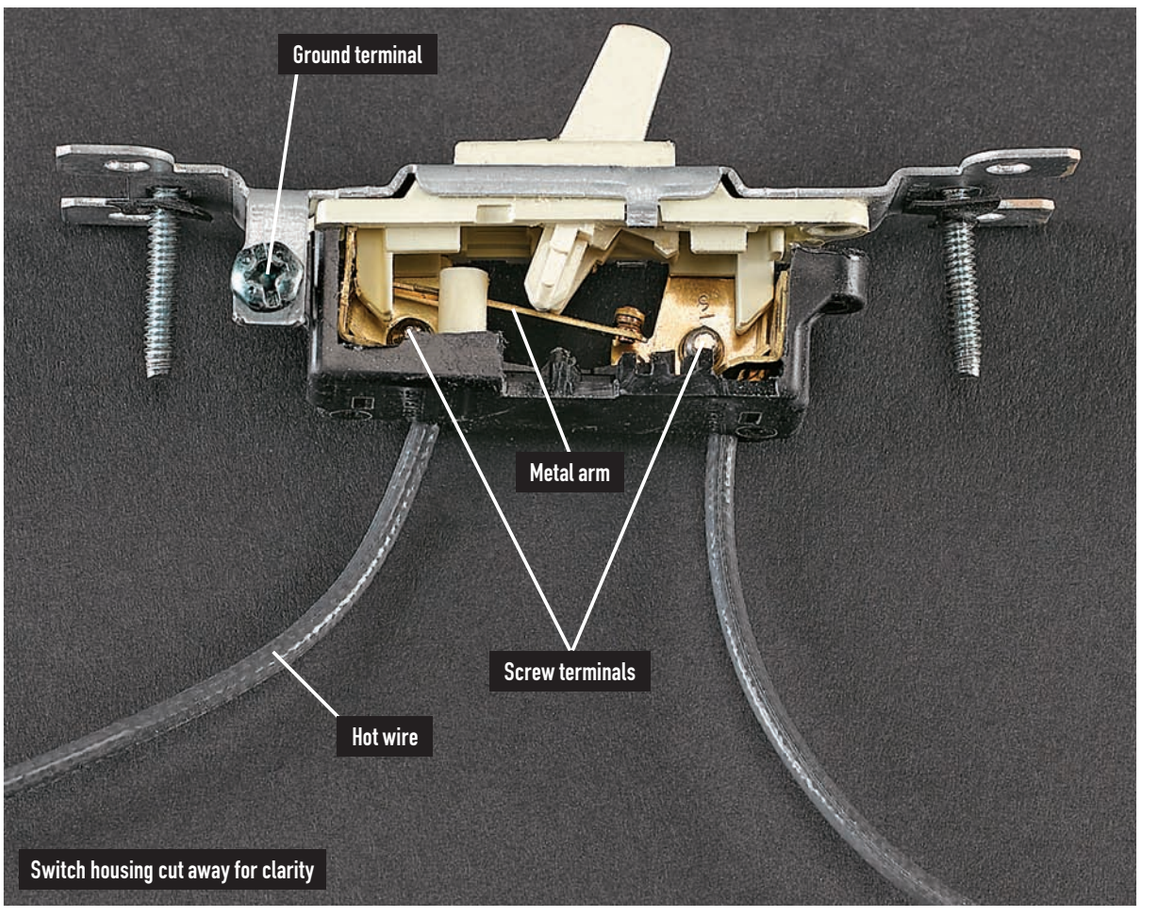
WALL SWITCHES

An average wall switch is turned on and off more than 1,000 times each year. Because switches receive constant use, wire connections can loosen and switch parts gradually wear out. If a switch no longer operates smoothly, it must be repaired or replaced.

The methods for repairing or replacing a switch vary slightly, depending on the switch type and its location along an electrical circuit. When working on a switch, use the photographs on pages 64 to 67 to identify your switch type and its wiring configuration. Individual switch styles may vary from manufacturer to manufacturer, but the basic switch types are universal.

It is possible to replace most ordinary wall switches with a specialty switch, like a timer switch or an electronic switch. When installing a specialty switch, make sure it is compatible with the wiring configuration of the switch box.



A typical wall switch has a movable metal arm that opens and closes the electrical circuit. When the switch is ON, the arm completes the circuit and power flows between the screw terminals and through the black hot wire to the light fixture. When the switch is OFF, the arm lifts away to interrupt the circuit, and no power flows. Switch problems can occur if the screw terminals are not tight or if the metal arm inside the switch wears out. The switch above has had part of its housing removed so the interior workings can be seen. Switches or fixtures that are not in original condition should never be installed.

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Rotary snap switches are found in many installations completed between 1900 and 1920. The handle is twisted clockwise to turn light on and off. The switch is enclosed in a ceramic housing.

Push-button switches were widely used from 1920 until about 1940. Many switches of this type are still in operation. Reproductions of this switch type are available for restoration projects.

Toggle switches were introduced in the 1930s. This early design has a switch mechanism that is mounted in a ceramic housing sealed with a layer of insulating paper.

Toggle switches were improved during the 1950s and are now the most commonly used type. This switch type was the first to use a sealed plastic housing that protects the inner switch mechanism from dust and moisture.

Mercury switches became common in the early 1960s. They conduct electrical current by means of a sealed vial of mercury. No longer manufactured for home use, old mercury switches are considered a hazardous waste.

Electronic motion-sensor switches have an infrared eye that senses movement and automatically turns on lights when a person enters a room. Motion-sensor switches can provide added security against intruders.

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TYPES OF WALL SWITCHES

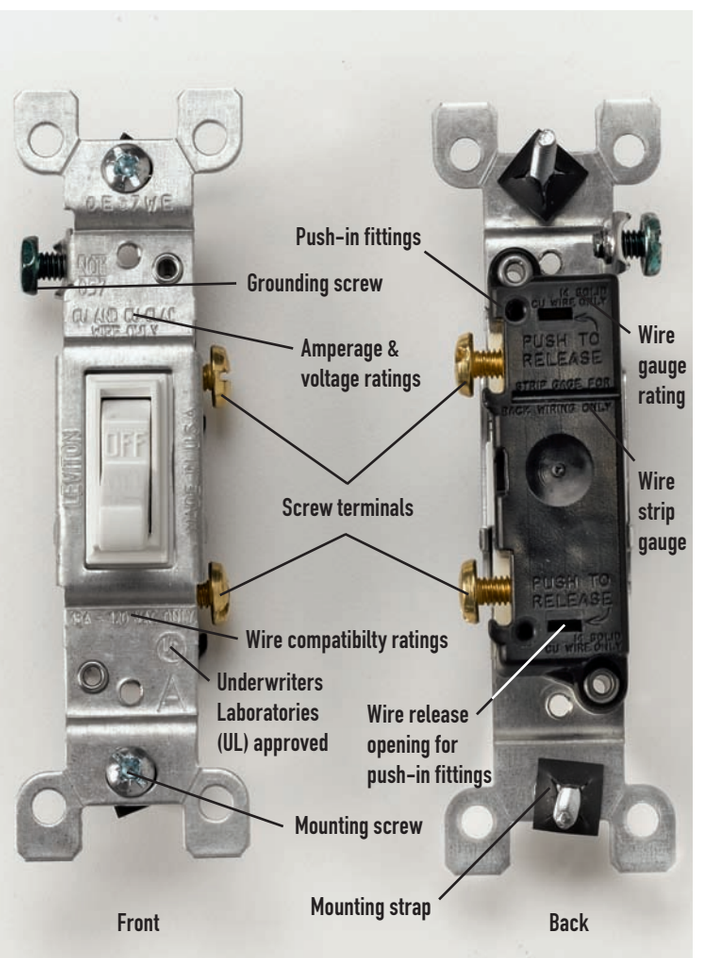
Wall switches are available in three general types. To repair or replace a switch, it is important to identify its type.

Single-pole switches are used to control a set of lights from one location. Three-way switches are used to control a set of lights from two different locations and are always installed in pairs. Four-way switches are used in combination with a pair of three-way switches to control a set of lights from three or more locations.

Identify switch types by counting the screw terminals. Single-pole switches have two screw terminals, three-way switches have three screw terminals, and four-way switches have four. Most switches include a grounding screw terminal, which is identified by its green color.

When replacing a switch, choose a new switch that has the same number of screw terminals as the old one. The location of the screws on the switch body varies depending on the manufacturer, but these differences will not affect the switch operation.

Whenever possible, connect switches using the screw terminals rather than push-in fittings. Some specialty switches have wire leads instead of screw terminals. They are connected to circuit wires with wire connectors.



A wall switch is connected to circuit wires with screw terminals or with push-in fittings on the back of the switch. A switch may have a stamped strip gauge that indicates how much insulation must be stripped from the circuit wires to make the connections.

The switch body is attached to a metal mounting strap that allows it to be mounted in an electrical box. Several rating stamps are found on the strap and on the back of the switch. The abbreviation UL or UND LAB INC LIST means that the switch meets the safety standards of the Underwriters Laboratories. Switches also are stamped with maximum voltage and amperage ratings. Standard wall switches are rated 15A or 125V. Voltage ratings of 110, 120, and 125 are considered to be identical for purposes of identification.

For standard wall switch installations, choose a switch that has a wire gauge rating of #12 or #14. For wire systems with solid-core copper wiring, use only switches marked COPPER or CU. For aluminum wiring, use only switches marked CO/ALR. Switches marked AL/CU can no longer be used with aluminum wiring, according to the National Electrical Code.

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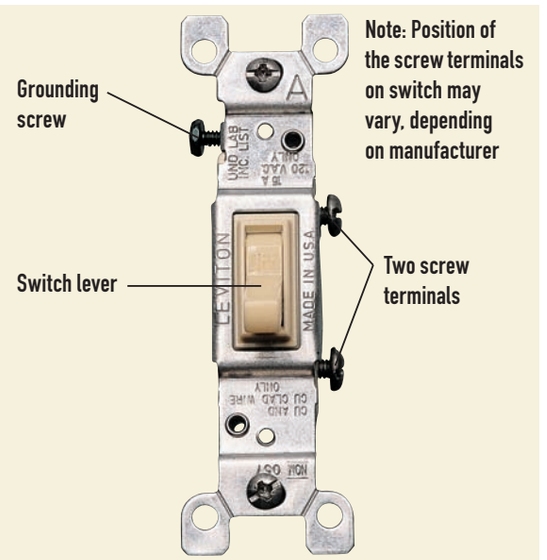
Single-Pole Wall Switches

A single-pole switch is the most common type of wall switch. It has ON-OFF markings on the switch lever and is used to control a set of lights, an appliance, or a receptacle from a single location. A single-pole switch has two screw terminals and a grounding screw. When installing a single-pole switch, check to make sure the ON marking shows when the switch lever is in the up position.

In a correctly wired single-pole switch, a hot circuit wire is attached to each screw terminal. However, the color and number of wires inside the switch box will vary, depending on the location of the switch along the electrical circuit.

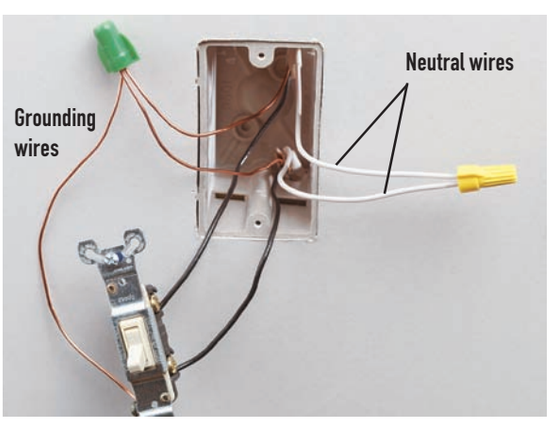
If two cables enter the box, then the switch lies in the middle of the circuit. In this installation, both of the hot wires attached to the switch are black.

If only one cable enters the box, then the switch lies at the end of the circuit. In this installation (sometimes called a switch loop), one of the hot wires is black, but the other hot wire usually is white. A white hot wire should be coded with black tape or paint.

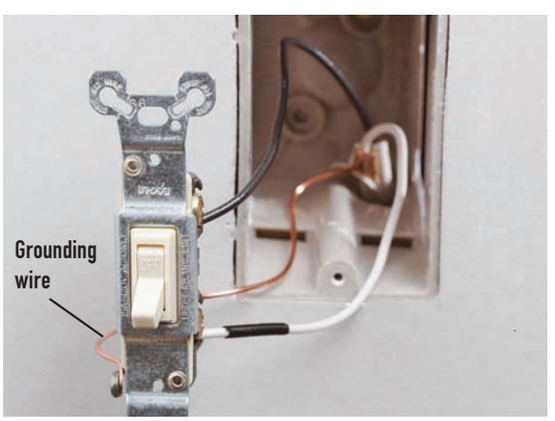


A single-pole switch is essentially an interruption in the black power supply wire that is opened or closed with the toggle. Single-pole switches are the simplest of all home wiring switches.

Typical Single-Pole Switch Installations



Two cables enter the box when a switch is located in the middle of a circuit. Each cable has a white and a black insulated wire, plus a bare copper grounding wire. The black wires are hot and are connected to the screw terminals on the switch. The white wires are neutral and are joined together with a wire connector. Grounding wires are pigtailed to the switch.



One cable enters the box when a switch is located at the end of a circuit. The cable has a white and a black insulated wire, plus a bare copper grounding wire. In this installation, both of the insulated wires are hot. The white wire may be labeled with black tape or paint to identify it as a hot wire. The grounding wire is connected to the switch grounding screw.

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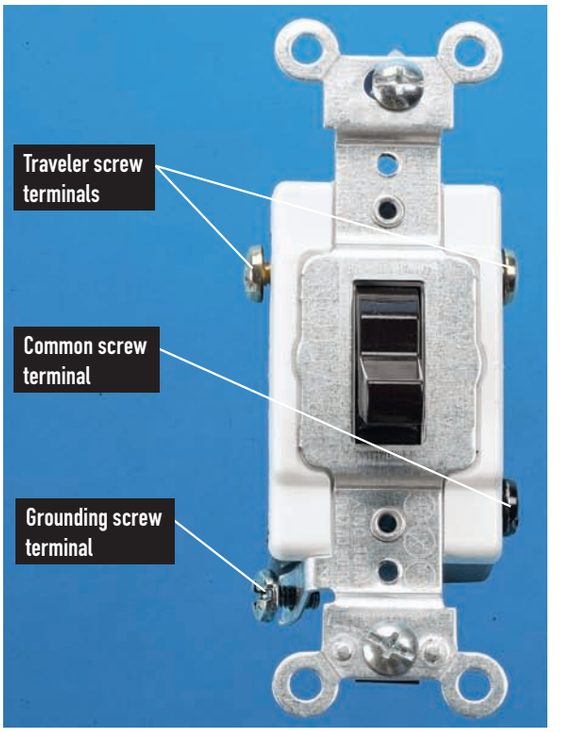
Three-way Wall Switches

Three-way switches have three screw terminals and do not have ON-OFF markings. Three-way switches are always installed in pairs and are used to control a set of lights from two locations.

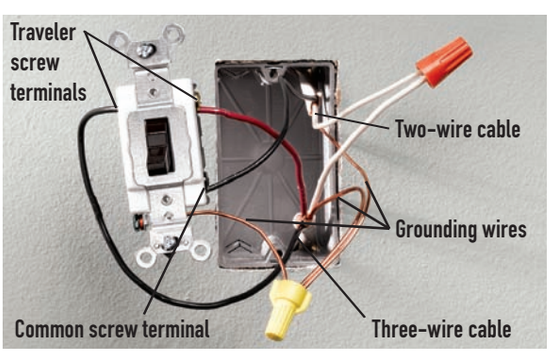
One of the screw terminals on a three-way switch is darker than the others. This screw is the common screw terminal. The position of the common screw terminal on the switch body may vary, depending on the manufacturer. Before disconnecting a three-way switch, always label the wire that is connected to the common screw terminal. It must be reconnected to the common screw terminal on the new switch.

The two, lighter-colored screw terminals on a three-way switch are called the traveler screw terminals. The traveler terminals are interchangeable, so there is no need to label the wires attached to them.

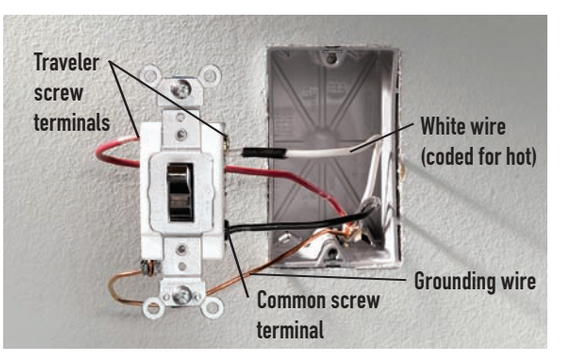
Because three-way switches are installed in pairs, it is sometimes difficult to determine which of the switches is causing a problem. The switch that receives greater use is more likely to fail, but you may need to inspect both switches to find the source of the problem.



Typical Three-way Switch Installations



Two cables enter the box if the switch lies in the middle of a circuit. One cable has two wires, plus a bare copper grounding wire; the other cable has three wires, plus a ground. The black wire from the two-wire cable is connected to the dark common screw terminal. The red and black wires from the three-wire cable are connected to the traveler screw terminals. The white neutral wires are joined together with a wire connector, and the grounding wires are pigtailed to the grounded metal box.



One cable enters the box if the switch lies at the end of the circuit. The cable has a black wire, red wire, and white wire, plus a bare copper grounding wire. The black wire must be connected to the common screw terminal, which is darker than the other two screw terminals. The white and red wires are connected to the two traveler screw terminals. The white wire is taped to indicate that it is hot. The bare copper grounding wire is connected to the grounded metal box.

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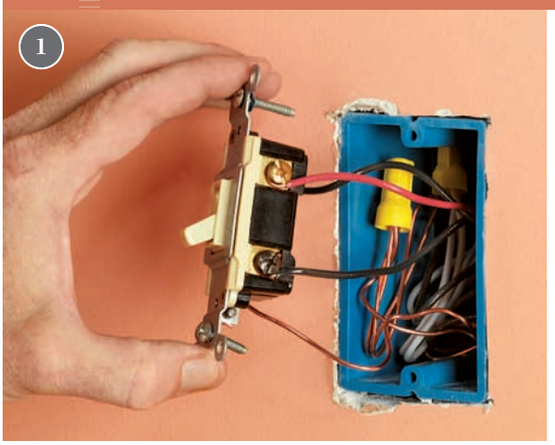
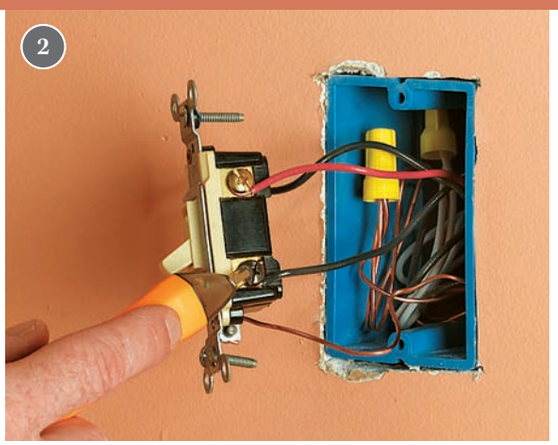
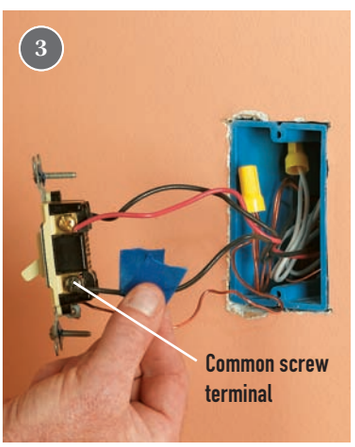
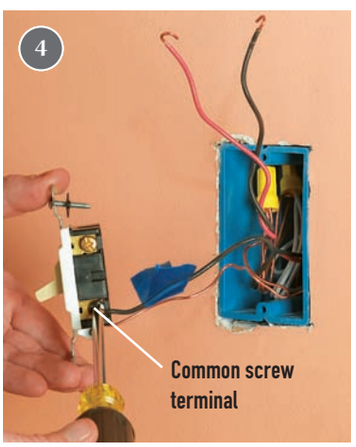
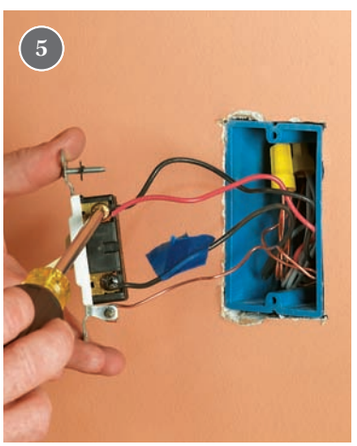
FIXING OR REPLACING A THREE-WAY WALL SWITCH











1 Turn off the power to the switch at the main service panel, then remove the switch cover plate and mounting screws. Holding the mounting strap carefully, pull the switch from the box. Be careful not to touch the bare wires or screw terminals until they have been tested for power.

2 Test for power by touching one probe of the circuit tester to the grounded metal box or to the bare copper grounding wire, and touching the other probe to each screw terminal. Tester should not glow. If it does, there is still power entering the box. Return to the service panel, and turn off the correct circuit.

3 Locate the dark common screw terminal, and use masking tape to label the "common" wire attached to it. Disconnect wires and remove the switch. Test the switch for continuity. If it tests faulty, buy a replacement. Inspect wires for nicks and scratches. If necessary, clip damaged wires and strip them.

4 Connect the common wire to the dark common screw terminal on the switch. On most three-way switches, the common screw terminal is black. Or it may be labeled with the word COMMON stamped on the back of the switch. Reconnect the grounding screw; connect it to the circuit grounding wires with a pigtail.

5 Connect the remaining two circuit wires to the screw terminals. These wires are interchangeable and can be connected to either screw terminal. Carefully tuck the wires into the box. Remount the switch, and attach the cover plate. Turn on the power at the main service panel.

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#175 Dtp:225 Page:67

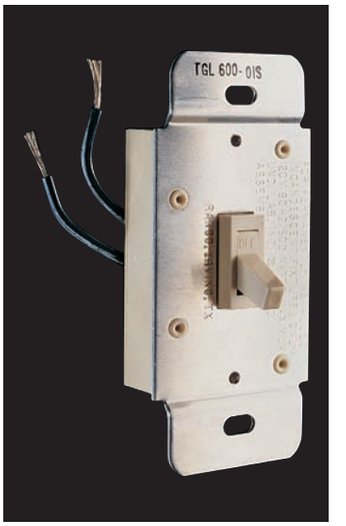
Dimmer Switches

A dimmer switch makes it possible to vary the brightness of a light fixture. Dimmers are often installed in dining rooms, recreation areas, or bedrooms.

Any standard single-pole switch can be replaced with a dimmer, as long as the switch box is of adequate size. Dimmer switches have larger bodies than standard switches. They also generate a small amount of heat that must dissipate. For these reasons, dimmers should not be installed in undersized electrical boxes or in boxes that are crowded with circuit wires. Always follow the manufacturer's specifications for installation.

In lighting configurations that use three-way switches (pages 66 to 67), replace the standard switches with special three-way dimmers. If replacing both the switches with dimmers, buy a packaged pair of three-way dimmers designed to work together.

Dimmer switches are available in several styles (photo, right). All types have wire leads instead of screw terminals, and they are connected to circuit wires using wire connectors. Some types have a green grounding lead that should be connected to the grounded metal box or to the bare copper grounding wires.



Toggle-type dimmer resembles standard switches. Toggle dimmers are available in both single-pole and three-way designs.

Dial-type dimmer is the most common style. Rotating the dial changes the light intensity.

Slide-action dimmer has an illuminated face that makes the switch easy to locate in the dark.

Automatic dimmer has an electronic sensor that adjusts the light fixture to compensate for the changing levels of natural light. An automatic dimmer also can be operated manually.

Tools & Materials

Screwdriver
Circuit tester
Needlenose pliers
Wire connectors
Masking tape

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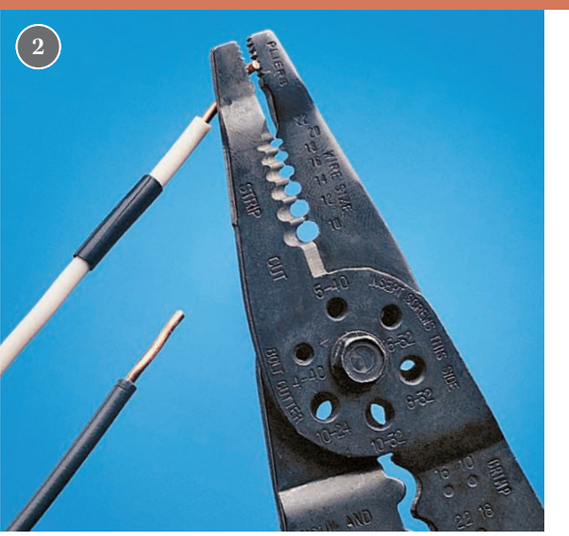
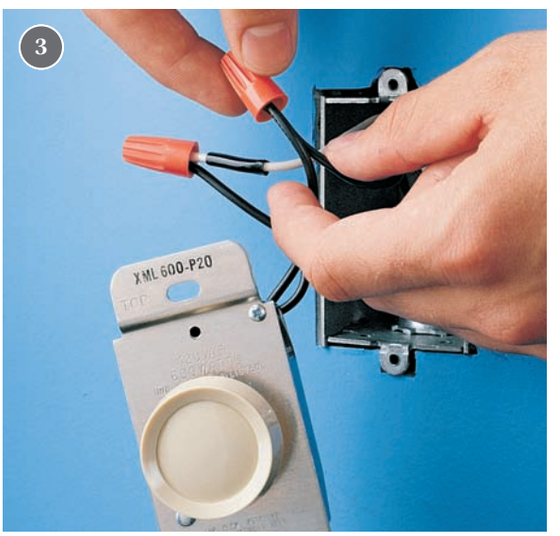
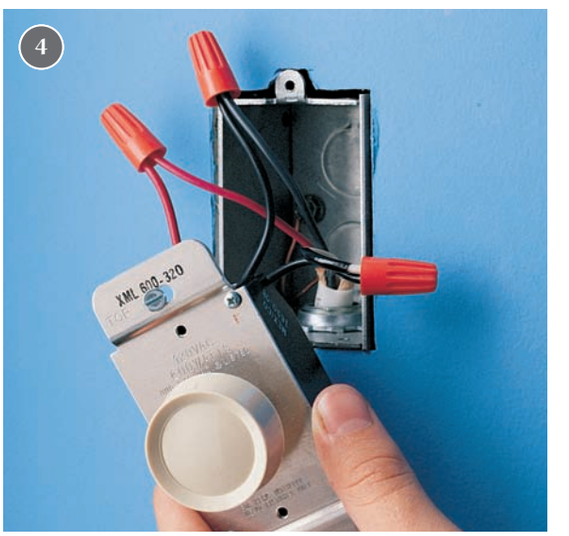
INSTALLING A DIMMER SWITCH







1 Turn off the power to the switch at the main service panel, then remove the cover plate and mounting screws. Holding the mounting straps carefully, pull the switch from the box. Be careful not to touch bare wires or screw terminals until they have been tested for power.

2 Disconnect the circuit wires and remove the switch. Straighten the circuit wires, and clip the ends, leaving about ½" of the bare wire end exposed.

3 Connect the wire leads on the dimmer switch to the circuit wires using wire connectors. The switch leads are interchangeable and can be attached to either of the two circuit wires.

4 A three-way dimmer has an additional wire lead. This "common" lead is connected to the common circuit wire. When replacing a standard three-way switch with a dimmer, the common circuit wire is attached to the darkest screw terminal on the old switch.

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#175 Dtp:225 Page:69

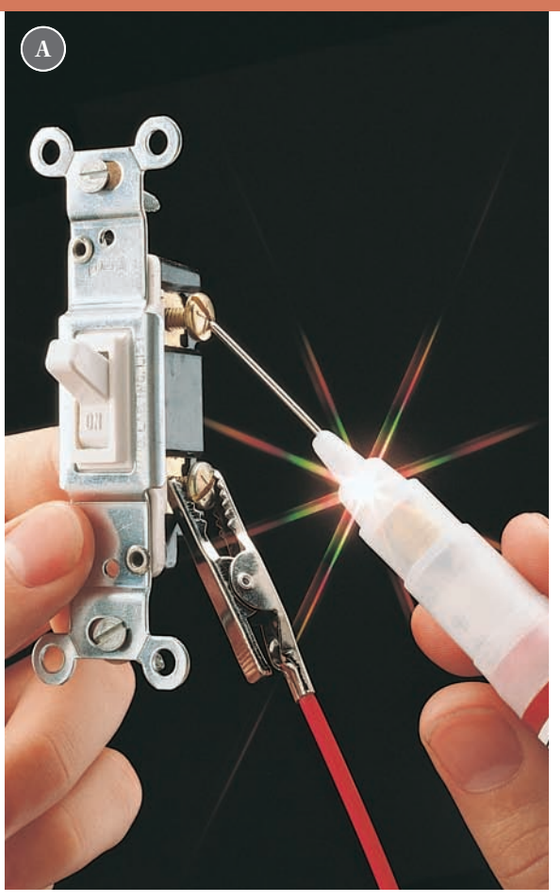
TESTING SWITCHES

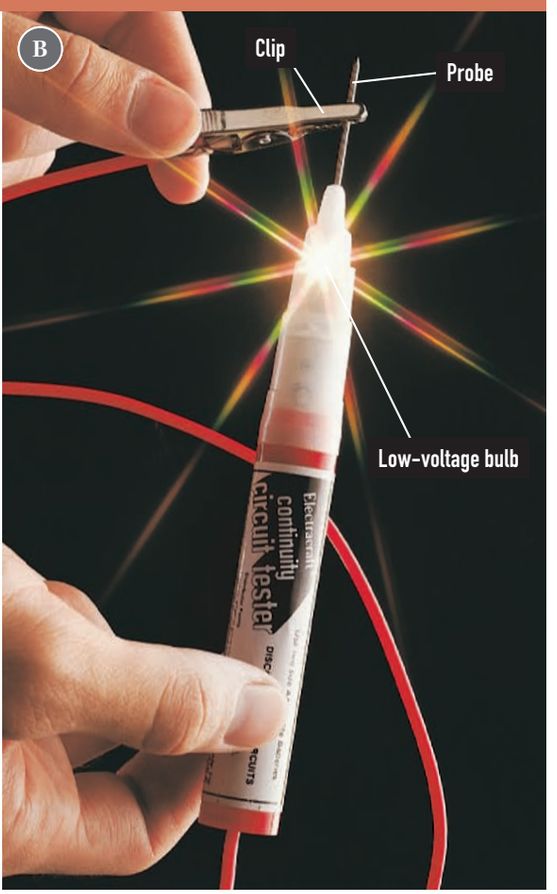
A switch that does not work properly may have worn or broken internal parts. Test switches with a battery-operated continuity tester. The continuity tester detects any break in the metal pathway inside the switch. Replace the switch if the continuity tester shows the switch to be faulty.

Never use a continuity tester on wires that might carry live current. Always shut off the power and disconnect the switch before testing for continuity.

Some specialty switches, like dimmers, cannot be tested for continuity. Electronic switches can be tested for manual operation using a continuity tester, but the automatic operation of these switches cannot be tested.

TESTING A SINGLE-POLE WALL SWITCH





A Attach the clip of the tester to one of the screw terminals. Touch the tester probe to the other screw terminal. Flip the switch lever from ON to OFF. If the switch is good, the tester glows when lever is ON, but not when OFF.

B A continuity tester uses battery-generated current to test the metal pathways running through switches and other electrical fixtures. Always "test" the tester before use. Touch the tester clip to the metal probe. The tester should glow. If not, then the battery or lightbulb is dead and must be replaced.

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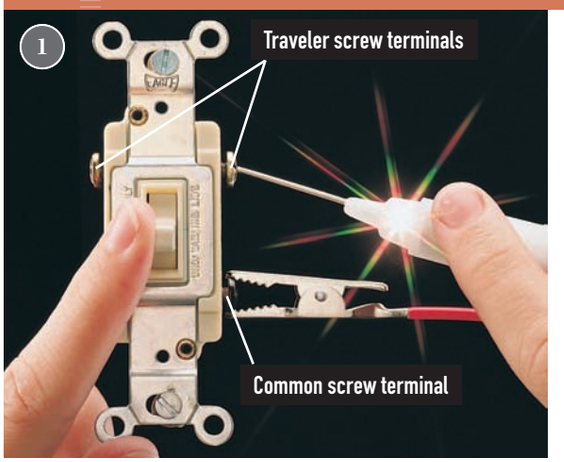
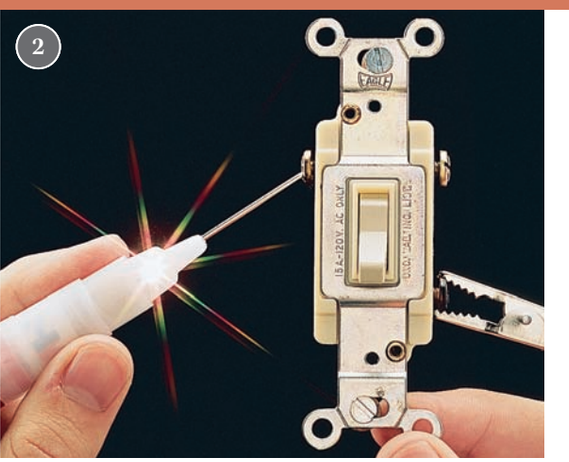
#175 Dtp:225 Page:70

TESTING A THREE-WAY WALL SWITCH

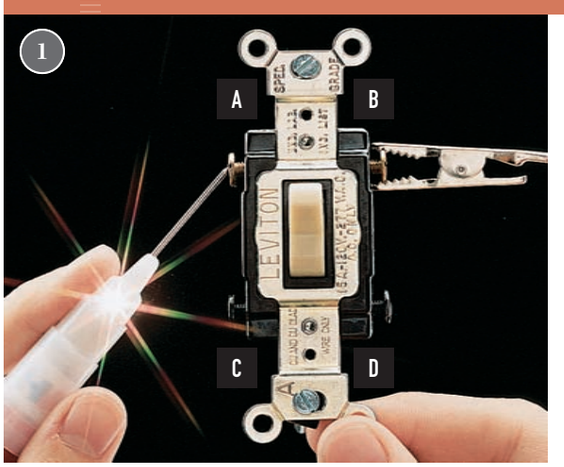


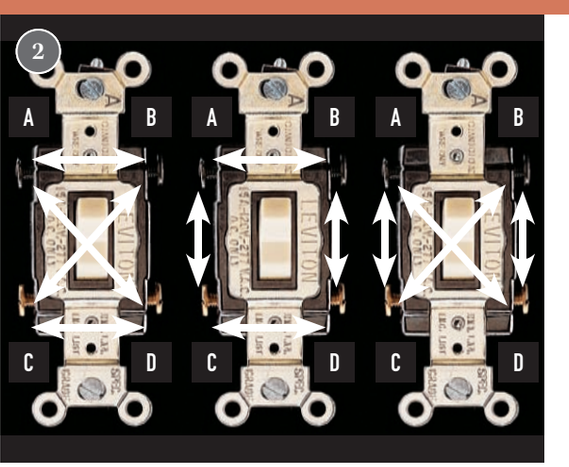


1 Attach the tester clip to the dark common screw terminal. Touch the tester probe to one of the traveler screw terminals, and flip the switch lever back and forth. If the switch is good, the tester should glow when the lever is in one position, but not both.

2 Touch the probe to the other traveler screw terminal, and flip the switch lever back and forth. If the switch is good, the tester will glow only when the switch lever is in the position opposite from the positive test in step 1.

TESTING A FOUR-WAY WALL SWITCH





1 Test the switch by touching the probe and clip of the continuity tester to each pair of screw terminals (A-B, C-D, A-D, B-C, A-C, B-D). The test should show continuous pathways between two different pairs of screw terminals. Flip the lever to the opposite position, and repeat the test. The test should show continuous pathways between two different pairs of screw terminals.

2 If the switch is good, the test will show a total of four continuous pathways between screw terminals—two pathways for each lever position. If not, then the switch is faulty and must be replaced. (The arrangement of the pathways may differ, depending on the switch manufacturer. The photo above shows the three possible pathway arrangements.)

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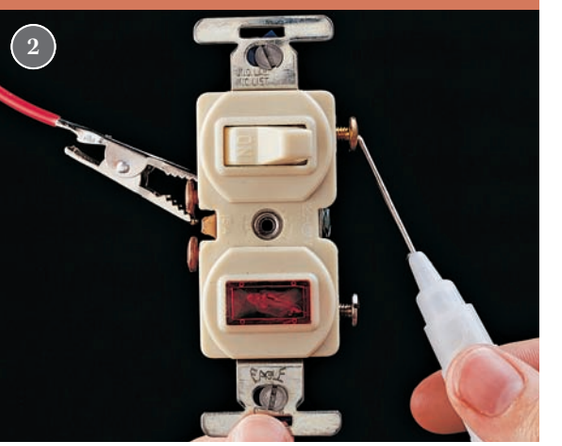
#175 Dtp:225 Page:71

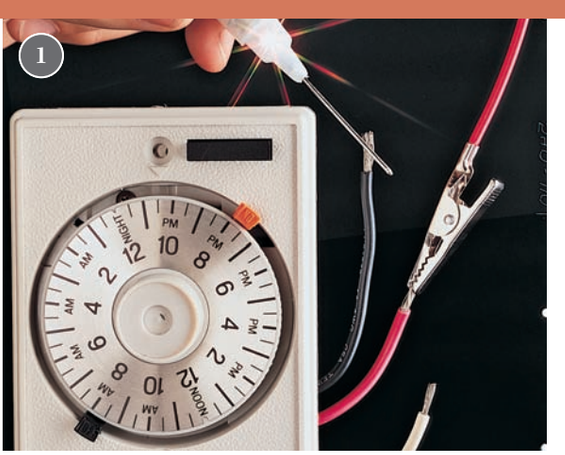
TESTING A PILOT-LIGHT SWITCH

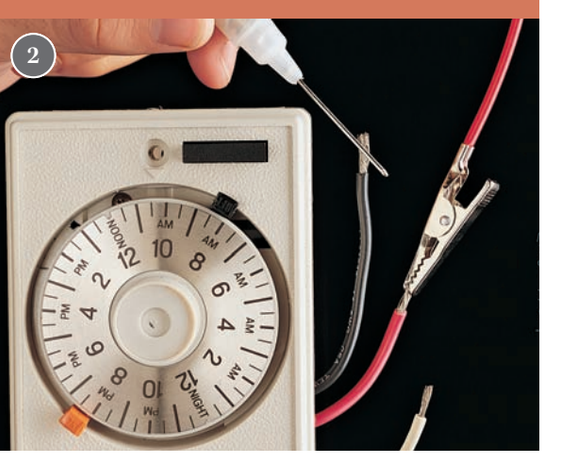


1 Test a pilot light by flipping the switch lever to the ON position. Check to see if the light fixture or appliance is working. If the pilot light does not glow even though the switch operates the light fixture or appliance, then the pilot light is defective and the unit must be replaced.

2 Test the switch by disconnecting the unit. With the switch lever in the ON position, attach the tester clip to the top screw terminal on one side of the switch. Touch the tester probe to top screw terminal on the opposite side of the switch. If the switch is good, the tester will glow when switch is ON, but not when OFF.

TESTING A TIMER SWITCH





1 Attach the tester clip to the red wire lead on the timer switch, and touch the tester probe to the black hot lead. Rotate the timer dial clockwise until the ON tab passes the arrow marker. The tester should glow. If it does not, the switch is faulty and must be replaced.

2 Rotate the dial clockwise until the OFF tab passes the arrow marker. The tester should not glow. If it does, the switch is faulty and must be replaced.

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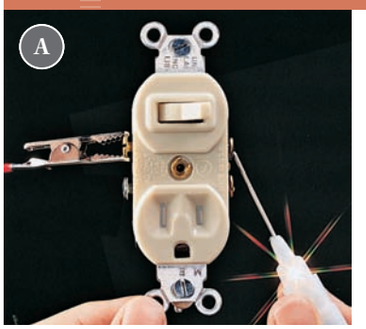
#175 Dtp:225 Page:72

TESTING A: A—SWITCH/RECEPTACLE, B—DOUBLE SWITCH, & C—TIME-DELAY SWITCH

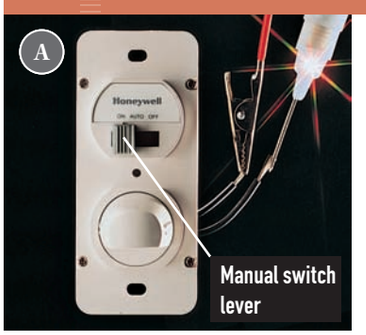


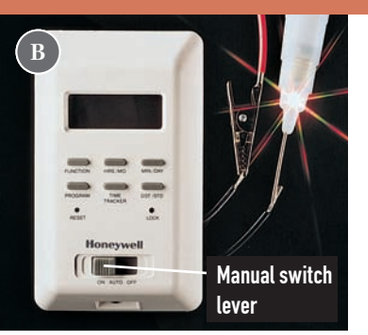
A Attach the tester clip to one of the top screw terminals. Touch the tester probe to the top screw terminal on the opposite side. Flip the switch lever from ON to OFF position. If the switch is working correctly, the tester will glow when the switch lever is ON, but not when OFF.

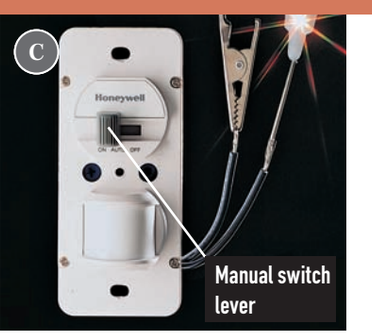
B Test each half of the switch by attaching the tester clip to one screw terminal and touching the probe to the opposite side. Flip the switch lever from ON to OFF position. If the switch is good, the tester glows when the switch lever is ON, but not when OFF. Repeat the test with the remaining pair of screw terminals. If either half tests faulty, replace the unit.

C Attach the tester clip to one of the wire leads, and touch the tester probe to the other lead. Set the timer for a few minutes. If the switch is working correctly, the tester will glow until the time expires.

TESTING MANUAL OPERATION OF ELECTRONIC SWITCHES







A Automatic switch: Attach the tester clip to a black wire lead, and touch the tester probe to the other black lead. Flip the manual switch lever from ON to OFF position. If the switch is working correctly, the tester will glow when the switch lever is ON, but not when OFF.

B Programmable switch: Attach the tester clip to a wire lead, and touch the tester probe to the other lead. Flip the manual switch lever from ON to OFF position. If the switch is working correctly, the tester will glow when the switch lever is ON, but not when OFF.

C Motion-sensor switch: Attach the tester clip to a wire lead, and touch the tester probe to the other lead. Flip the manual switch lever from ON to OFF position. If the switch is working correctly, the tester will glow when the switch lever is ON, but not when OFF.

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#175 Dtp:225 Page:73

RECEPTACLE WIRING

A 120-volt duplex receptacle can be wired to the electrical system in a number of ways. The most common are shown on these pages.

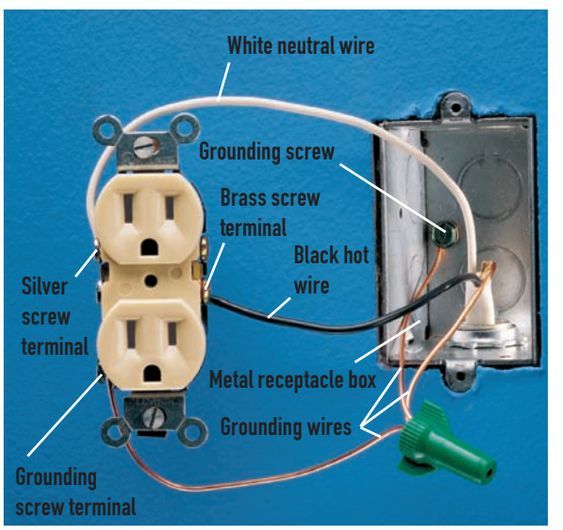
Wiring configurations may vary slightly from these photographs, depending on the kind of receptacles used, the type of cable, or the technique of the electrician who installed the wiring. To make dependable repairs or replacements, use masking tape and label each wire according to its location on the terminals of the existing receptacle.

Receptacles are wired as either end-of-run or middle-of-run. These two basic configurations are easily identified by counting the number of cables entering the receptacle box. End-of-run wiring has only one cable, indicating that the circuit ends. Middle-of-run wiring has two cables, indicating that the circuit continues on to other receptacles, switches, or fixtures.

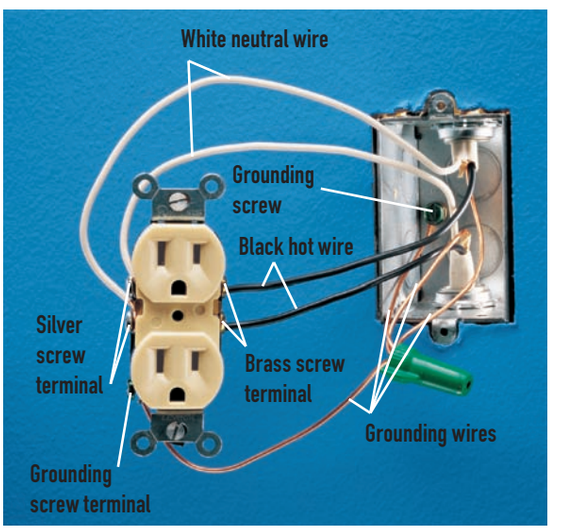
A split-circuit receptacle is shown on the next page. Each half of a split-circuit receptacle is wired to a separate circuit. This allows two appliances of high wattage to be plugged into the same receptacle without blowing a fuse or tripping a breaker. This wiring configuration is similar to a receptacle that is controlled by a wall switch. Code requires a switch-controlled receptacle in any room that does not have a built-in light fixture operated by a wall switch.

Split-circuit and switch-controlled receptacles are connected to two hot wires, so use caution during repairs or replacements. Make sure the connecting tab between the hot screw terminals is removed.

Two-slot receptacles are common in older homes. There is no grounding wire attached to the receptacle, but the box may be grounded with armored cable or conduit. Tamper-resistant receptacles are now required in all new residential installations.



Single cable entering the box indicates end-of-run wiring. The black hot wire is attached to a brass screw terminal, and the white neutral wire is connected to a silver screw terminal. If the box is metal, the grounding wire is pigtailed to the grounding screws of the receptacle and the box. In a plastic box, the grounding wire is attached directly to the grounding screw terminal of the receptacle.



Two cables entering the box indicate middle-of-run wiring. Black hot wires are connected to brass screw terminals, and white neutral wires to silver screw terminals. The grounding wire is pigtailed to the grounding screws of the receptacle and the box.

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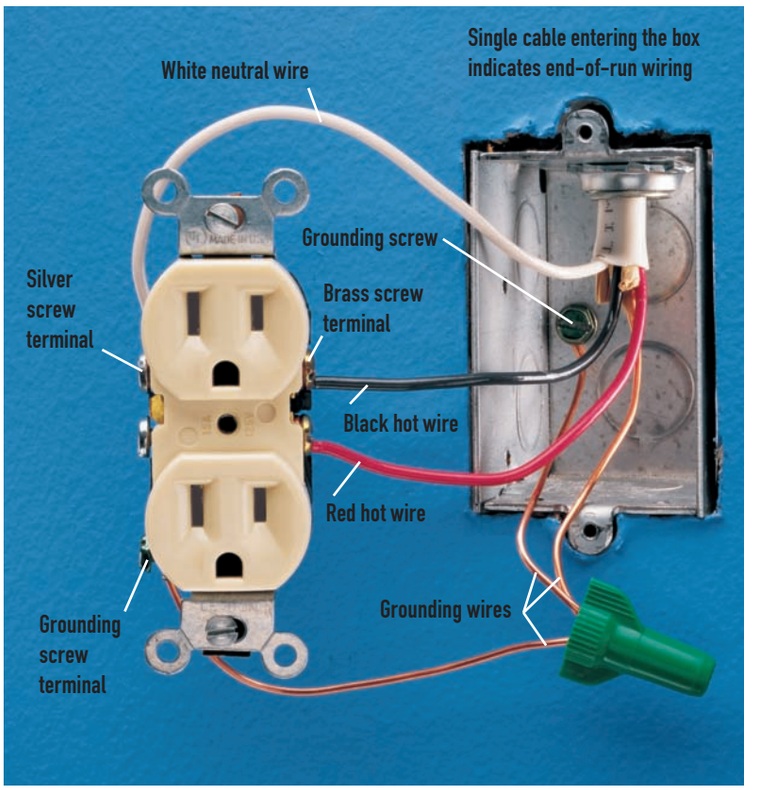
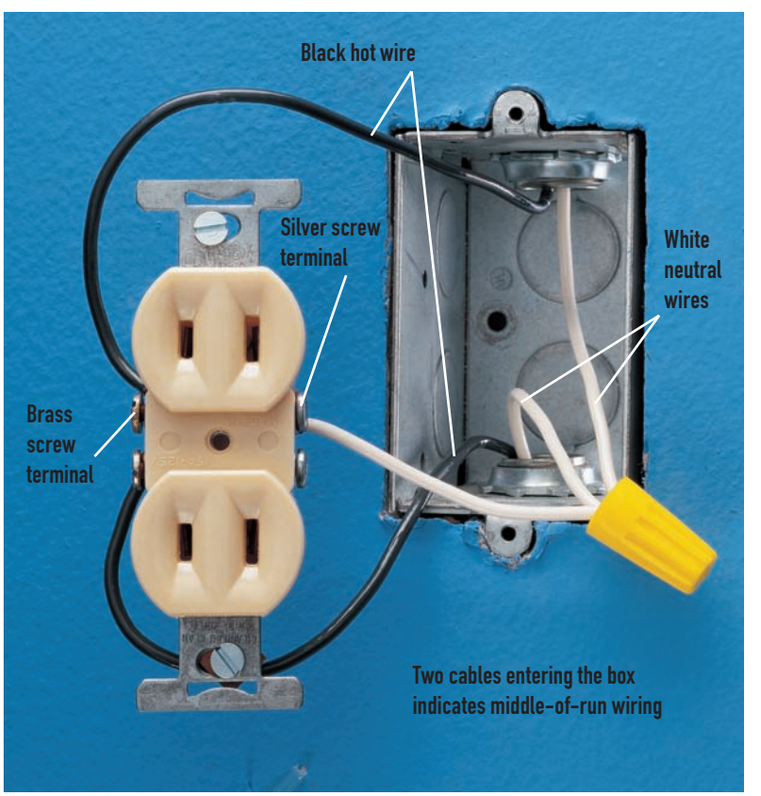


A split-circuit receptacle is attached to a black hot wire, a red hot wire, a white neutral wire, and a bare grounding wire. The wiring is similar to a switch-controlled receptacle. The hot wires are attached to the brass screw terminals, and the connecting tab or fin between the brass terminals is removed. The white wire is attached to a silver screw terminal, and the connecting tab on the neutral side remains intact. The grounding wire is pigtailed to the grounding screw terminal of the receptacle and to the grounding screw attached to the box.



A two-slot receptacle is often found in older homes. The black hot wires are connected to the brass screw terminals, and the white neutral wires are pigtailed to a silver screw terminal. Two-slot receptacles may be replaced with three-slot types, but only if a means of grounding exists at the receptacle box. In some municipalities, you may replace a two-slot receptacle with a GFCI receptacle as long as the receptacle has a sticker that reads "No equipment ground."

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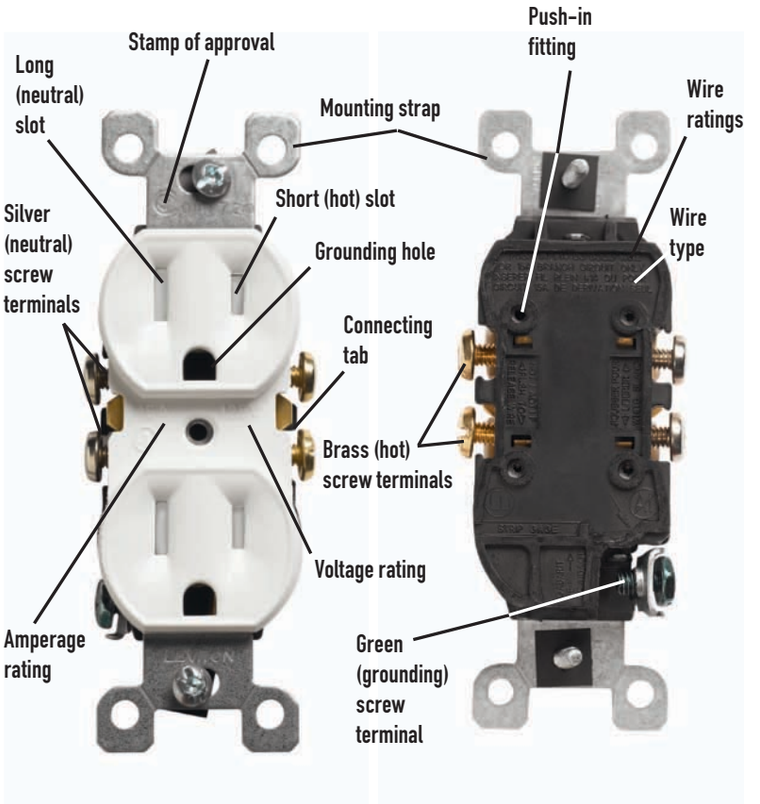
#175 Dtp:225 Page:75

Duplex Receptacles



The standard duplex receptacle has two halves for receiving plugs. Each half has a long (neutral) slot, a short (hot) slot, and a U-shaped grounding hole. The slots fit the wide prong, narrow prong, and grounding prong of a three-prong plug. This ensures that the connection between receptacle and plug will be polarized and grounded for safety.

Wires are attached to the receptacle at screw terminals or push-in fittings. A connecting tab between the screw terminals allows a variety of different wiring configurations. Receptacles also include mounting straps for attaching to electrical boxes.

Stamps of approval from testing agencies are found on the front and back of the receptacle. Look for the symbol UL or UND LAB INC LIST to make sure the receptacle meets the strict standards of Underwriters Laboratories.

The receptacle is marked with ratings for maximum volts and amps. The common receptacle is marked 15A, 125V. Receptacles marked CU or COPPER are used with solid copper wire. Those marked CU-CLAD ONLY are used with copper-coated aluminum wire. Only receptacles marked CO/ALR may be used with solid aluminum wiring. Receptacles marked AL/CU no longer may be used with aluminum wire, according to code.

The polarized receptacle became standard in the 1920s. The different sized slots direct current flow for safety.

The ground-fault circuit-interrupter, or GFCI receptacle, is a modern safety device. When it detects slight changes in current, it instantly shuts off power.

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#175 Dtp:225 Page:76

Common Receptacle Problems

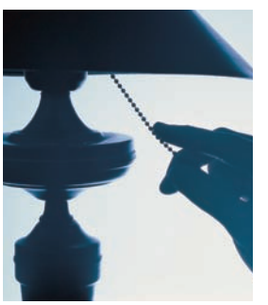
Household receptacles, also called outlets, have no moving parts to wear out and usually last for many years without servicing. Most problems associated with receptacles are actually caused by faulty lamps and appliances, or their plugs and cords. However, the constant plugging in and removal of appliance cords can wear out the metal contacts inside a receptacle. Any receptacle that does not hold plugs firmly should be replaced. In addition, older receptacles made of hard plastic may harden and crack with age. They must be replaced when this happens.

A loose wire connection with the receptacle box is another possible problem. A loose connection can spark (called arcing), trip a circuit breaker, or cause heat to build up in the receptacle box, creating a potential fire hazard.

Wires can come loose for a number of reasons. Everyday vibrations caused by walking across floors, or from nearby street traffic, may cause a connection to shake loose. In addition, because wires heat and cool with normal use, the ends of the wires will expand and contract slightly. This movement also may cause the wires to come loose from the screw terminal connections.

Not all receptacles are created equally. When replacing, make sure to buy one with the same amp rating as the old one. Inadvertently installing a 20-amp receptacle in replacement of a 15-amp receptacle is a very common error.

Problem	Repair
Circuit breaker trips repeatedly, or fuse burns out immediately after being replaced.	1. Repair or replace worn or damaged lamp or appliance cord. 2. Move lamps or appliances to other circuits to prevent overloads. 3. Tighten any loose wire connections. 4. Clean dirty or oxidized wire ends.
Lamp or appliance does not work.	1. Make sure lamp or appliance is plugged in. 2. Replace burned–out bulbs. 3. Repair or replace worn or damaged lamp or appliance cord. 4. Tighten any loose wire connections. 5. Clean dirty or oxidized wire ends. 6. Repair or replace any faulty receptacle.
Receptacle does not hold plugs firmly.	1. Repair or replace worn or damaged plugs. 2. Replace faulty receptacle.
Receptacle is warm to the touch, buzzes, or sparks when plugs are inserted or removed.	1. Move lamps or appliances to other circuits to prevent overloads. 2. Tighten any loose wire connections. 3. Clean dirty or oxidized wire ends. 4. Replace faulty receptacle.



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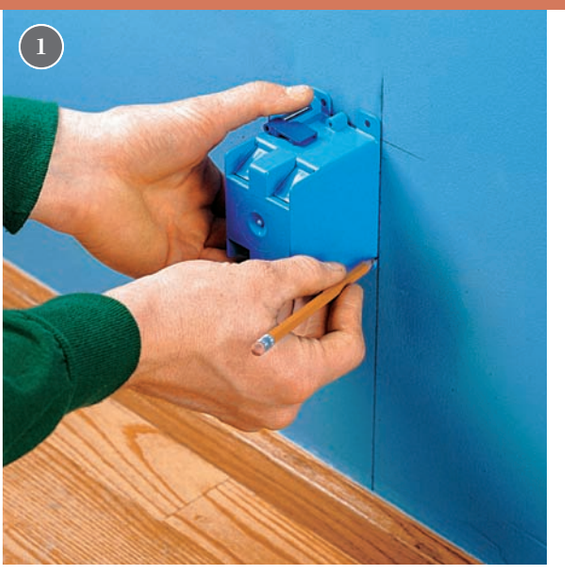
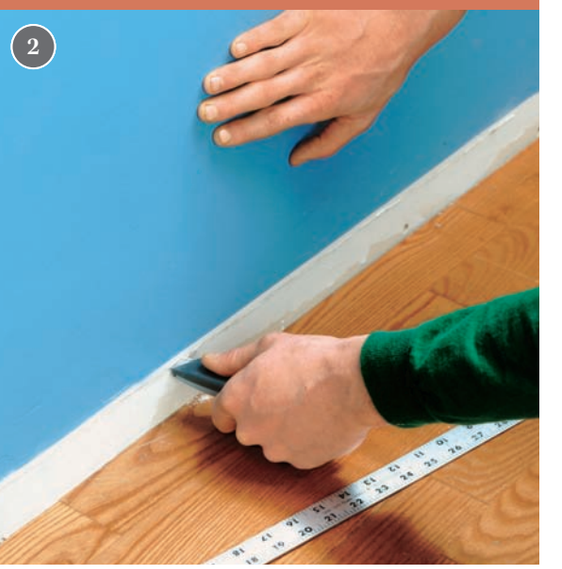
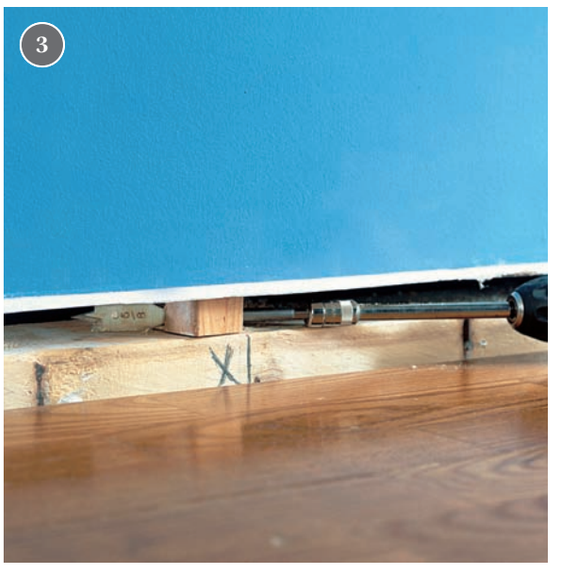
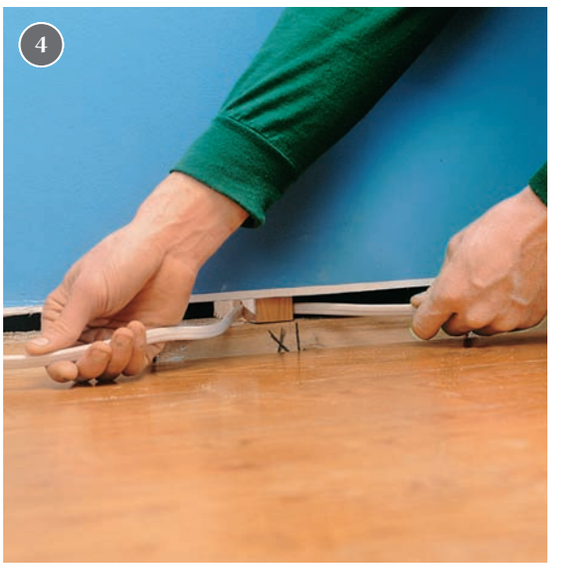
#175 Dtp:225 Page:77

INSTALLING A NEW RECEPTACLE









1 Position the new pop-in box on the wall and trace around it. Consider the location of hidden utilities within the wall before you cut.

2 Remove baseboard between the new and existing receptacle. Cut away the drywall about 1" below the baseboard with a jigsaw, wallboard saw, or utility knife.

3 Drill a ⅝" hole in the center of each stud along the opening between the two receptacles. A drill bit extender or a flexible drill bit will allow you a better angle and make drilling the holes easier.

4 Run the branch cable through the holes from the new location to the existing receptacle. Staple the cable to the stud below the box. Install a metal nail plate on the front edge of each stud that the cable routes through.

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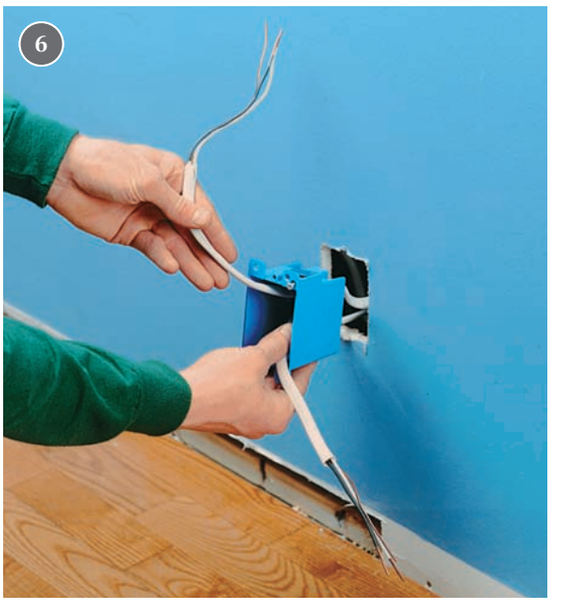

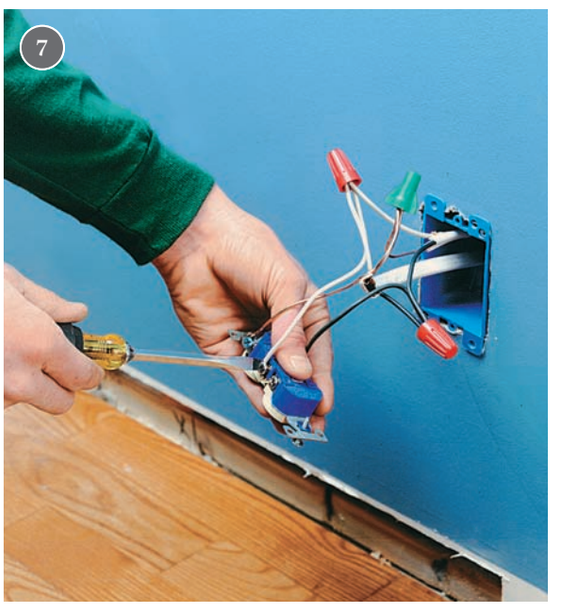

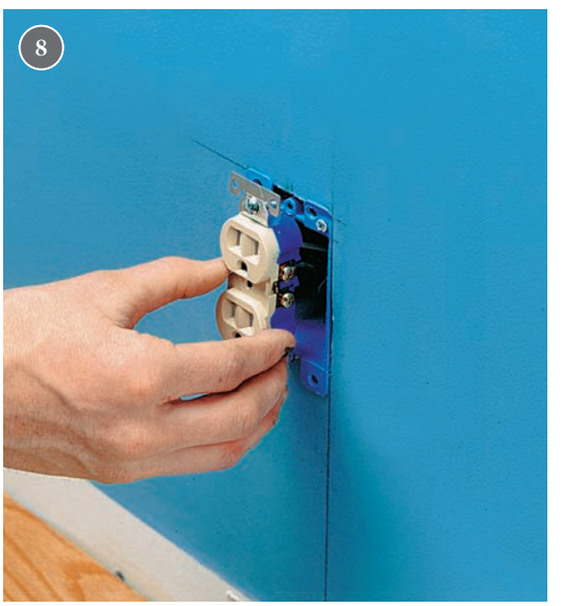

5 Turn off the power at the main panel and test for power. Remove the old receptacle and its box, and pull the new branch cable up through the hole. Remove sheathing and insulation from both ends of the new cable.

6 Thread the new and old cables into a pop-in box large enough to contain the added wires and clamp the cables. Fit the box into the old hole and attach it.

7 Reconnect the old receptacle by connecting its neutral, hot, and grounding screws to the new branch cable and the old cable from the panel with pigtails.

8 Pull the cable through another pop-in box for the new receptacle. Secure the cable and install the box. Connect the new receptacle to the new branch cable. Insert the receptacle into the box and attach the receptacle and cover plate with screws. Patch the opening with ½"-thick wood strips or drywall. Reattach the baseboard to the studs.

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GFCI RECEPTACLES

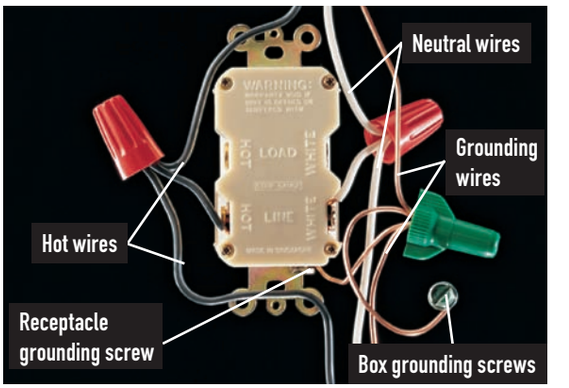
The ground-fault circuit-interrupter (GFCI) receptacle protects against electrical shock caused by a faulty appliance, or a worn cord or plug. It senses small changes in current flow and can shut off power in as little as 1/40 of a second.

GFCIs are now required in bathrooms, kitchens, garages, crawl spaces, unfinished basements, and outdoor receptacle locations. Consult your local codes for any requirements regarding the installation of GFCI receptacles. Most GFCIs use standard screw terminal connections, but some have wire leads and are attached with wire connectors. Because the body of a GFCI receptacle is larger than a standard receptacle, small crowded electrical boxes may need to be replaced with more spacious boxes.

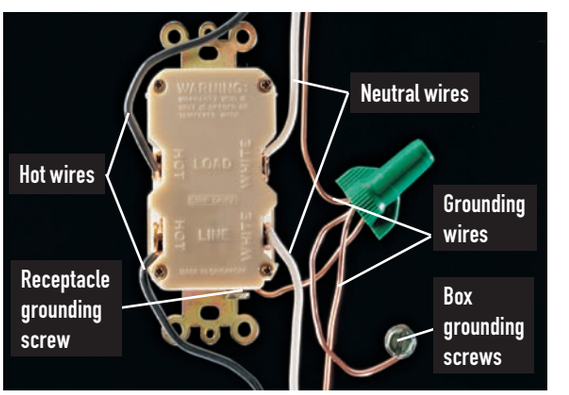
The GFCI receptacle may be wired to protect only itself (single location), or it can be wired to protect all receptacles, switches, and light fixtures from the GFCI "forward" to the end of the circuit (multiple locations).

Because the GFCI is so sensitive, it is most effective when wired to protect a single location. The more receptacles any one GFCI protects, the more susceptible it is to "phantom tripping," shutting off power because of tiny, normal fluctuations in current flow. GFCI receptacles installed in outdoor locations must be rated for outdoor use and weather resistance (WR) along with ground fault protection.

Modern GFCI receptacles have tamper-resistant slots. Look for a model that's rated "WR" (for weather resistance) if you'll be installing it outdoors or in a wet location.



A GFCI wired for single-location protection (shown from the back) has hot and neutral wires connected only to the screw terminals marked LINE. A GFCI connected for single-location protection may be wired as either an end-of-run or middle-of-run configuration.



A GFCI wired for multiple-location protection (shown from the back) has one set of hot and neutral wires connected to the LINE pair of screw terminals, and the other set connected to the LOAD pair of screw terminals. A GFCI receptacle connected for multiple-location protection may be wired only as a middle-of-run configuration.

Tools & Materials

Circuit tester	Wire connectors
Screwdriver	Masking tape

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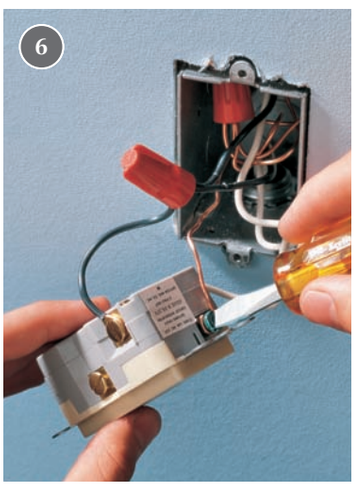
#175 Dtp:225 Page:80

INSTALLING A GFCI FOR SINGLE-LOCATION PROTECTION



1 Shut off power to the receptacle at the main service panel. Test for power with a neon circuit tester. Be sure to check both halves of the receptacle.

2 Remove cover plate. Loosen mounting screws, and gently pull receptacle from the box. Do not touch wires. Confirm power is off with a circuit tester.

3 Disconnect all white neutral wires from the silver screw terminals of the old receptacle.

4 Pigtail all the white neutral wires together, and connect the pigtail to the terminal marked WHITE LINE on the GFCI (see photo on opposite page).

5 Disconnect all black hot wires from the brass screw terminals of the old receptacle. Pigtail these wires together, and connect them to the terminal marked HOT LINE on the GFCI.

6 If a grounding wire is available, connect it to the green grounding screw terminal of the GFCI. Mount the GFCI in the receptacle box, and reattach the cover plate. Restore power, and test the GFCI according to the manufacturer's instructions.

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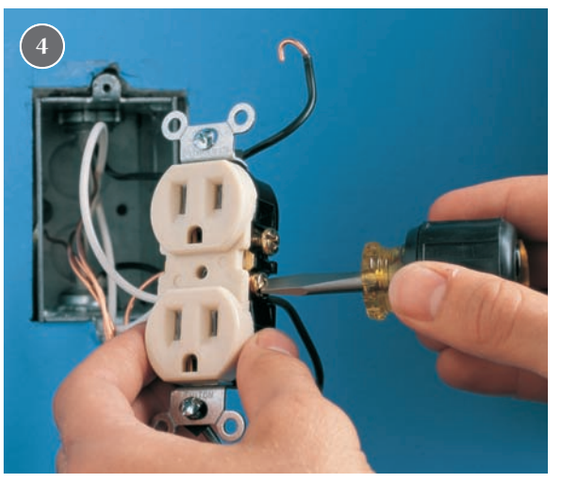
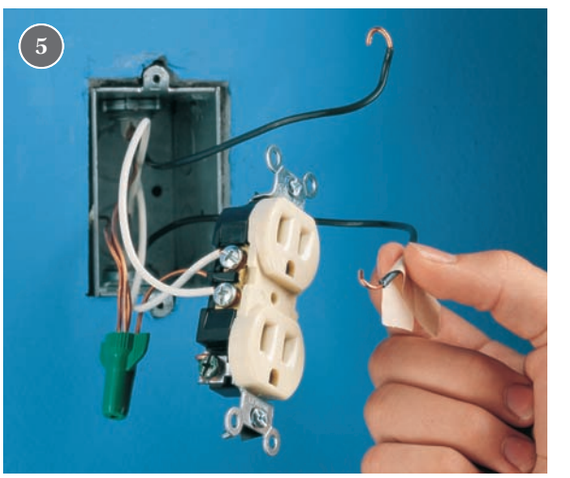
#175 Dtp:225 Page:81

INSTALLING A GFCI FOR MULTIPLE-LOCATION PROTECTION





1 Use a map of your house circuits to determine a location for your GFCI. Indicate all receptacles that will be protected by the GFCI installation.

2 Turn off power to the correct circuit at the main service panel. Test all the receptacles in the circuit with a neon circuit tester to make sure the power is off. Always check both halves of each duplex receptacle.

3 Remove the cover plate from the receptacle that will be replaced with the GFCI. Loosen the mounting screws and gently pull the receptacle from its box. Take care not to touch any bare wires. Confirm the power is off with a neon circuit tester.

4 Disconnect all black hot wires. Carefully separate the hot wires and position them so that the bare ends do not touch anything. Restore power to the circuit at the main service panel. Determine which black wire is the feed wire by testing for hot wires. The feed wire brings power to the receptacle from the service panel. Use caution: This is a live wire test, during which the power is turned on temporarily.

5 When you have found the hot feed wire, turn off power at the main service panel. Identify the feed wire by marking it with masking tape.

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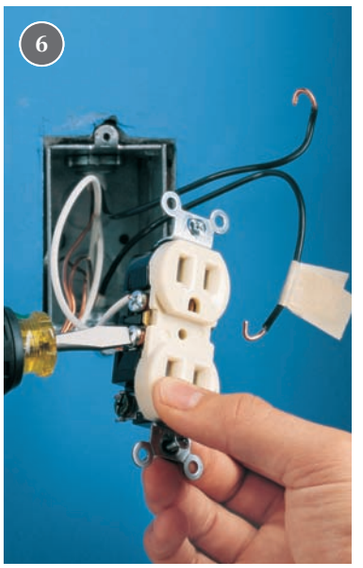
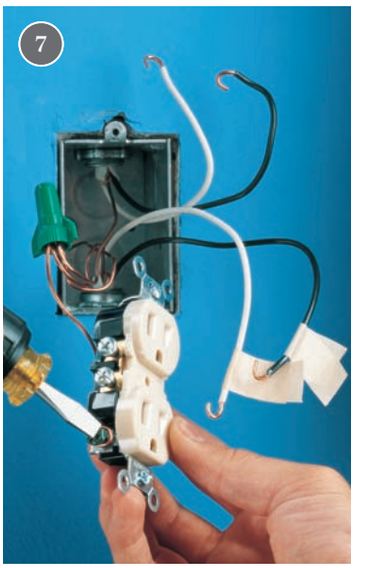
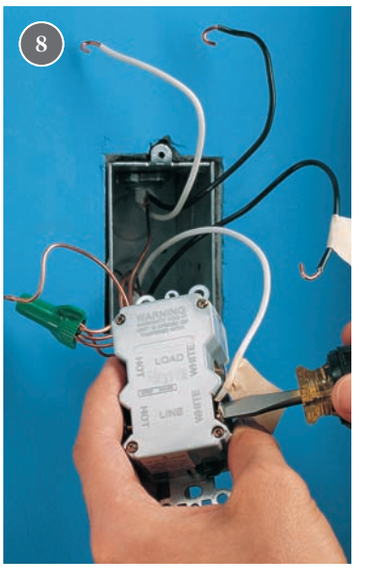
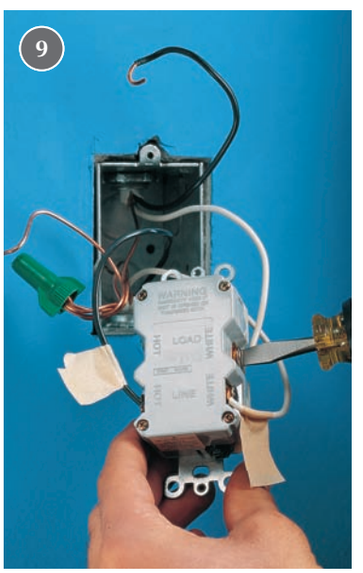
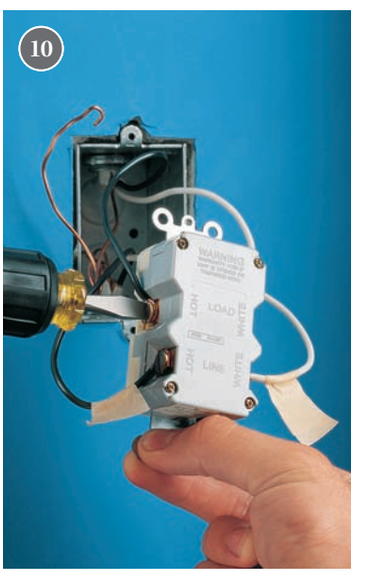
#175 Dtp:225 Page:82











6 Disconnect the white neutral wires from the old receptacle. Identify the white feed wire and label it with masking tape. The white feed wire will be the one that shares the same cable as the black feed wire.

7 Disconnect the grounding wire from the grounding screw terminal of the old receptacle. Remove the old receptacle. Connect the grounding wire to the grounding screw terminal of the GFCI.

8 Connect the white feed wire to the terminal marked WHITE LINE on the GFCI. Connect the black feed wire to the terminal marked HOT LINE on the GFCI.

9 Connect the other white neutral wire to the terminal marked WHITE LOAD on the GFCI.

10 Connect the other black hot wire to the terminal marked HOT LOAD on the GFCI.

11 Carefully tuck all wires into the receptacle box. Mount the GFCI in the box and attach the cover plate. Turn on power to the circuit at the main service panel. Test the GFCI according to the manufacturer's instructions.

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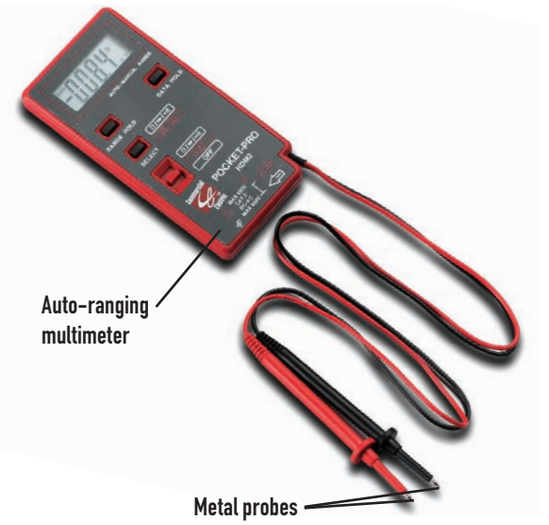
#175 Dtp:225 Page:83

TESTING RECEPTACLES

For testing receptacles and other devices for power, grounding, and polarity, neon circuit testers are inexpensive and easy to use. But they are less sensitive than auto-ranging multimeters. In some cases, neon testers won't detect the presence of lower voltage in a circuit. This can lead you to believe that a circuit is shut off when it is not—a dangerous mistake. The small probes on a neon circuit tester also force you to get too close to live terminals and wires. For a quick check and confirmation, a neon circuit tester (or a plug-in tester) is adequate. But for the most reliable readings, buy and learn to use a multimeter.

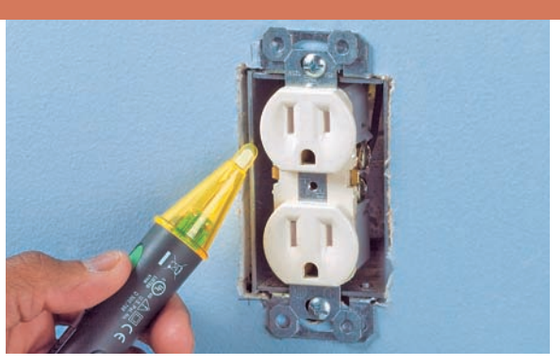
The best multimeters are auto-ranging models with a digital readout. Unlike manual multimeters, auto-ranging models do not require you to preset the voltage range to get an accurate reading. Unlike neon testers, multimeters may be used for a host of additional diagnostic functions such as testing fuses, measuring battery voltage, testing internal wiring in appliances, and checking light fixtures to determine if they're functional.



Tools & Materials

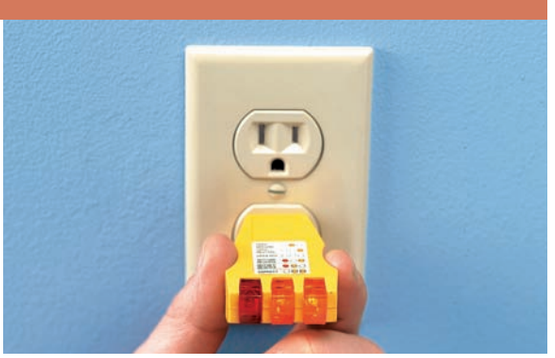
Multimeter	Plug-in tester
Touchless circuit tester	Screwdriver

USING A PLUG-IN TESTER



Use a touchless circuit tester to verify that power is not flowing to a receptacle. Using either a no-touch sensor or a probe-style circuit tester, test the receptacle for current before you remove the cover plate. Once the plate is removed, double-check at the terminals to make sure there is no current.

TESTING QUICKLY FOR POWER



Use a plug-in tester to test a three-slot receptacle. With the power on, insert the tester into the suspect outlet. The face of the tester has three colored lights that will light up in different combinations, according to the outlet's problem. A reference chart is provided with the tester, and may have a chart on the tester itself.

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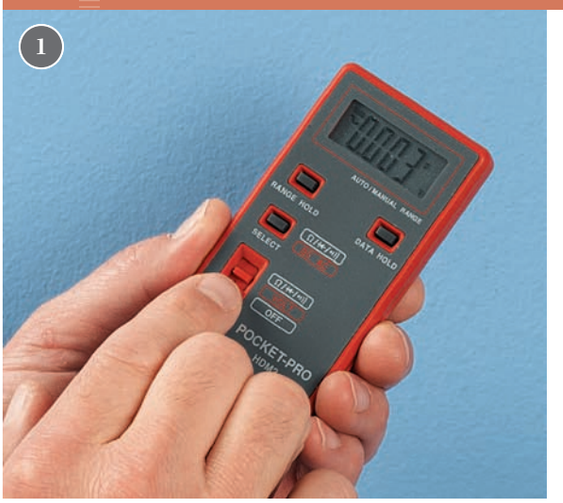
#175 Dtp:225 Page:84

TESTING A RECEPTACLE WITH A MULTIMETER



1 Set the selector dial for alternating-current voltage. Plug the black probe lead into the common jack on the multimeter (labeled COM). Plug the red probe lead into the V-labeled jack.

2 Insert the test ends of the probe into the receptacle slots. It does not make a difference which probe goes into which slot as long as they're in the same receptacle. If power is present and flowing normally, you will see a voltage reading on the readout screen.

3 If the multimeter reads 0 or gives a very low reading (less than 1 or 2 volts), power is not present in the receptacle and it is safe to remove the cover plate and work on the fixture (although it's always a good idea to confirm your reading by touching the probes directly to the screw terminals on the receptacles).

Option:

When a receptacle or switch is in the middle of a circuit, it is difficult to tell which wires are carrying current. Use a multimeter to check. With power off, remove the receptacle and separate the wires. Restore power. Touch one probe to the bare ground or the grounded metal box and touch the other probe to the end of each wire. The wire that shows current on the meter is hot.

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#175 Dtp:225 Page:85

WIRING PROJECTS

GFCI & AFCI Breakers 92

120/240-Volt Dryer Receptacles 94

120/240-Volt Range Receptacles 95

Ceiling Lights 96

Recessed Ceiling Lights 100

Hard-wired Smoke & CO Detectors 104

Baseboard Heaters 106

Ceiling Fans 110

Repairing Light Fixtures 114

Repairing Fluorescent Lights 118

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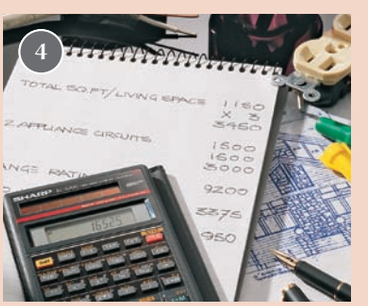
#175 Dtp:225 Page:86

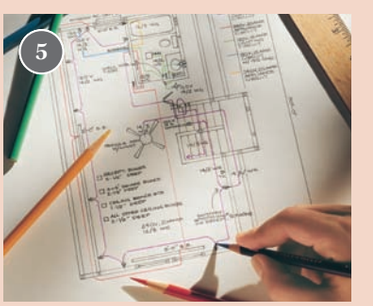
EVEN THOUGH THIS BOOK does not cover a major wiring construction project in detail, here are some guidelines for a major project, should you decide to pursue one.

Careful planning of a wiring project ensures you will have plenty of power for present and future needs. Whether you are adding circuits in a room addition, wiring a remodeled kitchen, or adding an outdoor circuit, consider all possible ways the space might be used, and plan for enough electrical service to meet peak needs.

A large wiring project adds a considerable load to your main electrical service. In about 25 percent of all homes, some type of service upgrade is needed before new wiring can be installed. This chapter gives an easy five-step method for determining your electrical needs and planning new circuits.

Five Steps for Planning a Wiring Project





1 Examine your main service panel. The amp rating of the electrical service and the size of the circuit breaker panel will help you determine if a service upgrade is needed.

2 Learn about codes. The National Electrical Code (NEC), and local electrical codes and building codes, provide guidelines for determining how much power and how many circuits your home needs. Your local electrical inspector can tell you which regulations apply to your job.

3 Prepare for inspections. Remember that your work must be reviewed by your local electrical inspector. When planning your wiring project, always follow the inspector's guidelines for quality workmanship.

4 Evaluate electrical loads. New circuits put an added load on your electrical service. Make sure that the total load of the existing wiring and the planned new circuits does not exceed the main service capacity.

5 Draw a wiring diagram and get a permit. This wiring plan will help you organize your work.

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#175 Dtp:225 Page:87

Examine Your Main Service Panel

The first step in planning a new wiring project is to look in your main circuit breaker panel and find the size of the service by reading the amperage rating on the main circuit breaker. As you plan new circuits and evaluate electrical loads, knowing the size of the main service helps you determine if you need a service upgrade.

Also look for open circuit breaker slots in the panel. The number of open slots will determine if you need to add a circuit breaker subpanel.

Find the service size by opening the main service panel and reading the amp rating printed on the main circuit breaker. In most cases, 100-amp service provides enough power to handle the added loads of projects like the ones shown in this book. A service rated for 60 amps or less may need to be upgraded.

Older service panels use fuses instead of circuit breakers. Have an electrician replace this type of panel with a circuit breaker panel that provides enough power and enough open breaker slots for the new circuits you are planning.

Look for open circuit breaker slots in the main circuit breaker panel or in a circuit breaker subpanel, if your home already has one. You will need one open slot for each 120-volt circuit you plan to install and two slots for each 240-volt circuit. If your main circuit breaker panel has no open breaker slots, install a subpanel to provide room for connecting new circuits.

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#175 Dtp:225 Page:88

Learn About Codes

To ensure public safety, your community requires that you get a permit to install new wiring and have the completed work reviewed by an appointed inspector. Electrical inspectors use the National Electrical Code (NEC) as the primary authority for evaluating wiring, but they also follow the local Building Code and Electrical Code standards.

As you begin planning new circuits, call or visit your local electrical inspector and discuss the project with him. The inspector can tell you which of the national and local code requirements apply to your job, and may give you a packet of information summarizing these regulations. Later, when you apply to the inspector for a work permit, he will expect you to understand the local guidelines as well as a few basic National Electrical Code requirements.

The National Electrical Code is a set of standards that provides minimum safety requirements for wiring installations. It is revised every three years. The national code requirements for the projects shown in this book are thoroughly explained on the following pages. For more information, you can find copies of the current NEC, as well as a number of excellent handbooks based on the NEC, at libraries and bookstores.

In addition to being the final authority of code requirements, inspectors are electrical professionals with years of experience. Although they have busy schedules, most inspectors are happy to answer questions and help you design well-planned circuits.

Basic Electrical Code Requirements

Electrical Code requirements for living areas: Living areas need at least one 15-amp or 20-amp basic lighting/receptacle circuit for each 600 sq. ft. of living space and should have a dedicated circuit for each type of permanent appliance, like an air conditioner, computer, or a group of baseboard heaters and within 6 ft. of any door opening. Receptacles on basic lighting/receptacle circuits should be spaced no more than 12 ft. apart. Many electricians and electrical inspectors recommend even closer spacing. Any wall more than 24" wide also needs a receptacle. Every room should have a wall switch at the point of entry to control either a ceiling light or plug-in lamp. Kitchens and bathrooms must have a ceiling-mounted light fixture.

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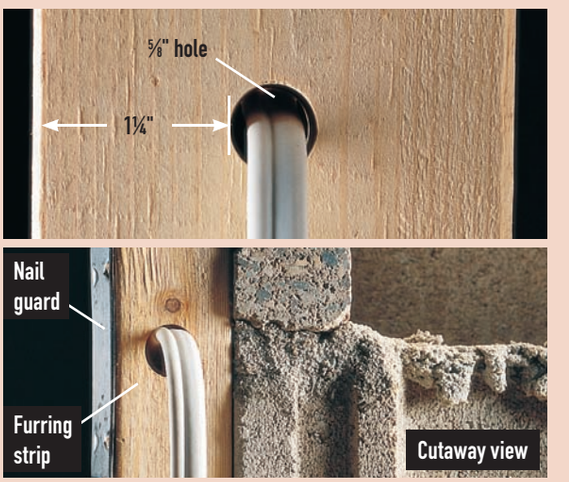
#175 Dtp:225 Page:89

Selected NEC Standards & Tips

Measure the living areas of your home, excluding closets and unfinished spaces. A sonic measuring tool gives room dimensions quickly and contains a built-in calculator for figuring floor area. You will need a minimum of one basic lighting/receptacle circuit for every 600 sq. ft. of living space. The total square footage also helps you determine heating and cooling needs for new room additions.

Stairways with six steps or more must have lighting that illuminates each step. The light fixture must be controlled by three-way switches at the top and bottom landings.

Kitchen and bathroom receptacles must be protected by a ground-fault circuit-interrupter (GFCI). Also, all outdoor receptacles and general-use receptacles in an unfinished basement or crawl space and garages must be protected by a GFCI.



Cables must be protected against damage from nails and screws by at least 1¼" of wood (top). When cables pass through 2 × 2 furring strips (bottom), protect the cables with metal nail guards. Nail guards also may be used to protect cable that cannot meet the 1¼" of wood protection standard.

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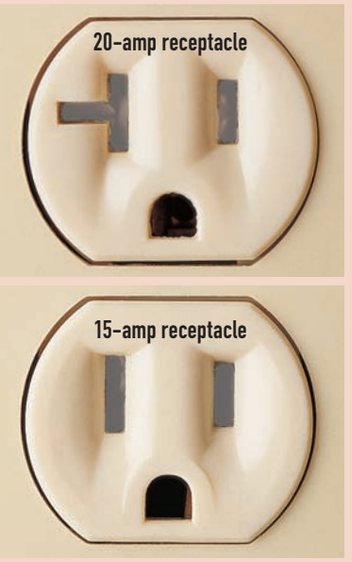
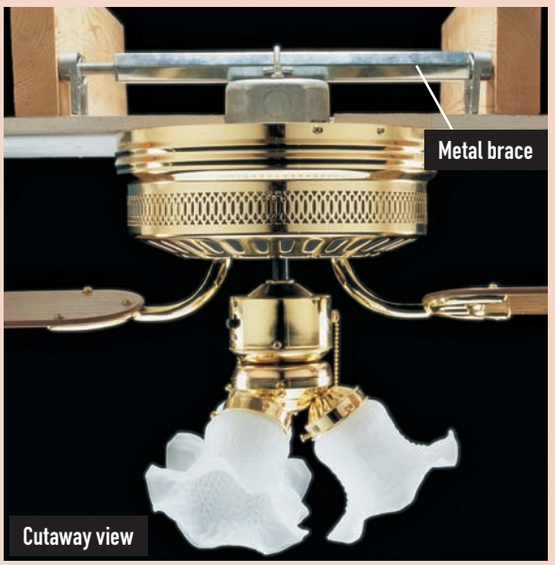
#175 Dtp:225 Page:90

Closets and other storage spaces need at least one light fixture that is controlled by a wall switch near the entrance. Prevent fire hazards by positioning the light fixtures so the outer globes are at least 12" away from all shelf areas.

Hallways more than 10 ft. long need at least one receptacle. All hallways should have a switch-controlled light fixture.



Amp ratings of receptacles must match the size of the circuit. A common mistake is to use 20-amp receptacles (top) on 15-amp circuits—a potential cause of dangerous circuit overloads because it allows you to plug in appliances that draw over 15 amps.



A metal brace attached to framing members is required for ceiling fans and large light fixtures that are too heavy to be supported by an electrical box. All ceiling fans must be installed in a box that is fan-rated.

Label new circuits on an index attached to the circuit breaker panel. List the rooms and appliances controlled by each circuit. Make sure the area around the panel is clean, well lighted, and accessible.

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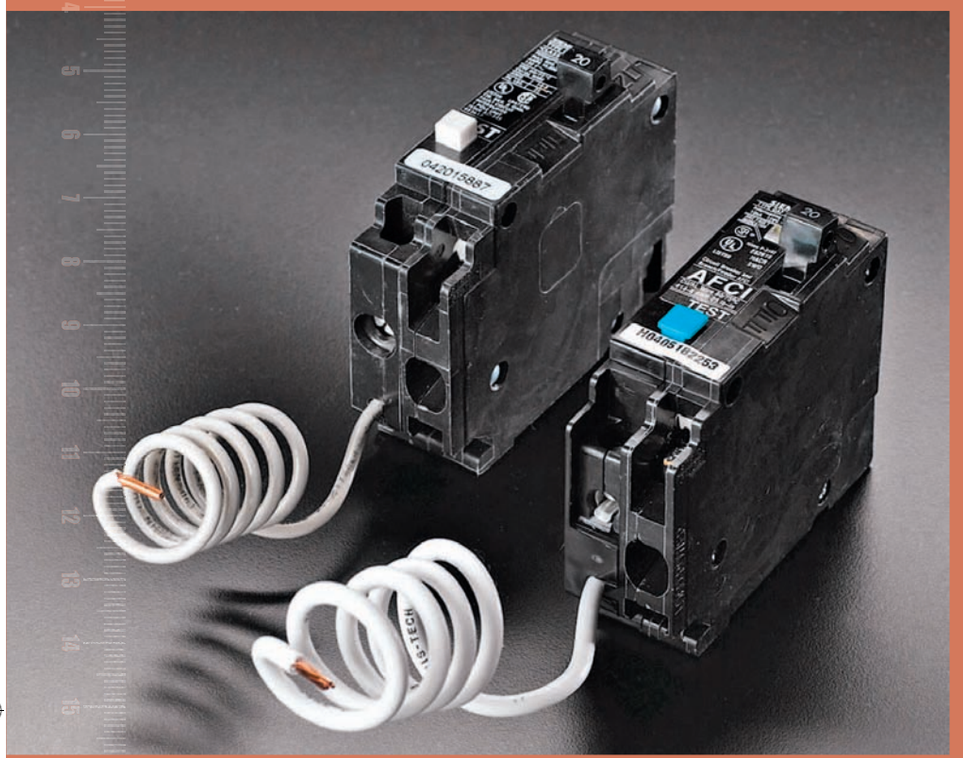
GFCI & AFCI Breakers



AFCI breakers (right) are similar in appearance to GFCI breakers (left), but they function differently. AFCI breakers trip when they sense an arc fault. GFCI breakers trip when they sense fault between the hot wire and the ground.

Tools & Materials

Insulated screwdriver
Circuit tester
Combination tool
AFCI or GFCI breaker

UNDERSTANDING THE DIFFERENCE between GFCI (ground-fault circuit interruption) and AFCI (arc fault circuit interruption) is very tricky for most homeowners who do not have a degree in electrical engineering. Essentially, it comes down to this: Arc-fault protection keeps your house from burning down; ground-fault protection keeps people from being electrocuted.

The National Electric Code (NEC) requires that an arc-fault circuit-interrupter (AFCI) breaker be installed on all branch circuits that supply outlets or fixtures in newly constructed homes. They're a prudent precaution in any home, especially if it has older wiring. AFCI breakers will not interfere with the operation of GFCI receptacles, so it is safe to install an AFCI breaker on a circuit that contains GFCI receptacles.

A GFCI breaker is an important safety device that disconnects a circuit in the event of a ground fault (when current takes a path other than the neutral back to the panel).

On new construction, GFCI protection is required on outlets in laundry and utility rooms, garages and unfinished basements, and near kitchen or bathroom sinks. In general it is a good practice to protect all receptacle and fixture locations that could encounter damp or wet circumstances. Typically, a GFCI receptacle is installed at each location, but in some cases—outdoor circuits or older homes with boxes too shallow for GFCI receptacles, for instance—it is advisable to protect the entire circuit with a GFCI breaker.

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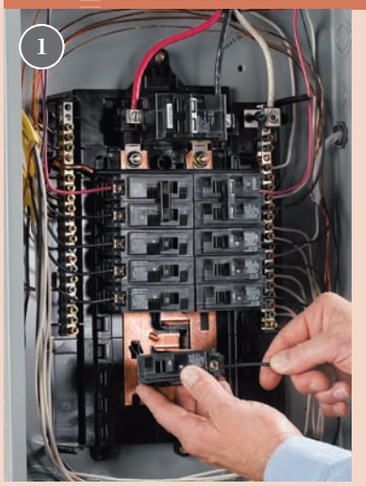
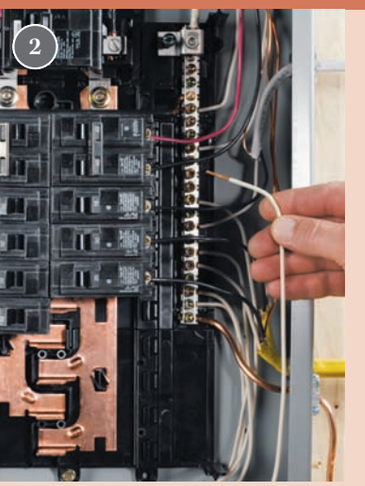
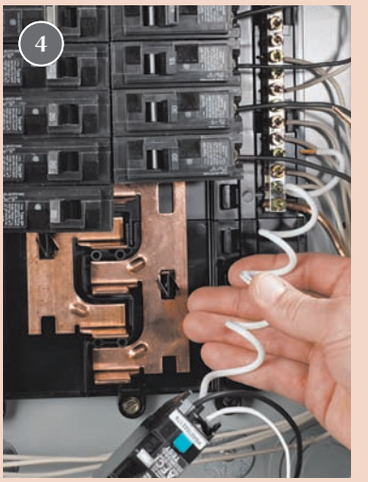
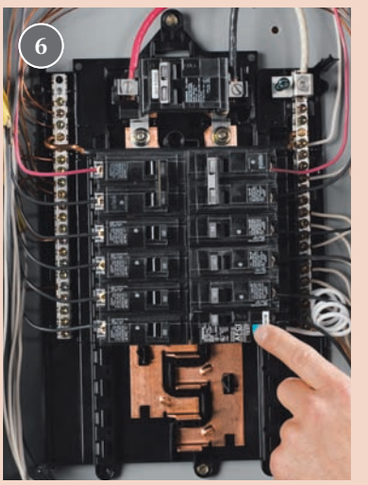
#175 Dtp:225 Page:92

INSTALLING AN AFCI OR GFCI BREAKER









1 Locate the breaker for the circuit you'd like to protect. Then turn off the main circuit breaker. Remove the cover from the panel, and test to ensure that power is off. Remove the breaker you want to replace from the panel. Remove the black wire from the LOAD terminal of the breaker.

2 Find the white wire on the circuit you want to protect, and remove it from the neutral bus bar.

3 Flip the handle of the new AFCI or GFCI breaker to OFF. Loosen both of the breaker's terminal screws. Connect the white circuit wire to the breaker terminal labeled PANEL NEUTRAL. Connect the black circuit wire to the breaker terminal labeled LOAD POWER.

4 Connect the new breaker's coiled white wire to the neutral bus bar on the service panel.

5 Make sure all the connections are tight. Snap the new breaker into the bus bar.

6 Turn the main breaker on. Turn off and unplug all fixtures and appliances on the AFCI or GFCI breaker circuit. Turn the AFCI or GFCI breaker on. Press the test button. If the breaker is wired correctly, the breaker trips open. If it doesn't trip, check all connections or consult an electrician. Replace the panel cover.

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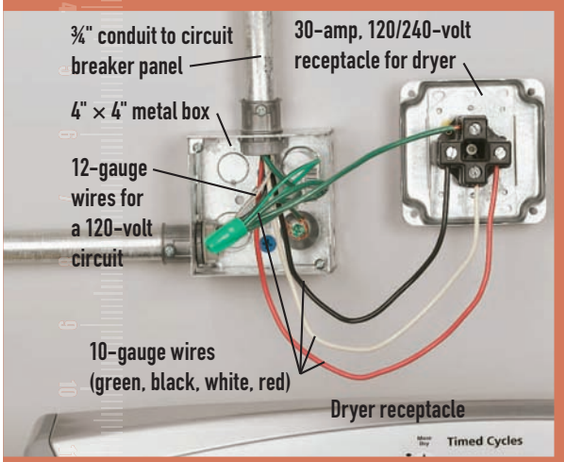
#175 Dtp:225 Page:93

120/240-Volt Dryer Receptacles



Tools & Materials

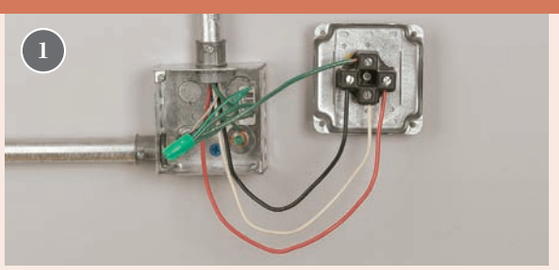
Combination tool
Drill
Circuit tester
Hammer
Screwdriver
30-amp double-pole breaker
30-amp 120/240-volt dryer receptacle
10/3 NM cable or 10-gauge THHN/THWN
Receptacle box
Conduit (for masonry walls)

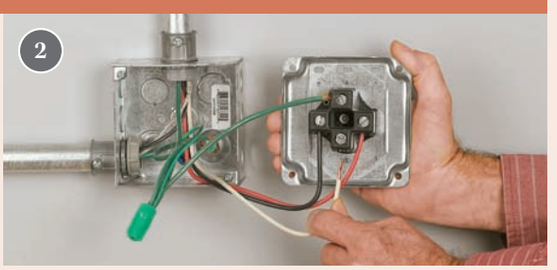
A 240-volt installation is no more complicated than wiring a single-pole breaker and outlet. The main difference is that the dryer circuit's double-pole breaker is designed to contact both 120-volt bus bars in the service panel. Together, these two 120-volt circuits serve the dryer's heating elements with 240 volts of power. The timer, switches, and other dryer electronics utilize the circuit's 120-volt power.

MANY DRYERS require both 120- and 240-volt power. If you are installing this type of electric dryer, you will need to install a 30-amp, 120/240-volt receptacle that feeds from a dedicated 30-amp double-pole breaker in your service panel. Verify your dryer's electric requirements before wiring a new receptacle.

Begin the installation by identifying a location for the dryer receptacle. Run 10/3 NM cable from the service panel to the new receptacle. If you are mounting the dryer receptacle box on an unfinished masonry wall, run the THNN wire in conduit and secure the box and conduit with masonry screws. If you are mounting the receptacle box in finished drywall, cut a hole, fish the cable through, and mount the receptacle in the wall opening.

INSTALLING A 120/240-VOLT DRYER RECEPTACLE





1 Connect the white neutral wire to the silver neutral screw terminal. Connect each of the black and the red wires to either of the brass screw terminals (the terminals are interchangeable). Connect the green ground wire to the receptacle grounding screw. Attach the cover plate.

2 With the service panel main breaker shut off, connect the dryer cable to a dedicated 30-amp double-pole breaker. Connect the ground wire to the panel grounding bar. Connect the white neutral wire to the neutral bar. Connect the red and the black wires to the two brass screw terminals on the breaker. Snap the breaker into the bus bar. Attach the panel cover. Turn the breakers on and test the circuit.

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#175 Dtp:225 Page:94

120/240-Volt Range Receptacles

MANY ELECTRIC RANGES require both 120- and 240-volt power. If you are installing this type of electric range, you will need to install a 40- or 50-amp 120/240-volt receptacle that feeds from a dedicated 40- or 50-amp breaker in the service panel. Breaker amperage depends on the amount of power the range draws. Verify requirements before wiring a receptacle.

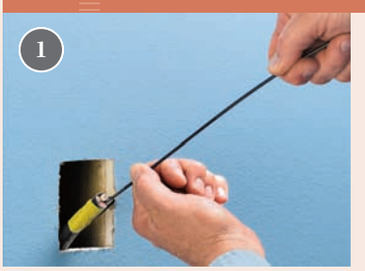
A range receptacle and breaker installation is no more complicated than wiring a single-pole breaker and outlet. The main difference is that the range circuit's double-pole breaker is designed to contact both 120-volt bus bars in the service panel. Together these two 120-volt circuits serve the range's heating elements with 240 volts of power. The timer, switches, and other range electronics utilize the circuit's 120-volt power.

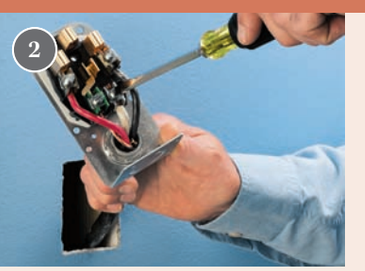
Modern range receptacles accept a four-prong plug configuration. The cable required is four-conductor service entrance round (SE or NM-B) cable, containing three insulated wires and one ground. The two hot wires might be black and red (shown below) or black and black with a red stripe. The neutral wire is generally white or gray. The grounding wire is green or bare. The size used for a kitchen range is usually 6/3 grounded SE or NM-B copper cable. The receptacle itself is generally surface mounted for easier installation (shown below), though flush-mounted units are also available.

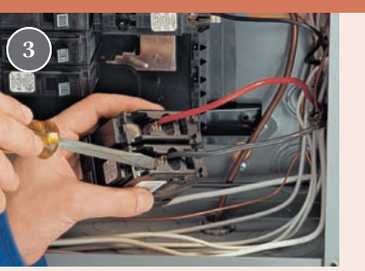
Tools & Materials

- Combination tool
- Circuit tester
- Drill
- Hammer
- Screwdriver
- Drywall saw
- Fish tape
- Surface-mounted range receptacle
- 6/3 grounded SER cable
- 50- or 60-amp double-pole circuit breaker

INSTALLING A KITCHEN RANGE RECEPTACLE







1 Turn power off. Identify a location for the surface-mounted range receptacle. Cut a small hole in the wall. Fish the SER cable from the service panel into the wall opening. Thread the cable into a surface-mounted receptacle and clamp it. Strip insulation from the individual wires.

2 Wire the receptacle. Connect the bare copper ground wire to the receptacle grounding screw. Connect the white neutral wire to the silver neutral screw terminal. Connect each of the hot (black and red) wires to either of the brass screw terminals (the terminals are interchangeable). Mount the housing on the wall and attach the cover plate.

3 Wire the SER cable to a 40- or 50-amp breaker. With the main breaker off, remove the panel cover. Remove a knockout from the panel and feed the cable into the panel. Connect the ground wire to the grounding bar. Connect the neutral wire from the cable to the neutral bar. Connect the red and the black wires to the two brass screw terminals on the breaker. Snap it into the bus bar. Attach the panel cover. Turn the breakers on and test the circuit.

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#175 Dtp:225 Page:95

Ceiling Lights

Installing a new ceiling fixture can provide more light to a space, not to mention an aesthetic lift. It's one of the easiest upgrades you can do.

Tools & Materials

Replacement light fixture
Wire stripper
Voltage sensor
Insulated screwdrivers
Wire connectors
Eye protection

CEILING FIXTURES don't have any moving parts and their wiring is very simple, so, other than changing bulbs, you're likely to get decades of trouble-free service from a fixture. This sounds like a good thing, but it also means that the fixture probably won't fail and give you an excuse to update a room's look with a new one. Fortunately, you don't need an excuse. Upgrading a fixture is easy and can make a dramatic impact on a room. You can substantially increase the light in a room by replacing a globe-style fixture with one that has separate spot lights, or you can simply install a new fixture that matches the room's décor.

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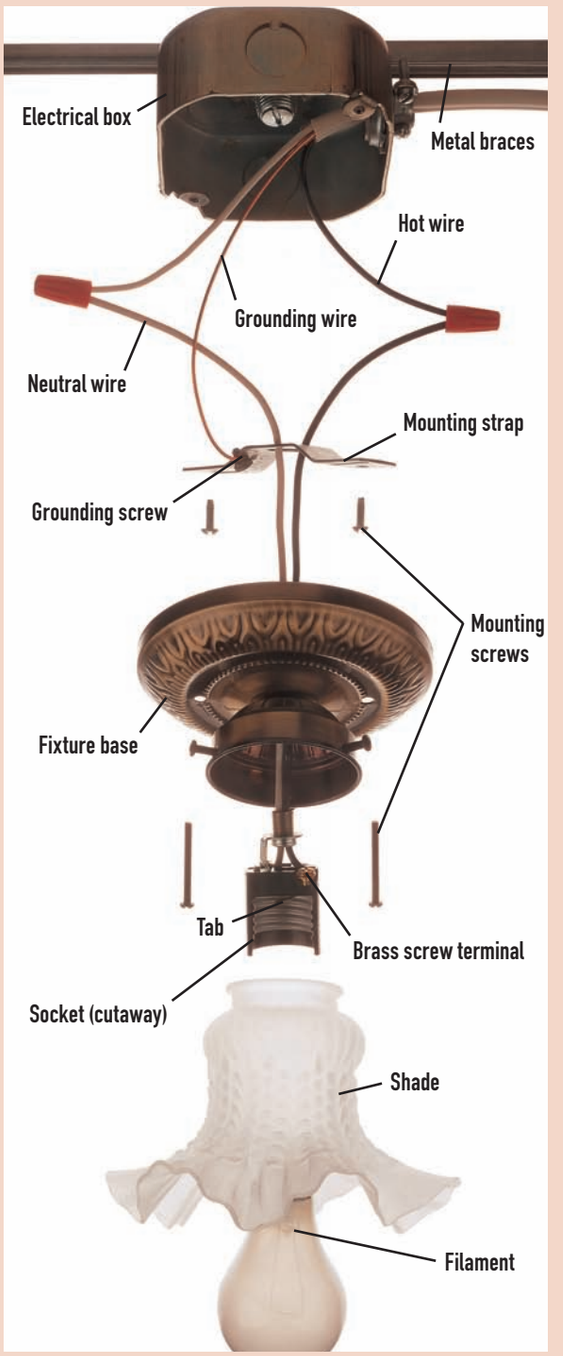
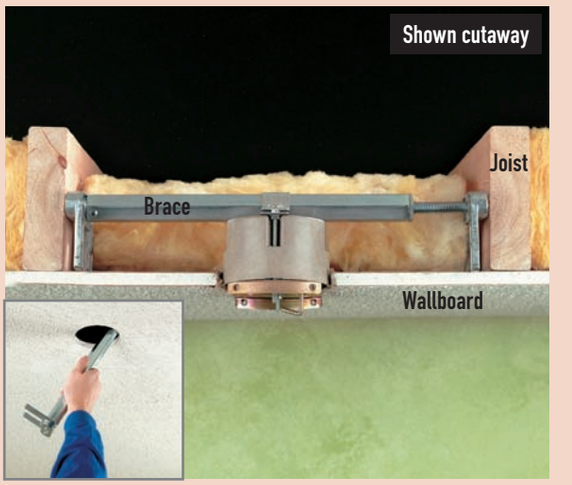
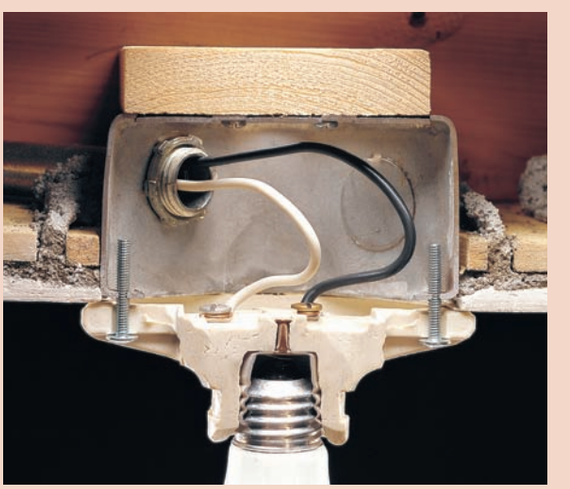


No matter what a ceiling light fixture looks like on the outside, they all attach in basically the same way. An electrical box in the ceiling is fitted with a mounting strap, which holds the fixture in place. The bare wire from the ceiling typically connects to the mounting strap. The two wires coming from the fixture connect to the black and the white wires from the ceiling.



If the new fixture is much heavier than the original fixture, it will require additional bracing in the ceiling to support the electrical box and the fixture. The manufacturer's instructions should specify the size and type of box. If the ceiling is finished and there is no access from above, you can remove the old box and use an adjustable remodeling brace appropriate for your fixture (shown). The brace fits into a small hole in the ceiling (inset). Once the bracing is in place, install a new electrical box specified for the new fixture.



Inexpensive light fixtures have screw terminals mounted directly to the backside of the fixture plate. Often, as *Seen* here, they have no grounding terminal. Some codes do not allow this type of fixture, but even if your hometown does approve them, it is a good idea to replace them with a better quality, safer fixture that is UL-approved.

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REPLACING A CEILING LIGHT

1 Shut off power to the ceiling light and remove the shade or diffuser. Loosen the mounting screws and carefully lower the fixture, supporting it as you work (do not let light fixtures hang by their electrical wires alone). Test with a voltage sensor to make sure no power is reaching the connections.

2 Remove the twist connectors from the fixture wires or unscrew the screw terminals and remove the white neutral wire and the black lead wire (inset).

3 Before you install the new fixture, check the ends of the wires coming from the ceiling electrical box. They should be clean and free of nicks or scorch marks. If they're dirty or worn, clip off the stripped portion with your combination tool. Then strip away about ¾" of insulation from the end of each wire.

4 Attach a mounting strap to the ceiling fixture box if there is not one already present. Your new light may come equipped with a strap, otherwise you can find one for purchase at any hardware store.

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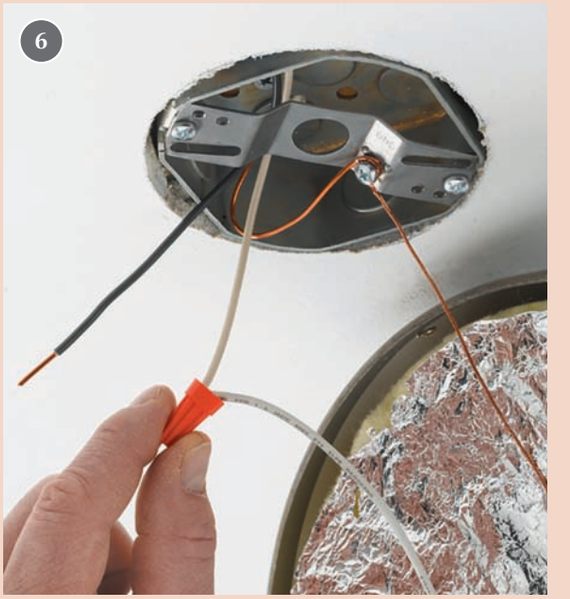

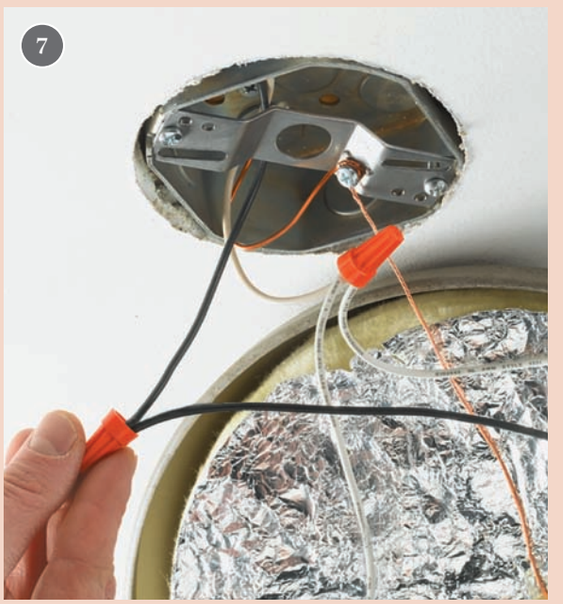

5 Lift the new fixture up to the ceiling (you may want a helper for this) and attach the bare copper ground wire from the power supply cable to the grounding screw or clip on the mounting strap. Also attach the ground wire from the fixture to the screw or clip.

6 With the fixture supported by a ladder or a helper, join the white wire lead and the white fixture wire with a wire connector (often supplied with the fixture).

7 Connect the black power supply wire to the black fixture wire with a wire connector.

8 Position the new fixture mounting plate over the box so the mounting screw holes align. Drive the screws until the fixture is secure against the ceiling. Some fixtures are supported by a threaded rod or nipple in the center that screws into a female threaded opening in the mounting strap (inset).

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Recessed Ceiling Lights

Recessed ceiling lights often are installed in series to provide exacting control over the amount and direction of light. Spacing the canisters in every other ceiling joist bay is a common practice.

Choose the proper type of recessed light fixture for your project. There are two types of fixtures: those rated for installation within insulation (left), and those which must be kept at least 3" from insulation (right). Self-contained thermal switches shut off power if the unit gets too hot for its rating. A recessed light fixture must be installed at least ½" from combustible materials.

Tools & Materials

- Recessed-lighting can for new construction or remodeling and trim
- Circuit tester
- Cable ripper
- Combination tool
- Pliers
- Fish tape
- Hack saw
- Drywall saw
- NM cable
- Work gloves
- Eye protection

RECESSED LIGHTS are versatile fixtures suited for a variety of situations. Fixtures rated for outdoor use can also be installed in roof soffits and overhangs for accent and security lighting. Recessed fixtures can also be installed over showers or tubs. Be sure to use fixture cans and trims rated for bathroom use.

There are recessed lighting cans in all shapes and sizes for almost every type of ceiling or cabinet. Cans are sold for unfinished ceilings (new construction) or for finished ceilings (retrofit installation). Cans are also rated as insulation compatible or for un-insulated ceilings. Be sure to use the correct one for your ceiling to prevent creating a fire hazard.

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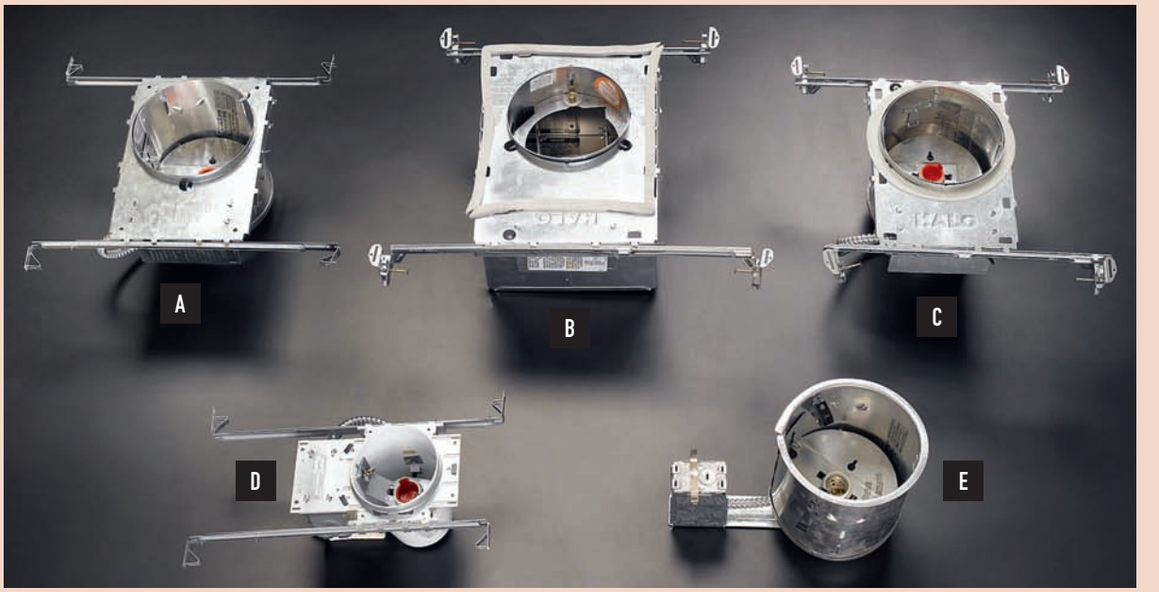
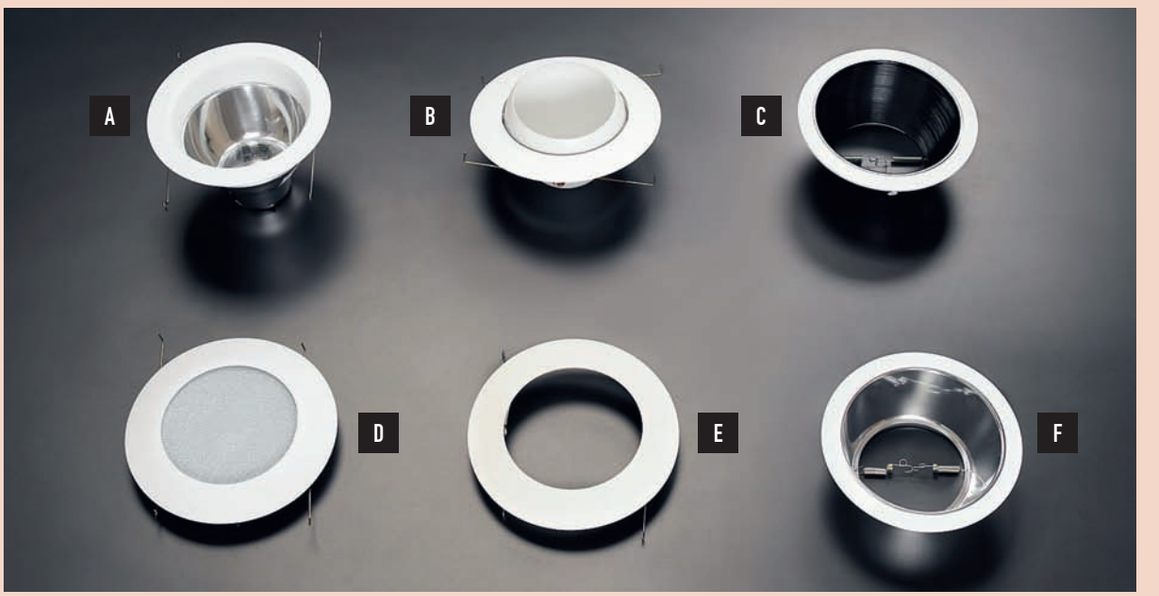
Recessed Lighting Housings & Trims



Recessed ceiling light housings come in many sizes and styles for various purposes and budgets. Some are sold with trim kits (below) included. Some common types are: new construction recessed housing (sold in economical multipacks) (A); airtight recessed housings (for heated rooms below unheated ceilings) (B); shallow recessed housings (for rooms with 2 × 6" ceiling joists) (C); small aperture recessed housing (D); recessed slope ceiling housing (for vaulted ceilings) (E).



Trim kits for recessed ceiling lights may be sold separately. Common types include: recessed open trim (E); baffle trim (C); recessed open trim with baffle (A, F); recessed eyeball trim (B); shower light trim (D); airtight recessed trim (E).

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#175 Dtp:225 Page:101

INSTALLING RECESSED CEILING LIGHTS

1 Mark the location for the light canister. If you are installing multiple lights, measure out from the wall at the start and end of the run, and connect them with a chalkline snapped parallel to the wall. If the ceiling is finished with a surface (wallboard), *See* next page.

2 Install the housing for the recessed fixture. Housings for new construction (or remodeling installations where the installation area is fully accessible from either above or below) have integral hanger bars that you attach to each joist in the joist bay.

3 Run electric cable from the switch to each canister location. Multiple lights are generally installed in series so there is no need to make pigtail connections in the individual boxes. Make sure to leave enough extra cable at each location to feed the wire into the housing and make the connection.

4 Run the feeder cables into the electrical boxes attached to the canister housings. You'll need to remove knockouts first and make sure to secure the cable with a wire staple within 8" of the entry point to the box.

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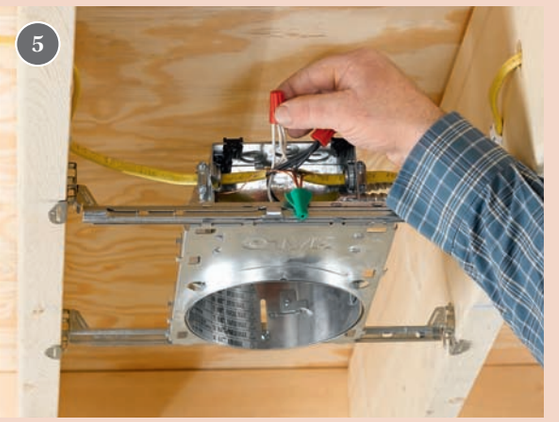
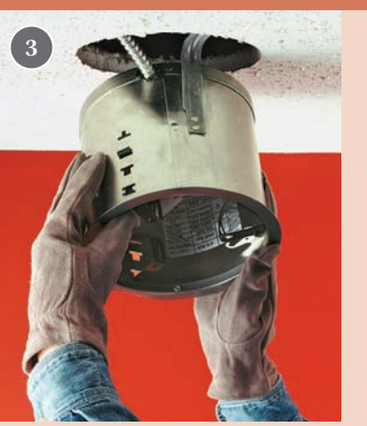


5 Connect the feeder wires to the fixture wires inside the junction box. Twist the hot lead together with the black fixture wire, as well as the black lead to other fixtures further downline. Also connect the neutral white wires. Join the ground wires and pigtail them to the grounding screw or clip in the box. Finish the ceiling, as desired.

6 Attach your trim kit of choice. Normally, these are hung with torsion spring clips from notches or hooks inside the canister. This should be done after the ceiling is installed and finished for new construction projects. With certain types of trim kits, such as eyeball trim, you'll need to install the light bulb before the trim kit.

CONNECTING A RECESSED FIXTURE CAN IN A FINISHED CEILING



1 Make the hole for the can. Most fixtures will include a template for sizing the hole. Fish 14/2 cable from the switch location to the hole. Pull about 16" of cable out of the hole for making the connection.

2 Remove a knockout from the electrical box attached to the can. Thread the cable into the box; secure it with a cable clamp. Remove sheathing insulation. Connect the black fixture wire to the black circuit wire, the white fixture wire to the white circuit wire, and then connect the ground wire to the grounding screw or grounding wire attached to the box.

3 Retrofit cans secure themselves in the hole with spring-loaded clips. Install the can in the ceiling by depressing the mounting clips so the can will fit into the hole. Insert the can so that its edge is tight to the ceiling. Push the mounting clips back out so they grip the drywall and hold the fixture in place. Install the trim piece.

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#175 Dtp:225 Page:103

Hard-wired Smoke & CO Detectors

Smoke detectors and carbon monoxide (CO) detectors are required in new construction. Hard-wired carbon monoxide detectors (A) are triggered by the presence of carbon monoxide gas. Smoke detectors are available in photoelectric and ionizing models. In ionizing detectors (B), a small amount of current flows in an ionization chamber. When smoke enters the chamber, it interrupts the current, triggering the alarm. Photoelectric detectors (C) rely on a beam of light, which when interrupted by smoke triggers an alarm. Heat alarms (D) sound an alarm when they detect areas of high heat in the room.

Tools & Materials

Screwdriver
Combination tool
Fish tape
Drywall saw
Wall or ceiling outlet boxes
Cable clamps
(if boxes are not self-clamping)
Two- and three-wire
14-gauge NM cable
Alarms
Wire connectors
15-amp single-pole breaker
Eye protection

SMOKE AND CARBON MONOXIDE (CO) alarms are an essential safety component of any living facility. All national fire protection codes require that new homes have a hard-wired smoke alarm in every sleeping room and on every level of a residence, including basements, attics, and attached garages. A smoke alarm needs to be protected with an AFCI circuit if it is installed in a bedroom.

Most authorities also recommend CO detectors on every level of the house and in every sleeping area.

Heat alarms, which detect heat instead of smoke, are often specified for locations like utility rooms, basements, or unfinished attics, where conditions may cause nuisance tripping of smoke alarms.

Hard-wired alarms operate on your household electrical current but have battery backups in case of a power outage. On new homes, all smoke alarms must be wired in a series so that every alarm sounds regardless of the fire's location. When wiring a series of alarms, be sure to use alarms of the same brand to ensure compatibility. Always check local codes before starting the job.

Ceiling-installed alarms should be 4 inches away from the nearest wall. Smoke alarms always need to be protected with an AFCI circuit.

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CONNECTING A SERIES OF HARD-WIRED SMOKE ALARMS

1 Pull 14/2 NM cable from the service panel into the first ceiling electrical box in the smoke alarm series. Pull 14/3 NM cable between the remaining alarm outlet boxes. Use cable clamps to secure the cable in each outlet box. Remove sheathing and strip insulation from wires.

2 Ensure power is off and test for power. Wire the first alarm in the series. Use a wire connector to connect the ground wires. Splice the black circuit wire with the alarm's black lead and the black wire going to the next alarm in the series. Splice the white circuit wire with the alarm's white wire and the white (neutral) wire going to the next alarm in the series. Splice the red traveler wire with the odd-colored alarm wire (in this case, also a red wire).

3 Wire the remaining alarms in the series by connecting the like-colored wires in each outlet box. Always connect the red traveler wire to the odd-colored (in this case, red) alarm wire. This red traveler wire connects all the alarms together so that when one alarm sounds, all the alarms sound. If the alarm doesn't have a grounding wire, cap the ground with a wire connector. When all alarms are wired, install and connect the new 15-amp breaker.

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#175 Dtp:225 Page:105

Baseboard Heaters

Tools & Materials

Drill/driver
Wire stripper
Cable ripper
Wallboard saw
Baseboard heater or heaters
240-thermostat (in-heater or in-wall)
12/2 NM cable
Electrical tape
Basic wiring supplies

Baseboard heaters can provide primary or supplemental heat for existing rooms or additions. Install heaters with clear space between the heater and the floor.

BASEBOARD HEATERS are a popular way to provide additional heating for an existing room or primary heat to a converted attic or basement.

Heaters are generally wired on a dedicated 240-volt circuit controlled by a thermostat. Several heaters can be wired in parallel and controlled by a single thermostat.

Baseboard heaters are generally surface-mounted without boxes, so in a remodeling situation, you only need to run cables before installing wallboard. Be sure to mark cable locations on the floor before installing drywall. Retrofit installations are also not difficult. You can remove existing baseboard and run new cable in the space behind.

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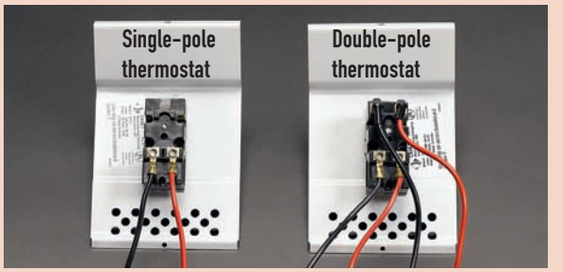
Baseboard Thermostats



In-heater and wall-mount are the two types of baseboard thermostats you can choose from. If you are installing multiple heaters, a single wall-mount thermostat is more convenient. Individual in-heater thermostats give you more zone control, which can result in energy savings.

Single-pole and double-pole thermostats work in a similar manner, but double-pole models are safer. The single-pole model will open the circuit (causing shutoff) in only one leg of the power service. Double-pole models have two sets of wires to open both legs, lessening the chance that a person servicing the heater will contact a live wire.

How Much Heater Do You Need?

If you don't mind doing a little math, determining how many lineal feet of baseboard heater a room requires is not hard.

1. Measure the area of the room in square feet (length × width): _____
2. Multiply the area by 10 to get the baseline minimum wattage: _____
3. Add 5% for each newer window or 10% for each older window: _____
4. Add 10% for each exterior wall in the room: _____
5. Add 10% for each exterior door: _____
6. Add 10% if the space below is not insulated: _____
7. Add 20% if the space above is not well insulated: _____
8. Add 10% if ceiling is more than 8 ft. high: _____
9. Total of the baseline wattage plus all additions: _____
10. Divide this number by 250 (the wattage produced per foot of standard baseboard heater): _____
11. Round up to a whole number. This is the minimum number of feet of heater you need. _____

Note: It is much better to have more feet of heater than is required than fewer. Having more footage of heater does not consume more energy; it does allow the heaters to work more efficiently.

Planning Tips for Baseboard Heaters

- Baseboard heaters require a dedicated circuit. A 20-amp, 240-volt circuit of 12-gauge copper wire will power up to 16 ft. of heater.
- Do not install a heater beneath a wall receptacle. Cords hanging down from the receptacle are a fire hazard.
- Do not mount heaters directly on the floor. You should maintain at least 1" of clear space between the baseboard heater and the floor covering.
- Install heaters directly beneath windows.
- Locate wall thermostats on interior walls only, and do not install directly above a heat source.

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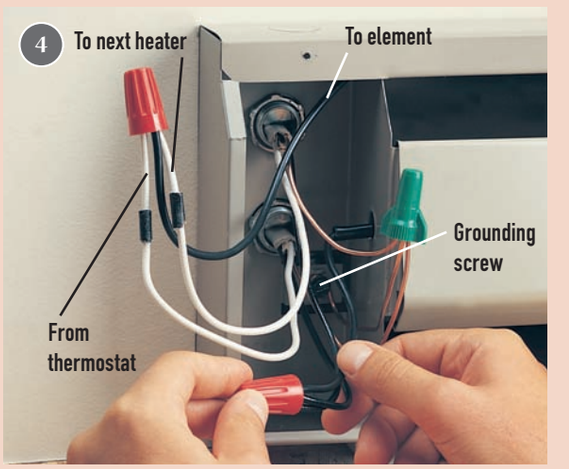
INSTALLING A 240-VOLT BASEBOARD HEATER



1 At the heater locations, cut a small hole in the drywall 3 to 4" above the floor. Pull 12/2 NM cables through the first hole: one from the thermostat, the other to the next heater. Pull all the cables for subsequent heaters. Middle-of-run heaters will have two cables, while end-of-run heaters have only one cable.

2 Remove the cover on the wire connection box. Open a knockout for each cable that will enter the box, then feed the cables through the cable clamps and into the wire connection box. Attach the clamps to the wire connection box, and tighten the clamp screws until the cables are gripped firmly.

3 Anchor the heater against the wall about 1" off the floor by driving flathead screws through the back of housing and into studs. Strip away cable sheathing so at least ½" of sheathing extends into the heater. Strip ¾" of insulation from each wire using a combination tool.

4 Make connections to the heating element if the power wires are coming from a thermostat or another heater controlled by a thermostat. *See* next page for other wiring schemes. Connect the white circuit wires to one of the wire leads on the heater. Tag white wires with black tape to indicate they are hot. Connect the black circuit wires to the other wire lead. Connect a grounding pigtail to the green grounding screw in the box, then join all grounding wires with a wire connector. Reattach cover.

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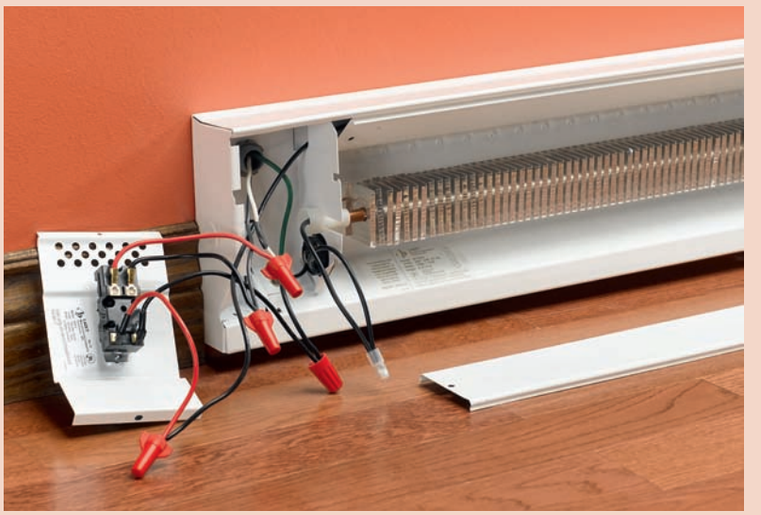
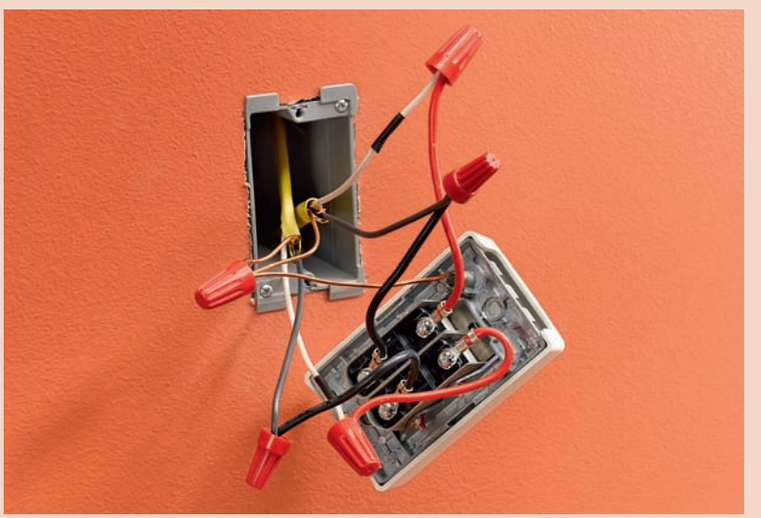


One heater with end-cap thermostat. Run both power leads (black plus tagged neutral) into the connection box at either end of the heater. If installing a single-pole thermostat, connect one power lead to one thermostat wire and connect the other thermostat wire to one of the heater leads. Connect the other hot LINE wire to the other heater lead. If you are installing a double-pole thermostat, make connections with both legs of the power supply.

Multiple heaters. At the first heater, join both hot wires from the thermostat to the wires leading to the second heater in line. Be sure to tag all white neutrals hot. Twist copper ground wires together and pigtail them to the grounding screw in the baseboard heater junction box. This parallel wiring configuration ensures that power flow will not be interrupted to the downstream heaters if an upstream heater fails.



Wall-mounted thermostat. If installing a wall-mounted thermostat, the power leads should enter the thermostat first and then be wired to the individual heaters singly or in series. Hookups at the heater are made as shown in step 4. Be sure to tag the white neutral as hot in the thermostat box as well as in the heater box.

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#175 Dtp:225 Page:109

Ceiling Fans

Tools & Materials

Screwdriver
Combination tool
Pliers or adjustable wrench
Circuit tester
Hammer
Ceiling fan light kit
2 × 4 lumber or adjustable ceiling fan crossbrace
1½" and 3" wallboard screws
Eye protection

A ceiling fan helps keep living spaces cooler in the summer and warmer in the winter. Replacing an overhead light with a fan/light is an easy project with big payback.

CEILING FANS are installed and wired like ceiling fixtures. They always require heavy-duty bracing and electrical boxes rated for ceiling fans.

Most standard ceiling fans work with a wall switch functioning as master power for the unit. Pull chains attached to the unit control the fan and lights. In these installations, it's fairly simple to replace an existing ceiling fixture with a fan and light.

If you will be installing a new circuit for the fan, use three-wire cable so both the light and the motor can be controlled by wall switches.

Because ceiling fans generally weigh more than ceiling lights and the motion of the blade creates more stress, it is very important that the ceiling box is securely mounted and is rated for ceiling fans. Ceiling boxes rated for ceiling fans are marked with the phrase "For ceiling fan support." If your existing ceiling box is not fan-rated, replace it with one that is. And be sure to inspect the manner in which the box is mounted to make sure it is strong enough.

Installation varies from fan to fan, so be sure to follow the manufacturer's instructions.

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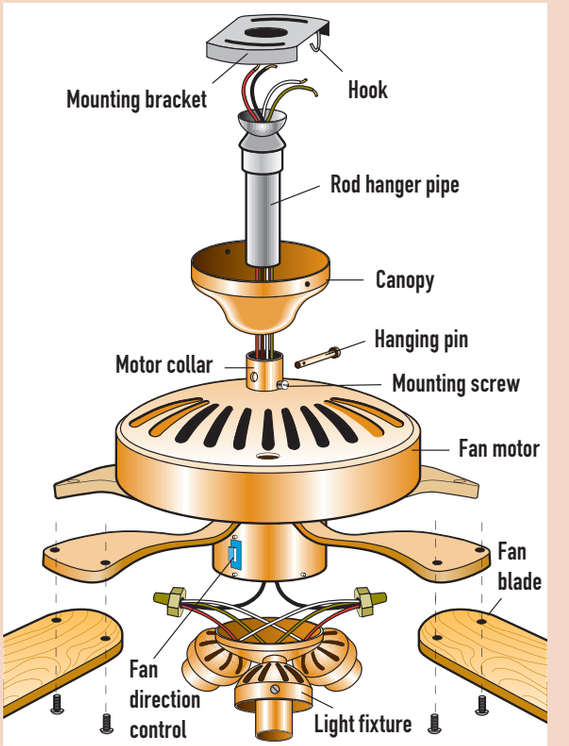
Ceiling Fan Types

Bracket-mounted ceiling fans are hung directly from a mounting bracket that is attached to the ceiling box. A canopy conceals the motor and the connections.



Downrod mounted ceiling fans are supported by a metal rod that's hung from the ceiling mounting bracket. The length of the rod determines the height of the fan. Downrod fans are used in rooms with ceilings 8 ft. high or higher.

Fans that Heat

The first generation of ceiling fans did one job: they spun and moved air. As the technology advanced, light kits were added to replace the light source that is lost when a fan-only appliance is installed. Now, some ceiling fans are manufactured with electric heating elements that can produce up to 5,000 BTUs of heat, comparable to a small space heater. Located in the fan canopy, the ceramic heat elements direct heat out the vents and force it down to the living level in the room, along with the heated air that naturally rises.

Fan-mounted heaters are relatively light duty, so they generally do not require a dedicated circuit. In most cases, you can supply power to the heater/fan with any 15-amp room light circuit that has extra capacity.

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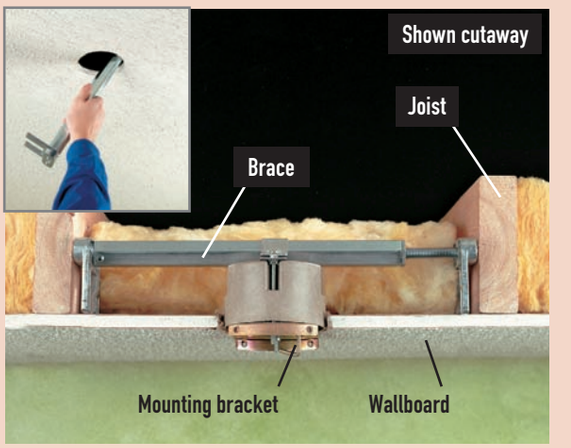
#175 Dtp:225 Page:111

Supporting Ceiling Boxes

Add a wood brace above the ceiling box if you have access from above (as in an attic). Cut a 24" brace to fit and nail it between the ceiling joists. Drive a couple of deck screws through the ceiling box and into the brace. If the box is not fan-rated, replace it with one that is.



Install an adjustable fan brace if the ceiling is closed and you don't want to remove the wallcoverings. Remove the old light and the electrical box and then insert the fan brace into the box opening (inset photo). Twist the brace housing to cause it to telescope outward. The brace should be centered over the opening and at the right height so the ceiling box is flush with the ceiling surface once it is hung from the brace.

Bracket-mounted Fans

Direct-mount fan units have a motor housing with a mounting tab that fits directly into a slot on the mounting bracket. Fans with this mounting approach are secure and easy to install but difficult to adjust.

Ball-and-socket fan units have a downrod, but instead of threading into the mounting bracket, the downrod has an attached ball that fits into a hanger "socket" in the mounting bracket. This installation allows the fan to move in the socket and find its own level for quiet operation.

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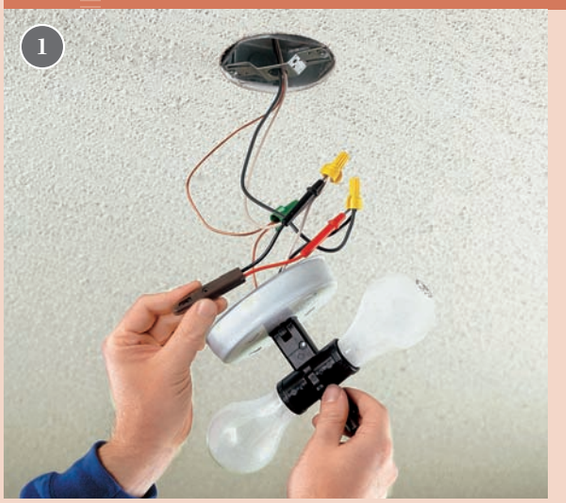
INSTALLING DOWNROD CEILING FANS



1 Shut off the power to the circuit at the service panel. Unscrew the existing fixture and carefully pull it away from the ceiling. Test for power by inserting the probes of a tester into the wire connectors on the black and the white wires. Disconnect and remove the old fixture.

2 Run the wires from the top of the fan motor through the canopy and then through the rod hanger pipe. Slide the rod hanger pipe through the canopy and attach the pipe to the motor collar using the included hanging pin. Tighten the mounting screws firmly.

3 Hang the motor assembly by the hook on the mounting bracket. Connect the wires according to manufacturer's directions using wire connectors to join the fixture wires to the circuit wires in the box. Gather the wires together and tuck them inside the fan canopy. Lift the canopy and attach it to the mounting bracket.

4 Attach the fan blades with the included hardware. Connect the wiring for the fan's light fixture according to the manufacturer's directions. Tuck all wires into the switch housing and attach the fixture. Install light bulbs. Restore power and test the fan.

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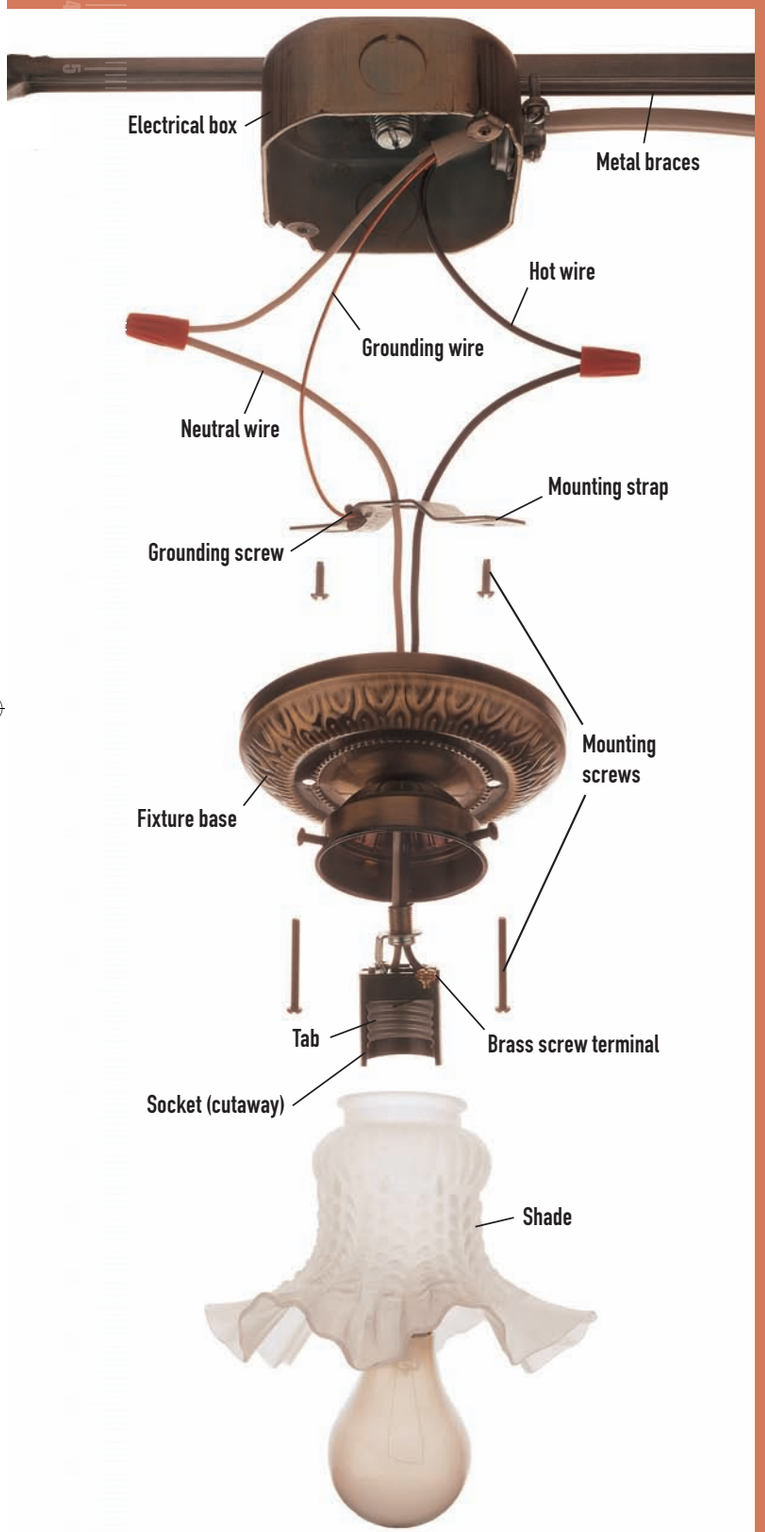
Repairing Light Fixtures



Tools & Materials

Circuit tester
Screwdriver
Continuity tester
Combination tool
Replacement parts, as needed

In a typical incandescent light fixture, a black hot wire is connected to a brass screw terminal on the socket. Power flows to a small tab at the bottom of the metal socket and through a metal filament inside the bulb. The power heats the filament and causes it to glow. The current then flows through the threaded portion of the socket and through the white neutral wire back to the main service panel.

LIGHT FIXTURES are attached permanently to ceilings or walls. They include wall-hung sconces, ceiling-hung globe fixtures, recessed light fixtures, and chandeliers. Most light fixtures are easy to repair using basic tools and inexpensive parts.

If a light fixture fails, always make sure the light bulb is screwed in tightly and is not burned out. A faulty light bulb is the most common cause of light fixture failure. If the light fixture is controlled by a wall switch, also check the switch as a possible source of problems.

Light fixtures can fail because the sockets or built-in switches wear out. Some fixtures have sockets and switches that can be removed for minor repairs. These parts are held to the base of the fixture with mounting screws or clips. Other fixtures have sockets and switches that are joined permanently to the base. If this type of fixture fails, purchase and install a new light fixture.

Damage to light fixtures often occurs because homeowners install light bulbs with wattage ratings that are too high. Prevent overheating and light fixture failures by using only light bulbs that match the wattage ratings printed on the fixtures.

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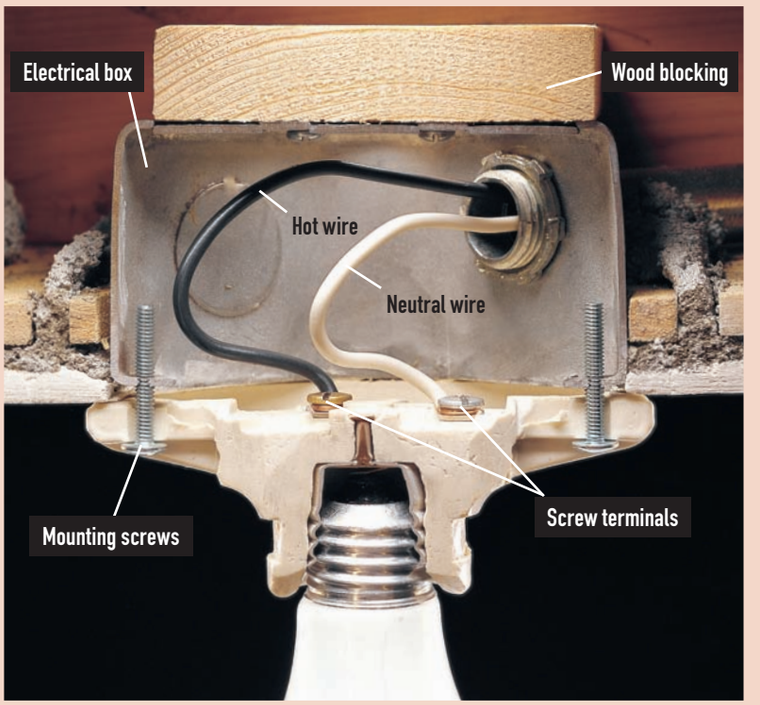
#175 Dtp:225 Page:114



A non-compliant fixture. Before 1959, incandescent light fixtures (shown cutaway) often were mounted directly to an electrical box or to plaster lath. Electrical codes now require that fixtures be attached to mounting straps that are anchored to the electrical boxes. If you have a light fixture attached to plaster lath, install an approved electrical box with a mounting strap to support the fixture.

Troubleshooting Fixture Problems

Problem	Repair
Wall– or ceiling–mounted fixture flickers or does not light.	1. Check for faulty light bulb. 2. Check wall switch and repair or replace, if needed. 3. Check for loose wire connections in electrical box. 4. Test socket and replace, if needed. 5. Replace light fixture.
Built–in switch on fixture does not work.	1. Check for faulty light bulb. 2. Check for loose wire connections on switch. 3. Replace switch. 4. Replace light fixture.
Chandelier flickers or does not light.	1. Check for faulty light bulb. 2. Check wall switch and repair or replace, if needed. 3. Check for loose wire connections in electrical box. 4. Test sockets and fixture wires, and replace, if needed.
Recessed fixture flickers or does not light.	1. Check for faulty light bulb. 2. Check wall switch and repair or replace, if needed. 3. Check for loose wire connections in electrical box. 4. Test fixture and replace, if needed.

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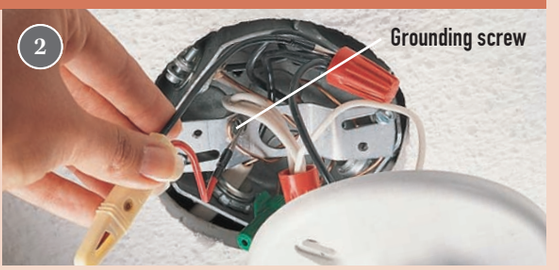
#175 Dtp:225 Page:115

REMOVING A LIGHT FIXTURE & TESTING A SOCKET



1 Turn off the power to the light fixture at the main service panel. Remove the light bulb and any shade or globe, then remove the mounting screws holding the fixture base to the electrical box or mounting strap. Carefully pull the fixture base away from the box.

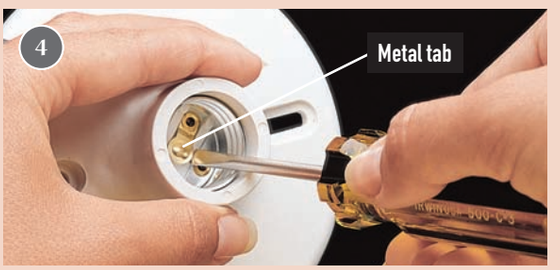
2 Test for power by touching one probe of a circuit tester to the green grounding screw, then insert the other probe into each wire connector. The tester should not glow. If it does, there is still power entering the box. Return to the service panel and turn off power to the correct circuit.

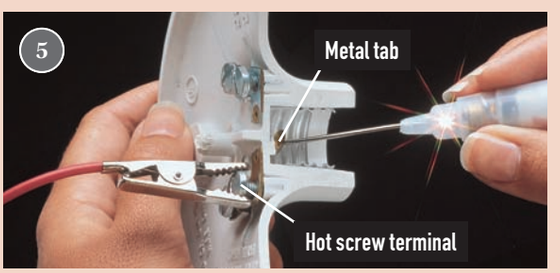
3 Disconnect the light fixture base by loosening the screw terminals. If the fixture has wire leads instead of screw terminals, remove the light fixture base by unscrewing the wire connectors.

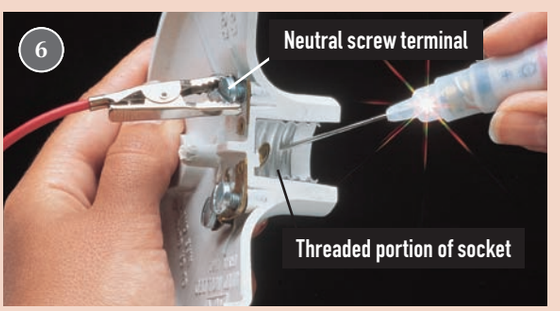
4 Adjust the metal tab at the bottom of the fixture socket by prying it up slightly with a small screwdriver. This adjustment will improve the contact between the socket and the light bulb.

5 Test the socket (shown cutaway) by attaching the clip of a continuity tester to the hot screw terminal (or black wire lead) and touching the probe of the tester to the metal tab in the bottom of the socket. The tester should glow. If not, the socket is faulty and must be replaced.

6 Attach the tester clip to the neutral screw terminal (or white wire lead), and touch the probe to the threaded portion of the socket. The tester should glow. If not, the socket is faulty and must be replaced. If the socket is permanently attached, replace the fixture.







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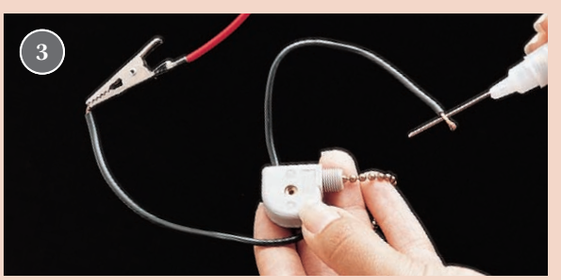
#175 Dtp:225 Page:116

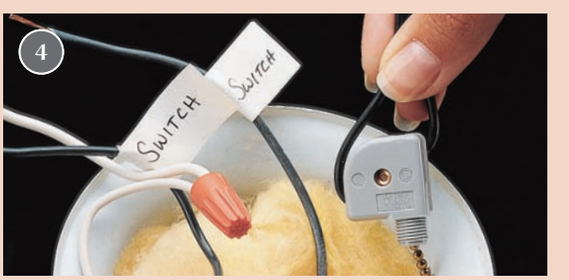
REPLACING A SOCKET

1 Remove the old light fixture. Remove the socket from the fixture. The socket may be held by a screw, clip, or retaining ring. Disconnect wires attached to the socket.

2 Purchase an identical replacement socket. Connect the white wire to the silver screw terminal on the socket, and connect the black wire to the brass screw terminal. Attach the socket to the fixture base, and reinstall the fixture.

TESTING & REPLACING A BUILT-IN LIGHT SWITCH





1 Remove the light fixture. Unscrew the retaining ring holding the switch.

2 Label the wires connected to the switch leads. Disconnect the switch leads and remove the switch.

3 Test the switch by attaching the clip of the continuity tester to one of the switch leads and holding the tester probe to the other lead. Operate the switch control. If the switch is good, the tester will glow when the switch is in one position, but not both.

4 If the switch is faulty, purchase and install an exact duplicate switch. Remount the light fixture, and turn on the power at the main service panel.

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#175 Dtp:225 Page:117

Repairing Fluorescent Lights

Tools & Materials

Screwdriver
Ratchet wrench
Combination tool
Circuit tester
Replacement tubes
Ballast (if needed)
Replacement fluorescent light fixture (if needed)

FLUORESCENT LIGHTS are relatively trouble free and use less energy than incandescent lights. A typical fluorescent tube lasts about three years and produces two to four times as much light per watt as a standard incandescent light bulb.

The most frequent problem with a fluorescent light fixture is a worn-out tube. If a fluorescent light fixture begins to flicker or does not light fully, remove and examine the tube. If the tube has bent or broken pins or black discoloration near the ends, replace it. Light gray discoloration is normal in working fluorescent tubes. When replacing an old tube, read the wattage rating printed on the glass surface, and buy a new tube with a matching rating. (*See* information below on new standards for fluorescent bulbs.) Never dispose of old tubes by breaking them. Fluorescent tubes contain a small amount of hazardous mercury. Check with your local environmental control agency or health department for disposal guidelines.

Fluorescent light fixtures also can malfunction if the sockets are cracked or worn. Inexpensive replacement sockets are available at any hardware store and can be installed in a few minutes.

If a fixture does not work even after the tube and sockets have been serviced, the ballast probably is defective. Faulty ballasts may leak a black, oily substance and can cause a fluorescent light fixture to make a loud humming sound. Although ballasts can be replaced, always check prices before buying a new ballast. It may be cheaper to purchase and install a new fluorescent fixture rather than to replace the ballast in an old fluorescent light fixture.

New Fluorescent Standards

New efficiency standards for fluorescent fixtures have recently been enacted. The old four-foot fluorescent tubes, sometimes called "fat fours" are no longer available for general use. Those tubes were called T12s, because the tube diameter was 1⅞ of an inch, or 1½ inches. The new tubes are called T8s and are 1 inch in diameter. The T8s use the same sockets, but do not illuminate in an old fixture because they require different ballasts. The new ballasts are electronic, as opposed to the old that were electromagnetic. A big plus of the new electronic ballasts is that they cycle much faster than the old ones. This eliminates the flicker of fluorescents that can be so annoying to some people. Another plus is that the new fixtures and bulbs produce brighter, better quality light using less power.

When your current fluorescent bulbs begin to burn out, you will need to either retrofit your fixtures with new ballasts, or purchase new fixtures. The new bulbs, ballasts, and fixtures may be slightly more expensive, but the lifespan and operating costs will be less than the older units. Simply replacing the whole fixture will require less time wiring than removing and re-wiring ballasts and sockets. If you do decide to do a re-wire, it may be easier to remove the fixture and perform the tasks on a tabletop, rather than over your head.

Tip

Recent changes to efficiency regulations mean older fluorescent tubes will soon cost more. As tubes burn out, it will make more sense to replace old fixtures with the more efficient new fixtures. The new tubes are not compatible with old fixtures.

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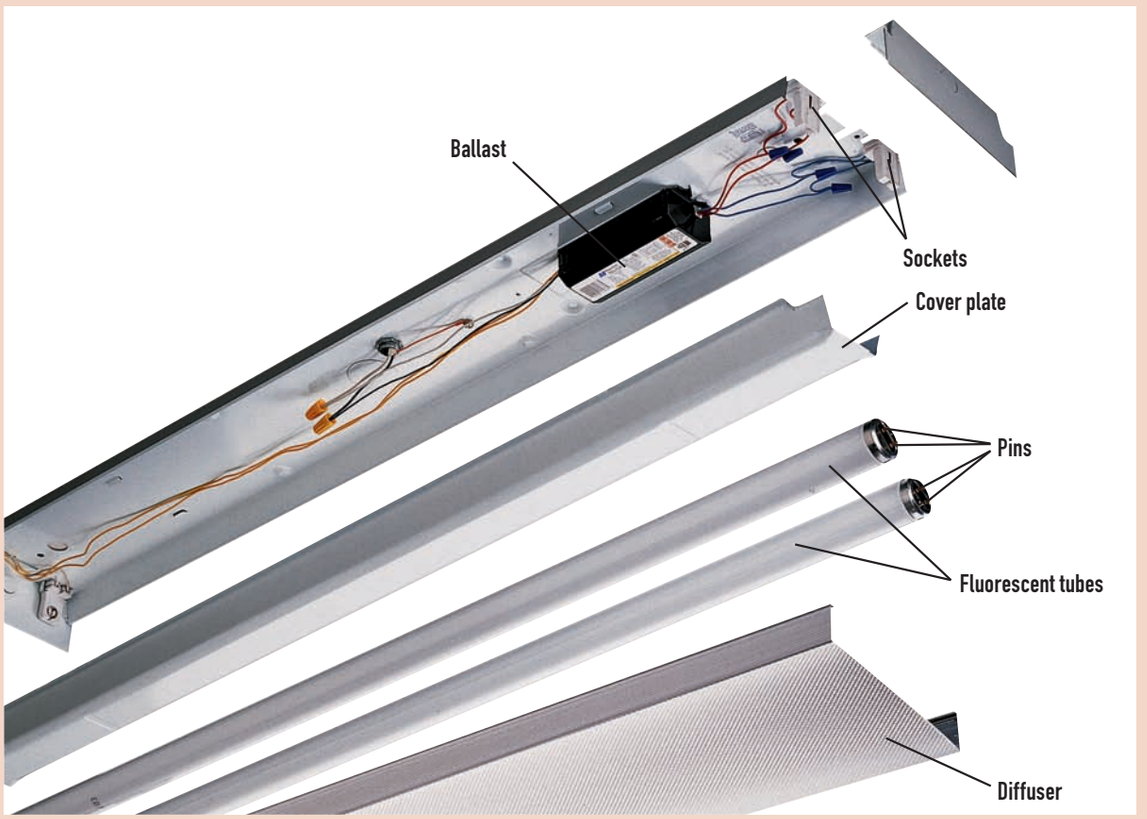
#175 Dtp:225 Page:118

Another advantage of the electronic ballast is that they are more sophisticated in the way they illuminate the bulb. Previous ballasts were labeled as rapid start or instant start, but now, with electronic ballasts, a programmable option is available. This technicality is probably only important in commercial settings, which use thousands of fluorescent fixtures. If you purchase separate ballasts and sockets for a retrofit, you do need to match the socket to the ballast as well as to the wattage bulb used.

Tip

Flourescent bulbs and ballasts are both hazardous waste. Check with your local waste agency for disposal locations.

Older fluorescent lights may have a small cylindrical device, called a starter, located near one of the sockets. When a tube begins to flicker, replace the entire fixture with an updated one.



A fluorescent light works by directing electrical current through a special gas-filled tube that glows when energized. A white translucent diffuser protects the fluorescent tube and softens the light. A cover plate protects a special transformer, called a ballast. The ballast regulates the flow of 120-volt household current to the sockets. The sockets transfer power to metal pins that extend into the tube.

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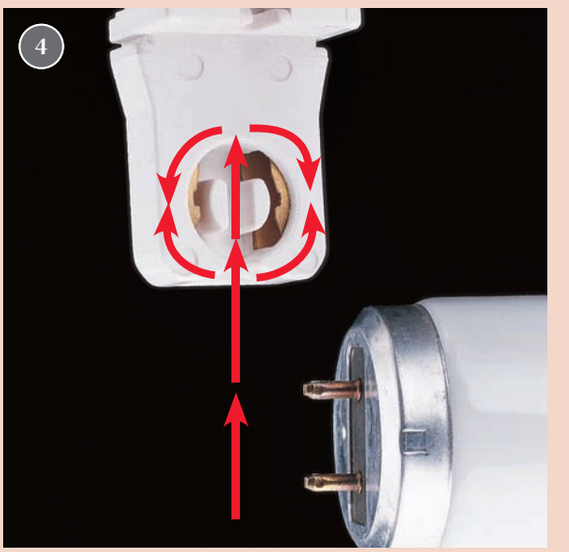
#175 Dtp:225 Page:119

REPLACING A FLUORESCENT TUBE



1 Turn off power to the light fixture at the switch. Remove the diffuser to expose the fluorescent tube.

2 Remove the fluorescent tube by rotating it ¼ turn in either direction and sliding the tube out of the sockets. Inspect the pins at the end of the tube. Tubes with bent or broken pins should be replaced.

3 Inspect the ends of the fluorescent tube for discoloration. A new tube in good working order (top) shows no discoloration. Normal, working tube (middle) may have gray color. A worn-out tube (bottom) shows black discoloration.

4 Install a new tube with the same wattage rating as the old tube. Insert the tube so that pins slide fully into sockets, then twist the tube ¼ turn in either direction until it is locked securely. Reattach the diffuser, and turn on the power at the main service panel.

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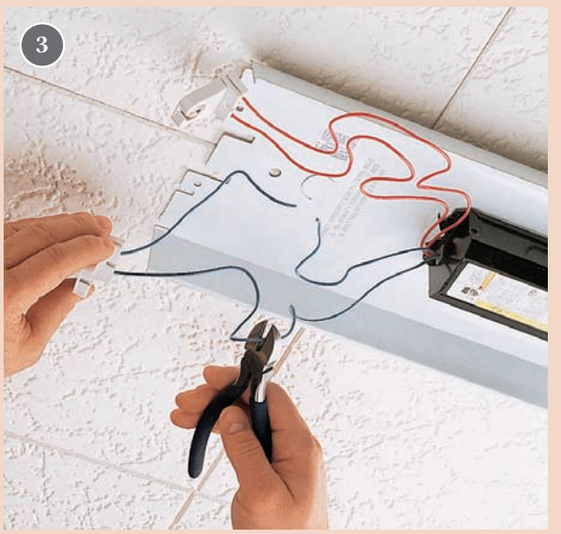
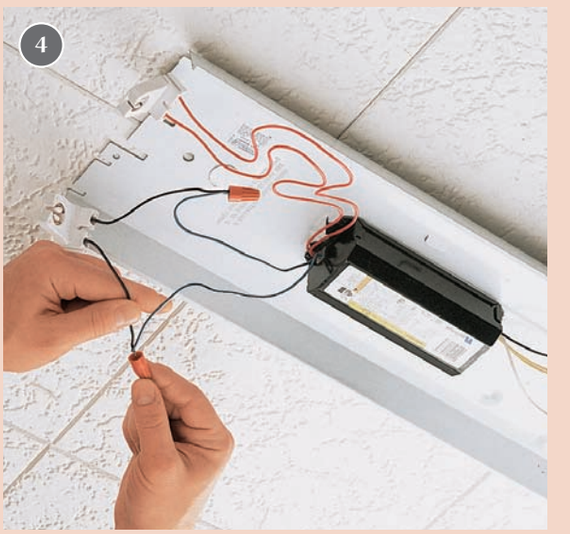
REPLACING A SOCKET





1 Turn off the power at the main service panel. Remove the diffuser, fluorescent tube, and the cover plate. Test for power by touching one probe of a neon circuit tester to the grounding screw and inserting the other probe into the hot wire connector. If the tester glows, return to the service panel and turn off the correct circuit.

2 Remove the faulty socket from the fixture housing. Some sockets slide out, while others must be unscrewed.

3 Disconnect wires attached to the socket. For push-in fittings (above) remove the wires by inserting a small screwdriver into the release openings. Some sockets have screw terminal connections, while others have preattached wires that must be cut before the socket can be removed.

4 Purchase and install a new socket. If the socket has preattached wire leads, connect the leads to the ballast wires using wire connectors. Replace the cover plate, and then the fluorescent tube, making sure that it seats properly. Replace the diffuser. Restore power to the fixture at the main service panel and test.

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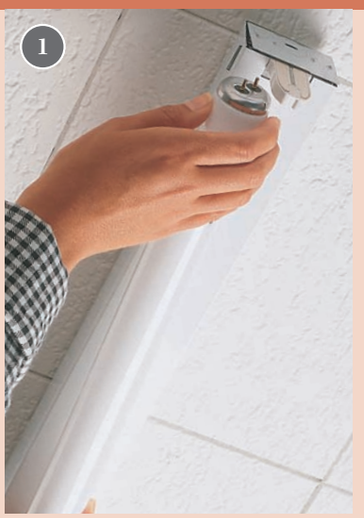
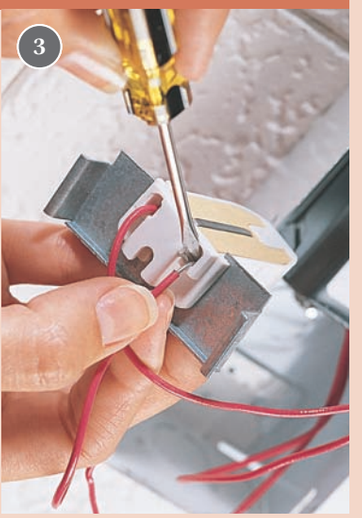
REPLACING A BALLAST





1 Turn off the power at the main service panel, then remove the diffuser, fluorescent tube, and cover plate. Test for power using a circuit tester.

2 Remove the sockets from the fixture housing by sliding them out, or by removing the mounting screws and lifting the sockets out.

3 Disconnect the wires attached to the sockets by pushing a small screwdriver into the release openings (above), by loosening the screw terminals, or by cutting wires to within 2" of sockets.

4 Remove the old ballast using a ratchet wrench or screwdriver. Make sure to support the ballast so it does not fall.

5 Install a new ballast that has the same ratings as the old ballast.

6 Attach the ballast wires to the socket wires using wire connectors, screw terminal connections, or push-in fittings. Reinstall the cover plate, fluorescent tube, and diffuser. Turn on power to the light fixture at the main service panel.

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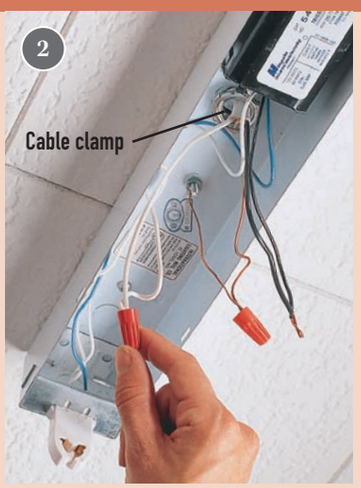
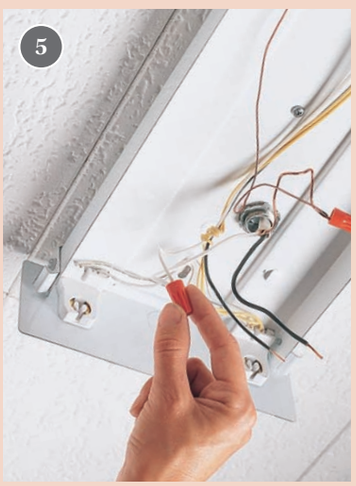
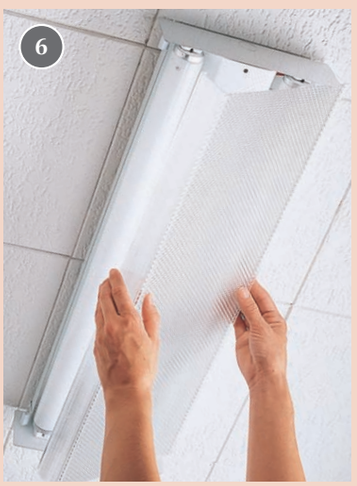
#175 Dtp:225 Page:122

REPLACING A FLUORESCENT LIGHT FIXTURE







1 Turn off power to the light fixture at the main service panel. Remove the diffuser, tube, and cover plate. Test for power using a circuit tester.

2 Disconnect the insulated circuit wires and the bare copper grounding wire from the light fixture. Loosen the cable clamp holding the circuit wires.

3 Unscrew the fixture from the wall or ceiling and carefully remove it. Make sure to support the fixture so it does not fall.

4 Position the new fixture, threading the circuit wires through the knockout opening in the back of the fixture. Screw the fixture in place so it is firmly anchored to framing members.

5 Connect the circuit wires to the fixture wires using wire connectors. Follow the wiring diagram included with the new fixture. Tighten the cable clamp holding the circuit wires.

6 Attach the fixture cover plate, then install the fluorescent tubes and attach the diffuser. Turn on power to the fixture at the main service panel and test.

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#175 Dtp:225 Page:123

Highlights of the National Electrical Code

BY MATERIAL

Service Panel

- Maintain a minimum 30" wide by 36" deep of clearance in front of the service panel.
- Ground all 120-volt and 240-volt circuits.
- Match the amperage rating of the circuit when replacing fuses.
- Use handle-tie breakers for 240-volt loads (line to line).
- Close all unused service panel openings.
- Label each fuse and breaker clearly on the panel.

Electrical Boxes

- Use boxes that are large enough to accommodate the number of wires entering the box.
- Locate all receptacle boxes 12 to 18" above the finished floor (standard).
- Locate all switch boxes 48" above the finished floor (standard). For special circumstances, inspectors will allow switch and location measurements to be altered, such as a switch at 36" above the floor in a child's bedroom or receptacles at 24" above the floor to make them more accessible for someone using a wheelchair.
- Install all boxes so they remain accessible.
- Leave no gaps greater than ⅛" between wallboard and front of electrical boxes.
- Place receptacle boxes flush with combustible surfaces.
- Leave a minimum of 6" of usable cable or wire extending past the front of the electrical box.

Wires & Cables

- Use wires that are large enough for the amperage rating of the circuit (*See* Wire Size Chart, page 28).
- Drill holes at least 2" back from the exposed edge of joists to run cables through. Do not attach cables to the bottom edge of joists.
- Do not run cables diagonally between framing members.
- Run cable between receptacles 20" above the floor.
- Use nail plates to protect cable that is run through holes drilled or cut into studs less than 1¼" from front edge of stud.
- Do not crimp cables sharply.
- Contain spliced wires or connections entirely in a plastic or metal electrical box.
- Use wire connectors to join wires.
- Use staples to fasten cables within 8" of an electrical box and every 48" along its run.
- Leave a minimum ¼" (maximum 1") of sheathing where cables enter an electrical box.
- Clamp cables and wires to electrical boxes with approved NM clamp. No clamp is necessary for one-gang plastic boxes if cables are stapled within 8".
- Label all cables and wires at each electrical box to show which circuits they serve for the rough-in inspection.
- Connect only a single wire to a single screw terminal. Use pigtails to join more than one wire to a screw terminal.

Switches

- Use a switch-controlled receptacle in rooms without a built-in light fixture operated by a wall switch.
- Use three-way switches at the top and bottom on stairways with six steps or more.
- Use switches with grounding screw with plastic electrical boxes.
- Locate all wall switches within easy reach of the room entrance.

Receptacles

- Match the amp rating of a receptacle with the size of the circuit.
- Install receptacles on all walls 24" wide or greater.
- Install receptacles so a 6-ft. cord can be plugged in from any point along a wall or every 12 ft. along a wall.
- Include receptacles in any hallway that is 10 ft. long or more.
- Use three-prong, grounded receptacles for all 15- or 20-amp, 120-volt branch circuits.
- Include a switch-controlled receptacle in rooms without a built-in light fixture operated by a wall switch.
- Install GFCI-protected receptacles in bathrooms, kitchens, garages, crawl spaces, unfinished basements, and outdoor receptacle locations.
- Install an isolated-ground circuit to protect sensitive equipment, like a computer, against tiny power fluctuations. Computers should also be protected by a standard surge protector.

Light Fixtures

- Use mounting straps that are anchored to the electrical boxes to mount ceiling fixtures.
- Keep non-IC-rated recessed light fixtures 3" from insulation and ½" from combustibles.
- Include at least one switch-operated lighting fixture in every room.

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#175 Dtp:225 Page:124

Grounding

- Ground all receptacles by connecting receptacle grounding screws to the circuit grounding wires.
- Use switches with grounding screws whenever possible. Always ground switches installed in plastic electrical boxes and all switches in kitchens, bathrooms, and basements.

BY ROOM

Kitchens/Dining Rooms

- Install a dedicated 40- or 50-amp, 120/240-volt circuit for a range (or two circuits for separate oven and countertop units).
- Install two 20-amp small appliance circuits.
- Install dedicated 15-amp, 120-volt circuits for dishwashers and food disposals (required by many local codes).
- Use GFCI receptacles for all accessible countertop receptacles; receptacles behind fixed appliances do not need to be GFCIs.
- Position receptacles for appliances that will be installed within cabinets, such as microwaves or food disposals, according to the manufacturer's instructions.
- Include receptacles on all counters wider than 12".
- Space receptacles a maximum of 48" apart above countertops and closer together in areas where many appliances will be used.
- Locate receptacles 4" above the top of the backsplash. If backsplash is more than the standard 4" or the bottom of cabinet is less than 18" from countertop, center the box in space between countertop and bottom of wall cabinet.
- Mount one receptacle within 12" of the countertop on islands and peninsulas that are 12 × 24" or greater.
- Do not put lights on small appliance circuits.
- Install additional lighting in work areas at a sink or range for convenience and safety.

Bathrooms

- Install a separate 20-amp circuit.
- Ground switches in bathrooms.
- Use GFCI-protected receptacles.
- Install at least one ceiling-mounted light fixture.
- Place blower heaters in bathrooms well away from the sink and tub.

Utility/Laundry Rooms

- Install a separate 20-amp circuit for a washing machine.
- Install a minimum feed 30-amp #10 THHN wire for the dryer powered by a separate 120/240-volt major appliance circuit.
- Install metal conduit for cable runs in unfinished rooms.
- Use GFCI-protected receptacles.

Living, Entertainment, Bedrooms

- Install a minimum of two 15-amp circuits in living rooms.
- Install a minimum of one 15- or 20-amp basic lighting/receptacle circuit for each 600 sq. ft. of living space.
- Install a dedicated circuit for each permanent appliance, like an air conditioner, computer, or group of electric baseboard heaters.
- Do not use standard electrical boxes to support ceiling fans.
- Include receptacles on walls 24" wide or more.
- Space receptacles on basic lighting/receptacle circuits a maximum of 12 ft. apart. For convenience you can space them as close as 6 ft.
- Position permanent light fixtures in the center of the room's ceiling.
- Install permanently wired smoke alarms in room additions that include sleeping areas and hallways.

Outdoors

- Check for underground utilities before digging.
- Use UF cable for outdoor wiring needs.
- Run cable in schedule 80 PVC plastic, as required by local code.
- Most local codes now require in-use rated weatherproof box covers.
- Bury cables housed in conduit at least 18" deep; cable not in conduit must be buried at least 24" deep.
- Use weatherproof electrical boxes with watertight covers.
- Use GFCI-protected receptacles.
- Install receptacles a minimum of 12" above ground level.
- Anchor freestanding receptacles not attached to a structure by embedding the schedule 80 PVC plastic conduit in a concrete footing, so that it is at least 12" but no more than 18" above ground level.
- Plan on installing a 20-amp, 120-volt circuit if the circuit contains more than one light fixture rated for 300 watts, or more than four receptacles.

Stairs/Hallways

- Use three-way switches at the top and bottom on stairways with six steps or more.
- Include receptacles in any hallway that is 10 ft. long or more.
- Position stairway lights so each step is illuminated.

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#175 Dtp:225 Page:125

Metric Conversions

Metric Equivalent

Inches (in.)	1/64	1/32	1/25	1/16	1/8	1/4	3/8	2/5	1/2	5/8	3/4	7/8	1	2	3	4	5	6	7	8	9	10	11	12	36	39.4
Feet (ft.)																								1	3	3 1/12
Yards (yd.)																									1	1 1/12
Millimeters (mm)	0.40	0.79	1	1.59	3.18	6.35	9.53	10	12.7	15.9	19.1	22.2	25.4	50.8	76.2	101.6	127	152	178	203	229	254	279	305	914	1,000
Centimeters (cm)							0.95	1	1.27	1.59	1.91	2.22	2.54	5.08	7.62	10.16	12.7	15.2	17.8	20.3	22.9	25.4	27.9	30.5	91.4	100
Meters (m)																								.30	.91	1.00

Converting Measurements

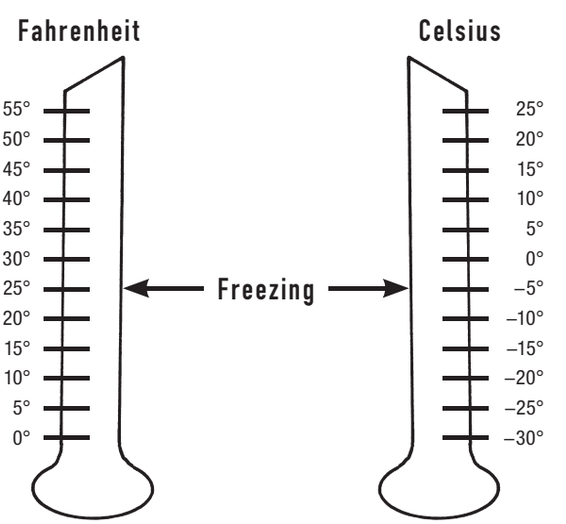
To Convert:	To:	Multiply by:
Inches	Millimeters	25.4
Inches	Centimeters	2.54
Feet	Meters	0.305
Yards	Meters	0.914
Miles	Kilometers	1.609
Square inches	Square centimeters	6.45
Square feet	Square meters	0.093
Square yards	Square meters	0.836
Cubic inches	Cubic centimeters	16.4
Cubic feet	Cubic meters	0.0283
Cubic yards	Cubic meters	0.765
Pints (U.S.)	Liters	0.473 (Imp. 0.568)
Quarts (U.S.)	Liters	0.946 (Imp. 1.136)
Gallons (U.S.)	Liters	3.785 (Imp. 4.546)
Ounces	Grams	28.4
Pounds	Kilograms	0.454
Tons	Metric tons	0.907

To Convert:	To:	Multiply by:
Millimeters	Inches	0.039
Centimeters	Inches	0.394
Meters	Feet	3.28
Meters	Yards	1.09
Kilometers	Miles	0.621
Square centimeters	Square inches	0.155
Square meters	Square feet	10.8
Square meters	Square yards	1.2
Cubic centimeters	Cubic inches	0.061
Cubic meters	Cubic feet	35.3
Cubic meters	Cubic yards	1.31
Liters	Pints (U.S.)	2.114 (Imp. 1.76)
Liters	Quarts (U.S.)	1.057 (Imp. 0.88)
Liters	Gallons (U.S.)	0.264 (Imp. 0.22)
Grams	Ounces	0.035
Kilograms	Pounds	2.2
Metric tons	Tons	1.1

Converting Temperatures

Convert degrees Fahrenheit (F) to degrees Celsius (C) by following this simple formula: Subtract 32 from the Fahrenheit temperature reading. Then mulitply that number by 5/9. For example, 77°F - 32 = 45. 45 × 5/9 = 25°C.

To convert degrees Celsius to degrees Fahrenheit, multiply the Celsius temperature reading by 9/5, then add 32. For example, 25°C × 9/5 = 45. 45 + 32 = 77°F.



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(Fogra 39)Job:04-30439 Title:MBI-HomeSkills Wiring
#175 Dtp:225 Page:126

Index

AFCI (arc-fault circuit interruption)
breakers
GFCI vs., 92
installing, 92–93
Baseboard heaters
calculating requirements, 107
electrical code requirements and, 89
installation, 106, 108–9
Cables
connecting, 23, 25, 26
protection of, 90
types of, 21–22
See also Conduit; NM (nonmetallic) cable; Wires
Ceiling fans
installation, 113
supporting, 112
types of, 111
Ceiling lights
bracing, 97
installation, 96–97
recessed fixtures
connecting in finished ceilings, 103
installation, 100, 102–3
types of, 100–101
replacing, 98–99
Ceilings
electrical boxes for, 50
See also Ceiling fans; Ceiling lights
Circuit breaker panels
about circuit breakers, 58
connecting circuit breakers, 56–57, 60–61
labeling, 91
new circuit installation, 56, 60–61
resetting circuit breakers, 59
shutting off individual circuits, 55
subpanel installation, 56–57
testing for current, 60
CO detectors
installation of hardwired, 104–5
Conduit
about, 21
making nonmetallic connections, 39
working with, 36–38
Dryers
120/240-volt receptacle installation, 94
Electrical boxes
ceiling boxes, 50
electrical code and, 11
fill chart, 40
fixtures which do not require, 46
installing, 46
junction box installation, 50–51
for light fixtures, 48
locating, 49
nonmetallic boxes, 44–45
pop-in retrofit box installation, 52–53
for receptacles, 47
replacing, 52–53
specifications for, 43
for switches, 48
types of, 40–42
Electrical panels. *See* service panels
Electrical system
Components of, 10–11, 13
glossary of terms, 12
Electric meters, 10
Fluorescent light fixtures
components of, 119
replacing, 123
replacing ballasts, 122
replacing sockets, 121
replacing tubes, 120
standards for, 118
Fuse panels
about fuses, 58
cartridge fuse testing/replacement, 59
plug fuse replacement, 59
shutting off individual circuits, 55
GFCI (ground-fault circuit-interrupter)
breakers
AFCI vs., 92
installing, 92–93
GFCI (ground-fault circuit-interrupter)
receptacles
about, 76
electrical code requirements for, 90
installation for multiple-location protection, 82–83
installation for single-location protection, 81
two-slot receptacles and, 75
Grounding, 10, 16–17
Junction boxes
installing, 50–51
Kitchens
120/240-volt range receptacle installation, 95
Light fixtures
electrical boxes for, 48
removing and testing a socket, 116
repairing, 114–17
socket replacement, 117
testing/replacing built-in switches, 117
troubleshooting, 115
See also Fluorescent light fixtures
Living areas
measuring, 90
National Electrical Code (NEC)
GFCI and AFCI breakers and, 92
highlights by area, 124–25
requirements of, 87, 89–91
NM (nonmetallic) cable
installation in finished ceilings, 35
installation in finished walls, 33–34
installation in framing, 28–32
working with, 21–24, 28
Polarization, 16–17, 76
Ranges
120/240-volt receptacle installation, 95
Receptacles
common problems, 77
components of, 76
electrical boxes for, 47
installation of new, 78–79
in kitchens and bathrooms, 90
120/240-volt
installation for dryers, 95
installation for ranges, 95
switch/receptacle combination
testing, 73
testing
multimeters, 85
plug-in testers, 84
touchless testers, 84
wiring configurations, 74–75
See also GFCI (ground-fault circuit-interrupter) receptacles
Service panels
cartridge fuse testing/replacement, 59
circuit breaker panel components, 56
connecting circuit breakers, 60–61
examining for wiring projects, 87–88
new circuit installation, 56, 60–61
plug fuse replacement, 59
resetting circuit breakers, 59
shutting off power, 55
subpanel installation, 56–57
testing for current, 60
Smoke detectors
installation of hardwired, 104–5
Switches. *See* wall switches
Wall coverings
thickness of, 49
Wall switches
about, 62
dimmer switch installation, 68–69
electrical boxes for, 48
single-pole installation, 65
testing
automatic switches, 73
double switches, 73
four-way, 71
manual operation of electronic, 73
motion sensor, 73
pilot-light switches, 72
single-pole, 70
switch/receptacle combination, 73
three-way, 71
time-delay switches, 73
timer switches, 72
three-way
installation, 66
repair/replacement, 67
types of, 63–64
Wires
color and size charts, 20
connecting, 23, 25–26
pigtailing, 27
protection of, 90
stripping, 24
types of, 21–22
See also Conduit; NM (nonmetallic) cable

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Consult your local building department for information on building permits, codes, and other laws as they apply to your project.

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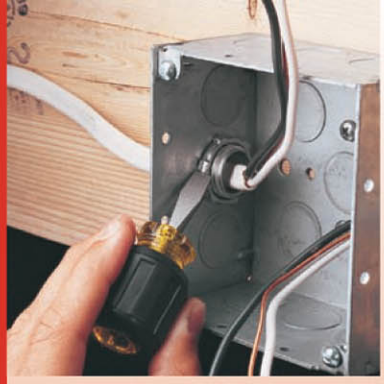

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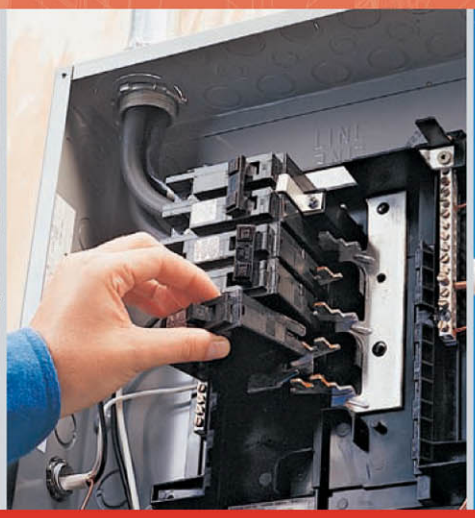

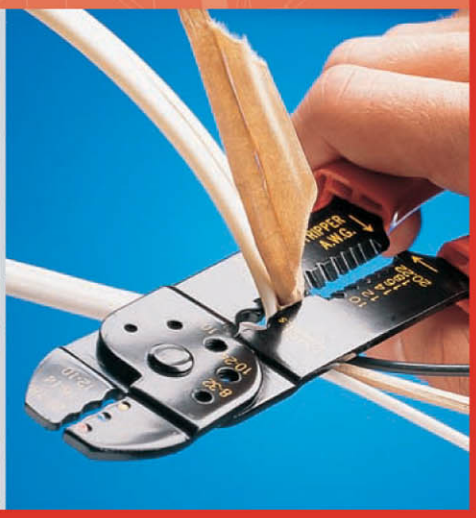

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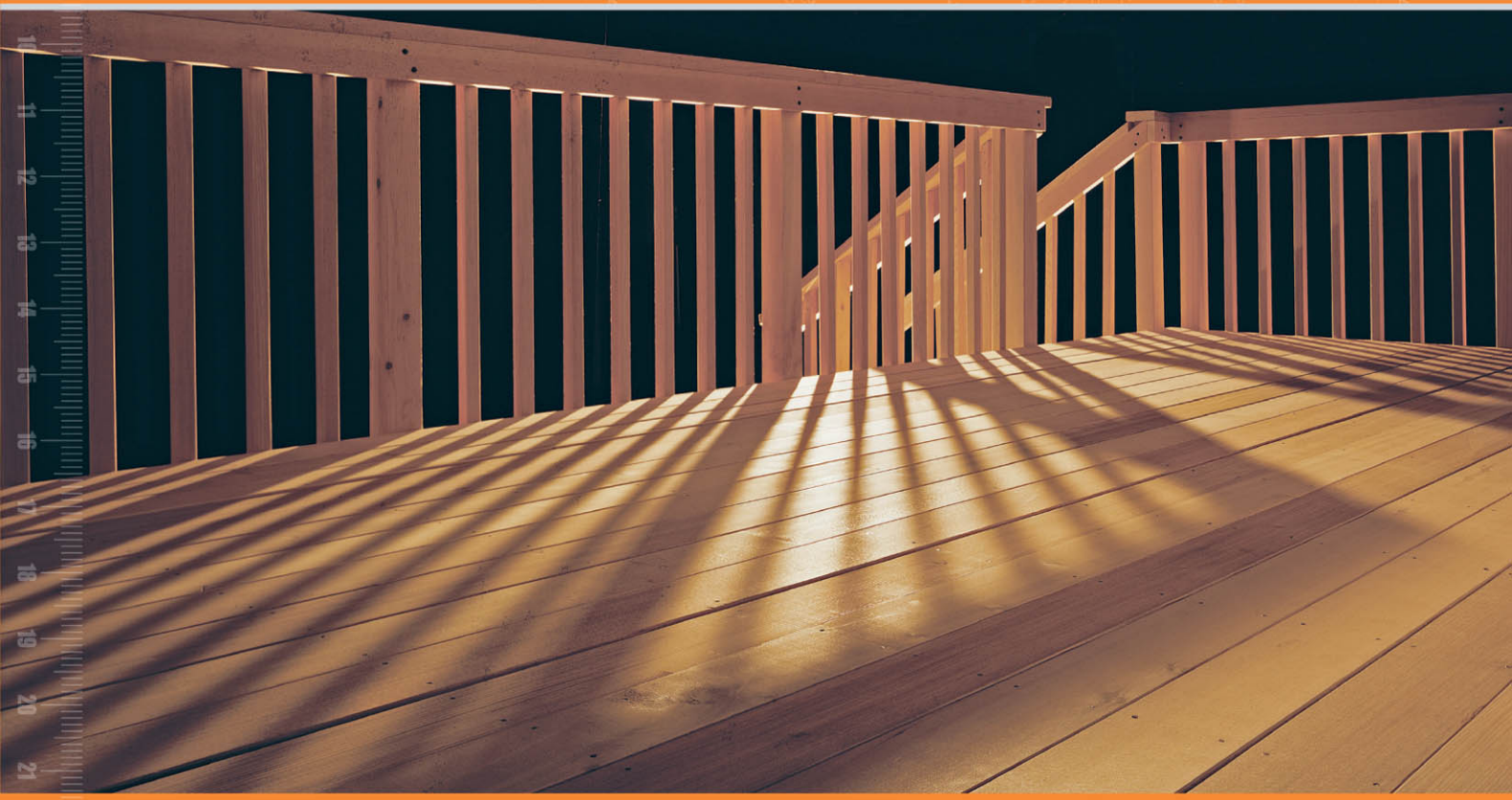

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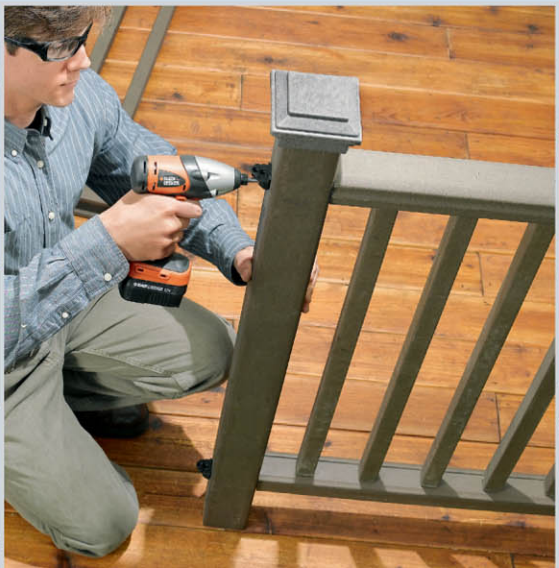

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#175 Dtp:225 Page:1

CONTENTS

Introduction 4

Deck Basics

Deck Building Codes 7

Determining Lumber Size 12

Understanding Loads 14

Developing Your Deck Plan 16

Working with Building Inspectors 18

Deck Materials

Footings & Structural Lumber 20

Wood Decking 22

Non-Wood Decking 24

Fasteners 26

Metal Connectors 28

Screws & Nails 32

Flashing 34

Footings 35

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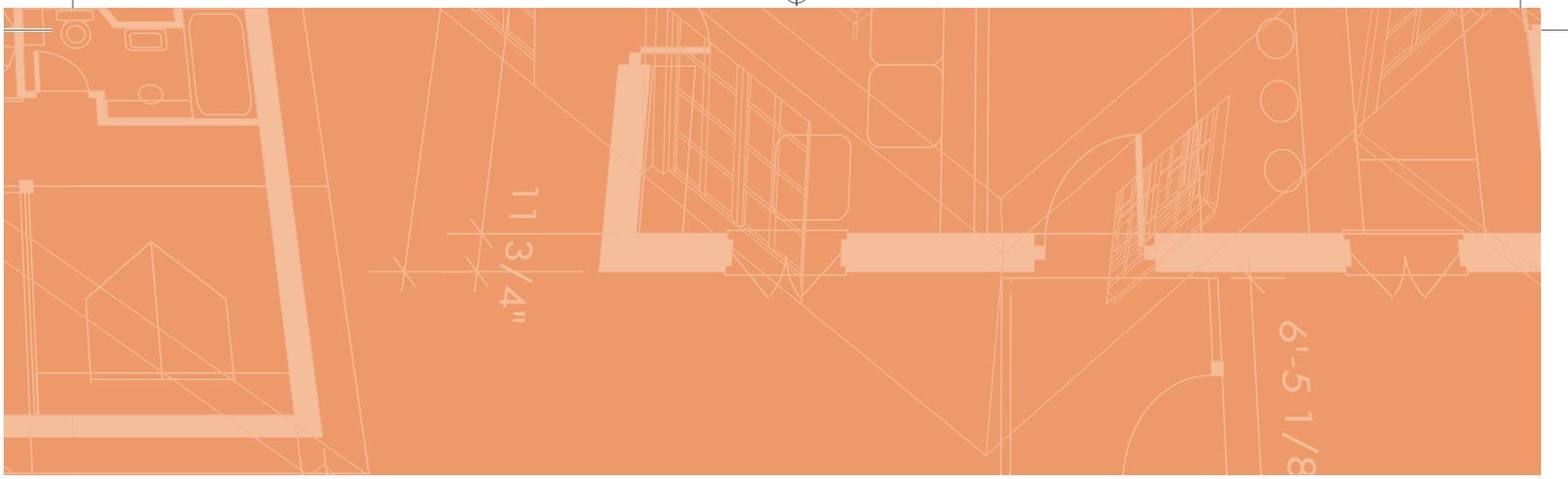

Deck Construction

A Step-by-Step Overview for Deck Building 38

Ledgers 40

Post Footings 48

Footings 54

Posts 58

Beams 64

Joists 68

Angles 74

Curves 80

Insets 86

Finishing Decks

Decking Patterns 90

Decking 92

Stairs 100

Railings 109

Curved Railings 118

Deck Skirting 122

Resources

Deck Building Glossary 124

Metric Conversions 126

Index 127

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Introduction

A DECK IS MANY THINGS, and a well-planned deck project can transform your home in so many ways. A deck can serve as a transition from yard to house, creating a room that is outside. A deck can add space to a yard by flattening out a slope to create a functional area. A deck can add space to a house by providing a dirt-free outdoor living space. Decks can be used for relaxation, entertainment, or even storage.

Decks come in all shapes and sizes—they can be as simple as an octagon only inches above the ground or as complex as a multi-level cascade flowing down two or three stories. It can look sleek and modern or weathered and full of character.

The good news about decks is that the construction skills necessary for a simple platform deck are quite basic. And, the skills needed for a complex deck are not that much more advanced. *HomeSkills: Building Decks* contains all the information you need to plan and construct the most popular walkout decks complete with railings and stairs. All aspects are covered from planning and working with building inspectors, to pouring concrete footings, decking options, curved railings, and tree cutouts.

The main issue in deck building is planning and following the very specific building codes for decks. These building codes are important because decks are often places where people congregate. No one wants a party to end with revelers on their way to the emergency room because proper building rules were not followed. If a deck is constructed properly and fully according to code, those accidents are unlikely to happen.

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#175 Dtp:225 Page:4

DECK BASICS

Deck Building Codes 7

Determining Lumber Size..... 12

Understanding Loads 14

Developing Your Deck Plan 16

Working with Building Inspectors..... 18

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ONE OF THE BENEFITS of building a deck is that you can create an impressive structure in a relatively short period of time, even with modest tools and skills. It's an exciting project to undertake, but don't let your energy and enthusiasm get the best of you. Without careful planning and design on the front end, your deck project could be frustrating to build, unnecessarily costly, or even dangerous to use when you're through. So, in order to put your best foot forward, plan to spend those first hours of the project at a desk developing a thorough plan.

As you begin the planning process, keep in mind that your deck needs to satisfy four goals: it should meet the functional needs of your household, contribute to your home's curb appeal and property value, fit your project budget, and satisfy local building codes for appearance, location, and safety. This chapter will help familiarize you with building codes and deck materials so you can build confidently and correctly, the first time.

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DECK BUILDING CODES

Most decks are relatively simple structures, but even a basic deck project must conform to the requirements of building codes in your area. In fact, virtually every aspect of your new deck—from its location on your property, to the design you choose and the materials you buy to build it—must meet stringent guidelines for safety. Codes vary to some degree from state to state, but they are based on general regulations established by the International Residential Code.

Your local building inspector can provide you with a list of the relevant deck codes and help you interpret them so you can create code-compliant plans for your deck project.

The next few pages will provide a survey of some of the more common code requirements for decks, although it is by no means comprehensive. Use this section as a way to familiarize yourself with the code requirements you will probably face as you plan and build your new deck.

Footing diameter and depth is determined by your local codes, based on the estimated load of the deck and on the composition of your soil. In regions with cold winters, footings must extend a prescribed depth below the frost line. Minimum diameter for concrete footings is 8".

Metal flashings must be used to prevent moisture from penetrating between the ledger and the wall.

Beams may overhang posts by no more than 1 foot. Building regulations generally require that beams should rest on top of or be fully notched into posts, secured with metal post-beam caps or bolts.

Tip

You may want to download a free PDF copy of the "Prescriptive Residential Deck Construction Guide" from the American Wood Council at www.awc.org. In addition, many communities publish local building codes on their websites.

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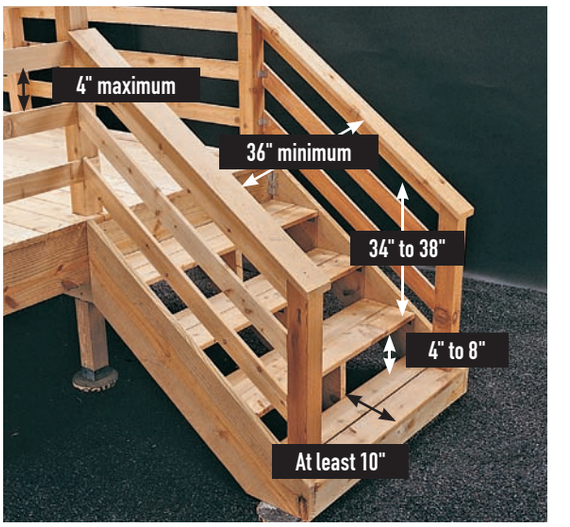
Railings are required by local codes for decks more than 30" above the ground and must usually be at least 36" in height. Bottom rails must be positioned with no more than 4" of open space below them. Balusters, whether vertical or horizontal, can be spaced no more than 4" apart.

Code violation. The International Building Code no longer allows joists to straddle the sides of a post fastened with through bolts, as shown here. It no longer endorses structural posts made of 4 × 4 lumber: 6 × 6 is the minimum size. Railing posts may be 4 × 4.



Stairs must be at least 36" wide. Vertical step risers must be between 4" and 7¾" and uniform in height within a staircase. Treads must have a horizontal run of at least 10" and be uniform in size within a staircase. Stair railings should be 34" to 38" above the noses of the step treads, and there should be no more than 6" of space between the bottom rail and the steps. The space between the rails or balusters should be no more than 4". Note: Grippable handrails may be required for decks with four or more risers. Consult your local building inspector.

Beam assemblies. Deck beams made of 2× lumber must be fastened together with staggered rows of 10d galvanized common nails or 3" deck screws. If the wood components that make up the beam are spliced together, stagger the splices and locate them over beams for added strength.

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Engineered beams, such as a laminated wood product or steel girder, should be used on decks with very long joist spans, where standard dimension lumber is not adequate for the load. Engineered beams for decks must be rated for exterior use.

Post-to-beam attachment. Deck posts, regardless of length or size of deck, should be made of minimum 6 × 6 structural lumber. Notch the posts so that beams can bear fully in the notch, and attach them with pairs of ½-in.-diameter galvanized through bolts and washers. Or, you can mount beams on top of posts with galvanized post cap hardware. Some codes prohibit the use of notched posts. Check with your local building department.

Ledgers and rim joists. When a ledger is fastened to a rim joist, the house siding must be removed prior to installation. Either ½-in.-diameter lag screws or through-bolts with washers can be used to make the connections.

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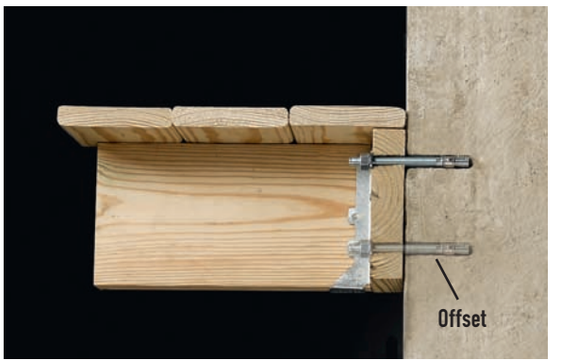
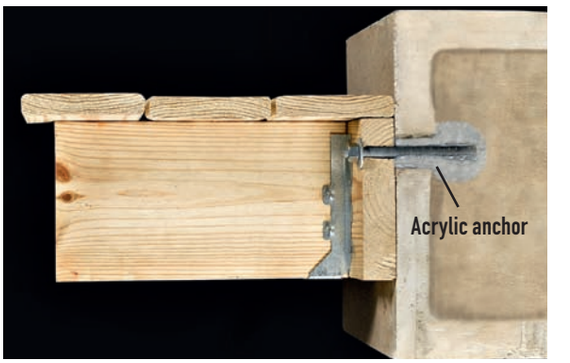
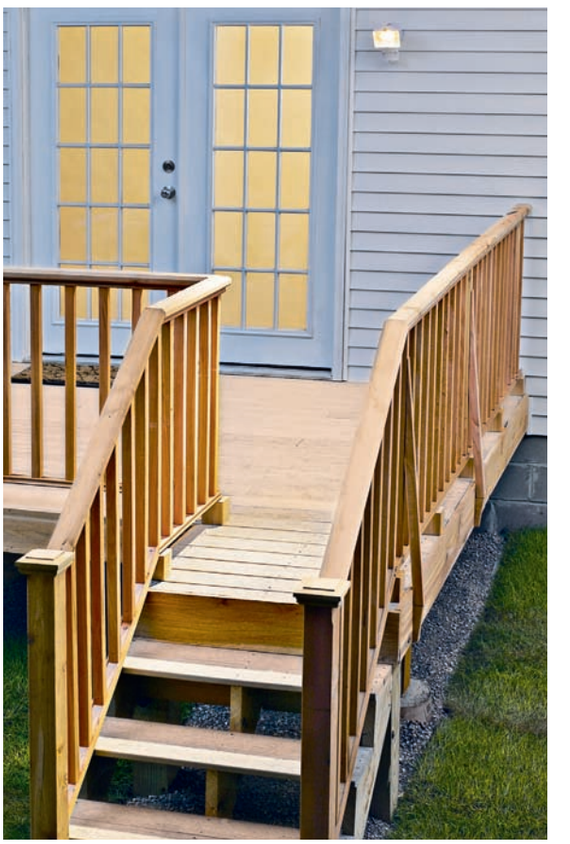


Ledgers and concrete walls. Ledgers fastened to solid concrete must be attached with bolts and washers driven into approved expansion, epoxy, or adhesive anchors.



Ledgers and block walls. When fastening ledgers to hollow concrete block walls, secure the attachment bolts to the wall with approved epoxy anchors (also called acrylic anchors).

No notched railing posts. Code no longer allows deck railing posts to be notched where they attach to the deck rim joists. Railing posts should be fastened to rim joists with pairs of ½-in.-diameter through bolts and washers. In some cases, hold-down anchor hardware may also be required.



Stair lighting. Deck stairs must be illuminated at night from a light located at the top of the landing. The light can be switch-controlled from inside the house, motion-controlled, or used in conjunction with a timer switch.

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Chimney chases and bays. When framing a deck around a chimney or bay window, a suitable double header must be added where the ledger is spliced to accommodate the obstruction. The type of header shown here can span a maximum of 6 ft.

Rim joist connections. Attach rim joists to the end of each joist with five #10 × 3-in. minimum wood screws. Secure decking to the top of rim joists with #10 × 3-in. minimum wood screws, two per board.

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DETERMINING LUMBER SIZE

A deck has seven major structural parts: the ledger, decking, joists, one or more beams, posts, stairway stringers, and stairway treads. To create a working design plan and choose the correct lumber size, you must know the span limits of each part of the deck. The ledger is attached directly to the house and does not have a span limit.

A span limit is the safe distance a board can cross without support from underneath. The maximum safe span depends on the size and wood species of the board. For example, 2 × 6 southern pine joists spaced 16 inches on-center can safely span 9 feet 9 inches, while 2 × 10 joists can span 16 feet 1 inch.

Begin planning your deck by first choosing the size and pattern for the decking. Determine the actual layout of joists and beams by using the tables on the opposite page and information in the "Prescriptive Residential Deck Construction Guide" available at www.awc.org. In general, a deck designed with larger lumber, such as 2 × 12 joists and beams, requires fewer pieces because the boards have a longer span limit. Finally, choose the stair and railing lumber that fits your plan, using the same tables.

Use the design plans to make a complete list of the quantities of each lumber size your deck requires. Add 10 percent to compensate for lumber flaws and construction errors. Full-service lumberyards have extensive selections of lumber, but prices may be higher than those at home improvement centers.

Nominal vs. Actual Lumber Dimensions:
When planning a deck, remember that the actual size of lumber is smaller than the nominal size by which lumber is sold. Use the actual dimensions when drawing a deck design plan.

Nominal	Actual
1 x 4	¾" x 3½"
5/4 x 6	1" x 5½"
2 x 4	1½" x 3½"
2 x 6	1½" x 5½"
2 x 8	1½" x 7¼"
2 x 10	1½" x 9¼"
2 x 12	1½" x 11¼"
4 x 4	3½" x 3½"
6 x 6	5¼" x 5¼"

Tip

The quality of lumber at home centers can vary. You can inspect the wood and hand-pick the pieces you want or add a larger percentage to compensate for lumber flaws. Both lumberyards and home centers will deliver lumber for a small fee, and you can usually return unused, uncut lumber if you keep your receipts.

CHART 1: MAXIMUM SPANS FOR VARIOUS JOIST SIZES

	Southern Pine			Ponderosa Pine			Western Cedar		
Size	12" OC	16" OC	24" OC	12" OC	16" OC	24" OC	12" OC	16" OC	24" OC
2 × 6	10 ft. 9"	9 ft. 9"	8 ft. 6"	9 ft. 2"	8 ft. 4"	7 ft. 0"	9 ft. 2"	8 ft. 4"	7 ft. 3"
2 × 8	14 ft. 2"	12 ft. 10"	11 ft. 0"	12 ft. 1"	10 ft. 10"	8 ft. 10"	12 ft. 1"	11 ft. 0"	9 ft. 2"
2 × 10	18 ft. 0"	16 ft. 1"	13 ft. 5"	15 ft. 4"	13 ft. 3"	10 ft. 10"	15 ft. 5"	13 ft. 9"	11 ft. 3"
2 × 12	21 ft. 9"	19 ft. 0"	15 ft. 4"	17 ft. 9"	15 ft. 5"	12 ft. 7"	18 ft. 5"	16 ft. 5"	13 ft. 0"

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DIMENSION & SPAN LIMIT TABLES FOR DECK LUMBER

Recommended Decking Span Between Joists: Decking boards can be made from a variety of lumber sizes. For a basic deck use 2 × 4 or 2 × 6 lumber with joists spaced 16 inches apart.

Decking Boards	Max Span
5/4 x 4 or 5/4 x 6, laid straight	6"
5/4 x 4 or 5/4 x 6, laid diagonal	12"
5/4 x 6 composite, laid straight	12"
5/4 x 6 composite, laid diagonal	See manu. specs
2 x 4 or 2 x 6, laid straight	16"
2 x 4 or 2 x 6, laid diagonal	12"
2 x 4, laid on edge	24"

Minimum Stair Stringer Sizes: Size of stair stringers depends on the span of the stairway. For example, if the bottom of the stairway lies 7 feet from the deck, build the stringers from 2 × 12s. Stringers should be spaced no more than 36 inches apart. Use of a center stringer is recommended for stairways with more than three steps.

Span of Stairway	Stringer Size
Up to 6 ft.	2 x 10
More than 6 ft.	2 x 12

Recommended Railing Sizes: Sizes of posts, rails, and caps depend on the spacing of the railing posts. For example, if railing posts are spaced 6 feet apart, use 4 × 4 posts and 2 × 6 rails and caps.

Space Between	Post Size	Cap Size	Rail Size
2 ft. to 3 ft.	2 x 4	2 x 4	2 x 4
3 ft. to 4 ft.	4 x 4	2 x 4	2 x 4
4 ft. to 6 ft.	4 x 4	2 x 6	2 x 6

Meet or exceed all lumber size codes. For example, use lumber that is at least 6 × 6" for all deck posts, regardless of the size of the deck or the length of the post.

Tip

Composite, plastic, and aluminum decking all have their own span specifications, which are shorter than the standardized specifications for lumber. Always consult the manufacturer's recommendations when using non-wood decking. None of these materials are suitable for use in structural support.

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UNDERSTANDING LOADS

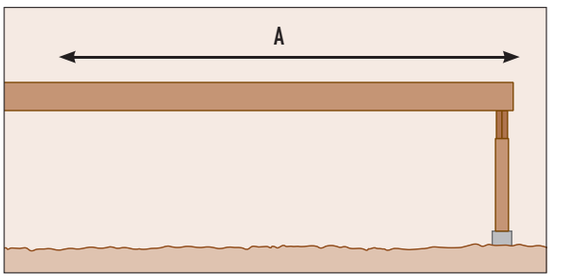
The supporting structural members of a deck—the posts, beams, and joists—must be sturdy enough to easily support the heaviest anticipated load on the deck. They must not only carry the substantial weight of the surface decking and railings, but also the weight of people, deck furnishings, and, in some climates, snow.

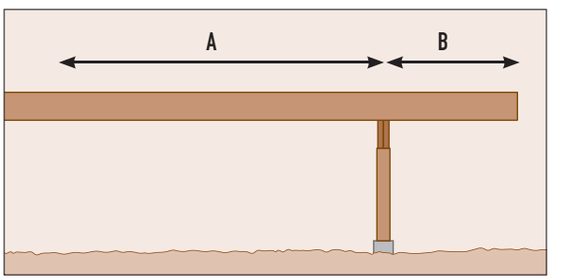
The charts and diagrams shown here will help you plan a deck so the size and spacing of the structural members are sufficient to support the load, assuming normal use. These recommendations are followed in most regions, but you should still check with your local building official for regulations that are unique to your area. In cases where the deck will support a hot tub or pool, you must consult your local building inspections office for load guidelines.

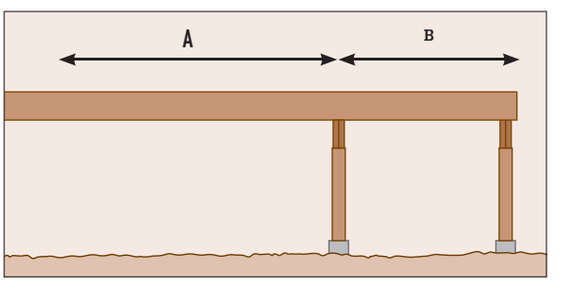
When choosing lumber for the structural members of your deck, select the diagram below that best matches your deck design, then follow the advice for applying the charts on the opposite page. Since different species of wood have different strengths, make sure to use the entries that match the type of lumber sold by your building center. When selecting the size for concrete footings, make sure to consider the composition of your soil; dense soils require footings with a larger diameter.

Post-and-beam deck: Using Chart 1, determine the proper size for your joists, based on the on-center (OC) spacing between joists and the overall length, or span, of the joists (A). For example, if you will be using southern pine joists to span a 12-ft. distance, you can use 2 × 8 lumber spaced no more than 16" apart, or 2 × 10 lumber spaced no more than 24" apart. Once you have determined allowable joist sizes, use Chart 2 to determine an appropriate beam size, post spacing, and footing size for your deck.

Cantilevered deck: Use the distance from the ledger to the beam (A) to determine minimum joist size, and use A + (2 × B) when choosing beam and footing sizes. For example, if your deck measures 9 ft. from ledger to beam, with an additional 3-ft. cantilevered overhang, use 9 ft. to choose a joist size from Chart 1 (2 × 6 southern pine joists spaced 16" apart, or







2 × 8 joists spaced 24" apart). Then, use A + (2 × B), or 15 ft., to find an appropriate beam size, post spacing, and footing size from Chart 2. If your deck cantilevers more than 18" beyond the support beam, add 1" to the recommended diameter for footings.

Multiple-beam deck: Use distance A or B, whichever is larger, when determining joist size from Chart 1. For example, if your deck measures 8 ft. to beam #1 and another 4 ft. to beam #2, you can use 2 × 6 southern pine joists. Referring to Chart 2, use the total distance A + B to determine the size of beam #1, the spacing for the posts, and the size of the footings. Use joist length B to determine the size of beam #2, the post spacing, and footing size. For example, with an overall span of 12 ft. (8 ft. to the first beam, 4 ft. to the second), beam #1 could be made from two southern pine 2 × 8s; beam #2, from two 2 × 6s.

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CHART 2: DIAMETERS FOR POST FOOTING (INCHES)

Joist Length		Post Spacing 4'	5'	6'	7'	8'	9'	10'	11'	12'
6'	Southern Pine Beam	1–2 × 6	1–2 × 6	1–2 × 6	2–2 × 6	2–2 × 6	2–2 × 6	2–2 × 8	2–2 × 8	2–2 × 10
	Ponderosa Pine Beam	1–2 × 6	1–2 × 6	1–2 × 8	2–2 × 8	2–2 × 8	2–2 × 8	2–2 × 10	2–2 × 10	2–2 × 12
	Corner Footing	6 5 4	7 6 5	7 6 5	8 7 6	9 7 6	9 7 6	10 8 7	10 8 7	10 9 7
	Intermediate Footing	9 8 7	10 8 7	10 9 7	11 9 8	12 10 9	13 10 9	14 11 10	14 12 10	15 12 10
7'	Southern Pine Beam	1–2 × 6	1–2 × 6	1–2 × 6	2–2 × 6	2–2 × 6	2–2 × 8	2–2 × 8	2–2 × 10	2–2 × 10
	Ponderosa Pine Beam	1–2 × 6	1–2 × 6	1–2 × 8	2–2 × 8	2–2 × 8	2–2 × 10	2–2 × 10	2–2 × 10	2–2 × 12
	Corner Footing	7 5 5	7 6 5	8 7 6	9 7 6	9 8 7	10 8 7	10 8 7	11 9 8	11 9 8
	Intermediate Footing	9 8 7	10 8 7	11 9 8	12 10 9	13 11 9	14 11 10	15 12 10	15 13 11	16 13 11
8'	Southern Pine Beam	1–2 × 6	1–2 × 6	2–2 × 6	2–2 × 6	2–2 × 8	2–2 × 8	2–2 × 8	2–2 × 10	2–2 × 10
	Ponderosa Pine Beam	1–2 × 6	2–2 × 6	2–2 × 8	2–2 × 8	2–2 × 8	2–2 × 10	2–2 × 10	2–2 × 10	3–2 × 10
	Corner Footing	7 6 5	8 6 6	9 7 6	9 8 7	10 8 7	10 8 7	11 9 8	11 9 8	12 10 9
	Intermediate Footing	10 8 7	11 9 8	12 10 9	13 11 9	14 11 10	15 12 10	16 13 11	16 13 12	17 14 12
9'	Southern Pine Beam	1–2 × 6	1–2 × 6	2–2 × 6	2–2 × 6	2–2 × 8	2–2 × 8	2–2 × 10	2–2 × 10	2–2 × 12
	Ponderosa Pine Beam	1–2 × 6	2–2 × 6	2–2 × 8	2–2 × 8	2–2 × 10	2–2 × 10	2–2 × 10	3–2 × 10	3–2 × 10
	Corner Footing	7 6 5	8 7 6	9 7 6	10 8 7	10 9 7	11 9 8	12 10 8	12 10 9	13 10 9
	Intermediate Footing	10 9 7	12 10 8	13 10 9	14 11 10	15 12 10	16 13 11	17 14 12	17 14 12	18 15 13
10'	Southern Pine Beam	1–2 × 6	1–2 × 6	2–2 × 6	2–2 × 6	2–2 × 8	2–2 × 8	2–2 × 10	2–2 × 12	2–2 × 12
	Ponderosa Pine Beam	1–2 × 6	1–2 × 6	2–2 × 8	2–2 × 8	2–2 × 10	2–2 × 10	2–2 × 12	3–2 × 10	3–2 × 12
	Corner Footing	8 6 6	9 7 6	10 8 7	10 8 7	11 9 8	12 10 8	12 10 9	13 11 9	14 11 10
	Intermediate Footing	11 9 8	12 10 9	14 11 10	15 12 10	16 13 11	17 14 12	17 14 12	18 15 13	19 16 14
11'	Southern Pine Beam	1–2 × 6	2–2 × 6	2–2 × 6	2–2 × 8	2–2 × 8	2–2 × 10	2–2 × 10	2–2 × 12	2–2 × 12
	Ponderosa Pine Beam	2–2 × 6	2–2 × 6	2–2 × 8	2–2 × 8	2–2 × 10	2–2 × 12	2–2 × 12	3–2 × 10	3–2 × 12
	Corner Footing	8 7 6	9 7 6	10 8 7	11 9 8	12 9 8	12 10 9	13 11 9	14 11 10	14 12 10
	Intermediate Footing	12 9 8	13 11 9	14 12 10	15 12 10	16 13 11	17 14 12	17 14 12	18 15 13	19 16 14
12'	Southern Pine Beam	1–2 × 6	2–2 × 6	2–2 × 6	2–2 × 8	2–2 × 8	2–2 × 10	2–2 × 10	2–2 × 12	3–2 × 10
	Ponderosa Pine Beam	2–2 × 6	2–2 × 6	2–2 × 8	2–2 × 10	2–2 × 10	2–2 × 12	2–2 × 12	3–2 × 12	3–2 × 12
	Corner Footing	9 7 6	10 8 7	10 9 7	11 9 8	12 10 9	13 10 9	14 11 10	14 12 10	15 12 10
	Intermediate Footing	12 10 9	14 11 10	15 12 10	16 13 11	17 14 12	18 15 13	19 16 14	20 16 14	21 17 15
13'	Southern Pine Beam	1–2 × 6	2–2 × 6	2–2 × 6	2–2 × 8	2–2 × 8	2–2 × 10	2–2 × 10	2–2 × 12	3–2 × 10
	Ponderosa Pine Beam	2–2 × 6	2–2 × 6	2–2 × 8	2–2 × 10	2–2 × 12	2–2 × 12	2–2 × 12	3–2 × 12	3–2 × 12
	Corner Footing	9 7 6	10 8 7	11 9 8	12 10 8	13 10 9	13 11 9	14 12 10	15 12 10	15 13 11
	Intermediate Footing	13 10 9	14 12 10	15 13 11	17 14 12	18 15 13	19 15 13	20 16 14	21 17 15	22 18 15
14'	Southern Pine Beam	1–2 × 6	2–2 × 6	2–2 × 6	2–2 × 8	2–2 × 10	2–2 × 10	2–2 × 12	3–2 × 10	3–2 × 12
	Ponderosa Pine Beam	2–2 × 6	2–2 × 8	2–2 × 8	2–2 × 10	2–2 × 12	3–2 × 10	3–2 × 12	3–2 × 12	Eng Bm
	Corner Footing	9 8 7	10 8 7	11 9 8	12 10 9	13 11 9	14 11 10	15 12 10	15 13 11	16 13 11
	Intermediate Footing	13 11 9	15 12 10	16 13 11	17 14 12	18 15 13	20 16 14	21 17 15	22 18 15	23 18 16
15'	Southern Pine Beam	2–2 × 6	2–2 × 6	2–2 × 8	2–2 × 8	2–2 × 10	2–2 × 12	2–2 × 12	3–2 × 10	3–2 × 12
	Ponderosa Pine Beam	2–2 × 6	2–2 × 8	2–2 × 8	2–2 × 10	3–2 × 10	3–2 × 10	3–2 × 12	3–2 × 12	Eng Bm
	Corner Footing	10 8 7	11 9 8	12 10 8	13 10 9	14 11 10	14 12 10	15 12 11	16 13 11	17 14 12
	Intermediate Footing	14 11 10	15 12 11	17 14 12	18 15 13	19 16 14	20 17 14	21 17 15	22 18 16	23 19 17

10 8 7
14 11 10

Soil composition: Clay Sand Gravel

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#175 Dtp:225 Page:15

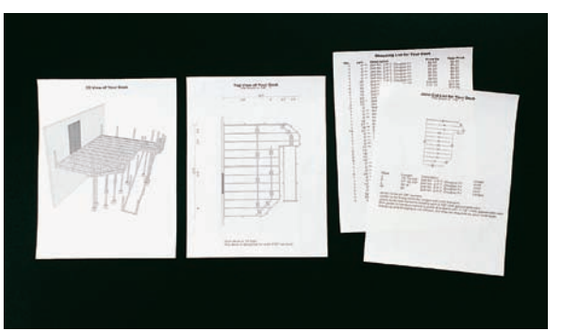
DEVELOPING YOUR DECK PLAN

A deck plan is more than just measured drawings. It needs to account for your deck's functional purposes as well as its dimensional form. Before you begin drawing plans, determine everything you want your deck to include. Here's where you'll focus on functional concerns. The size, shape, and location of your deck can be affected by several questions: Will the deck be used for entertaining? Will you cook on it? Do you need privacy? Consider how the features of the house and yard influence the deck design. Weather, time of day, and seasonal changes affect deck usage. For example, if your deck will be used mainly for summertime evening meals, look at the sun, shade, and wind patterns on the planned site during this time of day.

Of course, building plans also help you estimate lumber and hardware needs, and provide the measurements needed to lay out the deck and cut the lumber. You will need two types of drawings for your deck plans and to obtain a building permit. A plan view shows the parts of the deck as they are viewed from directly overhead. An elevation shows the deck parts as viewed from the side or front.

Tip

Is a southern or western exposure your only option for a deck? Retractable awnings can keep these sunny decks cool and useable.



Many building centers will help you design and create deck plan drawings if you purchase your lumber and other deck materials from them. Their design capabilities include determining a detailed lumber and materials list based on the exact deck plan created.

Calculator Conversion Chart

As a carpenter you will measure in eighths and sixteenths. But your calculator works in tenths and hundredths. Here's a handy chart to help you convert back and forth.

8ths	16ths	Decimal
	1	.0625
1	2	.125
	3	.1875
2	4	.25
	5	.3125
3	6	.375
	7	.4375
4	8	.5
	9	.5625
5	10	.625
	11	.6875
6	12	.75
	13	.8125
7	14	.875
	15	.9375
8	16	1

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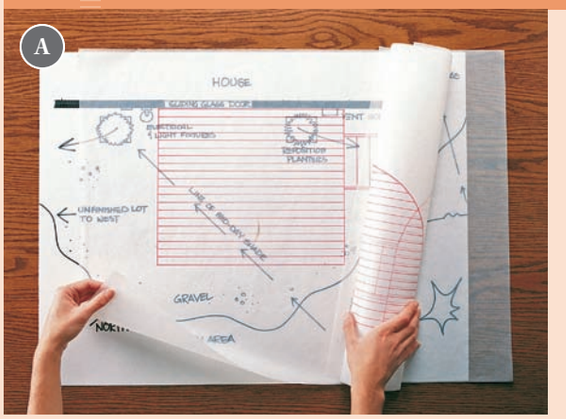
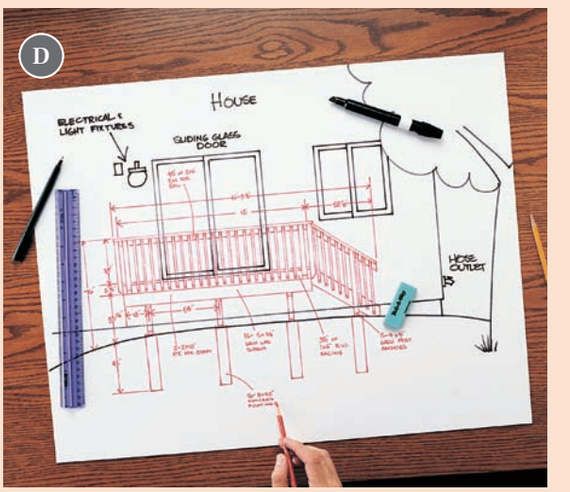
#175 Dtp:225 Page:16

CREATING DESIGN DRAWINGS





A Use tracing paper to sketch different deck layouts. Then, test your ideas by overlaying the deck sketches onto a drawing of your building site. Make sure to consider sun patterns and the locations of existing landscape features when developing a deck plan. Adapt an existing deck plan, either borrowed from a book or magazine, or purchased in blueprint form. Tracing paper, pens, and measuring tools are all you need to revise an existing deck plan.

B Use drafting tools and graph paper if you are creating a deck plan from scratch. Use a generous scale, such as 1" equals 1 ft., that allows you to illustrate the deck in fine detail. Remember to create both overhead plan drawings and side elevation drawings of your project.

C To avoid confusion, do not try to show all parts of the deck in a single plan view, especially for a complicated or multi-level deck. First, draw one plan view that shows the deck outline and the pattern of the decking boards. Then make another plan view (or more) that shows the underlying ledger, joists, beams, and posts.

D Elevation drawings must include deck dimensions, size and type of hardware to be used, beam sizes (if visible in drawing), and footing locations and their dimensions. Also indicate the grade of the ground in the deck area. Make multiple elevation drawings if necessary for complicated or multi-level decks.

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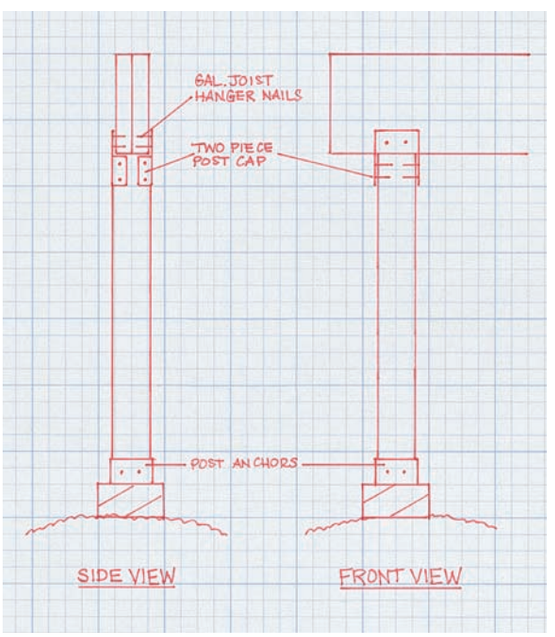
#175 Dtp:225 Page:17

WORKING WITH BUILDING INSPECTORS

In most regions, you must have your plans reviewed and approved by a building official if your deck is attached to a permanent structure or if it is more than 30 inches high. The building official makes sure that your planned deck meets building code requirements for safe construction.

These pages show some of the most common code requirements for decks. But before you design your project, check with the building inspection division of your city office, since code regulations can vary from area to area. A valuable source of planning information, the building official may provide you with a free information sheet outlining the relevant requirements.

Once you have completed your deck plans, return to the building inspections office and have the official review them. Make certain you know how many copies of the plans they require before you go. If your plans meet code, you will be issued a building permit, usually for a small fee. This process often takes a few days. Regulations may require that a field inspector review the deck at specified stages in the building process. If so, make sure to allow for the review schedule in your project schedule.



Draw detailed illustrations of the joinery methods you plan to use for all structural members of your deck. Your building official will want to see details on post-footing connections, post-beam joints, beam-joist joints, and ledger connections. Be prepared to make adjustments.

Plan-approval Checklist

When the building official reviews your deck plans, he or she will look for the following details. Make sure your plan drawings include all this information.

- Overall size and shape of the deck.
- Position of the deck relative to buildings, property lines, and setbacks. Generally, a deck must be at least 5 ft. from the property line, although this varies locality to locality.
- Location of all beams and posts.
- Detailed drawings of joinery methods for all structural members of the deck.
- Size and on-center (OC) spacing of joists.
- Height of deck above grade.
- Thickness of deck boards—or profile of composite decking.
- Type of soil that will support the concrete post footings: sand, loam, or clay.
- Species of wood to be used, and/or type of composite material.
- Types of metal connectors and other hardware you plan to use in constructing the deck.
- Lighting and other electrical outlets or fixtures that will be wired into the deck.

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#175 Dtp:225 Page:18

DECK MATERIALS

Footings & Structural Lumber.....20
Wood Decking 22
Non-Wood Decking 24
Fasteners.....26
Metal Connectors.....28
Screws & Nails 32
Flashing 34
Footings 35

001-063_30436.indd 19 4/15/13 9:57 AM
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FOOTINGS & STRUCTURAL LUMBER

Generally, pressure-treated lumber is the preferred choice for deck posts, beams, and joist framing. It offers good resistance to decay and insect infestation, it's widely available in most parts of the country and it's a cheaper alternative to other rot-resistant wood species such as cedar or redwood. Treated lumber is milled in 4 × 4, 4 × 6, and 6 × 6 sizes for posts. Larger dimensions are available by special order. You'll need 2× treated lumber for beams and joists. Joists are usually 2 × 8 or larger. If your deck is particularly large or designed with oversized spans, you may need to use engineered beams instead of building beams from treated lumber. Make sure your engineered beams are rated for exterior use. Check the grade stamps or the stapled tags on your pressure-treated posts; they should be approved to a level of .40 retention for ground contact.

Composite lumber is widely used for non-structural purposes such as decking, skirting, and railing. Made from sawdust, recycled plastic, and binders, composite lumber is available in solid, hollow, and other profiles.

Engineered beams that are rated for exterior use are a sturdy alternative to beams made from 2× lumber. They may be required if you are building a large deck with expansive or unusual spans. Your building inspector will help you make this determination.

Treated lumber is available in common nominal sizes for use as deck beams and joists. The Chemical formulations of pressure-treated lumber are alkaline copper quaternary (ACQ) and copper boron azole (CBA). Both ACQ and CBA provide wood with the same protection from decay and insect attack. However these treatments are corrosive to metals. Make sure to choose fasteners and connective hardware that are approved for use with ACQ- and CBA-treated lumber.

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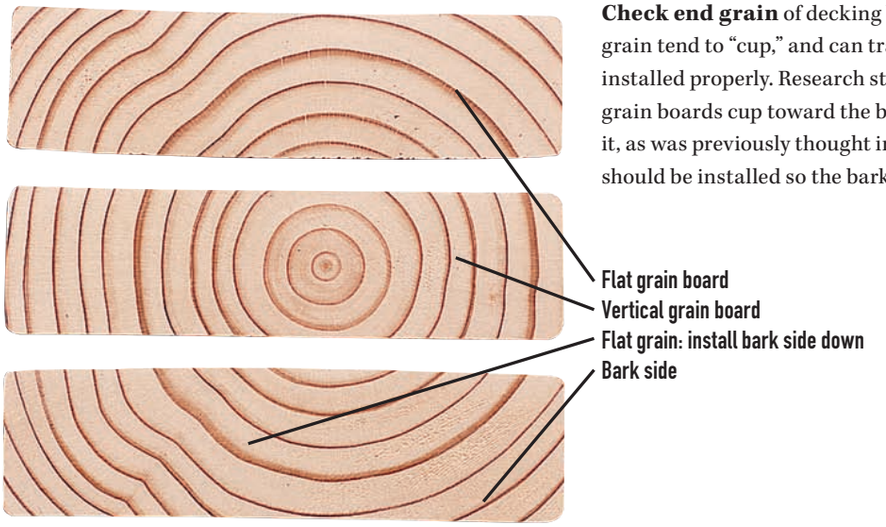

Check end grain of decking boards. Boards with flat grain tend to "cup," and can trap standing water if not installed properly. Research studies indicate that flat grain boards cup toward the bark side (not away from it, as was previously thought in the industry), and they should be installed so the bark side faces down.

Tip

Select the flattest structural lumber you can find, free of splits, checks, and large loose knots. To prevent warping, stack and store it in a dry place or cover it with a tarp until you need it.

Tip: Sealing End Grain

Seal cut edges of all lumber, including pressure-treated wood, by brushing on clear liquid sealer-preservative. Chemicals used in pressure treatment do not always penetrate completely. Sealer-preservative protects all types of wood from rot.

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#175 Dtp:225 Page:21

WOOD DECKING

Wood continues to be the most popular choice among decking materials, due in large part to price. Pressure-treated decking remains the least expensive deck option, but other types of hardwoods and softwoods feature unique grain pattern and coloring that makes them consistently desirable. Wood of all types is easy to work with, and most softwoods take stain or paint well, allowing you to alter the appearance almost at will.

The two most popular choices for wood decking are pressure-treated and cedar. Depending on where you live, you may have other options as well. Redwood may still be available if you live on the West Coast, and cypress is common in the South. Redwood, cypress, and cedar are naturally resistant to decay and insects, which makes them excellent choices for decking.

If cost is less important than quality, you might consider covering your deck with mahogany, ipê, or any of several other exotic hardwoods grouped under the term "ironwood"—so-called because their cell structures are so dense the woods will sink in water.

Tip

Naturally decay-resistant lumbers can be left unfinished to weather to a silvery gray color in a few years. However, the lifespan of the wood will be increased if you apply some sort of finish.

For pressure-treated or cedar decking, you'll have to select a thickness that works for your budget and design. One option is to use 2× lumber. It will span wider joist spacing without flexing, but generally 2× lumber is made from lower-grade material that may contain more natural defects. Another choice is to use 5/4 decking, pronounced "five quarter." Its actual dry thickness is 1 inch and the edges are radiused to help minimize splinters. Often, 5/4 lumber is clearer than 2× lumber, but it's not as stiff. You may need to space your joists more closely with 5/4 decking. Either way, you can commonly find 2× or 5/4 decking in lengths up to 16 or even 20 feet at most home centers.

Ipê

Cedar

Pressure-treated pine

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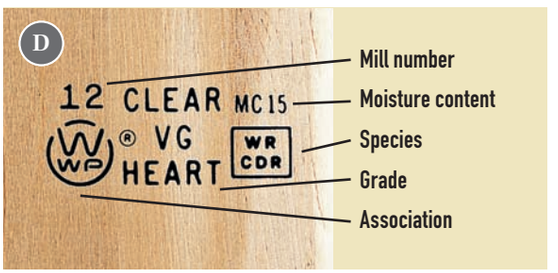

A Both 2× and 5/4 lumber are suitable for use as decking. However, 5/4 will generally be of higher quality, and the radiused edges prevent splintering—an important consideration for bare feet or if you have young children.

B Pressure-treated lumber stamps list the type of preservative and the chemical retention level, as well as the exposure rating and the name and location of the treating company.

C Be picky about the quality of the decking you buy. Natural defects in the wood could make the piece harder to install or deteriorate prematurely. Watch for soft pockets of sap in the wood. Sap will get sticky in warm weather, and the resin can bleed through wood finishes, leaving brown stains.

D Cedar grade stamps list the mill number, moisture content, species, lumber grade, and membership association. Western red cedar (WRC) or incense cedar (INC) for decks should be heartwood (HEART) with a maximum moisture content of 15% (MC15).

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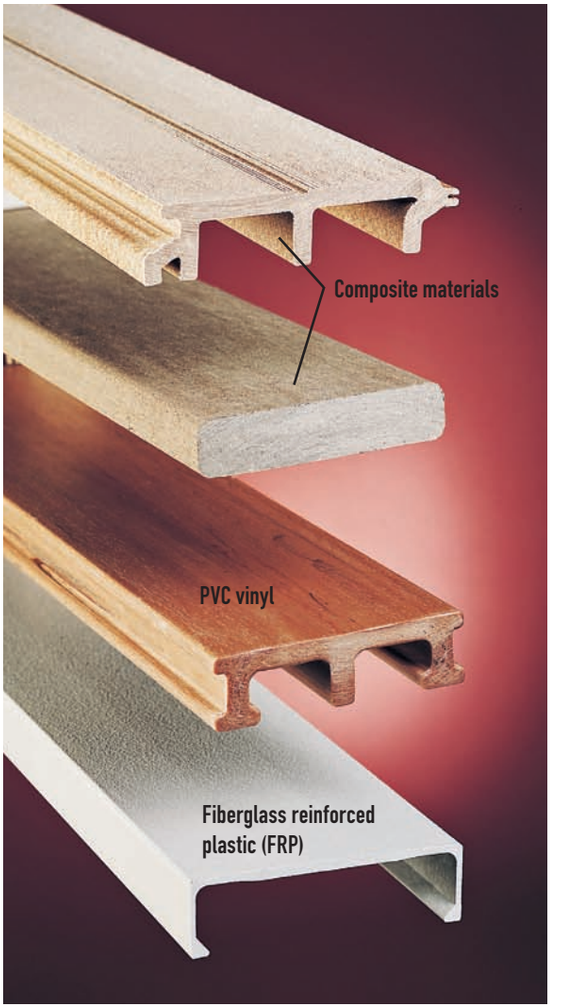
NON-WOOD DECKING

Decking made from non-wood materials such as composite lumber and PVC has taken over a large share of the decking market in recent years. Composite decking has only been around for a few decades, but it's a compelling option to consider for your deck. Most forms of composite decking are made from a blend of post-consumer plastic waste and wood pulp or non-wood fibers. The plastic component—polyethylene or polypropylene—makes the material impervious to rotting, and insects don't like it. Unlike solid wood, it has no grain, so it won't splinter or crack, and there are no knots or natural defects to cut away. Other formulations of synthetic decking contain no wood at all. These are made from polyethylene, PVC, polystyrene, or fiberglass blends.

When composite lumber first hit the market, it didn't look anything like wood, and color choices were limited. Now, it's available in a range of wood textures and colors. Most products are non-toxic, easy to cut, drill, and fasten, and do not require finishing. Maintenance is usually limited to an occasional cleaning or spot removal. However, composite decking is more flexible than wood, so you may need to use closer joist spacing in your deck design. It's also heavier than wood and generally more expensive.

Tip

Composite decking comes with impressive warranties, which may last from 10 years to a lifetime, depending on the product. Some warranties are transferable from one homeowner to the next.



Composite and other non-wood decking often require special fasteners that are designed to reduce "mushrooming" that occurs when the decking material bulges up around the screwhead. Pilot holes are recommended for some types as well.

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Composite decking colors cover the spectrum of wood tones, plus grays and white. The color is continuous throughout the material, but exposure to strong, direct sunlight may cause the surface color to fade. Surface patterns and textures of composite decking range from virtually smooth to intricate wood grain styles. Patterns and textures vary by manufacturer, but many offer varieties that convincingly mimic species of wood.

While composite decking can be fastened down conventionally with screws, you may be able to use various edge-fastening systems instead to avoid driving screws through the board faces.

Composite Materials

Composite materials blend together wood fibers and recycled plastics to create a rigid product that, unlike wood, will not rot, splinter, warp, or crack. Painting or staining is unnecessary. Like wood, these deck boards can be cut to size, using a circular saw with a large-tooth blade.

PVC vinyl and plastic decking materials are shipped in kits that contain everything necessary to install the decking other than the deck screws. The kits are preordered to size, usually in multiples of the combined width of a deck board and the fasteners. The drawback of PVC vinyl decking is that it expands and contracts with freeze/thaw cycles.

Fiberglass reinforced plastic (FRP) decking will last a lifetime. Manufacturers claim that the material is three times as strong as wood and not affected by heat, sunlight, or severe weather. The decking is preordered to size, but if necessary, it can be cut using a circular saw with a diamond-tip or masonry blade.

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FASTENERS

Certain structural connections of your deck will require the use of lag screws, through bolts, and concrete anchors to withstand the heavy loads and sheer forces applied to a deck. Be sure to use hot-dipped galvanized or stainless steel hardware to prevent rusting or corrosion from pressure-treating chemicals.

Here is an overview of the anchoring fasteners you may need for your project.

Tip

Building codes require that you install a washer beneath the heads of lag screws or bolts and another washer before attaching nuts. Washers prevent fasteners from tearing through wood and secure hardware under stress.

Galvanized or stainless steel lag screws and washers are the correct fasteners for installing ledgers to the band joist of a house. You can also use them for making other wood-to-wood connections.

Fasteners for Anchoring

Use ½"-diameter or larger through bolts, washers, and nuts for fastening beams to posts or railing posts to joists. They should be galvanized or made of stainless steel for corrosion resistance.

J-bolts, embedded in the wet concrete of deck footings, provide a secure connection for attaching concrete footings to metal connecting hardware.

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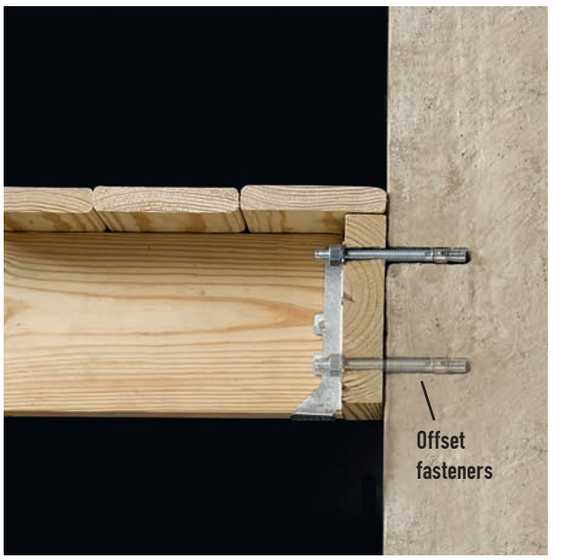

Wedge or sleeve anchors draw a wedge through a hollow sleeve, expanding it to form a tight fit in solid concrete. A nut on the threaded end holds the ledger boards in place.

A bolt driven through the foundation from the inside can be fitted with a washer and nut to secure the ledger.

Soft metal shield anchors expand when lag screws are driven into them. They make suitable connections in either solid concrete or hollow block foundations.

High strength epoxy and threaded rod are good options for attaching metal connecting hardware to concrete footings.

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METAL CONNECTORS

Sheet-metal connecting hardware comes in assorted shapes and styles. It is used to create strong wood-to-wood or wood-to-concrete joints quickly and easily. For instance, metal post anchors not only provide a simple way to attach posts and footings, they also create space between the two surfaces so post ends stay dry. Joist hangers are a fast way to hang long, heavy joists accurately. Post beam caps, T-straps, and angled joist hangers are ideal solutions for building stacked joints or when space doesn't allow you access to drive screws or nails from behind the joint.

Make sure to buy hot-dipped galvanized or stainless steel connecting hardware.

Tip

Metal connector product labels should identify whether or not the hardware is suitable for pressure-treated wood and outdoor use. Only use hangers rated for exposure to weather and the type of lumber being used. Use joist hanger nails made from the same material as the hardware.

Deck post ties fasten stair or railing posts to stringers or joists without through bolts. Hardware is manufactured in 2 × 4 and 4 × 4 size options.

Framing anchors can be used to fasten rim joists together at corners or make other right-angle attachments, such as stair stringers to rim joists.

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#175 Dtp:225 Page:28

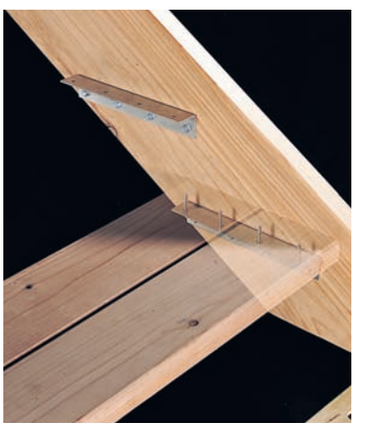
Hanger Hardware for Decks

Post anchors hold deck posts in place, and raise the base of the posts to help prevent water from entering the end grain of the post.

Angle brackets help reinforce header and outside joists. Angle brackets are also used to attach stair stringers to the deck.

Joist hangers are used to attach joists to the ledger and header joist. Double hangers are used when decking patterns require a double-width joist.

Angled joist hangers are used to frame decks that have unusual angles or decking patterns.



Stair cleats support the treads of deck steps. Cleats are attached to stair stringers with ¼ × 1¼" galvanized lag screws.

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(Fogra 39)Job:04-30436 Title:MBI-HomeSkills Building Decks
#175 Dtp:225 Page:29

Post-beam caps secure beams on top of posts and are available in one-piece or adjustable styles.

H-fit rafter ties attach 2× joists or rafters to the top of a beam between beam ends.

Seismic ties attach 2× joists or rafters to the top of a beam at its ends.

Skewable joist hangers attach 2× lumber, such as stair stringers, to the face of framing at an adjustable angle.

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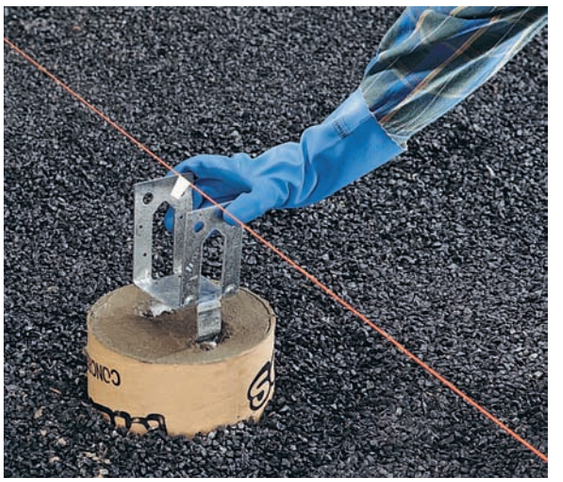

Direct-bearing footing connectors attach beams directly to footings on low profile decks.

Skewable angle brackets reinforce framing connections at angles other than 90° or at beam ends where 45° joist hangers won't fit.

T-straps reinforce the connection between beam and post, particularly on long beams requiring spliced construction. Local building codes may also allow their use in place of post caps.

Strapping plates, also known as nailing plates or mending plates, are useful for a variety of reinforcement applications.

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(Fogra 39)Job:04-30436 Title:MBI-HomeSkills Building Decks
#175 Dtp:225 Page:31

SCREWS & NAILS

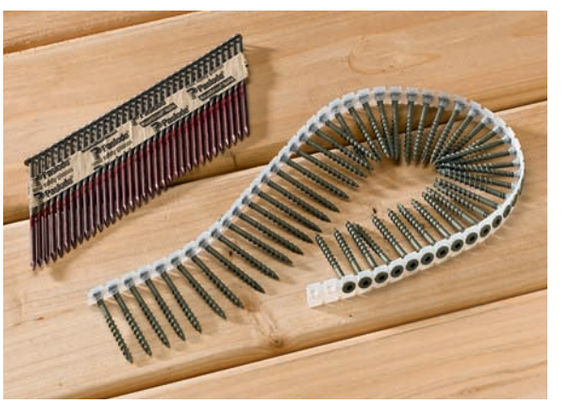
When you attach the beams and joists of your deck, and probably the decking as well, you'll need a collection of screws and/or nails to get these jobs done. It may not seem like screw and nail technology would ever change all that much, but in fact there are many new products available for making these essential connections. If you build your deck from pressure-treated lumber, be sure to use stainless, hot-dipped galvanized, or specially coated fasteners that are approved for use with the more corrosive ACQ and CBA wood preservatives. Spiral or ring-shank nails will offer better holding power than smooth nails. Use screws with auger tips and self-drilling heads to avoid drilling pilot holes. Some screws are specially designed for installing composite decking. They have a variable thread pattern that keeps the heads from mushrooming the surrounding material when driven flush.

If you are building a large deck, consider using a pneumatic nailer with collated nails instead of hand nailing. Collated screws are a faster way to lay deck boards than driving each screw individually. Here's an overview of your fastener options.

Tip

Stainless steel screws (left) are expensive, but suitable for all decking materials. Galvanized screws (second from left) are available for treated lumber, and screws with colored coatings (two on right) are formulated to resist corrosion from pressure-treated wood or prevent staining on cedar. Notice that drive choices include square, Phillips, and star. Some deck screws have proprietary drive choices. Make sure you have enough drive bits on hand, as you will be driving many screws.

Use stainless steel or hot-dipped galvanized framing nails to assemble beams and joists. Install metal connector hardware with 8d or 10d hot-dipped galvanized metal connector nails.



For large deck projects, galvanized pneumatic nails or coated, collated screws are a faster way to fasten framing and decking than driving each nail or screw by hand.

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#175 Dtp:225 Page:32

If you'd prefer not to see screwheads in your decking but still want to drive them from the surface, you can buy screws with snap-off heads. A special tool breaks the head off after the screw is driven. The resulting hole is much smaller than a screwhead.

Many composite decking manufacturers supply special screw types that hold the material in place better than ordinary screws would, and that are colored to match the decking boards.

Choose your nails and screws carefully. Screws with "bright" or black-oxide coatings and uncoated nails will not stand up to exterior use or pressure-treating chemicals. Fasteners are as crucial to your deck's long-term durability as the quality of the framing lumber or decking.

Make sure your fasteners will resist the corrosive effects of today's pressure-treating chemicals. Fastener manufacturers will usually provide this information on the product label.

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#175 Dtp:225 Page:33

FLASHING

Building codes require that a deck's ledger board be attached directly to wall sheathing and house framing, and that a corrosion-resistant flashing material be used at any junction between a deck ledger and a house. If your home is sided, you'll need to remove the siding in the ledger board area before attaching the ledger to the house. Be sure to install 15# or 30# building paper or self-sealing, adhesive backed membrane behind the ledger to prevent moisture damage. Rotting in the area behind the ledger is one of the leading causes of premature deck deterioration. Flashing is particularly important if there's no housewrap behind the siding. Once the ledger is in place, cap it with a piece of galvanized Z-flashing, tucked behind the siding, for added protection.

Building felt, also called building paper, is used behind house siding materials. Use it to replace felt damaged during a ledger installation. Ledger flashing, or Z-flashing, prevents moisture damage behind the deck ledger. Self-sealing membrane provides extra protection from moisture in damp climates or in areas where there is snow accumulation. It can be used over flashing or on top of beams and posts (see below left), and it self-seals around nails or screws that pierce it.

To apply self-sealing membrane, cut a piece to size and position it over the application area. Starting at one end, begin removing the thin plastic backing that protects the adhesive. Firmly press the membrane in place as you remove the backing, working along the installation area. To install long pieces of membrane, enlist the aid of a helper.

Install self-sealing membrane behind the ledger as extra protection from moisture. Apply the membrane over the house wrap or building felt, using the same method shown at left.

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#175 Dtp:225 Page:34

FOOTINGS

Footings, which are also called piers, anchor a deck to the ground and create a stable foundation for the posts. They transfer the weight of the deck into the soil and prevent it from heaving upward in climates where the ground freezes. Generally, footings are made from long, hollow tubes of fiber-reinforced paper in several diameters. Once a tube footing is set into the ground below the frostline, you backfill around the outside with soil, tamp it down firmly, and fill with concrete. Metal connective hardware imbedded in the concrete will attach the footings permanently to the deck posts.

Tip

For low-profile platform decks that aren't attached to a house, you may be able to use pre-cast concrete footings instead of buried piers. These footings simply rest on the surface of the soil. Notches on top of the pier are designed to hold joists without fasteners or other hardware.

Lumberyards and building centers will stock round footing forms in various diameters. The diameter you need will depend on the size and weight of your deck. If you are unsure, your building official can help you determine the correct size when you apply for a building permit.

When building heavy decks or placing footings in unstable, loose soil, you may need to use piers with flared footings. Some styles are molded in one piece, or you can attach a flared footing to a conventional footing form with screws.

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#175 Dtp:225 Page:35

DECK CONSTRUCTION

A Step-by-Step Overview for Deck Building 38
Ledgers 40
Post Footings 48
Footings 54
Posts 58
Beams 64
Joists 68
Angles 74
Curves 80
Insets 86

001-063_30436.indd 36 4/15/13 9:58 AM
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REGARDLESS OF THE DECK DESIGN you choose, every permanent deck has a fundamentally similar structure. Posts and footings anchored in the ground, working in tandem with a ledger board fastened to the house, support a framework of beams and joists that form a deck's undercarriage. Decking, railings, and steps are added to this platform to make it accessible and safe. There are proven techniques for installing each of these structural elements, and that's what you'll learn in this chapter. Once you get comfortable with these skills, you'll be able to apply them to any deck project.

The time it takes to build a deck depends on the size and complexity of the design as well as your building skills. If you're comfortable using tools and start with thorough, accurate plans, you should be able to complete a single-level deck in a few weekends.

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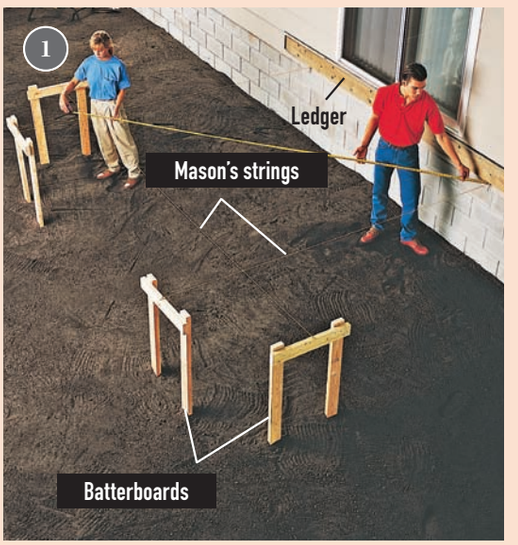
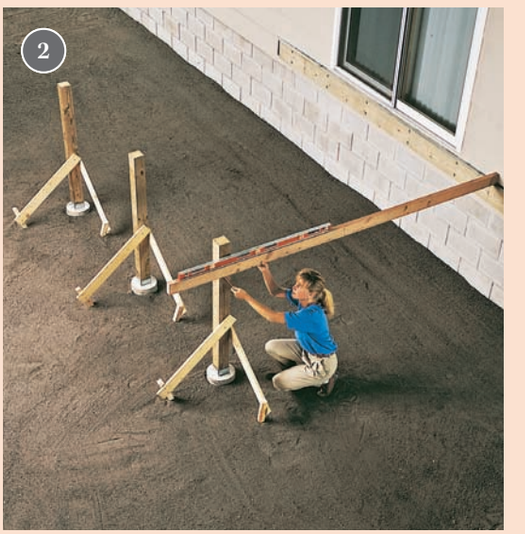
A Step-by-Step Overview for Deck Building

DECK-BUILDING IS A PROJECT you'll tackle in stages, no matter what design you choose. Before you begin construction, review the photos on these two pages. They outline the basic procedure you'll want to follow when building your deck. The chapters to follow will explore each of these stages extensively.

Be sure to gather your tools and materials before you begin the project, and arrange to have a helper available for the more difficult stages. Apply for a building permit, where required, and make sure a building inspector has approved the deck design before beginning work.





1 Install a ledger to anchor the deck to the house and to serve as reference for laying out footings. Use batterboards and mason's strings to locate footings, and check for square by measuring diagonals.

2 Pour concrete post footings, and install metal post anchors. Set and brace the posts, attach them to the post anchors, and mark posts to show where the beam will be attached.

Tip

Call before you dig! It's required. Call 811 two to three days before you begin digging. Your local utilities will mark the location of underground electrical, telephone, gas, or water lines for you. If you don't call and you damage a line, you may be subject to a fine!

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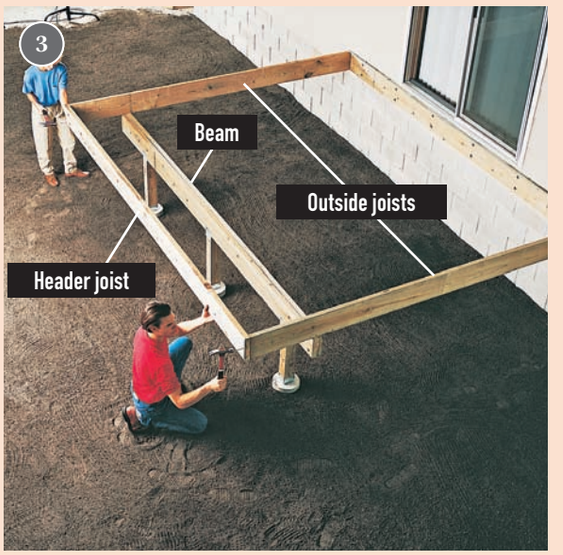

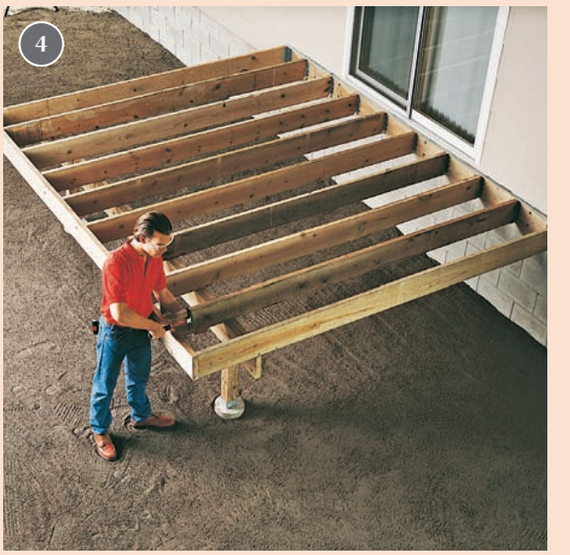

3 Fasten the beam to the posts. Install the outside joists and header joist using galvanized nails.

4 Install metal joist hangers on the ledger and header joist, then hang the remaining joists. Most decking patterns require joists that are spaced 16" on center.

5 Lay decking boards, and trim them with a circular saw. If desired for appearance, cover pressure-treated header and outside joists with redwood or cedar facing boards. Build the deck stairs. Stairs provide access to the deck and establish traffic patterns.

6 Install a railing around the deck and stairway. A railing adds a decorative touch and may be required on any deck that is more than 30" above the ground. If desired, finish the underside of the deck.

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#175 Dtp:225 Page:39

Ledgers

A deck ledger (shown in cross section) is usually made of pressure-treated lumber. Lap siding is cut away to expose sheathing and to provide a flat surface for attaching the ledger. Galvanized flashing tucked under siding prevents moisture damage to wood. Countersunk ½ × 4" lag screws hold the ledger to the header joist inside the house. If there is access to the space behind the header joist, such as in an unfinished basement, attach the ledger with carriage bolts, washers, and nuts.

Tools & Materials

Pencil
Level
Circular saw with carbide blade
Chisel
Hammer
Metal snips
Caulk gun
Drill and bits
(⅜" twist, 1⅜" spade, ½" and ⅝–¾" masonry)
Ratchet wrench
Awl
Rubber mallet
Pressure-treated lumber
Galvanized flashing
8d galvanized common nails
Silicone caulk
½ × 4" lag screws and 1⅜" washers
Masonry anchors for ½" lag screws (for masonry walls)
2 × 4s for braces

Tip

Install the ledger so that the surface of the decking boards will be 1" below the indoor floor level. This height difference prevents rainwater or melted snow from seeping into the house.

THE FIRST STEP IN BUILDING an attached deck is to fasten the ledger to the house. The ledger anchors the deck and establishes a reference point for building the deck square and level. The ledger also supports one end of all the deck joists, so it must be attached securely to the framing members of the house.

If your deck's ledger is made from pressure-treated lumber, make sure to use hot-dipped, galvanized lag screws and washers to attach it to the house. Ordinary zinc-coated hardware will corrode and eventually fail if placed in contact with ACQ pressure-treating chemicals. For additional strength on large decks—and where the framing structure will permit it—use through bolts instead of lag screws, tightening down with a washer and nut on the opposite side.

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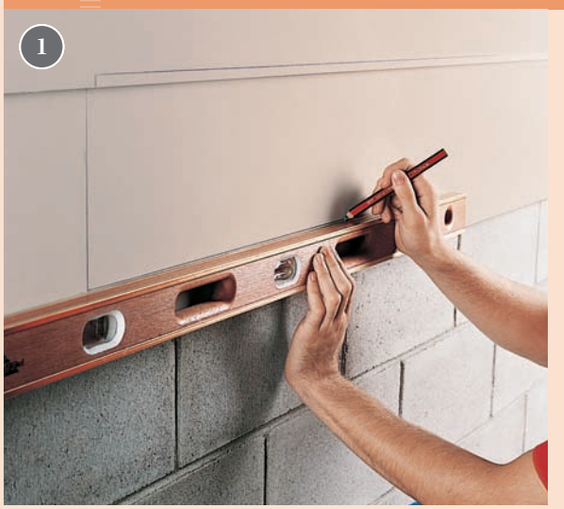
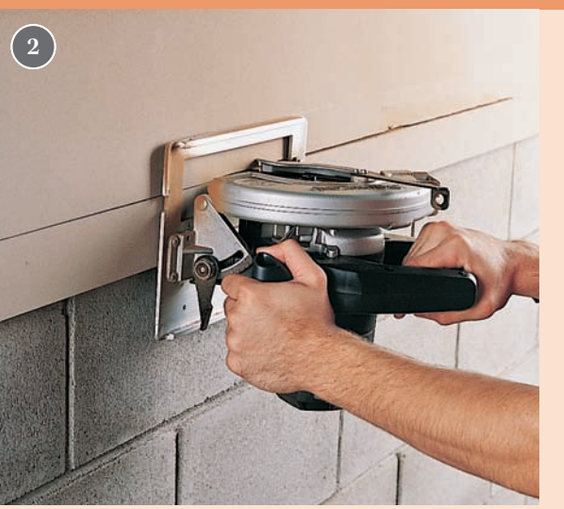
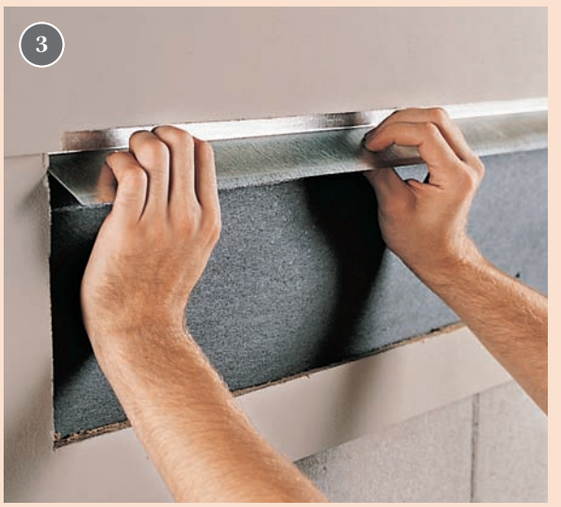
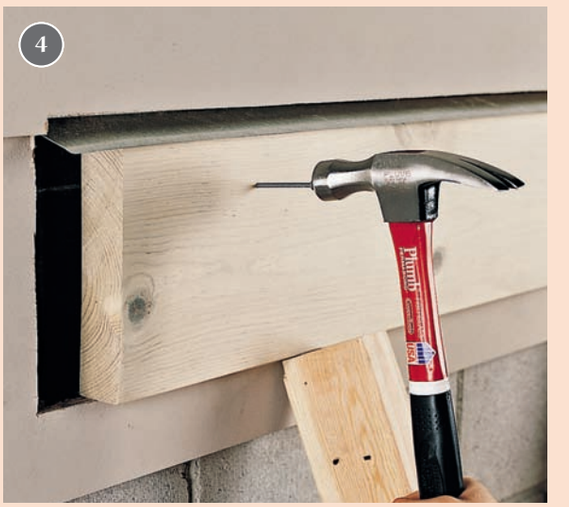
ATTACHING A LEDGER TO LAP SIDING









1 Draw an outline showing where the deck will fit against the house, using a level as a guide. Include the thickness of the outside joists and any decorative facing boards that will be installed.

2 Cut out the siding along the outline, using a circular saw. Set the blade depth to the same thickness as the siding, so that the blade does not cut into the sheathing. Use a chisel or oscillating saw to finish the cutout where the circular saw blade does not reach. Hold the chisel with the bevel-side in.

3 Install the self-adhesive moisture barrier and cut galvanized flashing to match the length of the cutout, using metal snips. Slide the flashing up under the siding. Do not nail the flashing in place.

4 Measure and cut the ledger from pressure-treated lumber. Remember that the ledger will be shorter than the overall length of the cutout. Center the ledger in the cutout, underneath the flashing. Brace in position, and tack the ledger into place with 8d galvanized nails. Apply a thick bead of silicone caulk to the space between the siding and flashing.

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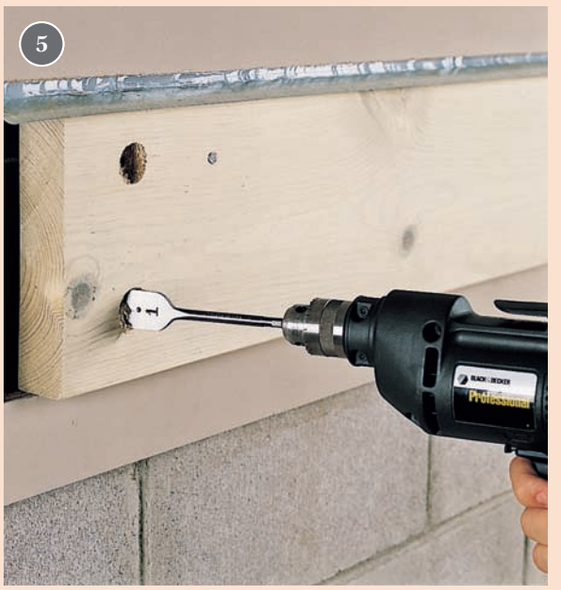

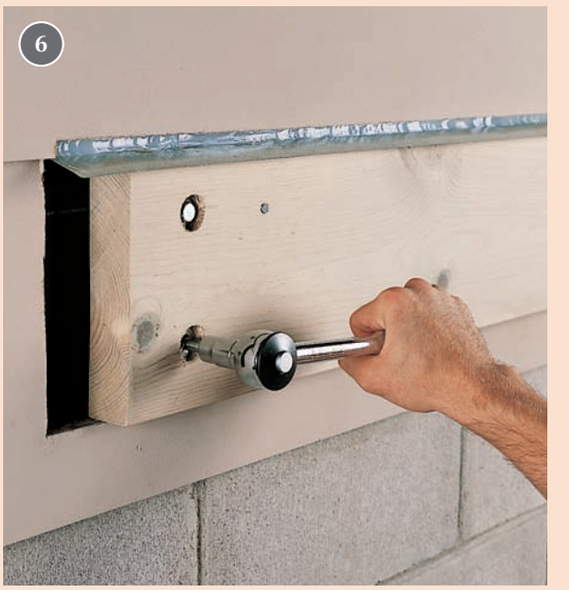

5 Drill pairs of ⅜" pilot holes through the ledger and sheathing, and into the house joist. Space the holes every 2 ft. Counterbore each pilot hole to ½" depth, using a 1⅜" spade bit.

6 Attach the ledger to the wall with ½" × 4" lag screws and washers, using a ratchet wrench or impact driver. Seal lag screw heads with silicone caulk. Seal the crack between the wall and the sides and bottom of the ledger.

Skillbuilder

If you have never used a spade bit to drill a counterbore or used a hammer drill and masonry anchors, it is a good idea to practice first on scrap material.

Clamp a piece of 2× to a work surface. The goal is to drill a hole only ½" deep—any deeper and you compromise the strength of the material. You can buy a portable drill jig for complete accuracy, or you can drill carefully and measure often. Practice drilling and measuring ½" deep holes.

Find a hunk of concrete or concrete block (not a concrete paver) and practice drilling holes with the hammer drill and a masonry bit. Pound masonry anchors into the holes you have drilled and drive lag screws.

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ATTACHING A LEDGER TO MASONRY

1 Measure and cut the ledger. The ledger will be shorter than the overall length of the outline. Drill pairs of pilot holes every 2 ft. along the ledger. Counterbore each hole ½" deep, using a 1⅜" spade bit. Draw an outline of the deck on the wall, using a level as a guide. Center the ledger in the outline, and brace in position. Mark the pilot-hole locations on the wall, using an awl or nail. Remove the ledger.

2 Drill anchor holes 3" deep into the wall, using a masonry bit large enough for the anchors.

3 Drive lead masonry anchors for ½" lag screws into the holes, using a rubber mallet.

4 Attach the ledger to the wall with ½ × 4" lag screws and washers, using a ratchet wrench or impact driver. Tighten screws firmly, but do not overtighten.

5 Seal the cracks between the wall and ledger with silicone caulk. Also seal the lag screw heads.

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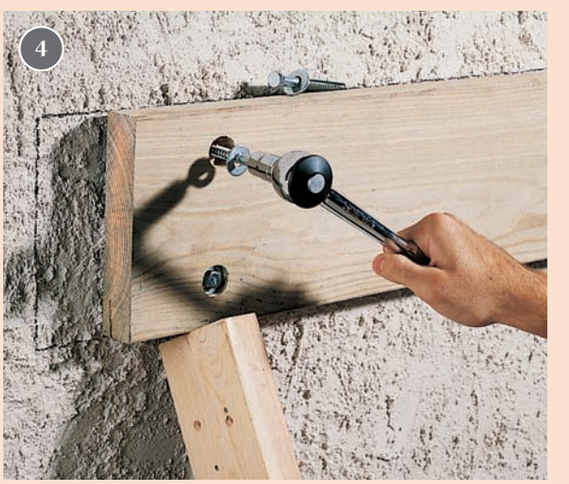
ATTACHING A LEDGER TO STUCCO



1 Draw the outline of the ledger on the wall, using a level as a guide. Measure and cut the ledger, and drill pilot holes. Brace the ledger against the wall, and mark hole locations using a nail or awl.

2 Remove the ledger. Drill guide holes through the stucco layer of the wall using a ½" masonry bit.

3 Extend each guide hole through the sheathing and into the header joist using a ⅜" bit. Reposition the ledger and brace it in place.

4 Attach the ledger to the wall with ½ × 4" lag screws and washers, using a ratchet wrench or impact driver. Seal the lag screw heads and the cracks between the wall and ledger with silicone caulk.

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ATTACHING A LEDGER TO METAL OR VINYL SIDING

1 Mark the length of the ledger location, adding 1½" at each end to allow for the rim joists that will be installed later. Also allow for fascia board thickness if it will be added, and create space for metal rim-joist hangers. Then mark the top and bottom edges of the ledger at both ends of its location. Snap lines for the ledger position between the marks. Check the lines for level and adjust as necessary. You may be able to use the siding edges to help determine the ledger location, but only after checking to see if the edges are level. Don't assume siding is installed level.

2 Set the circular saw blade depth to cut through the siding. Use a metal cutting blade for metal siding; a 40-tooth carbide blade works well on vinyl siding. Cut on the outside of the lines along the top and sides of the ledger location, stopping the blade when it reaches a corner.

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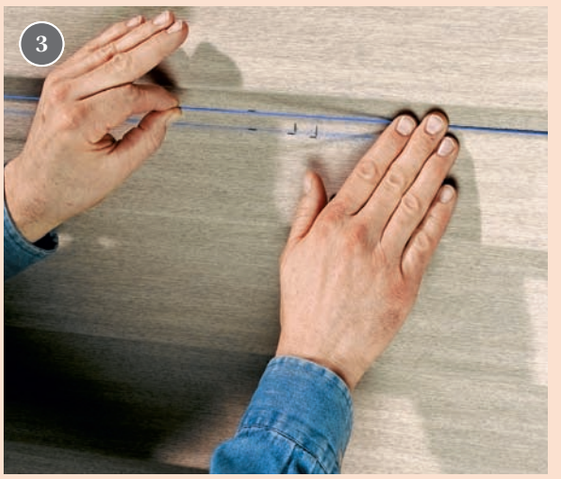

3 Snap a new level line ½" above the bottom line and make your final cut along this line. This leaves a small lip of siding that will fit under the ledger.

4 Complete the cuts in the corners, using tin snips on metal siding or a utility knife on vinyl siding. An oscillating saw also may be used.

5 Insert building felt underneath the siding and over the existing felt that has been damaged by the cuts. It is easiest to cut and install two long strips. Cut and insert the first strip so it is underneath the siding at the ends and bottom edge of the cutout and attach it with staples. Cut and insert the second strip so it is underneath the siding at the ends and top edge of the cutout, and so that it overlaps the first strip by at least 3".

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Pro-Vision C M Y K (Text) (Ray)
(Fogra 39)Job:04-30436 Title:MBI-HomeSkills Building Decks
#175 Dtp:225 Page:46

6 Cut and insert galvanized flashing (also called Z-flashing) underneath the full length of the top edge of the cutout. Do not use fasteners; pressure will hold the flashing in place until the ledger is installed.

7 Cut and install the ledger board. See page 40.

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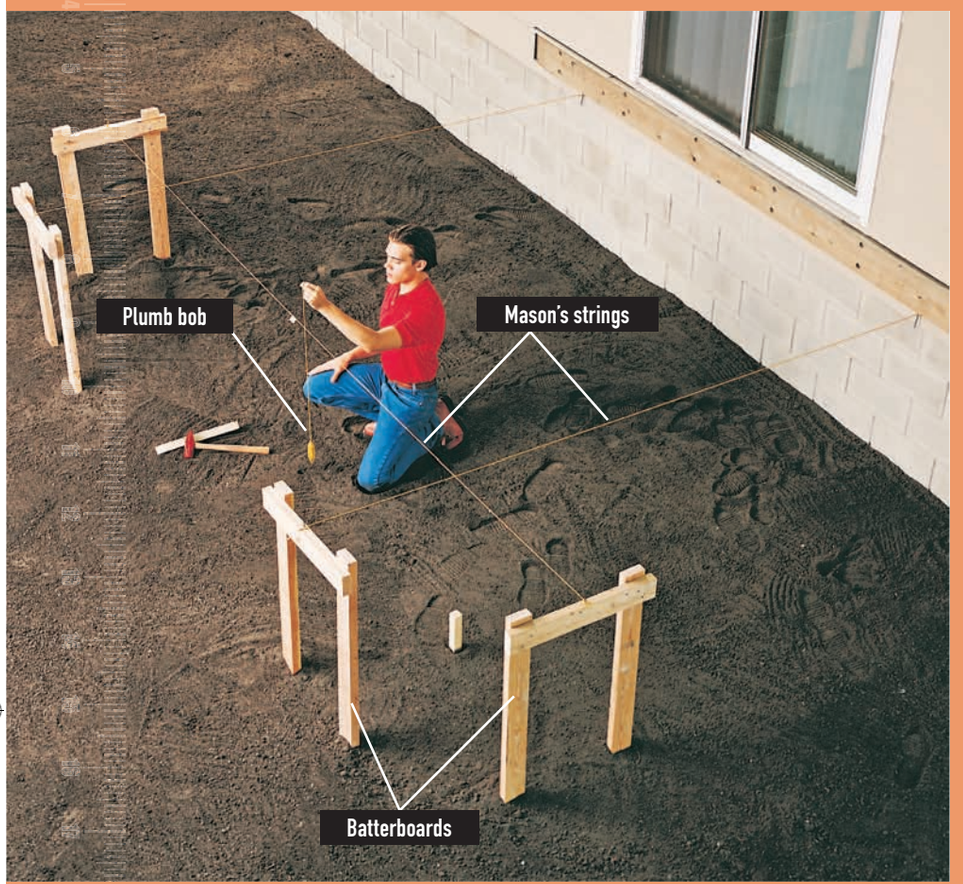
#175 Dtp:225 Page:47

Post Footings



Tools & Materials

Tape measure
Felt-tipped pen
Circular saw
Screwgun
Framing square
Masonry hammer
Claw hammer
Line level
Plumb bob
2 × 4s
10d nails
2½" drywall screws
Mason's strings
Masking tape

Tip

You may want to leave the batterboards in place until after the footings are dug. That way, you can use the strings to accurately locate the J-bolts in the concrete.

Mason's strings stretched between the ledger and the batterboards are used to position footings for deck posts. Use a plumb bob and stakes to mark the ground at the exact centerpoints of footings.

ESTABLISH THE EXACT locations of all concrete footings by stretching mason's strings across the site. Use the ledger board as a starting point. These perpendicular layout strings will be used to locate holes for concrete footings and to position metal post anchors on the finished footings. Anchor the layout strings with temporary 2 × 4 supports, often called batterboards.

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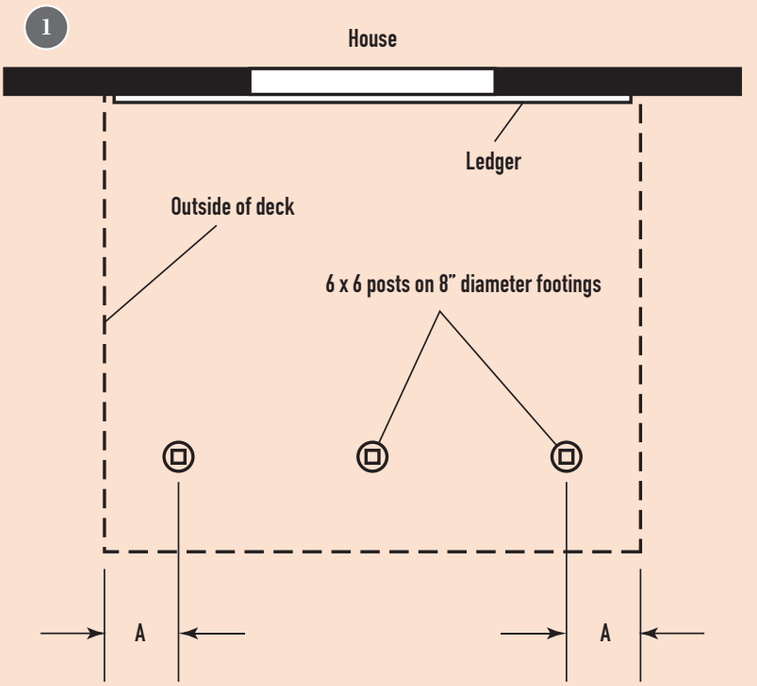
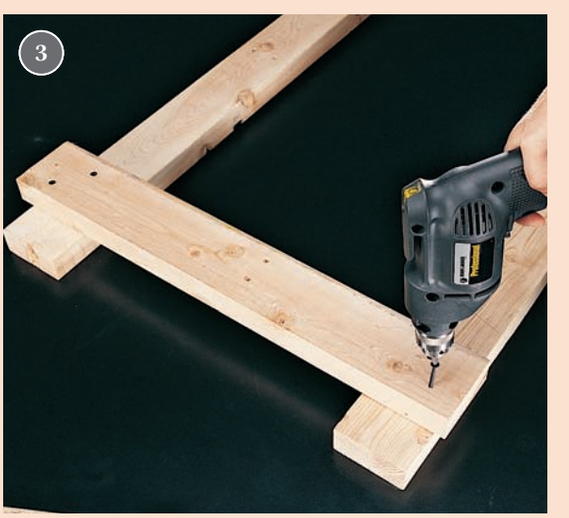
#175 Dtp:225 Page:48

LOCATING POST FOOTINGS



1 Use your design plan to find distance (A). Measure from the side of the deck to the center of each outside post. Use your elevation drawings to find the height of each deck post.



2 Cut 2 × 4 stakes for batterboards, each about 8" longer than post height. Trim one end of each stake to a point, using a circular saw. Cut 2 × 4 crosspieces, each about 2 ft. long.

3 Assemble batterboards by attaching crosspieces to stakes with 2½" wallboard screws. Crosspieces should be about 2" below the tops of the stakes.

continued

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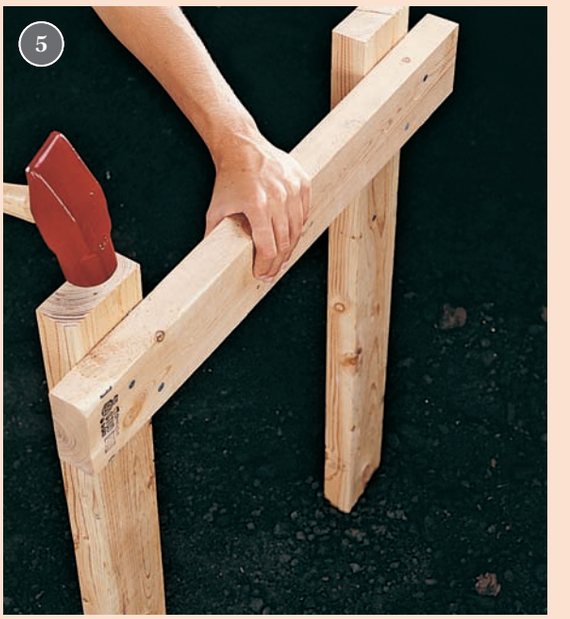

4 Transfer measurement A (step 1) to the ledger, and mark reference points at each end of the ledger. String lines will be stretched from these points on the ledger. When measuring, remember to allow for outside joists and facing that will be butted to the ends of the ledger.

5 Drive a batterboard 6" into the ground, about 2 ft. past the post location. The crosspiece of the batterboard should be parallel to the ledger.

6 Drive a 10d nail into the bottom of the ledger at the reference point (step 4). Attach a mason's string to the nail.

7 Extend the mason's string so that it is taut and perpendicular to the ledger. Use a framing square as a guide. Secure the string temporarily by wrapping it several times around the batterboard.

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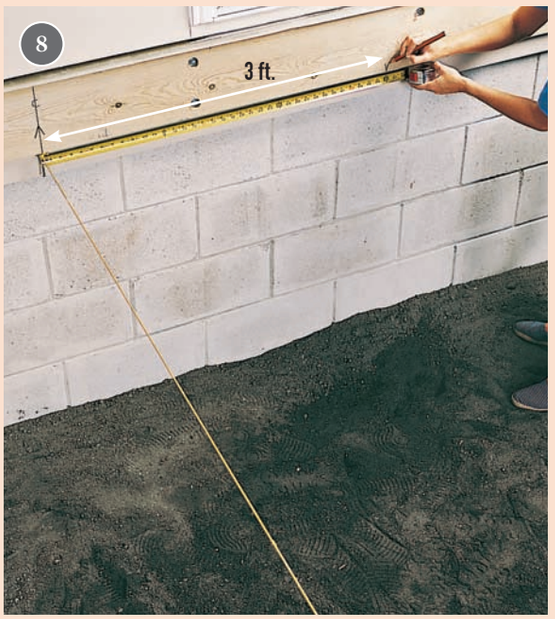

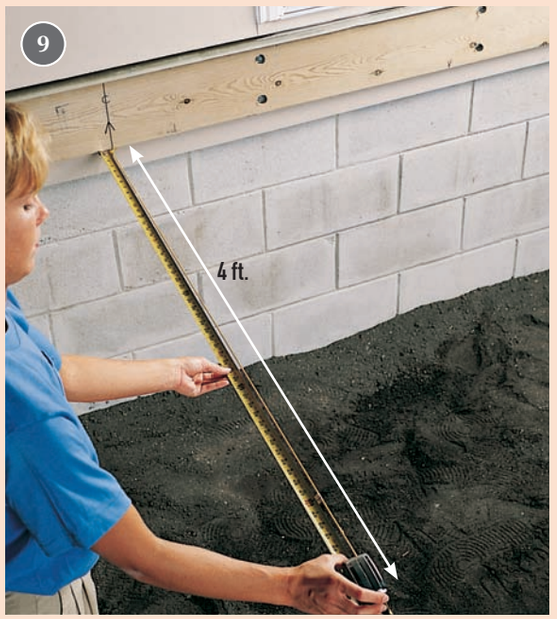

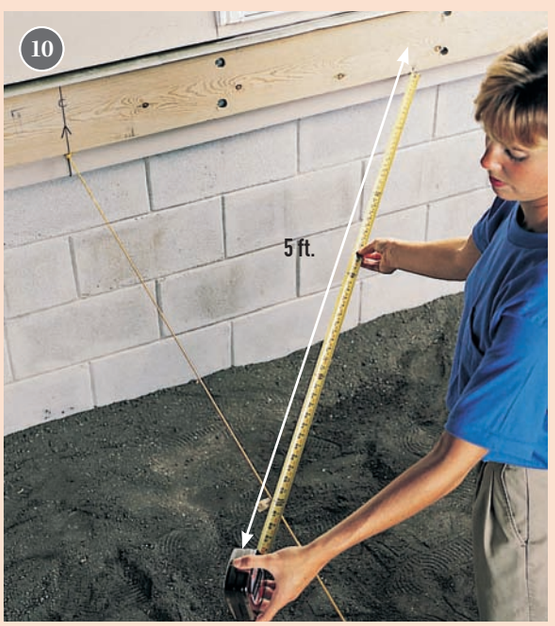

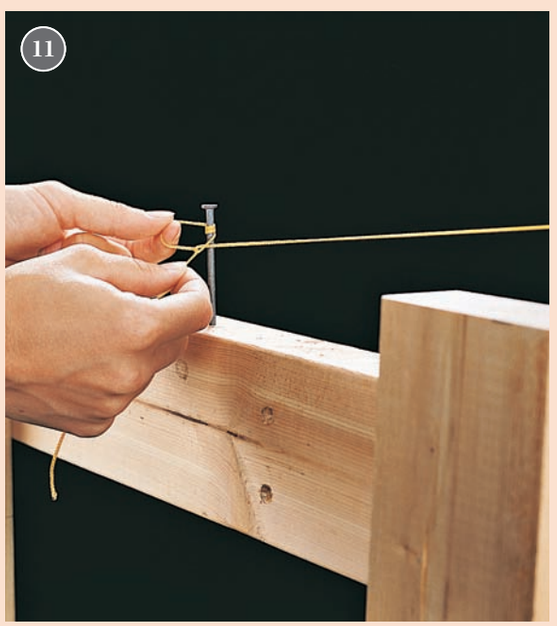

8 Check the mason's string for square using a "3-4-5 carpenter's triangle." First, measure along the ledger 3 ft. from the mason's string and mark a point, using a felt-tipped pen.

9 Measure the mason's string 4 ft. from the edge of the ledger, and mark with masking tape.

10 Measure the distance between the marks. If the string is perpendicular to the ledger, the distance will be exactly 5 ft. If necessary, move the string left or right on the batterboard until the distance between the marks is 5 ft.

11 Drive a 10d nail into the top of the batterboard at the string location. Leave about 2" of nail exposed. Tie the string to the nail.

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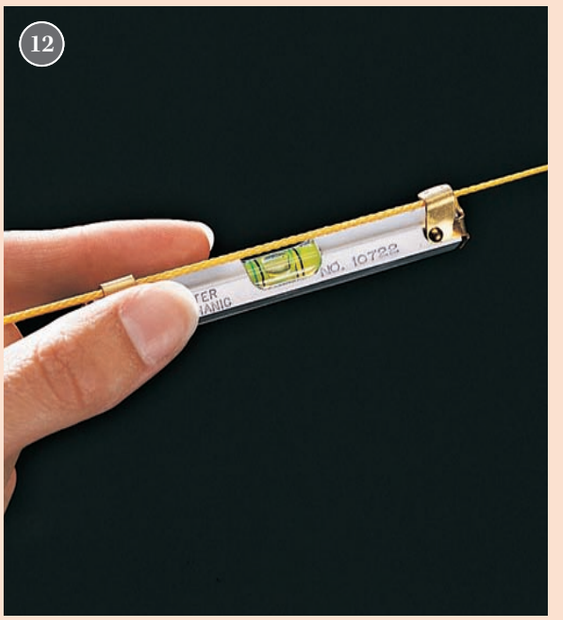

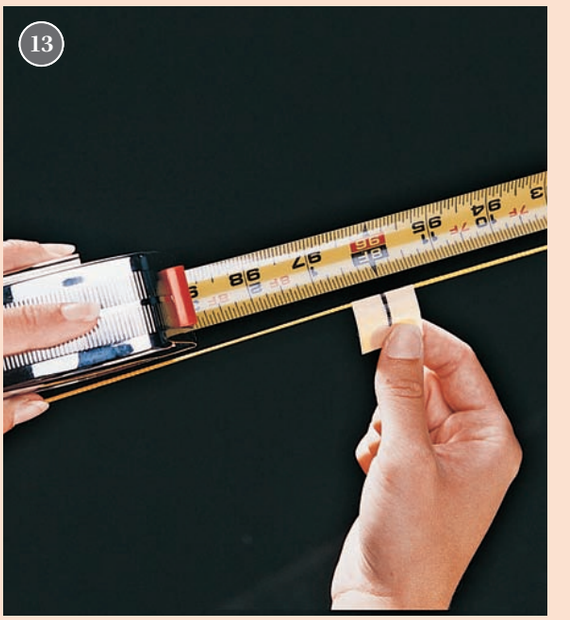

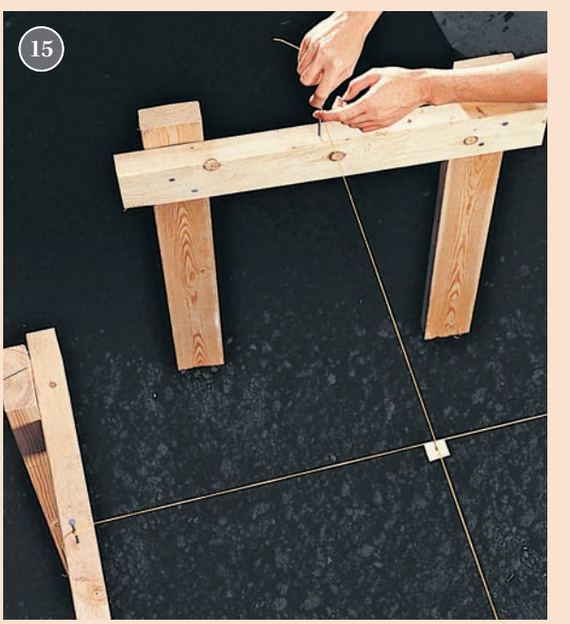

12 Hang a line level on the mason's string. Raise or lower the string until it is level. Locate the other outside post footing, repeating steps 5 to 12.

13 Measure along the mason's strings from the ledger to find the centerpoint of the posts. Mark the centerpoints on the strings, using masking tape.

14 Drive additional batterboards into the ground, about 2 ft. outside of the mason's strings and lined up with the post centerpoint marks (step 13).

15 Align a third cross string with the centerpoint marks on the first strings. Drive 10d nails in new batterboards, and tie off the cross strings on the nails. The cross string should be close to, but not touching, the first strings.

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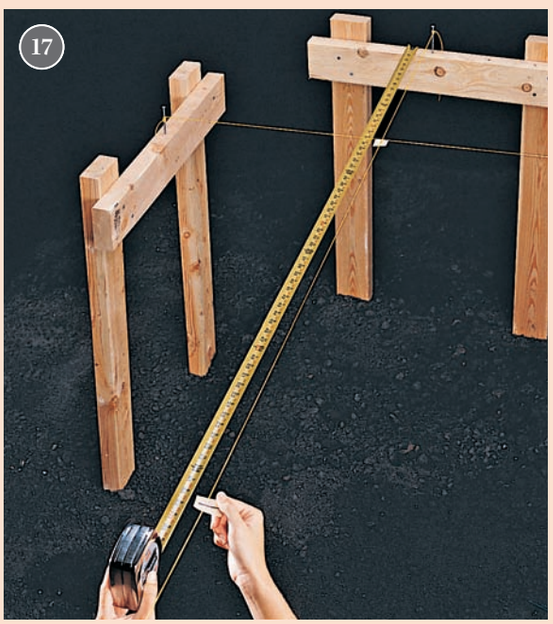
(Fogra 39)Job:04-30436 Title:MBI-HomeSkills Building Decks
#175 Dtp:225 Page:52

16 Check the strings for square by measuring distances A-B and C-D. Measure the diagonals A-D and B-C from the edge of the ledger to the opposite corners. If the strings are square, measurement A-B will be the same as C-D, and diagonal A-D will be the same as B-C. If necessary, adjust the strings on the batterboards until they are square.



17 Measure along the cross string and mark the centerpoints of any posts that will be installed between the outside posts.

18 Use a plumb bob to mark the post centerpoints on the ground, directly under the marks on the mason's strings. Drive a stake into the ground at each point. Remove the mason's strings before digging the footings.

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#175 Dtp:225 Page:53

Footings

CONCRETE FOOTINGS hold deck posts in place and support the weight of the deck. Check local codes to determine the size and depth of footings required for your area. In cold climates, footings must be deeper than the soil frost line.

To help protect posts from water damage, footings are generally poured so that they are at least 2 inches above ground level. You can create footings by pouring concrete directly into a triangular hole with a form on top to create the aboveground portion, or turn to the more common solution of a tube-shaped form that allows you to pour the post you need quickly and easily. Mix your own cement to fill the form by combining Portland cement, sand, gravel, and water. You can also use premixed concrete, which is often a simpler solution.

As an alternative to inserting J-bolts into wet concrete, you can use masonry anchors, metal post brackets with pins, legs, or hooks, or install anchor bolts with an epoxy designed for deck footings and other masonry installations. The epoxy method provides you with more time to reset layout strings for locating bolt locations, and it eliminates the problem of J-bolts tilting or sinking into concrete that is too loose. Most building centers sell threaded rod, washers, nuts, and epoxy syringes, but you can also buy these items separately at most hardware centers.

Before digging, consult local utilities for locations of any underground electrical, telephone, or water lines that might interfere with footings.

Tools & Materials

- Power auger or clamshell posthole digger
- Tape measure
- Pruning saw
- Shovel
- Reciprocating saw or handsaw
- Torpedo level
- Hoe
- Trowel
- Shovel
- Old toothbrush
- Plumb bob
- Utility knife
- Concrete tube forms
- Portland cement
- Sand
- Gravel
- J-bolts
- Wheelbarrow
- Scrap 2 × 4

Tip

You could dig holes for post footings by hand with a clamshell posthole digger, but a power auger speeds up the task considerably. They are available at rental centers. Some models can be operated by one person, while others require two people. Call before you dig!

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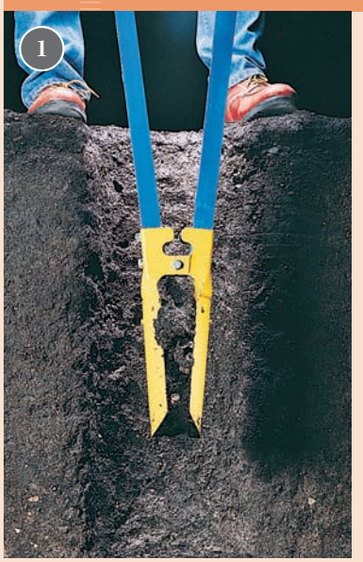
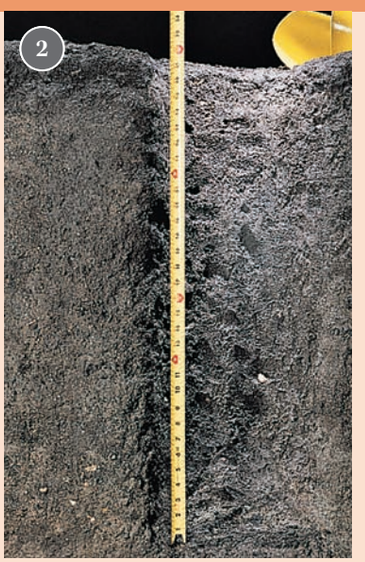
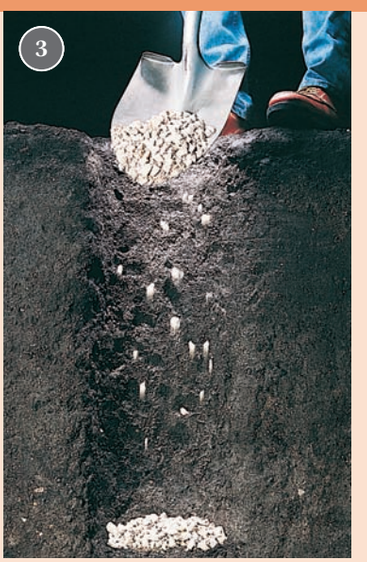
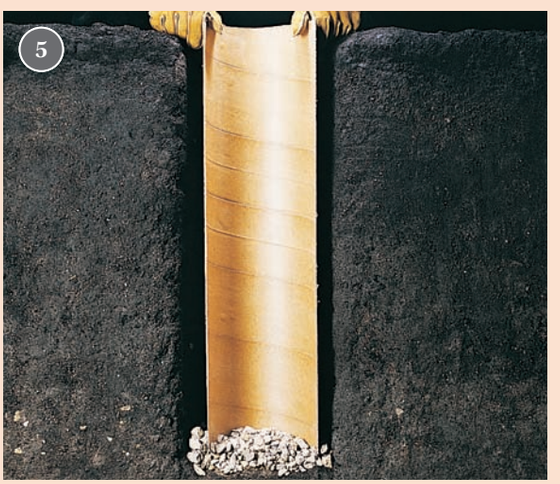
#175 Dtp:225 Page:54

DIGGING AND POURING POST FOOTINGS









1 Dig holes for post footings with a clamshell digger or power auger, centering the holes on the layout stakes. For holes deeper than 35", use a power auger.

2 Measure hole depth. Local building codes specify depth of footings. Cut away tree roots, if necessary, using a pruning saw.

3 Pour 2" to 3" of loose gravel in the bottom of each footing hole. Gravel will provide drainage under concrete footings.

4 Add 2" to hole depth so that footings will be above ground level. Cut concrete tube forms to length, using a reciprocating saw or handsaw. Make sure the cuts are straight.

5 Insert the tubes into footing holes, leaving about 2" of the tube above ground level. Use a level to make sure the tops of the tubes are level. Pack soil around tubes to hold them in place.

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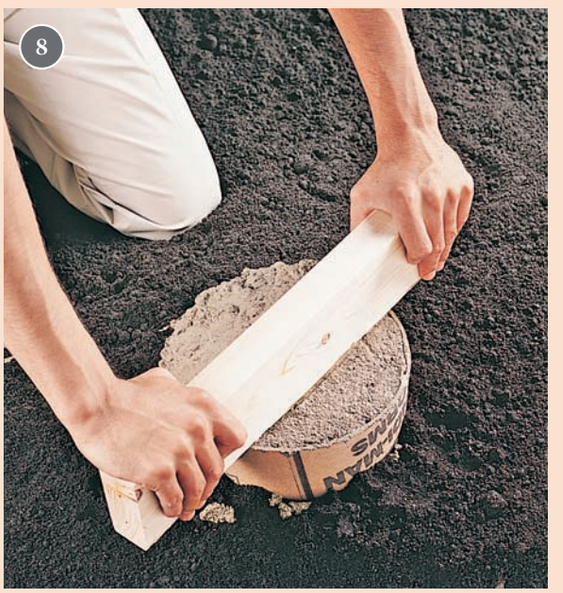

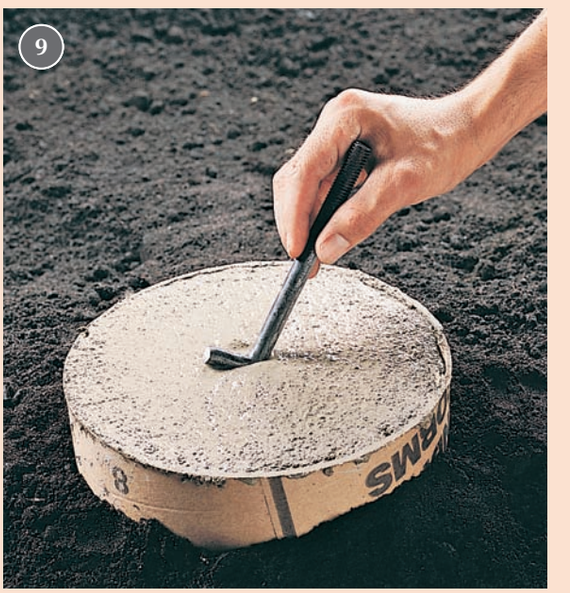

6 Mix the concrete using a basic formula of 4 parts gravel, 2 parts sand to 1 part cement. Mix the dry ingredients with a hoe. Form a hollow in the center of the dry mix, and slowly pour a small amount of water into the hollow. Blend it in using the hoe. Add more water gradually, mixing thoroughly until concrete is firm enough to hold its shape when sliced with a trowel.

7 Pour concrete slowly into the tube form, guiding concrete from the wheelbarrow with a shovel. Fill about half of the form, using a long stick to tamp the concrete, filling any air gaps in the footing. Then finish pouring and tamping concrete into the form.

8 Level the concrete by pulling a 2 × 4 across the top of the tube form, using a sawing motion. Add concrete to any low spots. Retie the mason's strings on the batterboards, and recheck measurements.

9 Insert a J-bolt at an angle into the wet concrete at the center of the footing.

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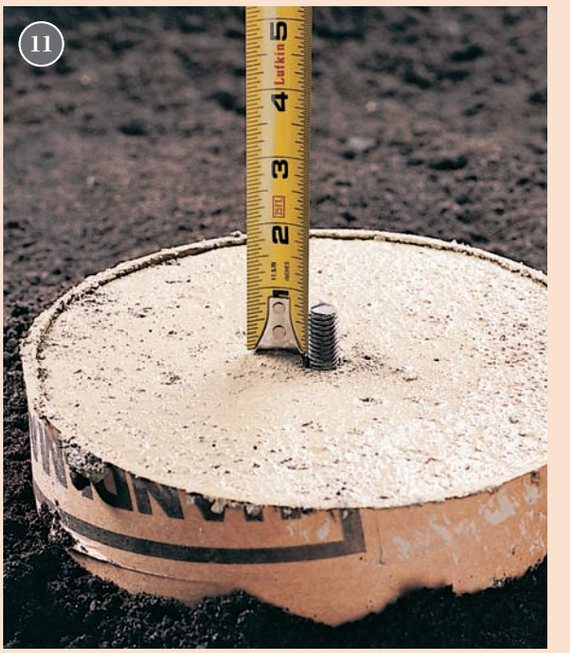

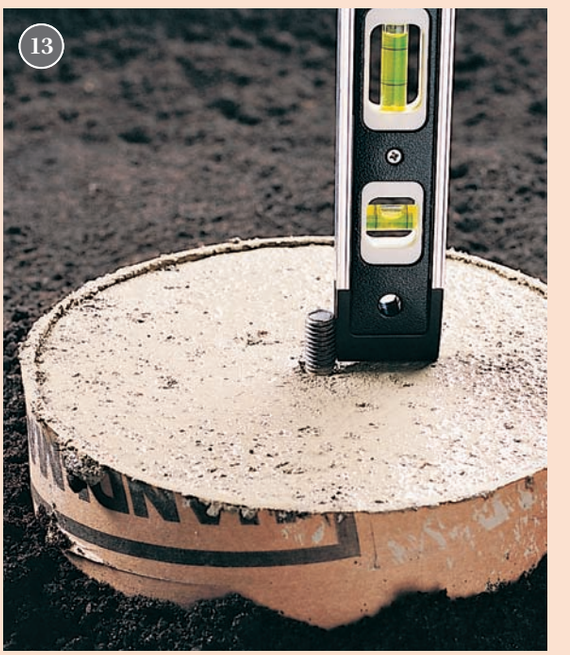

10 Lower the J-bolt slowly into the concrete, wiggling it slightly to eliminate any air gaps.

11 Set the J-bolt so ¾" to 1" is exposed above the concrete. Brush away any wet concrete on the bolt threads with an old toothbrush.

12 Use a plumb bob to make sure the J-bolt is positioned exactly at the center of the post location.

13 Use a torpedo level to make sure the J-bolt is plumb. If necessary, adjust the bolt and repack the concrete. Let the concrete cure, then cut away the exposed portion of tube with a utility knife.

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(Fogra 39)Job:04-30436 Title:MBI-HomeSkills Building Decks
#175 Dtp:225 Page:57

Posts

POSTS SUPPORT the deck beams and transfer the weight of the deck, as well as everything on it, to the concrete footings. They create the above-ground foundation of your deck. Your building inspector will verify that the posts you plan to use are sized correctly to suit your deck design.

Choose post lumber carefully so the posts will be able to carry these substantial loads for the life of your deck. Pressure-treated lumber is your best defense against rot or insect damage. Try not to cut off the factory-treated ends when trimming the posts to length; they contain more of the treatment chemicals and generally last longer than cut ends. Face the factory ends down against the post hardware where water is more likely to accumulate.

Use galvanized metal post anchors to attach the posts to concrete footings. If posts are set directly on concrete, the ends won't dry properly. You'll also have a harder time making the necessary mechanical connection to the footings. Post anchors have drainage holes and pedestals that raise the ends of the wood above the footings and improve drainage. Make sure the posts are installed plumb for maximum strength.

Tools & Materials

Pencil
Framing square
Ratchet wrench
Tape measure
Power miter saw or circular saw
Hammer
Screwgun
Level
Combination square
Metal post anchors
Nuts for J-bolts
Lumber for posts
6d galvanized common nails
2" drywall screws
Long, straight 2 × 4
1 × 4s
Pointed 2 × 2 stakes

Select posts that are straight and free of deep cracks, large knots, or other natural defects that could compromise their strength.

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(Fogra 39)Job:04-30436 Title:MBI-HomeSkills Building Decks
#175 Dtp:225 Page:58

ATTACHING POST ANCHORS

1 Mark the top of each footing as a reference line for installing post anchors. Lay a long, straight 2 × 4 flat across two or three concrete footings, parallel to the ledger, with one edge tight against the J-bolts.

2 Place a metal post anchor on each concrete footing, and center it over the J-bolt.

3 Use a framing square to make sure the post anchor is positioned square to the reference line drawn on the footing.

4 Thread a nut over each J-bolt, and tighten it securely with a ratchet wrench or impact driver.

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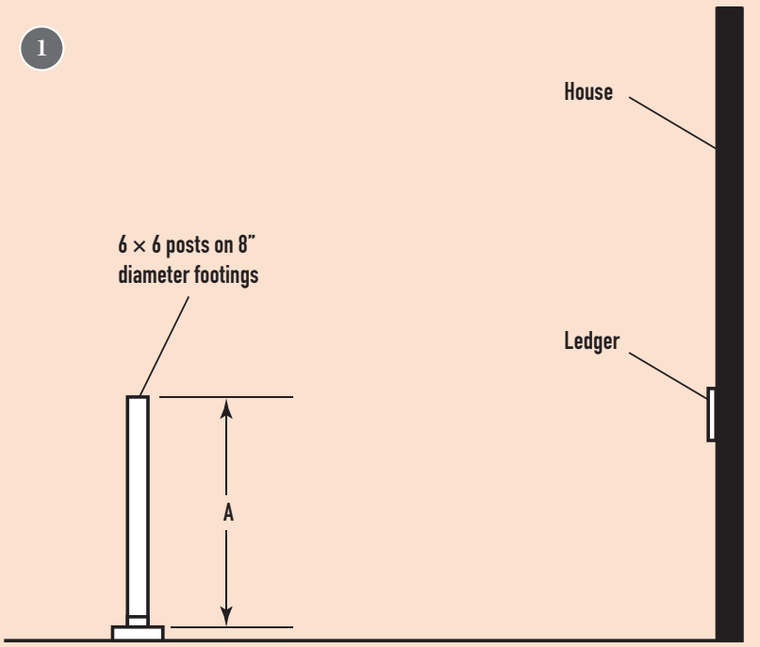
SETTING POSTS



Post elevation

1 Use the elevation drawing from your design plan to find the length of each post (A). Add 6" to the length for a cutting margin.

2 Cut posts to rough length with a power miter saw or circular saw. Make sure factory-treated ends of posts are square. If necessary, square them by trimming with a power miter saw or circular saw.

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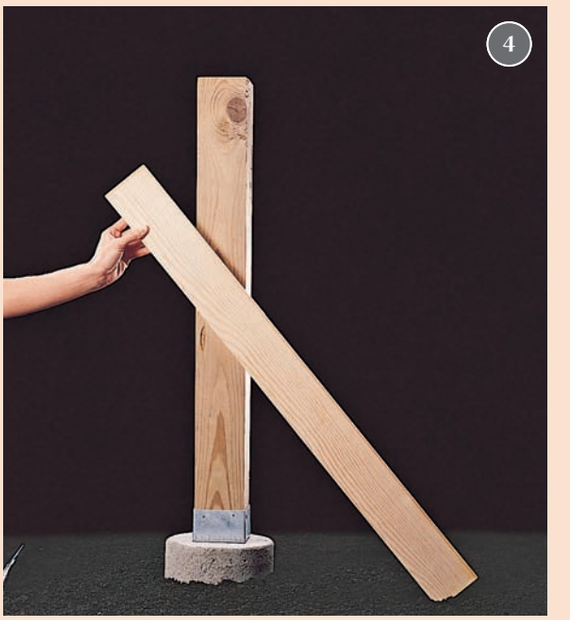

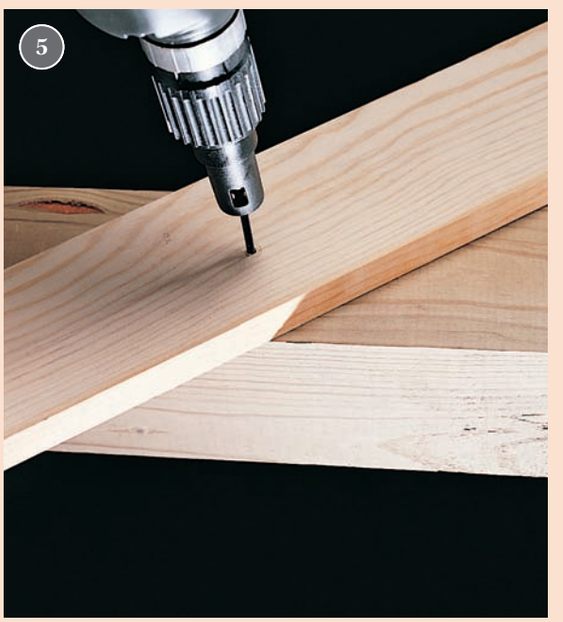

3 Place the post in the anchor and tack it into place with a single 6d galvanized common nail. Do not drive the nail all the way in.

4 Brace the post with a 1 × 4. Place the 1 × 4 flat across the post so that it crosses the post at a 45º angle about halfway up.

5 Attach the brace to the post temporarily with a single 2" drywall or deck screw.

6 Drive a pointed 2 × 2 stake into the ground next to the end of the brace.

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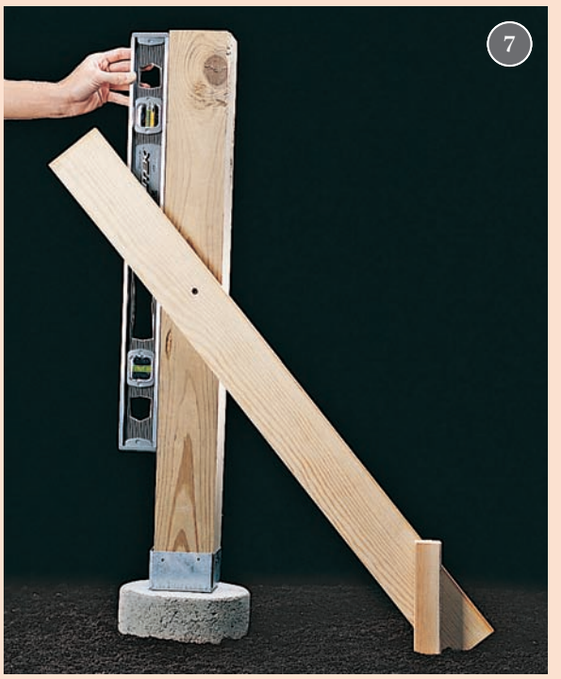

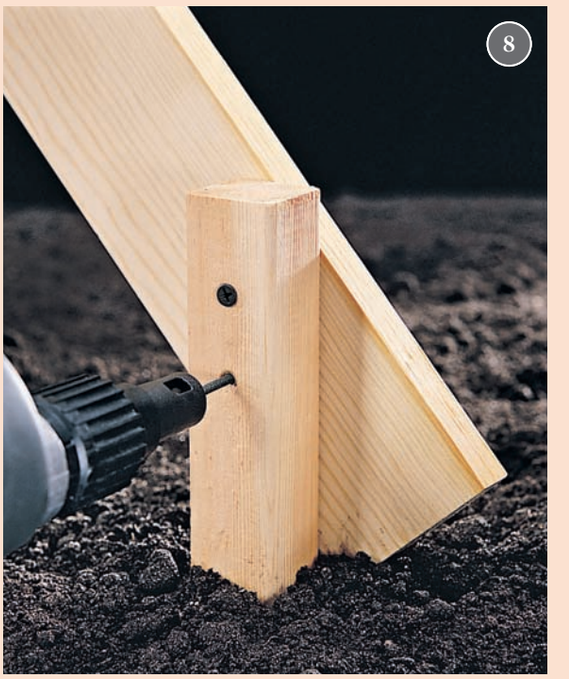

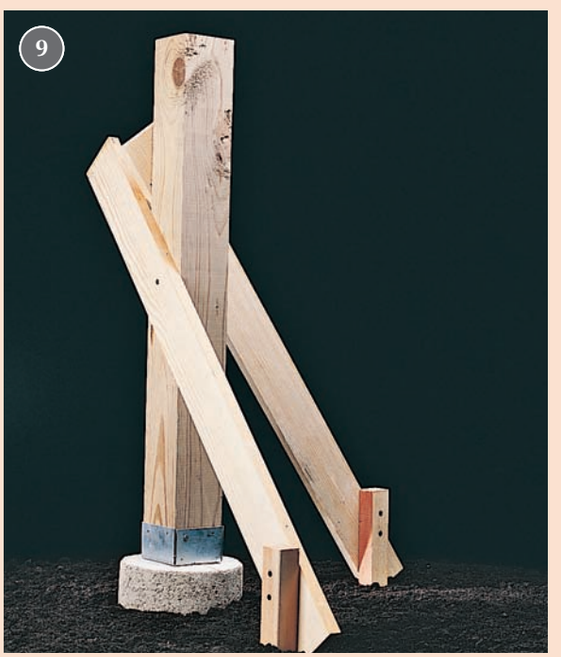

7 Use a level to make sure the post is plumb. Adjust the post, if necessary.

8 Attach the brace to the stake with two 2" drywall screws.

9 Plumb and brace the post on the side perpendicular to the first brace.

10 Attach the post to the post anchor with 10d galvanized joist hanger nails. (You can also mark the post, then remove it and cut it on the ground, and then nail it in place.)

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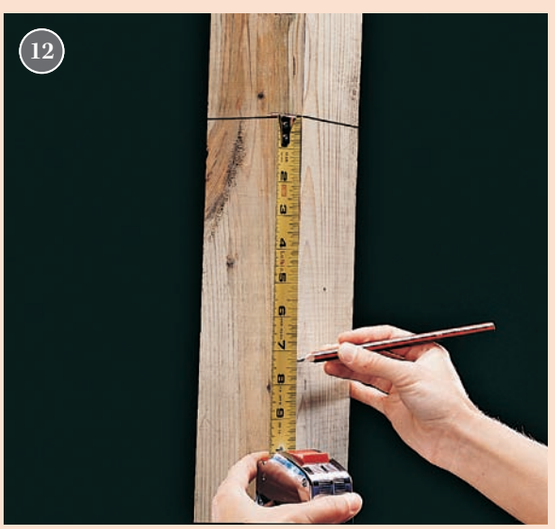

11 Position a straight 2 × 4 with one end on the ledger and the other end across the face of the post. Level the 2 × 4. Draw a line on the post along the bottom of the 2 × 4. This line indicates the top of the joists.

12 From the line shown in step 11, measure down and mark the posts a distance equal to the actual width of the joists.

13 Use a square to draw a line completely around the post. This line indicates the top of the beam. From this line, repeat steps 12 and 13 to determine the bottom of the beam.

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Beams

Deck beams, resting in a notch on the tops of the posts and secured with through bolts and nuts, guarantee strong connections that will bear the weight of your deck.

Tools & Materials

Tape measure
Pencil
Circular saw
Paint brush
Combination square
Screwgun
Drill
½" auger bit
1⅜" spade bit
Ratchet wrench
Caulk gun
Reciprocating saw or handsaw
Pressure-treated lumber
Clear sealer-preservative
2½" galvanized deck screws
10d joist hanger nails
½ × 8" carriage bolts with washers and nuts
Silicone caulk

DECK BEAMS attach to the posts to help support the weight of the joists and decking. Installation methods depend on the deck design and local codes, so check with a building inspector to determine what is acceptable in your area.

In a saddle beam deck, the beam is attached directly on top of the posts. Metal fasteners, called post-saddles, are used to align and strengthen the beam-to-post connection. The advantage is that the post bears the weight of the deck.

A notched-post deck requires 6 × 6 posts notched at the post top to accommodate the full size of the beam. The deck's weight is transferred to the posts, as in a post-and-beam deck.

Tip

In years past, a third style of beam construction, called sandwiching, was also generally acceptable for deck construction. (You can see an example of it on page 8.) It consisted of two beams that straddled both sides of the post, connected by long through bolts. Because this method has less strength than the saddle or notched styles, it is no longer approved by most building codes.

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MARKING POST LOCATIONS ON A BEAM

1 Measure along the beam to the post locations, making sure the ends of the boards of a doubled beam are flush. Mark both the near and far edges of the post onto the beam.

2 Use a combination square or speed square to transfer the post marks onto the top and then the other face of the beam, allowing you to make sure the post and post hardware align with both faces.

FABRICATING A BEAM

1 Select two straight boards of the same dimension (generally 2 × 8 or larger) and lay them face to face to see which alignment comes closest to flush on all sides. Apply exterior grade construction adhesive to one board and lay the mating board onto it. Drive a pair of 10d nails near the end of the assembly to pin the boards together.

2 Clamp the beam members together every 2–3 ft., forcing the boards into alignment as you go, if necessary. Drive 10d nails in a regular, staggered pattern every 12" to 16" or so. Flip the beam over and repeat the nailing pattern from the other side.

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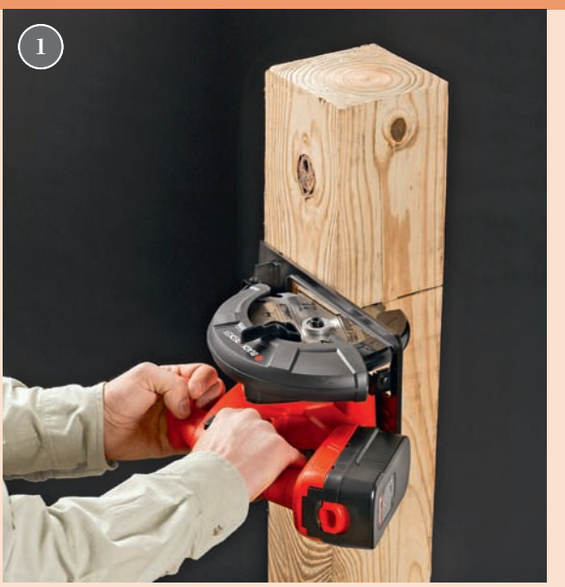
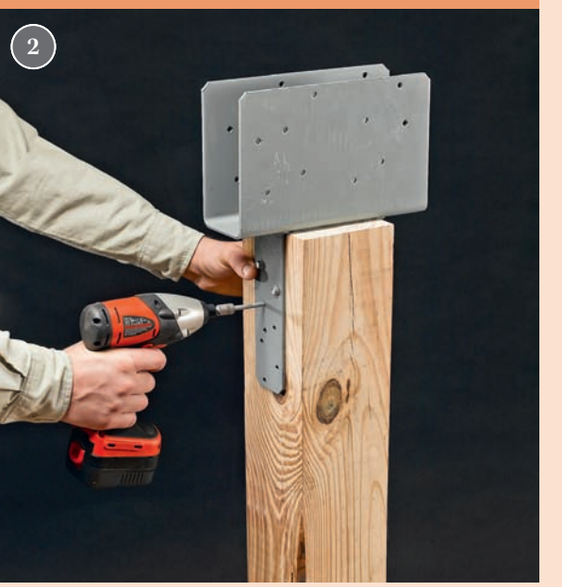
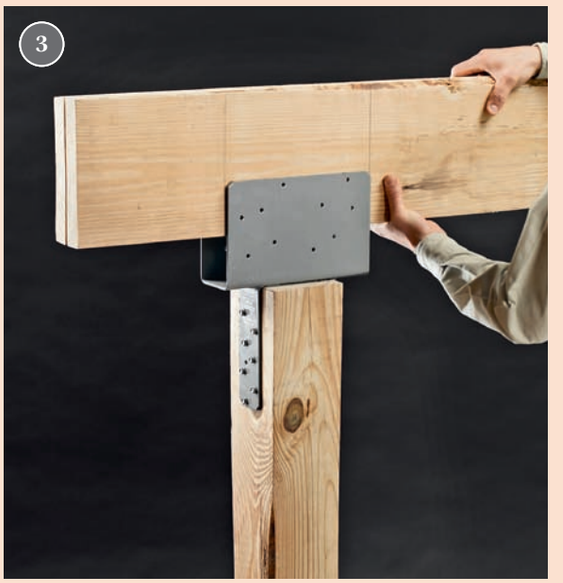
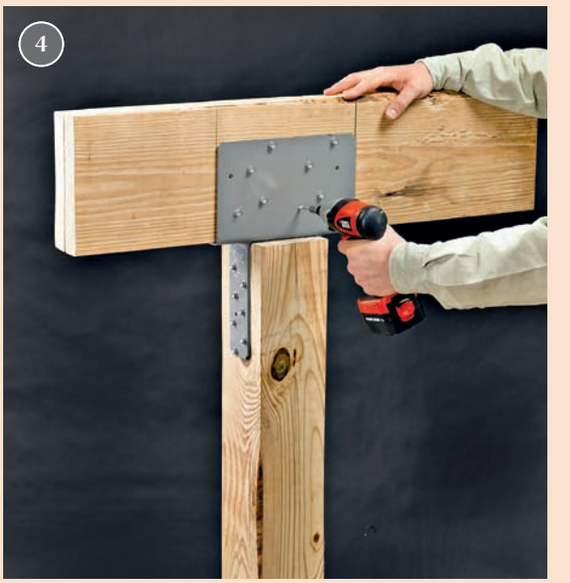
INSTALLING A BEAM WITH A POST SADDLE









1 Cut the post to final height after securing it in place. Make two passes with a circular saw and finish with a reciprocating saw.

2 Attach the saddle hardware to the top of the post using joist hanger screws, 10d galvanized common nails, or joist hanger nails. You must drive a fastener at every predrilled hole in the saddle hardware.

3 Set the beam into the saddle, making sure the sides of the saddle align with the layout marks on the beam.

4 Secure the beam into the saddle by driving galvanized common nails or joist hanger screws through the predrilled holes in the top half of the saddle.

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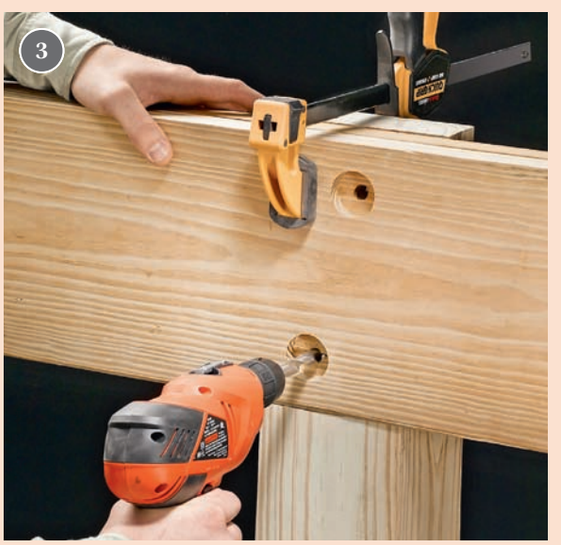
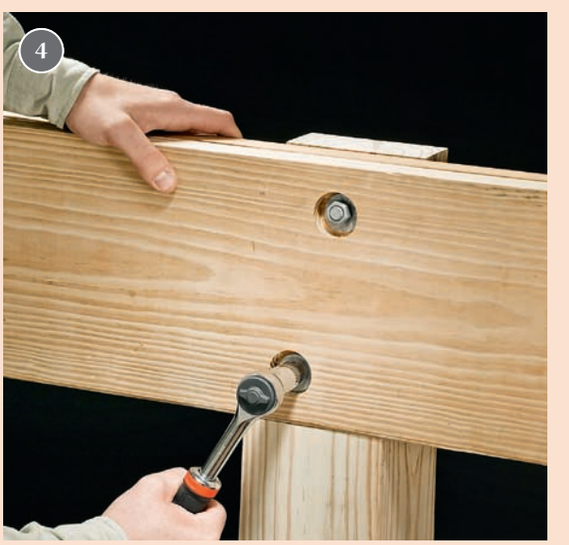
INSTALLING A BEAM FOR A NOTCHED-POST DECK





1 Remove 6 × 6 posts from post anchors and cut to finished height. Measure and mark a notch at the top of each post, sized to fit the thickness and width of the beam. Trace the lines on all sides using a framing square.

2 Use a circular saw to rough-cut the notches, then switch to a reciprocating saw or hand saw to finish. Reattach posts to the post anchors, with the notch-side facing away from the deck.

3 With someone's help, lift the beam (crown side up) into the notches. Align the beam and clamp it to the post. Counterbore two ½"-deep holes, using a 1⅜" spade bit, then drill ½" pilot holes through the beam and post, using a ½" auger bit.

4 Insert carriage bolts to each pilot hole. Add a washer and nut to the counterbore-side of each, and tighten using a ratchet. Seal both ends with silicone caulk. Apply self-sealing membrane to the top surfaces of beam and posts if necessary.

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#175 Dtp:225 Page:67

Joists

Tools & Materials

Tape measure
Pencil
Hammer
Combination square
Circular saw
Paintbrush
Drill
Twist bits (⅛", ¼")
Pressure-treated lumber
10d joist hanger nails
10d and 16d galvanized common nails
Clear sealer-preservative
Joist angle brackets
Galvanized metal joist hangers

Metal joist hangers attached to rim joists or ledgers are practically foolproof for hanging intermediate deck joists. Look for hanger hardware that is triple-dipped galvanized metal.

JOISTS PROVIDE SUPPORT for the decking boards. They are attached to the ledger and header joist with galvanized metal joist hangers and are nailed or strapped to the top of the beam. For strength and durability, use pressure-treated lumber for all joists.

Tip

Trim off the ends of structural lumber to get a clean, straight edge.

Tip

The exposed outside joists and header joist can be faced with composite or cedar boards for a more attractive appearance.

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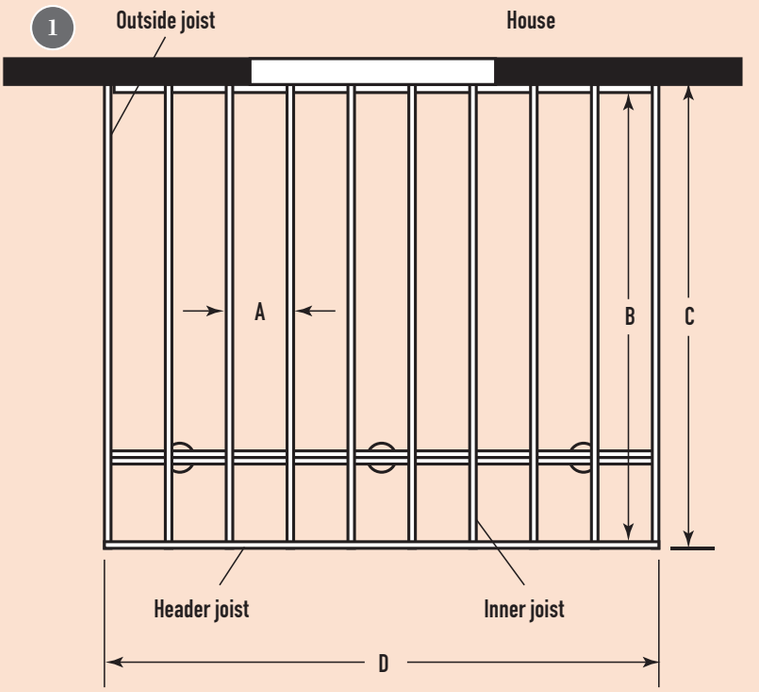
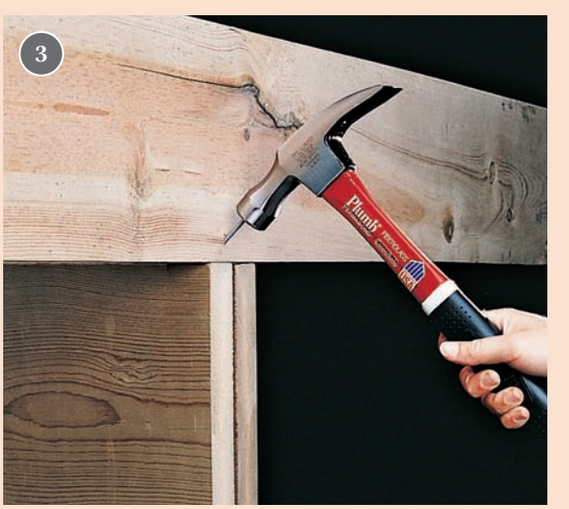
HANGING JOISTS



Joist plan

1 Use your deck plan to find the spacing (A) between joists, and the length of inner joists (B), outside joists (C), and the header joist (D). Measure and mark lumber for outside joists using a combination square as a guide. Cut joists with a miter or circular saw. Seal cut ends with clear sealer-preservative.



2 Attach joist hanger hardware near each end of the ledger board, according to your layout. Previous building codes allowed you to face nail the joists into the ends of the ledger, but this is no longer accepted practice. Attach only enough fasteners to hold the hanger in position while you square up the joist layout.

3 Attach the outside joists to the top of the beam by toenailing them with 10d galvanized common nails.

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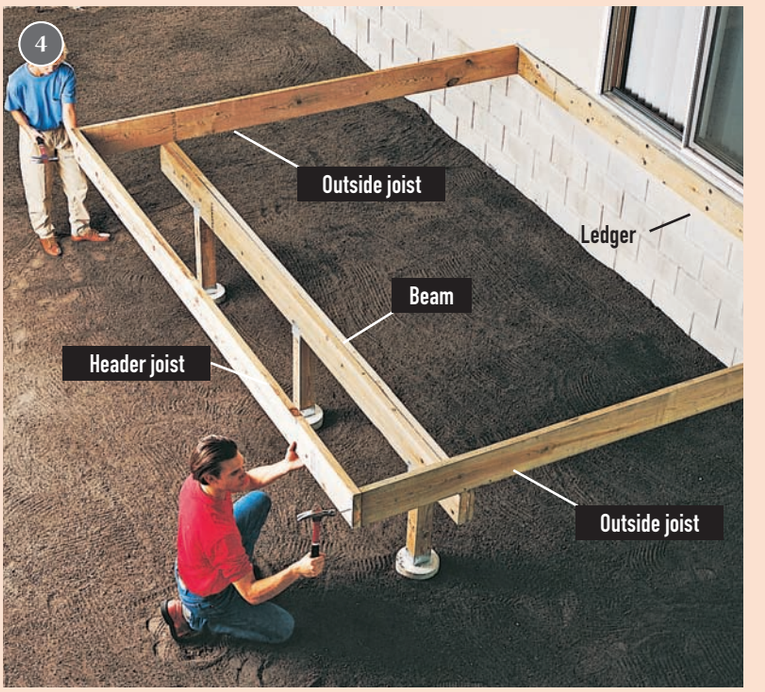
#175 Dtp:225 Page:69

HANGING JOISTS CONTINUED

4 Measure and cut the header joist. Seal cut ends with clear sealer-preservative. Drill ⅛" pilot holes at each end of the header joist. Attach the header to ends of outside joists with 16d galvanized common nails. For extra reinforcement, add metal corner brackets to the inside corner joints.



5 Finish nailing the end joist hangers, making sure you have a joist hanger nail in every punched hole in the hanger.

6 Measure along the ledger from the edge of the outside joist, and mark where the joists will be attached to the ledger. Draw the outline of each joist on the ledger, using a square as a guide.

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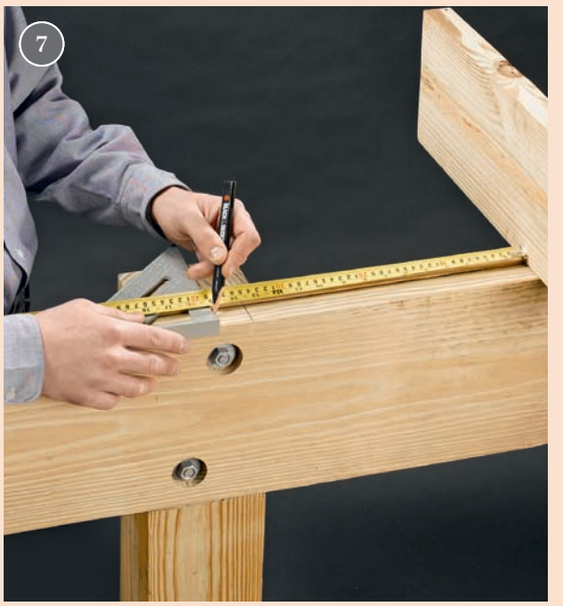

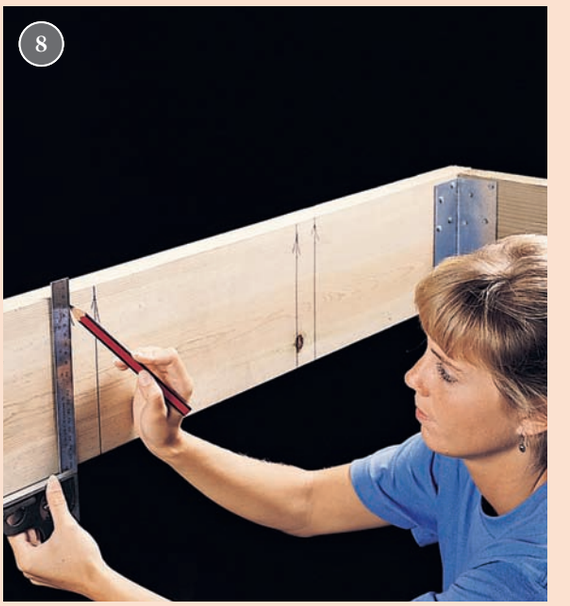

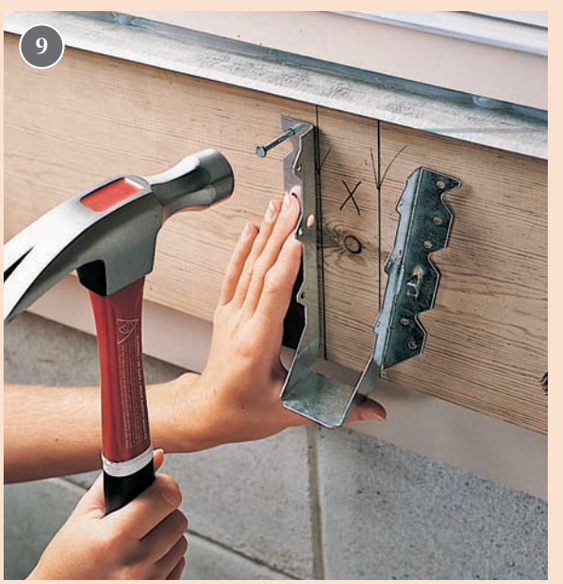

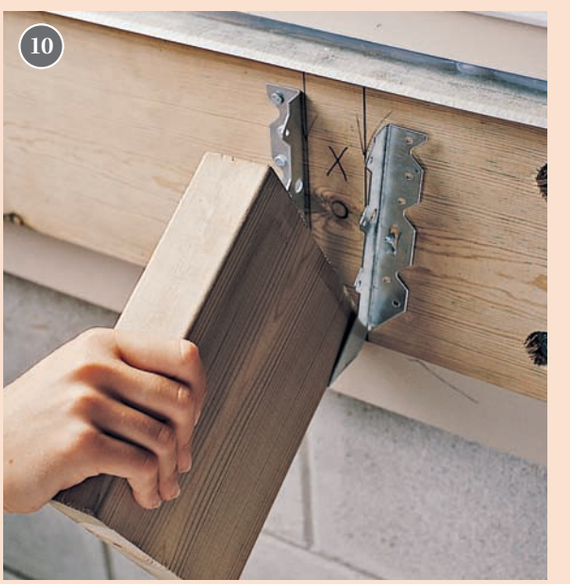

7 Measure along the beam from the outside joist, and mark where joists will cross the beam. Draw the outlines across the top of both beam boards.

8 Measure along the header joist from the outside joist, and mark where joists will be attached to the header joist. Draw the outlines on the inside of the header, using a square as a guide.

9 Attach joist hangers to the ledger and to the header joist. Position each hanger so that one of the flanges is against the joist outline. Nail one flange to framing members with 10d galvanized joist hanger nails.

10 Cut a scrap board to use as a spacer. Hold the spacer inside each joist hanger, then close the hanger around the spacer.

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#175 Dtp:225 Page:71

11 Nail the remaining side flange to the framing member with 10d joist hanger nails. Remove the spacer. Measure and mark lumber for joists, using a combination square as a guide. Cut joists with a circular saw or power miter saw.

12 Seal cut ends with clear sealer-preservative. Place the joists in the hangers with crowned edge up.

13 Attach the ledger joist hangers to the joists with joist hanger nails. Drive nails into both sides of each joist.

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#175 Dtp:225 Page:72

14 Align the joists with the outlines drawn on the top of the beam. Anchor the joists to the beam by toenailing from both sides with 10d galvanized nails.

15 Attach the joists to the hangers on the joist with 10d joist hanger nails. Drive nails into both sides of each joist.

Alternate Method

Fasten joists to beams using H-fit joist ties for strength and durability.

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#175 Dtp:225 Page:73

Angles

Joists on a cantilevered deck can be easily marked for angled cuts by snapping a chalk line between two points on adjacent sides of the deck corner. Marking and cutting joists in this fashion is easier than measuring and cutting the joists individually. To help hold the joists in place while marking, tack a brace across the ends. Mark joist locations on the brace for reference.

DECKS WITH GEOMETRIC SHAPES and angled sides have much more visual interest than basic square or rectangular decks. Most homes and yards are configured with predictable 90-degree angles and straight sides, so an angled deck offers a pleasing visual surprise.

Contrary to popular belief, elaborate angled decks are relatively easy to plan and build, if you follow the lead of professional designers. As professionals know, most polygon-shaped decks are nothing more than basic square or rectangular shapes with one or more corners removed.

Seen in this light, complicated multi-level decks with many sides become easier to visualize and design.

For visual balance and ease of construction, use 45-degree angles when designing an angled, geometric deck. In this way, the joinery requires only common cutting angles (90-degree, 45-degree, or 22½-degree), and you can use skewed 45-degree joist hangers, readily available at home centers. The angled deck construction shown on the following pages was built using primarily 4 × 4 inch posts. Recent changes to many building codes require 6 × 6 inch posts. Always check with your local building department to learn applicable codes for your deck.

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DESIGN OPTIONS FOR ANGLED DECKS

Cantilever design is the easiest and least expensive to build, since it requires the fewest posts. But the length of the angled side is limited by code regulations that restrict the amount of joist overhang. And since the joists rest on top of the beam, cantilever designs are not suited for a deck with a very low profile. On cantilever designs, the joists along the angled side are beveled at 45° at the ends, and are attached to the rim joist by endnailing.

Corner-post design is a good choice for large decks with long, angled sides. It also works well for low-profile decks, since the joists are mounted to the inside faces of the beams. Many builders use a single beveled post to support the angled corners on this type of deck, but our method calls for two posts and footings at each of these corners, making the design easier to construct and more versatile. On a corner-post deck, the joists on the angled side are square-cut, and are attached to the beam with skewed 45° joist hangers.

Multi-level design features an upper platform built using the corner-post method (above), but adds a lower platform. The lower level is supported by a second angled beam, created by sandwiching timbers around the same posts that support the upper platform. On the lower platform, the joists rest on top of the beam and are beveled on the back ends so they are flush with the edge of the beam. Check with your local building department to make sure this design strategy is allowed by your local building codes.

Tip

An octagonal island deck is simply a square with all four corners omitted.

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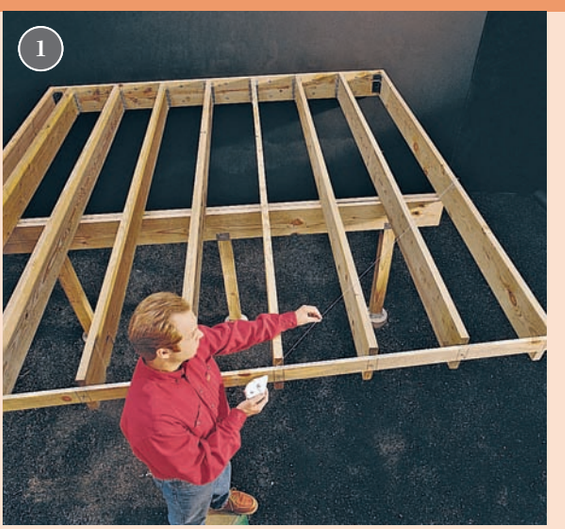
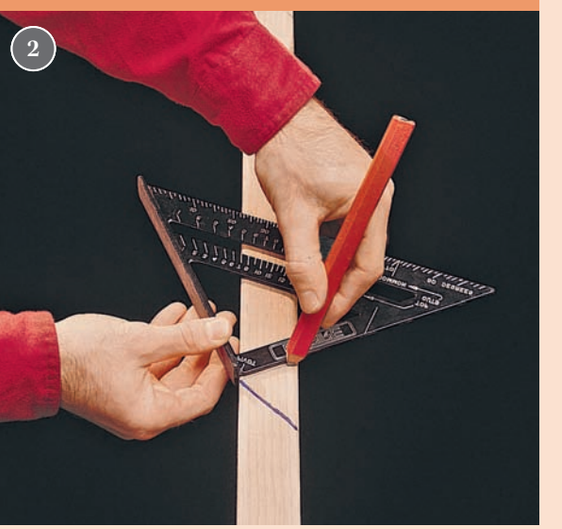
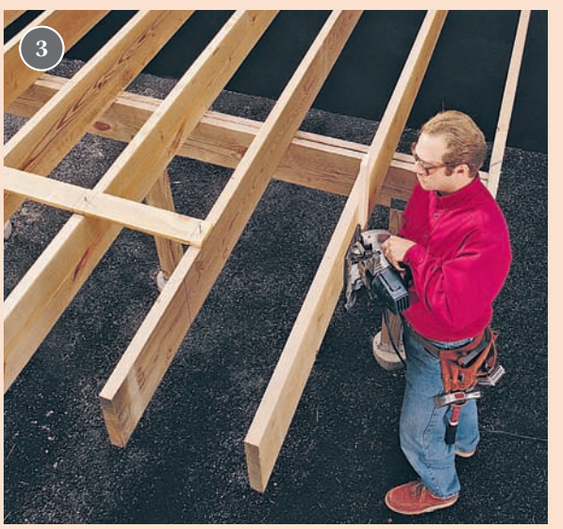
BUILDING SUPPORT FOR AN ANGLED DECK







1 Lay out and begin construction, using standard deck-building techniques. After installing the joists, mark cutting lines on the angled side by snapping a chalk line across the tops of the joists. Make sure the chalk line is angled 45° to the edge of the deck.

2 At the outside joists, use a speed square to change the 45° chalk line to a line angled at 22½° in the opposite direction. When joined to a rim joist that is also cut to 22½°, the corner will form the correct angle.

3 Use a combination square to extend the angle marks down the faces of the joists. Bevel-cut the deck joists with a circular saw, using a clamped board as a guide for the saw foot. Interior joists should be beveled to 45°; outside joists to 22½°.

4 Cut and install the rim joists. At the angled corners, bevel-cut the ends of the rim joists at 22½°. Endnail the rim joists in place, and reinforce the inside corners with adjustable angle brackets attached with joist-hanger nails. Finish the deck using standard deck-building techniques.

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BUILDING AN ANGLED DECK USING THE CORNER-POST DESIGN

1 Use boards to create a rectangular template of the deck. To ensure that the template is square, use the 3-4-5 triangle method: From the corner directly below the ledger, measure 3 ft. along the foundation, and mark a point. Measure out along the template board 4 ft., and mark a second point. Measure diagonally between the two points. This measurement should be 5 ft.; if not, adjust the template to square it.

2 Indicate each angled edge by positioning a board diagonally across the corner of the template. To ensure that the angles measure 45°, make sure the perpendicular legs of the triangle have exactly the same measurement. Nail the boards together where they overlap.

3 Mark locations for post footings with stakes or spray paint. At each 45° corner, mark locations for two posts, positioned about 1 ft. on each side of the corner. Temporarily move the board template, then dig and pour concrete footings.

4 While the concrete is still wet, reposition the template and check to make sure it is square to the ledger. Use a nail to scratch a reference line across the concrete next to the template boards, then insert J-bolts in the wet concrete. Let the concrete dry completely.

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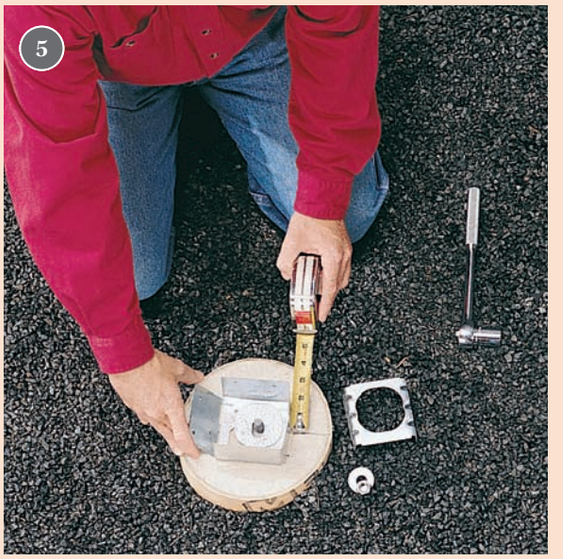

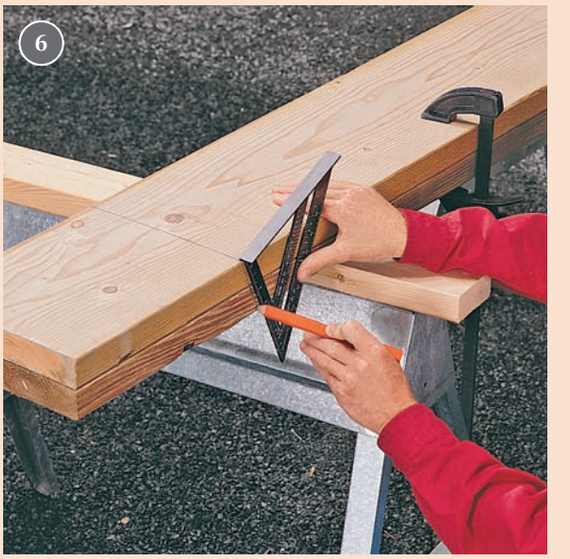

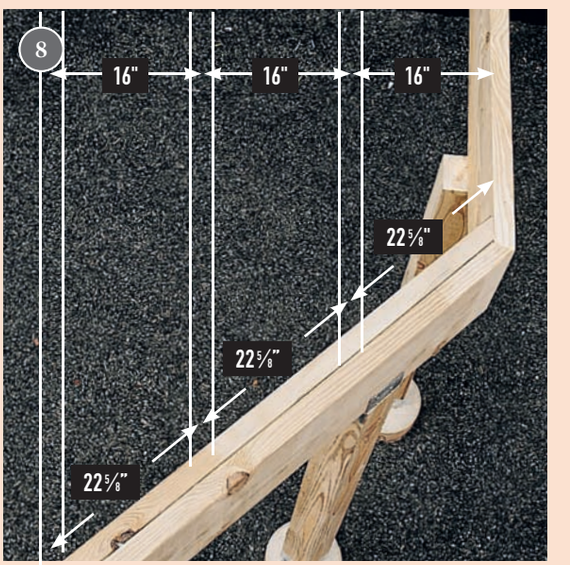

5 Attach metal post anchors to the J-bolts, centering them on the reference lines scratched in the concrete. The front and back edges of the anchors should be parallel to the reference line.

6 Measure and cut beam timbers to size. On ends that will form angled corners, use a speed square to mark 22½° angles on the tops of the timbers, then use a combination square to extend cutting lines down the face of the boards. Use a circular saw set for a 22½° bevel to cut off the timbers, then join them together with 16d nails.

7 Set posts into the post anchors, then use a mason's string and line level to mark cutoff lines on the posts at a point level with the bottom of the ledger. Cut off the posts using a circular saw. Attach post-beam caps to the posts, then set the beams into place. Secure beam corners together with adjustable angle brackets attached to the inside of each corner with joist-hanger nails.

8 Measure and mark joist locations on the ledger and beams. If your joists are spaced 16" on center along the ledger, they will be spaced 22⅝" apart measured along the angled beam. If they are spaced 24" on center at the ledger, the joists will be spaced 33⁵⁄₁₆" apart along the angled beam.

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#175 Dtp:225 Page:78

9 Attach joist hangers at the layout marks on the ledger and beam. Use skewed 45° joist hangers on the angled beam.

10 Cut and install joists, securing them with joist-hanger nails. Joists installed in skewed 45° joist hangers can be square-cut; they need not be beveled to match the angle of the beam. Complete the deck, using standard deck-building techniques.

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#175 Dtp:225 Page:79

Curves

BY THEIR NATURE, curved shapes lend a feeling of tranquility to a landscape. A deck with curved sides tends to encourage quiet relaxation. A curved deck can also provide an effective visual transition between the sharp architectural angles of the house and the more sweeping natural lines of the surrounding landscape.

Curved decks nearly always use a cantilevered design, in which the curved portion of the deck overhangs a beam that is set back from the edge of the deck. This setback distance generally should be no more than one-third of the total length of the deck joists, but longer cantilevers are possible if you use a combination of thicker joists, closer joist spacing, and stronger wood species, such as southern yellow pine.

The curved deck shown on the following pages was built using primarily 4 × 4 inch posts. Recent changes to many building codes require 6 × 6 inch posts. Always check with your local building department to learn applicable codes for your deck.

If your curved deck will be high enough to require a railing, we recommend a design that incorporates a circular curve rather than an elliptical or irregular curve. Adding a curved railing is much easier if the deck curve is based on a circular shape.

Tip

Adding curves to your deck is not something you should do on the spur of the moment. Consider the pros and cons carefully before you commit to curves. Here are some to think about:

Pros:

- Curves can add visual appeal and uniqueness to your deck.
- Curves soften the overall feeling.
- Used wisely, curves have a natural, organic visual quality.
- A curve can be used to work around an obstacle in a pleasing way.
- A curved corner can preserve space below the deck.

Cons:

- Decks that incorporate curves almost always require more posts and beams, and they make less efficient use of building materials.
- A deck with curves takes at least twice as long to build as a square or rectangular one.
- Curved railings are tricky to make.
- Impact is lessened if curves are overused.
- Curves reduce and constrict deck floorspace.

A curved deck is created by cutting joists to match the curved profile, then attaching a curved rim joist, which can be shaped in one of two ways (page opposite). Braces attached to the tops of the joists hold them in place as the rim joist is installed.

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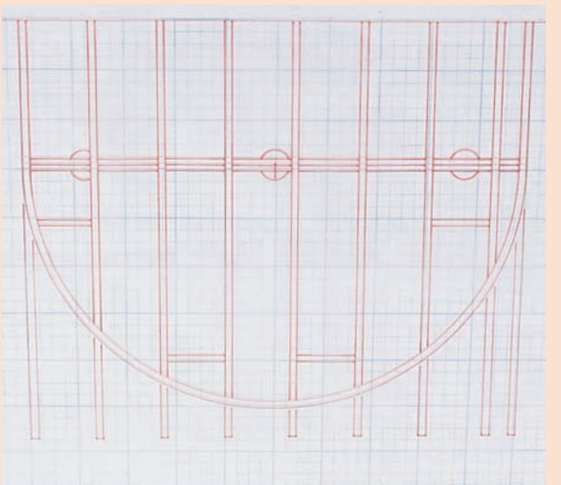
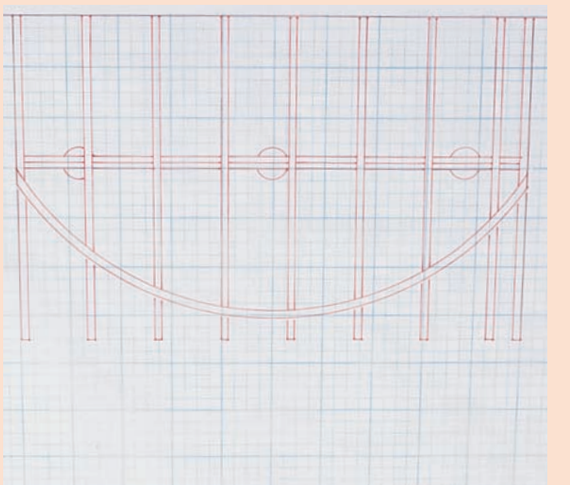
DESIGN OPTIONS FOR CURVED DECKS



Circular designs are the best choice for curved decks that require railings. However, circular curves require a fairly long cantilever, a limitation that may limit the overall size of your deck. Circular decks are laid out using simple geometry and a long compass tool, called a trammel, which you can make yourself.



Irregular or elliptical curves should be used only on relatively low decks, since railings are quite difficult to construct for this kind of curve. These designs also work well for large decks, since the amount of overhang on the cantilever is relatively short compared to that for a circular curve.

CONSTRUCTION OPTIONS FOR CURVES

A kerfed rim joist is formed by making a series of thin vertical cuts (kerfs) across the inside face of the board, making it flexible enough to wrap around the curve. A kerfed rim joist made from 2"-thick dimension lumber is sufficiently strong, but if you are kerfing a 1"-thick redwood or cedar fascia board, it should be backed with a laminated rim joist (photo, right).

Laminated rim joist is made by bending several layers of flexible ¼"- or ⅜"-thick exterior-grade plywood around the curve, joining each layer to the preceding layer with glue and screws. A laminated rim joist can stand alone, or it can provide backing for a more decorative fascia, such as a kerfed redwood or cedar board.

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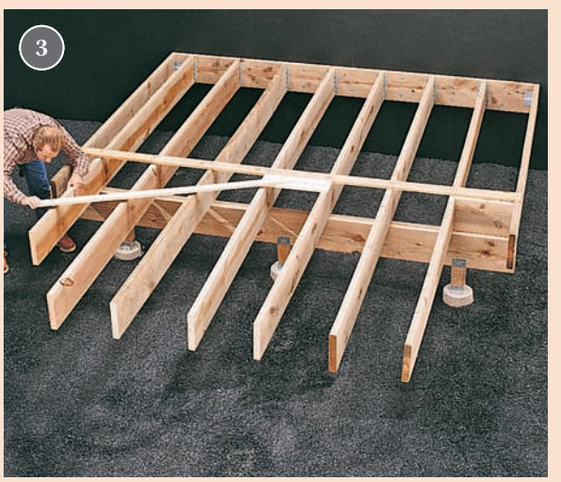
LAYING OUT A CURVED DECK



1 Install posts and beam for a cantilevered deck. Cut joists slightly longer than their final length, and attach them to the ledger and the beam. Add cross-blocking between the two outside joists to ensure that they remain plumb.

2 Mark the joist spacing on a 1 × 4 brace, and tack it across the tops of the joists at the point where the deck curve will begin. Measure the distance between the inside edges of the outer joists at each end of the beam, then divide this measurement in half to determine the radius of the circular curve. Mark the 1 × 4 brace to indicate the midpoint of the curve.

3 Build a trammel by anchoring one end of a long, straight 1 × 2 to the centerpoint of the curve, using a nail. (If the centerpoint lies between joists, attach a 1 × 4 brace across the joists to provide an anchor.) Measure out along the arm of the trammel a distance equal to the curve radius, and drill a hole. Insert a pencil in the hole, and pivot the trammel around the centerpoint, marking the joists for angled cuts.

Variation

For elliptical or irregular curves, temporarily nail vertical anchor boards to the outside joists at the start of the curve. Position a long strip of flexible material, such as hardboard or paneling, inside the anchor boards, then push the strip to create the desired bow. Drive nails into the joists to hold the bow in position, then scribe cutting lines on the tops of the joists.

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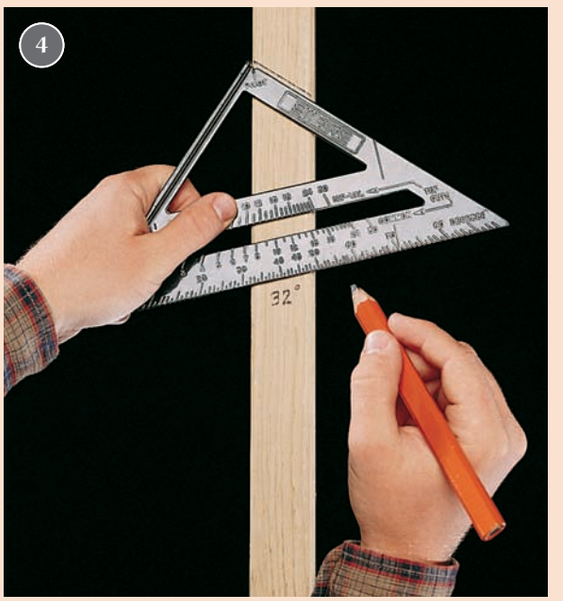

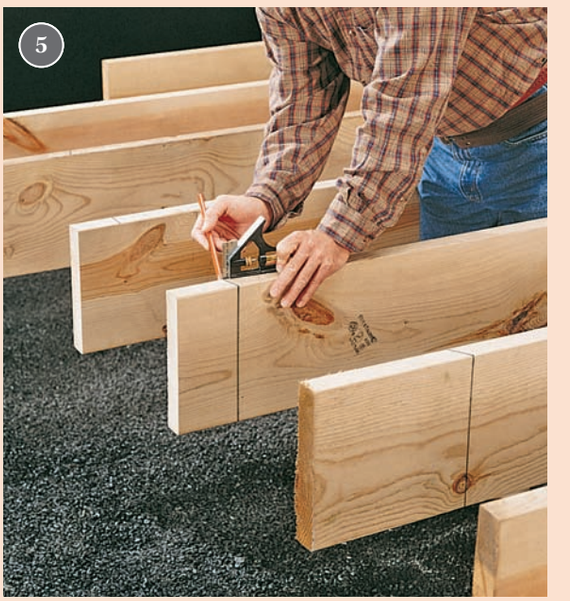

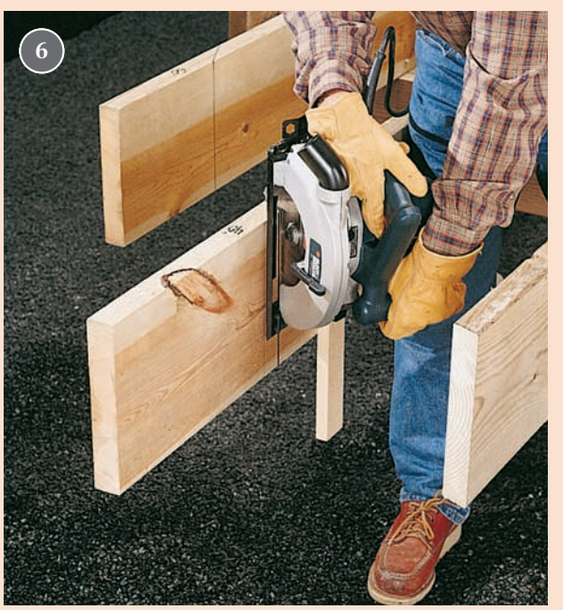

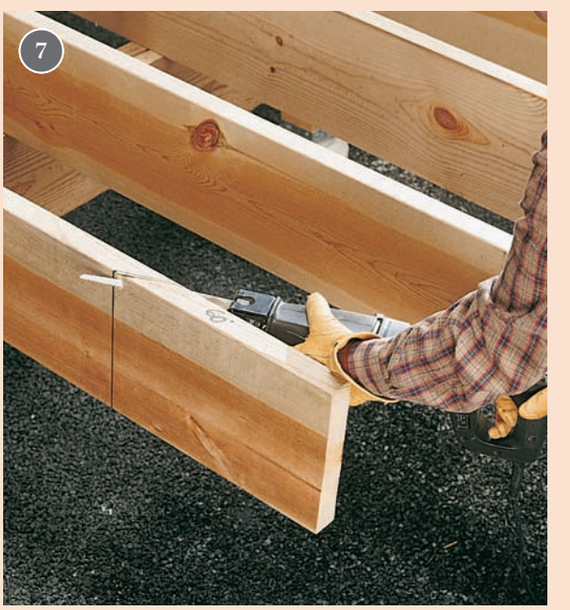

4 Use a speed square or protractor to determine the bevel angles you will use to cut the joists. Position the square so the top is aligned with the layout mark on the joist, then find the degree measurement by following the edge of the joist down from the pivot point and reading where it intersects the degree scale on the square.

5 Use a combination square to extend the cutting lines down the front and back faces of the joists. At the outside joists where the curve begins, mark square cutting lines at the point where the circular curve touches the inside edge of the joists.

6 Cut off each joist with a circular saw set to the proper bevel. Clamp a straightedge to the joist to provide a guide for the foot of the saw. On the outside joists where the curve begins, make 90° cuts.

7 Where the bevel angle is beyond the range of your circular saw, use a reciprocating saw to cut off the joists.

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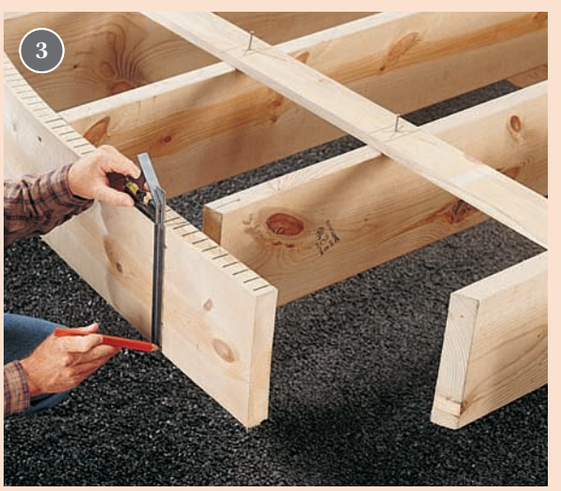
#175 Dtp:225 Page:83

CONSTRUCTING A KERFED RIM JOIST FOR A CURVED DECK



1 Mark the inside face of the rim joist lumber with a series of parallel lines, 1" apart. Using a circular saw or radial-arm saw set to a blade depth equal to ¾ of the rim joist thickness (1⅛" for 1½"-thick lumber), make crosscut kerfs at each line. Soak the rim joist in hot water for about 2 hours to make it easier to bend.

2 Install a cross block between the first two joists on each side of the curve, positioned so half the block is covered by the square-cut outside joist (inset). While it is still damp, attach the rim joist by butting it against the end joist and attaching it to the cross block with 3" deck screws. Bend the rim joist so it is flush against the ends of the joists, and attach with two or three 3" deck screws driven at each joist.

3 Where butt joints are necessary, mark and cut the rim joist so the joint will fall at the center of a joist. To avoid chipping, cut off the rim joist at one of the saw kerfs.

4 Complete the installation by butting the end of the rim joist against the outside joist and attaching it to the cross block. Use bar clamps to hold the rim joist in position as you screw it to the blocking. If the rim joist flattens near the sides of the deck, install additional cross-blocking, cut to the contour of the curve, to hold the rim joist in proper position.

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#175 Dtp:225 Page:84

CONSTRUCTING A CURVED RIM JOIST WITH LAMINATED PLYWOOD

1 Install blocking between the first two joists on each side of the deck (step 2, previous page). Cut four strips of ¼"-thick exterior plywood the same width as the joists. Butt the first strip against the outside joist and attach it to the blocking with 1⅝" deck screws. Bend the strip around the joists and attach with deck screws. If necessary, install additional blocking to keep the plywood in the proper curve. If butt joints are necessary, make sure they fall at the centers of joists.

2 Attach the remaining strips of plywood one at a time, attaching them to previous layers with 1" deck screws and exterior wood glue. Make sure butt joints are staggered so they do not overlap previous joints. For the last layer, use a finish strip of ⅜" cedar plywood. Where the finish strip butts against the outside joists, bevel-cut the ends at 10° to ensure a tight fit.

INSTALLING DECKING ON A CURVED DECK

1 Install decking for the square portion of the deck, then test-fit decking boards on the curved portion. If necessary, you can make minor adjustments in the spacing to avoid cutting very narrow decking boards at the end of the curve. When satisfied with the layout, scribe cutting lines on the underside of the decking boards, following the edge of the rim joist.

2 Remove the scribed decking boards, and cut along the cutting lines with a jig saw. Install the decking boards with deck screws, and smooth the cut edges of the decking boards with a belt sander or random-orbit sander, if necessary.

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#175 Dtp:225 Page:85

Insets

IF YOUR PLANNED deck site has a tree, boulder, or other large obstacle, you may be better off building around it rather than removing it. Although framing around a landscape feature makes construction more difficult, the benefits usually make the effort worthwhile. A deck with an attractive tree set into it, for example, is much more appealing than a stark, exposed deck built on a site that has been leveled by a bulldozer.

The same methods used to frame around a preexisting obstacle also can be used to create a decorative or functional inset feature, such as a planter box, child's sandbox, or brick barbecue. On a larger scale, the same framing techniques can be used to enclose a hot tub or above-ground pool.

Large insets that interrupt joists can compromise the strength of your deck. For this reason, inset openings require modified framing to ensure adequate strength. Double joists on either side of the opening bear the weight of double headers, which in turn support the interrupted joists. Always consult your building inspector for specifics when constructing a deck with a large inset.

Tip

A framed opening can also provide access to a utility fixture, such as a water faucet, electrical outlet, or central air-conditioning compressor. Covering a framed opening with a removable hatch preserves the smooth, finished look of your deck.

Inset framing makes it possible to save mature trees when building a deck. Keeping trees and other landscape features intact helps preserve the value and appearance of your property. Check with a tree nursery for an adequate opening size for any tree you want to contain within an inset.

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#175 Dtp:225 Page:86

FRAMING AN INSET

1 Modify your deck plan, if necessary, to provide the proper support for the interrupted joists in the inset opening. If the inset will interrupt one or two joists, frame both sides of the opening with double joists. If the opening is larger, you may need to install additional beams and posts around the opening to provide adequate support. Consult your building inspector for specific requirements for your situation.

2 Rough-frame the opening by using double joist hangers to install double joists on each side of the inset, and double headers between these joists. Install the interrupted joists between the double headers and the rim joist and ledger.

3 Where needed, cut and install angled nailing blocks between the joists and headers to provide additional support for the decking boards. When trimmed, decking boards may overhang support members by as much as 4" around an inset opening.

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#175 Dtp:225 Page:87

FINISHING DECKS

Decking Patterns 90
Decking 92
Stairs 100
Railings 109
Curved Railings 118
Deck Skirting 122

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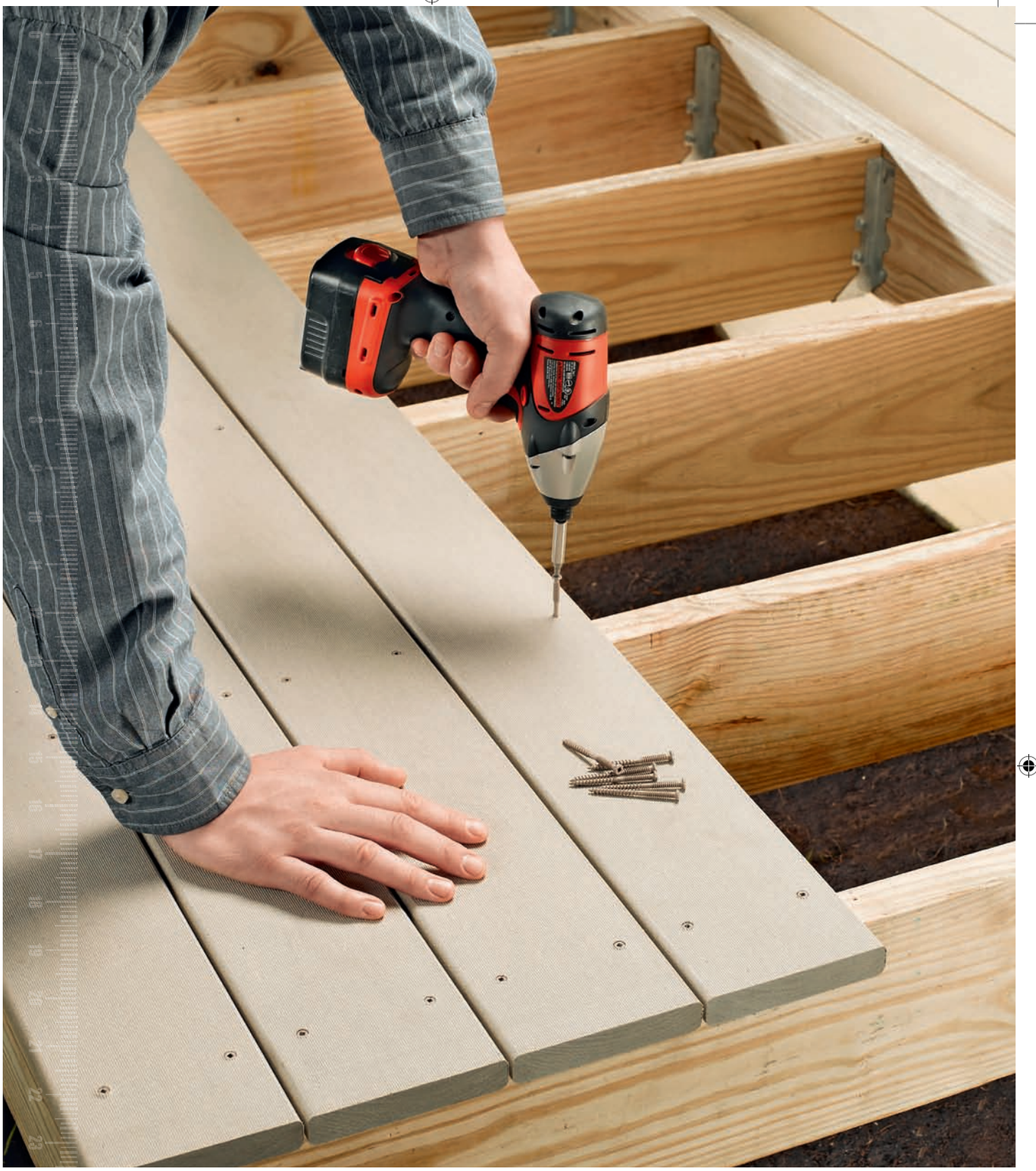

JUST LIKE CLOTHES MAKE THE MAN, design details make the deck. Although there's no crime in building a simple, plan platform to take advantage of a backyard view, or as a no-frills summer hangout to share a few drinks with friends, it's the very rare deck that isn't improved with one or more built-in features.

Some of these are required. Handrails, for instance, are mandated by local codes for decks a certain height above the ground. Stairs are simply practical necessities for elevated or multilevel decks. As practical as these features may be, however, they can also be built with incredible style.

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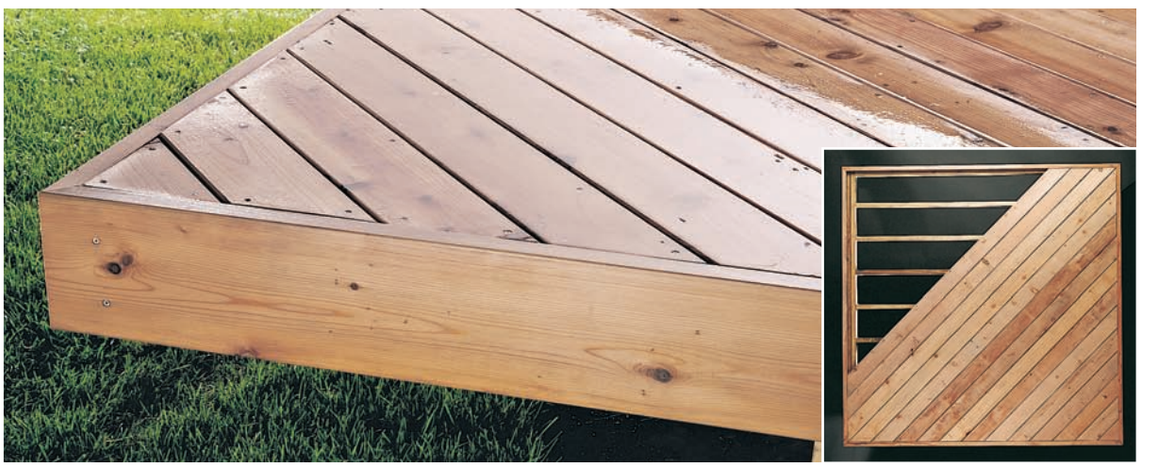
DECKING PATTERNS

Decking boards are the most visible element of your deck, and there are a number of ways to install them. You can use different board widths and lay the boards in any of a number of patterns to increase visual interest. The pattern you choose will affect joist spacing and layout. For instance, a straight decking pattern usually requires joists spaced 16 inches on-center. Diagonal decking generally requires joist spacing of 12 inches on-center. Parquet and other intricate patterns may require extra support, such as double joists or additional blocking. For sturdy wood decking, always use at least 5/4 lumber. Thinner boards are more likely to twist or cup.



Diagonal decking is one of the simplest alternatives to straight runs, and can be an interesting look—especially if you run the diagonals in different directions on different platforms or levels of the deck. However, diagonal patterns often require joists spaced closer than a straight pattern.

Parquet patterns are visually stunning and best suited to more formal decks, and those that don't include bi- or multicolored design features. These patterns require double joists and blocking to provide adequate support surface for attaching the butted ends of boards.

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#175 Dtp:225 Page:90

Even a straight pattern can be interesting when interrupted with built-in shapes. A framed opening for a tree or large rock requires extra blocking between joists. Short joists are attached to blocking with joist hangers.

Border patterns with mitered corners provide an elegant finished look to any deck. They are especially effective when used around the inside deck edge bordering a swimming pool. Install trim joists to support the border decking.

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#175 Dtp:225 Page:91

Decking

BUY DECKING BOARDS that are long enough to span the width of the deck, if possible. If you have to use more than one, butt the boards end-to-end over a joist. Install decking so that there is a gap approximately ⅛" between boards to provide drainage. You can use a nail as a spacer between rows. Some wood boards naturally "cup" as they age. Lay the boards with the bark side facing down, so that any cupping occurs on the bottom side, and to prevent the board holding water on the top.

The common installation method for wood decking is shown here. We've limited the discussion to face-screwing boards to joists, but you can nail the boards down as well. However, nailing is rarely used on modern decking because it requires as much work, and nails inevitably pop up. Screws are just more efficient. If you do decide to nail boards down, use 10d galvanized common nails, angling the nails toward each other to improve holding power. Composite and plastic deck boards are never nailed down. For a much sleeker appearance, you can choose from the large number of "invisible" fasteners on the market. The technology for these has come a long way and, whether you're using wood, composite, or another type of deck boards, hidden fasteners are an easy, quick, and just a slightly more expensive option than screwing the boards down. In any case, always follow the installation instructions and methods recommended by the manufacturer of the product you select.

Tools & Materials

Tape measure
Circular saw
Screwgun
Hammer
Drill
⅛" twist bit
Pry bar
Chalk line
Jigsaw or handsaw
Decking boards
2½" corrosion-resistant deck screws
Galvanized common nails (8d, 10d)
Redwood or cedar facing boards

Tip

Stagger butted joints so that they do not overlap row to row.

Tip: Using a Template

Lay the decking boards so the ends overhang the rough opening. Make a cardboard template to draw a cutting line on the deck boards. (When framing for a tree, check with a tree nursery for adequate opening size to provide space for growth.) Cut the decking boards along the marked line, using a jigsaw. Unattached deckboards can also be cut to curved profiles with a jigsaw.

Skillbuilder

Driving fasteners through damp treated lumber requires a powerful drill/driver. Before beginning your construction project, try driving fasteners into scraps of treated lumber. You may find that your cordless drill/driver does not have the oomph to drive hundreds of fasteners into the dense treated lumber. Upgrade to a higher voltage tool, or drag out the adjustable speed corded drill and use it as a driver. Because corded drills don't have a clutch, you will need to dial down the speed and take care not to strip out the screws.

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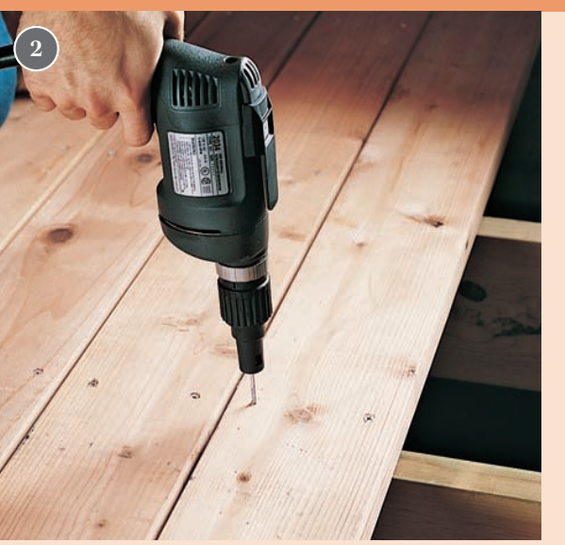
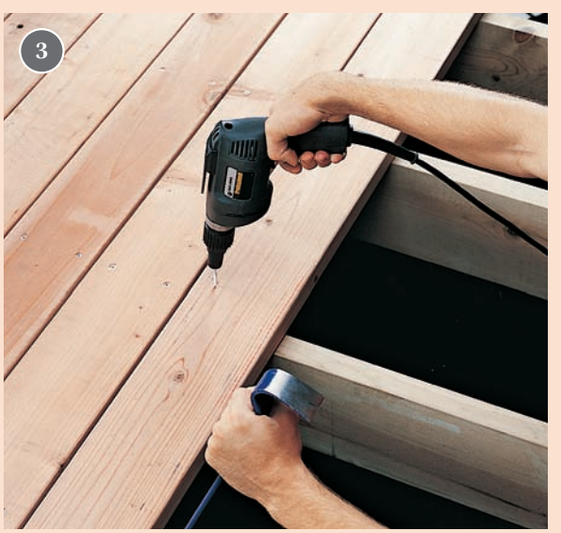
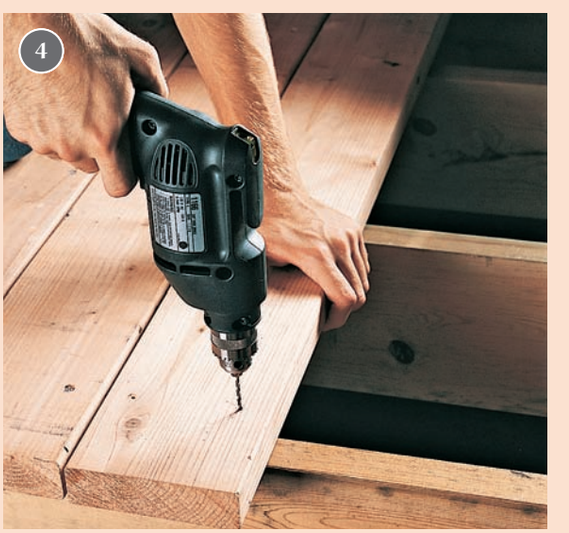
LAYING DECKING







1 Position the first row of decking flush against the house. The first decking board should be perfectly straight, and should be precut to proper length. Attach the first decking board by driving a pair of 2½" corrosion-resistant deck screws into each joist.

2 Position remaining decking boards so that ends overhang outside joists. Space boards about ⅛" apart. Attach boards to each joist with a pair of 2½" deck screws driven into each joist.

3 If the boards are bowed, use a pry bar to maneuver them into position while fastening. You can also use a specialized tool to align a warped board.

4 Drill ⅛" pilot holes in the ends of boards before attaching them to the outside joists. Pilot holes prevent screws from splitting decking boards at ends.

continued

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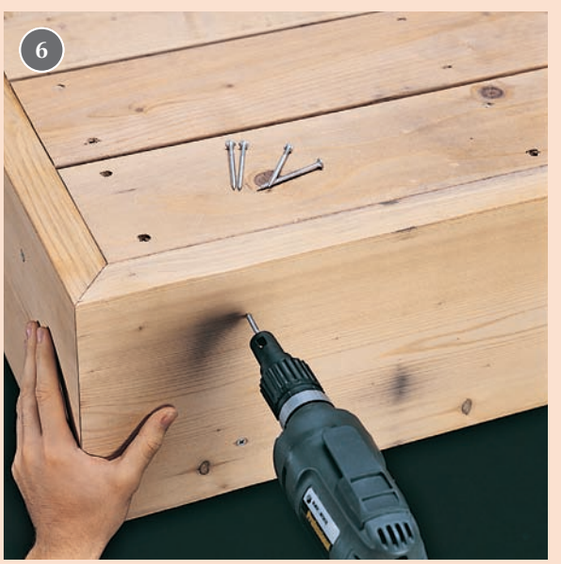
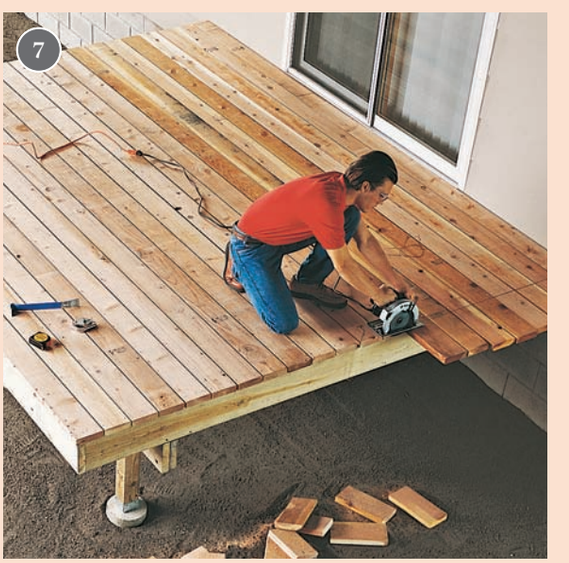
#175 Dtp:225 Page:93

Tip

Adjust board spacing by changing the gaps between boards by a small amount over three or four rows of boards. Very small spacing changes will not be obvious to the eye.





5 After every few rows of decking are installed, measure from the edge of the decking board to the edge of header joist. If the measurements show that the last board will not fit flush against the edge of the deck, adjust board spacing.

6 Use a chalk line to mark the edge of the decking flush with the outside of deck. Cut off decking, using a circular saw. Set the saw blade ⅛" deeper than the thickness of the decking so that the saw will not cut the side of the deck. At areas where the circular saw cannot reach, finish the cutoff with a jigsaw or handsaw.

7 For a more attractive appearance, face the deck with redwood or cedar facing boards. Miter cut corners, and attach boards with deck screws or 8d galvanized nails.

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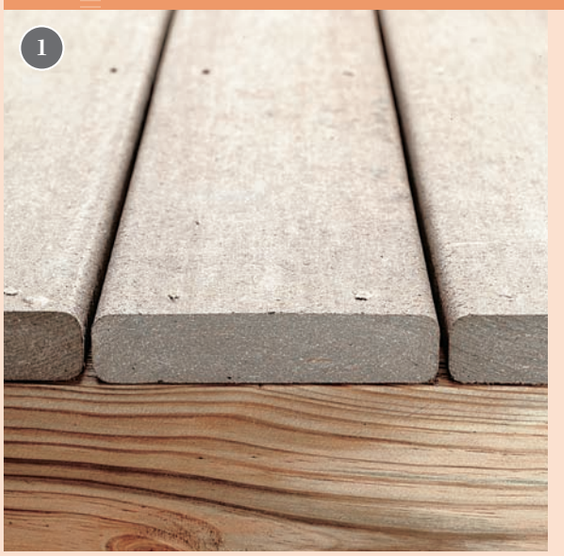
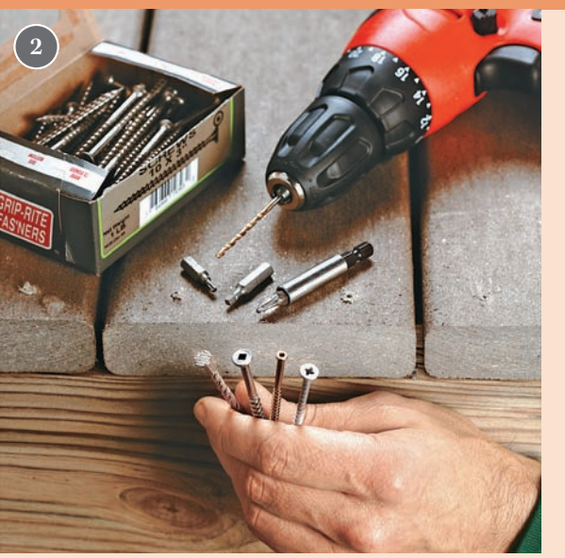
#175 Dtp:225 Page:94

LAYING COMPOSITE DECKING





1 Lay composite decking as you would wood decking (previous pages). Position with the factory crown up so water will run off, and space rows ⅛" to ¼" apart for drainage.

2 Predrill pilot holes at ¾ the diameter of the fasteners, but do not countersink. Composite materials allow fasteners to set themselves. Use spiral shank nails, hot-dipped galvanized ceramic coated screws, or stainless steel nails or deck screws.

3 Lay remaining decking. For boards 16 ft. or shorter, leave a gap at deck ends and any butt joints, 1/16" for every 20°F difference between the temperature at the time of installation and the expected high temperature for the year.

Alternate method:

Attach composite decking with self-tapping composite screws. These specially designed screws require no pilot holes. If the decking "mushrooms" over the screw head, use a hammer to tap back in place.

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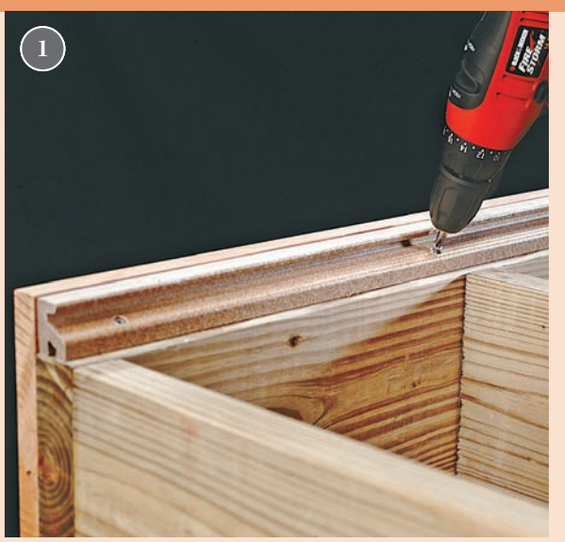
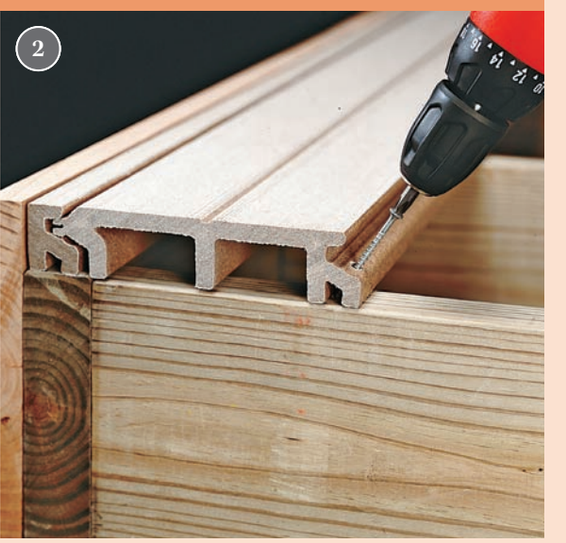
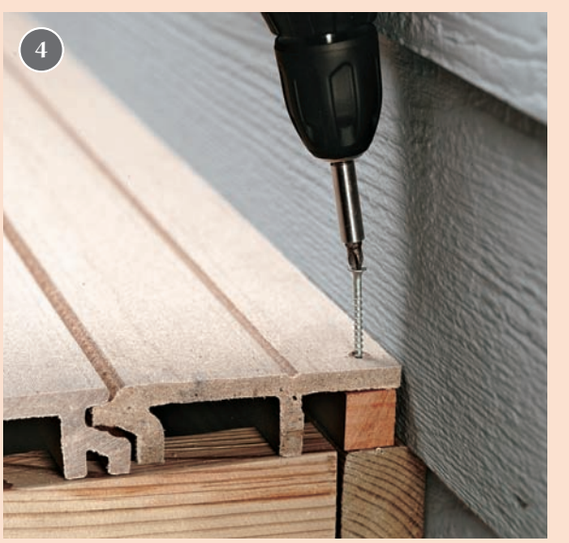
#175 Dtp:225 Page:95

LAYING TONGUE-AND-GROOVE DECKING







1 Position the starter strip at the far end of the deck. Make sure it is straight and properly aligned. Attach it with 2½" galvanized deck screws driven into the lower runner found under the lip of the starter strip.

2 Fit the tongue of a deck board into the groove of the starter strip. There will be approximately a ¼" gap between the deck board and the starter strip. Fasten the deck board to the joists with 2½" galvanized deck screws, working from the middle out to the sides of the deck.

3 Continue to add decking. To lay deck boards end-to-end, leave a ⅛" gap between them, and make sure any butt joints are centered over a joist.

4 Place the final deck board and attach it with 2½" galvanized deck screws driven through the top of the deck board into the joist. If necessary, rip the final board to size, then support the board with a length of 1 × 1 and attach both to the joist. Attach facing boards to conceal exposed ends (photo 4, next page).

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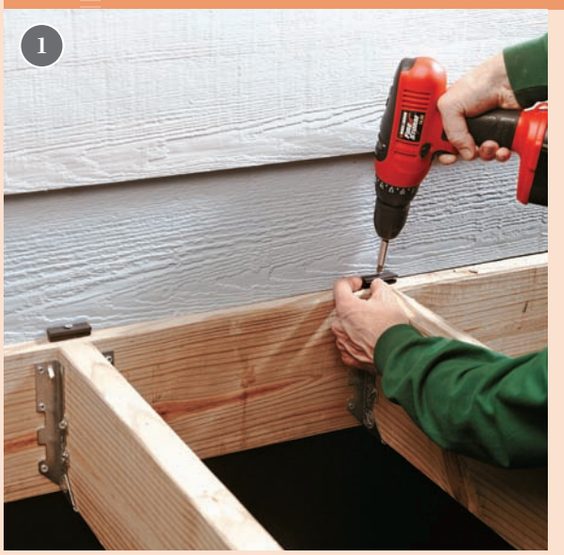
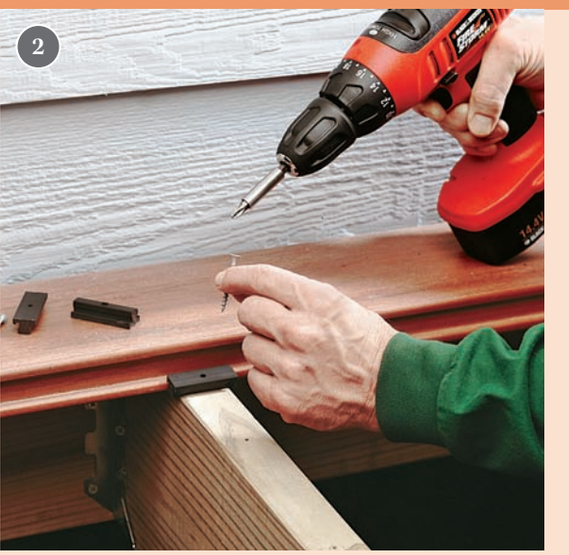
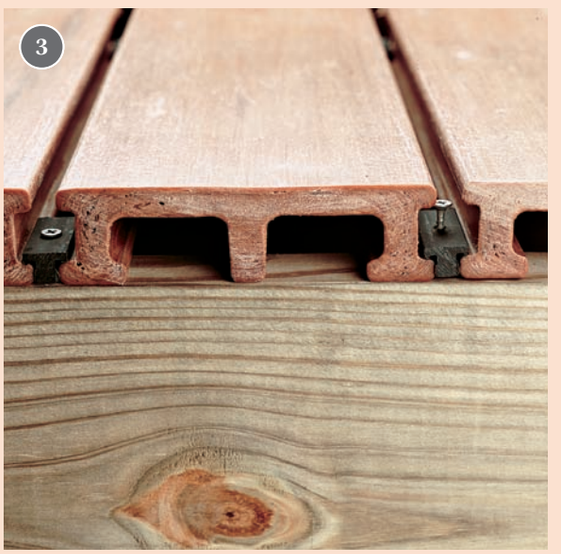
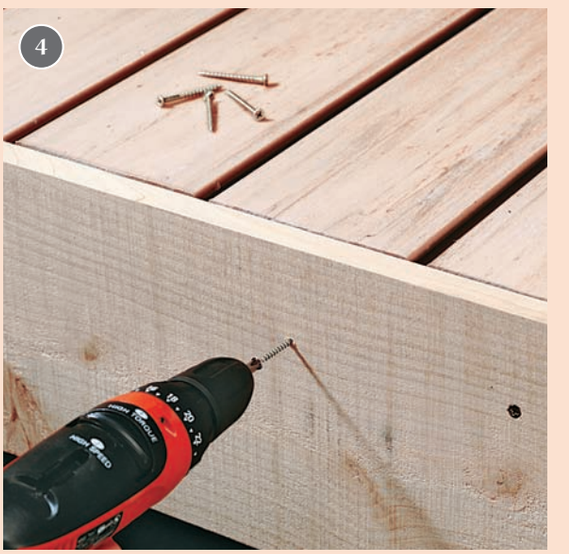
#175 Dtp:225 Page:96

LAYING T-CLIP DECKING









1 Insert 2" galvanized deck screws into T-clips. Loosely attach one T-clip to the ledger at each joist location.

2 Position a deck board tight against the T-clips. Loosely attach T-clips against bottom lip on front side of deck board, just tight enough to keep the board in place. Fully tighten T-clips at the back of the board, against the house.

3 Push another deck board tightly against the front T-clips, attach T-clips at the front of the new board, then fully tighten the previous set of T-clips. Add another deck board and repeat the process to the end of the deck.

4 Cover exposed deck board ends. Miter cut corners of the facing, and drill pilot holes ¾ the diameter of the screws. Attach with 3" galvanized deck screws.

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#175 Dtp:225 Page:97

INSTALLING DECKING WITH UNDERMOUNT DECK BRACKETS

1 Install the deck brackets along the top edge of each joist, alternating brackets from one side of the joist to the other in a continuous series. Secure the brackets with screws driven into the side of the joist.

2 Secure the deck boards by driving screws up through the bracket holes and into the joists. Depending on space constraints, these screws can be driven from above if necessary.

3 Continue installing all of the deck boards from below. When you reach the last board, you may need to install it from above for access reasons. Drive deck screws through the deck board and into the joists below. To maintain the hidden fastener appearance, counterbore the pilot holes for the screws and fill the counterbore with a plug cut from a piece of scrap decking.

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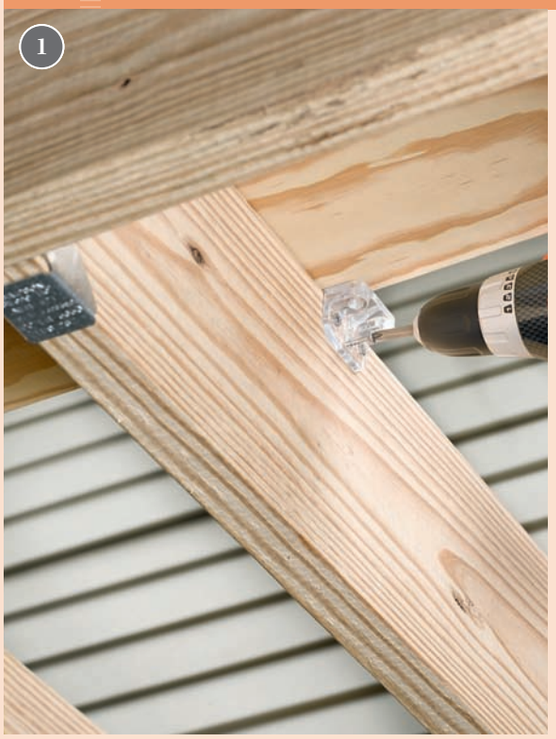
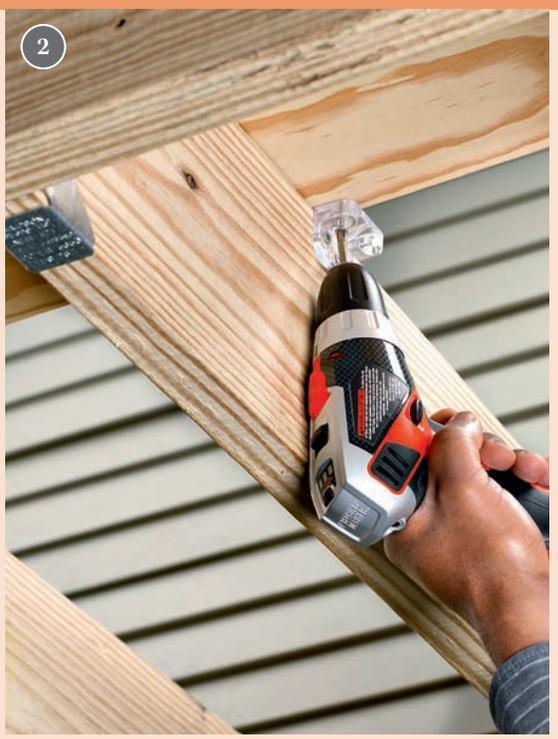
#175 Dtp:225 Page:98

INSTALLING DECKING WITH UNDERMOUNT CLIPS





1 Set a deck board into place on the joists, and slide a clip against it so the spacer tab touches the edge of the deck board. Drive a screw through the center hole of the clip and into the joist.

2 Drive a deck screw up through the plastic clip and into the deck board to secure it.

3 Position the next deck board against the clip's spacer tab, and drive a deck screw up through the clip to fasten it in place. One clip secures two deck boards at each joist location.

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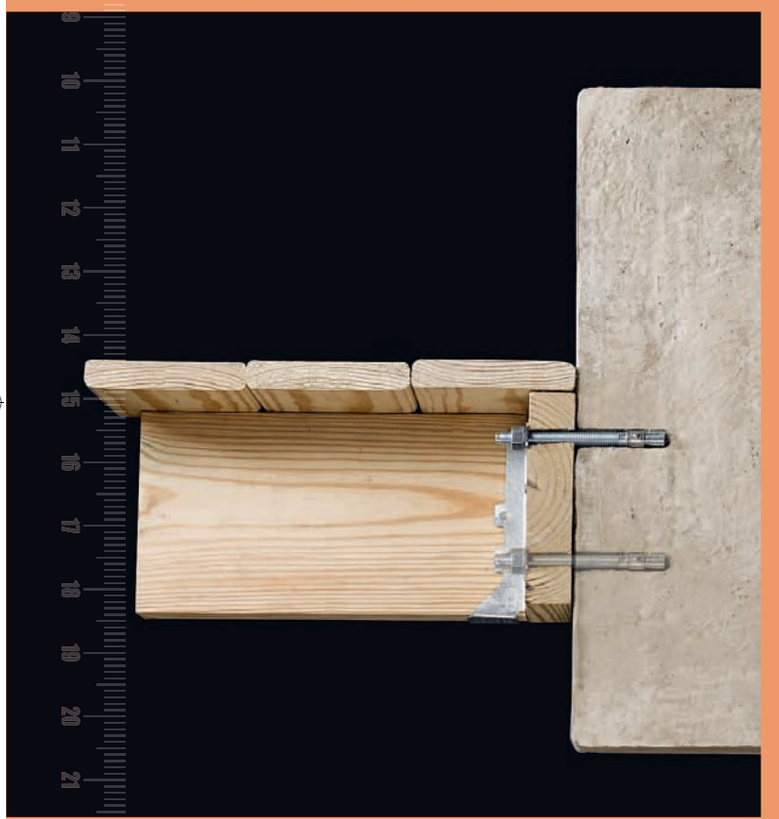
#175 Dtp:225 Page:99

Stairs

HOW YOU BUILD STAIRS for your deck is perhaps the most tightly regulated portion of the building code related to decks. Whenever you are in doubt about measurements for deck stairs—or wondering if you even need to install stairs in the first place—consult the local building codes or local building inspector. Basically, designing deck stairs involves four calculations:



- **The number of stairs** depends on the vertical drop of the deck—the distance from the deck surface to the nearest ground level.
- **Rise** is the vertical space between treads. The proper rise prevents stumbling on the stairs. Most codes call for a maximum rise of 7¾ inches; a lower rise generally makes it easier to ascend or descend the stairs. The thickness of one tread is added to the space between steps to determine actual rise.
- **Run** is the depth of the treads, and is usually a minimum of 10 inches, although the deeper the tread, the more comfortable the stairs will be. Stair step thickness is also dictated by code and is usually a minimum of 1 inches, although most builders use 2× lumber for stair steps. A convenient way to build step treads is by using two 2 × 6s.
- **Span** is calculated by multiplying the run by the number of treads. The span helps you locate the end of the stairway so that you can properly position the posts.

Specifications for other elements such as the stringers and the method of attachment used to connect stairs to decking are also usually mandated in local codes. For instance, stringers normally have to be at least 1½ inches thick.

Although there are different ways to construct stairs, the same basic code requirements apply to any staircase used with a deck.

Tip: Materials for Deck Stairs

Most local building codes require that you use pressure-treated lumber for stairway posts and stringers. Install stair treads and risers cut from material that matches the surface decking. If possible, create treads that use the same board pattern as the decking. You may cover visible pressure-treated portions of the stairway with material matching the decking, too, or stain them to match the decking as closely as possible. Local codes may require handrails on stairways with three or more treads. Many codes also require a separate grippable handrail attached inside stair railings (on one side) in certain circumstances.

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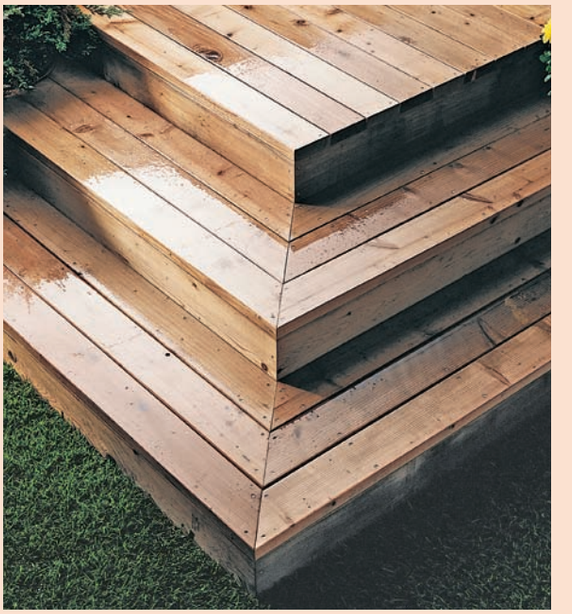
#175 Dtp:225 Page:100

STAIRWAY STYLES

Open steps have metal cleats that hold the treads between the stringers. The treads on this stairway are built with 2 × 6s to match the surface decking.



Platform steps feature wide treads. Each step is built on a framework of posts and joists.

Boxed steps, built with notched stringers and solid risers, give a finished look to a deck stairway. Predrill the ends of treads to prevent splitting.

Long stairways sometimes require landings. A landing is a small platform to which both flights of stairs are attached.

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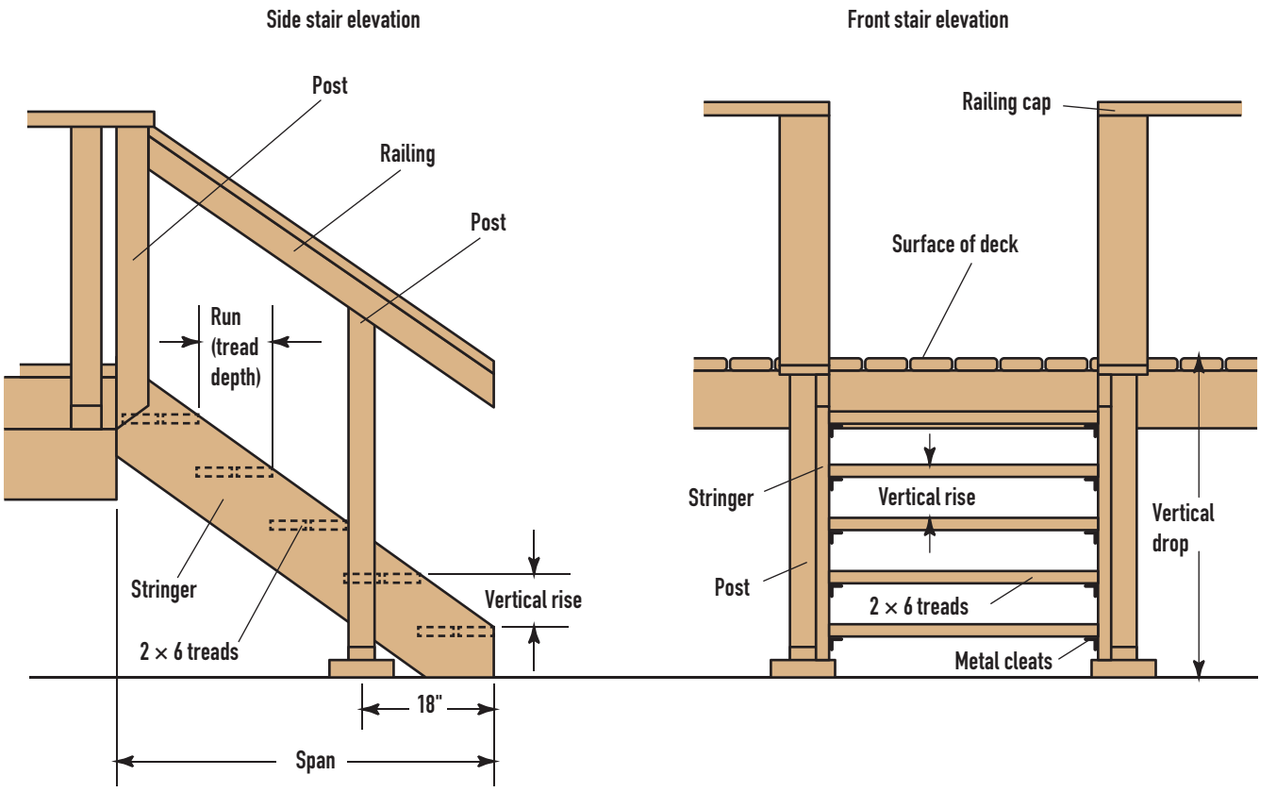

A common deck stairway is made from two 2 × 12 stringers and pairs of 2 × 6 treads attached with metal cleats. Posts set 18" back from the end of the stairway help to anchor the stringers and the railings. Calculations needed to build stairs include the number of steps, the rise of each step, the run of each step, and the stairway span.

FINDING MEASUREMENTS FOR STAIRWAY LAYOUT

				EXAMPLE (39" High Deck)
1.	Find the number of steps: Measure vertical drop from deck surface to ground. Divide by 7. Round off to nearest whole number.	Vertical drop:		39"
		÷ 7 =		÷ 5.57"
		Number of steps: =		= 6
2.	Find step rise: Divide the vertical drop by the number of steps.	Vertical drop: =		39"
		Number of steps: ÷		÷ 6
		Rise: =		= 6.5"
3.	Find step run: Typical treads made from two 2 × 6s have a run of 11¼". If your design is different, find run by measuring depth of tread, including any space between boards.	Run:		11¼"
4.	Find stairway span: Multiply the run by the number of treads. (Number of treads is always one less than number of steps.)	Run:		11¼"
		Number of treads:		× 5
		Span: =		= 56¼"

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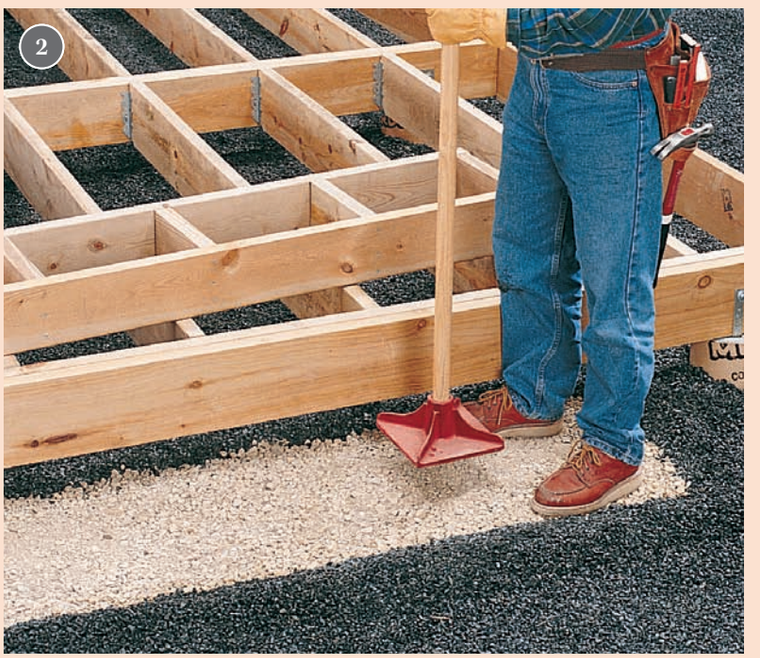
#175 Dtp:225 Page:102

SIMPLE STAIRS: BUILDING A BOX-FRAME STEP

1 Construct a rectangular frame for the step using dimension lumber (2 × 6 lumber is standard). Join the pieces with deck screws. The step must be at least 36" wide and 10" deep. Cut cross blocks and install them inside the frame, spaced every 16".



2 Dig a flat-bottomed trench, about 4" deep, where the step will rest. Fill the trench with compactible gravel, and pack with a tamper. Set the step in position, then measure and attach deck boards to form the tread of the step.

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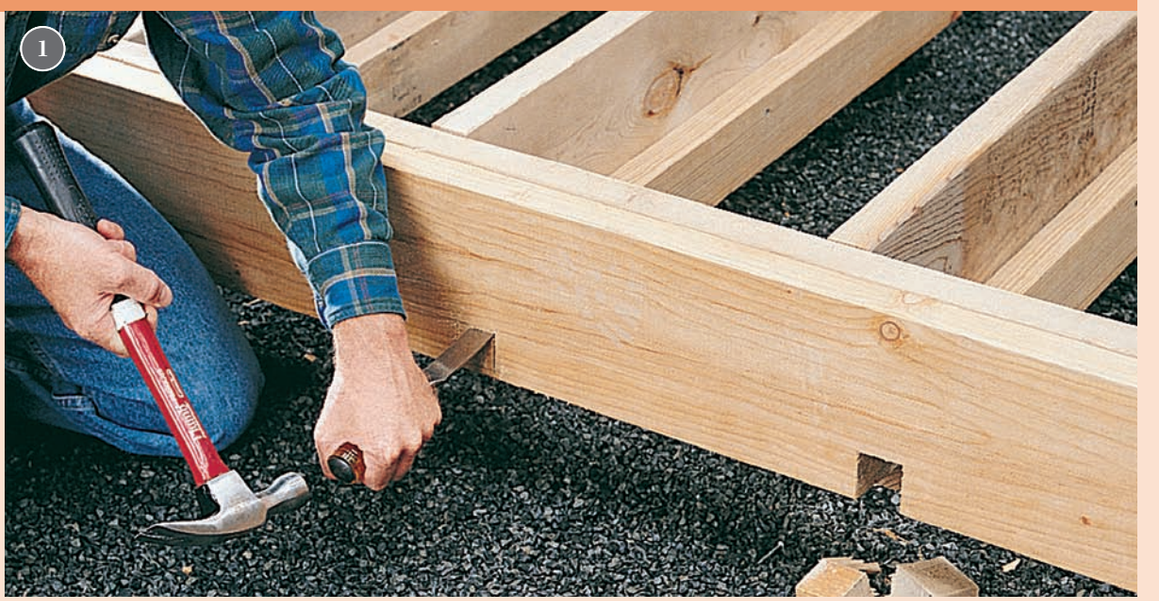
SIMPLE STAIRS: BUILDING A SUSPENDED STEP



1 Screw 2 × 4 furring strips against one side of the deck joists where the step joists will be installed. These strips provide an offset so the step joists will not conflict with the joist hangers attached to the beam. Use a reciprocating saw and chisel to make 1½"-wide notches in the rim joist adjacent to the furring strips. To maintain adequate structural strength, notches in the joists should be no more than 1½" deep.

2 Measure and cut step joists, allowing about 3 ft. of nailing surface inside the deck frame, and 10" or more of exposed tread. Make sure the step joists are level with one another, then attach them to the deck joists using deck screws. Cut and attach deck boards to the tread area of the step.

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BUILDING BASIC DECK STAIRS

Tools & Materials

Tape measure
Circular saw
Screwgun
Hammer
Drill
⅛" twist bit
Pry bar
Chalk line
Jigsaw or handsaw
Decking boards
2½" corrosion-resistant deck screws
Galvanized common nails (8d, 10d)
Redwood or cedar facing boards

1 Use the stairway elevation drawings to find measurements for stair stringers and posts. Use a pencil and framing square to outline where stair stringers will be attached to the side of the deck.

2 Locate the post footings so they are 18" back from the end of the stairway span. Lay a straight 2 × 4 on the deck so that it is level and square to the side of the deck. Use a plumb bob or level to mark the ground at footing centerpoints.

3 Dig holes and pour the footings for posts. Attach metal post anchors to the footings and install the posts. Check with your building department to find out if 6 × 6 posts are now required.

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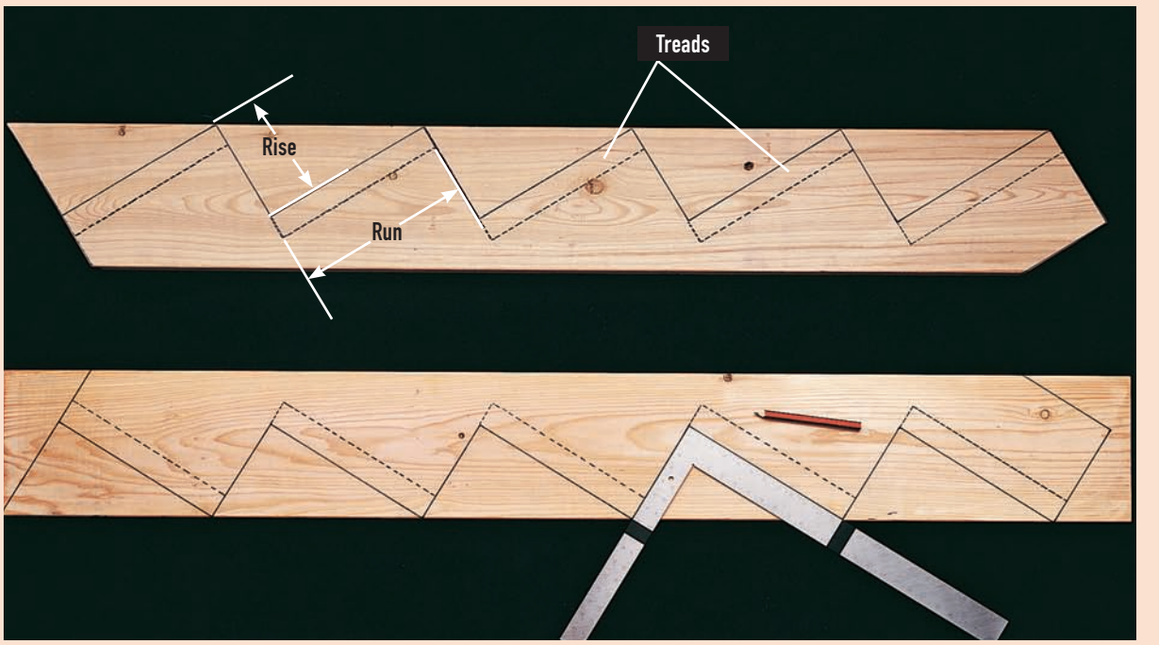

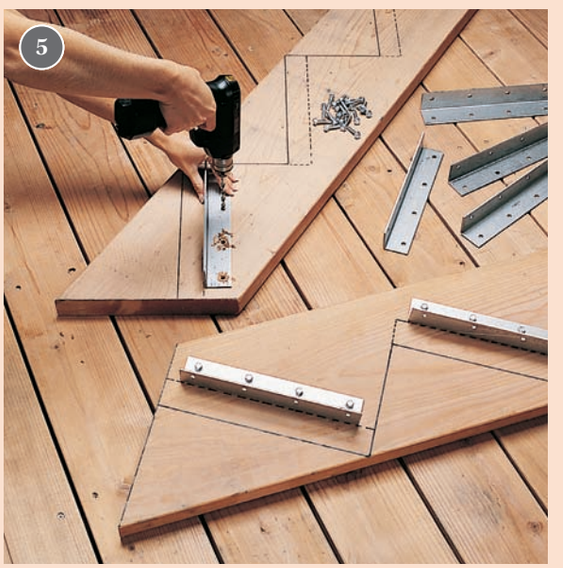

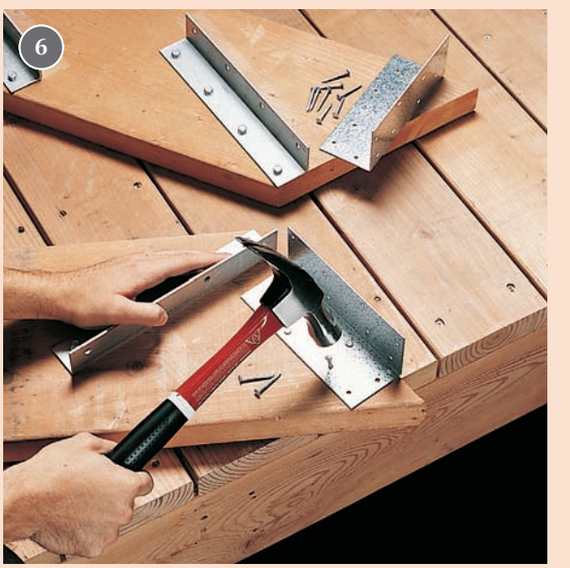

4 Lay out the stair stringers. Use tape to mark the rise measurement on one leg of a framing square, and the run measurement on the other leg. Beginning at one end of the stringer, position the square with tape marks flush to the edge of the board, and outline the rise and run for each step. Then draw in the tread outline against the bottom of each run line. Use a circular saw to trim the ends of the stringers as shown. (When cutting the stringers for stairs without metal cleats, just cut on the solid lines.)

5 Attach metal tread cleats flush with the bottom of each tread outline, using ¼" × 1¼" lag screws. Drill ⅛" pilot holes to prevent the screws from splitting the wood.

6 Attach angle brackets to the upper ends of the stringers using 10d joist hanger nails. Brackets should be flush with the cut ends of the stringers.

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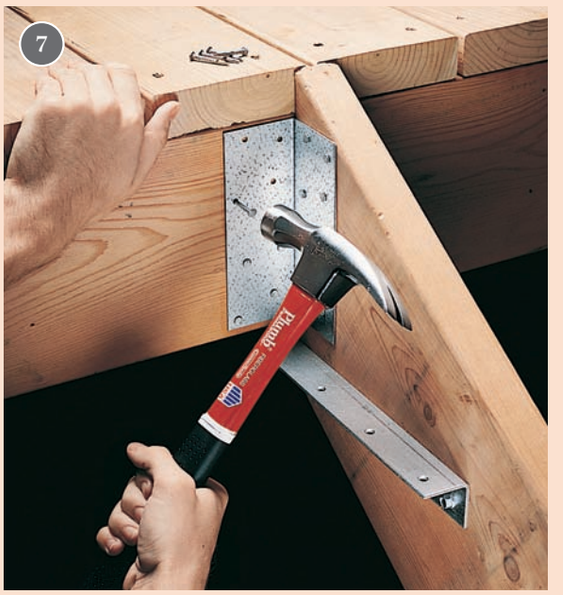
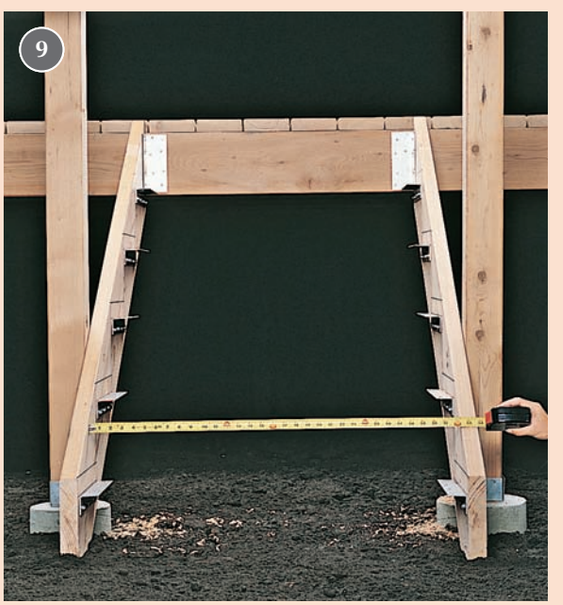
#175 Dtp:225 Page:106





7 Position the stair stringers against the side of the deck, over the stringer outlines. Align the top point of the stringer flush with the surface of the deck. Attach the stringers by nailing the angle brackets to the deck with joist hanger nails.

8 Drill two ¼" pilot holes through each stringer and into each adjacent post. Counterbore each hole to a depth of ½", using a 1⅜" spade bit. Attach the stringers to the posts with ½ × 4" lag screws and washers, using a ratchet wrench or impact driver. Seal screw heads with silicone caulk.

9 Measure the width of the stair treads. Cut two 2 × 6s for each tread, using a circular saw.

10 For each step, position the front 2 × 6 on the tread cleat, so that the front edge is flush with the tread outline on the stringers.

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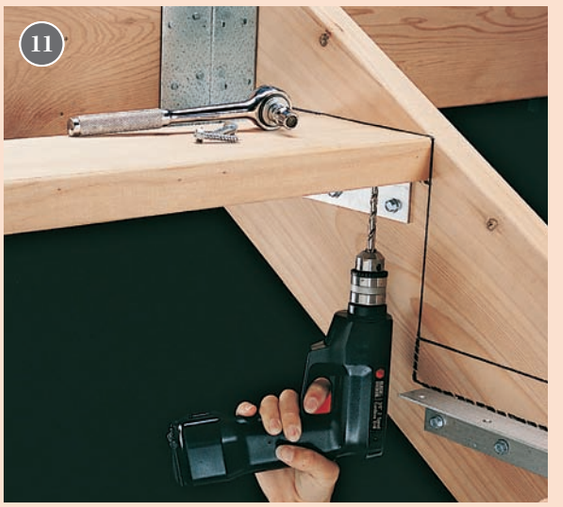

11 Drill ⅛" pilot holes, then attach the front 2 × 6 to the cleats with ¼ × 1¼" lag screws.

12 Position the rear 2 × 6 on the cleats, allowing a small space between boards. Use a 16d nail as a spacing guide. Drill ⅛" pilot holes, and attach the 2 × 6 to the cleats with ¼ × 1¼" lag screws. Repeat for the remaining steps.

STAIRBUILDING OPTION

Notched stringers precut from pressure-treated wood are available at building centers. Edges of cutout areas should be coated with sealer-preservative to prevent rot.

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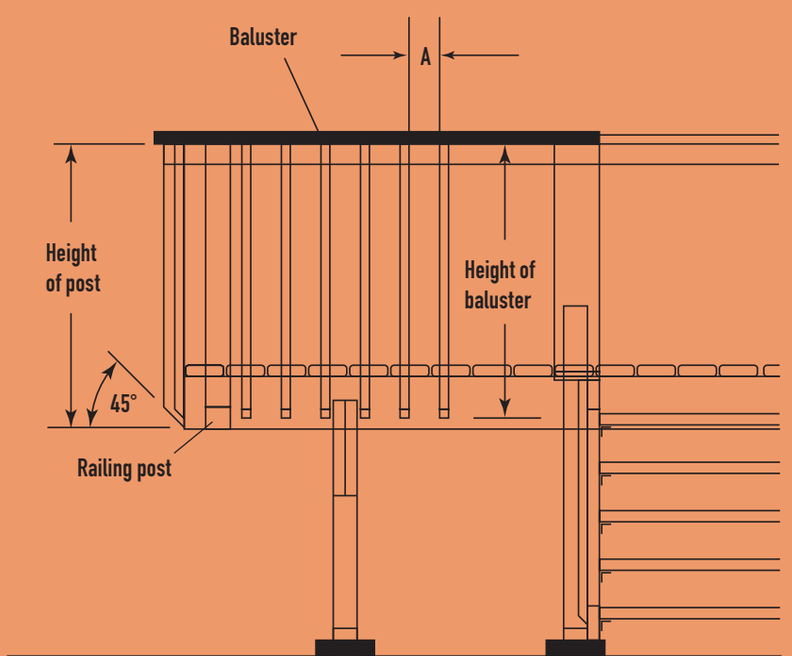
#175 Dtp:225 Page:108

Railings

RAILINGS MUST BE STURDY and firmly attached to the framing members of the deck. Never attach railing posts to the surface decking. Check local building codes for guidelines regarding railing construction. Most codes require that railings be at least 36 inches above decking. Vertical balusters should be spaced no more than 4 inches apart. In some areas, a grippable handrail may be required for any stairway over four treads. Check with your local building inspector for the building codes in your area.



Railing detail

Tools & Materials

Tape measure
Pencil
Power miter saw
Drill
Twist bits (⅛", ⅜")
1⅜" spade bit
Combination square
Awl
Ratchet wrench
Caulk gun
Reciprocating saw
Circular saw
Jigsaw with wood-cutting blade
Miter saw
Level
Railing lumber (4 × 4s, 2 × 6s, 2 × 4s, 2 × 2s)
Clear sealer-preservative
½ × 4½" lag screws and 1⅜" washers
Silicone caulk
2½" corrosion-resistant deck screws
10d galvanized common nails

Railings are mandatory safety features for any deck that's more than 30" above grade. There are numerous code issues and stipulations that will dictate how you build your deck railings. Consult with your local building inspector for any code clarification you may need.

Refer to your deck design plan for spacing (A) and length of railing posts and balusters. Posts should be spaced no more than 6 ft. apart.

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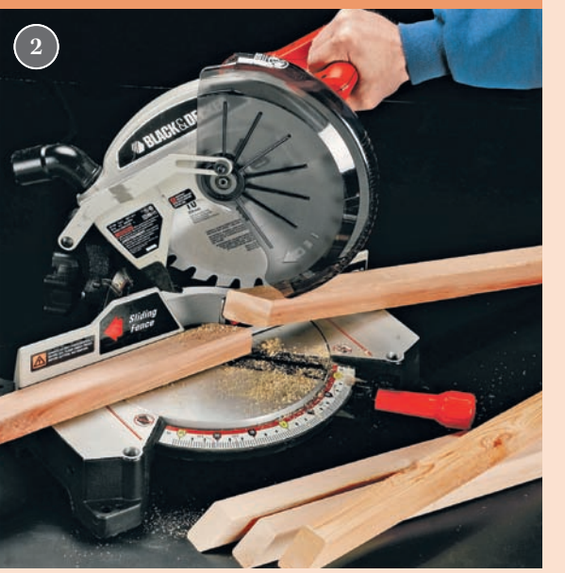
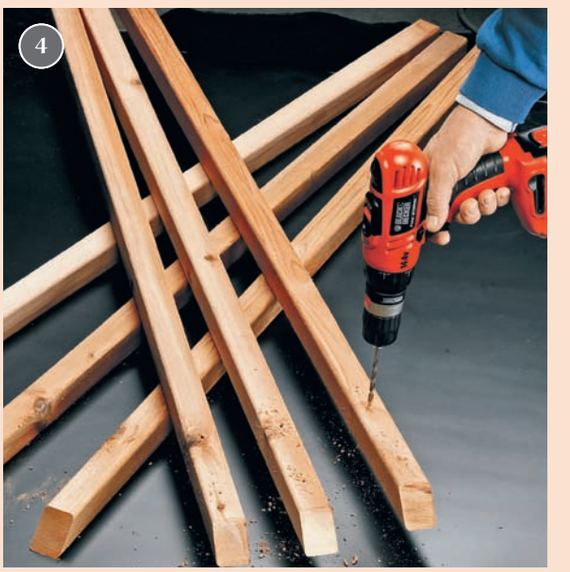
#175 Dtp:225 Page:109

INSTALLING A WOOD DECK RAILING





1 Measure and cut 4 × 4 posts using a power miter saw or circular saw. Cut the tops of the posts square, and cut the bottoms at a 45° angle. Seal cut ends of lumber with clear sealer-preservative.

2 Measure and cut the balusters for the main deck railing using a power miter saw or circular saw. Cut the tops of the balusters square, and cut the bottoms at a 45° angle. Seal cut ends of lumber with clear sealer-preservative.

3 Drill two ⅜" pilot holes spaced 2" apart through the bottom end of each post. Counterbore each pilot hole to ½" depth, using a 1⅜" spade bit.

4 Drill two ⅛" pilot holes spaced 4" apart near the bottom end of each baluster. Drill two ⅛" pilot holes at the top of each baluster, spaced 1½" apart.

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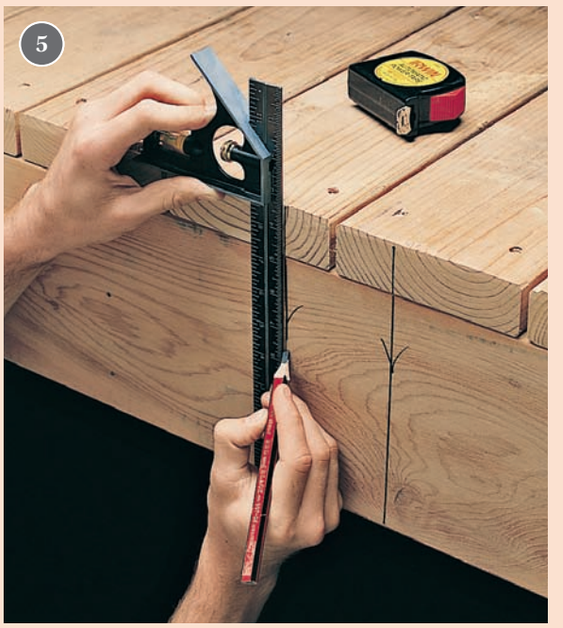
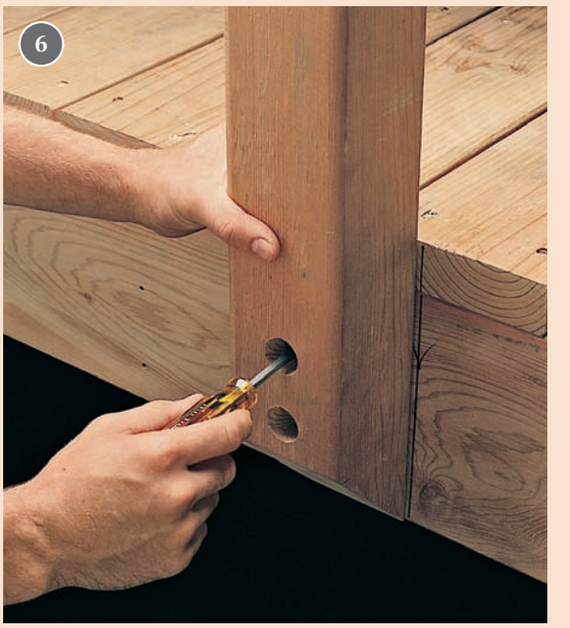
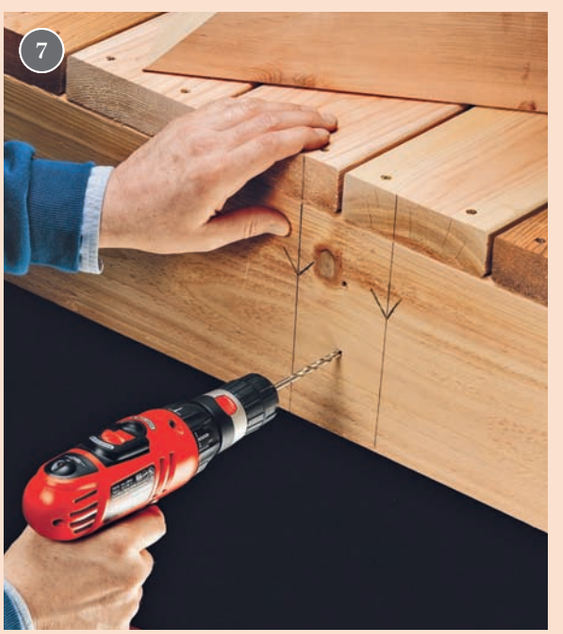
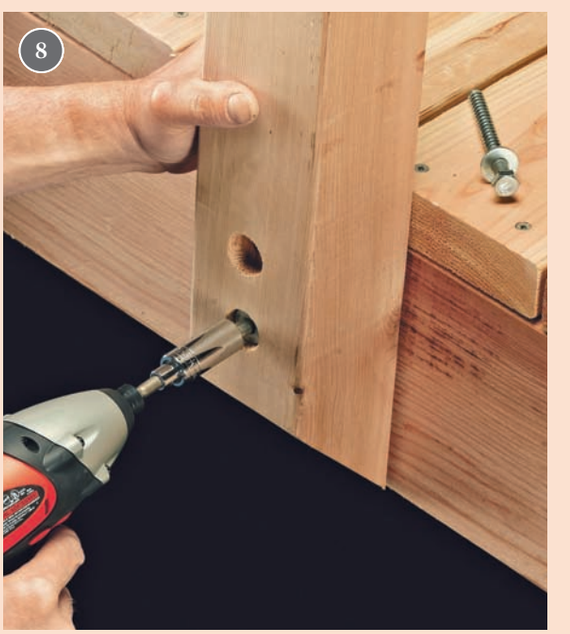
#175 Dtp:225 Page:110









5 Measure and mark the position of posts around the outside of the deck using a combination square as a guide. Plan to install a post on the outside edge of each stair stringer.

6 Position each post with the beveled end flush with the bottom of the deck. Plumb the post with a level. Insert a screwdriver or the ⅜" drill bit into the pilot holes and mark the side of the deck.

7 Remove the post and drill ⅜" holes into the side of the deck.

8 Attach railing posts to the side of the deck with ⅜ × 4½" lag screws and washers, using a ratchet wrench or impact driver. Seal the screw heads with silicone caulk.

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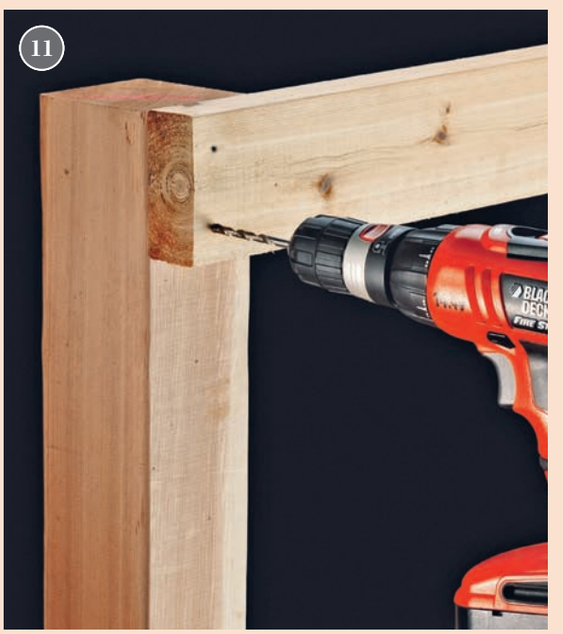
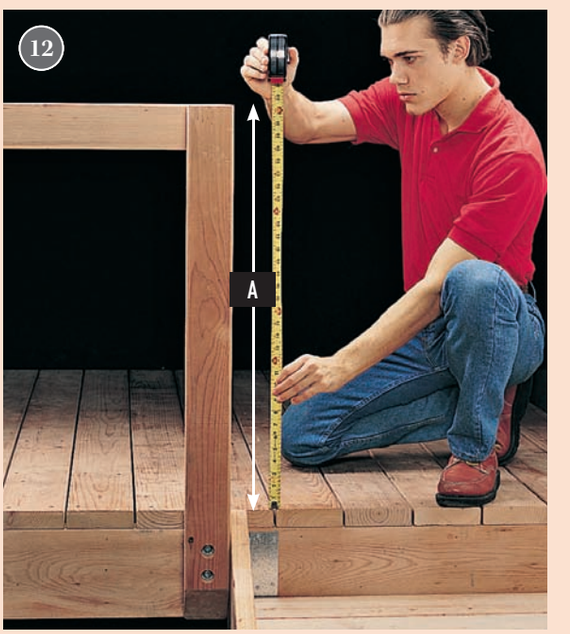
#175 Dtp:225 Page:111





9 Measure and cut 2 × 4 side rails. Position the rails with their edges flush to the tops of posts, and attach to posts with 2½" corrosion-resistant deck screws.

10 Join 2 × 4s for long rails by cutting the ends at 45° angles. Drill ⅛" pilot holes to prevent nails from splitting the end grain, and attach the rails with 10d galvanized nails. (Screws may split mitered ends.)

11 Attach the ends of rails to the stairway posts, flush with the edges of the posts, as shown. Drill ⅛" pilot holes, and attach the rails with 2½" deck screws.

12 At a stairway, measure from the surface of the decking to the top of the upper stairway post (A).

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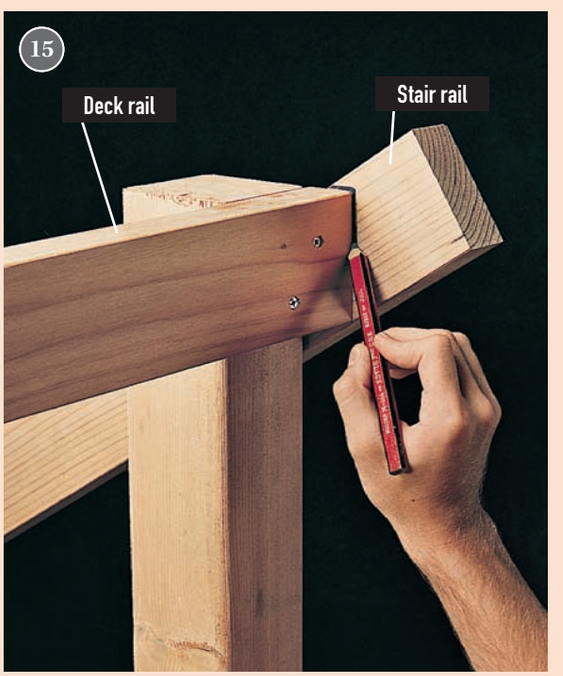
(Fogra 39)Job:04-30436 Title:MBI-HomeSkills Building Decks
#175 Dtp:225 Page:112



13 Transfer measurement A to the lower stairway post, measuring from the edge of the stair stringer.

14 Position a 2 × 4 rail against the inside of the stairway posts. Align the rail with the top rear corner of the top post and with the pencil mark on the lower post. Have a helper attach the rail temporarily with 2½" deck screws.

15 Mark the outline of the post and the deck rail on the back side of the stairway rail.

16 Mark the outline of the stairway rail on the lower stairway post.

continued

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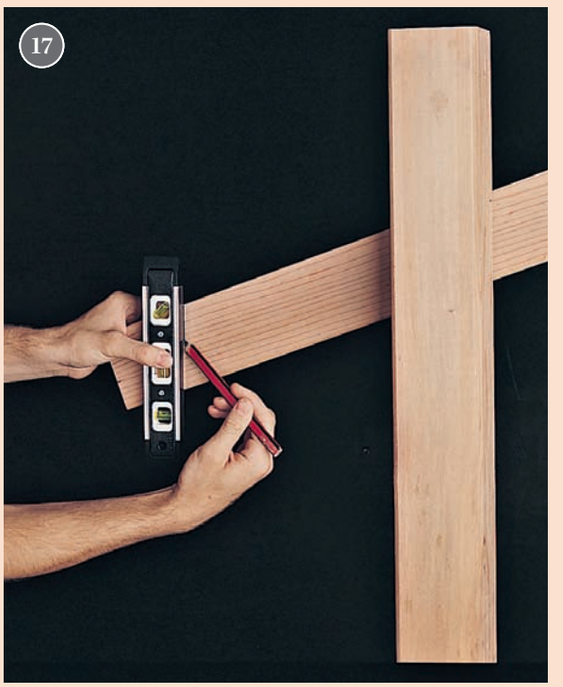
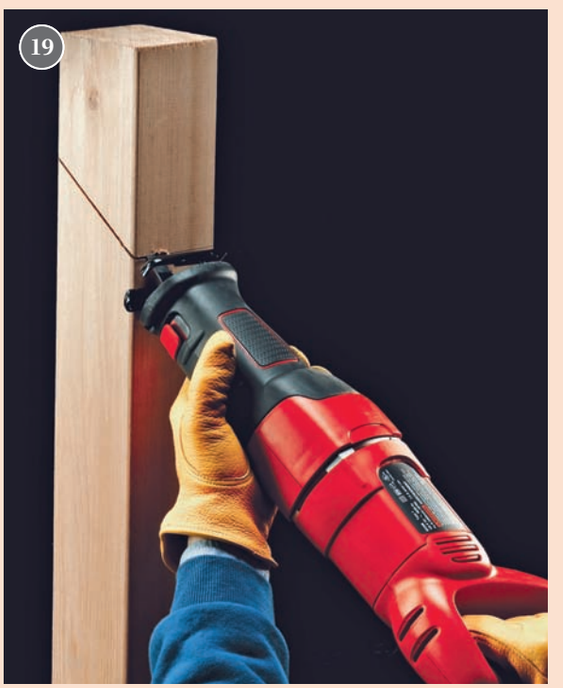
#175 Dtp:225 Page:113





17 Use a level to mark a plumb cutoff line at the bottom end of the stairway rail. Remove the rail.

18 Extend the pencil lines across both sides of the stairway post, using a combination square as a guide.

19 Cut off the lower stairway post along the diagonal cutoff line using a reciprocating saw or circular saw.

20 Use a jigsaw or miter saw to cut the stairway rail along the marked outlines.

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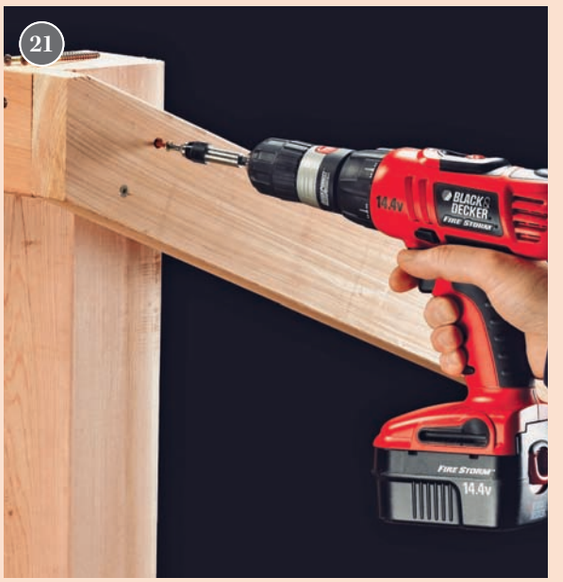

21 Position the stairway rail flush against the top edge of the posts. Drill ⅛" pilot holes, then attach the rail to the posts with 2½" deck screws.

22 Use a spacer block to ensure equal spacing between balusters. Beginning next to a plumb railing post, position each baluster tight against the spacer block, with the top of the baluster flush to the top of the rail. Attach each baluster with 2½" deck screws.

23 For the stairway, position the baluster against the stringer and rail, and adjust for plumb. Draw a diagonal cutoff line on top of the baluster, using the top of the stair rail as a guide. Cut the baluster on the marked line, using a power miter saw. Seal the ends with clear sealer-preservative.

24 Beginning next to the upper stairway post, position each baluster tight against the spacer block, with the top flush to the top of the stair rail. Predrill and attach the baluster with 2½" deck screws.

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(Fogra 39)Job:04-30436 Title:MBI-HomeSkills Building Decks
#175 Dtp:225 Page:115

25 Position the 2 × 6 cap so that the edge is flush with the rail's inside edge. Drill ⅛" pilot holes and attach the cap to the rail with 2½" deck screws every 12". Drive screws into each post and into every third baluster. For long caps, bevel the ends at 45°. Drill 1⁄16" pilot holes and nail to the post with 10d nails.

26 At the corners, miter the ends of the railing cap at 45°. Drill ⅛" pilot holes, and attach the cap to the post with 2½" deck screws.

27 At the top of the stairs, cut the cap so that it is flush with the stairway rail. Drill ⅛" pilot holes and attach the cap with 2½" deck screws.

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(Fogra 39)Job:04-30436 Title:MBI-HomeSkills Building Decks
#175 Dtp:225 Page:116

28 Measure and cut the cap for the stairway rail. Mark the outline of the post on the side of the cap, and bevel cut the ends of the cap. Position the cap over the stairway rail and balusters so that the edge of the cap is flush with the inside edge of the rail.

29 Drill ⅛" pilot holes and attach the cap to the rail with 2½" deck screws driven every 12". Also drive screws through the cap into the stair post and into every third baluster.

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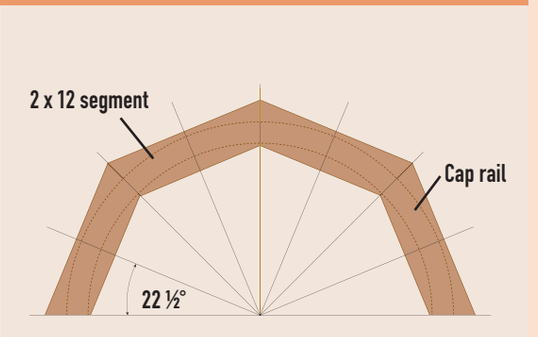
(Fogra 39)Job:04-30436 Title:MBI-HomeSkills Building Decks
#175 Dtp:225 Page:117

Curved Railings

Components of a curved railing include: vertical balusters attached to the curved rim joist, a top rail built from laminated layers of plywood, and a curved cap rail. The cap rail is constructed by laying out mitered sections of 2 × 12 lumber, marking a curved shape, and cutting it out with a jigsaw.



A curved cap rail is created from mitered segments of 2 × 12 lumber. After positioning the 2 × 12 segments end to end, the shape of the 6"-wide cap rail is outlined on the pieces. For a semicircle with a radius of up to 7 ft., four 2 × 12 segments will be needed, with ends mitered at 22½°. For a semicircle with a larger radius, you will need eight segments, with ends mitered at 11¼°.

LAYING OUT AND CONSTRUCTING a curved railing requires a basic understanding of geometry and the ability to make detailed drawings using a compass, protractor, and a special measuring tool called a scale ruler. It is a fairly advanced technique, but the results are worth the effort. Making the top rail involves bending and gluing thinner strips of wood together around the deck's curved rim joist, which acts like a bending form. You'll need lots of medium-sized clamps on hand to hold the railing in the proper shape while it dries. The cap rail is formed by joining several mitered pieces of lumber together, end to end, to form an oversized blank, then cutting out the curved shape.

The method for constructing a curved cap rail shown on the following pages works only for symmetrical curves—quarter circles, half circles, or full circles. If your deck has irregular or elliptical curves, creating a cap rail is very difficult. For these curves, it is best to limit the railing design to include only balusters and a laminated top rail. Lastly, if this seems too complicated for your skills, you can opt for a composite curved railing, which can be made to order.

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(Fogra 39)Job:04-30436 Title:MBI-HomeSkills Building Decks
#175 Dtp:225 Page:118

BUILDING A CURVED RAILING

1 To create a curved top rail, use exterior glue to laminate four 1½"-wide strips of ⅜"-thick cedar plywood together, using the curved rim joist of the deck as a bending form. First, cover the rim joist with kraft paper for protection. Then, begin wrapping strips of plywood around the rim joist. Clamp each strip in position, starting at one end of the curve. The strips should differ in length to ensure that butt joints will be staggered from layer to layer.

2 Continue working your way around the rim joist, toward the other end. Make sure to apply clamps on both sides of the butt joints where plywood strips meet. Cut the last strips slightly long, then trim the laminated rail to the correct length after the glue has set. For extra strength, drive 1" deck screws through the rail at 12" intervals after all strips are glued together. Unclamp the rail, and sand the top and bottom edges smooth.

3 Install posts at the square corners of the deck. Then, cut 2 × 2 balusters to length, beveling the bottom ends at 45°. Attach the balusters to the rim joist with 2½" deck screws, using a spacer to maintain even intervals. Clamp the curved top rail to the tops of the balusters and posts, then attach it with deck screws.

4 After the top rail and balusters are in place, attach 2 × 2 top rails to the balusters in the straight sections of the deck. The ends of the straight top rails should be flush against the ends of the curved top rail. Now, measure the distance between the inside faces of the balusters at each end of the curve. Divide this distance in half to find the required radius for the curved cap rail.

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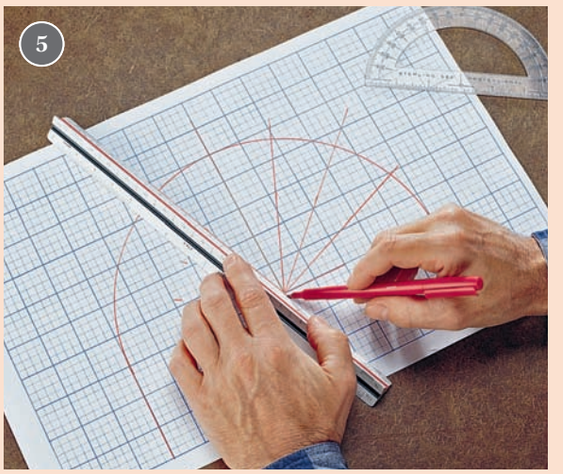

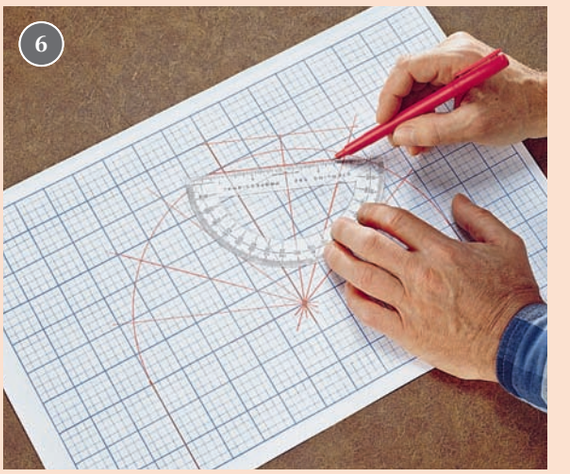

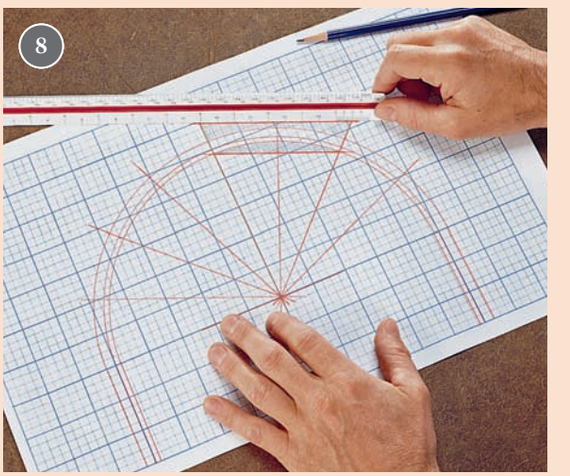

5 Using a scale of 1" to 1 ft., make a diagram of the deck. (A scale ruler makes this job easier.) First, draw the arc of the deck with a compass, using the radius measurement found in step 4. Divide the curved portion of the deck into an even number of equal sections by using a protractor to draw radius lines from the center of the curve. For a semicircular curve, it is usually sufficient to draw eight radius lines, angled at 22½° to one another. (For a deck with a radius of more than 7 ft., you may need to divide the semicircle into 16 portions, with radius lines angled at 11¼°.)

6 From the point where one of the radius lines intersects the curved outline of the deck, use the scale ruler to mark points 5½" above and 5½" below the intersection. From these points, use a protractor to draw perpendicular lines to the adjoining radius lines. The polygon outlined by the perpendicular lines and the adjoining radius lines represents the shape and size for all of the 2 × 12 segments that will be used to construct the cap rail.

7 Draw a pair of parallel arcs 5½" apart, representing the curved cap railing, inside the outline for the 2 × 12 segments. Shade the portion of the drawing that lies between the straight parallel lines and the two adjacent radius lines. This area represents the shape and size for each of the angled 2 × 12 segments. Measure the angle of the miter at the ends of the board; in this example, the segments are mitered at 22½°.

8 Measure the length of the long edge; this number is the overall length for each of the 2 × 12 segments you will be cutting. Using this highlighted area, determine how many segments you will need to complete the curve. For a semicircular curve with a radius of up to 7 ft., four segments are required, with ends mitered at 22½°. For curves with a larger radius, you need eight segments, with ends mitered at 11¼°.

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(Fogra 39)Job:04-30436 Title:MBI-HomeSkills Building Decks
#175 Dtp:225 Page:120

9 Measure and mark 2 × 12 lumber for the cap rail segments, with ends angled inward at 22½° from perpendicular. Set the blade on your circular saw or tablesaw to a 15° bevel, then make compound miter cuts along the marked lines. When cut to compound miters, the segments will form overlapping scarf joints that are less likely to reveal gaps between the boards.

10 Arrange the cap rail segments over the curved deck railing, and adjust the pieces, if necessary, so they are centered over the top rail. When you are satisfied with the layout, temporarily attach the segments in place by driving 2" deck screws up through the curved top rail. Measure and install the 2 × 6 cap railing for the straight portion of the railing.

11 Temporarily nail or clamp a long sturdy board between the sides at the start of the curve. Build a long compass, called a trammel, by nailing one end of a long 1 × 2 to a 1 ft.-long piece of 1 × 4. Measure from the nail out along the arm of the trammel, and drill holes at the desired radius measurements; for our application, there will be two holes, 5½" apart, representing the width of the finished cap rail. Attach the 1 × 4 base of the trammel to the temporary board so the nail point is at the centerpoint of the deck rail curve, then insert a pencil through one of the holes in the trammel arm. Pivot the arm of the trammel around the cap rail, scribing a cutting line. Move the pencil to the other hole, and scribe a second line.

12 Remove the trammel, and unscrew the cap rail segments. Use a jigsaw to cut along the scribed lines, then reposition the curved cap rail pieces over the top rail. Secure the cap rail by applying exterior adhesive to the joints and driving 2½" deck screws up through the top rail. Use a belt sander to remove saw marks.

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Pro-Vision C M Y K (Text) (Ray)
(Fogra 39)Job:04-30436 Title:MBI-HomeSkills Building Decks
#175 Dtp:225 Page:121

Deck Skirting

Tools & Materials

Measuring tape
Speed square
Circular saw
Miter saw
Power drill & bits
¾" exterior grade lattice panel
1 × 4 pressure treated lumber
2" galvanized finish nails
3" deck screws
Angle and T braces

Tip

You can even build in a storage space underneath the deck—a perfect location for lawnmowers, leaf blowers, and other yard equipment. Install a vinyl underdeck system to manage water run-off.

ELEVATED DECKS are often the best solution for a sloped yard or a multi-story house. A deck on high can also take advantage of spectacular views. But the aesthetic drawback to many elevated decks is the view from other parts of the yard. The supporting structure can seem naked and unattractive.

The solution is to install deck skirting. Skirting is essentially a framed screen attached to support posts. Skirting effectively creates a visual base on an elevated deck and adds a more finished look to the entire structure. It looks attractive on just about any deck.

There are many different types of skirting. The project here uses lattice skirting, perhaps the most common and easiest to install. But you can opt for solid walls of boards run vertically or horizontally, depending on the look you're after and how much time and money you're willing to spend. However, keep in mind that lattice allows for air circulation underneath the deck. If you install solid skirting, you may need to add vents to prevent rot or other moisture related conditions under the deck. Codes also require that you allow access to egress windows, electrical panels, and other utilities under the deck, which may involve adding a gate or other structure to the skirting.

Regardless of the design, the basic idea behind building skirting is to create a supporting framework that runs between posts, with the skirting surface attached to the framework. Obviously, this provides the opportunity to add a lot of style to an elevated deck. The lattice skirting shown here is fairly easy on the eyes. If you choose to use boards instead, you can arrange them in intriguing patterns, just as you would design a showcase fence for your property. You can use wood skirting of the same species as the decking, or vary the material to create a more captivating look.

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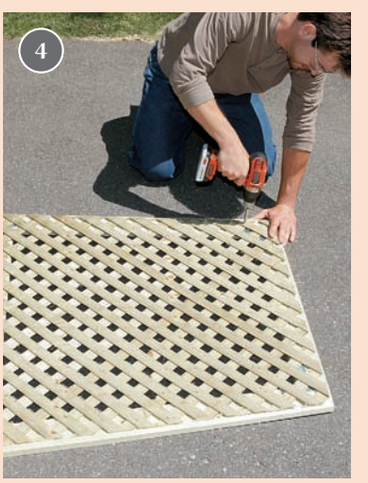
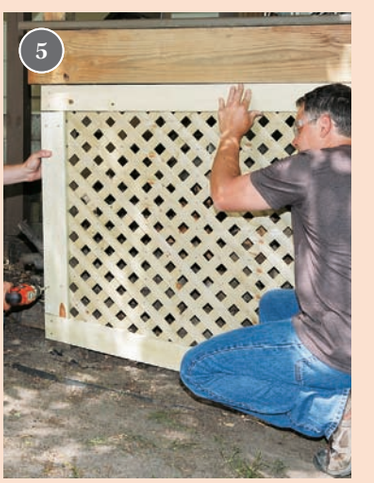
#175 Dtp:225 Page:122

INSTALLING DECK SKIRTING





1 Determine the length of the skirting sections by measuring the space between posts. Measure on center and mark the posts. At corners, measure from the outer edge of the corner post to the center of the next post in line. Determine the height of the skirting by measuring from the top of a post to grade leaving at least 1" between the skirt bottom and ground.

2 Cut the top and side frame sections for the skirting from 1 × 4 pressure treated lumber. You can also use cedar or other rot- and insect-resistant material. Snap a chalk line 1" above the bottom of the post, and use a speed square to find the angle of the slope.

3 Cut the ends of the frame pieces to fit. Assemble the 1 × 4 frame using galvanized angle brackets.

4 Cut the ¾" lattice to dimensions of the frame, using a circular saw or jigsaw. Align the lattice on the back of the 1 × 4 frame, and screw the lattice to the frame about every 10".

5 Install each finished lattice skirting section as soon as it is assembled. Align the edges of the frame with the marks you've made on the posts and drill pilot holes through the front of the frame and lattice into the post. Screw the section to the post with 3" galvanized deck screws, using a screw at the top, bottom, and middle of the frame.

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#175 Dtp:225 Page:123

Deckbuilding Glossary

Baluster—a vertical railing member.

Batterboards—temporary stake structures used for positioning layout strings.

Beam—the main horizontal support for the deck, usually made from a pair of 2 × 8s or 2 × 10s attached to the deck posts.

Blocking—short pieces of lumber cut from joist material and fastened between joists for reinforcement.

Cap—the topmost horizontal railing member.

Cantilever—a common construction method (employed in some of the deck plans in this book) that involves extending the joists beyond the beam. The maximum overhang is specified in the Building Code.

Corner-post design—a construction method that incorporates posts at the outside edges of the deck, so the joists do not overhang the beam.

Decking—the floor boards of a deck (also known as deck boards).

End joists—the joists that are at each end of a series of parallel joists.

Face board—attractive wood, usually redwood or cedar, used to cover the rim joists and end joists.

Footing—a concrete pier that extends below the frost line and that bears the weight of the deck and any inset structures or furnishings.

Horizontal span—the horizontal distance a stairway covers.

Inset—an area of a deck that has been cut out to accommodate landscape features such as trees or to provide access to fixtures.

Joist—dimensional lumber, set on edge, that supports decking. Joists on attached decks hang between the ledger and rim joist.

Joist hanger—metal connecting pieces used to attach joists at right angles to ledger or header joists so that top edges are flush.

Ledger—a board, equal in size to the joists, that anchors the deck to the house and supports one end of the joists.

Open step—a step composed of treads mounted between stair stringers without any risers.

Post—a vertical member that supports a deck, stairway, or railing.

Post anchors—metal hardware for attaching deck posts to footings and raising the bottom of the post to keep it away from water. The end grain itself can be protected with sealer as added protection from rot.

Rim joist—a board fastened to the end of the joists, typically at the opposite end from the ledger. Rim joists attach to both ends of a free-standing deck.

Rise—the height of a step.

Riser—a board attached to the front of a step between treads.

Run—the depth of a step.

Span limit—the distance a board can safely cross between supports.

Stair cleat—supports for treads that are attached to stair stringers.

Stair stringer—an inclined member that supports a stairway's treads. A stair stringer may be solid, with treads attached to cleats mounted on the inside face, or cut out, with treads resting on top of the cutouts.

Tread—the horizontal face of each step in a stairway, often composed of two 2 × 6 boards.

Vertical drop—the vertical distance from the deck surface to the ground.

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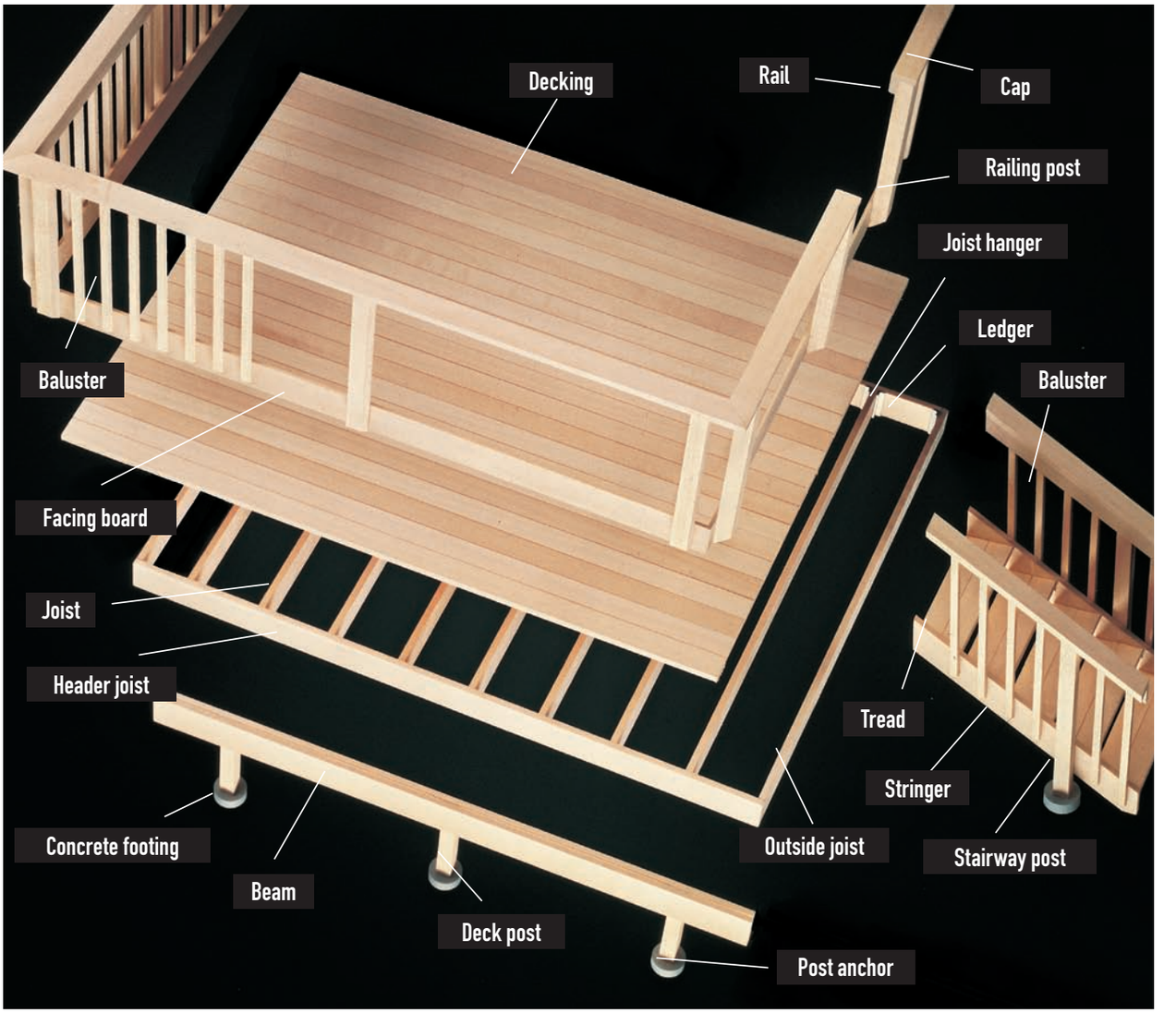

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#175 Dtp:225 Page:125

Metric Conversions

Metric Equivalent

Inches (in.)	1/64	1/32	1/25	1/16	1/8	1/4	3/8	2/5	1/2	5/8	3/4	7/8	1	2	3	4	5	6	7	8	9	10	11	12	36	39.4
Feet (ft.)																								1	3	3 1/12
Yards (yd.)																									1	1 1/12
Millimeters (mm)	0.40	0.79	1	1.59	3.18	6.35	9.53	10	12.7	15.9	19.1	22.2	25.4	50.8	76.2	101.6	127	152	178	203	229	254	279	305	914	1,000
Centimeters (cm)							0.95	1	1.27	1.59	1.91	2.22	2.54	5.08	7.62	10.16	12.7	15.2	17.8	20.3	22.9	25.4	27.9	30.5	91.4	100
Meters (m)																								.30	.91	1.00

Converting Measurements

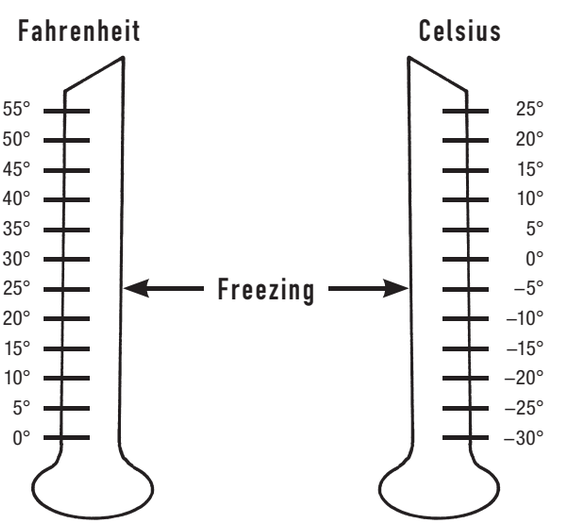
To Convert:	To:	Multiply by:
Inches	Millimeters	25.4
Inches	Centimeters	2.54
Feet	Meters	0.305
Yards	Meters	0.914
Miles	Kilometers	1.609
Square inches	Square centimeters	6.45
Square feet	Square meters	0.093
Square yards	Square meters	0.836
Cubic inches	Cubic centimeters	16.4
Cubic feet	Cubic meters	0.0283
Cubic yards	Cubic meters	0.765
Pints (U.S.)	Liters	0.473 (Imp. 0.568)
Quarts (U.S.)	Liters	0.946 (Imp. 1.136)
Gallons (U.S.)	Liters	3.785 (Imp. 4.546)
Ounces	Grams	28.4
Pounds	Kilograms	0.454
Tons	Metric tons	0.907

To Convert:	To:	Multiply by:
Millimeters	Inches	0.039
Centimeters	Inches	0.394
Meters	Feet	3.28
Meters	Yards	1.09
Kilometers	Miles	0.621
Square centimeters	Square inches	0.155
Square meters	Square feet	10.8
Square meters	Square yards	1.2
Cubic centimeters	Cubic inches	0.061
Cubic meters	Cubic feet	35.3
Cubic meters	Cubic yards	1.31
Liters	Pints (U.S.)	2.114 (Imp. 1.76)
Liters	Quarts (U.S.)	1.057 (Imp. 0.88)
Liters	Gallons (U.S.)	0.264 (Imp. 0.22)
Grams	Ounces	0.035
Kilograms	Pounds	2.2
Metric tons	Tons	1.1

Converting Temperatures

Convert degrees Fahrenheit (F) to degrees Celsius (C) by following this simple formula: Subtract 32 from the Fahrenheit temperature reading. Then mulitply that number by 5/9. For example, 77°F - 32 = 45. 45 × 5/9 = 25°C.

To convert degrees Celsius to degrees Fahrenheit, multiply the Celsius temperature reading by 9/5, then add 32. For example, 25°C × 9/5 = 45. 45 + 32 = 77°F.



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#175 Dtp:225 Page:126

Index

anchors, 27, 28–29
angle brackets, 29, 31
angles
  building support for, 76
  building with corner-post design, 77–79
  design options for, 75
  overview of, 74
awnings, 16

balusters, 8
batterboards, 38, 48
beams
  assembly of, 8
  engineered, 9, 20
  fabricating, 65
  installing (overview), 64
  installing with a post saddle, 66
  installing with notched post, 67
  marking post locations on, 65
  overhanging, 7
  posts and, 9
block walls, 10
border patterns, 91
building codes, 7–11, 18, 100
building felt, 34
building inspectors, 18
building process, overview of, 38–39

calculator conversion chart, 16
cantilevered decks, 14, 75, 80
chimney chases and bays, 11
composite lumber, 20, 24–25, 95
concrete walls, 10
corner-post designs, 75, 77–79
curves
  construction options for, 81
  design options for, 81
  installing decking and, 85
  laying out, 82–83
  overview of, 80

decking
  installing with undermount brackets, 98
  installing with undermount clips, 99
  laying (wood), 39, 93–94
  laying T-clip, 97
  laying tongue-and-groove, 96
  laying composite, 95
  overview of, 92
  patterns for, 90–91
design drawings/plans
  approval and, 18
  creating, 17
  overview of, 16
diagonal decking, 90

fasteners, 24, 26–27, 33
fiberglass reinforced plastic (FRP), 25
flashing, 7, 34
footings
  description of, 35
  diameter and depth for, 7, 15
  digging, 55
  fasteners and, 26, 27
  locating, 38, 48–53
  materials for, 20, 35
  metal connectors and, 31
  overview of, 54
  pouring, 56–57

H-fit rafter ties, 30

insets, framing, 86–87, 92
International Residential Code, 7

J-bolts, 26, 48
joists
  building codes and, 8
  description of, 68
  hanging, 69–73
  installing, 39
  kerfed rim, 81, 84
  laminated rim, 81, 85
  metal connectors and, 29, 30
  post spacing and, 15
  posts and, 10
  rim, 9, 11
  spans and, 12, 13

kerfed rim joist, 81, 84

laminated rim joist, 81, 85
landings, 101
ledgers
  attaching to lap siding, 41–42
  attaching to masonry, 43
  attaching to metal or vinyl siding, 45–47
  attaching to stucco, 44
  building codes and, 10, 34
  overview of, 40
  rim joists and, 9
lighting, 10
loads, understanding, 14
lumber
  cedar, 22–23
  composite, 20, 24–25
  determining size, 12
  dimensions of, 12
  end grain and, 21
  pressure-treated, 20, 22–23
  span limits and, 13
  treated, 20

mason's strings, 38, 48
materials
  fasteners, 24, 26–27, 33
  flashing, 7, 34
  footings, 35
  lumber, 12, 13, 20–23
  metal connectors, 28–31
  non-wood, 24–25
  PVC, 24–25
  screws and nails, 32–33
  washers, 26
metal connectors, 28–31
metric conversions, 126
multi-level designs, 75
multiple-beam decks, 14

non-wood decking, 20, 24–25, 95

parquet patterns, 90
piers. *See* footings
plans/design drawings
  approval checklist for, 18
  creating, 17
  developing, 16
post-and-beam decks, 14
post-beam caps, 7, 30
posts
  attaching anchors for, 59
  beams and, 7, 9
  building codes and, 8
  notched, 9, 67
  overview of, 58
  setting, 60–63
  spacing of, 15
PVC materials, 24–25

railings
  building codes and, 8, 10
  building curved, 118–121
  installing (overview), 39
  installing wood, 110–117
  overview of, 109
  sizes for, 13
rim joists, 9, 11

screws and nails, 26, 32–33
sealing end grain, 21
seismic ties, 30
self-sealing membrane, 34
Skillbuilders
  drilling, 42
  driving fasteners, 92
skirting
  building, 123
  overview of, 122
sleeve anchors, 27
soil composition, 15
span limits, 12, 13
stairs
  building basic, 105–108
  building box-frame, 103
  building codes and, 8, 10
  building suspended, 104
  cleats for, 29
  measurements for, 102
  overview of, 100
  stringer size for, 13
  styles for, 101
strapping plates, 31
structure, overview of, 37

T-clip decking, 97
temperature conversions, 126
Tips
  on angles, 75
  on awnings, 16
  on beams, 64
  on building codes, 7, 64
  on composite decking, 24
  on curves, 80
  on decking, 92
  on end grain, 21
  on fasteners, 26
  on insets, 86
  on joists, 68
  on ledgers, 40
  on locating footings, 48
  on lumber, 12, 21, 22
  on materials, 13
  on metal connectors, 28
  on screws, 32
  on stairs, 100
  on storage, 122
  on underground utility lines, 38
tongue-and-groove decking, 96
T-straps, 31

walls, attaching ledgers to, 10. *See also* ledgers
wedge anchors, 27
wood decking, 22–23. *See also* lumber

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The techniques shown in this book are general techniques for various applications. In some instances, additional techniques not shown in this book may be required. Always follow manufacturers' instructions included with products, since deviating from the directions may void warranties. The projects in this book vary widely as to skill levels required: some may not be appropriate for all do-it-yourselfers, and some may require professional help.

Consult your local building department for information on building permits, codes, and other laws as they apply to your project.

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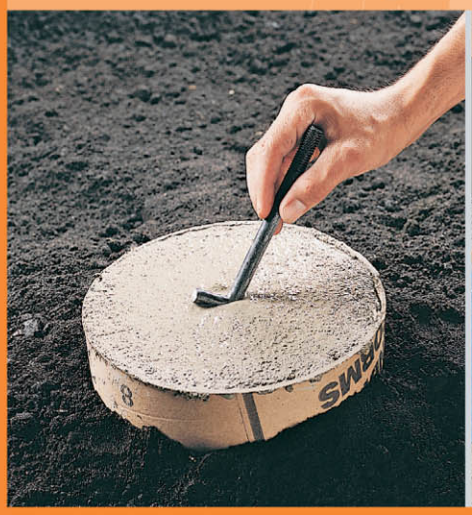
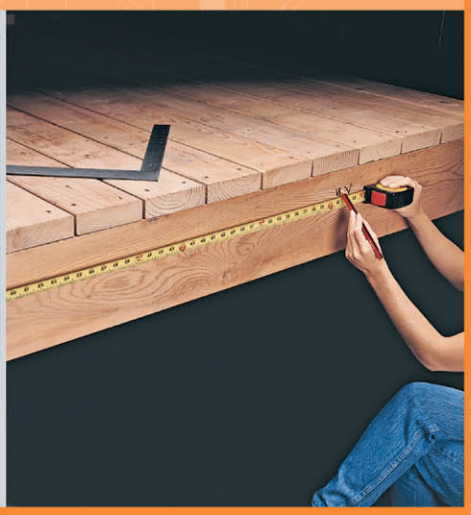
In *HomeSkills: Building Decks*, the expert editors of Cool Springs Press cover every skill needed for deck building, providing streamlined project descriptions with crystal-clear photos that leave no room for guesswork. You'll learn how to plan and design a deck, then select materials, dig postholes, hang joists, and install the decking itself. We even cover stairs and railings. With 300 illustrations and complete step-by-step instructions, this book is the complete deck-building package that you have been looking for.





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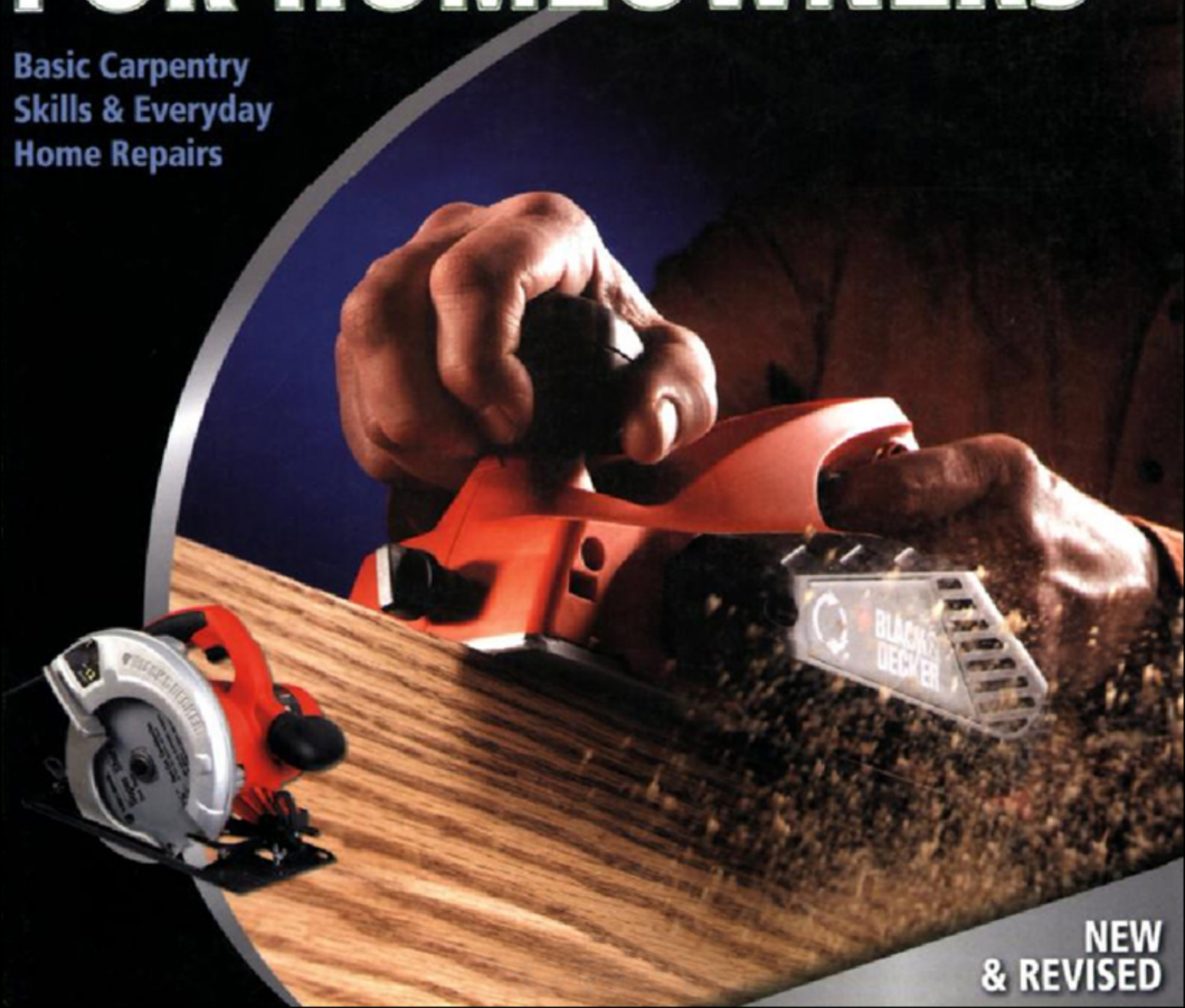
CARPENTRY FOR HOMEOWNERS

Basic Carpentry Skills & Everyday Home Repairs



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Contents

The Complete Guide to Carpentry for Homeowners

Introduction

Planning a Carpentry Project

Project Safety

Workshop Basics

Building a Workbench

Building a Sawhorse

Materials

Lumber

Transporting Materials

Plywood & Sheet Goods

Trim Moldings

Nails

Screws & Other Hardware

Glues & Adhesives

TOOlS & Skills

Prying Tools

Measuring & Marking Tools

Handsaws

Hammers

Screwdrivers

Clamps & Vises

Chisels

Planes & Surface Forming Rasps

Extension Cords

Jigsaws

Circular Saws

Straightedge Guides

Power Miter Saws

Table Saws

Drills & Bits

Sanders

Pneumatic Nailers

Powder-Actuated Tools

Specialty Tools

Basic Carpentry

Anatomy of a House

Preparing the Work Area

Building Walls

Soundproofing Walls & Ceilings

Installing Wallboard

Installing Interior Doors

Mounting Bifold Doors

Installing a Storm Door

Installing Door & Window Casings

Installing Window Trim

Installing Base Molding

Paneling an Attic Ceiling

Installing Wainscoting

Covering Foundation Walls

Framing Basement Foundation Walls

Trimming Basement Windows

Advanced Carpentry

Enlarging Openings & Removing Walls

Removing Wallboard

Removing Plaster

Removing Exterior Surfaces

Removing Doors & Windows

Removing a Non-loadbearing Wall

Installing an Attic Access Ladder

Framing & Installing Doors

Framing & Installing Windows

Installing New Window Sashes

Installing a Standard Skylight

Installing a Bay Window

Patching Wood Siding & Stucco

Patching Flooring

Cabinets & Countertops

Removing Trim & Old Cabinets

Preparing for New Cabinets

Installing Cabinets

Installing Countertops

Building a Custom Laminate Countertop

Glossary

Index

Introduction

Unless you live in a brand-new home that's built exactly to your specifications, you probably consider your house to be a perpetual work-in-progress. Most homeowners feel this way. It could be that the previous owner didn't quite take regular repairs and maintenance as seriously as you do. You know those irritating blemishes: the scuffed door molding in the entryway, a ding in the wallboard from a wayward rocker, or the closet door that rubs the carpet and sticks in its opening every time you close it. You'd love to fix them, if only you knew exactly what to do. Or, maybe your home is still stuck in a bygone decade and needs a serious facelift. Those dark, chintzy hollow-core doors really have to go someday, right?

More than likely, you also have projects that get perpetually pushed deeper down the "to do" list because they just seem too daunting to start. Oh, how nice it would be to replace the drafty family room windows with a large bay window. Do you dream of a cozy casual space or home theater room in the basement, if only you had the skills to frame the walls and finish it all off without hiring it done?

This new book, *The Complete Guide to Carpentry for Homeowners*, is not written for the do-it-yourselfer who already has a truckload of tools and years of experience. Instead, it's written for the homeowner who simply needs the confidence and know-how to do the job right.

We've prepared this book in three major sections to make navigating the material as easy as possible. The first section on tools and materials will give you a shop-class crash course. You'll learn about essential carpentry tools and how to use them correctly and safely.

The second section focuses on basic carpentry skills and projects. Here you'll learn how your house is fundamentally put together so you can remove and build walls, frame and hang interior doors, install wallboard and finish up with trim and moldings. You could probably check off many of the "gotta do" projects on your list with this section alone.

The third part—an advanced projects section—will earn you your black belt in home carpentry. You'll discover how to enlarge window and door openings, learn how to install windows, exterior doors, and skylights, and

flash them properly, just like the pros do. Finally, an extended section will show you how to remove and replace kitchen cabinets, install ready-made countertops, and even build your own custom version from scratch. Here’s how you can create the room you’ve always wanted without hiring an expensive crew to do it.

So, read carefully and then start planning your first carpentry project. It’s easier than you think. Be sure to keep this book handy. With this much helpful information, you’ll come back to it again and again.

Planning a Carpentry Project

A carpentry project can be fun and rewarding, but it requires more than just a knack for cutting lumber and pounding nails. In fact, your natural ability with tools may not affect the finished product as much as your attention to details, materials, costs, and local building codes. Address these issues in the planning stages so you can use your time efficiently once you start to cut. Start any project by asking yourself the questions below. Once you've addressed each question, you can feel confident about the project you're about to start.

Is a permit required? Most building departments require a permit if your carpentry project will significantly alter your home's condition. You'll probably need a permit for anything more extensive than replacing a rotted window. Permits are required for adding or replacing beams, posts, joists, rafters; for building additions; for converting a basement or attic; and for many other projects. Ask your building department for any literature on carpentry projects. If a permit is required, you'll need to show an inspector a detailed diagram and a list of building materials before you begin.

How will the project affect my living space? Building a wall or installing a new window may drastically change your living environment. Make sure you consider the pros and cons each project will produce before starting.

What types of materials will work best for my project? To maintain a common theme throughout a room, choose building materials that match your existing living space. Always choose well-crafted materials that meet the requirements of local building codes.

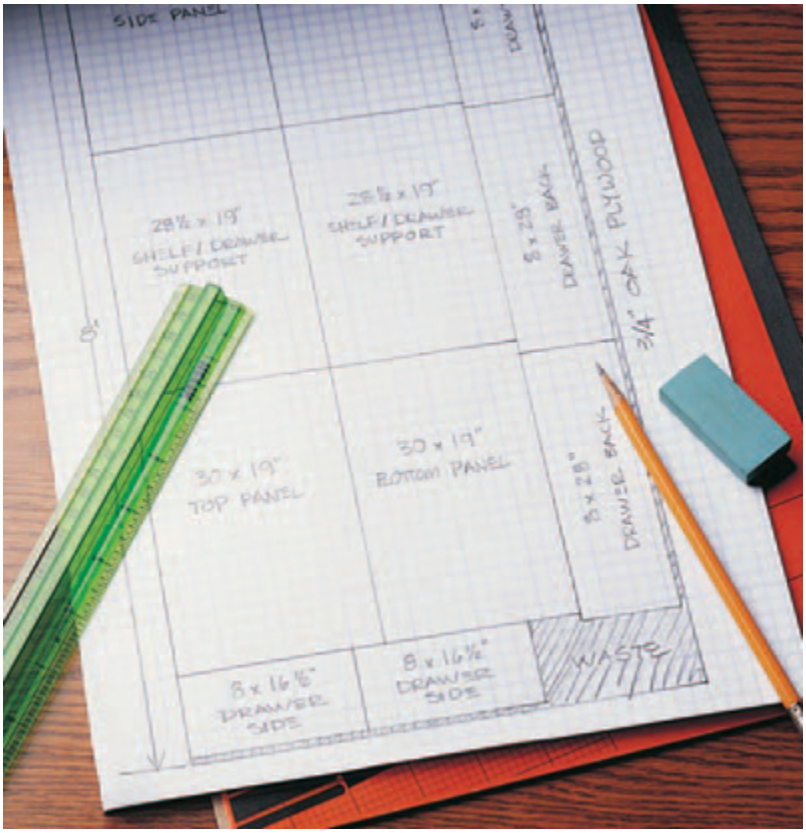
Which tools do I need? Each carpentry project in this book includes a list of tools, including portable power tools. Some tools, such as a power drill and circular saw, should be considered essential. Others—such as a power miter saw—simplify the job, but are not essential. Dado cuts for shelves can be made using a circular saw, instead of a router. Making miter cuts with a hacksaw and miter box is also possible. Using different tools to complete specific tasks usually takes extra time, but you'll be able to enjoy a sense of craftsmanship that using hand tools brings to a project.

Begin any carpentry project by making pencil drawings of the project you have in mind. As you refine the project idea, add as much detail as possible to the drawing, so you can anticipate issues such as what tools and materials the project will require and how the project will affect your living space.

How to Plan a Carpentry Project

Lay out the project using 2" masking tape on the floor to indicate the boundaries of the project. An actual-size layout will help you visualize the end result and can often draw your attention to issues that aren’t obvious from a scale drawing.

Examine the areas directly below and above the project before cutting into a wall to determine the location of water lines, ductwork, and gas pipes. In most cases, pipes, utility lines, and ductwork run through the wall vertically between floors. Original blueprints for your house, if available, usually show the locations of the utility lines.



Draw cutting diagrams to help you make efficient use of materials. Make scale drawings of sheet goods on graph paper, and sketch cutting lines for each part of your project. When laying out cutting lines, remember that the cutting path (kerf) of a saw blade consumes up to ⅛" of material.

Make a list of materials, using your plan drawings and cutting diagrams as a guide. Photocopy the materials list, and use it to organize your work and estimate costs.

Project Safety

Your personal safety when working on carpentry projects depends greatly on what safety measures you take. The power tools sold today offer many safety features, such as blade guards, locks to prevent accidental starts, and double insulation to reduce the risk of shock in the event of a short circuit. It's up to you to take advantage of these safety features. For example, never operate a saw with the blade guard removed. You risk injury from flying debris as well as from being cut by the blade.

Follow all precautions outlined in the owner's manuals for your tools and make sure you protect yourself with safety glasses, earplugs, and a dust mask or respirator to filter out dust and debris.

Keep your work environment clean. A cluttered work area is more likely to result in accidents. Clean your tools and put them away at the end of every work period, and sweep up dust and debris.

Some materials emit dangerous fumes or particles. Keep such materials stored away from heat sources and out of the reach of children; always use these products in a well-ventilated area.

Maintaining safety is an ongoing project. Take the time to update your first-aid kit and evaluate your workspace, tools, and safety equipment on a regular basis. To avoid accidents, repair and replace old and worn-out parts before they break.

Read the owner's manual before operating any power tool. Your tools may differ in many ways from those described in this book, so it's best to familiarize yourself with the features and capabilities of the tools you own. Always wear eye and ear protection when operating a power tool. Wear a dust mask when the project will produce dust.

Some walls may contain asbestos. Many homes built or remodeled between 1930 and 1950 have older varieties of insulation that included asbestos. Consult a professional for removal of hazardous pollutants like asbestos, and if you find asbestos or materials that may contain asbestos, do not attempt to remove them on your own. Even if you determine that no asbestos is present, it is a good idea to wear a particle mask and other safety gear when doing demolition.

First-Aid Kits

Assemble a first-aid kit. Cuts from a hand or power tool can be serious and require prompt and thoughtful attention. Be prepared for such situations with a well-equipped first-aid kit that is easy to find. Record any emergency telephone numbers on the first-aid kit or by the nearest phone so they are available in an emergency.

Equip your kit with a variety of items (photo right), including bandages, needles, tweezers, antiseptic ointment, cotton swabs, cotton balls, eye drops, a first-aid handbook, a chemical-filled cold pack, elastic bandages, first-aid tape, and sterile gauze.

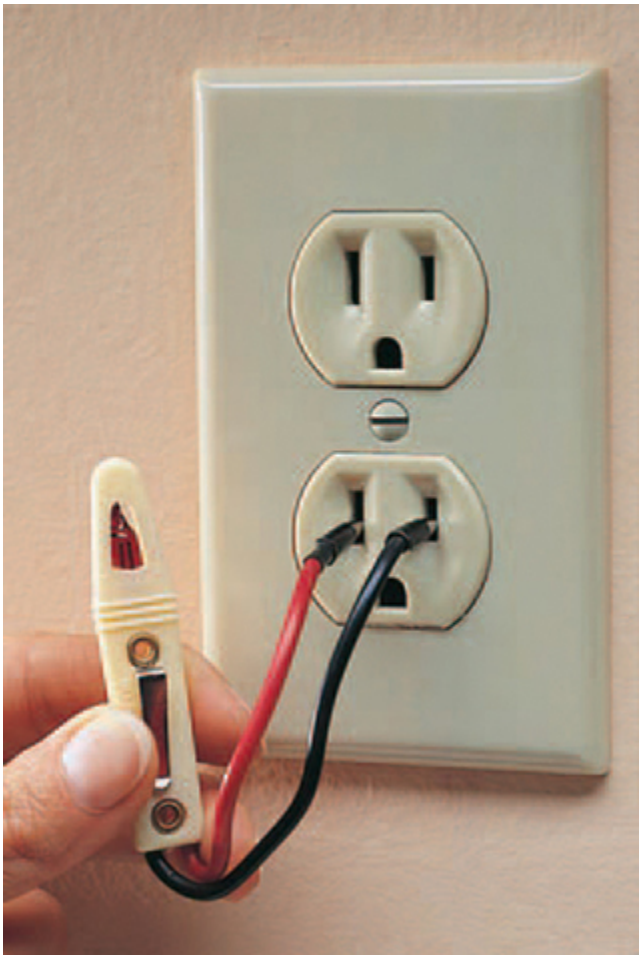
For puncture wounds, cuts, burns, and other serious injuries, always seek medical attention as soon as first aid—such as washing and wrapping of cuts — has been provided.

STERI-PAD
Steri-Pad
ANTISEPTIC WIPE
Cold Comfort
Johnson & Johnson
FIRST AID GUIDE

Safe Practices

Keep your tools sharp and clean.
Accidents are more likely when blades are dull and tools are filled with sawdust and dirt.

Use a GFCI receptacle, adapter, or extension cord to reduce the risk of shock while operating a power tool outdoors or in wet conditions.



Check with a neon circuit tester
to make sure the power is off before removing cover plates, exposing wires, or drilling or cutting into walls that contain wiring.

Workshop Basics

Whether your workshop is in a basement utility room, a shed, or a garage, it should be a comfortable place to work and should provide convenient space for organizing your tools and equipment. Your workshop should include a generous benchtop at a comfortable height, plenty of well-directed lighting, and ample floor space to operate a table saw or other stationary power tools. If you plan to store paints or solvents, make sure the room has plenty of ventilation and is equipped with a smoke detector and fire extinguisher.

Your workshop should have enough electrical circuits to supply power to the lights and several pieces of equipment without overloading a circuit. Calculate your shop's circuit capacity , and contact an electrician if you need to add a circuit.

There are many devices for hanging tools on workshop walls, but the most versatile is still a sheet of pegboard with tool hooks hung from it. Pegboard allows you to organize the hooks to suit your needs.

Deep, sturdy shelves provide a great place to store toolboxes, buckets, and portable power tools. Ready-to-assemble shelf units are available at home centers.

If your workshop is in the house, you may want to add hollow-core tiles to the inside of the workshop door to reduce sound transmission and a door sweep to block noise and keep dust from traveling under the door.

A carpenter's workshop should be a well-lighted space that's large enough to keep common tools, hardware, and equipment easily accessible and well organized. A workbench is convenient for various tasks. To operate a table saw or other large power equipment, you'll need plenty of space for handling large lumber and sheet goods.

Lighting and Dust Control

Use a wet/dry shop vacuum for quick cleanup. Many power tools have attachments that allow you to connect the vacuum's hose to the tool, so most debris is sucked directly into the cannister. Buy a vacuum with durable parts and a powerful motor.

Improve visibility in your shop by replacing incandescent lights with fluorescent fixtures. Fluorescent lights provide more light than incandescent lights and are less expensive to operate. Some types of fluorescent light fixtures come with preattached cords for plugging into a receptacle. Other types are permanently wired; you may want to hire an electrician to make permanent installations.

Assessing Your Workshop’s Electricity Supply

To know whether your workshop circuitry is sufficient to run your power tools and other equipment safely, first determine the circuit’s safe capacity—the maximum load or wattage that it can handle without overheating. Locate the correct circuit on your service panel and check the amperage rating. Multiply that number by 120 volts, then subtract 20% to find the safe capacity. Next, find the wattage of each tool or appliance that will use that circuit. All tools and appliances are labeled with their amperage and voltage ratings. Calculate wattage by multiplying the amperage by the voltage. Add together the wattages of all of the tools and appliances you’re likely to use simultaneously to find out whether they are within the circuit’s safe capacity. The chart shows wattages for some common power tools and appliances. If the circuit’s safe capacity is not high enough to handle the load, you may need another circuit in the workshop. Ask an electrician to inspect your service panel. You can probably add a circuit to the service panel and additional receptacles to your workshop.

CIRCUIT
INDEX

Volts
Amps
Professional
DANGER / WARNING:

Typical Wattage Ratings

Appliance	Amps	Watts
Circular saw	10 to 12	1200 to 1440
Drill	2 to 4	240 to 480
Fan (portable)	2	240
Heater (portable)	7 to 12	840 to 1440
Router	10 to 12	1200 to 1440
Sander	2 to 5	240 to 600
Table saw	12 to 15	1440 to 1800
Shop vacuum	6 to 11	720 to 1320

Building a Workbench

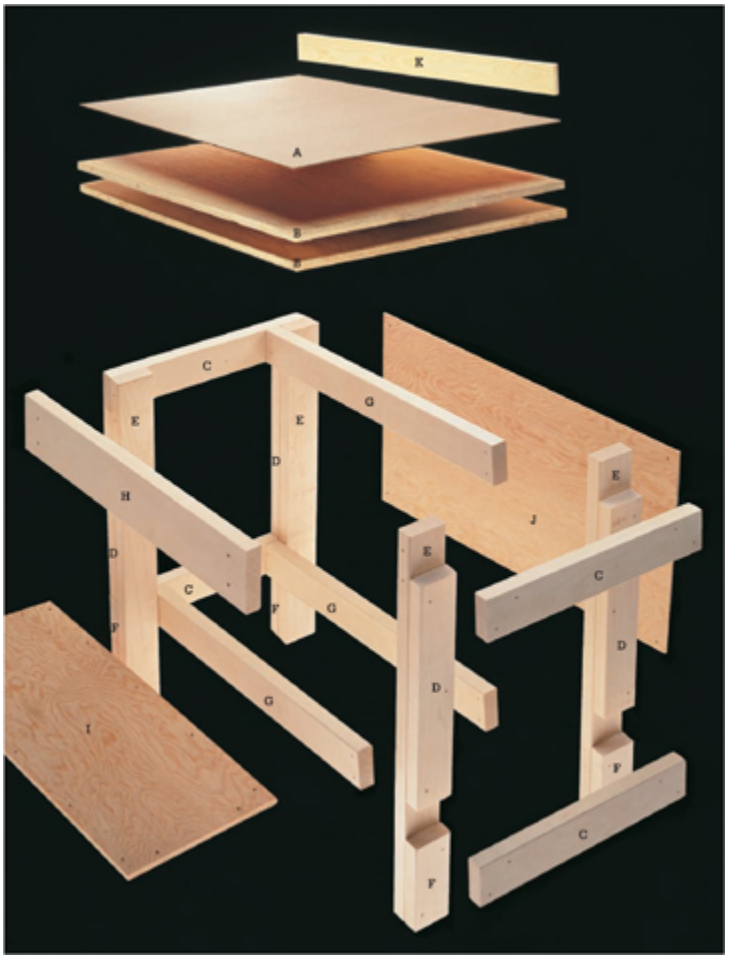
This workbench has heavy-duty legs to support big loads and a sturdy double-layer top to withstand pounding. Cover the top with a hardboard surface that can be removed when it becomes damaged. Build a shelf below the work surface for storing power tools. If desired, mount an all-purpose vise on top of the workbench.

Tools, Materials & Cutting List

- Circular saw
- Carpenter's square
- Drill and bits, including screwdriver bits
- Ratchet or adjustable wrench
- Hammer
- Nail set
- Wallboard screws (1⅝", 2½", and 3")
- Lag screws (1½" and 3")
- 4d finish nails
- Six 8-ft. 2 × 4s
- One 5-ft. 2 × 6
- One 4 × 8-ft. sheet of ¾" plywood
- One 4 × 8-ft. sheet of ½" plywood
- One 4 × 8-ft. sheet of ⅛" hardboard

Key	Pieces	Size and Description
A	1	1/8" hardboard top, 24 × 60"
B	2	3/4" plywood top, 24 × 60"
C	4	2 × 4 crosspieces, 21"
D	4	2 × 4 legs, 19 3/4"
E	4	2 × 4 legs, 34 1/2"
F	4	2 × 4 legs, 7 3/4"
G	3	2 × 4 braces, 54"
H	1	2 × 6 front (top) brace, 57"
I	1	1/2" plywood shelf, 14 × 57"
J	1	1/2" plywood shelf back, 19 1/4 × 57"
K	1	1 × 4 backstop, 60"

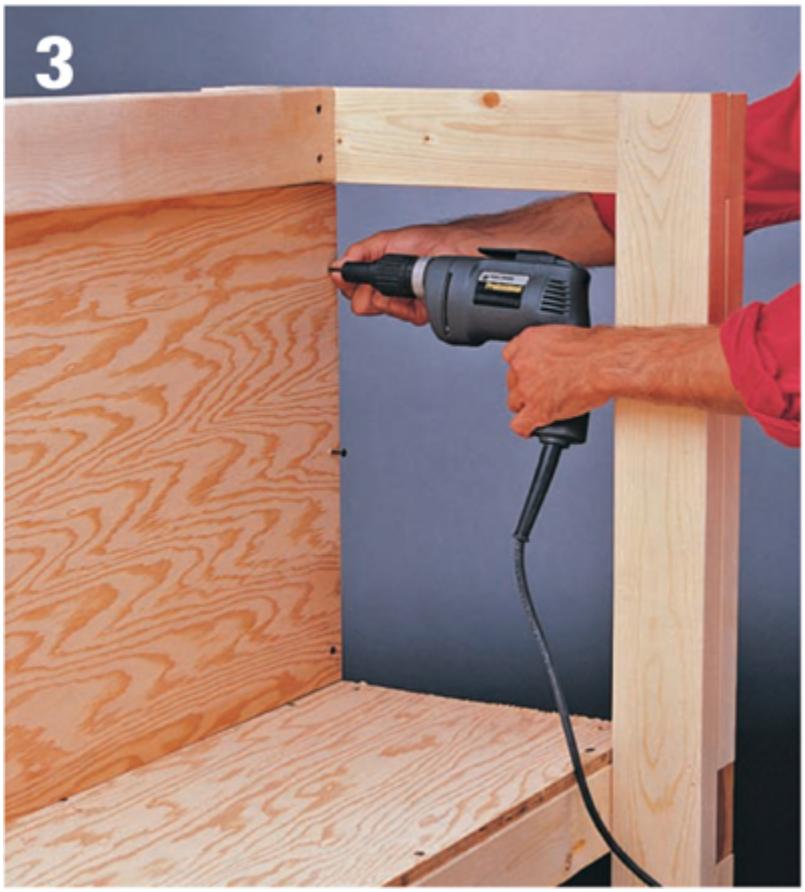
Workbench Cutting Diagram



How to Build a Workbench

Cut two pieces of C, D, E, and F for each end of the bench. Assemble them with 2½" wallboard screws.

Attach both 2 × 4 rear braces (G) inside the back legs of the assembled ends, using 2½" wallboard screws.



Attach the 2 × 4 front lower brace (G) inside the front legs of the assembled ends. Secure the bottom shelf (I) and workbench back (J) to the assembled 2 × 4 frame, using 2½" wallboard screws.

Drill pilot holes and join the 2 × 6 front upper brace (H) outside the front legs with 3" lag screws.

Center the bottom layer of the ¾" plywood work surface (B) on top of the frame. Align the plywood with the back edge, draw a reference line for driving the nails, and fasten it in place with 4d nails.

Align the bottom and top layers of the plywood work surface (B), and draw a reference line at least ½" closer to the edge to avoid the nails in the first layer. Drive 3" wallboard screws through both layers and into the bench frame.

Nail the hardboard work surface (A) to the plywood substrate with 4d finish nails. Set the nails below the surface.

Position the vise at one end of the bench. On the bench top, mark holes for the vise base. Bore ¼" pilot holes into the bench top.

Attach the vise with 1½" lag screws. Attach the backstop (K) to the back of the bench top, with 2½" wallboard screws.

Building a Sawhorse

Sawhorses provide a stable work surface that can support materials during marking and cutting. They can also form the base for temporary scaffolding to use while installing wallboard or ceiling panels. For scaffolding, place straight 2 × 10s or 2 × 12s across a pair of heavy-duty sawhorses (right). A wide top is best for supporting large loads. Small break-down sawhorses are a good choice if storage space is limited.

Tools & Materials ▸

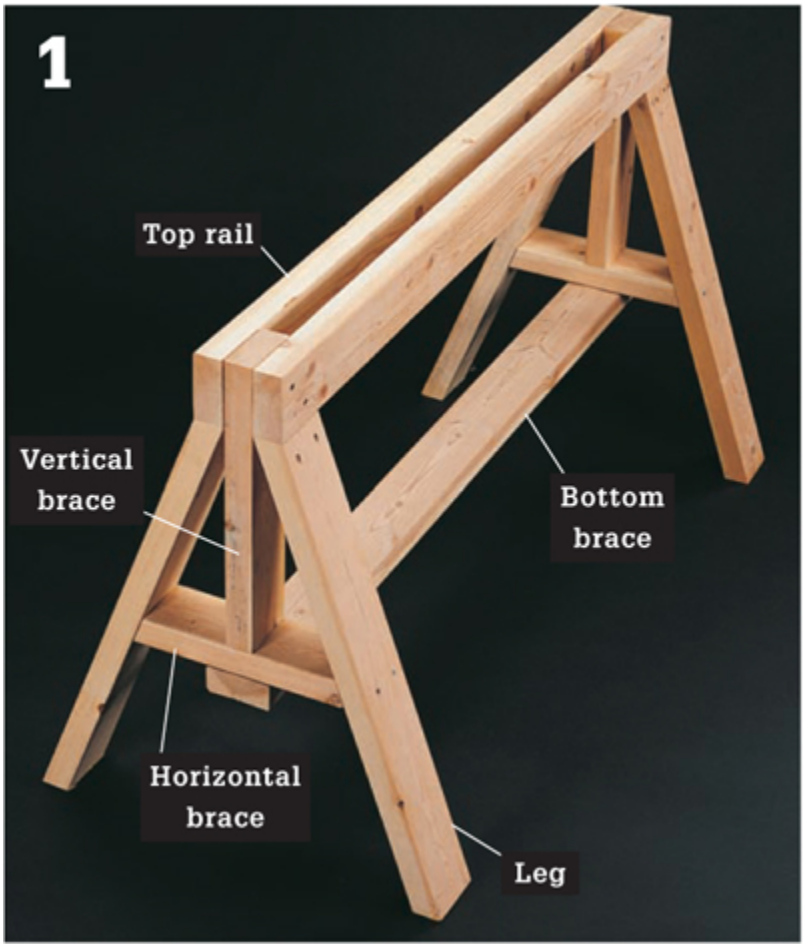
- Circular saw
- Tape measure
- Screw gun or cordless screwdriver
- Four 8-ft. 2 × 4s
- 2½" wallboard screws
- (2) Vertical braces, 15½"
- (2) Top rails, 48"
- (1) Bottom brace, 48"
- (2) Horizontal braces, 11¼"
- (4) Legs, 26"

Easy-storing Sawhorse Options

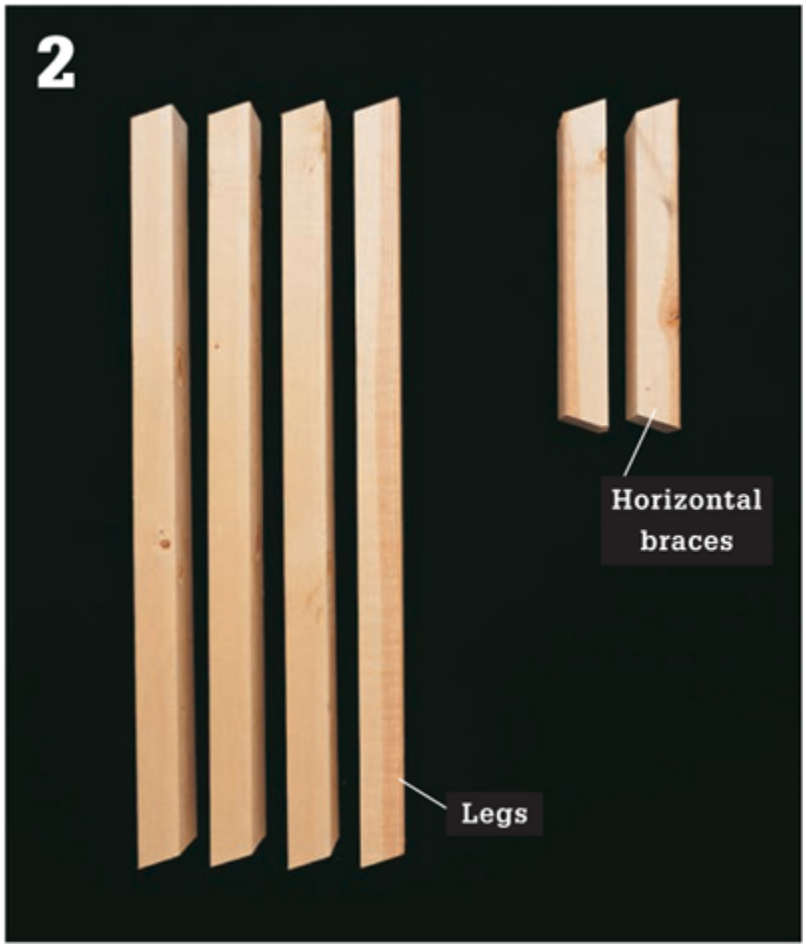
Fold metal sawhorses and hang them on the workshop wall when they are not in use.

Buy brackets made from fiberglass or metal, and cut a 48" top rail and four 26" legs from 2 × 4s. Disassemble sawhorses for storage.

How to Build a Heavy-duty Sawhorse



Measure and cut the vertical braces, top rails, and bottom brace to the lengths specified in the Material List (opposite page), using a tape measure and a circular saw.



Set a circular or miter saw to a 17° bevel angle. (Bevel cuts will match the angle shown above.) Cut the ends of the horizontal braces with opposing angles. Cut the ends of the legs with similar angles.

Attach the top rails to the vertical braces, as shown, using 2½" wallboard screws.

Attach the horizontal braces to the vertical braces, using 2½" wallboard screws. Attach a pair of legs to the horizontal braces and then to the brace at each end. Complete the sawhorse by attaching the bottom brace to the horizontal braces.

Materials

Materials selection is an important factor that contributes to a successful carpentry project. Choosing the right construction lumber and sheet goods will ensure that walls and floors can bear the loads applied to them, remain flat and plumb, and provide suitable surfaces for installing wall coverings and finished flooring. You should also know your options for nails, screws, and other metal connective hardware that are necessary for the job, especially when a project involves joining dissimilar materials like concrete and wood or when you're building with pressure-treated lumber. Carpentry often requires various glues, adhesives, and sealants for bonding, soundproofing, and weatherizing purposes. You don't have to be a chemist to choose the correct glue or caulk, but it helps to know the various families of these products so you can make informed decisions.

Since many home carpentry projects require a building permit, your local building inspector can also offer helpful advice about which materials you'll need for a project. Take that information to heart: using undersized or unsuitable lumber and fasteners can lead to failed inspections and extra work and expense for you in the end.

In This Chapter:

- Lumber
- Transporting Materials
- Plywood & Sheet Goods
- Trim Moldings
- Nails
- Screws & Other Hardware
- Glues & Adhesives

Lumber

Lumber for structural applications such as walls, floors, and ceilings is usually milled from strong softwoods and is categorized by grade, moisture content, and dimension.

Grade: Characteristics such as knots, splits, and grain slope affect the strength of the lumber and determine the grade (chart, opposite page).

Moisture content: Lumber is also categorized by moisture content. S-DRY (surfaced dry) is the designation for lumber with a moisture content of 19 percent or less. S-DRY lumber is the least likely to warp or shrink and is a good choice for framing walls. S-GRN (surfaced green) means the lumber contains a moisture content of 19 percent or more.

Exterior lumber: Lumber milled from redwood or cedar is naturally resistant to decay and insect infestation and is a good choice for exterior applications. The most durable part of a tree is the heartwood, so specify heartwood for pieces that will be in contact with the ground.

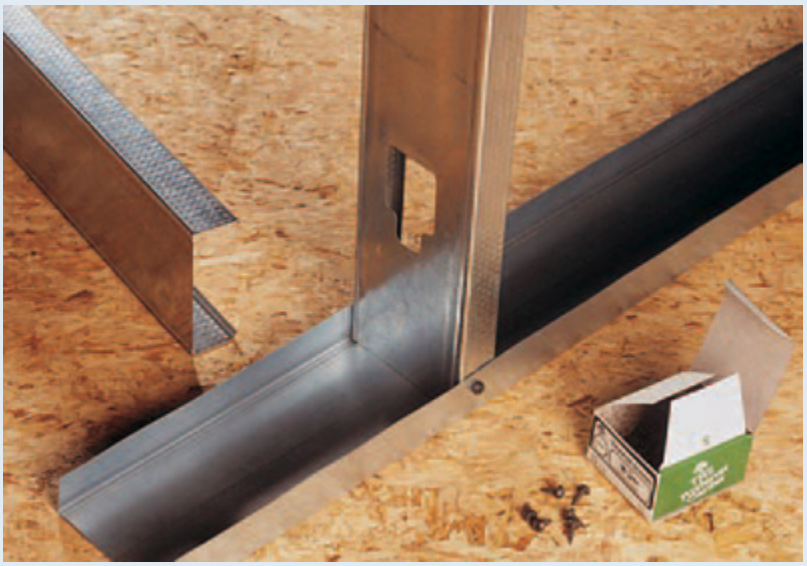
Treated lumber: Lumber injected with chemicals under pressure is resistant to decay and is generally less expensive than decay-resistant heartwoods such as redwood and cedar. For outdoor structures like decks, use treated lumber for posts and joists and more attractive redwood or cedar for decks and railings.

Dimension lumber: Lumber is sold according to its nominal size, such as 2 × 4. Its actual size (chart, page 23) is smaller. Always use actual sizes for measuring and estimating.

Check lumber visually before using it. Stored lumber can warp from temperature and humidity changes.

The Steel-Framing Alternative

Lumber is not the only material available for framing walls. Metal studs and tracks offer an attractive—if less common—choice for new construction. Steel-framed walls can be installed faster than wood stud walls—the parts are attached by crimping and screwing the flanges—and the channels are precut to accommodate electrical and plumbing lines. Steel framing is also lighter in weight, easy to recycle, fireproof, and comparable in price to lumber. If you are interested in using steel framing for a new wall in a wood-framed home, consult a professional for information about electrical, plumbing, and load-bearing safety precautions. Steel framing is available at most home centers.

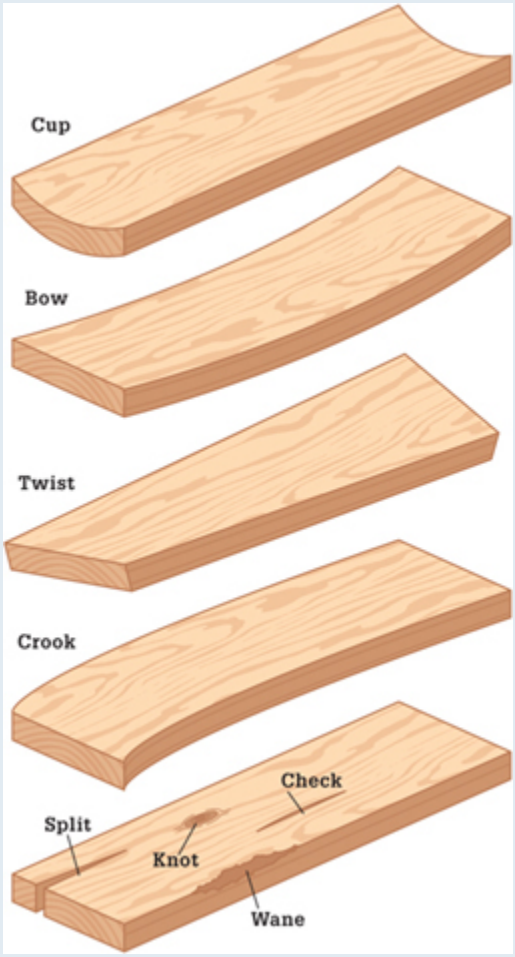


Lumber Grading Chart

Grade stamps provide valuable information about a piece of lumber. The lumber's grade is usually indicated by the largest number stamped on the wood. Also stamped on each piece of lumber are its moisture content, species, and lumber mill of origin.

Grade	Description, uses
Clear	Free of knots and defects.
SEL STR or Select Structural	Good appearance, strength, and stiffness.
1,2,3	1,2,3 grades indicate knot size.
CONST or Construction	Both grades used for general framing.
STAND or Standard	Good strength and serviceability.
STUD or Stud	Special designation used in any stud application, including load-bearing walls.
UTIL or Utility	Economical choice for blocking and bracing.

Much of today's lumber is still fairly wet when it is sold, so it's hard to predict how it will behave as it dries. But a quick inspection of each board at the lumberyard or home center will help you disqualify flawed boards. Lumber that is cupped, twisted, or crooked should not be used at full length. However, you may be able to cut out good sections for use as blocking or other short framing pieces. If a board is slightly bowed, you can probably flatten it out as you nail it. Checks, wanes, and knots are cosmetic flaws that seldom affect the strength of the board. The exception is a knot that is loose or missing. In this case, cut off the damaged area. Sections with splits should also be cut off. Splits are likely to spread as the wood dries.


Cup
Bow
Twist
Crook
Check
Split
Knot
Wane

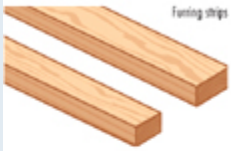
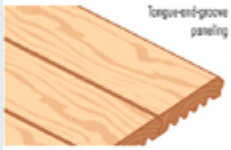
Selecting the Right Lumber for a Project

Picking the right wood for a project is a decision that will affect the durability and attractiveness of the final product. Some woods are more prone to warping than others, some are more resistant to decay, and some are superior when it comes to accepting a coat of paint. Matching styles and wood varieties will help to create a common theme throughout your home.

Lumber sizes such as 2 × 4 are nominal dimensions, not actual dimensions. The actual size of lumber is slightly smaller than the nominal size. When it is originally milled, lumber is cut at the nominal size; however, the boards are then planed down for a smoother finish, producing the actual dimensions you buy in the store. See the chart on the opposite page for nominal and actual dimensions.

Softwood	Description	Uses
Cedar	Easy to cut, holds paint well. Heartwood resists decay.	Decks, shakes, shingles, posts, and other decay-prone surfaces.
Fir, larch	Stiff, hard wood. Holds nails well. Some varieties are hard to cut.	Framing materials, flooring, and subflooring.
Pine	Lightweight, soft wood with a tendency to shrink. Holds nails well. Some varieties resist decay.	Paneling, trim, siding, and decks.
Redwood	Lightweight, soft wood that holds paint well. Easy to cut. Heartwood resists decay and insect damage.	Outdoor applications, such as decks, posts, and fences.
Treated lumber	Chemically treated to resist decay. Use corrosion-resistant fasteners only. Wear protective eye wear and clothing to avoid skin, lung, and eye irritation.	Ground-contact and other outdoor applications where resistance to decay is important.

Hardwood	Description	Uses
Birch	Hard, strong wood that is easy to cut and holds paint well.	Painted cabinets, trim, and plywood.
Maple	Heavy, hard, strong wood that is difficult to cut with hand tools.	Flooring, furniture, and countertops.
Poplar	Soft, light wood that is easy to cut with hand or power tools.	Painted cabinets, trim, tongue-and-groove paneling, and plywood cores.
Oak	Heavy, hard, strong wood that is difficult to cut with hand tools.	Furniture, flooring, doors, and trim.
Walnut	Heavy, hard, strong wood that is easy to cut.	Fine woodwork, paneling, and mantelpieces.

Type	Description	Common Nominal Sizes	Actual Sizes
Dimensional lumber	Used in framing of walls, ceilings, floors, and rafters, structural finishing, exterior decking, fencing, and stairs.	1 × 4 1 × 6 1 × 8 2 × 2 2 × 4 2 × 6 2 × 8	¾" × 3½" ¾" × 5½" ¾" × 7¼" 1½" × 1½" 1½" × 3½" 1½" × 5½" 1½" × 7¼"
Furring strips 	Used in framing of walls, ceilings, floors, and rafters, structural finishing, exterior decking, fencing, and stairs.	1 × 2 1 × 3	¾" × 1½" ¾" × 2½"
Tongue-and-groove paneling 	Used in wainscoting and full-length paneling of walls and ceilings.	½" × 4 1 × 4 1 × 6 1 × 8	Varies, depending on milling process and application.
Finished boards	Used in trim, shelving, cabinetry, and other applications where a fine finish is required.	1 × 4 1 × 6 1 × 8 1 × 10 1 × 12	¾" × 3½" ¾" × 5½" ¾" × 7¼" ¾" × 9¼" ¾" × 11¼"
Glue laminate	Composed of layers of lumber laminated to form a solid piece. Used for beams and joists.	4 × 10 4 × 12 6 × 10 6 × 12	3½" × 9 3½" × 12 5½" × 9 5½" × 12
Micro-lam	Composed of thin layers glued together for use in joists and beams.	4 × 12	3½" × 11¾"

Transporting Materials

Transporting building materials from the lumberyard or home center to your home is the first step in any workshop project—and it may be the most difficult. Framing lumber can be tied to a roof carrier rack for transporting, but sheets of plywood, paneling, or wallboard should be delivered by truck. Your lumberyard may deliver your materials for a small additional charge.

If you transport materials on a roof carrier, make sure to tie the load securely. Materials that extend past the rear bumper should be tagged with a red flag to warn drivers behind you. Drive carefully and avoid sudden starts and stops. When using your vehicle to carry heavy loads, like bags of concrete or sand, allow extra braking distance.

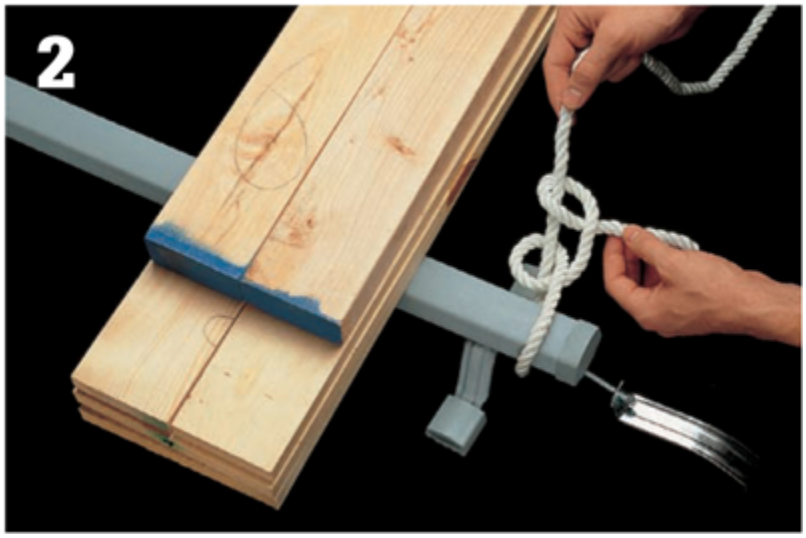
To carry full-sized sheets of plywood, paneling, or wallboard by yourself, tie a single length of rope, about 18 ft. long, in a loop. Hook the ends of the loop over the lower corners of the sheet, and grip the middle of the rope in one hand. Use the other hand to balance the sheet.

If you already know the cutting dimensions for plywood, paneling, or other sheet goods, you can make transportation easier by cutting the materials to size while still at the lumberyard or home center. Some lumberyards will cut your materials free of charge. Or, you can bring along a saw and cut the materials yourself.

Tie materials onto the roof of your car using inexpensive, vinyl-coated roof brackets. Hook the brackets over the edge of the roof, then attach nylon packing straps or ropes to the brackets for cinching materials in place. Place carpet scraps under the materials to prevent scratches, and center the load on the car roof.

How to Tie a Load onto an Auto Roof Carrier

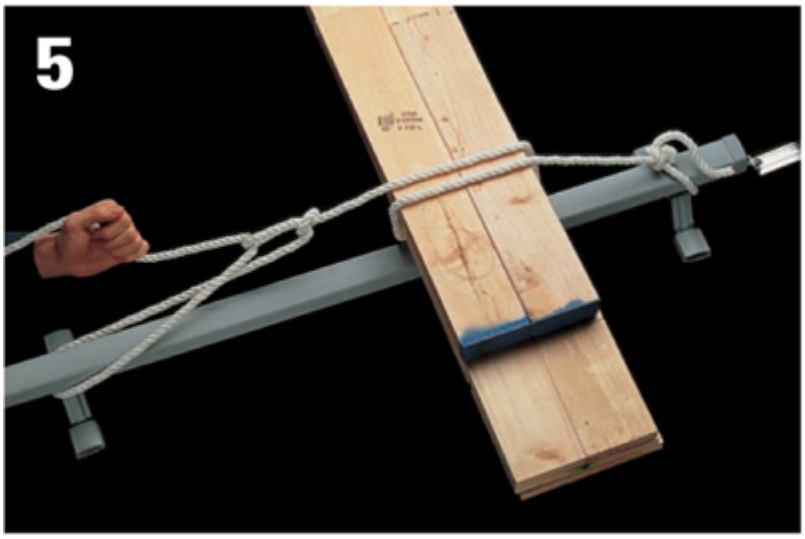
Tie a half hitch around one end of the roof carrier bar. Pull the knot tight.



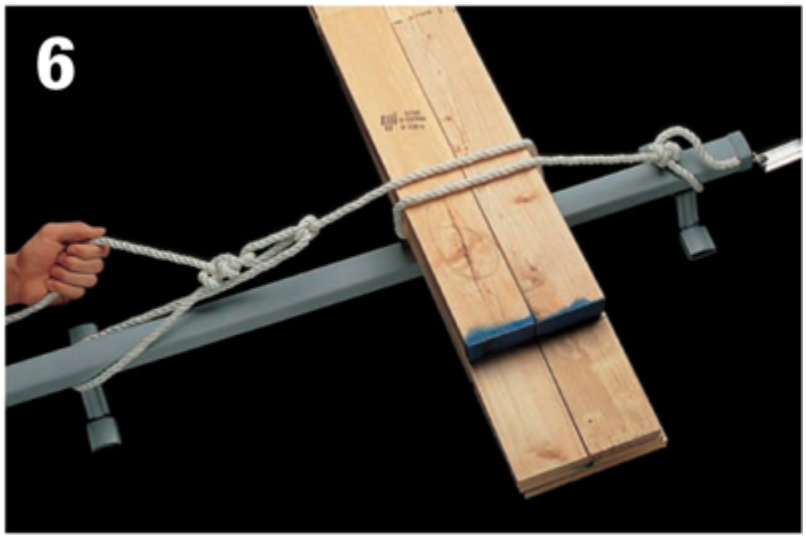
Tie a second half hitch in the rope, and pull the knot tight. A half hitch has good holding power, yet is easy to untie.

Pull the rope over the top of the load. If possible, wrap the rope once around the load. Tie a small slip loop in the rope.

Stretch the rope around the opposite end of the roof carrier bar.



Thread the end of the rope through the slip loop. Pull the rope firmly against the loop to cinch the load tight against the roof carrier.



Tie off the rope below the slip loop, using half hitches. Repeat steps 1 to 6 at the other carrier bar. If desired, large loads also can be tied to the front and rear bumpers of the car, using the same rope technique.

Plywood & Sheet Goods

There are many different types of sheet goods, but plywood is the most widely used. Plywood is an extremely versatile sheet material that is made up of thinly sliced layers or plies of wood. Plywood is available in thicknesses ranging from 3/16" to ¾" and is graded A through D, depending on the quality of the wood in its outer plies. It is also graded for interior or exterior usage. Classifications for plywood are based on the wood species used for the face and back veneers. Group 1 species are the strongest and stiffest, Group 2 is the next strongest.

Finish plywood is graded either A-C, meaning it has a finish-quality wood veneer on one side and a utility-grade ply on the other side, or A-A, indicating it has a finish veneer on both sides.

Sheathing plywood is graded C-D with two rough sides and features a bond between plies that is waterproof. Plywood rated EXPOSURE 1 is for use where some moisture is present, and plywood rated EXTERIOR is used in applications that are permanently exposed to weather. Sheathing plywood also carries a thickness rating and a roof and floor span index, which appear as two numbers separated by a diagonal slash. The first number, for roofing application, indicates the maximum spacing for rafters. The second number specifies the joist spacing when plywood is used for subflooring. Some plywood is stamped “sized for spacing.” This means that the actual dimensions are slightly smaller than 4 × 8 ft. to allow space for expansion between sheets after installation.

Plastic laminates make durable surfaces for countertops and furniture. Plastic laminates are sometimes bonded to particleboard for use in shelving, cabinets, and countertops.

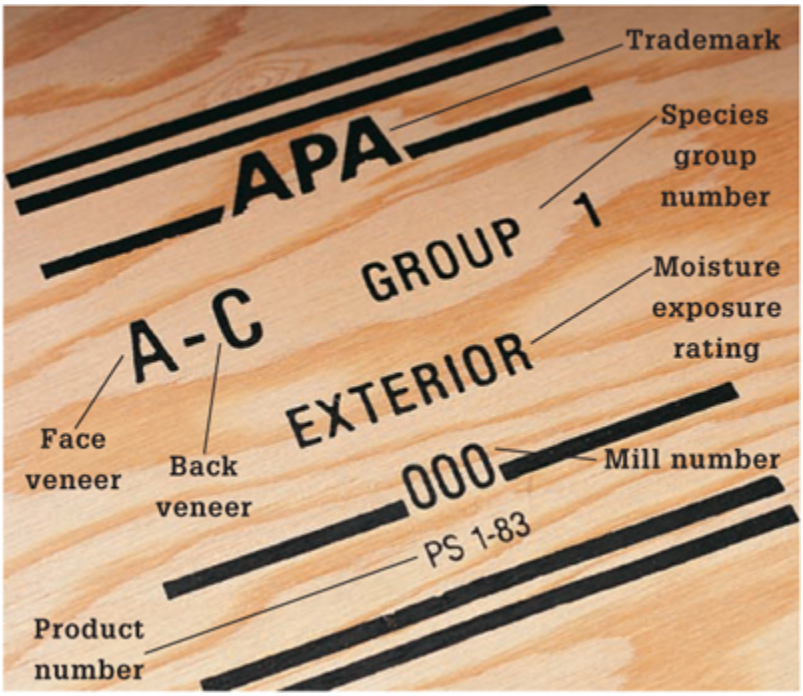
Standard-, Particle-, and waferboard are made from waste chips or inexpensive wood species and are used for shelving and floor underlayment.

Foam insulating board is lightweight and serves as insulation for basement walls.

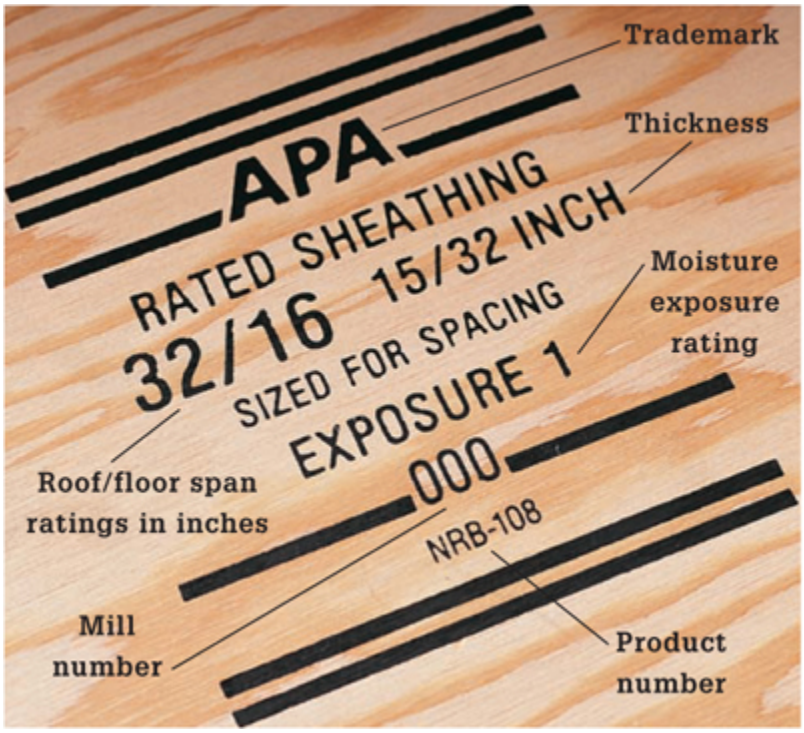
Water-resistant wallboard is used behind ceramic wall tiles and in other high-moisture areas.

Wallboard, also known as drywall, Sheetrock, and plasterboard, comes in panels 4-feet wide and 2, 4, 8, 10, or 12-feet long and in ⅜", ½", and ⅝" thicknesses.

Pegboard and hardboard are made from wood fibers and resins bonded together under high pressure and are used for tool organization with a workbench and as shelf backing.



The finish plywood grading stamp shows the grade of face and back veneers, species group number, and a moisture exposure rating. Mill numbers and product numbers are for the manufacturer’s use.



The sheathing plywood grading stamp shows thickness, roof or floor span index, and exposure rating, in addition to the manufacturer's information.

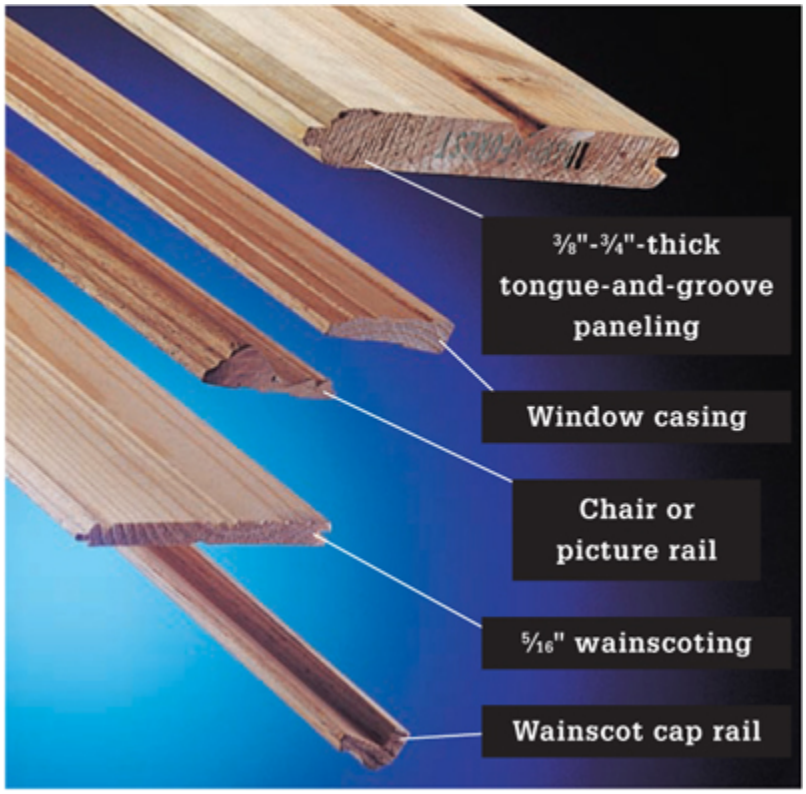
Plastic foam insulating board
Water-resistant wallboard
Wallboard
Pegboard
Hardboard

Trim Moldings

Trim moldings give character and definition to many carpentry projects. In addition, you can sometimes use them to cover up carpentry mistakes, such as hiding small gaps in wall corners when the wallboard hasn't been cut perfectly.

It's important to measure and cut moldings precisely so that when installed, they fit together snugly without gaps. Predrilling moldings is recommended, especially when hardwoods such as oak are used. Predrilling makes hand nailing easier, reduces splitting during installation, and makes it easier to set nails cleanly. There's no need to predrill when using a pneumatic nail gun.

Most moldings should be painted or stained before installation. Cove moldings and wainscoting can be purchased with a factory coat of white paint. Care must be taken to ensure that paint or stain does not interfere with installation (see "Installing Wainscoting," page 168). Pine and poplar are good choices if you plan to paint. For stained surfaces, use a hardwood with a pleasing grain, such as oak.



Use the same wood species whenever possible in selecting trim materials for walls, doors, and windows. Similar materials will provide visual consistency throughout a room.

Decorative moldings give a finished appearance to a carpentry project. Other finish materials include door and window casings, baseboard, and other types of trim.

A
B
C
D
E
F
G

H
I
J
K
L
M

Trim moldings are both functional and decorative. They can be used to conceal gaps at the base and around the sides of a carpentry project, to hide the edges of plywood surfaces, or simply to add visual interest to the project. Moldings are available in dozens of styles, but the samples shown here are widely available at all home improvement centers.

Synthetic trim moldings, available in many styles, are less expensive than hardwood moldings. Synthetic moldings are made of wood composites (A) or rigid foam (B) covered with a layer of melamine.

Baseboard molding (C) is used to trim the bottom edge of a wall along the floor line. Choosing molding that matches the baseboard elsewhere in your home helps your project fit in with its surroundings.

Hardwood strips (D) are used to construct face frames for carpentry projects and to cover unfinished edges of plywood shelves. Maple, oak, and poplar strips are widely available in 1 × 2, 1 × 3, and 1 × 4 sizes.

Crown moldings (E, F) cover gaps between the top of a wall and the ceiling. They can also add a decorative accent to other projects.

Cove molding (G) is a simple, unobtrusive trim for covering gaps.

Ornamental moldings, including spindle and rail (H) and embossed moldings (I, J), give a distinctive look to many projects.

Door-edge molding (K), also called cap molding, is only available in specialty stores in some areas. It is used with finish-grade plywood to create panel-style doors and drawer faces.

Shelf-edge molding (L), also called base cap molding, provides a decorative edge to plywood shelves or can be used to create a wider baseboard molding.

Base-shoe molding (M) covers gaps around the top, bottom, and sides of a wall. Because it bends easily, base-shoe molding works well to cover irregular gaps caused by uneven walls and loose floors.

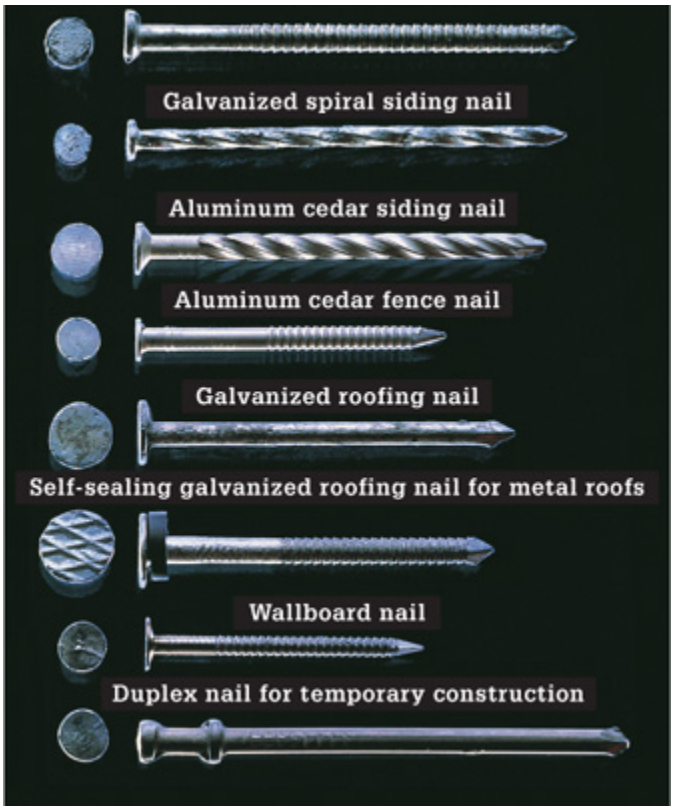
Nails

The wide variety of nail styles and sizes makes it possible to choose exactly the right fastener for each job. Nails are identified by their typical purpose, such as casing, flooring, or roofing nails; or by a physical feature, such as galvanized, coated, or spiral. Some nails come in both a galvanized and non-galvanized version. Use galvanized nails for outdoor projects and non-galvanized indoors. Nail lengths may be specified in inches or by numbers from 4 to 60 followed by the letter “d,” which stands for “penny” (see “Nail Sizes,” opposite page).

Some of the most popular nails for carpentry projects include:

- Common and box nails for general framing work. Box nails are smaller in diameter, which makes them less likely to split wood. Box nails were designed for constructing boxes and crates, but they can be used in any application where thin, dry wood will be nailed close to the edge of the piece. Most common and box nails have a cement or vinyl coating that improves their holding power.
- Finish and casing nails, which have small heads and are driven just below the work surface with a nail set. Finish nails are used for attaching moldings and other trim to walls. Casing nails are used for nailing window and door casings. They have a slightly larger head than finish nails for better holding power.
- Brads, small wire nails sometimes referred to as finish nails. They are used primarily in cabinetry, where very small nail holes are preferred.
- Flooring nails, which are often spiral-shanked for extra holding power to prevent floorboards from separating or squeaking. Spiral flooring nails are sometimes used in other applications, such as installing tongue-and-groove paneling on ceilings.
- Galvanized nails, which have a zinc coating that resists rusting. They are used for outdoor projects.
- Wallboard nails, once the standard fastener for wallboard, are less common today because of the development of Phillips-head wallboard screws that drive quickly with a screw gun or drill and offer superior holding power (page 32).

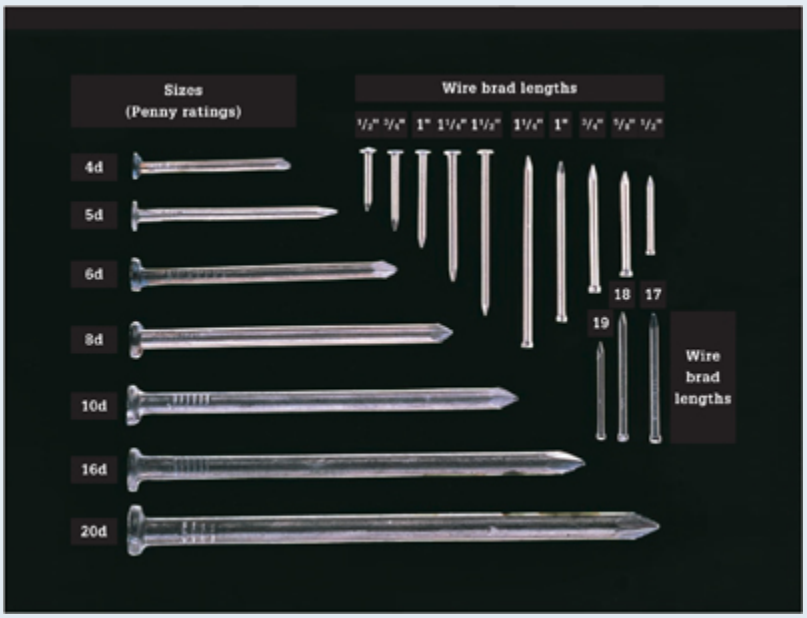
Types of Nails
Common nail for heavy-duty framing
Box nail for light work or edge nailing
Cement-coated sinker nail for outside sheathing
Finish nail for fastening wood trim
Galvanized casing nail for outside trim
Spiral flooring nail for subflooring
Cement nail for fastening wood to concrete
Masonry nail for brick and concrete
Galvanized ring-shank siding nail


Galvanized spiral siding nail
Aluminum cedar siding nail
Aluminum cedar fence nail
Galvanized roofing nail
Self-sealing galvanized roofing nail for metal roofs
Wallboard nail
Duplex nail for temporary construction

Nail Sizes

The pennyweight scale that manufacturers use to size nails was developed centuries ago as an approximation of the number of pennies it would take to buy 100 nails of that size. The range of nail types available today (and what they cost) is much wider, but the scale is still in use.

Each pennyweight refers to a specific length (see chart, below), although you will find slight variations in length from one nail type to the next. For example, box nails of a given pennyweight are roughly ⅛" shorter than common nails of the same weight.



Estimating Nail Quantities

Estimate the number of nails you'll need for a project, then use the chart to determine approximately how many pounds of nails to purchase.

Note: Sizes and quantities not listed are less common, although they may be available through some manufacturers.

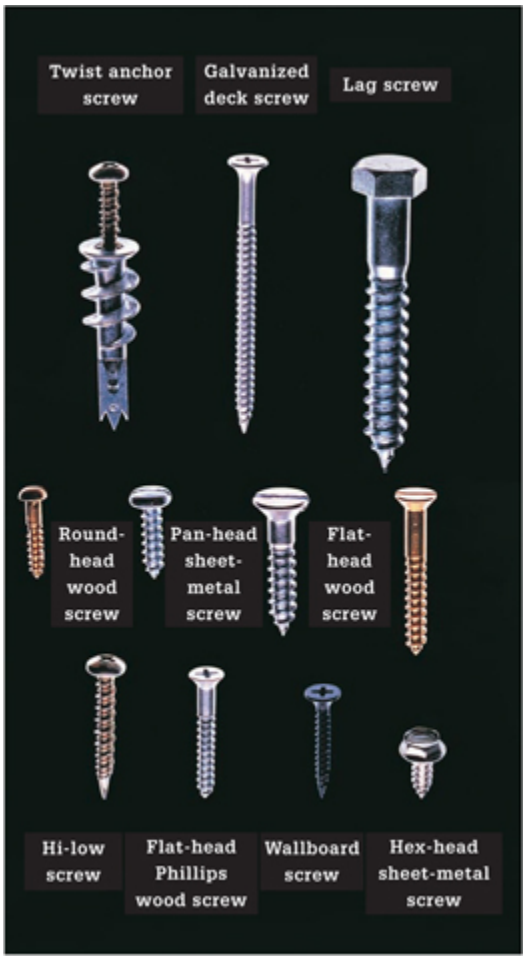
Nails per lb.

Pennyweight	2d	3d	4d	5d	6d	7d	8d	10d	12d	16d	20d
Length (in.)	1	1¼	1½	1¾	2	2¼	2½	3	3¼	3½	4
Common	870	543	294	254	167		101	66	61	47	29
Box	635	473	406	236	210	145	94	88	71	39	
Cement-coated			527	387	293	223	153	111	81	64	52
Finish	1350	880	630	535	288		196	124	113	93	39
Masonry			155	138	100	78	64	48	43	34	

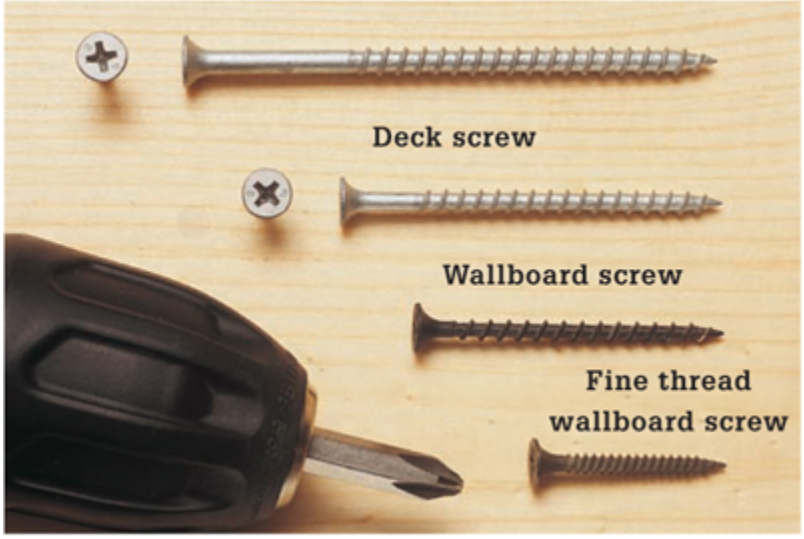
Screws & Other Hardware

The advent of the screw gun and numerous types of driver bits for drills have made screws a mainstay of the carpentry trade. With literally hundreds of different screws and types of fastening hardware available, there is a specific screw for almost every job. But, for most carpentry jobs you will only need to consider a few general-purpose types. Although nails are still preferred for framing jobs, screws have replaced nails for hanging wallboard, installing blocking between studs, and attaching sheathing and flooring. Screws are also used to attach a workpiece to plaster, brick, or concrete, which requires an anchoring device (opposite page, top).

Screws are categorized according to length, slot style, head shape, and gauge. The thickness of the screw body is indicated by the gauge number. The larger the number, the larger the screw. Large screws provide extra holding power; small screws are less likely to split a workpiece. There are various styles of screw slot, including Phillips, slotted, and square. Square-drive screwdrivers are increasing in popularity because they grip the screw head tightly, but Phillips head screws are still the most popular.

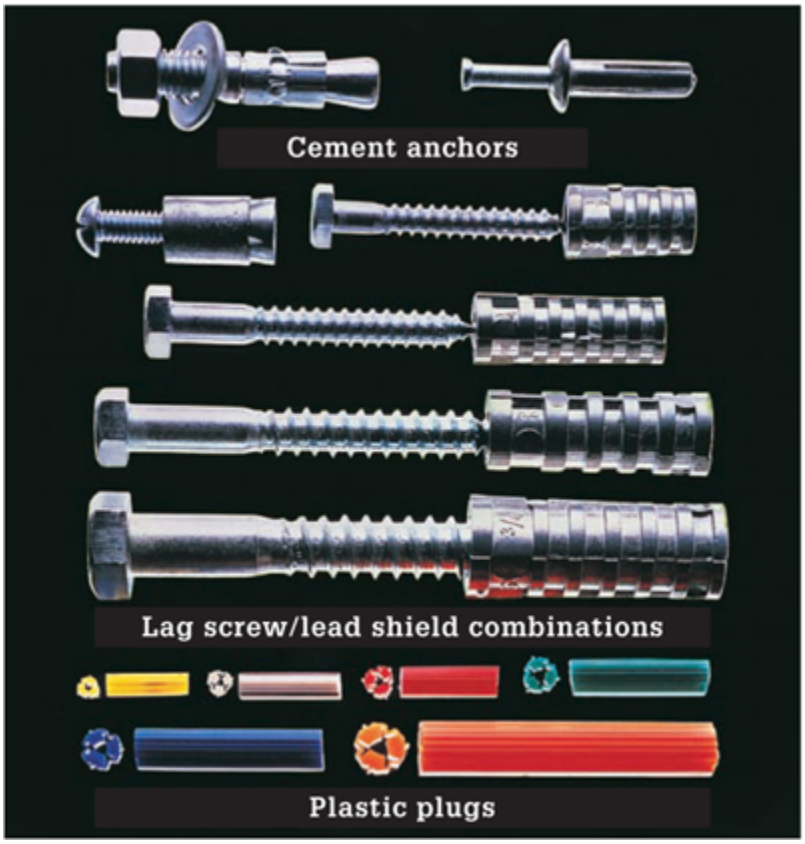

Twist anchor screw
Galvanized deck screw
Lag screw
Round-head wood screw
Pan-head sheet-metal screw
Flat-head wood screw
Hi-low screw
Flat-head Phillips wood screw
Wallboard screw
Hex-head sheet-metal screw

WALLBOARD SCREWS & DECK SCREWS



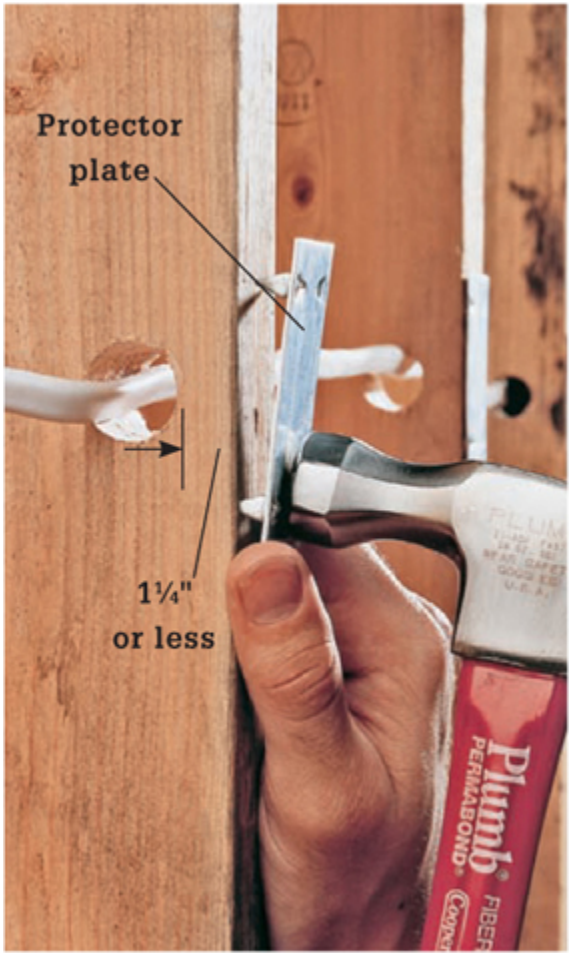
Use wallboard screws for general-purpose, convenient fastening. Easily recognizable by their bugle-shaped heads, wallboard screws are designed to dimple the surface of the wallboard without ripping the facing paper (see photo). However, they are often used for non-wallboard projects because they drive easily with a drill or screw gun, don’t require pilot holes, and seldom pop up as wood dries. In soft wood, the bugle-shaped heads allow the screws to countersink themselves. Deck screws are corrosion-resistant wallboard screws made specifically for outdoor use.

Using Masonry & Wall Anchors

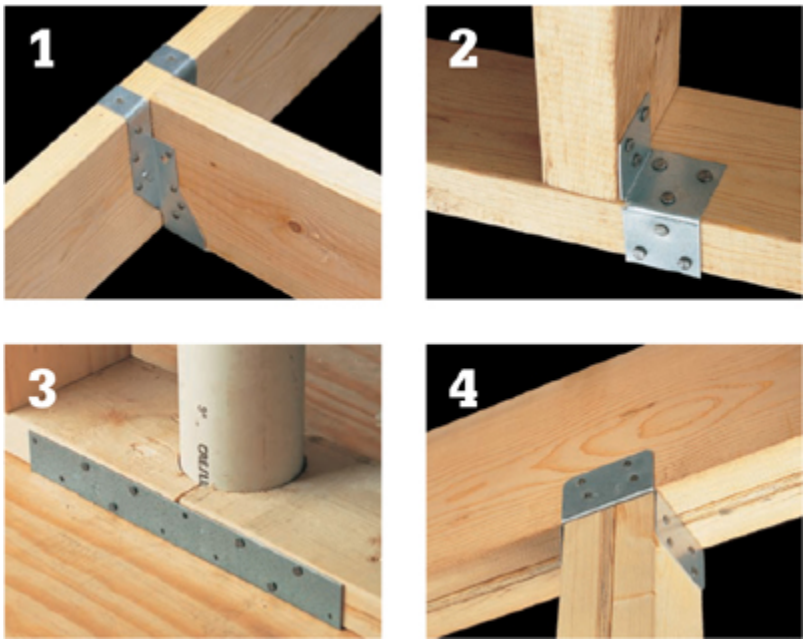


Use wall anchors to attach hardware or lumber to plaster, concrete, or brick. Choose an anchor that is equal in length to the thickness of the wall's surface material. Plastic plugs are used for anchoring in hollow walls.

To install a wall anchor, drill a pilot hole equal in diameter to the plastic anchor. Insert the anchor in the hole and drive it flush with the wall surface. Insert the screw and tighten it; as the anchor expands, it will create a tight grip.



Use protector plates where wires or pipes pass through framing members and are less than 1¼" from the edge. The plates prevent wallboard screws or nails from puncturing wires or pipes.



Metal framing connectors may be required in some communities, especially in areas prone to high winds or earthquakes. Metal joist hangers (1), stud ties (2), connector straps (3), and post-and-beam saddles (4) all provide extra reinforcement to structural joints. Wood joints made with metal connectors are stronger than toenailed joints.

Glues & Adhesives

When used properly, glues and adhesives can be stronger than the materials they hold together. Use hot glue in lightweight woodworking projects, carpenter's glue for wood joints, and carpentry adhesive for preliminary installation of thin panels and lumber. Panel adhesive, a thinner formula that can be applied from a tube or with a brush, is used to install paneling, wainscoting, and other lightweight tongue-and-groove materials. Most caulk is applied with a caulk gun, but some types are available in squeeze tubes for smaller applications. Caulks are designed to permanently close joints, fill gaps in woodwork, and hide subtle imperfections. Different caulks are made of different compounds and vary greatly in durability and workability. While silicone caulks last longer, they are not paintable and are difficult to smooth out. Latex caulks are less durable than silicone, but are much easier to work with, especially when used to hide gaps. Many caulks are rated on scales of 1 to 4 to indicate how well they bond to masonry, glass, tile, metals, wood, fiberglass, and plastic. Read the label carefully to choose the right caulk for the job.

Carpentry adhesives include (clockwise from top right): clear adhesive caulk, for sealing gaps in damp areas; waterproof construction adhesive, for bonding lumber for outdoor projects; multi-purpose adhesive, for attaching paneling and forming strong bonds between lumber pieces; electric hot glue gun and glue sticks, for bonding small decorative trim pieces on built-ins; wood glues and all-purpose glue, for many woodworking projects.

Using Adhesives & Glues

Strengthen floors and decks and reduce squeaks with joist and deck adhesive. For outdoor applications, make sure you choose a waterproof adhesive.

Construction adhesive adds strength to carpentry and woodworking joints. It also has two advantages over glue. It has high initial tack, so parts don’t slide apart, and it retains some flexibility after drying.

Exterior-grade construction adhesive fortifies the bond between wood structural members and the masonry house foundation. Additional fasteners, such as powder-actuated nails, are still needed.

Specialty molding and trim glue has a thicker formulation than standard wood glue to resist running and dripping on vertical surfaces. It is tackier than regular glue, which helps hold ceiling trims in place when they are positioned, creating a small amount of time for you to fasten them with nails.

Tools & Skills

Whether you are framing a wall, removing a window, or planing a new door to fit its jambs, carpentry projects require an assortment of different tools. This chapter will familiarize you with those tools, offering helpful information regarding techniques, blade or bit options, and tool maintenance.

In This Chapter:

- Prying Tools
- Measuring & Marking Tools
- Handsaws
- Hammers
- Screwdrivers
- Clamps & Vises
- Chisels
- Planes & Surface Forming Rasps
- Extension Cords
- Jigsaws
- Circular Saws
- Straightedge Guides
- Power Miter Saws
- Table Saws
- Drills & Bits
- Sanders
- Pneumatic Nailers
- Powder-Actuated Tools
- Specialty Tools

Carrying Your Tools

Carpentry jobs are easier when your tools are organized in a tool belt, because you spend less time searching for the right tool.

Standard features for tool belts include slots for screwdrivers, files, a carpenter's pencil, and a utility knife; at least one hammer loop; and a deep pouch or two for carrying nails and screws. Many belts also have a slot for a tape measure and a hook for hanging a small level.

Think about the tools you most often use, and choose a tool belt that has the right number of slots, pockets, or loops for your tool load. The more varied the tasks you'll be handling, the more elaborate your belt should be. If you'll only be framing, a simple canvas nailing apron with a hammer loop may be all you need.

If you carry a lot of tools on your belt, a pair of suspenders can be useful. Suspenders reduce some of the weight on your hips. Several companies offer suspenders designed to attach to your tool belt.

For projects that require tools you can't fit into your belt, consider using a bucket apron (page opposite).

If you plan to carry a drill, you may want to purchase a separate drill holster with slots for commonly used bits.

There are two basic types of tool belts: apron-style and side-mounted bags (shown here). Side bags don't get in your way when you crouch, and make the tools easier to reach. However, it is easier to squeeze between wall studs while wearing an apron-style belt.

Optional belt attachments, such as holsters for drills, help organize your tool load. They can be worn alone or with other tool bags.

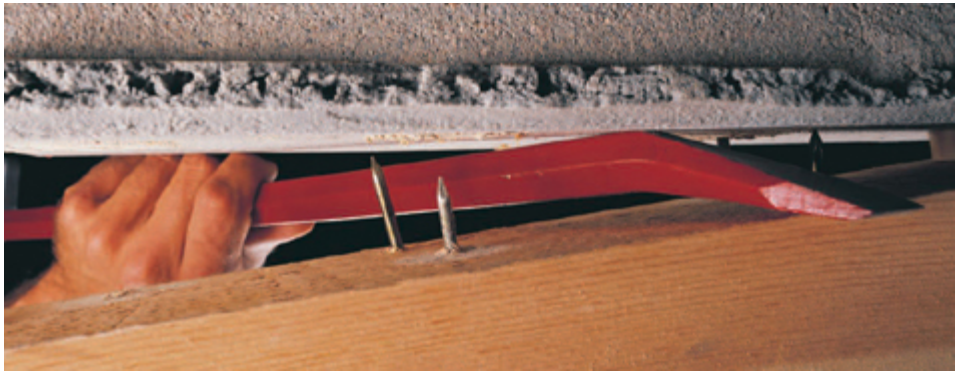
Use a tool bucket for larger or less frequently needed tools and a tool belt for quick access to small tools. The bucket apron is a convenient way to carry specialty tools that will not fit into your tool belt, such as a long level or a caulk gun. The tool bucket also allows several people to share tools.

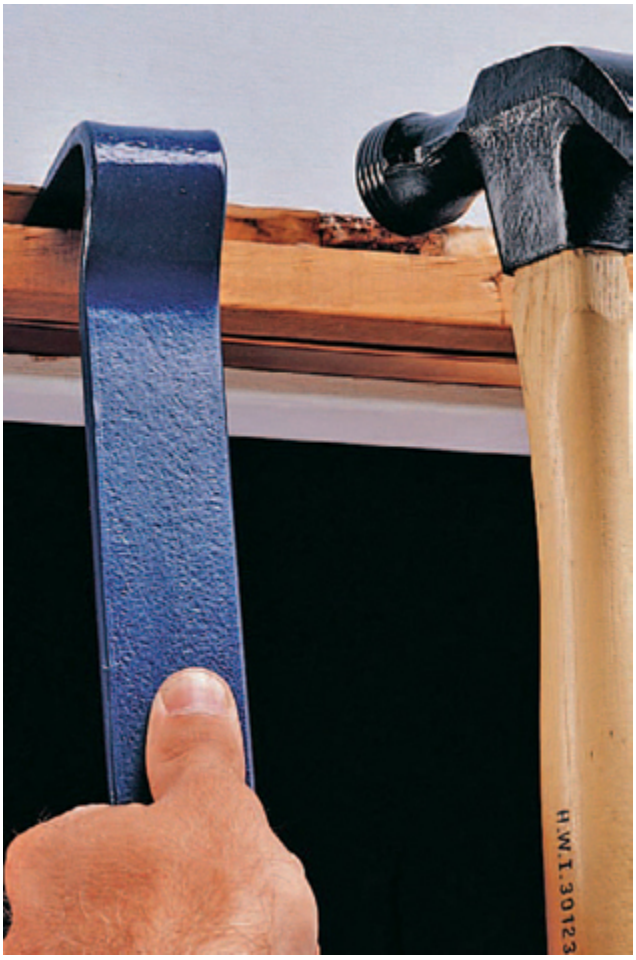
Prying Tools

Prying tools are an essential part of any carpenter's tool arsenal, because many carpentry projects start with the removal of existing materials. With the right tools, you can often remove nails without damaging the lumber, so that it can be used again.

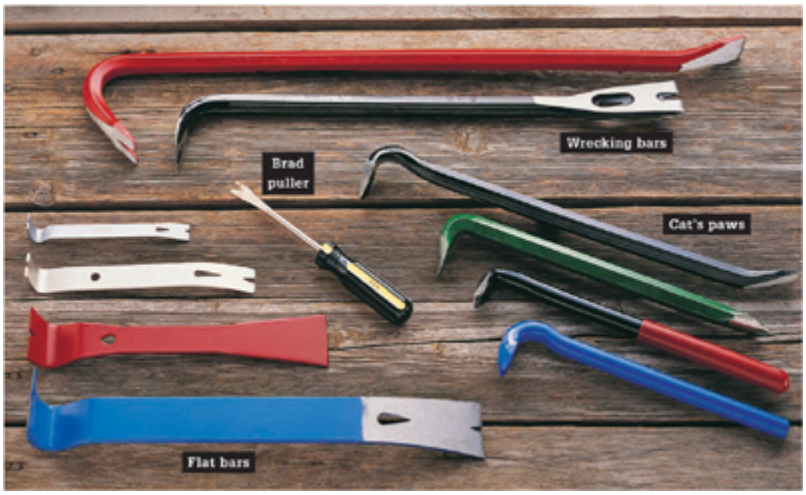
Pry bars are available in many sizes. Choose quality pry bars forged from high-carbon steel in a single piece. Forged tools are stronger than those made from welded parts.

Most pry bars have a curved claw at one end for pulling nails and a chisel-shaped tip at the opposite end for other prying jobs. You can improve leverage by placing a wood block an inch or two away from the material you're trying to pry loose.





A flat bar is made of flattened, slightly flexible steel. This tool is useful for a variety of prying and demolition jobs. Both ends can be used for pulling nails.



Prying tools include wrecking bars for heavy demolition work, cat's paws for removing nails, and a brad puller. Flat bars are made of flattened steel and come in a variety of sizes for light- and heavy-duty use.

A wrecking bar, sometimes called a crowbar, is a rigid tool for demolition and heavy prying jobs. Use scrap wood under the bar to protect surfaces.

A cat's paw has a sharpened claw for removing stubborn nails. Use a hammer to drive the claw into the wood under the nail head, then lever the tool to pull up the nail.

Measuring & Marking Tools

Tape Measures

An important step in every carpentry project is measuring accurately. Buy a 25-foot steel tape measure with a ¾"-wide blade for general use. Most tape measures are retractable, so the tape returns easily. Make sure your tape has a locking mechanism, so you can keep it extended to a desired length. A belt clip is also essential.

Wider tapes normally have a longer standout—the distance a tape can be extended before it bends under its own weight. A long standout is an extremely useful feature when you're measuring without a partner to support the far end of the tape. Open a tape in the store and extend it until it bends. It should have a standout of at least 7 feet.

Tape measures are commonly set in 1/16" increments along the top edge and 1/32 increments for the first six inches across the bottom. Select one with numbers that are easy to read. "Easy reader" tapes feature a fractional readout for people who have difficulty reading a measurement calibrated with dash marks. Most tape measures feature numbers that are marked or labeled every 16" for easy marking of studs. A high-quality tape measure also has a two- or three-rivet hook to control the amount of play in the tape, ensuring your measurements are as accurate as possible.

Buy a 25-ft. retractable steel tape for general carpentry projects. If you are working on a large project like a deck, patio, or retaining wall, consider purchasing a 50-ft. reel-type tape.

“Bury an inch.” The end hook on a tape measure has a small amount of play and should not be used when an extremely accurate measurement is required. For precise measurements, use the 1" mark as your starting point (called burying an inch), then subtract 1" from your reading.

Use only one tape measure, if possible, while working on a project. If you must work with two tapes, make sure they record the same measurement. Different tape measures do not always measure equally. A slight difference in the end hooks can create an error of 1/16" or more between two tapes, even if they are of the same brand and style.

Simplify the task of making straight, horizontal cuts in wallboard. Lock a tape measure at the desired width and position a utility knife blade under the tape hook. Hold the tape body in one hand and the knife and tape hook in the other as you slide the blade along the wallboard.

Check for square when building frames, boxes, cabinets, drawers, and other projects where fit is important. Hold a tape measure across the diagonals of the workpiece (A-C, B-D). The measurements will be identical if the workpiece is square.

Plumb Bobs, Chalk Lines & Stud Finders

The plumb bob is a simple, yet extremely precise tool used to establish a line that is plumb—or exactly vertical. Plumb bobs are commonly used to find marking points to position a sole plate when building a wall. Plumb refers to a hypothetical line running to the exact center of the earth. Think of it as a line that is exactly perpendicular to a level surface.

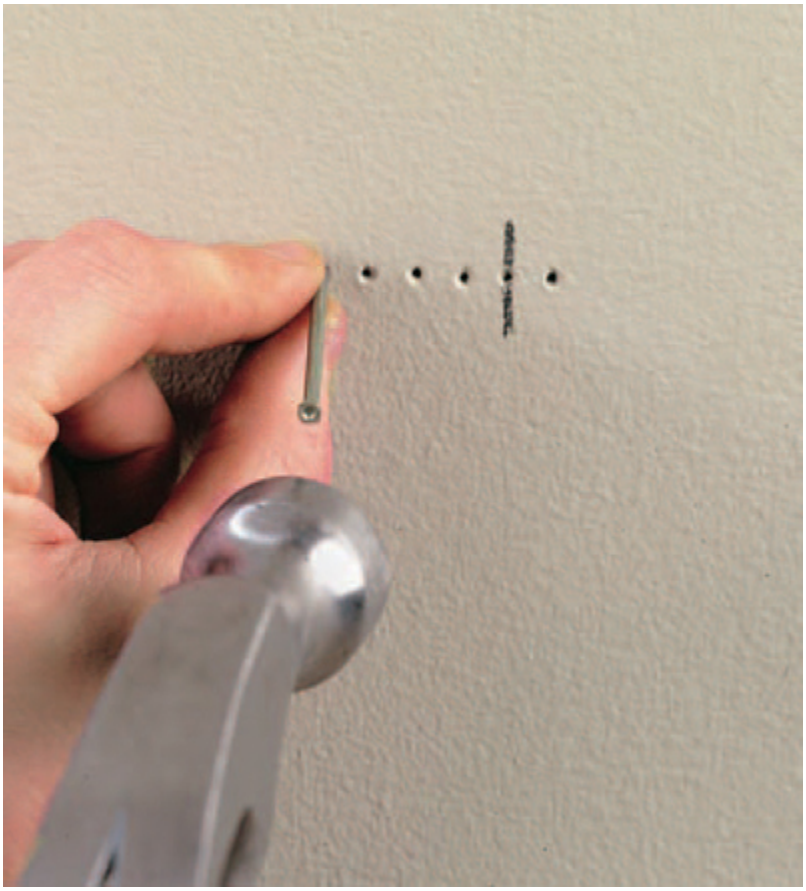
The chalk line is a tool used to mark straight lines on flat surfaces for layout or to mark sheet goods and lumber for cutting. Typical chalk lines contain 50 to 100 feet of line wound up in a case filled with chalk. Always tap the box lightly to fully coat the line with chalk before pulling it out. To mark a line, extend it from the case, pull it taut, and snap it using the thumb and forefinger. Chalk lines have a crank that is used to reel in the line when the job is complete and a locking mechanism to help keep the line taut during marking.

Most of today's chalk lines (sometimes called chalk boxes) double as plumb bobs for general use (see photos). A chalk box isn't quite as accurate as a plumb bob for establishing a vertical line. However, if you don't own a plumb bob, using a chalk box is an easy alternative.

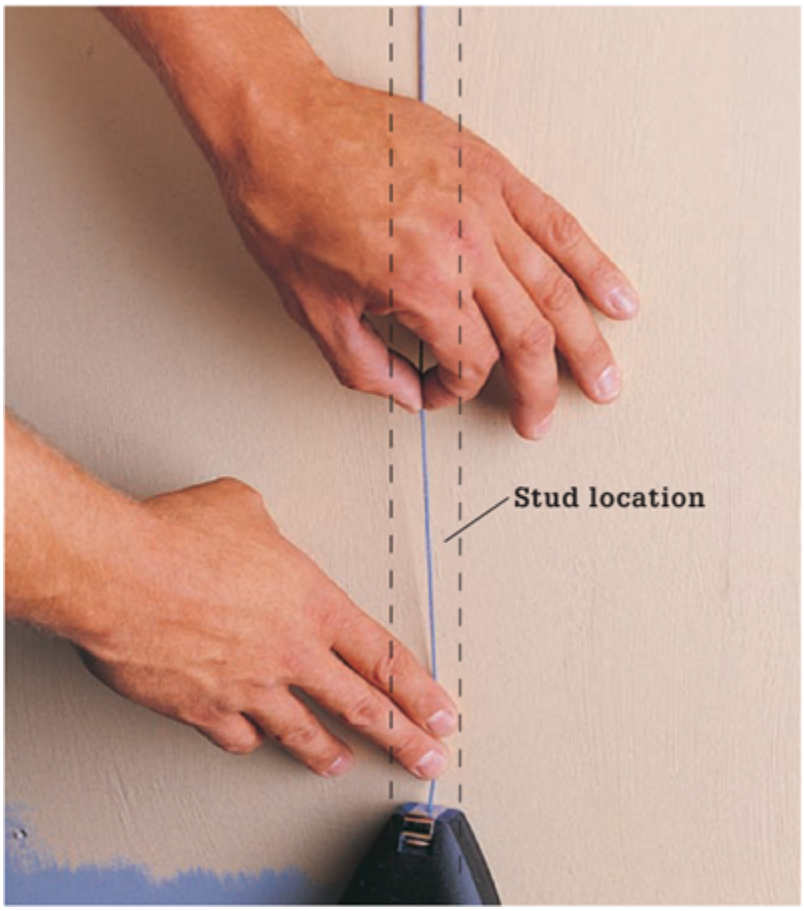
Studfinders are battery-powered electronic devices that analyze wall density. They can help you locate wall framing and even electrical wires, depending on the model.

Buy powdered chalk refills of blue or red chalk. Do not overfill your chalk box or the string will be difficult to pull out and wind in. Keep moisture out of your chalk box or the chalk will clump together, causing uneven coverage of the line.

Use a studfinder to locate wall studs or ceiling blocking. These devices locate the edges of framing so you can determine the center of studs and joists.



Confirm framing locations by driving a finish nail through the wall in an inconspicuous area. Locate and measure from the center point in 16" or 24" intervals to find neighboring members.



To snap a chalk line over a very short distance, pin the string down with the edge of your palm, then use your thumb and forefinger on the same hand to snap the line. When snapping lines to mark stud locations, make sure you snap over the center of the studs, so you will know where to drive screws or nails.

To position a sole plate, hang a plumb bob from the edge of the top plate so that it nearly touches the floor. When it hangs motionless, mark the floor directly below the point of the plumb bob. Repeat the process at each end of the new wall space to determine the proper sole plate position.

Levels

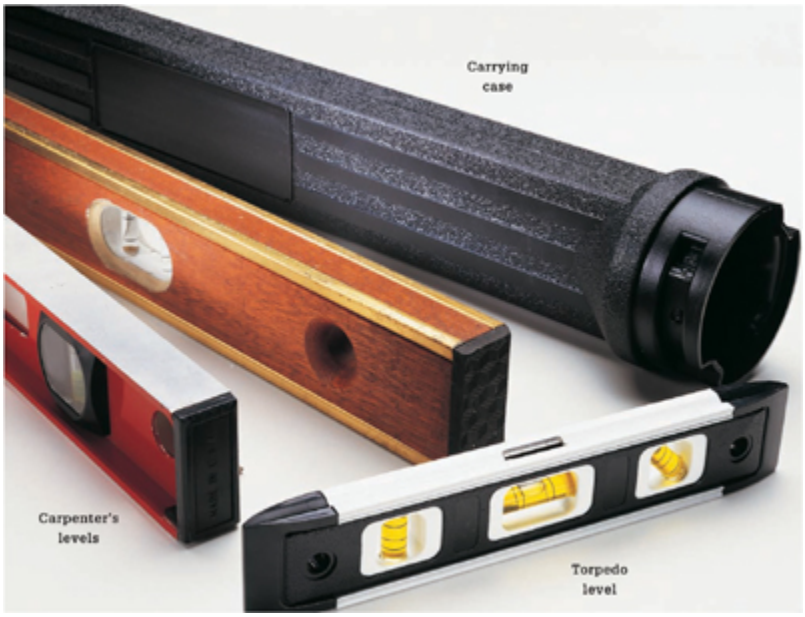
Levels are essential to virtually every carpentry project. They help you build walls that are perfectly vertical (plumb), shelves, countertops, steps that are level, and roofs that incline at a correct and consistent pitch.

Take care of your levels. Unlike some other tools that can be tossed into a tool bucket without damage, a level is a finely tuned instrument that is easily broken. Before you buy a level, test it on a level surface to make sure the vials are accurate (opposite page).

Most levels contain one or more bubble gauges— sealed vials with a single small air bubble suspended in fluid—that indicate the level's orientation in space at any moment. As the level is tilted, the bubble shifts its position inside the vial to reflect the change. This type of level is sometimes referred to as a spirit level because of the use of alcohol inside the gauge. There are also several types of electronic levels that offer digital readouts instead of using a bubble gauge.

Most carpenter's levels contain three gauges: one for checking level (horizontal orientation), one for plumb (vertical orientation), and one for 45° angles. Some levels include pairs of gauges with opposing curves to improve readability.

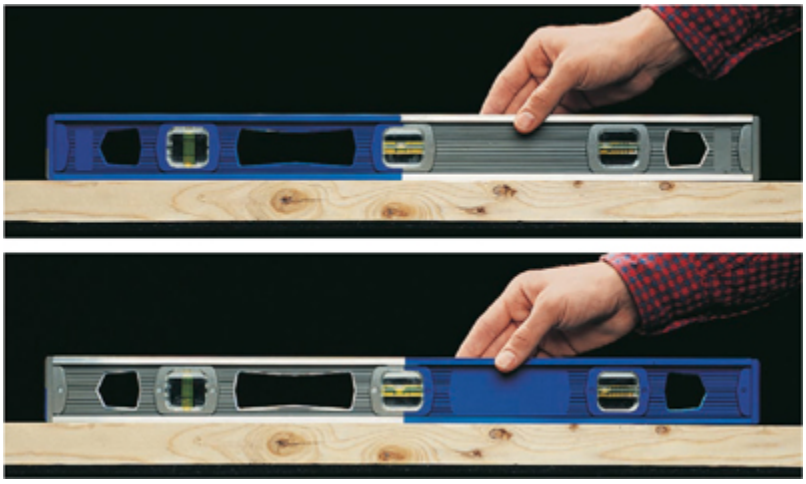
Laser levels project highly accurate beams of light around rooms or along walls. Many styles automatically establish their own level orientation.



You should own at least two levels: a 2-ft. carpenter’s level for checking studs, joists, and other long construction surfaces, and a 8 to 9" torpedo level that is easy to carry in a tool belt and is perfect for checking shelves and other small workpieces. A 4-ft. version of the carpenter’s level is most useful for framing projects. Consider purchasing a level with a protective carrying case.

Battery-powered digital levels represent the latest advance in level design. Digital levels provide very accurate digital readouts, so you don’t have to trust your eye when judging bubble position within a vial. Digital levels also measure slope and offer rise/run ratios, which are useful when building stairs. The electronic components are contained in a module that can be used alone as a torpedo level or inserted into frames of varying lengths.

Laser levels project a beam of light to create a level line all around a room or for level lines of longer lengths. A laser can eliminate the need for snapping chalk reference lines.



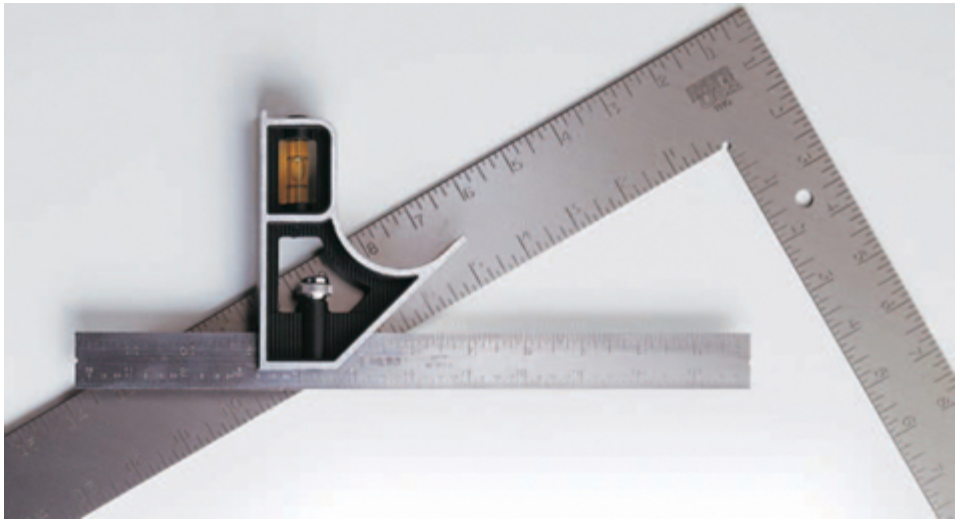
Make sure your level is accurate. Hold one side of the level against a flat, even surface (top photo), mark the location, and read the bubble gauge carefully. Pivot the level 180° (bottom photo) and read the gauge again. Next, flip the level over and read the gauge. The bubble should give the same reading each time. If not, adjust the mounting screws to calibrate the bubble, or buy a new level.

Squares

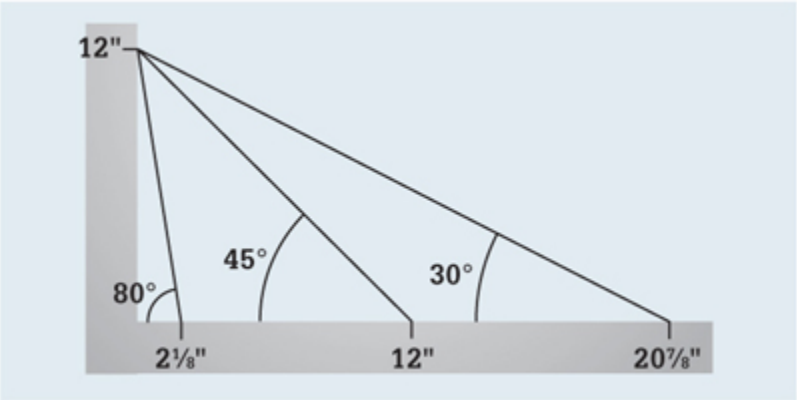
Squares come in many shapes and sizes, but they are all designed with one general purpose: to help you mark lumber and sheet goods for cutting.

There are, however, distinct differences between the various types of squares. Some are made for marking straight cuts on sheet goods, while others are best for making quick crosscuts on 2 × 4s or marking angles on rafters. Using the right tool will speed your work and improve the accuracy of your cuts.

Familiarize yourself with the different types of squares and their uses so you can choose the right tool for the job.



A wallboard T-square simplifies the task of marking and cutting straight lines on sheets of wallboard. The top of the T hooks over the edge of the wallboard, while the leg is used as a straightedge. A T-square is also handy for marking cutting lines on plywood and other sheet goods. Some models have an adjustable T that can be set to common angles.



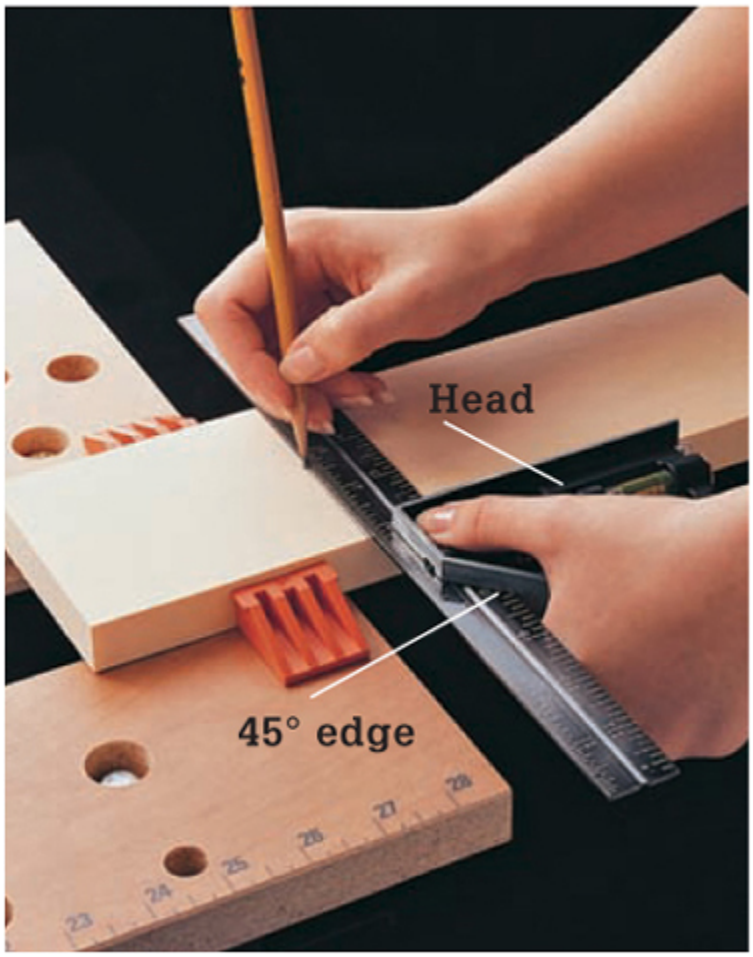
A framing square is commonly used to mark right angles on sheet goods and other large surfaces, but it can also be used to establish other angles by using different measurements along the body (long arm) and the tongue (short arm). The tool has gradations marked in tiny increments, and many come with detailed tables to help you make angles.

Common Framing Square Angles

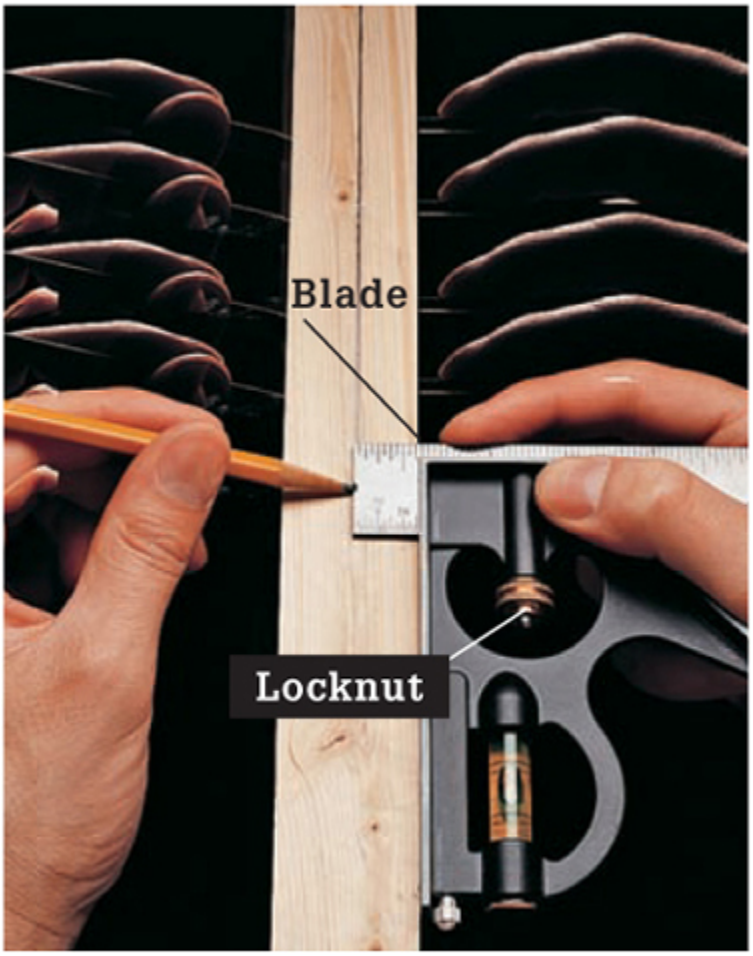
Angle	Tongue	Body
30°	12"	20⅞"
45°	12"	12"
60°	12"	6 15/16"
70°	12"	4⅜"
75°	12"	3 7/32"
80°	12"	2⅛"

The chart above shows the markings to use on the framing square to obtain commonly required angles. If you want to make a line at a 30° angle, mark the workpiece at 12" on the tongue and 20⅞" on the body, and connect the marks with a straight line.

How to Use a Combination Square



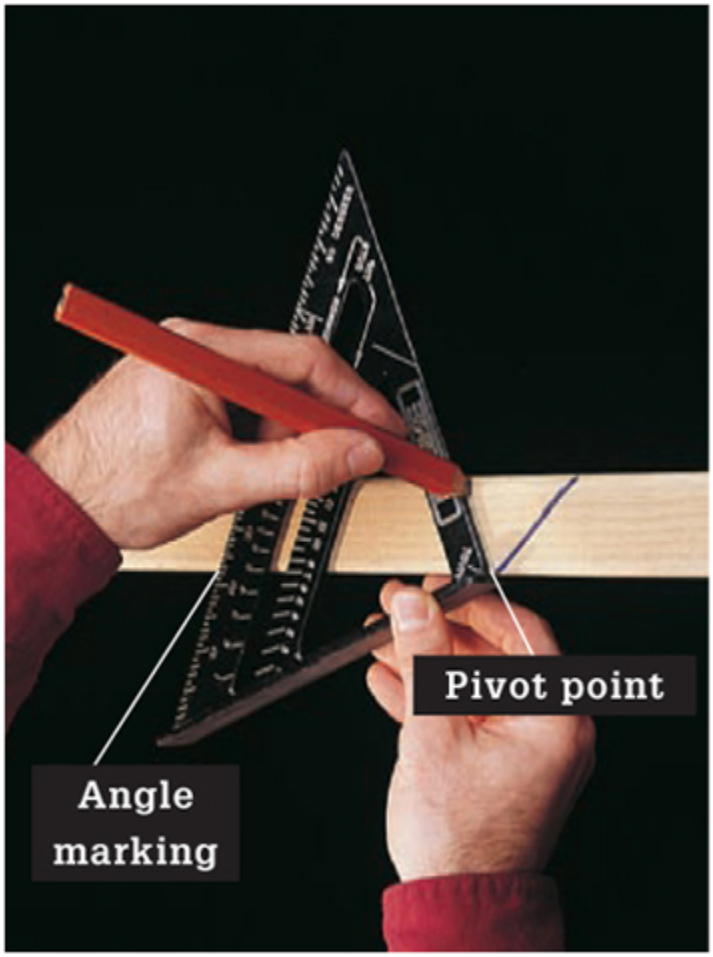
To mark a board for crosscutting, hold the square against the edge of the workpiece with the head locked, then use the edge of the blade to guide your pencil. Use the handle's 45° edge to mark boards for miter cuts.



To mark a line parallel to the edge of a board, lock the blade at the desired measurement, then hold the tip of the pencil along the end of the blade as you slide the tool along the workpiece. This is useful when marking reveal lines on window and door jambs (page 154).

To check for square, set the blade of a square flush with the end of the workpiece (and set the head flush with one edge). If the end is a true 90°, there will not be a gap between the blade and the workpiece.

How to Use a Rafter Square



To mark angle cuts, position the rafter square's pivot point against the edge of the workpiece, and set the tool so the desired angle marking is aligned with the same edge. Scribe a line to mark the angle on the workpiece. Flip the tool over to mark angles in the opposite direction.

To mark crosscuts, place a rafter square's raised edge flush with one edge of the board, and use the perpendicular edge to guide your pencil. On wide boards, you'll need to flip the square to the board's other edge to extend the line across the board.

To guide a circular saw when making crosscuts, first align the blade of the saw with your cutting line. As you cut, hold the raised edge of the square against the front edge of the workpiece and the perpendicular edge flush with the foot of the saw.

Handsaws

For every portable power saw available today, there is also a handsaw available that was originally used to make the same type of cut. Although you will probably use a circular, miter, or jigsaw for most cutting, there are times when using a hand saw is easier, more convenient, and produces better results. Handsaws also provide the do-it-yourselfer a cost-effective alternative to the higher price of power tools.

There are many differences between handsaws. When you shop for a saw, look for one that's designed for the type of cutting you plan to do. Differences in handle design and the number, shape, and angle (set) of the teeth make each saw work best in specific applications.

For general carpentry cuts, use a crosscut saw with 8 to 10 teeth per inch. Crosscut saws have pointed teeth designed to slice through wood on the forward stroke and to deepen the cut and remove sawdust from the kerf on the back stroke.

Always use a handsaw for its intended purpose. Misuse of a handsaw will only damage the tool, dull the blade, or lead to injury.

When saw blades become dull, take them to a professional blade sharpener for tuning. It's worth the extra cost to ensure the job is done right.

Hacksaw
Coping saw
Crosscut saw
Backsaw

Making a cutout by hand requires a saw with a narrow, tapered blade that fits into confined spaces. Use a keyhole saw for making cutouts in plywood, paneling, and other thin materials and a wallboard saw for making fixture cutouts in wallboard.

Choosing the Right Handsaw

A crosscut saw comes in handy for single-cut projects or in confined spaces where power tools won't fit. At the end of a cut, saw slowly, and support waste material with your free hand to prevent splintering.

A backsaw with a miter box cuts precise angles on moldings and other trim. Clamp or hold the workpiece in the miter box and make sure the miter box is securely fastened to the work surface.

A coping saw has a thin, flexible blade designed to cut curves. It is also essential for making professional-looking joints in trim moldings. The blade of a coping saw breaks easily when under heavy use. Buy extra blades.

A hacksaw has a flexible, fine-tooth blade designed to cut metal. Carpenters use hacksaws to cut plumbing pipe or to cut away stubborn metal fasteners. To avoid breaking the blade, stretch the blade tight in the hacksaw frame before cutting.

Hammers

Selecting the right hammer for a task depends mainly on finding one that feels comfortable and manageable, but that also has enough weight to get the job done. For general carpentry, choose a hammer with a smooth finish, a high-carbon steel head, and a quality handle made of hickory, fiberglass, or solid steel. Less expensive steel handles often have hollow cores that are not as efficient at transmitting force to the head.

For light-duty nailing, a 16-ounce, curved-claw finish hammer is a popular choice. It is designed for driving, setting, and pulling nails.

A mallet with a non-marking rubber or plastic head is the best tool for driving chisels without damaging the tools. Mallets are also useful for making slight adjustments to a workpiece without marring the surface of the wood.

A sledgehammer or maul is effective for demolishing old construction or adjusting the position of framing members.

Straight-claw framing hammers—usually with a 20-ounce or heavier head (opposite page)—are used for framing walls and other heavy-duty tasks. The extra weight helps drive large nails with fewer swings. Most framing hammers are too heavy for finish carpentry, where control is of primary importance.

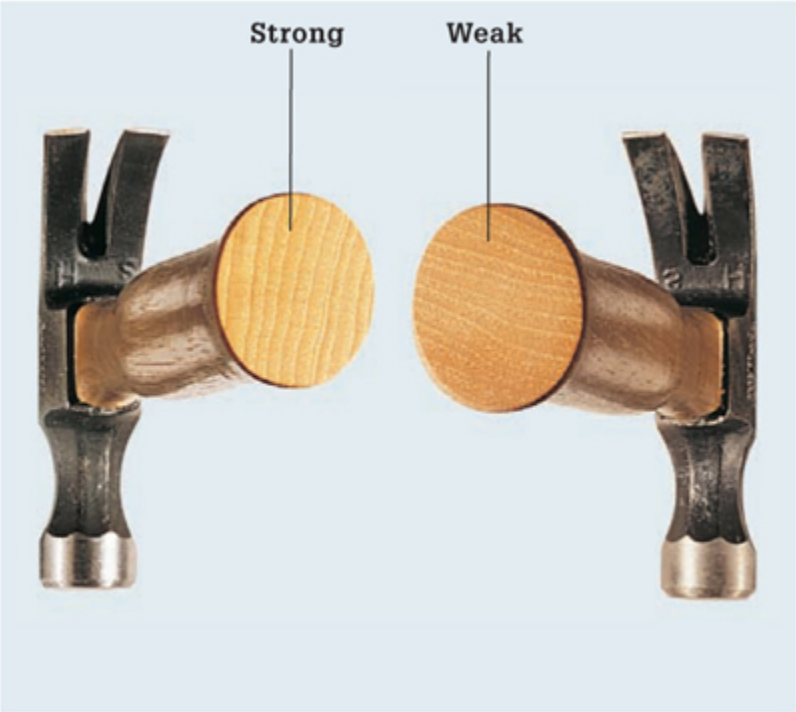
A hammer is not a one-size-fits-all tool. For most homeowners, a finish hammer with a claw will be the hammer most often used, but having a selection of hammers to choose from is a real benefit. It’s good to have on hand a mallet, sledgehammer, and large framing hammer.

Framing hammers vary in size, length, and handle material. Handle types include fiberglass, solid steel, hollow core, and wood. Hammers typically range in length from 14 to 18". Most framing hammers have a head weighing at least 20 ounces, but lighter and heavier models are available. Some heads feature a waffle pattern across the face that increases the hammer’s hold on the nail for more efficiency and accuracy. Framing hammers have straight claws for prying boards.

Use a sledgehammer to demolish wall framing and to drive spikes and stakes. Sledgehammers vary in weight from 2 to 20 pounds, and in length from 10 to 36".

A mallet with a rubber or plastic head drives woodworking chisels. A soft mallet will not damage fine woodworking tools.

Shopping for a Hammer



The strongest wooden tool handles have wood grain that runs parallel to the tool head (left). Handles with the grain running perpendicular to the tool head (right) are more likely to break. Check the end grain before buying a new tool or tool handle. Tool handles that are cracked or loose should be replaced. Wood handles absorb more shock than fiberglass or metal.

A new hammer may have a very smooth face that tends to slip off the heads of nails. Rough up the face with sandpaper to increase friction between the hammer and the nail. For finish hammering, you may want to stick with a smooth-face hammer. *Note: You can also use fine sandpaper to remove wood resins and nail coatings that build up on the face of your hammers.*

How to Pull Nails with a Hammer

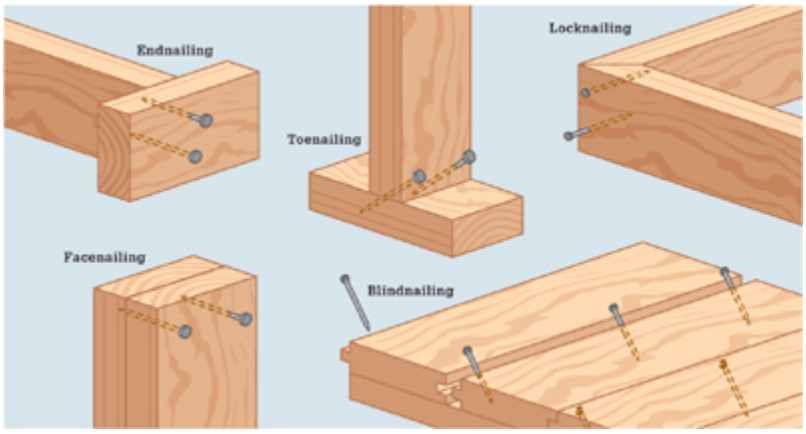
Remove stubborn nails by placing a block of wood under the hammer head for added leverage. To avoid damage to the workpiece, use a block big enough to evenly distribute pressure from the hammer head.

Pull large nails by wedging the shank of the nail tightly in the claws and levering the hammer handle sideways.

How to Drive Nails with a Hammer

Hold the hammer with a relaxed grip: Take advantage of the hammer's momentum and weight by releasing your wrist at the bottom of the swing as if you were throwing the head of the hammer onto the nail. Hit the nail squarely on the head, repeating the motion until the nail head is flush with the work surface.

To set a finish nail below the surface, position the tip of a nail set on the nail head and strike the other end with a hammer.



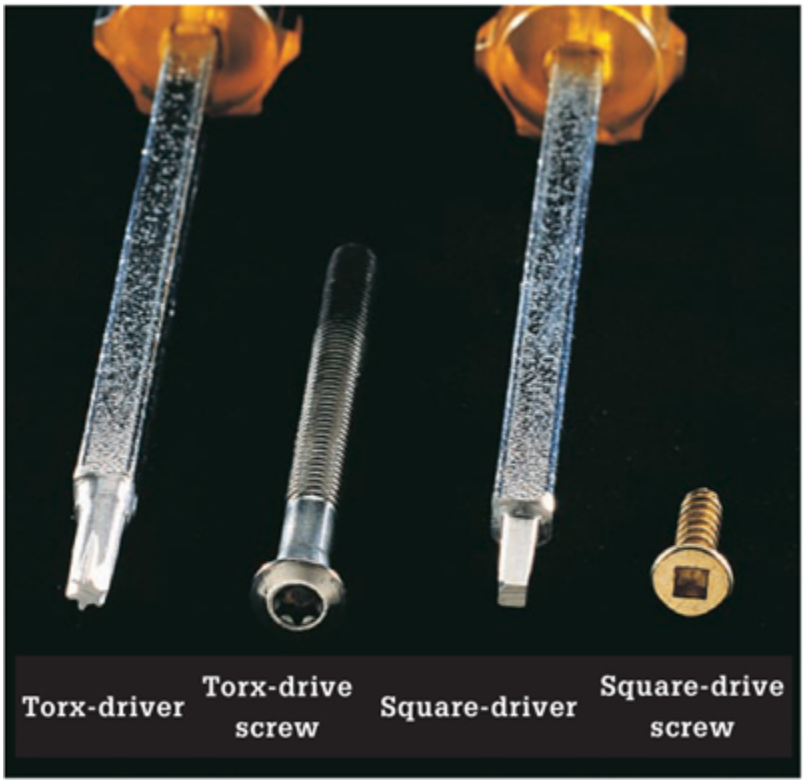
Use the proper nailing technique for the task. Endnailing is used to attach perpendicular boards when moderate strength is required. Toenail at a 45° angle for extra strength when joining perpendicular framing members. Facenail to create strong headers for door and window openings. Blindnail tongue-and-groove boards to conceal nails, eliminating the need to set nails and cover them with putty before painting or staining. Locknail outside miter joints in trim projects to prevent gaps from developing as the trim pieces dry.

Screwdrivers

Every carpenter should own several Phillips and slotted screwdrivers. Even though the drill-mounted screw bit has become the standard for large projects, screwdrivers are still essential for a variety of carpentry tasks. Look for quality screwdrivers with hardened-steel blades and handles that are easy to grip. Other features to look for include insulated handles to protect against electrical shock and oxide-coated tips for a strong hold on screw heads. For working in tight spots, a screwdriver with a magnetic head can also be helpful.

Cordless power screwdrivers save time and effort. For small projects, they are an inexpensive alternative to a cordless drill or screw gun. Most models include a removable battery pack and charger, so you can keep one battery in the charger at all times. Cordless power screwdrivers have a universal ¼" drive and come with a slotted bit and a #2 Phillips bit. Other bits, such as Torx and socket bits are also available.

Note: Always use the correct screwdriver for the job. Screwdrivers should fit the slot of the screw tightly so you can avoid stripping the head of the screw or damaging the ivorkpiece.



Other driving options include square-drive and Torx-drive screws. Square-drive screwdrivers are gaining popularity because square-drive screws are difficult to strip. Torx-drivers are used on electronics, tools, and automotive applications.

Common screwdrivers include: slot screwdriver with insulated handle, Phillips screwdriver with insulated handle and oxide tip for better control, spiral ratchet driver with interchangeable bits, offset screwdriver for driving in tight places, and cordless power screwdriver with battery pack and pivoting shaft.

Tips for Using Screwdrivers

Use a screwdriver or screw bit that closely matches the screw head. A tip that's too big or too small will damage the screw and the driver, and it will make the screw hard to remove later.

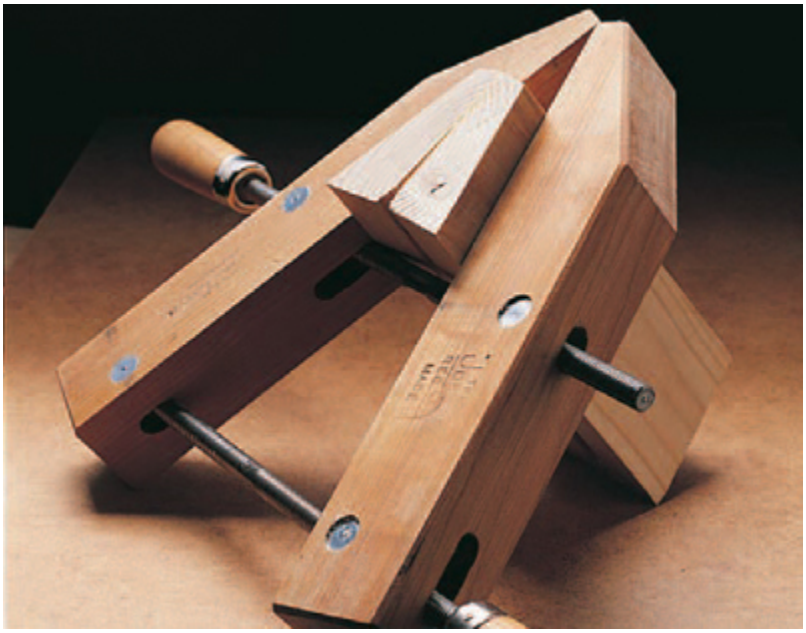
Recondition a slotted screwdriver on a bench grinder if the tip becomes damaged. Dip the tip of the screwdriver in cold water periodically to keep it from getting too hot and turning blue during grinding.

Clamps & Vises

Vises and clamps are used to hold workpieces in place during cutting or other tasks and to hold pieces together while glue sets.

Your workbench should include a heavy-duty carpenter's vise. For specialty clamping jobs, a wide variety of clamps are available, including C-clamps, locking pliers, handscrews, web clamps, or ratchet-type clamps.

For clamping wide stock, use pipe clamps or bar clamps. The jaws of pipe clamps are connected by a steel pipe. The distance between the jaws is limited only by the length of the pipe.



Use handscrews to hold materials together at various angles while glue is drying. Handscrews are wooden clamps with two adjusting screws. The jaws won’t damage wood surfaces.

Use C-clamps for clamping jobs from 1 to 6". To protect workpieces, place scrap wood blocks between the jaws of the clamp and the workpiece surface.

Use ratchet-type clamps to clamp a workpiece quickly and easily. Large ratchet-type clamps can span up to 4 ft. and can be tightened with one hand while supporting the workpiece with the other hand.

Hold large workpieces with pipe clamps or bar clamps. Bar clamps are sold with the bars. Pipe clamp jaws are available to fit ½" or ¾" diameter pipe of any length.

Mount a sturdy bench vise on the end of your workbench to hold workpieces securely. Select a vise that adjusts easily and has a minimum jaw opening of about 4".

Chisels

A wood chisel consists of a sharp steel blade beveled on one face and set in a wood or plastic handle. It cuts with light hand pressure or when the end of the handle is tapped with a mallet. A wood chisel is often used to cut hinge and lock mortises.

When creating deep cuts, make several shallow cuts instead of one deep cut. Forcing a chisel to make deep cuts only dulls the tool and can damage the workpiece.

Sharpen the blades of your chisels often (see pages 60 and 61). Chisels are easier and safer to use and produce better results when they are sharp.

Types of chisels include (from left to right): a framing chisel, used for rough trimming of lumber; a small wood chisel, for light-duty wood carving; a mortise chisel, for framing hinge and lock mortises; a mason’s chisel, for cutting stone and masonry; and a cold chisel that is made of solid steel and is used for cutting through metal.

How to Chisel a Mortise

Cut the outline of the mortise. Hold the chisel bevel-side-in and tap the butt end lightly with a mallet until the cut has reached the proper depth.

Make a series of parallel depth cuts ¼" apart across the mortise, with the chisel held at a 45° angle. Drive the chisel with light mallet blows to the handle.

Pry out waste chips by holding the chisel at a low angle with the beveled side toward the work surface. Drive the chisel using light hand pressure.

Sharpening Chisels & Plane Blades

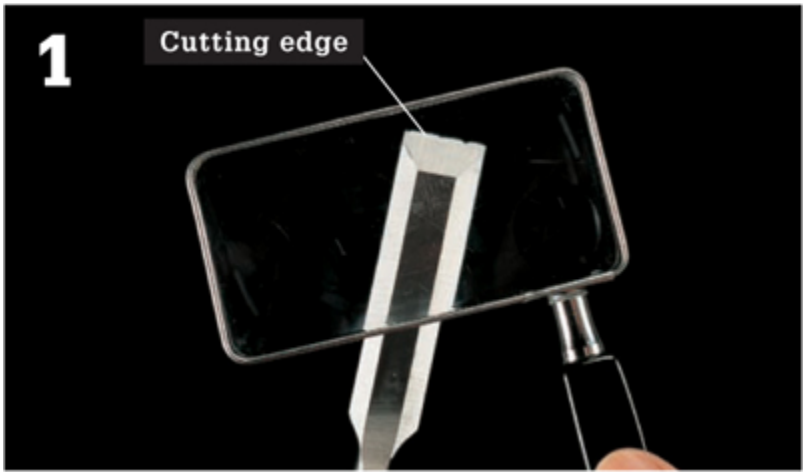
It is a good idea to sharpen chisels and plane blades before each use, even if the tools are brand new. The factory edges on new blades are sharpened by machine and are not as sharp as hand-sharpened blades.

Sharpening a tool blade is a two-step process. First, the tool is rough-ground on an electric bench grinder, then it is finish-honed on a fine-grit sharpening stone. If you do not have a bench grinder, you can use a coarse-grit sharpening stone to rough-grind the blade.

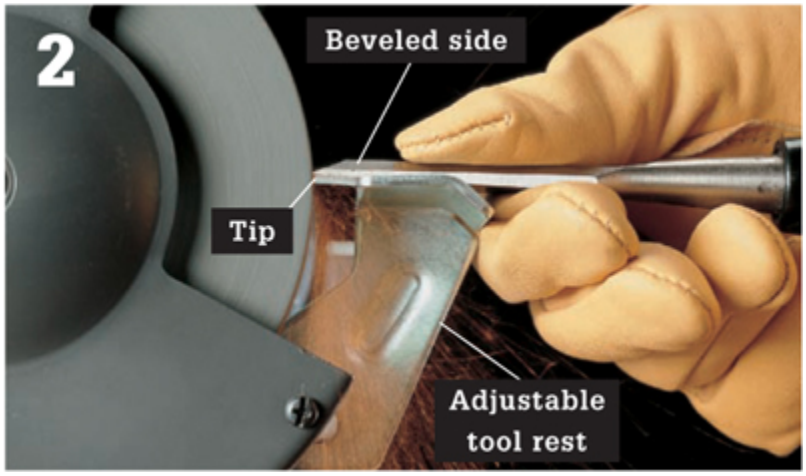
Tools & Materials

- Electric bench grinder
  - or coarse-grit sharpening stone
- Work gloves
- Fine-grit sharpening stone
- Cup of water
- Light machine oil

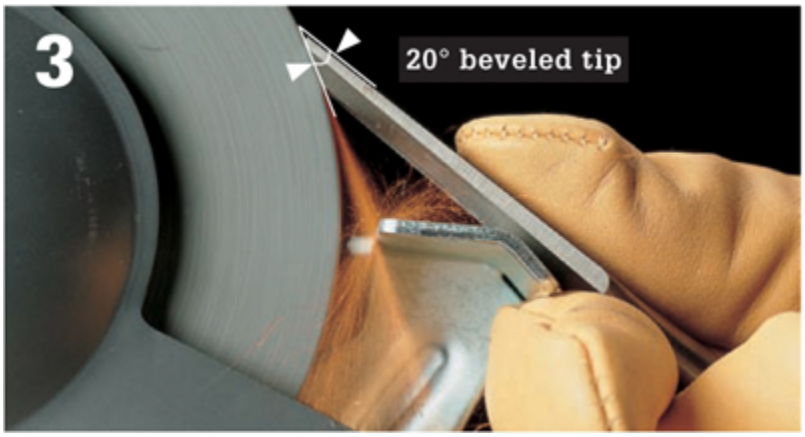
How to Sharpen Chisels & Plane Blades



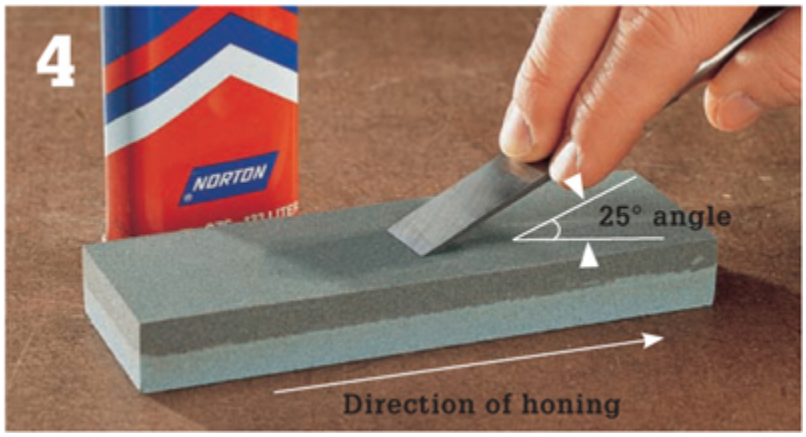
Inspect the cutting edge for nicks. Before the blade can be honed on a sharpening stone, any nicks in the steel must be completely removed by grinding.



Grind off nicks, using a bench grinder with a medium-grit wheel. Hold the tool on the flat portion of the tool rest, with the beveled side facing up. Hold the tip against the wheel and move it from side to side. Make sure the cutting edge remains square, and cool the blade frequently in water.



Rough-grind the cutting edge by turning the blade so that the beveled side is down. Rest the blade on the angled portion of the tool rest. Move the blade from side to side against the wheel to grind the tip to a 20° bevel, checking often with an angle gauge. Cool the metal frequently in water while grinding.



Finish-hone the cutting edge on a fine-grit sharpening stone. Place a few drops of light machine oil on the stone to lubricate the steel and to float away grit and filings. Hold the blade at a 25° angle so the bevel is flat against the stone. Draw it several times across the stone, lifting it away after each pass. Wipe the stone often with a clean rag, and apply oil after each wiping.

Put a “micro-bevel” on the blade by lifting it slightly so only the tip touches the stone. Draw the blade two or three times across the stone, until a slight burr can be felt along the back of the blade.

Turn the blade over. Holding the blade flat, draw it across the stone one or two times to remove the burr.

Examine the cutting edge of the blade. The fine micro-bevel should be about 1/16" wide. The micro-bevel gives the chisel its razor-sharp edge.

Tip: Sponge Bath

One way to keep the blade cool when grinding is to hot-glue a piece of sponge to the back of the blade near the cutting edge. Dip the blade in water. The sponge holds water against the back of the blade to draw off heat. When the sponge gets warm, wet it again.

Tip:Temper

Keep a container of cool water close by when grinding a tool blade. Dip the blade in water frequently to prevent heat from ruining the temper of the steel. When the beads of water on the blade evaporate, it should be dipped again.

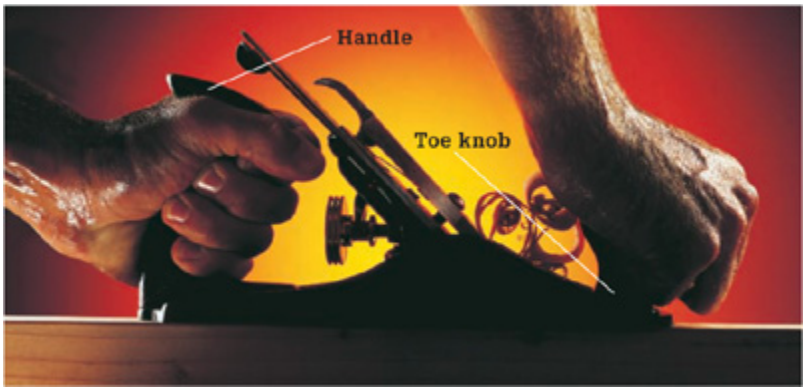
Planes & Surface-Forming Rasps

Planes are designed for removing shavings of material from lumber when a saw would cut off too much material and sanding would remove too little. A hand plane consists of a razor-sharp cutting blade, or iron, set in a steel or wood base. Adjusting the blade requires some trial and error. After making an adjustment, test the plane on a scrap piece before using it on your workpiece. Usually, the shallower the blade is set, the better the plane cuts.

The blade on a surface-forming rasp can't be adjusted, but interchangeable blades are available for fine and rough work. Surface-forming rasp blades have a series of holes stamped in the metal, so shavings seldom become clogged in the tool's blade.

If you plan on planing many large workpieces, consider purchasing a power planer. A power planer does the job more quickly than a hand plane and with equally fine results.

Common carpentry planes include: a jack plane, for trimming framing lumber, doors, and other large workpieces; a power planer, for removing lots of material quickly; a block plane, for shaving material from trim and other narrow workpieces; and surface-forming rasps, for trimming flat or curved surfaces.



Clamp your workpiece into a vise. Operate the plane so the wood grain runs "uphill" ahead of the plane. Grip the toe knob and handle firmly, and plane with long, smooth strokes. To prevent overplaning at the beginning and end of the board, called dipping, press down on the toe knob at the beginning of the stroke and bear down on the heel at the end of the stroke.

Use a block plane for common jobs, like trimming end grain, planing the edges of particleboard and plywood, and trimming laminates.

Power Planer Overview

Traditional hand planes are still used by both carpenters and woodworkers, but it takes practice to sharpen, adjust, and use them properly. If you're not experienced with hand planes, a power planer may be a better choice for your carpentry projects. It's much easier to set up and operate, and it will generally plane away material more quickly than a hand plane.

Typical power planers have two narrow blades mounted in a cylindrical-shaped cutterhead. The cutterhead spins at high speeds to provide the planing action. Power planer blades are made of carbide, which stays sharp much longer than a conventional steel plane blade. When the blades dull, they do not need to be resharpened. Instead, you simply remove them from the cutterhead and replace. Most power planers have double-edged blades, so you have a second sharp edge to use before it's necessary to buy new blades.

To use a power planer, set the depth of cut by turning a dial on the front of the tool. This raises the front portion of the planer's sole to expose the cutters. Limit your cutting depth to not more than ⅛" on softwood and 1⁄16" on hardwoods like oak or maple. If possible, connect the planer to a dust bag or shop vacuum to collect the planer shavings; these tools make considerable debris quickly. Start the planer and slide it slowly along the wood to make the cut, keeping the sole of the tool pressed firmly against the workpiece. Push down on the front of the planer as you begin the cut, then transfer pressure to the rear of the planer as you reach the end of the cut. If you are planing both across the grain and along it, make the cross-grain passes first, then finish up with long-grain passes. This will allow you to plane away any tearout or chipping that occurs on the cross-grain passes.

To change power planer blades, remove the screws and gib bars that hold the blades in place and carefully remove the dull blade. Wear gloves to protect your hands. For double-edged blades, flip the blade to the fresh edge and reinstall. Tighten the gib screws securely.

Turn the planer's cutting depth dial to set the amount of material you'll remove with each pass. Limit cutting depth to ⅛" or less to prevent overloading the motor and to ensure a smooth cut.

Draw layout lines on your workpiece to mark the amount of material you need to plane away. Make repeated passes with the planer until it reaches the layout lines. Keep an eye on your layout lines as you work to make sure the planer removes material evenly.

As you make each pass, apply more hand pressure on the front of the tool to begin, then transfer pressure to the rear as you end the cut. Slide the tool smoothly and slowly so the motor doesn’t labor in the cut.

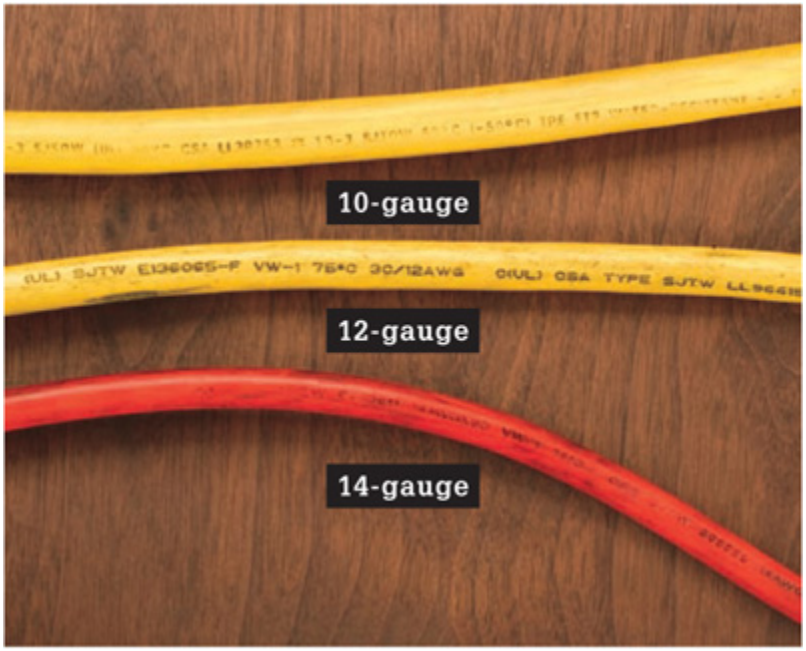
Extension Cords

Despite the popularity and variety of cordless tools, chances are many of your power tools still have power cords. So, good extension cords are a necessity for most carpentry projects. There are several important issues to keep in mind when choosing a suitable extension cord. First, make sure the cord is rated to handle the maximum amperage of the tool you are using. In other words, a tool that draws 15 amps will require a cord that can handle at least 15 amps. An extension cord rated for higher amperage is even better. As a rule of thumb, a cord made of 16- or 14-gauge wire is sufficient to power a tool that draws a maximum of 15 amps. To check your cords, you can usually find the wire gauge printed or embossed on the outer casing.

It's important to keep in mind that extension cords lose a certain amount of voltage over their length. Long cords lose more voltage than shorter cords. If you need to use a cord longer than about 50 feet or need to connect more than one extension cord together to reach your work area, use a heavy-duty cord rated for a higher amperage than your tools require. If the tool seems to labor more than necessary during use, switch to a higher amperage extension cord.

When you're working outside or in a damp area, use a three-prong, ground-fault-protected extension cord to prevent accidental shocks. Or, plug your extension cord into a GFCI-protected wall receptacle.

Here are some tips to help you choose, care for, and store your extension cords. To make your own ground-fault-protected extension cord, see pages 66 and 67.



Power tool extension cords are manufactured in several wire gauges. Lower numbers indicate larger wire gauges. Use a 16- or 14-gauge cord for 15-amp tools and a 12- or 10-gauge cord for tools that draw higher amperage.

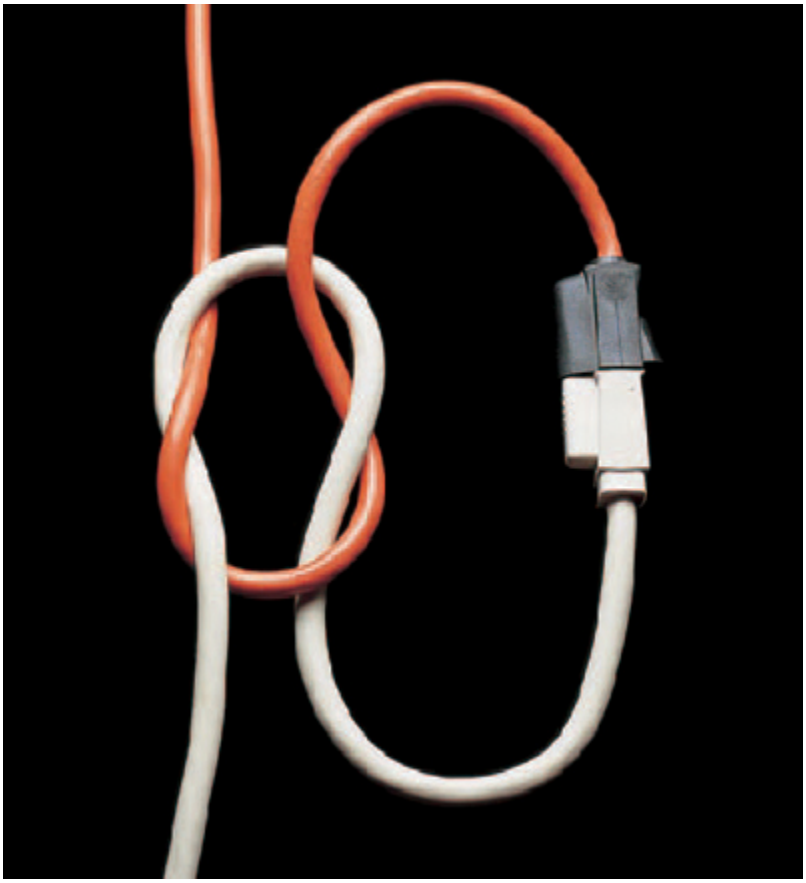
How to Coil Long Extension Cords

Hold the end of the extension cord in one hand. Use the other hand to loop the extension cord back and forth in a figure-eight pattern until it is completely coiled.

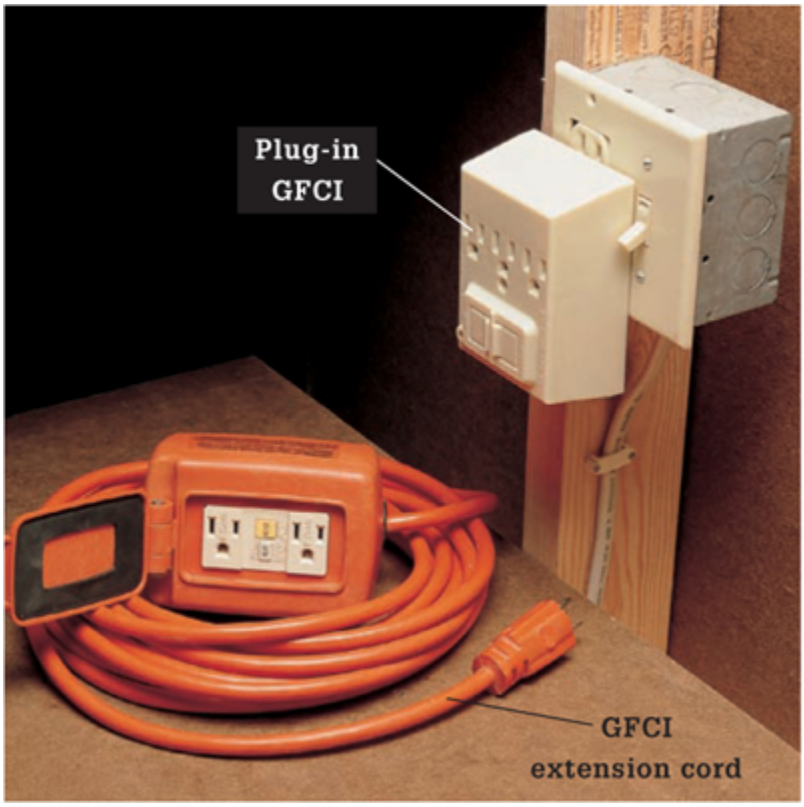
Take one of the cord loops and wrap it twice around one end of the coil.

insert the loop through the center of the coil, and pull it tight. Store the cord by hanging it from this loop.

Keep extension cords tangle-free by storing them in 5-gallon plastic buckets. Cut a hole in the side of the bucket near the bottom. Thread the pronged extension cord plug through the hole from the inside, then coil the cord into the bucket. The extension cord will remain tangle-free when pulled from the bucket. You can also use the bucket to carry tools to a work site.



Prevent tool cords from pulling free of electrical extension cords by tying them in a simple knot. Knotting the cords is especially helpful when you are working on a ladder.



Although three-slot grounded receptacles provide some protection against shock, for maximum safety it is a good idea to use a GFCI (ground-fault circuit-interrupter) device in conjunction with a grounded receptacle. Common GFCI devices include plug-in portable GFCIs and GFCI extension cords.

Prevent extension cord tangles by hanging retractable or reel-type extension cords from overhead hooks. They can be positioned wherever they are needed and retracted when not in use. Retractable cords are available in lengths ranging from 10 to 30 ft.

GFCI Extension Cords

If a permanently wired GFCI receptacle is not available, use a GFCI extension cord whenever working outdoors or in damp locations. A GFCI extension cord has a built-in ground-fault circuit-interrupter to reduce the chance of shock.

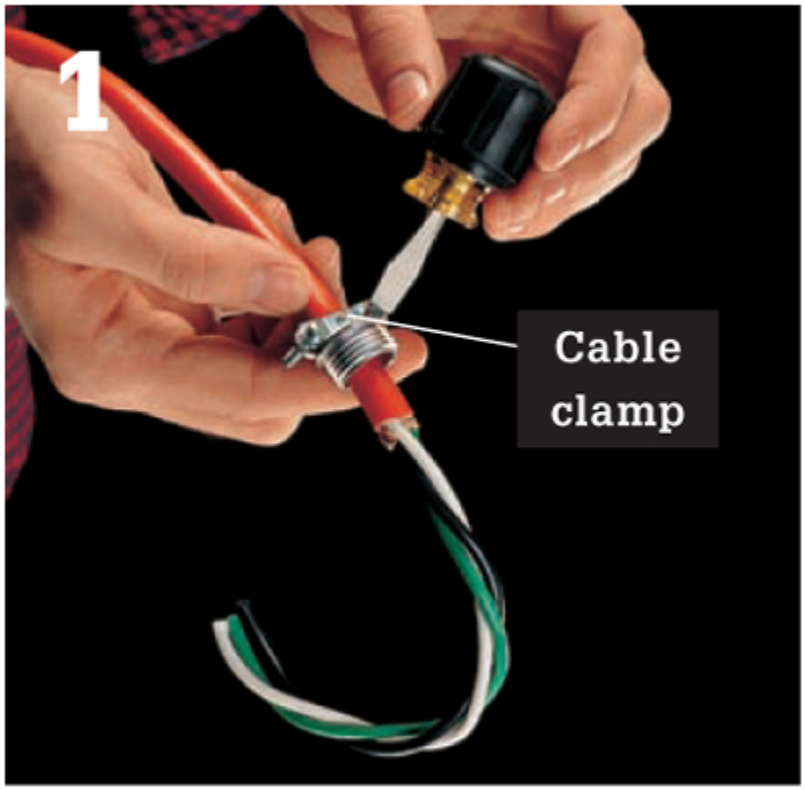
GFCI extension cords can be purchased, but it is cheaper to make your own. Adding a switch to the extension cord lets you shut off power on-site without unplugging the cord. You can also use the cord as an accessory for a portable workbench.

Tools & Materials

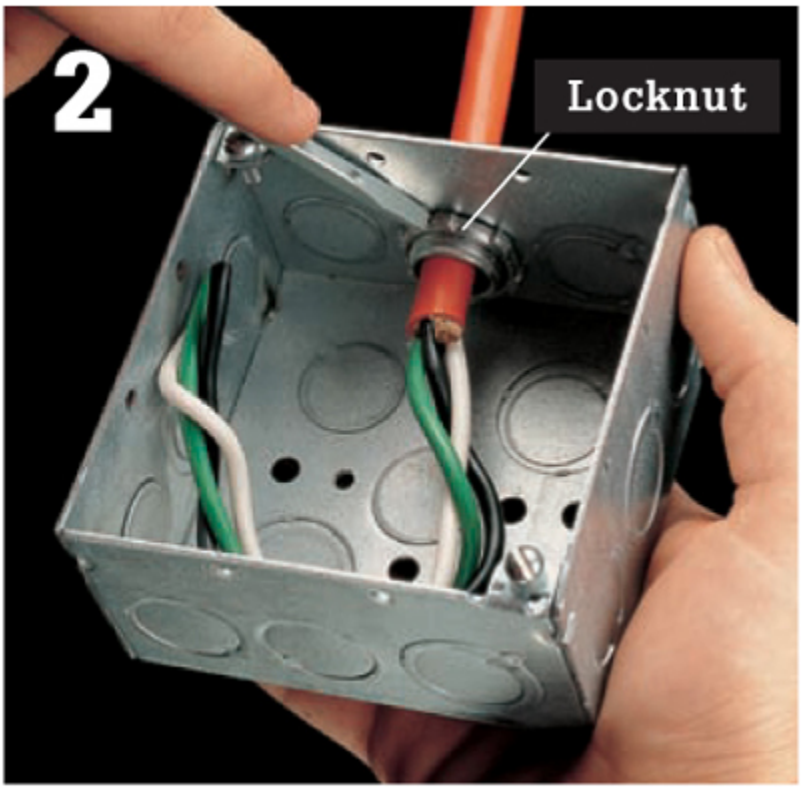
- Linesman's pliers
- Utility knife
- Screwdriver
- Locknut
- Combination tool
- 12-gauge grounded extension cord
- Cable clamp
- 4 × 4" metal electrical box (2⅛" deep) with extension ring and grounding screw
- GFCI receptacle
- Single-pole wall switch with grounding screw
- 6" length of 12-gauge black wire
- Three grounding pigtails
- Wire nut
- Plastic coverplate

A GFCI extension cord provides extra protection against shock, making it a good choice when working outdoors or in damp locations where shocks are more likely to occur.

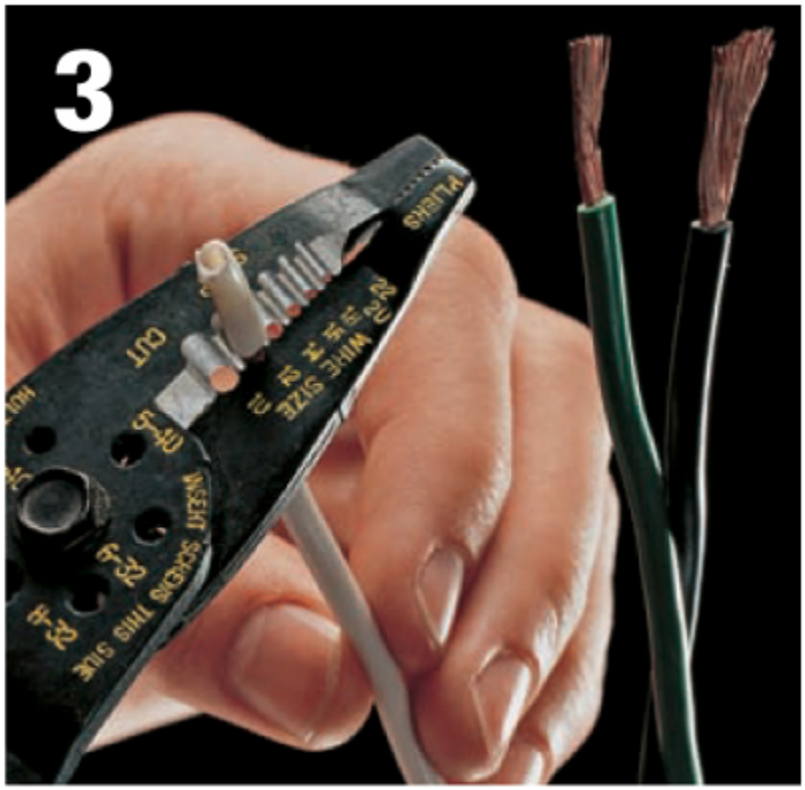
How to Make a GFCI Extension Cord



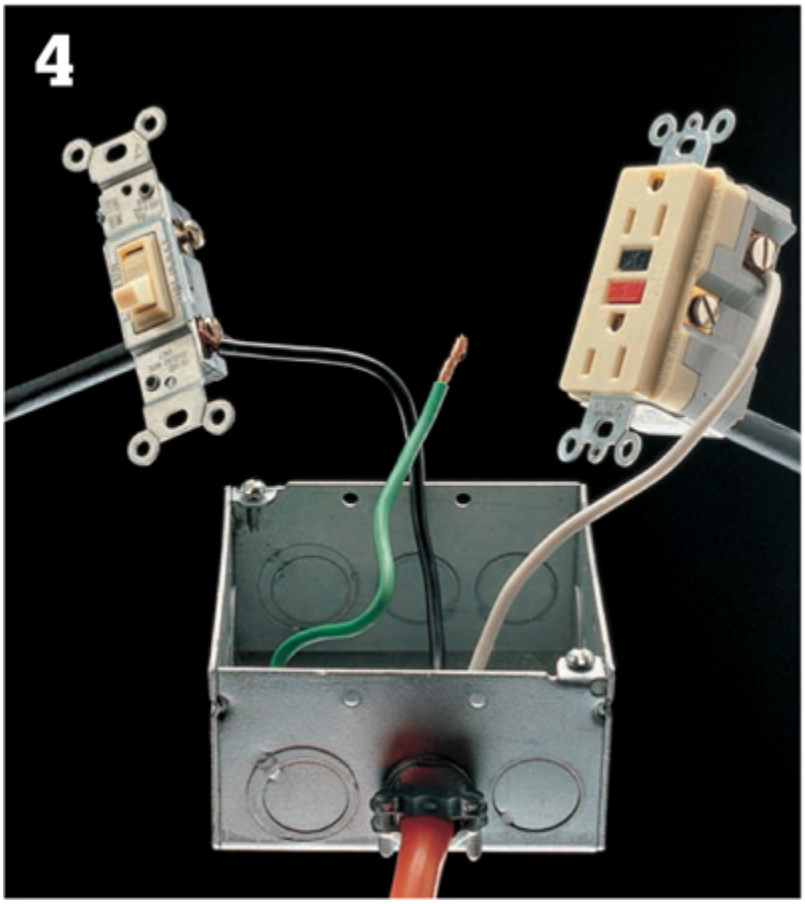
Cut off slotted receptacle end of the extension cord with a linesman's pliers. Strip 8" of outer insulation from the cord, using a utility knife. Thread the cord through a cable clamp, and tighten the clamp with a screwdriver.



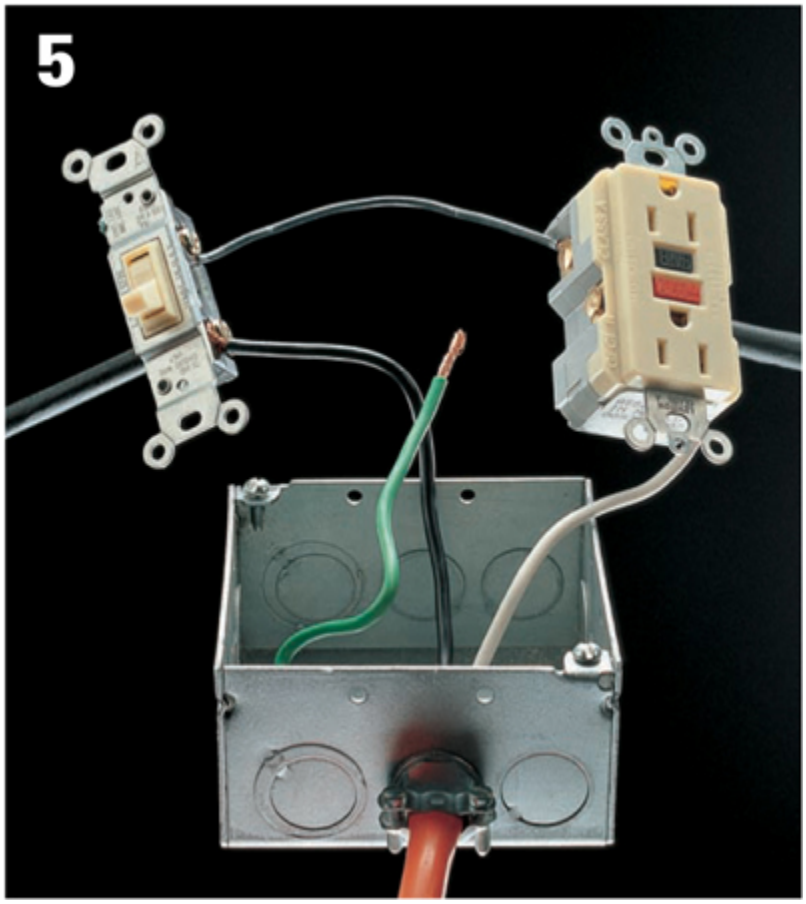
Insert the cable clamp into one of the knockouts on the electrical box. Screw a locknut onto the cable clamp, and tighten it by pushing against the locknut lugs with a screwdriver.



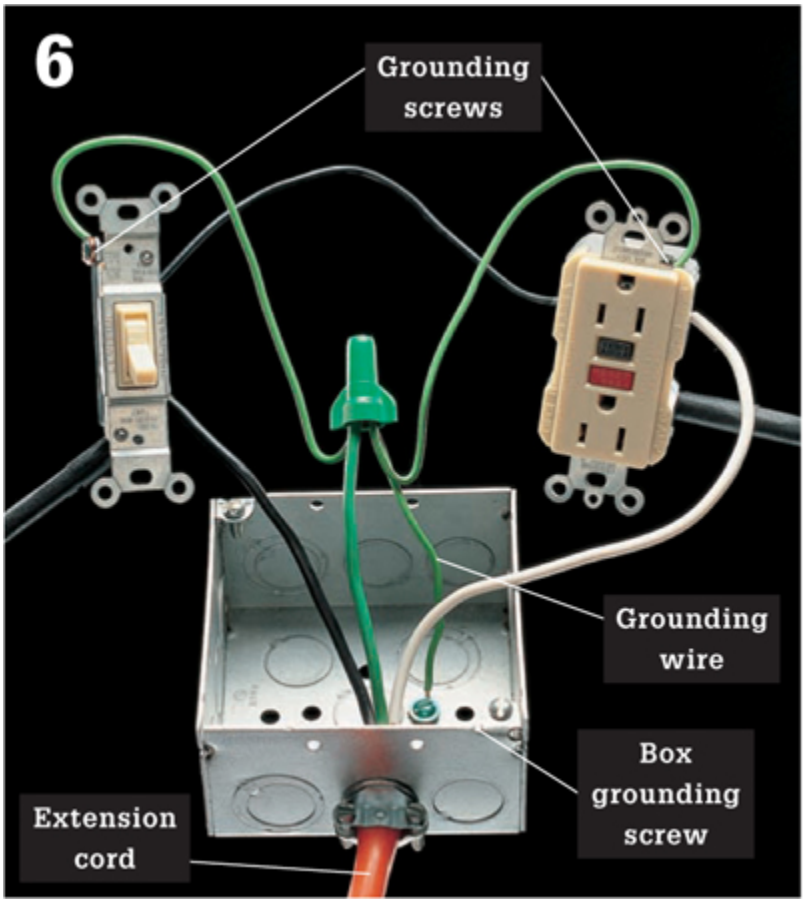
Strip about ¾" of plastic insulation from each wire in the box, using a combination tool.



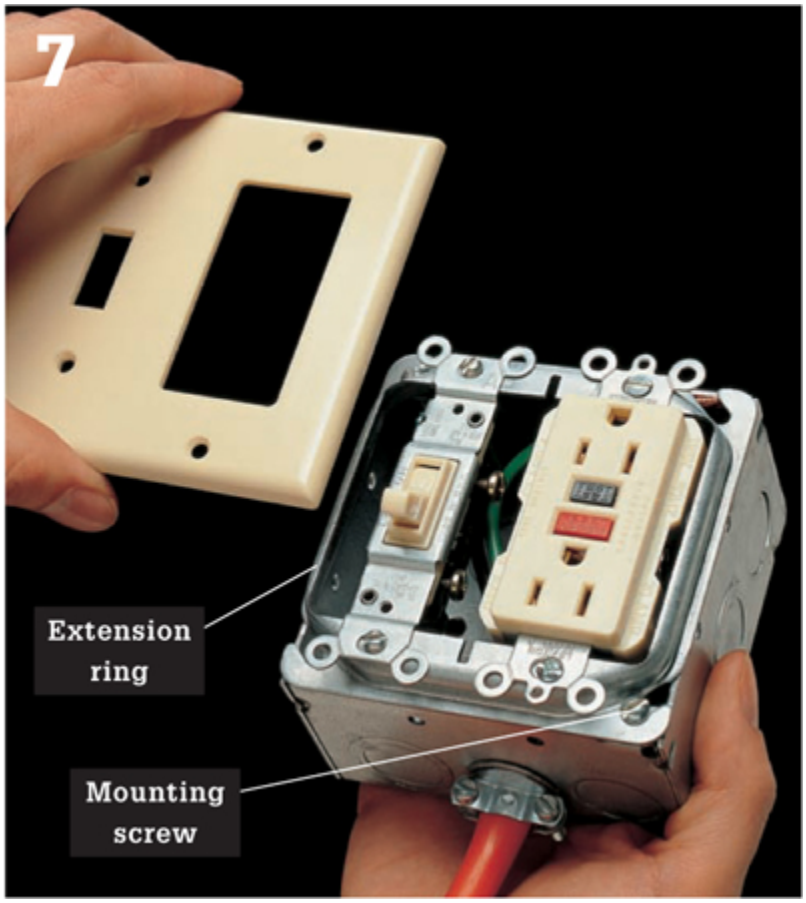
Connect the white wire to the silver screw terminal marked LINE on the GFCI, wrapping the stripped portion of the wire around the screw in a clockwise direction. Tighten the screw terminal with a screwdriver. Attach the black wire to one of the brass screw terminals on the single-pole switch.



Strip ¾" of insulation from both ends of a 6" length of 12-gauge black wire. Connect one end of the wire to the remaining brass screw terminal on the switch, and connect the other end to the brass screw terminal marked LINE on the GFCI.



Attach the green grounding screw to the threaded hole in the back of the box, and attach a grounding pigtail to the screw. Attach additional grounding pigtails to the grounding screws on the switch and the receptacle. Join the pigtails and the extension cord grounding wire with a green wire nut.



Slide the extension ring over the switch and receptacle, and attach it to the box with mounting screws. Carefully tuck the wires into the box, and secure the switch and receptacle to the extension ring. Attach the plastic coverplate.

Jigsaws

The jigsaw is a very good portable power tool for cutting curves. The cutting capacity of a jigsaw depends on its power and the length of its blade stroke. Choose a saw rated to cut 2"-thick softwood and ¾"-thick hardwood stock. Many jigsaws have a pivoting baseplate that can be locked so you can make bevel cuts as well.

A variable-speed jigsaw is the best choice, because different blade styles require different cutting speeds for best results. In general, faster blade speeds are used for cutting with coarse-tooth blades and slower speeds with fine-tooth blades.

Jigsaws vibrate more than other power saws because of the up-and-down blade action. However, top-quality jigsaws have a heavy-gauge steel baseplate that reduces vibration to help you hold the saw tightly against the workpiece for better control.

Because jigsaw blades cut on the upward stroke, the top side of the workpiece may splinter. If the wood has a good side to protect, cut with this surface facing downward.

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DECKER

Jigsaw blades come in an array of designs for cutting different materials. Choose the right blade for the job. With fine-tooth blades that have 14 or more teeth per inch, set the saw at a low speed. Coarse blades require faster blade speeds.

Do not force blades. Jigsaw blades are flexible and may bend or break if forced. Move the saw slowly when cutting bevels or tough material like knots in wood.

Make plunge cuts by tipping the saw so the front edge of the baseplate is held firmly against the workpiece. Start the saw, and slowly lower it to a horizontal position, letting the blade gradually cut through the workpiece.

Another option to plunge-cutting is to first drill a pair of clearance holes for the blade on opposite corners of the cutout. Start the saw in each hole and cut to the corners. You’l only need one starter hole for circular cutouts.

Cut metals with a fine-tooth metal-cutting blade and select a slow blade speed. Support sheet metals with thin plywood to eliminate vibration. Use emery paper or a file to smooth burred edges left by the blade.

Circular Saws

A portable circular saw has become the most frequently used cutting tool for do-it-yourselfers. With the right set of blades, you can use a circular saw to cut wood, metal, plaster, concrete, or other masonry materials. An adjustable baseplate lets you set the blade depth for your workpiece, and it also pivots from side to side for bevel cuts.

Most professional carpenters use a 7¼"-blade circular saw. For home carpentry, 7¼"-blade and 6½"-blade models are the most popular. A smaller blade means a smaller, lighter saw body, but bear in mind that a smaller saw is usually less powerful and is limited when cutting bevel cuts or material that is thicker than 2× stock.

Cordless circular saws have 5⅜"-wide blades— wide enough to cut through sheet goods or to make square cuts on 2× lumber. Cordless models are useful in situations where a power cord gets in the way. However, most cordless circular saws aren't powerful enough to be the primary cutting tool for big projects.

Because circular saw blades cut in an upward direction, the top face of the workpiece may splinter. To protect the finished side of the workpiece, mark measurements on the back side and place the good side down for cutting.

Get the most out of your saw by inspecting your blade regularly and changing it as needed (pages 72 to 73). You can also improve your results with a straightedge guide (page 75), which makes it easier to cut long stock precisely.

Common types of circular saws include (photo, next page):

A. 7¼"-blade, standard-drive saw. Standard-drive circular saws are the most popular choice among do-it-yourselfers and are widely used by professional carpenters. This model has a sawdust-release pipe that connects to a collection bag.

B. 7¼"-blade, worm-drive saw. Some carpenters prefer the worm-drive saw for heavy-duty cutting. Worm-drive saws offer more torque at any given speed. As a result, they are less likely to slow, bind, or kick back when subjected to a heavy load.

C. 6½"-blade, standard-drive saw. Do-it-yourselfers looking for a lightweight saw may want to consider a standard-drive saw with a 6½" blade. This

model has a convenient window for an easy view of the line while cutting.

D. 5⅜"-blade, cordless trim saw. Cordless trim saws are convenient for cutting trim and other thin stock, especially when the work site is outdoors or away from an electrical receptacle.

BLACK&DECKER™
Piranha

B
A
D
Viewing window
Sawdust-release pipe
Viewing window
C

Circular Saw Blade Options

To get full use from your circular saw, you'll need an assortment of blades designed for specific cutting tasks. Your collection should include at least one general-purpose combination blade with carbide teeth. In addition to cutting wood and sheet material, you can also use a circular saw to cut masonry and thin metal with the appropriate abrasive blade. Here are the main types of circular saw blades:

- Remodeling blade: Designed to make both ripcuts and crosscuts in construction lumber that may also be embedded with nails or screws. It will have a low tooth count and tall shoulders behind the teeth to prevent them from cutting too aggressively or breaking on metal. It's a good choice for opening wall cavities or removing exterior or floor sheathing.
- Ripping/general framing blade: Higher tooth counts than a remodeling blade, usually ranging from 16 to 24 teeth. A suitable blade for fast rip cuts in construction plywood and general crosscuts in framing lumber. Fewer teeth will produce more splintering, so this is not a blade for finish cutting.
- General-purpose blade: The workhorse blade of most circular saws, these blades will have 30 to 40 teeth and are good choices for fast, semi-smooth wood cutting in any direction.
- Fine crosscutting blade: A 40- to 60-tooth blade designed to make smooth crosscuts in veneered plywood with minimal splintering.
- Masonry or metal-cutting blade: A toothless blade made of special abrasives for cutting cinder block, concrete, and both ferrous and non-ferrous metal. Be sure to wear a dust mask when using these blades; abrasive particles and masonry dust is hazardous to breathe.

You can keep a blade in good condition and prolong its life by using it only for the material it's designed to cut and cleaning it when the teeth become dirty. Wipe the blade with kerosene or blade cleaner and steel wool, then dry the blade and coat it with silicone spray or machine oil to prevent rust. Replace blades that are dull or have cracked or missing teeth.

General-purpose blade
BLACK & DECKER
Piranha
CARBIDE
Fine blade
BLACK & DECKER
Precision Ground Steel Saw Blade
Fine cross-cutting blade
BLACK & DECKER
Piranha
CARBIDE
Abrasive
7"
Metal Cutting
Metal-cutting blade

How to Set the Blade Depth

The blade on a circular saw does not move when you set the blade depth. Instead, on most circular saws, the saw baseplate pivots up and down, changing the amount of blade that is exposed. Unplug the saw, then pull out the depth adjustment lever and slide it up or down to adjust the blade depth.

Pull up on the blade guard lever to expose the blade, then position the blade flush with the edge of the workpiece to check the setting. The blade should extend beyond the bottom of the workpiece by no more than the depth of a saw tooth. Release the knob to lock the blade. *Note: Some saws have a baseplate that drops rather than pivots. When the knob is pulled out, the entire baseplate can be moved up or down.*

How to Change the Blade

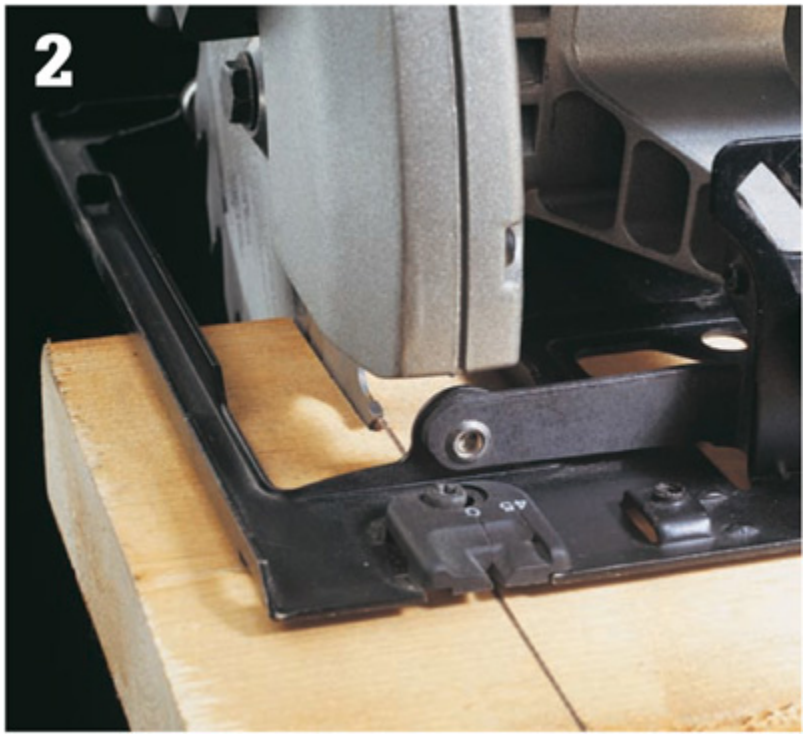
Unplug the saw and inspect the blade, wearing gloves to protect your hands. Replace the blade if you find worn, cracked, or chipped teeth. Remove the blade for cleaning if sticky resin or pitch has accumulated.

To loosen the blade, first depress the arbor lock button or lever to lock the blade in position, then loosen the bolt with a wrench and slide the bolt and washer out of the assembly. *Note: On older models with no arbor lock, insert a wood block between the blade and baseplate to keep the blade from turning as you loosen the bolt.*

Install a new blade. Or, if the old blade is soiled but in otherwise good condition, clean and reinstall it. Use the directional markings on the side of the blade as a guide when attaching a blade. Insert the bolt and washer, then tighten the bolt with a wrench until the bolt is snug. Do not overtighten.

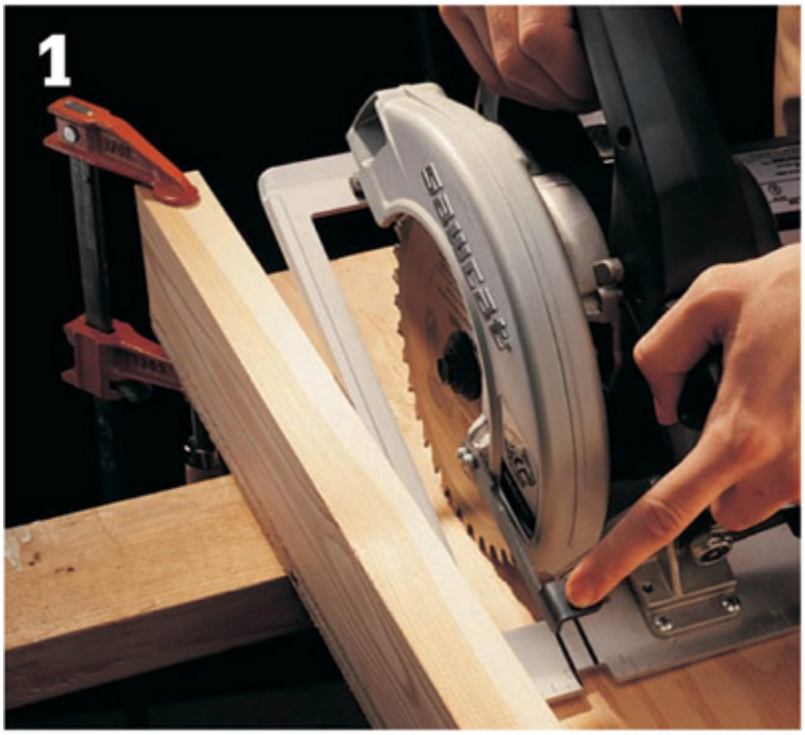
How to Make Crosscuts

Secure the workpiece with clamps and position the baseplate with the blade approximately 1" from the edge. Align the guide mark with the cutting line. *Note: The saw will remove a small amount of material on each side of the blade. If your project requires exact cuts, make your first cut in the waste area. You can make a second pass with the saw, as necessary, to remove more material.*

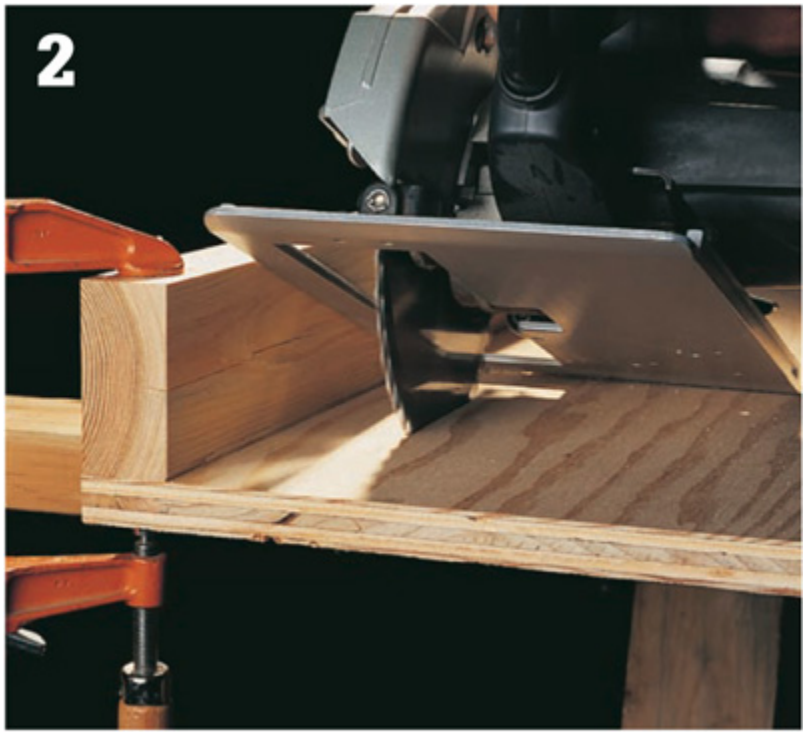


While holding the saw with two hands, squeeze the trigger and guide the blade into the workpiece, following the cutting line with the guide mark and applying steady pressure as you push the saw forward. The guide mark on every saw is different. If you will be cutting material with someone else’s saw, make a few practice cuts to familiarize yourself with the new saw.

How to Make Plunge Cuts



Support the workpiece by clamping it down on sawhorses. Clamp a 2 × 4 on the edge as a guide. Retract the blade guard and position the saw so the front edge of the foot, not the blade, is against the workpiece.



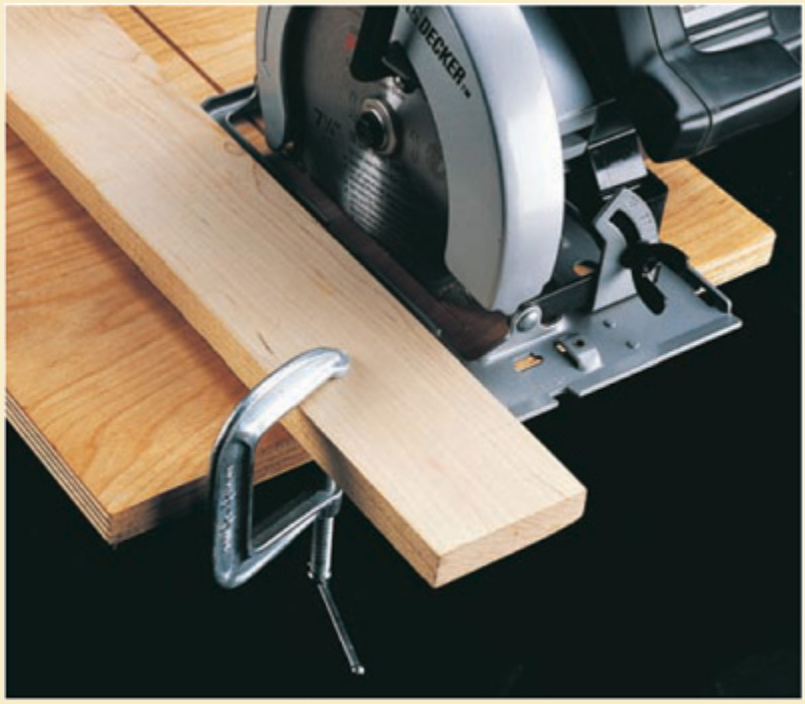
Hold the saw with two hands as you make the cut. Start the saw, and slowly lower the blade into the workpiece, keeping the baseplate against the 2 × 4.

How to Make Rip Cuts

Attach a commercial straightedge guide to the baseplate of your circular saw. For greater stability, attach a straight 8" strip of hardwood to the base of the guide, using panhead screws. For even more reliable edges, build your own straightedge guide (page 77).

It’s much safer to cut up full-sized, heavy sheets of plywood with a circular saw than a table saw. Lay the sheet over several pieces of framing lumber to provide room for the blade underneath. Set the blade depth so the teeth protrude about ¼" below the plywood. Once the sheets are cut into manageable sizes, you can make finish cuts on the table saw.

Tips for Making Rip Cuts



Clamp a straightedge to your workpiece for straight, long cuts. Keep the baseplate tight against the straightedge and move the saw smoothly through the material.

Drive a wood shim into the kerf after you have started cutting the workpiece to keep your saw from binding. For longer cuts, stop the saw and position the shim about 12" behind the baseplate.

How to Make Bevel Cuts

Loosen the bevel adjustment knob and slide the knob to the required setting. Note: Some *models have a setscrew for common angles such as 90° (no bevel) and 45°. Tighten the knob.*

Position the baseplate of your saw on the workpiece. As you cut, sight down the blade to ensure it remains aligned with the cutting line on the waste side of the workpiece.

Tip

Copy existing angles with a T-bevel. Transpose the cutting line to your workpiece and adjust the angle of your circular saw to cut on the line.

How to Cut Dadoes

To cut dadoes with a circular saw, set the blade depth to ⅓" the desired depth of the dado, and mark the outside edges where you want the dado. Secure the workpiece with a clamp and cut the outside lines using a straightedge. Make several parallel passes between the outside cuts, every ¼".

Clean out the material between the cuts with a wood chisel. To avoid gouging the workpiece, apply hand pressure or tap the chisel with the bevel side up using a mallet. For more information on chisels, see page 59.

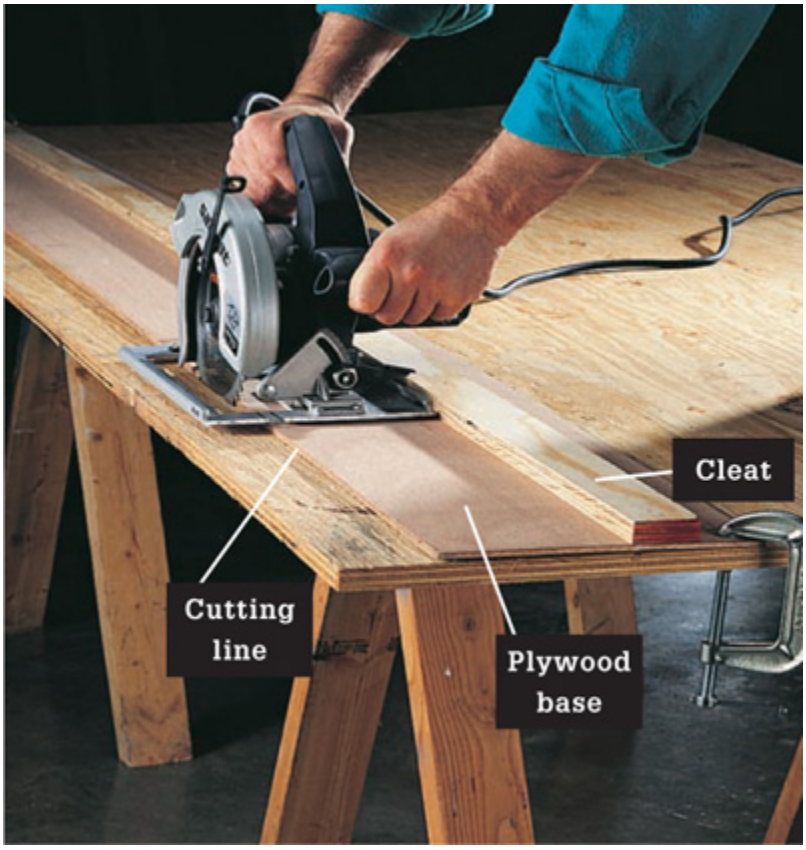
Straightedge Guides

Making straight and accurate rip cuts or cutting long sheets of plywood or paneling is a challenge. Even the best carpenter can't always keep the blade on the cutline, especially over a longer span. A straightedge guide or jig solves the problem. As long as you keep the saw's baseplate flush with the edge of the cleat as you make the cut, you're assured of a straight cut on your workpiece.

The guide's cleated edge provides a reliable anchor for the baseplate of the circular saw as the blade passes through the material. For accurate cutting, the cleat must have a perfectly straight edge.

Tools & Materials

- C-clamps
- Pencil
- Circular saw
- ¼" finish plywood base (10 × 96")
- ¾" plywood cleat (2 × 96")
- Carpenter's glue



A straightedge guide overcomes the difficulty of making square rip cuts and other square cuts on long workpieces. The guide's flat edge ensures that any cuts made with it will be flat as well.

How to Build a Straightedge Guide

Apply carpenter's glue to the bottom of the ¾" plywood cleat, then position the cleat on the ¼" plywood base, 2" from one edge. Clamp the pieces together until the glue dries.

Position the circular saw with its foot tight against the ¾" plywood cleat. Cut away the excess portion of the plywood base with a single pass of the saw to create a square, flat edge.

To use the guide, position it on top of the workpiece, so the guide's flat edge is flush with the cutting line on the workpiece. Clamp the guide in place with C-clamps.

Power Miter Saws

Power miter saws are versatile, portable tools that are used to cut angles in trim, framing lumber, and other narrow stock.

The blade assembly of a power miter saw swivels up to 45° in either direction, allowing it to make straight, mitered, and beveled cuts. However, when the assembly is turned to a 45° angle, the cutting depth is considerably shortened.

If you are considering buying or renting a power miter saw for a specific project, such as building a deck, don’t assume that every saw will have the capacity to cut wider boards at a 45° angle. Ask the salesperson about the maximum cutting capacity for each saw at a 45° angle, and make sure the saw you choose can make clean cuts through the stock you use most frequently.

A compound miter saw (opposite page, top) has a second pivot point on the blade assembly that makes it possible to cut a bevel and miter angle at the same time. This option is useful when cutting cove moldings. See page 85 (bottom photo), for more information about compound miter cuts.

The biggest limitation of a power miter saw is cutting extra-wide stock. A sliding compound miter saw (opposite page, bottom) eliminates this limitation. The entire blade assembly is mounted on a sliding carriage, giving the saw a much greater cutting capacity than a standard or compound miter saw. For tips on cutting extra-wide boards without a sliding compound miter saw, see page 83.

The power miter saw has evolved from a new and relatively rare tool just a generation ago into the workhorse saw seen in many home workshops today. They combine speed, accuracy, and fast set-up time, and as they've become more popular they've become quite affordable.

Types of Power Miter Saws

A compound miter saw cuts bevels and miters at the same time. The miter and bevel scales make it easy to set the saw quickly for precise angles. Before cutting, make sure the material is flush with the guide fence. Otherwise, the angle you cut will be incorrect. Extension arms provide a safe way to hold longer materials in place. Some models also offer stock clamps that secure workpieces to the saw table. Always remove debris or small wood scraps that may be blocking the kerf board before beginning any cut, and remember to empty the dust collection bag regularly.

A sliding compound miter saw has all the components of a regular compound miter saw, with the addition of a sliding blade assembly that makes it possible to cut much wider stock.

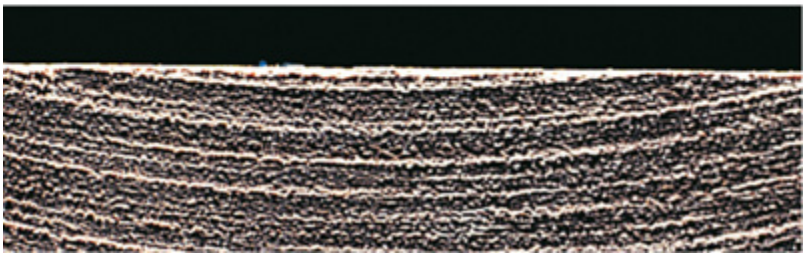
Types of Blades & Their Applications

The quality of the cut produced by a power miter saw depends on the blade you use and the speed at which the blade is forced through the workpiece. Let the motor reach full speed before cutting, then lower the blade assembly slowly for the best results.

A 16-tooth carbide-tipped blade (1) cuts quickly and is good for rough-cutting framing lumber.

A 60-tooth carbide-tipped blade (2) makes smooth cuts in both softwoods and hardwoods. It is a good all-purpose blade for general carpentry work.

1



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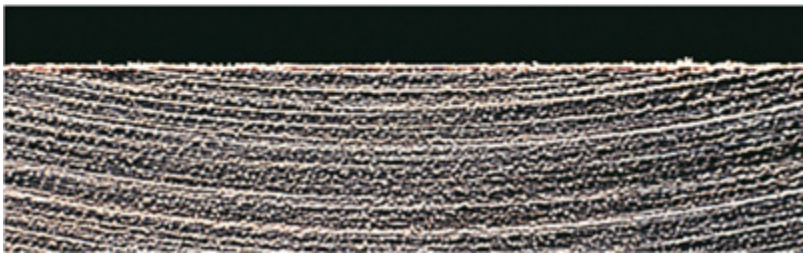
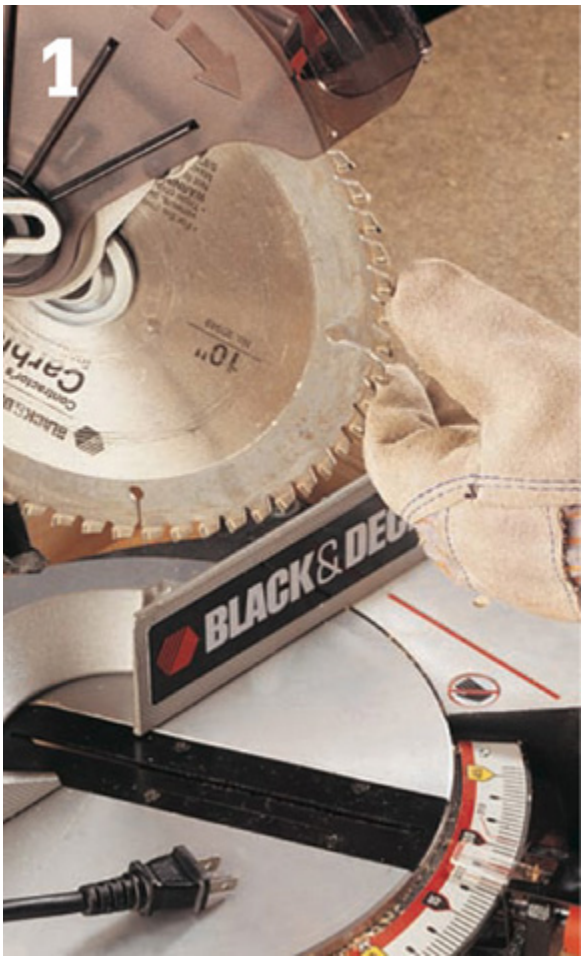


How to Change the Blade on a Power Miter Saw



Unplug the saw and inspect the blade; check for dull or damaged teeth.

If the blade is dull or is the wrong type for the material you want to cut, depress the arbor lock button and turn the arbor nut on the blade clockwise to remove it.

When the nut is free, carefully remove the blade and slide the new blade into position. Tighten the arbor nut until snug. Do not overtighten the nut.

How to Set Up a Power Miter Saw

Anchor the saw to a stationary workbench, using C-clamps. To support long moldings or other stock, build a pair of blocks the height of the saw table, using 1x lumber. Align the blocks with the saw fence and clamp them to the workbench.

Position the adjustable fence to support the workpiece, then tighten the fence clamp.

Option: Consider building a cutting table with a recessed area the same depth as the saw bed. The table will support longer stock, eliminating the need for support arms.

Option: Rent or buy a portable power miter saw table for extensive cutting of long stock. Or, use a portable workbench and a roller-type support stand to support your saw and workpieces.

How to Cut with a Power Miter Saw

It's easy to make precise crosscuts on a miter saw with this simple procedure. First, lower the blade so the edges of the teeth meet your cutting line. Make sure the blade will cut on the waste side of the line.

Hold the workpiece securely against the saw table and fence, and raise the motor arm to its highest position. Start the saw and pivot the blade slowly into the wood to make the cut.

To cut multiple pieces of stock to the same length, clamp a stop block to your support table at the desired distance from the blade. After cutting the first piece, position each additional length against the stop block and the fence to cut pieces of equal length.

Set the saw assembly in the down position when storing or moving it or when you won’t be using it for a long period of time.

How to Cut Extra-wide Boards

Make a full downward cut. Release the trigger and let the blade come to a full stop, then raise the saw arm.

Turn the workpiece over and carefully align the first cut with the saw blade. Make a second downward cut to finish the job.

How to Use a Sliding Miter Saw

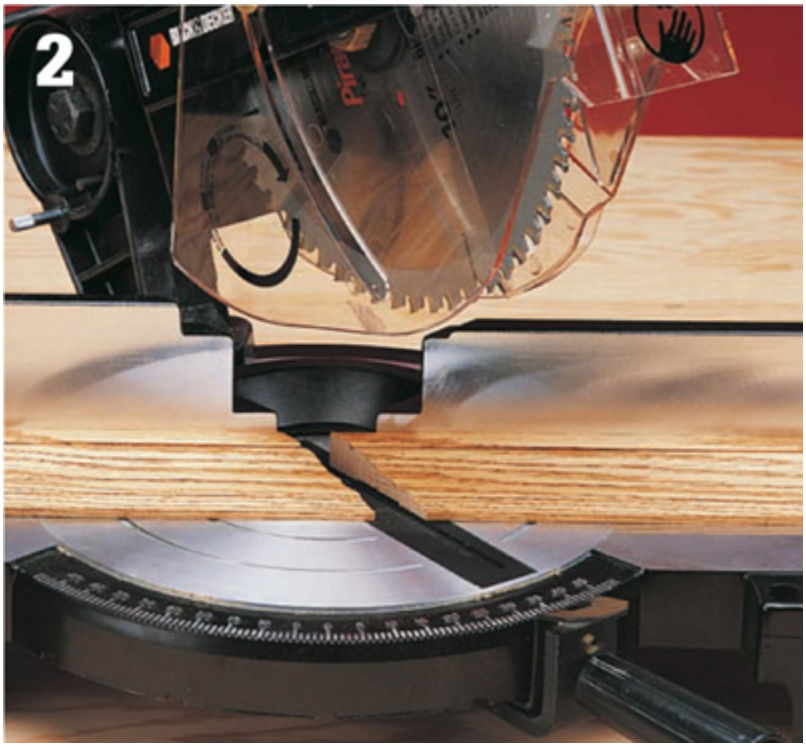
Sliding miter saws will cut with a plunge stroke, like a conventional miter saw. For wide workpieces, however, the saw's sliding arm allows it to also cut on a push stroke. First pull the saw toward you and align the blade with the cutting line. Start the saw to begin the cut, pivoting the blade down into the workpiece.

Lower the blade until it is all the way through the wood and then stop the motor.

Once the piece is cut in two, stop the saw and wait until the blade stops before lifting it out of the workpiece.

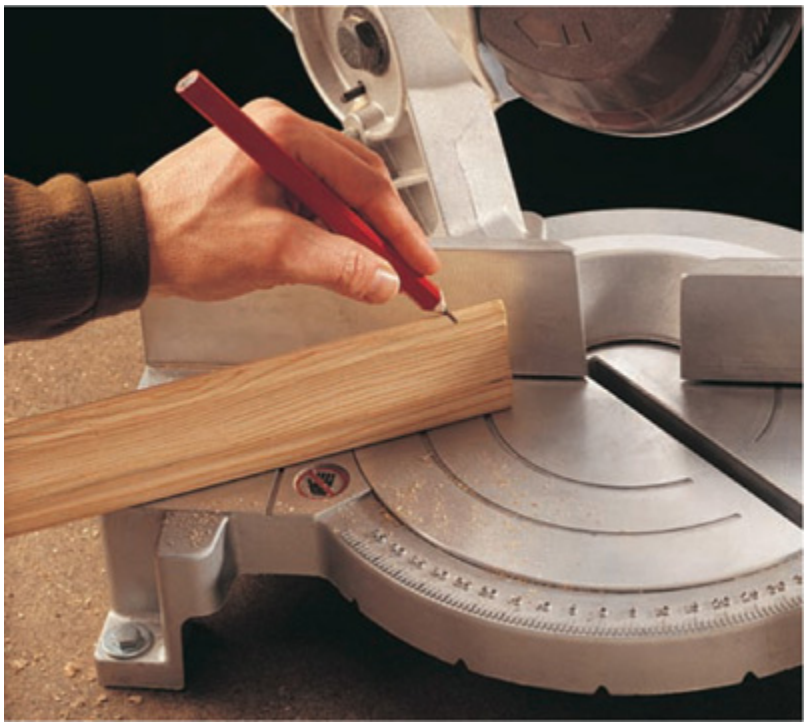
How to Cut Case Moldings

Mark cutting lines on each piece of molding or other material you plan to cut. On window and door casings, mark a line across the front face of the piece as a reference for the cutting direction. Remember: Only the beginning of the cutting line should actually be used to line up the saw blade. The freehand line across the face of the molding is a directional reference only.



Lay door and window casing stock flat on the saw bed and set the blade to match the cutting line. If you have a compound saw, set the bevel adjustment to 0°. Anchor the casing with your hand at a safe distance from the blade.

How to Cut Baseboards



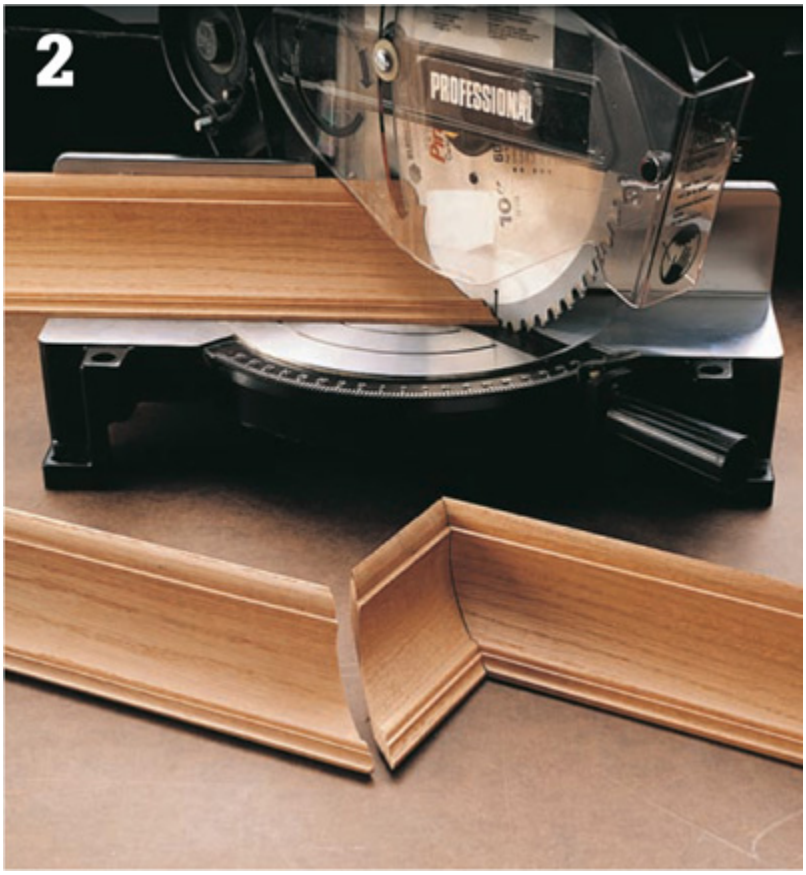
Mark a cutting line along the top edge of baseboards to indicate the starting point and direction for each cut. Baseboards and moldings that run the length of a wall are cut by standing the stock against the saw fence.

How to Make Scarf Joints

Join molding pieces for longer spans by mitering the ends at 45° angles. The mitered joint (scarf) cannot open up and show a crack if the wood shrinks.

How to Make Compound Miter Cuts

On a non-compound miter saw, cove moldings must be positioned at an angle for cutting. Position the molding upside-down so the flats on the back of the molding are flush with the saw bed and fence.



Set the blade at 45" and cut the molding. To cut the molding for an adjoining wall, swivel the miter saw to the opposite 45" setting, and make a cut on the second piece that will fit with the first piece to form a corner.

Option: To miter cove molding on a compound miter saw, lay the molding flat on the saw bed and set the miter and bevel angles. For cove moldings, the standard settings are 33" (miter) and 31.62" (bevel). On many saws, these settings are highlighted for easy identification. If the walls are not perpendicular, you will need to experiment to find the correct settings.

Table Saws

For any serious do-it-yourself carpenter, a table saw is one of the most useful of all tools. Table saws make miter, rip, cross, and bevel cuts. They can also produce dadoes, dovetails, rabbets, and tenon joints for countless carpentry projects.

Several handmade accessories can improve your results and minimize the risk of injury when using a table saw. Pushsticks (page 88) make it easier to push stock through the blade's path while keeping your hands at a safe distance. Featherboards help keep your stock flat against the rip fence and table during cutting.

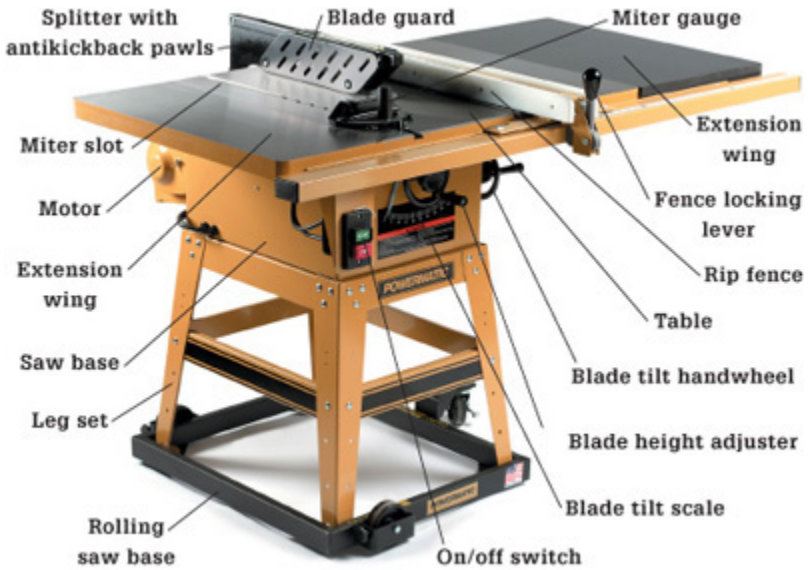
If you want to add a table saw to your workshop but don't have the money or enough space for a full-sized model, consider buying a portable table saw. Although they are smaller, these saws have most of the capabilities of a full-sized table saw.

For general carpentry work, use a combination blade. If you plan to do a lot of ripping or crosscutting and want the most accurate cuts possible, switch to a blade that's designed exclusively for that purpose.

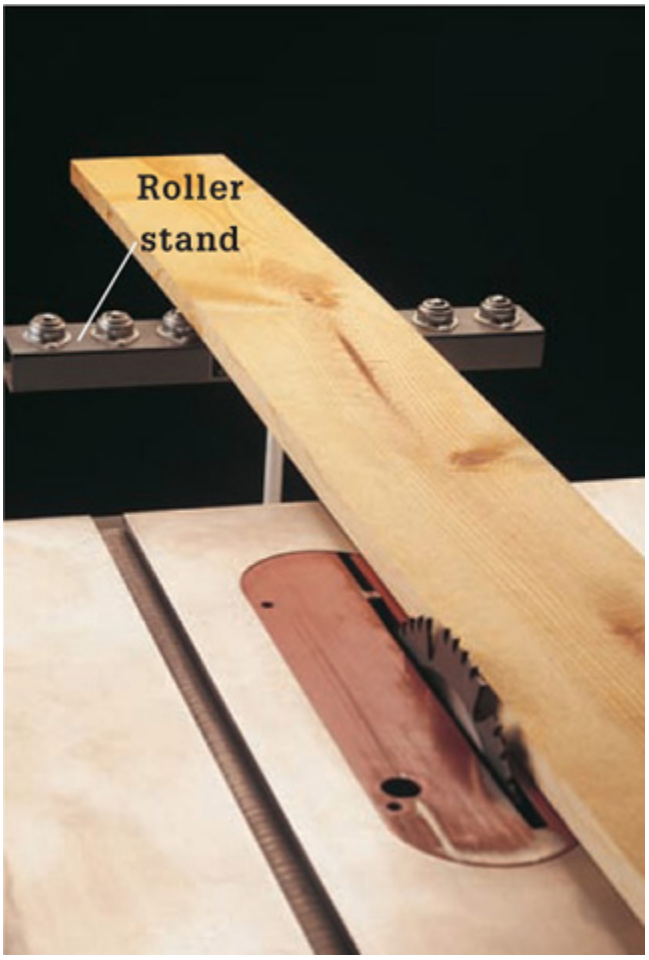
Note: Using a table saw requires extra caution because of the exposed position of the blade. Remember that your hands and fingers are vulnerable, even with a safety guard in place. Read the owner's manual for specific instructions on how to operate your saw. In the following photos, the blade guard and splitter have been removed for clarity.

The table saw is a versatile, highly accurate cutting tool. With virtually unlimited jigs and accessories available, such as this taper-cutting jig, there are very few cuts a table saw cannot make.

Using a Table Saw



Learn what the parts and accessories of a table saw do before operating one. This portable table saw includes: blade guard; rip fence, for aligning the cutting line on the workpiece with the blade; blade height adjuster and bevel angle scale; on/off switch; bevel tilt adjuster; and miter gauge, for setting miter angles.

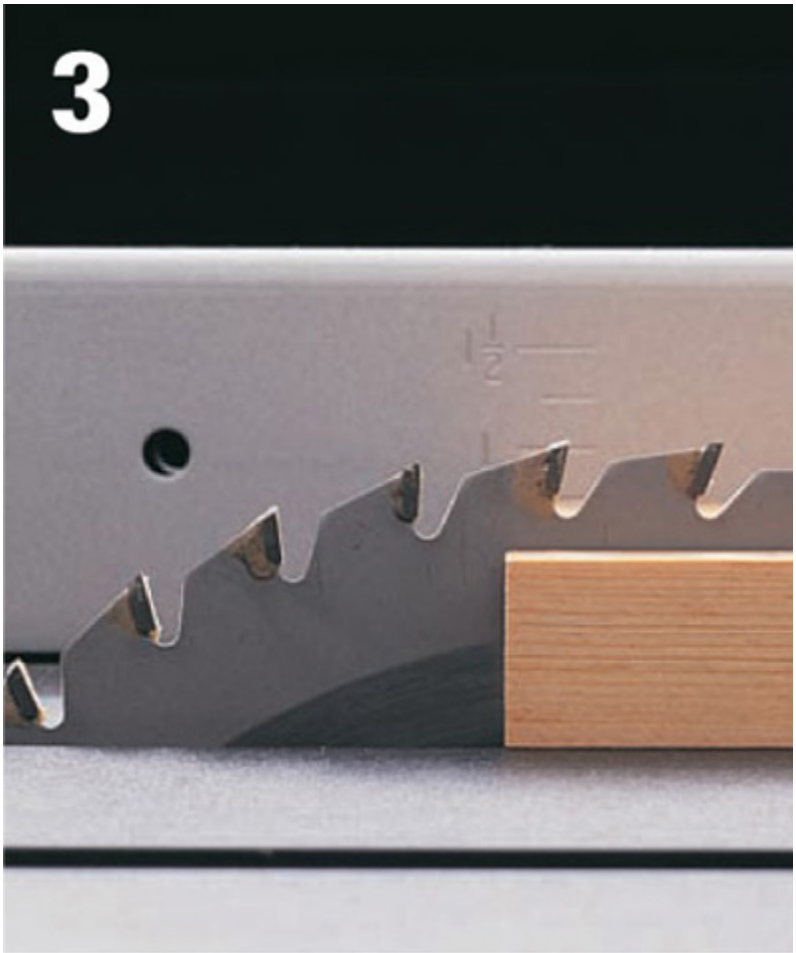


Use a roller stand to hold long pieces of stock at the proper height when cutting them on a table saw. A roller stand allows you to slide the material across the table without letting the workpiece fall to the floor.

How to Set Up a Table Saw

Check the vertical alignment of a table saw blade by adjusting the bevel to 0° and holding a try square against it. The blade and square must be flush. If not, adjust the blade according to the instructions in the owner's manual.

Check the horizontal blade alignment by measuring the distance between the blade and the rip fence at both ends of the blade. If the blade is not parallel to the fence, it may cause binding or kickback. Adjust the saw according to the owner’s manual.



Set the blade so it extends no more than ½" above the surface of the workpiece. This minimizes strain on the motor and produces better cutting results.

How to Change a Table Saw Blade

Unplug the table saw. Remove the blade guard and the table insert, then turn the blade height adjustment knob clockwise to raise the blade to its maximum height.

Wearing gloves, hold the blade stationary with a piece of scrap wood. Loosen and remove the arbor nut. (An arbor wrench is supplied with most saws).

Carefully remove the old blade, and install the new blade so the teeth curve toward the front of the saw. Don’t overtighten the arbor nut. Replace the table insert and the blade guard.

Using Pushsticks & Featherboards

Pushsticks are essential safety items during rip cuts. They keep your hands clear of the blade.

Featherboards in various styles hold workpieces against the saw table or rip fence. They're especially useful for ripping long stock, where control can be difficult.

How to Rip Cut with a Table Saw

Start a rip cut by standing to the left of the workpiece, placing your left leg against the corner of the saw with your hip touching the front fence rail.

Feed the workpiece into the blade with your right hand while pressing the board against the fence with your left hand.

As you near the end of the cut, use a pushstick to feed the board past the blade.

When the board is cut in two, a waste piece will be left next to the blade. Don’t reach for it by hand. Turn the saw off.

With the workpiece clear of the blade, use the pushstick to slide the waste piece away from the blade.

How to Crosscut with a Table Saw

Align the blade carefully with the layout line before starting the saw and making the cut.

With the workpiece held firmly against the miter gauge, slide both past the blade to make the cut. Stand behind the miter gauge so your body is clear of the waste piece.

Push the miter gauge past the blade until the workpiece is cut in two and the workpiece is clear.

Slide the waste piece away from the blade with a pushstick. If it is too small to reach easily, turn off the saw first. Do not remove short waste pieces by hand with the saw running.

Ripping Sheet Goods on a Table Saw

A table saw is a good choice for making clean, accurate cuts in plywood. Generally, it will produce better results than a circular saw. However, full-sized sheets of plywood can be unwieldly to handle and hard to lift up onto the saw table. The safest approach for cutting up large sheets is to cut them into smaller pieces first with a circular saw. Smaller sections will be much easier and safer to maneuver over the saw. Use extreme caution if a table saw is your only option for cutting up a full-sized sheet. To set up the cut, position a sturdy roller stand or shop table behind the saw to catch the plywood as it exits the blade. Make sure the outfeed support is slightly shorter than the saw table height to keep it from catching on workpieces during cutting. Install a general-purpose or fine-cutting blade. Set the blade height about ¼" higher than the plywood's thickness, and lock down the rip fence clamp.

Start the saw and tip the sheet up onto the saw table, making sure a long edge is flush against the rip fence. Stand along the opposite edge of the sheet near the back corner and push it into the blade. When the cut is underway, walk the sheet slowly into the blade and move around behind it to support the rear edge. Keep your hands clear as you complete the cut, pushing the section against the rip fence all the way past and clear of the blade. Turn off the saw and wait for the blade to stop before removing the workpieces.

How to Rip Sheet Goods on a Table Saw

If a plywood panel is too large to handle easily, cut it into smaller pieces with a circular saw first. Cut just outside the final layout lines so you can make the finish cuts on the table saw.

Start the cut by standing behind the rear corner of the sheet and pushing with your right hand. Keep the material pressed firmly against the rip fence with your left hand. Slowly walk the sheet into the blade.

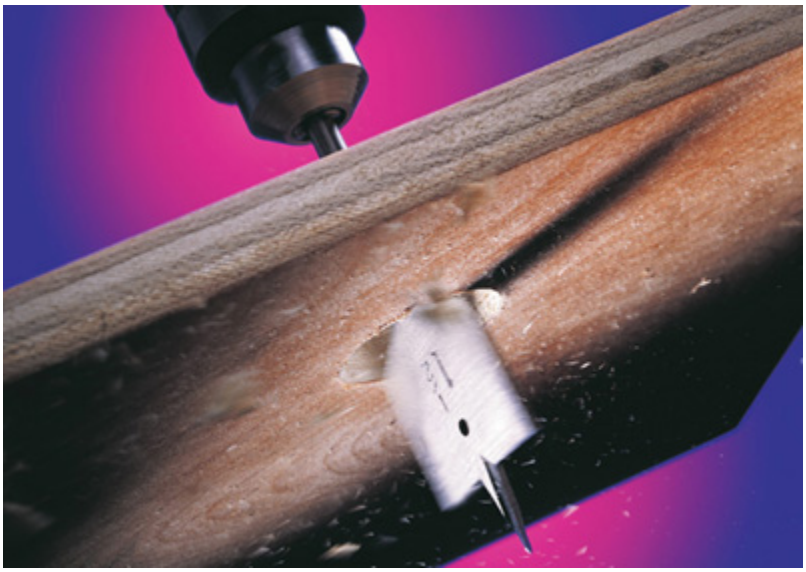
As the cut progresses, move your body behind the sheet to support the rear edge. Eventually, your right hand should push the material between the fence and blade all the way through the cut.

Drills & Bits

The power drill is one of the most popular and versatile power tools. Thanks to a host of improvements in its design, today's drills have many more functions than just drilling holes. Most have variable speed and reverse, making them convenient for driving and removing screws, nuts, and bolts, as well as for drilling, sanding, and stirring paint. A keyless chuck makes it easy to swap bits or quickly convert a drill into a grinder, sander, or paint mixer. Newer models allow you to adjust the drill's clutch for drilling or for driving into various materials, so the clutch will automatically disengage before screw heads strip or sink too far into the material.

Drills are commonly available in ¼", ⅜", and ½" sizes. The size refers to the maximum diameter of the bits and other accessories that the drill will accept. A ⅜" drill is standard for carpentry projects because it accepts a wide variety of bits and accessories and runs at a higher speed than ½" models.

Cordless technology has made drills more portable than ever. But it's important to understand the strengths of corded and cordless designs before deciding which one you should own. Most cordless drills operate at slower speeds and with less torque than corded models. Yet, cordless models are convenient because they allow up to several hours of operation between charges and eliminate the need for extension cords. Top-of-the-line cordless drills generate about 1,200 rpm. Corded drills weigh significantly less because they don't require battery packs, and some operate at more than 2,000 rpm. For most jobs, a cordless drill's slower speed is not a problem, but as the battery wears down, drilling becomes difficult and more of a strain on the motor. Spare battery packs can offset this problem. If you own both types of drills, keep your corded model on hand as a backup.

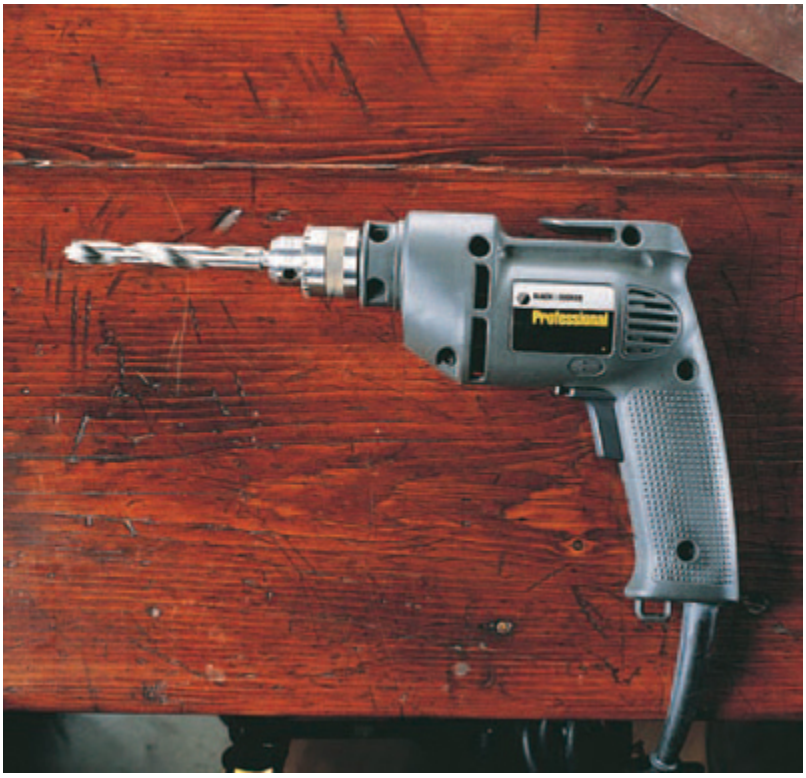


Shopping for Drills

When shopping for a drill, remember that the most powerful tool is not necessarily the best one for the job. This is especially true of cordless drills, because higher voltage ratings usually require heavier batteries. A more powerful cordless model is useful for heavy-duty drilling, when extra power will allow you to drill holes in thick timbers or masonry more quickly and easily. For driving screws and for light-duty drilling, a medium-voltage cordless model or a corded drill is a better choice. A drill in the 12- to 14.4-volt range is usually sufficient for most tasks. Try out several drills so you can compare the feel of the tools under load.

You'll also appreciate having two battery packs to minimize waiting for recharging. Most good-quality cordless drills come with one-hour chargers.

Drills include: (A) Clutch adjustment dial, (B) Variable speed switch, (C) Screw bit holder, (D) Keyless chuck, (E) Trigger lock and reversing switch, (F) Voltage rating, (G) Battery pack.



Corded drills are still widely available because they can generate lots of torque and operate at speeds of 2,000 rpm or more. If you want a fast, powerful, lightweight drill, a corded drill may be the right tool for you.

A hammer drill combines the rotary motion of a conventional drill with the impact action of a hammer. It can drill holes in masonry much faster than a regular drill. Hammer drills can also be set for rotary motion only, making them useful for general drilling applications.

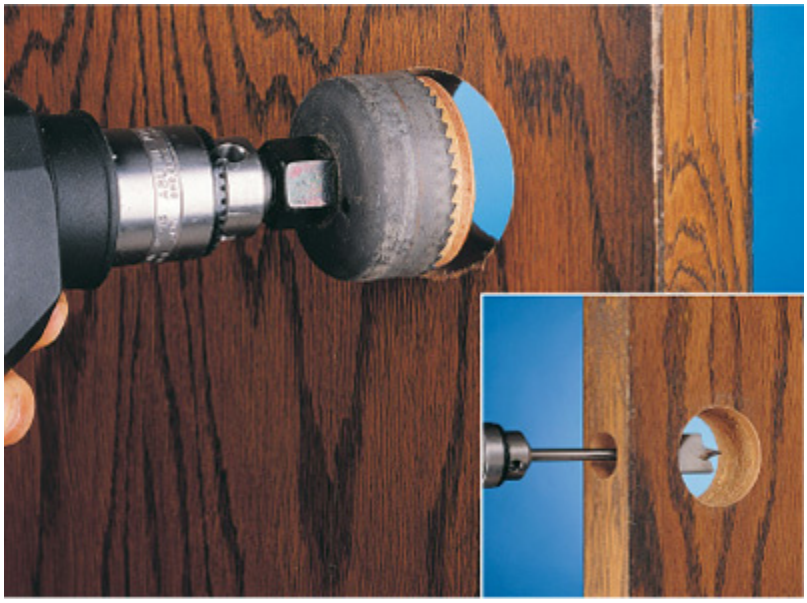
Using Drill Bits

Drill bits include: a magnetic drive guide, twist bit set, screwdriver and nut driver set, plug cutter, glass and tile bits, spade bit set, hole saw bits, and adjustable counterbore bit. These accessories are often sold with a drill or are available separately.

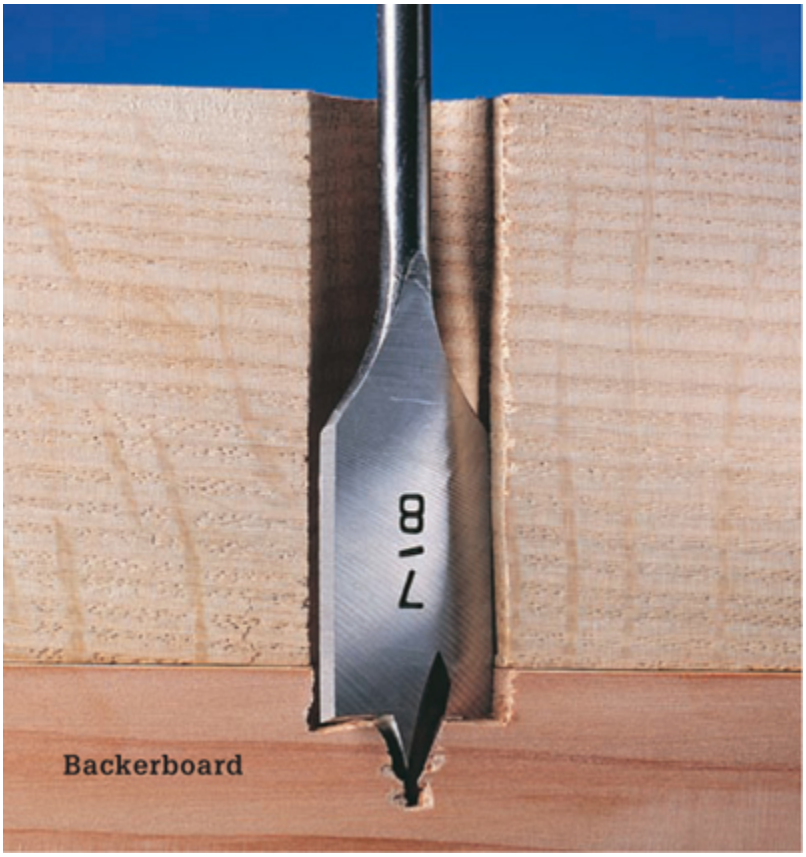
An auger bit is designed with a screw-like tip and deep threads. It bores raceway holes for wiring quickly and easily by self-feeding through the wood.

Prebore holes in hardwood. Start with a small bit, then drill again using a bit of the required size. The extra step will prevent binding and splintering as the larger bit cuts through the wood.

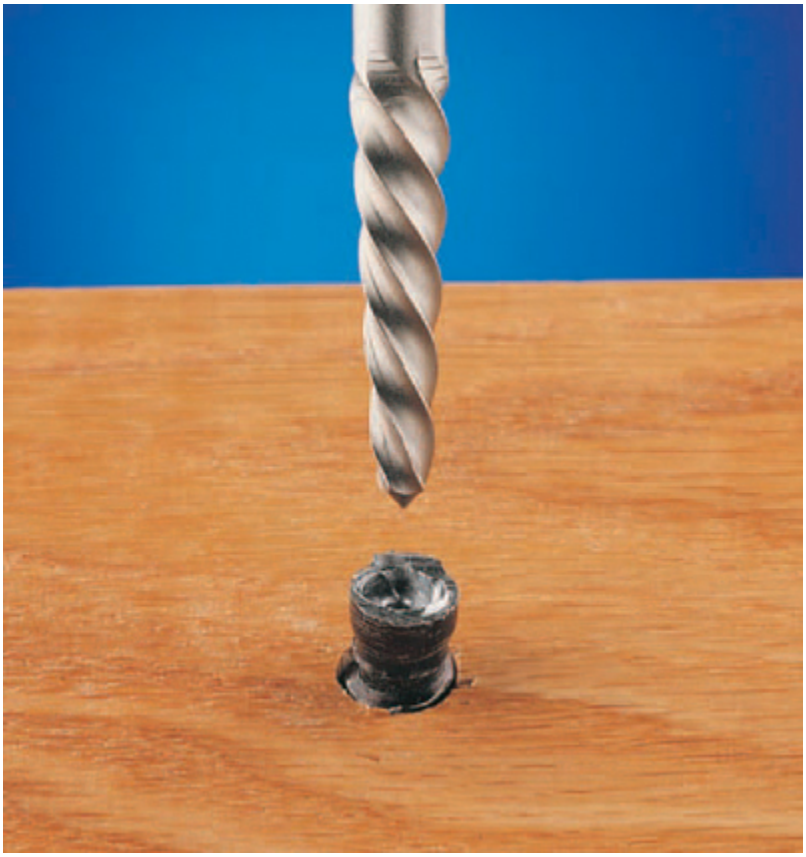
Use an adjustable counterbore bit to pilot, countersink, and counterbore holes with one action. Loosen the setscrew to match the bit to the size and shape of the screw.



Drill holes for door knobs and cylinders with a hole saw (top) and a spade bit (inset). To prevent the door from splintering, drill until the hole saw pilot (mandrel) just comes through the other side of the door. Complete the hole from the opposite side. Use a spade bit to drill the latch bolt hole perpendicular to the door.



Use a backerboard when drilling holes in hardwood and finish plywood or any time you want to prevent blemishes. A backerboard placed on the bottom of the workpiece prevents splintering as the bit breaks through.



Remove a broken screw by drilling a pilot hole in the top of the screw and removing it with a properly sized extracting bit. Extracting bits can be used in a drill when it is set in reverse or with a manual extracting tool.

Sanders

Power sanding tools shape and smooth wood and other building materials in preparation for painting and finishing. Carpenters also use them for removing small amounts of material. Finish sanders (opposite page, top) are best for light to medium sanding and for achieving very smooth surfaces. Belt sanders (opposite page, bottom left) are suitable for most work involving rough, fast removal of material. For very small, intricate, or contoured areas, sand by hand with folded sandpaper or a sanding block, or use drill-mounted sanding accessories (opposite page, bottom right).

When sanding a rough workpiece that requires a fine finish, begin sanding with a lower-grit sandpaper. Slowly move up to a higher grit to achieve the finish you want. Medium sanding jobs normally consist of three sanding steps: coarse, medium, and fine.

Sanding is painstaking work. Take your time and do it right the first time. If you attempt to cut corners when sanding a project, you will see it in the end result.

Note: Sanders create airborne particles of material. Consider buying a sander that has a dust collection bag, and always wear a dust mask and eye protection.

Use a sander to remove unwanted material and create a smooth finish. This random-orbital sander is used in general applications that require medium to heavy sanding. The orbital motion combines a circular pattern with side-to-side motion. Unlike disc sanders, random orbit sanders leave no circular markings, and there’s no need to follow the grain of the wood. Sanding discs are available with hook-and-loop fasteners or pressure-sensitive adhesive. Sponge applicators and accessories are available for buffing and applying paste waxes.

Finish sanders are designed for jobs that require medium- to light-duty sanding to achieve a fine finish. Types of finish sanders include: (1) 3-in-1 sander for finish sanding, medium material removal, and detail work; (2) traditional finish sander for finishing larger areas; (3) palm sander for detail work; and (4) detail sander for smaller-scale finish work and easy corner access. The palm sander is also ideal for polishing and scrubbing jobs when fitted with the appropriate accessories.

Remove material from large areas quickly with a belt sander. Disposable belts are available ranging from 36 (extra-coarse) to 100 (fine). Most belt sanding is done with the grain. However, sanding across the grain is an effective way to remove material from rough-hewn lumber.

Sanding accessories for power drills include (clockwise from top right): disc sander for fast sanding, sanding drums, and flap sanders to smooth contoured surfaces.

Using Sanders

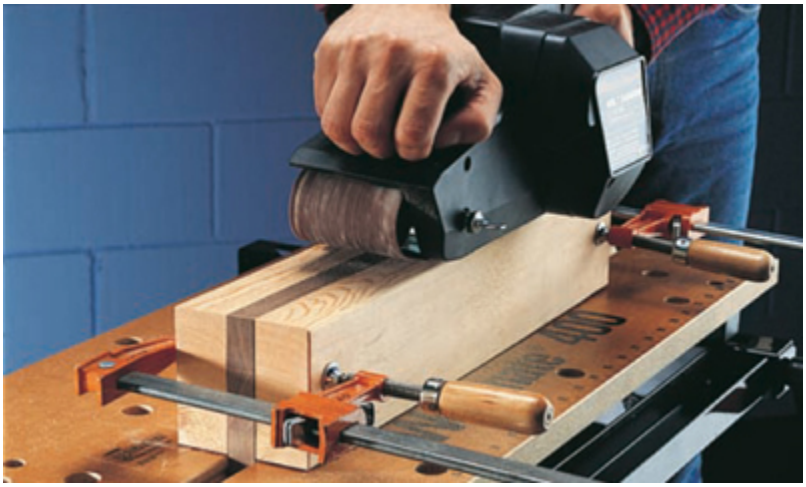
A disk sander's flat table and miter gauge make it helpful for sanding edges flat and square. Tip the miter gauge to refine angled workpieces, such as mitered trim. For best accuracy, sand up to a marked layout line.

It’s possible to sand broad curves using a belt or randomorbital sander, but use a drum sander mounted in a drill press or power drill for sanding tight curves.

Clean sandpaper with a stiff-bristle brush to remove sawdust and grit that can clog the sandpaper and reduce its effectiveness.

It’s often faster to start heavy stock removal with a coarse rasp, then switch to a sander when most of the stock is filed away. A rasp will not create airborne sawdust, so it is also a cleaner tool to use. Wear gloves if you need to hold the rasp by the blade. Notice that a rasp cuts on the push stroke only.

A sanding block is helpful for smoothing flat surfaces. For curved areas, wrap sandpaper around a folded piece of scrap carpeting or 2 × 4.



When sanding the edge of a board with a belt sander, clamp it between two pieces of scrap lumber to prevent the belt sander from wobbling and rounding off the edges.

How to Select the Proper Sandpaper for the Job

Use 60-grit coarse sandpaper on hardwood flooring and to grind down badly scratched surfaces. Move sander across the grain for quickest removal.

Use 100-grit coarse sandpaper for initial smoothing of wood. Move the sander in the direction of the wood grain to achieve the smoothest surface.

Use 150-, then 180-grit fine sandpaper to put a smooth finish on wood surfaces. Fine sandpaper will prepare wood surfaces for staining or smooth wallboard joints.

Use 220-grit extra-fine sandpaper to smooth stained wood before varnishing or between coats of varnish.

Pneumatic Nailers

Nail guns use compressed air, other gas, or a battery to drive nails into wood. The air-powered—or pneumatic—nail guns offer many advantages over hand-nailing, for both novices and professional carpenters alike. For one, the guns are simple and efficient to use. Rather than swinging a hammer several times to drive and set a nail, a nail gun completes the whole task in one trigger squeeze. Position the gun's tip where you want the nail to be, press down the safety on the nailing tip, and squeeze the trigger to fire the nail. The process is the same, whether you're driving a tiny brad or a 3-inch framing nail. Most professional carpenters use nail guns because large framing or trim carpentry jobs can be completed in much less time than hand-nailing.

Nail guns will help improve your nailing accuracy. You'll never need to worry about a glanced hammer blow denting the wood or bending a nail. Air nailers never miss the nail head. As long as you choose the correct nails for the application and set the air compressor pressure properly, a pneumatic nailer will drive and set nails reliably, time after time.

Nail guns are made in various sizes to suit different carpentry applications. Framing nailers are designed to drive large-shank nails through framing lumber. Brad nailers drive smaller, casing-sized nails for installing trim moldings. Roofing nailers tack shingles in place using long coils of collated nails, sometimes with washers on the shanks.

There are even nail guns made for attaching metal joist hanger hardware and strapping. Most styles are available for rent if you only need a nail gun for occasional projects.

When using a nail gun, you'll usually need a tank-style air compressor to supply the air. Set the air pressure correctly for the gun you're using. Most nailers require around 60 to 100 psi of continuous pressure to operate. Use the correct style and sizes of nails for the gun—some nail styles are not interchangeable from one nailer to the next. Also, add a few drops of nail gun oil into the air nozzle to lubricate the internal drive mechanism if your gun requires it. Always wear ear and eye protection when operating a nail gun.

SENCO
Model PC1131
2.5 HP (Peak)
4.3 Gallon
4.4 CFM @ 90 PSI
Oil Splash

Unlike some other pneumatic tools, nail guns don’t require a large air compressor or high volume of air to operate properly. A 4-gallon compressor is generally adequate. Compressors are made in several styles, including single tank, twin-tank, and pancake varieties. Some are equipped to power more than one nailer at a time.

Framing nailers are ideal for assembling wall, floor, and roof framework. They're the largest nail guns for home carpentry, capable of driving 2 to 4" framing nails.

Brad nailers are designed for attaching baseboard, wall moldings, and window and door casings. Some styles have angled magazines that make it easier to work in tight spaces and corners.

Coil roofing nailers install shingles or wall sheathing quickly and easily. The round magazine stores longer clips of nails than a straight magazine for improved efficiency. These guns can be fired repeatedly by holding the trigger and tapping the gun along the work surface.

Pneumatic nails are made in a variety of styles, sizes, and compositions to suit specific tasks. Clips are either straight or angled, and framing nail heads can be round or clipped. You can buy uncoated or galvanized nails as well as nails designed for use with treated lumber or marine applications.

To prepare a nail gun for use, slide a clip of nails down into a slot in the magazine and close the cover. Add a few drops of oil into the air hose nozzle, if necessary, before each use.

Adjust the air compressor's regulator to achieve the recommended air pressure for the gun you're using. Incorrect air pressure will cause the nailer to either overdrive the nails or stop them short of setting properly.

Drive a nail by positioning the gun's nailing tip where you want the nail to be and pushing the safety tip against the workpiece. Hold the gun firmly and squeeze the trigger. Lift the gun off to re-engage the safety.

Powder-Actuated Tools

Occasionally, your carpentry projects may involve fastening wood to metal or concrete, such as attaching wall sole plates to concrete floors. You may even need to fasten metal plumbing straps or conduit clips to steel I-beams. In these situations, you could use hardened screws for fastening, but that involves lots of tedious drilling and usually a few broken or stripped screw heads. An easier alternative is to use small charges of gunpowder to drive hardened nails into metal or concrete with a powder-actuated nail gun.

Powder-actuated nailers look and work a bit like a pile driver or handgun. A steel barrel holds specially designed, hardened nails called drive pins. The nails are equipped with a plastic sleeve to keep them centered in the barrel. Driving force is delivered by a small gunpowder charge, called a power load, which looks like a rifle shell with a crimped tip. The power loads fit into a magazine behind the barrel on the tool. Squeezing the tool's trigger, or hitting the end with a hammer (depending on the tool style), activates a firing pin that ignites the gunpowder. The expanding gasses drive a piston against the nail at great force. Powder-actuated nailers can drive only one fastener at a time, but some styles will hold a clip of multiple power loads for faster operation.

Power loads are made in a range of color-coded calibers to suit different nailing applications and drive pin sizes. Follow the manufacturer's recommendations carefully to choose the correct load and fastener for your task. Generally, the safest method is to start with the lowest energy load that will work for your nailing situation and see if it's sufficient to fully drive the nail. Use the next stronger load, if necessary.

Powder-actuated nailers are easy to use for do-it-yourselfers and safe for indoor projects, provided you wear hearing and eye protection and follow all manufacturer's instructions. Most home centers sell the nail guns and supplies, or you can rent these tools.

Powder-actuated nailers offer the quickest and easiest method for fastening framing to block, poured concrete, and steel.

Powder-actuated nail guns (PATs) are designed in two styles. Plunger types are activated by hitting the end of the shaft with a hammer, while trigger styles function like a handgun. With either type, the barrel must be depressed against the work surface to release a safety before a drive pin can be fired.

Power loads contain various amounts of gunpowder inside a crimped shell. Color coding ensures that you're using the right amount of charge for your drive pin size and the materials you're fastening together. Follow the color charts carefully, starting with a low-power charge.

PATs use hardened nails, called drive pins, in a range of sizes. A plastic finned sleeve centers the drive pin in the tool barrel.

How to Use a PAT

To prepare a PAT for use, slide a drive pin into the barrel first. Push it in until the nail tip is flush with the end of the barrel. Be sure there’s no power load in the magazine.

Slide the magazine open and insert a power load into the barrel. A rim on the load shell ensures that it can only be loaded one way. Close the magazine.

Press the end of the barrel firmly against the work surface to release the safety. Squeeze the trigger or strike the end of the tool sharply with a hammer to fire the drive pin. Once the pin is fired, slide open the magazine to eject the spent load shell.

Tip

Occasionally, your first power load selection won’t completely set the nail, in these situations, use a hand maul to drive it in the rest of the way. Choose a stronger power load for driving subsequent fasteners.

Specialty Tools

When a carpentry project calls for a tool that you don’t own, you need to decide whether it’s worth the investment to buy it. Good-quality tools can be expensive, making purchases hard to justify if you won’t be using them often. For these types of tools, renting may be a better option.

A wide assortment of tools, including the ones featured on these pages, are available at rental centers at a reasonable cost. Renting gives you an opportunity to try a tool that you’re considering buying and gives you access to tools you would never consider buying, such as a jackhammer, that may make a specific project easier.

When you rent tools, always ask for the accompanying owner’s manual and a demonstration of the tool’s operation. You’ll save time on the job and avoid unsafe or improper use.

Many rental tools are available by the hour rather than by the day. When renting by the hour, prepare your work area prior to picking up the tool to minimize rental costs.

A hammer drill combines impact action with rotary motion for quick boring in concrete and masonry. To minimize dust and to keep bits from overheating, lubricate the drilling site with water. A hammer drill can be used for conventional drilling when the motor is set for rotary action only.

A collated screw gun makes quick work of hanging wallboard or fastening subfloor sheathing. These tools accept strips of wallboard or wood screws, and an advancing mechanism allows you to drive them one after the next without stopping. An adjustable clutch disengages the driver when the screw sets to prevent overdriving.

An impact driver features a unique internal hammering mechanism that drives long or large screws and lag screws with much less arm fatigue than ordinary drill/drivers or hammer drills. The drivers are cordless and accept both screwdriver bits and sockets.

Cordless nail guns use blasts of compressed gas or battery power to drive nails. They're useful when your carpentry projects are out of range of an outlet or when you're working at heights. No air compressor is required.

A drywall lift makes it manageable for one person to hang wallboard on ceilings or tall walls. The lift can raise even oversized sheets of wallboard to a height of 10 ft. Drywall lifts can be rented from most rental stores for day, weekend, or longer periods.

Basic Carpentry

Adding a second floor to your home is clearly an advanced project requiring specialized skills. However, most home carpentry projects are much smaller in scope and reasonable to attempt for people with moderate skills. You don't have to be a professional contractor to install wallboard or to trim out a basement window. All it takes is a set of clear instructions, a little patience, and practice.

The following section of this book is dedicated to basic projects you are likely to take on. Contact your local building inspector to see if your project requires a permit.

In This Chapter:

- Anatomy of a House
- Preparing the Work Area
- Building Walls
- Soundproofing Walls & Ceilings
- Installing Wallboard
- Installing Interior Doors
- Mounting Bifold Doors

- Installing a Storm Door
- Installing Door & Window Casings
- Installing Window Trim
- Installing Base Molding
- Paneling an Attic Ceiling
- Installing Wainscoting
- Covering Foundation Walls
- Framing Basement Foundation Walls
- Trimming Basement Windows

Anatomy of a House

Before you start a do-it-yourself carpentry project, you should familiarize yourself with a few basic elements of home construction and remodeling. Take some time to get comfortable with the terminology of the models shown on the next few pages. The understanding you will gain in this section will make it easier to plan your project, buy the right materials, and clear up any confusion you might have about the internal design of your home.

If your project includes modifying exterior or load-bearing walls, you must determine if your house was built using platform- or balloon-style framing. The framing style of your home determines what kind of temporary supports you will need to install while the work is in progress. If you have trouble determining what type of framing was used in your home, refer to the original blueprints, if you have them, or consult a building contractor or licensed home inspector.

A House With Platform Framing
Ridge board
Skylight header
Roof sheathing
Shingles
Rafter
Header
Load-bearing wall
Jack stud
King stud
Top plate
Sole plate
Joist
Rim joist
Header
Subfloor
Rough sill
Studs
Joist
Support beam
Support posts
Foundation

ANATOMY OF A HOUSE WITH PLATFORM FRAMING

Platform framing (photos, left and above) is identified by the floor-level sole plates and ceiling-level top plates to which the wall studs are attached. Most houses built after 1930 use platform framing. If you do not have access to unfinished areas, you can remove the wall surface at the bottom of a wall to determine what kind of framing was used in your home.

Framing in a new door or window on an exterior wall normally requires installing a header. Make sure that the header you install meets the requirements of your local building code, and always install cripple studs where necessary.

Floors and ceilings consist of sheet materials, joists, and support beams. All floors used as living areas must have joists with at least 2 × 8 construction. For modification of smaller joists, see page 112.

There are two types of walls: load-bearing and partition. Load-bearing walls require temporary supports during wall removal or framing of a door or window. Partition walls carry no structural load and do not require temporary supports. For more information on determining types of walls, see page 113.

A House With Balloon Framing
Ridge board
Rafters
Roof sheathing
Shingles
Header
Joist
Load-bearing wall
Cripple studs
Studs
King stud
Jack stud
Sill plate
Rough sill
Subfloor
Main beam
Bracing
Fire blocks
Support posts
Foundation

ANATOMY OF A HOUSE WITH BALLOON FRAMING

Balloon framing (photos, right and above) is identified by wall studs that run uninterrupted from the roof to a sill plate on the foundation, without the sole plates and top plates found in platform-framed walls (page opposite). Balloon framing was used in houses built before 1930, and it is still used in some new home styles, especially those with high vaulted ceilings.

Anatomy Details

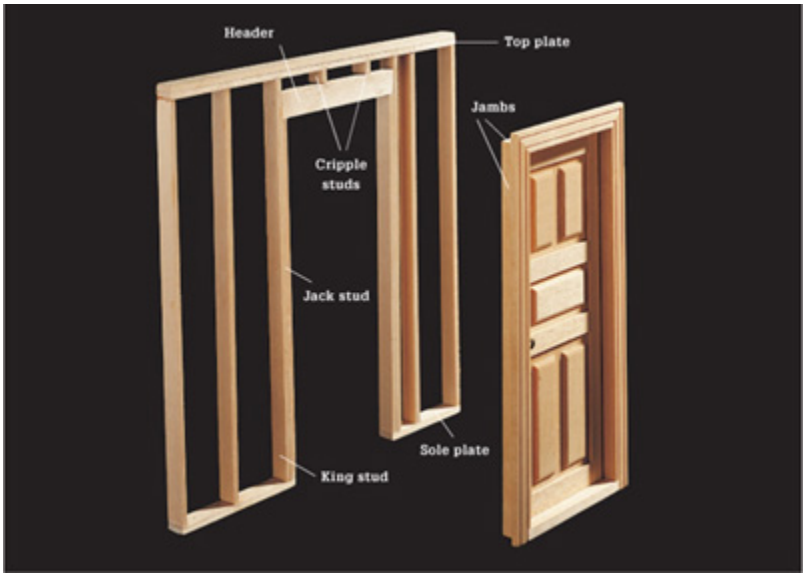
Many remodeling projects, like adding new doors or windows, require that you remove one or more studs in a load-bearing wall to create an opening. When planning your project, remember that new openings require a permanent support beam called a header, above the removed studs, to carry the structural load directly.

The required size for the header is set by local building codes and varies according to the width of the rough opening. For a window or door opening, a header can be built from two pieces of 2" dimensional lumber sandwiched around ⅜" plywood (chart, right). When a large portion of a load-bearing wall (or an entire wall) is removed, a laminated beam product can be used to make the new header (page 23).

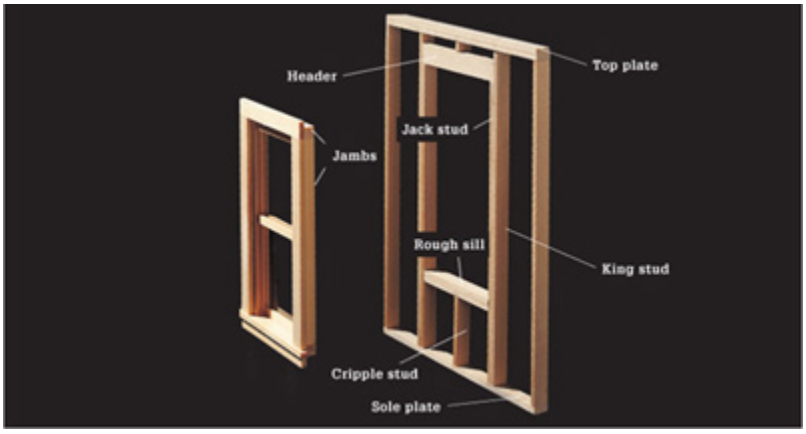
If you will be removing more than one wall stud, make temporary supports to carry the structural load until the header is installed.

Recommended Header Sizes

Rough Opening Width	Recommended Header Construction
Up to 3 ft.	⅜" plywood between two 2 × 4s
3 ft. to 5 ft.	⅜" plywood between two 2 × 6s
5 ft. to 7 ft.	⅜" plywood between two 2 × 8s
7 ft. to 8 ft.	⅜" plywood between two 2 × 10s



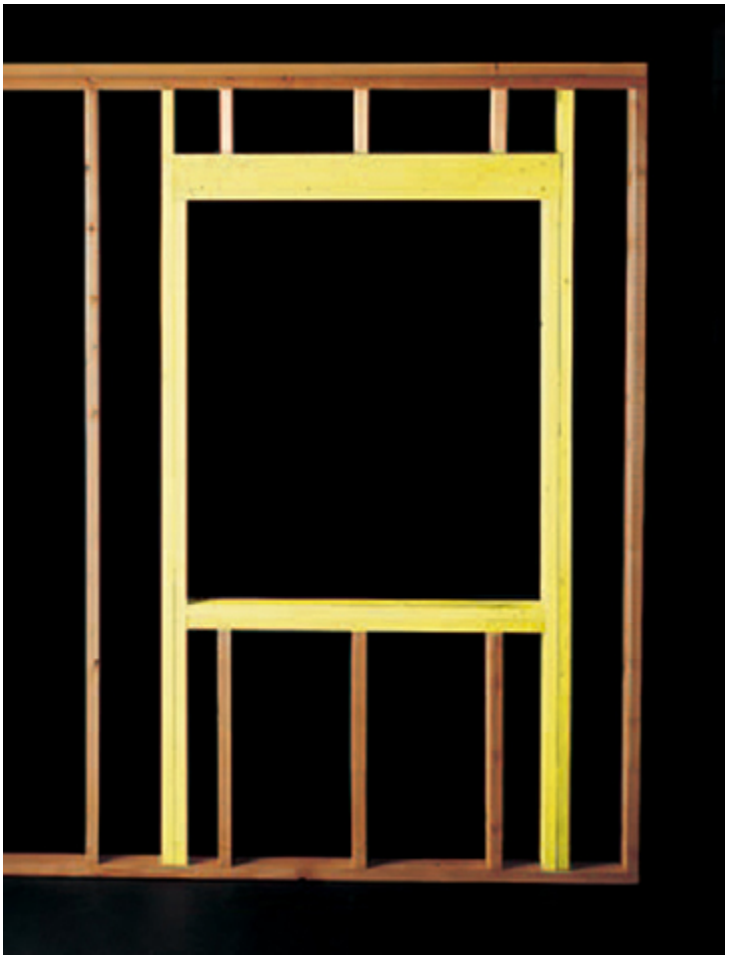
Door opening: The structural load above the door is carried by cripple studs that rest on a header. The ends of the header are supported by jack studs (also known as trimmer studs) and king studs that transfer the load to the sole plate and the foundation of the house. The rough opening for a door should be 1" wider and ½" taller than the dimensions of the door unit, including the jambs. This extra space lets you adjust the door unit during installation.



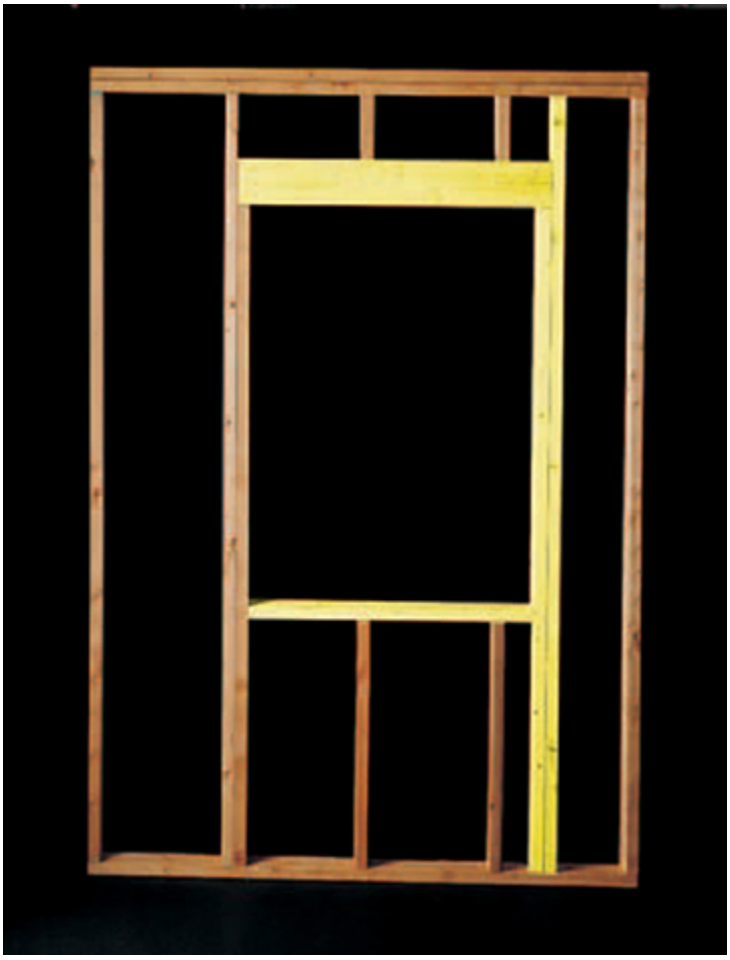
Window opening: The structural load above the window is carried by cripple studs resting on a header. The ends of the header are supported by jack studs and king studs, which transfer the load to the sole plate and the foundation of the house. The rough sill, which helps anchor the window unit but carries no structural weight, is supported by cripple studs. To provide room for adjustments during installation, the rough opening for a window should be 1" wider and ½" taller than the window unit, including the jambs.

Framing Options for Window & Door Openings (new lumber shown in yellow)

Using an existing opening avoids the need for new framing. This is a good option in homes with masonry exteriors, which are difficult to alter. Order a replacement unit that is 1" narrower and ½" shorter than the rough opening.

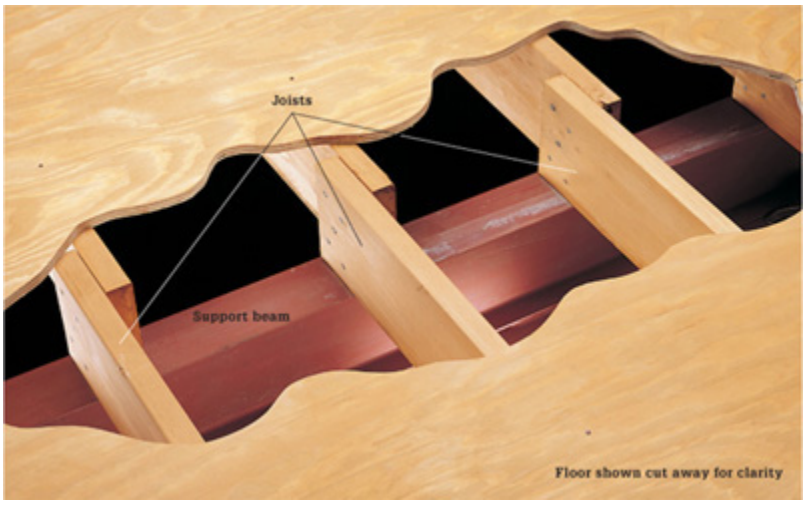


Framing a new opening is the only solution when you're installing a window or door where none existed or when you're replacing a unit with one that is much larger.

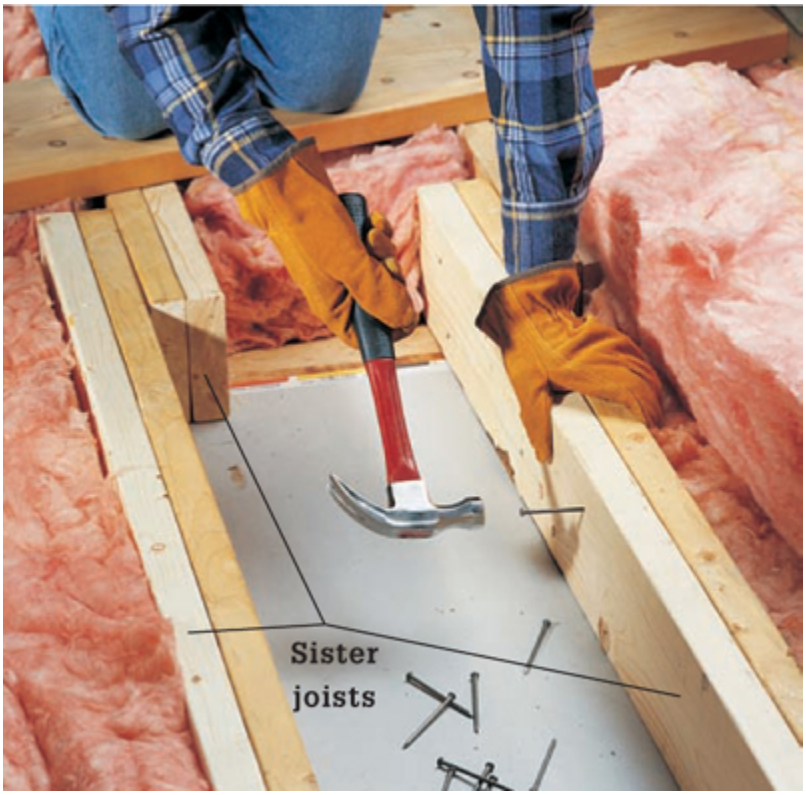


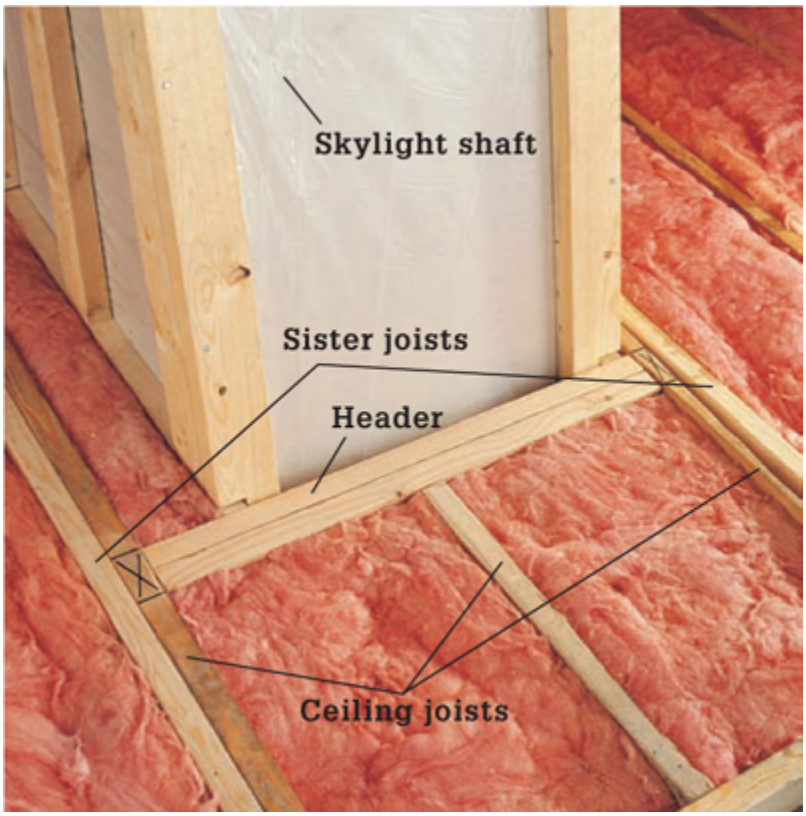
Enlarging an existing opening simplifies the framing. In many cases, you can use an existing king stud and jack stud to form one side of the new opening.

Floor & Ceiling Anatomy



Joists carry the structural load of floors and ceilings. The ends of the joists rest on support beams, foundations, or load-bearing walls. Rooms used as living areas must be supported by floor joists that are at least 2 × 8 in size. Floors with smaller joists can be reinforced with sister joists (photos, below).





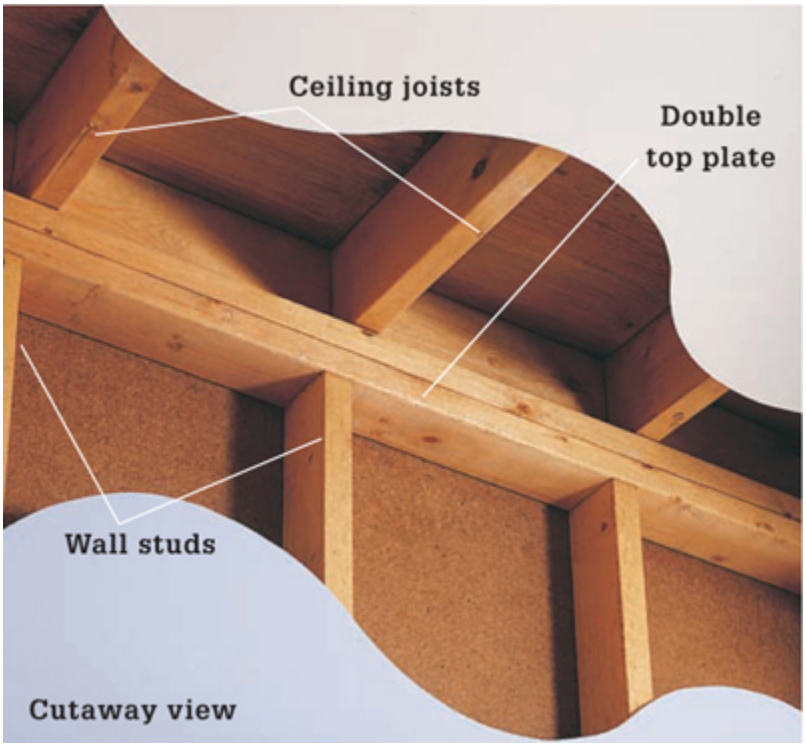
Floors with 2 × 6 joists, like those sometimes found in attics, cannot support living areas unless a sister joist is attached alongside each original joist to strengthen it (above, left). This often is necessary when an attic is converted to a living area. Sister joists also are used to help support a header when ceiling joists must be cut, such as when framing a skylight shaft (above, right).

Roof Anatomy

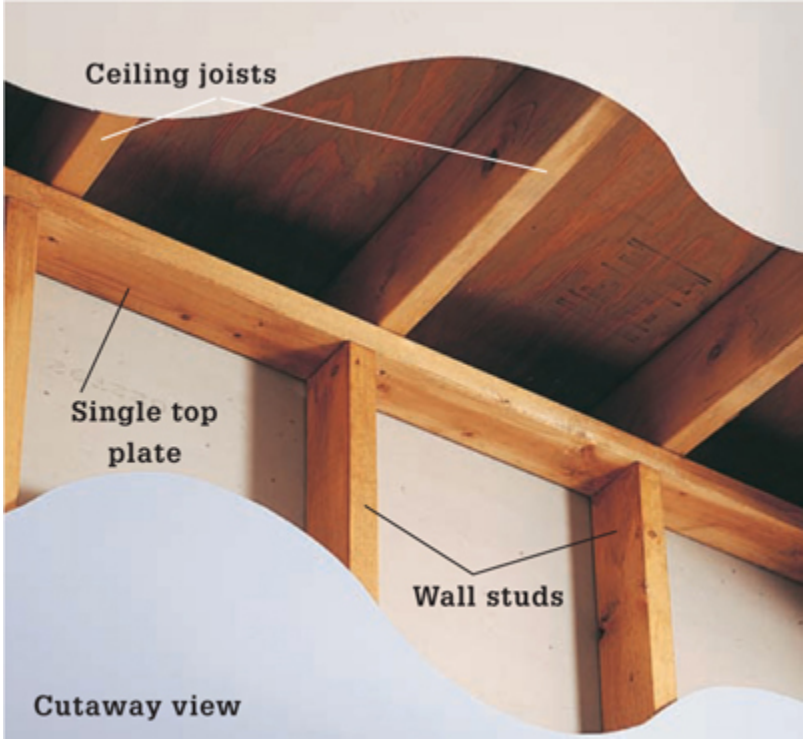
Rafters made from 2 × 4s or 2 × 6s spaced every 16" or 24" are used to support roofs in most houses built before 1950. If necessary, rafters can be cut to make room for a large skylight. Check in your attic to determine if your roof is framed with rafters or roof trusses (right).

Trusses are prefabricated “webs” made from 2" dimensional lumber. They are found in many houses built after 1950. Never cut through or alter roof trusses. If you want to install a skylight in a house with roof trusses, buy a unit that fits in the space between the trusses.

Wall Anatomy



Load-bearing walls carry the structural weight of your home. In platform-framed houses, load-bearing walls can be identified by double top plates made from two layers of framing lumber. Load-bearing walls include all exterior walls and any interior walls that are aligned above support beams.



Partition walls are interior walls that do not carry the structural weight of the house. They have a single top plate and can be perpendicular to the floor and ceiling joists but are not aligned above support beams. Any interior wall that is parallel to floor and ceiling joists is a partition wall.

Preparing the Work Area

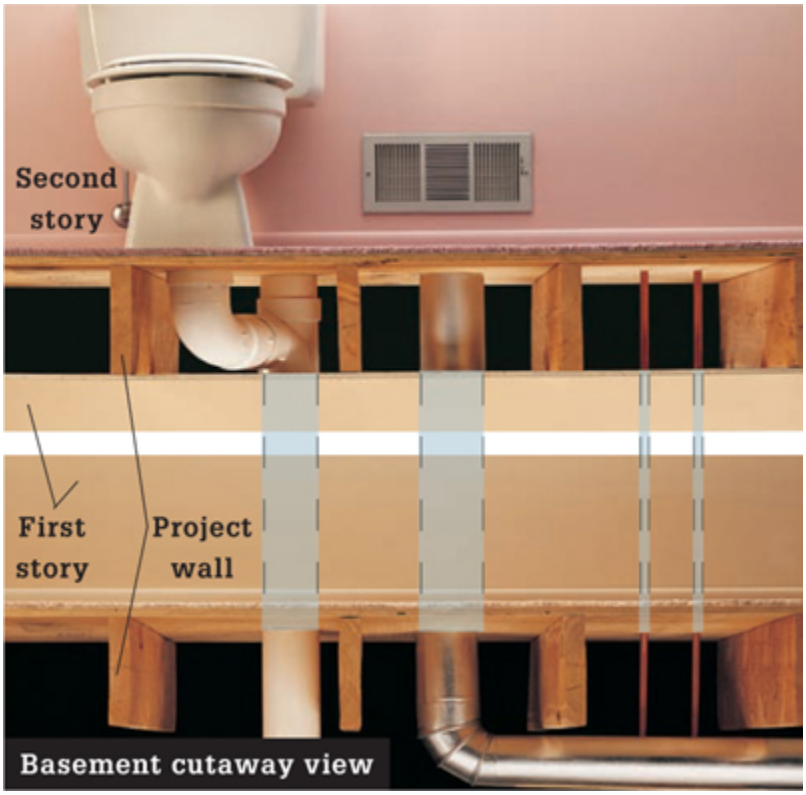
Taking the time to prepare your space makes any project proceed more efficiently. Lay down drop cloths, provide ventilation and light, add a means of disposal, and test all wiring circuits in the area.

Most carpentry projects share the same basic preparation techniques and follow a similar sequence. Start by checking for hidden mechanicals in the work area and shutting off and rerouting electrical wiring, plumbing pipes, and other utility lines. If you are not comfortable performing these tasks, hire a professional.

Test all electrical outlets before beginning any demolition of walls, ceilings, or floors. Shovel all demolition debris away from the work area. Clear away the debris whenever materials begin to pile up during the construction of a project. For larger jobs, consider renting a dumpster.

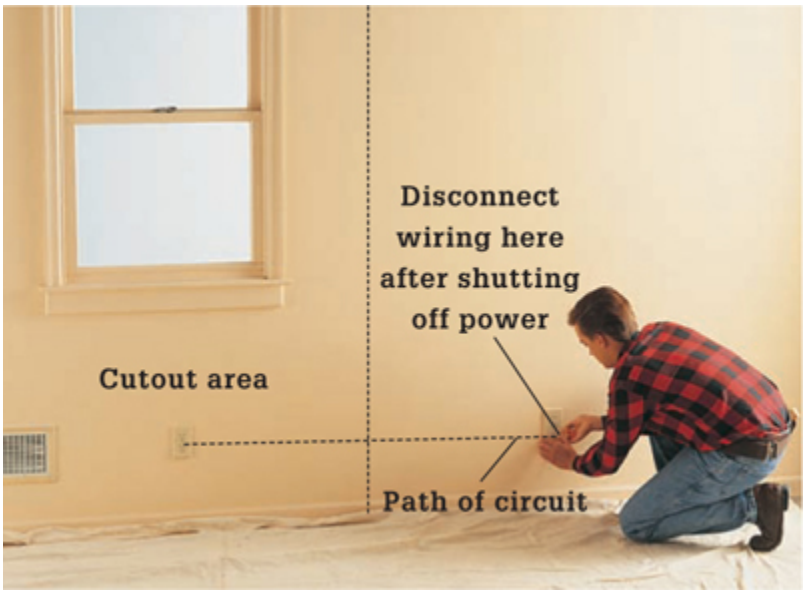
Tools & Materials

- Screwdrivers
- Broom
- Trash containers
- Neon circuit tester
- Electronic stud finder
- Flat pry bar
- Channel-type pliers
- Drop cloths
- Masking tape
- Building paper
- Plywood



Check for hidden plumbing lines, ductwork, and gas pipes before you cut into a wall. To determine the location of the pipes and ducts, examine the areas directly below and above the project wall. In most cases, pipes, utility lines, and ductwork run through the wall vertically between floors. Original blueprints for your house, if available, usually show the location of the utility lines.

Preparation Tips



Disconnect electrical wiring before you cut into walls. Trace the wiring back to a fixture outside the cutout area, then shut off the power and disconnect the wires leading into the cutout area. Turn the power back on and check for current with a circuit tester before cutting into the walls.

Shovel debris through a convenient window into a wheelbarrow to speed up demolition work. Use sheets of plywood to cover shrubs and flower gardens next to open windows and doors. Cover adjoining lawn areas with sheets of plastic or canvas to simplify cleanup.

Removing Old Trim

Damaged trim moldings are an eyesore and a potentially dangerous splinter waiting to happen. There is no reason not to remove damaged moldings and replace them. Home centers and lumberyards sell many styles of moldings, but they may not stock the one you need, especially if you live in an older home. If you have trouble finding the trim you need, consider looking at home salvage stores in your area. They sometimes carry styles no longer manufactured.

Removing existing trim so that it can be reused is not always easy, especially if you live in a home with intricate moldings. Age of the trim and the nailing sequence used to install it greatly affect your ability to remove it without cracks or splits. Some moldings may be reusable in other areas of the home as well.

Whether you intend to reuse the trim or not, take your time and work patiently. It is always a good idea to remove trim carefully so you don’t damage the finished walls, floor, or ceiling surrounding it.

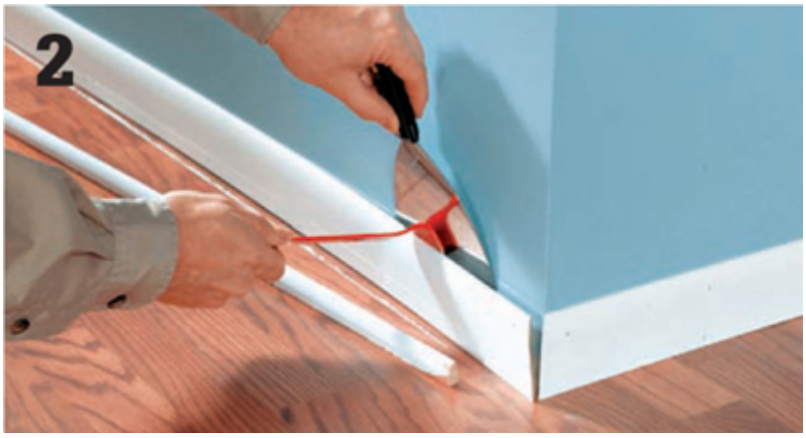
Tools & Materials

- Utility knife
- Flat pry bars (2)
- Nail set
- Hammer
- Side cutters or end nippers
- Metal file
- Scrap plywood or dimensional lumber

Even trim that’s been damaged should be removed carefully.

How to Remove Painted Moldings

Before removing painted trim, cut along the top seam of the molding and the wall with a utility knife to free the molding from any paint buildup on the wall. Cut squarely on the top edge of the molding, being careful not to cut into the wallboard or plaster behind it.



Work the molding away from the wall from one end to the other, prying at the nail locations. Apply pressure to the molding with your other hand to help draw it away from the wall. A wide joint compound or putty knife makes a good guard to insert between the tool and the wall.

How to Remove Clear-finish Moldings

Remove the molding starting with the base shoe or the thinnest piece of trim. Pry off the trim with a flat bar, using leverage rather than brute force, and work from one end to the other. Tap the end of the bar with a hammer if necessary to free the trim.

Use large flat scraps of wood to protect finished surfaces from damage. Insert one bar beneath the trim and work the other between the base and wall. Force the pry bars in opposing directions to draw the molding away from the wall.

How to Remove Nails

OPTION 1: Extraction. Use an end nips or a side cutter to pull the nails from the moldings. Take advantage of the rounded head of the end nippers, “rolling” the nail out of the molding rather than pulling it straight out.

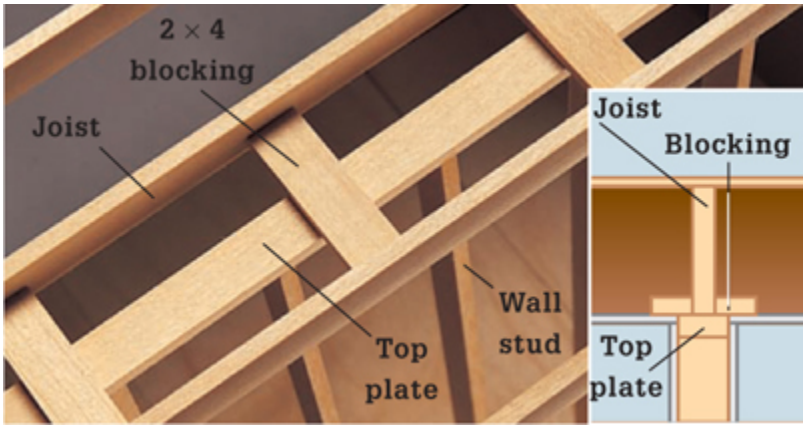
OPTION 2: Reversing course. Secure the workpiece with a gap beneath the nail and drive the nail through the molding from the front with a nail set and hammer.

Building Walls

Partition walls are constructed between load-bearing walls to divide space. They should be strong and well made, but their main job is to house doors and to support wall coverings.

Anchoring New Partition Walls

When a new wall is perpendicular to the ceiling or floor joists above, attach the top plate directly to the joists, using 16d nails.



When a new wall falls between parallel joists, install 2×4 blocking between the joists every 24". If the new wall is aligned with a parallel joist, install blocks on both sides of the wall, and attach the top plate to the joist (inset).

How to Build a Non-loadbearing Partition Wall

Mark the location of the new wall on the ceiling, then snap two chalk lines or use a scrap piece of 2x lumber as a template to mark layout lines for the top plate. Use a stud finder to locate floor joists or roof framing above the ceiling, and mark these locations with tick marks or tape outside the layout lines.

Cut the top and sole plates to length and lay them side by side. Use a combination or framing square to draw pairs of lines across both plates to mark the stud locations. Space the studs at 16" intervals, on center.

Mark the location of any door framing on the top and sole plates. Refer to the door's rough opening specifications when marking the layout. Draw lines for both the king and jack studs.

Fasten the top plate to the ceiling using 3" deck screws or 10d nails. Be sure to orient the plate so the stud layout faces down.

Hang a plumb bob from the edge of the top plate at several points along its length to find the sole plate location on the floor. The tip of the plumb bob should almost touch the floor. Wait until it stops moving before marking the sole plate reference point. Connect the points with a line to establish one edge of the sole plate. Use a piece of scrap 2X material as a template for marking the other edge.

Cut away the portion of the sole plate where the new door will be, and nail or screw the two sections to the floor between the sole plate layout lines. Use the cutaway door section as a spacer for the door when fastening the plates. Drive the fasteners into the floor framing. For concrete floors, attach the sole plate with a powder-actuated nail gun (see page 102) or with hardened masonry screws.

Measure the distance between the top and sole plates at several places along the wall to determine the stud lengths. The stud length distance may vary, depending on structural settling or an out-of-flat floor. Add ⅛" to the stud length(s), and cut them to size. The extra length will ensure a snug fit between the wall plates.

Use a hammer to tap each stud into position, then toenail the studs to the top and sole plates. You may need to first trim the stud slightly to improve the fit. Fit, trim, and nail the studs, one at a time. TIP: If the studs tend to shift during nailing, drive pilot holes for the nails first, or use 3" deck screws instead of nails. (Inset) An option for attaching wall studs to plates is to use metal connectors and 4d nails.

Nail the king studs, jack studs, a header and a cripple stud in place to complete the rough door framing. See page 110 for more information on framing a door opening.

If building codes in your area require fire blocking, install 2× cutoff scraps between the studs, 4 ft. from the floor, to serve this purpose. Stagger the blocks so you can endnail each piece.

Drill holes through the studs to create raceways for wiring and plumbing. When this work is completed, fasten metal protector plates over these areas to prevent drilling or nailing through wiring and pipes later. Have your work inspected before proceeding with wallboard.

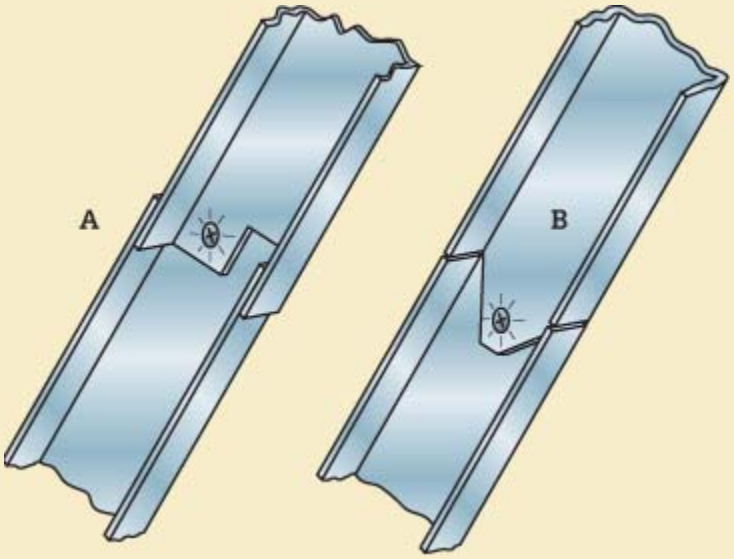
Cover the wall with wallboard. Plan the layout wisely to minimize waste and to avoid butted joints with untapered seams. If you are installing wallboard on a ceiling as well, do that first. For more on installing wallboard, see pages 128 to 135.

Tools & Materials for Framing with Steel

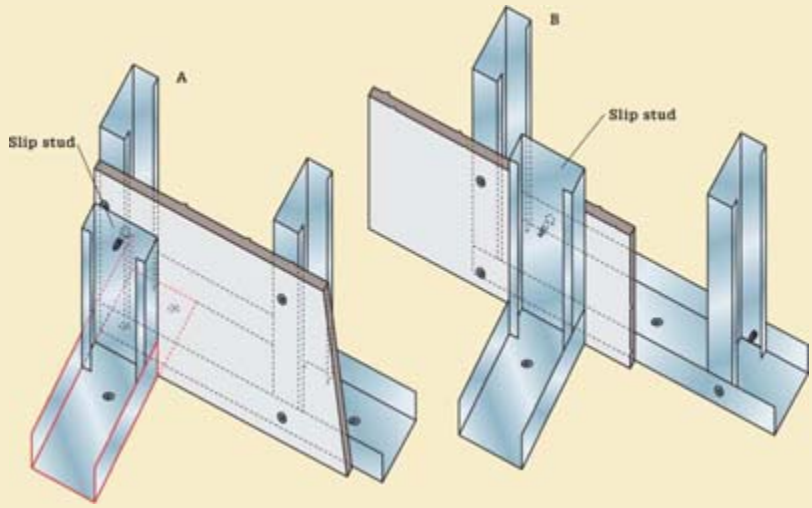
Steel framing requires a few specialty tools and materials. Aviation snips (A) are needed to cut tracks and studs, though a miter saw outfitted with a steel-cutting abrasive blade (B) can speed up the process. A drill or screw gun (C) is required for fastening framing. Handy for large projects, a stud crimper (D) creates mechanical joints between tracks and studs. Plastic grommets (E) are placed in knockouts to help protect utility lines. Protective eyewear and heavy work gloves (F, G) are necessities when working with the sharp edges of hand-cut steel framing. Use self-tapping screws (inset) to fasten steel components. To install wood trim, use type S trim-head screws (H); to fasten wallboard, type S wallboard screws (I); and to fasten studs and tracks together, 7/16" type S panhead screws (J).

Joining Sections Using Steel Studs

Steel studs and tracks have the same basic structure— a web that spans two flanged sides—however, studs also contain a ¼" lip to improve their rigidity.



Join sections with a spliced joint (A) or notched joint (B). Make a spliced joint by cutting a 2" slit in the web of one track. Slip the other track into the slit and secure with a screw. For a notched joint, cut back the flanges of one track and taper the web so it fits into the other track; secure with a screw.



Build corners using a slip stud: A slip stud is not fastened until the adjacent drywall is in place. Form L-shaped corners (A) by overlapping the tracks. Cut off the flange on one side of one track, removing enough to allow room for the overlapping track and drywall. Form a T-shaped corner (B) by leaving a gap between the tracks for the drywall. Secure each slip stud by screwing through the stud into the tracks of the adjacent wall. Also screw through the back side of the drywall into the slip stud, if possible. Where there’s no backing behind the slip stud, drive screws at a 45° angle through the back corners of the slip stud and into the drywall.

Building a Kneewall

Knee-walls are shortened versions of conventional walls that usually stand three to four feet tall. They typically fasten to an adjoining wall and tie into it with matching base moldings. The top surface may be trimmed with a wood cap and moldings or simply wrapped with wallboard. Kneewalls can also be constructed from glass block for a more contemporary look or modified into a deeper built-in display case or bookshelf.

From a design standpoint, a kneewall helps to divide a large room into smaller spaces without losing the openness of a large space. A pair of kneewalls can even provide an attractive entryway into a living or dining room if the ends terminate in matching posts. Depending on the house design, these posts could serve a load-bearing purpose as well. Large bathrooms can benefit from a kneewall that creates a modesty divider next to a toilet or bath changing area.

Kneewalls are straightforward projects that require only basic wall-building skills. You can even build the kneewall in the workshop and carry it to the job site for installation. Unless you are building a kneewall with a load-bearing post or installing wiring in it, there’s no need to get a permit or have the project inspected.

Tools & Materials

- Utility knife
- Tape measure
- Framing and combination squares
- Hammer or nail gun
- Nailset
- Drill/driver
- Level
- Wallboard finishing tools
- Framing lumber
- 10d nails or pneumatic framing nails
- Wallboard
- Wood casing material
- 6d finish nails or 16-gauge pneumatic brad nails
- Deck screws
- Construction adhesive
- Wallboard finishing supplies

How to Build a Kneewall

Mark the kneewall location on an adjacent wall. It helps to position the kneewall in front of a wall stud for convenient attachment.

Option: If you cannot hit a wall stud, you'll need to remove the wallboard between two wall studs and install blocking between them to bridge the cavity and create an attachment point. See "Removing a Non-loadbearing Wall," page 198.

Mark the kneewall layout area on the floor with masking tape, dark marker, or pencil lines. If the kneewall will be installed on a carpeted floor, cut out the carpet and pad within the layout lines. Use a sharp chisel to remove the carpet tack strip against the wall. Carefully pry off the wall base molding; you can reuse it if it doesn’t break.

Construct the kneewall frame from framing lumber. Build it with a top plate, sole plate, and studs, just as you would a conventional wall. Space the studs 16" on center. Keep in mind that top and sole plates will add height to the kneewall. Be sure to account for this when measuring the length of the kneewall studs.

Set the kneewall frame in position and check it for level. Shim beneath the sole plate, if necessary. Fasten the kneewall to the adjacent wall stud with 3" deck screws. Use shorter deck screws and a bead of construction adhesive to fasten the sole plate to the subflooring. Arrange the sole plate screws in a zigzag pattern for added strength. *(Note: If you're installing a kneewall over ceramic tile, drill pilot holes for attachment screws with a masonry bit to prevent cracking the tile.)*

Fasten wallboard to the sides and end of the kneewall (and over the top if the project does not include a wooden top cap). Nail strips of metal corner bead to the outside corners, then tape and mud the corners and seams (see pages 128 to 135). Prime and paint the wall coverings.

Nail a wooden top cap to the kneewall top plate with 6d casing nails or brads. Size the cap so it overhangs the wallboard and any moldings you plan to apply beneath it. Miter-cut these molding strips and install them beneath the top cap to hide the wallboard joint.

Cut and reinstall the moldings you removed earlier on the existing wall. Then wrap the base of the kneewall with mitered base moldings that match the room moldings.

Soundproofing Walls & Ceilings

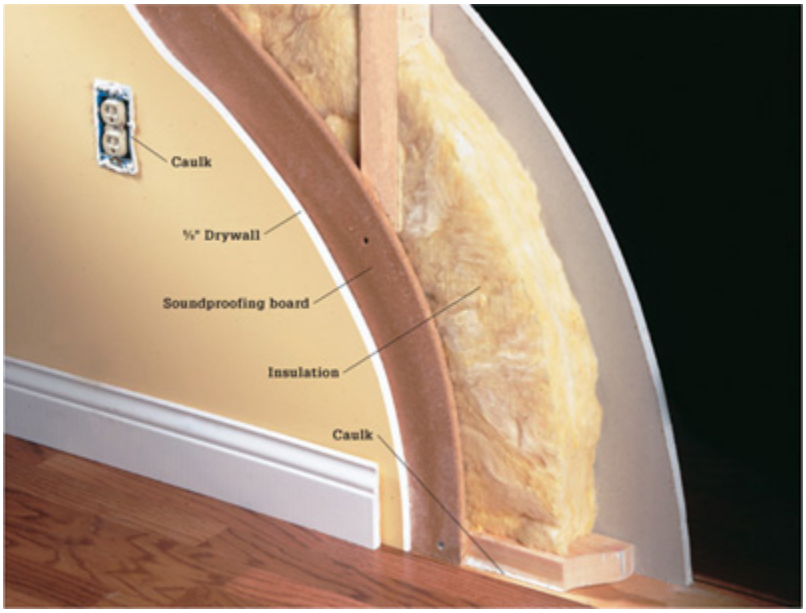
The best time to soundproof walls and ceilings is during construction, when the framing is accessible and soundproofing materials can be concealed inside the wall. Existing walls can be soundproofed by adding materials such as sound board or a layer of additional wallboard attached to resilient steel channels. Either of these methods will cushion the wall against noise transmission.

Walls and ceilings are rated for sound transmission by a system called Sound Transmission Class (STC). The higher the STC rating, the quieter the house. For example, if a wall is rated at 30 to 35 STC, loud speech can be understood through the wall. At 42 STC, loud speech is reduced to a murmur. At 50 STC, loud speech cannot be heard. Standard construction has a 32 STC rating, while soundproofed walls and ceilings can carry a rating of up to 48 STC.

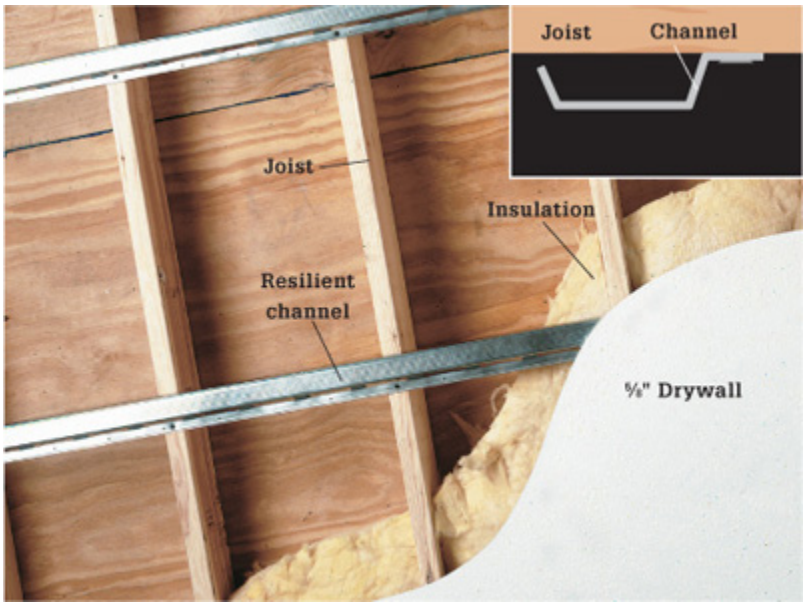
Tip: When building new walls, caulk along the floor and ceiling joints to reduce sound transmission.

Tools & Materials

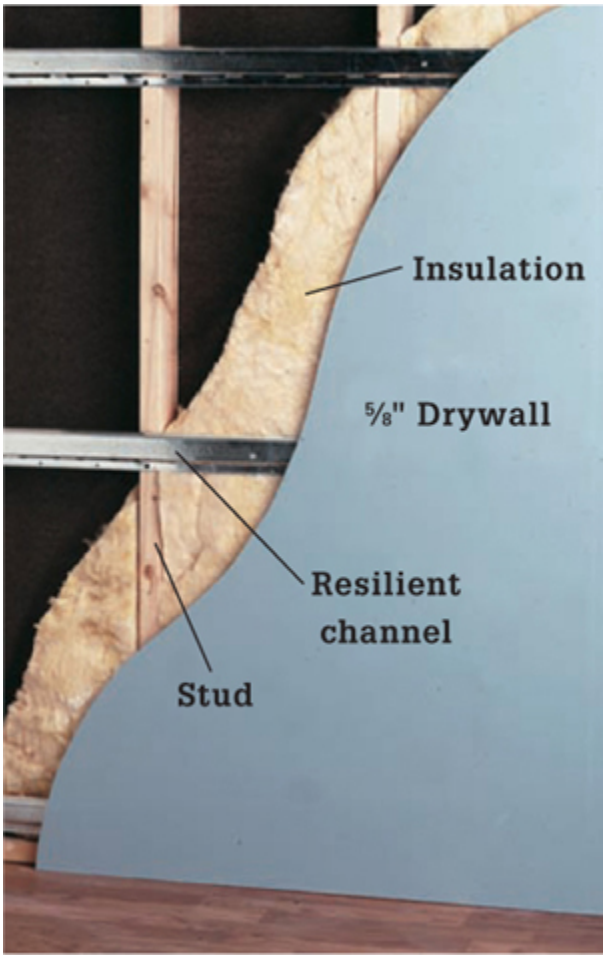
- 2 × 6 lumber for top and sole plates
- Fiberglass batt insulation
- Sound board
- Drill
- Drive bits
- Resilient steel channels
- ⅝" wallboard
- Construction adhesive
- Caulk
- Caulk gun
- 1½" and 1" wallboard screws


Caulk
⅝" Drywall
Soundproofing board
Insulation
Caulk

How to Install Resilient Steel Channels



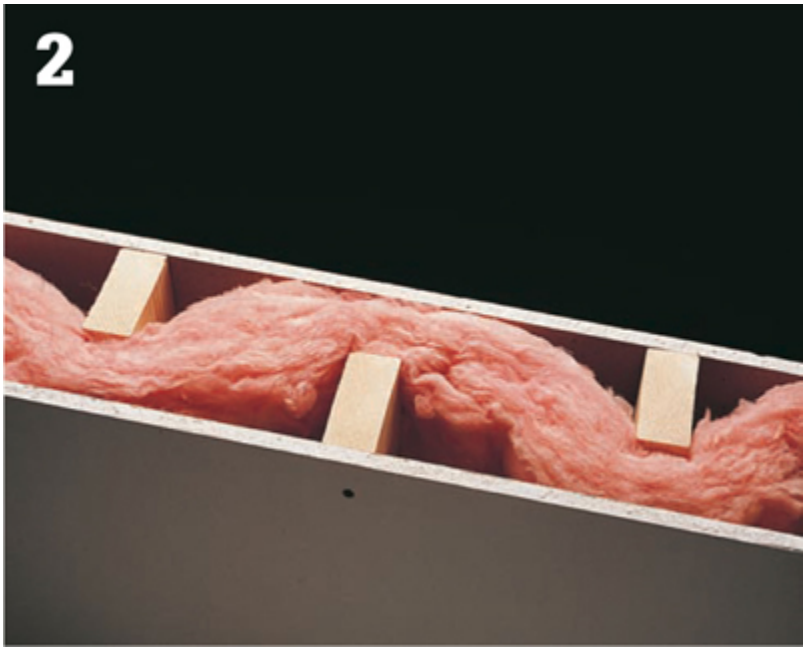
On ceilings, install channels perpendicular to the joists, spaced 24" on center. Fasten at each joist with 1¼" type W drywall screws, driven through the channel flange. Stop the channels 1" short of all walls. Join pieces on long runs by overlapping the ends and fastening through both pieces. Insulate the joist bays with R-11 unfaced fiberglass or other insulation and install ⅝" fire-resistant drywall, run perpendicular to the channels. For double-layer application, install the second layer of drywall perpendicular to the first.



On walls, use the same installation techniques as with the ceiling application, installing the channels horizontally. Position the bottom channel 2" from the floor and the top channel within 6" of the ceiling. Insulate the stud cavities and install the drywall vertically.

How to Build Staggered-stud Partition Walls

Frame new partition walls using 2 × 6 plates. Space the studs 12" apart, staggering them so alternate studs are aligned with opposite sides of the plates. Seal under and above the plates with acoustic sealant.



Weave R-11 unfaced fiberglass blanket insulation horizontally between the studs. Cover each side with one or more layers of ⅝" fire-resistant drywall.

Installing Wallboard

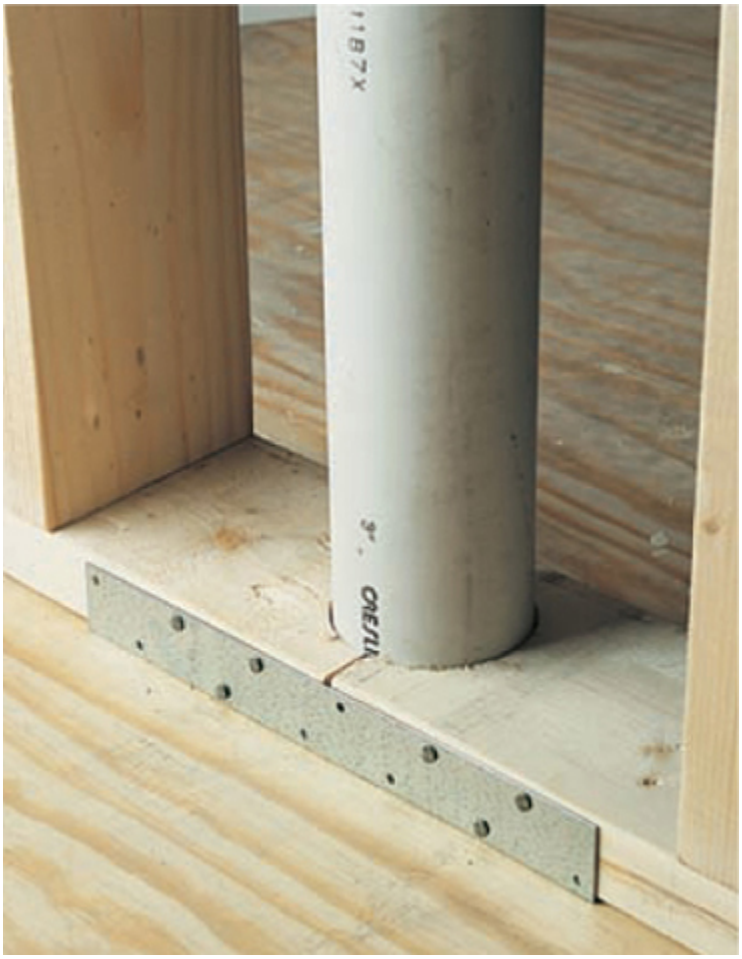
Hanging wallboard is a project that can be completed quickly and easily with a little preplanning and a helping hand.

Planning the layout of panels will help you reduce waste and deal with problem areas. Where possible, install full panels perpendicular to the framing to add strength and rigidity to walls and ceilings. To save yourself time and trouble during the finishing process, avoid joints where two untapered panel ends arebutted together. These are difficult to finish because there’s no recess for the compound and tape. In small areas, install long sheets horizontally that run the full length of the walls. Or hang the panels vertically, which produces more seams that need taping but eliminates butted end joints. If butted joints are unavoidable, stagger the seams and locate them away from the center of the wall, or install back blocking to help mask unflattering effects.

Tools & Prep work

Tools for installing wallboard include: chalkline (A), surform plane (B), compass (C), wallboard compass (D), protective masks (E), drill with hole saw (F), trim router (G), drywall gun (H), utility knife (I), eye protection (J), tape measure (K), wallboard lifter (L), caulk gun (M), pry bar (N), wallboard saw (O), keyhole saw (P), framing square (Q), level (R), wallboard T-square (S).

Preparing for Wallboard Installation



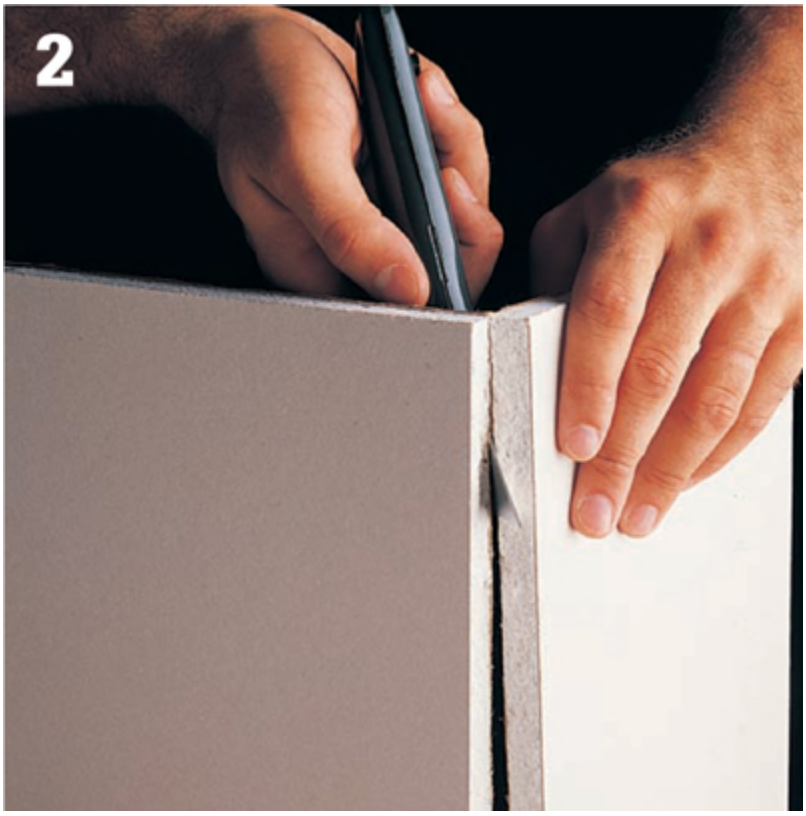
Use protector plates where wires or pipes pass through framing members less than 1¼" from the face. The plates prevent wallboard screws from puncturing wires or pipes.

Nail furring strips to the framing to extend the wall surface beyond any obstructions such as water pipes or heating ducts.

Mark the locations of the studs on the floor with a carpenter's pencil or masking tape. After wallboard covers the studs, the marks indicate the stud locations.

How to Cut Wallboard

Position the wallboard T-square with the short arm flush against the edge. Use a utility knife to score the wallboard face paper along the arm of the square at the cutting point.



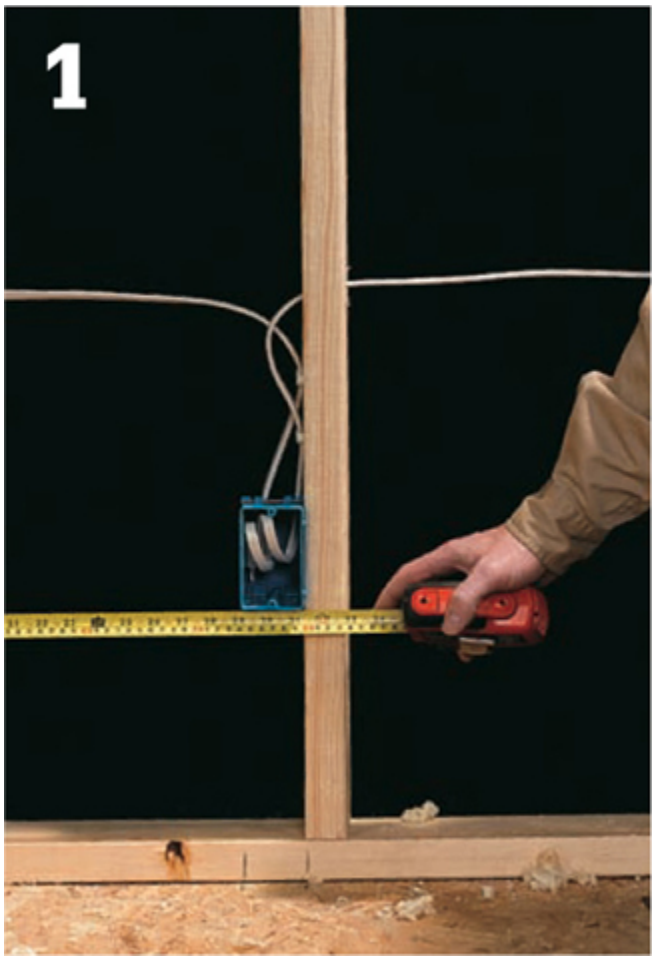
Bend the scored section with both hands to break the plaster core of the wallboard. Fold back the unwanted piece and cut through the back paper to separate the pieces.

Making Straight Cuts

Smooth rough edges with a drywall rasp. One or two passes with the rasp should be sufficient. To help fit a piece into a tight space, bevel the edge slightly toward the back of the panel.

Where untapered panel ends will be butted together, bevel-cut the outside edges of each panel at 45°, removing about ⅛" of material. This helps prevent the paper from creating a ridge along the seam. Peel off any loose paper from the edge.

How to Cut an Electrical Box Opening: Coordinate Method

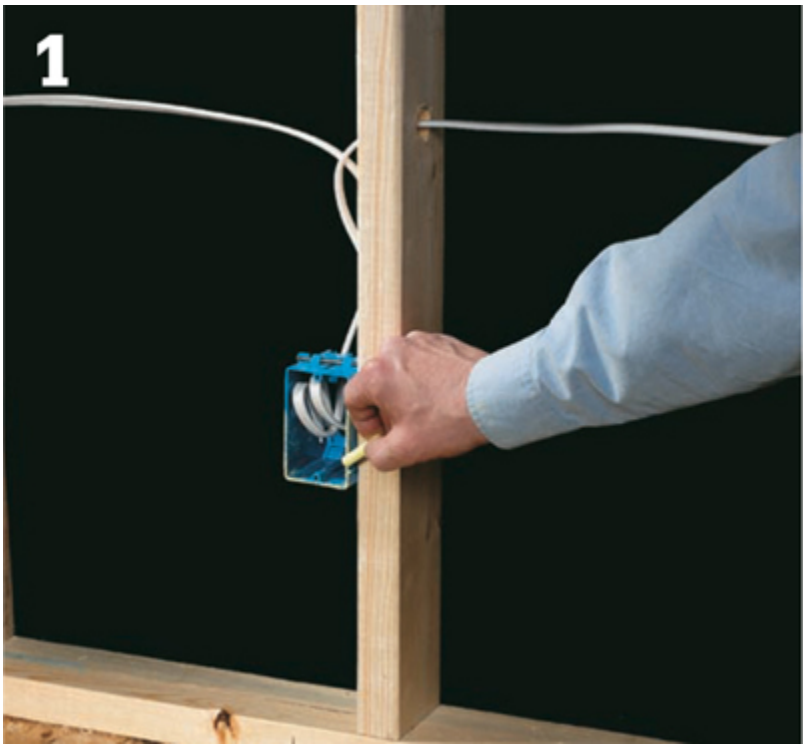


Locate the four corners of the box by measuring from the nearest fixed edge—a corner, the ceiling, or the edge of an installed panel—to the outside edges of the box.

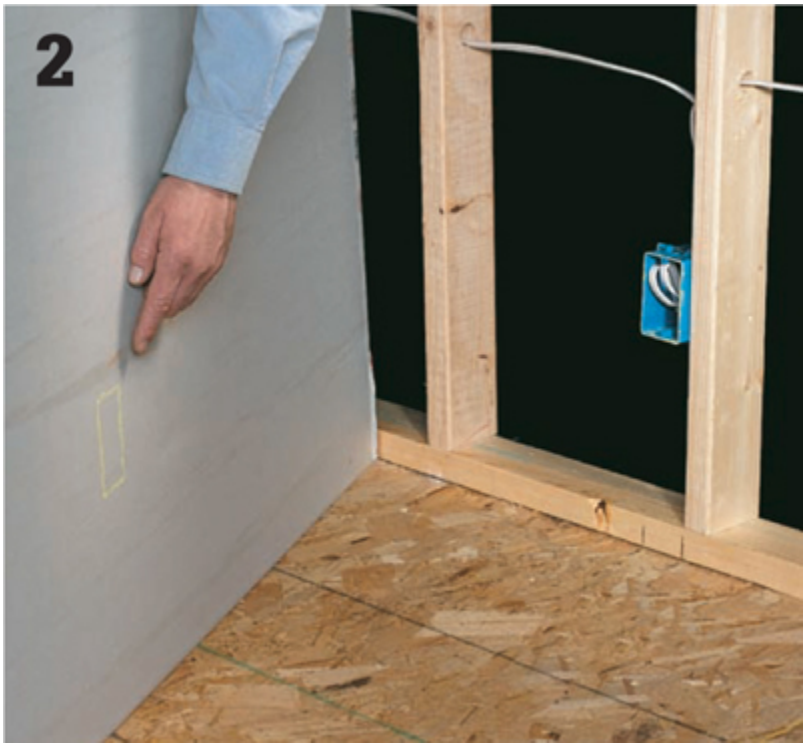
Transfer the coordinates to the panel and connect the points, using a T-square. Measure from the panel edge that will abut the fixed edge you measured from. If the panel has been cut short for a better fit, make sure to account for this in your measurements

Drill a pilot hole in one corner of the outline, then make the cutout with a keyhole saw.

How to Cut an Electrical Box Opening: Chalk Method



Rub the face of the electrical box with chalk, then carefully position the panel where it will be installed, and press it against the box.



Pull the panel back from the wall; a chalk outline of the box is on the back of the panel. Drill a pilot hole in one corner of the outline, then make the cut with a keyhole saw.

How to Install Wallboard on Flat Ceilings

Snap a chalk line perpendicular to the joists, 48⅛" from the starting wall.

Measure to make sure the first panel will break on the center of a joist, if necessary, cut the panel on the end that abuts the side wall so the panel breaks on the next farthest joist. Load the panel onto a rented drywall lift, or use a helper, and lift the panel flat against the joists.

Position the panel with the leading edge on the chalk line and the end centered on a joist. Fasten the panel with appropriately sized screws driven every 12" along the joists.

After the first row of panels is installed, begin the next row with a half-panel. This ensures that the butted end joints will be staggered between rows.

Tip

Drywall stilts bring you within reach of ceilings, so you can fasten and finish the drywall without a ladder. Stilts are commonly available at rental centers and are surprisingly easy to use.

How to Install Wallboard on Walls

Plan wallboard placement so joints do not fall at the corners of doors or windows. Wallboard joints at corners often crack and cause bulges that interfere with miter joints in window or door trim.

With a helper or a wallboard lift, hoist the first panel tight against the ceiling, making sure the side edge is centered on a stud. Push the panel flat against the framing and drive the starter screws to secure the panel. Make any cutouts, then fasten the field of the panel with drywall screws driven every 12".

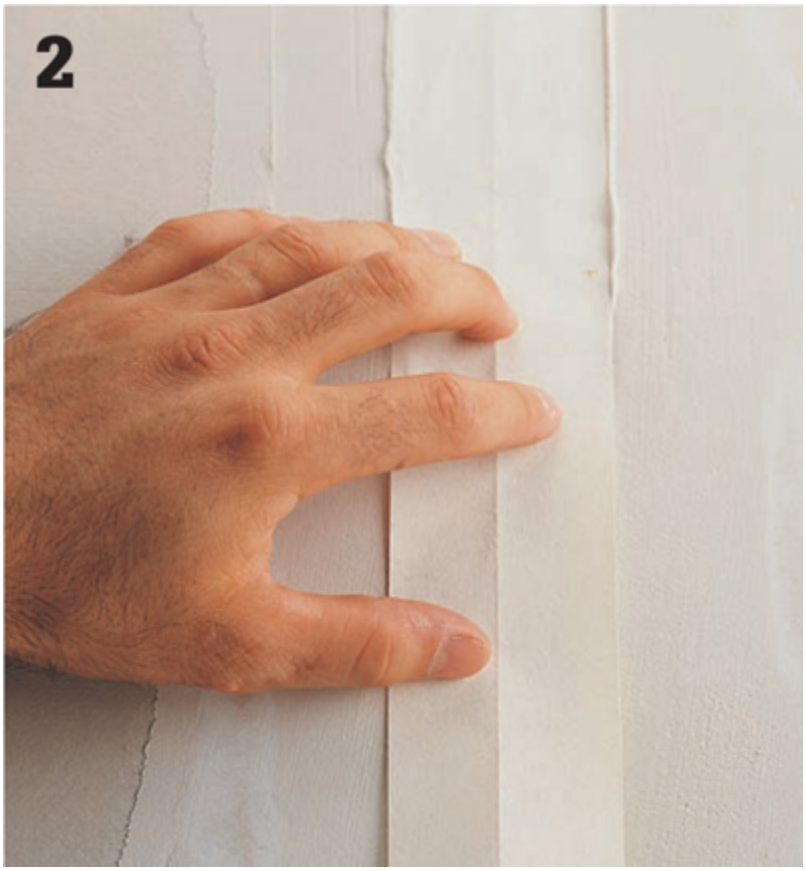
Measure, cut, and install the remaining panels along the upper wall. Bevel panel ends slightly, leaving a ⅛" gap between them at the joint. Butt joints can also be installed using back blocking to create a recess.

Measure, cut, and install the bottom row, butting the panels tight to the upper row and leaving a ½" gap at the floor. Secure to the framing along the top edge using the starter screws, then make all cutouts before fastening the rest of the panel.

Variation: When installing wallboard vertically, cut each panel so it’s ½" shorter than the ceiling height to allow for expansion. (The gap will be covered by base molding.) Avoid placing tapered edges at outside corners; they are difficult to finish.

How to Tape Wallboard Joints

Apply a thin layer of wallboard compound over the joint with a 4" or 6" wallboard knife. To load the knife, dip it into a pan filled with wallboard compound.



Press the wallboard tape into the compound immediately, centering the tape on the joint. Wipe away the excess compound and smooth the joint with a 6" knife. Let dry overnight.

Apply a thin finish coat of compound with a 10" wallboard knife. Allow the second coat to dry and shrink overnight. Apply the last coat and let it harden slightly before wet-sanding.

Tip

Use premixed wallboard compound for most taping and finishing jobs to eliminate mixing. Use paper wallboard tape when using premixed wallboard compound.

How to Finish inside Corners

Fold a strip of paper wallboard tape in half by pinching the strip and pulling it between thumb and forefinger. Apply a thin layer of wallboard compound to both sides of the inside corner, using a 4" wallboard knife.

Position the end of the folded tape strip at the top of the joint and press the tape into the wet compound with the knife. Smooth both sides of the corner. Finish as described in step 3, preceding page.

How to Finish Outside Corners

Position corner bead on outside corners. Using a level, adjust the bead so corner is plumb. Attach with 1¼" wallboard nails or screws spaced at 8" intervals. (Some corner beads are fastened with wallboard compound.)

Cover the corner bead with three coats of wallboard compound, using a 6" or 10" wallboard knife. Let each coat dry and shrink overnight before applying the next coat. Smooth the final coat with a wet sander.

Tip

Sand joints lightly after wallboard compound dries. Use a pole sander to reach high areas without a ladder. Wear a dust mask when dry-sanding.

Installing Interior Doors

Creating an opening for a door in a wall involves building a framework about 1" wider and ½" taller than the door’s jamb frame. This oversized opening, called a rough opening, will enable you to position the door easily and shim it plumb and level. Before framing a door, it’s always a good idea to buy the door and refer to the manufacturer’s recommendations for rough opening size.

Door frames consist of a pair of full-length king studs and two shorter jack studs that support the header above the door. A header provides an attachment point for wallboard and door casings. On load-bearing walls, it also helps to transfer the building’s structural loads from above down into the wall framework and eventually the foundation.

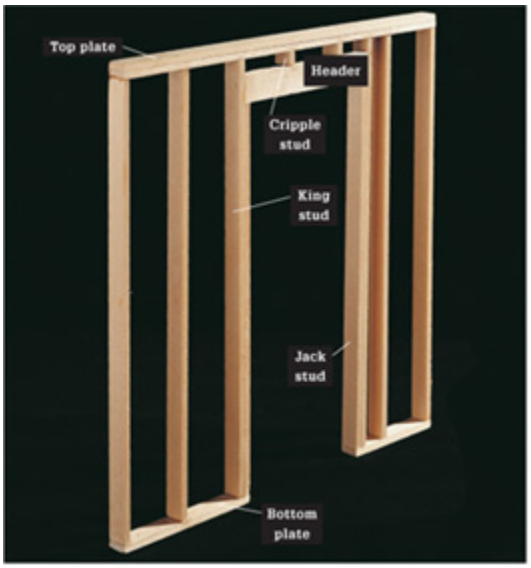
Door framing requires flat, straight, and dry framing lumber, so choose your king, jack, and header pieces carefully. Sight down the edges and ends to look for warpage, and cut off the ends of pieces with splits.

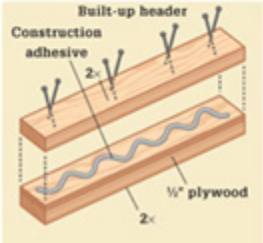
Tools & Materials

- Tape measure
- Framing square
- Hammer or nail gun
- Handsaw or reciprocating saw
- Framing lumber
- 10d or pneumatic framing nails
- 3/8" plywood (for structural headers)
- Construction adhesive

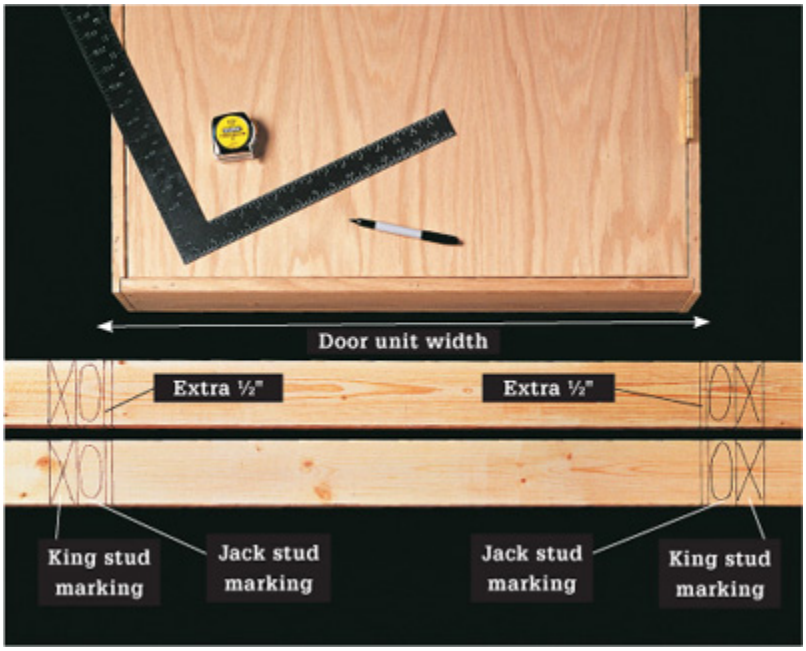
Creating a square, properly sized opening for a door is the most important element of a successful door installation project.

How to Frame a Rough Opening for an Interior Prehung Door





Door frames for prehung doors (photo) start with king studs that attach to the top and bottom plates. Inside the king studs, jack studs support the header at the top of the opening. Cripple studs continue the wall-stud layout above the opening. In non-loadbearing walls, the header may be a 2 × 4 laid flat or a built-up header (illustration). The dimensions of the framed opening are are referred to as the rough opening.



To mark the layout for the door frame, measure the width of the door unit along the bottom. Add 1" to this dimension to determine the width of the rough opening (the distance between the jack studs). This gives you a ½" gap on each side for adjusting the door frame during installation. Mark the top and bottom plates for the jack and king studs.

How to Frame a Prehung Door Opening

Mark layout lines for the king and jack studs on the wall's top and sole plates (see page 137). Cut the king studs slightly longer than the distance between the wall plates, and toenail them in place with 10d nails or 3" pneumatic nails.

Cut the jack studs to length (they should rest on the sole plate). The height of a jack stud for a standard interior door is 83½", or ½" taller than the door. Nail the jack studs to the king studs.

In a non-loadbearing wall, the header can be a piece of 2x framing lumber that lays flat on top of the jack studs. Cut it to length, and install by endnailing through the king studs or down into the jack studs.

Fasten a cripple stud above the header halfway between the king studs. It will prevent the header from warping. Toenail it into the top plate, and drive nails into it through the header.

If you haven't cut a sole plate opening for the door yet, do that now with a reciprocating saw or handsaw. Trim the sole plate flush with the jack studs.

How to Frame an Opening for a Load-bearing Wall

Door framing on load-bearing walls will require a structural header that transfers loads above the wall into the jack studs, sole plate, and down into the house foundation. Build it by sandwiching a piece of 38" plywood between two 2 × 4s. Use construction adhesive and nails to fasten the header together.

Install the built-up header by resting it on the jack studs and endnailing through the king studs. Use 10d nails or 3" pneumatic nails.

Toenail a cripple stud between the top plate and header, halfway between the king studs. It transfers structural loads into the header.

Option: Framing Openings for Sliding & Folding Doors

The same basic framing techniques are used, whether you're planning to install a sliding, bifold, pocket, or prehung interior door. The different door styles require different frame openings. You may need to frame an opening 2 to 3 times wider than the opening for a standard prehung door. Purchase the doors and hardware in advance, and consult the hardware manufacturer's instructions for the exact dimensions of the rough opening and header size for the type of door you select.

Most bifold doors are designed to fit in a 80"-high finished opening. Wood bifold doors have the advantage of allowing you to trim the doors, if necessary, to fit openings that are slightly shorter.

Installing a Prehung Interior Door

Install prehung interior doors after the framing work is complete and the wallboard has been installed. If the rough opening for the door has been framed accurately, installing the door takes about an hour.

Standard prehung doors have 4½"-wide jambs and are sized to fit walls with 2×4 construction and ½" wallboard. If you have 2×6 construction or thicker wall surface material, you can special-order a door to match, or you can add jamb extensions to a standard-sized door (photo).

Tools & Materials

Level	Prehung interior door
Hammer	Wood shims
Handsaw	8d casing nails

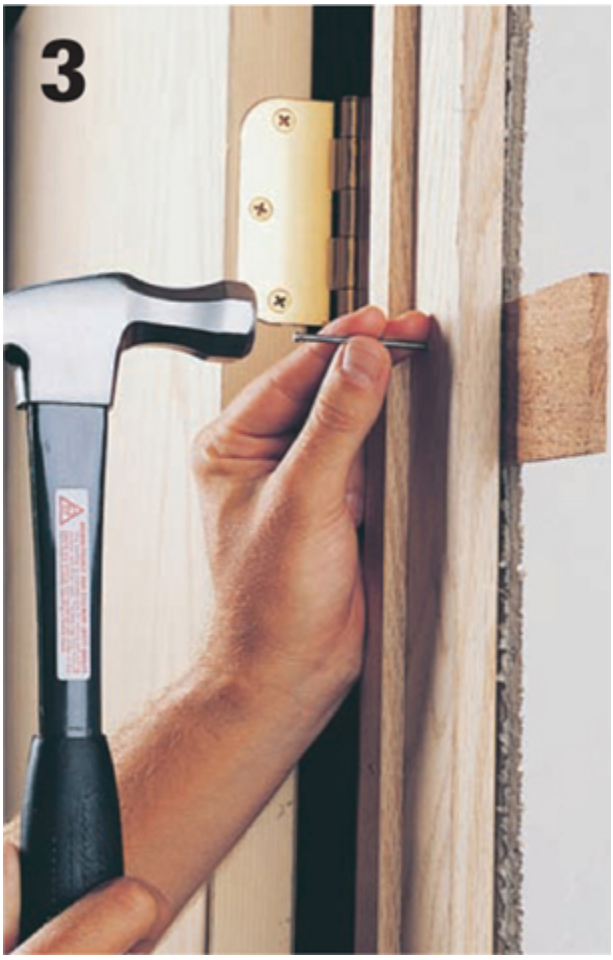
Tip

If your walls are built with 2 × 6 studs, you'll need to extend the jambs by attaching 1"-thick wood strips to the edges of the jamb after the door is installed. Use glue and 4d casing nails when attaching jamb extensions. Make the strips from the same wood as the jamb.

How to Install a Prehung Interior Door

Slide the door unit into the framed opening so the edges of the jambs are flush with the wall surface and the hinge-side jamb is plumb.

Insert pairs of wood shims driven from opposite directions into the gap between the framing members and the hinge-side jamb, spaced every 12". Check the hinge-side jamb to make sure it is still plumb and does not bow.



Anchor the hinge-side jamb with 8d casing nails driven through the jamb and shims and into the jack stud.

Insert pairs of shims in the gap between the framing members and the latch-side jamb and top jamb, spaced every 12". With the door closed, adjust the shims so the gap between door edge and jamb is ⅛" wide. Drive 8d casing nails through the jambs and shims, into the framing members.

Cut the shims flush with the wall surface, using a handsaw. Hold the saw vertically to prevent damage to the door jamb or wall. Finish the door and install the lockset as directed by the manufacturer. See pages 152 to 155 to install trim around the door.

Shortening an Interior Door

Prehung interior doors should allow a ¾" gap between the bottom of the door and the floor. This gap lets the door swing without binding on carpet or floor covering. If a thicker carpet or a larger threshold is installed, the door may need to be shortened.

Shortening a hollow-core door requires a few more steps because the door consists of multiple pieces. Depending on the width of the cut, the pieces may need to be cut and then reassembled.

If the door is solid wood, material can usually be removed by planing the edge, using a hand plane or power plane.

Hollow-core doors have solid wood frames with hollow center cores. If the entire frame member is cut away when shortening a door, it can be reinserted to close the hollow door cavity. Measure carefully when marking a door for cutting.

Tools & Materials

Tape measure	Circular saw
Hammer	Chisel
Screwdriver	Straightedge
Utility knife	Clamps
Sawhorses	Carpenter's glue

How to Cut Off a Hollow-core Interior Door

With the door in place, measure ⅜" up from the top of the floor covering and mark the door. Remove the door from the hinges by tapping out the hinge pins with a screwdriver and a hammer.

Mark the cutting line. Cut through the door veneer with a sharp utility knife to prevent it from chipping when the door is sawed.

Lay the door on sawhorses and clamp a straightedge to the door as a cutting guide.

Saw off the bottom of the door. The hollow core of the door may be exposed.

To reinstall a cutoff frame piece in the bottom of the door, chisel the veneer from both sides of the removed portion.

Apply wood glue to the cutoff frame, insert the frame piece into the opening of the door and clamp it. Wipe away any excess glue and let the door dry overnight.

Hanging a New Door in an Old Jamb

If you've got an unsightly or damaged door to replace but the jamb and trimwork are in good condition, there's no need to remove the jambs. Instead, buy a slab door and hang it in the existing jamb. It's an excellent way to preserve existing moldings and trim, especially if you live in an old home, and you won't have to color-match a new jamb to its surroundings.

If the hinges are also in good condition, you can reuse them as well. This may be particularly desirable in a historic home with ornate hinges. Most home centers stock six-panel slab doors, or you can order them in a variety of styles and wood types. For aesthetic and practical reasons, choose a door size as close to the original door as possible.

The process for hanging the door involves shimming the door into position in the jamb, scribing the ends and edges, and trimming or planing it to fit the opening. You'll also need to chisel hinge mortises in the door edge to accommodate the jamb hinge positions.

This is a project where patience and careful scribing will pay dividends in the end. Have a helper on hand to hold the door in position as you scribe and fit the door in place.

Tools & Materials

- Door shims
- Tape measure
- Compass
- Combination square
- Utility knife
- Circular saw
- C-clamps
- Self-centering drill bit
- Power plane or hand plane
- Hammer
- Chisel
- Drill/driver
- Hole saw
- Spade bit
- Slab door
- Hinge screws

By installing a new door in an old jamb, an entranceway can instantly be transformed.

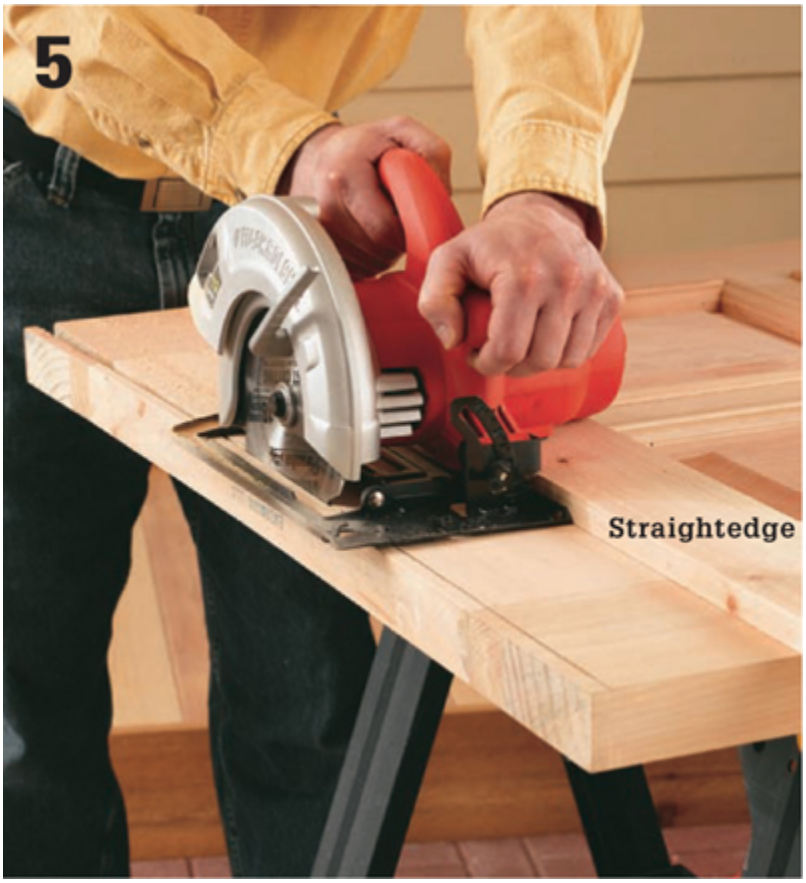
How to Hang a New Door in an Old Jamb

Have a helper hold the new door in place against the jamb from inside the room (into which the door will swing). Slide a pair of thick shims under the door to raise it up slightly off the floor or threshold. Move the shims in or out until the door's top and side rails are roughly even with the jamb so it looks balanced in the opening.

Use pieces of colored masking tape to mark the outside of the door along the hinge edge. This will help keep the door’s orientation clear throughout the installation process.

Use a pencil compass, set to an opening of 3/16" to scribe layout lines along both long edges of the door and across the top. These lines will create a clear space for the hinges and door swing. If the bottom of the door will close over carpet, set the dividers for ½" and scribe the bottom edge. Remove the door and transfer these scribe lines to the other door face.

Lay the door on a sturdy bench or across a pair of sawhorses with the tape side facing up. Score the top and bottom scribe lines with a utility knife to keep the wood fibers from splintering when you cut across the ends.



Trim the door ends with a circular saw equipped with a fine-cutting blade. Run the saw base along a clamped straightedge with the blade cutting 1/16" on the waste side of the layout lines. Check to make sure the blade is set square to the saw base before cutting. Use a power planer or hand plane to plane the door ends to the layout lines.

Stand the door on edge and use a power planer or hand plane to plane down to the edge scribe lines. Set the tool for a fine cut; use a 1/16" cutting depth for power planing and a shallower cutting depth for a hand plane. Try to make each planing pass in long strokes from one end of the door to the other.

Shim the door back into position in the jamb, with a helper supporting it from behind. Set the door slightly out from the doorstop moldings so you can mark the hinge locations on the door face.

Use a combination square or one of the hinge leaves to draw hinge mortise layout lines on the door edge. Score the layout lines with a utility knife.

Cut shallow hinge leaf mortises in the door edge with a sharp chisel and hammer. First score the mortise shape with a straightedge and utility knife or a chisel, then make a series of shallow chisel cuts inside the hinge leaf area. Pare away this waste so the mortise depth is slightly deeper than the hinge leaf thickness.

Set the hinges in the door mortises, and drill pilot holes for the hinge screws. Attach the hinges to the door.

Hang the door in the jamb by tipping it into place so the top hinge leaf rests in the top mortise of the jamb. Drive one screw into this mortise. Then set the other leaves into their mortises and install the remaining hinge screws.

Bore holes for the lockset and bolt using a hole saw and spade bit. If you're re-using the original hardware, measure the old door hole sizes and cut matching holes in the new door, starting with the large lockset hole. For new locksets, use the manufacturer's template and hole sizing recommendations to bore the holes. Install the hardware.

Mounting Bifold Doors

Bifold doors provide easy access to a room or area without requiring much clearance for opening. They are a convenient addition to closets, as well as a clever way to conceal a utility room or washing machine and clothes dryer.

Most home centers stock kits that include two pairs of prehinged doors, a head track, and all the necessary hardware and fasteners. Typically, the doors in these kits have predrilled holes for the pivot and guide posts. Hardware kits are also sold separately for custom projects.

A variety of door styles are available, some featuring louvered panels or glass panes. Most doors are designed to fit a standard 80-inch opening, but if the floor is carpeted or tiled, you may need to trim them. Make minor adjustments using a plane, and larger alterations with a circular saw and straightedge (pages 142 to 143).

To operate properly, bifold doors must be hung level and plumb in the opening. Before installation begins, make sure the opening has square corners, a level header, and straight jambs.

Allow a minimum clearance gap of ⅛" between the doors at the center, hinges, and jambs to prevent binding.

Installing bifold doors is an easy task, though just as there are many door styles, there are also many types of mounting hardware. Make sure to read and follow the manufacturer’s instructions for the product you use. Most models operate by means of a two-post system: pivot posts on each jamb-side door and a top guide post on each lead door. The top posts fit in the track at the header, while the pivot post fits into an anchor bracket at the foot of each jamb, providing a pivot point.

After the doors are installed, the top and bottom pivots can be adjusted to align the doors. Adjustments to door height typically require turning the bottom pivot clockwise to lower the door and counterclockwise to raise it. To align the doors vertically, loosen the screw in the top guide post and slide it left or right. Some jamb brackets also allow the bottom pivot post to be repositioned along the length of the bracket for additional vertical adjustment.

Tools & Materials

Tape measure	Prehinged bifold doors
Circular saw	Head track
Drill	Mounting hardware
Plane	Panhead screws
Screwdriver	Flathead screws
Hacksaw	

A variety of designer bifold doors are available for installation between rooms. They provide the same attractive appearance as French doors but require much less floor space.

How to Mount Bifold Doors

Cut the head track to the width of the opening, using a hacksaw. Insert the roller mounts into the track, then position the track in the opening. Fasten it to the header, using panhead screws.

Measure and mark each side jamb at the floor for the anchor bracket, so the center of the bracket aligns exactly with the center of the head track. Fasten the brackets in place with flathead screws.

Check the height of the doors in the opening, and trim if necessary. Insert a pivot post into predrilled holes at the top and bottom of the two jamb-side doors, at the jamb side of each door. Make sure the pivot posts fit snugly.

Insert a guide post into the predrilled holes at the top of both lead doors. Make sure the guide posts fit snugly.

Fold one pair of doors closed and lift into position, inserting the pivot and guide posts into the head track. Slip the bottom pivot post into the anchor bracket. Repeat for the other pair of doors.

Close the doors and check for equal spacing along the side jambs and down the center. To align the doors, adjust the top and bottom pivots following the manufacturer’s directions.

Installing a Storm Door

Install a storm door to improve the appearance and weather resistance of an old entry door or to protect a newly installed door against weathering. In all climates, adding a storm door can extend the life of an entry door.

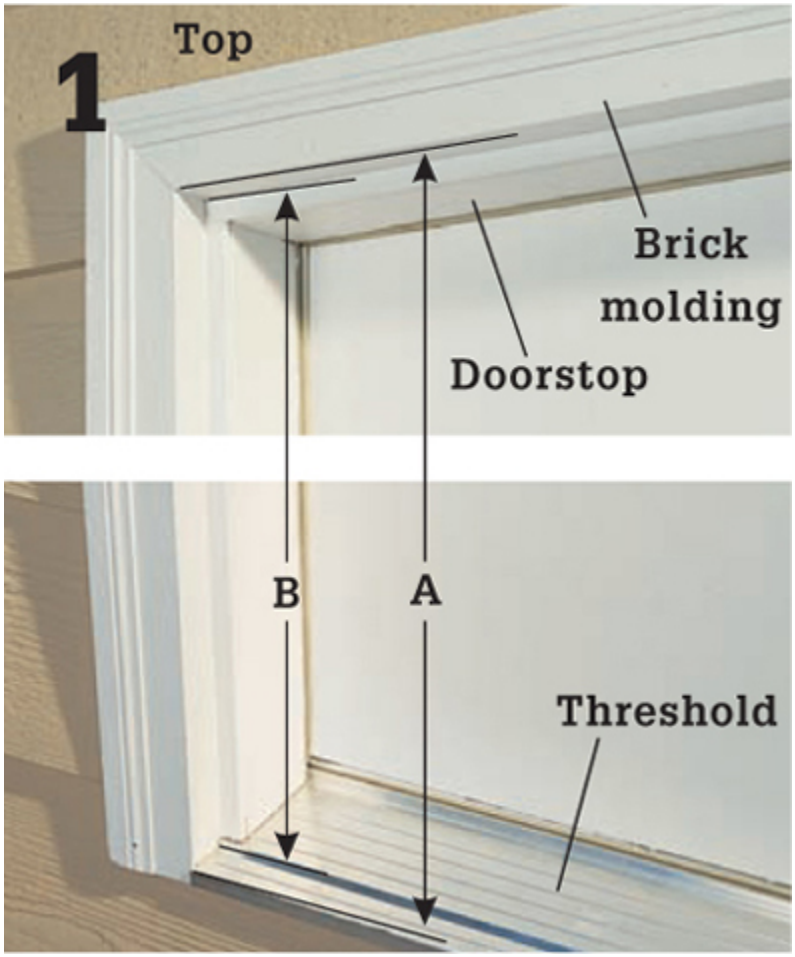
When buying a storm door, look for models that have a solid inner core and seamless outer shell construction. Carefully note the dimensions of your door opening, measuring from the inside edges of the entry door's brick molding. Choose a storm door that opens from the same side as your entry door.

Tools & Materials

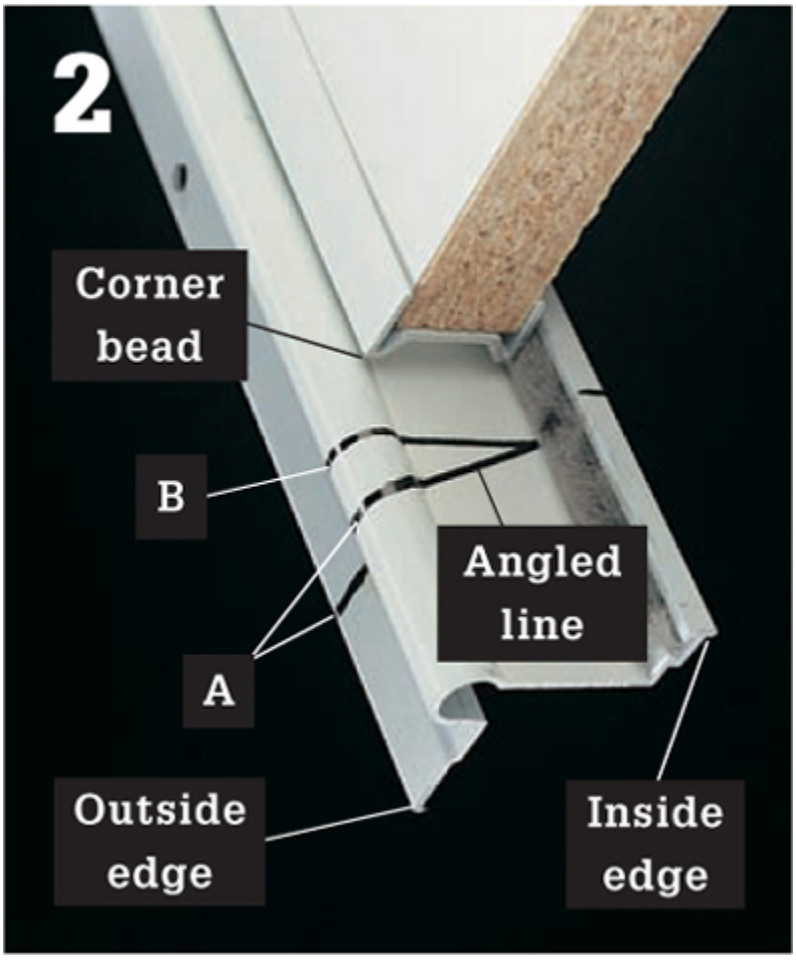
Tape measure	Drill and bits
Pencil	Screwdrivers
Plumb bob	Storm door unit
Hacksaw	Wood spacer strips
Hammer	4d casing nails

Adjustable sweeps help make storm doors weathertight. Before installing the door, attach the sweep to the bottom of the door. After the door is mounted, adjust the height of the sweep so it brushes the top of the sill lightly when the door is closed.

How to Cut a Storm Door Frame to Fit a Door Opening



Because entry door thresholds are slanted, the bottom of the storm door frame needs to be cut to match the threshold angle. Measure from the threshold to the top of the door opening along the corner of the brick molding (A), then measure along the front edge of the entry doorstop (B).



Subtract ⅛" from measurements A and B to allow for small adjustments when the door is installed. Measuring from the top of the storm door frame, mark the adjusted points A and B on the corner bead. Draw a line from point A to the outside edge of the frame and from point B to the inside edge. Draw an angled line from point A on the corner bead to point B on the inside edge.

Use a hacksaw to cut down through the bottom of the storm door frame, following the angled line. Make sure to hold the hacksaw at the same slant as the angled line to ensure that the cut will be smooth and straight.

How to Fit & Install a Storm Door

Position the storm door in the opening and push the frame tight against the brick molding on the hinge side of the storm door, then draw a reference line on the brick molding, following the edge of the storm door frame.

Push the storm door frame tight against the brick molding on the latch side, then measure the gap between the reference line and the hinge side of the door frame. If the distance is greater than ⅜" spacer strips must be installed to ensure the door will fit snugly.

To install spacers, remove the door, then nail thin strips of wood to the inside of the brick molding at storm door hinge locations. The thickness of the wood strips should be ⅛" less than the gap measured in step 2.

Replace the storm door and push it tight against the brick molding on the hinge side. Drill pilot holes through the hinge-side frame of the storm door and into the brick molding spaced every 12". Attach the frame with mounting screws.

Remove any spacer clips holding the frame to the storm door. With the storm door closed, drill pilot holes and attach the latch-side frame to the brick molding. Use a coin to keep an even gap between the storm door and the storm door frame.

Center the top piece of the storm door frame on top of the frame sides. Drill pilot holes and screw the top piece to the brick molding. Adjust the bottom sweep, then attach the locks and latch hardware as directed by the manufacturer.

Installing Door & Window Casings

Door and window casings provide an attractive border around doors and windows. They also cover the gaps between door or window jambs and the surfaces of surrounding walls.

Install door and window casings with a consistent reveal between the inside edges of the jambs and casings, making sure the casings are level and plumb.

In order to fit casings properly, the jambs and wallcoverings must lie in the same plane. If either one protrudes, the casings will not lie flush. To solve this problem, you'll need to remove some material from whichever surface is protruding.

Use a block plane to shave protruding jambs or a surface forming rasp to shave a protruding wallboard edge (page 130). Wallboard screws rely on the strength of untorn facing paper to support the wallboard. If the paper around the screws is damaged, drive additional screws nearby where the paper is still intact.

Tools & Materials

- Tape measure
- Pencil
- Combination square
- Nail set
- Level
- Straightedge
- Power miter saw
- Hammer or pneumatic nailer
- Casing material
- Plinths and corner blocks (optional)
- 4d and 6d finish nails
- Wood putty

How to Install Mitered Casing on Doors & Windows

On each jamb, mark a reveal line ⅛" from the inside edge. The casings will be installed flush with these lines. Note: *On double-hung windows, the casings are usually installed flush with the edge of the jambs, so no reveal line is needed.*

Place a length of casing along one side jamb, flush with the reveal line. At the top and bottom of the molding, mark the points where horizontal and vertical reveal lines meet. (When working with doors, mark the molding at the top only).

Make 45° miter cuts on the ends of the moldings (page 84). Measure and cut the other vertical molding piece, using the same method.

Drill pilot holes spaced every 12" to prevent splitting and attach the vertical casings with 4d finish nails driven through the casings and into the jambs. Drive 6d finish nails into framing members near the outside edge of the casings.

Measure the distance between the side casings, and cut top and bottom casings to fit, with ends mitered at 45°. If window or door unit is not perfectly square, make test cuts on scrap pieces to find the correct angle of the joints. Drill pilot holes and attach with 4d and 6d finish nails.

Locknail the corner joints by drilling pilot holes and driving 4d finish nails through each corner, as shown. Drive all nail heads below the wood surface, using a nail set, then fill the nail holes with wood putty.

How to Install Butted Door Casings

On each jamb, mark a reveal line ⅛" from the inside edge. The casings will be installed flush with these lines.

Cut the head casing to length. Mark the centerpoint of the head casing and the centerpoint of the head jamb. Align the casing with the head jamb reveal line, matching the centerpoints so that the head casing extends evenly beyond both side jamb casings. Nail the casing to the wall at stud locations and at the jamb.

Hold the side casings against the head casing and mark them for cutting then cut the side casings to fit.

Align the side casings with the side jamb reveal lines, then nail the casings to the jambs and framing members. Set the nails, using a nail set. Fill the nail holes with wood putty.

Options for Installing Door & Window Casings

Dress up door casings by adding plinths. Cut the plinths from 1× stock and bevel one edge. Nail the plinths to the jambs with 2" 10d finish nails so the beveled edges are aligned with the reveal lines for the casings. Measure and cut the casings to fit.

Add corner blocks, also known as rosettes, at the ends of the head casing. Attach the corner blocks once the side casings are in place, then cut the head casing to fit. Set the nails, using a nailset, after all pieces are installed.

Backband molding can dress up butted window casings. Install the back band around the perimeter of the window, mitering the joints at the corners. Nail the back band in place with 4d finish nails or pneumatic brads.

Create a decorative door header by nailing a combination of bed and lattice moldings over the top casing. Size the header to overhang the side casings.

Installing Window Trim

Stool and apron trim brings a traditional look to a window, and it is most commonly used with double-hung styles. The stool serves as an interior sill; the apron (bottom casing) conceals the gap between the stool and the finished wall.

In many cases, such as with 2 × 6 walls, jamb extensions made from ,1x finish-grade lumber need to be installed to bring the window jambs flush with the finished wall. Many window manufacturers also sell jamb extensions for their windows.

The stool is usually made from 1x finish-grade lumber, cut to fit the rough opening, with “horns” at each end extending along the wall for the side casings to butt against. The horns extend beyond the outer edge of the casing by the same amount that the front edge of the stool extends past the face of the casing, usually under 1 inch.

If the edge of the stool is rounded, beveled, or otherwise decoratively routed, you can create a more finished appearance by returning the ends of the stool to hide the end grain. A pair of miter cuts at the rough horn will create the perfect cap piece for wrapping the grain of the front edge of the stool around the horn. The same can be done for an apron cut from a molded casing.

As with any trim project, tight joints are the secret to a successful stool and apron trim job. Take your time to ensure all the pieces fit tightly. Also, use a pneumatic nailer—you don’t want to spend all that time shimming the jambs perfectly only to knock them out of position with one bad swing of a hammer.

Tip

“Back-cut” the ends of casing pieces where needed to help create tight joints, using a sharp utility knife.

Tools & Materials

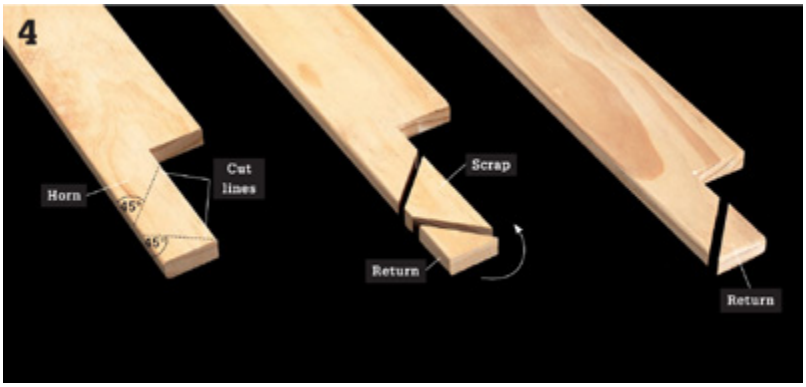
Tape measure
Straightedge
Circular saw or jigsaw
Handsaw
Plane or rasp
Drill
Hammer
Pneumatic nailer (optional)
1× finish lumber
Casing
Wood shims
4d, 6d, and 8d finish nails

How to Install Stool & Apron Window Trim

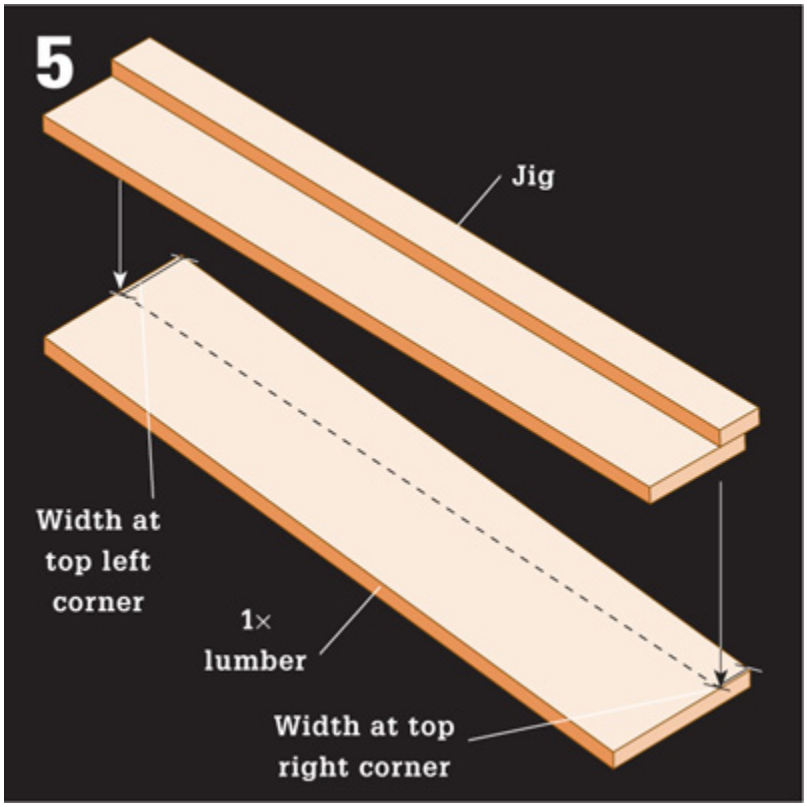
Cut the stool to length, with several inches at each end for creating the horn returns. With the stool centered at the window and tight against the wallboard, shim it to its finished height. At each corner, measure the distance between the window frame and the stool, then mark that dimension on the stool.

Open a compass so it touches the wall and the tip of the rough opening mark on the stool, then scribe the plane of the wall onto the stool to complete the cutting line for the horn.

Cut out the notches for the horn, using a jigsaw or a sharp handsaw. Test-fit the stool, making any minor adjustments with a plane or a rasp to fit it tightly to the window and the walls.



To create a return at the horn of the stool, miter-cut the return pieces at 45° angles. Mark the stool at its overall length and cut it to size with 45° miter cuts. Glue the return to the mitered end of the horn so the grain wraps around the corner. Note: *Use this same technique to create the returns on the apron (step 13, page 159), but make the cuts with the apron held on edge, rather than flat.*



Where extensions are needed, cut the head extension to its finished length—the distance between the window side jambs plus the thickness of both side extensions (typically 1x stock). For the width, measure the distance between the window jamb and the finished wall at each corner, then mark the measurements on the ends of the extension. Use a straightedge to draw a reference line connecting the points. Build a simple cutting jig, as shown (see page 77).

Clamp the jig on the reference line, then rip the extension to width, using a circular saw; keep the baseplate tight against the jig and move the saw smoothly along the cut. Reposition the clamp when you near the end of the cut. Cut both side extensions to length and width, using the same technique as for the head extension (step 5).

Build a box frame with the extensions and stool, using 6d finish nails and a pneumatic nailer. Measure to make sure the box has the same dimensions as the window jambs. Drive nails through the top of the head extension into the side extensions and through the bottom of the stool into side extensions.

Apply wood glue to the back edge of the frame, then position it against the front edge of the window jambs. Use wood shims to adjust the frame, making sure pieces are flush with window jambs. Fasten the frame at each shim location, using 8d finish nails driven through pilot holes. Loosely pack insulation between framing members and extensions.

On the edge of each extension, mark a ¼" reveal at the corners, the middle, and the stool. Place a length of casing along the head extension, aligned with the reveal marks at the corners. Mark where the reveal marks intersect, then make 45° miter cuts at each point. Reposition the casing at the head extension and attach, using 4d finish nails at the extensions and 6d finish nails at the framing members.

Cut the side casings to rough length, leaving the ends slightly long for final trimming. Miter one end at 45°. With the pointed end on the stool, mark the height of the side casing at the top edge of the head casing.

To get a tight fit for side casings, align one side of a T-bevel with the reveal, mark the side extension, and position the other side flush against the horn. Transfer angle from T-bevel to end of casing, and cut casing to length.

Test-fit the casings, making any final adjustments with a plane or rasp. Fasten the casing with 4d finish nails at the extensions and 6d finish nails at the framing members.

Cut apron to length, leaving a few inches at each end for creating the returns (step 4, page 157). Position the apron tight against the bottom edge of the stool, then attach it, using 6d finish nails driven every 12".

Installing Base Molding

Baseboard trim is installed to conceal the joint between the finished floor and the wallcovering. It also serves to protect the wallboard at the floor. Installing plain, one-piece baseboard such as ranch-style base or cove base is a straightforward project. Outside corner joints are mitered, inside corners are coped, and long runs are joined with scarf cuts.

The biggest difficulty to installing base is dealing with out-of-plumb and nonsquare corners. However, a T-bevel makes these obstacles easy to overcome.

Plan the order of your installation prior to cutting any pieces and lay out a specific piece for each length of wall. It may be helpful to mark the type of cut on the back of each piece so you don’t have any confusion during the install.

Locate all studs and mark them with painter’s tape 6 inches higher than your molding height. If you need to make any scarf joints along a wall, make sure they fall on the center of a stud. Before you begin nailing trim in place, take the time to pre-finish the moldings. Doing so will minimize the cleanup afterward.

Tools & Materials

- Pencil
- Tape measure
- Power miter saw
- T-bevel
- Coping saw
- Metal file set
- Pneumatic finish nail gun & compressor
- Moldings
- Pneumatic fasteners
- Carpenter's glue
- Finishing putty

How to Install One-piece Base Molding

Measure, cut, and install the first piece of baseboard. Butt both ends into the corners tightly. For longer lengths, it is a good idea to cut the piece slightly oversized (up to 1/16" on strips over 10 ft. long) and “spring” it into place. Nail the molding in place with two nails at every stud location.

Cut the second piece of molding oversized by 6" to 10" and cope-cut the adjoining end to the first piece. Fine-tune the cope with a metal file and sandpaper. Dry-fit the joint, adjusting it as necessary to produce a tight-fitting joint.

Check the corner for square with a framing square. If necessary, adjust the miter cut of your saw. Use a T-bevel to transfer the proper angle. Cut the second piece (coped) to length and install it with two nails at each stud location.

Adjust the miter angle of your saw to cut the adjoining outside corner piece (3). Test-fit the cut to ensure a tight joint (inset photo). Remove the mating piece of trim and fasten the first piece for the outside corner joint.

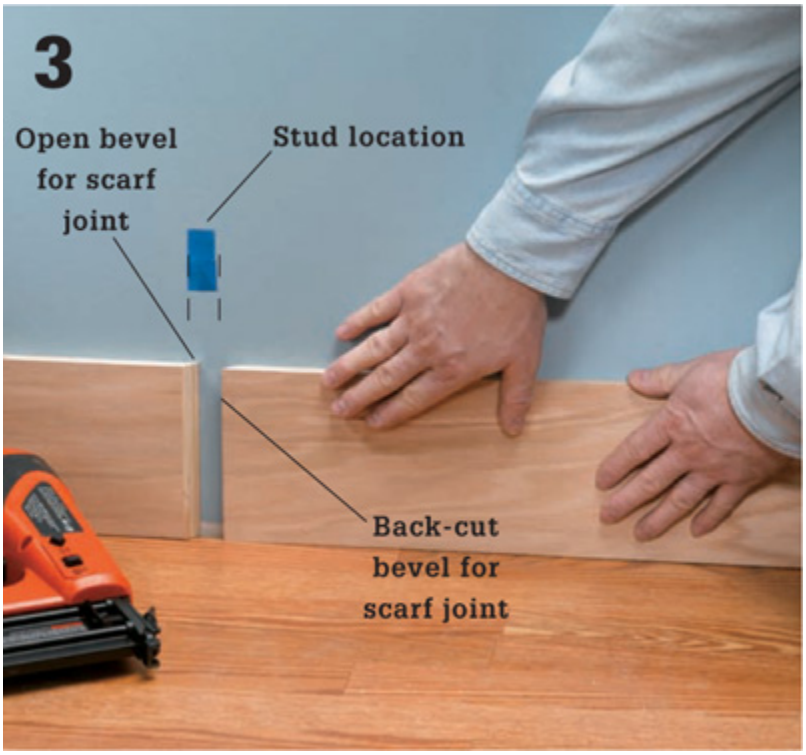
Lay out any scarf joints by placing the piece in position so that the previous joint is tight and then marking the center of a stud location nearest the opposite end. Set the angle of your saw to a 30° angle and cut the molding at the marked location (see page 84).

Nail the third piece in place, making sure the outside corner joint is tight. Cut the end of the fourth piece to match the scarf joint angle and nail it in place with two nails at each stud location. Add the remaining pieces of molding, fill the nail holes with putty, and apply a final coat of finish.

How to Install Built-up Base Molding

Dress up simple baseboard stock with cap moldings and base shoe or quarter round. The baseboard can be made of solid wood, as shown above, or from strips of veneered plywood, as shown at right.

Cut the plywood panel into 6" strips with a table saw or a straightedge guide and a circular saw. Lightly sand the strips, removing any splinters left from the saw. Then, apply the finish of your choice to the moldings and the plywood strips.



Install the plywood strips with 2" finish nails driven at stud locations. Use scarf joints on continuous runs, driving pairs of fasteners into the joints. Cut and install moldings so that all scarf joints fall at stud locations.

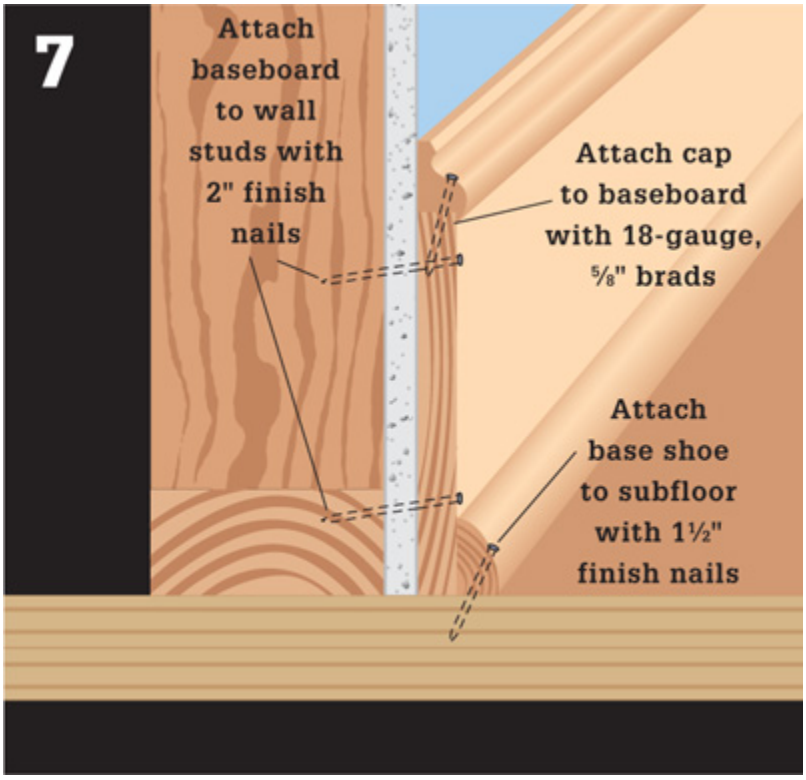
Tip

Baseboard can be built up on the back with spacer strips so it will project further out from the wall. This can allow you to match existing casings or to create the impression of a thicker molding. However, the cap rail needs to be thick enough to cover the plywood edge completely, or the core of the panel may be visible.

Test-fit inside corner butt joints before cutting a workpiece. If the walls are not square or straight, angle or bevel the end cut a few degrees to fit the profile of the adjoining piece. The cap molding will cover any gaps at the top of the joint.

Miter outside corners squarely at 45°. Use wood glue and 1¼" brad nails to pull the mitered pieces tight, and then nail the base to the wall at stud locations with 2" finish nails. Small gaps at the bottom or top of the base molding will be covered with cap or base shoe.

Use a brad nailer with 18-gauge, ⅝" brads to install the cap and base shoe moldings along the edges of the plywood base. Fit scarf joints on longer lengths, coped joints on inside corners, and miter joints on outside corners. Stagger the seams so that they do not line up with the base molding seams, following the suggested nailing pattern (right). Set any protruding nails with a nail set and fill all nail holes with putty.



Built-up baseboard requires more attention to the nailing schedule than simple one-piece baseboards. The most important consideration (other than making sure your nails are all driven into studs or other solid wood) is that the base shoe must be attached to the floor, while the baseboard is attached to the wall. This way, as the gap between the wall and floor changes, the parts of the built-up molding can change with them.

Paneling an Attic Ceiling

Tongue-and-groove paneling is a pleasing alternative to a wallboard ceiling, particularly in a knee-wall attic. Pine paneling is most common, but any tongue-and-groove material can be used. These materials are typically ⅜ to ¾" thick and are attached directly to ceiling joists and rafters (over faced insulation, when required). Most codes require you to install ⅜" wallboard as a fire stop under ceiling material thinner than ¼".

Allow for waste by purchasing 15% more material than the square footage of the ceiling; add more for waste if the ceiling requires many angled cuts. Since the tongue portion on most pieces slips into the groove on an adjacent piece, square footage is based on the exposed face (called the reveal) once the boards are installed. A compound miter saw is the best tool for ensuring clean cuts. This is especially important if the ceiling includes non-90° angles.

Tongue-and-groove boards are attached with flooring nails driven through the shoulder of the tongue into each rafter (called blindnailing because the nail heads are covered by the next board). Nailing through the board face is only necessary on the first and last course and on scarf joints.

Layout is very important to the success of a paneled surface, because the lines clearly reveal flaws such as pattern deviations, misaligned walls, and installation mistakes. Before beginning the installation, measure to see how many boards will be installed (using the reveal measurement). If the final board will be less than 2 inches wide, trim the first, or starter board, by trimming the long edge that abuts the wall.

If the angle of the ceiling peak is not parallel to the wall, you must compensate for the difference by ripping the starter piece at an angle so that the leading edge, and every piece thereafter, is parallel to the peak.

Tools & Materials

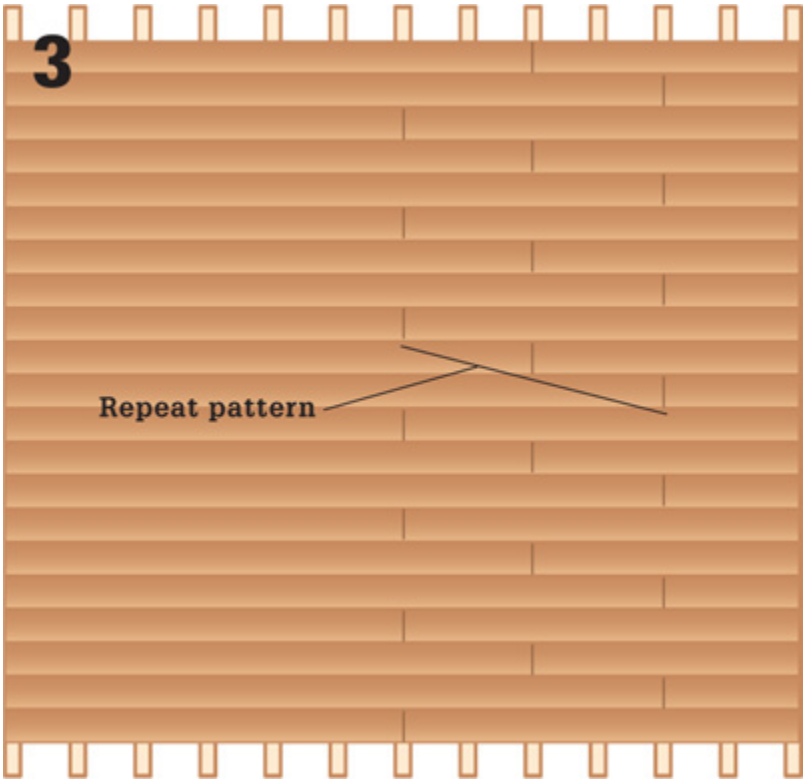
- Tape measure
- Drill
- Hammer
- Jigsaw
- Table saw or circular saw with guide fence
- T-bevel
- Chalk line
- Nail set
- Tongue-and-groove boards
- $1\frac{3}{4}$" spiral flooring nails
- Trim molding

Tongue-and-groove paneling can be installed directly over rafters or joists or over wallboard. In attic installations, it's important to insulate first, adding a separate vapor barrier if required by building codes. Local code may also require that paper-faced insulation behind a kneewall be covered with drywall or other material.

How to Panel an Attic Ceiling

To plan your layout, first measure the reveal of the boards— the exposed surface when they are installed. Fit two pieces together and measure from the bottom edge of the upper board to the bottom edge of the lower board. Calculate the number of boards needed to cover one side of the ceiling by dividing the reveal dimension into the overall distance between the top of one wall and the peak.

Use the measurement from step 1 to snap a line marking the top of the first row: at both ends of the ceiling, measure down from the peak an equal distance, and make a mark to represent the tongue (top) edges of the starter boards. Keep in mind that the bottom edges must be bevel-cut to fit flush against the wall (see step 4). Snap a chalk line through the marks.



If the boards aren't long enough to span the entire ceiling, plan the locations of the seams. Staggering the locations of the seams in a three-step pattern will help hide the seams. Note *that each seam must fall in the middle of a rafter.*

Rip the first starter board to width by bevel-cutting the bottom (grooved) edge with a circular saw. If the starter row will have seams, cut the board to length using a 30° bevel cut on the seam end only. Two beveled ends joined together form a scarf joint (inset), which is less noticeable than a butt joint. If the board spans the ceiling, square-cut both ends.

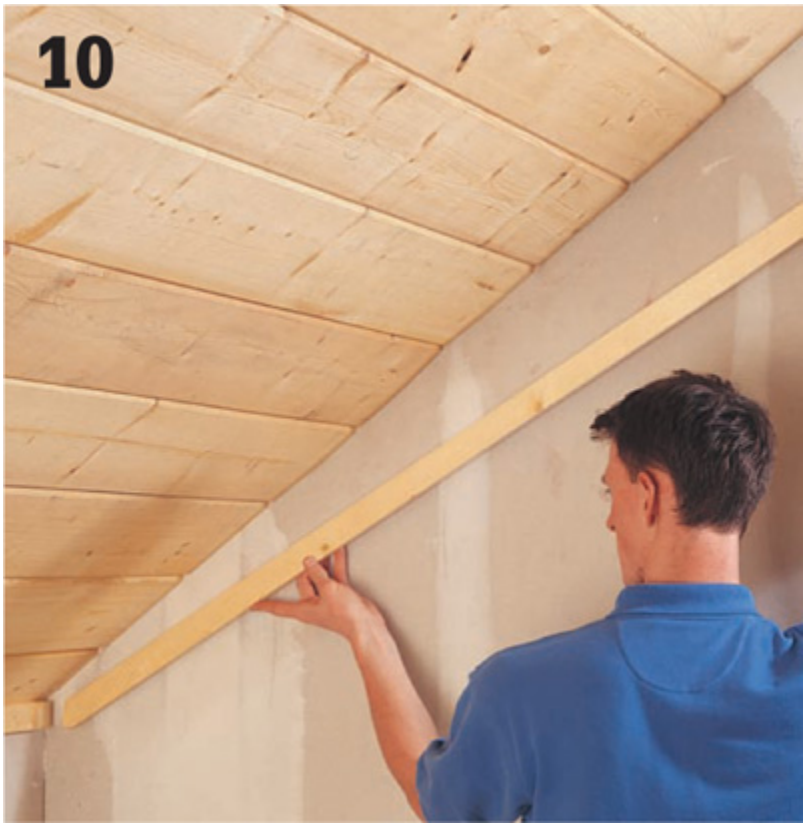
Position the starter board so the grooved (or cut) edge butts against the side wall and the tongue is aligned with the control line. Leave a ⅛" gap between the square board end and the wall. Fasten the board by nailing through its face about 1" from the grooved edge, into the rafters. Then, blindnail through the base of the tongue into each rafter, angling the nail backwards at 45°. Drive the nail heads beneath the wood surface, using a nail set.

Cut and install any remaining boards in the starter row one at a time, making sure the scarf-joint seams fit together tightly. For best appearance, select boards of similar coloring and grain for each row.

Cut the first board for the next row, then fit its grooved edge over the tongue of the board in the starter row. Use a hammer and a scrap piece of paneling to tap along the tongue edge, seating the grooved edge over the tongue of the starter board. Fasten the second row of board with blindnails only.

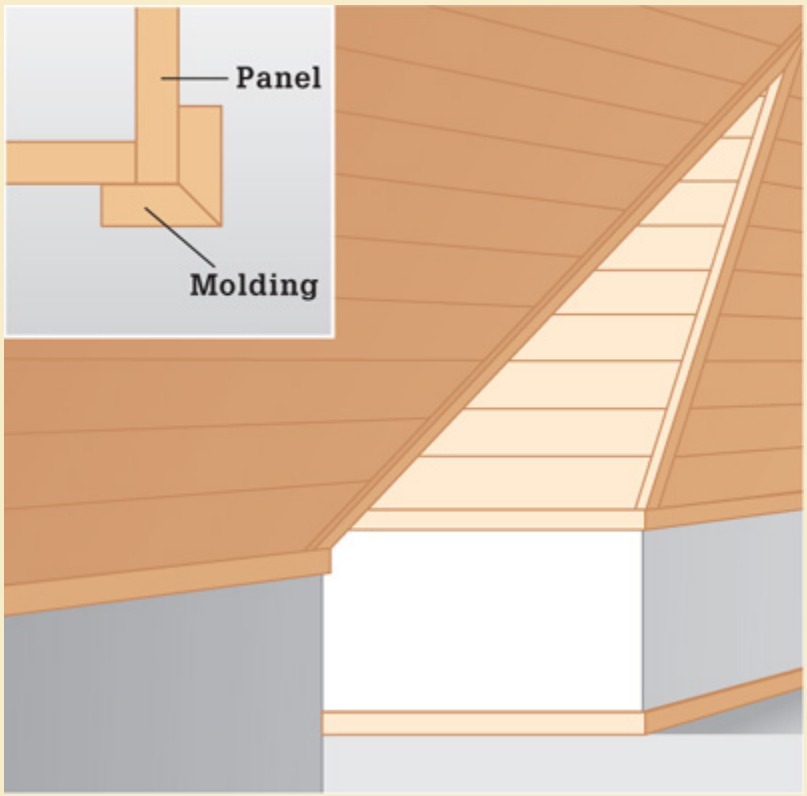
As you install successive rows, measure down from the peak to make sure the boards are parallel to the peak. Correct any misalignment by adjusting the tongue-and-groove joint slightly with each row. You can also snap additional control lines to help align the rows.

Rip the boards for the last row to width, beveling the top edges so they fit flush against the ridge board. Facenail the boards in place. Install paneling on the other side of the ceiling, then custom-cut the final row of panels to form a closed joint at the peak (inset).

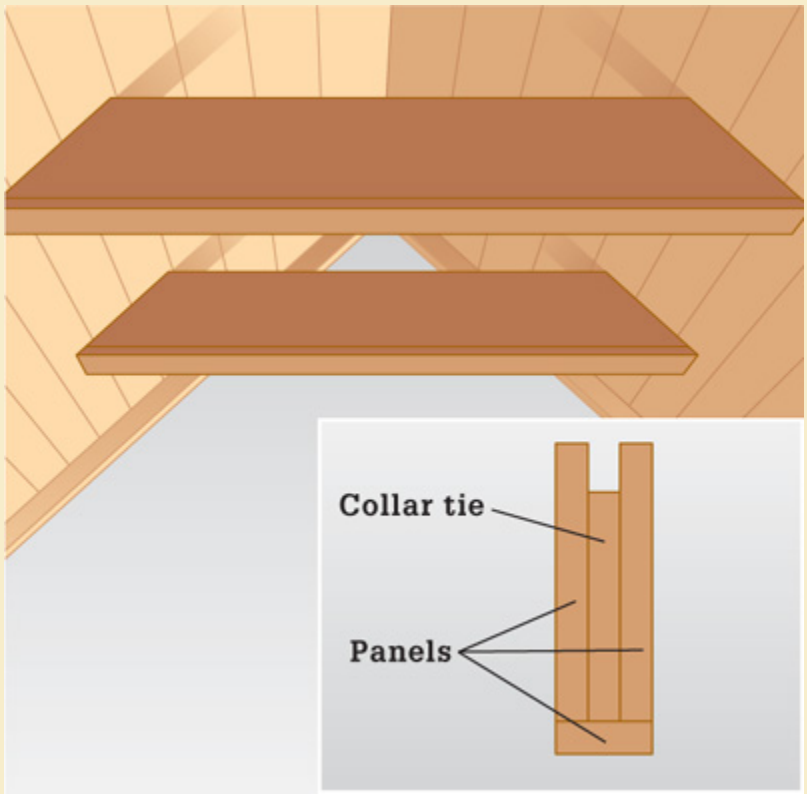


Install trim molding along walls, at seams, around obstacles, and along inside and outside corners, if desired. (Select-grade 1 × 2s work well as trim along walls.) For trim along the bottom edge, bevel the back of the trim to match the slope of the ceiling.

Tips for Paneling an Attic Ceiling



Install trim molding to hide the joints where panels meet at opposing angles, such as on the corners of a dormer. Miter-cut the moldings and install them over the butt joint of the corners to hide the seam. Moldings can also be cut from paneling boards and given a decorative edge with a router and bit.



Wrap collar ties or exposed beams with custom-cut panels. Use a T-bevel to determine the angle for mitering the board ends where they meet the ceiling surface. Mitered joints are best when wrapping a collar tie, but if boards are installed with butt joints, make the bottom piece wide enough so that the side pieces will butt against it.

Installing Wainscoting

Wainscoting refers to virtually any specialized treatment of the lower three to four feet of interior walls. The form demonstrated here, using tongue-and-groove boards, first gained popularity in the early twentieth century. Recently, it has re-emerged as a way to dress up a room.

Typical tongue-and-groove boards for wainscoting are made of pine, fir, or other softwoods and measure ¼ to ¾" thick. Each board has a tongue on one edge, a groove on the other, and usually a decorative bevel or bead on each edge. Boards are cut to length, then attached with nails, most of which are driven through the tongues of the boards. This technique, known as blindnailing, hides the nails from view.

Once installed, the wainscoting is capped at a height of 30 to 36" with a molding called a cap rail. The exact height of the wainscoting is a matter of personal preference. When installed to the height of the furniture in the room, wainscoting provides visual symmetry. It also allows the cap rail to double as a chair rail, protecting the lower portion of the walls from damage.

When installed over finished wallboard, wainscoting usually requires that nailers be fastened to the wall studs to provide a reliable backing for nailing. You can skip this step if you know there is consistent blocking between the studs to substitute for this backing. However, this is usually difficult to confirm unless the walls were framed with tongue-and-groove wainscoting in mind.

Wainscoting can be painted or stained. Oil-based stains can be applied before or after installation, since most of the stain will be absorbed into the wood and won’t interfere with the tongue-and-groove joints. If you’re painting, choose a latex-based paint; it will resist cracking as the joints expand and contract with changes in the weather.

Tools & Materials

Pencil	Tape measure
Level	Paintbrush
Circular saw	Tongue-and-groove boards
Miter saw	Finish nails
Miter box	1 × 3 furring strips
Hammer	2" 10d finish nails
Nail set	Receptacle box extenders, as required
Plane	
Circuit tester	Paint or stain
Pry bar	

Tongue-and-groove wainscoting boards are milled with smooth faces, or contoured to add additional texture to your walls. For staining, choose a wood species with a pronounced grain. For painting, poplar is a good choice, since it has few knots and a consistent, closed grain that accepts paint evenly.

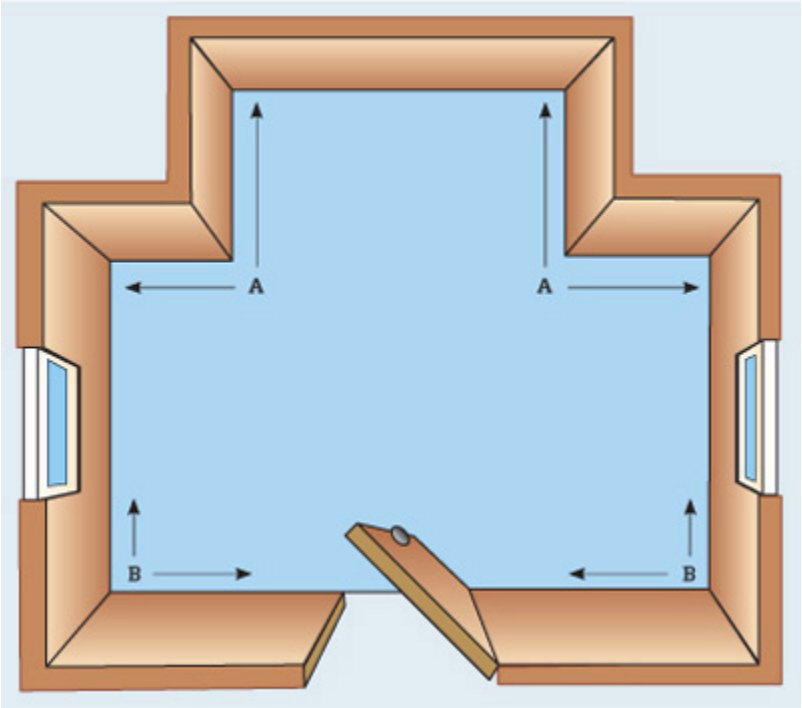
How to Prepare for a Wainscoting Project

Measure to make a plan drawing of each wall in your project. Indicate the locations of fixtures, receptacles, and windows. Use a level to make sure the corners are plumb. If not, mark plumb lines on the walls to use as reference points.

Condition the planking by stacking it in the room where it will be installed. Place spacers between the planks to let air circulate around each board, allowing the wood to adjust to the room's temperature and humidity. Wait 72 hours before staining or sealing the front, back, and edges of each plank.

Remove the baseboard moldings, along with any receptacle cover plates, vent covers, or other wall fixtures within the area you plan to cover. Before you begin, turn off the electricity to the circuits in the area.

Mark the walls with level lines to indicate the top of the wainscoting. Mark a line ¼" from the floor to provide a small gap for expansion at the floor.



Begin installation at the corners. Install any outside corners (A) first, working your way toward the inside corners. In sections of a room that have no outside corners, start at the inside corners (B), and work your way toward the door and window casings. Calculate the number of boards required for each wall, using the measurements on the drawing you created earlier (length of wall divided by width of one plank). When making this calculation, remember that the tongues are removed from the corner boards. If the total number of boards for a wall includes a fraction of less than ½ of a board, plan to trim the first and last boards to avoid ending with a board cut to less than half its original width.

How to Install Wainscoting at Outside Corners

Cut a pair of boards to the widths indicated in the calculations you developed during the planning process.

Position the boards at the corner, butting them to create a plumb corner. Facenail the boards in place, then nail the joint, using 6d finish nails. Drive the nails to within ⅛" of the face of the boards, then finish with a nail set.

Position a piece of corner trim and nail it in place, using 6d finish nails. Install the remaining boards (opposite, steps 5 and 6).

How to Install Wainscoting at Inside Corners

Hold a level against the first board and hold the board flush with the corner. If the wall is out of plumb, trim the board to compensate: Hold the board plumb, position a compass at the inside corner of the wall, and use it to scribe a line down the board.

Cut along the scribed line with a circular saw. Subsequent boards may require minor tapering with a plane to adjust for plumb.

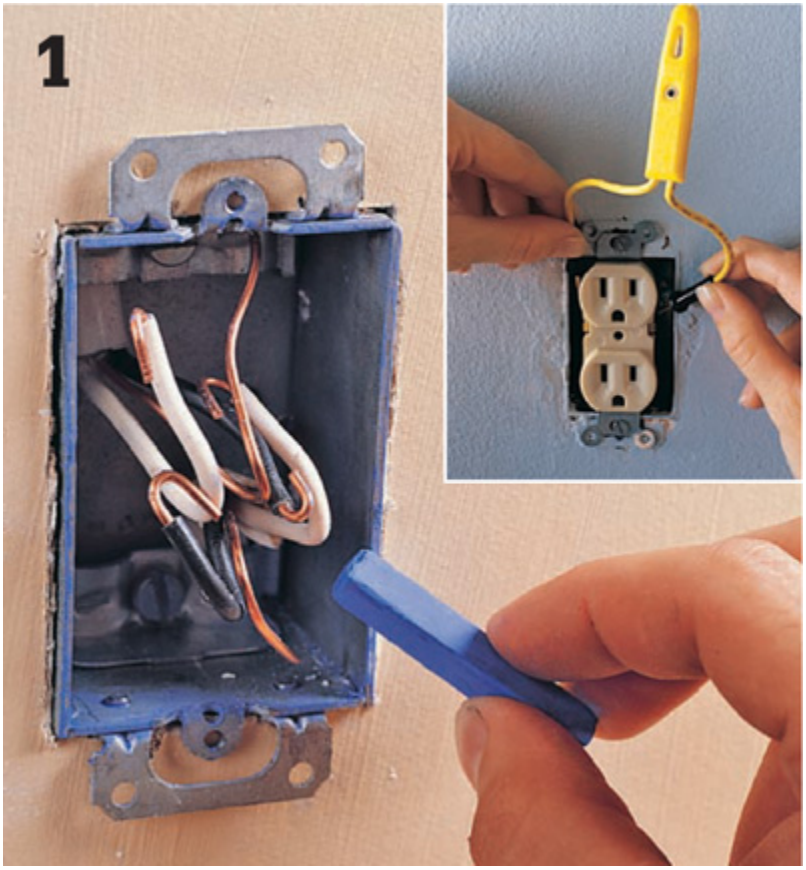
Hold the first board in the corner, leaving a ¼" gap for expansion, and facenail into the center of the board at each nailer location, using 6d finish nails. Drive the top nails roughly ½" from the edge so they'll be hidden from view once the cap rail is attached.

Install a second board at the corner by butting it against the first one, then facenailing in at least two locations. Nail to within ⅛" of the face of the board, then use a nail set to finish.

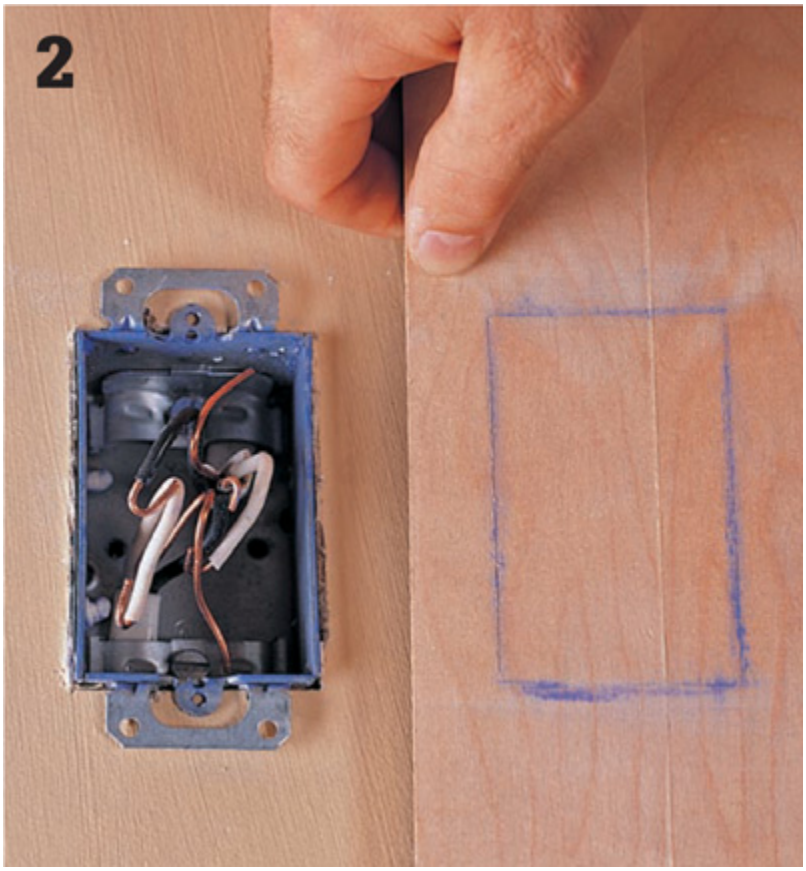
Position subsequent boards. Leave a 1/16" gap at each joint to allow for seasonal expansion. Use a level to check every third board for plumb. If the wainscoting is out of plumb, adjust the fourth board, as necessary, to compensate.

Mark and cut the final board to fit. If you're at a door casing, cut the board to fit flush with the casing (trim off at least the tongue). If you're at an inside corner, make sure it is plumb. If not, scribe and trim the board to fit.

How to Make a Cutout



Test the receptacle (inset) to make sure the power is off. Then, unscrew and remove the receptacle from the box. Coat the edges of the electrical box with bright colored chalk.



Press the back of the board that will be installed over the receptacle, directly against the electrical box, to create a cutting outline.

Lay the board face down and drill a large pilot hole near one corner of the outline. Use a jigsaw fitted with a fine-tooth woodcutting blade to make the cutout. Be careful not to cut outside the lines.

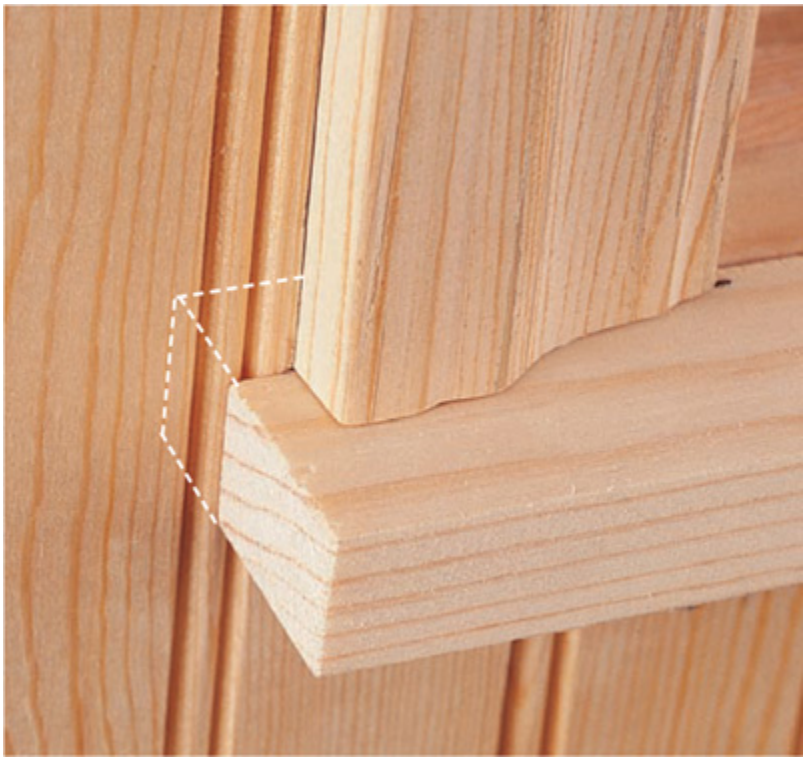
Facenail the wainscoting to the wall, then reattach the receptacle with the tabs overlapping the wainscoting so the receptacle is flush with the opening. You may need longer screws.

Tip

When paneling around a receptacle with thick stock, you will need to attach a receptacle box extender to the inside of the box, then reconnect the receptacle so it is flush with the opening in the paneling.

How to Install Wainscoting Around a Window

On casement windows, install wainscoting up to the casings on the sides and below the window. Install ½" cove molding, quarter round, or other trim to finish the edges.



On double-hung windows, remove any window trim and install wainscoting up to the jambs on the sides and below the window. Cut the stool to fit over the wainscoting, then reinstall the apron.

How to Finish a Wainscoting Project

Cut baseboard moldings (pages 160 to 163) to fit over the wainscoting and attach them by nailing 6d finishing nails at the stud locations. If you plan to install a base shoe, leave a small gap at the floor.

Cut cap rail to fit as you would contoured baseboard (page 85). At doors and windows, install the cap rail so its edge is flush with the side casings.

Attach the cap rail by nailing 4d finish nails through the flats of the moldings at the stud locations so that nails enter both the studs and the wainscoting. Set the nails with a nail set.

Covering Foundation Walls

There are two common methods for covering foundation walls. Because it saves space, the more popular method is to attach 2 × 2 furring strips to the masonry wall. These strips provide a 1½"-deep cavity between strips for insulation and service lines, as well as a framework for attaching wallboard. The other method is to build a complete 2 × 4 stud wall and install it just in front of the foundation wall. This method offers a full 3½" for insulation and lines, and it provides a flat, plumb wall surface, regardless of the foundation wall's condition.

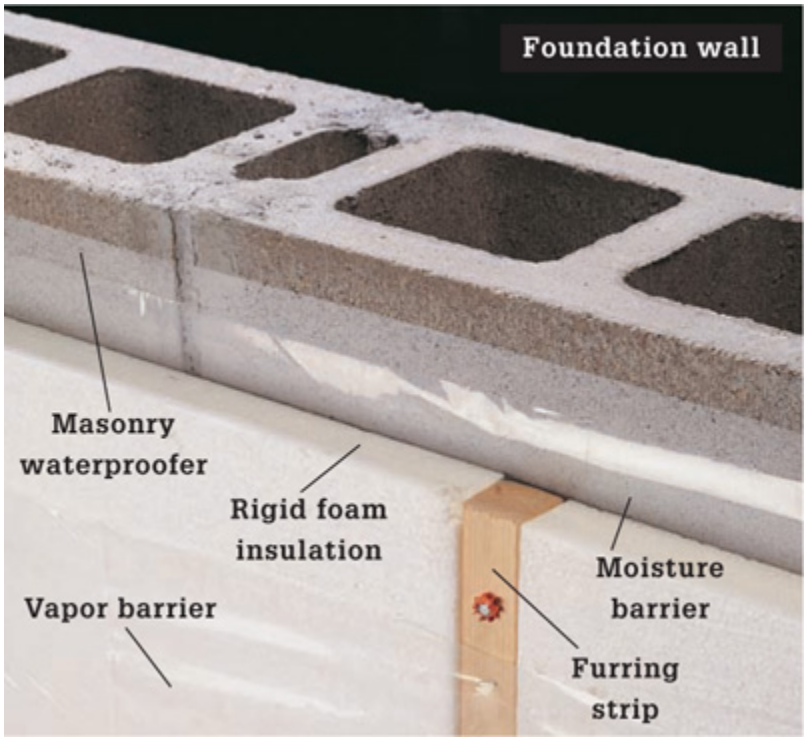
To determine the best method for your project, examine the foundation walls. If they're fairly plumb and flat, you can consider furring them. If the walls are wavy or out of plumb, however, it may be easier to use the stud-wall method. Also check with the local building department before you decide on a framing method. There may be codes regarding insulation minimums and methods of running service lines along foundation walls.

A local building official can also tell you what's recommended—or required—in your area for sealing foundation walls against moisture. Commonly used moisture barriers include a masonry waterproofer that's applied like paint and plastic sheeting installed between the masonry wall and the wood framing. The local building code will also specify whether you need a vapor barrier between the framing and the wallboard.

Before you shop for materials, decide how you'll fasten the wood framing to your foundation walls and floor. If you're covering a large wall area, it will be worth it to buy or rent a powder-actuated nailer for the job.

Tools & Materials

Caulk gun	Silicone caulk
Trowel	Hydraulic cement
Paint roller	Masonry waterproofer
Circular saw	2 × 2 and 2 × 4 lumber
Drill	$2^1/_2$" wallboard screws
Powder-actuated nailer	Construction adhesive
Plumb bob	Concrete fasteners
Paper-faced insulation	Rigid foam insulation



Local building codes may require a barrier to prevent moisture from damaging wood and insulation covering foundation walls. This may be plastic sheeting placed behind or in front of the framing.

Tip

Fill small cracks with hydraulic cement or masonry caulk, and smooth the excess with a trowel. Ask the building department whether masonry waterproofer or a plastic moisture barrier is required in your area. Apply waterproofer as directed by the manufacturer or install plastic sheeting to code specifications.

How to Install Furring Strips on Masonry Walls

Cut a 2 × 2 top plate to span the length of the wall. Mark the furring-strip layout onto the bottom edge of the plate every 16" (so the center of the furring strips will line up with the marks). Attach the plate to the bottom of the joists with 2½" wall board screws. The back edge of the plate should line up with the front of the blocks.

Install a bottom plate cut from pressure-treated 2 × 2 lumber so the plate spans the length of the wall. Apply construction adhesive to the back and bottom of the plate, then attach it to the floor with a nailer. Use a plumb bob to transfer the furring-strip layout marks from the top plate to the bottom plate.

Fill the cavities between furring strips with rigid insulation board. Cut the pieces so they fit snugly within the framing. If necessary, make cutouts in the insulation to fit around mechanical elements, and cover any chases with metal protective plates before attaching the wall surface. Add a vapor barrier, as required by local building code.

Option: Leave a chase for the installation of wires or supply pipes by installing pairs of vertically aligned furring strips with a 2" gap between each pair. Note: *Consult local codes to ensure proper installation of electrical or plumbing materials.*

Framing Basement Foundation Walls

You can use conventional wall-framing techniques to turn an unused basement into a warm, inviting living space. Stud walls provide deep bays for insulation and allow you to use ordinary receptacle boxes for wall outlets. Fully framed walls will be stronger than the furring strip method discussed on pages 174 to 175, and they may be your only option if your basement walls aren't flat and plumb. The downside to framing your basement walls is that the material costs will be greater than using furring strips and foam insulation. Stud walls will also reduce the size of the room, which may be an issue if you have a small basement.

Assembling a stud wall next to a foundation wall is essentially the same process as building a wall elsewhere. However, since there's always the potential for water infiltration through cinder block or poured basement walls, it's a good idea to build your walls about ½" away from the foundation to create an airspace. This gap will also be useful for avoiding any unevenness in your foundation walls.

Tools & Materials

- Tape measure
- Plumb bob
- Combination square
- Powder-actuated nailer or hammer drill
- Pneumatic nailer or hammer
- Miter saw or circular saw
- Staple gun
- Utility knife
- Wallboard finishing tools

- Framing materials
- 10d nails (coated if using treated lumber) or pneumatic framing nails
- PAT fasteners or masonry screws
- Rolled insulation
- 6 mil vapor barrier
- Moisture-resistant wallboard

How to Frame a Basement Foundation Wall

Mark the location of the new wall on the floor joists above, then use a scrap piece of 2 × 4 as a template to draw layout lines for the new top plate. Position the top plate about ½" away from the foundation wall to create an airspace. If the joists run parallel to the foundation wall, nail blocking between them to create attachment points for the new wall.

Hang a plumb bob from the top plate layout lines to mark the sole plate position on the floor. Move the bob along the top plate and mark the sole plate at several points on the floor. Set a piece of scrap 2 × 4 in place on the floor to make sure the sole plate will still allow for an air gap. Draw pairs of lines across both plates with a combination square to mark stud locations.

Fasten the top plate to the floor joists using 3" deck screws or 10d nails (top). Be sure to orient the plate so the stud layout faces down. Attach the sole plate to the concrete floor with a powder-actuated nailer (lower) or with hardened masonry screws. Drill pilot holes for the screws with a hammer drill.

Measure the distance between the top and sole plates at several places along the wall to determine the stud lengths. The stud length distance may vary, depending on structural settling or an out-of-flat floor. Add ⅛" to the stud length(s), and cut them to size.

Toenail the studs in place. Add framing around any basement windows and install fire blocking if local codes require it.

Drill holes through the studs to create raceways for wiring and plumbing. Install these systems and fasten metal protector plates over these areas to prevent drilling or nailing through wiring and pipes later. Have your work inspected before proceeding with insulation and wallboard.

Install rolled insulation in the stud bays. Using plastic encapsulated insulation is a good preventive measure against mold growth. Otherwise, use kraft-faced insulation.

Staple 6 mil plastic sheeting to the wall studs to form a vapor barrier behind the finished wall. Cut holes in the plastic for receptacle openings. *NOTE: There is considerable debate over whether or not you should employ a vapor barrier on a basement wall, mostly because the barrier can trap water that enters from the exterior. Check with your local building inspector.*

Install your wallcovering of choice. If you choose wallboard, finish the seams with wallboard compound and tape as usual. Be sure to use moisture-resistant wall board for basement walls (some new wallboard products are also mold and mildew resistant —ask at your building center).

Trimming Basement Windows

Basement windows bring much-needed sunlight into dark areas, but even in finished basements they often get ignored on the trim front. This is partly because most basement foundation walls are at least 8 inches thick, and often a lot thicker. Add a furred-out wall and the window starts to look more like a tunnel with a pane of glass at the end. But with some well-designed and well-executed trim carpentry, you can turn the depth disadvantage into a positive.

A basement window opening may be finished with wallboard, but the easiest way to trim one is by making extra-wide custom jambs that extend from the inside face of the window frame to the interior wall surface. Because of the extra width, plywood stock is a good choice for the custom jambs. The project shown here is created with veneer-core plywood with oak veneer surface. The jamb members are fastened together into a nice square frame, using rabbet joints at the corners. The frame is scribed and installed as a single unit and then trimmed out with oak casing. The casing is applied flush with the inside edges of the frame opening. If you prefer to have a reveal edge around the interior edge of the casing, you will need to add a solid hardwood strip to the edge of the frame so the plies of the plywood are not visible.

Tools & Materials

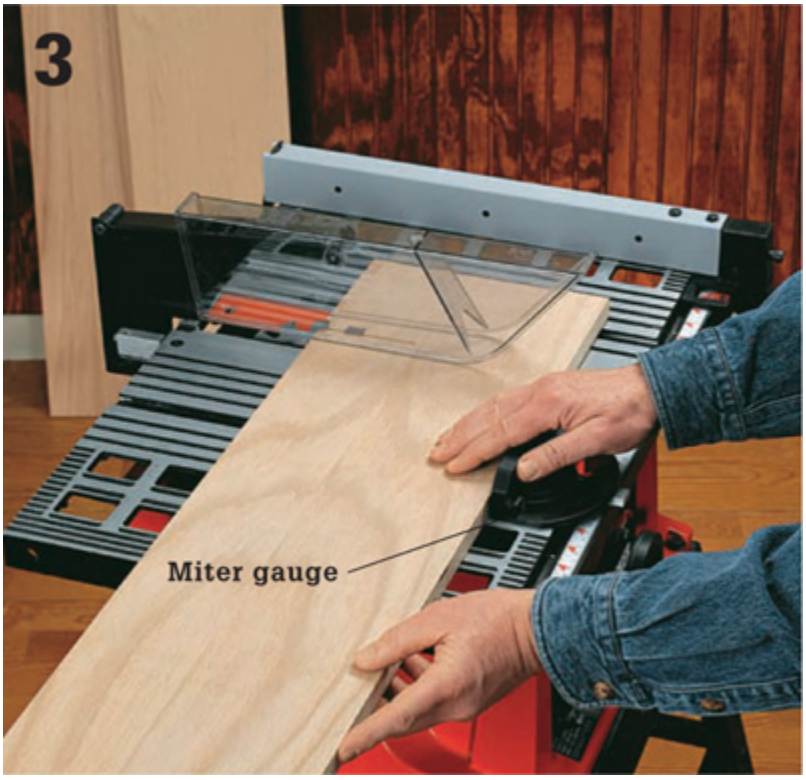
- Pencil
- Tape measure
- Table saw
- Drill with bits
- 2-ft level
- Framing square
- Utility knife
- Straightedge
- Finish-grade ¾" oak plywood
- Spray-foam insulation
- Composite or cedar wood shims
- 1¼" and 2" finish nails
- 1⅝" drywall screws
- Carpenter's glue

Because they are set into thick foundation walls, basement windows present a bit of a trimming challenge. But the thickness of the foundation wall also lets you create a handy ledge that’s deep enough to hold potted plants or even sunning cats.

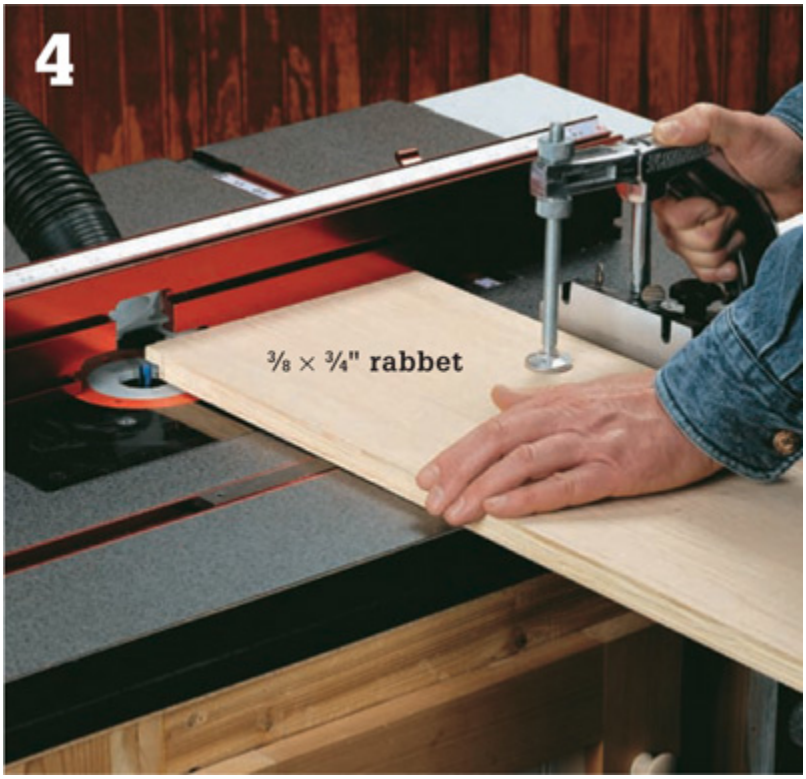
How to Trim a Basement Window

Check to make sure the window frame and surrounding area are dry and free of rot, mold, or damage. At all four corners of the basement window, measure from the inside edges of the window frame to the wall surface. Add 1" to the longest of these measurements.

Set your table saw to make a rip cut to the width arrived at in step 1. If you don’t have a table saw, set up a circular saw and straightedge cutting guide to cut strips to this length. With a fine-tooth panel-cutting blade, rip enough plywood strips to make the four jamb frame components.



Crosscut the plywood strips to correct lengths, In our case, we designed the jamb frame to be the exact same outside dimensions as the window frame, since there was some space between the jamb frame and the rough opening.



Cut ⅜"-deep × ¾"-wide rabbets at each end of the head jamb and the sill jamb. A router table is the best tool for this job, but you may use a table saw or handsaws and chisels. Inspect the jambs first and cut the rabbets in whichever face is in better condition. To ensure uniformity, we ganged the two jambs together (they're the same length). It's also a good idea to include backerboards to prevent tear-out.

Glue and clamp the frame parts together, making sure to clamp near each end from both directions. Set a carpenter's square inside the frame and check it to make sure it's square.

Before the glue sets, carefully drill three perpendicular pilot holes, countersunk, through the rabbeted workpieces and into the side jambs at each corner. Space the pilot holes evenly, keeping the end ones at least ¾" in from the end. Drive a 1⅝" drywall screw into each pilot hole, taking care not to overdrive. Double-check each corner for square as you work, adjusting the clamps if needed.

Let the glue dry for at least one hour (overnight is better), then remove the clamps and set the frame in the window opening. Adjust the frame so it is centered and level in the opening and the exterior-side edges fit flush against the window frame.

Taking care not to disturb the frame's position (rest a heavy tool on the sill to hold it in place if you wish), press a steel rule against the wall surface and mark trimming points at the point where the rule meets the jambs at each side of all four frame corners, using a sharp pencil.

Remove the frame and clamp it on a flat work surface. Use a straightedge to connect the scribe marks at the ends of each jamb frame side. Set the cutting depth of your circular saw to just a small fraction over ¾". Clamp a straightedge guide to the frame so the saw blade will follow the cutting line, and trim each frame side in succession. (The advantage to using a circular saw here is that any tear-out from the blade will be on the nonvisible faces of the frame.)

Replace the frame in the window opening in the same orientation as when you scribed it, and install shims until it is level and centered in the opening. Drive a few finish nails (hand or pneumatic) through the side jambs into the rough frame. Also drive a few nails through the sill jamb. Most trim carpenters do not drive nails into the head jamb.

Insulate between the jamb frame and the rough frame with spray-in polyurethane foam. Look for minimal-expanding foam labeled “window and door” and don’t spray in too much. Let the foam dry for a half hour or so and then trim off the excess with a utility knife. Tip: Protect the wood surfaces near the edges with wide strips of masking tape.

Remove the masking tape and clean up the mess from the foam (there is always some). Install case molding. We used picture-frame techniques to install fairly simple oak casing.

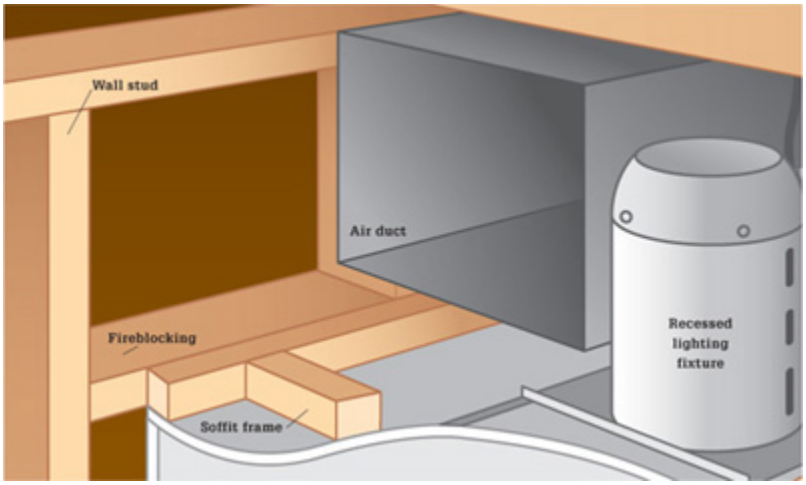
How to Frame Soffits and Chases

Install 2×4 blocking between floor joists to form a square framework around the obstruction. Use 3" deck screws to fasten the framework in place.

Build another square framework on the floor that matches the size of the top frame. Make this frame from treated lumber, and fasten it to the concrete with a powder-actuated nailer or a hammer drill and masonry screws. Hang a plumb bob down from the top frame to find the exact location of this bottom frame before attaching it.

Toenail four 2 × 4 studs between the two frames to complete the chase framework. Finish the chase with wallboard, metal corner bead, and wallboard compound.

If the chase encloses a DWV stack or other plumbing with valves or cleanouts, be sure to build an access panel in the chase to keep these areas accessible. Use furring strips or plywood behind two sides of the access opening to form tabs that hold the access panel in place. Attach the panel with screws, and glue on decorative trim to hide the wallboard edges.



Hide immovable obstructions in a soffit built from dimension lumber or steel and covered with drywall or other finish material. An extra-wide soffit is also a great place to install recessed lighting fixtures.

How to Frame a Furnace Duct

Build a pair of ladder-like frames that match the side dimensions of the furnace duct from standard 2 × 2s. Fasten the parts together with 3" deck screws.

Set the frames against the sides of the duct and fasten them to the floor joists above with 3" deck screws.

Install 2 × 2 crosspieces between the frames to provide attachment points below the duct for wallboard. Then finish the soffit with wallboard, metal corner bead, and wallboard compound.

Advanced Carpentry

After you've tackled a few interior wall and door projects, you should have the fundamental skills needed to tackle the more advanced projects in this book. The essential process of framing structures, shimming rough openings, and removing or replacing trimwork is basically the same. The difference is that several of the advanced projects shown here will involve altering your home's exterior "envelope"— enlarging or creating openings in walls for patio doors or a bay window, for example. In these situations, you must do a thorough job of framing and installation and carry out the proper flashing and weatherizing steps.

In This Chapter:

- Enlarging Openings & Removing Walls
- Removing Wallboard
- Removing Plaster
- Removing Exterior Surfaces
- Removing Doors & Windows
- Removing a Non-loadbearing Wall
- Installing an Attic Access Ladder

- Framing & Installing Doors
- Framing & Installing Windows
- Installing New Window Sashes
- Installing a Standard Skylight
- Installing a Bay Window
- Patching Wood Siding & Stucco
- Patching Flooring

Enlarging Openings & Removing Walls

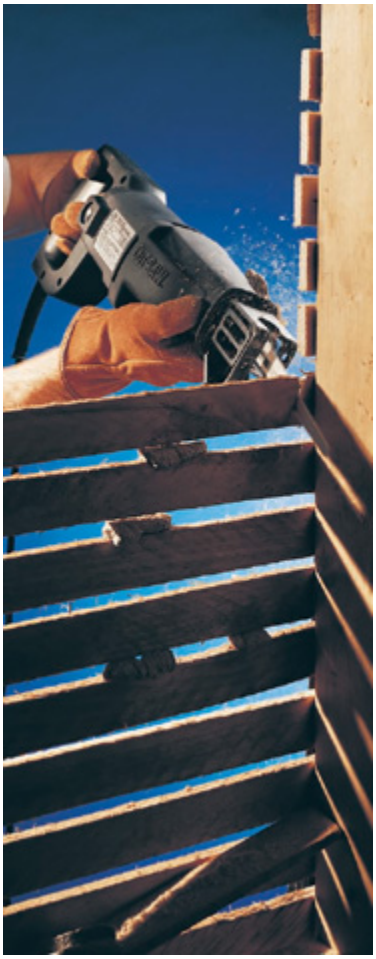
Many carpentry projects actually begin with demolition. When you're remodeling, it's often necessary to cut or enlarge openings for new doors or windows or even to remove entire walls. The basic procedures for this type of demolition are the same whether you're working with doors and windows on exterior walls or altering interior walls.

Your first step will be to determine how your house was framed (pages 108 to 111). House framing variations will dictate the proper procedures for creating openings in walls or removing walls altogether. Then, you'll need to inspect the walls for hidden mechanicals—wiring, plumbing, and HVAC lines.

After you've rerouted any utility lines, you're ready to remove the interior wall surfaces (pages 188 to 191). If you're replacing old windows and doors, now is the time to remove them as well (pages 196 to 197). Where necessary, you can now remove exterior wall surfaces (pages 192 to 195), but don't remove any framing members yet.

The next step will depend on the nature of your project. If you are removing a load-bearing wall or creating a new or enlarged opening in one, you'll need to build temporary supports to brace the ceiling while the work is being done (see next page). This step won't be necessary if you are removing a non-loadbearing wall. Then you can remove any wall framing members, following the applicable procedures for load-bearing or non-loadbearing walls.

With the removal steps of the project completed, you'll be ready to install your new windows and doors.



Demolition is the starting point of most projects where a window or door opening is enlarged.

How to Install Temporary Support Walls

Build a 2 × 4 stud wall that is 4 ft. wider than the planned wall opening and 1¾" shorter than the distance from floor to ceiling.

Raise the stud wall up and position it 3 ft. from the wall, centered on the planned rough opening.

Slide a 2 × 4 top plate between the temporary wall and the ceiling. Check to make sure the wall is plumb, and drive shims under the top plate at 12" intervals until the wall is wedged tightly in place.

How to Support Platform Framing (Joists Parallel to the Wall)

Build two 4-ft.-long cross braces, using pairs of 2 × 4s nailed together. Attach the cross braces to the double top plate, 1 ft. from the ends, using countersunk lag screws.

Place a 2 × 4 sole plate directly over a floor joist, then set hydraulic jacks on the sole plate. For each jack, build a post 8" shorter than the jack-to-ceiling distance. Nail the posts to the top plate, 2 ft. from the ends. Cover the braces with the cloth, and set the support structure on the jacks.

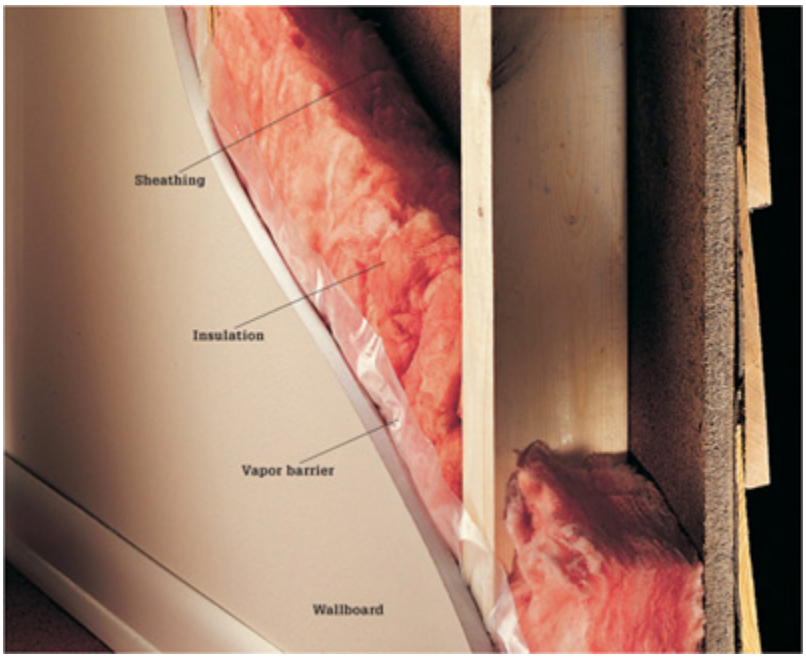
Adjust the support structure so the posts are exactly plumb, and pump the hydraulic jacks until the cross braces just begin to lift the ceiling. Do not lift too far or you may damage the ceiling or floor.

Removing Wallboard

You must remove interior wall surfaces before starting the framing work for most remodeling projects. Most often, the material you'll be removing is wallboard. Demolishing a section of wallboard is a messy job, but it is not difficult. Before you begin, shut off the power and inspect the wall for wiring and plumbing.

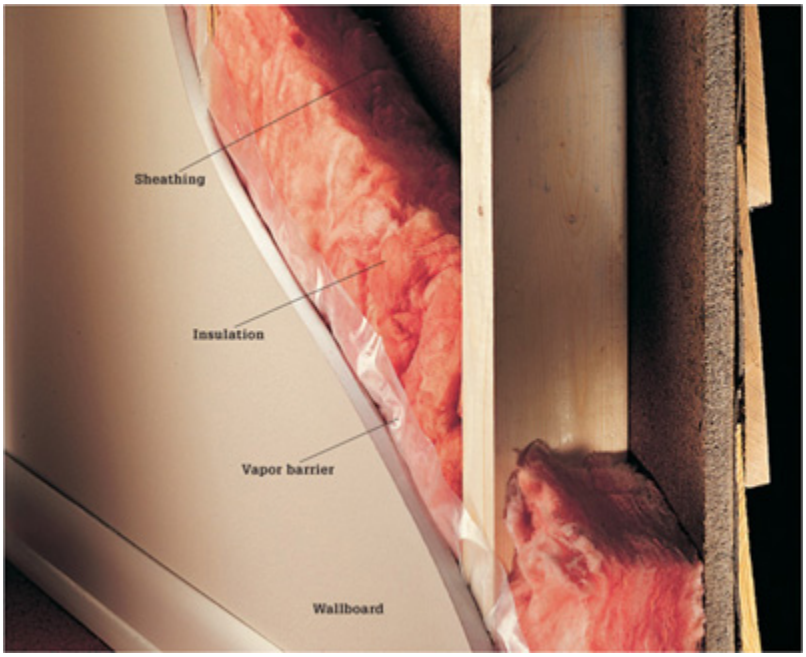
Remove enough surface material so that there is plenty of room to install the new framing members. When framing for a window or door, remove the wall surface from floor to ceiling and all the way to the first wall studs on either side of the planned rough opening. If the wallboard was attached with construction adhesive, clean the framing members with a rasp or an old chisel.

Note: If your walls are covered in wood paneling, remove it in full sheets if you intend to reuse it. It may be difficult to find new paneling to match the old style.

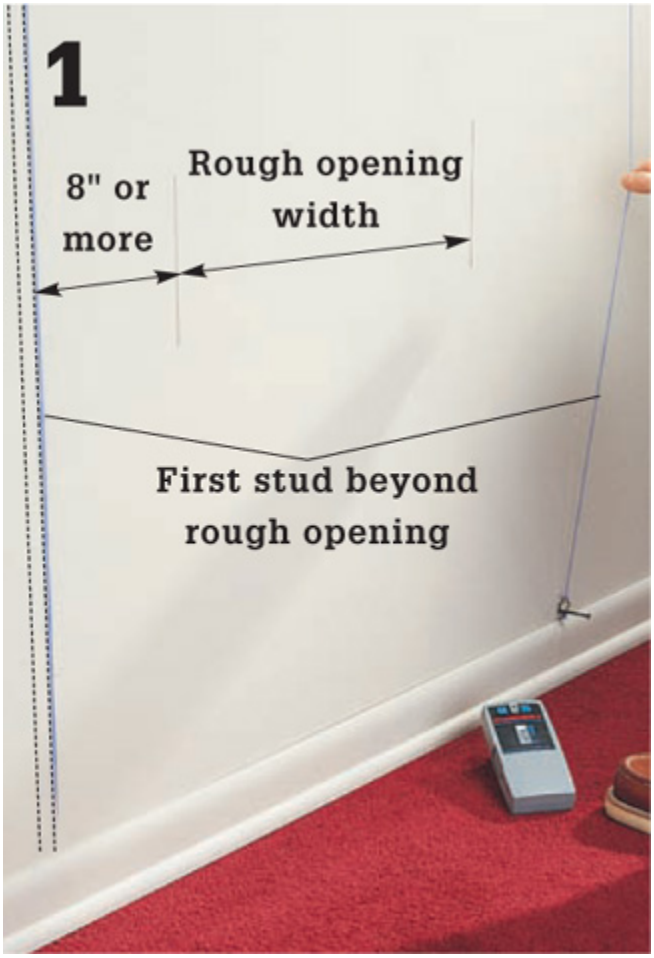

Sheathing
Insulation
Vapor barrier
Wallboard

Tools & Materials

- Screwdrivers
- Tape measure
- Pencil
- Stud finder
- Chalk line
- Circular saw with remodeling blade
- Utility knife
- Pry bar
- Protective eye wear
- Hammer


Sheathing
Insulation
Vapor barrier
Wallboard

How to Remove Wallboard



Mark the width of the rough opening on the wall and locate the first stud on either side of the planned rough opening. If the rough opening is more than 8" from the next stud, use a chalk line to mark a cutting line on the inside edge of the stud.

Remove the baseboards and other trim, and prepare the work area (page 115). Make a ¾"-deep cut from floor to ceiling along both cutting lines, using a circular saw. Use a utility knife to finish the cuts at the top and bottom and to cut through the taped horizontal seam where the wall meets the ceiling surface.

Insert the end of a pry bar into the cut near a corner of the opening. Pull the pry bar until the wallboard breaks, then tear away the broken pieces. Take care to avoid damaging the wallboard outside the project area.

Continue removing the wallboard by striking the surface with the side of a hammer and pulling the wallboard away from the wall with the pry bar or your hands.

Remove nails, screws, and any remaining wallboard from the framing members, using a pry bar. Remove any vapor barrier and insulation.

Removing Plaster

Plaster removal is a dusty job, so always wear eye protection and a particle mask during demolition, and use sheets of plastic to protect furniture and to block open doorways. Plaster walls are very brittle, so work carefully to avoid cracking the plaster in areas that will not be removed.

If the material being removed encompasses most of the wall surface, consider removing the whole interior surface of the wall. Replacing the entire wall with wallboard is easier and produces better results than trying to patch around the project area.

Plaster
Wood lath
Insulation

Tools & Materials

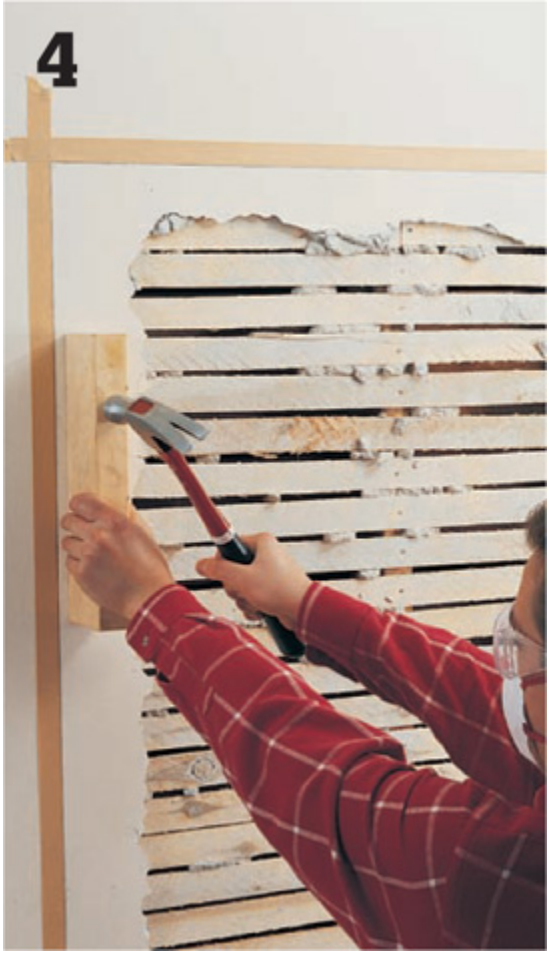
Straightedge	Pry bar
Pencil	Reciprocating saw or jigsaw
Chalk line	Aviation snips
Utility knife	Protective eye wear
Particle mask	Masking tape
Work gloves	Scrap 2 × 4
Hammer	

HOW to Remove Plaster Walls

Shut off the power and inspect the wall for wiring and plumbing. Mark the wall area to be removed by following the directions on page 189. Apply a double layer of masking tape along the outside edge of each cutting line.

Score each line several times with a utility knife, using a straightedge as a guide. Scored lines should be at least ⅛" deep.

Beginning at the top of the wall in the center of the planned opening, break up the plaster by striking the wall lightly with the side of a hammer. Clear away all plaster from floor to ceiling to within 3" of the marked lines.



Break the plaster along the edges by holding a scrap piece of 2 × 4 on edge just inside the scored line and rapping it with a hammer. Use a pry bar to remove the remaining plaster.

Cut through the lath along the edges of the plaster, using a reciprocating saw or jigsaw.

Variation: If the wall has metal lath laid over the wood lath, use aviation snips to clip the edges of the metal lath. Press the jagged edges of the lath flat against the stud. The cut edges of metal lath are very sharp; be sure to wear work gloves.

Remove the lath from the studs, using a pry bar. Pry away any remaining nails, and remove any vapor barrier and insulation.

Removing Exterior Surfaces

Exterior surfaces must be removed when you want to create a new opening for a door, window, or room addition in an exterior wall. Start by identifying the surface. If it is lap siding, it may be wood, vinyl, or metal. The same basic method is used for removal of any exterior surface. However, some materials must be cut with a specialty saw blade, such as a metal-cutting blade (page 72).

Always shut off the power and reroute utility lines, remove any interior surfaces, and frame in the new opening before removing an exterior surface. To protect the wall cavities against moisture, enclose the new opening as soon as you remove the old siding.

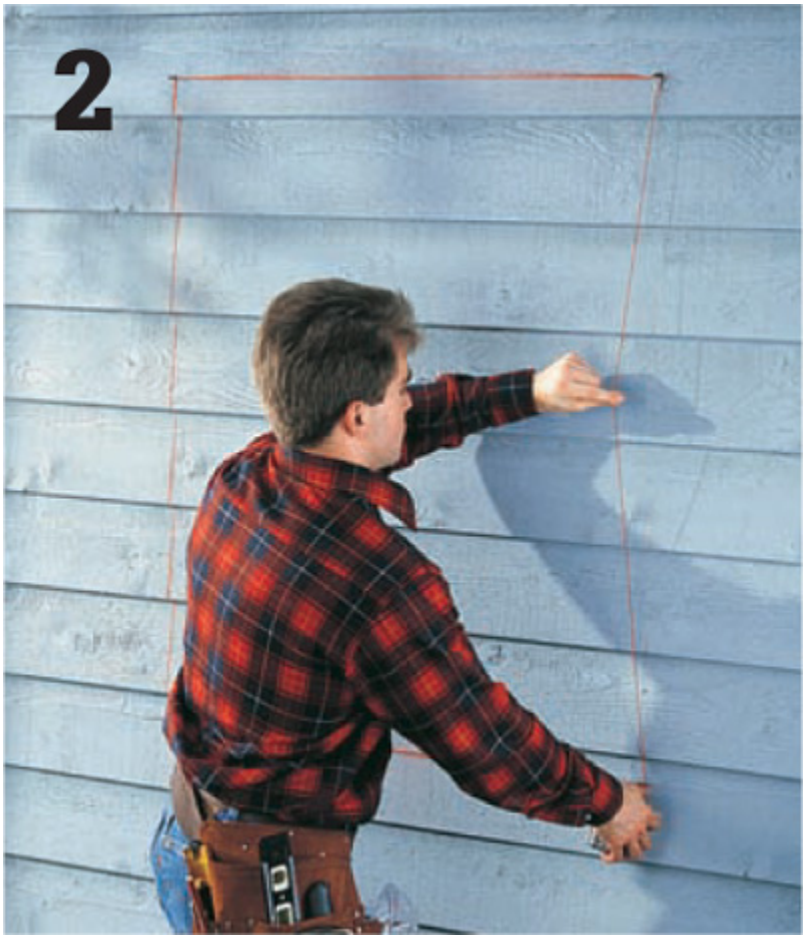
Vapor barrier
Lap siding
Insulation
Building paper
Fiberboard sheathing

Tools & Materials

- Drill with an 8"-long, 3/16" twist bit
- Hammer
- Tape measure
- Chalk line
- Circular saw with remodeling blade
- Reciprocating saw
- Eye protection
- 8d casing nails
- Straight 1 × 4

How to Make an Opening in Lap Siding

From inside the house, drill through the wall at the corners of the framed opening. Push casing nails through the holes to mark their location. For round-top windows, drill holes around the curved outline (see variation, page 195).



Measure the distance between the nails on the outside of the house to make sure the dimensions are accurate. Mark the cutting lines with a chalk line stretched between the nails. Push the nails back through the wall.

Nail a straight 1 × 4 flush with the inside edge of the right cutting line. Sink the nail heads with a nail set to prevent scratches to the foot of the saw. Set the circular saw to its maximum blade depth.

Rest the saw on the 1 × 4, and cut along the marked line, using the edge of the board as a guide. Stop the cuts about 1" short of the corners to keep from damaging the framing members.

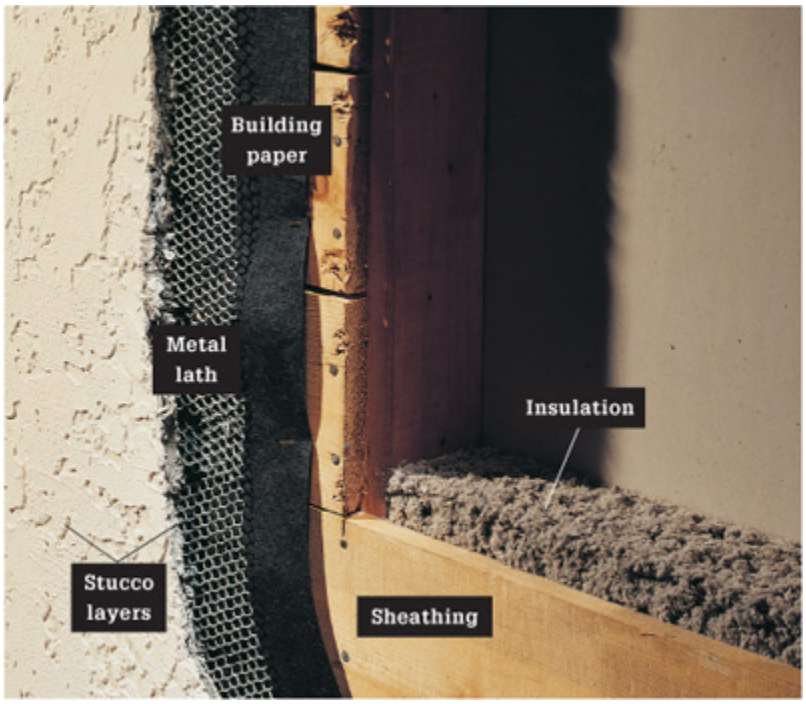
Reposition the 1 × 4, and make the remaining straight cuts. Drive nails within 1¼" of the inside edge of the board, because the siding under this area will be removed to make room for door or window brick moldings.

Variation: For round-top windows, make curved cuts using a reciprocating saw or jigsaw. Move the saw slowly to ensure smooth, straight cuts. To draw an outline for round-top windows, use a cardboard template.

Complete the cuts at the corner with a reciprocating saw or jigsaw.

Remove the cut wall section. If you are working with metal siding, wear work gloves. If you wish, remove the siding pieces from the sheathing and save them for future use.

How to Make an Opening in Stucco

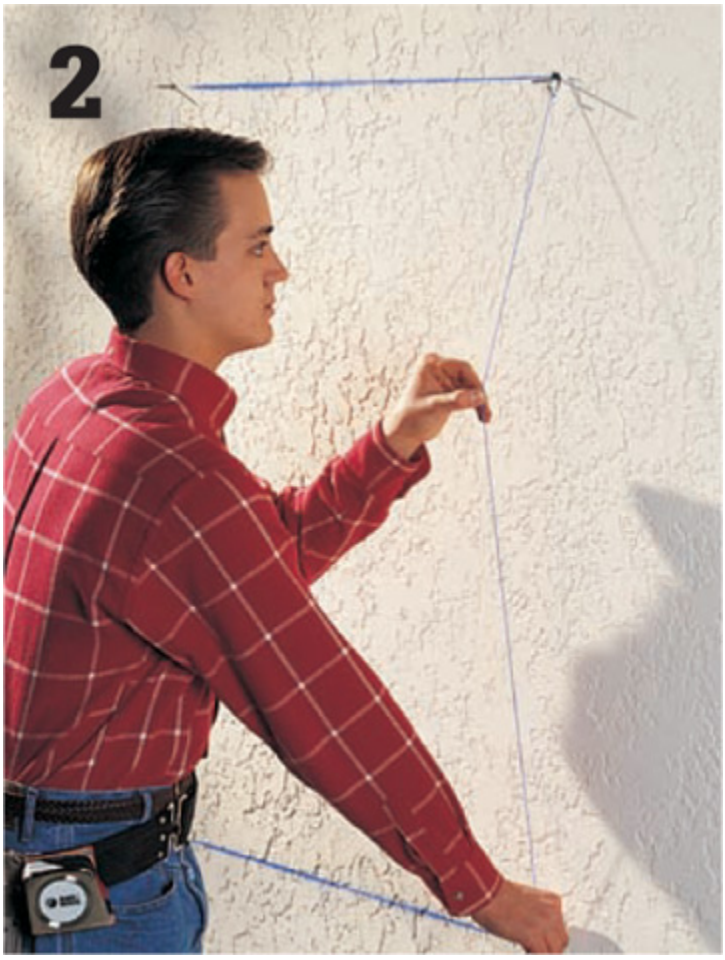


Stucco is a multiple-layer cement product applied to metal lath. Building paper is sandwiched between the metal lath and the sheathing to create a waterproof barrier. Stucco is extremely durable due to its cement base. But if you don't do the removal carefully, it's easy to crack the stucco past the outline for the new window or door.

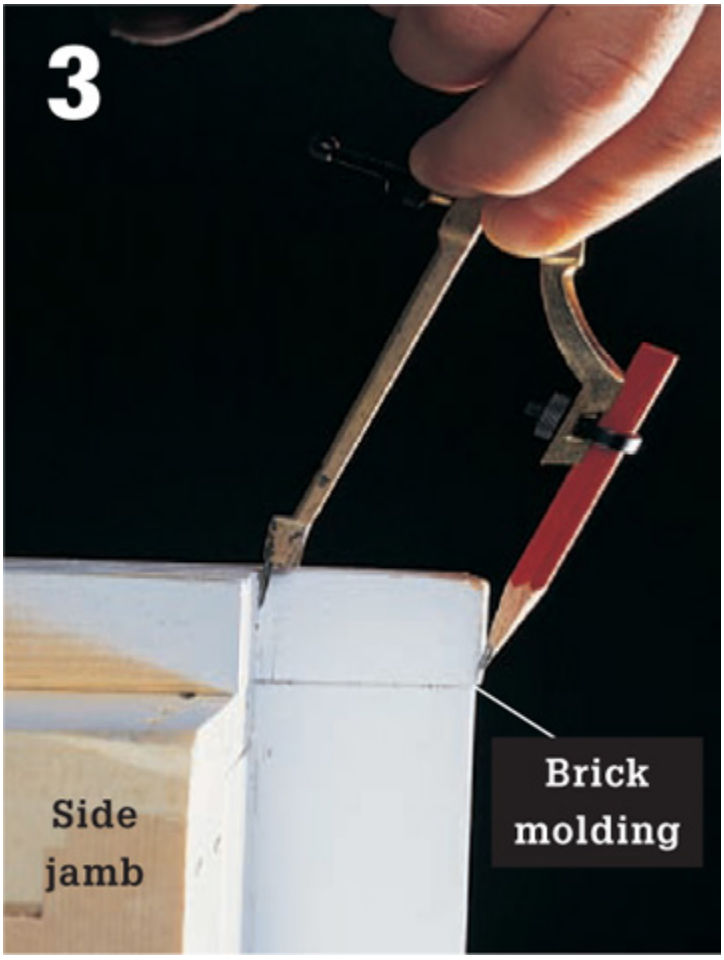
Tools & Materials

Drill with an 8" long, 3/16" twist and masonry bits
Tape measure
Chalk line
Compass
Masonry hammer
Eye and ear protection
Circular saw and blades (masonry-cutting and remodeling)
Masonry chisels
Pry bar
Aviation snips
8d casing nails

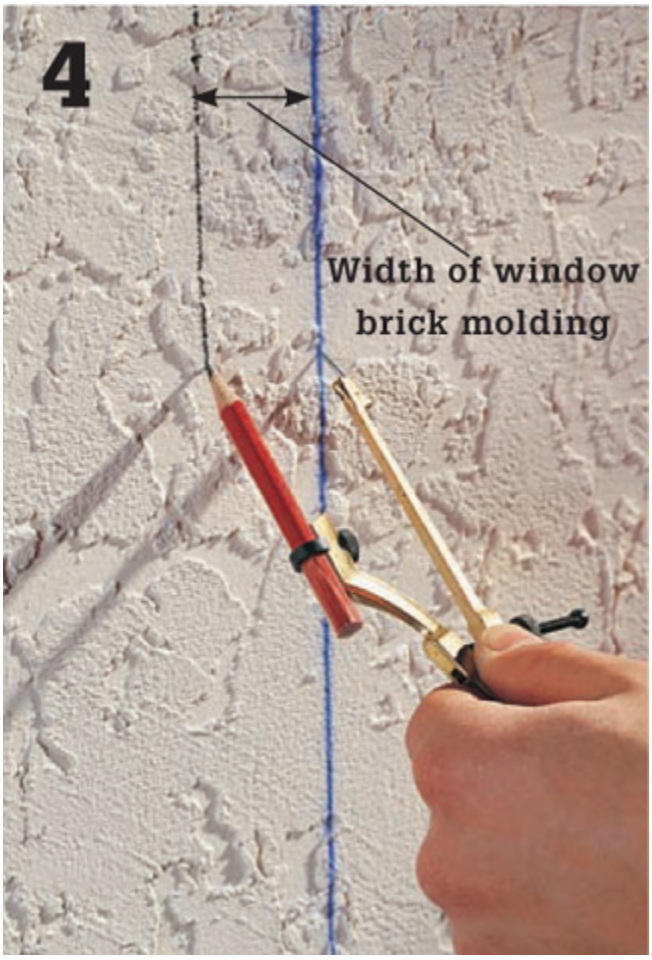
From inside the house, drill through the wall at the corners of the framed opening. Use a twist bit to drill through the sheathing, then use a masonry bit to finish the holes. Push casing nails through the holes to mark their locations.



On the outside wall, measure the distance between the nails to make sure the rough opening dimensions are accurate. Mark cutting lines between the nails, using a chalk line.



Match the distance between the side jambs and the edge of the brick molding on a window or door with the legs of a compass.



Scribe a cutting line on the stucco by moving the compass along the outline, with the compass point held on the marked line. This added margin will allow the brick molding to fit tight against the wall sheathing.

Score the stucco surface around the outside edge of the scribed line, using a masonry chisel and masonry hammer. The scored grooves should be at least ⅛" deep to serve as a guide for the circular saw blade.

Make straight cuts using a circular saw and masonry-cutting blade. Make several passes with the saw, gradually deepening the cuts until the blade just cuts through the metal lath, causing sparks to fly. Stop cuts just ahead of the corners to avoid damaging the stucco past the cutting line; complete the cuts with a masonry chisel.

Variation: For round-top windows, mark the outline on the stucco, using a cardboard template, and drill a series of holes around the outline, using a masonry bit. Complete the cut with a masonry chisel.

Break up the stucco with a masonry hammer or sledgehammer, exposing the underlying metal lath. Use aviation snips to cut through the lath around the opening. Use a pry bar to pull away the lath and attached stucco.

Outline the rough opening on the sheathing, using a straightedge as a guide. Cut the rough opening along the inside edge of the framing members, using a circular saw or reciprocating saw. Remove the cut section of sheathing.

Removing Doors & Windows

If your remodeling project requires removing old doors and windows, do not start this work until all preparation work is finished and the interior wall surfaces and trim have been removed. You will need to close up the wall openings as soon as possible, so make sure you have all the necessary tools, framing lumber, and new window or door units before starting the final stages of demolition. Be prepared to finish the work as quickly as possible.

Doors and windows are removed using the same basic procedures. In many cases, old units can be salvaged for resale or later use, so use care when removing them.

Tools & Materials

- Utility knife
- Flat pry bar
- Screwdriver
- Hammer
- Reciprocating saw
- Plywood sheets
- Masking tape

If wall openings cannot be filled immediately, protect your home by covering the openings with scrap pieces of plywood screwed to the framing members. Plastic sheeting stapled to the outside of the openings will prevent moisture damage.

Masking
tape used to
contain glass
in the event of
breakage

How to Remove Doors & Windows

Remove the window trim, using a pry bar.

For double-hung windows with sash weights, remove the weights by cutting the cords and pulling the weights from the pockets.

Cut through the nails holding the window and door frames to the framing members, using a reciprocating saw.

Pry the brick moldings free from the framing members, using a pry bar.

Pull the unit from the rough opening, using a pry bar, and remove it completely.

Variation: For windows and doors attached with nailing fins, cut or pry loose the siding material or brick moldings, then remove the mounting nails holding the unit to the sheathing.

Removing a Non-loadbearing Wall

Removing an existing interior wall is an easy way to create more usable space without the expense of building an addition. Removing a wall turns two small rooms into a large space perfect for family living. Adding new walls in a larger area creates a private space to use as a quiet study or as a new bedroom.

Be sure the wall you plan to remove is not load-bearing before you begin (see page 113). If you need to remove a load-bearing wall, check with a contractor or building inspector first. Load-bearing walls carry the weight of the structure above them. You'll need to install a temporary support wall (see page 187) to take the place of the structural wall you're removing.

Remember that walls also hold the essential mechanical systems that run through your home. You need to consider how your project affects these mechanicals. Contact a professional carpenter to review your plans.

Tools & Materials

- Stud finder
- Tape measure
- Utility knife
- Hammer
- Pry bars
- Reciprocating or circular saw
- Drill

How to Remove a Non-loadbearing Wall

Use a utility knife to score the intersections where the wall you're removing meets the ceiling to keep from damaging it during wall removal. Pry away baseboard trim and remove receptacle plates and switch covers to prepare for demolition.

Use the side of a hammer to punch a starter hole in the wallboard, then carefully remove the wallboard with a pry bar. Try to pull off large sections at a time to minimize dust. Remove any remaining wallboard nails or screws from the wall studs.

Reroute outlets, switches, plumbing, or ductwork. Have professionals do this for you if you are not experienced with these systems or confident in your skills. This work should be inspected after it is completed.

Locate the closest permanent studs on the adjacent wall or walls with a stud finder, and carefully remove the wallboard up to these studs. Score the wallboard first with a utility knife, then cut through it with a circular saw.

Remove the wall studs by cutting through them in the middle with a reciprocating saw and prying out the upper and lower sections. Remove the endmost studs where the wall meets an adjacent wall or walls.

Cut through the wall's top plate with a circular saw or reciprocating saw. Pry out the top plate sections carefully to avoid damaging the ceiling.

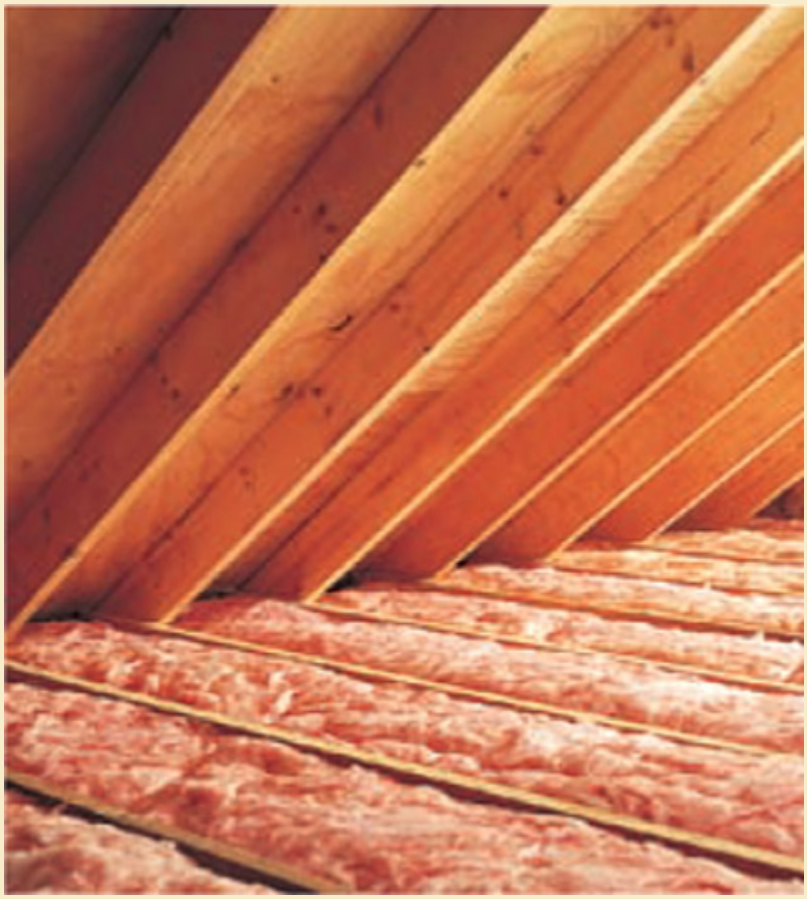
Remove the sole plate just as you did the top plate by cutting through it and prying up the long pieces.

Patch the walls and ceiling with strips of wallboard, and repair the floor as needed with new floor coverings. (For more on patching a finished or carpeted floor, see pages 254 to 255.)

Installing an Attic Access Ladder

Before purchasing an attic access ladder, examine your home's framing in the attic. If your roof is framed with trusses, make sure to purchase a ladder unit that will fit between the trusses; never cut or alter the trusses.

Tip



Standard rafter and joist framing allows you the option to cut one of the joists to install a wider ladder unit. If you have to cut a joist, build temporary supports to support the joist during the project, then frame in permanent headers to carry the cut joist as shown on the next page.

How to Install an Attic Access Ladder

Mark the approximate location for the attic access door on the room ceiling. Drill a hole at one of the corners and push the end of a stiff wire up into the attic. In the attic, locate the wire and clear away insulation in the area. Using dimensions provided by the manufacturer, mark the rough opening across the framing members, using one of the existing joists as one side of the frame. Add 3" (the width of two 2xs) to the rough opening length dimension to allow for the headers.

If the width of your ladder unit requires that you cut a joist, build temporary supports in the room below to support each end of the cut joist to prevent damage to your ceiling (page 187). Use a reciprocating saw to cut through the joist at both end marks, then remove the cut piece. Caution: Do not stand on the cut joist.

Cut two headers to fit between the joists using 2x lumber the same size as your ceiling joists. Position the headers perpendicular to the joists, butting them against the cut joists. Make sure the corners are square and attach the headers with three 3" deck screws into each joist.

Cut a piece of 2x lumber to the length of the rough opening to form the other side of the frame. Square the corners and attach the side piece to each header with three 3" deck screws.

Cut the rough opening in the ceiling, using a wallboard saw. Use the rough opening frame to guide your saw blade.

Fasten the edges of the wallboard to the rough opening frame using 1¼" wallboard screws spaced every 8". Prepare the ladder’s temporary support clips according to the manufacturer’s directions.

If your ladder does not include support clips, attach 1 × 4 boards at both ends of the opening, slightly overlapping the edges, to act as ledgers to support the unit while fastening.

With a helper, lift the unit through the opening and rest it on the ledgers. Make sure the unit is square in the frame and the door is flush with the ceiling surface. Shim the unit as needed. *Note: Do not stand on the unit until it is firmly attached to the framing.*

Attach the ladder unit to the rough framing with 10d nails or 2" screws driven through the holes in the corner brackets and hinge plates. Continue fastening the unit to the frame, driving screws or nails through each side of the ladder frame into the rough frame. Remove the temporary ledgers or support clips when complete.

Open the ladder, keeping the lower section folded back. With the tape measure along the top of the rail, measure the distance from the end of the middle section to the floor on each rail. Subtract 3" and mark the distances on the right and left rails of the third section. Use a square to mark a cutting line across the rails. Place a support under the lower section and trim along the cutting line with a hacksaw. (For wooden ladders, see manufacturer’s directions.)

Fully extend the ladder and test-fit the adjustable feet on the rails. Adjust the feet so there are no gaps in the hinges and the feet are flush with the floor. Drill through the rails, using a recommended size bit, and attach the adjustable feet with included nuts, washers, and bolts.

Install casing around the edges to cover the gap between the ceiling wallboard and the ladder frame (page 153). Leave a ⅜" clearance between the door panel and the casing.

Framing & Installing Doors

The first step in installing a new door is deciding what size and style you want. Although many styles of doors are carried in stock at home centers, if you want a custom size, you may need to have the home center special-order the doors from the manufacturer. Special orders generally take three or four weeks for delivery.

For easy installation, buy a prehung door, which is already mounted in the jamb. You can also fit and hang a new door in an old jamb to preserve the existing moldings (see pages 144 to 147).

When replacing an existing door, choose a new unit the same size as the old door because you'll be able to use the framing members that are already in place.

This section shows:

- Framing an exterior door opening
- Installing an entry door
- Installing a storm door
- Installing a patio door

The following pages show installation techniques for woodframe houses with lap siding. If your home exterior is stucco, see pages 194 to 195. For information on interior door installation, see pages 140 to 141.

When it’s time to install the door trim, you’ll find out in a hurry whether the door was installed squarely in the opening.

Framing an Exterior Door Opening

The rough opening for a new exterior door should be framed after the interior preparation work is done, but before the exterior wall surfaces are removed. The methods for framing the opening will vary, depending on what type of construction your house was built with (see photos).

Make sure the rough opening is 1" wider and ½" taller than the dimensions of the door you plan to install, including the jambs, to allow space for adjustment during installation.

Because exterior walls are always load-bearing, the framing for an exterior door requires doubled studs on each side of the door opening and a larger header than those used for interior partition walls. The double-framed stud construction cuts down on vibration in the wall when the door is opened and closed and ensures adequate support for the larger header.

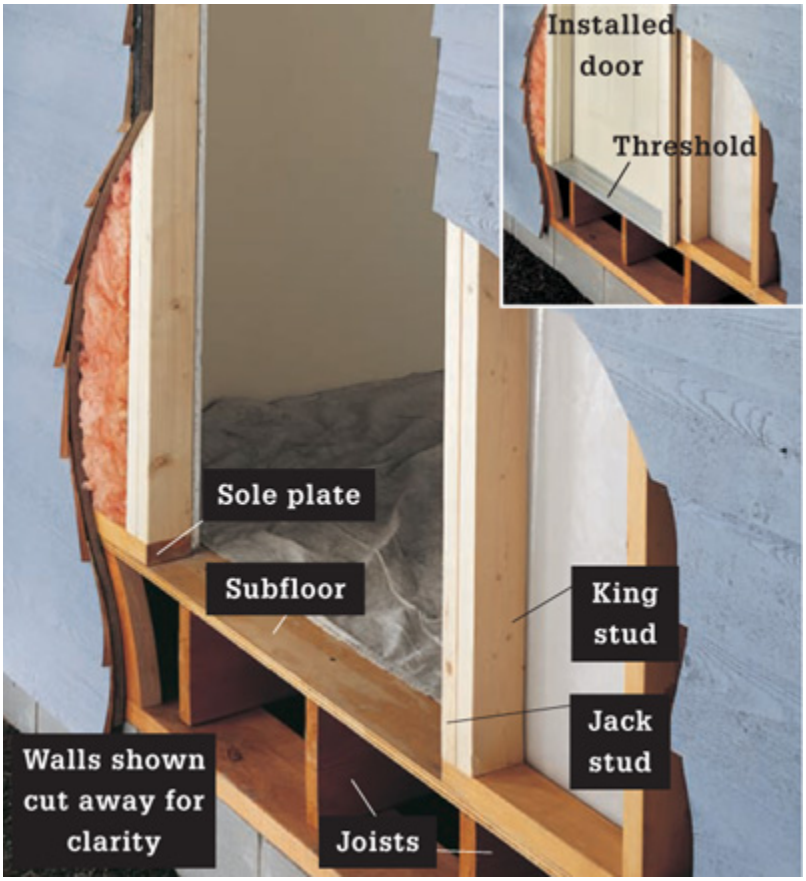
Local building codes will specify a minimum size for the door header based on the size of your rough opening, but you can get an estimation of what size the header will be on page 110.

Always build temporary supports to hold up the ceiling if your project requires that you cut or remove more than one stud in a load-bearing wall (page 187).

When you finish framing, measure across the top, middle, and bottom of the door opening to make sure it is uniform from the top to the bottom. If there are major differences in the opening size, adjust the studs so the opening is uniform.

Tools & Materials

Tape measure	Hammer
Pencil	Pry bar
Level	Nippers
Plumb bob	2" dimension lumber
Reciprocating saw	⅜" plywood
Circular saw	10d nails
Handsaw	



A new door opening in a platform-framed house has studs that rest on a sole plate running across the top of the subfloor. The sole plate is cut away between the jack studs so the threshold for the new door can rest directly on the subfloor.

A new door opening in a balloon-framed house has studs extending past the subfloor to rest on the sill plate. Jack studs rest either on the sill plate or on top of the joists. To provide a surface for the door threshold, install nailing blocks, and extend the subfloor out to the ends of the joists, using plywood.

How to Frame an Exterior Door Opening (Platform Framing)

Prepare the project site and remove the interior wall surfaces to expose the framing. See pages 115 and 188 to 191.

Measure and mark the rough opening width on the sole plate. Mark the locations of the jack studs and king studs on the sole plate. (Where practical, use existing studs as king studs.)

If king studs need to be added, measure and cut them to fit between the sole plate and top plate. Position the king studs and toenail them to the sole plate with 10d nails.

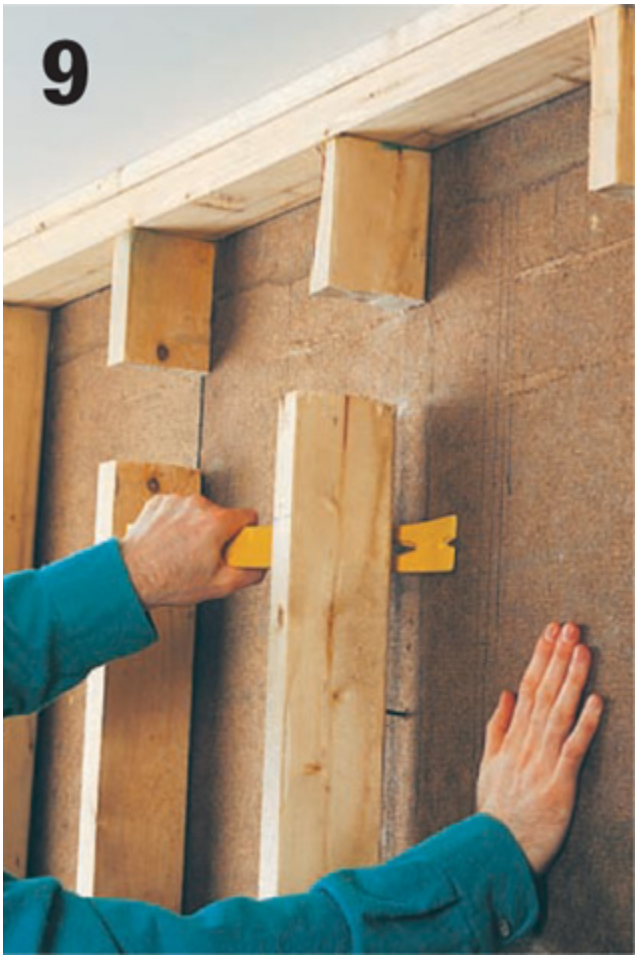
Check the king studs with a level to make sure they are plumb, then toenail them to the top plate with 10d nails.

Measuring from the floor, mark the rough opening height on one king stud. For most doors, the recommended rough opening is ½" greater than the height of the door jamb. This line marks the bottom of the door header.

Determine the size of the header needed (page 110), and measure and mark where the top of it will fit against a king stud. Use a level to extend the lines across the intermediate studs to the opposite king stud.

Cut two jack studs to reach from the top of the sole plate to the rough opening marks on the king studs. Nail the jack studs to the king studs with 10d nails driven every 12". Make temporary supports (page 187) if the wall is load-bearing and you are removing more than one stud.

Use a circular saw set to maximum blade depth to cut through the old studs that will be removed. The remaining stud sections will be used as cripple studs for the door frame. Note: *Do not cut king studs. Make additional cuts 3" below the first cuts, then finish the cuts with a handsaw.*

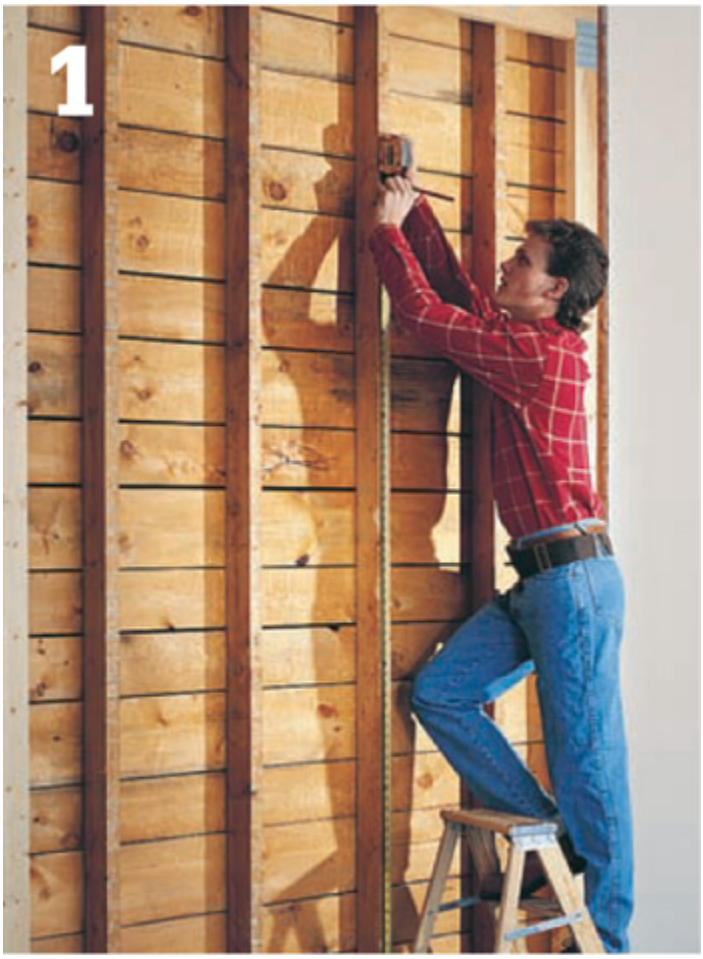


Knock out the 3" stud sections, then tear out the rest of the studs with a pry bar. Clip away any exposed nails, using nippers.

Build a header to fit between the king studs on top of the jack studs. Use two pieces of 2" dimensional lumber sandwiched around ⅜" plywood (page 137). Attach the header to the jack studs, king studs, and cripple studs, using 10d nails.

Use a reciprocating saw to cut through the sole plate next to each jack stud, then remove the sole plate with a pry bar. Cut off any exposed nails or anchors, using nippers.

How to Frame a Door Opening (Balloon Framing)



Remove the interior wall surfaces (pages 188 to 191). Select two existing studs to use as king studs. The distance between selected studs must be at least 3" wider than the planned rough opening. Measuring from the floor, mark the rough opening height on a king stud.

Determine the header size (page 110), and measure and mark where the top of it will fit against a king stud. Use a level to extend the line across the studs to the opposite king stud.

Use a reciprocating saw to cut open the subfloor between the studs, and remove any fireblocking in the stud cavities. This allows access to the sill plate when installing the jack studs. If you will be removing more than one wall stud, make temporary supports (page 187).

Use a circular saw to cut studs along the lines marking the top header. *Note: Do not cut king studs. Make two additional cuts on each stud, 3" below the first cut and 6" above the floor. Finish cuts with a handsaw, then knock out the 3" sections with a hammer. Remove studs with a pry bar.*

Cut two jack studs to reach from the top of the sill plate to the rough opening mark on the king studs. Nail the jack studs to the king studs with 10d nails driven every 12".

Build a header to fit between the king studs on top of the jack studs, using two pieces of 2" dimension lumber sandwiched around ⅜" plywood (page 137). Attach the header to the jack studs, king studs, and cripple studs, using 10d nails.

Measure and mark the rough opening width on the header. Use a plumb bob to mark the rough opening on the sill plate (inset).

Cut and install additional jack studs, as necessary, to frame the sides of the rough opening. Toenail the jack studs to the header and the sill plate, using 10d nails. Note: *You may have to go to the basement to do this.*

Install horizontal 2 × 4 blocking between the studs on each side of the rough opening, using 10d nails. Blocking should be installed at the lockset location and at the hinge locations on the new door.

Remove the exterior wall surface as directed on pages 192 to 195.

Cut off the ends of the exposed studs flush with the tops of the floor joists, using a reciprocating saw or handsaw.

Install 2 × 4 nailing blocks next to the jack studs and joists, flush with the tops of the floor joists. Replace any fireblocking that was removed. Patch the subfloor area between the jack studs with plywood to form a flat, level surface for the door threshold.

Installing an Entry Door

Prehung entry doors come in many styles, but all are installed using the same basic methods. Because entry doors are very heavy—some large units weigh several hundred pounds—make sure you have help before beginning installation.

To speed your work, do the indoor surface removal (pages 188 to 191) and framing work (pages 206 to 209) in advance. Before installing the door, make sure you have all the necessary hardware. Protect the door against the weather by painting or staining it and by adding a storm door (pages 150 and 151).

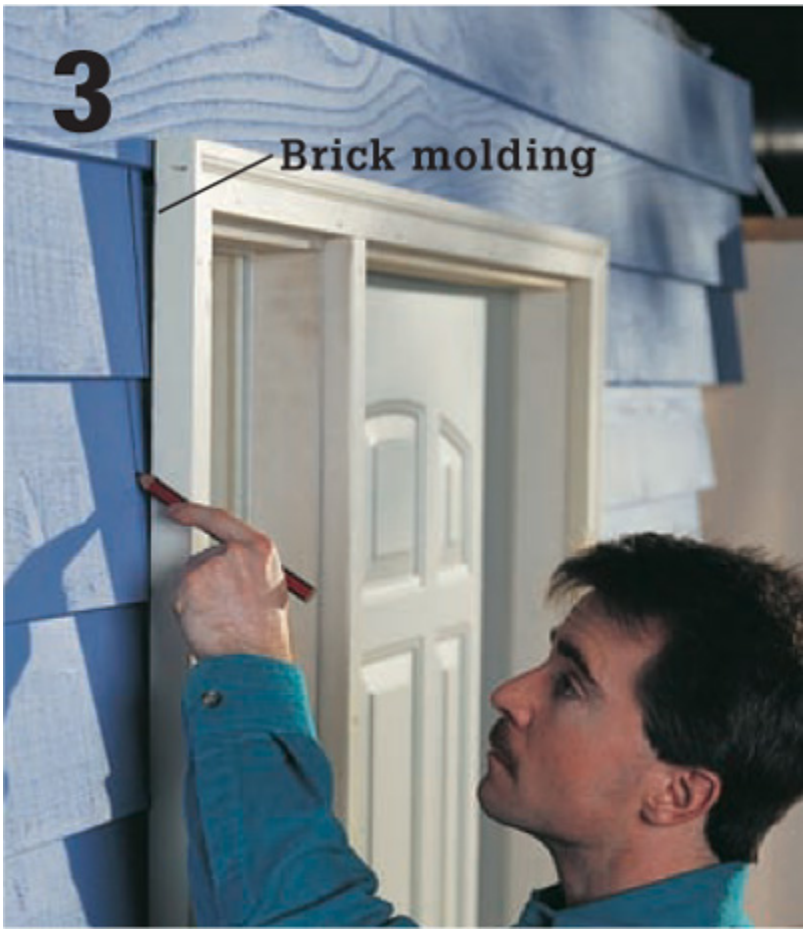
Tools & Materials

Metal snips	Drill and bits
Hammer	Handsaw
Level	Building paper
Pencil	Drip edge
Circular saw	Wood shims
Wood chisel	Fiberglass insulation
Nail set	10d galvanized casing nails
Caulk gun	Silicone caulk
Stapler	Entry door kit

How to Install an Entry Door

Remove the door unit from its packing. Do not remove the retaining brackets that hold the door closed. Remove the exterior face material inside the framed opening as directed on page 197.

Test-fit the door unit, centering it in the rough opening. Check to make sure the door is plumb. If necessary, shim under the lower side of the door jamb until the door is plumb and level.



Trace an outline of brick molding on the siding. Note: *If you have vinyl or metal siding, enlarge the outline to make room for the extra trim moldings required by these sidings. Remove the door unit after finishing the outline.*

Cut the siding along the outline, just down to the sheathing, using a circular saw. Stop just short of the corners to prevent damage to the siding that will remain.

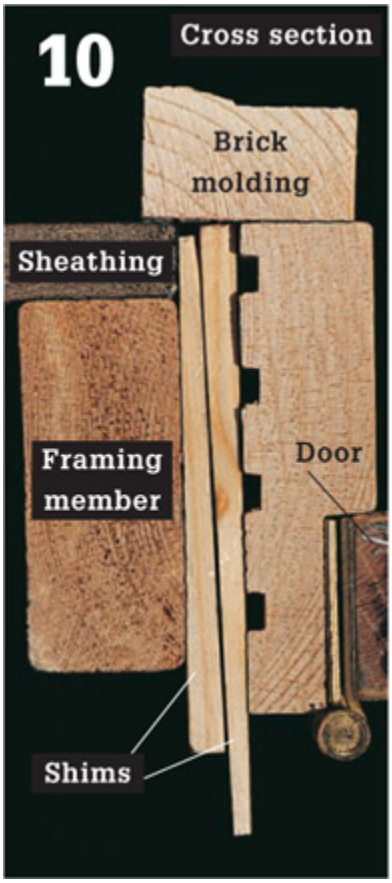
Finish the cuts at the corners with a sharp wood chisel.

Cut 8"-wide strips of building paper and slide them between the siding and sheathing at the top and sides of the opening to shield framing members from moisture. Bend paper around the framing members and staple it in place.

To provide an added moisture barrier, cut a piece of drip edge to fit the width of the rough opening, then slide it between the siding and the building paper at the top of the opening. Do not nail the drip edge.

Apply several thick beads of silicone caulk to the subfloor at the bottom of the door opening. Also apply silicone caulk over the building paper on the front edges of the jack studs and header.

Center the door unit in the rough opening, and push the brick molding tight against the sheathing. Have a helper hold the door unit steady until it is nailed in place.



From inside, place pairs of hardwood wedge shims together to form flat shims (left), and insert shims into the gaps between the door jambs and framing members. Insert shims at the lockset and hinge locations and every 12" thereafter.

Make sure the door unit is plumb. Adjust the shims, if necessary, until the door is plumb and level. Fill the gaps between the jambs and the framing members with loosely packed fiberglass insulation.

From outside, drive 10d casing nails through the door jambs and into the framing members at each shim location. Use a nail set to drive the nail heads below the surface of the wood.

Remove the retaining brackets installed by the manufacturer, then open and close the door to make sure that it works properly.

Remove two of the screws on the top hinge and replace them with long anchor screws (usually included with the unit). These anchor screws will penetrate into the framing members to strengthen the installation.

Anchor brick molding to the framing members with 10d galvanized casing nails driven every 12". Use a nail set to drive the nail heads below the surface of the wood.

Adjust the door threshold to create a tight seal, following manufacturer's recommendations.

Cut off the shims flush with the framing members, using a handsaw.

Apply silicone caulk around the entire door unit. Fill the nail holes with latex caulk if you plan on painting the area. Finish the door and install the lockset as directed by the manufacturer.

Installing a Patio Door

For easy installation, buy a patio door with the door panels already mounted in a preassembled frame. Try to avoid patio doors sold with frame kits that require complicated assembly.

Because patio doors have very long bottom sills and top jambs, they are susceptible to bowing and warping. To avoid these problems, be very careful to install the patio door so it is level and plumb and to anchor the unit securely to framing members. Yearly caulking and touch-up painting helps prevent moisture from warping the jambs.

Tools & Materials

Pencil	Nail set
Hammer	Shims
Circular saw	Drip edge
Wood chisel	Building paper
Stapler	Silicone and latex caulk
Caulk gun	10d casing nails
Pry bar	3" wood screws
Level	Sill nosing
Drill	Patio door kit
Handsaw	Fiberglass insulation
Drill and bits	

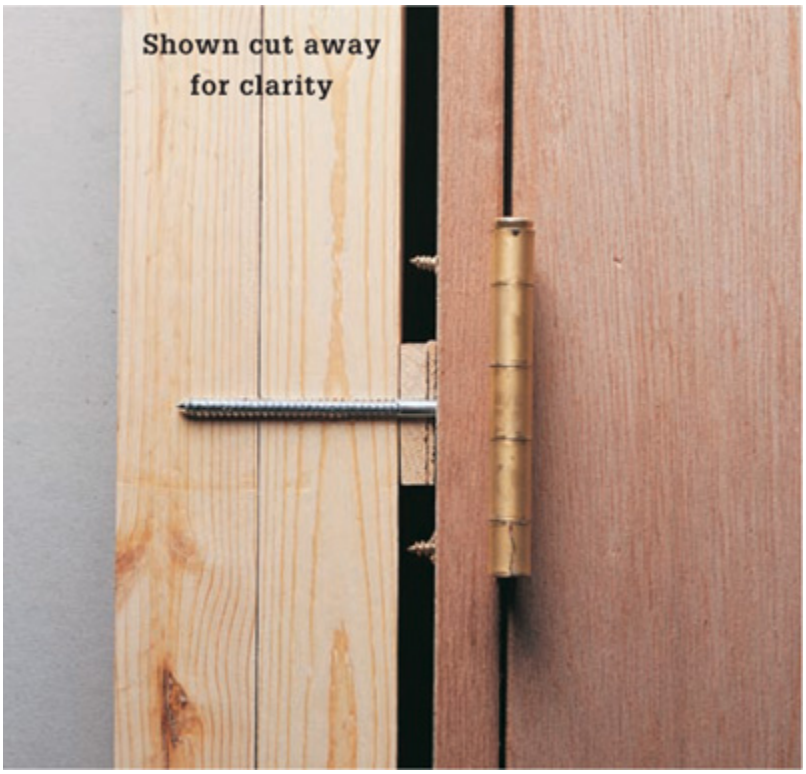
Screen doors, if not included with the unit, can be ordered from most patio door manufacturers. Screen doors have spring-mounted rollers that fit into a narrow track on the outside of the patio door threshold.

Installing Sliding Doors

Remove heavy, glass panels if you must install the door without help. Reinstall the panels after the frame has been placed in the rough opening and nailed at opposite corners. To remove and install the panels, remove the stop rail, found on the top jamb of the door unit.

Adjust the bottom rollers after installation is complete. Remove the coverplate on the adjusting screw, found on the inside edge of the bottom rail. Turn the screw in small increments until the door rolls smoothly along the track without binding when it is opened and closed.

Installing French-style Patio Doors



Provide extra support for door hinges by replacing the center mounting screw on each hinge with a 3" wood screw. These long screws extend through the side jambs and deep into the framing members.

Keep a uniform ⅛" gap between the door, side jambs, and top jamb to ensure that the door will swing freely without binding. Check this gap frequently as you shim around the door unit.

How to Install a Patio Door

Prepare the work area and remove the interior wall surfaces (pages 188 to 191), then frame the rough opening for the patio door (page 205). Remove the exterior surfaces inside the framed opening (page 192).

Test-fit the door unit, centering it in the rough opening. Check to make sure the door is plumb. If necessary, shim under the lower side jamb until the door is plumb and level. Have a helper hold the door in place while you adjust it.

Trace the outline of the brick molding onto the siding, then remove the door unit. Note: *If you have vinyl or metal siding, enlarge the outline to make room for the extra trim moldings required by these sidings.*

Cut the siding along the outline, just down to the sheathing, using a circular saw. Stop just short of the corners to prevent damage to the remaining siding. Finish the cuts at the corners with a sharp wood chisel.

To provide an added moisture barrier, cut a piece of drip edge to fit the width of the rough opening, then slide it between the siding and the existing building paper at the top of the opening. Do not nail the drip edge.

Cut 8"-wide strips of building paper and slide them between the siding and the sheathing. Bend the paper around the framing members and staple it in place.

Apply several thick beads of silicone caulk to the subfloor at the bottom of the door opening.

Apply silicone caulk around the front edge of the framing members, where the siding meets the building paper.

Center the patio door unit in the rough opening so the brick molding is tight against the sheathing. Have a helper hold the door unit from outside until it is shimmed and nailed in place.

Check the door threshold to make sure it is level, if necessary, shim under the lower side jamb until the patio door unit is level.

If there are gaps between the threshold and subfloor, insert shims coated with caulk into the gaps, spaced every 6". Shims should be snug, but not so tight that they cause the threshold to bow. Clear off excess caulk immediately.

Place pairs of hardwood wedge shims together to form flat shims. Insert the shims every 12" into the gaps between the side jambs and the jack studs. For sliding doors, shim behind the strike plate for the door latch.

Insert shims every 12" into the gap between the top jamb and the header.

From outside, drive 10d casing nails, spaced every 12", through the brick molding and into the framing members. Use a nail set to drive the nail heads below the surface of the wood.

From inside, drive 10d casing nails through the door jambs and into the framing members at each shim location. Use a nail set to drive the nail heads below the surface of the wood.

Remove one of the screws and cut the shims flush with the stop block found in the center of the threshold. Replace the screw with a 3" wood screw driven into the subfloor as an anchor.

Cut off the shims flush with the face of the framing members, using a handsaw. Fill gaps around the door jambs and beneath the threshold with loosely packed fiberglass insulation.

Reinforce and seal the edge of the threshold by installing sill nosing under the threshold and against the wall. Drill pilot holes and attach the sill nosing with 10d casing nails.

Make sure the drip edge is tight against the top brick molding, then apply silicone caulk along the top of the drip edge and along the outside edge of the side brick moldings. Fill all exterior nail holes with silicone caulk. Use latex caulk for the nail holes if you plan to paint over the area.

Caulk completely around the sill nosing, using your finger to press the caulk into any cracks. As soon as the caulk is dry, paint the sill nosing. Finish the door and install the lockset as directed by the manufacturer. See pages 152 to 153 to trim the interior of the door.

Framing & Installing Windows

Many windows must be custom-ordered several weeks in advance. To save time, you can complete the interior framing before the window unit arrives, but be sure you have the exact dimensions of the window unit before building the frame. Do not remove the outside wall surface until you have the window and accessories and are ready to install them.

Follow the manufacturer's specifications for the rough opening size when framing for a window. The listed opening usually is 1" wider and ½" taller than the actual dimensions of the window unit. The following pages show techniques for woodframe houses with platform framing.

If your house has balloon framing (page 109), use the method shown on pages 208 to 209 to install a header. Consult a professional to install a window on the second story of a balloon-framed house.

If your house has masonry walls or if you are installing polymer-coated windows, you may want to attach your window using masonry clips instead of nails.

If your home's exterior has siding or is stucco, see pages 192 to 195 for tips on removing these surfaces and making the opening.

Tools & Materials

Tape measure	10d common nails
Pencil	5d galvanized roofing nails
Combination square	Shims
Hammer	2× lumber
Level	⅛" plywood
Circular saw	Building paper
Handsaw	Drip edge
Pry bar	10d galvanized casing nails
Nippers	8d casing nails
Drill	Fiberglass insulation
Reciprocating saw	Paintable silicone caulk
Stapler	
Nail set	
Caulk gun	

Header
Angled stud
Jambs
Shims
Insulation
Double rough sill
Cripple studs
Jack stud
King stud

How to Frame a Window Opening

Prepare the project site and remove the interior wall surfaces (pages 188 to 191). Measure and mark the rough opening width on the sole plate. Mark the locations of the jack studs and king studs on the sole plate. Where practical, use the existing studs as king studs.

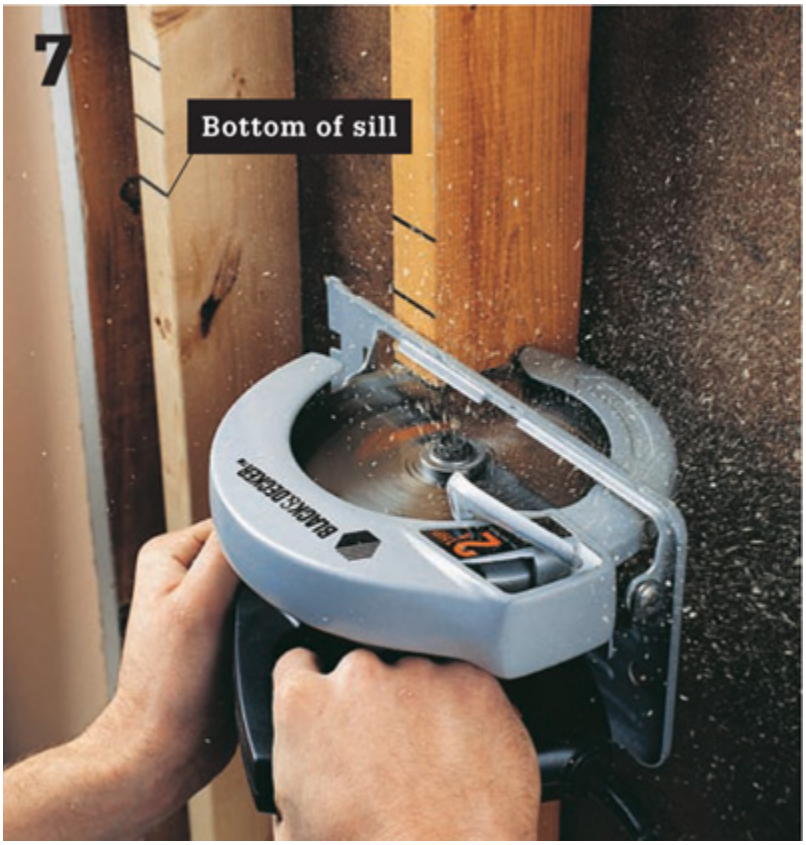
Measure and cut the king studs, as needed, to fit between the sole plate and the top plate. Position the king studs and toenail them to the sole plate with 10d nails.

Check the king studs with a level to make sure they are plumb, then toenail them to the top plate with 10d nails.

Measuring from the floor, mark the top of the rough opening on one of the king studs. This line represents the bottom of the window header. For most windows, the recommended rough opening is ½" taller than the height of the window frame.

Measure and mark where the top of the window header will fit against the king stud. The header size depends on the distance between the king studs (page 110). Use a carpenter's level to extend the lines across the old studs to the opposite king stud.

Measure down from header line and mark the double rough sill on the king stud. Use a carpenter's level to extend the lines across the old studs to the opposite king stud. Make temporary supports (page 187) if removing more than one stud.



Set a circular saw to its maximum blade depth, then cut through the old studs along the lines marking the bottom of the rough sill and along the lines marking the top of the header. Do not cut the king studs. On each stud, make an additional cut about 3" above the sill cut. Finish the cuts with a handsaw.

Knock out the 3" stud sections, then tear out the old studs inside the rough opening, using a pry bar. Clip away any exposed nails, using nippers. The remaining sections of the cut studs will serve as cripple studs for the window.

Cut two jack studs to reach from the top of the sole plate to the bottom header lines on the king studs. Nail the jack studs to the king studs with 10d nails driven every 12". Note: *On a balloon-framed house, the jack studs will reach to the sill plate.*

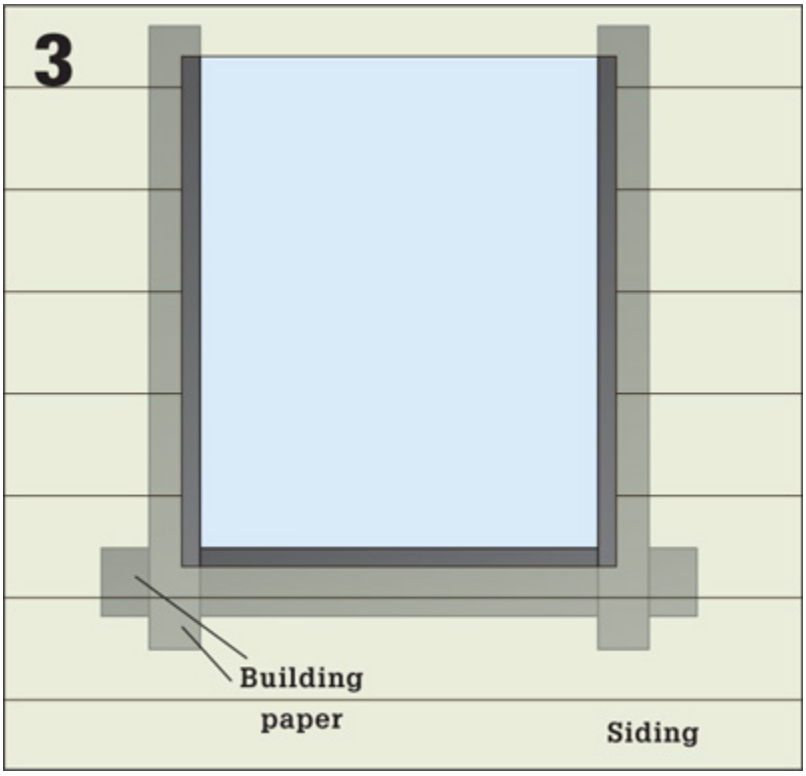
Position the header on the jack studs, using a hammer to tap it into place if necessary. Attach the header to the king studs, jack studs, and cripple studs, using 10d nails.

Build the rough sill to reach between the jack studs by nailing a pair of 2 × 4s together. Position the rough sill on the cripple studs, and nail it to the jack studs and cripple studs with 10d nails.

How to Install a Window with a Nailing Flange

Test-fit the window in the rough opening, centering it side-to-side in the opening. On the interior side, level and plumb the window, using shims at the sill to make any necessary adjustments. Do not allow shims to cause the sill or jambs to bow or impede the window's operation. Mark the position of the shims on the wall.

On the exterior side, measure out from the window on all sides and mark the wood siding at the width of the brick molding to be installed. Remove the window and connect the marks, using a straightedge. Cut along the outline using a circular saw (page 216). Note: *See pages 192 to 195 for removing different types of exterior wall surfaces.*

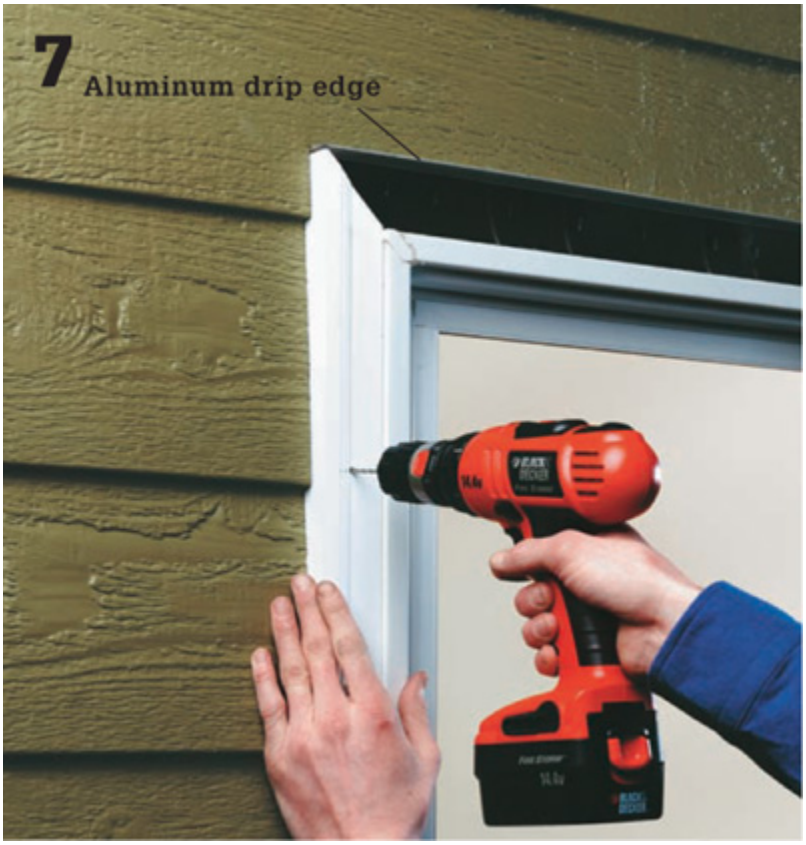


Cut an 8"-wide strip of building paper for the sill, long enough to extend several inches past the sides of the rough opening. Slide paper between siding and sheathing, wrapping it over the inside of the rough opening, and staple it in place. Also install building paper along the sides of the rough opening, overlapping the paper at the sill by a few inches, and tucking the top edge under the existing paper at the header.

Apply a heavy bead of silicone caulk around the perimeter of the exterior rough opening. Set the window in position, then reshim it so it is level and plumb, as in step 1. On the exterior side, make sure the space between siding and window frame is equal to the width of the brick molding on all sides of the window. Tack window to the header at one end of the top nailing flange, using a 5d galvanized roofing nail.

Make final adjustments to ensure the window is level and plumb, then nail the window in place with 5d galvanized roofing nails, beginning at the header. Follow the nailing pattern specified by the manufacturer. Check to make sure the window is fully operable and that the interior trim will not impede its operation before fastening at the sides and sill.

Cut an 8"-wide strip of building paper and install it at the header, so it is tucked beneath the existing building paper and covering the nailing flange at the top of the window. Make sure it also overlaps the building paper at the sides by a few inches. Staple the paper in place.



Install the aluminum drip edge along the length of the cutout. Apply construction adhesive to the drip edge, then slide it under the siding at the top of the window. Cut each brick molding piece to size, mitering the ends at 45°. Position brick molding between window jamb and siding. Drill pilot holes through the brick molding and into the framing members.

Attach the brick molding with 8d galvanized casing nails, then set the heads with a nail set. Caulk the joint between brick molding and siding. On the interior side, loosely pack fiberglass insulation in the spaces between the window frame and framing members. See pages 152 to 153 to trim the interior of the window.

How to Install a Window with Brick Molding

Remove the exterior wall surface as directed on pages 192 to 195, then test-fit the window, centering it in the rough opening. Support the window with wood blocks and shims placed under the side jambs and mullion post. Check to make sure the window is plumb and level, and adjust the shims, if necessary.

Trace the outline of the brick molding on the wood siding. Remove the window after finishing the outline. Note: *If you have vinyl or metal siding, you should have enlarged the outline to make room for the extra J-channel moldings required by these sidings.*

Cut the siding along the outline just down to the sheathing. For a round-top window, use a reciprocating saw held at a low angle. For straight cuts, use a circular saw adjusted so the blade cuts through only the siding. Use a sharp chisel to complete the cuts at the corners (page 211).

Cut 8"-wide strips of building paper and slide them between the siding and sheathing around the entire window opening. Bend the paper around the framing members and staple it in place. Work from the bottom up, so each piece overlaps the piece below.

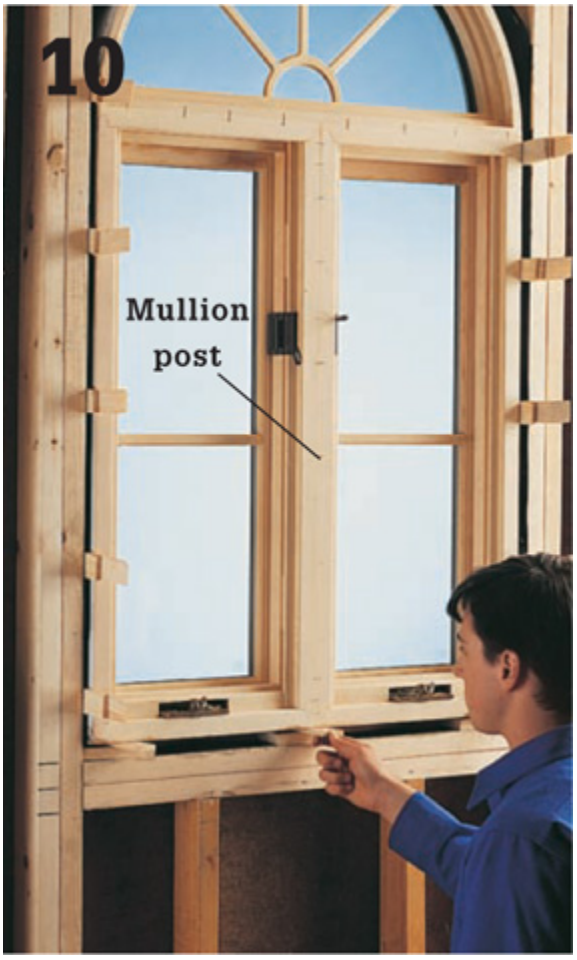
Cut a length of drip edge to fit over the top of the window, then slide it between the siding and building paper. For round-top windows, use flexible vinyl drip edge; for rectangular windows, use rigid metal drip edge (inset).

Insert the window in the opening, and push the brick molding tight against the sheathing.

Check to make sure the window is level.

If the window is perfectly level, nail both bottom corners of the brick molding with 10d galvanized casing nails. If the window is not perfectly level, nail only at the higher of the two bottom corners.

From outside, drive 10d galvanized casing nails through the brick molding and into the framing members near the remaining corners of the window.



Adjust the shims so they are snug, but not so tight that they cause the jambs to bow. On multiple-unit windows, make sure the shims under the mullion posts are tight.

Use a straightedge to check the side jambs to make sure they do not bow. If necessary, adjust the shims until the jambs are flat. Open and close the window to make sure it works properly.

At each shim location, drill a pilot hole, then drive an 8d casing nail through the jamb and shims. Be careful not to damage the window. Drive the nail heads below the wood surface with a nail set.

Fill the gaps between the window jambs and the framing members with loosely packed fiberglass insulation. Wear work gloves when handling insulation.

Trim the shims flush with the framing members, using a handsaw.

Apply paintable silicone caulk around the entire window unit. Fill nail holes with caulk. See pages 152 to 153 to trim the interior of the window.

Installing New Window Sashes

If you're looking to replace or improve old single-or double-hung windows, consider using sash-replacement kits. They can give you energy-efficient, maintenance-free windows without changing the outward appearance of your home or breaking your budget.

Unlike prime window replacement, which changes the entire window and frame, or pocket window replacement, in which a complete window unit is set into the existing frame, sash replacement uses the original window jambs, eliminating the need to alter exterior or interior walls or trim. Installing a sash-replacement kit involves little more than removing the old window stops and sashes and installing new vinyl jamb liners and wood or vinyl sashes. All of the work can be done from inside your home.

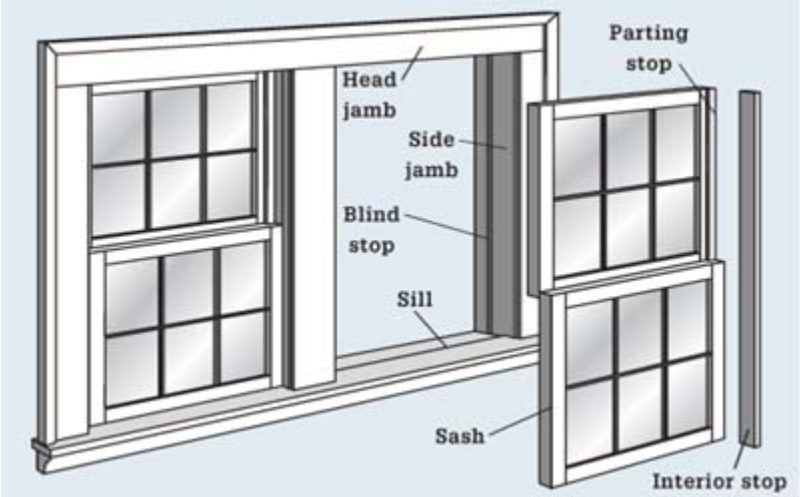
Most sash-replacement kits offer tilt features and other contemporary conveniences. Kits are available in vinyl, aluminum, or wood construction, with various options for color and glazing, energy efficiency, security features, and noise reduction.

Nearly all major window manufacturers offer sash-replacement kits designed to fit their own windows. You can also order custom kits that are sized to your specific window dimensions. A good fit is essential to the performance of your new windows. Review the tips shown on the next page for measuring your existing windows, and follow the manufacturer's instructions for the best fit.

Tools & Materials

- Sill-bevel gauge
- Flat pry bar
- Scissors
- Screwdriver
- Nail set
- Sash-replacement kit
- 1" galvanized roofing nails
- Fiberglass insulation
- Finish nails
- Wood-finishing materials

Upgrade old, leaky windows with new, energy-efficient sash-replacement kits. Kits are available in a variety of styles to match your existing windows or to add a new decorative accent to your home. Most kits offer natural or painted interior surfaces and a choice of outdoor surface finishes.



Double-hung windows have two operating window sashes, unlike singlehung windows where only one sash moves. Stops are installed to separate the sashes and keep them on track .

Measuring for Sash-Replacement Kits

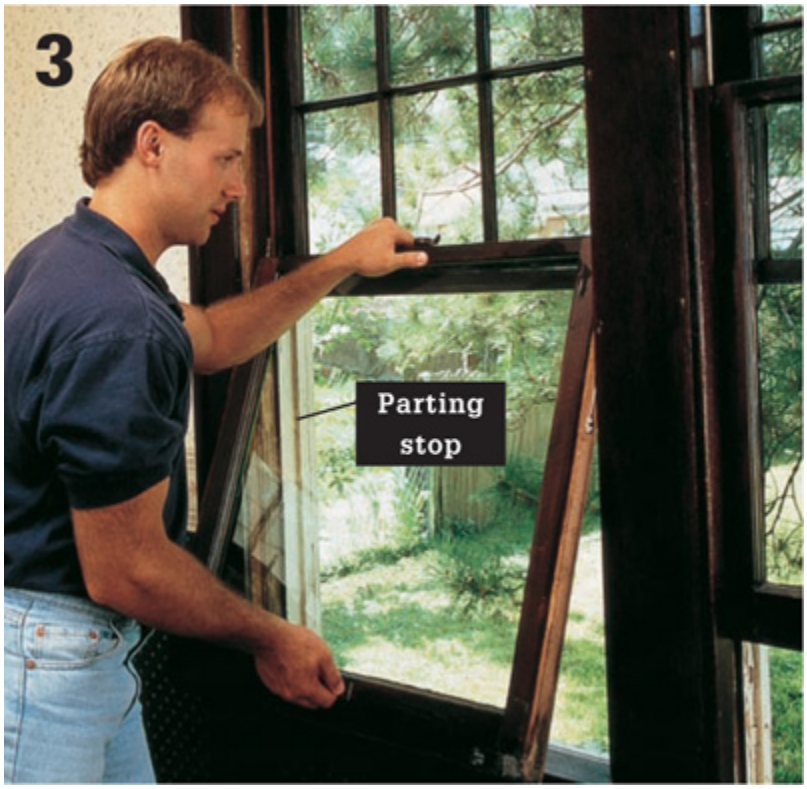
Measure the width of the existing window at the top, middle, and bottom of the frame. Use the smallest measurement, then reduce the figure by ⅜". Measure the height of the existing window from the head jamb to the point where the outside edge of the bottom sash meets the sill. Reduce the figure by ⅜". *Note: Manufacturers' specifications for window sizing may vary.*

Use a sill-bevel gauge to determine the bevel of the existing windowsill. This helps ensure the sash kit will fit properly. Also make sure that the sill, side, and head jambs are straight, level, and plumb. Measure the frame diagonally to check for square (if the diagonal measurements are equal, the frame is square). If the frame is not square, check with the sash-kit manufacturer: Most window kits can accommodate some deviation in frame dimensions.

How to Install a Sash-Replacement Kit

Carefully remove the interior stops from the side jambs, using a putty knife or pry bar. Save the stops for reinstallation.

With the bottom sash down, cut the cord holding the sash balancing weight on each side of the sash. Let the weights and cords fall into the weight pockets.

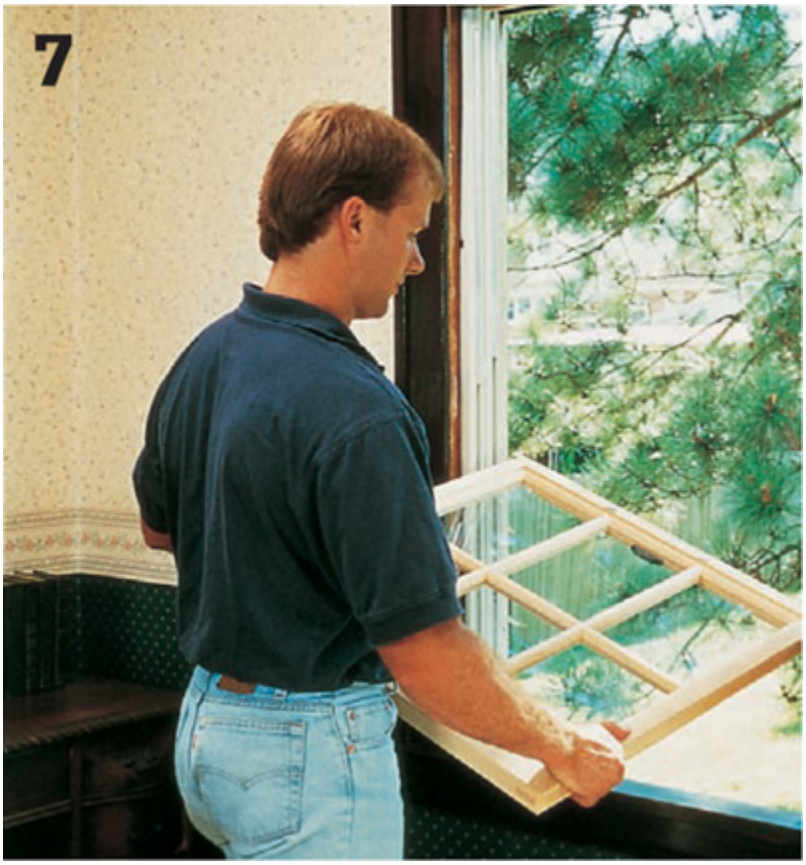


Lift out the bottom sash. Remove the parting stops from the head and side jambs. (The parting stops are the strips of wood that separate the top and bottom sash.) Cut the sash cords for the top sash, then lift out the top sash. Remove the sash-cord pulleys. If possible, pull the weights from the weight pockets at the bottom of the side jambs, then fill the weight pockets with fiberglass insulation. Repair any parts of the jambs that are rotted or damaged.

Position the jamb-liner brackets, and fasten them to the jambs with 1" galvanized roofing nails. Place one bracket approximately 4" from the head jamb and one 4" from the sill. *Leave* 1/16" clearance between the blind stop and the jamb-liner bracket. Install any remaining brackets, spacing them evenly along the jambs.

Position any gaskets or weatherstripping provided for the jamb liners. Carefully position each liner against its brackets and snap it into place. When both liners are installed, set the new parting stop into the groove of the existing head jamb, and fasten it with small finish nails. Install a vinyl sash stop in the interior track at the top of each liner to prevent the bottom sash from being opened too far.

Set the sash control mechanism, using a slotted screwdriver. Gripping the screwdriver firmly, slide down the mechanism until it is about 9" above the sill, then turn the screwdriver to lock the mechanism and prevent it from springing upward. The control mechanisms are spring-loaded—do not let them go until they are locked in place. Set the mechanism in each of the four sash channels.



Install the top sash into the jamb liners. Set the cam pivot on one side of the sash into the outside channel. Tilt the sash, and set the cam pivot on the other side of the sash. Make sure both pivots are set above the sash control mechanisms. Holding the sash level, tilt it up, depress the jamb liners on both sides, and set the sash in the vertical position in the jamb liners. Once the sash is in position, slide it down until the cam pivots contact the locking terminal assemblies.

Install the bottom sash into the jamb liners, setting it into the inside sash channels. When the bottom sash is set in the vertical position, slide it down until it engages the control mechanisms. Open and close both sashes to make sure they operate properly.

Reinstall the stops that you removed in step 1. Fasten them with finish nails, using the old nail holes, or drill new pilot holes for the nails.

Check the tilt operation of the bottom sash to make sure the stops do not interfere. Remove the labels, and clean the windows. Paint or varnish the new sash as desired.

Installing a Standard Skylight

Depending on the model you choose and where you place it, a skylight can offer warmth in the winter, cooling ventilation in the summer, and a view of the sky or the treetops around your house during any season. And, of course, skylights provide natural light.

Because a skylight lets in so much light, the sizing and placement of the unit are important considerations. A skylight that's too big can quickly overheat a space, especially in an attic. The same is true of using too many skylights in any one room. For that reason it's often best to position a skylight away from the day's brightest sun. You may want an operable skylight that opens and closes to vent warm air.

When a skylight is installed above an unfinished attic space, a special skylight shaft must be constructed to channel light directly to the room below. To install a skylight shaft, see pages 238 to 241.

Installing a skylight above finished space involves other considerations. First, the ceiling surface must be removed to expose the rafters. To remove wall and ceiling surfaces, see pages 188 to 191.

A skylight frame is similar to a standard window frame (page 111). It has a header and sill, like a window frame, but has king rafters, rather than king studs. Skylight frames also have trimmers that define the sides of the rough opening. Refer to the manufacturer's instructions to determine what size to make the opening for the skylight you select.

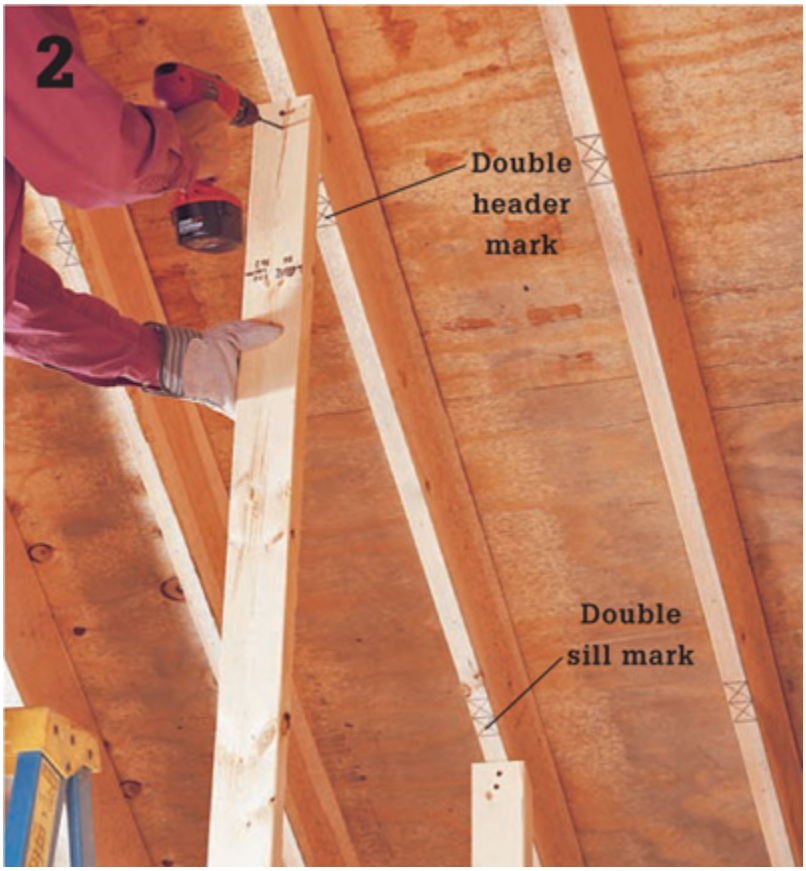
With standard rafter-frame roof construction, you can safely cut into one or two rafters as long as you permanently support the cut rafters, as shown in the following steps. If your skylight requires alteration of more than two rafters or if your roofing is made with unusually heavy material, such as clay tile or slate, consult an architect or engineer before starting the project.

Tools & Materials

- 4-ft. level
- Circular saw
- Drill
- Combination square
- Reciprocating saw
- Pry bar
- Chalk line
- Stapler
- Caulk gun
- Utility knife
- Tin snips
- Plumb bob
- Jigsaw
- Wallboard tools
- 2× lumber
- 16d and 10d common nails
- 1 × 4
- Building paper
- Roofing cement
- Skylight flashing
- 2", 1¼", and ¾" roofing nails
- Finish nails
- Fiberglass insulation
- ½" wallboard
- Twine
- Wallboard screws
- 6-mil polyethylene sheeting
- Finishing materials

How to Install a Skylight

Use the first rafter on each side of the planned rough opening as a king rafter. Measure and mark where the double header and sill will fit against the king rafters. Then, use a level as a straightedge to extend the marks across the intermediate rafter.



Brace the intermediate rafter by installing two 2 × 4s between the rafter and the attic floor. Position the braces just above the header marks and just below the sill marks. Secure them temporarily to the rafter and subfloor (or joists) with screws.

Reinforce each king rafter by attaching a full-length “sister” rafter against its outside face. Cut sister rafters from the same size of lumber as existing rafters, matching lengths and end cuts exactly. Work each one into position, flush against the outside face of the king rafters, then nail the sisters to the kings with pairs of 10d common nails, spaced 12" apart.

Use a combination square to transfer the sill and header marks across the face of the intermediate rafter, then cut along the outermost lines with a reciprocating saw. Do not cut into the roof sheathing. Carefully remove the cutout section with a pry bar. The remaining rafter portions will serve as cripple rafters.

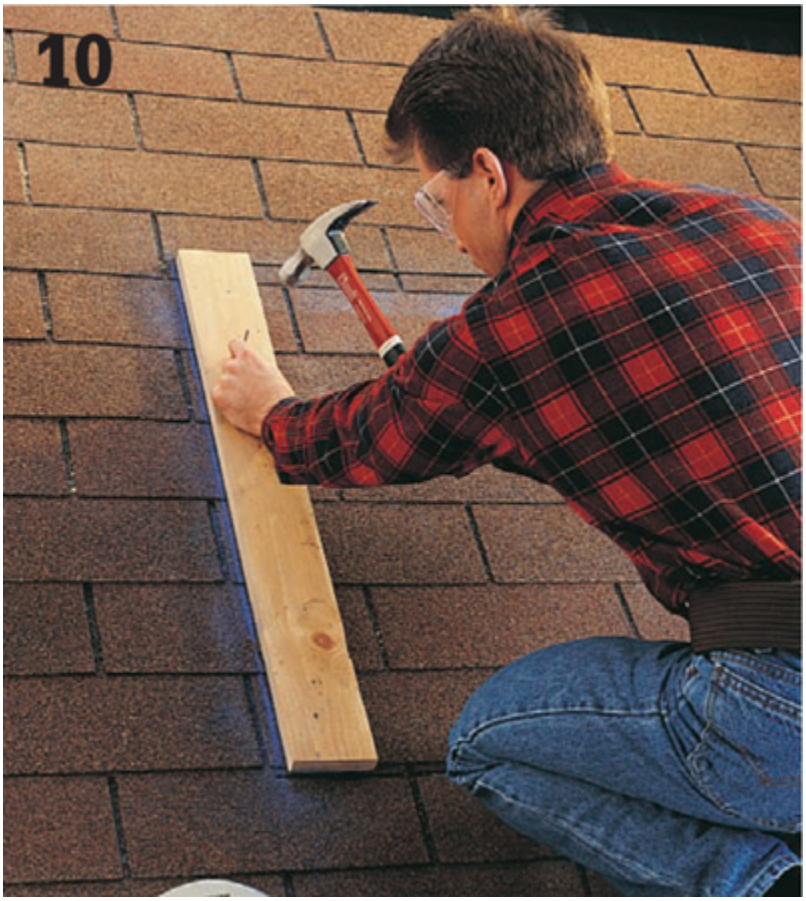
Build a double header and double sill to fit snugly between the king rafters, using 2x lumber that is the same size as the rafters. Nail the header pieces together, using pairs of 10d nails spaced 6" apart.

Ibnstall the header and sill, anchoring them to the king rafters and cripple rafters with 16d common nails. Make sure the ends of the header and sill are aligned with the appropriate marks on the king rafters.

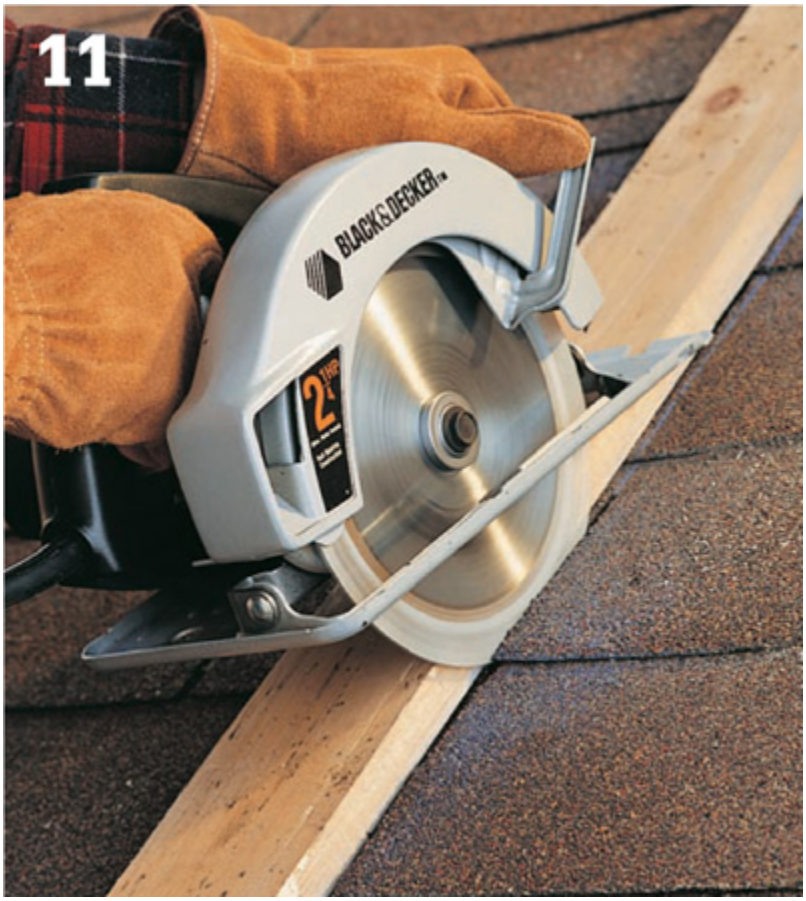
If your skylight unit is narrower than the opening between the king studs, measure and make marks for the trimmers: They should be centered in the opening and spaced according to the manufacturer's specifications. Cut the trimmers from the same 2x lumber used for the rest of the frame, and nail them in place with 10d common nails. Remove the 2 × 4 braces.

Mark the opening for the roof cutout by driving a screw through the sheathing at each corner of the frame. Then, tack a couple of scrap boards across the opening to prevent the roof cutout from falling and causing damage below.

From the roof, measure between the screws to make sure the rough opening dimensions are accurate. Snap chalk lines between the screws to mark the rough opening, then remove the screws.



Tack a straight 1 × 4 to the roof, aligned with the inside edge of one chalk line. Make sure the nail heads are flush with the surface of the board.



Cut through the shingles and sheathing along the chalk line, using a circular saw and an old blade or a remodeling blade. Rest the saw foot on the 1 × 4, and use the edge of the board as a guide. Reposition the 1 × 4, and cut along the remaining lines. Remove the cutout roof section.

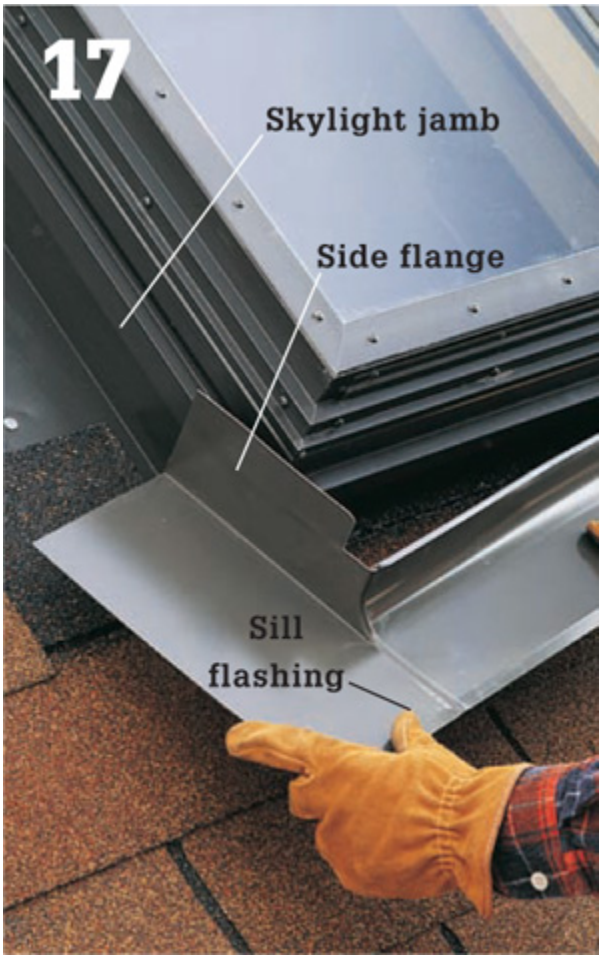
Remove the shingles around the rough opening with a flat pry bar, exposing at least 9" of building paper on all sides of the opening. Remove whole shingles, rather than cutting them.

Cut strips of building paper and slide them between the shingles and the existing building paper. Wrap the paper so that it covers the faces of the framing members, and staple it in place.

Spread a 5"-wide layer of roofing cement around the roof opening. Set the skylight into the opening so that the nailing flange rests on the roof. Adjust the unit so it sits squarely in the opening.

Nail through the flange and into the sheathing and framing members with 2" galvanized roofing nails spaced every 6". Note: *If the skylight uses L-shaped brackets instead of a nailing flange, follow manufacturer's instructions.*

Patch in shingles up to the bottom edge of skylight unit. Attach the shingles with 1¼" roofing nails driven just below the adhesive strip. If necessary, cut shingles with a utility knife so they fit against the bottom of the skylight.



Spread roofing cement on the bottom edge of the sill flashing, then fit flashing around bottom of unit. Attach flashing by driving ¾" galvanized roofing nails through the vertical side flange (near the top of the flashing) and into the skylight jambs.

Spread roofing cement on the bottom of a piece of step flashing, then slide flashing under the drip edge on one side of the skylight. Step flashing should overlap sill flashing by 5". Press the step flashing down to bond it. Repeat on opposite side of skylight.

Patch in the next row of shingles on each side of the skylight, following the existing shingle pattern. Drive a 1¼" roofing nail through each shingle and the step flashing and into the sheathing. Drive additional nails just above the notches in the shingles.

Continue applying alternate rows of step flashing and shingles, using roofing cement and roofing nails. Each piece of flashing should overlap the preceding piece by 5".

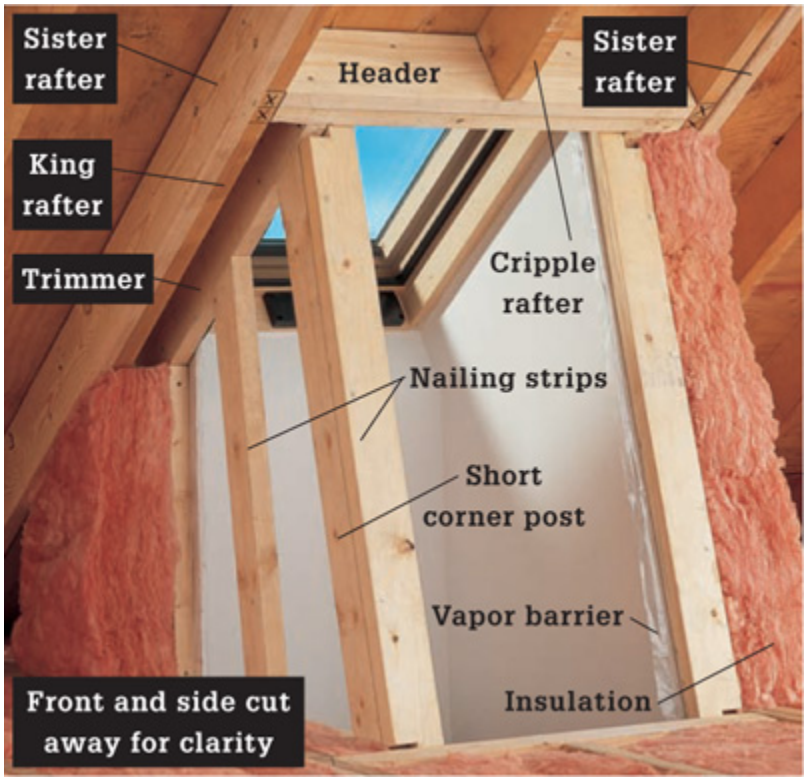
At the top of the skylight, cut and bend the last piece of step flashing on each side, so the vertical flange wraps around the corner of the skylight. Patch in the next row of shingles.

Spread roofing cement on bottom of head flashing to bond it to the roof. Place flashing against top of skylight so the vertical flange fits under the drip edge and the horizontal flange fits under the shingles above the skylight.

Fill in the remaining shingles, cutting them to fit, if necessary. Attach the shingles with roofing nails driven just above the notches.

Apply a continuous bead of roofing cement along the joint between the shingles and the skylight. Finish the interior of the framed opening as desired.

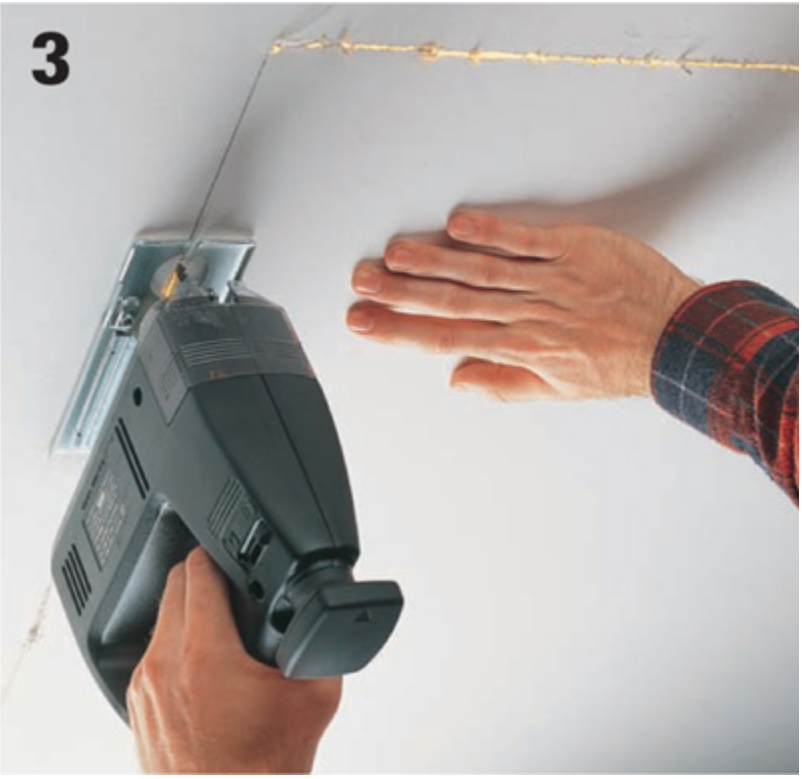
How to Build a Skylight Shaft



A skylight shaft is made with 2 × 4 lumber and wallboard and includes a vapor barrier and fiberglass insulation. You can build a straight shaft with four vertical sides or an angled shaft that has a longer frame at ceiling level and one or more sides set at an angle. Since the ceiling opening is larger, an angled shaft lets in more direct light than a straight shaft.

Remove any insulation in the area where the skylight will be located; turn off and reroute electrical circuits as necessary. Use a plumb bob as a guide to mark reference points on the ceiling surface, directly below the inside corners of the skylight frame.

If you are installing a straight shaft, use the plumb marks made in step 1 to define the corners of the ceiling opening; drive a finish nail through the ceiling surface at each mark. If you are installing an angled shaft, measure out from the plumb marks and make new marks that define the corners of the ceiling opening; drive finish nails at the new marks.



From the room below, mark cutting lines, then remove the ceiling surface (pages 188 to 191).

Use the nearest joists on either side of the ceiling opening to serve as king joists. Measure and mark where the double header and double sill will fit against the king joists and where the outside edge of the header and sill will cross any intermediate joists.

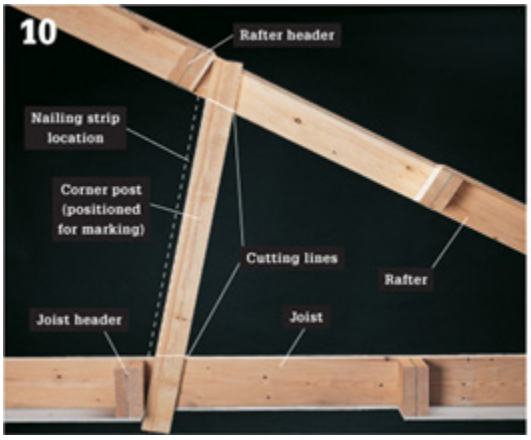
If you will be removing a section of an intermediate joist, reinforce the king joists by nailing full-length “sister” joists to the outside faces of the king joists, using 10d nails.

Install temporary supports below the project area to support the intermediate rafter on both sides of the opening (page 187). Use a combination square to extend cutting lines down the sides of the intermediate joist, then cut out the joist section with a reciprocating saw. Pry loose the cutout portion of the joist, being careful not to damage the ceiling surface.

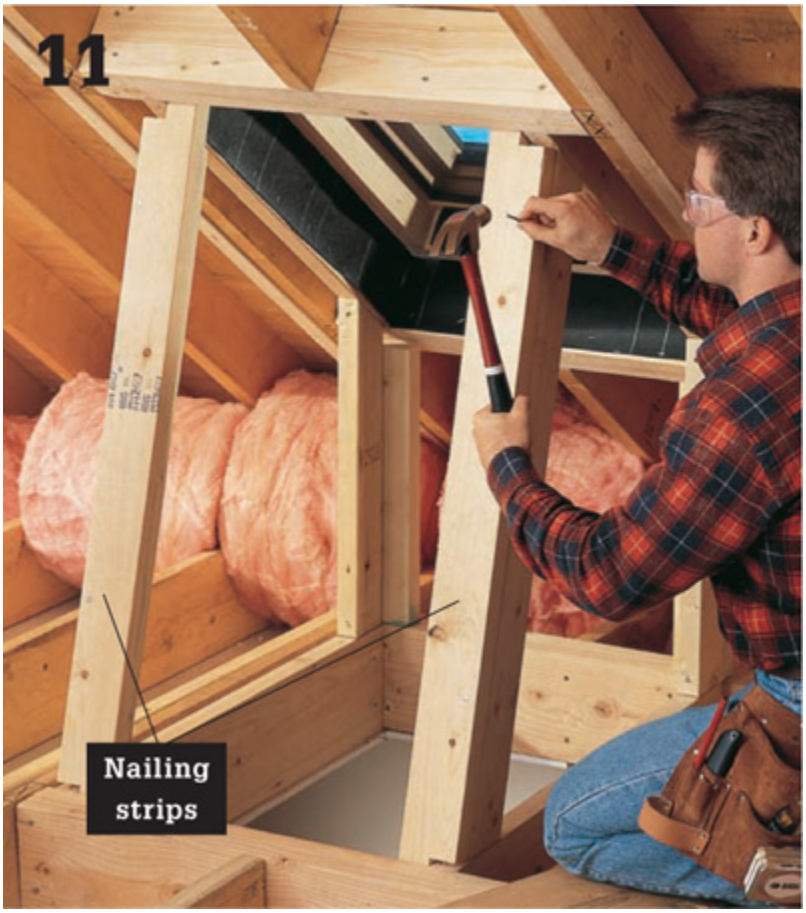
Build a double header and double sill to span the distance between the king joists, using 2x dimensional lumber the same size as the joists.

Install the double header and double sill, anchoring them to the king joists and cripple joists with 10d nails. The inside edges of the header and sill should be aligned with the edge of the ceiling cutout.

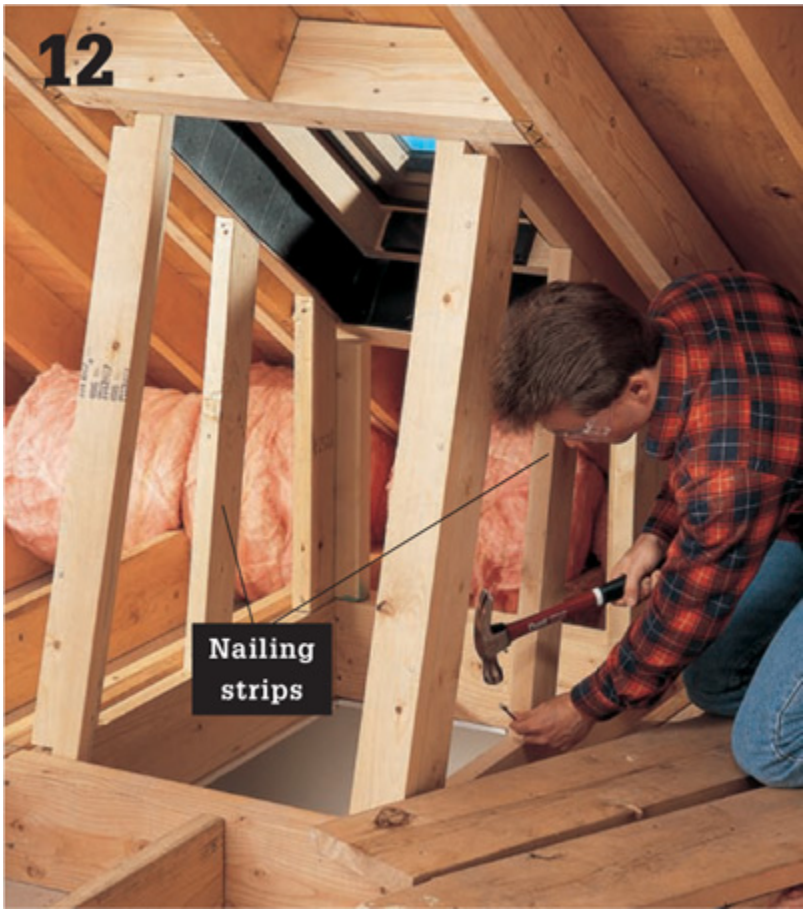
Complete the ceiling opening by cutting and attaching trimmers, if required, along the sides of the ceiling cutout between the header and sill. Toenail the trimmers to the header and sill with 10d nails.



Install 2 × 4 corner posts for the skylight shaft. To measure for the posts, begin with a 2 × 4 that is long enough to reach from the top to the bottom of the shaft. Hold the 2 × 4 against the inside of the framed openings, so it is flush with the top of the rafter header and the bottom of the joist header (left photo). Mark cutting lines where the 2 × 4 meets the top of the joist or trimmer and the bottom of the rafter or trimmer (right photo). Cut along the lines, then toenail the posts to the top and bottom of the frame with 10d nails.



Attach a 2 × 4 nailing strip to the outside edge of each corner post to provide a nailing surface for attaching the wallboard. Notch the ends of the nailing strips to fit around the trimmers; a perfect fit is not necessary.



Install additional 2 × 4 nailing strips between the corner posts if the distances between posts are more than 24". Miter the top ends of the nailing strips to fit against the rafter trimmers.

Wrap the skylight shaft with fiberglass insulation. Secure the insulation by wrapping twine around the shaft and insulation.

From inside the shaft, staple a plastic vapor barrier of 6-mil polyethylene sheeting over the insulation.

Finish the inside of the shaft with wallboard (pages 128 to 135). Tip: To reflect light, paint the shaft interior with a light-colored, semigloss paint.

Installing a Bay Window

Modern bay windows are preassembled for easy installation, but it still will take several days to complete an installation. Bay windows are large and heavy, and installing them requires special techniques. Have at least one helper to assist you, and try to schedule the work when there's little chance of rain. Using prebuilt bay window accessories will speed your work (see next page).

A large bay window can weigh several hundred pounds, so it must be anchored securely to framing members in the wall and supported by braces attached to framing members below the window. Some window manufacturers include cable-support hardware that can be used instead of metal support braces.

Before purchasing a bay window unit, check with the local building department regarding the code requirements. Many local codes require large windows and low bay windows with window seats to be glazed with tempered glass for safety.

Cripple stud
Metal flashing
Building paper
Roof frame
Header (double 2 × 8s with ½" plywood)
Sheathing
Shingles
Building paper
Preattached head board
Drip edge
Insulation
Side jam
Support brace
Preattached seat board
Skirt board
Rough sill (double 2 × 6s with ½" plywood)
Plastic vapor barrier
Wall sheathing
Furring strip
Insulation
Siding
Plywood skirt bottom
Cutaway view

Tools & Materials

- Straightedge
- Circular saw
- Wood chisel
- Pry bar
- Drill
- Level
- Nail set
- Stapler
- Aviation snips
- Roofing knife
- Caulk gun
- Utility knife
- T-bevel
- Bay window unit
- Prebuilt roof frame kit
- Metal support brackets
- 2× lumber
- 16d galvanized common nails
- 16d and 8d galvanized casing nails
- 3" and 2" galvanized screws
- 16d casing nails
- Tapered wood shims
- Building paper
- Fiberglass insulation
- 6-mil polyethylene sheeting
- Drip edge
- 1" roofing nails
- Step flashing
- Shingles
- Top flashing
- Roofing cement
- 2 × 2 lumber
- 5½" skirt boards
- Window trim
- ¾" exterior-grade plywood
- Paintable silicone caulk

Bay Window Materials & Construction

Use prebuilt accessories to ease installation of a bay window. Roof frames (A) come complete with sheathing (B), metal top flashing (C), and step flashing (D) and can be special-ordered at most home centers. You will have to specify the exact size of your window unit and the angle (pitch) you want for the roof. You can cover the roof inexpensively with building paper and shingles or order a copper or aluminum shell. Metal support braces (E) and skirt boards (F) can be ordered at your home center if not included with the window unit. Use two braces for bay windows up to 5 ft. wide and three braces for larger windows. Skirt boards are clad with aluminum or vinyl and can be cut to fit with a circular saw or miter saw.

Construct a bay window frame similar to that for a standard window (see page 111) but use a built-up sill made from two 2 × 6s sandwiched around ½" plywood (page 137). Install extra jack studs under the sill ends to help carry the window's weight.

Build an enclosure above the bay window if the roof soffit overhangs the window. Build a 2 × 2 frame (top) to match the angles of the bay window, and attach the frame securely to the wall and overhanging soffit. Install a vapor barrier and insulation (page 247), then finish the enclosure so it matches the siding (bottom).

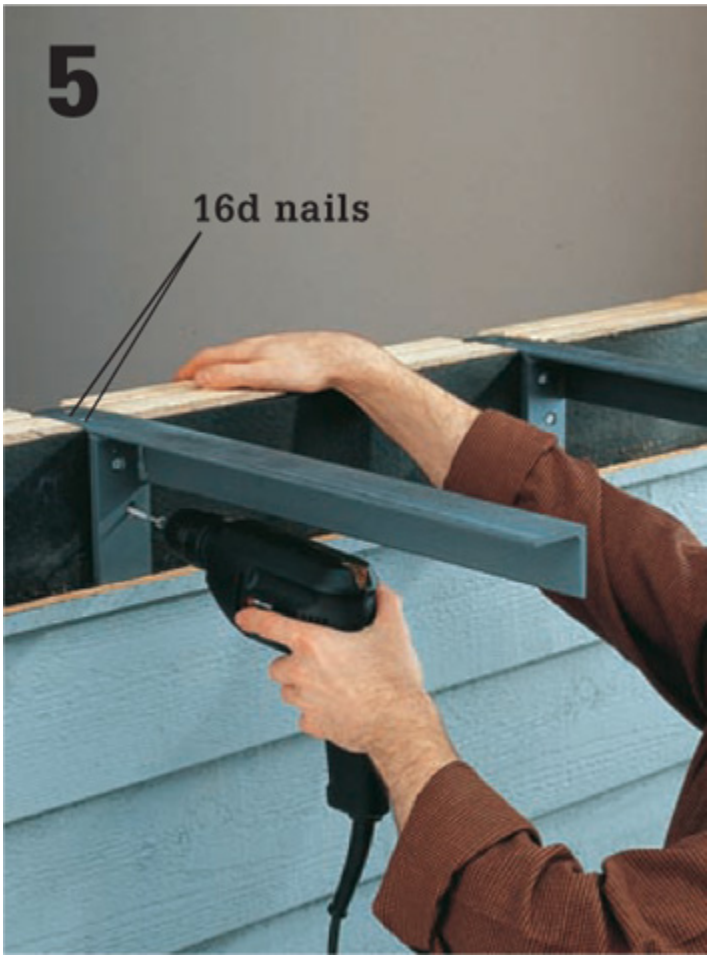
How to Install a Bay Window

Prepare the project site and remove interior wall surfaces (pages 188 to 191), then frame the rough opening. Remove the exterior wall surfaces as directed on pages 192 to 195. Mark for removal a section of siding directly below the rough opening. The width of the marked area should equal that of the window unit and the height should equal that of the skirt board.

Set the blade on a circular saw just deep enough to cut through the siding, then cut along the outline. Stop just short of the corners to avoid damaging the siding outside the outline. Use a sharp chisel to complete the corner cuts. Remove the cut siding inside the outline.

Position the support braces along the rough sill within widest part of the bay window and above the cripple stud locations. Add cripple studs to match the support brace locations, if necessary. Draw outlines of the braces on the top of the sill. Use a chisel or circular saw to notch the sill to a depth equal to the thickness of the top arm of the support braces.

Slide the support braces down between the siding and the sheathing. Pry the siding material away from the sheathing slightly to make room for the braces, if necessary. Note: *On stucco, you will need to chisel notches in the masonry surface to fit the support braces.*

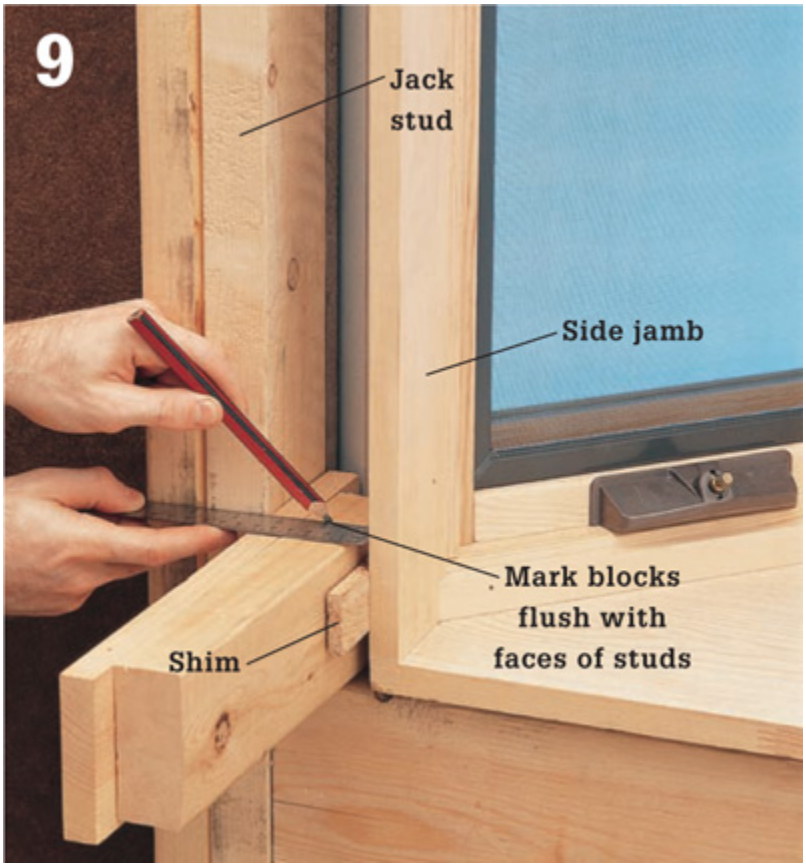


Attach the braces to the rough sill with galvanized 16d common nails. Drive 3" screws through the front of the braces and into the rough sill to prevent twisting.

Lift the bay window onto the support braces and slide it into the rough opening. Center the unit within the opening.

Check the window unit to make sure it is level, if necessary, drive shims under the low side to level the window. Temporarily brace the outside bottom edge of the unit with 2 × 4s to keep it from moving on the braces.

Set the roof frame on top of the window, with the sheathing loosely tacked in place. Trace the outline of the window and roof unit onto the siding. Leave a gap of about ½" around the roof unit to allow room for flashing and shingles.



If the gap between side jambs and jack studs is more than 1" wide, mark and cut wood blocks to bridge the gap (smaller gaps require no blocks). Leave a small space for inserting wood shims. Remove the window, then attach blocks every 12" along the studs.

Cut the siding just down to the sheathing along the outline, using a circular saw. Stop just short of the corners, then use a wood chisel to complete the corner cuts. Remove the cut siding. Pry the remaining siding slightly away from the sheathing around the roof outline to allow for easy installation of the metal flashing. Cover the exposed sheathing with 8"-wide strips of building paper (step 4, page 225).

Set the bay window unit back on the braces, and slide it back into the rough opening until the brick moldings are tight against the sheathing. Insert wood shims between the outside end of the metal braces and the seat board (inset). Check the unit to make sure it is level, and adjust the shims, if necessary.

Anchor the window by drilling pilot holes and driving 16d casing nails through the brick molding and into the framing members. Space nails every 12", and use a nail set to drive the nail heads below the surface of the wood.

Drive wood shims into the spaces between the side jambs and the blocking or jack studs and between the headboard and header, spacing the shims every 12". Fill the spaces around the window with loosely packed fiberglass insulation. At each shim location, drive 16d casing nails through the jambs and shims and into the framing members. Cut off the shims flush with the framing members, using a handsaw or utility knife. Use a nail set to drive the nail heads below the surface. If necessary, drill pilot holes to prevent splitting the wood.

Staple sheet plastic over the top of the window unit to serve as a vapor barrier. Trim the edges of the plastic around the top of the window, using a utility knife.

Remove the sheathing pieces from the roof frame, then position the frame on top of the window unit. Attach the roof frame to the window and to the wall at stud locations, using 3" utility screws.

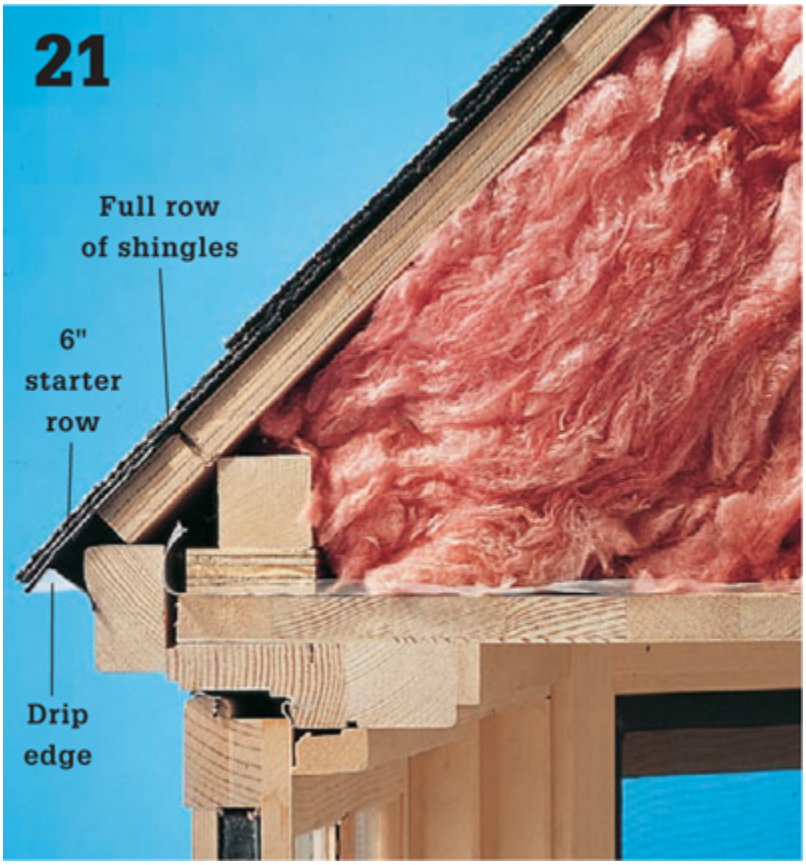
Fill the empty space inside the roof frame with loosely packed fiberglass insulation. Screw the sheathing back onto the roof frame, using 2" utility screws.

Staple asphalt building paper over the roof sheathing. Make sure each piece of building paper overlaps the one below by at least 5".

Cut drip edges with aviation snips, then attach them around the edge of the roof sheathing, using roofing nails.

Cut and fit a piece of step flashing on each side of the roof frame. Adjust the flashing so it overhangs the drip edge by ¼" (Inset). Flashings help guard against moisture damage. Trim the end of the flashing to the same angle as the drip edge. Nail the flashing to the sheathing with roofing nails.

Cut 6"-wide strips of shingles for the starter row. Use roofing nails to attach the starter row shingles so they overhang the drip edge by about ½". Cut the shingles along the roof hips with a straightedge and roofing knife.



Nail a full row of shingles over the starter row, aligning the bottom edges with the bottom edge of the starter row. Make sure shingle notches are not aligned.

Install another piece of step flashing on each side of the roof, overlapping the first piece of flashing by about 5". Cut and install another row of full shingles. The bottom edges should overlap the tops of the notches on the previous row by ½". Attach the shingles with roofing nails driven just above the notches.

Continue installing alternate rows of step flashing and shingles to the top of the roof. Bend the last pieces of step flashing to fit over the roof hips.

When the roof sheathing is covered with shingles, install the top flashing. Cut and bend the ends over the roof hips, and attach it with roofing nails. Attach the remaining rows of shingles over the top flashing.

Find the height of the final rows of shingles by measuring from the top of the roof to a point ½" below the top of the notches on the last installed shingle. Trim the shingles to fit. Attach the final row of shingles with a thick bead of roofing cement—not nails. Press firmly to ensure a good bond.

Make ridge caps by cutting shingles into 1-ft-long sections. Use a roofing knife to trim off the top corners of each piece. Install the ridge caps over the roof hips, beginning at the bottom of the roof. Trim the bottom ridge caps to match the edges of the roof. Keep the same amount of overlap with each layer.

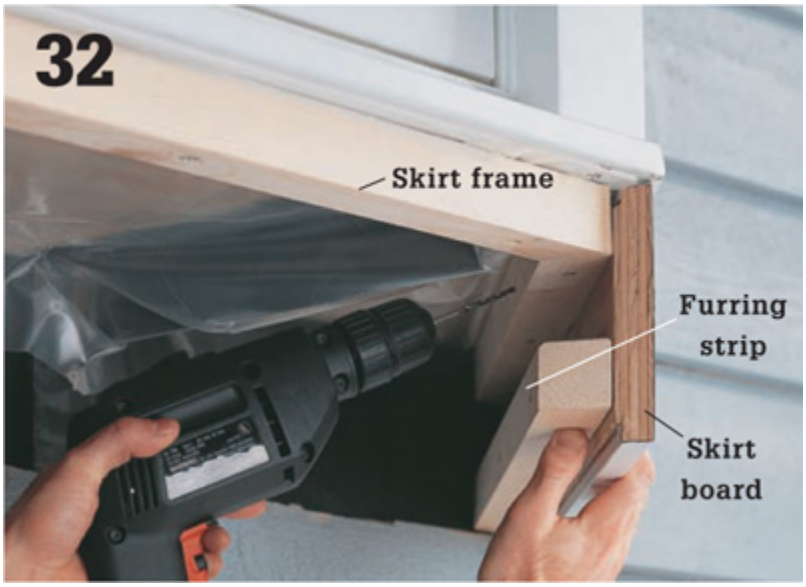
At the top of the roof hips, use a roofing knife to cut the shingles to fit flush with the wall. Attach the shingles with roofing cement. Do not use any nails.

Staple sheet plastic over the bottom of the window unit to serve as a vapor barrier. Trim the plastic around the bottom of the window.

Cut and attach a 2 × 2 skirt frame around the bottom of the bay window, using 3" galvanized screws. Set the skirt frame back about 1" from the edges of the window.

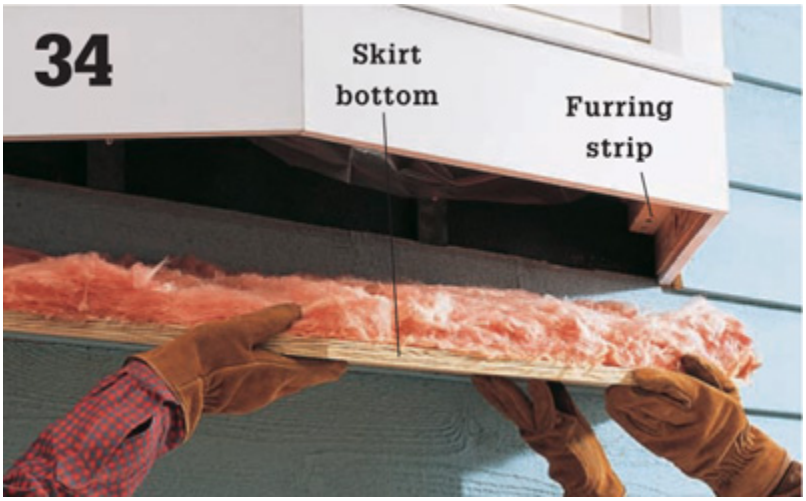
Cut skirt boards to match the shape of the bay window bottom, mitering the ends to ensure a tight fit. Test-fit the skirt board pieces to make sure they match the bay window bottom.

Cut a 2 × 2 furring strip for each skirt board. Miter the ends to the same angles as the skirt boards. Attach the furring strips to the back of the skirt boards, 1" from the bottom edges, using 2" galvanized screws.



Attach the skirt board pieces to the skirt frame. Drill ⅛" pilot holes every 6" through the back of the skirt frame and into the skirt boards, then attach the skirt boards with 2" galvanized screws.

Measure the space inside the skirt boards, using a T-bevel to duplicate the angles. Cut a skirt bottom from ¾" exterior-grade plywood to fit this space.



Lay fiberglass insulation on the skirt bottom. Position the skirt bottom against the furring strips and attach it by driving 2" galvanized screws every 6" through the bottom and into the furring strips.

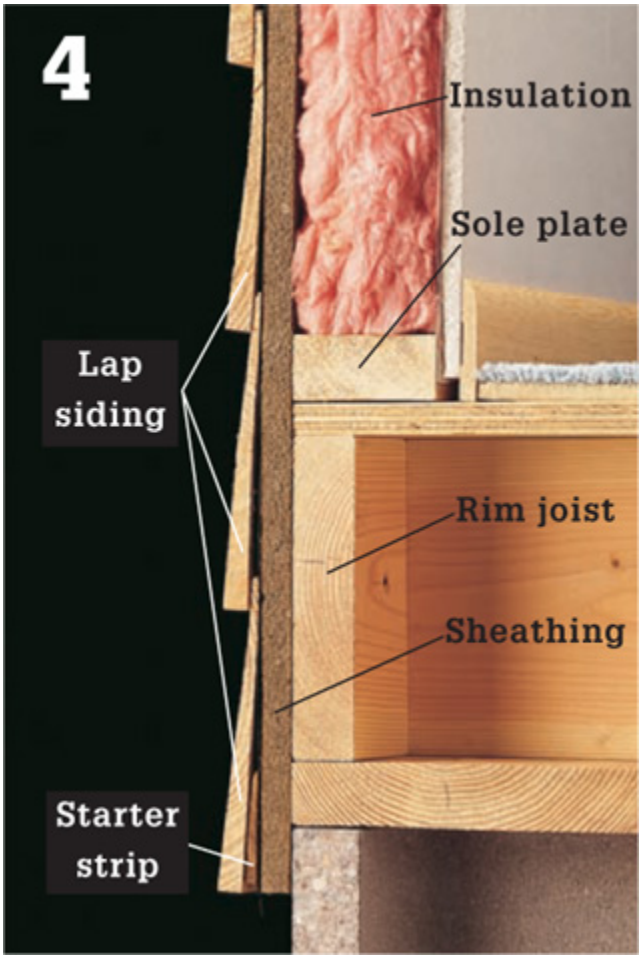
Install any additional trim pieces (inset) specified by your window manufacturer, using 8d galvanized casing nails. Seal roof edges with roofing cement, and seal around the rest of the window with paintable silicone caulk. See pages 152 to 153 and 156 to 159 to trim the interior of the window.

Patching Wood Siding & Stucco

Cover the patch area with sheathing and building paper, if not already present. If the bottom row of siding is missing, nail a starter strip cut from a piece of siding along the bottom of the patch area, using 6d siding nails. Leave a ¼" gap at each joint in the starter strip to allow for expansion.

Use a flat pry bar to remove lengths of lap siding on both sides of the patch area, creating a staggered pattern. When new siding is installed, the end joints will be offset for a less conspicuous appearance.

Cut the bottom piece of lap siding to span the entire opening, and lay it over the starter strip. Allow a ¼" expansion gap between board ends. Attach the siding with pairs of 6d siding nails driven at each stud location.



Cut and install succeeding rows of siding, nailing only near the top of the siding at stud locations. Work upward from the bottom to create the proper overlap.

Fill joints between the siding pieces with paintable silicone caulk. Repaint the entire wall surface as soon as the caulk dries to protect the new siding against weather.

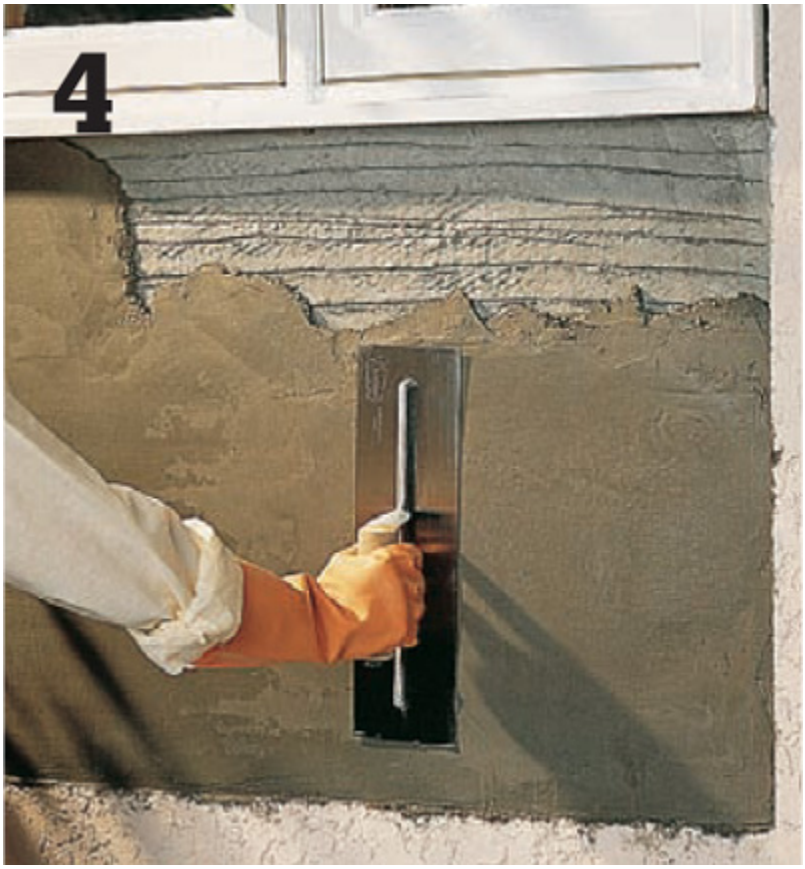
How to Patch Stucco

For small jobs, use premixed stucco, available at building centers. For best results, apply the stucco in two or three layers, letting each layer dry completely between applications. Premixed stucco also can be used on larger areas, but it is more expensive than mixing your own ingredients.

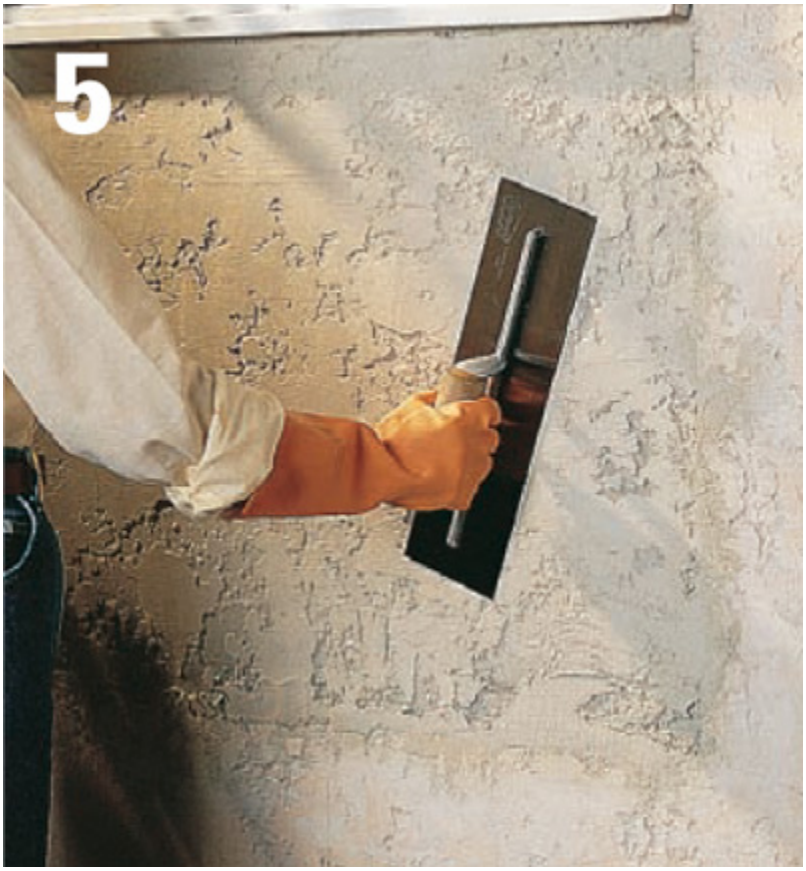
Cut self-furring metal lath and attach it to the sheathing with roofing nails. Pieces of lath should overlap by 2". Note: *If the patch area goes to the base of the stucco wall, attach metal "stop bead" at the bottom of the opening to prevent the stucco material from leaking out.*

Mix the first stucco coat by combining 3 parts sand, 2 parts Portland cement, 1 part masonry cement, and water. The mixture should be just moist enough to hold its shape when squeezed.

Use a trowel to apply the first stucco coat in a ¾"-thick layer, directly onto the metal lath. Scratch horizontal grooves into the wet surface of the stucco. Let the stucco set for two days, dampening it every few hours with fine spray to help it cure evenly.



Mix and apply a second stucco coat in a smooth layer, so the patch area is within ¼" of the wall surface. Let the second coat set for two days, dampening it every few hours. Mix a stucco finish coat made of 1 part lime, 3 parts sand, 6 parts white cement, and water.



Dampen the wall, then apply the finish coat to match the old stucco. Practice helps. The finish coat above was dabbed on with a whisk broom, then flattened with a trowel. Keep the finish coat damp for a week, and let it dry for several more days if you plan to paint it.

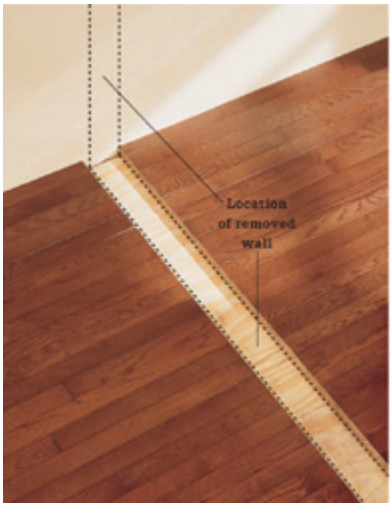
Patching Flooring

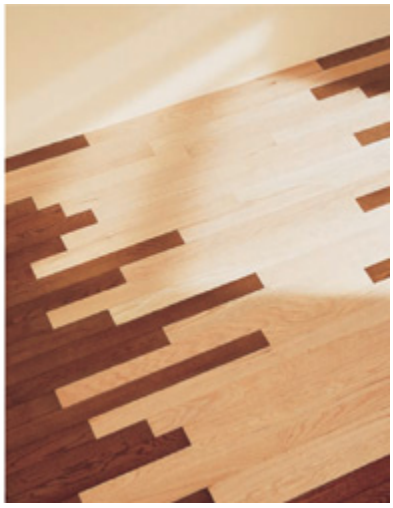
When an interior wall or section of wall has been removed during remodeling, you will need to patch gaps in the flooring where the wall was located. There are several options for patching floors, depending on your budget and the level of your do-it-yourself skills.

If the existing flooring shows signs of wear, consider replacing the entire flooring surface. Although it can be expensive, new flooring will hide any gaps in the floor and will provide an elegant finishing touch for your remodeling project.

If you choose to patch the existing flooring, be aware that it is difficult to hide patched areas completely, especially if the flooring uses unique patterns or finishes. A creative solution is to intentionally patch the floor with material that contrasts with the surrounding flooring.

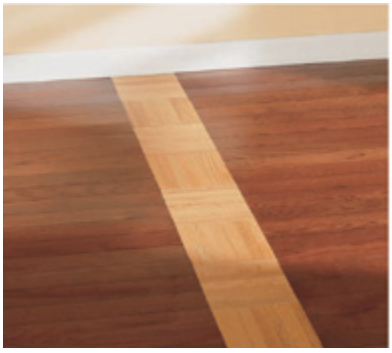
A quick, inexpensive solution is to install T-molding to bridge a gap in a wood strip floor. T-moldings are especially useful when the surrounding boards run parallel to the gap. T-moldings are available in several widths and can be stained to match the flooring.





When patching a wood-strip floor, remove all of the floor boards that butt against the flooring gap, using a pry bar, and replace them with boards cut to fit. This may require that you trim the tongues from some tongue-and-groove floorboards. Sand and refinish the entire floor, so the new boards match with the old.

How to Use Contrasting Flooring Material



Fill gaps in floors with materials that have a contrasting color and pattern. For wood floors, parquet tiles are an easy and inexpensive choice. You may need to widen the flooring gap with a circular saw to make room for the contrasting tiles. To enhance the effect, cut away a border strip around the room and fill these areas with the same contrasting flooring material. (Inset) Build up the subfloor in the patch area, using layers of thin plywood and building paper.

Patching Carpet

Make a carpet patch by laying the patch material over the old flooring, then double-cutting through both layers. When the cut strip of old flooring is removed, the new patch will fit tightly. If flooring material is patterned, make sure the patterns are aligned before you cut.

Install a carpet patch using heat-activated carpet tape and a rented seam iron. Original carpet remnants are ideal for patching. New carpet—even of the same brand, style, and color—seldom will match the old carpet exactly.

Cabinets & Countertops

This section includes a comprehensive overview of removing and installing cabinets, installing new countertops, and even building a custom laminate countertop. Don’t be intimidated by the challenge. Installing cabinets has more to do with careful planning and accurate layout than mastering new tool techniques. Take your time with a big cabinet or countertop project, working from a thorough set of plans, and you should have good success. Many home centers can help you design your kitchen layout and draft a set of CAD drawings to make the process easier.

Some projects covered here will require heavy lifting. Enlist a helper or two to help you lift wall cabinets into position or place long sections of countertop.

In This Chapter:

- Removing Trim & Old Cabinets
- Preparing for New Cabinets
- Installing Cabinets
- Installing Countertops
- Building a Custom Laminate Countertop

Removing Trim & Old Cabinets

Old cabinets can be salvaged fairly easily if they are modular units that were installed with screws, and some custom built-in cabinets can be removed in one piece. If you're not planning to salvage the cabinets (they can be donated to charitable organizations that process building materials), they should be cut into pieces or otherwise broken down and discarded. If you're demolishing your old cabinets, the main danger is causing collateral damage in the room, especially to the plumbing, so work with care.

Tools & Materials

Pry bar
Putty knife
Cordless screwdriver
Reciprocating saw
Hammer
Eye protection

Remove trim moldings at the edges and tops of the cabinets with a flat pry bar or putty knife.

Remove base shoe from cabinet base if the molding is attached to the floor.

Remove baseboards and other trim moldings with a pry bar. Protect wall surfaces with scraps of wood. Label the trim boards on the back side so you can replace them correctly.

Remove valances above cabinets. Some valances are attached to the cabinets or soffits with screws. Others are nailed and must be pried loose.

How to Remove Cabinets

Remove doors and drawers to make it easier to get at interior spaces. You may need to scrape away old paint to expose hinge screws.

At the backs of cabinets, remove any screws holding the cabinet to the wall. Cabinets can be removed as a group or can be disassembled.

Detach individual cabinets by removing screws that hold face frames together.

Countertops are usually not salvageable. Cut them into manageable pieces with a reciprocating saw, or take them apart piece by piece with a hammer and pry bar.

Preparing for New Cabinets

Installing new cabinets is easiest if the kitchen is completely empty. Disconnect the plumbing and wiring and remove the appliances. To remove old cabinets and countertops, see pages 258 to 259. If the new kitchen requires plumbing or electrical changes, now is the time to have this work done. If the kitchen flooring is to be replaced, finish it before beginning layout and installation of cabinets.

Cabinets must be installed plumb and level. Using a level as a guide, draw reference lines on the walls to indicate cabinet location. If the kitchen floor is uneven, find the highest point of the floor area that will be covered by base cabinets. Measure up from this point to draw reference lines.

Tools & Materials

Stud finder	Marking pencil
Pry bar	Tape measure
Trowel	1 × 3 boards
Putty knife	Straight 6- to 8-ft.-long 2 × 4
Screwdriver	Wallboard compound
Straightedge	2½" wallboard screws
Level	

The first step in cabinet installation is to establish level reference lines to mark cabinet height and locate and mark wall studs.

How to Prepare Walls

Find high and low spots on wall surfaces, using a long, straight 2 × 4. Sand down any high spots.

Fill in low spots of wall by applying wallboard compound with a taping knife. Let the compound dry, and then sand it lightly.

Locate and mark wall studs, using an electronic stud finder. Cabinets normally will be hung by driving screws into the studs through the back of the cabinets.

Find the highest point along the floor that will be covered by base cabinets. Place a level on a long, straight 2 × 4, and move the board across the floor to determine if the floor is uneven. Mark the wall at the high point.

Measure up 34½" from the high-point mark (for standard cabinets). Use a level (a laser level is perfect) to mark a reference line on the walls. Base cabinets will be installed with top edges flush against this line.

Measure up 84" from the high-point mark and draw a second reference line. Wall cabinets will be installed with their top edges flush against this line.

Measure down 30" from the wall-cabinet reference line and draw another level line where the bottoms of the cabinets will be. Temporary ledgers will be installed against this line.

Install 1 × 3 temporary ledgers with top edges flush against the reference lines. Attach ledgers with 2½" wallboard screws driven into every other wall stud. Mark stud locations on ledgers. Cabinets will rest temporarily on ledgers during installation (the ledgers alone will not support them, however).

Installing Cabinets

Cabinets must be firmly anchored to wall studs, and they must be plumb and level when installed. The best way to ensure this is by attaching a ledger board to the wall to assist in the installation. As a general rule, install the upper cabinets first so your access is not impeded by the base cabinets. (Although some pros prefer to install the base cabinets first so they can be used to support the uppers during installation.) It’s also best to begin in a corner and work outward from there.

Tools & Materials

Handscrew clamps	Cabinets
Level	Trim molding
Hammer	Toe-kick molding
Utility knife	Filler strips
Nail set	Valance
Stepladder	6d finish nails
Drill	Finish washers
Counterbore drill bit	Panhead wood screws
Cordless screwdriver	(#8), 2½" screws
Jigsaw	3" wallboard screws

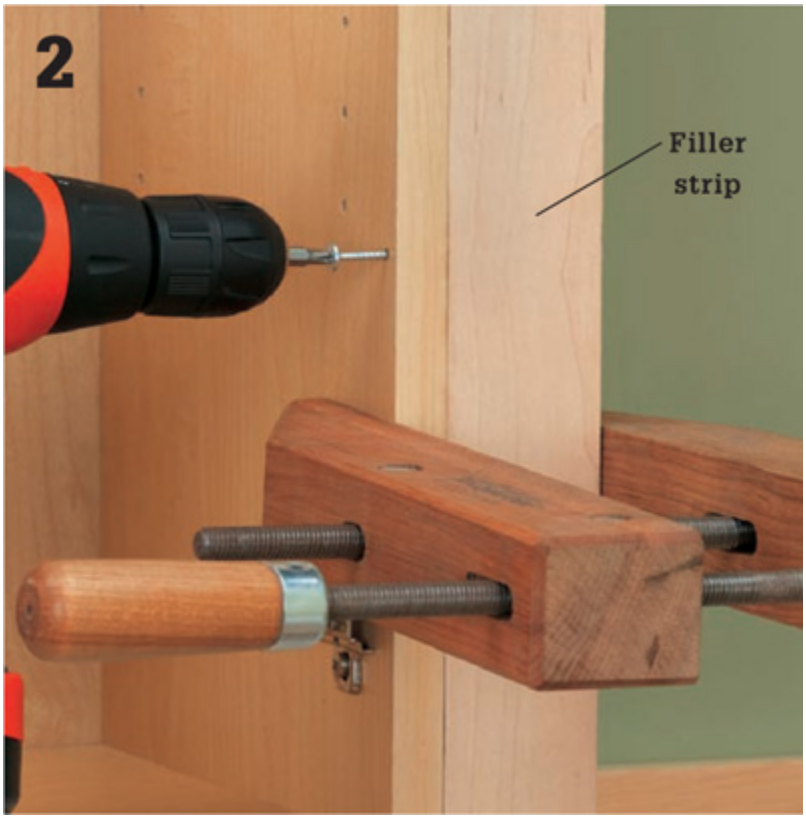
Stock cabinets are sold in boxes that are keyed to door and drawer packs (you need to buy these separately). It is important that you realize this when you are estimating your project costs at the building center (often a door pack will cost as much or more than the cabinet). Also allow plenty of time for assembling the cabinets out of the box. It can take an hour or more to put complex cabinets together.

How to Fit a Corner Cabinet

Before installation, test-fit corner and adjoining cabinets to make sure doors and handles do not interfere with each other. If necessary, increase the clearance by pulling the corner cabinet away from the side wall by no more than 4". To maintain even spacing between the edges of the doors and the cabinet corner, cut a filler strip and attach it to the corner cabinet or the adjoining cabinet. Filler strips should be made from material that matches the cabinet doors and face frames.

How to Install Wall Cabinets

Position a corner upper cabinet on a ledger (see page 263) and hold it in place, making sure it is resting cleanly on the ledger. Drill 3⁄16" pilot holes into the wall studs through the hanging strips at the top rear of cabinet. Attach the cabinet to the wall with 2½" screws. Do not tighten fully until all cabinets are hung.



Attach a filler strip to the front edge of the cabinet, if needed (see preceding page). Clamp the filler in place, and drill counterbored pilot holes through the cabinet face frame, near hinge locations. Attach filler to cabinet with 2½" wallboard screws or flathead wood screws.

Position the adjoining cabinet on the ledger, tight against the corner cabinet or filler strip. Clamp the corner cabinet and the adjoining cabinet together at the top and bottom. Handscrew clamps will not damage wood face frames.

Check the front cabinet edges or face frames for plumb. Drill 3⁄16" pilot holes into wall studs through hanging strips in rear of cabinet. Attach cabinet with 2½" screws. Do not tighten wall screws fully until all cabinets are hung.

Attach the corner cabinet to the adjoining cabinet. From inside the corner cabinet, drill pilot holes through face frame. Join cabinets with panhead wood screws.

Position and attach each additional cabinet. Clamp frames together, and drill counterbored pilot holes through the side of the face frame. Join cabinets with wood screws. Drill 3⁄16" pilot holes in the hanging strips, and attach the cabinet to the studs with wood screws.

Join frameless cabinets with (#8) 1¼" panhead wood screws or wood screws with decorative washers. Each pair of cabinets should be joined by at least four screws.

Fill gaps between the cabinet and wall with a filler strip. Cut the filler strip to fit the space, then wedge wood shims between the filler and the wall to create a friction fit that holds it in place temporarily. Drill counterbored pilot holes through the side of the cabinet (or the edge of the face frame) and attach the filler with screws.

Remove the temporary ledger. Check the cabinet run for plumb, and adjust if necessary by placing wood shims behind the cabinet, near stud locations. Tighten wall screws completely. Cut off shims with a utility knife.

Use trim moldings to cover any gaps between cabinets and walls. Stain moldings to match cabinet finish.

Attach decorative valance above the sink. Clamp valance to edge of cabinet frames, and drill counterbored pilot holes through cabinet frames into end of valance. Attach with panhead wood screws.

Install the cabinet doors, if necessary, adjust the hinges so the doors are straight and plumb.

How to Install Base Cabinets

Begin the installation with a corner cabinet. Draw plumb lines that intersect the 34½" reference line (measured from the high point of the floor; see page 263) at the locations for the cabinet sides.

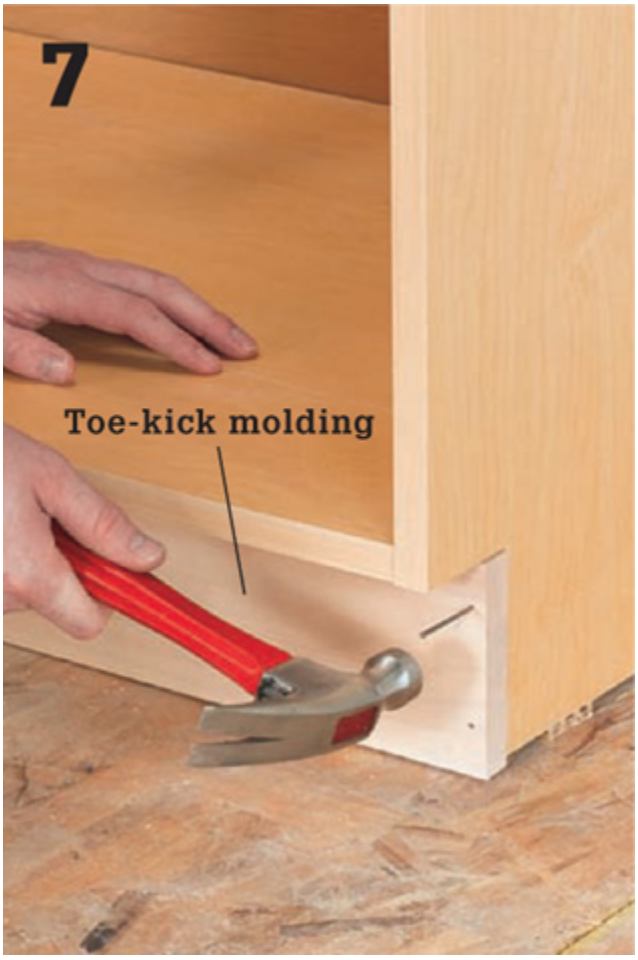
Place a cabinet in the corner. Make sure the cabinet is plumb and level. If necessary, adjust by driving wood shims under the cabinet base. Be careful not to damage flooring. Drill 3⁄16" pilot holes through the hanging strip and into the wall studs. Tack the cabinet to the wall with wood screws or wallboard screws.

Clamp the adjoining cabinet to the corner cabinet. Make sure the new cabinet is plumb, then drill counterbored pilot holes through the cabinet sides or the face frame and filler strip. Screw the cabinets together. Drill 3⁄16" pilot holes through the hanging strips and into the wall studs. Tack the cabinets loosely to the wall studs with wood screws or wallboard screws.

Use a jigsaw to cut any cabinet openings needed in the cabinet backs (for example, in the sink base seen here) for plumbing or wiring.

Position and attach additional cabinets, making sure the frames are aligned and the cabinet tops are level. Clamp the cabinets together, then attach the face frames or cabinet sides with panhead screws driven into pilot holes. Tack the cabinets to the wall studs, but don’t drive screws too tight—you may need to make adjustments once the entire cabinet is installed.

Make sure all cabinets are level. If necessary, adjust by driving shims underneath cabinets. Place shims behind the cabinets near stud locations to fill any gaps. Tighten wall screws. Cut off shims with utility knife.



Use trim moldings to cover gaps between the cabinets and the wall or floor. The toe-kick area is often covered with a strip of wood finished to match the cabinets or painted black.

Hang cabinet doors and mount drawer fronts, then test to make sure they close smoothly and the doors fit evenly and flush. Self-closing cabinet hinges (by far the most common type installed today) have adjustment screws that allow you to make minor changes to the hardware to correct any problems.

Installing Countertops

If you are installing countertops on brand-new cabinets, the best way to ensure a successful installation is to do a good job installing the cabinets. If they are level, half the countertop battle is over. If you are replacing only the countertop, the success of the new installation hinges on two critical elements: removing the old countertop without causing any damage or disruption to the cabinets and taking careful measurements of the cabinets so you can order new countertops that fit perfectly.

If you are replacing your old countertops with the same type of material, it may be worth your time to take careful measurements of the old countertop before you remove it. On the other hand, there is nothing guaranteeing that the old countertop was sized correctly or that the counter and cabinets haven’t shifted since the original installation. The surest method is to rely on the cabinets for your measurements. But before taking them, do any minor repairs or leveling that may be required. Then, once your cabinets are level, take the measurements you’ll need for ordering materials.

Tools & Materials

Channel-type pliers	Circular saw
Reciprocating saw	Ball peen hammer
Pry bar	Gloves
Utility knife	Eye protection
Masonry chisel	

Take careful measurements of your base cabinets before ordering countertop material. Take measurements along the wall and at the front edge of the cabinets. If there is a discrepancy, use the smaller measurement if the countertop will butt against a wall or appliance on each end. Use the larger measurement if the cabinet is open on one end or both ends. Be sure to add length for overhang on countertops with open ends (generally, 1" overhang per end). If the countertop will butt up against an appliance, do not include any allowance for overhang (in fact, some installers recommend subtracting 1/16" to prevent contact between the countertop and the appliance).

How to Remove an Old Countertop

Turn off the water at the shutoff valves. Disconnect and remove plumbing fixtures and appliances. Remove any brackets or screws holding the countertop to the cabinets. Unscrew the take-up bolts at the corners of mitered countertops.

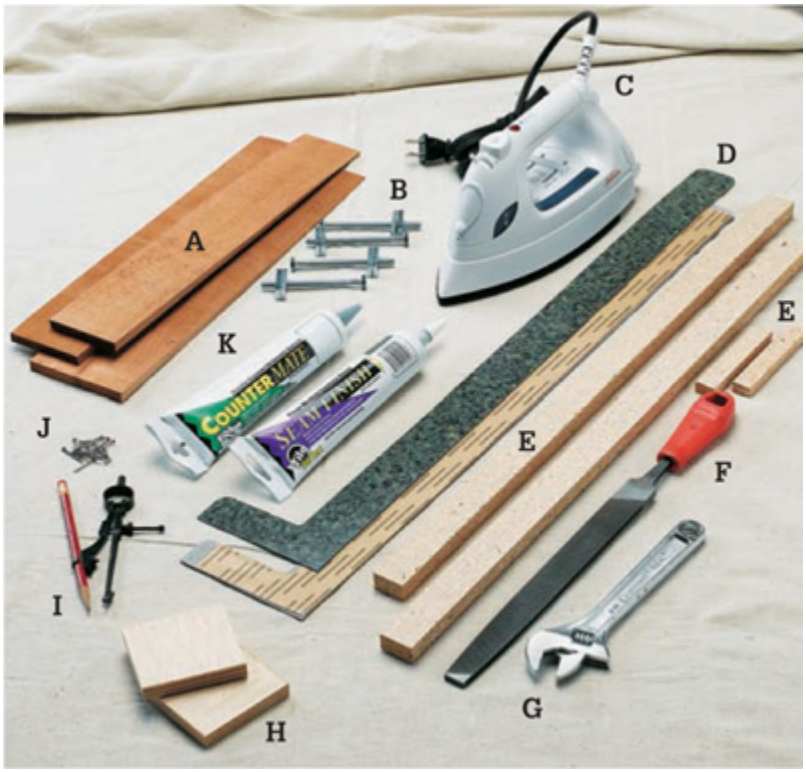
Use a utility knife to cut caulk beads along the backsplash and edge of the countertop. Remove any trim. Using a flat pry bar, try to lift the countertop away from the base cabinets.

If the countertop cannot be pried up, use a reciprocating saw or jigsaw with coarse wood-cutting blade to cut the countertop into pieces for removal. Be careful not to cut into the base cabinets.

Variation: Wear eye protection when working with ceramic tile. Chisel tile off with a masonry chisel to create a few tile-free cutting lines. Use a circular saw and remodeling blade to cut the countertop and substrate into pieces for removal.

Installing a Post-form Countertop

Post-form laminate countertops are available in stock and custom colors. Pre-mitered sections are available for two- or three-piece countertops that continue around corners. If the countertop has an exposed end, you will need an endcap kit that contains a preshaped strip of matching laminate. Post-form countertops have either a waterfall edge or a no-drip edge. Stock colors are typically available in 4-, 6-, 8-, 10-, and 12-foot straight lengths and 6- and 8-foot mitered lengths.



Materials and tools for installing a post-form countertop include: Wood for shimming (A), take-up bolts for drawing miters together (B), household iron (C), endcap laminate to match countertop (D), endcap battens (E), file (F), adjustable wrench (G), buildup blocks (H), compass (I), fasteners (J), silicone caulk and sealer (K).

Post-form countertops are among the easiest and cheapest to install. They are a good choice for beginning do-it-yourselfers, but the design and color options are fairly limited.

How to Install a Post-form Countertop

OPTION: Use a jigsaw fitted with a downstroke blade to cut the post-form if the saw foot must rest on the good surface of the post-form. If you are unable to locate a downstroke blade, you can try applying tape over the cutting lines and set the sawing action so there is no orbital motion. Some saws allow for this setting.

Tools & Materials

Tape measure	Belt sander
Framing square	Drill and spade bit
Pencil	Cordless screwdriver
Straightedge	Post-form countertop
C-clamps	Wood shims
Hammer	Take-up bolts
Level	Drywall screws
Caulking gun	Wire brads
Jigsaw	Endcap laminate
Compass	Silicone caulk
Adjustable wrench	Wood glue

Use a framing square to mark a cutting line on the bottom surface of the countertop. Cut off the countertop with a jigsaw, using a clamped straightedge as a guide. Sand out any unevenness with a belt sander.

Attach the battens from the endcap kit to the edge of the countertop, using carpenter's glue and small brads.

Hold the endcap laminate against the end, slightly overlapping the edges. Activate the adhesive by pressing an iron set at medium heat against the endcap. Cool with a wet cloth, then file the endcap laminate flush with the edges of the countertop.

Position the countertop on base cabinets. Make sure the front edge of the countertop is parallel to the cabinet faces. Check the countertop for level. Make sure that drawers and doors open and close freely. If needed, adjust the countertop with shims.

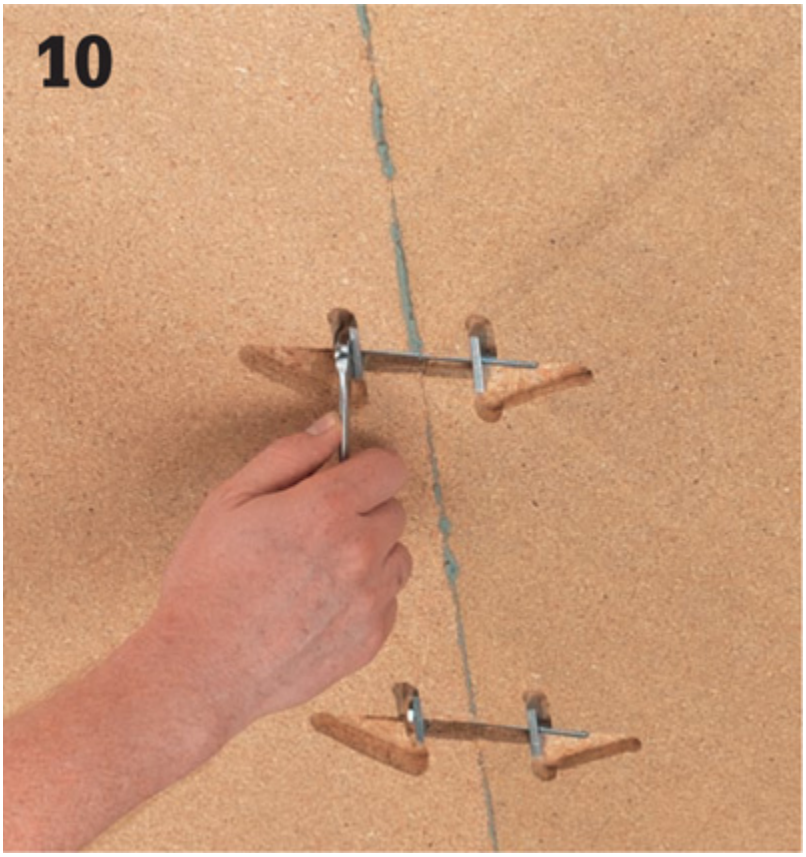
Because walls are usually uneven, use a compass to trace the wall outline onto the backsplash. Set the compass arms to match the widest gap, then move the compass along the length of the wall to transfer the outline to the top of the backsplash. Apply painter’s tape to the top edge of the backsplash, following the scribe line (inset).

Remove the countertop. Use a belt sander to grind the backsplash to the scribe line.

Mark cutout for self-rimming sink. Position the sink upside down on the countertop and trace its outline. Remove the sink and draw a cutting line ⅝" inside the sink outline.

Drill a starter hole just inside the cutting line. Make sink cutouts with a jigsaw. Support the cutout area from below so that the falling cutout does not damage the cabinet.

Apply a bead of silicone caulk to the edges of the mitered countertop sections. Force the countertop pieces tightly together.



From underneath the countertop, install and tighten miter take-up bolts. Position countertop tightly against the wall and fasten it to the cabinets by driving wallboard screws up through the corner brackets and into the countertop. Screws should be long enough to provide maximum holding power, but not long enough to puncture the laminate surface.

Seal the seam between the backsplash and the wall with silicone caulk. Smooth the bead with a wet fingertip. Wipe away excess caulk.

Building a Custom Laminate Countertop

Building your own custom laminate countertop using sheets of plastic laminate and particleboard offers two advantages: the countertop you get will be less expensive than a custom-ordered countertop, and it will allow you more options in terms of colors and edge treatments. A countertop made with laminates can also be tailored to fit any space, unlike premade countertop material that is a standard width (usually 25 inches).

Laminate commonly is sold in 8-foot or 12-foot lengths that are about 1/20" thick. In width, they range from 30-inch strips to 48-inch sheets. The 30-inch strips are sized specifically for countertops, allowing for a 25"-wide countertop, a 1½" -wide front edge strip, and a short backsplash.

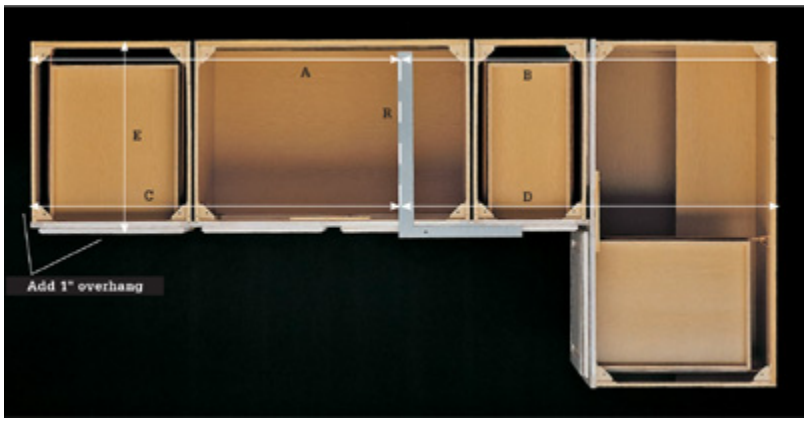
The plastic laminate is bonded to the particle-board or MDF substrate with contact cement (although most professional installers use products that are available only to the trades). Water-base contact cement is nonflammable and nontoxic, but solvent-base contact cement (which requires a respirator and is highly flammable) creates a much stronger, more durable bond.

Tools & Materials

- Tape measure
- Framing square
- Straightedge
- Scoring tool
- Paint roller
- 3-way clamps
- Caulk gun
- J-roller
- Miter saw
- Scribing compass
- Circular saw
- Screwdriver
- Belt sander
- File
- Router
- ¾" particleboard
- Sheet laminate
- Contact cement and thinner
- Wood glue
- Wallboard screws

Fabricating your own custom countertop from particleboard and plastic laminate is not exactly an easy do-it-yourself project, but it gives you unlimited options and the results can be very satisfying.

Working with Laminate



Measure along tops of base cabinets to determine the size of the countertop. If wall corners are not square, use a framing square to establish a reference line (R) near the middle of the base cabinets, perpendicular to the front of the cabinets. Take four measurements (A, B, C, D) from the reference line to the cabinet ends. Allow for overhangs by adding 1" to the length for each exposed end and 1" to the width (E).

Lay out cutting lines on the particleboard so you can rip-cut the substrate and buildup strips to size, using a framing square to establish a reference line. Cut the core to size, using a circular saw with a clamped straightedge as a guide. Cut 4" strips of particleboard for a backsplash and for joint support where sections of countertop core are butted together. Cut 3" strips for edge buildups.

How to Build a Custom Laminate Countertop

Join the countertop substrate pieces on the bottom side. Attach a 4" particleboard joint support across the seam, using carpenter’s glue and 1¼" wallboard screws.

Attach 3"-wide edge buildup strips to the bottom of the countertop, using 1¼" wallboard screws. Fill any gaps on the outside edges with latex wood patch, and then sand the edges with a belt sander.

To determine the size of the laminate top, measure the countertop substrate. Laminate seams should not overlap the substrate. Add ½" trimming margin to both the length and width of each piece. Measure laminate needed for face and edges of a backsplash and for exposed edges of the countertop substrate. Add ½" to each measurement.

Cut laminate by scoring and breaking it. Draw a cutting line, then etch along the line with a utility knife or other sharp cutting tool. Use a straightedge as a guide. Two passes of the scoring tool will help laminate break cleanly.

OPTION: Some laminate installers prefer to cut laminate with special snips that resemble aviator snips. Available from laminate suppliers, the snips are faster than scoring and snapping and less likely to cause cracks or tears in the material. You'll still need to square the cut edges with a trimmer or router.

Bend laminate toward the scored line until the sheet breaks cleanly. For better control on narrow pieces, clamp a straightedge along the scored line before bending laminate. Wear gloves and safety glasses to avoid being cut by sharp edges.

Create tight-piloted seams with plastic laminate by using a router and a straight bit to trim edges that will butt together. Measure from cutting edge of the bit to edge of the router baseplate (A). Place laminate on scrap wood and align edges. To guide the router, clamp a straightedge on the laminate at distance A plus ¼", parallel to laminate edge. Trim laminate.

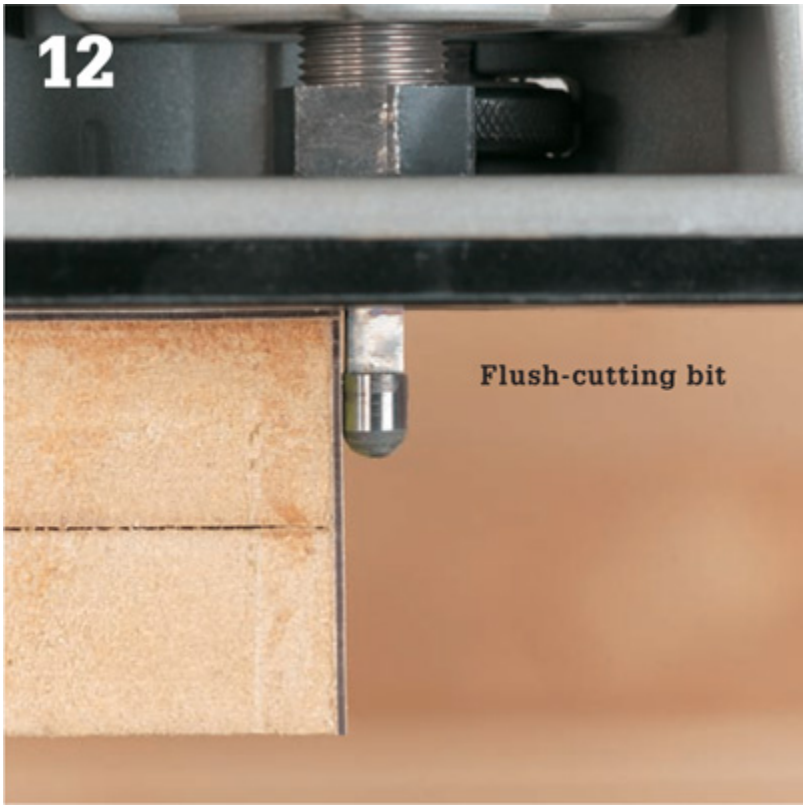
Apply laminate to sides of countertop first. Using a paint roller, apply two coats of contact cement to the edge of the countertop and one coat to back of laminate. Let cement dry according to manufacturer’s directions. Position laminate carefully, then press against edge of countertop. Bond laminate to substrate firmly with J-roller.

Use a router and flush-cutting bit to trim edge strip flush with top and bottom surfaces of countertop substrate. At edges where router cannot reach, trim excess laminate with a file. Apply laminate to remaining edges, and trim with router.

Test-fit laminate top on countertop substrate. Check that laminate overhangs all edges. At seam locations, draw a reference line on the core where laminate edges will butt together. Remove laminate. Make sure all surfaces are free of dust, then apply one coat of contact cement to back of laminate and two coats to substrate. Place spacers made of ¼"-thick scrap wood at 6" intervals across the countertop core. Because contact cement bonds instantly, spacers allow laminate to be positioned accurately over the core without bonding. Align laminate with seam reference line. Beginning at one end, remove spacers and press laminate to the countertop core.

Apply contact cement to remaining substrate and next piece of laminate. Let cement dry, then position laminate on spacers and carefully align butt seam. Beginning at seam edge, remove spacers and press laminate to the countertop substrate.

Roll the entire surface with a J-roller to bond laminate to the substrate. Clean off any excess contact cement with a soft cloth and mineral spirits.



Remove excess laminate with a router and flush-cutting bit. At edges where router cannot reach, trim excess laminate with a file. Countertop is now ready for final trimming with bevel-cutting bit.

Finish-trim the edges with a router and 15° bevel-cutting bit. Set bit depth so that the bevel edge is cut only on the top laminate layer. Bit should not cut into vertical edge surface.

Tip

File all edges and sharp corners smooth. Use downward file strokes to avoid chipping the laminate.

Cut 1¼"-wide strips of ¼" plywood to form an overhanging scribing strip for the backsplash. Attach to the top and sides of the backsplash substrate with glue and wallboard screws. Cut laminate pieces and apply to exposed sides, top, and front of the backsplash. Trim each piece as it is applied.

Test-fit the countertop and backsplash. Because your walls may be uneven, use a compass to trace the wall outline onto the backsplash scribing strip. Use a belt sander to grind the backsplash to the scribe line (see page 274).

Apply a bead of silicone caulk to the bottom edge of the backsplash.

Position the backsplash on the countertop, and clamp it into place with bar clamps. Wipe away excess caulk, and let the caulk cure completely.

Screw 2" wallboard screws through the countertop and into the backsplash core. Make sure screw heads are countersunk completely for a tight fit against the base cabinet. Install countertops.

Glossary

Balloon framing — a type of framing construction in which the studs run from the sill plate on the foundation to the roof framing in one continuous piece. Used most commonly in house construction before 1930.

Base-shoe molding — a strip of molding nailed to baseboard at the floor to conceal gaps and add a decorative edge.

Beam — a term that applies to any horizontal member such as a joist or header.

Bevel cut — an angled cut through the width or thickness of a board or other piece of stock.

Blindnailing — a nailing technique used in the installation of tongue-and-groove panels where the nail head is hidden from view by the groove of the next panel.

Blocking — a piece of dimensional lumber used between framing members for additional support and for use as a nailer in the installation of finish materials.

Box nail — a nail similar in appearance to a common nail, but with a thinner shaft. Used for lighter construction and on materials that split easily.

Brick molding — used between the exterior surface of a house and a window or door frame.

Casing — any trim around a window, door, or other opening.

Casing nail — similar to a finishing nail, but with a slightly larger dimpled head for better holding power.

Cat's paw — a type of prying tool used primarily in demolition, good for extracting nails.

Chalk box — also known as a chalk line, used to mark straight lines over long areas or as a plumb bob.

Common nail — a heavy-shaft nail used primarily for framing carpentry work and concrete forms, available from 2d to 60d.

Coped joint — a joint between two pieces of molding where one piece is cut to match the profile of another.

Coping saw — a handsaw with a flexible blade and fine teeth for cutting intricate curves and bends in wood.

Cripple stud — a short stud that is normally located above or below window and door openings.

Crosscut — to cut a piece of wood perpendicular to its grain.

Drip edge — a piece of molding placed over any exterior opening so that water runs or drips away from the opening.

Endnailing — joining two boards at a right angle by driving nails through the face of one board into the end of another.

Facenailing — joining two parallel boards by driving nails through the faces of both boards.

Finish nail — a nail with a small, dimpled head, used for fastening wood trim and other detail work.

Full-, half-, quarter-sheet — referring to the size of a sheet good relative to a 4 × 8-ft. sheet. A half-sheet is 4 × 4-ft, a quarter-sheet is 2 × 4-ft.

Furring strips — strips of wood, normally 2 × 2 or 1 × 2, that are used to even out a wall or prepare it for finishing with wallboard.

GFCl receptacle — a receptacle outfitted with a ground-fault circuit-interrupter. Also used on some extension cords to reduce the possibility of electric shock when operating an appliance or power tool.

Glue laminate — a type of engineered lumber specifically created for headers or support beams, in which layers of wood are bonded to form a solid unit.

Header — a piece of lumber used as a support beam over a doorway or window opening.

Jack stud — a wall-framing member used to support a header in a doorway or window opening.

Jamb — the top and side pieces that make up the finished frame of a door or window.

Joist — a piece of dimensional lumber used to support a ceiling or floor.

Kerf — a saw cut in wood. The set of the teeth — the degree of outward angle — determine the width of a kerf.

King studs — the first studs on either side of a framed opening to span from the sole plate to the top plate.

Ledger board — a piece of dimensional lumber used to mount cabinets and other elements on a wall.

Load-bearing wall — any wall (interior or exterior) that bears some of the structural weight of a house. All exterior walls are load-bearing.

Locknailing — strengthening a miter joint in window or door casings by driving nails through the middle of the joint from the outer edge of the casing. This technique also works well with picture frames.

Mandrel — the drill bit tip in the center of a hole saw, used in the cutting of an opening for a doorknob in a door.

MicroLam® — a structural member made of thin layers of wood glued together; used for joists and beams.

Miter cut — a 45° bevel cut in the end of a piece of molding or a framing member.

O.C. (on center) — refers to the distance from the center of one framing member to the center of the next.

Partition wall — an interior, non-loadbearing wall.

Pennyweight — a measure used to indicate nail size and length, commonly shown as a lower case “d.”

Platform framing — a type of framing construction in which the studs only span a single story, and each floor acts as a platform to build and support the next higher level. Most common framing method in modern home construction.

Plumb bob — a device consisting of a pointed weight on the end of a string, used to determine whether a surface is exactly vertical or to transfer marks along a vertical plane.

Plunge cut — a cut that begins in the field of a board or piece of plywood by slowly pivoting the blade into the wood.

Post — a vertical timber used to support any structural member such as a rafter or header.

Powder-actuated nailer — a fastening device used to drive hardened nails into concrete and steel with the aid of gunpowder.

Reciprocating saw — a type of power saw that cuts with a back and forth action through wood, metal, and plastic.

Rip — to cut a piece of wood parallel to the grain.

Rough opening — the opening of the rough framing for a window or door.

Scarf joint — a joint made by beveling the ends of two pieces of lumber or molding and nailing them together so that they appear to be seamless.

Shim — a thin wedge of wood used to make slight adjustments in doors or windows during installation.

Sister joist — dimensional lumber attached alongside an existing joist to provide additional strength.

Soffits & chases — boxes made with dimensional lumber and plywood or wallboard to cover up existing mechanicals or other obstructions.

Sole plate — a piece of dimensional lumber (normally 2 × 4) that supports the studs of a wall.

Standout — the distance a tape measure can be drawn out before the tape bends under its own weight.

STC (sound transmission class) — a rating system referring to how well sound is contained within a room due to the construction. Normal wall construction has a rating of 32 STC.

Stud — a vertical framing member used in the framework of a house or building.

Toenailing — joining two boards at a right angle by driving nails at a 45° angle through the side of one board into the face of another.

Tongue-and-groove paneling — a type of lumber with a machined tongue on one side and a groove on the other, so that when pushed together, the groove of one board fits snugly over the tongue of the adjacent board.

Top plate — a piece of dimensional lumber (normally 2 × 4) that rests on top of the studs in a wall and supports the ends of rafters.

Treated wood — lumber that has been impregnated with chemicals to make it resistant to pests and rot.

VSR (variable speed reversing) — an option available in most drills sold today, allowing the user to control the drill speed and direction.

Wallboard — also known as drywall; flat panels available in various sizes made of gypsum covered with durable paper. Used for most interior wall and ceiling surfaces.

Whaler — a temporary support beam used in the modification of balloon framing.

Conversion Charts

Lumber Dimensions

Nominal - U.S.	Actual - U.S. (in inches)	Metric
1 × 2	¾ × 1½	19 × 38 mm
1 × 3	¾ × 2½	19 × 64 mm
1 × 4	¾ × 3½	19 × 89 mm
1 × 5	¾ × 4½	19 × 114 mm
1 × 6	¾ × 5½	19 × 140 mm
1 × 7	¾ × 6¼	19 × 159 mm
1 × 8	¾ × 7¼	19 × 184 mm
1 × 10	¾ × 9¼	19 × 235 mm
1 × 12	¾ × 11¼	19 × 286 mm
1¼ × 4	1 × 3½	25 × 89 mm
1¼ × 6	1 × 5½	25 × 140 mm
1¼ × 8	1 × 7¼	25 × 184 mm
1¼ × 10	1 × 9¼	25 × 235 mm
1¼ × 12	1 × 11¼	25 × 286 mm
Nominal - U.S.	**Actual - U.S. (in inches)**	**Metric**
1½ × 4	1¼ × 3½	32 × 89 mm
1½ × 6	1¼ × 5½	32 × 140 mm
1½ × 8	1¼ × 7¼	32 × 184 mm
1½ × 10	1¼ × 9¼	32 × 235 mm
1½ × 12	1¼ × 11¼	32 × 286 mm
2 × 4	1½ × 3½	38 × 89 mm
2 × 6	1½ × 5½	38 × 140 mm
2 × 8	1½ × 7¼	38 × 184 mm
2 × 10	1½ × 9¼	38 × 235 mm
2 × 12	1½ × 11¼	38 × 286 mm
3 × 6	2½ × 5½	64 × 140 mm
4 × 4	3½ × 3½	89 × 89 mm
4 × 6	3½ × 5½	89 × 140 mm

Metric conversions

To Convert:	To:	Multiply by:
Inches	Millimeters	25.4
Inches	Centimeters	25.4
Feet	Meters	0.305
Yards	Meters	0.914
Square inches	Square centimeters	6.45
Square feet	Square meters	0.093
Square yards	Square meters	0.836
Ounces	Milliliters	30.0
Pints (U.S.)	Liters	0.473 (Imp. 0.568)
Quarts (U.S.)	Liters	0.946 (Imp. 1.136)
Gallons (U.S.)	Liters	3.785 (Imp. 4.546)
Ounces	Grams	28.4
Pounds	Kilograms	0.454

To Convert:	To:	Multiply by:
Millimeters	Inches	0.039
Centimeters	Inches	0.394
Meters	Feet	3.28
Meters	Yards	1.09
Square centimeters	Square inches	0.155
Square meters	Square feet	10.8
Square meters	Square yards	1.2
Milliliters	Ounces	.033
Liters	Pints (U.S.)	2.114 (Imp. 1.76)
Liters	Quarts (U.S.)	1.057 (Imp. 0.88)
Liters	Gallons (U.S.)	0.264 (Imp. 0.22)
Grams	Ounces	0.035
Kilograms	Pounds	2.2

Index

A

Access ladders, installing attic, 200-203

Adhesives, 34-35

Appliances, wattage ratings, 11

Apron & stool window trim, installing, 156-159

Asbestos, 8

Attics

installing access ladders, 200-203

paneling ceilings, 164-167

Auger bits, 94

B

Backerboards, 95

Backsaws, 50, 51

Balloon framing

anatomy of houses, 109

door openings, 208-209

Bars for prying, 40, 41

Baseboard molding, 29

Baseboards

making with power miter saws, 84

see also Trim moldings

Base cabinets, installing, 267-268

Basements

building code requirements, 174

framing foundation walls, 176-177

trimming windows, 178-181

Base moldings, installing, 160-163

Base-shoe molding, 29
Bay windows, installing, 242-252
Bevel cuts, making with circular
  saws, 76
Bifold doors
  framing openings, 139
  mounting, 148-149
Birch, 22
Blades
  for circular saws
    changing, 73
    setting depth, 73
    sizes and types, 70, 72
  cooling, 61
  for power miter saws, 80
  for power planers, 63
  sharpening, 60-61
  for table saws, 86, 88
Box nails, 30
Brad pullers, 41
Brads, 30
Brick molding, installing windows with, 225-227
Building code requirements
  basements, 174
  bay windows, 242
  exterior doors, 110, 205
  foundation walls, 174
  framing connectors, 33
Building inspections, 19

Building permits, 6
Butted door casings, installing, 154
C
Cabinets
installing new
base, 268—269
fitting corner, 264
preparing walls, 260-263
wall, 265-267
removing old, 259
Carpenter's levels, 46
Carpet, patching, 255
Case moldings, cutting, 84
Casing nails, 30
Casings, installing on doors & windows, 152-155
Cat's paws, 41
Caulks, 34
Cedar, 22
Ceilings
anatomy of, 112
installing wallboard on flat, 132
paneling attic, 164-167
soundproofing, 126-127
Chalk lines, 44, 45
Chases & soffits, framing, 182-183
Chisels, 59-61
Circular saws
blades
changing, 73

setting depth, 73
sizes and types, 70, 72
making cuts with, 74-76
making straightedge guides for, 77
parts of, 71
Clamps, 58
Collated screw guns, 105
Combination squares, 49
Common nails, 30
Compound miter cuts, making, 85
Compound power miter saws, 79
Cooling blades, 61
Coping saws, 51
Corded drills, 93
Cordless drills, 92-93
Cordless screw guns, 105
Corners
finishing after installing wallboard, 135
fitting cabinets, 264
installing wainscoting at, 170-171
Counterbore bits, 95
Countertops
installing new
custom laminate, 276-283
overview of, 270
post-form laminate, 272-275
removing old, 271
Cove molding, 29
Crosscuts

making with circular saws, 74
making with power miter saws, 82
making with table saws, 90
Crosscut saws, 50, 51
Crown molding, 29
Cutting lines, material consumed by
blade, 7

D

Dadoes, making with circular saws, 76
Deck screws, 32
Digital levels, 47
Dimension lumber, 20, 22, 23
Door-edge molding, 29
Doors
framing
exterior, 204-209
interior in load-bearing walls, 139
interior prehung doors, 136-138
interior sliding & folding doors, 139
overview of, 110-111
storm, 150
installing
bifold, 148-149
casings, 152-155
entry, 210-213
exterior in old jambs, 144-147
interior prehung, 140-141
patio, 214-219
storm, 150-151

removing, 196-197
shortening hollow-core interior, 142-143
Drawings/diagrams, 6, 7
Drills & bits, 92-95
Drywall. See Wallboard Drywall lifts, 105
Drywall stilts, 132
Ductwork
framing furnace, 183
locating, 7
protecting, 33
E
Electrical supply
assessing adequacy of workshop, 10, 11
cutting electrical box openings in
wallboard, 130-131
extension cords, 64-67
GFCI receptacles, 9
locating lines, 7
making cutouts for receptacles, 172
protecting, 33
testing, 9
work area preparation and, 115
Extension cords, 64-67
Exterior lumber, 20
Extra-wide boards, cutting, 83
F
Featherboards, using, 88
Finished boards, 23
Finish nails, 30

Finish plywood, 26
Fir, 22
Flooring nails, 30
Floors
  anatomy of, 112
  patching, 254-255
Foam insulating board, 27
Folding doors, framing openings, 139
Foundation walls
  covering, 174-177
  framing basement, 176-177
Framing
  basement foundations walls, 176-177
  doors
    exterior, 204-209
    interior in load-bearing walls, 139
    interior prehung, 136-138
    interior sliding & folding, 139
    overview of, 110-111
    storm, 150
  furnace ducts, 183
  metal connectors, 33
  soffits & chases, 182-183
  with steel, 120-121
  supporting platform, 187
Framing anatomy of houses
  door & window opening, 110-111
  floors & ceilings, 112
  types of, 108-109

Framing squares, 48
French-style patio doors, installing, 214-219
Furring strips
described, 23
installing on masonry walls, 174,175
G
Galvanized nails, 30
Gas pipes, locating, 7
GFCI extension cords, making, 66-67
GFCI receptacles, 9
Glue laminate, 23
Glues, 34-35
H
Hacksaws, 50
Hammer drills, 93, 104
Hammers
types of, 52-53
using, 54-55
Handsaws, 50-51
Hardboard, 27
Hardware, 32-33
Hardwoods, 22
Hardwood strips, 29
Hollow-core interior doors, cutting, 142-143
I
Impact drivers, 105
J
Jigsaws, 68-69

K

Kneewalls, building, 122-125

L

Ladders, installing attic access, 200-203

Lap siding, making opening in, 192-193

Larch, 22

Laser levels, 46, 47

Levels, 46-47

Load-bearing walls

described, 113

framing doors in, 139

in houses with balloon framing, 109

in houses with platform framing, 108

removing, 186-187

Lumber

grading, 20-21

moisture content, 20

selecting, 22-23

transporting, 24-25

M

Mallets, 52, 53

Maple, 22

Masonry anchors, 33

Masonry walls, covering, 174-175

Materials

lists, 7

purchase amounts, 31, 164

Measuring & marking tools

chalk lines, 44, 45

levels, 46-47
plumb bobs, 44, 45
squares, 48-49
stud finders, 44, 45
tape measures, 42-43
Micro-lam, 23
Mitered casings, installing on doors & windows, 152-153
Molding trims. See Trim moldings
Mortises, chiseling, 59
N
Nail guns/nailers
pneumatic, 100-101
power-actuated, 102-103
Nailing flanges, installing windows with, 223-224
Nails
driving in, 55
estimating quantities, 31
removing, 54, 117
sizes, 31
types of, 30
Non-loadbearing walls
building, 118-120
removing, 198-199
O
Oak, 22
Ornamental molding, 29
P
Panel adhesive, 34
Paneling attic ceilings, 164-167

Particleboard, 26, 27
Partition walls
building, 118-120
building staggered-stud, 127
described, 113
in houses with balloon framing, 109
in houses with platform framing, 108
Patio doors, installing, 214-219
Pegboard, 27
Pennyweights, 31
Pine, 22
Pipes
locating, 7
protecting, 33
Planes, 62-63
Plasterboard
removing, 190-191
see also Wallboard
Plastic foam insulating board, 27
Plastic laminates, 26, 27
Platform framing
anatomy of houses, 108
exterior doors, 206-207
supporting, 187
Plumb bobs, 44, 45
Plumbing, 7, 33
Plunge cuts, making with circular
saws, 74
Plywood

ripping with table saws, 91
types, 26-27
Pneumatic nailers, 100-101
Poplar, 22
Power-actuated tools (PATs), 102-103
Power miter saws
blades for, 80
overview of, 78
setting up, 81
types of, 79
using, 82-85
Power planers, 62-63
Projects
planning, 6-7
safety, 8-9
Prying tools, 40-41
Pushsticks, using, 88
R
Rafter squares, 49
Redwood, 22
Resilient steel channels, installing, 127
Rip cuts
making with circular saws, 75
making with table saws, 89
Roofs, anatomy of, 113
S
Sanders, 96-99
Sandpaper, 99
Sawhorses, building, 16-17

Saws
blade guards, 8
circular
blades
changing, 73
setting depth, 73
sizes and types, 70, 72
making cuts with, 74-76
making straightedge guides for, 77
parts of, 71
handsaws, 50-51
jigsaws, 68-69
material consumed in cutting path, 7
power miter
blades for, 80
overview of, 78
setting up, 81
types of, 79
using, 82-85
table saws, 86-91
wattage ratings, 11
Scarf joints, making with power miter saws, 84
Screwdrivers, 56-57
Screws, 32
Screws, removing broken, 95
Sheathing plywood, 26-27
Sheet goods
ripping on table saws, 91

types of, 26-27
Sheetrock. See Wallboard
Shelf-edge molding, 29
Siding
framing exterior doors for houses
with, 204-209
making opening in lap, 192-193
patching wood, 252
Skylights,
building shafts, 238-241
installing standard, 232-237
Sledgehammers, 52, 53
Sliding doors
framing openings, 139
installing patio, 214-219
Sliding miter saws
described, 79
using, 83
Small-wire nails, 30
Soffits & chases, framing, 182-183
Softwoods, 22
Soundproofing walls & ceilings, 126-127
Square, checking for, 43
Squares, 48-49
Steel-framing
described, 20
joining sections, 121
tools for, 120
Stool & apron window trim, installing, 156-159

Storm doors, installing, 150-151
Straightedge guides, 77
Strandboard, 26, 27
Stucco
making opening in, 194-195
patching, 253
Stud finders, 44, 45
T
Table saws
overview of, 86-87
setting up, 87
using, 88-91
Tape measures, 42-43
Temporary support walls, installing, 187
Tongue-and-groove paneling, 23, 164
Tongue-and-groove wainscoting, 168
Tools
carrying, 38-39
maintaining, 9
owner's manuals, 8
renting, 104
wattage requirements, 11
see also specific tools
Torpedo levels, 46
Treated lumber, 20, 22
Trim moldings
attaching, 101
case
cutting, 84

making with power miter saws, 84
glue for, 35
installing
around basement windows, 178-181
in attic ceilings, 167
base, 160-163
stool & apron window, 156-159
window, 156-159
overview of, 28-29
removing old, 116-117, 258
T-squares, 48
U
Utilities
electrical supply
assessing adequacy of workshop, 10, 11
cutting electrical box openings in
wallboard, 130-131
extension cords, 64-67
GFCI receptacles, 9
locating lines and pipes, 7, 115
making cutouts for receptacles, 172
testing, 9
pipes & ductwork
framing furnace ductwork, 183
locating, 7
protecting, 33
V
Vises, 58
W

Waferboard, 26, 27
Wainscoting, installing, 168-173
Wall anchors, 33
Wallboard
  described, 27
  installing
    cutting, 130-131
    finishing corners, 135
    on flat ceilings, 132
    planning & preparation, 128-129
    taping joints, 134
    on walls, 133
  nails, 30
  removing, 188-189
  screws, 32
Wall cabinets, installing, 264-267
Walls
  anatomy of, 113
  building kneewalls, 122-125
  building non-loadbearing, 118-120
  covering foundation/masonry 174-175
  framing basement foundation, 176-177
  framing interior doors in load-bearing, 139
  installing temporary support, 187
  installing wallboard on, 133
  preparing for new cabinets, 260-263
  removing
    exterior surfaces, 192-195
    load-bearing, 186-187

non-loadbearing, 198-199
plaster, 190-191
wallboard, 188-189
soundproofing, 126-127
types of, 108, 109
Walnut, 22
Water-resistant wallboard, 27
Windows
framing, 110-111, 220-222
installing, 220, 223-227
bay, 242-252
casings, 152-153, 155
new sashes, 228-231
trim, 156-159
wainscoting around, 173
removing, 196-197
trimming basement, 178-181
Wiring. *See* Electrical supply
Wood siding, patching, 252
Work area, preparing, 114-117
Workbenches, building, 12-15
Workshops
building sawhorses, 16-17
building workbenches, 12-15
necessities, 10-11
Wrecking bars, 41

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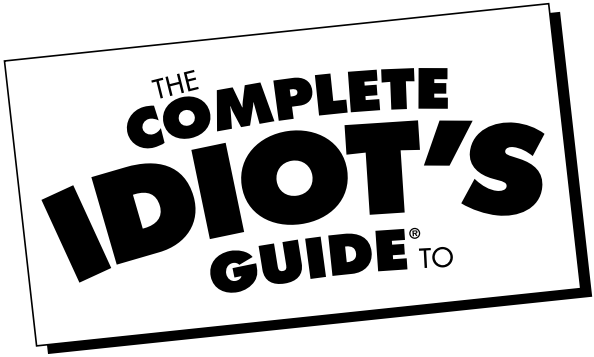

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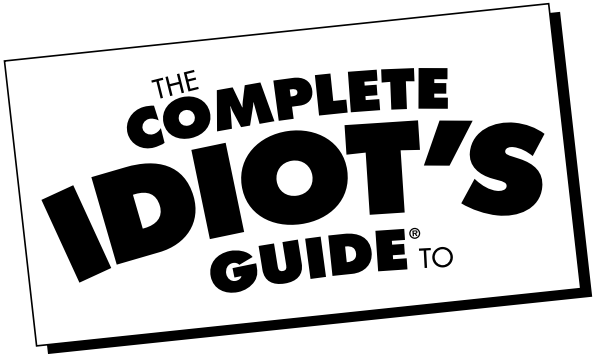

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Contents at a Glance

Part 1: Getting to Know Your House 1

1 Your Personal Tool Kit 3
What equipment is essential for home repair? Tools can be categorized by the functions they perform; here's an illustrated and organized list you can use.

2 Your Most Important Tool: The Safety Drill 21
Here's the gear and the rules you need to stay safe when you work on your house. Learn which jobs require professional help.

3 Your Supply Closet 31
Gather an inventory of materials for home repair, including first-aid supplies for your house and leftovers from home projects that you won't want to throw away.

4 A Map of Your World 41
Find the systems that power your home. Learn to operate their controls, and know what to do in case of an emergency.

Part 2: Skin Deep: Repairing Surfaces and Openings 53

5 Walls: From Trash Talk to Smooth Talk 55
Here is advice and detailed repair instructions for all types of surface materials, including drywall, plaster, tile, and wallpaper.

6 Floors and Ceilings: Beneath Your Feet and (Not Really) Over Your Head 77
Repair blemishes to your hardwood floors, learn how to repair a resilient floor, and clean up carpet stains.

7 Stairs: A Few Steps to a Happy Landing 103
Silence squeaks and tighten treads. Make sure that rails and balusters are solid. Keep children and elders safe around stairways.

8 Getting Clear About Windows 113
How to deal with windows that get stuck or rattle. Avoid pane pain: learn to replace broken glass and worn screens.

9 Doors: An Open-and-Shut Case 133
Understand the parts of a door and how to keep them working together so they don't stick—or stay open when you want them closed.

Part 3: The Circulatory System: Plumbing and Fixtures 151

10 Solving Pipe Problems 153
Thaw pipes that have frozen and get tips for preventing future freeze-ups. Protect outside faucets from winter's chill, clear clogs from the sink, and rescue valuables that go down the drain.

11 Controlling the Flow: Faucets, Sprays, and Showerheads 167
Check out the four main faucet types and how to repair them. Clean a spitting faucet or a showerhead with a flawed flow. Figure out how to make a sink stopper pop after it's flopped.

12 Tub and Toilet Techniques 183
Spot-repair a tub surface and prevent leaks around the tub. Clear and prevent a clogged tub drain. Understand how your toilet works and diagnose various problems.

Part 4: Mission Control: Wiring, Appliances, Heating, and Cooling 197

13 In the Loop: Understanding Your Wiring 199
Understand your home's electrical system and how to control its circuits. Map your own system, and make simple diagnoses, repairs, and replacements.

14 Smooth Transitions: Cleaning and Replacing Filters and Hoses 213
Change and replace the filters and hoses associated with washers, dryers, air conditioners, furnaces, and stovetops.

15 Appliance Repairs 223
Find an appliance model number and use manuals and help lines to troubleshoot appliance problems. Learn some easy repair techniques for common appliance ailments.

16 Heating and Cooling 235
Understand the basics about your equipment and how to recognize problems. Extend your water heater's life expectancy by learning to drain it and replace a crucial part.

Part 5: Preventive Maintenance: Safety and Upkeep 251

17 Safety Must-Haves 253
Get the facts about installing and using smoke detectors, carbon monoxide detectors, and fire extinguishers. Develop a family emergency escape plan.

18 Preventing Repairs: Inside Maintenance 263
Inspect your home twice yearly for small defects before they become big problems. Find out what tools you need and what to look for. Prevent pest problems.

19 Preventing Repairs: Outside Maintenance 273
Give your home's exterior a closer look. Fix the landscape and drainage system so that your home's big enemies—water and weather—can't get started on a destructive path.

Appendixes

A Glossary 283

B Online Resources 287

C Home Inspection Checklists 293

Index 305

Contents

Part 1: Getting to Know Your House 1

1 Your Personal Tool Kit 3

Quality Counts ... 4
Measure Up: Rule(r)s of the Road ... 4
Make Your Mark ... 6
The Cutting Edge: Sharp Helpers ... 7
Putting It Together: Tools for Fastening and Joining ... 9
Basic Tools ... *10*
Specialized Tools ... *11*
Demolition Derby: Tools That Take Things Apart ... 12
The One Tool You Can't Live Without ... 14
Power ... *15*
Speed ... *15*
Keyless Chuck ... *16*
Screwdriving ... *16*
Helpful Bits About Drilling ... *16*
Put It There! Applying the Right Stuff ... 17
Hold It! Transporting Your Tools ... 17
I Can See Clearly Now ... 19
Your Work Space ... 19

2 Your Most Important Tool: The Safety Drill 21

Good Safety Habits ... 22
Safety Gear: The Basics ... 23
The Job Site ... 25
The Ups and Downs of Ladder Safety ... 26
Choosing a Ladder ... *26*
Using a Ladder ... *27*
Knowing Your Limits: When to Call a Pro ... 29

3 Your Supply Closet 31

DIY Depot: Storing Your Repair Stuff ... 32
The Supply Side ... 32
Keep It Moving: Lubricants ... *32*
Keep It Together: Adhesives ... *33*
Fill the Gap ... *34*

Cover It Up *34*
Rub It Off: Abrasives *34*
More Togetherness: A Quick Guide to Fasteners *35*
Hold It: Containers *37*
In Case of Small Water Emergencies 37
Storing Those Leftovers! 39

4 A Map of Your World 41

The Main Thing: Your Home's Power Centers 42
Finding the Flow: Your Water Supply 42
Oh, Well *44*
Where the Well Water Goes *44*
Your Gas System (Outside the House) 45
If You Smell Gas *45*
Other Gas Controls *45*
Your Electric Service 47
A Workbook for Your Home 49
Appliance and Fixture Use and Care Manuals *50*
Receipts and Manufacturer's/Dealer's Warranties *51*
Equipment Manuals or Schematics *51*
A Circuit Map of Your Home *51*
Service Records *52*
Other Workbook Items *52*

Part 2: Skin Deep: Repairing Surfaces and Openings 53

5 Walls: From Trash Talk to Smooth Talk 55

Minor Drywall Repairs 56
Repairing Dings and Dents *56*
Popped Nails *58*
Patching Holes *60*
Loose Drywall Tape *62*
Repairing Cracks in Plaster 62
Grout and Tile Crackups 64
Replacing Grout *65*
Replacing a Ceramic Tile *67*
Minor Wallpaper Repairs 70
Bursting Those Bubbles *71*
Flattening Flappy Seams *72*
Patching a Torn Section of Wallpaper *73*

6 Floors and Ceilings: Beneath Your Feet and (Not Really) Over Your Head 77

Wood Floors: Skin Repair....78
Water Marks....78
Burn Marks....79
Scratches and Gouges....80
Preventing Blemishes....80
Floorboard Fixes....80
Drilling Pilot Holes....81
Split or Cracked Boards....81
More Bit Bits....83
Warped Boards....84
Loose Boards....85
Stopping Squeaks....87
Getting at Squeaks from Down Under....88
Resilient Floor Fixes....89
Replacing a Vinyl Tile....90
Patching Sheet Flooring....92
Ceramic Tile Floor Repairs....93
Carpet Capers....93
Taking Up a Wall-to-Wall Carpet....93
Dealing with Spots and Spills....94
When Spot Makes a Spot....96
Replacing a Stained or Damaged Section of Carpet....97
First Aid for Floating Laminate Floors....99
Ceiling Repairs....100

7 Stairs: A Few Steps to a Happy Landing 103

Parts of a Staircase....104
Silencing Squeaks....104
A Lube Job....104
Repairing Squeaks from Below the Stairs....105
Fixing the Squeak or Loose Tread from Above....106
Getting a Grip on Handrails....108
Off-Base Balusters....109
Safe Stairs....110
Elder Safety....110
Kidproofing the Stairs....111

8 Getting Clear About Windows 113

What a Pane! Parts of a Window 114
How Double-Hung Windows Work 115
Stubborn Stuck Sash 116
Wait and See *116*
Gentle Tap, Tap, Tapping *116*
Don't Want to Pry, But … *117*
Windows That Won't Stay Open 119
When Windows Break 121
Screen Test 124
Screen Repairs 125
Small Holes *125*
Replacing Screens *126*
Installing Security Pins in Windows *129*

9 Doors: An Open-and-Shut Case 133

Anatomy of a Door 134
Silencing the Talking Door 135
Tightening Loose Hinges 136
Fix #1: Gum Up the Holes *137*
Fix #2: Longer Screws *137*
Sticking Doors 138
Doors That Won't Stay Closed 138
Getting a Grip on Doorknobs 140
Tighten a Loose Knob *141*
Replacing a Passage, Privacy, or Keyed Entry Lockset *143*
Screen and Storm Doors 143
Adjusting the Door Closer *144*
If You Need a New Closer *145*
Lock and Key Dilemmas 145
Key Sticks in the Lock *145*
Key Breaks Off in the Lock *145*
Lock Is Frozen *146*
Locked in (Privacy Lock) *146*
Installing a Peephole 146
Sliding Door Fixes 148
Wobbly Tracks *148*
Dirty Tracks *148*
Bent Track *149*
Securing a Sliding Door *149*

Part 3: The Circulatory System: Plumbing and Fixtures 151

10 Solving Pipe Problems 153

Small Leaks: Emergency Fix 154
Thawing Frozen Pipes 156
Hot Water Thaw *157*
Applied Heat Thaw: Beware! *157*
Preventing Frozen Pipes *157*
Another Cold Subject: Winterizing an Outside Faucet 158
Pipe Down! Quieting Noisy Pipes 159
Preventing Drainage Disasters 160
Unclogging a Sink 161
Chemical Reactions *161*
Taking the Plunge *161*
Meet the Sink Trap 162
Clearing the Trap *163*
When Valuables Go Down the Drain *165*

11 Controlling the Flow: Faucets, Sprays, and Showerheads 167

Faucet Facts 168
Faucet Fix Prep List *168*
Fixing a Leaky Compression Faucet *169*
Still Dripping? *172*
Fixing a Leaky Rotary Ball Faucet *172*
Repairing a Cartridge Faucet *174*
Ceramic Disk Faucet Fix *175*
Cleaning a Clogged Aerator 177
Brushing Up on Showerheads 178
Cleaning Showerhead Outlet Holes *179*
Removing/Replacing a Showerhead *179*
When the Pop-Up Stopper Flops 180

12 Tub and Toilet Techniques 183

Bathtubs: The Surface Story 184
Concealing Surface Flaws in Porcelain-Enameled Cast Iron *184*
Renewing a Scratched Acrylic Tub *185*
Waterproofing Around the Bathtub 185
Clearing a Tub Clog 187
Pop-Up Stopper *187*
Strainer *187*

Take the Plunge *188*
The Worst Case: Toilet Clogs 188
Low-Tech De-Clogging *188*
The Toilet Plunge *189*
Other Toilet Trouble 190
Inside the Tank: A Toilet's Vital Organs *191*
Stopping a Running Toilet 192
Worn-Out Float Ball *192*
Float Ball Won't Rise *193*
Tank Stopper Won't Close *193*
The Flush Is Weak 194
Leak or Sweat? 194
When the Toilet Rocks 195

Part 4: Mission Control: Wiring, Appliances, Heating, and Cooling 197

13 In the Loop: Understanding Your Wiring 199

Time to Call a Pro? 200
Your Electricity Dictionary 200
Mapping Your Electrical System 201
Calculating the Load on Your System 204
Receptacle ID 205
But Is It Grounded? 207
GFCI: Initials You Need to Know 208
Shattered! Replacing a Bulb That Breaks in Its Fixture 209

14 Smooth Transitions: Cleaning and Replacing Filters and Hoses 213

De-Linting the Clothes Dryer 214
Clothes Washer Hoses and Filters 215
Replacing Washing Machine Supply Hoses *215*
About Metal Mesh Household Hoses *217*
Cleaning and Replacing Washing Machine Water Inlet Filters *218*
Cleaning the Room Air Conditioner Filter 219
Cleaning or Replacing a Forced-Air Furnace Filter 220
Cleaning a Range Hood Filter 220

15 Appliance Repairs 223

Ailing Appliances: Diagnosis 224
What's Your Model? *224*
Troubleshooting *225*

Manufacturer Help ... *225*
Refrigerator Repairs ... 226
Keeping Your Cool ... *226*
Poor Door Seal ... *226*
Cleaning Condenser Coils ... *227*
Water in the Cabinet ... *228*
Closing the Open Door ... *229*
Water Underneath the Refrigerator ... 230
Leaky Drip Pan ... *230*
Leaky Icemaker Supply Line ... *230*
Dishwasher Dilemmas ... 230
Leaky Drain Connection ... *231*
Dirty Dishes ... *231*
Washing Machines: On the Move? ... 231
Jammin' with Your Garbage Disposal ... 232
Service Calls and Replacement ... 234

16 Heating and Cooling 235

Maintenance of Heating/Cooling Equipment ... 236
Gas Heat ... 236
Oil Heat ... 237
Electric Heat ... 239
Troubleshooting Your Heating System ... 239
Gas Furnace ... *240*
Lighting the Pilot—or Not? ... *240*
Electric Heat ... *241*
Oil Furnace/Boiler ... *241*
DIY Heating System Maintenance ... 242
Filtering Forced Air Systems ... *242*
Ducts, Vents, and Registers ... *242*
Cleaning Radiators ... *243*
Bleeding Radiators ... *243*
Steam Heat ... *244*
Water Heaters ... 245
Basic Water Heater Anatomy ... *245*
Testing the Pressure Relief Valve ... *246*
Replacing the Pressure Relief Valve ... *247*
Draining the Water Heater ... *248*
Central Air ... 248

Part 5: Preventive Maintenance: Safety and Upkeep 251

17 Safety Must-Haves 253

Your #1 Safety Device: Smoke Detectors....254
Chirpy Smoke Detector....254
Testing the Smoke Detector Alarm....255
Replacing the Batteries....255
Smoke Detector Placement....256
Carbon Monoxide Detector....256
Installing the CO Detector....257
Replacing the CO Detector Battery....257
If the CO Alarm Goes Off....257
Fire Extinguisher Facts....258
Using the Extinguisher....259
Storing the Extinguisher....259
Maintaining the Extinguisher....259
Emergency Exit: Your Family Plan....260
Your Little Red Book....261

18 Preventing Repairs: Inside Maintenance 263

Your House Detective Tool Kit....264
Tools....264
The Lists....264
Inspection Checklists: How to Use Them....265
Basement/Utility/Laundry Room....265
Bathrooms....266
Kitchen....267
Attic/Under Roof Crawl Space....268
General Inspection....268
Keeping Out Water and Critters....269
Screening Attic Vents....269
Rodent-Proofing Gaps....270
Planning Ahead for Maintenance....271

19 Preventing Repairs: Outside Maintenance 273

Outside Inspection....274
Foundation....274
Walls, Windows, and Doors....275
Roof....276
Landscape....276

Maintaining Your Home's Exterior 277
Gutters and Drainage 277
How Gutters Work *277*
Cleaning Gutters and Downspouts *278*
Directing Water Flow: Extenders and Splash Blocks *279*
Small Gutter Repairs *280*
Driveway Repair 280
Finding and Using a Pro 281

Appendixes

A Glossary **283**

B Online Resources **287**

C Home Inspection Checklists **293**

Index **305**

Introduction

There's a truism about houses: sooner or later, whatever can go wrong, will go wrong. Most people recognize this phrase as Murphy's Law, but after twenty-five years of fixing things, I know that it's also the First Law of Homeownership.

Because stuff goes bad—often in a hurry, usually when you least expect it, and most likely when there's a tiny balance in your checking account—being able to diagnose a small problem before it's a big one, and even fix it yourself, is a very nice aptitude to develop.

That's what got me excited about writing *The Complete Idiot's Guide to Simple Home Repair*.

After about a year in our first house, we had a new baby and lots of bills, and the First Law of Homeownership kicked in. Pipes froze, the pump died, and the gutters started leaking. I noticed that moss was growing on the garage roof! My husband traveled all the time, and so the ball was in my court. I had to fix some of this stuff myself, or we'd go bust paying repair people.

So I took the next step: I started learning about my house's structure, systems, and appliances, and started down the DIY highway.

I was a bit tentative at first, but the simple repairs I completed successfully encouraged me to try others. When I did call repairmen, I asked them to explain what they were doing, and why. I picked their brains about the finer points of my house's plumbing, wiring, heating, and appliances. Pretty soon, my friends were calling *me* to walk them through the fixes for their own appliance breakdowns and plumbing disasters.

In this book, I pass along what I've learned, along with lots of good advice from fellow DIY-ers and seasoned pros. I hope you find that acquiring these skills is fun and empowering. And I hope that the knowledge will save you money; it's saved me and my family plenty!

Taking care of a home is quite a bit like taking care of ourselves; keeping it in shape requires maintenance and, when needed, tweaks and touch-ups to keep it looking and functioning at its best. Like our own bodies, a home has lots of parts and systems that need care and attention. We can do a good portion of the work ourselves. And when things happen that are beyond our scope and ability, we call in an expert.

This book will acquaint you with many modest efforts you can make yourself to keep a house in shape. It's designed as a sensible, starter volume for someone who's never worked on a house before but wants to learn. It tells you what tools you need, and how to work safely. There are no big, complicated repairs here—no major surgery. But you'll find lots of step-by-step instructions, many illustrated, to help you become well acquainted with your house and take a role in its well-being.

How to Use This Book

The Complete Idiot's Guide to Simple Home Repair contains 19 chapters and 3 helpful appendixes. Here's how it's structured:

Part 1, "Getting to Know Your House," is a beginner's guide to equip and prepare yourself for doing home repairs effectively and safely. It tells you everything you need to know about the tools, supplies, and safety equipment that anyone interested in DIY repairs should have. It also provides you with an orientation about your home's systems, and how you can control them.

Part 2, "Skin Deep: Repairing Surfaces and Openings," teaches you some basic repair techniques you'll use for your home's most visible parts. You'll find out how to make dinged and dented walls and ceilings look new, and remove some of the squeaks and bounces in floors and stairs. This section will also help you get your home's simplest moving parts—the windows and doors—moving smoothly.

Part 3, "The Circulatory System: Plumbing and Fixtures," deals with all the places where water runs through your home: kitchens, baths, and the supply lines that deliver this most necessary element to the fixtures you use every day. Tackle emergency repairs and learn the techniques to address minor problems with plumbing fixtures and fittings.

Part 4, "Mission Control: Wiring, Appliances, Heating, and Cooling," covers the systems and conveniences that make your home run like it's the twenty-first century. While your wiring, many appliances, and the heating system in your home may be complex and major repair beyond your beginner's scope and talents, you can learn some simple fixes and do some needed maintenance on your own.

Part 5, "Preventive Maintenance: Safety and Upkeep," teaches you about installing, maintaining, and using the necessary equipment for home safety. It also provides you with a routine to keep up with the maintenance of your house, inside and out, to prevent small problems from becoming larger ones.

To round out your beginner skills, you'll find a Glossary of the specialized vocabulary for house parts, systems, and repair techniques you should know; a chapter-by-chapter list of Online Resources for additional information about specific repairs, tools, materials, and training; and helpful Home Inspection Checklists that you can photocopy and use to keep track of your home's condition—both inside and out—on a regular basis.

Extras

For every repair in the book that requires tools and materials, you'll find a helpful checklist to gather what you need. And in every chapter are little helpful nuggets to further expand your knowledge without flipping back and forth in the book. Watch for them:

def•i•ni•tion

The boxes quickly clarify words and phrases related to house parts and home repair that you may not have encountered before.

Ounce of Prevention

These little "red flags" let you know when you must be extra careful, or when you can take some action to save time or money.

What Pros Know

Experienced DIY-ers and repair people who fix houses for a living know a lot of facts and shortcuts. Get their tips here!

Acknowledgments

For as long as I've been learning about home repair, I've had patient, willing teachers to guide me in learning the empowering secrets of getting hands-on with a house. And I am so appreciative that because of them, I've developed some mechanical know-how that I would otherwise have never possessed.

First there was my dad, who engaged me with the sweet smells of the lumber yard, deep bins of nails, screws, nuts, and bolts, the mysteries of his big metal tool box, and all those gadgets in the basement. He could fix anything; I am still in awe.

I bow to my first carpentry teachers, Patti Garbeck and Lizabeth Moniz, who helped me get past the noise and speed of power tools and tame, if not defeat, the fear factor. They'll both tell you that respect for your tools and what they can do is a good thing.

For learning about my own houses I owe a lot of helpful and talkative (once I got them started) contractors: Steve Sferra, Richard Gates, Bob Warner, Todd Lawson, Curt Haskell, and many others who've let me look over their shoulders.

A great hardware guy or woman is invaluable when you're looking for just the right tool, material, or part for a job. Thanks to Joe di Pietro, Jr., at Chubby's Hardware in Pound Ridge, New York. Whenever I was stumped, he could point the way. I hope everyone who reads this book can find a hardware salesperson as helpful.

On safety issues, thanks to Lorraine Carli, a spokesperson at the National Fire Protection Association, for her help with a most important subject.

For the ways of old doors and doorknobs, I thank Mike at Old House Parts, in Kennebunk, Maine.

For her pictures that saved me thousands of words, I am deeply grateful to my illustrator, Karen Burgess, whose clean and beautiful drawings will surely help any beginning repair person. And to her model, Lisa McCarthy, thanks for demonstrating some intricate repair moves that made the illustrations just right.

I deeply appreciate the editorial assistance that made the book's concept a reality. Mike Sanders at Alpha Books set everything in motion. Warmest thanks are also due to Lynn Northrup, Jan Lynn, and Ross Patty, whose thoughtful suggestions and unflagging attention made the journey through their word processors feel like a spa makeover. I am also grateful for the encouragement of my agent, Bob Diforio, without whom this wonderful project would not have come my way.

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Part 1

Getting to Know Your House

Of course, your house is more than the sum of its many parts: it's your *home*. But even before you start the little jobs that will make it look better or run more smoothly, you need to know some basic information.

First of all, the right tool makes common repairs easier and quicker, and you should acquire a basic assortment. Also, if you're going to do repairs yourself, you need to do them safely. There are a few important rules for keeping you, your family, and your home safe when doing repairs, and they're simple to learn. Next, you need a few basic supplies that you can use for a variety of repairs, as well as a couple of things that will serve you well in small emergencies. And finally, if your house has electric power, a gas supply, and running water, you need to know where the main controls for each system are located, and how to start and stop them.

Even if you were never a Scout as a kid, the organization's motto is a good one: "Be prepared." By the time you finish Part 1, you'll be equipped and ready for lots of the little glitches and mishaps that homeownership is sure to send your way.

"Do we have some kind of water shut-off thingy?"

Chapter 1

Your Personal Tool Kit

In This Chapter

- When it comes to tools, quality counts
- The basic categories of tools
- Must-have tools in your starter set
- The one power tool you'll need for repairs
- How to choose the right tools for you

I've never tried it, but I could probably knit a sweater using two pencils, and coax a nail out of the wall with the tip of a metal ruler. But pencils weren't designed for knitting, and the ruler isn't really a nail-pulling tool. Having the right equipment for a task usually makes the work easier, quicker, and safer.

Home repair and improvement can be broken down into a handful of actions: measuring and marking, cutting, fastening and joining, taking apart (also known as demolition), and applying. A few tools can do more than one thing, but this way of sorting them will help you remember what their primary use is.

If you can, hold a new tool in your hand before you buy it; it should be a comfortable fit, like a good pair of shoes!

Quality Counts

You can buy a cheap set of tools, and they'll probably work fine, at least for a while. Expect to replace the bargains after a couple of years. Often made of lesser-grade metals and plastic, the tips, teeth, and edges of inexpensive tools will show wear sooner, rather than later. When it comes to tools, quality counts … and costs. Most of the well-known brand name manufacturers produce tools at differing quality levels, with professional grade being the best and most expensive of the lot. Good tools will probably last a lifetime, and you can leave best-quality equipment to your grandchildren!

Sets of multiple sizes of screwdrivers, wrenches, and the like will be cheaper than buying each item singly. However, unless you're planning to repair your whole house yourself, unassisted by friends or hired hands who have their own tools, don't go overboard. Buy the best equipment you can afford and, except for the most basic tools, buy them as you need them.

If cash is tight, and you're *really* good about returning things you borrow, neighbors and friends might loan you their equipment. Take good care of borrowed tools, and return them *promptly*. Most folks I know are very possessive of their toolbox, and want things returned in the same condition as when they were loaned. If your borrowing etiquette is poor, most lenders won't give you a second chance!

Measure Up: Rule(r)s of the Road

A sturdy 20- or 25-foot retractable *measuring tape* is indispensable for all kinds of jobs around the house. Some people opt for the lighter-weight, 12-foot model, but eventually realize that the longer one is more versatile.

These come in plastic or metal cases, and the best have a stop lever so that you can extend and hold the tape in its extended position, without holding on to the case. This is a particularly good feature when you're marking the distance of long runs around a room.

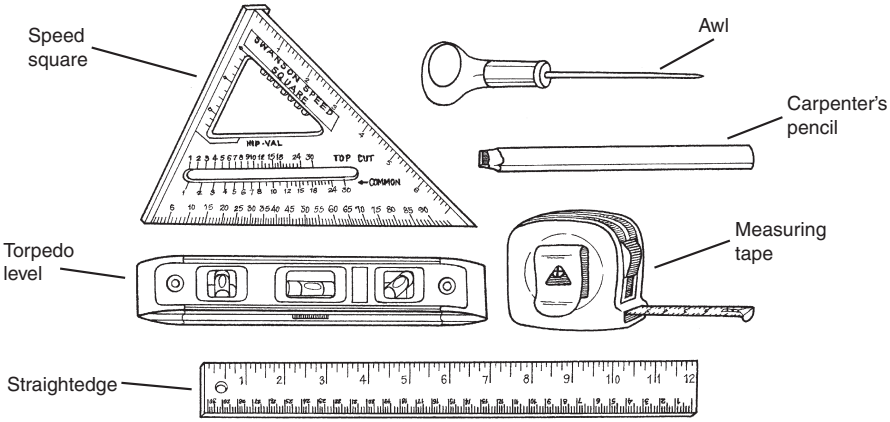
About those little tick marks along the tape: carpenters can tell at a glance whether a mark indicates $7^3/_8$ inches or $7^5/_8$. If you're not so good at fractions, get a tape with a fractional read. This measure has the intervals—eighths, quarters, and halves of inches—marked clearly with the appropriate fraction, so you don't need to guess.

Better-quality tapes also have a clasp that makes it easy to attach the case to your belt while working, so you don't have to constantly hunt for it.

A metal ruler—also known as a *straightedge*—is another handy device for measuring. It serves as a ruler and as a rigid guide for a utility knife or glass cutter when you want to score a surface. An 18" straightedge is a good size for lots of jobs. Straightedges are also available in plastic; metal is slightly more expensive but much more durable.

A *speed square* has a lot of uses in carpentry, allowing you to mark angles, then draw guidelines. One of the straight sides of this triangular device has a lip, which can fit along the edge of a piece of material (a 2×4 piece of framing lumber, for example) letting its other straight side serve as a guide for marking/cutting a piece of wood or other material at a perfectly perpendicular angle (90 degrees). Speed squares are made in metal and plastic; I like the heft and feel of the metal variety.

Unless you're planning to do lots of carpentry, you don't need a big, fancy, and expensive carpenter's level. Instead, opt for a small *torpedo level*, so called because of its shape, to check whether shelves, rods, curtain poles, doors, and other household objects are hanging straight horizontally (level) or vertically (plumb). The torpedo level is one type of spirit level, so called because the measuring device employs a vial filled with liquid, usually ethanol—the "spirit"—containing an air bubble that falls between guidelines when the instrument rests plumb or level.



Measuring and marking tools.

Ounce of Prevention

Though its name sounds like a guided weapon, a torpedo level is easily damaged. If you drop it, it may no longer read true. So handle it with care!

Make Your Mark

An *awl* is a tool with a handle attached to a slim metal shaft with a pointed tip; it looks like a miniature ice pick. It can punch a hole in a piece of leather or a strip of wood, but for our purposes, it's a great way to scratch-mark the location for a new screw or nail on a wall or other surface.

An awl is one of those tools you can pick up for a quarter at a tag sale. Some older models have nice wooden handles. Just make sure that the shaft is firmly attached to the handle, or the tool is useless.

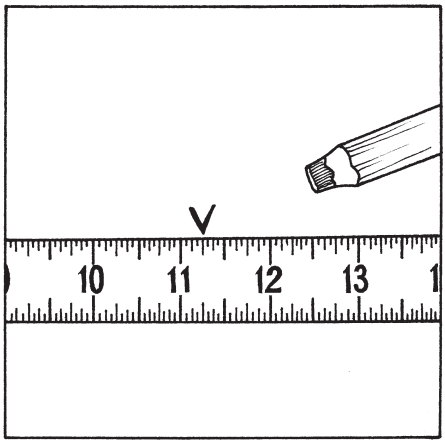
If you like to stash your pencil behind your ear, any sharpened #2 pencil is a good marker for your measurements and guidelines. A lot of pros think the garden-variety yellow pencil is just fine, too, but some like the *carpenter's pencil*, which can be sharpened with a utility knife and won't roll away. It looks like a regular pencil flattened by a steamroller! One disadvantage is that the carpenter model does not have an eraser attached; carpenters may not need erasers when they make marks, but sometimes newbie DIY-ers (do-it-yourselfers) do!

Sometimes using a pencil line as the guide for installing a fastener or making a cut leaves a mark that's wiggly, and leaves you scratching your head about the right location. Or, you used a dull pencil and the line is too thick to be precise. Instead, mark the right spot with a V. Put the point of the V at the spot you measured (see next figure). Then your nail or cut will be true to your intentions.

There's an old saying—a carpenter's old saw, to be precise—that goes, "Measure twice, cut once." This alludes to the importance of making good measurements, then checking them before you pick up your other tools.

When I first learned to use a circular saw, I measured twice, then turned on this most awe-inspiring power tool and made my cut. The cut was perfect, but my measurement was not; my piece was off by a quarter inch! I had to put my beautiful 2×4 in the "use later" pile for another part of the cabin I was working on.

Scrap you don't use becomes expensive trash. Until I mastered measuring, I always measured *three times*, or until I got the same measurement twice in a row. DIY 101-ers, take heed!



V-mark measurement.

The Cutting Edge: Sharp Helpers

You need just a few sharp tools for most of the cutting you'll do for basic improvements and repairs.

I don't know about your house, but in mine, *scissors* tend to migrate, like all those socks that disappear in the dryer, never to be seen again. To remind yourself to return them to your toolbox when you've "borrowed" them for another purpose, take a piece of masking tape and label your toolbox scissors ("Mom's toolbox," or "Dad's toolbox," or "My toolbox") so they aren't MIA when you need them. Sturdy scissors with 5" blades should handle most cutting tasks nicely.

There are so many uses for a *utility knif*e around the house that a list of them could practically fill this book. Although you can pick up a plastic, pencil-sized, 99-cent model at most hardware checkout counters, invest in the standard, palm-filling metal model. It fits comfortably in your hand, and you can adjust and retract the blade with a simple lever. Plus, it uses disposable blades that can be stored inside the handle. It costs a couple of bucks and will last a lifetime.

Ounce of Prevention

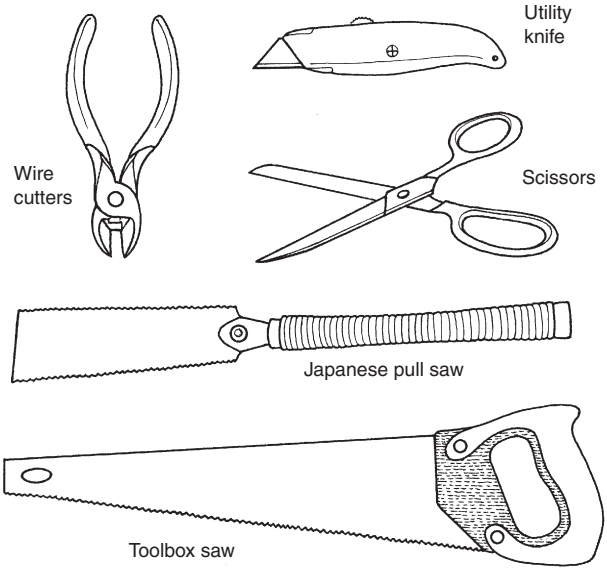
The blade of a utility knife is very sharp. Always keep the business end retracted when you're not using the knife.

Wire cutters do what they say. In a pinch, you can repeatedly twist a wire until it breaks from all the abuse, but a wire cutter does the job in a single snip!

When you're learning repair and DIY skills, the most versatile hand saw for cutting wood is called, simply, a *toolbox saw*; it has a fairly short blade (about 15 inches or so), and is easy to use. Look for a model that can be re-sharpened, as all saws will lose their edge over time. The toolbox saw is good for making short cuts; remember only to apply pressure on your downstroke (push).

Although it may look scary, it works great. I'd never seen a *Japanese pull saw* before I took a course in carpentry for women a few years ago. The one pictured is a double-edged saw; one side has coarse rip teeth for cutting wood with the grain, and the other side has more closely spaced cross-cut teeth, for (did you guess?) cutting across the grain. It looks like a most imposing spatula, and unlike the American toolbox saw, it cuts on the pull stroke—a much easier and more elegant way to saw, to my way of thinking. And when the saw gets dull, you can buy a replacement blade.

Cutting tools.



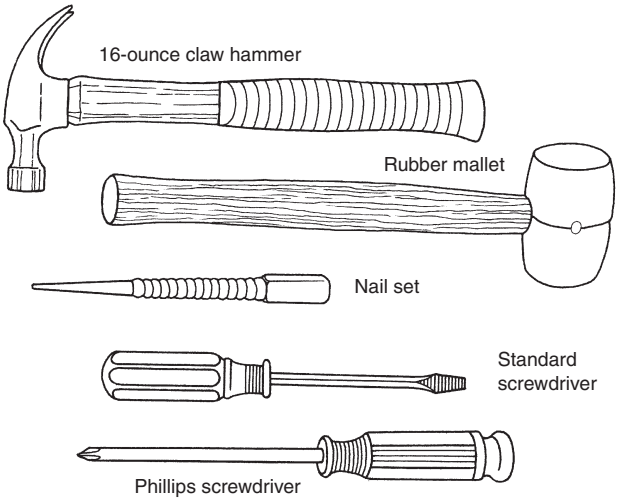
What Pros Know

The first time I used a toolbox saw, I started hacking away, using pressure while I pushed down and pressure when I pulled back. Being a more sensitive creature than you'd think, the saw bucked and whined, and later, my husband accused me of dulling the blade. He was right! Saws cut one way; most American saws will cut on the push—the downstroke; Japanese saws will cut on the pull movement. I never noticed this little wrinkle when I was growing up, watching my Dad do stuff around the house. But now I know. If you get a chance to try before you buy, you can decide which type of saw you prefer.

Putting It Together: Tools for Fastening and Joining

Nail meets wall, screw meets joist. Putting things together is a major part of home repair and improvement. Having a good selection of tools to make this togetherness happen is an important facet of homeownership. Because, as you will discover, things meant to be together will sometimes fall apart!

Fastening/joining tools.



Basic Tools

A hammer is such a basic piece of equipment that it should be anyone's going-away present when leaving the comfort of Mom and Dad's house, where things so magically stayed together. A *16-ounce claw hammer*, with a curved claw for pulling out nailing mistakes, is a good basic size and style. You can tell the difference between this one and the larger framing hammer (for putting up walls and other work requiring nailing above one's head, or at funny angles), because the framing hammer has a longer handle.

There is usually such an array of hammers at the home center or hardware store that you may have trouble choosing. Pick what feels good in your hand. Don't choke up on the hammer handle, but use the handle as an extension of your arm. If the 16-ounce model feels too heavy, drop down to a 12-ounce. But don't go for a cheap, wimpy, 7-ounce hammer (these are sometimes part of an equally cheap set of fastening/joining tools). This mini is good for tacks but not much else.

Sometimes you need to drive in a nail but don't want to damage the surrounding area, so the metal head of your claw hammer won't do. An inexpensive *rubber mallet* gets the job done.

Another tool that lets you drive a nail below a surface (called countersinking) while leaving the surrounding area undisturbed is a *nail set*. Often sold in sets of three or more standard sizes to match different nail heads, you can position the nail set over the nail head to drive your nail smoothly "underground."

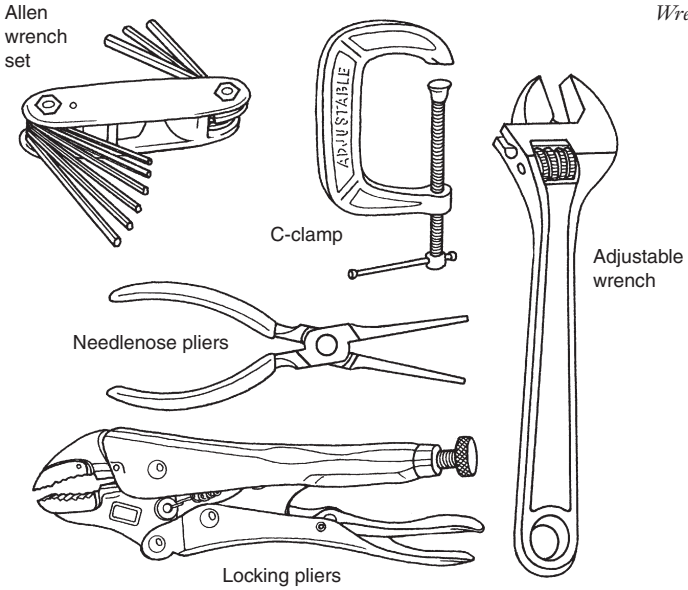
A good selection of screwdrivers belongs in every tool kit. Composed of a shank with a flat tip that looks like a minus sign (-), called a *standard* screwdriver, or a tip that looks like a plus sign (+) called a *Phillips* screwdriver, with a handle of wood, metal, or some type of hardened plastic, screwdrivers are available in a number of point sizes. Shanks also come in a number of different lengths: long shanks let you reach into tight spaces; short, stubby shanks give you more turning power.

What Pros Know

Always use the right size driver for the fastener you are driving. Use the Phillips screwdriver for Phillips head screws (more prevalent than single-slot screws today). Use the standard driver for slotted screws. Too-big or too-small driver points can damage or deform the fastener. And don't forget this helpful saying: "Righty, tighty; lefty, loosey." Translation: tighten by turning to the right (clockwise); loosen by turning to the left (counterclockwise). It works for screws, nuts, light bulbs. Any threaded object turns on the same principle.

Specialized Tools

A good hammer and half a dozen screwdrivers will suffice for probably 75 percent of the joining and fastening tasks in your home. But other fastening tools, for grasping and turning specialized fasteners, and holding the work while you do the job, are great to have on hand.



Wrenches, pliers, and clamps.

Nuts, big bolts, pipes, hard-to-reach wires—sooner or later, you'll have a job that requires more specialized gear to help you grab hold of an irregularly sized piece of something, keep it steady, turn it, move it, or attach it to something else.

Sometimes, door latches, light fixtures, or other house hardware is joined with fasteners that require a hexagonal tool, called an *Allen (or hex) wrench* to attach or detach a part. Allen wrenches are sold in sets, sometimes conveniently encased in a penknife-like sheath. This is a good way to buy them, since the wrenches are comparatively small and easy to lose. Simply extend the right size wrench, leaving the others tucked away in the sheath.

An *adjustable wrench* is a great way to get hold of a nut so that you can loosen and remove it from its bolt. The jaws of the wrench hold tight to the nut with a few turns of the little adjusting gear. While you can buy a set of wrenches that fit perfectly around each size nut, often the size you need will be missing from the set. (This has happened to me more than once at crucial moments such as—gulp!—Christmas Eve, with something complicated that needs assembly.) An adjustable model is inexpensive and versatile.

If you're all thumbs, *needlenose pliers* are perfect for "grab and twist" workouts with wires of all types—phone, electrical, audio. They look just like their name sounds. If you're working with electric wires, choose a model with insulated handles, one of the many safeguards against shocks you'll learn about as you read this book.

Locking pliers are another handy tool; the most famous variety is the Vise-Grip brand, invented by a smart Danish-American from Nebraska named William Peterson. He wanted a tool that worked like pliers and could grip metal parts in his blacksmith shop "like a vise." They still do, and several manufacturers have variations on this tool, which has a lever that locks the jaws of the pliers in place. They work like a third hand for many jobs.

When you have to glue things together and hold them tightly in place until the adhesive dries, *C-clamps* will do the job. There are a variety of other, more expensive clamping devices, and you can explore the shelves of the hardware or woodworking shop when the time comes to expand your collection.

Ounce of Prevention

If you want to protect the surfaces you're clamping together, insert little pieces of wood or cardboard, also known as shims, between the clamp jaws and the work piece, so the clamps don't leave a mark.

Demolition Derby: Tools That Take Things Apart

The pros call it "demo," and they usually enjoy this part of home improvement: you see the results of your work nearly instantly. Some of you may think this sounds like your kind of fun. But before you start tearing up that 70s shag carpet in the den, remember that you'll have to figure out what to do with what lies beneath the fuzzy, matted mess. And it might not be pretty. So before you tear anything apart, think: can I live with the result for a while?

Sometimes you get lucky. In one room of our family's Maine house, armed with utility knives and small pry bars to remove the furring strips, my niece and I tore out an old, worn red carpet that was driving me crazy. It was a messy job, but we found a wax-and-buff-ready maple floor beneath.

We were not so lucky in the kitchen. Beneath the multicolor indoor/outdoor carpet was a glued-down layer of carpet padding. Beneath that was a layer of brown linoleum with yellow, red, and green spots. And beneath that was a layer of fifty-year-old gooey black adhesive. Having made this discovery in an inconspicuous corner of the kitchen, I knew my limits, and called in the pros. But it was several months before they could schedule the work and reveal the golden planks of the original maple floor.

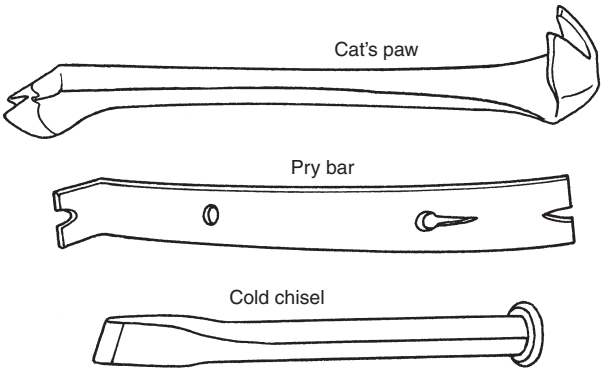
So be careful about using your demolition tools!

Pry bars come in many different sizes; keep one that's about 8"–10" long in your tool kit. It can neatly squeeze under old tile, flooring, or carpet furring strips, and its lever action plus your muscles make quick work of many demo jobs. (One company even calls its model the "Wonder Bar," a great name for this handy tool.)

I've always been a cat person, but never heard of the handy *cat's paw* until I went to carpentry class. Like its larger cousin the crowbar, this sturdy tool is a fairly heavy (for its size) round or hexagonal bar of steel. It curves at one end to form a cup-shaped tip with a V-slot that can grip around a nail head. Hammer just above the back of the V-slotted tip, working the slot around the nail head. When the nail head is seated in the slot, rock back the cat's paw and the nail glides out (finish it off with your hammer claw). It's a beautiful piece of equipment for removing nails when you don't care how the surrounding wood looks afterwards (you can lessen the damage by sliding a shim under the "heel" of the V-slotted paw as you work out the nail). You may not need this tool right away, but when you get to taking out old work with lots of nails, this will come in handy.

A *cold chisel* is another one of those old tools that show up at tag sales on the cheap. It gets its name from the fact that this tempered steel cutter is used for cutting "cold" metals, and not used in conjunction with heat, as in torches or forges. Paired with a hammer to drive its point, it's a good tool for removing cemented tile. Just remember that when you're cutting into hard materials, these can chip and fly. Always wear safety goggles and other protective gear; see Chapter 2 for the particulars.

Demolition tools.



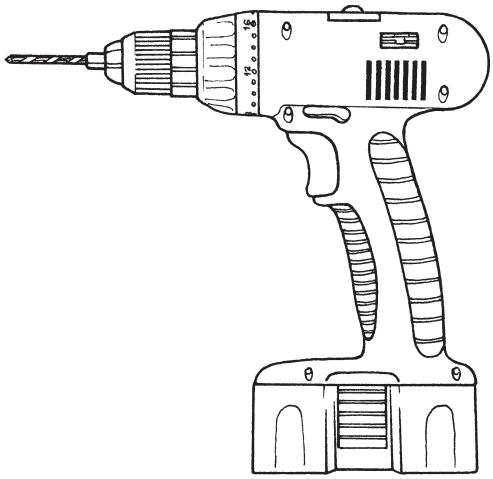
The One Tool You Can't Live Without

For the repairs in this book, you'll need just one basic power tool: an *electric drill*. Corded models have been around for years, but battery-powered drills are so improved that they are worth more than a second look. You won't have to plug into a socket with the cordless variety, so it's much more versatile. For optimum use time, buy one with a charger and two batteries (one to use, one spare to keep charged when you're doing a lot of drilling and don't want to lose power at a crucial moment).

A visit to the power tool department of your hardware or home center can be a heady experience: so many drills, lots of different prices. When considering which to buy, think about what you need.

What Pros Know

Don't forget the feel-good factor! Get a drill with the features you want, but also make sure it feels comfortable in your hands and doesn't weigh you down. If it doesn't feel right, you've wasted your good money.



Cordless electric drill.

Power

Most DIY (not pro-grade) corded models quote power in the range of 500 to 1,000 watts. The higher-wattage models will have sturdier parts and be able to take more abuse.

Same with cordless; 9.6-volt batteries don't pack the power of a 12V- or 18V-powered cordless drill. If you are going to use the drill a lot, or want it to last, opt for the most power you can handle (the higher voltage battery packs and sturdier parts increase the weight of the tool).

There are different types of batteries for cordless drills; the most common are Nickel Metal Hydride (Ni-Mh) and Nickel Cadmium (Ni-Cd, or "ni-cad").

Speed

Single-speed drills lack versatility. If you're using large bits for big holes, the bit needs to turn more slowly or you'll wear out the bit quickly. A step-up option is a drill with two fixed speeds—there's usually a manual switch that makes this adjustment.

A variable speed control offers an infinite number of speeds up to an indicated (read the package) limit. You control the speed by a trigger, and some drills have adjustable trigger stops so you don't accidentally put the tool in overdrive when high speed is not needed.

Keyless Chuck

In the old days, bits were inserted into the business end of the drill by opening and closing the *chuck* (which holds the shaft of the bit) with a key. After a bunch of years, manufacturers realized that people always lost the key, so drills with a keyless chuck are pretty standard these days. Lots of pros love them; my dad had one, but I haven't seen a keyed chuck drill in years! $^3/_8$" is the most common chuck size, and right for the work in this book.

Screwdriving

For your drill to work like a screwdriver, it needs three attributes: variable speed, a reverse drive, and a torque control that shuts off the drill when a certain turning force is reached. You know the drill has this last feature if there's a numbered dial (up to 16 positions). Torque control prevents you from driving the screw too deeply or too tightly.

Helpful Bits About Drilling

If you've never used an electric drill before, know that it's destined to make many home repairs simpler than you can imagine. Here are a few tips for using it safely and well:

What Pros Know

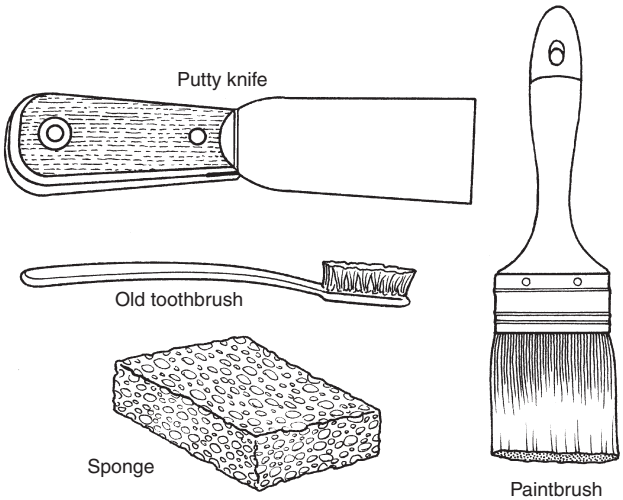
If you're driving a bunch of screws, find the right turning force for the job by testing your setting and screw on a scrap piece (wood or drywall). Oh, and one more thing: to use the drill like a screwdriver you'll need screwdriver bits!

- Always wear safety goggles when you drill. That stuff you're drilling has to go somewhere, and you don't want that somewhere to be your eyes.
- Use the highest speeds for jobs that use the small bits, and slower speeds for big bits.
- Indent your drill-in point with a nail or the tip of a nail or screw. This will prevent the drill from sliding off the mark.
- Leave the motor running when you're removing the bit from your work. If the drill ever gets stuck in the work, turn off the drill and then restart it in reverse.

Put It There! Applying the Right Stuff

Lots of repairs use patching compounds, adhesives, and other stuff best applied (or smoothed) with a tool. These are almost self-explanatory:

- *Putty knives* come in a variety of widths; they're great for applying all kinds of goop for various repair chores. They're also quite useful for scraping, lifting, and prying in certain circumstances. A narrow one (2") and a broader one (4–6") are a good basic pair to own. Better models have metal ends on the handles that will take the force of a hammer (when you're trying to open a stuck window, for example) without breaking the handle.
- A 2" nylon-bristle *paintbrush* and a clean *old toothbrush* can be used to brush away dust or other particles, and also to apply various liquids.
- A household *sponge* is good for cleanups, but it's also good as an applicator for certain liquids. Keep a clean one handy.



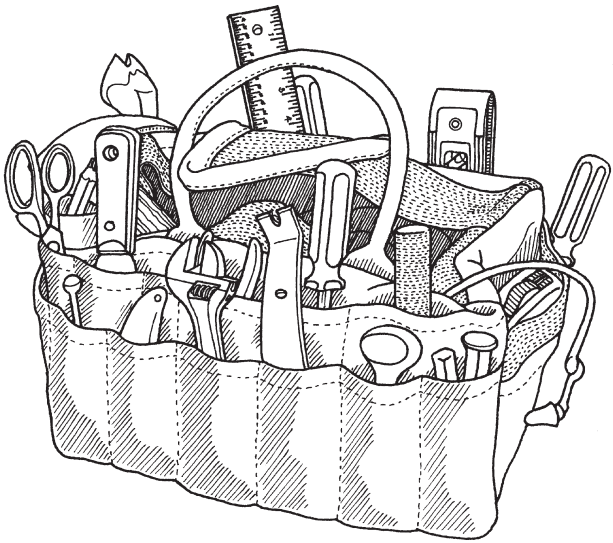
Applicators.

Hold It! Transporting Your Tools

Box, bag, or bucket? When you're assembling tools to do a repair job, it's good to have a container that holds everything you need. I like my canvas rigger's bag. It holds a ton of tools, was inexpensive, and is incredibly sturdy. However, you can get a tool

bucket, which is an ordinary bucket equipped with a canvas tool holder that makes an incredibly roomy tool caddy. Or opt for a conventional toolbox. Go for sturdy, go for capacity, and choose a container that has enough slots for those tools you want to keep handy, or those you want to protect from other tools banging against them.

Tool bag.

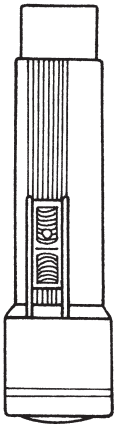


Tool belts are another personal choice. I like the simple canvas apron that costs a couple of dollars. It has a few sturdy pockets to held the fasteners I'm using and a small tool or two. I use the tool bag to carry the rest of the stuff. Too many tools around my waist weigh me down.

Some people opt for the heavy belt with leather or canvas pockets and a nice loop in which to slide the handle of your hammer. My husband bought me one of these when I went off to carpentry class. I use it sometimes, but the hammer kept hitting me in the thigh and gave me a bruise after a week of building. I did notice, however, that my carpentry teacher had a solution for this: she maneuvered the belt so the hammer hung over her backside, and whenever she needed it, she'd just reach back and pull it out. What's that old saying? Each to his/her own!

I Can See Clearly Now

No set of tools is complete without a working flashlight. Because so much repair goes on in basements, attics, and other dimly-lit recesses of the house, buy one that fits in your tool bag, make sure it lights, and stick an extra set of batteries for it in the bag for good measure!



Flashlight.

Your Work Space

Most of the repairs in this book are done on-site, where the damage has occurred. But once in a while you'll need to cut or saw something, and will need a flat, durable surface on which to place and maneuver your work.

If you're reading this book, you probably don't have a big, fancy workbench with a *vise* to hold things. The good news is: there are many fairly inexpensive substitutes for this handyman's standby.

If you're old enough to remember the film *The Graduate*, when actor Dustin Hoffman was a young man, there's a memorable scene when an old guy gives our hero a word to live by: *plastics*.

def•i•ni•tion

A **vise** is a tool with two jaws, closed by a screw or a lever to hold objects immobile.

If you've got very little space to set up a workbench, a couple of companies now make very sturdy, hardened plastic, portable workbenches that fold into a couple of inches

of space in a small closet, and give you a place to set and clamp your work. This is a worthy investment.

And if you're a purist, a sheet of plywood clamped to a pair of sawhorses (you can buy a sturdy, folding, portable pair for less than forty bucks) will serve you well for most jobs, and also fits into a small space for storage.

The key here is sturdy, stable, and clamp-able. A work surface should support your work and keep it steady, and you should be able to hold your work piece in place with a clamp.

When you graduate from DIY 101, you can move on up to one of those big hardwood workbenches that sell for a couple of hundred bucks at specialty woodworking shops. But you won't need it right now.

Ounce of Prevention

Never work with a saw or other cutting device without clamping the work piece to the work surface. 'Nuf said.

The Least You Need to Know

- Cheap tools don't last long; get the basics, but get the best you can afford.
- Tools can be categorized by their functions: measuring and marking, cutting, fastening and joining, demolition, and application.
- An electric drill should be your first power tool; look for features you'll really use, and a model that feels good in your hands.
- You need a stable, sturdy surface for some DIY work where you can clamp a piece that needs cutting or sawing.
- There are portable options that are easy to store if your working space is limited.

Chapter 2

Your Most Important Tool: The Safety Drill

In This Chapter

- Seven habits of intact DIY-ers
- What gear you'll need to stay safe when working on your house
- Ladder safety, top to bottom
- How to set your own limits, and hire a pro when you need one

Okay, so you just bought a house, and a slew of new tools, and you're ready to fix everything that seems to be ailing your new digs.

Not so fast. You've got one more little investment to make, and that's the insurance you provide for your own personal safety. I'm not talking about your homeowner's policy, but the commonsense rules you follow when you work on your house.

A few years ago, I wanted to expand my DIY know-how and signed up for a course in carpentry. I was eager to learn, and couldn't wait to get my hands on some of the terrific tools that make renovation and improvement easier to do myself. Before the course ever started, the school sent me a list of safety equipment to bring and use. And when my classmates and I arrived,

our teachers sat us down for a discussion of self-protection and good work habits. Their guidance was invaluable to my class, and to any beginner do-it-yourselfer who wants to stay safe.

I've used the equipment I brought, and the rules I learned, ever since. Except for a couple of minor scrapes and bruises, the knowledge has served me well. I'll share it here.

Good Safety Habits

Basically, there are seven things to keep in mind when you work on your home. Think of them as the seven habits of intact DIY-ers:

1. **Choose the right wardrobe.** When you work with tools, don't wear anything that can get tangled up in your work. Leave off the bracelets, earrings, and anything that dangles. If you have long hair, tie it back or wear it up, or under a cap or bandanna.

   Wear comfortable work clothes. If you are working with something dusty, or something that makes debris, cover up!

   Sturdy shoes that cover your feet, with non-slip soles, will help prevent injury. Never wear sandals or flip-flops; they're an invitation to hazards like splinters and dropped tools—ow!

Ounce of Prevention

Sturdy shoes are good, but steel- or titanium-toed work boots are better. Spring for a pair and you won't have to worry about broken toes. These industrial-strength boots are available in men's and women's sizes. My friend Siobhan, who installed all the siding on her 4,000-square-foot house, put pink shoe laces in her steel-toed footwear for a feminine touch! She keeps the ends of the laces tucked in to prevent tripping.

2. **Make sure your tools are clean and in good repair.** Inspect the cords of power tools and extension cords for signs of wear. Never work with damaged equipment.
3. **Wear your safety gear.** The goggles and earplugs will do nothing to protect your eyes and your hearing if you leave them in your bag. Carry and use your safety equipment, every time!
4. **Check your attitude.** Don't tackle a job if you're feeling tired, rushed, or upset. You're setting yourself up to lose focus, and that's when accidents happen.
5. **Take a break every couple of hours.** If you need a breather, hang out with your family, kids, or pets away from the worksite. Chit-chat can be distracting while you're working on something, so save the socializing for your timeout.

6. **Keep your worksite organized and clean.** Protect nonwork areas from debris with drop cloths and/or newspaper. Carefully follow the directions for any chemicals or compounds you are using; if they say "make sure the area is well-ventilated," open the windows!
7. **When you need one, ask a friend to help.** If you're working on a ladder that needs holding, or just need an extra pair of hands, make sure you've got the assistance you need.

Lastly, trust your gut! If a little voice inside your head says, "Maybe this job is just too much for me," listen. Better to pay a pro than the bill from the E.R.

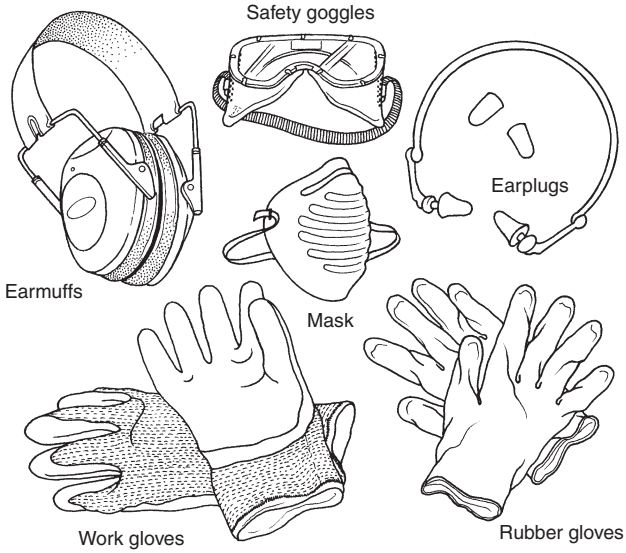
Safety Gear: The Basics

Here's a rhyming couplet to remember:

Eyes, ears, nose,

Fingers and toes!

When you finish a repair job, you want to keep all those parts I've just mentioned!



Safety gear: don't start a job without it!

Good *safety goggles* are not designed for high fashion, but to protect your eyes and their socket area from injury. They are usually made of high-quality plastic and won't shatter when hit; they'll also protect eyes from spilled or airborne liquids. Make sure the pair you use gives good coverage. Some styles use conventional earpieces, just like eyeglasses or sunglasses; others are secured by elastic. Just make sure the pair you select fits, and stays on when you're looking up, down, and side-to-side.

What Pros Know

At a certain age, most people need glasses to magnify close work, such as reading fine print, attaching/detaching jewelry clasps, and discerning the details of a home repair. Instead of wearing your reading glasses under goggles, which can feel uncomfortable and appear awkward, look for a pair of safety goggles equipped with magnifying lenses; these make the goggles look like bifocals. These specialized glasses are made by at least one major manufacturer of work safety equipment, in varying strengths (1.5, 2.0, 2.5, and so forth). If you can't find them in your local hardware/home center, check Appendix B for a source.

Hearing loss is a progressive ailment; it results from long-term exposure to high levels of noise. Foam *earplugs* or safety *earmuffs* should be used in noisy work environments—when power tools or other loud equipment is in use. It isn't necessary, but I also like to wear my safety earmuffs when I'm using any equipment that makes noise I don't like—the vacuum cleaner, for instance. Even though I haven't seen any evidence that proves vacuum noise can hurt your hearing long-term, it makes the experience more pleasant for me!

Wearing a *mask*, also called a respirator, to avoid inhaling dust or chemical-laden fumes is always a good idea. In order to get the right mask, you need to read the manufacturer's label. Depending on the products you are working with, you will need differing amounts of protection. Masks are labeled for the kinds of dust and fumes they filter.

There are several different types of disposable masks, which are the economical choice unless you are working repeatedly with materials that produce particles or fumes you don't want to breathe. If you're doing a lot of work that requires protecting your lungs, then it might be more budget-wise to buy a reusable respirator, which has replaceable filters, rather than a large quantity of disposable masks.

A pair of sturdy *work gloves* in a heavyweight fabric—canvas, leather, or one of the rugged new synthetic fabrics—will protect your hands when you're carrying materials that could splinter or irritate your hands in some other way. Unless you lose them, a good pair can last a lifetime. *Rubber gloves* will protect your hands from prolonged exposure to liquid, and a tight-fitting pair of surgical-style latex gloves can protect your skin from irritants often found in certain paints, adhesives, and other repair compounds. (If you're allergic to latex, use a different type of tight-fitting glove to protect your hands.)

As discussed in the previous section, wear appropriate, sturdy footwear to protect your toes!

Ounce of Prevention

Not all safety masks are created equal. The National Institute for Occupational Safety and Health (NIOSH) sets standards for workplace safety equipment. When a product is labeled "NIOSH approved," it means that the mask meets certain workplace standards for the process and/or material (painting, drywall, fiberglass) indicated.

The Job Site

If you can set up, work, and finish your repair in a day, the seven habits of intact DIYers should be enough rules to keep you safe.

For projects of longer duration, remember the following:

- Train your kids, your pets, your elders—anyone who's not working with you—to keep away from a work site unless they're invited to observe. You can show them what you're up to when you're on a break.
- Repair materials and tools should be safely stored away whenever you finish for the day. If toxic materials like paint and solvents or power tools are being used, keep them out of reach of children or pets, even when you just step away for a couple of minutes.
- Drop cloths and spread-out newspaper can be slippery for other members of your household who are not dressed for the work; pick them up and sweep at the end of a repair session. Replace the protective coverings when you start the next day (or the next weekend).

This may seem logical to most readers, but sometimes an extra step for safety—securing tools and materials *just in case* a child or pet may get curious, or carefully

picking up *just in case* someone's not paying attention—seems like too much work to others. Making a mistake that someone you love might have to pay for is just too high a price.

Be safe, not sorry.

The Ups and Downs of Ladder Safety

When you have jobs in tall places, a ladder is a terrific help. But be careful! According to the American Academy of Orthopedic Surgeons (AAOS), more than half a million people wind up in emergency rooms every year because of mishaps with ladders. Don't become another statistic. Follow these tips to stay safe.

Choosing a Ladder

Safety begins when you choose your ladder. Most people start with a stepladder that's good for indoor jobs, and some outdoor work as well.

- **Materials:** Wood is traditional, but subject to rot and weathering. Aluminum is lightweight, but metal is not good for working around electricity. Fiberglass is the current preference of professionals; it is versatile, lightweight, and sturdy, but more expensive than either wood or aluminum.
- **Height:** If you have standard, 8-foot ceilings, a 5-foot stepladder will probably be fine for any indoor task, and a lot of outdoor work, too. For stepladders, the ladder's height plus 4 feet equals the height limit you can achieve.
- **Strength:** Ladders have a duty rating—the amount of weight they can carry—established by the American National Safety Institute. Type 1A extra heavy duty carries up to 300 pounds; Type I heavy duty will carry 250 pounds; Type II medium duty 225 pounds; and Type III light duty 200 pounds. Err on the side of a heavier rated model when you're in doubt as to which model to choose.

Ounce of Prevention

When you buy a stepladder, there will usually be a sticker on the pail shelf that says "This is not a step," and one on the step below the top of the ladder that says "Do not stand above this step." Take these cautions seriously. If you need to climb higher, you'll need a taller ladder.

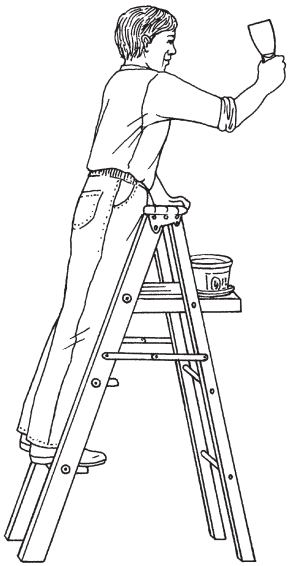
Using a Ladder

Safe ladder use means taking a few steps in the right direction:

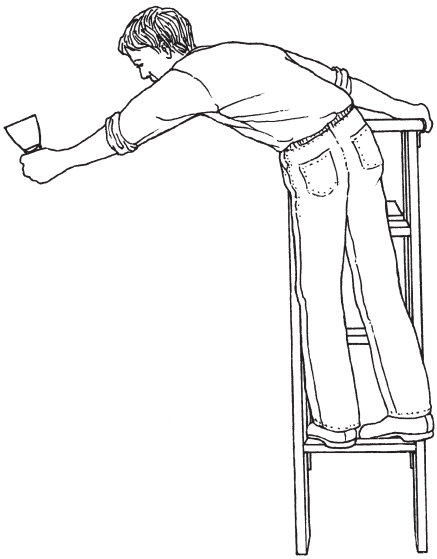
- Don't wear leather soles; they're slippery. And tie your shoelaces securely. Likewise, don't wear baggy pants or loose clothing that could catch on the sides of a ladder or nearby obstructions.
- Inspect your ladder before you use it. Check it for any loose screws, hinges, or rungs. Clean off any dirt, grease, or dried spills. If the ladder has defects that can't be fixed, replace it.
- Place the ladder on a firm, level surface. Don't place a ladder on uneven ground, or prop up with bricks or other small items under the legs.
- Climb or descend with your hands on the side rails, not on the treads.
- Never position a ladder in front of a door that opens in the direction of the ladder unless the door is locked, blocked, or guarded on the other side. If you're working while other household members are moving around, put some tape and a sign across the door frame on the inside so they don't accidentally open it and topple you!
- Don't stretch—move the ladder instead. Reaching or leaning too far to either side of the ladder can make you lose your balance and fall. The AAOS has a good guideline: your bellybutton should not go beyond the sides of the ladder!
- Move things with caution; if you're cleaning out closet or garage shelves, always keep the load in your arm small enough that it doesn't throw you off balance. Push and pull things carefully.
- Get help if you need it. If you feel the least bit wobbly, have someone hold the ladder. And two people should never be *on* the ladder at the same time.

When you're outside, you may need to use an extension ladder if you have tall gutters or need to reach an outside light to replace it. Learn additional rules of using long ladders in Chapter 19.

Keep your body centered on the ladder.



Don't lean far outside the rails of the ladder. It's easy to lose your balance in this position.



Knowing Your Limits: When to Call a Pro

Some people like to try everything; others know what they're good at, and only occasionally stray into unfamiliar territory. Only you know your own degree of risk tolerance for DIY tasks. You may really like working on walls and floors—all those nice, solid things—but go queasy at the idea of clearing the gunk-clogged trap under the kitchen sink.

It's best to start your DIY career with those jobs that you feel comfortable and safe doing. As you build your confidence, you can tackle more things.

Here are three questions to ask yourself before you try doing a new kind of repair:

- Do I have the time?
- Do I have the tools—or can I get them easily?
- Do I have the skill?

The tasks in this book are not large ones; they require only small amounts of labor, tools, and know-how. This is, after all, a guide to *simple* home repairs. But if any jobs in this book make you hesitate for more than a few minutes after reading the instructions, or if you have to answer "no" to any of the three questions listed above, then you're probably right to call in the pro.

And should you call the handyman, the plumber, or the electrician, watch him or her do the job. You may learn something you'll be able to do yourself—next time.

The Least You Need to Know

- Eyes, ears, nose, fingers, and toes all need protection when you work.
- Tackle repairs when you're rested and calm; working when you're tired or stressed invites accidents.
- When on a ladder, stay centered; when you need to lean out to reach what you're after, it's time to move the ladder.
- Know thyself! Make your first home repairs the ones you feel most comfortable with. Success begets confidence.

Chapter 3

Your Supply Closet

In This Chapter

- Where to store your tools and supplies for home repairs
- Which supplies solve different repair dilemmas
- The subtle differences between fasteners
- The importance of leftovers (the home repair kind)

There are a couple of rules about household repair problems and the supplies that fix them:

1. Repair emergencies usually happen at night, or on weekends and holidays when it's hard to find someone to help you.
2. A few inexpensive supplies can save a lot of money and grief.

If you can impress upon yourself that bad stuff will happen to your house at the worst possible times, you will not be stuck, as I was, trying to stop a leaky pipe with my finger while being told by my plumber's answering service that he wouldn't be back for a week. I had an infant and a 3-year-old, and had to shut off the water to the whole house while the kids and I drove to the home center at 9 P.M. for emergency repair supplies. Of course, my husband was out of town!

DIY Depot: Storing Your Repair Stuff

All the tools and materials in the world are worthless if you can't put your hands on the right item when you need it.

Lots of handy gentlemen and ladies dedicate a corner of their spotless garage to a workbench and storage area, but maybe you're not lucky enough to have such a clean corner, or even a garage.

A closet shelf, a cleared cabinet—any place you can get to easily, but also close off and make child- and pet-proof, if these wonderful creatures share your home with you, is fine for storage.

Ounce of Prevention

You do not want your children playing with grown-up tools, tampering with sharp objects like nails and screws, or investigating the contents of bottles of adhesives or cans of lubricants. Whatever place you choose for your repair tools and supplies, make sure it's out of the reach of children and pets. If not, secure the door of your supply storage area with a keyed or combination lock.

The Supply Side

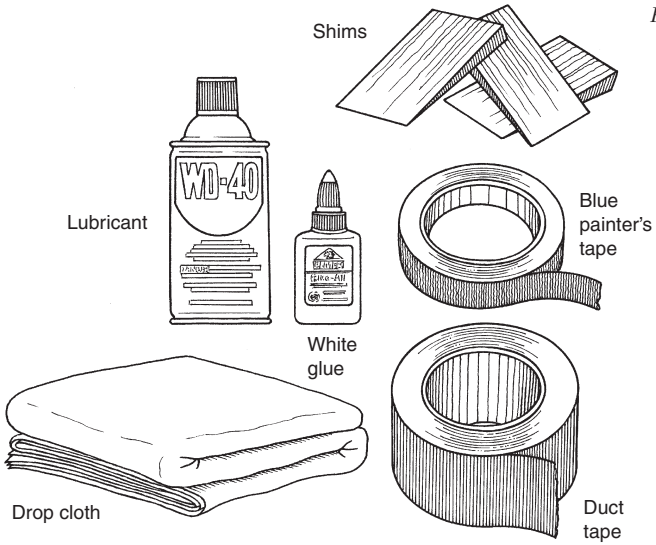
As your home repair savvy grows, you'll be doing more jobs and adding to your supply cabinet. But for starters, here are some basic supplies to keep on hand.

Keep It Moving: Lubricants

The places where parts come together often need a bit of help to move smoothly and quietly, or to get unstuck when they haven't been moved in a while.

A spray or liquid *lubricant* can help when you've got a noisy hinge, a draggy sliding door, or a nut that just won't turn when you're trying to loosen it. WD-40 is a popular brand of lubricant that comes in a can; it has a narrow straw that attaches to its sprayer so that you can direct a stream of lubricant to a precise location.

Lubricants are useful for hundreds of chores and repairs. Special lubricants that contain a high percentage of silicon are often helpful for moving parts made of wood, vinyl, or rubber. See Appendix B for more helpful information.



Repair supplies.

Keep It Together: Adhesives

While there are many varieties of adhesive—for every kind of material that can break or fall apart—you can start with a single basic type. *White glue*, available in supermarkets, stationery stores—virtually everywhere—is good for sticking together paper, cardboard, wood, leather, cloth, and lots of other materials. Keep a container in your supply closet. Keep in mind, however, that it's not waterproof; you'll need a different adhesive when water resistance is required.

When you start working with wood, add a container of carpenter's (wood) glue, which is usually yellow and of the same consistency as white glue.

Specialized adhesives—instant glue or contact cement, for example—are powerful products that create an incredibly tough and virtually instantaneous bond. If you use them, follow directions carefully, and keep the appropriate solvent on hand in case you stick your fingers together!

Blue painter's tape, like the familiar off-white masking tape, is a light-duty adhesive tape that is easy to apply and remove. The blue variety is called painter's tape because its adhesive is formulated to lift off a surface without damaging a new coat of paint; regular masking tape can be difficult to remove because it makes a tighter bond, and will

often lift off the new paint, shred, or leave a residue if it's left on a surface too long. The blue stuff is good for holding many lightweight objects in place temporarily.

Duct tape—most people know the gray or silver-colored variety—has a strong adhesive backing because its original use was to seal gaps in lengths of flexible ductwork. (This is no longer an approved use in most building codes.) People have found thousands of uses for duct tape, and written books about it, but it's an emergency fix for a lot of breaks and tears in household objects: patching a small hole in window glass until you can replace the pane; holding two pieces of wood together while you screw or nail them. Having it in your supply closet will definitely prove handy at some point.

Fill the Gap

Small *shims* are little wedges of soft wood, usually cedar, that look like miniature shingles. They're useful for closing gaps between stair treads and risers, for example—you'll see them used in some repairs in Chapter 7.

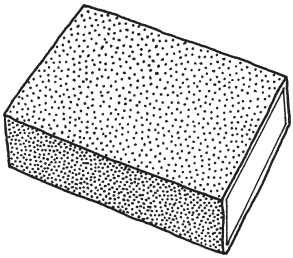
They're also good to level out a table, couch, or chairs when your floors are uneven—just slide a couple under the wobbly leg. While pieces of corrugated cardboard will work as shims in a pinch, a package of these little wooden helpers is cheap; if you've got an older home, I guarantee you'll find uses for them.

Cover It Up

A *drop cloth* is essential for protecting the areas of your home where you're doing a repair. Many people use plastic drop cloths; they're cheap and disposable. But they're also slippery to walk on, and some are so thin that they tear with little provocation. Buy a 9'×12' canvas model and you can shake it out, fold it easily, even wash it when it gets too soiled.

Rub It Off: Abrasives

Get at least one sanding block with a combination of surfaces—a medium-grade grit (80–100) side and a finer grit (120–150) is a nice toolbox standby. It's easier to handle than sheets of sandpaper. 220-grit sandpaper or blocks are good for fine surface work such as touch-ups to floors and furniture.

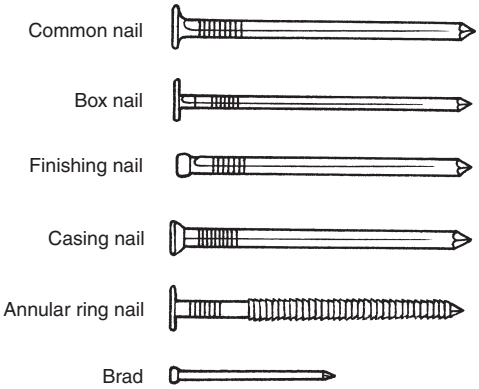


Sanding block.

Eventually, you may also want to get some files: a metal file and a wood rasp for quickly filing edges of these materials.

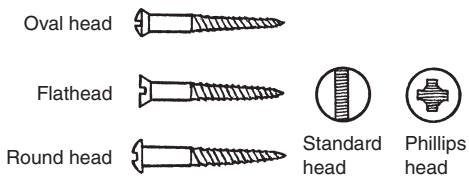
More Togetherness: A Quick Guide to Fasteners

A variety of fasteners for joining house parts and hanging accessories is good to keep on hand. Invariably if you have a giant coffee can full of wood screws, what you'll need are a couple of brads. Fasteners are generally inexpensive bits of metal, so a good supply won't set you back more than a few dollars.



An assortment of practical fasteners.

Screws.



Common nails and their more slender brothers, *box nails*, are good for general use. They have fairly large heads and good holding power; coated varieties will grip even harder.

Nails used for outside work should be galvanized (zinc coated); in high-moisture areas—by the shore, for example—stainless-steel nails will hold up to the environment best.

Because their heads are relatively large, use common and box nails when surface appearance doesn't matter.

Small-headed nails—*casing* or *finishing nails*—are good for woodwork. Both can be countersunk with a nail set, and the hole filled with wood putty to leave a smooth surface for painting or finishing. Use the smaller *brad* for nailing very thin pieces of molding or paneling.

What Pros Know

In the United States, nails are sized in "pennies," symbolized by the letter "d." This sizing system is a traditional one, going back to England a few hundred years ago. A 2d, or two-penny nail, is 1 inch long; the longest nails, 60d, are 6 inches long. The rule of thumb is to use a nail that is 2½ to 3 times as long as the thickness of the piece being fastened.

For some of the repairs in this book, you'll use *annular ring nails*, which have a grooved shaft to "bite" into wood like a screw.

Screws have great holding power, and because they can be loosened or tightened, they can be removed without undue damage to the surrounding surface. Depending on what's being fastened, you can use *flathead* (flush to the surface), *round head* (sits atop the surface), or *oval head* (usually for decorative use) wood screws.

Wood screws are available with a *standard* (looks like a minus [–] sign) or *Phillips* (looks like a plus [+] sign) driver slot. Some professionals like to use screws with a square slot (called a Robertson), which requires a matching, square-headed driver.

If you like to cover your walls with art, you'll probably have use for an assortment of fasteners for hanging pictures and other decorations. Picture hooks that feature an

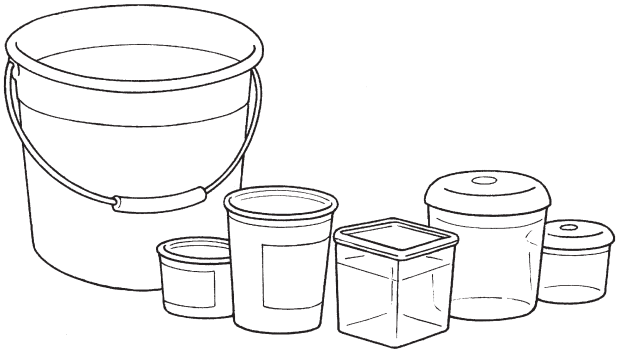
angled receptacle for driving in a small nail with ease—even into plaster—are good to keep on hand in a range of sizes for items of varying weights, up to about 25 pounds or so. Larger items that must be wall-mounted will use larger fasteners; check with your helpful hardware salesperson about the type and size of fastener best suited to your walls and what you're hanging.

Keep a handful of tacks—the large-headed thumbtacks and small-headed metal tacks—for hanging other small items.

Hold It: Containers

Even when you're not using liquids, a household bucket makes a good tote for tools and supplies for any DIY job. Get a sturdy, good-quality plastic model with an equally sturdy handle for those times when you do transport water (at about 7 pounds per gallon, water can be unwieldy to carry).

Also keep a supply of small lidded containers for those occasions when you need to carry around fasteners, small quantities of liquid, or other little items that can easily go astray.



A variety of containers.

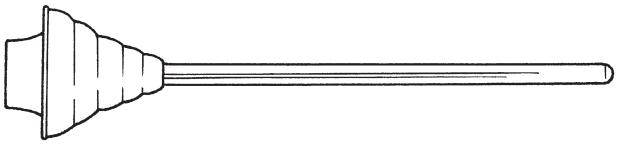
In Case of Small Water Emergencies

Between your tool kit and the supplies I've already described, you're covered for a lot of different small breakdowns in the house. And here are two more things you shouldn't neglect.

Plumbing leaks and backups are the most potentially damaging of the small home repair crises you will encounter day to day. Of course, you can always just shut off the household water at the main (see Chapter 4) and wait for the plumber. But a stopped sink or toilet, or a pinhole leak in a pipe, can be addressed with a couple of simple and inexpensive items.

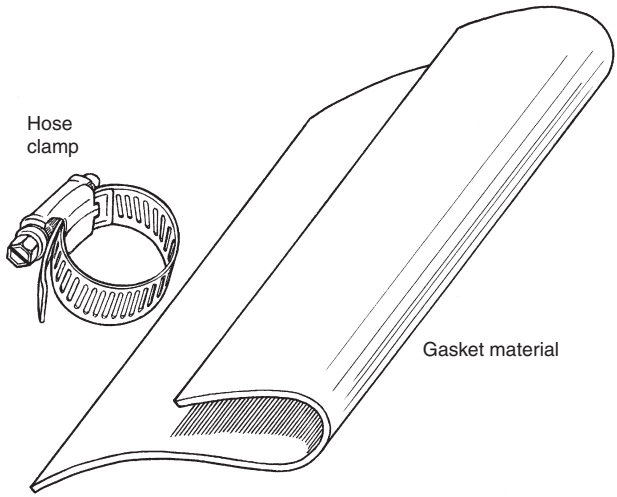
A plunger, also known as a "plumber's helper," will help you clear many types of clogs in your waste water (drain) system; you can find out how to make these fixes in Chapter 10.

Plunger.



For tiny leaks in supply pipes, you can buy a package of do-it-yourself gasket material (cork or rubber is good), and a couple of adjustable hose clamps that fit your pipe (metal supply pipe is usually $^1/_2$") to hold back the water until your plumber arrives. This fix is also covered in Chapter 10.

Pipe leak repair supplies.



Storing Those Leftovers!

Whenever you or a pro do a home improvement project in your house, there's usually material left over: extra tiles, extra paint or wallpaper, carpet scraps, or resilient flooring pieces.

In most houses, there never seems to be enough closets and cabinets to hold all our stuff; those DIY leftovers feel like just another pile of junk to deal with. So too often, the leftovers are thrown out or given away.

Even if you save that last half-roll of bedroom wallpaper, or the extra tile from the bathroom re-do, the tendency is to just throw the stuff in a box and put it anywhere out of the way where the box fits. The problem with that strategy is that you probably won't find it when you need it!

If you look through this book, you'll notice that many of the repair instructions call for leftover this-and-that. So do yourself a favor you'll thank yourself for later. Buy some clear plastic storage containers and keep the leftover stuff in those. Label the containers with what's in them and which room the leftovers came from. It's an easy system, sure to save time, money, and trouble down the road.

In the case of leftover paint—great for touch-ups—you may not need the leftover half-gallon of the custom color in your living room ever again, but you might need a small amount. To have what you need to cover a future minor repair, save a half-pint or pint in a clean, airtight container; label it with the room, paint brand, color name, and color number. You'll be glad you did. Custom colored paint is usually available in gallons only, a big expense and a big waste if you're just doing touch-ups after a small repair.

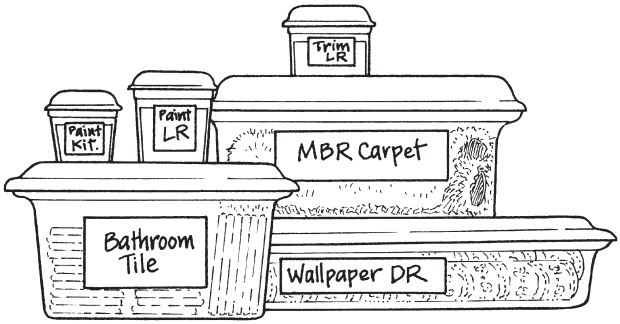
Check with your local waste removal carrier (private or municipal), about the rules for paint and solvent disposal in your area. Usually, you cannot throw these substances away in the regular household trash pickup.

When you finally move on to your next place, you can give the leftovers to the next owners as a housewarming present. Having replacement parts is always handy!

Ounce of Prevention

Take care not to store certain liquids—like paint or solvents—in your home's hot spots: near a heat source or in attics. Always check the original label; most DIY liquids belong in cool, dry places, with their lids tightly secured.

Closed containers for storing leftover materials.



The Least You Need to Know

- DIY supplies and materials deserve a dedicated place in your house. Find one that's convenient for you and secure for all family members, including pets.
- A well-stocked supply closet includes at least one lubricant, a liquid adhesive and DIY tape, a selection of fasteners, and stuff for cover-ups and clean-ups.
- You'll appreciate the value of a plunger and a pipe repair kit after your first night, weekend, or holiday plumbing emergency, when pros are hard to find.
- Leftover DIY stuff that you organize and save is destined to be very helpful later.

Chapter 4

A Map of Your World

In This Chapter

- Locating the main controls for the systems in your house
- Starting and stopping water flow, whether it's from a well or from an outside supplier
- Controlling your gas supply, and what to do if you suddenly smell gas
- Safe handling of your electrical panel
- Creating a personal home workbook

You need a lot of information to run a house. Unless you're a person who leads a very simple life, your home has a plumbing system, an electrical system, and maybe a gas supply to heat your home or hot water. If you're out in the country, you probably have a water well and a septic field, too.

Not to mention all those helpful appliances! They have plugs, hoses, switches, gaskets … a whole bunch of parts that may someday give you grief. And when one of them breaks down, you discover that you don't really remember where you tossed that use and care manual; it might have come in handy, if you could find it!

This chapter will help you figure out how to get more control of all the equipment that helps you run your home. You'll get some ideas about how to organize everything you should know about your house in a single location. It will make taking care of things a little bit easier.

The Main Thing: Your Home's Power Centers

The least convenient time to search for the controls for your home's water, gas, and electric service is when something suddenly goes very wrong. In the case of a gas leak, not understanding where and how service comes into your house can be life-threatening. So listen up!

Go to the stationery store, or with your own creative know-how, make labels or tags that say "Main Shutoff" for the primary gas and water valves in your house, as well as for the main electric service panel. Then follow the directions below and on the following pages so you can find, mark, and use them.

Basements are not always well-lit or easy to negotiate, so you'll want to take along a flashlight for this activity. If you don't have a basement, your utilities may be in a dedicated closet, or small room close to where the wires and pipes enter the house. Unless it's well lighted, you'll need a flashlight here, too.

Finding the Flow: Your Water Supply

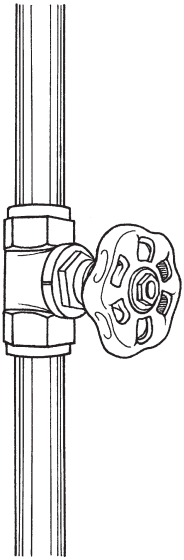
If your water comes into the house from a municipal or private water company, there will be an outside shutoff for the water as it comes from the main pipe under the street onto your property and into your house. Don't concern yourself with this control, as the shutoff can only be made by water company employees with special tools. (You should call the water company if an unusual flow of water near the street causes you to suspect a leak in the larger system.)

Find the water meter on the outside of your house; then look inside in a corresponding area for the water supply pipe that comes into the house.

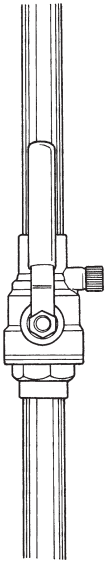
The water control in an older home is often a gate valve with a round handle. In newer homes, the straight-handled ball valve has replaced the old-style control.

The gate valve works like any round handled faucet; a clockwise turn (or turns) shuts off the water supply, and counterclockwise turns restore the flow. There's no need to play with it if you don't need to shut off the water supply. When you do need to turn it off, if it's difficult to turn, get your can of lubricant and give the valve a little squirt. If it still won't budge, leave it alone and call the plumber.

Ball valves work differently. They are sturdy and long-lasting, and the best replacement for a worn gate valve. When the water supply is flowing, the handle is in-line (parallel) to the pipe. A quarter-turn (90°) shuts off the water. The ball valve turns off in only one direction, so don't try to force it the wrong way.



Gate valve.



Ball valve in "on" position.

What Pros Know

Ball valves are a lot easier to operate than gate valves. Because main controls are operated infrequently, an old gate valve can become very hard to turn on and off. If you've got one of these antique numbers, and it's looking worn, consider having a plumber replace it the next time you hire him for another job. It's a nasty problem when the main gate valve starts leaking!

Once you've found your main water control, label it "Main Water Shutoff." To make it easier to see in a dark basement, you might want to mark it with fluorescent tape.

Oh, Well

If you live in the country and do not have municipal water service, you'll need to know where your well is located, and figure out where the supply pipe enters your house. The shutoffs will look the same as those for metered service, except that you don't have a meter. Instead, you've probably got an electric pump, positioned deep in your well, that pumps water into holding tanks, and from there into your house.

A well supplies the water for my own house, but fixing the pump is not my kind of work. And the pump always decides to give us trouble on the holidays, when our well service man is otherwise engaged. Fortunately, these pumps are built to last, and breakdowns don't happen often.

However, if a there's a water leak in your house and you want to stop the flow of water, there's an additional water/off option. You can use the main shutoff at the pipe, just as you would shut off the municipal supply, *or* you can go to your electrical panel (see more about this control later in the chapter) and shut off the circuit that controls the well pump.

Where the Well Water Goes

It has to go somewhere, and if you have a private water well that serves your home, chances are your wastewater goes to a septic tank and septic field on your property.

When you bought your house, if you have a septic system you should have gotten a map showing the location of your tank and field. If not, one should be on file at your county Board of Health.

The good news about septic systems is that they work very well—until they don't. If you don't have a company to pump out your septic tank, you should get one and use their services at recommended intervals. (These intervals are based on the number of

occupants of your home; the Board of Health sizes septic fields based on the number of bedrooms.) Most septic service companies will put you on a schedule and call when you're due for a pump-out. Do not neglect this regular service!

A septic system is a mess to repair, if the waste (effluent) is blocked from leaving your house via the waste line. And a failed septic system is a huge expense to replace. So make friends with a reliable septic system service company.

Your Gas System (Outside the House)

If you use natural gas for your heating system, hot water, clothes dryer, or stove, your supply also comes in from the street through a pipe that registers your usage at a meter outside the house. Just before the gas meter, you will see a shutoff valve that usually looks like a small, rectangular handle. When this control is parallel to the pipe, it means the gas is flowing. When it's turned perpendicular (90°) to the gas pipe, the gas is turned off.

The outside gas main control requires a wrench to turn it on and off. Like other outside controls for municipal and private utility service, in most cases the outside gas shutoff should only be turned on and off by gas company personnel, or the fire department.

If You Smell Gas

When natural gas comes out of the ground at its source, it has no color or smell. Companies that supply gas to consumers and businesses add the very noticeable odor of rotten eggs to gas so that a leak is easy to detect.

This is very important. If you should ever smell a *strong* odor of natural gas, do not use any devices that might make a spark. Light switches, phones, even turning on a flashlight could ignite the gas and cause an explosion.

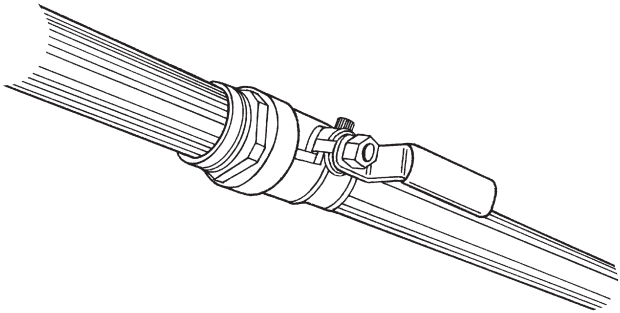
Leave your home immediately and take anyone else in the house with you, including pets. Once you're *safely out of and away from the house*, call the gas company or 911 from a neighbor's house or your cell phone, if you've got one.

Other Gas Controls

There is sometimes a gas supply main control inside the house, in addition to the valve outside before the meter. It should be located close to where the gas supply comes into the house. This one (if you've got one) is usually a ball valve, operated

in the same way as a water supply main ball valve: parallel to the pipe means the gas is flowing, and perpendicular to the pipe means the gas is off. Label this one "inside main gas control." Like the water supply valve, you may want to use fluorescent tape on the label so it's easy to see in a dark space.

Inside main gas supply control.



There are also individual controls for every gas appliance in your home. Usually they're located on the metal supply pipe, where it connects to the flexible pipe that supplies the appliance. While the gas *supply stops*, as they are called, may have a slightly different look than the main supply ball valve, they work the same way.

def•i•ni•tion

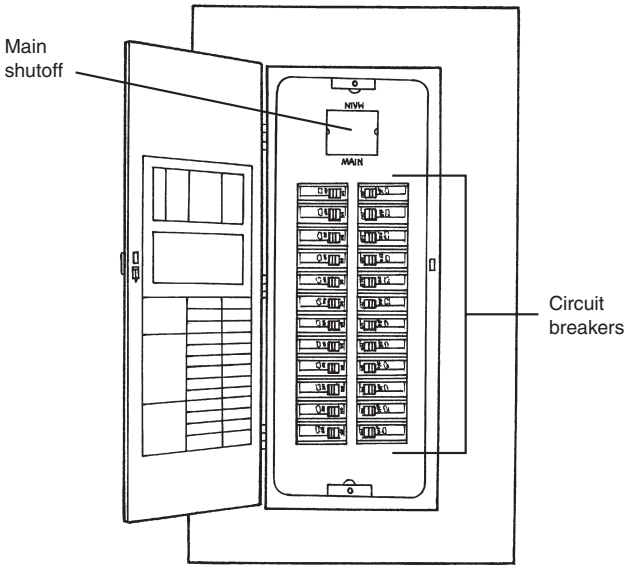
Supply stops, also known as supply valves, are on/off controls found along household utility supply lines, managing the flow of gas or water to individual fixtures and appliances. Gas supply stops usually work on the principle of the ball valve, with the position in line with supply pipe indicating "on," and a position perpendicular to the pipe indicating "off." Supply stops for water fixtures usually work by turning the stops clockwise for shutoff, and counterclockwise for the open/on position. (Remember: righty, tighty; lefty, loosey.) The handles of water supply stops are usually round or oval, but sometimes older stops look like the gate valve pictured earlier in this chapter.

Propane is a gas derivative of the production of petroleum and natural gas, which is then compressed into a transportable liquid. Many rural homeowners who do not have access to natural gas pipelines use propane to power their gas appliances. Propane is stored in a tank outside the house and piped inside. There is a shutoff at the tank (reserved for the use of the propane service that you pay to keep the tank filled). Inside the house, appliances using propane will have supply stops at the juncture of the supply line and the appliance's gas line. These stops will work the same way as supply stops for natural gas.

Propane is just as flammable as natural gas, and is treated to have the same rotten egg odor if it leaks into the air. If you detect the strong smell of gas, use the same extreme caution as you would with natural gas. Don't fool around, get outside quickly, and call for help.

Your Electric Service

Before you reach for your flashlight to go figure out your home's electrical system, remember that you need to use common sense when working around electrical wiring. Do not even touch the electric service panel if there is standing water in the room where it is located. Don't use both hands to explore the panel; keep one at your side. Touching both hands to the panel completes a circuit (you!), and you don't want to be the recipient of current gone astray. Take care!

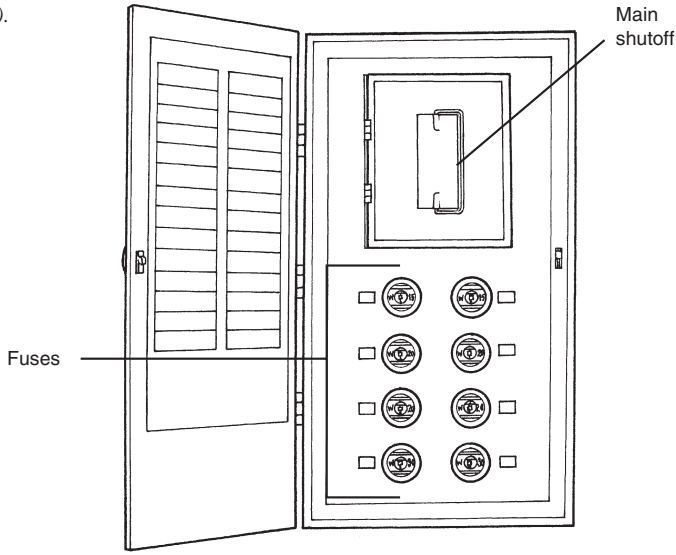


Electric service panel: circuit breaker panel.

Depending upon how old your home is, your electrical controls will be located in a metal box containing fuses—which look like tubes or glass-topped plugs—or toggle switches, called *circuit breakers*. The toggle-switch type of circuit breaker meets current electrical code requirements and has been around for more than 40 years; you'll find fuses in an older house. This metal box is connected to the large insulated wires

that come into your house from the electric meter outside, and the electric company's power grid beyond it. The box, called an electric service panel, or "breaker box," is control central for the electric current that powers all the switches, receptacles, and light sockets in your home.

Fuse panel (aka fuse box).



def•i•ni•tion

A **circuit breaker** is a device that stops the flow of electricity in a circuit if there is too much current for safe operation. Both the toggle switches and the fuses used in the two types of service panels act as circuit breakers, but only the toggle-switch type are commonly referred to as circuit breakers. Toggle types move automatically to "off" in an overload. Fuses "blow"; that is, the metal strip inside the fuse melts from the overload. You will have to replace it with the same size and type of fuse.

If you have toggle-type circuit breakers, the main control that turns on and shuts off all the electric current for the house is often (but not always) located at the top of the service panel, above all the other circuit breakers. Sometimes, as in the previous illustration, the main toggle switch is enclosed with a little access door; open the door, and flip the switch to "off" to shut off. If you have fuses, you'll find the main fuse at the top of the box. The main toggle in the circuit breaker panel will usually have a number on it, indicating the type of service coming into your home. This

service is measured in *amps* (amperes), so you will usually see the main toggle marked 100, 150, or 200.

Occasionally the main control for the service coming into your house will be located in a different metal box, and sometimes a different location, than the service panel containing the toggle switches or fuses for separate circuits. If you can't locate the main control—if it's not obvious—then you need to call an electrician. They may be nice enough to direct you to the main by instructing you over the phone, or you may need to hire one to explain your system. Either way, you're talking about electricity, so knowledge is much safer than ignorance here.

If you're lucky, someone has taken time to clearly identify all the circuits in the house for you; each toggle switch or fuse is labeled with the rooms, switches, and receptacles, or appliances that each breaker or fuse controls. If not, or if they're labeled ambiguously (for example, the previous owner marked a switch "Grandma's bedroom," so you can't identify it), it's a good idea to create a "map" of all the circuits in your house, then label the switches or fuses in the service panel or fuse box. When the lights shut off from a current overload in the future, you'll be glad you took the time to do this. You'll find instructions for creating a circuit map in Chapter 13.

A Workbook for Your Home

When something goes wrong with the workings of your house, you'll find a lot of solutions in this book. But as you read, you'll find that some instructions contain the words "often," or "usually," or "consult your owner's manual." That's because every mechanical system and appliance may have parts or works that diverge from a certain reliable standard. Perhaps the switch you're looking for is on the back of the appliance, not the front, where it is on 90 percent of the models most people see.

The more information you make available to yourself about your house, its systems, and all the appliances and conveniences it holds, the better able you will be to troubleshoot problems, judge which ones you can handle, and quickly assign the tough chores to the pros.

So, put it all together. Get yourself a 3-ring notebook with a wide spine (3 inches or more). The D-ring style holds pages flat most easily. If you have a lot of notebooks, buy this one in a color you can find quickly (red or yellow are highly visible). Fill it with those clear plastic sheet protectors—the kind that hold multi-page documents. If you want to be really organized, buy a pack or two of dividers, and label them with the name of each room and section of the house: kitchen, baths, bedrooms, living room, basement, attic, garage, and so on.

What will you put in this notebook? Let me give you a few ideas of basic things you can keep in it.

Appliance and Fixture Use and Care Manuals

Not every equipment problem signals the need for a repair or a service call. Sometimes you may have forgotten to turn a switch on or off. Maybe you've tried to start the device improperly. Use and care manuals contain instructions for assembling (when necessary), starting and stopping an appliance or fixture, and using it properly and safely. This handy guide usually has an illustrated diagram of the device, complete with the names and location of all its parts, including the label that will provide the model and serial numbers for your specific piece of equipment.

Often there's a handy section on troubleshooting—that is, strategies for figuring out what's wrong if something's not working properly, usually followed by the manufacturer's 800 helpline number or website URL. In addition, you'll find a listing of authorized service representatives.

These manuals are great. If you've got them all in a drawer somewhere, transfer them to the sheet protectors in your notebook. If you're really organized, file each one behind the divider you've labeled with the name of the room where the equipment is located.

If you're not very organized, now's the time to start. Those little instruction booklets can save you a lot of time!

What Pros Know

Can't find the use and care manual for an appliance or piece of equipment? If you can locate the manufacturer name, model number, and serial number (usually listed on a label somewhere on the device), you may be able to find the manual from the manufacturer's website. This is very possible if your equipment is fairly new, less so if it's more than five to seven years old. Once you find the manual online, you can download and then print a hard copy of it to file in your workbook. (Be sure to have plenty of printer paper and an almost-full ink cartridge before you try to do this.) If an Internet search proves fruitless, try calling the manufacturer's 800-number consumer help line.

Receipts and Manufacturer's/Dealer's Warranties

When something breaks down not long after you've purchased it, it may be covered for service or repair by the existing manufacturer's warranty, or a warranty you purchased from the retailer when you bought the equipment. File your purchase receipt and a copy of the warranty with the use and care manual. If your device is covered, your tool kit can stay in its storage location. In fact, *never try to repair something yourself when it is still under warranty; you'll void the warranty.* Call the number listed on the warranty; or call the dealer, if you purchased the warranty through the retail store.

Some manufacturers guarantee their equipment for life. I never believed I'd take someone up on this promise, and was doubtful that what was promised was indeed true (I can be cynical). But most companies who make this pledge turn out to actually mean it. When my very expensive, guaranteed-for-life kitchen faucet came apart after just a year, I called the manufacturer, and two days later, they had a new one delivered to my door!

Now, there must have been some serious flaw in the design (or in the user—me!) but the faucet broke again about two years later. And, true to its word, the manufacturer sent me another new faucet.

Make use of your lifetime guarantees! They'll save you money and time.

Equipment Manuals or Schematics

Heating and cooling devices (furnaces, central air-conditioning units), water treatment units, and other big items that figure in the major operations of your home, may have been installed long before you arrived. In that case, you may be out of luck on obtaining a manual or a detailed drawing (called a schematic) that illustrates the equipment with labels for its parts. If you've got a drawing or manual, pop it in your workbook. It will help you when something goes wrong with your big systems. Down the road, if and when you sell the house, the buyer will appreciate this documentation.

A Circuit Map of Your Home

If your circuits are clearly labeled, copy the information on a piece of paper to keep in your home workbook. If they're not, you should go to Chapter 13 as soon as you can and learn how to create this valuable map.

Service Records

When you do a repair on any equipment in your home, save the receipt. Make sure you or the professional service person notes the scope of the work and the date it was done. That way if a repair fails you've got a record, and you'll know if you've got a chronic problem with something in your house.

File these records right behind the manuals and warranties you keep for the equipment.

Other Workbook Items

When you do a home improvement—install new carpet, paint a room, upgrade your kitchen—you can put the records and specifications, receipts, and manuals in the appropriate section of your workbook. This is particularly helpful when you're looking to match paint or other materials to do a repair later on.

If you take the time to start it, and use it as information central for all the important components of your house, your personal home workbook will save you hours of time, and probably lots of money!

The Least You Need to Know

- The proper time to find out where to find the controls for your water, gas, and electric service is before there's a problem—that is, *right now*.
- Label all the main shutoffs to make them easy to see and read.
- If you can't locate your main controls, don't hesitate. Call a pro who can help you find them.
- For easy reference, for saving time and money, and for troubleshooting problems, create a home workbook to keep your manuals, diagrams, and service and repair records in one place.

Part 2

Skin Deep: Repairing Surfaces and Openings

Walls, floors, ceilings, stairs, windows, and doors are the first things you see when you look at a house. If the heating system and appliances are like its vital organs, a home's surfaces are like its skin. And although neglecting surfaces will not usually make a house fall down, they're components that everyone notices.

Unfortunately, like our own skin, these parts of the house show signs of aging and the bruises of long and continued use. Your house may have little indicators of time passing—nicked walls, bumpy floors, doors and stairs that squeak and sigh. It's inevitable, just like wrinkles.

But if you're not yet ready for the face lift—a full-tilt, expensive renovation—there are a lot of small repairs and cosmetic fixes that will brighten this top layer of your house, and help you enjoy it more. Part 2 gives you lots of ideas and plenty of instruction.

"Make my day."

Chapter 5

Walls: From Trash Talk to Smooth Talk

In This Chapter

- Making minor repairs to drywall surfaces, and patching a larger hole
- Repairing small cracks in plaster
- Replacing grout, and removing and replacing a cracked or broken ceramic tile
- Making minor repairs to wallpaper

Unfortunately, your walls *do* talk. Every bump with a furniture leg, hit with a hockey stick, and bounce of a ball where it shouldn't be can make a mess of your nice, smooth walls. Sometimes, a scuff will wash away with soap and water, but sooner or later, deeper evidence of close encounters of the worst kind will need treatment.

In this chapter, you'll learn to work with joint compound and other soft stuff: grout, tile cement, glue, and other materials to make beat-up walls look clean and new. And working with all this goop may bring back nice memories of your sandbox days!

Minor Drywall Repairs

Drywall is the most common type of base wall material, and what you'll usually find in houses less than fifty years old. It is made by sandwiching a gypsum core, which is fire resistant, between layers of paper. Sometimes known as Sheetrock, wallboard, or gypsum board, this material is also made in a water-resistant variety for use in damp areas such as basements and bathrooms.

You may not want to fix dings, dents, or popped fasteners every time they happen; if you've got an active family or an enthusiastic pet, little nicks and dents are bound to occur frequently. But sooner or later, your walls will get that tired, worn-out look. If possible, wait until your room is ready for its next paint job.

These little repairs are easy to do but take time because there are several steps. Between each step, you must wait for the patching medium to dry. Normally this means waiting 8–12 hours (or overnight) to go to the next step. Unless you're that rare bird with time on her hands, make all the wall repairs in one room on the same weekend, or successive days, so that all the fill-ins dry in one waiting period, are primed at one time, then painted at one time.

With little repairs, work gently. A bold, heavy hand will make a small flaw larger.

Ounce of Prevention

Be sure to wear safety goggles and a dust mask whenever you sand to protect your eyes and lungs. Maybe you think it's wimpy to protect your eyes, nose, and mouth for simple, small repairs. But I think my vital parts are worth protecting, no matter how few small particles are flying. Over time, little particles add up to bigger problems, and tiny crumbs of plaster in the eye can create a big problem. So be safe when you sand! I also hate sweeping and dusting, so the newspapers or drop cloth are my constant home repair sidekicks; they're much cheaper than a cleaning service.

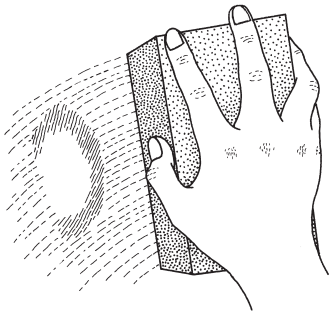
Repairing Dings and Dents

You'll need the following:

- Sanding block or sandpaper (80–100 grit and 120–150 grit)
- Utility knife
- Clean sponge or cloth

- ❑ Putty knife
- ❑ Joint compound

1. Lay newspaper or a drop cloth below the repair site to catch debris. Put on safety goggles and a dust mask when you sand to protect your eyes and lungs.
2. Using the 80–100 grit sanding block or paper, *lightly* sand the dent to remove little flecks of the drywall or paint that hang on the surface.



Sand the dent.

3. *Gently* cut away any torn pieces of the drywall that remain at the repair site with a utility knife.
4. Wipe the dent with a damp cloth or sponge to remove any bits that remain in the dent area.
5. With the putty knife, fill the dent with joint compound, and smooth the surface of the repair. Wipe off and clean the putty knife. Allow the repair to dry (usually overnight; see joint compound package directions).

Fill the dent.

6. When the repaired surface is dry, sand with the fine (150-grit) sandpaper.

If the surface looks rough or bumpy, or if any of the dents can still be seen, you'll need another cycle of compound application/drying time/sanding. If you're satisfied with the repair, wipe it off with a damp cloth or sponge, or vacuum the repaired area using the brush tool. You are ready to prime and repaint.

What Pros Know

When applying joint compound, your result should blend into the surrounding wall. While the recesses caused by denting and nicking should be filled, you don't want the surrounding walls to look like a relief map of the Rockies. Aim for a finished repair that is as flush to the intact drywall surface as you can make it. Think of the compound as a thin glaze, not fluffy frosting!

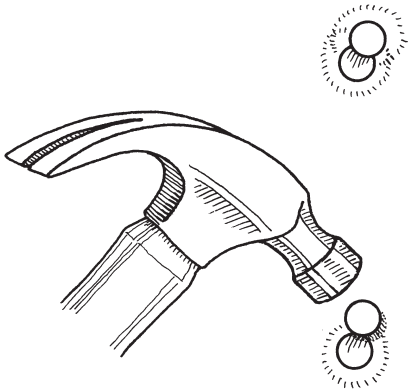
Popped Nails

While most pros now opt for screws and power drivers to install drywall, nails used to be the fastener of choice for attaching wallboard to the wall studs (lumber that creates the frame for the walls). A drywall/wallboard nail (they may be called by either name) has little rings on its shank and a flat, round head. Even though they're designed to stay put, these sturdy fasteners do pop out from time to time. Here's how to keep them in their place.

You'll need the following:

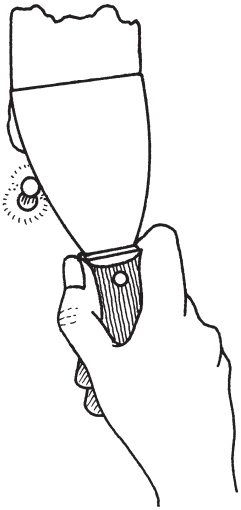
- ❑ Claw hammer
- ❑ Drywall nails
- ❑ Putty knife
- ❑ Joint compound
- ❑ Sanding block or sandpaper (150-grit)
- ❑ Clean sponge or cloth

1. Lay newspaper or a drop cloth below the repair site to catch debris. Put on safety goggles and a dust mask when you sand to protect your eyes and lungs.
2. Hammer the nail back into the drywall so it's flush with the wall. With a second hit, create a small dimple in the wall around the nail. Don't pound hard; you want a dimple, not a tear. Then drive a second nail next to the first, to hold the popped one in its place, and create a second, overlapping dimple.



Create dimple.

3. Using the putty knife, apply joint compound over the nail heads and dimples. Clean the putty knife and allow the compound to dry. When the repair is dry, sand the area and wipe off any remaining dust. You are ready to prime and repaint.



Apply compound to dimples.

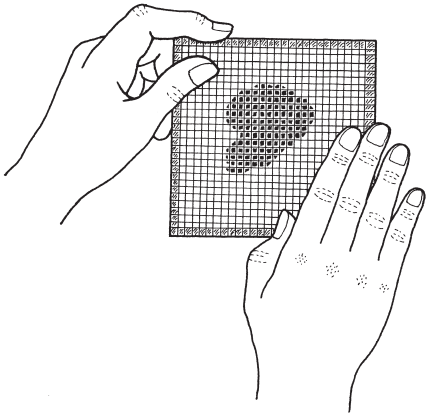
Patching Holes

Oops! I know you didn't mean to put your hammer (or the shower rod, or some other object) through the wall, but there it is: a nasty-looking void in the drywall. It used to be that fixing this kind of damage meant ripping out a section of drywall between studs and doing a (very) labor-intensive repair. Hardware stores now stock a great invention for holes of relatively small diameter: a mesh patch you can place over the hole. It's got a sticky back that adheres to the intact wall surface around the cavity. These patches are available in sizes up to about 8 inches square.

You'll need the following:

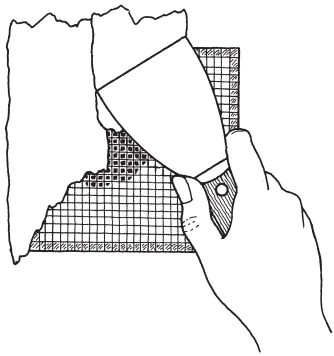
- ❑ Utility knife
- ❑ Sanding block or sandpaper (80–100 and 120–150 grit)
- ❑ Mesh wall patch (about 2× the area of the hole)
- ❑ Tray to hold compound
- ❑ Joint compound
- ❑ Putty knife (4" or wider, depending on the hole)
- ❑ Clean sponge or cloth

1. Cover the floor with newspaper and place a drop cloth on the surrounding area to protect furnishings. (This job may raise more dust than the others!) Put on safety goggles and a dust mask when you sand to protect your eyes and lungs.
2. Prepare the surface for the patch. Use the utility knife to cut away any protruding or hanging pieces of drywall. You might also want to sand the edge of the hole gently with the coarser grit (80–100) sandpaper. The idea is to make the surface of the hole flush with the wall, not to make the hole bigger!
3. Peel away the backing paper from the mesh patch and center the patch over the hole; then stick it down, smoothing the edges.



Apply the mesh patch.

4. Load your tray with joint compound. Use the putty knife to apply the compound over the patch. Cover the mesh area completely, applying compound beyond the borders of the mesh. Smooth on the compound from side to side, top to bottom, corner to corner. When you're finished, clean and dry the knife and tray.



Apply compound to patch.

5. Let the repair dry—like other drywall repairs, this one will take 8 or more hours. Then sand the dried area with the coarse (80–100) sandpaper. Wipe away any dust with a damp sponge or cloth.
6. Apply a second coat of compound as in Step 4. Let the compound dry. This time, use the fine sandpaper (120–150), and clean up as before. You're ready to prime and paint.

What Pros Know

Small flaws—dents, popped nails, and the like—can usually be covered with a 2" or 3" putty knife, and joint compound applied right from its small container. If you've got holes or a lot of imperfections to cover, you'll probably want a larger bucket of compound and a broader knife, 4" or wider, to cover the hole(s). To keep the compound from drying out, transfer the quantity you think you'll need into a tray (you'll find trays near the joint compound in the hardware store or home center). Then reclose the lid on the compound bucket to preserve the rest. Professional drywall installers work quickly, and waste neither time nor words. They call joint compound "mud," an apt description that saves two syllables!

Loose Drywall Tape

Drywall seams are joined and sealed by means of drywall tape, now a nice, self-stick product that usually stays put. But the drywall seams in your house may be put together with the old, paper product. This sometimes lifts off, and you can smooth it down with a new strip of 2-inch drywall repair tape, then go over it with joint compound and your putty knife, just the way you repaired everything else in this section.

If the old drywall tape is lifting all over the place in a section of a room, or rooms, this may be an indication of a moisture problem behind the sheetrock, and that's not funny.

Moisture in the walls not only damages drywall. It could degrade insulation, cause mold, and on and on. If you repair lifted tape and the problem keeps popping up, call in a pro.

Repairing Cracks in Plaster

Plaster is a beautiful wall surface; intact plaster has a smooth, hard finish that is beautiful to the eye and the touch. If you've got an old house, your walls may be covered with this material, which is traditionally applied in three coats over a layer of *lath* that is attached to the wall studs. But houses settle, and that's when the fun begins. Sooner or later, cracks and other defects may appear.

For all of us in DIY 101, the cracks are what we'll deal with. Bigger jobs are for the pros.

Spackling compound is a bit thicker than joint compound, and is good for repairing hairline cracks in plaster.

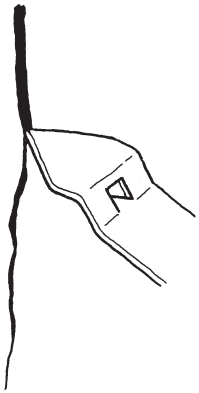
You'll need the following:

- ❑ Lever-type can opener
- ❑ Clean sponge or cloth
- ❑ Spackling compound
- ❑ Sanding block (150-grit)

def•i•ni•tion

Lath is the foundation for plaster, or sometimes for tile. It is traditionally a framework of thin wood strips, or, more recently, wire mesh.

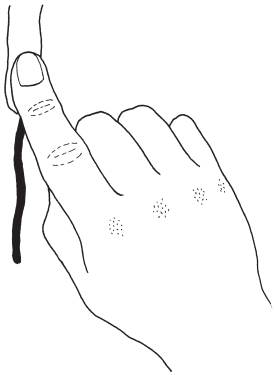
1. Lay newspaper or a drop cloth below the work area to catch debris. Put on safety goggles and a dust mask when you sand to protect your eyes and lungs.
2. In order for the compound to make a good bond with the wall and the underlying layer of plaster beneath the crack, a hairline crack should be opened to about $^1/_8$" wide. Do this by running the tip of a lever-type can opener (or the tip of the blade of a table knife) down the length of the crack. Brush away any crumbs of plaster that remain with a damp sponge or cloth.



Open plaster crack uniformly.

3. With your forefinger, push the spackling compound into the crack using smooth strokes until the crack is filled, end to end. The repair should overlap the wall slightly, creating a bond with the plaster.

Apply spackling compound.



4. Wash your hands, and let the repair dry (up to 24 hours; check the spackling compound package directions). When it's dry, if the patch seems to have shrunk into the crack, repeat Step 3, filling the indentation until the patch is flush with the wall, then let the area dry completely.
5. Sand the dry surface of the repair, and wipe away remaining dust. You're ready to prime and paint.

Because plaster is usually composed of three layers—a base coat, a second thicker coat, and a top coat (the beauty part), damage below the surface layer and beyond small cracks can be a tough DIY project. If you're patient, don't mind a *lot* of dust, and have plenty of spare time, see Appendix B for some sources of help for larger repairs.

You may prefer to call in a professional. Plasterers are artisans, but since drywall has so overwhelmingly replaced plaster in modern construction, masters of this craft are disappearing. It may take some time and sleuthing to find a good one.

Grout and Tile Crackups

Attractive, quite sturdy, and easy to clean, tile is a great wall covering in bathrooms, on kitchen backsplashes, and anywhere moisture can settle. A sponge or damp cloth wipes away dust and grime. It's wonderful stuff!

Over time, though, the grout (cement filling) between the tiles can become dirty and start to degrade; little bits of grout can chip or crack, and then it's time to renew the

offending seams. If grout is falling like rain, you may want to call a pro. Doing a whole wall or a whole room could be more work than you bargained for.

Sometimes, bad stuff happens to good walls. A single tile will develop an obvious crack, or fracture from too many hits with a pot, or the vacuum cleaner. Replacement is fairly straightforward if you've got some leftover tile stashed away.

You'll need to remove the grout around the broken piece before you remove the tile.

Ounce of Prevention

If the grout in the tiled areas of your home still looks good, a great little weekend project would be to seal it. Your local tile dealer stocks sealers that are easy to apply, and will protect the surface of the grout; just follow the package directions. If you seal the grout every couple of years, you may be able to skip this section for a while!

Replacing Grout

Finding grout to match what's already there may be the hardest part of this small job. Before you start, chip out a little sample of grout from the crumbling area with a utility knife, and bring it to the tile store. If you can't find a perfect match, ask the tile dealer about grout dye, which is applied like paint, with a brush, to the replacement grout. You may find just the right shade to make your repair invisible.

Oh, and if you've got a match, after you take what you need, be sure to close the package containing the remaining grout. Store it in an airtight container, labeled with the color and where it is used in your house. Love those leftovers!

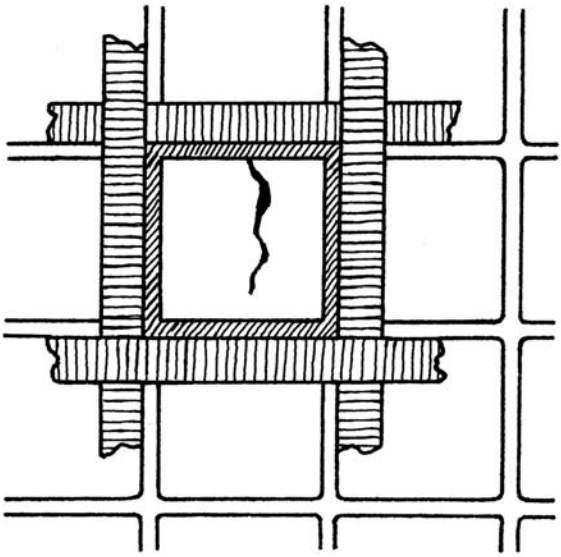
You'll need the following:

- ❑ Masking or painter's tape
- ❑ Utility knife or grout saw
- ❑ Grout to match what's already there
- ❑ Clean sponge or cloth
- ❑ Grout sealer

1. Removing grout will create some debris in the area below the damage; spread newspaper or a drop cloth in the work area. Put on safety goggles to protect your eyes from flying debris.

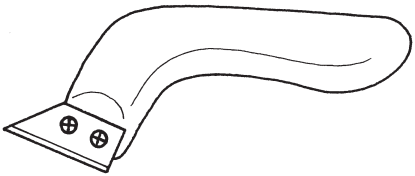
2. The surface of ceramic tile is vulnerable to scratching and chipping. If you're removing grout, or a cracked or broken tile, you'll want to mask the edges of the surrounding tiles with masking or painter's tape so the repair you're doing won't create more work!

Mask around the repair.



3. Remove the old grout with a utility knife or a grout saw. Ceramic tile is usually 1/4" thick (or less) so work carefully and don't cut into the surface of the wall.

A grout saw looks like a large utility knife with an offset handle. It is useful for cutting grout, especially if grout seams are wider than 1/4". A utility knife is fine for cutting narrower seams.



4. Make sure the seams are free of the old grout, then mix the new grout according to package directions.
5. You won't be needing the masking at this point, so remove it from around the open seam(s). Apply the grout to the open seam(s); smooth it with your finger.
6. When the seams are completely filled and look smooth, you can wipe away any grout remaining on the surrounding tiles with a damp sponge or cloth. Let the grout dry, then seal it with a grout sealer according to package directions.

Replacing a Ceramic Tile

If you're only replacing one or two tiles, you will only need a small quantity of tile adhesive, also called mastic. Bring the replacement tile with you, or ask the tile dealer when you buy a replacement which adhesive is suited to the job. Purchase that variety.

You'll need the following:

- ❑ Masking or painter's tape
- ❑ Utility knife or grout saw
- ❑ Metal straight edge
- ❑ Glass-cutting tool
- ❑ Nail set
- ❑ Hammer
- ❑ Cold chisel
- ❑ Putty knife
- ❑ Tile adhesive/mastic
- ❑ Replacement tile
- ❑ Wood block
- ❑ Grout to match what's already there
- ❑ Clean sponge or cloth

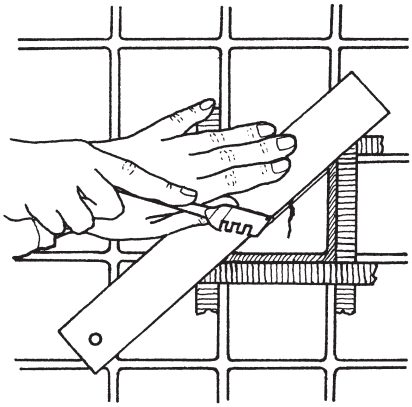
Ounce of Prevention

If your broken tile is over the bathtub, you'll want to protect the surface of the tub from flying shards of tile. Cover the whole tub with a drop cloth. Bits of tile can be very sharp and downright dangerous when they become airborne. In addition to your goggles, protect your arms with long sleeves—button sleeves if they have buttons so loose cuffs won't be in your way.

1. Protect surrounding tiles with masking or painter's tape, and cover the floor around the work area with newspapers or a drop cloth. Put on safety goggles to protect your eyes from flying debris.

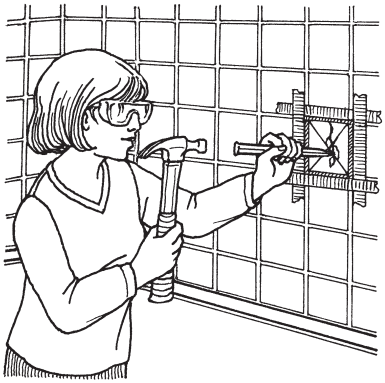
2. Remove the old grout; follow the instructions in the repair just described.
3. Using the straight edge as a cutting guide, and the glass-cutting tool, score the damaged/broken tile with an X mark, corner to corner on the diagonal.

The glass-cutting tool is not only good for cutting glass; you can use it to score many hard, brittle materials.



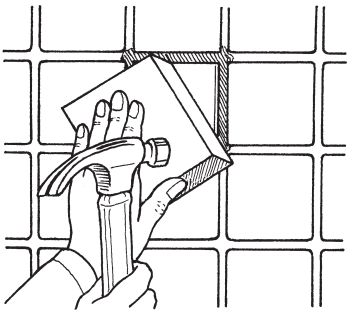
Score the crack.

4. Position the nail set at the center of the X, and tap with the hammer to loosen the cracked tile.
5. Using the hammer and the cold chisel, carefully chip out the tile. Once you have gotten enough small pieces out, you can hammer the end of the putty knife (if it's got a metal end on the handle) to carefully work out the tile. Take care not to gouge the underlying wallboard. Hold the chisel or knife at an angle so that you're lifting tile but not denting or tearing drywall.



Chisel out broken tile.

6. When all the tile bits are removed, scrape out the remaining dried tile adhesive with the putty knife, also taking care to leave the underlying wall intact.
7. If you do make a gouge in the wall, go back to the drywall repair section of this chapter and make the repair. You'll have to wait for the compound to dry, then sand it and wipe away any remaining dust before you set the tile. (Remember to wear a dust mask when you sand.)
8. Using the putty knife (be sure it's clean and dry), "butter" the back of the tile with adhesive, and position it where the old tile was set. Wipe away any mastic that squishes up from beneath the tile.
9. Using a wood block to protect the surface of the new tile, hammer the block gently so that the tile is level with the surrounding work.
10. Hold the tile in place with masking or painter's tape while it dries (tape it up and down, side to side, to the adjoining intact tile work).



Secure the new tile in place.

11. Once the tile is set (adhesive should usually set for 24 hours; check the directions on the adhesive packaging), grout the seams around the tile, and wipe any excess grout away with a damp sponge.

Replace grout.

12. When the grout dries, apply a sealer according to package directions.

What Pros Know

Uh oh! You have no leftover tile and there's nothing resembling it at the six or seven tile stores you've visited. (Did you check their discard piles of extras from old jobs? Don't forget to try.) If you're willing to sacrifice a few intact tiles, and the field (your tile wall) isn't too large, you can make lemonade out of this lemon of a dilemma. Buy a few contrasting tiles that fit the color scheme in your room, or a few pretty art tiles that will complement the décor, and install them randomly. This replacement method will look like a design, not a repair, if done well. If this sounds like too much work, it won't take a pro long to replace a few tiles with substitutes, and the price will beat a complete retiling.

Minor Wallpaper Repairs

After he graduated from the crib to a big-boy bed, my son lulled himself to sleep by picking at the wallpaper where his bed aligned with the wall. Cleverly, he did this below the level of the mattress, so I didn't notice until he had removed a fairly large patch of paper. To give him an alternative sleep aid to peeling wallpaper, we went shopping for a new fuzzy stuffed friend, and then I learned to patch. Fortunately for

me, the paper was a simple grid pattern; it was easy to line up the pattern and cut a patch along the grid lines. And my son loved Jerry, his new bear!

Even though you can return unused rolls of wallpaper and get a little money back, save at least one roll of leftover paper from any wallpaper project for unexpected mishaps, and store it with your other leftover supplies. Most wallpaper patterns go out of production after a couple of seasons, and if you've got a tear or hole in a prominent position that you can't cover with a hanging picture, you will regret being penny-wise!

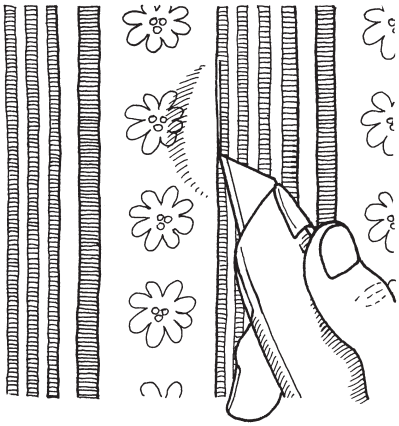
Bursting Those Bubbles

Unlike popping balloons, getting rid of air bubbles beneath wallpaper is a delicate maneuver.

You'll need the following:

- Utility knife
- All-purpose glue
- Toothpick
- Clean sponge or cloth

Carefully make a slit in the bubble and press it flat with your fingertip. If it won't stay down, put a little all-purpose glue on a toothpick, and carefully spread the glue underneath the lifted area. Press down, and wipe away any excess glue with a damp sponge.



Flatten a wallpaper bubble.

Flattening Flappy Seams

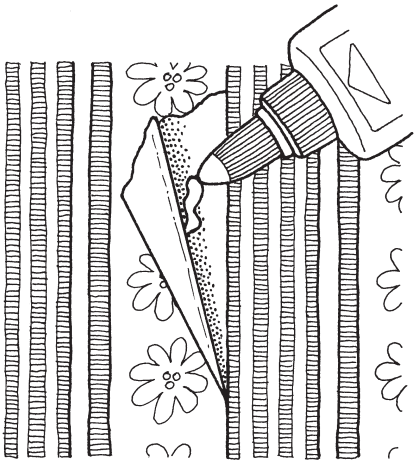
A good paperhanger takes care to match and flatten each strip of wallpaper so that the pattern—not the strips—are what you see when you walk into the room. Over time, the adhesive that once kept the edges down may dry out sufficiently that the seams begin to lift off the wall in places. And these little "lift-offs" can tear if someone brushes against them. A little first aid will keep your seams straight!

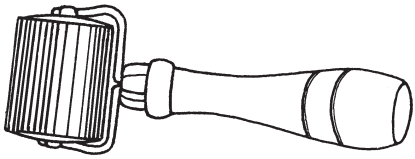
You'll need the following:

- All-purpose glue
- Toothpick
- Clean sponge or cloth
- Wallpaper seam roller

As with the burst bubble, put a little glue behind the tear or the lift. Use a toothpick for gluing very small lifts. Press down, making sure the repair lines up properly with the adjoining pattern. Wipe away any excess glue that blobs out from under the repair with a damp sponge. Roll the seam with the seam roller for a neat, flat finish.

Glue a wallpaper seam.





A wallpaper seam roller will glide over your repair without hitting a snag. It's also great for smoothing anything else you have to glue and flatten.

Patching a Torn Section of Wallpaper

That leftover roll of wallpaper is key to this repair. You'll need to make your patch line up with the existing paper, to make it less visible. It's best if the corners of the patch wind up inside the pattern, rather than on the plain background of the paper, so the repair is less visible. If the paper is a very busy pattern with little or no plain background, the corners should disappear nicely.

You'll need the following:

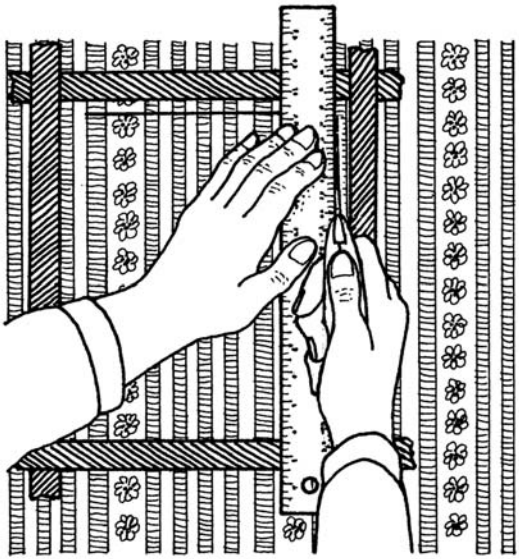
- ❑ Utility knife
- ❑ Blue painter's tape
- ❑ Straight edge
- ❑ Putty knife
- ❑ Wall sealer (for repair area)
- ❑ Bucket of lukewarm water
- ❑ Sponge
- ❑ Leftover matching wallpaper
- ❑ Wallpaper adhesive, or a shallow pan of water
- ❑ Brush for applying wallpaper adhesive, if necessary
- ❑ Wallpaper seam roller

What Pros Know

Dipping it for about ten seconds in a pan of water activates the adhesive on prepasted wallpaper. Unpasted wallpaper is applied with wallpaper paste. Which kind is yours? Sometimes the manufacturer will tell you by printing the information on the backside of the paper. If you can't figure it out, dip a scrap of paper in water and see if it will stick to a wall surface. (Unless you want to keep it there, remove immediately after checking and wipe away the residue with a sponge!) Expensive designer papers, meant to be installed by pros, are often unpasted. If you're still in doubt, bring a scrap to the wallpaper store and ask.

1. Spread newspaper or a drop cloth below the work area to catch debris.
2. With the utility knife, remove any bits of wallpaper that are hanging loose. Cut a piece of wallpaper from your leftover roll that covers the torn or damaged area with a generous border around it.

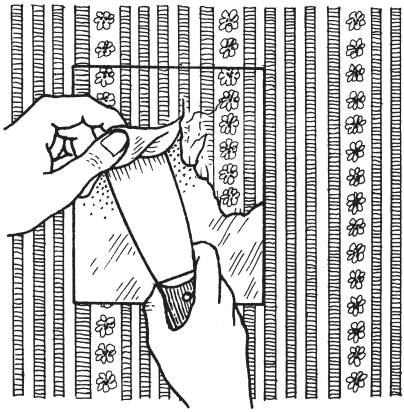
Cut the patch.



3. Carefully match the edges of the patch to the existing wallpaper, and tape it flush to the wall with blue painter's tape.
4. Using the utility knife and your straight edge, cut out a square or rectangular patch inside the taped edges that also encloses the torn area. You will be cutting the patch and scoring the existing paper at the same time. Take care not to gouge the wall. (If you should slip, you can always repair the underlying drywall with the skill you learned earlier in this chapter!)

5. Set aside your newly cut patch for the moment. Dampen the scored area around the torn area and use the putty knife to scrape away the wallpaper. You may have to apply warm water to the paper and let it soak for a few minutes to make removal easier.

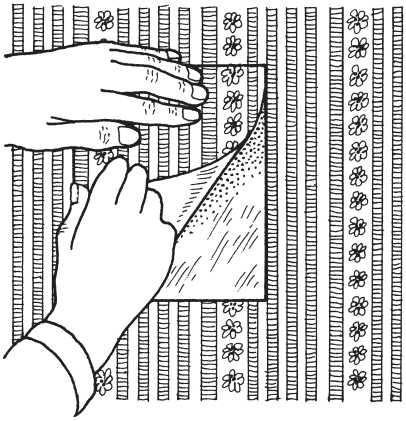
   If your old paper is strippable (it may say so on the back of the paper), you can just lift the corner of the paper with your putty knife and pull it back, holding the paper at a sharp 10° angle. Peel *carefully.*



Remove old paper.

6. When all the paper is removed from the area you will patch (with your "custom fit" replacement), apply wall sealer (from the wallpaper store; ask the dealer) according to package directions, and let it dry.
7. If you're using a prepasted wallpaper, dip it in water and then install it over the opening you've prepared, taking care to line up the pattern and the seams. Use the sponge to wipe away excess moisture. (If using unpasted paper, apply adhesive to the back of the patch according to directions. Wipe away any excess adhesive from the edges of the repair.) Smooth the paper from the center to the edges, taking care to keep the pattern in line.

Install the patch.



8. When you're satisfied with the fit, run the seam roller along the edges for a nice, flat edge. Let the patch dry.

The Least You Need to Know

- Wall repairs take time because many patch products dry slowly. The good news: you don't have to watch! Do something else while you wait.
- Save and label leftovers from renovation projects. You never know when you'll need an extra tile or piece of wallpaper.
- A heavy hand in wall repairs makes more work. Light and easy does it!
- Always protect your eyes, mouth, and nose when sanding.

Chapter 6

Floors and Ceilings: Beneath Your Feet and (Not Really) Over Your Head

In This Chapter

- Making small repairs to hardwood floors, and replacing a laminate floorboard
- Replacing a vinyl or ceramic tile or a small area of resilient flooring that's been damaged
- Cleaning stains and replacing a section of wall-to-wall carpet
- Smoothing a ceiling that's starting to show its age

There's a trend today for people to take care of their floors by adopting the Japanese custom of leaving their shoes at the door. It's a nice idea if your family can live with it; it will certainly cut down on the sweeping/vacuuming schedule. Of course, if you have pets who track in all kinds of debris, and you're not compulsive about making your guests and your UPS delivery man remove their shoes, your floors will sooner or later suffer the same indignities as any shoe-wearing household.

When really bad things happen to floors—deep gouges, extensive water damage, I'm talking disaster here—you'll have to opt for refinishing or replacement. But barring a crisis, there are lots of things you can do to maintain an old floor's—or its covering's—attractive appearance. Read on.

Wood Floors: Skin Repair

Water marks, burn marks, and scratches all affect the appearance of your hardwood floors. They're like blemishes; some people don't mind them, but others rush for a cover-up. If you choose the cover-up strategy, it's best to deal with them as soon after they happen as possible. When you're trying to fix a minor flaw, you'll need to use a wax stripper to remove the protective finish from the damage site. Check with your hardware store associate about the appropriate stripping product for the finish on your floor. When you're finished with the repair, you can rewax or oil the area.

Ounce of Prevention

The liquids used for oiling, waxing, and repairing blemished floors may be flammable and toxic. Read the directions on the product container, and use and store these substances according to manufacturer's instructions. When you're working and the stuff is wet or drying, close off your work area from children and pets. Be sure to wear snug-fitting rubber or latex gloves to protect your hands from these liquids.

Water Marks

I know everyone in your house is supposed to use a coaster under their drinks, but if Dad set a glass of water on the floor and forgot it, try this fix.

You'll need the following:

- Fine steel wool (#0000)
- Paste wax or liquid floor wax
- Wax stripper
- Clean soft rags (or *cheesecloth*, cut into little pads)
- Odorless mineral spirits

1. Open the windows when you're using waxes and other floor repair products. Some people like the smell, but it's really not good to expose yourself to these fumes in an unventilated area. Wear gloves when you're using the liquids.
2. Using a wax stripper, remove the finish from the stained area.
3. Rub the water marks with the steel wool and a little paste or liquid wax.
4. If the marks don't disappear, wipe up the wax with a clean rag or cheesecloth pad. Rub the area again with the steel wool, using a small amount of mineral spirits.

Wipe clean, let dry, and rewax or reoil the area.

def•i•ni•tion

Cheesecloth is a light, gauzy fabric originally used to strain and hold cheese. In the absence of a good supply of soft, clean rags, and folded into palm-sized pads, it's a great substitute if you've run out of old flannel shirts and pajamas. Hardware stores and home centers sell it in inexpensive and generous packages.

Burn Marks

Grandpa's lit cigar fell on the floor and left a mark in the finish. Now you've got a good excuse to make him take his habit outside! But you still need to repair the floor. You'll need the following:

- Fine sandpaper (220–400 grit)
- Clean, damp rag
- Utility knife
- Putty stick or stick shellac to match the floor surface

If a burn has just darkened the surface of the wood, you can sand it with fine sandpaper, and wipe up the sanding dust with the damp cloth. (Wear a dust mask when sanding to protect your lungs from particles.) Finish as desired; you may want to give the area a light coat with the putty or shellac stick before you reoil or rewax the spot. Use the sticks according to manufacturer's directions.

For a deeper burn, follow these steps:

1. Carefully scrape out the burned area with the tip of your utility knife; be sure the blade is sharp (if in doubt, pop in a new one first).

2. Apply one or more coats of the putty stick or stick shellac.

Rewax or reoil the spot.

What Pros Know

Putty sticks, stick shellac, and small containers of wood putty are sold in different colors to match different wood finishes. Without a spare piece of wood to make a perfect match, use your digital camera to take a photo of your floor and bring your snapshot to the hardware store. When in doubt about the color, go lighter rather than darker. You can always cover the lighter filler with a darker shade, but too-dark material will create another blemish.

Scratches and Gouges

You don't have to be too compulsive about this; if you've got dogs and kids, you'll be fixing scratches every other day. But before routine waxing or oiling of your floor, and after stripping the protective finish, you can spend a little time touching up the scratches with your handy putty stick or stick shellac, then rewax or reoil the area.

For a deeper gouge, you may get a better result by using wood putty from a can to fill the gouged spot. When it dries, you can feather the edges with fine sandpaper. If the patch is too visible, touch it up with the putty stick or stick shellac. Then rewax or reoil the spot.

Preventing Blemishes

If you dislike housecleaning as much as I do, you won't like this advice. But it works. I've already discussed the no-shoes strategy. But if you can't deal with that, the best defense for your floor's finish is frequent sweeping or vacuuming. Surface dirt is the real culprit in floor wear.

Floorboard Fixes

Wobbly wood floors are annoying and dangerous: that thing that goes bump in the night could be you! Here are a few common problems, and how to solve them.

Drilling Pilot Holes

Before you drive a screw or nail into hardwood floors, you must first excavate one or more of what's called a *pilot hole* with your electric drill. The drill hole acts like a "pilot" for your nail or screw, literally directing it toward a tight, clean insertion. Pilot holes are your insurance that you won't chew up the flooring with a poorly hammered nail or a screwy screw . Many instructions in this book call for pilot holes. If you're unfamiliar with using the drill, practice on a piece of wood that you clamp firmly to a work table (careful, don't drill the table). Wear safety goggles when you drill. Drill holes until you get a feel for the tool. (If you're having trouble, refer to the drill's use and care manual for further guidance.)

Split or Cracked Boards

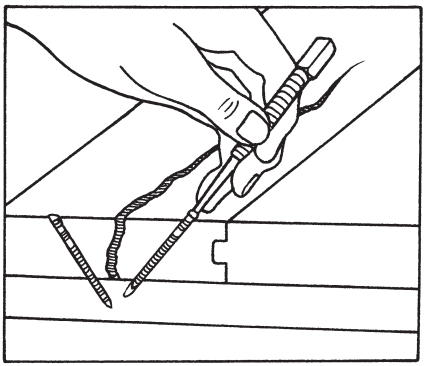
You'd be amazed at what falls in the cracks! One Christmas, my husband gave me a beautiful pair of earrings, and I lost one. It was tiny, and I'd given up ever finding it again. But when I repaired a crack in a dining room floorboard, what do you think I found?

You'll need the following:

- Electric drill
- A combination pilot bit (its shank should be slightly shorter than the depth you drive your nail)
- Annular ring nails, long enough to go through the floorboard and almost through the subfloor when countersunk (your nails can be about 2" for standard $^3/_4$" floor and subfloor)
- Claw hammer
- Nail set
- Wood putty or wood filler
- Finish to match your floor

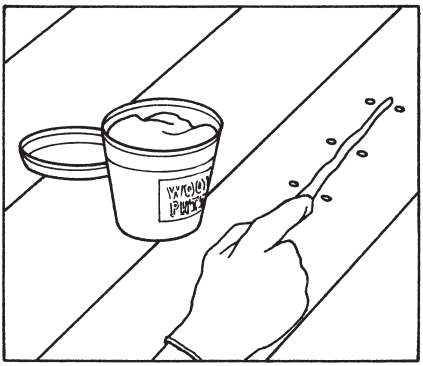
A combination bit, or screw pilot, is the right bit for drilling a pilot hole and countersinking the fastener. The bit is graduated to a larger diameter at the top, allowing the fastener head to be countersunk with a nail set (if it's a nail) or a screwdriver (if it's a screw). If you're not sure of bit length, check with your hardware store salesperson.

1. Wearing safety goggles, drill pilot holes at an angle every few inches along both sides of the crack.



Countersink pilot holes along a floorboard crack.

2. Drive in the annular ring nails, then countersink them using the nail set.
3. Wearing snug-fitting rubber or disposable latex gloves if you don't like putty on your hands, fill the nail holes and the crack with wood putty; let it dry.



Fill crack and nail holes with putty.

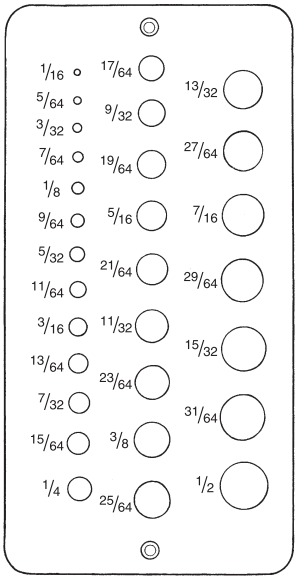
4. If a better match is needed, apply a color putty stick or stick shellac, or finish to match the surrounding floor. Let it dry, then wax or oil as needed.

More Bit Bits

This and upcoming chapters call for the electric drill and various bits. I don't know about you, but I have trouble sometimes judging whether a bit is "slightly smaller" than my fastener. I'm at that stage of life where I need reading glasses for all close-up work. If you also have trouble when comparing bits and fasteners, keep a drill gauge in your pocket or purse when you buy fasteners and corresponding bits in the hardware store or home center.

Your fastener should fit through the *next size larger* hole in the gauge than the correct hole for your drill bit. (The following illustration is a sample of what a gauge looks like; real gauges have the fractional sizes of each hole marked.) The fastener should be larger than the pilot hole, because you want the fastener to grab the wood (or other material) that surrounds the pilot hole. You want that fastener to fit tightly. With a drill gauge there's no more guessing.

Fractional drill gauge.



Warped Boards

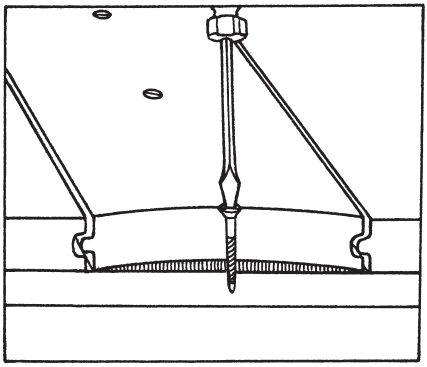
You may notice warping boards in the winter, when your heating system starts to dry things out, and wood fiber starts to shrink as it loses its natural moisture. If this is a persistent problem in your house, you may want to put more moisture into the air by using humidifiers in winter months.

This is a fix for a *badly* warped board; it doesn't yet look like Mount Everest, but creates a slight rise that looks weird and presents a possible tripping hazard.

You'll need the following:

- Electric drill
- Combination bit sized for your screws
- Standard screwdriver
- Slotted wood screws ($1\frac{1}{4}$"; you'll be driving them straight)
- Wood putty
- Finish to match the floor

1. Wearing safety goggles, drill pilot holes every few inches at the high point of the warp along the length of the warped board.
2. Insert and then tighten the screws in each hole. Take care not to tighten so hard that you deform the screw head. Be firm but gentle.



Drive screws into the warp.

3. Wearing snug-fitting rubber or disposable latex gloves if you don't like putty on your hands, cover the holes with wood putty and then apply finish to match the surrounding floor.

Loose Boards

Loose boards are a fairly easy fix. If you can get to them from *underneath*, the solution is invisible, but this is only possible if you've got an unfinished ceiling below the floor, as in a basement or garage.

If you are so blessed, you'll need the following:

- ❑ Stepladder
- ❑ Electric drill
- ❑ Corresponding bit for your screws (no need to countersink these, aesthetics are not an issue)
- ❑ Screwdriver (standard or Phillips, depending on the screw heads)
- ❑ Measuring tape (for marking the drill bit, and locating the loose boards)

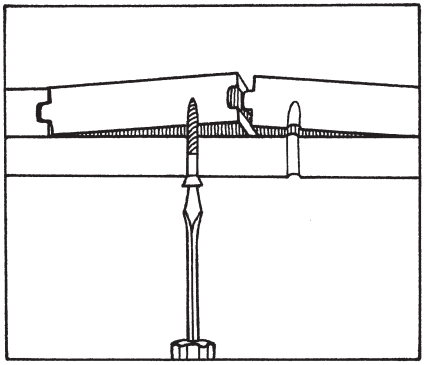
- ❑ Wood screws ($1\frac{1}{4}$" for standard $\frac{3}{4}$" floor and subfloor; the screws should be $\frac{1}{4}$" shorter than the thickness of the two layers)
- ❑ Masking or painter's tape

1. The worst part of the job is locating precisely where on the ceiling the loose floorboard above is located. You can have a friend jump on the loose board, watch the movement in the subfloor and locate it that way, or you can do a measuring job to find it. (If walls above and below match up, it's easier.)
2. Once you've located the spot, put on safety goggles to protect your eyes, and drill several pilot holes straight up from below, then insert and tighten your wood screws. It will help if your friend stands on the loose board, putting some downward pressure on the board as you tighten each screw. Your friend can also make sure that the screw does not break through the surface of the hardwood floor.

What Pros Know

When you're drilling holes from below the floor, you don't want screw points coming up through the floorboards. You can buy drill bits with stops that you can adjust to the desired drilling depth, or wrap a piece of painter's or masking tape at the correct point on the bit so you don't drill past it. Use either strategy whenever you want your drill holes to be a specific length.

Fix loose board from below.

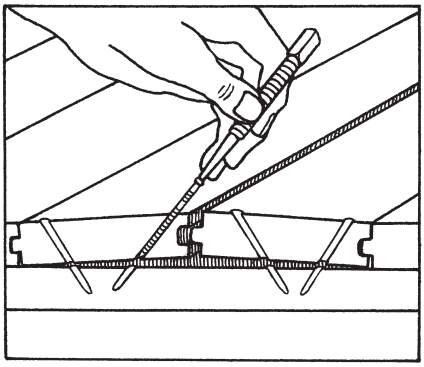


After all the effort it took to find the right board, the good news is, you don't have to cover the screws on the unfinished ceiling with wood putty. Phew!

To fix the loose board from above, you'll need the following:

- ❑ Electric drill
- ❑ Combination bit sized for nail diameter and countersink
- ❑ Claw hammer
- ❑ Nail set
- ❑ Annular ring nails
- ❑ Wood putty
- ❑ Finish to match the floor

1. Wearing safety goggles, drill pilot holes as shown in the following illustration, angled in from the board edge, through the board and into the subfloor.



Nail loose boards from above.

2. Drive in nails with a hammer and countersink them with a nail set.
3. Wearing snug-fitting rubber or disposable latex gloves if you don't like putty on your hands, fill the nail holes with wood putty, and apply finish to match the surrounding floor.

Stopping Squeaks

Squeaks are caused by pieces of flooring rubbing together. When my children were teenagers, I never bothered to fix the squeaks in the floor. In fact, I liked them. The more they squeaked, the easier it was to detect the patter of adolescent feet, sneaking in past curfew.

Here are two ways to try to silence a squeaky floor. For the first strategy, you'll need the following:

- A block of wood (a foot-long piece of 2×4 framing lumber is good; your local lumber yard may have some scrap if you don't)
- A piece of felt, scrap carpet, or other thick fabric to cover the block
- Claw hammer
- A few common or box nails

1. Cover the faces (not the ends) of the block of wood with your heavy fabric or carpet and nail the material snugly in place on one long end of the block, leaving you three cushioned sides to work with.
2. Starting in the center of the room and moving around and outward in a path toward the edges of the room, position the long, unnailed face of the fabric-covered block flat on the floor, and perpendicular to the floorboards, and tap it sharply with the hammer. Doing this may help ease the floorboards, which may have dried and shifted, back into place, so they don't rub together so noticeably.

For the second strategy you'll need the following:

- Glazier's points (the little metal pieces used to position glass in a window frame)
- Graphite
- Claw hammer
- Putty knife (2")

Coat the glazier's points in graphite, and then hammer them between offending floorboards. To do this, tap the hammer on the edge of the blade of the putty knife, using the opposite edge of the putty knife to push the points between the boards. Make sure the points don't protrude from the spaces so that they stick out above the boards (ouch!). The graphite-coated points act as space holders to keep the boards away from each other.

Getting at Squeaks from Down Under

If the offending floor is in a room above an unfinished basement or garage, you can try to stop squeaks with yet a third strategy.

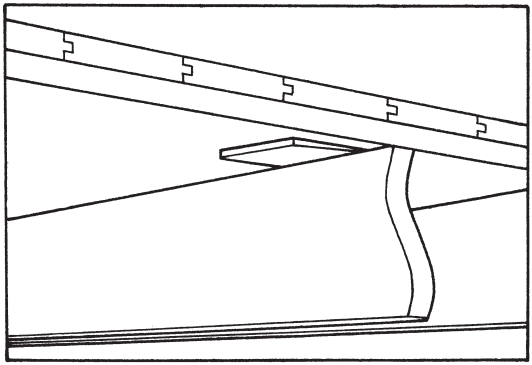
You'll need the following:

- ❑ Stepladder
- ❑ Claw hammer
- ❑ Wood shims

Again, you'll need a friend to walk around upstairs to locate the squeaky parts of the floor. Wherever the floor is squeaking, tap a shim into the space between the *joist* and the subfloor. Be sure to wear safety goggles to protect your eyes from falling debris.

def•i•ni•tion

A **joist** is the framing that supports a floor or ceiling.



Silence a squeak from down under.

Resilient Floor Fixes

Vinyl flooring in sheets and tiles is everywhere; it holds up to a lot of hard wear, which is probably why it's known as *resilient*. Cork and asphalt tile are also known as resilient flooring, but vinyl dominates.

The routine for maintaining a resilient floor is fairly simple: regular sweeping, vacuuming, damp-mopping, and occasional waxing to renew the surface when its factory-applied wear layer starts to wear thin. But sometimes, bad stuff happens to perfectly good floors.

At our house we had a bad habit of bringing home the pizza and putting it in the oven on a low setting to warm it up, still in its box. One day, my son was home alone and

tried to warm up the pizza I'd left on the counter. It was still in the box; I don't know the oven temperature he set.

The box caught fire, my son threw it on the vinyl floor and doused it with water and baking soda. No one was hurt, and the only damage was a nice, 2" square burn mark in the middle of the kitchen floor. You can be sure that no one in my house ever put a pizza box in the oven again! My heart still beats fast when I think of the dumb example I set for my children.

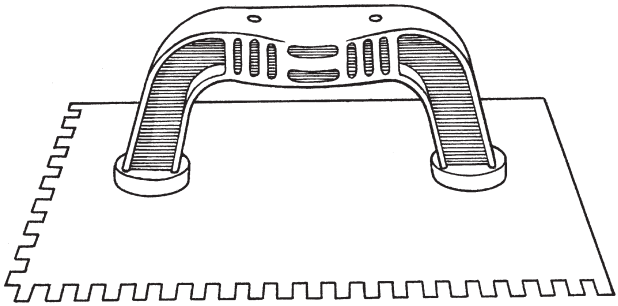
We were years away from renovating the kitchen, but fortunately I had some leftover tile. Here's how I made the repair.

Replacing a Vinyl Tile

You must have a replacement tile for this one. Bring your replacement tile to the floor or hardware store and get the right adhesive and solvent.

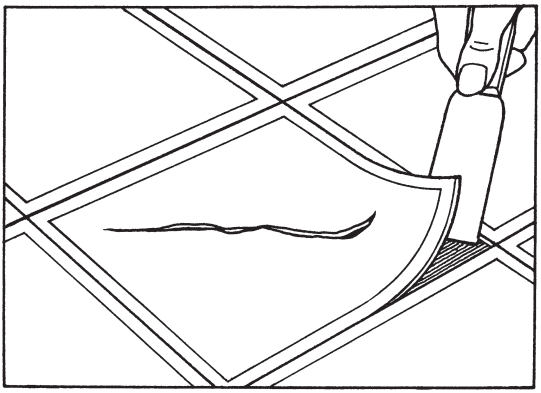
You'll also need the following:

- Kitchen towel
- Steam iron
- Putty knife
- Notched trowel
- Adhesive for the tile
- Appropriate solvent to clean excess adhesive
- Clean rag to apply the solvent



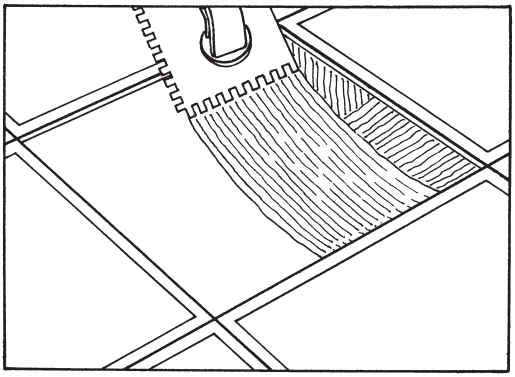
A notched trowel is used to apply adhesive for all kinds of tile and other flooring materials. Its notches leave a swirled pattern.

1. To soften the tile, place a towel over the damaged piece and iron it on a medium setting until the tile (and underlying adhesive) is very warm and begins to soften.
2. Remove the damaged tile by prying it up at one corner with the putty knife; gradually and carefully pull it up and off. (If you need to soften it more, lay it back down and apply more heat with the iron over the towel.)



Remove the damaged tile.

3. Let the adhesive cool and harden, then scrape up the dry adhesive with the putty knife until the subfloor is smooth, clean, and flat.
4. Using the notched trowel, apply the adhesive to the clean, dry, flat subfloor. If any adhesive settles on the adjacent tiles, clean them up with the solvent, according to the directions.



Apply adhesive for tile replacement.

5. Position the replacement tile above the adhesive-covered opening; make sure you've got the pattern, if there is one, going in the right direction.
6. Set two adjacent edges of the new tile against two adjacent tiles surrounding the repair; again, make sure the pattern matches. Press the tile into place.

If any adhesive comes up between the new tile and the adjacent ones, clean it with the solvent according to directions. Set the new tile level with the surrounding pieces; if it's too low, pull it up and add more adhesive.

If it's too high, press it down hard, and clean up any excess adhesive that squishes up at the edges with the solvent. Don't walk on the floor until the repair dries completely (check drying time on the adhesive container).

Patching Sheet Flooring

If you look at the illustrations for patching a hole in wallpaper in Chapter 5, this repair is done in a similar way, just with a different material. Again, you'll need a leftover piece of flooring, enough to cover the damage and match the pattern.

You'll also need the following:

- Utility knife
- Straightedge
- Painter's or masking tape

Many floor patterns have imprinted seams in the shapes of blocks, bricks, or other geometric forms. Try to make your patch so the edges fall within the pattern's seams; it will be less noticeable.

1. Cut a piece of the leftover flooring with a utility knife and a straightedge. Work on a protected surface so that the utility knife doesn't damage bare wood (or the good portion of your floor!).
2. Position the replacement piece over the damaged area and match up the pattern. Secure this piece to the surrounding floor with painter's or masking tape. Cut a patch large enough to cover the damaged area by using the straightedge and utility knife to cut through both the replacement flooring and the old flooring, around the damaged area. Set aside the replacement patch you've just cut. Now you're ready to remove the damaged piece of flooring.

Removal and replacement are exactly the same as the fix for replacing a tile. Use the same tools and materials, and follow Steps 1–6 for "Replacing a Vinyl Tile," described earlier. You'll be substituting your patch for the replacement tile, but the procedure is the same.

Ceramic Tile Floor Repairs

If you drop a pot or a tool and break a tile, or if the grout is chipping away, you can handle replacement and grout repair by following the instructions for wall tile repairs in Chapter 5. It will actually be a bit easier working on the floor instead of the wall!

To keep your floor grout in shape, you should treat it every year or two with sealant. This will make it easier to clean; it also keeps out the water you use when mopping—repeated soaking will degrade unsealed grout.

Carpet Capers

Wall-to-wall carpeting feels great under your feet on a cold morning. And manufacturers have worked hard to perfect carpet technology so that this stuff is more stain resistant than ever. When you have new carpet installed, be sure to ask the dealer or installer to provide manufacturer's specifications for cleaning the type of fiber your carpet is made of (file it in your home workbook!); knowing this info will help you when someone drops something nasty on it down the road.

Taking Up a Wall-to-Wall Carpet

Sometimes you just have to get beneath your carpeting—a squeaky floor, perhaps, or a run of pipe that's in a crawl space the plumber can't get to from below.

Wall-to-wall carpet is usually attached around the perimeter of your room by means of narrow *furring strips* that are nailed to the subfloor along the walls. These furring strips are treacherous! The carpet sticks to them by means of dozens of protruding carpet tacks. So lifting the carpet for any reason can hurt you if you're not prepared.

def•i•ni•tion

In construction, **furring strips** are thin, narrow pieces of wood used to provide backing to support a finished surface. In the case of carpeting, the strips are prenailed with carpet tacks, making a base to hold down the edges of the carpet. The carpet padding is cut to fit within the perimeter of the strips, then the carpet is laid on top. It's all very neat.

You'll need the following:

- ❑ Pry bar
- ❑ Wood shims
- ❑ Rubber mallet

You'll also need to move any furniture that obstructs the area you're trying to get at. Ease the heavy lifting by asking a friend or family member to help you with the moving. Four hands are also better than two when you're trying to move carpet. Its backing material—the stiff burlapy stuff that holds the fiber—is tough and sometimes heavy.

The process is simple.

1. Wearing a pair of heavy, good-fitting safety gloves, start in a corner of the room that's nearest to the spot on the floor you want to reach, and use the pry bar to loosen the edge of the carpet from the tacks, then pull the carpet up at its edge. If you've got base molding around the perimeter of the room, you can place a shim behind the heel of the pry bar to protect the molding from getting blemished or nicked as you pry up the carpet. Peel back as much carpet as you must to get to the problem; you'll probably have to weight the carpet ends with a pile of books or piece of furniture to keep them from snapping back at you.
2. Once you've got the carpet pulled back, you'll also have to deal with the padding, usually nice, light, springy foam stuff that's not too hard to handle. Fold this back too, and do your repair.

   Be aware of the tacky furring strips. You don't want to put a bare hand down on them; the tacks can also snag your clothes.
3. When you finish your repair, first replace the padding; make sure it's nice and flat before you pull the carpet down.
4. Press the carpet in place along the furring strips, using a rubber mallet to hammer the carpet (gently) back in place on the tacks.

Dealing with Spots and Spills

Many years ago, I was invited to a cocktail party at the home of a very famous writer and his equally illustrious wife. They lived in a beautiful brownstone townhouse in Manhattan. It had just been decorated: white rug, white upholstery—it was a

blizzard in there! I made the mistake of taking a glass of red wine, and of course someone bumped me from behind. The full glass of red wine began to seep ominously into the pristine carpet. I was horrified, and sure that replacing the rug would take all of my salary for a year or two.

Fortunately, the hostess was as smart as she was famous, and also most gracious to a young, clumsy woman (me). She quickly retrieved a towel and a bottle of club soda from the kitchen and blotted up the red wine. The blotting, the towel, and the club soda did the job perfectly. Her rug was saved, as was my equilibrium.

In addition to keeping plenty of clean towels and club soda on hand for clumsy guests at cocktail parties, here are the ABCs of spot and spill cleaning:

- **Act quickly.** The sooner you can take action to remove a substance from the carpet, the more likely you'll be to prevent a permanent stain.
- **Blot, don't rub.** Rubbing at the spill only sticks the mess more securely to the carpet fibers.
- **Continue.** You may have to repeat the process more than once. Persistence usually pays off.

You should keep a bottle of carpet spot remover with your cleaning supplies just in case of spills. Read the label, as not all removers work for every type of spot.

There are hundreds of substances that can leave their mark; refer to Appendix B for some good websites with further information on treating different kinds of stains.

Here are a couple of general guidelines:

- When you start trying to remove a spot, whether liquid, gooey, or solid, work from the outside toward the center of the spill, so you don't spread the mess around.
- Pudding, peanut butter, melted chocolate, and other gooey, semi-solid spills can be gently scraped up and lifted with a spoon or table knife. Remove as much of the stuff as you can with this technique, then use your spot remover and blot with paper towels. Don't rub. Repeat until you've done your best. When you're finished, rinse the area with water and

Ounce of Prevention

When you buy a bottle of spot remover, don't wait for the first spill to see if it's compatible with your rugs. Apply some (follow the package directions) to an inconspicuous corner of the carpet, and blot it up with a paper towel. If you see the carpet color on the paper towel, the remover and your rug are not compatible. Try another brand.

blot with paper towels. You can leave some dry towels on the spot and weight them down to soak up the water. When the towels have done their job, let the area dry some more.

- With ground-in dry solids, break them up with a fork or table knife and vacuum. Use the spot remover, followed by the blotting technique, for whatever residue remains.

When Spot Makes a Spot

Pet urine can really mess up a carpet. I won't get into the psychology of why cats and dogs suddenly lose their manners. That's a subject for another book, but here's what you can do to take care of this business, pronto.

For stains that are still wet, follow these steps. You'll need the following:

- Paper towels
- Newspaper
- Bucket of cool water

1. Place a thick layer of paper towels on the wet spot; on top of this put a nice thick layer of newspaper. Weight the area with some heavy books, or stand on top of the newspaper/towel layers for a couple of minutes, then remove the dampened paper, and repeat the process.
2. Rinse the area with cool water (warm or hot water will set the stain). Remove the water by blotting it up with paper towels. Let the area dry and, if an odor remains, use the product recommended below.

For stains that have already dried, try this:

Go to a pet store and find an odor neutralizing product and follow the instructions. These special solutions contain enzymes that work on the odor caused by urine. My friends and I, pet owners all, swear by a liquid neutralizer called Nature's Miracle, but there are other enzyme-based cleaners that also do the trick. The key is to follow the directions and repeat applications if needed. And repeat after me, *blot* the spots, don't rub them.

If Spot or Fluffy returns to the "spot," it means you haven't gotten rid of all the odor. Repeat the process, or go to the more radical solution, described next.

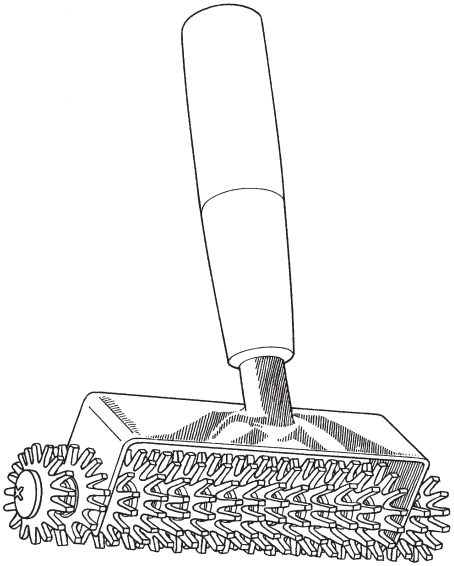
Replacing a Stained or Damaged Section of Carpet

When all else fails, a badly discolored stain, a burn, or a tear in your wall-to-wall carpet can be cut out and replaced with a patch. This technique works on cut pile carpets; a patch is hard to hide on a looped pile rug. If you've got the latter, it's time to call in the professionals, or put a nice area rug over the bad spot.

This repair requires a piece of carpet that matches what you've got. Hopefully, you've saved your leftovers from the installation. If not, and you've carpeted a closet with the same material, cut a piece from a back corner or from under a piece of furniture. I'll never tell!

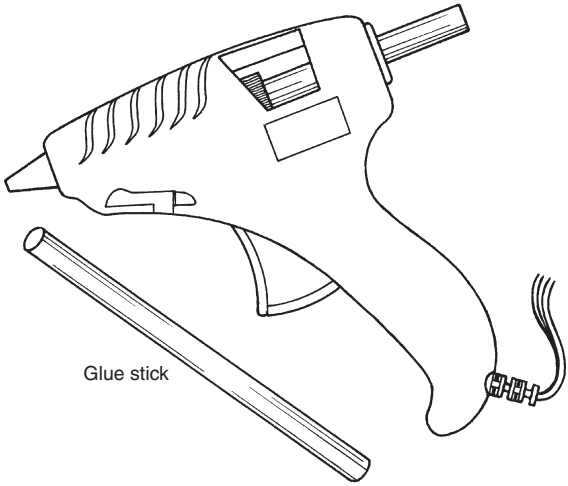
In addition, you'll need the following:

- Utility knife
- Straightedge
- Hot glue gun
- Carpet tractor



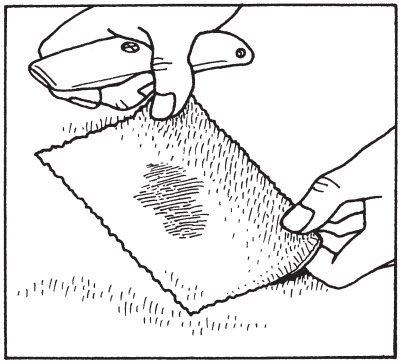
If it were any larger than a hand tool, a carpet tractor would look like an instrument of torture. Rolling it over the seams between pieces of carpet hides the seams and blends the carpet fibers together. It's not cheap—about $30—but it's a lot cheaper than a new carpet.

Crafters know all the wonderful ways a hot glue gun can pull things together. Available in corded or cordless (battery powered) models, these little heater/applicators use small sticks of glue that are heated and then squeezed out of the nose of the gun.



1. Use the utility knife to cut out a square around the stained area; guide the knife with your straightedge, and leave a border of 2"–3" around the damaged spot. Try to cut between the fibers so you only cut the backing, and take care not to cut the padding underneath.

Cut out the damaged area of carpet. You'll use the damaged piece as a template for your patch.



2. Use the damaged cutout as a template to cut the replacement patch from your leftover piece.

3. Apply glue to the edges of the patch, and set it into place. (Be careful of the gun's tip; it's hot when turned on. And keep the gun in an upright position when you're using it; laying it on its side can damage this little tool's thermostat.) As you set in the patch, work the glue into the edges of the carpet and the backing. Check the seams to see that they're well glued. If there are any gaps, carefully remove the patch, add glue, and reset.
4. Use the carpet tractor to roll the seams of the patch.

First Aid for Floating Laminate Floors

With a finish that's tougher than hardwood, floating laminate floors are a homeowner's dream. It's really difficult to hurt them. Manufacturers sell repair kits to hide any surface flaws that develop.

If a strip gets punctured or badly scratched and needs to be replaced, here's how to proceed.

Fortunately, damage most often occurs in the hard-wear areas of a floor: at entryways and along high-traffic hallways. Because floating floors actually "float"—their tongue-and-groove, snap-together design is resting, but not nailed on an insulating underlayment—they can be removed without pulling nails or sawing them apart.

If the damaged piece is close to a wall, the replacement is something like taking apart a jigsaw puzzle, then putting it back together. All you need to do is carefully and gently remove the baseboard molding and, starting with the piece closest to the walls, disengage the tongues from their interlocking grooves until you reach the piece that needs to be replaced.

To do this repair, you'll need a replacement piece to match the damaged one. And to remove baseboard molding, you'll need the following:

- ❑ Pry bar
- ❑ Wood shims
- ❑ Hammer
- ❑ Nail set

1. Start from the corner of the room nearest the damaged board. Move all furnishings, rugs, and obstructions from the area to clear your working space.

2. The baseboard molding is generally nailed at its seams and where the molding passes over an underlying framing stud. First, wearing work gloves, pry the molding at these nailing points, then pry the molding carefully from the wall with your pry bar, putting a shim under the heel of the pry bar to protect the wall.
3. Starting closest to the wall and the corner, remove the floorboards one by one until you get to the damaged piece. Remove the damaged piece, and click in the new one. If it is an end piece and has been cut, you'll need to saw the new board to the same size. Measure carefully, and be sure you cut the right small end of the board—one end has a tongue, the other a groove; check before you cut!
4. Click the rest of the floor back together and replace the molding. Use a shim between the hammer and the molding when you nail it back in.

What Pros Know

If a board has been ruined, and it's in the middle of the floor, the repair is a time-consuming process. The board needs to be cut out, removed, and a new one fitted and glued, so the floor no longer "floats" in 100 percent of its area. This is a painstaking and tedious process. I suggest picking up the phone and calling your installer for this fix.

If you've bent any nails, drive them through the backside of the molding, using the hammer and a nail set that matches the nail head. Drive in a new nail to replace the one you've removed. Countersink the nail; you can repair the nail holes with wood putty. When the putty dries, paint or use a wood-tone putty stick to match the baseboard.

Ceiling Repairs

Most ceilings are composed of drywall; in older homes, they may be plaster. You can use the same techniques used to repair wall flaws that are described in Chapter 5, with one difference: you'll be working on a ladder. This means that you need to always wear goggles and some head protection (a cap or bandanna) to shield yourself from any debris that falls when you're working. Follow the rules for ladder safety in Chapter 2. Be sure your stepladder is tall enough for you to work comfortably; remember, the rule of thumb is that a ladder gives you its height, plus 4 feet, as its total comfortable upward reach.

Some ceilings are in terrible trouble. Plaster is chipping, and perhaps the cracks or holes you already repaired are not holding their own. There may be underlying structural damage, or a leak somewhere above the ceiling. Water stains are a clue that the damage extends beyond wear and tear; moisture is coming from a leaky roof or pipe.

Badly damaged ceilings take a lot of work and time, and you should call a pro if your ceiling's "time" has come.

The Least You Need to Know

- Hardwood floors sometimes stain, spot, squeak, and warp, but you can fix a good portion of what ails them.
- Pilot holes are the best way to get a nail or screw into hard materials. If you're in doubt about which drill bit matches the fastener you're using, bring the fastener to the store and ask the hardware guy—or gal—to help you pick it out.
- You can soften up a vinyl tile with a steam iron and a towel to make it easier to remove.
- Removing stains from carpets requires quick action and no rubbing! Also, if at first you don't succeed, repeat the removal process. When all else fails, you can repair a small damaged area with a replacement patch.
- Repair of drywall and plaster ceilings is quite similar to fixing flaws in walls. Just use your ladder safely!

Chapter 7

Stairs: A Few Steps to a Happy Landing

In This Chapter

- The anatomy of a staircase
- Silencing annoying, squeaky stairs
- Fixing a loose tread
- Securing handrails and balusters
- Making your stairways safe for elders and children

Fixing a staircase is usually a matter of tightening up its parts. Most stairs are constructed of wood, and wood is a responsive material: it expands when the surrounding humidity increases and shrinks when its environment is dry. Even though we can't see it happening, these tiny movements in the wood, coupled with human contact—you, your family, and your pets, walking, stomping, and bounding up and down, every day—loosen the parts of a staircase. Eventually, the stairs begin to talk, as only stairs can: they squeak.

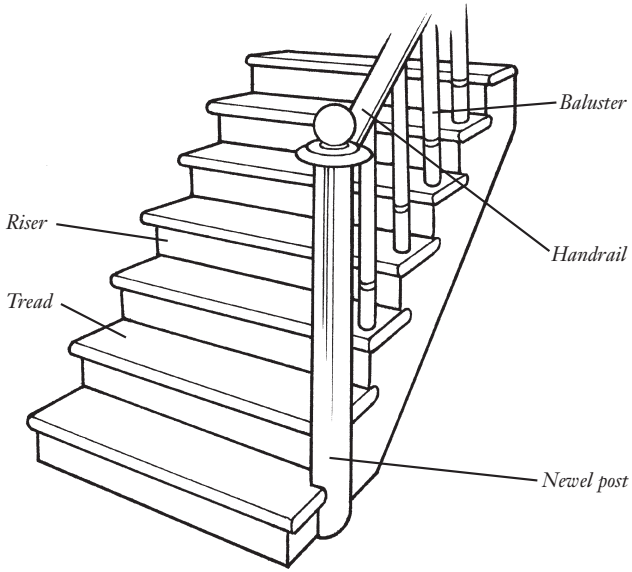
If the joints of your staircase are not as snug as they once were, you can help them settle down.

Stairs can also be a hazard for the elderly and for small children. I'll talk about a couple of fixes to improve safety, too.

Parts of a Staircase

It has more parts, but for our purposes, this is what you should know about staircases. Let's start with what we step on: the horizontal part of a step is called the *tread;* the vertical part is the *riser*. The *banister*—what we hold onto going up and down—has three main parts: the *handrail* that we grasp, the vertical posts spaced evenly along its length, which support the handrail, called *balusters*, and a larger, supporting vertical piece at the bottom of the handrail, called a *newel post*.

Anatomy of a staircase.



Silencing Squeaks

Squeaky stairs signal loose joints, and they're fairly easy to fix. We'll start with the simplest procedure, and go from there.

A Lube Job

This doesn't make it easier, but if you must, remove carpet and padding from the steps to get to the stair. (Find out how in Chapter 6.) Follow the directions and watch out for furring strips, which may be located not only at the top and bottom of the stair run, but also at an interval or intervals where seams of the carpet start and end.

To mark the offending steps, you'll need your roll of painter's or masking tape.

Ask the heaviest member of your family (no offense intended) to walk up and down the stairs so you can locate the protesting tread or treads. Mark them with a piece of tape.

You'll also need some powdered graphite, which comes in a little squeeze bottle. You can squeeze the graphite out of the container and into the offending, noisy *joints*. In the case where the joint is between the top of the riser and the tread, you might want to hold a piece of cardboard underneath the graphite bottle to catch the falling powder, then blow it off the cardboard into the joint.

This will lubricate the joints, and may be all you need. If not, try the next procedure.

def•i•ni•tion

In carpentry, a **joint** is the intersection of two pieces of wood. There are many different kinds of wood joints.

Repairing Squeaks from Below the Stairs

Like the wood floor fixes in Chapter 6, taming squeaks is much easier if you can get to them from under the stairs.

You'll need the following:

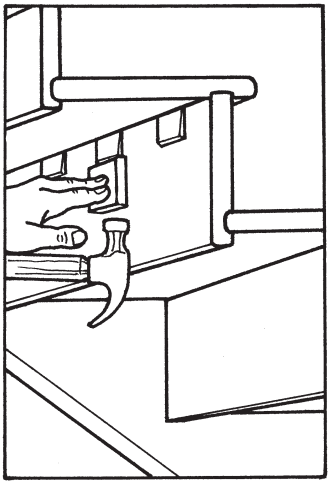
- Hammer
- Wood shims
- Carpenter's glue (yellow)
- A small block of wood for driving the shims

1. Put on safety goggles to protect your eyes from falling debris. Since you've already marked the offending stair(s), have your friend stomp on the squeaky treads, so you can see what moves.
2. Coat the wood shims with glue, and tap them, thin end forward, into the joint between the offending tread and its riser. Drive the shims in by placing the wood block between the butt end of the shim and the hammer head.

What Pros Know

Basements can be dark, and sometimes it's hard to position a flashlight and work simultaneously. If your work area is poorly illuminated, buy yourself a work light. It's essentially a light bulb in a socket, surrounded by a little plastic cage, with a long cord, that you can hook or hang where you're working. Just always be aware of the cord so you don't trip yourself.

Silence a squeaky stair with wood shims.



Fixing the Squeak or Loose Tread from Above

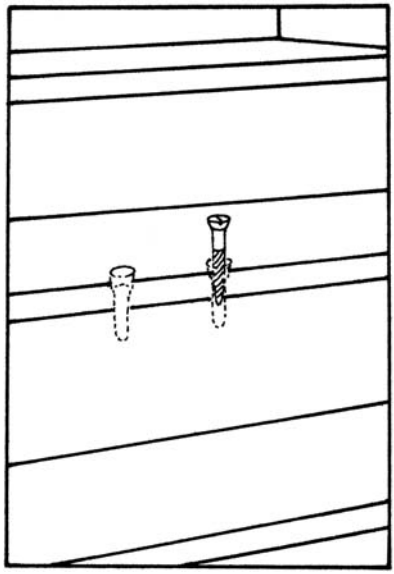
You can tighten the joint between tread and riser by drilling straight down through the tread into the riser, and inserting and tightening the screw.

Be sure to mark the location for your drill bit carefully, and keep your drill bit straight—that is, perpendicular to the surface you are drilling. You don't want the screw to go through the tread and miss the riser!

You'll need the following:

- Measuring tape
- Pencil or awl
- Electric drill
- Combination bit sized for the screw you're using
- Screwdriver
- Flathead wood screws ($2^1/_2$")
- Wood putty
- Sandpaper (220-grit)
- Finish or paint to match stair surface (not important if the stairs are covered)

1. Measure carefully if your stair tread is not flush with the riser; most treads extend at least $1^1/_2$" from their supporting risers. The edge of a standard riser where it meets the tread is $^3/_4$" thick, and ideally you want to drill into the center of the riser. Mark the spot with a pencil or awl.
2. Wearing safety goggles, drill two or three pilot holes; insert and tighten screws below the tread surface.



Insert screws from above.

3. Fill the holes with wood putty; wear gloves to protect your hands if you don't like to handle the putty. Let the putty dry, sand, and finish as desired.

Another way to fill the gap left by a countersunk fastener is to buy a package of small, round wooden plugs, the same size as the screw head. These are called *dowel plugs*, because these small wood wafers are cut from a wooden dowel. Coat one side of the plug with glue and insert the glued side in the hole; then finish as desired. Some people like to use these plugs; others prefer the putty fix.

Getting a Grip on Handrails

With use, time, and fluctuations in humidity, the vertical balusters sometimes loosen in the *mortises* where they join the handrail, causing a shaky situation that's not good when you're negotiating stairs—the handrail should support *you*, not the reverse.

def•i•ni•tion

A **mortise** is a hole or slot cut into wood or other material so that a projecting piece (called a tenon) can be precisely inserted. In woodworking, a mortise and tenon joint creates a good bond between two pieces of wood.

Here are two ways to tighten the relationship between handrail and baluster.

For the "shimy" solution, you'll need the following:

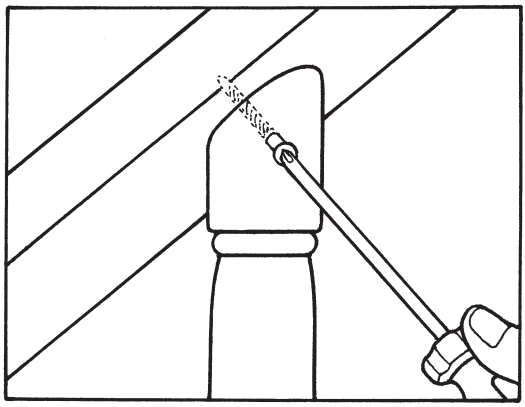
- ❑ Wood shim
- ❑ Carpenter's glue (yellow)
- ❑ Small wood block (to drive the shim)
- ❑ Hammer
- ❑ Utility knife

1. Coat the wood shim with glue.
2. Using the small block as a driver, hammer the shim into the joint between the baluster and the handrail. Don't try to drive the two pieces apart, just drive the shim until it closes the gap between handrail and baluster.
3. Using the utility knife, trim the shim flush with the banister. Shims are pretty easy to cut; they're softwood.

For the "screwy" solution, you'll need the following:

- ❑ Electric drill
- ❑ Combination bit sized for the screw you're using
- ❑ Screwdriver to match screw head
- ❑ Flathead wood screws
- ❑ Wood putty
- ❑ Sandpaper (220-grit)
- ❑ Finish to cover repair (wood finish or paint)

1. Wearing safety goggles, using the combination bit, drill a pilot hole up through the baluster into the handrail at a 45° angle.



Angle a screw through the baluster and handrail.

2. Drive in, countersink, and tighten the screw.
3. Fill the hole with wood putty; let it dry. Sand the repair and finish as desired.

Off-Base Balusters

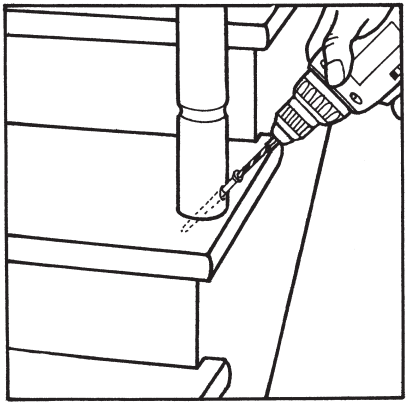
Sometimes the baluster gets loose in its bottom mortise—its joint with the stair tread. You'll need another pilot hole and countersunk screw for this one.

You'll also need the following:

- ❑ Electric drill
- ❑ Combination bit sized for the screw you're using
- ❑ Screwdriver to match screw head
- ❑ Flathead wood screws
- ❑ Wood putty
- ❑ Sandpaper (220-grit)
- ❑ Finish to cover repair (wood finish or paint)

1. Wearing safety goggles, drill the pilot hole at an angle through the baluster and into the tread.

Tighten a baluster with a screw support.



2. Drive in, countersink, and tighten the screw in the predrilled hole.
3. Fill the hole with wood putty; let it dry, then sand and finish.

Safe Stairs

For elders and children, a staircase can be a hazard. A secure handrail and stair treads tight to the risers are great first steps, but the young and the frail may need extra help.

Ounce of Prevention

Equip the electrical receptacles (outlets) in your stair halls with night lights. They use a miniscule amount of energy but make the way safe for anyone who's moving around when the house is dark. Keep a supply of the little bulbs with your other light bulbs, so you always have a spare when this little "night watchman" suffers a burnout.

Elder Safety

Falls are the leading cause of life-threatening, debilitating injury for the elderly, and falls on stairs are a common culprit. If you have an older person living with you, you want to make sure that they can *see* the steps.

You'll need the following:

- Scissors
- A roll of reflective tape (it glows in the dark, a plus at night and during power outages and other emergencies)

1. Make sure the stairs are clean and dry so the tape will adhere.
2. Cut each strip of tape so that it will extend the entire length of the tread.
3. Secure the reflective tape to the top, front edge of the tread. Make sure it is lying flat. Place the tape on the top front edge of the stair landing, and every stair in the staircase.

If there are any step-ups or places where the floor is uneven—sills in doorways, for example, where an elderly person might trip—mark these step-ups and sills with reflective tape as well. Even a half-inch rise in the floor surface could create a problem for someone with poor mobility or vision.

Kidproofing the Stairs

Child safety gates have been around for years. They're an inexpensive way to keep active and curious youngsters from an accident on the stairs, or any other place where they might find themselves in harm's way.

When my son was just 10 months old, he was quite the little bruiser, built solid and full of energy. We had put safety gates on our stairs, but at that time, what was available was a fairly simple design that clamped to the sides of the stairway by means of pressure. There were no fasteners on the thing that I could screw into the wall.

One day, my boy was cruising around on the upper floor in his little walker, careening against the walls (why I learned to repair drywall). He worked up such a head of steam that, in a split second, he crashed against the pressure-installed gate and was on his way down the steps when I grabbed him, and the walker, preventing a disaster. Within an hour I was at the hardware store, looking for the right straps and screws to secure the gate to the walls. We rigged our own safety setup. And the walker went, as my son would say when he couldn't locate something, "bye-bye someplace."

Pressure mounted gates are still around, but the Consumer Product Safety Commission does not recommend their installation at the top of stairs, because children (like someone I know) can push them over and fall down the stairs. Select gates with hardware mounts, screw them into the wall securely, and periodically check the screws to see that they are still tightly fastened.

The Least You Need to Know

- A staircase is made up of the tread, riser, handrail, balusters, and newel post.
- You can make invisible repairs to the stairs if you can get at them from underneath.
- Wood shims and countersunk screws tame squeaks and tighten wobbly parts.
- Add safety insurance to your stairs: night lights in the hall, reflective tape on the treads for your elders, and hardware-mounted safety gates for your tots.

Chapter 8

Getting Clear About Windows

In This Chapter

- Parts of a window
- How double-hung windows work
- Smoothing the passage of sticky windows, and tightening up loose ones
- Dealing with the pain of broken panes
- Common screen repairs

Your home's windows are its (and your) eyes on the bigger world. In addition to lighting your interiors, keeping fresh air flowing in good weather, and shutting out the elements when it's foul outside, windows that work and look good make a statement about you. So subdue that stubborn sash, banish those broken windows and torn screens, and give your home a clean, bright face.

What a Pane! Parts of a Window

There are many kinds of windows, but nothing's better for your *fenestration* vocabulary than learning the names of the parts of the most common window style—the double-hung. Now you can talk the talk!

def•i•ni•tion

Fenestration is the term architects use for the design and placement of windows in a building.

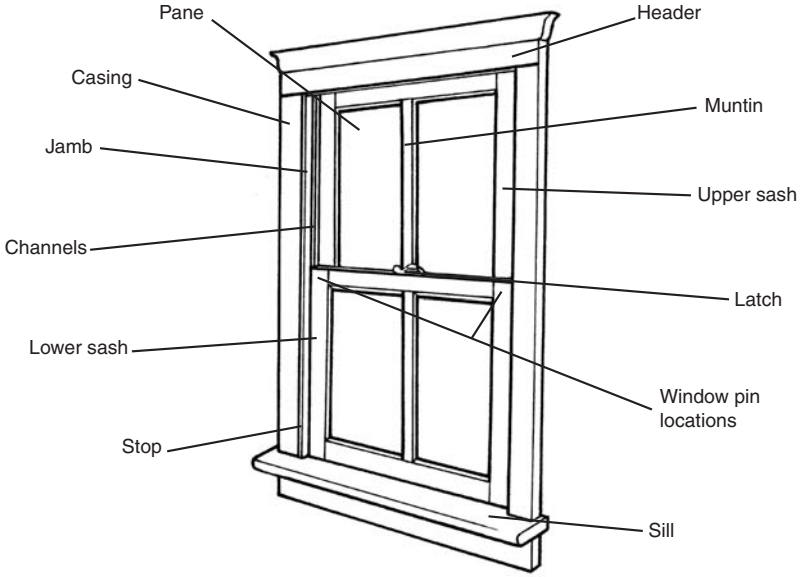
Let's start from the top. The *header* is the top horizontal piece of the frame. The *jamb* refers to the vertical side pieces of the frame. The *sill* is the horizontal part at the bottom of the frame. (Looking at the window from outside, you'd see the stool where the sill is, often supported by a small board called an apron.)

Now let's get to the real business of this window. Double-hungs have two moving pieces, called the *sash*. The piece on top is the *upper sash*, which can be lowered from its closed position, and on the bottom is the *lower sash*, which can be raised. The rails are the horizontal part of the sash frame and the stiles are the vertical parts.

The sash, upper and lower, hold the glass portion of the window. A single piece of glass is called a *pane*. A sash can have one or more panes; the dividers between the panes are called *muntins.* On both vertical sides of the sash are *channels*, which guide the sash up or down in a straight line. The small molding piece that runs up the front, at the sides of the lower sash is called the inside *stop*, which keeps the sash running smoothly in its channel. The sashes lock together by means of a two-piece *latch*, positioned atop the upper rail of the lower sash, and the bottom rail of the upper sash.

If your windows look like double-hungs, but the upper sash doesn't move, these are called single-hung windows.

Are you getting clear about windows yet? Don't worry; review the illustration if you forget some of the names referred to in the repairs.



Parts of a double-hung window, as it looks when viewed from inside.

How Double-Hung Windows Work

Modern double-hung windows are truly things of beauty. Double glazed, weather-stripped, and vinyl-clad at the factory, they need very little maintenance. In the spring and fall, you just clean the channels, and spray and wipe the moving parts with a little lubricant.

When it's time to wash the glass parts, the real benefits of modern double-hung windows are even more apparent. The sash of most good-quality double hung windows can be removed from their channels and washed. No more ladders, no more freezing fingers as you try to clean them from the outside. Technology can be a blessing.

However, this part of the chapter is not for owners of fabulous, new, easy-care windows. It's for the rest of us who have sticky, drafty, balky, and unrepentant old wood windows that need more than their fair share of attention. So let's get busy!

Stubborn Stuck Sash

This section proceeds from a no-load solution to some nitty-gritty ideas.

Wait and See

This is not often the case (it's too easy), but sometimes the only problems with your windows is that it's been hot and humid for days. If the windows worked well before the heat wave, you may want to leave them alone temporarily.

Once a dry spell arrives, your windows may go up and down as before.

Don't take drastic action to sand or plane windows during humid seasons. While they may be sticky in the spring and summer, the cooler, drier months could set your newly sanded windows rattling in the jambs because you removed too much wood. If you are trying to make balky windows glide to your tune in summer—when you need to open and close them frequently—try the less invasive fixes.

Gentle Tap, Tap, Tapping

Before you disturb the paint on the windows with any type of prying tool, you can try this little wake-up call. This technique works best if you can work both sides of the window; you may need a helper if the windows are on the second floor and require a ladder to reach their exterior side.

You'll need the following:

- ❑ Small wood block
- ❑ Piece of heavy cloth
- ❑ Duct tape
- ❑ Claw hammer
- ❑ Sponge
- ❑ Lubricant or silicon spray

1. Make sure the sash is unlatched. Wrap the wood block in a piece of heavy cloth or felt to protect the finish on the windows. Keep the cloth in place on the block with some duct tape, if you like.

2. Place the block against the frame along the bottom rail of the lower sash and gently tap it with the hammer along the width of the sash. If your windows are on the first floor, go outside and do this to the same rail on its exterior side. Gradually work along the stiles of the sash, inside and out, working upward until you reach the top of the window.
3. If this frees the sash, move it up and down, and examine the channels. Clean out any debris and dirt with a damp sponge. Let dry, and spray some lubricant or silicon spray in the channels.

What Pros Know

If your windows are stuck because they've been painted shut, use a utility knife to carefully score the paint that has bonded any window parts together: between stop and sash, between upper and lower sash, between sill and sash. You'll only do more damage to the paint if you skip this step before trying to move or pry the windows.

Don't Want to Pry, But ...

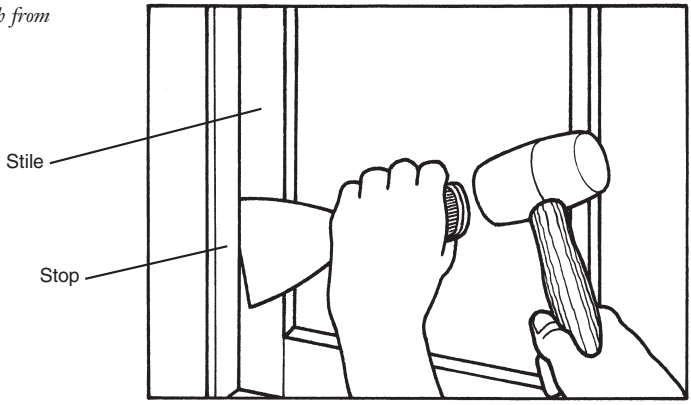
If gentle tapping doesn't work, you'll need a stronger approach. You'll need the following:

- Putty knife
- Rubber mallet
- Pry bar
- Shim or thin block of wood

To pry the window from inside:

1. Make sure the sash is unlatched. Insert the blade of a putty knife into the crack between the stile of the lower sash and the stop, tapping it lightly with the rubber mallet to free the window. Do this along both stiles.

Pry open a tight sash from the inside.



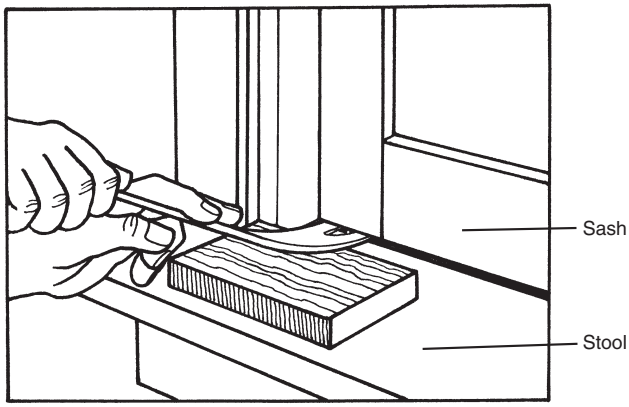
2. If this frees the sash, move it up and down. Work the putty knife into any spots that are still resistant.

Once the window is moving freely, examine the channels. Clean out any debris and dirt with a damp sponge. Let dry, and spray some lubricant or silicon spray in the channels.

To pry the window from outside:

1. Make sure the sash is unlatched. Using a thin wood block or shim to protect the stool from the pry bar, insert the pry bar into the crack between the stool and the sash. Work first at one end of the sash, then the other, so that the sash will move up evenly.

Pry open a tight sash from the outside.



2. If this moves the window, go back inside and open it. Examine the channels, then clean and lubricate them.

Windows That Won't Stay Open

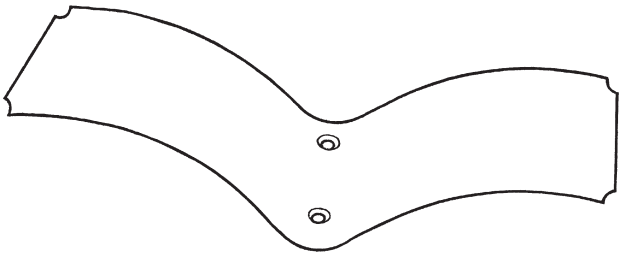
You can prop up a window that won't stay open with a stick or a ruler, set in the channel below one side of the sash. Or you can install some hardware, as described next. But neither of these "make do" fixes really corrects the underlying problem.

A sash that's loose in the jamb, and won't stay put when it's opened, usually means that its raising/lowering mechanism has failed. In old, single-paned wood windows, this is often a rope-and-weight pulley system; your window won't stay open because the weights have come loose from the rope, or the rope has simply broken from age and wear. If you look at the top of the jamb, you'll probably see the little pulley.

Some rope-and-pulley controlled windows have access panels in the jambs that allow you to get to the weights without removing the window casings. Even when you can get to them, though, this is a delicate, often frustrating (the weights fall down inside the walls!), and time-consuming job. Remember, these old, single-paned windows are probably leaky, and they're costing you for the extra money you have to spend on heating and air-conditioning your drafty house. The best fix is to start saving for new, energy-efficient sashes that can be fitted in the old jambs, or spring for completely new windows.

In the meantime, you can apply weather stripping at the joints of your windows: between sash and sill, between the sash and the stops, anywhere air is leaking in (put your hand at one of the joints on a cold, windy day and you'll feel the cold air passing through).

And to keep the windows up when you do want fresh air, you can install little stainless steel controls in the channels of the lower sash that provide some resistance to your weight-less window. They work like the stick or the ruler, but they're a bit more sturdy, and only cost a couple of dollars.



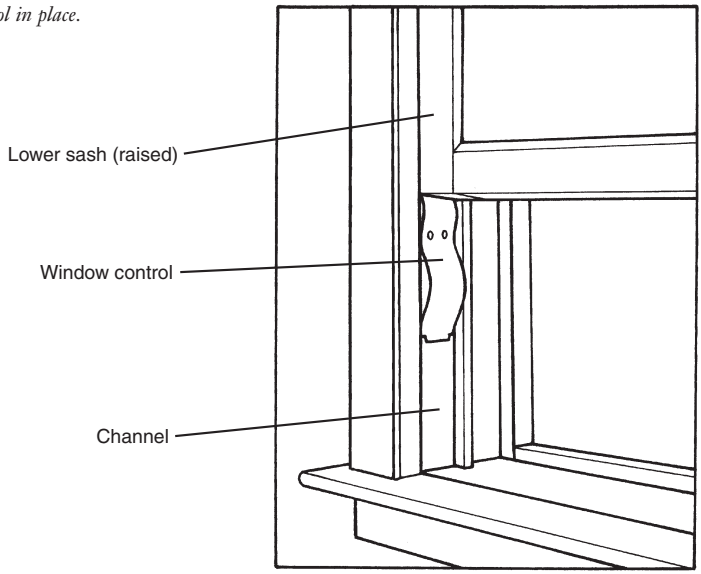
Window control.

To install them, you'll need the following:

- ❑ Ruler or dowel (to hold up the window while you work)
- ❑ One pair of window controls per loose window
- ❑ Claw hammer
- ❑ Box nails
- ❑ Measuring tape
- ❑ Pencil or awl

1. Raise the lower sash as far as it will go, and secure with the dowel or ruler; you may want to prop it on both sides for safety.
2. Position the control in the lower sash channel so that the nail holes (which have little burrs on the backside where they meet the channel) are about an inch below the highest opening you want for your window. Nail in one control.

Window control in place.



3. Nail in the control on the opposite side of the window. Measure and mark the location of the nail holes for the second control with the pencil or awl, so both controls are nailed at the same height in the channel.
4. Remove the supporting dowel or ruler and carefully lower the window so that the top sections of the controls are between the sash and channel as you lower the sash (see the previous illustration). The controls are flexible, so they act like springs to tighten the movement of the sash.

When Windows Break

Modern windows—the double-glazed, gas-filled, or tempered variety—are pretty sturdy. But when they break, you'll need a professional glass installer to fix them. Current building codes require that door glass (for *sidelights* and other door panes) be tempered. If it breaks, it does so harmlessly into about a million little chips per pane. I know this because my lawn guys got too close to our French doors with a weed-whacker, and it was doomsday for the bottom right pane. Specialized glass products have a little seal imprinted in a lower corner of the glass, which is your indicator that all such panes need professional replacement.

When tempered or other specialty glass breaks, you'll have to do a temporary repair until the glass man arrives. Even when you're just picking up glass chips, take precautions when you clean up the glass.

def•i•ni•tion

A **sidelight** is a window positioned next to a door. Usually doors with sidelights have one on either side of the door. Tempered glass has been heated and cooled repeatedly in a controlled environment to give it more strength than conventional, single-layer window glass.

You'll need the following:

- Newspaper
- Painter's, masking, or duct tape
- Putty knife
- Measuring tape
- Utility knife (to cut cardboard make-do)
- Sheet of corrugated (box) cardboard, or sheet of transparent acrylic plastic, cut to fit opening

To clean up a broken specialty glass window:

1. Sweep up and discard any chips of glass on either side of the window (interior and exterior). Tape a piece of newspaper on the inside of the opening so more glass does not fall inside. Wearing heavy gloves and safety goggles, and working from outside, use the putty knife to carefully knock off any remaining pieces of glass; put the debris in a supermarket paper bag (it's thick), and discard.
2. Measure the dimensions of the now-empty opening, and cut a cardboard template that you can put in place with duct tape or masking tape from the inside. (You can also take your measurements to a hardware store and get a piece of Plexiglas cut to fit, for a more aesthetic make-do.)

Ounce of Prevention

Large panes of glass are too heavy to handle. If your panes are larger than a foot-and-a-half square, leave replacement to the pros. You must handle glass carefully, by its edges, or it will easily crack. Start small if you want to learn to work with glass!

For small window panes that are single-glazed (one layer of conventional glass, no little imprint in the lower corner), you can replace them yourself. I don't recommend cutting your own glass unless you've had a lot of experience with a glass cutter (it's best to test your skill with a small pane first). Do the cardboard make-do fix, and take your window frame measurements to the hardware store so they can cut your glass.

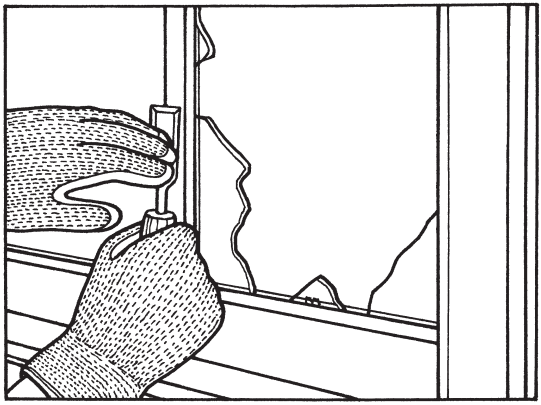
You'll need all the tools and materials mentioned earlier for removing tempered glass and installing a temporary make-do (cardboard will do until you get your replacement glass).

In addition, if you're doing the replacement, you'll need the following:

- ❑ Pliers
- ❑ Sandpaper (100–150 grit)
- ❑ Sheet of glass (see Step 6)
- ❑ Glazing putty (sold in ropes so you don't have to roll your own)
- ❑ Glazier's points
- ❑ Touch-up paint (for repaired window frame)

1. Unlike tempered glass, shards of single sheets of glass are very sharp. Work from outside and, as with tempered glass, tape newspaper on the inside of the window.

2. Wearing heavy gloves and safety goggles, remove the large pieces of glass first. Use the putty knife to knock out remaining small bits of glass.



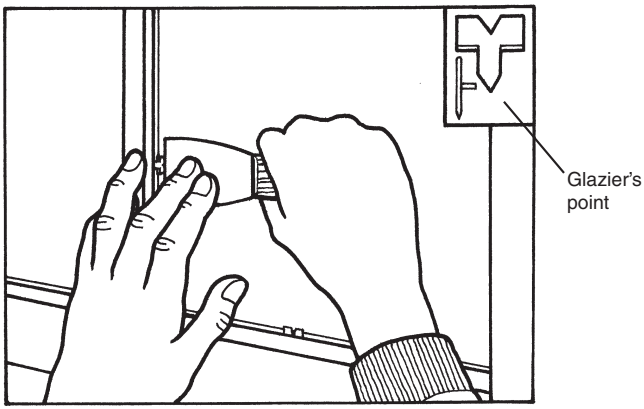
Remove a broken single-glazed pane.

3. Remove the old glazier's points with pliers.
4. Lightly sand the edges of the opening to get rid of any remaining putty.
5. Measure the window opening; measure and install the cardboard make-do.
6. Take your opening measurements (remember, measure twice, cut once) to the hardware store and get a piece of glass cut. Tell them that your measurements are the actual size of the opening; they'll cut the glass $^1/_8$ of an inch less than the total width and length.

Once you have your replacement glass, you can proceed with the next part of the repair:

1. Remove the cardboard make-do. Working from outside, press a rope of glazing putty, about $^1/_4$ inch thick, around all the edges of the window opening. This is your setup for installing the glass.
2. Carefully press the pane into place, then insert the glazier's points into the frame, pushing them in with the putty knife. Use two points on each side if it's a small pane. If the glass is longer than a foot in length or width, insert the glazier's point's every four to six inches.

Insert glazier's points into frame.



3. Apply another 1/4-inch rope of putty around the edges of the opening. Use the putty knife to smooth the putty and form a good seal with the window frame.
4. When the putty is dry, you can paint it to match the surrounding wood.

Screen Test

The screen and storm windows at our ancient house are heavy and cranky. They're in wood frames—no nice little slide-out or pop-out aluminum framed stuff. Our least favorite weekends in spring and fall are those when we have to change from storms to screens, and from screens to storms. But before we do any of the really tiresome leg work and ladder climbing, the stored windows must be cleaned. You clean storms the way you clean any window: with glass cleaner and clean rags or paper towels. And the spring changeover is the time to replace any storm window glass. If it's the single-glazed variety of storm window, you can follow the previous directions.

This is also a good time to clean the frames, if your storm/screens are of the slide-out variety. Clean the runners and the channels where they fit, and lubricate them with a lubricating oil or silicon spray—they'll go in and out more easily.

To clean dirty screens, simply spray the screens with your garden hose and clean them with the sponge (or a wire brush) and soapy water. Rinse, let dry, and hang 'em!

Screen Repairs

Once the screens are out, you may notice some defects: a loose screen here, a little hole there. Last spring while cleaning her window screens, my sister noticed that her big red Persian cat, Gizmo, had been slipping out of the house the previous summer because one of the screens for the living room windows had come loose from its frame. She had to replace it, or Gizmo would be doing his warm-weather wandering once again!

Here's how to handle common screen defects.

Small Holes

Holes in the screens let in all kinds of unappealing critters when your windows are open: mosquitoes, moths, flies, and other little creatures will take advantage.

To some of us, little repairs in a screen door might look a bit tacky, so if it bothers you to have a patch at your door, you might want to go all the way and replace the whole screen (see how in the next section; door screens work just like the window screens). But for window screens that don't get as much scrutiny as a front or back door, you can patch; it's a less time-consuming fix.

You'll need the following:

- Scissors
- Screen patch (these come in various sizes, available at most hardware stores; make sure the color/material is a close match to your screen—some are metal, some are fiberglass—or it really will show)
- Glue for fiberglass screen (ask the store salesperson for a good, waterproof variety)

def•i•ni•tion

A **filament** is a slender strand of fiber or other material. The thin wire that is the light-producing element of a bulb when electric current passes through it and the element that emits electrons in a vacuum tube when current is passed through it are also known as filaments.

You'll notice that screens are composed of lengths of fine, interwoven metal wire or fiberglass *filament*.

1. Cut a patch to fit over the hole in the screen; the patch should extend at least 1"–2" around the circumference of the hole.

2. You'll want to remove a wire or filament (or two) from each side of your screen patch to give you a little bit of extra length to make the fix.
3. Position the patch over the hole on the interior side of the screen. Insert the wire ends of each side of the patch into the intact screen holes around the tear or hole you are covering. Bend the wire ends so they grip the intact screen. You may want to use needlenose pliers or even a nail file to help you bend the wires—they're tiny, and tough to work with if you have big hands. If the screen is the soft, fiberglass filament type, you won't bend the ends—they'll lie on top of the edges of the repair. You can glue the ends to the existing screen with the waterproof glue.

Replacing Screens

If a screen has big holes or tears or has become loose and taken on a "wavy" look, you'll want to replace it. Even if the old screen isn't torn, if it's bulging in places it may be weakened by the stretching. You may as well get new material to work with. Use the old screen for patches (store it in one of your "leftovers" bins).

The most common window and door screens are attached to the screen's frame with a flexible, vinyl rope known as *spline*. The spline fits into a groove where mesh meets frame. If you look carefully at the corners of the screen, you may also see little plastic pieces that help fit the spline snugly in each corner.

def•i•ni•tion

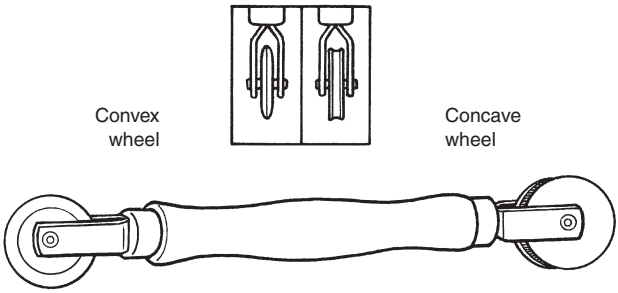
Spline is a piece of wood, metal, or plastic that is used as a connecting or framing piece between two sections of material. Spline can be used to hold a screen in its surrounding frame; the material that frames caning in a chair seat where it meets the wood or metal part of the seat is also known as spline.

If the screen is mounted in the window (or door), you'll need to detach it from the surrounding frame. In the case of window screens, you'll probably just need to pop or slide them out. A door screen may be mounted to the frame with screws; if so, unscrew the screen from the frame, take out the screen, and put the screws in the screw holes in the window or door with a couple of turns so they don't fall out. Loose screws are always rolling away and getting lost!

You'll need the following:

- ❑ Needlenose pliers
- ❑ Narrow putty knife or flat-tipped (standard) screwdriver

- Mesh screening
- Measuring tape
- Scissors
- Spline tool
- Utility knife
- Replacement spline
- Plastic corner pieces, if you have these in the corners



A spline tool is a hand tool with a wheel at each end. One wheel has a convex (◡) rim, for pushing the screen into the spline channel; the other wheel has a concave (◠) rim, for pushing the spline down over the mesh and into the channel.

While setting in the mesh and inserting the spline, an extra set of hands is helpful for holding the mesh in place. Or you can hold the mesh down at the corners you're not working on with a wood block or two.

You will need to bring samples of your mesh screening, old spline, and plastic corners (if they're used for your screens) to the hardware store so that you can buy the exact match of each material. There are different types of all three.

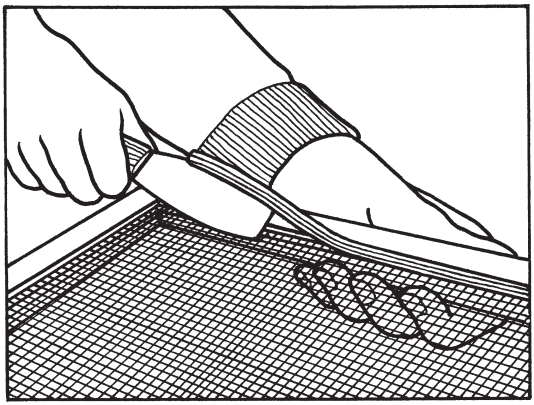
You will also need to measure the screen so that you buy replacement screening of sufficient size to cover the screen opening. Also, measure the perimeter of the window opening(s) so that you buy a sufficient length of spline.

What Pros Know

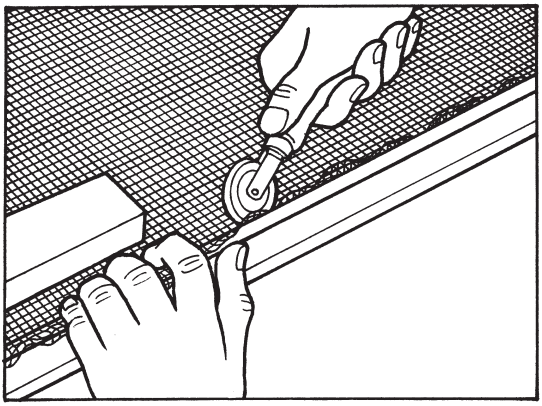
Remember geometry? If you do, skip this tip. If math gave you a rash, read on. It's not necessary to measure all four sides of a rectangular opening to find the distance around it. Perimeter = length + width times 2. Aha, applied mathematics! Your geometry teacher told you it would be useful, and the time has come!

1. Lay the screen flat on a sturdy work surface. Starting in one corner, remove the little plastic corners (if they're there) with the needlenose pliers, or pop them out with the screwdriver tip. Pry out the spline with the putty knife or screwdriver, going corner to corner. The spline may be dirty or gunky, so the edge of the knife or tip of the screwdriver can assist you in getting it out cleanly.

Remove old spline.



2. If you're saving the old screen, roll it up and set it aside. Otherwise discard it. Check the channels from which the old spline and screen have been removed. If they're clean, go to Step 3. If they're dirty, get a bucket of warm water, a sponge, and some paper towels, clean them and let them dry.
3. Lay the new mesh screen over the window (door) frame. Make sure the mesh is lying square to the frame; check at the edges to see that the gridwork of the mesh lines up with the frame so it doesn't look crooked.
4. Measure the frame's outer dimensions, and with the scissors, cut the mesh to this size. Cut a little square out of each corner of the cut piece, no wider than the frame. This will keep the mesh from bunching in the corners when you install it.
5. Starting in a corner, push the mesh into the spline channel with the convex (◡) wheel of the spline tool. Go all the way up and down one side. You're trying to create a light indentation, not scrunch down the mesh. The spline will do the holding.



Use spline tool (convex wheel) to insert mesh in channels.

6. Starting in the same corner where you began Step 5, using the concave (∩) wheel of the tool, push the spline into the channel over the mesh. Put your other hand on the screen, or have your helper hold it, so that the tension on the screen is even and it doesn't bunch up. When you've fully inserted the spline on one side, follow Steps 5 and 6 to install the spline on the other three sides.
7. Once the spline is set around the perimeter, use the screwdriver to push the spline into all four corners; trim the end of the spline with the scissors. Trim any mesh that still overlaps the frame with the utility knife. If your original screening had plastic corners, install the new ones.

You're done! Put the screen back in the window or door opening.

Installing Security Pins in Windows

In areas of your home that are hidden from view on the ground floor, it's easy for someone with bad intentions to break a window, undo the latch, and make mayhem. If you have a perimeter security system installed, that's one way to safeguard unwanted entry. Security gates (not window guards, which protect children from falling out) for windows will do the job, but will also make you feel like you're living in a prison. I had these in one apartment in Manhattan where my bedroom windows opened on a fire escape. I hated the feeling of being locked in, and moved out within months.

If you don't have the budget for a security service, you can add a layer of protection from forced window entry using the simple method of drilling holes through the

lower sash of your double hung windows and installing window security pins, common nails, or eye bolts that prevent the window from easily being raised, even if a pane is broken out.

You'll need the following:

- Measuring tape
- Awl or pencil
- Electric drill
- Window pins, eyebolts, or common nails; one pair for each window
- Drill bit slightly larger than pins, bolts, or nail you are using
- Masking or painter's tape, or bit stop to fit your bit
- Lubricant or silicon spray

Ounce of Prevention

If you can only find window pins that operate with a key, don't buy them; use bolts or nails instead. In case of fire or other emergency, you don't want to be looking for a misplaced key!

1. Fully close and lock the window you'll be drilling; you want the upper rail of the lower (inside) sash, and the lower rail of the upper (outside) sash to be parallel. (The double-hung window shown at the beginning of this chapter shows it in locked position.)
2. You don't want to drill through both sashes completely, because this will enable someone to foil your security plan from outside! So measure the depth of the two sashes in locked position, and mark your drill bit to $^3/_4$ of that measure with a piece of masking tape or a bit stop. You will stop drilling when the bit gets to this mark.
3. Find the center of the top left and top right corners of the lower sash; mark it with the awl or pencil; the awl is good for this mark, because it "grounds" the drill as you begin drilling. (Security pin hole locations are marked on the window illustration earlier in this chapter.)
4. Wearing safety goggles, hold the drill straight, drill into the window at the marks. Keep your grip firm, because you're drilling through two wood rails and possibly some weather stripping between them. Stop drilling when your bit is inserted to the stop or masking tape mark.
5. When both holes are drilled, lubricate your fasteners before you insert them in the holes. The fasteners should be a little loose so you can remove them easily.

The Least You Need to Know

- Some sticky window problems are merely the result of sticky weather; don't apply invasive measures unless you must.
- Old wood windows that have lost their weights can still be controlled by installing devices in the channels.
- To fix screens mounted with splines, an exact duplicate material is needed.
- Window pins are a simple addition to your home's security.

Chapter 9

Doors: An Open-and-Shut Case

In This Chapter

- Parts of a door
- Silencing the talkative door, and making the stubborn one respond
- Getting a grip on doorknobs with a couple of easy repairs
- Keeping balky sliders on track
- Installing a peephole in a windowless outer door

Do you have door slammers at your house? I do. They announce themselves with a bang, not a whimper, which is okay, except that our back door gets a workout. Screws loosen, the strike plate wobbles, and pretty soon it's time to get out the screwdriver for a couple of minor repairs.

Throughout her teenage years, our daughter would voice her displeasure with a resounding bang of her bedroom door. The last slam came when she broke one of the ancient hinges clear through its cast iron body—I believe the term is metal fatigue, and I'm sure it was very tired. Replacement hinges set Rachel back several weeks of allowance money, so she's become much gentler with doors ever since.

Even without a resident slammer, doors get a workout over the years, and some at your house may be showing signs of age or hard wear. This chapter will teach you all the important parts of doors, and how to make them swing to *your* rhythm—and eliminate wobbles, squeaks, drags, or rattles.

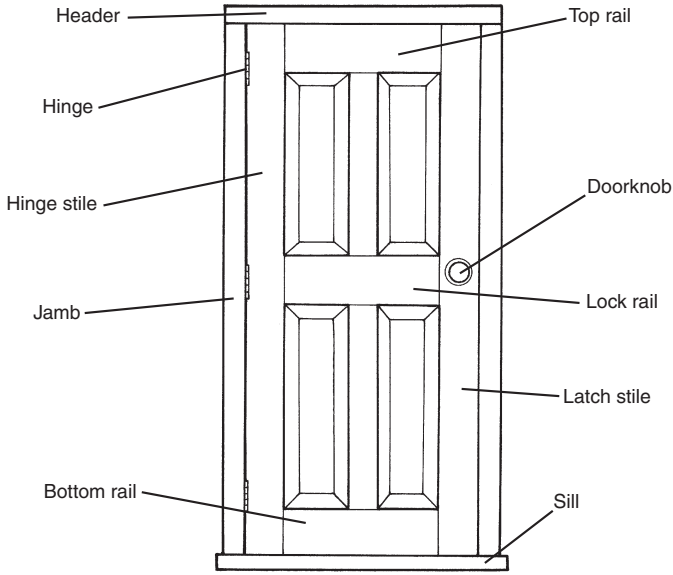
Of course, you can avoid many of these little repairs by insisting that all members of your household close doors with their hand *on* the knob: no slamming! It's the best preventive maintenance I can think of.

Anatomy of a Door

You may notice some of the same words that are also used to describe a window. The *jamb* is the vertical part of the door frame—the opening in which the door is installed. The frame's top piece is called the *header*; the bottom piece is the *sill*. On exterior doors, the sill may have another piece over it that spans the sill; this is known as a saddle (not shown).

The door itself has horizontal parts, called the *rails*; and vertical parts, called *stiles*. The *hinge stile* is the vertical piece where hinges are attached; the *latch stile* is the vertical piece that holds the latch, doorknob, and/or lock, if there is one.

Parts of a door:



What Pros Know

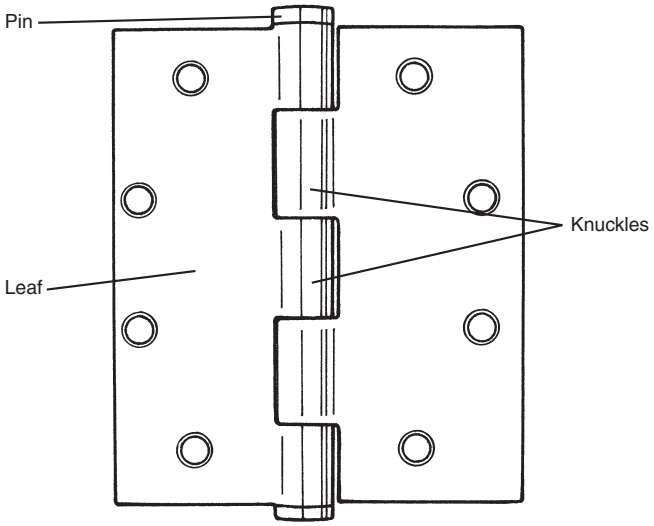
The previous illustration shows the door from the outside; because the hinges are on the left side of the door, it is known as a *left-handed* door. Looking at the door from the outside, doors that are hinged on the right are known as *right-handed* doors.

Knowing whether a door is right- or left-handed is important if you are buying or replacing a doorknob that can be locked, also known as a lockset, that works with one or the other, but not both. Since you want the key to be on the outside of the door and the push- or turn-button lock on the inside, you need to buy a right- or left-handed lockset, depending upon the door in which it will be installed.

Many older doors are composed of rails, stiles, and panels, like the one shown in the illustration. Other, newer doors may not be solid wood; they may be made of thin layers of wood or metal applied over a core of rigid foam or other material.

Silencing the Talking Door

A door that squeaks usually needs attention to its hinges—the metal hardware that attaches the door to its frame. There are lots of different kinds of hinges, but the principle is the same. The two sides of the hinge, called leaves, connect to each other by means of a pin threaded through interlocking knuckles.



Common door hinge.

Squeaks are usually eliminated by applying a little lubricant—a penetrating oil is good, though some people have told me that vegetable oil is also effective!

You'll need the following:

- ❑ Newspaper to put under the hinges (oil can spot the carpet!)
- ❑ Small-tipped nail set or thin-shanked standard screwdriver
- ❑ Claw hammer
- ❑ Can of penetrating oil or similar lubricant, equipped with a straw for applying a narrow stream
- ❑ Clean rag or sponge

1. Lay newspaper under the door to protect the carpet. Open the door and look at the hinge. You'll want to lubricate the area where the pin meets the knuckles of the two hinge leaves.
2. If you know which hinge is squeaking, start there. But lubricate all the hinges and you'll have silence longer!
3. In most cases, you can loosen the pin by driving the nail set or screwdriver tip into the hole at the bottom of the hinge joint. Wearing safety goggles, use the hammer to drive the pin up from between the leaves an inch or so.
4. Spray a little lubricant into the pin hole at the top, where the head of the pin has been raised. Give the oil a minute to seep down inside, around the pin and the knuckles. Wipe off any excess or drips of lubricant with your rag. Reset the pin and try the door.
5. If the door is no longer squeaking, repeat this exercise with the other hinge or hinges. If it's still squeaking, drive up the first pin again and repeat Steps 2–4 until you achieve silence.

Tightening Loose Hinges

Time, use, and wear can make two things that belong together—the hinge and its screws—come apart. Tighten screws as soon as you notice they are loose. The longer loose screws are left untightened, the greater the likelihood that they'll widen the screw holes or wear (strip) the screw threads and need replacement. Because of the law of gravity—the weight of the door that the hinges support—the top hinge will most likely exhibit loose screws first.

If you've got loose screws, here are a couple of suggestions.

Fix #1: Gum Up the Holes

This quick fix will work for repairing loose screw holes for hinges of lighter-weight doors. For heavy doors, skip to Fix #2.

You'll need the following:

- ❑ Screwdriver (standard or Phillips, whichever fits)
- ❑ Book of cardboard matches
- ❑ Wood glue
- ❑ Utility knife

1. Open the door wide and wedge something under it so the door's weight won't stress the hinge.
2. Remove the loose screw or screws from the hinge leaf. Dip one or two cardboard matches in the wood glue and put them in the loose screw hole. Cut away any bits of matchstick that stick out of the hole with the utility knife. Reinsert the screws and tighten.

Fix #2: Longer Screws

If you already have the right-size fasteners, this is even easier than Fix #1.

You'll need the following:

- ❑ Screwdriver
- ❑ $2\,^1/_2$" wood screws, same diameter as the old ones (you may want to use Phillips head screws rather than standard head screws; most people think they're easier to tighten and loosen)

1. Prop up the open door as in Fix #1.
2. Replace the loose screws one by one.

What Pros Know

When you go to the hardware store and look at door hinges, you'll notice that the hinges are sold with fairly short screws. By using a longer screw, you'll fasten the hinge more deeply into the door jamb.

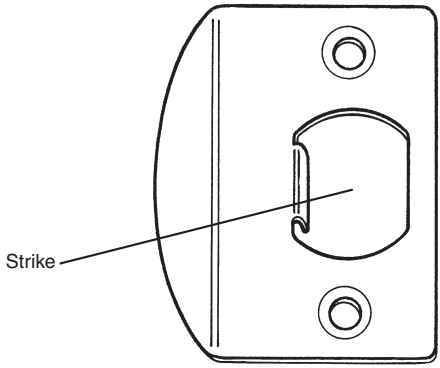
Sticking Doors

Sometimes a door binds because the door itself is swollen from humidity; if binding doors are a problem in this kind of weather, you may want to lightly sand and refinish the latch edge of the door, particularly if the door is peeling paint—bare wood swells more than finished material. Or you can take the lazy strategy, and wait for cool weather. Several of the interior doors in my old New York house bind in summer when it's very warm and sticky; I just don't close them. They work perfectly in winter, when I want to keep them closed, anyway.

And sometimes, there's a bit of a hardware problem. If the hinges are loose, the door may bind along the latch jamb (the doorknob side). Tightening the hinge screws may cure the problem. Or the problem may be located on the opposite side of the door.

Open and close the door slowly, and look at the strike plate; that's the little square or rectangular gizmo that has a hole in its center (the strike) which holds the latch or bolt that's released when you let go of the doorknob and the door is shut. If the strike plate is loose (continual slamming can loosen it!), get out your screwdriver and try Fix #1 or #2 described previously to tighten the screws into the latch jamb.

Strike plate.



Doors That Won't Stay Closed

First, test the doorknob; the latch or bolt that fits into the strike plate may be sticking, and thus not releasing and engaging with the strike. You can probably fix this by lubricating the latch with a little graphite or penetrating oil.

The tale of the mysterious shrinking door is actually not very mysterious. If the weather is cold and dry, or if the humidity level in your house is very low, a wooden door will shrink in response. In turn, the latch or bolt may no longer engage with the strike, and the door won't close.

This is a job for shims! It's a good idea to use a fix that can be reversed, in case the door swells up again.

You'll need the following:

- Screwdriver (to match the strike plate screws)
- Cardboard (file folder stock makes good shims for this purpose)
- Pencil
- Scissors

On an interior door, shimming the strike plate works fine, and you don't have to mess with the hinges. Here's what you do.

1. Unscrew the strike plate and put the screws in a safe place so you don't lose track of them.
2. Trace the strike plate on cardboard; make a few copies. Cut out the cardboard templates.
3. Position one cardboard shim behind the strike plate, and screw the shim and plate back into its mortise. Then try the door. If the latch holds, you've solved the problem. If not, insert additional shims until the door closes properly.

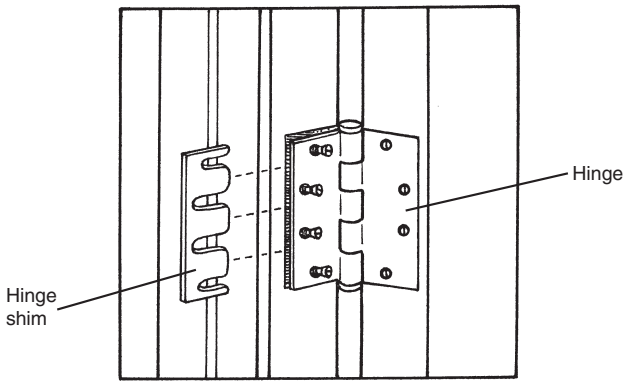
On an exterior door, shimming out the strike plate can create a problem with door security. In this case, you can shim out the hinges. If you follow the direction suggested by the following illustration, you'll be able to shim the hinges without removing the door.

In addition to the tools and supplies listed for the strike plate shim fix, get a thin piece of paper so you can trace the outline of the hinge. You will also need something to support the door—wood blocks, shims, books—while you are tinkering with the hinges.

1. Open the door and, using pencil and paper, trace the outline of the hinge on the door jamb, including the screw positioning. Close the door when you're done and continue to Steps 2 and 3.

2. Using the tracing as a template, make a couple of cardboard shims for each door hinge (many modern doors have two hinges; others three, some four).
3. Cut the hinge shim like the illustration, with slots cut to the edge of the template so you can slide the shim under loosened screws.

Placing a cardboard shim behind a hinge may fix a door that won't stay closed.



4. Open the door wide, exposing the jamb side of the hinge. Loosen one hinge at a time, slide in a shim, and tighten; shim all the hinges. Add shims until the door latches properly.

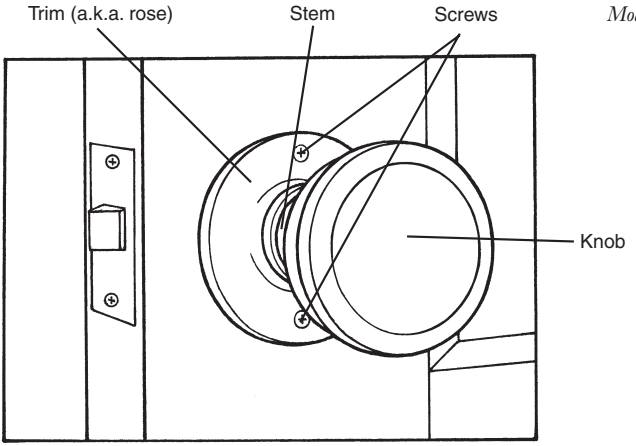
Getting a Grip on Doorknobs

There are four basic types of doorknobs:

1. *Dummy* doorknobs don't turn and are often used just for appearance.
2. *Passage* doorknobs turn, but have no keys or locks; these are often used in children's bedrooms or playrooms where a locking door could be a problem.
3. *Privacy* doorknobs lock and can be unlocked only from the inside; these are good for adult bedrooms and bathrooms. If someone should accidentally lock themselves in, you can quickly free them (see how later in this chapter).
4. *Keyed entry* doorknobs mean what they say; to gain entrance, you must unlock them with a key.

Tighten a Loose Knob

Modern doorknobs—the ones you'll find in a house that's less than fifty or sixty years old—are fairly simple to tighten. On these models, the whole works may be jiggling—from trim to knob. Usually you'll find two surface-mounted screws on the face of the inside doorknob trim piece that is mounted flush with the door—it's traditionally called a rose. Sometimes the screws are concealed under the trim piece. In this case, you'll have to pry off the trim piece to get to the screws. The screws actually pass all the way through the door to the trim piece on the other side.



Modern doorknob.

You'll need the following:

- Screwdriver (Phillips or standard, to match the screws)
- Utility knife (if you need to score the paint around the trim piece to remove it)
- Small pry bar or standard screwdriver to remove trim piece, if the screws are underneath

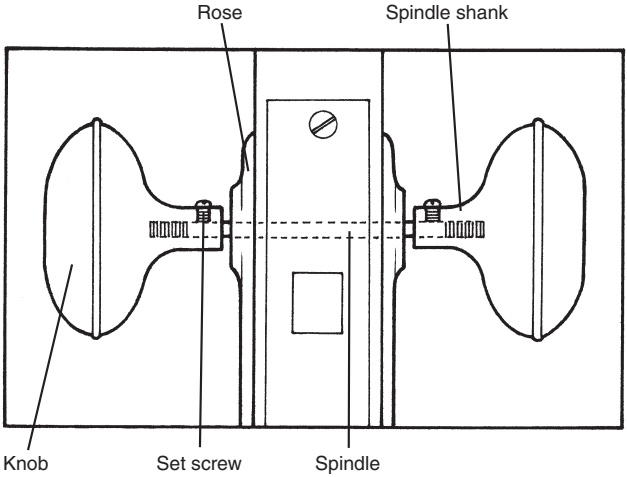
Ounce of Prevention

Careless painters may have painted the edge of the trim piece where it meets the door. If your door trim is paint-bound, use a utility knife to carefully score the paint around the rose so you won't mess up the surface of the door by hacking away at it with the screwdriver.

Only one step here—tighten the screws. Hold both trim pieces tight to the door with one hand as you tighten the screws with the other. Tighten the screw closest to the edge of the door first.

The house I grew up in (circa 1940), and the one I live in now ("renovated" in the 1870s), have old-style doorknobs. You may have them, too. Instead of two screws passing through the lock cylinder to the other side of the door, there is a square metal spindle with threads on both ends that passes through the rose. The spindles are covered on both sides of the door with little metal shanks; the knobs screw (usually) onto the spindle at each threaded end. All of this is held in place by means of a single set screw in each of the two shanks. The screw threads through the shank and tightens against the spindle on one of its four flat surfaces.

Old-style doorknob.



Wobbles happen when the set screw gets loose, or disappears. You may have to hunt for a replacement screw (see Appendix B for a dealer in old hardware), but these antique knobs are often beautiful, made of glass, bronze, chrome (1930s), or nicely aged and worn wood. They're worth saving—or selling to someone who likes them!

You'll need the following:

- Standard screwdriver—make sure it's the right size or you may deform the set screw head; some late-model (1940s and after) set screws may unscrew with a hex head (Allen wrench)
- Lubricating oil (penetrating oil, such as WD-40)

1. Loosen the set screw in the shank of the loose knob. If the screw is tight, don't force it! Lubricate the screw with a drop of lubricating oil, and then try to unscrew it.
2. Examine the screw. If the base (the opposite end from the head) looks deformed, it should be replaced. You can finish the repair once you have a new set screw.
3. If the screw is intact, check the set screw that holds the knob in place on the other side of the door. If it's tight, proceed.
4. Press the knob that still has its set screw in place tightly against the rose on the other side of the door. Turn the knob until one of the flat sides of the spindle is facing up through the set screw hole. Replace the set screw, tightening it firmly against the flat side of the spindle.
5. Operate the knob; you should be able to turn it freely.

Replacing a Passage, Privacy, or Keyed Entry Lockset

It's fairly easy to replace a set of doorknobs and latch with a modern doorknob—the kind that attaches both knobs and engages the latch with two long screws. Remove the screws, and then the knobs and trim will pull out easily. Then take the old set to the store and purchase a new one by the same maker. The new set will install in the reverse order that you removed the old set. All it takes is the right screwdriver; on modern doorknob sets, usually a Phillips head. If the trim piece conceals the long screws, you'll need a standard (flat head) screwdriver or small pry bar to pry off the trim piece.

If you've got the old-style doorknobs in your house, replacement is more problematic, as these are not so standard. Refer to Appendix B for an old house parts supplier; they may have the parts or replacements to do the job, and they work by fax or e-mail to assist customers.

Screen and Storm Doors

Having an extra door can be helpful. In winter, a glass-windowed storm door adds an extra layer of insulation to the door. Usually these doors have interchangeable storm and screen panels. In summer, when you change to screens, you can get a nice breeze going through your house when the entry doors are open and the screen doors are closed. One problem with these extra doors is that the screens can get torn or loose and need replacement. See Chapter 8 for instructions on repairing and replacing screens.

Adjusting the Door Closer

The other problem with storm/screen doors is that they usually operate with a mechanical closer that may be too fast or too slow—either slapping into your ankles or letting in flies along with the person who's coming or going. The good news is that this problem is incredibly easy to fix.

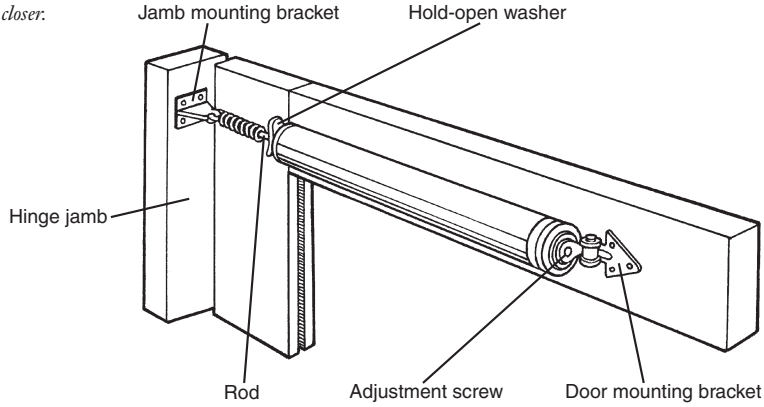
def•i•ni•tion

Pneumatic refers to a tool or machine that is operated by compressed air.

Let's take a look at the most common mechanical closer, the *pneumatic* variety. It looks a lot like a bicycle pump.

This device is attached to the hinge jamb and (usually) the top rail of the door. When you need to hold the door open, you can adjust the little washer shown in the illustration to keep the door in place; move the washer next to the tube when you want the door to close as usual.

Pneumatic door closer.



To slow down or speed up the closing action, you'll need to use a Phillips or standard head screwdriver to turn the adjustment screw, usually located in the same position on the closer as the one shown in the illustration. To slow the closing action, turn the screw clockwise (righty, tighty). To speed up the door, turn the screw counterclockwise (lefty, loosey).

If You Need a New Closer

These door closers have a long life span. But they eventually wear out, and installing a new one is very easy. If you can find a duplicate model, you can even use the same screw holes for the brackets. If you have to drill new holes, follow the closer package instructions, use a torpedo level to make sure the installation is level, and wear safety goggles when you drill the bracket holes.

Just be sure to put a stop or bit of masking tape on your drill bit at a length less than the door's thickness, so that you don't drill *through* the door!

What Pros Know

When you install a door closer, you can position it anywhere on the screen door, as long as the jamb bracket is unobstructed by other hardware; however, it's generally attached along the top rail of the door, so it doesn't interfere or get tangled with people and things passing by.

Lock and Key Dilemmas

Usually, your key fits in its corresponding lock, the door opens, no problem. But when glitches happen, here's what to do.

Key Sticks in the Lock

If the key does not go smoothly into and out of the keyhole, you can put a little graphite on the key, and work it into the lock, or squeeze a little graphite into the keyhole, and do the same.

Key Breaks Off in the Lock

This happens, but don't panic. Before you call the locksmith, try to grab whatever is still sticking out of the lock with locking or needlenose pliers. Pull *straight out*. If the key fragment won't budge, try squirting a little lubricant into the lock, and try again with the pliers. If this doesn't do it, or if you can't grip the key fragment that remains in the lock, you'll have to call the pro.

Lock Is Frozen

This occasionally happens when there's been a lot of wet weather followed by bitter cold; the moisture freezes and can find its way into keyholes, too. Keep a small container of spray de-icer in your purse or other easily accessible place in the wintertime. Spray a little on the keyhole, and it should break the ice in seconds. I've also heard of people warming up the key with a hair dryer, but this isn't going to work if you're locked outside the house!

Locked in (Privacy Lock)

If you have small children or live with elderly family members, the kids or seniors may occasionally lock themselves into a room that is accessed with a privacy doorknob set; that is, there's a locking mechanism on the inside of the door. They lock themselves in, and can't get themselves out. And there's no key on the exterior doorknob for you to unlock.

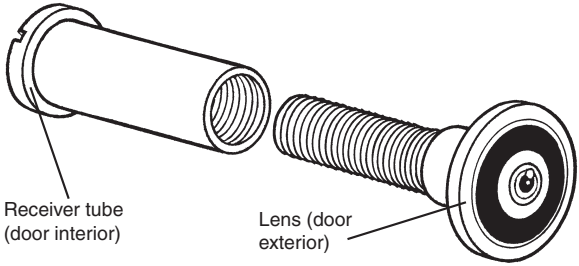
You can first try to coax your elderly relative or child to turn the little locking mechanism on the inside of the door to the "unlock" position. If that doesn't work, try the following fix. Assuming you have modern doorknobs, you can release them if you can locate a slot or hole on the exterior doorknob, or on the rose (trim piece) of the exterior doorknob. Use the tip of a metal nail file, or the point of a straightened paper clip to push straight into the hole or slot. This will probably open the door. If it doesn't, you'll have to call a locksmith.

While children are small, or seniors are living with you, consider changing from privacy to passage locks. My daughter locked herself in the bathroom when she was little, and the experience scared her enough that she didn't repeat it. However, kids and elders alone in the bathroom are always at risk for an accident while they're stuck.

Installing a Peephole

If there is no way to see who's on the other side of your exterior door, it's a good idea to install a peephole. You should never open the door if you don't know the person who's there, or if the person will not identify himself/herself. You can buy peepholes in the section of the hardware or home center where locks, keys, and other door security equipment is sold. Look for one that has a vision field of 190°, which will permit the widest view of who's standing outside your door.

To install a peephole, you'll need a good-sized bit to drill a hole of sufficient diameter to accommodate this device. (This fix presumes your door is wood, not metal or metal-clad. If you have the latter type, ask your hardware salesperson to recommend the right drill bit for the job.)



Door peephole.

You'll need the following:

- ❑ Pencil or awl
- ❑ Measuring tape
- ❑ Electric drill
- ❑ $^{9}/_{16}$" spade bit (for peephole shown; check package)
- ❑ Old toothbrush

The spade bit is designed for drilling large holes at slow speed.

1. Mark a point on the inside of the door with the pencil that is at eye level with the shortest adult in your house (children shouldn't answer the door to unknown people!).
2. Measure the center point of the door from left to right at eye level and mark it with a pencil or tip of an awl.
3. Close and lock the door. You may want to position someone on the other side of the door for Step 4.
4. Attach the spade bit to your drill, and put on the safety goggles. Using the awl or pencil center mark as a guide, position the tip of the drill on the mark, and drill straight through the door. It is important that you hold the drill steady

and straight. When you feel the center point of the spade bit touch the surface on the other side of the door (or your friend sees it), stop drilling forward and remove the bit straight out from the hole you've drilled. (Don't stop the movement of the bit as you remove it.)

5. Go around to the other side of the door; close and lock it, and, using the bit mark as your center point, drill through the door from the outside. Brush any wood splinters or sawdust out of the hole with the old toothbrush.
6. Insert the receiver tube through the hole from the inside of the door; then thread the lens end into the receiver tube from the outside of the door.

Sliding Door Fixes

Sliding doors make for an easy transition from indoors to outside; their big glass panes provide a nice view. But the problem with sliders is that they are heavy, and when they don't slide smoothly, they're annoying to use.

There are two ways that sliding doors may not measure up:

- They don't slide smoothly.
- They are a security risk.

Let's address the first problem.

Wobbly Tracks

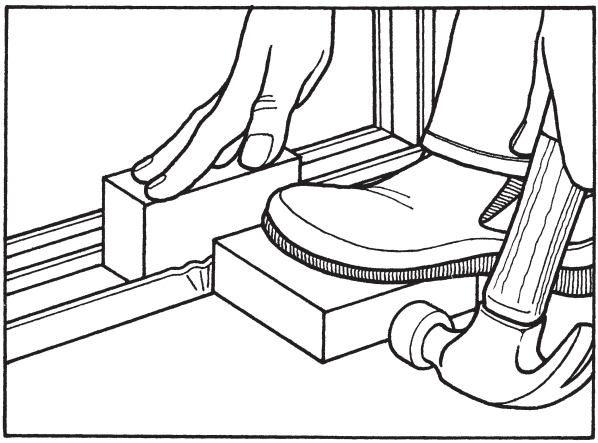
You'll need a screwdriver to tighten the screws in the sliding door tracks (usually Phillips). If the screws seem not to want to stay put—they spin uselessly in their screw holes—it means that the screws are stripped, and not engaging with the wood sill that should anchor the door below its metal frame. Replace the screws with longer ones, to better hold them down. Make sure the doors are aligned in the tracks before you tighten the new screws.

Dirty Tracks

Dirt, grease, leaves, gunk—all of these can make a sliding door bump and balk. Clean out the tracks and lubricate them; some people like to rub paraffin in the lower track to assist door movement.

Bent Track

If the slider track is only slightly bent, you can bend it back into shape by putting a wood block on either side of the bend (room side and track side) and hammering the block on the room side of the bend to iron out the bend.



Straighten bent sliding door track.

Now, for the second problem.

Securing a Sliding Door

The simple latch on a sliding door is easy for any burglar to foil. Because they usually open to back yards and other property areas not visible from the street, many burglars attempt entry through a slider.

Many people stop unwanted entries by wedging a broomstick or 1"×2" piece of lumber cut to length between the edge of the slider and the door frame. This would jam the door if someone were to try to pry it open.

You can also buy locking devices that are more secure. You will need an electric drill, a drill bit for drilling through metal, and mounting screws, to install either a "Charley bar"—a locking metal bar that serves the same purpose as the stick—or a foot-operated lock that prevents the slider from opening. Follow the manufacturer's instructions for installing these.

The Least You Need to Know

- Don't attempt a dramatic fix when simple will serve you. Sometimes doors that stick simply need the hinges or strike plate tightened to the jamb.
- You can fill a loose hinge or strike screw hole with glued up matchsticks for a tighter fit, or use a longer screw.
- The adjustment for a storm/screen door closer is usually the turn of a single screw.
- When creating a security peephole for an outer door, drill straight through the door; a spade bit works well for this large-sized hole.

Part 3

The Circulatory System: Plumbing and Fixtures

The idea of water running through pipes from underground, to provide for drinking, cooking, and cleaning, would have been considered miraculous to the original owners of my New York house. They had a nearby pond and a two-hole privy to take care of water and waste disposal. Fortunately for us, subsequent owners updated the place, and we've got all the conveniences, including a bathroom on every floor. Modern plumbing has solved the problems of maintaining a running water supply—where and when we need it—and disposing of waste with near-invisible efficiency. Our system of pipes and fixtures is practically infallible.

But like the veins and arteries of our own circulatory system, the pipes that bring us water and take away waste can sometimes clog or leak, causing a small breakdown that can get much worse if it's not addressed promptly. And the plumbing system's "organs"—the tubs, toilets, sinks and showers—can also wreak havoc on a house when they're not doing their jobs, letting water travel where it shouldn't. Part 3 helps you take care of this vital home system, keeping the water flowing, and in its place!

"Oh, darling! I looove it!"

Chapter 10

Solving Pipe Problems

In This Chapter

- Quickly stopping a pipe leak until the plumber shows up
- Defrosting a frozen pipe, and preventing it from happening in the future
- Winterizing an outside faucet
- Quieting noisy pipes
- Keeping drain pipes free from obstructions
- How to rescue what falls in the sink trap

Problems with your home's system of water delivery and waste disposal fall into two general categories: supply flow and drainage. If clean water's not flowing properly, or waste water's not discharging, sooner or later you'll have water or waste (yuck) where it's not supposed to be.

This chapter will help you tackle the minor disruptions to flow and disposal, and also provide some guidance for maintenance to keep things moving along as they should.

Small Leaks: Emergency Fix

Copper—the most common material used for supply lines—and other metal pipes last many years, but occasionally, one of your pipes will spring a leak. You'll have to stop the spray until the plumber shows up. The kind of repair described next—using a clamp and gasket material—will often hold for quite a while, but don't be overconfident. Call in the plumber as soon as you can to replace the leaking section of pipe.

Where the leak happens will determine how you first shut off the water, and then do a temporary fix on the leak. If the pipe is leaking between a supply stop and an appliance, simply shut off the water at the supply stop. Of course, you won't be able to use that appliance until you've done the repair.

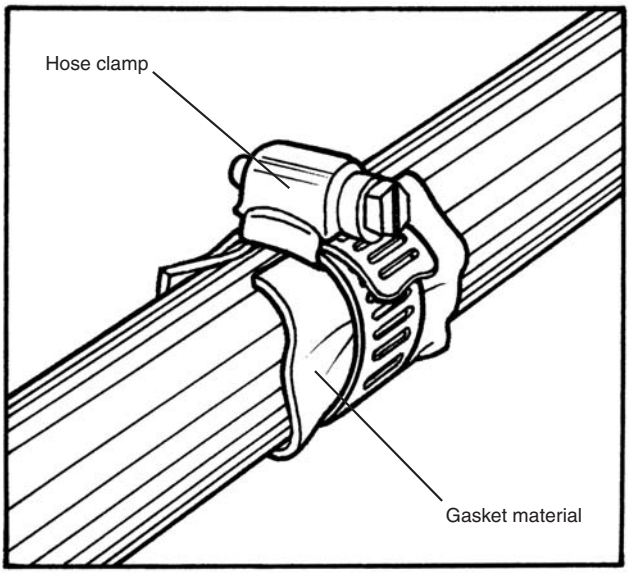
If the leak is in one of the supply lines running from the main shutoff to somewhere else in the house, and there is no interim supply stop between the leak and the main valve, you'll need to shut the water off at the main. (See Chapter 4 for locating/shutting off directions.)

If you've stocked your supply closet with emergency supplies as discussed in Chapter 3, you'll be glad you have them now!

To stop a small leak, you'll need the following:

- ❑ Scissors
- ❑ Rubber gasket material
- ❑ Hose clamp
- ❑ Screwdriver
- ❑ Bucket
- ❑ Mop or sponge

1. Shut off the water supply at the closest supply stop, or at the main.
2. Wearing safety goggles, cut out a small piece of rubber gasket material, of sufficient size to wrap the pipe, cover the leak and provide about $^1/_2$" of material on either side of the leaking spot. Wrap it around the pipe at the site of the leak.



Emergency leak repair.

3. Unstrap the hose clamp, wrap it around the gasket material at the leak site, and thread the strap end through the end that has the screw mounted on it. Make the strap fit snugly around the gasket repair.
4. Tighten the clamp screw with the screwdriver.
5. Clean up the area around the leak with the bucket and mop (if it was leaking for awhile), or sponge (if you caught it quickly).
6. Turn on the water supply. Sometimes the repaired area will drip briefly; if the dripping continues, you can tighten the clamp/gasket. And call the plumber! Even a really good repair won't hold indefinitely.

What Pros Know

Small ruptures or splits in supply pipe are rare, but they happen. To make an emergency fix, you'll need a different kind of metal clamp, called a sleeve clamp. This does what it says: wraps around the pipe and gasket material like a tight metal sleeve. Like the hose clamp, it closes with screws. You can make the repair as above, with this exception: use a metal file to smooth any roughness or sharpness around the pipe rupture, so that the leaky spot doesn't cut the gasket material.

Thawing Frozen Pipes

You know there's a frozen pipe when you turn on a faucet and no water comes out, or if it barely drips, and the weather's been very cold.

One bitter January evening, we had our first pipe freeze-up at the kitchen sink of our New York house. It was some kind of a record cold snap, -15°F. outside, and we'd just gotten home from work in the city to discover that the water wasn't moving. Of course, we hadn't made dinner yet, so we were hungry, too!

Fortunately, the freeze-up wasn't significant. We got the water moving again with a hair dryer aimed at the supply pipes under the sink. We kept the under-sink cabinet doors open on all subzero nights after that, and, just to be safe, let the water drip all night whenever a deep freeze was predicted. It sounds wasteful, but a little drip will waste far less water than a burst, spurting supply pipe! And it certainly won't damage the house the way a burst pipe can.

We had neighbors in Maine who had a four-season house that they used occasionally throughout the year. They didn't have a caretaker, though. One miserable winter, when they didn't visit, and the temperature dipped below zero for more than two weeks, the neighbors' pipes froze. When the thaw finally arrived, a pipe burst in an interior wall. They hadn't shut off their water at the main, and the damage was in multiple thousands of dollars. Plus, they had to pay the water company for 30,000 gallons of water that served no other purpose than the destruction of their walls, floors, furniture, and appliances!

Moral of this story: if your house will be unoccupied in the coldest weather months, shut off the water at the main. If you don't drain the pipes, have someone check the house regularly.

Here are some basic rules for thawing pipes:

- Shut off the water supply at the main. This will ease the pressure at the freeze site (remember, water expands when it freezes).
- Open (turn on) the faucet closest to the freeze site. Once the water starts moving, it needs somewhere to go!
- In case there's a leak or a burst of water when the pipe thaws, cover the surrounding area with plastic drop cloths, or position a bucket or two underneath the freeze site.
- Work from the open faucet toward the area of the freeze.

Hot Water Thaw

To thaw frozen pipes, try this simple method first. You'll need the following:

- ❑ Rags or old towels
- ❑ Bucket
- ❑ String or masking tape

1. Boil some water in a teakettle.
2. Wrap the frozen pipe in rags; secure the rags at each end with string or tape. Put the bucket under the pipe to catch the poured water.
3. Slowly and carefully pour the hot water over the rags.

Applied Heat Thaw: Beware!

You can try using a hair dryer to blow warm air on the frozen pipe; you can also wrap the pipe with heating tape plugged into a nearby outlet. However, remember that water and electricity do not mix! If the electric receptacle for the hair dryer or tape is not equipped with a *ground fault circuit interrupter (GFCI)*, you risk electrical shock if the appliance or heat tape comes into contact with water (for example, if the pipe bursts while you're using the electrical device). You must be very careful.

def•i•ni•tion

A **ground fault circuit interrupter (GFCI)** is a device used in code-compliant electrical receptacles near water sources. The GFCI almost instantly cuts power to a circuit if it detects a leakage of electric current.

Preventing Frozen Pipes

To prevent pipes from freezing next time, remember these strategies:

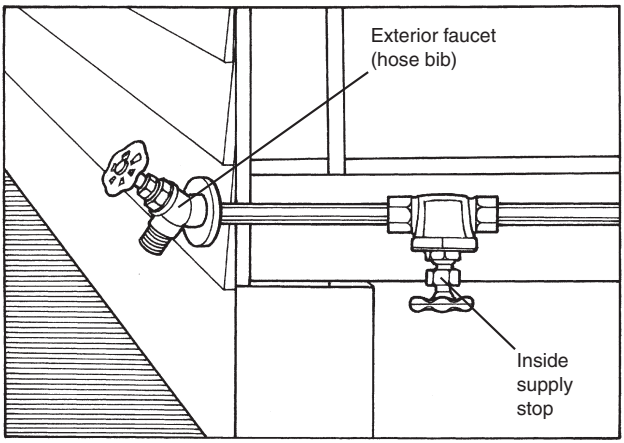
- ◆ On very cold nights, open hot and cold faucets to a constant trickle.
- ◆ To allow warm air to circulate around pipes, open kitchen and bathroom sink cabinet doors in freezing weather; the ambient room temperature will keep them warmer.
- ◆ *Before* cold weather sets in, wrap insulating foam tubing around uninsulated pipes that run close or adjacent to exterior walls, under sinks, or anywhere the pipes are likely to freeze. This will also prevent the pipes from "sweating" in

hot, humid summer weather, and keep the hot water in hot water supply pipes warmer, longer—an energy saver.

Another Cold Subject: Winterizing an Outside Faucet

If you have exterior faucets for the garden hose on the exterior walls of your house, and you live in a freeze-prone zone of the country, you'll want to shut off and bleed these faucets before the first frost.

Most exterior faucets have an inside supply stop, usually a ball-valve (turns off with a quarter-turn) or a gate valve (wheel-shaped, shuts off clockwise—for illustrations see Chapter 4).



This cutaway drawing shows the usual location of the inside shutoff for an exterior faucet, which is also referred to as a hose bib.

1. Turn off the water supply at the inside stops.
2. Go outside and turn on the faucet until the remaining water in the pipe drains out.
3. When the water drains out, turn off (close) the faucet.

You can buy foam faucet covers for exterior faucets; they provide an extra layer of protection from the freeze-burst scenario.

Pipe Down! Quieting Noisy Pipes

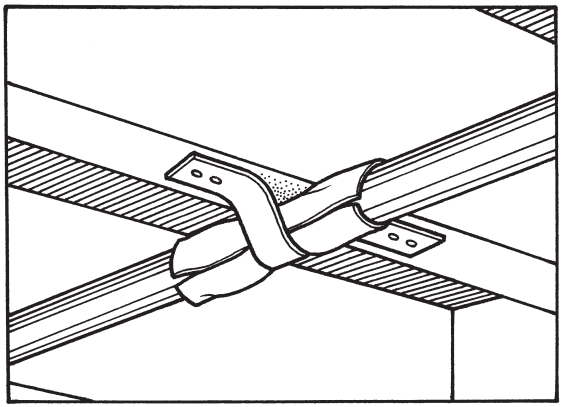
Pipes that bang and squeak are annoying. Usually, pipes are anchored every few feet along long horizontal and vertical runs. The vibration caused by water moving through the pipes can make them noisy, when they bang against a joist or wall. Tightening the straps, insulating the pipe, or installing more pipe straps should settle them down.

You'll need a flashlight to do the detective work. Once you locate the source of the bangs or squeaks (squeaks come from hot water pipes, which expand from the hot water moving inside them), you can insulate between the pipe and strap with rubber gasket material, tighten loose strap screws, or install additional straps.

To insulate a noisy pipe, you'll need the following:

- Scissors
- Rubber gasket material
- Screwdriver (standard or Phillips, depending on strap screws)

You can cushion a noisy pipe (or squeaky hot water pipe) with the same gasket material that you use to stop a leak in an emergency. Just cut the right amount of gasket to fit around the pipe between the pipe and the strap, as shown in the following illustration. Then loosen the straps with the screwdriver, wrap the pipe with the gasket material, and tighten the straps.



Insulate a noisy pipe with rubber gasket material.

Preventing Drainage Disasters

Clogged sinks, showers, and toilets are usually the unpleasant consequence of inappropriate items finding their way into your waste disposal (sewage) system. When my daughter lost the top to a bottle of shampoo down the toilet, our septic system balked. Within a couple of days, the system was backflowing into the lowest drain in the house—the first floor bathroom shower. It was a stinky mess, and no job for the DIY 101-er. I called our septic system guy, who repaired the problem in a couple of hours.

The following rules really help keep your drainage system intact if you follow them:

- Once a month, boil water and pour a kettleful down each drain in your house: sinks, tubs, shower. This is the most carefree way to keep them flowing. Of course, be careful when you're carrying/pouring the boiling water. You don't want to scald yourself.
- Keep the stopper in the sink when you are brushing your hair/shaving/applying makeup/giving yourself a facial, even if you're not using the water. Dropped stuff and drain pluggers like hair, bottle tops, and makeup brushes will stay in the sink bowl. You can politely remove them/wipe out the bowl when you're finished with grooming activities.
- Keep the toilet lid closed when you're not using this fixture. If men live in your house, you know already that this will never happen. But you can try; tell them my septic repair bill for the shampoo cap was $400; maybe that will be an effective deterrent. Maybe not.
- I know it's not the most pleasant task, but take a moment to remove hair from the drain right after you shower. Hair and ordinary gunk that goes down the drain will create a nearly impenetrable clog in a pretty short time if you neglect to remove the hair after every shower.
- Do *not* throw anything more fibrous than a few sheets of toilet or facial tissue in the toilet and try to flush it away. Contrary to urban legend, household drain pipes will not accommodate full-grown alligators. I am always amazed at what people think will flow away to the municipal sewage system or the septic field: disposable diapers, huge wads of paper towels, even rags. Don't make this expensive mistake.
- Grease is the enemy of kitchen drains; letting grease ooze down the sink drain is the equivalent of pouring glue into the pipes. Everything will stick to the grease, and soon you'll have a nasty old clog. Pour leftover cooking oil, bacon grease, and other slimy stuff in a coffee can and dispose of it in the trash.

Unclogging a Sink

What's done is done. The water in the sink won't drain. You can first try pouring a kettle of boiling water into the drain. But if the water doesn't start to move, you'll need stronger measures.

Chemical Reactions

Using commercial liquid or powdered drain openers in a drain that's already clogged can be a problem. The chemicals are highly caustic and toxic, and if water is already backing into the sink, you may splash the chemicals on yourself if you later have to plunge the drain. Many of these concoctions are also toxic to the bacteria that keep your septic system (if you have one) flowing. If you must use a commercial drain declogger, follow the package directions to the letter.

If you want to try to create a harmless chemical reaction that just might work, use this nontoxic household remedy. It reminds me of my childhood days making "volcanoes." Pour a half-cup of vinegar and a half-cup of baking soda down the drain; stuff a rag in the stopper opening. The chemical reaction may be enough to loosen the clog's grip on your pipes. If not, try mechanical means.

Ounce of Prevention

Keep commercial drain decloggers out of reach of children or pets—they're deadly!

Taking the Plunge

There are two kinds of plungers. Plungers used for clearing toilets usually have a second, ball-shaped cup inside the outside cup. The plunger used for sink, shower, and tub drains is the single-cup model shown in Chapter 3.

You'll need the following:

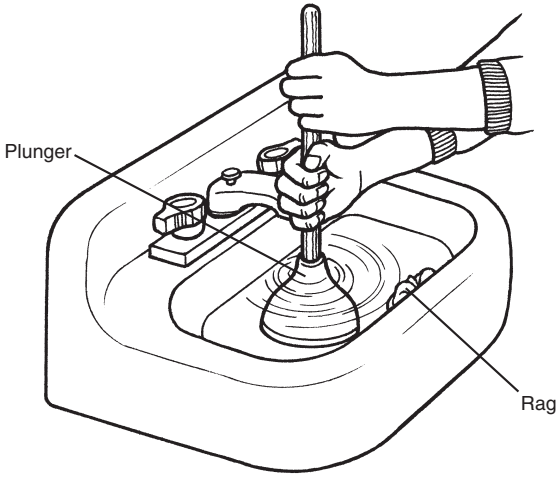
- Plunger (the plunger cup should be large enough to fully cover the drain opening)
- Rag

1. Remove the sink stopper. If you're working on a bathroom sink, find the overflow hole and stuff the rag into it; the overflow hole is usually positioned high up on the basin on the side of the bowl opposite the faucets. Feel under the lip of the sink if you can't find it.

If you're working on a kitchen sink, there will be no overflow hole. However, if your kitchen sink has two basins, you'll need to plug one of them with a rag. Otherwise, you'll divert the drain water into the second sink, rather than clearing the clog.

2. Fill the sink with enough water to nearly submerge the plunger cup; this will provide added pressure as you plunge.
3. Position the plunger cup over the drain hole so that the drain is completely covered.
4. Holding the plunger upright, pump the handle up and down forcefully, fifteen to twenty times; make sure the plunger cup is sealed over the drain. Then check to see if the water drains. If not, try again. Try plunging for three or four rounds of fifteen to twenty strokes each before you give up. (Most people quit too soon.)

Plunge a sink.



If plunging doesn't work, it's time to meet the trap.

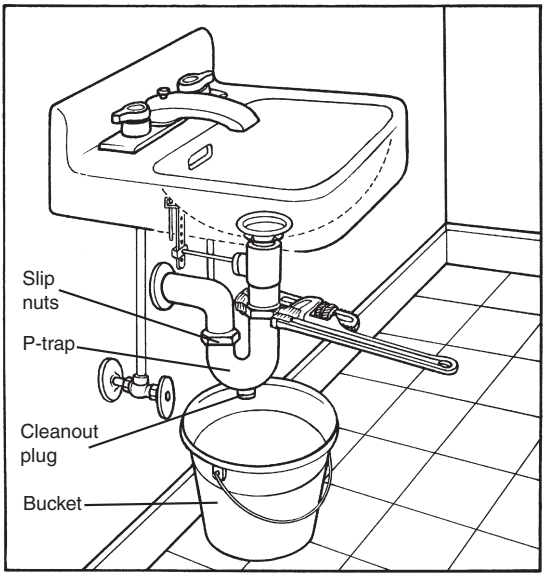
Meet the Sink Trap

The trap—a piece of bent pipe in the shape of a "P" resting on its side—was invented about 150 years ago, and made the wonders of indoor plumbing possible. Because of its shape, it always holds some water, which effectively seals off the waste line and prevents noxious gases from leaking up into the house. Its use as a clog-maker and holder of valuable objects is only a side benefit.

Back to your clog. The trap's shape also makes it a great place for grease and gunk to collect. A big enough build-up has gotten you to the point where the waste water has no escape and is backing into the sink. Plunging hasn't improved things, so now you've got to move to the trap.

Clearing the Trap

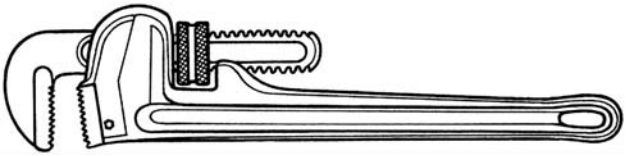
This is easy to do; the gunk and the gunk's odor make it somewhat unpleasant.



Clear the trap.

You'll need the following:

- ❑ Pipe wrench or slip-jointed pliers
- ❑ Painter's or masking tape
- ❑ Bucket
- ❑ Lubricating spray



A pipe wrench or slip-jointed pliers have jaws large enough to get a grip on plumbing pipes.

1. Turn off the faucets; don't run any water.
2. Tape the jaws of your pipe wrench or slip-jointed pliers with painter's or masking tape so they don't mar the nuts you'll be loosening or scratch the pipe's metal finish.
3. Position the bucket under the trap.
4. If the trap under your sink has a cleanout plug (like the one in the earlier illustration; not all traps do), loosen the plug and let the water/debris fall into the bucket. If there's no cleanout plug, go to Step 5.
5. Using the wrench/pliers, give each slip nut a half-turn counterclockwise, then loosen them the rest of the way by hand.
6. Remove the trap pipe. Don't lose track of the slip nuts and washers. Use lubricating spray if the nuts are stubborn.
7. Wearing rubber gloves, empty any debris inside the trap into the bucket.
8. Examine the trap pipe, the slip nuts, and washers. If any of these parts look worn, now is the time to take them to the hardware and purchase an exact replacement.
9. Using a flashlight, examine the pipe beyond the trap piece where the sink drain leads out to the larger drain system. Clear any obvious blockages you can see.
10. Replace the cleaned (or the replacement) pipe and washers, and tighten the nuts. Don't forget to replace the cleanout plug, if there is one. Turn the water supply back on with the supply stops. If the water runs freely down the drain and there's no leak at the trap, you're done. Remove and clean out the bucket. Put the gunk in the trash, not back in the drain!

When Valuables Go Down the Drain

If a piece of jewelry or other valuable object goes down the drain, *immediately* turn off the water and plug the drain hole with the sink stopper. Then, using the same tools and materials as in previous directions, follow Steps 2–7. Go through all the gunk that falls into the bucket. If your valuable isn't there, there is still a chance it may be in the pipe between the drain hole in the sink and the trap. Leave the bucket under the open trap and run the water briefly. Examine the pipe section with the flashlight and check the debris. If the jewelry or valuable isn't there, it's gone. But you did your best.

Replace the trap as in Step 10 above.

The Least You Need to Know

- A hose clamp and gasket material can stop a small leak; it's an easy repair, so keep these supplies around.
- Insulate pipes that are vulnerable to freezing—near exterior walls, in unheated parts of the house—with foam sleeves. When you insulate the hot water pipes, the sleeves will also save on water heating costs.
- Putting masking/painter's tape around the jaws of your pipe wrench or pliers will prevent the tools from marring your metal pipe and parts.
- Quick action is necessary if something valuable goes down the drain; turn off the water immediately.

Chapter 11

Controlling the Flow: Faucets, Sprays, and Showerheads

In This Chapter

- How faucets come apart and go together again
- Maintaining your sink sprayer
- Replacing a showerhead
- Adjusting a bathroom sink stopper so it opens and closes easily

Leaky hardware wastes a lot of water, and you don't usually have to be a pro to make good fixes on your faucets, sprayers, and showerheads. And that drain stopper in the bathroom that won't pop up—or go down? It's easier to adjust than you think.

Faucet Facts

The drip, drip, drip of a leaky faucet is annoying, and getting to the cause of the problem may seem complicated. But the fix is usually the replacement of a small and inexpensive part. It just requires patience to get there and back!

If you have very old (50-plus years) faucets, the biggest problem with fixing them may be finding replacement washers and nuts. Follow the directions for fixing compression faucets, as old stem faucets are put together in much the same way. But most of the old stuff wore out long ago, so chances are you've got faucets that can be repaired with parts or kits that are easily obtainable to replace worn or broken components.

Modern faucets are a little more complicated than the old-fashioned kind. Some have lots of little pieces! Be methodical when you repair a multi-part gizmo like a faucet. Careful work is always more effective than a hurried job.

If you don't know the brand and model number of your faucet, or it's very old, you'll need to remove it and bring it with you to find the correct size replacement parts and fittings.

Ounce of Prevention

If you're going to take apart a faucet, clear an area where you can line up the pieces in the order you remove them. If you need to take parts to the store to find replacements, make a list of the parts and the order, so you can put things back the way you took them out. It's always so frustrating to put something back together and have one piece left over!

Faucet Fix Prep List

Before you begin fixing any type of faucet, you'll need to do four things:

1. Shut off the water at the supply stops under the sink; if you don't have supply stops, shut off the water at the main. Drain whatever water remains in the faucet.
2. Close the sink drain with its stopper and cover it with a towel or rag—preferably white or light-colored. That way, if little faucet parts (some are tiny!) should fall in the sink, they won't go down the drain. Lining the sink with a towel or cloth will also protect the finish if you drop your tools.

3. Tape the jaws of whatever pliers or wrenches you are using with masking or painter's tape, so the tool doesn't scratch the fixture.
4. Figure out where you'll lay out your parts in order.

Basically, there are four types of faucets. The *compression* faucet has two handles. Opening or closing the handles, which in turn loosens or compresses the rubber washers at the base of the stem beneath each handle, controls the water flow (see the illustration in the next section). Because the key controller is made of rubber, which wears out more quickly than plastic, metal, or ceramic, this type of faucet needs repair more frequently than other types.

The other types of faucets are often called *washerless* faucets. *Ball-type*, *cartridge*, and *ceramic disk* faucets are appreciated for their sturdiness, but they also have small rubber and plastic seals and O-rings that are part of flow control and can wear out.

Balls, cartridges, and ceramic discs—the "works" of these other types of faucets—occasionally need replacement, but you can purchase the entire set of parts—the assembly—for much less than the cost of a new faucet. (You're not buying the handle(s) and spout, just the innards.)

Every manufacturer makes many variations of each type of faucet, so it's impossible to illustrate every detail of all of them. Use the illustrations shown as a general guide.

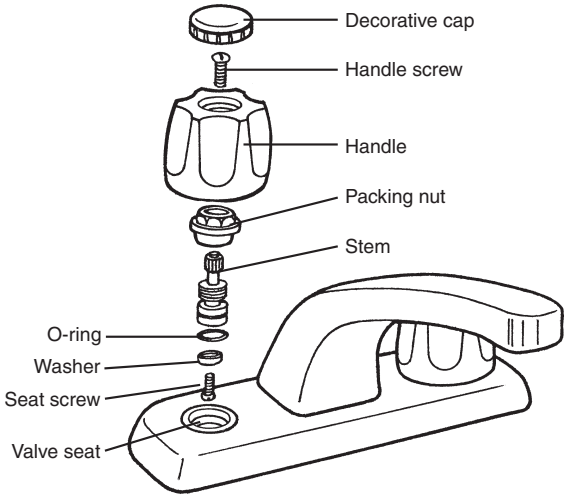
What Pros Know

If you get a printed diagram when you purchase parts or a faucet assembly, save it and put it in your home workbook (see Chapter 4). It'll make the next repair easier.

Fixing a Leaky Compression Faucet

Generally, leaks from the spout indicate a worn washer; leaks from the handle are caused by a worn O-ring. Once you get the faucet apart, examining all the parts for wear and corrosion is a good idea. You can fix what's broken *and* replace a worn part at the same time. Be sure to bring the defective part(s) with you to the store. O-rings and washers come in so many sizes, you need to know what will exactly replace the worn, damaged, or broken part.

Compression faucet.



You'll need the following:

- ❑ Adjustable wrench
- ❑ Screwdrivers (Phillips and standard)
- ❑ Penetrating oil or other lubricant
- ❑ Fine steel wool

What Pros Know

When you buy replacement washers and O-rings for a compression faucet, always buy several—they're cheap—label the leftovers, and keep them in your supply closet. That way you won't have to disassemble the faucet and bring the works to the hardware store to find replacement washers, rings, and the like, next time.

- ❑ Rag or towel
- ❑ Heatproof plumber's grease
- ❑ Replacement parts: washers, O-rings, or packing

1. Do all the steps in the "Faucet Fix Prep List" earlier in this chapter.

2. If the handle screw is visible, unscrew it and lift the handle straight up and off. If you don't see the handle screw, use the tip of the screwdriver to carefully lift off the decorative cap, which should reveal the handle screw. Unscrew it and remove the handle.
3. Remove the packing nut with your taped wrench or pliers.
4. Put the handle back on the stem and turn the handle to loosen the stem. If this doesn't work, use the wrench or pliers to loosen the stem. Lift it out.
5. Once the stem is out, unscrew the seat screw and remove the washer. If it's tough to remove the screw, use a little penetrating oil.
6. Using the tip of the standard screwdriver, gently guide the O-ring out of its little groove and remove it from the stem. Don't break or cut it; you need the original to buy its exact replacement.

   Instead of an O-ring, you may have found a soft washer-like part made of wound string at the top of the stem—this is called *packing*—and is sometimes found in older compression faucets between the stem and the cap. If your faucet has packing, you'll need to bring this stuff to the hardware store, buy replacement packing, and rewind it on the top of the stem.
7. Once you've got your replacement parts, clean up the screws and stem by buffing them with steel wool. Clean and wipe everything off so there's no steel wool or other residue that may wear the new parts.

Ounce of Prevention

A lot of plumbers will take this interim step before they reassemble a faucet. After removing the towel and any tools or parts from the sink, they'll cover the faucet hole with a rag, open the supply stops a little to let water flush out any residue from the repair that remains. Little bits of rubber, metal, or steel wool can mess up their work! Then they turn off the water and reassemble the faucet.

8. After coating them with heatproof plumber's grease, install the new washer and/or O-ring (if one is worn, it's good to do both) and reinstall the faucet. Open the supply stops and try it. If you hear a funny noise or the spout still leaks, you'll have to disassemble and tighten the screw (the one that holds the washer to the stem) another quarter turn. Don't tighten too hard or you'll deform the washer.

Still Dripping?

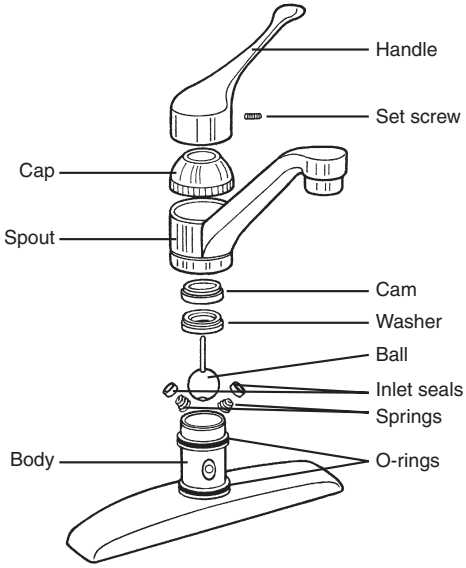
Don't despair. There's one more thing you can try: you may need a new valve seat (if it's removable, you'll need an Allen wrench or a seat wrench to get it out), or you may need to grind the existing valve seat with a seat-grinding tool. If you grind the old seat, this will create some debris. Be sure to flush the seat out with water (see the previous sidebar) before you reinstall the faucet.

Fixing a Leaky Rotary Ball Faucet

About 30 percent of all kitchen faucets are this type. Most DIY-ers find rotary ball faucets the most annoying to fix: they have more parts than any of the other types!

Once you disassemble this faucet, bring the works to the hardware and buy a kit with all-new parts. The kits are cheap and it's hard to tell what's causing the leak in a ball faucet. Unless you really love taking this faucet apart repeatedly, it's much easier to just replace everything. Your parts kit should come with a schematic drawing of the faucet and its parts. You can use this as a guide to get everything back together in the proper order.

Rotary ball faucet.



You'll need the following:

- ❑ Allen wrench set
- ❑ Adjustable wrench or pliers
- ❑ Tweezers (for removing/setting the seals and springs; they are minis!)
- ❑ Standard screwdriver
- ❑ Rag or towel
- ❑ Heatproof plumber's grease
- ❑ Replacement parts kit for your faucet

1. Do all the steps in the "Faucet Fix Prep List" earlier in this chapter.
2. Turn the handle so the lever faces you. Lift it, and remove the set screw that holds it in place with the Allen wrench. Lift off the handle. (Tape the set screw to the handle so you don't lose it!)
3. Use the tape-wrapped wrench or pliers to remove the cap; then lift off the spout.
4. Carefully remove the cam and washer, then lift out the metal or plastic ball.
5. With the tweezers, lift out the seats and springs. Lay them on a piece of tape and mark how they are inserted so you can put the new ones back the same way.
6. Peel off the O-rings. Use the tip of the standard screwdriver to ease them off; don't cut them.
7. Once you've gotten your replacement parts kit, reassemble the faucet. Coat the O-rings with plumber's grease to make it easier to slide them into their grooves. Pay very careful attention to the instructions that come with the kit, especially the order and positions of the little springs and seats.
8. When the faucet is reassembled, open the supply stops and turn on the faucet.

What Pros Know

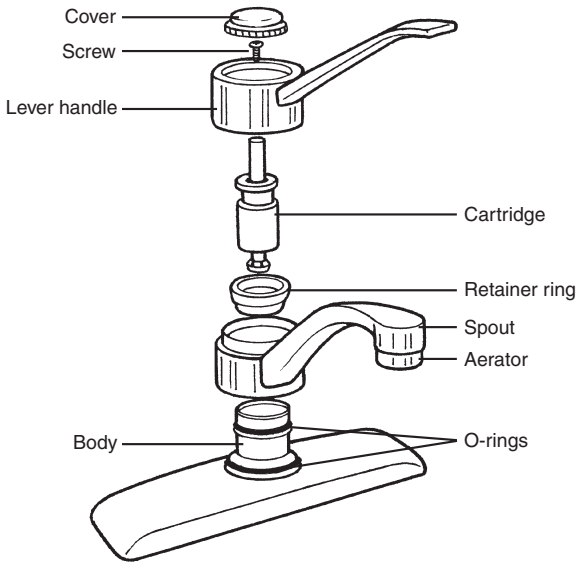
The ball and seats of a rotary ball faucet are prone to clogging—the little inlets are quite small. Now that you know how to take this one apart, you know how to get to the ball and seats to clean them out if the water flow seems to be restricted and the problem's not the spout's aerator (see "Cleaning a Clogged Aerator" later in this chapter).

Repairing a Cartridge Faucet

As you may have noticed from the other faucet repair instructions, each type of faucet has its own assets and drawbacks. The main difficulty with cartridge models is that there are so many kinds of cartridges—you really must bring in the old one to find its exact match.

While the cartridge faucet will work just fine once you replace the faulty cartridge, you need to be careful when trying to remove it. The cartridge is secured by a small clip on an interior ring below the cartridge, or a little clip that you may be able to feel below the handle; if you feel it below the handle, then pull it out with a pair of pliers or screwdriver; then you can remove the handle, unscrew the retaining cap below the cartridge, and lift out the cartridge.

Cartridge faucet.



You'll need the following:

- ❑ Adjustable wrench or pliers
- ❑ Needlenose pliers (to remove retainer clip)

- ❑ Screwdrivers, standard and Phillips
- ❑ Allen wrench set
- ❑ Rag or towel
- ❑ Heatproof plumber's grease
- ❑ Replacement cartridge and O-rings

1. Do all the steps in the "Faucet Fix Prep List" earlier in this chapter.
2. Pry off the decorative cap on the handle. Remove the screw. Then tilt the handle back and pull it up and off.
3. If there's a retainer clip holding the cartridge, use the needlenose pliers to remove it. Pull the cartridge straight up and off.
4. Remove the spout and then pry off the O-rings.
5. When you have the replacement cartridge and O-rings, coat the new O-rings with plumber's grease and slip them onto the body and into the grooves. Replace the spout, the retainer ring, and the cartridge. Insert the retainer clip in the same location from which you removed it. Replace the handle, the screw and the decorative cap.
6. When the faucet is fully reassembled, open the water supply stops. It's ready to use.

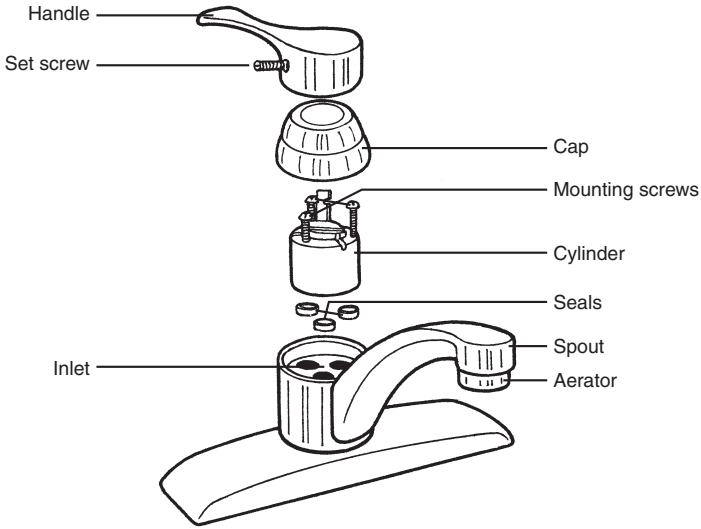
Ounce of Prevention

Whenever you're replacing a major faucet part, go ahead and replace the O-rings. It beats having to disassemble the faucet once again!

Ceramic Disk Faucet Fix

This type of faucet is expensive and usually quite sturdy. Check the manufacturer's website or call the manufacturer; ceramic disk faucets often have a long or lifetime warranty, and you may be able to get free parts and directions if you contact the maker of your faucet.

Ceramic disk faucet.



You'll need the following:

- ❑ Adjustable wrench or pliers
- ❑ Allen wrench set
- ❑ Screwdrivers, standard and Phillips (to loosen disk mounting screws and lift seals on the disk)
- ❑ White vinegar
- ❑ Old toothbrush or nonscratch abrasive pad (blue)

1. Do all the steps in the "Faucet Fix Prep List" earlier in this chapter.
2. Push back the faucet handle to reveal the set screw; remove the set screw with the right size Allen wrench and lift the handle off. Remove the cap and any other parts above the ceramic disk; use the taped wrench or pliers when necessary.
3. Unscrew the disk cylinder's mounting screws with the Phillips screwdriver and lift out the cylinder.

4. Use the flat tip of the standard screwdriver to lift off the seals from the bottom of the disk. If they are worn, replace them (they are very inexpensive).
5. If it's not broken or cracked, clean the cylinder with vinegar and the toothbrush or soft abrasive pad. If it's broken, replace it with the exact matching part.
6. Replace the seals and disk, and reassemble the faucet.
7. Ceramic disk faucets can be susceptible to damage when you reopen them, so you must be careful turning on the water! Open the faucet in the center position before you open the supply stops. Then open the supply stops very gradually and slowly. Air forcing its way through the pipes ahead of the water can crack the disk, so you need to proceed with caution.

Cleaning a Clogged Aerator

If the water pressure at one of your faucet spouts is weak, or if the water is coming out irregularly— spitting or splashing out of the sink, for example—the problem is probably a dirty or faulty aerator in the spout (see the following illustration).

You'll need the following:

- ❑ Rag or towel
- ❑ Adjustable wrench or pliers
- ❑ White vinegar
- ❑ Wire brush
- ❑ Old toothbrush

What Pros Know

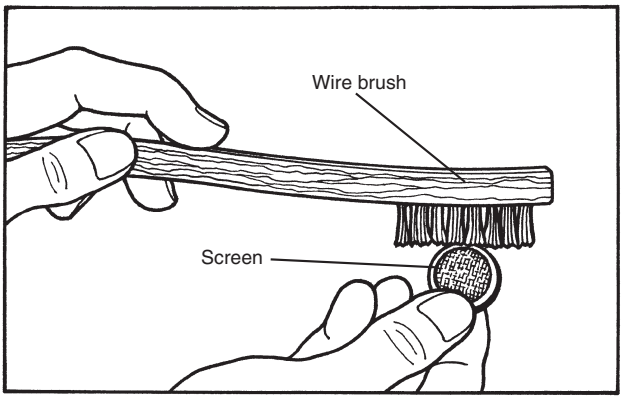
Weak water pressure throughout the house may be an indication of some problem with the main coming into the house (a leak, perhaps), or with your well or pump, if you have private water. Call your water company or well service company for professional help.

You don't need to turn off the water at the supply stops for this repair; just turn off the water at the faucet. Put a towel or rag over the drain so you don't lose a part.

1. To remove the aerator from the spout, turn it by hand in a counterclockwise direction (remember: lefty, loosey). If it won't budge, gently loosen it with the tape-wrapped wrench or pliers.
2. Once you remove it, you'll notice that the aerator may have several parts; set them out on a flat surface in the correct order. Rinse the pieces in water to

remove debris. If they still look clogged, soak them in white vinegar for a few minutes and scrub them with the wire brush (metal screen) or old toothbrush (plastic parts).

Cleaning the aerator screen.



3. If any of the parts are damaged, bring them to the hardware store and find replacements.
4. Put the aerator parts back together in the right sequence. Reinstall the aerator on the faucet spout by hand-turning it clockwise. Try the faucet; the cleaned/replaced aerator should correct any flow/pressure problems.

Brushing Up on Showerheads

You may have an old showerhead that's begun to leak at the joint between the head and the arm, or you might simply want to remove an old model and change it for a new style with a different flow pattern. Either way, it's fairly simple to repair or change the head.

Sometimes the little holes that direct the shower spray get clogged by dirt, or by mineral deposits in the water. It's easy to clean them. White vinegar is a great cleaner for many types of plumbing fittings; it dissolves crud, and does not damage the fixtures.

Cleaning Showerhead Outlet Holes

You'll need the following:

- ❑ Screwdriver (standard or Phillips head)
- ❑ White vinegar
- ❑ Straight pin

The flat metal surface of the showerhead from which the water spray emerges is called the faceplate. You can detach it from the showerhead by removing the faceplate screw or screws. Soak the faceplate in vinegar overnight, and clean the water outlet holes with a straight pin.

Removing/Replacing a Showerhead

As you did with faucets, you'll need to prepare your work area and tools:

1. Shut off the water at the supply stops or the main.
2. To protect the fixture, wrap the jaws of your wrench or pliers with masking or painter's tape.
3. Close or cover the drain with a rag or towel so you don't lose any parts. If your shower is in the tub, you may want to further protect the tub by putting corrugated board on the tub bottom, or cover the whole tub with a drop cloth.
4. Clear a place to set out the showerhead parts in order. There are usually only a few parts, but you don't want any to go astray if you're putting back the same head.

You'll need the following:

- ❑ Locking pliers
- ❑ Adjustable wrench or pliers
- ❑ Lubricating spray
- ❑ Teflon tape

The showerhead and the shower arm screw together by means of a collar nut on the showerhead, which threads onto the shower arm. The shower arm is wrapped with Teflon tape that provides a secure seal between nut and threads.

1. Hold the shower arm in place with the taped jaws of the locking pliers; with the taped jaws of the adjustable wrench or slip-jointed pliers loosen the collar nut of the showerhead by turning it counterclockwise. If it's stiff and won't turn, try a little lubricating spray.
2. Once the collar nut is loosened, finish loosening it by hand and remove the showerhead.

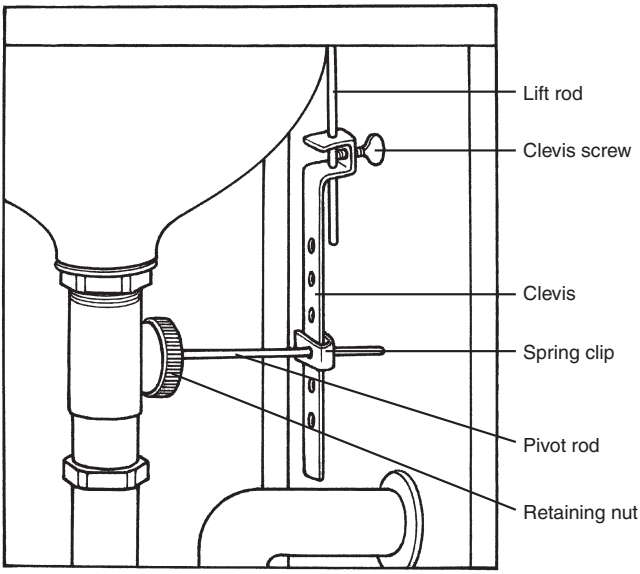
   Once the showerhead is removed, you can perform these fixes (if you're replacing the head, skip to Step 3):

   - If the showerhead is leaking near the collar nut, you may have a bad washer. Unscrew the showerhead until you expose the swivel ball and washer. If the washer looks corroded, you can take it to the hardware store and get a replacement.
   - If the shower has a stiff pivot, you can lubricate the swivel ball with some petroleum jelly.

3. Remove any old tape from the shower arm, and clean the arm so there's no residue remaining. Wrap the threads at the end of the shower arm with Teflon tape. Wind the tape counterclockwise, with two layers. The tape should be taut, but the threads of the shower arm should not be cutting through the tape.
4. To replace or reinstall the old showerhead, screw the head onto the tape coated arm, then tighten the collar nut with the adjustable wrench or slip-jointed pliers, while keeping the shower arm immobile with the locking pliers.
5. Uncover the drain, open the supply stops or main water control, and turn on the shower. If there are no leaks, you're done. If there's a drip, turn off the water and try turning the collar nut another quarter turn. Don't over-tighten. If the leaking persists, you'll have to remove the showerhead, unwrap the Teflon tape, wrap with new tape, and reinstall the showerhead.

When the Pop-Up Stopper Flops

Pop-up drain stoppers in bathroom sinks are a convenient invention, but fixing them requires you to crawl around under and behind the sink—tough duty if your bathroom sink is mounted in a vanity cabinet. You'll have to unload everything you've stored under the sink (be careful to put any toxic items out of the reach of children or pets), and use a flashlight to take a good look at what you're working on.



Pop-up drain assembly.

The mechanics of a pop-up drain stopper are really pretty simple; the handle of the lift rod sits on top of the sink between the faucets and (usually) behind the spout. When the handle is raised, the pop-up drain closes; when the handle is pushed down, the drain opens.

Underneath the sink, the lift rod attaches to a perforated metal bar called the *clevis* by means of a *clevis screw*, which is loosened or tightened by hand or by screwdriver.

Also attached to the clevis with a spring clip is a *pivot rod*, which passes through a retaining nut into the drain. Beyond the retaining nut, the rod also passes through a pivot ball, a plastic gasket, and a washer. It then passes through a small loop in the tail end of the pop-up stopper. So—the lift rod connects to the clevis, which connects to the pivot rod, which connects to the pop-up stopper. Got it?

Here's how to adjust the under-sink mechanics so your pop-up stopper will work the way it's supposed to.

If the pop-up stopper doesn't sit tight in the drain when you raise the lift rod:

1. Loosen the clevis screw (with your fingers, a screwdriver, or an adjustable wrench, depending on the type of screw).
2. Push the stopper down by hand to close the drain.

3. Tighten the clevis screw. Once you make this adjustment, the stopper should close snugly.

If the pop-up stopper doesn't stay open when you push down the lift rod:

1. Squeeze the spring clip (see the previous illustration), and release the pivot rod from the clevis.
2. Move the pivot rod to the next hole up on the clevis, holding it in place with the spring clip.

If you need to remove the pop-up stopper to clean out the drain, or for any other reason (you'll need an adjustable wrench or slip jointed pliers with taped jaws to perform this repair):

1. Loosen the retaining nut with the wrench and pull back the pivot rod, which will disengage the rod from the stopper. If you remove any parts from the pivot rod, be sure to replace them in the right order.
2. Once the rod is disengaged from the stopper, you can lift it right out.

Ounce of Prevention

Bathroom drains get gunky with all of the hair and grooming products that slide down into the pipes. To prevent clogs, and prevent the need to go through the acrobatics of working under the sink to remove the pop-up stopper, do the following preventive maintenance:

1. Keep the stopper closed when you're using grooming aids, and wipe out the basin before you let the water run.
2. Once a month, run very hot (or a pot of boiling) water down each of your bathroom drains; this will help keep them flowing.

The Least You Need to Know

- There are four basic types of faucets: compression, rotary ball, cartridge, and ceramic disk.
- Arrange faucet parts in the order you remove them; this will help you get them back in the correct order—a must for an effective repair.
- Your spitting faucet is probably a sign of a clogged or faulty aerator—an easy fix.
- Pop-up bathroom sink stoppers are controlled from behind and underneath the sink. You'll need a flashlight and some physical agility to squeeze in for the repair!

Chapter 12

Tub and Toilet Techniques

In This Chapter

- Cosmetic improvements for the tub
- How to clear tub and toilet clogs
- How to stop a running toilet in its tracks
- Toilet innards, old and new

Tubs and toilets are sturdy fixtures; most last for years without any major problems. If you have an old, porcelain enamel-coated cast iron tub, you can improve its looks by repairing chips with a kit from the home center. And you can guard against moisture problems around the tub by occasionally renewing the bond between tub and wall.

As for the toilet, there's a lot you can do to improve the way it works beyond the old "jiggle the handle" trick, which rarely fixes one of its potential problems, and then, only temporarily.

Bathtubs: The Surface Story

A century ago, after indoor bathroom fixtures became more universal, the standard tub was cast iron, coated with white porcelain. In the past couple of decades, however, coated stainless steel and molded acrylic are lighter-weight, cheaper, and easier-to-install tub alternatives.

If you've got an old tub, you can improve its appearance. New products can help you repair the surface of an old fixture.

Concealing Surface Flaws in Porcelain-Enameled Cast Iron

Cast iron tubs are very heavy. Rap your knuckles against the tub wall; iron will respond with a deep thrum (and probably hurt your knuckles). The only vulnerability of these sturdy standbys is their lovely porcelain skin. Dropping something heavy in the tub can crack or chip the porcelain enamel, sometimes exposing the iron beneath the delicate surface.

The only permanent and flawless solution to repairing the damaged "skin" of an old fixture is to have it completely resurfaced (see Appendix B). The process is somewhat expensive, but far less than the cost of removing an old cast iron tub and replacing it with a similar model.

However, improvements in epoxy products have made spot repairs more acceptable. Hardware stores and home centers now stock repair kits for filling chips and small cracks in a porcelain surface. Several companies offer the repair products in a range of colors beyond plain white (and anyone who has white fixtures knows that there is a range of whites, as well).

These repairs should be done carefully, according to product directions. There are usually three steps:

1. Sand the chipped or cracked area with very fine sandpaper (220-grit or higher) or an emery cloth, and clean the surface thoroughly.
2. Apply a chip filler with a putty knife or tongue depressor. If the chip or gouge is deep, Steps 1 and 2 are repeated several times, allowing the filler to dry according to instructions.
3. When the repair is smooth and dry, apply a porcelain touch-up glaze and allow to dry according to directions.

What Pros Know

Enameled cast iron kitchen sinks can be repaired with the same type of repair kits used to spot-repair an old tub.

If a large piece of porcelain chips off, don't discard it. Use epoxy cement (according to directions) to glue it back in place, then perform the repair just described.

Renewing a Scratched Acrylic Tub

These tubs are molded from sheets of acrylic; the surface color goes completely through the material. However, people who don't realize that acrylic is *plastic* mistakenly use an abrasive cleaner on this surface, and wind up scratching or dulling it. You can remove the dullness by using a product designed to polish plastic surfaces. (Many people swear by a liquid polish called Gel Gloss.)

Remove scratches and burns from acrylic tub surfaces with extremely fine sandpaper (1,500-grit is available at automotive supply stores); use a little water when you sand. Then finish the job with the liquid polish.

Waterproofing Around the Bathtub

Whether the walls around your tub are tile, laminate, paneling, or wallpapered drywall, there should be a waterproof seam between the top edge of the tub and the wall. This nice finish is usually accomplished by applying a line of waterproof *caulk* at the juncture between tub and wall. The caulk prevents water from the tub or the shower-in-tub from leaking behind the tub edge, and damaging the adjoining walls and the floor beneath.

Caulk does eventually dry out, but the real culprit that cracks caulk around the tub is weight. Remember, water is heavy—more than seven pounds per gallon. So every time you fill the tub, with water and yourself, you are putting some stress on that nice, straight caulk seam. Here's how to renew it.

def•i•ni•tion

Caulk is a material used to create a watertight seal between two adjoining surfaces.

To remove old caulk, you'll need the following:

- ❑ Painter's tape
- ❑ Standard screwdriver

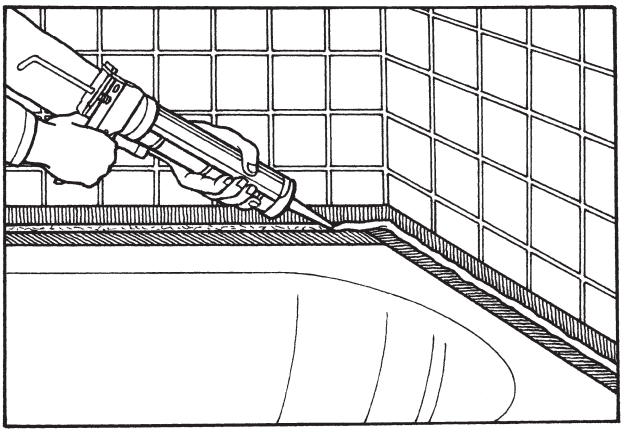
1. You'll want to protect the wall and the tub surface when you remove the old caulk. Apply painter's tape to the edge of the wall above the caulk line, and to the edge of the tub below the caulk.

2. Using the standard screwdriver, and wearing rubber gloves if you don't want to touch the old caulk, remove the old caulk, using the tip of the screwdriver to scrape it away anywhere it sticks.
3. Clean any dirt or mildew from around the seam location. New caulking will not adhere properly to a dirty surface. Let the open joint dry. If the painter's tape has lifted, reapply it so you have a nice clean guideline for installing the new caulk.

To install new caulk, you'll need the following:

- ❑ Painter's tape
- ❑ Waterproof caulk (silicon or other product recommended for tub joints)
- ❑ Caulking gun

1. Apply painter's tape to the edge of the wall above the caulk line, and to the edge of the tub below the caulk.
2. Puncture or cut the tip of the caulking tube and insert the tube in the caulking gun according to gun directions. (Some sealants come in a hand-held tube; use them according to package instructions.)
3. Starting from a corner or end of the tub, install a straight bead of caulk along the joint between tub and wall.



Install new caulk. The caulking gun shown is a common type, but there are many designs for this tool.

4. Allow the caulk to dry according to package directions.
5. Remove the painter's tape.

You can use the same process to install new caulk in the joint between the base of the tub and the floor.

Clearing a Tub Clog

Because the pipes that supply and drain the tub are usually behind the wall and/or under the tub, clearing a clogged tub drain is slightly different than clearing a sink drain. Some tubs have pop-up stoppers (like sinks), while others have strainer/drains. Old claw foot tubs may have a rubber plug!

Pop-Up Stopper

The overflow for a tub is located above the drain on the wall of the tub below the tub spout.

1. Open the stopper, using the lever on the overflow.
2. Turn the stopper counterclockwise, then pull it out.
3. Wearing rubber gloves, remove any accumulation of hair and other yucky stuff. Replace the stopper.

Strainer

You'll need needlenose pliers for this one.

1. Grip the strainer by inserting the two narrow jaws of the pliers into two holes in the strainer.
2. Turn the strainer counterclockwise, then lift it out.
3. Wearing rubber gloves, remove hair and other debris; replace the strainer, gripping it with the pliers as before. Turn it clockwise to set it back in place.

Take the Plunge

If the clog is stubborn, try the plunger. You'll need the following:

- Screwdriver (standard or Phillips) to remove the overflow cover
- Rag
- Plunger

What Pros Know

Address slow bathtub drains *before* you have standing water—an indication that the problem has become a difficult one. To avoid future clogs, pour a kettle full of boiling water down each of your tub drains once a month. Remove hair from the drain stopper regularly—whenever you use the tub.

1. Unscrew the metal cover on the overflow and stuff the rag in the hole.
2. If there's sufficient standing water in the tub to cover the plunger cup, proceed to the next step. If not, add water so it covers the plunger cup.
3. Maintaining the seal of the cup over the drain, plunge straight up and down a dozen times; see if the water starts to flow down the drain. Repeat this process at least three or four times before you give up! It usually works.

The Worst Case: Toilet Clogs

Warning! When the flush handle on your toilet fails to move the water and waste out of the toilet and down the drain, *ignore* your impulse to flush again. You'll probably succeed only in making the water (and everything else!) wind up on the floor.

An excess of paper (usually big wads of toilet paper) is often the culprit in a clog. Before you try any muscular solutions, try the following fix.

Low-Tech De-Clogging

When my kids were little, they often used toilet paper *enthusiastically*, and the toilet would clog. My husband was the pro in this case. He'd ignore my bleats of dismay and go to his closet for a wire coat hanger. He'd untwist the hanger and maneuver one end into the drain portion of the toilet until the hanger hooked into the paper dam that one or the other child had created. Then he'd ease the paper back up into the bowl,

with instructions to leave the mess alone for a while. If it was a really huge mass of paper, he'd remove some and dispose of it in another toilet. An hour or two later, the remains of the original offending wad would have disintegrated a bit, and usually flushed right down.

You can try it, especially if your little ones are extravagant users of toilet paper!

Ounce of Prevention

Other toilet cloggers are dental floss, napkins, paper towels, and nonflushable feminine sanitary products. *None* of these should be discarded in the toilet! These items are also fatal, or nearly so, to septic waste systems.

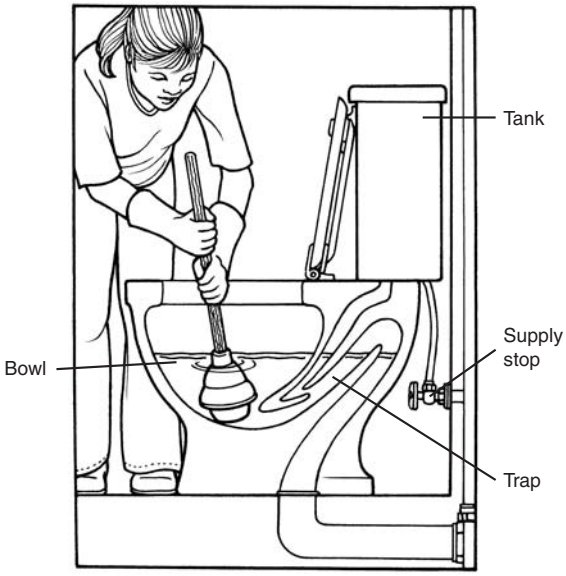
The Toilet Plunge

For a basic toilet plunge you'll need a plunger and a bucket.

1. Turn off the water at the supply stop underneath the toilet. If there is no supply stop, turn off the main water supply valve.
2. If the toilet bowl is less than half full, add enough water to cover the plunger cup, once you place the plunger in the toilet over the drain hole. If the toilet is quite full, get a cup and bail some water from the bowl into the bucket. Otherwise you'll splash water all over the place when you plunge.
3. Pump the plunger up and down at least a dozen times. If the water doesn't start to drain, plunge again. Try this routine a couple of times. Be patient, and don't pump violently; push the handle down gently, then pull it up. If you shake the bowl too much you could unseal the ring-shaped wax gasket that seams the base of the toilet (called the *horn* in plumbing lingo) to the waste pipe. (The only solution to a broken wax seal—which can cause a leak—is removing the toilet and replacing the gasket, a job for a pro.)
4. Once the obstruction clears, turn on the water supply at the supply stop or main valve.

If you cannot clear the obstruction, you'll need to call a pro.

Plunge the toilet.



Other Toilet Trouble

Q: Is your toilet running?

A: Yes.

Well, go catch it!

Five-year-olds love this joke, but for the adults in the house, a running toilet isn't funny. It's annoying and it wastes a lot of water.

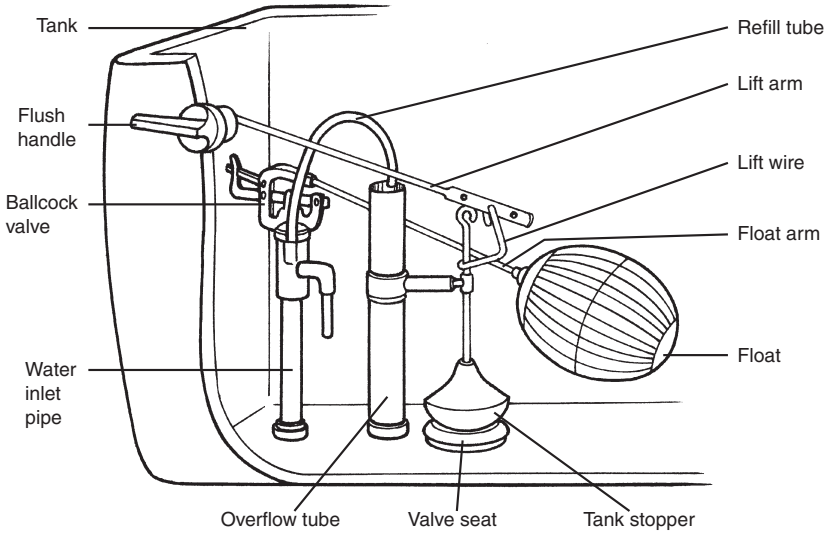
In addition to running when they shouldn't, toilets can sweat, leak, and (believe it or not) rock. Here's how to handle some of these problems (and which ones to leave for the pros).

What Pros Know

Old toilets of pre-1990s vintage should be replaced whenever your budget will allow. Most older toilets flush with about 7 gallons of water; new models flush with 1.6 gallons! If you live in a drought-prone area, or pay a water company for your water, the new fixture will soon pay for itself.

Inside the Tank: A Toilet's Vital Organs

First, let's take a look at two common configurations you're likely to see inside the toilet when you lift the tank lid.



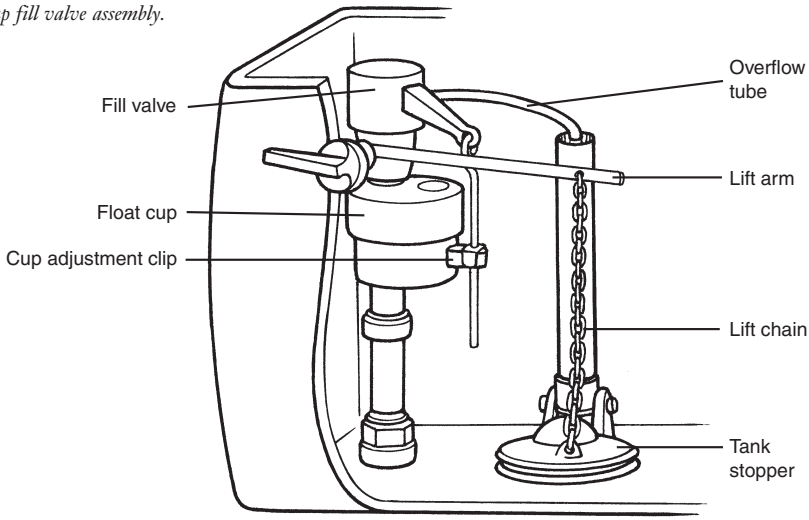
Toilet with ballcock valve assembly.

Yes, there are a lot of named parts in this setup. But if you look at the drawing, you'll see that the way it works is rather simple.

When you depress the *flush handle* to flush the toilet, the *lift arm* raises the *lift wire*, which raises the *tank stopper* (also called a *flapper*) out of the *valve seat*, so that water can move from the tank to the bowl, creating the flush action that siphons waste into the drain.

Because the water level is going down, the *float* (in this configuration, a big rubber ball) begins to drop down in the tank, also lowering the *float arm.* The lowering float and arm pull open the *ballcock valve*, which allows fresh water to enter the tank through the *refill tube.* As the water rises, so does the float, gradually closing the ballcock valve. When the tank is full, the water should stop flowing.

Float cup fill valve assembly.



In this more modern setup, the *float cup* takes the place of the float (the rubber ball) in the older version. The cup can be raised or lowered to adjust the water level in the tank.

Stopping a Running Toilet

If the water runs and runs after you flush, you'll need to take a look inside the tank. So remove the lid and observe the following.

Worn-Out Float Ball

If you've got a float ball in your tank and it's partially submerged, or has water inside it, you need to replace it. Shut off the water supply at the supply stop (or the main, if there is no supply stop), and flush the toilet. Unscrew the float from the float arm (turn counterclockwise), take it to the hardware store and buy a replacement. Attach the new float (turn clockwise), and turn on the supply stop.

Float Ball Won't Rise

If the float won't rise sufficiently to stop the inlet valve from running water into the tank, then the water will keep running. To adjust the float, manually lift the float arm; if that stops the water from running, bend the float arm down, or away from the tank wall. To adjust the float cup, press the clip that adjusts the float cup and try moving it up to raise the water level.

Tank Stopper Won't Close

If the water level is not the problem, a running toilet is often caused by a poor seal between the tank stopper and the valve seat. Or, the stopper is worn and needs to be replaced.

With the tank lid open, if you observe the flush and notice that the tank stopper (see the earlier illustration of a toilet with ballcock valve assembly) is not closing firmly over the toilet valve seat, the water will continue to run out of the tank, no matter how much water flows in. You want the stopper to drop directly over the valve seat.

Try changing the position of the lift rod (or chain) on the lift arm. You can try making the chain longer or shorter. If that doesn't help the stopper seal over the valve seat, you can try two other fixes.

To clean the stopper and valve seat, you'll need a sponge and a pad of fine steel wool.

1. Turn off the water and flush the tank to empty it.
2. Lift the stopper. Clean it with the sponge.
3. Examine and feel the edge of the valve seat. It may have corroded a bit and feel rough. Smooth and clean it with the steel wool.
4. Replace the stopper. Turn the water back on, and leaving the tank lid open, watch the stopper as you flush. If the stopper seals and the water stops running, you're done.

If not, here's how to replace the stopper.

1. Turn off the water and flush the tank to empty it.
2. Remove the stopper from the lift rod or chain (it will unscrew or unhook), and bring it to the hardware store or home center for a replacement.
3. Install the new stopper.

The Flush Is Weak

You'll need to remove the tank lid to watch the flush action.

If the screw that connects the flush handle to the lift arm is loose, tighten this connection.

Or the stopper may close before the tank empties; in that case, adjust the lift rod or chain. If this is the cause, usually the rod or chain needs to be lengthened a bit to give the water a tiny bit more time to drain out.

Leak or Sweat?

Water dripping in various locations on the outside of the tank or bowl can mean a leak—which can be serious. Or the water can be a result of condensation ("sweat"), which can be cured by insulating the inside of the tank.

To detect a leak, you'll need the following:

- Old clean towels or rags
- Food coloring (red or green)
- Paper towels

1. Flush the toilet, then use the towels to dry all the exterior surfaces: tank, seat, bowl, bolts, everything.
2. Open the tank lid and pour a little (half a teaspoon) of the food coloring into the water. Cover the tank, and wait an hour or so.
3. Wipe a paper towel under the tank where it connects to the bowl. If the towel shows food coloring, you've found your leak.
4. If not, run the paper towel around the base of the toilet. If the towel is the color of the food coloring, you've probably got a leak at the wax gasket connection.

With either of these problems, the toilet needs to be taken apart. It's best to call a plumber. However, if there is no leak, you've probably got a condensation problem. This often happens in the summer, when humid conditions create the ideal environment for sweaty toilets. You can live with the problem in hot weather, wiping down the fixture when it gets sweaty, or you can be industrious and insulate the tank.

Personally, I just use a towel in hot weather when one or more of our toilets sweat. But if you want, you can insulate the tank with ¼" sheets of polystyrene foam cut to match the dimensions of the sides, front and back of the tank.

To do this, you need to turn off the water supply, flush the toilet until the tank is empty, wipe it down, and create paper templates for all four inside walls of the toilet tank. Trace the dimensions of the templates onto the polystyrene sheets, cut them out, and then fit them in the tank. Glue the polystyrene to the walls of the tank with waterproof mastic. Be careful that the insulation does not block or impede any of the toilet's inner workings.

If this sounds like too much work, when your toilet starts to sweat, just grab a clean old towel and do the daily wipe down!

When the Toilet Rocks

A rocking toilet is not a good thing. When you sit on the toilet and it seems to rock, it most likely means that the wax ring seal is broken. This can cause a leak that can ruin your floor (and the ceiling below it). Call a plumber right away.

The Least You Need to Know

- It's possible to spot-repair the finish on an old enameled cast iron tub.
- Keep tub drains flowing by removing hair after every use, and pouring a kettle of boiling water down each one, every month.
- Toilet tanks seem to have a lot of stuff in them, but the mechanics are simple.
- Leaks from the tank, the base, or a rocking toilet bowl require professional attention.

Part 4 Mission Control: Wiring, Appliances, Heating, and Cooling

Now we come to the brains of your home: its system of wiring and conveniences that make daily life run smoothly.

I often look around my house and try to imagine how its original owners managed with just a couple of candles and the heat from their fireplaces. Winters must really have been dark, chilly, and unrelenting.

Lights, central heating, automatic washing machines, refrigerators—how could we live without them? When one of these things doesn't work, we're up in arms in a matter of hours. Part 4 won't keep you free from power outages—they're beyond your control—but it will help you keep things humming along smoothly otherwise.

"June, I can do this wiring myself. Trust me. It's not a fire hazard, and we're not going to get electrocuted."

Chapter 13

In the Loop: Understanding Your Wiring

In This Chapter

- A look at electrical terms
- Mapping your home's electrical system
- Understanding circuitry
- Really receptive receptacles
- GFCI: four initials you need to know
- Removing a broken bulb from a light socket

The NEC (National Electrical Code) Handbook is nearly 800 pages long; a new edition is published every three years. That's a lot of reading just to learn the standards for electrical systems.

Then you have to learn to *do* this stuff. An apprenticed electrician studies for two years and spends 8,000 hours on the job (about four years), just to earn the designation of Journeyman for his trade.

Why am I telling you all this? Because working safely with electricity requires knowledge and skill. There's a lot to learn. And mistakes can be dangerous to your health. So my advice to you as you learn about your electrical system can be summed up in three words: proceed with care. If you are unsure or confused about anything described in this chapter, don't hesitate. Call a licensed electrician to help with your wiring problem.

Time to Call a Pro?

In this chapter, you'll find a lot of information about household electrical systems, but only a couple of things to do yourself. Some houses have up-to-date electrical systems, and others are deplorably out of date. If yours is of the latter variety, I advise you not to work on it yourself. And even if you have a modern system, there are as many "exceptions to the rules" in wiring as there are conforming setups. To become well versed in wiring takes more space than there is available in this chapter.

Ounce of Prevention

If you need an electrician, beware of using a friend of a friend who "works with wiring." You want a *licensed* electrician. Ask: "Are you licensed?" The genuine article will be happy to give you his or her license number. It's a credential that's earned with a lot of hard work.

I can't see what's in your house and behind your walls. If your equipment is thoroughly up to date, you can do a few things yourself, like change a light fixture or install a dimmer. Refer to the equipment instructions for those projects. But for more complicated projects, study a book that's strictly devoted to household electrical systems. And don't attempt things you don't understand and are not comfortable with; call a pro.

Your Electricity Dictionary

Volts, amps, watts … aren't they all the same thing? If you think so, you may be in a bit of trouble around an electrical panel. Let's start by defining our terms.

Electricity is the flow of electrons through a *conductor*. In the case of your electrical system, the conductor is wire, which for safety is encased in a nonconductive sheath. The force with which the electrons move is measured in *volts*. The speed with which electrons move is measured in *amperes* (commonly known as *amps*). Output of electricity is measured in *watts*.

The electrical service that enters your home from the utility meter, and connects to the electrical panel, consists of two 120-volt "hot" (live) wires and one neutral. An

old electrical system will have only one 120-volt wire plus the neutral, and is usually insufficient for most large, modern appliances. If you have the latter, it's time for an upgrade.

In Chapter 4, I covered your home's electrical power source—the electrical service panel. From this control center, the power coming into the panel is divided into branches of electrical current, which travel around your house along loops of wire, called *circuits*, that begin and end at the panel. Circuits are controlled by means of individual circuit breakers or fuses. Each breaker or fuse has a number—15, 20, 30—which represents the number of amps that a circuit can conduct. Large equipment such as clothes dryers, electric ranges, or air conditioners usually requires a large-capacity (= large number of amps) circuit to run, so each of these appliances usually has a circuit dedicated solely to its operation.

When a particular circuit breaker keeps flipping to "off," or a fuse keeps blowing, sometimes the cause is too great a demand for electric current along a particular circuit. You will have to unplug some power-using devices (lights or appliances) to lighten the demand (also known as the *load*) on that circuit. If there's another circuit nearby where you can safely plug in the additional items, your problem is solved. If you can't solve the overload problem, or if that does not seem to be the cause of the blown fuse or tripped circuit breaker, you'll need the assistance of a licensed electrician.

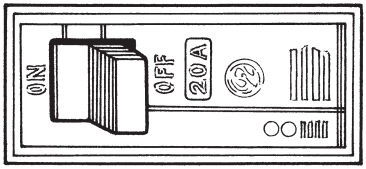
When you create a map of the circuits on your panel, which is the layout of your home's electrical system, you will be able to see if the capacity of your electrical service is equal to or greater than the load. It's good knowledge to have, and reassuring when you know you've got plenty of power. If your home is underpowered for all the equipment and appliances you want to use, you should make an electrical upgrade as soon as you can manage it. An underpowered system is dangerous.

Mapping Your Electrical System

First, look at your electrical panel; on most panels, each circuit breaker or fuse is numbered on the face of the panel. If yours are not numbered, you can do this yourself with a fine-tipped permanent marker. Starting with number 1 at the top left, put a number on the panel next to each breaker or fuse, sequentially.

You may notice that in some cases, two circuit breakers seem to be toggled together. These are the large capacity breakers for major appliances and systems. Their amperage (30, 40, etc.) is marked on the toggle.

This is a 20-amp—see its markings—circuit breaker, which has been flipped off.



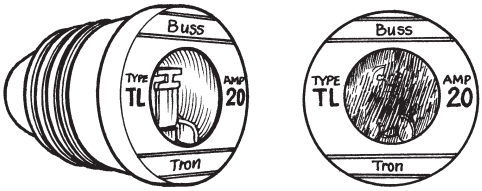
If your electrical panel is equipped with circuit breakers, you will need to flip the breaker to the "off" position to shut off power to any location that is serviced by the circuit it controls.

To return power to the circuit, you'll need to flip it back to the "on" position.

Remember, use *one hand* when you work at the panel. The other hand should be at your side. You want to avoid becoming an open circuit for any loose current!

When a fuse has blown, its center may look black (like the illustration below on the right) or the little lead strip in the center may look broken or melted. Either way, it must be replaced. Again, use one hand to remove/replace the blown fuse, with your other hand at your side.

A fresh, 20-amp fuse is shown on the left; a fuse that has blown is on the right.



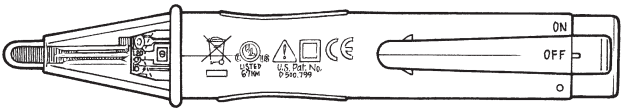
The fuses shown can be removed and replaced with a fuse of *the same amperage*. This is important. One of the reasons that circuit breaker panels have pretty much replaced fuse panels is that many accidents and fires have been caused by the replacement of one fuse with another of a different, and thus incompatible, size. Circuit breakers are not necessarily safer than fuses. But the problem with fuses is that you need to have a supply of them, in all the right sizes, at all times.

Ounce of Prevention

Ordinary fuses (Type T, shown in the previous illustration) can be replaced by equipping the fuse receptacles in an electrical panel with Type S fuse adapters, which use only Type S fuses of the correct amperage. This will prevent anyone from replacing a fuse with anything except a fuse with the right number of amps.

Now, let's get to mapping. You'll need the following:

- ❑ Clipboard, pencil, and paper
- ❑ Plug-in radio or lamp, or a voltage tester, for testing circuit locations



Voltage tester. When turned to "on," this simple, battery-operated tool will light and beep when its point is inserted into the "hot" (live current) side of an electric receptacle.

1. Begin by turning on any light fixtures or receptacles that are controlled by wall switches. If a receptacle is controlled by a wall switch, plug in the lamp or radio, or test the receptacle with the voltage tester, to make sure the receptacle is on.
2. In a room with no overhead light, plug in and turn on a lamp in that room. This will help you to identify the general location when a circuit is turned off, because the lamp will go out.
3. Once you know the power is on throughout your house, start with the circuit breaker or fuse in the location labeled 1. Next to number 1 on your paper, write down the amperage of the circuit; this will help you later (for example, if it's a 15-amp circuit breaker or fuse, make a notation that reads: #1–15 amp). Flip the circuit breaker off, or remove the fuse.
4. You or a friend need to identify which fixtures and receptacles the circuit controls by locating which lights and receptacles are now off. Write down the location of all the fixtures and receptacles controlled by breaker/fuse #1.
5. Continue turning off circuits and identifying fixtures and receptacles on each circuit until you have a complete map of your electrical service panel. Tape a copy of the map on the door of your service panel; make a photocopy and put it in your home workbook (see Chapter 4).

Once all of the circuits in your house are identified, it will be safer and easier to work with your home's electrical system.

What Pros Know

Pros know, and you should, too, that some houses were wired by amateurs. If you're using a voltage tester to check for power, test both straight slots of an electrical receptacle before you determine it's off. It may have been wired backward. Most receptacles are duplex (for two plugs); some receptacles have space for four plugs; to make certain the power is off, test all the straight slots in a receptacle. (There's more on receptacles later in this chapter.)

Calculating the Load on Your System

To find out whether your circuits are sufficient for what's plugged in or wired to them, you can calculate the electrical load for each circuit. You'll need the following:

- Paper and pencil
- Calculator

Take your electrical circuit map, and on a separate piece of paper note the number of watts for everything that's on a particular circuit. The wattage of light fixtures is the total wattage of the light bulbs in the fixture; three 100-watt bulbs have a load of 300 watts. Appliance wattage is often listed on the back or underside of the unit.

The formula for determining the maximum load is:

Total watts ÷ 120 (volts) = amps required

Or look at it another way:

Amps × 120 = maximum watts

So, if 15-amp circuit #1 has four 100-watt bulb fixtures and a radio (15 watts) for a total of 415 watts, divide that by 120 (= 3.4 amps) and you know there's room on that circuit for a few more light bulbs and probably a television set.

But if you've got a toaster oven (1,400 watts) plugged into circuit #1, you're getting very close to the limit of the 15-amp circuit's capacity (1,800 watts). That circuit is near full, and so should not have other things plugged into it.

The proper load for any circuit is about 80 percent of its capacity. So, if you've got a 15-amp circuit, a load of about 1,400 watts is just right.

By doing these calculations for your system and what's plugged into it, you'll know whether or not your home is adequately powered.

If a licensed electrician has not checked out your electrical system in ten years, or you have just moved in, you might want the pro to have a look. He or she can tell you whether your electrical service is properly sized for the amount of electricity you are using, or plan to use. In the case of an old house, you may find that your house has aluminum wiring (you do ***not*** want to do it yourself with aluminum wires), or that the system is not properly *grounded*. Before you go beyond your mapping project, it's good to know as much as you can about your system.

def•i•ni•tion

Grounding means just what it says. When the electrician grounds your electrical system, he or she has connected it to the earth. Grounding provides a safe path for any loose current—from a defective fixture or appliance, or exposed wire touching metal somewhere in the system.

Receptacle ID

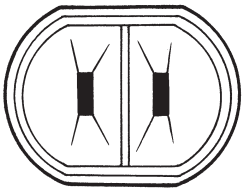
You might call them plugs (they're not), or outlets (not quite right). The correct term for the little face-like electrical devices in your walls, where you plug in lamps and appliances, is receptacle. There are three basic types you should be able to identify:

- Two-pole, nonpolarized receptacle
- Two-pole, polarized receptacle
- Two-pole, three-wire grounding receptacle

A receptacle with two slots of equal size is nonpolarized. This type of receptacle is often found in old houses where the wiring has not been upgraded or grounded. If you have this type of receptacle throughout your house, you need to consult an electrician.

Polarization helps reduce the potential for shock. Most electrical devices and appliances have polarized plugs—one blade is wider than the other. Nonpolarized receptacles do not accept polarized plugs; these receptacles are outdated and should be replaced.

Two-pole, nonpolarized receptacle.

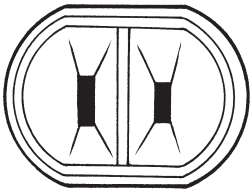


Ounce of Prevention

If you have two-prong, nonpolarized receptacles and have been chopping off the grounding (half-round) prong on an appliance plug to fit your old receptacles, I am amazed you're still alive. Never cut the half-round grounding prong off a plug.

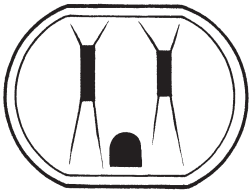
A two-pole, polarized receptacle's slots are unequal in length; one is longer than the other. When a polarized plug is inserted in this receptacle (if it's wired correctly), the wires in the cord connect to the corresponding wires in the circuit; the short slot is the "hot" side, the long slot is neutral. This receptacle accepts polarized plugs, but does not have a half round hole for a grounding prong. These receptacles are safer than nonpolarized receptacles, but not as safe as a grounded system.

Two-pole, polarized receptacle.



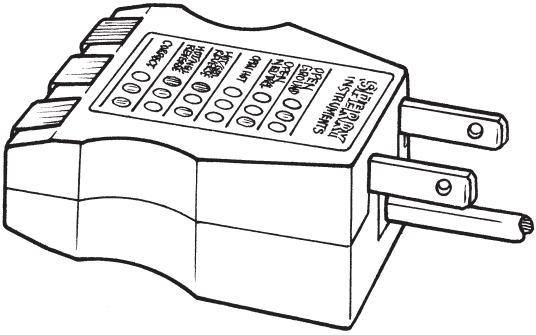
A two-pole, three-wire grounding receptacle has all the right stuff, and accepts plugs for all modern electric devices except the special plugs used for large electrical equipment and appliances (ranges, dryers), which have matching receptacles for their large-capacity circuits.

Two-pole, three-wire grounding receptacle.



But Is It Grounded?

If you have two-pole, three-wire grounding receptacles in your home, your system appears to be up to date. One way to check that the receptacles are grounded (other than calling the electrician) is to check them with a handy, inexpensive (around $3) device called a receptacle analyzer. This device will tell you at a glance if your receptacle is properly wired and grounded. The sequence of lights will alert you to any problems.



Receptacle analyzer.

Amazing, but this little plug-in will tell you a lot about the wiring of any receptacle. Besides telling you that the receptacle is grounded and all the wires are attached correctly, it will alert you if …

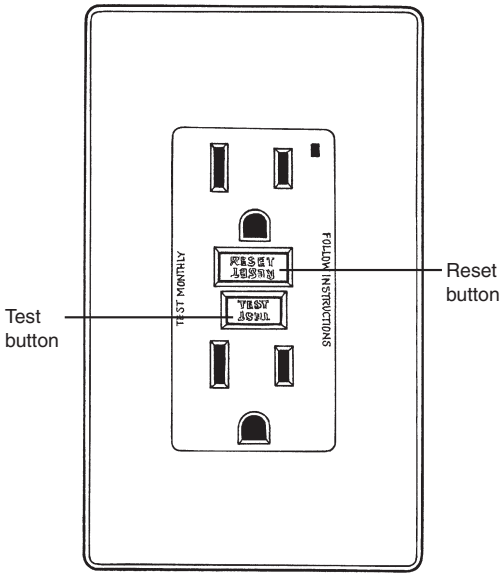
- There's an open ground, meaning that the ground wire is not connected.
- There's an open neutral, which means the neutral wire is not connected.
- There's an open hot, which means the hot wire is not connected. None of the analyzer's lights go on. But remember, this indicator can also mean that the circuit for this receptacle is turned off by a removed fuse or flipped-off breaker. Check before you panic.

The receptacle analyzer will also tell you if the wires are not connected properly.

GFCI: Initials You Need to Know

In the bathroom, near the kitchen sink, outdoors, and in other spots where water may come close to electric power, the electrical code demands that GFCIs (ground fault circuit interrupters) be installed, instead of ordinary three-wire grounded receptacles. These receptacles, invented about thirty years ago, will shut down if the current level in the circuit changes even a tiny bit. This is important near water; if an appliance that's turned on should fall into water or become wet and you touch it, the result can be a lethal shock.

GFCI receptacle.



GFCIs are useless unless they work properly, and they do wear out over time. Here how to test one; you should test every GFCI in your home every month. To do this you'll need a lamp, plug-in radio, or voltage tester.

1. Press the button on the GFCI marked "TEST." If the receptacle is operating properly, this button will shut off the current. Test that the GFCI is off by inserting the voltage tester into the short (hot) slots of the receptacle, or plugging in a radio or lamp and trying to turn them on.

2. To restart the current, press the button marked "RESET." The current should return to the receptacle: the lamp or radio will turn on, and the voltage tester will light and beep when inserted in the hot slots of the receptacle.

If a GFCI does not operate properly, it needs to be replaced.

Shattered! Replacing a Bulb That Breaks in Its Fixture

Every so often, a light bulb will shatter, and you've got a very sharp problem on your hands. If the bulb is in a lamp, unplug the lamp before you do anything else. If the bulb is in an overhead fixture, you'll need to turn off the switch that controls the bulb, and also, turn off the circuit breaker (or remove the fuse) that controls the fixture. Then you can proceed.

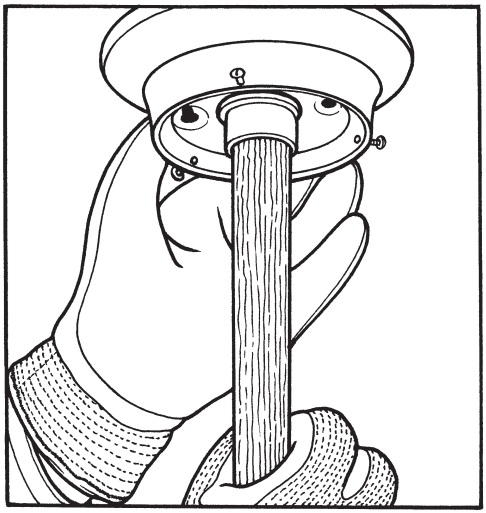
First, get out your work gloves; those shards of broken bulbs are extremely sharp. If you're working above your head on a ceiling fixture, you'll want to wear safety goggles, too.

You'll need the following:

- ❑ Voltage tester
- ❑ Broom handle
- ❑ Needlenose pliers

1. By placing the voltage tester next to the bulb socket on your overhead fixture, you can check whether there is still current at the socket. Do *not* touch the socket with your hands! If there is still power, go back and turn off the circuit breaker for that fixture. Test that the power is off before you try to remove the bulb. (If the broken bulb is in a lamp, the lamp needs to be unplugged. Then follow Step 4.)
2. Remove any loose bits of glass from the bulb base before you start working on it.
3. The right-sized broom handle can help you get a grip on the bulb base, and turn it counterclockwise (remember: lefty, loosey) to remove it from the socket.
4. If the bulb base won't move by turning the broom handle, you'll have to work on the bulb base with needlenose pliers.

Remove a broken bulb from a light socket.



After removing as many sharp shard of glass from the bulb base with your gloved hands as you can, grip the bulb base with the ends of the pliers and try to work the bulb base out of the socket as you carefully turn it counterclockwise. This may take some deliberate, careful work; take your time and don't try to force the base. If you can't get the bulb base out, you'll need to replace the fixture.

Ounce of Prevention

When you screw in a light bulb, screw it in just far enough so it's secure in the socket, but not tight. A bulb that's screwed too tightly is the one that will break in the socket!

Many people have told me that you can use a half of a raw potato to remove a broken bulb; just stick the flat end of the potato onto the broken-off end of the bulb, and turn counterclockwise (after turning off the power, of course!). However, I've only been told this. I've never met someone who's removed a broken bulb with a potato. When I do, I can confirm the effectiveness of this method.

The Least You Need to Know

- If it's been a long time, or if you've just moved in, have a licensed professional check out your electrical system.
- The load—the power required by the various electrical fixtures and devices in your home—can be managed if you understand each circuit's capacity.
- A grounded system is the safest system; check your receptacles.
- Power near water should be protected with GFCI (ground fault circuit interrupter) receptacles.
- A bulb that's broken in its socket can be removed by following safe procedures, and being careful of the broken glass.

Chapter 14

Smooth Transitions: Cleaning and Replacing Filters and Hoses

In This Chapter

- Dryer filters and hoses
- Moving water safely
- Keeping room air conditioners chillin'
- Furnaces aren't just full of hot air!
- Cleaning the filter on your range hood

The intake, flow, and exhaust of liquids and gases are factors in the everyday operation of a house. But too often, we so take for granted that everything will move smoothly that one day things take a very bad turn.

My kids went to nursery school in a neighboring town, a couple of miles from where we live. I didn't mind the commute; driving them to school, we'd pass some very beautiful houses. And since I love houses, it was a fun drive for me.

One day, while on the way to preschool, I was shocked to see that one of my favorite old farmhouses was in ruins. Except for the fireplace and chimney, the place was gone—burned to the ground. Later that week, I found out why. The newspaper reported that the fire had started in the clothes dryer when lint ignited. Fortunately, no one was hurt, but it was several years before that beautiful home was finally rebuilt.

I don't mean to scare you, but you must take care of all the filters and hoses that your systems and appliances use. Neglecting them can have negative consequences; keeping them in shape is an essential chore.

De-Linting the Clothes Dryer

The house fire caused by a dryer put me on a campaign to keep my own appliance free from fluff. If you ever hang around when the dryer is doing its work, you'll notice that the heating element gets bright red as the clothes turn in the drying drum. You want to keep the hose that vents the damp air to the outside, and the cavity where the lint trap captures other fibers, very clean. Lint is highly flammable, so clean the filter faithfully every time you use the dryer, and follow these instructions for cleaning the hose—every month, if you do a lot of laundry.

You'll need the following:

- Standard screwdriver
- Vacuum cleaner with long attachment, crevice tool, or brush

1. Before you disconnect the dryer hose, turn off the power at the circuit breaker, and unplug the dryer. If you have a gas dryer, turn off the gas at the gas supply stop (remember, "on" is parallel to the pipe; "off" is perpendicular).
2. Move the dryer away from the wall and disconnect the hose at the back of the dryer; you may have to twist off the hose, or unscrew the hose clamp that attaches it, depending upon how it is connected. Disconnect the other end of the hose from the dryer vent.
3. Using the long attachment and the brush or crevice tool, vacuum the lint from inside the hose.
4. Use your crevice tool or the lint brush to clean out the cavity underneath the lint trap. Often, lots of the fluffy stuff doesn't make it all the way to the trap. Your goal is to keep the dryer as lint-free as possible.
5. Once you've cleaned the hose and filter cavity, replace the hose and turn the electricity or the gas back on.

Clothes Washer Hoses and Filters

A couple of years ago, I came home from running an errand and heard the sound of rushing water (like a waterfall!) coming from my basement. I tore down the stairs and saw what looked like the Old Faithful geyser spewing water from behind my washing machine.

I immediately cut off the water at the supply stop behind the washer, but there was quite a pool on the floor. I cut the power to the washing machine (at the electrical panel), then unplugged it and moved the appliance back from the wall.

The washer was about 15 years old, and so were the hoses that ran from the supply valve to the machine. Made of rubber, they had grown brittle and corroded with minerals from our well water over the years. One of them finally split; that's what caused the gusher. I'd never given them a thought before the split.

If you've had your washing machine for eight years or more, it might be wise to replace the supply hoses *now*, before they do to you what mine did to me! Insurance companies—who often wind up paying out for the damage done by burst hoses—advise homeowners to replace supply hoses every 3 to 5 years.

Ounce of Prevention

Get in the habit of shutting off the water for the washing machine at the supply stops, whenever you finish doing the laundry. Lots of people neglect this step, but just an hour's worth of water running freely from a split hose can unleash *hundreds* of gallons of water and do thousands of dollars of damage.

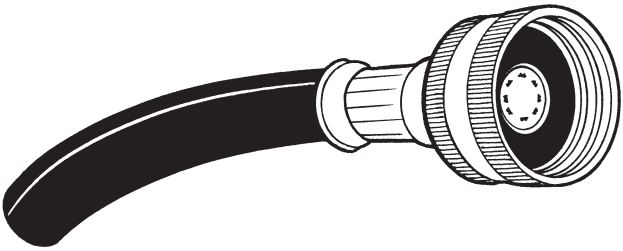
Replacing Washing Machine Supply Hoses

You'll need the following:

- Measuring tape
- Bucket
- Adjustable or pipe wrench
- Lubricating spray
- Replacement hose
- Bristle paintbrush

1. Shut off the water at the supply stops. Then turn on the washing machine so the water that's already in the hoses empties into your machine; this will only take a few seconds before the water stops running in. Then turn off the appliance.
2. Unplug the appliance and turn off the circuit breaker that controls its receptacle. Move the machine away from the wall. Remove the drain hose from the drain; if it's cracked, replace it, too.
3. Measure the length of the supply hose so that you can buy replacements. If you're replacing a hose that has already split, don't replace just one; replace both the hot and cold water hoses. You can buy single replacements, but you really don't want another catastrophe when the other old hose gives up the ghost.

Washing machine hose gets corroded over time; insurance companies wish you'd replace it every 3–5 years.



4. Put the bucket underneath the hose connections at the supply side, and remove the hoses. If they've been screwed on for years, they probably won't unscrew easily. You might need to use a bit of lubricating spray, as well as the adjustable pliers or pipe wrench. Once you've loosened the first set of connections, loosen the hose at the washing machine side.

What Pros Know

It's hard to keep track of what you did and when you did it. Take a piece of waterproof tape, write the date that you replaced the supply hose, and stick it to the hose. That way you'll remember when it's time to replace it again. Washing machines can normally last three to five hose lifetimes!

5. Before you install the new hoses, take a good look at the inlets on the washing machine side of the hose connections. If they are full of debris, clean them out with the bristle brush. If you can't get them clean, go to the next repair in this chapter (cleaning/replacing washing machine inlet filters) and follow those steps to more thoroughly clean or replace the filters.
6. Hook up the new hoses to the washing machine inlets. Then hook up the other hose ends to the water supply lines. *Be sure you attach the hot water*

line to the hot water supply, the cold water line to the cold supply. Open the supply stops and check for leaks. If you've replaced the drain hose, reconnect it to the drain.

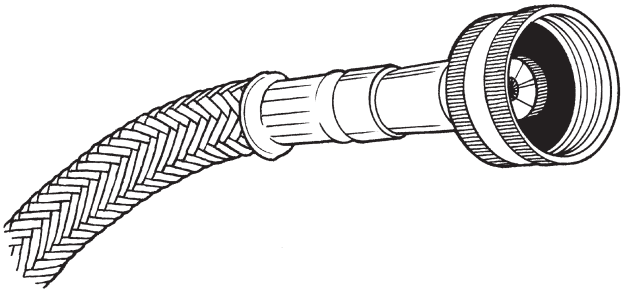
7. Now you can push the washing machine back against the wall and plug in the appliance. Be sure that you don't put a kink in the supply hose; leave a little space between the machine and the wall so the hose bends but doesn't fold up on itself. Kinked hose will wear out faster!

About Metal Mesh Household Hoses

After my washing machine supply hose burst, I was much more sensitive to the potential for this problem. We installed a stainless steel mesh hose in place of the old rubber one, because the label said it wouldn't burst. It cost about twice what an ordinary rubber supply hose costs. But I figured, "burst-proof" sounds like a fix-it-and-forget-it option to me.

No so fast.

Insurance companies note that, while these hoses have lower failure rates than ordinary rubber hose, they can still leak. Factors like the chemical content of your water, the age of the hose, and the nonmetal interiors that may deteriorate, can lead to a breakdown. Inspect them whenever you do your routine home inspection (see Chapters 18 and 19). And replace them on the same 3–5-year cycle as you would an ordinary rubber hose.



So-called burst-proof hose is made of very flexible plastic that is wrapped in a mesh of stainless steel wire—but it's not immune to leaks.

Cleaning and Replacing Washing Machine Water Inlet Filters

If your washing machine is filling slowly, or if, when replacing the water supply hoses, you notice that the little filters in the washing machine water inlets are grubby, you'll need to clean or replace them..

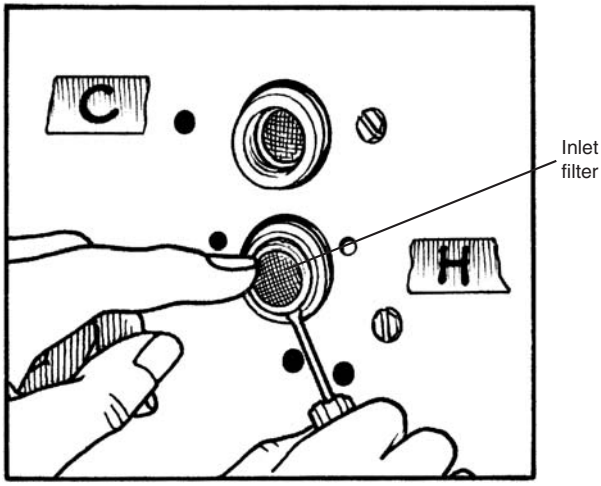
You'll need the following:

- ❑ Adjustable pliers or pipe wrench
- ❑ Lubricating spray
- ❑ Tweezers or a small standard screwdriver
- ❑ White vinegar
- ❑ Bucket

Follow Steps 1–4 for "Replacing Washing Machine Supply Hoses" described earlier.

If the inlets are not clearly marked "H" and "C" label them with pieces of masking tape before you remove the hoses, so you can properly reconnect the hoses when you're done.

1. Remove the water inlet filters with a pair of tweezers or a small screwdriver. If you damage them, you'll have to replace them, so be careful.



Washing machine water inlets.

2. Clean the filters by soaking them in white vinegar overnight.
3. Replace the filters with the domed side facing outward. Reattach the water supply hoses. Open the water supply stops and check for leaks.
4. Push the washing machine back against the wall, taking care not to kink the supply hose. Plug in the appliance and flip the circuit breaker to on.

Ounce of Prevention

Sometimes a too-full washing machine will leak a little water out of the tub. Also, you may want extra protection if your washer is installed on the second floor. You can buy a specially designed plastic pan (available at home supply stores) that fits underneath the washer and can catch a small leak if and when this happens. It's an extra, inexpensive layer of insurance.

Cleaning the Room Air Conditioner Filter

If you live in a section of the country with four distinct seasons, as I do, then you'll notice how your electric bill soars in the summer. The bill reflects the high cost of running air-conditioning. Room air conditioners can use even more power than a central system, especially if the filter is dirty and the appliance must work harder.

Every month during cooling season, you'll need to clean or replace the filter on every room air conditioner in your home.

You'll need the following:

- ❑ Replacement filter, or access to soap and water
- ❑ Sponge

1. Switch off the unit and unplug it.
2. Remove the front grill on the unit; if you're not sure how to do this, check your use and care manual. It usually pulls right off, but don't try to force it.
3. The filter should be right under the grill. A reusable filter looks like a thin piece of sponge. You can wash this with dishwasher soap and water, carefully wring it out, and let it dry thoroughly.
4. While you're at it, clean, rinse, and dry the air conditioner grill. It collects dust, too.

5. Reinsert the cleaned, dry filter. Usually there are a couple of clips on either side of the unit that hold it in place.

What Pros Know

Some (not many) room air conditioners have disposable filters that cannot be washed. If you've got one of these, take it to the hardware or appliance store and buy a replacement (or buy a quantity if they're cheaper that way).

Cleaning or Replacing a Forced-Air Furnace Filter

If your heating system includes a blower and ducts that deliver heat to the various rooms in your house, this forced-air system, as it is known, will have a filter to screen out dirt and debris that collect in the system. Usually the filter is located on the return-air side of the system. Refer to your owner's manual or ask your heating professional if you can't locate the filter.

There's usually a little fitting or clip that holds the filter in place. You should be able to easily remove it. You need to replace it with the same-sized filter; these are sold in supermarkets, hardware stores, even drugstores.

Change a disposable filter every month during heating season.

If the filter in your system is reusable, you still need to clean it every month in heating season. Remove it, and wash and rinse it in the tub or in your utility sink. This is easier if you have a sprayer or can attach one to your tub or sink spout. Make sure the filter is thoroughly dry before replacing it.

Cleaning a Range Hood Filter

Nearly everyone with a cooktop or a range also has some type of fan or hood to exhaust the smoke, grease particles, and steam that are byproducts of cooking.

The most common grease filters are made of wire mesh. Most can be washed in the dishwasher. Otherwise, give them a good soaking in warm water and dishwashing liquid. Carefully scrub them with a nonabrasive (blue) pad, and do this gently, so you don't crush the mesh.

Fin-type metal filters are also dishwasher safe; in fact, this is the best way to clean them. Stainless steel should not be scrubbed with abrasives of any kind—these will permanently scratch the metal. If you need to remove greasy film from the filter, use a nonabrasive (blue) plastic pad.

The Least You Need to Know

- Dryer lint can be dangerous to you and your home; lint buildup is a fire hazard. Vacuum hose, vents, and lint filter cavities every month.
- Stainless steel mesh-covered water supply hose is probably more sturdy than rubber, but is no guarantee against leaks.
- If your washing machine is filling slowly, the problem may be your water inlet filters; clean or change them.
- Dirty room air conditioner filters will drive your electric bill higher.
- During heating season, clean or replace the furnace filter (depending on the type) every month.
- Keep the range hood over your stove working effectively by washing it regularly—usually once a month.

Chapter 15

Appliance Repairs

In This Chapter

- Troubleshooting troubling appliance symptoms
- Manufacturers ‘ assistance
- General solutions to common appliance problems
- Service calls and replacements

What’s that puddle underneath the refrigerator? Why is the garbage disposal making that noise? Why won’t the burner on the stove boil water?

Modern conveniences that don’t work frustrate and annoy us. But, thankfully, not everything that goes wrong requires an expensive visit from a repairperson. I learned this happy fact many years ago.

It had been a bad month for the Ostrow budget: my car needed four new tires, the old furnace needed a new motor, and record snowstorms had the plow guy working overtime on our long, hilly driveway. I didn’t need another repair bill when my electric oven stopped working. So I decided to try calling the maker of my range, to see if someone at the source had a solution.

It was a revelation. Not only did the service rep who answered help me figure out what was wrong—a bad heating element—but she told me I could easily fix the problem myself. Through her I ordered the part with my credit card; two days later, with the part delivered by parcel service, I got on the line with another service rep, who talked me through the repair. In 10 minutes, I had a working oven.

While some repairs are best left to trained professionals, there are plenty of little problems you can solve yourself, with the aid of a friendly help line, Internet information, or just a bit of common sense and a few directions you find here. It will restore your faith in modern convenience!

Ailing Appliances: Diagnosis

When an appliance isn't doing its job to customary standards—the refrigerator's not keeping food cold enough, or there are troublesome small puddles where the dishwasher hose meets the sink drain—you've got to assess the problem, and figure out what's wrong before things get worse.

What's Your Model?

If you've got a use and care manual for your appliance, you're already on your way to a fix. But if you don't, you'll need to find out the model number of your appliance before you call a manufacturer for help, or to download a copy of the manual from the Internet (see Appendix B for some popular manufacturer 800 numbers and websites). The model and serial numbers are stamped or printed on a metal, plastic, or paper label affixed to the appliance.

Here's a list of the locations where the model/serial number is often found on appliances. It may vary a little from maker to maker, but it's a good place to start:

- **Clothes washer or dryer:** On front-loading models, open the door and look for the label on the left or right of the wash cavity rim. On top-loaders, look under the lid or at the back of the rim above the tub.
- **Dishwashers:** Look along the edge of the door, or along the rim of the wash cavity, left or right.
- **Range (combination unit with stovetop burners and oven):** Open the oven door and look for the label along the rim of the oven cavity. If the unit has a drawer, open the drawer and look around that rim for the label.

- **Wall oven:** Look along the rim of the oven cavity.
- **Refrigerator:** Open the door, and look for the label at eye level, left or right. In side-by-side models, look for the label on the refrigerator side.

Troubleshooting

Every use and care manual has at least one table labeled "troubleshooting," which lists common symptoms of problems and their possible causes. Using this table is always a good place to start your diagnosis. Often, manufacturers list not only the symptom and its cause, but also the cure. Reading your owner's manual is like a free repair clinic.

Always begin troubleshooting appliance problems with what my kids like to call the "duh" questions (meaning, if you don't do this first, have your brain checked):

- Is the appliance plugged in?
- Is the circuit breaker for the receptacle where it's plugged in flipped to the "on" position?
- If the appliance uses water and there is none (e.g., the dishwasher or the ice-maker), are the supply stops open?

It's smart to look for obvious oversights before you pursue more strenuous solutions.

I once called an electrician because I thought all the power was out in our new addition. He got to the house and showed me the circuit breaker in the main panel that controlled the sub-panel for the addition. I had flipped it off by mistake the day before when someone's hair dryer flipped a breaker on the main panel! That was an expensive error on my part—no one had labeled this controlling breaker (see Chapter 13 for directions on how to avoid this blooper).

Manufacturer Help

Because so many people now use the Internet, manufacturers' websites are equipped not only with downloadable manuals, but with their own appliance repair pages and parts stores. You can do a lot online to service your own appliances without calling a pro.

Ounce of Prevention

Many online repair sites will tell you when you can DIY, or when you really should call in the professional. In some cases, trying to tamper with the innards of the appliance may void its warranty, or be a danger to your safety. Follow the manufacturers' recommendations.

If you need the encouraging voice of a live customer service person, this is still available from several manufacturers via a toll-free call, though you may have to wait on hold for a bit. Having someone "talk me through" my first appliance repair built my confidence; it may also help yours.

Please note: appliances have different designs, and really old appliances may have different features than newer ones. If your appliance doesn't have the features referred to in the repairs below, please contact the manufacturer. These are *general* instructions that may not apply to every make and model of appliance.

Refrigerator Repairs

Refrigerators last a long time, and you can keep yours humming by paying attention to any troubling symptoms. Here are a few problems you can solve yourself.

Keeping Your Cool

The ideal temperature inside the fresh food cabinet of a refrigerator is between 36° and 38° F. For a freezer, the temperature should range between –5° and 5° F.

If you think your refrigerator and freezer are too warm or too cold, test them by putting a thermometer in the refrigerator and freezer cabinets for a couple of hours each, and check the readings. If they're high or low, try adjusting temperature controls up or down to reach the correct temperature.

If the temperature controls don't handle the problem, you need to consult a pro.

Poor Door Seal

If the seal of your refrigerator door is loose, cold air is escaping and your appliance will run more often than it should to maintain the proper temperature. Check the gasket between the door and cabinet by inserting a dollar bill and closing the door. The bill should come out, but you should feel a bit of resistance.

If the gasket isn't snug, and looks dirty or crusty, try cleaning the gasket material with warm soapy water, then rinse. You can also lubricate the gasket with a little petroleum

jelly. If this improves the seal, you're done. If the gasket is hopelessly dried out and cracked, you'll need to replace it (a pro will do it right). Some people will try fixing a gasket themselves, but the gasket material isn't cheap, and you may have trouble achieving a sufficiently tight replacement seal; amateur jobs are often weak at the corners.

Cleaning Condenser Coils

Dirty condenser coils can make the appliance run overtime. You should clean them once or twice a year.

You'll need the following:

- ❑ Carpet scraps to put under the refrigerator feet
- ❑ Vacuum cleaner

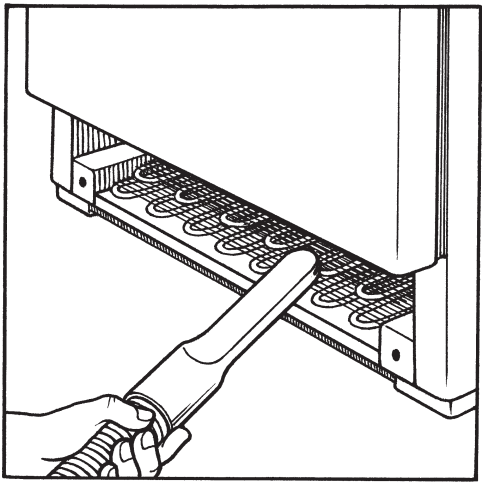
The condenser coils are sometimes located on the back of the appliance; to clean these, use the brush attachment on your vacuum cleaner. You'll also need a friend to help you move the refrigerator away from the wall. Be careful, it's heavy!

1. Turn off the refrigerator. Put a couple of carpet scraps under the feet of the refrigerator so you don't scratch the floor. Move the appliance away from the wall, and unplug it.
2. Vacuum the coils using the brush attachment.
3. When you're done, plug in the refrigerator and move it back against the wall. Turn it on if you've turned it off from inside.

If the coils are not on the back of the appliance, you'll find them at the bottom of the appliance, behind the little grill panel below the door(s). For coils in this location, use the vacuum's crevice tool.

1. Turn off and unplug the appliance.
2. Remove the grill panel at the bottom front of the refrigerator.
3. Vacuum the condenser coils using the crevice tool.

Vacuum the condenser coils.



4. Replace the grill panel, plug in and turn on the appliance.

Water in the Cabinet

If water collects in the bottom of the refrigerator cabinet, you may have a clogged drain. The drain is a little hole, usually found under the vegetable bins, that drains condensation into the drip pan under the appliance, where it evaporates. If it's not obvious where the drain is located, refer to your appliance use and care manual. (Some drains can only be serviced by a pro; if you can't find the drain, call a repairperson.)

If you see water pooling near the drain, you'll need to clear the passageway. Sometimes food or debris gets caught there and creates a clog.

You'll need the following:

- ❑ Piece of plastic tubing
- ❑ Turkey baster

Once you locate the drain hole, insert the tube down through the drain hole. Clear any debris. Fill the turkey baster with warm water and squeeze the baster tube so the water runs down the drain hole. If the drain is still clogged, call a repair pro.

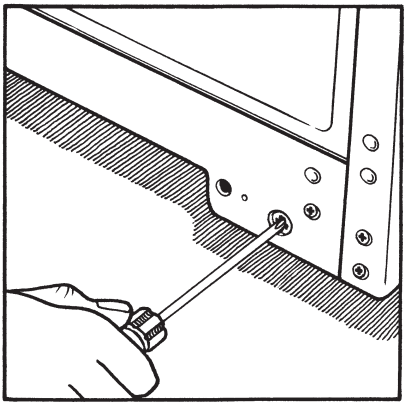
Closing the Open Door

If the refrigerator is properly positioned, the front of the appliance will be just slightly higher than the back, so the door swings shut easily, by itself. If it's not positioned correctly, your door may hang open, which wastes energy and money. To correct the problem, you have to adjust the appliance's front feet.

You'll need the following:

- ❑ Torpedo level
- ❑ Screwdriver

1. Check that the appliance is level from side to side. Place the level horizontally on top of the refrigerator cabinet. If the spirit bubble is centered, it's level. If not, you'll need to adjust the front feet. If the bubble slopes to the right, you can raise the right foot slightly to level the appliance. To adjust the feet:
2. Remove the small front grill panel of the refrigerator below the door(s).
3. Each foot will have an adjusting screw. Turn the screw counterclockwise (lefty, loosey) to raise each foot.
4. Adjust the feet so the appliance is level side to side. Check your adjustment with the torpedo level. Then raise each foot just a bit more. After you make the adjustment, open the refrigerator door to make sure it closes by itself. If it doesn't, continue raising the feet a quarter-turn each time until it does.



Adjust refrigerator feet.

Water Underneath the Refrigerator

Water gathering underneath the refrigerator is a troubling symptom, but often, it's not a sign of serious trouble. It could be caused by a couple of conditions.

Leaky Drip Pan

The drip pan usually sits on top of the condenser coils, under the refrigerator.

1. Remove the front grill panel. If you don't see the drip pan, shine a flashlight underneath the refrigerator, or refer to your owner's manual.
2. Remove the drip pan, put it in the sink, clean it, and fill it with warm water. If it doesn't leak, it's not the problem. If it does, get a new pan from your local appliance store or through the parts ordering service on the manufacturers' website (or via the 800 number).

Leaky Icemaker Supply Line

If you have an icemaker, the supply line may be leaking somewhere along its length.

1. Turn off the refrigerator, pull it away from the wall, and unplug it.
2. Look for the supply tubing that brings water to the icemaker. Dry it off and examine it for any drips, either along its length or where it connects to the refrigerator. If the line is leaking, you'll need to disconnect it.
3. You'll need an adjustable wrench to disconnect the line at the point where it connects to the refrigerator, and also where it connects to the supply pipe.
4. Before disconnecting the line, turn off the water at the supply stop for this line; it may be at the sink, or in the basement where the supply line joins your water line below the refrigerator. You can then disconnect the supply line and bring it to the appliance store to get an exact replacement.
5. Reconnect the new line, using the adjustable wrench.

Dishwasher Dilemmas

Most dishwashers are installed under the kitchen counter and are a major pain to repair, unless the problems are quite minor. The pro route is preferable for most problems. Here are a couple of defects you can deal with.

Leaky Drain Connection

Usually, the drain hose for the dishwasher connects to the kitchen sink drain at a junction just above the trap. Installers usually connect the flexible dishwasher drainpipe to the copper or PVC drain with a clamp. You can tighten this clamp if the connection gets drippy, or replace the clamp. It's a job just like the emergency leak repair described in Chapter 10.

Other leaks in the hose, which will require hose removal, and taking the dishwasher out from under the counter, should be left to the pros.

Dirty Dishes

Many dishwashers have built-in mini garbage disposals to handle the debris left on dishes. Others do not; they have filters that must be emptied regularly, or the dishes won't get clean and the dishwasher tub may start to smell.

Read your dishwasher use and care manual. If you have a filter in the tub, the manual will show you how to remove and clean it—an operation that usually takes less than a minute.

Ounce of Prevention

Don't overload the dishwasher soap cup. Often the problem is too much soap, not too little. Try using a little less. Sometimes an overfilled cup results in a film on your dishes, or at the very least the scent of dishwasher soap.

Washing Machines: On the Move?

Washing machines that are properly installed are usually sturdy creatures that deliver clean clothes year after year without much trouble. One of the most widely reported problems with washing machines is that the hoses leak, or they may fill slowly. You can deal with these problems when you read Chapter 14.

However, the other major complaint about this appliance is that, on occasion, it starts to move around of its own accord, usually during the turbulent spin cycle. How do you get your washer to stop "walking"?

This is another foot problem; you'll need to level the appliance. To adjust washing machine feet, you'll need the following:

- ❑ Short length of 2"×4" lumber
- ❑ Torpedo level
- ❑ Adjustable wrench

If you can tilt the washer forward with your own strength, fine. If not, ask a friend to help. If you want to take the lazy person's approach to a washer that walks, level the back feet (see the following instructions) and put a rubber mat under the front feet. I have friends who swear this cures the problem.

1. You need to level the back legs of the appliance, which is easy. They are self-leveling, so if you tilt the washing machine forward, lifting the back legs off the floor a few inches (no more than 4), and gently drop it back down, the back legs will be level.
2. Now, tilt the machine *back.* To make it easier to access the front feet, prop the 2×4 under the center front of the washer, and loosen the locknuts on the machine's feet with the adjustable wrench.
3. Pull out the 2×4. Make sure the machine is positioned where you want it to be when you're done. If it's out of place, push it back where it belongs.
4. Take your torpedo level and lay it horizontally across the top front edge of the washer, to check if it's level from side to side. If it's not, adjust the right and left feet so it is.
5. Then place the level along the top of the machine so it's at a 90 degree angle (perpendicular) to you, lying front to back on the machine. If the machine's not level front to back, you should tilt the machine forward again and drop it as in Step 1. Now it should be level.
6. Retighten the lock nuts.

Jammin' with Your Garbage Disposal

I've never had a relationship with a garbage disposal. There were none in any of the apartments I lived in, and my homes in New York and Maine are serviced by septic systems; disposals are a no-no.

So I researched fixing one with my sister, who had an old, extremely loud disposal in her last house. With three kids who put all kinds of things in the sink, hers often jammed. I don't want to publish the long list of stuff that got stuck in her disposal, but the appliance was still working when her kids were finally grown and she moved to a smaller house. So, she's a disposal repair expert!

Occasionally, something that shouldn't will drop into the disposal: a spoon, a coin, a plastic action figure. The grinder starts up, but the motor will just hum, because the grinder blades won't turn. Or the thing shuts off completely via its built-in circuit breaker (which protects the motor from self-destruction).

To fix a jam, you'll need the following:

- Allen wrench set
- Long tongs or tweezers
- Broom handle (the worst case)

1. In order to do any work on a garbage disposal, you *must* first shut off the power. You can do this by turning off the switch, or unplugging the disposal if it plugs in under the sink. However, I am in awe of this appliance's noise and grinding capacity, so my advice is to shut off the disposal's circuit at the main electric panel. I would take no chances with this noisy set of "jaws."
2. Once the power's off, use a flashlight to see if you can see what's jamming the disposal. If it's a big item, use the tongs, tweezers, or if you're brave, like my sister, your hand to get it out.
3. A really small item may go through if you put some ice cubes into the disposal and run cold water through the disposal. You can turn on the machine (press the reset button after you turn on the electricity) and try it.
4. If you can't see what's causing the jam, you'll have to spin the grinding machinery by hand.
5. A newer disposal will have a small hexagonal recess at the base of the disposal (get out the flashlight and *squeeze* yourself underneath the sink) that can be turned with an Allen (hex) wrench. If you're lucky, the wrench that came with the appliance will be under the sink or (jackpot!) taped to the disposal.

   Insert the wrench and turn it back and forth, clockwise and then counterclockwise to free the mechanism. Pay attention, you may hear the obstruction drop down the drain. Or the offending jammer may pop up into the cavity above the grinders. You may have to work the wrench a couple of times to free the jam.

Keep checking the disposal cavity with the flashlight until you're successful.

Ounce of Prevention

Always run water through the disposal when you're operating the appliance.

6. If your disposal is an oldie, with no hex slot at the base, you'll need the broom handle to try and free the grinder blades. Put the handle into the cavity and set the end of the handle against the blade. Push it clockwise, then counterclockwise until you free the blades. Remove the source of the jam, restore power, and turn on the disposal.

Service Calls and Replacement

Sometimes, appliances just wear out. In Chapter 18, you'll see a listing of various appliances and their life expectancies. While a new appliance may be pricey, professional repair is also costly, and you have to weigh the value of a repair against the potential costs/benefits of replacement.

Many appliances—washing machines, dishwashers, and especially refrigerators—have become much more energy efficient. The money you can save by retiring an old, energy-gobbling appliance and replacing it may justify the added expense over the cost of repair. See Appendix B for some helpful information on making the replace/repair decision.

The Least You Need to Know

- Repair is much easier when you hang on to the use and care manuals for your appliances. If you don't have them, you can download them from a maker's website.
- Manufacturers' 800 phone numbers and websites are bountiful sources of information and parts for DIY repair.
- Keeping refrigerator parts clean—the gaskets, the drain, the coils—goes a long way to keeping the appliance cool.
- Have a healthy respect for power (the electric kind) when you try to clear a garbage disposal jam.

Chapter 16

Heating and Cooling

In This Chapter

- Learning about your heating and cooling systems
- Facts about gas, oil, and electric heat
- Tips for troubleshooting your heating system
- Maintenance you can do yourself
- Getting to know your water heater
- Central air conditioning systems

Most residential central heating systems are fueled by gas, oil, or electricity. In hot climates, this arrangement is replaced by central air conditioning. And some folks in places where winters are cold and summers are hot have both.

No matter where you live, keeping warm when it's cold and cool when it's hot is a high priority for most of us. It's important to take care of the equipment that makes it happen.

Because there are hundreds of brands and models of furnaces, boilers, and other heating components, this chapter will give you basic information that anyone with a heating or cooling system should know. For specifics, you should check with your system service company and/or your use and care manual.

Maintenance of Heating/Cooling Equipment

Let me begin with one basic piece of advice. The best way to keep your heating and cooling equipment working well is to have it checked annually by a service professional. For heating systems, that means a fall checkup before the peak heating season begins. For central air, spring is the season for this work.

What Pros Know

It's all timing. Systems going bad often fail the first time they are turned on in any heating/cooling season. The professional who services your equipment, and test-runs it during his maintenance call, will help you avoid this sad scenario.

Nothing is more frustrating than having equipment fail when you need it. Anyone who's had the experience knows that a furnace man is hard to find on the first very cold day of heating season. Likewise, the air conditioning specialist disappears during a heat wave; the demand for his services may put your repair at the back of the line.

If you've never had your heating system serviced before, it's worth doing for two reasons:

- Your equipment will be ready to run when the season starts.
- You can learn how your system functions, including how to turn it on and off, what any dials and gauges mean, the location of parts you need to take care of between service calls, and how to take care of them. Since you're paying for the service call, ask the pro to show you how the system works.

You should take notes on the operation of your system for your home workbook:

- Location(s) of emergency shut-off switches, and where applicable, supply shut-offs for gas and water
- Directions for restarting the system; for a gas system, how to light the pilot (if it's not automatic), and for oil, the location of the restart button
- The normal readings for temperature, pressure, and other gauges so that you'll know if something is going wrong

Gas Heat

More than half the households in the United States are heated with gas, so we'll address this furnace type first.

While gas furnaces have few moving parts, they should be checked annually. Most companies that provide your gas supply will also, for a monthly fee, offer a contract to service your furnace.

Among the things a service pro will inspect:

- Heat exchanger
- Gas pipes
- Electronic ignition system
- Fan, motor, bearings, belts, pumps
- Air filter
- Air cleaner
- Pilot and its safety system
- Furnace controls
- Exhaust
- Flame pattern, venting, chimney
- Thermostat

Gas furnaces do not usually need annual cleaning (every couple of years is fine), and this can be done via the gas company service people (usually this requires an additional fee), or a certified heating/cooling specialist.

Every 5 years or so, the ductwork should be cleaned. Over time, these heat passageways become collection centers for dust, and sometimes mold or mildew, if your home has a humidity problem. All of these pollutants can be bad for your and your family. This is also a job for a specialist.

Between the annual checkups, your only important task is to change or clean your furnace filter regularly. See Chapter 14 to learn how it's done.

Oil Heat

Only about 7 percent of the country heats with oil, but oil heating systems are more complex than gas furnaces or electric units. If you heat with oil, an annual maintenance appointment should be a given.

Ounce of Prevention

If your heating system vents into the chimney—oil systems do—you should have a chimney sweep clean the chimney before your heating system is serviced. Normally, the heating pro will clean the smoke pipe that vents into the chimney. If the sweep shows up *after* the system maintenance, he'll dirty the pipe with the soot he dislodges from the chimney!

When the pro performs the annual tune up for your *furnace*, he'll do a lot of things:

- Test and adjust the oil burner for maximum efficiency; determine an efficiency rating.
- Inspect the combustion chamber.
- Clean and check electrodes and nozzle assembly.
- Change filter and nozzle.
- Check all motors, fans, circulator, pump.
- Check all the safety features and operating controls.
- Vacuum the furnace and flue pipe.

Some service pros will also balance a heating system (steam), or bleed radiators (hot water). Actually, you can do the bleeding yourself (see the section later in this chapter).

Like many households in the Northeast, we have an old, oil-fired hot water *boiler*. It's been running for quite a long time, because it is serviced and cleaned every year. We repair and replace anything that's needed to keep it running. In fact, we've replaced so many of its components my repair guy jokes that, at this point, we've got all-new equipment!

def•i•ni•tion

The heating plant for forced-air systems—the majority of systems in the United States—is called the **furnace**. The heating plant for systems that heat and move water or steam through pipes is called a **boiler**.

We've also got a service contract, an agreement with our oil delivery/service company, that has probably saved us thousands of dollars over the 25 years we've lived in our house.

Our service contract is like an insurance policy. It pays the company a certain amount of money to cover the costs of an annual cleaning. It also covers any emergency service calls that might be made in the course of that year, and it provides for replacement of certain parts, which can be a big savings if you should need them. It's not very costly.

On the other hand, without a contract, midnight runs by oil furnace repairmen, purchased à la carte, can be very expensive. If you have oil heat, a relationship and a contract with a full-service company that delivers oil and does repairs is well worth the price.

Electric Heat

As the cost of electricity rises, electric heat becomes less and less of a bargain, especially in parts of the country with a long heating season. Many of the systems installed in the 1960s and 70s, when *kilowatt hours* (kWh) were cheap, have become very expensive to run.

In places where freezing temperatures are rare, a backup system of baseboard heaters, or a pump that can be controlled to provide both heating and cooling, makes sense. But if you live in a frigid area and have electric heat, I have a word for you: sweaters. Wearing them inside will help keep the bill down.

def•i•ni•tion

A **kilowatt hour** (kWh) is a unit of energy equivalent to one kilowatt (1 kW) of power used for one hour (1 h) of time. To illustrate, if you ran a 1000-watt bulb for one hour, you would use 1 kilowatt hour of energy.

Baseboard electric heaters have their own heating elements that connect directly to your home's wiring system. While using them constantly is very expensive, most of these systems have thermostats in each room; you can turn off the heat in unused spaces.

Because these baseboard heaters collect dust, debris, and animal hair, they can smell very funky when you first turn them on in cold weather. Be sure to dust and vacuum these units before using them, to avoid the smell and to prevent a fire hazard.

Another type of electric heat is generated by a furnace that will warm air and, via a mechanical blower, will push the air through a system of ducts and registers, or to baseboards. While the system is configured like a gas furnace—with electric-powered heating elements instead of the gas flame—heating air this way is inefficient and very costly.

No combustion takes place in this type of furnace, so there's no flue. And only the blower unit of an electric furnace has moving parts, so servicing of the equipment is fairly easy. Filter and humidifier (if there is one), need to be maintained according to manufacturers' directions.

Troubleshooting Your Heating System

If you call for heat by turning up the thermostat—and nothing happens—don't panic. Here are the steps you can try for each type of furnace before calling your professional heating company for service. If you have a good service company, they may walk you through these steps, anyway, before sending someone out.

Gas Furnace

Before picking up the phone to call your repair service, try these fixes in this sequence:

1. Make sure you've turned the thermostat above the current temperature of the room where it is located.
2. If you have a programmable thermostat, be sure it has fresh batteries. If in doubt, change them.
3. Check the emergency switch, usually identified with a red switch plate. It is often located at the top of the stairs or next to the furnace. Someone may have turned it off by mistake.
4. Check your electrical panel. If the breaker is tripped or the fuse blown, replace the fuse/flip the breaker back to on. Follow the manufacturer's instructions for restarting the furnace. If you don't know these, call for service (and learn the startup routine!) If you know how startup works, try it, and if the breaker flips to "off" again, or the fuse blows, call for service.
5. Some newer furnaces are vented directly through the wall with plastic (PVC) pipe. If there is any blockage on the exterior of this pipe, the system will shut down. You can try checking this if it applies to your system.

Ounce of Prevention

If you're in a new house or condo, the builder may have put in an ordinary switch plate over your emergency switch. Change to a red plate that says "Emergency" right away. Unmarked switches can cause a lot of confusion when it's time to power up the heat.

Lighting the Pilot—or Not?

If you have an older, standing pilot furnace (you should know this before you start playing around with it), if the pilot has gone out the burner will not light. *Do not light the pilot yourself if you are not sure how your own system works!* Put on a sweater, call for service, and wait for the pro to arrive.

In general, to light the pilot on a gas furnace, you will find instructions near the pilot control knob on the furnace. You'll need a long match or a long, tubular grill lighter to do the lighting.

- Set the control knob to the pilot position. Hold a long match to the gas port for the pilot.

- Press down on the control knob; sometimes you must press down for thirty seconds or more until the gas burner starts up. If this makes you nervous, don't hesitate to call the pro. Let them walk you through the process until you're comfortable doing it yourself. It's worth a chilly night to learn your system and be confident of your own ability.

Electric Heat

Electric baseboard heat will not work in a power outage. If you have baseboard units with heating elements and they're not getting warm, and your lights are on, try these actions:

1. If the thermostat is programmable, change the batteries unless you know they are fresh. Then try turning on the heat.
2. Check the electrical panel. First, turn the thermostat that controls the baseboard heat to off.

At the main panel if the breaker that controls the baseboard heater(s) is flipped to off, turn it back on. If you have a fuse panel and the fuse is blown, replace the fuse with a fresh, identically sized fuse. Then turn up the thermostat that controls the baseboard heat. If it still doesn't work because the breaker has flipped or the fuse has blown again, you need to call an electrician.

If you have an electric furnace, you can try Steps 1 and 2 above, first. Also make sure, if your thermostat controls both heating and cooling, that the selector switch is on heat mode.

Call for service if the furnace fails to start.

Oil Furnace/Boiler

First, check that the emergency switch has not been flipped off. Also check the electrical panel to see whether or not the breaker or fuse that controls the heating system has flipped off or blown. Flip the switch to on, or change the blown fuse.

You can turn on the furnace if you know the location of the restart button. This is a red button located in one of two places:

- On or next to the motor that starts the oil burner.
- On older systems, there may be a switch on the smoke pipe that connects the furnace/boiler to the chimney.

Press this control *only once*. Pressing it repeatedly is dangerous. If the system doesn't fire up immediately, call for service.

DIY Heating System Maintenance

I hope you understand from this chapter that the maintenance that keeps your heating equipment in top running shape is best done by a trained professional. However, that doesn't mean that there's nothing *you* can do. In fact, there are a few important things that you should do.

Filtering Forced Air Systems

Any forced air heating system is equipped with a filter, usually located next to the blower on your equipment. Have your service pro show you the filter, or refer to your equipment manual. Disposable filters should be replaced, and the old ones discarded, every month during heating season.

If you have an *ionizing filter*—an air-cleaning device that gives tiny particles a charge that makes them stick to the surface of the filter until they are cleaned off—it is not disposable, but needs to be cleaned regularly. For information about furnace filters, check out Chapter 14.

What Pros Know

Is your furnace filter dirty? Hold it up to the light. If you can see through it, it's fine. If you have no pets, carpets, or upholstery, your system may not draw up as many pollutants that will clog a filter. But most people need to replace their filter every month.

Ducts, Vents, and Registers

Warm air (and cool air, if you have a central air system that uses the same ducts) comes into your living spaces through vents and/or registers. These need to be clean and unobstructed by furnishings and drapes.

Before any heating or cooling season, make sure that no furnishings block the vents or registers. Vacuum any dust, debris, or pet hair that accumulates on these outlets; remember the forced hot or cold air will blow this stuff around your house if you don't remove it!

Every couple of years you should have your heating/cooling ducts professionally cleaned. This process not only vacuum-cleans these passageways, but also removes any pollutants such as mold or mildew.

Cleaning Radiators

Use the brush or the crevice tool of your vacuum cleaner to keep your radiators and baseboard heaters clean. Be careful not to bend or damage the little aluminum fins on modern baseboard units. And don't use the tops of radiators for storage! Let the heat flow.

Bleeding Radiators

Hot water heating systems often have radiators; ours are old, heavy cast iron. When these units are partially filled with air, the radiators will not completely fill with water, creating cold spots. Completely cold radiators are full of air.

To fill the system uniformly, you need to bleed each radiator, usually starting at the radiator farthest from the boiler on the supply loop of your system. It sounds gruesome, but it's really easy, and painless to all (if you take care not to scald yourself with the very hot water from the radiator).

The bleed valve on each radiator may be operated by a standard screwdriver tip, a key (you can trace the shape of your valve and bring it to the hardware to get a replacement key—these tend to disappear), or, if you're lucky (we are), a little knob at the end of the valve.

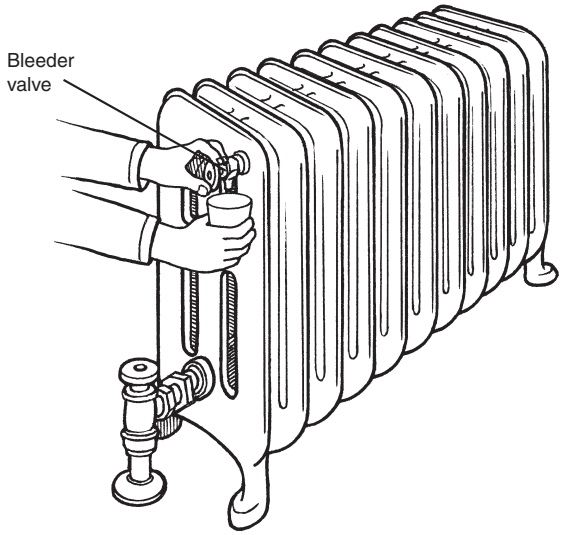
You'll need the following:

- The right tool to open the bleeder valve
- Cup
- Rag

1. The heat must be turned on to bleed the system, so turn on your heat and run it so that the radiators start to get warm. Start with the radiator at one end of the pipe run.
2. Hold the cup underneath the valve; if the control is a handle, use the rag to insulate yourself from the heat.

3. Open the valve; if water comes out, the radiator is fine. Close the valve, and go to the next one.
4. If air comes out when you open the valve, let the air escape until water starts pouring out of the valve, then close it.
5. Bleed every radiator in the system so that no air remains in the units.

Bleeding a hot water radiator.



Steam Heat

These systems are uncommon, but they're out there, especially in houses built between about 1920 and 1940. While there are some gas-fired steam systems, most are powered by an oil burner. Like other heating plants, steam systems need an annual tune-up. To keep the steam flowing into every radiator, the system needs to be balanced, and every radiator must have a working vent; these cost around $20 each. You'll recognize the steam vent because it will probably whistle a little happy tune when the steam escapes! Most vents look like a larger version of a metal pen cap.

Make sure your service pro shows you all the fine points of steam heat. This will include how to flush the sediment from your system so that its safety mechanism, which shuts off the boiler should the water level get too low, will operate properly.

Usually this feature needs regular (weekly, during heat season) flushing. But most steam-heat homeowners love the incredibly fast, efficient heat provided by their system.

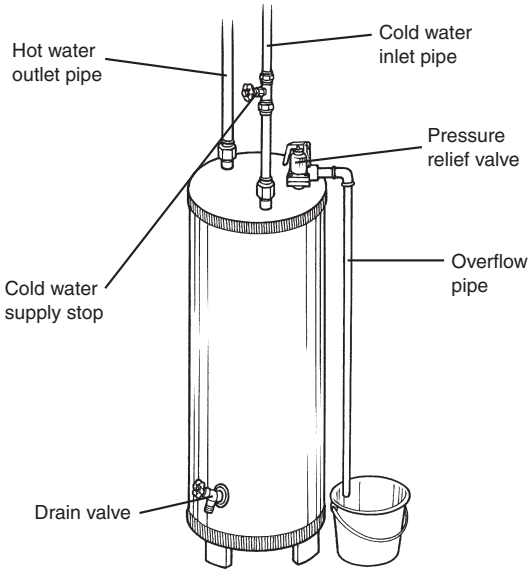
Water Heaters

Few things will make your family as grumpy as being without hot water for a shower when they want it. Water heaters, which are powered by gas in about half the homes in the United States, and by electricity in the other half, are hardworking members of your heating/cooling equipment brigade.

Most water heaters will last about ten years, but you can help prolong their life by knowing a little more about them.

Basic Water Heater Anatomy

A gas water heater differs from an electric model (shown in the following illustration) because it has a vent pipe (at the top of the tank), and a gas supply pipe with a supply valve (stop).



Electric water heater.

Whether your water is heated by gas-fired or electric heating elements, both types of water heaters have certain parts in common, and a couple of differences.

A gas unit must be vented, so it will have a vent pipe, usually located at the top of the heater. The pipe vents into a chimney, or (with more recent models) through the wall. An electric model has no vent.

The gas unit also has a combustion chamber inside the bottom of the unit; electric water heaters usually have heating elements inside the top and bottom of the tank.

Warm water is able to dissolve minerals that are not soluble in cold water. For this reason, the hot water in the tank is corrosive (a good reason not to drink hot water from the tap). Inside both the electric and the gas water tanks are rods, called sacrificial anodes, that act like mineral magnets. They will corrode so that the mineralized water will not go to work corroding the tank and shortening its life. Some homeowners will have the anodes replaced after a few years to lengthen the life of the water heater.

Other parts shared by gas and electric models include the *drain valve*. This is used to drain the water in the tank. Because the tank collects sediment from the water at its base, it's a good idea to drain the tank every couple of years (see the instructions later in this chapter).

You'll also want to pay attention to the *pressure relief valve* (see the previous illustration). This valve will automatically discharge water from the tank should pressure build up inside from an overheating element. These valves go bad on occasion and you can replace yours with an exact duplicate part, as described later in this chapter.

Testing the Pressure Relief Valve

Once a year, you should make sure this valve is working the way it's supposed to. Unless you have a floor drain close to the water heater, you'll need a sturdy bucket (remember, the water inside the tank is *hot*; a cheap plastic bucket might soften from the heat). Position the bucket beneath the overflow pipe that is connected to the pressure relief valve.

Lift the handle on top of the valve; the overflow pipe below the valve should expel hot water. If water doesn't come out, the valve is not working. Replace it at once. (You should also replace this part if it is leaking.)

Ounce of Prevention

Remember, water heaters contain hot water! Wear gloves and use caution when you test the pressure relief valve.

You will need an exact replacement valve and overflow pipe. If you have the use and care manual for your water heater, you can find the part number in the manual. Or call the manufacturer with the model number of your heater (find this info on the tank); they may be able to give you the number, and even sell you the part!

Replacing the Pressure Relief Valve

If the pilot for your gas water heater does not relight automatically with a restart device after the gas has been turned off, be sure that you know how to relight the pilot before you try replacing the pressure valve or draining the water heater (see next section). Do not do these repairs if you are unfamiliar with the gas pilot!

You'll need the following:

- ❑ Bucket
- ❑ Locking pliers
- ❑ Pipe wrench
- ❑ Replacement valve
- ❑ Teflon tape

1. Turn off the gas at the supply stop; turn off the electricity for an electric unit at the electrical panel. Close the shutoff valve (supply stop) at the cold water inlet pipe. If there is no supply stop, you'll need to shut off the water at the main.
2. Drain water from the heater tank to below the level of the pressure relief valve—usually a couple of gallons. You can do this from the drain valve, by filling the bucket a couple of times.
3. Wearing work gloves and safety goggles, hold the valve with the locking pliers. First remove the overflow pipe, then the pressure relief valve, by turning them counterclockwise with the pipe wrench.
4. You may notice that the valve is covered with sediment; this is a major reason for the valve to go bad. It also indicates that you need to drain the water tank more frequently (see the following section).
5. Cover the threads of the new valve with Teflon tape, and screw the valve into the tank. Make sure it's tight. Then cover the threads of the overflow pipe with Teflon tape, and screw it into the new valve.

6. Turn on the water and electric/gas supply. Test the valve to make sure it runs when the handle is lifted, but does not leak.

Draining the Water Heater

You'll need a sturdy bucket (water may be hot!) or a hose that you can thread onto the drain valve and discharge in a floor drain, sump hole, or outside.

1. For electric water heaters, turn off the electricity for the water heater at the electrical panel. If you have never drained the water heater before, and you have a gas heater, you may want a pro to do it the first time. Or follow the instructions in your model's manual.
2. Turn off the cold water supply stop on the inlet valve.
3. Open a hot water faucet anywhere in the house.
4. Open the drain and allow it to empty. If you have a floor drain, this will be easy. If not, you'll be a one-person bucket brigade.
5. When the tank is empty, shut off the drain valve and turn on the cold water, to loosen up any sediment remaining in the tank. Let the tank partially fill, and then drain it again. If the drain water is running clear, you're done.
6. Shut off the drain valve, open the cold water supply stop, and allow the tank to fill.
7. Once water comes out of the hot water faucet you opened (Step 3), your tank is full. You can turn on the electricity or the gas supply to heat the water.

Central Air

Ah! The beauty of a central air conditioning system is something I'll never experience in my two old homes. The cost of installing the ductwork in either house is prohibitive. Besides, our home on the Maine coast needs air conditioning only about three days a year.

Anyway, most central air systems are best served by a maintenance and tune-up appointment with an air conditioning service company. Do this every year, before cooling season.

Basically, there are four main parts to any air conditioner (even the little room air conditioners that are mounted in a window opening):

- A chemical refrigerant
- A condenser
- A compressor
- An evaporator coil

During your first service appointment, have the pro show you all the parts of the system, its controls, and how to start and stop your unit. Have him or her also go over any troubleshooting you can do yourself to diagnose problems.

Keep all this information in your home workbook.

The Least You Need to Know

- Owners of gas-fired heating systems are the majority of households in the United States, and should know how to change the furnace filter.
- Bleeding a hot-water system's radiators sounds scary, but is easily accomplished with the turn of a valve, key, or screwdriver at each radiator.
- Sediment is the enemy of water heaters; draining yours every year or two can extend its life.
- Problems with a central air conditioning system are best left to professionals.

Part 5

Preventive Maintenance: Safety and Upkeep

One of the things that surprised me when we moved from a rental apartment to our own house was the amount of maintenance needed to keep up with our big investment. While it was kind to us in the first, cash-strapped year that we owned it, after that our house developed problems with pipes, the furnace, lights, dead appliances—everything that makes a first-time home-owner wish for the good old days of renting.

The biggest realization for me was that we had to take a proactive stance and go looking for trouble before it surprised us with inconvenience and a large bill. Inspecting the house every spring and fall, I'd notice small flaws: trees that needed trimming, little drips, and cracks. Timely repairs of little things saved lots of money. And when my first child was born, I became more aware that safety, as well as upkeep, requires a similar "do it before it goes bad" mind-set. After 25 years of home ownership, I'm convinced that a little prevention is worth a ton of cure. Part 5 will help you apply this strategy, too.

"Can't we just put a painting over it?"

Chapter 17

Safety Must-Haves

In This Chapter

- The most important device to install and maintain
- Facts about carbon monoxide detectors and fire extinguishers
- Creating a family emergency escape plan
- Critical information to leave with caretakers/caregivers while you're away

With your newfound repair skills, you ought to be able to keep your place running pretty smoothly. But unless you're equipped for *real* emergencies, all the repairs in this book will not keep you, your family, or your home safe. You need to have the right safety equipment in your house, and know how to use and maintain it. You also need to train your family members how to exit the house in an emergency, and know where everyone will meet up once they're out. Finally, when you have someone watching your home while you're away, you need to give them the critical emergency and repair information, should they need to address a problem with your house in your absence. It's probably true that you don't keep your plumber's phone number in your pocket when you go on vacation!

Your #1 Safety Device: Smoke Detectors

The modern smoke detector was patented in 1969; since then, this simple, inexpensive household device has saved countless lives. And it can save yours.

There's only one thing to remember once you've installed smoke detectors: *you must maintain them.* This is critical; a smoke detector that's not working because of a tripped circuit breaker or a dead or removed battery is worthless.

Chirpy Smoke Detector

Sometimes folks get annoyed because their smoke detector is chirping. This can mean a couple of things:

- **The batteries are losing their charge**. Test the alarm; if it doesn't sound, replace the batteries immediately. Battery-operated smoke detectors and most hard-wired detectors (connected to your electric system, with battery backup) use 9-volt alkaline batteries. Keep a supply of 9-volt batteries just for this purpose.
- **Dust and debris are confounding the detector and making it chirp.** If the test shows that the alarm is still working—the batteries are good—check the instructions that came with the device, if you have them. You may need to vacuum the detector with the soft brush attachment of your vacuum cleaner. If you can't stop the chirping, replace the detector. Do not remove the battery and leave a nonworking detector to protect your family. Many people have been injured or died in fires because they removed a battery rather than replacing the detector—usually an inexpensive (under $12) item.

What Pros Know

The instructions for your safety equipment should be filed in your personal home workbook with other use and care information. It will help you maintain the protection that safety gear in working order affords to you and your family.

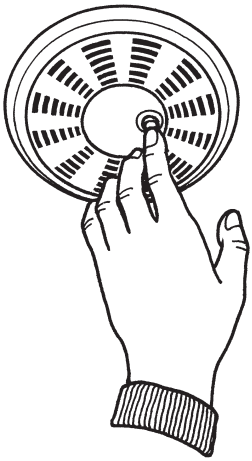
The National Fire Protection Association recommends replacing smoke detectors every 10 years—even if they don't chirp!

Testing the Smoke Detector Alarm

The ear-splitting beep of the detector is its life-saving feature; this alarm is designed to rouse even the heaviest sleeper.

Every month, test every detector in your house by pressing the test button on the surface of the detector for a few seconds. If the beep doesn't sound, replace the battery. If the new battery doesn't make the alarm go off when you test it, replace the detector.

If your smoke detectors are hard-wired (connected to your electrical system), and they don't sound when you press the test button, check to see that the circuit breaker on your electrical panel that controls the detectors is in the "on" position. If it is not, flip it on. If the detectors still don't beep when tested, call an electrician.



Test your alarm monthly.

Replacing the Batteries

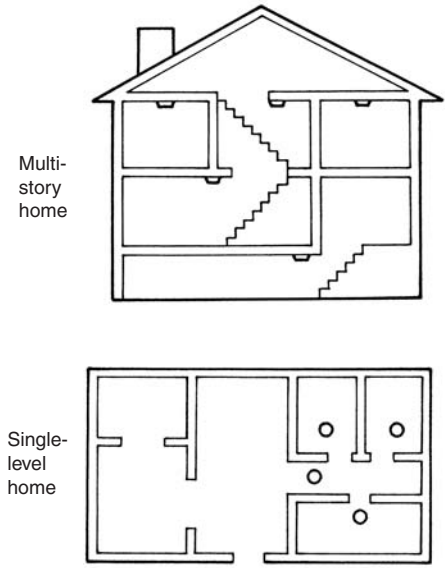
In general, fresh batteries last at least a year. However, most safety organizations recommend that you change the batteries in the smoke detector every time you change the clocks (spring ahead, fall back) as an extra precaution—it's a routine that's easy to remember.

Smoke Detector Placement

Smoke detectors should be installed on every level of the home, and near sleeping areas. If you or your family members sleep with bedroom doors closed, install the smoke detector inside the bedroom. Smoke rises, so install the detectors on a ceiling, or on the wall close to the ceiling.

Avoid installing detectors near heating appliances, windows, or close to ceiling fans, which can foil the effectiveness of the detector, or cause conditions that make it sound when no smoke or fire conditions exist.

Smoke detector locations.



Carbon Monoxide Detector

Carbon monoxide (CO) is a colorless, odorless gas that is the product of incomplete combustion from any device that is not electrically fueled: gas ranges, ovens, clothes dryers, furnaces, grills, space heaters, water heaters, fireplaces, and vehicles. Open flames produced by ovens and ranges are the most common sources of carbon monoxide; vehicles cause the most carbon monoxide poisoning.

Because you can't see or smell carbon monoxide, it is potentially lethal. Carbon monoxide detectors with an audible alarm have been around for the past twenty years.

Ounce of Prevention

While smoke detectors, if maintained, will last ten years or more, carbon monoxide detectors do not have similar longevity. CO detectors should be replaced every two years. Mark the date of installation on the cover of your CO detectors when you put them up.

Installing the CO Detector

Carbon monoxide detectors can be mounted on the wall at least five feet above the floor, or mounted on the ceiling.

Place a CO detector in the sleeping areas in your home. Because it is impossible to detect, a lethal dose of CO is most dangerous to sleepers.

Because CO is often produced by heat sources, do not install the detector close to gas appliances or near a fireplace; it will often give you a false alarm when placed in these locations.

Replacing the CO Detector Battery

Replace the battery when you replace smoke detector batteries; like smoke detector batteries, check the CO detector alarm once a month. You may have to hold down the tester button for 5–10 seconds to sound the alarm.

If the CO Alarm Goes Off

Don't ignore this alarm. Get all members of your household (including pets) out of the house immediately and call 911. Know the symptoms of CO poisoning:

- Low-level CO poisoning prompts flu-like symptoms: mild headache, nausea, slight shortness of breath from mild exertion.
- Higher levels of poisoning cause dizziness, mental confusion, severe headache, nausea, and fainting.

If the alarm sounds and any members of the household have these symptoms, call 911.

Fire Extinguisher Facts

You always hear the caution to keep a fire extinguisher in the kitchen and the garage, and any place else where there's danger of a sudden fire. But how much do you really know about fire extinguishers?

Do you know how they work?

Do you know what types of fires your fire extinguisher will put out?

Is your fire extinguisher in good working order? How can you tell?

In fact, unless a fire is quite small—in a frying pan, or a wastebasket—most fire prevention authorities would prefer you to leave the house and leave the firefighting to the professionals.

But here are some things you should know:

- Household extinguishers are labeled A, B, or C; these letters indicate the type of fire the device can extinguish. *Class A* fires are ordinary combustible materials—paper, cloth, wood, rubber, and many plastics; *Class B* fires are fires caused by flammable liquids—oils, gasoline, paints, grease, solvents, and the like; *Class C* fires are electrical—in wiring, fuse boxes, electrical equipment, computers, etc.
- Home fire extinguishers labeled ABC will work on all three classes of fires, and are known as all-purpose extinguishers.
- If you look at the fine print on extinguishers, you'll see numbers next to the letters A and B. These numbers refer to the amount of fire suppression available in the extinguisher. In general, the higher the numbers, the more extinguishing power is available (and usually, the more expensive the unit). There are no numbers associated with the C designation; the dry chemicals contained in an extinguisher labeled C do not conduct electricity.
- Home fire extinguishers are either disposable or rechargeable; generally, disposable models have plastic valves, rechargeable models have metal valves.
- Purchase at least three extinguishers of the correct type (three ABC for the most versatile equipment) to keep in the kitchen, basement if applicable, and garage. If you use flammable materials in other rooms, then have one for each of those spaces as well.

Using the Extinguisher

Don't try to use an extinguisher to put out a fire if you are not familiar with its operation. The contents of this device are under pressure and come out with some force. Practice using the extinguisher *before* you need it so you will know how it works. That said, when you use an extinguisher—even to try it—it must be recharged right away (if it is rechargeable) or discarded. A partially discharged extinguisher is useless. Yes, it's an expense to have to discard a non-rechargeable extinguisher after practicing with it, but it's worth it.

What Pros Know

Many fire departments offer training in extinguisher use; if you are unsure how to work these devices and don't wish to practice with your own, get some instruction!

To use the extinguisher, remember the acronym P.A.S.S.:

Pull the extinguisher's safety pin.

Aim low, pointing the extinguisher's nozzle at the base of the flames; stand away from the fire—6 feet or more.

Squeeze the extinguisher handle to release the extinguishing agent. Keep the extinguisher upright.

Sweep from side to side at the base of the fire until the unit is fully discharged.

Storing the Extinguisher

Don't put the extinguisher in the back of a closet or cabinet. Fire can spread rapidly, and you may endanger yourself or others while trying to get to the extinguisher in an emergency. The wall near the entry to the kitchen, garage, or basement is a logical place to mount a fire extinguisher.

Maintaining the Extinguisher

When you check your smoke and CO detectors every month, put your extinguishers on the safety route, too. Check the following:

- The needle in the pressure gauge on the extinguisher is in the green (charged) zone. If not, have it recharged or replace it.
- The unit is not blocked by anything that would interfere with access in an emergency.

- The pin and seal (if there is one) are intact.
- The unit shows no signs of wear, such as rust, leaks, corrosion, or dents.

Emergency Exit: Your Family Plan

Emergencies that happen can be scary for everyone in the family—children and adults. If the smoke or CO alarm goes off in your house, does everyone know what to do? You all should.

Getting cooperation on making an emergency escape plan can be difficult; it sounds like chores! Make it into a contest; dream up a prize for whoever can perform the drill in the least time. Serve a treat when you finish practicing. Do what you have to do so that your family knows what to do if there's an emergency and they have to leave the house quickly.

Here are the procedures that you need to review with your family members. Be sure to cover all the points:

1. Find two ways out of every room. Obviously, the first route is the door. Make sure everyone can open the door easily. Teach everyone to feel around the door frame with the back of their hand; if their hands feel warm when they check, it means fire is near. They need to use the second exit.
   - If the second exit is a window, can you get to it easily? Remove anything blocking it. Does the window open easily? If not, you'll need to unstick it so it does (see Chapter 8).
   - Is a room with a window exit on the second floor (or higher)? You will need a safety ladder for window egress from *every* room where a window more than 3 feet above the ground is the second exit. These ladders are an investment you should make *right away*.
   - Practice using the escape ladder from a first-story window with your children, so they are familiar with how to set it in the window.

2. Once everyone knows two ways out of each room, practice the exit routes. Figure out if there are any obstructions along the way that would impede children or elderly family members, and remove the obstructions.

   Practice a "smoky exit." When there's smoke, you need to crouch low in order to breathe more easily. Have the family do a crouching exit, for practice.

3. Decide together on a meeting place away from the house. We made our meeting place our kids' swing set; it was away from the house, and easy to see from most vantage points.
4. Run an emergency drill. You can do this on a weekend night when everyone's home. Press the test button on the smoke detector, and look at your watch. When everyone has arrived at the family meeting place, check your watch again to see how long it took. Figure out any problems with your plan and then fix them:
    - Doors hard to open? (Fix locks and latches.)
    - Hard to see? (Put a flashlight on every bedside table.)
    - Bumping into things? (Clear all obstructions.)

Run through your escape plan every couple of weeks until it's automatic. Then do it at least twice a year—perhaps when you change your smoke detector batteries.

Your Little Red Book

When you're away and someone else is watching your home, or more important, taking care of your children and/or pets, your caretaker/caregiver needs to know how to use your home's main controls, and whom to call if things should go wrong in a hurry. Get yourself a notebook with a red cover (red is easy to see and broadcasts "important").

In addition to standard emergency info—numbers where you can be reached, emergency service numbers (police, fire, ambulance), doctors (for your children)—you should list the following:

- ❑ Gas, electric, and phone company emergency contact numbers
- ❑ Plumber and electrician phone numbers
- ❑ Any friend or neighbor's phone number who has a spare key
- ❑ The location of shutoffs for gas, water, and electricity
- ❑ Your emergency exit plan and meeting location
- ❑ Pet veterinarian and emergency vet numbers

Making the safety preparations detailed in this chapter takes only a little time, and it's time well spent. Doing everything that's within your power to protect your home and family is its own reward. My wish to every reader is that none of this equipment will ever need to be put to use in your home. But you'll feel good just knowing it's there and ready.

The Least You Need to Know

- Keep fresh 9-volt batteries in stock for your smoke detectors; test smoke and CO detectors once a month.
- A fire extinguisher labeled ABC will extinguish all three types of common household fires: ordinary combustibles like paper, flammable liquids, and electrical fires.
- Do *not* try to extinguish a blaze larger than wastebasket size yourself. Call 911.
- Prepare your family for emergencies by creating and practicing an exit strategy from your house, including a meeting place outside.
- Keep important information and contact numbers in a notebook for caretakers/caregivers to refer to while you're away.

Chapter 18

Preventing Repairs: Inside Maintenance

In This Chapter

- Tools for the house detective
- Using an inspection checklist
- Water- and pest-proofing
- Planning ahead

If you're like me, there are lots of things you'd rather do than home repairs. So, to avoid having to use this book much more than you'd like, this chapter will help you become a house detective, starting with your home's interior. (I'll cover exterior repairs in the following chapter.)

Good maintenance begins with regular inspection. You can do this every season, or in spring and fall, after your home has endured the months of most extreme weather. Spring and fall are probably the times when you schedule your most intense cleanup efforts anyway. So, while you're at it, take a good look at things as you go through the house. Be brave, grab a flashlight, and examine the nooks and crannies in the basement and your attic. If you know what to look for, you'll save yourself time, money, and grief by stopping any deterioration of your home before it becomes a big and expensive problem.

Your House Detective Tool Kit

If you like detective novels, you know that a good p.i. (that's private investigator for the uninitiated) notices *details:* the color of a car, the sound of a voice. That's how he or she comes up with clues that will help solve a mystery by the end of the book.

To do a good home inspection, you need to focus on the details of your house, looking for clues that it's running fine, or on the downside, that it could use a little TLC in some areas.

Tools

Inside the house, you won't need too many tools to do a thorough inspection. But you will need the following:

- Flashlight
- Standard screwdriver
- Clipboard and pencil
- Small lamp (to check outlet receptacles)
- Piece of chalk
- Safety goggles (attics and basements can be messy)
- Work gloves
- Stepladder (if you've got vaulted ceilings or need to climb into the attic or look in the backs of closets)

Without going to the tool bag or the supply closet, you already have the best resources for checking your house: your senses. Observing, listening, touching, smelling—the only one of the five I don't recommend using during an inspection is your sense of *taste*—all of these faculties will alert you when something is going wrong with your house. Use them.

The Lists

In Appendix C, you'll find two sets of checklists that will help you zero in on the fine points of your house: one for interiors and one for exteriors. They list just about everything related to your home's structure and systems that you should check out regularly.

Inspection Checklists: How to Use Them

Each part of the checklists is organized very much like this book. It proceeds from surface elements (walls, floors, ceilings, etc.) to the systems and appliances you'll find in the various rooms.

For interior inspections, there are individual checklists for rooms with heating, cooling, or plumbing fixtures, appliances, or system controls (basement/utility/laundry room; kitchen; bathroom). There is also a general checklist for rooms without these more complicated features (bedrooms, family room, living room, dining room). Start the process by making copies for performing your first inspection, as directed in Appendix C.

When you use each checklist, there are spaces for you to note the condition of each element. You can also note whether the item is something you can handle yourself, or something that needs professional service/repair.

Basement/Utility/Laundry Room

If you don't have a basement, you may have a utility room where the electrical panel, heating equipment, and other service controls are located. Laundry equipment is also listed on this checklist, if you have a separate laundry room.

Surfaces: First check surfaces—walls, floors, ceilings, stairs—for signs of deterioration or water intrusion. Note any damage or defect that needs repair. You will probably be able to do some yourself, using Chapters 5–7. If a surface needs attention or repair, you might want to mark the area with a chalked "x" so you can find it later (chalk will wipe off). Pay attention to the basement ceiling, if the joists are exposed. If there is any evidence of water damage or other deterioration, you can try sticking the tip of your screwdriver into a joist that doesn't look "right." If the screwdriver goes in easily, you may have a problem with rot. Call a pro.

Windows and doors: If your basement or utility room has windows or doors, operate these. Windows should open and close smoothly; the door or doors should also open/close properly. Note any cleaning or lubrication necessary for these moving parts. Repairs described in Chapters 8 and 9 may help here.

Electrical: DO NOT TOUCH THE PANEL IF THE FLOOR IS WET. Open the panel door (remember, only use one hand at the panel; the other should be at your side). Look for any signs of damage. Operate all light switches. Plug the lamp into every receptacle outlet; switch on the lamp to see that the outlet is working. Chapter 13 may come in handy.

Ounce of Prevention

Your circuit breakers need exercise! At least twice a year, you should turn every circuit breaker in the electrical panel from the on to the off position, and back to on. By doing this, you'll know that all breakers are operating freely; none are "frozen." If you have any difficulty flipping the breakers on and off, consult a licensed electrician.

Plumbing: Look for any signs of leaks or corrosion at the main water shutoff and at any pipe junctures. The signs are rust, crusty deposits, and of course, any standing water. Address leaks immediately. Chapters 4 and 10 apply.

Gas supply: If you have an inside main, check that the valve is in good condition, with no sign of deterioration or corrosion.

Heating/cooling: Your furnace or boiler, and your central air conditioner (if you have one), should be inspected and serviced by a professional every year. Note the date of the last service. If you are doing your interior inspection in the fall, make a note to call your heating professional now, before the heating season starts. If you have a water heating system, fall is a good time to bleed your radiators (see Chapter 16).

Hot water: If you have never drained your water heater, please see Chapter 16 to find out how to do this, and how to check the pressure relief valve.

Laundry equipment: Check that the valve that links the washing machine hoses to the water supply turns on and off easily. When it's not used for years, this shut-off can freeze up—a big problem if the water's on and your washing machine hose starts to leak! Also check the dryer vent and the back of the dryer for evidence of lint. Lint is highly flammable; if you haven't cleaned the dryer vent recently, see Chapter 14.

Safety equipment: You should have a smoke detector near the entry to your basement or utility room. Check that it is operating, and also check the fire extinguisher, if you have one in this area (see Chapter 17 if you don't know how to run this check).

Bathrooms

Surfaces: Bathroom surfaces may include tile, grout, and caulk (sealant). Check all of these for signs of deterioration, mold, or mildew. Because water pipes may go through walls and under floors in the bathroom, check for any sign of water infiltration: bubbling or lifted wallpaper seams, stained paint, popped nails (see Chapters 5 and 6).

Openings: Check doors and windows for ease of opening/closing. Since humidity can be a problem in bathroom environments, look at metal parts: hinges, doorknobs,

locks, strikes. Note any rust. You can clean rust with a wire brush, but rusting metal is a sign of too much humidity. You may need a dehumidifier or a more powerful exhaust fan in your bathroom.

Electrical: Check the operation of all lights and outlets. Test the GFCI receptacles (see Chapter 13).

Heating/cooling: Check that heating and cooling devices (baseboard heaters, heating or a/c vents, radiators) are clean and unobstructed by furnishings.

Plumbing: Operate tub and sink faucets and stoppers; make note of any leaks or mechanical problems. Check the condition of all drains; water should flow out freely. Check under the sink and behind toilet for signs of leaks. Operate the showerhead; check its spray and pivoting mechanism. Flush the toilet. Note any weak flush or running. (Refer to Chapters 11 and 12 for simple repairs.) Check the surfaces of all fixtures—sink, tub, toilet—for scratches or chips. Make note of any needed repairs. Make sure that supply stops for sink, toilet, and tub/shower (if accessible) turn on and off freely. Note any stops that need lubrication.

Kitchen

Surfaces: Because everything is susceptible to cooking grease and smoke that are by-products of kitchens, note any surfaces that need cleaning, particularly light fixture covers, exhaust fan parts, and little-noticed places like the top of the refrigerator and the tops of cabinets. (You'll need the stepladder; don't climb on the counters!) Note the condition of floor coverings and any polishing, cleaning, or repair that might be necessary. Pay attention to the points where kitchen flooring meets other flooring; make sure screws, nails, or sills are tightly in place.

Openings: Note any drawers or cabinet doors that don't open and close smoothly. Make a note to lubricate any hinges or drawer glides that are balky. Make sure hardware is secure (use a screwdriver to tighten loose knobs or pulls now). Shine a flashlight in the backs of cabinets and around openings for pipes and vents; this is the area where unwanted critters can enter the kitchen (mouse droppings look like small bits of graying rice—yuck!—see the later section of this chapter for what to do about it). Make sure windows and doors operate smoothly; note if they don't. Refer to Chapters 8 and 9 for easy repairs you can do yourself.

Appliances: Note any problems you have with these, so that you can troubleshoot and call for repairs if necessary. Review Chapter 15 if you're not sure what you're looking for.

Heating/cooling: Check that heating and cooling devices (baseboard heaters, heating or a/c vents, radiators) are clean and unobstructed by furnishings.

Plumbing: Check faucets, sprays, and spouts for leaks or problems that require maintenance (see Chapter 11); check pipes under the sink for any evidence of leaks; try the supply stops and note if they need lubricating (they should open and close freely).

Electrical: Check that light fixtures, switches, and receptacles are operating; test GFCI receptacles (see Chapter 13).

Safety: You should have a smoke detector and fire extinguisher installed near the entrance to your kitchen. You should check these monthly, and during this inspection (see Chapter 17 for how to do this).

Attic/Under Roof Crawl Space

Access: Make sure the drop-down hatch or steps are operating properly.

Surfaces: Use your flashlight liberally to examine the *ridge*, *rafters*, and attic insulation for any signs of water penetration. Discolored or degraded insulation (possible mold) and water marks on the roof framing (leaks?) are cause for further investigation. Check that roof vents are screened, and that the screens are intact (this is a place where critters—rodents, birds, bees or hornets—can enter, and cause a *lot* of damage). If you see evidence of bats or flying, stinging insects, don't try to handle this problem yourself. Leave the attic immediately, close the door or hatch, and call a pro.

def•i•ni•tion

The **ridge** is the long, straight center timber at the joint between the sloping sides of a gabled roof. The **rafters** are the sloping supporting timbers or boards that run from the ridge to the edge of the roof.

Heating/cooling: Check that the attic fan (if you have one) is operating properly, and is unobstructed and clean. Shine a flashlight on heating/cooling ducts; check that seams in these ducts are intact.

General Inspection

For rooms without plumbing and appliances, you will be checking surfaces, openings, and heating and cooling units or vents.

Electrical: Check that switches and receptacles are all operating. Plug in a lamp to each outlet of every receptacle.

Plumbing/heating: Don't forget to check closets; often, the *chase* where plumbing and heating pipes run from floor to floor is located in such an out-of-the-way place; you want to make sure there's no evidence of water damage or critter entry.

Keeping Out Water and Critters

If you find evidence of leaks or pests that have infiltrated your home from outside, you'll have to plug any outside gaps to control these problems. See Chapter 19 for outside inspection and maintenance information.

If you've got insects that seem to have taken up residence indoors, or a mouse problem that won't quit, you'll either have to use insecticides or traps yourself, or call someone to do this unpleasant task.

Because professional exterminators are licensed to apply pesticides and remove critters (rodents, bats, wild birds), my advice is to get a company that is recommended by someone you know, and use them on a regular basis to inspect your home and remove any pests when and if a problem occurs.

It is in *prevention* that your DIY skills can be most effective. Here are some ideas to keep the inside of your home pest-free.

First, use common sense to avoid problems with bugs and critters:

- Keep food in closed containers with tight-fitting lids.
- Do not leave food out in the open.
- Clean up food spills (including pet food) immediately.

Here are two DIY projects that can make two frequently overlooked areas of your home impervious to pests.

Screening Attic Vents

The vents that allow air to circulate in the attic spaces and along the ridge of your roof are usually large enough to admit many small creatures, as well as providing an entryway for flying and crawling insects to come in and build a nest in the rafters—not something you want!

Be sure you don't have insects or critters already in residence. If you do, you'll have to have an exterminator remove them. If you've got a resident critter and you don't want to harm the little guy, you or your exterminator can try the live-trapping method before taking more extreme or lethal measures. Home supply stores sell live traps for this purpose.

To screen the vents you'll need the following:

- ❑ Measuring tape
- ❑ Hardware cloth
- ❑ Straightedge
- ❑ Scissors
- ❑ Staple gun
- ❑ Duct tape

The edges of hardware cloth are very sharp. Wear gloves when you work with this material. Also wear safety goggles and cover your body when you work in the attic. If your house is insulated with fiberglass bats, you should avoid handling this material.

1. Measure and cut the hardware cloth to cover each vent to its perimeter.
2. Staple the hardware cloth to the perimeter of the vent. Space the staples close together so pests cannot push or crawl through the barrier. You may also want to seal the perimeter with a layer of duct tape, for an extra-tight critter barrier.

Rodent-Proofing Gaps

Rodents are especially attracted to areas of your home where there is a food supply. Although in desperation they'll eat soap and other usually unpalatable items, your kitchen is where they want to be!

Mice can squeeze through very small spaces. If you notice gaps in the seams of your kitchen cabinet interiors, or spaces between pipes and the surfaces through which they come into your kitchen, you can make them less vulnerable.

You'll need the following:

- ❑ Standard screwdriver
- ❑ Steel wool or insulating spray foam

Wearing work gloves, use the screwdriver to work chunks of steel wool into the cracks noted above. Or you can spray these gaps with insulating spray foam (the foam will keep drafts out, too!). Mice and other critters will not be able to gnaw through these two substances.

Planning Ahead for Maintenance

In addition to the cost of your mortgage, homeowners' insurance, and real estate taxes, homeownership makes other demands on your pocketbook. You should try to set aside money on a regular basis for keeping up your house. Doing some of the small repair and maintenance chores outlined in this book will save you a lot, and help you set money aside for equipment, appliances, and other major elements of your house that may need extensive repair or replacement as the years go by.

I've read advice to put away 1 or 2 percent of the purchase price of your home, every year, so you'll have money when something big breaks down. I think this is a good guideline.

Here's a list of large household items and their average life spans:

- Heating system: 25 years
- Roof: 20–25 years
- Refrigerator: 15–20 years
- Range/oven: 18 years
- Room air conditioner: 12–15 years
- Clothes washer: 13–15 years
- Clothes dryer: 12–18 years
- Dishwasher: 10–12 years
- Water heater: 10–13 years

The Least You Need to Know

- When it comes to home repair, take a proactive stance; look for small problems before they become big ones.
- Spring and fall cleanup seasons are good times to inspect your home, inside and out.
- Inspection checklists will help you set DIY priorities and create a "to-do" list for hired professionals.

- Pests are most likely to infiltrate your kitchen and attic spaces; you can create defensive barriers.
- Plan ahead. Be aware of equipment life spans, and set aside 1 or 2 percent of the purchase price of your home every year for replacing things that wear out.

Chapter 19

Preventing Repairs: Outside Maintenance

In This Chapter

- Figuring out your home's weaknesses
- Reinforcing your home's defenses
- Redirecting water flow
- Necessary outdoor repairs
- Tips for finding and using a pro

We all like to think of our homes as *shelter:* from the troubles of the world, from the hustle-bustle of daily life, and certainly from anything outside that we might find threatening.

The major enemies of an intact house—structurally, that is—are water and other weather-influenced conditions. By paying attention to your home's exterior, and maintaining its protective "skin"—siding, roofing, trim, and openings—and the landscape, you'll guard against deterioration that can cause expensive problems outside, and later, inside.

Outside Inspection

Taking a good look around your home's exterior, from the foundation walls to the peak of the chimney, is a helpful way to spot small defects before they become big problems.

As with Chapter 18, which shows you how to check out your home's interior, turn to Appendix C for a checklist for an outside inspection of your home. It will take you through all of the details you should look at. When you're done, you'll have a to-do list for your home's exterior.

You'll need the following:

- ❑ Flashlight
- ❑ Screwdriver
- ❑ Work gloves
- ❑ Stepladder (for inspecting hard-to-reach places)
- ❑ Binoculars (to inspect roof, shingles, and chimney)
- ❑ Clipboard
- ❑ Pencil/pen
- ❑ Inspection checklist (see Appendix C)

Foundation

Clear perimeter: Start with your house where it meets the ground; this is known as "at grade." Walk completely around the building. If there are any obstructions between the house and the ground within a foot of the walls—branches or shrubs, piled-up wood—these need to be removed. A good border to install on the first foot of ground surrounding your home is a layer of pea gravel. Anything stacked or growing against the house wall creates a "bridge" for insects and critters to get to your home and find their way in. Don't provide this opportunity! If branches are growing close to the house, make a note to cut them.

Crawl space vents: If you don't have a full basement under the house, and the house isn't built on a concrete slab at grade, you may have crawl spaces beneath the house. Crawl spaces are usually vented. Be sure your vents are screened and secure.

Foundation cracking: If you see cracks in the masonry foundation, note their location and size. If they have grown larger, wider, or deeper the next time you inspect your home's exterior, contact a pro. If the cracks extend to the interior foundation wall, remember that mice can enter the home through cracks as small as a pencil's diameter. Have a masonry repair person address this problem.

Insect evidence: If you see any signs of insect infestation—grayish mud tubes, sawdust, insect wings—contact a professional exterminator immediately. Remediation for wood-eating insects is not a job for an amateur.

Basement windows: If you have basement windows, be sure the area around them is clean and free of debris. Clean out window wells, if basement windows are below-grade. Note any cracked or broken basement window glass; the panes need to be replaced.

Ounce of Prevention

Secure your crawl space openings! A couple of years ago, an injured skunk crawled under our house and chose to depart his/her life there; it had entered through an opening in our crawl space vent that no one had noticed! The fix for this one wasn't fun; we ran an exhaust fan in the first floor den for nearly two months, and no one could use that room (above the skunk's resting place!) until the odor dissipated. Our wildlife removal expert was helpful but expensive—and even he couldn't get the critter out!

Walls, Windows, and Doors

Masonry/brick walls: Check this type of wall for cracked or missing mortar, which need to be addressed to prevent water penetration.

Siding: Check for loose or missing pieces; warping; signs of mold or mildew.

Painted surfaces: Look for blistering, cracking, peeling, chipping, or a chalky appearance. These indicate your paint finish may need touch-up or repainting. If paint is dirty, washing the surface may extend the life of the finish.

Caulking: A well-maintained exterior is caulked wherever two surfaces meet. Check the integrity of caulking between foundation and siding, between siding and trim boards, between siding and window and door trim.

Examine window glass and screens: note any panes/screens that need to be repaired/replaced.

Check operation of doors (you already checked the windows and doors inside if you did an interior inspection; see Chapter 18).

Examine weather stripping, especially around doors. Make sure there are no small gaps that will permit pests to enter the house.

Roof

Obstructions: Notice whether any tree branches are overhanging or scraping against the roof. These can damage shingles, create a fire hazard if they're near the chimney, and form a "bridge" for animals to access your roof. Make a note to trim them, and have this done as soon as possible.

Shingles: Survey the entire roof. Note any curled, damaged, loose, or missing shingles. They will need to be replaced before the roof starts to leak.

Ounce of Prevention

Climbing onto the roof is not recommended for DIY 101-ers! Use your binoculars to check the details of your roof's condition. If repairs are indicated, call a pro.

Flashing: Usually copper sheeting, flashing is installed around chimneys, vents, dormers, and skylights, and at any other roof seams. Use your binoculars to see whether the flashing appears intact, or whether there are signs of deterioration of the materials above or below the flashing. If you have had interior leaking, and the roof shingles look fine, poorly installed or deteriorated flashing may be the culprit. Call a professional roofer.

Gutters: Examine paint on gutters to see if it needs touching up. Check gutter runs and note if any gutters have slipped from their mountings—they will need to be rehung if they've fallen. Even screened gutters need to be cleaned at least once, if not more, in the fall and spring. See how to do this a little later in the chapter.

Also if gutters end right next to the house, they are dumping hundreds of gallons of water next to the foundation. You will want to address this potential problem by adding extenders to the gutters (described later in this chapter).

Landscape

Check driveways and walkways for cracks, breaks, or wear. You need to kill or pull weeds growing between the cracks of bricks or pavers. Check fences and gates for cleanliness, gate operation, and need for paint and repair. In spring, check the

condition of exterior water valves (hose bibs); remove covers if frost danger is past. Make sure outside heating/cooling equipment is not obstructed or damaged. Have it serviced professionally if needed.

Maintaining Your Home's Exterior

Once you've done an exterior inspection, you've got a ready-to-use work sheet for what needs to be done. If you have the time, the skill, and the tools necessary to perform a chore or repair, then do it. If not, you need to find someone to help you get it done.

While some people (myself included) don't have time to do the weekly yard work, seasonal and occasional maintenance and repairs fit within my scope of time and capability. And I like to save the money! Here are a couple of chores you may find doable on your own schedule.

Gutters and Drainage

Water is the great enemy of a house; along with its companion—foul weather, especially high winds—water can do more damage to a structure than any other factor.

When shingles fail and need replacement, leave the job to professionals. Roof work is tricky and dangerous; most construction companies assign their youngest and most agile (and lowest-paid!) employees to the strenuous job of removing and attaching shingles, and walking on the slippery, steeply pitched roof surfaces. Enough said to scare you away from roof repair? I hope so.

If your gutters are not dizzyingly distant from the ground, cleaning them seasonally and installing leaf guards are jobs you can do. I recommend that any work involving ladders outside be done with a helper.

How Gutters Work

Gutters collect rainwater and melted snow and ice that drains from the roof, and carry the water to the ground by means of downspouts. When too much debris—falling leaves, dirt, twigs—clog the gutters, this gunk can clump over the downspout holes and shut down the system. The water then spills out of the gutters, front and back. At worst, the water backs up and damages the roof or leaks into the walls.

There is a large variety of leaf guard products for gutters. Hundreds of inventors have put their minds to the task of a convenient design that helps keep gutters running free. The screens (and other devices, too) fit on top of the gutter, usually attached or fitted to the gutter edges, and prevent leaves from clogging up gutter runs. Depending upon what your gutters look like and how they are attached, you can buy and install an appropriate leaf guard, or hire someone to do this.

What Pros Know

One leaf guard I like—because it's very easy to handle—is constructed like a large bottle brush, with big bristles that have a diameter as large as a standard gutter. These come in manageable three-foot lengths and can be laid end to end in the gutter. They prevent leaves and debris from becoming lodged in the gutter, and are easily lifted out, hosed off, and replaced.

Cleaning Gutters and Downspouts

To clean gutters, you will need to climb a ladder. Please review the ladder safety rules in Chapter 2. They're important.

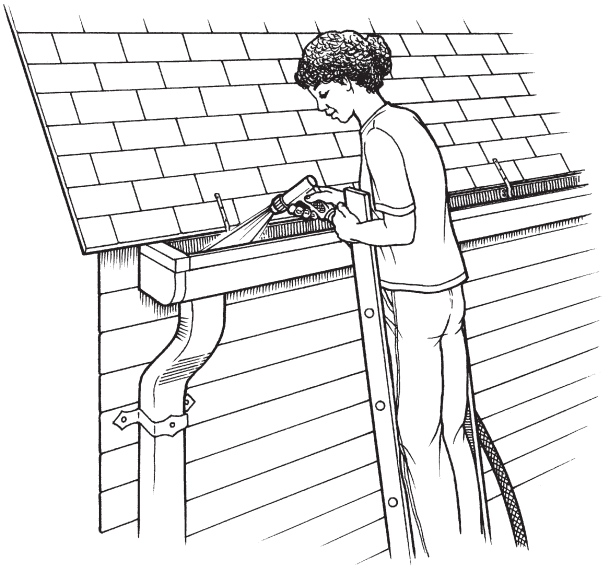
If your gutters are higher than you can reach with a stepladder, you'll need to use an extension ladder. If you are not afraid of heights, fine. Just follow these rules:

- Make sure that the base of the ladder is firm and level.
- The bottom of the ladder should be one foot away from the wall of your house for every four feet of its length. If the ladder is extended 12 feet up, for example, you'll need to place the base of the ladder 3 feet from the wall of the house.
- Do not stand on the top three steps of the ladder.
- Keep your hips between the vertical rails of the ladder. Climb down and move the ladder; don't extend your body beyond safety range.
- Have a friend hold the ladder at its base.

To clean gutters, you'll need the following:

- ❑ Plastic or metal trowel
- ❑ Plastic trash bag or a bucket
- ❑ Hose, attached to outdoor faucet

1. Position the ladder at one end of the gutter. Wearing work gloves (it's messy up there!), use the trowel to scoop the debris into the trash bag. Remember, do not stretch beyond the rails of the ladder; move the ladder to reposition yourself along the gutter. When the bag or bucket is full, descend the ladder and empty the trash.
2. Once you've cleared the debris, climb the ladder with the spray end of the hose. Have your partner help you so the hose does not tangle in the rungs of the ladder. Spray water toward the downspout of each gutter. When you get to the downspout, flush it with water. Clear every gutter.

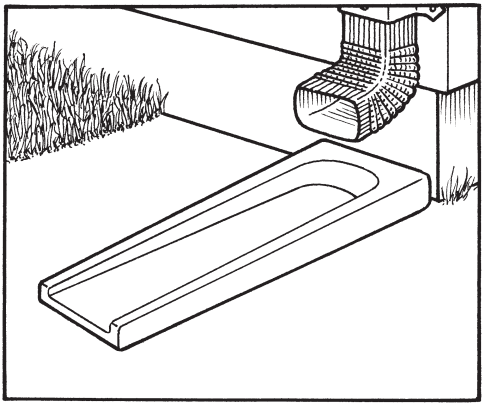


After removing debris, hose out each gutter and downspout.

Directing Water Flow: Extenders and Splash Blocks

Downspouts are generally connected to an elbow piece near the ground, with an angled extender that helps deflect water away from the foundation of your house. Attach extenders to your downspouts if they are not so equipped. If water from the downspout is pooling within five feet of your house after a rainstorm, you can add a longer extender to the downspout (simply detach a piece of downspout and bring it to the hardware for a match).

Or you can purchase a plastic or concrete splash block that will also run the water away from your home's foundation.



The splash block acts like a waterslide and helps keep your home's foundation dry.

Small Gutter Repairs

If your gutters are bent, rusted out, or otherwise seriously degraded, you should replace them. However, caulking them with silicon sealant can repair leaky joints between sections of gutter. Also if you notice a little hole or two in the gutter, you can patch the holes with a thin coat of roofing cement, applied with a putty knife.

Driveway Repair

Our driveway is as long as a football field, and resurfacing it is more expensive than I want to think about. In our northern climate zone, water always finds its way beneath the asphalt, and sooner or later cracks appear.

Filling the cracks when you notice them is the best way to make your driveway last longer, sparing you the painful cost of replacement.

You'll need the following:

- Ice-chipping tool
- Connected garden hose
- Broom

- ❑ Driveway cleaner
- ❑ Bucket
- ❑ Heavy-duty scrub brush
- ❑ Rubberized asphalt crack filler
- ❑ Putty knife
- ❑ Cold patch blacktop
- ❑ Small shovel
- ❑ Piece of 4" × 4" lumber to tamp down patch material

1. Use the ice chipper or a similar tool to scrape away weeds or anything else growing in and around the cracks.
2. Clean out the cracks with the hose spray. Sweep away any debris—dirt, plant matter, chunks of asphalt—and discard.
3. Scrub the area around the cracks with driveway cleaner. You want to get rid of any oil spills and residue. The crack filler needs a clean surface to adhere to.
4. Let the area dry thoroughly.
5. For small cracks less than $^1/_2$ inch wide, pour asphalt crack filler into the gap. Smooth it with a putty knife.
6. For larger cracks or holes, prepare the area as described in Steps 1–4. Shovel in the cold patch, compact it with the end of the 4 × 4. Overfill the hole a little, and compact it again.

Finding and Using a Pro

No matter how handy you find yourself to be, you'll eventually need to find someone with expertise that you don't have. The best way to find professionals (for outside *and* inside work) is to get recommendations from people you trust. If you don't know the kind of pro you're looking for, ask prospective contractors for references, and *check them*. Problems with hired contractors can be avoided if you follow these tips:

- Get a *written* estimate of the scope, timing, and cost of a repair.
- Check references. If your job is a large one, visit the site of one of the pro's completed jobs, and talk with the homeowners.

- Never pay for a job in advance. Agree in writing on a deposit and then benchmarks (stages of completion) for further payments, with the last payment (at least 10–15 percent of the cost) to *follow* the finished job.
- Don't leave money details "for later." Time and again, I've overspent on a job because I didn't itemize and know the budget for everything before a job began.
- Trust your gut. If a little voice inside you keeps telling you to hold on, instead of trusting a smooth-talking contractor, listen to that little voice. Check one more reference; read the contract one more time. Don't be afraid to back away from a deal if it doesn't feel right.

The Least You Need to Know

- A close inspection of your home's exterior, twice a year, will alert you to small problems before they become big ones.
- Trim away any shrubs or tree limbs that brush against, or overhang your house. They're a natural bridge for critters and insects to make themselves at home—at your expense!
- Route water away from your house with downspout extenders or splash blocks.
- When you need a pro, get references you can check and an estimate in writing.

Appendix A

Glossary

amps (amperes) A unit of measurement for the speed of the flow of electrons in electric current.

assembly A set of components before they're put together.

bleeding Removing the air from a hot water heating system by releasing air from individual radiator valves. This provides consistent heat throughout the system.

boiler The heating plant for systems that heat and move water or steam through pipes.

caulk A material used to create a watertight seal between two adjoining surfaces.

chase A channel in the wall of a structure that holds pipes or wires, providing space for them to run from room to room or floor to floor.

cheesecloth A light, gauzy fabric originally used to strain and hold cheese. When it comes to home repair, cheesecloth is a great applicator for various liquids.

circuit A loop through which electrical current can flow, beginning and ending at the same point. Household electrical circuits begin and end at the electrical panel, which receives its current from electric utility service lines that enter at the top of the panel.

circuit breaker A device that stops the flow of electricity in a circuit if there is too much current for safe operation. Both the toggle switches and the fuses used in the two types of service panels act as circuit breakers, but only the toggle switch type are commonly referred to as circuit breakers.

conductor A medium that allows heat, electricity, light, or sound to pass through or along it. Copper wire is a good conductor of electrical current.

drywall The most common type of base wall material. It is made by sandwiching a gypsum core, which is fire resistant, between layers of paper. Also known as Sheetrock, wallboard, or gypsum board, this material is also made in a water resistant variety for use in damp areas.

electricity The flow of electrons through a conductor.

fenestration The architectural term that refers to the design and placement of windows in a building.

furnace The heating plant for forced-air systems—the majority of systems in the U.S—that heat air and then move it, by means of a blower, through a system of ducts.

furring strips Thin, narrow pieces of wood used to provide backing to support a finished surface.

filament A slender strand of fiber or other material. The thin wire that is the light-producing element of a bulb when electricity passes through it, and the element that emits electrons in a vacuum tube when current is passed through it, are also known as filaments.

gasket A material that creates a seal between two surfaces—for example, a door and its opening—that prevents the passage of liquid or gas. Many home appliances have rubber gaskets around their doors.

gauge The sizing system for the diameter of wire. The smaller the gauge number, the larger the diameter of the wire.

grade The level at which the ground meets a structure.

ground fault circuit interrupter (GFCI) A device used in code-compliant electrical receptacles near water sources. The GFCI almost instantly cuts power to a circuit if it detects a leakage of electric current.

grounding When he or she grounds your electrical system, the electrician has connected it to the earth. Grounding provides a safe path for any loose current—from a defective fixture or appliance, or exposed wire touching metal somewhere in the system.

grout Thin mortar used to fill gaps between tiles or other surfacing materials.

grout saw a small hand tool that looks like a knife with an offset handle. It's great for cutting between tiles so that grout can be easily removed, without scratching adjacent tiles.

header The top horizontal part of a door or window frame.

ionizing filter An air-cleaning device that gives tiny particles a charge that makes them stick to the surface of the filter until they are cleaned off.

jamb The vertical part of the frame of an opening, either a window or a door.

joint In carpentry, the intersection of two pieces of wood. There are many different kinds of wood joints.

joist The framing that supports a floor or ceiling.

kilowatt hour (kWh) A unit of energy equivalent to one kilowatt (1 kW) of power used for one hour (1 h) of time.

lath A framework of thin wood strips, or, more recently, wire mesh, that is used as the foundation for plaster or sometimes for tile.

load The amount of electrical current that is drawn from a source. An excessive load on a household circuit will cause a fuse to blow or a circuit breaker to trip to "off."

mastic A flexible cement used as an adhesive for affixing tile to an underlying surface.

mortise A hole or slot cut into wood or other material, so that a projecting piece (called a tenon) can be precisely inserted. Mortise-and-tenon joints are a very sturdy joinery technique used in woodworking and carpentry.

packing A material, often string, that is used like a washer in the assembly of a compression faucet.

pneumatic A tool or machine that is operated by compressed air.

rafters The sloping supporting timbers or boards that run from the ridge to the edge of the roof.

rails The horizontal framing pieces of a window sash or door.

ridge The long, straight center timber at the joint between the sloping sides of a gabled roof.

sash The part of a window that holds one or more panes of glass or other transparent or translucent material.

shim A thin, wedge-shaped piece of wood, metal, plastic, or cardboard. It's used to help position something properly by filling a gap, or to protect a surface from something that may scratch or mar it.

stiles The vertical framing pieces of a window sash or door.

sidelight A window positioned next to a door.

solvent A substance in which other substances are dissolved.

spirit level An instrument designed to indicate whether a surface is level (horizontal measure) or plumb (measured vertically).

spline A piece of wood, metal, or plastic that is used as a connecting or framing piece between two sections of material. Spline can be used to hold a screen in its surrounding frame; the material that frames caning in a chair seat where it meets the wood or metal part of the seat is also known as spline.

spline tool A hand tool for installing spline; it has a wheel at each end. One wheel has a convex (∪) rim, for pushing the screen into the spline channel; the other wheel has a concave (∩) rim, for pushing the spline down over the mesh and into the channel.

supply stops On/off controls found along household utility supply lines, managing the flow of gas or water to individual fixtures and appliances.

tempered glass Glass that has been heated and cooled repeatedly in a controlled environment to give it more strength than conventional, single-layer window glass.

vise A tool with two jaws, closed by a screw or a lever to hold objects immobile.

volt A measure of the force with which electrons move in electrical current.

watt A measure of electrical output.

Appendix B

Online Resources

Chapter 1: Your Personal Toolkit

If you want to learn more about hand and power tools, consider a hands-on, education vacation! Volunteer with Habitat for Humanity (ladies, Habitat's Women Build program is a great way to learn your way around a house). Go to www.habitat.org or www.habitat.org/wb/ (for Women Build). Or, sign up for a weekend or more at a school that offers hands-on training; this is a more expensive option, as you will pay tuition, plus the cost of a local room and meals. But the courses are great fun, and introduce you to other folks who like to work on their houses. Here are a couple:

Yestermorrow Design/Build School, Warren, VT: www.yestermorrow.org

Shelter Institute, Woolwich, ME: www.shelterinstitute.com

If you're shopping for tools, try tag sales, especially estate sales. You may find some very good buys. And if you're traveling in the state of Maine, check out one of the three stores owned by the Jonesport Wood Company. You can fill a bag with tools for very little money! Info at: www.jonesport-wood.com/jwabout.htm.

Chapter 2: Your Most Important Tool: The Safety Drill

For information on safety glasses with magnifying (reader) lenses, go to www.aosafety.com, click on "eyewear," and look for the "Readers" product.

Chapter 3: Your Supply Closet

WD-40 is such a popular lubricant, with so many uses, that its manufacturer started a fan club where users can post some of the nifty ways they've used the product around the house and at work. Register for all this helpful DIY info at http://fanclub.wd40.com.

Chapter 4: A Map of Your World

If you have a well and septic system, rather than municipal or private water and sanitary service (sewer system), these websites will give you more information than you'll probably ever need:

For water wells, the U.S. Environmental Protection Agency has a huge amount of information you can access through www.epa.gov/safewater/privatewells/.

For septic systems, www.inspect-ny.com/septbook.htm is comprehensive and easy to navigate.

Chapter 5: Walls: From Trash Talk to Smooth Talk

Plaster walls are tough to repair. If you've got an old house with lots of plaster and lots of damage, you'll probably need professional help to repair it. The National Park Service, part of the U.S. Department of the Interior, publishes a vast amount of how-to information for preserving and repairing old buildings—not only plaster, but old windows, roofing materials, floors, and so on. Check out their online resources at www.cr.nps.gov/hps/tps/briefs/presbhom.htm.

Chapter 6: Floors and Ceilings: Beneath Your Feet and (Not Really) Over Your Head

For further information about hardwood floors, visit the website of the American Hardwood Information Center: www.hardwoodinfo.com.

A good general website for flooring information: www.floorfacts.com.

The Carpet & Rug Institute (an industry organization) has a large website with a spot-cleaning section: www.carpet-rug.com.

Chapter 7: Stairs: A Few Steps to a Happy Landing

The Consumer Product Safety Commission has an extensive website and many downloadable publications that address safety issues for children and seniors: www.cpsc.gov.

Chapter 8: Getting Clear About Windows

If your windows are beyond repair, you'll need the latest information on replacements. Pay particular attention to energy efficiency, and get windows that can save you money on heating and cooling your house. Here are two helpful sites to check out:

The Efficient Windows Collaborative: www.efficientwindows.org

National Fenestration Ratings Council: www.nfrc.org/windowshop/

Chapter 9: Doors: An Open-and-Shut Case

The Old House Parts Company has been salvaging old mantels, woodwork, doors, windows, and hardware from antique—and just plain old—houses for many years. You may be able to locate parts for old doorknobs and locksets here, if you can't find them anywhere else. They'll be happy to work with you by fax or e-mail:

1 Trackside Drive, Kennebunk, Maine 04043
Phone: (207) 985-1999
Fax: (207) 985-1911
www.oldhouseparts.com

Chapter 10: Solving Pipe Problems

If your home is old and has never been re-plumbed with new copper or PVC (plastic) pipes, there may be lengths of lead pipe, or lead solder used in connecting other metal pipe. For more information about pipes, lead, and drinking water, visit this address at the Environmental Protection Agency's (EPA) website: www.epa.gov/safewater/.

Chapter 11: Controlling the Flow: Faucets, Sprays, and Showerheads

Most large home centers and well-stocked hardware stores have extensive inventories of faucet parts. Danco is one company that provides a huge range of parts, plus a helpful in-store guide to help you match your originals to their replacements. For more information and listing of the company's retailers: www.danco.com.

Chapter 12: Tub and Toilet Techniques

Small repairs on porcelain tubs and sinks will not provide an ultra-smooth, like-new finish. But there are companies that specialize in refinishing tubs, which are expensive to replace when you factor in the cost of the fixture, removing the old tub, and labor for both removal and new installation, including plumbing. One national company has franchises that do this work, which is comparable to auto-body repair and painting. Visit the website: www.miraclemethod.com.

Also check your local business phone directory under "Bathtub Refinishing." Be sure to get references for professional service companies with which you are unfamiliar.

Chapter 13: In the Loop: Understanding Your Wiring

Edison Electric Institute, the national association of shareholder-owned electric utility companies, provides a wealth of information about using energy wisely at www.eei.org/wiseuse.

Chapter 14: Smooth Transitions: Cleaning and Replacing Filters and Hoses

Your electrician can install a device that can turn off the water supply to the washing machine automatically (lots of people forget, with disastrous and expensive results). Called an IntelliFlow, it's available from a company called Watts. See the website: www.watts.com/pro/divisions/watersafety_flowcontrol/learnabout/learnabout_intelliflow.asp or call at (978) 688-1811.

Chapter 15: Appliance Repairs

Nearly every major appliance manufacturer has a toll-free customer service number, plus a web site that provides comprehensive information on maintenance and repair, including downloadable use and care manuals, and a parts department. Here is contact information for some major producers:

GE Appliances: www.GEappliances.com; 1-800-626-6005

Sears: www.Sears.com; 1-800-469-4663

Whirlpool: www.whirlpool.com; 1-866-698-2538

Maytag: www.maytag.com; 1-800-688-9900

Bosch: www.boschappliances.com; 1-800-921-9622

Jenn-Air: www.jennair.com; 1-800-688-1100

If you can no longer repair your appliance, consider finding a new one that will cost you less to run. Go to the government's Energy Star website: www.energystar.gov.

Chapter 16: Heating and Cooling

More than half of the homeowners in the U.S. heat with natural gas; about a third use electric heat; seven percent use heating oil; and about five percent use propane. Here are some information packed websites for learning more about your system:

Natural gas: www.aga.org/Content/ContentGroups/Public_Relations2/Natural_Gas_Heating_Systems.htm

Electric heat: www.energyguide.com/library/EnergyLibraryTopic.asp?bid=austin&prd=10&TID=17212&SubjectID=8372

Oil heat: www.oilheatamerica.com

Propane heat: www.usepropane.com/select/furnace?categories=heating&products=furnace

Chapter 17: Safety Must-Haves

The National Fire Protection Association (NFPA) has a website packed with information about safeguarding your home and family from fire dangers: www.nfpa.org.

NFPA also has a well-known mascot, Sparky the Fire Dog, who guides you through a child- and family-friendly website with illustrations of fire safety tools and techniques: www.sparky.org.

You can get safety decals from your local firehouse to mark children's bedroom windows so that the fire department can get to them quickly. But many people also worry about their pets being left in the house when there's an emergency. You can find decals to put on your door that indicate you have pets, and how many you have: www.petalertdecal.com.

Chapter 18: Preventing Repairs: Inside Maintenance

Doing major repairs and replacing equipment is expensive. As part of its fundraising operation to enable more people to become homeowners, Habitat for Humanity operates ReStores in many locations throughout the United States and Canada. Builders and homeowners can salvage good quality building materials and household equipment from renovation projects (that would otherwise wind up in a dumpster and in a landfill), and donate them to ReStores, which will resell these at bargain prices.

My niece, who's just setting up her home, has shopped the ReStore in her area and found a number of bargains. You can too. Check out the website, which has links to a list of ReStore locations: www.habitat.org/env/restores.aspx.

Chapter 19: Preventing Repairs: Outside Maintenance

The American Society of Home Inspectors offers a virtual tour of what a professional covers in a home inspection, inside and out. You'll need a flash plug-in to play the video (it's free to download): www.ashi.org/customers/vhi_tour.asp.

Appendix C

Home Inspection Checklists

How to Use This Appendix

Use this appendix to inspect your home on a regular basis. Spring and fall are the best times to give your home a thorough going-over. These are usually the seasons when we tackle cleaning and maintenance in a big push.

For interiors, copy the checklists for all the rooms in your home. For example, if you have a basement, a kitchen, two bathrooms, two bedrooms, a living room, and dining room, you can make one copy of the basement list, one of the kitchen, two of the bathroom, and four copies of the general checklist, which covers any room without special fixtures or appliances. For exteriors, simply photocopy the exterior inspection list. Then do the following:

1. Date your lists.
2. When an element is in good condition, check it off.
3. If there's a problem and you can fix it yourself, write "DIY" next to the description of the problem.
4. If there's a problem and you need to call someone to fix it, write "Pro" next to that entry.

As you complete the maintenance and repairs on your inspection sheet, note the date completed, and the cost—either for materials if you did it yourself, or labor plus materials if you hired a pro.

Once you've completed your inspection, you'll have a complete to-do list for repairs and maintenance around your house. It's a convenient, simple way to keep your home in order, in timely fashion. These completed inspection sheets become excellent documentation of what you do, and how much you spend, in the years you own your home. Keep your inspection checklists in your home workbook (see Chapter 4).

Inspection Checklist: Interior Date: _____

Room: Basement/Utility/Laundry

(Make additional copies if these functions are in separate rooms/spaces.)

Note the condition of the following in the space provided:

Surfaces

❑ Floors _____

❑ Walls _____

❑ Ceilings _____

❑ Stairs _____

Openings

❑ Windows _____

❑ Doors _____

Electrical

❑ Service panel _____

❑ Circuit breakers (test) _____

❑ Light fixtures _____

❑ Receptacles _____

❑ Switches _____

❑ Visible wires _____

Plumbing

❑ Main shut-off _____

❑ Visible pipes _____

Gas Supply

❑ Inside shut-off _____

Heating

❑ Last pro service date _____

Hot Water (Check one:) Gas _____ Electric _____

❑ Drain check _____

❑ Pressure relief valve _____

Laundry Equipment

❑ Clothes washer _____

❑ Hoses _____

❑ Water inlets _____

❑ Dryer *(Check one:)* Gas _____ Electric _____

❑ Vent _____

Safety Equipment

❑ Smoke detector _____

❑ Fire extinguisher _____

❑ Other _____

Other/Notes

_____

_____

_____

_____

Inspection Checklist: Interior Date: _____

Room: Bathroom (Location: _____)

(Make one copy for each bathroom.)

Note the condition of the following in the space provided:

Surfaces

❑ Floors _____

❑ Walls _____

❑ Ceilings _____

❑ Tile/stone _____

❑ Grout _____

❑ Sealant _____

Openings

❑ Windows _____

❑ Doors _____

Electrical

❑ Light fixtures _____

❑ Switches _____

❑ Receptacles _____

❑ GFCI (test) _____

Heating/Cooling

❑ Vents _____

❑ Radiators/baseboard heaters _____

Plumbing

❑ Faucets (tub/sink/shower) _____

❑ Stoppers (tub/sink/shower) _____

- ❑ Drains (tub/sink/shower) _____
- ❑ Showerhead _____
- ❑ Toilet _____
- ❑ Fixture surfaces (tub/sink) _____
- ❑ Supply stops _____

Other/Notes

_____

_____

_____

_____

Inspection Checklist: Interior

Date: _____

Room: Kitchen

Note the condition of the following in the space provided:

Surfaces

- ❑ Floors _____
- ❑ Walls _____
- ❑ Ceilings _____
- ❑ Cabinets _____
- ❑ Countertops _____

Openings

- ❑ Windows _____
- ❑ Doors _____
- ❑ Cabinet doors _____
- ❑ Cabinet drawers _____

Appliances

- ❑ Range _____
- ❑ Cook top _____
- ❑ Wall oven _____
- ❑ Microwave oven _____
- ❑ Exhaust fan _____
- ❑ Refrigerator _____
- ❑ Dishwasher _____
- ❑ Garbage disposer _____
- ❑ Trash compactor _____

Heating/Cooling

❑ Vents _____

❑ Radiator/baseboard unit _____

❑ Room a/c _____

Plumbing

❑ Faucet _____

❑ Sink sprayer _____

❑ Under-sink pipes _____

❑ Supply stops _____

❑ Dishwasher connection _____

Electrical

❑ Light fixtures _____

❑ Switches _____

❑ Receptacles _____

❑ GFCI (test) _____

Safety

❑ Smoke detector _____

❑ Fire extinguisher _____

❑ Other _____

Other/Notes

_____

_____

_____

_____

Inspection Checklist: Interior Date: _____

Room: Attic (Under Roof Crawl Space)

(Make one copy for this space, if applicable.)

Note the condition of the following in the space provided:

Access

❑ Stair or hatchway _____

Surfaces

❑ Roof ridge _____

❑ Rafters _____

❑ Vents _____

❑ Insulation _____

❑ Flooring _____

Heating/Cooling

❑ Ducts _____

❑ Attic fan _____

Other/Notes

_____

_____

_____

_____

*

Inspection Checklist: Interior Date: _____

Room: General Interior Space: Living Room/Family Room/ Bedroom/Hallway

(Make one copy for each of these rooms.)

Note the condition of the following in the space provided:

Surfaces

❑ Walls _____

❑ Floors _____

❑ Ceilings _____

❑ Stairs _____

❑ Closets _____

Openings

❑ Windows _____

❑ Doors _____

❑ Fireplace (if applicable; have this cleaned and inspected by a professional every year) _____

Electrical

❑ Light fixtures _____

❑ Switches _____

❑ Receptacles _____

Heating/Cooling/Plumbing

❑ Vents _____

❑ Radiators/baseboard heating units _____

❑ Pipes (if any) _____

Other/Notes

_____

_____

Inspection Checklist: Exterior Date: _____

Note the condition of the following in the space provided:

Foundation

- ❑ Foundation at grade _____
- ❑ Crawl space _____
- ❑ Crawl space vents _____
- ❑ Foundation walls _____
- ❑ Basement windows _____
- ❑ Basement window wells _____
- ❑ Pest evidence (if any) _____

Surface and Openings

- ❑ Masonry or brick face _____
- ❑ Wood siding _____
- ❑ Stucco/plaster _____
- ❑ Paint _____
- ❑ Caulking _____
- ❑ Window/door trim _____
- ❑ Shutters _____
- ❑ Window hardware _____
- ❑ Window glass _____
- ❑ Window screens _____
- ❑ Door _____
- ❑ Door hardware _____
- ❑ Weather stripping _____

Roof

- ❑ Obstructions _____
- ❑ Shingles/tiles _____

- ❑ Chimney _____
- ❑ Chimney mortar _____
- ❑ Vents; other roof projections _____
- ❑ Flashing _____
- ❑ Gutters _____
- ❑ Downspouts/extenders _____

Landscape

- ❑ Driveways _____
- ❑ Walkways _____
- ❑ Exterior faucets _____
- ❑ Heating/cooling unit (should be serviced once a year) _____

_____

- ❑ Other: trees, plantings, etc. _____

_____

_____

_____

Other/Notes

_____

_____

_____

_____

Index

A

acrylic tubs, surface flaws, concealing, 185
adhesives, 33-34
adjustable wrenches, 12
aerators, faucets, cleaning, 177-178
air bubbles, wallpaper, repairing, 71
air conditioners, filters, cleaning, 219-220
Allen wrenches, 11
amperes, electricity, 200
annular ring nails, 36
appliances
  dishwashers, repairing, 230-231
  garbage disposals, repairing, 232-234
  manuals, importance of, 50
  models, determining, 224-225
  problems, troubleshooting, 224-226
  refrigerators, repairing, 226-230
  replacing, 234
  service calls, 234
  washing machines, repairing, 231-232
applicators, 17
attics
  inspecting, 268
  rafters, 268
  ridges, 268
  vents, screening, 269-270
awls, 6

B

ball-type faucets, 169
ballcock valve assembly, toilets, 191
ball valves, water control, 42-44
balusters, 104
  staircases, repairing, 109-110
baseboard heating systems, troubleshooting, 241
basements
  inspecting, 265-266
  windows, inspecting, 275
bathrooms, inspecting, 266-267
bathtubs, 184
  clogs, unclogging, 187-188
  surface flaws, concealing, 184-185
  waterproofing, 185-187
batteries, CO (carbon monoxide) detectors, replacing, 257
bent tracks, sliding doors, cleaning, 149
bleeding radiators, repairing, 243-244
blemishes, wood floors, preventing, 80
blue painters tape, 33
boilers, 238
  troubleshooting, 241-242
box cutters, 7
brads, 36
brick walls, inspecting, 275
broken bulbs, fixtures, replacing, 209-210
broken panes, repairing, 121-124
bubbles, wallpaper, repairing, 71
burn marks, wood floors, repairing, 79-80

C

C-clamps, 12
calculations, loads, electrical systems, 204-205
care manuals, importance of, 50
carpenters pencils, 6-7
carpets
  damaged sections, replacing, 97-99
  furring strips, 93
  pet urine, cleaning, 96
  spots, cleaning, 94-96
  wall-to-wall carpeting, taking up, 93-94
cartridge faucets, 169
  leaks, repairing, 174-175
casing nails, 36
cats paws, 13
caulk, 185
caulking
  bathtubs, 185-187
  inspecting, 275
ceilings
  joists, 89
  repairing, 100-101
central air conditioning, 248-249
ceramic disk faucets, 169
  leaks, repairing, 175-177

ceramic tile, replacing, 66-70
ceramic tile floors, repairing, 93
channels, windows, 114
checklists, home inspections, 265
cheesecloths, 79
chisels, cold chisels, 13
circuit breaker panels, 47, 201-202
circuit breakers, 47-49
circuit maps, creating, 51
circuits, electrical service panels, 201
clamps, 11
  C-clamps, 12
classes, fire extinguishers, 258
claw hammers, 10
clogs
  aerators, unclogging, 177-178
  bathtubs, unclogging, 187-188
  drains
    preventing clogs, 160
    unclogging, 161-165
  toilets, unclogging, 188-190
clothes dryers, de-linting, 214
clothes washers, 215
  metal mesh household hoses, replacing, 217
  supply hoses, replacing, 215-217
  water inlet filters, replacing, 218-219
CO (carbon monoxide) detectors, 256-257
cold chisels, 13
common nails, 36
compression faucets, 169
  leaks, repairing, 169-172
condenser coils, refrigerators, cleaning, 227-228
conductors, electricity, 200
contact cement, 33
containers, 37
cooling systems, 236
  central air conditioning, 248-249
  filters, cleaning, 219-220
cordless electric drills, 14-16
  keyless chucks, 16
  power, 15
  screwdriving, 16
  speeds, 15
cracked boards, wood floors, repairing, 81-83
cracks, foundations, inspecting, 275
crawl space vents, inspecting, 274
cutting tools, 7-9

D

damaged sections, carpeting, replacing, 97-99
dealers warranties, retaining, 51
de-linting clothes dryers, 214
demolition tools, 12-14
dents, walls, repairing, 56-58
dirty tracks, sliding doors, cleaning, 148
dishwashers, repairing, 230, 231
disposable fire extinguishers, 258
doorknobs
  dummy doorknobs, 140
  keyed entry doorknobs, 140
  loose doorknobs, tightening, 141-143
  modern doorknobs, 141
  old-style doorknobs, 142
  passage doorknobs, 140
  privacy doorknobs, 140
  replacing, 143
doors, 133-134
  headers, 134
  hinge stiles, 134
  inspecting, 276
  jambs, 134
  latch stiles, 134
  left-handed doors, 135
  locks, repairing, 145-146
  locksets, 135
  loose doors, repairing, 138-140
  loose hinges, tightening, 136-137
  peepholes, installing, 146-148
  rails, 134
  right-handed doors, 135
  screen doors, repairing, 143-145
  sidelights, 121
  sills, 134
  sliding doors, repairing, 148-149
  squeaks, stopping, 135-136
  sticking doors, repairing, 138
  storm doors, repairing, 143-145
  strike plates, 138
door seals, refrigerators, repairing, 226-227
double-hung windows, 114-115
  loose sashes, repairing, 119-121
  stuck sashes, repairing, 116-119
downspouts, cleaning, 278-279
draining water heaters, 248
drains
  bathtubs, unclogging, 187-188

clogs
preventing, 160
unclogging, 161-165
pop-up stoppers, repairing, 180-182
drain valves, water heaters, 246
drilling
below floors, 86
pilot holes, wood floors, 81-84
drills
cordless electric drills, 14-16
keyless chucks, 16
power, 15
screwdriving, 16
speeds, 15
fractional drill gauges, 84
drip pans, refrigerators, cleaning, 230
driveways, repairing, 280-281
drop cloths, 34
dryers, de-linting, 214
drywall
loose drywall tape, repairing, 62
minor drywall repairs, performing, 56-62
plaster cracks, repairing, 62-64
duct tape, 34
dummy doorknobs, 140

E

earplugs, 24
electrical service panels, 201
electrical systems
broken bulbs, replacing, 209-210
grounding, 205
loads, calculating, 204-205
mapping, 201-204
receptacles
GFCI receptacles, 208-209
grounding, 207
identifying, 205-206
electric drills, 14-16
keyless chucks, 16
power, 15
screwdriving, 16
speeds, 15
electric heating systems, 239
troubleshooting, 241
electric service, 47
circuit breaker panels, 47
circuit breakers, 47-49
main shutoffs, 48
electric service panels, 202
electric water heaters, 245
electricians, hiring, 200
electricity, 200
emergency exits, designating, 260-261
energy, kilowatt hours (kWh), 239
equipment manuals, importance of, 51-52

F

fasteners, 35
fastening tools, 9-10
faucets, 168
cartridge faucets, repairing, 174-175
ceramic disk faucets, repairing, 175-177
clogged aerators, cleaning, 177-178
compression faucets, 169
repairing, 169-172
repair preparation list, 168-169
rotary ball faucets, repairing, 172, 173
washerless faucets, 169
fenestration, windows, 114
fiberglass filaments, 125
filtering, forced air heating systems, 242-245
filters
air conditioners, cleaning, 219-220
clothes washers, replacing, 215-219
forced-air furnaces, cleaning and replacing, 220
ionizing filters, 242
range hoods, cleaning, 220
finishing nails, 36
fire extinguishers, 258-260
fixtures
broken bulbs, replacing, 209-210
manuals, importance of, 50
flappers, toilets, 191
flappy seams, wallpaper, repairing, 72-73
flashing, inspecting, 276
flashlights, 19
flathead screws, 36
float arms, toilets, 191
float cup fill valve assembly, toilets, 192
floats, toilets, 191
flooring
carpet, repairing, 93-99
ceramic tile floors, repairing, 93
laminate flooring, repairing, 99-100
vinyl floors, repairing, 89-93
wall-to-wall carpeting, taking up, 93-94
wood floors, repairing, 78-89

floors
drilling below, 86
joists, 89
flushes, toilets, improving, 194
flush handles, toilets, 191
forced-air furnaces, filters, cleaning and replacing, 220
forced air heating systems, filtering, 242-245
foundations, inspecting, 274-275
fractional drill gauges, 84
frozen locks, thawing, 146
furnaces, 238
filters, cleaning and replacing, 220
troubleshooting, 240-241
furring strips, 93
fuses, electric service panels, 202

G

garbage disposals, repairing, 232-234
gas furnaces, troubleshooting, 240-241
gas heating systems, 236-237
gas systems
propane, 46
shutoffs, locating, 45-47
supply stops, 46
gasket material, 38
gate valves, water control, 42-43
GFCI (ground fault circuit interrupter) receptacles, 157, 208-209
glass-cutting tools, 68
glaziers points, 124
gloves, work gloves, 25
glue, 33
gouges, wood floors, repairing, 80
Graduate, The, 19
grounding electrical systems, 205-207
grout
cracks, repairing, 64-65
replacing, 65-67
gutters
cleaning, 278-279
inspecting, 276
maintaining, 277-280

H

hammers, sixteen-ounce claw hammers, 10
handrails, staircases, 104, 108-109
headers
doors, 134
windows, 114
heating systems, 236, 239
electric heating systems, 239
troubleshooting, 241
forced air systems, filtering, 242-245
gas furnaces, troubleshooting, 240-241
gas heating systems, 236-237
oil heating systems, 237-238
troubleshooting, 241-242
height, ladders, 26
hex wrenches, 11
hinges
loose hinges, stopping, 136-137
squeaks, stopping, 135-136
hinge stiles, doors, 134
hiring professionals, 29, 281-282
holes, walls, repairing, 60-62
home information, notebooks, keeping in, 50
homes, inspecting, 264
attics, 268
basements, 265-266
bathrooms, 266-267
checklists, 265
general inspections, 268-270
kitchens, 267-268
laundry rooms, 265-266
outside inspections, 274-277
tools, 264
utility rooms, 265-266
hose clamps, 38
hoses, clothes washers, replacing, 215-217
hot water heaters, 245-246
draining, 248
drain valves, 246
pressure relief valves, 246
replacing, 247-248
testing, 246-247

I

inside stops, windows, 114
inspections
attics, 268
basement windows, 275
basements, 265-266
bathrooms, 266-267
brick walls, 275
checklists, 265
caulking, 275
crawl space vents, 274
doors, 276
foundations, 274-275
general inspections, 268-270
kitchens, 267-268
landscapes, 276
laundry rooms, 265-266
masonry walls, 275

outside inspections, 274-277
painted surfaces, 275
roofs, 276
siding, 275
tools, 264
utility rooms, 265-266
windows, 275
instant glue, 33
ionizing filters, 242

J

jambs
doors, 134
windows, 114
Japanese pull saws, 8-9
job sites, safety, 25-26
joining tools, 9-10
joints, wood, 105
joists, 89

K

keyed entry doorknobs, 140
replacing, 143
keyless chucks, cordless electric drills, 16
kilowatt hours (kWh), 239
kitchens, inspecting, 267-268
knobs (door), 140
dummy doorknobs, 140
keyed entry doorknobs, 140
loose doorknobs, tightening, 141-143
modern doorknobs, 141
old-style doorknobs, 142
passage doorknobs, 140
privacy doorknobs, 140
replacing, 143
kWh (kilowatt hours), 239

L

labeling main shutoffs, 42
ladders
choosing, 26
proper use, 27-28
safety, 26-28
stepladders, 26
laminate flooring, repairing, 99-100
landscapes, inspecting, 276
latch stiles, doors, 134
latches, windows, 114
laths, 63
laundry rooms, inspecting, 265-266
leaf guards, 278
leaks
cartridge faucets, repairing, 174-175
ceramic disk faucets, repairing, 175-177
compression faucets, repairing, 169-172
pipes, repairing, 154-155
refrigerators, cleaning, 230
rotary ball faucets, repairing, 172-173
toilets, repairing, 194-195
left-handed doors, 135
leftover materials, storing, 39-40
levels, torpedo levels, 5-6
lift arms, toilets, 191
lift wires, toilets, 191
lighting pilot lights, gas furnaces, 240
loads, electrical systems, calculating, 204-205
locking pliers, 12
locks, doors, repairing, 145-146
locksets
doors, 135
replacing, 143
loose
boards, wood floors, repairing, 85-87
doorknobs, tightening, 141-143
doors, repairing, 138-140
drywall tape, repairing, 62
hinges, tightening, 136-137
sashes, repairing, 119-121
lower sashes, windows, 114
lubricants, 32

M

main electric service panels, labeling, 42
main shutoffs, labeling, 42
maintenance
gutters, 277-280
homes, inspecting, 264-270
outside inspections, 274-277
planning for, 271
mallets, rubber mallets, 10
manufacturers warranties, retaining, 51
mapping electrical systems, 201-204
marking tools, 4-7
masks (respirators), 24-25
masonry walls, inspecting, 275
materials
ladders, 26
leftover materials, storing, 39-40
storing, 32
measurements, V-mark measurements, 6-7
measuring, three-time rule, 6
measuring tape, 4
measuring tools, 4-5
mechanical door closers, repairing, 144

metal mesh household hoses, clothes washers, replacing, 217
metal rulers, 5
minor drywall repairs, performing, 56-62
models, appliances, determining, 224-225
modern doorknobs, 141
mortises, handrails, 108
muntins, windows, 114

N-O

nail sets, 10
nails, 36
NEC (National Electrical Code) Handbook, 199
needlenose pliers, 12
newel posts, staircases, 104
NIOSH (National Institute for Occupational Safety and Health), 25
noisy pipes, repairing, 159
nonpolarized, two-pole receptacles, identifying, 205-206
notebooks, home information, keeping in, 50

oil heating system, 237-238
  troubleshooting, 241-242
old-style doorknobs, 142
outlet holes, showerheads, cleaning, 179
outside faucets, winterizing, 158
oval head screws, 36

P-Q

paintbrushes, 17
painted surfaces, inspecting, 275
painters tape, 33
panes, windows, 114
  broken panes, repairing, 121-124
passage doorknobs, 140
  replacing, 143
patching, sheet flooring, 92-93
peepholes, doors, installing, 146-148
pennies, nails, 36
pet urine, carpeting, cleaning, 96
Phillips screwdrivers, 10
pilot holes, wood floors, drilling, 81-84
pilot lights, gas furnaces, lighting, 240
pipe leak repair supplies, 38
pipes, 153
  clogs
    preventing, 160
    unclogging, 161-165
  frozen pipes
    preventing, 157
    thawing, 156-157
  leaks, repairing, 154-155
  noisy pipes, repairing, 159
  outside faucets, winterizing, 158
plaster cracks, repairing, 62-64
pliers, 11-12
plumbing, 153
  bathtubs, unclogging, 187-188
  cartridge faucets, repairing, 174-175
  ceramic disk faucets, repairing, 175-177
  clogged aerators, cleaning, 177-178
  compression faucets, repairing, 169-172
  drain clogs, preventing, 160
  drains, unclogging, 161-165
  faucets, 168
    repairing, 168-169
  frozen pipes
    preventing, 157
    thawing, 156-157
  leaks, repairing, 154-155
  noisy pipes, repairing, 159
  outside faucets, winterizing, 158
  pop-up stoppers, repairing, 180-182
  rotary ball faucets, repairing, 172-173
  showerheads, 178
    repairing, 179
    replacing, 179-180
  toilets, 190
    ballcock valve assembly, 191
    float arms, 191
    float cup fill valve assembly, 192
    floats, 191
    flush handles, 191
    lift arms, 191
    lift wires, 191
    refill tubes, 191
    repairing, 192-195
    tank stoppers, 191
    unclogging, 188-190
plumbing tools, 37-38
plungers, 37-38
pneumatic door closers, repairing, 144
polarized, two-pole receptacles, identifying, 205-206
popped nails, repairing, 58-59
pop-up stoppers, repairing, 180-182
porcelain-enameled cast iron tubs, surface flaws, concealing, 184-185
power, cordless electric drills, 15

power centers, labeling, 42
pressure relief valves, water heaters, 246
  replacing, 247-248
  testing, 246-247
preventing frozen pipes, 157
primary water valves, labeling, 42
primary gas valves, labeling, 42
privacy doorknobs, 140
  replacing, 143
professionals, hiring, 29, 281-282
propane gas systems, 46
pry bars, 13
putty knives, 17
putty sticks, 80

R

radiators
  bleeding radiators, repairing, 243-244
  cleaning, 243
rafters, attics, 268
rails, doors, 134
range hoods, filters, cleaning, 220
receipts, retaining, 51
receptacles
  electrical systems
    grounding, 207
    identifying, 205-206
  GFCI receptacles, 208-209
rechargeable fire extinguishers, 258
refill tubes, toilets, 191
refrigerators, repairing, 226-230
respirators, 24-25
retractable measuring tape, 4
ridges, attics, 268
right-handed doors, 135
risers, staircases, 104
rocking toilets, repairing, 195
rodent-proofing homes, 270
roofs, inspecting, 276
rotary ball faucets, leaks, repairing, 172-173
round head screws, 36
round-handle gate valves, water control, 42-43
rubber gloves, 25
rubber mallets, 10
running toilets, stopping, 192-193

S

safety
  emergency exits, designating, 260-261
  gear, 23
    earplugs, 24
    respirators, 24-25
    rubber gloves, 25
    safety goggles, 24
    work gloves, 25
  good habits, 22-23
  importance of, 21-22
  information, listing, 261-262
  job sites, 25-26
  ladders, 26-28
  staircases, 110-111
safety devices
  CO (carbon monoxide) detectors, 256-257
    battery replacement, 257
    installing, 257
  fire extinguishers, 258-260
    training, 259
  smoke detectors, repairing, 254-256
safety goggles, 24
sanding blocks, 34-35
sashes, windows, 114
  loose sashes, repairing, 119-121
  stuck sashes, repairing, 116-119
schematics, importance of, 51-52
scissors, 7
scratches, wood floors, repairing, 80
screen doors, repairing, 143-145
screening attic vents, 269-270
screens, windows
  repairing, 124-126
  replacing, 126-129
screwdrivers, 10
  cordless electric drills, 16
screws, 36
seams, wallpaper, repairing, 72-73
security pins, windows, installing, 129-130
service calls, appliances, 234
service records, keeping, 52
sheet flooring, patching, 92-93
shims, 34
shingles, inspecting, 276
showerheads, 178
  outlet holes, cleaning, 179
  replacing, 179-180
shutoffs
  electric service, 48
  gas systems, locating, 45-47
  wells, locating, 44-45
sidelights, 121
siding, inspecting, 275
sills, doors, 134
sills, windows, 114
sinks
  drains, unclogging, 161-165
  garbage disposals, repairing, 232-234
  traps, 162-164

sixteen-ounce claw hammers, 10
skins, wood floors, repairing, 78
sliding doors, repairing, 148-149
small-head nails, 36
smoke detectors, repairing, 254-256
speed squares, 5
speeds, cordless electric drills, 15
spline tools, 127
splines, 126-127
split boards, wood floors, repairing, 81-83
sponges, 17
spots, carpeting, cleaning, 94-96
squeaks
  doors, stopping, 135-136
  stairs, stopping, 104-107
  wood floors, stopping, 87-89
staircases
  balusters, repairing, 109-110
  handrails, repairing, 108-109
  parts, 104
  safety, 110-111
stairs, 103
  squeaks, stopping, 104-107
standard screwdrivers, 10
steam heating systems, repairing, 244
stepladders, 26
stick shellac, 80
sticking doors, repairing, 138
stops, windows, 114
storing
  fire extinguishers, 259
  leftover materials, 39-40
  tools and materials, 32
storm doors, repairing, 143-145
straightedges (metal rulers), 5
straight-handle ball valves, water control, 42-44
strength, ladders, 26
strike plates, doors, 138
stuck sashes, repairing, 116-119
supplies, 33
  adhesives, 33-34
  cheesecloths, 79
  containers, 37
  drop cloths, 34
  fasteners, 35-36
  lubricants, 32
  pipe leak repair supplies, 38
  sanding blocks, 34-35
  shims, 34
supply hoses, clothes washers, replacing, 215-217
supply lines, refrigerators, cleaning, 230
supply stops, gas systems, 46
surface flaws, bathtubs, concealing, 184-185

T

tank stoppers, toilets, 191
tape
  blue painters tape, 33
  duct tape, 34
testing
  smoke detectors, 255-256
  water heater pressure relief valves, 246-247
thawing frozen pipes, 156-157
three-time rule (measuring), 6
three-wire grounding, two-pole receptacles, indentifying, 205-206
tile
  ceramic tile floors, repairing, 93
  cracks, repairing, 64-65
  replacing, 66-70
  vinyl tiles, replacing, 90-92
toggle-type circuit breakers, 48
toilets, 190
  ballcock valve assembly, 191
  clogs, unclogging, 188-190
  continuously running toilets, stopping, 192-193
  float arms, 191
  float cup fill valve assembly, 192
  floats, 191
  flush handles, 191
  leaks, repairing, 194-195
  lift arms, 191
  lift wires, 191
  refill tubes, 191
  rocking toilets, repairing, 195
  tank stoppers, 191
  weak flush, improving, 194
tool bags, 17-18
tool belts, 17-18
tool boxes, 17-18
tools, 19-20
  adjustable wrenches, 12
  Allen wrenches, 11
  awls, 6
  C-clamps, 12
  carpenters pencils, 6-7
  cats paws, 13
  cold chisels, 13
  cordless electric drills, 14-16
    keyless chucks, 16
    power, 15
    screwdriving, 16
    speeds, 15
  flashlights, 19
  glass-cutting tools, 68
  homes, inspections, 264
  importance of, 3

Japanese pull saws, 8-9
locking pliers, 12
nail sets, 10
needlenose pliers, 12
paintbrushes, 17
Phillips screwdrivers, 10
plungers, 37-38
pry bars, 13
putty knives, 17
quality, 4
retractiable measuring tape, 4
rubber mallets, 10
scissors, 7
sixteen-ounce claw hammers, 10
speed squares, 5
spline tools, 127
sponges, 17
standard screwdrivers, 10
storing, 32
straightedges, 5
toothbrushes, 17
torpedo levels, 5-6
transporting, 17-18
utility knives, 7
vises, 19
voltage testers, 203
wire cutters, 7
toothbrushes, 17
torn sections, wallpaper, repairing, 73-76
torpedo levels, 5-6
tracks, sliding doors, repairing, 148-149
training fire extinguishers, 259
transporting tools, 17-18
traps (sinks), 162-164
treads, staircases, 104
troubleshooting
appliances, 224-226
gas furnaces, 240-241
tubs, 184
clogs, unclogging, 187-188
pop-up stoppers, repairing, 180-182
surface flaws, concealing, 184-185
waterproofing, 185-187
Type S fuses, 202
Type T fuses, 202

U-V

under roof crawl spaces, inspecting, 268
upper sashes, windows, 114
user manuals, importance of, 50
utility knives, 7
utility rooms, inspecting, 265-266

vents, attics, screening, 269-270
vinyl floors, 89
sheet flooring, patching, 92-93
vinyl tiles, replacing, 90-92
vises, 19
V-mark measurements, 6-7
voltage testers, 203

W-X-Y-Z

wallpaper
bubbles, repairing, 71
repairing, 70-76
seams, repairing, 72-73
torn sections, repairing, 73-76
walls
minor drywall repairs, performing, 56-62
plaster cracks, repairing, 62-64
wallpaper, repairing, 70-76
warped boards, wood floors, repairing, 84-85
warranties, retaining, 51
washerless faucets, 169
washers
metal mesh household hoses, replacing, 217
repairing, 215
supply hoses, replacing, 215-217
water inlet filters, replacing, 218-219
washing machines, repairing, 231-232
water controls, locating, 42-45
water heaters, 245-246
draining, 248
drain valves, 246
electric water heaters, 245
pressure relief valves, 246
replacing, 247-248
testing, 246-247
water inlet filters, clothes washers, replacing, 218-219
water marks, wood floors, repairing, 78-79
waterproofing bathtubs, 185-187
watts, electricity, 200
WD-40 lubricant, 32
wells, shutoffs, locating, 44-45
white glue, 33
windows, 113
broken panes, repairing, 121-124
channels, 114
double-hung windows, 114-115
fenestration, 114
headers, 114
inspecting, 275
jambs, 114
latches, 114
loose sashes, repairing, 119-121

muntins, 114
panes, 114
sashes, 114
screens
repairing, 124-126
replacing, 126-129
security pins, installing, 129-130
sidelights, 121
sills, 114
stops, 114
stuck sashes, repairing, 116-119
winterizing, outside faucets, 158
wire cutters, 7
wobbly tracks, sliding doors, repairing, 148
wood, joints, 105
wood floors
blemishes, preventing, 80
burn marks, repairing, 79-80
cracked boards, repairing, 81-83
gouges, repairing, 80
loose boards, repairing, 85-87
pilot holes, drilling, 81-84
scratches, repairing, 80
skins, repairing, 78
split boards, repairing, 81-83
squeaks, stopping, 87-89
warped boards, repairing, 84-85
water marks, repairing, 78-79
wood putty, 80
wood screws, 36
work gloves, 25
work sites, safety, 25-26
workbenches, 19-20
workbooks, creating, 49-52
workspaces, 19-20
wrenches, 11
adjustable wrenches, 12
Allen wrenches, 11

WELDING COMPLETE

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CONTENTS

INTRODUCTION

Basics

Safety
Setting Up Shop
Shop Tools
Metal Basics
Metal Shapes & Sizes
Purchasing Metal
Repairing Metal
Cleaning Metal

Techniques

Mechanical Cutting
Plasma Cutting
Oxyacetelen Cutting
Shaping
Finishing
Jointing
Oxyacetylene Welding
Shielded Metal Arc Welding (SMAW)
Metal Arc Welding (GMAW/MIG)
Gas Tungsten Arc Welding (GTAW/TIG)

WELDING PROJECTS

Shop

Rolling Welding Curtain
Welding Table
Welding Machine Cart
Cylinder Cart
Grinder Stand
Portable Welding Table
Saw Stand

Home Décor

Coffee Table
Wine Rack
Swivel Mirror
Coat Hanger
Room Divider
Iron Cross
Nesting Tables
Swing-away Coat Hooks
Nightstand
Fireplace Candelabrum
Magazine Rack
Angled Metal Shelves
Wall-mounted Shelf
Étagère
Corner Étagère

Outdoor

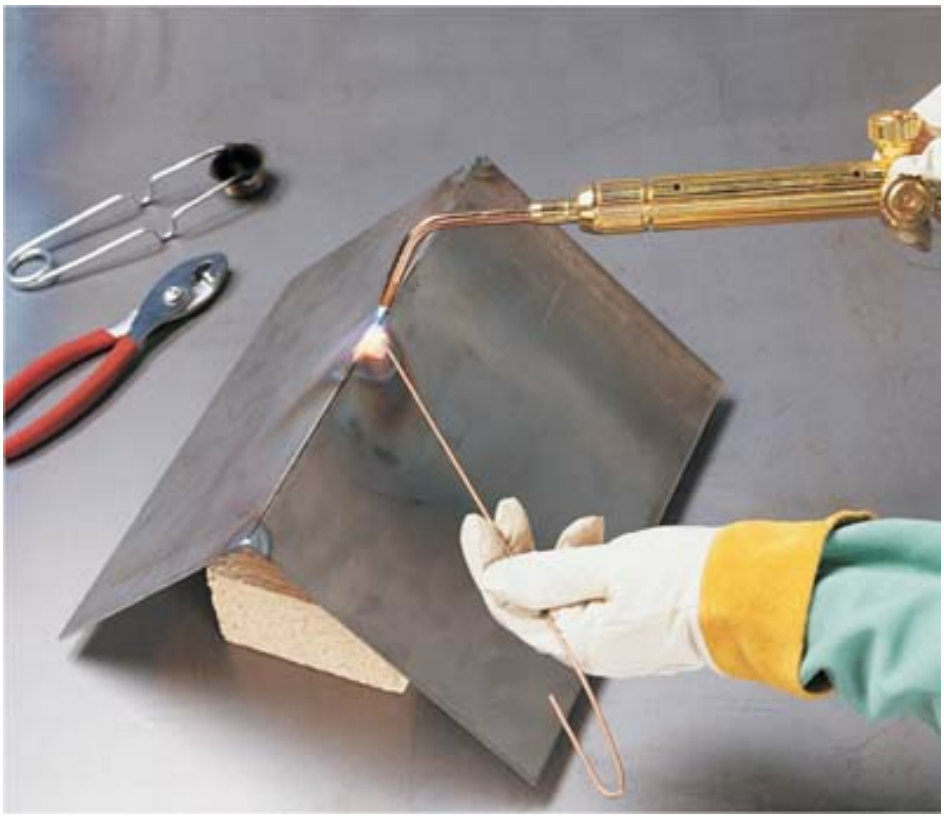
Truck Rack
Trailer Frame
Stair Railing
Gate
Firepit
Vineyard Trellis
Arch & Gate
Gazebo
Arbor

APPENDIX: ADDITIONAL PLANS

GLOSSARY

RESOURCES & PHOTO CREDITS

INDEX



TILLMAN

Introduction

Welding is a practical skill that is also great fun. The number of welded items in our everyday lives is practically uncountable—the spot welds on our cars and tractors, the welded railing on our front steps, the superstructure of the buildings in which we work, and the bridges over which we drive. Welding also makes everyday yard and interior items possible, like patio trellises, wine racks, tables, and shelves.

This book thoroughly discusses welding basics and techniques such as safety, setting up shop, tools, metals, and welding types. Once you have covered the basics, you can move on to the specific projects in this book—complete with how-to instructions, tools and materials lists, and illustrated plans—to develop your welding skills. At the same time, you'll benefit from a wide range of new furnishings in and around your home.

The home décor section includes instructions for practical and useful items commonly used in homes, such as mirrors, coat hooks, tables, and shelves, as well as decorative items like the iron cross and fireplace candelabrum.

The outdoor chapter includes heavy-duty projects suitable for hardworking DIYers, including a yard trailer and truck rack. There are also common exterior home improvement projects such as the stair railing, arbor, gate, and firepit.

Notice To Readers

Welding is a dangerous activity. Failure to follow safety procedures may result in serious injury or death. This book provides useful instruction, but we cannot anticipate all of your working conditions or the characteristics of your materials and tools. For safety, you should use caution, care, and good judgment when following the procedures described in this book. Consider your own skill level and the instructions and safety precautions associated with the various tools and materials shown. The publisher cannot assume responsibility for any damage to property or injury to persons as a result of misuse of the information provided.

Welding is all about heat, about using heat to melt separate pieces of metal so they will flow together and fuse to form a single seamless piece. Regardless of the welding or cutting process, your ability to control the heat generated by the flame or arc determines the quality of your welds and cuts.

Certain terms are used to describe the heat and action of all the welding processes. The parts being welded together are referred to as the base metal. Additional metal, called filler, is often added to the weld. The molten puddle is the area of melted base metal and filler metal that you maintain as you create your weld. To have fusion of metals, the base metal and filler metals must have the same composition. Methods for joining metal without fusion are called soldering, brazing, and braze welding. These methods can be used to join similar or dissimilar metals.

Oxyacetylene welding and cutting use flames to generate the heat to melt the metal. Shielded metal arc, gas metal arc, gas tungsten arc welding, and plasma cutting use an electric arc for heat generation. With oxyacetylene welding, you have time to watch the puddle develop as the metal turns red, then glossy and wet looking, then finally melts. With the arc processes, the puddle forms quickly and may be difficult to see because of the intensity of the arc. It is important to have ample lighting and clear vision so you can watch the puddle and move it steadily.

Penetration of the weld is also a critical heat-dependent factor. A strong weld penetrates all the way through the base metal. Matching filler material size and heat input to the thickness of the base metal is important. It is easy to get a good-looking weld that has not penetrated the base metal at all and merely sits on the surface. At the opposite end of the spectrum from a “cold,” nonpenetrating weld is burn through—where the base metal has gotten too hot and is entirely burned away, leaving a hole in the base metal and the weld.

Heat distortion is a byproduct of all welding and cutting processes. It is obvious that applying a flame to metal in the oxyacetylene process makes the metal hot—and the electrical arcs are actually four to five thousand degrees hotter than the oxyacetylene flame. When metal is heated, it expands; when it cools, it contracts. If not taken into consideration, this expansion and contraction may cause parts to move out of alignment. This is why tack welding and clamping project pieces is critical to successful welding. It is also important to match the welding process to the base metal thickness. For example, shielded metal arc welding is generally not used on materials less than 1/8″ thick. The process is too hot and too difficult to control on thin material. On the other hand, gas metal arc welding works well on very thin sheet metal, if you are able to adjust the machine to a low enough voltage.

Oxyacetylene welding

Shielded metal arc welding

Gas metal arc welding

Gas tungsten arc welding

Plasma cutting

Oxyacetylene cutting

Protecting the molten puddle from oxygen is also an important part of welding. Oxygen makes steel rust and causes corrosion in other metals. The exclusion of oxygen from the weld when it is in the molten state makes a stronger weld. This is accomplished in a variety of ways. A properly adjusted oxyacetylene flame burns off the ambient oxygen in a small zone around the weld puddle. Gas metal arc and gas tungsten arc welding bathe the weld in an inert gas from a pressurized cylinder. Inert gas keeps oxygen away from the molten puddle. Flux cored arc welding and shielded metal arc welding use fluxes in or on the welding filler metal. When these fluxes burn, they produce shielding gases and slag, both of which protect the weld area until it has cooled.

Welding well is difficult and takes years to master, but it is possible to make many useful and decorative items with basic knowledge and a little practice. If you wish to move beyond the projects outlined in this book, it is a good idea to talk with a welder and have him or her evaluate some of your welds. Remember the safety of others is involved when you choose to make a utility trailer or spiral staircase. Take the time and make the effort to ensure that any project you make is safe.

This book is intended as a reference for people who have had some exposure to welding and need reminders about what steps to follow and precautions to take. It is not intended to teach welding to someone who has never handled welding equipment. If you wish to further your welding skills, many community colleges, technical schools, and art centers offer welding classes. Such classes are an ideal way to learn the basics of welding, proper techniques for each process, and welding safety.

Basics

The costs involved in setting up a well-equipped home welding shop are comparable to setting up a well-equipped woodworking shop. A great advantage of welding is that the materials are generally inexpensive, yet you can create items that sell in shops for hundreds of dollars and make repairs that would carry a considerable cost. Because fewer people are knowledgeable about welding, there is always a rewarding “awe” factor to showing off what you have created.

IN THIS CHAPTER:

Safety
Setting Up Shop
Shop Tools
Metal Basics
Metal Shapes & Sizes
Purchasing Metal
Repairing Metal
Cleaning Metal

Safety

When safety measures are overlooked or ignored welders can encounter such dangers as electric shock, overexposure to fumes and gases, arc radiation, and fire and explosion; which may result in serious or even fatal injuries. Preparations for welding—grinding, burnishing, and sawing—are also potentially dangerous. Familiarize yourself with the American National Standard Safety in Welding and Cutting practices (see Resources, page 220).

Always read, understand, and follow manufacturers' material safety data sheets (MSDS), which include specific instructions and recommendations for equipment and product use. Also follow general welding safety rules.

Fumes. Welding produces potentially hazardous fumes and gases. Always keep your face out of the weld plume and avoid breathing concentrations of those fumes. Welding indoors requires special precautions when considering ventilation and may require a ventilation fan, exhaust hood, or fume extractor. If you cannot provide adequate ventilation, an OSHA-approved respirator or particle mask may be needed. If you may be pregnant or plan to become pregnant, consult your physician.

Burns. Hot sparks and flying slag can cause burns. Protect your hands, head, and body with natural fibers—leather, wool, or cotton. Synthetic fibers such as nylon and polyester melt when ignited, which causes serious burns. Wear leather slip-on boots and pants that fall over the top of the boots. Cuffed pants, frayed edges, and pants with holes are fire hazards. Wear a welding cap and keep hair tucked away.

Arc burn. Welding arcs produce ultraviolet and infrared light. Both of these can damage your eyes permanently, burn your skin, and potentially lead to skin cancer. A welding helmet with a filter lens protects your eyes and face, while long-sleeve shirts and long pants protect your skin. Remember to use welding screens and have an extra helmet on hand for observers.

Fire. Remove flammable items such as lumber, rags, dropcloths, cigarette lighters, and matches from the work area. Do not grind or weld in a sawdust-filled shop—the sparks can ignite airborne dust and fumes or ignite flammable materials. Mount an ABC-rated fire extinguisher and first aid kit in the work area. Periodically check your welding area up to one half hour after welding to make sure no sparks have found a place to smolder.

Explosion. Non-flammable gases such as carbon dioxide are stored in high-pressure cylinders that can be dangerous. If regulators are not installed, keep the cylinder's protective cap on and keep cylinders chained or strapped. Never use cylinders as rollers or supports, and never weld protective caps to anything. Shut acetylene and oxygen

cylinder valves if you’re away for more than 10 minutes. Cylinders must be transported right side up and chained, even if empty. Similarly, never weld or cut on any closed container, tank, or cylinder. Bring tanks to a welding specialist for evaluation and repair. Another explosion hazard is concrete. Tack welding is acceptable, but using a concrete surface for welds is dangerous due to the amount of water contained in concrete. Use fire bricks instead.

Welding safety includes protecting yourself with protective gear, following manufacturer's instructions, and being aware of the surroundings in which you are welding.

Electric Shock. Be sure to insulate yourself from the work piece and ground using dry insulation. Always wear dry, hole-free gloves. Do not touch electrically “hot” parts or electrode with bare skin or wet clothing. Only use electrode holders and cable insulation in good condition.

Other hazards include noise from grinding, sawing, sanding, and plasma cutting; laceration from sharp metal edges; electrocution during arc welding; and asphyxiation from inert shielding gases. Carefully read all manufacturers’ instructions before starting any welding process.

Minimum Lens Shade Numbers for Welding

APPLICATION	SUGGESTED SHADE
Shielded Metal Arc Welding (SMAW)	
1/16 to 5/32" electrodes	10
3/16 to 1/4" electrodes	12
5/16 to 3/8" electrodes	14
Gas Metal Arc Welding (GMAW)	
1/16 to 5/32" non-ferrous	11
1/16 to 5/32" ferrous	12
Gas Tungsten Arc Welding (GTAW)	10 to 14
Plasma Cutting	8
Oxyacetylene Welding	5
Oxyacetylene Cutting	5
Brazing	3 to 5

Welding helmets are typically available with filter lenses in either 2" × 4¼" or 4½" × 5¼" sizes. Helmets with auto-darkening lenses are also available. Clear, full-face protective shields are available for grinding or chipping, and with a #5 filter for oxyacetylene operations.

Welding safety equipment includes: (A) safety glasses, (B) particle mask, (C) low-profile respirator, (D) leather slip-on boots,(E) fire-retardant jacket, (F) fire-retardant jacket with leather sleeves, (G) welding cap, (H) leather cape with apron, (I) leather gloves with gauntlets, (J) heavy-duty welding gloves, (K) welding helmet with auto-darkening lens, (L) welding helmet with flip-up lens, (M) full-face #5 filter, (N) full-face clear protective shield.

Setting Up Shop

Shop space with a concrete floor and cement block walls is ideal for welding. Good ventilation is also important.

If you plan to weld on a regular basis, it makes sense to set up a welding shop. The primary concern with welding is containing the hot sparks or slag and the flammable elements while exhausting dangerous fumes. It is possible to weld outside, but not all processes allow that. Gas metal and gas tungsten arc welding require that the surrounding air be still so the shielding gas is not disturbed. All the arc processes must be done in dry conditions to prevent electrical shock. Cold metals do not respond as well as metals at 70°F and may not be weldable using certain processes. A heated garage or outbuilding is best suited for a welding shop. A basement is not suitable due to the dangers of fire and compressed gases next to living spaces. Additionally, your homeowner's insurance may not cover a welding shop if it is inside your living area instead of in a detached garage or shop building.

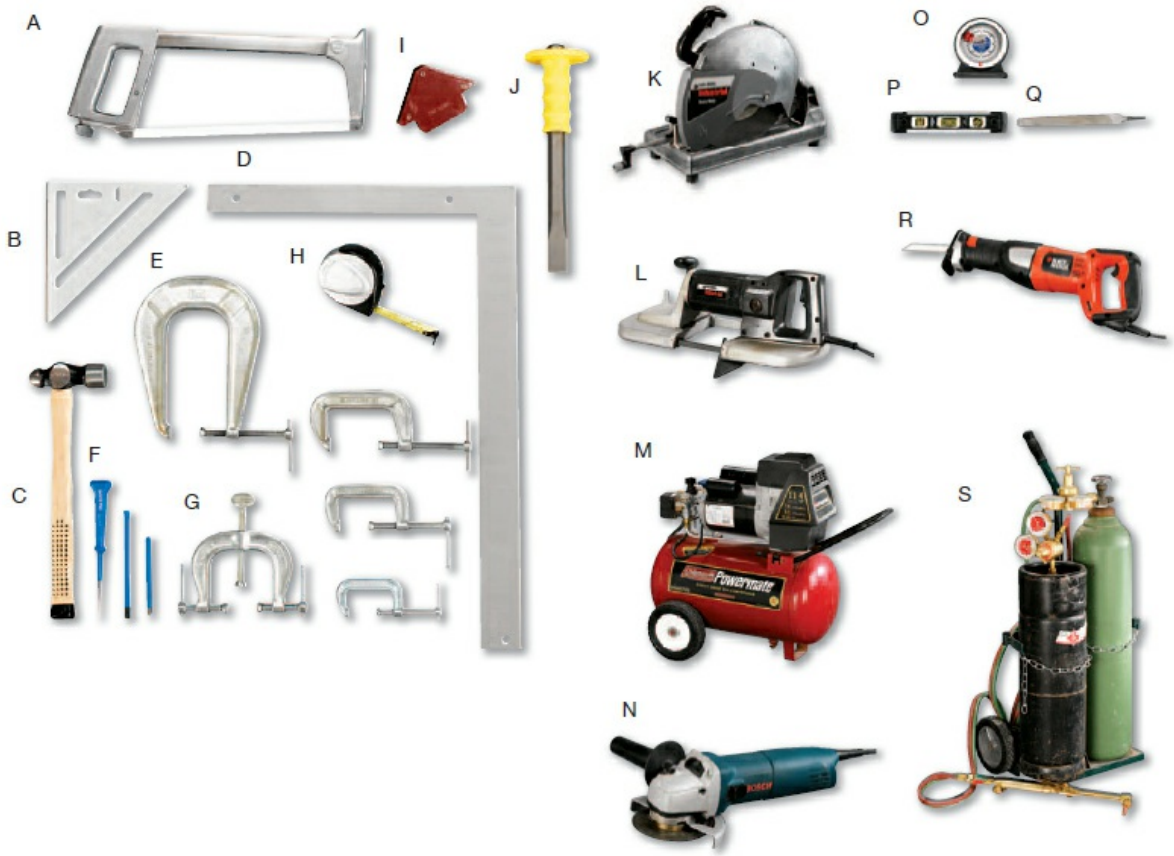
It is important to remember that tiny sparks and pieces of hot slag may scatter up to 30 or 40 feet from the source. If they come to rest on flammable materials, they may smolder, and given the right conditions they can ignite the material. Always check your welding area one half hour after you have completed welding to make certain no sparks are smoldering. A wooden table covered with metal is not a good work surface, as the

transferred heat may cause the wood to smolder. Any wooden jigs or clamping devices should be doused with water to extinguish smoldering embers or stored outside after use.

Shop Tools

Power tools such as the reciprocating saw, angle grinder, portable band saw, and chop saw are useful when cutting and fitting metal parts to be welded. A drill press and metal cutting band saw are also useful tools for welding.

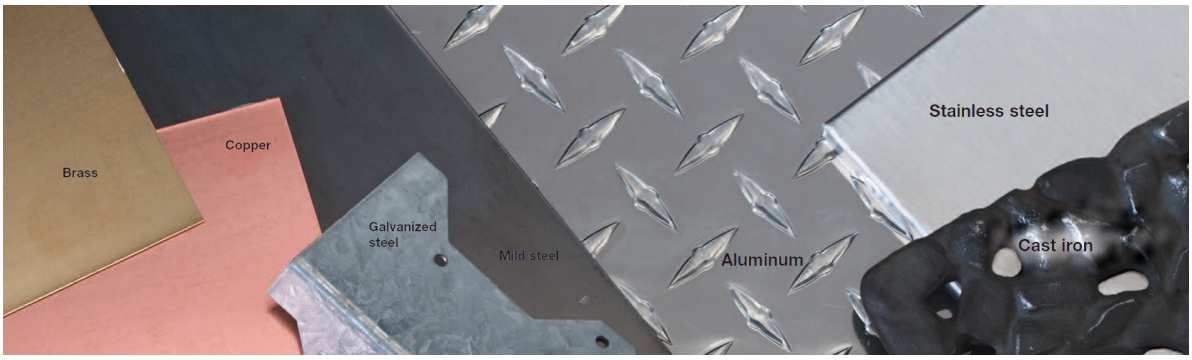
Specific metal-working tools, including metal brakes and metal benders, are available for all sizes of metal. These can range from inexpensive sheet metal tools, such as the scroll bender shown on page 37, to expensive hydraulic tools.



Standard tools for a welding shop include: (A) hacksaw, (B) combination square, (C) ball peen hammer, (D) framing square, (E) various sizes of C-clamps, (F) center punches, (G) alternative C-clamp, (H) measuring tape, (I) magnetic clamp, (J) cold chisel, (K) circular saw, (L) portable band saw, (M) air compressor, (N) angle grinder, (O) angle pointer/calculator, (P) level, (Q) metal file, (R) reciprocating saw, (S) oxyacetylene and oxygen (including regulators, hoses, torch with tip).

Standard tools for a welding shop include: (T) plasma cutter, (U) TIG stick welder, (V) multiple-purpose cut-off saw, (W) MIG welder.

Metal Basics



Different metals have different characteristics that affect their ability to be welded or cut with any of the processes described in this book. In general, only metals of the same type are welded together because welding involves melting the base metal parts and adding melted filler metal. In order to accomplish this, the parts and filler must have the same melting temperature and characteristics. Dissimilar metals can be joined by brazing and braze welding because these processes do not actually melt the base metal.

Metals are divided into the categories of ferrous and non-ferrous. Ferrous metals contain iron and will generally be attracted to a magnet. Cast iron, forged steel, mild steel, and stainless steel all contain iron, along with varying amounts of carbon and other alloying elements.

Mild steel, which has a low carbon content, is the most commonly used type of steel and the easiest with which to work. Mild steel can be welded with all the processes covered in this book and can be cut with either oxyfuel or plasma cutting. It makes up most of the metal items you commonly use, make, or repair, such as automobile bodies, bicycles, railings, patio furniture, file cabinets, and shelving. Adding more carbon to steel makes it harder, more brittle, and more difficult to cut and weld. High- carbon steel is called tool steel and is used to make drill bits and other metal cutting tools.

METAL	WELDING PROCESS	CUTTING PROCESS
Mild steel	All welding processes	Oxyfuel, plasma
Aluminum	Gas tungsten arc, gas metal arc	Plasma
Stainless steel	Gas tungsten arc, gas metal arc, shielded metal arc	Plasma
Chrome moly steel	Gas tungsten arc, oxyfuel	Plasma
Titanium	Gas tungsten arc	Plasma
Cast iron	Shielded metal arc, brazing	Plasma
Brass	Braze welding	Plasma

Metal Melting Points

METAL	MELTING POINT (F)
Aluminum	1217°
Brass	1652 - 1724°
Bronze	1566 - 1832°
Chromium	3034°
Copper	1981°
Gold	1946°
Iron	2786°
Lead	621°
Mild steel	2462 - 2786°
Titanium	3263°
Tungsten	5432°
Zinc	786°

Other elements are added to steel to make a variety of alloys, such as chrome moly steel and stainless steel. These additions may make the steel non-magnetic. Because stainless steel does not oxidize (rust) easily, it is difficult to cut with oxyfuel. When welding steel alloys, the filler material must be matched to the alloy to get a high-quality weld.

In addition to alloying, many metals are heat treated to improve characteristics such as hardness. Because welding and cutting would reheat these metals and destroy those characteristics, heat treating is an important factor to consider. Many vehicle chassis parts, including motorcycles and bicycles, are made of heat-treated metals.

Aluminum is a widely used non-ferrous metal because of its light weight and corrosion resistance. Like steel, it is available in many alloys and is often heat treated. Aluminum is used for engine parts, boats, bicycles, furniture, and kitchenware. Various characteristics make aluminum difficult to weld successfully—it does not change color when it melts, it conducts heat rapidly, and it immediately develops an oxidized layer.

Metal Shapes & Sizes

Mild steel (and most other metals) come in a variety of shapes, sizes, and thicknesses. Metal thickness may be given as a fraction of an inch, a decimal, or a gauge (see chart, page 18).

Rectangular tube (A) and **square tube** (B) are used for structural framing, trailers, and furniture. Dimensions for rectangular and square tubing are given as width × height × wall thickness × length.

Rail cap(C) is used for making handrails. Rail cap dimensions are the overall width and the widths of the channels on the underside.

Channel (D) is often used for making handrails. Very large channels are used for truck bodies. The legs, or flanges, make it stronger than flat bars. Dimensions for channel are given as flange thickness × flange height × channel (outside) height × length.

Round tube (E) is not the same as pipe. Round tube is used for structures, and pipe is used for carrying liquids or gases. Dimensions for a round tube are given as outside diameter (O.D.) × wall thickness × length. Pipe dimensions are nominal, that is, in name only. They are given as nominal inside diameter (I.D.) × length.

T-bar (F) dimensions are given as width × height × thickness of flanges × length.

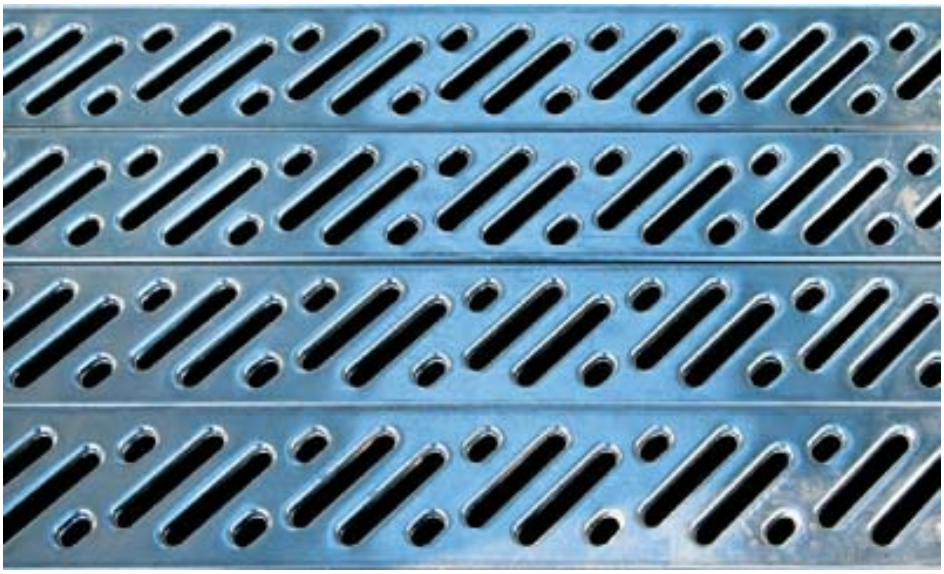
Angle or **angle iron** (G) has many structural and decorative uses. Dimensions for angle iron are flange thickness × flange width × flange height × length.

Square bar (H), **round bar** (I), and **hexagonal** or **hex bar** (J) dimensions are given as width or outside diameter × length.

Flat bar or **strap** (not pictured) is available in many sizes. Dimensions are given as thickness × width × length.

Sheet metal (not pictured) is $^{3}/_{16}$" or less in thickness and is often referred to by gauge. **Plate metal** (not pictured) is more than $^{3}/_{16}$" thick and is referred to by fractions or inches.

Diamond plate is used as a heavy-duty siding for toolboxes and carts because of its durability and strength. It is also used for decorative applications. It is sold as length × width × thickness.



Perforated sheet metal is used for industrial shelving, fences, stair treads, grates for floor drains, and a host of decorative sidings and top treatments. There are numerous shapes and styles available. They are sometimes referred to as perforated metal screens. Perforated sheets are sold as length × width × thickness. Lighter-weight sheets are sold by the yard in a roll.

Metal Identification Chart

Test	Appearance	Fracture	Magnetic	Torch	Chip	Spark	Volume of stream
Manganese Steel	Dull cast finish	Rough grained	Non-magnetic	Turns bright red, melts quickly	Hard to chip	Bright white bursts, heavy pattern	Moderately large
Stainless Steel	Bright, smooth surface lines	Bright appearance	Depends on exact composition	Turns bright red, melts quickly	Smooth chip, smooth bright color	Very few short full red sparks with few forks	Moderate
Low Carbon Steel (mild steel <.30% carbon)	Gray, fine	Gray, bright crystalline	Highly magnetic	Gives off sparks when melted, pool solidifies rapidly	Chips easily, smooth and long chip	Long white sparks, some forks near end of stream	Moderately large
Medium Carbon Steel (.30 to .45% carbon)	Gray finish	Light gray	Highly magnetic	Melts quickly, gives off some sparks	Chips easily, smooth and long chip	Long white sparks with secondary bursts along stream	Moderately large
High Carbon Steel (>.45% carbon)	Dark gray, smooth finish	Light gray-white, finer grained than low carbon steel	Highly magnetic	Melts quickly, molten metal is brighter than low carbon steel	Difficult to chip, brittle	Large volume of brilliant white sparks	Moderate
Wrought Iron	Gray, fine surface lines	Fibrous structure, split in same direction of fibers	Highly magnetic	Melts quickly, slight tendency to spark	Chips easily, continuous chip	Straw-colored sparks near wheel, few white forks near stream end	Large
Cast Iron	Rough, very dull gray	Brittle gray	Highly magnetic	Turns dull red, first puddle is very fluid, no sparks	Very small and brittle chips	Dull red sparks formed close to wheel	Small
High Sulfur Steel	Dark Gray	Gray, very fine grain	Highly magnetic	Melts quickly, turns bright red before melting	Chips easily, smooth and long chips	Bright carrier lines with cigar-shaped swells	Large

Purchasing Metal

Finding a metal supplier can be a challenging task. The materials that are readily available at home centers and hardware stores may not be the sizes and shapes needed for a project and tend to be expensive. Because steel is so heavy, Internet or catalog shopping entails significant shipping costs. With some searching, however, most materials can be found.

Metal is generally priced by weight, unless you are purchasing it at a retail store. The price for small pieces of mild steel at a home center or hardware store work out to be as much as $3 to $5 per pound. The price per pound for small orders at a steel dealership may be in the range of $1. Large orders or repeat orders may be priced as low as 50 cents per pound. Many metal suppliers have an odds and ends bin or rack where pieces may be as low as 10 cents per pound. Specialty metals such as stainless steel and aluminum start at $2 to $3 per pound.

Smaller sizes and shapes of mild steel and aluminum are available at home improvement and hardware stores in three-, four-, and six-foot lengths. Welding supply stores often have a selection of ten- and twelve-foot lengths of the commonly used sizes. Steel dealers have most common sizes in stock and will order other sizes for you. Most mild steel shapes and sizes come in twenty-foot lengths, and many steel dealers will make one free courtesy cut per piece. You might want to have the metal delivered, depending on the amount of material you are purchasing.

Some steel dealers are distributors for decorative metal products, but many specialty items such as wrought iron railing materials, decorative accessories, and weldable hardware are only available by catalog. A number of catalog supply houses sell to the public and have varied selections and reasonable prices. (See Resources, page 220.)

Inch Equivalent for Gauge Thickness

GAUGE	INCHES
24	0.020
22	0.026
20	0.032
18	0.043
16	0.054
14	0.069
12	0.098
11	0.113
10	0.128

Metal less than ⅛" thick is often referred to by gauge. For reference, the decimal equivalent of ⅛" is 0.125.

Wall plates, hooks, rings, balls, bushings, candle cups, drip plates, and stamped or cast items are available in a wide variety of shapes, sizes, and sheets.

Repairing Metal

Once you begin welding, you will encounter numerous opportunities to repair items. When your friends and neighbors discover you can do repairs, even more challenges will come your way.

Performing welded repairs can be very tricky. It is important to assess your welding skills, the difficulty of the repair, and the intended use of the repaired item. Any structural or vehicle repairs, such as stairways, ladders, trailers, or truck chassis, need to meet the same safety standards as they did in their original condition.

The first step in considering a repair is determining why the item broke. If a weld was poorly executed, the repair might simply be to prepare the area and perform a good weld. If a piece has broken due to metal fatigue, simply patching over the crack will only cause more cracks outside the patched area. Cast iron and cast aluminum may have broken due to imperfections or inclusions in the casting, or they may have gone through rapid heating and cooling that caused cracking.

The next step in a repair is determining the base metal. A magnet will be attracted to any metal with a certain concentration of iron in it, but stainless steel (which is sometimes non-magnetic), mild steel, and cast iron require very different welding techniques. Aluminum is non-magnetic and is discernable from stainless steel by its light weight—but which alloy is it? In the case of aluminum, some alloys are not weldable. Unfortunately, many manufactured metal items are made of alloys and may have been heat treated. Without access to the manufacturer's specifications, it might be impossible to determine what the base metal composition is. It is important to understand the effects of welding on these materials before attempting a welded repair.

Once you have determined the feasibility of a repair on a particular piece, the piece must be prepared carefully. All rust, paint, and finishes must be removed from the area of the weld, and, if you are arc welding, from an area for the work clamp. Grease and oil must be cleaned off. If the break is on a weld joint, the old weld bead needs to be ground down.

Mild steel is the easiest material to repair. Simply prepare the material as for any other weld, and weld using any of the welding processes.

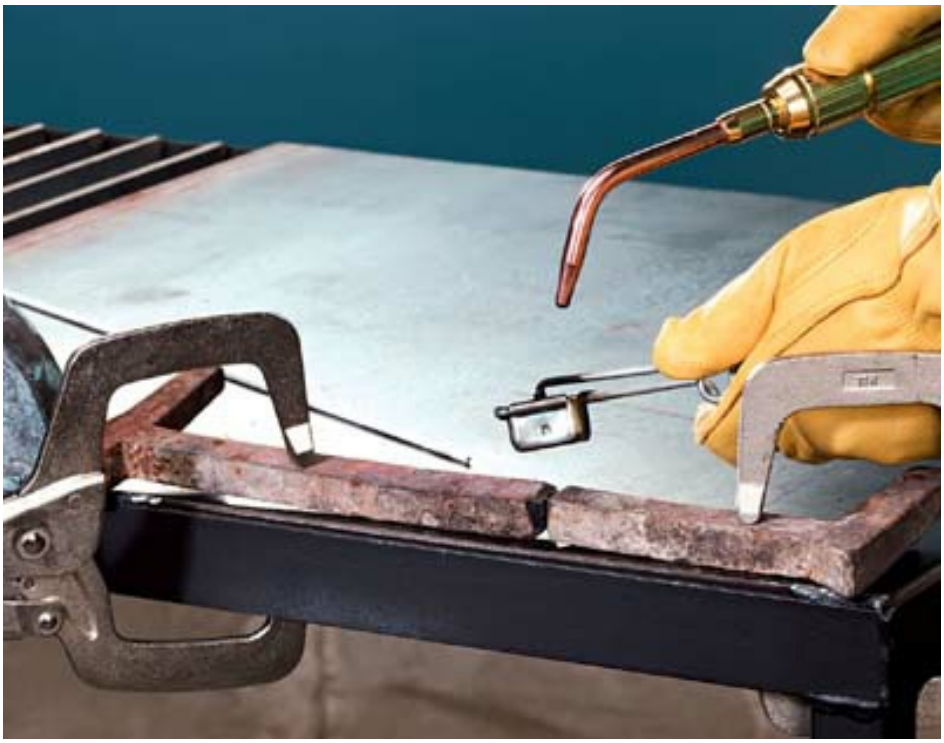
All parts need to be carefully prepared before attempting a repair. Paint needs to be ground or sanded off and grease and oil need to be cleaned away. This cast iron part is being beveled to allow greater weld penetration

Cast iron and cast aluminum need to be preheated before welding to prevent cracking due to temperature fluctuations. If the piece is small enough, you can put it in the oven and heat it to 400 to 500°F. Otherwise, use an oxyacetylene or propane rosebud tip. Temperature crayons, which melt at specific temperatures, are available for marking metal to be preheated. Cast iron can be brazed if the fit between the broken parts is good, or it can be braze welded or welded with shielded metal arc. Specific electrodes for cast iron are available. Cast aluminum can be brazed, braze welded, or welded with gas tungsten or gas metal arc welding.

Some aluminum is not weldable. If the piece to be repaired has been welded, you can perform a welded repair. If you can determine the composition of aluminum parts, match the electrode or filler rod to that. Some filler rods and electrodes are multipurpose and can be used on more than one alloy. Gas tungsten arc welding is the best choice for aluminum, but it can also be welded with gas metal arc, or it can be brazed.

Stainless steel comes in numerous alloys, and it is important to match the filler material to the base metal. Do not clean stainless steel with a steel wire brush, as the mild steel wires may contaminate the stainless steel. Stainless steel is best repaired with gas tungsten arc welding, although it can be brazed as well.

Remove the paint and finish from the weld area. If you are arc welding, also remove the paint from an area close to the weld for attaching the work clamp.



Cast iron can be braze welded as shown here, or shielded metal arc welded with cast iron electrodes. Either way, the metal needs to be preheated to 450° F before being welded.

Cleaning Metal

A successful weld begins with a well-prepared piece of metal. The cleaner the pieces to be welded, the better the weld quality and appearance. Steel is not available in a pre-cleaned state, so you will need to clean all project parts by removing oil, mill scale, dirt, and rust. Although this can be a tedious step, a well-cleaned project lasts many years and you soon forget the time spent conscientiously cleaning every piece.

For any project that will be painted, it is important to thoroughly clean the entire part. For objects that will be allowed to rust gracefully outdoors, thoroughly clean the joint areas and allow the weather to clean the remainder.

The first step in cleaning is to wipe down the part with denatured alcohol, acetone, or a commercial degreaser to remove oil and dirt. The alcohol works best as it has little odor, unlike the degreaser, and it won't dissolve plastics, like the acetone will. Both acetone and degreasers tend to leave a residue that may diminish the quality of the final finish.

Once the grease, oil, and dirt have been removed from the surface, the mill scale (often found on mild steel) must be removed. Mill scale is a dark gray flaky oxide layer that forms on the steel as it cools. Cold-rolled steel often has a thinner layer of scale than hot-rolled steel, but even the thin layer needs to be removed before welding and finishing. Manufacturers use a pickling bath to remove scale; except for very small projects, it is unlikely that a home do-it-yourselfer would want to work with the hot acid bath needed for pickling. The remaining options are wire brushing, grinding, sanding, or sandblasting.

A bench-mounted power wire brush is perfect for cleaning the ends of parts. Unfortunately, it is not suitable for cleaning the remaining surfaces. For this you will need an angle grinder outfitted with a wire brush cup or flap sander. A drill or rotary tool with a wire brush wheel, wire brush cup, or flap sander also works well. When working with power wire brushes it is crucial you wear appropriate protective gear. A full face mask and long sleeves protect your eyes and arms from wire fragments that are thrown from the brush. Heavy leather gloves will protect your fingertips from getting skinned. These tools operate at very high speeds and can quickly do serious damage to eyes and skin.

Once the metal has been cleaned and de-scaled, it is important that you complete the project in a timely manner before the metal parts.

Apply denatured alcohol with a clean rag to clean dirt and oil from project parts. Wear rubber gloves to protect your hands.

Cleaning the mill scale off mild steel is an important step. A bench-mounted power wire brush works well on small pieces. Wire brushing the entire project prior to finishing is critical for good paint adhesion.

Techniques

In this chapter, all of the basic welding skills are covered—from cleaning to cutting and jointing to jigging. These are the techniques that you will use again and again regardless of the type of welding you pursue. This chapter also provides basic directions and step-by-step photos that illustrate major welding and cutting processes. You will find quick reference charts that describe electrode and filler wire choices, metal types and weldability, and joint and weld types.

IN THIS CHAPTER:

Mechanical Cutting
Plasma Cutting
Oxyacetylene Cutting
Shaping
Finishing
Oxyacetylene Welding
Shielded Metal Arc Welding (SMAW)
Gas Metal Arc Welding (GMAW/MIG)
Gas Tungsten Arc Welding (GTAW/TIG)

Mechanical Cutting

For some projects, cutting the metal is the most difficult step. A variety of tools exist for cutting metal, but the thicker and larger the stock, the fewer your choices. If you want to build muscle, a hacksaw is great for tubes, rods, and bars, but a large project will soon have you wishing for some more powerful cutters. Cutting thin-gauge sheet metal can be done with sheet metal snips, but thicker gauges and plates require shears or cutting torches. You can spend a few hundred dollars or a few thousand dollars on power metal cutting tools. Here are some of your options.

Bimetal saw blades are the best for cutting metal, whether you are using them in your hacksaw or bandsaw. Make the blades in your hacksaw and portable bandsaw last longer not by forcing the cuts, but by allowing the saw to cut slowly and steadily. Excess pressure simply wears the blades out before their time.

A horizontal metal-cutting bandsaw is a bench-mounted bandsaw with clamps to hold work pieces, and an automatic shut-off feature that turns off the saw when the cut is completed. The most common cutting capacity is 4 × 6", which can cut through a rectangular piece of that dimension or a 4½" round. A portable metal-cutting bandsaw is slightly less expensive than the bench version and obviously more portable. The most common size cuts 4" stock. It is more difficult to create accurate cuts with the portable bandsaw, but the portability makes the machine more versatile in a do-it-yourself shop. A distinct advantage of the bandsaws is the very small kerf (less than $^{1}/_{16}$").

Metal-cutting chop saws, cut-off machines, and angle grinders use abrasive wheels for cutting. Most of these produce a great deal of heat and metal dust, and cut pieces typically have burred edges. Metal-cutting circular saws with carbide blades produce cleaner cuts with less heat. They are also faster than chop saws. Both of these types of saws have larger kerfs (at least $^{3}/_{32}$") than the bandsaw. A portable steel saw looks and operates like a standard circular saw, but is capable of cutting up to ¼" sheet metal, as well as cutting tubes and rods. Reciprocating saws can also be used for cutting rods and tubes.

Manual or hydraulic metal shears and punches in small sizes suitable for home shops are relatively inexpensive. They are limited to thin-gauge materials, usually less than 16 gauge. And the heavier the material capacity is, the more expensive the machine.

Manual snips are sufficient for cutting curves in sheet metal thinner than 18 gauge. Power nibblers make quick work of curves but are commonly available for 18-gauge or thicker.

Power tools for a welding shop include: (A) reciprocating saw, (B) cut-off saw, (C) portable band saw, (D) angle grinder.

Plasma Cutting

Plasma cutting is an arc process. Plasma is a gas that can conduct electricity because it is in a highly ionized form. The gas transfers the arc, but because of the constriction of the gas, the gas resistance is very high, which creates the extreme heat for plasma processes. Plasma cutting uses a very constricted arc to melt the base metal while compressed air or other gas blows the melted metal out of the kerf. This process can be used on any conductive metal—aluminum, brass, cast iron, copper, steel, stainless steel, and titanium—which sets it apart from oxyacetylene cutting, which is only useable on oxidizable metals.

Though the plasma arc temperature is 40,000°F, it is so constricted and the cutting speed is so fast that the thermal distortion to the metal being cut is low. Plasma cuts are clean and are often weldable with no additional cleanup if the base metal was initially clean. Properly done, the kerf is fairly straight sided, and no slag is present.

Safety: Plasma cutting produces sparks, smoke, and fumes. When cutting materials that contain chromium and nickel (such as stainless steel) or materials that have been galvanized or zinc coated, many toxins will be present in the fumes. When cutting through painted, bonded, or dirty metals, these surface additions often burn off, producing hazardous smoke. Plasma cutting often produces ozone and various nitrogen oxides that are colorless and can be odorless; both are hazardous. Therefore, good ventilation is important even when plasma cutting.

A plasma cutter consists of a power source with a compressed air or inert gas connection, work cable with clamp, supply cable, and torch.

Safety

- Welding helmet with #8 filter
- Leather, wool, or cotton long pants, long-sleeve shirt, and hat
- Heavy-duty welding gloves
- Leather boots or shoes
- Ventilation

Plasma cutting may not seem as bright as other arc processes, but it is. It produces ultraviolet rays, so it is important to protect your skin and eyes. Because of the high level of open circuit voltage, plasma cutting has added electrical shock hazard. Make sure all surfaces around the cutting area are dry, as well as your clothing and gloves. Turn off the power to the machine before changing any torch parts.

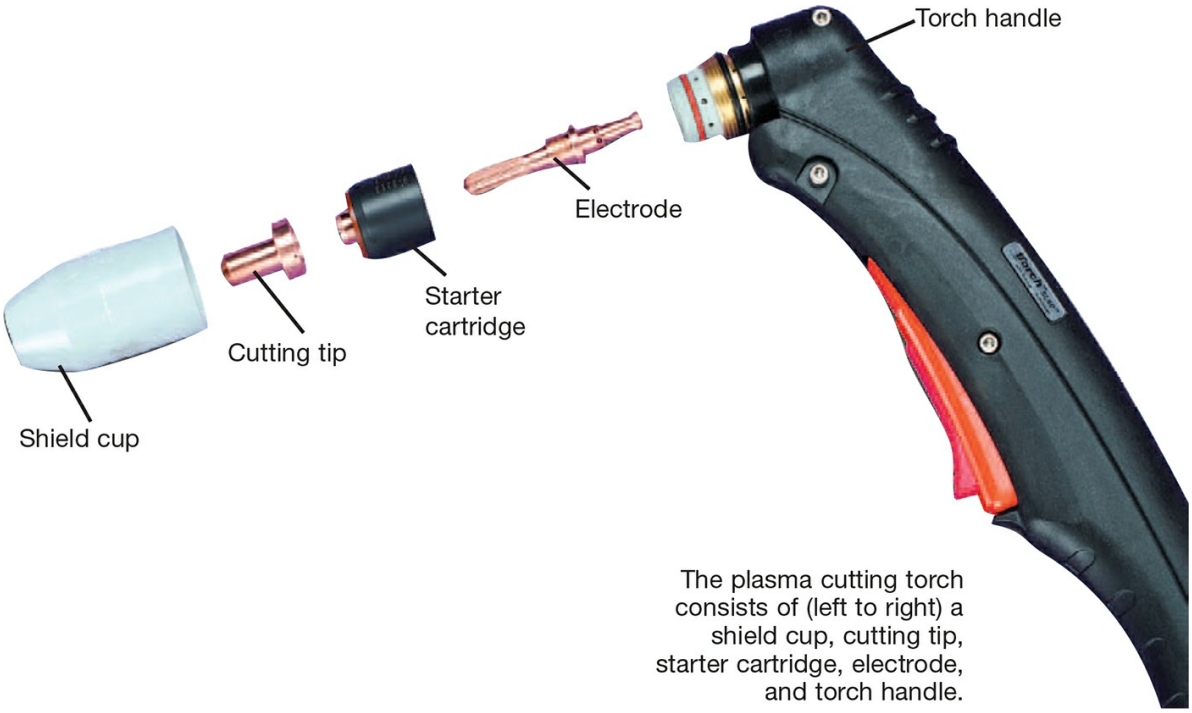
Never cut containers, tanks, or cylinders that may have held flammable materials. Even a small amount of flammable residue can cause an enclosed vessel to explode when cut.

Equipment: Plasma cutting machines are expensive, but as technological advances are made and demand increases, more companies are introducing smaller, less expensive home and small shop equipment. If you regularly need to cut stainless steel, aluminum, or the high-strength steel now used in automobile bodies, this machine can be worth the cost. Small, 115-volt plasma cutters are available that will cut up to 3/8" material. Larger 220-volt machines can cut thicker materials and have higher duty cycles. Aluminum and stainless steel require higher amperages, so check whether the machine easily can cut the materials with which you typically work.

Most plasma cutters require a compressed air source. Any shop air compressor that can deliver 65 psi is sufficient. It is critical that a filter be installed to keep the air dry and oil free. Follow the manufacturer’s directions for installing the filter. Some plasma cutters have an internal air compressor. These units often require more maintenance than models that utilize a separate compressor.

Most plasma torches have a manual switch on the torch body. The cutting tip and electrode are consumable parts. Check them frequently for wear and replace them when necessary.

A dehumidifying filter is very important for the compressed air source for plasma cutting.



The plasma cutting torch consists of (left to right) a shield cup, cutting tip, starter cartridge, electrode, and torch handle.

Precutting Checklist

- Compressed air fittings are tightly attached.
- Cables are in good condition.
- Ventilation is sufficient to remove fumes from cutting area.
- Work area is dry.
- Flammable materials are removed from area.
- Sparks and slag from cutting will be contained.

How to Plasma Cut

1 Check the manufacturer's recommended settings for the material to be cut. Arrange the material on a cutting table and determine the most comfortable cutting position. Attach the work clamp to the workpiece or welding table. Dry run through the cutting motion to practice speed and cutting position.

2 Check manufacturer's directions for arc starting procedure. Most current machines are designed to drag the nozzle directly on the material's surface. Activate the arc and hold the torch perpendicular to the surface of the material. Move steadily and smoothly along the entire length of the cut. Do not stop the arc until you have passed through the end of the cut.

3 A good plasma cut has squared edges, small vertical ripples, and little or no slag.

Troubleshooting & Techniques

A high-quality circle cutting attachment for a plasma cutter is expensive, but worth the investment if you will be making repeated circle cuts. Inset photo: This unit comes with a magnetic pivot holder for steel and a suction cup pivot holder for all other metals.

Plasma Troubleshooting

PROBLEM	SOLUTIONS
Arc does not start	• Connect work clamp to workpiece • Turn on power source • Tighten cable connections • Make sure electrode is in working condition
Cut does not penetrate through material	• Cut more slowly • Make sure torch is held perpendicular to material • Make sure machine is capable of cutting that thickness • Increase amperage setting • Verify correct air flow and pressure
Excessive slag or dross	• Increase cutting speed • Decrease torch standoff distance • Replace worn torch parts • Adjust amperage setting
Torch parts consumed quickly	• Install or replace air filter to prevent oil or water from reaching torch • Cut metal within the capability of the machine • Make sure gas pressure is correct

The adjustable pressure regulator with gauge is located on the front of the Lincoln Pro-Cut 55 plasma cutting machine. This compact machine generates 60 amps of cutting power capable of cutting conductive materials up to ¾" thick. It has a built-in air filter.

This plastic box contains the consumables for a Lincoln plasma cutter. The consumables are made of copper, which resists sticking to almost all other metals. The parts should be replaced when they become too worn out to work properly.

Tip
Making a good-quality plasma cut is dependent on a consistent travel speed. Consult the owner’s manual for cutting speeds for different material thicknesses and amperage settings. With the machine off, practice moving across the planned cut at the correct speed.

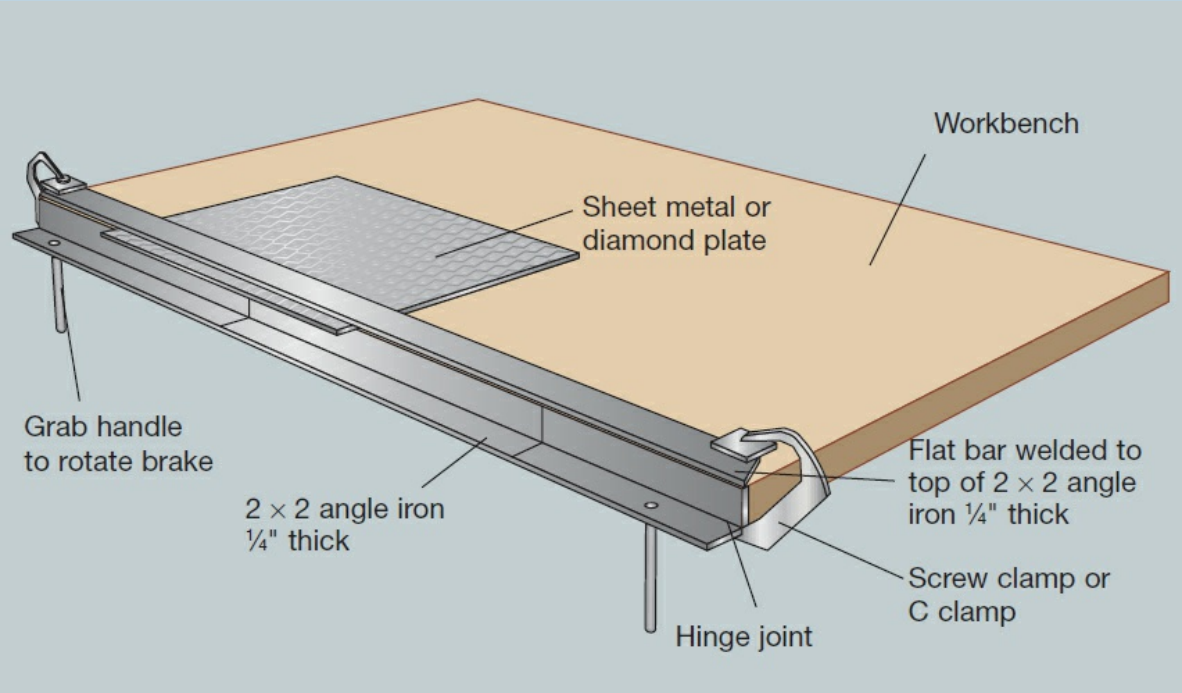
More Plasma Cutting Techniques

This operator can make precise cuts with a plasma cutter without adding the heat input of an oxyacetylene torch. This will prevent heat distortion in surrounding regions of the work area.

Plasma cutters can also pierce small pieces of thick metal, but for a cleaner cut first drill a small 1/8" - hole to start the cut.

Bending & Cutting Diamond Plate

Although diamond plate can be plasma cut, there are times when you'll want to bend the sides instead. Cut a bird's mouth with a plasma cutter (see page 97) and then use a simple break like the one shown here to bend the sheet (see page 101). Bend a little at a time until you get what you want. If you score the backside beforehand it makes the bend easier with less stress, but don't score it deep or it will crack.



Cutting the ends off of pipes is a cinch with a plug-in plasma cutter. It even cuts through a significant amount of rust, as shown here.

Making detail cuts—even on a round tube, as shown here— is easy with a plasma cutter. Here, the welder is cutting a new, clean tube. Note the sparks are much smaller than they would be with an oxyacetylene torch.

Here, custom motorcycle builder Scott Webster (of Leroy Thompson choppers) uses the Pro-Cut 55 to cut a piece of steel over a barrel that catches the debris.

The Lincoln Pro-Cut 25 plasma cutting machine is good for fish-mouth fitting tubing, including tailpipe tubing. After the cut is made, a die grinder removes slag from the cut line.

A Miller plasma cutter is being operated by a gasoline generator and an air compressor to make a repair on this hay baler. When the broken part is removed, a replacement will be welded on by a wire-feed machine.

Oxyacetylene Cutting

Safety

- Full-face #5 filter
- Leather, wool, or cotton long pants, leather jacket, and hat
- Heavy-duty welding gloves
- Leather boots or shoes
- Ventilation

Oxyacetylene cutting uses acetylene and oxygen to preheat metal to a temperature of 1600°F, then uses pure oxygen to burn away the heated metal. Because the cutting is achieved by oxidation of the metal, oxyacetylene cutting only works on metals that are readily oxidized at this temperature. Metals that can be cut with the oxyacetylene process are mild steel and low alloy steels. Oxyacetylene cutting can be used to cut thicknesses from less than 1/8" up to 12". Oxyacetylene cutting is inexpensive compared to machine cutting. It is very portable because no external power source is necessary, and it is faster than machine cutting. It is, however, limited to steel. The molten slag presents a fire and burn hazard, and the heat input to the base metal may cause distortion or changes to the properties of the steel.

Safety: The risk of starting a fire or being burned is high with oxyacetylene cutting. It is important to prevent molten slag and sparks from coming into contact with skin and flammable materials. Make sure you are wearing heavy-duty leather gloves with gauntlets, a leather jacket or leather-sleeve jacket, and leather boots. The work area should be cleared of flammable materials. If an item will be cut in place, make sure surrounding areas are protected from heat, sparks, and dropping slag. Never cut sealed tanks, cylinders, or items that have contained flammable materials. Never cut near gasoline tanks or fuel lines.

Equipment: The basic equipment for oxyacetylene cutting is the same as for oxyacetylene gas welding, with the addition of a cutting torch or cutting attachment. An oxyacetylene cutting setup consists of an oxygen cylinder, an acetylene cylinder, regulators and hoses, and a torch with cutting attachment or a dedicated cutting torch. Cutting attachments and dedicated cutting torches have levers to activate the oxygen flow.

Oxyacetylene cutting equipment consists of two cylinders—oxygen and acetylene—regulators, hoses, and a cutting torch with tip.

Cutting torch and tips: Most oxyacetylene welding sets come with a cutting accessory that attaches to the torch body in the same way that the welding tips do. A dedicated cutting torch is a one-piece unit that has its own mixing chamber. Its greater overall length allows for more distance between the heat zone and the operator, and it can handle higher oxygen flow rates. A dedicated cutting torch is usually fairly expensive and not necessary unless very thick metals will be cut, which requires greater oxygen flow.

Both the cutting torch and the cutting attachment take a variety of cutting tip sizes. The cutting tip has a number of preheat holes surrounding the pure oxygen orifice. It is important to match the cutting tip to the thickness of the metal being cut. A welder often takes a one-size-fits-all approach to cutting tips, which always results in poor-quality cuts. Thinner metals require fewer preheat holes and a smaller oxygen orifice; thicker metals require more preheat holes and a larger oxygen orifice. Cutting tips are made of copper and can be damaged easily. They need to be cleaned regularly with an appropriately sized tip cleaner.

Fuel gas options: Because the metal being cut does not need to be brought to the melting point, various gases other than acetylene can be used. Propane, natural gas, propylene, and methylacetylene-propadiene can be used as the preheating fuel source. Each of these gases requires specific regulators and may require different torches and torch tips. Check manufacturer’s recommended usage before substituting an alternate fuel gas.

A striker (A), tank wrench (B), pliers (C), and tip cleaner (D) are needed for oxyacetylene cutting.

A dedicated cutting torch (top) is a one-piece unit with one oxygen and one fuel-gas valve. A cutting tip is attached to a standard torch body (bottom) and includes an additional oxygen valve. A range of tip sizes is available for both torch styles.

Precutting Checklist

- Surrounding area is free of flammable materials.
- There is room for cut metal to fall away from arms, legs, hoses, and cylinders.
- Hoses are free from damage before pressurizing the system.
- Ventilation is adequate to remove smoke and fumes from area.

How to Cut with Oxyacetylene

1 See pages 44 to 47 to learn how to set up, pressurize, and light an oxyacetylene torch. Set up the material to be cut on a cutting table. Use soapstone to mark the cutting line, and practice your cutting position and bracing. Hold the torch in your left hand with your thumb and forefinger on the acetylene valve. Hold the striker in your right hand, 3 to 6" from the torch tip. Turn the acetylene valve ¼ to ½ turn and strike sparks.

2 Adjust the acetylene so the flame is not smoking and is not separated from the tip (see page 47). Add oxygen to create a neutral flame. With a dedicated cutting torch, depress the oxygen lever to make sure neutral flame is maintained; if necessary, adjust with the oxygen lever depressed. With a cutting tip on a torch base, depress the oxygen lever and use the cutting tip adjustment valve to adjust the oxygen.

3 Release the oxygen lever, flip down your face shield, and direct the flames at the edge of the cut. Once the metal begins to glow red and appears shiny but not yet molten, depress the oxygen lever. If it fails to pierce a hole immediately, release and continue to heat until depressing the lever pierces a hole. Move slowly and steadily along the cutting line, holding the torch at a 90° angle.

4 The finished cut should have very small vertical ridges (draglines), very little slag on the bottom, and the top edges should not be rounded over.

Oxyacetylene Cutting Tips

Oxyacetylene cutting safety.

Oxyacetylene cutting produces molten slag, sparks, and hot metal scraps. Move items that are to be cut away from burnable material. If the item cannot be moved, protect surrounding areas with sheet metal and fire retardant welding blankets (not tarps). Make sure sparks and slag will not fall into cracks, holes, or ventilation grates in the floor. Wet down any wooden material around the cutting area. Have water, sand, or a fire extinguisher on hand, and monitor the area for one half hour after cutting is completed. Plan where cut metal will fall so it does not hit your arms, legs, gas hoses, or cylinders.

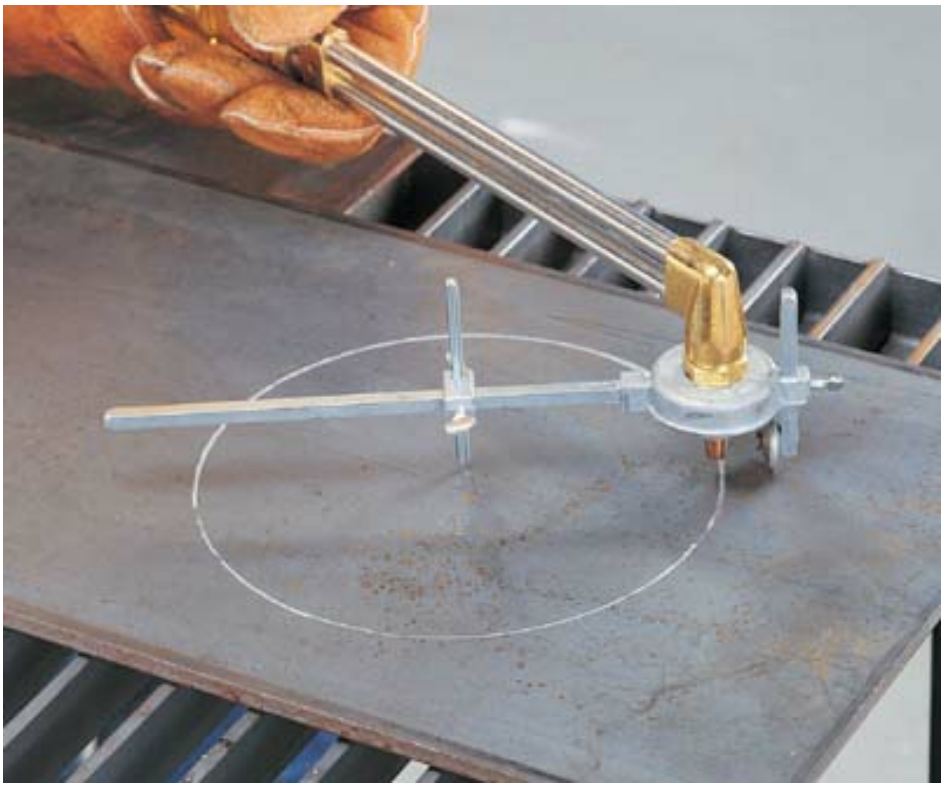
Piercing Holes and Making Cutouts

Piercing a hole: Preheat the material to a dull red. Pull back the torch from the surface and angle slightly. Squeeze the oxygen lever. As soon as the material has been pierced, return the torch tip to the perpendicular position and move back to just above the surface. Complete the hole.

Making a cutout: Begin in the center of the cutout and move to the cutout line after piercing a hole. A spiral approach to the edge works best. To give maximum protection to the surrounding material when piercing a hole, drill a $^{3}/_{16}$" hole to start the piercing action.

Warning

- Never cut into a sealed container.
- Never cut into a tank or container that contains or may have contained flammable materials.
- Never cut near a gasoline tank or fuel lines.



Circle cutting guides are available for making accurate circle cuts. If you need to make several circle cutouts, this can be a handy tool.

Use a piece of angle iron as a brace to support the torch or to hold the pipe in place for cutting.

Cutting Defects

A good oxyacetylene cut has square edges, small vertical draglines, and little slag. A dirty cutting tip is the cause of many poor-quality cuts. Clean the orifices with a properly-sized tip cleaner and use very fine sandpaper on a flat surface to polish the flat surface of the tip. Here are a few possibilities for causes of cutting defects:

Kerf is wider at the bottom than at the top (bell-mouthed).
Oxygen pressure is too high.

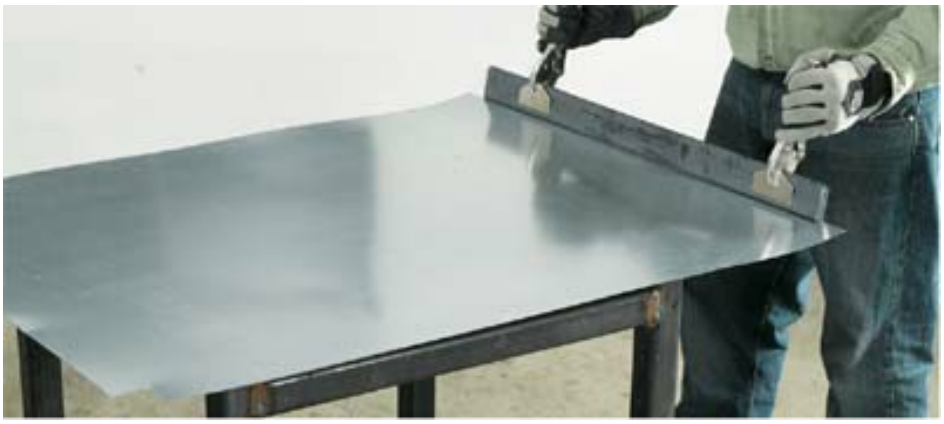
Top edge melted over.
Cutting speed is too slow or preheat flames are too long.

Irregular cut edge.
Speed is too fast or too slow, oxygen pressure is too high, or cutting tip is too small or too large.

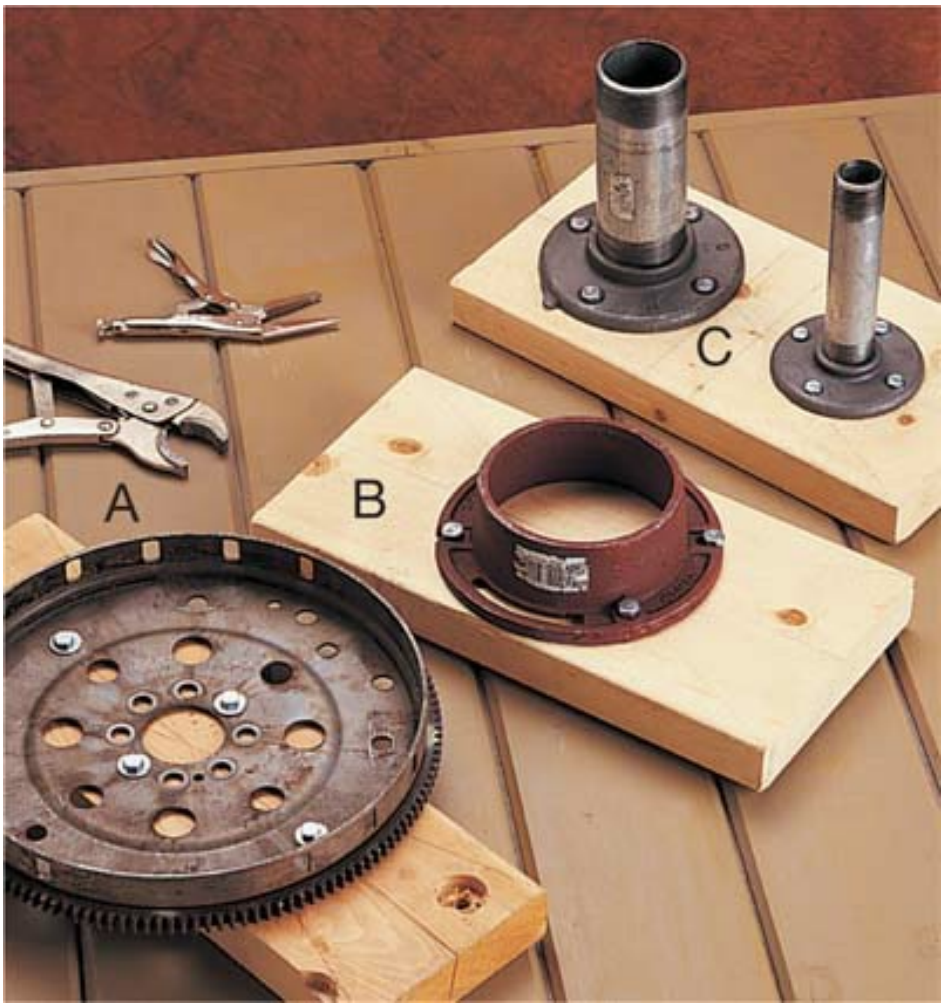
Shaping

There are a number of ways to bend and shape mild steel. Brakes for creating angles in sheet metal, and ring rollers and scroll benders to create circles and scrolls are readily available for the home crafter. Unfortunately, the higher the capacity of these bending tools, the higher the price. You can make simple bending jigs from any round, rigid, strong form, such as pipe and salvaged flywheels, pulley wheels, or wheel rims. Using these jigs, it is fairly easy to bend a round rod up to ¼" and a flat bar up to 1/8" into complex shapes. A bench vise is handy for making acute bends. Tubing, rail caps, and channels can be bent with a heavy-duty electrical conduit bender. With practice and patience, you can create well-formed circles by making incremental bends with the conduit bender.

Thicker materials are bent more easily if you have a long end for applying pressure; it is better to cut pieces to length after bending. Sliding a pipe over a short end will increase your leverage. When shaping metal into sharp bends, take into account the length needed for the radius of the bend. Cold-formed metal springs back somewhat, so it may take trial and error to find which size jig makes the bend size you desire.



Use a flat bar and locking pliers to bend sheet metal.



Bending jigs can be made from many rigid, circular items. An engine flywheel (A), toilet flange (B), and various pipe sizes (C) are shown here.

Use locking pliers to hold the metal to the jig. Wrap the metal around the jig in a smooth motion.

Use a scroll bender to bend decorative scrolls.

Finishing

A nice finish adds to the beauty of your welded project. Unless you intend to let your project fully rust, even bare metal needs some type of coating. Applying a paint coating is best done by spraying, not brushing.

If you look closely at most welded furniture or garden accessories you'll see that they typically have rough welds and spatter. With your own projects, especially indoor projects, taking the time to grind down welds and grind off spatter is time well spent. A nicely ground, good weld looks like a continuous solid piece of metal. This is especially important for glossy finishes, as a smooth, shiny paint job will highlight even the tiniest imperfections.

A primer coat is recommended underneath all but bare metal coatings. If you're going for bare metal, use a clear coat or a metal polish minimally to prevent rust. If already deeply rusted areas cannot be cleaned to bare metal, use a rusty metal primer or, even better, a rust converter. Carefully read product labels, as some converters require oil-based top coats and other specific finishes.

A wide variety of spray-on finishes is available. With a single application you can create beautiful, detailed faux finishes, such as a hammered texture or granite (Rust-Oleum® Stone Creations, for example). Crackle and antiquing finishes are also available as single spray-on finish paints and brush-on paints. Of course, you can create your own antique look as well (see photo, this page).

If you have more time and a higher budget, consider a verdigris finish. This finish requires more steps and time due to paint layers, but it creates a unique look that is very impressive yet natural looking for metal. The great part of simulating a patina is that you can control the hues and coloration, and then seal it all so that it remains perfect for years and years. Powder coating and brass plating are other, more expensive, finish options.

For exterior applications, look to railing and gate suppliers; they carry a variety of primers, paints, dyes, and patinas to give your project a one-of-a-kind look and withstand the constant exposure to natural elements. If the product will be near open flames, make sure to buy paint specifically for such purposes (like the square fire pit on page 186).

Never to be underestimated, bare metal creates intriguing looks just by using sanding, grinding, and heating techniques. One example of this is shown on the tapered-leg table on this page. The effect was achieved with an angle grinder that was used in a circular motion until the desired texture was achieved. It is time-consuming work that requires a little muscle action, but the finished look is unmatched.

There are a number of ways to create an antique or aged painted finish. One is to paint the surface with three or four layers of different paint colors, allowing each layer to dry thoroughly between coats. When the final coat is dry, sand off corners and high spots to reveal the paint layers. Another method is to apply one color layer and allow it to dry completely. Then apply a second layer and third layer without allowing drying time. Use a damp sponge to wipe off layers at corners and high spots (see photo page 38, top). To create a crackly, “alligatored” look, purchase crackle base and crackle top coat, either as a spray paint or brush on paint. Apply the two coats as directed to create the crackle effect (see photo page 38, middle).

One method for creating an antique finish is to apply two wet top coats of different colors to a dry base coat of a third color. Before the top coats dry, wipe the top coats off in selected areas with a wet sponge.

There are many possibilities for finishing metal. Pictured here, from left to right: brush-on crackle finish, spray- painted stone, spray-painted hammered metal, and a swirl pattern created with an angle grinder.

An angle grinder works well for beveling edges on thick material. Grinding down welds gives projects a finished look.

Use an angle grinder in a circular motion to achieve a shiny textured effect. On thin material, as shown here, use small circles with light pressure.

Clean and then apply primer to prevent rust. Standard white is suitable if you intend to paint the finished project.

After the primer is completely dry, add the final top coat paint. This top coat should also be formulated for metal and/or exterior applications.

Oxyacetylene Welding

Oxyfuel welding is the process that uses the heat from a gas flame to melt base materials and cause them to join together. The gas flame is created by the combustion of oxygen and a fuel gas. Fuel gases are: acetylene, propane, butane, hydrogen, natural gas, and methyl acetylene-propadiene, (MPS, formerly known as MAPP gas). Oxygen and acetylene burn in a neutral flame at a temperature between 5600° and 6300°F, the hottest of any gas flame and capable of melting most metals. Other oxygen-fuel gas combinations are hot enough to use for soldering and brazing, but not hot enough for welding. Oxyfuel welding with acetylene is called oxyacetylene welding, but it is often simply referred to as gas welding.

The oxyacetylene process is versatile, as it can be used for both welding and cutting materials (see page 33) as well as heating, soldering, and brazing. It can be much less expensive than arc welding and is very portable because it needs no electrical power source. Oxyacetylene can be used to weld any thickness of metal, but sections over ¼" are difficult to weld. Unfortunately, the techniques of oxyacetylene welding can be very hard to master, and there are serious safety concerns with the extreme flammability of acetylene and the high-pressure gas cylinders.

Oxyacetylene welding equipment consists of an oxygen cylinder and an acetylene cylinder, each with regulators and gauges, oxygen hose, acetylene hose, torch, and tips.

Oxyacetylene welding may use fusion welding, where the base metals are melted together without filler material, or, more commonly, it may use a filler metal.

An oxyacetylene welding rig consists of two cylinders—oxygen and acetylene, regulators, hoses, and a torch with tip.

Safety

- Welding helmet or face shield with #5 filter
- Leather, wool, or cotton long pants, long sleeve shirt, and hat
- Leather gloves with gauntlet
- Leather boots or shoes
- Ventilation

The Equipment

Cylinders: Oxygen comes in high-pressure cylinders (sometimes called bottles or tanks) at 2200 pounds per square inch (psi) or more when full. The oxygen cylinder has a valve, and it always comes with a safety cap that screws on to the top to protect the valve. Never use the safety cap to lift an oxygen tank. The oxygen cylinder has a safety valve that will rupture to relieve tank pressure if the tank becomes overheated. Oxygen tanks should always be stored and transported in an upright position.

Acetylene: Acetylene is an extremely unstable gas. It cannot be pressurized above 15 psi in a free state. To safely pressurize the acetylene to 225 psi, the acetylene cylinder is filled with a porous material and acetone. When pressurized, the acetylene is absorbed by the acetone, which stabilizes it. When the pressure is released (the valve opened) the acetylene bubbles out of solution. Acetylene cylinders have fusible plugs that will melt in case of a fire and allow the gas to slowly escape rather than explode. Acetylene cylinders should always be stored in an upright position. Using an acetylene tank at an angle will allow acetone through the regulator and hoses, which will destroy them.

Cylinders should always be kept upright and secured with a chain or strap to prevent them from falling over. Never use a cylinder as a roller for moving heavy objects or for any purpose other than its intended use.

Cylinder valves: Each type of cylinder has a valve that controls the flow of gas from the cylinder. A handwheel or valve wrench is used to open the valve. The oxygen cylinder valve should always be opened fully, as it is a backseating valve. A backseating valve is leakproof when closed and fully opened, but not otherwise. The acetylene valve should never be opened more than ¾ to 1½ turns. Less than this may lead to insufficient amounts of fuel and backflash; more than this makes it difficult to turn the acetylene off quickly in case of an emergency. If the acetylene valve is opened all the way, or opened suddenly, the acetone may escape from the cylinder, just like an overflowing soda can. Acetone can destroy the hoses and regulator fittings.

Tools for oxyacetylene welding include fire bricks (A), pliers (B), striker (C), tip cleaner (D), and acetylene tank wrench (E).

Note
Never use oil or any other type of lubricant on regulators or other welding equipment. The combination of oil and oxygen in a spark-filled environment can lead to a fire in the regulator, which could cause a cylinder explosion.

Pressure regulators and gauges: Pressure regulators reduce the pressure of the gas leaving the cylinder. A single-stage regulator reduces the cylinder pressure to working pressure in one step. A two-stage regulator reduces the cylinder pressure to working pressure in two steps. A two- stage regulator is better because it gives more precise control over gas flow. but it is substantially more expensive. The regulator adjusting screw turns clockwise to increase pressure and counterclockwise to reduce pressure. The regulator is completely off when the adjusting screw is loose or “backed out.” Always back out adjusting screws as part of your post-welding routine.

Hoses: The flexible rubber hoses that move the gas from the regulator to the torch are designed to be leakproof and withstand high pressure. The oxygen hose is green, and the acetylene or fuel hose is red. Hoses are available either as a single hose or a dual hose where the oxygen and fuel hoses are paired together. The dual hoses are more common and more convenient. Always protect hoses from damage by moving them off the floor when not in use, keeping them behind the welding area so they are not burned with sparks, and keeping them out of traffic lanes so they are not stepped on or run over by vehicles. Hoses should not be allowed to come in contact with oily surfaces and should be protected from sunlight and chemical fumes to keep them in good condition. Always drain hoses when you have finished your welding session.

Fittings: Fittings connect the hoses to the regulator at one end and the torch at the other. For safety, the nut for the fuel hose (red hose) is left-hand threaded and has a groove machined around thte nut. The oxygen (green) hose nut is right-hand threaded and has no groove. Never interchange the oxygen and fuel hoses or fittings. Never force a fitting—brass is a very soft metal, and it is easy to damage the fitting threads. Always hand thread and hand tighten fittings before using a wrench, and be careful not to overtighten them. Never use pliers to tighten fittings, as they will damage the brass nuts.

Oxygen and acetylene hoses with flashback arrestors, torch body, and welding tip.

Oxygen and acetylene regulators

Available tips for an oxyacetylene torch body include cutting head, rosebud heating tip, and welding tip.

Check valves and flashback arrestors: Check valves and flashback arrestors are two safety features to prevent reverse gas flow or flashbacks. The check valve allows gas to flow from the hose to the torch. If gas pressure within the torch exceeds the hose pressure, a spring closes the valve to prevent backflow. In the event of a flashback, the check valve needs to be replaced. A flashback arrestor is installed between the torch and the hose, and offers more protection than the check valve. The flashback arrestor prevents burning oxygen and fuel from flashing back into the hoses and regulator, which could cause an explosion. The flashback arrestor consists of a check valve, pressure-sensitive valve, stainless steel filter, and heat sensitive check valve. In the event of a flashback, the flashback arrestor does not need to be replaced.

Torch: The torch mixes and controls the flow of the fuel gas and oxygen. The torch consists of valves, torch body, mixing chamber, and tips. The torch is sometimes referred to as a blowpipe, but this is not technically correct.

Tips: Tips attach to the torch body and come in many sizes to create different-size flames. A cutting tip, also called a cutting head or cutting torch, is attached to the torch body to use for flame cutting. A cutting tip has a number of holes for the preheating flames around a center hole for the pure oxygen. Cutting tips also come in a variety of sizes and with different numbers of preheating holes. Heating, or rosebud, tips are used to preheat metals to improve their weldability. Welding tips come in a wide range of sizes to match the thickness of the metal being welded. Matching the tip size to the welding material and gas pressure is critical for creating quality welds.

How to Set Up an Oxyacetylene Outfit

1 Secure the cylinders in an upright position, chained to a cart or strapped to a wall or post. Remove the protective cylinder caps. Wipe off the cylinder valve seats, regulator connections, and hose connections with a clean cloth. Crack open each cylinder valve briefly to expel any trapped dirt particles. “Flat top” acetylene cylinders (inset) may have antifreeze in the recessed valve seat. Use a clean rag to remove the liquid and dry the valve seat. This style acetylene cylinder requires a cylinder wrench to open the valve.

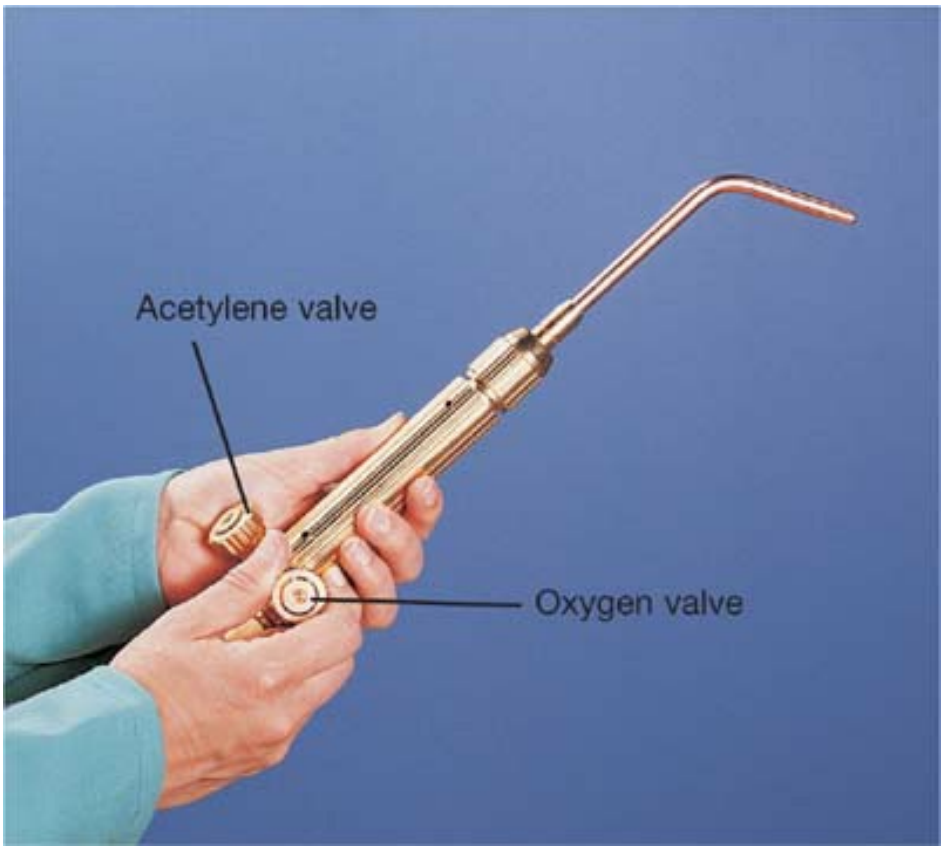
2 Attach the regulators to the cylinders. (The acetylene connectors have left-hand threads.) Always hand tighten, then use a fixed wrench, not a pliers or an adjustable wrench, to tighten. Do not overtighten—a firm seating is all that is necessary. Attach the hoses to the regulators. The acetylene hose is red and left-hand threaded. The oxygen hose is green. NEVER use grease, oil, or pipe dope to lubricate fittings. Grease and oil can ignite spontaneously when they come in contact with oxygen—even without a spark or flame present.

3 Turn the regulator adjustment screws on the oxygen and acetylene regulators counterclockwise until they are loose. (Some regulators have a knob.)

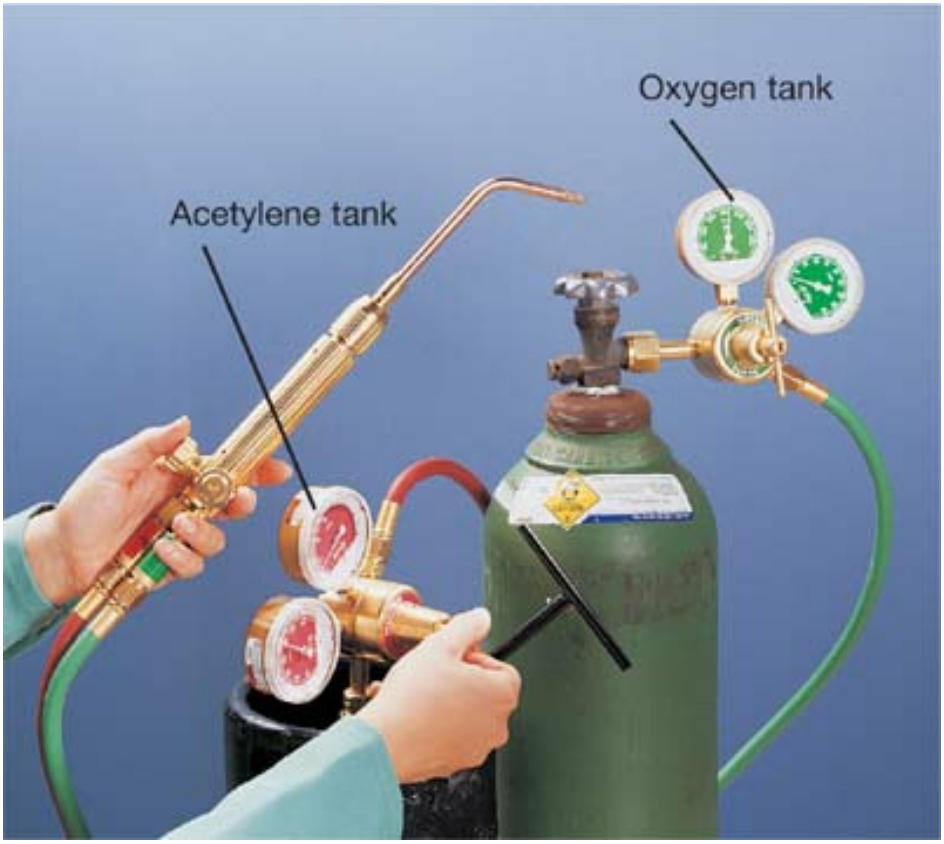
4 Open the oxygen valve slowly all the way while standing to the side in case the regulator gauge glass shatters. Turn the regulator adjustment screw until oxygen begins to flow through the hose, then loosen the regulator adjustment screw to stop the oxygen flow. Slowly turn the acetylene cylinder valve ¾ to 1½ turns.

5 Adjust the acetylene regulator valve until the gas begins to flow, then loosen the regulator adjustment screw to stop the flow. Attach the torch to the hoses. Be sure to pressurize the system and check for leaks before lighting.

How to Pressurize (Turn On) an Oxyacetylene Outfit



Make sure both torch valves are off. Turn both regulator adjustment screws counterclockwise until loose. Slowly turn the oxygen cylinder valve on. Once open, turn the valve all the way open to ensure proper seating without leaks. Turn the oxygen regulator adjustment screw clockwise until the gauge reads the desired pressure. (Refer to the manufacturer's specific instructions for operating pressures.) Open the oxygen valve on the torch to check the flowing oxygen pressure.



Adjust if necessary and close the torch valve. Slowly open the acetylene cylinder valve ¾ to 1½ turns. (Leave the wrench on the valve if it is a wrench-style valve.) Turn the acetylene regulator pressure adjustment screw until the desired pressure reads on the regulator gauge. Open the acetylene valve on the torch briefly to make sure the flowing pressure matches the desired working pressure. If not, adjust the regulator until the proper pressure is reached.

Checking for Leaks

Apply leak-detecting solution to all connections with a small brush. (You can use soap and water so long as the soap is not petroleum based.) If any connections cause bubbles in the solution, tighten the connections and check again.

Backfire & Flashback

Backfire and flashback are two hazardous situations that can be caused by improper gas pressures. Backfire is the pre-ignition of the acetylene and oxygen inside the tip that causes a popping sound. This may damage the tip or spray molten metal from the weld area. Flashback is the flame burning backward into the torch or hoses, causing a popping or squealing noise. Flashback can cause an explosion in the hoses. Avoid both hazards by matching the tip size to the material being welded and by using the proper pressure settings. Using lower pressures than recommended can cause backfire and possibly flashback.

Prelighting Checklist

- Make sure torch valves are closed.
- Turn both regulator adjustment screws counterclockwise until loose.
- Slowly turn on the oxygen cylinder valve all the way. Turn the regulator adjustment to the proper pressure.
- Slowly turn the acetylene cylinder valve ¾ to 1½ turns. Turn the regulator adjustment valve to the proper pressure.

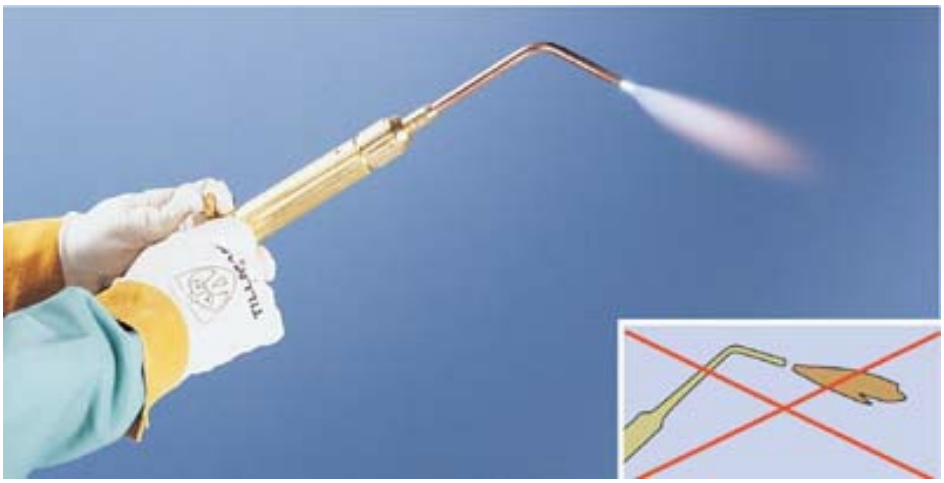
Some welders have been taught to open both the acetylene and oxygen valves before lighting the torch to avoid the smoky acetylene flame. This practice is no longer recommended.

NEVER light a torch with a match or butane lighter.

Lighting the Torch

1 Hold the torch in one hand with the thumb and forefinger on the acetylene torch valve. Hold the striker in front of the torch about 3 to 6" away at a slight angle. Turn on the acetylene torch valve ¼ to ½ turn. Immediately use the spark lighter to light the flame.

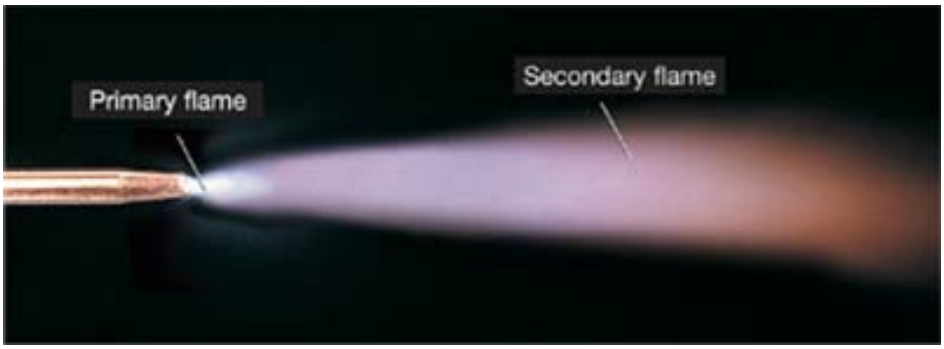
2 The flame will be yellow and smoky.



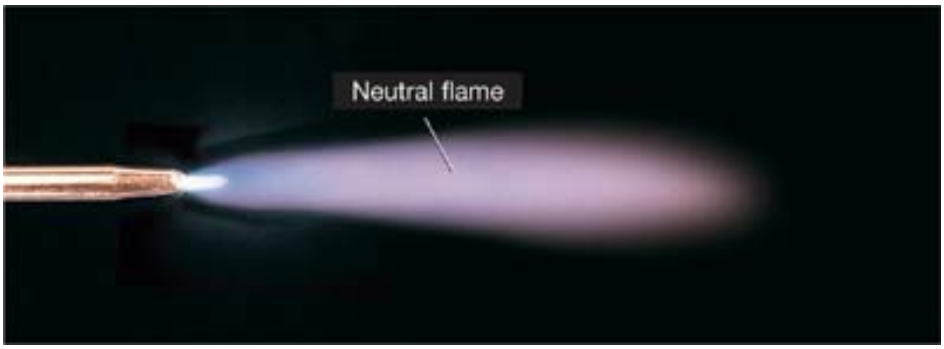
3 Put the striker down and adjust the acetylene torch valve with your right hand so the flame is burning without producing soot. The flame should not be separated from the torch (inset). Open the oxygen torch valve slowly. Adjust the oxygen to get a bright white inner flame and a bluish outer flame. Turn down the acetylene to eliminate the excess acetylene feather if present. When you have finished welding, turn off the oxygen first, then the acetylene.

Flame & Flame States

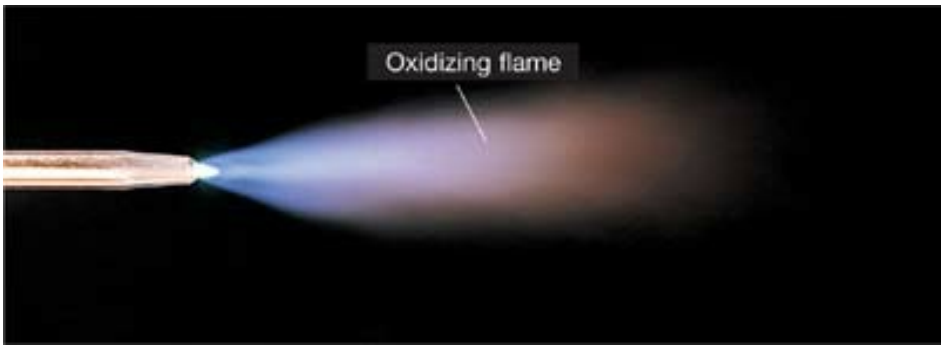
The flame of an oxyacetylene torch has two parts—the inner or primary flame and the outer or secondary flame. The flame has different temperatures at different locations. The outside edges are cooler because they are burning with the ambient air, which is only 21% oxygen. The torch tip is cooler because complete combustion hasn't been reached. The hottest area is the tip of the primary or inner flame cone. Here the gases are completely combusted and are insulated by the secondary flame. There are three flame states for the oxyacetylene flame: carburizing, neutral, and oxidizing.



The carburizing or reducing flame has an excess of fuel. This is a useful flame as it will break down metal oxides to get at the oxygen, thus cleaning the weld area to a small degree. This process adds carbon to welds, which makes them harder. The carburizing flame has a bright white primary flame, an acetylene “feather” around the primary flame, and a bluish white secondary flame with orange edging.



The neutral flame is the exact point where the feather and the inner cone come together. In this flame, there is exactly enough oxygen present to provide total combustion of the fuel gas. Most welding and cutting operations use a neutral flame. The neutral flame has a bright white primary flame and a colorless to bluish secondary flame.



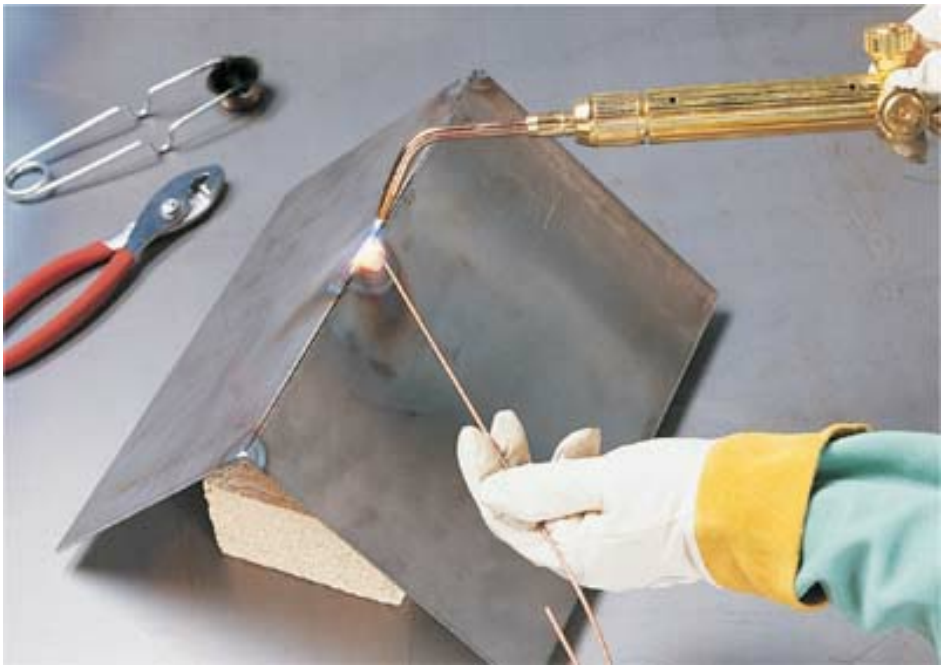
The oxidizing flame has an excess of oxygen. The white cone of this flame is small and pointed and somewhat paler than the neutral flame. A hissing sound often accompanies this flame. This flame is not particularly useful as it hastens oxidizing, which is not desirable in welding. It can, however, be used for removing carbon from molten metal, thus softening the metal.

Prewelding Checklist

- Check hoses for damage before pressurizing the system.
- Prepare metal for welding by wire brushing or sanding off mill scale and rust. Use acetone or denatured alcohol to remove oil or other chemical residues.
- Use fire bricks to avoid unnecessary heat loss and prevent welding to the welding table.
- See manufacturer's recommendations for appropriate tip sizes and gas pressures.
- Set up materials and clamp if necessary.

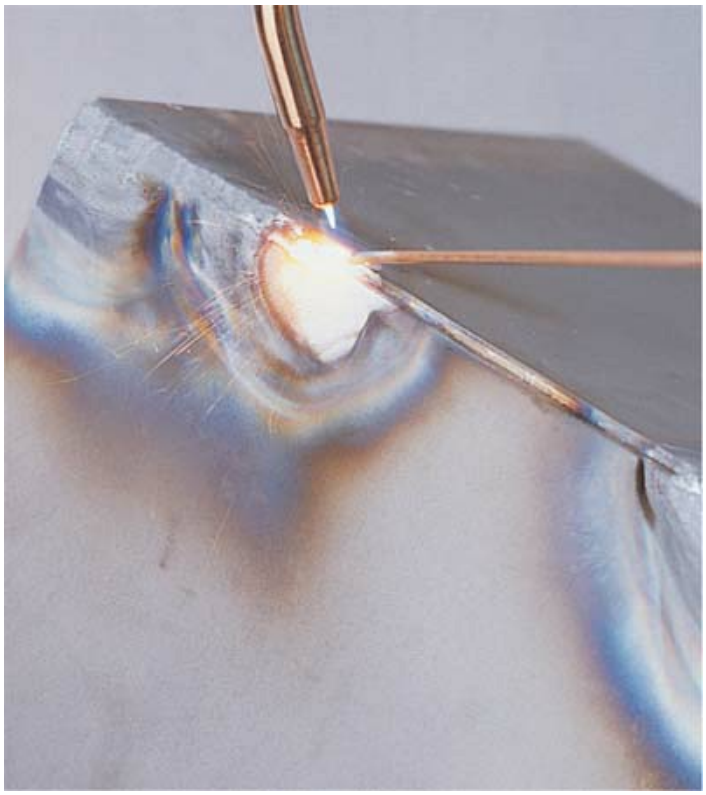
NOTE: The directions for oxy-acetylene welding are for right-handed welding. Reverse the directions for left-handed welding, or if you find it easier to manipulate the filler rod with your right hand.

How to Weld with Oxyacetylene



1 Select an appropriate filler rod and lay it on the table next to the bricks. Light the torch and adjust to a neutral flame. Pull down your face shield. Place small fusion tack welds at each end of the joint and in the middle if it is a long joint. (A fusion weld uses no filler rod.) Turn off the torch, oxygen first then acetylene, and check that your tacked piece is still in the desired position. If not, use a hammer to move it into position or break the tack weld and reposition.

2 With the torch at a 45° angle to the right and oscillating the torch in a ¼ to ½" circle over both metal pieces, create a weld puddle at the right end of your workpiece.



3 When a molten puddle has formed, move the filler rod close to the puddle and flame, but not in it. Begin moving slowly to the left while oscillating and maintaining the molten puddle. Dip the filler rod into the middle of the molten puddle and remove it, but keep it within the heat zone.

4 Continue dipping, oscillating, and moving to the left. As you reach the end of the weld, the cumulative heat buildup may make it necessary to adjust to a shallower angle to deflect heat away from the puddle and prevent burn through. When finished, turn off the oxygen torch valve first, then the acetylene torch valve. The weld should penetrate to the back without burning through.

Depressurizing an Oxyacetylene Outfit

When you have finished welding, or if you are going to stop welding for more than 10 or 15 minutes, depressurize your setup. The hoses and regulators are designed to leak small amounts of fuel and oxygen if they are pressurized and not being used, so it is important for safety and economy to depressurize them. You will soon be so comfortable with the pressurizing and depressurizing steps that it won't seem like an inconvenience at all. It is important to do the fuel gas and oxygen in separate steps, to prevent having mixed, unburned oxyacetylene in the torch.

- Close the fuel gas cylinder valve.
- Open the fuel gas torch valve until both gauges read zero.
- Loosen (counterclockwise) the fuel gas regulator adjustment screw.
- Close the fuel gas torch valve.
- Close the oxygen cylinder valve.
- Open the oxygen torch valve until both gauges read zero.
- Loosen (counterclockwise) the oxygen regulator adjustment screw.
- Close the oxygen torch valve.

Oxyfuel Tips

Gas Options:

The most useful fuel gas for oxyfuel welding is acetylene. Its neutral flame generates the highest heat and heat concentration with the lowest chemical interactions with the molten metal. Other fuel gases, such as MPS or MAPP and propylene can be used for brazing and cutting applications. Natural gas and propane can be used for brazing and heating operations. Make sure that the equipment—hoses, regulators, torches, and tips—are designed for use with the gas you choose.

GAS	DENSITY (AIR = 1)	TEMPERATURE OF NEUTRAL FLAME WITH OXYGEN
Acetylene	0.906	5589° F
Methylacetylene-propadiene (MPS)	1.48	5300° F
Natural gas	0.62	4600° F
Propane	1.52	4579° F
Propylene	1.48	5250° F

Fire Bricks:

Fire bricks are specially made bricks that have little water content so they will not explode when heated to high temperatures. Fire bricks do not pull the heat from your weld or braze, and you cannot weld your material to them.

Maintenance. The primary maintenance for oxyacetylene welding equipment is cleaning the torch tip. A dirty tip will spark, pop, and often direct the flame sideways. Tip cleaners are inexpensive sets of cleaning rods used to clean the various sized tip orifices (see photo, page 43). The set usually comes with a small file to smooth the tip. To clean, simply insert the correctly sized tip cleaning rod into the orifice, and pull back and forth. Do not rotate the tip cleaner as this may enlarge the orifice. Also, do not use drill bits to clean tips. The sharp edges of the bit will cut grooves into the tip. Cleaning rods have smoothed edges and are sized especially for tips. Do not clean tips while the torch is lit.

Brazing

Brazing is very similar to soldering since flux is applied to tightly fitted metal parts that are then heated to the point where filler material will melt and be drawn into the joint. Silver soldering and hard soldering are terms incorrectly used to refer to brazing. Brazing is different from soldering because it takes place at temperatures over 840°F and below the melting point of the base metals. The metals are not fused, but held together by the filler metal adhering to the base metals through capillary action.

There are a number of industrial brazing processes, such as dip brazing, furnace brazing, and induction brazing. The home welder is likely only to do torch brazing. Torch brazing can be done with an oxyfuel torch using acetylene as the fuel gas, or any of the other fuel gases (see page 49). NOTE: Different fuel gases require different regulators, hoses, torches, and tips.

For brazing to work, the gap between the parts must be between 0.002 and 0.010". If the gap is too tight, the flux and filler will not flow evenly through the joint. If the gap is too big, the strength of the joint is lessened. Gaps between parts can be measured with a feeler tool, available at automotive stores. Items to be brazed must be absolutely clean and free from rust, corrosion, grease, oil, and cleaning compound residues.

Brazing is often used commercially to join dissimilar metals such as tungsten carbide saw teeth to a steel saw blade. Another common use for brazing is in lugged bicycle frames. Because nearly every metal can be joined using brazing, it is highly suitable for art applications.

Brazing supplies include flux and silver solder (left). Braze welding requires flux-coated rods or separate flux and rods (sold individually or in bulk).

Thoroughly clean and flux both sides of the joint area. Using a small torch tip, heat the entire joint area until the flux turns clear and starts to run. Add enough filler metal to fill the joint. (Silver alloy is shown.) After the metal has cooled, the flux residue can be removed with hot water.

Braze Welding

Braze welding is similar to standard oxyacetylene gas welding except the parent or base metals are not melted, so there is no molten puddle. Instead of a steel alloy filler rod, a flux coated brass filler rod is used. Braze welding is often incorrectly referred to as brazing. Braze welding does not use capillary action to pull filler material into the joint —the filler metal is deposited as fillet or groove welds.

The brazing rod is melted by the heat of the metal and the flame, but it should not be held in the flame itself. The parts for braze welding should fit tightly, but the gap is not as important as with brazing.

Braze welding is used for joining dissimilar metals and for metals of different thicknesses. This technique is often used to repair cracked or broken cast iron.

Braze welding has less distortion than oxyacetylene welding because less heat is applied to the parts. A disadvantage is that it is not as strong as welding where the base metal is melted, but a well-made braze weld is still sufficient for most non-structural applications. Because the base metals do not need to be melted, braze welding can be done with any of the fuel gases listed on page 49.

If you are creating a piece that will be welded and braze welded, you must be careful to complete the non-brazed welds first. The heat involved with all other welding processes will boil off the brass alloy of a braze weld, ruining the weld and creating toxic fumes.

1 Braze welding is useful for joining thin metals, like this expanded metal, to thicker metals. Heat both parts, directing more heat toward the thicker part. It may take a long time for the thicker metal to heat. Using fire bricks will prevent a metal tabletop from absorbing any heat.

2 When both parts glow a dull cherry red, touch the flux coated rod to the joint. The flux and the filler metal will melt. If the metal is molten or the fluxed rod comes in contact with the flame, the flux will burn and the filler metal will boil. This results in a poor joint in addition to giving off toxic fumes.

Electricity For Welding

Arc welding and cutting processes—shielded metal arc, gas metal arc, gas tungsten arc welding, and plasma cutting—all use electricity to generate the necessary heat. Understanding electricity is not necessary to use these processes, but knowing basic terms and concepts will help you understand why certain welding events occur.

Electric current is the flow of electrons through a conductor from a high concentration of electrons (negative charge) to a low concentration of electrons (positive charge). As electricity flows through a conductor, it generates heat based on how much resistance the conductor offers. An arc is simply a sustained electrical discharge across an air gap. Because air is highly resistant to electron flow, an enormous amount of heat is generated by the movement of electrons across this gap. The heat generated by an arc is in the area of 11,000° F, but about half of this heat is dissipated.

Electrical units. The units used to refer to electricity are voltage, amperage, and wattage.

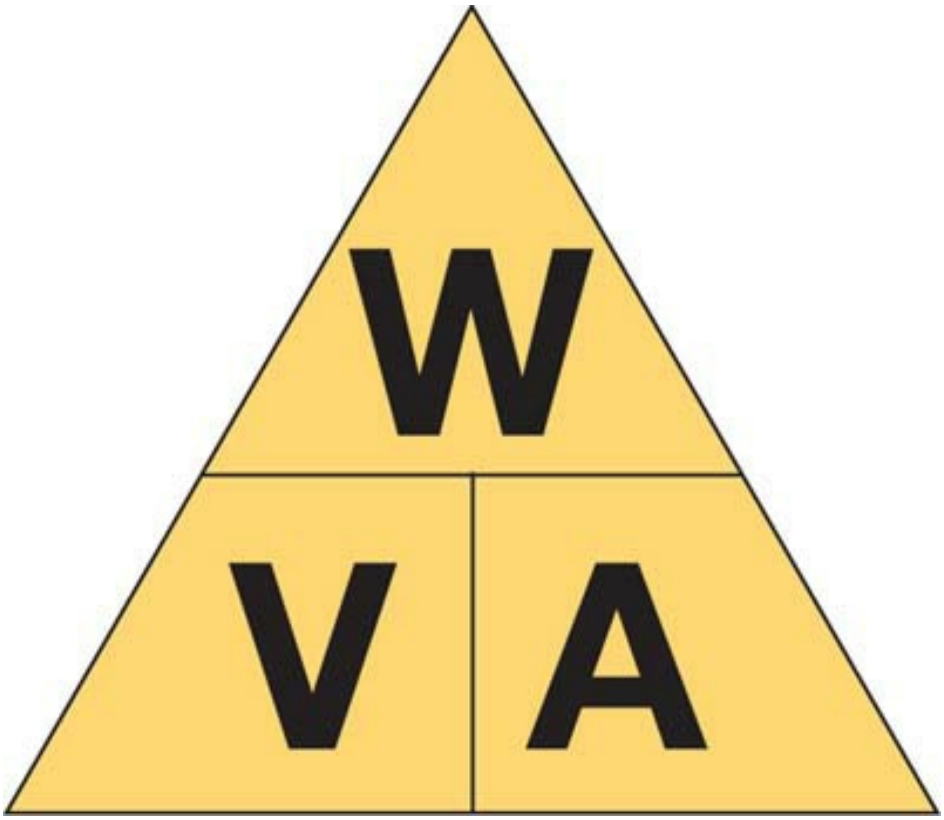
> **Voltage or volts (V)** is the measure of electric potential or the electric pressure. The voltage controls the size of the air gap that the arc can cross. The higher the voltage, the larger the gap the arc can cross.
>
> **Amperage or amps (A)** is the volume of electrons flowing through a conductor. The amperage controls the size of the arc.
>
> **Wattage or watts (W)** is the measurement of the amount of electrical energy or power contained in the arc. Wattage affects the width and depth of a weld.

Welding power. Power for welding may be supplied in one of the following ways:

> **Constant voltage (CV)**. The arc voltage is maintained even when the current (amps) changes. This means if the arc length is changed, which changes the current flow, the voltage stays relatively the same.
>
> **Constant current (CC)**. As the amperage fluctuates, the voltage increases or decreases to keep the total power (wattage) output the same.

Open circuit and operating voltage. The open circuit voltage is the voltage that exists at the electrode tip when the machine is on but no arc has been struck. The higher the open circuit voltage, the easier it is to strike an arc. Open circuit voltage is usually between 50 and 80 volts. The higher the voltage, the greater the risk of electrical shock.

The operating voltage is the voltage when the arc is struck and the circuit is completed. This is usually between 17 and 32 volts depending on the arc length, the type of electrode, the type of current, and the polarity.



Volts, amps, and watts are related to each other in such a way that volts × amps = watts.

Power sources for welding. There are three sources for producing the low-voltage high-amperage combination that arc welding needs.

A mechanical generator produces power through the use of a gasoline or diesel engine.

A step-down transformer takes available high-voltage alternating current and changes it to a low-voltage high-amperage current.

An inverter uses solid-state electronics to change the current without the weight of a transformer.

Currents used for welding. The type of current used and the polarity is important to welding.

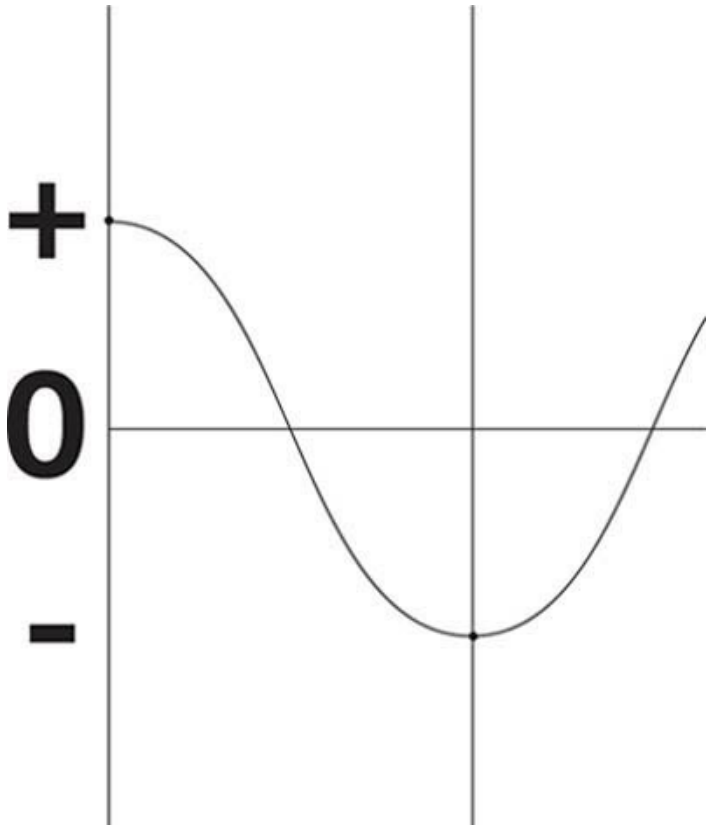
Alternating current (AC) is standard available household current. The electron flow changes direction two times per cycle. Welding with AC means that the electrode and the workpiece alternate between positive and negative, so the welding heat is distributed evenly to both. This balances penetration and buildup.

Direct current (DC) electrons flow in one direction only. A rectifier is used to convert alternating current to direct current. With direct current, there are two polarity options:

Direct current electrode negative (DCEN)— formerly called straight polarity—means the electrode is negative, the workpiece is positive; electrons are flowing from the electrode to the workpiece and the heat is concentrated in the electrode.

Direct current electrode positive (DCEP)— formerly called reverse polarity—means the electrode is positive, the workpiece is negative; the electrons are flowing from the workpiece to the electrode. DCEP produces the best welding arc characteristics.

Duty cycle. The duty cycle is the amount of continuous running time at a given power output for a welding machine, given as a percentage for a ten minute period. Because welding machines produce heat internally, they need a certain amount of cooling time. A 60% duty cycle means that a machine can run continously at that setting for six minutes, then it will need to cool for four minutes. Duty cycle is critical in construction and industrial applications, and it can be important for home shop use. A 10% duty cycle at the maximum setting means one minute of welding and nine minutes of cooling. This could be a problem for large projects on thick material. The higher the duty cycle, the more expensive the machine.



Alternating current alternates between positive and negative polarities, passing through a zero, or no current point, between the two.

Note
Work leads and work clamps are sometimes referred to as ground leads and ground clamps. This is not technically correct, as the electricity is not being grounded. Instead, the work lead and clamp are allowing for completion of the circuit back to the machine.

Shielded Metal Arc Welding (SMAW)

Shielded metal arc welding (SMAW) is also referred to as arc or stick welding. The process involves the heating of the base metal to fusion or welding temperature by an electric arc that is created between a covered metal electrode and the base metal. The coating or covering on the electrode provides both flux and shielding gas for the weld. The electrodes come in 9 to 15" straight lengths in a range of wire thicknesses from $^{1}/_{16}$ to $^{3}/_{8}$", hence the name “stick.” SMAW is used extensively for fabrication, construction, and repair work because the machinery is inexpensive and fairly simple, and the electrodes are inexpensive. There are drawbacks to SMAW: it doesn’t work well on thin materials (less than $^{1}/_{8}$" is difficult), electrodes need to be changed frequently as they are used up, and the protective slag coating must be chipped off each weld.

Safety: Shielded metal arc welding uses electricity, so there is always the possibility of receiving an electric shock or being electrocuted. When an electrode (stick) is placed into the electrode holder, it is “live." If the electrode touches anything that the work clamp is in contact with, the circuit will be completed and an arc will be struck. To prevent this from happening, always remove the electrode from the holder when you are not actively welding. Do not use your bare hands to insert or remove electrodes—always touch electrodes with dry gloves. Remember that water and electricity never mix well, so do not weld while standing on a wet or damp floor or ground, and do not weld outdoors in the rain. The electrode will be hot after use, so take care where you dispose of electrode stubs. A metal bucket is a good addition to your SMAW workshop.

SMAW welding produces ultraviolet and infrared rays, harmful fumes, and hot spatter. Protect your eyes with a #10 to #14 filter in a full-face welding helmet or hood. Heavy-duty leather welding gloves and a welding jacket with leather sleeves are necessary to protect you from the molten spatter. Proper ventilation from an exhaust hood or fan is important since many of the chemicals used in the electrode coatings are hazardous if inhaled. Also, it is a good idea to screen off your welding area so others are protected from the intense light of the arc.

A shielded metal arc welder consists of a power source, electrode holder, and work clamp.

Equipment: SMAW machines are available as either alternating current (AC) or direct current (DC), or with the capability of switching between the two. The machine itself is simple in that it merely converts high-voltage low-amperage line current into low-voltage high-amperage welding current. Output is controlled with one knob. You often will hear SMAW machines referred to as “buzz boxes.”

AC welding machines meet most home and small shop needs, are inexpensive, and are readily available. Because the alternating current cycles through a zero current between the positive and negative polarities, it can be difficult to strike and maintain an arc. DC machines are easier to use and have many home and hobby applications, but they are more expensive. Because DC current can have its flow reversed (see page 53), a DC machine has more versatility in terms of the electrodes that can be used. This allows for a wider range of welding positions, metal thicknesses, and metal types that can be welded. This versatility makes a DC shielded metal arc welder well worth the extra expense.

The equipment itself consists of the welding machine, which usually has one adjustment knob, an electrode lead with electrode holder (sometimes called a stinger), and a work lead with work clamp. You will often see work leads and work clamps referred to as ground leads and ground clamps. The work lead and clamp are not grounding the electricity, they are completing the circuit back to the machine.

Safety

- Welding helmet with #10 to #14 filter
- Leather, wool, or cotton long pants; leather jacket
- Heavy-duty welding gloves
- Safety glasses
- Hat
- Leather boots or shoes
- Ventilation

Useful tools for shielded metal arc welding are a pliers, chipping hammer, and wire brush.

SMAW electrodes: SMAW electrodes are solid, round, metal wires coated with flux and other components. In addition to producing shielding gas and flux, the covering may also contain additional metals for filler or alloying elements for the weld.

The American Welding Society (AWS) publishes standards for the electrodes. Electrodes come in diameters ranging from $^{1}/_{16}$ to $^{3}/_{8}$" in increments of $^{1}/_{32}$". The electrode diameter measures the wire itself, not the diameter of the wire with the covering. The electrode designation is inked onto the covering near the bare end of the electrode. The number classification for SMAW electrodes begins with the letter E because they are electrodes. The first two or three numbers on the left denote the tensile strength of the properly completed weld in thousands of pounds per square inch. The second number from the right indicates the welding position appropriate for that electrode: 1 = all, 2 = flat grooves and flat or horizontal fillet weld, 3 = flat only, 4 = all. The last two numbers designate the current and polarity uses and other special notes. There also may be electrode suffixes that denote alloys that have been added to the electrode.

Each electrode manufacturer may have a number of electrodes of a specific AWS designation that are slightly different and have been tailored to specific uses. The diameter of the electrode will determine which amperage to use. Use the manufacturer's guidelines to determine amperage. If not available, start with 90 to 120 amps minimum range for a $^{1}/_{8}$" electrode and add 40 amps for each $^{1}/_{32}$" increase in diameter. This will give you a rough minimum starting amperage.

The most commonly used electrodes are 6011, 6013, 7014, and 7018. The 6011 and 6013 electrodes will work with AC power, the 7000 electrodes will not. For a beginner, 6013 with DC power is generally the easiest electrode to use in terms of striking an arc and maintaining a consistent arc. It is always a good idea to talk with your welding supplies dealer about what type of welder you are using, the type of welds you are making, and the materials you are working on to get the best electrode for your purposes.

Slag: Shielded metal arc welding produces a weld that is covered with a coating of ceramic-like slag. The flux and other components in the covering clean the material to be welded and also float out impurities in the weld. These impurities and flux solidify on top of the weld, which protects the cooling weld from the effects of oxygen in the atmosphere. The slag must be scraped or chipped away before the weld bead is covered with another weld layer or before the weld is painted or finished. Safety glasses should be worn during this procedure.

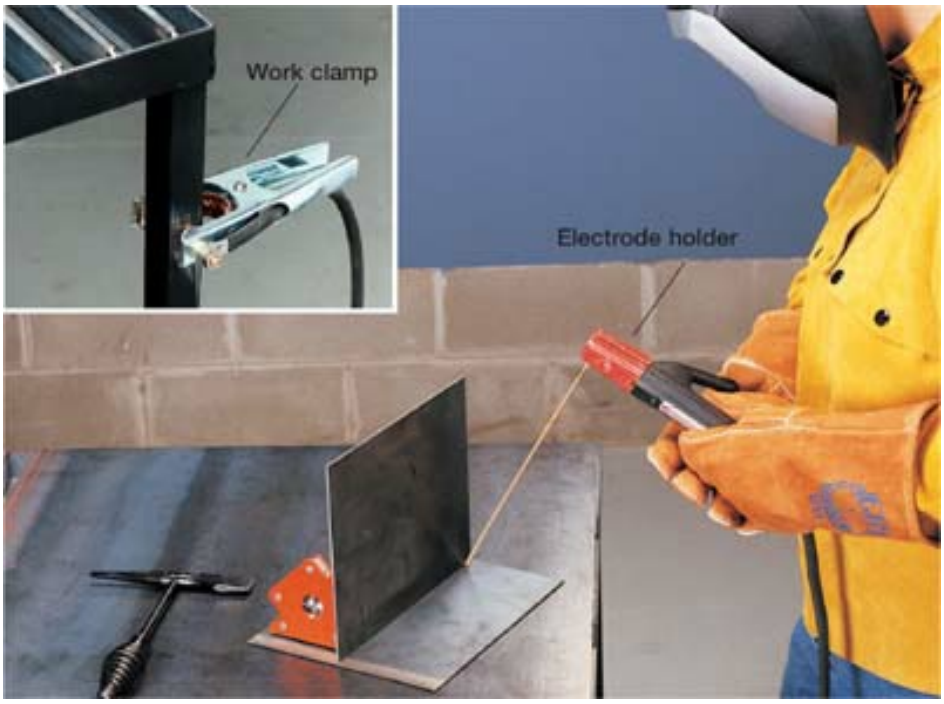
SMAW electrodes are sold in 5- or 10-pound boxes. Specialty electrodes may be bought a pound at a time. It is important to keep electrodes dry either in the original box or a storage container.

Electrodes for SMAW are stamped with a numeric code so you can tell which to use with arc power and which are for DC.

Prewelding Checklist

- Electrode and work leads are tightly attached to machine terminals.
- Cable insulation is free of cuts, damage, and wear.
- Electrode lead is tightly connected to electrode holder.
- Work lead is tightly connected to clamp.
- Work clamp is firmly clamped to worktable or workpiece.
- Floor is dry.
- Ventilation is adequate to draw fumes away from welder’s face.

How to Weld with Shielded Metal Arc



1 Set up your material to be welded. Make sure the electrode holder is not touching the workpiece or worktable. Attach the work clamp to the table (inset) or workpiece. Turn on the machine. Adjust the range switch for the desired amperage. Wearing leather gloves, place an electrode in the electrode holder. Position the electrode over the area to be tacked, flip down your helmet, and tap or scratch the electrode on the area to be tacked to strike an arc. After making your tack welds, remove the electrode from the electrode holder. Check to see that the tacked pieces are aligned properly. If not, use a hammer to move them into alignment or break the tack welds and retack. Chip slag from tack welds so it does not contaminate the final weld.

2 Replace the electrode in the electrode holder, and position the electrode over the left side of the area to be welded. Hold the electrode at a 10 to 20° angle to the right. Flip down your hood and scratch or tap to strike an arc. The distance between the metal and electrode should not exceed the thickness of the electrode bare wire diameter. Move slowly to the right until the weld is completed.

3 To remove slag, hold the workpiece with pliers at an angle and scrape or knock the slag with the flat blade of the chipping hammer. Wear safety glasses when chipping slag.

Gas Metal Arc Welding (GMAW/MIG)

Gas metal arc welding (GMAW), also referred to as MIG (metal inert gas) or wire feed, is a process where a consumable electrode (wire) is automatically fed through a welding gun along with a continuous flow of a shielding gas. The actual application of filler metal is achieved with most small machines through the short circuit transfer method. Other transfer methods used by more powerful machines are short circuit globular and spray pulse.

The GMAW process has a number of advantages. The gun or torch can be held at a uniform distance from the weld, unlike shielded metal arc welding where the distance from the electrode holder to the weld becomes shorter as the electrode is consumed. The trigger power control on the welding gun also makes it possible to be completely positioned and ready to weld without accidentally striking an arc. When ready to weld, the welder can flip down the helmet and pull the trigger without getting off target. Because the electrode is the filler, the welder does not need to coordinate a filler rod in one hand and the torch in the other. The GMAW gun can be held steady with both hands to create a uniform bead. Because of the shielding gas, GMAW welds are smooth and clean, with no slag to chip or grind. The GMAW process can operate at very low amperages and is a relatively cool welding process, so 22- and 24-gauge sheet metals can be welded without distortion. The process also requires narrower beveling for thicker plate welds, so less time is spent on grinding.

Some disadvantages of GMAW are that the shielding gas nozzle does not allow for welding in tight spaces without some modifications. Because the shielding gas can be disrupted or blown away by drafts easily, the process is not suited for working outdoors.

A gas metal arc welding setup consists of a power source, wire feed (inside power source), work cable with clamp, supply cable with gun, and gas cylinder with regulator.

Safety
• Welding helmet with #11 to #12 filter • Leather, wool, or cotton long pants, long sleeve shirt, and hat • Leather gloves with gauntlet • Leather boots or shoes • Ventilation

The Equipment

Power supply: In the small GMAW units, the power supply and wire feed are integrated into the same cabinet. In larger multipurpose machines, the wire feed is a separate unit. The power supply converts the standard alternating current (AC) into direct current (DC). Alternating current is not appropriate for gas metal arc welding because its constantly switching flow does not yield a steady, consistent arc. On the machine, you will be able to adjust the voltage, polarity, and wire feed rate; the machine adjusts the amperage. When using the power source to weld with a shielding gas, the machine should generally be set up for electrode positive, that is, the electrode is positive and the workpiece is negative. If used without shielding gas and with flux cored wire, the polarity usually needs to be switched to electrode negative. This is achieved by switching the contact wires within the machine. Larger multipurpose machines may have a switch to change the polarity. Always check manufacturer's recommendations for polarity settings.

Wire feed: The wire feed consists of a spool of wire, a tension controller, and rollers and a roller motor. The wire speed is set by the speed adjustment knob, depending on the thickness of the material being welded. The rollers have V or U grooves sized to match particular wires. Most machines come with two-sided rollers that can be switched over to handle two different size wires.

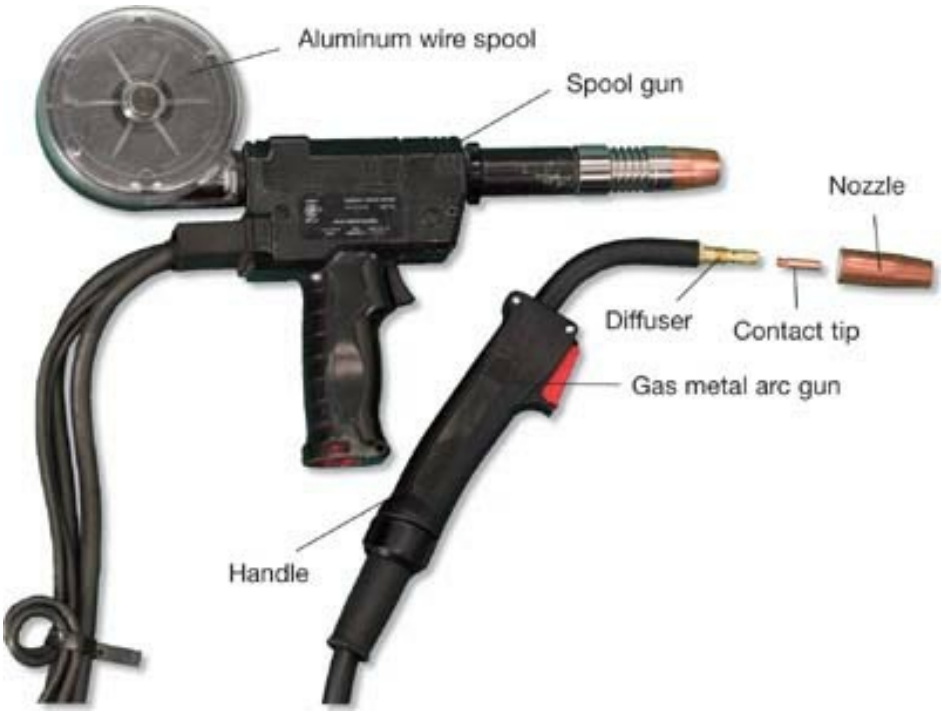
Gun: The GMAW gun, sometimes referred to as a torch, is attached to the welding machine via the supply cable. The cable carries the power, the power control, the wire in a special liner, and the shielding gas. The gun has a trigger that turns the power on and off, which also starts the wire feed and the shielding gas flow. The gun generally has a goose neck shape, although straight neck and flexible neck guns are available. A contact tip is screwed or cam locked into the gun. This tip has an orifice the same size as the wire being used. It is important that this be sized correctly—too large and good electrical contact between the source and the electrode will not be made, too small and the wire will not fit. The shielding gas is directed toward the work area with a nozzle. On most home versions, the relationship between the contact tip and the gas nozzle stickout is not adjustable; larger welders have a wider variety of nozzle sizes and shapes. It may be worthwhile to purchase an aftermarket adjustable system. When using the GMAW process, it is important that the supply cable be kept as straight as possible to prevent kinking the wire or impeding the gas flow.

MIG pliers is a handy tool for gas metal arc welding. It is designed for hammering, wire cutting, insulation brushing removal and installation, and drawing out wire. It is also ideal for removing spatter from inside, outside, and the nozzle end.

The wire feeding mechanism consists of a spindle to hold the wire spool, drive wheels, rollers, and a tension adjustment. Most welders now have a reference chart with recommended settings.

Most home GMAW welders use 1-pound or 10-pound wire spools. Larger spools are generally more economical.

Work cable with clamps: This is clamped to the workpiece or to a metal work surface that the piece sits on to complete the circuit.



A spool gun is used for feeding aluminum wire because it often breaks or misfeeds through a standard cable. A standard gas metal arc gun consists of a handle, gas diffuser, contact tip, and nozzle.

Electrodes: When choosing an electrode (wire), consider the composition properties, cleanliness of the base metal, and the shielding gas. If you will be welding out of position, this will also be a factor. There are dozens of wire choices for GMAW.

Electrodes are labeled with alphanumeric codes that describe their type, tensile strength of the weld, whether it is solid or tubular (tubular is flux cored), and chemical composition. For mild steel, ER70S-3 is a good general-purpose wire. ER70S-4 and ER70S-6 are good wires for dirty or rusty metals. Wire also is available for welding aluminum and stainless steel. Available wire sizes are 0.024, 0.030, 0.035, and 0.045".

Using a wire feed machine without shielding gas requires the use of flux cored wire (often called innershield), and the process is then called flux cored arc welding (FCAW). Because the wire makes the electrical contact as it travels through the contact tip, the flux must be inside the wire, which makes flux cored wire more expensive than regular GMAW wire. Commercial welders may use a “dual shield” flux cored wire that does use a shielding gas. Welds made with this process are as clean as regular GMAW welds.

Flux cored arc welding can be done outdoors because there is no shielding gas to be disturbed by wind and weather. Unfortunately, using flux cored wire results in a less attractive weld due to the presence of slag and more spatter. The flux cored wire usually has greater penetration and is often used to stretch the capabilities of a small welding machine. Because 0.035" is the smallest diameter for flux cored wire, it is not appropriate for welding thin sheet metal. The lowest setting for this size wire is still too hot for this application.

Shielding gas: The shielding gas for GMAW is supplied by a cylinder with a flow regulator and connecting hoses. The gas line is connected to the welding machine, which directs it through the cable.

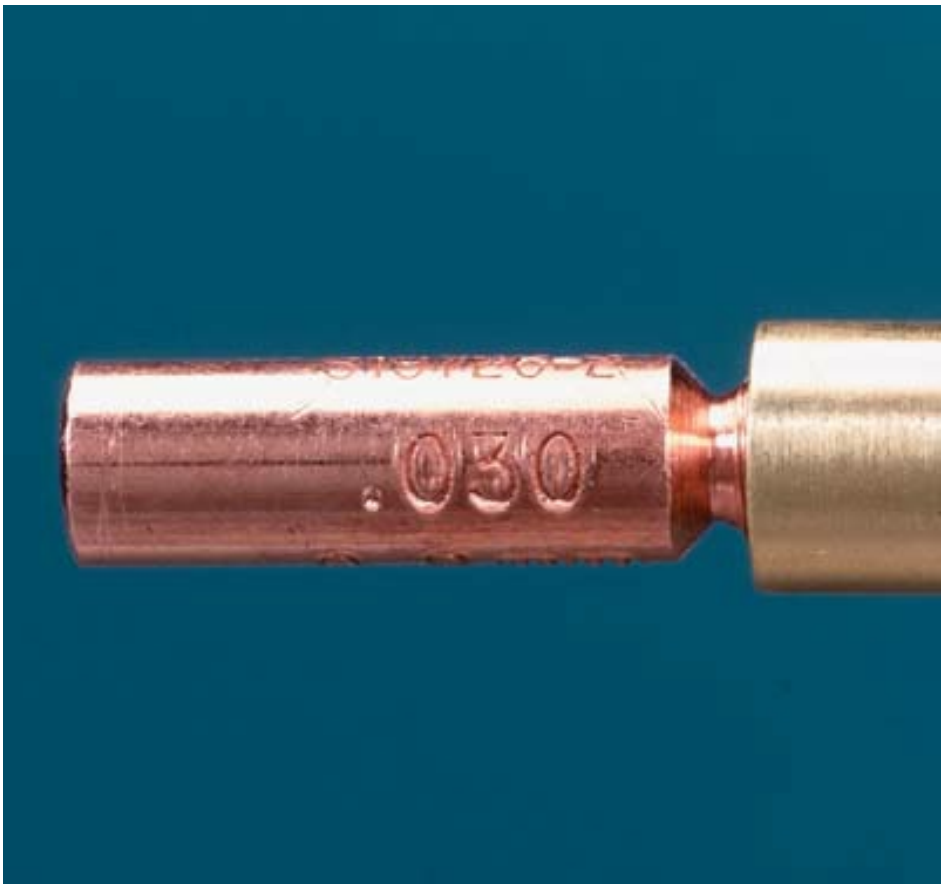
Carbon dioxide is suitable for general GMAW welding. It gives good penetration and is inexpensive compared to other gases. Argon and carbon dioxide in a 75% argon and 25% carbon dioxide mix is the standard GMAW shielding gas. It is slightly more expensive than pure carbon dioxide, but it yields welds with less spatter. Pure argon is used for shielding aluminum welds. If you choose to use pure carbon dioxide, select an electrode that performs well with this shielding gas.

Gas cylinder safety: Gas cylinders store compressed gases at pressures up to and greater than 2000 psi. This is sufficient pressure to send a tank through a concrete wall if the cylinder valve should be damaged. It is important to be extremely careful with gas cylinders even when they hold the non-flammable gases used in GMAW welding. Gas cylinders should always be upright and chained or strapped to a wall, post, or cart. Never drag a cylinder; never lay one down or roll it flat. To move a cylinder, chain it to a

handcart first. If you must move a cylinder without a handcart, tip it slightly and roll it. Never weld anything to the cylinder or safety cap—and be careful never to accidentally strike an arc against a cylinder. If you do, you will have to purchase that cylinder.

A flow meter registers gas flow with a small floating ball.

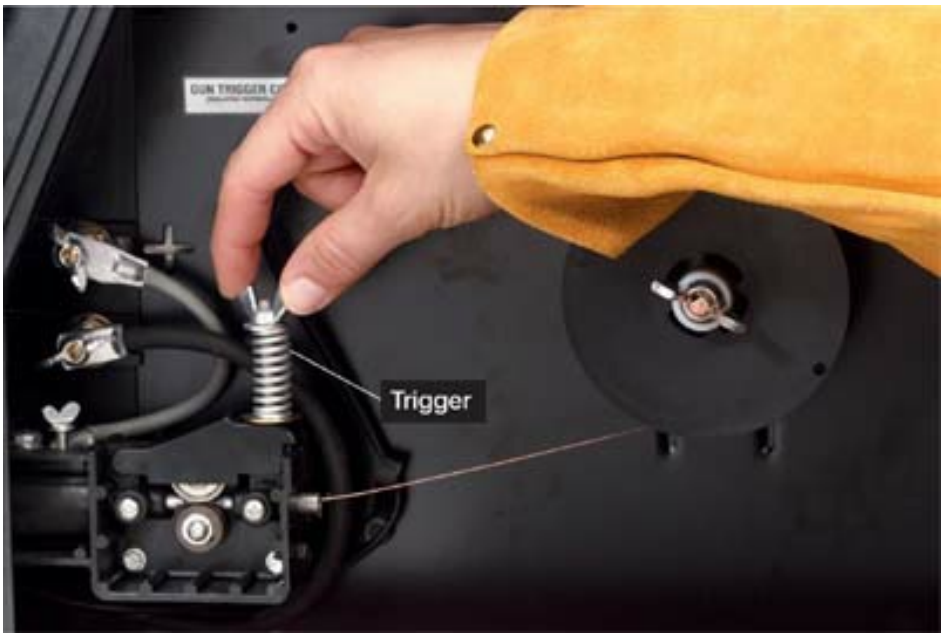
How to Set Up the Wire Feed



1 Contact tubes are stamped with their size. Make sure the contact tube and the drive roll grooves are the correct size for the electrode you are using. Place the wire spool on the spindle, and secure it with the pin lock, lock ring, or wing nut. Make sure it is feeding in the proper direction.

Note
Unless your machine has an inch switch for advancing wire or a purge switch for activating gas flow, you will use the gun trigger to accomplish both tasks. Using the gun trigger means the wire is “live” and will arc to anything the work clamp is touching.

2 After releasing and cutting off the crimped wire end, hold the wire firmly with a pliers. The wire is tensioned and the entire spool will rapidly unroll if you do not hold it firmly. Swing the tension arm or pressure roll out of the way. Push the wire through the inlet wire guide, through the groove on the drive roll, and out through the outlet wire guide.



3 Swing the tension arm or pressure roll back into position. Adjust tension according to manufacturer's directions. On a new machine, the drive roll pressure will already be set. Make sure the wire is aligned perfectly straight—not up and down or side to side—on the drive roll. Turn the machine on, turn the wire speed to its highest setting, pull the cable straight, and depress the trigger (shown). Some machines have an inch button that feeds the wire without supplying power to the contact tip or wasting shielding gas while loading wire.

How to Set Up the Shielding Gas Flow Meter

1 Open the cylinder valve briefly to clear out any dirt. Wipe the cylinder threads with a clean, dry cloth.

2 Attach the flow meter to the cylinder. Use a fixed wrench to prevent damaging the brass fittings.

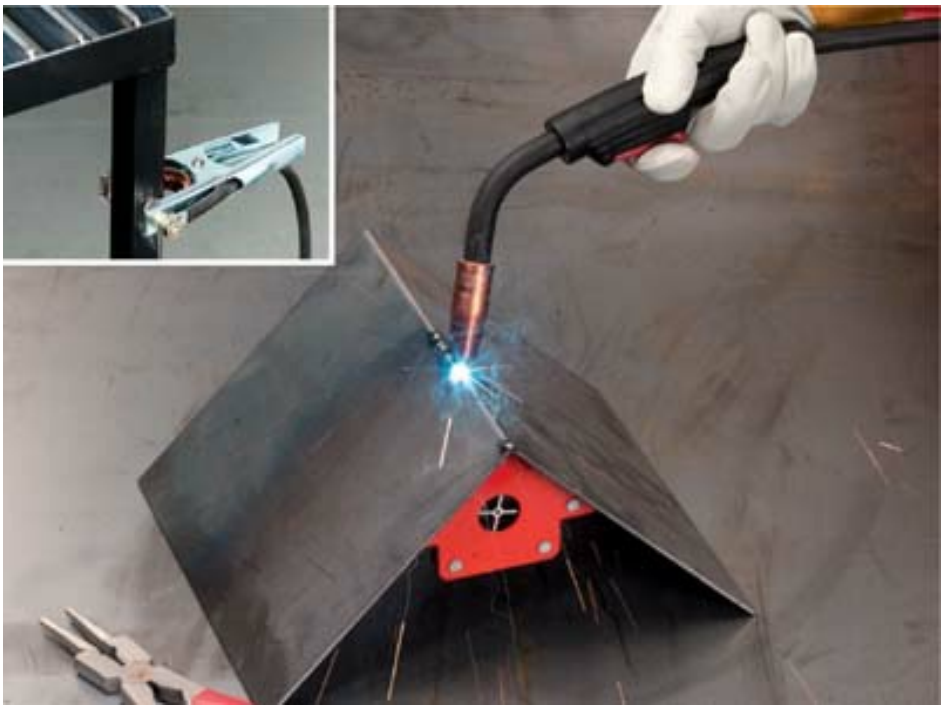
3 Turn the knob on the flow meter clockwise to tighten it so no gas can flow through it. If the flow meter is open when you open the cylinder valve, the high pressure can damage the flow meter.

4 Attach the hose to the flow meter and to the welding machine. Slowly open the cylinder valve, then, once it is open, open the cylinder valve completely. To set the flow rate, turn on the machine. Depress the trigger to activate the gas flow, and turn the flow meter knob counterclockwise. While gas is flowing, continue turning the knob until the meter registers the proper flow rate. Make sure that the flow meter or flow gauge is rated for use with the shielding gas you are using. For example, an argon/carbon dioxide flow meter cannot handle pure carbon dioxide.

Prewelding Checklist

- Gun, shielding gas, and machine cables, hoses, and connectors are tight.
- Polarity is set correctly for type of wire being used.
- Cables are in good condition.
- Supply cable is straight and unkinked.
- Gas regulator and flow meter are correctly installed.
- Contact tube is in good condition.
- Spatter has been cleaned from nozzle and contact tube (see page 66).

How to Weld with Gas Metal Arc



1 Prepare and fit up the material to be welded. Attach the work cable clamp to your welding table (inset) or the workpiece. Turn on the machine and shielding gas. Adjust the wire speed and voltage according to the manufacturer's recommendations. Cut the electrode to 3/8" stickout. Put the tip of the electrode at the point of the first tack weld, flip down your helmet, and pull the trigger. Place tack welds evenly around the weld area. Trim the electrode for proper stickout at the end of each use. Check to see that the workpiece is still aligned properly. If not, adjust with a hammer or break the tack welds and retack.

2 Start at the left end of the weld. Hold the gun with both hands and position it at a 20° angle with the tip pointing to the left. Put the tip of the electrode at the beginning of the weld, flip down your helmet, and pull the trigger.

3 Begin welding, moving steadily to the right. GMAW has a distinctive sizzling sound. Popping and snapping indicate dirty material or an improper voltage or wire speed adjustment.

Postwelding Sequence

When you have finished welding with a GMAW rig, it is important to shut it down properly so you are set for your next welding session. If you do not turn off your shielding gas, you will lose much of it to bleed off even if you weld the next day.

- Close the gas cylinder valve.
- Press the gun trigger or purge switch until the flow meter or flow gauge reads zero.
- Turn off the flow meter.
- Turn off the machine.
- Coil the supply and work cables and store them off the floor.

4 A finished GMAW is smooth with even ripples or weave pattern, no slag, and little spatter.

Flux Cored Arc Welding

Flux cored arc welding uses the same wire feed and power supply as gas metal arc welding but usually without the gas shielding. This is convenient for welding outdoors in windy conditions, but the weld is not as clean. To use flux cored wires, most welding machines need to be converted. Usually this involves changing the output polarity and installing a gasless nozzle. It also might require installing proper drive rolls and a different cable liner. Otherwise, follow the same steps to weld with flux cored wire as with solid wire.

Flux cored wire welds are covered with a layer of slag.

Maintenance & Troubleshooting

A small amount of maintenance on your GMAW equipment will result in better, more consistent welds and longer-lasting equipment. Spatter—tiny pieces of the electrode or base metal that have sizzled off—builds up on the nozzle and the contact tip. Remove this spatter frequently as you weld so it does not interfere with gas flow or electrical conductivity. Turn off the machine, remove the nozzle, and use the closed point of the MIG pliers (page 59) to ream out the nozzle and file the end of the contact tip. An anti-spatter gel is available in which to dip the hot nozzle and contact tip. Anti-spatter spray can be used to coat the contact tip and the nozzle. This spray is also useful for coating your welding table to prevent spatter from sticking to your work surface. Eventually you will need to replace the nozzle, but regular maintenance and proper welding techniques will extend the life of a nozzle considerably.

Contact tubes become worn because they are a soft copper alloy and the electrode is steel. The electrode will wear through the contact tip, possibly making the electrical flow irregular. Contact tips should be visually inspected for wear on a regular basis. The orifice on a worn contact tip will appear oval instead of round. Tips generally are good for about eight hours of continuous welding use. NOTE: Always turn off the welder before changing the contact tip.

It is important to keep the welder fan motor and rectifier free of dirt and dust to prevent it from overheating. If your welder is stored in a dusty shop, or you use it infrequently, keep it covered. Use low pressure air to blow dust and dirt from these assemblies. Use a vacuum to remove dirt from the wire feed mechanism.

The supply cable needs to be cleaned occasionally as well. Check the manufacturer’s recommendations for frequency, but it's generally recommended to clean after you’ve used 50 pounds of flux cored wire or 300 pounds of solid wire. With the power off, remove the cable from the machine. Remove the gas nozzle and contact tip from the gun, lay out the cable straight, and use low-pressure air to blow into the gun end. (Using high-pressure air may create a dirt plug that will clog the cable permanently.)

Always store the supply and work cables and the gas hose off the floor and away from chemicals, hot sparks, and sunlight.

Stub Out, or Stubbing

“Stub out” is when the electrode welds to the base metal without melting or breaking off. This is caused by the voltage being too low, the wire feed being set too fast, or holding the gun too close to the work when starting. Correct the settings, grind off the stub outs, and restart the weld.

Stub out results in short sections of wire poking out of the weld.

Removing a Bird’s Nest

A bird’s nest is a tangle of wire in the wire drive mechanism. This happens when the wire drive rolls continue feeding wire but the cable is blocked, the outfeed tube is misaligned, the wire is stubbing out on the base metal, or the wire has been welded to the contact tip. The drive rolls are set to slip in these cases, but if the tension has been adjusted too tightly, they may continue to push wire.

To fix a bird’s nest, turn off the machine and cut the wire as it comes off the spool. Remember the wire is under tension, so you must hold the spool end, then tie it off through one of the spool holes. The tangled wire also may be storing tension, so it may fly out of the drive roll area. Release the tension arm or roller arm. Pull the wire out of the drive mechanism and the supply cable. Wear safety glasses when removing a bird’s nest.

Use dippable anti-spatter gel to prevent spatter buildup on the nozzle and contact tip. Simply dip the hot nozzle into the gel.

GMAW Troubleshooting

PROBLEM	SOLUTION
Wire feeds, but no arc can be struck	• Check to see that the work clamp is connected
Weld bead is full of holes like a sponge (porosity)	• Make sure the shielding gas is on • Adjust shielding gas to a higher flow rate • Eliminate drafts • Verify correct polarity
Weld bead is tall and looks like a rope	• Make sure the voltage setting is appropriate for the material's thickness • Reduce your travel speed
Excessive spatter or dirty welds	• Reduce the gun angle • Hold the nozzle closer to the work • Decrease the voltage
Arc starts and stops	• Check the wire feed for steady feeding • Check the cable connections • Clean the weld materials

Gas Tungsten Arc Welding (GTAW/TIG)

Gas tungsten arc welding (GTAW), commonly called TIG (tungsten inert gas), and sometimes referred to as Heliarc (the L-TECH trade name), is a process that generates an arc between a non-consumable tungsten electrode and the workpiece. The electrode and the weld are protected by a shielding gas, and filler metal may or may not be used.

Gas tungsten arc welding differs from the other arc welding processes because the electrode is non-consumable and not used as filler material. GTAW is more like oxyfuel welding in terms of the skills needed to manipulate the torch with one hand and the filler rod with the other. GTAW requires another layer of coordination because most machines also use a foot activated amperage control.

Like gas metal arc welding, gas tungsten arc welding is a clean process be cause the shielding gas eliminates the need for flux and the resultant slag.

Safety: Because gas tungsten arc welding is such a clean process, welders often are tempted to weld without gloves or in short-sleeve shirts. This is not recommended. The arc most likely produces more ultraviolet rays than other processes, and because there are no fumes or smoke, those rays are entirely unfiltered. It is important to cover all exposed skin to prevent UV burns. Filter requirements are a minimum #10 shade, and if you have an auto-darkening hood, be sure that it is rated for the GTAW process. Some entry level auto-darkening hoods are not. The arc may produce ozone, which is hazardous to breathe over long periods. Make sure your gloves, clothes, and work area are dry. Always turn off the power when changing electrodes.

Equipment: The basic equipment needed for GTAW is a constant current welding machine, cable with torch, work cable and clamp, electrode, and inert gas cylinder with regulator and flow meter. Optional equipment includes a remote amperage control and a water-cooled torch with water cooler and hoses.

A gas tungsten arc welding setup consists of a power source, work cable and clamp, supply cable and torch, foot control, and gas cylinder with regulator.

Although a mid-range shielded metal arc machine can be used to deliver the current for gas tungsten arc welding, a dedicated good-quality GTAW machine delivers the current as AC or DC, provides an optional high-frequency output for no-touch arc starting, has a remote control option for foot pedal control, and has a solenoid for shielding gas control. The combination of AC and high frequency makes it possible to weld aluminum with good results. The newest electronic GTAW machines have advanced current control capabilities and are becoming more and more affordable.

Torch and cables: The GTAW torch holds the electrode and delivers the shielding gas. It can be air or water cooled. The torch parts are the cup or nozzle, collet body, collet, end cap, and torch body. The collet and collet body hold the electrode firmly and establish electrical contact with the electrode. The cup directs the shielding gas. A torch may be air cooled for use below 200 amps, but over 200 amps the torch usually is water cooled. The supply cable supplies electricity, shielding gas, and coolant to the torch. This may be an integrated cable or individual cables. A work cable with clamp is also necessary.

Some GTAW torches have flexible necks, which allows them to be bent into the most convenient angle for supporting the torch. Unfortunately, the non-flexible torches will bend if forced, and then they will be ruined. Some torches also have a gas on/off valve. This is necessary for machines that are simply power sources with no internal gas flow controls.

Safety
• Welding helmet with #10 to #14 filter • Long pants, long- sleeve shirt, and hat • Leather gloves • Leather boots or shoes • Ventilation

Pliers and a stainless steel wire brush are handy for gas tungsten arc welding.

The collet body, collet, end cap, and cups all come in a variety of sizes. The collet body and collet are sized to match electrode diameters. Each part is stamped with its size. The end caps come in a variety of lengths—some accommodate an entire 7" electrode, others are shorter for more clearance while welding.

Cups come in a variety of sizes denoted by $^{1}/_{16}$" increments. A #4 nozzle is $^{4}/_{16}$", a #8 is $^{8}/_{16}$". Cups should ideally be 4 to 6 times the size of the electrode. A cup that is too large will not direct the gas in a proper stream, a cup that is too small may not provide adequate steady flow. A gas lens or screen in the torch balances the gas flow. Good shielding designs allow you to use a lower gas flow. Higher flow creates turbulence and jetting, which disturbs the shielding—more does not equal better when it comes to shielding gas flow. Cups also are available in different lengths. A longer nozzle increases the electrode extension from the collet, which may increase the electrode temperature. Use either lower amperage or larger diameter electrodes if you are using a longer nozzle. Shorter nozzles may be necessary for tight working conditions. Nozzles are also available in clear (fused quartz) types, which are more expensive but give greater visibility, especially in cramped quarters.

Shielding gases. Two inert shielding gases are used for gas tungsten arc welding: argon and helium. They may be used alone or in combination with one another. Argon yields better starts and better arc maintenance. Helium gives a hotter arc and allows faster travel speeds. Helium, however, is very expensive. Argon and helium are both contained in standard cylinders, and a pressure regulator flow meter combination will need to be attached. Because of the density difference between the two, either a separate flow meter needs to be used for each, or use a flow meter that has calibrations for each type of gas. Argon flow rates for up to $^{1}/_{8}$" steel is 8 to 10 cubic feet per hour (CFH), for stainless steel 11 to 13 CFH, and 12 to 20 CFH for aluminum. Drafty locations may require higher flow rates. Check the manufacturer’s recommendations.

Electrodes. The electrode for gas tungsten arc welding is always a tungsten or tungsten alloy rod with either a pointed or a rounded end. The electrodes come in a variety of diameters.

Preparing the electrode. Prior to use, the cut end of the electrode must be sharpened to a point or melted to a ball. The tip may be ground to a point or chemically sharpened. The electrodes come in 7" lengths. To increase the number of points available, score the electrode with a file or cut-off wheel, and snap it in half. Tungsten is very hard but brittle, so it is easy to grasp each end of the electrode with pliers and snap it in half over a sharp table edge.

A gas tungsten arc welding torch includes the electrode, collet body, collet, cup, backcap, and torch body with heat shield.

Tungsten is very brittle, so electrodes can be scored with a file, then snapped over a sharp table edge.

Because all tungsten electrodes look and feel the same regardless of their composition, it is important to keep them clearly separated by type. The color codes will wear off, or, if you point each end of your electrode, be ground off. It is helpful to have clearly labeled containers for each type of electrode.

Two critical factors in grinding the electrodes are the grinding wheel and the grinding direction. You must use a hard, fine grinding wheel dedicated exclusively to tungsten. Metal particles left on the wheel from grinding aluminum or steel would contaminate the tungsten, which causes erratic arc behavior and poor weld quality. An extremely hard material, tungsten will become hot as it is ground. Sharpen the electrode tip so that grinding marks run lengthwise down the tip, not in a circular or crosswise pattern. Lengthwise grinding focuses the electron flow toward the tip; circular grinding causes the arc to be unfocused and possibly jump sidewise from the electrode rather than off the tip point. Chemical means also can be used to sharpen tungsten by dipping a hot tungsten rod into a chemical agent. The length of the taper on the tungsten tip should be two to three times the diameter of the tungsten.

To safely hold tungsten electrodes for sharpening with a grinder, insert them into the chuck of a drill. Running the drill while sharpening the tungsten ensures a uniform point. Move the tungsten across the wheel to prevent grooves in the wheel edge.

Electrode Characteristics

ALLOY	AC/DC	TRAITS & USES	COLOR
Pure tungsten	AC	• Welding of aluminum • Forms ball at tip	Green
1% Thorium oxide (thoriated)	Primarily DC, but also AC	• Easier arc starts • Carries more current • Low-level radioactive	Yellow
2% Thorium oxide	DC	• Long life • Easier arc starts	Red
Zirconium oxide	AC	• Similar to pure tungsten but carries more current	Brown
2% Cerium oxide (ceriated)	DC	• Not as good as thoriated but not radioactive	Orange
Lanthanum oxide	DC	• Similar to ceriated	Black

Welding with AC current requires that the tip of the electrode be balled, which is accomplished by running DC electrode positive or AC current and striking an arc on copper or brass. The ball should not extend beyond the diameter of the electrode, although many sources recommend a ball one and one half times the diameter of the tungsten.

If you touch the weld puddle or filler rod with the electrode during welding, you must change to a fresh electrode. Any time the electrode tip becomes pitted or blackened, is no longer pointed, or the ball becomes too large, you must change to a fresh electrode. This will happen often, so it is best to have a number of electrodes sharpened and ready to go. If you forget to turn on the shielding gas or the flow is interrupted, the electrode will give off a thick yellow tungsten oxide smoke. This smoke is hazardous, so resume welding only after the smoke has cleared. You will need to change electrodes if this happens.

Chemical sharpeners are available for sharpening tungsten.

Tightening the back cap locks the tungsten electrode into place. The tip of the electrode should extend beyond the end of the cup by a distance of three times the electrode’s diameter.

Anatomy of the GTAW Machine

Setting Up the GTAW Machine

Dedicated GTAW machines, like this one and the one pictured on page 68, have many advanced features. The basic setup, however, is the same.

The positive and negative output receptacles are for the torch and work clamp connections.

The gas outlet connects to the torch gas hose.

The remote control socket is for the foot or finger control. Using a remote control allows the welder to control the amount of current while welding.

The operating mode selects high frequency or scratch starts.

Polarity selects either AC or DC.

AC balance control allows for adjusting AC power to be more positive or more negative to create either more cleaning action or deeper penetration. Advanced machines can adjust the AC power to be as much as 90% positive or negative, rather than the 50% for standard AC power.

Start current controls the current for arc starting.

Welding current sets the range for welding. The foot or finger control then operates within this range.

Slope down time gradually reduces power to the arc without extinguishing the arc. This allows for the weld crater to fill before the arc is extinguished.

Gas post flow controls how long the shielding gas will flow after the arc is extinguished.

Prewelding Checklist

- If using a water-cooled torch, check for leaking.
- Check all cables for wear and damage.
- Clean and fit up parts to be welded.

How to Weld with GTAW

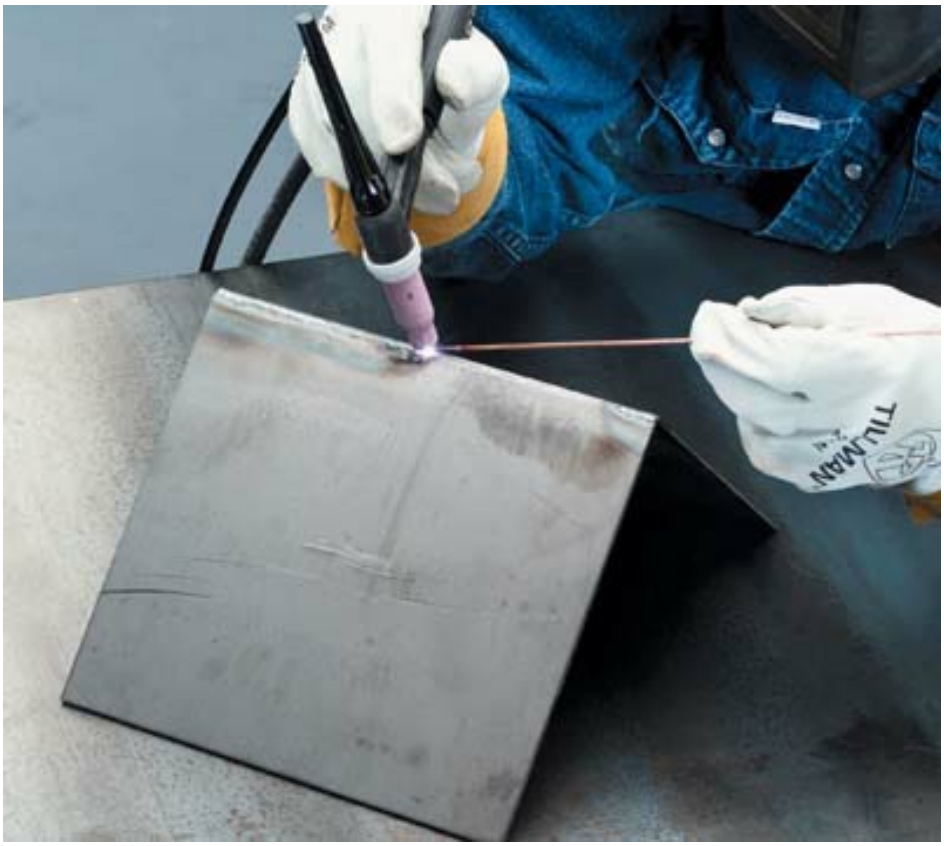
1 Set the controls based on manufacturer's recommendations for the material to be welded. Turn on the machine, and turn on the water pump, if available. Attach the work clamp to the welding table or workpiece. Flip down your helmet, activate the foot or finger control if using one, and strike an arc by scratching the tip of the tungsten against the base metal. If your welder has a high frequency option, you do not need to scratch start the arc. Place a tack weld at each end of the joint to be welded. You may be able to tack the joint by simply fusing the two pieces with the heat of the torch, or you may have to use filler rod.

2 Position yourself to weld from right to left (if you are right handed) with the torch at a 15° angle to the right of center. Hold the filler rod in your left hand. Position yourself so you can comfortably hold the torch and filler rod for the duration of the weld.

Striking an Arc

Unless you have a high frequency option, you will need to physically strike an arc—called a scratch start. Rest the cup on the workpiece at a sharp angle. Move the tip until it briefly contacts the work, then angle it back again to start the arc. After the arc is started, lift the cup off the workpiece and establish the proper torch angle.

High frequency allows the arc to jump the gap without needing to create physical contact between the electrode and the workpiece.



3 When a molten puddle has formed, dip the tip of the filler rod into the middle of the molten puddle. Keep the filler rod at a low angle to prevent disturbing the shielding gas. Keep the tip of the filler rod near—but not in—the puddle. Move the electrode to the left and continue the melting and dipping process.

4 As you approach the end of your weld, you may need to adjust your travel speed because the buildup of heat in the material makes the molten puddle form more quickly at the end of the weld than at the beginning. You also may need to adjust the torch angle to be more shallow (not shown here) so that less heat is directed into the base metal.

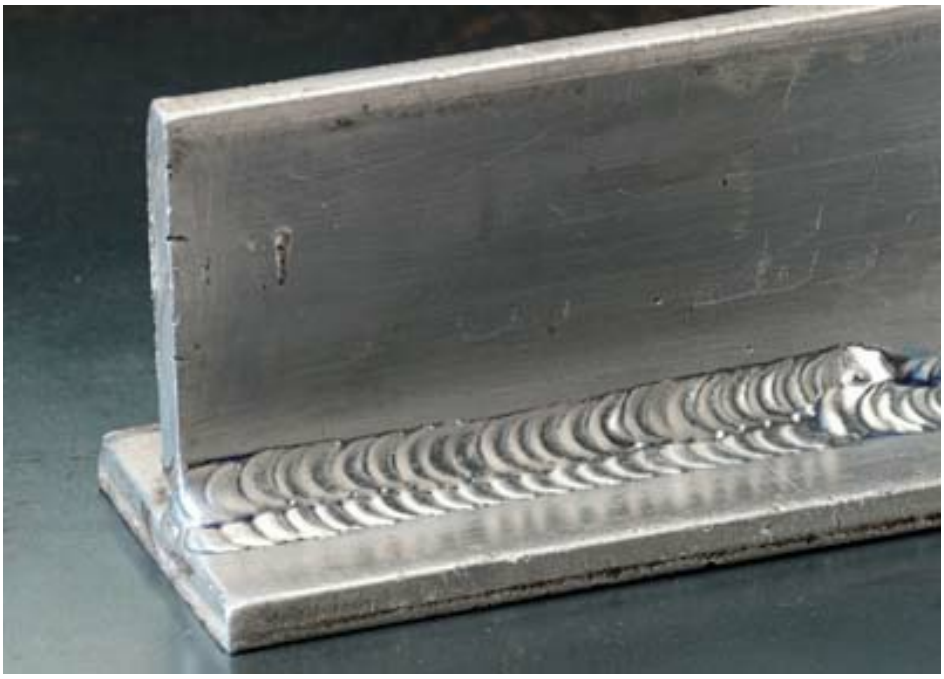
Postwelding Sequence

- Turn off the cylinder valve.
- Purge gas from the gas line.
- Turn off the flow meter or gauge.
- Turn off the machine.
- Coil hoses and cables off the floor.

Troubleshooting

Filler metal for gas tungsten arc welding comes in rod form and ranges from $^{1}/_{16}$" to $^{3}/_{16}$" in size. Rods are available in a variety of alloys, including aluminum, chromium and chromium nickel, copper, nickel and nickel alloys, magnesium, titanium, and zirconium. Specific alloy compositions are available for creating specific weld types on specific base metals. These filler metals are similar to those used in oxyfuel welding, with the exception of the carbon steel rods, which are not copper coated as they are for oxyfuel.

Becoming proficient in gas tungsten arc welding takes practice, and identifying problem welds is an important step. Weld A is too hot. Increase the travel speed or decrease the amperage. Weld B is too cold and is simply sitting on top of the base metal rather than penetrating it. Decrease the travel speed or increase the amperage. Weld C was done too quickly. Travel speed needs to be controlled and consistent. Weld D is a good-quality weld with even ripples, good penetration, and a moderate crown.



A well-done gas tungsten arc weld on aluminum has even ripples and good penetration. This sample weld shows two passes to create a fillet weld on ¼" stock.

GTAW Troubleshooting

PROBLEM	SOLUTIONS
Weld looks porous or sooty	• Make sure shielding gas is on and is correct type • Make sure shielding gas cylinder is not empty • Eliminate drafts • Make sure base metal is totally dry • Clean base metal thoroughly • Increase gas flow rate
Base metal distorts	• Tack weld parts before welding • Clamp parts down to rigid surface • Scatter welds to diminish heat buildup
Unstable arc	• Adjust electrode to work angle • Clean base metal thoroughly • Clean electrode • Connect work clamp to workpiece • Bring arc closer to work
Electrode is rapidly consumed	• Make sure polarity and current settings are correct • Increase electrode size • Increase gas flow • Decrease current • Increase gas postflow time • Use proper shielding gas

WELDING PROJECTS

Here’s a chance to put all these welding and cutting techniques to use. The following chapters have directions for creating 23 different projects. Each contains a detailed cutting list, technical drawing, and step-by-step directions. Among the shop projects you will find a sturdy welding table and a handy welding machine cart. The lighting projects feature a variety of candleholders and lamps. Included in the furniture projects are a delightful wine rack and a handy solution to creating a coffee table out of a slab of stone or wood. The outdoor projects will spark your creativity with an add-your-own-found-objects gate.

IN THIS SECTION:

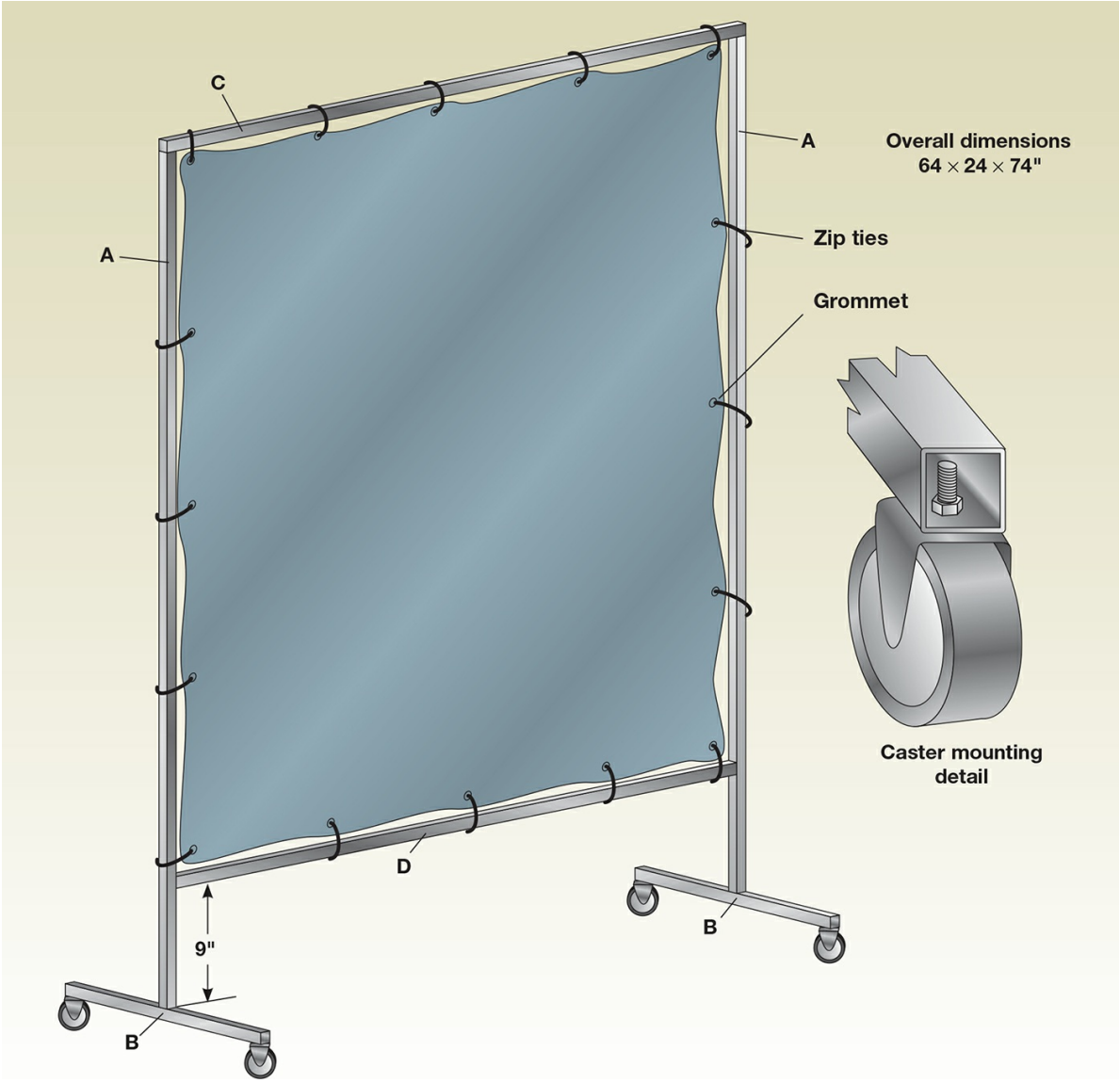
Shop
Home Décor
Outdoor

Shop

IN THIS CHAPTER:

Rolling Welding Curtain
Welding Table
Welding Machine Cart
Cylinder Cart
Grinder Stand
Portable Welding Table
Saw Stand

Rolling Welding Curtain



For arc welding and plasma cutting, it is very important to screen your work area so other shop workers, passersby, family members, and pets are not exposed to the damaging rays. This rolling curtain is quick and easy to make, and it offers the necessary screening while you work. You can purchase ready-made welding tarps in a variety of colors, shapes, and sizes (see Resources, page 220). Or you can make your own welding tarp with 12-ounce cotton duck, fire retardant, and grommets.

Materials

- 1 × 1" square tube (27 feet)
- 4 threaded swivel casters, at least one locking
- 5 × 5 foot welding tarp
- Zip ties

PART	NAME	DIMENSION	QUANTITY
A	Sides	1 × 1" square tube × 72"	2
B	Wheel supports	1 × 1" square tube × 24"	2
C	Top crossbar	1 × 1" square tube × 64"	1
D	Bottom crossbar	1 × 1" square tube × 62"	1

Sixteen gauge or thin wall tube is sufficient for this project.

How to Build a Rolling Welding Curtain

Attach the Wheel Supports to the Sides

1. Clean all parts with denatured alcohol, acetone, or degreaser. Prepare weld joint areas by wire brushing until shiny.

2. Cut the sides and wheel supports (A & B) to length.

3. Clamp one side piece to the work surface. Center a wheel support at the end of the side piece to form a T.

4. Check for square and tack weld along the butt joint between the two parts. Turn the assembly over and reclamp it to the work surface. Check that the wheel support is still square to the side piece. Make a final weld along the butt joint.

5. Repeat steps 3 and 4 to assemble the second side piece and wheel support.

Weld the Wheel Support T-joints

1. Clamp a side and wheel support assembly to the work surface so the wheel supports hang over the edge.

2. Weld the T-joint between the wheel support and the side piece. Turn the assembly over and weld the second T-joint.

3. Repeat steps 1 and 2 for the second side and wheel support.

Install the Crossbars

1. Cut the top and bottom crossbars (C & D) to length.

2. Place the top crossbar over the side pieces (see photo). Check for square, clamp in place, and tack weld.

3. Make a mark 10" up from the bottom of each wheel support. Align the lower edge of the bottom crossbar with the marks, check for square, and tack in place.

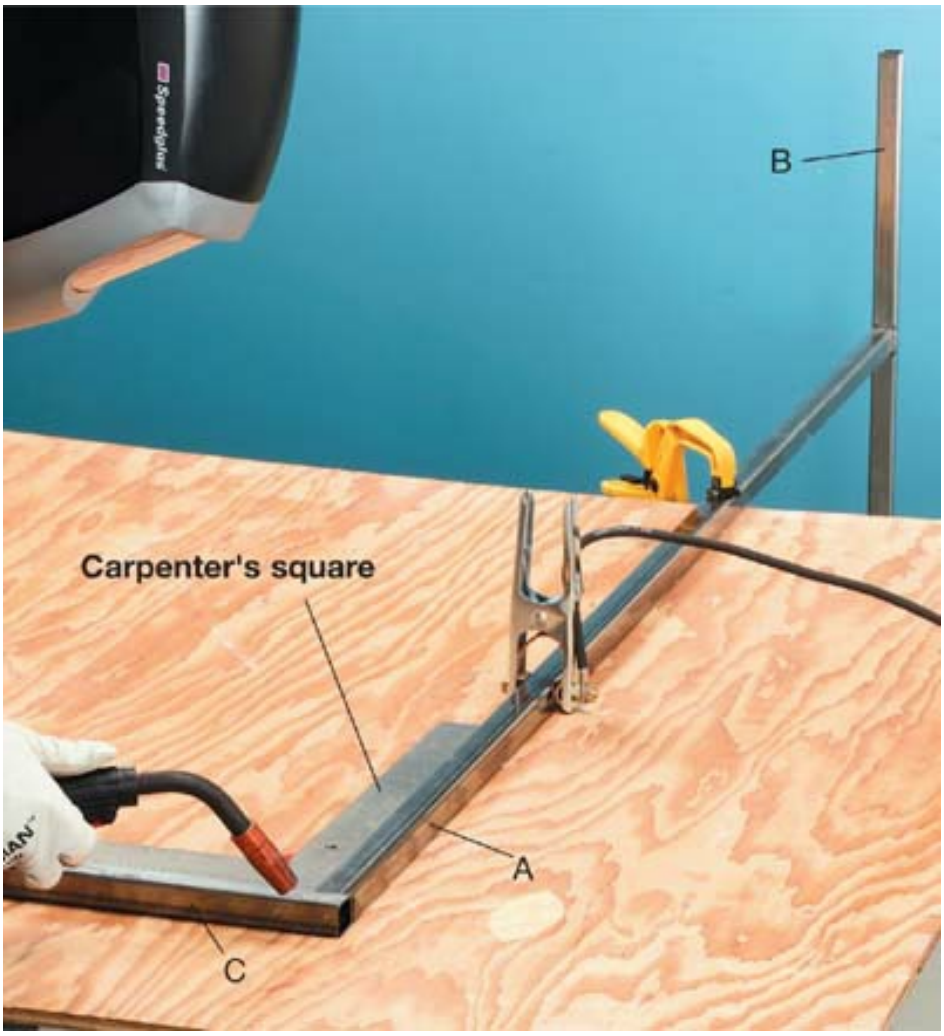
4. Flip the assembly over and check for square by measuring across both diagonals. If the measurements are equal, the structure is square. Clamp the assembly in place and complete the welds. Flip the assembly over and finish the welds on the other side.

Apply Finishing Touches

1. Paint the framework, if desired.

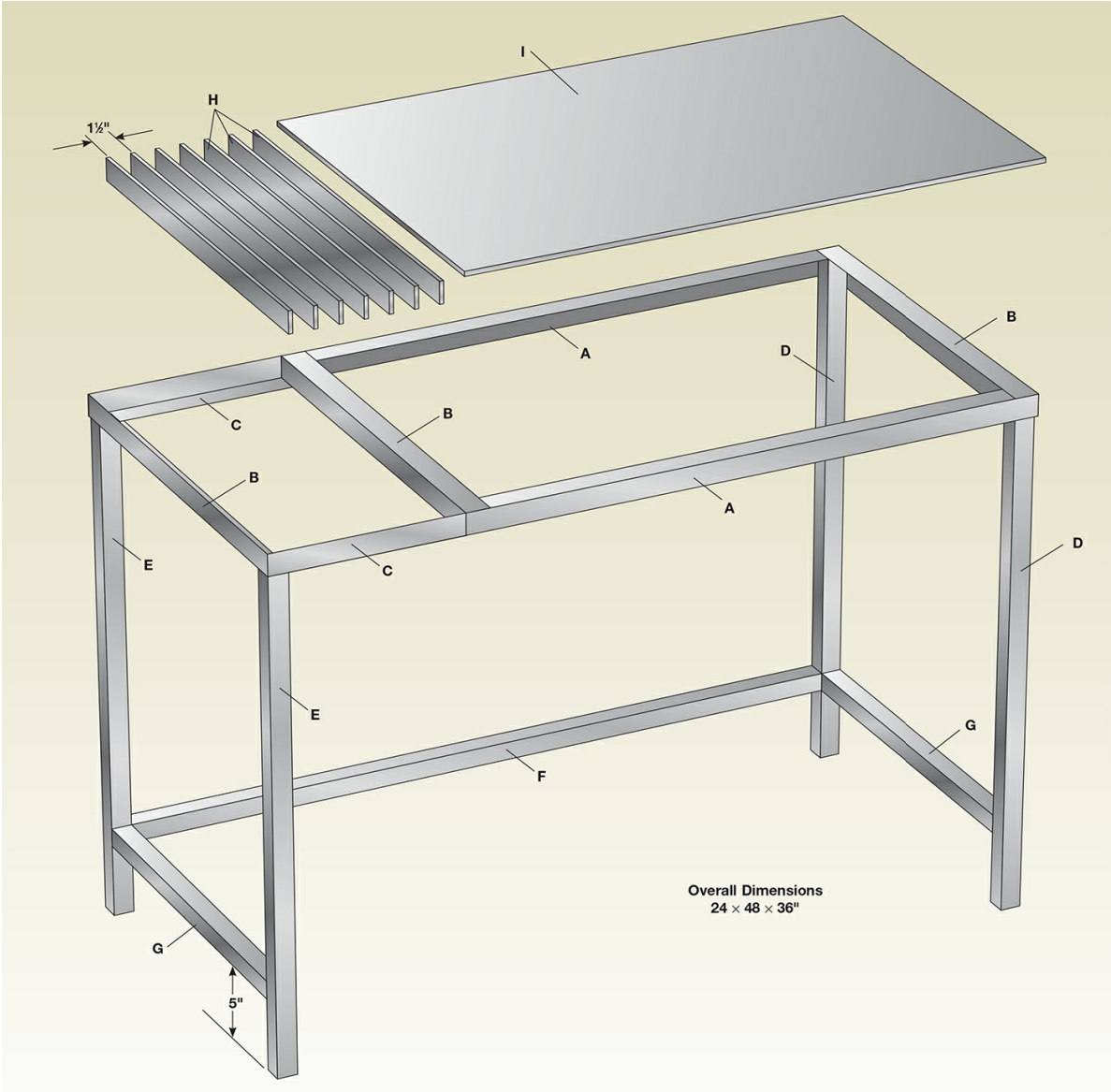
2. Drill holes for the threaded post swivels ½" from the end of the wheel supports. Install the casters.

3. Attach the welding tarp to the framework with zip ties.



Clamp the sides to the table with the wheel supports hanging over the edge. Finish weld the wheel supports to the sides, then weld the top and bottom crossbars to the sides. Make sure the plywood work surface does not have smoldering embers when you are finished.

Welding Table



A sturdy welding table is the heart of any metal shop. Used for arc welding, cutting, or oxyfuel welding, the welding table is a versatile addition to your shop. The model shown here is sized to allow you to work while sitting on a stool or while standing. You may want to check the scrap bin at the local steel yard to see if you can find a bargain price for the tabletop. Some yards sell plate in 4 foot by 2 foot pre-cut sections that you can cut to size. Or you can have the piece custom cut. You can use material that's thinner than $^{3}/_{16}$", but thicker material is better as the table top will have less distortion from the welding heat and the heat generated when you grind spatter off of it. Set the sheet metal for the table top on top of sawhorses or a workbench for use as a work surface to build the rest of the table.

PART	NAME	DIMENSIONS	QUANTITY
A	Table top supports (front & back)	⅛ × 1½ × 1½" angle iron × 36"	2
B	Table top supports (sides)	⅛ × 1½ × 1½" angle iron × 24"	3
C	Cutting table supports (front & back)	⅛ × 1½ × 1½" angle iron × 12"	2
D	Right side legs	⅛ × 1¼ × 1¼" square tube × 36"	2
E	Left side legs	⅛ × 1¼ × 1¼" square tube × 34½"	2
F	Stretcher (rear)	⅛ × 1¼ × 1¼" square tube × 45½"	1
G	Stretcher (sides)	⅛ × 1¼ × 1¼" square tube × 21½"	2
H	Cutting table slat	¼ × 1½" flat bar × 23⅞"	7
I	Table top	3⁄16" rolled steel 24 × 36"	1

Materials

- $^{1}/_{8}$ × 1½ × 1½" angle iron (12 feet)
- $^{1}/_{8}$ × 1¼ × 1¼" square tube (20 feet)
- ¼ × 1½" flat bar (14 feet)
- $^{3}/_{16}$" sheet metal (2 × 2 feet)
- 4 leg levelers

How to Build a Welding Table

Weld the Table Top Supports

Cutting notches for the side supports in the front and back table top supports is easier than cutting 45° miters and provides more welding surface area.

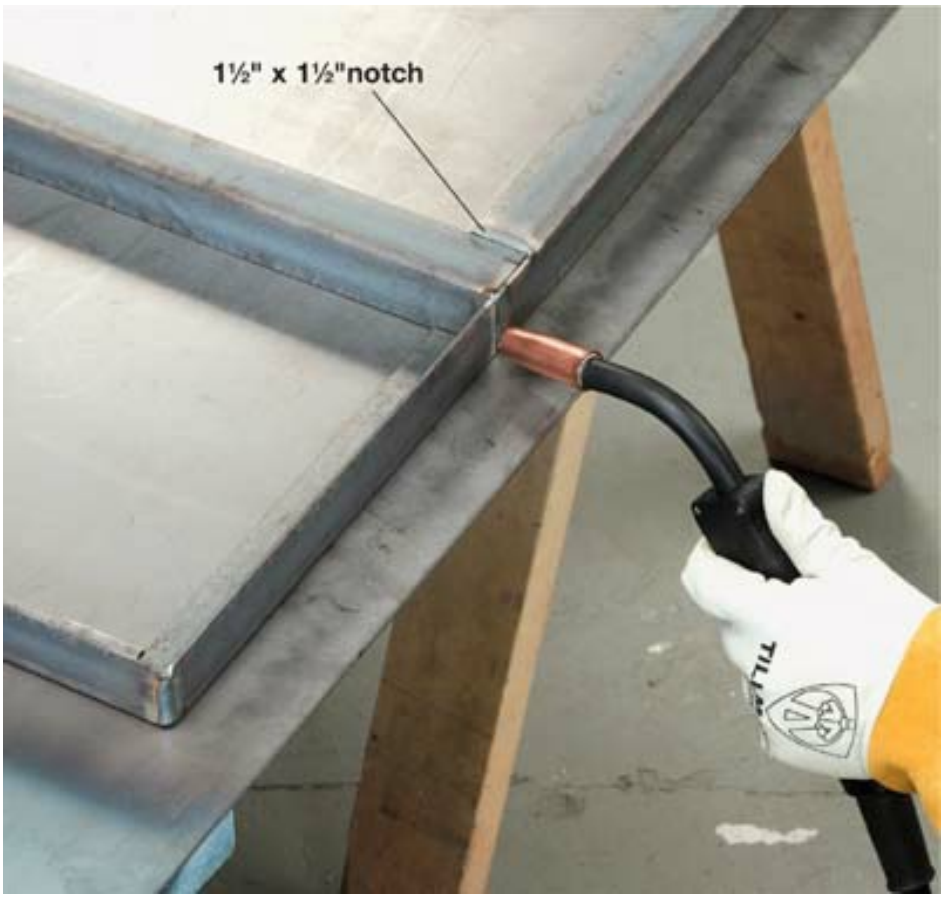
1. Cut the table top supports (A & B) and cutting table supports (C) to length. Cut 1½" notches where each end of the three side supports (B) fits against the table top supports to create a 90° angle joint.

2. Place the table top front support (A) and a table top side support (B) together to form a right angle. Check for square and tack weld.

3. Repeat step 2 using the table top back support and another side support.

4. Assemble these two right angles to make a square. Check all corners for square, and check the assembly for square by measuring both diagonals—they should be equal. If not, adjust the supports so the assembly is square.

5. Complete each outside corner weld, re-checking for square as you go. Flip the assembly over and complete the remaining welds of the joints.



Weld the cutting table section to the table top assembly. The angle iron flange for the table top will face up to support the table top. The angle iron flange for the cutting table will face down to form a well to support the cutting table strips.

Complete the Table Top Supports

The cutting table supports are positioned with the flange at the bottom to hold the ¼" thick strips. The table top supports are positioned with the flange at the top to support the table top (see photo, above left).

1. Place the remaining side support (B) and the front and back cutting table supports (C) at right angles to form three sides of a rectangle. Check the corners for square and tack weld the pieces together.

2. Assemble the pieces so the table top supports have the flange at the top, the cutting table supports have the flange at the bottom, and the cutting table supports are abutting the table top supports. Tack weld where the table top sides butt together. Turn the assembly over and weld the remaining joints.

Prepare the Leg Assembly

1. Cut the legs (D & E) to length.

2. Measure the completed tabletop. It may be slightly more or less than 24" deep and 48" wide. Adjust the stretcher lengths (F & G) to those measurements, minus the 1¼" for each leg thickness. Cut the stretchers to length.

3. Mark both sets of side legs 5" up from the bottom. Starting with the right side legs (D), place a side stretcher (G) between the legs with the bottom of the stretcher aligned with the 5" mark.

Place the back stretcher between the right and left side leg assemblies. Make sure the stretcher is square to the legs, then weld in place.

4. Align the stretcher at a 90° angle to the side legs and clamp the assembly to your work surface. Tack weld the top inside angle at each end of the stretcher.

5. Repeat this process for the left side legs.

Finish the Leg Assembly

1. Place the leg assemblies on their sides with the rear side down, and clamp to your work surface.

2. Position the rear stretcher (F) between the right and left leg assemblies, aligning the bottom of the stretcher with the 5" mark.

3. Align the stretcher at a 90° angle to the assemblies and clamp in place. Tack weld the inside angles (see photo, bottom previous page).

Tack weld cutting table slats to the angle iron every 1½" to form the cutting table top.

Assemble the Table

The right legs fit inside the corner made by the angle iron, while the left legs are set back 1/8" from the edges of the angle iron.

1. Turn the table top and cutting table assembly upside down, then set the leg assembly into it.

2. Clamp the pieces in place. Check for square on both sides, front, and back.

3. Tack weld all corners. Check for square again, then weld all pieces into place.

Install the Cutting Table Top

Tack welding the cutting table grating allows you to remove and replace the ¼" strips as they become worn from the cutting torch.

1. Cut the cutting table slats (H) to length.

2. Place a slat onto the ledge formed by the cutting table top supports 1½" from the table top edge.

3. Tack weld the top edge of the slat to the angle iron.

4. Place another slat 1½" from the first slat and tack weld in place. Continue building the cutting table top in this manner until complete (see photo, above).

5. Grind down the welds on the top of the table top support assembly.

Finish the Table

1. Place the table top (I) onto the assembly and tack weld twice on each side.

2. Weld the table top to the supports using 1 or 2" weld beads at both sides of each corner and twice along each side.

3. Grind down the welds, if desired. Wire brush, sand, or sandblast the entire table.

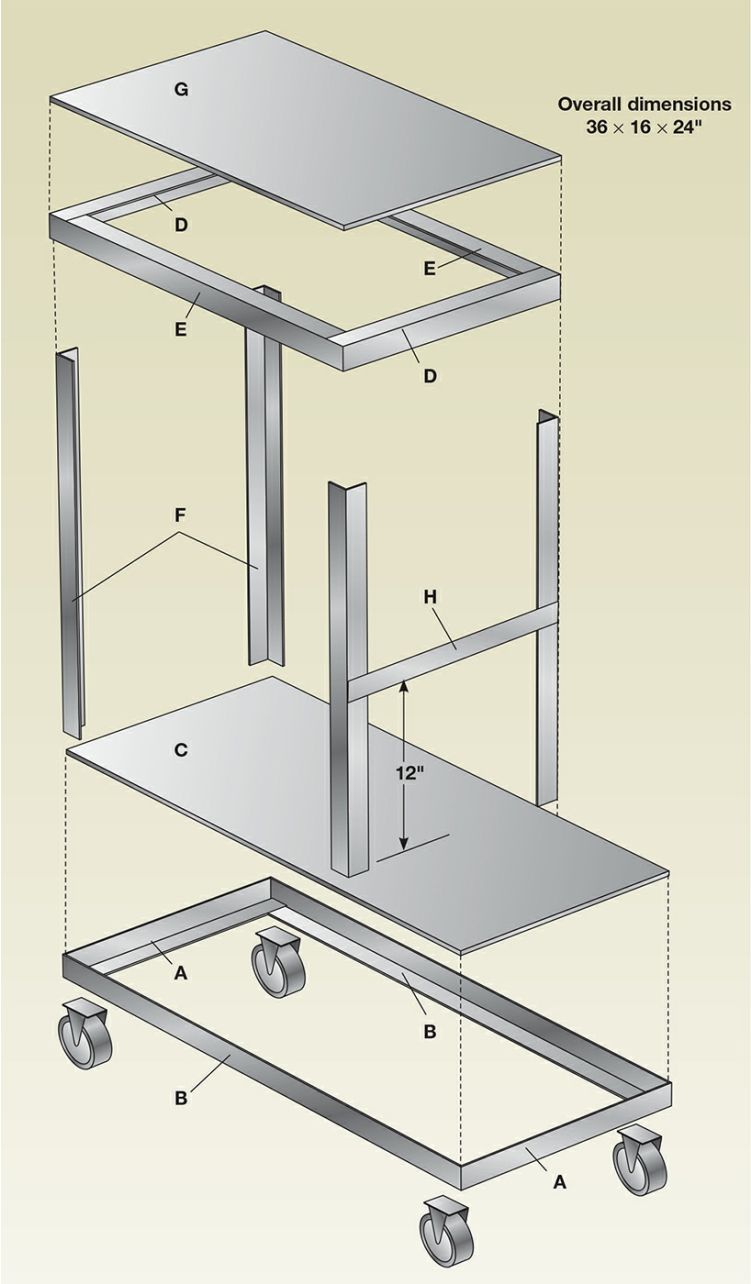
4. Paint the table, but do not paint the table top or cutting grate.

5. Install leg levelers as needed.

Welding Machine Cart

You'll want a cart for your GMAW or GTAW machine and gas cylinder—why not build it as your first project? It's good practice, and the materials will cost much less than most commercial carts. If you keep your eyes open, you can probably pick up the angle iron for free the next time a neighbor throws away an old bedframe. Remember, however, to grind off the paint at the joints, otherwise you'll have nasty fumes and poor- quality welds.

Include a rubber pad and insulated chain for the gas cylinder (not shown) so an arc can't accidentally be struck against the cylinder.


G
Overall dimensions
36 × 16 × 24"
D
E
E
D
F
H
C
12"
A
B
B
A

Materials

- 1/8 × 1½ × 1½" angle iron (24 feet)
- 1/8" sheet metal (16 × 64")
- 1/8 × 1¼" flat bar (16")
- Swivel casters (4)

PART	NAME	DIMENSIONS	QUANTITY
A	Bottom front & back	⅛ × 1½ × 1½" angle iron × 16"	2
B	Bottom sides	⅛ × 1½ × 1½" angle iron × 36"	2
C	Tray	⅛" sheet × 16 × 36"*	1
D	Top front & back	⅛ × 1½ × 1½" angle iron × 16"	2
E	Top sides	⅛ × 1½ × 1½" angle iron × 26"	2
F	Legs	⅛ × 1½ × 1½" angle iron × 24"	4
G	Top	⅛" sheet × 16 × 26"*	1
H	Brace	⅛ × 1¼" flat bar × 16"	1

*Approximate dimensions, cut to fit

How to Build a Welding Machine Cart

Assemble the Base & Tray

1. Cut the bottom front and back (A) to length. Cut the bottom side pieces (B) to length. Instead of mitering the corners, cut a 1½" notch at each end.

2. Arrange the front, back, and side pieces to form a rectangle. Check the corners for square, clamp in place, and tack weld the pieces together.

3. Measure diagonally across the corners to make sure they are square. If the measurements are equal, the base is square. If they are not, adjust the pieces until they are.

4. Clamp the base in place. Weld each outside corner. Turn the base over and weld each joint. Do not weld inside the base, as the weld beads will interfere with the tray and leg placement.

5. Measure the inside dimensions of the base and cut the tray (C) to size.

6. Insert the tray into the angles of the base. Tack weld the tray at points along the perimeter.

7. Turn the assembly over and place three 1" welds along each long side, and two 1" welds along each short side to join the tray to the base.

Assemble the Top

1. Cut the top front and back (D) and top side pieces (E) to length. Cut a 1½" notch at each end of the side pieces.

2. Arrange the front, back, and side pieces to form a rectangle. Check the corners for square, clamp in place, and tack weld the pieces together.

3. Measure diagonally across the corners to make sure they are square. If the measurements are equal, the top assembly is square. If they are not, adjust the pieces until they are.

4. Clamp the pieces in place. Weld each outside corner. Turn the assembly over and weld each joint. Do not weld inside the top assembly, as the weld beads will interfere with the top and leg placement.

5. Measure the top assembly to allow a 1/8" setback on all sides, and cut the top (G) to size.

6. Grind down the welds and place the top over the assembly. Tack weld the top along the perimeter, then finish weld with two 1" welds per side.

Attach the Legs

1. Cut the legs (F) and brace (H) to size.

2. Turn the top upside down. Place a leg in one of the corners. Use a scrap piece of angle iron to assist in clamping (see photo). Make sure the leg is square to the top and tack weld into place.

3. Repeat step 2 to attach the other three legs to the corners of the top.

4. Place the legs and top assembly into the bottom assembly. The back legs should fit into the corners of the bottom assembly, and the front legs into the angles of the side pieces of the base.

5. Make sure the legs are square to the base, clamp, and tack weld.

6. Measure across the diagonals between the base and the top to make sure the unit is square. Adjust, if necessary, and finish welding the legs to the top and base.

7. Measure 12" from the bottom of the front legs. Center the brace over the marks, check it for square, and clamp in place. Weld the brace to the front legs.

Use a scrap of angle iron to hold the legs in place for tacking.

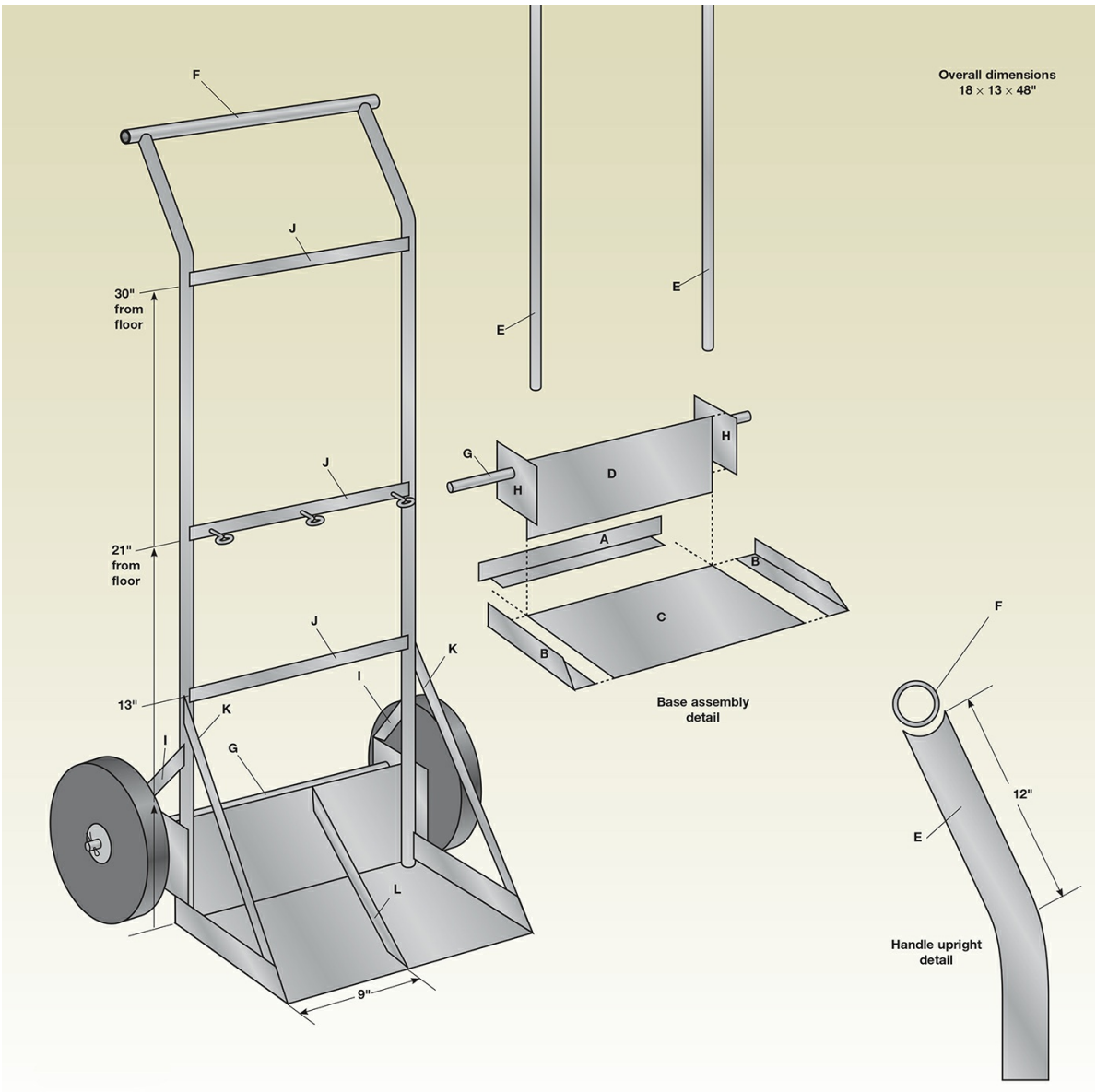
Add Finishing Touches

1. Sand and clean the cart, and paint.

2. Drill holes 2" in from the ends of the brace and attach the eyebolts. Use the threaded chain links to attach the chain.

3. Turn the cart over. Grind down the welds at the corners and attach the casters. If you are welding the casters, make sure you grind off the zinc coating.

Cylinder Cart



You can purchase a cylinder cart for your oxyfuel rig—your dealer might even give you a discount—but it's fun and challenging to make your own. This cart is constructed with 1/8" stock, which is oxyfuel weldable, but we used GMAW. The base platform and back support can be flame or plasma cut. If you have access to a heavy-duty metal brake, you can make the base platform and back support from one 16¼ × 17¾" piece and bend it to 90° (allow ¼" for the radius of the bend).

PART	NAME	DIMENSIONS	QUANTITY
A	Base back	⅛ × 1½ × 1½" angle iron × 18"	1
B	Base sides	⅛ × 1½ × 1½" angle iron × 10"	2
C	Base platform	⅛" sheet × 10 × 17¾"*	1
D	Back support	⅛" sheet × 6 × 17¾"*	1
E	Handle uprights	⅛ × 1" round tube × 60"*	2
F	Handle	⅛ × 1" round tube × 18"	1
G	Axle	⅝" round bar × 22"*	1
H	Axle brackets	⅛" sheet × 4 × 4½"	2
I	Bracket supports	⅛ × 1½" flat bar × 8"*	2
J	Crosspieces	⅛ × 1½" flat bar × 17"*	3
K	Side supports	⅛ × 1¼" flat bar × 24"*	2
L	Base support	⅛ × 1½" flat bar × 12"*	1

*Approximate dimensions, cut to fit

Materials

- 1/8 × 1½ × 1½" angle iron (3½ feet)
- 1/8" sheet metal (18 × 24" sheet)
- 1/8 × 1" round tube (12 feet)
- 5/8" round bar (2 feet)
- 1/8 × 1½" flat bar (7 feet)
- 1/8 × 1¼" flat bar (4 feet)
- 1" eyebolts with nuts (3)
- Chain
- Snap closures or threaded chain links (3)
- 8" wheels with hubs (2)
- Washers and cotter pins (2)

How to Build a Cylinder Cart

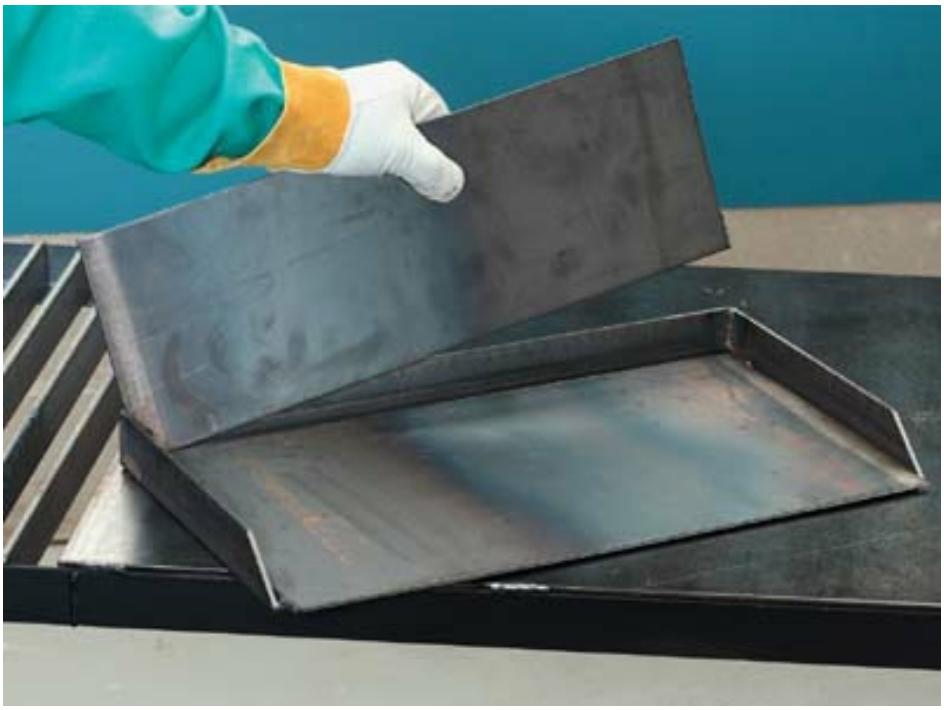
Prepare the Cart Base

1. Cut the base back (A) and base sides (B) to size. Rather than mitering the corners, cut a 1½" notch in each end of the base back (see diagram).

2. Mark and cut a triangular section off the front end of each base side to soften the edge.

3. Lay out the base back and sides to form a three-sided rectangle. Square the corners and clamp the assembly to your work surface.

4. Tack the joints at both ends of the base back. Turn the assembly over and weld the corner and butt joints.



After welding the base back and sides, cut the base platform and back support to fit, then weld them in place.

Install the Base Platform & Back Support

1. Measure the inside width of the base assembly and cut the base platform (C) and back support (D) to size.

2. Place the base platform into the base assembly and tack weld it into place along the base sides.(Do not weld along the base back, as that would prevent the back support from fitting flat against the base platform.)

3. Turn the base over and place two 1" welds along each side where the base platform meets the back and sides.

4. Set the base flat on the work surface, right-side up, and place the back support upright against the inside of the base back (see photo, above).

5. Clamp the back support to the base back. Place three 1" welds on the back side of the support where it meets the angle iron.

6. Place two 1" welds on the inside T-joint, making sure not to weld within two inches of the corner.

Tack the axle brackets to the base assembly. Insert the axle to check for proper alignment, then finish weld the bracket joints.

Attach the Axle Brackets

1. Cut the axle brackets (H) to size.

2. Place the base assembly on its side and align an axle bracket along the top edge of the base side, resting it on top of the back support and extending 3" off the back side.

3. Measure 4" up from the bottom of the base assembly and 1½" from the back edge to mark the axle location on the axle bracket. Drill, flame cut, or plasma cut a 5/8" hole at the mark.

4. Tack weld the axle bracket in place (see photo, above left). Insert the axle to check for proper alignment, then weld both sides of the T-joint between the bracket and the back support.

5. Weld the outside butt joint between the bracket and the base side.

6. Repeat steps 2 to 5 to weld an axle bracket to the other side of the base assembly.

Prepare the Handle Uprights

1. Cut the handle uprights (E) to length.

2. Make a 20 to 30° bend in one of the handle uprights 13" from one end using a heavy-duty conduit bender. Bend the other handle upright to match.

3. Cut both pieces so the curve is 12" from the top end and the overall upright height of each is 48". Grind the tops of both handle uprights so they fit around the handle tube.

Assemble & Install Handle Uprights

1. Place a handle upright against the inside corner of the base assembly. Turn the handle so the curve points straight back. Tack weld the handle in place. Repeat this process for the other handle upright.

2. Cut the handle (F) to size.

3. Place the cart on its back. Set the handle against the cutouts in the handle uprights keeping an equal amount of overhang on each end and tack weld in place.

4. Finish weld the handle uprights to the base assembly. Place welds between the handle uprights and top back support, and between the handle uprights and axle brackets.

Attach the Crosspieces

1. Measure and cut the crosspieces (J) so they are slightly recessed against the handle uprights.

2. Drill three 3/16" holes—one in the center and one on each end of one crosspiece. Place this crosspiece 21" up from the base.

3. Set the remaining crosspieces at 13" and 30" from the base on the forward side of the handle uprights, and weld in place (see photo, right).

Lay the crosspieces across the handle uprights at the proper heights. Weld the pieces to the uprights.

Attach the Supports

1. Turn the assembly on its side. Place a bracket support (I) in position across the handle upright and the axle bracket. Mark the angles on the support and cut it to size.

2. Weld the bracket support in place against the handle upright and axle bracket.

3. Set the side support (K) in position against the base side and the handle upright. Mark the angles and cut to fit. Weld the support in place.

4. Turn the assembly on its opposite side and repeat steps 1 to 3.

5. Mark the angles and cut the base support (L) to size to fit between the base platform and the base back.

6. Center the base support from side to side on the base assembly. Weld both sides of each T-joint.

Complete the Cart

1. Center the axle (G) between the axle brackets. Place the wheels on the axle to make sure the wheels barely make contact with the floor (see photo, right).

2. Mark the axle for its final length and cut to size. Drill holes in each end of the axle to fit the cotter pins.

3. Center the axle between the axle brackets and weld in place.

4. Complete any unfinished welds.

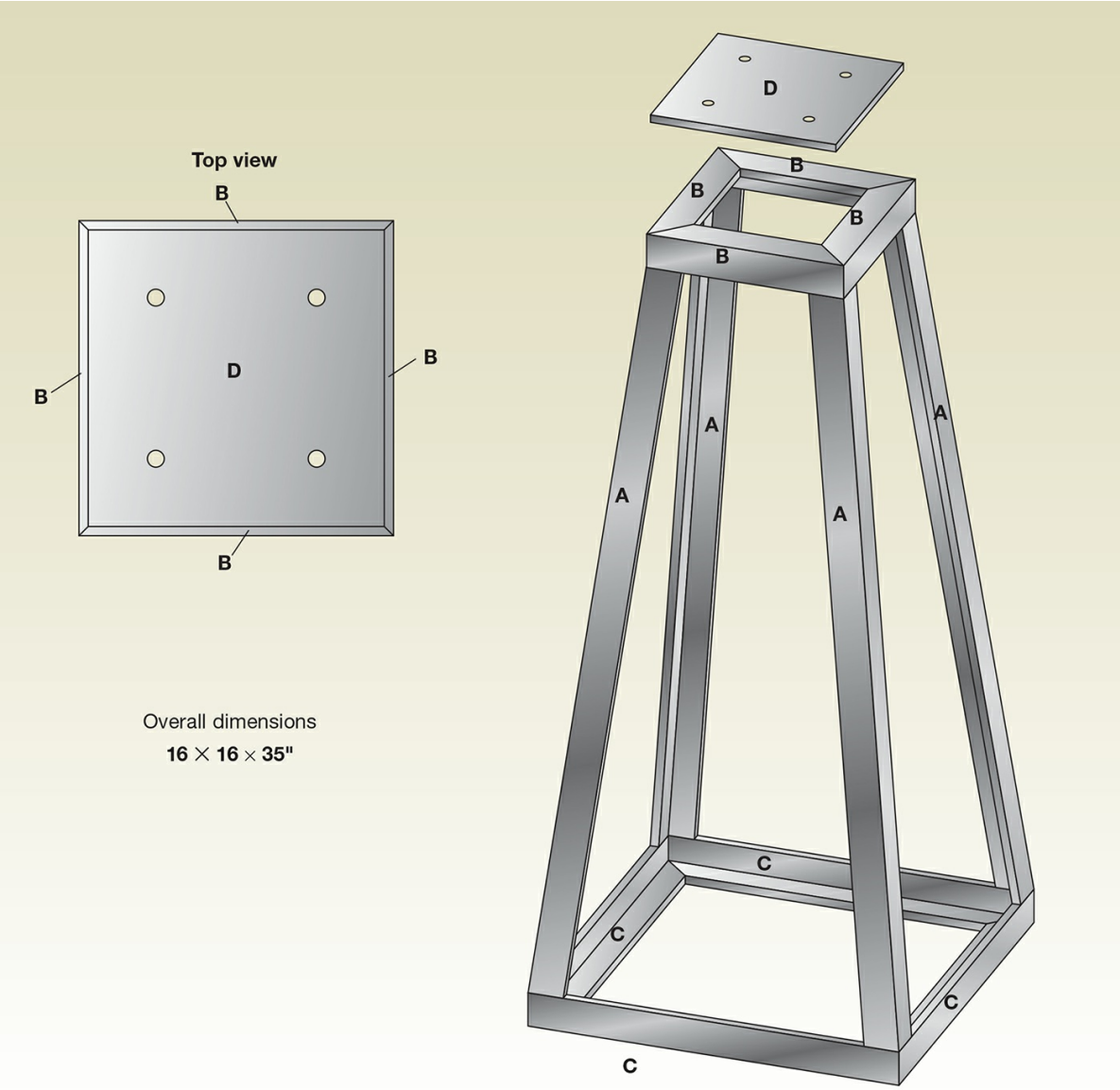
5. Wire brush or sandblast the cart. Clean the cart and paint as desired.

6. Attach the wheels to the axle. Insert cotter pins in the axle holes.

7. Affix eyebolts with nuts in the 3 holes in the middle crosspiece. Attach the chain to the eyebolts with snap closures or threaded chain links.

Trial fit the wheels before welding the axle into place. The wheels should just barely make contact with the floor.

Grinder Stand



This is a good project to make with angle iron from the discount bin at the local steel supply center. You can often buy short pieces for 10 cents a pound rather than the 30 to 50 cents you would normally pay. Take along your calipers or micrometer to measure thicknesses, as well as your measuring tape, cutting list, and tough gloves so you don't get cut digging through the scrap pile.

Materials

- $^{3}/_{16}$ × 1½ × 1½" angle iron (19 feet)
- $^{3}/_{16}$" plate (8 × 8")

PART	NAME	DIMENSIONS	QUANTITY
A	Legs	3⁄16 × 1½ × 1½" angle iron × 32"	4
B	Top	3⁄16 × 1½ × 1½" angle iron × 8½"	4
C	Bottom	3⁄16 × 1½ × 1½" angle iron × 16"	4
D	Platform	3⁄16 to ½" plate 8 × 8"	1

How to Build a Grinder Stand

Build the Top & Bottom Assemblies

1. Cut the top and bottom pieces (B & C) to length. Miter the corners at 45° or cut 1½" notches into the pieces.

2. Assemble pairs of bottom pieces into right angles. Clamp the pieces to your work surface and tack weld at each corner.

3. Assemble the two right angles into a square. Check for square by measuring across each diagonal—if the measurements are equal, the assembly is square. Tack weld the corners.

4. Repeat steps 2 to 3 to assemble the top.

Mark & Cut the Legs

1. Cut the legs (A) to size.

2. Place the bottom assembly on your work surface and loosely clamp the legs into each corner.

3. Set the top assembly over the legs and clamp it in place. Make sure the top is level.

4. Mark each leg at the top and bottom where they cross the platforms (see photo).

5. Unclamp the legs and cut to size.

Assemble the Stand

1. Place one leg on top of a corner of the bottom assembly and tack weld it in place. Tack weld the other three legs in the corners the same way.

2. Align a corner of the top assembly with the top of one leg and tack it in place. Tack weld the top assembly to the other three legs the same way.

3. Adjust the stand so the top is level. You may need to remove tack welds and grind down some angles.

4. When you are satisfied with the alignment, complete the welds. To minimize distortion, alternate between the sides, top, and bottom as you weld.

Assemble the grinder stand using clamps. Mark the top and bottom of each leg and cut to fit.

Attach the Platform Plate

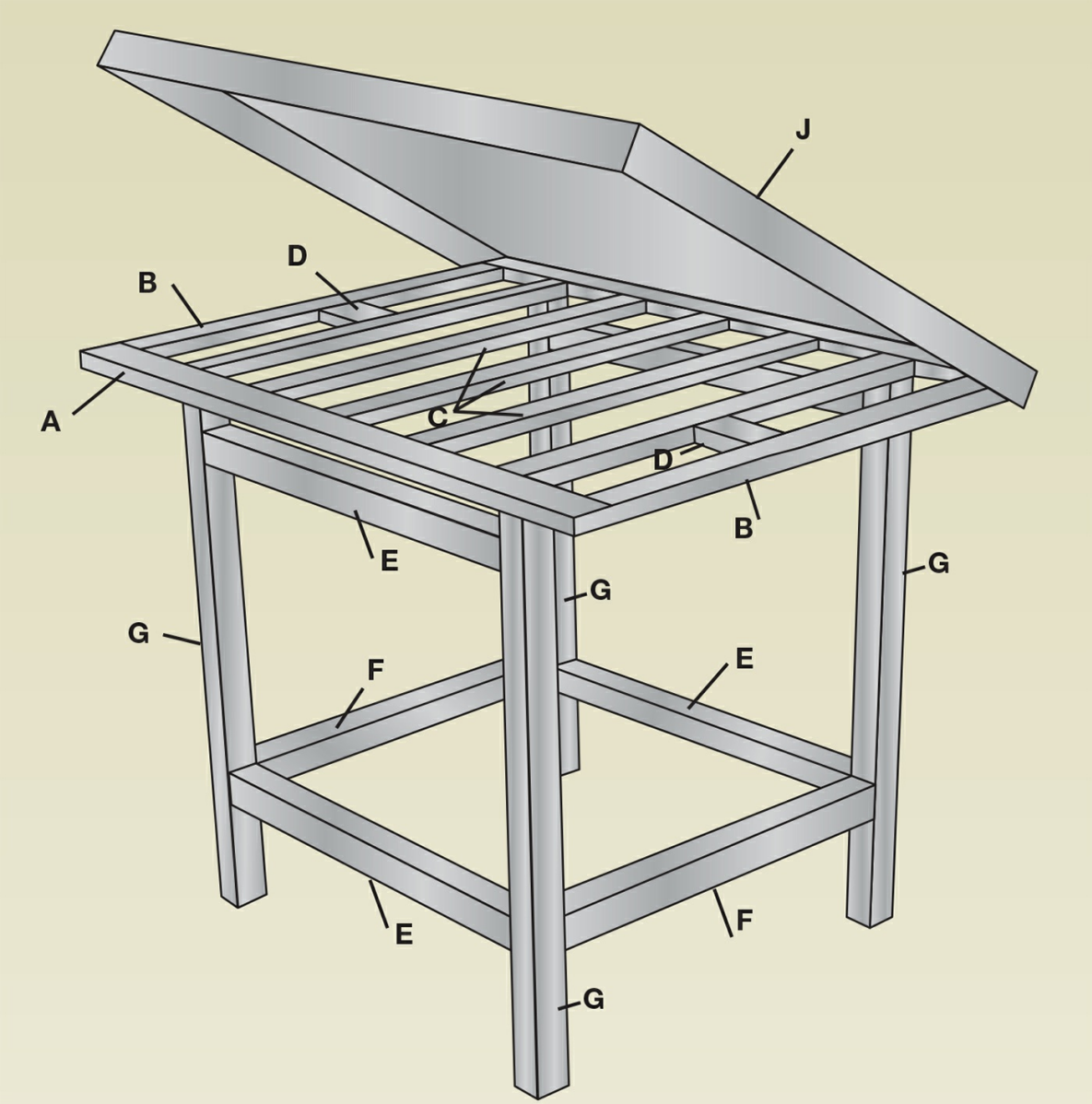
1. Cut the platform plate (D) to size. Drill four holes in the face to match your grinder mounting holes.

2. Set the plate over the top of the stand, aligning the edges with the outside of the top pieces. Weld the plate to the stand.

Portable Welding Table

Building a heavy-duty welding table helps you develop your welding skills and it also provides a useful piece of equipment on which to build future projects. Because the table seen here is mounted on casters it can be rolled away into a corner of the garage when not in use. The metal-slat tabletop can be covered with a removable sheet-metal welding surface that can be cleaned and reused as necessary. You can also build a plywood work surface for doing woodworking and metalworking that doesn’t involve welding.

The welding table dimensions can be altered to meet the requirements of the welder. You could even build two tables of the same height to create an extended work surface. In short, this table is a very versatile tool and the more you use it the more you’ll appreciate it.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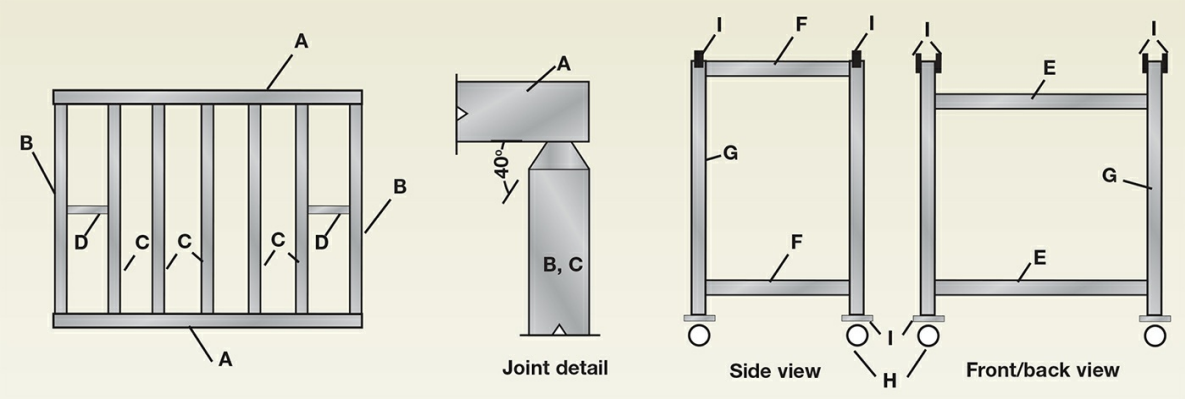
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Front/back view

Materials

- ¾ x 2" cold-rolled steel bar (CRS) stock (23 feet)
- $^{3}/_{16}$" x 2 x 2" square tube (22 feet)
- 4 Locking swivel casters (rated for at least 500 lbs. each)
- ¼" flat stock sheet metal (3 x 4 feet, allows extra for tabs)

PART	NAME	DIMENSION	QUANTITY
A	Top fronts	¾" x 2 CRS 40"	2
B	Top sides	¾" x 2 CRS 26"	2
C	Top cross pieces	¾" x 2 CRS 26"	5
D	Top short cross pieces	¾" x 2 CRS 4"	2
E	Front rails	3⁄16" x 2" x 2" square tube 24"	4
F	Side rails	3⁄16" x 2" x 2" square tube 22"	4
G	Legs	3⁄16" x 2" x 2" square tube 34"	4
H	Casters		4
I	Tabs	2 x 2"	8
J	Table top	38 x 48 sheet metal	1

How to Build a Welding Table

Before welding, thoroughly clean all parts with denatured alcohol.

Build the Base Sides

1. Measure and mark $^{3}/_{16}$" × 2 × 2 square tube for the four front rails (E) at 24" each, the four side rails (F) at 22" each, and the four legs (G) at 34" each.

2. Cut the pieces using a portable band saw or hardened-carbide-blade cut-off saw.

3. Align the side rails (F) flush in between two legs (see page 97): the uppermost side rail (F) is flush with the tops of the legs; the lower sides are 6" up from the bottoms of the legs. Use corner magnets to hold the lower sides square. To maintain your proper dimensions, use a 24" piece of scrap metal or 2 × 4 as a spacer between the two lower ends. Alternatively, tack weld a piece of metal in between the two pieces, and remove it later.

4. Tack the side rails in place. Repeat step 3 for the other side frame.

5. Align two front rails (E) between the side frame legs for the front: the uppermost front is 2" down from the top edge of the legs; the lower front is 6" up from the bottom edges of the legs. To maintain your proper dimensions, use a 22" piece of scrap metal or 2 × 4 as a spacer between the two lower ends. Alternatively, tack weld a piece of metal in between the two pieces, and remove it later. Tack a 6" scrap metal piece below the

lowest part E so that the entire front/back frame can stand in place on its own as you tack the pieces to the legs.

6. Tack the front rails (E) to the legs in between both of the two side frames.

Measure and mark 2 x 2 x $^{3}/_{16}$" square tube for the four front rails (E) at 24" each, the four side rails (F) at 22" each, and the four legs (G) at 30" each.

Add the Tabs & Casters

1. Measure and mark ¼" flat stock for the tabs (I) at 2 × 2.

2. Check to make sure each tab is square, and then cut out eight tabs.

3. Align the tabs (I) no more than $1^{1}/_{16}$" above the top of each leg (see page 97).

4. Hold the tabs in place with clamps, and then tack the tabs to the verticals. The top cross pieces (C) closest to the top ends (B) fit in between the tabs.

5. Center casters over the ends of the legs.

6. Tack the casters, and then check for square. Adjust as necessary and then weld. Use SMAW; $^{3}/_{32}$ or $^{1}/_{8}$" diameter E 6013 electrode to weld on caster plates. Continuous welds are not necessary.

7. Weld all the way around each joint for the entire base frame tacked together thus far. Note: don't accidentally weld your temporary spacer bars that are used only to maintain dimension.

Build the Top Frame

1. Measure and mark two ¾" cold-rolled steel bars to 40" for the top fronts (A). Cut them to length using a hardened-carbide-blade cut-off saw.

2. Also measure and mark ¾" cold-rolled steel bars to 26" each for two top sides (B) and five top cross pieces (C).

3. Measure and mark ¾" cold-rolled steel bars to 4" each for the two top short cross pieces (D).

4. Cut each of the pieces (A, B, C, D) for the tabletop frame following your cut lines.

5. Make the 40° end joints in each cross piece (see JOINT DETAIL) by grinding or flame-cutting the ends. The depth of each double bevel should be between ¼" and $^{1}/_{8}$".

6. Align the top sides (A) and top ends (B), and then check for square. Hold them in place with corner magnets.

7. Tack together all four sides. Use enough heat to get good fusion so when you move the frame the tacks won't break (metal is heavy).

8. Lay the top frame right-side up on a level table and start to align the cross pieces. Start in the center and evenly space each piece in between the two top sides (B). Make sure the cross pieces closest to the top sides are aligned so they fit in between the tabs that are welded onto the legs.

9. Align each cross piece and hold it in place with corner magnets or clamps. Once everything is aligned properly, tack the cross pieces to the top fronts. Note: 4.5" TYP indicates the "typical" spacing between the five middle crossbars is 4½".

Cut the square tube using a metal-cutting bandsaw (shown) or cut-off saw with a hardened carbide blade.

Align the side rails in between legs. The side rail part is 6" up from the leg bottom. You will make two of these side frames and then add front rails in between the sides for the front and back of the table base.

10. Align the top short cross pieces in between the top sides (B) and cross pieces (C). Check for square, and then tack in place.

11. Check for final square of the entire table top frame, and make any final adjustments. Align the table top frame over the base to make sure the cross pieces fit in between the tabs on legs.

12. Complete all welds using sequence welding. Alternate from side to side, starting at the center cross pieces and moving to the outer cross pieces.

Make the Table Tops

1. Measure and mark a 38 × 48" table top out of ¼" sheet metal.

2. Mark a line 4" in from the edge of each side. Also make the detailed marks for each corner bird's mouth. This will allow one edge of each corner to bend inside of the other edge of the corner for neat and strong edges.

3. Cut the table top sheet metal with portable shears (see photo).

4. Bend up the triangular bird's mouth tabs.

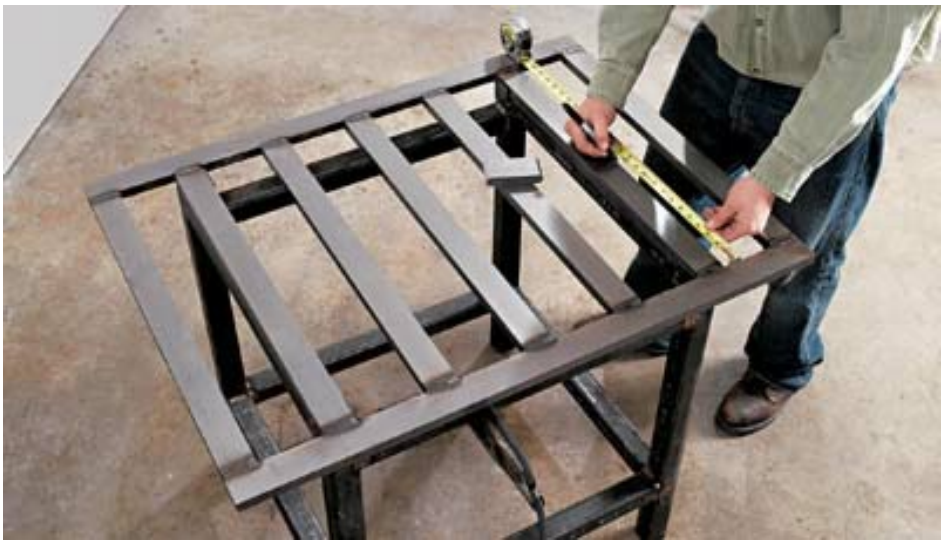
5. Use 1/8" steel as a bender. Lay the bender 4" in from the edges and then grasp the sheet metal and bender with clamps. Bend the sheet up at 90° (see photo, top opposite page). The triangular bird's mouth tabs fold in to the inside for clean exterior corner edges.

6. Fit the table top over the top frame (see photo, bottom right, opposite page).

Finishing

1. Use a 4½" angle grinder with a 60-grit flapper disk to grind all welds until smooth.

2. Clean the metal, and then prime and paint the base, if desired. *Note: Do not paint the top*.



Measure and mark for the top short cross pieces. The table top frame should fit on top of the base with the cross pieces fitting in between the tabs on legs. The short cross pieces then fit in between the cross pieces and top sides (B) for extra strength.

Cut the sheet metal top to 38 x 48 using a portable metal shears.

Use a strip of 1/8" -thick steel as a bender. Clamp the bender to the table top sheet metal and bend up to 90°. Shown here: first make a bird's mouth cut on corners; bend those sides first so that the tabs are on the inside of the bend for a clean exterior edge.

Lower the finished table top onto the table frame.

Saw Stand

A saw table like this is commonly used in workshops, home shops, and on job sites. Designed for use with a power miter saw or metal cut-off saw, it features outriggers that are adjustable, accommodating a variety of stock lengths. The outriggers slide out on both sides, opening to their maximum length of 24". If both sides need to be extended (for extra long material), the outriggers can both be placed in the front and extend out of the same outrigger tubes. And this will be necessary because the back outriggers sit behind the saw—good for storage when the outriggers need to slide all the way in, flush with the stand sides (for moving and storage). You can add wood blocks on the ends of the outriggers to keep the object being cut level with the saw table.

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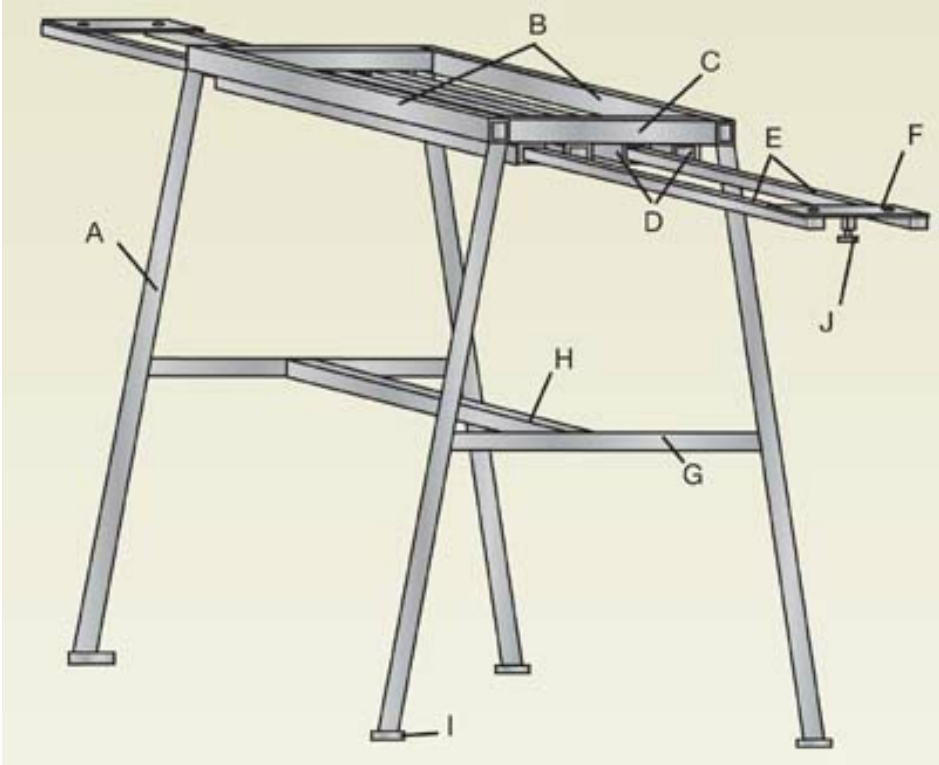
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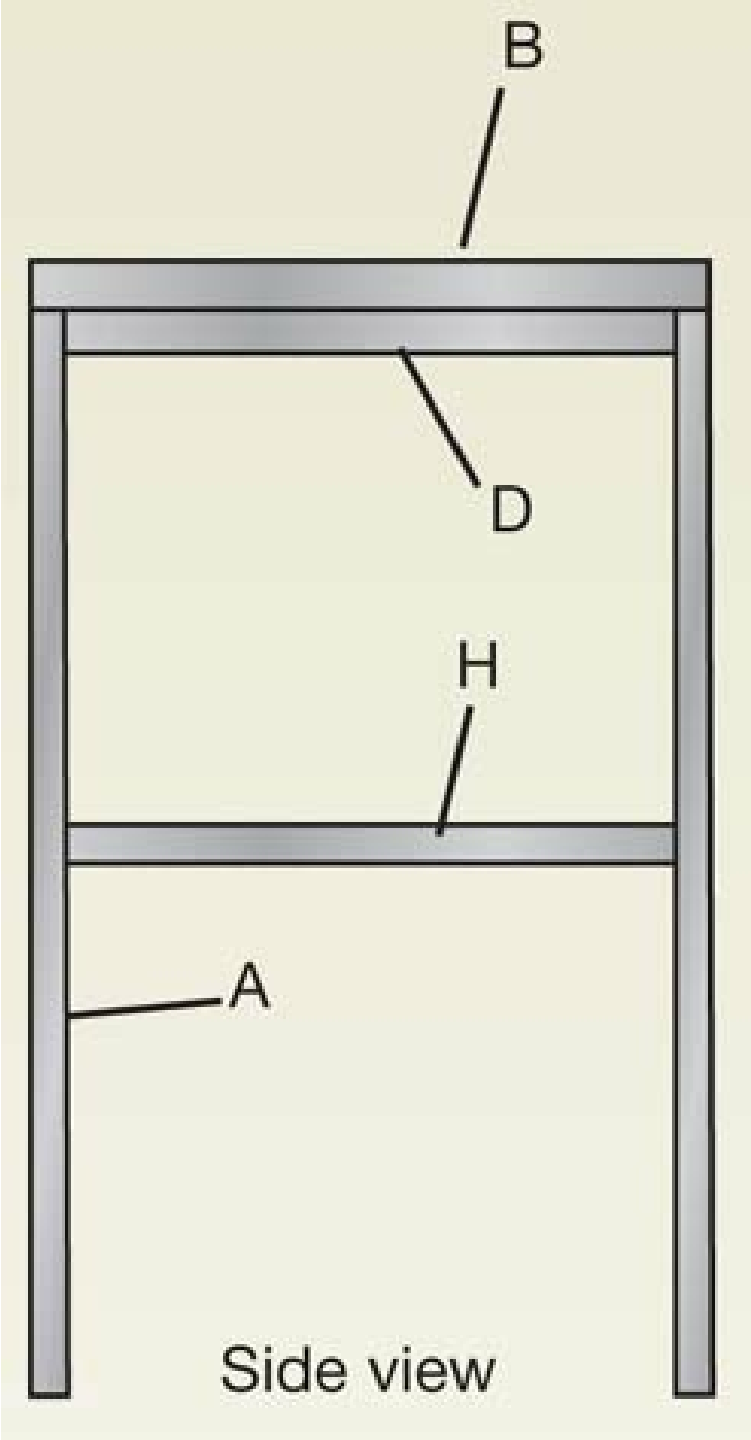
B
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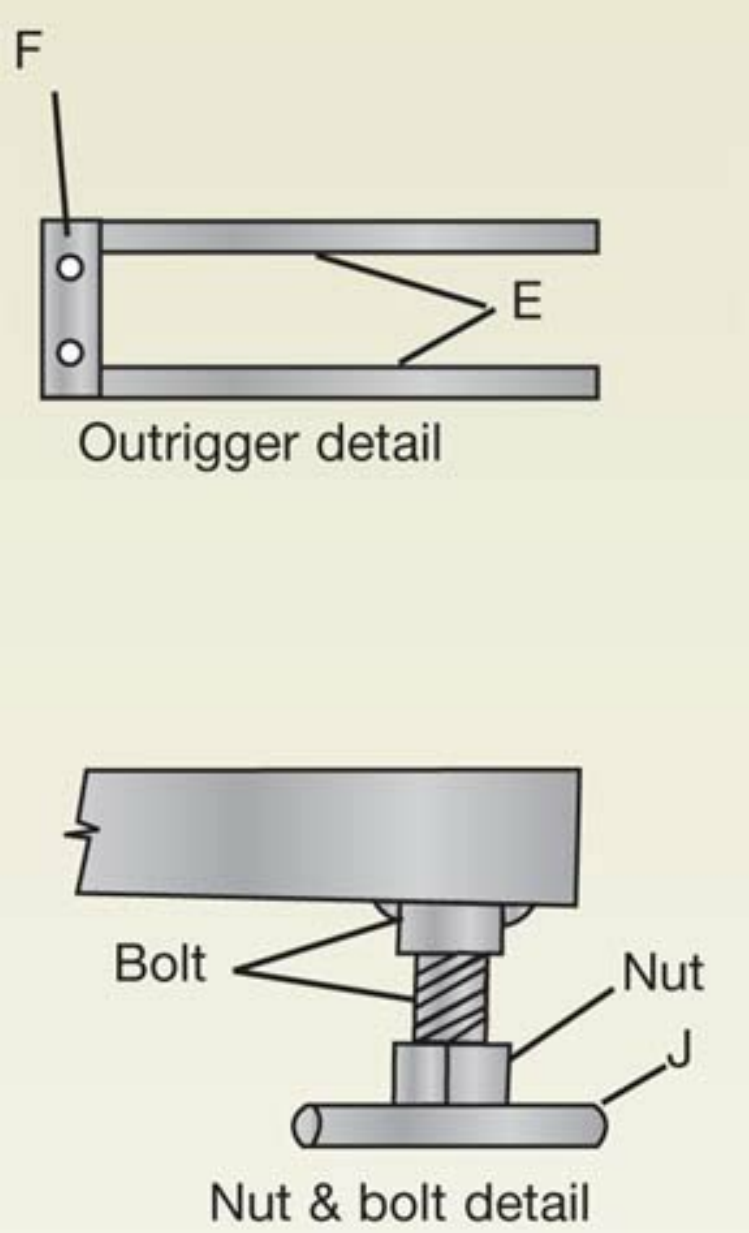
A
Side view


F
E
Outrigger detail
Bolt
Nut
J
Nut & bolt detail

Materials

- 1¼ x 1¼" x 12 gauge steel (35 feet)
- 8 feet of 1" x 1 x 12-gauge steel tubing
- $^{3}/_{16}$" x 2" flat bar (2 feet)
- ¼" round stock (1 foot)
- Hex bolts and nuts $^{5}/_{16}$- 18 UNC (4)
- ¾ to 1" thick Plywood (16 x 24")

Part	Name	Dimensions	Quantity
A	Legs	1¼ x 1¼", 12-gauge steel x 39"	4
B	Top long pieces	1¼ x 1¼", 12-gauge steel x 24"	2
C	Top short pieces	1¼ x 1¼", 12-gauge steel x 13½"	2
D	Outrigger tubes	1¼ x 1¼", 12-gauge steel x 24"	4
E	Outriggers	1 x 1, 12-gauge steel x 24"	4
F	Outrigger end	3⁄16 x 2" flat bar x 7¾"2	
G	Leg connectors	1¼ x 1¼, 12-gauge steel x 20" (at top edge)	2
H	Leg connector cross piece	1¼ x 1¼, 12-gauge steel x 21½"	1
I	Leg feet	3⁄16" x 2" flat bar x 2 x 4 (approx)	4
J	Outrigger handle	3 x ¼" round stock	4
K	Table top	16 x 24" plywood	1

Building the Top Frame

1. Cut the top long pieces (B) to 24".

2. Cut the top short pieces (C) to 13½".

3. Align the top long pieces (B) and top short pieces (C) at 90°. Use a corner magnet to hold the pieces together squarely.

4. Check for square again. Use a magnetic clamp or simply hold the parts in place as you tack them together. Tack all of the long and short tops together to create the top frame.

5. Check for square again, and then weld the four pieces together.

Note: Recommended methods for all welds: SMAW $^{3}/_{32}$" E 6013 electrode; GMAW short circuit transfer; GTAW; ER 70S-6 filler metal, or MIG (as shown here).

Tack together the top long (B) and short (C) parts. Shown here: MIG welder.

Building the Sides

1. Cut the legs out at 39" with parallel 10° ends (see page 103).

2. Align the 10° cut end of a leg (A) 90° to a top long piece(B).

3. Check the pieces for square, and then hold the legs in place 90° against the top long piece. Tack the leg in place.

4. Repeat steps 2 and 3 for the other leg on the same side.

5. Repeat steps 2 through 4 for the other side.

6. Cut the leg connectors (G) to length at 20" with a 10° angle on each end (from top edge of the angle to top edge of opposite angle it should measure 20").

7. Hold a leg connector (G) in between two legs. Check for proper alignment and then tack in place.

8. Check for square and then weld the connectors in place.

9. Repeat the above steps for the leg connector (G) on the other side.

Tack the ends of the legs (A) cut to 10° onto the top frame.

10. Center the leg connector cross piece (H) in between each leg connector (G). Align at 90°, and then use a magnetic clamp to hold in place. Check for square, and then tack the cross piece to the two leg connectors.

11. Check for square and then weld in place.

12. Cut all four feet (I), each at 2".

13. Flip the table upside down on the floor, and then align the feet under the table legs. Hold them in place with pliers and then tack in place.

14. Flip the entire table right-side up to check for level. Adjust as necessary, breaking the feet off and cutting legs for level, if necessary. Shims could also be added.

15. Weld the feet to the legs.

Tack the horizontal leg connectors (G) and then center cross piece (H) that spans between the two leg connectors.

Building the Outriggers

Note: 12-gauge square tubing will always slide, one tube inside the other, when they are ¼ difference in size. More precisely, in order for the outriggers to slide into the outrigger tubes, 12-gauge tubing must be used. 12-gauge tubing has a wall thickness of .110 to .115", so tubes will slide into each other in ¼" increments. For a tighter fit,11-gauge seamless tubing can also be used, but seamless tubing is more expensive.

1. Cut outrigger tubes (D) from 1¼ × 1¼ ", 12-gauge steel to length at 24".

2. Cut the outriggers (E) from 1 × 1, 12-gauge steel to length at 24". Drill a single 3/8" hole on one end of each outrigger. This hole will eventually allow the screw/bolt on the outrigger tube to screw up into the extended outrigger, securely holding it in place when fully extended.

3. Cut the outrigger ends (F) to size at 7¾". Drill two 3/8" holes in them, 2" in from each end.

4. Align an outrigger end (F) 90° to outriggers 1 and 3 (E) at the opposite end of the 3/8" hole you drilled in step 2.

5. Align the other outrigger end 90° to outriggers 2 and 4 (also at the opposite end of the 3/8" hole you drilled in step 2).

6. Use a carpenter's square to ensure proper alignment, and then clamp in place. Tack an outrigger end to outriggers 1 and 3, then repeat for outriggers 2 and 4. Check for square, and then weld the outrigger ends in place.

7. Drill a 3/8" hole on one end of each outrigger tube (D) underside.

8. Hold the outrigger handle (K) in place over bolt end (J), and then weld in place.

Flip the entire stand over and weld the leg feet (I) to the bottom side of the legs (A). If desired, casters could be added to the bottom for increased mobility. Be sure to pick casters that can lock.

Fastening Outriggers to Frame

1. Center a nut (J) over each of the outrigger tube (D) holes from step 7 (see NUT & BOLT DETAIL). Use pliers to hold the nut in place, and then weld. Make sure to alternate: nuts should be on the same end of 1 and 3 outrigger end (F); and 2 and 4 outrigger end (F). The nut is welded onto the tubing after drilling a hole in it. The bolt that screws in is used as a locking mechanism.

2. Clamp outrigger tubes (D) to the bottom side of the top short pieces (C) with 2" spacing. Check alignment with a ruler.

3. Insert the outriggers (E) into the outrigger tubes (D) so that 1 and 3 extend to one side and 2 and 4 extend to the opposite side. Check for ease of sliding.

4. Once the slides are positioned so that they can be pulled out easily, remove them and tack the outrigger tubes onto the top short pieces (C).

5. Double check to see that outriggers slide in and out with ease. If they do, completely weld the outrigger tubes in place. Weld only two sides of the connections, where tubes connect together. No need to weld all around it.

Adding the Tops

1. Cut a 16 x 24" table top (L) out of ¾- to 1"-thick plywood.

2. Predrill $^{5}/_{16}$" holes for the plywood table top (L) into the frame (B, C). Screw or bolt the table top in place.

Option: Cut 2 x 2" wood blocks for the outrigger tops (M). These sit directly above the holes you previously drilled in the outrigger ends (F). Predrill holes in the wood blocks (see below), and then screw the blocks onto the outrigger ends (F). These blocks keep your cutting object level as it spans out on the outriggers.

Finishing

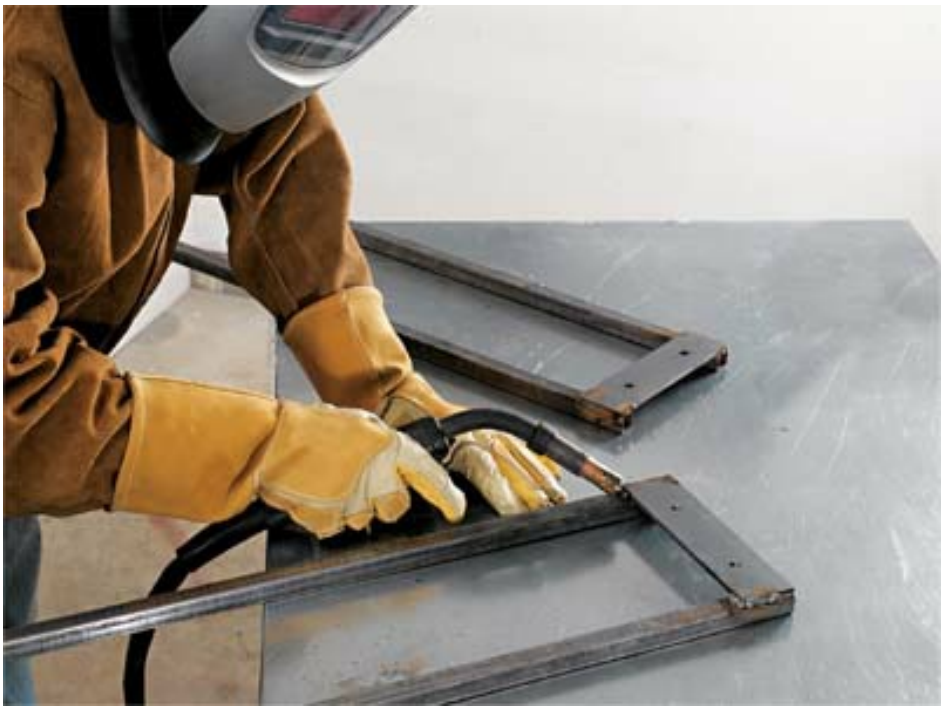
1. Cap all ends of exposed tubing.

2. Prime and paint the saw table.

3. Prime and paint the table frame.

4. Completely remove outriggers and prime them. Once dry, they should be painted or powder-coated for extra durability. For optimal rust protection, first roughen the surfaces by sanding and apply a rust-resistant metal primer before painting.

Drill 3/8" holes in the outrigger ends (F). Use a scrap piece of wood under the flat bar, and clamp the bar and wood to a table.



Tack weld the outrigger ends (F) to the outriggers (E). There are two complete pullout outriggers for both sides of the stand.

Tack weld the outrigger tubes (D) to the top frame underside.

Fasten the plywood top to the frame.

Home Décor

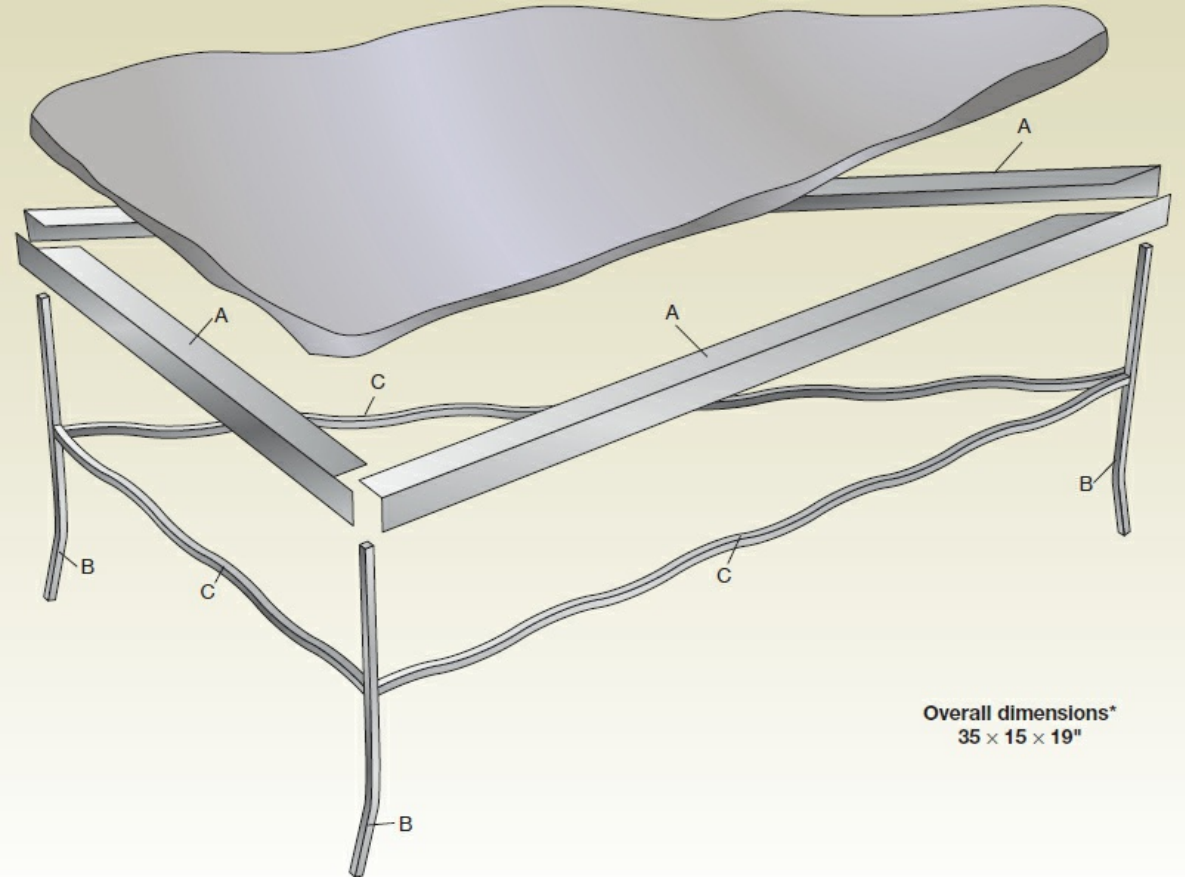
IN THIS CHAPTER:

Coffee Table
Wine Rack
Swivel Mirror
Coat Hanger
Room Divider
Iron Cross
Nesting Tables
Swing-away Coat Hooks
Nightstand
Fireplace Candelabrum

Magazine Rack
Angled Metal Shelves
Wall-mounted Shelf
Étagère
Corner Étagère

Coffee Table

A nice slab of stone or a cross section of a tree makes an appealing coffee table, but how do you support it simply and easily? A table base welded from 1" angle iron and ½" square bar can support the weight of stone or wood without being cumbersome or bulky. This design is for a triangular base to suit the piece of marble being used. Creating a layout with tape allows you to experiment with different sizes and locations for your triangle. If you are using fence pickets, as we have here, make sure the length of the longest side of the triangle does not exceed the length of the picket. Pickets are generally 35 to 39" long.


A
A
A
C
B
B
C
C
B
Overall dimensions*
35 × 15 × 19"

Materials

• Masking tape

• Table top

• 1/8" × 1 × 1" angle iron

(amount will vary)

• ½" square bar (5 feet)

• ½" wavy bar fence pickets (3)

• Construction adhesive,

silicone glue, or screws

PART	NAME	DIMENSIONS	QUANTITY
A	Top supports	⅛ × 1 × 1" angle iron*	3
B	Legs	½" square bar × 20"	3
C	Wavy crosspieces	½" wavy bar fence pickets*	3

*Side pieces and top supports must be cut to fit the particular tabletop.

How to Build a Coffee Table

Create the Triangle

1. Turn the table top upside down and use masking tape to lay out a triangle. The triangle should be at least 3" in from the edges of the table top material, but not so far in that the table will tip easily.

2. Measure each side of the triangle. Cut the top support pieces (A) to match these three measurements. Miter both ends of the longest piece.

3. Place the longest support piece on top of the second longest support. Set both pieces on the tape layout on the table top. Mark the angle and notch on the second support where it intersects the first support (see photo) to allow these pieces to butt together. Cut out the notch and angle on the support.

4. Place the two supports back together on the triangle layout. Set the third support on the layout under the first two support pieces. Mark the notches and angles at the intersections. Cut the third support piece. (You may need to make an additional angle cut on the second long piece, depending on the triangle.)

5. On a work surface, arrange the support pieces to form the triangle. Weld the outside corners. Turn the assembly over and weld the top butt joints.

6. Use an angle grinder to smooth the top joints so the table top rests on a flat surface.

Install the Legs

1. Cut the legs (B) to size.

2. Mark each leg 4" from one end. Place a leg in a bench vise, lining up the mark with the edge of the vise jaws and bend the leg end 15°. Repeat this process for the other two legs.

3. Turn the top assembly upside down on your work surface. Place a leg in a corner with the bend of the leg pointing outward in the same line as the point of the triangle.

4. Check to make sure the leg is perpendicular to the top assembly, then tack weld in place. Tack weld the other two legs in the remaining corners the same way.

Attach the Side Pieces

1. Measure the distance between the legs. Cut one wavy crosspiece (C) to fit each of the three sides. Bevel the ends to fit the angled legs.

2. Clamp a crosspiece against two legs 7" from the top assembly. Check for square and tack weld. Install the remaining crosspieces the same way.

3. Turn the assembly right-side up and check for square and level. Make adjustments if necessary. Complete all the welds.

Complete the Table

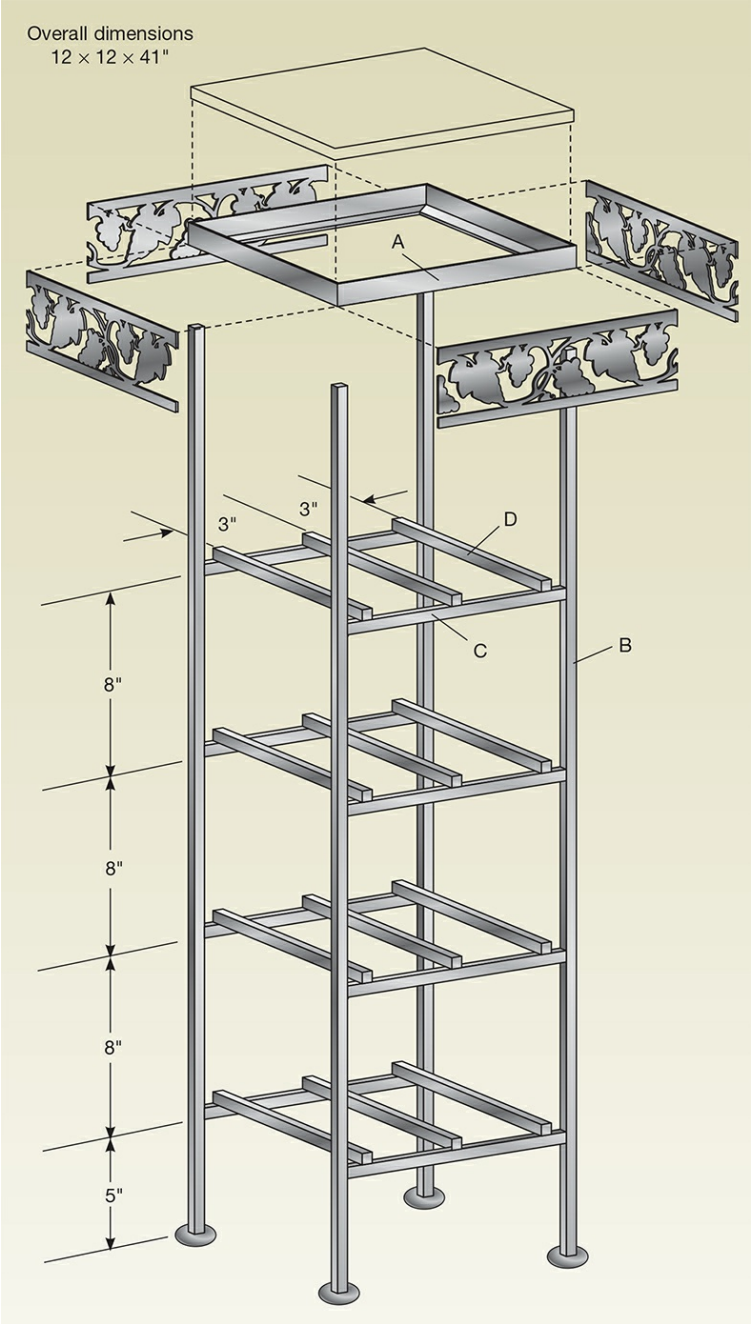
1. Grind down the welds, if desired. (You may also want to grind down the feet of the table so they make flat contact with the floor.) Clean or wire brush the assembly. Apply your choice of finish.

2. Drill holes in the angle iron and attach a wooden table top with screws, or use silicone or construction adhesive to attach a stone top.

Place the mitered long support piece on top of the second longest support piece. Mark the angle and notch needed to fit the pieces together.

Wine Rack

This wine rack is designed so you can install a wall or floor tile as the top surface. Measure the tile and cut the top pieces to fit. Butcher block or marble would also make a nice-looking top. The decorative frieze stamping and squashed ball are available from Architectural Iron Designs—see Resources on page 220.


Overall dimensions
12 × 12 × 41"
A
B
C
D
3"
3"
8"
8"
8"
5"

Materials

- 1/8 × 1 × 1" angle iron (4½ feet)
- ½" square bar (33 feet)
- Decorative frieze (4½ feet)
- 2" squashed balls (4)
- 12" floor or wall tile (1)

PART	NAME	DIMENSIONS	QUANTITY
A	Top	⅛ × 1 x 1" angle iron × 12"*	4
B	Legs	½" square bar × 40"	4
C	Rack supports	½" square bar × 11" *	8
D	Bottle holders	½" square bar × 12" *	12

*Cut to fit selected tile top

How to Make a Wine Rack

Assemble the Top

1. Cut the top pieces (A) to size to fit your top surface, mitering the corners at 45°.

2. Clamp two top pieces together with a corner clamp. Use a carpenter's square to check the pieces for square, and tack weld.

3. Repeat step 2 to assemble the other two top pieces.

4. Clamp the two L-shaped top pieces together, and check for square by measuring across both diagonals. If the measurements are equal, the assembly is square. If it is not square, adjust until both measurements are equal.

5. Tack weld the two corners. Unclamp the pieces and recheck for square. Finish welding the corner joints.

Assemble the Stand

1. Cut the legs (B), rack supports (C), and bottle holders (D) to size.

2. Mark the legs at 5", 13", 21", and 29" from one end. Mark the rack supports at 2½", 5½" and 8½" from one end.

3. Position four rack supports between two of the legs at the marks. Check the pieces for square and tack weld in place.

4. Repeat step 3 to tack weld the remaining four rack supports to the other two legs.

5. Stand the leg assemblies upright and clamp a bottle holder centered on the 5½" mark on the bottom rack support. Clamp the other end of the bottle holder to the other leg assembly. Check for square and tack weld the bottle holder in place.

6. Repeat step 5 to attach a bottle holder at the 5½" marks on the other three rack supports.

7. Make sure the legs assemblies and bottle holders are square, then add the remaining bottle holders at the 2½" and 8½" marks. Finish all welds.

Attach the Top, Legs & Frieze

1. Place the top onto the legs and weld in place.

2. Center a squashed ball at the bottom end of each leg and weld in place.

3. Bend or cut the decorative frieze to fit around the top of the legs and top. Braze, braze weld, or tack weld the frieze into place at the top of the legs and slightly below the top.

4. Grind down the welds as needed. Wire brush or sandblast the wine rack, then apply the finish of your choice.

5. Place the tile into the top.

Clamp the center bottle holders to the leg assemblies and tack weld in place.

Swivel Mirror

Reflect your great taste with this sturdy modern mirror. Its classic design creates a mirror built to last and will make a stunning first impression when displayed in your front entryway for years to come. The clean lines and black paint give this mirror a modern feel, but this can easily be altered by the finish treatment you choose. The adjustable mirror allows even the most petite guests to swivel it to the perfect height.

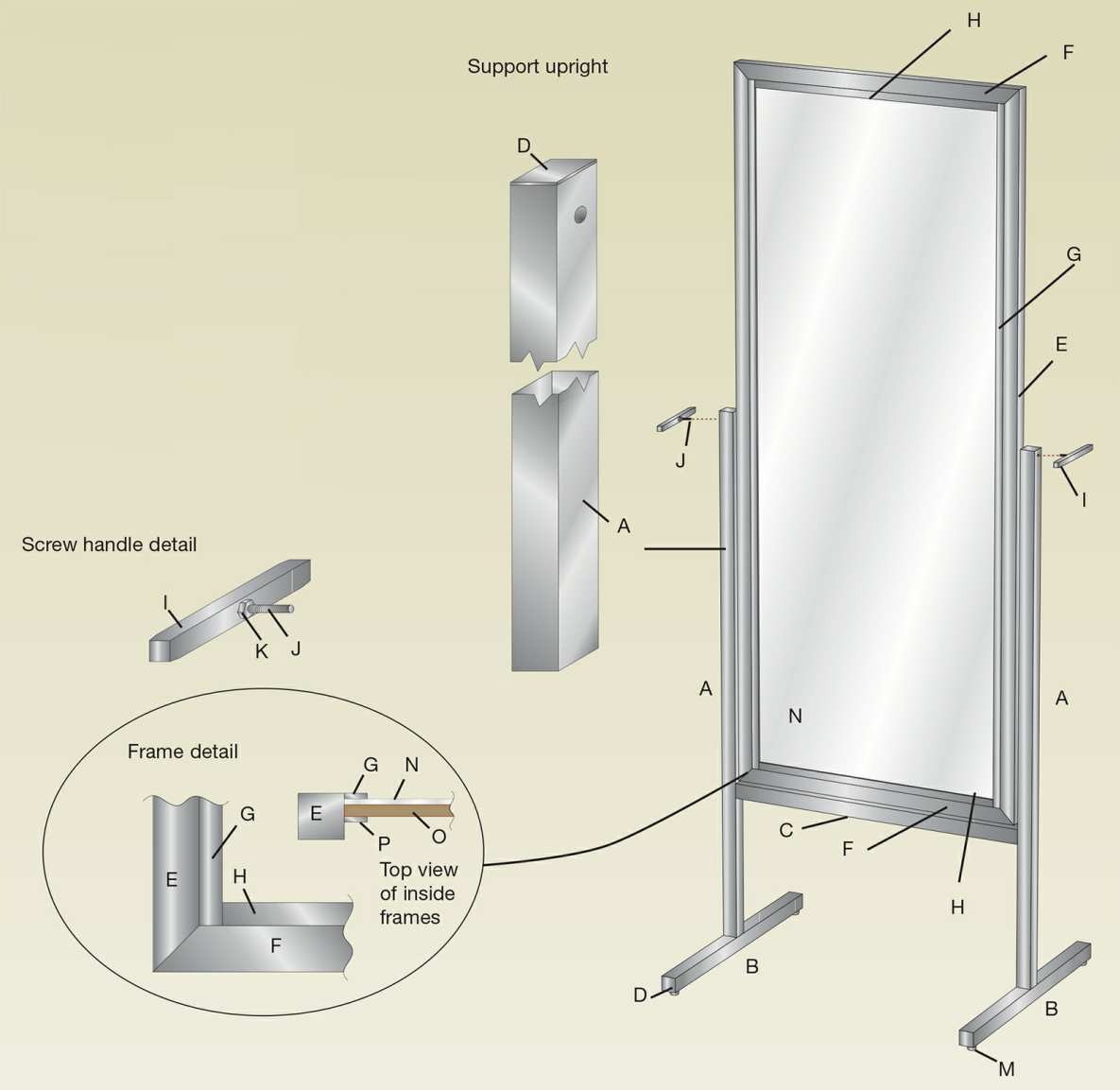
As described here, the inside frame is welded to the outside frame from the back using numerous small welds. The joints between the inside frame pieces are welded from the front, and those welds are ground down. The final look is a frame within a frame, rather than a completely smooth single frame. If you prefer a solid frame, you may continuously weld the inside frame to the outside frame from the front and then grind the welds smooth.

Materials

- 16-gauge 1 × 1" square tube (22 feet)
- 1/8 × ½" flat bar (11 feet)
- ½ × ½" square bar (7")
- 1½" × 5/16" hex bolts (2)
- ¼"–20 hex nuts (6)
- Levelers (4, Rockler #32498)
- ½ × 1" flat bar (6")
- Mirror (45 7/8" × 17 7/8")
- ¼" fiberboard (46" × 18")

PART	NAME	DIMENSIONS	QUANTITY
A	Support uprights	16-gauge 1 × 1" square tube × 36"	2
B	Support bases	16-gauge 1 × 1" square tube × 18"	2
C	Crossbar	16-gauge 1 × 1" square tube × 18½"*	1
D	End caps	⅛ × 1" flat bar × 1"	6
E	Frame sides	16-gauge 1 × 1" square tube × 48"	2
F	Frame ends	16-gauge 1 × 1" square tube × 20"	2
G	Inside frame sides	⅛ × ½" flat bar × 46"	2
H	Inside frame ends	⅛ × ½" flat bar × 17"	2
I	Screw handles	½ × ½" square bar × 3½"	2
J	Handle bolts	1 ½" hex bolt	2
K	Handle nuts	¼"–20 hex nut	2
L	Leveler nuts (optional)	¼"–20 hex nut	4
M	Levelers (optional)		4
N	Mirror	45¾ × 17¾"*	1
O	Mirror backing	45⅞ × 17⅞"* fiberboard	1
P	Tabs	⅛ × ½" flat bar × ½"	8

* Approximate measurement, cut to fit.


Support upright
D
A
H
F
G
E
J
I
A
A
N
C
F
H
B
D
B
M
Screw handle detail
I
K
J
Frame detail
G
E
H
F
G
N
E
P
O
Top view
of inside
frames

How to Build a Swivel Mirror

Before welding, thoroughly clean all parts with denatured alcohol.

Assemble the Supports

1. Cut the supports upright (A) and support base pieces (B) to length.

2. If using levelers, drill two $11^{7}/_{64}$" holes in one side of each loose piece, 2" from the ends. Drill through one wall only. Weld ¼" hex nuts over the holes.

3. Center an upright on a base at 90° and check for square. Weld into place and repeat with the second upright and base.

4. At 2" from the top outside of each upright, drill a $1^{1}/_{32}$" hole. Drill the hole through both walls of the tube.

5. Cut end caps (D) to size. Weld caps to the support upright and base ends. The two supports are in the shape of a T, thus creating the need for six end caps.

6. Grind all welds smooth.

Assemble the Frame

1. Cut the frame sides (E) and frame ends (F) to size. Miter the ends at 45°, or create a joint as shown in the Frame Detail (on page 115).

2. Drill a $1^{1}/_{32}$" hole at the outside midpoint of each side through one wall for the mirror pivot bolts.

3. Align a frame side and a frame end to make a 90° angle. Use a carpenter's square to check for square and clamp in place. Tack weld the pieces together to form an L. Repeat with the other frame side and frame end.

4. Align the two Ls to form a rectangle. Use a carpenter's square to check for square. Clamp into place. Measure the diagonals of the rectangle to check for square. The diagonal measures should be equal; if not, adjust until they are. Tack weld together and recheck for square.

5. Complete all the frame welds. Grind down each weld until flush.

6. Grind the zinc coating off the handle nuts (K). Center the nuts over the holes and weld into place. Protect threads with anti-spatter gel.

Assemble the Inside Frame

1. Before cutting the inside frame sides (G) to length, measure the inside length of the assembled frame. Cut the inside frame sides to fit.

2. Place the assembled frame on a flat surface. Place the two inside frame sides in place against the two frame sides and tack weld into place.

3. Measure between the inside frame sides and cut the inside frame ends (H) to length.

4. Place the inside frame ends in place against the frame ends and tack weld into place.

5. Turn the frame unit over. The inside frame should be flush with the frame. If not, remove pieces and retack, as necessary.

6. Weld the inside frame to the frame from the back with small welds every 3 to 4". Weld the joints between the inside frame members from the front.

7. Grind down all the welds on the front so they are flush.

Tack weld the end caps in place, then weld and grind the welds smooth.

Weld the nuts over the holes in the frame sides before assembling the frame. Use anti-spatter gel to protect the nut threads.

From the back, weld the inside frame to the frame. A small weld every 3 to 4" is sufficient.

Weld the bolts to the beveled screw handles. Use masking tape or anti-spatter gel to protect the threads.

Make the Handles & Apply Finish

1. Cut the screw handles (I) to length. Bevel the ends.

2. Grind the zinc coating from the head of the handle bolt (J). Coat the bolt threads with anti-spatter gel or cover with masking tape. Weld the bolts to the center of the bolt handles.

3. Assemble the frame and supports. With the bolts tightened enough to prevent the frame from moving, measure the distance between the support uprights making sure the uprights are parallel during measurement. Cut the support crossbar (C) to this length.

4. Measure the distance between the frame and the uprights (it should be about ¼"). Mark the uprights below the frame at that same distance. The top of the crossbar will align with these marks so the spacing between the frame and uprights and crossbar is uniform.

5. Disassemble the frame and supports. Align the top of the crossbar with the marks on the uprights. (This is easiest with support bases hanging over the edge of the work surface.) Tack weld the crossbar into place. Use a carpenter's square to check that all angles between the crossbar and support uprights are 90°. Complete the welds and grind them smooth.

6. Grind all welds smooth and grind off any spatter. Wipe the parts down with denatured alcohol to remove grinding dust. Prime and paint. For a natural metal look, use a clear coat. Protect bolt and nut threads with tape during painting to prevent fouling. Don't forget to paint the handles.

Assemble the frame and uprights and mark the location for the crossbar. Remove the frame and weld the crossbar in place.

Install the Mirror

1. Measure the inside of the completed frame to determine the exact mirror size to order. The mirror (N) should be ¼" shorter and ¼" narrower than the frame.

2. Cut the mirror backing (O) to size.

3. Apply small dots of silicone adhesive every 12" around the inside frame. Place the mirror into the frame.

4. Apply small dots of silicone adhesive to the back of the mirror. Place the backing against the mirror. Place the mirror assembly face down on a non-scratching surface.

5. Cut the tabs (P) to size and grind one end to a semi-circle.

6. Space the tabs at 6", 23", and 40" along the frame sides. Sand a small amount of paint off the frame at these points. Center a tab along the frame top and bottom.

7. Firmly push the tabs against the mirror backing and frame sides. Weld into place.

8. Paint the tabs and the smooth side of the mirror backing to match the frame.

9. Install the levelers, if desired, and assemble the mirror. Position the mirror within the uprights and thread the handle bolts through the support uprights and into the frame sides.

Install the mirror and back in the frame. Sand the finish from the frame and weld the tabs per Step 6.

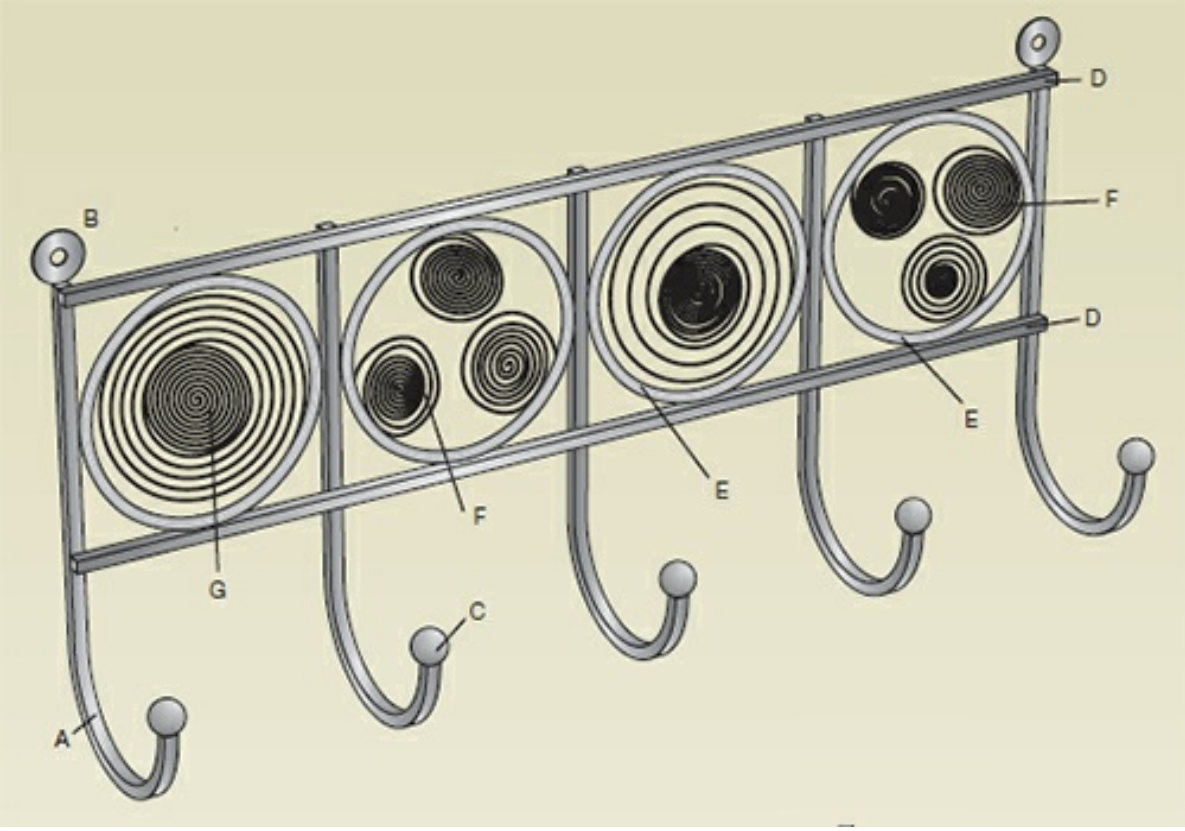
Coat Hanger

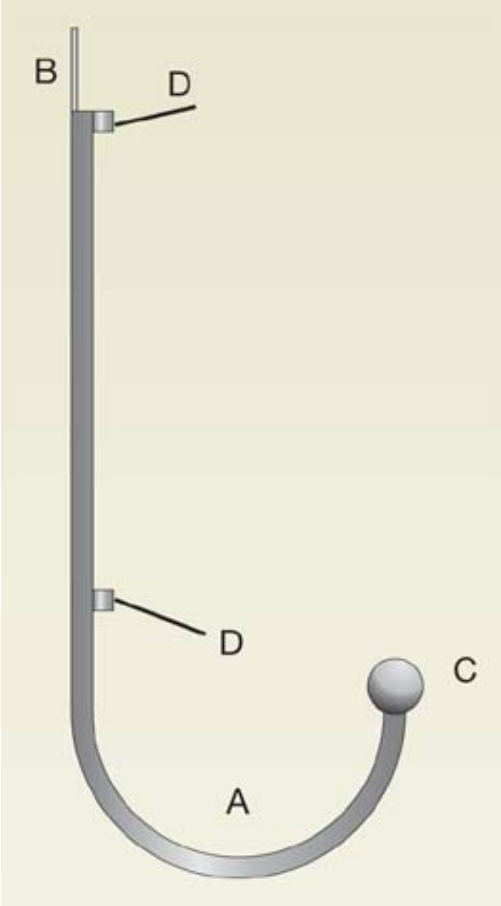
This chic coat hanger has a modern artistic flair due to the unique circular patterns. But the basic design has unlimited potential. You can customize this rack for any part of your life—the front entryway, the garage, the gardening shed, and the cabin may all have different styles. Simply replace the spirals with a punched tin pattern, decorative frieze, or dragonfly, moose, or bear stampings. The rack is sized to mount on studs spaced 16 inches apart. If you like the spirals but want more contrast, use copper or brass 14-gauge wire and leave the entire piece unpainted—but be sure to braze the spirals into place, instead of welding them.

Materials

- $^{3}/_{16}$" square bar (8 feet)
- $^{1}/_{8}$" square rod (8 feet)
- ½" balls (5, decorative iron #JG8851)
- ¾" washers (2)
- 18-gauge annealed stove- pipe wire (25 feet)

PART	NAME	DIMENSIONS	QUANTITY
A	Hooks	$^{3}/_{16}$" square bar × 11½"	5
B	Mounting washers	¾"	2
C	Balls	½"	5
D	Crossbars	$^{3}/_{16}$" square bar × 16"	2
E	Circles	⅛" square rod × 24"	4
F	Mini-spirals	18-gauge wire	6
G	Spirals	18-gauge wire	2


D
F
B
D
E
E
F
G
C
A


B
D
D
C
A

How to Build a Coat Hanger

Before welding, thoroughly clean all parts with denatured alcohol.

Make the Hooks & Frame

1. Cut the hooks (A) to length.

2. Clamp one end of each hook to a 2"-diameter pipe with a vise-style pliers. Bend the bar a half turn around the pipe to create each hook.

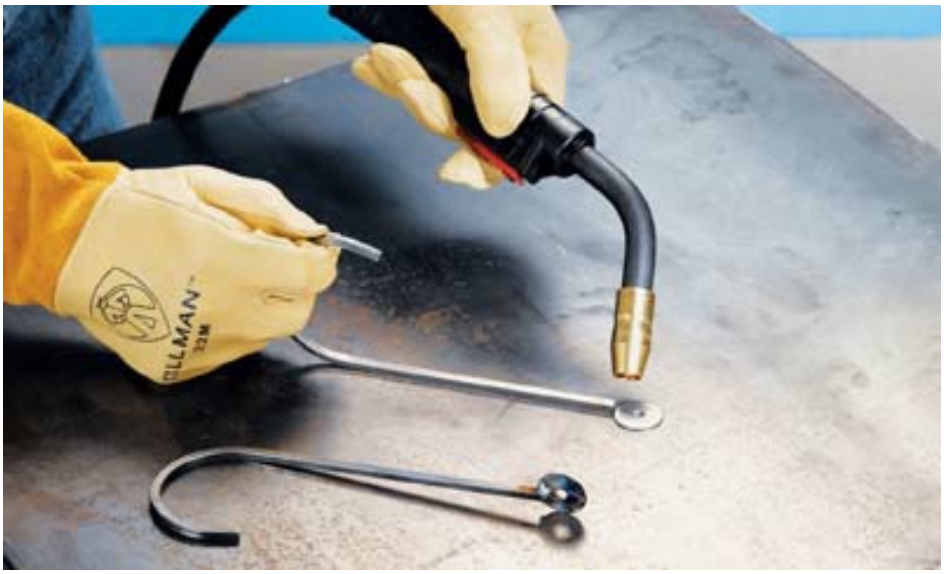
3. Weld each of the two mounting washers (B) to the top of two separate hooks. Weld a ball (C) to the end of all hooks.

4. Cut the crossbars (D) to length. Mark the crossbars at 4", 8", and 12".

5. Align the two hooks that have the mounting washers flush with the crossbar ends. Tack weld in place. Place the second crossbar 4" from the top crossbar and tack weld in place. Check that the angle between the crossbars and hooks is 90° and finish the welds.

6. Center a hook under the two crossbars at the 12" mark lining the top of the hook flush with the top crossbar. Check that the angle between the hook and crossbars is 90° and weld into place.

7. Weld the remaining two hooks to the crossbars at 4" and 8".



Weld the mounting washers to two of the hooks.

Weld the crossbars to the end hooks. Then weld the remaining hooks centered at 4", 8", and 12".

Begin a spiral by wrapping the wire around the tip of a needlenose pliers. Then grip the circle in the pliers and bend the wire until the desired size spiral is achieved.

Make the Circles & Spirals

1. Cut the circles (E) to length.

2. Clamp one end of a circle blank to a 4" pipe using a vise-style pliers. Bend the rod around the pipe one and a half turns to form a circle. Repeat to form the remaining circles.

3. Create the spirals (F) and mini-spirals (G) using a needlenose pliers. Wrap the wire around the end of the pliers to create a circle. Remove the circle from the pliers and grip it in the pliers. Wrap the wire around the circle until the desired size spiral has been formed.

Assemble the Decorative Features

1. Place a circle in the space between the first two hooks starting either on the far left or far right end. Squeeze or expand the circle to fit into the space and cut off any extra length. Weld the circle ends together and weld the circle to the two hooks.

2. Repeat step 2 with the remaining circles.

3. Arrange three mini-spirals inside the second and fourth circles. Weld them to each other and to the circle at contact points.

4. Place the large spirals between the remaining hooks and weld in place.

5. Wire brush or sandblast the coat hanger. Apply the desired finish.

Room Divider

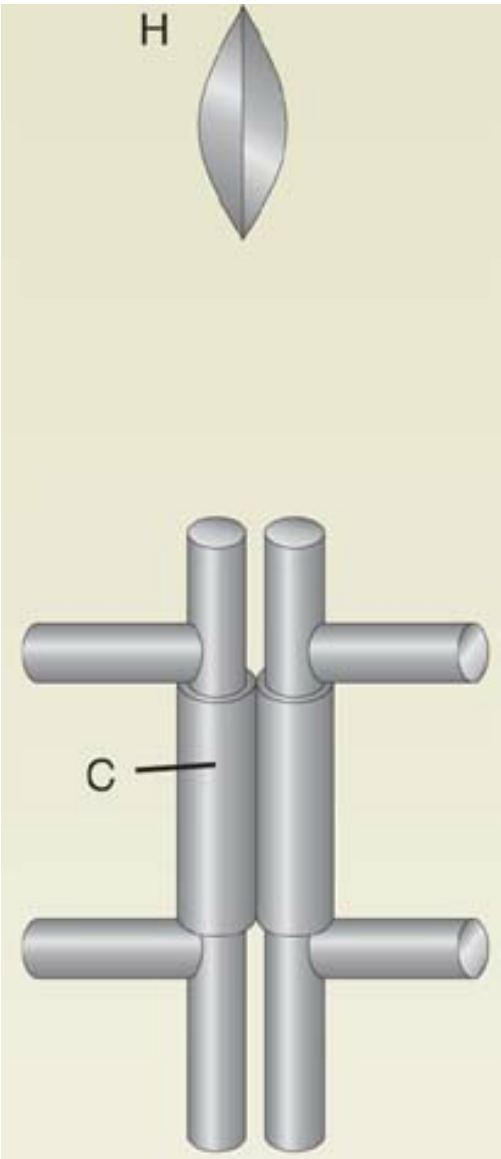
Folding screens are versatile interior design pieces. Used as an accent behind furniture, as a room divider, or as a way to hide an unsightly outlet or wall blemish, this piece holds its own as a piece of art but is also practical furniture. In large spaces it provides a focus while also creating a seamless flow throughout the room. But don’t limit this folding screen to indoor spaces. The all-metal version presented here could easily be incorporated into a garden as a trellis or fence panel.

This project includes two options. You can make a gathered fabric panel or a decorative metal panel. Or you could create both together. As constructed, this screen is moderately sized. Measure the area where the screen will reside and change the proportions accordingly.

Any number of decorative options can be used for the screen panels. Stained glass and pierced or expanded sheet metal are options not covered here, but they would be fabulous additions. If you spend some time with the catalogs of the decorative metal suppliers (see Resources, page 220) you will discover many leaf and flower stampings that could be used to create your own personalized pattern. Grapevines, oak leaves, and sunflowers are available in many different sizes; animal figures, sporting figures, and numbers and letters are available as well.

Note: If you don't care to cut out the leaves as listed in this project, use a small dapped leaf by Architectural Iron Designs. Try to find a leaf in a similar pattern.

A
A
B
H
F
A
G
B
C


H
C

Materials

- 16-gauge ¾" round tube (49 feet)
- 16-gauge 1" round tube (2 feet)
- ¼" round rod (6 feet, optional)
- Fabric (5 yards)
- 16-gauge ½" round tube (28 feet)
- 1/8" round rod (14 feet)
- 22-gauge sheet metal (12 × 24")

PART	NAME	DIMENSIONS	QUANTITY
A	Legs	16-gauge ¾" round tube × 68"	6
B	Crossbars	16-gauge ¾" round tube × 15"	12
C	Hinges	⅛ × 1" round tube × 3"	8
D	Fabric hanging rods (optional)	¼" round rod × 15½"	4
E	Fabric (optional)	60 × 30"	2
F	Verticals	16-gauge ½" round tube × 54¾"	6
G	Stems	⅛" round rod*	15
H	Leaves	22-gauge sheet metal × 4 × 1½"*	45

* Approximate measurement, cut to fit.

How to Build a Room Divider

Before welding, thoroughly clean all parts with denatured alcohol.

Make the Frames

1. Cut the legs and crossbars (A and B) to length.

2. Mark each leg at 6" in from each end.

3. Using a bench or angle grinder, grind the end of each crossbar to shape it to fit around the leg. Make sure the curves are oriented in the same direction at both ends.

4. Place two legs on a large work surface. Align the bottom of one crossbar and the top of another with the 6" marks. Tack weld the crossbars in place. Check the frame for square and weld in place. Grind the welds smooth.

5. Repeat step 4 for the remaining two panels.

Add the Hinges & Complete the Frames

1. Cut the hinges (C) to length.

2. Slide the hinges over all four leg ends of one panel and the top and bottom leg ends of the one side of the other two panels.

3. Align the second set of crossbars above and below the hinges and tack weld in place. Check for square and weld. Make certain you are not welding the hinges to the legs as you weld the crossbars.

Option 1: Create a Fabric Panel

The fabric panel is gathered. If you prefer a smooth look, decrease the fabric width to 15½".

Make the Hanging Rods

1. Cut the hanging rods (D) to length.

2. Mark points on the inside of each panel leg, ½" down from the inside top and bottom crossbars.

3. At the marked points, drill a $1^{7}/_{64}$" hole through the leg wall.

4. Insert one end of a hanging rod into a hole until it contacts the opposite wall. It should then be possible to insert the other end of the hanging rod into the hole on the opposite leg. If it is too long, grind it down until it fits.

5. Lay the three panels flat and parallel to each other, hinges touching. Weld each pair of hinges together.

6. Grind down any rough welds and grind off spatter. Wipe down with denatured alcohol to remove grinding dust. Finish as desired.

Grind a semicircle in the crossbar ends to create a saddle to fit around the legs.

Make the Fabric Panel

1. Make a ¼" flat-felled hem on the long sides of the fabric.

2. Drape the fabric over the top hanging rod so that equal amounts are extending past the top and bottom hanging rods.

3. Pin the fabric together around the rods.

4. Remove the rods and sew the rod pocket, turning the raw edge under.

5. Slide the fabric over the rods and reinstall the rods.

Option 2: Create a Decorated Panel

Make the Supports & Stems

1. Cut the verticals (F) to length.

2. Mark the interior crossbars at 5" and 10".

3. Center the supports over the marks and tack weld in place. Check for square and complete the welds. Grind the welds smooth.

4. Lay out the stems (G) in the desired pattern across the supports.

Make the Leaves

1. Cut the leaves (H) to desired size using a tin snips or plasma cutter.

2. Place a leaf lengthwise in a bench vise and slightly bend it to form a crease down the center.

3. Arrange the leaves in clusters of three. Weld the leaves together at the base.

4. Place the leaf clusters on the stem ends and weld in place.

5. Lay out the three panels parallel to each other, hinges touching. Weld each pair of hinges together.

6. Grind down any rough welds and grind off any spatter. Wipe down with denatured alcohol to remove grinding dust. Finish as desired.

Arrange the leaves in sets of three. Weld the points together, then weld the stem to the leaf sets.

Align the hinge barrels and weld them together.

Iron Cross

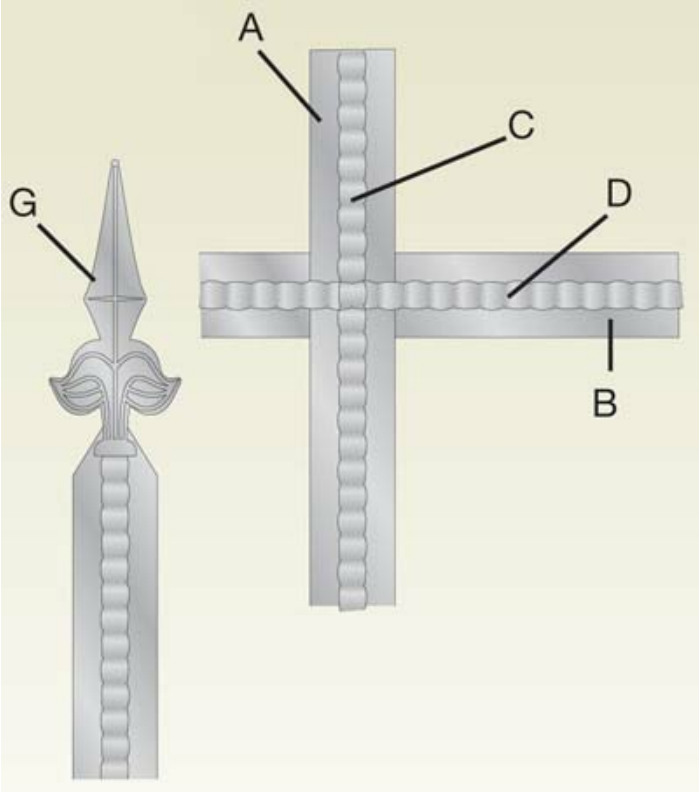
Rusted iron cross wall hangings evoke a sense of history. They create a distinctive air of mystery when hung over a fireplace or against exposed brickwork. Design centers and antique stores want hundreds of dollars for something that you can make for much less, so run wild with your imagination on this project and create a cross that personally resonates with you. The more ornate, the better. Search the catalogs from the suppliers listed in the Resource section on page 220 for just the right touches—you'll find dozens of decorative pieces to make this project uniquely yours.

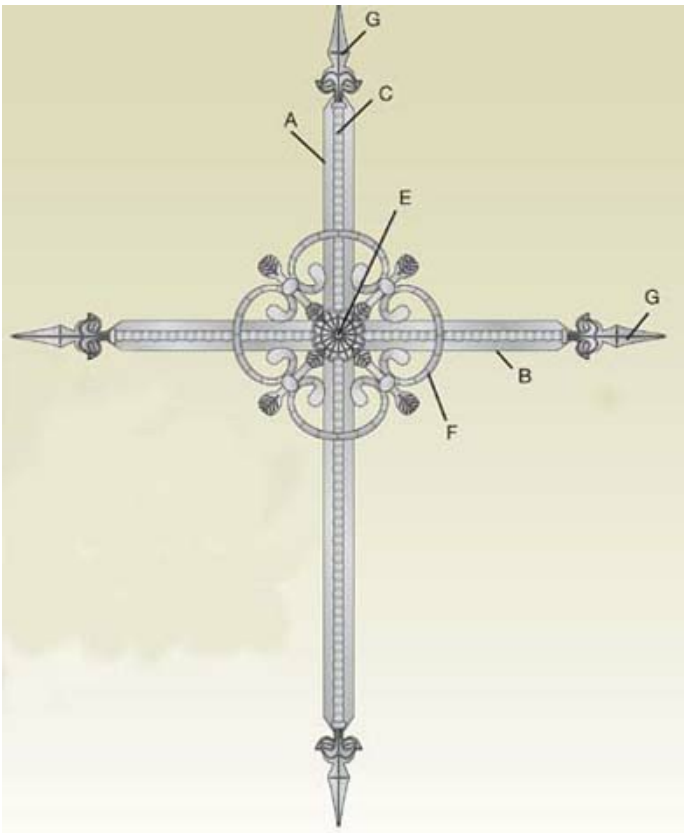
Rather than purchasing a 10- or 20-foot length of hammered or decorative bar—that's a lot of crosses—buy two 39" hammered railing pickets. To get a natural rust finish, thoroughly clean the completed cross with denatured alcohol, wet it down with salt water, and allow it to sit outside for a few months. You'll end up with a naturally beautiful rust.

Materials

- 1/8 × 1½" flat bar (4½ feet)
- ½" hammered bar (4½ feet, Decorative Iron PM-013)
- 2" rosette (1, Decorative Iron LRD-65)
- Scroll set (1, Architectural Iron Designs #55/9)
- Finials (4, Architectural Iron #81/3)

PART	NAME	DIMENSIONS	QUANTITY
A	Vertical base	⅛ × 1½" flat bar × 30"	1
B	Horizontal bases	⅛ × 1½" flat bar × 10"	2
C	Vertical top	½" hammered bar × 29"	1
D	Horizontal tops	½" hammered bar × 9"	2
E	Rosette	2"	1
F	Scroll set	10 × 10"	1
G	Finials	5¼ × 2⅜"	4


A
C
D
G
B


G
C
A
E
G
B
F

How to Build an Iron Cross

Before welding, thoroughly clean all parts with denatured alcohol.

Make the Base

1. Cut the base bars (A and B) to length.

2. Mark the center point of each end of the vertical base and one end of each horizontal base. Mark the bars 1" in from the ends. Draw lines from the 1" mark to the center point to create a point. Cut along the lines.

3. Mark the vertical base 11" from one end. Center the two horizontal bases at this mark to form the cross. Check for square and weld in place. Grind the welds smooth.

Make the Top

1. Cut the vertical and horizontal tops (C and D) to length.

2. Center the top vertical bar on the base. The points should extend ½ to ¾" beyond the bar ends. Weld the top bar to the base with two to three welds along each side.

3. Center the top horizontals on the base. They should touch the top vertical bar at the center and end about an inch before the points. Weld in place.

Add the Decorative Elements

1. Center the rosette (E) in the middle of the cross and weld in place.

2. Center the scroll set (F) over the rosette. Bend the arrow tips upward until the scroll set makes contact with all four arms. Weld in place.

3. Center the finials (G) on the bar ends and weld in place.

Mark the midpoint of both vertical base ends and one end of each horizontal base. Mark 1" from the ends. Connect the marks at a diagonal to create a point.

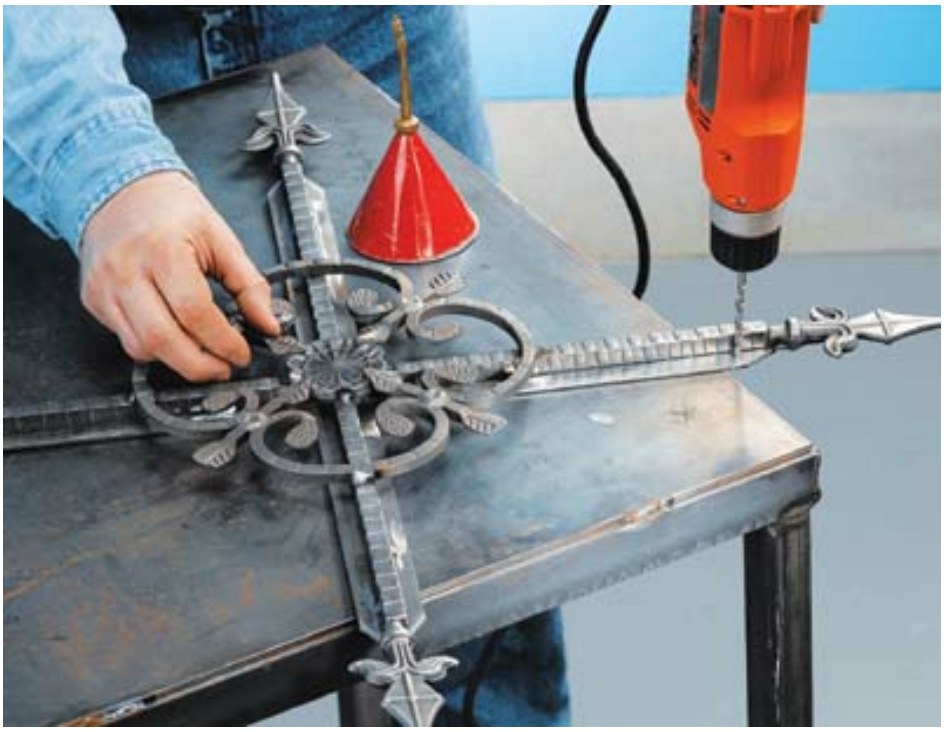
Center the vertical top on the vertical base and weld in place with two to three welds per side.

Finish the Cross

1. Drill $^{3}/_{16}$" mounting holes through the vertical base on either side of the top bar and about 1" from the top and bottom.

2. Wire brush or sandblast the cross. Finish as desired.

3. Because of the weight of the cross, make sure it is mounted on a wall stud. Hang the cross with 1½" screws.



Drill mounting holes through the vertical base. Use machine oil and a slow drill speed to preserve the drill bit.

Nesting Tables

Do you like to entertain but find that you're constantly searching for extra tables as the guests arrive? Nesting tables are the perfect way to always be ready to entertain on the fly. Best of all, they can be tucked away at the end of the evening. The basic pattern here is for three tabletops. These tables have wooden tops with a ½" overhang. You may adjust the measurements for tile or metal tops. If you want the tables to nest even closer, use ½" angle iron with a 16-gauge or 1/8" metal top. And don't forget to dress these tables up! Consider using hammered bar or adding decorative elements to the legs to allow them to show off a bit at parties.

Materials

- ½ × ½" square bar (28 feet)
- 1 × 1 × 1/8" angle iron (17 feet)
- ½" handipanel or veneered plywood (2 ft. × 4 ft. sheet)
- ¾" #8 panhead screws (12)

Large Table

PART	NAME	DIMENSIONS	QUANTITY
A	Legs	½ × ½" square bar × 18"	4
B	Table long sides	1 × 1 × ⅛" angle iron × 23"	2
C	Table short sides	1 × 1 × ⅛" angle iron × 17"	2
D	Crossbars	½ × ½" square bar × 15¾"	2
E	Long crossbar	½ × ½" square bar × 21¾"	1
F	Tabletop	½" plywood 24 × 18"	1

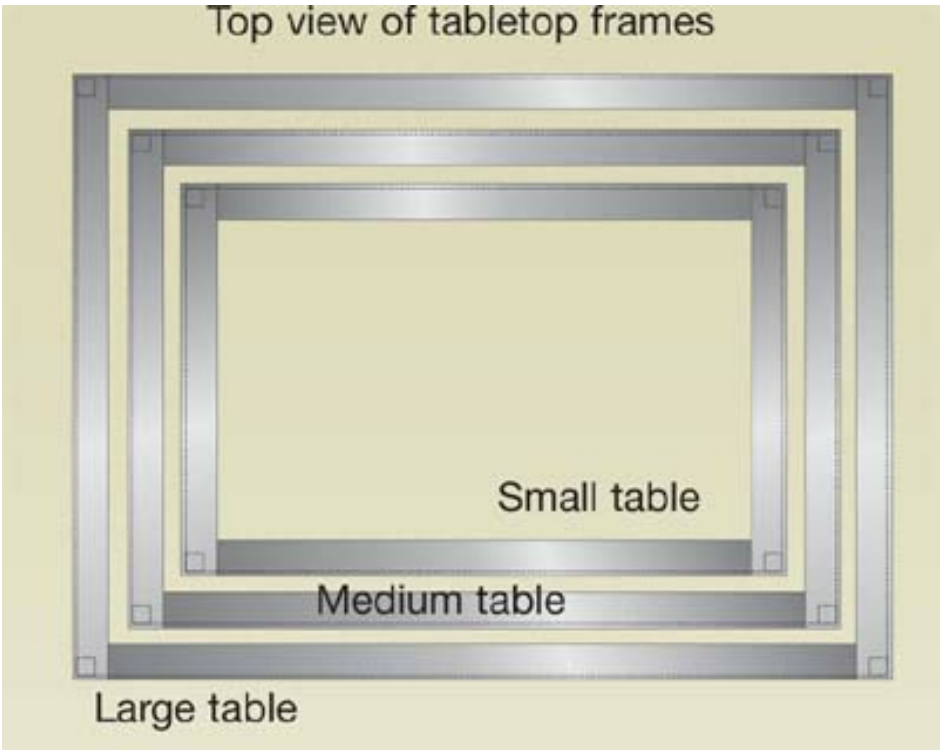
Medium Table

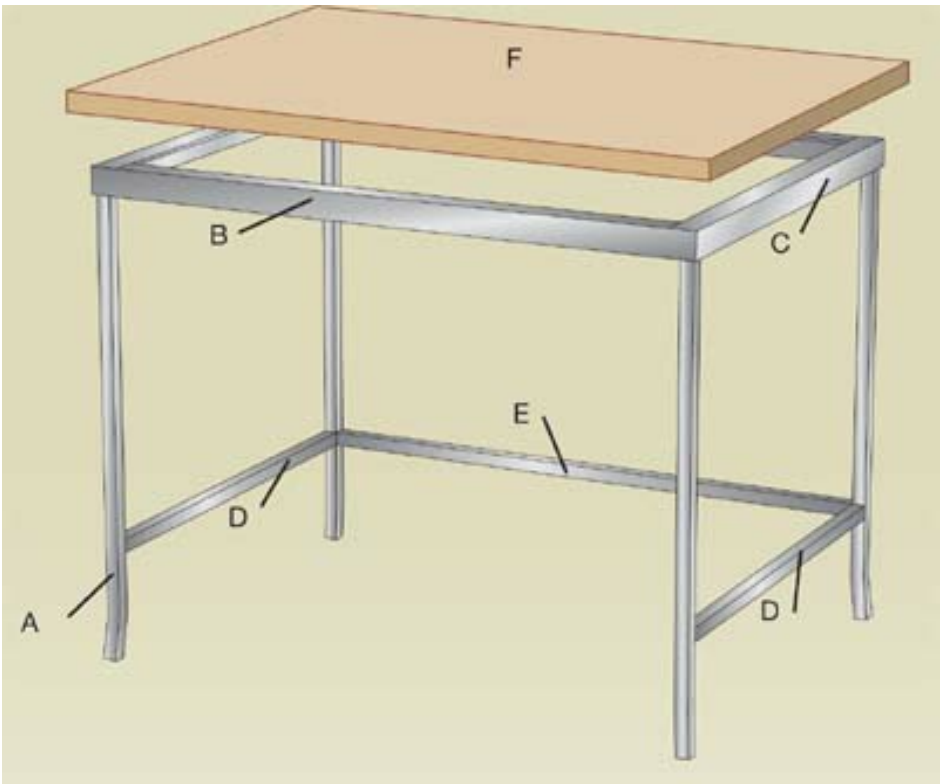
PART	NAME	DIMENSIONS	QUANTITY
A	Legs	½ × ½" square bar × 16"	4
B	Table long sides	1 × 1 × ⅛" angle iron × 20"	2
C	Table short sides	1 × 1 × ⅛" angle iron × 14"	2
D	Crossbars	½ × ½" square bar × 12¾"*	2
E	Long crossbar	½ × ½" square bar × 18¾"*	1
F	Tabletop	½" plywood 21 × 15"	1

Small Table

PART	NAME	DIMENSIONS	QUANTITY
A	Legs	½ × ½" square bar × 14"	4
B	Table long sides	1 × 1 × ⅛" angle iron × 17"	2
C	Table short sides	1 × 1 × ⅛" angle iron × 11"	2
D	Crossbars	½ × ½" square bar × 9¾"	2
E	Long crossbar	½ × ½" square bar × 15¾"	1
F	Tabletop	½" plywood 18 × 12"	1

* Approximate dimensions, cut to fit.


Top view of tabletop frames
Small table
Medium table
Large table


F
B
C
E
D
A
D

How to Build Nesting Tables

Before welding, thoroughly clean all parts with denatured alcohol.

Using a carpenter’s square, lay out the table sides. Tack weld together and check for square before final welding.

Make the Legs

1. Cut the legs of the large table (A) to length.

2. Clamp the lower 1½" of a leg into a sturdy bench vise. Slide a 3-ft. length of ½" pipe over the leg. Bend it about 5°.

3. Using the first leg as a template, bend all the remaining legs to match.

4. Repeat steps 1 to 3 with the medium and small tables.

Make the Tabletop Frames

1. Cut the table long sides (B) and table short sides (C) to length. Miter the ends at 45°, or cut notches in the long sides.

2. Lay out one long side and one short side of the large table using a carpenter's square to check for square. Clamp into place and tack weld the corner.

3. Repeat Step 2 with the other long and short sides.

4. Use a carpenter's square to align the two Ls to form a rectangle.

5. Weld the outside joints together. Grind down the welds.

6. Repeat steps 1 to 5 with the medium and small tables.

Attach the Legs

If you will be making a wooden or metal tabletop, turn the table frame so the flanges of the angle iron are pointing downward. Weld the legs inside the corner. If you will be making a tile tabletop, turn the frame so the flanges are pointing up to create a cradle for the base and tile. Weld the legs to the bottom of the frame.

1. Place a leg on or in a corner, with the bend facing the long side. Use a carpenter's square to check that it is square from front to back and side to side. Weld in place.

2. Repeat step 1 with the remaining legs.

3. Measure the distance between the legs on the short sides, close to the frame. Cut the crossbars (D) to fit. Weld the crossbars into place at 4" from the bottom of the legs.

4. Measure the distance between the legs on a long side, close to the frame. Cut the back bar (E) to fit. Weld into place, even with the crossbars.

5. Repeat steps 1 to 4 with the medium and small tables.

6. Grind down all the welds. Sand, wire brush, or sandblast the tables. Finish as desired. (If using a metal top, install it before finishing.)

For a wood or metal tabletop, weld the legs inside the corner formed by the flanges. Align the curved legs so they point toward the long sides.

Option 1: Create a Wood Top

The wood tabletops have a ½" overhang.

1. Cut the wood tabletop (F) to size.

2. If using a handipanel, sand the edges smooth, slightly rounding the top edge and corners, or use a ½" roundover bit and rout the edges.

3. If the top is veneered plywood, apply edge banding with an iron. Trim the banding to fit and lightly sand the edges and corners.

4. Apply paint, stain, or finish.

5. Turn the table upside down and drill a $^{3}/_{16}$" hole in each side. Drill a corresponding $^{1}/_{8}$" pilot hole in the underside of the tabletop. Attach the top to the table with ¾" panhead screws.

6. Repeat steps 1 to 5 with the medium and small tables.

After drilling holes in each of the table’s sides, align the wood top and drill pilot holes for the mounting screws.

Option 2: Create a Tile Top

1. Measure the inside dimension of the tabletop. Cut ¾" exterior-grade plywood to fit.

2. Mark the plywood piece with your desired tile layout.

3. Apply a small amount of silicone adhesive to the lip of the table. Place the plywood onto the table.

4. Apply a layer of adhesive to the back of each tile using a notched trowel. Place the tiles on the plywood according to your pattern. After placing the tiles, use a carpet-covered 2 × 4 and a rubber mallet to set the tiles.

5. After the adhesive sets, apply grout to the tile spaces according to manufacturer's instructions. Do not apply grout to the gap between the metal frame and the tiles. Use colored silicone sealant between the metal and the tiles.

6. Repeat steps 1 to 5 with the medium and small tables.

Option 3: Create a Metal Top

You can make a metal top of matching steel or create a contrasting look with expanded sheet metal, patterned stainless steel, or aluminum. A glass panel covering patterned metal creates a smooth surface while allowing the pattern to shine through.

1. Cut the metal to fit the dimensions of the table.

2. Tack weld the top to the table from the underside, or weld around the entire perimeter. Grind the contact points to create a smooth transition.

3. Repeat steps 1 and 2 with the medium and small tables.

For a tiled tabletop, weld the legs to the flat underside so that the flanges form a cradle for the tile and backing material.

Swing-away Coat Hooks

These good-looking, easy-to-make coat hooks are considerably sturdier than those you might purchase at discount stores. The pivoting design lets them fold flat against the wall when not in use, so you can install them wherever you want.

Customize the hooks with a special shaped back plate or use cutout letters to personalize hooks for a child’s room. Make the hooks shorter, if desired, or use more than three hooks. Mount the hooks on a stud to prevent the weight of coats from pulling them out of the wall.

Materials

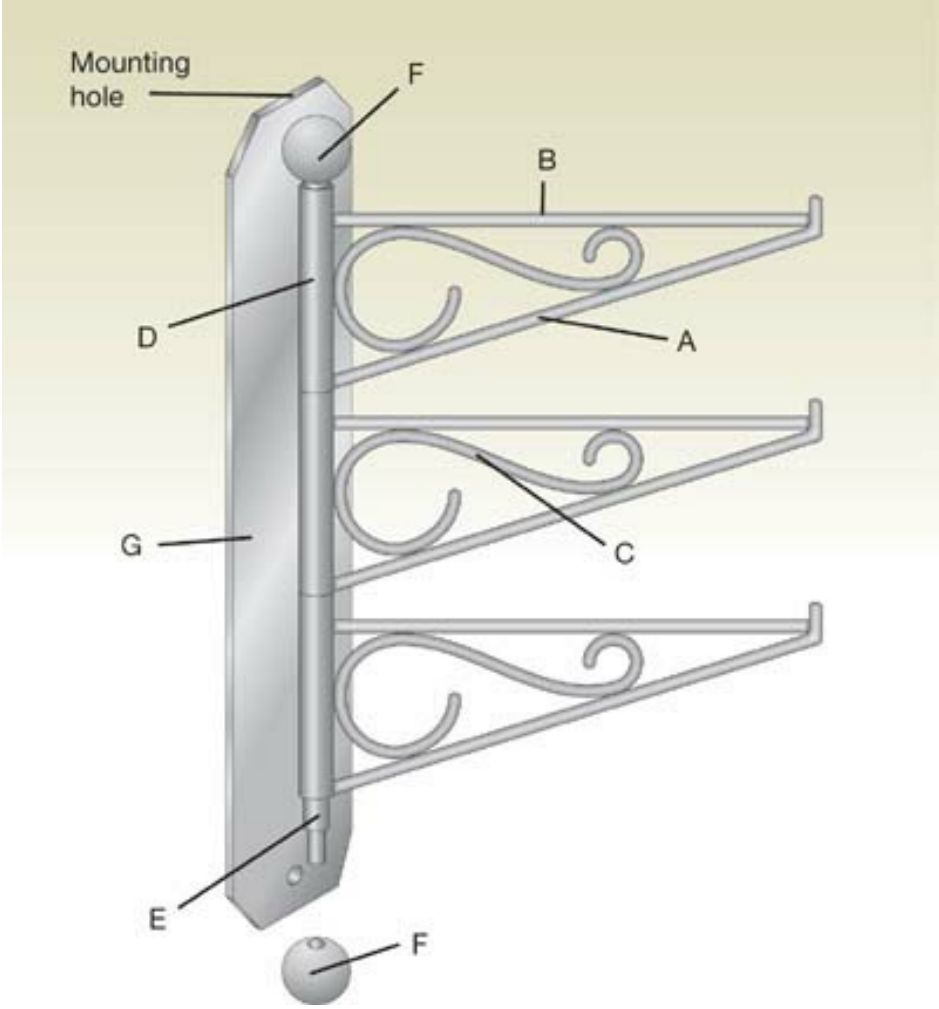
- 16-gauge ½" round tube (9")
- ¼" round rod (10")
- $^{3}/_{16}$" round rod (6½ feet)
- $^{1}/_{8}$ × 2" flat bar (12")
- 1" O.D. ball ¼" 20 threaded (2, Decorative Iron #C50035)

PART	NAME	DIMENSIONS	QUANTITY
A	Hooks	3/16" round rod × 9"*	3
B	Crossbars	3/16" round rod × 7"*	3
C	Scrolls	3/16" round rod × 9"	3
D	Barrels	16-gauge ½" round tube × 3"	3
E	Pin	¼" round rod × 10"	1
F	Balls	1" round balls	2
G	Back plate	⅛ × 2" flat bar × 12"	1

* Approximate dimensions, cut to fit.

How to Build Swing-away Coat Hooks

Before welding, thoroughly clean all parts with denatured alcohol.


Mounting hole
F
B
D
A
G
C
E
F

Make the Scrolls

1. Cut the scroll blanks (C) to length. Round the rod ends with a grinder.

2. Clamp one end of the scroll blank to a ½" pipe. Bend the scroll around the pipe a three-quarter turn.

3. Clamp the other end of the scroll to a 1" pipe. Bend the scroll around the pipe a three-quarter turn in the opposite direction.

4. Repeat with the other two scrolls, matching the bends in the first scroll.

Make the Hooks

1. Cut the hooks and crossbars (A and B) to length. Round one hook end with a grinder.

2. Place 1" of the hook into a bench vise and bend to about 110°. Repeat with the other two hooks.

3. Align a crossbar at 90° to the hook and weld in place.

4. Trim the hook and crossbar ends to match, if necessary.

5. Place a scroll between the legs of a hook. The hook legs should be no more than 2¾" apart.

6. Arrange the other hooks and scrolls to match the first. Weld together.

Make the Hinge

1. Cut the barrels (D) to length. Draw a guideline down the center of each barrel. Make a mark at ½" down from the top of each barrel along the guideline.

2. Align the hook with the barrel so the upper leg of the hook is at the intersection of the guideline and the ½" mark.

3. Weld the hook legs to the barrel.

4. Repeat steps 2 and 3 with the other two hooks.

5. Cut the pin (E) to length. Grind down ½" at each end of the pin to fit the holes in the balls. Slide the barrels over the pin. Place the balls (F) over the pin at each end.

Assemble the Coat Hooks

1. Cut the back plate (G) to size. Round the corners with a grinder.

2. Drill $^{5}/_{32}$" mounting holes centered 1" from each end.

3. Measure the distance between the centers of the balls on the hook assembly. Drill ¼" holes this distance apart on the centerline of the back plate.

4. Place the hook assembly on the back so the balls rest in the holes. From the back side, weld the balls to the back plate.

5. Sand, wire brush, or sandblast the coat hooks. Finish as desired.

Align the crossbar with the hook and weld the ends together. A magnetic clamp helps hold the small parts in place.

Nightstand

Sleek and sophisticated, this table may be designed like a wood table, but its unmatched style comes from metal. Many people find metal easier to work with than wood, and metal can offer the same great looks without all that sawdust.

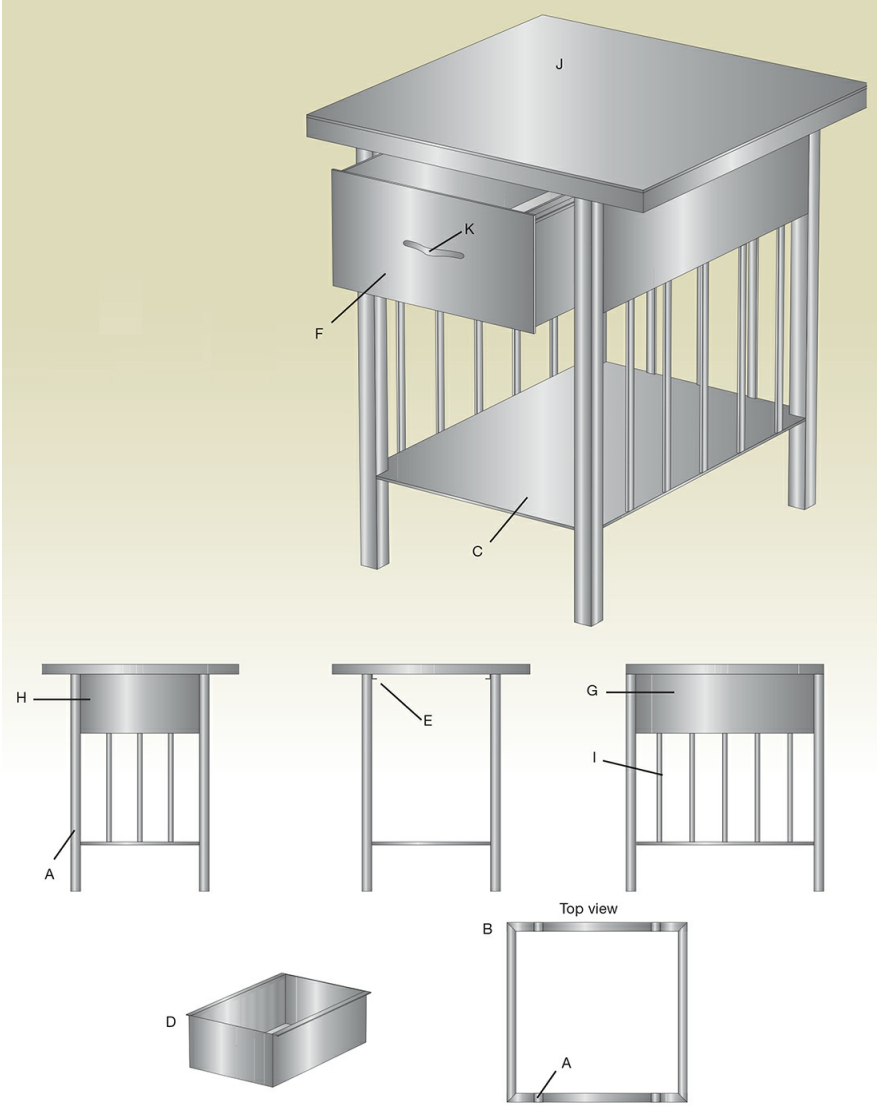
When working with thinner materials, make sure to turn your welder to the appropriate setting to prevent burn through and distortion.

Materials

- 16-gauge 1 × 1" square tube (14½ feet)
- 16-gauge sheet metal (3 ft. × 5½ ft. sheet)
- 16-gauge angle iron (3 feet)
- 1/8 × ½" flat bar (14 feet)
- 22-gauge sheet metal (2 ft. × 1 ft. sheet)
- Drawer handle

PART	NAME	DIMENSIONS	QUANTITY
A	Legs	16-gauge 1 × 1" square tube × 22"	4
B	Table frames	16-gauge 1 × 1" square tube × 20"	4
C	Shelf	16-gauge sheet metal × 14 × 20"*	1
D	Drawer box	22-gauge sheet metal × 18 × 6"	1
E	Drawer glides	16-gauge ½ × ½" angle iron × 18"	2
F	Drawer face	16-gauge sheet metal × 6 × 12*	1
G	Sides	16-gauge sheet metal × 18 × 6"	2
H	Back	16-gauge sheet metal × 12 × 6"	1
I	Bars	⅛ × ½" flat bar × 11"*	13
J	Tabletop	16-gauge sheet metal × 20 × 20"*	1
K	Drawer handle		1

*Approximate dimensions, cut to fit.


J
K
F
C
H
A
E
G
I
Top view
B
A
D

How to Build a Nightstand

Before welding, thoroughly clean all parts with denatured alcohol.

Clamp a leg in place with a piece of angle iron and two C-clamps. Check for square and weld the leg to the table frame.

Make the Table Frame

1. Cut the legs (A) and table frame (B) to size. Miter the frame ends at 45°.

2. On a flat work surface, position two sides of the frame in an L shape. Use a carpenter's square to check for square and then clamp in place. Tack weld the corner. Repeat with the other two sides.

3. Arrange the two Ls to make a square. Clamp in place. Measure across the diagonals to check for square. If the diagonal measurements are not equal, the assembly is not square. Adjust and recheck. Tack weld the corners.

4. After rechecking for square, finish welding all the joints.

5. Grind down the welds to be flush with the surrounding metal.

6. Mark points 3" in from the ends on one frame side. Mark points 3" in from the ends on the opposite frame side.

7. Align a leg with the mark and tack weld into place. Use clamps and an angle iron to securely hold the leg. Repeat with the other three legs.

8. Make sure the legs are perpendicular to the frame and weld in place.

Make the Shelf

1. Before cutting the shelf (C) to size, measure between the outside faces of the front and side legs to make sure this dimension is correct. Cut the shelf to size.

2. Make 1 × 1" cutouts in each corner of the shelf using a plasma cutter, oxyacetylene torch, or bandsaw. Note that the square tube has slightly rounded edges, so round the cutouts to match.

3. Mark each leg at 5" from the bottom.

4. Align the shelf with the marks and tack weld in place. Make sure the shelf is level before finish welding.

Make the Drawer

1. Cut the drawer (D) to size.

2. Use a hand seamer to bend the drawer sides at $^{3}/_{8}$" to 90°.

3. Bend the sides and ends of the drawer to 90° to make a box.

4. Weld the seams.

Finish the Drawer

1. Measure the distance between the two front legs. Subtract $^{1}/_{8}$" and cut the drawer face (F) to size.

2. With the drawer in the frame, place the drawer face over the drawer front. Align the drawer face with a $^{1}/_{16}$" gap between the frame and legs. Placing magnetic right-angle clamps in the drawer makes this task easier.

3. Tack weld the drawer face to the drawer from the inside.

4. Remove the drawer and complete the welds.

5. Center your chosen drawer pull on the drawer face and mark the screw locations. Drill the holes for the pull.

Cut the drawer to size. Clamp the drawer to a sharp-edged surface using C clamps and a piece of angle iron. Bend the sides, back and front of the drawer to 90°.

Add the Sides & Back

1. Before cutting the sides (G) and back (H), measure between the side legs and the back legs to determine the exact lengths. Cut the back and sides to size.

2. Place the sides and back and weld in place.

3. Measure from the top of the shelf to the bottom of the sides and back to determine the correct length for the bars (I). Cut the bars to length.

4. Place three bars evenly spaced (approximately 3" on center) across the back. Make sure the bars are perfectly vertical before welding. Place five bars evenly spaced (approximately 3" on center) across each side. Make sure the bars are perfectly vertical before welding.

Weld the decorative bars to the table sides and shelf every 3". Weld from the inside.

Finish the Table

1. Measure the top outside dimension of the table frame. Cut the tabletop (J) to size using these dimensions.

2. Attach the tabletop from the underside using two small welds per side. If you prefer a tabletop that appears one with the frame, weld around the entire perimeter of the tabletop and grind the weld smooth.

3. Wire brush, sand, or sandblast the table and drawer. Finish as desired.

4. Attach the drawer pull.

Weld the drawer glides to the legs.

Make the Drawer Glides

1. Cut the glides (E) to size.

2. Mark ¼" down from the top inside of each leg. Align the glides with the lines and tack weld in place.

3. Slide the drawer into the frame and check for fit. Adjust if necessary, and complete the welds.

Fireplace Candelabrum

Warm up your hearth, without all the chopping and stacking of wood, with this wavy candelabrum. The simple waves imitate tongues of flames, while the large candleholders support illuminating pillar candles. Romantic, simple, and great for warm summer evenings when a hot fire might be too much.

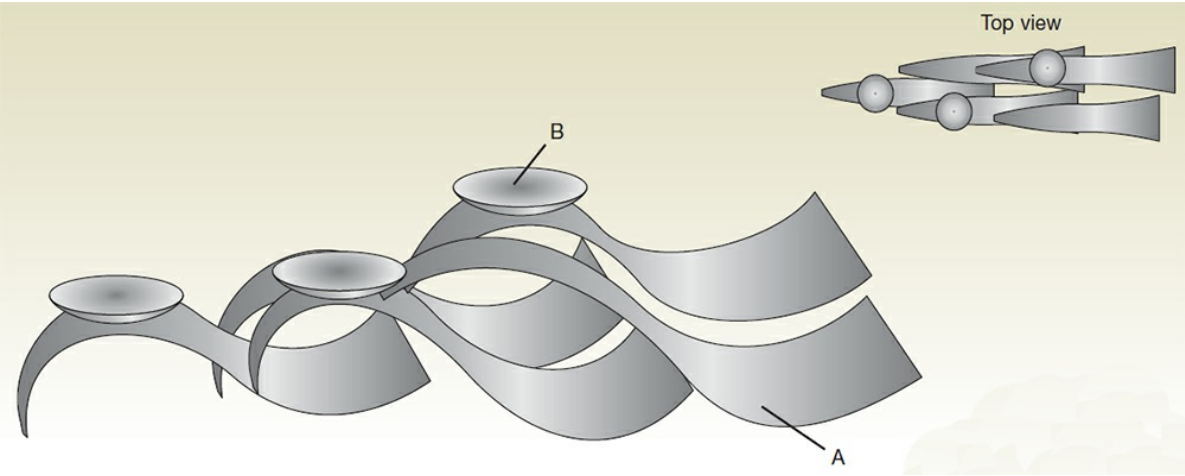
Materials

- 1/8" sheet metal (13 × 19")
- 4½" bobeches (3, Architectural Iron Designs #79/12)

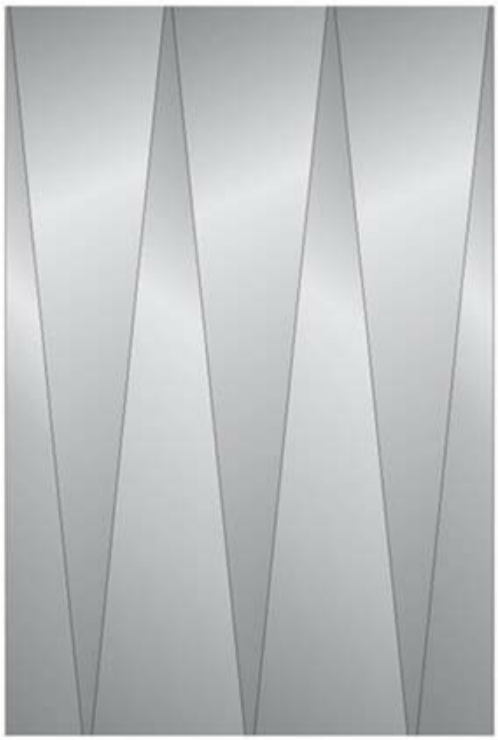
PART	NAME	DIMENSIONS	QUANTITY
A	Waves	⅛" sheet metal × 4 × 19"	5
B	Bobeches	4½"	3

How to Build a Fireplace Candelabrum

Before welding, thoroughly clean all parts with denatured alcohol.



Cutting Diagram



Clamp the narrow wave end to a 4" bending form and bend it slightly past halfway.

Cut the Waves

1. Mark the sheet metal at 4", 4½", 8½", and 9" along one 13" side, and 2", 2½", 6½", 7", 11", and 11½" along the opposite 13" side.

2. Use a straightedge and a permanent marker or soapstone to connect the marks (see diagram).

3. Cut the waves (A) to size using an oxyacetylene torch or plasma cutter.

4. Grind the cut edges smooth, if necessary, and sand or wire brush the metal.

Bend the Waves

1. Clamp the narrow end of a wave to a 4" bending form. Bend the wave around just slightly past halfway (see photo).

2. Clamp the wide end of the wave to a 4" bending form. Wrap the wave around the tube a half turn in the opposite direction from the first wave.

3. Repeat steps 1 and 2 with the other four waves.

Arrange & Finish

1. Arrange the waves as desired. Make sure the arrangement fits in the fireplace.

2. Weld the waves together at the contact points.

3. Place the bobeches on the waves, making sure they are level. Drill a ¼" hole in the center of each bobeche.

4. Weld the bobeches to the waves by welding through the hole. If you choose to use brass bobeches, braze or braze weld the bobeches to the waves.

5. Finish the candelabrum as desired.

Magazine Rack

Form follows function with this nifty M design. It’s a magazine rack that’s a snap to put together and perfect for keeping magazines organized and off the floor. You can use virtually any combination of sheet metal and tubing to make this rack. In this project, 16-gauge sheet metal and ¾ x 1¾" rectangular tubing is used. You could also try it with round tubing, hammered tubing, pierced sheet metal, or expanded sheet metal. Make it to fit your favorite magazine, and it will be truly customized.

Materials

- 16-gauge sheet metal (20 × 12" sheet)
- 16-gauge ¾ × 1½" rectangular tube (40")

PART	NAME	DIMENSIONS	QUANTITY
A	Sides	16-gauge sheet metal 10 × 12"	2
B	Legs	16-gauge ¾ × 1½" rectangular tube × 10"	4

How to Build a Magazine Rack

Before welding, thoroughly clean all parts with denatured alcohol.

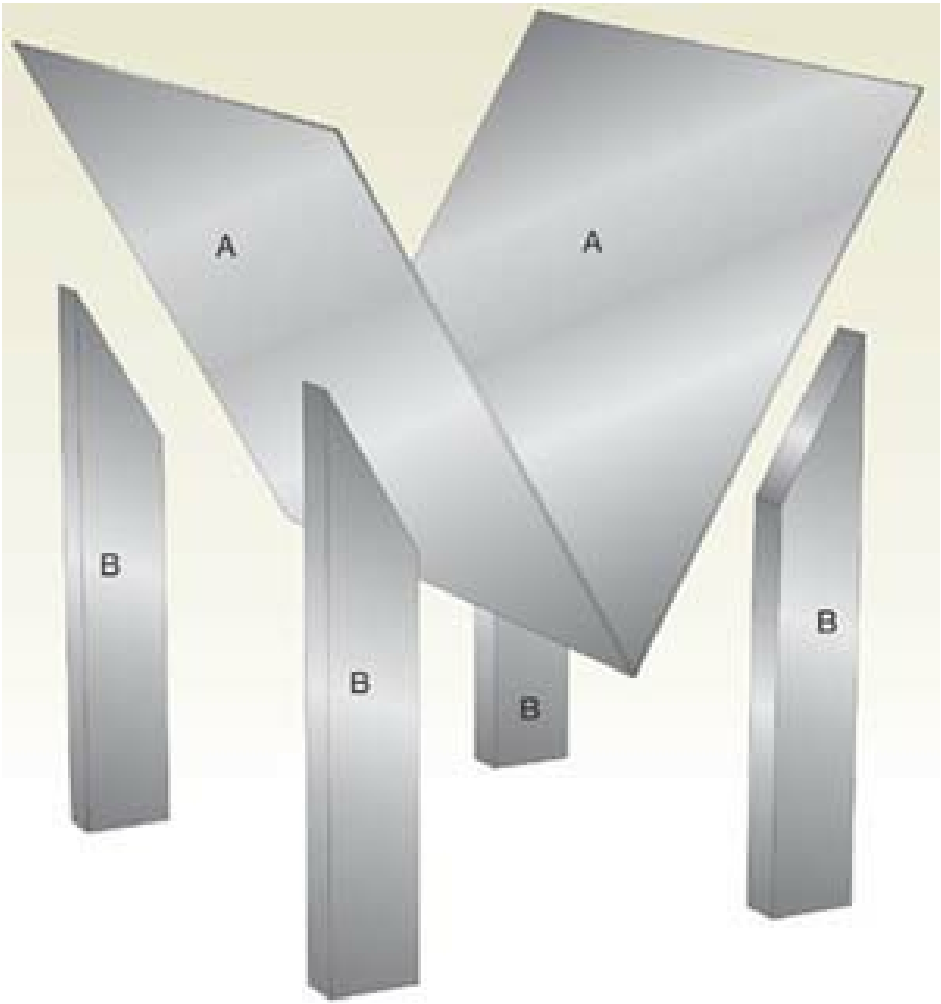
Assemble the Sides

1. Cut the sides (A) to size.

2. Remove slag and grind down any cutting imperfections.

3. Set up the sides in an upsidedown V. The V angle should be between 50° and 60°. Clamp the sides in place and tack weld the sides together (see photo).

4. Weld the sides together with four 1" welds.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Cut the Legs

1. Cut the legs (B) to length.

2. To get the exact angle measurement for the angle at the top of the legs, trace the outside of the V on a piece of paper. Align a carpenter's square along the tops of the V, with one side of the V contacting the corner of the square. Mark the line for the leg (as though you are making an M). Repeat for the other side.

3. Flip the carpenter's square over and align it with one of the newly drawn lines. Align a leg in the corner of the square. Using a straightedge, mark the leg where it crosses the V. Repeat on the same side. Mark the remaining two legs using the other side of the pattern.

4. Cut the leg angles.

Assemble the Rack

1. Place the V upside down. Place a leg about ½" in from the front or back end of the V. Use a try square to check that the leg is perpendicular and tack weld in place.

2. Repeat step 1 with the other three legs.

3. Turn the rack upright to check for leg alignment. Make adjustments, if necessary, and complete the welds.

4. Grind down welds and spatter. Wire brush the rack and wipe down with denatured alcohol before finishing.

Form a V with rack sides and clamp with magnetic clamps. Weld the seam.

Angled Metal Shelves

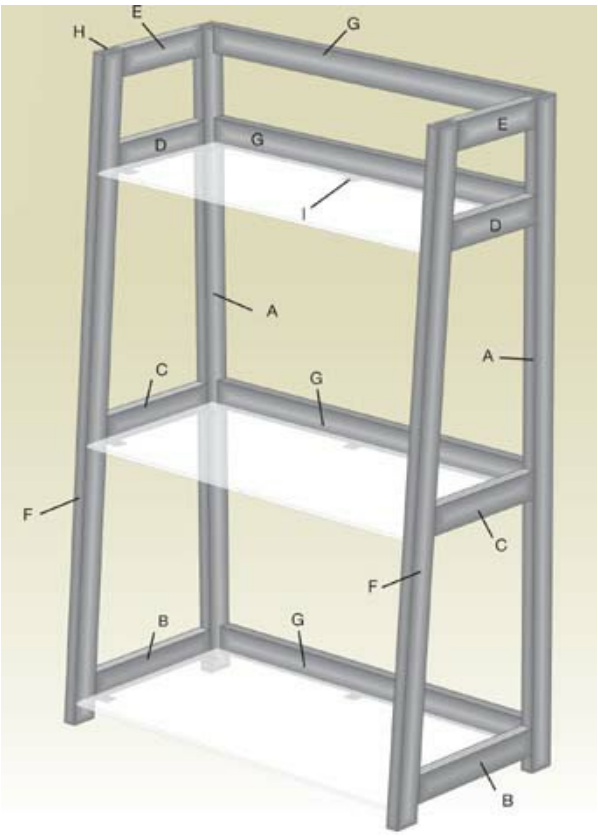
This shelf design is very versatile. The pattern can be altered infinitely—change the width, height, depth, and number of shelves to create a unit to fit in any space and display any item. Dress it up or down by using different materials. Consider using shelves with smooth tubing, a metallic finish, and glass (as we have done here), or use hammered tube, an antique finish, and weathered wood shelves for a rustic look.

Materials

- ¾ × 1½" rectangular tube (24½ feet)
- 1/8 × ¾" flat bar (2½ feet)
- Tempered glass or wood (6 feet)

PART	NAME	DIMENSIONS	QUANTITY
A	Back legs	16-gauge ¾ × 1½" rectangular tube × 36"	2
B	Bottom shelf sides	16-gauge ¾ × 1½" rectangular tube × 9"	2
C	Middle shelf sides	16-gauge ¾ × 1½" rectangular tube × 7¾"	2
D	Top shelf sides	16-gauge ¾ × 1½" rectangular tube × 6½"	2
E	Top sides	16-gauge ¾ × 1½" rectangular tube × 6"	2
F	Front legs	16-gauge ¾ × 1½" rectangular tube × 37½"	2
G	Backs	16-gauge ¾ × 1½" rectangular tube × 22"	4
H	End caps	⅛ × ¾" flat bar × 1½"*	8
I	Shelf supports	⅛ × ¾" flat bar × ¾"	21
J	Shelves	Tempered glass*	3

* Cut to fit.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How to Build Angled Metal Shelves

Before welding, thoroughly clean all parts with denatured alcohol.

Make the Sides

1. Cut the back legs (A) to length.

2. Cut the shelf and top sides (B, C, D, E) to length with one end mitered at 83°.

3. Mark the back legs at 1", 7", and 15".

4. Align the flat end of the bottom, middle, and top shelf side pieces with the marks. Align the top side piece with the top of the back leg. Before welding, hold a straightedge against the angled side to check for alignment. Adjust if necessary. Tack weld in place. Repeat with the other back leg and sides.

5. Align a front leg (F) with the side and back leg assembly. Using a carpenter’s square held against the back leg, mark the top and bottom angled cuts for the front leg. Repeat with the other front leg.

6. Cut the first front leg to length along the marks.

7. Tack weld the front leg to the side. Repeat with the second front leg.

To get the exact angle for cutting the front leg, align the tube with the side pieces and use a carpenter's square to mark a line even with the top of the top side.

Assemble the Shelves

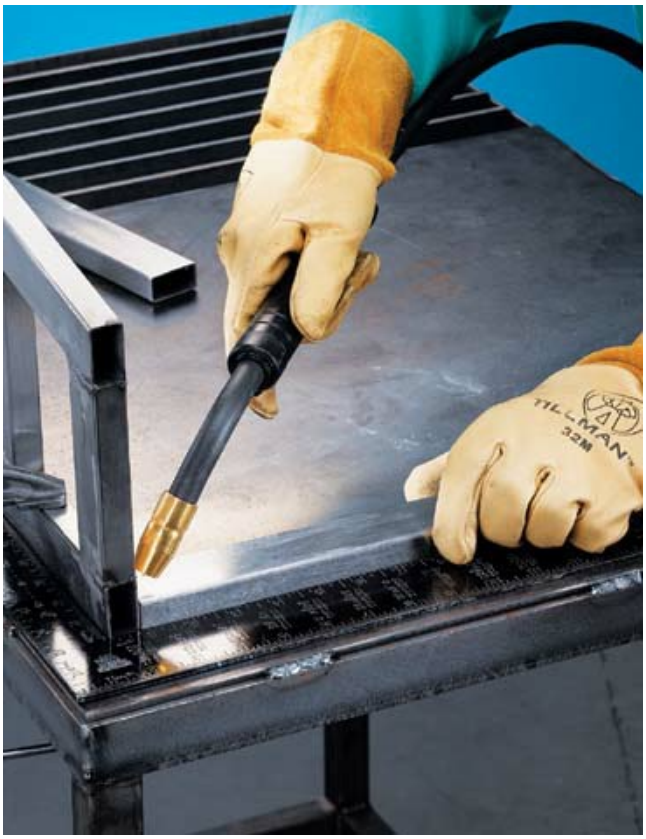
1. Cut the backs (G) to size.

2. Stand a side unit on its back and line up a back piece with the top of the unit. Use a carpenter's square to check that the back is square to the side. Tack weld in place.

3. Align the second side unit with the back piece and tack weld in place.

4. Repeat with the other three back pieces, aligning them with the top, middle, and bottom side pieces. Check for square and complete all welds.

5. Cut the end caps (H) to fit the tops and bottoms of the front and back legs. (The front pieces will need to be longer due to the angle.) Weld the caps to the leg ends. Grind down all the welds.



After assembling the sides, weld the backs in place. Check for square both vertically and horizontally.

Install Shelf Supports & Finish

1. Cut the shelf supports (I) to length.

2. Round the end of each with a bench grinder.

3. Weld two supports to the underside of each top, middle, and bottom shelf side piece. Weld three supports to each back piece. Weld two supports 1" in from the sides and center the third on each back piece.

4. Sand, sandblast, or wire brush the unit. Finish as desired.

5. Measure the dimensions for each shelf and order tempered glass to fit, or cut wooden shelves.

Weld the shelf supports to the bottom of the sides and backs.

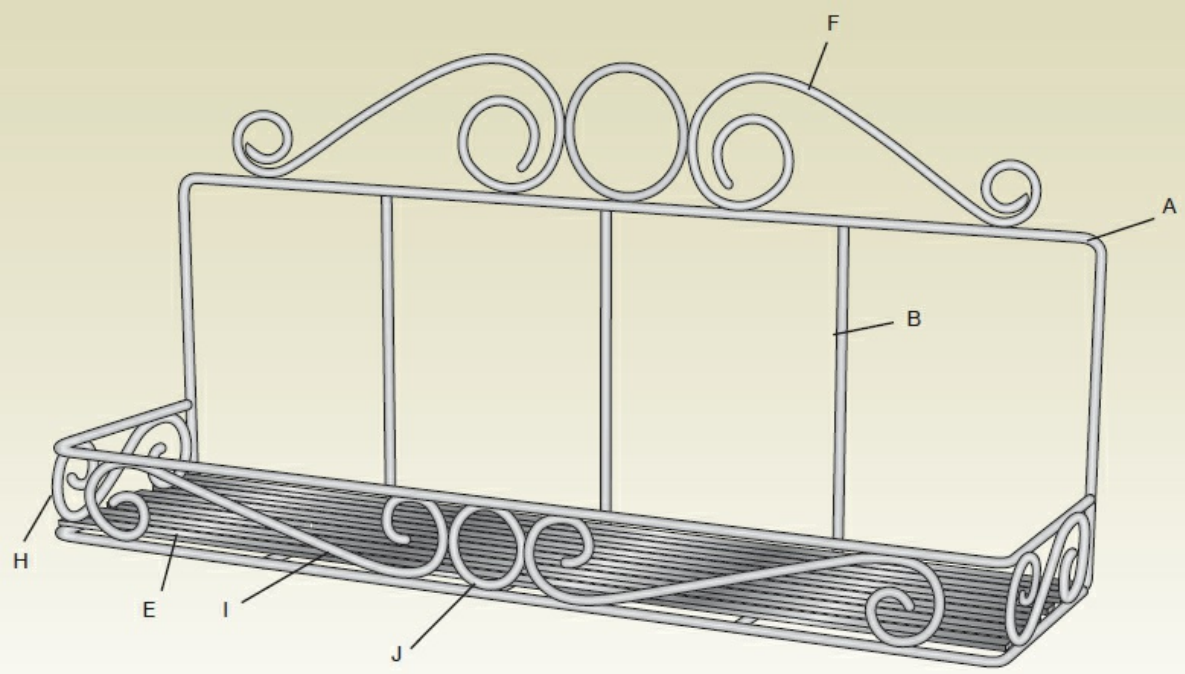
Wall-mounted Shelf

This wall-mounted shelf is perfect for displaying your decorative jars that hold cooking oils or spices. A single 24" square tile used for ceilings is cut to size at 24 × 6", which gives the appearance of four separate 6 × 6" tiles. A variety of tin tile sources are available on the Internet: see Resources on page 220 for addresses. You may also find ceiling tiles at salvage stores and antique stores—and they already have the antique character. The tiles don't need to be welding-quality steel; installing them with two-part epoxy is sufficient.

Materials

- ¼" round rod (18½ feet)
- 1/8 × ½" flat bar (12 feet)
- 24" metal ceiling tile (1, M-BOSS #0613)
- 3/16" round rod (5 feet)

PART	NAME	DIMENSIONS	QUANTITY
A	Frame	¼" round rod × 64"	1
B	Tile supports	¼" round rod × 8"	3
C	Shelf frames	¼" round rod × 36"	2
D	Shelf supports	¼" round rod × 6"	1
E	Shelf cross pieces	⅛ × ½" flat bar × 24"	6
F	Top scrolls	¼" round rod × 15"	2
G	Top circle	¼" round rod × 12"	1
H	Side shelf scrolls	3/16" round rod × 9"	2
I	Front shelf scroll	3/16" round rod × 15"	2
J	Shelf circle	3/16" round rod × 10"	1
K	Tin tile	24" × 6"	1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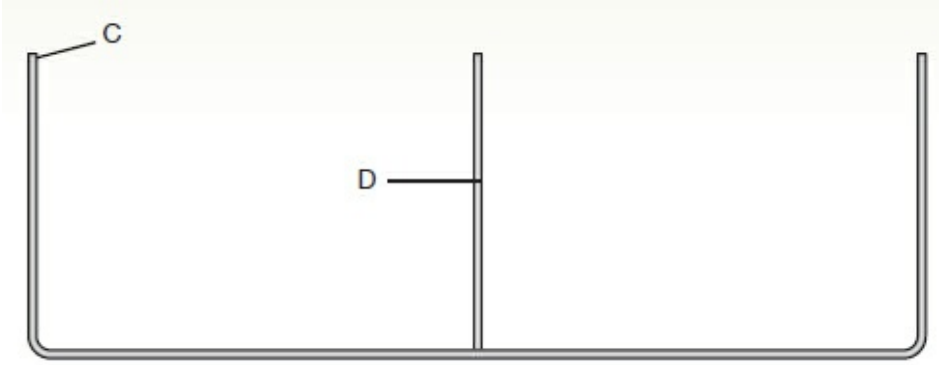


Bottom shelf

How to Build a Wall-mounted Shelf

Before welding, thoroughly clean all parts with denatured alcohol.

Create the Frame

1. Cut the frame (A) to length.

2. Mark the frame at 12", 19¾", 43½", and 52¼". Create a rectangle by making 90° bends at the marks. Weld the ends together.

3. Cut the tile supports (B) to length.

4. Weld the tile supports into the frame at 6" intervals.

Create the Shelf

1. Cut the shelf frames (C) to length.

2. Mark each of the shelf frames at 6" in from each end. Make 90° bends at the marks to create the shelf frames.

3. Weld one shelf frame to the base of the frame at a 90° angle.

4. Cut the shelf supports (D) and cross pieces (E) to length.

5. Weld the first shelf support to the installed shelf frame at the midpoint. Weld the remaining two supports centered between an outside edge of the shelf frame and the center shelf support.

6. Space the shelf cross pieces at ½" intervals across the supports. Weld in place.

7. Weld the second shelf frame to the frame 2" above the shelf at a 90° angle.

Weld the tile supports to the frame at 6" intervals.

Make the Scrolls

1. Cut the top (F), side (H), and front (I) scrolls to length.

2. Clamp the top scroll rod to a 2" pipe. Bend the rod one full turn around the pipe. Clamp the other end around a 1" pipe and bend the rod one full turn around the pipe in the opposite direction from the first bend. Repeat with the second top scroll, making sure the scrolls match.

3. Clamp the end of a front shelf scroll to a 1" pipe. Bend the rod one full turn around the pipe. Clamp the other end to the pipe and bend the rod one full turn around the pipe in the opposite direction. Repeat with the second front scroll.

4. Clamp the end of a side scroll to a 1" pipe. Bend the rod one turn around the pipe. Clamp the other end to a 1" pipe and bend the rod one turn around the pipe in the opposite direction. Repeat with the second side scroll.

5. Bend the top circle (G) around a 2" pipe, overlapping the ends. Cut the overlap off and weld the circle ends together.

6. Bend the shelf circle (J) around a 1" pipe, overlapping the ends. Cut the overlap off and weld the circle ends together.

7. Place the shelf unit on its back and align the top scrolls and circle along the top. Weld at the contact points.

8. Align the front scrolls and circle in between the shelf and the shelf support. Weld at the contact points. Repeat with each of the side scrolls.

Weld the top shelf frame to the frame 2" above the shelf.

Finish the Shelf

1. Cut the tile down to a 6 × 24" strip, or 6" squares, depending on the tile and pattern you have chosen.

2. Use two-part epoxy to glue the tiles to the frame.

3. Sand, wire brush, or sandblast the shelf.

4. Finish as desired.

Weld the decorative scrolls and circles to the frames.

Étagère

Étagère is a French term for a metal structure used to display items in the house, or plants in the garden. Étagères can be shockingly expensive, but this project is not only affordable, but it is much sturdier than many available in stores. The corner Étagère that follows (on page 160) is created to match the style of this project.

This decorated shelf may be used inside or outside the home. Paint it or allow it to gently rust. The decorative elements are not structural, so you may change them to suit your desired level of fuss. The flat expanded sheet metal was chosen because it repeats the diamond pattern, but anything from metal to wood to tile can be used as shelving material. Check out the decorative iron suppliers listed in the Resources section on page 220 for dozens of friezes and metal stampings that may be used instead of the diagonals and scrolls.

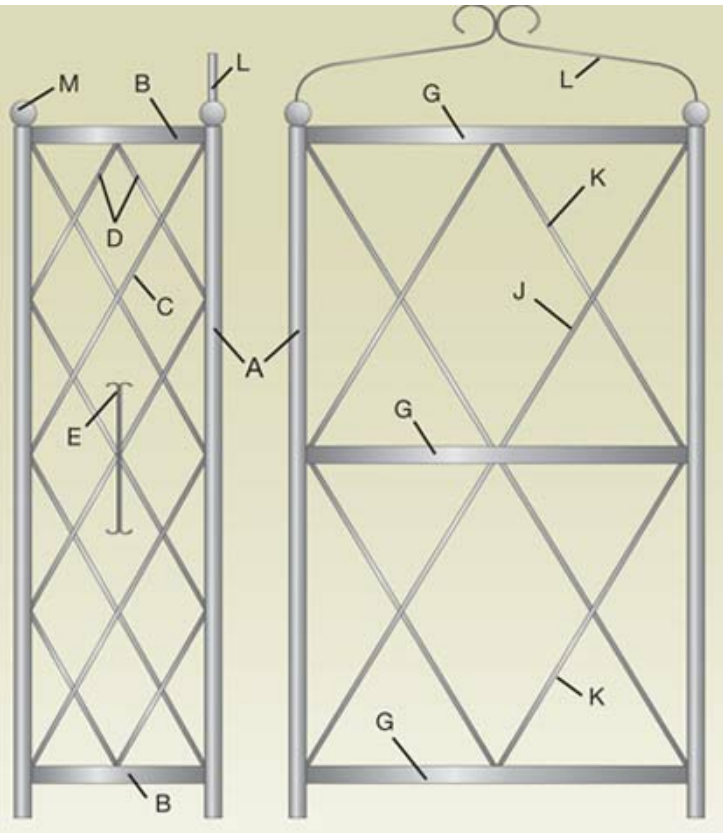
Materials

- 16-gauge 1 × 1" square tube (23 feet)

- 16-gauge ½" flat expanded sheet metal (2 ft. × 3 ft.)
- ¼" round rod (31 feet)
- 1/8 × ½" flat bar (5 feet)
- 1½" balls (4, Triple S Steel #SF116F4)
- 1 × 1" × 1/8" angle iron (6 feet)

PART	NAME	DIMENSIONS	QUANTITY
A	Legs	16-gauge 1 × 1" square tube × 40"	4
B	Crossbars	16-gauge 1 × 1" square tube × 10"	4
C	Long diagonals	¼" round rod × 21"*	12
D	Short diagonals	¼" round rod × 10"*	8
E	Side decorations	⅛ × ½" flat bar × 5¾"	8
F	Front supports	1 × 1" × square tube × 22"	3
G	Back supports	1 × 1" × ⅛" angle iron × 22"	3
H	Shelf supports	⅛ × ½" flat bar × 9"	2
I	Shelves	Expanded sheet metal 23 × 11"	3
J	Back long diagonals	¼" round rod × 43"	2
K	Back short diagonals	¼" round rod × 21"	4
L	Scrolls	⅛ × ½" flat bar × 24"	2
M	Balls	1½" diameter	4

*Approximate dimension, cut to fit.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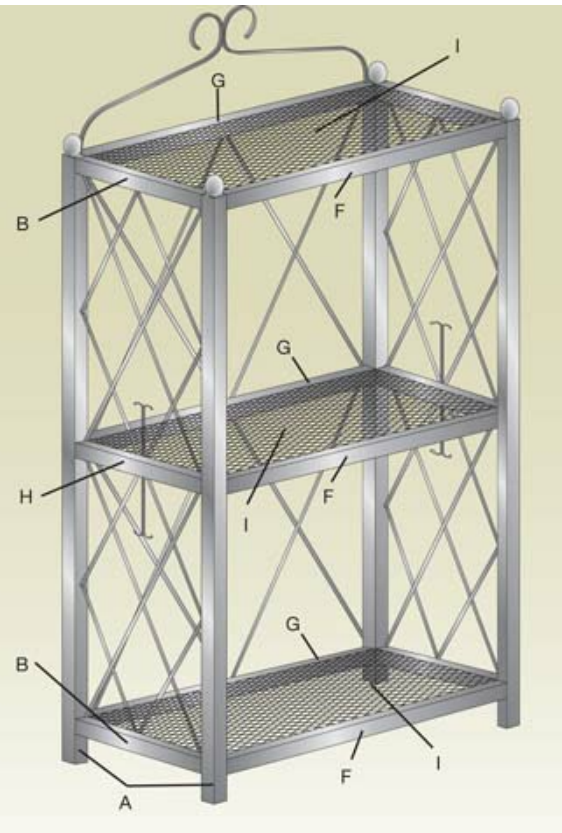
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How to Build an Étagère

Before welding, thoroughly clean all parts with denatured alcohol.

Make the Sides

1. Cut the legs (A) and crossbars (B) to length.

2. Mark each leg 2" from one end. This is the bottom of the leg.

3. On a flat work surface, lay out two legs and two crossbars. Align the bottom of one crossbar with the marks. Align the top of the other crossbar with the top of the legs. Clamp in place.

4. Check all corners for square. Tack weld all corners. Recheck for square by measuring across the diagonals. If the two measurements are equal, the unit is square. If the measurements are not equal, make adjustments until they are. Complete the welds.

5. Repeat steps 3 and 4 to make the second side panel.

Cut the Decorative Side Diagonals

1. Find the midpoint of the top and bottom crossbars and mark.

2. Find the midpoint of the front and back legs between the crossbars and mark.

3. Mark the points halfway between the midpoints and the crossbars. These are the quarterpoints.

4. Determine the lengths for the long diagonals (C) by measuring from a corner to the opposite midpoint and from an upper quarterpoint to a lower, opposite quarterpoint. These measurements should be equal if the panel is square. Cut the long diagonals slightly longer than this measurement.

5. Determine the lengths for the short diagonals (D) by measuring from a quarterpoint to the adjoining crossbar midpoint. Cut the short diagonals slightly longer than this measurement.

6. Hold the diagonals in place against the side panels and mark the necessary cutting angle. Cut at the marks.

Measure between a corner and the opposite midpoint to find the length for the long diagonals.

Assemble the Decorative Side Diagonals

1. With the side panel on a flat surface, lay the three long and two short diagonals that slant down from upper left to lower right in place. Weld to the frame.

2. Lay the three long and two short diagonals that slant from upper right to lower left in place on top of the other set of diagonals. Weld in place.

3. Cut the side decorations (E) to length. Round one end of each to a smooth semicircle using a bench grinder.

4. Clamp the rounded end to a ½" pipe and bend the bar a half turn around the tube. Repeat with all the pieces.

5. Place two pieces back to back and weld together. Repeat with the other pieces.

6. Grind the flat ends of the decoration to a V.

7. Place one welded piece vertically at the middle of the diagonal pattern and weld in place. Place the second welded piece upside down at the middle and weld in place.

8. Cut and assemble the diagonals for the second side panel.

Weld the first layer of diagonals in place.

Assemble the Étagère

1. Cut the front supports (F) and back supports (G) to length.

2. The decorations on the side panels should be flush on one side and recessed on the other. The flush side is the outside. Place the two sides parallel to each other lying on their backs. Align the front supports with the top and bottom crossbars and centered over the midpoint. Check for square and tack weld in place.

3. Orient the top back support so the flat faces are to the top and front and aligned with the top crossbar. Tack weld in place.

4. Orient the midpoint and bottom back supports with the flat faces to the top and back. Align with the front of the back leg. (This will allow the back panel decorations to be recessed).

5. Cut the shelf supports (H) to length.

Weld the decorations to the middle X of the diagonals.

Tack weld the front supports in place and check for square.

6. Weld the shelf supports flush with the top of the middle shelf frames at the ends. Bend the top shelf to fit inside the four supports. Weld in place.

7. Cut the shelves (I) to size.

8. Bend the front of the middle shelf to fit behind the front support. The shelf lies on top of the shelf suport and back support. Weld in place.

9. Bend the front and sides of the bottom shelf to fit between the supports. The back lies on top of the back support. Weld in place.

Make the Back Panel Decorations

1. Measure the diagonal across the back of the shelves from corner to corner. Cut the back long diagonals (J) to this length.

2. Measure from the midpoint of the top back shelf support to the midpoint of the leg panel. Cut the short diagonals (K) to this length.

3. Place the left to right descending diagonals in place and weld. Place the right to left diagonals and weld.

Bend the top shelf to fit inside the sides and supports.

Weld the spheres to the tops of the legs and weld the scroll to the tops of the rear spheres.

Make the Decorative Scrolls

1. Cut the scrolls (L) to length.

2. Round one end of each scroll to a smooth semicircle using a bench grinder.

3. Clamp the flat end to a 4" pipe and bend slightly past a one-quarter turn to create a rounded 90° angle. Repeat with the second scroll.

4. Cut a 1/8" notch in a 2" pipe.

5. Insert the rounded end of the scroll through both notches. Bend the scroll a three-quarter turn around the pipe. Repeat with the second scroll.

6. Weld the balls (M) into the tops of the legs.

7. Align the two scrolls so they meet in the middle and are symmetrical. Weld at the contact points.

8. Weld the scrolls to the top of the rear balls.

9. Sand, wire brush, or sandblast the shelf unit. Finish as desired.

Tip
Welding thick material to thin material. Welding solid spheres to 16-gauge material won’t be successful without an extra step. The spheres will not weld easily because they absorb a great deal of heat before melting. Heating them first with a propane torch assures a good weld.

Corner Étagère

Why have an empty corner when it can display a beautiful shelf? Designed to match the étagère, this shelf unit is perfect for displaying plants or other decorative curios. You don't need to hide it in a corner—it can stand on its own in your backyard, or you can build two to create a semi-circle shelf to stand out along a wall.

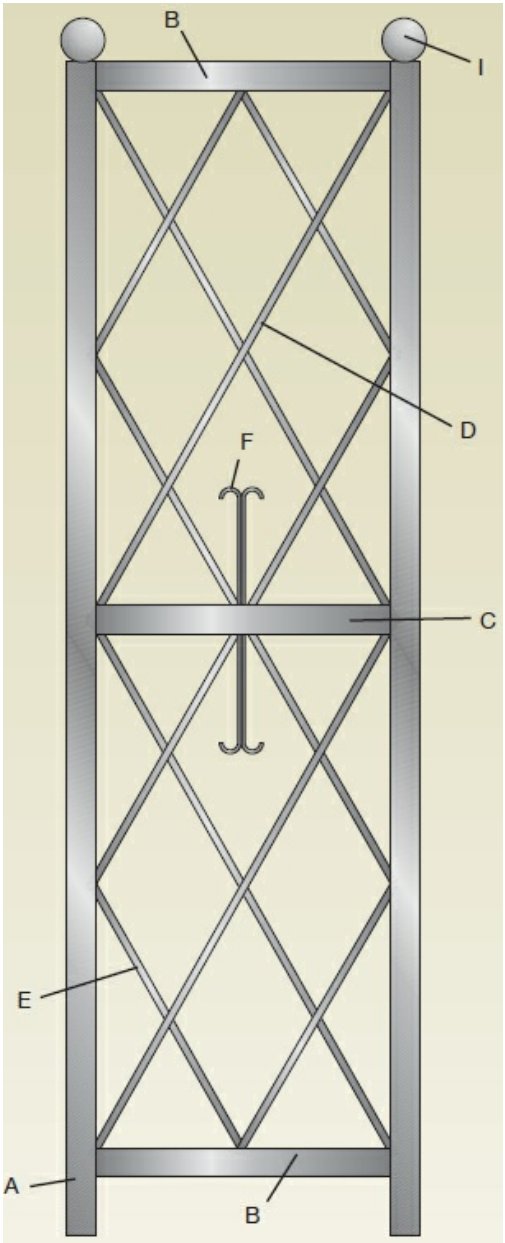
The arcing shelf fronts look fancy but are actually fairly simple to execute. Face the front with a decorative frieze or metal stampings for a different look. The diagonals do not provide structural support, so you may personalize the sides in any way you choose.

Materials

- 16-gauge 1 × 1" square tube (10 feet)
- ¼" round rod (15½ feet)
- 1/8 × 1" flat bar (4½ feet)
- 16-gauge ½" flat expanded sheet metal (2 ft. × 2 ft.)
- 1½" balls (3, Triple S Steel #SF116F4)
- 1 × 1 × 1/8" angle iron (20")

PART	NAME	DIMENSIONS	QUANTITY
A	Legs	16-gauge 1 × 1" square tube × 40"	3
B	Crossbars	16-gauge 1 × 1" angle iron × 10"	4
C	Middle crossbars	1 × 1 × ⅛" angle iron × 10"	2
D	Long diagonals	¼" round rod × 21"*	12
E	Short diagonals	¼" round rod × 10"*	8
F	Decorations	½ × ⅛" flat bar × 5¾"	8
G	Shelf fronts	⅛ × 1" flat bar × 18"	3
H	Shelves	16-gauge expanded sheet metal*	3
I	Balls	1½" dia.	3

* Cut to fit.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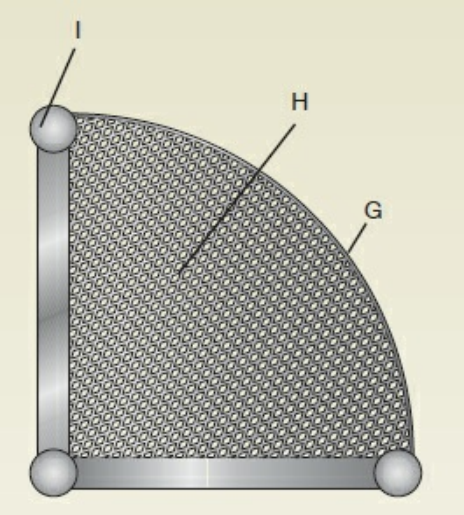

I
H
G

How to Build a Corner Étagère

Before welding, thoroughly clean all parts with denatured alcohol.

Make the Frame

1. Cut the legs (A) and crossbars (B) to length.

2. Measure 2" up from the ends of the legs and make a mark.

3. Align one crossbar in between and flush with the tops of two legs. Check for square and tack weld in place. Align the bottom of a second crossbar with the end marks, check for square and tack weld in place.

4. Measure across the diagonals of this unit to check for square. The measurements should be equal; if not, adjust until they are. Weld in place.

5. Repeat steps 3 to 4, attaching the third leg and the crosspieces to the leg unit at right angles to form a triangular frame.

6. Cut the middle crossbars (C) to length, mitering one end at 45°. Center the crossbars over the midpoints and even with the insides of the legs. Weld in place.

Cut the Decorative Diagonals

1. Find the midpoint of the top and bottom crossbars and mark.

2. Find the midpoint of the front and back legs between the crossbars and mark.

3. Mark the points halfway between the midpoints and the crossbars. These are the quarterpoints.

4. Determine the lengths for the long diagonals (D) by measuring from a corner to the opposite midpoint and from an upper quarterpoint to a lower, opposite quarterpoint. Cut the long diagonals to length. Place the diagonals and mark the angled cut necessary for an exact fit.

5. Determine the lengths for the short diagonals (E) by measuring from a quarterpoint to the adjoining crossbar midpoint. Cut the short diagonals to length. Cut the long diagonals to length. Place the diagonals and mark the angled cut necessary for an exact fit.

Attach the third leg and crosspieces to create a 90° angle.

After cutting the diagonals to approximate length, mark the angles where the diagonal crosses the framework.

Assemble the Decorative Diagonals

1. With the side panel on a flat surface, lay the three long and two short diagonals that slant down from upper left to lower right in place. Weld to the frame.

2. Lay the three long and two short diagonals that slant from upper right to lower left in place on top of the other set of diagonals. Weld in place.

3. Cut the side decorations (F) to length. Round one end of each to a smooth semicircle, using a bench grinder.

4. Clamp the rounded end to a ½" round tube and bend the bar a half turn around the tube. Repeat with all the pieces.

5. Place two pieces back to back and weld together. Repeat with the other pieces.

6. Place one welded piece vertically upright at the middle X of the diagonal pattern and weld in place. Place the second welded piece upside down at the middle X and weld in place.

7. Cut and assemble the diagonals for the second side panel.

Make the Shelves

1. Cut the shelf fronts (G) to length.

2. Bend a shelf front into a 12" radius arc by making small bends every ½". Check that it fits in between the two front legs. Adjust, if necessary. Bend the other two shelf fronts.

3. Weld the shelf fronts to the forward inner corners of the front legs.

4. Cut the shelves (H) to size. Allow ¾" bending allowance on all sides.

5. Use pliers and a hand seamer to bend the shelf to fit inside the top and bottom crossbars and shelf fronts. The middle shelf rests on top of the crossbars. Cut notches in the sheet metal, if necessary, to help it fit.

6. Weld the shelves in place.

Finish

1. Place balls (I) in the tops of each leg and weld in place.

2. Sand, wire brush, or sandblast the shelf unit. Finish as desired.

Weld the arched fronts to the sides, even with the crossbars.

Use a hand seamer and pliers to bend the expanded sheet metal to fit inside the top and bottom crossbars.

Outdoor

IN THIS CHAPTER:

Truck Rack
Trailer
Stair Railing
Gate
Firepit
Vineyard Trellis
Arch & Gate
Gazebo
Arbor

Truck Rack

A carrying rack that mounts on the walls of your truck bed is a very handy accessory for serious metalworkers and DIYers with a frequent need to transport building materials. The heavy-duty metal rack shown here is made from 12-gauge steel tubing and can be rescaled to fit onto just about any pickup truck, from compact to full-size. The full-length bedrails distribute the load, protect the truck's bedrail, and provide rack attachment points along the entire length of the truck bed. They also provide a flat base for mounting a toolbox or cover. If your truck has stake holes and you prefer to align the uprights to fit into those spaces, you must alter the rack design a bit—this is a valid design consideration for ease of installation and less drilling into your truck.

Perhaps the most unique feature of this rack is the round spacer plates that fit between the upper rack bars. The circular cutouts are very handy for tying down a load.

To protect the rear window of the cab, consider attaching a panel of expanded metal mesh to span between the front uprights. You can weld the mesh directly to the uprights or build a metal sub-frame to fit between the uprights and weld the mesh to the subframe. Also consider mesh for over the cab to protect the truck, as we have done.

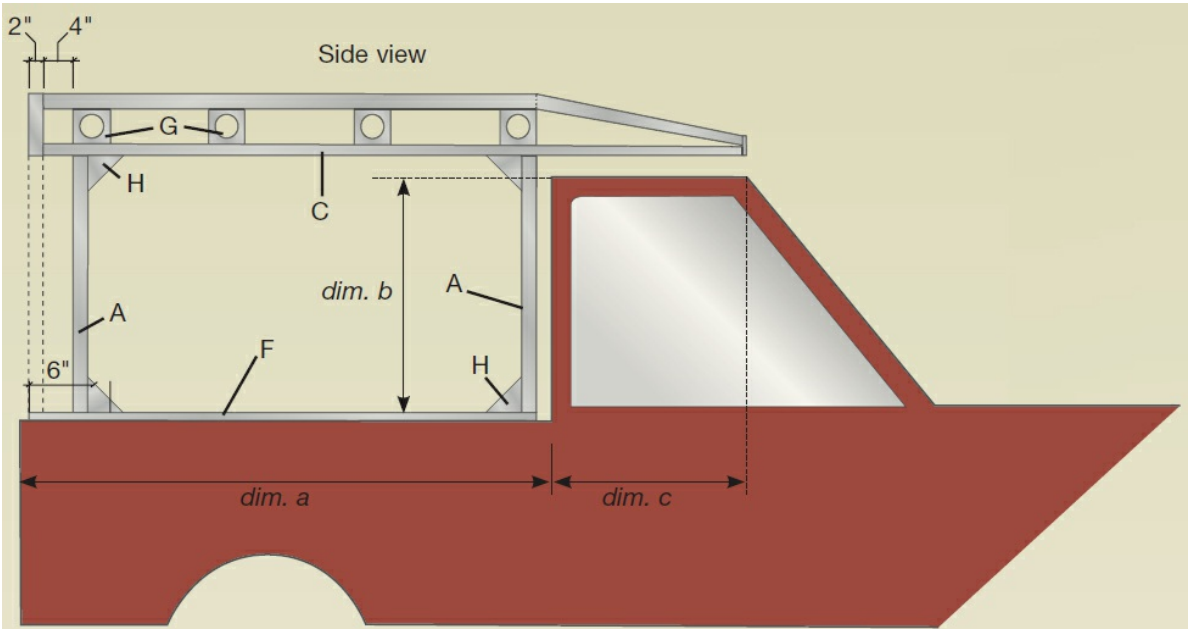
Even when scaled for a compact pickup, this rack will weigh at least 200 pounds. The final weight, of course, depends on the size of the rack and the gauge of the metal you use. In any event, you will need at least one helper to lift the rack into position. A person for each corner is best. Finally, be sure to finish the metal so that it does not rust.

Materials

- 12-gauge (1/8") 2 × 2" steel tubing, approx. (*dim. a* + *dim. c*) × 4) + (*dim. b* × 4)
- 1/8 × 3 × 3" angle iron (*dim. a.* × 2)
- ¼ × 4 × 4" flat stock steel (5½ feet)
- ¼ × 2 × 2" flat stock steel

PART	NAME	DIMENSIONS	QUANTITY
A	Uprights	⅛" × 12-gauge 2 × 2" steel tubing × (*dim. b* + 3")	4
B)	Crossbars	⅛" × 12-gauge 2 × 2" steel tubing × (*dim. d* - 4")	3
C)	Long top bars	⅛" × 12-gauge 2 × 2" steel tubing × (*dim. a* + *dim. c*)	4
D)	Rear crossbar tabs	¼" × 2" flat stock steel, 2½"	2
E)	Rear crossbar top	¼" × 2" flat stock steel	1
F)	Angle iron on bedrails	⅛" × 3 x 3" angle iron × (*dim. a*)	2
G)	Spacer plates with holes	¼" × 4" × 4-ft. flat stock steel 4 × 4"	8
H)	Gussets	¼" × 4" × 4-ft. flat stock steel 4 × 4" hypotenuse	8
I)	End piece	2 × 2 steel tubing × 8"	2

* Caps in sizes 2 × 2" and 2 × 4" needed for all exposed tube ends.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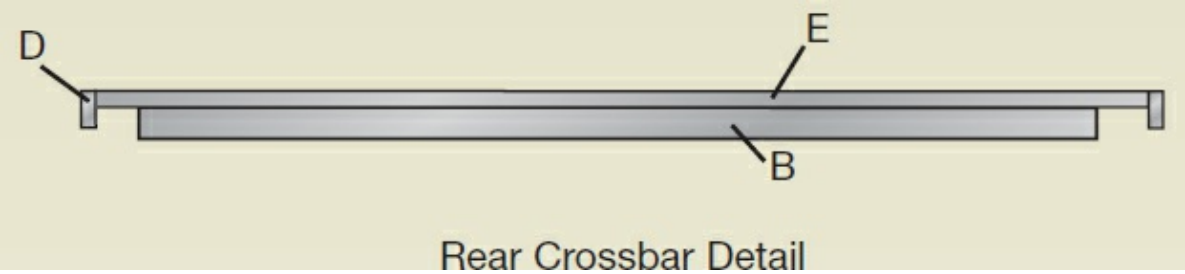
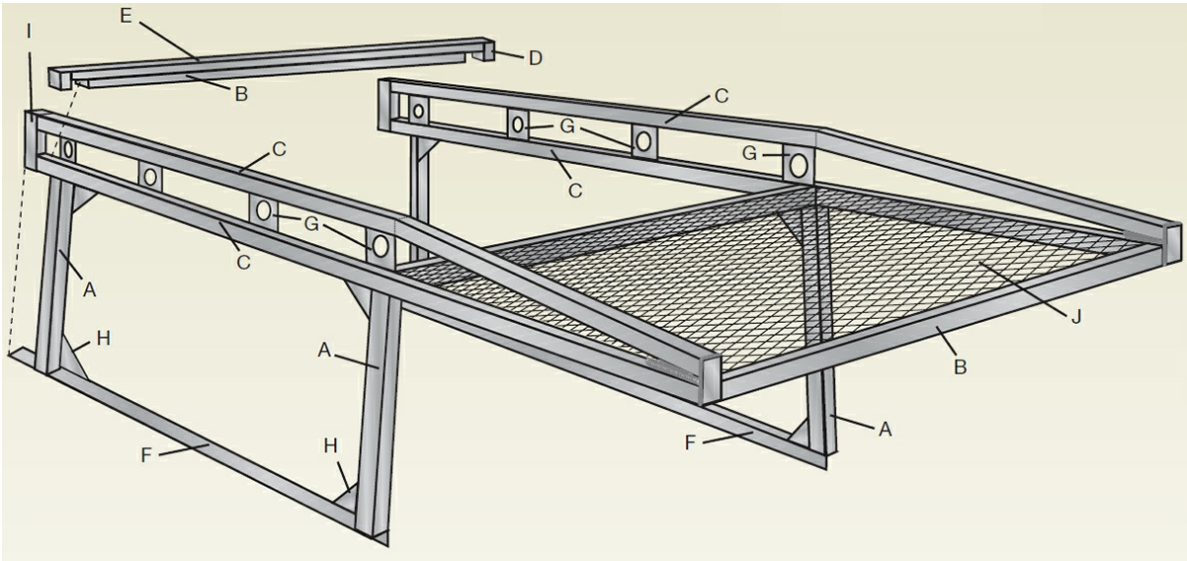


Rear Crossbar Detail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How to Build a Truck Rack

Safety
NOTICE: For safe use of this rack project only use approved, safety-rated products to attach the rack securely to your vehicle. These may include clamp-based, bolt-based, or stake-pocket systems. Inspect clamps and fasteners regularly to make sure they are tightened properly.

Measure the Truck

1. Measure corner to corner on your truck bed for square.

2. Measure and mark your truck bedrails for angle iron (F) placement. The full length of the truck bed is *dimension a*. This dimension is required to design your rack so that it custom fits your truck.

3. Measure the length of your truck cab roof from front to back (*dimension c*)—refer to drawing on page 167. Add this measurement to *dimension a* for the total length of the long top bars (C).

4. Measure from the truck bedrail to the top of the cab. Add 1" for additional clearance above the cab. The height from the truck bedrail to the top of cab is *dimension b*.

Note: The uprights on this rack lean toward the center at a 10° angle so that the long top bars (C) are aligned roughly with the inside walls of the truck bed.

Measure from corner to corner of the truck bed for square.

Prepare the Angle Irons

1. Mark two 1/8 × 3 × 3" angle irons (F) to length (*dimension a*). Use a speed square to ensure a straight cutting line across the parts.

2. Cut the two angle irons at marks using a cutoff saw.

Option: If you choose not to bolt the angle iron to the truck and instead use clamping all along the bedrail angle iron or some other fastening technique, skip to Cut & Fasten Uprights to Angle Irons.

3. Align the angle irons on the truck bedrails. Align the solid edge butted up flush against the inside edge of the truck bed so it caps over the bedrails and clamp in place.

4. Make a mark 6" in from the tailgate edge of the angle irons. The 2 × 2 uprights are aligned 6" in from the tailgate edge. The cab-side upright sits flush to the ends of the angle irons (F) on the cab-side edge, so make a mark 2" in from the cab-side edge of the angle iron as well.

5. Measure in from the marks made in step 4 for four to five evenly spaced bolts along the angle iron (F). It is standard to use four bolts to fasten a truck rack to a smaller truck; larger trucks will require more bolts. Check with your truck manufacturer and the fastener manufacturer's recommendations.

6. Remove the angle irons and bring them back to your shop.

7. Slowly drill 5/16" holes through the angle iron (F) for grade 8¾" hex bolts at your bolt marks using a drill press or handheld drill. Use cutting oil and drill slowly. Repeat for the other angle iron (F).

Measure in 6" from the tailgate ends of the angle iron and make a mark for the tailgate uprights. Make a mark 2" in from the cab-side ends of the angle irons for cab-side uprights. Then measure and mark the bolt (or other fastener) locations evenly spaced along the angle iron while it is still clamped in place on the truck bedrail.

Cut & Fasten Uprights to Angle Irons

1. On a flat surface, measure and mark 12-gauge (1/8") × 2 × 2" steel tubing lengths at *dimension b* for the four uprights (A). This will leave a 4" clearance between the rack and your truck cab roof.

2. Mark for a 10° angle cut on each upright end. This angle cut ensures the rack fits roughly parallel with the cab roof.

3. Cut the uprights to length using a cutoff saw. Refine the 10° angle with an angle grinder.

4. Align the cab-side uprights flush with the angle iron (F) cab-side ends. Tack along two sides so that you can easily break the tacks and realign, if necessary. *Note: The location of the cab-side uprights determines where you need to bend the long top bar. The edges of A and G and the bend on C should all be aligned.*

5. Align the tailgate-end uprights 6" in from the angle iron ends. Tack along two sides so that you can easily break the tacks and realign, if necessary.

Tack the cab-end uprights (A) onto the angle iron bedrails (F). Then tack the tailgate-side uprights onto the angle iron bedrails 6" in from the edge. Tack only along two sides because you may need to break your tack welds to realign parts several times.

Build the Basic Frame

1. Measure and mark the two lower long bars (C) to the length of the truck bed (minus 2") plus the length of the cab (*dim. a* – 2") + *dim. c*.

Note: When planning out the four long top bar lengths, remember to account for end caps. There is a 2 × 2" tubing cap at the tailgate end and ¼" flat stock steel cap at the front end. Some racks hang slightly over the cab front while others (like our rack) sit behind the cab front. The length of your rack depends on your truck size and how much length you need for typical loads. Consult with your truck manufacturer on recommended clearances.

2. Measure and mark the two top long bars (C) for length (*dim. a* + *dim. c*).

Note: The bend itself creates a variable in the final length of the top bars. When the long top bar bends to meet the lower long bar, the two parts do not meet flush at the ends. The square end is created with a ¼" flat stock steel end cap(s); also, the small triangular space in between the two parts is filled with slag.

3. Cut all four long top bars to length using a cutoff saw.

4. Align the two lower long bars flush on top of the uprights. The long bars will extend beyond the tailgate upright by 4".

Note: The top and lower long bars will be joined with a 2 × 2" steel tubing (8" long) cap at the tailgate end. To have the top bars align with the tailgate end of your truck, the top bars must be aligned 2" in from the tailgate end.

5. Tack the lower long bars to the uprights. Make minimal tacks so that you can break the welds and realign parts, if necessary.

Note: Consider adding a temporary brace made of scrap steel tubing that spans horizontally from the tailgate ends of the two long top bars to help maintain the proper angle. We realigned the top frame later and then introduced the brace, but it may save you some time to add the brace now to avoid making time-consuming breaks and re-tacking later.

6. Measure between the front two edges of the long top bars. Also measure between the long top bars at the cab-side (in between two uprights). Use these measurements to mark the lengths of the two permanent crossbars (B).

7. Cut the two crossbars to length with a cutoff saw.

8. Align the crossbars in between the two lower long bars and then tack them to the long bars. Use four 1" welds evenly spaced 1 to 2"; do not weld all the way down the joint.

9. Measure between the two long bars at the tailgate side of the truck for the removable crossbar. Measure, mark, and then cut this crossbar to length using a cutoff saw.

10. Measure and mark the two rear crossbar tabs (D) to 2 × 2½". Also measure and mark the rear crossbar top (E) to length (length of removable crossbar + 2"). Cut the tabs and top to size.

11. Center the crossbar top (E) over the removable crossbar (B) and clamp together with a corner clamp. Tack weld the two parts together.

12. Align the crossbar tabs (D) flush with the top edges of the crossbar top (E) ends, and then weld them together (see Rear Crossbar Detail).

13. Measure and mark eight 4 × 4" square spacer plates (G) from ¼ × 4 × 4" flat stock steel.

14. Cut the spacer plates using a portable band saw.

15. Mark the center circle on each spacer plate using a piece of 2½" (o.d.) pipe as a guide.

16. Cut the center circles out of the spacer plates using a plasma cutter.

17. Center the spacer closest to the tailgate 5" in from the long bar end and make a mark (C). This leaves a 4" space in between the end piece (I) and spacer for the rear removable crossbar.

18. Align a spacer with its cab-side edge flush with the cab-side edge of the upright. Mark this placement on the long bar (C).

19. Evenly space the other two spacers along the long bar and mark the placements onto the lower long bars (C).

20. Repeat the alignment of the spacer plates (G) along the other long bar (C).

21. Align each spacer plate on the lower long bars (C) in alignment with your marks.

22. Hold the spacer plates in place with pliers and tack weld each spacer to the long bars.

Cut the circle in center of spacer plates using a plasma cutter. Shown here: clamped 4 × 4" flat stock (with circle cutout premarked) and ground secured to table.

Add Top Long Bars

1. Align the two uppermost long top bars (C) directly above the lower long top bars. Center them over the spacer plates.

2. Tack weld the uppermost long top bars to the spacer plates every several inches.

3. Mark the bend location flush with the edge of the cab-side spacer plate and upright.

4. Check the entire rack for proper alignment. Break tack welds and realign parts as necessary. Make adjustment marks and re-tack parts together in proper alignment. *Note: We had to break the welds at the lower top bar and uprights in order to adjust the uprights to proper alignment with 10° angles at each upright*.

5. When the long bars are removed from the uprights (this is very likely going to be necessary; see Note above), take advantage of this situation to make the long top bar bends on a sturdy worktable.

6. Score along the bend mark using an angle grinder or reciprocating saw. Score only as deep as necessary to make the bend.

7. Bend the top long bars to meet the bottom long bars.

8. Mark the cutting line at the front (cab-side) of the uppermost long top bars for the final length. Cut the excess length off the top bars with a portable bandsaw.

9. Tack weld the top long bar to the lower long bar at the front only. *Note: Leave the bend open (not welded) for now*.

Bend the notched top long bar to reach the lower bar. The front finished triangular ends fill in with slag. The ends are capped with 2× flat stock steel. Inset: The top long bar was capped with a 2 × 2" flat stock steel to bring ends flush; then a 2 × 4" flat stock steel piece was used for the final end cap that spans from top to bottom of the two long bars.

Re-attach the top frame to the uprights, welding at the inside corner of each crosspiece and long bar.

Re-Fasten Top & Bottom Frames Together

1. With the long bars tacked, realign the top/lower long top bars (top frame) atop the uprights and check for proper alignment. *Note: We also tacked on a temporary brace made of scrap steel tubing over the tailgate ends of the lower long bars (C) to help maintain alignment*.

2. Re-tack the long top bars in place on the uprights. Check for proper alignment and make final adjustments, as necessary.

3. Finish the welds at the bend (previously tacked to allow for adjustments), allowing slag to fill the void.

4. Finish the welds at the fronts of the long bars, allowing slag to fill in between the triangular corner.

Weld the final 2 × 4" caps onto the ends of the long top bars for flush front edges.

Add End Caps & Gussets

1. Cap the exposed ends of long bar tubing for a flush front edge. *Note: We had to use a 2 × 2 " end cap on the top long bar and then another 2 × 4 " end cap to cover both the top and lower long bars.*

2. Cap all remaining exposed tube ends.

3. Cut 12-gauge (1/8") 2 × 2" steel tubing to 8" (I). Align each piece against the lower and uppermost top long bars at the tailgate end of the rack. Weld in place.

4. Measure and mark the eight triangular gussets (H) to fit in four inside corners of the rack (see illustration).

5. Cut the gussets with a band saw.

6. Align the gusset plates in each inside corner of the rack, and then weld them in place.

Finish

1. Fully weld all final joints. Make at least 2" welds at the inside corner of each crosspiece and long bar. Do not weld any braces used. And do not weld the rear removable crossbar.

2. Grind down all of the welds and sand all surfaces in preparation for primer.

3. Break the tacks on any temporary braces and remove them. Grind down those final edges.

4. Prime the entire truck rack to protect it from the elements. Allow the rack to dry.

5. Paint or powder-coat the entire truck rack. Use exterior-rated enamel spray paint. Powder coating is best, but it is also the most expensive and requires special equipment.

Install the Rack

1. To install the rack onto your truck, you’ll need a helper or two. Lift the rack up onto the truck and align the angle irons onto the truck bedrail.

2. Fasten the rack angle irons to the truck with clamps, bolts, and/or your chosen fastening method.

Grind all welds and caps smooth with an angle grinder.

Trailer Frame

Most trailers have a very specific purpose. It could be to transport lawn equipment or snow removal machines for a small business, it might be to haul all-terrain vehicles or dirt bikes, or perhaps to transport building materials for DIY projects or cart away trash to the dump on the weekend. Each purpose carries special requirements that are reflected in the trailer construction. The welding project seen here is a highly adaptable trailer frame that can be finished and accessorized in just about any way you can imagine to serve your own needs.

A trailer is basically a metal frame with axles and wheels that you attach with a hitch to your vehicle. When choosing an axle kit consider weight capacity, type of suspension (leaf spring, torsion bar, etc.), width of frame, and height of the hitch. Axle kits typically include the axle, brackets to fasten the axle to the trailer frame, suspension (ours included leaf springs), fastening system to attach the leaf springs to the axle (ours included U-bolts, plates, bolts, and nuts), and a hub set. Our kit also included the trailer fenders, tires, and wheels—some kits include necessary parts for brakes and lights as well. The axle kit shown in this project was purchased from Northern Tool Company. The cost for a similar axle kit ranges from $170 to $300.

You'll also need to choose and purchase a floor material. For vehicle transport—such as snowmobiles or ATVs—expanded metal lath is an excellent choice. If you'll be hauling construction debris or yard waste, exterior-rated plywood is a good choice; hardwood boards (such as white oak) are a good option for high durability. Walls can also be formed with similar materials.

Further customization of your trailer can include tie-downs and anchors, removable or hinged ramps, and custom tongue or coupler hardware.

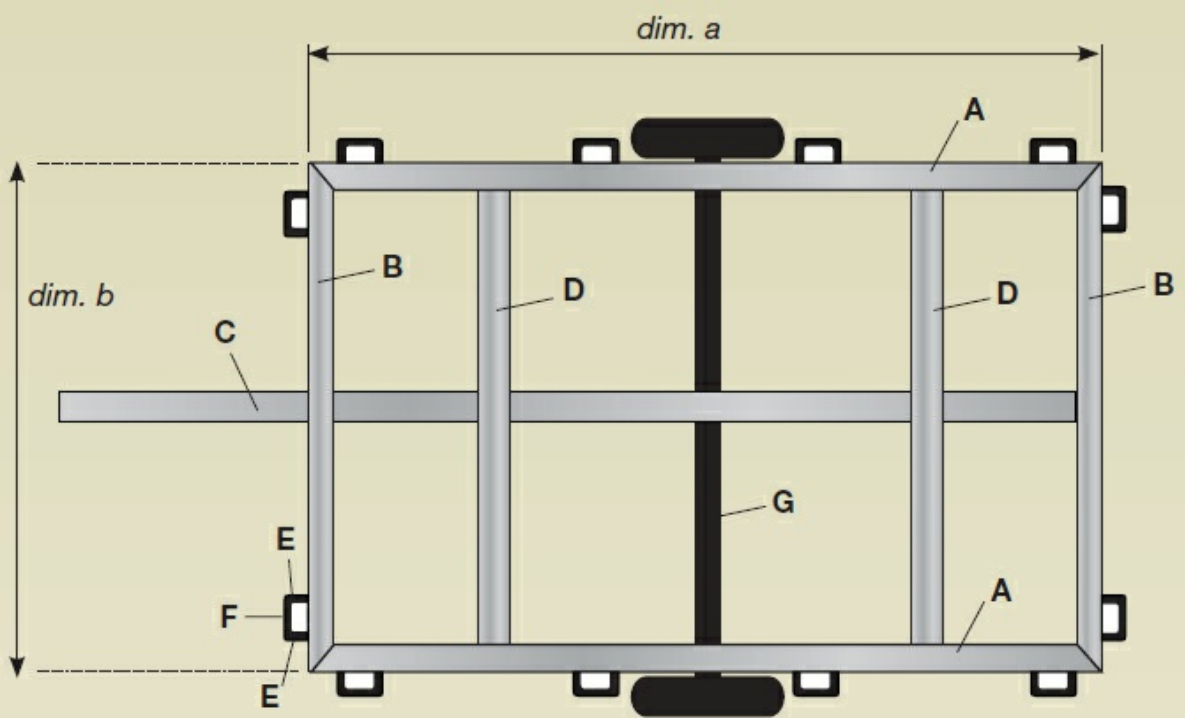
Materials

- 14-gauge 2 × 2" steel tubing
- $^{3}/_{16}$ × 2" HRS flat bar (7 feet)
- ¼" × 1¾" HRS flat bar (1 foot)
- Axle kit (incl. leaf springs, U-bolts, U-brackets, axle)
- Hubs and wheels
- Side stakes (2 × 4 treated lumber or metal tubes)
- Trailer sides, front/back, and bed (treated plywood or expanded metal)
- Trailer coupler

PART	NAME	DIMENSIONS	QUANTITY
A	Frame sides	14-gauge 2 × 2" steel tubing × (*dim. a*)	2
B	Frame front/back	14-gauge 2 × 2" steel tubing × (*dim. b*)	2
C	Trailer tongue	14-gauge 2 × 2" steel tubing × (variable dim.)	1
D	Cross bars	14-gauge 2 × 2" steel tubing × (variable dim.)	2
E	Stake pocket sides	3/16 × 2" HRS × 1¾"	24
F	Stake pocket fronts	3/16 × 2" HRS × 3½"	12
G	Axle kit	Incl. axle, 2 leaf springs, 2 hubs, 4 U-bolts (2 plates, 8 nuts), 4 suspension brackets	1
H	Wheels, tires		2 ea.
I	Trailer side stakes	2 × 4 treated lumbar or metal tubes × 15" (not shown)	12
J	Trailer sides*	1" thick × (*dim. a*) × 12" (not shown)	2
K	Trailer front/back*	1" thick × (*dim. b*) × 12"	2
L	Coupler plates	1¼ × 1¾" HRS flat bar	2
M	Trailer bed*	(*dim. a* × *dim. b*) (not shown)	1

* Treated 2 × 4" lumber, plywood, planks, or expanded metal.

Note: caps in sizes 2 × 2" and 2 × 4" will also be needed for all exposed tube ends.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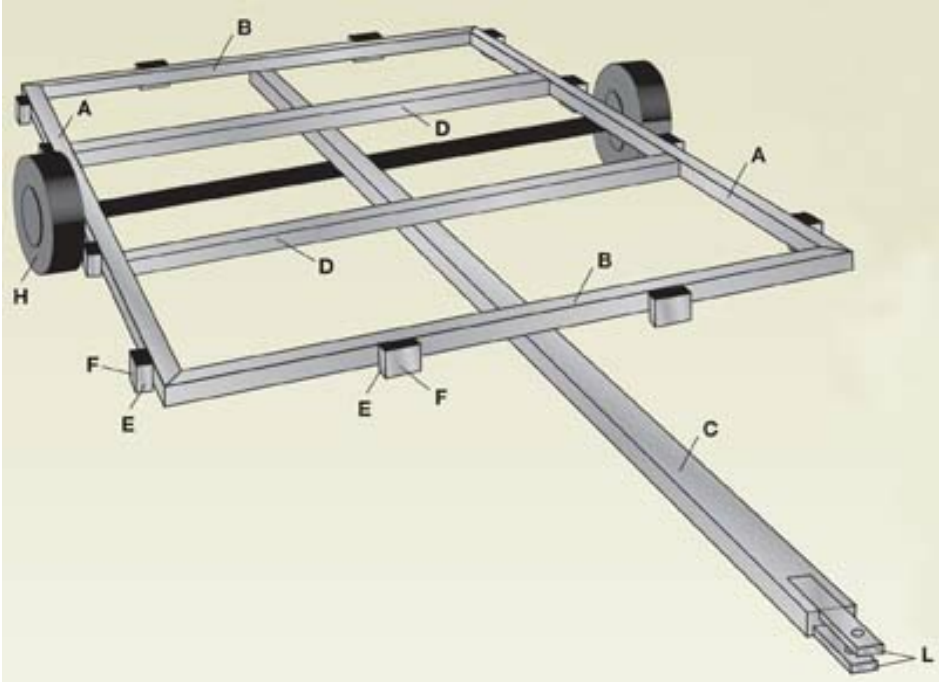
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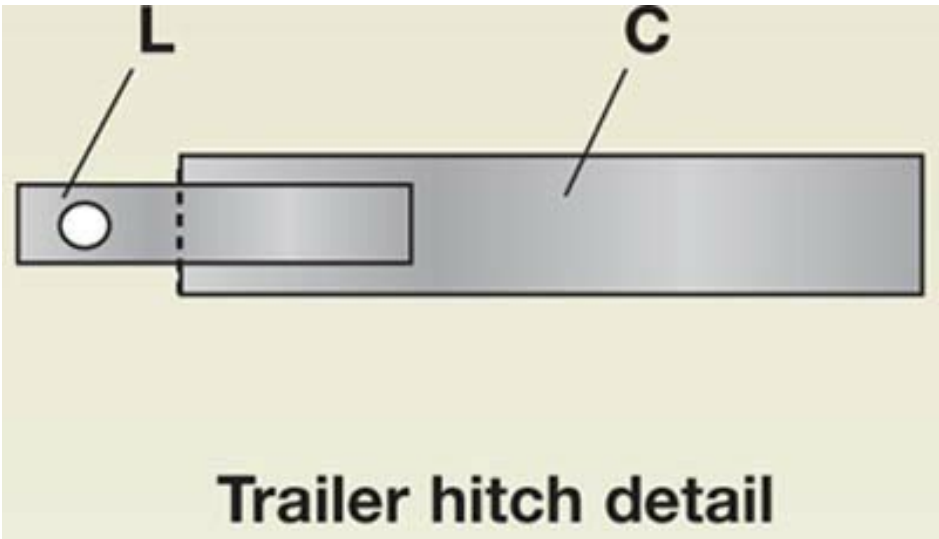
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Trailer hitch detail

How to Build a Trailer Frame

Build the Frame

1. Measure, mark, and then cut the frame sides (A) and frame front/back (B) parts to length (*dimension a* and *dimension b* respectively). *Note: We cut the ends at a 45 ° angle for mitered corners.*

2. Square one frame side tube (A) with one frame front tube (B), and tack them together to make an L.

3. Repeat step 2 for the other frame side tube and back tube.

4. Tack the two Ls together and check for square using a combination square or framing square.

5. Weld the inside corners; then weld the outside corners; lastly, weld along the top and bottom.

6. Cut the two cross bars (D) to length.

7. Align the cross bars in between the frame sides. *Note: The exact location is determined by the axle size and placement. The cross bars add overall support to the frame. Most axle kits come with instructions and placement recommendations based on the size of your trailer and the loads you intend to carry*.

8. Check each cross bar for square, and then tack them onto the frame.

Tack weld together the trailer sides and front/back to make the basic frame.

Safety

NOTICE: If you plan on using your trailer on streets or roads it must be licensed and, in most cases, it must have working brake lights, reflectors, and safety chains in case of hitch failure. Some areas may also require that your trailer pass a safety inspection.

Weld the trailer tongue to the underside of the frame.

Connect the Trailer Tongue to Cross Bars

1. Measure, mark, and then cut the trailer tongue (C) to length.

2. Align the trailer tongue down the center of the frame, on top of the cross bars. Clamp the trailer tongue to the cross bars. Measure to ensure the tongue is centered and square. Adjust as necessary. *Note: We extended the trailer tongue to the far back of the trailer frame for optimal strength.*

3. Tack the trailer tongue to the two cross bars, and then weld it onto the frame.

Install the Axle Kit & Wheels

1. Align a bracket onto each underside of the trailer frame sides. Follow the axle kit instructions, and make sure the brackets are square and aligned at the exact same location on both sides of the frame.

2. Tack the brackets onto the frame.

3. Align the leaf spring into the bracket tacked onto the trailer following the manufacturer's instructions. Locate the placement for the other bracket under the leaf spring, and then align it on the trailer frame. Repeat for the other trailer side.

4. Check the brackets on both sides of the trailer for squareness to each other.

5. Set the leaf spring aside, and then weld all brackets in place.

6. Bolt the leaf spring to the brackets following the manufacturer's instructions.

7. Align the axle in place under the leaf spring following the manufacturer's instructions. Fasten the axle to each leaf spring. Our kit came with two heavy-duty U-bolts that wrap around the axle and then bolt onto each leaf spring.

8. Install the hubs and wheels onto the axle following the axle kit instructions. Inflate the tires.

Tack the first axle bracket onto the underside of the trailer frame. Repeat for the other trailer side. The brackets need to be perfectly square to each other. Hold the leaf spring in place over the bracket to align the second bracket on each side. Weld the brackets to the frame, and then bolt the leaf spring to the brackets.

Bolt the axle to the leaf spring with large U-bolts.

Make the Trailer Coupler Plates

1. Cut the coupler plates (L) to size, and then drill holes in the plates. Match the hole size and location to the coupler used. *Note: Our coupler slid over the plates and fastened to the tongue on the top and bottom so we aligned the plates with holes at top and bottom of tongue, but some couplers fasten to tongues at the sides and the hole locations will vary. The coupler and hitch type is determined by your vehicle type, final trailer construction, and the weight of your trailer and anticipated loads (see Resources).*

2. Visually align, clamp, and then tack the coupler plates to the trailer tongue. Extend the coupler plates at least 3" past the trailer tongue end.

3. Mark the angle bend location(s) on the tongue. Determine the tongue angle(s) by measuring from the hitch of the towing vehicle to the trailer tongue (remember to inflate tires). *Note: If the angle is significantly steep, making multiple bends at incremental angles will provide a stronger tongue.*

4. Score the angle mark using a 4½ angle grinder with a fiber cut-off wheel.

5. Bend the tongue to the proper angles.

6. Tack the tongue back together at the scores. Double-check the fit next to the towing vehicle. The trailer should be level.

7. Weld the coupler plates to the tongue.

8. Make all final welds at bends along tongue.

9. Slide the coupler over the coupler plates. Bolt the coupler to the plates, and then weld along all points on which the coupler and tongue connect.

Cut the coupler plates 8” long using a chop saw.

Make the Stake Side Pockets

1. Measure and cut the two sides for each stake pocket (E) to $^{3}/_{16}$ × 2" HRS × 1¾".

2. Measure and cut one front for each stake pocket (F) to $^{3}/_{16}$ × 2" HRS × 3½".

3. Align a pocket side (E) and front (F) onto a 90° magnetic square to form open corner joints. Tack the pieces together to form an L, and then make the final weld.

4. Use a magnetic square to weld on the second pocket side to form the complete U for all twelve pockets—be sure to use an open corner joint again. Make all final welds.

5. Repeat for all twelve pockets.

6. Align pockets around the trailer so they are evenly spaced along the long frame sides, starting at 2" in from the corners.

7. Tack the pockets to the trailer frame. Check for square.

Finish

1. Roughen the surfaces by sanding.

2. Apply a rusty metal primer for optimal rust protection.

3. Paint or powder coat the trailer with paint rated for exterior applications for extra durability and weatherproofing.

Drill holes into the coupler plates according to the coupler specifications.

To determine the angle for the trailer tongue, align an angle finder on your truck or ATV hitch and on the trailer tongue. Mark this angle at the appropriate location on the tongue.

Score notches along the tongue to achieve the desired angle using a handheld grinder. Tack the bends and then hook up the trailer to your towing vehicle—the trailer should be level. If necessary, break tacks and re-bend tongue. Make final welds along each bend.

Powder Coating

Powder coating is the most effective painting technique to protect exterior metal projects, as it produces a very thick coating, results in little to no paint drips or runs, and produces an abrasion-resistant and tough finish. Home powder-coating systems range in price from $100 to $700. See Resources.

Assemble the side pockets. These pockets are available pre-made if you find this to be too time-consuming. They are relatively inexpensive.

Tack the pockets around the perimeter of the frame.

Floor & Side Options

If you plan to use your trailer for yardwork and hauling debris, you'll want to add a solid floor and sides to your trailer. A simple method, which we show here, is to attach plywood siding to 2 × 4 exterior-rated stakes set into the pockets along the trailer frame. The stakes are exterior-treated 2 × 4 lumber and the siding is ¾" × 4 × 8" plywood. The plywood floor is drilled directly to the trailer frame.

Make Removable Sides & Trailer Bed

1. Measure and cut twelve 2 × 4s (I) into 15" lengths.

2. Measure and cut the plywood bed (M) to *dimension a* × *dimension b*.

3. Measure and cut the plywood sides (J) to *dimension a* × 12".

4. Measure and cut the plywood front/back pieces to *dimension b* × 12" (h).

5. Insert the twelve 2 × 4 stakes into the trailer pockets.

6. Fasten the plywood sides and front/back to the 2 × 4s. If a 2 × 4 does not quite fit, use a chisel and hammer to adjust it.

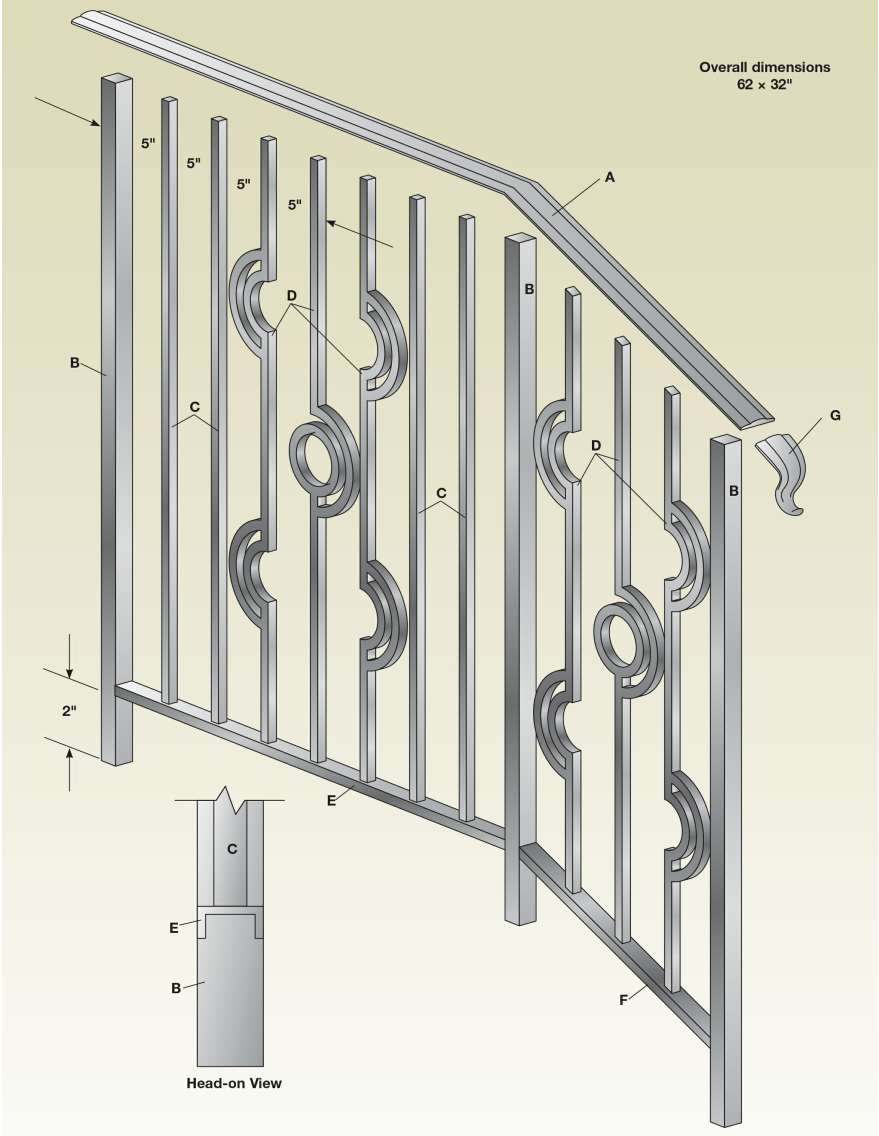
7. Fasten the trailer bed to the frame with bolts or self-tapping metal screws spaced every 6 to 12".

Fasten ¾"-thick plywood trailer sides to the exterior-rated 2 × 4 stakes.

Drill the exterior-rated plywood sheet for flooring directly to the trailer frame.

Alternative: Weld expanded metal lath all along the top of the frame perimeter. This is more suitable than wood for hauling ATVs, motorcycles, and snowmobiles.

If the primary use of your trailer is to transport vehicles, another feature to consider is a drop-down back. This requires building out a frame and then welding expanded metal lath onto the frame—just as you did with the trailer floor—and then using a purchased or custom-made bolt-on hinge system with latches.


Overall dimensions
62 × 32"
5"
5"
5"
5"
A
B
D
B
C
G
D
C
B
2"
E
C
E
B
F
Head-on View

Stair Railing

With the number of companies selling decorative metal pickets and newel posts, it is easy to create a railing distinctly your own. The railing we are making is for a two step concrete stairway.

Some important information about creating railings:

The rail top should not be interrupted by knobs or other decorations—it must allow continuous hand to rail contact and should be between 1½ and 2" in diameter to ensure easy gripping.

Some railings—those mounted against a wall or in an area where the stair surface is not raised above the surrounding surface, like the stairs in the slope of your lawn—can be a single rail at the appropriate height. A railing that separates the stair, landing, balcony, or deck from a vertical drop has to conform to certain safety standards. Typically, the pickets or balusters must not have any gaps larger than 5½" for child safety. The lower rail should not be more than 2" from the floor surface. If the vertical drop from the floor line is more than 6 feet, the railing must be a minimum of 34" tall. If the vertical drop is less than 6 feet, the railing must be a minimum of 32" in height. Railings must have turn-outs or roundovers at their ends to prevent blunt projections. The safest handrails continue 12" beyond the top and bottom stairs. Railings must be able to withstand a 250-pound force in any direction without giving way. Check your local building codes for specific requirements.

You can purchase rail cap, also called cap rail or handrail, at most steel supply centers. Handrail terminations come in a variety of styles. Those that scroll in an S shape are called “lamb tongues.” A “volute” is a spiral termination, and a “lateral” is a flat curl to the side. These may be ordered through specialty railing distributors. See Resources page 220.

Materials

- 1¾" rail cap (as needed)
- 1" square tube (as needed)
- ½" square rod (as needed)
- ½" decorative pickets (as needed)
- 1/8 × ½ × 1" channel (as needed)

- Lamb tongue rail termination
- Mounting hardware

PART	NAME	DIMENSIONS	QUANTITY
A	Handrail	1¾" rail cap × 64"*	1
B	Newel posts	⅛ × 1 × 1" square tube × 32½"	3*
C	Plain pickets	½" square rod × 30"	4*
D	Decorative pickets	½" decorative pickets × 30"	6*
E	Flat bottom rail	⅛ × ½ × 1" channel × 40"*	1
F	Angled bottom rail	⅛ × ½ × 1" channel × 24"*	1
G	Rail termination		1

*Dimensions and quantities must be adjusted to fit the particular stairs.

How to Build Stair Railing

Cut the Handrail to Length

1. Measure from the edge of the house to the edge of the landing. Measure from the edge of the landing to where the newel post will be located. Add these two measurements to get the length of the handrail.

2. Cut the handrail (A) to size.

Heat the bending point of the handrail to red hot with an acetylene torch or cutting tip to make the metal easy to bend.

Shape the Handrail

It is a good idea to create an angle guide for bending the handrail by screwing two pieces of wood together at the length and angle to match the stairway.

1. Set the handrail on the landing with one end butting against the house. Mark the handrail at the edge of the landing.

2. Clamp the railing in a bench vise and heat the bending point red hot with an acetylene torch. A cutting torch preheat works best, just make sure you don't hit the oxygen and accidentally cut the metal.

3. When the metal is red hot, bend it to create the angle. It is helpful if you pull on the longer end of the rail to bend so you have more leverage.

4. When finished bending the handrail, place it on the stairs to make sure the bend is correct.

Lay Out the Newel Posts & Pickets

The newel posts will be anchored in the concrete or attached using square footings that will bolt into the concrete, so they have to be far enough from the edge not to destroy the edge of the concrete.

1. Determine the number of plain pickets (C), decorative pickets (D), and newel posts (B) you need.

2. Place the bent handrail on the floor or a large work surface. Place newel posts at each end of the handrail and near the bend.

3. Lay out the pickets in a pleasing pattern, making sure they are no more than 5½" apart.

4. Mark and cut the two bottom rails (E & F) to fit between the newel posts, once you have the layout determined. Place the channel flat side up, with the legs down. Mark the picket locations on the railings.

Option: *When you look at railings, you will see that some railings have the pickets and newel posts welded directly to the rail cap, as you see here. Other railings have a piece of channel welded into the underside of the rail cap and the pickets are welded to the flat side of the channel. Punched channel can be purchased with ½ × ½" square holes pierced through it. This is welded under the rail cap, and the pickets are inserted through the punched holes and welded in place. You also can use the punched channel for the bottom rail. Using punched channel means you cannot adjust spacing to account for the unique shapes and sizes of decorative pickets*.

Cut the Posts & Pickets to Length

Purchased decorative pickets range from 36 to 39". When cutting decorative pickets, cut equal amounts from each end unless you wish the pattern to be off center.

1. Determine the height of your handrail and the depth that the newel posts will be footed in the concrete (if they are to be footed, otherwise measure to the top of the concrete).

2. Cut the newel posts and pickets to length. Cut the appropriate angle for the stair pickets.

Assemble the Railing

Concrete can explode when heated, so it is best to do your welds on a sheet of plywood that can be doused with water when you have finished.

1. Tack weld the newel posts to the rail cap. Tack weld the bottom rails to the newel posts.

2. Place the rail assembly on the stairs to make sure the dimensions are correct. If they are not, break or grind off the tack welds and make adjustments.

3. Return the assembly to the work surface, and tack weld the pickets in place, maintaining the proper spacing. Use a combination square to check each piece for square before welding.

4. Make the final welds. Weld the lamb’s tongue termination to the end of the rail cap.

5. Grind down any rough or unsightly welds. Wire brush or sandblast the rail assembly.

6. Install the railing by cementing the newel posts into the stairs or using bolt-down flange shoes.

7. Prime and paint the railing with a high quality outdoor metal paint.

Lay out the pickets and newel posts in a pleasing arrangement, keeping them no more than 5½" apart.

Gate

This gate framework can be used to hold a collection of found metal objects. Use brazing or braze welding to join non-matching metals or thicknesses of metals. Rusty objects will need to be cleaned at the point of contact. If the objects you find are large, you may want to space the uprights at 8", rather than 4". The 4" spacing meets code requirements for gates and fences—this spacing prevents children from getting their heads stuck between uprights.

Materials

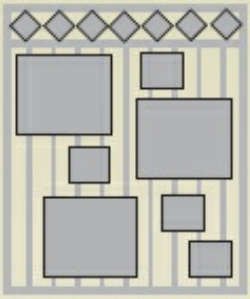
- 16 gauge 1 × 1" square

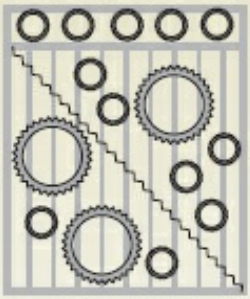
tube (17½ feet)

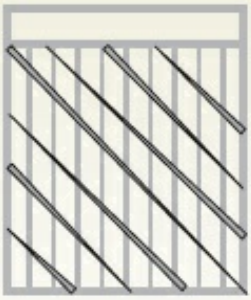
- 16 gauge ½ × ½" square tube (30 feet)
- 4" weldable barrel hinges (2)
- Gate latch hardware
- Found objects
- Wood and brass spacers

PART	NAME	DIMENSIONS	QUANTITY
A	Sides	16 gauge 1 × 1" square tube × 46"	2
B	Crosspieces	16 gauge 1 × 1" square tube × 40"	2
C	Interior crosspiece	16 gauge 1 × 1" square tube × 38"	1
D	Vertical inserts	16 gauge ½ × ½" square tube × 40"	9

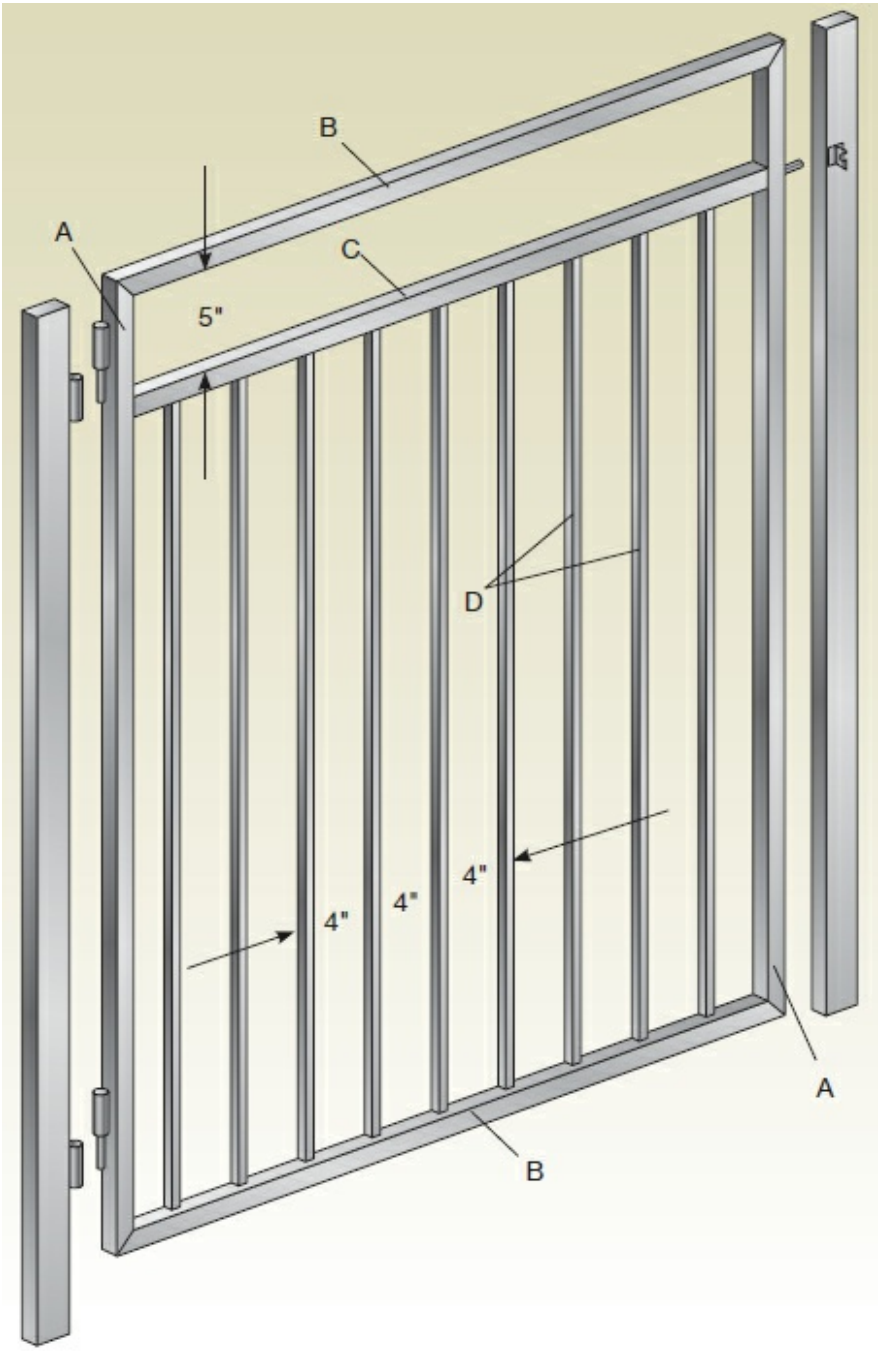
Alternate styles







Overall dimensions
40 × 1 × 46"


B
A
C
5"
D
4"
4"
4"
A
B

How to Make a Gate

Assemble the Frame

1. Cut the sides and crosspieces (A & B) to size, mitering the ends at 45°.

2. Place the left side piece and bottom crosspiece together at a 90° angle to form one corner of the rectangle. Check the pieces for square, and clamp in place. Tack weld the pieces together.

3. Place the right side piece and top crosspiece together to form another corner of the rectangle. Check for square, clamp in place, and tack weld together.

4. Join the two pieces to form the rectangle. Check the corners for square and clamp in place. Tack weld the corners together.

5. Measure the diagonals of the rectangle to check for square. If the measurements of both diagonals are equal, the assembly is square. If it is not square, pull or push it into alignment. When aligned, clamp it in place, and finish the corner welds.

6. Turn the assembly over, and complete the welds.

Attach the Interior Crosspiece & Inserts

1. Cut the interior crosspiece (C) and vertical inserts (D) to size.

2. Place the interior crosspiece against the inside edges of the side pieces 5" down from the top crosspiece. Check the pieces for square, and clamp in place. Weld the interior crosspiece to the sides.

3. Place the vertical inserts at 4" intervals between the interior and bottom crosspieces. Make sure the spacing is even—you might need to adjust to slightly less or more than 4" if the miter cuts are slightly off. Keep the outside edge of the inserts flush with the outside edge of the crosspieces.

4. When the spacing is adjusted properly and the inserts are square to the crosspieces, tack weld each insert at both ends.

5. Check the assembly and inserts for square one more time. Turn the assembly over, and weld each upright in place.

Attach the Found Objects

Objects other than mild steel will need to be brazed or braze welded. Connect non-metallic objects by wrapping or folding a thin strip of mild steel sheet metal or a short piece of 1/8" steel rod around an edge. Weld the ends of the rod or strap to the framework.

1. Arrange your found objects artfully across the interior space.

2. Carefully clean rust or paint from the areas where the found objects contact the uprights.

3. Weld the found objects in place.

Attach the Hinges

Our gate is made to hang attached to a metal gate post. We chose to use barrel style hinges.

1. Place the gate between the gate posts. Use wood spacers and braces to position the gate between the gate posts, and clamp or brace solidly in place.

2. Line up the hinges on the post and the gate (see photo). Use a level to check for plumb. (For the gate to swing properly, the hinges need to be installed perfectly plumb.) Tack weld the hinges to the gate and post.

3. Remove the bracing, and check that gate swings freely. When it does, complete the hinge welds.

4. Install the gate latch hardware. If the hardware is painted or zinc coated, grind off the coating before welding, or install with screws.

Brace the gate in position between the gate posts. Clamp a wood spacer between the gate post and the gate side. Position the hinge and check for plumb.

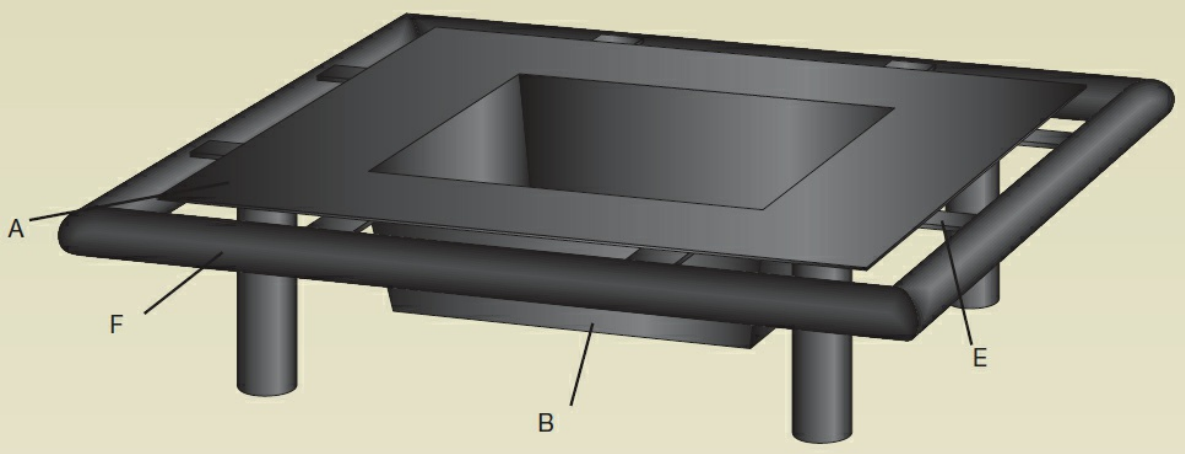
Firepit

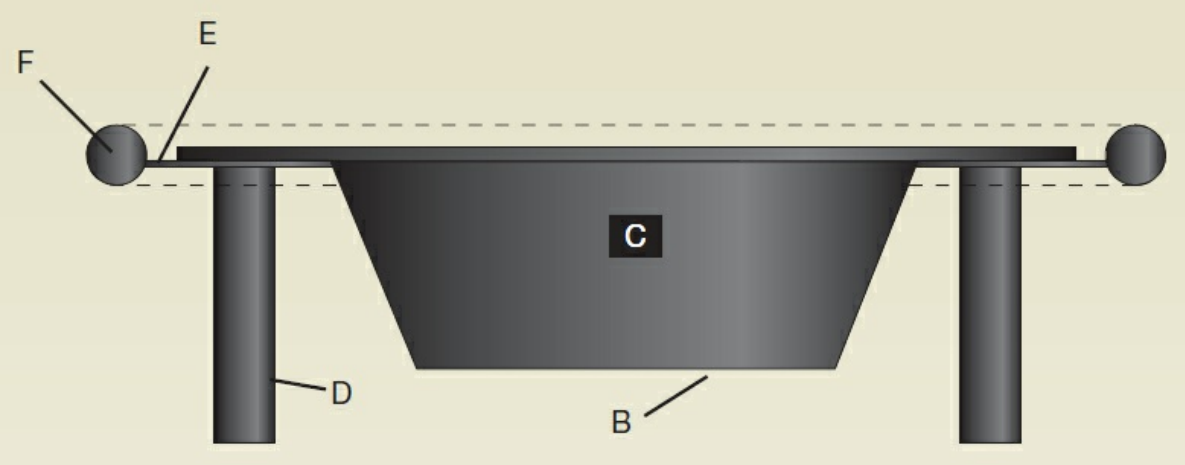
All kids and most adults love having a fire in the backyard. Here's a firepit that takes into account safety precautions, and it is easy to build. The deep box holds large chunks of wood, and the wide table lip minimizes scattering sparks. The footrests are great for kicking back by the fire, and they also help keep small hands away from the heat. If you want a spark screen, Smith & Hawken sells a clamshell screen on its website (see Resources). This firepit has been sized to use such a screen.

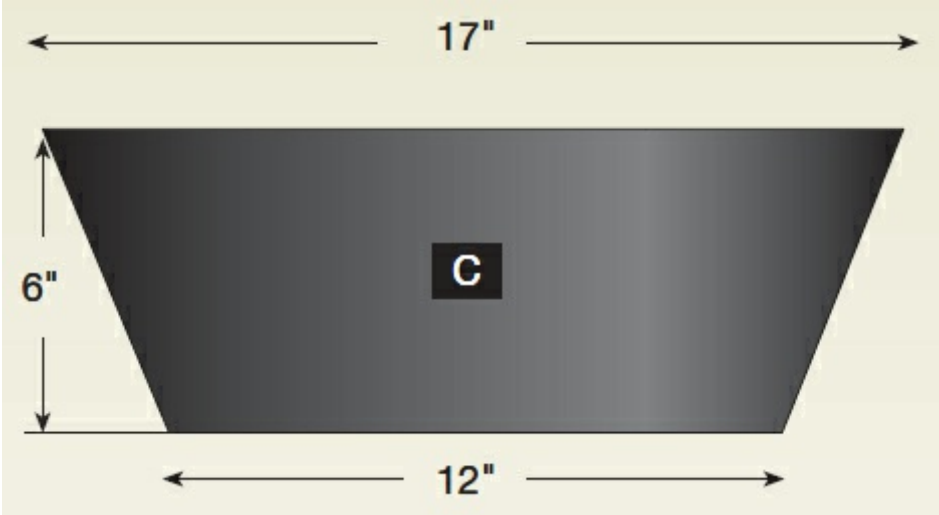
Materials

- 1/8" sheet metal (30 × 30", 6 × 60½")
- 1/8 × ½ × 1" channel × 4 feet
- 16-gauge 2" round tube (15½ feet)
- Spark screen (Smith & Hawken #749622, optional)

PART	NAME	DIMENSIONS	QUANTITY
A	Top	⅛" sheet metal × 30 × 30"	1
B	Bottom	⅛" sheet metal × 12 × 12"	1
C	Sides	⅛" sheet metal × 12 × 17 × 6" (trapezoidal)	4
D	Legs	16-gauge 2" round tube × 9"	4
E	Arms	⅛ × ½" × 1" channel × 6"	8
F	Footrests	16-gauge 2" round tube × 36"	4


A
F
B
E


F
E
C
D
B


17"
6"
C
12"

How to Build a Firepit

Before welding, clean all parts thoroughly with denatured alcohol.

Make the Top

1. Cut the top (A) to size.

2. Mark a straight line 6½" in from each side. This will create a center square.

3. Using a plasma cutter or acetylene torch, cut the inside square out of the top.

Make the Box

1. Cut the bottom (B) to size by cutting down the scrap from the top. Mark in 5" from two sides of the scrap to form the 12" square. Cut along the lines.

2. On a 6 × 60½" piece of sheet metal, mark one long side at 17", 29", 46", and 58". Mark the other side at 2½", 14½", 31½", and 43½". Use a straightedge and marker or soapstone to draw lines from the corner to the 2½" mark, from the 14½" mark to the 17" mark and so on to create four trapezoids with the parallel sides being 17" and 12". Cut the sides (C) to size.

3. Tack weld a side to the bottom. Tack weld an adjacent side to the bottom. Bend the sides so their seam aligns, if necessary, and tack-weld. Continue with the other sides.

4. Turn the box over and weld all the seams.

5. Place the box over the cutout in the table and tack weld in place.

6. Complete all the welds.

On the scrap piece cut from the top, mark 5" in from two edges to create a 12" square.

Make the Legs

1. Cut the legs (D) to length.

2. Place the legs 2" from each corner of the box. Weld in place.

Make the Footrest

1. Cut the footrests (F) to length, mitering each end at 45°. Make sure the miters are perfectly aligned. Use a clamping jig to prevent rolling.

2. Lay out the footrests to form a square. Tack weld the corners.

3. Turn the table and fire box upside down on top of 1" spacers. Place the footrest around the top. Align the footrest evenly with the table edges.

4. Cut the arms (E) to length.

5. Place the arms so they touch the footrest and are aligned with the box edges.

6. Tack weld the arms to the footrest. Tack weld the arms to the table underside. Make sure the footrest is still aligned with the top.

7. Complete all the welds for the arms and footrests.

Finish the Project

1. Grind down all welds.

2. Wire brush and clean fire pit.

3. Finish with Rust-Oleum High Heat spray enamel.

Tack weld the sides to the base from the inside. Then turn the pit over and weld all the seams.

Creating a jig using a piece of channel iron and plywood makes cutting the 45° angles easier.

Vineyard Trellis

This arbor is a beautiful stand- alone piece, but it is also a brilliant addition to the Arch & Gate. Either way it is an impressive addition to your yard. Mount it against a wall or fence, or use it as a panel within a fence. Better yet, make an entire fence of trellises! To do so, screw mount the panels to 4 × 4 wood posts, or weld the panels to 3 × 3 steel posts.

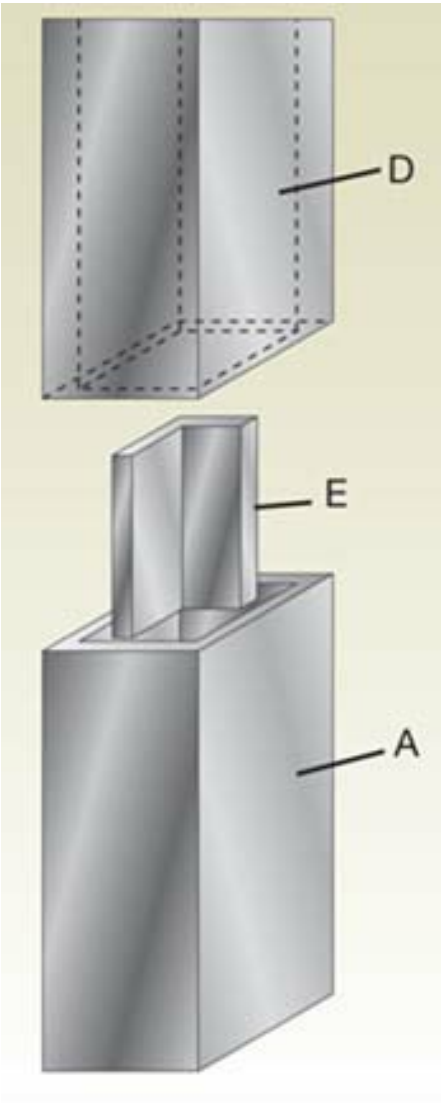
You may want to cap off your trellis with a finial or decorate the panels with permanent trailing vines for the off season. See Resources for finial, frieze, and stamped metal sources. Make sure to order parts that can be welded. Cast iron cannot be easily welded to the steel trellis parts.

Materials

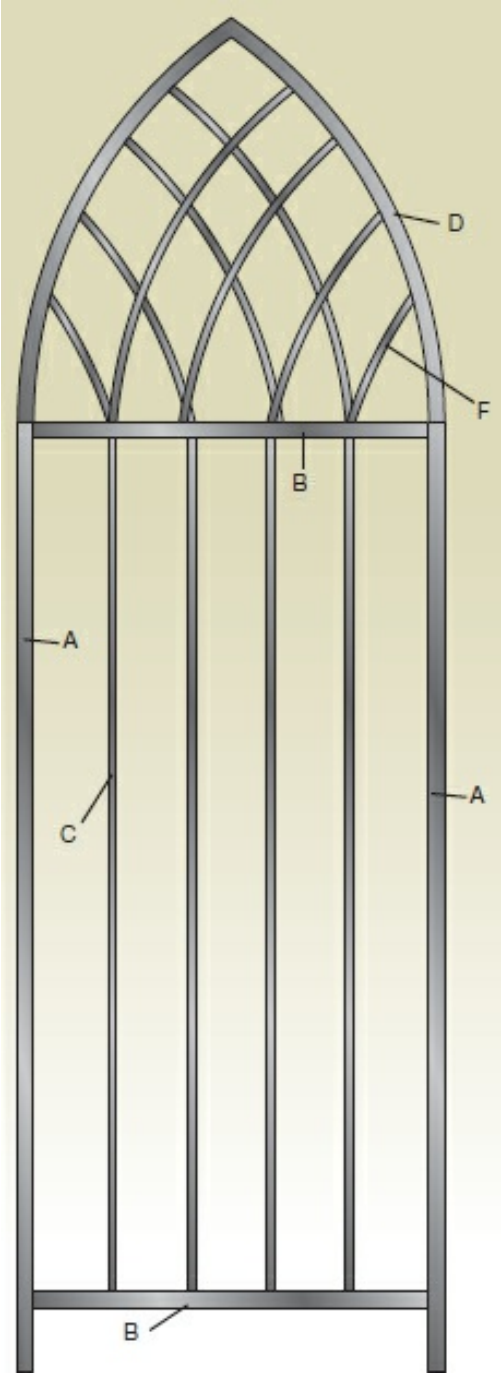
- 16-gauge 1 × 1" square tube (23 feet)
- 16-gauge ½ × ½" square tube (18 feet)
- ¾" round rod (6 feet)
- 1/8 × ½ × ½" angle iron (4")
- ¼" round rod (18 feet)

PART	NAME	DIMENSIONS	QUANTITY
A	Legs	16-gauge 1 × 1" square tube × 60"	2
B	Crossbars	16-gauge 1 × 1" square tube × 25"	2
C	Verticals	16-gauge ½ × ½" square tube × 54"	4
D	Main arch	16-gauge 1 × 1" square tube × 51"*	2
E	Sleeves	⅛ × ½ × ½" angle iron × 2"	2
F	Decorative arches	¼" round rod × varied*	8
G	Mounting stakes	¾" round rod × 36"	2

* Approximate dimensions, cut to fit.



Sleeve detail


D
F
B
A
A
C
B

How to Build a Vineyard Trellis

Before welding, clean all parts thoroughly with denatured alcohol.

Make the panel

1. Cut the legs (A) and crossbars (B) to length.

2. Lay out the crossbars between the legs. Align the top crossbar with the top of the legs. Place the lower crossbar 4" from the bottom of the legs.

3. Check for square, clamp in place, and tack weld together.

4. Measure across the diagonals to check for square. If the diagonals are not equal, adjust until they are. Complete the welds.

5. Cut the verticals (C) to length.

6. Mark the crossbars at 5", 10", 15", and 20". Center the verticals at the marks, check for square, and weld in place.

Bend the Main Arches

1. Cut a 28" radius semicircle from ½" plywood. Cut the semicircle in half.

2. Stack the quarter circles and screw them onto a 3 × 3 sheet of plywood. Screw 2 × 4 stops along the bottom.

3. Clamp this bending jig to a stable work surface. Slide an arch piece (D) between the stops so it extends 2" below the bottom of the semicircle. Bend the tube around the curve. Bend the second arch in the same manner.

Finish the Main Arches

1. Remove the quarter circles from the bending jig. From the right angles of the quarter circles, measure in 17½" along one flat side. At this point, draw a line perpendicular to the side. Cut along the line. Repeat with the second quarter circle.

2. Mount these two arcs at the top of a 4 × 8 sheet of plywood, abutting them together on the new cuts to create a template for the arch.

3. Place one arch into the left side of the jig. Mark a vertical line on the arch to match the joint of the two wood arcs. Cut the arch along the line.

4. Place the other arch into the right side of the jig. Mark the centerline and cut.

5. Place both arches back into the jig and weld together at the peak.

6. Cut the sleeves (E) to length. Slide a sleeve 1" into each end of the arch. Slide the top of the panel over the sleeves. Weld the arch to the legs.

Make the Decorative Arches

1. Attach a stop block ½" from the base of the arch jig. Bend a decorative arch piece (F) around the jig to make a curve. Continue bending curves as needed.

2. At the 5" mark on the top crossbar, center one end of the arch piece. Align the arch parallel to the main arch. Mark the arch where it crosses the main arch. Cut on this line. At both ends, tack weld in place.

3. Repeat step 2 at the 10", 15", and 20" marks.

4. Repeat the process of placing, cutting, and welding arches for arches curving in the opposite direction. Finish all welds.

5. To prevent rattling, tack weld the arches to each other where they cross.

Finish the Arbor

1. Wire brush or sandblast the arbor. Finish as desired.

2. Pound the mounting stakes (G) 2 ft. into the ground, 26" apart. Slide the legs over the mounting stakes.

3. Using wire, secure the top or sides of the arbor to a wall or fence.

Bend the arch around the jig. Insert a ½" black pipe into the tube end to create more leverage.

Place an arch in the second jig and mark where the arc crosses the vertical line between the two half circles.

After bending the decorative arches, mark where they cross the crossbar and main arches.

Arch & Gate

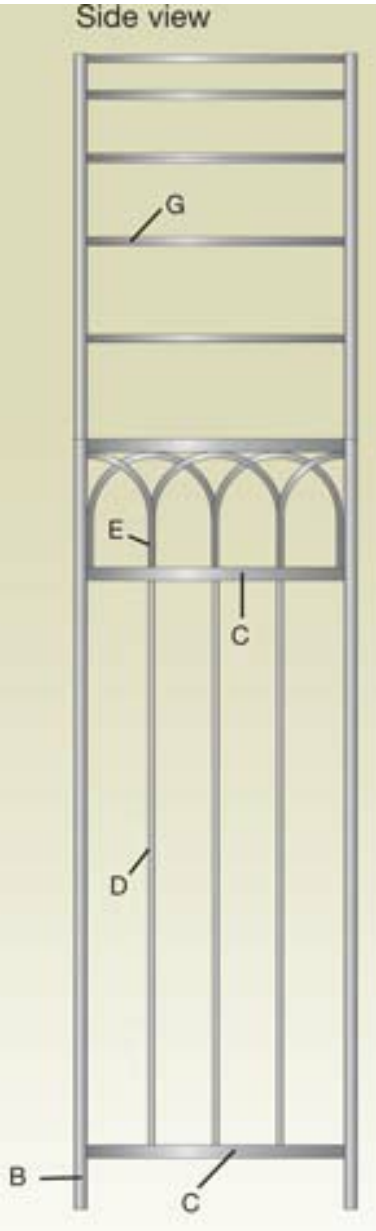
What a grand entryway this arch and gate provides! Unlike many manufactured archways, this one stands a full 8 feet tall, allowing easy passage underneath and plenty of room for trailing foliage. It is proportioned to fit over a 42" walkway. The arching pattern is beautiful and fairly easy to create. When paired with the matching vineyard trellis, this project will really add class to your yard or garden.

Materials

- 16-gauge ½ × ½" square tube (48½ feet)
- 16-gauge 1 × 1" square tube (70 feet)
- 1/8 × ½ × ½" angle iron (8")
- ¼" round rod (48 feet)
- ¾" round tube (8 feet)
- 2" weldable barrel hinges (2 pair, Decorative Iron #14.1120)
- Gate latch (1, Decorative Iron #14.2012)
- ½" plywood (2, 4 × 8) sheets

PART	NAME	DIMENSIONS	QUANTITY
A	Main arch	16-gauge 1 × 1" square tube × 51"*	4
B	Legs	16-gauge 1 × 1" square tube × 60"	4
C	Crossbars	16-gauge 1 × 1" square tube × 20"	6
D	Decorative vertical	16-gauge ½ × ½" square tube × 44"	6
E	Decorative arch	¼" round rod × 36"*	16
F	Sleeves	⅛ × ½ × ½" angle iron × 2"	2
G	Arch crossbars	16-gauge ½ × ½" square tube × 20"	9
H	Gate uprights	16-gauge × 1 × 1" square tube × 34"	4
I	Gate crossbars	16-gauge 1 × 1" square tube × 22⅜"	6
J	Gate verticals	16-gauge ½ × ½" square tube × 23"	6
K	Barrel hinges	3"	4
L	Latch		1
M	Mounting stakes	¾" round tube × 24"	4

* Approximate dimensions, cut to fit.


Side view
G
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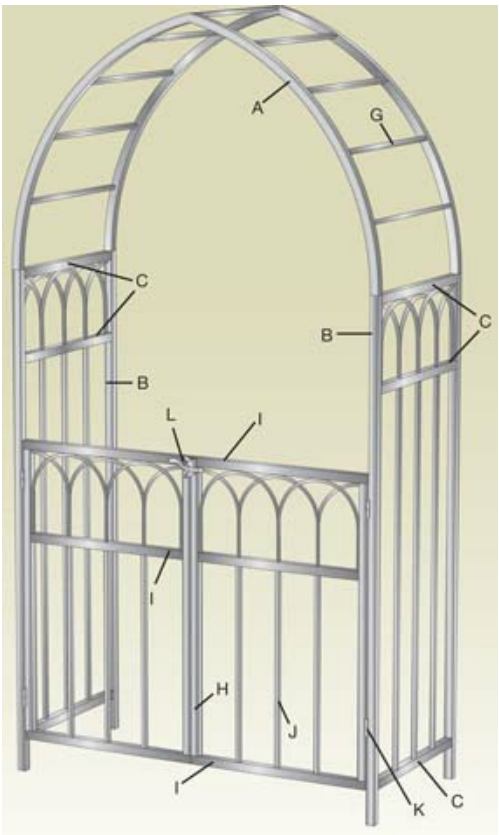
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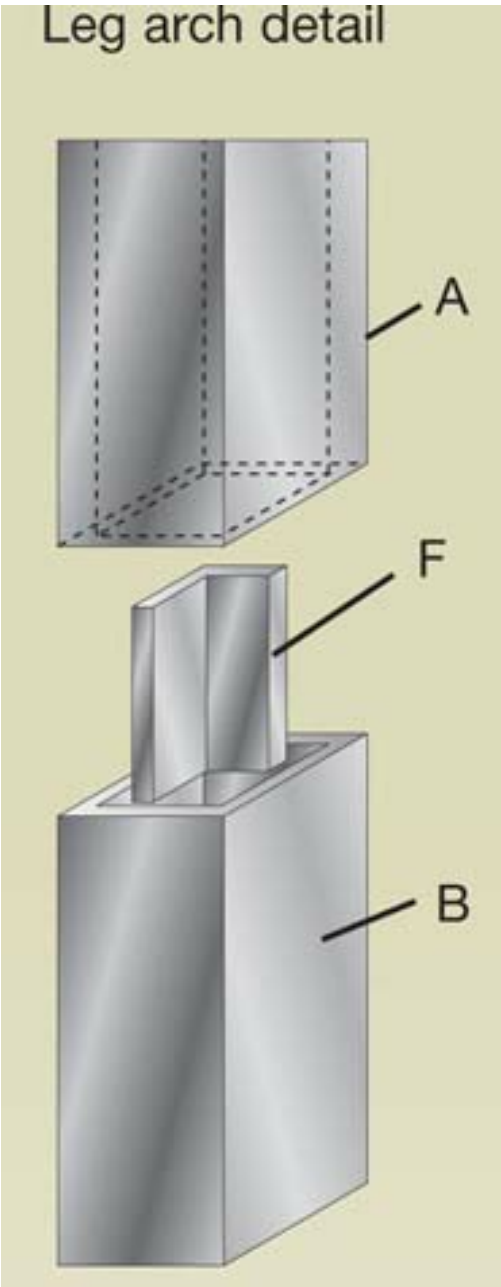

Leg arch detail
A
F
B

How to Build an Arch Gate

Before welding, clean all parts thoroughly with denatured alcohol.

Make the Main Arches

1. Cut a 28" radius semicircle from ½" plywood. Cut the semicircle in half.

2. Stack the quarter circles and screw them onto a 3 × 3 sheet of plywood. Screw 2 × 4 stops along the bottom.

3. Clamp this bending jig to a stable work surface. Slide an arch piece (A) between the stops, so it extends 4" below the bottom of the semicircle. Bend the tube around the curve. Bend the remaining arches.

Make the Side Panels

1. Cut the legs (B) and crossbars (C) to length.

2. Lay out two legs and three crossbars on a flat surface. Align the top crossbar flush with the top of the legs and the base of the bottom crossbar 4" from the bottom of the legs. Align the top of the third crossbar 10" down from the top of the legs. Check for square, clamp in place, and tack weld. Repeat to form the second side panel.

3. Before cutting the decorative verticals (D), measure between the bottom and middle crossbars for an exact length. Cut the decorative verticals to length. Mark all three crossbars at 5", 10", and 15".

4. Center the verticals at the marks. Check for square and weld in place. Finish all welds.

Weld the crossbars to the legs.

Create the Decorative Arches

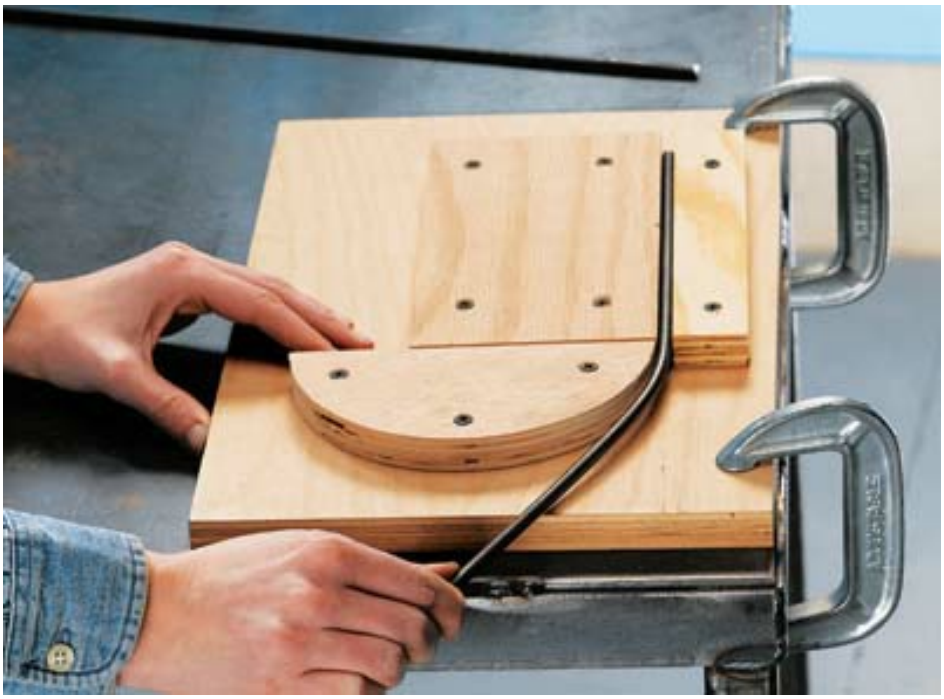
1. Make a bending jig by attaching a 9" diameter half circle and 10" long squares to a 15 × 19" rectangle. Slide a decorative arch piece (E) between the stops and bend it around the curve.

2. Place two hoops between the top and middle crossbars aligned with the legs and the 10" mark. Mark where the legs cross the middle crossbar, cut and weld in place.

3. Place a hoop with one leg at the 5" mark and the other at the 15" mark. Mark, cut, and weld (see photo, middle right).

4. Cut a hoop in half and place the halves starting from the 5" and 15" weld in place.

5. Repeat steps 2 to 4 for the other side panel.



Make a bending jig to create the hoops for the decorative arches.

Finish the Arches

1. Remove the quarter circles from the bending jig. From the right angles of the quarter circles, measure in 7½" along one flat side. At this point, draw a line perpendicular to the side. Cut along the line. Repeat with the second quarter circle.

2. Mount these two arches at the top of a 4 × 8 sheet of plywood, abutting them together on the new cuts to create a template for the arches. Place stop blocks 1" from the arch.

3. Place one arch into the left side of the jig. Mark a vertical line on the arch to match the joint of the two wood arches. Cut the arch along the line.

4. Place the other arch into the right side of the jig. Mark the centerline and cut.

5. Place both arches back into the jig and weld together at the peak. Repeat steps 3 and 4 for the second arch. Remove the arch jig from the plywood sheet.

Align the top of the hoop with the top crossbar and mark where the legs cross the middle crossbar.

Assemble the Archway

1. Cut the sleeves (F) to length. Cut the arch crossbars (G) to length.

2. Mark two parallel lines 45" apart on the sides of the plywood. Attach 2 × 4 clamping blocks along these lines.

3. Clamp the two side panels, lying on their backs, to the jig.

4. Slide sleeves into the legs 1", and weld in place.

5. Slide an arch over the sleeves and weld in place. Repeat with the second arch.

6. Weld a crossbar (G) between the two arches at the peak. Weld crossbars spaced 9" apart on the sides of the arches.

After bending the main arches, remove the quarter circles from the jig. Mark in 7½" from one flat edge and cut the form down.

Make the Gate Frame

1. Cut the gate uprights (H) and crossbars (I) to length.

2. Lay out the two gate frames with the crossbars on the top and bottom of the uprights. Place the third crossbar 10" from the top of the uprights. Check for square and tack weld together. Check the diagonals and adjust if necessary. Finish the welds.

3. Cut the gate verticals (J) to length. Mark all three crossbars at $5^{3}/_{16}$", $10^{3}/_{16}$", and $15^{3}/_{16}$". Center the verticals at the marks. Check for square and weld in place (see center photo, opposite page).

4. Make and assemble the gate decorative arches using the same method as described under Create the Decorative Arches on page 197.

Install the Gate

1. Stand the archway upright. Using scrap metal or wood, clamp the archway legs so that the space between the legs is 45" and the panels are parallel.

2. Align the gates flush with a set of legs (the legs and gate are flush front to back) and clamp in place. Allow a slight gap between the gates and legs (the gap is between the legs and gate side to side).

3. Tack weld the hinges (K) in place (see bottom photo, opposite page). Remove the clamps holding the gates and check that the gates swing freely. Adjust if necessary and complete the welds. Install the gate latch (L).

Finish the Archway

1. If you plan to finish the archway, sand or wire brush or sandblast it. Apply the finish of your choice.

2. Install the archway by clamping the side panels 45" apart.

3. On the ground where the arch will be installed, mark a 21 × 46" rectangle. At the corners of the rectangle, pound the mounting stakes 1 ft. into the ground. Lift the archway onto the mounting stakes and remove the clamps.

Clamp the sides to clamping blocks on a 4 × 8 sheet of plywood. Slide the main arches over the angle iron sleeves in the legs.

Weld the arch crossbars to the arches.

Center the gate verticals at the marks and weld in place.

Use shims and clamps to hold the gates in place. Weld the base, pin side of the hinge to the frame, and the top to the gate.

Gazebo

This moderate-size gazebo is also a special addition to any yard. Big enough for a table and chairs, it is small enough to fit in all but the tiniest of yards. Covered with vines in the summer, it provides delightful shade. In the off-season it supplies a point of visual interest with its scrolling patterns.

Want a different scroll pattern? Simply peruse the online catalogs of the companies listed in the Resources on for dozens of alternative patterns.

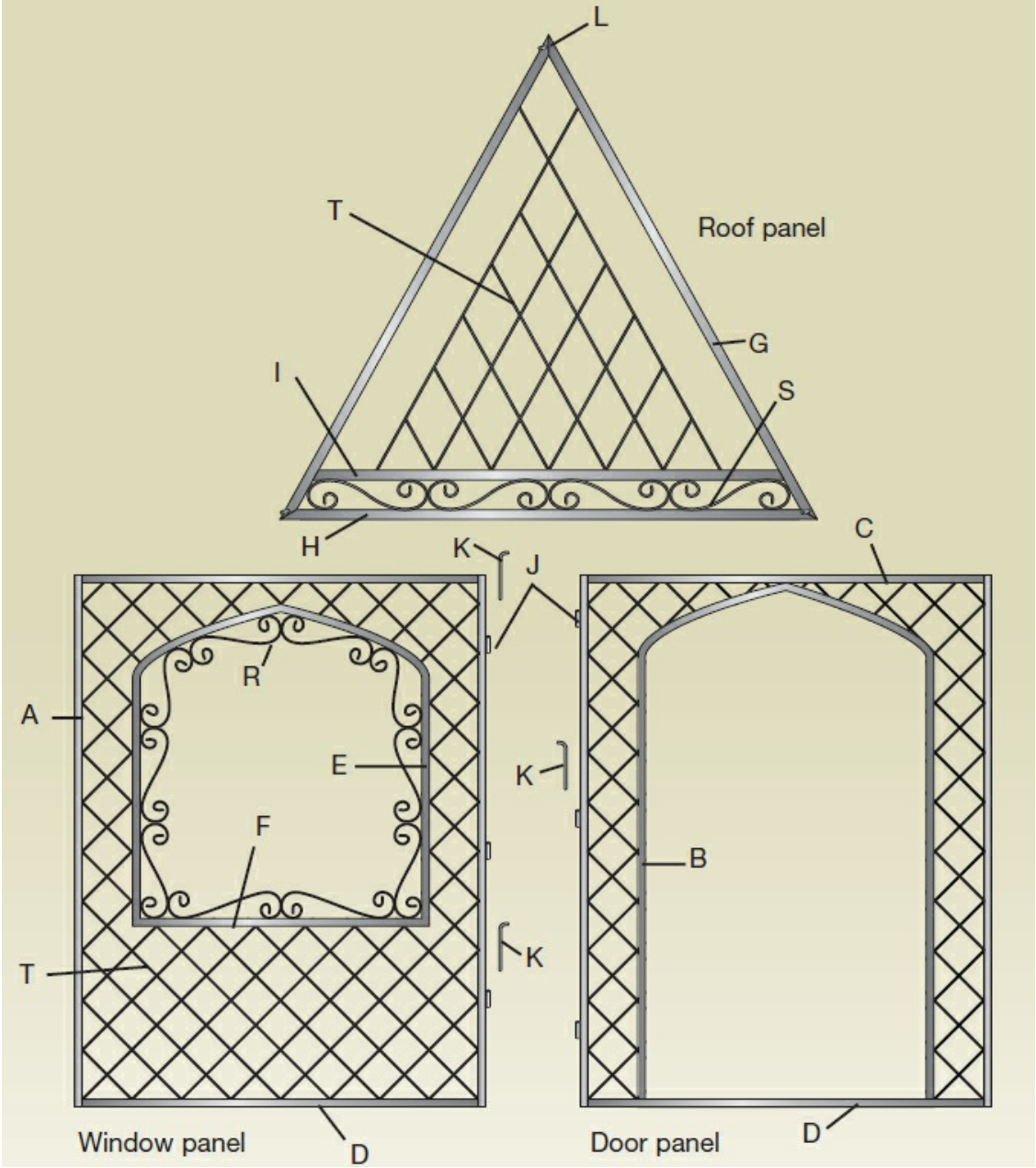
The directions here describe how to build door, window, and roof panels. The material quantities are for a gazebo with three door panels and three window panels. You can choose to construct your gazebo with any combination, just remember to adjust your quantities list accordingly.

Materials

- 4" finial (1, Decorative Iron #126)
- 1 × 1" square tube (344 feet)
- $^{3}/_{16}$" round rod (1,000 feet)
- ½" round tube (6 feet)
- $^{3}/_{8}$" round rod (10½ feet)
- ¼" round rod (3 feet)
- 4½" drip trays (2)
- 2" round tube (2")
- ½ × 6" carriage bolt, nut, and washer (1)
- ¾" round rod or rebar (9 feet)

PART	NAME	DIMENSIONS	QUANTITY
A	Legs	16-gauge 1 × 1" square tube × 80"	12
B	Door frames	16-gauge 1 × 1" square tube × 96"	6
C	Top crossbars	16-gauge 1 × 1" square tube × 54"	6
D	Bottom crossbars	16-gauge 1 × 1" square tube × 52"	6
E	Window frames	16-gauge 1 × 1" square tube × 40"	6
F	Window crossbars	16-gauge 1 × 1" square tube × 30"*	6
G	Roof sides	16-gauge 1 × 1" square tube × 66½"	12
H	Roof bases	16-gauge 1 × 1" square tube × 61"	6
I	Roof crossbars	16-gauge 1 × 1" square tube × 61"*	6
J	Hinge barrels	16-gauge ½" round tube × 3"	24
K	Hinge pins	⅜" round rod × 7½"	12
L	Finial pegs	¼" round rod × 6"	6
M	Finial sleeve	16-gauge 2" round tube × 2"	1
N	Finial	4"	1
O	Drip trays	4½"	2
P	Roof pegs	⅜" round rod × 3"	12
Q	Peg sleeves	16-gauge ½" round tube × 3"	12
R	Window scrolls	3/16" round rod × 24"	30
S	Roof scrolls	3/16" round rod × 36"	24
T	Diagonals	3/16" round rod × varied*	624

* Cut to fit.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Window panel
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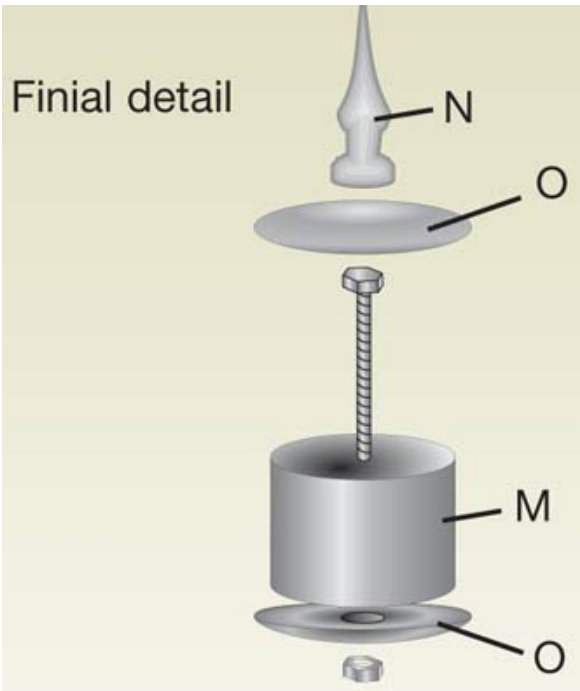
Door panel
D


Finial detail
N
O
M
O

How to Build a Gazebo

Before welding, thoroughly clean all parts with denatured alcohol.

Make the Door Panels

1. Cut two legs (A), two door frames (B), a top crossbar (C), and bottom crossbar (D) to length. Miter one end of each leg at 45°, and both ends of the top crossbar at 45°.

2. Lay out the legs, top crossbar, and bottom crossbar to form a rectangle. The bottom crossbar fits between the legs.

3. Check the rectangle for square and tack weld all corners.

4. Mark the door frames at 24". Using a conduit bender, bend the frames at the mark to 50°.

5. Place the door frames inside the assembled panel frame. Align the door frames 8" in from the panel sides. Mark vertical lines on the door frames where they overlap at the peak. Cut on the marks and tack weld the door frame arch together.

6. Align the door frame arch inside the panel frame with the point of the arch touching the top crossbar. Mark the legs where they cross the bottom crossbar. Cut the legs to length. Tack weld the door frame to the top and bottom crossbars.

7. Repeat steps 1 through 6 to make the desired number of door panels. Complete the welds.

Make the Window Panels

1. Cut two window frames (E) and a window crossbar (F) to length.

2. Mark the window frames at 24". Using a conduit bender, bend the frames at the mark to 50°.

3. Lay out the window frames with the window crossbar between two legs (A). Mark the vertical line at the peak where the frames cross each other. Cut the frames on the line and tack weld together.

4. Trim the legs to length, if necessary. Tack weld the window crossbar in place. Put the window frame aside for later installation.

5. Repeat steps 1 through 4 to make the desired number of window panels.

Make the Roof Panels

1. Cut two roof sides (G) to length. Miter one end of each side at 29°. Align the mitered edges and tack weld.

2. Cut a roof base (H) to size. Evenly align it underneath the sides. Mark where the sides cross the base. Cut on this line. Tack weld the base to the sides.

3. Cut a roof crossbar (I) to size. Place the crossbar 5" up from the roof base and mark the angles where the roof sides cross the crossbar.

4. Repeat steps 1 to 3 to make the remaining five roof panels. Complete the welds.

Assemble the Gazebo

Assembling the gazebo before all the decorations are added makes it lighter and easier to maneuver. In addition, if a panel is slightly skewed, it is easier to make corrections without having to rearrange decorative elements. Because the hinges will be perfectly aligned only for one arrangement, make sure you assemble the panels in the order desired.

1. Cut the hinge barrels (J) and pins (K) to length. With a bench vise, bend a right angle ½" in from one end of each pin.

2. Slide a pin into two barrels. Place two panels on the floor or upright against a wall. Place the barrels against the joint between the panels at 20" from the top. Tack weld one barrel to one panel and the other barrel to the second panel.

3. Tack weld another hinge to the panels at about 20" from the bottom.

4. Repeat steps 2 and 3 with the two other sets of two panels.

5. With the panels standing, arrange the three sets of two panels to form a hexagon. The angle between each panel pair should be 120°.

6. Install hinges at the remaining three panel joints.

Create the window and door arches by bending the tubing with a large conduit bender.

Assemble the Finial

1. Cut the finial pegs (L) to length. Bend the finial pegs in half to 110°. Support the roof sections on a cinder block or stool and tack weld a finial peg to the point of each roof section.

2. Cut the finial sleeve (M) to length.

3. Weld the finial (N) to the center of one drip tray (O) on the convex side.

4. Grind down the head of a ½ × 6" carriage bolt until it matches the concave curve of the drip tray. Welt the carriage bolt to the middle of the concave side of the drip tray from step 3.

5. Center the finial sleeve over the bolt and weld in place. Drill a $^{9}/_{16}$" hole through the center of the second drip tray.

6. With the peaks of the roof panels resting on a cinder block or low stool, slide the finial assembly over the finial pegs. Bend the finial pegs if necessary to fit inside the finial sleeve.

Assemble the Roof

Assembling the roof is easiest with an assistant or two.

1. Cut the roof pegs (P) and peg sleeves (Q) to length.

2. Weld two sleeves to the tops of each side panel ¾" in from the sides of the legs.

3. Measure the distance between a pair of sleeves. Use this measurement to mark the peg locations on a roof panel. Grind the pegs to 60° on one end and weld the ground end to the roof panel.

4. With the side panels assembled, place a roof section on top of a wall panel, sliding the pegs into the sleeves. Have an assistant hold up the center of the roof, or create awood support.

5. Place the remaining roof sections. Slide the finial over the finial pegs, slide the drip cup over the bolt, and install the washer and nut.

6. Adjust roof and finial pegs as needed.

7. Number or otherwise mark the side and roof panels for reassembly.

8. Remove the finial and take the roof panels down. Disassemble the panels by pounding out the hinge pins.

Mark the roof crossbar for cutting.

Insert a hinge pin into two hinge barrels. Place the hinge between two side panels and weld one barrel to one panel and the other barrel to the adjoining panel.

Make the Window Scrolls

1. Cut the scroll blanks (R) to length.

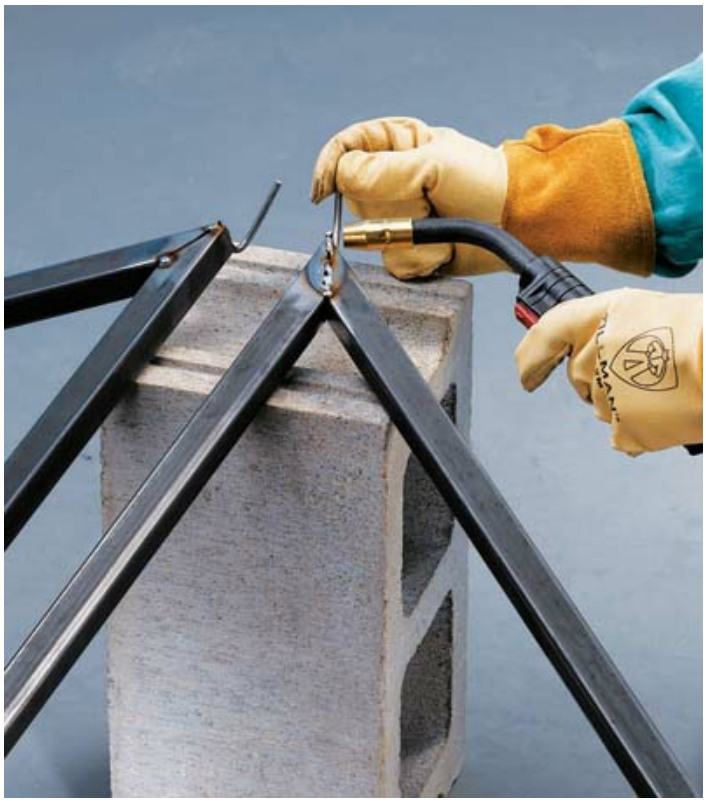
2. Cut a $^{3}/_{16}$" slot in a 2" pipe. Place the rod in both slots, then bend the rod around the outside of the pipe one and a half times.

3. Place the other end of the rod in the slot and bend one and a half turns around the outside of the pipe in the opposite direction.

4. Slightly open the bends to create a pleasing scroll.

5. Repeat to form the remaining window scrolls.

6. Weld the scrolls into the window frames as pictured.



Support roof sections on a cinder block. Weld the finial pegs to the points of the panels.

Make the Roof Scrolls

1. Cut the scroll blanks (S) to length.

2. Cut a $^{3}/_{16}$" in a 3" pipe. Place the rod through both slots, then bend the rod around the outside of the pipe one and a half times.

3. Place the other end of the rod in the slot and bend one and a half turns around the outside of the pipe in the opposite direction.

4. Slightly open or close the bends to make the scroll fit between the roof base and roof crossbar.

5. Repeat for the other roof scrolls.

6. Weld the scrolls between the roof base and roof crossbar as pictured.

Create the finial assembly by welding the finial to the drip tray, then welding the bolt to the drip tray.

Add Decoration to the Roof

You can make the roof a simple diamond pattern.

1. To make the diagonals (T), mark the roof sides every 6" down from the peak and 6" down from the roof crossbar. Lay out two rods from the peak marks to the opposite first two marks on the roof crossbar to match the roof panel diagram (page 201). Cut the rods to fit and weld in place.

2. Mark the diagonals from step 1 every 6".

3. Make the internal diagonals by cutting pieces to fit between the marks on the right side and base. Weld in place.

4. Finish the internal diagonals by cutting pieces to fit between the marks on the left side and base. Weld in place.

Add Diagonal Filler to Side Panels

Diagonal rods can fill the space below and above the windows, or you can add scrolls and hearts.

1. On the door panels, mark the legs, door frames, and top crossbars every 8".

2. Cut diagonals to fit between the marks.

3. Weld the descending left to right diagonals in place, then weld the ascending left to right diagonals in place.

4. On the window panels, mark the legs, top and bottom crossbars, window frames, and window crossbars every 8". Align the window frame between the legs, 8" in from each side with the 8" marks aligned. The bottom of the window should be 32" from the bottom crossbar.

5. Cut diagonals to fit between the marks on the window frame and legs.

6. Cut diagonals to fit between the marks on the crossbars and the window frames and window crossbars.

7. Weld the descending left to right diagonals in place, then weld the ascending left to right diagonals in place.

Weld the roof sleeves to the tops of the side panels.

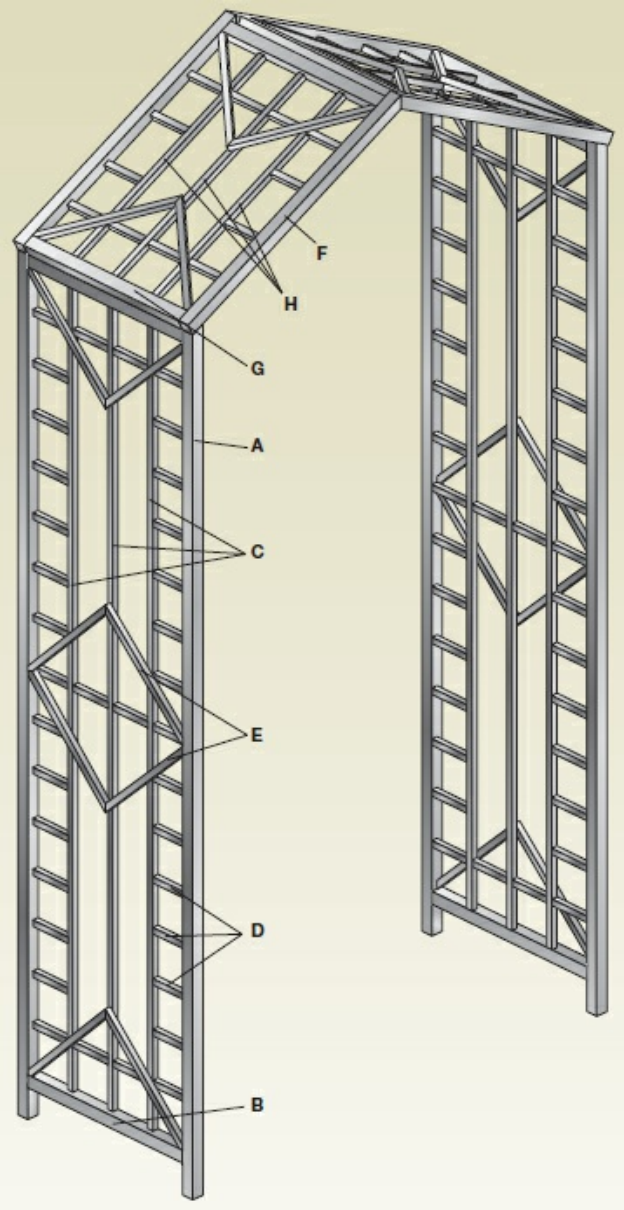
Finish the Gazebo

1. Wire brush or sand blast the gazebo. Finish as desired. *Note: Take care to track the panel numbers so you can reassemble the gazebo.*

2. Reassemble the gazebo.

3. For at least three corners of the gazebo, pound 3-ft. lengths of ¾" round bar or 18" rebar into the ground and slide the leg ends over the bars.

Cut a $^{3}/_{16}$" notch in a 2" pipe to create the bending jig for the scrolls. Slide the rod into the notch, then bend the rod around the pipe.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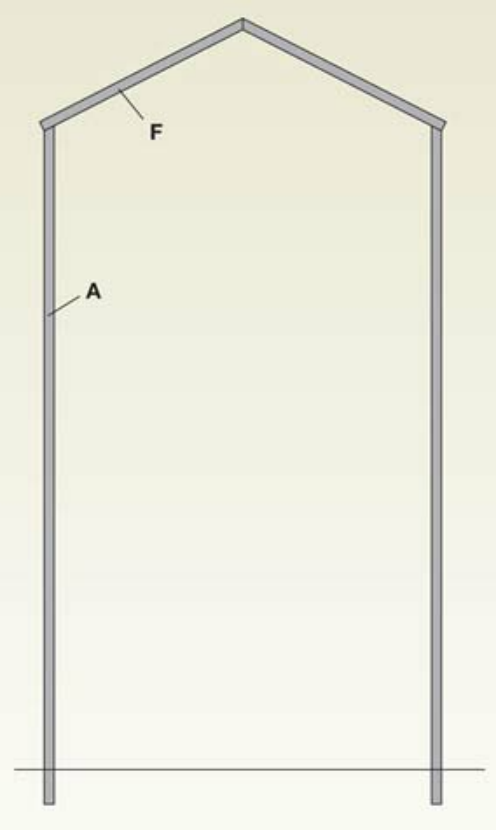


Overall dimensions

44 × 16½ × 84"

Arbor

This distinctive arbor will add a touch of class to any garden. Modeled after the prairie style, its clean lines are straightforward to cut and weld, and they provide plenty of climbing support for a variety of vines. The ½" inserts are placed flush with the back of the 1" sides and ends, eliminating the need for difficult centering and giving an increased sense of depth. The arbor can be made from the 6-foot steel lengths available at home improvement centers, but because of the amount of steel used, a trip to a steel supplier might be worthwhile, especially if you have a way to transport 20-foot lengths. The ½" square tube bows quite easily, so if you do buy 20 foot lengths, make sure they are well supported in transit. Otherwise, they will bow and not be suitable for the vertical inserts.

Materials

- 16 gauge 1 × 1"

square tube (44 feet)

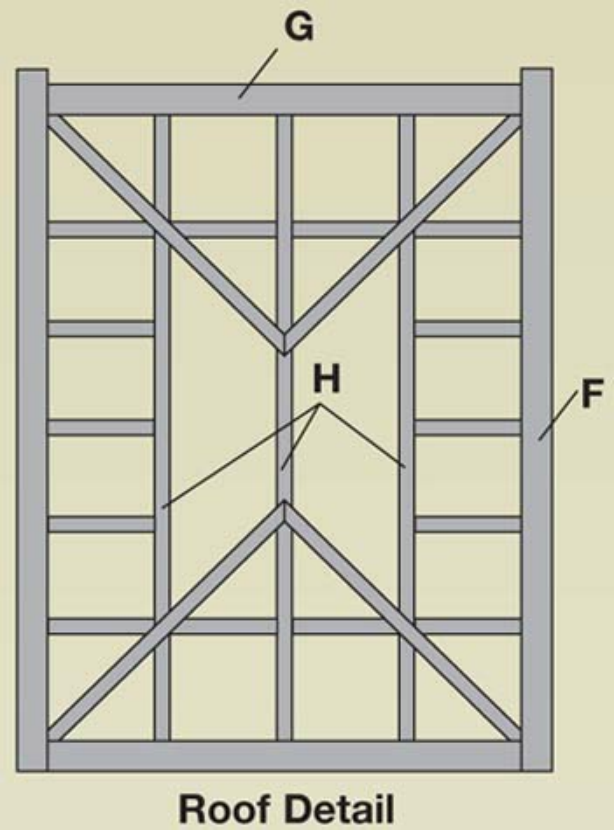
- 16 gauge ½ × ½"

square tube (100 feet)

- Wood scraps

PART	NAME	DIMENSIONS	QUANTITY
A	Panel sides	16-gauge 1 × 1" square tube × 72"	4
B	Panel ends	16-gauge 1 × 1" square tube × 15½"	4
C	Panel vertical inserts	16-gauge ½ × ½" square tube × 63½"	6
D	Horizontal inserts	16-gauge ½ × ½" square tube × 3½"	100
E	Diagonal inserts	16-gauge ½ × ½" square tube × 12"*	24
F	Roof ends	16-gauge 1 × 1" square tube × 15½"	4
G	Roof sides	16-gauge 1 × 1" square tube × 25½"	4
H	Roof vertical inserts	16-gauge ½ × ½" square tube × 23½"	6

*Approximate dimension, cut to fit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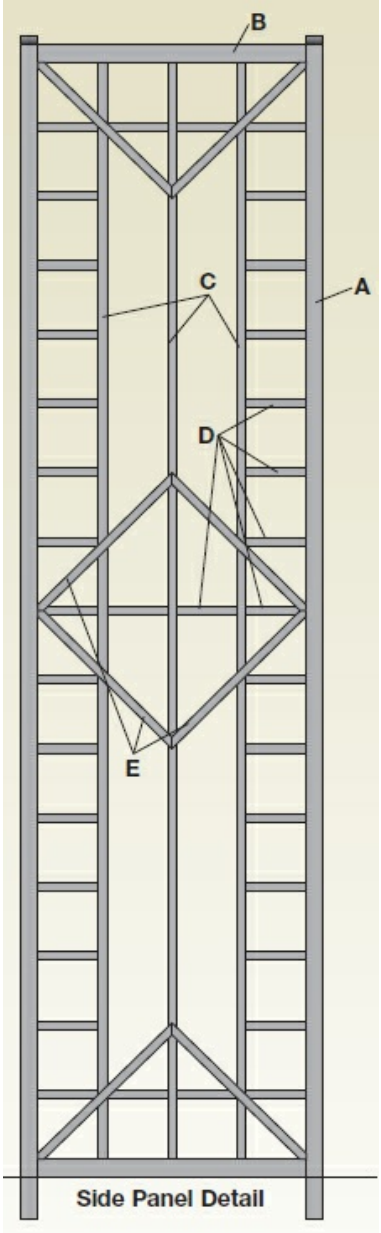
Roof Detail



Side Panel Detail

Check the panel for square by measuring the diagonals. If the measurements are equal, the assembly is square.

How to Build an Arbor

Assemble the Panels

Set up the project on a sheet of ¾" plywood placed on sawhorses. Make sure the plywood is not bowed or it will cause misalignment of the project pieces. Working on a raised surface is easier than working on the floor, and you can clamp the metal to the plywood. Remember to clamp your work cable to the workpiece. If you want the arbor wider or narrower than 44", you must adjust the miter angles for the roof and side panels.

1. Cut the panel sides (A) to size, mitering one end at 30°. The mitered end is the top. Cut the panel ends (B), vertical inserts (C), and horizontal inserts (D) to size.

2. Place a panel end between the top of two panel sides, keeping the outside edge of the panel end flush with the short ends of the mitered panel sides. Clamp the pieces in place.

3. Position three vertical inserts between the two panel sides. (This is just to hold the bottom panel end in place. The exact location of the inserts is not important at this time.)

4. Place the bottom panel end between the panel sides, keeping it snug against the vertical inserts. Clamp the bottom panel end in place.

5. Remove the vertical inserts. Use a carpenter’s square to check the panel sides and ends for square. Tack weld each corner. Check for square again by measuring the two diagonals. If the measurements are equal, the panel is square. If not, adjust the workpieces until the diagonals are the same.

6. Turn the panel over and complete the welds at the four corners. Grind the tack welds flat so the panel lays flat on the work surface.

Weld the diagonal inserts to the panel framework and to the center vertical insert.

Attach the Vertical & Horizontal Inserts

1. Replace the vertical inserts between the panel sides. Place several horizontal inserts between the vertical inserts and the panel sides to ensure the correct spacing of the vertical inserts.

2. Weld the vertical inserts to the panel top and bottom.

3. Place the horizontal inserts into the vertical framework every 3½". (Use horizontal inserts as spacers.)

4. Starting at the top of the panel, use a combination square to align the first row of horizontal inserts. Once they are aligned, weld them in place.

5. Continue aligning and welding the inserts one row at a time. If the vertical inserts are bowed side to side, use a clamp to hold them against the inserts. If they bow upward, weigh them down with a sandbag or other weight.

Insert the Diagonal Inserts

1. Cut four diagonal inserts (E) to size, mitering one end at 45°.

2. Place two diagonal inserts against the bottom edge of the top panel. The mitered ends of the inserts should butt together over the middle vertical insert. Mark the other end of the diagonal inserts where they cross the top panel so they will fit in the corner.

3. Make the angled cuts on the diagonal inserts.

4. Grind down the welds that will be underneath the diagonal inserts so they will lie flat. Weld the diagonal inserts in place.

5. Repeat steps 2 to 4 to weld the diagonal inserts to the bottom of the panel.

6. Cut four more diagonal inserts, mitering both ends at 45°.

7. Center these four inserts over the eighth row of horizontal inserts to form a diamond shape. Weld the inserts in place.

8. Repeat this entire process to construct a second panel.

Make clamping blocks out of wood scraps. Clamp the roof panels to the blocks. Place two or three tack welds along the joint between the panel ends.

Build the Roof Panels

1. Construct two roof panels following the same procedure used for the side panels, except with no central diamond insert.

2. Stand the roof panels on edge and join the mitered ends to form the 120° angle for the roof peak.

3. Clamp the roof panels in place. (You may need to attach temporary wooden clamping points to the work surface by fastening 1 × 2 or 2 × 4 scraps to match the layout. Clamp the panels to the scraps.) Place two or three tack welds along the joint between the panel ends.

Fasten the Roof to the Sides

1. Place a side panel on edge, and set it against one side of the roof panel. Line them up so the mitered edge of the side panel is making contact with the bottom edge of the roof panel. Clamp the panels in place.

2. Tack weld the panels at two points along the joint.

3. Repeat steps 1 and 2 for the other side panel.

4. Measure the distance between the tops and the bottoms of the side panels to ensure the panels are an equal distance apart at both ends.

5. Check the panels for square by measuring the diagonals. Make any necessary adjustments, and make sure the roof assembly is still fitted against the side panels.

6. Weld all the mitered roof peak joints and the mitered joints between the side panels and the roof panels.

Place tack welds along the joint between the roof and side panels.

Finishing Touches

To prevent putting stress on the welds, and to maintain the arbor's shape, clamp wooden crosspieces between the panel sides before moving it.

1. The easiest finish for the arbor is to allow it to gently rust over the years. You may want to place plastic end caps over the exposed tube ends on the roof, or you can weld on small caps.

2. The arbor can sit on the ground or can be mounted in concrete footings. If you live in a windy location, you may want to drive four lengths of rebar into the ground and slip the arbor legs over them.

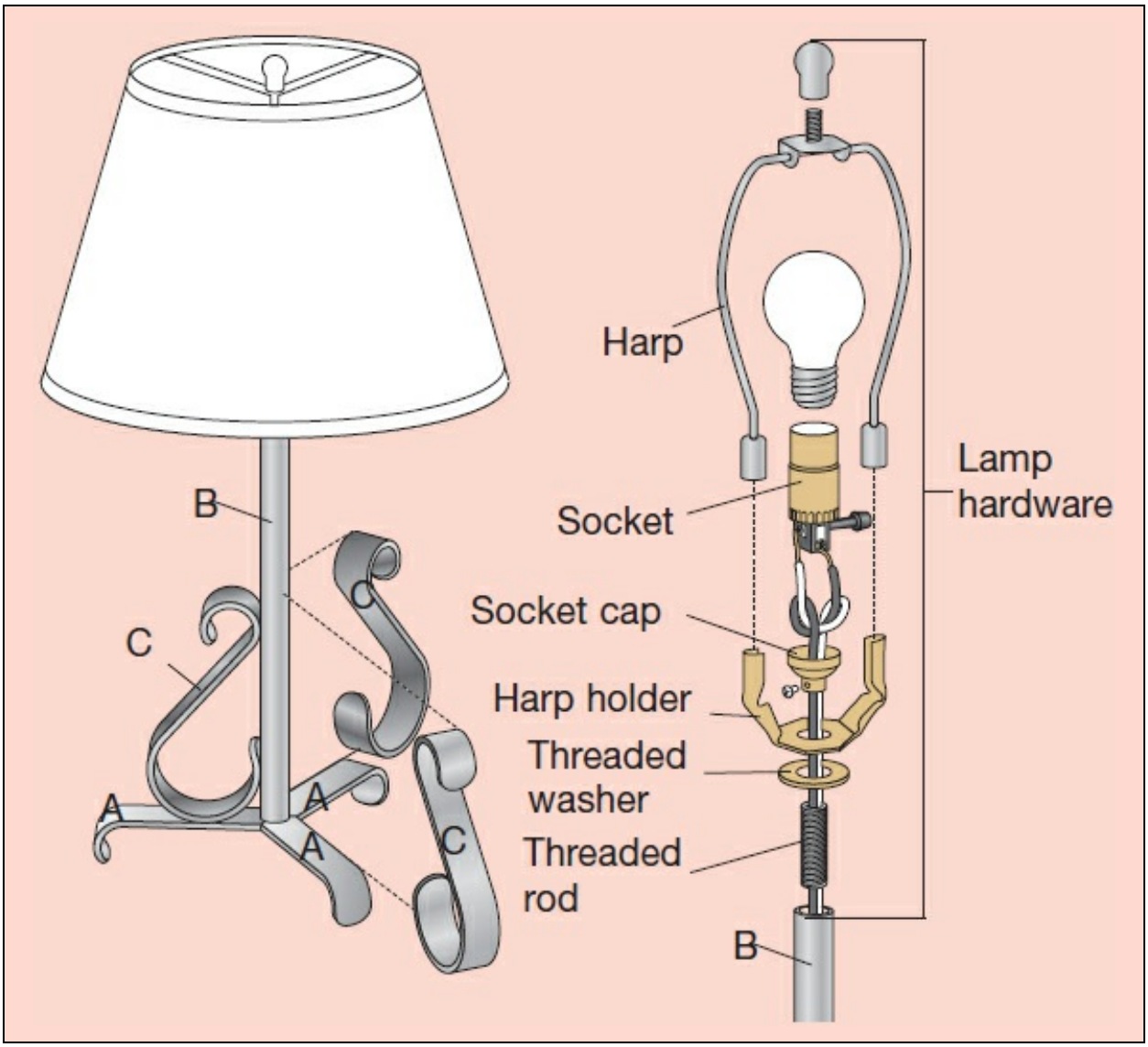
Appendix: Additional Plans

Scroll Desk Lamp

Materials

- 1/8 × ¾" flat bar (15")
- ½" round tube (9")
- 1/8 × ½" flat bar (36")
- ½", 1", and 2" pipe
- Lamp hardware and shade
- 3/8" hollow threaded rod (1")

PART	NAME	DIMENSIONS	QUANTITY
A	Bases	⅛ × ¾" flat bar × 5"	3
B	Shaft	½" round tube × 9"	1
C	Scrolls	⅛ × ½" flat bar × 12"	3

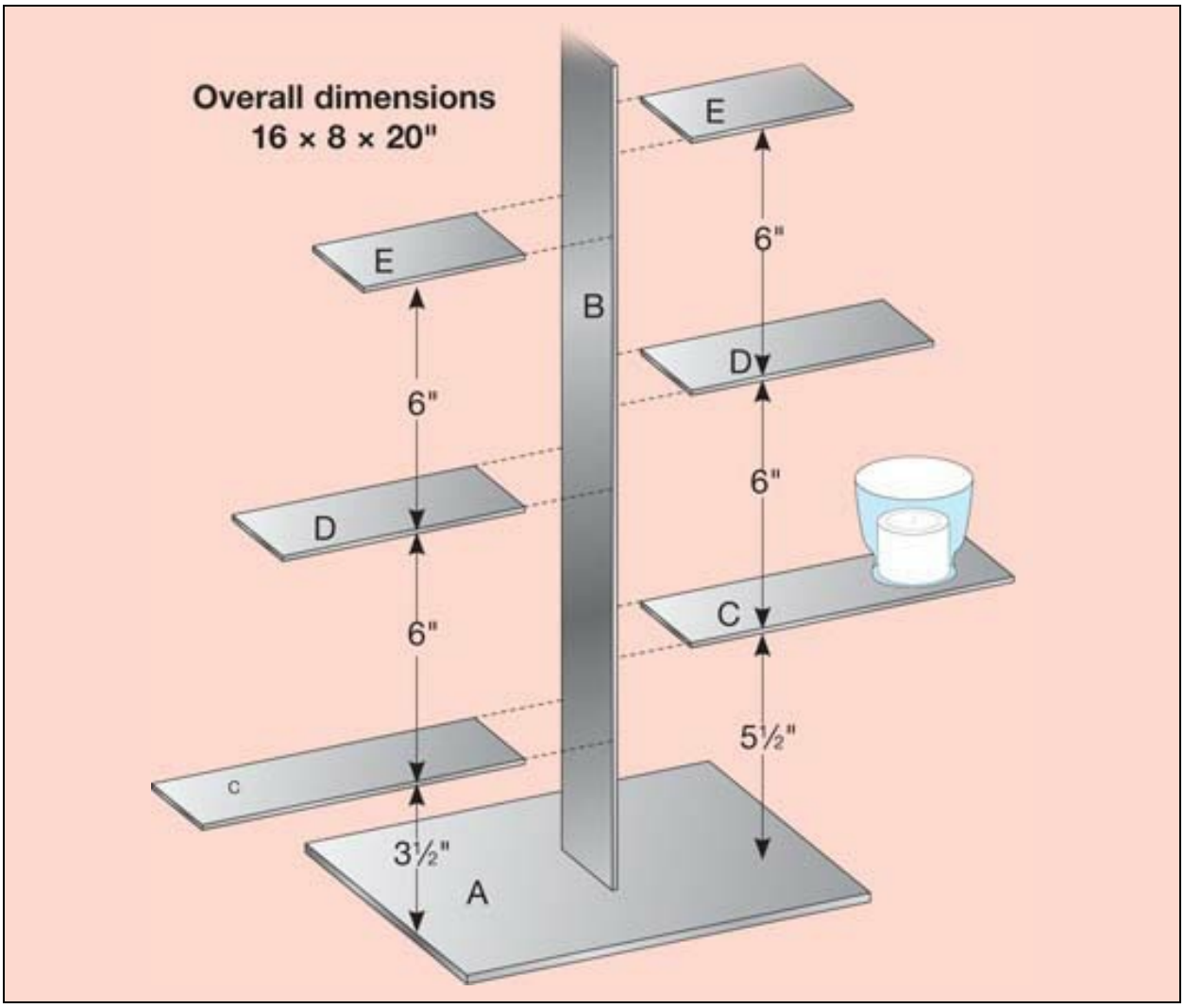

B
C
C
A
A
A
C
Harp
Socket
Socket cap
Harp holder
Threaded washer
Threaded rod
Lamp hardware
B

Tree-shaped Candleholder

Materials

- $^{3}/_{16}$" sheet (8 × 10")
- $^{3}/_{16}$" × 2" flat bar (5 feet)
- Votive holders and candles
- Silicone adhesive

PART	NAME	DIMENSIONS	QUANTITY
A	Base	3⁄16" sheet × 8 × 10"	1
B	Trunk	3⁄16 × 2" flat bar × 20"	1
C	Bottom branches	3⁄16 × 2" flat bar × 8"	2
D	Middle branches	3⁄16 × 2" flat bar × 6"	2
E	Top branches	3⁄16 × 2" flat bar × 4"	2


Overall dimensions
16 × 8 × 20"
E
E
B
6"
D
6"
D
6"
C
6"
C
5½"
3½"
A

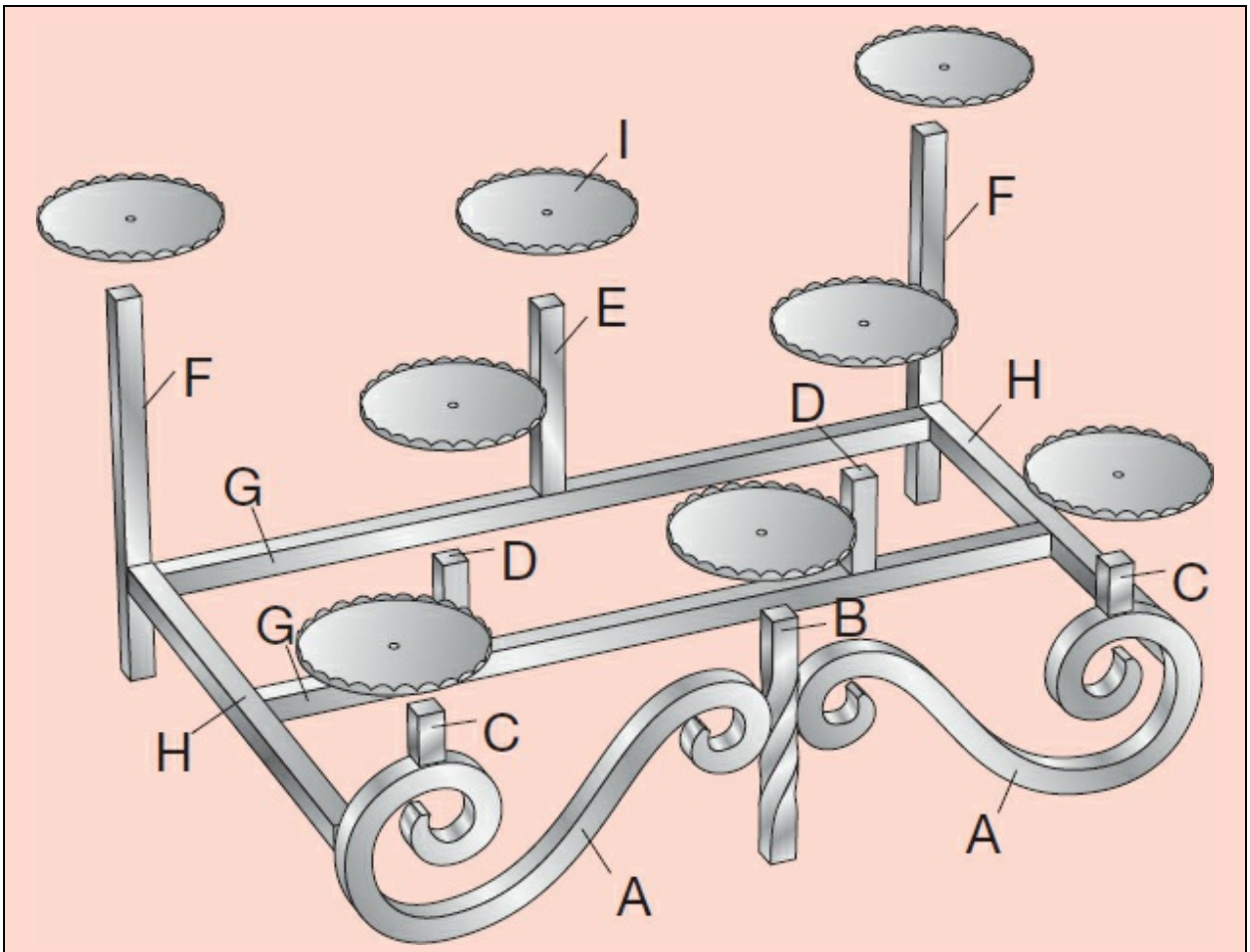
Fireplace Candleholder

Materials

- 4 × 8" scrolls (2)
- ½" twisted square rod (5")
- ½" square rod (7 feet)
- 3⅜" bobeches (8)
- Candles (8)

PART	NAME	DIMENSIONS	QUANTITY
A	Scrolls	4 × 8"	2
B	Center post	½" twisted square rod × 5"	1
C	Front extenders	½" square rod × 1"	2
D	Middle extenders	½" square rod × 2"	2
E	Rear extender	½" square rod × 3"	1
F	Rear posts	½" square rod × 6"	2
G	Crosspieces	½" square rod × 16"*	2
H	Side pieces	½" square rod × 10"	2
I	Bobeches	3⅜"	8

*Approximate dimensions, cut to fit.



Overall dimensions

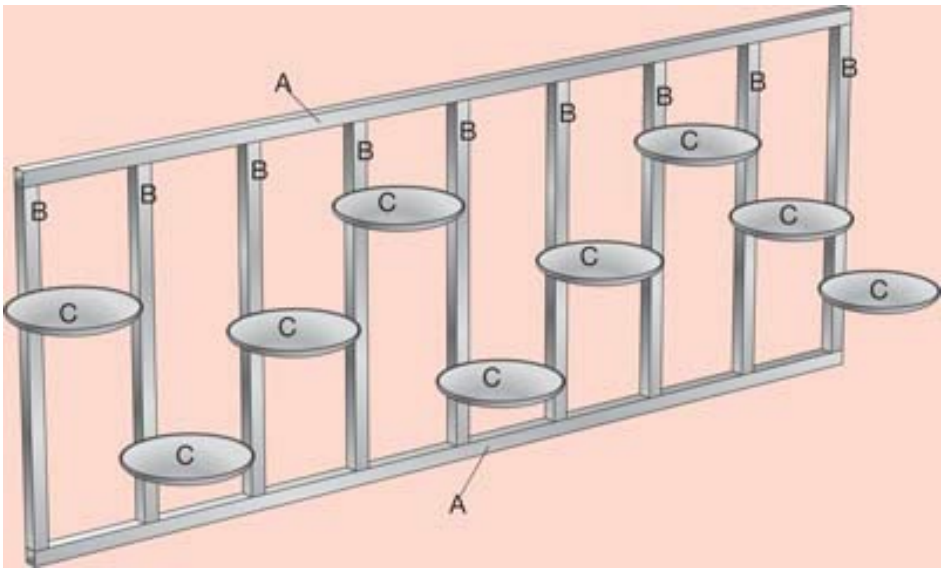
16 × 11 × 6"

Wall-mounted Candleholder

Materials

- ½" square bar (14 feet)
- 2¼" bobeche (9)
- Candles (9)

PART	NAME	DIMENSIONS	QUANTITY
A	Horizontal bars	½" square bar × 32"	2
B	Vertical bars	½" square bar × 11½"	9
C	Bobeches	2¼"	9



Overall dimensions

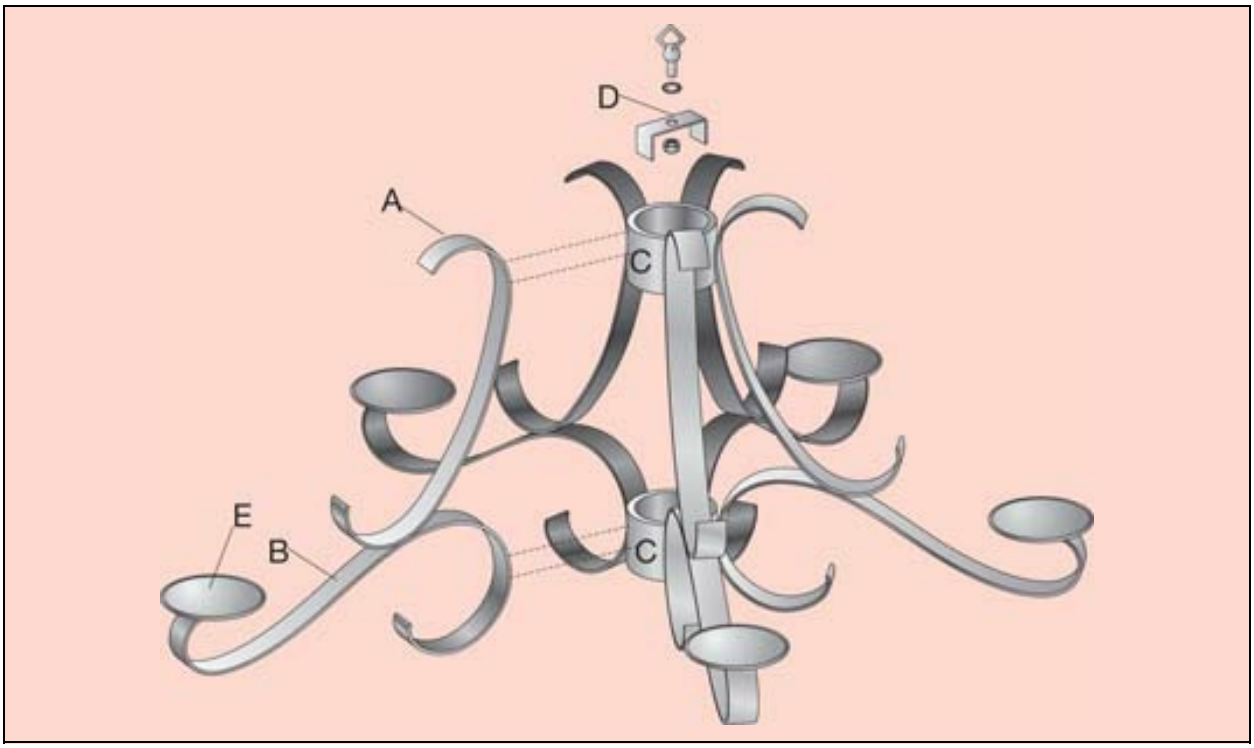
32 × 3 × 12½"

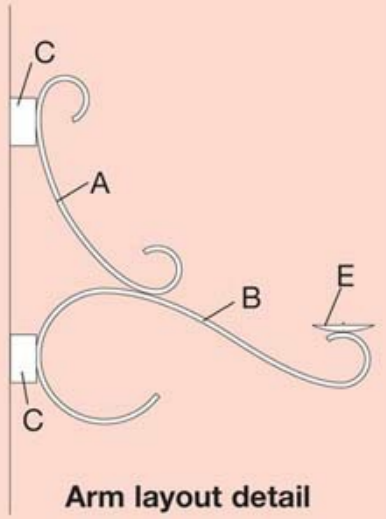
Chandelier

Materials

- 1/8 × ¾" flat bar (17 feet)
- 10", 6", 2", and 1" bending forms
- 2¼" round tube (4")
- 2½" bobeches (5)
- 2" threaded nipple
- Lock washers (2)
- Threaded brass washers (3)
- Finial
- Decorative chain
- Candles (5)

PART	NAME	DIMENSIONS	QUANTITY
A	C scrolls	⅛ × ¾" flat bar × 16"	5
B	S scrolls	⅛ × ¾" flat bar × 24"	5
C	Couplers	2¼" round tube × 2"	2
D	Insert	⅛ × ¾" flat bar × 4"	1
E	Bobeches	2½"	5


D
A
C
E
B
C



Arm layout detail

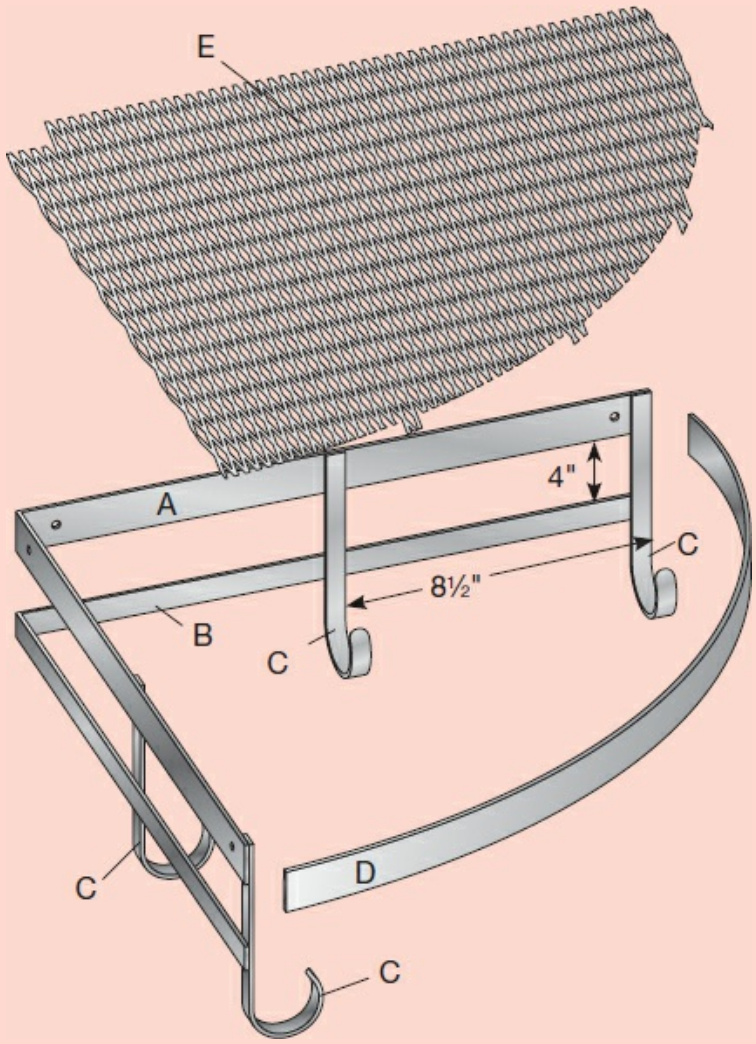
Corner Coat Rack

Materials

- 1/8 × 1¼" flat bar (7 feet)
- 1/8 × ¾" flat bar (7 feet)
- Expanded sheet metal (2 × 2 feet)
- 2" pipe
- Hanging hardware

PART	NAME	DIMENSIONS	QUANTITY
A	Rack top	⅛ × 1¼" flat bar × 36"	1
B	Rack bottom	⅛ × ¾" flat bar × 36"	1
C	Hooks	⅛ × ¾" flat bar × 12"	4
D	Rack front	⅛ × 1¼" flat bar × 38"*	1
E	Shelf	Expanded sheet metal	1

*Approximate dimension, cut to fit.



Overall dimensions

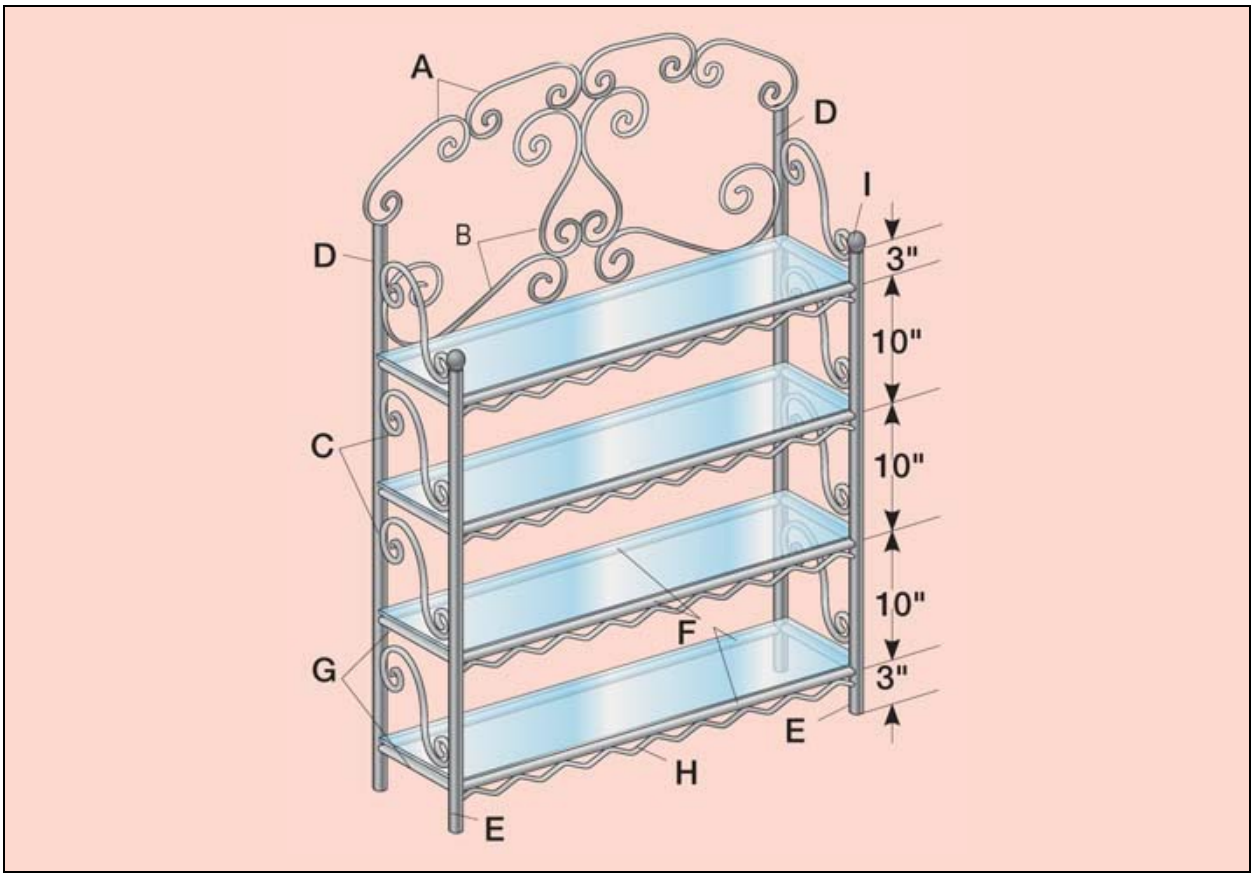
18 × 18 × 8"

Baker's Shelves

Materials

- ¼" round bar (54 feet)
- 16 gauge × ¾" round tube (13½ feet)
- 16 gauge × ½" round tube (29 feet)
- 4 × 6 foot plywood
- 2 × 4 foot plywood
- 1 × 2 lumber × 36" (7)
- Drywall screws
- 2 × 2 lumber × 36"
- Pre-drilled ¾" on center flat bar (3 feet)
- $^{5}/_{16}$ × 2½" machine bolts (24)
- ¾" rubber pipe tips or glides (4)
- Brass or wood finials (2)
- Tempered glass shelves cut to fit (4)

PART	NAME	DIMENSIONS	QUANTITY
A	C scrolls	¼" round bar × 26½"	4
B	Top S scrolls	¼" round bar × 35"	4
C	Side S scrolls	¼" round bar × 24½"	8
D	Back legs	¾" round tube × 44"	2
E	Front legs	¾" round tube × 36"	2
F	Shelf supports, front & back	½" round tube × 34½"	8
G	Shelf supports, sides	½" round tube × 8½"	8
H	Zig zag trim	¼" round bar × 48"	4
I	Finials	1" brass or wood ball	2


A
D
I
B
D
3"
10"
C
10"
10"
F
G
3"
E
H
E

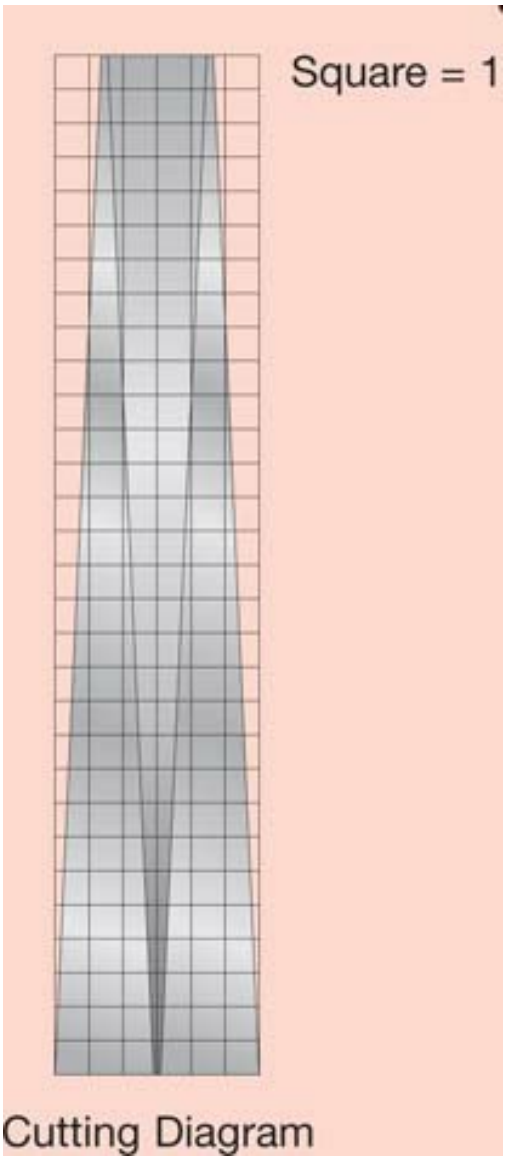
Tapered-Leg Table

Materials

- 1/8" sheet metal (6 × 30" rectangle, 12" square)
- 1/8 × 2" flat bar (2½ feet)
- ½" black pipe (6")

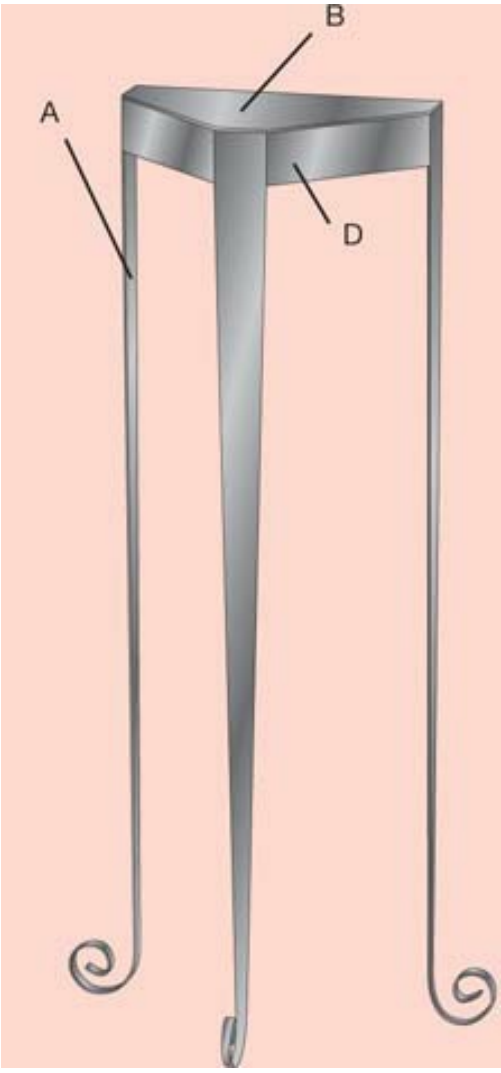
PART	NAME	DIMENSIONS	QUANTITY
A	Legs	⅛" sheet metal × 3" × 30"	3
B	Top	⅛" sheet metal × 12 × 12" right triangle	1
C	Front skirt	⅛" × 2" flat bar × 12"*	1
D	Side skirts	⅛" × 2" flat bar × 7"*	2

* Approximate dimensions, cut to fit.



Cutting Diagram

Square = 1"

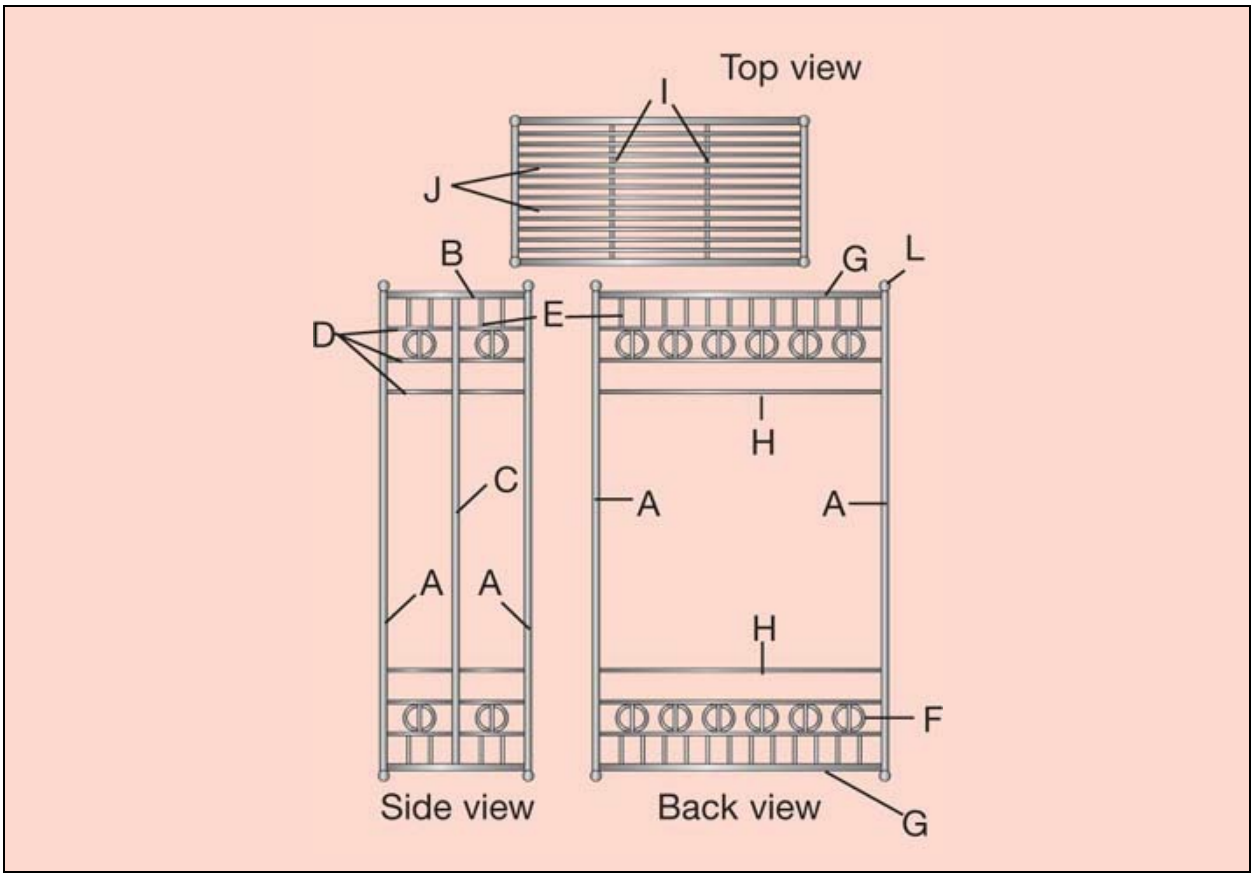

B
A
D

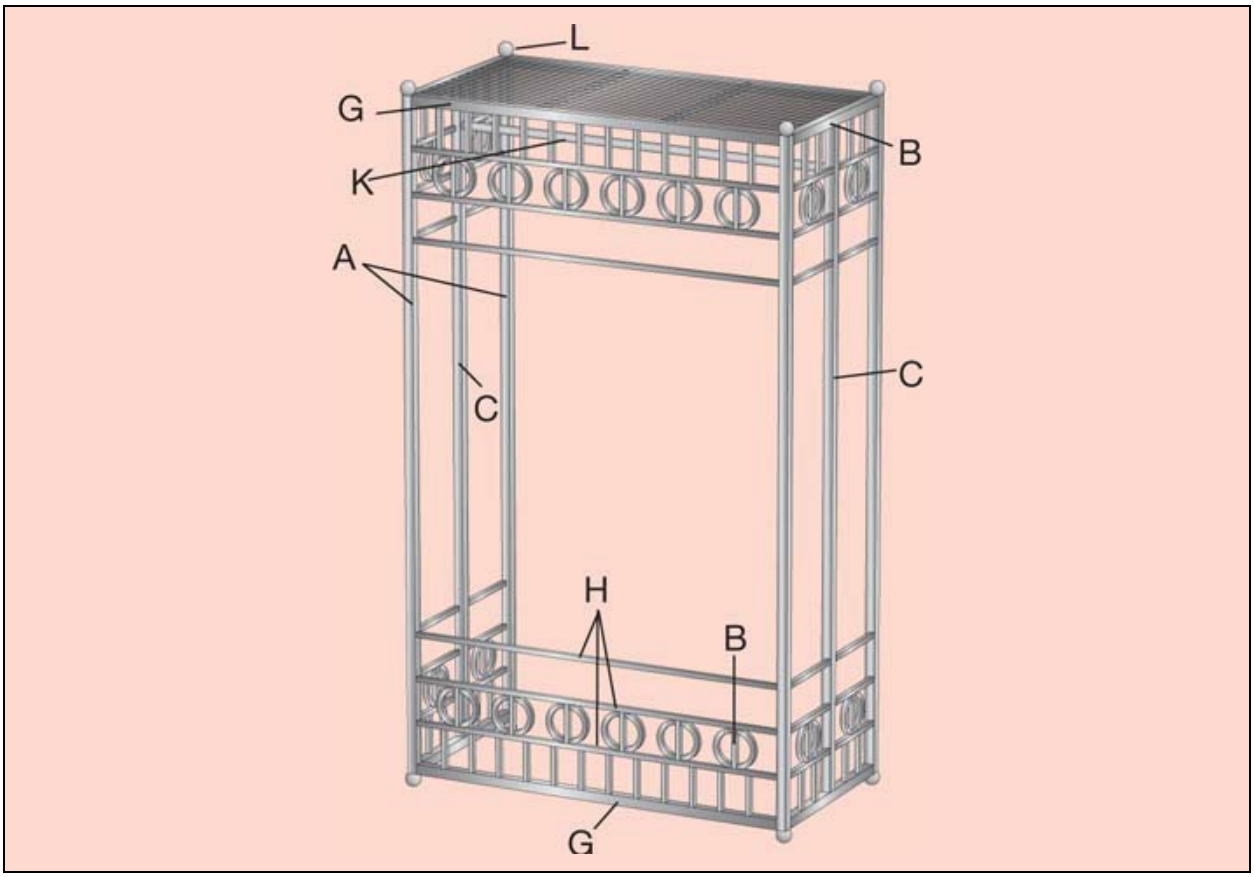
Coat Rack

Materials

- 16-gauge ½ × ½" square tube (58 feet)
- 16-gauge 1 × 1" square tube (50 feet)
- 4" O.D. square tube rings (20, Triple S Steel #SR 4)
- 1/8 × 1" round tube (39")
- 1/8 × ½" flat bar (39 feet)
- 1½" spheres (8, Triple S Steel SF116F4)

PART	NAME	DIMENSIONS	QUANTITY
A	Legs	16-gauge 1 × 1" square tube × 68"	4
B	Side crossbars	16-gauge 1 × 1" square tube × 19"	4
C	Center supports	16-gauge 1 × 1" square tube × 66"	2
D	Side horizontals	16-gauge ½ × ½" square tube × 9"	24
E	Verticals	16-gauge ½ × ½" square tube × 4"	60
F	Circles	4" O.D. square tube rings	20
G	Crossbars	16-gauge 1 × 1" square tube × 39"	3
H	Back horizontals	16-gauge ½ × ½" square tube × 39"	6
I	Shelf supports	16-gauge ½ × ½" square tube × 19"	2
J	Shelf rods	⅛ × ½" flat bar × 39"	12
K	Hanging rod	⅛ × 1" round tube × 39"	1
L	Spheres	1½"	8


Top view
I
J
B
G
L
E
D
H
C
A
A
A
A
H
F
Side view
Back view
G


L
G
K
B
A
C
C
H
B
G

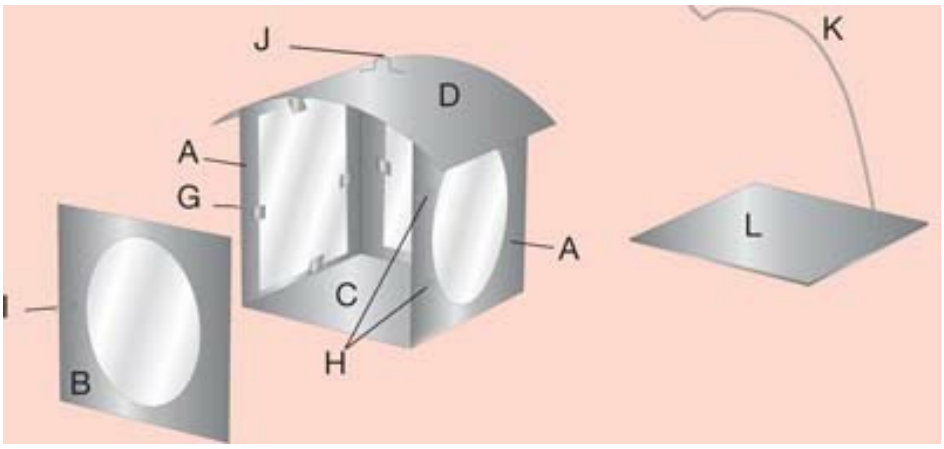
Votive Lantern with Chain and Holder

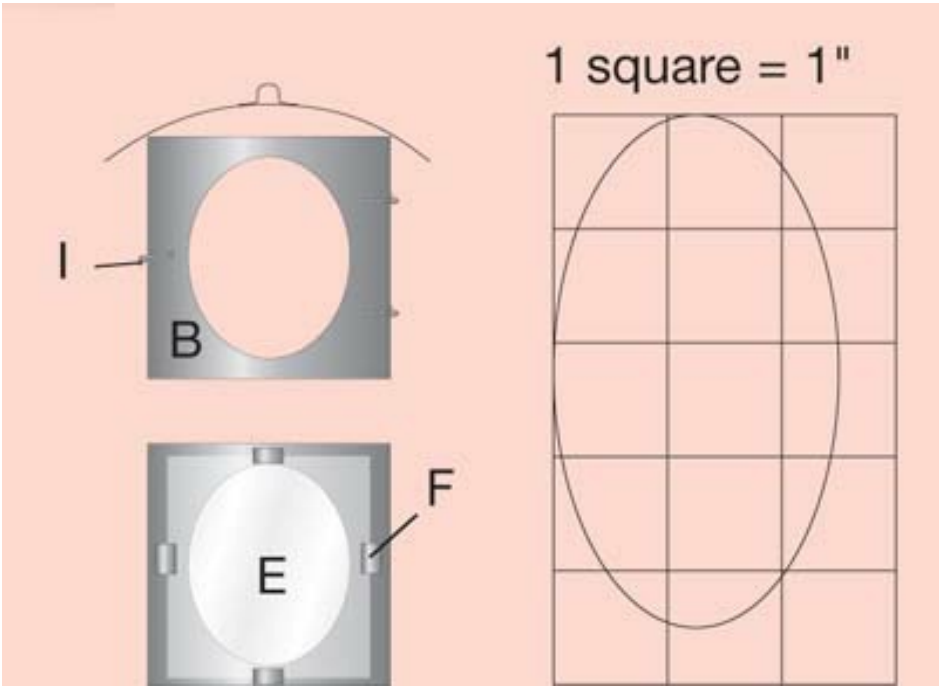
Materials

- 22-gauge sheet metal (3, 6 × 18" sheets)
- Glass (7 × 11")
- 1/8" round rod (4 feet)
- ¼" round rod (26")
- 3/16" sheet metal (10 × 10")
- Hardwood stick
- 1¼" wire nails (7)

PART	NAME	DIMENSIONS	QUANTITY
A	Sides	22-gauge sheet metal × 6 × 18"	1
B	Door	22-gauge sheet metal × 6 × 6"	1
C	Base	22-gauge sheet metal × 6 × 6"	1
D	Top	22-gauge sheet metal × 9 × 6"	1
E	Glass	3½ × 5½"	4
F	Tabs	22-gauge sheet metal × ¾"*	12
G	Eyelets	1¼" wire nails	3
H	Hinges	1¼" wire nails	3
I	Hook	1¼" wire nail	1
J	Hanger	⅛" round rod × 2"	1
K	Arm	¼" round rod × 26"	1
L	Stand base	3/16" sheet metal × 10 × 10"	1
M	Chain	⅛" round rod × 36"	

*Cut to fit.


J
K
D
A
G
A
L
C
H
B


1 square = 1"
I
B
F
E

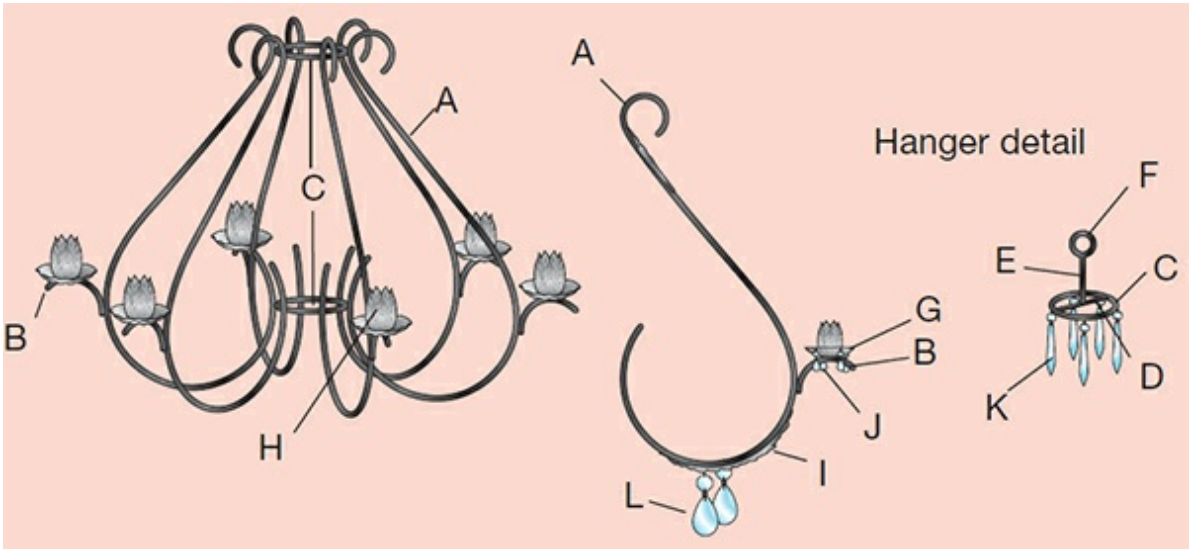
Hanging Chandelier

Materials

- 3/16" round rod (24 feet)
- 2 3/8" bobeches (6, Architectural Iron Designs #79/6)
- Candle cups (6, Architectural Iron Designs #78/4)
- 8½" acanthuses (6, Architectural Iron Designs #11942 8½)
- 1" teardrop crystals (24, Chandelierparts)
- 3" hangdrop crystal prisms (5, Chandelierparts)
- 3" teardrop prisms (12, Chandelierparts)

PART	NAME	DIMENSIONS	QUANTITY
A	Scrolls	3/16" round rod × 36"	6
B	Candle arms	3/16" round rod × 3"*	6
C	Rings	3/16" round rod × 9½"*	2
D	Crossbar	3/16" round rod × 3"	1
E	Hanger	3/16" round rod × 6"	1
F	Hanging ring	3/16" round rod × 4"*	1
G	Bobeches (drip trays)	2 3/8"	6
H	Candle cups	1¼ × 1¼"	6
I	Acanthus leaves	1¼ × 8½"	6
J	Teardrop crystals	1"	24
K	Hangdrop crystal prisms	3"	5
L	Teardrop prisms	3"	12

* Approximate dimensions, cut to fit.

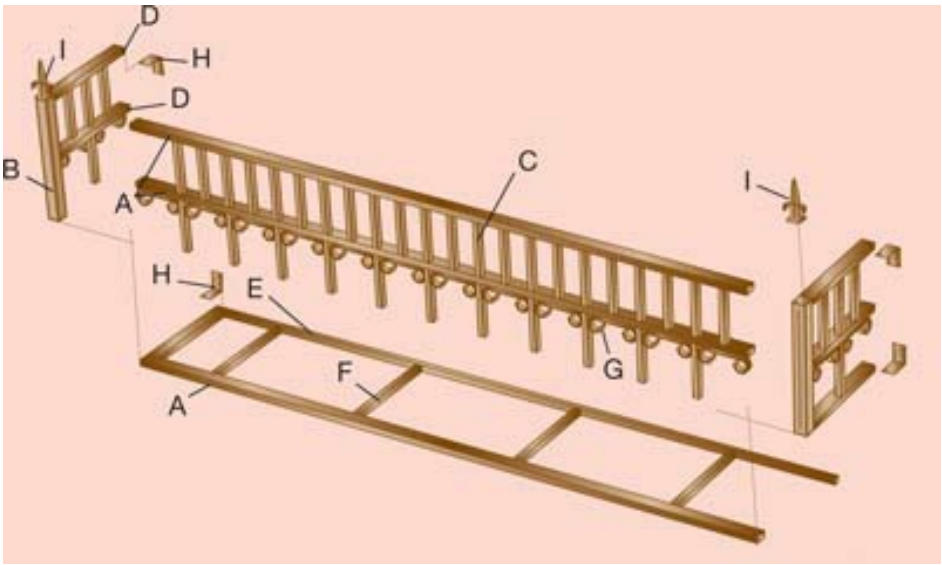

A
C
B
H
A
G
B
J
I
L
Hanger detail
F
E
C
D
K

Window Box

Materials

- 1 × ½ × 1/8" channel (18 feet)
- 1" square tube (20")
- ½" square tube (16 feet)
- ½" square bar (8 feet)
- 1/8 × ½" flat bar (14½ feet)
- 1/8 × 1" flat bar (8")
- Finials (2, Architectural Iron #8¾)

PART	NAME	DIMENSIONS	QUANTITY
A	Front crossbars	1 × ½ × ⅛" channel × 52½"	3
B	End posts	16-gauge 1" square tube × 10"	2
C	Uprights	16-gauge ½" square tube × 4¼"	42
D	Side crossbars	1 × ½ x ⅛" channel × 8⅞"	6
E	Base	½" square bar × 54½"	1
F	Base crossbars	½" square bar × 9¾"	4
G	C-scrolls	⅛ × ½" flat bar × 10½"	16
H	Mounting brackets	⅛ × 1" flat bar × 2"	4
I	Finials		2


D
I
H
D
B
A
C
I
H
E
F
G
A

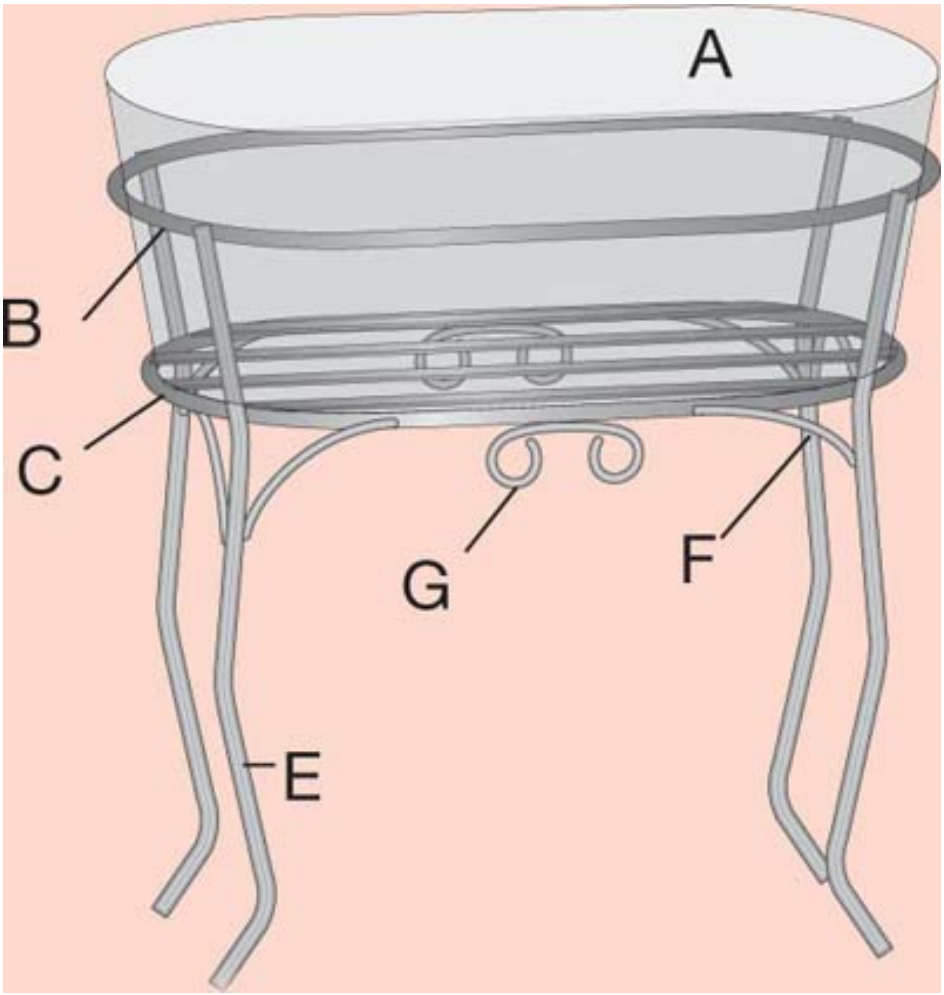
Laundry-Tub Planter

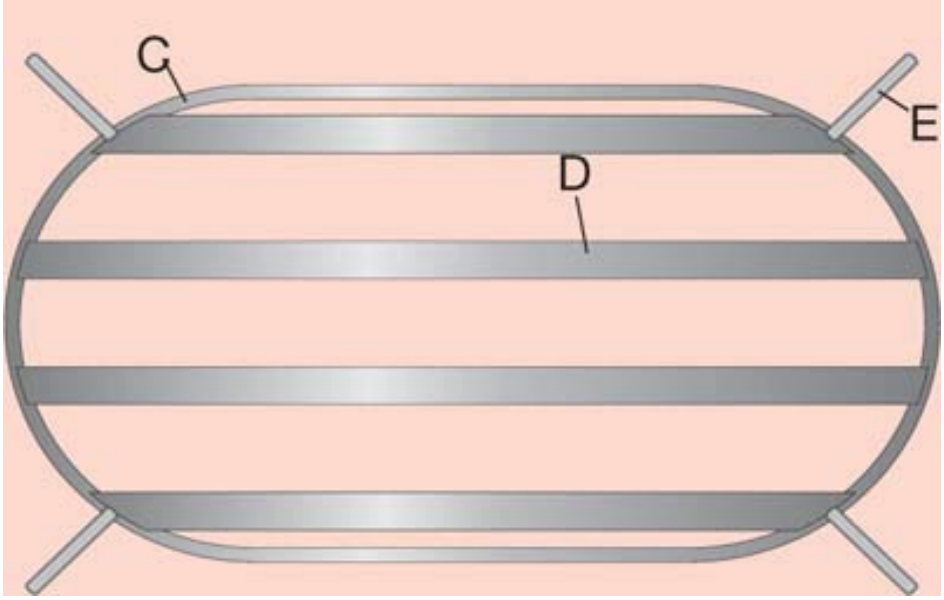
Materials

- 3/8" round bar (30 feet)
- 1/8 × 1" flat bar (9 feet)
- 10.5 gal. laundry tub (1, Main St. Supply)
- ½" plywood (4 × 4 sheet)
- 2 × 4 scraps
- Wood screws
- 3/16" round bar (10 feet)

PART	NAME	DIMENSIONS	QUANTITY
A	Tub	10½ gallon	1
B	Tub support	⅜" round bar × 60"*	1
C	Base	⅜" round bar × 56"*	1
D	Crossbars	⅛ × 1" flat bar × 27"*	4
E	Legs	⅜" round bar × 25"	4
F	Leg braces	3/16" round bar × 10"	8
G	C-scroll	3/16" round bar × 15"	2

* Approximate dimensions, cut to fit.


A
B
C
G
F
E

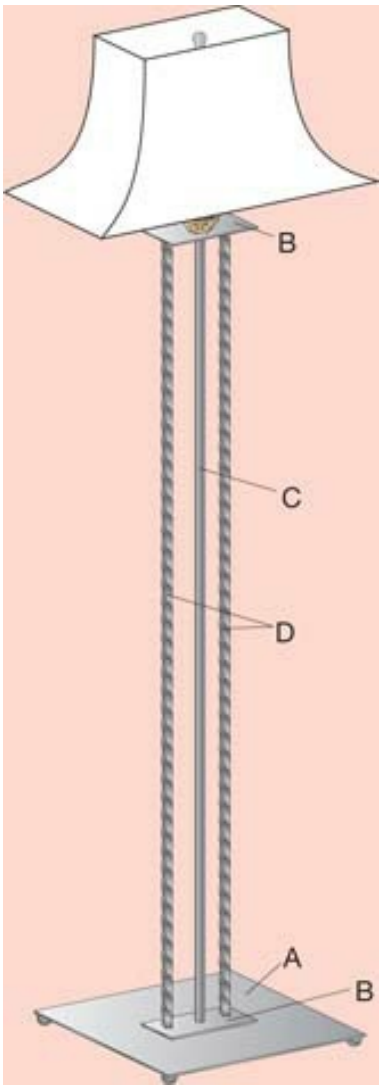

C
E
D

Three Post Floor Lamp

Materials

- ½" round tube (48 3/8")
- ½" twisted square rod (96")
- 3/16" sheet (10 × 10")
- 3/16 × 2" flat bar (8")
- 1" round balls (4)
- Lamp hardware and shade

PART	NAME	DIMENSIONS	QUANTITY
A	Base	3/16" sheet 10 × 10"	1
B	End caps	3/16" flat bar 2 × 4"	2
C	Center post	½" round tube 48 3/8"	1
D	Side posts	½" twisted rod 48"	2


B
C
D
A
B

Glossary

Active gas A gas, such as oxygen, that will react with other substances.

Alloy A substance composed of two or more metals or a metal and other non-metal material.

Arc welding Welding processes that use an electric arc to produce heat to melt and fuse the base metals. Often used to refer specifically to shielded metal arc welding.

Backfire and flashback Combustion taking place inside the oxyacetylene torch creating a loud pop or explosion.

Base metal The metal that is being welded, brazed, braze welded, or cut.

Bead or weld bead The seam between workpieces that have been joined with welding.

Braze A process used to join metals using a non-ferrous material that melts above 850° F but below the melting point of the base metal. Brazing uses capillary action to join closely fitted parts.

Braze welding A process used to join metals with a filler material that melts above 840° F and below the melting point of the base metal where the filler metal is not distributed by capillary action.

Butt joint A joint between two workpieces in the same plane.

Carburizing flame An oxyfuel flame with an excess of fuel.

Consumable electrode An electrode that also serves as the filler material.

Corner joint A joint between workpieces meeting at right angles and forming an L shape.

Cutting tip Converts an oxyfuel welding torch into an oxyfuel cutting torch.

Direct current Direct current welding where the electrode is negative and the

electrode negative workpiece is positive.

Direct current Direct current welding where the electrode is positive and the

electrode positive workpiece is negative.

Duty cycle The amount of continuous time in a 10-minute period that an arc welder can run before it needs to cool down. Expressed as a percentage at a given amperage output.

Edge joint A joint between parallel workpieces.

Electrode The conductive element that makes the connection with the workpiece to create an electrical arc.

FCAW Flux cored arc welding.

Filler, filler metal Metal added to a welded joint.

Fillet weld A triangular shaped weld between two members that meet at 90° angles.

Flame cutting See oxyfuel cutting.

Flux A chemical compound that produces cleaning action and reduces the formation of oxides when heated.

Flux core, flux cored wire	An electrode for flux cored arc welding that contains flux within a wire tube.
Flux cored arc welding (FCAW)	A semi-automatic arc welding process using an electrode wire that contains flux.
Gas metal arc welding (GMAW)	A semi-automatic arc welding process using a wire electrode, which also is the filler material. An inert gas is distributed over the weld area to shield the molten metal from oxygen. Commonly referred to as MIG (metal inert gas) or wire feed.
Gas tungsten arc welding (GTAW)	An arc welding process using a tungsten electrode, hand-held filler material, and an inert shielding gas. Also referred to as TIG (tungsten inert gas) and Heliarc.
GMAW	Gas metal arc welding.
Groove weld	A weld made in grooves between workpieces.
GTAW	Gas tungsten arc welding.
Heliarc	Gas tungsten arc welding.
Inert gas	A non-reactive or non-combining gas such as argon or helium.
Kerf	The width of a cut.
Lap joint	A joint between overlapping workpieces.
MIG	Metal inert gas—see gas metal arc welding.
Oxyacetylene cutting	Oxyfuel cutting using acetylene as the fuel gas.
Oxyacetylene welding	Oxyfuel welding using acetylene as the fuel gas.

Oxyfuel cutting	Cutting process using the combustion of a pressurized fuel gas and oxygen to heat steel to 1600° F at which time a pure oxygen stream is delivered to burn through the metal. Also called flame cutting.
Oxyfuel welding	Welding process that uses the heat produced by the combustion of a pressurized fuel gas and pressurized oxygen. A hand-held filler material is used. Also called gas welding.
Plasma cutting	An arc cutting process using a constricted arc. Compressed air or inert gas blows the molten metal from the kerf.
Plate	Flat metal thicker than $^{3}/_{16}$".
Saddle joint	A joint between round tubes where one tube has been cut to fit around the other.
Sheet metal	Flat metal $^{3}/_{16}$" or less in thickness.
Shielded metal arc welding (SMAW)	An arc welding process using a flux coated consumable electrode. Also referred to as arc welding or stick welding.
Shielding gas	A gas that prevents contaminants from entering the molten weld pool.
Slag	Oxidized impurities formed as a coating over the weld bead; waste material found along the bottom edge of an oxyfuel cut.
SMAW	Shielded metal arc welding.
Spatter	Small droplets or balls of metal stuck to the base metal around the weld. Produced by shielded metal arc, gas metal arc, and flux cored arc welding.
Stick welding	Shielded metal arc welding.

T-joint A joint between workpieces meeting at right angles and forming a T shape.

TIG Tungsten inert gas—see gas tungsten arc welding.

Wire feed See gas metal arc welding.

Resources

Architectural Iron Designs
950 South 2nd Street
Plainfield, NJ 07063
www.archirondesign.com

Century Trailer Inc.
800 366 3395
www.centurytrailer.com

Chandelierparts.com
218 763 7000

Decorative Iron
10600 Telephone Road
Houston, TX 77075
888 380 9278
www.decorativeiron.com

Eastwood Company
800 343 9353
www.eastwoodco.com

e-Tarps.com
1205-202 Winter Springs Court
Louisville, KY 40243
www.e-tarps.com

Garland's Inc.
2501 26th Avenue South
Minneapolis, MN 55406
800 809 7888
www.garlandsinc.com

Hooker Glass Mirror & Beveling Group
1127 East El Dorado Street
Decatur, IL 62521
800 274 0114
www.miror.com

The Lincoln Electric Company
22801 St. Clair Ave.
Cleveland, OH 44117
216 481 8100
www.lincolnelectric.com

M-Boss, Inc.
4400 willow Parkway
Cleveland, OH 44125
866 886 2677
www.mbossinc.com

Main Street Supply
PO Box 729
Monroe, NC 2811
800 624 8373
www.mainstsupply.com

Miller Electric Manufacturing Co.
1635 W. Spencer St.
P.O. Box 1079
Appleton, WI 54912-1079
920 734 9821
www.millerwelds.com

National Ornamental & Miscellaneous Metals Association (NOMMA)
1535 Pennsylvnia Ave.
McDonogh, GA 30253
888 516 8586
www.nomma.org

Northern Tool + Equipment
800 221 0516
www.northerntool.com

Norton Metals
1350 Lawson Road
Fort Worth, TX 76131
817 232 0404
www.nortonmetals.com

Red Trailers
Website helps you locate the perfect hitch, drawbar, and wiring to fit your vehicle.

215 538 1155
www.redtrailers.com

SIC Metals & Fabrication, LLC
Diamond plate, aluminum materials, stainless steel, and fabrication; also welding services and CAD design.
10883 Rt 322
Shippenville, PA 16254
814 227 5546 (fax 814 227 2536)
email sales@sicmetalfab.com
www.sicmetalfab.com

Silent Source
58 Nonotuck Street
Northampton, MA 01062
413 584 7944
www.silentsource.com

Smith & Hawken
PO Box 8690
Pueblo, CO 81008-99998
800 940 1170
www.smithandhawken.com

Toll Gas & Welding Supply
3005 Niagara Lane
Plymouth, MN 55447
763 551 5300
www.tollgas.com

Triple-S Steel Supply Co.
6000 Jensen Drive
Houston, TX 77026
713 697 7105
www.sss-steel.com

Wagner Railing Systems & Components/JG Braun Co.
10600 West Brown Deer Road
Milwaukee, WI 53224
800 786 2111
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www.jgbraun.com

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p. 30 (lower) Brake design courtesy of SIC

Safety

Read, understand, and follow safety precautions and rules when welding. In addition to general safety rules, also reference the material safety data sheet (MSDS) as provided by manufacturers as well as the American National Standard (ANSI Z49.1) as available at these websites for free download:

American Welding Society

www.aws.org

The Lincoln Electric Company

www.lincolnelectric.com/community/safety

Welding safety publications available as PDF download (see E205 document).

Index

A

Acetone for cleaning, 21
Acetylene basics, 41
Alcohol for cleaning, 21
Alternating current (AC), 59
Aluminum
    basics, 15
    cutting process for, 14
    repairing cast, 20
    welding processes for, 14
Amperage/amps, defined, 52
Angle/angle iron, uses & dimensions, 16
Angled metal shelves, building, 146–149
Antique finishes, 38, 39
Arbor, building, 206–210
Arc burns, preventing, 10
Arch and gate, building, 194–199
Arcs, striking, 74
Arc welding
    building
    rolling welding curtain for, 82–83
    welding table for, 84–87
    electricity terms & concepts for, 52–53
    See also specific types

B

Backfire, 45
Baker's shelves, plans for, 212
Base metal, defined, 6
Bird's nest, removing, 67
Blowpipes. See Torches
Brass welding & cutting processes, 14

Brazing/braze welding, 50–51, 184–185
Burns, preventing, 10

C

Candelabrum, building, 142–143
Candleholders
    building for fireplace, 142–143
    plans for
    fireplace, 212
    tree-shaped, 211
    wall-mounted, 212
Cast aluminum, repairing, 20
Cast iron
    characteristics of, 17
    cutting process for, 14
    repairing, 20
    steel and, 190
    welding processes for, 14
Chandeliers, plans for, 213, 216
Channels, uses & dimensions, 16
Check valve basics, 43
Chrome moly steel welding & cutting processes, 14
Cleaning metals, 21
Clothing, safe, 10, 11, 21
Coat hanger rack, building, 120–123
Coat hooks, building swing-away, 136–137
Coat racks
    building
    with swing-away hooks, 136–137
    wall-mounted, 120–123
    plans for
    corner, 213
    free-standing, 215
Coffee table, building, 110–111
Constant current (CC), described, 52
Constant voltage (CV), described, 52

Corner coat rack, plans for, 213
Cross, building, 128–131
Currents used, described, 53
Cutouts, making, 36
Cutting techniques
    mechanical, 24
    plasma, 27, 29, 30–31
Cylinder basics, 41
Cylinder cart, building, 90–93
Cylinders, gas, 61
Cylinder valve basics, 41

D

Decorative products, 18
Degreasers for cleaning, 21
Desk lamp, plans for, 211
Diamond plate metal, uses for, 17
Direct current (DC), described, 53
Direct current electrode negative (DCEN), described, 53
Direct current electrode positive (DCEP), described, 53
Duty cycle, described, 53

E

Electrical units, described, 52
Electricity, terms & concepts, 52–53
Electric shocks, preventing, 11
Electrodes
    direct current electrode negative (DCEN), described, 53
    direct current electrode positive (DCEP), described, 53
    for gas metal arc welding, 61
    for gas tungsten arc welding, 70–72
Equipment
    building
    cylinder cart, 90–93
    grind stand, 94–95
    portable welding table, 96–101

rolling welding curtain, 82–83
saw stand, 102–107
welding machine cart, 88–89
welding table, 84–87
for cleaning metal, 21
for gas metal arc welding, 59–61
for gas tungsten arc welding, 68–73
for mechanical cutting, 24
for oxyacetylene welding, 40–43
for plasma cutting, 26, 29, 32
for shielded metal arc welding (SMAW), 55–56
shop tools, 13
Étagères, building
corner, 160–163
straight, 154–159
Explosions, preventing, 10–11

F

Fence panel, building, 124–127, 190–193
Ferrous metals, 14
Filler metals, defined, 6
Finishing, 38–39
Fire, preventing, 10
Fire bricks, 48, 49
Firepit, building, 186–189
Fireplace candelabrum, building, 142–143
Fireplace candleholder, plans for, 212
Fittings basics, 42
Flashback, 45
Flashback arrestor basics, 43
Flat bars, dimensions, 16
Floor lamp, plans for three post, 217
Flux cord arc welding, described, 7, 65
Free-standing coat rack, plans for, 215
Fuels
for oxyacetylene cutting, 34

for oxyacetylene welding, 49
Fumes, avoiding, 10

G

Garden trellis, building, 124–127
Gas cylinder safety, 61
Gas metal arc welding (GMAW/MIG)
building welding machine cart for, 88–89
described, 6, 7, 58
directions, 64–65
setting up shielding gas flow meter, 63
setting up wire feed, 62
electricity terms & concepts for, 52–53
equipment for, 59–61
lens shade numbers for, 11
maintenance, 66–67
requirements, 12
safety, 59
troubleshooting, 66–67
Gas options for oxyfuel welding, 49
Gas tungsten arc welding (GTAW/TIG)
building welding machine cart for, 88–89
described, 6, 7, 68
directions, 74–75
electricity terms & concepts for, 52–53
equipment for, 68–73
lens shade numbers for, 11
requirements, 12
safety, 69
troubleshooting, 76–77
Gate, building, 184–185, 194–199
Gauge thickness, inch equivalents, 18
Gazebo, building, 200–205
Glossary, 218–219
Grind stand, building, 94–95

Gun basics, 59–60

H

Heat distortion, described, 6–7
Hex/hexagonal bars, dimensions, 16
Holes, piercing, 36
Hose basics, 42

I

Inverters, described, 53
Iron cross, building, 128–131

L

Lamps, plans for
    scroll desk, 211
    three post floor, 217
Laundry-tub planter, plans for, 217
Leaks, checking for, 45
Lens shade numbers, 11

M

Magazine rack, building, 143–145
Mechanical cutting techniques, 24
Mechanical generators, described, 53
Melting points, 15
Metals
    basics, 14–15
    cleaning, 21
    decorative, 18
    ferrous, 14
    filler, 6
    identification chart, 17
    melting points, 15
    methods to join, 6
    purchasing, 18
    repairing, 19–20
    shapes & sizes, 16–17

Mild steel
basics, 14
cutting processes for, 14
repairing, 19
shaping, 37
welding processes for, 14
Mirror, building swivel, 114–119
Molten puddle
defined, 6
protecting from oxygen, 7

N

Nesting tables, building, 132–135
Nightstand, building, 138–141

O

Open circuit voltage, described, 52
Operating voltage, described, 52
Oxyacetylene cutting
equipment for, 33–34
fuel options, 34
precutting checklist, 35
safety, 32, 36
techniques, 35–36
troubleshooting, 36
Oxyacetylene welding
depressurizing outfit, 49
described, 6, 7, 40
directions, 48
equipment for, 40–43
flame & flame states, 47
fuel, 49
requirements, 12
safety, 41, 42
setting up outfit, 44
torch lighting, 46

troubleshooting, 45
turning on outfit, 45
Oxyfuel welding
building
cylinder cart for, 90–93
welding table for, 84–87
gas options for, 49
Oxygen, protecting molten puddle from, 7
Oxygen cylinder basics, 41

P

Penetration, described, 6
Perforated sheet metal basics, 17
Planter, plans for laundry-tub, 217
Plasma cutting
bending & cutting diamond plate, 30
building rolling welding curtain for, 82–83
electricity terms & concepts for, 52–53
equipment for, 26, 29, 32
overview of, 25
precutting checklist, 27
safety and, 25–26
techniques, 27, 29, 30–31
troubleshooting, 28
Plate metal, thicknesses, 16
Portable welding table, building, 96–101
Power sources, described, 53
Pressure regulator & gauge basics, 42
Primers and finishing, 38, 39

R

Rail caps, uses & dimensions, 16
Railing, building, 180–183
Rectangular tubes, uses & dimensions, 16
Repairing metal directions, 19–20
Reverse polarity, 53

Rolling welding curtain, building, 82–83
Room divider, building, 124–127
Round bars, dimensions, 16
Round tubes, uses & dimensions, 16

S

Safety, 10–11
    with gas cylinders, 61
    truck rack materials and, 168
    when cleaning metal, 21
    when gas metal arc welding, 59
    when gas tungsten arc welding, 68, 69
    when oxyacetylene cutting, 26, 33, 36
    when oxyacetylene welding, 41, 42
    when plasma cutting, 25–26
    when shielded metal arc welding, 54–55
Saw stand, building, 102–107
Scratch starts, 74
Scroll desk lamp, plans for, 211
Shapes of metals, 16
Shaping, 37
Sheet metal, thicknesses, 16
Shelves
    building
    angled metal, 146–149
    étagères
    corner, 160–163
    straight, 154–159
    wall-mounted, 150–153
    plans for baker's, 212
Shielded metal arc welding (SMAW)
    described, 6, 7, 54
    directions, 57
    electricity terms & concepts for, 52–53
    equipment for, 55–56

lens shade numbers for, 11
requirements, 12
Shielding gases
for gas metal arc welding, 61
for gas tungsten arc welding, 70
Shop requirements, 12
Shop tools needed, 13
Spray-on finishes, 38
Square bars, dimensions, 16
Square tubes, uses & dimensions, 16
Stainless steel
characteristics of, 17
cutting process for, 14
repairing, 20
welding processes for, 14
Stair railing, building, 180–183
Steel
basics, 14–15
cast iron and, 190
characteristics of, 17
repairing, 20
Step-down transformer, 53
Stick welding. *See* Shielded metal arc welding (SMAW)
Straight polarity, 53
Straps, dimensions, 16
Stub out/stubbing, 66
Swing-away coat hooks, building, 136–137
Swivel mirror, building, 114–119

T

Tables
building
for arc welding, 84–87
coffee, 110–111
nesting, 132–135
nightstand, 138–141

portable welding, 96–101
plans for tapered-leg, 212
T-bars, dimensions, 16
Thick materials, welding to thin, 159
Three post floor lamp, plans for, 217
Tips for torches, 43
Titanium welding & cutting processes, 14
Tools. *See* Equipment
Torches
for gas tungsten arc welding, 69–70
for oxyacetylene welding
described, 43
flame & flame states, 47
lighting, 46
maintaining, 49
tips for, 43
Trailer frame, building, 172–179
Tree-shaped candleholder, plans for, 211
Trellises, building, 124–127, 190–193
Truck rack, building, 166–171

V

Verdigris finishes, 38–39
Vineyard trellis, building, 190–193
Voltage/volts, defined, 52
Votive lantern with chain & holder, plans for, 215

W

Wall-mounted candleholder, plans for, 212
Wall-mounted coat rack, building, 120–123
Wall-mounted shelves, building, 150–153
Wattage/watts, defined, 52
Welding
electricity terms & concepts for, 52–53
overview of, 6–7
Welding curtain, building, 82–83

Welding machine cart, building, 88–89
Welding table, building, 84–87
Window box, plans for, 216
Wine rack, building, 112–113
Wire feed basics, 59
Work clamps, 53, 60
Work leads, 53
Wrought iron, characteristics of, 17

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WELDING BASICS

An Introduction to Practical & Ornamental Welding

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An Introduction to Practical & Ornamental Welding

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CONTENTS

Introduction
- Introduction to Welding
- Safety
- Setting Up Shop
- Shop Tools
- Metal Basics

Welding & Cutting Processes
- Oxyacetylene Welding
- Electricity for Welding
- Shielded Metal Arc Welding
- Gas Metal Arc Welding
- Gas Tungsten Arc Welding
- Plasma Cutting
- Oxyacetylene Cutting

Welding Projects
- Shop Projects
  - *Rolling Welding Curtain*
  - *Welding Table*
  - *Welding Machine Cart*
  - *Cylinder Cart*
  - *Grinder Stand*
- Lighting Projects
  - *Scroll Desk Lamp*
  - *Three Post Floor Lamp*
  - *Chandelier*
  - *Wall-mounted Candleholder*
  - *Tree-shaped Candleholder*
  - *Fireplace Candleholder*
- Furniture Projects
  - *Baker's Shelves*
  - *Coffee Table*

Corner Coatrack
Kitchen Appliance Stand
Wall Hung Plate Rack
Wine Rack
Headboard
Outdoor Projects
Stair Railing
Gate
Critter Boot Brush
Disk Fountain
Arbor

Glossary
Resources
Index

A simple flame-cut silhouette is a charming addition to any garden.

photo/©John Gregor

INTRODUCTION

Welding is a practical skill that is also great fun. The number of welded items in our everyday lives is practically uncountable—the spot welds on the bodies of our automobile, the welded railing on our front steps, the superstructure of the buildings in which we work, and the bridges over which we drive. But welding also makes smaller, more delicate functional and decorative items possible, like patio chairs and trellises, wine racks and candleholders, baker’s shelves and headboards. The photos on these pages reveal only a fraction of what welding artisans have created with heat and metal.

The strength and malleability of steel makes it perfectly suitable for forming whimsical structures like this candelabra.

©Millet/Inside/Beateworks

Cutting and welding creates beautiful and useful household items, like this fireplace screen.

Photo courtesy of Sleeper Welding/Tom Sleeper

The costs involved in setting up a well-equipped home welding shop are comparable to setting up a well-equipped woodworking shop. A great advantage of welding is that the materials are generally inexpensive, yet you can create items that sell in shops for hundreds of dollars. Because fewer people are knowledgeable about welding, there is always a rewarding “awe” factor to showing off what you have created.

This book provides basic directions and step-by-step photos that illustrate the four major welding processes and the two major cutting processes. You also will find quick reference charts that describe electrode and filler wire choices, metals and their weldability, and joint and weld types. Suggestions for setting up a welding shop, detailed safety guidelines, and ideas for finishing your metal projects are also included.

Simple and graceful arches and trellises are easily made from mild steel. A few bends, decorative finials, and a handful of welds are all it took to make this simple garden archway.

Photo courtesy of Gardeners Supply Company

A variety of metals, shapes, and joining techniques were combined to create this beautiful artwork.

Photo courtesy of Gene Olson/Photo by Ytsma Photography

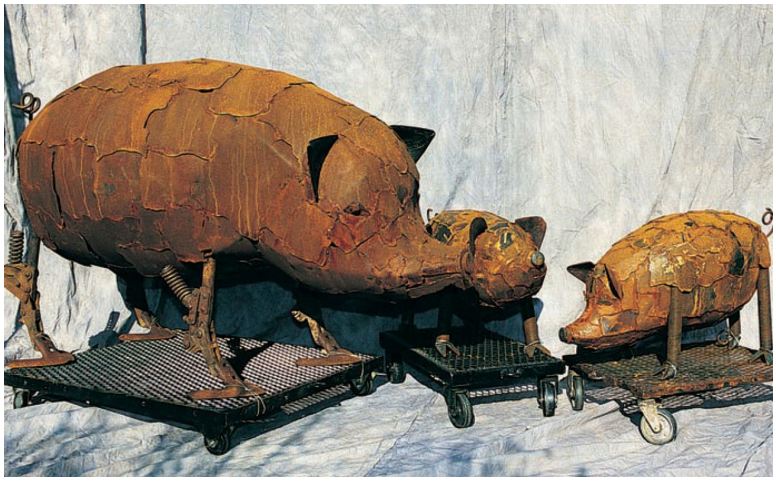
Best of all, this book includes detailed directions for 23 practical and decorative projects. You can make a welding and cutting table for your welding shop, a scrolled desktop lamp, a wrought iron railing, or a cute critter boot brush. You can practice your techniques and make accessories for your own home or as gifts. We also encourage you to use the project ideas to branch out and create your own versions of a baker's rack, coffee table, or kitchen accessory stand.

These colorful puppies are cut from junked car hoods.

Photo courtesy of Lizard Breath Ranch, Inc.

Creating fanciful creatures from garden tools is a rewarding welding project.

Photo courtesy of Heebie GBS Metalworks



Scales of sheet metal, springy legs, and mesh trolleys—what a fun piggy collection.

Photo courtesy of Dave Johnson/Birds & Beasts

Old tools and recycled metal odds and ends make this gate geometrically pleasing.

Photo courtesy of Heebie GBS Metalworks

Old farm implements and spare parts are great sources of weldable material. This chicken shows what a little imagination can do with a pile of parts.

Photo courtesy of Dave Johnson/Birds & Beasts

The strength of steel allows for solid yet airy structures like this plant stand.

Photo courtesy of Gardeners Supply Company

Notice To Readers:

Welding is a dangerous activity. Failure to follow safety procedures may result in serious injury or death. This book provides useful instruction, but we cannot anticipate all of your working conditions or the characteristics of your materials and tools. For safety, you should use caution, care, and good judgment when following the procedures described in this book. Consider your own skill level and the instructions and safety precautions associated with the various tools and materials shown. The publisher cannot assume responsibility for any damage to property or injury to persons as a result of misuse of the information provided.

Introduction to Welding

Welding is all about heat, about using heat to melt separate pieces of metal so they will flow together and fuse to form a single, seamless piece. Regardless of the welding or cutting process, your ability to control the heat generated by the flame or arc determines the quality of your welds and cuts.

Certain terms are used to describe the heat and action of all the welding processes. The parts being welded together are referred to as the base metal. Additional metal, called filler, is often added to the weld. The molten puddle is the area of melted base metal and filler metal that you maintain as you create your weld. To have fusion of metals, the base metal and filler metals must be the same composition. Methods for joining metal without fusion are called soldering, brazing, and braze welding. These methods can be used to join similar or dissimilar metals.

Oxyacetylene welding and cutting use flames to generate the heat to melt the metal. Shielded metal arc, gas metal arc, and gas tungsten arc welding and plasma cutting use an electric arc for heat generation. With oxyacetylene welding, you have time to watch the puddle develop as the metal turns red, then glossy and wet looking, then finally melts. With the arc processes, the puddle forms quickly and may be difficult to see because of the intensity of the arc. It is important to have ample lighting and clear vision so you can watch the puddle and move it steadily.

Oxyacetylene welding

Penetration of the weld is also a critical heat dependent factor. A strong weld penetrates all the way through the base metal. Matching filler material size and heat input to the thickness of the base metal is important. It is easy to get a good looking weld that has not penetrated the base metal at all and merely sits on the surface. At the opposite end of the spectrum from a “cold,” non-penetrating weld is burn through—where the base metal has gotten too hot and is entirely burned away, leaving a hole in the base metal and the weld.

Heat distortion is a by-product of all welding and cutting processes. It is obvious that applying a flame to metal in the oxyacetylene process makes the metal hot —and the electrical arcs are actually four to five thousand degrees hotter than the oxyacetylene flame. When metal is heated it expands; when it cools it contracts. If not taken into consideration, this expansion and contraction may cause parts to move out of alignment. This is why tack welding and clamping project pieces is critical to successful welding. It is also important to match the welding process to the base metal thickness. For example, shielded metal arc welding is generally not used on materials less than 1/8" thick. The process is too hot and too difficult to control on thin material. On the other hand, gas metal arc welding works well on very thin sheet metal, if you are able to adjust the machine to a low enough voltage.

Shielded metal arc welding

Gas metal arc welding

Protecting the molten puddle from oxygen is also an important part of welding. Oxygen makes steel rust and causes corrosion in other metals. The exclusion of oxygen from the weld when it is in the molten state makes a stronger weld. This is accomplished in a variety of ways. A properly adjusted oxyacetylene flame burns off the ambient oxygen in a small zone around the weld puddle. Gas metal arc and gas tungsten arc welding bathe the weld in an inert gas from a pressurized cylinder. These inert gases keep oxygen away from the molten puddle. Flux cored arc welding and shielded metal arc welding use fluxes in or on the welding filler metal. When these fluxes burn, they produce shielding gases and slag, both of which protect the weld area until it has cooled.

Gas tungsten arc welding

Plasma cutting

Welding well is difficult and takes years to master, but it is possible to make many useful and decorative items with basic knowledge and a little practice. If you wish to move beyond the decorative projects outlined in this book, it is a good idea to talk with a welder and have him or her evaluate some of your welds. Remember, the safety of others is involved when you choose to make a utility trailer or spiral staircase. Take the time and make the effort to ensure that any structural project you make is safe.

This book is intended as a reference for people who have had some exposure to welding and need reminders about what steps to follow and precautions to take. It is not intended to teach welding to someone who has never handled welding equipment. Many community colleges, technical schools, and art centers offer welding classes. Such classes are an ideal way to learn the basics of welding, proper techniques for each process, and welding safety.

Oxyacetylene cutting

Safety

Welding can be a dangerous activity. Possibilities exist for getting cut, burned, electrocuted, and causing fires or explosions. Preparations for welding—grinding, burnishing, and sawing—are also dangerous. That said, it is absolutely possible, with a little care and diligence, to weld for years and never suffer more than a burnt thumb from being too eager to examine a just-completed weld.

It is very important to follow manufacturer's specific instructions and recommendations for equipment and product use and to follow general welding safety rules. Whether you are welding in a dedicated welding shop or have set up your own shop at home, you need to be aware of a number of specific safety concerns.

Welding safety includes protecting yourself with protective gear, following manufacturer's instructions, and being aware of the surroundings in which you are welding.

Fumes. Welding produces hazardous smoke and fumes. It is always important to keep your face out of the weld plume. Welding indoors requires either a ventilation fan, exhaust hood, or fume extractor. Wear an OSHA approved N99 particle mask or a respirator. If you are pregnant or plan to become pregnant, a respirator is a necessity.

Burns. Hot sparks and flying slag can cause burns. Protect your hands, head, and body with natural fibers—leather, wool, or cotton. Manufactured fibers such as nylon and polyester melt when ignited, which causes serious burns. Wear leather slip-on boots, and make sure your pant legs fall over the top of your footwear. Cuffed pants and pants with frayed edges are fire hazards. Also, welding sparks will find tiny holes, so don't wear holey jeans. Wear a welding cap and tie back long hair and keep it tucked under your shirt or cap.

Arc burn. Welding arcs produce ultraviolet and infrared light. Both of these can damage your eyes permanently, burn your skin, and potentially lead to skin cancer. A welding helmet with a filter lens protects your eyes and face, while long sleeve shirts and long pants protect your skin. Remember, you are also responsible for protecting the vision of curious neighbors, passersby, and pets. Use welding screens and have an extra helmet on hand for observers.

Fire. The area you're working in should be cleared of any flammable items such as lumber, rags, dropcloths, cigarette lighters, and matches. Absolutely do not weld or grind metal in a sawdust-filled shop. Sparks from welding and grinding can ignite airborne dust or fumes, or travel across the floor and come to rest against flammable materials. A fire extinguisher rated ABC is a must—mount it next to a first aid kit so you know where both are. Check your welding area one half hour after welding to make sure no sparks have found a place to smolder.

Minimum Lens Shade Numbers for welding

APPLICATION	SUGGESTED SHADE #
Shielded Metal Arc Welding (SMAW)	
1/16 to 5/32" electrodes	10
3/16 to 1/4" electrodes	12

5/16 to 3/8" electrodes	14
Gas Metal Arc Welding (GMAW)	
1/16 to 5/32" non-ferrous	11
1/16 to 5/32" ferrous	12
Gas Tungsten Arc Welding (GTAW)	10 to 14
Plasma Cutting	8
Oxyacetylene Welding	5
Oxyacetylene Cutting	5
Brazing	3 to 5

Welding helmets are typically available with filter lenses in either 2" × 4-1/4" or 4-1/2" × 5-1/4" sizes. Helmets with auto-darkening lenses are also available. Full-face protective shields are available in clear, for grinding or chipping, and with a #5 filter for oxyacetylene operations.

Explosion. Even non-flammable gases such as carbon dioxide are stored in cylinders at such high pressure that they can easily become dangerous missiles. Keep the cylinder's protective cap on if regulators are not installed, and keep cylinders chained or strapped at all times. Cylinders should never be used as rollers or supports, and cylinders and protective caps should never be welded on. Shut acetylene and oxygen cylinder valves if you're away for more than 10 minutes. Cylinders must be transported right side up and chained, even if empty.

Another explosion hazard is concrete. Because of the amount of water contained in concrete, it can become a steam bomb if welded upon. Tack welding on concrete is acceptable, but using a concrete surface to back your welds is not. Use fire bricks, which have been cured to have very low water content. Never weld or cut on any closed container, tank, or cylinder. Even if it has been empty for years, it might have enough residual material to release toxic fumes or explode. Always bring tanks of any sort to a tank welding specialist for repair.

Other hazards include noise from grinding, sawing, sanding, and plasma cutting; laceration from sharp metal edges; electrocution during arc welding; and asphyxiation from inert shielding gases. Carefully read all manufacturers' instructions before starting any welding process.

Welding safety equipment includes: A. safety glasses, B. particle mask, C. low-profile respirator, D. leather slip-on boots, E. fire-retardant jacket, F. fire-retardant jacket with leather sleeves, G. welding cap, H. leather cape with apron, I. leather gloves with gauntlets, J. heavy-duty welding gloves, K. welding helmet with auto-darkening lens, L. welding helmet with flip-up lens, M. full-face #5 filter, N. full-face clear protective shield.

Setting Up Shop

If you plan to weld on a regular basis, it makes sense to set up a welding shop. The primary concern with welding is containing the hot sparks or slag and the flammable elements while exhausting dangerous fumes. It is possible to weld outside, but not all processes allow that. Gas metal and gas tungsten arc welding require that the surrounding air be still so the shielding gas is not disturbed. All the arc processes must be done in dry conditions to prevent electrical shock. Cold metals do not respond as well as metals at 70° F and may not be weldable using certain processes. A heated garage or outbuilding is best suited for a welding shop. A basement is not suitable due to the dangers of fire and compressed gases next to living spaces. Additionally, your homeowner's insurance may not cover a welding shop if it is inside your living area as opposed to in a detached garage or shop building.

Shop space with a concrete floor and cement block walls is ideal for welding. Good ventilation is also important.

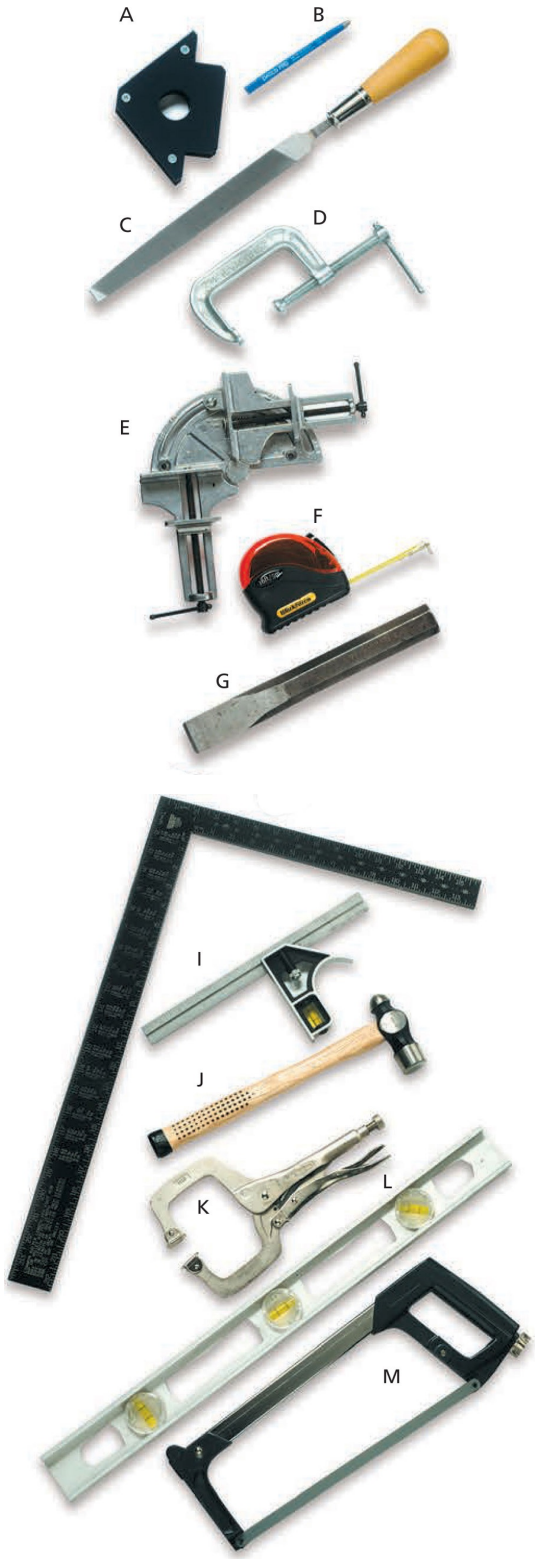
It is important to remember that tiny sparks and pieces of hot slag may scatter up to 30 or 40 feet from the source. If they come to rest on flammable materials, they may smolder, and given the right conditions, can ignite the material. Always check your welding area one half hour after you have completed welding to make certain no sparks are smoldering. A wooden table covered with metal is not a good work surface, as the transferred heat may cause the wood to smolder. Any wooden jigs or clamping devices should be doused with water to extinguish smoldering embers or stored outside after use.

Shop Tools

Power tools such as the reciprocating saw, angle grinder, portable band saw, and chop saw are useful when cutting and fitting metal parts to be welded. A drill press and metal cutting band saw are also useful tools for welding.

Specific metal working tools, including metal brakes and metal benders, are available for all sizes of metal. These can range from inexpensive sheet metal tools, such as the scroll bender shown on page 108, to expensive hydraulic tools.

Power tools for a welding shop (above photo) include: A. reciprocating saw, B. chop saw, C. portable band saw, D. angle grinder.

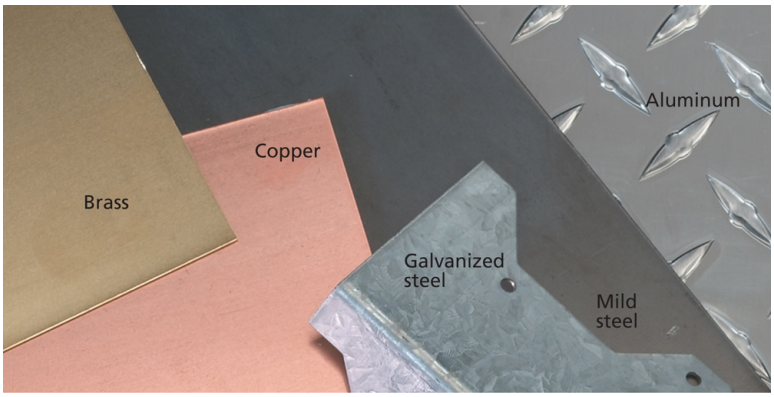


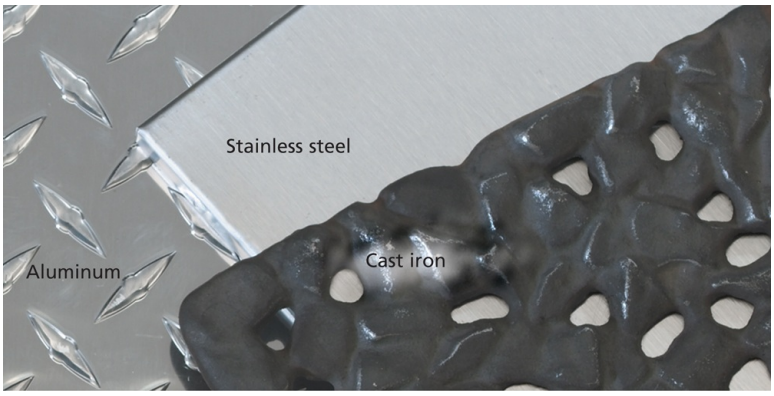
Standard tools for a welding shop include: A. magnetic clamp, B. center punch, C. metal file, D. C-clamp, E. corner clamp, F. tape measure, G. cold chisel, H. carpenter's square, I. combination square, J. ball peen hammer, K. clamping pliers, L. magnetic level, M. hacksaw.

Metal Basics

Weldability & Cutability

Different metals have different characteristics that affect their ability to be welded or cut with any of the processes described in this book. In general, only metals of the same type are welded together because welding involves melting the base metal parts and adding melted filler metal. In order to accomplish this, the parts and filler must have the same melting temperature and characteristics. Dissimilar metals can be joined by brazing and braze welding because these processes do not actually melt the base metal.





Metals are divided into the categories of ferrous and non-ferrous. Ferrous metals contain iron and will generally be attracted to a magnet. Cast iron, forged steel, mild steel, and stainless steel all contain iron, along with varying amounts of carbon and other alloying elements.

Mild steel, which has a low carbon content, is the most commonly used type of steel and the easiest with which to work. Mild steel can be welded with all the processes covered in this book and can be cut with either oxyfuel or plasma cutting. It makes up most of the metal items you commonly use, make, or repair, such as automobile bodies, bicycles, railings, patio furniture, file cabinets, and shelving. Adding more carbon to steel makes it harder, more brittle, and more difficult to cut and weld. High carbon steel is called tool steel and is used to make drill bits and other metal cutting tools.

METAL	WELDING PROCESS	CUTTING PROCESS
Mild steel	All welding processes	Oxyfuel, plasma
Aluminum	Gas tungsten arc, gas metal arc	Plasma
Stainless steel	Gas tungsten arc, gas metal arc, shielded metal arc	Plasma
Chrome moly steel	Gas tungsten arc, oxyfuel	Plasma
Titanium	Gas tungsten arc	Plasma
Cast iron	Shielded metal arc, brazing	Plasma
Brass	Braze welding	Plasma

Metal Melting Points

METAL	MELTING POINT (F)

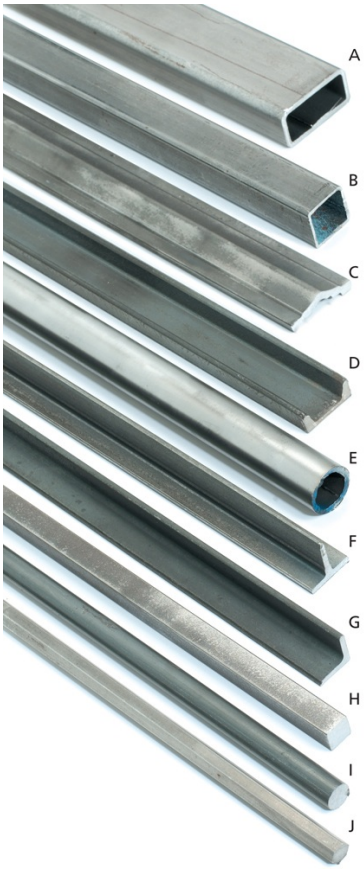
Aluminum	1217°
Brass	1652-1724°
Bronze	1566-1832°
Chromium	3034°
Copper	1981°
Gold	1946°
Iron	2786°
Lead	621°
Mild steel	2462-2786°
Titanium	3263°
Tungsten	5432°
Zinc	786°

Other elements are added to steel to make a variety of alloys, such as chrome moly steel and stainless steel. These additions may make the steel non-magnetic. Because stainless steel does not oxidize (rust) easily, it is difficult to cut with oxyfuel. When welding steel alloys, the filler material must be matched to the alloy to get a high-quality weld.

In addition to alloying, many metals are heat-treated to improve characteristics such as hardness. Because welding and cutting would reheat these metals and destroy those characteristics, heat-treating is an important factor to consider. Many vehicle chassis parts, including motorcycles and bicycles, are made of heat-treated metals.

Aluminum is a widely used non-ferrous metal because of its light weight and corrosion resistance. Like steel, it is available in many alloys and is often heat treated. Aluminum is used for engine parts, boats, bicycles, furniture, and kitchenware. Various characteristics make aluminum difficult to weld successfully—it does not change color when it melts, it conducts heat rapidly, and it immediately develops an oxidized layer.

Metal Shapes & Sizes



Mild steel (and most other metals) come in a variety of shapes, sizes, and thicknesses. Metal thickness may be given as a fraction of an inch, a decimal, or a gauge (see following chart).

Rectangular tube (A) and **square tube** (B) are used for structural framing, trailers, and furniture. Dimensions for rectangular and square tubing are given as width × height × wall thickness × length.

Rail cap (C) is used for making handrails. Rail cap dimensions are the overall width and the widths of the channels on the underside.

Channel (D) is often used for making handrails. Very large channel is used for truck bodies. The legs, or flanges, make it stronger than flat bars. Dimensions for channel are given as flange thickness × flange height × channel (outside) height × length.

Round tube (E) is not the same as pipe. Round tube is used for structures, and pipe is used for carrying liquids or gases. Dimensions for round tube are given as outside diameter (O.D.) × wall thickness × length. Pipe dimensions are nominal, that is, in name only. They are given as nominal inside diameter (I.D.) × length.

T-bar (F) dimensions are given as width × height × thickness of flanges × length.

Angle or **angle iron** (G) has many structural and decorative uses. Dimensions for angle iron are flange thickness × flange width × flange height × length.

Square bar (H), **round bar** (I), and **hexagonal** or **hex bar** (J) dimensions are given as width or outside diameter × length.

Flat bar or **strap** (not pictured) is available in many sizes. Dimensions are given as thickness × width × length.

Sheet metal (not pictured) is $^{3}/16$" or less in thickness and is often referred to by gauge. **Plate metal** is more than 3/16" thick and is referred to by fractions or inches.

Inch Equivalent for Gauge Thickness

GAUGE	INCHES
24	0.020
22	0.026
20	0.032
18	0.043
16	0.054
14	0.069
12	0.098
11	0.113
10	0.128

Metal less than 1/8" thick is often referred to by gauge. For reference, the decimal equivalent of 1/8" is 0.125.

Purchasing Metal

Finding a metal supplier can be a challenging task. The materials that are readily available may not be the sizes and shapes needed for a project and may be expensive. Metal dealerships may not be friendly to small accounts. Because steel is so heavy, Internet or catalog shopping carries prohibitive shipping costs. With some searching, however, most necessary materials can be found.

Metal is generally priced by weight, unless you are purchasing it at a retail store. The price for small pieces of mild steel at a home center or hardware store work out to be as much as $2 to $3 per pound. The price per pound for small orders at a steel dealership may be in the range of 50 cents. Large orders or repeat orders may be priced as low as 30 cents per pound. Many metal suppliers have an odds and ends bin or rack where pieces may be as low as 10 cents per pound. Specialty metals such as stainless steel and aluminum start at $2 to $3 per pound.

Smaller sizes and shapes of mild steel and aluminum are available at home improvement and hardware stores in three-, four-, and six-foot lengths. Welding supply stores often have a selection of ten- and twelve-foot lengths of the commonly used sizes. Steel dealers have most common sizes in stock and will order other sizes for you. Most mild steel shapes and sizes come in twenty-foot lengths, and many steel dealers will make one free courtesy cut per piece. You might want to have the metal delivered, depending on the amount of material you are purchasing. You can order metal through catalogs or the Internet, but remember that shipping is expensive.

Some steel dealers are distributors for decorative metal products, but many specialty items such as wrought iron railing materials, decorative items, and weldable hardware are only available by catalog. A number of catalog supply houses sell to the public and have varied selections and reasonable prices. (See Resources, page 140.)

Sheet metal is available as pierced or expanded. Wall plates, hooks, rings, balls, bushings, candle cups, drip plates, and stamped or cast items are available in a wide variety of shapes, sizes, and metals.

Preparing Metal for Welding

A successful weld begins with a well-prepared piece of metal. The cleaner the pieces to be welded, the better the weld quality and appearance. When working with mild steel, it is possible to clean batches of parts ahead of time. When working with aluminum, parts need to be cleaned immediately before welding due to aluminum's nearly instant formation of a protective layer of oxidation. Mild steel is usually covered with mill scale and, often, oil or grease. Round and square tubes are usually thickly coated with oil, which helps in the manufacturing process. This oil can be removed with denatured alcohol, acetone, or a commercial degreaser.

Cleaning the mill scale off mild steel is an important step. A bench mounted power wire brush works well on small pieces. Wire brushing the entire project prior to finishing is critical for good paint adhesion.

After the oil has been cleaned off, the mill scale can be removed by wire brushing manually or with a bench-mounted or hand-held power wire brush, with sandpaper or sanding screens, or with an angle or bench grinder. Aluminum and stainless steel need to be brushed with stainless steel brushes that are dedicated to cleaning only that metal. Small particles of mild steel will contaminate aluminum and stainless steel welds.

Finishing Metal

Though most commercially available metal items—patio furniture, indoor furniture, and garden accessories—have rough welds and spatter still present, it is nice to grind these down on your projects. An angle grinder is good for flat area welds, and a small rotary grinding tool can get into nooks and crannies. You'll be pleased with the results of a nicely ground, good weld because it looks like a solid piece of metal. Wire brushing, sanding, or sandblasting the entire piece will further prepare it for finishing.

Painting metal projects is best accomplished by spraying, not brushing. You will need to thoroughly clean all oil, dirt, slag, and spatter from the project because even advanced rusty metal primers will not to stick to dirty, oily areas. Metal spray paints are available in various finishes and a huge array of colors.

Powder coating and brass plating are other, more expensive, finish options. Various antiquing and rusting finishes are available as well, or you can let the piece slowly rust on its own if you prefer this look.

An angle grinder works well for beveling edges on thick material. Grinding down welds gives projects a finished look.

Metal Shaping Techniques

There are a number of ways to bend and shape mild steel. Bending tools for creating right angle bends are called metal brakes. Rollers create circles, punches make holes, and shearers make cuts. You can purchase simple hand-powered metalworking tools, though they can be costly—the higher the quality or larger the capacity, the higher the price. (See page 108 for a photo of a scroll bender.) Powerful hydraulic metal shaping tools made for commercial use can cost thousands of dollars.

Simple bending jigs can be made using any round, rigid, strong form, such as pipe and salvaged flywheels, pulley wheels, or wheel rims. Using these jigs, it is fairly easy to bend round rod up to 1/4" in diameter and flat bars up to 1/8" thick into complex shapes. Rebar up to 3/8" can be bent into large curves by clamping it into a bench vise. Tubing can be bent using an electrical conduit bender. Thick material such as rail cap can be heated and bent.

You can bend materials more easily if you have a long end to apply pressure to, so you may want to cut pieces to length *after* bending. Whenever you shape metal into sharp angles, take into account the length needed for the radius of the bend. Also, cold-formed metal will spring back somewhat, so it may take trial and error to find what size jig will make the size bend you desire.

Use a sturdy hacksaw, jig saw, or reciprocating saw with bi-metal blades to saw metal. A miter box will help you make accurate cuts. A metal band saw, either portable or bench mounted, is handy if you will be making many projects that require numerous cuts. You can drill metal with a power drill or drill press, using metal cutting bits and oiling the bit often to prevent overheating. Large holes or holes in very thick material might be made more easily with an oxyfuel cutter or plasma cutter. An angle grinder or bench grinder can be used to create tapers or to correct miscut items to get better fit ups for welding.

Bending jigs can be made from any rigid circular item. An engine fly-wheel, toilet flange, and various pipe sizes are shown here.

Use a vise style pliers to hold the metal to the jig. Wrap the metal around the jig in a smooth motion.

Use a slower drill speed and a metal cutting bit for metal drilling. Frequent application of oil prevents overheating.

Joint Types

The basic joints in welding are the butt joint, lap joint, corner joint, T-joint, edge joint, and saddle joint.

The **butt joint** is two pieces in the same plane butted against each other. The gap between the pieces is determined by the thickness of the pieces. Whether or not the surfaces need to be ground down (beveled) is also determined by the plate thickness. The type of weld used for a butt joint is a **groove weld.** The butt joint is a weak joint and should be avoided if at all possible.

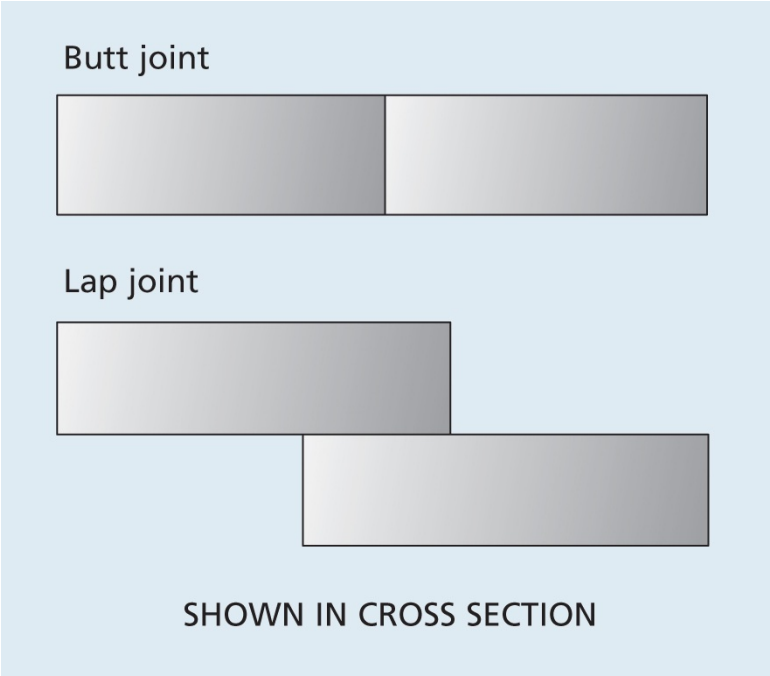
A **lap joint** is two pieces in the same plane overlapped. The type of weld used for a lap joint is called a **fillet weld.** The strongest lap joint has welds on both sides.

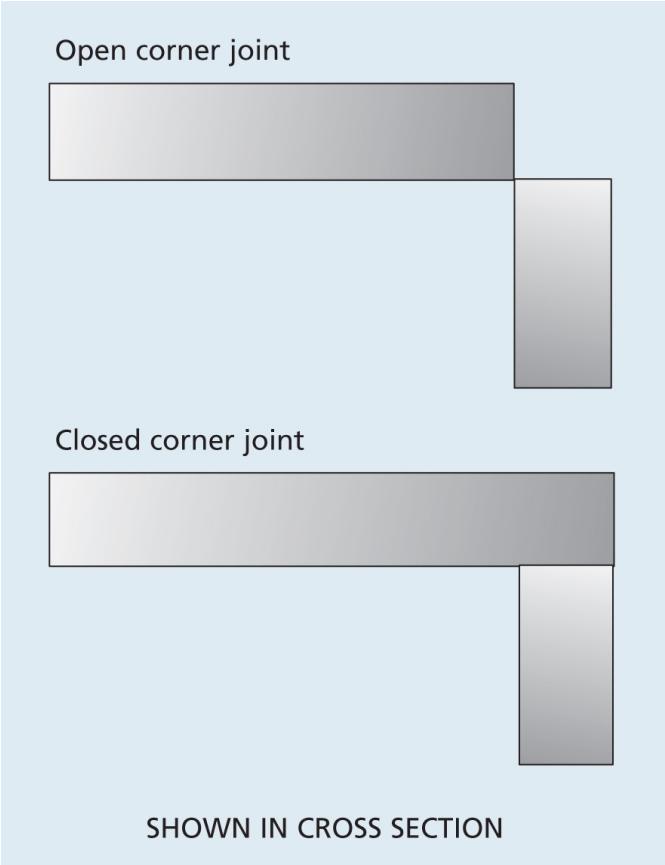
A **corner joint** is two pieces coming together to make a right angle at a corner. The joint can be open, partially open, or closed. An open corner takes a fillet weld, but other corner joints may take groove welds. For hobby welding on metal 3/16" and thinner, an open corner joint is stronger and allows more penetration. A closed corner joint may be weakened if the weld is ground.

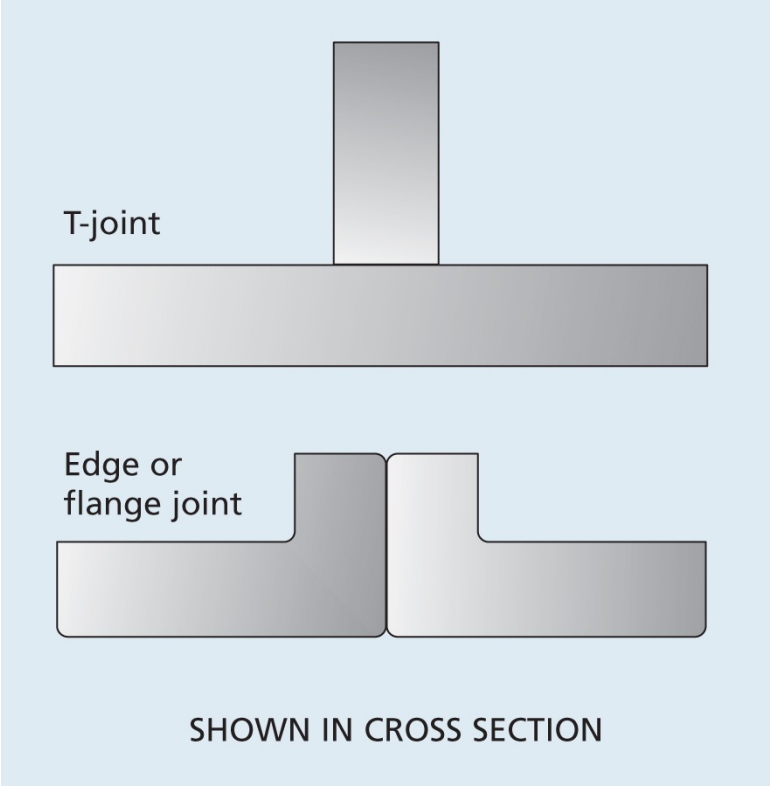
A **T-joint** is two pieces placed together to make a right angle T shape. Again, it is welded with a fillet weld. A T-joint is stronger if both sides are welded.

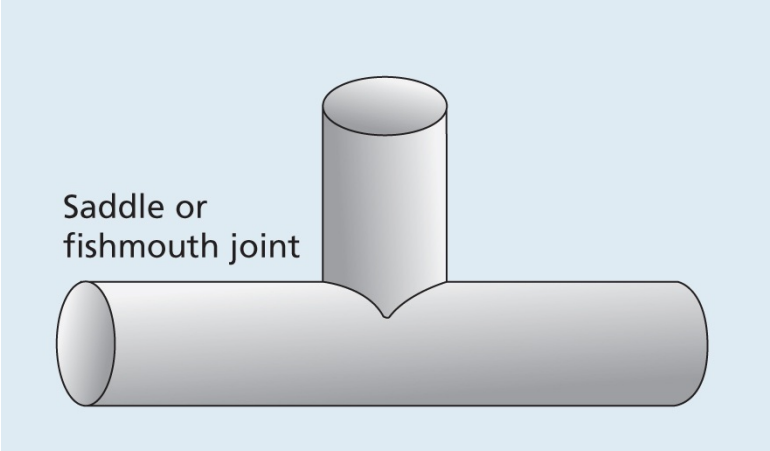
The **edge joint,** or **flange joint,** as it is sometimes called, is predominantly used to join thin sheet metal components. The turned up edge lessens the heat distortion to the thin sheets. With the advent of cooler welding processes, the need for the edge joint has diminished.

The **saddle joint,** or **fishmouth joint,** is used to join structural tubing. The tubes may join at any angle, and more than two tubes may be part of the joint. A fillet weld is used, most often all the way around the joint.


Butt joint
Lap joint
SHOWN IN CROSS SECTION


Open corner joint
Closed corner joint
SHOWN IN CROSS SECTION


T-joint
Edge or
flange joint
SHOWN IN CROSS SECTION


Saddle or
fishmouth joint

Weld Symbols & Weld Types

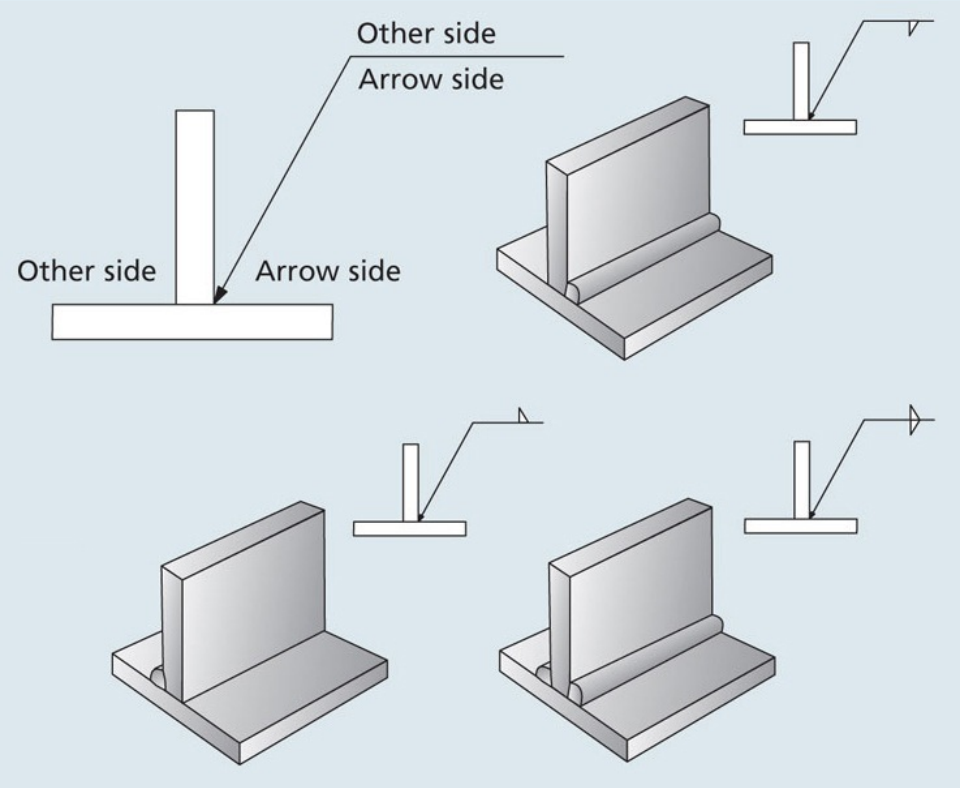
Welding blueprints use specific symbols to denote weld types, locations, and other factors. The basic symbol consists of an arrow and a reference line with weld symbol. The weld symbol is placed above the reference line if the weld is located on the side opposite the arrow, and below the reference line for a weld located on the same side as the arrow. Weld symbols above and below the reference line indicate to weld both sides. A circle at the junction of the arrow line and reference line means to weld all around. Most hobby welders will not encounter these symbols.

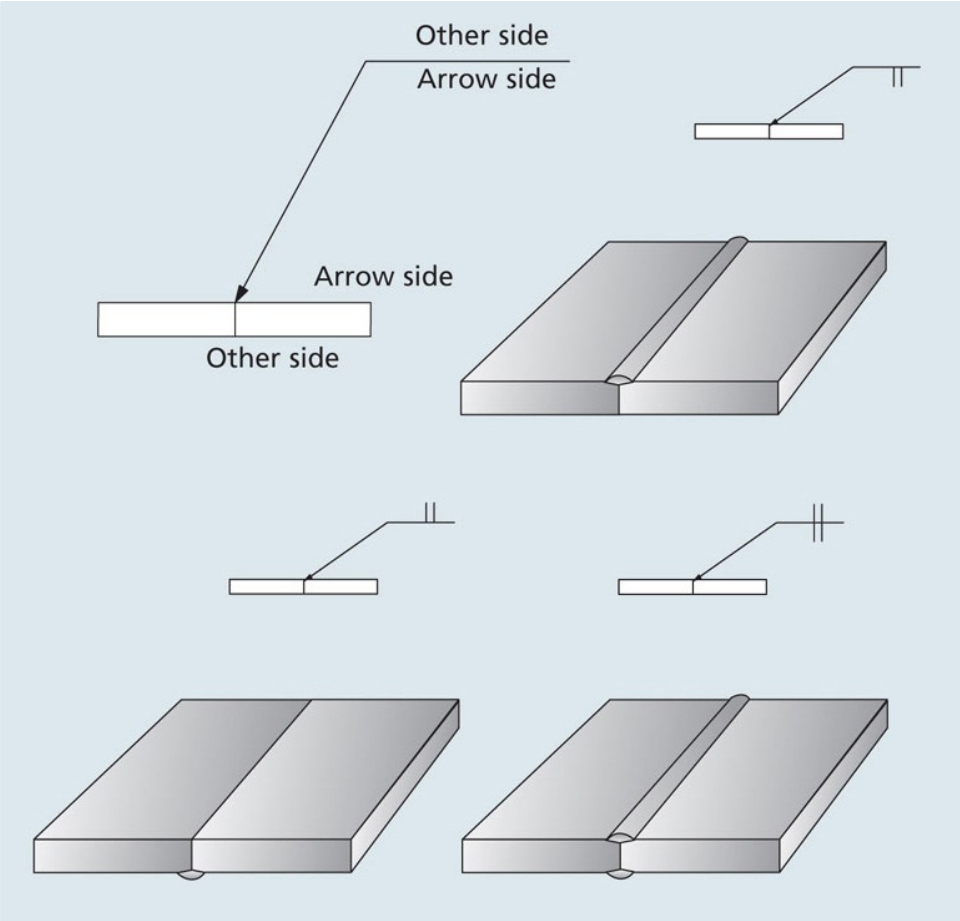
The most common weld types used for home welding are the fillet and groove welds.

The **fillet weld** is roughly triangular in shape. It is made when welding most 90° angle joints. T-joints, open corner joints, lap joints, and saddle joints all take fillet welds.

The **groove weld** is made in a groove between pieces. The groove may be square grooved (straight sides), beveled (flat angled sides), or U shaped. The groove weld is used for butt joints, edge joints, and closed corner joints.

WELDING SYMBOLS




Other side
Arrow side
Arrow side
Other side

Repairing Metal

Once you begin welding, you will encounter numerous opportunities to repair items. When your friends and neighbors discover you can do repairs, even more challenges will come your way.

Performing welded repairs can be very tricky. It is important to assess your welding skills, the difficulty of the repair, and the intended use of the repaired item. Any structural or vehicle repairs, such as stairways, ladders, trailers, or truck chassis, need to meet the same safety standards as they did in their original condition.

The first step in considering a repair is determining why the item broke. If a weld was poorly executed, the repair might simply be to prepare the area and perform a good weld. If a piece has broken due to metal fatigue, simply "patching" over the crack will only cause more cracks outside the patched area. Cast iron and cast aluminum may have broken due to imperfections or inclusions in the casting, or they may have gone through rapid heating and cooling that caused cracking. Very often things break because they have been misused—which means your repair will likely be broken unless the behavior of the user changes.

All parts need to be carefully prepared before attempting a repair. Paint needs to be ground or sanded off and grease and oil need to be cleaned away. This cast iron part is being beveled to allow greater weld penetration.

The next step in a repair is determining what the base metal is. A magnet will be attracted to any metal with a certain concentration of iron in it, but stainless steel (which is sometimes non-magnetic), mild steel, and cast iron require very different welding techniques. Aluminum is non-magnetic and is discernable from stainless steel by its light weight—but which alloy is it? In the case of aluminum, some alloys are not weldable. Unfortunately, many manufactured metal items are made of alloys and may have been heat treated. Without access to the manufacturer's specifications, it might be impossible to determine what the base metal composition is. It is important to understand the effects of welding on these materials before attempting a welded repair.

Once you have determined the feasibility of a repair on a particular piece, the piece must be prepared carefully. All rust, paint, and finishes must be removed from the area of the weld, and, if you are arc welding, from an area for the work clamp. Grease and oil must be cleaned off. If the break is on a weld joint, the old weld bead needs to be ground down.

Mild steel is the easiest material to repair. Simply prepare the material as for any other weld, and weld using any of the welding processes.

Cast iron and cast aluminum need to be preheated before welding to prevent cracking due to temperature fluctuations. If the piece is small enough, you can put it in the oven and heat it to 400 to 500° F. Otherwise, use an oxyacetylene or propane rosebud tip. Temperature crayons, which melt at specific temperatures, are available for marking metal to be preheated. Cast iron can be brazed if the fit between the broken parts is good, or it can be braze welded or welded with shielded metal arc. Specific electrodes for cast iron are available. Cast aluminum can be brazed, braze welded, or welded with gas tungsten or gas metal arc welding. Allow cast parts to cool slowly after welding.

Some aluminum is not weldable. If the piece to be repaired has been welded, you can perform a welded repair. If you can determine the composition of aluminum parts, match the electrode or filler rod to that. Some filler rods and electrodes are multipurpose and can be used on more than one alloy. Gas tungsten arc welding is the best choice for aluminum, but it can also be welded with gas metal arc, or it can be brazed.

Stainless steel comes in numerous alloys, and it is important to match the filler material to the base metal. Do not clean stainless steel with a steel wire brush, as

the mild steel wires may contaminate the stainless steel. Stainless steel is best repaired with gas tungsten arc welding, although it can be brazed as well.

If you are unsure of any aspect of a potential repair, consult with your welding supply dealer or an expert welder.

Remove the paint and finish from the weld area. If you are arc welding, also remove the paint from an area close to the weld for attaching the work clamp.

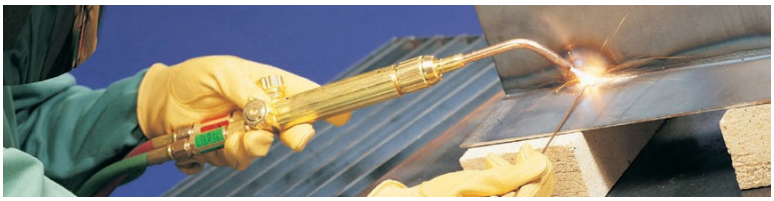
Cast iron can be braze welded as shown here, or shielded metal arc welded with cast iron electrodes. Either way, the metal needs to be preheated to 450° F before being welded.

WELDING & CUTTING PROCESSES

The following chapters give basic background information on the four major welding processes and two cutting processes that home hobbyists are most likely to use. Each chapter includes the equipment needed for the process and safety precautions. How-to photographs with step-by-step directions show specific techniques for each process. Tip sections offer suggestions for improving skills and keeping equipment in good condition. A separate chapter on electricity covers some basic points that are important to all of the arc processes.

Oxyacetylene Welding 26
Electricity for Welding 38
Shielded Metal Arc Welding 40
Gas Metal Arc Welding 44
Gas Tungsten Arc Welding 54
Plasma Cutting 64
Oxyacetylene Cutting 68

OXYACETYLENE WELDING



An oxyacetylene welding rig consists of two cylinders—oxygen and acetylene, regulators, hoses, and a torch with tip.

Oxyfuel welding is the process that uses the heat from a gas flame to melt base materials and cause them to join together. The gas flame is created by the combustion of oxygen and a fuel gas. Fuel gases are: acetylene, propane, butane, hydrogen, natural gas, and MPS (methyl acetylene-propa-diene, formerly known as MAPP gas). Oxygen and acetylene burn in a neutral flame at a temperature between 5600° and 6300° F, the hottest of any gas flame and capable of melting most metals. Other oxygen-fuel gas combinations are hot enough to use for soldering and brazing, but not hot enough for welding. Oxyfuel welding with acetylene is called oxyacetylene welding, but it is often simply referred to as gas welding.

The oxyacetylene process is versatile, as it can be used for both welding and cutting materials (see page 68) as well as heating, soldering, and brazing. It can be much less expensive than arc welding and is very portable because it needs no electrical power source. Oxyacetylene can be used to weld any thickness of metal, but sections over 1/4" are difficult to weld. Unfortunately, the techniques of oxyacetylene welding can be very hard to master, and there are serious safety concerns with the extreme flammability of acetylene and the high pressure gas cylinders.

Oxyacetylene welding equipment consists of an oxygen cylinder and an acetylene cylinder, each with regulators and gauges, oxygen hose, acetylene hose, torch, and tips.

Oxyacetylene welding may use fusion welding, where the base metals are melted together without filler material, or, more commonly, it may use a filler metal.

Safety

- Welding helmet or face shield with #5 filter
- Leather, wool, or cotton long pants, long sleeve shirt, and hat
- Leather gloves with gauntlet
- Leather boots or shoes
- Ventilation

THE EQUIPMENT

Cylinders. Oxygen comes in high pressure cylinders (sometimes called bottles or tanks) at 2200 pounds per square inch (psi) or more when full. The oxygen cylinder has a valve, and it always comes with a safety cap that screws on to the top to protect the valve. Never use the safety cap to lift an oxygen tank. The oxygen cylinder has a safety valve that will rupture to relieve tank pressure if the tank becomes overheated. Oxygen tanks should always be stored and transported in the upright position.

Acetylene. Acetylene is an extremely unstable gas. It cannot be pressurized above 15 psi in a free state. To safely pressurize the acetylene to 225 psi, the acetylene cylinder is filled with a porous material and acetone. When pressurized, the acetylene is absorbed by the acetone, which stabilizes it. When the pressure is released (the valve opened) the acetylene bubbles out of solution. Acetylene cylinders have fusible plugs that will melt in case of a fire and allow the gas to slowly escape rather than explode. Acetylene cylinders should always be stored in an upright position. Using an acetylene tank at an angle will allow acetone through the regulator and hoses, which will destroy them.

Cylinders should always be kept upright and secured with a chain or strap to prevent them from falling over. Never use a cylinder as a roller for moving heavy objects or for any purpose other than their intended use.

Tools for oxyacetylene welding include fire bricks, pliers, striker, tip cleaner, and acetylene tank wrench.

Cylinder Valves. Each type of cylinder has a valve that controls the flow of gas from the cylinder. A handwheel or valve wrench is used to open the valve. The oxygen cylinder valve should always be opened fully, as it is a backseating valve. A backseating valve is leakproof when closed and fully opened, but not otherwise. The acetylene valve should never be opened more than 3/4 to 1 1/2 turns. Less than this may lead to insufficient amounts of fuel and backflash; more than this makes it difficult to turn the acetylene off quickly in case of an emergency. If the acetylene valve is opened all the way, or opened suddenly, the acetone may escape from the cylinder, just like an overflowing soda can. Acetone can destroy the hoses and regulator fittings.

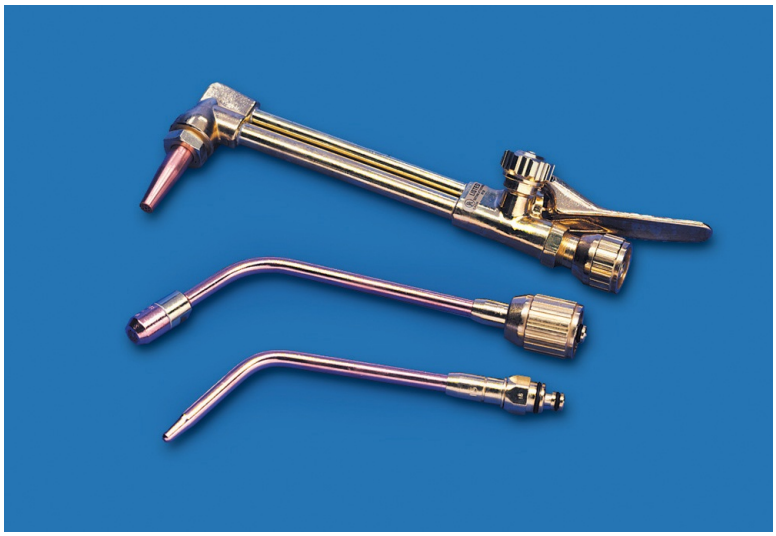
NOTE:

Never use oil or any other type of lubricant on regulators or other welding equipment. The combination of oil and oxygen in a spark-filled environment can lead to a fire in the regulator, which could cause a cylinder explosion.

Pressure Regulators and Gauges. Pressure regulators reduce the pressure of the gas leaving the cylinder. A single-stage regulator reduces the cylinder pressure to working pressure in one step. A two-stage regulator reduces the cylinder pressure to working pressure in two steps. A two- stage regulator is better because it gives more precise control over gas flow. but it is substantially more expensive. The regulator adjusting screw turns clockwise to increase pressure and counterclockwise to reduce pressure. The regulator is completely off when the adjusting screw is loose or “backed out.” Always back out adjusting screws as part of your post-welding routine.

Hoses. The flexible rubber hoses that move the gas from the regulator to the torch are designed to be leakproof and withstand high pressure. The oxygen hose is green, and the acetylene or fuel hose is red. Hoses are available either as a single hose or a dual hose where the oxygen and fuel hoses are paired together. The dual hoses are more common and more convenient. Always protect hoses from damage by moving them off the floor when not in use, keeping them behind the welding area so they are not burned with sparks, and keeping them out of traffic lanes so they are not stepped on or run over by vehicles. Hoses should not be allowed to come in contact with oily surfaces and should be protected from sunlight and chemical fumes to keep them in good condition. Always drain hoses when you have finished your welding session.

Oxygen and acetylene regulators.



Available tips for an oxyacetylene torch body include cutting head, rosebud heating tip, and welding tip.

Oxygen and acetylene hoses with flashback arrestors, torch body, and welding tip.

Fittings. Fittings connect the hoses to the regulator at one end and the torch at the other. For safety, the nut for the fuel hose (red hose) is left-hand threaded and has a groove machined around the nut. The oxygen (green) hose nut is right-hand threaded and has no groove. Never interchange the oxygen and fuel hoses or fittings. Never force a fitting—brass is a very soft metal, and it is easy to damage the fitting threads. Always hand thread and hand tighten fittings before using a wrench, and be careful not to overtighten them. Never use pliers to tighten fittings, as they will damage the brass nuts.

Check Valves and Flashback Arrestors. Check valves and flashback arrestors are two safety features to prevent reverse gas flow or flashbacks. The check valve allows gas to flow from the hose to the torch. If gas pressure within the torch exceeds the hose pressure, a spring closes the valve to prevent back flow. In the event of a flashback, the check valve needs to be replaced. A flashback arrestor is installed between the torch and hose, and offers more protection than the check valve. The flashback arrestor prevents burning oxygen and fuel from flashing back into the hoses and regulator, which could cause an explosion. The flashback arrestor consists of a check valve, pressure-sensitive valve, stainless steel filter, and heat sensitive check valve. In the event of a flashback, the flashback arrestor does not need to be replaced.

Torch. The torch mixes and controls the flow of the fuel gas and oxygen. The torch consists of valves, torch body, mixing chamber, and tips. The torch is sometimes referred to as a blowpipe, but this is not technically correct.

Tips. Tips attach to the torch body and come in many sizes to create different size flames. A cutting tip, also called a cutting head or cutting torch, is attached to the torch body to use for flame cutting. A cutting tip has a number of holes for the preheating flames around a center hole for the pure oxygen. Cutting tips also come in a variety of sizes and with different numbers of preheating holes. Heating, or rosebud, tips are used to preheat metals to improve their weldability. Welding tips come in a wide range of sizes to match the thickness of the metal being welded. Matching the tip size to the welding material and gas pressure is critical for creating quality welds.

Setting Up an Oxyacetylene Outfit

1 Secure the cylinders in an upright position, chained to a cart or strapped to a wall or post. Remove the protective cylinder caps. Wipe off the cylinder valve seats, regulator connections, and hose connections with a clean cloth. Crack open each cylinder valve briefly to expel any trapped dirt particles. "Flat top" acetylene cylinders (inset) may have antifreeze in the recessed valve seat. Use a clean rag to remove the liquid and dry the valve seat. This style acetylene cylinder requires a cylinder wrench to open the valve.

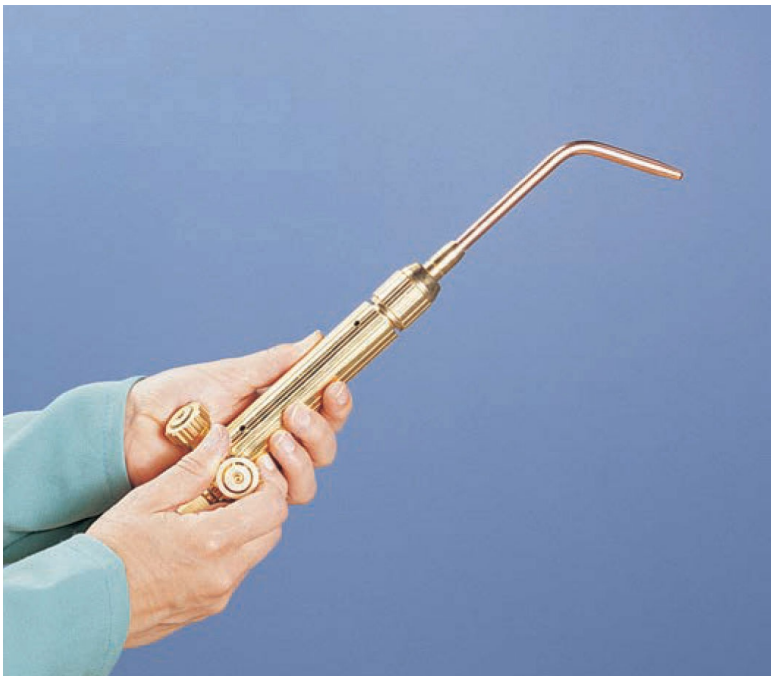
2 **Attach the regulators to the cylinders. (The acetylene connectors have left-hand threads.) Always hand tighten, then use a fixed wrench, not a pliers or an adjustable wrench, to tighten. Do not overtighten—a firm seating is all that is necessary. Attach the hoses to the regulators. The acetylene hose is red and left-hand threaded. The oxygen hose is green. NEVER use grease, oil, or pipe dope to lubricate fittings. Grease and oil can ignite spontaneously when they come in contact with oxygen—even without a spark or flame present.**

3 **Turn the regulator adjustment screws on the oxygen and acetylene regulators counterclockwise until they are loose. (Some regulators may have a knob.)**

4 **Open the oxygen valve slowly all the way, while standing to the side in case the regulator gauge glass shatters. Turn the regulator adjustment screw until oxygen begins to flow through the hose, then loosen the regulator adjustment screw to stop the oxygen flow. Slowly turn the acetylene cylinder valve 3/4 to 1 1/2 turns.**

5 **Adjust the acetylene regulator valve until the gas begins to flow, then loosen the regulator adjustment screw to stop the flow. Attach the torch to the hoses. Be sure to pressurize the system and check for leaks before lighting.**

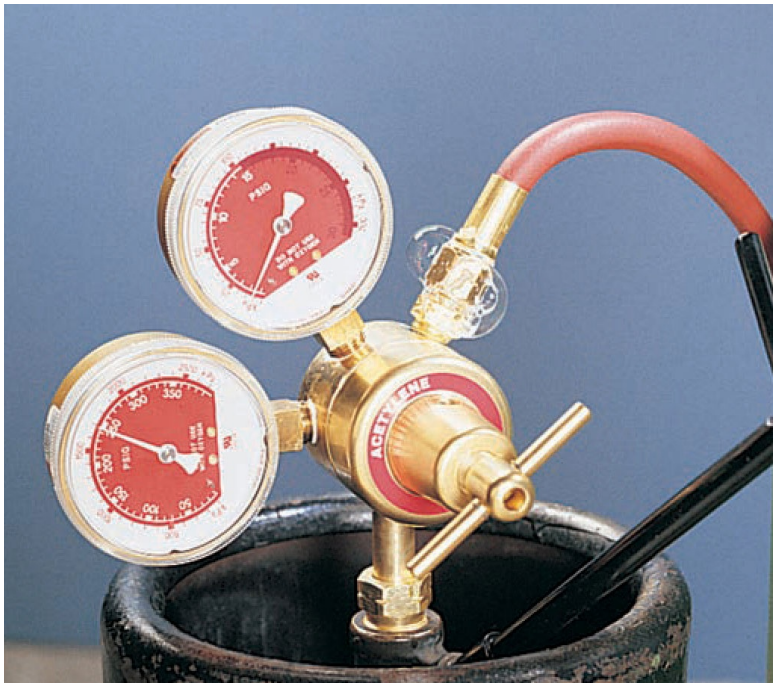
Pressurizing (turning on) an Oxyacetylene System



Make sure both torch valves are off. Turn both regulator adjustment screws counterclockwise until loose. Slowly turn the oxygen cylinder valve on. Once open, turn the valve all the way open to ensure proper seating without leaks. Turn the oxygen regulator adjustment screw clockwise until the gauge reads the desired pressure. (Refer to the manufacturer's specific instructions for operating pressures.) Open the oxygen valve on the torch to check the flowing oxygen pressure. Adjust if necessary and close the torch valve. Slowly open the acetylene cylinder valve 3/3 to 11/1 turns. (Leave the wrench on the valve if it is a

wrench-style valve.) Turn the acetylene regulator pressure adjustment screw until the desired pressure reads on the regulator gauge. Open the acetylene valve on the torch briefly to make sure the flowing pressure matches the desired working pressure. If not, adjust the regulator until the proper pressure is reached.

Checking for Leaks



Apply leak-detecting solution to all connections with a small brush. (You can use soap and water so long as the soap is not petroleum based.) If any connections cause bubbles in the solution, tighten the connections and check again.

BACKFIRE & FLASHBACK:

Backfire and flashback are two hazardous situations that can be caused by improper gas pressures. Backfire is the pre-ignition of the acetylene and oxygen inside the tip that causes a popping sound. This may damage the tip or spray molten metal from the weld area. Flashback is the flame burning backward into the torch or hoses, causing a popping or squealing noise. Flashback can cause an explosion in the hoses. Avoid both hazards by matching the tip size to the material being welded and by using the proper pressure settings. Using lower pressures than recommended can cause backfire and possibly flashback.

Pre-lighting Checklist:

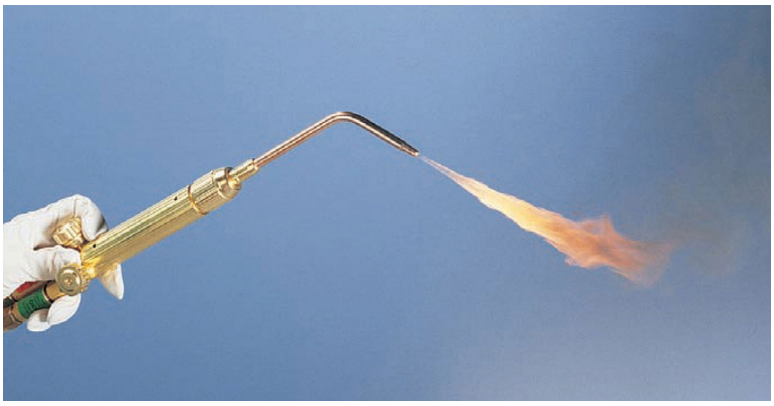
- Make sure torch valves are closed.
- Turn both regulator adjustment screws counterclockwise until loose.
- Slowly turn on the oxygen cylinder valve all the way. Turn the regulator adjustment to the proper pressure.
- Slowly turn the acetylene cylinder valve 1 1/2 turns. Turn the regulator adjustment valve to the proper pressure.

Some welders have been taught to open both the acetylene and oxygen valves before lighting the torch to avoid the smoky acetylene flame. This practice is no longer recommended.

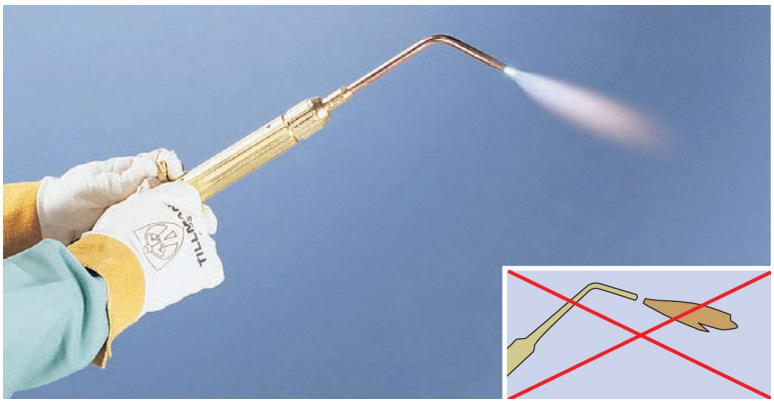
NEVER light a torch with a match or butane lighter.

Lighting the Torch

1 Hold the torch in one hand with the thumb and forefinger on the acetylene torch valve. Hold the striker in front of the torch about 3" to 6" away at a slight angle. Turn on the acetylene torch valve 1/1 to 1/1 turn.



2 Immediately use the spark lighter to light the flame. The flame will be yellow and smoky.

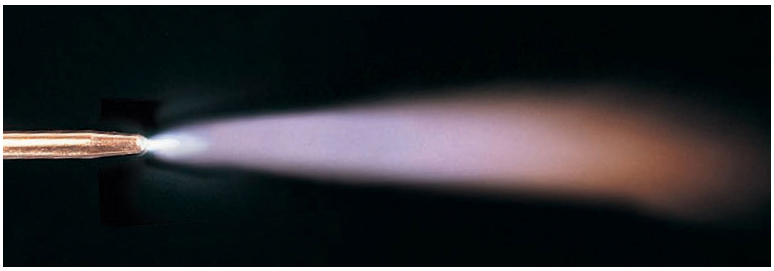


3 Put the striker down and adjust the acetylene torch valve with your right hand so the flame is burning without producing soot. The flame should not be separated from the torch (inset). Open the oxygen torch valve slowly. Adjust the oxygen to get a bright white inner flame and a bluish outer flame. Turn down the

acetylene to eliminate the excess acetylene feather if present. When you have finished welding, turn off the oxygen first, then the acetylene.

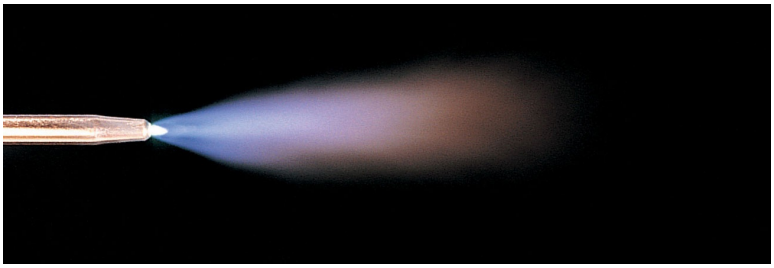
Flame & Flame States

The flame of an oxyacetylene torch has two parts—the inner or primary flame and the outer or secondary flame. The flame has different temperatures at different locations. The outside edges are cooler because they are burning with the ambient air, which is only 21% oxygen. The torch tip is cooler because complete combustion hasn't been reached. The hottest area is the tip of the primary or inner flame cone. Here the gases are completely combusted and are insulated by the secondary flame. There are three flame states for the oxyacetylene flame: carburizing, neutral, and oxidizing.



The carburizing or reducing flame has an excess of fuel. This is a useful flame as it will break down metal oxides to get at the oxygen, thus cleaning the weld area to a small degree. This process adds carbon to welds, which makes them harder. The carburizing flame has a bright white primary flame, an acetylene "feather" around the primary flame, and a bluish white secondary flame with orange edging.

The neutral flame is the exact point where the feather and the inner cone come together. In this flame, there is exactly enough oxygen present to provide total combustion of the fuel gas. Most welding and cutting operations use a neutral flame. The neutral flame has a bright white primary flame and a colorless to bluish secondary flame.



The oxidizing flame has an excess of oxygen. The white cone of this flame is small and pointed and somewhat paler than the neutral flame. A hissing sound often accompanies this flame. This flame is not

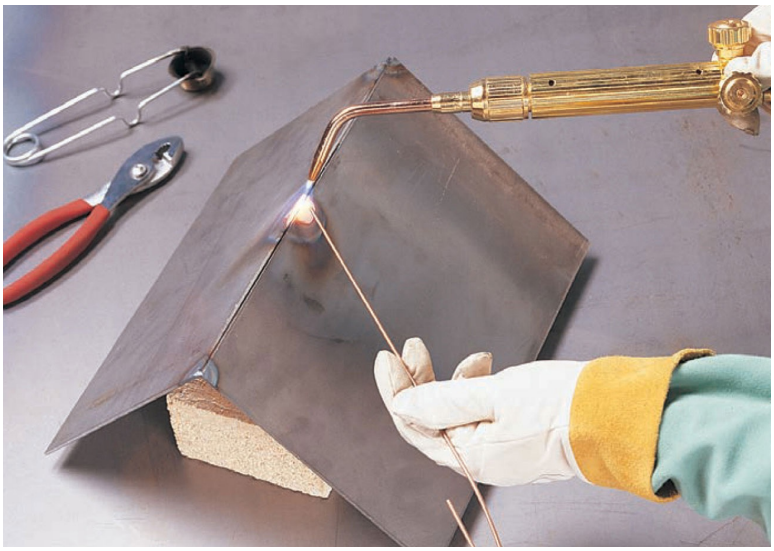
particularly useful as it hastens oxidizing, which is not desirable in welding. It can, however, be used for removing carbon from molten metal, thus softening the metal.

Pre-welding Checklist:

- Check hoses for damage before pressurizing the system.
- Prepare metal for welding by wire brushing or sanding off mill scale and rust. Use acetone or denatured alcohol to remove oil or other chemical residues.
- Use fire bricks to avoid unnecessary heat loss and prevent welding to the welding table.
- See manufacturer's recommendations for appropriate tip sizes and gas pressures.
- Set up materials and clamp if necessary.

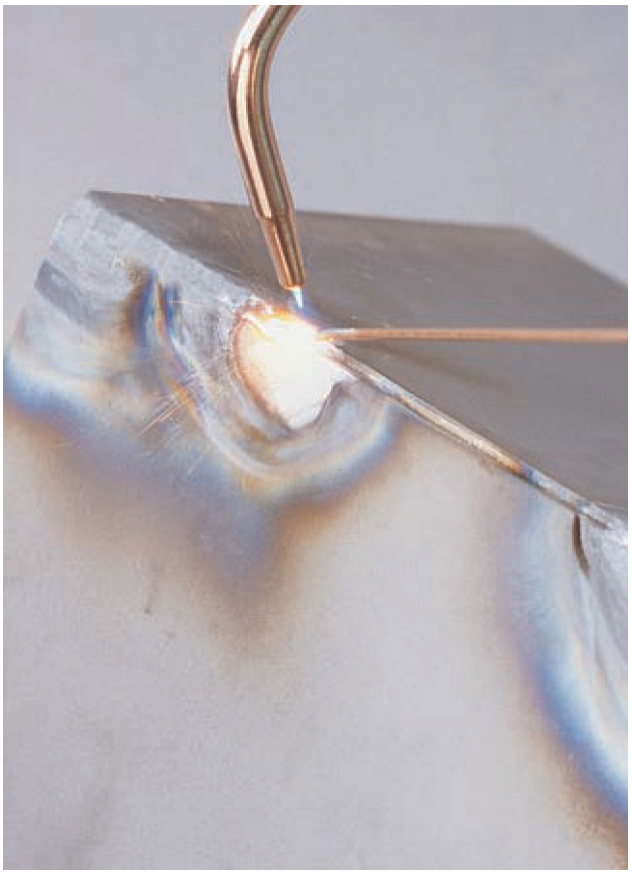
NOTE: The directions for oxyacetylene welding are for right-handed welding. Reverse the directions for left-handed welding, or if you find it easier to manipulate the filler rod with your right hand.

Welding with Oxyacetylene



1 Select an appropriate filler rod and lay it on the table next to the bricks. Light the torch and adjust to a neutral flame. Pull down your face shield. Place small fusion tack welds at each end of the joint and in the middle if it is a long joint. (A fusion weld uses no filler rod.) Turn off the torch, oxygen first then acetylene, and check that your tacked piece is still in the desired position. If not, use a hammer to move it into position or break the tack weld and reposition.

2 With the torch at a 45° angle to the right and oscillating the torch in a 1/4" to 1/2" circle over both metal pieces, create a weld puddle at the right end of your workpiece.



3 When a molten puddle has formed, move the filler rod close to the puddle and flame, but not in it. Begin moving slowly to the left while oscillating and maintaining the molten puddle. Dip the filler rod into the middle of the molten puddle and remove it, but keep it within the heat zone.

4 **Continue dipping, oscillating, and moving to the left. As you reach the end of the weld, the cumulative heat build-up may make it necessary to adjust to a shallower angle to deflect heat away from the puddle and prevent burn through. When finished, turn off the oxygen torch valve first, then the acetylene torch valve. The weld should penetrate to the back without burning through.**

Depressurizing an Oxyacetylene Outfit:

When you have finished welding, or if you are going to stop welding for more than 10 or 15 minutes, depressurize your setup. The hoses and regulators are designed to leak small amounts of fuel and oxygen if they are pressurized and not being used, so it is important for safety and economy to depressurize them. You will soon be so comfortable with the pressurizing and depressurizing steps that it won't seem like an inconvenience at all. It is important to do the fuel gas and oxygen in separate steps, to prevent having mixed, unburned oxyacetylene in the torch.

- Close the fuel gas cylinder valve.
- Open the fuel gas torch valve until both gauges read zero.
- Loosen (counterclockwise) the fuel gas regulator adjustment screw.

- Close the fuel gas torch valve.
- Close the oxygen cylinder valve.
- Open the oxygen torch valve until both gauges read zero.
- Loosen (counterclockwise) the oxygen regulator adjustment screw.
- Close the oxygen torch valve.

Oxyfuel Tips

Gas Options:

The most useful fuel gas for oxyfuel welding is acetylene. Its neutral flame generates the highest heat and heat concentration with the lowest chemical interactions with the molten metal. Other fuel gases, such as MPS or MAPP and propylene can be used for brazing and cutting applications. Natural gas and propane can be used for brazing and heating operations. Make sure that the equipment—hoses, regulators, torches, and tips—are designed for use with the gas you choose.

GAS	DENSITY (Air = 1)	TEMPERATURE OF NEUTRAL FLAME WITH OXYGEN
Acetylene	0.906	5589° F
Methylacetylene-propadiene (MPS)	1.48	5300° F
Natural gas	0.62	4600° F
Propane	1.52	4579° F
Propylene	1.48	5250° F

Maintenance. The primary maintenance for oxyacetylene welding equipment is cleaning the torch tip. A dirty tip will spark, pop, and often direct the flame sideways. Tip cleaners are inexpensive sets of cleaning rods used to clean the various sized tip orifices (see photo, page 27). The set usually comes with a small file to smooth the tip. To clean, simply insert the correctly sized tip cleaning rod into the orifice, and pull back and forth. Do not rotate the tip cleaner as this may enlarge the orifice. Also, do not use drill bits to clean tips. The sharp edges of the bit will cut grooves into the tip. Cleaning rods have smoothed edges and are sized especially for tips. Do not clean tips while the torch is lit.

Fire Bricks:

Fire bricks are specially made bricks that have little water content so they will not explode when heated to high temperatures. Fire bricks do not pull the heat from your weld or braze, and you cannot weld your material to them.

Brazing

Brazing is very similar to soldering since flux is applied to tightly fitted metal parts that are then heated to the point where filler material will melt and be drawn into the joint. Silver soldering and hard soldering are terms incorrectly used to refer to brazing. Brazing is different from soldering because it takes place at temperatures over 840° F and below the melting point of the base metals. The metals are not fused, but held together by the filler metal adhering to the base metals through capillary action.

Brazing supplies include flux and silver solder (left). Braze welding requires flux coated rods, or separate flux and rods.

There are a number of industrial brazing processes, such as dip brazing, furnace brazing, and induction brazing. The home welder is likely only to do torch brazing. Torch brazing can be done with an oxyfuel torch using acetylene as the fuel gas, or any of the other fuel gases (see page 35). NOTE: Different fuel gases require different regulators, hoses, torches, and tips.

For brazing to work, the gap between the parts must be between 0.002 and 0.010 inches. If the gap is too tight, the flux and filler will not flow evenly through the joint. If the gap is too big, the strength of the joint is lessened. Gaps between parts can be measured with a feeler tool, available at automotive stores. Items to be brazed must be absolutely clean and free from rust, corrosion, grease, oil, and cleaning compound residues.

Brazing is often used commercially to join dissimilar metals such as tungsten carbide saw teeth to a steel saw blade. Another common use for brazing is in lugged bicycle frames. Because nearly every metal can be joined using brazing, it is highly suitable for art applications.

Thoroughly clean and flux both sides of the joint area. Using a small torch tip, heat the entire joint area until the flux turns clear and starts to run. Add enough filler metal to fill the joint. (Silver alloy is shown.) After the metal has cooled, the flux residue can be removed with hot water.

Braze Welding

Braze welding is similar to standard oxyacetylene gas welding except the parent or base metals are not melted, so there is no molten puddle. Instead of a steel alloy filler rod, a flux coated brass filler rod is used. Braze welding is often incorrectly referred to as brazing. Braze welding does not use capillary action to pull filler material into the joint—the filler metal is deposited as fillet or groove welds.

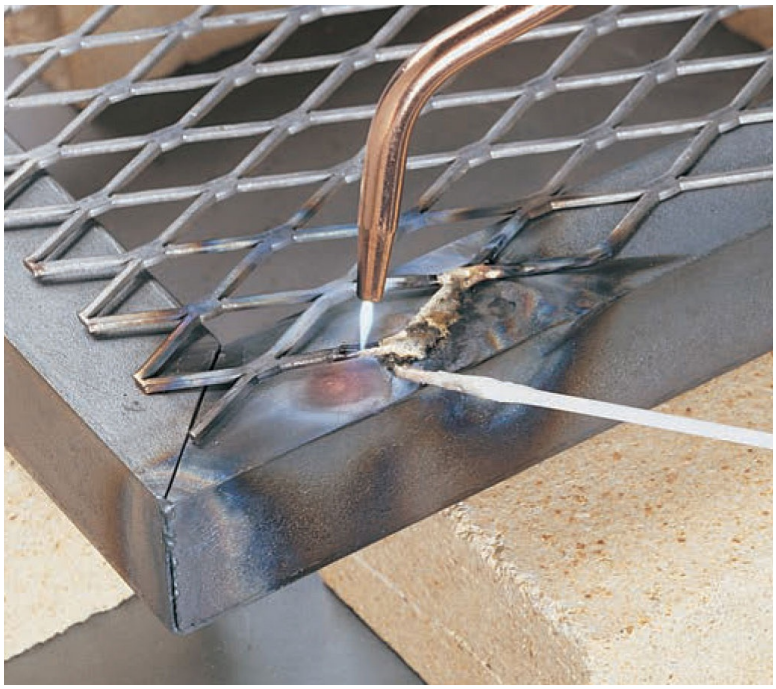
The brazing rod is melted by the heat of the metal and the flame, but it should not be held in the flame itself. The parts for braze welding should fit tightly, but the gap is not as important as with brazing.

Braze welding is used for joining dissimilar metals and for metals of different thicknesses. This technique is often used to repair cracked or broken cast iron.

Braze welding has less distortion than oxyacetylene welding because less heat is applied to the parts. A disadvantage is that it is not as strong as welding where the base metal is melted, but a well-made braze weld is still sufficient for most non-structural applications. Because the base metals do not need to be melted, braze welding can be done with any of the fuel gases listed on page 35.

If you are creating a piece that will be welded and braze welded, you must be careful to complete the non-brazed welds first. The heat involved with all other welding processes will boil off the brass alloy of a braze weld, ruining the weld and creating toxic fumes.

1 Braze welding is useful for joining thin metals, like this expanded metal, to thicker metals. Heat both parts, directing more heat toward the thicker part. It may take a long time for the thicker metal to heat. Using fire bricks will prevent a metal table top from absorbing any heat.



2 When both parts glow a dull cherry red, touch the flux coated rod to the joint. The flux and the filler metal will melt. If the metal is molten or the fluxed rod comes in contact with the flame, the flux will burn and the filler metal will boil. This results in a poor joint in addition to giving off toxic fumes.

ELECTRICITY FOR WELDING

Arc welding and cutting processes—shielded metal arc, gas metal arc, gas tungsten arc welding, and plasma cutting—all use electricity to generate the necessary heat. Understanding electricity is not necessary to use these processes, but knowing basic terms and concepts will help you understand why certain welding events occur.

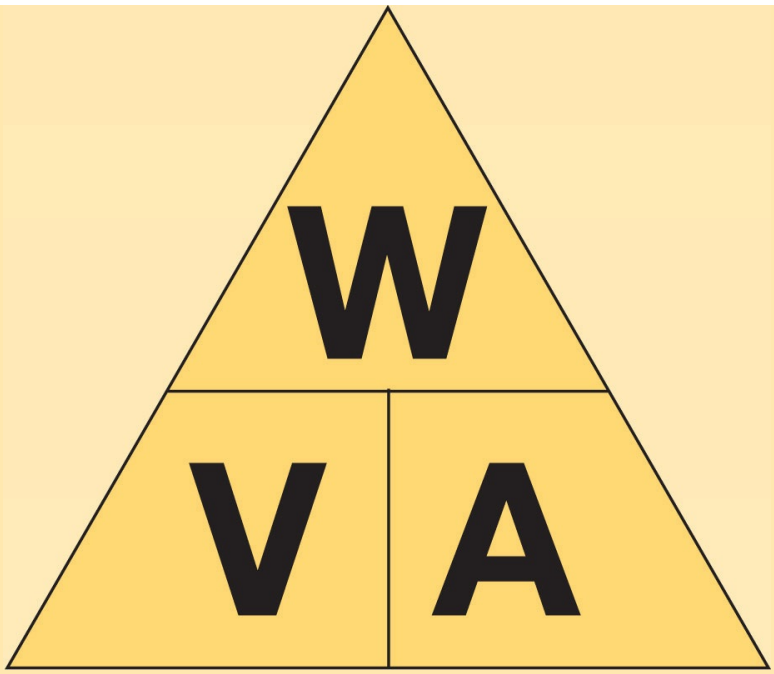
Electric current is the flow of electrons through a conductor from a high concentration of electrons (negative charge) to a low concentration of electrons (positive charge). As electricity flows through a conductor, it generates heat based on how much resistance the conductor offers. An arc is simply a sustained electrical discharge across an air gap. Because air is highly resistant to electron flow, an enormous amount of heat is generated by the movement of electrons across this gap. The heat generated by an arc is in the area of 11,000° F, but about half of this heat is dissipated.

ELECTRICAL UNITS. The units used to refer to electricity are voltage, amperage, and wattage.

Voltage or volts (v) is the measure of electric potential or the electric pressure. The voltage controls the size of the air gap that the arc can cross. The higher the voltage, the larger the gap the arc can cross.

Amperage or amps (a) is the volume of electrons flowing through a conductor. The amperage controls the size of the arc.

Wattage or watts (w) is the measurement of the amount of electrical energy or power contained in the arc. Wattage affects the width and depth of a weld.



Volts, amps, and watts are related to each other in such a way that volts × amps = watts.

WELDING POWER. Power for welding may be supplied in one of the following ways:

Constant Voltage (CV). The arc voltage is maintained even when the current (amps) changes. This means if the arc length is changed, which changes the current flow, the voltage stays relatively the same.

Constant Current (CC). As the amperage fluctuates, the voltage increases or decreases to keep the total power (wattage) output the same.

OPEN CIRCUIT AND OPERATING VOLTAGE. The open circuit voltage is the voltage that exists at the electrode tip when the machine is on but no arc has been struck. The higher the open circuit voltage, the easier it is to strike an arc. Open circuit voltage is usually between 50 and 80 volts. The higher the voltage, the greater the risk of electrical shock.

The operating voltage is the voltage when the arc is struck and the circuit is completed. This is usually between 17 and 32 volts depending on the arc length, the type of electrode, the type of current, and the polarity.

POWER SOURCES FOR WELDING. There are three sources for producing the low-voltage high-amperage combination that arc welding needs.

A mechanical generator produces power through the use of a gasoline or diesel engine.

A step-down transformer takes available high voltage alternating current and changes it to a low-voltage high-amperage current.

An inverter uses solid state electronics to change the current without the weight of a transformer.

CURRENTS USED FOR WELDING. The type of current used and the polarity is important to welding.

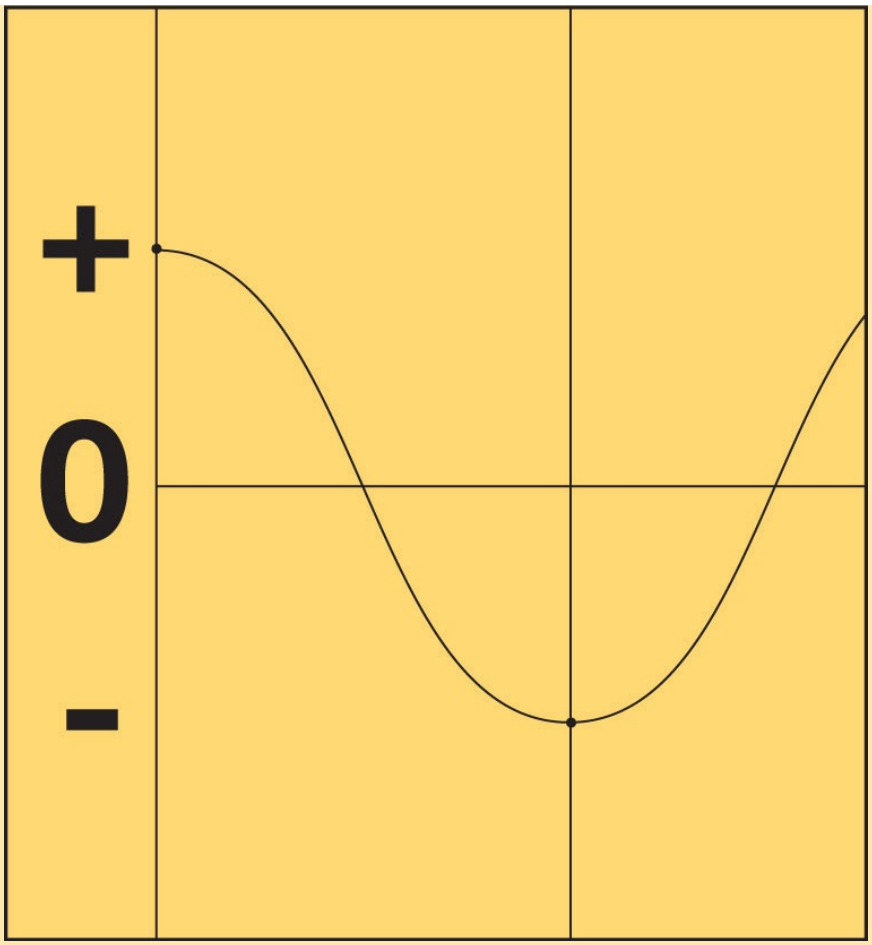
Alternating Current (AC) is standard available household current. The electron flow changes direction two times per cycle. Welding with AC means that the electrode and the workpiece alternate between positive and negative, so the welding heat is distributed evenly to both. This balances

penetration and build-up.

Direct Current (DC) electrons flow in one direction only. A rectifier is used to convert alternating current to direct current. With direct current, there are two polarity options:

> **Direct Current Electrode Negative (DCEN)—**formerly called straight polarity—means the electrode is negative, the workpiece is positive; electrons are flowing from the electrode to the workpiece and the heat is concentrated in the electrode.
>
> **Direct Current Electrode Positive (DCEP)—**formerly called reverse polarity—means the electrode is positive, the workpiece is negative; the electrons are flowing from the workpiece to the electrode. DCEP produces the best welding arc characteristics.

DUTY CYCLE. The duty cycle is the amount of continuous running time at a given power output for a welding machine, given as a percentage for a ten minute period. Because welding machines produce heat internally, they need a certain amount of cooling time. A 60% duty cycle means that a machine can run continously at that setting for six minutes, then it will need to cool for four minutes. Duty cycle is critical in construction and industrial applications, and it can be important for home shop use. A 10% duty cycle at the maximum setting means one minute of welding and nine minutes of cooling. This could be a problem for large projects on thick material. The higher the duty cycle, the more expensive the machine.

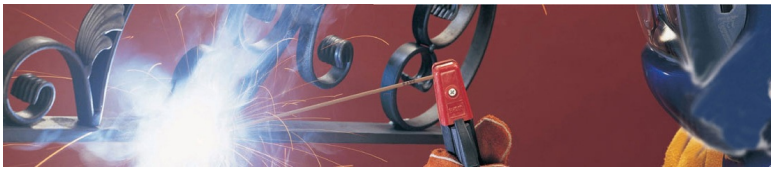


Alternating current alternates between positive and negative polarities, passing through a zero, or no current point, between the two.

NOTE:

Work leads and work clamps are sometimes referred to as ground leads and ground clamps. This is not technically correct, as the electricity is not being grounded. Instead, the work lead and clamp are allowing for completion of the circuit back to the machine.

SHIELDED METAL ARC WELDING



A shielded metal arc welder consists of a power source, electrode holder, and work clamp.

Shielded metal arc welding (SMAW) is also referred to as arc or stick welding. The process involves the heating of the base metal to fusion or welding temperature by an electric arc that is created between a covered metal electrode and the base metal. The coating or covering on the electrode provides both flux and shielding gas for the weld. The electrodes come in 9" to 15" straight lengths in a range of wire thicknesses from 1/1" to 3/8", hence the name “stick.” SMAW is used extensively for fabrication, construction, and repair work because the machinery is inexpensive and fairly simple, and the electrodes are inexpensive. There are drawbacks to SMAW: It doesn’t work well on thin materials (less than 1/8" is difficult), electrodes need to be changed frequently as they are used up, and the protective slag coating must be chipped off each weld.

Safety. Shielded metal arc welding uses electricity, so there is always the possibility of receiving an electric shock or being electrocuted. When an electrode (stick) is placed into the electrode holder, it is “live.” If the electrode touches anything that the work clamp is in contact with, the circuit will be completed and an arc will be struck. To prevent this from happening, always remove the electrode from the holder when you are not actively welding. Do not use your bare hands to insert or remove electrodes—always touch electrodes with dry gloves. Remember that water and electricity never mix well, so do not weld while standing on a wet or damp floor or ground, and do not weld outdoors in the rain. The electrode will be hot after use, so take care where you dispose of electrode stubs. A metal bucket is a good addition to your SMAW workshop.

SAFETY

- Welding helmet with #10 to #14 filter
- Leather, wool, or cotton long pants; leather jacket
- Heavy-duty welding gloves
- Safety glasses
- Hat
- Leather boots or shoes
- Ventilation

SMAW welding produces ultraviolet and infrared rays, harmful fumes, and hot spatter. Protect your eyes with a #10 to #14 filter in a full-face welding helmet or

hood. Heavy-duty leather welding gloves and a welding jacket with leather sleeves are necessary to protect you from the molten spatter. Proper ventilation from an exhaust hood or fan is important since many of the chemicals used in the electrode coatings are hazardous if inhaled. Also, it is a good idea to screen off your welding area so others are protected from the intense light of the arc.

The Equipment. SMAW machines are available as either alternating current (AC), direct current (DC), or with the capability of switching between the two. The machine itself is simple in that it merely converts high-voltage low-amperage line current into low-voltage high-amperage welding current. Output is controlled with one knob. You often will hear SMAW machines referred to as "buzz boxes."

AC welding machines meet most home and small shop needs, are inexpensive, and are readily available. Because the alternating current cycles through a zero current between the positive and negative polarities, it can be difficult to strike and maintain an arc. DC machines are easier to use and have many home and hobby applications, but they are more expensive. Because DC current can have its flow reversed (see page 39), a DC machine has more versatility in terms of the electrodes that can be used. This allows for a wider range of welding positions, metal thicknesses, and metal types that can be welded. This versatility makes a DC shielded metal arc welder well worth the extra expense.

The equipment itself consists of the welding machine, which usually has one adjustment knob, an electrode lead with electrode holder (sometimes called a stinger), and a work lead with work clamp. You will often see work leads and work clamps referred to as ground leads and ground clamps. The work lead and clamp are not grounding the electricity, they are completing the circuit back to the machine.

Useful tools for shielded metal arc welding are a pliers, chipping hammer, and wire brush.

SMAW Electrodes. SMAW electrodes are solid, round, metal wires coated with flux and other components. In addition to producing shielding gas and flux, the covering may also contain additional metals for filler or alloying elements for the weld.

The American Welding Society (AWS) publishes standards for the electrodes. Electrodes come in diameters ranging from 1/16" to 3/8" in increments of 1/32". The electrode diameter measures the wire itself, not the diameter of the wire with the covering. The electrode designation is inked onto the covering near the bare end of the electrode. The number classification for SMAW electrodes begins with the letter E because they are electrodes. The first two or three numbers on the left denote the tensile strength of the properly completed weld in thousands of pounds per square inch. The second number from the right indicates the welding position appropriate for that electrode: 1 = all, 2 = flat grooves and flat or horizontal fillet weld, 3 = flat only, 4 = all. The last two numbers designate the current and polarity uses and other special notes. There also may be electrode suffixes that denote alloys that have been added to the electrode.

SMAW electrodes are sold in 5- or 10-pound boxes. Specialty electrodes may be bought a pound at a time. It is important to keep electrodes dry, either in the original box or a storage container.

Each electrode manufacturer may have a number of electrodes of a specific AWS designation that are slightly different and have been tailored to specific uses. The diameter of the electrode will determine which amperage to use. Use the manufacturer’s guidelines to determine amperage. If not available, start with 90 to 120 amps minimum range for a 1/8" electrode and add 40 amps for each 1/1" increase in diameter. This will give you a rough minimum starting amperage.

Electrodes for SMAW are stamped with a numeric code.

The most commonly used electrodes are 6011, 6013, 7014, and 7018. The 6011 and 6013 electrodes will work with AC power, the 7000 electrodes will not. For a beginner, 6013 with DC power is generally the easiest electrode to use in terms of striking an arc and maintaining a consistent arc. It is always a good idea to talk with your welding supplies dealer about what type of welder you are using, the type of welds you are making, and the materials you are working on to get the best electrode for your purposes.

Slag. Shielded metal arc welding produces a weld that is covered with a coating of ceramic-like slag. The flux and other components in the covering clean the material to be welded and also float out impurities in the weld. These impurities and flux solidify on top of the weld which protects the cooling weld from the effects of oxygen in the atmosphere. The slag must be scraped or chipped away before the weld bead is covered with another weld layer or before the weld is painted or finished. Safety glasses should be worn during this procedure.

Pre-welding Checklist:

- Electrode and work leads tightly attached to machine terminals.
- Cable insulation free of cuts, damage, and wear.
- Electrode lead tightly connected to electrode holder.
- Work lead tightly connected to clamp.
- Work clamp firmly clamped to worktable or workpiece.
- Floor is dry.
- Ventilation is adequate to draw fumes away from welder’s face.

Shielded Metal Arc Welding

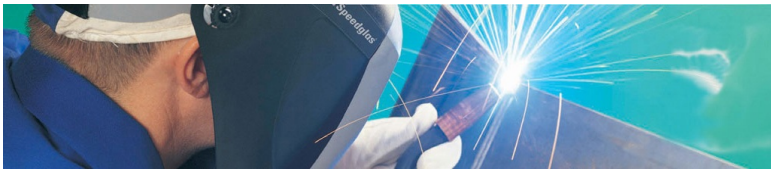
1 Set up your material to be welded. Make sure the electrode holder is not touching the workpiece or worktable. Attach the work cable clamp to the table (inset) or workpiece. Turn on machine. Adjust the range switch for the desired amperage. Wearing leather gloves, place an electrode in the electrode holder. Position the electrode over the area to be tacked, flip down your helmet, and tap or scratch the electrode on the area to be tacked to strike an arc. After making your tack welds, remove the electrode from the electrode holder. Check to see that the tacked pieces are aligned properly. If not, use a hammer to move them into alignment or break the tack welds and retack. Chip slag from tack welds so it does not contaminate the final weld.

2 Replace the electrode in the electrode holder, and position the electrode over the left side of the area to be welded. Hold the electrode at a 10° to 20° angle to the right. Flip down your hood and scratch or tap to strike an arc. The distance between the metal and electrode should not exceed the thickness of the electrode bare wire diameter. Move slowly to the right until the weld is completed.

3 To remove slag, hold the workpiece with pliers at an angle and scrape or knock the slag with the flat

blade of the chipping hammer. Wear safety glasses when chipping slag.

GAS METAL ARC WELDING



A gas metal arc welding setup consists of a power source, wire feed, work cable with clamp, supply cable with gun, and gas cylinder with regulator.

Gas metal arc welding (GMAW), also referred to as MIG (metal inert gas) or wire feed, is a process where a consumable electrode (wire) is automatically fed through a welding gun along with a continuous flow of a shielding gas. The actual application of filler metal is achieved with most small machines through the short circuit transfer method. Other transfer methods used by more powerful machines are short circuit globular and spray pulse.

The GMAW process has a number of advantages. The gun or torch can be held at a uniform distance from the weld, unlike shielded metal arc welding where the distance from the electrode holder to the weld becomes shorter as the electrode is consumed. The trigger power control on the welding gun also makes it possible to be completely positioned and ready to weld without accidentally striking an arc. When ready to weld, the welder can flip down the helmet and pull the trigger without getting off target. Because the electrode is the filler, the welder does not need to coordinate a filler rod in one hand and the torch in the other. The GMAW gun can be held steady with both hands to create a uniform bead. Because of the shielding gas, GMAW welds are smooth and clean, with no slag to chip or grind. The GMAW process can operate at very low amperages and is a relatively cool welding process, so 22 and 24 gauge sheet metals can be welded without distortion. The process also requires narrower beveling for thicker plate welds, so less time is spent on grinding.

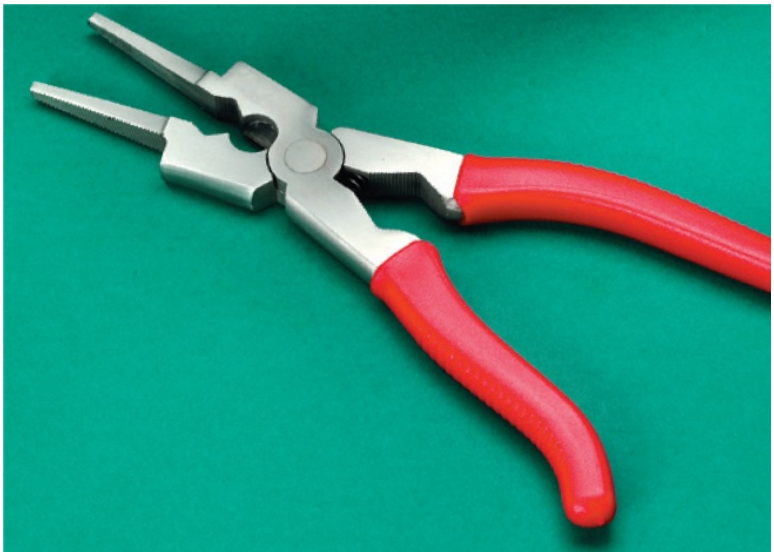
SAFETY

- Welding helmet with #11 to #12 filter
- Leather, wool, or cotton long pants, long sleeve shirt, and hat
- Leather gloves with gauntlet
- Leather boots or shoes
- Ventilation

Some disadvantages of GMAW are that the shielding gas nozzle does not allow for welding in tight spaces without some modifications. Because the shielding gas can be disrupted or blown away by drafts easily, the process is not suited for working outdoors.

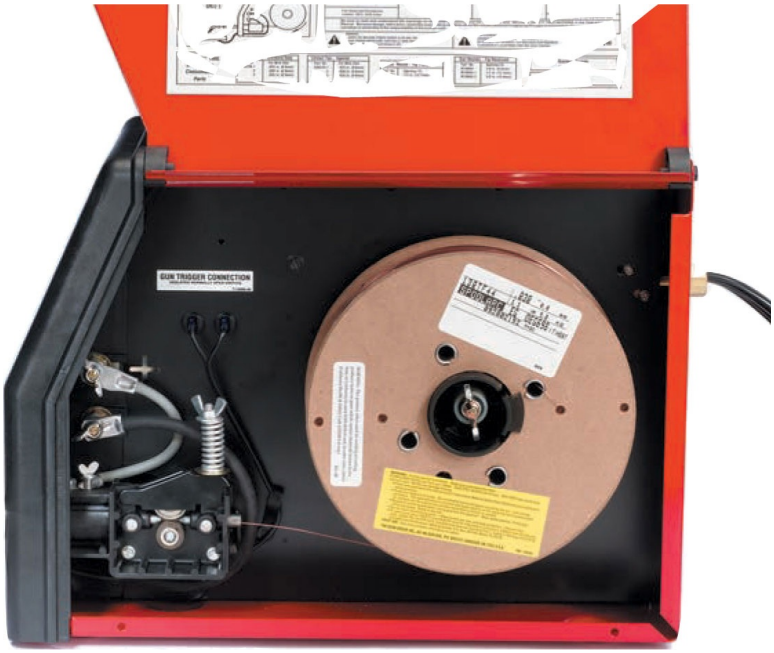
The Equipment

Power supply. In the small GMAW units, the power supply and wire feed are integrated into the same cabinet. In larger, multipurpose machines, the wire feed is a separate unit. The power supply converts the standard alternating current (AC) into direct current (DC). Alternating current is not appropriate for gas metal arc welding because its constantly switching flow does not yield a steady, consistent arc. On the machine, you will be able to adjust the voltage, polarity, and wire feed rate; the machine adjusts the amperage. When using the power source to weld with a shielding gas, the machine should generally be set up for electrode positive, that is, the electrode is positive and the workpiece is negative. If used without shielding gas and with flux cored wire, the polarity usually needs to be switched to electrode negative. This is achieved by switching the contact wires within the machine. Larger, multipurpose machines may have a switch to change the polarity. Always check manufacturer's recommendations for polarity settings.



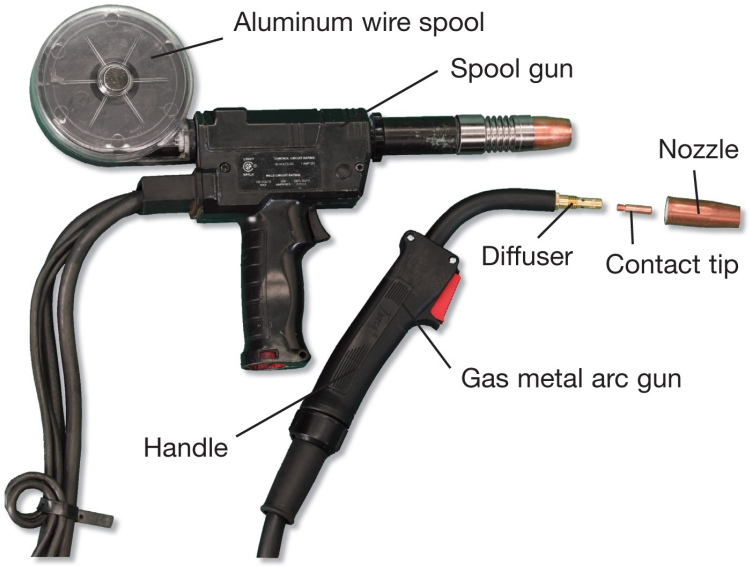
A MIG pliers is a handy tool for gas metal arc welding.

Wire feed. The wire feed consists of a spool of wire, a tension controller, and rollers and a roller motor. The wire speed is set by the speed adjustment knob, depending on the thickness of the material being welded. The rollers have V or U grooves sized to match particular wires. Most machines come with two-sided rollers that can be switched over to handle two different size wires.



The wire feeding mechanism consists of a spindle to hold the wire spool, drive wheels, rollers, and a tension adjustment. Most welders now have a reference chart with recommended settings.

Gun. The GMAW gun, sometimes referred to as a torch, is attached to the welding machine via the supply cable. The cable carries the power, the power control, the wire in a special liner, and the shielding gas. The gun has a trigger that turns the power on and off, which also starts the wire feed and the shielding gas flow. The gun generally has a goose neck shape, although straight neck and flexible neck guns are available. A contact tip is screwed or cam locked into the gun. This tip has an orifice the same size as the wire being used. It is important that this be sized correctly—too large and good electrical contact between the source and the electrode will not be made, too small and the wire will not fit. The shielding gas is directed toward the work area with a nozzle. On most home versions, the relationship between the contact tip and the gas nozzle stickout is not adjustable; larger welders have a wider variety of nozzle sizes and shapes. It may be worthwhile to purchase an aftermarket adjustable system. When using the GMAW process, it is important that the supply cable be kept as straight as possible to prevent kinking the wire or impeding the gas flow.



A spool gun is used for feeding aluminum wire because it often breaks or misfeeds through a standard cable. A standard gas metal arc gun consists of a handle, gas diffuser, contact tip, and nozzle.

The final piece of equipment is the work cable with clamp. This is clamped to the workpiece or to a metal work surface that the piece sits on to complete the circuit.

Electrodes. When choosing an electrode (wire), consider the composition properties, cleanliness of the base metal, and the shielding gas. If you will be welding out of position, this will also be a factor. There are dozens of wire choices for GMAW.

Most home GMAW welders use 1-pound or 10-pound wire spools. Larger spools are generally less expensive.

Electrodes are labeled with alpha-numeric codes that describe their type, tensile strength of the weld, whether it is solid or tubular (tubular is flux cored), and chemical composition. For mild steel, ER70S-3 is a good general purpose wire. ER70S-4 and ER70S-6 are good wires for dirty or rusty metals. Wire also is available for welding aluminum and stainless steel. Available wire sizes are 0.024, 0.030, 0.035, and 0.045 inches.

Using a wire feed machine without shielding gas requires the use of flux cored wire (often called innershield), and the process is then called flux cored arc welding (FCAW). Because the wire makes the electrical contact as it travels through the contact tip, the flux must be inside the wire, which makes flux cored wire more expensive than regular GMAW wire. Commercial welders may use a “dual shield” flux cored wire that does use a shielding gas. Welds made with this process are as clean as regular GMAW welds.

Flux cored arc welding can be done outdoors because there is no shielding gas to be disturbed by wind and weather. Unfortunately, using flux cored wire results in a less attractive weld due to the presence of slag and more spatter. The flux cored wire usually has greater penetration and is often used to stretch the capabilities of a small welding machine. Because 0.035" is the smallest diameter for flux cored wire, it is not appropriate for welding thin sheet metal. The lowest setting for this size wire is still too hot for this application.

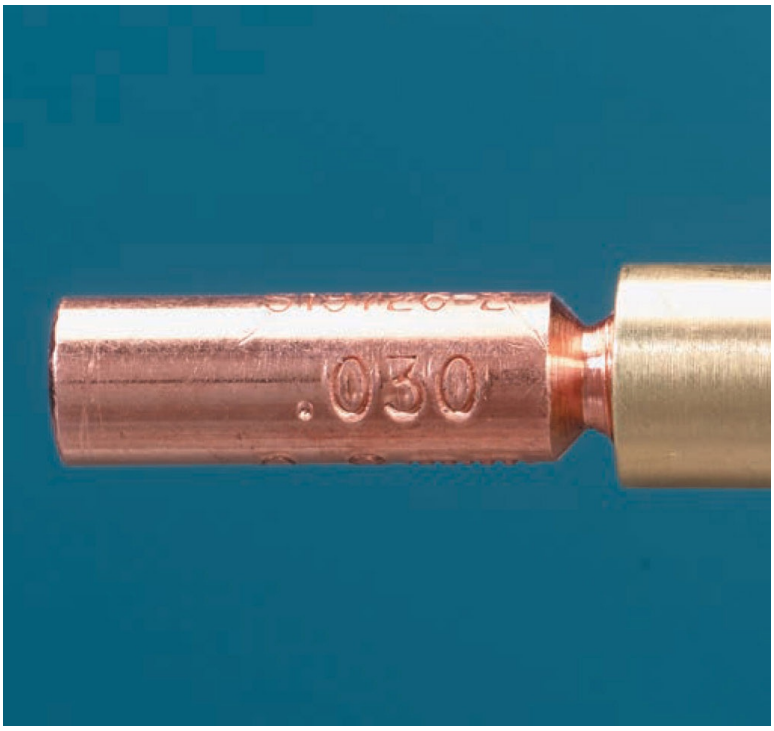
Shielding Gas. The shielding gas for GMAW is supplied by a cylinder with a flow regulator and connecting hoses. The gas line is connected to the welding machine, which directs it through the cable.

Carbon dioxide is suitable for general GMAW welding. It gives good penetration and is inexpensive compared to other gases. Argon and carbon dioxide in a 75% argon and 25% carbon dioxide mix is the standard GMAW shielding gas. It is slightly more expensive than pure carbon dioxide, but it yields welds with less spatter. Pure argon is used for shielding aluminum welds. If you choose to use pure carbon dioxide, select an electrode that performs well with this shielding gas.

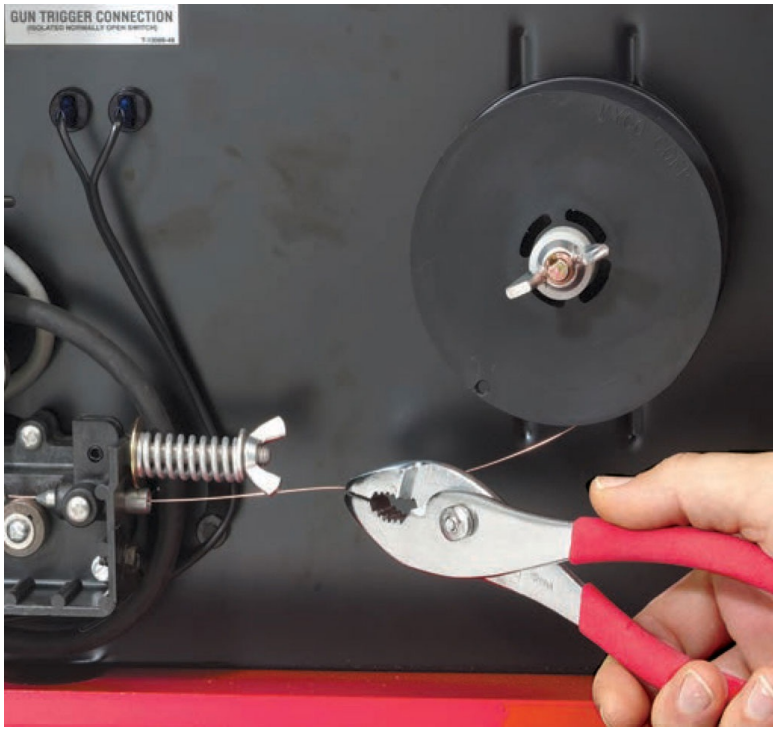
A flow meter registers gas flow with a small floating ball.

Gas Cylinder Safety. Gas cylinders store compressed gases at pressures up to and greater than 2000 psi. This is sufficient pressure to send a tank through a concrete wall if the cylinder valve should be damaged. It is important to be extremely careful with gas cylinders even when they hold the non-flammable gases used in GMAW welding. Gas cylinders should always be upright and chained or strapped to a wall, post, or cart. Never drag a cylinder; never lay one down or roll it flat. To move a cylinder, chain it to a handcart first. If you must move a cylinder without a handcart, tip it slightly and roll it. Never weld anything to the cylinder or safety cap—and be careful to never accidentally strike an arc against a cylinder. If you do, you will have to purchase that cylinder.

Setting Up the Wire Feed



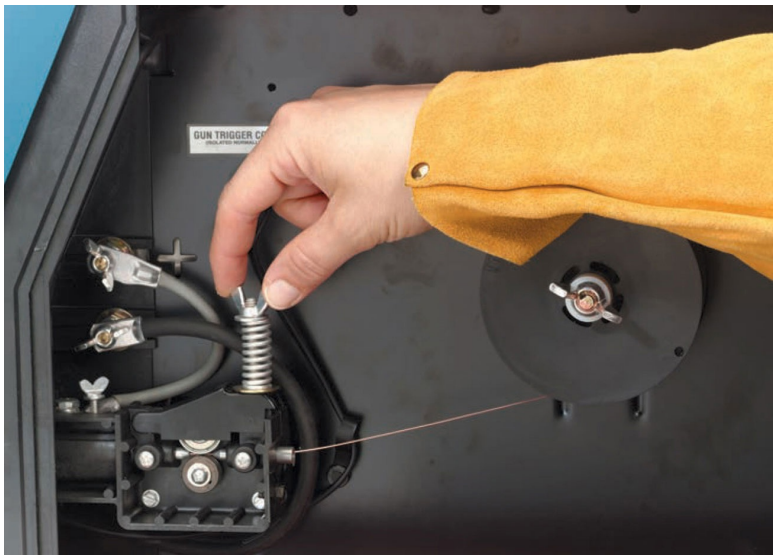
1 Contact tubes are stamped with their size. Make sure the contact tube and the drive roll grooves are the correct size for the electrode you are using. Place the wire spool on the spindle, and secure it with the pin lock, lock ring, or wing nut. Make sure it is feeding in the proper direction.



2 **After releasing and cutting off the crimped wire end, hold the wire firmly with a pliers. The wire is tensioned and the entire spool will rapidly unroll if you do not hold it firmly. Swing the tension arm or pressure roll out of the way. Push the wire through the inlet wire guide, through the groove on the drive roll, and out through the outlet wire guide.**

NOTE:

Unless your machine has an inch switch for advancing wire or a purge switch for activating gas flow, you will use the gun trigger to accomplish both tasks. Using the gun trigger means the wire is “live” and will arc to anything the work clamp is touching.



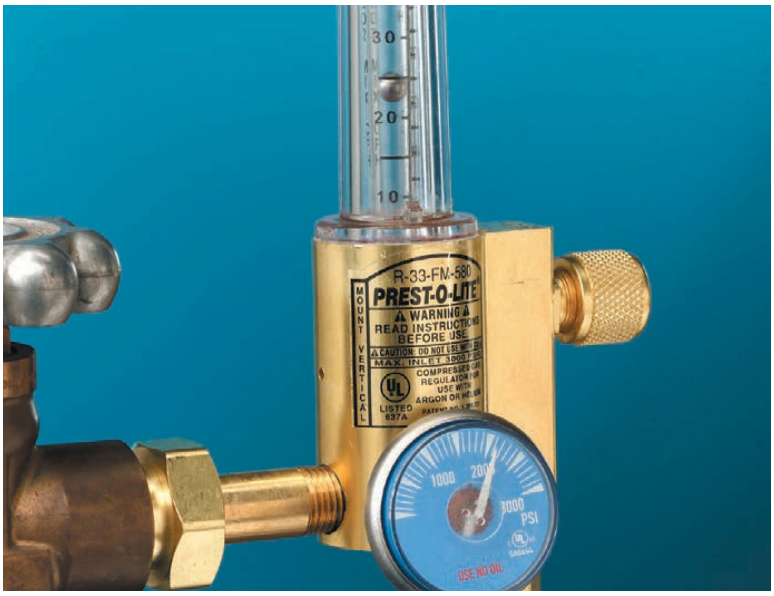
3 Swing the tension arm or pressure roll back into position. Adjust tension according to manufacturer's directions. On a new machine, the drive roll pressure will already be set. Make sure the wire is aligned perfectly straight—not up and down or side to side—on the drive roll. Turn the machine on, turn the wire speed to its highest setting, pull the cable straight, and depress the trigger. Some machines have an inch button that feeds the wire without supplying power to the contact tip or wasting shielding gas while loading wire.

Setting Up the Shielding Gas Flow Meter

1 **Open the cylinder valve briefly to clear out any dirt. Wipe the cylinder threads with a clean, dry cloth.**

2 **Attach the flow meter to the cylinder. Use a fixed wrench to prevent damaging the brass fittings.**

3 Turn the knob on the flow meter clockwise to tighten it so no gas can flow through it. If the flow meter is open when you open the cylinder valve, the high pressure can damage the flow meter.



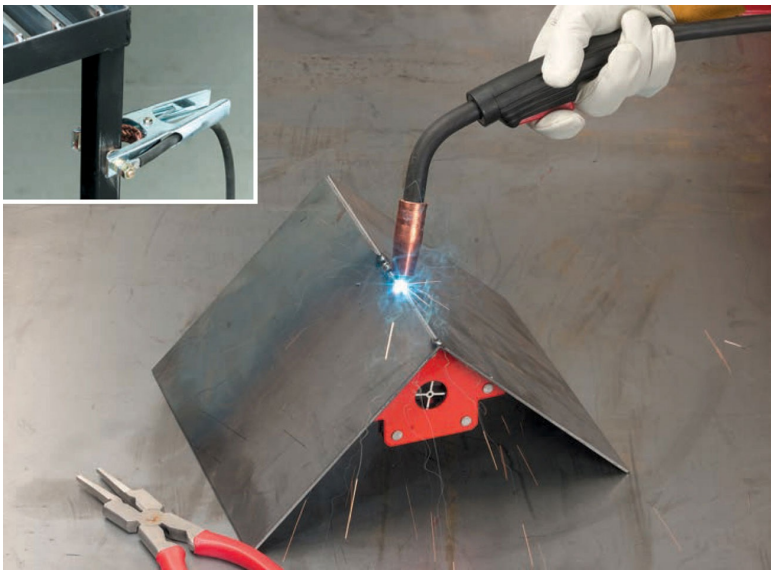
4 Attach the hose to the flow meter and to the welding machine. Slowly open the cylinder valve, then, once it is open, open the cylinder valve completely. To set the flow rate, turn on the machine. Depress the

trigger to activate the gas flow, and turn the flow meter knob counterclockwise. While gas is flowing, continue turning the knob until the meter registers the proper flow rate. Make sure that the flow meter or flow gauge is rated for use with the shielding gas you are using. For example, an argon/carbon dioxide flow meter cannot handle pure carbon dioxide.

Pre-welding Checklist:

- Gun, shielding gas, and machine cables, hoses, and connectors are tight.
- Polarity is set correctly for type of wire being used.
- Cables are in good condition.
- Supply cable is straight and unkinked.
- Gas regulator and flow meter are correctly installed.
- Contact tube is in good condition.
- Spatter has been cleaned from nozzle and contact tube (see page 40).

Gas Metal Arc Welding



1 Prepare and fit up the material to be welded. Attach the work cable clamp to your welding table (inset) or the workpiece. Turn on the machine and shielding gas. Adjust the wire speed and voltage according to the manufacturer's recommendations. Cut the electrode to 3/3" stickout. Put the tip of the electrode at the point of the first tack weld, flip down your helmet, and pull the trigger. Place tack welds evenly around the weld area. Trim the electrode for proper stickout at the end of each use. Check to see that the workpiece is still aligned properly. If not, adjust with a hammer or break the tack welds and retack.

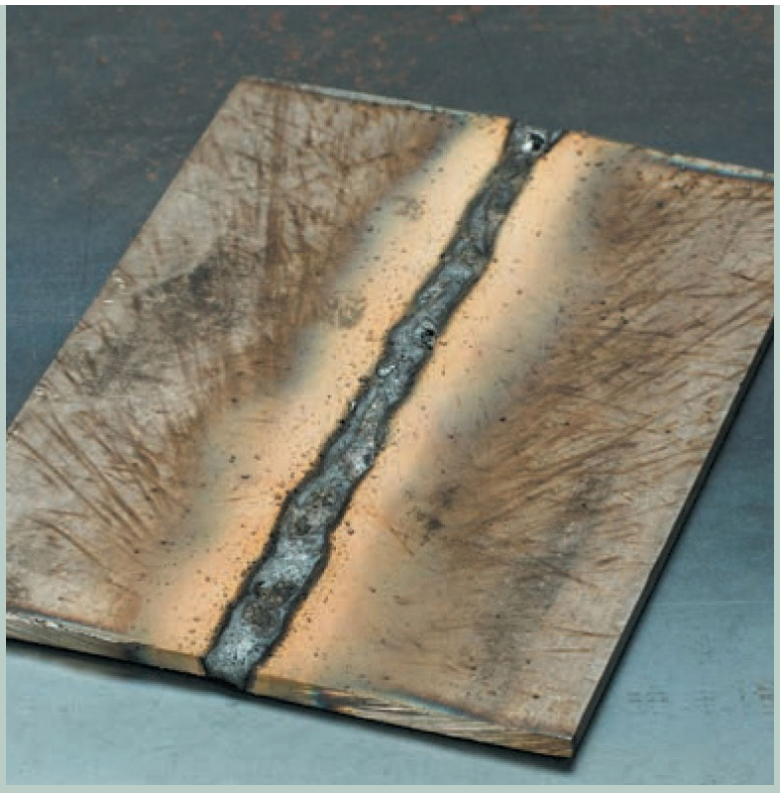
2 Start at the left end of the weld. Hold the gun with both hands and position it at a 20° angle with the tip pointing to the left. Put the tip of the electrode at the beginning of the weld, flip down your helmet, and pull the trigger.

3 **Begin welding, moving steadily to the right. GMAW has a distinctive sizzling sound. Popping and snapping indicate dirty material or an improper voltage or wire speed adjustment.**

4 A finished GMAW is smooth with even ripples or weave pattern, no slag, and little spatter.

Flux Cored Arc Welding:

Flux cored arc welding uses the same wire feed and power supply as gas metal arc welding but usually without the gas shielding. This is convenient for welding outdoors in windy conditions, but the weld is not as clean. To use flux cored wires, most welding machines need to be converted. Usually this involves changing the output polarity, and installing a gasless nozzle. It also might require installing proper drive rolls and a different cable liner. Otherwise, follow the same steps to weld with flux cored wire as with solid wire.



Flux cored wire welds are covered with a layer of slag.

Post-welding Sequence:

When you have finished welding with a GMAW rig, it is important to shut it down properly so you are set for your next welding session. If you do not turn off your shielding gas, you will lose much of it to bleed off even if you weld the next day.

- Close the gas cylinder valve.
- Press the gun trigger or purge switch until the flow meter or flow gauge reads zero.
- Turn off the flow meter.
- Turn off the machine.
- Coil the supply and work cables and store them off the floor.

Maintenance & Troubleshooting

A small amount of maintenance on your GMAW equipment will result in better, more consistent welds and longer lasting equipment. Spatter—tiny pieces of the electrode or base metal that have sizzled off—builds up on the nozzle and the contact tip. Remove this spatter frequently as you weld so it does not interfere with gas flow or electrical conductivity. Turn off the machine, remove the nozzle, and use the closed point of the MIG pliers (page 45) to ream out the nozzle and file the end of the contact tip. An anti-spatter gel is available in which to dip the hot nozzle and contact tip. Anti-spatter spray can be used to coat the contact tip and the nozzle. This spray is also useful for coating your welding table to prevent spatter from sticking to your work surface. Eventually you will need to replace the nozzle, but regular maintenance and proper welding techniques will extend the life of a nozzle considerably.

Contact tubes become worn because they are a soft copper alloy and the electrode is steel. The electrode will wear through the contact tip, possibly making the electrical flow irregular. Contact tips should be visually inspected for wear on a regular basis. The orifice on a worn contact tip will appear oval instead of round. Tips generally are good for about eight hours of continuous welding use. NOTE: Always turn off the welder before changing the contact tip.

It is important to keep the welder fan motor and rectifier free of dirt and dust to prevent it from overheating. If your welder is stored in a dusty shop, or you use it infrequently, keep it covered. Use low pressure air to blow dust and dirt from these assemblies. Use a vacuum to remove dirt from the wire feed mechanism.

The supply cable needs to be cleaned occasionally as well. Check the manufacturer’s recommendations for frequency, but they generally recommend cleaning after you’ve used 50 pounds of flux cored wire or 300 pounds of solid wire. With the power off, remove the cable from the machine. Remove the gas nozzle and contact tip from the gun, lay out the cable straight, and use low pressure air to blow into the gun end. (Using high pressure air may create a dirt plug that will clog the cable permanently.)

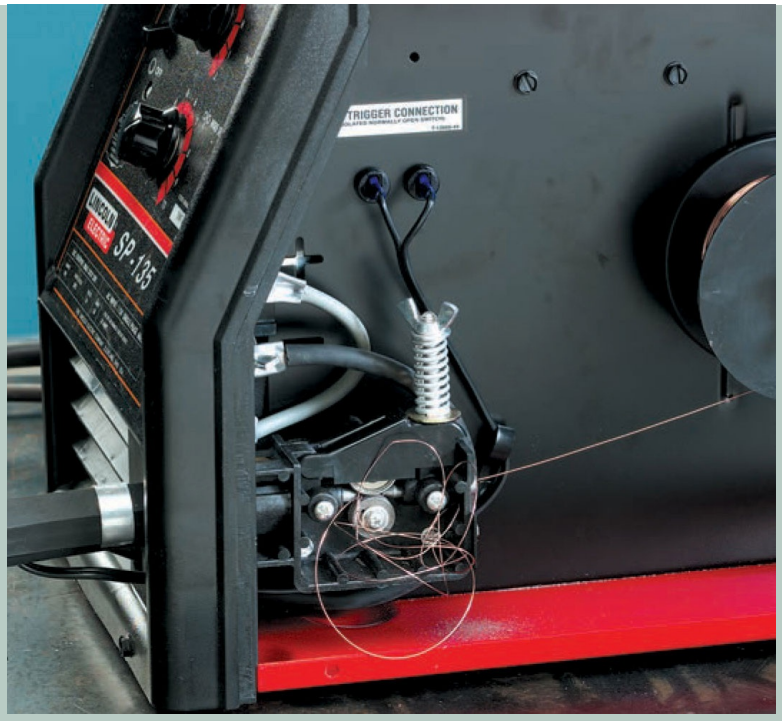
Always store the supply and work cables and the gas hose off the floor and away from chemicals, hot sparks, and sunlight.

Use dippable anti-spatter gel to prevent spatter build up on the nozzle and contact tip. Simply dip the hot nozzle into the gel.

Removing a Bird's Nest:

A "bird's nest" is a tangle of wire in the wire drive mechanism. This happens when the wire drive rolls continue feeding wire but the cable is blocked, the outfeed tube is misaligned, the wire is stubbing out on the base metal, or the wire has been welded to the contact tip. The drive rolls are set to slip in these cases, but if the tension has been adjusted too tightly, they may continue to push wire.

To fix a bird's nest, turn off the machine and cut the wire as it comes off the spool. Remember the wire is under tension, so you must hold the spool end, then tie it off through one of the spool holes. The tangled wire also may be storing tension, so it may fly out of the drive roll area. Release the tension arm or roller arm. Pull the wire out of the drive mechanism and the supply cable. Wear safety glasses when removing a bird's nest.



A "bird's nest" is a tangle of wire in the drive roll mechanism.

Stub Out or Stubbing:

"Stub out" is when the electrode welds to the base metal without melting or breaking off. This is caused by the voltage being too low, the wire feed being set too fast, or holding the gun too close to the work when starting. Correct the settings, grind off the stub outs, and restart the weld.

Stub out results in short sections of wire poking out of the weld.

GMAW Troubleshooting:

PROBLEM	SOLUTION
Wire feeds, but no arc can be struck	• Check to see that work clamp is connected
Weld bead is full of holes like a sponge (porosity) rate	• Make sure shielding gas is on • Adjust shielding gas to a higher flow • Eliminate drafts • Verify correct polarity
	• Make sure voltage setting is

Weld bead is tall and looks like a rope	appropriate for the material's thickness • Reduce your travel speed
Excessive spatter or dirty welds	• Reduce the gun angle • Hold the nozzle closer to the work • Decrease voltage
Arc starts and stops	• Check the wire feed for steady feeding • Check cable connections • Clean the weld materials

GAS TUNGSTEN ARC WELDING

A gas tungsten arc welding setup consists of a power source, work cable and clamp, supply cable and torch, foot control, and gas cylinder with regulator.

Gas tungsten arc welding (GTAW), commonly called TIG (tungsten inert gas), and sometimes referred to as Heliarc (the L-TECH trade name), is a process that generates an arc between a non-consumable tungsten electrode and the work-piece. The electrode and the weld are protected by a shielding gas, and filler metal may or may not be used.

Gas tungsten arc welding differs from the other arc welding processes because the electrode is non-consumable and not used as filler material. GTAW is more like oxyfuel welding in terms of the skills needed to manipulate the torch with one hand and the filler rod with the other. GTAW requires another layer of coordination because most machines also use a foot activated amperage control.

Like gas metal arc welding, gas tungsten arc welding is a clean process because the shielding gas eliminates the need for flux and the resultant slag.

Safety. Because gas tungsten arc welding is such a clean process, welders often are tempted to weld without gloves or in short sleeve shirts. This is not recommended. The arc most likely produces more ultraviolet rays than other processes, and because there are no fumes or smoke, those rays are entirely unfiltered. It is important to cover all exposed skin to prevent UV burns. Filter requirements are a minimum #10 shade, and if you have an auto-darkening hood, be sure that it is rated for the GTAW process. Some entry level auto-darkening hoods are not. The arc may produce ozone, which is hazardous to breathe over long periods. Make sure your gloves, clothes, and work area are dry. Always turn off the power when changing electrodes.

SAFETY

- Welding helmet with #10 to #14 filter
- Long pants, long sleeved shirt, and hat
- Leather gloves
- Leather boots or shoes
- Ventilation

The Equipment. The basic equipment needed for GTAW is a constant current welding machine, cable with torch, work cable and clamp, electrode, and inert gas cylinder with regulator and flow meter. Optional equipment includes a

remote amperage control and a water cooled torch with water cooler and hoses.

Although a mid-range shielded metal arc machine can be used to deliver the current for gas tungsten arc welding, a dedicated, good quality GTAW machine delivers the current as AC or DC, provides an optional high frequency output for no touch arc starting, has a remote control option for foot pedal control, and has a solenoid for shielding gas control. The combination of AC and high frequency makes it possible to weld aluminum with good results. The newest electronic GTAW machines have advanced current control capabilities and are becoming more and more affordable.

Torch & Cables. The GTAW torch holds the electrode and delivers the shielding gas. It can be air or water cooled. The torch parts are the cup or nozzle, collet body, collet, end cap, and torch body. The collet and collet body hold the electrode firmly and establish electrical contact with the electrode. The cup directs the shielding gas. A torch may be air cooled for use below 200 amps, but over 200 amps the torch usually is water cooled. The supply cable supplies electricity, shielding gas, and coolant to the torch. This may be an integrated cable or individual cables. A work cable with clamp is also necessary.

Some GTAW torches have flexible necks, which allows them to be bent into the most convenient angle for supporting the torch. Unfortunately, the non-flexible torches will bend if forced, and then they will be ruined. Some torches also have a gas on/ off valve. This is necessary for machines that are simply power sources with no internal gas flow controls.

The collet body, collet, end cap, and cups all come in a variety of sizes. The collet body and collet are sized to match electrode diameters. Each part is stamped with its size. The end caps come in a variety of lengths—some accommodate an entire 7" electrode, others are shorter for more clearance while welding.

Pliers and a stainless steel wire brush are handy for gas tungsten arc welding.

Cups come in a variety of sizes denoted by 1/16" increments. A #4 nozzle is 4/16", a #8 is 8/16". Cups should ideally be 4 to 6 times the size of the electrode. A cup that is too large will not direct the gas in a proper stream, a cup that is too small may not provide adequate steady flow. A gas lens or screen in the torch balances the gas flow. Good shielding designs allow you to use a lower gas flow. Higher flow creates turbulence and jetting, which disturbs the shielding—more does not equal better when it comes to shielding gas flow. Cups also are available in different lengths. A longer nozzle increases the electrode extension from the collet, which may increase the electrode temperature. Use either lower amperage or larger diameter electrodes if you are using a longer nozzle. Shorter nozzles may be necessary for tight working conditions. Nozzles are also available in clear (fused quartz) types, which are more expensive but give greater visibility, especially in cramped quarters.

A gas tungsten arc welding torch includes the electrode, collet body, collet, cup, backcap, and torch body with heat shield.

Shielding Gases. Two inert shielding gases are used for gas tungsten arc welding: argon and helium. They may be used alone or in combination with one another. Argon yields better starts and better arc maintenance. Helium gives a hotter arc and allows faster travel speeds. Helium, however, is very expensive. Argon and helium are both contained in standard cylinders, and a pressure regulator flow meter combination will need to be attached. Because of the density difference between the two, either a separate flow meter needs to be used for each, or use a flow meter that has calibrations for each type of gas. Argon flow rates for up to 1/8" steel is 8-10 cubic feet per hour (CFH), for stainless steel 11-13 CFH, and 12-20 CFH for aluminum. Drafty locations may require higher flow rates. Check the manufacturer's recommendations.

Electrodes. The electrode for gas tungsten arc welding is always a tungsten or tungsten alloy rod with either a pointed or rounded end. The electrodes come in a variety of diameters.

Tungsten is very brittle, so electrodes can be scored with a file, then snapped over a sharp table edge.

Preparing the Electrode. Prior to use, the cut end of the electrode must be sharpened to a point or melted to a ball. The tip may be ground to a point or chemically sharpened. The electrodes come in 7" lengths. To increase the number of points available, score the electrode with a file or cut-off wheel, and snap it in half. Tungsten is very hard but brittle, so it is easy to grasp each end of the electrode with pliers and snap it in half over a sharp table edge.

ELECTRODE CHARACTERISTICS:

ALLOY	AC/DC	TRAITS & USES	COLOR
Pure tungsten	AC	• Welding of aluminum • Forms ball at tip	Green
1% Thorium oxide (thoriated)	Primarily DC, but also AC	• Easier arc starts • Carries more current • Low level radioactive	Yellow
2% Thorium oxide	DC	• Long life • Easier arc starts	Red
Zirconium oxide	AC	• Similar to pure tungsten but carries more current	Brown
2% Cerium oxide (ceriated)	DC	• Not as good as thoriated but not radioactive	Orange
Lanthanum oxide	DC	• Similar to ceriated	Black

Because all tungsten electrodes look and feel the same regardless of their composition, it is important to keep them clearly separated by type. The color codes will wear off, or, if you point each end of your electrode, be ground off. It is helpful to have clearly labeled containers for each type of electrode.

Two critical factors in grinding the electrodes are the grinding wheel and the grinding direction. You must use a hard, fine grinding wheel dedicated exclusively to tungsten. Metal particles left on the wheel from grinding aluminum or steel would contaminate the tungsten, which causes erratic arc behavior and poor weld quality. An extremely hard material, tungsten will become hot as it is ground. Sharpen the electrode tip so that grinding marks run lengthwise down the tip, not in a circular or crosswise pattern. Lengthwise grinding focuses the electron flow toward the tip; circular grinding causes the arc to be unfocused and possibly jump sidewise from the electrode rather than off the tip point. Chemical means also can be used to sharpen tungsten by dipping a hot tungsten rod into a chemical agent. The length of the taper on the tungsten tip should be two to three times the diameter of the tungsten.

To safely hold tungstens for sharpening with a grinder, insert them into the chuck of a drill. Running the drill while sharpening the tungsten ensures a uniform point. Move the tungsten across the wheel to prevent grooves in the wheel face.

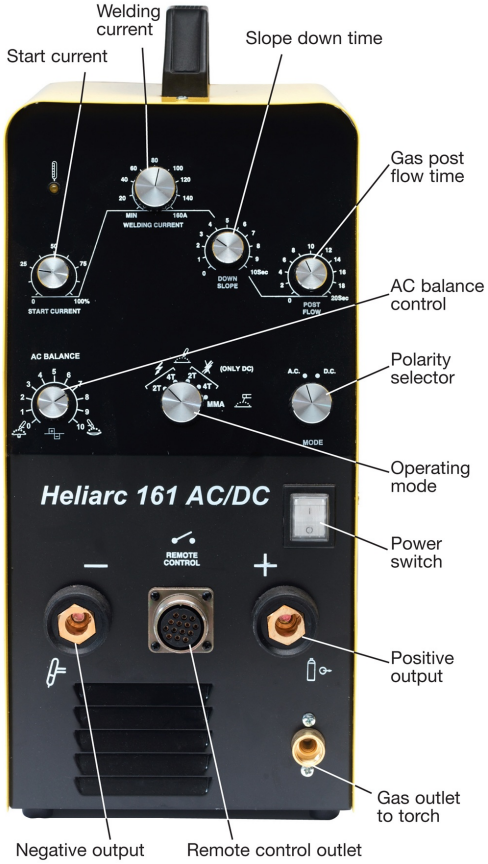
Chemical sharpeners are available for sharpening tungsten.

Welding with AC current requires that the tip of the electrode be balled, which is accomplished by running DC electrode positive or AC current and striking an arc on copper or brass. The ball should not extend beyond the diameter of the electrode, although many sources recommend a ball one and one half times the diameter of the tungsten.

If you touch the weld puddle or filler rod with the electrode during welding, you must change to a fresh electrode. Any time the electrode tip becomes pitted or blackened, is no longer pointed, or the ball becomes too large, you must change to a fresh electrode. This will happen often, so it is best to have a number of electrodes sharpened and ready to go. If you forget to turn on the shielding gas or the flow is interrupted, the electrode will give off a thick yellow tungsten oxide smoke. This smoke is hazardous, so resume welding only after the smoke has cleared. You will need to change electrodes if this happens.

Tightening the back cap locks the tungsten electrode into place. The tip of the electrode should extend beyond the end of the cup by a distance of three times the electrode's diameter.

Anatomy of the GTAW Machine



Setting Up the GTAW Machine:

Dedicated GTAW machines, like this one and the one pictured on page 54, have many advanced features. The basic setup, however, is the same.

The positive and negative output receptacles are for the torch and work clamp connections.

The gas outlet connects to the torch gas hose.

The remote control socket is for the foot or finger control. Using a remote control allows the welder to control the amount of current while welding.

The operating mode selects high frequency or scratch starts.

Polarity selects either AC or DC.

AC balance control allows for adjusting AC power to be more positive or more negative to create either more cleaning action or deeper penetration. Advanced machines can adjust the AC power to be as much as 90% positive or negative, rather than the 50% for standard AC power.

Start current controls the current for arc starting.

Welding current sets the range for welding. The foot or finger control then operates within this range.

Slope down time gradually reduces power to the arc with-out extinguishing the arc. This allows for the weld crater to fill before the arc is extinguished.

Gas post flow controls how long the shielding gas will flow after the arc is extinguished.

Pre-welding Checklist:

- If using a water cooled torch, check for leaking.
- Check all cables for wear and damage.
- Clean and fit up parts to be welded.

Welding with GTAW

1 Set the controls based on manufacturer's recommendations for the material to be welded. Turn on the machine, and turn on the water pump, if available. Attach the work clamp to the welding table or workpiece. Flip down your helmet, activate the foot or finger control if using one, and strike an arc by scratching the tip of the tungsten against the base metal. If your welder has a high frequency option, you do not need to scratch start the arc. Place a tack weld at each end of the joint to be welded. You may be able to tack the joint by simply fusing the two pieces with the heat of the torch, or you may have to use filler rod.

2 Position yourself to weld from right to left (if you are right handed) with the torch at a 15° angle to the right of center. Hold the filler rod in your left hand. Position yourself so you can comfortably hold the torch and filler rod for the duration of the weld.

Striking an Arc:

Unless you have a high frequency option, you will need to physically strike an arc—called a scratch start. Rest the cup on the work-piece at a sharp angle. Move the tip until it briefly contacts the work, then angle it back again to start the arc. After the arc is started, lift the cup off the workpiece and establish the proper torch angle.

High frequency allows the arc to jump the gap without needing to create physical contact between the electrode and the workpiece.

3 When a molten puddle has formed, dip the tip of the filler rod into the middle of the molten puddle. Keep the filler rod at a low angle to prevent disturbing the shielding gas. Keep the tip of the filler rod near—but not in—the puddle. Move the electrode to the left and continue the melting and dipping process.

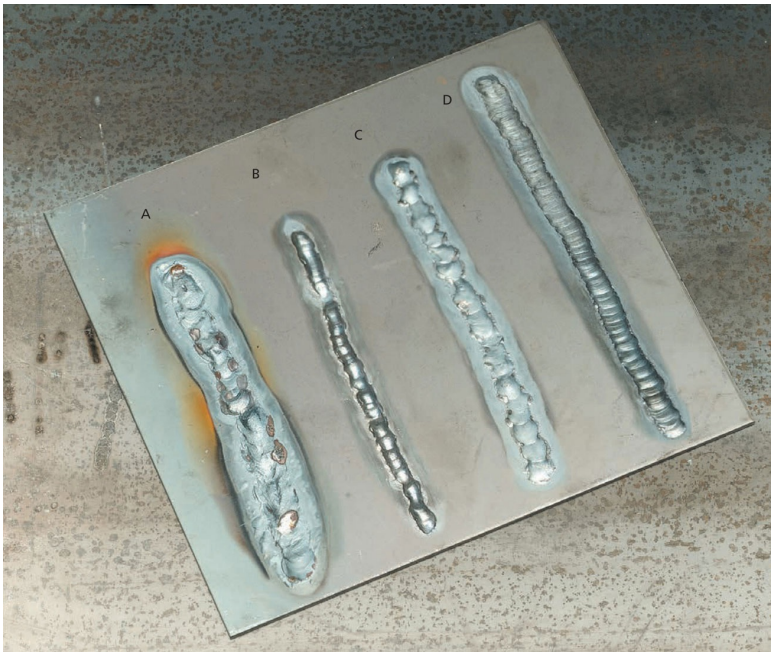
4 As you approach the end of your weld, you may need to adjust your travel speed because the buildup of heat in the material makes the molten puddle form more quickly at the end of the weld than at the beginning. You also may need to adjust the torch angle to be more shallow (not shown here) so that less heat is directed into the base metal.

Post-welding Sequence:

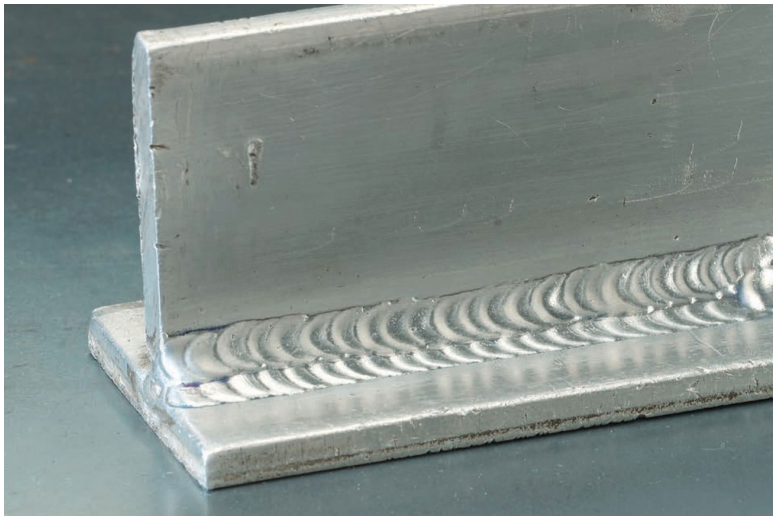
- Turn off cylinder valve.
- Purge gas from gas line.
- Turn off flow meter or gauge.
- Turn off machine.
- Coil hoses and cables off the floor.

Troubleshooting

Filler metal for gas tungsten arc welding comes in rod form and ranges from 1/16" to 3/16" in size. Rods are available in a variety of alloys, including aluminum, chromium and chromium nickel, copper, nickel and nickel alloys, magnesium, titanium, and zirconium. Specific alloy compositions are available for creating specific weld types on specific base metals. These filler metals are similar to those used in oxyfuel welding, with the exception of the carbon steel rods, which are not copper coated as they are for oxyfuel.



Becoming proficient in gas tungsten arc welding takes practice, and identifying problem welds is an important step. Weld A is too hot. Increase the travel speed or decrease the amperage. Weld B is too cold and is simply sitting on top of the base metal rather than penetrating it. Decrease the travel speed or increase the amperage. Weld C was done too quickly. Travel speed needs to be controlled and consistent. Weld D is a good quality weld with even ripples, good penetration, and a moderate crown.



A well-done gas tungsten arc weld on aluminum has even ripples and good penetration. This sample weld shows two passes to create a fillet weld on 1/4" stock.

GTAW Troubleshooting:

PROBLEM	SOLUTIONS
Weld looks porous or sooty	• Make sure shielding gas is on and is correct type • Make sure shielding gas cylinder is not empty • Eliminate drafts • Make sure base metal is totally dry • Clean base metal thoroughly • Increase gas flow rate
Base metal distorts	• Tack weld parts before welding • Clamp parts down to rigid surface • Scatter welds to diminish heat buildup
Unstable arc	• Adjust electrode to work angle • Clean base metal thoroughly • Clean electrode • Connect work clamp to workpiece • Bring arc closer to work • Make sure polarity and current settings are correct

Electrode is rapidly consumed	• Increase electrode size • Increase gas flow • Decrease current • Increase gas post flow time • Use proper shielding gas

PLASMA CUTTING

A plasma cutter consists of a power source with a compressed air or inert gas connection, work cable with clamp, supply cable, and torch.

Plasma cutting and welding are arc processes. Plasma is a gas that can conduct electricity because it is in a highly ionized form. The gas transfers the arc, but because of the constriction of the gas, the gas resistance is very high, which creates the extreme heat for plasma processes. Plasma cutting uses a very constricted arc to melt the base metal while compressed air or other gas blows the melted metal out of the kerf. This process can be used on any conductive metal—aluminum, brass, cast iron, copper, steel, stainless steel, and titanium—which sets it apart from oxy-acetylene cutting, which is only useable on oxidizable metals.

Though the plasma arc temperature is 40,000° F, it is so constricted and the cutting speed is so fast that the thermal distortion to the metal being cut is low. Plasma cuts are clean and are often weldable with no additional clean up if the base metal was initially clean. Properly done, the kerf is fairly straight sided, and no slag is present.

Safety. Plasma cutting produces sparks, smoke, and fumes. When cutting materials that contain chromium and nickel (such as stainless steel) or materials that have been galvanized or zinc coated, many toxins will be present in the fumes. When cutting through painted, bonded, or dirty metals, these surface additions often burn off, producing hazardous smoke. Plasma cutting often produces ozone and various nitrogen oxides that are colorless and can be odorless; both are hazardous. Therefore, good ventilation is important even when plasma cutting.

SAFETY

- Welding helmet with #8 filter
- Leather, wool, or cotton long pants, long sleeve shirt, and hat
- Heavy duty welding gloves
- Leather boots or shoes
- Ventilation

Plasma cutting may not seem as bright as other arc processes, but it is. It produces ultraviolet rays, so it is important to protect your skin and eyes. Because of the high level of open circuit voltage, plasma cutting has added

electrical shock hazard. Make sure all surfaces around the cutting area are dry and all your clothing and gloves are dry. Turn off the power to the machine before changing any torch parts.

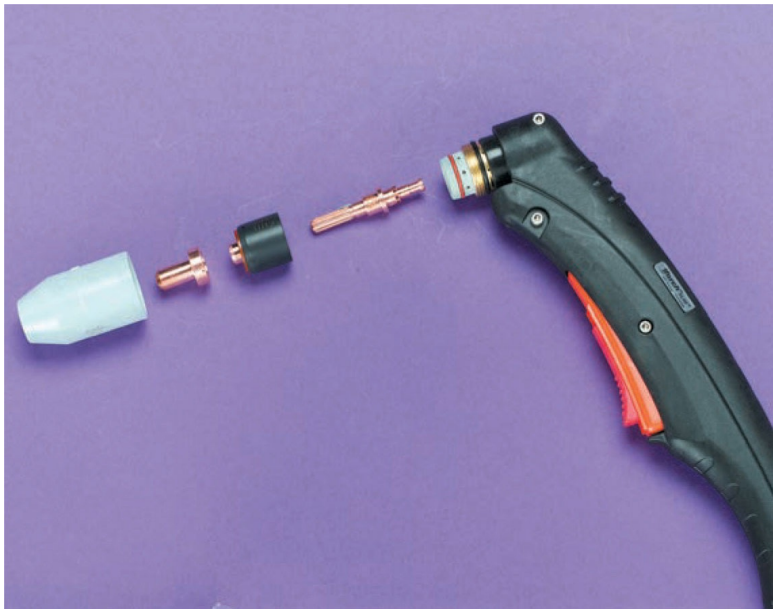
Never cut containers, tanks, or cylinders that may have held flammable materials. Even a small amount of flammable residue can cause an enclosed vessel to explode when cut.

Equipment. Plasma cutting machines are expensive, but as technological advances are made and demand increases, more companies are introducing smaller, less expensive home and small shop equipment. If you regularly need to cut stainless steel, aluminum, or the high strength steel now used in automobile bodies, this machine can be worth the cost. Small, 115-volt plasma cutters are available that will cut up to 3/8" material. Larger, 220-volt machines can cut thicker materials and have higher duty cycles. Aluminum and stainless steel require higher amperages, so check whether the machine easily can cut the materials with which you typically work.

Most plasma cutters require a compressed air source. Any shop air compressor that can deliver 65 psi is sufficient. It is critical that a filter be installed to keep the air dry and oil free. Follow the manufacturer’s directions for installing the filter. Some plasma cutters have an internal air compressor. These units often require more maintenance than models that utilize a separate compressor.

The plasma torch consists of a shield cup, cutting tip, starter cartridge, electrode, and torch handle. Most plasma torches have a manual switch on the torch body. The cutting tip and electrode are consumable parts. Check them frequently for wear and replace them when necessary.

A dehumidifying filter is very important for the compressed air source for plasma cutting.



The plasma cutting torch consists of (left to right) a shield cup, cutting tip, starter cartridge, electrode, and torch handle.

Pre-cutting Checklist:

- Compressed air fittings are tightly attached.
- Cables are in good condition.
- Ventilation is sufficient to remove fumes from cutting area.
- Work area is dry.
- Flammable materials are removed from area.
- Sparks and slag from cutting will be contained.

How to Plasma Cut

1 Check the manufacturer's recommended settings for the material to be cut. Arrange the material on a cutting table and determine the most comfortable cutting position. Attach the work clamp to the workpiece or welding table. Dry run through the cutting motion to practice speed and cutting position.

2 Check manufacturer's directions for arc starting procedure. Most current machines are designed to drag the nozzle directly on the material's surface. Activate the arc and hold the torch perpendicular to the surface of the material. Move steadily and smoothly along the entire length of the cut. Do not stop the arc until you have passed through the end of the cut.

3 A good plasma cut has squared edges, small vertical ripples, and little or no slag.

Troubleshooting and Techniques

A high-quality circle cutting attachment for a plasma cutter is expensive, but worth the investment if you will be making repeated circle cuts. This unit comes with a magnetic pivot holder for steel and a suction cup pivot holder for all other metals.

Plasma Troubleshooting:

PROBLEM	SOLUTIONS
Arc does not start	• Connect work clamp to workpiece • Turn on power source • Tighten cable connections • Make sure electrode is in working condition
Cut does not penetrate through material	• Cut more slowly • Make sure torch is held perpendicular to material • Make sure machine is capable of cutting that thickness • Increase amperage setting • Verify correct air flow and pressure
Excessive slag or dross	• Increase cutting speed • Decrease torch standoff distance • Replace worn torch parts • Adjust amperage setting
Torch parts consumed quickly	• Install or replace air filter to prevent oil or water from reaching torch • Cut metal within the capability of the machine • Make sure gas pressure is correct

Tip:

Making a good-quality plasma cut is dependent on a consistent travel speed. Consult the owner’s manual for cutting speeds for different material thicknesses and amperage settings. With the machine off, practice moving across the planned cut at the correct speed.

OXYACETYLENE CUTTING

Oxyacetylene cutting equipment consists of two cylinders—oxygen and acetylene—regulators, hoses, and a cutting torch with tip.

Oxyacetylene cutting uses acetylene and oxygen to preheat metal to a temperature of 1600° F, then uses pure oxygen to burn away the heated metal. Because the cutting is achieved by oxidation of the metal, oxyacetylene cutting only works on metals that are readily oxidized at this temperature. Metals that can be cut with the oxyacetylene process are mild steel and low alloy steels. Oxyacetylene cutting can be used to cut thicknesses from less than 1/8" up to 12". Oxyacetylene cutting is inexpensive compared to machine cutting. It is very portable because no external power source is necessary, and it is faster than machine cutting. It is, however, limited to steel. The molten slag presents a fire and burn hazard, and the heat input to the base metal may cause distortion or changes to the properties of the steel.

Safety. The risk of starting a fire or being burned is high with oxyacetylene cutting. It is important to prevent molten slag and sparks from coming into contact with skin and flammable materials. Make sure you are wearing heavy-duty leather gloves with gauntlets, a leather jacket or leather-sleeved jacket, and leather boots. The work area should be cleared of flammable materials. If an item will be cut in place, make sure surrounding areas are protected from heat, sparks, and dropping slag. Never cut sealed tanks, cylinders, or items that have contained flammable materials. Never cut near gasoline tanks or fuel lines.

The Equipment. The basic equipment for oxyacetylene cutting is the same as for oxyacetylene gas welding, with the addition of a cutting torch or cutting attachment. An oxyacetylene cutting setup consists of an oxygen cylinder, an acetylene cylinder, regulators and hoses, and a torch with cutting attachment or a dedicated cutting torch. Cutting attachments and dedicated cutting torches have levers to activate the oxygen flow.

SAFETY

- Full-face #5 filter
- Leather, wool, or cotton long pants, leather jacket, and hat
- Heavy-duty welding gloves
- Leather boots or shoes
- Ventilation

Cutting Torch & Tips. Most oxyacetylene welding sets come with a cutting accessory that attaches to the torch body in the same way that the welding tips

do. A dedicated cutting torch is a one-piece unit that has its own mixing chamber. Its greater overall length allows for more distance between the heat zone and the operator, and it can handle higher oxygen flow rates. A dedicated cutting torch is usually fairly expensive and not necessary unless very thick metals will be cut, which requires greater oxygen flow.

Both the cutting torch and the cutting attachment take a variety of cutting tip sizes. The cutting tip has a number of preheat holes surrounding the pure oxygen orifice. It is important to match the cutting tip to the thickness of the metal being cut. A welder often takes a one-size-fits-all approach to cutting tips, which always results in poor-quality cuts. Thinner metals require fewer preheat holes and a smaller oxygen orifice; thicker metals require more preheat holes and a larger oxygen orifice. Cutting tips are made of copper and can be damaged easily. They need to be cleaned regularly with an appropriately sized tip cleaner.

Fuel Gas Options. Because the metal being cut does not need to be brought to the melting point, various gases other than acetylene can be used. Propane, natural gas, propylene, and methylacety-lene-propadiene can be used as the preheating fuel source. Each of these gases requires specific regulators and may require different torches and torch tips. Check manufacturer’s recommended usage before substituting an alternate fuel gas.

A striker, tank wrench, pliers, and tip cleaner are needed for oxyacetylene cutting.

A dedicated cutting torch (top) is a one-piece unit with one oxygen and one fuel-gas valve. A cutting tip is attached to a standard torch body (bottom) and includes an additional oxygen valve. A range of tip sizes is available for both torch styles.

Pre-cutting Checklist:

- Surrounding area is free of flammable materials.
- There is room for cut metal to fall away from arms, legs, hoses, and cylinders.
- Hoses are free from damage before pressurizing the system.
- Ventilation is adequate to remove smoke and fumes from area.

How to Cut with Oxyacetylene

1 See pages 30 to 32 to learn how to set up, pressurize, and light an oxy-acetylene torch. Set up the material to be cut on a cutting table. Use soapstone to mark the cutting line, and practice your cutting position and bracing. Hold the torch in your left hand with your thumb and forefinger on the acetylene valve. Hold the striker in your right hand, 3" to 6" from the torch tip. Turn the acetylene valve $^1/_4$ to $^1/_2$ turn and strike sparks.

2 Adjust the acetylene so the flame is not smoking and is not separated from the tip (see page 32). Add oxygen to create a neutral flame. With a dedicated cutting torch, depress the oxygen lever to make sure neutral flame is maintained; if necessary, adjust with the oxygen lever depressed. With a cutting tip on a torch base, depress the oxygen lever and use the cutting tip adjustment valve to adjust the oxygen.

3 **Release the oxygen lever, flip down your face shield, and direct the flames at the edge of the cut. Once the metal begins to glow red and appears shiny but not yet molten, depress the oxygen lever. If it fails to pierce a hole immediately, release and continue to heat until depressing the lever pierces a hole. Move slowly and steadily along the cutting line, holding the torch at a 90° angle.**

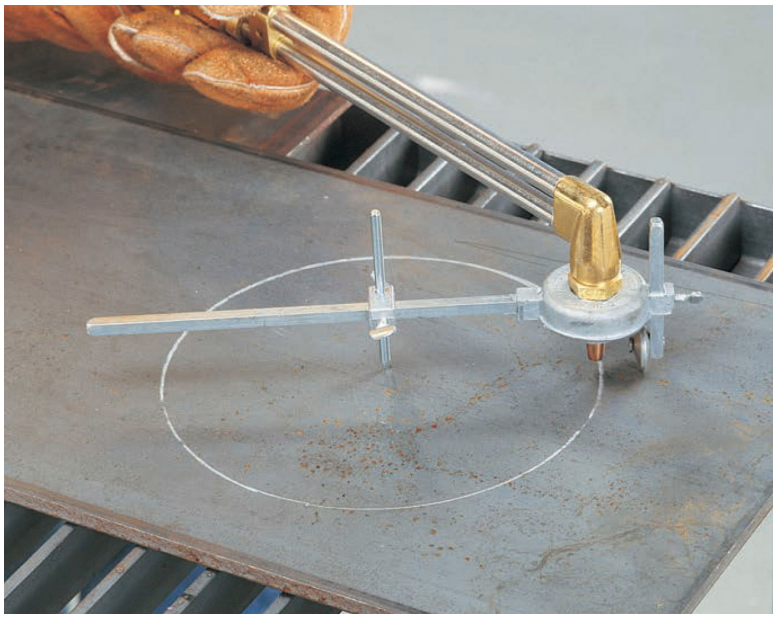
4 The finished cut should have very small vertical ridges (drag-lines), very little slag on the bottom, and the top edges should not be rounded over.

Oxyacetylene Cutting Tips

Piercing Holes and Making Cutouts:

Piercing a hole: Preheat the material to a dull red. Pull back the torch from the surface and angle slightly. Squeeze the oxygen lever. As soon as the material has been pierced, return the torch tip to the perpendicular position and move back to just above the surface. Complete the hole.

Making a cutout: Begin in the center of the cutout and move to the cutout line after piercing a hole. A spiral approach to the edge works best. To give maximum protection to the surrounding material when piercing a hole, drill a 3/16" hole to start the piercing action.



Circle cutting guides are available for making accurate circle cuts. If you need to make several circle cutouts, this can be a handy tool.

Cutting Defects:

A good oxyacetylene cut has square edges, small vertical draglines, and little slag. A dirty cutting tip is the cause of many poor-quality cuts. Clean the orifices with a properly-sized tip cleaner and use very fine sandpaper on a flat surface to polish the flat surface of the tip. Here are a few possibilities for causes of cutting defects:

Kerf is wider at the bottom than at the top (bell-mouthed).
Oxygen pressure is too high.

Top edge melted over.
Cutting speed is too slow or preheat flames are too long.

Irregular cut edge.
Speed is too fast or too slow, oxygen pressure is too high, or cutting tip is too small or too large.

Warning:

- Never cut into a sealed container.

- Never cut into a tank or container that contains or may have contained flammable materials.
- Never cut near a gasoline tank or fuel lines.

Oxyacetylene Cutting Safety

Oxyacetylene cutting produces molten slag, sparks, and hot metal scraps. Move items that are to be cut away from burnable material. If the item cannot be moved, protect surrounding areas with sheet metal and fire retardant welding blankets (not tarps). Make sure sparks and slag will not fall into cracks, holes, or ventilation grates in the floor. Wet down any wooden material around the cutting area. Have water, sand, or a fire extinguisher on hand, and monitor the area for one half hour after cutting is completed. Plan where cut metal will fall so it does not hit your arms, legs, gas hoses, or cylinders.

Use a piece of angle iron as a brace to support the torch or to hold pipe in place for cutting.

WELDING PROJECTS

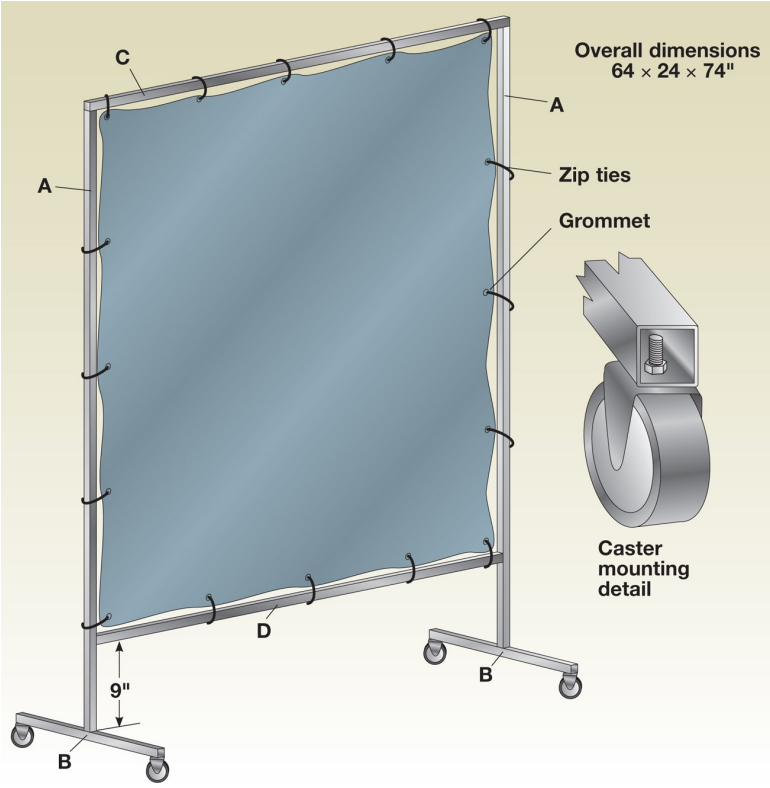
Here’s a chance to put all these welding and cutting techniques to use. The following chapters have directions for creating 23 different projects. Each contains a detailed cutting list, technical drawing, and step-by-step directions.

Among the shop projects you will find a sturdy welding table and a handy welding machine cart. The lighting projects feature a variety of candleholders and lamps. Included in the furniture projects are a delightful wine rack and a handy solution to creating a coffee table out of a slab of stone or wood. The outdoor projects will spark your creativity with an add-your-own-found-objects gate.

Shop Projects 74
Lighting Projects 90
Furniture Projects 104
Outdoor Projects 122

SHOP PROJECTS

Rolling Welding Curtain 76
Welding Table 78
Welding Machine Cart 82
Cylinder Cart 84
Grinder Stand 88


Overall dimensions
64 × 24 × 74"
C
A
A
Zip ties
Grommet
Caster
mounting
detail
D
B
B
9"

Rolling Welding Curtain

For arc welding and plasma cutting, it is very important to screen your work area so other shop workers, passersby, family members, and pets are not exposed to the damaging rays. This rolling curtain is quick and easy to make, and it offers the necessary screening while you work. You can purchase ready made welding tarps in a variety of colors, shapes, and sizes (see Resources, page 140). Or you can make your own welding tarp with 12-ounce cotton duck, fire retardant, and grommets.

PART	NAME	DIMENSION	QUANTITY
A	Sides	1 × 1" square tube × 72"	2
B	Wheel supports	1 × 1" square tube × 24"	2
C	Top crossbar	1 × 1" square tube × 64"	1
D	Bottom crossbar	1 × 1" square tube × 62"	1

Sixteen gauge or “thin wall” tube is sufficient for this project.

Materials

- 1 × 1" square tube (27 feet)
- 4 threaded swivel casters, at least one locking
- 5 × 5 foot welding tarp
- Zip ties

How to Build a Rolling Welding Curtain

Attach the Wheel Supports to the Sides

1. Clean all parts with denatured alcohol, acetone, or degreaser. Prepare weld joint areas by wire brushing until shiny.

2. Cut the sides and wheel supports (A & B) to size.

3. Clamp one side piece to the work surface. Center a wheel support at the end of the side piece to form a T.

4. Check for square and tack weld along the butt joint between the two parts. Turn the assembly over and reclamp it to the work surface. Check that the wheel support is still square to the side piece. Make a final weld along the butt joint.

5. Repeat steps 3 and 4 to assemble the second side piece and wheel support.

Weld the Wheel Support T-joints

1. Clamp a side and wheel support assembly to the work surface so the wheel supports hang over the edge.

2. Weld the T-joint between the wheel support and the side piece. Turn the assembly over and weld the second T-joint.

3. Repeat steps 1 to 2 for the second side and wheel support.

Install the Crossbars

1. Cut the top and bottom crossbars (C & D) to size.

2. Place the top crossbar over the side pieces (see photo). Check for square, clamp in place, and tack weld.

3. Make a mark 10" up from the bottom of each wheel support. Align the lower edge of the bottom crossbar with the marks, check for square, and tack in place.

4. Flip the assembly over and check for square by measuring across both diagonals. If the measurements are equal, the structure is square. Clamp the assembly in place and complete the welds. Flip the assembly over and finish the welds on the other side.

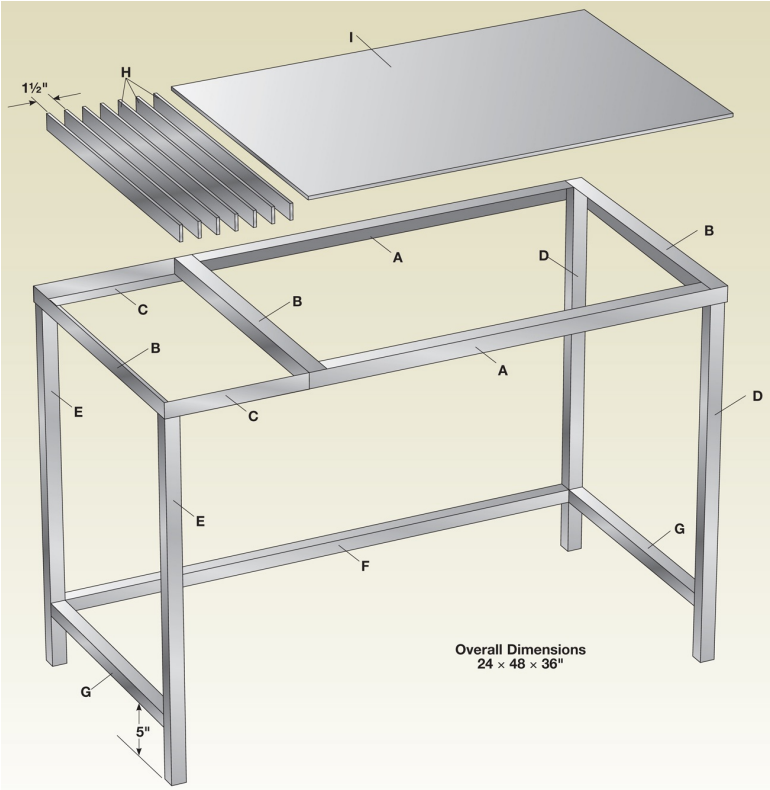
Apply Finishing Touches

1. Paint the framework, if desired.

2. Drill holes for the threaded post swivels, 1/2" from the end of the wheel supports. Install the casters.

3. Attach the tarp to the framework with zip ties.

Clamp the sides to the table with the wheel supports hanging over the edge. Finish weld the wheel supports to the sides, then weld the top and bottom crossbars to the sides. Make sure the plywood work surface does not have smoldering embers when you are finished.


I
H
1½"
A
B
D
C
B
B
A
E
C
D
E
G
F
Overall Dimensions
24 × 48 × 36"
G
5"

Welding Table

Use it for arc welding, cutting, or oxyfuel welding—this welding table is a versatile addition to your shop. It is sized to allow you to work while sitting on a stool or while standing. You may want to check the scrap bin at the local steel yard to see what size plate steel can be gotten for a reasonable price. Some yards sell plate in 4 foot by 2 foot pre-cut sections that you can cut to size. Or you can have the piece custom cut. You can use material thinner than 3/16"—or thicker. Thicker material is better as the table top will have less distortion from the welding heat and the heat generated when you grind spatter off from the table top. You may be able to purchase a small piece of cutting grate; we've constructed our own. Use the sheet metal for the table top on top of sawhorses or a workbench as a work surface to build the rest of the table. You can enclose the area under the cutting table with sheet metal and a door to contain cutting slag and sparks.

PART	NAME	DIMENSIONS	QUANTITY
A	Table top supports (front & back)	1/8 × 1 1/2 × 1 1/2" angle iron × 24"	2
B	Table top supports (sides)	1/8 × 1 1/2 × 1 1/2" angle iron × 24"	3
C	Cutting table supports (front & back)	1/8 × 1 1/2 × 1 1/2" angle iron × 12"	2
D	Right side legs	1/8 × 1-1/4 × 1-1/4" square tube × 36"	2
E	Left side legs	1/8 × 1-1/4 × 1-1/4" square tube × 34 1/2"	2
F	Stretcher (rear)	1/8 × 1-1/4 × 1-1/4" square tube × 36"*	1
G	Stretcher (sides)	1/8 × 1-1/4 × 1-1/4" square tube × 21 1/2"*	2
H	Cutting table top	1/4 × 1 1/2" flat bar × 23-7/8"*	7
I	Table top	3/16" sheet metal 24 × 24"	1

*Approximate dimensions, cut to fit

MATERIALS

- 1/8 × 1 1/2 × 1 1/2" angle iron (12 feet)
- 1/8 × 1-1/4 × 1-1/4" square tube (19 feet)
- 1/4 × 1 1/2" flat bar (14 feet)
- 3/16" sheet metal (2 × 2 feet)
- 4 leg levelers

Weld the cutting table section to the table top assembly. The angle iron flange for the table top will face up to support the table top. The angle iron flange for the cutting table will face down to form a well to support the cutting table strips.

How to Build a Welding Table

Weld the Table Top Supports

Cutting notches at the end of the side supports is easier than cutting 45° miters and provides more welding surface area.

1. Cut the table top supports (A & B) and cutting table supports (C) to size. Cut 1 1/2" notches at each end of the three side supports (B) to create a 90° angle joint.

2. Place the table top front support (A) and a table top side support (B) together to form a right angle. Check for square and tack weld.

3. Repeat step 2 using the table top back support and another side support.

4. Assemble these two right angles to make a square. Check all corners for square, and check the assembly for square by measuring both diagonals—they should be equal. If not, adjust the supports so the assembly is square.

5. Complete each outside corner weld, re-checking for square as you go. Flip the assembly over and complete the remaining welds of the joints.

Complete the Table Top Supports

The cutting table supports are positioned with the flange at the bottom to hold the 1/4" strips. The table top supports are positioned with the flange at the top to support the table top (see photo).

1. Place the remaining side support (B) and the front and back cutting table supports (C) at right angles to form three sides of a rectangle. Check the corners for square and tack weld the pieces together.

2. Assemble the pieces so the table top supports have the flange at the top, the cutting table supports have the flange at the bottom, and the cutting table supports are abutting the table top supports. Tack weld where the table top sides butt together (see photo). Turn the assembly over and weld the remaining joints.

Prepare the Leg Assembly

1. Cut the legs (D & E) to size.

2. Measure the completed table-top. It may be slightly more or less than 24" deep and 36" wide. Adjust the stretcher lengths (F & G) to those measurements, minus the 1-1/4" for each leg thickness. Cut the stretchers to size.

Place the back stretcher between the right and left side leg assemblies. Make sure the stretcher is square to the legs, then weld in place.

3. Mark both sets of side legs 5" up from the bottom. Starting with the right side legs (D), place a side stretcher (G) between the legs with the bottom of the stretcher aligned with the 5" mark.

4. Align the stretcher at a 90° angle to the side legs and clamp the assembly to your work surface. Tack weld the top inside angle at each end of the stretcher.

5. Repeat this process for the left side legs.

Finish the Leg Assembly

1. Place the leg assemblies on their sides with the rear side down, and clamp to your work surface.

2. Position the rear stretcher (F) between the right and left leg assemblies, aligning the bottom of the stretcher with the 5" mark.

3. Align the stretcher at a 90° angle to the assemblies and clamp in place. Tack weld the inside angles (see photo, below left).

Assemble the Table

The right legs fit inside the corner made by the angle iron, while the left legs are set back 1/8" from the edges of the angle iron.

1. Turn the table top and cutting table assembly upside down, then set the leg assembly into it.

2. Clamp the pieces in place. Check for square on both sides, front, and back.

3. Tack weld all corners. Check for square again, then weld all pieces into place.

Install the Cutting Table Top

Tack welding the cutting table grating allows you to remove and replace the 1/4" strips as they become worn from the cutting torch.

1. Cut the cutting table top grating (H) to size.

2. Place a strip of grating into the well formed by the cutting table top supports, 1-1/2" from the table top edge.

3. Tack weld the top edge of the grating to the angle iron.

4. Place another grating strip 1 1/2" from the first strip and tack weld in place. Continue building the cutting table top in this manner until complete (see photo, above).

5. Grind down the welds on the top of the table top support assembly.

Finish the Table

1. Place the table top (I) onto the assembly and tack weld twice on each side.

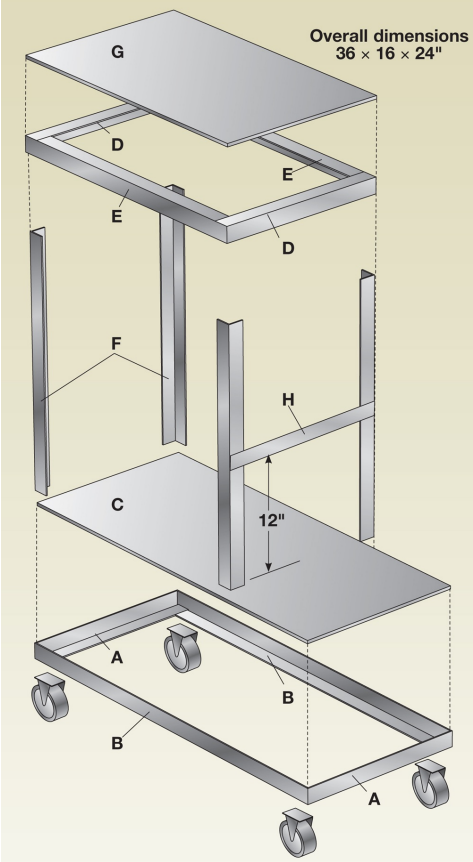
2. Weld the table top to the supports using 1" or 2" weld beads at both sides of each corner and twice along each side.

3. Grind down the welds, if desired. Wire brush, sand, or sandblast the entire table.

4. Paint the table, but do not paint the table top or cutting grate.

5. Install leg levelers as needed.

Tack weld grating strips to the angle iron every 1-1/2" to form the cutting table top.



PART	NAME	DIMENSIONS	QUANTITY
A	Bottom front & back 1/8 × 1 1/2 × 1 1/2" angle iron × 16"	2	
B	Bottom sides	1/8 × 1 1/2 × 1 1/2" angle iron × 36"	2
C	Tray	1/8" sheet × 16 × 36"*	1
D	Top front & back	1/8 × 1 1/2 × 1 1/2" angle iron × 16"	2
E	Top sides	1/8 × 1 1/2 × 1 1/2" angle iron ×	2

		26"	
F	Legs	1/8 × 1 1/2 × 1 1/2" angle iron × 24"	4
G	Top	1/8" sheet × 16 × 26"*	1
H	Brace	1/8 × 1-1/4" flat bar × 16"	1
*Approximate dimensions, cut to fit			

Welding Machine Cart

You'll want a cart for your GMAW or GTAW machine and gas cylinder—why not build it as your first project? It's good practice, and the materials will cost much less than most commercial carts. If you keep your eyes open, you can probably pick up the angle iron for free the next time a neighbor throws away an old bedframe. Remember, however, to grind off the paint at the joints, otherwise you'll have nasty fumes and poor quality welds.

Include a rubber pad and insulated chain for the gas cylinder (not shown) so an arc can't accidentally be struck against the cylinder.

MATERIALS

- 1/8 × 1 1/2 × 1 1/2" angle iron (24 feet)
- 1/8" sheet metal (3 × 3 feet)
- 1/8 × 1-1/4" flat bar (16")
- Swivel casters (4)
- Eyebolts (2)
- Chain (2 feet)
- Threaded chain links (2)
- Rubber pad (10 × 16")
- Rubber tubing (2 feet)

How to Build a Welding Machine Cart

Assemble the Base & Tray

1. Cut the bottom front and back (A) to size. Cut the bottom side pieces (B) to size. Instead of mitering the corners, cut a 1 1/2" notch at each end (see diagram).

2. Arrange the front, back, and side pieces to form a rectangle. Check the corners for square, clamp in place, and tack weld the pieces together.

3. Measure diagonally across the corners to make sure they are square. If the measurements are equal, the base is square. If they are not, adjust the pieces until they are.

4. Clamp the base in place. Weld each outside corner. Turn the base over and weld each joint. Do not weld inside the base, as the weld beads will interfere with the tray and leg placement.

5. Measure the inside dimensions of the base and cut the tray (C) to size.

6. Insert the tray into the angles of the base. Tack weld the tray at points along the perimeter.

7. Turn the assembly over and place three 1" welds along each long side, and two 1" welds along each short side to join the tray to the base.

Assemble the Top

1. Cut the top front and back (D) and top side pieces (E) to size. Cut a 1 1/2" notch at each end of the side pieces.

2. Arrange the front, back, and side pieces to form a rectangle. Check the corners for square, clamp in place, and tack weld the pieces together.

3. Measure diagonally across the corners to make sure they are square. If the measurements are equal, the top assembly is square. If they are not, adjust the pieces until they are.

4. Clamp the pieces in place. Weld each outside corner. Turn the assembly over and weld each joint. Do not weld inside the top assembly, as the weld beads will interfere with the top and leg placement.

5. Measure the top assembly to allow a 1/8" setback on all sides, and cut the top (G) to size.

6. Grind down the welds and place the top over the assembly. Tack weld the top along the perimeter, then finish weld with two 1" welds per side.

Attach the Legs

1. Cut the legs (F) and brace (H) to size.

2. Turn the top upside down. Place a leg in one of the corners. Use a scrap piece of angle iron to assist in clamping (see photo). Make sure the leg is square to the top and tack weld into place.

3. Repeat step 2 to attach the other three legs to the corners of the top.

4. Place the legs and top assembly into the bottom assembly. The back legs should fit into the corners of the bottom assembly, and the front legs into the angles of the side pieces of the base.

5. Make sure the legs are square to the base, clamp, and tack weld.

6. Measure across the diagonals between the base and the top to make sure the unit is square. Adjust, if necessary, and finish welding the legs to the top and base.

7. Measure 12" from the bottom of the front legs Center the brace over the marks, check it for square, and clamp in place. Weld the brace to the front legs.

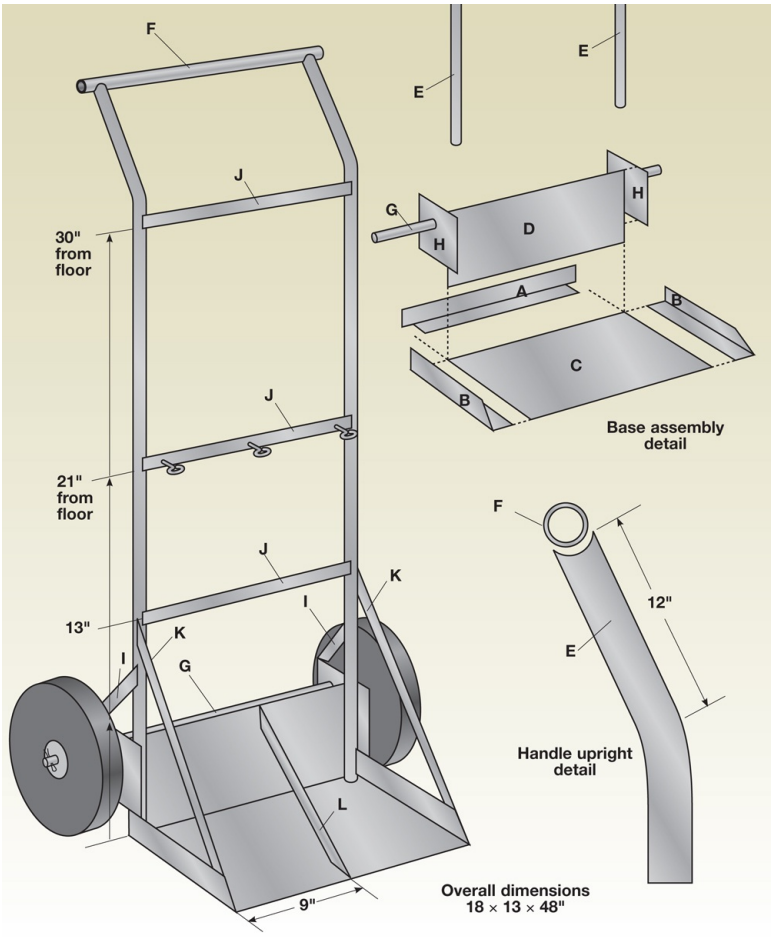
Add Finishing Touches

1. Sand and clean the cart, and paint.

2. Drill holes 2" in from the ends of the brace and attach the eyebolts. Use the threaded chain links to attach the chain.

3. Turn the cart over. Grind down the welds at the corners and attach the casters. If you are welding the casters, make sure you grind off the zinc coating.

Use a scrap of angle iron to hold the legs in place for tacking.



Overall dimensions
18 × 13 × 48"

Cylinder Cart

You can purchase a cylinder cart for your oxyfuel rig—your dealer might even give you a discount—but it’s fun and challenging to make your own. This cart is constructed with 1/8” stock, which is oxyfuel weldable, but we used GMAW. The base platform and back support can be flame or plasma cut. If you have access to a heavy-duty metal brake, you can make the base platform and back support from one 16-1/4 × 17-3/4” piece and bend it to 90° (allow 1/4” for the radius of the bend).

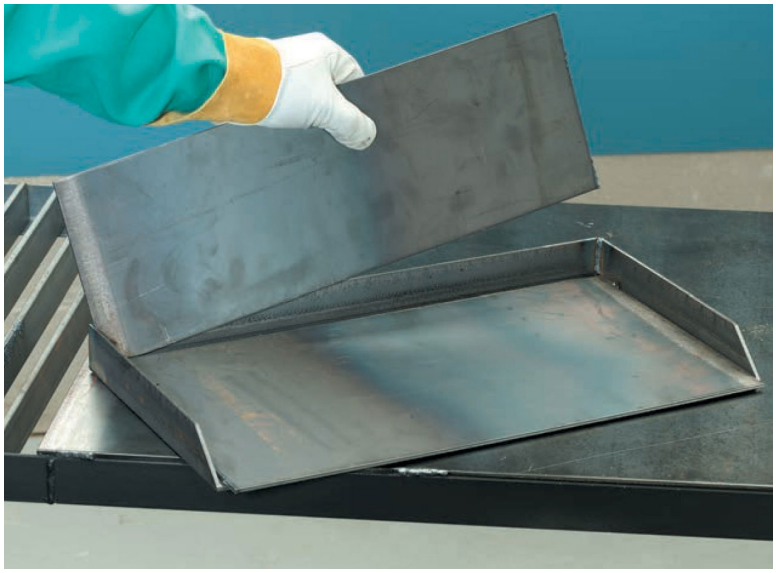
PART	NAME	DIMENSIONS	QUANTITY
A	Base back	1/8 × 1 1/2 × 1 1/2" angle iron × 18"	1
B	Base sides	1/8 × 1 1/2 × 1 1/2" angle iron × 10"	2
C	Base platform	1/8" sheet × 10 × 17-3/4"*	1
D	Back support	1/8" sheet × 6 × 17-3/4"*	1
E	Handle uprights	1/8 × 1" round tube × 60"*	2
F	Handle	1/8 × 1" round tube × 18"	1
G	Axle	5/8" round bar × 22"*	1
H	Axle brackets	1/8" sheet × 4 × 4 1/2"	2
I	Bracket supports	1/8 × 1 1/2" flat bar × 8"*	2
J	Crosspieces	1/8 × 1 1/2" flat bar × 17"*	3
K	Side supports	1/8 × 1-1/4" flat bar × 24"*	2

L	Base support	1/8 × 1 1/2" flat bar × 12"*	1

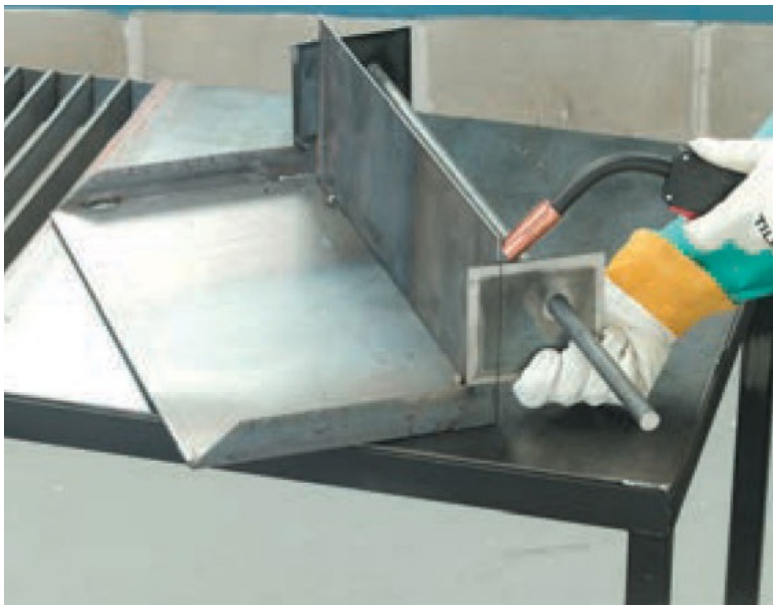
*Approximate dimensions, cut to fit

MATERIALS

- 1/8 × 1 1/2 × 1 1/2” angle iron (3 1/2 feet)
- 1/8” sheet metal (18 × 24” sheet)
- 1/8 × 1” round tube (12 feet)
- 5/8” round bar (2 feet)
- 1/8 × 1 1/2” flat bar (7 feet)
- 1/8 × 1-1/4” flat bar (4 feet)
- 1” eyebolts with nuts (3)
- Chain
- Snap closures or threaded chain links (3)
- 8” wheels with hubs (2)
- Washers and cotter pins (2)



After welding the base back and sides, cut the base platform and back support to fit, then weld them in place.



Tack the axle brackets to the base assembly. Insert the axle to check for proper alignment, then finish weld the bracket joints.

How to Build a Cylinder Cart

Prepare the Cart Base

1. Cut the base back (A) and base sides (B) to size. Rather than mitering the corners, cut a 1 1/2” notch in each end of the base back (see diagram).

2. Mark and cut a triangular section off the front end of each base side to soften the edge.

3. Lay out the base back and sides to form a three sided rectangle. Square the corners and clamp the assembly to your work surface.

4. Tack the joints at both ends of the base back. Turn the assembly over and weld the corner and butt joints.

Install the Base Platform & Back Support

1. Measure the inside width of the base assembly and cut the base platform (C) and back support (D) to size.

2. Place the base platform into the base assembly and tack weld it into place along the base sides.(Do not weld along the base back, as that would prevent the back support from fitting flat against the base platform.)

3. Turn the base over and place two 1” welds along each side where the base platform meets the back and sides.

4. Set the base flat on the work surface, right side up, and place the back support upright against the inside of the base back (see photo).

5. Clamp the back support to the base back. Place three 1” welds on the back side of the support where it meets the angle iron.

6. Place two 1” welds on the inside T-joint, making sure not to weld within two inches of the corner.

Attach the Axle Brackets

1. Cut the axle brackets (H) to size.

2. Place the base assembly on its side and align an axle bracket along the top edge of the base side, resting it on top of the back support and extending 3” off the back side.

3. Measure 4” up from the bottom of the base assembly and 1 1/2” from the back edge to mark the axle location on the axle bracket. Drill, flame cut, or plasma cut a 5/8” hole at the mark.

4. Tack weld the axle bracket in place (see photo, above left). Insert the axle to check for proper alignment, then weld both sides of the T-joint between the bracket and the back support.

5. Weld the outside butt joint between the bracket and the base side.

6. Repeat steps 2 to 5 to weld an axle bracket to the other side of the base assembly.

Prepare the Handle Uprights

1. Cut the handle uprights (E) to length.

2. Make a 20° to 30° bend in one of the handle uprights, 13” from one end, using a heavy-duty conduit bender. Bend the other handle upright to match.

3. Cut both pieces so the curve is 12” from the top end and the overall upright height of each is 48”. Grind the tops of both handle uprights so they fit around the handle tube.

Assemble & Install Handle Uprights

1. Place a handle upright against the inside corner of the base assembly. Turn the handle so the curve points straight back. Tack weld the handle in place. Repeat this process for the other handle upright.

2. Cut the handle (F) to size.

3. Place the cart on its back. Set the handle against the cutouts in the handle uprights, keeping an equal amount of overhang on each end, and tack weld in place.

4. Finish weld the handle uprights to the base assembly. Place welds between the handle uprights and top back support, and between the handle uprights and axle brackets.

Attach the Crosspieces

1. Measure and cut the crosspieces (J) so they are slightly recessed against the handle uprights.

2. Drill three 3/16” holes—one in the center and one on each end of one crosspiece. Place this crosspiece 21” up from the base.

3. Set the remaining crosspieces at 13” and 30” from the base on the forward side of the handle uprights, and weld in place (see photo).

Attach the Supports

1. Turn the assembly on its side. Place a bracket support (I) in position across the handle upright and the axle bracket. Mark the angles on the support and cut it to size.

2. Weld the bracket support in place against the handle upright and axle bracket.

3. Set the side support (K) in position against the base side and the handle upright. Mark the angles and cut to fit. Weld the support in place.

4. Turn the assembly on its opposite side and repeat steps 1 to 3.

5. Mark the angles and cut the base support (L) to size to fit between the base platform and the base back.

6. Center the base support from side to side on the base assembly. Weld both sides of each T-joint.

Complete the Cart

1. Center the axle (G) between the axle brackets. Place the wheels on the axle to make sure the wheels barely make contact with the floor (see photo, right).

2. Mark the axle for its final length and cut to size. Drill holes in each end of the axle to fit the cotter pins.

3. Center the axle between the axle brackets and weld in place.

4. Complete any unfinished welds.

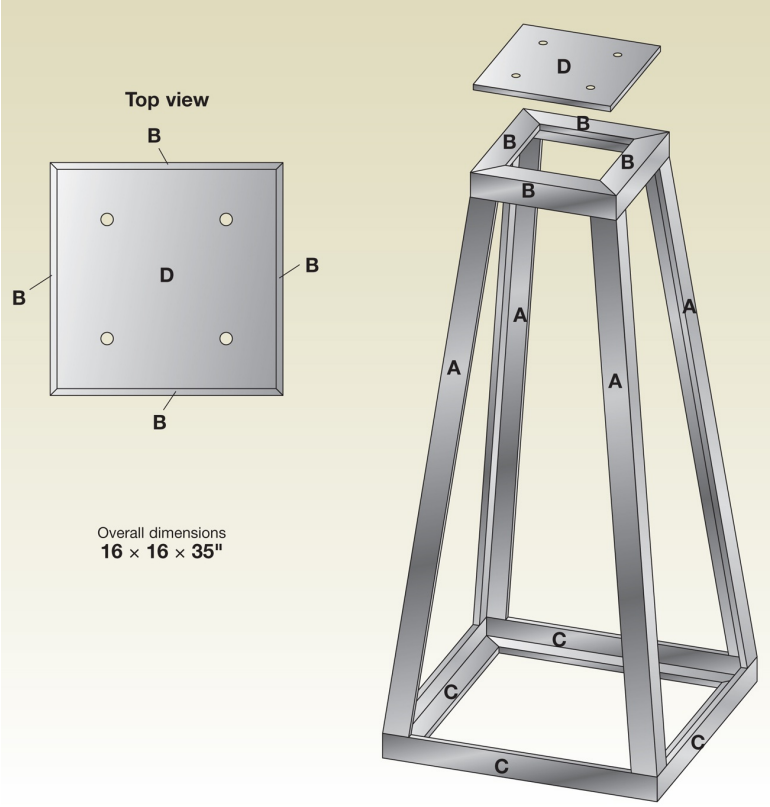
5. Wire brush or sandblast the cart. Clean the cart and paint as desired.

6. Attach the wheels to the axle. Insert cotter pins in the axle holes.

7. Affix eyebolts with nuts in the 3 holes in the middle crosspiece. Attach the chain to the eyebolts with snap closures or threaded chain links.

Lay the crosspieces across the handle uprights at the proper heights. Weld the pieces to the uprights.

Trial fit the wheels before welding the axle into place. The wheels should just barely make contact with the floor.



Grinder Stand

This is a good project to make with angle iron from the discount bin at the local steel supply center. You can often buy short pieces for 10 cents a pound rather than the 30 to 50 cents you would normally pay. Take along your calipers or micrometer to measure thicknesses, as well as your measuring tape, cutting list, and tough gloves so you don’t get cut digging through the scrap pile.

PART	NAME	DIMENSIONS	QUANTITY
A	Legs	3/16 × 1 1/2 × 1 1/2" angle iron × 32"	4
B	Top	3/16 × 1 1/2 × 1 1/2" angle iron × 8 1/2"	4
C	Bottom	3/16 × 1 1/2 × 1 1/2" angle iron × 16"	4
D	Platform	3/16 to 1/2" plate 8 × 8"	1

Materials

- 3/16 × 1 1/2 × 1 1/2" angle iron (19 feet)
- 3/16" plate (8 × 8")

How to Build a Grinder Stand

Build the Top & Bottom Assemblies

1. Cut the top and bottom pieces (B & C) to length. Miter the corners at 45° or cut 1 1/2" notches into the pieces.

2. Assemble pairs of bottom pieces into right angles. Clamp the pieces to your work surface and tack weld at each corner.

3. Assemble the two right angles into a square. Check for square by measuring across each diagonal—if the measurements are equal, the assembly is square. Tack weld the corners.

4. Repeat steps 2 to 3 to assemble the top.

Mark & Cut the Legs

1. Cut the legs (A) to size.

2. Place the bottom assembly on your work surface and loosely clamp the legs into each corner.

3. Set the top assembly over the legs and clamp it in place. Make sure the top is level.

4. Mark each leg at the top and bottom where they cross the platforms (see photo).

5. Unclamp the legs and cut to size.

Assemble the Stand

1. Place one leg on top of a corner of the bottom assembly and tack weld it in place. Tack weld the other three legs in the corners the same way.

2. Align a corner of the top assembly with the top of one leg and tack it in place. Tack weld the top assembly to the other three legs the same way.

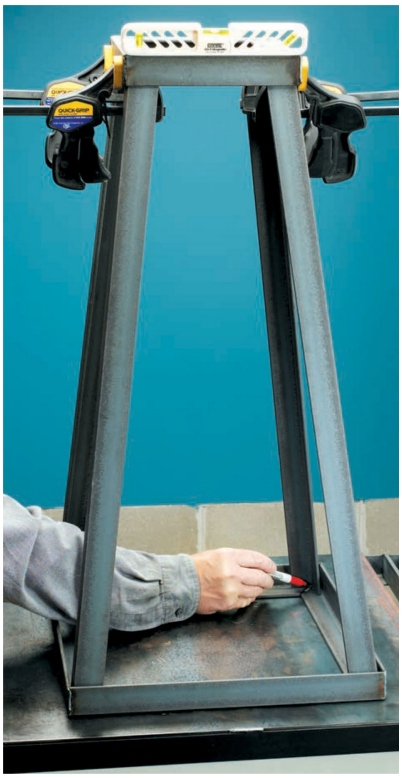
3. Adjust the stand so the top is level. You may need to remove tack welds and grind down some angles.

4. When you are satisfied with the alignment, complete the welds. To minimize distortion, alternate between the sides, top, and bottom as you weld.

Attach the Platform Plate

1. Cut the platform plate (D) to size. Drill four holes in the face to match your grinder mounting holes.

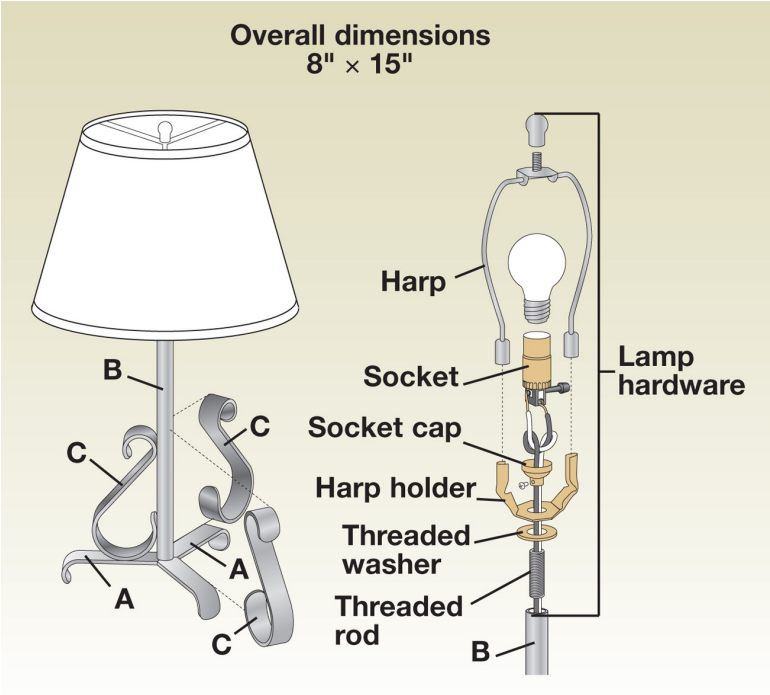
2. Set the plate over the top of the stand, aligning the edges with the outside of the top pieces. Weld the plate to the stand.



Assemble the grinder stand using clamps. Mark the top and bottom of each leg and cut to fit.

LIGHTING PROJECTS

Scroll Desk Lamp 92
Three Post Floor Lamp 94
Chandelier 96
Wall-mounted Candleholder 98
Tree-shaped Candleholder 100
Fireplace Candleholder 102


Overall dimensions
8" × 15"
B
C
C
A
A
C
Harp
Socket
Socket cap
Harp holder
Threaded washer
Threaded rod
B
Lamp hardware

Scroll Desk Lamp

In this project, you will make simple scrolls—or you can purchase wrought iron scrolls from a wrought iron supplier or blacksmith. (See Metal Shaping Techniques, page 19, or Resources, page 140.) Either way, this makes a delightful little desk lamp.

PART	NAME	DIMENSIONS	QUANTITY
A	Bases	1/8 × 3/4" flat bar × 5"	3
B	Shaft	1/2 " round tube × 9"	1
C	Scrolls	1/8 × 1/2" flat bar × 12"	3

Materials

- 1/8 × 3/4" flat bar (15")
- 1/2" round tube (9")
- 1/8 × 1/2" flat bar (36")
- 1/2", 1" and 2" pipe
- Lamp hardware and shade
- 1/8" hollow threaded rod (1")

How to Make a Scroll Desk Lamp

Assemble the Base

1. Cut the base pieces (A) and shaft (B) to size.

2. Round one end of each base piece using a bench or angle grinder. Clamp the rounded ends to a 1/2" pipe. Curl the ends to form an arc.

3. Turn the base pieces upside down and arrange them so they are equally spaced at the 12, 4, and 8 o’clock positions (120° between adjacent pieces at their centerlines).

4. Use a grinder to shape the flat end on each base piece to fit against the other two legs. Once the pieces are fitted, center the 1/2" tube on the arranged pieces and mark around the tube.

5. Grind the legs so the tube fits in the shaped opening, but don't insert the shaft at this time.

6. Tack weld the undersides of the legs at each contact point.

Attach the Tube

1. Turn the base assembly right side up and insert the tube. Check for square and tack weld at three points.

2. Check for square again, adjust the pieces if necessary, and complete the weld around the base of the tube. (You can weld the tube from the bottom side only, but a solid weld all around the top looks nice.)

Prepare & Attach Scrolls

1. Cut the scrolls (C) to size.

2. Round both ends of the scroll pieces with a grinder.

3. Using a 1" pipe, make a 1" circle at one end of each scroll. Using a 2" pipe, make a 2" circle at the other end of the scrolls, facing the opposite direction. (Because of the springiness of the steel, the final circles will be slightly larger.)

4. Place one scroll against the base and the shaft, arranging it in a pleasing manner. Tack weld it in place where it touches the base and shaft.

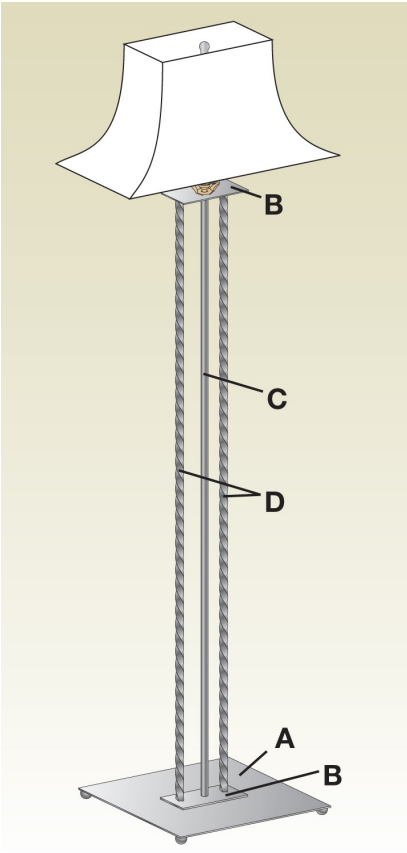
5. Place and tack weld the second and third scrolls, taking care to align them carefully. When satisfied with the placement and alignment, tack weld on the opposite sides of the scrolls (see photo).

Apply Finishing Touches

1. Clean up the welds, and apply the finish of your choice.

2. Tap threads in the top of the shaft (or weld a small nut to the top of the shaft), and insert the hollow threaded rod. Thread the wire through the shaft and rod. Thread the washer, and place the harp holder over the threaded rod. Screw on the socket cap, and tighten the set screw. Wire the fixture (see diagram). Press the socket assembly into the socket cap, place the harp in the harp holder, and install the lightbulb and shade.

Arrange the scrolls against the base and shaft, then weld the scrolls in place on both sides.


B
C
D
A
B

Three Post Floor Lamp

A welded lamp has a nice heft to it—with this 10" square base, it will be difficult to tip, no doubt! We used fully twisted rod because it creates a simple contrast of square twists and smooth rounds and is available in longer lengths. Partially twisted rod is also available. You also could use any of a variety of decorative hammered square bars or tubes from the sources listed in the Resource section on page 140. While you're making a floor lamp, you could make a desk lamp to match. Just adjust the dimensions to fit.

PART	NAME	DIMENSIONS	QUANTITY
A	Base	3/16" sheet 10 × 10"	1
B	End caps	3/16" flat bar 2 × 4"	2
C	Center post	1/2" round tube 48-3/8"	1
D	Side posts	1/2" twisted rod 48"	2

Materials

- 1/2" round tube (48-3/8")
- 1/2" twisted square rod (96")
- 3/16" sheet (10 × 10")
- 3/16 × 2" flat bar (8")
- 1" round balls (4)
- Lamp hardware and shade

How to Make a Three Post Floor Lamp

Prepare the Work Pieces

1. Cut the end caps (B) to size. Cut the center post (C) and side posts (D) to size.

2. Mark the end caps at 3/4", 2", and 3 1/4" from one end. Make a mark lengthwise through the center of each end cap.

3. At the intersection of the 2" and the centerline marks in each end cap, drill a 1/2" diameter hole.

Attach the Center Post to the End Caps

1. Insert the center post into the hole in one of the end caps. Check the post for square, then tack weld the post at the bottom.

2. Repeat step 1 to tack weld the other end cap onto the opposite end of the center post.

3. Stand the center post and end caps upright and carefully weld around the post.

Attach the Side Posts

1. Place the lamp assembly flat on your work surface. Center a side post over the 3/4" mark on one of the end caps. Check the post for square and tack weld in place.

2. Place the side post in position on the second end cap. Check for square and tack weld.

3. Repeat steps 1 and 2 to attach the second side post to the end caps at the 3-1/4" marks.

4. Square all the parts and complete each weld all around each post and end cap (see photo).

Attach the Post Assembly to the Base

1. Cut the base (A) to size.

2. Make a line 3" in from each side of the base and 4" in from the top and bottom. Draw lines at 5" lengthwise and widthwise to mark the center point.

3. Drill a 1/2" diameter hole at the center of the base for the cord.

4. Weld a 1" ball 1/2" from the edges at each corner of the base for the feet.

5. Turn the base right side up. Clamp the post assembly to the base, centering the base on the lines marked in step 2. The holes for the cord should line up. If not, enlarge the hole in the base.

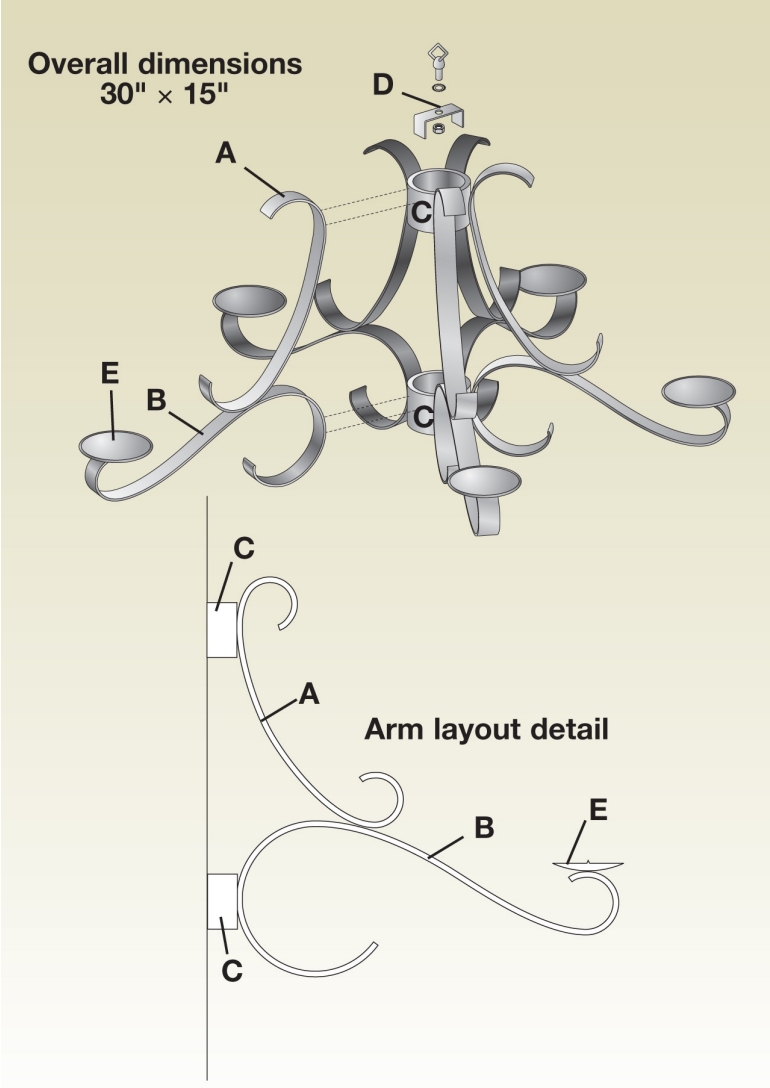
6. Tack weld the post assembly to the base on two sides. Check for square. Complete the fillet weld around the base. Weld toward the tack points to minimize distortion.

Apply Finishing Touches

1. Grind down any spatter or uneven welds. Apply the finish of your choice.

2. Tap threads in the top of the shaft (or weld a small nut to the top of the shaft), and insert the hollow threaded rod. Thread the wire through the shaft and rod. Place the washer and harp holder over the threaded rod. Screw on the socket cap, and tighten the set screw. Wire the fixture (see diagram, page 92). Press the socket assembly into the socket cap, place the harp in the harp holder, and install the lightbulb and shade.

Make sure the posts are square to the end caps, then weld them in place.


Overall dimensions
30" × 15"
D
A
C
E
B
C
C
A
Arm layout detail
B
E
C

Chandelier

This delightful candle chandelier is a wonderful accent for cabins, porches, or even outside dining. Making the scrolls is easy, but if you want something a bit fancier, you can purchase wrought iron scrolls. Place the scrolls carefully around the couplers to ensure the fixture will hang straight. If you do not want to purchase a long section of round tube for two 2" pieces and can't find any in the scrap bin at the steel yard, use threaded black pipe couplers.

PART	NAME	DIMENSIONS	QUANTITY
A	C scrolls	1/8 × 3/4" flat bar × 16"	5
B	S scrolls	1/8 × 3/4" flat bar × 24"	5
C	Couplers	2-1/4" round tube × 2"	2
D	Insert	1/8 × 3/4" flat bar × 4"	1
E	Bobeches	2-1/2"	5

Materials

- 1/8 × 3/4" flat bar (17 feet)
- 10", 6", 2", and 1" bending forms
- 2-1/4" round tube (4")
- 2-1/2" bobeches (5)
- 2" threaded nipple
- Lock washers (2)
- Threaded brass washers (3)
- Finial
- Decorative chain
- Candles (5)

How to Make a Chandelier

Prepare the C Scroll Blanks

1. Cut the C scroll (A) and S scroll (B) blanks to size.

2. Clamp a C scroll blank to the 10" bending form. Shape the entire length of the scroll blank. Lightly tap the scroll with a hammer, if necessary, to get it to conform.

3. Remove the scroll from the form. Reclamp one end of the scroll to the 1" form and shape that end into a tight curve. Repeat this step to shape the opposite end.

4. Repeat steps 2 and 3 to shape the remaining C scrolls.

Prepare the S Scroll Blanks

1. Mark each S scroll blank 9-1/2" from one end. Clamp the marked end to the 6" bending form.

2. Wrap the bar around the form, shaping it just past the mark.

3. Clamp that same end to the 2" form. Wrap the bar almost all the way around the form.

4. Unwrap the large curve slightly, refining the scroll into a pleasing shape.

5. To curve the other end in the opposite direction, turn the piece over and clamp it to the 2" form. Wrap the bar almost all the way around.

Assemble the Scrolls

1. Set a straightedge on a large piece of paper. Lay out one C scroll and one S scroll along the straightedge, and adjust them until they form a pleasing shape. Mark the contact point on the bars.

2. Remove the scrolls from the paper and weld them together at the contact point.

3. Trace the outline of this assembly on the paper (see photo, top right). Use this pattern to arrange and assemble the remaining arms.

Assemble the Chandelier

1. Cut the couplers (C) and insert (D) to length.

2. Drill a hole in the center of the insert large enough for the threaded nipple. Bend tabs on each end of the insert so it will fit inside a coupler.

3. Place the insert into a coupler, with the tabs pointing down. Weld the insert to the coupler along the tabs. This forms the top coupler.

4. Draw a line around the outside of each coupler on paper.

5. Mark five equidistant points around the coupler outline. Place the coupler back on the paper and transfer the lines onto the coupler, using a combination square (see photo).

6. Weld the arms to the couplers. Weld the bobeches to the arms.

Apply Finishing Touches

1. Place a lock washer and threaded brass washer on the threaded nipple. Set this in the hole in the insert and secure it with another lock washer and threaded brass washer.

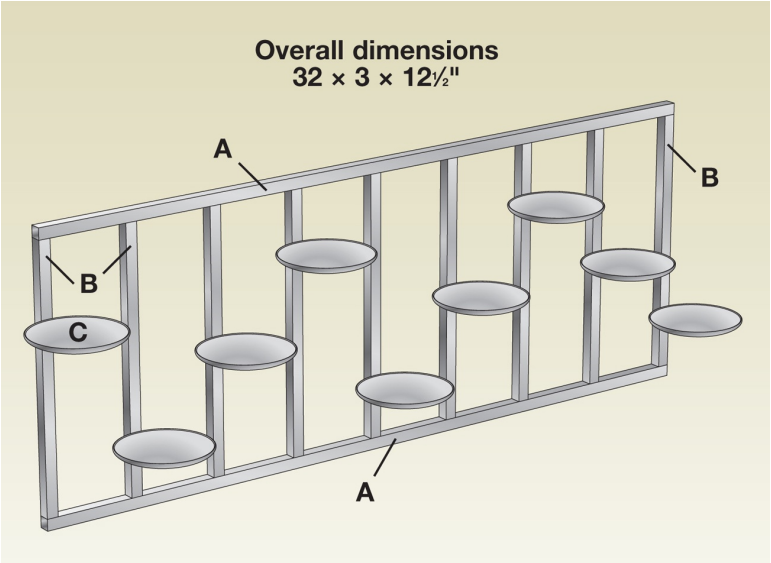
2. Add a threaded brass washer and a finial.

3. Wire brush and clean the chandelier. Apply your choice of finish.

4. Clip the chain into the finial, and it's ready to hang.

After welding the first set of scrolls, trace the outline on a sheet of paper. Use this pattern to arrange the remaining scrolls.

Use a combination square to mark the arm placement on each coupler.



Wall-mounted Candleholder

This wall-mounted candleholder is perfect for a patio wall or over a buffet table. The length and height can be adjusted easily to suit your particular wall space. Or it easily can be turned to run vertically rather than horizontally. Candle drip trays, or bobeches, do not have holes, while bobeches for electrical fixtures do. See Resources, page 140, for bobeche sources. Clean all weld areas prior to welding. When hanging the candleholder, use hangers rated to hold 25 pounds. (The holder will weigh about 13 pounds, plus candles. Remember never to leave burning candles unattended.)

PART	NAME	DIMENSIONS	QUANTITY
A	Horizontal bars	1/2 " square bar × 32"	2
B	Vertical bars	1/2 " square bar × 11-1/2"	9
C	Bobeches	2-1/4"	9

Materials

- 1/2" square bar (14 feet)
- 2-1/4" bobeche (9)
- Candles (9)

How to Build a Wall mounted Candleholder

Assemble the Horizontal & Vertical Bars

1. Cut the horizontal (A) and vertical (B) bars to length.

2. Butt a vertical bar against the inside left edge of the top horizontal bar. Use a framing square to ensure the pieces are set at a 90° angle. Tack weld the inside of the angle.

3. Butt another vertical bar against the inside right end of the bottom horizontal bar. Make sure the angle is 90° and tack weld on the inside.

4. Place the two angled pieces together to make a rectangle, with the vertical bars on the inside of the horizontal bars. Use the framing square to adjust the angles to 90° and clamp in place.

5. Measure diagonally across the corners. If the measurements are the same, the piece is square. If not, adjust the bars so the measurements are equal.

6. Tack the two corners, and check again for square. Weld all four outside corners.

Attach the Vertical Bars

1. Place the remaining vertical bars at 4" intervals between the end pieces. Make sure the spacing is even, then mark where each vertical piece should go.

2. Check each piece for square and weld in place.

Attach the Bobeches

1. Place the bobeches (C) on the vertical bars in a pleasingly staggered pattern.

2. Clean the edge of each bobeche and the areas on the bars where they will be placed to ensure a good weld.

3. Use a magnetic clamp to hold the bobeche at a right angle to the bar and weld from the top side (see photo). When welding, direct most of the heat toward the bar since it is much thicker than the bobeche.

4. Remove the clamp. Make sure the bobeche still meets the vertical bar at a right angle and is level from side to side. Weld the bobeche from the bottom side.

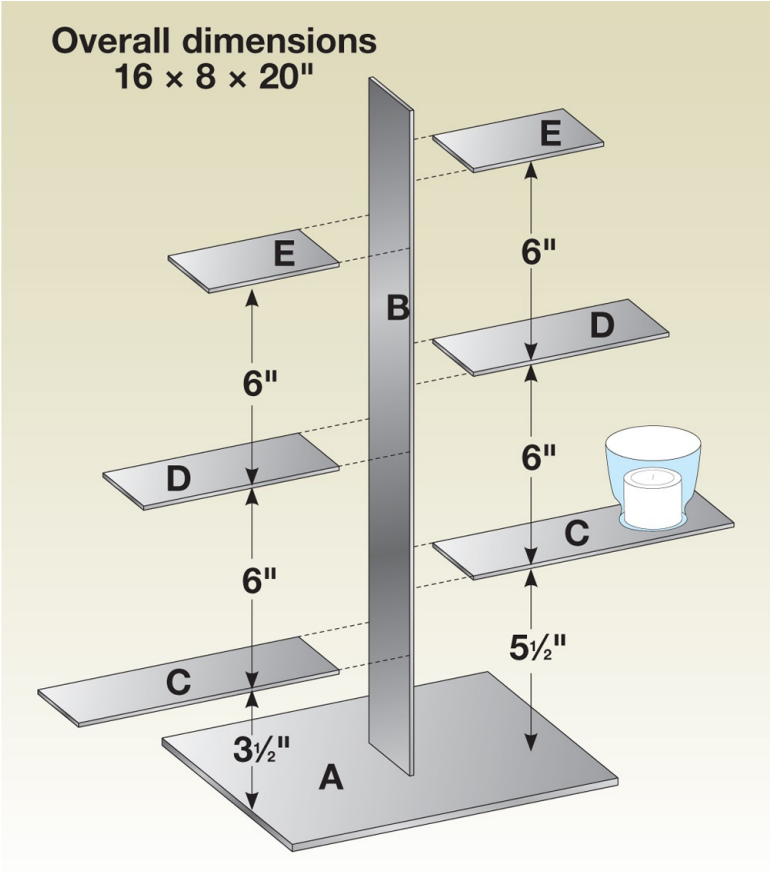
5. Repeat steps 3 to 4 to attach the remaining bobeches.

Apply Finishing Touches

1. Grind down the welds for a smooth look.

2. Finish the piece as desired. A rusted metal finish is appropriately rustic for outdoor use.

Place the bobeche at a right angle to the vertical bar using a magnetic clamp. Weld the bobeche in place, directing most of the heat toward the bar.


Overall dimensions
16 × 8 × 20"
E
E
6"
B
D
6"
6"
D
C
6"
5½"
C
3½"
A

Tree-shaped Candleholder

This tree-shaped candleholder displays an assortment of votive candles. The tree shape is also handy as a photo display area, if you aren't interested in a candle-holder. An option is to use square tubing and make a four-sided tree—perhaps even a larger version as a dramatic substitute for a Christmas tree. Most steel supply shops have pre-cut squares of steel sheet and plate in a variety of sizes. A smaller, thicker base would be just as stable. You may opt to make the base round and give the tree trunk a pointed top, if you will be cutting your own pieces. Some steel distributors and welding shops do custom shearing. (Remember not to leave burning candles unattended.)

PART	NAME	DIMENSIONS	QUANTITY
A	Base	3/16" sheet × 8 × 10"	1
B	Trunk	3/16 × 2" flat bar × 20"	1
C	Bottom branches	3/16 × 2" flat bar × 8"	2
D	Middle branches	3/16 × 2" flat bar × 6"	2
E	Top branches	3/16 × 2" flat bar × 4"	2

Materials

- 3/16" sheet (8 × 10")
- 3/16" × 2" flat bar (5 feet)
- Votive holders and candles
- Silicone adhesive

How to Make a Tree-shaped Candleholder

Assemble the Trunk

1. Cut the base (A), trunk (B), and branches (C, D, & E) to size.

2. Place the trunk upright in the center of the base, parallel to the 8" sides of the base. Clamp the trunk at a 90° angle to the base using a magnetic clamp.

3. Tack weld the trunk at each end on both sides.

4. Remove the clamp. Make sure the trunk is still square, then complete the welds.

Attach the Branches

1. Place the bottom branch 3-1/2" up from the base and magnetically clamp it in place at a 90° angle to the trunk.

2. Tack weld the branch to the trunk at each end on the top side (see photo).

3. Remove the clamp and complete the weld.

4. Place the second bottom branch on the opposite side of the trunk, 5-1/2" from the base. Weld in place.

5. Repeat the process by setting the middle branches 9-1/2" and 11-1/2" from the base, and the top branches 15-1/2" and 17-1/2" from the base.

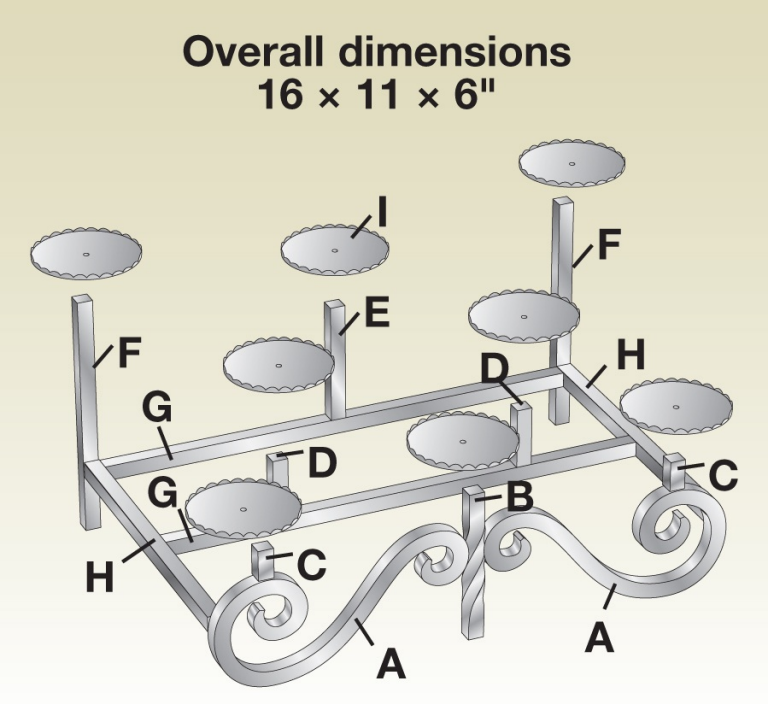
Apply Finishing Touches

1. Clean the metal and the welds with a wire brush.

2. Finish the candleholder as desired.

3. Use silicone adhesive to attach a votive holder to the end of each branch if desired.

A right angle magnetic clamp makes welding the branches an easy task.



Fireplace Candleholder

In the summertime, place this candleholder in your fireplace to enjoy flickering flames of firelight without the heat of the fire. This project uses forged scrolls, but you can bend your own, if you wish.

PART	NAME	DIMENSIONS	QUANTITY
A	Scrolls	4 × 8"	2
B	Center post	1/2 " twisted square rod × 5"	1
C	Front extenders	1/2 " square rod × 1"	2
D	Middle extenders	1/2 " square rod × 2"	2
E	Rear extender	1/2 " square rod × 3"	1
F	Rear posts	1/2 " square rod × 6"	2
G	Crosspieces	1/2 " square rod × 16"*	2
H	Side pieces	1/2 " square rod × 10"	2
I	Bobeches	3-3/8"	8

*Approximate dimensions, cut to fit

Materials

- 4 × 8" scrolls (2)
- 1/2" twisted square rod (5")
- 1/2" square rod (7 feet)
- 3-3/8" bobeches (8)
- Candles (8)

How to Build a Fireplace Candleholder

Assemble the Scrolls

1. Cut the center post (B) to size.

2. Place the scrolls (A) on their sides with the small circles butted against the center post. (If the scroll ends have been hammered out to form a flared end, you will need to use shims to make the pieces lie flat.)

3. Clamp the workpieces to your work surface, and weld the scrolls to the center post.

Assemble the Holder Base

1. Measure the length of the two scrolls and center post, and subtract 1". Cut the crosspieces (G) to this length.

2. Cut the rear posts (F) and side pieces (H) to size.

3. Place the crosspieces between the side pieces; one at one end and one in the middle. Weld the crosspieces in place.

4. Mark 2" up from the bottom of the rear posts. (Depending on the size of scroll you are using, you may want to make this higher or lower.) Clamp the rear posts to the work surface, and align the cross and side piece assembly with the 2" marks. Weld into place.

5. Weld this assembly to the back of the scrolls, making sure the side pieces are level.

Attach the Bobeches

1. Cut the front (C), middle (D), and rear (E) extenders to size.

2. Weld the front extenders to the tops of the scrolls. Center the rear extender over the rear crosspiece and weld in place. Set the middle extenders 4" from each end of the middle cross piece and weld in place (see photo).

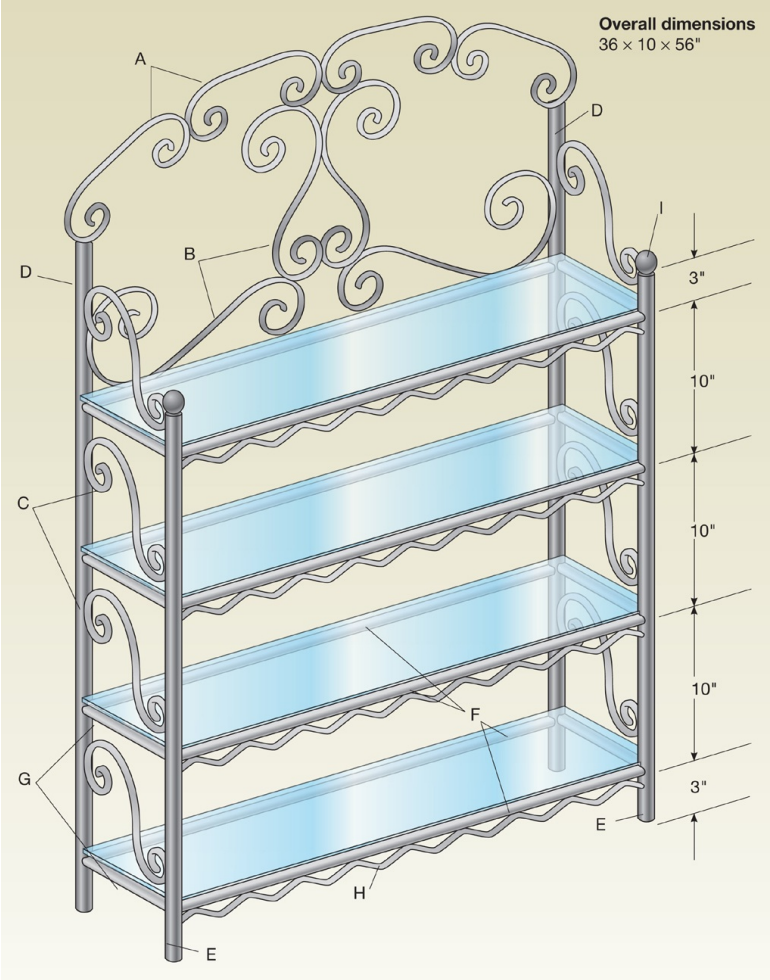
3. Center a bobeche (I) over each extender, rear post, and center post. Make sure the bobeches are level, and weld in place. You may need to grind down the tops of the posts to get a level seating for the bobeches.

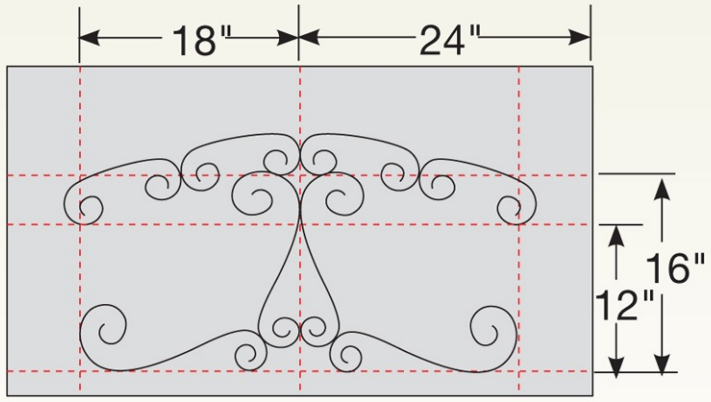
4. Wire brush, clean, and apply the finish of your choice.

Weld the extenders into place.

FURNITURE PROJECTS

Baker's Shelves 106
Coffee Table 110
Corner Coatrack 112
Kitchen Appliance Stand 114
Wall Hung Plate Rack 116
Wine Rack 118
Headboard 120





Decorative scroll layout detail

Baker’s Shelves

Baker’s shelves are a great welding project—the possibilities are nearly endless. Many gift and furnishing stores sell various baker’s shelves, but if you look closely, many have sloppy welds and thin wire scrolls. On our project, the shelves feature 1/4" round bar scrolls and a nice zigzag trim. You can make the scrolls with the homemade jigs featured on page 19, which works nicely. We also tried out a scroll making attachment for a hand-powered metal bender. This scroller was meant to use flat bar stock, but by grinding the round bar ends slightly, we could bend round stock. The ground ends actually added a nice touch to the scrolls. The metal bender could be used for the zigzag as well.

PART	NAME	DIMENSIONS	QUANTITY
A	C scrolls	1/4" round bar × 26-1/2"	4
B	Top S scrolls	1/4" round bar × 35"	4
C	Side S scrolls	1/4" round bar × 24-1/2"	8
D	Back legs	3/4" round tube × 44"	2
E	Front legs	3/4" round tube × 36"	2
F	Shelf supports, front & back	1/2 " round tube × 34-1/2"	8
G	Shelf supports, sides	1/2 " round tube × 8-1/2"	8
H	Zig zag trim	1/4" round bar × 48"	4
I	Finials	1" brass or wood ball	2

Materials

- 1/4" round bar (54 feet)
- 16 gauge × 3/4" round tube (13-1/2 feet)
- 16 gauge × 1/2" round tube (29 feet)
- 4 × 6 foot plywood
- 2 × 4 foot plywood
- 1 × 2 lumber × 36" (7)
- Drywall screws
- 2 × 2 lumber × 36"

- Pre-drilled 3/4" on center flat bar (3 feet)
- 5/16 × 2-1/2" machine bolts (24)
- 3/4" rubber pipe tips or glides (4)
- Brass or wood finials (2)
- Tempered glass shelves cut to fit (4)

Use a scroll bender to bend the decorative scrolls.

How to Build Baker’s Shelves

Prepare the Scrolls

1. Cut the C scrolls (A) and top S scrolls (B) to size.

2. Mark a stop point 10-3/4" from each end of a C scroll. Insert one end into the scroll maker (flatten the end by grinding, if necessary), and bend it to the stop point. Do the same for the other end (see photo).

3. Repeat step 2 to shape the remaining three C scrolls.

4. Mark a stop point 20" from one end of a top S scroll. Mark a stop point 8" from the other end.

5. Insert the 20" end of the S scroll into the scroll maker and bend to the stop point for the large circle. Insert the opposite end into the scroll maker and bend to the 8" mark for the small circle.

6. Repeat steps 4 to 5 to shape the other S scrolls.

Assemble the Scrolls

1. On a 2 × 4 foot sheet of plywood, lay out the scroll pattern shown below.

2. Draw a line 6" in from one side of the plywood. Draw parallel lines at 18" and 36" from this line to mark the outside edges of the back legs and the center line. Draw a perpendicular line across the bottom of these lines for the base line.

3. On the center line, mark a point 16" up from the baseline to mark the base of the uppermost C scroll pair. On the side lines, mark points 12" up from the baseline to mark the base of the side C scrolls. The back legs will meet the C scrolls at the underside of the scroll. The S scroll will butt up against the back leg. (Because the scrolls you turn will be slightly smaller or larger, you may need to adjust the layout dimensions as you go.)

4. Lay out the scrolls on the pattern. When you are satisfied with the layout of the scrolls, weld them together at the contact points.

Create the Assembly Jig

1. Use drywall screws to fasten a 3-foot piece of 1 × 2 along the long edge of a 4 × 6 piece of plywood. Attach another 3-foot piece of 1 × 2 parallel to the first piece, 36" apart. These mark the outside edges of the legs.

2. Attach a third piece of 1 × 2 across the bottom of these two, making sure the corners are square. This will align the bottom of the legs.

3. Attach four 24" pieces of 1 × 2 perpendicular to the sides at 3", 13", 23" and 33" to mark the shelf heights. Center these pieces between the side pieces.

Lay out the scroll design dimensions on a piece of plywood. Place the scrolls into the layout, and weld at each contact point.

Assemble the Legs & Shelf Supports

1. Cut the back legs (D), front legs (E), and shelf supports (F & G) to size. Grind the ends of the shelf supports slightly to fit around the curve of the legs.

2. Clamp the back legs to the side 1 × 2s, making sure the leg ends are firmly against the bottom crosspiece.

3. Clamp the back shelf supports to the four shelf crosspieces of the jig.

4. Weld the back shelf supports to the back legs.

5. Repeat steps 2 to 4 to attach the front legs to the front shelf supports.

Attach the Shelf Sides

1. Stand the back legs and shelf support assembly upright. Use a magnetic clamp to hold a shelf side support even with a back shelf support. Tack weld into place.

2. Stand the front legs and shelf support assembly upright. Align with the back assembly, and tack weld the shelf side support even with its corresponding front shelf support.

3. Continue to line up and attach the shelf side supports.

4. Place the shelf assembly on its back, and align it with the scroll assembly. Weld the two assemblies together at all contact points.

Install the ZigZag Trim

1. Cut the zigzag blanks (H) to length.

2. Bend the zigzag trim to shape. Create a bending jig by attaching a 3-foot length of pre-drilled flat bar to a 3-foot length of 2 × 2. Drill 1" deep holes through every other hole. Use 2-1/2" bolts as the bending posts. Insert two bolts into the jig, and clamp the zigzag blank between them. Bend the metal around the second bolt and insert a third bolt, bend the metal around that, and continue (see photo). As you get toward the end, if you need more leverage, slip a piece of 1/2" tube over the rod.

3. Cut the zigzag trim to fit between the front legs.

4. Weld the zigzag trim to the legs and to points on the underside of each shelf.

Attach the Side S Scroll

1. Cut the side S scrolls (C) to size.

2. Mark a stop point 11-7/8" from one end for the large circle of the scroll, and 6-3/8" from the opposite end for the small circle. Do this for each S scroll.

3. Bend the scrolls at the marks.

4. Place the scrolls between the front and back legs, setting the scrolls 1/2" above the shelf supports to allow room for the glass shelf.

5. Weld the scrolls to the front and back legs.

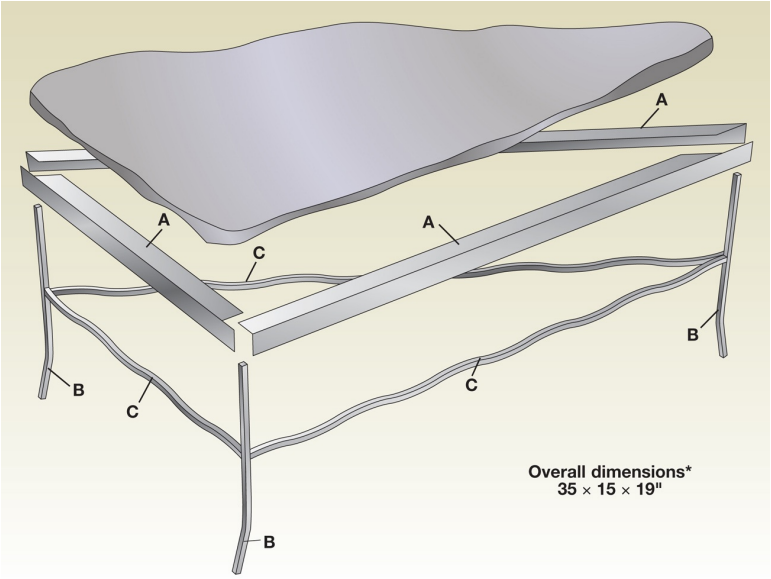
Add Finishing Touches

1. Grind down all welds and spatter. Clean and wire brush or sandblast the baker's shelves. Apply the finish of your choice.

2. Install glides or rubber tips on the legs. Place finials on the front leg tops.

3. Measure the shelf dimensions, including the cutout dimensions to fit around the legs, and order tempered glass shelves cut to fit.

Use pre-drilled 3/4" on center flat bar attached to a 2 × 2 to create a bending jig for the zig zag trim. Clamp the rod between the first two bolts and bend. Continue adding bolts and bending until complete.


A
A
A
C
B
B
C
C
B
Overall dimensions*
35 × 15 × 19"

Coffee Table

A nice slab of stone or a cross section of a tree makes an appealing coffee table, but how do you support it simply and easily? A table base welded from 1" angle iron and 1/2" square bar can support the weight of stone or wood without being cumbersome or bulky. This design is for a triangular base to suit the piece of marble being used. Creating a layout with tape allows you to experiment with different sizes and locations for your triangle. If you are using fence pickets, as we have here, make sure the length of the longest side of the triangle does not exceed the length of the picket. Pickets are generally 35 to 39" long.

PART	NAME	DIMENSIONS	QUANTITY
A	Top supports	1/8 × 1 × 1" angle iron*	3
B	Legs	1/2 " square bar × 20"	3
C	Wavy crosspieces	1/2 " wavy bar fence pickets*	3

*Side pieces and top supports must be cut to fit the particular tabletop.

MATERIALS

- 1/8" × 1 × 1" angle iron (amount will vary)
- 1/2" square bar (5 feet)
- 1/2" wavy bar fence pickets (3)
- Construction adhesive, silicone glue, or screws
- Masking tape
- Table top

How to Build a Coffee Table

Create the Triangle

1. Turn the table top upside down, and use masking tape to lay out a triangle. The triangle should be at least 3" in from the edges of the table top material, but not so far in that the table will tip easily.

2. Measure each side of the triangle. Cut the top support pieces (A) to match these three measurements. Miter both ends of the longest piece.

3. Place the longest support piece on top of the second longest support. Set both pieces on the tape layout on the table top. Mark the angle and notch on the second support where it intersects the first support (see photo) to allow these pieces to butt together. Cut out the notch and angle on the support.

4. Place the two supports back together on the triangle layout. Set the third support on the layout under the first two support pieces. Mark the notches and angles at the intersections. Cut the third support piece. (You may need to make an additional angle cut on the second long piece, depending on the triangle.)

5. On a work surface, arrange the support pieces to form the triangle. Weld the outside corners. Turn the assembly over and weld the top butt joints.

6. Use an angle grinder to smooth the top joints so the table top rests on a flat surface.

Install the Legs

1. Cut the legs (B) to size.

2. Mark each leg 4" from one end. Place a leg in a bench vise, lining up the mark with the edge of the vise jaws, and bend the leg end 15°. Repeat this process for the other two legs.

3. Turn the top assembly upside down on your work surface. Place a leg in a corner with the bend of the leg pointing outward in the same line as the point of the triangle.

4. Check to make sure the leg is perpendicular to the top assembly, then tack weld in place. Tack weld the other two legs in the remaining corners the same way.

Attach the Side Pieces

1. Measure the distance between the legs. Cut one wavy crosspiece (C) to fit each of the three sides. Bevel the ends to fit the angled legs.

2. Clamp a crosspiece against two legs, 7” from the top assembly. Check for square and tack weld. Install the remaining crosspieces the same way.

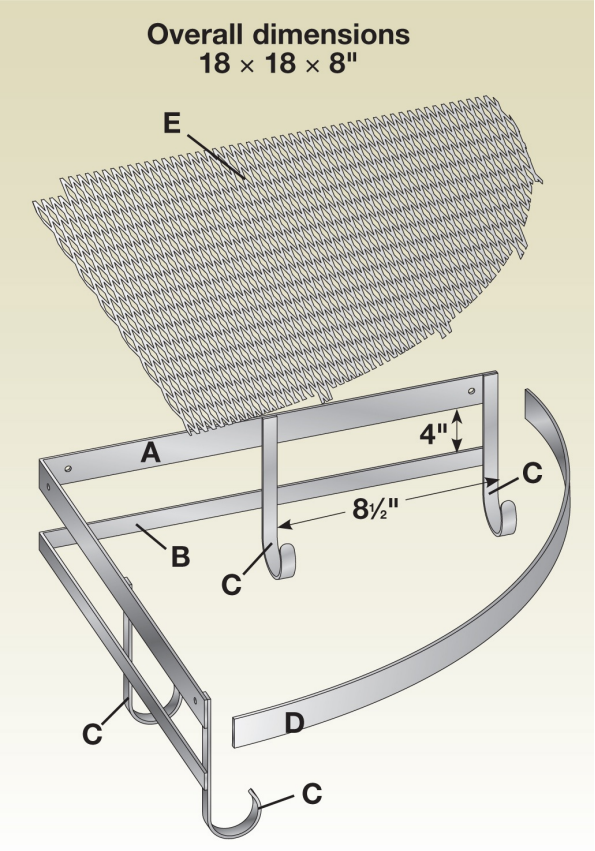
3. Turn the assembly right side up and check for square and level. Make adjustments if necessary. Complete all the welds.

Complete the Table

1. Grind down the welds, if desired. (You may also want to grind down the feet of the table so they make flat contact with the floor.) Clean or wire brush the assembly. Apply your choice of finish.

2. Drill holes in the angle iron and attach a wooden table top with screws, or use silicone or construction adhesive to attach a stone top.

Place the mitered long support piece on top of the second longest support piece. Mark the angle and notch needed to fit the pieces together.



PART	NAME	DIMENSIONS	QUANTITY
A	Rack top	1/8 × 1-1/4" flat bar × 36"	1
B	Rack bottom	1/8 × 3/4" flat bar × 36"	1
C	Hooks	1/8 × 3/4" flat bar × 12"	4
D	Rack front	1/8 × 1-1/4" flat bar × 38"*	1
E	Shelf	Expanded sheet metal	1

*approximate dimension, cut to fit

Corner Coatrack

In a small hallway with limited or no closet space, a corner coat-rack is one of the handiest things you can add. The expanded sheet metal used for the shelf is available in a variety of thicknesses and hole sizes. You may choose to use patterned sheet metal, which is available in many designs and gauges—see the Resources section on page 140. If the shelf will be used for items heavier than hats and mittens, you will need to use thicker gauge sheet metal or add some crosspieces for support. The mounting holes are spaced to account for 16" on-center studs. If you know where you will be hanging your coatrack, locate the studs and space the mounting holes accordingly.

Materials

- 1/8 × 1-1/4" flat bar (7 feet)
- 1/8 × 3/4" flat bar (7 feet)
- Expanded sheet metal (2 × 2 feet)
- 2" pipe
- Hanging hardware

How to Make a Corner Coatrack

Prepare the Rack Top & Bottom

The bend in the rack top and rack bottom takes 1/4" of material. By bending the pieces at the 17-3/4" mark, both legs will be equal length.

1. Cut the rack top (A) and rack bottom (B) to size.

2. Drill 1/4" holes in the top piece at 1", 17", 19", and 35". (These are the rack mounting holes.)

3. Mark the top piece 17-3/4" from one end. Place the piece in a bench vise with the mark at the edge of the vise and the longer end extending upward. Bend the end to 90°.

4. Repeat step 3 with the rack bottom piece.

Assemble the Rack

1. Cut the hooks (C) to size.

2. Grind one end of each hook into a smooth, rounded semi-circle. Make a 2"-radius bend in the rounded ends by clamping them to a section of 2" pipe and bending the hooks.

3. Lay the rack top and rack bottom on one side on your work surface, keeping them 4" apart. Make sure the ends are aligned and the bars are parallel.

4. Place a coat hook over the rack top and bottom, flush with the ends and with the top of the rack. Make sure the corners are square, then clamp the workpieces in place. Tack weld the coat hook to each bar.

5. Place the second hook 8-1/2" from the outside edge of the first hook. Check for square, clamp in place, and tack weld to each bar.

6. Rotate the rack so the other side is flat on the work surface. Repeat steps 4 to 5 to attach the hooks to that side.

7. Make sure that all hooks are still square to the rack. Weld the hooks to each bar, starting on the side opposite the tack.

Attach the Rack Front

1. Bend the rack front (D) into an 18"-radius arc. (The easiest way to do this is to place the bar over a table edge and make a slight bend every 2" along the length of the bar. Keep making bends until the proper radius is formed.)

2. Place one end of the arc against an end of the rack top. Make a mark where the other end of the arc meets the other end of the rack top. Cut the arc to size.

3. Place the arc against the rack top, leaving an open corner for the weld. Tack weld in place.

4. Position the other end of the arc against the opposite end of the rack top. Tack weld in place. Make sure the arc is aligned properly and not twisted. Complete the corner welds.

Attach the Shelf & Finish

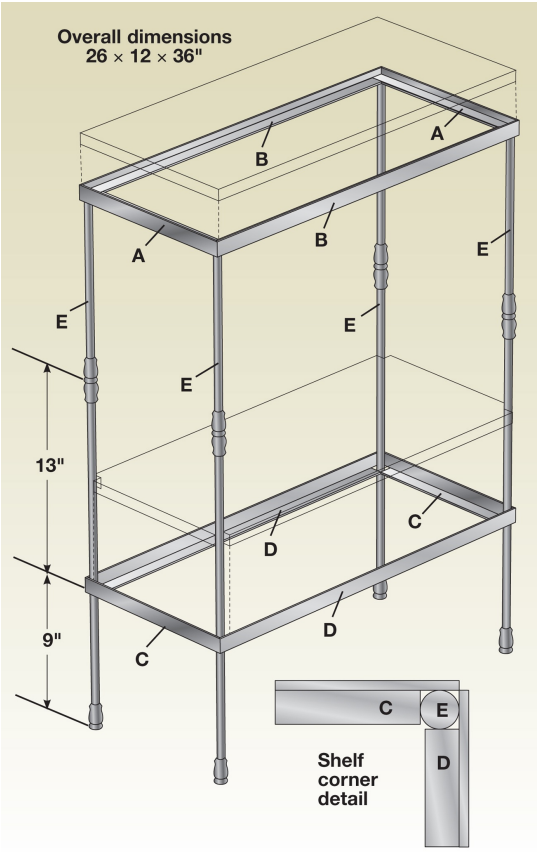
1. Place the rack upside down on top of the decorative sheet metal (E), with the 90° corner of the assembly 1" from the corner of the sheet metal. Using a permanent marker, trace the inside of the arc onto the sheet metal. Draw 1/2" tabs at regular intervals in front of the arc (see photo). Trace along the sides of the rack so you will know where to bend the sides.

2. Cut the sheet metal with a plasma cutter, tin snips, or a jig saw with a bi-metal blade. Cut a notch at the 90° corner so the sides can be bent. Bend the front tabs and sides to 90°.

3. With the rack upside down, place the shelf inside the rack so the top is flush with the top of the rack. Clamp it in place and weld the sheet metal to the rack.

4. Clean and finish the rack as desired.

Mark the 1/2" tabs at regular intervals on the outside.



PART	NAME	DIMENSIONS	QUANTITY
A	Top sides	1/8 × 1 × 1" T-bar × 12"	2
B	Top front and back	1/8 × 1 × 1" T-bar × 26"	2
C	Shelf sides	1/8 × 1 × 1" angle iron × 12"	2
D	Shelf front and back	1/8 × 1 × 1" angle iron × 26"	2
E	Legs	1/2 " round bar × 36"	4

Kitchen Appliance Stand

This freestanding table is sized to be placed next to a stove, but it could go anywhere in the house as an incidental table or plant stand.

The stand is lightweight and easy to move, yet sturdy enough to support a good deal of weight. The decorative bushings and feet provide a touch of elegance and give the stand decorative appeal.

Materials

- 1/8 × 1 × 1" T-bar (6-1/2 feet)
- 1/8 × 1 × 1" angle iron (6-1/2 feet)
- 1/2" round bar (12 feet)
- Decorative bushings (4)
- Decorative feet (4)
- Ceramic tile or wood top
- Ceramic tile or wood shelf
- Felt bumpers (4)

How to Build a Kitchen Appliance Stand

Build the Top

1. Cut the top sides (A) and the top front and back (B) to size. Rather than mitering the corners, cut a 1" notch at each end of the front and back pieces.

2. Position the top front and a side piece at a right angle. (Because the T-bars do not sit flat on the table top, it can be difficult to assemble the top pieces. Use shims or create a wooden clamping jig to hold the pieces securely while you align them.)

3. Check the top front and side piece for square and tack weld the corner.

4. Place the top back and other side piece together at a right angle. Check the corner for square and tack weld.

5. Assemble the two pieces to make a rectangle. Check for square by measuring diagonally between the corners. If the measurements are equal, the assembly is square. If it is not square, adjust until both measurements are equal.

6. Tack weld the top pieces together. Recheck the assembly for square, then finish the corner welds.

Build the Shelf

1. Cut the shelf sides (C) and the shelf front and back (D) to size.

2. Cut a 1/2" notch at both ends of all four shelf pieces to create a hole for the legs to fit through (see Shelf Corner Detail in diagram).

3. Position the shelf front and a shelf side piece at a right angle. Check the pieces for square and tack weld the corner.

4. Repeat step 3 to weld the shelf back to the other shelf side piece.

5. Assemble the two pieces to make a rectangle. Check the assembly for square and tack weld together.

6. Recheck the assembly for square, then finish the corner welds.

Attach the Legs

1. Cut the legs (E) to size.

2. Insert the legs through the cutouts in the shelf. If using decorative slide-on bushings, position them on the legs and tack weld in place.

3. Place the top over the legs. Make sure the legs are flush against the T-bar and tack weld in place.

4. Measure 9" from the bottom of the legs and make a mark. Align the shelf with the marks and tack weld in place.

5. Stand the unit upright. Check the top and shelf for level. If they are not level, break the tack welds and adjust until level. Complete the welds between the legs and the top, and the legs and the shelf.

Attach the Feet & Finish

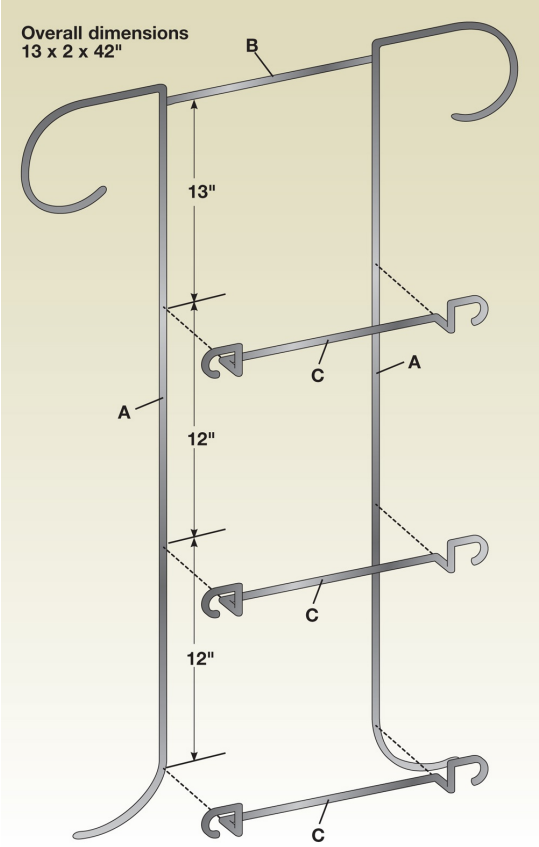
1. Weld, braze, or braze weld the feet in place (see photo).

2. Wire brush or sandblast the appliance stand and apply the finish of your choice.

3. Attach felt bumpers to the feet.

4. Make shelves of wood, stone, or ceramic tile, and place them on the shelf and the top.

Weld around the joint between the decorative feet and the leg.



PART	NAME	DIMENSIONS	QUANTITY
A	Side supports	3/16" round rod × 48"	2
B	Top piece	3/16" round rod × 6-1/4"	1
C	Racks	3/16" round rod × 16-1/2"	3

Wall Hung Plate Rack

This rack offers a nice way to display plates and makes a great gift for a plate collector. You can use any variety of bends and scrolls to add detail to the rack. The only difficult part is the three dimensional aspect of the racks—it can be hard to follow the bend direction. You may want to adjust the spacing or the number of plate racks to fit the plates to be displayed. These directions assume a 10" diameter plate.

Materials

- 3/16" round rod (13 feet)
- 1/2" and 3" pipe for bending jig

How to Make a Plate Rack

Prepare the Side Supports

1. Cut the side supports (A) to size.

2. Using the bending methods on page 19, make a 3" radius half circle at one end of each side support.

3. At the other end of the supports, make a 90° bend 6" from the end. Curl these ends into a 3" radius half circle. Make sure your work piece does not twist.

Prepare the Racks

1. Cut the racks (C) to size.

2. Make marks at 2", 4", and 5" from each end of the racks for bending points.

3. Bend a 1/2" radius curve at the first mark on each end of the racks.

4. Make a 90° bend at each of the other marks using a bench vise and ball peen hammer (see photo). Refer to the diagram on the opposite page for the orientation of the bends.

Assemble the Structure

1. Cut the top piece (B) to size.

2. Make a mark 1" down from the top of the two side supports.

3. Weld the top piece to the side supports at the 1" marks.

4. Place the first plate rack 3" from the bottom of the side supports. Square the rack to the sides and weld in place.

5. Set the remaining racks at 12" and 24" from the bottom rack. Make sure the racks are square to the sides, then weld in place.

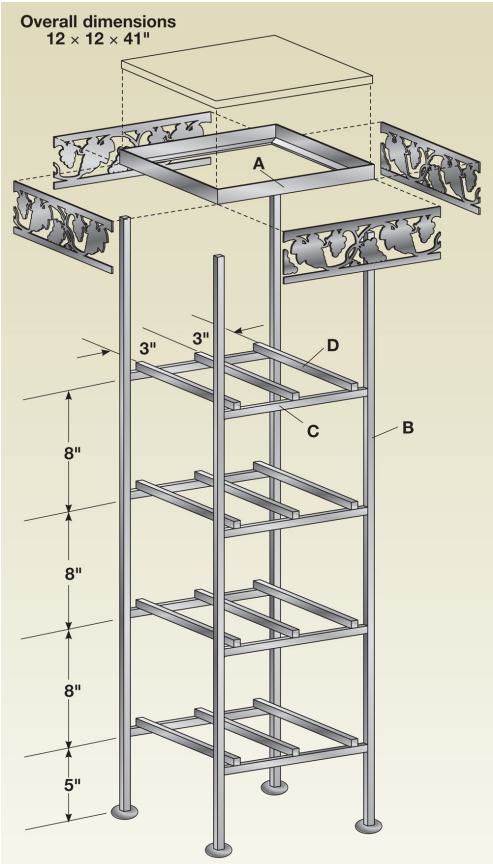
6. Turn the rack over and weld the back side of each joint.

Apply Finishing Touches

1. Clean the structure with a wire brush.

2. Apply your choice of finish to the rack.

Make the right angle bends using a bench vise and a ball peen hammer.



PART	NAME	DIMENSIONS	QUANTITY
A	Top	1/8 × 1 x 1" angle iron × 12"*	4
B	Legs	1/2 " square bar × 40"	4
C	Rack supports	1/2 " square bar × 11" *	8
D	Bottle holders	1/2 " square bar × 12" *	12

*Cut to fit selected tile top

Wine Rack

This wine rack is designed so you can install a wall or floor tile as the top surface. Measure the tile and cut the top pieces to fit. Butcher block or marble would also make a nice looking top. The decorative frieze stamping and squashed ball are available from Architectural Iron Designs—see Resources on page 140.

MATERIALS

- 1/8 × 1 × 1" angle iron (4-1/2 feet)
- 1/2" square bar (33 feet)
- Decorative frieze (4-1/2 feet)
- 2" Squashed balls (4)
- 12" floor or wall tile (1)

How to Make a Wine Rack

Assemble the Top

1. Cut the top pieces (A) to size to fit your top surface, mitering the corners at 45°.

2. Clamp two top pieces together with a corner clamp. Use a carpenter’s square to check the pieces for square, and tack weld.

3. Repeat step 2 to assemble the other two top pieces.

4. Clamp the two L-shaped top pieces together, and check for square by measuring across both diagonals. If the measurements are equal, the assembly is square. If it is not square, adjust until both measurements are equal.

5. Tack weld the two corners. Unclamp the pieces and recheck for square. Finish welding the corner joints.

Assemble the Stand

1. Cut the legs (B), rack supports (C), and bottle holders (D) to size.

2. Mark the legs at 5", 13", 21", and 29" from one end. Mark the rack supports at 2-1/2", 5-1/2" and 8-1/2" from one end.

3. Position four rack supports between two of the legs at the marks. Check the pieces for square and tack weld in place.

4. Repeat step 3 to tack weld the remaining four rack supports to the other two legs.

5. Stand the leg assemblies upright and clamp a bottle holder centered on the 5-1/2" mark on the bottom rack support. Clamp the other end of the bottle holder to the other leg assembly. Check for square and tack weld the bottle holder in place.

6. Repeat step 5 to attach a bottle holder at the 5-1/2" marks on the other three rack supports (see photo).

7. Make sure the legs assemblies and bottle holders are square, then add the remaining bottle holders at the 2-1/2" and 8-1/2" marks. Finish all welds.

Attach the Top, Legs, & Frieze

1. Place the top onto the legs and weld in place.

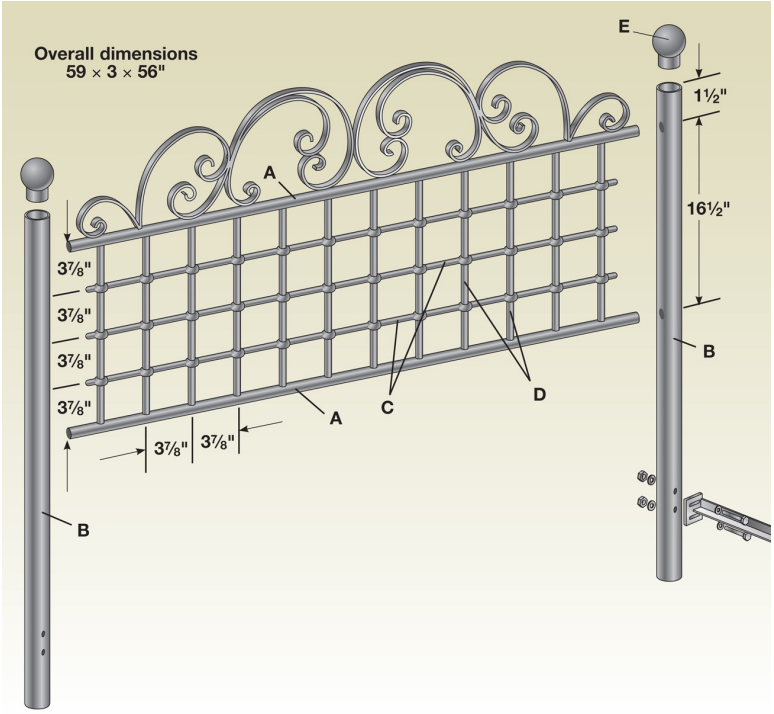
2. Center a squashed ball at the bottom end of each leg and weld in place.

3. Bend or cut the decorative frieze to fit around the top of the legs and top. Braze, braze weld, or tack weld the frieze into place at the top of the legs and slightly below the top.

4. Grind down the welds as needed. Wire brush or sand-blast the wine rack, then apply the finish of your choice.

5. Place the tile into the top.

Clamp the center bottle holders to the leg assemblies and tack weld in place.


Overall dimensions
59 × 3 × 56"
E
1½"
16½"
A
3⅞"
3⅞"
3⅞"
3⅞"
A
C
D
3⅞"
3⅞"
B
B

Headboard

A custom headboard for your bed is a great welding project. Here's an example using decorative fence and gate materials. We used top scrolls numbered 3-1/3 and 3-1/2 from Architectural Iron Designs, and hot pierced bar number SF 422US and hammered bar SF 5995 from Triple-S Steel Supply. (See Resources on page 140.)

PART	NAME	DIMENSIONS	QUANTITY
A	Top & bottom bars	1/8 × 1" round tube × 57"	2
B	End posts	1/8 × 2-1/4" round tube × 48"	2
C	Horizontal inserts	5/8 × 3-7/8" on center decorative pierced bar × 51-1/2"	3
D	Vertical inserts	5/8" hammered bar style rod × 18"	12
E	Finials/caps		2

Materials

- 1/8 × 1" round tube (9-1/2 feet)
- 1/8 × 2-1/4" round tube (8 feet)
- 5/8 × 3-7/8" pierced bar (13 feet)
- 5/8" hammered rod (18 feet)
- Decorative scrolls (2)
- Ball post finals/caps (2)
- 3/8 × 2-3/4" machine bolts with washer and nuts (4)

How to Build a Headboard

Assemble the Grid

1. Cut the top and bottom bars (A) and end posts (B) to size.

2. Cut the horizontal inserts (C) to size, cutting at the outside edge of the pierced circle at each end. Cut the vertical inserts (D) to size.

3. Insert the vertical inserts through the holes in the horizontal inserts. Adjust the inserts so they are square.

4. Mark the top and bottom bars 3-1/2" from each end. Align the first and last vertical inserts with the marks. Tack weld the end inserts to the bars.

5. Check the assembly for square by measuring the diagonals. If the diagonal measurements are equal, the assembly is square. Weld each vertical insert to the top and bottom bars.

6. Adjust the horizontal inserts so they are spaced evenly. Weld them to the vertical inserts at each end and at one or two points in the middle.

Insert the Grid into the End Posts

1. Place an end post in a piece of channel or angle iron and mark a straight line down the side of the post. Mark a point 1-1/2" down from the top of the post and centered on this line.

2. Cut a 1" diameter hole centered at the mark, using a hole saw with a bi-metal blade or a plasma or flame cutter.

3. Align the top bar with the hole in the end post. Mark the placement of the hole for the bottom bar, also centered along the same line on the end post. Cut the hole in the post.

4. Repeat steps 1 to 3 to cut holes in the second end post.

5. Insert both ends of the grid assembly into the holes in the end posts (see photo). The distance between the posts should be 55". Make sure the cross bars are square to the end posts, then weld in place.

Attach Decorative Scrolls

1. Place the decorative scrolls on top of the top bar, centering them between the end posts. Weld the scrolls in place.

2. Set the post caps on top of the end posts and weld in place.

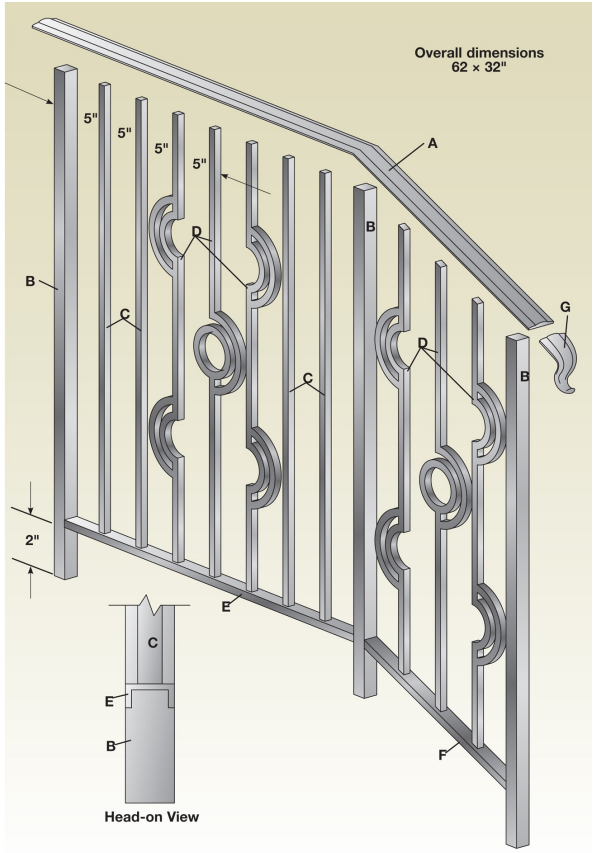
3. Wire brush or sandblast the headboard clean. Finish with your choice of finish.

4. Mark the location of the bed-frame bolt holes onto the end posts. Drill 3/8" holes through the end posts. Attach the bedframe to the posts with 3/8 × 2-3/4" machine bolts.

Cut holes in the end posts. Insert the grid assembly into the holes and weld in place.

OUTDOOR PROJECTS

Stair Railing 124
Gate 128
Critter Boot Brush 130
Disk Fountain 132
Arbor 134


Overall dimensions
62 × 32"
5"
5"
5"
5"
A
B
B
B
C
C
D
D
G
2"
E
F
C
E
B
Head-on View

Stair Railing

With the number of companies selling decorative metal pickets and newel posts, it is easy to create a railing distinctly your own. The railing we are making is for a two step concrete stairway.

Some important information about creating railings:

The rail top should not be interrupted by knobs or other decorations—it must allow continuous hand to rail contact and should be between 1-1/2" and 2" in diameter to ensure easy gripping.

Some railings—like one that is mounted against a wall or in an area where the stair surface is not raised above the surrounding surface, like the stairs in the slope of your lawn—can be a single rail at the appropriate height. A railing that separates the stair, landing, balcony, or deck from a vertical drop has to conform to certain safety standards. The pickets or balusters must not have any gaps larger than 5-1/2" to prevent children from poking their heads through and getting stuck. The lower rail should not be more than 2 inches from the floor surface. If the vertical drop from the floor line is more than 6 feet, the railing must be a minimum of 34" tall. If the vertical drop is less than 6 feet, the railing must be a minimum of 32" in height. Railings must have turn-outs or roundovers at their ends to prevent blunt projections. The safest handrails continue 12" beyond the top and bottom stairs. Railings must be able to withstand a 250 pound force in any direction without giving way.

You can purchase rail cap, also called cap rail or handrail, at most steel supply centers. Handrail terminations come in a variety of styles. Those that scroll in an S shape are called “lamb tongues.” A volute is a spiral termination, and a lateral is a flat curl to the side. These may be ordered through specialty railing distributors. (See Resources page 140.)

Materials

- 1-3/4" rail cap (as needed)
- 1" square tube (as needed)
- 1/2" square rod (as needed)
- 1/2" decorative pickets (as needed)
- 1/8 × 1/2 × 1" channel (as needed)
- Lamb tongue rail termination
- Mounting hardware

PART	NAME	DIMENSIONS	QUANTITY
A	Handrail	1-3/4" rail cap × 64"*	1
B	Newel posts	1/8 × 1 × 1" square tube × 36"	3*
C	Plain pickets	1/2 " square rod × 30"	4*
D	Decorative pickets	1/2 " decorative pickets × 30"	6*
E	Flat bottom rail	1/8 × 1/2 × 1" channel × 40"*	1
F	Angled bottom rail	1/8 × 1/2 × 1" channel × 24"*	1
G	Rail termination		1

*Dimensions and quantities must be adjusted to fit the particular stairs.

Heat the bending point of the handrail to red hot with an acetylene torch or cutting tip to make the metal easy to bend.

How to Build Stair Railing

Cut the Handrail to Length

1. Measure from the edge of the house to the edge of the landing. Measure from the edge of the landing to where the newel post will be located. Add these two measurements to get the length of the handrail.

2. Cut the handrail (A) to size.

Shape the Handrail

It is a good idea to create an angle guide for bending the handrail by screwing two pieces of wood together at the length and angle to match the stairway.

1. Set the handrail on the landing with one end butting against the house. Mark the handrail at the edge of the landing.

2. Clamp the railing in a bench vise and heat the bending point red hot with an acetylene torch (see photo). A cutting torch preheat works best, just make sure you don’t hit the oxygen and accidentally cut the metal.

3. When the metal is red hot, bend it to create the angle. It is helpful if you pull on the longer end of the rail to bend so you have more leverage.

4. When finished bending the handrail, place it on the stairs to make sure the bend is correct.

Lay Out the Newel Posts & Pickets

The newel posts will be anchored in the concrete or attached using square footings that will bolt into the concrete, so they have to be far enough from the edge not to destroy the edge of the concrete.

1. Determine the number of plain pickets (C), decorative pickets (D), and newel posts (B) you need.

2. Place the bent handrail on the floor or a large work surface. Place newel posts at each end of the handrail and near the bend.

3. Lay out the pickets in a pleasing pattern, making sure they are no more than 5-1/2" apart (see photo).

4. Mark and cut the two bottom rails (E & F) to fit between the newel posts, once you have the layout determined. Place the channel flat side up, with the legs down. Mark the picket locations on the railings.

OPTION: When you look at railings, you will see that some railings have the pickets and newel posts welded directly to the rail cap, as you see here. Other railings have a piece of channel welded into the underside of the rail cap and the pickets are welded to the flat side of the channel. Punched channel can be purchased with 1/2 × 1/2" square holes pierced through it. This is welded under the rail cap, and the pickets are inserted through the punched holes and welded in place. You also can use the punched channel for the bottom rail. Using punched channel means you cannot adjust spacing to account for the unique shapes and sizes of decorative pickets.

Cut the Posts & Pickets to Length

Purchased decorative pickets range from 36" to 39". When cutting decorative pickets, cut equal amounts from each end unless you wish the pattern to be off center.

1. Determine the height of your handrail and the depth that the newel posts will be footed in the concrete (if they are to be footed, otherwise measure to the top of the concrete).

2. Cut the newel posts and pickets to length. Cut the appropriate angle for the stair pickets.

Assemble the Railing

Concrete can explode when heated, so it is best to do your welds on a sheet of plywood that can be doused with water when you have finished.

1. Tack weld the newel posts to the rail cap. Tack weld the bottom rails to the newel posts.

2. Place the rail assembly on the stairs to make sure the dimensions are correct. If they are not, break or grind off the tack welds and make adjustments.

3. Return the assembly to the work surface, and tack weld the pickets in place, maintaining the proper spacing. Use a combination square to check each piece for square before welding.

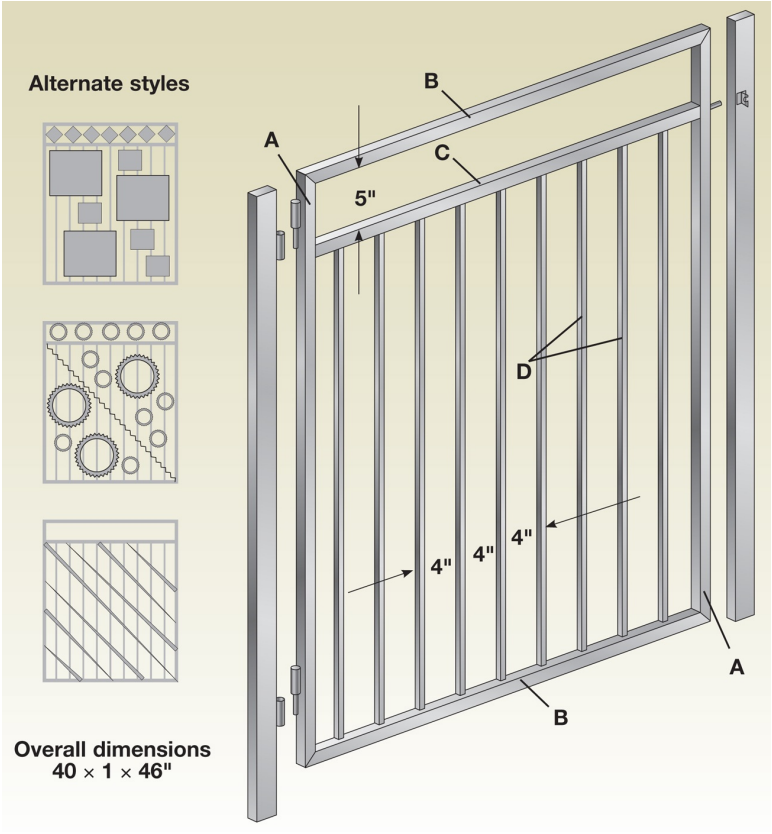
4. Make the final welds. Weld the lamb tongue termination to the end of the rail cap.

5. Grind down any rough or unsightly welds. Wire brush or sandblast the rail assembly.

6. Install the railing by cementing the newel posts into the stairs or using bolt-down flange shoes.

7. Prime and paint the railing with a high quality outdoor metal paint.

Lay out the pickets and newel posts in a pleasing arrangement, keeping them no more than $5^1/_2$" apart.


Alternate styles
B
A
C
5"
D
4"
4"
4"
A
B
Overall dimensions
40 × 1 × 46"

Gate

This gate framework can be used to hold a collection of found metal objects. Use brazing or braze welding to join non-matching metals or thicknesses of metals. Rusty objects will need to be cleaned at the point of contact. If the objects you find are large, you may want to space the uprights at 8", rather than 4". The 4" spacing meets code requirements for gates and fences—this spacing prevents children from getting their heads stuck between uprights.

PART	NAME	DIMENSIONS	QUANTITY
A	Sides	16 gauge 1 × 1" square tube × 46"	2
B	Crosspieces	16 gauge 1 × 1" square tube × 40"	2
C	Interior crosspiece	16 gauge 1 × 1" square tube × 38"	1
D	Vertical inserts	16 gauge 1/2 × 1/2" square tube × 40"	9

Materials

- 16 gauge 1 × 1" square tube (17-1/2 feet)
- 16 gauge 1/2 × 1/2" square tube (30 feet)
- 4" weldable barrel hinges (2)
- Gate latch hardware
- Found objects
- Wood and brass spacers

How to Make a Gate

Assemble the Frame

1. Cut the sides and crosspieces (A & B) to size, mitering the ends at 45°.

2. Place the left side piece and bottom crosspiece together at a 90° angle to form one corner of the rectangle. Check the pieces for square, and clamp in place. Tack weld the pieces together.

3. Place the right side piece and top crosspiece together to form another corner of the rectangle. Check for square, clamp in place, and tack weld together.

4. Join the two pieces to form the rectangle. Check the corners for square and clamp in place. Tack weld the corners together.

5. Measure the diagonals of the rectangle to check for square. If the measurements of both diagonals are equal, the assembly is square. If it is not square, pull or push it into alignment. When aligned, clamp it in place, and finish the corner welds.

6. Turn the assembly over, and complete the welds.

Attach the Interior Crosspiece & Inserts

1. Cut the interior crosspiece (C) and vertical inserts (D) to size.

2. Place the interior crosspiece against the inside edges of the side pieces, 5" down from the top crosspiece. Check the pieces for square, and clamp in place. Weld the interior crosspiece to the sides.

3. Place the vertical inserts at 4" intervals between the interior and bottom crosspieces. Make sure the spacing is even—you might need to adjust to slightly less or more than 4" if the miter cuts are slightly off. Keep the outside edge of the inserts flush with the outside edge of the crosspieces.

4. When the spacing is adjusted properly and the inserts are square to the crosspieces, tack weld each insert at both ends.

5. Check the assembly and inserts for square one more time. Turn the assembly over, and weld each upright in place.

Attach the Found Objects

Objects other than mild steel will need to be brazed or braze welded. Connect non-metallic objects by wrapping or folding a thin strip of mild steel sheet metal or a short piece of 1/8" steel rod around an edge. Weld the ends of the rod or strap to the framework.

1. Arrange your found objects artfully across the interior space.

2. Carefully clean rust or paint from the areas where the found objects contact the uprights.

3. Weld the found objects in place.

Attach the hinges

Our gate is made to hang attached to a metal gate post. We chose to use barrel style hinges.

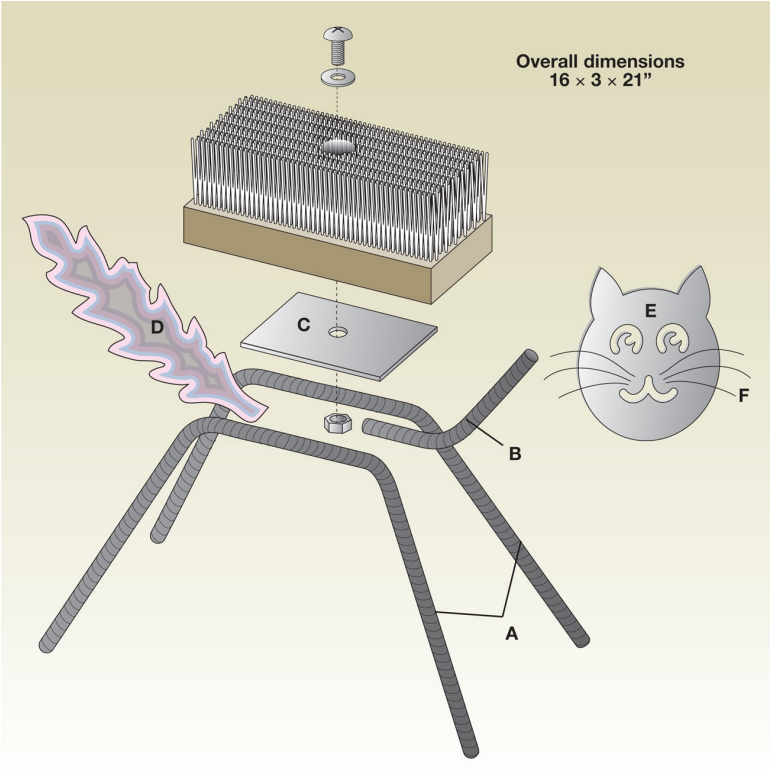
1. Place the gate between the gate posts. Use wood spacers and braces to position the gate between the gate posts, and clamp or brace solidly in place.

2. Line up the hinges on the post and the gate (see photo). Use a level to check for plumb. (For the gate to swing properly, the hinges need to be installed perfectly plumb.) Tack weld the hinges to the gate and post.

3. Remove the bracing, and check that gate swings freely. When it does, complete the hinge welds.

4. Install the gate latch hardware. If the hardware is painted or zinc coated, grind off the coating before welding, or install with screws.

Brace the gate in position between the gate posts. Clamp a wood spacer between the gate post and the gate side. Position the hinge and check for plumb.


Overall dimensions
16 × 3 × 21”
D
C
E
F
B
A

Critter Boot Brush

A critter boot brush is a fun and functional addition to your back door area. This critter is made to be stuck in the ground (then the mud flies on the grass, not around the door!) but it can be mounted in cement or even on a hefty chunk of wood. This plan is for a cat because the brush mimics the classic upright fur look of an angry cat, but any animal could have this scratchy back.

PART	NAME	DIMENSIONS	QUANTITY
A	Legs	3/8 or 1/2" rebar × 30"	2
B	Neck	3/8 or 1/2" rebar × 12"	1
C	Body	1/8 or 3/16 × 3" flat bar × 6"	1
D	Tail	16 gauge sheet metal × 4 × 14"	1
E	Face	3/8 or 1/4" plate × 5 × 5"	1
F	Whiskers	16 gauge wire × 4"	6

How to Make a Critter Boot Brush

Materials

- 1/8 or 1/2" rebar (6 feet)
- 1/8 or 3/16 × 3" flat bar (6")
- 16 gauge sheet metal (4 × 14")
- 1/8 or 1/4" plate (5 × 5")
- Wire or bristle brush with handle hole
- 2" machine bolt, washer, and nut
- 16 gauge wire (24")

Prepare the Legs & Neck

1. Cut the legs (A) to length.

2. Mark each leg 12" from each end. Using a bench vise, bend the legs at the marks to a 75° to 85° angle.

3. Cut the neck (B) to length.

4. Make a mark 3" from one end of the neck. Bend the neck at the mark to 85°.

Assemble the Body

1. Cut the body (C) to size.

2. Drill, flame cut, or plasma cut a hole through the center of the body for the placement of the brush.

3. Place the legs lengthwise along the edges of the body, and weld in place.

4. Position the hole in the brush over the hole in the body to get the spacing for the neck extension (if the neck is set back too far, the brush will not lay flat).

5. Weld the neck in place.

Attach the Tail

1. Use flame or plasma cutting to cut the tail (D), leaving a minimum of 4" of straight flat metal for attachment.

2. Remove any slag from the tail, and weld in place between the legs at the opposite end from the neck (see photo).

Prepare & Attach the Face

If using a flame cutter for the face, you will get the best results if you allow the metal to cool between cutting each individual feature. If you don’t let it cool, the metal begins to melt and round over, making it difficult to get a sharp outline of the features.

1. Use flame or plasma cutting to cut out the face shape (E) and features.

2. Remove any slag from the back side of the face. Cut the whiskers (F) to size and attach to the face.

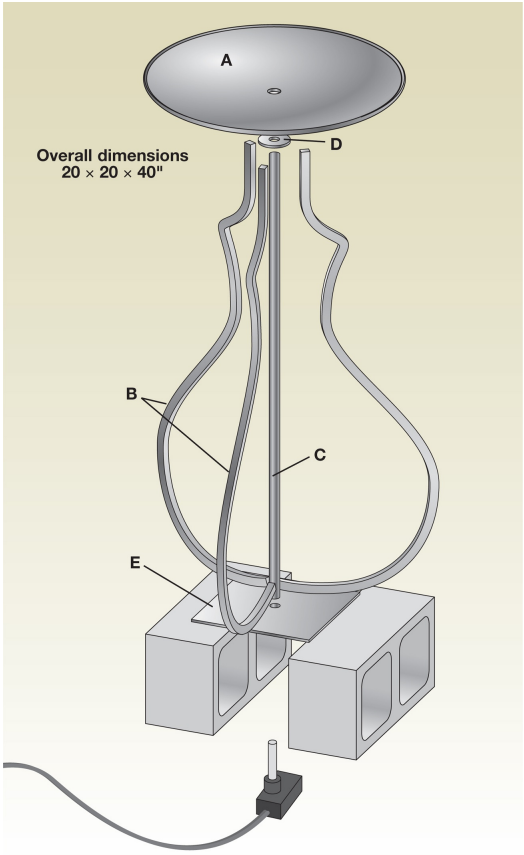
3. Position the face and weld it to the end of the neck.

Attach Brush & Set in Place

1. Bolt the brush onto the body and adjust the tail in an upright position.

2. Push the legs into the ground or mount the critter in a concrete base.

Cut and bend the legs and neck to size, then weld the legs, neck, and tail to the body.



PART	NAME	DIMENSIONS	QUANTITY
A	Basin	9 gauge × 20" plow disk	1
B	Legs	Decorative pickets × 35"	3
C	Supply pipe	1/8 × 1" round tube × 35-1/2"	1
D	Flange	3/16" sheet metal × 3" circle	1
E	Base	1/4" plate × 12 × 12"	1

Disk Fountain

This fountain uses a plow disk, which can be found at farm implement stores, and three decorative fence pickets. Decorative scrolls also could be used. You'll get to see how watertight your welds are, because you'll need to weld the supply pipe and a flange to the disk. You could use a slightly smaller disk for the base—we simply used a square plate.

Materials

- 9 gauge × 20" plow disk (1)
- Decorative fence pickets (3)
- 1/8 × 1" round tube (3 feet)
- 3/16" sheet metal (3" circle)
- 1/4" plate (12 × 12")
- Fountain and pump

How to Make a Disk Fountain

Assemble the Flange

You can purchase round metal blanks in 3" sizes, or you can cut your own. We purchased one at a steel surplus store.

1. Cut the supply pipe (C), flange (D), and base (E) to size.

2. Cut a 1" diameter hole in the center of the flange and the center of the base.

3. Place the hole in the flange over the end of the supply pipe and weld all around.

4. Grind down the weld until it is flush.

Attach the Basin

1. Grind off the paint from the basin (A) in a 4" diameter circle around the center hole.

2. Turn the basin over and place the flange and pipe assembly on top of it, centering it over the hole in the basin.

3. Tack weld the flange to the disk in at least three places. Make sure the supply pipe is perpendicular to the basin, then complete the weld all around the flange.

Attach the Legs

1. Tack weld the legs to the basin assembly (see photo), keeping an equal distance between each leg.

2. Insert the supply pipe into the hole in the base and tack in place.

3. Turn the assembly upright, and check for level. Adjust if necessary. Complete the welds for the legs and the base.

Apply Finishing Touches

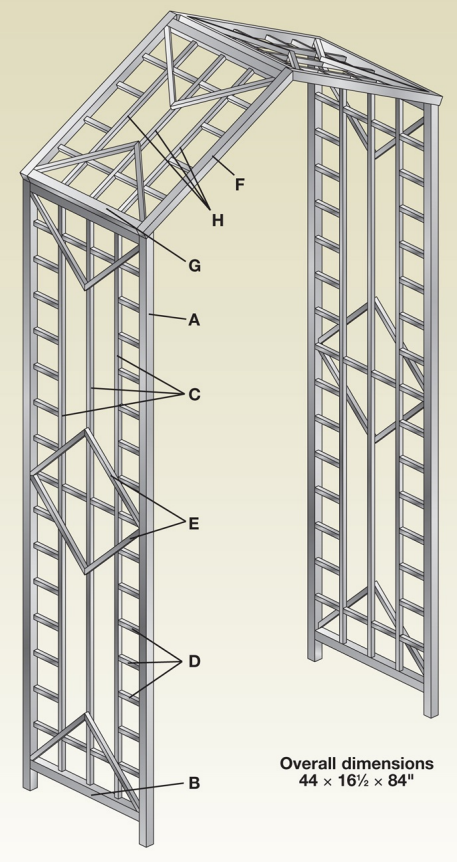
1. Grind down all rough welds. Thoroughly wire brush or sandblast the fountain.

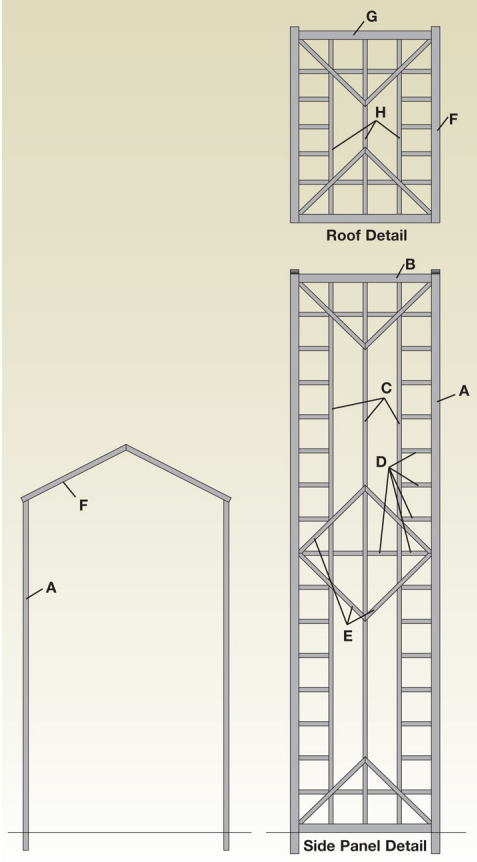
2. Prime and paint the fountain with a high quality outdoor metal paint.

3. Place the fountain on a brick or cement block base in a pool or over an appropriately sized reservoir.

4. Install the fountain hardware and tubing following manufacturer's directions.

Tack weld the pickets to the basin and to the supply tube.


F
H
G
A
C
E
D
B
Overall dimensions
44 × 16½ × 84"


G
H
F
Roof Detail
B
C
A
D
F
A
E
Side Panel Detail

Arbor

This distinctive arbor will add a touch of class to any garden. Modeled after the “Prairie Style,” its clean lines are straightforward to cut and weld, and they provide plenty of climbing support for a variety of vines. The 1/2" inserts are placed flush with the back of the 1" sides and ends, eliminating the need for difficult centering and giving an increased sense of depth. The arbor can be made from the 6-foot steel lengths available at home improvement centers, but because of the amount of steel used, a trip to a steel supplier might be worthwhile, especially if you have a way to transport 20-foot lengths. The 1/2" square tube bows quite easily, so if you do buy 20 foot lengths, make sure they are well supported in transit. Otherwise, they will bow and not be suitable for the vertical inserts.

PART	NAME	DIMENSIONS	QUANTITY
A	Panel sides	16 gauge 1 × 1" square tube × 72"	4
B	Panel ends	16 gauge 1 × 1" square tube × 15-1/2"	4
C	Panel vertical inserts	16 gauge 1/2 × 1/2" square tube × 63-1/2"	6
D	Horizontal inserts	16 gauge 1/2 × 1/2" square tube × 3-1/2"	100
E	Diagonal inserts	16 gauge 1/2 × 1/2" square tube × 12"*	24
F	Roof ends	16 gauge 1 × 1" square tube × 15-1/2"	4
G	Roof sides	16 gauge 1 × 1" square tube × 25-1/2"	4
H	Roof vertical inserts	16 gauge 1/2 × 1/2" square tube × 23-1/2"	6

*Approximate dimension, cut to fit

MATERIALS

- 16 gauge 1 × 1" square tube (44 feet)
- 16 gauge 1/2 × 1/2" square tube (100 feet)
- Wood scraps

Check the panel for square by measuring the diagonals. If the measurements are equal, the assembly is square.

How to Build an Arbor

Assemble the Panels

Set up the project on a sheet of 3/4" plywood placed on sawhorses. Make sure the plywood is not bowed or it will cause misalignment of the project pieces. Working on a raised surface is easier than working on the floor, and you can clamp the metal to the plywood. Remember to clamp your work cable to the workpiece. If you want the arbor wider or narrower than 44", you must adjust the miter angles for the roof and side panels.

1. Cut the panel sides (A) to size, mitering one end at 30°. The mitered end is the top. Cut the panel ends (B), vertical inserts (C), and horizontal inserts (D) to size.

2. Place a panel end between the top of two panel sides, keeping the outside edge of the panel end flush with the short ends of the mitered panel sides. Clamp the pieces in place.

3. Position three vertical inserts between the two panel sides. (This is just to hold the bottom panel end in place. The exact location of the inserts is not important at this time.)

4. Place the bottom panel end between the panel sides, keeping it snug against the vertical inserts. Clamp the bottom panel end in place.

5. Remove the vertical inserts. Use a carpenter’s square to check the panel sides and ends for square. Tack weld each corner. Check for square again by measuring the two diagonals (see photo, page 135). If the measurements are equal, the panel is square. If not, adjust the workpieces until the diagonals are the same.

6. Turn the panel over and complete the welds at the four corners. Grind the tack welds flat so the panel lays flat on the work surface.

Attach the Vertical & Horizontal Inserts

1. Replace the vertical inserts between the panel sides. Place several horizontal inserts between the vertical inserts and the panel sides to ensure the correct spacing of the vertical inserts.

2. Weld the vertical inserts to the panel top and bottom.

3. Place the horizontal inserts into the vertical framework every 3-1/2". (Use horizontal inserts as spacers.)

4. Starting at the top of the panel, use a combination square to align the first row of horizontal inserts. Once they are aligned, weld them in place.

5. Continue aligning and welding the inserts one row at a time. If the vertical inserts are bowed side to side, use a clamp to hold them against the inserts. If they bow upward, weight them down with a sandbag or other weight.

Insert the Diagonal Inserts

1. Cut four diagonal inserts (E) to size, mitering one end at 45°.

2. Place two diagonal inserts against the bottom edge of the top panel. The mitered ends of the inserts should butt together over the middle vertical insert. Mark the other end of the diagonal inserts where they cross the top panel so they will fit in the corner.

3. Make the angled cuts on the diagonal inserts.

4. Grind down the welds that will be underneath the diagonal inserts so they will lie flat. Weld the diagonal inserts in place (see photo).

Weld the diagonal inserts to the panel framework and to the center vertical insert.

Make clamping blocks out of wood scraps. Clamp the roof panels to the blocks. Place two or three tack welds along the joint between the panel ends.

5. Repeat steps 2 to 4 to weld the diagonal inserts to the bottom of the panel.

6. Cut four more diagonal inserts, mitering both ends at 45°.

7. Center these four inserts over the eighth row of horizontal inserts to form a diamond shape. Weld the inserts in place.

8. Repeat this entire process to construct a second panel.

Build the Roof Panels

1. Construct two roof panels following the same procedure used for the side panels, except there is no central diamond insert.

2. Stand the roof panels on edge and join the mitered ends to form the 120° angle for the roof peak.

3. Clamp the roof panels in place. (You may need to attach temporary wooden clamping points to the work surface by fastening 1 × 2 or 2 × 4 scraps to match the layout. Clamp the panels to the scraps.) Place two or three tack welds along the joint between the panel ends (see photo).

Fasten the Roof to the Sides

1. Place a side panel on edge, and set it against one side of the roof panel. Line them up so the mitered edge of the side panel is making contact with the bottom edge of the roof panel. Clamp the panels in place.

2. Tack weld the panels at two points along the joint (see photo).

3. Repeat steps 1 and 2 for the other side panel.

4. Measure the distance between the tops and the bottoms of the side panels to ensure the panels are an equal distance apart at both ends.

5. Check the panels for square by measuring the diagonals. Make any necessary adjustments, and make sure the roof assembly is still fitted against the side panels.

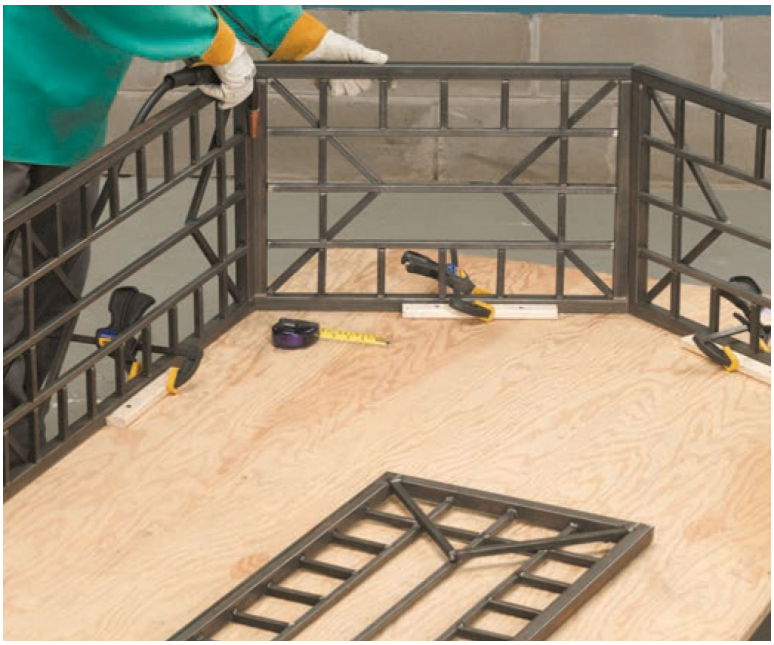
6. Weld all the mitered roof peak joints and the mitered joints between the side panels and the roof panels.

Finishing Touches

To prevent putting stress on the welds, and to maintain the arbor's shape, clamp wooden crosspieces between the panel sides before moving it.

1. The easiest finish for the arbor is to allow it to gently rust over the years. You may want to place plastic end caps over the exposed tube ends on the roof, or you can weld on small caps.

2. The arbor can sit on the ground or can be mounted in concrete footings. If you live in a windy location, you may want to drive four lengths of rebar into the ground and slip the arbor legs over them.



Place tack welds along the joint between the roof and side panels.

GLOSSARY

Active gas	A gas, such as oxygen, that will react with other substances.
Alloy	A substance composed of two or more metals or a metal and other non-metal material.
Arc welding	Welding processes that use an electric arc to produce heat to melt and fuse the base metals. Often used to refer specifically to shielded metal arc welding.
Backfire and flashback	Combustion taking place inside the oxyacetylene torch creating a loud pop or explosion.
Base metal	The metal that is being welded, brazed, braze welded, or cut.
Bead or weld bead	The seam between workpieces that have been joined with welding.
Braze	A process used to join metals using a non-ferrous material that melts above 850° F but below the melting point of the base metal. Brazing uses capillary action to join closely fitted parts.
Braze welding	A process used to join metals with a filler material that melts above 840° F and below the melting point of the base metal where the filler metal is not distributed by capillary action.
Butt joint	A joint between two workpieces in the same plane.
Carburizing flame	An oxyfuel flame with an excess of fuel.
Consumable electrode	An electrode that also serves as the filler material.
Corner joint	A joint between workpieces meeting at right angles and forming an L shape.
Cutting tip	Converts an oxyfuel welding torch into an oxyfuel cutting torch.

Direct current electrode negative	Direct current welding where the electrode is negative and the workpiece is positive.
Direct current electrode positive	Direct current welding where the electrode is positive and the workpiece is negative.
Duty cycle	The amount of continuous time in a 10-minute period that an arc welder can run before it needs to cool down. Expressed as a percentage at a given amperage output.
Edge joint	A joint between parallel workpieces.
Electrode	The conductive element that makes the connection with the workpiece to create an electrical arc.
FCAW	Flux cored arc welding.
Filler, filler metal	Metal added to a welded joint.
Fillet weld	A triangular shaped weld between two members that meet at 90° angles.
Flame cutting	See oxyfuel cutting.
Flux	A chemical compound that produces cleaning action and reduces the formation of oxides when heated.
Flux core, flux cored wire	An electrode for flux cored arc welding that contains flux within a wire tube.
Flux cored arc welding (FCAW)	A semi-automatic arc welding process using an electrode wire that contains flux.
Gas metal arc welding (GMAW)	A semi-automatic arc welding process using a wire electrode which also is the filler material. An inert gas is distributed over the weld area to shield the molten metal from oxygen.

	Commonly referred to as MIG (metal inert gas) or wire feed.
Gas tungsten arc welding (GTAW)	An arc welding process using a tungsten electrode, hand-held filler material, and an inert shielding gas. Also referred to as TIG (tungsten inert gas) and Heliarc.
GMAW	Gas metal arc welding.
Groove weld	A weld made in grooves between workpieces.
GTAW	Gas tungsten arc welding.
Heliarc	Gas tungsten arc welding.
Inert gas	A non-reactive or non-combining gas such as argon or helium.
Kerf	The width of a cut.
Lap joint	A joint between overlapping workpieces.
MIG	Metal inert gas—see gas metal arc welding.
Oxyacetylene cutting	Oxyfuel cutting using acetylene as the fuel gas.
Oxyacetylene welding	Oxyfuel welding using acetylene as the fuel gas.
Oxyfuel cutting	Cutting process using the combustion of a pressurized fuel gas and oxygen to heat steel to 1600° F at which time a pure oxygen stream is delivered to burn through the metal. Also called flame cutting.
Oxyfuel welding	Welding process that uses the heat produced by the combustion of a pressurized fuel gas and pressurized oxygen. A hand-held filler material is used. Also called gas welding.
Plasma cutting	An arc cutting process using a constricted arc. Compressed air or inert gas blows the molten metal from the kerf
Plate	Flat metal thicker than 3/16".
Saddle joint	A joint between round tubes where one tube has been cut to fit around the other.
Sheet metal	Flat metal 3/16" or less in thickness.
Shielded	

metal arc welding (SMAW)	An arc welding process using a flux coated consumable electrode. Also referred to as arc welding or stick welding.
Shielding gas	A gas that prevents contaminants from entering the molten weld pool.
Slag	Oxidized impurities formed as a coating over the weld bead; waste material found along the bottom edge of an oxyfuel cut.
SMAW	Shielded metal arc welding.
Spatter	Small droplets or balls of metal stuck to the base metal around the weld. Produced by shielded metal arc, gas metal arc, and flux cored arc welding.
Stick welding	Shielded metal arc welding.
T-joint	A joint between workpieces meeting at right angles and forming a T shape.
TIG	Tungsten inert gas—see gas tungsten arc welding.
Wire feed	See gas metal arc welding.

Resources

Thanks to Tony Litwinchuk of Toll Gas & Welding Supply for arranging for the generous loan of the welding machinery pictured in this book. Thank you to Loren Johnson, also of Toll, for his technical advice on a variety of issues. Thank you to Jerry Foley and Dwight Affeldt, the welding instructors at Minneapolis Community and Technical College Continuing Eduction and Training Programs. Their knowledge of and enthusiasm for welding is fantastic. Thank you to Dwight also for reading the book and suggesting changes to make it more accurate. Finally, thank you to Paige Gamet for giving me the gift of my first welding class.—*Karen Ruth*

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Triple-S Steel Supply Company
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Sleeper Welding
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INDEX

Acetylene, 27, 35
  See also: Oxyacetylene cutting, Oxyacetylene welding
Air compressors, 64, 65, 66
Alloys, 15, 22, 57, 62
Aluminum, 15
  preparing, 18
  repairing, 22, 23
Amperage, 38–39, 42, 43, 65
Angle iron, 16
Arbor, 134–137
Arc welding,
  electricity, 38–39
  preparing for, 23
  See also: Flux cored arc welding,
  Gas metal arc welding, Gas tungsten
  arc welding, Shielded metal arc
  welding
Arcs, 38, 64, 66
  burn, 10
  striking, 60
Artwork, 4, 5, 6, 7, 36
Auto-darkening lenses, 11, 54
  See also: Helmets

Backfire, 31
Backseating valve, see: Cylinders
Baker's shelves, 106–109
Base metals,
  identifying, 22
  matching electrode size, 8, 23
  matching filler material, 8, 23
  matching welding process, 9
  See also: Metals
Bird's nests, 53
Blowpipes, see: Torches Boot brush, 130–131
Brakes, 19
Braze welding, 14, 37
Brazing, 11, 14, 35, 36
Burns, 10, 68
Burn through, 8, 34
Butt joint, 20

Candelabra, 5
Candleholders,
chandelier, 96–97
fireplace, 102–103
tree-shaped, 100–101
wall-mounted, 98–99
Carburizing flames, 33
Carts, see: Cylinders, Welding machines
Cast aluminum, see: Aluminum
Cast iron, repairing, 23
Chandelier, 96–97
Channel, 16
Chemical sharpeners, 57, 58
Circle cutting, 67, 71
Clothing, protective, 10, 11, 27, 41, 45, 54, 55, 65, 68, 69
Coatrack, 112–113
Coffee table, 110–111
Collet and collet body, see: Torches
Concrete, risk of explosion, 11
Corner joint, 20
Corrosion, 9, 15
Costs, 5, 17, 26, 65, 67, 68, 69
Cutouts, making, 71
Cutting processes, 14, 38–39
See also: Oxyacetylene cutting,
Plasma cutting
Cylinders,
cart, 85–87
gas metal arc welding, 44, 47, 49
gas tungsten arc welding, 54, 55, 61
oxyacetylene cutting, 68
oxyacetylene welding, 26, 30
risk of explosion, 11, 28, 65
safety, 27, 47, 68, 71
valves, 27, 29, 31, 32, 49
wrenches, 30, 31

Decorative metal products, 17, 94–95, 102–103, 110–111, 114–115, 118–119, 120–121, 124–127
Duty cycles, 39, 65

Edge joint, 20
Electrical shocks, 11, 12, 40, 65
Electricity, 38–39, 41, 55, 59, 64
Electrodes, 8, 23, 40, 42, 44, 46, 50, 52, 54, 55, 58, 65

characteristics, 57
holders, 40, 41, 43
leads, 41, 43
stub out or stubbing, 53
tungsten, 56, 57
Equipment, see: Air compressors,
Cylinders, Electrodes, Fillers, Fire bricks, Fittings, Flashback arrestors, Flow meters, Foot control, Gases, Gauges, Guns, Hoses, Power supply, Regulators, Supply cables, Tips, Tools, Torches, Welding machines, Wire feed, Work cables/leads and clamps
Explosions, risk of, 11, 28, 65

FCAW, see: Flux cored arc welding
Ferrous metals, 14
Fillers, 8, 15, 23, 34, 42
braze welding, 37
brazing, 36
gas metal arc welding, 44
gas tungsten arc welding, 54, 58, 60–61, 62
oxyacetylene welding, 26
Fillet weld, 20, 21, 37, 63
Filters, 10, 11, 27, 41, 45, 55, 65, 69
See also: Shades, Shields Finishes, 18
Fire bricks, 11, 27, 34, 35, 37
Fire extinguishers, 10, 71
Fires, risk of, 10, 12, 68
Fishmouth joint, 20
Fittings, oxyacetylene, 28
Flame cutting, see: Oxyacetylene cutting
Flames, 32, 33, 70
Flange joint, 20
Flashback, 28, 31
arrestors, 29
Flat bar, 16
Flow meters, 47, 49, 50, 51, 55, 56, 61
Flux, 9, 36, 37, 42, 45
Flux cored arc welding, 9, 47, 51
Foot control, 54, 55, 60
Fountain, 132–133
Fuel gases, see: Gases
Fumes, 10, 12, 41, 64
Furniture projects, 104–121
Fusion welding, 26, 34
Gas leaks, 30, 31
Gas metal arc welding, 8, 9, 53

electricity, 38–39
equipment, 44, 45–47, 52
maintenance, 52–53
safety, 47
shades/lenses, 11, 45
troubleshooting, 52–53
See also: Flux cored arc welding
Gas tungsten arc welding, 9, 54–63
electricity, 38–39, 59, 60
equipment, 54, 55–56, 59
preparing the electrode, 56–58
safety, 54, 55
shades/lenses, 11, 54
troubleshooting, 62–63
Gas welding, see: Oxyacetylene welding
Gases,
fuel, 26, 35, 69
shielding, 42, 44, 45, 46, 47, 49, 50, 51, 54, 55, 56, 61
Gates, 7, 129
Gauges, 30, 31
Gauge thickness, inch equivalents, 17
Glasses, safety, 11
GMAW, see: Gas metal arc welding Grinder stand, 88–89
Groove weld, 20, 21, 37
Ground leads and clamps, see: Work cables/leads and clamps
GTAW, see: Gas tungsten arc welding
Guns, 44, 45, 48, 50, 51, 52
spool, 46
Hard soldering, 36
Headboard, 120–121
Heat distortion, 8
Heat-treated metals, 15, 22
Heliarc, see: Gas tungsten arc welding, 54
Helmets, 11, 27, 41, 45, 55, 65
auto-darkening lenses, 11, 54
See also: Filters, Shades, Shields Hexagonal bar, 16
High-carbon steel, 15
Holes, piercing, 71
Hooks, making, 113
Hoses,
gas metal arc welding, 47, 49, 50, 52
gas tungsten arc welding, 61
oxyacetylene cutting, 68, 70

oxyacetylene welding, 26, 28, 29, 30, 34, 35

Infrared light, safety, 10, 41
Innershield, see: Flux cored arc welding
Insurance, 12

Jigs, 19, 108, 109, 115, 117
Joints, 20

Kerf, 64, 71
Kitchen appliance stand, 114–115

Lamps, 92–93, 94–95
Lap joint, 20
Lighting projects, 90–103

Melting points, 15
Metal inert gas (MIG), see: Gas metal arc welding
Metals, 14–23
braze welding, 37
brazing, 36
cutability, 14, 19
finishing, 18
heat-treated, 15
measuring, 16–17
melting points, 15
painting, 18
preheating, 23, 69, 71
preparing, 18, 22, 34
purchasing, 17, 79, 88, 92, 125, 132–133, 140
repairing, 22–23
shapes, 16
shaping, 19, 93, 97, 108, 109, 117
sizes, 16
types, 14–15
weldability, 14
See also: Decorative metal products,
Fillers
Metalworking tools, 19, 107, 108, 109, 117
MIG, see: Gas metal arc welding MIG pliers, 45, 52
Mild steel, 14, 16
preparing, 18
repairing, 22
Mill scale, 18, 34
Molten puddle, 8, 9, 58, 60

Neutral flames, 33, 35, 70
Non-ferrous metals, 14
Nozzles, see: Tips

Outdoor projects, 122–137
Oxidizing flames, 33
Oxyacetylene cutting, 9, 68–71
  equipment, 68–69
  pressuring the system, 30, 31, 70
  safety, 7, 68, 69, 71
  setting up, 30, 70
  shades/lenses, 11, 69
  tools, 69, 71
Oxyacetylene welding, 8, 26–37
  depressurizing the system, 35
  equipment, 26–29
  leaks, 30, 31
  pressuring the system, 30, 31, 34
  safety, 27, 28, 29, 31, 32
  setting up, 30
  shades/lenses, 11, 27
  tools, 27
Oxyfuel brazing, see: Brazing
Oxyfuel cutting, see: Oxyacetylene cutting
Oxyfuel welding, 26
  See also: Oxyacetylene welding
Oxyfuels, 26, 35
Oxygen, 9

Particle masks, 10, 11
Penetration of the weld, 8, 22
Pipe, 16
Plant stand, 7, 114
Plasma cutting, 9, 64–67
  electricity, 38–39
  safety, 11, 64–65
  shades/lenses, 11, 65
  troubleshooting, 67
Plate metal, 16
Plate rack, 116–117
Power supply, 39, 40, 44, 45, 51, 54, 64
Preheating metals, 23, 69, 71
Pressure regulators, see: Regulators
Puddle, see: Molten puddle

Purchasing metal, 17, 79, 88, 92, 125, 132–133, 140
Racks,
  corner, 112–113
  plate, 116–117
  wine, 118–119
Rail cap, 16, 125
Railing, see: Stair railing
Rectangular tube, 16
Reducing flames, 33
Regulators,
  gas metal arc welding, 44, 47, 50
  gas tungsten arc welding, 54, 55
  oxyacetylene cutting, 68, 69
  oxyacetylene welding, 26, 28, 30, 31, 32, 35
Repairing metal, 22–23
Resources, 140
Respirators, 10, 11
Round bar, 16
Round tube, 16
Rust, 9, 15, 34

Saddle joint, 20
Safety, 7, 9, 10–11, 12, 22, 27, 28, 29, 31, 32, 40, 41, 47, 54, 55, 64–65, 68, 69, 71, 125, 128
Scratch starts, 60
  See also: Arcs
Scrolls, making, 92–93, 96–97, 102, 107–109, 116–117
Shades, 11
  See also: Filters, Shields
Sheet metal, 16, 17
Shelves,
  baker's shelves, 107–109
  corner coatrack, 112–113
  kitchen appliance stand, 114–115
Shielded metal arc welding, 8, 9, 43
  electricity, 38–39
  equipment, 40, 41–42
  safety, 40–41
  shades/lenses, 11, 41
Shielding gases, 9, 12, 42, 44, 45, 46, 47, 49, 50, 51, 54, 55, 56, 61
Shields, for helmets, 11, 27
  See also: Filters, Shades
Shocks, see: Electrical shocks
Shops, welding,
  projects, 74–89

safety, 12, 40
See also: Costs
Slag, 9, 40, 42, 43, 47, 51, 70, 71, 79
burns, 10, 68
risk of fire, 12, 68
SMAW, see: Shielded metal arc welding
Smoke, 10, 58, 64
Soldering, see: Brazing
Spark lighter, 27, 32, 69, 70
Sparks, 64, 68, 71, 79
burns 10
risk of fire, 12
Spatter, 41, 47, 50, 52
Square bar, 16
Square tube, 16
Stainless steel, repairing, 23
Stair railing, 125–127
Stands,
grinder stand, 88–89
kitchen appliance, 114–115
See also: Tables
Starter cartridge, see: Plasma cutting
Stick welding, see: Shielded metal arc welding
Strap, see: Flat bar
Stub out or stubbing, 53
Suppliers, 17, 140
Supply cables, 44, 45, 50, 51, 52, 55, 64
Tables, see: Coffee table, Welding table
See also: Stands
Tanks, see: Cylinders
T-bar, 16
Temperature crayons, 23
TIG, see: Gas tungsten arc welding
Tip cleaner, 27, 69, 71
Tips,
cutting head, 28, 29, 65, 70
gas metal arc welding, 46, 50–51, 52
matching to material or process, 29, 31, 34
oxyacetylene cutting, 68, 69, 70, 71
oxyacetylene welding, 26, 28, 29
rosebud heating, 28, 29
T-joint, 20

Tools, 13, 97, 99, 101, 119
gas metal arc welding, 45
gas tungsten arc welding, 55, 57
metalworking, 19, 107, 108, 109, 117
oxyacetylene cutting, 69, 71
oxyacetylene welding, 27
plasma cutting, 65
shielded metal arc welding, 41
Torches,
flames, 32, 33, 70
gas tungsten arc welding, 54, 55
lighting, 32
oxyacetylene cutting, 68, 69, 70
oxyacetylene welding, 26, 29, 31, 32
plasma cutting, 64, 65
valves, 32
See also: Guns, Tips
Tungsten inert gas (TIG), see: Gas tungsten arc welding

Ultraviolet light, safety, 10, 41, 54, 65

Valves, see: Cylinders, Torches
Ventilation, 10, 12, 27, 41, 43, 45, 55, 64, 65, 66, 69, 70
Voltage, 8, 39, 50–51, 65

Wattage, 38–39
Welding curtain, rolling, 76–77
Welding machines, 40, 41, 43, 44, 45, 46, 47, 49, 52, 53, 55, 59
cart, 82–83
Welding processes, 14
See also: Flux cored arc welding,
Gas metal arc welding, Gas tungsten
arc welding, Oxyacetylene welding,
Shielded metal arc welding
Welding table, 79–81
Welding tarp, see: Welding curtain
Welds,
fillet weld, 20, 21
groove weld, 20, 21
symbols, 21
troubleshooting, 62–63
Wine rack, 118–119
Wire brushing, 18, 23, 34, 41
Wire feed, 44, 45, 46, 51, 53

bird’s nests, 53
setting up, 48
Wire speed, 8, 45, 48, 50–51
Wire spools, 46
Wires,
tangles, see: Bird’s nests
See also: Electrodes
Work cables/leads and clamps, 39, 40, 41, 43, 44, 46, 50, 51, 52, 54, 55, 61, 64, 66

Zigzag trim, 106–109

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Subject To Real Estate: The (ULTIMATE) Guide

creative financing real estate real estate investing real estate investor subject to Feb 22, 2022

Subject to real estate is a type of real estate transaction. It can be mutually beneficial for both the buyer and the seller.

While subject to real estate may seem intimidating or confusing at first, it is, in many ways, simpler and more accessible than the more traditional ways of buying or selling a property.

- What Is Subject To Real Estate?
- Types Of Subject To Real Estate
- How To Find Subject To Properties For Sale
- Subject To Real Estate Benefits
- Subject To Real Estate Cons
- How To Do A Subject To Real Estate Transaction Step By Step
- Why Would A Seller Agree To Subject To?
- Subject To Real Estate Contract
- Subject To Real Estate Checklist
- Final Thoughts

What Is Subject To Real Estate?

"**Subject to**" real estate refers to the transaction of a property while maintaining the integrity of the existing loan on the parcel.

In subject to real estate, **the investor** purchases the property and agre to make payments on the existing loan of the house. The seller gives tl title to the investor.

This loan stays in the seller's name, but the buyer makes the **mortgag payments** on behalf of the seller, and the lender does not know about the property's transaction.

The Types Of Subject To Real Estat

There are three primary kinds of subject to real estate transactions.

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Cash To Loan Subject To

A **cash to loan subject to** is the most common form of subject to.

For this type of sale, the investor pays the seller the difference between the sales price and the mortgage balance in cash, while taking over the mortgage payments.

For example, if both parties agree that the property is worth $325,000, but the mortgage remaining is only $275,000, the investor will pay the seller $50,000 in cash and cover the remaining mortgage.

Usually, though not always, properties sold under these circumstances are in (or are about to be in) foreclosure.

Seller Carryback Subject To

A **seller carryback subject to** is the second most common form of a subject to. You're likely to have already heard of this type, just in different terms. This type of transaction is often called "owner financing" or "seller financing."

This works as an additional form of financing to be used if the investor's lender won't allow them the total funding that is needed for the purchase of the property.

The investor will get a mortgage for as much of the property's value as possible and then make payments to the lender in the form of a traditional mortgage, as well as payments to the seller in the form of a seller carryback subject to.

The seller never gives the investor the difference in cash. Rather, they a not paid in full for their house and instead slowly receive the differenc in payments directly from the investor.

The seller is in control of the terms of this transaction. They generally control the interest rate, downpayment, and loan length. Usually, the original homeowner wants the investor to put down a downpayment c five to twenty-five percent and pay off this portion in five years or less.

The official mortgage with the lender can take much longer to pay off and will likely be on different terms with different stipulations, down payments, etc.

Wrap Around Subject To

A **wrap-around subject to** is the least common type and for a good reason. The loan's interest rate is based on the original mortgage loan but with additional interest on top of that.

Since the seller has to pay interest on their original mortgage from their lender, they ask the investor to pay an additional, proportional interest rate to cover that.

If the original homeowner's mortgage is 4%, the seller will likely ask th investor to pay 6% on the carryback. At low-interest rates, this isn't mu of an issue. If, however, the seller had a higher interest rate, to begin with, then this is not an ideal situation for the investor.

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How To Find Subject To Properties For Sale

You will likely find subject to deals wherever you can find **distressed properties** or **motivated sellers**.

Connect with a real estate agent for assistance, look up soon-to-be foreclosed, auctioned, or short-sale properties through public records or online, and speak directly to the distressed homeowners.

Here are a few websites to help you get started:

- The Multiple Listing Service ("**The MLS**")
- **PropStream** (use our link for a free 7-day trial!)
- **Foreclosure.com** (here is our **review of Foreclosure.com**)
- **Zillow.com** (filter the results to only show pre-foreclosures)
- **Redfin.com**
- **Mashvisor.com**
- **RedX.com**
- Your local newspaper. Your local newspaper is required to publis the addresses of houses that are in the foreclosure process.
- **Real Estate Wholesalers**. Real estate wholesalers will have acces to **pre-foreclosure** listings and can get you in touch with distressed property owners.
- **Real Estate Attorneys**. Your local attorney will also have access t a list of pre-foreclosure and foreclosure properties.
- **Driving for Dollars**. You can also drive around neighborhoods a speak to homeowners; you never know who may be interested ir selling their home in a subject to transaction.

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Subject To Real Estate Benefits

There are three primary benefits for investors to utilize subject to, and two significant benefits for sellers. Here they are:

Subject To Pros For Investors

- **No Credit Checks.** If you're young, don't have credit, or don't have a favorable credit score, this is a great way to get your foot in the door as a new real estate investor. You don't have to have your credit checked at all for subject to real estate. And because you are using someone else's existing mortgage, you may get a better interest rate, even if you did have a decent credit score.
- **It's Cheaper.** Usually subject to sales have low or no closing costs. You can also benefit from fewer up-front costs, no bank fees, no realtor commissions, title companies, or loan officers involved.
- **It's a Quick Way to Build Equity and Grow Your Income.** Subject to properties gain equity faster than other real estate investing strategies because some of the mortgages is already paid off. It's also a quick process to close on a subject to property because there's little red tape involved. If you like to flip houses, you can get started much quicker with this method.

Subject To Pros For The Selling Homeowner

- **It's a Quick Sale.** Selling their place using subject to allows them to dispose of a property quickly so they can move onto something else.
- **It may save their financial life.** If the homeowner is facing foreclosure or needs cash in a hurry, subject to is a great solution. Foreclosure can be avoided because the investor takes over the foreclosure payments and keeps that off the seller's record. They can also get some cash pretty quickly from the investor, especially if the investor does a cash to loan subject to.

Subject To Real Estate Cons

No type of sales transaction is perfect, and that includes subject to rea estate.

Untrustworthy Sellers

If the homeowner (seller) doesn't take the money that the investor pay them to their lender or mortgage company, the investment property could still be foreclosed. Yes, this means that the investor cou be doing everything right and paying the monthly payment, and the house could still be foreclosed on.

The investor is trusting that the seller will continue to pay down the mortgage balance.

Untrustworthy Investors

Likewise, the seller has to trust that the investor will continue making payments on the subject to real estate. If the new buyer stops paying, the seller will have to continue making payments to the lender. The sel will also have to pursue legal action in order to regain their title to the property.

Due On Sale Clauses

Due on sale clauses would require the seller to pay back the bank the amount of the mortgage loan once the subject to agreement is made.

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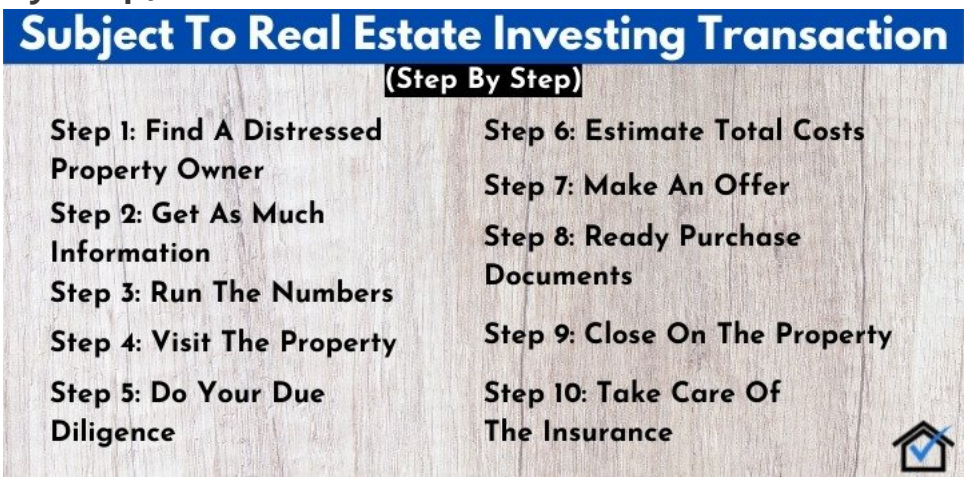
High-Interest Rates

If the original homeowner had bad credit when they bought the property, the interest rates could be high. If the seller's credit is bad, then the investor will have to pay high-interest rates during the subject to transaction.

How To Do A Subject To Real Estate Investing Transaction (Step By Step)



Step 1 - Find A Distressed Property Owner Willing To Do A Subject To Sale

Again, here are some great places to start looking:

- Mashvisor.com
- Zillow.com (filter the results to only show pre-foreclosures)
- Foreclosure.com
- RedX.com
- Your local newspaper
- Real Estate Wholesalers
- Real Estate Attorneys
- Driving for Dollars
- The MLS

Step 2 - Approach the Homeowner And Get As Much Information As You Can

Be kind and respectful. This may be a challenging time for the homeowner, so be on your best behavior, be thoughtful, respectful and kind.

Figure out why the homeowner may be in distress and how motivated they are to sell.

Ask who their lender is, the current loan balance, the mortgage payment amount, and how many payments they're behind. It would be best to ask about tax liens and mechanic liens.

Get the seller to sign an "Authorization to Release Information" form. This will allow you to double-check all of the above information they gave you with their mortgage lender. You're not doing this to test the homeowners, but rather to make sure you can offer the very best, most fair offer on their home.

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Step 3 - Run The Numbers

Now you need to calculate the "**After Repair Value**," figure out how much it will cost to rehab the property, and also plan out your exit strategy.

Compare other properties in the neighborhood to the property subject to the sale.

You should also run a thorough sales comparison analysis and adjust the comps to reflect the property's features, square footage, and the number of bedrooms and bathrooms in the house.

What's your exit strategy? Do you want to sell the house for more cash flow, turn it into a rental property, or offer a **lease option**? If selling it, compare to other local sales. If renting it, compare it to other rentals in the area. If leasing it, compare it to nearby leases.

Step 4 - Visit The Property

Get permission from the homeowners and then visit the house. This will fill in the blanks on repairs you'll need to make, the condition of the property, and how long it will take you to fully rehab the home. Take pictures if you've been given permission, and don't forget to bring your checklist. We'll provide you with that checklist down below.

If you can get a home inspector to tag along with you, that's even better.

After your visit through the property, you may need to revisit step three and adjust your estimates.

Step 5 - Do Your Due Diligence

The experienced investor knows to never, ever skip this step. This isn't exactly a fun part of real estate deals, but it is crucial to protect yourse and ensure a smooth, profitable sale.

Authorization to Release Information

If you haven't already, get the seller to sign an "Authorization to Relea Information" form. Once this form is signed, call their lender and fax o email this form to them. Once they see you have the authorization, the lender will give you lots of really important information regarding your potential new property.

Title Search

Have a **title company** run a preliminary search. This will tell you who t complete list of owners are, and if there are any liens or owed taxes or the property. During this search, you may find that tax liens, mechanics liens, HOA liens, code enforcement liens, or Federal IRS liens are owed against the property.

Utility Bills and Property Taxes

You should also call all of the local utility companies to get informatior on the property.

Here are utility companies you should be checking with to see if there are any past due bills:

- Water Company
- Electric Company
- Sewer Company
- Trash Company
- Internet, Cable, Landline Company
- Alarm System Company

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After checking on the utilities, check the property tax amount. This will let you know when and what to expect to pay in property taxes once the parcel is yours. It will also let you know if the current homeowner is behind on any of these taxes and how much money will be owed once you make the purchase.

Step 6 - Estimate The Total Costs

You will likely to need pay at least some amount of money in order to carry the property.

You may need to pay:

- the seller part of their equity, perhaps however much of the loan they've already paid off.
- arrears on the mortgage so that it is no longer behind.
- closing costs, such as transfer fees, transfer taxes, **escrow fees**, closing attorney, title insurance.

Step 7 - Make An Offer To The Homeowner

Using all of the above information that you've gathered, make a fair offer to the homeowner for their property.

You may offer to take over payments for the homeowner without paying them any cash.

You may offer to take over payments for the homeowner and pay them some lump sum of cash to cover their equity in the property. Usually, this is because they owe less than what the property is worth.

You may also offer to take over payments for the homeowner and negotiate that they pay you to take this property off their hands. For instances like this, it's usually because the owners owe a lot more mon on the mortgage than what the property is worth.

It's always a good idea to have a mentor or real estate attorney help y draft an offer. They can accurately tell homebuyers if the existing loan balance is appropriate and what a fair purchase price should be.

Step 8 - Organize And Ready Your Purchase Documents

For this step, you need a purchase document that is enforceable in you state. At the bare minimum, have your subject to agreement checked l a real estate attorney. Better yet, have your attorney write up the document for you.

Your real estate attorney is already knowledgeable with loan terms, a fair sales price, and how to make a proper loan assumption. They are good people to have on your team.

Step 9 - Close On The Property And Ge Your Keys

Depending on the state, you can finalize the property transaction at home with the seller, at a title company, or with a closing attorney. Wh "kitchen table" closings are valid in some states, they are almost never good idea. It's wise to stick to attorneys and title companies for the m financial safety.

Most closing documents will need to be notarized, which is why kitche table sales are such a bad idea.

×

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Founder Real Estate Skills

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All owners will need to present to sign the documents, and that includes spouses. If an owner has died, a death certificate will likely be needed to make the transaction.

At closing, you will receive your new investment property's keys.

Step 10 - Take Care Of The Insurance

This is a two-part step.

First, you will need to cancel the seller's insurance. Use your limited power of attorney to change the mailing address to your address, and then cancel their homeowner's insurance policy.

Next, you'll need to obtain your own homeowner's insurance. You should always have your own policy on the house to ensure that you are never denied a claim. This can happen if the primary insured person is not the owner.

When you create your new policy, make sure that you get a non-owner-occupied landlord policy. You need to be the first name listed on the insurance, and then the existing mortgage company as the mortgagee. Make the seller the additional insured on the policy.

Why Would A Seller Agree To A Subject To?

A seller would agree to a subject to because they cannot afford their property, are about to be foreclosed on, they need quick cash, or they need a quick sale.

A subject to can allow them to avoid foreclosure, which can really save their credit history and credit score.

In some cases, the buyer pays the seller a lump sum of cash to cover their equity in the home.

Each of these reasons, or a combination of them, are all good reasons a seller to agree to a subject to sale.

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Subject To Real Estate Contract

You should contact your real estate attorney for a subject to contract c
an agreement for the purchase and sale of a real estate subject
to transaction.

With that said, here is an example of a **simple subject to agreement**. Use this just to get an idea of what to expect.

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AGREEMENT FOR PURCHASE & SALE OF REAL E
(Subject to Transaction)

AGREEMENT dated this ____ day of _____ 20___, by and between _____

hereinafter "**Seller**", whose address is _____

_____ hereinafter "**Buyer**" (or its assignee

_____

1. **THE PROPERTY**. The Seller agrees to sell and Buyer agrees to buy the following property, located in th

Lot ____, Block ____, CB/NCB _____ commonly known as _____

The sale shall also include all windows shades, blinds, screens, shutters, electric and plumbing fixture

_____

2. **PURCHASE PRICE**. Buyer to pay the purchase price as follows (check all that applies):

☐ EARNEST DEPOSIT (Payable to the **Law Firm, Trust Account**) ..... $

☐ CASH DOWN PAYMENT due at closing in the amount ..... $

☐ TAKE TITLE SUBJECT TO AN EXISTING **FIRST** TRUST DEED NOTE
held by _____ with an approximate unpaid amount of ..... $
payable $_____ monthly until paid, including interest not exceeding ____%.

☐ TAKE TITLE SUBJECT TO AN EXISTING **SECOND** TRUST DEED NOTE
held by _____ with an approximate unpaid amount of ..... $
payable $_____ monthly until paid, including interest not exceeding ____%,

☐ A PROMISSORY NOTE in the principal amount of ..... $
For the Terms of the Note, see paragraph 10 below.

TOTAL PURCHASE PRICE IS THE AMOUNT OF ..... $

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3. **FINANCING.** Buyer will be taking the property subject to d
and is not expressly assuming responsibility through a form
20____, the Buyer shall pay all monthly obligations on the
other expenses related to the property.

If the actual loan balance of said loan is less than as statec
actual loan balance is more than as stated herein, then Bu
waive any remaining balance of tax, MIP and insurance es

4. **CLOSING.** Closing will be held on or about _____

_____

Responsible for Closing Cost ☐ Seller ☐ Buyer ☐

The following Items will be prorated at closing: ☐ Homeow
The Law Firm will not provide Title Insurance but will perfor
Title Insurance companies will not provide Title Insurance v

5. **POSSESION.** ☐ Seller shall surrender possession to t
☐ In the event possession is not deliver
$ _____ as security de

6. **ADDITIONAL PROVISIONS.**

- Seller is aware that this loan will not be satisfied in full at clos
with loan payment booklets and written permission to contact
Limited Power of Attorney pertaining to the subject property, a
- Both Seller and Buyer acknowledge that the deed(s) of tru
giving the lender an option to call the loan immediately pay
the said loans.
- _____

7. **DEFAULT BY BUYER**. If Buyer fails to perform the agree
liquidated damages and not as a penalty, all of the earnest money deposit specified in paragraph 2 ab

8. **DEFAULT BY SELLER.** If Seller fails to perform any of the agreements of this contract, Buyer shall b damages resulting from the breach of contract, or the Buyer may bring an action for specific performar

9. **OFFER.** This is an offer to purchase the Property on the above terms and conditions. Unless this offe personally received by Buyer, by _____, at ___ AM/PM, the offer shall be deemed revoked anc

10. **OTHER TERMS**: _____

Buyer(s): _____, **Date**: _____

Email: _____ Phone #(s): _____

Seller(s): _____, **Date**: _____

Email: _____ Phone #(s): _____

FREE Wholesale Real Estate Contracts [PDF Download]

Subject To Real Estate Checklist

Here is an example of a **comprehensive subject to real estate checklist**. Again, speak to your mentor, or better yet, a real estate attorney, for complete safety and coverage. Use a home inspector during step four if at all possible.

Final Thoughts

Subject to real estate can seem intimidating at first glance, but it's real not that difficult to break into. Subject to transactions can be mutually beneficial for the seller and the investor. For the seller, they get to avo financial ruin, foreclosure, or hard hits on their credit. It also grants the the ability to walk away from a property relatively quickly, and sometimes with cash in hand.

For the investor, subject to real estate transactions are attractive becau they don't require credit checks, they need very little or no money dov and the sale closes quickly.

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The Steps to a Subject To Real Estate Deal

In Part 1 (https://www.reikit.com/wholesaling-houses/acquisition/what-is-subject-to-real-estate-investment-strategy) of this series on how to transact Subject To deals, I explained exactly what is Subject To investing and how you can both profit from them and help a distressed homeowner as well.

Part 2 (https://www.reikit.com/wholesaling-houses/acquisition/benefits-risks-investing-real-estate-subject-to-existing-mortgage) outlined the risks and benefits of entering into a subject to transaction that affect not only you, but also the seller, and how to mitigate them.

In this post, I break down the steps necessary to a successful Subject To real estate deal, from verifying seller facts to closing.

The steps to acquire a property Subject To an existing mortgage are:

1. Perform initial due diligence on the seller and property
2. Verify the facts
3. Determine your exit strategy and offer
4. Prepare your purchase documents
5. Finalize the transaction
6. After the closing

Let's start with the first step, the initial contact.

Perform initial due diligence on the seller and property

When you first get a distressed seller lead, the first step is to perform a through due diligence of that seller's situation, and determine the condition and value of the property.

The Ultimate Whole

The Ultimate Guide to W (https://www.reikit.com/ houses)

Marketing Wholesale (https://www.reikit.co houses/marketing)

The ROCKET ChatGPT Form Supercharging Prompts for I Estate Wholesalers (https://www.reikit.com/whc houses/marketing/rocket-fo chatgpt-prompts-for-real-est wholesalers)

Revolutionize Your SMS Mar with ChatGPT: Crafting Tailo Messages for Real Estate Wholesaling Success (https://www.reikit.com/whc houses/marketing/sms-mar with-chatgpt)

5X Your Deals: Omnichannel Marketing Secrets For Real E Investors (https://www.reikit.com/whc houses/marketing/omnicha marketing-secrets-for-real-es investors)

Best Marketing Channel for I Estate Investors (Hint: There Just One) (https://www.reikit.com/whc houses/marketing/best-mar channels-for-real-estate-inve

How to Create a Lead Ad fro Facebook Page to Capture Wholesaling Leads (https://www.reikit.com/whc houses/marketing/how-to-c lead-ad-from-your-facebook

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In this section I cover: what information to get from the seller, determining a property's value, what you should look for when you visit the property, how to get the facts from the lender, and other information you will need to obtain, to evaluate a deal and determine your offer.

First, get the facts from the seller

Prior to stepping foot on the property you need to understand the seller's situation. You will want to find out not only the reason for their distress, but also their level of motivation.

With the seller on the phone, or in person, ask them who their mortgage lender is, how many payments they are behind on, what the latest mortgage payment amount is, the current loan balance, and any known arrears or liens on the property, such as tax liens or mechanics liens.

If you are speaking with the seller in person, you can ask them to sign an Authorization to Release Information form that will give you the ability to verify the information they gave you with their lender.

This will be one of the documents described in the next post about the documents necessary for a Subject To transaction.

Now that you have the seller's facts, it's time to calculate the property's After Repair Value (ARV), or what the property would sell for on the open market after it has been rehabbed.

Determine the After Repair Value

There are a two major parts to determining the property's value.

The first is to select appropriate rehabbed comps that are within the same neighborhood, that sold recently, and that are as much like the property that you are looking at.

The second part is to perform a thorough sales comparison analysis, adjusting those comps for feature values such as beds, baths, garages and pools.

> *This guide explains exactly how to do that, by finding comps and adjusting them to accurately calculate ARV:*
>
> *ARV Real Estate Meaning: How to Calculate It Quickly & Accurately (https://www.reikit.com/wholesaling-houses/deal-analysis/arv-real-estate-meaning-calculate-after-repair-value)*

You will need to make sure that you take your exit strategy into account when you are determining these adjustments.

For example, if you are intending on rehabbing the property for resale to a homeowner, then you will want to look at recently rehabbed properties for valid comparison. On the other hand if you will be renting the property out, or using a lease option strategy, then it may be better compared to other rental properties in the area.

Get your initial documents signed

One of the first documents that you will need to get the seller to sign in order to perform more in-depth fact checking is the Third-Party Authorization to Release Information form, which will allow you to contact the seller's lending institution and creditors.

This form should be readily available on the lender's website or search online for it using the words Third-Party Authorization to Release Information + lender's name.

The Step By Step Guide To F
Ads For Motivated Seller Lea
(https://www.reikit.com/who
houses/marketing/guide-to-
facebook-ads-for-motivated-
leads)

Facebook Retarge
Guide for Real Est
(https://www.reikit
houses/marketing
retargeting-guide-f
investors)

34 Actionable Way
Cash Buyers List
(https://www.reikit
houses/marketing
cash-buyers-list)

Wholesale Propert
The Critical Components of
Wholesale Deal Sheet to Sel
Contracts
(https://www.reikit.com/who
houses/marketing/wholesal
property-marketing-tips-the-
components-of-a-wholesale
sheet-to-sell-more-contracts

Wholesale Real Estate Acquisit
(https://www.reikit.com/wholes
houses/acquisition)

List Stacking 101: How to Fi
Most Highly Motivated Selle
(https://www.reikit.com/who
houses/acquisition/list-stac
most-highly-motivated-seller

Vacant Property List Market
Real Estate Wholesalers
(https://www.reikit.com/mot
seller-leads/vacant-property

Absentee Owner List Market
Real Estate Wholesalers
(https://www.reikit.com/mot
seller-leads/absentee-owner

How to Market to Subject-To
(https://www.reikit.com/who
houses/acquisition/how-to-r
to-subject-to-sellers)

What is the Subject To Real
Investment Strategy?
(https://www.reikit.com/who

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You should get your seller to sign this form via DocuSign or using any other electronic signature platform, which will save you a ton of time in performing your lender due diligence.

If you can't get this done electronically, you should bring this form with you when you visit the property.

Visit the property

So far, you understand the seller's financial position and motivation, and you have the property's ARV.

You're still missing a big piece of the puzzle, and that piece is the repair items that you will find when you visit the property.

Determine the repairs necessary

When you visit the seller's home, you'll need to walk the property and note any needed repairs.

Personally, when I first walk a property I get so excited with the potential of a deal, that if I don't have a checklist with me, I always forget to identify half the necessary items.

This is why I use this Rehab Walkthrough Estimation Checklist (https://www.reikit.com/rehab-walkthrough-estimation-checklist) link to keep me focused on noting the condition of the property, making sure that I account for all of the major systems that may or may not need to be repaired.

Additionally, if you don't know what to look for, you should consider picking up a copy of this book, used by home inspectors to prepare for their exams:

> *The NHIE Home Inspection Manual*
>
>
>
>
> *(https://www.amazon.com/gp/product/0996451803/ref=as_li_tl?ie=UTF8&camp=1789&creative=9325&creativeASIN=0996451803&linkCode=as2&tag=rfaf-20&linkId=82d2b19fc3e192a43f2d03a7ec1aef81) This manual was developed by the Examination Board of Professional Home Inspectors with technical information on the inspection of the major components and systems of a property.*
>
> *Show On Amazon (https://amzn.to/2JFwLiB)*

Determine the cost of repairs

Once you have noted the repairs that need to occur, you should estimate their costs.

If you have never estimated rehab costs before, then here are a number of resources available to you that will get you a long way to doing so:

First, if you haven't already, you should read this post from the Flipping Guide:

> *How to Estimate Real Estate Rehab Construction Costs (https://www.reikit.com/house-flipping-guide/how-to-estimate-rehab-construction-costs)*

Next, in the Resources menu, I list several books that you should read. Specifically you should have already read:

houses/acquisition/what-is-
to-real-estate-investment-str
The Benefits and Risks of In
in Real Estate Subject To an
Mortgage
(https://www.reikit.com/whc
houses/acquisition
investing-real-esta
existing-mortgage
The Essential Doc
Contract Clauses t
Property Subject T
(https://www.reikit
houses/acquisitio
documents-and-c
purchase-property
The Steps to a Sub
Estate Deal
(https://www.reikit.com/whc
houses/acquisition/steps-to
subject-to-real-estate-deal)
Virtual Wholesaling: Real Est
Wholesaler's Guide to Scalin
Nationwide
(https://www.reikit.com/whc
houses/virtual-wholesaling)
Top 14 Cold Calling Mistake
Avoid for Real Estate Whole
(https://www.reikit.com/whc
houses/acquisition/top-cold
mistakes-avoid-real-estate-
wholesalers)
Top 15 Seller Objections in R
Estate Wholesaling (and Ho
Overcome Them)
(https://www.reikit.com/ove
objections-real-estate-whole
How to Hire a Virtual Assista
Your Real Estate Wholesalin
Business
(https://www.reikit.com/whc
houses/how-to-hire-virtual-a
real-estate-wholesaling-busi
55 Resources to Find Real E
Deals Online
(https://www.reikit.com/whc
houses/acquisition/55-reso
find-real-estate-deals-online)
35 Relationships To Help Yo
More Houses To Flip
Send Me New Wholesaling and Flipping Posts

J Scott's Book on Estimating Rehab costs

(https://www.amazon.com/Book-Estimating-Rehab-Costs-BiggerPockets/dp/0988973715/ref=sr_1_1?s=books&ie=UTF8&qid=1541448331&sr=1-1&keywords=j+scott+book+on+estimating+rehab+costs&linkCode=li1&tag=rfaf-20&linkId=f1fb4268021fc7efe848799f871915f0)I cannot recommend this book highly enough for getting your estimating legs.

Show On Amazon (https://amzn.to/2Dnx5Cc)

Verify the facts

The next step in the process is to verify all of the information that the seller has told you.

Get the facts from the lender

With your signed Third-Party Authorization to Release Information form, call the lender, who will ask you to email or fax the form to them before they let you discuss the seller's account.

You will want to request the history of the loan, the balance remaining, any arrears, escrow balance, and payoff documentation.

Once you have received the information from the lender, compare it to what the seller provided to you to make sure that the information matches up. If there are differences between the lender's current information and the seller's information, such as the number of months behind on payments, payment amount and so on, make note of them so you can properly calculate your offer.

Run a title search

Perform a preliminary title search, or have a title company do a preliminary search, to fully understand who are all the owners of the property, and the chain of title. The title search will reveal any other liens or taxes on the property, such as Federal IRS Liens, Tax Liens, Mechanics Liens, HOA Liens, or Code Enforcement Liens, among others.

Check owed balances on utilities and property taxes

The seller's water, electric, sewer, and other utilities accounts as well as alarm companies and the like can have existing balances owed. When utilities are behind and get sent to a credit-reporting agency, there may also be a lien on the property for the amount.

You should call all of the utilities to make sure the payments are current.

Also check the property tax amount, which is usually public record and can be found online using the Assessor's Parcel Number or some other identifier, and that property taxes have been brought up to date, or note when the next payment is due.

With the seller's current liabilities, the property's ARV, and the estimated repair costs written down, you'll have a rough estimate of what kind of deal you're looking at.

Identify potential costs

Next let's talk costs, specifically your costs when it comes to executing a Subject To transaction.

(https://www.reikit.com/whc
houses/acquisition/35-relati
to-help-you-find-more-house

29 Ways to Find Off-Market
Wholesale Real Estate Deals
(https://www.reikit.com/whc
houses/acquisitior
market-wholesale-
offline)

The True Cost Per
For Dollars
(https://www.reikit
houses/acquisitior
lead-driving-for-do

Wholesale Deal Analy
(https://www.reikit.cc
houses/deal-analysis

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Calculate It Quickly & Accura
(https://www.reikit.com/whc
houses/deal-analysis/arv-re
meaning-calculate-after-repa

How to Estimate Real Estate
Construction Costs
(https://www.reikit.com/whc
houses/deal-analysis/how-t
estimate-rehab-construction

Real Estate Wholesaling Res

REI/kit House Flipping & Wholesal
Software (https://www.reikit.com)

Top 14 Best Real Estate Wholesali
Software Tools to Power Your Bus
2023
(https://www.reikit.com/resources
real-estate-wholesaling-software-t
features)

Real Estate Investor CRM Softwar
How to Choose the Best One
(https://www.reikit.com/how-to-ch
best-real-estate-investor-crm)

Free ARV Calculator
(https://tools.reikit.com/comps)

Free 70 Percent Rule Calculator
(https://tools.reikit.com/70-percer
calculator)

The Best Real Estate Wholesaling
Podcasts in 2023

While Subject To is often touted as a 'no money required' strategy, there are many cases in which you'll find that you need *some* funds to carry the property.

For example, you many need money to:

- Pay off arrears on the mortgage to get it caught up
- Pay seller part of their equity in the property
- Pay closing costs such as:
  - Closing attorney
  - Transfer fees or taxes
  - Escrow fees
  - Title insurance
- Make the payments after you've transferred title and are looking for a buyer

Once you have identified all of those costs, you can start to formulate your exit strategy and draw up your offer.

Determine your exit strategy and offer

It is the seller's financial situation that will determine your available exit strategies, and thus the details of the offer.

Although I devote the final post to showing a few examples of seller situations and how those will impact your exit strategies, for now you can begin thinking about the following basic situations. These will guide you as you start formulating your exit strategies to create a win-win offer that gets the seller from under the house, and makes sure that you profit:

- In some cases, you can take title to a property Subject To, without putting up *any* of your own money. In fact, in situations where the seller is behind on payments, they may agree to catch up the loan before transferring the deed.
- If the seller owes more than the property is worth, you could negotiate that they give *you* money to take a problem property off their hands.
- In many cases, *you* may need to pay the seller. This could be, for example, to pay for some of their equity in the property, if they owe less than what the property is worth.

You can review your potential exit strategies in the first post (https://www.reikit.com/wholesaling-houses/acquisition/what-is-subject-to-real-estate-investment-strategy), to see how each of these situations will have an impact on your exit strategy, and your offer.

Prepare your purchase documents

As with most things involving the law, the basics of contracts would take up several chapters, so I will not go into those here. I will, however, go into detail about some of the most important documents that you will need as part of your purchase, in the next post.

Specifically, you will need a purchase agreement that is valid and enforceable in your state.

For this reason, I strongly recommend that you always have your Subject To contracts and documentation created by a real estate attorney in your jurisdiction that is also familiar with Subject to transactions.

In general, your purchase contract will serve two major purposes:

(https://www.reikit.com/wholesali
houses/best-real-estate-wholesali
podcasts)

Skip Tracing Real Estate: Ultimate
Find a Property Owner NOW
(https://www.reikit.com/resources
tracing-real-estate-find-p

Cold Calling Machines F
(https://www.freecoldca
cold-call-scriptshqat42o
affiliate_id=1559982)

US Legal Real Estate Fo
(https://www.uslegalforr
auslf=cl2018)

JScott's Book on Estima
(https://www.amazon.co
ie=UTF8&camp=1789&c
20&linkId=c89d7b6326f

The Real Estate Wholesaling Bible
Fastest, Easiest Way to Get Starte
Estate Investing
(https://www.amazon.com/Real-E
Wholesaling-Bible-
Investing/dp/1118807529/ref=as_
s=books&ie=UTF8&qid=1518492
1&keywords=wholesaling+bible&c
20&linkId=d6c6140ce1880fcf15ba

Never Split the Difference: Negotia
If Your Life Depended On It
(https://www.amazon.com/gp/pro
ie=UTF8&linkCode=ll1&tag=rfaf-
20&linkId=3043c53246dfe489a34

If You Can't Wholesale After This:
Nothing For You
(https://www.amazon.com/gp/pro
ie=UTF8&tag=rfaf-
20&camp=1789&creative=9325&l

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1. To present the offer and exchange of value to your seller
2. If you are unable to close, disclose the risks to the seller

In the next post, I will go into more detail about the major clauses that you should have your attorney include in your contract, especially the disclosure of your intent to make a profit, and the risks of the due-on sale clause.

If your offer is accepted, now it's time to close.

Finalize the transaction

Title company, closing attorney, or the kitchen table?

Every state has different laws as to how to close real estate transactions. Some require a title company, others require an attorney at close, some allow you to close at the seller's kitchen table, and some allow all of those closing methods.

If you are just starting out with the Subject To strategy, I don't recommend kitchen table closings, even if they are valid in your state. You'll want to close using a closing attorney or through a title company; find out which (if any) might be required in your state.

> *This PDF from First American Title, shows a good outline of some of the documents and costs that you may need in each state and whether an attorney is required at closing:*
>
> *Real Estate Customs Guide by State (https://www.reikit.com/wp-content/uploads/Real-Estate-Customs.pdf)*

In general, of the documents that will be required for closing, some will be recorded, and some you will keep for your records. Most documentation will need to be signed by the sellers, some will need to be notarized, and others just witnessed.

If the seller is married, you should always make sure that the spouse signs all of the documents.

A great title company or attorney that is well versed in these transactions will guide you through the closing process from A-Z and smooth out any bumps. There are always bumps.

You might find when you first start calling around for a title company, that many do not understand how to process a Subject To. The only difference between a traditional closing and a closing Subject To is that the lender is not receiving a payoff and there is no new mortgage being prepared for you, the buyer, and so the title is encumbered with the original financing.

Some title companies will not perform a Subject To transaction, period, while others do them frequently, so you may need to call several to find one that performs these.

Your title company does matter, so try to have this in place *before* you start marketing for sellers. Ask for company recommendations at Real Estate Investment Clubs in the areas where you are finding motivated sellers.

What happens after you close and your documents are sent for recording?

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After the closing

Once the transaction is complete you'll need to do the following:

Keys

You should have exchanged these at closing. You'll need to make sure that the seller gives you any keys and garage door openers as well as any alarm codes. After closing, you'll need to get a locksmith to re-key all of your doors.

Cancel seller's insurance.

Using your Limited Power of Attorney, cancel the seller's homeowner's insurance policy, but make sure you change the mailing address to your address before canceling.

This will ensure that you, and not the seller, will get proceeds should the seller make a claim against the property. Alternatively, you can, at closing, have the seller sign a letter of insurance cancellation, requesting that any unearned premiums be sent to your or your company's address.

Obtain your own insurance.

You will need to create a new policy, specifically a non-owner occupied landlord policy. You will want to be listed as the first named insured, with the existing mortgage company as the mortgagee. Add the seller as additional insured.

Our insurance provider (NREIG) (https://nreig.com/a/citylightllc/), recommends that you should always have your own policy on the property to avoid a denied claim because the primary insured is no longer the owner.

Change of address and phone number.

If you are sending the lender a letter informing them of the title transfer, request that the seller sign the change of address form from the lender, making your address the new billing address, as well as your phone number.

Lender's Online Payment Information

Get the lender's online payment methods, such as a payment portal, or any applicable paper methods so that you can begin to make payments.

Summary

Subject To agreements can seem complex on the surface, but the steps needed to execute this creative method of investing in real estate are fairly straightforward. In this post I covered how to vet information from the sellers, a summary of how to perform due diligence on the property, where you should perform the closing, and what to do after the closing.

In the next part, The Essential Documents and Contract Clauses to Purchase a Property Subject To (https://www.reikit.com/wholesaling-houses/acquisition/essential-documents-and-contract-clauses-to-purchase-property-subject-to), I talk about the specifics of the Subject To purchase agreement, and some of the most important disclosure items to include, so as to keep you out of trouble.

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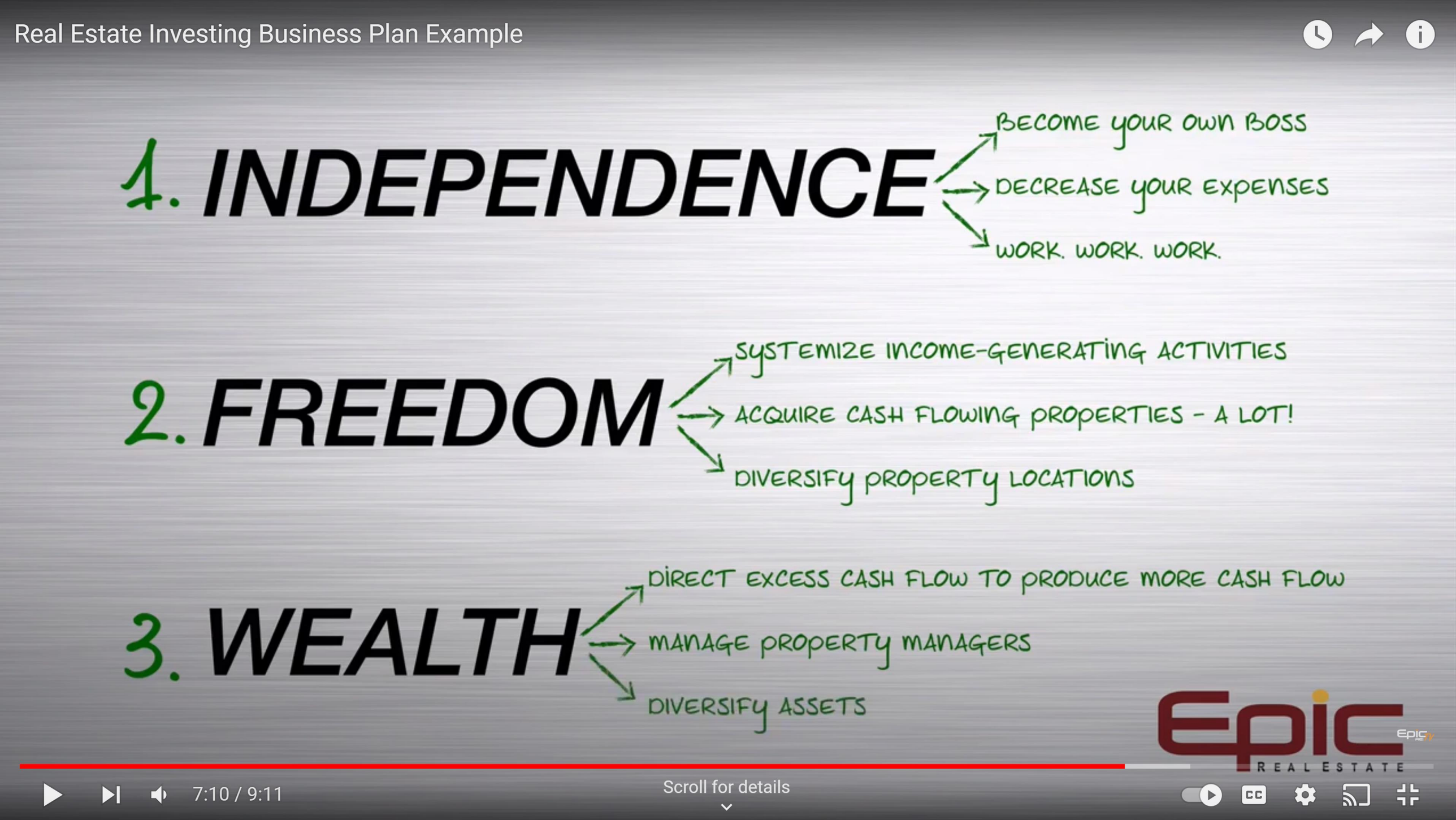
Real Estate Investing Business Plan Example



Typical Owner Financing Terms (defined!)

FMV: $100,000

ASKING: $95,000

RENT: $1,100

NO MORTGAGE
NO REPAIRS NEEDED.

PRICE	TERMS
$60,000	Cash
$70,000	$7,000 down, $63,000 @ 5% amortized over 30 years.
$80,000	$10,000 down, $70,000 @ 4% interest only monthly payments, balance due in 10 years.
$90,000	$15,000 down, $75,000 divided by 150 equal monthly payments.
$120,000	$20,000 down, $500/month (6 month moratorium on 1st payment) with remaining balance due in 15 years.

6:32 / 11:56

Scroll for details

Typical Owner Financing Terms (defined!)

FMV: $100,000

ASKING: $95,000

RENT: $1,100

NO MORTGAGE

NO REPAIRS NEEDED

PRICE	TERMS
$100,000	20% down, 30 year bank mortgage @ 6%
	Total paid after 30 years… **$182,760**
$120,000	$20,000 down, $500/month (6 month moratorium on 1st payment) with remaining balance due in 15 years.

7:13 / 11:56

Scroll for details

TYPICAL OWNER FINANCING TERMS

1. **Payments** - A payment is the trade of value from one party to another to fulfill a legal obligation.
2. **Interest** - Interest is payment from a borrower to a lender of an amount above repayment of the principal amount borrowed, at a particular rate.
3. **Principal** - A capital sum earning interest, due as a debt.
4. **Credit** - The provision of money, goods, or services with the expectation of future payment.
5. **Down Payment** - A part of the full price paid at the time of purchase with the balance to be paid later.
6. **Balloon Payment** - a final payment that is much larger than any earlier payment made on a debt.
7. **Moratorium** - an authorized period of delay in the performance of a legal obligation or the payment of a debt.
8. **Profit Share** - Payments to principals in a transaction that depend on the profitability of the transaction.
9. **Option** - A contract that offers the buyer the right, but not the obligation, to buy a property at an agreed-upon price during a certain period of time or on a specific date.
10. **Lease** - A contract by which one party conveys property to another for a specified time, usually in return for a periodic payment.
11. **Lease to Own** - A contract that combines elements of a traditional lease agreement with an exclusive option to purchase.
12. **Carry Back** - When a seller acts as the bank or lender and carries a mortgage on the subject property.
13. **Subject-to** - Buying a home subject to the existing mortgage. While title is transferred to a buyer, the existing mortgage stays in place where the buyer takes over the payments.
14. **Deferral** - A postponement of an action or event (deferred interest, deferred profit, deferred down)

5:02 / 11:56
Scroll for details

The Essential Documents and Contract Clauses to Purchas Property Subject To

In this post, I dive deeper into the essential documents that you'll need for a Subject To deal, and some of the clauses that you should insert into the contracts to help protect you.

If this is the first part of this series on Subject To that you've come across, you might want to also check out Parts 1-3. Here's a summary of what I've covered so far:

What is the Subject To Real Estate Investment Strategy? (https://www.reikit.com/wholesaling-houses/acquisition/what-is-subject-to-real-estate-investment-strategy) Provides a thorough explanation of exactly what Subject To investing is, and how you can both make money with it and help homeowners in distress.

The Benefits and Risks of Investing in Real Estate Subject to an Existing Mortgage (https://www.reikit.com/wholesaling-houses/acquisition/benefits-risks-investing-real-estate-subject-to-existing-mortgage) Covers the benefits and risks of Subject To transactions that you and your seller should be aware of, including the due-on-sale clause.

The Steps to a Subject To Real Estate Deal (https://www.reikit.com/wholesaling-houses/acquisition/steps-to-a-subject-to-real-estate-deal) Breaks down the steps necessary to a successful Subject To real estate deal, from verifying seller facts to the closing.

As with most things involving the law, the basics of contracts would take up several chapters, so I'll only briefly cover the documents that you may need, and the clauses that you may want to have in your contracts when performing these transactions.

Let's start with defining the documents that you're most likely to need throughout the process and at closing.

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The Ultimate Whole

The Ultimate Guide to W (https://www.reikit.com/ houses)

Marketing Wholesale (https://www.reikit.com/wholes houses/marketing)

The ROCKET ChatGPT Form Supercharging Prompts for I Estate Wholesalers (https://www.reikit.com/whc houses/marketing/rocket-fo chatgpt-prompts-for-real-est wholesalers)

Revolutionize Your SMS Mar with ChatGPT: Crafting Tailo Messages for Real Estate Wholesaling Success (https://www.reikit.com/whc houses/marketing/sms-mar with-chatgpt)

5X Your Deals: Omnichannel Marketing Secrets For Real E Investors (https://www.reikit.com/whc houses/marketing/omnicha marketing-secrets-for-real-es investors)

Best Marketing Channel for I Estate Investors (Hint: There Just One) (https://www.reikit.com/whc houses/marketing/best-mar channels-for-real-estate-inve

How to Create a Lead Ad fro Facebook Page to Capture Wholesaling Leads

The Documents Used in a Typical Subject To Transaction

This list is not inclusive of all possible forms, and your state or county may require more or less forms or they may be named differently.

As a good starting point, you can get a list of forms and documents required for a typical real estate transaction in your state from US Legal Forms (https://www.uslegalforms.com/realestate/?auslf=cl2018).

Once you have the basic contracts to ensure a legal transfer of property, you can add your own amendments and clauses specific to the Subject To transaction.

I recommend that you always have your Subject To contracts and documentation looked over by a real estate attorney in your jurisdiction.

Some of these documents are for your due diligence, some will be required for closing, others will be recorded, and some are simply for your records.

Most documentation will need to be signed by the sellers, some will need to be notarized and others just witnessed. It's most efficient to try to get all paperwork done at the same time, for example by having a mobile notary come to a central place where you and the sellers can meet.

Third-Party Authorization to Release Information

As mentioned in the last post, the steps to a subject to deal (https://www.reikit.com/wholesaling-houses/acquisition/steps-to-a-subject-to-real-estate-deal), you'll need this signed form to perform basic due diligence and verify the information the seller gives you regarding the status and terms of the mortgage and payoff amount.

To find this form, just search online for it using the words "Third-Party Authorization to Release Information" + lender's name.

You should have your seller sign this form as soon as possible, either using an online tool such as DocuSign, or in wet ink on your first visit to the property.

Purchase and Sale Agreement

The terms of the purchase are laid out in this contract. Typically you or the attorney setting up your Agreement will want to add, at a minimum, a Subject To section with some variation of the following verbiage, "This agreement is subject to the existing mortgage".

In the next section of this post I'll talk about the most important clauses to include in this contract.

Federal, State, County & City Disclosures & Pamphlets

Each property may be subject to disclosures required by every level of government from the city, up to the federal level. These are mandated disclosures between the seller and the buyer. Some are actual disclosures, others are information pamphlets.

These can include:

Lead-Based Paint Disclosure & Pamphlet

This disclosure is required by the federal government for any residence constructed before 1978.

Natural Hazard Disclosure

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Facebook Retarge
Guide for Real Est
(https://www.reikit
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retargeting-guide-f
investors)

34 Actionable Way
Cash Buyers List
(https://www.reikit
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cash-buyers-list)

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most-highly-motivated-seller

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Real Estate Wholesalers
(https://www.reikit.com/mot
seller-leads/vacant-property

Absentee Owner List Market
Real Estate Wholesalers
(https://www.reikit.com/mot
seller-leads/absentee-owner

How to Market to Subject-To
(https://www.reikit.com/whc
houses/acquisition/how-to-r
to-subject-to-sellers)

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States like California require this report, which provides information on official hazard zones affecting the property; shows any specific property taxes and assessments, and environmental hazards in the area.

Seller's Property Disclosure

This will be the seller's disclosure of all of the defects of the property.

Compliance Forms

California requires that buildings have the required smoke detectors in each room, and that they comply with certain earthquake bracing requirements. Other locations will have similar compliance requirements.

Military Ordinance Disclosure

The seller must disclose whether the property was within one mile of an area previously identified as used for military training purposes, which may contain unexploded ordinances.

Industrial Use Disclosure

The property might be affected by nearby industrial activity such as airport noise, industrial smells, or safety concerns.

Notices & Disclosures of any Supplemental Taxes

These may be local taxes and levies on properties to finance public works and services.

Any Local Disclosures

These could be disclosures such as specific ordinances affecting the use, restrictions, and or taxation of the property.

Due on Sale Disclosure

You will add this disclosure, or if you choose, an addendum in your Purchase Agreement, to clearly explain to seller the risks in agreeing to sell the property Subject To their existing mortgage.

Specifically you want to disclose that the lender may call the loan due at any time and that you make no guarantees that you will pay the remaining balance due should that happen.

Affidavit of Liens

In this document, the seller lists any and all liens on the property, whether officially recorded or not, that they are aware of.

Affidavit of Marital Status

Records the marital status of parties to the transaction. This is especially important with separated spouses, to ensure that the Subject to sale has been approved by all parties to a marriage.

Deed

This document will be filed with the Recorder's Office or County Clerk in the county that the property is located in, and places your name on title to the property.

What is the Subject To Real Investment Strategy? (https://www.reikit.com/whc houses/acquisition/what-is- to-real-estate-investment-str
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Virtual Wholesaling: Real Est Wholesaler's Guide to Scalin Nationwide (https://www.reikit.com/whc houses/virtual-wholesaling)
Top 14 Cold Calling Mistake Avoid for Real Estate Whole (https://www.reikit.com/whc houses/acquisition/top-cold mistakes-avoid-real-estate- wholesalers)
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55 Resources to Find Real E Deals Online (https://www.reikit.com/whc
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Notification to Lender (If you choose to notify the lender)

This form is essentially notice to the sellers lending institution that:

1. You are taking title to the property and/or
2. There has been a change in address to a land trust address or into your name or your business name.

Limited Power of Attorney for Real Estate Transactions

This document allows you to sign documents regarding the property — and only the property — on behalf of the seller.

Important Clauses to Include in Your Purchase Contract

Now let's talk about clauses that you should add to the purchase contract to protect yourself or give yourself rights by the contract.

Of course, I am not a lawyer and this should not be construed as legal advice. Instead use this as a starting point for you to have your own conversations with your own real estate attorney.

Clauses in a contract basically spell out specific actions that must be performed, and what the seller and the buyer are specifically agreeing to, such as who is financially responsible for what, and within what time period.

Subject To Clauses

There are a number of essential clauses that you'll want to include in your purchase contract that are fairly specific to Subject To:

Subject To existing financing

List the mortgagee and the mortgage amount that you determined with your authorization at their lending institution.

Example:

"This property is being purchased "Subject To" the current existing mortgage owned by [seller's mortgage company]."

Total purchase price

Statement that you are paying X amount for the property and that if any additional mortgages, liens, judgments, or other come up on the property the seller is responsible for them.

Example:

"Buyer will pay a total of no more than X dollars for the property. If any additional mortgages, judgments, or liens, mortgages attached to property as of the time of closing, it will be the responsibility of the Seller to pay these amounts."

Seller payout

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Wholesale Deal Analysis
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ARV Real Estate Meaning: H
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How to Estimate Real Estate
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features)
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How to Choose the Best One
(https://www.reikit.com/how-to-ch
best-real-estate-investor-crm)
Free ARV Calculator
(https://tools.reikit.com/comps)

Seller will receive X at closing or if Seller negotiates a payout, when that payout occurs and as a result of a sale.

Example:

"Buyer shall pay the balance of the purchase price agreed to, amounting to X dollars, within X years of date of closing. Seller will receive approximately X dollars, on or before [date].

Alternatively,

"Seller will receive no cash at closing."

Seller comfort clause

If you choose to do so, have a clause stating that should the buyer fail to pay on the mortgage payments for X amount of days, the seller can ask for the property to be returned. This gives the seller assurance that they have some control over their credit risk.

Example:

"Buyer is purchasing the property "Subject To" the existing mortgage. In regards to that mortgage, should Buyer fail to make any payment due, and should Buyer continue to fail to make the payment for more than thirty (30) days after the due date, upon written request from Seller, Buyer will convey the property back to the Seller."

Other Important Clauses to Include

Assignability clause

Especially important to wholesale investors who may want to assign their Sub 2 contract.

Example:

"Buyer may assign this Agreement."

Alternatively, you can put after your name on the contract, "and/or assigns."

Marketing clause

If you are marketing the property to other investors, then make sure the seller is abundantly clear on that.

Example:

"Seller agrees that property may be marketed to other prospective buyers. Buyer may place signs on the property or use any other advertising method at their disposal."

Access to Property

Seller will allow buyer access to the property during reasonable hours for the purpose of showing property to prospective buyers.

Example:

"Seller agrees to provide reasonable access to the property upon request or with [X] notice, prior to closing, for the purpose of showing property to prospective Buyers."

Possession clause

If sellers are required to leave by the closing date, or some other date agreed upon, you should have that stated in the contract. Don't forget to detail the condition you agreed the property will be left in, and/or what happens if the sellers have not vacated by that date.

Example:

Free 70 Percent Rule Calculator (https://tools.reikit.com/70-percer calculator)

The Best Real Estate Wholesaling Podcasts in 2023 (https://www.reikit.com/wholesali houses/best-real-estate podcasts)

Skip Tracing Real Estate Find a Property Owner N (https://www.reikit.com/ tracing-real-estate-find-p

Cold Calling Machines F (https://www.freecoldca cold-call-scriptshqat42o affiliate_id=1559982)

US Legal Real Estate Fo (https://www.uslegalforms.com/re auslf=cl2018)

JScott's Book on Estimating Reha (https://www.amazon.com/gp/pro ie=UTF8&camp=1789&creative=9 20&linkId=c89d7b6326f345ea98f

The Real Estate Wholesaling Bible Fastest, Easiest Way to Get Starte Estate Investing (https://www.amazon.com/Real-E Wholesaling-Bible-Investing/dp/1118807529/ref=as_ s=books&ie=UTF8&qid=1518492 1&keywords=wholesaling+bible&c 20&linkId=d6c6140ce1880fcf15ba

Never Split the Difference: Negotia If Your Life Depended On It (https://www.amazon.com/gp/pro ie=UTF8&linkCode=ll1&tag=rfaf- 20&linkId=3043c53246dfe489a34

If You Can't Wholesale After This: Nothing For You (https://www.amazon.com/gp/pro ie=UTF8&tag=rfaf- 20&camp=1789&creative=9325&l

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"Upon closing or [insert date] Sellers will be required to vacate property, and such property will be free of debris and in clean condition unless otherwise agreed upon by the parties."

Earnest money clause

This clause states what happens to your earnest money deposit if you decide to exercise any of these clauses and decide not to move forward with a property. Ideally you would want to get every penny back.

Example:

"If earnest money deposit or payment to Seller be given, Buyer shall receive a full return of any earnest money deposit or payment to Seller, should Buyer exercise any contingency."

Acknowledgement Clauses to Ensure Full Disclosure

Big profit

Make sure you add a section in the contract that spells out for the seller's acknowledgement that you are expecting to make a large profit on the property.

Example:

"Buyer is purchasing the property with the intent to sell, lease, or rent such property for a large profit."

Due-on-sale clause

These acknowledgments should be included and signed by seller:

1. Acknowledgement that the underlying loan will remain in seller's name and on seller's credit
2. Acknowledgment that loan will not be paid off at closing, but will be paid monthly to lender by buyer
3. Acknowledgment that lender may call the loan due in full at any time, if lender documentation contains a Due-on-Sale clause
   a. Acknowledgement that should the Due-on-Sale clause be enforced by lender, lender has a right to call loan due immediately and may force foreclosure
   b. Acknowledgement that should the lender force foreclosure, a subsequent Notice of Default will appear on seller's credit report
   c. Acknowledgement that should the lender force foreclosure, buyer's title will be extinguished (all rights to the property will become non-existent)

Details, Details, Details

In addition to the preceding clauses, with Subject To transactions you want to include in your contract **exactly** every detail that you negotiated in clear language, as well as seller's loan information, for example including these if applicable:

1. Your offer price
2. Closing date – make this "on or about [date]" for the most flexibility, or "a date not more than 30 days after the expiration of the [inspection period, appraisal, etc.], or such other date mutually agreed upon in writing by both parties."
3. Title company or closing attorney named by buyer
4. What will be included (and *not* included) in the sale in terms of fixtures and personal property — it would be easiest to specify that if not specifically excluded, then it is included in the sale
5. That escrow is held by buyer's attorney, title company, escrow agent, or another party named by buyer

Specific to the financing:

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1. Loan payoff amount
2. Monthly mortgage payment amount
3. Interest rate of loan
4. Taxes and insurance, if applicable
5. How many months negotiated for buyer to pay the monthly mortgage, if negotiating for the loan to stay in place for a number of months or years
6. Details as to when buyer has to pay off mortgage

If it's not in writing and not included in your agreement, then it never existed, so you must be sure to include all possible clauses. Keep the language simple and make sure *you* know what every clause means so that you can easily explain it to the sellers.

Since clauses are virtually unlimited in scope, and unique to every property and seller, getting your contracts drawn up by an attorney is worthwhile; your lawyer may suggest additional protective clauses that you haven't thought of.

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Summary

In this post I listed many of the essential documents that you'll likely need to enter into a Subject To real estate transaction. I also explained and gave examples of important clauses, some specific to Subject To and others that are protective for you and even the seller. You can use these to draw up your contract, get it double-checked by a real estate attorney, and be well on your way to profiting with your Subject To investing strategy.

Ready to get started with finding Subject To sellers (https://www.reikit.com/wholesaling-houses/acquisition/how-to-market-to-subject-to-sellers)? In the next post, we cover how to market effectively to Subject To sellers by learning the four key elements of how to build a Subject-To email or text marketing campaign, and the three simple steps you can take to get started with marketing specifically to Subject To quickly: How to Market to Subject-To Sellers (https://www.reikit.com/wholesaling-houses/acquisition/how-to-market-to-subject-to-sellers)

"Subject To" Transactions in Texas

by David J. Willis J.D., LL.M.

Introduction

In order to understand "subject to" transactions, one must separate the concept of title from the concept of debt. They are divisible. A deed is a signed and acknowledged document that conveys legal title to real property. A note is a signed document promising to repay a debt. The two can be split and frequently are. Transferring title to real property without transferring the obligation to pay the debt associated with it is a "subject to" transaction.

Mechanics of a Sub2

In a sub2, an investor-buyer takes title but makes no promises (either to the lender or to the seller) about assuming the existing debt. In fact, a properly worded sub2 deed expressly states that the buyer is not assuming any such responsibility. Sub2s are often used by investor-buyers in order to buy, fix, and flip for a short-term profit, all before the loan gets so far in arrears that a foreclosure occurs. Presumably, upon resale, the buyer's new loan eliminates any existing arrearage or default.

Core sub2 documents include a sub2 addendum to the TREC 1 to 4 contract; a sub2 agreement (details below); and sub2 deed (either general or special warranty).

Form of Sub2 Deeds

There is no standard form for a sub2 deed although Texas does have certain rules that apply if any deed is to be valid. This is a sample sub 2 clause in warranty deed:

> This conveyance is made subject to any and all indebtedness of Grantor

> the order of ____, which note is secured by a vendor's lien retained in deed of even date recorded at Clerk's File No. ____in the Official Public Records of Real Property of ____ County, Texas, and is additionally secured by a deed of trust of even date to ____, Trustee, recorded at Clerk's File No. ____ in the Official Public Records of Real Property of ____ County, Texas. Grantee does not assume payment of this or any other indebtedness of Grantor.

Must the buyer sign a sub2 deed? Usually not. Most often, the investor-buyer is accepting title and making no promises or agreements at all, so there is no reason for a signature. However, if there are additional points of agreement, then these may be inserted into the deed and accompanied by the investor-buyer's signature, making the deed serve the dual purpose of a conveyance and a contract. If these additional deal points are lengthy (or perhaps better kept confidential) then it is advisable to create a stand-alone unrecorded sub2 agreement, which is similar in many ways to the side agreement often executed as part of an assumption package-except, of course, for the obvious difference that in the case of a sub2 transaction the existing indebtedness is not being assumed.

The sub2 deed need not show the actual price by the investor-buyer (presumably a buyout of the seller's equity in the property, if any). It is customary for confidentiality reasons to recite that consideration paid is "ten dollars and other valuable consideration" although the actual amount paid can be shown if the parties desire to make this information part of the public record.

Recording

As with any other deed, there is no requirement that a sub2 deed be recorded in the county clerk's real property records in order to be valid-only that execution occur before a notary followed by delivery to the grantee. When this is done, the title transfer is effective between the parties. It is nonetheless in the buyer's interest to record the deed, not just to preserve the record chain of title but to avoid the possibility that the grantor may sell the property twice.
General Warranty Deeds Versus Special Warranty Deeds

The term "warranty deed" is loosely used to refer to a deed that contains both express and implied warranties. There is also a deed without warranties. A

common in commercial transactions, receiving a sub 2 deed with special warranty should not trouble an investor, particularly since the last transaction involving the property likely encumbered it with a purchase-money lien and therefore a title policy was issued at that time.

Sub2 Versus Quitclaims

Some investors consider it adequate to acquire a quitclaim from a seller rather than a sub2 deed with either general or special warranties. This is not the best practice. Why? A quitclaim is the weakest form of transfer and title companies often decline to insure a chain of title containing a quitclaim. A title company may ask that a deed with general or special warranties be obtained to replace the quitclaim. If a grantor is unable or unwilling to provide any warranties then a deed without warranties should be used.

Seven-Day Notice Requirement

As with wraparounds, a Section 5.016 seven-day notice is required. Specifically, the seller must: (1) give seven days' notice to the buyer before closing that an existing loan will remain in place; (2) inform the buyer that buyer has this same seven-day period in which to rescind the earnest money contract without penalty; and (3) also provide a seven-day notice to the lender. Lenders do not usually respond to Section 5.016 notices, nor is lender consent required under this law. As a consequence, the seven-day notice requirement is widely disregarded in sub2 transactions. However, when representing sellers, we always advise full compliance.

Due-on-Sale Issues

There is no such thing as breaching or violating the usual residential due-on-sale clause. Transferring title without prior lender consent does not constitute an offense-moral, civil, or criminal. Due-on-sale merely enables the lender to choose to act-if the borrower transfers title then the lender *may* demand immediate payment in full, but the lender would have to decide that such action is in its best interest, and most lenders will balk at accelerating an otherwise performing loan. Experience shows that the risk of acceleration is small while the loan remains current. This will likely continue to be the case so long as interest

environment.

What is a Sub2 agreement and why is it advisable to have one?

A Sub2 agreement goes beyond the other documents and addresses specifics of the transaction, for example, the details of the existing note or notes; representations and warranties by seller (it is always a good idea to have these if you are the buyer); investor disclosures to the seller that the loan may go unpaid and that there is a due-on-sale clause; matters relating to Dodd-Frank and the SAFE Act; the mechanics of obtaining an eventual release of lien; an assignment of rents, escrow, and security deposit; and other important items. Any of these issues could become problematic later and create a headache for the investor.

If you are the buyer, a sub2 agreement is also a good place to include the online access information for the loan account. Sooner or later, the investor will want to sell the property and it will be necessary to get a loan payoff. If the investor is not the original borrower, then the lender's privacy policies will prevent disclosure of this information.

Hybrid Agreements

As stated above an investor-buyer generally makes no promises about assuming the existing debt. But is this a rigid rule? Not at all, as it turns out. Recall, if you will, that sub2s fall into the category of creative transactions, meaning that all sorts of variations are possible. For example, the investor-buyer may make an agreement with the seller to catch up on part or all of any arrearage that may exist. Other options include a pledge to make payments until the property re-sells, or even to split gross profits upon resale, which incorporates elements of a joint venture. Extensive additional agreements of this nature are best placed in a stand-alone unrecorded sub2 agreement.

Resale of Sub2s

A sub2 may be resold several different ways. First, having put a property under contract, an investor may simply assign the contract to a new buyer. For this reason, the sub2 contract should be expressly made assignable without requirement for the seller's prior consent. Another method is for the investor to close and then flip the property for a sum of cash, transferring the property on a

deed of trust. The latter option obviously involves a long-term commitment by the investor.

Contract Note

Generally speaking, the TREC 1-4 contract should be used for acquiring sub 2s, but it should be accompanied by a "Subject To Addendum." Since neither TREC nor TAR offer such an addendum, a custom addendum drafted by an attorney will be needed.

A sub2 deed is a useful device that should be part of any investor's tool kit, ready to be deployed when the opportunity arises. Sub2 documents, like other creative real estate documents, are not created equal. Consult a real estate attorney. Never use seminar forms, forms from other states, or Internet junk to do a sophisticated transaction like a sub2.

DISCLAIMER

Information in this article is provided for general educational purposes only and is not offered as legal advice upon which anyone may rely. The law changes. Legal counsel relating to your individual needs and circumstances is advisable before taking any action that has legal consequences. Consult your tax advisor as well. This firm does not represent you unless and until it is expressly retained in writing to do so.

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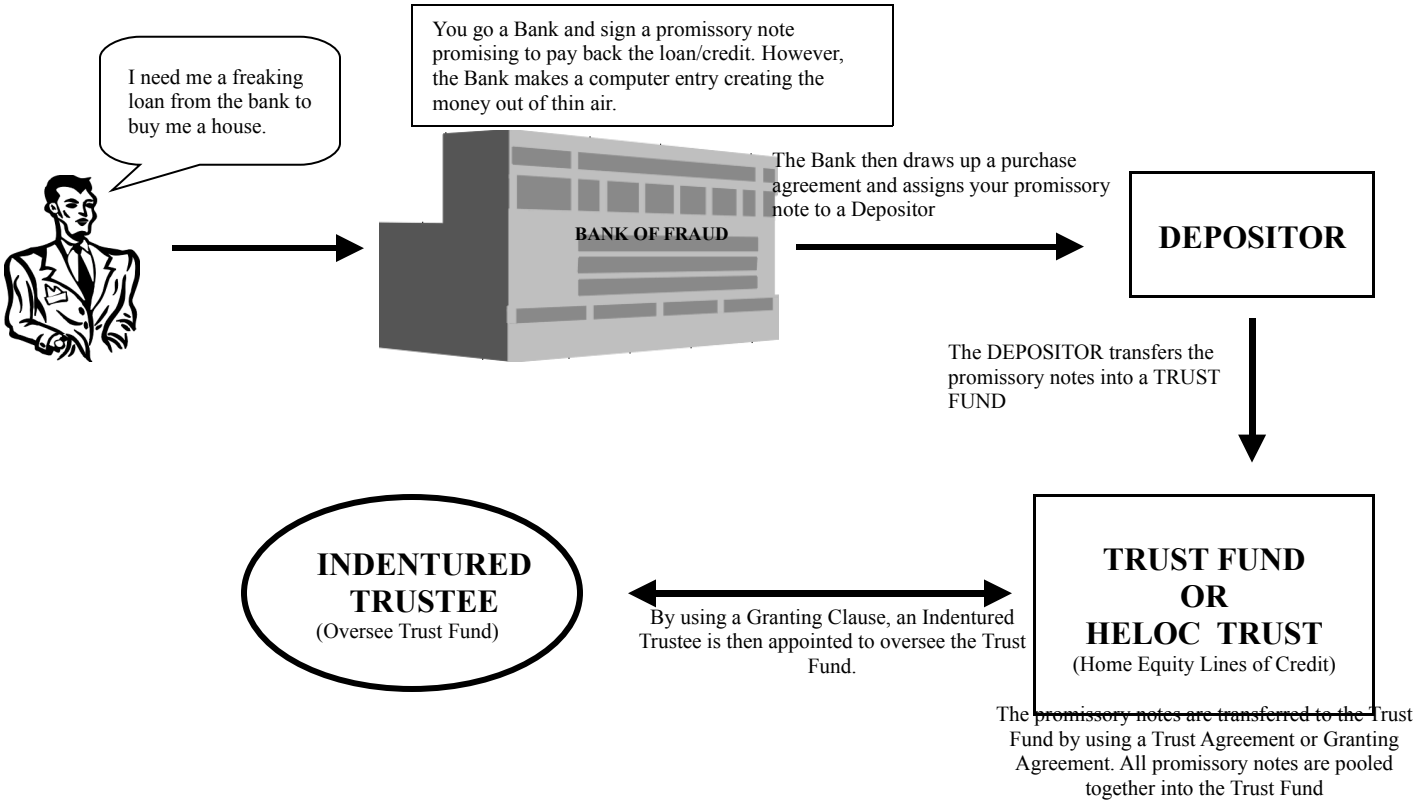
WHAT HAPPENS WHEN YOU GET A LOAN



Note:

- The Bank uses your signature on the promissory note and creates money (from your energy).
- Promissory notes are used/held as collateral for the Bond.
- Promissory notes are considered account receivables for the Bank. Your monthly payment to the Bank (for the mortgage) becomes an Account Receivables on the Bank accounting ledger. The Bank then take these Account receivables (assets) and sell them on the open market.
- They are 2 types of Trustees: Owner Trustee & Indentured Trustee. Some banks act as the Trustee or appoint a third party as Trustee.
- The Granting Clause gives the Indentured Trustee all rights title and interest in the property. In other words, all property is given to the Indentured Trustee.
- According to Rule 424 b (5), all banks are required to file a Prospectus quarterly (3 months before & after the loan)
- RC –S Schedule Call Report, TFR (Thrift Finance Report) or (FFIEC): These are the schedules that show what the banks are doing with the loans/notes. (Also research S3 Register Statement and Security Exchange Act of 1934 & 1933)
- Remember, there is no lawful money…everything is a promise to pay.
- Banks conduct an unlawful conveyance/transfer of your property by using the mortgage (without informing you).
- Banks assigns there servicing rights to the Trust Fund.
- Secretary of State website where the bank is registered will list the Register Agent for the Bank that holds all their capital stock. For example (http://www.dos.state.ny.us/)

ITEMIZED NOTE BASED ON DIAGRAM:

1. Bank makes fraudulent offer; is actually a serving agent. Does not loan money.

2. Principal signs promissory note.

3. Bank draws up purchase agreement and sells servicing rights and mortgage loans to depositor who transfers to trust fund known as H.E.L.O.C. [Home Equity Line Of Credit] registered in Delaware for tax purposes so no paying tax on funds transfers.

4. Once in the trust fund, the mortgage loans are pooled with others then a trust agreement is drafted with a granting clause where all right, title and interest in the trust is granted to an indentured trustee who oversees the trust funds.

5. Whenever a transfer of the note or change services, principal must be notified or a violation of Fair Debt Practices Act and also Real Estate Settlement Procedures Act.

6. Two types of trustees: 1. Owner Trustee. 2. Indentured trustee.

7. Certificated and un-certificated securities are created off the trust and sold as shares and dividends from the Depository Trust Clearinghouse (DTC) to direct participants as bookkeeping entries.

8. Underwriter comes in and issues bonds and uses the promissory notes signed by principal as collateral for bonds. This is how the bond market functions.

9. The bonds and certificated securities when pooled are sold on the Securities Exchange as certificated securities and also are bonds.

10. Some serving agents (banks) put up the bonds to underwrite and indemnify the mortgage loans as a surety. They sell all right, title and interest in the mortgage loans.

11. They have no standing to bring a foreclosure action because they sold all right, title, and interest to an indentured trustee.

12. The Securities Exchange Act of 1933 and Securities & Exchange Act of 1934 is the basis of this trust law. The S-3 Registration Statement and Prospectus (form 424-B5) is where this information is logged. Rule 12-G of the SEC 1934 requires the S-3 Registration Statement.

13. The RCB and RCS call reports and schedules shows the mortgage loans as zero (0). RCS shows no resident – mortgage under HUD and shows no mortgages at all.

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14. The RC-S Schedule call report F.F.I.E.C. 041 means Federal Financial Institution Examination Council and will show the TFR (Thrift Finance Reports) will show all the call reports and what kind of business their doing and what their doing with these mortgage loans.

15. If their loaning money and there's mortgage loans, then their lying to the Securities Exchange because their not reporting on the Securities Exchange and that is what the report shows.

Definitions

1. **Mortgage:** An estate created by a conveyance absolute in its form, but intended to secure the performance of some act, such as the payment of money, and the like, by the grantor or some other person, and to become void if the act is performed agreeably to the terms prescribed at the time of making such conveyance.

   A conditional conveyance of land. Mitchell v. Burnham, 44 Me. 299.

   A transfer of property passing conditionally as security for debt. Potter V. Vernon, 129 Okl. 251, 264 P. 611,613.

   Black's Law, 4th Edition (page 1162)

2. **Convey:** To pass or transmit the title to property from one to another. *Black's Law, 4th Edition (page 402)*

3. **Conveyance:** In real property law. In the strict legal sense, a transfer of legal title to land. *Black's Law, 4th Edition (page 402)*

4. **Indentured:** A deed to which two or more person are parties, in which these enter into reciprocal and corresponding grant or obligations towards each other, whereas a deed poll is properly one in which only the party marking its executed, or binds himself by it as a deed through the grantor or grantee therein maybe several in number. *Black's Law, 4th Edition (page 911)*

5. **Promissory Note:** A promise or engagement, in writing, to pay a specified sum at a time therein limited, or on demand, or at sight, to a person therein named, or to his order, or bearer. *Black's Law, 4th Edition (page 1379)*

6. **Trust:** A right of property, real or personal, held by one party for the benefit of another. A confidence reposed in one person, who is termed trustee, for the benefit of another, who is called the cestui que trust, respecting property which is held by the trustee for the benefit of the cestui que trust. *Black's Law, 4th Edition (page 1680)*

7. **Cestui que Trust:** The person for whose benefit a trust is created or who is to enjoy the income of the avails of it. *Black's Law, 4th Edition (page 1680)*

8. **Trustee:** The person appointed, or required by law, to execute a trust; one in whom an estate, interest, or power is vested, under an express or implied agreement to administer or exercise it for the benefit or to the use of another call the cestui que trust.

   In a strict sense, a "trustee" is one who holds the legal title to property for the benefit of another, while, in a broad sense, the term is sometimes applied to anyone standing in a fiduciary or confidential relation to another, such as agent, attorney, bailee, etc. *Black's Law, 4th Edition (page 1684)*

Note: The information in this study sheet is based on The Real World Conference Call with Jean Keating.

Al: Jean if you're ready then push 6 and take the floor please.

Jean: Ok, huh…what I'm going to talk about tonight is the mortgage racket and what's going on behind the scenes. I talked to the head trustee for J.P. Morgan Chase today on the phone for about 2 hours and I found out what they do with the promissory notes and its in the S-3 Registration Statement and Prospectus; form 424-B5. You guys need to read these rules…you guys are going to have to do some research on your own.

First thing you need to do is down-load the Securities and Exchange Act of 1934 and the Securities Exchange Act of 1933. That's number 1…you can down-load this right off the internet for free; doesn't cost you a penny. All you have to do is type in the Securities Exchange Act of 1934 in your search engine and it will bring it right up and its about 125 pages. You can down-load the whole law…I've already done it. I have not told you to do anything that I have not already done; and you can down-load the Securities and Exchange Act of 1933 and that's where you find rule….it's in Regulation-C…you can get this right off the internet. You type in Rule 424-B5 and put Regulation-C after it and when it comes up on the screen, just click on it and you can print it right out; down-load it and print it right out.

Al: Jean what was that rule number again?

Jean: 424-B5. Four Hundred Twenty-Four B-5. B as in boy.

Al: Thank you.

Jean: That is the rule that requires them to file a PROSPECTUS and all banks do this and they file this on a quarterly basis, which means every three (3) months and you need it for the last quarter, which is the 3 month period before your loan and the 3 month period after your loan, which would be the 4th quarter. The quarter before would be the first quarter; you have a first, second and third. You've got 3 quarters…you've got to get it for the first quarter and the last quarter before and after your loan and this tells you everything their doing…what their doing with your notes. He told me…verified what they do with your promissory note is that they take it and put into a Trust Fund and they use that as COLLATERAL for BONDS. The get an UNDERWRITER to come in and the UNDERWRITER buts up the BONDS as the BOND HOLDER and what they do is they COLLATERALIZE the BONDS using the PROMISSORY NOTES the DEEDS OF TRUST, the MORTGAGE DEEDS… some states call them MORTGAGE DEEDS and some states call them DEEDS OF TRUST. That's what COLLATERALIZES these MORTGAGE LOANS and the POOL these MORTGAGE LOANS and the bank you have your loan with nothing but a SERVICING COMPANY. And what they do is they draw up a PURCHASE AGREEMENT and they sell the MORTGAGE LOANS to a DEPOSITOR and what the DEPOSITOR does is he transfers them to a TRUST FUND. In the case of MORTGAGE LOANS its called H.E.L.O.C. which means HOME EQUITY LINES OF CREDIT and if you find what the number of the TRUST is you can download it right off the internet…it's all on the internet all this stuff is published on the internet. You can get it for different quarters and for different years. I've got the S-3 prior to the loan and then I've got the two PROSPECTUS before and after the loan.

What they are doing is drawing up the PURCHASE AGREEMENT and selling the SERVICING RIGHTS and they sell the MORTGAGE LOANS to the TRUST FUND via the

DEPOSITOR who TRANSFERS it to the TRUST FUND. Once it gets into the TRUST FUND they POOL the MORTGAGE LOANS and then they do what is called a TRUST AGREEMENT then they do what is called a GRANTING CLAUSE where they GRANT all RIGHT, TITLE & INTEREST in the TRUST to a INDENTURED TRUSTEE and there are two types of TRUSTEES: 1. OWNER TRUSTEE. 2. INDENTURED TRUSTEE. Sometimes the bank acts as the TRUSTEE and sometimes they appoint somebody as the TRUSTEE.

The guy I called today knew exactly what I was talking about and verified that everything I was saying was true. They sell all RIGHT, TITLE & INTEREST of the loan to the INDENTURED TRUSTEE who oversees the TRUST FUNDS and these TRUST FUNDS are set up in the State of DELAWARE for tax purposes, that way they don't have to pay any taxes on the FUND TRANSFERS and what they do is get an UNDERWRITER to come in and he issues BONDS and uses the LOANS and PROMISSORY NOTES you sign as the COLLATERAL for the BONDS. This is how the BOND MARKET functions. Then all the BONDS and CERTIFICATED SECURITIES when they POOL them they become CERTIFICATED SECURITIES and when they sell them on the SECURITIES EXCHANGE and when they POOL them together they become BONDS. A lot of the companies put up the BONDS to INDEMNIFY and UNDERWRITE these MORTGAGE LOANS. Anytime you have an UNDERWRITER you have a SURETY and what they do is issue BONDS to UNDERWRITE these MORTGAGE LOANS and they sell all RIGHT, TITLE & INTEREST in the MORTGAGE LOANS so they don't have anything…**they have no standing to bring a foreclosure action** because they **sold all RIGHT, TITLE & INTEREST to an INDENTURED TRUSTEE.** They first sell it to a DEPOSITOR as a SELLER … see they become a SELLER as well as a SERVICER. Then the DEPOSITOR TRANSFERS it to a TRUST FUND then the TRUST FUND TRANSFERS it to an INDENTURED TRUSTEE through a TRUST AGREEMENT and Paul will verify this as all this is handled under TRUST LAW and the INDENTURED TRUSTEE is the person that has all RIGHTS, TITLE & INTEREST in the LOAN not the SERVICER; the SERVICER transferred all that. Its like me selling you my car then me trying to enforce my RIGHT, TITLE & INTEREST after I sold it to you…YOU CAN'T DO THAT!!! But you've got to get the documentation for this and all this stuff is on the internet…all you have to do is get off your lazy ass and do it. You got to get on the internet and type in this stuff. You can down load these S-3 Registration Statements from the Security Exchange website. All you have to do is type in WWW.SEC.GOV and it will pull it right up. What you want to do is type in… like our particular case…a lot of the times they change the name of the bank; you have to be careful here…I've done a lot of research here and I found out they have about 4 or 5 different names that they put this loan under like BANK ONE, NA is BANK ONE CORP, which is a DELAWARE CORPORATION and they also have BANK ONE ABS, which means ASSET BACKED SECURITIES. And our case, ABS was the DEPOSITOR and BANK ONE NA was the SELLER or the SERVISOR; they sold all their RIGHT, TITLE & INTEREST to ABS CORPORATION, which TRANSFERRED it to the TRUST FUND and the name of the TRUST FUND is H.E.L.O.C. TRUST 1998-1. All these Home Equity Lines Of Credit are from the HELOC TRUST…all of them are and the bank that we are dealing with is one of the largest in the United States because it is owned by J.P. MORGAN CHASE; it merged with them.

Another thing that will help you in your research is get on the Secretary of State's website and type in the bank…..(thump) is everyone still here? I just got cut off….someone is shorting out this line.

Al: We're still her Jean….go ahead.

Jean: Get on the Secretary of State's website for whatever state your in and you can do a search for a corporation and get their incorporating papers. incorporating purchase, they have the MERGER papers, when they MERGE with another corporation they have to register with the

Secretary of State. You would be amazed of what you can find out and there's 4 different companies and they all have the same address under Bank One, NA of 100 East Broad Street in Columbus Ohio and you can do that in every state under the Secretary of State. Go there and find out if they have the same name or if they MERGED with someone and you can find out whom the agent is. All these Corporations have an agent that they report to, which is on the Secretary of State's website, you just have to go in there and find it, I found it in my state and it shows who the agents are, they appoint an agents who holds all their CAPITAL STOCK.

Al: Jean, can you stand by a second? I'm going to go around the horn.

Al: Jean push 6 and continue please.

Jean: OK, so you can go into the Secretary of State's website that your in and it will tell you, just put in…click on CORPORATIONS and it will say CORPORATION FILINGS and click on that it will tell you…just do a search for the company you want and it will give you a box to type in their name, but it may not be the company you want…these people are really tricky.

Vince-Oregon: Jean, this is Vince in Oregon. With my mortgage company its in another state; its in Arizona so that's where I went to look…I researched it, their name and address and they also have another company which is the same name, but an LLC and that's how I tracked my Mortgage.

Jean: Ya, every corporation has a BUSINESS AGENT that handles all of their CAPITAL STOCK and Paul will tell you this, he understand this..everything is based on TRUST LAW and what they do is set up this TRUST and put everything into this TRUST and the *TRUST owns the TRUST and the TRUSTEE* and the S-3 REGISTRATION STATEMENT will tell you whom the TRUSTEE is. You need to read the PURCHASE AGREEMENT, they'll have a TRUST AGREEMENT and then they'll have a GRANTING CLAUSE and the GRANTING CLAUSE is what give the INDENTURED TRUSTEE all RIGHT, TITLE & INTEREST in the MORTGAGE LOANS and not only the MORTGAGE LOANS, but all the property in the TRUST is given to the INDENTURED TRUSTEE and that's what they ISSUE these CERTIFICATE SHARES on…these ASSET-BACKED-SECURITIES become CERTIFICATED in BOOKKEEPING FORM and this is what the DTC sells to DIRECT PARTICIPANTS who has signed up and established an ACCOUNT with them. This is what they're doing and their doing the same thing with MORTGAGE LOANS, CREDIT CARD ACCOUNTS, I don't care what kind of loan..MORTGAGE, CREDIT CARD, AUTO…their doing the same with thin with every loan.

Their doing it with the PRISON SYSTEM. You get into the PRISON SYSTEM and CORRECTION CORPORATION OF AMERICA, which is located in Nashville Tennesse and they changed their name to R.E.I.T. or REAL ESTATE INVESTMENT TRUST. Now what they have is a CORRECTIONS CORPORATION that owns all your prisons and now changed their name to REAL ESTATE INVESTMENT TRUST and you will find that FANNIEMAE, SALLIEMAE, GENNIEMAE and FREDDIE MAC are all involved in this REAL ESTATE INVESTMENT TRUST, which was established in 1880. All you have to do is type in R-E-I-T and research it. It will tell you that it originated in the 1880's and they use it for the simple reason that they only pay the TAX on one side of the TRUST. They pay the tax on the incoming-corporate side, but not on the out-going, outs-sourcing side and that's why use these REAL ESTATE INVESTMENT TRUSTS.

Why would the PRISON SYSTEM change their name to REAL ESTATE INVESTMENT TRUST? <u>That's because they're using these prisoners for the COLLATERAL for these MORTGAGE LOANS</u>. When you put someone in prison, they become COLLATERAL. You have a

REPOSITORY BANK….all these PRISONERS are a REPOSITORY BANKs and what they do is use these PRISONERS for the COLLATERAL for these LOAN CONTRACTS for the BID BONDS, the PERFORMANCE BONDS and PAYMENT BONDS. This is what's going on…I've verified all this….this is not my opinion, this is what they are doing. That's what this WARRANTING CONTRACTING OFFICER does is he draws up these contracts for the BUREAU OF PRISONS for the DEPARTMENT OF STATE and this is all under the ACQUISITION DEPARTMENT under the DEPARTMENT OF JUST-ICE and this WARRANTING CONTRACTING OFFICER is in the MILITARY and his is selling products and services to the prisons. There is a North, South, East and West Region for the BUREAU OF PRISONS and they have assigned a WARRANTING CONTRACTING OFFICER and he sells these CONSTRUCTION CONTRACTS through a BID BOND to the prisons.

Now where are they getting the money to buy CONSTRUCTION and SERVICE CONTRACTS if their not using the BID BONDS and these PRISONERS as COLLATERAL? That's exactly what's going on. What you have is institutionalized slavery in this country. All these people are nothing but CHATTEL for the PAYMENT OF DEBT. That's what their doing and that's what their doing on these MORTGAGE LOANS. You can get a lot of information off of the internet.

Paul-Colorado: I want everyone to know that if you do a little research, you'll find that you can set-up a REAL ESTATE INVESTMENT TRUST yourself. I have 2 or 3 clients that have them and there very powerful; they insulate you from any taxes with respect to your investments etc, just like Jean says and all you have to do in maintain a certain level of volume etc according to the regulations and you'll find out that it is a very beneficial shield and their using it and you can too….I'm out.

Jean: As long as they can show that they are paying out shares and dividends to participants, they get a tax exemption, they don't pay any taxes on the out-sourcing or the PAY-OUTS, that's why use this REAL ESTATE INVESTMENT TRUST. It's a very powerful too and their hiding all their ASSETS that way. Another thing this guy told me is that the state of DELAWARE is the wealthiest state in the Union. If you go on their website, there's something like 350 million corporations having incorporated in the state of DELAWARE. That's the wealthiest state in the Union. I got a copy of a law suit where these people owned property in a bank in New York and they died without leaving an estate and it became abandoned property so the state of New York lay claim to it because the people had accounts in New York banks, but they had a company in DELAWARE so DELAWARE went after it and they got it, they got over 500 million dollars in abandoned property and they put it in a TRUST called the SUN-SET TRUST. They got a lot of money, the state of DELAWARE does. And they do it through this CAFR too, this COMPREHENSIVE ANNUAL FINANCIAL REPORT; their getting all these funds from the government and yet their running in the red. Someone is putting money in their pocket…what they are doing is stealing the people blind…their making you pay all the taxes and stealing your exemptions and now their stealing your property through these mortgage loans, which their alleging that they loan money on and they never loaned anything on it. It says right in the TRUST AGREEMENT that it is a FUTURES CONTRACT, if you read your TRUST AGREEMENT it actually says that. **YOU NEED TO GET INTO THIS S-3 REGISTRATION STATEMENT** , which is found under **rule 12-G** of the **SECURITIES EXCHANGE ACT of 1934**. Go read RULE 12-G; that's the rule that requires them to file a REGISTRATION STATEMENT whenever they make an OFFERING and they publish all this stuff on the internet.. On October 1, of 2005 their using an automated…their using software called CENTRAL DATA REPOSITORY "CDR". All you have to do is type in CENTRAL DATA REPOSITORY and it will pull up the website and read it, what they are doing is using SOFTWARE VENDERS and these SOFTWARE VENDERS and the ones that sell the software for the CALL REPORTS and the TFR REPORTS. Now the CALL

REPORTS are SCHEDULES …like the RCS and the RCB. These show ASSETS and SECURITIES and what they do is show these MORTGAGE LOANS and shows ZERO…if you go into the RCS, which they started using in 2001, you'll see that there is no…1 to 4, RESIDENT-MORTGAGE under HUD, they show absolute no MORTGAGES at all.

If you go read the RC-S "SCHEDULE" CALL REPORT..F.F.I.E.C.041 is another number they use. It means: FEDERAL FINANCIAL INSTITUTION EXAMINATION COUNCIL..that's what that means. Just type in FFIEC and it will show the CALL and TFR Reports all you got to do is click on that and it will show the whole schedule. It shows all the CALL REPORTS and they also have TFR, which means THRIFT FINANCE REPORTS…its called TFR, its abbreviated TFR and once you get in their you'll TFR and information page; all you have to do is click on that. It also has a home website and it shows all the call reports…it gives you a schedule of all the call reports. Their called CALL REPORT SCHEDULES. These are the schedules that shows what kind of business their doing and what their doing with these MORTGAGE LOANS. These are documents that they filed. If their loaning money and there's MORTGAGE LOANS then their lying to the SECURITIES EXCHANGE because their not reporting it on the SECURITIES EXCHANGE and that is what the REPORT SHOWS.

Paul-Colorado: Jean, what I see happening with some of this as I have been digging around as you have and I appreciate what you have found here in the past few days and I'm glad that your getting someone at the top shelf to talk to you. Anyway, I feel that when we create the Trust and we put the property in their custodialship, they have the ability to go ahead and pull it and use it for assets out there in their bankruptcy because there really isn't any money so all they have to do is play with the assets out there and they have a monster machine going on..we don't understand it and when we pledge that property to them in that trust in your mortgage agreement, they not only have that to play with they also have the promissory note. It's all fraud..I agree with Jean 100%. We do have the enforceability to hold these people accountable as they are playing on our ignorance. I'm out…

Jean: Ya, what their doing is they pool these MORTGAGE LOANS. What their doing is collecting on something that they have no RIGHT, TITLE & INTEREST to. If you read your MORTGAGE AGREEMENT , TRUST DEED or SECURITIES AGREEMENT, whenever they transfer ownership of that or change services, THEIR SUPPOSED TO TELL YOU. That's a violation of the FAIR DEBT PRACTICES ACT. That's also a violation of R.E.S.P.A.

Jean: Their doing an unlawful CONVERSION and CONVEYANCE of your PROPERTY without telling you…that's exactly what their doing. Their doing a TRANSFER and CONVEYANCE of your property rights**. EVERYBODY IS USING YOUR PROPERTY AS COLLATERAL** that's why you can't own anything…do you know what the clinical definition of COMMUNISM? **A MULTIPLE DEMAND UPON A COMMON SUBSTANCE**. When you have 5 or 6 people that have a demand on a common substance…who owns the substance? Isn't it **COMMUN**ITY PROPERTY? Ok , where does the word COMMUNISM come from? COMMUNITY-ISM. If you do the research into the ENTOMOLOGY of the word COMMUNISM, you'll find that it means COMMUNITY. True COMMUNISM is based on COMMUNITY ownership of something or a COLLECTIVE ownership of something instead of the individual. But when you get around the semantics, what it is, is the STATE owns everything. Whenever you REGISTER something, you give the state a SECURITY INTEREST in whatever you REGISTER
"…..**FATE IT SEEMS, IS NOT WITHOUT A SENSE OF IRONY**….."

Morpheous

THE END

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7 Real Estate Contract Buyer Clauses Checklist

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by Bill Bronchick

One of the most important parts of real estate investing is the Real Estate Purchase Contract.

The following is a seven-point checklist for items that investors should include in their purchase contract when they are buying real estate investment property.

Some of these clauses may be found in some form or another in the "standard" real estate contract which is used in your area.

7 Real Estate Contract Buyer Clauses Checklist

1. "And/or assigns" or "and/or Nominees." As the buyer, you want to have the right to assign your contract. By placing your name with the words, "and/or assigns," you don't automatically give yourself that right; you also must find anything in the contract that says you CAN'T assign and cross that out. The words, "and/or nominees" is not as broad, but it has been interpreted as giving the buyer the right to place title in the name of a trust or corporate entity.

2. Inclusions and Exclusions. Most real estate contracts have a clause which specifies what personal property is included in or excluded from the sale. Sellers and buyers often forget to specify certain items, which leads to arguments at closing. As the buyer, you would prefer the clause, "anything not specifically excluded will be

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escrow company so that you remain in control. Also, you want the ability to have as much time as necessary to close. Most contracts call for a date certain for closing. If the buyer is not ready to close, the seller can hold him in default. Here are some tips for buying time:

Make the closing date "on or about" June 1st. What does "on or about" mean? I'm not sure, but it certainly means LATER than June 1st!

Have the right to extend the closing date if it is not your fault: "Said date may be extended an additional fifteen (15) days if lender requires additional documentation, paperwork or actions from the buyer and said delay is not due to the fault of the buyer."

Have the right to extend for thirty days by paying the seller the equivalent of one month's mortgage payment.

Have right to choose the title company. A friendly title company (friendly to you, that is) can create an "unexpected" scheduling conflict if you need it.

5. Possession. As the buyer, you want possession of the property concurrent with closing. If the sellers are living there, make sure that you have the right to charge them a hefty per diem rent. Also, the contract should state that the property be left "broom clean and free from all debris."

6. Warranties. As the buyer, you may want the seller to warrant some of the items included in the sale, such as, "seller warrants that the appliances, roof, plumbing, heating, and ventilation systems are in good and working order at time of closing. This clause shall survive closing of title."

7. "Weasel" Clauses. A buyer wants as many contingencies or "weasel" clauses as possible. If the buyer can get out of a contract without breaching, he gets his earnest money back. My philosophy is that the less earnest money you put up, the less you need a weasel clause. If you do need a few, here are my favorites:

"This agreement is subject to inspection and approval of the property by the buyer in writing prior to _____."
"This agreement is subject to attorney approval within 72 hours"
"This agreement is subject to satisfactory appraisal by buyer or buyer's agent"

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Real Estate Finance

6th Edition

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Table of Contents

For Online and CD-ROM versions

Real Estate Finance Sixth Edition

Table of Forms 7
Introduction. 9

Section A

The Borrower-Lender Relationship

Chapter 1 Pre-Wellenkamp history
Ownership objectives were paramount 13

Chapter 2 Wellenkamp to Garn
A sale without lender interference 23

Chapter 3 Portfolio yields and increasing interest rates
The failed economic experiment 28

Section B

Notes and Their Provisions

Chapter 4 The promissory note
Evidence of the debt 38

Chapter 5 Basic provisions in trust deed notes
Minimum elements for enforceability. 45

Chapter 6 Special provisions for a promissory note
Beyond fundamental debt obligations 55

Chapter 7 Adjustable rate notes
Bargaining for real estate's inflation hedge 64

Chapter 8 Modification of the note
Changing provisions in a note 70

Chapter 9 Prepayment penalties
Debt reduction as a costly privilege. 78

Chapter 10 Loan lock-in clauses
Restraints on rights of alienation 88

Chapter 11 Late charges and grace periods
Related amounts are enforceable 93

Chapter 12 Balloon payment notices
Carrybacks and loans on one-to-four units 102

Section C

The Trust Deed

Chapter 13 Trust deed characteristics
The security device and a lien 108

Chapter 14 The long form trust deed
Reflecting the limits of enforcement 117

Chapter 15 Hazard insurance proceeds
The right to rebuild vs. loan impairment 128

Chapter 16 Impound accounts
Taxes and premiums paid through the lender 133

Chapter 17 Assignment of rents provision
The lender's rent collection on default 143

Chapter 18 Beneficiary statements and payoff demands
Confirming loan conditions 155

Chapter 19 Grant deed as a mortgage
Risks in alternative security devices 161

Chapter 20 Equity purchase: sale-leaseback, no option
The home equity sales scheme 166

Chapter 21 Due-on-sale regulations
Rising rates bring lender interference 173

Chapter 22 Assumptions: formal and subject-to
Loan takeovers by buyers 185

Chapter 23 FHA and VA loan assumptions
Avoiding fees and investor prohibitions 191

Chapter 24 Personal property as security
A lien on additional collateral 196

Section D

Carryback Financing

Chapter 25 Carryback financing in lieu of cash
Seller financing supports the price 207

Chapter 26 The carryback purchase agreement
Negotiating the terms for seller financing 211

Chapter 27 No down payment carryback sales
Minimizing the risks of default 217

Chapter 28 Due-on waiver and junior financing
Prior planning prevents lender interference 224

Chapter 29 Required disclosures on seller carrybacks
Mandated notices for risk assessment 231

Chapter 30 Carryback foreclosure and resale costs
Protection is led by disclosures 240

Chapter 31 Buyer's creditworthiness: seller's further approval
The informed seller carries paper 247

Chapter 32 Working the AITD and note
Flexible carryback financing 256

Chapter 33 The AITD's leveraged yield
The wraparound multiplier effect 265

Chapter 34 The all-inclusive note and trust deed rider
Negotiating interest rates and payments 272

Chapter 35 Alternative security devices for sellers
Creative financing vs. creative chaos 281

Section E

Lenders

Chapter 36 Conventional financing for a sale
Role of the transaction agent (TA) 295

Chapter 37 A lender's loan commitment
No responsibility for oral or conditional promises . . 315

Chapter 38 Referral fees: by lender or escrow
The hidden costs surrounding a loan 318

Chapter 39 The FHA-insured home loan
Enabling renters to become homeowners 334

Chapter 40 Private mortgage insurance
Covering lender losses on default 346

Chapter 41 Usury and the private lender
Broker arranged loans avoid usury 356

Chapter 42 Usury and the carryback note
Modified, assigned or unconscionable rates 364

Section F

Recourse and Nonrecourse Loans

Chapter 43 Anti-deficiency: past, present and future
Are buyers losing their shield? 370

Chapter 44 Converting nonrecourse paper into recourse paper
Eliminating or substituting security 379

Section G

Default and Foreclosure

Chapter 45 Notice of default, reinstatement, and redemption
Nullifying the call during foreclosure 387

Chapter 46 Judicial foreclosure
Deficient property value; recourse paper 394

Chapter 47 Trustee's foreclosure procedures
Power-of-sale provision 405

Chapter 48 Requests for default and delinquency notices
Protection of the last resort 426

Chapter 49 Accepting partial payments after a default
The lender may continue to foreclose 432

Chapter 50 A deed-in-lieu of foreclosure
Reducing the risk of loss 436

Chapter 51 Trustee's or attorney fees, not both
The three-stage foreclosure period 441

Section H

Tax Aspects of Financing

Chapter 52 Deductions of points by homebuyers
Prepaid interest write-off exception 447

Chapter 53 Home loan interest deductions
Two residences, two deductions 453

Chapter 54 Seller financing diminshes tax impact
Installment sale defers profit reporting 458

Chapter 55 Interest reported on a carryback note
Charge or impute a note's AFR 470

Table of Forms

No.	Form Name	Page
155-1	Carryback ARM Addendum	68
203	Uniform Residential Loan Application	298
222	Notice of Right to Rescind — Borrower's Right to Cancel	342
281	Agreement to Subordinate	383
300	Financial Disclosure Statement	232
302	Credit Application	252
303	Foreclosure Cost Sheet	244
406	Deed-in-Lieu of Foreclosure	438
410	Further Encumbrance Consent	226
412	Request for Notice of Default and Notice of Delinquency	428
415	Beneficiary Statement	157
418-1	Late Payment Provisions — Addendum to Promissory Note	95
418-2	Prepayment of Principal Provisions — Penalties and Discounts	80
418-3	Final/Balloon Due Date Provisions	57
418-4	Right of First Refusal to Buy Note	59
418-5	Note Enforcement Provisions	376
419	Notice of Balloon Payment Due	104
420	Note Secured by Deed of Trust — Installment — Interest Included	47
421	All-Inclusive Promissory Note Secured by Deed of Trust	274
422	Note Secured by Deed of Trust — Installment Note — Interest Extra	51
423	Note Secured by Deed of Trust — Straight Note	40
424	Promissory Note – Unsecured	221
425	Modification of the Promissory Note	74
426	Agreement to Modify a Promissory Note	71
431	Assumption Agreement — Unsecured and Subrogated	189
433	Adjustable Rate Note Secured by Deed of Trust	66
436	Security Agreement — For Note Secured by Personal Property	198

No.	Form Name	Page
439	Guarantee Agreement — For Promissory Note	109
442	All-Inclusive Trust Deed Addendum — Equity Payoff	276
443	All-Inclusive Trust Deed Addendum — Full Payoff	278
450	Long Form Trust Deed and Assignment of Rents	118
455	Impound Addendum — Taxes and Insurance	135
456	Demand on Owner to Pay Rent to Lender	147
457	Demand on Tenant to Pay Rent to Party Other than Landlord	149
472	Substitution of Trustee and Reconveyance	114
479	Notice of Surplus Funds From Trustee's Sale	421

Government Forms

Franchise Tax Board Form 593 I 466

UCC-1 Financing Statement 200

Introduction

Real Estate Finance is part of the **first tuesday** series of California-specific real estate study materials. Each title in the series has a different topic as its primary content. As part of a comprehensive real estate education program, the series includes Principles of Real Estate, Real Estate Practice, Legal Aspects of Real Estate and Real Estate Property Management.

first tuesday's real estate series uses plain language and eliminates the extensive overlap of identical course material commonly offered by other publishers. Issues arising in more than one factual setting are referenced as necessary, but are dealt with fully in only one **first tuesday** title.

Real Estate Finance is written for real estate licensees, lenders, attorneys, title officers, buyers and sellers. This course material is designed to be an educational tool for use in the classroom and as a technical research and reference tool on mortgage law in California. The scope of the materials presented extends beyond a minimum acceptable level of knowledge and professional development.

The objective of this material is to fully develop the real estate professional's knowledge of the historical relationship between lenders and borrowers and the rights and obligations arising out of debts secured by real estate. **Real Estate Finance** also discusses notes, trust deeds and other security devices, as well as their provisions and foreclosure procedures. Also analyzed in this material is carryback financing, private money lending by individuals and the sale and assignment of trust deeds.

Included, with an explanation for their use, are all the forms and notices required to establish and disclose real estate loan arrangements, to create and document an installment sale of real estate by a carryback seller, and to enforce or defend against foreclosure. Forms are treated as itemized check lists of disclosures by an agent and reviewed with buyers and sellers of real estate.

These forms fully reflect relevant codes, regulations, judicial decisions and practices in effect on the date of this publication. The forms referenced are developed and published by **first tuesday**.

SECTION A

The Borrower-Lender Relationship

Chapter 1 Pre-Wellenkamp history

This chapter presents the background for the legal and legislative resolutions to the historic conflicts between real estate owners and their lenders.

Ownership objectives were paramount

The conflicting demands for financial survival between property owners who invest in real estate for income and mortgage lenders, who invest in loans based on the value of real estate as security, collide when an owner encumbers real estate with a trust deed loan.

Owners and lenders always compete for a higher return on their investment. Their investment positions are generally in opposition to one another since they are in a "zero-sum" game. The financial return to both the owner and the lender flows from the property's *market value* and the actual or *implicit income* the property produces.

Capital growth and a return on the equity are the owner's objectives. Lenders seek an interest income yield, payable either out of the property's rental income or the value of the owner's personal or business use of the property, called *implicit rent*. Pursuit of these goals often involves a degree of confrontation and economic violence.

Owners risk their invested money in the expectation of a return and to hedge against the constantly diminishing purchasing power of the dollar. However, lenders share this same risk.

The return expected by an owner from his property is based on his forecast of the effect the general and local economy will have on the value of the property.

If the owner's choice of location, the price he pays and the timing of his acquisition is favorable, his invested capital will increase in value due to general price inflation and possible human appreciation. In real estate, the owner has a **useful hedge** against the continued deterioration of the dollar's purchasing power, called *inflation*.

Owners are also placed at risk for the **time and effort** invested in locating suitable real estate and managing the maintenance and enhancement of their investment. Owners of real estate typically take an active role in its maintenance, looking after their property on a daily basis. Thus, while the owner is protecting his investment, the lender's security interest and investment returns are protected at the same time.

Lender objectives

Lenders avoid the ownership risks and liability exposure accompanying the care and maintenance of property. Mortgage lenders are *portfolio investors*, uninvolved in the activities of managing the real estate which secures repayment of their loan and produces income to provide a return on the funds they lent to the owner.

Mortgage lenders seek lending opportunities on properties in locations where they feel properties will hold their value. When originating loans, lenders try to reduce their exposure to the risks inherent in real estate investments, such as the depreciation of property due to a depressed or recessionary local economy.

However, the favorable movement of a property's value and income flow is precisely what an investor who owns real estate is gambling on.

A lender takes care to avoid becoming the owner of the secured property as a consequence for having made a loan. While the owner's investment risk is 100% of the property's value, a prudent mortgage lender takes an invested risk of only 70% or 75% of the value.

The mortgage lender's margin, called a *loan-to-value (LTV) ratio*, indicates lenders are not in the business of owning real estate. Lenders select desirable investment locations, lend amounts less than the current appraisal market value of the property, and lend only to borrowers/owners who have other substantial assets or sources of income in case of economic trouble.

Lenders favor owners with other assets to cover the risk of the secured property value falling below the loan balance. A deficiency in the value of the secured property to cover the amount of the loan is foremost in lenders' minds.

Lenders want a return on their investment based on the current rate at which they can lend, or rent, their money. No mortgage lender formulates its rate of return (*interest income*) on the annual rental income the secured property will produce, actual or implicit. To do so would base the lenders' earnings and wealth on both the property's current market value, and on the effect of the future strength or weakness in the general and local economies on rental income.

Only when stuck with foreclosed properties do lenders succumb to the pressures of the real estate market for a return on what remains of their investment gone bad.

Lenders vs. owners

The positions, goals and anticipations of the lender and the owner of real estate are diametrically opposed.

This **adversarial relationship** stems partly from greed, an entrepreneurial trait which is generally what brings both parties to a property in the first place.

California Supreme Court decisions in the 1960s and 1970s brought the confrontation between lenders and owners into sharp focus, as did antideficiency legislation in the 1930s.

Property owners took one case after another of lender injustices to the courts, challenging the right of lenders to flex their due-on-sale muscles by raising interest rates at will when the owner of a parcel of real estate encumbered by a loan needed to sell, or by taking insurance proceeds and applying them to the loan balance at will.

Before litigation slowed in the mid-1980s, two decades of judicial favor had come and gone for owners of real estate as litigation and deregulation were rearranging priorities in the economy.

To understand the cause of the ongoing lender- versus-owner battles, a review of the events in the 1960s and the 1970s is necessary. Important factors included the shifting control of the marketplace from lender to owner, then back again to lender, and the often conflicting national and California economies, while the case law developed into the early 1980s.

The early '60s: a stable market

No shocking economic events occurred between 1960 and 1965 for owners and lenders. General prosperity reigned and relative satisfaction with real estate interests existed among most owners and lenders. However, the recurring cycle of tight money contributed to the real estate recession of 1965 through 1967.

In between the 1958 and 1965 recessionary dips in the California real estate economy, the savings and loan associations (S&Ls) in Southern California fell into what became for them the disastrous period of the 1963-64 economic boom.

A massive inflow of funds to be lent on real estate forced the S&Ls, who were only staffed for a minimal steady flow of funds and investment lending, to rely on new inexperienced staff and the brokerage industry to place the funds.

Lenders paid commissions and points to real estate brokers who procured or referred borrowers to them. The construction industry verged on hysteria at this abundance of funds. Anyone, it was then said, could use the back of an old envelope to sketch a building plan and obtain a lender's "horseback" commitment for a construction loan — and close on it!

Credit was secondary. The lender's objective was to get the funds out. Interest earnings and short-term profits, called *points* and *dutch interest* (18- month prepaid), were the major concern.

Lenders frankly viewed the excess money as lettuce about to rot on the shelf. Money had to be moved. As a result, lenders chased deals to place the funds, a classic prelude to investment error for lenders and investors.

Broker control during the early '60s

In an environment of excess private investment and abundant loan funds, brokers and owners usually control the market.

In the early 1960s, builders and buyers picked and chose projects and properties with little concern over the availability of loan funds. Funds were advanced for the asking, the interest rate was below 7%, and inflation was lower.

Builders overbuilt and by 1966, vacancy rates and foreclosures soared. Lenders had lent and sellers had sold to unqualified borrowers and buyers, causing defaults and increasing foreclosure rates. Brokers did their job of rendering the services which brought the different parties together.

Suddenly, the real estate industry, having grown too fast due to the lack of financial safeguards on the lenders, became mired in its own excesses.

By the late 1960s, lenders started looking for ways to protect themselves, and, with governmental administrative assistance in mergers, regained control of their investments.

Lenders begin massing forces

At the time, a case handed down by the California Supreme Court went generally unnoticed. The first in a continuing series of cases relating to the lender's use of the *due-on clause* in their trust deeds, the court modified common law's rigid interpretation and application of the **due-on clause**. [**Coast Bank** v. **Minderhout** (1964) 61 C2d 311]

Common law had rendered due-on clauses absolutely **void and unenforceable**. The due-on clause, simply put, was a restraint on the free use of any ownership interest. In *Coast Bank*, a more permissive reasonable enforcement (use) of the due-on clause by lenders was judicially injected into the law of restraints on alienation. [Calif. Civil Code § 711]

As a result of the new **reasonable enforcement** test, the lower courts and the lenders' attorneys began carving out purposes for a lender's use of the clause which might be considered *commercially reasonable*, under the circumstances surrounding the note and trust deed.

If reasonable circumstances existed to justify lender's calling of a loan, then the clause could be enforced by a demand for payoff, increased rates or foreclosure if the demand was not met.

Coast Bank had no immediate influence on the real estate market of the early 1960s, since most lenders were not using the due-on clause to improve their profits and maintain their portfolio yields.

Real estate professionals in the early 1960s paid little attention to the presence of the due-on clause in trust deeds.

The late '60s: Marketplace instability

In 1965, the money supply tightened, interest rates increased, availability of mortgage funds significantly decreased and inflation started to soar.

What occurred was entirely due to governmental expenditures unrelated to the general economy; the prime culprit being the Vietnam conflict and the related industrial buildup for the war effort.

Portfolio lenders did not foresee the massive inflation which would adversely affect their fixed-rate portfolios of 30-year loans.

Almost a quarter of all the savings and loan associations (S&Ls) in California were in serious financial turmoil. The S&Ls had lent on anything to everyone, and had done so at rates which did not adequately cover the risk of inflation.

The result was property foreclosures by the thousands — and by entire tracts — as well as the collapse of a large number of large California-based S&Ls.

Real estate owned (REO) became common jargon of the real estate broker. Lenders acquired property in foreclosure which had to be sold, and lender insolvency ran rampant. Thus, merger upon merger occurred.

Most often, mergers were induced by governmental administrative pressure (and money) to keep weak lenders from going under or being taken over at greater expense to the government.

As a result, the big got bigger.

Added to this marketplace dilemma was the fact that real estate brokers and agents who had previously been making good (and comparatively easy) money in the early 1960s were now unable to remain in real estate as a source of livelihood. The industry and dwindling sales could no longer support the huge number of agents who had amassed during the boom.

As weak lenders merged into bigger, stronger lenders, the ranks of the brokerage business and the real estate trade organizations were decimated.

Lenders were the first to regroup and adjust to the changing economy, getting a head start in gaining control of the real estate marketplace. By 1968, lenders had pulled themselves together and were organized and prepared for the times ahead.

However, brokers were not so adept. Each broker had pretty much been reduced to operating alone. Little cooperation existed between brokers, and the fear of losing their remaining control over lenders and owners literally drove them apart. Franchising and the bundling of offices – mergers – as we know it today did not yet exist.

Sympathy for lenders in some courts

To top off the bad economics of the late 1960s for the non-lending, sales portion of the real estate industry, California appellate courts decided two due-on-sale cases in favor of the beleaguered lenders.

It was now reasonable for real estate lenders to use the due-on clause for profit and to adjust their portfolio yields to reflect current (higher) yields in the marketplace at the moment the owner decided to sell his property. [**Cherry** v. **Home Savings & Loan Association** (1969) 276 CA2d 574; **Hellbaum** v. **Lytton Savings and Loan Association of Northern California** (1969) 274 CA2d 456]

The reasoning of *Cherry* was repudiated by the Supreme Court two years later. [**La Sala** v. **American Savings & Loan Association** (1971) 5 C3d 864]

However, it almost took another decade for the legal confusion caused by the reasonableness doctrine of these cases, starting with the earlier *Coast Bank* case, to be put to rest judicially in *Wellenkamp* v. *Bank of America* (1978) 21 C3d 943.

During the late 1960s and until the mid-1970s, the due-on ambiguity strengthened the lender's control over the real estate industry. Without the agent first discussing an impending sale with the existing lender, no sale was allowed by a lender to be consummated unless they were paid in full or the loan was modified.

Vocabulary development geared to profit lenders

With the advent of greater-than-expected inflation and the failure of money market interest rates to return to normal within a year or so, lenders were forced to look for extra profits from less traditional sources.

Lenders developed a new vocabulary. *Non-assumable loans* and *conventional loans* became the parlance of the time period. In contrast, *assumable loans* were loans insured by the Federal Housing Administration (FHA) and the Veterans Administration (VA).

The **non-assumable loans** were required to be formally assumed and modified if taken over by a buyer of the secured property. **Assumable loans** were not required to be assumed or modified. These were only misnomers at best.

The interest rate on non-assumable loans would be increased on their assumption by a buyer to the current rate charged by the lender. Points and fees would be charged as though the loan was being newly originated. Terms of the loans were **recast and adjusted** under the due-on clause on the takeover of the loan by the buyer.

Conventional lenders were able to obtain more than the originally bargained-for fixed rate of return. Upon an owner's sale or further encumbrance of his property, lenders would interfere and exact additional profits by an adjustment, the precursor of the adjustable rate mortgage (ARM). This shift in wealth to the lenders diminished the market value and marketability of the real estate which carried the loan. Smart buyers wanted properties with FHA loans on them.

Conventional lenders achieved a dual profit role with no downside risk:

- a *floor rate*, the original fixed rate of interest; and

- an upward-only *adjusted rate* on the sale or further encumbrance of the real estate by enforcing the due-on clause.

The 1970s was certainly a dynamic decade for lenders.

Non-disclosure as the "Medovoi" syndrome

Brokers and owners fought to keep the real estate market alive. In an effort to rejuvenate sales, they developed methods to avoid the due-on clause.

Games were played to covertly transfer ownership and avoid disclosure of the transfer to the lender.

For example, brokers would have the owner transfer title to the secured property into a trust or family partnership for the owner's benefit. The lender would be advised of the action. Explanations were made, but these were hardly the reasons for the establishment of the trust or partnership vesting.

Then, without detection by the lender, the beneficial use of the trust's property would be transferred, or the ownership of the partnership would be assigned. Both transfers are off the record.

Even with recorded transfers by grant deed, lenders would not be advised. All-inclusive trust deeds (AITDs) became popular. Lenders were completely unaware of transfers as long as sellers continued to make payments and hazard insurance policies were left in place.

If the lender happened to discover the transfer through tax rolls, insurance policies or inspection of the record for transfers, buyers would attempt to avoid full disclosure. [**Medovoi** v. **American Savings and Loan Association** (1979) 89 CA3d 244 (decertified)]

Some transfer methods had built-in hazards for owners. Many sales occurred without documentation or recording. Grant deeds piled up in the safes of escrow companies and brokerage offices to someday be recorded when financial arrangements could be worked out by buyers.

This failure to record caused problems for both owners and lenders since there were too many facilitator handling payments and deeds.

The '70s: adjusting to inflation

It was clear inflation would run high during the 1970s. Real estate lenders needed a hard or *real rate of return* in the region of 3%, after inflation and taxes on that inflation were deducted from the interest rate they received, called the *nominal rate* or *note rate*.

Depository lenders (banks, savings and loan associations (S&Ls) and thrifts) looked for a 3% spread over their cost of funds. They were willing to net 1% on total capital assets (which includes liability for deposits).

The lenders' risk lay in projecting a profitable annual rate of return over a 30-year period on the fixed-rate loans they held. Institutional lenders did not relish the idea of making mistakes they would have to live with for years.

Mortgage lenders seized on the due-on clause in their trust deeds to cure their miscalculations on the long-term cost of doing business. During this time, lenders retained ownership of the loans they made and had good reason to maintain yields on the loans sufficient to keep them solvent. Thus, lenders serviced the loans they made.

Any interest rate mistakes which had adverse ongoing effects on the lender's portfolio could be remedied by calling the loan due when the property changed hands. The sale of property was frequent, given California's typical short-term turnover of property.

But at the outset of the 70's, a few larger lenders began to see the judicial handwriting on the wall. They knew they could not rely on the due-on clause as a long-term tool to correct their erroneous financial decisions.

VIR legislation to vary from fixed

Lenders lobbied for legislation to allow them to shift the burden of a changing economy onto owners. The benefit of real estate as a *hedge against inflation* could be shifted from the owner to the lender.

The variable interest rate loan (VIR) was lobbied into legislation in 1969 as a way to pass the cost of inflation to the owners of real estate encumbered by a VIR loan. [CC §1916.5]

Mortgage lenders believed this would help them rectify any misjudgment in forecasting rates for fixed rate loans, while giving them constant earnings of a 2-1/2% to 3% margin on their entire loan portfolio.

Lenders preferred for owners, not themselves, to live with lender miscalculation about future economic uncertainties, and the due-on clause was an excellent conduit for shifting wealth.

Further encumbrance interference

A due-on clause is triggered in several ways:

- on **sale**, the conveyance of ownership;
- on **lease**, a conveyance of the right to possession; and
- on **further encumbrance**, a lien establishing a security interest in property.

A 1971 California lower-court case dealt with an owner who used his equity to secure borrowed funds while still retaining ownership. The owner further encumbered his property with a second trust deed lien to secure the loan.

The first trust deed holder called the loan, claiming the **further encumbrances** breached the due-on clause. The holder claimed the junior trust deed triggered the right to prematurely call the loan due and payable on the unconsented-to further encumbrance of the property.

However, the California Supreme Court held a mortgage lender could not use the due-on clause on the owner's further encumbrance of the property without showing a reasonable justification to protect the loan based on an increased risk of loss brought about by the further encumbrance.

The mere placing of a second trust deed on the property gave the first trust deed lender no legitimate cause for concern over the loss of the loan balance, or the loss of the trust deed position held on title to the property.

In truth, the lender had two individuals with vested interests in keeping the property well maintained and the first trust deed note current. These two were the original trustor/owner and the new second trust deed holder.

The interests of both individuals were junior to the lender's claim against the property's value. Hence, there was no impairment of the lender's security interest in the property due to the further encumbrance. [La Sala, *supra*]

In effect, trust deed liens are intended to **protect the lender** from loss on the loan, not provide him with a sword to cut a better deal or interfere with the owner's exercise of his ownership rights.

As a result, the market for arranging second trust deed loans promptly expanded. Now a private lender could originate a second trust deed loan without the concern the first trust deed holder would call the loan. Loan escrows could once again close on receipt of the existing lender's beneficiary statement.

La Sala permitted owners to obtain additional financing based on the equity of their property. Authority to make second trust deed loans was all most brokers saw in the case. The rule of reasonableness between lenders and owners was mostly overlooked by lenders, agents and owners.

Misdirected attention to security devices

In 1974, the California Supreme Court again looked into lenders' use of the due-on clause. This time a sale of the secured real estate prompted a lender to call a loan due prematurely, claiming the transfer of *equitable ownership* under a land sales contract triggered the due-on clause. [**Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629]

The *Tucker* court rejected the lender's need for additional profits to enhance their *portfolio yield* as a legal justification to interfere with the change of ownership.

Good faith interference on the part of the lender was now rejected by the court. **Good faith** meant a genuine belief, supported by facts, that the lender's trust deed lien interest in the property was **impaired**, or the transfer to the buyer created a substantial **risk of default** on the loan obligation.

The legal noose was tightening around the economic necks of the lenders.

The need for impairment was so clear that the lender in the *Tucker* case later filed only judicial foreclosures to get legal cover when seeking to use the due-on clause (and intimidate the owner).

Lenders were made aware of the potentially expensive threat of punitive damages for their **tortuous conduct**, due to their lack of good faith in their use of the due-on clause to increase their portfolio yields.

Also, a later case imposed attorney fees on a lender who improperly used the due-on clause against a non-assuming buyer. [**Saucedo** v. **Mercury Savings and Loan Association** (1980) 111 CA3d 309]

Now the owners of property encumbered by a due-on trust deed had taken on some economic clout. Lenders, for the first time, had something to lose, not gain, when they sought to interfere with the ownership of the secured property for the purpose of increasing their portfolio yield.

Still, some agents used deception when conveying property for clients. More and more contract escrows were opened which held documents off the record until the legal issues regarding due-on clauses were better understood.

Reverse trust deeds became popular. A buyer would be given a note and trust deed from the seller as a lien held by the buyer on the property he purchased, since title remained with the seller.

The phony loan amount would actually be for the amount of the down payment. The seller's grant deed and any carryback trust deed would remain unrecorded. The official record would state the seller was still the owner, and the buyer was merely a lender of funds to the seller — and all this before the passing of Proposition 13 in 1978.

Yet the change of ownership occurred and possession was transferred and the operative documents were held off-record.

Time for the Wellenkamp assumption

The *La Sala* case specifically dealt with further encumbrances in the form of second trust deeds. A footnote in *La Sala* indicated a further review and application would be made of the reasonableness standard when a case involving a sale came along.

Tucker, a case involving a carryback sale, became the fulfillment of the footnote. But the carryback sale was structured as a land sales contract, not a grant deed, trust deed or note.

The facts of *Tucker* regarding the carryback financing device used in the sale distracted nearly everyone from the legal concepts controlling lender conduct on a change in ownership.

The brokerage community focused on the wraparound security device, called a *land sales contract*, used by the seller to document the installment sale of the property.

The form used to document the sale, a land sales contract, and the legal fact the seller merely retained a lien on the property to secure his carryback financing, overshadowed application of the rule which the court applied to lender interference in sales.

Use of a land sales contract caused uncertainty as to whether the same rule would apply to other forms of sale, such as a grant deed conveyance on a cash-to-loan sale.

Thus, the question lingered: Was there justification for calling a loan when the borrower/owner no longer owned any interest whatsoever in the property which secured the lender's real estate loan?

Wellenkamp answered this question without equivocation.

Chapter 2 Wellenkamp to Garn

This chapter reviews the legal high ground once held by owners over lenders, and the sudden reversal of owners' rights under federal mortgage law in the early 1980s.

A sale without lender interference

For the decade prior to mid-1974, mortgage lenders consistently threatened to call loans due should the owner sell the secured property and the buyer take title subject to the lender's loan.

No concern existed for the type of property being sold, or arrangements for carryback financing between the seller and buyer. If not paid in full on a call under the due-on clause, or a modification of the interest rate and monthly payments was not agreed to, a Notice of Default (NOD) was recorded. The trustee would then complete the foreclosure unless the loan was renegotiated or paid in full.

By the mid-1970s, most institutional lenders with competent legal advice were aware that courts were not going to allow them to continue using the due-on clause to extort greater yields when owners sold or further encumbered their property. The judicial trend was to return the due-on clause to its former status as a provision designed to **protect the lender** against a loss, not to provide the lender with increased earnings.

Then the case of *Tucker* was decided which required the *good faith* use of a due-on clause by lenders. [**Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629]

After *Tucker* in 1974, the lenders, virtually en masse, stopped recording NODs on transfers of ownership interests.

However, lenders continued to take advantage of owners and their brokers who were unaware of a property owner's resale rights, or unwilling to undergo the inconvenience of pursuing their ownership rights to sell, further encumber or lease their property when a lender who had a trust deed lien on the property would attempt to interfere.

Lenders continued to play their hand at assumption until sellers, buyers, and brokers learned to call these lenders' bluffs. Brokers and the buying public were slow to catch on, and only did so as the result of individual experiences rather than organizational efforts. A weak real estate sales market eventually spurred buyers and brokers to challenge the lenders.

Agent's conduct with lender of record

Between 1974 and 1978, prior to the *Wellenkamp* decision, agents negotiating sales involving loan takeovers frequently did not understand their clients' rights. Uninformed agents would actually call the lender of record on the listed property to seek advice on a loan assumption by a buyer before writing a purchase agreement offer.

Agents typically asked three questions of the lender with regard to the buyer's assumption of the loan:

- Is the loan assumable?
- What interest rate will be charged on an assumption?

- What points and fees will the buyer be charged to assume the loan?

The lender's response to the agent's inquiry was always adverse to their client's best interests, be he seller or buyer. The lender inferred, due to the nature of the inquiry, that the seller and buyer were ignorant of the buyer's right to take over the loan in a *subject-to sales transaction*.

This environment of agent and buyer ignorance suited the objectives of the lenders perfectly. Lenders could still make good use of the due-on clause against unknowing consumers to increase the yield on their loan portfolio.

Lenders received considerable institutional assistance from brokerage trade groups and federal agencies who supported the lenders' drive to increase earnings, perceiving the survival of institutional lenders as necessary for the financing of the resale of real estate.

But, as the business cycle in 1974 and 1975 brought about tighter money conditions with higher rates, tensions grew. Buyers, sellers and agents asked more questions and became better informed. Information enabled them to cut through to a closing and avoid lender **interference and modification** of loan rates.

On closing a subject-to transaction, the lender was promptly advised of the sale and the buyer's name and address. The transfer arrangements – escrow – had deliberately avoided a note modification and any increased portfolio yield for the lender on their fixed-rate, 30 year loans.

Lenders would press buyers for a formal assumption. When the sellers, buyers and agents presented a concerted front against lender-requested assumptions, lenders eased off from calling loans and filing notices of default.

Thus, by the time *Wellenkamp* was decided in 1978, almost all lenders, including federal savings and loan associations (S&Ls) and private lenders, had dramatically toned down their due-on interference.

Wellenkamp prohibited profiteering

In 1978, the California Supreme Court put a stop to the lenders' use of a due-on clause to vary the term of their loans. The era of automatic use of the due-on clause as a tool to adjust **portfolio yields** was brought to an end.

In California, as in most other states, mortgage law prohibits enforcement of any contract provisions in a trust deed which purports to restrict the owner's right to sell, lease or encumber his property, called a *restraint on alienation*. [Calif. Civil Code §711]

This California law existed even before codes were enacted in 1872. The California Supreme Court decision in *Wellenkamp* simply stated what knowledgeable real estate lawyers already knew — Civil Code §711 made it illegal for lenders to use a due-on clause when their security interests were not placed in **danger of impairment** by a transfer of the secured property to a buyer. [**Wellenkamp** v. **Bank of America** (1978) 21 C3d 943]

Wellenkamp prohibited any lender interference with a sale, except when it was reasonably **necessary to protect** the lender's security interest in the transferred real estate. Financially, lenders were prohibited from exploiting the due-on clause to increase their **portfolio yield** at the expense of the consumer.

If the seller's prospects of a sale were inhibited by the lender in any way, by the veiled or threatened use of the due-on clause, the lender was now considered to have illegally interfered with the owner's right to sell the secured property.

The lenders who had made mistakes setting interest rates on loans they had originated were now prevented from shifting the cost of those errors onto borrowers.

The California Supreme Court described the provision as the due-on clause, not the due-on-**sale** clause.

The ruling was not limited to just the sales aspect of ownership, any interest was included. In 1982, leasehold assignments were included, barring (until 1990) the landlord's unreasonable termination of the lease on its assignment by the tenant to another tenant.

Lenders were told to use the clause for **protective purposes** only. No longer could the lender use the due-on clause for the economic suppression of the very ownership interest which supported their loans and assured their repayment.

Until 1982, the interest rate risks were to remain with those who created the portfolio yield problem, the lenders.

The Wellenkamp era

After *Wellenkamp*, many agents began advising their clients to consider the use of existing financing to buy property and close transactions in cash-to-loan and carryback sales.

Those brokers who previously had cooperated with lenders who had interfered now advocated *subject-to* financing.

Judicial favor in California was so strongly behind the unrestricted sale of real estate that as late as February 1982, the *Wellenkamp* ruling was finally also applied to private lenders. [**Dawn Investment Co., Inc.** v. **Superior Court of Los Angeles** (1982) 30 C3d 695]

Unfortunately, many lenders placed a high value on their ability to coerce extra profits and simply refused to fully accept the court's decisions.

In particular, the federal savings and loan associations (S&Ls) continued to interfere successfully with sales, arguing that they were not subject to state law.

State lenders also continued to fight but shifted the battle from the legal to the political arena.

In June 1982, the United States Supreme Court gave all federal S&Ls the ability to **automatically** enforce their due-on-sale clauses on a sale, further encumbrance or leasing of the secured property, and do so without concern for the impairment of their security or the buyer's creditworthiness. [**Fidelity Federal Savings & Loan Association** v. **de la Cuesta** (1982) 458 US 141]

This resulted in serious inconsistencies between state and federal due-on practices, seriously hindering the federal S&Ls' ability to lend at rates obtainable by all other institutional lenders.

The recapitalization of lenders by their borrowers

Intended to settle this due-on imbalance and impending wide-spread lender insolvency, the *Garn-St. Germain Federal Depository Institutions Act of 1982 (Garn)* extended to **all** lenders and carryback sellers the rights which *de la Cuesta* gave federally chartered S&Ls.

Together, *de la Cuesta* and *Garn* created a new body of federal mortgage law.

Signed into law on October 15, 1982, *Garn* brought about a blanket preemption of state law limitations on due-on practices.

Garn deemed due-on clauses to be **automatically** enforceable by all lenders secured by real estate or mobilehomes. Thus, previously fixed rate loans with due-on clauses became variable rate loans on the transfer of any interest in the property.

Garn gave both institutional and private lenders the right to enforce the due-on clause which existed as a boilerplate provision in most trust deeds. Thus, since 1982, buyers, sellers, brokers and lenders alike have scrambled to protect their interests and win at the real estate game.

In economic terms, the right to automatic enforcement shifted an enormous amount of wealth from real estate owners to their lenders through loan modifications or new loans at higher interest rates. However, the need for the lender's consent to a sale and the resulting transfer of wealth began to stifle sales.

Garn made one limited concession. A *window period* was established which prohibited due-on interferences by lenders holding loans originated during the window period, except for loans originated by federally chartered savings and loan associations (S&Ls).

In California, this **window period** of loan origination permitted subject-to sales to be closed on properties with loans originated between Aug. 25, 1978 (the date of the *Wellenkamp* decision) and Oct. 15, 1982 (the date *Garn* became law).

The window period allowed owners who bought property during the window period to realize their expectations of reselling the property subject to the old loan. Not so for owners of property encumbered by a federal S&L loan.

Loans which were either originated or assumed during the window period, other than federal S&L loans, were thus **exempt** from automatic due-on enforcement on a resale of the property for **three years** after the window closed. The exemption period was simply a grace period for agents to close subject-to transactions.

The exemption from automatic due-on enforcement applied to the take over of window period loans until Oct. 15, 1985. After that, **any** loan with a due-on clause made or held by **any** lender, institutional or private, could be accelerated on the sale of the secured property without regard to security impairment, risk of default or loan origination date.

The FHLBB steps in

The *Garn* legislation provides only general guidelines for due-on enforcement. The *Garn Act* gave the Federal Home Loan Bank Board (FHLBB), now known as the Office of Thrift Supervision, authority to issue rules, regulations and opinions interpreting *Garn*. This authority was also delegated to other regulatory agencies. [12 United States Code §1701j-3(e)]

In early 1983, the FHLBB issued a set of detailed regulations spelling out what constitutes a sale or transfer, what types of transfers will trigger the due-on-sale clause, and what limitations are placed on the enforcement of the due-on clause.

Transfers which trigger due-on enforcement are those resulting from:

- a grant or quitclaim deed;

- a land sale contract;
- a lease with option-to-buy;
- a purchase under a lease/option;
- a lease for a term more than three years;
- the creation or refinancing of a junior lien (owner-occupied, single family residences excluded);
- the foreclosure of a second trust deed; and
- the transfer into a trust (owner-occupied, single family residences excluded on conditions).

In drawing up these regulations, the FHLBB took care to specifically define what events constitute as a sale or transfer under *Garn*. The FHLBB defines a transfer as the conveyance of any right, title or interest in the secured real estate, whether equitable or legal, voluntary or involuntary (as in a sale of property under a judgment or tax lien sale).

In fact, a completed sale or transfer is not always necessary. With homeowner exceptions, any transfer (sale, encumbrance or lease) will trigger the lender's acceleration rights.

Depending on the wording of the due-on clause in the trust deed, the lender's acceleration right can be triggered by an owner merely entering into a *purchase agreement* to sell the secured property. Options to buy, purchase agreements and sales escrows will trigger the due-on clause if the trust deed so states (though most do not).

Unfinished business

The FHLBB regulations left some significant issues undetermined, and loopholes still exist in the due-on catch-all.

Neither the regulations nor *Garn* itself mention anything about purchase agreements, escrow instructions or limited partnership LLC interests. These loopholes are exploited as paths to avoid due-on enforcement under *Garn*.

Three-year escrow periods with interim occupancy, "agreements-to-agree" and LLCs are only a few of the vehicles the ingenious real estate industry have seen as replacing the subject-to transfer to avoid the shift in wealth which takes place on the sale of property when interest rates on new loans rise.

Chapter 3 Portfolio yields and increasing interest rates

This chapter analyzes the economic impact of due-on interference on real estate transactions, and takes a detailed look at the causes behind the severity of the current real estate downturn and the necessary steps on the path towards recovery.

The failed economic experiment

In 1982, Congress enacted the *Garn St. Germain Federal Depository Institutions Act* (Garn) to provide an **economic catalyst** for rejuvenating the then current cyclical failure of institutional lenders by:

- allowing savings and loan associations (S&Ls) to venture into exotic and highly speculative investments;
- lifting the previous $40,000 federal guarantee on individual savings accounts to $100,000;
- allowing portfolio yields to be increased through loan modifications and recast rights by unfettered use of due-on clauses; and
- eliminating loan rate competition between lenders by awarding them a level playing field.

All these lending conditions – speculation being a naturally pre-existing ingredient – were granted on the premise they would create an environment which would increase S&L earnings. The S&Ls needed to cover their capital losses on fixed-rate loans made in the late 1970s, prior to the "hot money" rules of the newly created money market accounts which dramatically increased their cost of funds.

By the early 1980s, fixed-rate loans and rising short-term rates were blamed for contributing to the extensive insolvency throughout the S&L industry. Thus, the 1970s money market deregulation of S&Ls' cost of funds, followed by the 1982 congressional due-on legislation, brought about mismanagement of the S&Ls which lead to the multi-billion dollar S&L debacle of the late 1980s.

By the mid-1980s, S&L mismanagement, which was allowed to run on too long without regulation or oversight, caused losses the industry could no longer cover by itself. The **Financial Institutions Reform, Recovery, and Enforcement Act** of 1989 (FIRREA) was passed to relieve the S&L industry of its financial insolvency.

The FIRREA was designed to prevent the S&L industry, considered a historically stable source of financing for homeownership, from collapsing. It renamed the S&Ls *thrifts* (which they had proved not to be) and re-regulated the S&L industry to:

- promote a safe and stable system for affordable financing for housing;
- provide better supervision of S&Ls by establishing an oversight agency; and
- limit investments by S&Ls in risky ventures. [12 United States Code §1811]

The financial burden placed on S&Ls by the re-regulation caused most of these institutions to convert themselves into banks to avoid the regulation imposed by the FIRREA.

However, in the reshuffle of legislation, the due-on clause was allowed to remain as a lender's profit-making device, continuing the *Garn* legislative shift of the inflationary hedge in real estate from owners to lenders who held adjustable rate mortgage (ARM) type loans.

The swing in mortgage rates

In California, the due-on clause has not been an issue for buyers and sellers since 1982, the year *Garn* was enacted. After 1982, interest rates generally declined until 1994, then continued to decline from 2000 to 2005. All the while, an abundance of mortgage money was readily available to buyers.

However, whenever inflationary conditions or massive government, corporate, or mortgage borrowing develop in our national economy, short-term and long-term interest rates rise in response.

Gradually, rising short-term interest rates cripple the demands of buyers (who have by then resorted to ARMs to fund their purchase) and temporarily paralyze the related real estate industries of brokers, lenders, credit agencies, title companies, and escrow officers for three years, from peak sales prices to bottom sales prices.

The ability to buy and sell real estate is adversely affected by an on-going general expectation of future increased inflation. *Inflationary expectations* ultimately result in an economic slowdown induced by efforts of the Federal Reserve Bank (the Fed) to increase short-term interest rates to stifle the inflation and the homeowner's use of ARM loans to finance the purchase of a residence.

Ultimately, short-term interest rates must increase faster than the rate of inflation if the Fed is to control the rate of inflation and reduce it to a level acceptable to the long-term bond market. Only then will long-term fixed mortgage rates remain fairly constant or decline, provided that government and corporate borrowing remain static.

Lenders see $ signs in due-on clauses

Lenders are motivated by profit. They do not call loans due or seek a rate modification on a sale of real estate when market interest rates fall below their note rate. Lenders simply permit assumptions of high-rate loans rather than calling them due.

Following the 1982 *Garn* due-on clause enforcement changes, interest rates continued on a downward trend until early 1994. Since 1994, rates have not risen enough or for a long enough period of time to cause brokers to address a practiced technique for handling the due-on issue. As a result, no practical experience with lender due-on interference has been attained by those brokers and agents who became licensed after the elimination of California's free transferability rules in 1982.

However, the early 1990s experienced a nearly eightfold increase in annual foreclosure sales over 1990. The glut of properties in foreclosure further influenced the downward adjustment in home prices which had been initiated by a decline in California employment, a per capita income reduction, and interest rate increases.

The inability of a buyer to take over financing in a subject-to sales transaction without fear of a call inhibited buyers and added to the decline in values. Fewer buyers, including speculators and displaced homeowners, were able or willing to meet institutional demands for loan reductions and assumptions at higher interest rates.

As shown by history, the cycle of values will again turn vicious for owners and lenders when interest rates on new and existing ARMs begin to rise due to the high percentage of loans which are ARMs.

An owner attempting to sell when current rates have risen above the note rate on his existing fixed-rate or ARM loan will experience more difficulty getting a loan assumption approved, except on a modification at current rates, plus the exaction of an assumption fee. These difficulties with lenders will only be exasperated by the fast-growing tendency in the 1990s of agents to step away from further involvement in a transaction once the seller and buyer enter into a purchase agreement.

Thus, lenders are now able to increase their portfolio yield without organized resistance, literally originating a **refinancing by modification** of the terms of the existing trust deed note to meet current lending market expectations.

California agents feel the effects of the due-on clause whenever either variable or fixed mortgage rates increase for a period of time greater than 18 months.

With steady and continuing rate increases, agents will again be shocked by the realization that due-on clauses permit lenders to call a note due (or modify its rate or payment schedule) when an owner seeks permission to sell, lease, or further encumber property financed by the lender.

This severe restraint on all types of real estate transactions was last felt during the 1974-75 recession. However, it was largely avoided by use of all-inclusive trust deeds (AITDs) in the form of land sales contracts with power-of-sale provisions — California documentation of a sale which would not avoid later due-on enforcement by lenders under the 1982 federal mortgage law.

Lenders vs. owners in 2000-2010: the real estate interest of each

In 1998 America's central bank, the Federal Reserve (the Fed) started raising short-term interest rates to induce a routine business recession. As planned, the recession took hold in early 2001. However, the effort to cool the economy was short-lived since the economic reaction to September 11, 2001 froze the price of homes at their peak.

Without real estate going through the normal downward market movement to return prices to their **historical pricing trend**, the stage could not be set for sustainable future real estate prices. Thus, owners of real estate were erroneously led to believe they had come under a new paradigm in economics. This hazardous myth prophesied that the deregulated markets, which had evolved since 1980, would never allow real estate prices to fall below peak levels, but would merely stabilize them for a period until demand would again push prices upward.

After September 11, the Fed and the U.S. Treasury opened the floodgates controlling the flow of money into mortgages. The Fed assisted by lending and buying treasuries in the money markets. In doing so, the Fed added large amounts of fresh cash to the supply of money available through bankers of all sort, be they mortgage or Wall Street bankers.

The cheap, short-term money provided upwards of $2 trillion dollars for lending on ARMs at teaser rates, all with the express government intent to induce tenants into homeownership. This practice was consistent with the government's ultimate goal of driving the percentage of homeownership in the U.S. from the stable 64% figure of the prior 20 years to a destabilizing 70% of the population.

The potential disadvantages of homeownership for those seeking new or transferred jobs due to job loss, an improvement in their labor skills, or coping with family dysfunctions such as divorce or disease, were never part of the dialogue.

Tenants were turned into first-time homeowners. Real estate was purchased without the requisite understanding that as owners they no longer had the mobility to move freely about the country. They became prisoners in their own homes and subject to the local job market since they could not quickly sell them and move.

This flood of money was both in excess of the true needs of people paying for shelter (as either tenants or owners) and cheap for the bankers to borrow (from the Fed and depositors) or receive (by taking profits on bonds driven up in value due to activity of the Fed).

The excess continued until July 2004 when the Fed began to slowly cut off bankers' easy access to the Fed's unlimited pool of funds by continually increasing the interest rate. This action significantly reduced the flow of funds into mortgages.

Providing more than money: deregulation

During the same period, the U.S. Treasury and Congress (encouraged by the Fed) continued deregulating and removing the lending parameters restricting mortgage lenders and Wall Street bankers, a process which had begun in the early 1980s. Deregulation allowed mortgage lenders to take on ever riskier lending activity until 2007, the year mortgage borrowers began defaulting and drowning mortgage lenders with foreclosures caused exclusively by imprudent lending practices.

At the time, the tortured reasoning behind the extensive deregulation of mortgage lenders was that Wall Street would look out for its own best interests. Therefore, excessive risk-taking would not be allowed by mortgage lenders as it would destroy its business of making and bundling loans. This flawed behavioral theory of economics overlooked the force behind *comparative advantage* between competitors of equal footing.

Comparative advantage is a force which drives Wall Street mortgage bankers to produce ever greater profits in a race to retain private sector investors who would otherwise go to the competitor producing a greater profit.

Underlying all this action was the **Reaganomics** doctrine that free enterprise functioned at its best when the risk of less was high enough to compel the bankers to set up appropriate parameters for safe lending in the mortgage markets. Government interference was seen as the problem, not the marketplace entrepreneurs — the logic supporting deregulation of money.

Wall Street bankers became more actively involved in the mortgage business in 2002. They willingly bought thousands of real estate loans at premium prices from mortgage bankers who originated them as rapidly as the Wall Street gang demanded.

Wall Street then bundled these real estate loans into **pools of mortgages**, each pool being separately managed under pool servicing agreements (PSAs), called *servicing*. Participation in the pools was then sold to investors in the bond market to recover the funds advanced by Wall Street to buy the loans, the cost of bundling and selling participation in the pools, and profits.

Each pool held the mortgages they acquired as the assets which backed up the market value of the bonds issued by the pool and provided monthly income to cover the interest due the bondholders. The bondholders eventually consisted of millions of small and large investors, individuals and institutional, domestic and foreign alike.

However, no one bondholder held any one mortgage. Instead, all bondholders in a pool indirectly held a minute interest in all the mortgages held by the pool. This created a chaotic environment, unlike the

Dutch system of mortgage backed bonds which allows homeowners to pay off their loans by buying the mortgage backed bond at toxic asset prices in the bond market. Thus, the homeowner creates his own discount for a short sale or retention of the home.

Mortgage bankers merge into Wall Street

During the rush to buy loans originated by mortgage bankers around the nation, Wall Street began buying up the mortgage bankers to get direct control over profits from both the loan origination and bundling/securitization phases. Thus, they were simultaneously able to

- originate loans at better rates and on more risky terms than a traditional mortgage lender; and
- resell **fractional interests** in those loans via their mortgage pooling to investors in bonds.

Selling mortgage-backed bonds become a world-wide effort as U.S. dollars accumulating in foreign banks needed a "safe" place to go. Bond rating agencies all duly collaborated with Wall Street bankers (for a fee) to assure bond investors all over the world that the mortgages backing their bond acquisitions were as solid as U.S. Treasuries.

Tranches were created within each pool to entitle different classes of investors to different priority claims on the interest income from the mortgages. **Tranches** are similar to first, second, and third trust deed holders who have varying priority claims to the value of the real estate securing their loans.

This Wall Street *modus operandi* was perfected by late 2004 when the Fed belatedly started to slow the flow of funds into the economy by raising interest rates on short-term financing to reduce availabilty. But it was the Fed's short-term financing that had supported the initial Wall Street involvement in mortgages.

However, by the time short-term rates began to rise, Wall Street was almost exclusively relying on private investors in mortgage-backed bonds. Wall Street no longer looked to the Fed to replenish the coffers of the involved mortgage bankers and mortgage loan brokers who were producing the flow of loans Wall Street needed to bundle and sell into the bond market.

The money supply had been increased by the Fed to keep all type of bankers and bond investors flush with cheap cash to invest. After 9/11, the Fed lent at extremely low rates (until their mid-2004 increase in short-term rates) to provide all the funds needed to finance:

- government deficits (too little tax revenue and egregious amounts of expenditures);
- the demands of stock market investors for ever greater leverage in stocks and bonds acquisitions; and
- the real estate market's need for mortgage and equity financing.

The Fed also supplied foreign central banks with dollars so their citizens could get in on the cycle of profits seeming to flow from investment and consumer demands within the U.S. At one 12-month period during the Fed's easy-money phase in the first part of the 2000s, the U.S. dollar supply increased nearly 25%.

The American Dream: policy vs. fundamentals

Considering the real estate investment cycles of boom and bust, the supply of money at cheap rates soon outran the demand buyers of real estate had for cash in the normal course of sales and refinance transactions. The excess mortgage money and equity investment funds were now managed conceptually based on Wall Street stocks-and-bonds analyses. The solid real estate fundamentals which are used to determine the inherent value of each parcel of real estate were not considered.

The uniqueness of each parcel of real estate which supported the mortgage-backed bond pools and made up the assets owned by real estate investment trusts (REITs) has never been understood by Wall Street. For Wall Street mortgage bundlers and first-time investors in real estate, all parcels look the same. Only the yield on the mortgages and profit on a parcel's resale were used to determine real estate values. These parasitic individuals relied on the borrowers and future buyers to produce their profits, largely ignoring the causes of the risks posed by the failure of these parties to "perform."

Going into 2000, the "American Dream" of homeownership was being aggressively pushed onto tenants. The government promotion was so successful it drove homeownership rates among the national population from 64% in 2000 to 70% by 2006.

This race into homeownership was financed by $2 trillion in additional guarantees and borrowings by **Freddie Mac** and **Fannie Mae**, government-sponsored (now government-owned) entities. The funds came primarily from the Fed's massive expansion of the money supply through their money-market operations. It should be remembered that the Fed has an unlimited supply of money, can never become insolvent, and is always repaid.

When money held by investors **starts chasing** real estate deals, be they acquisitions of ownership or mortgage lending, mistakes will be made. The more money and investors involved in the chase for assets, the greater the magnitude of the mistakes. Rational analysis is either set aside to get in on the wild ride for profits, or it is overlooked by newcomers due to ignorance of the rules for judging an investment related to real estate.

Wanting a share of the resurgence of cash into mortgages and real estate equities, real estate brokers and appraisers rationalized their way into the extravaganza of buying, lending, and refinancing by limiting their determinations of value to only comparable sales. However, these sales were being driven artificially by the excessive availability of funds.

Real estate brokers and appraisers deliberately rejected — abandoned — the rational tone carried by historic valuation techniques of *replacement cost approach* (land, labor, and materials) and the *income approach* (present worth of future benefits of ownership).

Even when the **income approach** was implemented, appraisers used a **cap rate** they divined from comparable sales prices. Appraisers deliberately failed to capitalize the net operating income of a project with a rate which included a return of capital, a long-term yield (as though the property were clear of liens), compensation for asset oversight, a reserve for replacement of structural components, and a risk premium for adverse future changes in local demographics.

A call to the wild: scammers, fraudsters and speculators

In addition to the entrance of novice, first-time real estate investors indirectly packaged into real estate via REITS and mortgage-backed bonds, this environment opened the door to scammers, fraudsters, rent skimmers, adverse possessors, and speculators directly owning real estate as hit-and-run types, called *flippers*. These **flippers** sensed a quick profit in an artificial fast-moving rise in sales volume and prices.

Flipping ownership for profit was fertile ground for speculators beginning in mid-2003, and ending abruptly in early 2006, roughly a three-year run. Without the ability to resell within six months to one year, speculators who acquired property had to convert to landlording until market prices recover sufficiently to produce a return on their investment. If no profit could be made, they were forced to walk away with whatever price they could get, or worse: merely pass the keys to the lender under their **put option** in the trust deed.

Real estate scammers engaged in rent skimming by collecting rents from tenants, but deliberately failed to make mortgage payments to the lender. Scammers also appeared under the guise of foreclosure consultants, sometimes cloaked in Department of Real Estate (DRE) advance-fee approvals, or as attorneys (acting as brokers without a brokers' licenses), and short-sale loan discount facilitators.

Real estate fraudsters posed a hazard for title companies as much as they did for lenders. Fraudsters stole the identities or misrepresented themselves as property owners to encumber properties with loans. Unfortunately, most mortgage fraud discovered by institutional lenders occurred through loans originated by mortgage loan brokers. This discovery resulted in institutional lenders avoiding loans packaged by mortgage loan brokers. Loan fraud also occurred when borrowers flipped property between controlled individuals or entities at artificially inflated prices, and, upon the final transfer in the series, applied for what appeared as purchase-assist loans, the type most sought by lenders.

However, on recording the loan and receiving the net proceeds of the financing, they never made a payment, as their profit had been received through the financing. The fraudsters then simply moved on to the next property to flip vestings at what appeared to be increased prices, finance the phony price on the last change in the vesting, and take another profit from the funds received on the refinancing. Fraudsters had quickly figured out a way to profit other than by selling property on a grant deed to a legitimate buyer. Thus, they left the lender (and the appraiser, and sometimes the notary) holding the bag on an excessive loan amount encumbering a low-valued property.

Others just **forged** documents to obtain a loan insured by a title company and left the insurer, not the lender, holding the empty bag – and at great cost to the title insurer as they had to pay out the entire amount of the insured trust deed loan without the ability to resort to any property, even for a partial recovery.

Stable rates and stable pricing

The tide of loan originations was turned back by higher mortgage rates, peaking in volume in August 2005. At the same time, the trajectory for the volume of home sales was beginning to peak, and did so six months later in early 2006. Home prices, the second shoe to drop in home sales during a recession, did not peak until late in 2006.

The mortgage scams and frauds that made the mid-2000s unusually risky existed in previous years, but were fewer in number. It was the chase by Wall Street bankers to originate ever more mortgages to be bundled and sold to remote bond market investors, all of whom had no sufficient grasp of real estate mortgage concepts or ownership default risks to protect themselves from the scammers and fraudsters that dealt in deceit.

All service providers affiliated with the settlement of real estate sales and loan originations, such as escrows, title insurers, mortgage default insurers, real estate brokers, etc., joined the hunt by employing great numbers of employees and agents. These tens of thousands of new employees were brought in during 2003 through 2007, and very few were properly trained to spot fraud, much less to prevent it from occurring.

Moving forward based on cause and effect

The cause of the carnage in the real estate bust following 2006 was the Fed's hyper lending through its open-market operations coupled with the utter failure of regulatory agencies to perform. Congress was a willing accomplice, deregulating mortgage lenders and their Wall Street bankers and removing what few restraints remained on lending after 25 years of loosening controls over mortgage lending.

Without parameters within which lenders had to structure real estate loans, the forces of **comparative advantage** pushed Wall Street bankers to drastic leveraging to keep investors in their programs. This drove them to take on the excessive risk of loss built into ever more exotic loan terms, such as *option ARMs*.

Borrowers taking out ARMs generally had zero ability to pay after the ARM interest rates reset, an effect which gave ARMs the cheerful nicknames back as early as 1982 of **ZAP** (Zero Ability to Pay) and **RIPOFF** (Reverse Interest and Principal for Optional Fast Foreclosure) loans. At the time, all that experienced real estate brokers and investors could do was wait out the cycle.

Veterans of the industry knew the consequence would be a disastrous collapse of both property values and public confidence in real estate ownership and mortgages. They will now have to wait until the bust morphs into a stable (more specifically, flat) volume of sales and prices that remains constant for a period of 12 to 18 months. Then they will be able to acquire real estate below or at replacement cost with a respectable rate of return at a 9-11% capitalization rate more suitable to income property investments – a return to basics once again.

While the Fed mistakenly plowed hugely excessive amounts of funds into mortgage-market situations during the boom and drove prices up, the correct remedy for a recession (or worse) is for the Fed to pump great amounts of cheap money into the banking system for all types of lending in an effort to support prices before they fall too low for lack of funds to finance buyers — deflation.

The future challenge of a well-administered Fed will be to pull back those excessive funds they fed into the banking system during the early part of the recession and do so before prices of consumer goods start to rise more than 2 or 3% annually.

Also, the Fed must change its attitude about asset inflation. In the future, the Fed must act quickly when stock market or real estate prices start to rise. Prices will again rise in both types of investment assets, but at different times — stocks first, followed by real estate two or three years later as in the past. The Fed will need to drive short-term rates up and make the dollar scarcer to keep the lid on asset inflation, something they have only done once before — during the late 1920s.

Mortgage rates will continue to follow 10-year treasury rates at a 1.5% spread after settling down from the spread of 2% which developed after the mortgage bust in 2007. Thus, a 3% 10-year treasury rate will support a 4.5% mortgage rate when the confidence level of the American public rises. Confidence will rise throughout 2009 and 2010 as the public learns more and begins to understand the basic operations of central banks and the U.S. Treasury during times of serious economic recession, typically a one year process.

But the Fed, for the same reasons they bought long-term treasuries in an effort to keep mortgage rates down, can just as easily reverse course as asset inflation begins to take place (property prices move up more than 4-5% per annum) and sell long-term bonds at high rates of interest. The Fed can also push

regulatory agencies and Congress to again regulate the risks a mortgage lender can take (down payment amounts, terms of the loan, type of appraisal – cost, income, and comparable approaches, repayment schedules, variable teaser rates, etc.).

SECTION B

Notes and Their Provisions

Chapter 4 The promissory note

This chapter reviews the types of notes used to evidence debt in financing arrangements which are secured by real estate.

Evidence of the debt

Almost all real estate sales hinge on the financing of some portion of the purchase price. The buyer promises to pay a sum of money, in installments or a single payment at a future time, either to the seller of the real estate or a lender who funds the sales transaction.

Given in exchange for property or a loan of money, the promise to pay evidences a debt owed by the borrower and payable to the seller or lender to whom the promise is made.

Usually, the promise to pay is set out in a written document called a promissory note, signed by the buyer/borrower. A promissory note merely represents an underlying debt owed by one person to another. The signed promissory note is not the debt itself, but evidence the debt exists.

The borrower, called the *debtor* or *payor*, signs the note and delivers it to the lender or carryback seller, also called the *creditor*.

The note can be either unsecured or secured. If the note is secured by real estate, the security device which should always be used is a trust deed. When secured, the debt becomes a voluntary lien on the borrower's real estate or the property purchased, as described in the trust deed.

The promissory note

Notes are categorized by the method for repayment of the debt:

- installment notes; and
- straight notes.

The installment note is used for debt obligations with constant periodic repayments in any amount and frequency negotiated.

Variations of the installment note include:

- interest-included; and
- interest-extra.

Finally, notes are further distinguished based on interest rate calculations:

- fixed interest rate notes, commonly called *fixed rate mortgages* (FRMs); and
- variable interest rate notes, commonly called *adjustable rate mortgages* (ARMs).

Installment note, interest included

An interest-included installment note with constant periodic payments produces a schedule of payments containing diametrically varying amounts of principal and interest from payment to payment. Principal reduction (on the loan) increases and interest paid decreases with each payment. [See Form 420 in Chapter 5]

Each payment is applied first to the interest accrued and owing on the remaining principal balance through the end of the payment period, typically monthly. The remainder of the payment is then applied to reduce the principal balance of the debt.

Interest-included installment notes may either:

- be fully amortized through constant periodic payments until paid; or
- include a final/balloon payment after a period of installment payments, called a due date.

Installment note, interest extra

Interest-extra installment notes call for a constant periodic payment of principal on the debt. In addition to the payment of principal, accrued interest is paid concurrently with the principal installment.

The principal payments typically remain constant, from payment to payment, until the principal amount is fully paid or a due date occurs. Accordingly, the interest payment decreases with each payment of principal since the interest is paid on the remaining balance. [See Form 422 in Chapter 4]

Thus, unlike an interest-included note, the amount of each scheduled payment of principal and interest on an interest-extra note is not constant from payment to payment.

For example, the first payment of interest is based on the entire original unpaid balance of the interest-extra note. The second interest payment will be on the principal amount remaining after the principal reduction resulting from the first payment. To set the amount of each periodic payment, recalculation of the accrued interest paid with each principal payment will continue until the entire note is fully paid.

Straight notes

A straight note calls for the entire amount of its principal to be paid in a single lump sum due at the end of a period of time, perhaps five years after close of escrow or on a fixed future date. No periodic payments of principal are scheduled, as in the installment note. [See Form 423 accompanying this chapter]

Interest usually accrues unpaid and is due with the lump sum principal installment, financing sometimes referred to as a “sleeper” trust deed. Occasionally, the interest accruing is paid periodically during the term of the straight note, such as monthly payments of interest only with the principal all due in seven years.

The straight note is typically used by bankers for short-term loans, called a *signature loan*, since a banker’s short-term note is not usually secured by real estate.

NOTE SECURED BY DEED OF TRUST

Straight Note

$_____, dated _____, 20_____, at _____, California.

1. _____ after date, for value received,

1.1 I/we promise to pay to _____, as the Payee, or order,

1.2 at _____,

1.3 the sum of _____ DOLLARS,

1.4 with interest from _____, 20_____, on unpaid principal,

1.5 at the rate of _____% per annum.

2. Interest payable:

2.1 ☐ with the principal.

2.2 ☐ on the _____ day of each _____ month, beginning on the _____ day of _____, 20_____.

3. Principal and interest payable in lawful money of the United States.

4. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note holder.

5. _____

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6. In any action to enforce this Note, the prevailing party shall receive attorney fees.

7. This Note is secured by a DEED OF TRUST.

8. ☐ See attached Signature Page Addendum. [**ft** Form 251]

Payor's Name: _____	Payor's Name: _____
Signature: _____	Signature: _____
Payor's Name: _____	Payor's Name: _____
Signature: _____	Signature: _____

Payment variations

While the installment note and the straight note are common, variations on the interest rate and repayment schedules contained in the installment and straight notes are available to meet the specific needs of the lender and borrower. The variations include the:

- adjustable rate note (ARM);
- graduated payment note (GPM);
- all-inclusive note (AITD); and
- shared appreciation mortgage (SAM).

The **adjustable rate note** (ARM), as opposed to a fixed-rate note, calls for periodic adjustments to both the interest rate and the amount of scheduled payments. The interest rate will vary according to a particular index, such as adjustments every six months based on the cost-of-funds index for the 11th District Federal Home Loan Bank.

The ARM provides the lender with periodic increases in his yield on the principal balance during periods of rising and high short-term interest rates.

When an upward interest adjustment occurs, the note's repayment schedule should call for an increase in the monthly payment to maintain the original amortization period. If the amount of the original monthly payment is retained without an increase compared to an increase in the interest rate, a longer or negative amortization results.

Graduated payment (GPM) provisions are in greater demand when interest rates or home prices rise too quickly. Fewer buyers are able to currently meet increased cost of financing home ownership.

A graduated payment schedule allows buyers time to adjust their income and expenses in the future to begin the eventual amortization of the loan. Often a GPM has a variable interest rate, called a *GPARM loan*.

For example, the GPM provision allows low monthly payments on origination. The payments are gradually increased over the first three- to five-year period of the loan, until the payment amortizes the loan over the desired number of remaining years.

However, any accrued monthly interest remaining unpaid each month is added to the principal balance on the carryback note, called *negative amortization*. The negative amortization causes the unpaid interest to bear interest as though it were principal, called *compounding*.

The **all-inclusive trust deed** (AITD) variation is used more often in carryback transactions than money lending. Lease-options, land sales contracts and AITDs become popular in times of recession, increased long-term rates and tight credit.

The lease-option and land sales contract are *security devices* which do not use a note to evidence the debt. Instead, they are themselves evidence of the debt owed the seller on the price. However, the lease-option and the land sales contract contain greater legal risks than the AITD, due to their recharacterization as mortgages, while producing the same financial function and tax result as the AITD.

Figure 1

SHARED APPRECIATION NOTE

Installment — Contingent Interest Extra

$_____, dated _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

1. In installments, I promise to pay to _____, as the Payee , or order, at _____,

1.1 the sum of _____ DOLLARS,

1.2 with interest from _____, 20_____, on unpaid principal,

1.3 at the rate of _____ % per annum, plus any contingent interest provided for below.

2. Principal and interest payable in installments of $_____, or more,

2.1 on the _____ day of each _____ month beginning on the _____ day of _____, 20_____,

2.2 and continuing until _____, 20_____, when the principal is due and payable.

3. CONTINGENT INTEREST:

3.1 Contingent interest shall be due on any of the following events:

a. maturity of the note;

b. resale of the property;

c. prepayment of the note; or

d. acceleration of the note.

3.2 Contingent interest shall be payable only from the net appreciated value of the secured property.

3.3 Contingent interest is computed as follows:

a. _____% of the net appreciated value of the property when the contingent interest is due; or

b. _____% annually on the original note amount, compounded annually at the aggregate note rate until the contingent interest is paid.

4. NET APPRECIATED VALUE:

4.1 The net appreciated value is the fair market value of the property when the contingent interest is due, less Payor's original acquisition costs, the value of additional capital improvements made by Payor, and customary resale costs including a brokerage fee.

4.2 Payor's original acquisition cost of the property includes the total purchase price, plus customary escrow and recording fees, title insurance premiums, notary fees, legal fees, credit report fees, appraisal fees, broker fees, loan origination or assumption fees, inspection fees and all other customary costs incurred in acquiring the security.

a. Payor must document the above costs within two months after close of escrow by delivering their escrow closing statement and other supporting documents to Payee.

5. FAIR MARKET VALUE:

The fair market value of the property shall be determined as follows:

5.1 When the security is not being resold, by appraisal on the following method:

a. Payor to obtain and pay the costs of an appraisal of the property value prepared by a certified residential real estate appraiser within three months prior to payment of the contingent interest.

5.2 On resale of the property, the sales price shall be deemed the fair market value, unless Payee contests the sales price in writing within 10 days after receipt of written notification of the sale from Payor. If Payee contests the sales price, fair market value will be the greater of the sales price or the amount determined by appraisal under Section 5.1.

5.3 Payor and Payee may at any time establish the fair market value by mutual agreement.

6. ADDITIONAL CAPITAL IMPROVEMENTS:

Payor may have the value of capital improvements added to his cost of the property by mailing to Payee a cost breakdown for approval prior to undertaking the improvement. If approval is withheld, the value of capital improvements shall be determined by appraisal at the time of improvement under Section 5.1.

— PAGE ONE OF TWO — FORM 430 —

— PAGE TWO OF TWO — FORM 430 —

7. PREPAYMENT: (check one only)

7.1 ☐ For owner-occupied, one-to-four residential units: If Payor voluntarily or involuntarily pays in any 12-month period within five years after origination an amount in excess of 20% of the original principal amount of the note before it is due, a prepayment penalty is due in the amount of six months' advance interest on the amount prepaid in excess of 20% of the original principal balance amount, except as prohibited by law on the use of any due-on clause.

7.2 ☐ For all other residential and nonresidential property: Privilege is reserved to prepay all or part of this note at any time by paying principal, accrued interest, and six months' unearned interest.

8. LATE PAYMENT:

If any installment payment under this note is not paid within _____ days after its due date, a late charge of $_____ shall be incurred by Payor and be due and payable upon Payee's demand.

9. BALLOON/FINAL PAYMENT NOTICE:

☐ This note is to contain the following balloon payment notice provision (mandatory on sales of four-or-less residential units): This Note is subject to Section 2966 of the Civil Code, which provides that the holder of this note shall give written notice to the trustor, or his successor in interest, of prescribed information at least 90 days and not more than 150 days before any balloon payment is due.

10. GENERAL PROVISIONS:

10.1 Any unpaid interest shall be added to the principal and thereafter bear interest as the principal.

10.2 Should default occur on any installment of principal or interest when due, then the whole sum of principal and interest shall be due at the option of Payee.

10.3 In any action to enforce this agreement, the prevailing party shall receive attorney fees.

10.4 Principal and interest payable in lawful money of the United States of America.

10.5 This note is secured by a DEED OF TRUST.

Payor: _____ Payor: _____

Payor: _____ Payor: _____

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The AITD "wraparound" note typically calls for the buyer to pay the carryback seller constant monthly installments of principal and interest. The carryback seller then pays installments due on the underlying (senior) trust deed note from the payments received on the AITD.

Another variation, the *shared appreciation mortgage* (SAM), is designed to help sellers attract buyers during times of tightening mortgage money, prior to a general decline in real estate sales, when no lack of buyers exists. The SAM is an example of a split-rate note. [See Figure 1]

Under a SAM note, the buyer pays an initial fixed interest rate, called a "floor" or "minimum" rate. The floor rate charged is typically two thirds to three fourths of the prevailing market rate but not less than the **applicable federal rate** (AFR) for reporting imputed interest.

In return, the carryback seller receives part of the property's appreciated value as additional interest, called *contingent interest*, when the property is sold or the carryback SAM is due.

Financial aspects

A note documents the terms for repayment of a loan or the unpaid portion of the sales price carried back after a down payment, including:

- the amount of the debt;
- the interest rate;
- the periodic (monthly) payment schedule; and
- any due date.

The amount of the note carried back on an installment sale is directly influenced by whether the carryback is:

- an AITD note; or
- a regular note.

The face amount of an AITD note carried back by a seller will always be a greater amount than had a regular note been negotiated in any given sales transaction. The AITD note includes the amount of the wrapped loans while a regular note is only for the amount of the seller's equity remaining after deductions of the down payment.

Interest rate limitations on loans

California's usury law limits the interest rate on non-exempt real estate loans to the greater of 10% or the discount rate charged by the Federal Reserve Bank of San Francisco, plus 5%. [Calif. Constitution, Article XV]

A non-exempt loan is usurious if the promissory note provides for an interest rate exceeding the ceiling rate on the day the note is agreed to. Other benefits received by the lender may make a loan usurious when the face amount of the note does not appear usurious. [See Chapter 41]

All real estate loans **made or arranged** by a real estate broker, however, are exempt from the usury restriction. [Calif. Const. Art. XV §1]

Since seller carryback notes are not money loans but rather extensions of credit on a sale, they are not covered by the usury laws. [**Boerner** v. **Colwell Company** (1978) 21 C3d 37]

The trust deed

In most carryback transactions, the buyer gives the seller a trust deed lien on the real estate sold to provide security for payment of the portion of the price left to be paid.

The trust deed attaches the debt to the property as a lien on the property. The trust deed is recorded to give notice (and establish priority) of the seller's security interest in the property. [**Monterey S.P. Partnership** v. **W.L. Bangham, Inc.** (1989) 49 C3d 454]

A trust deed alone, without a monetary obligation for it to attach to the described property, is a worthless trust deed. Although the note and trust deed executed by a buyer in favor of the seller are separate documents, a trust deed can only exist when it secures an existing promise to pay or perform any lawful act. [**Domarad** v. **Fisher & Burke, Inc.** (1969) 270 CA2d 543]

Even though separate documents, the note and trust deed are for the same transaction and are considered one contract to be read together. [Calif. Civil Code §1642]

Satisfaction of the debt

The promissory note, once signed by the borrower and delivered to the lender or its agent, represents the existence of a debt. [Calif. Code of Civil Procedure §1933]

When a secured debt has been fully paid, the trust deed securing the debt must be removed from title to the secured property. [CC §2941]

The trustee under the trust deed will require the original note and a request for reconveyance from the lender before the trustee will release the lender's trust deed lien from the real estate, a process called *reconveyance*.

If the original note has been lost or the note holder cannot be located, the trustee will require a bond be posted in its place before **reconveyance**.

If the lender or the trustee fails to reconvey the security interest after full payment, either may be subject to a civil fine of $300, a criminal fine of $400 and/or six months imprisonment. [CC §§2941, 2941.5]

Chapter 5 Basic provisions in trust deed notes

This chapter analyzes the basic provisions necessarily included in a note for a creditor to enforce collection of the debt evidenced by the note.

Minimum elements for enforceability

The forms for a **promissory note,** more commonly called a *note*, containf the minimum required provisions to describe the amount owed, interest rate and repayment schedule of a debt. The note is *evidence* of a debt created by an underlying agreement to pay money. An agreement to pay money on a future date must be **definite** and **certain** in its terms to be enforceable. [See Form 420 accompanying this chapter]

A note secured by a trust deed typically provides for the payment of installments of principal and interest on a debt amortization schedule.

Occasionally, the terms for payment of a debt set the amount of principal to be paid periodically, with accrued interest paid in addition to the specific principal amount. [See Form 422 accompanying this chapter]

The note is used to document the amount of the debt and terms for its repayment. Note forms also provide a checklist of the minimum fundamental elements of a debt which must be agreed to for it to be enforceable by the creditor or the payor who owns the secured property.

The following analysis and instructions are for the preparation and use of Form 420, an installment note providing for periodic payments of principal and interest. Form 420 is designed for brokers, their agents and escrow officers to document a debt previously created by a purchase agreement, loan agreement or escrow instructions. The note will be prepared concurrent with the preparation of the trust deed used to impose a lien on the real estate for the amount of the debt evidenced by the note. The note will be signed by those who agreed to the debt, called the *payors*, such as the buyers or owners of the real estate which will secure the debt, or, as is most often said, the note.

The numbers on the instructions correspond to the numbers given provisions in Form 420.

Identification of the note

The **dollar amount** of the note is entered at the top left corner of the note and is for identification purposes only.

The actual **principal amount** of the debt to be paid appears in the body of the note at §1.3, or in an *allonge*. The amount of the principal debt may be different from the dollar amount entered to identify the note, due primarily to adjustments and prorations at the close of escrow which may alter the amount initially set as the debt.

The dollar amount entered at the top of the note for identification purposes is also entered in the trust deed to cross reference the note. Thus, the debt becomes secured by the real estate described in the trust deed.

Consider a trust deed securing a debt which makes reference to a promissory note "of same date" to the identification date of the trust deed. In this scenario, the identification dates in the note and its trust deed must correspond to each other.

However, if the trust deed is not prepared on the same date as the identification date for an existing note, the words "same date" should be **stricken** from the trust deed and the date of the note should be entered to identify the note secured by the trust deed, an activity called *interlineation*. [See Form 450 in Chapter 14]

The **location** where the note is prepared is also entered at the top of the note, again for identification purposes only. The location of preparation may differ from the place the payments on the debt are to be made as called for in §1.2.

The entries for the dollar amount, date and city are used when referencing the note.

1. Consideration for the note

The person signing the note, called the *debtor* and entitled the *payor*, must receive something of value in exchange for his promise to pay contained in the note. In the context of real estate finance, the consideration for the promise to pay is the money lent or property sold on credit to a buyer.

The words "for value received' document the buyer's **receipt of consideration** given by the lender (in the form of money) or carryback seller (in the form of property) in exchange for the buyer's promise to pay. A note is unenforceable by its holder unless valid consideration is given to the buyer or borrower in exchange for executing the note. [**Doria** v. **International Union, Allied Industrial Workers of America, AFL-CIO** (1961) 196 CA2d 22; Calif. Commercial Code §3303]

The buyer **promises to pay** the debt owed to the lender or carryback seller according to the terms for repayment *memorialized* in the note, on an installment basis which often includes a lump sum as a final/balloon payment.

An *unconditional promise to pay* is essential for the note to be negotiable — transferable — by the carryback seller.

A promise to pay is considered **unconditional,** unless the promise states:

- an express condition to payment exists;
- the promise is governed by another contract; or
- the rights and obligations concerning the promise are contained in another contract. [Com C §3106]

The note must be negotiable if the seller is to sell or borrow against (*hypothecate*) the note and trust deed. [Com C §3104]

However, the buyer's promise to pay on a note secured by a trust deed is not always enforceable against him personally. On a nonrecourse *purchase-money* loan or a carryback note, secured by the real estate acquired, the promise to pay money is only enforceable by foreclosure on the real estate, and is not enforceable by way of a money judgment against the payors who signed the note. [See Chapter 25]

NOTE SECURED BY DEED OF TRUST

Installment — Interest Included

$_____, dated _____, 20_____, at _____, California.

1. In installments, for value received, I, jointly and severally, promise to pay to

1.1 _____, as the Payee, or order,

1.2 at _____,

1.3 the sum of _____ DOLLARS,

1.4 with interest from _____, 20_____, on unpaid principal,

1.5 at the rate of _____% per annum.

2. Principal and interest payable in installments of _____ DOLLARS, or more,

2.1 on the _____ day of each _____ month,

2.2 beginning on the _____ day of _____, 20_____,

2.3 and continuing until _____, 20_____, when the principal is due and payable.

2.4 Principal and interest payable in lawful money of the United States.

2.5 Each payment shall be credited first on interest then due and the remainder on principal.

3. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note holder.

4. _____

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5. In any action to enforce this Note, the prevailing party shall receive attorney fees.

6. This Note is secured by a DEED OF TRUST.

Payor's Name: _____	Payor's Name: _____
Signature: _____	Signature: _____
Payor's Name: _____	Payor's Name: _____
Signature: _____	Signature: _____

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1.1 Identification of creditor as payee

The **unconditional promise to pay** must be made to a specific person or persons, whether the person is an individual or an entity, called the *creditor* and entitled the *payee*.

The **name of the lender** or carryback seller as creditor must be entered in the note for it to be enforceable, unless their identity is apparent from the conduct of the parties by the receipt and acceptance of payment. [**Schweitzer** v. **Bank of America N. T. & S. A.** (1941) 42 CA2d 536]

The words "or order" immediately following the name of the creditor (the lender or carryback seller) allow the creditor to *assign* the note. The buyer not only promises to pay the creditor, but the words "or order" extend this promise to whomever the creditor assigns the note and trust deed. [See **first tuesday** Form 445]

The "or order" provision also allows the creditor to designate someone to collect payments and service the note on the creditor's behalf, called *contract collection*. [See **first tuesday** Form 237]

1.2 Place of performance

The note must specify the place where payment is to be made, usually the city or county in which the creditor lives or does business.

If the note is not clear as to the place of performance — delivery of the payments — the location of the creditor is the appropriate place for performance.

The place of performance is important since it determines the proper court for any litigation between the parties, called *venue*, should the note be unsecured and in default, or be a recourse note secured by a trust deed which has been wiped out by the foreclosure of a senior trust deed holder.

If a lawsuit involves the secured real estate, such as a judicial foreclosure, the location of the real estate, called *situs*, determines the county where the action will be filed. [California Code of Civil Procedure §392]

However, if the action only involves a dispute over the terms of the note, not the trust deed, then the place of performance or the location of the carryback seller would be a proper venue. [**Dawson** v. **Goff** (1954) 43 C2d 310]

1.3 The amount of the principal debt

Unless the dollar amount of the **original debt** is entered in the body of the note, the note will be unenforceable due to the uncertainty of the amount due. Also, a note which does not specify the dollar amount of the debt is nonnegotiable. [Com C §3104]

The principal amount of the debt which is entered in the body of the note, like the amount identifying the note, is not necessarily the actual amount of the original debt. Often, the actual principal amount of the debt differs from the dollar amount stated in the note, due to adjustments and prorates in the sales escrow creating the note.

The actual principal amount of the debt on close of escrow is often entered on the back of the note as an endorsement or attached to the note in an *allonge* at the close of escrow.

Generally, escrow is handed a note which has been signed before the note amount is entered, together with instructions to enter the actual principal amount of the debt on closing.

1.4 Interest accrual commencement date

Here, the note specifies the date interest begins to accrue on the principal debt. A rate of interest is not required to make a note enforceable.

Usually, interest begins to accrue on the date escrow closes. However, at the time the note is prepared, the date escrow will actually close is not yet known.

If the exact date interest is to begin to accrue has not been set by prior agreement, the space for the accrual date is left blank when the note is prepared. Escrow is then instructed to fill in the date when closing occurs, or correct the date by *endorsement* or an *allonge* entered or prepared by escrow.

1.5 The interest provision

The note specifies the annual interest rate charged by the lender or carryback seller.

If an interest rate is not called for in the note, interest will accrue at the legal rate (10%) after the due date for payment of the principal. [**Bank of United States** v. **Foreman** (1929) 102 CA 756]

A lender or a carryback seller is not required to charge any rate of interest at all, in which case the rate of interest would be entered as zero. However, the carryback seller must be aware he will report interest income for tax purposes at an *imputed rate*, the applicable federal rate (AFR) for the note, when he charges a rate less than the AFR. When interest is **imputed**, the principal amount of the note is reduced and allocated to interest for the seller's tax reporting purposes only. The buyer and the note are unaffected by the seller's tax issues. [Internal Revenue Code §483; see Chapter 31]

Also, instead of a fixed rate of interest, the parties may agree to a different method of figuring interest, such as an adjustable rate mortgage (ARM) or a shared appreciation at maturity (SAM) note. [See Chapter 11]

2. Installment provision

Here, the dollar amount of each installment of principal and interest is entered on the note.

Only the amount of the constant regular installments are stated in the body of the note. Additional amounts of principal only payments, accrued and unpaid interest, or balloon payments are entered elsewhere on the face of the note.

By the terms of the note, the borrower or buyer promises to pay installments in the amount stated, "or more."

The "or more" clause, unless deleted or restricted by the entry of other provisions, allows the buyer to prepay a portion or all of the debt at any time by making principal payments larger than the amount of periodic installments. Other prepayment provisions added to the note may bar the use of the "or more" clause, or place a dollar penalty on additional principal payments which are paid as allowed by the or more clause. [See Chapter 4]

The lender can charge and enforce a dollar penalty for early payment of principal, within statutory and case law limitations on penalty amounts, if the penalty is provided for in the note. [See Chapter 13]

The lender or carryback seller may negotiate a deletion of the words "or more" to prohibit the buyer from prepaying the note in some situations. Thus, the buyer is **locked into paying only** the agreed-to installments. [See Chapter 14]

2.1 Time of performance

In this section of the note, the day of the month a payment will be due and the period between the payment of installments are entered.

The installment period establishes the frequency of payments and is defined by the number of one or more months separating these payments.

Installment payments are typically due on a monthly basis, payable on the first day of each consecutive month. Thus, the payment period entered on the note is "consecutive" if the installments are due every month. If they are due every other month, the period entered is "second", or "third" if due quarterly, etc.

A payment becomes delinquent the day after its due date, unless a *grace period* is provided by statute or by agreement in the note. A **grace period** extends the time after the due date for the lender or carryback seller to **actually receive** the payment before it becomes delinquent, *allowing* a late charge to be assessed or foreclosure to be commenced. [See Chapter 12]

2.2 First payment date

The date the payment of installments is to begin is entered on the note in this section. Often, the date of the first payment is 30 days after escrow closes. Alternatively, the commencement of payments could be the first day of the month first following 30 days after the close of escrow, in which case escrow should be instructed to credit the seller with interest which will accrue through the end of the month of closing.

2.3 Date of final payment

Installment payments are to continue until the note is due or paid in full.

Unless prior agreements call for a final/balloon payment, the note should read: "*and continuing until* ***paid****"*, with the word "paid" being entered in the space provided for a date. If a final/balloon payment has been agreed to, enter the date of its payment. Often the due date is set as a fixed period of years after the close of escrow, in which case escrow will be instructed to enter the date of this anniversary when the date is known to escrow—on closing.

2.4 Form of payment

All payments made on a promissory note entered into in the United States, unless agreed to the contrary, are to be made in United States currency, either cash, check, money order or cashier's check. If an off-shore currency or other medium of exchange (such as a weight of gold) is to be used, the note must provide for it.

2.5 Interest accrual

The note provides for installment payments to be credited first toward interest accrued and then to principal, called an *accrual note*.

NOTE SECURED BY DEED OF TRUST

Installment Note — Interest Extra

$_____, dated _____, 20_____, at _____, California.

1. In installments as herein stated, for value received, I/we, jointly and severally, promise to pay to

1.1 _____, as the Payee, or order,

1.2 at _____,

1.3 the sum of _____ DOLLARS,

1.4 with interest from _____, 20_____, on unpaid principal,

1.5 at the rate of _____% per annum.

2. Interest payable on the _____ day of each _____ month,

2.1 beginning on the _____ day of _____, 20_____.

3. Principal payable in installments of _____DOLLARS, or more,

3.1 on the _____ day of each _____ month,

3.2 beginning on the _____ day of _____, 20_____,

3.3 and continuing until _____, 20_____, when the principal is due and payable.

4. Principal and interest payable in lawful money of the United States.

5. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note holder.

6. _____

7. In any action to enforce this Note the prevailing party shall receive attorney fees.

8. This Note is secured by a DEED OF TRUST.

9. ☐ See attached Signature Page Addendum. [**ft** Form 251]

Payor's Name: _____	Payor's Name: _____
Signature: _____	Signature: _____
Payor's Name: _____	Payor's Name: _____
Signature: _____	Signature: _____

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On an **accrual note**, interest is charged only on *unpaid* principal. Interest is calculated and paid periodically after the interest has been earned — accrued. Interest is not prepaid by the terms of an accrual note.

An accrual note differs from an *add-on note*. Interest on an **add-on note** is charged on the original loan amount for the entire term of the loan. The entire amount of interest is then added to the original loan amount to set the total amount of principal and interest to be paid over the life of the note. Computation of interest amounts and principal payoffs on add-on notes are controlled by the Rule of 78.

3. Default provision

The failure of the borrower or buyer to timely pay an installment on the note allows the note holder to declare the note due, called *acceleration*.

The right to accelerate the loan balance is exercised by calling the unpaid principal due. Acceleration does not operate automatically on the occurrence of a triggering event, such as a material default. Thus, the holder of the carryback note must act to call the loan by making a demand on the property owner to pay all sums due. [**Green** v. **Carlstrom** (1963) 212 CA2d 240]

However, a proper call is unenforceable until after a foreclosure has been commenced and the reinstatement period has expired, except in the case of an incurable breach, such as an acceleration under a due-on clause or waste provision. If the debt is secured by a trust deed on real estate, the owner of the real estate has up to five business days before the trustee's sale to cure the default by bringing the loan current and paying no more than the statutorily authorized costs of foreclosure, called *reinstatement* of the loan. [Calif. Civil Code §2924c]

A similar **reinstatement** right exists for notes secured by mobilehomes and automobiles. [CC §2983.3; Calif. Health and Safety Code §18037.5]

However, when the note is secured solely by a security interest in personal property other than a mobilehome or automobile, the lender can accelerate the entire balance due on any default. The terms of the note allowing the personal property lender (except in the instance of mobilehomes and automobiles) to call do not permit a reinstatement of the note and no statutory right to a reinstatement period exists. [Com C §9623]

Further, when the note is **unsecured**, the option to accelerate is not restricted. Any reinstatement permitted must be voluntarily agreed to by the holder of the note. [**Messner** v. **Mallory** (1951) 107 CA2d 377]

4. Additional provisions

Optional provisions for inclusion in the note may be negotiated in purchase agreements, loan agreements, and escrow instructions, such as:

- additional principal payments;
- a prepayment penalty; [See Form 418-2 in Chapter 9]
- late charges and grace periods; [See Form 418-1 in Chapter 11]
- compounding on a default; [See Form 418-1 in Chapter 11]

- a balloon payment notice; [See **first tuesday** Forms 418-3 and 419]
- extension of the due date; [See **first tuesday** Forms 418-3 and 425]
- an option for a payoff discount; [See Form 418-2 in Chapter 9]
- the right of first refusal on the sale of the note; [See **first tuesday** Form 418-4]
- reference to a guarantor; [See **first tuesday** Form 418-5]
- an exculpatory clause; and [See **first tuesday** Form 418-5]
- governing law. [See Chapter 10; See **first tuesday** Form 418-5]

An all-inclusive provision is added to the note when the remaining balance of any encumbrance on the secured real estate is included in the principal of the carryback note and remains the responsibility of the seller to pay, called an all-inclusive trust deed (AITD) note. [See Chapter 22]

5. Attorney fees

The note includes a promise to pay attorney fees if legal action is necessary to enforce or interpret the note.

Although the wording in some attorney fees provisions may appear to be one-sided against the borrower, California law automatically makes the recovery of attorney fees *reciprocal*. Thus, if the borrower is the winning party in litigation on the note and trust deed, he will recover his legal fees from the holder of the note, even though the holder may never have promised to pay attorney fees. [CC §1717]

The attorney fees provision applies not only to the original borrower and lender or carryback seller, but also to their grantees and assignees. For example, a buyer who acquires property subject to an existing loan without entering into a loan assumption agreement is not a party to the loan. However, he can collect legal fees in a successful lawsuit against the lender regarding the note and trust deed since the lender would be able to collect its attorney fees if it prevailed. [**Saucedo** v. **Mercury Savings and Loan Association** (1980) 111 CA3d 309]

Additionally, the attorney fees provision permits the prevailing party to recover their attorney fees even if the note and trust deed are declared void or unenforceable. [**Manier** v. **Anaheim Business Center Company** (1984) 161 CA3d 503]

6. Identification of security

The note states the debt is secured by a deed of trust.

However, neither the trustee under the trust deed nor the real estate which is the security need to be identified. The link-up is made through the trust deed reference to a note of the same date (or other date entered) with a corresponding amount due to the beneficiary on the note as payee.

7. Borrower identification and signature

At the bottom of the note, the borrower or the buyer, also known as *debtor, payor, obligor* or *trustor*, signs and thus identifies himself as the person promising to pay money to the creditor, whether the creditor is a lender or a carryback seller.

Neither the lender nor the carryback seller signs the note or the companion trust deed.

Chapter 6 Special provisions for a promissory note

This chapter presents provisions which may be added to a promissory note, as supplements to the basic provisions in regular note forms.

Beyond fundamental debt obligations

A *promissory note* contains a buyer's **promise to pay** a private lender or carryback seller the principal amount of the debt agreed to, plus any interest. The note is **evidence** the debt exists.

The schedule and conditions for payment of the principal and interest are also contained in the note.

In contrast, provisions in a *trust deed*, besides referencing the note and describing the real estate liened to secure the debt, primarily address the **maintenance and preservation** of the noteholder's *security interest* in the real estate.

Special provisions added to a note serve to:

- **protect** the noteholder against risk of loss due to late payments, early payoff or other defaults on the note; and
- **comply** with statutorily mandated provisions for controlled transactions.

Special provisions to be considered for inclusion in a **promissory note** include:

- a prepayment penalty [See Figure 1];
- due date extension [See Form 418-3 §2.2 accompanying this chapter; see **first tuesday** Form 425];
- compounding on default [See Figure 2 §2.6];
- balloon payment notice [See Form 418-3];
- grace period and late charges [See Figure 2];
- option for payoff discount [See Figure 3];
- right of first refusal on sale on the note [See Form 418-4 accompanying this chapter];
- reference to a guarantee agreement [See Figure 4 §2.1];
- exculpatory clause [See Figure 4 §2.2]; and
- governing law. [See Figure 4 §2.3]

Prepayment penalties

A prepayment penalty is a charge voluntarily incurred by agreement when a debtor pays off principal on a note before the principal is due by the terms of the note. [See Chapter 9]

A prepayment penalty is enforceable if it is reasonably related to money losses suffered by a private lender or carryback seller, such as the payment of profit taxes incurred by a carryback seller on a premature reduction in principal or final payoff. [**Williams** v. **Fassler** (1980) 110 CA3d 7]

The amount of the prepayment penalty the private lender or carryback seller can charge depends on:

- the **type** of property; and
- the owner's **use** of the property.

A prepayment penalty on a note secured by an owner-occupied, one-to-four unit residential property, when more than 20% of the original amount of the note is prepaid in any 12-month period, is limited to no more than six months' advance interest on any principal prepaid in excess of 20% of the original balance. [See Figure 1 §2.1]

The prepayment penalty on a note secured by an owner-occupied, one-to-four unit residential property may only be charged in the first five years of the note. **After five years**, the note can be prepaid without a penalty. [Calif. Civil Code §2954.9(b)]

Figure 1 *Excerpt from **first tuesday** Form 418-2 — Prepayment of Prinicpal Provisions*

2.1 *For owner-occupied, one-to-four residential units*:

☐ If Payor voluntarily or involuntarily pays in any 12-month period within five years after origination an amount in excess of 20% of the original principal amount of the note before it is due, a prepayment penalty is due, on demand, in the amount of six months' advance interest on the amount prepaid in excess of 20% of the original principal balance amount, except as prohibited by law on the use of any due-on clause.

2.2 *For broker-made/-arranged loans on owner-occupied, single family residences* [Calif. Business and Professions Code §10242.6(a)]:

☐ If Payor voluntarily or involuntarily pays in any 12-month period within seven years after origination an amount in excess of 20% of the remaining principal amount of the note before it is due, a prepayment penalty is due, on demand, in the amount of six months' advance interest on the amount prepaid in excess of 20% of the remaining principal balance, except as prohibited by law on the use of any due-on clause.

2.3 *On all other residential and nonresidential property*:

☐ If all or part of the principal is paid, voluntarily or involuntarily, before it is due, a prepayment penalty is due, on demand, in the amount of _____% of the principal prepaid in excess of the principal included in the regularly scheduled payments, except as prohibited by law on the use of any due-on clause.

FINAL/BALLOON DUE DATE PROVISION

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to a promissory note

1.1 ☐ of same date, or dated _____, 20_____ at _____, California,

1.2 entered into by _____, as the Payor,

1.3 in favor of _____, as the Payee, and

1.4 secured by a trust deed on real estate referred to as _____

_____.

AGREEMENT:

2. In addition to the terms of the above referenced promissory note, Payee agrees to the following checked provisions:

2.1 *For final/balloon payment notes secured by one-to-four unit residential property*:

☐ This note is subject to Calif. Civil Code §2966, which provides that the holder of this note shall give written notice to Trustor, or his successor(s) in interest, of prescribed information at least 90 and not more than 150 days before any final/balloon payment is due.

2.2 *For extending the due date for a final/balloon payment*:

☐ The due date will be extended for _____ year(s) if:

a. ☐ all monthly installments due within _____ month(s) of the final/balloon payment due date have been received prior to their delinquency.

b. ☐ _____

_____

_____

Payor's name: _____	Payor's name: _____
Signature: _____	Signature: _____
Payor's name: _____	Payor's name: _____
Signature: _____	Signature: _____

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On a loan arranged by a mortgage loan broker and originated by a private lender which is secured by an owner-occupied, single family residence (SFR), up to 20% of the remaining principal balance may be prepaid in any 12-month period without penalty.

The penalty on broker-arranged loans for any prepaid principal exceeding 20% of the remaining balance is limited to six months' advance interest on the excess principal reduction. However, the penalty may be imposed for up to **seven years** after origination of the loan. [Calif. Business and Professions §10242.6; see Figure 1 §2.2]

On notes secured by other than owner-occupied, one-to-four residential units, the noteholder may charge a prepayment penalty limited in amount and time only by reasonableness.

However, if the noteholder intends to collect a prepayment penalty should he ever call the note under a due-on clause in his trust deed (excluding one-to-four unit residential property), the payor must sign or initial a separate prepayment penalty provision which includes a waiver of his right to prepay without a penalty. [CC §2954.10; see Figure 1 §2.3]

Late charges and grace periods

A late charge provision in a trust deed note usually permits collection of an additional one-time fee or interest accrual on the amount of the delinquent payment of principal and interest. [See Chapter 11]

On notes secured by real estate, except a note secured by an owner-occupied single family residence (SFR) or a loan made or arranged by a mortgage loan broker, the **late charge** assessed for the delinquent payment of an installment must be an amount *reasonably related* to:

- the private lender's or carryback seller's actual out-of-pocket losses incurred in preforeclosure collection efforts; or

- the value of the lost use of the delinquent funds. [CC §1671; see Figure 2 §2.3]

Figure 2 *Excerpt from **first tuesday** Form 418-1 — Late Payment Provisions*

2.1 *For an owner-occupied, single family residence*:

☐ Any installment on this note not received within 10 days after the due date is delinquent and will incur a late charge, on demand, in the sum of 6% of the delinquent principal and interest installment amount.

2.2 *For a broker-made/-arranged loan on any property* [Calif. Business and Professions Code §10242.5(a)]:

☐ Any installment on this note not received within 10 days of the due date is delinquent and will incur a late charge, on demand, in the sum of 10% of the delinquent principal and interest installment amount.

2.3 *On other than owner-occupied, single family residences or broker-made/-arranged loans*:

☐ If any installment on this note is not received ☐ when due, or ☐ within _____ days of the due date, the installment will be delinquent and will incur a late charge, on demand, in the sum of ☐ $_____, or ☐ _____% of the delinquent principal and interest installment amount.

2.4 *For a broker-made/-arranged loan on any property, final/balloon payment late charge* [Calif. Business and Professions Code §10242.5(c)]:

☐ If the final/balloon payment due on this note is not received within 10 days after the due date, the final/balloon payment will be delinquent and will incur a late charge on the delinquency and thereafter, on demand, for each month the final/balloon payment remains unpaid. The late charge will be the sum of 10% of the largest scheduled monthly installment on the Note.

2.5 *For a balloon payment late charge on other than owner-occupied, single family residences or broker-made/-arranged loans*:

☐ If the final/balloon payment is not paid by the due date, the remaining principal balance will thereafter accrue at the rate of _____%.

2.6 *For compounding interest on a default on other than one-to-four residential units*:

☐ On default in the payment of a principal and interest installment when due, the unpaid interest will be added to the remaining principal balance and accrue interest at the same rate as the principal debt until the delinquent payment and the accrued interest on the delinquent interest are received.

RIGHT OF FIRST REFUSAL TO BUY NOTE

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to a promissory note

1.1 ☐ of same date, or dated _____, 20_____, at _____, California,

1.2 entered into by _____, as the Payor,

1.3 in favor of _____, as the Payee, and

1.4 secured by a Trust Deed on real estate referred to as _____
_____.

AGREEMENT:

2. In addition to the terms of the above referenced Note and Trust Deed, Payor agrees to the following:

Right of first refusal to buy:

3. Payee hereby grants Payor a right of first refusal to purchase the Note and Trust Deed.

4. Should Payee decide to sell an interest in the Note and Trust Deed, Payee shall notify Payor of the terms on which Payee is willing to sell and assign the Note and Trust Deed.

4.1 Payor has the option, for a period of _____ days after receiving notice, to purchase the Note and Trust Deed on the terms stated in the notice.

4.2 Should Payor fail to exercise the option within the option period, Payee has the right to sell the Note and Trust Deed to a third party on the same terms stated in the notice to Payor.

4.3 Any sale on different terms reinstates the right of first refusal.

5. If the Note and Trust Deed is not sold and assigned within six months after Payor's receipt of notice, the right of first refusal is reinstated.

6. _____
_____
_____
_____

Payor: I agree to the terms stated above.	**Payee: I agree to the terms stated above.**
Date: _____, 20_____	Date: _____, 20_____
Payor's Name: _____	Payee's Name: _____
Signature: _____	Signature: _____
Payor's Name: _____	Payee's Name: _____
Signature: _____	Signature: _____

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A typical late charge provision takes the form of a flat fee or a percentage of the monthly installment or note balance.

However, a late charge provision in a note specifying an increased interest rate on the **entire remaining principal** on default of any monthly installment, called a *default interest rate*, is unenforceable since it is a penalty provision in disguise.

A penalty provision is **void** if it fails to reasonably estimate compensation for the lender's losses caused by the default. The rate of interest on a default can only be applied to the delinquent principal and interest payment since only an installment is delinquent, not the entire principal balance of the note. [**Walker** v. **Countrywide Home Loans, Inc.** (2002) 98 CA4th 1158]

The amount of a late charge on any note secured by an **owner-occupied SFR** is limited to the greater of:

- 6% of the delinquent principal and interest installment; or
- $5. [CC §2954.4; see Figure 2 §2.1]

For loans made or arranged by a real estate broker and secured by **any type of real estate**, a late charge on delinquent monthly payments is limited to the greater of:

- 10% of the delinquent principal and interest payment; or
- $5. [Bus & P C §10242.5(a); see Figure 2 §2.2]

A default on the balloon payment

When a broker-arranged loan contains a due date for a balloon payment, a late charge may be assessed if the balloon payment is not received within ten days after the due date.

The maximum enforceable late charge assessed on the a delinquency of a balloon payment on a **broker-arranged** loan, which can be further assessed for each following month the balloon payment remains unpaid, is an amount equal to the maximum late charge imposed on the **largest installment payment scheduled** in the note. [Bus & P C §10242.5(c); see Figure 2 §2.4]

On all installment sales, except for an owner-occupied SFR, an **increased interest rate** on the remaining principal, triggered by a delinquency of the final/balloon payment, is an acceptable late charge provision. [**Southwest Concrete Products** v. **Gosh Construction Corporation** (1990) 51 C3d 701; see Figure 2 §2.5]

Figure 3 *Excerpt from **first tuesday** Form 418-2 — Prepayment of Prinicipal Provisions*

2.4 *Discount for early payoff provision*:

☐ Payor is hereby granted the irrevocable right to purchase or pay off and fully satisfy the note on payment of the sum equal to the principal remaining unpaid less a _____% discount, plus accrued interest and future advances, for the period expiring _____, 20_____.

Figure 4 *Excerpt from **first tuesday** Form 418-5 — Note Enforcement Provisions*

2.1 **Guarantee provision**

☐ The Note is guaranteed by _____, under a Guarantee Agreement dated _____, 20_____, at _____, California. [See **ft** Form 439]

2.2 **Exculpatory provision**

☐ Enforcement of the Note and Trust Deed is subject to the purchase money anti-deficiency provisions of Code of Civil Procedure §580b.

2.3 **Governing law provision**

☐ This Note is governed by California law.

However, as a late charge, any increase in the interest rate triggered by a delinquency is still controlled by reasonableness. [Garrett, *supra*]

For carryback SFR notes and broker-arranged loans, an installment is not late if paid within ten days after the installment is due, called a *statutory grace period*. [CC §2954.4; Bus & P C §10242.5]

Also, on an SFR note or broker-arranged loan, the private lender or carryback seller cannot charge more than one late charge per delinquent monthly installment payment — no matter how long the payment remains delinquent. [CC §2954.4(a); Bus & P C §10242.5(b); see Chapter 12]

Compounding on default

A *compounding-on-default interest provision* is triggered by a delinquency in a payment. Compounding causes interest to accrue on the interest contained in the delinquent installment at the note rate until the delinquent payment and compounded interest are paid. [See Figure 2 §2.6]

Compounding interest provisions are used in lieu of flat fee or percentage late charge provisions.

Under a compounding interest provision, the reinstatement amount includes the delinquent principal and interest payment plus the additional compounded interest which has accrued.

A compounding interest provision is a type of **late charge** since it penalizes the borrower and is triggered by a delinquency in a payment, although no case or statute defines it as such.

As a late charge, the limitations on amounts and grace periods for late charges apply to the enforcement of provisions calling for compounding on default.

Balloon payment notice

A balloon payment is a final lump sum payment of remaining unpaid principal, which is due on an earlier date than had the periodic payment schedule continued until the principal was fully amortized. [See Chapter 12]

A **balloon payment note** secured by an owner-occupied, one-to-four unit residential property is a note which contains provisions for:

- a *final payment* which is more than twice the amount of any of the six regularly scheduled payments preceding the date of the balloon payment; or

- a *call provision*. [CC §§2924i(d), 2957(b), (c)]

A **call provision** gives the private lender or carryback seller the right to demand final payment at any time after a specified period.

All balloon payment notes secured by one-to-four unit residential property must include a reference to the buyer's right to receive a *balloon payment notice* 90 to 150 days before the due date. [CC §§2924i, 2966; see Form 418-3]

Failure to include the balloon payment notice provision in the note does not invalidate the note, but enforcement of the note's balloon payment provision is continued until the 90-day notice requirements are met. [CC §2966(d)]

Extension of due date

A provision may grant the buyer an extension of the due date for a **final/balloon payment** conditioned, for example, on the payment of all scheduled installments without delinquency, or on other consideration, such as a charge or change of terms. [See Form 418-3 §2.2]

An agreement to extend the due date in a carryback note should be considered by a buyer when the term of the note is for a short period of time (less than five years) and the buyer is uncertain about the source and availability of funds for payoff.

Discount for early payoff

A buyer's right to pay off the note early is usually documented in the form of an option to buy the note at a discount. [See Form 418-4]

A carryback seller who prefers to be cashed out before the due date set in his trust deed note could include a discount provision to encourage the buyer to pay off the note within a lesser time period than the due date period. The provision can be structured to give the buyer several months to exercise the option to pay off the debt at a discount on the face value (or remaining balance) of the note.

By exercising the option, the buyer who executed the note may either buy the note and trust deed from the seller by an assignment or request a reconveyance of the trust deed.

Right of first refusal

When the noteholder decides to sell the note, a *right of first refusal* provision contained in the note or a separate agreement allows the owner of the secured real estate to purchase or pay off the note. [See Form 418-4]

If the noteholder decides to sell the trust deed note, the buyer is notified of the amount necessary for payoff.

The **payoff amount** will be the sales price of the note and is set based on the lesser of either:

- the noteholder's listing of the trust deed note for sale, or their offer to sell the note; or
- an offer from an investor to purchase the note, which, if accepted, must be accepted contingent on the buyer's exercise of the right to pay off the note.

The buyer, to exercise the right of first refusal, must then match the price.

However, when granting the right of first refusal, the noteholder must be careful not to set the price in advance by stating a price in the right of first refusal provision.

If the payoff amount is set by a prior agreement, the seller is bound by the amount, even if market conditions allow for a higher value when the seller decides to sell the note.

Guarantor

To protect the private lender or carryback seller from loss due to a default on his trust deed note, the private lender or seller may require a third party with sufficient assets to become *liable on call* for all amounts due

under the note and trust deed, called a *put option*. By guaranteeing the note, a guarantor literally agrees to buy the note from the private lender or carryback seller, a legal process called *subrogation* or *equitable assignment*.

The private lender or carryback seller has three types of third party assurances:

- a co-owner's signature on the note and trust deed;
- a co-signer's signature on the note only; or
- a personal guarantee of the note by one other than the buyer.

When a third party signs the note, the third party becomes **liable for repayment** of the note, subject to anti-deficiency rules protecting co-owners on any type of foreclosures and co- signers on trustee's foreclosures. [California Code of Civil Procedure §580b]

However, if a third party agrees to guarantee the note and trust deed, a **guarantee agreement** is signed by the third party and is **enforceable separately** from the note and trust deed. [See Form 439 in Chapter 39]

If the note is guaranteed, a provision may be included in the note to reference the separate guarantee agreement. [See Figure 4 §2.1]

By referencing the separate guarantee agreement in the note, everyone is on notice of the additional security for the note provided by the guarantee.

Exculpatory clause

An *exculpatory clause* in a note converts a lender's recourse paper into nonrecourse paper. When the note carried back by a seller is either separately or additionally secured by property other than the property sold, the note becomes recourse paper. Thus, the buyer needs to consider negotiating for inclusion of an exculpatory clause as a provision in the note. [See Figure 4 §2.2]

When an exculpatory clause is included in a cross-collateralized note (two or more properties are described in the trust deed as the security), neither the private lender nor the carryback seller can obtain a money judgment for any deficiency on a judicial foreclosure of the secured property. Thus, the note has agreed-to anti-deficiency protection. [See Chapter 46]

Governing law

A private lender or carryback seller involved in negotiating a carryback sale with an out-of-state buyer must include a *choice-of-law* provision to assure judgments arising from disputes on the note will be based on California law. [See Chapter 46; see Figure 4 §2.3]

Chapter 7 Adjustable rate notes

This chapter considers the use of an adjustable rate note (ARM) by a carryback seller during periods of low short-term interest rates when it is foreseeable those interest rates will rise.

Editor's note — This chapter does not apply to ARMs originated by private lender loans secured by owner-occupied, one-to-four unit residential properties as they, unlike carryback ARM notes, are heavily regulated by state law and federal agencies. [Calif. Civil Code §1916.7]

Bargaining for real estate's inflation hedge

The seller of a parcel of any type of real estate agrees to carry back a note secured by the property. The sale will take place during a phase in the business cycle when real estate related interest rates are rising or are likely to rise in the future.

The seller and his listing agent have indications that both short-term and long-term interest rates are going to maintain (or begin) an upward swing over the next few years of national economic or inflationary upturn.

The **resale value** of a fixed-rate note negotiated before the rise in rates will be decreased by any future rise in interest rates. A future loss of value in the note is an event any seller wants to consider avoiding. The seller wants to be able to sell or pledge the note in the future without having to deal with a loss in its value caused by rising interest rates which were foreseeable.

Can the carryback seller receive both the current interest rate charged for fixed-rate loans and any future increase in interest rates without renegotiating the interest rate on his carryback note every year or two based on due-dates or call options?

Yes! A carryback seller and his prospective buyer can agree to an adjustable rate mortgage (ARM) note. ARM provisions give the carryback seller both the current market rate for fixed-rate loans and a rate adjustment on each future increase in short-term interest rates. Thus, he reduces his risk of a loss in the value of his note due to inflation. [See Form 433 accompanying this chapter]

For the carryback seller to benefit from any future increases in short-term interest rates, the terms negotiated for the note need to include a provision for periodic adjustments of interest, based on:

- a rise in figures in the index selected, such as the twelve month treasury average; and
- an agreed-to margin representing the spread between the current figure in the selected index and the market rate charged by private lenders for fixed-rate loans.

Negotiating a carryback ARM

An agent solicits a seller of income producing property to list the property for sale on terms which include a carryback of short-term junior financing by the seller, called an *installment sale*. The carryback will assist a buyer in financing the price he will pay to purchase the property. The current market rate for a comparable fixed-rate loan made by a second trust deed lender is, say 10%.

ARM Checklist

When negotiating an adjustable rate mortgage (ARM) loan or carryback note, the listing agent, borrower and private lender or carryback seller will need to establish:

- the amount of the note;
- the initial interest rate on the note;
- the frequency of interest rate adjustments;
- the index and margin to be used to adjust the interest rate;
- the life-of-loan floor and ceiling interest rates;
- the amortization period for setting the amount of the periodic principal and interest payments; and
- the due date for the final/balloon payment.

The seller wants to offset the financial risk of what he believes will be a future money market of rising interest rates driven by consumer inflation fears, asset inflation with its excess demand for mortgage funds and corporate financing, and massive government borrowing in lieu of tax revenues.

To hedge against rising rates, the seller wants an adjustable rate of interest on any note he agrees to carry. The initial interest rate sought by the seller for the first six months will be the current market rate for private loans. When the initial interest period runs, the note rate will adjust upward every six months to match any periodic increase in rates as reflected by an index tied to short-term interest rates for treasury bills.

The carryback seller wants his interest rate adjustments to be set by figures from an index based on short-term rates. He believes short-term rates will be driven upward by the Federal Reserve (Fed) more rapidly than long-term rates, and remain up for many months after the decline of long-term rates as the Fed fights inflation.

In addition to an **index figure**, an *interest rate margin* must be set to make the periodic adjustment in the interest rate on the carryback note. The amount of the margin will be added to the index figure to establish the periodic interest rate on the carryback note, called the *note rate*.

When negotiating the amount of the **margin**, consider basing it on the percentage spread between:

- the interest rate currently charged by private lenders on comparable fixed-rate second trust deed loans; and
- the current figure from an index for short-term treasury rates (one-year T-Bills) or lender cost-of-funds (11th District cost-of- funds).

ADJUSTABLE RATE NOTE SECURED BY DEED OF TRUST

NOTE: Not for use by private lenders on owner-occupied, one-to-four unit residential property. [Calif. Civil Code §1916.7]

$_____, **DATED** _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

1. In installments, I _____, as the Payor,

1.1 promise to pay to_____, as the Payee, or order,

1.2 at _____,

1.3 the sum of _____dollars ($_____) plus interest.

2. Interest to accrue from _____, 20_____ on the unpaid principal at an initial yearly rate of _____ % through the last day of the month of _____, 20_____.

On the first day of the following month and every _____ month thereafter, until paid, interest will be adjusted to the note rate calculated as follows:

2.1 The note rate is the sum of the Index Figure and the Margin, rounded to the nearest one-hundredth of one percent (0.01%).

2.2 The index used to calculate the note rate of interest will be the ☐ 11th Federal Home Loan Bank Board District cost-of-funds, or ☐_____.

The Index Figure for the third month prior to the month of the adjustment date will be used to calculate the adjusted interest rate. If the selected index is no longer available, the Note Holder will select a new index which is based on comparable information.

2.3 A margin of _____% will be added to the index figure to determine the note rate of interest.

2.4 The interest rate of this note shall not rise above _____ %.

2.5 The interest rate of this note shall not fall below _____ %.

3. Principal and interest is payable in monthly installments on the first day of each month, beginning _____, 20_____, and continuing until _____, 20_____, when the principal is due and payable.

3.1 The initial installment of principal and interest is to be $_____.

3.2 Monthly installments payable beginning the next month following each note rate adjustment will be changed to an amount sufficient to pay off the remaining principal at the adjusted note rate over an amortization period of _____ years from the date interest first commenced on this note.

3.3 Borrower may prepay all or part of the outstanding principal amount at any time without penalty.

3.4 Principal and interest payable in lawful money of the United States.

3.5 Each payment to be credited first on interest then due and the remainder on principal.

3.6 In the event this note evidences a money loan and the interest on this note exceeds the limit allowed by usury law and the loan is not exempt from usury laws, excess interest will be applied to the principal.

4. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note Holder.

5. ☐ Special provisions attached.

6. In any action to enforce this agreement, the prevailing party shall receive attorney fees.

7. This note is secured by a trust deed.

Payor: _____	Payor: _____
Signature: _____	Signature: _____
Payor: _____	Payor: _____
Signature: _____	Signature: _____

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Thus, with the amount of the margin set for the life of the carryback note, the carryback seller's yield on the note will change every sixth months as the index figures issued by the government change, reflecting any increase or decrease in short- term interest rates.

In our example, the current market rate for comparable fixed-rate loans originated by private lenders is 10%.

The index agreed to is the one-year constant maturity treasury index, which is at 4%. The margin agreed to is 6%, the difference between the market rate on fixed-rate loans made by private lenders (10%) and the index figure (4%).

Thus, when short-term interest rates increase as the economy or inflation picks up, and the index figure rises as a result, the interest rate on the note will be adjusted accordingly.

Editor's note — In periods when short-term interest rates have peaked or are in decline, as occurred in the early-1980s, in 1989, in 2001, and again in 2007, it is often advantageous for buyers to finance purchases by using an ARM. ARM financing allows their payments to drift downward with declining short-term interest rates. Later, when the note rates on fixed rate loans are at a reduced level, the buyer then refinances the ARM with a fixed-rate loan to provide permanent long-term financing if he intends to continue owning the property.

Conversely, the moment ARM rates move downward to the benefit of buyers, carryback sellers should arrange fixed-rate notes with prepayment penalties to cover losses of future earnings due to an early payoff during a period of reduced rates, part of the normal process during a recession.

Carryback seller

A carryback note provides the seller with a steady stream of relatively management-free future income.

The carryback seller understands an adjustable rate mortgage (ARM) note would help maintain his present *real rate of return* by adjusting his yield to keep up with any increase in inflation. He also knows potential buyers are unlikely to make offers containing terms for a carryback ARM when fixed-rate loans are plentiful and cheap. Also, arranging regular carryback financing, especially an ARM, is foreign to most brokers and agents who began negotiating real estate transactions after the mid 1990s.

What can the seller do to encourage buyers to make an offer containing a provision for a carryback ARM?

The seller and his listing agent should publish information on the seller's willingness to carry back an ARM as detailed in the listing agreement, making the carryback information available to the public and other brokers. Publishing listing information is accomplished primarily through multiple listing services (MLS), electronic networks, flyers and newspapers.

However, if an offer submitted to the seller by a buyer does not include a carryback ARM, the seller can include the carryback ARM in the terms of a counteroffer by preparing and attaching an ARM agreement as an addendum referenced in the counteroffer. [See Form 155-1 accompanying this chapter]

ARMing the AITD

A carryback seller includes an all-inclusive provision in an adjustable rate mortgage (ARM) note to create an all-inclusive ARM.

CARRYBACK ARM ADDENDUM

NOTE: Recommended for use with **first tuesday** Form 150 through 159. Not for use by private party on owner-occupied, one-to-four unit residential property. [California Civil Code §1916.7]

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to the following agreement:
☐ Purchase agreement, ☐ Option, ☐ Counteroffer, ☐ Escrow,
1.1 ☐ of the same date, or dated _____, 20_____, at _____, California,
1.2 entered into by _____
1.3 regarding real estate referred to as _____.

TERMS: Buyer to pay the purchase price as follows:

2. ☐ Cash down payment through escrow, including deposits, in the amount of . . . . . $_____
2.1 Other consideration to be paid through escrow . . . . . $_____

3. Buyer to obtain a ☐ first, or ☐ second, trust deed loan in the amount of . . . . . $_____
payable approximately $_____ monthly for a period of _____ years, interest on closing not to exceed _____%, ☐ ARM _____.

4. ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by _____ with an unpaid principal balance of . . . . . $_____
payable $_____ monthly until paid, including interest not exceeding _____%, ☐ ARM, ☐ plus monthly taxes/insurance impound payments.
3.1 At closing, loan balance differences per beneficiary's statement(s) to be adjusted into:
☐ cash, ☐ carryback note, or ☐ sales price.
3.2 The impound account to be transferred ☐ with charge to Buyer, or ☐ without charge to Buyer.

5. ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by _____ with an unpaid principal balance of . . . . . $_____
payable $_____ monthly, including interest not exceeding _____%, ☐ ARM, due _____, 20_____. _____

6. Assume a bond or assessment lien of record in the amount of . . . . . $_____

7. An ARM Note for the balance of the purchase price in the amount of . . . . . $_____
to be executed by Buyer in favor of Seller and secured by a trust deed on the property junior to any above referenced financing, payable monthly, or more, amortized over _____ years, beginning on the first day of the month after closing, including interest from closing at the initial yearly rate of _____% for _____ months, and thereafter at the note rate adjusted every _____ months based on a margin of _____% over the 11th District cost-of-funds, or _____, with a life-of-loan ceiling rate of _____% and a floor rate of _____%, due and payable _____. [See **ft** Form 433]
7.1 This note and trust deed to contain provisions to be provided by Seller for:
☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐ _____
7.2 ☐ A Carryback Disclosure Statement is attached as an addendum. [See **ft** Form 300]
7.3 ☐ Buyer to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **ft** Form 412]
7.4 ☐ Buyer to hand Seller a completed credit application on acceptance. [See **ft** Form 302] Seller may terminate the agreement within _____ days of acceptance by delivering to Buyer, Buyer's Broker or Escrow written Notice of Cancellation based on Seller's disapproval of Buyer's credit. [See **ft** Form 183]

8. Total Purchase Price is . . . . . $ 0.00

I agree to the terms stated above.	**I agree to the terms stated above.**
Date: _____, 20_____	Date: _____, 20_____
Buyer: _____	Seller: _____
Buyer: _____	Seller: _____

If the existing loan wrapped by an all-inclusive trust deed (AITD) contains a variable interest rate provision, structuring the carryback AITD note as an ARM must be considered imperative. The ARM provision attached to an AITD note protects the dollar amount of the equity attached to the AITD note from shrinking during a rise in short-term rates.

Thus, ARM provisions in the AITD maintain the amount of the payment override (spread) in AITD installments when market rates rise and drive up the interest rate and the amount of the installment payments on the underlying ARM.

As the interest rate on the wrapped loan varies, the AITD's note rate and payment schedule will increase or decrease parallel to the changing interest rate and payments on the wrapped loan. Tying the AITD note rate and payment schedule to variations in the underlying ARM provides the seller with a constant yield and cash flow over the life of the AITD, equal to the override margin set in the AITD ARM note provision.

Converting the ARM note to an all-inclusive ARM only requires adding an all-inclusive provision from a fixed-rate AITD note to the ARM note. The added provision references the inclusion of the balance of the wrapped loan in the principal amount of the AITD note. [See Form 421 §3 in Chapter 34]

The all-inclusive provision is added to the ARM note by entering the provision on the face of the ARM note. If insufficient space exists on the face of the note, attach an addendum to the note which includes the provision and reference the addendum on the face of the note. [See **first tuesday** Form 250]

Chapter 8 Modification of the note

This chapter discusses the typical modifications of a note, the use of a note modification agreement for negotiations and the modification of note form to implement changes.

Changing provisions in a note

A promissory note is written evidence of a promise made to repay a loan or pay a carryback installment debt. The **provisions in the note** determine a borrower's or buyer's debt payment schedule and interest obligations.

During the life of a promissory note, a lender or carryback seller holding the note and the owner of the secured real estate may agree to change the terms of payment, such as to *modify*, *add* or *rescind* one or more of the note's provisions. Any change in the terms of a note requires:

- *mutual agreement* between the debtor (borrower or buyer) and the creditor (lender or carryback seller holding the note); and

- *consideration* given in exchange for agreeing to the modification, with the exception of bankruptcy. [See Form 426 accompanying this chapter]

Modifications of a note secured by a trust deed usually arise out of a financial necessity experienced by the owner of the secured property. Conversely, profit taxes a seller owes on payoff of his carryback note may cause the seller to be the one to bargain to extend the time for payoff.

The modification of a promissory note is a transaction controlled by rules of contract law. Thus, a written contract, in this example a note, can be modified by:

- a written agreement; or

- an oral agreement. [Calif. Civil Code §1698]

However, for an oral modification to be enforceable, both the lender and the borrower must put the oral modification into effect by taking action on it, called *execution*. To be certain of the modified terms they agreed to, the lender and the borrower must memorialize the modification in a writing.

Negotiations to modify the note are best implemented in writing by filling out a form designed to make an **offer to modify** the note. Importantly, the form functions as a checklist of issues the agent must consider when negotiating a modification. When filled out, the agreement sets forth the terms sought by the person initiating the modification effort. Typically an agent facilitates the negotiations. [See Form 426]

Once the agreement to modify has been negotiated and entered into to set the new terms for payment, a **Modification of the Promissory Note** form is prepared by the agent, broker or escrow officer involved. It is the modification form, not the agreement to modify form, which changes the terms of the **existing debt** from those originally stated in the note. [See Form 425 accompanying this chapter]

AGREEMENT TO MODIFY A PROMISSORY NOTE

DATE:_____, 20_____, at_____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. Creditor is the holder of a Note dated _____, in the face amount of $_____, executed by _____, as the Payor, in favor of_____, as the Payee.

1.1 The Note has a remaining principal balance of $_____, with interest paid through the _____ day of _____, 20_____.

1.2 Unpaid late charges, due and not included in the principal, equal $_____.

1.3 Advances unpaid, due and not included in principal, equal $_____.

2. The Note is secured by a trust deed of the same date recorded on _____, as Instrument No. _____, Records of _____ County, California, executed by _____, as the Trustor, in which _____ is the Beneficiary.

2.1 The real estate securing the Note under the trust deed lien is referred to as

_____.

Assessor's parcel number _____.

2.2 The Note is additionally secured by a trust deed or UCC-1 on other property described as

_____.

2.3 Impound account held by Beneficiary for property taxes and insurance has a balance of $_____.

2.4 The name of the Property Owner of the secured real estate is_____.

3. The trust deed securing the Note is subordinate to the following senior note and trust deed

3.1 recorded on _____, as Instrument No. _____, records of _____County, California, executed by _____, as the Trustor, in which_____ is the Beneficiary, securing a note in the face amount of $_____, with an unpaid balance of $_____, principal and interest payable $_____ monthly, including _____% interest, ☐ ARM, type _____, ☐ plus impounds, all due and payable _____, 20_____.

3.2 ☐ See attached addendum for further senior encumbrances.

4. The trust deed securing the Note has priority over the following junior note and trust deed

4.1 recorded on _____, as Instrument No. _____, records of _____County, California, executed by _____, as the Trustor, in which _____is the Beneficiary, securing a note in the face amount of $_____, with an unpaid balance of $_____, principal and interest payable $_____ monthly, including _____% interest, ☐ ARM, type _____, all due and payable _____, 20_____.

4.2 ☐ See attached addendum for further junior liens.

TERMS:

5. The Note is to be modified as follows:

5.1 Interest on the unpaid principal to be at the annual rate of _____%, commencing _____, 20_____.

5.2 Monthly payments shall be $_____, commencing with the month of _____, 20_____.

5.3 The remaining principal balance to be due and payable _____, 20_____.

5.4 ☐ **Impounds:** The Property Owner, with the payment of each Note installment, to deposit with Creditor one-twelfth ($\frac{1}{12}$) of the annual requirement for the payment of taxes and fire insurance. An advance deposit for such payment to be made to Creditor on modification in the amount of $_____.

6. ☐ See attached addendum for additional modifications of the Note and trust deed. [See **ft** Form 250]

7. Property Owner to deliver additional consideration to Creditor in the form of:

7.1 ☐ The Buyer of the secured property is to assume the Note. [See **ft** Form 431]

7.2 Out-of-pocket costs incurred by Creditor in the amount of $_____.

7.3 Bonus or points in the amount of $_____.

7.4 Payment toward reduction of the principal balance in the amount of $_____.

7.5 ☐ Additional, or ☐ Substitute, security for the Note in the form of a trust deed on property described as _____ _____, which will be junior to an existing trust deed securing a Note with an unpaid balance of $_____, payable $_____ monthly, or more, including interest of _____%, all due _____, 20_____.

7.6 ☐ Property Owner to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **ft** Form 412]

7.7 ☐ See attached addendum for additional consideration. [See **ft** Form 250]

AND IT IS FURTHER AGREED:

8. This offer will be deemed revoked unless accepted in writing within _____ days after date and acceptance is personally delivered to Offeror or Offeror's Agent within the period.

9. This transaction to be escrowed with _____. Signed instructions to be delivered to escrow as soon as reasonably possible after acceptance.

10. Escrow to be handed all instruments needed to close escrow ☐ on or before _____, 20_____, or ☐ within _____ days after acceptance. Property Owner to pay all escrow and title company charges.

11. The Note and trust deed are to be insured by _____ Title Insurance Company under:

11.1 A ☐ CLTA form policy, or ☐ ALTA form policy, of title insurance; or

11.2 ☐ An endorsement of the existing policy, held by Creditor; and

11.3 Showing title subject to property taxes, CC&Rs, and underlying trust deeds in §3;

11.4 With a specific subordination agreement to be obtained from all junior encumbrances listed in §4; and

11.5 Paid for by Property Owner.

12. ☐ Property Owner to obtain beneficiary statement(s) on underlying encumbrance(s) showing all payments to be current and confirming their terms and unpaid balance(s).

13. Creditor to incur no costs or charges under this agreement or the modification of the Note.

14. Brokerage Fee:

Property Owner on closing to pay Broker _____ a fee of $_____.

Broker's Name: _____ Broker's DRE Identification #: _____

Agent's Name: _____ Agent's DRE Identification #: _____

Signature: _____

Address: _____

Phone: _____ Fax: _____

Email: _____

I agree to the terms stated above.	**I agree to the terms stated above.**
Date: _____, 20_____	Date: _____, 20_____
Creditor's Name: _____	Property Owner's Name: _____
Creditor's Name: _____	Property Owner's Name: _____
Signature: _____	Signature: _____
Signature: _____	Signature: _____

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Provisions in the modification form identify the promissory note which it modifies, names the parties to the note and identifies the trust deed and the property involved in the transaction.

To complete the paper work called for in the agreement, the prepared and signed modification form is attached to the promissory note as an *allonge*, the terms of which then become part of the original note.

On a modification, the note itself should not be canceled or rewritten, especially if it is secured by a trust deed. The dates of the note and trust deed will differ if the note is redrafted, even though the debt evidenced by the new note remains the same with only a change in the terms for repayment of that debt. The different dates will cause difficulty on foreclosure or reconveyance of the trust deed since the recorded trust deed refers to the secured debt as that evidenced by a note "of same date" as the identification date on the trust deed.

Common modifications of a trust deed note include:

- a due date extension;
- interest rate changes;
- installment payments rescheduled or changed in amount, either temporarily or permanently;
- cash advances or accrued interest added to principal; and
- the addition of special provisions.

Owners of real estate encumbered by a debt secured by a trust deed lien, and lenders or carryback sellers as creditors holding that lien, agree to the modification of the note which evidences the debt for many reasons:

Scenario 1

A buyer of real estate is willing to cash out a seller's equity in real estate and **assume the existing** recourse loan which encumbers the property, called a *cash-to-loan* (CTL) transaction.

However, the seller is unwilling to remain liable for the recourse loan, even though the buyer agrees to assume the loan. Due to the listing agent's negotiations, the lender, buyer and seller agree to the buyer's **assumption** of the loan together with the lender's **release** of the seller from further liability on the loan, a combination of activities called a *novation*.

The novation agreement is accompanied by an agreement to modify the note held by the lender, the modification being the *consideration* received by the lender for its release of the seller's liability for the debt. The modification agreement calls for:

- an increase in the note's interest rate and monthly payments; and
- payment of an assumption fee to the lender.

MODIFICATION OF THE PROMISSORY NOTE

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is a modification of a promissory note

1.1 executed by _____, as the Payee,

1.2 in which _____, is the Payor,

1.3 dated _____, at _____, California,

1.4 in the original amount of $_____.

2. The promissory note is secured by a deed of trust of the same date

2.1 executed by _____, as the Trustor,

2.2 in which _____ is the Beneficiary,

2.3 recorded on _____, as Instrument No. _____,

in the records of _____ County, California,

3. regarding real estate referred to as _____

_____.

AGREEMENT:

4. The above mentioned promissory note is modified as follows: _____

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____

I agree to the terms stated above.	**I agree to the terms stated above.**
☐ See attached Signature Page Addendum. [**ft** Form 251]	☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: _____, 20_____	Date: _____, 20_____
Payee's Name: _____	Payor's Name: _____
Signature: _____	Signature: _____
Signature: _____	Signature: _____

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Scenario 2

An owner of real estate has property which is located on an earthquake fault line or in the path of the prevailing wind from a nuclear power plant. The existing trust deed loan encumbering the property is recourse paper.

The owner is concerned about his future liability exposure should an earthquake or nuclear disaster render the property valueless. If disaster **reduces the property's value** below the amount owed on the loan, the owner would be personally liable for the deficiency should the lender need to foreclose, and do so judicially, a risk of loss he wishes to eliminate.

The trust deed on the property calls for the owner to carry **earthquake insurance** which would shift the risk of loss from the owner to the insurance carrier. However, the premium for the insurance policy has become too expensive.

The owner seeks a loan modification with the lender, increasing the interest rate in exchange for:

- elimination of the earthquake insurance provision; and

- a release of the owner's liability should the security become impaired due to causes beyond his control, called an *exculpatory clause*. [See Chapter 6]

Scenario 3

A seller carries back a note and first trust deed on the sale of an unimproved parcel of real estate. Later, the buyer asks the seller to subordinate his carryback trust deed to a construction loan, an event which would increase the seller's risk of loss and automatically convert the carryback note to recourse paper.

The carryback seller will **subordinate** the carryback trust deed to a construction loan if the buyer modifies the note to increase the interest rate and monthly payments, and record a **Request for Notice of Delinquency** (NODq) and serve a copy on the senior lienholder. [See Form 412 in Chapter 48]

*Editor's note — The modification of the interest rate on a carryback note is not subject to usury laws, whether or not the modification is negotiated by a real estate broker. [**DCM Partners** v. **Smith** (1991) 228 CA3d 729]*

*If a modification or replacement note restructures the debt created by a carry back credit sale and the debt remains secured solely by the property sold, the debt remains outside the interest rate limitation imposed by the usury laws. The debt retains its original purchase-money anti-deficiency characteristics since the modified or replacement note evidences a **continuation** or* **rollover** *of the original carryback debt. [**Ghirardo** v. **Antonioli** (1994) 8 C4th 791; see Chapter 43]*

Scenario 4

A dispute arises between a buyer and carryback seller after the close of escrow about the **seller's representations** concerning the property's condition.

The carryback seller offers to modify the note by reducing the note balance and the monthly payments to compensate the buyer for an over-valuation of the property in exchange for the buyer releasing the seller from any further claims concerning the condition of the property and the purchase transaction.

The buyer agrees to modify the note and enter into a release and waive of any future claims as offered by the seller.

Scenario 5

An owner of real estate executes a trust deed note with a five-year due date. Later, with the due date of the final/balloon payment approaching, the owner realizes he will be unable to meet a demand for the final payoff of the note.

The owner contacts the noteholder to negotiate a **due date extension** for the payoff of the note.

The noteholder offers to extend the payoff date if the owner agrees to:

- a higher interest rate and increased monthly payments; and

- allow the noteholder to run a credit check for any change in the owner's financial status since originally entering into the note. [See Form 302 in Chapter 31]

Scenario 6

A seller carried back a note containing a five-year due date. By its terms, the note will soon be due.

However, the seller does not want the note paid off at this time since **capital gains taxes** will be due on the profit in the final/balloon payment. Payment of the taxes will reduce his net worth and income. Also, the current market interest rate is much lower than the interest rate on the carryback note.

The seller wants to negotiate an extension of the due date and include a prepayment penalty in the note, sufficient to cover his profit taxes if prepaid. The seller will lower the interest rate — possibly below market rates — in exchange for the buyer agreeing to an extension of the due date and a prepayment penalty.

Junior lienholder is subordinated

Most debts relating to real estate are secured by a **lien on title** to the real estate, typically a recorded trust deed which describes the property involved and is insured by a title company.

Since the priority of the trust deed is insured, an agreement to modify the trust deed note should always be conditioned on re-insuring the trust deed by obtaining a title insurance policy or an endorsement to the existing policy held by the lender or carryback seller.

Title insurance is needed to assure a lender or carryback seller of the **continued priority** of his trust deed as against the interest of others on title to the real estate.

For example, consider a property which is encumbered by first, second and third trust deed liens. The terms for payment of the second trust deed note are modified.

However, the modification of the interest rate, payments or due date, or a combination of these, cannot result in a substantial economic change in the terms of the debt which would put the third trust deed holder at a significantly greater risk of loss than already exists. If it does, the trust deed securing the modified note will lose its priority on title. To avoid loss of priority on a significant modification, the third trust deed holder must agree to being subjected to the greater risk of loss, called *subordination*.

Consider a holder of a first trust deed lien on a parcel of real estate who agrees to modify the trust deed note. The modification agreement entered into shortens the note's due date, raises the interest rate and increases the amount of principal due.

The holder of a second trust deed claims the first trust deed lien lost its *priority* to his trust deed since the modification of the first trust deed note significantly reduced the value of the second trust deed holder's security interest in the property.

The first trust deed holder claims only the modifications in the note lose priority to the second trust deed since only the modified portions of the note would impair the secured position of the second trust deed.

Here, the agreement which modified the original note does not have priority to the second trust deed, but the terms of the original note do retain their priority. Thus, the second trust deed lien remains unimpaired by the modification in the first trust deed note and in the same financial and legal position as when the second trust deed was recorded. [**Lennar Northeast Partners** v. **Buice** (1996) 49 CA4th 1576]

Now consider a seller who carries back a second trust deed on the sale of property which is subject to a first trust deed containing a due-on clause. The holder of the first trust deed note is not advised of the sale.

Later, the first trust deed lender learns of the sale and calls the loan. To avoid the call, the buyer assumes the first trust deed loan and modifies the note to shorten its due date.

On discovering the modifications, the carryback seller claims his second trust deed now has priority over the first trust deed since the modification on the note secured by the first trust deed substantially impairs his security by increasing the potential for default.

In this example, the modification of the note secured by a first trust deed without the consent of the junior carryback seller does not result in a change in trust deed priorities. The secured property was sold (and the seller accepted a second trust deed) without first obtaining the lender's prior written consent. Thus, the seller breached the due-on clause in the lender's trust deed. Due to the breach, no duty is imposed on the first trust deed lender to avoid impairment of the owner's second trust deed lien. [**Friery** v. **Sutter Buttes Savings Bank** (1998) 61 CA4th 869]

However, the modification of an existing trust deed note does not trigger the due-on clause in trust deeds of record on title to a property. Only the initial act of *creating* a security interest, such as occurs by recording a trust deed, not the later modifying of the secured note, triggers the due-on clause.

Title insurance

A policy of title insurance on the modification of a trust deed note is obtained to assure the trust deed holder that any junior trust deed liens of record will be considered junior after the note modification. An owner seeking the modification of the trust deed note usually pays the premium charged for the title insurance policy.

The junior trust deed holder, even if he has agreed to a *future subordination agreement* permitting the owner to later modify the senior trust deed note, will be required by the title insurance company to sign a *specific subordination agreement* on title company forms before the trust deed securing the modified note will be re-insured.

Chapter 9 Prepayment penalties

This chapter discusses the financial consequences experienced by an owner of real estate on the prepayment of a debt secured by the property when the note evidencing the debt includes prepayment provisions.

Debt reduction as a costly privilege

An owner of real estate who wants to reduce or pays off principal on a debt evidenced by trust deed note **before** it is due by its terms may have previously agreed to an extra or additional charge the lender can levy to reduce or pay off the debt, called a *prepayment penalty*. The penalty agreement is included in the promissory note, not a provision in the trust deed, since it relates to the payment of the debt, not the care and maintenance of the real estate.

The unscheduled prepayment of any principal on a debt before it is due by the terms of the note is considered a **privilege**. If a prepayment penalty provision is agreed to, a lender can exact a bonus on each exercise of the privilege, whether the reduction is a portion or all of the principal remaining on the debt. [See Form 418-2 accompanying this chapter]

Historically, prepayment penalties were used by lenders in an effort to prevent the loss of interest during the period following the receipt of principal until the funds were re-lent to another borrower.

California courts have embraced a number of rationales which support lender enforcement of the prepayment penalty, including:

- **Administrative costs**: The net costs and the loss of profit (earning) incurred by a lender on the unscheduled reduction of principal [**Hellbaum** v. **Lytton Savings and Loan Association** (1969) 274 CA2d 456];

- **Lag time**: The loss of interest income due to money sitting idle between payoff and re-lending [**Lazzareschi Investment Company** v. **San Francisco Federal Savings and Loan Association** (1971) 22 CA3d 303];

- **Lender profitability**: Use of the prepayment penalty as a device to enable lenders to maintain a generous loan portfolio yield [Lazzareschi Investment Company, *supra*];

- **Lender expectations**: When a lender is committed to a long-term return of funds, prepayment disrupts its expectations [Lazzareschi Investment Company, *supra*]; and

- **Loss due to falling market rates**: Income lost due to prepaid funds being re-lent at lower interest rates than originally bargained. [**Sacramento Savings and Loan Association** v. **Superior Court** (1982) 137 CA3d 142]

Economic reality

For each justification in support of the need to receive prepayment penalties offered by lenders, a counter-argument exists:

- **Administrative costs**: Costs incurred by lenders when re-lending the funds by making new loans are always recovered up-front. Items, such as loan origination fees and charges received by a lender to re-lend the funds from a payoff, always offset lender costs incurred to re-lend principal to fund new loans;

- **Lag time**: Cash on hand does not sit idle in today's lending institutions. Lenders used to have a saying, "Lettuce rots if it sits on the shelf." Unlike lettuce, prepaid funds are promptly re-invested in short-term securities until placed again in long-term mortgages; and

- **Lender profitability**: When lenders call loans on the transfer of the secured property, they do so only because they can re-lend the money at higher rates. They welcome the prepayment of fixed-rate loans in markets of rising interest rates since principal repaid and re-lent increases their portfolio yield and helps maintain profitability, the prepayment penalty earnings being a bonus.

While it can be argued lenders should have the right to collect prepayment penalties to compensate for losses incurred when re-lending funds in a declining interest market, this argument is inapplicable when interest rates are rising.

However, prepayment penalty provisions are enforced on premature principal payments in both rising and falling interest rate markets;

- **Lender expectations**: The *Hellbaum* and *Lazzareschi Investment Company* decisions stress the belief that having made long-term commitments, lenders can expect long-term benefits.

When viewed against lenders' adjustable rate lending practices and many of the portfolio yield claims made with regard to the due-on controversy, this argument fails to withstand analysis.

Lenders expect loans to be paid prior to maturity. Lenders take the risk of prepayment into consideration when setting interest rates or evaluating the worth of a portfolio of loans. The standard industry long-term projection shows the average mortgage prepays by its twelfth year. In California, the average in the 1990s was a mere five years due to several refinancing episodes as rates constantly declined, and again in the mid-2000s as home values doubled or tripled and refinancing conditions converted real estate equities into ATMs.

Such turnover generates profits from loan origination fees, points and interest rate adjustments. It is reasonable to assume prudent lenders base their annual profit projections on portfolio turnover.

Further, with the predominant secondary mortgage market, many institutional lenders pool and sell their mortgages on an advantageous change in interest rates, and generally do not own the mortgages with the intent of obtaining long-term income.

To justify prepayment penalties by citing lenders' expectations of long-term returns seems unjustified when viewed against adjustable rate loan (ARM) lending and loan turnover history; and

PREPAYMENT OF PRINCIPAL PROVISIONS

Penalties and Discounts

DATE _____, 20_____, at_____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to a promissory note

1.1 ☐ of same date, or dated _____, 20_____ at _____, California,

1.2 entered into by_____, as the Payor,

1.3 in favor of _____, as the Payee, and

1.4 secured by a trust deed on real estate referred to as _____

_____.

AGREEMENT:

2. In addition to the terms of the above referenced promissory note, Payee agrees to the following checked provisions:

2.1 *For owner-occupied, one-to-four residential units*:

☐ If Payor voluntarily or involuntarily pays in any 12-month period within five years after origination an amount in excess of 20% of the original principal amount of the note before it is due, a prepayment penalty is due, on demand, in the amount of six months' advance interest on the amount prepaid in excess of 20% of the original principal balance amount, except as prohibited by law on the use of any due-on clause.

2.2 *For broker-made/-arranged loans on owner-occupied, single family residences* [Calif. Business and Professions Code §10242.6(a)]:

☐ If Payor voluntarily or involuntarily pays in any 12-month period within seven years after origination an amount in excess of 20% of the remaining principal amount of the note before it is due, a prepayment penalty is due, on demand, in the amount of six months' advance interest on the amount prepaid in excess of 20% of the remaining principal balance, except as prohibited by law on the use of any due-on clause.

2.3 *On all other residential and nonresidential property*:

☐ If all or part of the principal is paid, voluntarily or involuntarily, before it is due, a prepayment penalty is due, on demand, in the amount of _____% of the principal prepaid in excess of the principal included in the regularly scheduled payments, except as prohibited by law on the use of any due-on clause.

2.4 *Discount for early payoff provision*:

☐ Payor is hereby granted the irrevocable right to purchase or pay off and fully satisfy the note on payment of the sum equal to the principal remaining unpaid less a _____% discount, plus accrued interest and future advances, for the period expiring _____, 20_____.

Payor's name _____	Payor's name _____
Signature _____	Signature _____
Payor's name _____	Payor's name _____
Signature _____	Signature _____

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- **Loss due to declining market rates**: For the declining market argument to succeed, penalties would be appropriate only when market rates drop below that of the prepaid loan, and only when the various front-end charges and points accruing over the life of the loan as well as the lender's cost of funds at the time of the prepayment are also taken into consideration.

Thus, it seems that all but the rarest situations, such as a catastrophic fall in long-term interest rates without a corresponding and immediate fall in short-term rates, prevent lenders from experiencing losses simply because of an early payoff.

Enforceable penalties

A property owner's right to prepay principal to reduce his debt or payoff and release the trust deed lien on his property is established by:

- the terms of the note;
- legislation and regulation; and
- case law.

A contractual bar against voluntary prepayment, called a *loan lock-in clause*, is **enforceable** if the borrower is aware of and agrees to the terms of the loan lock-in clause, unless:

- the note is secured by one-to-four unit residential property [Calif. Civil Code §2954.9(a)];
- the note is a variable interest rate secured by one-to-four residential units, and within 90 days of notification of a change in the rate, the borrower prepays the note [CC §1916.5(a)(5)];
- the debt is evidenced by a land sales contract which provides for the land to be subdivided into lots of one-to-four residential units and prepayment is postponed not more than 12 months [CC §2985.6(a)]; or
- the property subject to a trust deed is acquired for public use. [Calif. Code of Civil Procedure §1265.240]

Also, a seller carrying back a note secured by a trust deed on one-to-four unit residential property can **bar prepayment** in the calendar year of the sale, unless the seller has already carried back notes on more than four sales within the same year. [CC §2954.9(a)(3)]

Further, the amount a lender or carryback seller can charge on prepayment of the debt depends on:

- the type of property;
- the owner's use of the property; and
- the broker's involvement in negotiations.

Owner-occupied residential property

A prepayment penalty in a note, secured by an **owner-occupied, one-to-four unit residential property** can only be exacted during the first five years after closing, unless a broker is involved arranging the note. [CC §2954.9(b)]

When a loan is made or arranged by a real estate broker and secured by an **owner-occupied, single-family residence (SFR)**, a prepayment penalty may be agreed to an enforced during the seven years immediately following the recording of the trust deed. [Calif. Business and Professions Code §10242.6]

Collection of a penalty in both situations is limited to the amount of principal prepaid during any one calendar year which exceeds 20% of the original loan amount. Also in both cases, penalties cannot exceed an amount equal to six months interest on the amount prepaid which exceeds 20% of the original amount of the note. [Bus & P C §10242.6(a); CC §2954.9(b)]

Consider a buyer who enters into a purchase agreement to acquire vacant property on which he will build his home.

The seller carries back a note and trust deed on the property. The note contains a 33% prepayment penalty, an amount sufficient to cover the state and federal income tax due on the profit in the note on the seller's receipt of a payoff.

Later, the buyer pre-pays the note and the entire 33% prepayment penalty demanded by the seller. The buyer now seeks to recover the penalty he paid, claiming the prepayment penalty provision was unenforceable since the amount of the penalty exceeded the limits allowed on the prepayment of a note secured by an owner-occupied, one-to-four unit residential property.

The seller claims the limitation does not apply to the prepayment penalty since, at the time of purchase, the property was an undeveloped parcel of land.

Can the seller enforce the 33% prepayment penalty?

No! The carryback seller expected the property to become an owner-occupied residential property during the life of the debt by agreement. Thus, the *statutory limitation* on the amount of the prepayment penalty applied to the buyer's note, rendering the penalty unenforceable. [**Garver** v. **Brace** (1996) 47 CA4th 995]

Due-on clause and prepayment penalties

Other approaches are available to buyers and sellers of one-to-four unit residential property who want to avoid a prepayment penalty on the payoff of a debt.

Prepayment penalty provisions in all notes secured by a trust deed which contains a **due-on clause** and encumbers an owner-occupied, one-to-four unit residential property are unenforceable if the lender or carryback seller:

- calls the loan due for a transfer in violation of the due-on clause;
- starts foreclosure to enforce a call under the due-on clause; or

- fails during the pendency of the sale of property subject to the loan to approve, within 30 days of receipt of the completed credit application from a qualified buyer, the assumption of the loan or carryback note. [12 Code of Federal Regulations §591.5(b)(2), (3)]

However, a seller carrying back a note secured by a one-to-four unit residential property can **bar prepayment** only for the calendar year of sale, if he has not already carried back more than three notes in the same year. [CC §2954.9(a)(3)]

The five-year prepayment penalty rule which applies to buyer-occupants of one-to-four residential units does not apply to **investors** who buy one-to-four unit residential properties or any other property.

After the calendar year lock-in period expires, the one-to-four unit investor can **pay off** the carryback note at any time, subject to any reasonable, agreed-to prepayment penalty. [CC §2954.9(a)(1), (2)]

The prepayment penalty included in a seller carryback note secured by one-to-four residential units (or any other investment property) and **executed by an investor** can be set at 25% of any principal prepaid to cover the seller's potential state and federal profit tax liability on early payoff. Thus, the carryback seller's potential profit tax liability on an early payoff of principal on a note executed by an investor who bought the property can be fully recovered. The investor is not a buyer-occupant and the property is not one-to-four residential units. [CC §2954.9(a)(2), (3)]

A 25% bonus for the seller

A seller of real estate, other than a one-to-four unit residential property to be acquired by a buyer/occupant, informs his broker he will carryback paper for a substantial portion of the property's sales price after a 20% down payment.

The seller is aware the **profit** in the carryback note will not be taxed until principal is received or the note is assigned by sale or as collateral, called *hypothecation*.

The seller's broker determines the seller's remaining **cost basis** for the property is less than the balance of the trust deed lien on the property. Thus, the entire amount of the carryback note on an installment sale will be profit, subject to taxes as principal is paid, due to the seller's *mortgage-over-basis* situation.

If the seller were to receive cash, and thus be taxed on all of his profit in the year of the sale, he would pay a combined federal and California state income tax of approximately 25% of his profit (2009). Here, his profit consists of depreciation produced *unrecaptured gain* (25% federal tax for 2009) and value increased *long-term capital gain* (15% federal tax rate for 2009).

If the seller were to cash out at the time of sale, he would deposit the balance of his net proceeds remaining after the payment of taxes in an interest-bearing account. Thus, he would receive interest earnings on less than 75% of his equity, the other 25% being disbursed (in cash) to pay state and federal profit taxes.

However, with taxes deferred until later years by an installment sale, the seller will earn interest (at the carryback note rate) on the full amount of his equity remaining unpaid after the down payment.

Thus, the seller is motivated to **defer taxes** on his profit until the carryback note is due in, for example, five years. Meanwhile, the seller will earn interest on the amount of the profit tax he retains as principal in the carryback note.

Compensation for an early payoff

To accomplish the goal of earning interest income for a five-year period on that portion of the sales price which will eventually be paid as profit taxes, the broker presents the carryback seller with two alternatives:

- lock in the buyer to payments of no more than the scheduled installments by eliminating the "or more" provision in the note and prevent early payoff of additional principal; or

- include provisions in the note for a prepayment penalty to be due on the payoff of any principal in addition to scheduled installments.

The seller selects the prepayment penalty alternative after the broker voices concern over the enforceability of a *lock-in clause*. Deletion of the **or-more clause** prohibits principal reductions except under regular monthly payments and the final/balloon payment.

The seller and his broker agree to include a prepayment penalty in all negotiations. A 25% penalty on the payoff of any principal not included in regular monthly payments is estimated to be sufficient to cover the income taxes due on an early payoff of the note.

Can a carryback seller enforce a prepayment penalty in the amount of the estimated tax he will pay on his profit should the buyer pay off any additional principal within five years?

Yes! A prepayment penalty is enforceable if the penalty amount is reasonably related to the carryback seller's **anticipated money losses** for the premature payment of profit taxes likely to be incurred due to a prepayment of part or all of the principal on the carryback note.

Since the anticipated amount of profit taxes to be paid on an unscheduled principal reduction is the amount of the penalty, a 25% penalty on the prepayment of remaining principal is reasonable. [**Williams** v. **Fassler** (1980) 110 CA3d 7]

A prepayment penalty provision in a note secured by property other than buyer-occupied, one-to-four unit residential property is enforceable if the amount of the penalty is reasonably related to the note holder's loss.

Reasonableness of the penalty

The reasonableness of the penalty amount is tested **at the time** the note and trust deed are entered into, not years later on payoff when interest and tax rates may have gone through major fluctuations, either up or down. [Williams, *supra*]

Although a prepayment penalty inhibits conveyancing and reconveyancing, it is considered to be a **reasonable restraint** on the owner's use of his title, a use called *alienation*. [Sacramento Savings and Loan Association, *supra*]

An exorbitant or unconscionable penalty is unreasonable and cannot be enforced. The courts are here to monitor the amount of prepayment penalties to ensure they are reasonable. [Hellbaum, *supra*]

Consider a borrower who enters into a loan transaction with a lender. The borrower later prepaid the principal of the note. In determining the amount of interest needed to satisfy the obligation, the lender calculated interest for February, a short month, as one-twelfth of a year, roughly 30.4 days.

The borrower claims the lender's calculation of interest breached the terms of the note since it calculated interest on the basis of a 30.4-day month not the literal days in the month, and thus the lender was guilty of unfair business practices.

Can the lender enforce the prepayment penalty using the 30.4-day month calculation?

Yes! Even though February is shorter than 30.4 days, the lender can use the 30.4-day month interest calculation for determining the loan payoff since that method of calculation was consistent with the industry standard, federal regulations and a reasonable interpretation of the terms of the note. [**Julie Puentes et al** v. W**ells Fargo Home Mortgage, Inc.** (2008) 160 CA4th 638]

Thrifts and government lending programs

Federal savings associations, called *thrifts*, may charge agreed-to prepayment penalties on owner-occupied, one-to-four unit residential property. [12 CFR §560.34]

Further, since federal regulations control thrifts, the California five-year limit for prepayment penalties on owner-occupied homes does not apply unless agreed to by both the borrower and federal savings association.

For loans insured by the Federal Housing Administration (FHA) and Veterans Administration (VA), a prepayment penalty is not charged on early payoff. Instead, unearned interest to the end of the month of payoff is charged. [24 CFR §203.22(b); 38 CFR §36.4310]

Also, as a policy, the Federal National Mortgage Association (Fannie Mae) does not usually enforce the prepayment provisions of most conventional single family residence (SFR) loans. However, Fannie Mae will enforce a prepayment penalty provision if the loan is an adjustable rate note, second mortgage, or participation pool first trust deed.

The policy of the Federal Home Loan Mortgage Corporation (Freddie Mac) is not to charge prepayment penalties if it will hurt the consumer.

Many SFR loans originated for sale in the secondary mortgage market do not contain prepayment penalty clauses. Inquiry should be made into the inclusion of penalty provisions in the loans secured by the listed property.

Penalty enforced by foreclosure

Consider an owner who defaults on both the first and second trust deeds on his property. The default is not related to a failure to pay a call triggered by the due-on clause.

The first trust deed contains a prepayment penalty clause. The clause calls for payment of the penalty whether the note is *voluntarily* (i.e., refinance) or *involuntarily* (i.e., foreclosure) paid off before the final payment is due. The first trust deed lender records a Notice of Default (NOD) calling the note due, and ultimately records a Notice of Trustee's Sale (NOTS).

In the NOTS, the amount to pay off the loan includes:

- any unpaid principal balance;
- all accrued and unpaid interest;

- all late charges;
- all foreclosure costs (including attorney and trustee's fees); plus
- a prepayment penalty as agreed to in the note.

Neither the borrower nor the second trust deed lender *reinstate* the loan prior to five business days before the trustee's sale. Also, the second trust deed lender elects not to *redeem* the property. Instead, he decides to bid on it at the trustee's sale on the belief the penalty cannot be included in the bid since the loan is now due by the lender's enforcement of its terms.

At the sale, the first trust deed lender includes the prepayment penalty in its bid.

Can the first trust deed lender demand and collect a prepayment penalty charge at the trustee's sale?

Yes! The first trust deed lender's right to collect a prepayment penalty charge, unless the amount is limited by statutes, is set by the provisions of the note. Since the note provides for a prepayment charge whether the loan is **voluntarily or involuntarily** prepaid, the second trust deed lender or any other bidder at the trustee's sale must pay the penalty charge as part of the trustee's sale price. [**Golden Forest Properties, Inc.** v. **Columbia Savings and Loan Association** (1988) 202 CA3d 193]

However, when the note or trust deed limits a prepayment penalty charge to only **voluntary payoffs**, the first trust deed lender cannot include the charge when the property is redeemed or bid on at the trustee's sale. Many pre-1983 notes and trust deeds do not give the lender the right to collect a prepayment penalty when the lender called the loan and forced an involuntary payoff. [**Tan** v. **California Federal Savings and Loan Association.** (1983) 140 CA3d 800]

Prepayment penalty triggered by late payments

Now consider a lender who holds a note secured by a trust deed on real estate other than an owner-occupied, one-to-four unit residential property. The note contains a prepayment penalty provision which states a charge of six months unearned interest will be due on any payoff within six months after the origination of the loan.

The provision also states the prepayment penalty will be due on a later payoff if any regularly scheduled payment is delinquent when paid. The owner makes a regular payment after the grace period had expired.

After the initial six months, the owner prepays the loan together with the prepayment penalty demanded by the lender.

The owner claims the prepayment penalty is an unenforceable *liquidated damages* penalty since the penalty was imposed based on a late payment of a regular installment, not the amount prepaid, and was unrelated to losses the lender incurred on prepayment of the loan.

Can the lender enforce a prepayment penalty on a final payoff which was triggered by a late payment?

No! The prepayment penalty here is worded as a penalty for having paid a regular installment late. Thus, the purported prepayment provision becomes an unenforceable **liquidated damages** provision. The pre-

payment penalty on payoff was triggered by the owner's late payment of a regular installment, not the prepayment. Thus, the amount of the penalty bore no relation to the lender's losses due to the late payment. [**Ridgley** v. **Topa Thrift and Loan Association** (1998) 17 C4th 970]

Prepayment penalty due on a call

Consider a prepayment penalty clause in a seller carryback note which allows the seller to collect a penalty on **voluntary or involuntary prepayment** of the debt.

The buyer defaults on the trust deed. The seller calls the note due, demanding a prepayment penalty for full satisfaction and reconveyance of the debt.

The buyer tenders full payment of the debt excluding the prepayment penalty, which the carryback seller refuses.

The buyer claims the prepayment penalty clause is unenforceable since the penalty can only be applied when the buyer **voluntarily** prepays the debt.

The seller claims the prepayment penalty clause is enforceable since the penalty provision allows the seller to demand a prepayment penalty whenever the note is called.

Is the prepayment penalty clause enforceable when the note is called?

Yes! The prepayment penalty clause is enforceable on the note holder's acceleration of the debt. The clause permits the seller to demand a prepayment penalty on an involuntary prepayment resulting from the seller's acceleration of the balance due on the note, unless the call resulted from the seller's exercise of the due-on clause. [**Biancalana** v. **Fleming** (1996) 45 CA4th 698]

Chapter 10 Loan lock-in clauses

This chapter addresses the lender's and carryback seller's need to avoid loan lock-in clauses and use prepayment penalties instead.

Restraints on rights of alienation

A builder obtains a long-term permanent loan from a lender to finance his development and continued ownership of non-residential real estate or an apartment project. The loan is secured by a trust deed on the property. The trust deed note contains a *lock-in clause* prohibiting prepayment of the debt for the first 7 years of the loan. The note also contains a **prepayment penalty** which applies to any principal paid off during or after the 7-year lock-in period.

The loan originates during tight money market conditions when long-term interest rates are at a cyclical high (and construction costs are low).

Later, during the 7-year lock-in period, interest rates drop significantly. Wanting to take advantage of the lower market rates to refinance the property, the builder requests a payoff demand from the lender and a reconveyance of the trust deed lien.

However, the lender refuses to allow a payoff and reconveyance. The lender claims the builder is locked in for the first 7 years of the loan by contract which **bars prepayment and reconveyance** at any time during the lock-in period.

The builder claims the lock-in clause and the prepayment penalty are in conflict with one another, which allows him to pay off the loan provided he pays the prepayment penalty called for *on a default* during the lock-in period.

Is the builder prohibited from prepaying the locked-in loan?

Yes, according to contract law! The builder has agreed to be locked into the loan absolutely for the period agreed to in the note. The provision prohibiting prepayment, and the duration of the prohibition, was stated in the loan documents. Thus, the builder was aware of the provision barring prepayment, which he freely agreed to. [**Trident Center** v. **Connecticut General Life Insurance Company** (9th Cir. 1988) 847 F2d 564]

Enter real estate law for the greater good

However, a real estate matter of public concern exists in the *Trident Center* fact situation which was not addressed. The lock-in provision contained in the loan documents completely restricts the owner's right to **freely reconvey** and re-encumber his interest in a parcel of real estate.

When applying real estate law, a lock-in clause becomes an unenforceable *restraint on alienation*. A prohibited prepayment of debt and reconveyance of the trust deed lien from title is an absolute interference with the right to clear his title and transfer a security interest in real estate to another lender.

When a provision which functions as a restraint on alienation is unnecessary to protect the lienholder's security interest in the property against the risk of loss, it is unreasonable and unenforceable under real estate law. A payoff eliminates any risk of loss and any need for the lender to protect its security interest in the property. [Calif. Civil Code §711]

Also, an owner's right to a reconveyance can be significantly **inhibited** by the financial impact of a prepayment penalty. However, the monetary penalty for prepayment is not considered in real estate law to be an unreasonable restraint. Under a prepayment penalty, the owner has the ability to obtain a reconveyance and clear title of the lender's security interest in the property, albeit at a high cost in terms of money expended.

A prepayment penalty does not bar the reconveyance which clears title of the lender's security interest. It only makes a borrower's payoff on a demand for payoff more financially difficult.

Unlike a lock-in clause, the monetary **prepayment penalty**, though an economic constraint, still allows for the *voluntary use* of the property by the owner, whether it be a further encumbrance or a sale. [**Sacramento Savings and Loan Association** v. **Superior Court** (1982) 137 CA3d 142]

Conversely, the lock-in clause absolutely bars the owner from obtaining a reconveyance to clear his title and re-encumber his property. Thus, the lock-in clause is void under real estate law since the lender experiences no risk of loss on a payoff, either by impairment or default, which would give him the right to restrict the use of ownership rights. Lenders claim that without the lock-in provision they lose the expectation of the interest to be earned on the note, but this expectation is covered by the prepayment penalty.

However, recent judicial decisions, such as those in *Trident Center*, have attempted to resolve restraints on alienation based solely on general contract law theories, rather than under the historic judicial preference to apply more specific rules controlling interference with an owner's interest in real estate.

Public policy breach

Trident Center rests solely on the **contract doctrine** that a restraint on alienation provision is valid if it is willingly entered into between an owner and a lender of relatively equal and sophisticated bargaining power.

However, **real estate law**, which is the foundation for real estate rights, prohibits unreasonable restraints on alienation no matter how contracted, or how aggressively the lender bargains to achieve an agreement from the borrower consenting to the restraint. The lock-in, as a contractual provision, attempts to trample ancient **public policy** which demands title remain unfettered and available to the real estate marketplace.

The prohibition of restraints on transfers of real estate interests gives property owners the right to voluntarily use or convey the many ownership rights and interests held in their real estate. This right is subject to lender interference only when it is necessary for the lender to protect himself from an increased risk of loss and interference by third parties holding involuntary liens, such as the Internal Revenue Service (IRS). [**Garber** v. **Fullerton Savings and Loan Association** (1981) 122 CA3d 423]

The owner's right to use his ownership interests, in spite of contractual provisions to the contrary, is historically long-standing. Court decisions imposing contract law theories to override the pre-existing statutory rights of owners to alienate real estate now jeopardize the property owners' right to freely transfer encumbered property in the real estate marketplace.

Contract law vs. real estate law

A seller carries back a note secured by a trust deed on the sale of his income producing property.

A boilerplate provision in the trust deed allows for prepayment of the note, subject to an early payoff penalty.

However, the trust deed note includes an additional typewritten provision which states the buyer is locked in to making monthly installments, and is prohibited from prepaying the note prior to its due date. Also, the "or more" clause is not stricken from the boilerplate provisions in the note.

Thus, the carryback note and trust deed include **conflicting provisions**, two in the printed form which permit prepayment and a reconveyance of the property without penalty, and one added to the printed note form which prohibits prepayment and reconveyance entirely.

The buyer, after making payments on the note, attempts to pay off the note prior to its due date.

The seller claims the addition of the lock-in clause in the note prohibits prepayment since the buyer agreed to the provision, which has authority over conflicting preprinted provisions.

The buyer claims the lock-in clause is unenforceable since the boilerplate and additional provisions in the note are inconsistent, allowing prepayment and reconveyance limited only to the payment of a monetary penalty.

Can the buyer be completely prohibited from prepaying the note, even though the boilerplate provision in the note provides for prepayment?

Yes! Under contract law, the buyer can be prohibited from prepaying the note.

When preprinted boilerpate provisions and additionally entered provisions in a set of documents are in conflict, the **added provisions control**. Thus, even if a provision allowing prepayment is located in the boilerplate provisions of a note, the additionally entered lock-in clause, which is in conflict, controls under contract law theory. [**Gutzi Associates** v. **Switzer** (1989) 215 CA3d 1636; CC §1651]

Restraints vs. the need to protect

However, under the more specific real estate law, any lock-in provision prohibiting the release of real estate interests is a restraint on alienation. The *Gutzi* case agreed, but held the restraint was *reasonable* since the property owner failed to demonstrate the unreasonableness of the interference. No request for payoff was ever made on the lender by the owner and no interference actually occurred.

The *quantum of restraint* on the sale or refinance of real estate necessary for the provisions in a note or trust deed to be unenforceable under real estate law is **weighed against** the lender's need to protect its investment from a risk of loss.

A contracted for lock-in clause becomes an unreasonable restraint on alienation if it causes transferable real estate rights to be unavailable to the marketplace under any present circumstance. [**Kendall** v. **Ernest Pestana, Inc.** (1985) 40 C3d 488]

The owner's ability to reconvey a lender's security interest, while concurrently encumbering the property by recording a trust deed to another lender with the same priority on title, or transferring the property to a cash buyer, is directly and absolutely barred by a lock-in clause.

When a lock-in clause imposes a restraint on an owner's right to reconvey and release liens of record, and this imposition cost is greater than that experienced by the lender due to an early payoff, the lock-in clause is an unenforceable provision.

Enforceable vs. unenforceable restraints

Prepayment of real estate loans is allowed, regardless of provisions in a note and trust deed prohibiting early payoff, when:

- the note is secured by four-or-less, owner-occupied residential units [CC §2954.9(a)];
- the note has a variable interest rate and on notification of a change in the rate, the borrower may prepay within 90 days [CC §1916.5(a)(5)];
- the debt is a land sales contract which provides for land to be subdivided into lots of four-or-less residential units [CC §2985.6(a)];
- the prepayment penalty clause is not sufficiently specific to allow enforcement [**Donahue** v. **LeVesque** (1985) 169 CA3d 620]; or
- the property subject to a trust deed is acquired for public use. [Calif. Code of Civil Procedure §1265.240]

Conversely, a lock-in clause is enforceable in two limited **carryback situations** when necessary to assure installment sales profit tax treatment. For example, the buyer of four-or-less residential units can only be locked into the trust deed note and barred from prepayment during the **calendar year** of sale. [CC §2954.9(a)(3)]

After the lock-in period expires, the buyer has the right to pay off the note at any time, subject to the prepayment penalty agreed to and as limited by law. [See Chapter 13]

The other is the repayment of a seller carryback documented as a land sales contract on four-or-less residential units which can be prohibited for up to a 12-month period following the sale. [CC §2985.6(a)]

Carrybacks and the lock-in

A carryback seller's primary motivation for locking in the buyer is his desire to prevent the seller's premature payment of profit taxes which would be due on an early payoff of the note.

Carryback sellers **reporting profits** on the installment sales method limit their taxable profit in any one year to the pro rata share (contract ratio) of profit in the principal paid on the note. The installments received each year on a carryback note typically include only a small amount of principal. Thus, use of a lock-in clause bars early payoff of principal, one method for allowing the seller to take full economic advantage of the tax deferral in **installment sales reporting**. [Internal Revenue Code §453; see Chapter 54]

However, the carryback seller's protection from premature reporting of profit and the resulting tax liability is not best remedied with the problematic lock-in clause, but by inclusion of the judicially acceptable prepayment penalty provision. [**Williams** v. **Fassler** (1980) 110 CA3d 7]

Lenders and lock-ins

For lenders, a lock-in clause is a portfolio tool to assure a consistent, long-term yield on a loan, regardless of actual market rate fluctuations during the life of the loan.

Locking in the borrower to prevent early payoff of loans made during periods of expected high future inflation and high interest rates is the lender's long-term profit motive. As cyclical inflation is inevitably broken by government monetary policy, the *real rate* of return to the lender, and thus real earnings, increases on the old fixed-rate loan.

As inflation abates, the lock-in clause protects the now excessive **real rate** of return, an economic distortion delivering a **windfall profit** to the lender due solely to government monetary policy moves. The profit in the lender's portfolio yield is the spread between the rate of inflation (cost of funds) and the note rate. As an exaction to enforce a right to protect a loan from loss, portfolio yield interference has been denounced in California as being beyond the legitimate purpose of a trust deed lien on real estate. [**Wellenkamp** v. **Bank of America** (1978) 21 C3d 943]

*Editor's note — A **real rate of return** is the difference between the rate charged on the loan and the present rate of inflation. Thus, the note rate the lender receives is broken down into the inflation rate and a real rate of return.*

Chapter 11 Late charges and grace periods

This chapter analyses the purpose of late charge provisions in trust deed notes and limitations on their enforcement by carryback sellers and private lenders.

Related amounts are enforceable

A seller carries back a note and trust deed on the sale of any type of real estate. The note calls for his buyer to pay periodic installments by the first day of each consecutive month commencing the month first following 30 days after the close of escrow, called the *payment due date*. The note also calls for the debt to be paid in full seven years from the close of escrow, called a *final balloon payment*.

Further, the note contains a **late charge provision**. It states that for a period of ten days following the due date for a payment it may be delivered before the seller may impose a late charge, called a *grace period*. If a past-due payment is not yet received by the seller before the grace period expires, the payment is then considered *delinquent*.

When an installment becomes **delinquent**, the late charge provision calls for the note rate of interest accruing on the principal amount of the entire remaining debt to be increased by 2% (200 basis points) and accrue thereafter until the delinquency is cured, an arrangement called a *default rate.*

The seller does not receive an installment before it becomes delinquent. The seller makes a **written demand** on the buyer to pay the delinquent installment, together with a daily amount equal to the 2% additional interest on the entire principal balance as the late charge until the seller receives the delinquent installment. The additional interest accrues on a per diem basis between the expiration of the grace period and seller's receipt of the delinquent installment.

The buyer tenders the delinquent payment, but refuses to pay the late charge. The buyer claims the default rate provision is an unenforceable *liquidated damages provision* — a penalty — since the amount exceeds the out-of-pocket money losses the seller incurred due to the delinquency of an installment.

The seller claims the late charge is enforceable since the buyer agreed to the charge in the note and the actual costs incurred by the seller in his efforts to collect the delinquent payment are difficult to ascertain.

Can the seller enforce the default rate late charge provision in the note?

No! As a late charge, the amount is unreasonable and thus unenforceable. The provision is an attempt to impose a penalty which is triggered by the delinquency in the payment of a scheduled installment. However, the amount of the late charge for the delinquency is calculated as a rate of interest accruing on the **entire debt**, not limited to interest on the amount of the delinquent principal and interest payment for which collection is sought. Thus, the late charge is based on amounts owed, but not yet due or delinquent.

For all notes secured by any type of real estate, a late charge provision calling for the charge to be calculated as a rate of interest on the entire principal balance to ascertain the amount of the late charge incurred for the delinquency of a monthly installment, is a *disguised penalty provision.*

Disguised penalty provisions are void and thus unenforceable. To be enforceable, the noteholder's compensation under a late charge provision is limited solely to his out-of-pocket **monetary losses** caused by the delinquency in the payment. No wild-fall profits can be taken when a payment is delinquent. [**Garrett** v. **Coast and Southern Federal Savings and Loan Association** (1973) 9 C3d 731]

Elements of a late charge

To establish the right to enforce collection of a late charge, the following conditions must be met by the noteholder:

- a **late charge provision** exists in the note [See Form 418-1 accompanying this chapter];
- a scheduled payment is **delinquent**;
- a **notice of amounts due** is delivered to the payor assessing the late charge and demanding its payment [See **first tuesday** Form 419-2];
- the **dollar amount** of the late charge is within the limits set by applicable lender statutes and *reasonableness standards*; and
- **accounting requirements** for semi-annual and annual reports have been complied with. [See **first tuesday** Form 419-3]

The failure of an owner to pay a late charge of a proper amount and for which a demand has been made on the delinquency of a payment is a *non-material breach* of the note and trust deed. As a non-material breach, the failure to pay late charges cannot be the sole monetary basis for initiating a foreclosure by recording a notice of default (NOD).

Distinctions exist in the treatment of late charges permitted for private lender loans as compared to charges permitted for seller carryback paper. For private lenders, late charges on loans **secured by single family residences** (SFRs) are treated differently than when they are secured by other types of property. Also, the amount of the late charge a private lender may impose is further controlled by whether or not the loan was **made or arranged** by a broker.

The negotiation of late charge provisions

Late charge provisions are included in all notes used by **institutional lenders**. Late charge provisions sought by institutional lenders are generally non-negotiable, due primarily to lender adherence to established uniformities, such as ceilings set by statute or pooling arrangements in the secondary mortgage money market. However, the inclusion of late charge provisions in notes carried back by **sellers** or originated by **private lenders** is never automatic and is left to negotiation.

Before a late charge provision is included in a note, the charge must be agreed to. When the late charge is one of the carryback note provisions agreed to in a **purchase agreement**, it is then proper for escrow to be instructed to include the applicable late charge provision in the note prepared for signatures. [See **first tuesday** Form 150 §8.1]

LATE PAYMENT PROVISIONS

Addendum to Promissory Note

DATE_____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to a promissory note

1.1 ☐ of same date, or dated _____, 20_____, at _____, California,

1.2 entered into by _____, as the Payor,

1.3 in favor of _____, as the Payee, and

1.4 secured by a trust deed on real estate referred to as _____
_____.

AGREEMENT:

2. In addition to the terms of the above referenced promissory note, Payee agrees to the following checked provisions:

2.1 *For an owner-occupied, single family residence*:

☐ Any installment on this note not received within 10 days after the due date is delinquent and will incur a late charge, on demand, in the sum of 6% of the delinquent principal and interest installment amount.

2.2 *For a broker-made/-arranged loan on any property* [Calif. Business and Professions Code §10242.5(a)]:

☐ Any installment on this note not received within 10 days of the due date is delinquent and will incur a late charge, on demand, in the sum of 10% of the delinquent principal and interest installment amount.

2.3 *On other than owner-occupied, single family residences or broker-made/-arranged loans*:

☐ If any installment on this note is not received ☐ when due, or ☐ within _____ days of the due date, the installment will be delinquent and will incur a late charge, on demand, in the sum of ☐ $_____, or ☐ _____% of the delinquent principal and interest installment amount.

2.4 *For a broker-made/-arranged loan on any property, final/balloon payment late charge* [Calif. Business and Professions Code §10242.5(c)]:

☐ If the final/balloon payment due on this note is not received within 10 days after the due date, the final/balloon payment will be delinquent and will incur a late charge on the delinquency and thereafter, on demand, for each month the final/balloon payment remains unpaid. The late charge will be the sum of 10% of the largest scheduled monthly installment on the Note.

2.5 *For a balloon payment late charge on other than owner-occupied, single family residences or broker-made/-arranged loans*:

☐ If the final/balloon payment is not paid by the due date, the remaining principal balance will thereafter accrue at the rate of _____%.

2.6 *For compounding interest on a default on other than one-to-four residential units*:

☐ On default in the payment of a principal and interest installment when due, the unpaid interest will be added to the remaining principal balance and accrue interest at the same rate as the principal debt until the delinquent payment and the accrued interest on the delinquent interest are received.

Payor's name _____	Payor's name _____
Signature _____	Signature _____
Payor's name _____	Payor's name _____
Signature _____	Signature _____

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The provision and the late charge amount

For a late charge provision to be complete, it must include:

- the **amount** of the late charge;
- the **duration of any grace period** following the due date before a payment becomes delinquent; and
- a **requirement for notice** from the trust deed holder to impose – assess – the late charge and make a demand for its payment. [See Form 418-1]

The amount of a late charge imposed on the delinquency of a payment on a debt secured by real estate, except private loans secured by an owner-occupied single family residence (SFR) or loans made or arranged by a broker, must be *reasonably related* to money losses incurred by the creditor (carryback seller and non-SFR private lenders) due to the delinquency. [Calif. Civil Code §1671; see Form 418-1 §2.3]

While late charge provisions are triggered by the delinquency of a periodic payment or the final/balloon payment, the late charge agreed to is not automatically due. Unless the delinquency is immediately preceded or followed by a notice imposing the charge and demanding its payment, the charge is *waived*. [CC §2954.5]

The reasonable amount of **monetary losses** collectible as a late charge include:

- the actual *out-of-pocket expenses* incurred in a reasonable collection effort; and
- the *lost use* of the principal and interest (PI) portion of the delinquent payment.

Money losses incurred in a reasonable effort to collect a late payment include the cost of forms, envelopes and postage for mailing the notice, and the administrative time spent by individuals to do so prior to recording a notice of default (NOD).

Even if the late charge provision is void as excessive and constituting a financial windfall to the carryback seller or private lender, the buyer is still liable for the seller's or lender's out-of-pocket money losses resulting from the delinquency, if assessed and payment demanded. [Garrett, *supra*]

When a scheduled payment is not received prior to its becoming delinquent, a late charge provision in an installment note properly calls for either:

- an additional one-time fixed fee stated as a dollar amount; or
- the accrual of interest on the amount of the delinquent PI payment.

For example, a one-time late charge takes the form of a **flat fee**, such as $50.00, or a **percentage** of the monthly PI installment, such as 6%. Infrequently, a late charge is disguised as an unenforceable default interest rate charged on the entire principal, as presented in this chapter's opening example.

Fundamentally, any formula or percentage figure used to determine the amount of a one-time late charge is questionable. A lender is only entitled to be reimbursed for his costs and efforts of collection. When a formula or percentage figure is used in larger loans to calculate the amount due they are suspect since the

issue of *unjust enrichment* for the lender arises. The same amount of time, effort and funds are expended in the collection of a delinquent payment on a $50,000 loan as are expended on a $500,000 loan, but use of the same formula or percentage for each imposes a hugely different and greater dollar amount on the larger loan involved. [Garrett, *supra*]

Late charge notice

To collect a late charge for the delinquent payment on a note secured by **any type of real estate**, the carryback seller or private lender holding the note must notify the property owner of the charge and **make a demand** for its payment.

Private lenders must give notice and make a demand for the late charge in a *timely manner* by use of either:

- a billing statement or notice sent for each payment prior to its due date stating the late charge amount and the date on which it will be incurred; or

- a written statement or notice of the late charge amount due concurrent with or within ten days after mailing a notice to cure a delinquency. [CC §2954.5(a); see **first tuesday** Form 419-2]

The notice of amounts due or the billing statement, whichever is used, must include the exact amount of the late charge or the formula used to calculate the charge. [CC §2954.5(a)]

If the private lender fails to initiate collection of the late charge for any delinquency by a notice and demand for its payment, the lender **waives** his right to collect a late charge on that payment. However, failure to comply with the late charge notice requirements on a delinquency does not waive the private lender's right to enforce the late charge provision on future delinquencies. [CC §2954.5(e)]

In regards to **carryback notes**, if, on receipt of a delinquent payment, the carryback seller fails to make a demand for payment of the late charge, he waives his right to collect a late charge on that installment. [Calif. Code of Civil Procedure §2076; CC §1501]

However, a carryback seller who continually waives his right to collect a late charge by failing to impose late charges must give the buyer an advance notice of his intention to reinstate the late charge provisions and demand a late charge on future installments should they become delinquent.

The right to enforce the grace period and late charge on future delinquencies must be **reinstated by a timely notice** of the beneficiaries intent to use the provision. A 30 day notice before taking action is considered timely. [**In re Hein** (9th Cir. 1986) 60 BR 769; CC §2954.5(b), (e)]

Late charges on SFRs

A private lender makes a loan to a homeowner secured by his single family residence (SFR) he occupies as his principal residence. The note calls for monthly installments of principal and accrued interest (PI) to be paid on the first day of each month. The loan is not made or arranged by a broker.

The note contains a **late charge** provision allowing:

- a ten day grace period after the due date for the lender to receive each monthly payment before it is delinquent; and

- a late charge of 6% of the delinquent PI installment on written notice and demand for its payment. [See Form 418-1 §2.1]

A monthly payment is not received on or before the eleventh day of the month, the expiration of the ten day grace period on the tenth day after the due date.

The lender sends the homeowner a **written notice** of amounts due demanding payment of the delinquent installment and the agreed-to 6% late charge. [See **first tuesday** Form 419-2]

The homeowner makes the delinquent payment but refuses to pay the late charge.

Is the private lender's demand for the late charge enforceable?

Yes! The installment was **not received** by the expiration of the ten day grace period following the due date of the installment. Thus, it is delinquent and a late charge is collectible on notice and demand.

Ten days is the **minimum grace period** allowed for a private lender secured by an owner-occupied SRF, even if the homeowner agrees to a shorter grace period, or no grace period is agreed to. [CC §2954.4(a), (b)]

The late charge amount on a private lender loan which is **not made or arranged** by a broker and is secured by an owner-occupied SFR is limited to the greater of:

- 6% of the delinquent principal and interest installment; or

- $5. [CC §2954.4(a), (e)]

What if the payment was post-marked as mailed within the grace period but was received by the lender after the grace period expired?

Mailing the installment within the grace period does not qualify the payment as timely paid. The payment must be **actually received** by the carryback seller, lender or collection agent no later than the last day of the grace period and be immediately negotiable. [**Cornwell** v. **Bank of America National Trust and Savings Association** (1990) 224 CA3d 995]

Conversely, the note may require the owner to tender the payment by employing a particular method of payment, such as by mail. Then the payment is considered received when the owner complies with the method of payment, such as placing the payment in the mail, even if the noteholder never receives it. [CC §1476]

Made or arranged by brokers

When a licensed real estate broker makes or arranges a loan as or for a private lender, the 6% limit for late charges established for loans secured by owner- occupied single family residences (SFRs) does not apply, nor do other reasonableness standards. [CC §2954.4(e)]

For private lender loans **made or arranged** by a real estate broker, called a *brokered loan*, and secured by any type of real estate, the late charge is limited to the greater of:

- 10% of the delinquent principal and interest payment; or

- $5. [Calif. Business and Professions Code 10242.5(a); see Form 418-1 §2.2]

Also, if the private lender loan made or arranged by a broker contains a due date for a **final/balloon payment**, a late charge may be assessed on the final/balloon payment if it is not received within ten days after its due date. [See Form 418-1 §2.4]

The amount of the late charge assessed on a delinquent final/balloon payment for a brokered loan is limited to the amount of the 10% late charge due (calculated) on regularly scheduled monthly installments. However, the late charge on a final/balloon payment for a brokered loan may be **charged for each month** the payment remains delinquent. In addition, interest at the note rate (or default or statutory rate) accrues and is payable with the final/balloon payment. [Bus & P C §10242.5(c)]

Like an owner-occupied SFR loan, an installment on a private lender loan made or arranged by a broker on any type of property is not late if paid (received by the lender) within ten days after the installment is due. [Bus & P C §10242.5(b)]

One charge per delinquency

For a private lender loan secured by an owner-occupied single family residence (SFR), or one made or arranged by a broker and secured by any type of property, the private lender cannot charge more than one late charge per delinquent monthly installment, no matter how many months the payment remains delinquent. [CC §2954.4(a); Bus & P C §10242.5(b)]

For example, a homeowner fails to make the January and February installments on a loan made by a private lender and secured by an owner-occupied SFR whether or not the loan was arranged by a broker.

The private lender charges the homeowner a late fee for each month a payment remains delinquent, demanding two late charges for the January payment and one for the February payment.

The homeowner pays one installment in March before the grace period expires.

The lender's accounting program applies the payment to the delinquent principal and accrued interest (PI) installment due in January, and demands payment of additional late charges for the failure to timely pay the February and March installments.

However, the lender may only collect two late payment charges, no matter how many months pass before catching up the **missed payments**, one for the January installment and one for the February installment (both of which still remain unpaid), and none for March since the March installment was timely paid. [CC §2954.5]

A payment received in the month following a delinquent and unpaid installment is deemed to be receipt of the **most recent payment** due on the loan, not payment of the most outstanding delinquent installment. Thus, for a series of payments which are always one month late, only one late charge is permitted by the lender over the entire period since only one installment has been missed. The charge is for the one missed installment which still remains unpaid by the homeowner. [CC §2954.4(b); Bus & P C §10242.5(b)]

However, for accounting purposes, funds from the most recent payment are applied to the interest accrued for the month of the oldest delinquency.

The statutory *one-delinquency, one-charge* rule does not apply to carryback sales even if the carryback note is negotiated by a broker.

Final/balloon payments untimely paid

When a **final/balloon payment** on a loan or an installment sale becomes delinquent, a private lender or carryback seller may enforce a *default rate* provision. A default rate increases the note rate on the remaining principal, unless the debt is secured by an owner-occupied single family residence (SFR) or is a broker-arranged loan. [**Southwest Concrete Products** v. **Gosh Construction Corporation** (1990) 51 C3d 701]

However, the default rate of interest must be reasonable and triggered only by the expiration of any grace period for delivery of the final payment. [Garrett, *supra*; see Form 418-1 §2.5]

Impound accounts

An *impound account* is a money reserve, also called an *escrow account*. The money in the account consists of the funds that the property owner advanced to the lender or carryback seller as an initial deposit, followed by regularly scheduled further deposits. From the impounded funds, the lender or carryback seller pays specified obligations the owner periodically owes on the property, such as:

- property taxes;
- insurance premiums;
- assessments for common area or easement maintenance;
- water stock; or
- bonded off-site improvements.

To fund the **impound account**, a pro rata amount of the costs anticipated to be incurred to pay annual taxes, assessments and insurance premiums (TI), is collected each month along with the monthly principal and interest (PI) payments (PITI). [See Chapter 16]

For late charge purposes, the tax and insurance portion - **impounds** - of the owner's monthly PITI payment must not be included in the formula for computing the amount of the late charge. The TI funds are the owner's money, accumulated by the carryback seller to pay obligations owed by the owner to others.

Enforcement of the late charge

Refusal or failure of an owner to meet a demand to pay a late charge agreed to in a trust deed note is a *non-material breach* of the note and trust deed. Thus, non-payment of a late charge by itself does not justify a call of the loan or initiation of foreclosure. [**Baypoint Mortgage Corporation** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818]

No lender or carryback seller is entitled to foreclose on an owner who has tendered all installments which are due, but has failed to pay outstanding late charges. Collection of late charges when no other monetary breach exists must be enforced by means other than foreclosure.

Additionally, a private lender making a loan on any type of real estate is required to furnish the owner with a **semi-annual accounting** for the total amount of late charges due and unpaid during the accounting period. [CC §2954.5(b); see **first tuesday** Form 419-3]

For late charges on a carryback note secured by property improved with only a one-to-four unit family residence, the carryback seller must also provide the owner with an **annual accounting** statement detailing any late charges due and unpaid during the entire year. [CC §2954.2(a); see **first tuesday** Form 419-3]

Consider an owner of real estate who is delinquent on his January payment for a loan made by a private lender and secured by his property. A timely notice and demand is made by the private lender for payment of the late charge. Before the grace period for the February payment expires, the private lender receives an amount equal to one installment.

Can the private lender reject the owner's principal and interest (PI) payment since the payment did not include the late charge or the past payment?

No! The private lender must accept the owner's installment. Further, if the late charge is not paid, the lender must notify the owner every six months of the outstanding unpaid late charges if he is to eventually enforce collection of the unpaid late charges. [CC §2954.5(b)]

A court action to collect the late charge is not advisable. An action would violate the *one-action rule* and cause a forfeiture of the trust deed lien since the late charge is part of the debt originating under the terms of the note and secured by the trust deed. [CCP §726(a)]

Thus, the collection of accumulated unpaid late charges is limited to a demand for reinstatement to rescind a foreclosure (started due to a material breach) or on a final payoff, if a proper periodic accounting has been made of the accumulated late charges.

Late charges and public policy

Carryback sellers and lenders holding notes secured by property other than owner-occupied single family residences (SFRs) tend to assume they can charge late fees of any amount they can get the signor of the note to agree to, since the statutory limitations only apply to loans secured by SFRs, or loans made or arranged by a real estate broker on any type of property. This conclusion is called a *negative presumption* and, as in this situation, it is usually erroneous.

However, legislation imposed on late charges for loans encumbering SFRs and one-to-four unit residential properties tends to establish public policy for amounts which are deemed reasonable. Further, case law has set standards requiring late charges to bear a reasonable relationship to the out-of-pocket cost of the lender's collection efforts and lost use of the delinquent principal and interest payment amount. [Garrett, *supra*]

Chapter 12 Balloon payment notices

This chapter presents the due date notice, its application to debts secured by one-to-four unit residential real estate, and the enforcement of due dates in trust deed notes.

Carrybacks and loans on one-to-four units

A buyer enters into a purchase agreement to acquire a two unit residential property, a duplex,, contingent on obtaining a 90% loan-to-value (LTV) fixed-rate loan to fund the balance of the price after his 10% down payment. Due to a rise in long-term interest rates, the maximum loan amount the buyer qualifies for is less than 90% of the purchase price.

The buyer wants to acquire the duplex, not cancel the transaction. However, he is unable (or unwilling) to increase his down payment and cannot (or will not) now purchase the property on the terms he has agreed to.

As explained to the seller by the listing agent, the seller now needs to consider responding to the buyer by acting on one of three alternatives available to the seller:

- carry back a note secured by a second trust deed for a portion of the agreed-to sales price, with the consent of the new lender;
- reduce the sales price; or
- cancel the sale for lack of sufficient financing, conventional or carryback.

Knowing prices have not risen recently and sensing they will not likely drop in the next few years, the seller agrees with the buyer to carry a second trust deed note, with monthly payments of interest only and a five-year due date. Thus, the carryback note contains a *final/balloon payment* since the debt does not fully amortize over the five-year term. [See **first tuesday** Form 150 §8]

The buyer's final/balloon payment in five years will be nearly 100 times greater than any of the regularly scheduled monthly payments.

Compute and disclose upfront

The dollar amount of the **final balloon payment** in a carryback transaction must be computed and disclosed to the buyer on two separate occasions, since:

- the balloon payment on the due date exceeds twice the regularly scheduled payments; and
- the property contains one-to-four residential units.

The times for the disclosures of the final/balloon payment dollar amount due on the carryback note are:

- first in a Seller Carryback Disclosure Statement submitted to the buyer and seller as an attachment to the purchase agreement, or for further approval (as a contingency) before the close of escrow [Calif. Civil Code §2963; see Form 300 in Chapter 29]; and

- again in a written due date notice delivered at least 90 days, but not more than 150 days, before the balloon payment is enforced by the carryback seller. [See Form 419 accompanying this chapter]

Additionally, the carryback note prepared by escrow is to include the statutory provision which calls for the balloon payment due date notice. [CC §2966(d); see **first tuesday** Form 418-3 §2.1]

Carryback sellers (or the broker or agent preparing the purchase offer) must compute and disclose in the carryback disclosure statement the dollar amount of the balloon payment on an installment sale of any one-to-four unit residential real estate in a carryback disclosure statement, whether or not the buyer will occupy the property. In contrast, money lenders are only required to make the balloon payment calculation and disclosure on loans secured by one-to-four residential units when the secured property is owner-occupied.

Notes containing a balloon payment

A *balloon payment* is any final payment on a note which is an amount greater than twice the amount of any one of the six regularly scheduled payments immediately preceding the date of the balloon payment. [CC §§2924i(d)(1), 2957(b)]

Balloon payment notes are notes with due date provisions calling for an accelerated final payoff of the principal in a lump sum amount before the note balance has been fully amortized.

Also, a note has a final balloon payment if it contains a call provision giving the carryback seller or money lender the right to demand final payment at any time or after a specified time. [CC §§2924i(d)(2), 2957(c)]

Balloon payment notice and due dates

Not all notes with due dates require a balloon payment notice.

A due date notice provision is required to be included in balloon payment notes with a term exceeding one year if:

- the note is carried back by a seller and secured by a trust deed on one-to-four residential units; or

- the note evidences a money loan secured by a trust deed on an owner-occupied, one-to-four unit residential property.

NOTICE OF BALLOON PAYMENT DUE

NOTE: Calif. Civil Code §2966 requires prior written notice at least 90 but not more than 150 days before any balloon payment is due under a carryback note secured by one-to-four unit residential property.

Calif. Civil Code §2924i requires prior written notice at least 90 but not more than 150 days before any balloon payment is due under a money loan secured by owner-occupied one-to-four unit residential property if the loan term is greater than one year.

DATE:_____, 20_____, at_____, California.

To _____the owner of,

real estate referred to as _____

_____,

securing a promissory note dated _____, in the original face amount of $_____.

NOTICE:

1. A final/balloon payment on this promissory note is due on _____, 20_____.

2. The approximate amount due (including all principal and interest and any other charges due between the date of this notice and the due date) is $_____.

3. Payment is to be made to _____
(Name and address)

_____

_____

4. You have a contract right with the undersigned to refinance this final/balloon payment in accordance with the following terms:

4.1 Origination or modification fee $_____

4.2 Principal amount $_____

4.3 Interest rate _____%

4.4 Installment payments payable monthly in the amount of $_____.

4.5 Due date extended to _____, 20_____.

Date:_____, 20_____

Trust Deed Holder: _____

Signature: _____

Address: _____

_____

Phone: _____

Fax:_____

Email: _____

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A due date notice for a final/balloon payment is not required, unless agreed to by both parties, on transactions including:

- carryback notes secured by nonresidential real estate or residential real estate exceeding four units;
- money loans secured by any type of real estate except owner- occupied, one-to-four residential units;
- open-ended credit secured by any real estate; and
- construction loans for any type of improvements. [CC §2924i(b)(1), (3)]

The purpose for the use of the 90/150-day due date notice in any note is to remind the owner of the property of the final payment, and to give him an opportunity to refinance or pay off the note. It also sends a signal to the owner who is negotiating for an extension of the time for a payoff that the noteholder is not likely to extend the due date.

Delivery and contents of the notice

Carryback sellers and lenders must deliver the notice to the buyer or the current owner of the property personally, or by first- class certified mail to the property owner's last known address. The notice must be given at least 90 days, but not more than 150 days, before the due date. [CC §§2924i(c), 2966(a)]

If the notice is not delivered on time, the final due date of the loan is extended until 90 days after proper notice is given. No other terms of the note are affected. Thus, the accrual of interest and the schedule of repayments (and all other terms) on the note remain the same during the extended due date period. [CC §§2924i(e), 2966(b)]

The failure to deliver the notice does not invalidate the note or lessen the property owner's obligation to continue making the regular periodic payments. Non-delivery of the notice merely extends the date by which the property owner is obligated to pay off the note.

If the property owner defaults on a payment during the due-date extension period, the noteholder may initiate foreclosure.

Consequences of non-delivery

A carryback seller secured by a one-to-four unit residential property cannot foreclose if the buyer fails to make a balloon payment on a scheduled due date unless timely written notice of the upcoming payoff date and the amount due was given. [CC §§2924i(e), 2966(b)]

Further, if the carryback seller begins foreclosure proceedings without first giving the due date notice, he is liable to the buyer for any money losses the buyer incurs due to the seller's foreclosure efforts, including attorney fees. [CC §§2924i(f), 2965]

If the carryback seller fails to give proper notice of the balloon payment to the buyer and successfully completes a foreclosure sale and takes title to the property as the high bidder at the trustee's sale, the buyer can rescind the foreclosure sale. However, if an unrelated third party purchases the property at the trustee's sale, the buyer cannot rescind the sale.

When the rescission remedy is not available, money in the amount of the buyer's lost equity can be recovered from the carryback seller. [CC §2966(c)]

Balloon payment disclosures

Sellers who carry back notes containing balloon payments due more than one year after closing and are secured by one-to-four residential units, must initially estimate and disclose the amount of the balloon payment in the Seller Carryback Disclosure Statement. [See Form 300 in Chapter 29]

The disclosure statement, if not prepared and attached to the purchase agreement, must be delivered before escrow closes.

Specifically, the carryback statement requires the buyer to be made aware of:

- the presence of a balloon obligation;
- the approximate amount of the balloon payment;
- any negative amortization; and
- the fact the buyer may not be able to refinance the balloon payment when it is due. [CC §2963]

SECTION C

The Trust Deed

Chapter 13 Trust deed characteristics

This chapter portrays the status of the parties to a trust deed and discusses the nature and purpose of a trust.

A security device and a lien

Financing, in its most basic form, involves a borrower or a buyer who signs and delivers a *promissory note* to the lender or seller as **evidence of the debt** owed for money lent or credit extended.

However, the promissory note itself is only a promise to pay as agreed, not a **guarantee or other assurance** the debt evidenced by the note will be repaid. A **guarantee** is an agreement entered into by a person not obligated under the note to which obligates the person as a *guarantor* pf the borrower's or buyer's performance on the note. In essence, the guarantor has agreed to buy the note on its default. [See Form 439 accompanying this chapter]

In real estate loan transactions, lenders want other assurance the debt owed by the borrower will be repaid. Thus, lenders require borrowers to provide real estate as *collateral* to **secure the performance** of the borrower's promise to pay should he default on the note.

To secure payment of the debt by a parcel of real estate, a *security device* is used in the form of a trust deed agreement. The trust deed is the preferential method used to impose a *lien* on real estate. The **lien** gives the lender or carryback seller both the right and the obligation to foreclose on the real estate on a default in either the note of the security device–the trust deed

The trust deed, by its words, purports to convey legal title to a neutral person, called a *trustee*. In law, the title is not transferred at all. Instead, a **lien** is created to encumber on the owner's title and establish the property as securtity for the debt.

By the use of the trust artifice, title to the property is theoretically held by a trustee as a middleman, **in trust** on behalf of the owner and for the benefit of the lender or carryback seller. Enforcement of the trust provision is permitted by the courts as a legal fiction, unnecessarily employed to invoke the privately contracted for power-of-sale foreclosure provisions which are fully controlled by statute and used in lieu of a judicial foreclosure.

Should the owner ever default on the note or trust deed, the middleman/trustee can be instructed by the lender to sell the property at a public auction to satisfy the debt.

A **trust deed lien** arrangement consists of:

- an identification of the parties and descriptions of the real estate liened as security;
- an identification of the primary money obligation, usually evidenced by a note, which brought about the need for security;
- the terms of the lender's security interest which is the encumbrance on the property, limited to setting out the rights and obligations of the borrower and the lender solely in regard to the real estate; and

GUARANTEE AGREEMENT

For Promissory Note

DATE:_____, 20_____, at _____,California.

Items left blank or unchecked are not applicable.

1. FACTS:

This Guarantee Agreement, called Guarantee, is entered into by

1.1 _____, as the Guarantor,

1.2 and_____, as the Creditor,

1.3 regarding a Note in the principal sum of $_____, dated _____,

1.4 executed by _____, as the Debtor, in favor of Creditor, and

1.5 secured by a ☐ first, or ☐ second, trust deed and assignment of rents of the same date executed by Debtor as the Trustor, in which Creditor is named as the Beneficiary,

1.6 encumbering real estate referred to as _____ _____.

1.7 The Note is accepted by Creditor in reliance on this Guarantee and the financial statements provided by Guarantor.

2. CREDITOR AGREES:

2.1 To notify Guarantor of any foreclosure by Creditor against real estate securing the note as provided in Calif. Civil Code §2924b(c).

2.2 To notify Guarantor of delinquencies in Debtor's payments under the note as provided in Calif Civil Code §2924e(b).

2.3 To apply in any manner and in its sole discretion any payments or recoveries from Debtor or from Guarantor to the indebtedness of Debtor.

2.4 To first credit any recovery by Creditor from any other Guarantor to that portion of the indebtedness of Debtor to Creditor that exceeds the maximum liability under this Guarantee.

3. GENERAL PROVISIONS:

3.1 Any communication or notice under this Guarantee is to be in writing and is effective only if delivered by personal service or mailed by registered or certified mail, postage-prepaid and return receipt requested, except as controlled by sections 2.1 and 2.2 of this agreement.

3.2 This Guarantee is binding on Guarantor, his successor and assigns, and inures to the benefit of Creditor and its successors and assigns.

3.3 No provision of this Guarantee or right of Creditor can be waived, nor can Guarantor be released from his obligations, except in writing signed by Creditor.

3.4 If Guarantor is a corporation, partnership or Limited Liability Company (LLC), each individual executing this Guarantee on behalf of Guarantor represents and warrants he is duly authorized to execute this Guarantee on its behalf.

3.5 In any action to enforce this agreement, the prevailing party shall receive attorney fees.

3.6 This Guarantee will be governed by California law.

4. GUARANTOR AGREES:

4.1 To guarantee to Creditor payment in full, on demand, of all Debtor's monetary obligations, including any future advances and any refund to Debtor by Creditor of any payment received by Creditor on the guaranteed debt, owed under the Note, trust deed and assignment of rents, and any other security agreement, collateral assignments of leases or any other present or future agreement securing performance of the Note.

4.2 To continue liability under this Guarantee, notwithstanding:

a. Any modification of the Note;
b. Any waiver or failure to enforce the Note or related security devices;
c. Any release or modification of any security for the Note, including other guarantees for performance of the Note;
d. Any unenforceability of part or all of the provisions of the Note and related security devices;
e. Any future advances made by Creditor under the Note and trust deed, without notice from Creditor or further authorization from Guarantor; or
f. Any transfer or release of all or a portion of any security for the Note.

4.3 To file all claims against Debtor in bankruptcy or other proceeding on any indebtedness of Debtor to the Guarantor, and to assign to Creditor all Guarantor's rights on any such indebtedness. If Guarantor fails to file any claim, Creditor is authorized to do so in the name of Guarantor or as Guarantor's attorney-in-fact.

4.4 To subordinate any of Guarantor's claims against Debtor to the Note obligations of Debtor to Creditor.

4.5 ☐ The Guarantee is secured by a trust deed. [See **ft** Form 451]

5. GUARANTOR WAIVES:

5.1 All right of subrogation to Creditor's rights against Debtor or to any security for the Note.

5.2 All notices to Guarantor or other persons of the creation, modification, renewal or accrual of any obligations under the Note and security devices, or notice of any other related manner.

5.3 Any failure to timely enforce the Note and trust deed.

5.4 Any statute of limitations.

5.5 Any duty of Creditor to disclose to Guarantor any facts known or discovered about Debtor which materially increase Guarantor's risks of liability.

5.6 Any circumstances which constitute a legal or equitable discharge of Guarantor.

5.7 The right to require Creditor to first proceed against Debtor, to foreclose any lien on any real or personal property to enforce the note, to pursue any remedy or to enforce any right before proceeding on this Guarantee.

5.8 Any Debtor defenses to Creditor's rights to collect on the Note or to Creditor's exercise of any of its rights under the Note, which Debtor defenses shall not constitute a legal or equitable discharge of Guarantor.

6. OTHER: _____

_____

_____

_____

I agree to the terms stated above.	**I agree to the terms stated above.**
Date:_____, 20_____	Date:_____, 20_____
Creditor's Signature: _____	Guarantor's Signature: _____
Creditor's Signature: _____	Guarantor's Signature: _____
Address: _____	Address: _____
_____	_____
Phone: _____	Phone: _____
Fax: _____	Fax: _____
Email:_____	Email:_____

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- the borrower's signature and notary acknowledgments. [See Form 450 in Chapter 14]

Parties to the trust deed

The trust deed identifies three parties, each of whom has distinctly separate roles in the secured transaction:

1. The owner, called the *trustor*, who voluntarily imposes the trust deed lien on his property.

2. The middlemen, called the *trustee*, who holds the power of sale over the property.

3. The lender or carryback seller, called the *beneficiary*, who benefits from the trust deed lien encumbering the property.

The trustor as the owner

The trustor who signs and delivers a trust deed to a lender or carryback seller must be the **owner** of the real estate interest encumbered when the trust deed is delivered. Delivery is usually accomplished by recording the trust deed with the county recorder, which also *perfects* its priority on title.

The owner creating a trust deed encumbrance on real estate usually is the borrower of money or buyer of the property in a credit sale. However, an owner can impose a trust deed lien on the title to his property to provide security for the performance of any lawful act he may have agreed to, or as security for another person's debt, including other individuals, a corporation, limited liability company (LLC) or partnership debt. [**Everly Enterprises, Inc.** v. **Altman** (1960) 54 C2d 761]

The owner's real estate interest which is encumbered can be less than the entire fee, such as a fractional co-ownership, leasehold interest or life estate in the property.

For example, a condominium owner, or any other property owner, can encumber his long-term leasehold interest under which he holds possession, even though some other person is the fee owner of the real estate. [Calif. Civil Code §§783, 1091, 2947]

Other real estate interests which can be encumbered besides the fee, leasehold, and life estates include beneficial interests of creditors in existing trust deeds, equitable ownership rights under land sales contracts, and purchase rights under options to buy.

As mentioned, the owner does not need to be the sole owner of an interest in the property to encumber his interest with a trust deed. For example, one tenant-in-common or joint tenant (except a husband or wife) can, unless agreed to the contrary with other co-owners, sell or encumber his individual ownership interest without the consent of his co-owner or co-owners. [**Thompson** v. **Thompson** (1963) 218 CA2d 804]

However, the trust deed lien created by the owner of a fractional interest in the real estate attaches only to the owner's interest in the property, not to the interests of his co-owners. [**Caito** v. **United California Bank** (1978) 20 C3d 694]

If community property is to be encumbered, both spouses must consent to the encumbrance of the community real estate interest, with the exception of attorney fees agreements in divorce proceedings. [Calif. Family Code §1102]

An off-record spouse who does not consent to an encumbrance can have a lien removed from the community property. To do so, the action must be filed within one year of the date the trust deed is recorded.

The trustee's authority

Despite the wording in the trust deed stating the trustor "hereby grants and conveys to trustee...the following real property...", the trustee receives no ownership or security interest in the real estate, and holds no legal right to any interest in the property. The trustee merely receives the **authority** to carry out the activities vested in the trustee by the power-of-sale provision in the trust deed lien held by the beneficiary. [**Lupertino** v. **Carbahal** (1973) 35 CA3d 742]

Under the trust deed, the trustee's only responsibilities concerning the property are:

- **to auction the property** at a public sale on notice from the lender of a default and election to sell; and

- **to reconvey title** to the owner and release the lender's lien on instructions from the beneficiary or the trustor.

The owner's *possessory right* (fee, leasehold, or life estate) to the property is not transferred to the trustee under a trust deed. The trustor, as the owner of the real estate, remains free to occupy, sell, lease or further encumber his property, subject to existing liens.

Any person other than the owner of the real estate may serve as trustee. This includes the beneficiary of the trust deed, be he lender or carryback seller. [**More** v. **Calkins** (1892) 95 C 435]

Some private lenders name their attorney or broker as the trustee. Most often, however, title and escrow companies unknowingly play the role of trustee in a particular transaction by virtue of the lender's use of regular trust deed forms the title companies distribute throughout the financial and brokerage industries.

The key difference between the trust deed's legal fiction as a trust and a genuine trust is that the trustee under a trust deed is designated without his knowledge or consent. A true trustee must consent to his appointment. [Calif. Probate Code §15600]

Under a trust deed lien, the trustee is treated as **non-existent** until the lender elects to foreclose by a trustee's sale or is required to reconvey (release) the beneficiary's security interest in the property.

The position held by the trustee in a trust deed functions merely as the passive repository of an auctioneer's power to conduct a private sale as agreed to in the trust deed. The trustee's conduct is in nearly all aspects completely controlled by statutes. [**Garfinkle** v. **Superior Court of Contra Costa County** (1978) 21 C3d 268; CC §2924 et seq.]

When the trustee is called on by the beneficiary to actually carry out its responsibilities under the power-of-sale provision, it is required to act impartially.

Thus, a trust deed lien does not create a trust relationship between the parties to the trust deed, even though words of trust and conveyancing are used.

Even though the trustee's instructions to sell or reconvey come primarily from the beneficiary, the trustee is regarded as a *common agent* and bears a responsibility to both the beneficiary and the trustor to absolutely follow the strict statutory foreclosure scheme. [**Kerivan** v. **Title Insurance and Trust Company** (1983) 147 CA3d 225]

The beneficiary is the lienholder

The **beneficiary**, such as a lender or carryback seller, is the person entitled to the performance of the promised activity referenced in the trust deed as the purpose for obtaining the security, usually the repayment of a debt evidenced by a note.

The beneficiary, like the trustee, receives no ownership interest in the property. But unlike the trustee, the beneficiary **holds an interest** in the property, a security interest called a *lien*.

Thus, the beneficiary has the power to instruct the trustee (who could be himself) to sell the secured property on behalf of the beneficiary (himself). In turn, the trustee has authority from both the trustor and the beneficiary under the power-of-sale provision in the trust deed to sell the property in conformance with the statutory scheme on a declaration from the trust deed beneficiary. [Prob C §§16000, 16420(a)(1)]

A trust deed acts only as a lien

The modern California trust deed gives the beneficiary a lien as a security interest in the real estate. The trust deed authorizes the sale of the property by a trustee's sale under the power-of-sale provision to enforce collection of the secured debt. With the exception of the power-of-sale provision, the trust deed is identical to its predecessor, the mortgage. [**Bank of Italy Nat. Trust & Savings Ass'n** v. **Bentley** (1933) 217 C 644]

For example, a lender is a beneficiary under a trust deed on property which secures a construction loan made to the owner of the property. The owner defaults on loan payments and the lender instructs the trustee under the trust deed to notice the default and proceed with a foreclosure sale, called a *trustee's sale*.

Before the trustee's sale is held, a contractor seeking to foreclose on a mechanic's lien sues and records a lis pendens, claiming an interest in title to the property. However, the mechanic's lien foreclosure action references only the trustee's interest in the real estate as the interest claimed by the contractor to satisfy his money demands.

At the trustee's sale, the lender acquires title to the property. Later, the contractor, under his mechanic's lien foreclosure action, obtains a judgment and is awarded the trustee's interest in the property. The contractor, to enforce collection of money under his judgment through a sheriff's sale, completes his judicial foreclosure and becomes the owner of the trustee's interest in the secured property. The contractor does not pursue any lien rights against the lender's interest in the property as the new owner under the trustee's deed.

Does the contractor's enforcement of his judgment against the trustee's interest under the trust deed give him any interest in the property?

No! A trustee under a trust deed has no interest in the property and thus holds nothing of value to be attached. The contractor failed to pursue the lender, who was the only person (other than the owner) with an interest in the property, both before and after the trustee's sale. The contractor's judgment against the trustee only attached to the trustee's interest under the trust deed — an interest limited to the power to sell the property at an auction for the benefit of the lender, which it did. [**Monterey S.P. Partnership** v. **W.L. Bangham, Inc.** (1989) 49 C3d 454]

Under a trust deed, title to the property appears to be held by a trustee. But the deed conveying title into the purported "trust" is a legal fiction. The sole purpose for recording a trust deed is to **perfect** the lender's security interest in the property. The trust deed conveyance only imposes a lien on the real estate and carries with it none of the possessory rights of ownership to the collateral.

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

SUBSTITUTION OF TRUSTEE AND RECONVEYANCE

DATE: _____, 20_____, at _____, California.

_____, as the present Beneficiary,

under a Deed of Trust dated _____, recorded on _____,

as Instrument No. _____, in the Official Records of _____County, California,

executed by _____, as the Trustor,

HEREBY APPOINTS_____, as the Trustee under the Deed of Trust.

Trustee, on written request from the present Beneficiary of the Deed of Trust, HEREBY RECONVEYS and releases, to the persons legally entitled thereto, the interest held by Trustee under the Deed of Trust.

_____
(Signature of Beneficiary)

_____
(Signature of Successor Trustee)

STATE OF CALIFORNIA
COUNTY OF_____
On _____ before me,

_____
(Name and title of officer)
personally appeared _____

_____,

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature_____
(Signature of notary public)

(This area for official notarial seal)

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Extinguishing the relationship

The trust deed ceases to exist when its purpose as security for a debt ends.

Thus, once the beneficiary has received the full amount of money he is entitled to receive under the note and trust deed, any later claim of the beneficiary to a security interest in the property or activity of the trustee (except reconveyance) is invalid.

Removing the trust deed from the title to the property on ending the debt relationship between the owner and the creditor is accomplished in one of three ways:

- **foreclosure** by issuance of a trustee's deed or sheriff's deed [See Form 475 in Chapter 47];
- **full repayment** by reconveyance [See Form 472 accompanying this chapter]; or
- **mutual agreement** by a deed-in-lieu of foreclosure. [See Form 406 in Chapter 50]

Foreclosure of the trust deed lien is accomplished by a public auction at a trustee's sale or sheriff's sale, the proceeds of which are applied to the debt.

Even if the price bid at the foreclosure sale is insufficient to fully satisfy the note, the foreclosure sale terminates the trust deed lien on the property sold by canceling the trust deed's effect on the title on issuance of the trustee's or sheriff's deed.

Full repayment of the debt requires the beneficiary to cause the trust deed to be reconveyed. Once the debt is fully repaid, the beneficiary delivers the original note to the trustee, together with a request for a reconveyance of title. In turn, the trustee records a reconveyance of the trust deed. [See Form 472]

A trustee who erroneously reconveys when the owner is not entitled to a release of the lender's lien on the property is liable for the beneficiary's resulting money losses.

However, the beneficiary's monetary recovery from the trustee is limited to the market value of the secured property. [**Jeanese, Inc.** v. **Surety Title & Guaranty Co.** (1959) 176 CA2d 449]

On a request for reconveyance, the trustee will demand identification of the beneficiary and require the original note be marked paid. After recording the reconveyance, the trustee will deliver the note to the owner at the owner's request.

Unless the recorded trust deed lien expires earlier, the lien expires and is no longer enforceable by any means after the later of:

- ten years after the final maturity date contained in the recorded trust deed; or
- 60 years after the recording of the trust deed if the final maturity date cannot be ascertained from the recorded trust deed. [CC §882.020]

Failure to reconvey on payoff

Failure of the beneficiary or trustee to comply with mandatory reconveyance requirements results in liability for the owner's actual money losses, a penalty of $300 and criminal liability punishable by a fine of $400 and six months imprisonment. [CC §§2941, 2941.5]

Copies of lost or destroyed originals will be accepted from the beneficiary by the trustee for purposes of reconveyance if they are accompanied by:

- the beneficiary's sworn statement;
- an agreement to indemnify; and
- a lost instruments bond. [**Huckell** v. **Matranga** (1979) 99 CA3d 471]

As an alternative, the beneficiary may avoid unnecessary fees and bonds by substituting trustees — such as himself — to act as the trustee and reconvey the trust deed lien.

When the beneficiary refuses to reconvey on full satisfaction of the debt or cannot be located, the owner, as trustor, can obtain and record a corporate bond in the county where the encumbered property is located. The corporate bond is to be issued in a sum the greater of either:

- two times the amount of the original obligation, plus advances; or
- half of the compounded obligation plus interest. [CC §2941.7(a)]

The corporate bond must be accompanied by a declaration containing the name of the trustor and beneficiary, as well as the name and address of the individual making the declaration, generally the trustor. The declaration must state either:

- the obligation has been fully satisfied but the beneficiary cannot be located or refuses to reconvey; or
- a balance exists, including principal and interest, but the beneficiary cannot be located. [CC §2941.7(b)(4)]

The trustor must send a notice by certified mail to the trustee and the last beneficiary of record stating the trustor has recorded the bond and declaration. The notice must state the trustee may record a written objection to the release of the obligation. [CC §2941.7(b)(5)]

Also, the creditor and property owner may **mutually agree** to terminate the security interest evidenced by the trust deed lien with:

- a deed-in-lieu of foreclosure and reconveyance of the trust deed; or
- a substitution of security and reconveyance of the trust deed without first paying the debt in full.

Under a deed-in-lieu of foreclosure, the owner conveys his entire interest in the property to the beneficiary in exchange for the beneficiary canceling any remaining debt and reconveying the trust deed. Thus, the trustor/beneficiary relationship between the owner and the creditor under the trust deed is terminated. [See Chapter 50]

Chapter 14 The long form trust deed

This chapter introduces and explains a modern trust deed used in California by carryback sellers and private lenders operating outside the national secondary mortgage market.

Reflecting the limits of enforcement

Through the provisions of a trust deed, a private lender or carryback seller, also called a *secured creditor*, tries contractually to restrict or to regulate as many aspects of **ownership and possession** of the liened property as they are legally able to control.

At first glance, the list of rights given to the private lender or carryback seller seems to authorize their use of tremendous **discretionary powers** over activity normally conducted by owners of real estate.

For example, trust deeds routinely purport to give the secured creditor the unhindered ability to:

- automatically accelerate the balance of the loan on the transfer of any interest in the property, such as an owner's sale, further encumbrance or lease of the property;
- determine the allocation of condemnation (eminent domain) proceeds;
- apply all fire insurance proceeds to the secured debt; and
- call the loan if it or any other loan between the parties is in default, called a *dragnet clause*.

Fortunately for owners of property they have encumbered with a trust deed lien, California law curbs the secured creditor's ability to strictly enforce **discretionary provisions**, as well as many other clauses which appear in some trust deeds.

First, trust deeds are recognized as *adhesion contracts*, offered by a person with superior bargaining power (the secured creditor) to a weaker person (the borrower) on a "take it or leave it" basis.

A prospective borrower typically has no power to negotiate better terms than those provided in regular trust deeds. The printed terms must be adhered to when borrowing money.

This imbalance in bargaining power led California courts to develop special adhesion contract rules for interpreting rights and obligations under trust deeds. [**Steven** v. **Fidelity and Casualty Company of New York** (1962) 58 C2d 862]

One rule of the adhesion theory requires a trust deed to be interpreted in light of the reasonable expectations of the weaker party, the borrower. [**Yeng Sue Chow** v. **Levi Strauss & Co.** (1975) 49 CA3d 315]

Second, as the discussion of each individual trust deed provision shows, many of the rights claimed by the secured creditor are restricted, if not completely unenforceable for lack of any basis for protecting the lender against the risk of loss on their loan.

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name ⌈ ⌉

Street Address

City & State

⌊ ⌋

SPACE ABOVE THIS LINE FOR RECORDER'S USE

LONG FORM TRUST DEED AND ASSIGNMENT OF RENTS

Securing a Promissory Note

This Deed of Trust, made this _____ day of _____, 20_____,
between _____, as the Trustor,
whose address is _____,
(Number and street) (City) (State) (Zip)
_____, a California corporation, as the Trustee, and
_____, as the Beneficiary.

1. Trustor hereby **IRREVOCABLY GRANTS TO TRUSTEE IN TRUST, WITH POWER OF SALE,**

1.1 The real property in the City of _____,
County of _____, California, referred to as:

1.2 TOGETHER WITH the rents, issues and profits of the real property, subject to the provisions of §3.4, herein to collect and apply the rents, issues and profits,

1.3 **For the purpose of securing payment of:**

a. the indebtedness evidenced by a promissory note of same date executed by Trustor, in the sum of $_____;
b. any additional sums and interest hereafter loaned by Beneficiary to the then record Owner of the real property, evidenced by a promissory note or notes, referencing this Deed of Trust as security for payment;
c. the Beneficiary's charge for a statement regarding the secured obligations requested by or for Trustor; and
d. the performance of each agreement contained in this Deed of Trust.

2. To protect the security of this Deed of Trust, Trustor agrees:

2.1 **CONDITION OF PROPERTY** — To keep the property in good condition and repair; not to remove or demolish any building; to complete and restore any building which may be constructed, damaged or destroyed; to comply with all laws affecting the property or requiring any alterations or improvements to be made; not to commit or permit waste; to cultivate, irrigate, fertilize, fumigate, prune and do all other acts which from the character or use of the property may be reasonably necessary.

2.2 **HAZARD INSURANCE** — Trustor will continuously maintain hazard insurance against loss by fire, hazards included within the term "extended coverage," and any other hazards for which Beneficiary requires insurance. The insurance shall be maintained in the amounts and for the periods Beneficiary requires. The insurance carrier providing the insurance shall be chosen by Trustor, subject to Beneficiary's approval, which shall not be unreasonably withheld. All insurance policies shall be acceptable to Beneficiary, and contain loss payable clauses in form acceptable to Beneficiary. Beneficiary shall have the right to hold policies and renewals.

In the event of loss, Trustor shall give prompt notice to the insurance carrier and Beneficiary. Beneficiary may make proof of loss if not made promptly by Trustor. Beneficiary may place the proceeds in a non-interest bearing account to be used for the cost of reconstruction of the damaged improvements. If Trustor fails to reconstruct, Beneficiary may receive and apply the loan proceeds to the principal debt hereby secured, without a showing of impairment.

2.3 **ATTORNEY FEES** — To appear in and defend any action or proceeding purporting to affect the security, or the rights and powers of Beneficiary or Trustee; and to pay all costs and expenses, including cost of evidencing title and attorney fees in a reasonable sum, in any such action or proceeding in which Beneficiary or Trustee may appear.

2.4 **TAXES AND SENIOR ENCUMBRANCES** — To pay at least 10 days before delinquency: all taxes and assessments affecting the property, including water stock assessments when due, all encumbrances, charges and liens, with interest, on the property which are or appear to be senior to this Deed of Trust; and all expenses of this Deed of Trust.

2.5 **ACTS AND ADVANCES TO PROTECT THE SECURITY** — If Trustor fails to make any payment or to perform any act provided for in this Deed of Trust, then Beneficiary or Trustee may, without obligation to do so, and with or without notice or demand upon Trustor, and without releasing Trustor from any obligation under this Deed of Trust:

a. make or do the same to the extent either deems necessary to protect the security, Beneficiary or Trustee being authorized to enter upon the property to do so;

b. appear in or commence any action or proceeding purporting to affect the security, or the rights or powers of Beneficiary or Trustee;

c. pay, purchase, contest or settle any encumbrance, charge or lien that appears to be senior to this Deed of Trust.

In exercising the power of this provision, Beneficiary or Trustee may incur necessary expenses, including reasonable attorney fees.

Trustor to immediately pay all sums expended by Beneficiary or Trustee provided for in this Deed of Trust, with interest from date of expenditure at the same rate as the principal debt hereby secured.

3. It is further mutually agreed that:

3.1 **ASSIGNMENT OF DAMAGES** — Any award of damages made in connection with:

a. condemnation for use of or injury to the property by the public, or conveyance in lieu of condemnation; or

b. injury to the property by any third party;

is assigned to Beneficiary, who may apply or release the proceeds of such award in the same manner and with the same effect as above provided for the disposition of hazard insurance proceeds.

3.2 **WAIVER** — By accepting payment of any sum due after its due date, Beneficiary does not waive Beneficiary's right to either require prompt payment when due of all other sums or to declare a default for failure to pay. Beneficiary may waive a default of any agreement of this Deed of Trust, by consent or acquiescence, without waiving any prior or subsequent default.

3.3 **DUE-ON-SALE** — Should Trustor sell, transfer or convey any interest in the property, legal or equitable, either voluntarily or by operation of law, then Beneficiary may, at Beneficiary's option, declare all sums secured by this Deed of Trust immediately due and payable.

3.4 **ASSIGNMENT OF RENTS** — Trustor hereby assigns and transfers to Beneficiary all right, title and interest in rents generated by the property, including rents now due, past due or to become due under any use of the property, to be applied to the obligations secured by this Deed of Trust.

a. Prior to a default on this Deed of Trust by Trustor, Trustor shall collect and retain the rents.

b. On default by Trustor, Beneficiary shall immediately be entitled to possession of all unpaid rents.

3.5 **ACCELERATION** — If payment of any indebtedness or performance of any agreement secured by this Deed of Trust is in default, Beneficiary may at Beneficiary's option, with or without notice to Trustor, declare all sums secured immediately due and payable by:

a. commencing suit for their recovery or for foreclosure of this Deed of Trust; or

b. delivering to Trustee a written notice declaring a default with demand for sale; a written Notice of Default and election to sell to be recorded by Trustee.

3.6 **TRUSTEE'S SALE** — On default of any obligation secured by this Deed of Trust and acceleration of all sums due, Beneficiary may instruct Trustee to proceed with a sale of the secured property under the power of sale granted herein, noticed and held in accordance with Calif. Civil Code §2924 et seq.

3.7 **TRUSTOR'S OFFSET STATEMENT** — Within 10 days of Trustor's receipt of a written request by Beneficiary, Trustor shall execute a written estoppel affidavit identifying for the benefit of any assignee or successor in interest of Beneficiary: the then owner of the secured property; the terms of the secured note, including its remaining principal balance; any taxes or assessments due on the secured property; that the secured note is valid and the Trustor received full and valid consideration for it; and that Trustor understands the note and this Deed of Trust are being assigned.

4. ADDENDA — If any of the following addenda are executed by Trustor and recorded together with this Deed of Trust, the covenants and agreements of each shall incorporate, amend and supplement the agreements of this Deed of Trust (check applicable boxes):
☐ Owner-occupancy rider; ☐ All-inclusive trust deed addendum; ☐ _____;
☐ Impounds for taxes and insurance addendum; ☐ Private Mortgage Insurance (PMI) rider.

5. RECONVEYANCE — Upon written request from Beneficiary stating that all sums secured by this Deed of Trust have been paid, surrender of this Deed of Trust and the note to Trustee for cancellation, and payment of Trustee's fees, Trustee shall reconvey the property held under this Deed of Trust.

6. SUCCESSORS, ASSIGNS AND PLEDGEES — This Deed of Trust applies to, inures to the benefit of, and binds all parties hereto, their heirs, legatees, devisees, administrators, executors, successors and assigns. The term Beneficiary shall mean the holder and owner of the secured note, or, if the note has been pledged, the pledgee.

7. TRUSTEE'S FORECLOSURE NOTICES — The undersigned Trustor requests a copy of any Notice of Default and of any Notice of Sale hereunder be mailed to Trustor at the address herein set forth.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: _____, 20_____ Trustor: _____

Date: _____, 20_____ Trustor: _____

STATE OF CALIFORNIA
COUNTY OF_____
On _____ before me,
_____
(Name and title of officer)
personally appeared _____
_____,
who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature _____
(Signature of notary public)

(This area for official notarial seal)

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The purported rights of the secured creditor, agreed to by the buyer or owner when executing the trust deed, are controlled by statutes, case law interpretations regarding fairness and good faith, and ancient common law doctrines governing the conduct of persons holding interests in real estate.

As a result of California's specific *mortgage law*, the mere inclusion of an otherwise valid and enforceable *contract clause* in a trust deed restricts the use of its provisions by setting parameters for the trust deed lender's enforcement of its powers.

Provisions of a trust deed

The following is an analysis of the necessary and enforceable provisions in a regular trust deed used to secure the performance of a note. Section references are to **first tuesday's** Form 450 — Long Form Deed of Trust and Assignment of Rents, accompanying this chapter.

2.1 — Condition of property

A **condition of property provision**, also called a **nonwaste provision**, obligates the owner to maintain the property in good physical condition. It covers two events.

First, the provision is, in its purpose for protection, a redundant recital. An owner of secured property is barred by statute from impairing the creditor's security interest in the property, called *waste*. [Calif. Civil Code §2929]

Secondly, inclusion of the nonwaste provision is necessary to give the secured creditor the **right to call** the secured loan on a breach of the owner's obligation to maintain the secured property in an unimpaired condition. If the loan is not paid in full on the call, the creditor may commence foreclosure. Without the provision, the creditor is limited to a court action for money damages, injunction and receivership of the property under the waste statute.

Conversely, a nonwaste provision in the trust deed is unenforceable if it is unrelated to protecting the value of the creditor's security from impairment. The owner of the secured real estate has the right to use the property as he wishes and is limited only by general land-use laws.

An owner's promise to maintain the property only bars him from activities and use of the property which jeopardizes the loan-to-value ratio of the creditor's security interest in the property. [**Krone** v. **Goff** (1975) 53 CA3d 191]

For example, many trust deeds contain a clause in which the owner promises "not to commit, suffer or permit any act *upon said property* in violation of law". Such a **violation of law provision** is unenforceable, since it address activities unrelated to the maintenance or value of the secured property. However, provisions promising to comply with laws **affecting** the property's value are enforceable, and are properly included in the nonwaste provision.

2.2 — Hazard insurance

Under the **hazard insurance provision**, the secured creditor has the right to **call the loan** when the owner fails to provide hazard insurance which is acceptable to the creditor.

Should the owner then fail to satisfy the loan after the call or to provide the insurance coverage to reinstate the trust deed, the secured creditor can:

- begin foreclosure immediately, subject to the owner's right to reinstate by providing acceptable insurance; or

- acquire acceptable insurance, pay the premium and either add the amount to the debt under the future advances clause in the trust deed and continue to accept payments on the note, or make a demand for reimbursement, and if not paid in full, call the loan and commence foreclosure.

The secured creditor can require the owner to carry hazard insurance up to the **replacement cost** of any improvements, even if the costs exceed the loan amount or the property's fair market value. [CC §2955.5]

However, the secured creditor must allow the owner to rebuild damaged improvements, unless the rebuilding effort would impair the creditor's security. [**Schoolcraft** v. **Ross** (1978) 81 CA3d 75; see Chapter 15]

2.3 — Attorney fees

Attorney fees and costs incurred in litigation to protect, not foreclose, the secured creditor's security interest in the property are recoverable under the **attorney fees provision** to the extent the fees are reasonable. [**Buck** v. **Barb** (1983) 147 CA3d 920]

Trust deeds give the secured creditor remedies to **protect his security interest** in the real estate. *Remedial actions* are unrelated to the collection of the debt evidenced by the note or other document which are secured by the trust deed. Thus, an attorney fees provision is needed in the trust deed, even though the note contains an attorney fees provision. [**Hellier** v. **Russell** (1902) 136 C 143]

Attorney fees paid by the secured creditor for professional services needed to enforce the trust deed are considered future advances, and are thus also secured by the trust deed.

If the secured creditor records a Notice of Default (NOD), all amounts advanced (including reasonable attorney fees incurred to enforce provisions to protect the status of the trust deed) must be paid to reinstate the trust deed. [**Bisno** v. **Sax** (1959) 175 CA2d 714; CC §2924c]

Conversely, recovery of attorney fees or trustee's fees incurred to judicially or nonjudicially foreclose on the property under the trust deed lien are capped by statute. [See Chapter 51]

2.4 — Taxes and senior encumbrances

The **tax and senior encumbrance provisions** obligate the owner to keep all taxes and senior liens current. If the owner fails to do so, the beneficiary may call the loan due and either:

- foreclose if not reimbursed; or

- pay the taxes under the future advances clause and add that amount to the loan balance. [CC §2876]

Should a senior lender commence foreclosure and the loan not be reinstated or paid in full, the senior lender's foreclosure sale will wipe out any junior creditor's security interest in the property as a lienholder.

Similarly, property tax liens annually attach to the property and are senior to all trust deed holders. A tax lien which is delinquent may be foreclosed after five years. Any property tax sale will eliminate a creditor's secured position in the title. [Calif. Revenue and Taxation Code §2192.1]

2.5 — Acts and advances to protect the security

The **future advances provision** obligates the owner to reimburse the secured creditor on demand for any amounts advanced by the creditor under any provision of the trust deed — e.g., to pay insurance premiums, defend the security, or bring taxes and senior liens current.

All advances made by the secured creditor become part of the debt secured by the trust deed. If the owner fails to reimburse the secured creditor, the creditor may call due (accelerate) all amounts secured by the trust deed and foreclose on the property if the call is not fully paid, unless the debt is brought current as permitted by reinstatement rules. [**Windt** v. **Covert** (1907) 152 C 350]

3.1 — Assignment of damages

Condemnation:

Government agencies sometimes condemn part or all of a secured property in an *eminent domain action*, or damage the value of the property by their actions. Here, the agency must compensate the secured creditor for the loss of his security, which occurs on the date of the **taking**, and for any loss of money (damages) additionally suffered by the owner. [Calif. Code of Civil Procedure §1260.220]

Accordingly, any condemnation award obtained by the owner of the secured property is subject to the lien created by the trust deed. Equity (fairness) law requires the money award to stand as *substitute security* for the property it replaces on the taking. [**American Savings and Loan Association** v. **Leeds** (1968) 68 C2d 611]

However, the assignment of condemnation proceeds to the secured creditor under the **condemnation provision** in the trust deed is not the absolute assignment it appears to be. The creditor is not allowed to apply the entire amount of the condemnation proceeds to the satisfaction of the secured debt if any portion of the secured real estate remains after the taking.

Rather, the assignment provision is merely a *collateral assignment* of the funds for the purpose of securing the debt. Thus, the secured creditor may keep only that portion of the condemnation proceeds necessary to **prevent impairment** of his security, called exercising control in *good faith*. The remaining funds must be released to the owner. [**Milstein** v. **Security Pacific National Bank** (1972) 27 CA3d 482]

With a partial taking, the secured creditor shares the award only to the extent necessary to protect and maintain the level of his security interest. If the partial taking does not create an impairment (reduces the property's value), the creditor is not entitled to any of the proceeds. [CCP §1265.225]

Impairment may occur even though the value of the property after a partial taking exceeds the balance outstanding on the debt. When the debt-to-equity or *loan-to-value ratio* (LTV) existing before the taking is altered substantially due to a reduction in value by the partial taking, the secured creditor is entitled to a portion of the funds needed to bring his debt-to-equity ratio back in line with the pre-taking ratio.

Any dispute regarding the extent of the secured creditor's impairment will be resolved by comparing the debt-to-equity (LTV) ratios before and after the taking. Other risk factors influencing the impairment include the owner's payment history, the economic effect of the taking on the remainder of the property, and whether the creditor has recourse on the obligation. [**People** v. **Redwood Baseline Ltd.** (1978) 84 CA3d 662]

Injury to the property by third-parties:

Coupled with the trust deed provision which collaterally assigns condemnation proceeds to the secured creditor is a **third-party injury clause**. It provides the creditor with an assignment of any award received by the owner for injuries to the property inflicted by private, non-governmental third parties.

Thus, the secured creditor may recover awards received by the owner for damages to the property, subject to the same standards of good faith which apply to the provisions assigning condemnation awards and insurance proceeds. [**Duarte** v. **Lake Gregory Land and Water Co.** (1974) 39 CA3d 101]

However, only money judgments compensating the owner for **actual injury** to the physical property which reduces its value may be participated in by the secured creditor.

3.2 — Waiver

The **nonwaiver provision** establishes the secured creditor's right to accept partial payments of amounts due under the note and trust deed without waiving the right to commence or continue foreclosure based on the owner's default in payments. [**M.E. Hersch** v. **Citizens Savings and Loan Association** (1983) 146 CA3d 1002; see Chapter 49]

The second part of the nonwaiver provision is a **general waiver** which allows the secured creditor to forego enforcement of the trust deed provisions on a default without waiving his right to commence foreclosure on a later default.

For example, the secured creditor's consent to a transfer of the real estate under the trust deed's due-on clause does not waive the right of the lender to interfere with further transfers, unless the creditor agrees in writing to waive his right to call or recast the debt on future transfers.

3.3 — Due-on-sale

A secured creditor may enforce his **due-on clause**, also called an *alienation clause*, by automatically calling the debt due on a voluntary or involuntary transfer of any legal or equitable interest in the property. [12 Code of Federal Regulations §591.2; see Chapter 16]

3.4 — Assignment of rents

Two types of **assignment of rents provisions** exist:

- an absolute assignment; and
- a conditional assignment.

However, the distinction between the two types of assignment of rents clauses is not of concern to the holder of a trust deed recorded after 1996.

Editor's note — For assignment of rents clauses recorded before 1997, the rules regarding the distinctions between the two types of rent clauses still govern their perfection and enforcement. [See Chapter 38]

A trust deed signed and delivered (recorded) after 1996, containing either type of assignment of rents clause, creates a *present security interest* in existing and future leases, rents, issues or profits on the secured real estate. This security interest is properly referred to as a *lien*. [CC §2938(a)]

The assignment of rents clause may be in a separate lien agreement, but is usually placed in the trust deed recorded against the real estate involved.

Once the assignment (trust deed containing the provision) is recorded, it:

- gives *constructive notice* to all persons of the lender's security interest in the rents; and
- is *fully perfected* even though the provision states the assignment is unenforceable until a default occurs on the note or trust deed. [CC §2938(b)]

Perfection by recording establishes that the lender's security interest in the rents has priority over security interests in the rents later acquired by other creditors or owners of the property.

3.5 — Acceleration

The trust deed debt **acceleration provision** allows the secured creditor to call the full amount of all sums secured by the trust deed due and payable on **any default** under the provisions of the trust deed.

Although not necessary, notes secured by trust deeds also contain acceleration clauses. However, trust deed provisions relate to the property and are not properly contained or referenced in the note secured by the trust deed.

Thus, an acceleration provision in the trust deed allows the secured creditor to accelerate payment of all secured obligations (not just the debt evidenced by the note) when the owner breaches any provision of the trust deed, which includes a default on the note.

Also, the acceleration provision in the trust deed gives notice to future owners and encumbrancers of the property that the secured obligation can be accelerated on any default. [Calif. Financial Code §1227.2]

Of course, any acceleration is subject to reinstatement rights, except for calls under the due-on clause, waste provisions and violations of law affecting the value of the real estate since they are incurable breaches requiring redemption of the property by payment in full. [See Chapter 45]

3.6 — Trustee's sale

The **power of sale provision** grants to a named or an unnamed trustee, coupled with an agreement between the owner and the secured creditor to hold a sale of the property on the owner's default, the authority to sell the property by a private trustees' sale if the owner defaults. [CC §2924 et seq.; see Chapter 47]

The completion of a trustee's foreclosure sale extinguishes the owner's ownership interest in the property and terminates his right to redeem the property by paying off the debt. [CC §2903]

3.7 — Trustor's offset statement

If the secured creditor later sells or collaterally assigns the trust deed note to a trust deed investor, the **offset statement provision** requires the owner to cooperate by completing and delivering a trustor's offset statement for use by the trust deed investor. [See **first tuesday** Form 428]

The trust deed investor buying or lending on the note will require the statement to confirm whether the note is valid.

The statement is requested by the secured creditor through the trust deed sales escrow, and delivered to the trust deed investor.

The trustor's offset statement confirms the terms of the note and the existence of any claims or offsets held by the owner against the note or the trust deed holder assigning the note. The offset information is necessary to establish the assignee's status as a holder in due course on his acquisition of a trust deed note.

The owner of the secured real estate has no duty to respond to the request for an offset statement, unless agreed to in the note or trust deed.

4 — Addenda

Special use agreements not covered by standard boilerplate provisions in the trust deed are attached as addenda to the trust deed, sometimes called *riders*.

Examples include:

- the all-inclusive trust deed (AITD) addendum [See Forms 442 and 443 in Chapter 34];
- agreements for impound accounts [See Form 455 in Chapter 16];
- owner-occupancy riders; and
- agreements for mortgage indemnity insurance.

5 — Reconveyance

Within 30 days after payoff of the secured obligation, the secured creditor must deliver instructions to the trustee to record a **deed of reconveyance** or reconvey the trust deed himself. Both the note and the trust deed are returned to the property owner when the debt is fully satisfied. [CC §2941; see **first tuesday** Form 472]

Failure by the secured creditor or trustee to reconvey is a misdemeanor, punishable by a fine of up to $400 and up to six months in jail, or both. Also, the secured creditor or trustee who fails to reconvey is liable for any losses sustained by the owner as a result, plus a civil penalty of $500. [CC §§2941.5, 2941(d)]

6 — Successors, assigns and pledgees

A **successor and assignee provision** extends the rights and obligations under the trust deed to all successors-in-interest of the owner of the secured real estate or the secured creditor.

Even without a successor provision, the owner's successor takes title to the secured property subject to the secured creditor's trust deed, regardless of whether he has in any manner assumed the owner's obligations on the secured note. Thus, the successor must maintain the terms of the note, even though he is not a party to it, to prevent losing the property to foreclosure, called *privity of estate*. [**Rodgers** v. **Peckham** (1898) 120 C 238]

Further, the owner can enforce provisions in the trust deed against the creditor even though he did not assume the obligations of the note and trust deed since a subject-to buyer's ownership of the property is the interest which secures the creditor's recovery on the note. [**Saucedo** v. **Mercury Savings and Loan Association** (1980) 111 CA3d 309]

7 — Trustee's foreclosure notices

A county recorder can only record those trust deeds which contain an owner's request for a notice of default (NOD). [Calif. Government Code §27321.5; see Form 471 in Chapter 47]

The trustee commencing foreclosure proceedings must mail a copy of the NOD by certified or registered mail, and a second copy by first-class mail, to the owner's last known address. [CC §2924b(b)]

If the owner fails to specify his address in the trust deed or changes his address, he may later request the NOD be mailed to him at a new address by recording a statutory **Request for NOD** form. [CC §2924b(a); see Form 412 in Chapter 48]

If there is no address for the owner in the trust deed or Request for NOD form, the trustee must:

- **Publish** a copy of the NOD in a newspaper of general circulation in the county where the property is located, once a week for four consecutive weeks commencing within ten days of recording the NOD;

- personally **deliver** a copy of the NOD to the borrower within ten days of recording or before publication is completed; or

- **post** a copy of the NOD in a conspicuous location on the property and mail a copy of the notice to the buyer's last known address. [CC §2924b(d)]

Junior secured creditors also request NODs and Notices of Delinquency (NODq) to better protect their interests in the secured property against foreclosure and extended delinquencies allowed by a senior lender. [See Chapter 4]

Chapter 15 Hazard insurance proceeds

This chapter clarifies the lender's ability to apply the proceeds from a hazard insurance claim to the balance due on the loan, before and after foreclosure.

The right to rebuild vs. loan impairment

A homeowner owes $300,000 on a loan secured by a trust deed on his home, which is valued at $500,000. A well constructed aviary is attached to the home.

As required by the trust deed, the owner maintains a fire insurance policy on the real estate, listing the lender as an additional named insured.

The trust deed also contains a **hazard insurance provision** granting the lender the option to:

- retain any fire insurance proceeds and apply them to the loan; or
- release the proceeds to the owner for rebuilding. [See Form 450 §2.2 in Chapter 14]

A fire destroys the aviary, a $5,000 loss for the homeowner, but does not damage the home. After the fire, the value of the real estate is $495,000.

The homeowner decides not to replace the aviary.

To cover the loss from the fire, the homeowner's insurance carrier issues a check payable to the homeowner and the lender as called for in their policy. The owner informs the lender of his intention not to rebuild, and requests the check be endorsed to him.

The lender refuses, demanding the insurance proceeds be applied:

- to the outstanding balance of the debt; or
- to reconstruct the damaged structure.

The owner claims he is entitled to the proceeds since the debt owed to the lender on the note is adequately secured by the dollar value of the remaining property.

Can the lender apply the insurance proceeds to the balance due on the debt?

Yes! The lender has full control over the proceeds since:

- the owner elected not to restore the improvements after the fire; and
- the trust deed contains a provision stating the lender is entitled to apply the insurance proceeds to the loan balance. [Calif. Financial Code §§1227.3, 7462]

*Editor's note — Prior to 1987, a lender could not apply insurance proceeds to the loan balance unless he could show his security was impaired, despite the owner's election not to rebuild. [**Kreshek** v. **Sperling** (1984) 157 CA3d 279]*

However, statutes enacted to deregulate lenders in 1987 legislatively reversed the Kreshek ruling and removed the issue requiring a showing of impairment due to losses suffered from a fire or other hazard. Now the issue of impairment only arises when the lender challenges an owner's arrangements to rebuild destroyed improvements on the secured property.

Good faith cooperation implied

Since a trust deed is a contract, a trust deed is subject to an *implied promise* on the part of both the owner and the lender to act in good faith and deal fairly with one another. [**Milstein** v. **Security Pacific National Bank** (1972) 27 CA3d 482]

The lender and the owner, as the contracting parties to a trust deed, must:

- refrain from conduct which interferes with each other's performance of the trust deed provisions; and

- perform all acts contemplated in the trust deed to accomplish the objectives served by the trust deed – lender security from loss.

For instance, a lender cannot **automatically refuse** to release the proceeds to an owner who intends to reconstruct the destroyed improvements and restore the property to its value before it was damaged.

Election to rebuild when funds exist

An owner's real estate is valued at $500,000, with $450,000 owed on a note secured by a first trust deed.

Trust deed provisions require the owner to maintain a fire insurance policy which also lists the lender as a named insured.

Again, the trust deed further provides the lender can either:

- apply any fire insurance proceeds to the loan; or

- release the proceeds to the owner for rebuilding the improvements.

A fire totally destroys the improvements.

The value of the remaining real estate is $200,000. The total rebuilding costs are $300,000.

The policy provides sufficient coverage to fund the replacement of the destroyed improvements.

The owner decides to rebuild, but the lender exercises its option to apply the insurance proceeds to the loan balance.

The lender refuses to release the proceeds to the owner, claiming the owner cannot receive the funds and rebuild since the trust deed states the lender has the option to apply the proceeds directly to the loan balance.

However, the lender must allow the owner to rebuild, unless the lender can show the security will be impaired by the reconstruction of the improvements as proposed by the owner. [**Schoolcraft** v. **Ross** (1978) 81 CA3d 75]

If the insurance proceeds are sufficient to fully rebuild and replace the destroyed improvements, the lender's security interest will not be impaired. Thus, the lender's loan will be restored on completion of construction to the loan-to-value (LTV) ratio it had before the fire loss. [**People** v. **Redwood Baseline, Ltd.** (1978) 84 CA3d 662]

Failure to release the proceeds constitutes a breach of the lender's obligation to act in good faith and fair dealing. [Schoolcraft, *supra*]

Lender impairment

While the lender cannot refuse to allow the owner to rebuild when the security interest will be unimpaired by the rebuilding, the lender can demand assurance the owner will use the proceeds to complete the reconstruction.

If the fire damage was substantial, the lender could reasonably require the owner to:

- submit the reconstruction plans to the lender;
- hire a licensed contractor; and
- obtain a building permit.

In addition, the lender might require the contractor to provide the lender with a **performance bond** to ensure completion of the reconstruction.

During reconstruction, the lender may require the insurance proceeds be disbursed in progress payments. As each phase of reconstruction is completed, the lender or a builder's control would release payment for work performed.

Should the lender determine the reconstruction plans to be deficient, the lender has a good obligation to inform the owner why the plans are considered deficient, and allow the owner time to correct the deficiencies.

Failure to provide insurance

A lender can require an owner to carry fire insurance up to the replacement cost of the improvements, even if the costs exceed the loan amount or the current value of the property. [Calif. Civil Code §2955.5]

Consider an owner of real estate, encumbered by a trust deed containing an insurance provision, who fails to maintain adequate fire insurance to recover **replacement costs** of the improvements on the property.

Under the due-on-default acceleration clause in the trust deed, the lender may call the loan due for the owner's failure to maintain insurance. [See Form 450 §3.5 in Chapter 14]

However, the prudent lender is likely to rely on another trust deed provision allowing the lender to advance payment for fire insurance premiums when the owner fails to maintain adequate insurance, called a *future advances clause*, since the security is in danger of impairment. [See Form 450 §2.5 in Chapter 14]

Under the **future advances clause**, an owner who fails to maintain a fire insurance policy, as required by the trust deed, authorizes the lender to:

- take out an insurance policy;
- pay the premiums;
- add the premiums paid to the loan balance; and
- demand immediate reimbursement. [Calif. Insurance Code §171]

If the owner fails to tender the amounts advanced on the lender's demand for reimbursement, the lender can call the loan, and if it is unpaid, initiate foreclosure proceedings. [Fin C §§1227.2, 7461]

Covered for value, not replacement

Now consider an owner of real estate whose hazard insurance coverage is limited to the current market value of the real estate, but is insufficient to cover the replacement cost of the improvements.

Real estate values in the area surrounding the property have declined or replacement costs have risen faster than real estate values. Thus, the replacement cost of the home now exceeds the current fair market value of the land and improvements.

A substantial portion of the improvements covered by the policy are destroyed.

The owner intends to rebuild the destroyed improvements, but the insurance proceeds are insufficient to cover the costs of reconstructing the same improvements.

Further, the owner cannot contribute funds to cover the shortage between the full replacement cost of the destroyed improvements and the insurance proceeds.

Since the insurance proceeds alone will not cover the costs of replacing the destroyed improvements with comparably valued improvements, the loan-to-value (LTV) ratio will not be restored. Thus, the lender's security interest is impaired as a result of the destruction and inadequate coverage.

The lender has two remedies when the insurance proceeds are inadequate to restore the lender's LTV ratio:

- apply the insurance proceeds to the loan balance; or
- call the loan due since the owner failed to maintain adequate coverage.

If the lender calls the loan due, the lender must underbid at the foreclosure sale by the amount of the coverage if the lender is to collect the insurance proceeds.

A full-credit bid at the trustee's sale satisfies the entire debt, leaving the lender with no loss on the loan, despite any potential losses to be incurred by the lender on a later resale of the real estate for a price less than the amount bid. [**Altus Bank** v. **State Farm Fire and Casualty Company** (1991) 758 F. Supp. 567]

Failure to require insurance

Consider an owner of real estate who maintains a hazard insurance policy as required by the trust deed encumbering the property.

The hazard insurance provision in the trust deed does not require the owner to maintain **earthquake insurance**. However, the owner purchases an earthquake insurance policy. Without the owner's consent, the insurer includes the lender as a beneficiary of the earthquake policy.

An earthquake seriously damages the property and the owner defaults on the trust deed loan.

To cover the earthquake damage, the insurer issues a check payable to the lender and the owner.

The owner requests the lender to endorse the check to the owner. The lender refuses, claiming it has the right to either apply the proceeds toward the repair of the property or to the unpaid loan balance.

The owner claims the lender must endorse the check to him since the hazard insurance provision in the trust deed did not require the owner to maintain earthquake insurance for the benefit of the lender.

The lender claims it is entitled to the insurance proceeds under the waste provision in the trust deed since the lender's security for the trust deed loan was destroyed by the earthquake.

Is the lender entitled to the insurance proceeds?

No! The lender is not entitled to the insurance proceeds since:

- the hazard insurance provision did not require the owner to maintain earthquake insurance; and
- the lender was named as a beneficiary of the earthquake insurance policy in error. [**Ziello** v. **Superior Court** (1995) 36 CA4th 321]

Also, the waste provision in the trust deed only allowed the lender to sue the owner should the lender's security interest become impaired due to the owner's action of committing waste.

To ensure the lender is covered for property damage due to hazards such as fires and earthquakes, the hazard insurance provision in the trust deed must state each type of hazard which must be covered. [Ziello, *supra*]

Chapter 16 Impound accounts

This chapter discusses the lender's use of an impound account provision in a trust deed to collect funds for annually recurring, lump sum property expenses.

Taxes and premiums paid through the lender

The seller of a single family residence (SFR) receives an offer from a buyer who intends to occupy the property as his primary residence.

Terms for payment of the purchase price include a cash down payment of less than 20%. To finance the purchase, the buyer assumes the existing first trust deed (or obtain purchase-assist financing) and executes a carryback note and trust deed in favor of the seller for the balance of the purchase price.

Thus, the loan-to-value (LTV) ratio of the combined first trust deed loan and the seller carryback is more than 80%.

Following a review of the seller's net sheet with his listing agent, the seller voices concern as to whether his net sales proceeds from the cash down payment will be adequate to cover his out-of-pocket expenditures for the property taxes, hazard insurance premiums and first trust deed payments should the buyer fail to pay them.

The buyer appears credit-worthy and financially capable of carrying the costs of owning the property (based on income to debt ratios of 31% for mortgage payments and 40% for all debts). However, the buyer's failure to pay property taxes and insurance premiums would **impair** the trust deed lien securing the carryback note, a risk of loss borne by the seller. If the seller were to pay these delinquencies, called a *future advance*, the amounts become part of the debt secured by the carryback trust deed since they are to be reimbursed by the buyer.

The seller believes he must minimize the risk of the buyer's default by insisting on a larger down payment. However, the seller's broker is concerned the seller may lose the buyer if he counters with an increase in the down payment.

As an alternative, the seller's broker suggests the seller consider a counteroffer to modify the terms in the buyer's offer by including an *impound provision* in the carryback trust deed, among other provisions sought by the broker to care for and protect his seller's interests.

An **impound provision** calls for taxes and insurance to be fully prepaid in monthly installments to the seller, in addition to principal and interest on the note, in a total monthly payment called PITI (principal, interest, taxes and insurance).

Can the seller enforce an impound provision for taxes and insurance if the SFR buyer accepts?

Yes! An impound account can be required and enforced by a carryback seller as a provision in a trust deed lien on an owner-occupied SFR when the principal of the first trust deed loan and the carryback note total more than 80% of the property's value. [Calif. Civil Code §2954(a)]

Under an impound provision in a trust deed lien on any real estate, the impound payments made by the buyer accumulate sufficient funds in advance for the payment of:

- property taxes and bond assessments; and
- hazard and mortgage insurance premiums. [CC §2954]

Impound account established

An owner of real estate subject to a trust deed is obligated to timely pay the taxes, bond assessments and insurance premiums under the trust deed provisions which protect the beneficiary of the trust deed lien against *impairment* of his interest in the property.

An impound account provision is included in the trust deed by way of an addendum. With an impound account, the security for the debt will not be impaired by defaults in taxes, assessment bonds, and insurance premiums should the beneficiaries have to initiate foreclose on the real estate to enforce collection of the debt. [See Form 455 accompanying this chapter]

The owner's payment of taxes and insurance premiums before they become delinquent is required by the trust deed, even if the trust deed does not include an impound account provision to accumulate funds in advance for the payment of taxes and insurance.

However, by establishing an impound account, the real estate owner must each month prepay a pro rata share of taxes and insurance premiums to the trust deed beneficiary, whether the beneficiary is a lender or a carryback seller. Impound payments are paid with and in addition to the regular monthly installment of principal and interest due on the note.

A lender or carryback seller secured by a trust deed on an **owner-occupied** single family residence (SFR) can only require the owner or buyer to agree to an impound account if:

- the combined principal amount of two or more notes secured by the real estate is 80% or more of the real estate's appraised value;
- the first trust deed note amount is 90% or more of the appraised value of the real estate;
- the owner becomes delinquent on two consecutive property tax installments [See **first tuesday** Form 455-1];
- the impound account is required by a state or federal agency; or
- the loan is made, guaranteed, or insured by a state or federal governmental lender or insurer. [CC §2954(a)]

For SFR situations where a beneficiary cannot require an impound account, the owner of the SFR may **agree** to an impound account. However, prior to the execution of the loan documents, carryback note and trust deed, the beneficiary must give the owner a written **impound account disclosure statement** notifying the owner:

- the impound account cannot be required as a condition to the funding of the loan or carrying paper; and

IMPOUNDS ADDENDUM
Taxes and Insurance

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to the Deed of Trust

1.1 ☐ of same date, or dated _____, 20_____, at _____, California,
1.2 executed by _____, as the Trustor,
1.3 naming _____ as the Beneficiary.

AGREEMENT:

2. Trustor will pay Beneficiary, in addition to regular monthly installments on the Note secured by the Deed of Trust, a sum equal to one-twelfth (1/12) of the annual taxes levied on the property and the annual premiums for hazard insurance, mortgage insurance and other insurance required by the Beneficiary.

3. An initial deposit of $_____ is required to establish the impound account.

4. Beneficiary will disburse money maintained in the impound account for the payment of taxes, assessments, and insurance premiums.

5. Any surplus amounts will be applied toward payment of the principal amount of the Note or future advances secured by the Deed of Trust.

I agree to the terms stated above.

Date: _____, 20_____

Trustor's Signature: _____ Trustor's Signature: _____

Trustor's Signature: _____ Trustor's Signature: _____

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- whether or not interest will be paid on the funds held in the impound account. [CC §2954(a); see **first tuesday** Form 455-3]

Canceling the impound account

Consider an owner of a single family residence (SFR) who agrees to pay his taxes and hazard insurance premiums into an impound account. The category of the property and its use by the owner does not allow the lender to require an impound account. No termination date is specified for the impound account.

Later, the owner notifies the lender he is canceling the impound account and will pay the taxes and hazard insurance premiums himself. The owner continues to make payments of principal and interest to the lender.

The lender returns the principal and interest payments and files a Notice of Default (NOD).

The owner reinstates the loan and makes the impound payments requested by the lender in protest. The owner then seeks to recover the impound payments as an overpayment, claiming the lender violated the owner's **right to cancel** the impound account by refusing to accept the payments of only principle and interest.

The lender claims the SFR owner cannot cancel the impound account since the owner agreed to a permanent impound account which could only be canceled with the lender's permission.

Can the owner cancel the impound account without the lender's approval?

Yes! The lender violated the SFR owner's right to cancel the impound account since the owner's consent to a permanent impound account was voluntary and **could not be required** on an owner-occupied SFR which did not qualify for mandatory inclusion by the lender. [**Kirk** v. **Source One Mortgage Services Corporation** (1996) 46 CA4th 483; CC §2954(a)]

Impound payment requirements

When provisions in a trust deed encumbering any type of real estate establish an impound account calling for taxes and insurance premiums, the **beneficiary must**:

- set the amount of the **initial deposit** and **monthly payments** to be made into the impound account — the amounts must be reasonably necessary to accumulate sufficient funds to pay the property taxes, assessments and insurance premiums when due; and

- from the funds received, pay property taxes before they are delinquent and insurance policy premiums before they are canceled. [CC §2954.1]

The **initial deposit** in an impound account on a note secured by any type of real estate, whether a loan or a carryback, is capped at:

- the total dollar amount of payments for taxes and insurance premiums prorated for the period running from the date their payment was last due to the date of the first installment due on the note; plus

- a reserve of one sixth of the total dollar amount of payments due for the period running from the date the last payments for property taxes and insurance premiums were due to the date of the first payment under the note.

Further, the **monthly impound payments** for an impound account on a note secured by any type of real estate are capped at:

- one twelfth of the estimated annual payments for taxes and insurance; plus

- any deficiency in the reserve of one sixth of the total annual payments for property taxes and insurance premiums. [CC §2954.1(a); 12 United States Code §2609]

Editor's note — The Real Estate Settlement Procedures Act (RESPA) has established regulations for impound accounts. [12 USC §2605(g); 24 Code of Federal Regulations §3500.17]

All federally related loans must comply with the requirements. A federally related loan subject to RESPA is a loan secured by a trust deed on one-to-four unit residential property or a mobilehome.

A lender making a federally related loan is subject to RESPA regulations if the lender:

- *annually invests or originates loans retained in the lender's portfolio totaling over $1,000,000;*

- *is a federally insured bank or thrift;*

- *is making loans eligible for purchase in the secondary mortgage market by the Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac) or the Government National Mortgage Association (Ginnie Mae); or*

- *is making loans insured by the Federal Housing Administration (FHA) or the Veterans Administration (VA). [24 CFR §3500.2(a)(3)]*

While a real estate broker making or arranging federally related loans is subject to RESPA requirements, a ***carryback seller*** *is not. However, the regulations do serve as one method for handling impounds.*

Refunds of excess impound amounts

Any funds accumulated in the impound account which exceed the reasonable amount necessary to pay the annual taxes and insurance premiums must be refunded within 30 days of the surplus being incurred, unless the owner and the beneficiary have agreed to apply the funds elsewhere. [CC §2954.1(b)]

For example, a beneficiary and owner can agree in the impound provision to either:

- credit the excess funds in the impound account to the principal; or

- retain the excess in the impound account to cover any later deficiencies in the impound account. [See Form 455 §4]

However, a written agreement for the use of the **surplus impound funds**, other than an immediate refund, can be rescinded by either the owner or beneficiary at any time. [CC §2954.1(b)]

Deficiency in the impound account

A beneficiary can require an owner of any type of real estate to pay additional amounts to cover a deficiency in the impound account. [CC §2954.1(c)]

However, a carryback seller under a land sales contract which documents the sale of a buyer-occupied single family residence (SFR) cannot increase the monthly payments until the buyer receives from the seller:

- an itemized accounting of the money currently in the impound account;

- a statement of the new monthly impound payments; and

- notice of the reasons the increase is necessary. [CC §2954]

If the amount in the impound account is insufficient to pay the property taxes and insurance premiums due to the owner's failure to pay, the impound account provision may call for the beneficiary to advance the deficient amounts.

The beneficiary and owner can agree in the terms of the trust deed that impound amounts advanced by the beneficiary to protect the security constitute a future advance. [See Form 450 §2.5 in Chapter 14]

When the beneficiary makes a future advance, the owner is obligated to reimburse the beneficiary on demand. [See **first tuesday** Form 454]

Figure 1

Impound account deposit

(Determines largest shortfall for disbursements)

	pmt	disb	bal
June	0	0	0
July	$417	0	$417
August	$417	0	$833
September	$417	0	$1,250
October	$417	0	$1,667
November	$417	0	$2,083
December	$417	$4,300	-$1,800
January	$417	0	-$1,383
February	$417	0	-$967
March	$417	0	-$550
April	$417	0	-$133
May	$417	$700	-$417
June	$417	0	$0

Figure 2

Adjusted balances

(Lowest initial impound balance)

	pmt	disb	bal
June	0	0	$1,800
July	$417	0	$2,217
August	$417	0	$2,633
September	$417	0	$3,050
October	$417	0	$3,467
November	$417	0	$3,883
December	$417	$4,300	$0
January	$417	0	$417
February	$417	0	$833
March	$417	0	$1,250
April	$417	0	$1,667
May	$417	$700	$1,383
June	$417	0	$1,800

All advances made by the beneficiary become a secured debt, and if the debt is not paid, the beneficiary may call the loan due by recording a NOD to start foreclosure.

Annual accounting

A seller carrying back a note and trust deed on one-to-four unit residential property with an impound provision must provide the buyer with an **annual impound accounting** within 60 days after the end of the calendar year. [CC §2954.2]

The annual impound accounting must itemize:

- the amount received and applied to interest and principal;
- money received and disbursed from the impound account for the payment of property taxes, bond assessments and insurance premiums; and

- any late charges. [CC §2954.2(a)]

A buyer of property on an impounded installment sale is entitled to the annual impound accounting statement without charge or prior request. [CC §2954.2]

The lender or carryback seller who furnishes the owner with an itemized monthly accounting of the principal, interest and impound account complies with the annual statement requirements. [See **first tuesday** Form 455-2]

For impound accounts on owner-occupied single family residence (SFR) loans, excluding seller carrybacks, the lender is only required to furnish an itemized accounting within 60 days of the end of the calendar year if requested by the owner. The lender may not charge the owner for the annual accounting. [CC §2954(b)]

Figure 3

Initial deposit for impound account

(Advance deposit to build reserves)

	pmt	disb	bal
May (deposit)	$2,633	0	$2,633
June	0	0	$2,633
July	$417	0	$3,050
August	$417	0	$3,466
September	$417	0	$3,883
October	$417	0	$4,300
November	$417	0	$4,716
December	$417	$4,300	$833
January	$417	0	$1,250
February	$417	0	$1,666
March	$417	0	$2,083
April	$417	0	$2,500
May	$417	$700	$2,216
June	$417	0	$2,633

The one-to-four unit residential property owner is entitled to more than one annual accounting, such as a monthly accounting, with a written request to the lender or carryback seller and on payment, in advance, of a fee of:

- $0.50 per statement when requested in advance on a monthly basis for at least one year;
- $1 per statement when requested for only one month; and
- $5 for a single cumulative statement giving all the monthly information back to the last statement given. [CC §2954(b)]

Both the lender and the carryback seller on one-to-four unit residential property must include in the annual accounting a statement in 10-point type notifying the owner of the additional accounting, for a fee, he can request from the lender or carryback seller. [CC §2954.2(a)]

Interest accruing on impound accounts

When the property securing a loan is a one-to-four unit residential property and the loan has an impound account, the financial institution hold-

ing the loan must pay 2% annual **simple interest** on any balance in the impound account. A fee cannot be charged for maintaining the impound account if it would cause the interest received on the account to fall below 2%. [CC §2954.8(b)]

A financial institution includes a bank, savings and loan association (S&L), credit union, or any other person or organization making loans secured by one-to-four unit residential property. [CC §2954.8(c)]

However, **carryback sellers** are not financial institutions, and are not required to pay interest on impound accounts established in a carryback trust deed.

Impounds and trust funds

Consider a carryback seller on any type of real estate whose buyer agrees to an impound account. The seller receives the monthly payments of principal, interest and impounds for the payment of property taxes, bond assessments and insurance premiums.

Is the seller required to maintain a separate bank account for the impounds?

No! Unlike trust funds, a carryback seller or lender may commingle the owner's impounds with its **general funds** and retain all the benefits from these funds.

However, the impound funds must remain in the state of California. If invested, the funds can only be invested with residents of the state or partnerships and corporations which are engaged in business in the state. [CC §2955]

On real property sales contracts carried back by sellers, also called *land sales contracts*, the impound funds must be held in a **trust account**. The trust funds can only be disbursed for property taxes and insurance premiums unless the buyer and all lienholders of record agree otherwise. [CC §2985.4]

A lender with a first trust deed on any type of real estate may deposit impound accounts in an out-of-state depository insured by the Federal Deposit Insurance Corporation (FDIC), if the lender is:

- Fannie Mae, Ginnie Mae, Freddie Mac, FHA or VA;
- licensed and certified under federal or state law to do business related to banking;
- a pension fund or profit sharing welfare fund worth $15,000,000 or more;
- a corporation with publicly traded securities;
- the California Housing Finance Agency or any local housing authority;
- a **syndication** of the above investors organized to purchase promissory notes;
- a **real estate broker** selling all or part of the note to lenders described in this section that may deposit impound accounts in an out-of-state depository; or
- a licensed residential mortgage lender acting under the authority of its license. [CC §2955(b)]

Calculating impound amounts

One method used by lenders and carryback sellers for calculating an impound account balance is found in Real Estate Settlement Procedures Act (RESPA) regulations. [24 CFR §3500 Appendix E]

Consider the sale of any type of real estate in which the seller will carry back a note and trust deed. The carryback seller will also maintain an impound account.

The buyer will incur:

- annual property taxes of $4,300, due on December 10; and
- an annual hazard insurance premium of $700, due on May 15.

Escrow will close on May 15 and the first payment is due to the carryback seller on the first of July.

The monthly impound balances are calculated to set the **initial deposit** necessary to avoid negative impound balances during any month due to disbursements.

The initial deposit for the impound account and the monthly impound payments are calculated based on whether:

- each disbursement by the seller from the impound account will be timely made; and
- the payments into the impound account by the buyer are one twelfth of the total annual property taxes and insurance premiums due. [See Figure 1]

From the balance in the impound calculated monthly in Figure 1, the lowest monthly balance — a deficiency — is to be **initially deposited** by the owner to keep the impound account balance from dropping below zero during any one month. [See Figure 2]

In our example, December has the lowest monthly balance of $1,800. [See Figure 1]

Also, a permissible **reserve balance** equal to one sixth of the total annual disbursements is added to the impound account balances.

In our example, the reserve is $833 — one sixth of $5000 in taxes and insurance premiums.

Thus, the initial deposit in the impound account is the $1,800 deficiency (Figure 1) and the one sixth reserve, which equals $2,633 (Figure 3). During the first year of loan payments, the buyer's monthly payment into the impound account is $417.

Impounds on AITDs

Consider a seller who will remain responsible for making payments on an underlying loan by carrying back an all-inclusive trust deed (AITD).

The wraparound note and trust deed will give the carryback seller additional protection against the buyer defaulting on the first trust deed payments, and the seller not learning of the default for several months.

The existing underlying loan contains an impound account provision for taxes and insurance. The seller currently pays the monthly impound amount in addition to regular installments of principal and interest.

Impounds on the underlying loan will continue to be paid by the seller. The AITD must also be impounded, so the seller is reimbursed monthly by the buyer, a pass-through of the amount due to be paid to the first trust deed lender.

Chapter 17 Assignment of rents provision

This chapter discusses the uniform rules for a lender's enforcement of an assignment of rents provision to collect rents and apply them to the loan on a default on the trust deed.

The lender's rent collection on default

A clause called an *assignment of rents provision* is commonly placed in trust deeds. The clause creates a lien on unpaid rents as additional security to the real estate described in the trust deed. Rents are property other than the secured real estate.

The **assignment of rents provision** in a trust deed transfers to the beneficiary (lender) the right to collect unpaid rental income from the income-producing real estate described in the trust deed **following a default** on the trust deed.

The assignment of rents provision is legally referred to as an *assignment of rents, issues and profits clause*, but is limited to rent without concern for other issues or profits.

Two types of the assignment of rents provision exist:

- an *absolute assignment*; and
- a *conditional assignment*.

However, the distinction between the two types of assignment of rents provisions is not of concern to the holder of a trust deed that was recorded after January 1, 1997.

Either type of assignment of rents provision contained in a trust deed executed and delivered after 1996 creates a **present security interest** in the rents from existing and future rental and lease agreements for possession of the secured real estate, generally referred to as a *lien on rents*. [Calif. Civil Code §2938(a)]

The statutory scheme provides for **uniform enforcement** of all post-1996 assignment clauses, no longer leaving the details to the trust deed contract.

For those assignment of rents provisions recorded before 1997, the rules based on the distinctions between the two types of rent clauses still govern their **perfection and enforcement**.

Editor's note — Unlike liens on real estate or personal property, enforcement of a security interest in rents had not been controlled by the state prior to 1997.

Like statutory schemes which control a trustee's foreclosure sale when enforcing a power-of-sale provision in a trust deed, and the creditor's sale of personal property when used as collateral for a loan, the statutory scheme for enforcement of assignment of rents provisions entered into after January 1, 1997, controls the procedures for perfecting the lien and enforcing the collection of rents.

Absolute assignments pre-1997

An *absolute assignment* of rents is a **present transfer** of all the owner's rights, title and interest in the rents generated by the real estate.

To be enforceable, a present transfer of ownership rights in the rents must first be *perfected*. The transfer of title to the rents is **perfected by recording** the trust deed which contains the absolute assignment of rents provision. [CC §2938]

However, the absolute assignment of rents provision by its wording **reserves** the owner's right to collect and use the rents until the owner defaults on the note or trust deed.

If the owner defaults, the lender can enforce its ownership of the rents and collect the rents. [CC §2938(c)]

Under an absolute assignment of rents, the lender is entitled to collect the rents **directly from the owner or tenants** without first taking possession of the real estate or using a court- appointed receiver.

Thus, the lender can directly enforce the absolute assignment of rents clause by making a written demand on the owner or tenant for the rent, an aspect of the post-1996 law.

Conditional pre-1997 assignments

A *conditional assignment* of rents provision in a trust deed **creates a lien** on all rents in favor of the lender. The rents become additional security to the real estate which is also liened by the trust deed.

As a lien, the conditional assignment of rents is **not a transfer** of any ownership rights to collect the rents, as occurs under an absolute assignment of rents provision. Instead, a lender merely holds a lien on the rents, as he does on the real estate — with no ownership of them. The lien on rents gives the lender the right to enforce collection of the rents only if he directly or indirectly **takes possession** of the real estate on a default on the trust deed. The lender can take possession and collect the rents himself, or more preferably, use a court-appointed receiver to take possession of the property and collect the rents.

For conditional assignments entered into before January 1, 1997, judicial confusion as to the distinction between the application of the terms *perfection* and *enforcement* existed. The two different types of assignment clauses led to chaos in perfection and enforcement of the lender's right to rents.

However, for all conditional assignment of rents provisions entered into between January 1, 1993 and January 1, 1997, the lender perfected his lien on the rents **by recording** the trust deed which contained the conditional assignment provision. [CC §2938.1]

Figure 1

*Excerpt from **first tuesday** Form 450—*
Long Form Trust Deed and Assignment of Rents

3.4 ASSIGNMENTS OF RENTS — Trustor hereby assigns and transfers to Beneficiary all the rights, title and interest in rents generated by the property, including rents now due, past due or to become due under any use of the property, to be applied to the obligations secured by this Deed of Trust.

Prior to a default on this Deed of Trust by the Trustor, Trustor shall collect and retain the rents. On default by Trustor, Beneficiary shall immediately be entitled to possession of all unpaid rents.

Current assignment of rents scheme

A trust deed recorded after 1996 which contains any type of assignment of rents provision establishes a **present security interest** — a *lien* — on existing and future unpaid rents generated by the property encumbered by the trust deed lien, regardless of whether the assignment is called absolute, absolute conditioned on default, additional security, a lien, etc. [CC §2938(a)]

The assignment of rents provision may be in a separate **lien agreement** but is usually placed in the trust deed describing the real estate involved. [See Figure 1]

Once the assignment is recorded it:

- gives *constructive notice* of the lender's security interest in the rents; and

- is *fully perfected* even though the provision states the lien is unenforceable until a default occurs on the note or trust deed. [CC §2938(b)]

Perfection gives priority to the lender's security interest in the rents over any security interest in the rents later acquired by other creditors or owners of the real estate.

Default on post-1996 recordings

A default under a post-1996 trust deed triggers the assignment of rents provision, allowing the lender to **collect the rents.** The lender may take any of several enforcement steps, including:

- delivering a written **demand for rents** to the owner, with a copy to all persons holding a recorded interest in the rents [See Form 456 accompanying this chapter];

- delivering a written **demand for rent** to the tenants with a copy to the owner and all persons holding a recorded interest in the rents, such as senior and junior trust deed holders [See Form 457 accompanying this chapter];

- having a **receiver appointed** judicially; or

- taking **possession** of the property and collecting rents nonjudicially, called *self-help*. [CC §2938(c)]

Whether the lender seeks the appointment of a receiver, takes possession of the property himself, or delivers a notice demanding the rents, the lender has *commenced enforcement* of his right to the rents. From the moment the lender **commences enforcement** of his right to collect the rents by taking one of these actions, the lender is entitled to collect and receive all rents accrued and unpaid from the time enforcement was commenced. [CC §2938(c)]

The written demand served on a tenant for collection of the rent must be made on a statutorily prescribed form, signed under penalty of perjury by the lender or the lender's agent. [See Form 457]

Editor's note — When an owner defaults on a pre-1997 ***absolute assignment (present transfer)*** *clause, the lender may use any of the 1997 statutory enforcement procedures to properly enforce its rights to the rents.*

However, for enforcement of a pre-1997 ***conditional assignment (lien provision)****, the lender is limited to taking possession of the property by:*

- *self-help; or*
- *a court-appointed receiver.*

*Under a pre-1997 conditional assignment provision, the owner of the secured real estate remains entitled to collect and keep the rents until the lender takes physical possession of the property or a receiver is appointed. [****Childs Real Estate Company Inc.*** *v.* ***Shelburne Realty Co.*** *(1943) 23 C2d 263]*

Thus, a trust deed lender with a pre-1997 conditional assignment on income-producing property should consider amending the clause in a separate recorded document as part of any future negotiations with the owner or an assuming buyer. The recorded post-1996 amendment is then enforceable under the new statutory scheme of notices to collect rent.

Regardless of whether the method of enforcement used is judicial or nonjudicial, a lender's enforcement of its collection rights under an assignment of rents provision does not constitute an action for purposes of the *one-action rule.* The **one-action rule** requires the trust deed lender to first resort to foreclosure on the real estate before pursuing other collection remedies. Thus, enforcement of the assignment of rents provision by collecting rents does not bar a lender from later foreclosing on the real estate or, on recourse loans, seeking a deficiency judgment against the owner. [CC §2938(e)]

Written demand on the tenant

After a lender makes a written demand for rent on a tenant, residential or non-residential, all unpaid rents due or becoming due in the future must be paid to the lender, unless:

- the tenant has in good faith previously paid, or within 10 days following receipt of the demand, pays the rent to the owner;
- the tenant previously received a demand for the rents from a different lender;
- a court order directs the tenant to pay rent differently; or
- the lender cancels his demand for the rents. [CC §2938(d); see **first tuesday** Form 458]

Payment of rent to the lender under the lender's demand fully satisfies the tenant's obligation to pay rent to the landlord under his lease or rental agreement.

The lender who makes a demand on a **residential tenant** to pay rents should concurrently make a demand on the owner to forward to the lender any rents collected by the landlord after receiving the lender's notice.

By serving a demand for rents on both the residential tenant and the owner, the owner becomes personally liable for those rents the residential tenant pays to the owner within 10 days after the tenant receives the demand notice.

Conversely, **nonresidential tenants** remain liable to the lender for rent if the nonresidential tenant disregards the lender's notice and continues to pay the rent to the owner. [CC §2938(d)(2)]

DEMAND ON OWNER TO PAY RENT TO LENDER

Under Assignment of Rents

DATE:_____, 20_____, at_____, California.

To Borrower: _____

1. _____, as the Lender, is the Assignee of leases, rents, issues, and profits under

1.1 a document entitled _____,

recorded on _____, as Instrument No. _____,

in _____ County Records, California.

2. In accordance with Calif. Civil Code §2938(c)(4), Borrower is hereby directed to pay to Lender at _____, all rents due Borrower under Borrower's leases or other rental agreements with Tenants

2.1 for the occupancy of the property at_____

_____.

3. Rents due include rents which are past due and payable and rents which become due and payable on or after the date Borrower receives this demand.

I declare under penalty of perjury that I have the authority to demand the rents, and that the assignment of leases, rents, issues or profits executed by Borrower or his predecessor in interest is being enforced pursuant to Calif. Civil Code §2938.

Date:_____, 20_____

Executed at:_____, California.

Lender:_____

By: _____

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By also noticing the owner, the lender protects itself against the tenant's failure to comply with the demand, since demand on the owner always imposes personal liability on the owner for his failure to pay forward to the lender the rent the owner later collects.

Lender payment of operating costs

Consider a lender who enforces the assignment of rents provision by making a written **demand on only the owner** to collect and hand over the rents. [See Form 456]

The lender does not seek the appointment of a receiver, does not take possession of the property himself and does not make a demand on the tenants for rent.

After receiving the lender's demand to hand over the rents, the owner voluntarily does so. In turn, the owner makes a **written demand** on the lender to pay the taxes and insurance premiums, as well as operating costs incurred by the owner of the property, for repair, maintenance and security.

Must the lender pay the ownership costs demanded by the owner?

Yes! If rent is collected under an assignment of rents provision without the appointment of a receiver (who would then be the one to pay the operating costs), the owner may make a demand on the lender to pay the reasonable costs the owner has incurred to **preserve the property** — including the payment of taxes and insurance premiums — which the lender is then obligated to pay from whatever rents the lender collects. [CC §2938(g)(1)]

Costs which are considered reasonable to **preserve and protect** the property include:

- pool maintenance;
- common area maintenance (CAM), whether paid through the rents or paid by the owner;
- repair costs, such as plumbing and roofing; and
- security patrols, if already provided by the owner before the default.

The lender's payment of costs on a demand from the owner does not make the lender a *mortgagee-in-possession*, or otherwise obligate the lender to operate or manage the property.

The owner of property subject to a trust deed and assignment of rents lien has the **primary duty** to operate and manage the property should the lender receive the rents and pay some of the property's operating and ownership expenses, unless a receiver is appointed or the lender takes physical possession of the property. [CC §2938(g)(2)]

Further, the lender's obligation to pay reasonable property operating expenses on written demand from the owner remains until:

- a receiver is appointed, in which case the receiver pays all further costs incurred to operate the property; or
- the lender ceases to enforce its assignment of rents clause. [CC §2938(g)(3)]

However, the lender is under no legal obligation to have a receiver appointed in order to enforce its assignment of rents provision. [CC §2938(g)(4)]

Also, no penalties exist should the lender fail to pay costs on the owner's written demand. However, the lender is liable to the owner for reimbursement of the costs.

Editor's note — A court-appointed receiver is basically a new owner-operator of the property, charged with the responsibility for the management and care of the property for the duration of the receivership.

Most lenders secured by a rents clause on rental properties have neither the administrative expertise (staff) nor the will to enforce the clause or receive a voluntary tender of the rents from the owner.

The lender's risk when disrupting tenants

Serving the tenants with a **statutory notice** to pay the rents to the lender seems to be an uncomplicated process for the trust deed lender.

DEMAND ON TENANT TO PAY RENT TO PARTY OTHER THAN LANDLORD

(Section 2938 of the Civil Code)

DATE:_____, 20_____, at_____, California.

To Tenant: _____
(Name of Tenant)

Property Occupied by Tenant _____
(Address)

Landlord _____
(Name of Landlord)

Secured Party _____
(Name of Secured Party)

Address _____
(Address for Payment of Rent to Secured Party and for Further Information)

1. The secured party named above is the assignee of leases, rents, issues, and profits under a document entitled _____, dated _____, and

1.1 recorded on _____, as Instrument No. _____, in the Official Records of _____County, California.

1.2 You may request a copy of such assignment from the secured party at _____.

2. THIS NOTICE AFFECTS YOUR LEASE OR RENTAL AGREEMENT RIGHTS AND OBLIGATIONS. YOU ARE THEREFORE ADVISED TO CONSULT AN ATTORNEY CONCERNING THOSE RIGHTS AND OBLIGATIONS IF YOU HAVE ANY QUESTIONS REGARDING YOUR RIGHTS AND OBLIGATIONS UNDER THIS NOTICE.

3. IN ACCORDANCE WITH SUBDIVISION (C) OF SECTION 2938 OF THE CIVIL CODE, YOU ARE HEREBY DIRECTED TO PAY TO THE SECURED PARTY, _____ AT_____,

ALL RENTS UNDER YOUR LEASE OR OTHER RENTAL AGREEMENT WITH THE LANDLORD OR PREDECESSOR IN INTEREST OF LANDLORD, FOR THE OCCUPANCY OF THE PROPERTY AT _____

WHICH ARE PAST DUE AND PAYABLE ON THE DATE YOU RECEIVE THIS DEMAND, AND ALL RENTS COMING DUE UNDER THE LEASE OR OTHER RENTAL AGREEMENT FOLLOWING THE DATE YOU RECEIVE THIS DEMAND UNLESS YOU HAVE ALREADY PAID THIS RENT TO THE LANDLORD IN GOOD FAITH AND IN A MANNER NOT INCONSISTENT WITH THE AGREEMENT BETWEEN YOU AND THE LANDLORD.

3.1. IN THIS CASE, THIS DEMAND NOTICE SHALL REQUIRE YOU TO PAY TO THE SECURED PARTY, _____

ALL RENTS THAT COME DUE FOLLOWING THE DATE OF THE PAYMENT TO THE LANDLORD.

4. IF YOU PAY THE RENT TO THE UNDERSIGNED SECURED PARTY _____, IN ACCORDANCE WITH THIS NOTICE, YOU DO NOT HAVE TO PAY THE RENT TO THE LANDLORD. YOU WILL NOT BE SUBJECT TO DAMAGES OR OBLIGATED TO PAY RENT TO THE SECURED PARTY IF YOU HAVE PREVIOUSLY RECEIVED A DEMAND OF THIS TYPE FROM A DIFFERENT SECURED PARTY.

5. **FOR NONRESIDENTIAL TENANTS**: IF YOU PAY ANY RENT TO THE LANDLORD THAT BY THE TERMS OF THIS DEMAND YOU ARE REQUIRED TO PAY TO THE SECURED PARTY, YOU MAY BE SUBJECT TO DAMAGES INCURRED BY THE SECURED PARTY BY REASON OF YOUR FAILURE TO COMPLY WITH THIS DEMAND, AND YOU MAY NOT BE DISCHARGED FROM YOUR OBLIGATION TO PAY SUCH RENT TO THE SECURED PARTY. YOU WILL NOT BE SUBJECT TO SUCH DAMAGES OR OBLIGATED TO PAY SUCH RENT TO THE SECURED PARTY IF YOU HAVE PREVIOUSLY RECEIVED A DEMAND OF THIS TYPE FROM A DIFFERENT ASSIGNEE.

6. Your obligation to pay rent under this demand shall continue until you receive either:

6.1. A written notice from a court directing you to pay the rent in a manner provided therein; or

6.2. A written notice from the secured party named above cancelling this demand.

7. The undersigned hereby certifies, under penalty of perjury, that the undersigned is an authorized officer or agent of the secured party and that the secured party is the assignee, or the current successor to the assignee, under an assignment of leases, rents, issues, or profits executed by the landlord, or a predecessor of interest, that is being enforced pursuant to and in accordance with Section 2938 of the Civil Code.

Executed at: _____, California,

this _____ day of _____, 20_____.

Name:_____

Title: _____

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While seemingly straight forward, notice to the tenant can lead to more involvement for the lender than would have occurred had he only made a demand on the owner or sought the appointment of a receiver.

Lenders may view the statutory notice for demanding rents from tenants as a fast and easy way to force the owner into curing a default, and as a way to protect their secured position on the rents.

But before the demand is delivered to the tenants, the lender must, as a practical matter:

- obtain a list of tenant names and addresses; or
- hand deliver the demand to each tenant to get the tenant's name, and then insert the tenant's name on the form before handing it to the tenant.

The lender must also conduct a **title search** for the names and addresses of the owners of record and lenders with a recorded interest in the rents. Title insurance companies will conduct this search for a fee.

Here a problem is created: once the lender makes a demand on a tenant, the demand will adversely affect the income flow from the property, making a cure of the default more difficult.

For example, consider an owner who defaults on a note additionally secured by an assignment of rents provision in a trust deed. The owner's default is on a monthly payment and the result of an unintentional oversight.

The lender informs the owner of the delinquency. However, before the owner cures the default, the lender serves a statutory notice on the tenants demanding the rents be paid to the lender.

When the tenants receive the demand for rent, the relationship between the owner and the tenants, which is often tenuous, is adversely disrupted. A tenant's confidence in the owner is diminished by the demand for rent notice.

Some tenants may consider relocating to other property (and some actually do) since the demand for rent raises concerns about the owner's solvency and his ability to maintain the property and provide security. In essence, the tenant may believe a change of ownership is underway, which is a destabilizing event under the best of circumstances since it creates uncertainties.

When tenants leave, the lender will experience a deterioration in the flow of income from the property since replacement tenants will not be on notice to pay rent to the lender. The lender will then have to make a demand on the replacement residents and risk further disruption of the landlord/tenant relationship with the replacement tenant — unless disruption is the lender's intent.

Instead of immediately serving the demand on the tenants, the lender should first determine whether the owner's default was merely an **infrequent delinquency** or a **serious default** worthy of the draconian step into the collection of rents and foreclosure on the real estate.

To investigate the nature of the tenant's default on the rent payment, the lender must contact the owner. The lender's collection effort requires staff, analysis and a pre-foreclosure workout ethic, not a knee-jerk, automatic foreclosure/collection reaction in retaliation.

If the default is more serious than an oversight or temporary cash-flow deficiency, the lender should seek to work out the default or establish a period of time for the owner to straighten out his financial affairs. Over a short period of time, such as a couple of months, the secured lender has little to lose but patience.

Property maintenance issues

Sending a demand for rent notice to a tenant also savages a lender's relationship with an owner since "notice" is perceived as a hostile event unless a meaningful dialogue first took place between the lender and owner.

To compound the hostilities, the owner may burden the lender with bills to be paid, whether the lender gives the demand notices for rent to the tenants, the owner, or both.

Further, if tenants have maintenance or security problems, the owner might refuse to correct them due to a lack of rental income to pay the bills, and simply in frustration refer the tenants to the lender, another example adversely affecting the tenant/landlord relationship.

The lender may then feel obligated to respond as would a property manager, even though the lender is not in possession of the property and the owner is still responsible for its operation. [CC §2938(g)(2)]

If the lender finds collecting the rents is necessary on the owner's default, the best course of action is to seek the **appointment of a receiver**, preferably selecting a licensed real estate broker experienced in property management.

When a lender makes the decision to collect rents through a receiver, the lender should immediately serve a notice on the owner demanding the rents. The demand on the owner establishes the date of enforcement and entitlement to unpaid rents from the owner.

By making a demand on the owner, the lender commences his claim to collect unpaid rents after a default occurs.

The lender can then file a *specific performance action* seeking a receiver. A receiver is appointed without the lender having to initiate a judicial foreclosure action or trustee's foreclosure on the real estate involved. [Calif. Code of Civil Procedure §564(b)(11)]

The court-appointed receiver is not considered an agent of the lender. Thus the lender is not liable for a receiver's mismanagement of the property. [**Tourny** v. **Bryan** (1924) 66 CA 426]

Although having a receiver appointed is not as easy nor as inexpensive as making a demand on the tenants or owner for rents, the lender will not be burdened with accounting for rent collections or disbursement, or property management situations, all of which take time and expertise to administer.

Accounting for rents received

All rents received by a lender must first be applied to the debt and credited to the amount in default. Thus, the rents collected apply to reinstate the debt, except when the lender complies with the owner's demand to reimburse him for reasonable costs. [CC §2938(c)]

However, failure of the lender to apply rents to the debt will not:

- result in a loss of the lender's security interest;
- render the debt unenforceable; or

- constitute as an action which would bar a foreclosure under the one-action rule. [CC §2938(c)]

Editor's note — No statutory sanctions exist to penalize a lender who does not follow the accounting rules.

Priority to rents between lienholders

Now consider property encumbered by a first and second trust deed. Both trust deeds contain an assignment of rents provision.

On a default in a payment, the junior lender promptly enforces its assignment of rents provision by making demands for the rents on both the tenants and the owner.

Later, the senior lender enforces its assignment of rents provision by making its demand for the rents on both the tenants and the owner.

The senior lender then claims the junior lender must pay him all rents collected by the junior lender after the owner defaulted on the first trust deed, even though the senior lender did not commence enforcement by notice of his right to the rents until after enforcement by the junior lender.

The junior lender claims the senior lender may only collect the rents which were paid after the senior lender made a demand on the tenants or the owner.

Is the senior lender entitled to all the rents from the time of the default on the first trust deed?

No! The junior lender serving notices under his assignment of rents provision is entitled to collect the rents **until** the senior lender enforces its right to collect the rents by serving notice.

All rents collected by the junior lender prior to the time the senior lender enforces its assignment of rents provision are uncollectible by the senior lender as a source of funds to cure the default on its loan. [CC §2938(h)]

When the junior lender who has enforced his assignment of rents provision receives notice of the senior's enforcement, the junior lender must then:

- **cease collecting** the rents; and

- **send a notice** to the tenants canceling his demand for rents. [CC §2938(h); see **first tuesday** Form 458]

The junior lender's failure to send the cancellation notice will not result in any penalties. However, the junior lender will be liable to the senior lender for any rents received by the junior lender and not forwarded to the senior lender after the senior lender enforces its assignment of rents clause.

Receiving rents after notice

If an owner or a junior lender receives rents after a notice of demand for rents from a senior lender has been served on the owner or tenant, the senior lender serving notice is entitled to the rents collected following notice.

To recover rents improperly received and withheld by the owner or junior lender, the senior lender serving notice has a right to bring an action against the owner or junior lender.

The senior lender's action to recover the rents collected by the owner or junior lender after the lender demands the rents is not a violation of the **one-action rule**. Again, the dispute over rents is unrelated to the foreclosure of the trust deed lien on the real estate, except for the amount of the debt remaining unpaid (which will require an **underbid** at a foreclosure sale to compensate for the net rent collected).

Further, if a dispute arises between the senior lender and another party claiming an interest in the rents — such as in bankruptcy — the lender has a continuously perfected security interest in those cash proceeds from rents which remain identifiable in the hands of the owner (or the court).

To remain identifiable, the cash proceeds must be in a segregated account, or traceable if the rent has been commingled with the owner's or junior lender's other accounts.

Owner files a bankruptcy petition

If an owner files for bankruptcy before his lender enforces the assignment of rents provision, the lender retains a security interest in the post-petition rents collected by the owner or bankruptcy trustee since they are considered *cash collateral*. [11 United States Code §363(a)]

Cash collateral can be used by the owner in bankruptcy in limited circumstances, and only then with the consent of the lender holding a security interest in the rents. [11 USC §363(c)(2)]

Before the statutory scheme for assignment of rents provisions was effective 01/01/1997, conflicting bankruptcy decisions hinged on whether the lender who enforced the assignment of rents provision after the bankruptcy petition was filed was entitled to control any pre-petition rents collected by the owner.

One court held the lender who enforced the assignment of rents provision after the bankruptcy petition was filed was entitled to, as cash collateral, the pre-petition rents paid, even though the lender did not enforce the assignment clause until after the filing. [**In re Scottsdale Medical Pavilion** (9th Cir. BAP 1993) 159 BR 295]

Another court held the lender only had a security interest in unpaid rents when the enforcement occurred after the petition was filed. Thus, the lender could not collect rents paid after the default and before the lender enforced the assignment of rents clause. [**In re Goco Realty Fund I** (1993) 151 BR 241]

California statutes cleared up the confusion created by these conflicting cases.

The *Goco Realty Fund I* case is now the codified rule for the enforcement of post-1997 assignment of rents provisions.

Under the current statutory assignment of rents scheme when no bankruptcy protection has been sought by the property owner, the lender is only entitled to rents which are paid **after the lender enforces** the assignment of rents provision, regardless of whether the rents accrued or became due and unpaid before enforcement.

However, when the owner files a bankruptcy petition, cash collateral includes those rents which were due pre-petition when the rents were received:

- after the petition for bankruptcy was filed; and
- after the assignment of rents provision was enforced through a demand for rents by the lender.

Chapter 18 Beneficiary statements and payoff demands

This chapter addresses requests made on the holder of a trust deed note for a report on the current status of the secured debt or a statement of the amounts due for a payoff and reconveyance of the trust deed.

Confirming loan conditions

A *beneficiary statement* is a written disclosure made by a lender or other creditor regarding the condition of a debt owed them, usually evidenced by a note, that is secured by a trust deed lien on real estate. [See Form 415 accompanying this chapter]

A complete **beneficiary statement** includes information and data regarding:

- the amount of the *unpaid balance*;
- the *interest rate* of the loan;
- the total of all *overdue payments* of principal and/or interest;
- the amounts of any *periodic payments*;
- the *due date* on the loan;
- the date to which *real estate taxes* and special assessments have been paid, if known;
- the amount of *hazard insurance* and its term and premium, if known;
- any *impound* balance reserve for the payment of taxes and insurance;
- the amount of any *additional charges* incurred by the beneficiary that have become part of the trust deed lien; and
- whether the trust deed debt can be *assumed* by a new owner (which was added following federal deregulation of lenders beginning 1982). [Calif. Civil Code §2943(a)(2)]

On adjustable rate mortgage (ARM) notes, the beneficiary statement must list the **note rate** as variable, and reference and attach a copy of the note containing the interest rate formula.

Formulas for ARM adjustments and payment options vary extensively from note to note. Thus, the seller or buyer relying on the beneficiary statement for an ARM needs greater detail than the current interest rate and payment amount. Thus, the lender must **attach a copy** of the ARM note to the beneficiary statement for full disclosure.

Lender response time to a request

Any *entitled person* may request, in writing, a beneficiary statement.

An **entitled person** includes:

- the *original borrower* on the note and trust deed;
- the *successor-in-interest* (new owner) to the original borrower; or
- an *authorized agent* of either, such as a real estate broker, attorney or escrow agent. [CC §2943(a)(4)]

The lender must, within 21 days of the receipt of the written request by an entitled person, prepare and deliver a beneficiary statement. [CC §§2943(b)(1), 2943(e)(6)]

The lender's intentional failure without legal excuse to send the statement within 21 days of receipt of request results in a $300 forfeiture by the lender to the person making the request. Also, the lender is liable for all damages resulting from its intentional failure to comply. [CC §2943(e)(4)]

However, the lender's failure to timely deliver the statement must be proven to be an intentional failure, a difficult task.

*Editor's note — Previous to deregulation, mere administrative failure to send the beneficiary statement within the 21-day period resulted in an automatic forfeiture of $300 by the lender. [**Anderson** v. **Heart Federal Savings** (1989) 208 CA3d 202]*

The request for a beneficiary statement may be made by an **entitled person** before or within two months after a Notice of Default (NOD) is recorded. [CC §2943(b)(2)]

The lender may charge no more than $30 for each beneficiary statement, with the exception of loans insured by the Federal Housing Administration (FHA) or the Veterans Administration (VA). Occasionally, the trust deed states a lesser amount that controls the beneficiary statement charge. [CC §2943(e)(6)]

Payoff demand

A *payoff demand statement* is a written demand, made by a lender, for the total dollar amount required on the date of preparation to pay off the loan as a requisite for recording a reconveyance of the property from the trust deed lien. [See **first tuesday** Form 429-2]

The **payoff demand statement** includes information and formulas to calculate the total payoff amount due after the date the demand is issued to account for and pay interest accruing on a per diem basis up to the date paid. The statement is valid for up to 30 days unless the loan terms change, such as may occur on loans with adjustable interest and payments. [CC §2943(a)(5)]

The payoff demand, as with the beneficiary statement, is required to be delivered within **21 days of receipt** of a written request from an entitled person. Additionally, and similar to the beneficiary statement, the charge for the service of preparing and delivering a payoff demand is limited to $30, unless the loan is insured by the FHA or VA. [CC §§2943(c), 2943(e)(6)]

As with the beneficiary statement, the lender's intentional failure, without legal excuse, to timely reply results in the forfeiture of $300 and liability for any resulting money damages. [CC §2943(e)(4)]

BENEFICIARY STATEMENT

DATE:_____, 20_____, at _____, California.

TO: _____

(Name and address of party requesting statement)

_____

Loan No._____

We are the holder(s) of a promissory note for $_____, dated _____,
made by _____,
and secured by a Trust Deed recorded on _____, as Instrument No._____,
in _____ County, California,
as a lien on property referred to as _____
_____.

1. Present principal balance . . . . . $_____

1.1 Additional charges, costs or expenses advanced by Lender under its lien . . . . . $_____

2. Balance in impound/escrow accounts . . . . . $_____

3. Rate of interest:

3.1 Annual fixed rate of interest is _____%

3.2 Present note rate of interest adjustable per the note is _____%

☐ Attached is a copy of the note containing adjustment formulas.

4. Interest is paid through _____, 20_____.

5. Taxes and special assessments are paid through _____, 20_____.

5.1 Taxes and special assessments for the fiscal year of _____ and _____ were . . . . . $_____

6. Payments are delinquent for the months of _____.

6.1 Total amount of delinquencies to bring the loan current is . . . . . $_____
which includes any late charges and foreclosure costs.

7. Monthly payments are due on the _____ day of each month.

7.1 Monthly payment in the present amount of . . . . . $_____

Comprised of:

Principal and interest. . . . . $_____

Tax impounds of . . . . . $_____

Hazard insurance premium impounds . . . . . $_____

The taxes and premiums are subject to change.

8. The principal balance is all due and payable on _____, in the amount of $_____.

9. Hazard insurance is described as follows:

Amount of Coverage $_____

Insurance Company _____

Policy No. _____

Expiration Date _____, 20_____

Policy Term from _____ to _____

Amount of Premium $_____

Insurance Agent _____

10. ☐ The Trust Deed securing the note contains a due-on-sale clause requiring Lender's consent and approval on any transfer of an interest in the secured real estate.

11. ☐ As requested, a copy of the Trust Deed securing this note is attached.

Date:_____, 20_____

Beneficiary: _____

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The request for a statement

Unless an entitled person, such as an owner-in-foreclosure, **specifically requests** a beneficiary statement, a lender need only send a payoff demand statement. [CC §2943(e)(1)]

The request for either statement must be in writing and sent to the lender at the address given in the payment notice or payment book. [CC §2943(e)(5)]

Before delivering the beneficiary statement or payoff demand, the lender may require proof the request is being made by an entitled person, such as evidence of ownership or authority as an agent of the owner. The written request by escrow should be accompanied by the escrow's written authorization from the owner to order out a beneficiary statement. [CC §2943(e)(3)]

If a request for either a beneficiary statement or a payoff demand includes a request for a copy of the trust deed, the lender must supply a copy of the document at no extra charge. [CC §2943(e)(2)]

The statutory scheme for beneficiary statements does not require that a payoff demand include delivery of a copy of the note.

The lender may issue either the beneficiary statement or the payoff demand statement to set forth the amounts necessary to pay a loan in full. [CC §2943(d)(1)]

Any **oral amendment** to either statement given by the lender must be followed up by delivery of a written amendment by the next business day. [CC §2943(d)(2)]

In addition to a beneficiary statement or a payoff demand, amended statements can also be relied on to establish payoff amounts. [CC §2943(d)(1)]

An erroneous statement or demand

Any error in the statements from a lender regarding the amount owed on a loan becomes an *unsecured obligation* of the **original borrower** after the close of escrow or completion of the trustee's sale. If the lender amends its loan statement prior to the close of escrow or the trustee's sale, the amount listed in the amended statement is valid and replaces the original amount. [CC §§2943(d)(3)(A), 2943(d)(3)(B)]

For example, an owner funds the payoff of a trust deed note by obtaining refinancing from a new lender. The payoff demand for the existing trust deed note erroneously understates the amount due. The new lender funds the amount stated in the payoff demand and the existing trust deed is reconveyed.

Later, the paid-off lender realizes the mistake in the amount of the payoff and seeks to recover the underpayment from the new lender. The paid-off lender claims the new lender is liable for the unpaid amount since it funded the payoff.

The new lender claims the real estate owner who signed the note is liable for the unpaid amount since the statutory beneficiary's payoff scheme only allows the lender to recover amounts remaining unpaid on reconveyance from the borrower obligated on the note.

Here, the lender issuing an erroneous payoff demand can only recover amounts remaining unpaid from the **original borrower**. The named borrower on the note is the sole source of recovery for amounts understated in the payoff demand. [**Freedom Financial Thrift & Loan** v. **Golden Pacific Bank** (1993) 20 CA4th 1305]

Nonrecourse debt payoff errors

A lender who makes a purchase-assist loan to a buyer of a one-to-four unit residential property he will occupy as his principal residence is barred from obtaining a money judgment for any deficiency in the value of the property to fully payoff the loan on a foreclosure. These loans are **nonrecourse loans**, called *purchase-money obligations*.

Likewise, carryback notes secured only by the property sold are nonrecourse *purchase-money* paper. Further, those who hold a purchase-money note by assignment are also barred from obtaining a deficiency judgment.

The carryback seller or lender who makes a mistake in the amount of a payoff demand or beneficiary statement issued on a *nonrecourse note*, is limited in its recovery to the value of the property at the time of the erroneous payoff demand.

Initially, the amount of the error on payoff becomes an *unsecured purchase-money* obligation of the original borrower. The amount unpaid remains a **nonrecourse debt**. The character of the remaining unpaid debt did not change; it only became unsecured. [CC §2943(d)(3)]

Thus, the lender or carryback seller on a nonrecourse debt is limited in his recovery of the error to the difference between the amount received and the value of the property at the time of the erroneously calculated payoff. [**Ghirardo** v. **Antonioli** (1996) 14 C4th 39]

Recourse debtor payoff error

The amount of an error made in a beneficiary statement or payoff demand for a **recourse debt** also becomes an unsecured obligation. However, recovery on a recourse loan is not limited to the value of the property on the date of the payoff as is the case for a nonrecourse debt. [Calif. Code of Civil Procedure §726(b)]

A lender who demands and is paid an erroneous amount on payoff of a **recourse loan** can proceed directly to a money judgment against the borrower obligated on the note for the uncollected amount, regardless of the value of the security.

Thus, sellers of property encumbered by a recourse loan expose themselves to a continuing liability for trust deed debts they owed as original or assuming borrowers after the property is sold subject to the existing trust deed lien.

A seller originating a recourse loan is considered a *guarantor*, secondarily liable for payment of the loan if the buyer fails to pay, unless the assumption of the loan by the buyer included a significant modification in its terms to which the seller was not a party. [**Braun** v. **Crew** (1920) 183 C 728]

When the buyer later resells the property acquired from the seller by an assumption of a loan, and a mistake is made by the lender in a payoff demand or beneficiary statement on the resale resulting in an underpayment to the lender, then the **seller** who originally borrowed the funds is a guarantor of payments on the original note and is liable for the error.

Thus, a seller who originated or assumed a loan that his buyer is now assuming with the lender may feel compelled to condition the closing of the sale on a **release of liability** from the lender, called a *novation*.

The release of liability eliminates the seller's risk of "original borrower liability" for a potential future error by the lender in payoff demands or beneficiary statements. [CC §1531]

In a **novation**, as with an assumption, the buyer promises to perform the duties of the original borrower. In addition, the lender agreeing to the novation releases the seller from all future liability for the debt. [See Chapter 16]

Chapter 19 Grant deed as a mortgage

This chapter explains the legally defective nature of a grant deed used to hold title to property when its use is intended to provide security for the repayment of money owed.

Risks in alternative security devices

A parcel of real estate is encumbered by a trust deed securing a loan which is due. The principal balance equals 70% of the property's value. The owner of the real estate does not have sufficient funds to pay off the loan himself.

The owner attempts to refinance the property but is unable to obtain a new conventional loan. Eventually, a private investor is located who advances the funds needed to pay off the loan. The investor wants to be repaid in two years.

As security for repayment of the funds advanced, the owner conveys title to the real estate to the investor by a grant deed. However, the owner retains possession of the property, maintains the improvements and pays all property taxes, insurance premiums and operating expenses.

The owner, on delivery of the grant deed to the private investor, is given a lease and an option to repurchase the property, called a *sale-leaseback* and *option*. The rent installments and a single final payment on exercise of the option equal the amount advanced and the yield sought by the private investor.

Did the grant deed from the owner convey **fee simple ownership** of the property to the investor?

No! The **sale-leaseback** and **option** transaction is not a sale at all, but is merely a **secured loan transaction.** Thus, delivery of a grant deed simply imposed a lien on the owner's interest in the property for the amount of the debt owed to the investor, since:

- the owner remains in possession of the property and pays all property taxes, insurance and operating costs;
- the amount of the purchase price is substantially less than the value of the property; and
- the repurchase option indicates the owner and lender intend the owner to recover title to the property by paying back the amount advanced, plus a fixed yield.

Thus, the grant deed conveying legal title to the lender is *recharacterized as a mortgage* to grant the lender a security interest in the real estate, not an ownership interest allowing for eviction. Here, the grant deed, like a trust deed, does not convey an ownership interest in the real estate; it establishes a lien in favor of the named grantee for recovery of money – limited to foreclosing. [**Orlando** v. **Berns** (1957) 154 CA2d 753]

A mortgage-in-fact on a grant

A grant deed is typically used to transfer the fee ownership of real estate from a seller to a buyer. At first glance, that is what everyone assumes occurs when a grant deed is recorded. The buyer acquires title and possession to the property conveyed, subject only to those encumbrances known to exist or recorded on title to the property. [Calif. Civil Code §1105]

However, a grant deed given by an owner for the sole purpose of securing the future *performance of an obligation* — such as the payment of money — is considered a **mortgage**. Thus, the grant only imposes a lien on the property, not a transfer of ownership or title. [CC §2924]

When a grant deed is given to secure a debt, the seller (grantor) remains the true owner of the property, subject to the security interest granted to the buyer (grantee) who, by the recharacterization of the grant as a mortgage, is merely a secured lender.

Thus, the rights and remedies of the grantor and grantee under the grant deed are those of an owner and a lender, not a seller and a buyer or a landlord and a tenant when repayment of a debt is involved.

A land sales contract is a variation on the grant deed as a mortgage. A grant deed is not used to provide security for money owed. Instead, title is **retained by the seller** as security for the buyer's payment of the purchase price.

The buyer on a land sales contract will not receive a grant deed until all payments on the purchase price have been made. Nonetheless, the buyer becomes the owner of the real estate on execution of the land sales contract and transfer of possession, called *equitable ownership*. The seller's retention of title on his entering into a land sales contract converts his interest in the property from ownership to that of a lien for money owed.

Likewise, CalVet lends money to buyers to purchase real estate when CalVet receives title to the property. As the vested owner of record and lender under a *participation contract*, CalVet has no ownership interest in the property and no duty to perform the obligations of ownership whatsoever; it is a lender with an imperfectly stated lien on title (due to a statutory aberration that has yet to be corrected). [**Cunningham** v. **Superior Court** (1998) 67 CA4th 743]

An owner's grant deed mortgage risks

For an owner, a grant deed given to a lender to secure a debt:

- creates confusion in the county records as to who owns the real estate should the owner later decide to sell or further encumber the property;
- triggers the due-on clause in any existing trust deeds on the real estate;
- triggers inquiry by the county assessor as to the reassessment of the property due to a change of ownership on title; and
- creates a risk the grant deed lender will deed out, further encumber the property, or attempt an eviction on the owner's default.

Transfer of title vs. a security interest

Whether a grant deed conveyance constitutes a mortgage or a **change of ownership** depends on all aspects of the transaction, including:

- whether a substantial difference exists between the price to be paid to repurchase the property under an option and the property's fair market value;
- who assumes the ownership duties of the property; and
- the intentions of the parties as evidenced by written documents, such as purchase agreements, escrow instructions, loan documents, leases and repurchase options.

For example, a real estate investor who receives a grant deed assumes the existing liens and takes possession of the property, collects rents, pays taxes and insurance premiums and maintains the property. Thus, the investor acts as the owner of the property. When the investor assumes the duties of ownership, the grant deed is treated as a true change of ownership, even if a repurchase option is included in favor of the seller. [**Develop-Amatic Engineering** v. **Republic Mortgage Co.** (1970) 12 CA3d 143]

Due-on and reassessment

Under normal circumstances, further encumbering an owner-occupied, single family residence (SFR) with a junior lien does not trigger a senior lender's due-on clause. [12 Code of Federal Regulations §591.5(b)(1)(i); see Chapter 21]

However, a grant deed used as security for a loan is not only a further encumbrance, but a purported transfer of legal title. The grant deed can lead to due-on enforcement, since the **due-on clause** in an existing trust deed is triggered by the conveyance of any interest in real estate — including a lease-option, a lease with a term over three years or a land sales contract. [12 CFR §591.2(b)]

While a junior trust deed will not lead to the senior lender calling the loan on an owner-occupied SFR, a grant deed used to document the same loan transaction will trigger the due-on clause unless it can be shown to the lender calling the loan to be a secured transaction.

A further risk exists regarding **reassessment** by the county assessor. A grant deed indicates a change of ownership. However, the transfer of a security interest in real estate, even by grant deed, is not considered a change of ownership for property tax purposes. [Calif. Revenue and Taxation Code §62(c)(1)]

Thus, to avoid reassessment, the true owner must demonstrate to the assessor (or the assessment appeals board) that the grant deed is only a lien on the property, and, by the evidence, was not intended to transfer any rights of ownership.

Subsequent buyers

A borrower who agrees to use a grant deed to secure repayment of a loan also faces the possibility the investor might deed the property to others, become incapacitated or die. Whether the conveyance of the property by the lender to another party constitutes a valid sale depends on whether the buyer has notice of the borrower's ownership interest in the property.

For example, if an owner executes a grant deed mortgage and remains in possession of the real estate acting as the owner of the property, the third party buyer is on notice to inquire into the rights of the owner. [**Gates Rubber Company** v. **Ulman** (1989) 214 CA3d 356]

Also, the buyer may have constructive notice of the owner's rights based on a recorded document, such as a lis pendens or any other document relating to the loan transaction for which the grant deed is security.

If the buyer has notice of the owner's rights, the buyer is not considered a bona fide purchaser (BFP), and does not acquire any greater title or interest in the property than was held by the lender who held the grant deed as security.

However, if the buyer acquires the property without receiving actual or constructive notice of the owner's rights — i.e., without being aware the grant deed to the lender functions as a mortgage — the buyer acquires clear title as a BFP. [**Carpenter** v. **Lewis** (1897) 119 C 18; CC §2950]

The owner cannot recover the property from a BFP. His only remedy would be to recover his lost equity in the property from the lender — the loss being the difference between the price received by the lender (or the property's fair market value, if greater) and the debts encumbering the property, including the debt owed to the lender. [**Segura** v. **McBride** (1992) 5 CA4th 1028]

A lender's grant deed mortgage risks

The private lender who holds a grant deed as the device for securing recovery of his funds has concerns which include:

- possible **usury claims** by the owner if the amount of the installments and repurchase price exceeds the amount of the funds advanced by more than the allowable average annual yield;

- the need to **foreclose judicially** to exhaust the *right of redemption* should the owner default, since the grant deed, when recharacterized as a security device, does not contain a power-of-sale provision, as does a trust deed;

- compliance with **equity purchase (EP) laws** if the property is an owner-occupied, one-to-four unit residential property in foreclosure; and

- **tax reporting** as an owner or lender.

Thus, in any loan transaction, a simple note and trust deed is a far better choice of documentation to express and establish the rights and obligations of both the lender and the borrower than the use of a grant deed as a mortgage.

Usury

A private lender using a grant deed as a security device may be charging a usurious rate of interest. [Orlando, *supra*]

When a grant deed with a leaseback and repurchase option is used to secure a loan, the interest charged on the loan is calculated as the difference between:

- the amount of the funds advanced by the lender, which is the loan amount; and

- the repurchase price to be paid by the borrower and rent payments.

Since a sale-leaseback transaction is considered a loan, **usury laws** limit the amount of the repurchase price (repayment of the loan plus a yield calculated as interest) the lender can charge the borrower. [See Chapter 41]

Equity purchase rules

Equity purchase laws protect owners who enter into sales-leaseback transactions on owner-occupied, one-to-four unit residential property **in foreclosure** in which a grant deed conveys title to the property as security for a loan. [Segura, *supra*]

If the equity purchase (EP) agreement grants the seller an **option to repurchase** the property, the transaction is considered a loan, and the conveyance of the property to the equity purchaser is a mortgage which grants only a security interest. [See Chapter 20]

Broker's duty to advise

A broker advising the use of a grant deed as a mortgage is not liable for malpractice, since the lender has received security for the loan. [**Lovelady** v. **Bryson Escrow, Inc.** (1994) 27 CA4th 25]

However, the broker giving such advice is not at all serving the best interests of his client. Given the heinous disadvantages for both the lender and the borrower when a grant deed is used as a mortgage, the conventional note and trust deed is always a better form for documenting a real estate loan transaction.

Chapter 20 Equity purchase: sale-leaseback, no option

This chapter digests the legal and tax consequences which arise due to the recharacterization of a sale-leaseback arrangement as a loan transaction when the leaseback is coupled with a repurchase option.

The home equity sales scheme

An *equity purchase* (EP) transaction is the sale or other transfer of title by an owner-occupant of a one-to-four unit residential property when:

- the property is in foreclosure under a recorded Notice of Default (NOD which has not been rescinded; and
- title to the property is acquired by either a buyer for rental, investment or dealer purposes, or a person advancing funds which are to be prepaid, called an *EP investor*.

Conversely, an EP transaction does not occur and the EP rules do not apply if the buyer acquires the property to occupy it as his *personal residence* or a lender originates a trust deed loan. The EP codes distinguish *prinicpal residence* of the seller from the buyer's acquisition of a property to be used by the buyer as his **personal residence**. Thus a buyer's acquisition of a second home or vacation home for "personal use" is legislatively intended to be exempt from the EP laws.

Equity purchase statutes apply to all investors regardless of the number of EP transactions the investor completes. The investor need not be **in the business** of purchasing or advancing funds on homes in foreclosure for the EP statutes to apply. [**Segura** v. **McBride** (1992) 5 CA4th 1028]

The investor and all brokers involved must use a written agreement configured and containing notices as required by EP law. Failure to use the correct forms subjects the investor and the brokers to liability for all the losses incurred by the seller-in-foreclosure, plus very severe penalties. [Segura, *supra*]

After entering into an EP sale, a **seller-in-foreclosure** has a statutory five-business day *right to cancel* the sales agreement he has entered into with an investor. Cancellation avoids the sale entirely.

The seller-in-foreclosure's five-business day **right to cancel** does not commence until proper notice of the cancellation period is given to the seller. Thus, the notice is contained in the purchase agreement forms designed for equity purchase transactions, to trigger the running of the cancellation period from the moment the seller accepts an offer. [Calif. Civil Code §§1695.4, 1695.5]

Further, and until expiration of the seller-in-foreclosure's right to cancel the transaction, the **EP investor** may not:

- **accept a conveyance** from the seller of any interest in the property;
- **record a conveyance** of the residence with the county recorder;
- **transfer an interest** in the property to a third party;

- **encumber any interest** in the residence; or

- **hand the seller** a "good faith" deposit or other consideration. [CC §1695.6]

In negotiations with the seller-in-foreclosure, the **EP investor** may not misrepresent:

- the **value of the property** in foreclosure;

- the **net sales proceeds** the seller will receive on closing escrow;

- the **terms of the purchase agreement** or any other document the EP investor uses to induce the seller to sign; or

- the **rights of the seller** in the EP transaction. [CC §1695.6(d)]

Cancellation of the purchase agreement by the seller-in-foreclosure is **effective on delivery** of the signed written notice of cancellation to the EP investor's address in the purchase agreement.

When the cancellation period expires for lack of cancellation, the purchase agreement becomes enforceable and escrow can be closed — unless other conditions exist which must first be eliminated.

After escrow closes, and while the EP investor remains the owner, his title is subject to the seller-in-foreclosure's **right of rescission** for two years. The rescission must be based on some *unconscionable conduct* of the EP investor. The seller's two-year right to *rescind and recover* the property from the EP investor cannot be waived by the seller. [CC §§1695.10, 1965.14]

An EP investor who violates the five-day cancellation period or takes *unconscionable advantage* of the seller-in-foreclosure will be subject to imprisonment and a fine no greater than $25,000 or both for each violation. [CC §1695.8]

Also, any broker representing an EP investor as the **buyer's agent** must provide the seller-in-foreclosure with proof he is currently licensed, together with a written affidavit stating under **penalty of perjury** that the broker is a licensed real estate broker. [CC §1695.17(a); see **first tuesday** Form 156 §14.1]

At the time of this writing, brokers representing EP investors are not required to be bonded by any surety insurer: The courts threw out the original bonding requirements. [**Schweitzer** v. **Westminster Investments** (2007) 157 CA4th 1195]

A mortgage or tenancy on breach?

A homeowner defaults on loan payments secured by a trust deed on his home. The lender begins foreclosure proceedings by recording a Notice of Default (NOD).

The NOD recording is picked up by a foreclosure reporting service. The service's subscribers are then advised of the NOD. An equity purchase (EP) investor tracking NOD recordings contacts the homeowner, intending to investigate the property for suitability and acquisition.

An offer to purchase the residence is prepared and submitted to the homeowner on an EP agreement form as mandated by state law.

However, the homeowner advises the EP investor he really wants to retain possession of the residence and **buy back** the ownership when his personal finances pick up.

As an alternative to the EP investor's offer, the homeowner proposes a **sale/lease-option** arrangement in which:

- the investor acquires title to the property by investing only the funds needed by the owner to cure the delinquent loan payments and property taxes, and pay the annual property insurance premium and foreclosure costs;

- the seller-in-foreclosure would remain in possession under a lease with sufficient rental payments to cover the investor's costs of ownership; and

- the owner would be given an *option to repurchase* the residence at a price to include a profit for the investor.

The EP investor refuses to go along with the owner's proposal to be granted an option to repurchase the property. The investor claims the grant of a purchase option to the owner would:

- transform the investor's intended purchase into a loan transaction; and

- bar the investor from conveying title or encumbering the property at any time without the owner's further consent; and

- deprive the investor of the investment and tax benefits of owning real estate.

As a result, the investor and the owner reach a compromise. They enter into an EP agreement that provides the owner with a six-month holdover tenancy — no repurchase option included.

Has the EP investor correctly represented the mortgage and tax consequences of holding title subject to a repurchase option as a loan, called a *mortgage-in-fact*?

Yes! A sale-leaseback and purchase option arrangement is a *mortgage*. Thus, the EP investor would have made a loan, not a purchase of ownership of the property. When an owner occupying a one-to-four unit residential property as his principal residence conveys title in exchange for money to cure delinquencies and the right to retain possession with an **option to repurchase** the property, a loan has been negotiated, not a sale.

The financial arrangement of the lease-option sale contains all the elements of a loan: a yield (interest and principal paid as rent) and a due date (final/balloon payment of principal on exercise of option) as a condition for returning (reconveying) title. Thus, the investor becomes a lender holding title as security for repayment of a debt, not a buyer receiving the possessory rights and economic risks and benefits of an owner. [Calif. Civil Code §1695.12]

As a lender, the EP investor is not able to take depreciation or other **tax benefits** available to an owner of rental property. [**Haggard** v. **Commissioner** (9th Cir. 1956) 241 F2d 288]

An investor who takes title to property while allowing the owner the right to remain in the property and the right to repurchase the property under an **option to buy** does not own the property. The grant deed the investor receives merely conveys title as security for repayment of a debt, a *mortgage-in-fact*. Despite any additional set of agreements or circumstances (even using EP agreements and fully com-

plying with right to cancel notices), the investor taking title must not give the owner-in-foreclosure an option to recover title to the property. However, the investor taking title who does not grant an option to buy to the owner must later obtain **written permission** from the owner before the investor may:

- encumber the property; or
- grant any interest in the property to another person. [CC §1695.6(e)]

Thus, when the owner defaults on the lease and vacates the property, the investor is left with naked title, unable to refinance the property, convey title to another person or create a leasehold interest under a rental or lease agreement with a tenant—without the owner's prior approval. [CC §1695.12]

Equity loan during foreclosure

Consider an owner whose home is in foreclosure due to a default under a trust deed lien on his home. He asks a friend to make him a loan.

The friend advances all funds necessary to cure the default under the trust deed and take the property out of foreclosure, called *reinstatement*.

As security for repayment of the friend's advance of funds, the homeowner conveys title to the friend. As part of the arrangements, the owner is to remain in possession under a lease agreement and is granted an option to recover title to the residence on a final payoff to the friend.

Later, the owner defaults on the rent and voluntarily vacates. The friend locates a buyer, enters into a purchase agreement and conveys title to the buyer.

The owner now out of possession seeks to recover the value of his lost equity from his (former) friend. The owner claims an investor who takes title and grants an option to the owner to repurchase the property must first obtain the owner's consent before the investor may convey any interest in the property to another since the transaction was entered into while the home was in foreclosure.

The friend claims EP law does not apply to him since he is not in the business of lending money, much less buying homes in foreclosure.

However, EP law applies to all persons whose conduct constitutes that of an EP investor, regardless of the number of EP transactions the person completes. The investor conveyed title to the property without first obtaining written consent from the owner (even though the investor held title), in violation of equity purchase law. [CC §1695.6]

The EP investor's failure to obtain the owner's written permission prior to conveyance on the property's resale imposes liability on the EP investor for breach of the owner's (redemption) rights when a loan is involved. The money losses collectible by the owner are based on the value of the property at the time the EP investor first transferred the property without the owner's consent. [Segura, *supra*]

Additionally, consider an owner-in-foreclosure who is in bankruptcy and conveys his property to an investor at a price lower than its market value. The transaction is structured as a grant deed conveyance to the investor with a leaseback agreement and the grant of a repurchase option to the owner. Specially printed equity purchase forms with right of rescission notices to the owner-in-foreclosure were not entered into by the owner and the investor.

The transaction is approved as a sale of the property by a trustee acting on behalf of the bankruptcy court.

The owner-in-foreclosure is not able to repurchase the property on expiration of the repurchase option. A notice to vacate is served by the owner.

The owner now seeks to quiet title to the property in his name, claiming the sale-leaseback agreement violated of the Home Equity Sales Contract Act (HESCA) EP law since the investor, knowing the home was in foreclosure, acquired title to the property without complying with the notice requirements of the EP law.

The investor claims the sale was authorized by the equivalent of a court order, and thus exempt from equity purchase laws, since the sale was approved by a bankruptcy trustee acting on behalf of the court. [CC §1695.1(a)(5)]

Here, the sale by the owner-in-foreclosure to the investor was subject to EP law since the exemption for court-ordered sales does not apply to sales of property approved by a mere bankruptcy trustee. [**Spencer** v. **Marshall** (2008) 168 CA4th 783]

Continued occupancy by the owner-in-foreclosure

Any leaseback agreement negotiated with a n owner-in-foreclosure must be reduced to a written addendum as part of the EP agreement, or by amendment prior to funding by the EP investor and conveyance of title by the seller. [CC §1695.3(f)]

The owner-in-foreclosure and EP investor structuring a transaction occasionally consider one of several occupancy arrangements for the owner:

- a sale-leaseback, typically a *holdover tenancy* for a fixed time period at which point the owner must vacate [See **first tuesday** Form 272];

- a sale-leaseback with an option to purchase as an addendum (which is a mortgage-in-fact), sometimes called a *reverse lease-option* [See **first tuesday** Forms 161 and 550]; or

- an unexecuted purchase agreement coupled with a lease-option agreement with the seller, a variation on the prior arrangement but does not call for immediate conveyance. [See Form 163 in Chapter 35]

In a straightforward lease arrangement, a security deposit and the first month's rent are payable to the EP investor at the closing of an EP sale since the seller will holdover for a specified time period. The seller usually prepays rent and a security deposit through escrow from his net sales proceeds. So long as the EP laws calling for the use of special Equity Purchase agreements and right-of-rescission notices are complied with, the sale-leaseback arrangement does not violate the EP laws. It is the repurchase option given under any circumstances which sets the investor up for a future violation of the EP law.

Sale-leaseback recharacterized

Inherent in an EP sale-leaseback and option to repurchase the property is the risk the loan transaction will be misinterpreted by the local assessor, the existing lender or the Internal Revenue Service (IRS).

Reassessment of the property occurs on execution of a sale-leaseback. [**Pacific Southwest Realty Company** v. **County of Los Angeles** (1991) 1 C4th 155]

However, if the "two-step" financing scheme is brought to the attention of the assessor, a sale-leaseback intertwined with an option to repurchase is correctly recharacterized by all agencies (and the seller) as a single **financing arrangement**, rather than two consecutive sale and repurchase transactions. Thus, no change of ownership occurs, even though the vesting of title is altered, and no reassessment takes place. [Calif. Revenue & Taxation Code §62(c)]

Existing lenders view a sale-leaseback, with or without a repurchase option, as an opportunity to **call or recast** a loan under their *due-on clause* — should they become aware of the facts. An EP investor should consider including a contingency in the EP agreement calling for a *due-on waiver* to be negotiated with the existing lender prior to closing. [See Chapter 28]

An existing lender usually will not demand a modification or call its loan unless the current market rates are so high as to allow the lender to increase its portfolio yield through points or an increased interest rate, either by loan modification or a payoff and reinvestment in a new loan.

Federal tax consequences

The **IRS** also treats sale-leasebacks as loan transactions, not a sale or a purchase, when the seller remains in possession and is given an option to repurchase title to the property. Taxwise, the sale-leaseback is a financing arrangement when:

- rental payments under a long-term lease equal an amortization of the fair market value over the term of the lease when title is to be reconveyed to the seller/tenant; or

- the final/balloon payment required to exercise a repurchase option equals principal and accrued interest that would be financially similar to the due-date payoff under a note and trust deed. [**M & W Gear Co**. v. **Commissioner** (7th Cir. 1971) 446 F2d 841]

The EP investor's tax consequences on **recharacterization** of a sale-leaseback and purchase option as a financing arrangement include:

- denial of any depreciation deductions;

- imputing of interest income reportable at 110% of the applicable federal rate (AFR) [Internal Revenue Code §1274(e)];

- reporting of would-be rental income as investment/portfolio category interest income on a loan; and

- denial of any rental operating expenses (impound for taxes and insurance premiums belonging to the seller), since the transaction is a loan.

For the EP investor to receive the tax benefits of owning real estate, he must limit the leaseback to a periodic tenancy (month-to-month) or a tenancy with a fixed date at which time the tenant is to vacate the premises (lease agreement)—no repurchase option allowed either way.

No repurchase options granted

An EP investor structuring a sale-leaseback, which does not include a repurchase option, eliminates the risk the transaction will be recharacterized as a financing arrangement if:

- the seller-in-foreclosure is given the lease in full or part exchange for his equity (or for his payment of rent); or
- the rent charged is the current fair market rate; and
- the leaseback agreement sets a "fixed" time period for the lease to terminate and possession to be transferred to the EP investor. [**Camp** v. **Matich** (1948) 87 CA2d 660]

If the seller-in-foreclosure is not given a repurchase option and remains in possession of the property after the lease expires, the EP investor can begin an unlawful detainer (UD) action without prior notice to the seller to vacate, and proceed to have the prior owner evicted. [**Ryland** v. **Appelbaum** (1924) 70 CA 268]

As in any lease, the leaseback agreement should provide for payment of increased rent if the seller-in-foreclosure does not vacate upon either the expiration of the lease or a notice to vacate used to terminate the tenancy under a month-to-month rental agreement. A reminder: The seller-in-foreclosure has defaulted on home payments. Thus, he is a serious adverse credit risk as a tenant for the EP investor.

Chapter 21 Due-on-sale regulations

This chapter clarifies the events which trigger a lender's due-on clause and analyzes the adverse socio-economic effects of due-on regulations on the real estate resale and equity loan markets.

Rising rates bring lender interference

During the good times of upward sales volume, expanding mortgage origination and increasing absorption rates for available rented space, the marketplace functions at full throttle—a virtuous cycle. Social benefits of lending abound.

Every sales activity feeds on every other sales activity. No one seems to care about the excuses and inherent inefficiencies buried in the process.

Responsibility for all this frenzy lies solely with the gatekeepers to entry into real estate ownership, and relocation—the brokers and lenders. All other parties to a real estate transaction, being merely affiliated, provide closing services once the broker has located a buyer and the lender qualifies that buyer (and the property) for a purchase-assist loan. Singularly, these two events by these two guardians of real estate are the nucleus of a sale, and all else follows as support services.

During the good times of rising prosperity for all, buyers will put up with the onerous threshold of entry procedures maintained by these gatekeepers. In the rush to do deals, all the numerous steps to ownership seem to be justified, or are simply overlooked as necessary tedium to get in on the act.

However, when, as always it must, the cause of a recession - short-term interest rates rise to outrun inflation - dampens enthusiasm (1989, 2000, 2005). The restrictions on entry posted by the brokers and lenders, burdensome in the first place, are actually tightened to discourage the able and ready buyers who then become unwilling to put up with both the hassles of entry or relocating and the regime of higher rates and increased credit standards: A vicious cycle which takes years to unwind after it bottoms.

Enter *due-on-sale* restrictions (and efforts to get around brokers). As a result, socio-economics decline.

One of the burdens on the mobility of title necessary to sell real estate which restricts the ease with which a buyer and seller can make a deal is the *due-on clause* you will find buried within the copy of all trust deeds held by lenders. During boom years, buyers can easily qualify for a new loans and sellers are relatively unconcerned about the size of the prepayment penalty on their mortgages that the due-on clause is not an issue.

However, as the boom turns to bust and buyers want to buy property, the most effective financing arrangement is to take over the seller's loan. However, the lender as the gatekeeper generally says no to any type of loan takeover or assumption—"I want my repayment penalty and I can re-lend the money at higher current rates." Thus, what was not a burden and not a factor inhibiting deals made during the boom becomes a noose about the seller's neck tying him to his property without a way through the MLS to get out from under the loan—or the property.

Attempts to circumvent the restraint

A parcel of real estate which is listed for sale is security for a loan under a first trust deed lien containing a **due-on clause**. The listing agent locates a buyer for the property.

The purchase agreement negotiated by the listing agent calls for closing to be contingent on the buyer entering into an *assumption agreement* with the first trust deed lender allowing the buyer to take over the loan on the property. The seller will carry back a note secured by a second trust deed for the balance of the purchase price after the buyer's down payment.

The buyer is advised the senior lender may:

- refuse to allow the loan to be assumed, forcing the buyer to arrange new financing suitable to acquire the property; or

- require a modification of the loan at a less favorable rate than the note rate on the loan and demand a large assumption fee.

Before contacting the lender to process an assumption, the buyer suggests the sale of the property be structured as a lease-option in an attempt to avoid due-on enforcement by the lender.

The buyer and seller discuss entering into a two-year lease agreement with an option to extend the lease for two years at an increased monthly payment. The buyer will be granted an option to purchase for the life of the lease.

The down payment will be restated as *option money*. The **option money** will apply to the purchase price of the property, as will a portion of each monthly payment, called *rent*.

Meanwhile, the seller will continue making payments on the trust deed loan. When the buyer exercises his purchase option, the loan will be assumed or paid off and the buyer will become the record owner of the property.

Does the lease-option sale avoid due-on enforcement by the lender?

No! Any lease agreement which contains an option to purchase triggers due-on enforcement by the lender on discovery. [12 Code of Federal Regulations §591.2(b)]

Lender interference authorized by federal mortgage law

Generally, all lenders and carryback sellers are allowed to enforce their due-on sale clauses in trust deeds on nearly all transfers of an interest in any type of real estate. [12 United States Code §1701j-3, Garn-St. Germain Depository Institutions Act of 1982 (Garn)]

Thus, federal mortgage law deprives Californians (and residents of numerous other states) of their state law right to convey real estate subject to trust deed liens without the lender interfering with the transfer of ownership, unless the lender can show the buyer lacks creditworthiness, a federal legislative process called *pre-emption*.

The occurrence of an event which triggers due-on enforcement automatically allows the lender to:

- **call the loan**, demanding the full amount remaining due be paid immediately, also known as *acceleration*; or

- **recast the loan**, requiring a modification of the loan's terms as a condition for the lender's consent to a transfer, called a *waiver by consent*.

The *Garn Act* encourages lenders to allow buyers to assume real estate loans at existing rates, but provides lenders no incentives for doing so. The congressional intent in passing the *Garn Act* was to **preempt state law restrictions** of due-on enforcement, allowing the lenders to increase their profits, a process called *deregulation*. However, the enforcement of the due-on clause by lenders was not intended to occur at the expense of permitting **excessive lender interference** with real estate transactions, whether they are sales, leases or further encumbrances. [12 USC §1701j-3(b)(3)]

Yet, when the Federal Home Loan Bank Board (now the Office of Thrift Supervision (OTS)) issued **due-on regulations** to implement *Garn*, no notice was taken of the congressional request for leniency when exercising due-on rights.

The OTS regulations allow automatic due-on enforcement on any transfer of an interest in real estate, with only a few family-related, owner-occupied single family residence exceptions. No encouragement or guidelines were established in the regulations as proffered by congress for lenders to consent to loan assumptions or to limit interference in commonplace transactions.

Since lenders often disregard the law in their trust deed lending and enforcement practices, it is hard to imagine why they would comply with a mere congressional request, a "moral risk" created by congressional reaction to lender misconduct. In the absence of any regulatory obligation, lenders use their due-on clauses to maximize their financial advantage over owners by calling or recasting loans on the sale of the secured property. Thus, they increase their portfolio yield in a rising interest rate market by adjusting the rate of interest.

Economic recessions and recoveries

In times of stable or falling interest rates, lenders, when requested, usually permit assumptions of loans at the existing note rate, unless a prepayment penalty clause exists. Lenders have no financial incentive to recast loans, or call and re-lend the funds at a lower rate when interest rates are dropping in the marketplace.

However, in times of steadily rising rates, lenders seize any event triggering the due-on clause as an opportunity to increase the interest yield on their portfolio. Once the due-on clause is triggered, the lender requires the loan be recast at current market rates as a condition for allowing an assumption, lease or further encumbrance of the property by the owner.

Thus, real estate ownership encumbered by due-on trust deeds becomes increasingly difficult to transfer as interest rates rise, contributing to the "imprisoning" of an owner in his own home as he is unable to relocate. Lender due-on interference is virtually guaranteed since the interference results in an increase in the lender's portfolio yield which permits them to remain solvent, if not the owner.

However, the *inhibiting effect* on buyers during recessions when buyers are required to assume existing financing at higher interest rates has an adverse economic effect on real estate sales, as well as the availability of private junior financing and long-term leasing. Ultimately, as rates and lender interference rise, many buyers, equity lenders and long-term tenants are driven out of the market, which further depresses property values.

"It has recently come to our attention . . ."

Trust deed called or recast at lender's option

Events triggering the due-on clause

Sale:

- transfer of legal title (grant or quitclaim deed);
- land sales contract or holding escrow;
- court-ordered conveyance; or
- death.

Lease:

- lease for more than three years; or
- lease with an option to buy.

Further encumbrance:

- creation or refinance of a junior lien; or
- foreclosure by junior lienholder.

Transfers not triggering due-on enforcement

(owner-occupied, four-or-less residential)

- creation of junior lien where owner continues to occupy;
- transfer to spouse or child who occupies;
- transfer into inter vivos trust (owner obtains lender's consent and continues to occupy);
- death of a joint tenant; or
- transfer on death to a relative who occupies.

Meanwhile, owners are faced with the prospect of watching the value of their property fall below the remaining balance on encumbrances, leaving owners with no (read: negative) equity in the property. It is a vicious cycle which evolves into a dramatic increase in loan foreclosures, the antithesis of the profit motive for automatic lender enforcement of the due-on clause.

Due-on interference was an obscure issue during the 25-year period (1982 through 2007) after *Garn* became law. During this period, fixed mortgage rates declined from 15% to 5% as managed by the Federal Reserve Bank, the earnings of buyers increased (but not as fast as inflation was rising), inflation dropped, and mortgage money became more plentiful. All that was reversed commencing in 2007.

Due-on-sale

Due-on clauses are most commonly known as *due-on-sale* clauses. However, "due-on clause" is a more accurate term. A sale is not the only event triggering the clause. Still, as the name "due-on-sale" suggests, the primary event triggering the lender's due-on clause is a sale of property which is subject to the lender's trust deed lien.

The due-on clause is triggered not only by a transfer using and recording a standard grant deed or quitclaim deed, but by any conveyance of legal or equitable ownership of real estate, whether or not it is recorded. Examples include a land sales contract, lease-option sale, or other alternative carryback devices, such as an all-inclusive trust deed (AITD).

For example, a land sales contract does not involve a conveyance of real estate to the buyer by grant deed. The seller on a contract (for deed) retains title as security for the carryback debt owed by the buyer rather than use a trust deed lien to evidence his security interest. However, the buyer becomes the *equitable owner* of the property as soon as the land sales contract is entered into and possession is transferred, triggering the due-on clause in any existing trust deed (and reassessment). [**Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629]

Due-on-lease

The due-on clause is also triggered by:

- a lease with a term over three years; or

- a lease for any term when coupled with the grant of an option to purchase to the tenant. [12 CFR §591.2(b)]

For example, an owner with a short-term interim construction loan for nonresidential rental property obtains a conditional commitment from a long-term lender for take-out financing to pay off the construction loan. Funding of the take-out loan is conditioned on the property being 80% occupied by tenants with an initial lease term of at least five years.

The owner locates tenants for 80% of the newly constructed property, all with a lease term of five years or more. The lender funds the loan. The loan is secured by a trust deed lien on the property, which contains a due-on clause. The existing five-year leases do not trigger the due-on clause in the lender's trust deed. The long-term leases were entered into before the loan funded and the trust deed recorded.

However, after obtaining the loan, the owner continues to lease out space in his property for five year terms. Later, after interest rates rise, a representative of the lender (a prior loan officer) visits the property and "discovers" new tenants. On inquiry, the officer learns that some of the tenants entered into leases, or had their leases extended for periods greater than three years, after the loan was recorded.

The lender sends the owner a letter informing him it is calling the loan due since the owner has entered into lease agreements with terms over three years without their prior consent.

The owner claims the lender cannot call the loan since long-term leases were required by the lender as a condition for funding the loan.

Can the lender call the loan due or demand a recast of its terms?

Yes! By requiring leases with terms over three years as a condition for funding the loan, the lender did not waive its right to call or recast the loan under its due-on clause should a lease with a term over three years be entered into after the loan was originated.

However, an **assignment** or **modification** of an existing lease does not trigger the due-on clause, unless the lease is modified to extend the term beyond three years, or a purchase option is granted to the tenant.

For example, consider an owner of real estate who enters into a lease with an initial term of 10 years. Later, the owner takes out a loan secured by a trust deed containing a due-on clause. After the trust deed is recorded, the tenant assigns the lease with the owner's approval, as provided in the lease agreement (which has priority to the lender's trust deed).

However, the lender's due-on clause is not triggered by the lease assignment. The trust deed is attached as a lien only on the owner's fee interest, not the leasehold interest the owner previously conveyed to the tenant. The fee owner whose interest is encumbered by the loan transferred nothing. The assignment of a leasehold by a tenant is not a transfer of any interest in the fee encumbered by the trust deed.

However, consider a landlord who releases the original tenant from all liability under the lease as part of an assumption of the lease by the new tenant and substitution of liability. The release of the original tenant from liability creates a novation of the lease — a new agreement conveying an interest in the secured property to the new tenant by the owner of the fee. Since the novations included a leasing period of over three years, the lender may call the loan. [**Wells Fargo Bank, N.A.** v. **Bank of America NT & SA** (1995) 32 CA4th 424]

Thus, an assumption of the lease by a new tenant, and a release of the former tenant from liability by the landlord, constitutes a present transfer of an interest affecting the fee ownership of the real estate since it is a novation. Accordingly, a lease **novation** triggers the due-on clause — if the lease has a remaining term of over three years or includes an option to purchase.

Due-on-further encumbrance

An owner-occupant of a single family residence (SFR) subject to a first trust deed applies for an **equity loan** to be secured by a second trust deed on his property. The first trust deed contains a due-on clause.

The loan broker tells the owner he is concerned about due-on enforcement by the senior lender, since the execution of a second trust deed will convey a security interest in the property by encumbering it with a lien. On inquiry, the owner informs the broker he will continue to occupy the property as his residence.

Due-on enforcement and prepayment penalties

Consider an owner of real estate which is encumbered by a trust deed securing a note containing a **prepayment penalty clause**. The owner sells the property, triggering the due-on clause in the lender's trust deed.

The lender, unwilling to consent to an assumption by the buyer, calls the loan due. The buyer obtains a new purchase-assist loan from a different lender, enabling the buyer to pay off the existing loan.

The lender informs the buyer he will have to pay a prepayment penalty due to his early payoff of the loan.

The buyer claims he cannot be charged a prepayment penalty since the early payoff was not the buyer's choice, but was a result of the lender exercising his right to call the loan due-on-sale. Thus, the note is due by its terms.

Can a lender charge a prepayment penalty after calling a loan due?

Yes! The prepayment penalty clause in most trust deeds allows the lender to charge a penalty if the loan is **voluntarily or involuntarily** paid off before the due date**.**

Before 1983, a lender's prepayment penalty clause frequently called for a penalty only if the property owner voluntarily paid off the loan before the due date. Thus, the lender was barred from enforcing prepayment penalties in an *involuntary payoff*, after calling a loan due under the due-on clause. [**Tan** v. **California Federal Savings and Loan Association** (1983) 140 CA3d 800]

The lenders' response to the *Tan* decision was to reword their prepayment penalty clauses to impose a penalty for any prepayment of the loan, whether voluntary or involuntary.

However, when a loan is secured by a trust deed on owner-occupied, one-to-four unit residential property, federal regulations bar the lender from imposing a prepayment penalty when accelerating the loan under its due-on clause. [12 CFR §591.5(b)(2)]

The broker correctly assures the owner the second trust deed encumbrance will not trigger the senior lender's due-on clause, as long as the owner continues to occupy the residence. Due-on enforcement based on a further encumbrance of an owner- occupied, one-to-four unit residential property is not permitted. Equity loans are a source of consumer funds which stimulate the economy. [12 CFR §591.5(b)(1)(i)]

However, on real estate other than an owner- occupied, one-to-four unit residential property, any further encumbrance without first obtaining the existing lender's waiver of its due-on clause triggers the due-on clause, giving the lender the right to call or recast the loan.

Thus, junior financing without a waiver of the senior lender's due-on clause becomes a risky enterprise for trust deed investors in times of rising interest rates. Increasing market rates give trust deed lenders a powerful incentive to call loans on the transfer of any interest in the secured real estate — with the exception of owner-occupied, one-to-four unit residential properties.

For example, a private lender accepting a junior trust deed position on a type of property other than an owner-occupied, one-to-four unit residence without first obtaining a **due-on waiver** from the senior lender risks having the economic value of his position in title:

- **reduced** by an increase in the interest rate on the first; or

- **wiped out** by the first's foreclosure, should the first exercise its due-on rights based on the further encumbrance and not be paid in full. [**La Sala** v. **American Savings & Loan Association** (1971) 5 C3d 864]

Owners are driven to look elsewhere for funds when the existing lender does not grant a due-on waiver. Thus an owner is forced to unnecessarily refinance existing encumbrances in order to generate cash from their equity in the property, a more expensive process due to prepayment penalties and increased rates than had they obtained an equity loan.

Now consider a seller who carries back a second trust deed on the sale of property without the consent of the holder of the first trust deed which contains a due-on clause.

The first trust deed lender learns of the sale and calls the loan. To avoid the call, the buyer assumes the first trust deed loan and modifies the note by shortening the due date.

The carryback seller claims his second trust deed now has priority over the first trust deed since the modification of the first trust deed note substantially impairs his security by increasing the potential for default on his trust deed.

Here, the modification of the first trust deed note without the consent of the junior carryback seller does not result in a change in trust deed priorities since the existence of the second trust deed note is in violation of the due-on clause in the first trust deed.

When the secured property is sold and the seller accepts a second trust deed without receiving the lender's prior written consent, the due-on clause has been breached under federal mortgage law. Thus, no duty is imposed on the first trust deed lender to avoid further subordinating the interest of the holder of the unconsented-to junior lien by recasting the first trust deed note. [**Friery** v. **Sutter Buttes Savings Bank** (1998) 61 CA4th 869]

Due-on-foreclosure

A parcel of real estate is subject to a first trust deed lien and second trust deed lien to which the first consented. The property owner defaults on the first trust deed. The junior trust deed holder reinstates the first trust deed and forecloses on the second, acquiring the property at the trustee's sale. At all times the second trust deed holder kept the first trust deed current.

The senior lender informs the junior lender, who now owns the property, that it is calling its loan due, based on the transfer of the property by trustee's deed.

Can the senior lender call its loan due based on the completion of foreclosure by the second trust deed lender?

Yes! A senior lender may call a loan due on completion of the **foreclosure sale** by a junior lender or carryback seller on any type of real estate. A *trustee's deed* on foreclosure is considered a voluntary transfer by the owner, since the power of sale authority in the junior trust deed was agreed to by the owner of the real estate.

However, the due-on clause is not only triggered by the voluntarily agreed-to trustee's sale, but also by any involuntary foreclosure, such as a tax lien sale. [**Garber** v. **Fullerton Savings and Loan Association** (1981) 122 CA3d 423]

Federal regulations allow due-on enforcement on **any transfer** of real estate which secures the lien, whether the transfer be voluntary or involuntary. [12 CFR §591.2(b)]

The risk of a senior lender enforcing its due-on clause on a trustee's sale by the junior lender has a **debilitating effect** on the availability of junior trust deed loans and carryback sales. Prudent lenders and sellers are unwilling to accept a junior position which exposes them to paying off a senior debt should they be forced to foreclose on the real estate. [**Pas** v. **Hill** (1978) 87 CA3d 521]

Due-on-death and exceptions

Transfers of real estate which trigger due-on enforcement include the inevitable transfer resulting from the death of a vested owner even if title was vested in a revocable inter vivos trust. However, as with due-on enforcement triggered by further encumbrances, narrow exceptions apply to the death of an owner who occupied a one-to-four unit residential property.

For example, the transfer of a one-to-four unit residential property to a relative on the death of the owner-occupant does not trigger the due-on clause, on the condition the relative becomes an occupant of the property. [12 CFR §591.5(b)(1)(v)(A)]

Also, where two or more people hold title to one-to- four unit residential property as joint tenants, the death of one **joint tenant** does not trigger due-on enforcement as long as at least one of the joint tenants, whether it was the deceased or a surviving joint tenant, occupied the property at the time the loan was originated. Occupancy is not required for a surviving joint tenant who qualifies for the joint tenancy exception. [12 CFR §591.5(b)(1)(iii)]

In all other transfers, the death of a vested owner, joint tenant or other co-owner will trigger the lender's due-on clause. Thus, due-on enforcement is **triggered on death** by:

- a transfer of the deceased's residence to a non-relative, by will or by trust, following the death of the owner;
- the death of a joint tenant owning a one-to-four unit residential property which was not originally occupied by any of the surviving joint tenants;
- the death of a co-owner of any type of property other than one-to-four residential units; and
- the transfer of any property, other than the deceased's residence, to a relative or anyone else on the death of the owner.

Divorce and inter-family transfers

A married couple occupies a residence which is vested in the name of the husband and owned as his separate property. The residence is subject to a trust deed containing a due-on clause.

The couple separates and the residence is transferred to the wife as part of the **property settlement** to dissolve the marriage. The wife continues to occupy the residence.

Does the transfer of the residence to the wife on divorce trigger due-on enforcement by the lender?

No! Federal due-on regulations bar due-on enforcement on transfer of one-to-four unit residential property to a spouse after a divorce, so long as the spouse occupies the property. [12 CFR §591.5(b)(1)(v)(C)]

However, if the acquiring spouse chooses to lease the residential property to tenants for any length of time rather than occupy it, the lender can call or recast its loan.

Also, the due-on clause is not triggered by an owner's transfer of his one-to-four unit residential property to a **spouse or child** who occupies the property. [12 CFR §591.5(b)(1)(v)(B)]

This inter-family transfer exception for four-or-less residential property applies only to transfers from an owner to a spouse or child. For instance, any transfer from a child to a parent to provide housing for the parent triggers due-on enforcement.

Finally, consider an owner-occupant of one-to-four unit residential property who transfers the property into an *inter vivos trust*, naming himself as beneficiary. The owner continues to occupy the property after transferring title into the trust, commonly known as a living trust.

The owner **notifies the lender** he will be transferring title into the trust vesting. The owner agrees to give the lender notice of any later transfer of his beneficial interest in the trust or change in occupancy of the property as requested by the lender.

Would this transfer into a living trust trigger the due-on clause in a trust deed encumbering the owner's residence?

No! The owner met the federal regulatory conditions for avoiding due-on enforcement based on a transfer of owner-occupied, one-to-four unit residential property into an inter vivos trust. [12 CFR §591.5(b)(1)(vi)]

To meet regulations, the owner must provide means **acceptable to the lender** by which the lender will be given notice of any later transfer of the beneficial interest in the trust or change in occupancy. If the owner conveys the property into the inter vivos trust without the lender's approval of the notice provision, the lender may call the loan due.

The notification provision requires the owner to first obtain the lender's consent before transferring the property into a trust vesting.

Also, if the owner does not continue to occupy the property, or later transfers the beneficial interest in the trust, the lender can call or recast the loan.

Waiver by negotiation and by conduct

Under federal regulations, lenders have the power to dictate the fate of financing in most real estate transactions, since most real estate is encumbered by adhesion trust deeds containing due-on clauses.

However, an owner wishing to enter into a transaction to sell, lease or further encumber his real estate without lender interference must first negotiate a **limitation or waiver** of the lender's due-on rights.

Waiver agreements are basically trade-offs. The lender will demand some consideration in return for waiving or agreeing to limit the exercise of its due-on rights in the future, such as increased points on origination, additional security, principal reduction, increased interest and larger payments, a shorter due date or an assumption fee.

For example, a buyer applies for a loan to purchase a residence which he intends to occupy for only a few years. The buyer is concerned due-on enforcement will later make it more difficult for him to resell the property since it will limit the seller's ability to finance the sale of his equity.

Thus, the buyer and the lender negotiate the conditions on which a qualified buyer in a later sale of the property will be able to assume the loan without a call by the lender. In exchange for the lender's limitation of its future due-on rights, the buyer agrees to pay increased points or interest.

Any time a lender recasts a loan as a condition for consenting to a buyer's assumption, it is essentially forcing a *modification agreement* on the buyer. In exchange for agreeing not to call the loan due on a transfer of the property to the buyer, the lender receives consideration, such as increased interest and payments (the modification of the loan) and an assumption fee.

The lender's waiver of its due-on rights under an assumption agreement applies only to the present transfer to the buyer. Unless additionally agreed to, any **later transfer** of an interest in the property will trigger the due-on clause, allowing the lender to call or recast the loan again.

In addition to a waiver (assumption) agreement, waiver of the lender's due-on rights may occur **by conduct** — the lender loses its due-on rights by failing to promptly enforce them.

For example, a buyer purchases real estate subject to a loan secured by a trust deed containing a due-on clause. The lender is informed of the transfer and immediately calls the loan. However, the lender then accepts payments from the buyer for over a year. Finally, the lender seeks to enforce its prior call by refusing further payments and foreclosing.

However, the lender, **by its conduct**, waived the right to enforce its due-on clause. The lender accepted payments from the buyer for over a year after calling the loan on learning of the transfer of the real estate. [**Rubin** v. **Los Angeles Federal Savings and Loan Association** (1984) 159 CA3d 292]

Broker liability for due-on avoidance

When the seller intends to transfer ownership of the property to the buyer, the senior lender's due-on clause is triggered regardless of the form used to document the sales transaction.

Of course, the lender can only call the loan when it actually discovers a change of ownership has taken place. If the buyer's option is not recorded, and the lease agreement is for a term under three years, the lender might not discover any transfer of an interest in the real estate has taken place, which triggered its due-on clause.

If the lender later discovers a change of ownership has taken place, its only remedy against the buyer and seller is to call the loan due, or arrange to recast the loan as a condition for waiving its right to call and allowing an assumption by the buyer. Under the note and trust deed, the lender cannot recover the *retroactive interest differential* (RID) for the period before it discovered the transfer and called the loan. The only recourse against the buyer or seller is to call the loan and be paid in full or foreclose. [**Hummell** v. **Republic Federal Savings & Loan** (1982) 133 CA3d 49]

However, **an adviser**, such as a broker or attorney, assisting the buyer or seller to mask the change of ownership from the lender with the primary purpose of avoiding the lender's due-on enforcement, can be held liable for wrongfully interfering with the lender's right to call or recast the loan, an offense called *tortious interference with prospective economic advantage*.

The adviser's liability arises based on the extent to which his actions were **specifically intended** to conceal the transfer and prevent a call by the lender, and on the **foreseeability** the lender would incur losses due to the concealment. [**J'Aire Corporation** v. **Gregory** (1979) 24 C3d 799]

The lender's losses caused by the adviser's wrongful interference are calculated based on the *interest differential* between the note rate and the market rate on the date of sale, retroactively applied from the date of discovery by the lender to the date of the transfer.

Chapter 22 Assumptions: formal and subject-to

This chapter explores the financing procedures available to a buyer when negotiating to take over an existing loan which encumbers the seller's property.

Loan takeovers by buyers

On the sale of a parcel of real estate, any existing financing encumbering the property may remain of record and be taken over by a buyer under one of four procedures:

- a **formal assumption** between the lender and the buyer;
- a **subject-to assumption** between the seller and the buyer;
- a **subject-to transfer** of ownership without an assumption agreement of any type; and
- a **novation** between the lender, seller and buyer.

Consider a seller of real estate which is encumbered by a first trust deed. The seller enters into a purchase agreement and escrow instructions which provide for the buyer to **take title subject-to** the existing loan encumbrance. [See **first tuesday** Form 150 §§ 5 and 6]

The buyer plans to close escrow on the subject-to transfer without entering into a written assumption agreement with the lender. The buyer intends to negotiate with the lender after closing if the lender calls the loan or demands an assumption. If not, the buyer will refinance the existing loan with another lender.

The interest rate on the seller's existing loan is at or above current market levels. Due to the buyer and his broker's experience with the lender, the buyer feels the lender will not call the loan and demand a payoff or assumption. If it calls the loan, the buyer reasons the lender will lose either its servicing fees or its high portfolio yield on the loan, depending on whether the lender owns the loan or is servicing the loan for another lender.

A beneficiary statement is requested by escrow. The lender properly complies with the request by sending a statement of the loan condition to escrow within 21 days of its receipt of the request. [Calif. Civil Code §2943(e)(3); see Chapter 18]

However, the lender unilaterally **instructs escrow** not to close until the buyer has been approved by the lender and has assumed the loan since the lender's trust deed contains a due-on clause.

Can the lender interfere with the closing of a subject-to transaction when the buyer and seller do not instruct escrow to process a lender approval or loan assumption?

No! Escrow instructions for the sale of property subject to the existing loan are entirely between the buyer, seller and escrow. The lender has no legal right to interfere with the transaction to prevent the closing since it is not a party to the escrow.

Further, escrow has no authority from its principals to follow any lender instructions attached to the beneficiary statement. The lender's remedy – and leverage to force a modification or payoff – is limited to calling the loan under its due-on clause in the trust deed after the subject-to transaction is closed, if the lender chooses to do so. [**Moss** v. **Minor Properties, Inc.** (1968) 262 CA2d 847]

The subject-to transaction

A subject-to transaction is initially structured by use of a financing provision in a purchase agreement which calls for the amount of an existing loan to be part of the purchase price the buyer is to pay for the property. The financing provision states the buyer is to take title to the property subject to the existing loan. [See **first tuesday** Form 150 §§5 and 6]

The seller's representation of the terms and condition of the loan is confirmed by the buyer during escrow on escrow's receipt of the lender's **beneficiary statement**. The buyer can rely on the beneficiary statement for future payment schedules, interest rates and loan balances in spite of the lender's attempts to conditionalize the use of the beneficiary statement on the buyer's assumption of the loan.

Some buyers do not instruct escrow to order a beneficiary statement, fearing the notice of the sale may cause the lender to **call or modify** the loan after escrow closes. The seller's most recent loan payment receipt or loan statement might then be used as the source of loan information. However, the buyer must be aware the lender is not bound by the payment statements as it is bound by the beneficiary statement. [See Chapter 18]

Some buyers acquire their ownership rights under **unrecorded sales documents**, such as lease-option agreements or land sales contracts. Thus, the seller and buyer completely avoid conveyances, escrow, title insurance, and other customary transfer activities until they can either work out an assumption or originate new financing. However, these unrecorded sales documents do trigger due-on clauses and reassessments, as well as create risks of loss inherent in an unrecorded transaction that leave room for misunderstandings about who owns the property.

During periods when current market interest rates are comparable to or lower than the note rate on an existing loan:

- a **beneficiary statement** should be ordered to confirm the loan amount and loan terms;
- the change of ownership conveyance should be **recorded and insured**; and
- the conveyance should promptly be brought to the **lender's attention** so it cannot wait and later call the loan when rates rise by claiming the transfer went undisclosed.

Conversely, during periods of rising or high interest rates, as compared to the note rate on an existing loan, the lender is often not notified of a subject-to sales transaction. Notice of the transaction would allow the lender to gain financially from a call or recast of the loan at the seller's and buyer's expense.

However, the lender can enforce its due-on clause and call the loan on its *future discovery* of any sale, regardless of how the sale is structured. Also, on a later discovery of the transfer, any brokers, attorneys or accountants whose **primary objective** in negotiating the sales transaction was to induce the buyer and seller into avoiding the due-on clause may be liable to the lender (in tort) for any *retroactive interest*

differential (RID) lost by the lender based on market rates at the time of the transfer. A *hold harmless agreement* from the seller or buyer would be appropriate for providing indemnity to the agents and brokers negotiating the undisclosed transaction. [See Chapter 21]

The seller of property, sold either subject-to or by an assumption of the seller's loan, should be concerned about his liability for the loan after it is taken over by the buyer. Seller liability depends on whether the loan is a recourse or a nonrecourse loan, unless the lender's loss is a result of its error on a beneficiary statement or a payoff demand. [See Chapter 46]

Nonrecourse debt

A seller is not liable for a deficiency on the foreclosure of a *purchase-money* debt taken over under any procedure by the buyer, since they are nonrecourse debts.

Purchase-money obligations secured by real estate include:

- seller carryback financing on the sale of any type of real estate which becomes the sole security for the carryback note;

- a loan or debt which funded or financed the purchase of an owner-occupied, one-to-four unit residential property [Calif. Code of Civil Procedure §580b]; and

- a loan made for the construction of an owner-occupied, single family residence (SFR), and perhaps a loan made to improve the structure (the legal status of dwelling improvement loans remains uncertain).

A lender may only resort to the secured property by foreclosing on it to recover the balance due when a default occurs on a **purchase-money loan**. [CCP §580b]

Even if the secured property has insufficient remaining value to satisfy the balance of the purchase-money loan, the lender cannot hold the original borrower or a subsequent assuming buyer personally liable on the nonrecourse note for the deficiency in the property value (unless the lender may recover from the buyer who inflicts waste on the property).

On the take-over of a purchase-money loan by a buyer, the loan retains its original non-recourse purchase-money characteristics, regardless of whether the buyer takes title subject-to or assumes the loan, or a novation occurs. [**Jackson** v. **Taylor** (1969) 272 CA2d 1]

Thus, a non-occupying buyer who takes over a purchase-money loan under any procedure is entitled to anti-deficiency protection. In contrast, **purchase-assist** financing originated by a non-occupying buyer of any type of residential property, including one-to-four unit residential property, would be a recourse loan, not a purchase-money loan.

However, while the lender may have no recourse to the buyer, if the loan is insured by the Federal Housing Administration (FHA) and the Veterans Administration (VA), the FHA or the VA have recourse to the borrower who signed the note for losses on a foreclosure and resale of the property. [See Chapter 39 and 40]

Recourse real estate loans

Recourse loans are all loans not classified as **purchase-money loans**, as reviewed above.

Consider a buyer who takes title to property subject to a seller's existing home equity loan which is a recourse (liability) loan. The loan proceeds were not used to purchase or improve the seller's residence.

The buyer defaults on the loan and the lender initiates and completes a judicial foreclosure (not a trustee's sale) on the property. The fair market value of the property at the time of the judicial foreclosure sale is insufficient to fully satisfy the loan, resulting in a deficiency.

The lender now seeks a money judgment against the seller for the amount of the deficiency in the property's value since the judicial foreclosure sale did not fully satisfy the loan amount. The seller claims he is not responsible for the loan since it was taken over by the buyer.

Is the seller liable for the deficiency on the recourse loan after the buyer takes title to the secured property subject to the existing loan?

Yes! When property is sold and its title is conveyed to a buyer **subject-to** an existing recourse loan, the seller remains liable for any deficiency on the recourse loan should the buyer fail to pay. [**Braun** v. **Crew** (1920) 183 C 728]

Further, unless the buyer enters into an **assumption agreement** with either the seller or the lender, a subject-to buyer is not liable to either the seller or the lender for a drop in the property's value below the loan balance (unless the buyer damages the property to an extent which decreases its value, called *waste*). [**Cornelison** v. **Kornbluth** (1975) 15 C3d 590; CC §2929]

However, if the subject-to buyer and the lender enter into an assumption agreement which significantly modifies the terms of the recourse loan without the seller's consent, the seller cannot be held liable for the loan. [Braun, *supra*; CC §2819]

Buyer-seller assumption

A seller can reduce his risk of loss on a buyer's takeover of a **recourse loan** by negotiating the adoption of a provision in the purchase agreement which requires the buyer to enter into an **assumption agreement** with the seller.

A buyer-seller assumption agreement is not to be confused with a so-called *formal assumption* between the buyer and a lender.

The buyer-seller assumption agreement, agreed to in the purchase agreement and prepared in escrow, is a promise given by the buyer to the seller to perform all the terms of the loan taken over by the buyer on the sale. [See Form 431 accompanying this chapter]

The assumption agreement gives the seller the right to collect from the buyer the amount of any deficiency judgment a recourse lender might be awarded against the seller in a judicial foreclosure. To be enforceable by the seller, the assumption agreement must be in writing. [CC §1624]

Although the buyer's promise to pay the loan under a buyer-seller assumption agreement is given to the seller, the buyer also becomes liable to the recourse lender under the legal doctrines of *equitable subrogation* and *third-party beneficiaries*. [Braun, *supra*; see Form 431 §6]

ASSUMPTION AGREEMENT

Unsecured and Subrogated

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This assumption agreement is entered into by

1.1 _____, as the Buyer,

1.2 and _____, as the Seller,

1.3 regarding Buyer's acquisition of real estate referred to as _____

_____.

2. FIRST TRUST DEED NOTE:

2.1 Buyer is acquiring title to the real estate subject to a first trust deed dated _____,

2.2 executed by _____, as the Trustor,

2.3 in which _____ is the Beneficiary,

2.4 recorded on _____, as Instrument No._____, in the Official Records of _____ County, California, and

2.5 given to secure a promissory note of the same date for the principal sum of $_____.

3. SECOND TRUST DEED NOTE:

3.1 Buyer is acquiring title to the real estate subject to a second trust deed dated _____,

3.2 executed by _____, as the Trustor,

3.3 in which _____ is the Beneficiary,

3.4 recorded on _____, as Instrument No._____, in the Official Records of _____ County, California, and

3.5 given to secure a promissory note of the same date for the principal sum of $_____.

AGREEMENT:

4. Seller hereby assigns and delegates to Buyer all rights and obligations in the above note(s) and trust deed(s).

5. Buyer hereby assumes and agrees to timely pay the debt evidenced by the above promissory note(s) and to perform all of Trustor's obligations under the trust deed(s) securing the note(s).

6. This agreement is made for the benefit of the Beneficiary(ies) of the trust deed(s) securing the note(s).

7. Should Buyer or Buyer's successors default in the performance of this agreement, the whole sum of the principal and interest on the assumed indebtedness(es) shall become immediately due at the option of the holder of this assumption agreement.

7.1 On default, Seller shall become subrogated to the interest of Beneficiary under the defaulted note and trust deed.

8. In any action to enforce this agreement, the prevailing party shall receive attorney fees.

I agree to the terms stated above.	**I agree to the terms stated above.**
Date:_____, 20_____	Date:_____, 20_____
Seller: _____	Buyer: _____
Seller: _____	Buyer: _____

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Even though the buyer, upon entering into any type of assumption agreement, takes over the primary responsibility for the recourse loan, the seller remains **secondarily liable** to the lender. The seller's risk of loss arises when the buyer fails to pay the recourse loan and there is a lack of market value remaining in the property to cover the loan amount. [**Everts** v. **Matteson** (1942) 21 C2d 437]

Unlike the subject-to seller, the seller under the buyer-seller assumption agreement is entitled to be *indemnified* (held harmless) by the buyer for any losses the seller later incurs due to his continued liability on the recourse loan taken over by the buyer.

To avoid the delay in pursuing reimbursement from the buyer for any loss covered by the buyer-seller assumption agreement, sales negotiations calling for the buyer to enter into an assumption agreement with the seller may also call for the buyer to **secure the assumption** agreement by a *performance trust deed* carried back by the seller as a lien on the property sold. [See **first tuesday** Forms 432 and 451]

With a recorded trust deed held by the seller to secure the buyer's promise to pay the lender as agreed in the assumption agreement, any default by the buyer on the loan allows the seller to:

- demand the buyer to tender the entire balance remaining due on the assumed loan, subject to the buyer's right to reinstate the delinquencies; and

- proceed with foreclosure under the performance trust deed to recover the property and cure the default on the loan assumed by the buyer.

A buyer-seller assumption, like a subject-to transaction, does not alter the lender's right to enforce its due-on clause on discovery of the conveyance, unless the lender has waived its due-on rights by failing to call the loan or promptly act on a call after acquiring knowledge of the transfer of ownership.

Novation

Consider a buyer who is willing to cash out theseller's equity and assume an existing recourse loan with the lender. However, the seller is unwilling to sell the property and remain liable for the loan after closing when he no longer has an interest in the property.

Can the sale be closed without the seller remaining liable on the recourse loan assumed by the buyer?

Yes! The lender can enter into an agreement with both the buyer and the seller for the buyer's **assumption** of the loan and a **release** of the seller's liability, an agreement called a *novation* or *substitution of liability*, for which the lender charges a fee and may demand a modification of the loan terms.

On a buyer-lender assumption of a loan secured by an owner-occupied, one-to-four unit residential property, the lender is required to **release the seller from liability** for the loan assumed by the buyer. [12 Code of Federal Regulations §591.5(b)(4)]

A **novation agreement** is comparable to the existing lender originating a new loan with the buyer, except the trust deed executed by the seller remains of record and the note remains unpaid.

Thus, the lender under a novation agreement (or an assumption) will review the buyer's credit status, seek a modification of the interest rate to current levels, and charge an assumption fee which are all benefits a lender would have received on an origination of a new loan made to the buyer.

However, any lender collection of fees or an increase in the interest rate on the loan, called *portfolio yield*, defeats most of the advantages a buyer and seller have when taking title subject to an existing loan.

Chapter 23 FHA and VA loan assumptions

This chapter reviews Federal Housing Administration (FHA) and Veterans Administration (VA) enforcement of assumption rules for loans they have insured.

Avoiding fees and investor prohibitions

An investor and his real estate agent discuss the investor's intent to add more single family residences (SFRs) to the pool of rentals he has owned for some time, a client situation called *counseling*. The investor is interested in inexpensive homes recently financed with maximum loan-to-value (LTV) fixed-rate loans insured by the Federal Housing Administration (FHA).

Specifically, the investor wants to **take over** existing financing rather than obtain new financing to fund his purchase of the SFRs. His cash reserves will be used to upgrade the properties. The investor is aware that the interest rate and the mortgage insurance premium (MIP) on FHA loans is higher by approximately 0.6% than conventional loans with private mortgage insurance (PMI), the result of greater leverage.

The investor's agent explains that the trust deed FHA uses for loans insured by the Department of Housing and Urban Development (HUD) includes a *due-on-sale clause*. In order to prevent investors from acquiring SFRs with FHA-insured financing, the **due-on-sale** provision allows HUD to call loans taken over by investors.

The reason for discouraging investors from taking over loans is HUD's need to reduce the number of defaults on FHA loans, since investor-owners generally have a high default rate compared to owner-occupants of SFRs.

However, the investor is made aware that before the lender can *call* an FHA-insured loan on the sale of the SFR property, the lender must first obtain HUD's approval. [HUD Mortgagee Handbook 4155.1 Rev-5 Ch-7 §1.b]

In practice, HUD does not grant the right to call unless a default already exists. Thus, lenders are limited to using the due-on clause as a device to pressure an investor to assume the loan, typically accomplished by contacting the seller prior to the close of escrow. The objective of lenders is *revenue*; they obtain it by demanding and receiving an assumption fee of one-half point or more on the sale and ignoring HUD's late-80s no-investor rule.

Taking over an FHA loan

Prudent long-term investors seek out desperate property owners who are in default, then pay little or no money down and convert the property to a rental unit based on the investment fundamentals of "price, time and location." The best time for property acquisition is during a crisis, such as a recession, when the market is temporarily devoid of sufficient buyers to keep prices at their past levels and selection within prime rental areas is extensive.

However, some individuals entering the real estate market are not in the ownership of real estate for long-term income benefits, but are *speculators* entering the market during boom times intending to immediately flip the property upon buying it, without investing any further capital. In doing so, they often do not make payments to the lender, looking only to pay off the loan on a prompt resale.

Homeowners' associations (HOAs) and the local tax collector (supplemental tax billings) also get burned by the conduct of speculators as they sandwich themselves in between sellers and homebuyers or rental investors to withdraw wealth from the real estate market.

Speculators often collect and keep rent without making payments on the loan, called *rent skimming*, or *equity skimming* if done on a scale of five or more units. **Rent and equity skimming** is a crime under federal and state law. [12 United States Code §1709-2; Calif. Civil Code §§890 et seq.]

In response to the activities of rent-skimming speculators during the 1980s, HUD prohibits investor assumptions on FHA-insured SFR loans. Thus, FHA will only allow the assumption or take-over of an FHA-insured SFR loan by qualified owner-occupant buyers. HUD has the right to call the loan if taken over by anyone other than a homebuyer. [HUD 4155.1 Ch-7 § 1.b]

However, in spite of the HUD due-on enforcement policy, only with HUD's prior approval can the servicing lender call the loan on a subject-to transfer to an investor. As a matter of practice, HUD has not authorized a call when an investor acquires the property, unless the investor defaults on loan payments.

Closing sales subject to FHA-insured loans

Rental investors and unqualified buyers who have the financial ability to make payments on an FHA loan encumbering property they have agreed to purchase should obtain a beneficiary statement from the lender, through escrow, to confirm the seller's representation of the loan terms.

The buyer then closes escrow, taking over the loan by either:

- cashing out the seller's equity; or
- combining cash and a note carried back by the seller to pay for the seller's equity.

The seller's risk of FHA recourse

Sellers must be made aware of their **risk of loss** when permitting a buyer to take title subject-to their FHA loan.

The downside risk for a seller of a property encumbered by an FHA-insured loan is his **personal liability** for any loss the FHA may incur due to a deficiency in the property value at the time of a default by the buyer. This deficiency in the property value might occur after the close of escrow.

If the subject-to buyer fails to make payments on the FHA loan, and the property's value becomes insufficient to satisfy the remaining loan balance, HUD has the right to collect a deficiency from the original borrower.

The right to pursue the original borrower for any deficiency belongs to HUD, not the lender.

Borrowers under programs insured by the FHA or Veterans Administration (VA) do not receive California **anti-deficiency protection** for losses sustained by these federal agencies. The federal statutory right to collect losses on the HUD loan insurance program preempts state law to the contrary. [**Carter** v. **Derwinski** (9th Cir. 1993) 987 F2d 611]

Thus, the seller, on a transfer of title subject to an FHA loan, should consider entering into an *assumption agreement* with the buyer and securing the agreement by a performance trust deed. [See **first tuesday** Forms 432 and 451]

Then, if the buyer does not perform on the **assumption agreement** by making payments on the loan, the seller may call all amounts due by the terms of the assumption agreement and foreclose under the trust deed to protect his interests.

Release of liability

To be released from liability for any deficiency on an FHA-insured loan taken over by a buyer, a seller must obtain a formal *release of liability* as part of the assumption package presented by the lender on an FHA-insured loan. [HUD 4155.1 Ch-7 § 1.e]

A **release of liability** will be granted by the lender if:

- the seller requests a release from personal liability;
- the prospective buyer is creditworthy;
- the prospective buyer assumes the loan; and
- the lender uses an FHA-approved form to release the seller from personal liability. [HUD Form 92210.1; 24 Code of Federal Regulations §203.510(a)]

If the conditions for a release of liability exist, but the seller does not request the release from personal liability, the seller remains liable to the FHA for any losses due to a default occurring within five years after the sale. [12 USC §1709(r)]

However, after five years pass from the time the property is resold, the seller is released from personal liability, if:

- the buyer assumes the loan with the lender;
- the loan is not in default at the end of the five-year period; and
- the seller requests the release of liability from the lender. [24 CFR §203.510(b)]

Many owners sell their homes subject-to FHA-insured loans knowing full well the risks of a deficiency. However, sellers generally believe future appreciation and HUD's recent refusal to pursue collection of loan losses minimize any real risk of value-deficiency exposure.

In economically depressed parts of the country, property is conveyed subject-to FHA-insured loans as a way to obtain buyers, an activity which tends to decrease the level of foreclosures against homeowners who can no longer afford to own the home or must relocate for job opportunities.

Conversely, a demand for a substitution of liability and assumption fees on a loan takeover tends to drive potential buyers away. Thus, the price of homes is driven down, adversely affecting the level of foreclosures and increasing the risk of loss in homeownership.

FHA inactivity on a sale

Any hesitation a seller may have about selling a single family residence (SFR) subject-to an FHA-insured loan is put at ease by HUD's internal policy not to collect deficiencies against owners who made loan payments in **good faith**.

After foreclosure by a lender, the FHA pays the lender for any loan losses under their mortgage insurance policy (MIP) or acquires the property by paying off the loan. If acquired, the FHA resells the properties to offset its losses. FHA then sends collection letters but does not hav ea history of otherwise contacting the homeowner.

Sellers who receive cash for their entire equity occasionally ignore the loan assumption provision and lender threats, and close subject to a FHA-insured loan.

Sellers with well-seasoned loans, or who are extremely motivated to sell, might disregard the due-on clause when selling their home.

HUD, with its **no-investor policy**, severely cripples a defaulting seller's ability to sell his home and financially right himself, or obtain mobility to relocate to a better job.

If HUD's no-investor policy were enforced, it would tend to increase the number of FHA repossessions and cause unemployment levels to remain higher than if owners could move to where the jobs are, which are undesirable effects.

Thus, buying a residence subject-to an FHA-insured loan, regardless of when the loan was originated, will likely continue without government interference and lender assumption threats, so long as the loan is kept current.

Assuming a VA loan

The VA loan assumption policy is entirely different from the HUD/FHA assumption policy.

A buyer of property secured by a VA-guaranteed loan may take over the loan if:

- the loan is **current**;
- the buyer **assumes** the loan; and
- the buyer is **creditworthy**. [38 USC §§3713(a); 3714(a)(1)]

For a buyer to assume a VA loan, a fee of 0.5% of the loan balance is to be paid to the VA by the buyer. [38 USC §3729(b)]

The VA **assumption fee** is to be paid to the lender on closing the sale with the buyer. The lender has 15 days to forward the fee to the VA or the lender will face late charges. [38 CFR §36.4312(e)(2)]

Additionally, the lender can charge and retain an assumption fee of the lesser of:

- $300, plus the costs of a credit report; or
- the maximum amount for an assumption fee allowed under state law. [38 CFR §36.4312(d)(8)]

While no statutory rule exists in California for calculating assumption fees, the fees should reflect actual out-of-pocket costs, or reasonable cost estimates for processing the assumption.

When an assumption application is approved by the lender, the VA borrower is released from further liability to the VA under the mortgage insurance program, including liability for losses caused by the buyer's default in payments. [38 CFR §36.4323(h)]

However, the veteran who is released by the VA is not necessarily released by the lender from further liabilities for the loan. For instance, the veteran who **refinances** his home with a VA insured loan has liability under the loan (as well as to the VA) for any deficiency in the property value to cover the loan.

The veteran exposed to refinancing liability should consider negotiating and entering into a *novation agreement* with the lender in order to be relieved of liability for a potential deficiency. Liability to a lender for a loan used to refinance a property is different from the mortgage insurance liability the veteran has with the VA.

A **novation agreement** requires the consent by three parties — the buyer, seller and lender — to release the seller from further liability to the lender when the seller is released from mortgage insurance liability by the VA under a *substitution of liability*.

If the lender refuses to allow the buyer to assume the loan, the VA may review the findings and determine whether the buyer is entitled to assume the loan.

If the veteran is unable to make payments on his VA-insured loan, but finds a qualified buyer to assume the loan, the VA may require the lender to agree to the loan assumption since it is in the best interest of the VA. [38 USC §3714(a)(4)(B)]

However, neither the lender nor the VA have to release the seller from liability on the loan when the assumption is granted to avoid foreclosure. [38 CFR §36.4323(h)]

If the VA refuses to allow the buyer to assume the loan, and the veteran borrower sells the property nonetheless, the lender may call the loan and demand payment of the remaining principal and interest without prior approval from the VA. [38 USC §3714(a)(4)(C)]

Also, the lender may call the VA loan if the veteran borrower sells his personal residence and fails to notify the lender of the sale. [38 USC §3714(b)]

However, when a lender becomes aware the veteran borrower sold the property secured by a VA loan and the lender fails to notify the VA, then the lender, not the seller, will be liable for any VA losses on the loan. [38 USC §3714(c)(1), (2)]

Chapter 24 Personal property as security

This chapter reviews the documentation in real estate transactions where personal property becomes additional security for a debt.

A lien on additional collateral

A real estate agent lists a furnished apartment complex for sale. The sale will include inside and outside furnishings, refrigerators and maintenance equipment.

The seller of the apartment complex is willing to carry a note secured by a trust deed on the property.

The seller's agent advises the seller the furnishings and maintenance equipment he is selling and transferring on a bill of sale will be **additional security** for any carryback note. Thus, the seller's risk of loss will be minimized should it become necessary to foreclose.

Likewise, loan brokers arrange short-term money loans with private lenders. Since brokered loans made by private lenders usually are secured by second trust deeds on a borrower's real estate, these lenders often want additional security. Additional security might take the form of personal property, such as furnishings, business inventory, equipment, machines or business revenue (accounts receivable).

Two documents are involved to properly secure a debt with personal property:

- a **security agreement** which creates a lien on the personal property; and
- a **financing statement** which is recorded to give public notice of the lien.

To **create a lien** on personal property transferred in a sale of real estate, an agreement is entered into which grants the carryback seller or lender a security interest in the form of a lien on the personal property described in the agreement, called a *security agreement.*

To put the public on **notice of the lien** created by the security agreement, a UCC-1 Financing Statement (UCC-1) is prepared and filed, which is called *perfecting the lien*. The filing is a recording of the UCC-1 with the Secretary of State or with the county recorder, depending on the type of personal property and its relationship to the real estate. [Calif. Commercial Code §§9310; 9501]

Perfecting the lien establishes the carryback seller's interest and priority over all other security interests in the personal property granted to or acquired by others and filed after the seller's UCC-1 is recorded.

A carryback seller should not use a trust deed as a security device to create a lien on personal property. A recorded trust deed imposes a perfected lien on real estate, not personal property.

Personal property defined

All property is divided into two categories — real property, commonly known as *real estate*, and personal property, also called *personality*.

Real estate includes land and anything affixed or appurtenant to it, such as buildings, trees or rivers. [Calif. Civil Code §658]

Every kind of property which is not real estate is classified as **personal property**. [CC §663]

Thus, personal property includes:

- **tangible goods**, such as furniture, equipment and vehicles;
- **general intangibles**, such as the good will of a business, accounts receivable and business income;
- **instruments and documents**, such as promissory notes, whether or not secured by a trust deed lien; and
- other items, such as cash and contract rights.

Rents form a separate category of personal property. Rents become security for a debt under a lien called an *assignment of rents provision* typically included in a trust deed. [See Chapter 17]

Real property vs. personal property

A *real estate fixture* is personal property which is permanently attached or affixed to the land or buildings located within the parameters of a parcel of real estate, and is part of that real estate. [CC §660]

For example, an air conditioning unit in an apartment complex is a **real estate fixture** since it is a necessary, integral part of the building. On the other hand, furniture is not a real estate fixture since it is not permanently attached to the building.

Fixtures which are used as part of a trade or business are called *trade fixtures*, such as the equipment and sinks in a restaurant, or chairs and plumbing fixtures affixed to the floor and walls in a beauty salon.

Trade fixtures, like real estate fixtures, are often affixed to the real estate. However, they remain personal property items since they are necessary to the operation of the business on the premises, not the use of the real estate itself. [**Beebe** v. **Richards** (1953) 115 CA2d 589]

Whether an item is a real estate fixture or personal property is resolved by the application of a three part test:

- the permanence of the item's attachment to the real estate;
- the degree to which the real estate was constructed to support the fixtures; and
- the parties' intentions when the items were attached to the real estate. [**Security Data, Inc.** v. **County of Contra Costa** (1983) 145 CA3d 108]

Intent is the crucial, overriding factor in determining whether an item is personal property or a real estate fixture. [**Seatrain Terminals of California, Inc.** v. **County of Alameda** (1978) 83 CA3d 69]

Intent to establish a fixture as real estate or personal property is usually manifested in an agreement.

SECURITY AGREEMENT

For Note Secured by Personal Property

NOTE: Recommended for use with **first tuesday** Form 435.

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This agreement provides security for the payment of a promissory Note in the amount of $ _____,

1.1 ☐ of same date, or dated _____, 20_____, at _____, California,

1.2 executed by _____, as the Debtor, and

1.3 _____, as the Creditor.

2. Debtor hereby grants to Creditor a security interest in the following personal property _____

_____

_____

_____

_____.

3. The personal property is located on real estate referred to as _____

_____

_____.

4. A UCC-1 financing statement will be executed concurrent with this agreement.

5. The Note is additionally secured by a trust deed entered into by the parties:

5.1 dated _____, at _____, California,

5.2 regarding real estate referred to as _____,

5.3 recorded on _____, as document number _____,
in the County of _____, California.

6. Should Debtor offer to sell, accept an offer to purchase, lease or encumber the personal property or his interest in the promissory Note, or remove the personal property from its location without Creditor's written consent, Creditor may call the promissory Note immediately due.

7. Debtor will maintain insurance on the personal property against risks of fire, theft, vandalism and other extended coverage risks in an amount sufficient to protect the promissory Note.

8. Any advances made by Creditor to protect the security from impairment, or for property taxes, insurance or defense of title, including reasonable costs and attorney fees, shall be reimbursed by Debtor on demand, and if not paid to be added to the amount due on the promissory Note and be immediately payable.

9. On default under the promissory Note or this agreement, or any other security device or obligation affecting the Note or this agreement, Creditor may call the Note due.

10. On default, Creditor has all the remedies of a secured party under the California Commercial Code.

I agree to the terms stated above.	**I agree to the terms stated above.**
Debtor's Name: _____	Creditor's Name: _____
Address: _____	Address: _____
_____	_____
Debtor's Signature: _____	Creditor's Signature: _____
Debtor's Signature: _____	Creditor's Signature: _____

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Thus, in a real estate transaction, the buyer and carryback seller or lender demonstrate their intent to treat an item as personal property, not a real estate fixture, by securing the item under a security agreement and filing a UCC-1 Financing Statement (UCC-1) to perfect the seller's security interest.

*Editor's note — The parties' intent as to whether an item is personal property or a fixture does not control for property assessment purposes. [**Kaiser Co.** v. **Reid** (1947) 30 C2d 610]*

Personal property secures the carryback

Consider a broker who advises a seller of an apartment complex to additionally secure his carryback note with the furnishings, refrigerators and maintenance equipment included in the purchase price.

Unless the personal property sold as part of an installment sale is security for the debt owed the seller, the buyer may sell the personal property at his whim. The buyer becomes the owner of the personal property, unencumbered by the debt owed the carryback seller unless the seller is granted a security interest in the personal property.

More importantly, if the personal property sold is not included with the real estate as additional security for the carryback note, the seller can foreclose only on the real estate and the personal property cannot be repossessed. [**C.B. Cunningham** v. **Security Title Insurance Co.** (1966) 241 CA2d 626]

However, even if the note is additionally secured by personal property sold in what is primarily a real estate transaction, the buyer has no personal liability on the carryback note for any deficiencies on a foreclosure. [Calif. Code of Civil Procedure §580b]

Documenting a perfected security interest

Three documents are required to properly structure a sale or loan transaction on the sale of real estate which is to include personal property as additional security for a debt:

- a **promissory note** [See Form 420 in Chapter 5];
- a **security agreement** [See Form 436 accompanying this chapter]; and
- a **UCC-1 Financing Statement**. [See UCC-1 Financing Statement accompanying this chapter]

To process a sale involving personal property, a *bill of sale* is prepared by escrow and executed by the seller. A **bill of sale** transfers ownership of the personal property to the buyer, just as a grant deed conveys the ownership of real estate. [See **first tuesday** Form 408]

The *promissory note* evidences the buyer's obligation to pay the debt created by the installment sale or loan.

The debt can be evidenced by one note and secured by both the real estate using a trust deed and the personal property using a UCC-1 in what is called a *mixed collateral transaction*.

Alternatively, when a carryback note or loan is to be secured by both real estate and personal property, the carryback seller or lender and the buyer can agree to divide the debt into two separate debts, each evidenced by a note — one debt secured by real estate and the other debt secured by personal property.

[redacted]

UCC FINANCING STATEMENT

FOLLOW INSTRUCTIONS (front and back) CAREFULLY

A. NAME & PHONE OF CONTACT AT FILER [optional]

B. SEND ACKNOWLEDGEMENT TO: (Name and Address)

THE ABOVE SPACE IS FOR FILING OFFICE USE ONLY

1. DEBTOR'S EXACT FULL LEGAL NAME – insert only one debtor name (1a or 1b) – do not abbreviate or combine names

1a. ORGANIZATION'S NAME				
OR 1b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME		SUFFIX
1c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY
[redacted] ADD'L INFO RE ORGANIZATION DEBTOR	1e. TYPE OF ORGANIZATION	1f. JURISDICTION OF ORGANIZATION	1g. ORGANIZATIONAL ID#, if any	☐ NONE

2. ADDITIONAL DEBTOR'S EXACT FULL LEGAL NAME – insert only one debtor name (2a or 2b) – do not abbreviate or combine names

2a. ORGANIZATION'S NAME				
OR 2b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME		SUFFIX
2c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY
[redacted] ADD'L INFO RE ORGANIZATION DEBTOR	2e. TYPE OF ORGANIZATION	2f. JURISDICTION OF ORGANIZATION	2g. ORGANIZATIONAL ID#, if any	☐ NONE

3. SECURED PARTY'S NAME (or NAME of TOTAL ASSIGNEE of ASSIGNOR S/P) – insert only one secured party name (3a or 3b)

3a. ORGANIZATION'S NAME				
OR 3b. INDIVIDUAL'S LAST NAME	FIRST NAME	MIDDLE NAME		SUFFIX
3c. MAILING ADDRESS	CITY	STATE	POSTAL CODE	COUNTRY

4. This FINANCING STATEMENT covers the following collateral:

5. ALTERNATIVE DESIGNATION [if applicable]: ☐ LESSEE/LESSOR ☐ CONSIGNEE/CONSIGNOR ☐ BAILEE/BAILOR ☐ SELLER/BUYER ☐ AG. LIEN ☐ NON-UCC FILING

6. ☐ This FINANCING STATEMENT is to be filed [for record] (or recorded) in the REAL ESTATE RECORDS. Attach Addendum [if applicable]

7. Check to REQUEST SEARCH REPORT(S) on Debtor(s) [ADDITIONAL FEE] [optional] ☐ All Debtors ☐ Debtor 1 ☐ Debtor 2

8. OPTIONAL FILER REFERENCE DATA

FILING OFFICE COPY – NATIONAL UCC FINANCING STATEMENT (FORM UCC1) – CALIFORNIA (REV. 01/01/08)

If two separately secured debts are created, both the trust deed and the security agreement can contain a cross-collateral provision stating a default in one of the debts is a default in both debts, called a *dragnet clause*. [**Wong** v. **Beneficial Savings and Loan Association** (1976) 56 CA3d 286; see Chapter 14]

The security agreement

A security agreement creates a **lien on personal property** and is the personal property counterpart to a trust deed used as a security device to impose a lien on real estate.

The security agreement contains the rights and obligations of the parties regarding the secured personal property, including protection against waste, remedies on default and transfer provisions. [See Form 436]

The security agreement is retained by the carryback seller or lender and not recorded with any agency.

To create an enforceable security interest in personal property, the **security agreement** must:

- identify the debt or other obligation for which the personal property is security, typically evidenced by a note;
- describe the personal property which is the security; and
- grant a security interest in the personal property from the buyer or borrower to the carryback seller or lender. [**Needle** v. **Lasco Industries, Inc.** (1970) 10 CA3d 1105]

An enforceable security interest or lien will **attach** to personal property if:

- the borrower or buyer signs and delivers a security agreement containing a description of the personal property;
- the borrower or buyer has ownership rights in the personal property, as are received under a bill of sale; and
- value is given in exchange for the security interest, such as an installment sale by a seller or a loan made by a lender. [Com C §9203(b)(3)]

If the personal property consists of **standing timber** or **unharvested crops** which the buyer intends to remove, the security agreement must also include a description of the real estate on which the personal property is located. [Com C §9203(b)]

A security agreement used to create a lien on **oil, gas or minerals** before they are extracted must also contain a description of the real estate on which the natural resources are located.

The recorded UCC-1 perfects the lien

A **security agreement**, unlike a trust deed, is not recorded. Thus, the agreement used to create the lien on personal property is not the document used to *perfect* the carryback seller's or lender's security interest in personal property against future claims or transfers of that personal property. [Com C §9308]

To **perfect a lien** on personal property against later claims acquired by others, a separate security device entitled the *UCC Financing Statement* (UCC-1), is prepared and filed with the Secretary of State, or the local county recorder depending on the type of property. [Com C §§9310, 9501]

The UCC-1 Financing Statement, UCC-2 Change Form and UCC-3 Request for Information Form may be downloaded from the Secretary of State's website at: http://www.ss.ca.gov.

The UCC-1 is a **statutory form** which contains information about:

- the lender, called the *secured party*;
- the borrower, called the *debtor*;
- a description of the personal property, called *collateral*; and
- a description of the real estate where the personal property is located. [Com C §§9502, 9503]

Additionally, a UCC-1 which describes timber, oil, gas, minerals or unharvested crops as the security for a debt must also contain:

- a description of the real estate, similar to the description used in a trust deed;
- a statement the UCC-1 will be recorded with the local county recorder; and
- the name of the owner of the described real estate, if the owner is not the borrower. [Com C §§9502, 9503]

A lender or carryback seller secured by personal property must file a UCC-1 to put all parties who later acquire an interest in the secured property on notice of the lender's or carryback seller's priority interest.

If the lender or carryback seller secured by personal property fails to file a UCC-1, they run the risk of their lien being wiped out should the borrower or buyer sell or encumber the property or file a bankruptcy petition.

Without the filing of a UCC-1, a later buyer or creditor will not have *constructive notice* of the lender's unperfected security interest in the personal property. [Com C §9317]

Filing requirements

In most cases, the UCC-1 Financing Statement (UCC-1) is filed with the Secretary of State to perfect a lien on personal property as agreed to in a security agreement. [Com C §9501(b)]

If the UCC-1 covers standing timber, oil, gas, minerals or unharvested crops it is recorded in the county in which the described real estate is located, usually concurrent with any trust deed recorded against the real estate. [Com C §9501(a)(1)]

A **search for liens** on personal property is initiated by filing a *UCC-3 Request for Information* (UCC-3) with the Secretary of State. The response from the Secretary of State to the UCC-3 request is comparable to a title search on real estate. [Com C §9523]

Editor's note — Before closing a sale involving personal property items, the broker should have escrow file a UCC-3 with the Secretary of State or the county recorder to obtain a lien report to assure the personal property is unencumbered.

Real estate sold with personal property

Several types of real estate when sold typically include the sale of personal property, such as:

- apartment complexes;
- office buildings;
- vacation homes;
- business opportunities;
- hotels or motels;
- farms or timberland;
- oil, gas or minerals; and
- mobilehome spaces.

The sale of apartment complexes and office buildings typically include the sale of furniture, maintenance equipment, computer systems and trade fixtures.

Vacation homes are often sold fully furnished for recreational uses. Thus, the sale of the vacation home might include everything from furniture and snow clearing equipment to linens and kitchenwares.

Sale of a business opportunity

The sale of a business consists of the transfer of personal property assets — goodwill, equipment, trade fixtures, receivables, and inventory — together with the transfer of the real estate interest held in the premises occupied by the business, whether fee simple or leasehold.

Usually, the sale of a business opportunity includes a leasehold interest in the real estate occupied by the business. Thus, the sale involves an **assignment** of the existing lease or a subletting.

The seller of a business located on leased property, in addition to filing a UCC-1 to secure the carryback note, obtains and records a trust deed executed by the buyer describing the leasehold under which the business occupies the premises. A lease of the premises is an interest in real estate, and is not personal property requiring use of a UCC Financing Statement (UCC-1). [CC §761]

A UCC-1 is not the proper document to be used to perfect a lien on a leasehold interest in real estate. [**Lovelady** v. **Bryson Escrow, Inc.** (1994) 27 CA4th 25]

However, when a UCC-1 is used to describe real estate as the property liened, a mortgage on the real estate is created which must be judicially foreclosed, unless a power-of-sale provision is included in the UCC-1 or security agreement.

Thus, a trust deed with a power-of-sale provision is preferable to a UCC-1 for creating liens on any interest in real estate. Security interests in leases on real estate are governed by real estate mortgage law, not the commercial codes which govern personal property liens.

The sale of hotels and motels

The sale of hotels, motels and boarding houses involves substantial amounts of personal property, such as furniture, trade fixtures, appliances, maintenance and kitchen equipment, as well as future *revenues* from the rooms, restaurants and shops owned and located on the premises.

Income from **room revenue** is classified as rent. Rent is recoverable by a secured creditor under an assignment of rents provision as contained in most trust deed forms.

Rent from real estate, even if generated by a hotel, is not considered business income and thus is not subject to UCC rules governing personal property security. [**In re Days California Riverside Limited Partnership** (9th Cir. 1994) 27 F3d 374]

Editor's note — To include the hotel's ***rental income*** *as security for the carryback note, the seller includes an assignment of rents provision in the trust deed carried back on the sale. An assignment of rents provision allows the lender or carryback seller to collect the rental income from a hotel, motel or any other type of income-producing building on the owner's default. [See Chapter 17]*

However, income from other services rendered by the hotel or motel owner, such as food and beverage sales, are liened by a security agreement and perfected by filing a UCC-1. [In re Days California Riverside Limited Partnership, *supra*; Com C §9102(a)(2)]

Sale of a farm or timberland

The sale of a farm involves personal property such as equipment, livestock, unborn livestock, and unharvested crops, all of which can be security for a debt. [Com C §9102(a)(34),(44)]

Although plants and trees are considered real estate until severed from the land, unharvested crops, also called *future crops*, and standing timber may be sold or encumbered as personal property, separate from the real estate, with a security agreement and a UCC Financing Statement (UCC-1). [Com C §9102(a)(34), (44)]

UCC-1 extension

The UCC-1 Financing Statement (UCC-1) is effective for **five years** after it is filed. [Com C §9515(a)]

To **prevent expiration** of the UCC-1 and retain priority, the lender must file a continuation statement, called a *UCC-2 Change Form*, with the Secretary of State or county recorder within the six month period before expiration.

The UCC-2 must identify the original UCC-1 and be signed by the lender or carryback seller. [Com C §9515(c), (d)]

Any number of later continuations may be filed, simply by repeating the process every five years. [Com C §9515(e)]

The fee for filing either an original UCC-1 or a continuation on a standard form prescribed by the Secretary of State, is $10. The filing fee for a nonstandard UCC-1 form is $20. [Calif. Government Code §12194]

SECTION D

Carryback Financing

Chapter 25 Carryback financing in lieu of cash

This chapter introduces the concept of carryback financing and presents the various forms of documentation and risks of loss involved.

Seller financing supports the price

Most real estate sales involve the financing of some portion of the purchase price. During economic periods of plentiful and inexpensive mortgage money, the financing needed to fund the purchase of real estate is provided by an institutional or private lender, or more likely a mortgage banker.

However, when **economic conditions** tighten and reduce the availability of real estate loans to previously qualified buyers, a seller hoping to sell his property – and maintain his asking price must consider financing the purchase himself if he is to obtain a buyer.

Seller financing, also called an *installment sale* or *credit sale*, involves carrying back a note for the unpaid portion of the price remaining after deducting the down payment and the amount of the loan the buyer is assuming. Under most circumstances, the note will be secured by a first if the property is free of trust deed liens, or a second trust deed on the property being sold.

Thus, the carryback seller takes a secured creditor's position in the property for the amount of the price remaining to be paid, comparable to that of a mortgage lender. On closing, the legal rights and obligations of real estate ownership previously held by the buyer are shifted by the transfer to the buyer, while the seller carrying back a note and trust deed takes on the rights and obligations of a secured creditor.

Carryback financing offers considerable financial and tax advantages for both buyers and sellers of real estate when the installment sales transaction is properly structured.

The seller who offers a convenient and flexible financing package to prospective buyers makes his property more marketable and defers the tax bite on his profits. Qualified buyers who are rational are always willing to pay a higher price for real estate when attractive financing is available, regardless of whether it is provided by the seller or a mortgage lender.

Even the most qualified buyer will agree to a higher price when he can defer payment of the price through financing provided by the seller. This is especially true when the rate of interest on the carryback financing is competitive or below the rates lenders are charging on their purchase-assist loans, or when market prices (and rents) are trending upward which is economically equivalent to reducing the fixed rate of interest paid to the seller. [See Chapter 55]

Tax benefits and flexible sales terms

Taxwise, it may be preferable for the seller to carry back a portion of the sales price, rather than be cashed-out on the sale. The seller taking a significant profit on a sale will be able to defer a meaningful amount of profit taxes, spreading the payment of profit taxes over a period of years. Thus, he avoids a premature tax bite in the year of the sale on his non-exempt transaction. [See Chapter 54]

Finally, the seller needs to understand the tax impact he will receive on his carryback financing is *portfolio category income*, without concern that the property sold was in another income category (passive/

business/personal). The seller converts his real estate equity into a note which generates a constant cash flow. Otherwise he is cashed-out of his equity, pays profit taxes (unless exempt – §1031 – or *excluded* – principal residence) and reinvests what remains of his diminished after-tax sales proceeds.

The carryback note, in a rising market, typically provides for a higher interest yield than is available on other investments with a similar level of risk. The converse is true in a recessionary market. Additionally, the seller has first hand knowledge about his security – the property he is selling.

For buyers, seller carryback financing is a situation that generally offers a moderate down payment, competitive interest rates, less stringent terms for qualification than those imposed by lenders and no origination (hassle) costs.

Mortgage lenders typically require a minimum down payment of 20% for the buyer to avoid the additional burden of qualifying for *private mortgage insurance* (PMI). In a carryback sale, the amount of the down payment is negotiable between the buyer and seller without outside influences, such as the requirements of the secondary mortgage market pools and PMI underwriters, which mortgage loan brokers and borrowers must contend with.

Also, the buyer is logically able to negotiate a lower-than-market interest rate in exchange for agreeing to the seller's higher-than-market asking price. The seller can have one or the other, but not both, if the buyer (or the buyer's broker) is knowledgeable and everyone involved is rational.

Variations on carryback financing

Seller financing is documented in a variety of ways, including land sales contracts, lease-option sales, sale-leasebacks and trust deed notes. [See Chapter 35]

Legally, the note and trust deed is the most certain, as well as the most universally understood, of the various documents for structuring seller financing. Importantly, the note and trust deed are combined to evidence the debt owed the seller and provide security for repayment on the seller's grant deed conveyance. The **carryback documentation** consists of:

- a **promissory note** executed by the buyer in favor of the seller as evidence that a portion of the price remains to be paid for the real estate; and

- a **trust deed lien** on the property sold to secure the debt owed by the buyer as evidenced by the note.

The promissory note states the exact amount and terms for repayment of the debt the buyer owes to the seller. On the other hand, the trust deed creates a lien on the property which acts as security for payment of the debt. The trust deed requires the buyer to maintain the secured property, and gives the seller the power to foreclose through a trustee's sale should the buyer default on note payments or trust deed conditions.

The note and trust deed can be structured in regular or all-inclusive terms to meet the financial needs of the buyer and seller.

For instance, if the real estate is encumbered by a first trust deed which a qualified buyer can **assume** with the lender, the seller can carry back a regular note secured by a second trust deed. The note will be for the balance of the **seller's equity** which remains unpaid after deducting the buyer's down payment.

However, if the lender or servicing agent for the existing loan will not allow the loan to be assumed by the buyer, the buyer might arrange a new first trust deed loan to pay off the existing financing. Here, the lender will need to approve of the seller carryback of a second trust deed. [See Chapter 28]

If the seller's borrowing power is greater than the buyer's, the seller might refinance the existing loan on the property himself and draw out a portion of his equity by placing new conventional financing on the property.

The buyer assumes the new loan and the seller carries back a regular note and junior trust deed for the remainder of his unpaid equity in the property.

Another alternative which reduces the seller's risk of loss and defers more profit taxes than a regular second trust deed note, is the all-inclusive trust deed (AITD) note, called a *wraparound security device*. In an AITD carryback arrangement, the amount owed the seller on the carryback note is always secured by a junior trust deed (AITD) lien on the property. However, the note secured by the AITD is for a dollar amount equal to the balance of the entire purchase price remaining unpaid after the down payment, and is not a regular note limited to the amount of equity remaining unpaid after the down payment. [See Chapter 32]

Thus, the AITD "wraps" the senior financing by including the dollar amount of the first trust deed in the principal amount of the AITD note. The buyer makes payments to the seller on the AITD note. In turn, the seller continues to remain responsible for making payments on the senior loan from payments received on the AITD. [See Chapter 32]

Carryback risks for the seller

A carryback seller must be aware he takes on the **role of a lender** in a carryback sale, with all the risks and obligations of a lender holding the seller's secured position. [See Chapter 35]

Above all, the seller must be willing to accept the **risk of loss on a default** by the buyer in payments on the note or provisions in the trust deed. A seller who forecloses in an effort to recover the amounts owed on the carryback note from the property's value will be forced to advance cash to make payments on the senior trust deed loan. Also, a risk of loss due to impairment of the security exists, allowing for foreclosure, should the buyer default on trust deed provisions for the payment of taxes, assessments and insurance premiums. [See Chapter 16]

Costs incurred in foreclosing and reselling the property can quickly turn a low-downpayment, high-interest-rate sale into a cash drain for the seller. [See Chapter 35]

Also, the seller must understand a carryback note is *nonrecourse paper*. Thus, the seller will be barred from obtaining a money judgment from the buyer for any part of the carryback debt not satisfied by the value of the property – the deficiency. [Calif. Code of Civil Procedure §580b]

On a default by the buyer, the carryback seller could suddenly find himself returned to his original position — owning property he no longer wanted to own and still subject to the senior trust deed. Further, the seller will incur out-of-pocket costs for:

- foreclosure;
- carrying the property;

- any reduction in property value or property taxes for reassessment;
- a modified (higher) interest rate on the old loan (foreclosure triggers the due-on clause); and
- profit taxes on any previously untaxed principal in the down payment.

As with any creditor, if the **risk premium** built into the price, down payment and interest rate on the carryback note is sufficient, the benefits of carryback financing outweigh the risks of loss.

Chapter 26 The carryback purchase agreement

This chapter discusses an agent's use of installment sale provisions in a purchase agreement to negotiate the financing of a sale by the seller carrying back a note and trust deed.

Negotiating the terms for seller financing

A buyer contacts a real estate agent to assist him to locate and purchase real estate. The agent obtains information about the buyer's financial status and general description of the real estate to be located and the terms of its purchase — price and financing — preferred by the buyer.

The buyer is able to make a down payment of $100,000 and is prequalified to originate or assume a loan up to $1,100,000.

Before the agent begins to locate suitable property, the buyer is presented with a fully prepared **Buyer's Listing Agreement** for review with the agent and signatures. The agent explains the written retainer agreement is a requisite to his receiving full recognition from other brokers and agents of the existence of his agency relationship with the buyer. When authorized by a listing to act on behalf of the buyer, brokers and agents readily provide information (disclosures) on their listed properties for analysis by his buyer. [See **first tuesday** Form 103]

The buyer enters into the **Buyer's Listing Agreement**, obligating the agent's broker and the agent to work diligently to locate property on behalf of the buyer in exchange for receiving an enforceable fee arrangement. [**Phillippe** v. **Shapell Industries, Inc.** (1987) 43 C3d 1247]

Later, the agent locates a property he believes meets the financial objectives and preferences of the buyer.

The listed sales price for the property is $1,100,000. After the agent's cursory review of the property's features with the buyer, the buyer indicates he wants more information about the conditions of the property. The agent gathers up all the basic property disclosures from the seller's listing agent so the buyer can make a decide whether to make an offer, and if so, on what terms and conditions.

After receiving and reviewing the seller's property disclosures, but before discussing the condition of the property and the terms of purchase with his buyer, the real estate agent prepares a purchase agreement. The proposed offer takes into consideration the buyer's financial condition and expectations known to the agent as a result of their prior discussions, called *counseling*. The buyer is not risk averse.

Having considered and prepared the purchase offer he will propose, the agent is ready to discuss with the buyer the merits and reasons for entering into the proposed offer. Together, the buyer and agent will mold the final purchase offer which will be signed and submitted to the seller. [See Figure 1]

Installment sale provisions

The agent, on investigation, learns the seller received one offer since he listed the property. It was a cash-out offer for $850,000, but called for the seller to pay all the buyer's nonrecurring financing charges and closing costs. The seller countered at $900,000, calling for the buyer to pay his own costs and charges. The buyer rejected the counter offer and withdrew from further negotiations with the seller.

The property is encumbered with an existing trust deed loan of $450,000, at a 6.5% fixed rate of interest, payable monthly, until paid, with 25 years remaining. The listing agent failed to include the financing in the MLS data on the property, but supplied it on request.

Interest charged on a new loan is currently at a *note rate* of 7.25%, whether fixed or variable. Thus, the difference in payments between the existing loan and a new loan is nearly $2,000 in annual savings, comprised entirely of interest.

The buyer's agent recommends that the buyer offer the seller $900,000, the amount of the seller's all-cash counter offer to the previous buyer. The agent informs the buyer of his belief that the cash value of the property is probably less than $900,000, but notes that sellers typically resist trends in weakening prices, causing prices to be "sticky" in deteriorating markets in spite of fewer prospective buyers.

The terms suggested by the agent include savings due to monthly payments and interest rate charges for a new loan, greater loan reduction (amortization), and avoidance of new loan costs, as well as reducing the seller's closing costs by avoiding a prepayment penalty on a payoff of his loan. The buyer's savings over the first five years of ownership would be approximately $36,000, which would effectively place a **present worth** on the property of less then a $900,000 cash offer.

The terms proposed by the buyer's agent for payment of the $900,000 price includes:

- a down payment of $100,000 in cash;
- a takeover of the $450,000 existing loan on the property; and
- a note for $350,000 executed by the buyer in favor of the seller, secured by a trust deed carried back on the property.

The terms for payment of the $350,000 carryback note include:

- interest greater than 4.5% the note's Applicable Federal Rate (APR) for imputing interest;
- a monthly payment (a 17 year, 10 months amortization schedule); and
- a final/balloon payment, due ten years after the close of escrow.

The agent prepares a worksheet to document the savings of $102,835.66 the buyer will realize over the first five years of ownership under the proposed carryback transaction, which include:

- $38,686.17 on the takeover of the existing $450,000 loan at 5.5% versus the current market rate of 7.25% on that amount (both amortized over 25 years). This amount includes a savings in monthly

payments over five years of $28,878.46 due to the differences in the dollar amount of payments ($2,750.79 versus $3,233.10, a $482.31 monthly saving), and additional principal reduction over five years of $9,807.71 ($401,712.86 at 5.5% versus $411,529.57 at 7.25%);

- $52,149.85 as the additional principal reduction over five years on the amortization of the $350,000 carryback at 4.5% ($278,175.87) versus current market rates of 7.25% ($330,325.72). This calculation is based on retaining the amount of the monthly payment set by a 30-year amortization at current 7.25% market rates ($2,373.28) as the monthly payment on the 4.5% carryback (amortizing the carryback over 17 years and ten months); and

- $12,000 (approximate) savings by avoiding the costs of originating a $800,000 purchase-assist loan with its costs, charges, discounts, fees, points, lender's title policy, etc.

The existing trust deed contains a due-on clause as disclosed by the trust deed accompanying the **property profile** the agent ordered out from the title company. The listing agent had not ordered a copy. On any take over of an existing loan, the lender has the right to call or demand a recast of the terms for payment of the note.

As a result of the discussion, a provision is added to the purchase agreement calling for the seller to enter into a *subordination agreement*. The buyer will need this arrangement if the lender calls the loan, or demands a loan modification or an early payoff. If a payoff is required, the property will need to be refinanced to borrow sufficient funds to pay off the demand on the existing first trust deed and cover the refinancing charges.

Should the lender call the loan or demand a modification, the seller will need to cooperate by entering into a specific **subordination agreement** at the time of the loan modification or recording of the refinancing. To be assured the seller will cooperate, he must sign an agreement consenting to the future subordination of the carryback trust deed on a modification or refinance of the first trust deed. [See **first tuesday** Form 281]

Adjustments on closing for any difference between the amount of the balance on the existing loan at closing and as stated in the purchase agreement will be made into the principal amount of the carryback note. No adjustments will be made in the price or downpayment amounts. [See Figure 1 §5.1]

Required financing disclosures

The agent preparing a carryback offer must disclose to both the buyer and seller the various financial and legal features which would influence prudent sellers and buyers in a carryback transaction. For offers involving four-or-less residential units, the minimum carryback financing disclosures are **mandated by statute**, other property disclosures are imposed by case law. [See Form 300 in Chapter 29]

A statutory **Carryback Disclosure Statement** on a credit sale of a one-to-four unit residential property is intended to be prepared and attached to the purchase agreement as an addendum. If it is not included with the purchase agreement, a statutory contingency is triggered, giving the buyer the right to cancel the transaction until the disclosure form is signed by the buyer and the seller. [See Chapter 29]

After the purchase agreement prepared by the agent is signed by the buyer, it will be submitted to the seller as an offer to buy. The seller will then consider whether to accept the offer, counter with another offer, or reject it without a counter offer.

Figure 1 *Excerpt from **first tuesday** Form 150 – Purchase Agreement*

TERMS: Buyer to pay the purchase price as follows:

3. Cash payment through escrow, including deposits, in the amount of . . . . . $_____

3.1 Other consideration paid through escrow _____ . . . $_____

4. Buyer to obtain a ☐ first, or ☐ second, trust deed loan in the amount of . . . . . $_____ payable approximately $_____ monthly for a period of _____ years. Interest on closing not to exceed _____%, ☐ ARM, type _____. Loan points not to exceed _____.

4.1 ☐ Unless Buyer, within _____ days after acceptance, hands Seller satisfactory written confirmation Buyer has been pre-approved for the financing of the purchase price, Seller may terminate the agreement. [See **ft** Form 183]

5. ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by _____ with an unpaid principal balance of . . . . $_____ payable $_____ monthly, including interest not exceeding _____%, ☐ ARM, type _____, plus a monthly tax/insurance impound payment of $_____. _____

5.1 At closing, loan balance differences per beneficiary statement(s) to be adjusted into: ☐ cash, ☐ carryback note, or ☐ sales price.

5.2 The impound account to be transferred: ☐ charged, or ☐ without charge, to Buyer.

6. ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by _____ with an unpaid principal balance of . . . $_____ payable $_____ monthly, including interest not exceeding _____%, ☐ ARM, type _____, due _____, 20 _____.

7. Assume a tax bond or assessment lien with an unpaid principal balance of . . . . . $_____

8. Note for the balance of the purchase price in the amount of. . . . . $_____ to be executed by Buyer in favor of Seller and secured by a trust deed on the property junior to any above referenced financing, payable $_____ monthly, or more, beginning one month after closing, including interest at _____% per annum from closing, due _____ years after closing.

8.1 This note and trust deed to contain provisions to be provided by Seller for: ☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐ _____.

8.2 A Carryback Disclosure Statement is attached as an addendum. [See **ft** Form 300]

8.3 Buyer to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **ft** Form 412]

8.4 Buyer to hand Seller a completed credit application on acceptance. [See **ft** Form 302]

8.5 Within _____ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness.

8.6 Seller may terminate the agreement on failure of the agreed terms for priority financing. [See **ft** Form 183]

8.7 As additional security, Buyer to execute a security agreement and file a UCC-1 financing statement on any property transferred by Bill of Sale. [See **ft** Form 436]

9. Total Purchase Price is . . . . . $_____

Analyzing the purchase agreement

The conventional purchase agreement, **first tuesday** Form 150, is used to prepare and submit the buyer's **written offer** to purchase one-to-four unit residential property. Terms for payment of the price are limited to conventional financing, an assumption of existing loans and a carryback note. Form 150 is also properly used by sellers in a counteroffer situation to submit their **fresh offer** to sell the real estate.

The purchase agreement offer, if accepted, becomes the binding written contract between the buyer and seller. Its terms must be complete and clear to prevent misunderstandings so the agreement can be judicially enforced. Thus, Form 150 is a comprehensive "boilerplate" purchase agreement which serves as a **checklist**, presenting the various conventional financing arrangements and conditions a prudent buyer would consider when making an offer to purchase.

Preparing the purchase agreement

The following instructions are for the preparation and use of the Purchase Agreement – One-to-Four Residential Units, **first tuesday** Form 150. Form 150 is designed as a checklist of practical provisions so a broker or his agent can prepare an offer for a prospective buyer who seeks to purchase conventionally financed, one-to-four unit residential property located in California. [See Figure 1]

The numbers on the instructions correspond to the numbers given provisions in the form.

*Editor's note — **Check** and **enter** items throughout the agreement in each provision with boxes and blanks, unless the provision is not intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Terms for payment of the purchase price:

3. *Cash down payment*: **Enter** the dollar amount of the buyer's cash down payment toward the purchase price.

   3.1 *Additional down payment*: **Enter** the description of any other consideration to be paid as part of the price, such as trust deed notes, personal property or real estate equities (an exchange). **Enter** the dollar amount of its value.

4. *New trust deed loan*: **Check** the appropriate box to indicate whether any new financing will be a first or second trust deed loan. **Enter** the amount of the loan, the monthly principal and interest (PI) payment, the term of the loan and the rate of interest. **Check** the box to indicate whether the interest will be adjustable (ARM), and if so, **enter** the index name. **Enter** any limitations on loan points.

   4.1 *Buyer's loan qualification*: **Check** the box to indicate the seller is authorized to cancel the agreement if the buyer is to obtain a new loan and fails to deliver documentation from a lender indicating he has been qualified for a loan. **Enter** the number of days the buyer has after acceptance to deliver written confirmation of his qualification for the loan.

5. *First trust deed note*: **Check** the appropriate box to indicate whether the transfer of title is to be "subject to" an existing loan or by an "assumption" of the loan if the buyer is to take over an existing first trust deed loan. **Enter** the lender's name. **Enter** the remaining balance, the monthly PI payment and the interest rate on the loan. **Check** the box to indicate whether the interest is adjustable (ARM), and if so, **enter** the index name. **Enter** any monthly impound payment made in addition to the PI payment. **Enter** any due date or other terms unique to the loan.

   5.1 *Loan balance adjustments*: **Check** the appropriate box to indicate the financial adjustment desired for loan balance differences at the close of escrow.

   5.2 *Impound balances*: **Check** the appropriate box to indicate whether the impound account transferred to the buyer will be with or without a charge to the buyer.

6. *Second trust deed note*: **Check** the appropriate box to indicate whether the transfer of title is to be "subject to" an existing loan or by an "assumption" of the loan if the buyer is to take over an existing second trust deed loan. **Enter** the lender's name. **Enter** the remaining balance, the monthly PI payment and the interest rate on the loan. **Check** the box to indicate whether the interest is adjustable (ARM), and if so, **enter** the index name. **Enter** the due date for payment of a final/balloon payment.

7. *Bond or assessment assumed*: **Enter** the amount of the principal balance remaining unpaid on bonds and special assessment liens (such as Mello-Roos or 1915 improvement bonds) which will remain unpaid and become the responsibility of the buyer on closing.

*Editor's note — Improvement bonds are obligations of the seller which may be assumed by the buyer in lieu of their payoff by the seller. If assumed, the bonded indebtedness becomes part of the consideration paid for the property. Some purchase agreements erroneously place these bonds under "property tax" as though they were **ad valorem taxes**, and then fail to prorate and charge the unpaid amount to the seller.*

8. *Seller carryback note*: **Enter** the amount of the carryback note to be executed by the buyer as partial payment of the price. **Enter** the amount of the note's monthly PI payment, the interest rate and the due date for the final/balloon payment.

   8.1 *Special carryback provisions:* **Check** the appropriate box to indicate any special provisions to be included in the carryback note or trust deed. **Enter** the name of any other special provision to be included in the carryback note or trust deed, such as impounds, discount options, extension provisions, guarantee arrangements or right of first refusal on the sale or hypothecation of the note.

   8.2 *Carryback disclosure:* **Fill out** and **attach** a Seller Carryback Disclosure Statement as an addendum. [See Form 300 in Chapter 29]

Editor's note — Further approval of the disclosure statement in escrow creates by statute a buyer's contingency allowing for cancellation until time of closing on any purchase of one-to-four unit residential property.

   8.3 *Notice of Delinquency:* **Requires** the buyer to execute a Request for Notice of Default and Notice of Delinquency and pay the costs of recording and serving it on senior lenders since they will have priority on title to the trust deed securing the carryback note. [See Form 412 in Chapter 48]

   8.4 *Buyer creditworthiness*: **Requires** the buyer to provide the seller with a completed credit application. [See Form 302 in Chapter 31]

   8.5 *Approval of creditworthiness*: **Enter** the number of days within which the seller may cancel the transaction for reasonable disapproval of the buyer's credit application and report.

   8.6 *Subordination*: **Provides** for the seller to terminate this transaction if the parameters agreed to for financing by an assumption or origination of a trust deed loan with priority on title to the carryback note are exceeded. [See **first tuesday** Form 183]

   8.7 *Personal property as security*: **Requires** the buyer on the transfer of any personal property in this transaction to execute a security agreement and UCC-1 financing statement to provide additional security for any carryback note. [See Form 436 in Chapter 24]

9. *Purchase price:* **Enter** the total amount of the purchase price as the sum of lines 3, 3.1, 4, 5, 6, 7 and 8.

Chapter 27 No down payment carryback sales

This chapter explores the seller's financial risks in an installment sale structured with little to no cash down payment.

Minimizing the risks of default

A couple decides to purchase income producing property to begin a long-term real estate investment program as an alternative to holding shares in businesses to develop wealth for the family.

Each spouse earns a significant annual income, with a combined discretionary disposable income in excess of $125,000 annually which they are prepared to commit to real estate investments.

In the past, the couple spent most of their disposable income on the costs of high living. Consequently, they have accumulated insufficient cash savings for a meaningful down payment on a purchase.

Despite their lack of substantial savings, the couple's large stable income enables them to make significant additional monthly or quarterly principal payments to pay for property they acquire, called a *deferred down payment* plan. Thus, the couple is willing to subject themselves to a self-enforcing savings program by committing themselves to **build up equity** in real estate through debt reduction.

The periodic installments of principal only will be in addition to the regular monthly payments. For the seller, the extra principal payments are rationally viewed as the **deferral** of a cash down payment.

The additional principal payments will be made during the first year or two following the purchase of the property. With the couple's $125,000 in excess annual income to invest, they have the capacity to pay a seller at least an additional $200,000 in principal over a two-year period.

At their agent's suggestion, the couple signs a purchase agreement offer on an income producing property which they have determined is financially suitable, on following the terms:

- the purchase price to be $1,500,000;
- no cash down payment to be made;
- the buyer to pay all closing costs;
- a note and trust deed to executed by the buyer in favor of the seller for the entire amount of the seller's equity in the property;
- the note interest rate to be the rate currently charged on mortgages;
- monthly payments to be based on a 30-year amortization;
- eight (8) equal quarterly payments of principal to be due on the note totalling $200,000 over two years; and

- a 10-year due date for a final/balloon payment.

Attached to the offer is the carryback disclosure statement prepared by the buyer's agent. [See Form 300 in Chapter 29]

The buyer's agent delivers the offer to the listing agent. Together, they review the offer for presentation to the seller.

The risk of default and foreclosure

Before submitting an offer to the seller, the listing agent concludes the offer is probably unsuitable for his client as it stands.

Must the agent hand the no-down offer to the seller?

Yes! A listing agent, acting as his broker's agent, is duty bound to present all offers he receives, no matter what form they may take, even though he may consider an offer to be unsound or otherwise unacceptable to the client. [DRE Bulletin Fall 2001]

The listing agent, on submitting the offer to the seller, points out the carryback aspects of the offer which present additional legal and financial risks to the seller, including:

- the seller will not be cashed out since the net proceeds of the sale will be in the form of a note — thus, the seller should receive either a higher-than-market interest rate or a higher-than-market price for his property to compensate for the risk of loss he would avoid on an all-cash sale [**Timmsen** v. **Forest E. Olson, Inc.** (1970) 6 CA3d 860];

- the carryback note is *purchase money* paper — a nonrecourse debt — so if the buyer does default, the seller's only remedy is to foreclose on the property since a money judgment is not allowed on a nonrecourse note [Calif. Code of Civil Procedure §580b]; and

- without a down payment, cash proceeds from the sale will not exist to absorb the out-of-pocket cash costs to foreclose should the couple default on the carryback note.

For the property to support the financial burdens imposed on the carryback seller by a foreclosure, an equity of no less than 10% to 15% must exist above the seller's carryback trust deed note. Without a cash down payment large enough to generate net cash proceeds to the seller on closing, the buyer has no equity in the property at the time of closing.

To demonstrate the financial risk facing the seller should he ever have to recover the property on a buyer's default, the listing agent prepares a **Carryback Foreclosure Cost Sheet** for review with the seller. On the cost sheet, the agent estimates the costs the seller will incur during a foreclosure and later resale of the property. The seller can use the disclosure to estimate the cash reserves he will need if he has to foreclose on the property. [See Chapter 30]

Also, the listing agent prepares a carryback disclosure statement on a form designed to comply with mandatory financial and legal disclosures on one-to-four unit residential properties, which this income producing property is not but to which the disclosures fully apply. [See Form 300 in Chapter 29]

Presenting the offer with advice

When presenting an offer, a listing agent's duty owed to the seller to care for and protect the seller in a transaction requires the agent to disclose all aspects of the proposed transaction which are *known or readily available* to the agent and might affect a prudent seller's decision to accept or reject the offer, such as:

- the **legal aspects** of carrying paper since the seller takes on the rights and obligations of a mortgage lender [Calif. Civil Code §2956];

- the **tax aspects** of the profit and income reportable in an installment sale [Internal Revenue Code §453; see Chapter 32]; and

- the **financial suitability** for the seller of the risks of loss involved in carrying paper. [Timmsen, *supra*]

Instead of accepting the offer or returning the offer as rejected, the listing agent suggests a counteroffer to re-structure the transaction so it will be financially suitable for the seller.

One hundred percent carryback financing on a little to no downpayment transaction provides benefits for a seller.

A seller may be motivated to accept a no-down offer by his desire to:

- increase his ability to sell the property at the price sought;

- receive a flow of interest income; and

- defer profit tax reporting on the sale until the principal is paid.

The seller who is able to provide carryback financing can sell his property more readily if the property is not aggressively (properly) priced to sell for cash. Buyers often do not have, or want to use, cash funds for a down payment. Also, buyers are typically more interested in acquiring property if the seller provides the purchase-assist financing needed to buy the property. Since carryback financing allows the buyer and seller to handle all the financing of the sale without the hassle and expense of arranging new financing with an institutional lender or mortgage banker.

The seller contemplating a no-downpayment transaction may be motivated by tax considerations, including:

- without a down payment, no profit will be reported in the year of sale except for any profit in the principal paid with the monthly payments;

- no debt relief will occur to trigger profit tax in the year of the sale, unless a mortgage exists with a balance which exceeds his remaining cost basis, in which case the seller will wrap it with an all-inclusive trust deed (AITD) note; and

- no profit will be reported in the carryback note until principal is paid, or the note is assigned in a sale or as collateral. [See Chapter 32]

Default and beyond

In a little to no downpayment carryback sale, the major legal and financial risk the carryback seller faces is a default by the buyer on the carryback note. A default and failure of a pre-foreclosure workout will force the seller to consider initiating foreclosure.

The sum of the combined amounts of the carryback note, underlying financing, the costs of foreclosure and resale are supported solely by the value of the property.

Thus, when sufficient downpayment funds have not been received to cover all these amounts, the seller commencing a foreclosure will have to use his own funds to pay the costs of foreclosure if he is to protect the value of his security interest in the property. Unless the **property value** rises, funds expended by the seller after a little to no down payment sale will not be recovered on a foreclosure and resale of the property.

No matter the amount of the down payment, a carryback seller must promptly start a pre-foreclosure workout or foreclosure proceedings on a default. The value of any equity securing the carryback note diminishes daily due to the accrual of property taxes, interest on underlying trust deed notes and property insurance premiums. Also, an actual decrease in the marketability, and thus the value of the property, occurs due to deferred maintenance and upkeep which often accompanies a default.

Even if the carryback seller immediately initiates the steps necessary to foreclosure on a default, completing a typical problem-free second trust deed **foreclosure and resale** of the property can easily consume cash funds equal to 15% of the property's value, paid approximately 50:50 from the seller's cash reserves and cash proceeds from a resale.

Minimizing the seller's risk of loss

All carryback sales involve some degree of risk of loss, as do all loans. However, a seller should not avoid a sale or a carryback note solely because a potential risk of loss exists.

The correct approach for the seller and his agent is to analyze the extent of the risk and take steps to **offset** and **cover the risk** by:

- reducing the degree of risk by a proportionately **larger down payment** sufficient in amount to cover the cost of foreclosure and resale;
- receiving a **premium** in the form of an increased price, a higher interest rate or greater principal reductions on the carryback note than provided by monthly amortization; or
- acquiring **additional security**, guarantees, letters of credit, etc.

The seller does not need to rely solely on the real estate sold to secure his carryback note in a no-down transaction. Through discussions and counteroffers, sellers negotiate with buyers for additional security acceptable to the seller. The additional security can be real estate or personal property, owned by the buyer or others.

Also, a carryback note becomes *recourse paper* when it is secured by property other than the property sold, or in addition to the property sold. With **recourse paper**, the seller may foreclose judicially and then pursue a money judgment against the buyer if the fair market value of the property securing the carryback note becomes insufficient to satisfy the seller's carryback note.

PROMISSORY NOTE — UNSECURED

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. On or before _____, 20_____, without a grace period, or ☐ on demand,

1.1 _____, as the Payor, promises to pay to the order of:

1.2 _____, as the Payee, address _____

1.3 the sum of $_____

2. Interest will be charged from Date at the rate of _____% per annum until paid.

3. Principal and interest will be payable in lawful money of the United States.

4. Should a default occur in payments when due, the entire sum of principal and interest will become immediately due at the option of the payee.

5. In any action to enforce this agreement, the prevailing party will receive attorney fees.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Signature of Payor: _____

Signature of Payor: _____

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Through a counteroffer, the carryback seller negotiates to include provisions such as:

- a **continuing guarantee** for the carryback note (guarantors are not protected by anti-deficiency laws as is the buyer who signed the note) [See Form 439 in Chapter 13];

- a **security interest** in personal property or other real estate, called *cross-collateralization* [See Form 436 in Chapter 24]; and

- the **carryback of an unsecured note** for part of the price (5% to 10% of the price). [See Form 424 accompanying this chapter]

The seller can negotiate to **cross-collateralize** the carryback note by securing it by both the property purchased and other property owned by the buyer (or other persons). Cross-collateralization by the buyer secures the carryback note by using **one trust deed** to describe multiple parcels of real estate as security for payment of the carryback note, called a *blanket trust deed*.

By carrying a **blanket trust deed** encumbering the property sold and other property, the seller is able to obtain a money judgment against the buyer when the combined market value of the properties on the date of a judicial foreclosure sale does not cover the balance due on the cross-collateralized carryback note. [CCP §580a, c]

The brokerage fee in a no-down deal

Payment of the brokerage fee is an additional concern for brokers and sellers involved in minimal or no down payment transactions.

The problem is not negotiating the amount of the fee, but how and when the broker will collect the fee in a cashless transaction, as occurs in a no-down sale or an exchange of equities (properties).

In cash sales, the fee is paid in cash by the seller on the close of escrow. When the sale or exchange includes little to no cash down payment and no new financing to generate cash funds, the broker, like the seller, must often wait to be paid.

Typically, the broker's fee in a carryback sale will be paid by the seller out of the first payments made by the buyer on the carryback note. Alternatively, the buyer can create a separate note for the amount of the broker's fee (and reduce the amount of the seller's carryback note by an equal amount), payable to the broker and secured by a junior trust deed on the property acquired. The purchase price for the real estate and transaction costs incurred by the buyer remain the same.

However, the broker must understand that a note signed by the buyer and secured by one-to-four unit residential property, purchased and occupied by the buyer, is **nonrecourse paper**. The note finances part of the purchase of the buyer's residence. [CCP §580b]

Thus, if the buyer defaults and an underlying trust deed holder (i.e., the seller) forecloses on the property, the broker's trust deed is wiped out, leaving the non-recourse note unsecured. Here, the broker cannot obtain a personal money judgment against the buyer/occupant of the one-to-four unit residential property. The broker simply loses his fee.

*Editor's note — This anti-deficiency rule only applies if the buyer purchases and occupies a one-to-four unit residential property. If the buyer does not occupy the property, or it is not one-to-four residential units, the broker can recover a money judgment for his unpaid services evidenced by the note previously secured by a wiped-out trust deed. [**Kistler** v. **Vasi** (1969) 71 C2d 261]*

The broker considering nonrecourse paper

To avoid being wiped out by the foreclosure of a senior trust deed, a broker may wish to avoid holding nonrecourse paper. Several options are available, for example:

- a seller can **guarantee** a buyer's junior trust deed note making the seller personally liable to the broker if a foreclosure wipes out the broker's security;

- the buyer or seller can provide property other than the real estate being sold as **additional or substitute security**;

- the broker can become a co-owner/beneficiary of a pro rata share of the carryback note;

- the broker can carry an unsecured recourse note, payable by the seller, or by the buyer as part of the price paid for the property; or

- the brokerage fee can be a recourse note signed by the seller and secured by a *collateral assignment* of the seller's carryback trust deed note. A security agreement would provide for all or part of the carryback payments to be received by the broker until the brokerage fee is paid in full. When the fee is fully paid, the broker will reassign the trust deed to the seller. [See **first tuesday** Forms 438 and 336]

However, the seller takes on an additional risk of loss under any arrangement in which he agrees to pay the deferred fee. The risk arises when the **buyer defaults** on payments and the carryback seller is required to foreclose on the property.

If the broker owns a percentage of the carryback, the carryback seller and the broker become partners in any foreclosure process. To avoid anarchy, they should enter into a co-ownership agreement as the beneficiaries of the trust deed before the closing of the sales escrow. Otherwise, on a foreclosure, they will have to find a way to cooperate as tenants-in-common (TIC) without the benefit of a previously written co-ownership agreement.

If the broker holds a note for the fee signed by the seller, collateralized or not by the seller's carryback note, the note for the fee is recourse/deficiency paper. The seller can be forced to pay — even when the carryback sale sours and the seller is faced with a loss — unless the note held by the broker provides for relief in the event the buyer defaults on the carryback note.

Chapter 28 Due-on waiver and junior financing

This chapter comments on the need in a sale conditioned on the buyer assuming the existing lender's trust deed loan for a carryback seller to negotiate a waiver of the senior lender's due-on clause.

Prior planning prevents lender interference

A seller of real estate encumbered with a first trust deed lists the property for sale with his broker. The trust deed contains a due-on clause which is triggered by any sale.

Later, the listing broker presents his seller with a purchase offer from a buyer on terms which include:

- a cash down payment;
- an assumption of the existing first trust deed by the buyer; and
- a carryback note executed by the buyer in favor of the seller for the balance of the purchase price, secured by a second trust deed on the property.

Following negotiations and acceptance, a sales escrow is opened. As called for in escrow instructions, escrow requests a **loan assumption package** from the lender who holds the trust deed note.

Before the close of escrow, the lender approves the sale on a few conditions: the buyer is to **assume** the loan obligation and agree to a **modification** of the interest rate and payment schedule in the note.

Again, after further negotiations, the buyer agrees to the lender's demands and signs the loan assumption and note modification agreement. The lender does not enter into a written consent agreement with the seller regarding the carryback second trust deed. However, the lender did receive a copy of the purchase agreement and escrow instructions during the loan assumption process which discloses the carryback second trust deed as part of the sales transaction.

In this example, the lender consented to the conveyance of the secured property to the buyer on the terms of the sale as set out in the purchase agreement and sale escrow instructions the lender received. Thus, by its conduct, the lender has *waived* its rights under the due-on clause regarding the further encumbrance (second trust deed) carried back by the seller. The carryback is a separate event from the grant deed conveyance to the buyer, which itself triggers the due-on clause. [**Rubin** v. **Los Angeles Federal Savings and Loan Association** (1984) 159 CA3d 292]

However, the lender was not asked to and has not entered into a written agreement to waive its due-on right to **call or recast** the loan in the event that the buyer later transfers an interest in the property while the carryback seller still holds his second trust deed, or the seller forecloses and becomes the owner of the property again.

After the buyer takes title to the property, a transfer by the buyer of his interest in the secured real estate will require the lender's prior consent to avoid the risk of the lender calling the loan under the due-on clause. Exceptions include a lease with a term under three years and most non-sale principal residence transfers. [See Chapter 17]

On a later transfer of any interest in the property by the buyer, the lender has the right on each transfer to:

- **accelerate** (call) the balance of the loan; or

- **recast** the loan, demanding modifications of the note and a fee as a condition for allowing an assumption or other waiver of the due-on clause.

The trust deed lender can call the loan or demand the note to be recast, with exceptions for conveyance of the personal residence to family members or for an equity loan encumbrance on that residence, if, after escrow closes, the buyer:

- dies;

- conveys or further encumbers the property;

- enters into a long-term lease (over a three year term) or a lease with a purchase option; or

- defaults on the carryback note and the seller completes a foreclosure sale, etc. [See Chapter 17]

The written waiver

A typical carryback sales transaction is structured as either:

- a **regular** second trust deed and note carried back by the seller with the existing trust deed lender consenting to the conveyance of the property and the carryback trust deed by waiving its due-on clause in exchange for an assumption fee and modification of the note by the buyer; or

- an **all-inclusive trust deed** (AITD) and note, or another wraparound security device, with the underlying lender consenting to the conveyance to the buyer and the carryback AITD by waiving its due-on clause in exchange for a modification of the trust deed note and payment of fees by the seller — all in lieu of the buyer's assumption of the loan, an activity sometimes called a *reverse assumption*.

After the lender consents to the carryback sale and escrow closes, future events beyond the seller's control can again trigger the due-on clause.

A carryback seller, like any junior trust deed holder, must be made aware and understand a due-on clause in the existing trust deed gives the lender the absolute right to call the loan on a **future transfer of any interest** in the property by the buyer with only two restrictions. The lender's call is restricted only on short-term (up to three years) leases on any type of property, and on inter-family transfers and the further encumbrance of owner-occupied, four-or-less unit residential properties.

FURTHER ENCUMBRANCE CONSENT

DATE:_____, 20_____, at _____, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This consent agreement is entered into between

1.1 _____, as the Existing First Lender,
1.2 and _____, as the New Junior Lender,
1.3 regarding the Existing First Lender's trust deed recorded on _____,
as Instrument No._____, in _____ County Records, California,
1.4 executed by _____, as the Trustor,
1.5 in which _____ is named as the Beneficiary,
1.6 encumbering property referred to as _____
_____.

2. A trust deed, junior and subordinate to the Existing First Lender's trust deed, will be executed in favor of the New Junior Lender in reliance on this consent agreement.

AGREEMENT:

3. The Existing First Lender hereby:

3.1 Consents to the further encumbrance of the property in favor of the New Junior Lender.
3.2 Waives its due-on rights until the New Junior Lender's trust deed encumbrance is reconveyed or foreclosed and no longer is a lien on the property.
3.3 Waives its due-on rights should the New Junior Lender later acquire title to the property by foreclosure or deed-in-lieu of foreclosure under its trust deed, subject to the following checked conditions at the time of transfer:

a. ☐ Payment of an assumption/transfer fee of $_____.
b. ☐ Modification of the Existing First Lender's note to reflect interest at the fixed rate of _____% per annum, amortized over the loan's remaining term, with the principal balance due _____, 20_____.
c. ☐ _____.

4. GENERAL PROVISIONS:

4.1 All other provisions of the Existing First Lender's trust deed remain unaffected by this consent.
4.2 This consent is for only one further encumbrance by the New Junior Lender.
4.3 This consent inures to the benefit of the successors and assigns of the parties.

NOTE: The following agreements are used when an existing second trust deed will remain of record after further encumbering the property.

5. SUBORDINATION AGREEMENT to any modification agreed to in Section 3.3 above.

5.1 _____ is the Beneficiary under a second trust deed lien on the property recorded as Instrument No. _____, in _____ County Records, California.
5.2 The Existing Second Trust Deed Beneficiary consents to this modification and agrees to subordinate his trust deed to these modifications on demand.
5.3 The Existing Second Trust Deed Beneficiary consents to this further encumbrance and waives enforcement of any due-on clause in its trust deed.
5.4 The Existing Second Lender is_____.

Date:_____, 20_____. Signature of Existing Second Lender:_____

EXISTING FIRST LENDER:	**NEW JUNIOR LENDER:**
I agree to the terms stated above.	**I agree to the terms stated above.**
Lender: _____	Lender: _____
By: _____	By: _____
Signature: _____	Signature: _____
Title: _____	Title: _____

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Without the lender's **prior written waiver** of its due-on enforcement rights, triggered by future transfers, the lender can call the loan due on a later transfer of the buyer's interest in the property, such as a resale, further encumbrance, lease for over three years, court ordered transfer, foreclosure, death, etc. (with some exceptions for the principal residence).

A written waiver of the lender's **future enforcement** of the due-on clause bars the lender from calling the loan and protects the carryback seller for so long a time as the seller has an interest in the property. The **waiver agreement** assures the carryback seller he can protect his security interest in the title without due-on interference from the underlying lender. [See Form 410 accompanying this chapter]

To best protect the seller's trust deed, the seller should have the lender waive its right to call the loan:

- on the conveyance and further encumbrance of the property on the close of the carryback sale;
- for as long a period as the carryback trust deed remains of record; and
- on the carryback seller's reacquisition of title to the property should the seller have to complete a foreclosure on the property or accept a deed-in-lieu of foreclosure.

To be enforceable against the lender, the waiver must be in writing. [12 Code of Federal Regulations §591.5(b)(4)]

AITD and waiver

The all-inclusive trust deed (AITD) carryback is merely a variation on the standard carryback second trust deed. An AITD is a junior trust deed, typically a second.

However, in contrast to the standard trust deed, the AITD:

- secures a note for a principal amount which totals the unpaid balances on underlying liens and the balance of the seller's equity remaining unpaid after a down payment;
- obligates the carryback seller to remain responsible for making payments on the underlying liens; and
- does not involve the buyer in an **assumption** of the underlying (wrapped) loan. [See Chapter 22]

However, the creation of the AITD, recorded or not, still triggers the due-on clause, as does a grant deed, since it is a further encumbrance of the real estate.

Prior to closing an AITD sale, it is **the seller**, not the buyer, who negotiates any modification of the lender's trust deed note and arranges for the payment of any fees required by the lender to waive the due-on clause. The note modification by the seller increases the lender's portfolio yield through an increase in the note rates and the monthly payments, no different than if the buyer assumed the loan. Thus, the lender of record receives the same economic benefits of fees and market rates on the seller's modification of the loan as though the buyer had assumed and modified the loan.

In exchange for the fees and modification, the lender consents to the seller's AITD financing. As part of the negotiations, the lender agrees in writing to waive its rights under the due-on clause for as long as the carryback seller holds an interest in the property.

The seller carrying back an AITD retains the responsibility for paying the principal and interest installments and any impounds due the lender on the underlying loan. Thus, the **credit review** of the buyer by the lender is avoided since the seller remains the sole party responsible for payment.

After closing, instead of the buyer making payments on the underlying loan, the buyer makes installment payments on the AITD note directly to the carryback seller. On receiving installment payments on the AITD note from the buyer, the carryback seller pays the installment due on the underlying trust deed and keeps any remaining amount as his funds.

Broker's duty to disclose risks

All brokers in an installment sale have a duty to disclose the **existence** of a due-on clause in trust deeds of record. However, it is the duty of care owed to client which imposes on the different brokers in the carryback transaction the **duty to advise** their client on the legal and financial aspects of the trust deed's due-on clause.

For instance, the listing broker negotiating the carryback of a junior trust deed on behalf of a seller must inform the seller of the risks posed by the due-on clause in the existing trust deed. As for the buyer, it is the buyer's selling agent who is obligated to review the due-on risks and advise the buyer on the consequences of structuring the transaction to either:

- obtain the consent of the lender to the transfer and carryback financing, called a *waiver*; or

- take title *subject to* the existing trust deed. [See **first tuesday** Form 150 §4]

Also, the carryback seller must be informed and understand that a default by the buyer on installments on the all-inclusive trust deed (AITD) note will force the seller to advance the delinquent installment to the underlying lender, the task of the listing agent, not the buyer's agent. If the installment is not advanced, the seller risks having his AITD wiped out by the lender's foreclosure, a result no different then if the seller had carried back a regular second trust deed note.

It is the duty of all brokers involved in a carryback transaction to:

- **investigate** the provisions in a trust deed which is to remain of record, whether payments remain the seller's responsibility or become the buyer's; and

- **advise** their respective clients, be they the seller or the buyer, of the nature of any due-on clause.

The broker who fails to disclose the existence of the due-on provision to any party involved is liable for their losses caused by the lender's use of the clause. Also, if its existence is disclosed but the lender's rights are not taken into consideration when structuring the transaction, due-on related losses suffered by a broker's client due to the loss of their financial expectations in the transaction will impose liability.

For example, a buyer who is qualified to make payments on both the existing trust deed and a carryback note and who is not represented by a selling agent presents an offer to purchase property through the seller's listing broker.

The purchase offer provides for a small cash down payment with the buyer taking title **subject to** the existing trust deed. The seller is to carry back a note for the balance of the purchase price. The seller accepts the offer.

However, the buyer is not advised the recorded trust deed contains a due-on clause. Since an assumption of the loan by the buyer will not occur, a beneficiary statement is not ordered. A beneficiary statement would have disclosed the existence of the due-on clause to the buyer prior to closing, as would a copy of the recorded trust deed. [Calif. Civil Code §2943]

After escrow closes, the first trust deed lender discovers the sale and calls the loan due. The buyer, unable to pay the balance due on the first trust deed, ultimately loses the property through a foreclosure sale under the first trust deed.

The buyer seeks to recover his lost value from the seller's listing broker, claiming the broker had a duty to investigate and disclose the existence of the due-on clause.

The broker claims he owed no duty to the buyer to investigate or disclose title conditions contained in the recorded trust deed since the buyer was not his client.

Can the buyer collect the dollar amount of his lost equity from the seller's listing broker?

Yes! Any broker negotiating a transaction as an agent for either party must disclose title conditions affecting ownership or use of the property to both parties, not just his client.

A due-on clause in a trust deed is a title condition directly affecting ownership of the real estate. The clause affects the buyer's ability to maintain financing for the acquisition and continued ownership of the property. Thus, the seller's broker has a general duty to disclose the existence of a due-on clause to both parties involved in the transaction, not just his client. [**Pepitone** v. **Russo** (1976) 64 CA3d 685]

Waiver negotiations

A seller's listing broker can lessen the seller's risk of loss on a carryback sale by negotiating and obtaining a **written waiver** of the existing lender's future due-on rights prior to closing the transaction.

Also, the broker negotiating the carryback sale structured as an all-inclusive trust deed (AITD) or other wraparound financing agreement needs to anticipate the parameters of the lender's demand for increased interest and payments in exchange for a waiver of its due-on clause.

In turn, the interest rate and payment schedule negotiated for the AITD note should **equal or exceed** the interest rate and payment schedule the existing lender will demand as a modification of its note to consent to the sale.

If the AITD carryback sale is negotiated when market interest rates are the same or lower than the interest rate on the existing loan, the lender will be inclined to retain the original rate and demand only an assumption fee, often expressed in terms of points, for consenting to the seller's AITD sales transaction.

Conversely, in a market of rising interest rates when the existing lender's note rate is below market interest rates, the lender is certain to use the due-on clause to take advantage of the higher current rates and increase the note rate, and their yield, on the buyer's assumption or on the seller's modification in the case of an AITD transaction.

The AITD purchase agreement should specify the terms for modification of the existing loan which are acceptable to both the buyer and the seller, placing limitations on the interest, monthly payments, due date, and assumption fee to be negotiated by the seller with the lender. Alternatively, the purchase agreement can include a contingency for the seller's further approval of the modification demands by the lender to avoid impairing his AITD.

The carryback seller or his broker will need to negotiate the assumption or modification agreement with the lender, as well as any waiver of the lender's exercise of its due-on rights for as long a period as the seller retains an interest in the property.

Chapter 29 Required disclosures on seller carrybacks

This chapter discusses the financing disclosures a broker must make or consider making to a buyer and seller in a carryback transaction.

Mandated notices for risk assessment

A seller is willing to help finance the sale of his one-to-four unit residential property by carrying back a note and trust deed, sometimes called an *installment sale* or *credit sale*.

The seller's listing agent locates a qualified prospective buyer. The agent prepares an offer on a purchase agreement form and presents it to the buyer for his approval and signature since the buyer is not represented by an agent.

The terms offered for payment of the purchase price include a note and trust deed, to be signed by the buyer in favor of the seller, for the amount of the price remaining to be paid after the down payment and an assumption of the existing loan on the property.

A *Seller Carryback Disclosure Statement* is prepared by the listing agent and attached to the purchase agreement as an addendum. The addendum contains numerous statements on the financial, legal and other risk-of-loss aspects of the carryback note and trust deed. [See Form 300 accompanying this chapter]

The information entered in the **carryback disclosure statement** is based on the terms of the purchase offer, the title conditions, the activities to be undertaken in escrow and the information obtained from the buyer.

However, the agent's disclosures regarding aspects of the property, which might affect the transactional decisions of the buyer or the seller, are addressed in statements other than the carryback disclosure statement.

The carryback financing statement contains only the legislatively mandated **minimum disclosures** to be included. [Calif. Civil Code §2956]

Besides confirming delivery of the carryback disclosure statement to both the buyer and the seller, the listing agent, and any buyer's agent involved must be assured their respective clients understand and appreciate the risks and consequences which rise out of the **financial and legal aspects** of the carryback transaction. The duty of an agent to disclose to his client the agent's knowledge about the **tax aspects** of the carryback transaction depends on the type of property being sold and the agent's willingness to express an opinion on the subject. [See Chapter 54]

One-to-four unit carryback transactions

All brokered transactions for the purchase of **one-to-four unit residential property** involving seller carryback financing are controlled by statute. For one-to-four unit residential properties, a written carryback disclosure statement is **required** to be presented to both a buyer and seller for their review and signatures. [CC §§2956 et seq.]

FINANCIAL DISCLOSURE STATEMENT

For Entering into a Seller Carryback Note

NOTE: This statement is required to be prepared when the seller carries back a note executed by the buyer as part of the sales price for property containing four-or-less residential units. [Calif. Civil Code §2956]

This statement is to be prepared by the broker who obtains the signature of the person who first offers or counteroffers to buy, sell, exchange or option on terms which include a carryback note.

Both the buyer and the seller shall be handed a copy of this statement and sign it to acknowledge they have read and received a copy.

DATE:_____, 20_____, at_____, California.

Items left blank or unchecked are not applicable.

1. This is an addendum to the following agreement:

☐ Purchase Agreement ☐ Option to Purchase (with or without lease)

☐ Counteroffer ☐ Exchange Agreement

1.1 dated _____, 20_____, at _____, California,

1.2 entered into by_____, as the Buyer,

1.3 and_____, as the Seller.

2. This addendum was prepared by _____.

DISCLOSURES:

3. GENERAL INFORMATION CONCERNING THE TERMS OF PAYMENT:

3.1 The Note to be executed by Buyer is in the original amount of $_____, payable in constant monthly _____ installments of $_____ to include _____% per annum interest, with a final/balloon payment due on _____, 20_____, in the approximate amount of $_____.

3.2 The note will be secured by a trust deed on the property referred to as_____ _____.

3.3 Should the Note contain a FINAL/BALLOON PAYMENT, the debt is not fully amortized. When the remaining balance of the Note is due and payable, there can now be no assurance that refinancing, modification or extension of the balloon payment will then be available to Buyer.

3.4 Unless stated and explained in an attached ARM addendum, the Note contains a fixed rate of interest with no variable or adjustable interest rates which would increase payments or result in a negative amortization of the debt. [See **ft** Form 155-1]

3.5 Unless otherwise agreed, the original amount of the Note will be adjusted by endorsement at the close of escrow to reflect differences in the then remaining balance of any underlying trust deed obligation(s) being assumed or obtained.

3.6 ☐ The Note and trust deed to be carried back by Seller is of the all-inclusive variety, and will contain provisions passing through to Buyer any prepayment penalties, late charges, due-on sale or further encumbrance acceleration and future advances due on the underlying wrapped loans.

4. SPECIAL PROVISIONS AND DISCLOSURES CONCERNING THE CARRYBACK NOTE AND TRUST DEED:

4.1 ☐ The all-inclusive Note and trust deed to be carried back by Seller contains provisions calling for Seller to place the Note on contract collection with any institutional lender or real estate broker, other than Seller, and the collection agent will be instructed to first disburse funds on payments due senior encumbrances. **NOTE: Inclusion of this provision may cause adverse income tax consequences for Seller.**

4.2 A joint protection policy of title insurance will be delivered to Buyer and Seller insuring their interests in title on the close of escrow.

4.3 The trust deeds and grant deeds to be executed will be recorded with the county recorder at the close of escrow.

4.4 Seller will be named, through escrow, as a loss payee under the hazard and fire insurance obtained by Buyer.

4.5 A tax reporting service ☐ will, or ☐ will not, be obtained by Buyer for Seller. If not obtained, Seller will assure himself that real estate taxes have been paid while he holds the Note.

4.6 ☐ Requests for Notice of Default and Notice of Delinquency under California Civil Code Sections 2924b and 2924e will be recorded and served on behalf of Seller on encumbrancers senior to the carryback.

4.7 Seller is aware that in the event of a default under the carryback Note and trust deed, his sole source of recovery is limited to the net proceeds from a foreclosure sale or his subsequent resale of the real estate; and he is not entitled to rental value for Buyer's occupancy or a deficiency money judgment under the Note. [Calif. Code of Civil Procedure §580b]

4.8 Buyer ☐ shall, or ☐ shall not, receive net proceeds or cash back upon the close of escrow. Amount to be received is $_____; source of funds _____; reason for receipt _____.

4.9 The Note shall include the following provision: "This note is subject to Section 2966 of the Civil Code, which provides that the holder of this note shall give written notice to the trustor, or his successor in interest, of prescribed information at least 90 and not more than 150 days before any balloon payment is due."

5. ENCUMBRANCES SENIOR AND PRIOR TO SELLER'S CARRYBACK TRUST DEED AND NOTE:

5.1 Conditions of encumbrances, with priority over Seller's carryback Note and trust deed, which will remain or be placed of record at time of closing are as follows:

	First Trust Deed	Second Trust Deed
Original balance	$_____	$_____
Current balance	$_____	$_____
Interest rate	_____% ☐ ARM	_____% ☐ ARM
	Type: _____	Type: _____
Monthly payments	$_____	$_____
Due date	_____, 20____	_____, 20____
Balloon payment	$_____	$_____
Current defaults	$_____	$_____

5.2 If any of the senior encumbrances contain a due date, it may be difficult or impossible to refinance, modify or extend the balloon payment in the conventional mortgage marketplace.

6. BUYER CREDIT INFORMATION (SUPPLIED BY BUYER):

6.1 Buyer to hand Seller a completed credit application on acceptance. [See **ft** Form 302]

6.2 Seller may terminate the agreement within _____ days of receipt of the credit application by delivering to Buyer, Buyer's Broker or Escrow written Notice of Cancellation based on Seller's disapproval of Buyer's credit. [See **ft** Form 183]

7. BROKER DISCLOSURES:

7.1 Credit data is supplied by Buyer. Broker knows of no falsity or omission concerning Buyer's credit information.

7.2 This statement and its contents are statutorily required disclosures and do not limit Broker's duties to disclose other material facts about Seller to Buyer or Seller about the carryback financing arrangements and which are known to Broker or his agent.

7.3 Buyer and Seller are not to sign this statement until they have read and understood all of the information in it. All parts of the form must be completed before signing below.

7.4 ☐ See attached addendum for additional disclosures which are part of this disclosure. [See **ft** Form 250]

8. OTHER: _____

_____

Date:_____, 20_____	Date:_____, 20_____
Buyer's Broker: _____	Seller's Broker: _____
By: _____	By: _____
I have read and received a copy of this statement.	**I have read and received a copy of this statement.**
Date:_____, 20_____	Date:_____, 20_____
Buyer: _____	Seller: _____
Buyer: _____	Seller: _____

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Even the use of a *masked security device*, such as a land sales contract, lease-option or unexecuted purchase agreement with interim occupancy, requires written carryback disclosure statements. The written disclosure statements inform the buyer and the seller about the extent of the risks presented by failing to use grant deeds, notes and trust deeds to evidence an installment sale when the buyer takes possession. [See Figure 1; see **first tuesday** Form 300-1]

On the sale of a one-to-four unit residential property, any credit extended by the seller to accommodate the buyer's deferred payment of the purchase price requires a written carryback disclosure statement when the carryback arrangements include:

- interest or other finance charges;
- five or more installments running beyond one year;
- an installment land sales contract;
- a purchase lease-option or a lease-option sale;
- credit (note) to adjust equities in an exchange of properties; or
- an all-inclusive note and trust deed (AITD). [CC §2957]

Carryback disclosure statements are not mandated in carryback transactions creating **straight notes** which do not bear interest or include finance charges. However, carryback disclosures should be included as a matter of good brokerage practice since the risks and issues for the buyer and seller are similar and the duty owed the client is the same.

Consider a real estate agent who is acting as a property manager or leasing agent negotiating a lease for the landlord of a single family residence (SFR).

A prospective tenant makes an offer to lease the property. The offer contains an option to purchase the property on expiration of the lease. The terms for payment of the price under the proposed option include:

- a **carryback note**, to be executed on exercise of the purchase option (on expiration of the lease) for the balance of the seller's equity in the property after the down payment; and
- part or all of the lease payments are to apply as a credit toward the price and down payment on the property.

Here, the tenant's offer to lease coupled with the grant of a purchase option provides for a credit toward the price. Thus the credit **builds up an equity** in the property for the buyer. As a result, the agent is required to prepare the mandated carryback financing disclosures on a written form as an addendum to the lease-option. [See Figure 1]

Figure 1

FINANCIAL DISCLOSURE STATEMENT

For Entering into a Lease-Option Sale

NOTE: This disclosure statement is required to be acknowledged by both the Seller (Lessor/Optionor) and the Buyer (Lessee/Optionee) when the Seller extends credit requiring the Buyer to execute a debt obligation to defer payment for part of the sales price of property containing four-or-less residential units. [Calif. Civil Code §2956]

This disclosure is to be prepared and presented to all parties by the Broker of the party who offers or counteroffers to buy, sell, or exchange on a Lease-Option sales agreement.

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to the following agreement:

☐ Offer for Lease-Option [See **ft** Form 164]

☐ Lease-Option Contract for Deed [See **ft** Form 163]

1.1 dated _____, 20_____

1.2 entered into by _____, as the Lessee/Optionee, and

1.3 _____, as the Lessor/Optionor,

1.4 regarding property referred to as _____.

DISCLOSURES:

2. GENERAL INFORMATION CONCERNING TERMS OF PAYMENT:

2.1 The purchase price is $_____. The price to be credited for $_____ of option money paid and for _____%, or $_____, of each payment of base monthly rent.

2.2 The Lease-Option provides for a final/balloon payment on exercise of the option. Thus, the debt is not fully amortized. On exercise of the option, the availability of refinancing, modification or extension of the final/balloon payment cannot be assured.

2.3 Lessee/Optionee will make Lease-Option payments to _____, who will be responsible for remitting these funds to Payees under senior encumbrances.

Notice: Lessee and Lessor may wish to use a collection agent for the purpose of accepting Lessee's payments and disbursing payment to underlying lenders and Lessor.

2.4 This Lease-Option is subject to the following provision: "This Lease-Option is subject to section 2966 of the Civil Code, which provides that the holder of this instrument shall give written notice to the Lessee/Optionee, or his successor in interest, of prescribed information at least 90 and not more than 150 days before any final/balloon payment is due on exercise of the option." [See **ft** Form 419]

2.5 The Lease-Option wraps an existing trust deed, and any costs incurred by Lessor/Optionor for prepayment penalties, late charges, due-on-sale or further encumbrance acceleration and future advances will be passed on to Lessee/Optionee as increased rent. [See **ft** Form 163]

3. SPECIAL PROVISIONS AND DISCLOSURES:

3.1 ☐ Lessor will be designated as loss payee under Lessee's hazard and fire insurance.

3.2 Requests for Notice of Default and Notice of Delinquency under California Civil Code sections 2924b and 2924e ☐ will, or ☐ will not, be recorded for notice to Lessee/Optionee on encumbrances senior to the Lease-Option. [See **ft** Form 164 §7.4]

3.3 The Lease-Option is an unescrowed seller-financing transaction which is fully executed on delivery of the signed Lease-Option documents and possession.

3.4 The Lease-Option will not be recorded, which may cause Lessee/Optionee's title to the property to be impaired if liens are levied against the Lessor/Optionor.

3.5 Lessee/Optionee should consider obtaining title insurance on his real estate interest created by the option.

3.6 No tax reporting service will be obtained. Lessee/Optionee will assure himself that real estate taxes are paid by Lessor/Optionor during the option period.

3.7 Lessee/Optionee shall receive no proceeds or cash back on execution of the Lease-Option.

3.8 Lessor/Optionor is aware his sole source of recovery on Lessee/Optionee's default is limited to the net proceeds in the event of foreclosure under the Lease-Option. [Calif. Code of Civil Procedure §580b]

4. ENCUMBRANCES SENIOR TO THE LEASE-OPTION:

4.1 The conditions of encumbrances with priority over the Lease-Option include:

	First Loan	Second Loan
Original balance:	$_____	$_____
Current balance:	$_____	$_____
Interest rate:	_____% ☐ ARM	_____% ☐ ARM
	Type _____	Type _____
Monthly payments:	$_____	$_____
Due date:	_____ 20____	_____ 20____
Balloon payment:	$_____	$_____
Current defaults:	$_____	$_____

4.2 If any of the senior encumbrances contain a due date for a final/balloon payment, it may be difficult or impossible to refinance, modify or extend the balloon payment in the mortgage marketplace.

5. LESSEE/OPTIONEE CREDIT INFORMATION:

5.1 ☐ Lessee/Optionee to hand Lessor/Optionor a completed credit application on acceptance [See **ft** Form 302]; and

5.2 Lessor/Optionor may terminate this agreement within _____ days of acceptance by delivering to Lessee/Optionee or Lessee/Optionee's Broker a written Notice of Cancellation based on disapproval of Lessee/Optionee's credit. [See **ft** Form 183]

6. BROKER DISCLOSURES:

6.1 Credit data is supplied by Lessee/Optionee. Broker knows of no falsity or omission concerning the Lessee/Optionee's credit information.

6.2 This statement and its contents, being statutorily required disclosures, do not limit Broker's duties to disclose other facts material to Lessee/Optionee or Lessor/Optionor.

6.3 This statement is an addendum to the agreement referenced at §1 and creates no rights to rescind the Lease-Option.

6.4 This statement was prepared by _____

_____.

7. OTHER:

_____

_____

_____

_____

_____

_____

_____

Buyer's Broker:	**Seller's Broker:**
By: _____	By: _____
I have received and read a copy of this statement.	**I have received and read a copy of this statement.**
Date: _____, 20_____	Date: _____, 20_____
Lessee/Optionee: _____	Lessor/Optionor: _____
Lessee/Optionee: _____	Lessor/Optionor: _____

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Who prepares the disclosure

A carryback disclosure statement must be **prepared and submitted** to all parties in a carryback transaction on one-to-four unit residential property by:

- the real estate broker, or his agent, who **negotiated** the carryback sales transaction and prepared the buyer's purchase offer; or

- the buyer or seller who is a real estate licensee or attorney, when neither the buyer nor the seller is represented by a broker. [CC §2957(a)(2)]

When both the buyer and seller are represented by **different brokers**, the carryback disclosure statement is prepared by the broker or agent who prepared the buyer's offer.

Many participants in a carryback sale transaction are not required to make carryback disclosures, including:

- escrow officers [CC §2957(a)(3)];

- attorneys representing a party and not also acting as a real estate licensee [CC §2957(a)(1)]; and

- individual buyers and sellers when acting as principals without the assistance of a broker, unless they are real estate licensees or attorneys. [CC §2957(a)(1)]

Offer includes disclosures

The best policy for a **buyer's agent** is to eliminate the need for further approval of the statutory carryback disclosures by **preparing and attaching** a carryback disclosure statement as an addendum to the purchase agreement. If the disclosure statement is not attached, it would be prudent for the **listing agent** to include it as an addendum to a counteroffer to eliminate the disclosure contingency. [CC §2956]

If neither the buyer's or seller's agent prepares and includes the disclosures as an addendum to the offers or counteroffers, then, as a minimum requirement, the **buyer's agent** is responsible for preparing the disclosures and obtaining both the buyer's and seller's signature **prior to closing** the carryback sales escrow. [CC §2959]

However, after a purchase agreement has been entered into, and until the carryback disclosure statement is approved by the buyer and seller in a one-to-four unit transaction, a **statutory contingency** exists in favor of the buyer allowing the buyer to cancel the transaction. The right to cancel does not arise if the carryback disclosure statement is attached as an addendum to the offer or counteroffer. [See Form 300]

If the buyer receives the carryback disclosures after entering into the purchase agreement and discovers a reasonable basis for disapproving it, he may cancel the transaction and terminate his obligation to purchase the property. [CC §2959]

However, the buyer may not arbitrarily cancel the sale when he is presented with the carryback disclosure statement for his acknowledgment and approval during escrow. To cancel, the buyer must act in good faith by showing the carryback disclosures are inconsistent with his **reasonable expectations** when he entered into the purchase agreement. [CC §2961]

After closing, the only legal remedy available to the buyer or seller for inadequate or nonexistent financial disclosures is to pursue the brokers for any money losses actually incurred as a result of the nondisclosure. If a broker or his agent fails to make the mandated carryback disclosures, he is liable to the buyer for the buyer's losses resulting from the non-disclosure. [CC §2965]

Contingency exercised to cancel

Consider a buyer and seller of a single family residence who enter into a purchase agreement. The terms call for carryback financing in the principal amount of $250,000 with an interest rate of 6%, payable in monthly installments with a 30-year amortization and a five-year due date for a final/balloon payment.

The purchase agreement does not state the dollar amount of the balloon payment due on the carryback note at the end of five years. The risks imposed and the consequences of failure to meet the five-year due date are not brought to the buyer's attention by his agent prior to entering into the purchase agreement.

Further, a carryback financial disclosure statement is not presented to the buyer or seller for their signatures as part of the purchase agreement and counteroffer negotiations. Thus, closing is automatically contingent on the buyer's and seller's **further approval** of the financial and legal aspects of the carryback note and trust deed as presented in the carryback disclosure statement.

Prior to closing, the buyer receives the carryback disclosure statement. He discovers his final balloon payment at the end of five years will be $232,600. The buyer is now concerned about the financial risks of ownership since he has no assurance he will be able to refinance, modify or extend the note, much less have the ability to accumulate funds in the interim for payoff of the final/balloon payment.

Unable to negotiate an extension agreement with the seller, the buyer cancels the purchase agreement and escrow, claiming he did not previously realize the extent of the financial risk created by the due date in the carryback financing. He is now aware the due date could force him to sell the property or lose it to foreclosure should he be unable to arrange refinancing or an extension of the carryback note. [See **first tuesday** Form 418-3 §2.2]

Can the buyer cancel the transaction as permitted by statutes due to a delayed financial disclosure by the agents?

Yes! The buyer did not sign the carryback disclosure statement at the time he agreed to buy the property. This failure triggers the **statutory further-approval contingency** allowing the buyer to cancel the transaction. The risks of loss imposed by the amount of the final/balloon payoff were significantly greater than the buyer realized when entering into the purchase agreement. Thus, the buyer has justification for exercising his right to cancel since the sale did not meet his reasonable expectations.

Approximations when uncertain

A purchase agreement entered into by a buyer and seller calls for:

- a 10% down payment;
- a new loan of no less than 60% of the purchase price; and
- the seller to carry back a note for the balance of the purchase price at 6% interest, amortized monthly over 30 years with a ten-year due date.

Thus, the precise amount of the carryback note provided for in the purchase agreement could be any amount up to 30% of the purchase price, depending on the loan amount available from a lender.

When the agent prepares the carryback disclosure statement, the amount of the carryback note and new loan can be disclosed as dollar figures he **reasonably believes** will exist at the time of closing. The carryback figures may be an approximation of the unknown amounts.

The **approximation** must be clearly identified as "approximate," or "approx.," in the carryback disclosure statement, and be based on the best information available to the agent. The approximation may not be used as an excuse to evade compliance with disclosure laws. [CC §§2960; 2961]

Further, as amounts approximated in the original carryback disclosure statement become certain and are available to the buyer's agent, he must at that time disclose the new figures in a written amendment signed by both the buyer and seller. [CC §2962; see **first tuesday** Form 250]

However, if figures and facts presented in the carryback disclosure statement change due to actions taken by the buyer or seller after making the disclosures, the agent is not obligated to amend the carryback disclosure statement, but should do so to conform all the paperwork to the transaction prior to closing. [CC §2960]

Buyer's ability to pay

A buyer's ability to meet the terms and conditions of a carryback note is of financial importance to a seller who is carrying back a note on a sale. Thus, a listing agent must alert his seller to facts about the buyer's financial condition which are known to the listing agent and his seller is not yet aware of.

For example, a listing agent locates a buyer willing to purchase his seller's property on terms which include a carryback note and assumption of the existing trust deed lien on the property. The agent advises the seller that the buyer is financially qualified to handle the cash down payment and monthly payments on the carryback financing.

Relying on his agent's representations regarding the buyer's financial qualifications, the seller agrees to carry paper to finance the sale.

Before escrow closes, the buyer tells the agent he does not have the cash down payment and will need to obtain a loan. The listing agent does not disclose the buyer's lack of capital to the seller. Further, the listing agent makes a loan to the buyer to help fund the down payment of the property.

Escrow closes and the buyer takes title to the property. Shortly after taking title, the buyer defaults on the carryback note and trust deed held by the seller. The seller suffers a total loss on his carryback note due to a foreclosure sale on the first trust deed.

The seller then discovers his listing agent loaned the buyer the money he needed for the down payment. The seller also discovers the agent knew the buyer was financially unstable prior to closing the transaction.

In this scenario, the listing agent had a primary agency duty to advise the seller of the buyer's reduced financial capability to repay the carryback note, a significant adverse fact which came to the seller's listing agent's attention prior to closing. Thus, the agent and the agent's broker are liable to the seller for the seller's money losses on the carryback note. The listing agent failed to disclose his knowledge of the negative aspects of the buyer's revised or altered financial status. [**Ziswasser** v. **Cole & Cowan, Inc.** (1985) 164 CA3d 417]

A seller willing to enter into a credit sale **needs to know** the prospective buyer will be able to make the payments and pay the operating costs incurred as owner of the property. As carryback financing becomes more prevalent during cyclical periods of declining real estate prices and tight mortgage money conditions, more unqualified buyers appear with whom agents must contend.

To filter out unqualified buyers as part of the carryback disclosure process, the listing agent has an **affirmative duty** to obtain a written financial statement from the buyer and hand it to the seller of one-to-four unit residential property. [See Form 300 §4]

The seller's risks change as a creditor

One purpose of a carryback disclosure statement is to inform a seller that owners and lenders are bound by different rules; that they face different risks based on their respective possessory and security interests in real estate.

For example, while a buyer is concerned with paying no more than the *fair market value* (FMV) for a property, the carryback seller is concerned with his loan-to-value (LTV) ratio, whatever the price may be, since he will become a "financier" on the close of escrow.

Typically, a seller wants to receive the highest sales price negotiable for his real estate. However, the seller as a carryback lender wants assurance the buyer's down payment is a large enough amount as a percentage of the purchase price to establish **adequate equity value** in the real estate, over and above the amount of the carryback trust deed note. An adequate loan-to-value (LTV) ratio allows for full recovery of the carryback note from the value of the property should a default require the seller to foreclose on the property. Any lesser amount of equity exposes the carryback seller to additional risk of loss.

Chapter 30 Carryback foreclosure and resale costs

This chapter discusses the risks undertaken by a seller on an installment sale should the buyer default, and the safeguards to consider for covering those risks.

Protection is led by disclosures

An absentee owner is unable to effectively manage a small income-producing property he owns. Confronted with below market rents, unreliable tenants and deferred maintenance, he decides to sell the property. The condition of the property and its income will continue to deteriorate until it is sold to a local buyer who has cash reserves and can provide hands-on management.

The owner contacts an agent for the purpose of marketing the property and locating a suitable buyer. The property has an existing fixed-rate, long-term loan which can be assumed by a qualified buyer. The listing agent believes the seller's asking price for the property is properly set to attract an investor.

To pursue his asking price and pass on the cost of disrepair and the delinquent rent situation to the buyer, the seller lists the property with the agent's broker to market the property for sale and locate a buyer. The listing terms for payment of the price include a low down payment and a **carryback note** and trust deed.

The seller and his listing agent agree an acceptable offer must include a *further-approval contingency* calling for the owner to confirm the buyer is financially and personally qualified to purchase the property, and is ready with cash to cure the deferred maintenance and upgrade the tenancies on the property. [See **first tuesday** Form 159 §§8.4 and 8.5]

However, the listing agent quickly concludes the owner is not familiar with real estate financing techniques and does not fully understand the **risk-of-loss** involved in carrying back a second trust deed note. The risks, if known and understood, might cause a (prudent) seller to take additional steps beyond a carryback trust deed to cover the risks and protect his continuing investment represented by the carryback note. The listing agent knows he is **duty bound to inform** the owner of the risks of carrying back a second trust deed note, so appropriate decisions can be made regarding the terms for payment of the sale price and management of the carryback note and trust deed.

Agency duties and carryback risks

Sellers often do not know what risks of loss exist when carrying back paper, much less understand or even ask about them. Brokers and their agents who represent carryback sellers under a listing must be knowledgeable enough to provide essential risk-management information for the care and protection of their clients.

Listing agents who do not know or understand the risks of carrying back paper on a sale often brush them aside as minimal. However, sellers need to be advised that they must consider risk reduction remedies other than just "taking back the property" if their buyer defaults.

When a seller does not inquire about the risks, his listing agent has an **affirmative duty** to voluntarily advise the seller of the **risks known** to the broker and the agent, and recommend any due diligence investigation or analysis the agent believes they or the seller should undertake in a carryback sale.

Risks posed to a creditor involved in holding carryback paper differ dramatically from the more commonly understood risks of owning real estate. When the seller carries back paper on the sale of property, his ownership interest is exchanged for a creditor's (lender's) secured position in the property, called a *security interest*.

Covering the risks of junior financing

The risks of carrying paper are similar to the risks taken by an equity lender holding a comparable junior lien position on title to a property. The risks of a junior lender, and thus a carryback seller, are covered or compensated by employing several techniques and variables, including:

1. The amount of the buyer's **down payment**, as it sets the amount of both the equity the buyer feels compelled to protect and the cash sales proceeds the seller nets to cover the risk of future advances he may have to make should the buyer default;

2. **Further collateral**, as additional security to the equity in the property, be it personal property or other real estate, a situation sometimes called *cross collateralization*, an event which converts a carryback note to *recourse paper* and avoids anti-deficiency laws;

3. A **personal guarantee** from someone other than the buyer, which may be secured by real estate owned by the *guarantor*, and is a "put option" requiring the guarantor to pay off (buy by assignment) the carryback note on the buyer's default [See Form 439 in Chapter 13];

4. A **premium interest rate** on the note, a note rate greater than the current market rate which further covers the risks created by a down payment inadequate in amount to provide the seller with sufficient cash sales proceeds to pay all the costs of foreclosure and resale of the property should the buyer default (the interest rate for this minimal down payment situation would be comparable to sub-prime mortgage rates and junk bonds which are generally 3% to 6% above prime rates);

5. **Monthly payments** based on a short amortization schedule to quickly reduce the principal balance remaining on the note and increase the seller's cash reserves before a default (which usually does not occur for three to five years, except during cycles of severe declines in property values);

6. **Private mortgage insurance** (PMI), available from insurance companies if the buyer qualifies, to cover any loss of principal and interest due to a default by the buyer [See Chapter 40];

7. **Assignment of rents** as additional security (in the form of cash) if the property is income property. Rents can be readily collected by the use of pre-printed notices sent to both the buyer and the tenants which informs them to pay the carryback seller or be personally liable to the carryback seller for nonpayment [See Chapter 17];

8. A **credit application** and a **net worth statement** (balance sheet) from the buyer, authorization to order out a credit report to confirm the buyer's propensity to timely pay his debts, debt to income ratios with several months cash reserves for payments, and by a review of the buyer's assets for sufficient equity to bolster the buyer's ability to pay the carryback note (and possibly provide additional security for the carryback note) [See Form 302 in Chapter 32 and **first tuesday** Form 207-1]; and

9. **Inspect and investigate** the care and management of real estate owned by the buyer to determine if he maintains and operates property without deferring maintenance.

The foreseeability of a default

A lender becomes acutely aware of his rights and obligations when a **buyer defaults**, a foreseeable occurrence against which the trust deed lien is the first line of defense.

When the buyer defaults on a trust deed, the carryback seller may proceed with a foreclosure and recover what is owed him from the value of his security interest in the property. Defaults on a trust deed include the buyer's failure to:

- pay installments on the carryback note;
- pay property taxes, assessments and hazard insurance premiums;
- pay senior lenders; or
- maintain the property.

During the foreclosure period, the carryback seller may need to draw on his cash reserves to keep the senior trust deed note current and avoid the initiation of foreclosure proceedings by a senior lender. Commencement of foreclosure by the senior lender will add to the carryback seller's costs of recovering the property.

If the downpayment amount is a small percentage of the price, which results in a high loan-to-value (LTV) ratio for the carryback seller, the seller who begins foreclosure and makes a full credit bid stands a good chance of taking the property back at the trustee's sale.

Most importantly, the seller's source of recovery on a carryback note which is secured solely by the property sold is limited to the value of his *security interest* held under the second trust deed lien. The dollar value of a junior trust deed holder's secured position on the property's title is the property's fair market value, minus:

- the balance remaining due on the senior loan;
- the dollar amount of foreclosure;
- resale costs; and
- carrying costs (taxes, insurance, operating expenses) until the property is resold.

Any rents collected from tenants by the seller due to the seller's enforcement of his assignment of rents lien (in the trust deed) will be applied to offset the costs of "carrying" the property during foreclosure and the amounts due the seller to set the amount of an underbid at a trustee's sale. Also, interest on the carryback will be unpaid and uncollected unless paid on a bid by a cash buyer at the trustee's sale, or recovered in the resale price should the seller recover the property at the trustee's sale and resell it.

For the seller to limit his risks of lost equity and interest on non-income producing property, the cash proceeds from the buyer's down payment on the initial sale of the property must equal or exceed the total of eight to twelve months of senior trust deed payments, other carrying costs incurred during this period,

and foreclosure and resale costs. If the buyer's down payment is large enough, the value of the seller's security interest in the property should be sufficient to recoup the principal balance and interest on the carryback note, the property's carrying costs and the costs to foreclose and resell the property.

The listing agent representing the broker must prepare and review a *Foreclosure Cost Sheet* with the carryback seller to impress upon the seller that he needs an adequate down payment (or additional security or a guarantee). The information in the disclosure will aid everyone in an analysis of the risks a second trust deed holder is exposed to and the steps to be taken to cover those risks. [See Form 303 accompanying this chapter]

The **Foreclosure Cost Sheet** is useful as a visual aid to make these disclosures about the financial risks of a carryback sale. The worksheet also documents the agents disclosure of the potential expenditures, and the cash reserves required to cover the risk of the buyer's default.

Foreclosure cost calculations are made by the agent and reviewed with the seller who is considering an installment sale on each of two occasions:

- once when accepting the listing; and
- a second time when presenting an offer.

Lastly, a major hidden cost of foreclosure is the **time and energy** spent by the carryback seller to keep track of any foreclosure and resale process he may have to undertake. The recovery of this opportunity cost is built into the increased sales price for the property, the increased interest yield and the increased monthly payment amount on the carryback note.

The foreclosure risk of having to sell the property again is often shared by the brokers and agents through various deferred fee arrangements to reduce any moral hazards present in an optimistic agent's encouragement of the seller to accept the terms of an offer calling for a carryback sale note.

A deed-in-lieu

When the amount of an underlying senior loan is more than 75% of the property's current market value and a buyer defaults on the seller's carryback note, the seller should first negotiate with the buyer for a *deed-in-lieu of foreclosure* and possession to the property before initiating foreclosure. Negotiations for a **deed-in-lien of foreclosure** should be considered at the time of the default, but must be considered before commencing foreclosure.

A deed-in-lieu is a grant deed containing special language to assure title insurers the debt has been canceled, and no lease-option or other lender/debtor relationships has been created to cause the deed-in-lieu to be recharacterized as a *mortgage-in-fact*. [See Chapter 50]

A deed-in-lieu, as a preforeclosure workout, eliminates many of the financial risks of foreclosing. The deed-in-lieu saves the carryback seller the high cost of foreclosure, while possibly providing the buyer with some "walking money" or "key money," consideration for immediately conveying title and transferring possession to the seller under the deed-in-lieu.

Also, the deed-in-lieu **must be insured** by a title company before the seller accepts it. Without title insurance on the deed-in-lieu to confirm the condition of the title, liens may have attached to the property or a change in vesting may have occurred which renders the deed unacceptable.

FORECLOSURE COST SHEET

Costs and Net Proceeds on Foreclosure and Resale

NOTE: This cost sheet is prepared and presented to carryback sellers and lenders secured by a junior trust deed. These disclosures help junior trust deed holders anticipate the funding necessary to foreclose and the net proceeds of a foreclosure and resale.

The figures estimated in this cost sheet will vary with time and thus are not a guarantee.

This form does not consider the effects of a bankruptcy, eviction, lost interest, or assignment of rents provision.

1. This estimate of costs incurred to foreclose and resell property under a trust deed is prepared for the following:

☐ Purchase Agreement ☐ Loan Agreement ☐ Exchange Agreement

☐ Trust Deed and Note ☐ Option

1.1 dated _____, 20_____, at _____, California,

1.2 entered into by _____,

1.3 regarding property referred to as _____.

2. Estimated resale value of the real estate . . . . . $_____

3. Balances on senior trust deeds at time of resale

3.1 Underlying first . . . . . $_____

3.2 Underlying second . . . . . $_____

4. Cash advances from the time of default through closing of a resale

4.1 Taxes . . . . . $_____

4.2 Insurance . . . . . $_____

4.3 Improvement bond assessments . . . . . $_____

4.4 Common interest development assessments (condos) . . . . . $_____

4.5 Payments on underlying trust deeds (number of months _____). . . . . $_____

5. Foreclosure costs and fees to recover a property

5.1 Trustee's guarantee policy . . . . . $_____

5.2 Recording notices . . . . . $_____

5.3 Publishing notices . . . . . $_____

5.4 Postage . . . . . $_____

5.5 Trustee's fees . . . . . $_____

5.6 Miscellaneous charges. . . . . $_____

6. Resale costs after foreclosure and recovery of the property

6.1 Repairs and fixer-up costs . . . . . $_____

6.2 Title insurance premiums . . . . . $_____

6.3 Escrow fees and charges. . . . . $_____

6.4 Broker fees and charges . . . . . $_____

7. Estimated loans, advances, costs and charges to foreclose and resell (3, 4, 5 and 6): . . . . (-)$_____

8. **Estimated net proceeds available to pay off carryback trust deed** . . . . . $_____

I have diligently prepared this estimate.	**I have read and received a copy of this estimate.**
Date: _____, 20_____	Date: _____, 20_____
Seller's Broker: _____	Seller's Name: _____
By: _____	Seller's Signature: _____
	Seller's Signature: _____

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Foreclosure

If a deed-in-lieu remedy or other pre-foreclosure workout (short payoff sale or modification of the note) is not available to resolve a default, a trustee's foreclosure sale is the next most expedient procedure for recovery on a defaulted note.

However, some or all of the financial benefits of a carryback note may be reduced by the carrying costs and trustee's charges incurred during a trustee's foreclosure if the down payment is inadequate (less than 15% to 20% of the price), the value of the property does not rise or the seller procrastinates in commencing foreclosure on a default.

For example, suppose a buyer pays $100,000 down and assumes $800,000 in existing loans on a $1,000,000 sales price. The seller carries back a $100,000 note secured by a trust deed lien on the property sold for the balance remaining to be paid on the purchase price.

The brokerage fees and other costs, credits and adjustments associated with the sale amount to $50,000. Thus, the seller's net proceeds on the sale are $50,000 cash and the $100,000 in paper. [See **first tuesday** Form 310]

However, foreclosure and resale costs can run from 15% to 20% of the property's resale value, in this case, $150,000 or more. More than half of this amount would be met from the seller's cash reserves to pay foreclosure and other carrying costs until the property is resold. Foreclosure on income producing property can be less demanding on a seller's cash reserves since the carrying costs may be offset by rent received under the trust deed's assignment of rents provision. [See Chapter 50]

The carryback seller is also subject to the risk the buyer may file a **bankruptcy petition** to preserve any equity he may have in the property. The carryback seller's foreclosure sale is automatically halted by filing the petition, called a *stay*, and remains in effect until the bankruptcy court releases the stay.

Any delay in the foreclosure process results in further expenditures to pay the property's carrying costs — caused by an insolvent and distraught buyer. Further, a buyer who realizes he will lose the property often fails to continue to properly maintain the property, called *impairment of the security* or *waste*.

If only deferred maintenance occurs, the carryback lender will incur the expense for **fixing up** the property to resell it (or to keep it and rent it).

These conditions are common risks any mortgage lender is exposed to. As with all mortgage risks, the risks are manageable and capable of being covered by a mix of a sufficient down payment, a premium interest rate, assignment of rents on income property, a short amortization period, additional security and guarantees. A real estate market of rising values is always a cure for a failure to adequately cover the risks of loss.

Eviction by the involuntary landlord

A buyer wiped out by a foreclosure sale must vacate and deliver possession of the property to the carryback seller who acquires it at a foreclosure sale. If the buyer does not vacate, the seller must serve the buyer with a written *Three-Day Notice to Quit Due to Foreclosure*. [Calif. Code of Civil Procedure §1161a(b); see **first tuesday** Form 578]

However, a wiped-out buyer might refuse to vacate the property on expiration of the three-day notice. If this occurs, the carryback seller will need to proceed with an *unlawful detainer* (UD) action, as would any landlord dealing with any tenant who unlawfully detains the property.

At the **unlawful detainer** hearing, the carryback seller must show the property was acquired at a trustee's sale and all statutory notice requirements for the sale and the UD action have been satisfied to evict the buyer.

After foreclosure and recovery of possession, the carryback seller who reacquires the property is back to square one — he owns the property again, minus his out-of-pocket expenses to foreclose.

A tenant or subtenant in possession of a residential unit at the time of a foreclosure sale must be given 60 days' written notice to quit before the tenant or subtenant may be removed from the property by an unlawful detainer action:

- tenant;
- subtenant; or
- occupant.

Other security devices

Land sales contracts, reverse trust deeds, unexecuted purchase agreements with occupancy (lease-purchase sale) and lease-option sales, are **installment sales** which typically include the additional risk and cost of a **judicial foreclosure** should the buyer default and challenge an eviction action.

The completion of a foreclosure of the lien created by any security device is a requisite to recovering possession, since the buyer's *right of redemption* (to pay off the debt) must be eliminated to clear title of the buyer's ownership interests. These alternative security devices do not usually contain a *power-of-sale* clause to authorize the more efficient, less expensive trustee's foreclosure sale. [See Chapter 35]

The exposure to the repossession risk of a judicial foreclosure outweighs any purported benefit these alternative security devices might offer on a small-downpayment installment sale to a buyer.

Chapter 31 Buyer's creditworthiness: seller's further approval

This chapter comments on a carryback seller's need to investigate and analyze a buyer's creditworthiness and capacity to pay.

The informed seller carries paper

An offer submitted by a buyer to purchase real estate calls for the seller to carry back an **unsecured note** for a portion of the sales price. The balance of the price will be paid with a cash down payment and the assumption of an existing loan on the property. The seller is given ten days after acceptance of the offer to further approve the buyer's creditworthiness and net worth, or cancel the transaction. [See Figure 1]

The buyer wants to acquire the property clear of any carryback encumbrance so the equity in the property can be used to finance the acquisition of other property.

On presentation of the offer, the seller's listing agent advises the seller that the buyer's financial statements indicate the buyer's net worth as itemized on the balance sheet includes the ownership of numerous properties known to the broker.

Relying on his agent's representations of the buyer's net worth, the seller accepts the offer. Prompted by the listing agent, the seller approves the buyer's credit, thus waiving the further-approval contingency. [See **first tuesday** Form 182]

Cash back disclosure

Prior to the close of escrow, the buyer informs the listing agent he needs to pay the brokerage fee with a promissory note to replace the cash fee the seller has agreed to pay his broker. The buyer has insufficient funds for the agreed-to down payment.

To close the transaction without bringing the buyer's lack of funds to the seller's attention, the agent enters into a "cash back" arrangement with the buyer. This arrangement will help the buyer fund the down payment, which in turn will fund the seller's payment of the brokerage fee.

Under the arrangement, the buyer and the agent will exchange a check from the agent payable to the buyer for a note from the buyer payable to the agent, both for the amount of the brokerage fee. On closing, the agent will deposit the fee paid by the seller into the agent's account and hand his check on that account to the buyer. In turn, the buyer will hand his promissory note to the agent. The brokerage fee paid by the seller on closing will cover the check issued by the agent to the buyer.

Figure 1 *Excerpt from Form 150 §8.4 and 8.5*

Buyer credit information

8.4 Buyer to hand Seller a completed credit application on acceptance. [**ft** Form 302]

8.5 Within _____ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness.

Further, the buyer finances the remaining portion of the down payment through a new loan arranged by the listing agent with a private lender. Thus, the buyer has restructured the entire down payment to avoid the investment of any of his **personal funds**.

The seller is not informed of the purchase-assist loan or the cash-back arrangement. Also, the seller's agent is aware the representations of the properties and the financing listed on the buyer's financial statement approved by the seller significantly overstate the buyer's net worth.

The transaction closes. Eventually, the buyer defaults on the unsecured carryback note, which is recourse paper collectible by a money judgment.

The seller is only able to recover a portion of the outstanding balance on the carryback note from the buyer.

The seller seeks to recover his loss on the carryback note from the agent's broker, claiming the broker and his listing agent wrongfully induced him to accept the unsecured carryback note.

Is the broker or his listing agent liable for the seller's losses due to the buyer's default?

Yes! The broker and his listing agent are both liable for the seller's losses. The agent intentionally misrepresented the buyer's ability to perform on the carryback note to induce the seller to enter into the installment sale with the buyer. [**Alhino** v. **Starr** (1980) 112 CA3d 158]

Broker's agency duty

The duty owed the seller by the broker's listing agent to disclose the **buyer's credit status** includes:

- correctly representing to a carryback seller a buyer's ability to meet the obligations imposed on him by entering into a carryback note;

- disclosing information about the prospective buyer's/borrower's identity, occupation, employment, income, and credit data as known to the broker and his listing agents;

- disclosing the buyer's existing and future loan obligations, including payment history and any pending bankruptcy known to the broker and his listing agent; and

- affirmatively advising on any credit investigation which should be conducted.

Also, written disclosures itemizing the buyer's credit information are mandated on all sales involving one-to-four unit residential properties when the seller carries back a portion of the sales price. [Calif. Civil Code §§2956 et seq.; see Chapter 29]

All disclosures must be made in *good faith* by the buyers, brokers and agents to meet the objective of the credit investigation. [CC §2961; see Form 302 accompanying this chapter; see **first tuesday** Forms 207 and 207-1]

The listing agent provides his seller with the buyer's credit information so the seller can make an informed decision to either proceed with the transaction or cancel it under a further-approval contingency in the purchase agreement. [See **first tuesday** Form 158 §8.5]

Any real estate agent who misrepresents a buyer's credit information or makes false statements to the carryback seller about the buyer's ability to repay the carryback note, is not only liable for money damages, but faces suspension or revocation of his license for committing fraud. [Calif. Business and Professions Code §10176]

The need for credit checks

A carryback seller must determine the creditworthiness of the buyer for the same reason a landlord must obtain reliable credit information on prospective tenants — will they, and are they able to, pay as agreed.

Accurate credit information on the buyer helps the seller analyze the **risk of default** when extending credit to the buyer. Also, the seller must assure himself the buyer will **maintain the property unimpaired** under the carryback trust deed. In other words, if the buyer is unqualified, the seller may justifiably cancel the transaction.

The buyer must have the financial ability and credit history to pay both the first trust deed loan and the second trust deed note carried back by the seller before the seller approves and proceeds to close the sale. Any default by the buyer on the first trust deed jeopardizes the seller's security interest in the property under his second trust deed lien.

The listing agent checks the buyer's creditworthiness and ability to perform by:

- analyzing an application for credit, along with credit reports, telecredit checks and criminal background reports he orders out [See **first tuesday** Form 203 and 302];

- reviewing financial statements, both an operating statement (profit and loss report) and a balance sheet (net worth statement) and confirming the bank balances [See **first tuesday** Forms 207 and 207-1];

- contacting the buyer's creditors (sellers, landlords, lenders) for their experiences with the buyer's payment history; and

- inspecting properties owned by the buyer to determine the level of care and maintenance the properties receive which are owned and managed by the buyer.

All carryback sellers face the risk a buyer will default, no matter how wealthy, conscientious and qualified the buyer might appear to be. On any default in payments on a trust deed note, the seller's **sole source of recovery** is a resort to the secured property, unless the note is subordinated to a construction loan or additionally secured by property other than the property sold.

Even an existing trust deed lender has a right to obtain credit information from the buyer on a change of ownership. The lender, like a carryback seller, needs to make an informed decision as to whether the risk of default in the payments or care and management of the property will increase under the new ownership, called *impairment*. [**Santa Clara Savings and Loan Association** v. **Pereira** (1985) 164 CA3d 1089]

The right to obtain credit information also applies to private parties such as carryback sellers.

For example, private lenders rely on their agents to obtain necessary information on the borrower's ability to comply with the terms of both the **note** (payments) and the **trust deed** (care and maintenance).

A private lender does not typically have the resources of institutional lenders to personally investigate and assess a buyer's creditworthiness and management capabilities prior to making a loan. Thus, a broker or an agent who assists private lenders and carryback sellers is obligated to help them determine the buyer's ability to operate the property and his propensity to make payments on a promissory note. [**Dawn Investment Co., Inc.** v. **Superior Court of Los Angeles** (1982) 30 C3d 695]

The creditworthiness contingency

A listing agent has the duty to obtain accurate credit information and disclose any facts known or readily available to him which might affect the seller's decision to carry paper in the transaction.

A **carryback disclosure statement** should be attached to any purchase agreement containing a carryback note. The carryback disclosure statement is mandated on the sale of four-or- less residential units. However, a prudent listing agent will also require a disclosure statement in carryback transactions on **all types** of property. [CC §§2956 et seq.; see Form 300 in Chapter 29; see Chapter 3]

Both the carryback disclosure statement and the purchase agreement includes a credit approval contingency. The **further-approval contingency** calls for the buyer to hand the seller a completed *credit application*. [See Form 302]

The agent preparing a carryback offer should consider having the buyer fill out the **credit application** on commencement of negotiations and attach it to the buyer's purchase agreement offer as an addendum. Early disclosure helps the seller to determine the buyer's sincerity and good-faith willingness to cooperate in the credit analysis process.

A review of the buyer's financial statements and the agent's verification of earnings and funds can be cleared during the contingency period. [See **first tuesday** Forms 208 through 213]

The credit contingency allows the carryback seller to terminate the purchase agreement by a written *Notice of Cancellation* should he disapprove of the buyer's creditworthiness. [See **first tuesday** Form 150 §10.5]

However, the credit contingency does not give the carryback seller the unrestricted right to withdraw from a binding and otherwise enforceable purchase agreement.

For example, a carryback seller enters into a purchase agreement containing a credit approval provision which gives him the right to cancel the transaction based on the buyer's lack of creditworthiness. [See Figure 1 §8.5]

During the contingency period and before the seller approves the buyer's credit, the seller changes his mind about selling the real estate. He decides to cancel the transaction by using the credit contingency as a "weasel clause," or "back door provision," in an attempt to escape enforcement of the purchase agreement. The seller has no grounds for disapproving the buyer's credit since he has received no derogatory information about the buyer's creditworthiness or ability to perform on the purchase agreement or the carryback note.

The seller must have good reason to disapprove the buyer's credit and cancel the transaction. A reason to cancel the transaction must relate to the creditworthiness sought to be determined under the contingency provision. Without good reason, the seller who cancels has breached the purchase agreement in bad faith by wrongfully using the credit contingency. [**Lyon** v. **Giannoni** (1959) 168 CA2d 336]

A credit report and telecredit check

A review of a buyer's creditworthiness requires accurate credit history data on the buyer. **Credit history** obtained from reporting agencies includes *consumer credit reports* and *telecredit checks*.

The **telecredit check** reviews the buyer's check writing history and informs the agent if the buyer has written bad checks in the past.

A **consumer credit report** contains information about a consumer's creditworthiness or credit standing supplied by a consumer credit reporting agency. The credit application form can require the buyer to cover the cost of the credit report.

A credit report does not assure the future performance of the buyer to repay the note, nor does the report demonstrate the buyer's ability to pay.

Properly reviewed, a credit report helps to establish the buyer's past performance in repaying money obligations. Money obligations include amounts owed on loans or financing agreements, on judgments or tax liens, or for late penalty charges on retail and bank credit accounts. The credit report is used by the broker to establish an individual's eligibility for:

- credit to be used for personal, family or household purposes;
- employment purposes; or
- rental of a dwelling unit. [CC §1785.3(c)]

When the carryback transaction involves a carryback note of $50,000 or more, a consumer credit report will also contain information not otherwise available in a credit report, regarding:

- bankruptcies predating the report by more than 14 years;
- paid tax liens or accounts predating the report by more than seven years;
- unlawful detainer (UD) actions where the landlord prevailed; and
- records of criminal activity predating the report by more than seven years.

Persons seeking credit information must identify themselves to the reporting agency, state their purpose for seeking the information and certify the information will be used for no other purpose than what is stated. [CC §1785.14]

An agent seeking information on a buyer will be refused a credit report unless the buyer to be investigated signs a release form for the information, typically included in credit application forms.

The release requirement is waived if the broker is a member of a credit reporting agency's credit association. Credit reports are provided at a preset cost-per-request by the agency to the broker (or agent) member for a one-time membership fee and a minimum monthly billing.

Membership in a credit association requires applicants (brokers or agents) to have their own creditworthiness reviewed by the agency.

CREDIT APPLICATION

Individual

DATE: _____, 20_____, at _____, California.

THIS CREDIT APPLICATION is for the amount of $_____.

Property address: _____

Received from Applicant(s) $_____, ☐ cash, or ☐ check, for a consumer credit report which is a non-refundable cost and not a deposit.

Applicant(s):

Applicant One _____
(Last Name) (First Name) (Middle Name) (Sr., Jr., etc.)

Social Sec. # _____ Drivers Lic. # _____ State_____

Applicant Two _____
(Last Name) (First Name) (Middle Name) (Sr., Jr., etc.)

Social Sec. # _____ Drivers Lic. # _____ State_____

Additional Occupant(s): Name _____

Name _____

Rental History: Have you ever been party to an eviction? ☐ Yes ☐ No Filed bankruptcy? ☐ Yes ☐ No

Present Address _____

City _____ Zip _____

Length of Residency _____ Monthly Rent $_____

Landlord/Agent _____

Address _____

City _____ Zip _____ Phone _____

Reason for Moving _____ Moving Date ____/____/____

Previous Address _____

City _____ Zip _____

Length of Residence _____ Monthly Rent $_____

Landlord/Agent _____

Address _____

City _____ Zip _____ Phone _____

Employment:

Applicant One

Employer _____

Address _____

City _____ Zip _____ Phone _____

Length of Employment _____ Position _____ Wages _____

Pay Period _____ Union _____

Previous Employer _____

Address _____

City _____ Zip _____ Phone _____

Applicant Two

Employer _____

Address _____

City _____ Zip _____ Phone _____

Length of Employment _____ Position _____ Wages _____

Pay Period _____ Union _____

Previous Employer _____

Address _____

City _____ Zip _____ Phone _____

Additional Income Amount $_____ Source _____

Recipient _____

General Credit Information:

Automobile One: Make _____

Year _____ Model _____ Lic. #/State _____

Lender _____

Automobile Two: Make _____

Year _____ Model _____ Lic. #/State _____

Lender _____

Bank/branch _____

Check Acc. # _____ Savings Acc. # _____

Bank/branch _____

Check Acc. # _____ Savings Acc. # _____

Credit References:

1. _____

Address _____

Account # _____ Balance due $_____ Phone _____

2. _____

Address _____

Account # _____ Balance due $_____ Phone _____

Personal Reference _____

Address _____ Phone _____

Personal Reference _____

Address _____ Phone _____

Nearest Relative (name/relationship) _____

Address _____ Phone _____

I/We declare all information given in this application is true and correct. I/We authorize your credit reporting agency to obtain and verify a complete consumer report and supply the information obtained to you. This information is not privileged.

Date: _____, 20_____

Name: _____

Signature: _____

(Applicant 1)

Name: _____

Signature: _____

(Applicant 2)

I acknowledge receipt of this credit application and accompanying payment.

Seller or Lender: _____

Signature: _____

Phone: _____

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The credit reporting agency will provide the necessary notice to the buyer being investigated.

Although necessary for completing a credit clearance, a credit report does not contain information on the buyer's capacity to pay, called *net worth*, or his propensity to commit a crime.

Financial statements for income and worth

Two financial aspects of a buyer's ability to perform on the carryback note must be investigated:

- the ability of the property's income to cover the **expenses** and carry the **debt service** if it is income producing; and

- the ability of the buyer to personally service any **negative cash flow**, called implicit rent, resulting from the debt burden or lack of rental income or the owner's use of property.

To investigate the property's ability to carry its debt service, the property's income and expenses are analyzed by using the *Annual Property Operating Data Sheet* (APOD). [See **first tuesday** Form 352]

If the property's income is unable to support its operating expenses and debt service, then the seller must look for other abilities of the buyer to carry the negative cash flow caused by the debt.

The buyer's personal capacity to pay is investigated by a review of financial statements delivered by the buyer itemizing his income/expenses and net worth.

The buyer's income includes his base salary, overtime, bonuses, commissions, interest earned, dividends, and rental income. Income from alimony, child support, or other separate maintenance income such as social security and military benefits does not have to be reported on the financial statement if the buyer does not want the income to be considered as available for repayment of the property's debt.

Personal expenses by a buyer are broken down into housing expenses and all other expenses.

The buyer's monthly housing expenses include real estate loan payments, rent, property taxes, association charges, homeowner's/tenant's insurance premiums and utilities.

When housing expenses are added to all other expenses, such as alimony, child support, income taxes and other installment payments such as credit cards, automobiles, etc., the buyer's total expenses are determined. [See **first tuesday** Form 203]

The buyer may be self-employed, or involved in a business, rental or investment activity which provides the buyer with his primary source of income used to establish his creditworthiness. For a self-employed buyer, **financial statements** such as an *operating statement* and *balance sheet* on each business, rental or investment activity are needed to determine any profit or loss and net worth, together with tax returns for at least two years, for confirmation of the financial statements. [See **first tuesday** Forms 207 and 207-1]

Assets of the buyer include cash balances in checking, savings and other accounts receivable. Also included is the current market value of stocks, bonds, personal property, businesses and real estate owned by the buyer. Finally, the current values of vested interests in retirement funds and insurance policies are included.

The buyer's liabilities include the balance owed and monthly payments on credit cards, open credit lines, alimony and child support. Also, loans secured by assets must be listed as liabilities. A buyer's **net worth** is the total value of his assets minus his total debt obligations. Net worth is the bottom line shown on the financial statement identified as the *balance sheet*.

Evaluating credit information

Once a listing agent has obtained a buyer's credit application and financial statements, the data must be evaluated by that agent and the seller of the real estate.

When evaluating the information provided on forms filled out by a buyer, the listing agent and seller must not conduct themselves in a manner which would discriminate against the buyer based on their race, color, religion, sex, sexual orientation, marital status, national origin, ancestry, familial status, source of income or disability of that person. [Calif. Government Code §12955]

The buyer's representations of employment, cash deposits and loans with existing lenders should be verified, as would be done by a mortgage lender. [See **first tuesday** Form 208 through 215-1]

Formulas for determining a buyer's ability to pay for any negative cash flow generated by the purchase of the real estate are structured as expense-to-income ratios. [See **first tuesday** Form 230]

For example, the Department of Housing and Urban Development (HUD) and Federal Housing Administration (FHA) ratio of housing expenses and debt to gross income should be no more than 31%. The ratio of total expenses and all debt to gross income should be no more than 38%.

Institutional lenders generally vary the ratio of housing expenses to gross income to around 30%, and the ratio of total expenses to gross income to around 40%. However, when applying ratios as guidelines to determine a buyer's creditworthiness, each buyer should be treated individually. A buyer who does not meet the expense-to-income ratio is not necessarily an increased credit risk.

Also, the seller may apply an arbitrary ratio or formula, such as a three-to-one *income-to-debt* ratio, as the only basis of determining the buyer's creditworthiness, as long as the ratio is uniformly applied to all transactions. [**Harris** v. **Capital Growth Investors XIV** (1991) 52 C3d 1142]

Income-to-debt ratios assume all non-conforming individuals are unable to pay based on arbitrary mathematical formulas.

Qualifying ratios cause the more complete credit reviews of a prospective buyer to be sacrificed for a quick and easy test of their financial ability. By the use of such qualifying ratios, some buyers who may qualify are not actually good credit risks and some disqualified buyers are actually good credit risks.

Also, requiring employment to be a qualification for prospective buyers unfairly discriminates against people who receive income from investments, annuities, retirement pay, family support or private subsidies.

The carryback seller should review all credit information supplied by the buyer and look for a reason why the buyer qualifies as a good credit risk.

Only after all credit information has been reviewed and creditworthiness has not been established can the seller reasonably cancel the carryback transaction for the buyer's lack of credit.

Chapter 32 Working the AITD and note

This chapter reviews the advantages of a carryback all-inclusive note and trust deed (AITD), the terms to be negotiated and the forms to be used.

Flexible carryback financing

As a *debt instrument* and *security device* for the credit sale of encumbered real estate, the all-inclusive note and trust deed (AITD) provides agents, sellers and buyers with the flexibility needed during periods of tightened availability of mortgage funds to finance the **balance of a sales price** remaining unpaid after a down payment.

For a buyer, the AITD note carried back by a seller is all the financing needed to acquire encumbered real estate on making a down payment. The principal amount of the AITD note includes:

- the seller's **remaining unpaid equity** in the property; and

- the **unpaid balance** on the existing loan which will remain of record, called the *wrapped loan* or *underlying loan*.

The buyer makes monthly payments to the seller on the AITD note. In turn, the seller makes monthly payments to the underlying lender.

The advantages of an AITD note over a regular second trust deed note are mainly felt by the seller. However, the buyer, seller and lender benefit since the buyer does not become personally obligated for the wrapped loan and the assumption process is avoided by all involved, including the lender.

For the benefit of the seller, the AITD note:

- **allows a greater yield** than could ordinarily be negotiated on a regular second trust deed note, a financial advantage due to the AITD note's *overriding interest rate* feature;

- **reduces the risk of loss** due to a default on the underlying loan since the seller remains primarily responsible for payments on the underlying loan;

- **defers profit tax liability** for a greater percentage of the transaction's profit taxes since an AITD note increases the percentage of profit allocated to the principal in the carryback;

- **supports the price** sought by the seller by providing financing; and

- **provides for a trustee's foreclosure** on the buyer's default, unlike other wraparound security devices, such as land sales contracts and purchase/lease-option agreements which require a judicial foreclosure (unless they contain a power- of-sale provision).

As a benefit to the buyer, the AITD note provides more simplicity and flexibility than conventional or government insured loans, since:

- the interest rate and payment schedules are **fully negotiable** and not tied to secondary money market standards;
- the carryback seller is less concerned with **creditworthiness** and income ratios than standardized institutional lenders due to the seller's knowledge of the property and a more personal relationship with the buyer (borrower);
- the buyer makes payments on only one debt, the AITD note; and
- no third-party lender fees are required, such as points, garbage fees, private mortgage insurance (PMI), assumption fees or a separate (and expensive for value received) lender's American Land Title Association (ALTA) title insurance policy.

AITD concepts

An all-inclusive trust deed (AITD) is always a **junior trust deed**, usually a second, subordinate to a pre-existing, underlying first trust deed lien. Legally, the AITD has the same function as a regular trust deed. An AITD is physically a regular trust deed form, with the addition of an AITD addendum covering the disclosures and accounting for the financial aspects of the all-inclusive wraparound device.

Land sales contracts and lease-option sales are also all-inclusive security devices and they exhibit the same wraparound debtor/creditor features as an AITD. In all three — AITD, land sales contract and lease-option sale — the seller has sold the property and remains responsible for payments on the underlying loan while receiving installments from the buyer. Income and property tax results for each device are treated the same by all government agencies.

AITD terms

The terms negotiated for payment of the sales price when the seller carries back an all-inclusive trust deed (AITD) note include five variables:

- the down payment;
- the amount of the AITD note;
- the interest rate;
- the periodic (monthly) payments; and
- the due date.

Down payment

The down payment in an all-inclusive trust deed (AITD) carryback note transaction is handled no differently than on any other method of carryback or conventional financing, such as a regular first or second

trust deed, land sales contract or lease-option sale financing. The amount of the down payment is fully negotiable between a buyer and seller, and can range from zero to the seller's entire equity in the property.

The prudent carryback seller will require a down payment of no less than 10% to 20% of the sales price depending on whether the property is sold as a buyer-occupied single family residence (SFR) or income producing property. The smaller the down payment, the greater the risk of loss for the seller should the buyer default and the property be repossessed and resold. The risk of loss created by a low down payment is covered financially by:

- an increase in the price or interest rate, or both;
- guarantee by a person other than a signer of the note;
- cross collateralization by a lien on additional property; or
- the bifurcation of the carryback debt into separate secured and unsecured debts.

Amount of the note

The distinguishing characteristic of the all- inclusive trust deed (AITD) note is its *face amount*. The **face amount** of the AITD note includes the unpaid balance on any underlying encumbrances which remain the responsibility of the seller to pay, **plus** the seller's equity remaining unpaid after a down payment. Viewed another way, the AITD note is the entire balance of the sales price remaining after the down payment. [See Form 421 in Chapter 34]

At first glance, the total dollar amount of the debts secured by the underlying trust deed and the all-inclusive carryback trust deed appear to over-encumber the property.

However, the amount of the AITD note **wraps around** and is **inclusive** of the underlying loan balance. Thus, the separate trust deed balances cannot be added together to determine the total dollar amount of encumbrances on the property. The amount of the AITD note is most frequently the total amount owed on **all** encumbrances.

For example, property encumbered by a $60,000 first trust deed is sold for $100,000 with a $30,000 down payment. An AITD note is carried back for $70,000, the amount remaining unpaid on the purchase price. The buyer does not assume or otherwise agree to pay the first trust deed. Collectively, the amounts secured by the two trust deeds total $130,000, yet the amount required to clear title of both trust deeds is controlled by provisions in the AITD addendum and is only $70,000, the amount of the AITD note.

Conversely, a **regular** trust deed note carried back as a second for the balance of the seller's equity (after the down payment) would have in this case been for $10,000, with the buyer assuming the $60,000 first trust deed, for an aggregate debt of $70,000.

The minimum dollar amount the seller can carry back on an AITD is the total amount of the underlying loans for which the seller remains responsible. The AITD note must be mathematically structured so that it has a remaining **principal balance** at all times equal to or greater than the remaining balance on the wrapped loans.

However, an AITD need not include all pre-existing trust deeds or other loans recorded against the property sold. The AITD may be a third trust deed which wraps only the second and not the first, or vice versa.

For example, the buyer takes over payments on the existing first trust deed loan which is not included in the AITD amount, with the seller remaining responsible for the second lien (which may be a tax, a judgment lien, or a loan with an interest rate unacceptable to the buyer).

When only one of two existing loans is wrapped, the dollar amount of the AITD note is for the remaining balance of the purchase price after deducting both the down payment and the balance remaining on the one loan taken over by the buyer.

The interest in alternatives

Use of an all-inclusive note and trust deed (AITD) by a seller can make attractive financing for buyers during periods of high interest rates by offering a **below-market rate**, whether or not the underlying note rate is below market.

For the seller, the interest rate on the AITD note will preferably, but will not always, equal or exceed the rate on the underlying note.

In this respect, the AITD rate is said to *override* the rate on the underlying trust deed note. The override is the difference between the interest rate on the underlying trust deed note and the higher rate negotiated for the AITD note.

For example, an AITD note with a 8% rate which wraps a first trust deed note at 5% gives the seller a 3% interest **override** on the underlying loan balance.

The override is the financial advantage available to the carryback seller when using an AITD, as it can greatly increase the yield on his equity in the AITD note. [See Chapter 21]

If the interest rate on the underlying loan **exceeds** the interest rate on the AITD, the seller's equity in the AITD is said to *burn-off* bit by bit, shrinking daily as interest accrues in dissimilar amounts on each trust deed note.

This principal burn-off reduces the seller's equity in the AITD. More importantly, the AITD note balance will reduce faster than the balance on the underlying loan, converting cash received as principal payments on the AITD into interest paid on the wrapped loan. As a result, a due date on the AITD must be set for payoff before the balance on the AITD note sinks below the balance on the wrapped loan, called a *crossover*.

Wrapping a variable rate loan

The seller wrapping a variable/adjustable rate mortgage (ARM) with an all-inclusive note and trust deed (AITD) should conform the interest rate provisions in the AITD note to the rate adjustment provisions in the underlying ARM. The same index, adjustment periods, floor and ceiling rates, and payment schedules should be included in the AITD note, making the AITD an ARM.

For example, an owner decides to sell real estate encumbered by an ARM. The ARM has a note rate periodically reset in accordance with the 11th District cost-of-funds index plus a margin rate of 2.5%. By using the same index and a **margin equal or greater** than on the underlying loan, the seller will receive sufficient interest to service the first trust deed without reducing the seller's return on the all-inclusive ARM, resulting in no **principal burn off**.

When the seller uses the same index on the AITD note as the index used on the underlying loan, but negotiates a greater margin, the seller receives additional **overriding interest** on the portion of the AITD note representing the balance on the underlying loan.

A carryback seller should not use a different index on the all-inclusive ARM than the index used on the underlying loan. If a different index is used, the index for the carryback could fall while the index on the underlying loan rises, leaving the seller to pay the difference.

Also, a seller can wrap a fixed-rate loan by carrying back an all-inclusive ARM. The adjustable rate provision included in the AITD note would set the life-of-loan *floor rate* at no less than the fixed rate on the underlying loan. Thus, the seller prevents the interest rate on the all-inclusive ARM from falling below the rate on the underlying fixed-rate loan. [See Chapter 11]

Payments and contract collection

In a typical all-inclusive note and trust deed (AITD) transaction, the buyer makes installment payments on the AITD note directly to a seller. The seller then makes the scheduled payments owed to the underlying senior lender. The seller retains the difference as his net cash flow on the AITD note.

The seller can enter into *contract collection* account with a servicing agent to receive payments and make disbursements to the underlying lender. Under contract collection, a bank, thrift, escrow or broker will collect and disburse the monthly payments called for in the AITD note. [See **first tuesday** Form 237]

Contract collection is convenient. However, if the seller and the buyer **mutually agree** that the seller will place the AITD note on contract collection, the agreement will severely reduce the deferral of profit tax on the installment sale. The collection agent is deemed to be the agent of the buyer when agreed to by the buyer and the seller. When payments are made by the buyer's agent, the responsibility for payments on the underlying loan is attributed to the buyer.

Due to the shift in responsibility created by a mutually agreed to contract collection account, the seller has **debt relief**, increasing the profit-to-equity ratio on the installment sale and increasing the percentage of down payment and principal payments reported annually as profit. [**Goodman** v. **Commissioner of Internal Revenue** (1980) 74 TC 684]

The buyer's monthly payments on the AITD note may be in any amount. However, prudence suggests the payments will be no less than the amount the seller must pay on the underlying note, even if good reason exists for a lesser payment.

Also, the flexibility available with the AITD note allows for payment schedules to be negotiated which are attractive to buyers.

For example, young buyers, whose rising incomes will allow them to make larger payments in the future, might be able to purchase the seller's property if a *graduated payment program* allows them to initially afford payments to buy the property.

Graduated monthly payments allow buyers to make monthly payments which start out low, but gradually increase from year to year. For instance, a buyer who cannot currently afford what should be a monthly AITD payment of $2,000 could offer to pay $1,400 monthly for the first year. With the agreement of the buyer and seller, the monthly payments could be increased $200 annually, until the full $2,000 amount needed to amortize the AITD is reached.

However, the low monthly payments may be insufficient to cover the accrual of a fixed rate of interest on the AITD note. A provision can be included in the note calling for any accrued and unpaid interest to be added to the principal, called *compounding*.

Thus, until the buyer's monthly payments increase enough to cover the accruing interest, the principal amount of the note will increase, an accounting situation called *negative amortization*.

Rather than adding interest to the principal, a provision for an additional installment could be negotiated and added into the note calling for an additional payment on a future date of all accrued interest which remains unpaid. For an alternative to **negative amortization** under the fixed rate, a *graduated rate* of interest could be charged which is consistent with the graduated payment schedule.

Another tax consideration for carryback sellers is the use of a *prepayment penalty* provision to induce the buyer to pay no more than the amount of the scheduled monthly payments for an agreed-to period of years. Any early payoff of additional principal during the enforcement period will include a prepayment penalty. Prepayment penalties are limited on one-to-four unit residential properties. [See Chapter 13]

A prepayment penalty should be a sufficient amount to provide funds for the seller (on other than one-to-four units) to cover the tax liability incurred on the premature termination of the installment sale due to an early payoff. [See Chapter 13]

Payoff amounts vary

Two types of all-inclusive trust deeds (AITDs) exist, including:

- an *equity payoff* AITD [See Form 442 in Chapter 34]; and
- a *full payoff* AITD. [See Form 443 in Chapter 34]

With an **equity payoff** AITD, reconveyance occurs when a seller's equity in the AITD — the principal amount of the AITD note remaining after deducting the underlying loan balance — is fully paid. [See Form 442 in Chapter 34]

Once the seller receives the payoff for the equity amount in his AITD and reconveys, the buyer becomes primarily responsible for installment payments on the underlying trust deed note. The underlying trust deed is not paid off and remains of record, the buyer having originally taken title subject to the loan.

Full payoff AITDs require payment of the entire balance on the AITD note — which includes amounts owed on the underlying loan — before reconveyance can occur. Thus, both the AITD and the underlying trust deed are fully satisfied and reconveyed on payoff of the AITD. The full payoff AITD is less financially flexible for the buyer when arranging for a payoff. [See Form 443 in Chapter 34]

Taxwise, the full payoff AITD is preferable for the seller. The full payoff AITD note, without a contract collection provision, provides for no debt relief at any time. The buyer can never take over the responsibility for the underlying loan, even on final payoff and reconveyance of the AITD. Thus, the full payoff AITD allows the seller to use the installment sales method of income tax reporting without the issue of debt relief ever arising. [See Chapter 32]

The due date for an AITD note can be set at any length of time, ranging from the first of the next calendar year to 15 years or more. However, the due date of the AITD note should fall on or before any due date on the underlying loan or a crossover in principle balances.

For example, if an underlying loan, perhaps a second, is due in three years and the AITD in five, the seller will be required to pay off the underlying lender before he is due to be paid off on the AITD.

In this scenario, the seller could pass the payoff burden to the buyer by including a special additional installment on the AITD note. The payment would be sufficient in time and amount to meet the final/balloon payment on the underlying loan. The alternative is to set the due date on the AITD to no later than the date of the final/balloon payment on the underlying loan.

Also, an amortization schedule which reduces the AITD note balance to an amount equal to the wrapped loan requires a due date on or before the date by which both notes will have the same remaining principal balance, before the crossover. Thus, the seller avoids liability for a reduction in the AITD note below the amount of the wrapped loan.

Pass-through clause protection

An all-inclusive trust deed (AITD) also contains *pass-through provisions* to cover charges demanded by the underlying lender. [See Forms 442 §5 and 443 §6 in Chapter 34]

For instance, the buyer may wish to refinance and pay off the AITD note and the underlying loan before they come due. With a **pass- through provision** in the AITD addendum, the buyer will fund any prepayment penalty the underlying lender is entitled to for early payoff, not the carryback seller, even though the seller is primarily responsible for paying principal and interest on the underlying debt.

Also, if the underlying lender demands payment of any late charges, future advances or the entire loan balance brought about by the buyer's use of his ownership, the payment of the demands is passed through to the buyer.

Due-on interference hazards

A lender holding a trust deed which contains a due-on clause can call the loan balance due on the transfer of almost any interest in the property. The due-on clause is called an *alienation clause* since it is triggered by transfers, and the call that results in the note being fully due and payable is referred to as an *acceleration* of the note balance. [See Chapter 17]

The **due-on clause** in an all-inclusive trust deed (AITD) is triggered by:

- any conveyance of ownership, including land sales contracts;
- origination (except home equity loans) or foreclosure of junior trust deeds on the property; or
- the creation of a lease for more than three years, or any lease with an option to buy. [12 Code of Federal Regulations §591.2(b); see Chapter 21]

The carryback AITD transaction involves both a sale (the grant deed) and a further encumbrance (the trust deed).

Thus, an AITD transaction triggers the due-on clause in any underlying trust deed which allows the lender holding that due-on trust deed to:

- call or recast the loan, unless they have given written consent to the sale; or

- fail to timely act on the right to call the loan after notice of the transaction, called a *waiver by consent*.

When current market interest rates are high and the AITD is most beneficial to both the buyer and seller, the senior trust deed lender is likely to call the underlying loan due on sale. Alternatively, the lender might demand the loan be recast at current market rates (including modified payments to retain the same amortization period and fees for doing so), or the lender may do nothing at all.

Consider an AITD buyer who takes title to the property **subject to** the underlying loan — the buyer **does not assume** the seller's obligation to pay the loan at the time of the sale. No lender consent to the carryback sale is sought or obtained by the seller.

Under the terms of the AITD, the seller agrees to hold the buyer harmless from all obligations which exist on the underlying loan. [See Form 442 §1 and Form 443 §1 in Chapter 34]

Thus, the buyer is **held harmless** (by the seller) against any activities of the underlying lender, unless:

- the **buyer interferes** by triggering the due-on clause through further encumbrance, long-term lease, resale, waste, etc; or

- a **pass-through provision** in the AITD shifts the due-on-sale burden to the buyer, as it does to late charges, prepayment penalties or future advances.

Payments made as payments received

A seller's primary duty is to make all the payments due on the underlying loan, as long as the all-inclusive trust deed (AITD) remains of record and the buyer is not in default.

If a buyer fails to make payments on the AITD note, the seller is under no legal obligation to forward his own funds to the underlying lender, or to protect the property from a foreclosure under the first trust deed.

Even without the obligation to keep the first trust deed current, the AITD seller may feel compelled by the buyer's default to advance funds to keep the underlying trust deed current. If he does not, he risks allowing his AITD to be wiped out by the underlying lender's foreclosure.

If the underlying lender calls the loan based on the AITD transaction, the seller may be forced to use his own funds or borrow against other assets (or collateralize the AITD) to pay off the lender. Thus, the AITD seller must have an agreement with the buyer to cooperate with the seller should the first trust deed be called due and it becomes necessary for the buyer to sign documents to refinance the real estate to fund the payoff.

If possible, prior arrangements should be made with senior lenders to prevent due-on enforcement during the term of the AITD, called a *reverse assumption*. [See Chapter 18]

AITD documentation

The all-inclusive trust deed (AITD) transaction should be documented:

- between a buyer and seller in a purchase agreement, escrow instructions, grant deed, trust deed and note;

- between a seller and lender in a written due-on waiver and any modification of the underlying note agreed-to with the lender for consent; and

- through escrow, by the buyer depositing the downpayment funds and the all-inclusive note and trust deed, and the seller depositing his grant deed.

Agents must make full disclosure to the buyer and the seller about the terms of the carryback and the underlying financing. Disclosure is accomplished in part by use of the AITD addendum. Further, a carryback financing disclosure form with statutorily mandated content is to be used on carryback sales of one-to-four unit residential property and, as good practice, on the carryback sale of all other types of property. [See Chapter 29]

Buyer NODq protection

A buyer and the buyer's agent must be sure the terms of the all-inclusive note and trust deed (AITD) are consistent with the underlying senior note and trust deed it wraps.

To assure consistency, escrow should be instructed to order a *beneficiary statement* from the existing trust deed lender. A lender's **beneficiary statement** confirms the terms of the underlying encumbrance are as represented by the seller. The statement enables the buyer to confirm the consistency of the terms in the underlying loan and the AITD. [See Form 429 in Chapter 18]

The buyer should also consider having the seller agree to **record and serve** the underlying lender with a *Request for Notice of Default* and *Notice of Delinquency* (NODq) on the underlying trust deeds. [See Form 412 in Chapter 48; see Chapter 4]

The request for an NODq assures the buyer he will promptly learn of any failure by the carryback seller to make payments to senior lienholders. [Calif. Civil Code §§2924b, 2924e]

Editor's note — A carryback seller who fails to pass AITD payments on to the wrapped lender exposes himself to criminal sanctions.

The PIQWOP risks in a blanket encumbrance

Finally, a buyer or his agent should check the preliminary title report to find out if the underlying trust deed is a **blanket encumbrance** which also affects property other than the property in question.

All-inclusive trust deeds (AITDs) are sometimes used by undercapitalized developers and land sales promoters. With the AITD, they can finance the sale of real estate lots which have been cut out of a larger parcel when the larger parcel is encumbered by a blanket trust deed which may lack a partial release clause.

For their purpose, these developers and promoters use an AITD which only discloses that "underlying loans may or may not exist."

Typically, in these cases of blanket encumbrances, no disclosure is made of the amount or terms of the underlying loan, nor of the existence of the blanket trust deed on the *parcel in question with other parcels* (PIQWOP).

If the seller defaults on a blanket trust deed which lacks a partial release clause, the buyer of a parcel of real estate on an AITD would have to pay off or refinance the entire blanket trust deed to protect himself. Paying off or refinancing the entire blanket trust deed is an economically unlikely possibility when, as in most cases, the underlying loan balance exceeds the AITD balance (and the price paid for the individual lot). [**Drake** v. **Martin** (1994) 30 CA4th 984]

Chapter 33 The AITD's leveraged yield

This chapter evaluates the annual yield a seller receives on his equity in an all-inclusive note, and addresses due date aspects of a reverse all-inclusive trust deed.

The wraparound multiplier effect

Consider a property encumbered by an existing trust deed which secures a note with a balance of $600,000, payable monthly, including 7% interest, until fully amortized in 26 years.

The owner of the property would like to cash out his equity without reducing the sales price of the property to below $1,000,000.

However, an inflationary economy and an over-active real estate market have brought on a corrective credit crunch, making it difficult for buyers with modest down payments to obtain financing from conventional lenders.

Accordingly, the owner agrees to list the property on sales terms which include a 20% down payment and a carryback note for the **balance of the purchase price**, called an *all-inclusive note and trust deed* (AITD).

The AITD will "wrap" the existing **underlying loan** encumbering the seller's property. Specifically, the principal amount of the AITD note will include the amount of the $600,000 principal balance remaining on the underlying loan.

AITD equity

Consider an example where a seller carries back an all-inclusive trust deed (AITD) note for $800,000, bearing an 8% interest rate with monthly payments amortized over 30 years, all due in seven years. The **seller's equity** in the AITD note is the difference between the $800,000 AITD note and the $600,000 balance remaining on the first trust deed note — a $200,000 equity in the AITD at the time of closing.

The seller receives 8% interest on the entire amount of the $800,000 AITD note. In turn, the seller pays the underlying lender 7% interest on the $600,000 first trust deed loan.

The AITD interest override

At a time when interest rates for mortgages are higher than rates charged during the prior 18 to 24 months, when the seller recorded his loan, a carryback seller can offer a below market rate on an all-inclusive trust deed (AITD) note and actually yield a greater return on his equity in the AITD note than currently charged by private money lenders.

The spread between the interest rate on an underlying loan and the AITD note is called an *overriding* interest rate. The AITD has an interest rate override on the underlying loan (in our example 1%; 8% AITD minus 7% loan).

The spread in the **override** between the interest rates accrues to the benefit of the seller. The interest rate override raises the **effective yield** on the seller equity in the AITD above the AITD note rate, the result

of *leveraging* (ratio of the underlying loan balance to the AITD equity; three to one). However, this **leveraging** ability is hindered by the seller's need for the first trust deed lender's consent under any due-on clause in the wrapped trust deed.

For the carryback seller, the AITD with its interest override can be compared to a private lender borrowing money from a bank at one rate (the rate on the underlying trust deed loan) and lending the funds to buyers of real estate at a higher rate (the rate on the AITD), as most lenders do.

In our example, the seller receives annual interest on his AITD of $64,000 (8% of $800,000). In turn, he pays the underlying lender $42,000 in interest (7% of $600,000). Thus, the seller's net annual interest income equals $22,000 during the first 12 months.

The $22,000 net interest income is the seller's annual interest income earned on his $200,000 AITD equity, resulting in an 11% yield.

The AITD equity allows the seller to receive a greater return than the trust deed note rate, called the *effective rate of return* on the AITD note.

Editor's note — The equity leverage on the 1% override on the existing debt is 600,000:200,000, or 3:1. Hence, the 1% override becomes an additional 3% yield on the equity in the AITD — a yield added to the 8% AITD note rate on the $200,000 equity in the AITD. Thus, the effective rate of return on the $200,000 equity in the AITD note is 11% (3% plus 8%).

The effective rate of return

The **effective rate of return** on a seller's equity in an all-inclusive trust deed (AITD) note is calculated using the principal amount of the underlying trust deed note, the equity amount in the AITD note and the interest rate spread between these two notes.

The mathematical formula to use with a financial calculator is:

- enter the amount of the underlying loan balance;
- ÷ equity in the AITD note;
- x the interest rate spread between the underlying loan and the AITD note;
- + the interest rate on the AITD note;
- = the yield on equity in the AITD note.

Thus, the seller's yield on the AITD equity in our previous example is:

- $600,000 underlying loan balance;
- ÷ $200,000 AITD equity;
- x 1% interest override;
- + 8% AITD note rate;

- = 11% yield on AITD equity.

The $800,000 AITD note carried back at an interest rate of 8% gives the seller the same yield as though the buyer assumed the underlying loan and executed a seller carryback note for $200,000 at 11%.

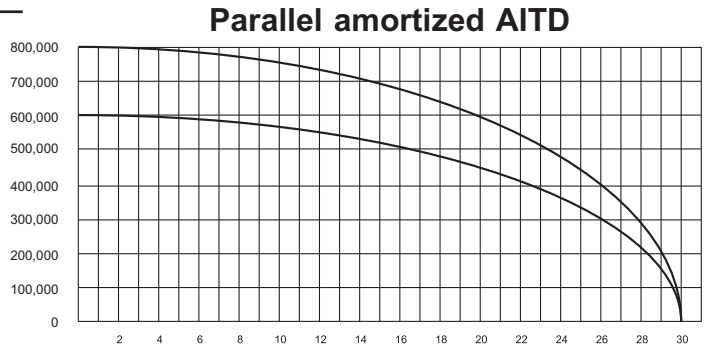
However, the AITD gives the seller a great psychological advantage over the typical buyer. With an AITD, the buyer can boast about the lucrative financing he negotiated with the seller.

The buyer has obtained maximum financing and pays 8% interest, with no points or garbage fees. Conversely, if the buyer executed a second trust deed note for $200,000 at 11% interest, he would have nothing to brag about, even though he would have taken over a first trust deed note at 7% and be paying the same overall amount of annual interest on the two encumbrances as he would have at the 8% rate on the AITD note.

Conflicting amortization periods

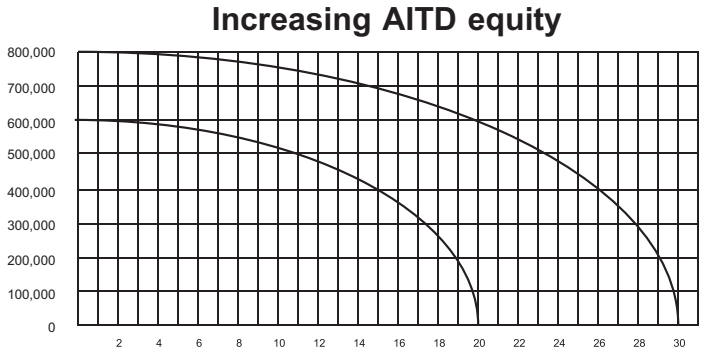
The yield calculation for the effective rate of return on an overriding all-inclusive trust deed (AITD) note sets the yield at the time of sale. However, the **effective interest yield** on the AITD note will vary following each payment throughout the life of the AITD.

Figure 1



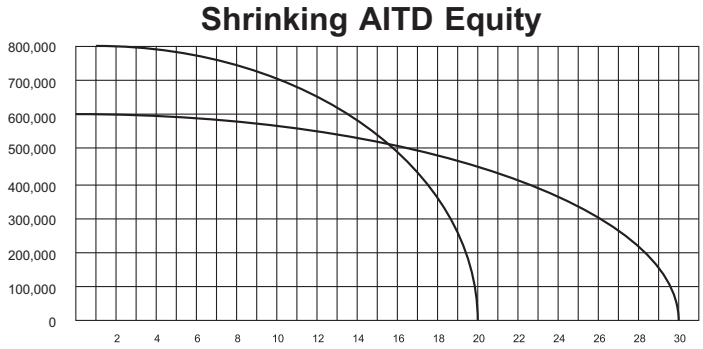
An $800,000 AITD and a $600,000 underlying loan are both amortized over 30 years. The result is an AITD equity which gradually increases as a percentage of the total AITD throughout the term of the AITD.

Figure 2



An $800,000 AITD amortized over 30 years wraps a $600,000 underlying loan amortized over 20 years. The result is AITD equity is increasing. The AITD equity increased from 25% of the AITD by year 18. Thus by year 20, the seller's AITD equity yield is 8%, a decrease from the original 11%.

Figure 3



An $800,000 AITD amortized over 20 years wraps a $600,000 underlying loan amortized over 30 years. Since the AITD equity is shrinking, the seller should demand a payoff of the AITD before year 12, since at this point the AITD and the underlying loan balance would cross over and the AITD would have a negative equity which must be avoided.

When the amortization periods for both the AITD note and the underlying loan are the same, the amount of equity in the AITD note decreases gradually until the principal on the AITD and the underlying note is fully paid.

With the amortization periods the same on both notes, the effective *rate of return* **decreases gradually** over the life of the AITD since the ratio of the AITD equity to the balance remaining on the underlying loan decreases. [See Figure 1]

More dramatically, when the underlying loan amortizes over a **shorter period** of time than the AITD note, the *equity* in the AITD note increases from month to month while its annual **rate of return decreases**. Earlier principal payoff on the underlying loan decreases the AITD leverage, causing the seller's equity in the remaining balance on the AITD note to increase and the effective rate of return to decrease until the underlying loan is fully paid. [See Figure 2]

Shrinking equity in the AITD

When the underlying loan is amortized over a longer period of time than the amortization period for the all-inclusive trust deed (AITD), the equity in the AITD decreases and the effective **rate of return increases**. The principal due on the AITD note is amortized (by payments) over a shorter period than the underlying loan.

Thus, the seller's equity in the AITD note decreases from month to month, until **no equity remains** in the AITD. Consequently, the increasing leverage causes the effective yield on the seller's equity in the AITD to increase from month to month, until there is a **cross-over** in the note balances. [See Figure 3]

Accordingly, the AITD note which produces a **shrinking AITD equity** must contain a **due date** by which it will be satisfied and reconveyed. The due date must be scheduled to occur before the date the AITD balance falls below the remaining balance on the underlying loan.

Further, the AITD must be satisfied and reconveyed prior to the cross-over of note balances. If not, the seller is **contractually liable** for the amount of the underlying loan which exceeds the balance of the AITD note when the AITD note is eventually satisfied. [See Figure 3]

Yield when wrapping two loans

Occasionally, a seller's property is encumbered by more than one loan. Two or more loans can be wrapped by an all-inclusive trust deed (AITD) and their principal balances included in the amount of the AITD note. Thus, a buyer only makes one payment each month, which is paid to the seller. In turn, the seller makes two payments, one on each of the wrapped loans.

The percentage yield on the AITD equity when wrapping two (or more) loans is calculated by dividing the dollar amount of the AITD equity into the seller's *net annual interest income*. The seller's **net annual interest income** is the total of the interest earned on the AITD minus all interest expenses incurred on the wrapped loans.

For example, a seller carries back an AITD which wraps two loans totaling $750,000, a first trust deed loan for $600,000 at 9% interest, and a second loan for $150,000 at 10 ½% interest.

The seller carries a $1,000,000 AITD at 12%.

The equity in the AITD note is $250,000 ($1,000,000 AITD minus the $750,000 due on the two wrapped loans).

The net interest income the seller receives is the difference between the $120,000 interest received on the AITD ($1,000,000 x 12%), and the $69,750 interest expense paid on the underlying first and second trust deed loans ($600,000 x 9% plus $150,000 x 10 ½%).

Thus, the seller's net annual interest income at the time of the AITD's creation is $5,025. The effective yield on the seller's equity in the AITD is calculated as the net interest income divided by the dollar amount of the equity in the AITD note.

Thus, the yield on the AITD note is:

$50,025 ÷ $250,000 = 20% effective yield.

The Reverse AITD

The interest rate on an all-inclusive trust deed (AITD) note usually is negotiated at a rate higher than the interest rate on the underlying loan, called an *override rate* or *spread*.

However, sellers occasionally have the incentive to carry back an AITD note with a lower interest rate than the rate on the underlying loan, called a *reverse rate of return* or *negative spread*.

To motivate buyers to pay the price sought by the seller for the property during a depressed seller's market, the seller can offer AITD financing at a **lower-than-market interest rate**.

For example, consider property offered for sale which is encumbered with an $800,000 loan bearing interest at the current market rate of 9%. The loan is payable monthly, amortized over the next 26 years.

To attract buyers to cash out his $200,000 equity in the property, the seller will carryback an $800,000 AITD note at an interest rate of 6%, a sort of **teaser rate** used to attract prospective buyers. The AITD rate, being lower than the rate on the underlying loan, called a *negative spread*, has the opposite mathematical effect from an overriding rate. Thus, the seller incurs monthly interest expense in excess of the interest income on the AITD note at the annual rate of 3%.

To accommodate the 3% negative spread, the price for the property is increased by approximately 15% above its current cash market value (five year x 3% reverse spread). The down payment will remain the same. The 15% increase in the purchase price will be reflected in the AITD amount and cover the 3% reverse interest rate charged by the seller until the AITD is due in five years. The AITD note will contain a five year due date so the seller will avoid incurring a *negative equity* in the AITD.

The price paid by a buyer is adjusted upward to offset the seller's *opportunity cost* of financing the sale by extending credit at a lower-than-market interest rate. Financially, what occurs is a one-time "buy down" of the interest rate for the five year life of the AITD note, paid for by the increased price.

Of course, the buyer will pay the exact same amount of dollars for financing and acquisition costs by the end of his first five years of ownership, including payoff amounts, as he would have paid had he assumed the underlying 9% loan and paid a price for the property of $1,000,000 with a $200,000 down payment.

At the end of five years, the final/balloon payment on the AITD will be the same amount as the balance remaining on the wrapped loan.

The entire AITD equity *burns off* gradually, decreasing to zero by the end of the five year period.

Since a default on the final/balloon payment due in five years is foreseeable, the AITD note with a negative interest rate spread must provide for a **default interest rate** of at least the rate on the underlying loan (9% in our example). [See Form 418-1 in Chapter 11]

Negative amortization

During periods of economic recession when new conventional financing is not available at interest rates which will support past property values and help finance the sale of real estate, a seller seeking to successfully encourage buyers to purchase his property must be willing to either accept a reduced purchase price or carry the financing at a lower-than-market interest rate.

Carryback financing facilitates a sale by supporting the seller's elevated price with a lower interest rate and an accommodating payment schedule which are readily acceptable by buyers.

To attract more creditworthy buyers, the seller can agree to a **graduated payment** schedule over a two or three year period to reduce the carrying costs of ownership and better qualify the property for acquisition by a buyer.

For example, a seller's monthly payment on his existing loan is $6,500. To reduce a perspective buyer's initial costs of ownership, the seller carries back an all-inclusive trust deed (AITD) note calling for the same ($6,500) monthly payment for the first year, sufficient in amount to cover the seller's payments due on the underlying loan.

The payments will rise on the AITD note each year until a payment schedule is reached which will amortize the balance over the desired number of years.

The seller does not need to periodically adjust the rate of interest on the AITD note. However, during the first year(s) of payments, he will be accepting a payment in an amount which will not cover the interest accruing each month, a situation called *negative amortization*.

Here, the accrued and unpaid monthly interest on the AITD note may be added by agreement to the note's principal balance each month. The unpaid interest will then earn interest as principal, called *compound interest*.

The graduated AITD

Instead of a fixed rate of interest coupled with a negative amortization, a seller might offer an all-inclusive trust deed (AITD) with an annually escalating rate of *interest and payment* schedule to attract buyers.

Being comparable to the 3-2-1 loan buy-down programs used by builders and other informed sellers, the terms of a graduated AITD note for the first three years reduces the present cash value of the AITD note by about 5% of its principal balance, a cost which is passed on to the buyer through a higher-than-market sales price.

Again, the seller carryback financing is facilitating the sale and supporting the price. Without carryback financing, either the value will drop or the property will not sell due to tight mortgage money conditions and uncertainty of buyers about the immediate future at the time of sale.

A seller can agree to a reduced interest rate on the AITD during the first few years after the sale. For example, the AITD interest could start at a low initial (teaser) rate and be adjusted upward periodically, annually or semiannually, by one-half or one percent until a fixed rate for the remainder of the AITD term is reached. Payments would start low and be adjusted upward to maintain the original amortization period, called a *graduated payment note*.

The **graduated AITD** allows property to be sold without the seller lowering the asking price. For example, a seller wants an interest rate of 9% on carryback AITD financing due in seven years.

For the seller to maintain his sales price and accommodate the buyer, he agrees to a 6% interest rate during the first year after the sale with monthly payments amortized over 30 years.

Further, on each anniversary of the AITD note, the interest rate is increased by 1% until the AITD interest rate is 9%. Thus, the interest rate on the AITD note is:

- 6% in the first year;
- 7% in the second year;
- 8% in the third year; and
- 9% fixed in the fourth year and for the remaining life of the AITD.

The amount of the AITD note payments graduate annually, reamortized over the remaining life of the AITD on each interest rate adjustment. Thus, negative amortization, with its build up of principal, is avoided by all.

Chapter 34 The all-inclusive note and trust deed rider

This chapter explains the preparation and relationship between the all-inclusive note and the two addenda which convert a trust deed to an all-inclusive trust deed (AITD).

Negotiating interest rates and payments

An all-inclusive trust deed (AITD) note, also called a *wraparound note* or *overriding note*, is evidence of an **installment debt** created to pay the balance due on the buyer's purchase price of real estate after a down payment. In turn, a seller retains responsibility for, and makes payments on, the existing trust deed note encumbering the property he sold.

The interest rate charged by the seller carrying back an AITD with a five-to ten-year due date is usually comparable to rates available on new first trust deed financing.

Conversely, the interest rate charged on carryback notes with due dates exceeding five to ten years usually exceeds market rates for new loans. However, rates charged by carryback sellers do vary greatly with the needs and expectations of the individuals in each transaction.

Also, sellers rarely seek points or origination fees as compensation for providing the buyer with AITD financing in addition to an interest rate override on the wrapped loan.

Waiver of due-on clause

The all-inclusive trust deed (AITD) carryback seller agreeing to wrap a first trust deed containing a due-on clause must, during negotiations, anticipate the lender's demand to recast its note by increasing the interest rate, payment amounts or due date.

Prior to closing the carryback sale, the seller may want the lender to waive the lender's right to call the loan on the sale and carryback of the AITD, called a *reverse assumption*.

In exchange for the seller agreeing to a modification of the note and the payment of a fee, the seller will obtain the lender's written waiver of the due-on clause. [See Form 410 in Chapter 28]

Thus, instead of the buyer assuming the first trust deed note, the carryback seller remains responsible for payment of the note.

Provisions of the all-inclusive promissory note

*Editor's note — **first tuesday** Form 421 is not created for use without major modification when wrapping a variable rate loan. [See Form 433 in Chapter 7; see Chapter 6]*

When the underlying loan is an adjustable rate mortgage (ARM), the seller must make sure the all-inclusive trust deed (AITD) is adjusted concurrent with adjustments in the underlying ARM to avoid a negative cash flow. Disclosures are required on ARM AITDs on one-to-four unit residential property sales.

The all-inclusive note is used with either the **equity payoff** or **full payoff** varieties of all-inclusive addenda to a regular trust deed.

Preparing the all-inclusive trust deed note

The following instructions are for the use and preparation of an all-inclusive trust deed (AITD) note, **first tuesday** Form 421. Form 421 consists of provisions from a regular interest-included installment note, modified by adding provisions (sections 3.1 and 3.2) to disclose that the amount of the all-inclusive note includes the balance remaining on one or more underlying loans, the payment of which the carryback seller remains responsible. [See Form 421 accompanying this chapter]

Each instruction corresponds to the provision in the form bearing the same number.

*Editor's note — **Check** and **enter** items throughout the agreement in each provision with boxes and blanks, unless the provision is not intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Document identification:

Enter the dollar amount of the all-inclusive note, the date the note is prepared and the name of the city where the note is prepared. This information is used when referring to this note and must conform with the dollar amount, date and location entered on the trust deed used to secure this note to real estate.

1. *Promise to pay*: **States** the payor's promise to pay the debt on the terms and provisions contained in the note.

    1.1 *Payee*: **Enter** the name of the person who is to receive the payments, typically the carryback seller, his assignee or a §1031 buyer's trustee. The all-inclusive trust deed identifies the payee as the *beneficiary*.

    1.2 *Place of payment*: **Enter** the city where payments are to be delivered to the payee.

    1.3 *Debt amount*: **Enter** the amount of the principal to be paid on the note.

Editor's note — The principal amount is the same as in the document identification section above, unless escrow is instructed to enter a different debt amount on closing due to adjustments in price or down payment.

    1.4 *Interest accrual date*: **Enter** the date interest begins to accrue, usually the date escrow closes.

Editor's note — The closing date of escrow is usually uncertain until it occurs. Thus, the space for commencement of accrual is left blank when the note is prepared. Escrow is instructed to enter the closing date when it is known.

    1.5 *Interest rate*: **Enter** the interest rate negotiated and agreed to in the purchase agreement.

*Editor's note — The all-inclusive note is not formulated for variable interest rates. Use **first tuesday** Form 433 and add all-inclusive provisions noted in instructions for its use.*

2. *Installment payments*: **Enter** the dollar amount to be paid as scheduled installments. If scheduled installments change during the life of the note, also **enter** an asterisk here and at section 5 and, following the asterisk at section 5, **enter** the dollar amount of each change and the date the change will begin.

    2.1 *Payment schedule*: **Enter** the day of the month each payment is due to be received by the holder of the note.

ALL-INCLUSIVE PROMISSORY NOTE
SECURED BY DEED OF TRUST

NOTE: RECOMMENDED FOR USE WITH **first tuesday** FORMS 442 AND 443.

$_____, dated _____, 20_____, at _____, California.

1. In installments as herein stated, for value received, I, jointly and severally, promise to pay to

1.1 _____, as the Payee, or order,

1.2 at _____,

1.3 the sum of _____ DOLLARS,

1.4 with interest from _____, 20_____, on unpaid principal

1.5 at the rate of _____% per annum.

2. Principal and interest payable in installments of _____ DOLLARS, or more,

2.1 on the _____ day of each _____ month,

2.2 beginning on the _____ day of _____, 20_____,

2.3 and continuing until _____, 20_____, when the principal is due and payable.

2.4 Principal and interest payable in lawful money of the United States.

2.5 Each payment shall be credited first on interest then due and the remainder on principal.

3. The principal amount of this Note includes:

3.1 The present unpaid balance of $_____, on a debt evidenced by a Note and secured by an existing Trust Deed held by _____, in the original amount of $_____, which debt remains the obligation of Payee.

3.2 The present unpaid balance of $_____, on a debt evidenced by a Note and secured by an existing Trust Deed held by _____, in the original amount of $_____, which debt remains the obligation of Payee.

4. On default in payment of any installment when due, the whole sum of principal and interest may be called immediately due at the option of the Note holder.

5. _____

_____

_____

_____

_____

_____

_____

_____

_____

6. In any action to enforce this Note, the prevailing party shall receive attorney fees.

7. This Note is secured by a DEED OF TRUST.

Payor's Name: _____	Payor's Name: _____
Signature: _____	Signature: _____
Payor's Name: _____	Payor's Name: _____
Signature: _____	Signature: _____

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Enter the frequency of payments by stating the number of months separating payments, e.g., "consecutive" when installments are due every month, "other" when bi-monthly, "third" when payable quarterly, "sixth" when payable semi-annually and "twelfth" when payable annually.

Editor's note — A payment is delinquent after the due date, unless a grace period, by statute or by agreement, extends the date on which payments may be delivered to the holder before becoming delinquent.

2.2 *First payment date*: **Enter** the due date (day and month) for the first payment, typically agreed to as 30 days after the commencement of interest, or the first day of the month first following 30 days after the close of escrow in which case escrow credits the seller with interest which will accrue through the end of the month of closing.

2.3 *Date of final installment*: **Enter** the words "until paid" if the carryback is to be fully amortized by constant monthly payments, or the date when any remaining balance is due. If the due date is on an anniversary of the close of escrow, such as five years after close of escrow, **instruct** escrow to enter this date on closing.

2.4 *Form of payment*: **States** the installment payments and final/balloon payment are to be paid in United States dollars.

2.5 *Interest accrual*: **States** the installment payments are to be credited first toward interest accrued and then to principal.

3. *All-inclusive provisions*: **Provides** that the dollar amount of the existing debt encumbering the property is included in the amount of principal of the all-inclusive note.

3.1 *First underlying encumbrance*: **Enter** the dollar amount of the principal balance remaining on the first trust deed as of the close of escrow, **enter** the name of the current lender (beneficiary), and **enter** the original dollar amount of the first trust deed. A beneficiary statement should be ordered to disclose this information.

3.2 *Second underlying encumbrance*: **Enter** the dollar amount of the principal balance remaining on the second trust deed as of the close of escrow, **enter** the name of the current lender, and **enter** the original dollar amount of the second trust deed note. A beneficiary statement is the primary source for disclosure of this information.

4. *Default provision*: **Provides** for the note holder to declare the entire amount of the note due and immediately payable on failure of the payee to timely pay an installment. However, a properly executed call is unenforceable until the reinstatement period during a foreclosure has expired, except in the case of an incurable breach under trust deed provisions for alienation and waste.

5. *Special provisions*: **Enter** any special provisions to be included in the note, such as a late charge or balloon payment notice.

6. *Attorney fees*: **Provides** for the prevailing party in any litigation on the note to recover his attorney fees incurred in the litigation.

7. *Identification of security*: **States** the note is secured by a trust deed. The link up with the property which is the security is made through the trust deed which references this note by amount, date prepared and city of preparation, naming the original payor and payee of this note as the trustor and beneficiary under the trust deed.

ALL-INCLUSIVE TRUST DEED ADDENDUM

Equity Payoff

NOTE: Recommended for use with **ft** Forms 421and 450.

DATE:_____, 20_____, at_____, California.

Items left blank or unchecked are not applicable.

FACTS:

This is an addendum to the trust deed dated_____, at _____, California, between _____, as the Trustor, and _____, as the Beneficiary.

AGREEMENT:

1. This trust deed is subordinate to the following notes and trust deeds referred to as Underlying Obligations:

1.1 A trust deed recorded on _____, as Instrument No. _____, in _____ County Records, California, executed by _____, as the Trustor, in which_____ is the Beneficiary, securing a note in the original amount of $_____ with an unpaid balance of $_____, payable in installments of $_____ monthly, including _____% interest, ☐ ARM, ☐ plus impounds.

1.2 A trust deed recorded on _____, as Instrument No. _____, in _____ County Records, California, executed by _____, as the Trustor, in which _____ is the Beneficiary, securing a note in the original amount of $_____ with an unpaid balance of $_____, payable in installments of $_____ monthly, including _____% interest, ☐ ARM, all due _____, 20_____.

1.3 Beneficiary to pay all installments and payments called for on the Underlying Obligations.

2. ☐ Check, if applicable:
Trustor to deposit with Beneficiary sufficient funds for the payment of taxes and fire insurance, specifically one-twelfth (1/12) of the annual requirements on each calendar month with installment payment. An advance deposit for such payment in the amount of $_____ from Trustor has been received by Beneficiary.

3. ☐ Check, if applicable: *[This provision may cause adverse income tax consequences for Beneficiary.]*
Beneficiary shall place the Note on contract collection with a bank, savings and loan, escrow or broker authorized to do so. Such collection shall disburse the monies received first toward the current installment on the Underlying Obligation, then to taxes and insurance if provided for herein, and any amount then remaining shall be disbursed to the holders of the Note.

4. If Beneficiary defaults in his performance under this trust deed, Trustor, provided that he is not then in default, shall have the right, at his option, to cure Beneficiary's default including the Underlying Obligations by either; (a) crediting any and all such payments against the principal and interest payments next becoming due under the Note, or (b) immediately recovering from Beneficiary the amount of such payments including interest thereon at the Note rate.

5. In the event of any monetary default by Trustor, Beneficiary's obligations shall be suspended until the default is cured. If Trustor is delinquent in any payments and Beneficiary consequently incurs penalties or expenses on the Underlying Obligations, the amount of such penalties and expenses shall be added to the Note and be payable by Trustor with the next payment.

6. Any additional principal paid on the Note shall, if Trustor so directs Beneficiary in writing, be paid by Beneficiary to the holders of the Underlying Obligations for credit to the unpaid principal thereof. If the prepayment entitles the holders to receive a prepayment penalty, this amount must then be paid by Trustor to Beneficiary for payment of the penalty. The prepayment penalty shall not reduce the unpaid balance of principal or interest under the Note.

7. In the event of foreclosure of this all-inclusive trust deed, Beneficiary will at the Trustee's sale bid an amount representing the amount then due on the obligations secured hereby less the total balance due on the Underlying Obligations, plus any advances or other disbursements which Beneficiary may be permitted to include.

8. When the Note becomes due and payable or Trustor requests a demand for payoff, the principal amount then unpaid shall be reduced by the then unpaid balance of the Underlying Obligations.

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Preparation of the all-inclusive trust deed addenda

The two variations of the all-inclusive trust deed (AITD), the **full payoff** and the **equity payoff**, are differentiated by the amount of the payoff demand the carryback seller can request for satisfaction of the all-inclusive note and reconveyance of the AITD. [See Forms 442 and 443 accompanying this chapter]

Each variety is documented by an addendum which is attached to a standard form trust deed, thus converting the trust deed into an AITD.

The two types of AITD addenda contain differing formulas for the amount of the payoff and foreclosure sale demands.

Other than their payoff formulas (sections 7 and 8), the two AITD addenda contain the same information and provisions.

The following instructions are for the use and preparation of AITD addenda to be attached to a regular trust deed. [See Form 450 in Chapter 14]

When attaching an AITD addendum to a trust deed, state on the face of the trust deed, "The attached AITD addendum is a part of this Deed of Trust."

Each instruction corresponds to the provision in the form bearing the same number.

*Editor's note — **Check** and **enter** items throughout the agreement in each provision with boxes and blanks, unless the provision is not intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Document identification:

Enter the date and name of the city where the all-inclusive trust deed (AITD) addendum is prepared. This date is used when referring to this document.

Facts: referenced trust deed:

Enter the same date and name of the city as entered on the trust deed to which this addendum is attached. The same date is also entered on the all-inclusive note.

Enter as the trustor the name of each individual or entity signing the trust deed, typically all persons signing the note, except co-signers.

Enter as the beneficiary the payee named in the note, be it the seller of the real estate, his assignee or the §1031 trustee.

1. *Existing financing*: **Provides** information identifying the existing encumbrances on the property, the principal amounts of which are included in the all-inclusive trust deed (AITD) note amount.

    1.1 *First trust deed*: **Enter** the date the underlying first trust deed was recorded, its instrument number and the county of record.

Enter the name of the borrower (trustor) and the lender (beneficiary) named in the underlying first trust deed.

ALL-INCLUSIVE TRUST DEED ADDENDUM

Full Payoff

NOTE: Recommended for use with **ft** Forms 421 and 450.

DATE:_____, 20_____, at_____, California.

Items left blank or unchecked are not applicable.

FACTS:

This is an addendum to the trust deed dated _____, 20_____, at _____, California, between _____, as the Trustor, and _____, as the Beneficiary.

AGREEMENT:

1. This trust deed is subordinate to the following notes and trust deeds referred to as Underlying Obligations:

1.1 A trust deed recorded on _____, as Instrument No. _____, in _____ County Records, California, executed by _____, as the Trustor, in which_____ is the Beneficiary, securing a note in the original amount of $_____ with an unpaid balance of $_____, payable in installments of $_____ monthly, including _____ % interest, ☐ ARM, ☐ plus impounds.

1.2 A trust deed recorded on _____, as Instrument No. _____, in _____ County Records, California, executed by _____, as the Trustor, in which _____ is the Beneficiary, securing a note in the original amount of $_____ with an unpaid balance of $_____, payable in installments of $_____ monthly, including _____% interest, ☐ ARM, all due _____, 20_____.

1.3 Beneficiary to pay all installments and payments called for on the Underlying Obligations.

2. ☐ Check, if applicable:
Trustor to deposit with Beneficiary sufficient funds for the payment of taxes and fire insurance, specifically one-twelfth (1/12) of the annual requirements on each calendar month with installment payment. An advance deposit for such payment in the amount of $_____ from Trustor has been received by Beneficiary.

3. ☐ Check, if applicable: *[This provision may cause adverse income tax consequences for Beneficiary.]*
Beneficiary shall place the Note on contract collection with a bank, savings and loan, escrow or broker authorized to do so. Such collection shall disburse the monies received first toward the current installment on the Underlying Obligations, then to taxes and insurance if provided for herein, and any amount then remaining shall be disbursed to the holders of the Note.

4. If Beneficiary defaults in his performance under this trust deed, Trustor, provided that he is not then in default, shall have the right, at his option, to cure Beneficiary's default including the Underlying Obligations by either; (a) crediting any and all such payments against the principal and interest payments next becoming due under the Note, or (b) immediately recovering from Beneficiary the amount of such payments including interest thereon at the Note rate.

5. In the event of any monetary default by Trustor, Beneficiary's obligations shall be suspended until the default is cured. If Trustor is delinquent in any payments and Beneficiary consequently incurs penalties or expenses on the Underlying Obligations, the amount of such penalties and expenses shall be added to the Note and be payable by Trustor with the next payment.

6. Any additional principal paid on the Note shall, if Trustor so directs Beneficiary in writing, be paid by Beneficiary to the holders of the Underlying Obligations for credit to the unpaid principal thereof. If the prepayment entitles the holders to receive a prepayment penalty, this amount must then be paid by Trustor to Beneficiary for payment of the penalty. The prepayment penalty shall not reduce the unpaid balance of principal or interest under the Note.

7. In the event of foreclosure of this all-inclusive trust deed, Beneficiary will at the Trustee's sale bid an amount representing the amount then due on the obligations secured hereby, plus any advances or other disbursements which Beneficiary may be permitted to include, on which bid Beneficiary to discharge and obtain reconveyance of the Underlying Obligations.

8. When the Note becomes due and payable or Trustor requests a demand for payoff, the principal amount of the payoff shall be the then unpaid principal and interest, and on receipt of payoff funds, Beneficiary to discharge and obtain reconveyance of the Underlying Obligations.

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Enter the original amount of the underlying first trust deed, the remaining principal balance, the dollar amount of the monthly payment, the interest rate and any due date.

Check the appropriate boxes to indicate a variable interest rate or impounds are provided for in the first trust deed note.

1.2 *Second trust deed*: **Enter** the date the underlying second trust deed was recorded, its instrument number and the county of record.

Enter the name of the borrower (trustor) and the lender (beneficiary) named in the underlying second trust deed.

Enter the original amount of the underlying second trust deed, the remaining principal balance, the dollar amount of the monthly payment, the interest rate and any due date.

Check the appropriate boxes to indicate a variable interest rate or impounds are provided for in the second trust deed note.

1.3 *Payment of wrapped loans*: **States** the seller, as the beneficiary of the trust deed, remains responsible for payment of the underlying wrapped loans referenced in sections 1.1 and 1.2, subject to the terms of the addendum.

2. *Impounds*: **Check** if monthly impounds will be paid to the seller by the buyer for property taxes and casualty insurance.

Editor's note — If a wrapped loan is impounded, then the AITD should also be impounded.

3. *Contract collection*: **Check** if the seller has agreed with the buyer to place the note on collection with a third party.

Editor's note — The seller should not agree to a contract collection provision if he intends to receive the full tax benefits of an installment sale. The collection agent under a mutual agreement with the buyer is deemed to be the agent of the buyer, thus relieving the seller of responsibility for payments on the underlying loan.

4. *Seller's default/buyer's remedies*: **States**, should the seller default on the underlying wrapped encumbrances, the buyer may cure the defaults and make payments directly on the delinquent underlying encumbrance. Payments advanced by the buyer either apply against the agreed-to AITD installments or, alternatively, are refunded by the seller on demand. One is an out-of-pocket setoff, the other is a refund.

5. *Buyer's default/seller's remedies*: **States**, should the buyer fail to make payments on the AITD note, the seller is no longer required to make payments on the underlying wrapped encumbrances unless the AITD is reinstated.

Editor's note — Any late charges or foreclosure costs incurred by the seller on the underlying wrapped encumbrances due to the buyer's default in AITD payments are "passed through" to the defaulting buyer as future advances due the seller if the AITD note does not itself contain a late charge provision.

6. *Prepayment penalty pass-through*: **States** a payoff of an underlying encumbrance caused by the buyer or made at the request of the buyer which incurs a prepayment penalty places responsibility for payment of the penalty on the buyer.

7. **Foreclosure bid, equity payoff AITD (Form 442): States** the seller's demand on foreclosure of the all-inclusive trust deed (AITD) will be the amount of his equity in the AITD. The AITD equity is the difference between the balance remaining on the all-inclusive note and the balance(s) remaining on the underlying encumbrance(s). The buyer at the foreclosure sale will take the trustee's deed subject to the underlying encumbrance(s).

8. **Foreclosure bid, full payoff AITD (Form 443): States**, on foreclosure under the AITD, the seller will demand and bid the entire balance of the all-inclusive note. Concurrent with the foreclosure sale, the seller will satisfy and obtain a reconveyance of the underlying encumbrance, unless the seller is the successful bidder and credits himself with the underlying loan amount he assumes.

9. **Payoff demand, equity payoff AITD (Form 442): States** the payoff demand for reconveyance of the all-inclusive trust deed (AITD) is the difference in the amounts remaining due on the all-inclusive note and the underlying wrapped encumbrances.

10. **Payoff demand, full payoff AITD (Form 443): States** the payoff demand for reconveyance of the all-inclusive trust deed (AITD) is the entire principal amount remaining on the all-inclusive note, plus accrued interest, advances and costs. On payoff, the AITD holder will satisfy and obtain reconveyance of the underlying encumbrances.

Chapter 35 Alternative security devices for sellers

This chapter comments on the use of alternative financing arrangements in lieu of a trust deed to mask a sale of real estate

Creative financing vs. creative chaos

The variables for repayment of any debt make up the "creative" aspect of financing, such as the amount of the debt, the interest rate, payment schedule and due date.

Two sets of forms are used in a sale of real estate to document the terms of any carryback financing which will be junior to any existing trust deed liens:

- a note and trust deed, to evidence and secure the balance of the seller's **equity remaining** to be paid after the down payment; or

- an all-inclusive note and trust deed (AITD), to evidence and secure the balance of the **price remaining** to be paid after the down payment.

All other forms used for documenting the terms of carryback financing offer not creative financing, but creative **chaos**, both legal and financial.

Seller financing consists solely of arranging the financing of real estate through the seller's extension of credit on the sales price — an installment sale. Arranging financing does not include the creation of **alternative documentation** to the note and trust deed, sometimes called *masked security devices*.

Creating new forms, by using forms which serve a different purpose than a trust deed (such as a lease-option) or using forms which have outlived their once useful purpose (such as the very obsolete land sales contract), is the primary cause of creative chaos and mistaken expectations.

Documents developed for otherwise legitimate business purposes are occasionally substituted for notes and trust deeds to set up a *smoke screen* in an attempt to avoid due-on enforcement, reassessment for property tax purposes, income tax reporting of profits and the buyer's right of reinstatement or redemption on a default. The purpose is to corrupt the system set up to track conveyancing and, too often, the intended result is actually attained without penalty.

Alternative documentation for a carryback sale includes such instruments as:

- land sales contracts, sometimes called *contracts for deed*;

- long-term escrows with interim occupancy;

- unexecuted or open-ended purchase agreements with interim occupancy, sometimes called *lease-purchase agreements*;

- lease-option sales contracts; and

- reverse trust deeds coupled with one of the above.

Masking the obvious sale

During periods of rising interest rates and decreasing sales, when the frequency of lender due-on enforcement also tends to rise, these alternative financing techniques share a common strategy of creating trappings that **mask the existence** of a sale in order to avoid due-on enforcement. In the masking process, reassessments for an increase in property taxes do not automatically occur.

However, trust deed lenders with due-on clauses are allowed to call or recast a loan on the transfer of any property interest, including a sale, a transfer of any possessory interest, a further encumbrance or a foreclosure of the property, whether recorded or not. [12 Code of Federal Regulations §591.2(b); see Chapter 18]

Notable exceptions for the marketplace allow leases of three years or less on any property (without a purchase option), and further encumbrance of owner-occupied, single family residences (SFRs) to escape due-on enforcement.

Since attempts to hide sales from the lender and county assessor usually involve the use of alternative security devices, inherent financial disadvantages exist from the outset of the transaction.

Additionally, by changing the intended use of legitimate documents, the legal rights of the parties to the transaction become different from the rights permitted by the use for which the document was originally drafted, called recharacterization.

With most alternative security arrangements, the new owner/buyer fails to become the owner of record and often fails to exercise the full benefits of ownership, such as interest/depreciation deductions, the right to further encumber the property, property tax exemptions, etc.

Hiding the purchase from the lender generally includes hiding it from everyone, including the Internal Revenue Service (IRS), Franchise Tax Board (FTB), assessors and creditors.

Other disadvantages exist for owner/buyers who use alternative carryback devices in lieu of a note and trust deed, such as the **lack of recording** the documents and the loss of the benefit extended to recorded documents, as well as the lack of title insurance.

If a carryback transaction is to go **unrecorded, unescrowed and uninsured**, at the very least the proper documents should be used — a grant deed, trust deed and note — to avoid compounding the failure to record and obtain a title insurance policy by using chaotic documentation.

Contract for deed: the land sales contract

The **land sales contract** was widely used from the late 1960s to the late 1970s as the preferred method for avoiding due-on enforcement by lenders.

The financing arrangement is deceptively simple. A buyer and seller enter into a contract for the sale of property. The buyer takes possession of the property and makes payments according to the terms of the contract. The transaction lacks a formal escrow, title insurance, the numerous disclosures of property conditions and statutorily mandated seller financing disclosures. [See Figure 1]

Title does not formally pass by grant deed until the buyer pays the seller in full.

Figure 1

FINANCIAL DISCLOSURE STATEMENT
For Entering Into a Land Sales Contract

NOTE: This disclosure statement is required to be acknowledged by both the Seller (Vendor) and the Buyer (Vendee) when the Seller extends credit by the Buyer executing a debt obligation to pay for part of the sales price of property containing four-or-less residential units on a Land Sales Contract. [Calif. Civil Code §2956]

This disclosure is to be prepared and presented to all parties by the Broker of the party who offers or counteroffers to buy, sell or exchange on a Lease-Option sales agreement.

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

1. FACTS:

This is an addendum to the following agreement:

☐ Offer for Land Sales Contract [See **ft** Form 167]

☐ Land Sales Contract [See **ft** Form 168]

1.1 dated _____, 20_____

1.2 entered into by _____, as the Vendor, and

1.3 _____, as the Vendee,

1.4 regarding property referred to as _____.

DISCLOSURES:

2. GENERAL INFORMATION CONCERNING TERMS OF PAYMENT:

2.1 The balance of the purchase price due Vendor is $_____, payable in constant monthly installments of $_____, to include _____% per annum interest, all due and payable with a final/balloon payment on _____, 20_____, in the approximate amount of $_____.

2.2 The Land Sales Contract provides for a final/balloon payment. Thus, the debt is not fully amortized. On the final/balloon payment date, the availability of refinancing, modification or extension of the final/balloon payment cannot be assured.

2.3 Vendor remains responsible to remit payments to Payees under senior encumbrances on receipt of installments paid by Vendee.

Notice: *The Vendor and Vendee may wish to use a collection agent for the purpose of accepting the Vendee's payments and disbursing payment to underlying lenders and the Land Sales Contract.*

2.4 This Land Sales Contract is subject to the following provision: "This Land Sales Contract is subject to section 2966 of the Civil Code, which provides that the holder of this instrument shall give written notice to the Vendee, or his successor in interest, of prescribed information at least 90 and not more than 150 days before any final/balloon payment is due." [See **ft** Form 419]

2.5 The Land Sales Contract wraps an existing trust deed, and any costs incurred by Vendor for prepayment penalties, late charges, due-on-sale or further encumbrance acceleration and future advances will be passed on to Vendee for payment. [See **ft** Form 168]

3. SPECIAL PROVISIONS AND DISCLOSURES:

3.1 ☐ Vendor will be designated as loss payee under Vendee's hazard and fire insurance, or
☐ Vendee will be designated as loss payee under Vendor's hazard and fire insurance.

3.2 Requests for Notice of Default and Notice of Delinquency under California Civil Code sections 2924b and 2924e ☐ will, or ☐ will not, be recorded for notice to Vendee on encumbrances senior to the Land Sales Contract. [See **ft** Form 167 §14]

3.3 The land sales contract transaction ☐ will, or ☐ will not, be escrowed for the delivery of the signed Land Sales Contract to Vendor and possession to Vendee.

3.4 The Land Sales Contract ☐ will, or ☐ will not, be recorded. The lack of a recording may impair Vendee's interest in the property if liens attach to Vendor's interest in the property.

3.5 Vendee's policy of title insurance ☐ will, or ☐ will not, be obtained from a title insurance company.

3.6 No tax reporting service will be obtained. If an impound rider is agreed to, Vendee will confirm the real estate taxes are paid by Vendor. If no impound rider is agreed to, Vendor will confirm the real estate taxes are paid by Vendee.

3.7 Vendee shall receive no proceeds or cash back on execution of the Land Sales Contract.

3.8 Vendor is aware his sole source of recovery on Vendee's default is limited to the credit bid or net proceeds

from Vendor's foreclosure under the Land Sales Contract. [Calif. Code of Civil Procedure §580b]

4. ENCUMBRANCES SENIOR TO THE LAND SALES CONTRACT:

4.1 The conditions of encumbrances with priority over the Land Sales Contract include:

	First Loan	Second Loan
Original balance:	$_____	$_____
Current balance:	$_____	$_____
Interest rate:	_____% ☐ ARM	_____% ☐ ARM
	Type _____	Type _____
Monthly payments:	$_____	$_____
Due date:	_____, 20____	_____, 20____
Balloon payment:	$_____	$_____
Current defaults:	$_____	$_____

4.2 If any of the senior encumbrances contain a due date for a final/balloon payment, it may be difficult or impossible to refinance, modify or extend the balloon payment in the mortgage marketplace.

5. VENDEE CREDIT INFORMATION:

5.1 ☐ Vendee to hand Vendor a completed credit application on acceptance [See **ft** Form 302]; and

5.2 Vendor may terminate this agreement within _____ days of Vendor's receipt of Vendee's credit application by delivering to Vendee or Vendee's Broker a written Notice of Cancellation based on disapproval of Vendee's credit. [**ft** Form 183]

6. BROKER DISCLOSURES:

6.1 Credit data is supplied by Vendee. Broker knows of no falsity or omission concerning Vendee's credit information.

6.2 This statement and its contents, being statutorily required disclosures, do not limit Broker's duties to disclose other facts material to Vendee or Vendor.

6.3 This statement is an addendum to the agreement referenced at §1 and creates no rights to rescind the Land Sales Contract.

6.4 This statement was prepared by _____

7. OTHER: _____

Buyer's Broker: _____	**Seller's Broker:** _____
By: _____	By: _____
I have received and read a copy of this statement.	**I have received and read a copy of this statement.**
Date: _____, 20_____	Date: _____, 20_____
Vendee: _____	Vendor: _____
Vendee: _____	Vendor: _____

One might argue the existing lender of record has no cause to call the loan since the record of ownership of the property does not officially change until the contract is fully performed. However, this argument fails since title is not in issue; ownership and its use is.

On entering into a land sales contract, an *equitable conversion* of ownership occurs since the seller from that moment forward is only entitled to receive money, not a return of the property except by foreclosure. Thus, the buyer becomes the *equitable owner* of the real estate with the **right of redemption** to pay all sums due the seller and get clear title. No right of reinstatement exists with a land sales contract. [**Tucker** v. **Lassen Savings and Loan Association** (1974) 12 C3d 629]

However, as straight forward as the land sales contract may sound, it has proven to be an extremely fragile economic and legal affair.

Although a land sales contract with a power-of-sale provision is accorded the same statutory treatment as a trust deed, courts give unequal treatment to the defaulting buyer under a land sales contract which is devoid of a power-of-sale provision. Most land sales contracts provide no such power of sale and must be **judicially foreclosed** on a default.

A defaulting buyer who has built up a substantial equity under a land sales contract has an unconditional right to complete the purchase by paying the entire remaining balance, a *redemption*. However, the buyer has no **right to reinstate** on a default, unless the contract includes terms for a reinstatement or a trustee's power-of-sale provision (which automatically permits the rights of reinstatement and redemption). [**Petersen** v. **Hartell** (1985) 40 C3d 102]

The trend is to regard the land sales contract without a power-of-sale provision as a mortgage. A mortgage bears no legal difference from a carryback trust deed, except for the lack of a power-of-sale provision and the owner's right to reinstate on a default, all of which accompanies the trustee's power-of-sale foreclosure process. [**Perry** v. **O'Donnell** (9th Cir. 1985) 759 F2d 702]

A basic land sales contract is an agreement to convey title to the buyer when the buyer **fully satisfies** the dollar amount remaining unpaid on the purchase price, sometimes called a *contract for deed*.

Also, to fit within the statutory definition of a land sales contract, the agreement to convey title must not call for the transfer of title until more than one year has passed after the buyer is given possession of the property. [Calif. Civil Code §2985]

The seller under the land sales contract, recharacterized as a *vendor*, retains legal title **as security** for the buyer's promised payment of the balance of the purchase price. The buyer, recharacterized as a *vendee*, receives possession of the property and automatically becomes the **equitable owner** of the property.

Although the unrecorded land sales contract is often used to mask a sale of real estate, the sale is actually completed when the land sales contract is signed by the parties and delivered to the seller in exchange for the transfer of possession of the property to the buyer. A small downpayment to the seller usually accompanies the transaction.

Conveyance of title to the buyer usually occurs years later when a formal sales escrow is opened to complete the seller's performance of the land sales contract, an event no different in legal and financial effect than the **reconveyance of a trust deed lien** from title on payment in full.

Figure 2

OFFER FOR LAND SALES CONTRACT

NOTE: To be used with Land Sales Contract Form 168 published by **first tuesday.**

DATE: _____, 20_____, at _____, California.
Items left blank or unchecked are not applicable.

FACTS:

1. Received from _____, as the Buyer(s),
1.1 the sum of $_____, evidenced by ☐ personal check, or ☐ _____, payable to _____, for deposit only on acceptance of this offer.
1.2 Deposit to be applied toward Buyer's obligations under this agreement to purchase property
1.3 situated in the City of _____, County of _____, California,
1.4 referred to as _____.
1.5 including personal property, ☐ see attached Personal Property Inventory. [See **ft** Form 256]

2. This agreement is comprised of this three-page form and _____ additional pages of addenda/attachments.

TERMS:

3. Buyer to purchase the property for the price of . . . . . $_____
3.1 The cash down payment on the price on entering into the Land Sales Contract. . . . . $_____
3.2 The balance of the purchase price is the sum of . . . . . $_____
a. bearing interest from the date of ☐ the Land Sales Contract, or ☐ _____, 20_____, on unpaid principal at the annual rate of _____%,
b. payable in installments of $_____, or more, on the _____ day of each consecutive month beginning on the _____ day of _____, 20_____, and continuing until _____, 20_____, when the principal is due and payable.

CONDITIONS:

4. This Offer shall be deemed revoked unless accepted in writing ☐ on presentation, or within _____ days after date, and acceptance is personally delivered to Offeror or Offeror's Broker within the period.
4.1 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

5. Buyer(s) and Seller(s) hereby approve the Land Sales Contract Form 168 published by **first tuesday** and agree to sign an original copy, held by Broker, within _____ days of receipt of the prepared Land Sales Contract. Broker will deliver the signed Land Sales Contract to Seller and keys/access codes to Buyer, along with possession, on _____, 20_____. [See **ft** Form 168]

6. Title is subject to current property taxes, covenants, conditions, restrictions, reservations and easements of record. Title is encumbered with the following debt obligations payable by Seller under the Land Sales Contract:
6.1 Trust deed note with an unpaid balance of $_____, principal and interest payments being $_____ monthly _____, including interest at _____%, ☐ adjustable, monthly impounds being an additional $_____. The note and trust deed contain provisions for ☐ due-on sale, ☐ prepayment penalty of _____.
6.2 Trust deed note with an unpaid balance of $_____, principal and interest payments being _____ monthly, including interest at _____%, due _____, 20_____.
6.3 Bond or assessment liens of record in the amount of $_____.

7. If an **Homeowners' Association** (HOA) is involved, ☐ Buyer has received and approves, or ☐ Buyer on acceptance to be handed copies of the HOA's Articles, Bylaws, CC&Rs, collection and lien enforcement policy, operating rules, operating budget, CPA's financial review, insurance policy summary and any age restriction statement.
7.1 Current monthly assessment is $_____. No association claims for defects or changes in regular or special assessments are pending or anticipated.
7.2 Seller is not in violation of CC&Rs, except _____.
7.3 Seller to pay association document and transfer fees.
7.4 Buyer to approve the HOA's statement of condition of assessments and confirm representations in subsection "a." above as a condition for closing escrow.
7.5 Within ten days of Buyer's post-acceptance receipt of the HOA's documents, Buyer may terminate the agreement based on a reasonable disapproval of the documents. [See **ft** Form 183]

8. Seller's Criminal Activity and Security Disclosure Statement [See **ft** Form 321]
8.1 ☐ is attached, or
8.2 ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may terminate this agreement based on a reasonable disapproval of the Criminal Activity and Security Disclosure Statement.

9. ☐ Buyer to hand Seller a completed credit application on acceptance. [See **ft** Form 302]
9.1 Within _____ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness. [See **ft** Form 183]

10. ☐ Parties to sign attached Land Sales Contract Financial Disclosure Statement. [See **ft** Form 309]

11. Seller to furnish prior to transfer of possession:
11.1 ☐ a structural pest control report and clearance.
11.2 ☐ a home inspection report prepared by an insured home inspector showing the land and improvements to be free of material defects.
11.3 ☐ a one-year home warranty policy:
Insurer _____
Coverage _____.
11.4 ☐ a certificate of occupancy, or other clearance or retrofitting, as required by local ordinance for the transfer of possession or title.

12. Seller's Natural Hazard Disclosure Statement [**ft** Form 314] ☐ is attached, or ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days of receipt, Buyer may terminate the agreement based on a reasonable disapproval of hazards disclosed by the statement and unknown to buyer prior to acceptance. [See **ft** Forms 182 and 183]

13. Seller's Condition of Property Disclosure — Transfer Disclosure Statement (TDS) [See **ft** Form 304]:
13.1 ☐ is attached; or
13.2 ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may deliver to Seller or Seller's Broker a written notice itemizing any material defects in the property disclosed by the statement and unknown to Buyer prior to acceptance [See **ft** Form 269]. Seller to repair, replace or correct noticed defects prior to closing.
13.3 On Seller's failure to repair, replace or correct noticed defects, Buyer may tender the purchase price reduced by the cost to repair, replace or correct the noticed defects, or close escrow and pursue available remedies. [See **ft** Form 183]

14. Buyer acknowledges receipt of a booklet and related Seller disclosures containing: ☐ *Environmental Hazards: A Guide for Homeowners, Buyers, Landlords and Tenants* (on all one-to-four units), ☐ *Protect Your Family from Lead in Your Home* (on all pre-1978, one-to-four units) [See **ft** Form 313], and ☐ *The Homeowner's Guide to* Earthquake Safety (on all pre-1960, one-to-four units). [See **ft** Form 315]

15. ☐ Seller to provide a Request for Notice of Default and Notice of Delinquency to underlying lenders. [See **ft** Form 412]

16. Fixtures and fittings attached to the property include but are not limited to: window shades, blinds, light fixtures, plumbing fixtures, curtain rods, wall-to-wall carpeting, draperies, hardware, TV antennas, air coolers and conditioners, trees, shrubs, mailboxes and other similar items.

17. This property is located in a(n): ☐ Industrial use area, ☐ Military ordnance area, ☐ Airport influence area, ☐ Rent Control Area, ☐ _____

18. Smoke detector(s) and water heater bracing exist in compliance with the law, and if not, Seller to install.

19. If this property or an adjoining property contains a solar collector authorized by the Solar Shade Control Act (California Public Resources Code §25980 et seq.) and notice of its existence has been sent or received by Seller, then on acceptance, Seller to hand Buyer copies of the notices sent or received by Seller or provided to Seller by prior Owners of the property for Buyer's review. Buyer may, within ten days after receipt, terminate this agreement based on a reasonable disapproval of the conditions disclosed by the solar shade control notices.

20. Both parties reserve their rights to assign and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow, on either party's written notice. [See **ft** Forms 172-2 or 173-2]

21. Should Buyer breach the agreement, Buyer's monetary liability to Seller is limited to $_____, or ☐ the deposit receipted in Section 1.

22. Notice: Pursuant to Section 290.46 of the Penal Code, information about specified registered sex offenders is made available to the public via an Internet Web site maintained by the Department of Justice at www.meganslaw.ca.gov. Depending on an offender's criminal history, this information will include either the address at which the offender resides or the community of residence and ZIP Code in which he or she resides.

23. Buyer to obtain hazard and personal liability insurance to cover Buyer's interest in the property.

24. Seller to pay a brokerage fee of $_____ on entering into the Land Sales Contract and $_____ on payoff of the balance due on the Land Sales Contract. Seller's Broker and Buyer's Broker, respectively, to share the brokerage fee _____:_____.

25. ☐ See attached Agency Law Disclosure. [See **ft** Form 305]

26. ☐ See attached Notice of Supplemental Property Tax Bill. [See **ft** Form 317]

27. _____

Buyer's/ Selling Broker: _____	Seller's/ Listing Broker: _____
Broker's DRE Identification #: _____	Broker's DRE Identification #: _____
Selling Agent: _____	Listing Agent: _____
Agent's DRE Identification #: _____	Agent's DRE Identification #: _____
Signature: _____	Signature: _____
Is the agent of: ☐ Buyer exclusively. ☐ Both Seller and Buyer.	Is the agent of: ☐ Seller exclusively. ☐ Both Seller and Buyer.
Address: _____	Address: _____
Phone: _____	Phone: _____
Fax: _____	Fax: _____
Email: _____	Email: _____
I agree to the terms stated above.	**I agree to the terms stated above.**
☐ See Signature Page Addendum. [**ft** Form 251]	☐ See Signature Page Addendum. [**ft** Form 251]
Date: _____, 20_____	Date: _____, 20_____
Buyer: _____	Seller: _____
Signature: _____	Signature: _____
Buyer: _____	Seller: _____
Signature: _____	Signature: _____

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The **conveyance escrow** is not a "sales escrow" at all. It is merely the means used to pay off and release the seller's security interest in the property under the land sales contract. The seller had retained title to the property not as owner, but as the holder of security for the remaining unpaid balance on the credit sale. But what escrow records and the assessor sees is a sale, not the mortgage-burning party it is.

The contentious contract

The buyer and seller should determine and analyze the risks and benefits accompanying their use of an unescrowed, unrecorded and uninsured **land sales contract** before they either:

- sign and deliver an offer to purchase on a land sales contract [See Figure 2]; or
- sign and deliver the land sales contract and transfer downpayment funds and possession. [See Figure 3]

Typically, when a land sales contract is used, the formal aspects of an escrowed sale of real estate are imprudently deferred until a "sales escrow" is opened to handle the buyer's payoff and the seller's transfer of record title to close out the land sales contract.

The later sales escrow, used to satisfy the land sales contract by final payoff, fails to reflect the fact that the actual sale occurred years earlier when the buyer and seller entered into the land sales contract.

The sales escrow, opened to close out the land sales contract transaction, is for the purpose of either:

- a full conveyance and refinancing of the property with a new lender who provides funding for the payoff of the debt owed to the seller on the land sales contract; or
- a seller "rollover" of the remaining contract debt into a note and trust deed, executed by the buyer and received by the seller on a transfer of the title to the buyer.

All costs of a conventional closing incurred in a formal sales escrow, also called *transactional costs*, are avoided at the time of entering into a land sales contract. A seller and a buyer choosing to use a land sales contract rarely if ever escrow the land sales contract transaction, obtain title insurance or local government occupancy or retrofit certificates.

The closing costs are actually deferred until a sales escrow is opened to complete performance of the land sales contract and convey title to the buyer.

Closing costs on a sale include escrow fees, recording costs, title insurance premiums, a beneficiary statement and assumption or loan fees. Reassessment, supplemental tax bills and income taxes are soon to follow these fees.

Often the payment of brokerage fees is in large part deferred as a fractional ownership in, or a lien on, the land sales contract until the seller is paid in full through the sales escrow.

Due-on-sale and reassessment

Consistent with their rationale for not recording a land sales contract, a buyer and seller do not request a **beneficiary statement** from the lender or a **waiver** of the lender's right to call or recast the loan on transfer of equitable ownership.

Thus, sellers and buyers often mistakenly believe an unrecorded sale of real estate (such as a sale on a land sales contract), which is not brought to the attention of the lender or the county assessor, does not trigger the *due-on clause* or *reassessment* as a sale and change of ownership.

On the contrary, entering into a land sales contract triggers both the **due-on clause** in an existing trust deed as a transfer of an interest and **reassessment** as a change of ownership, even if the land sales contract document is not recorded.

Whenever the holder of a trust deed containing a due-on clause discovers the secured property has been sold on a land sales contract, the lender can enforce the due-on clause. Likewise, the county assessor can retroactively reassess on their discovery of the sale.

Contract escrows for delayed recording

Escrow companies have contributed to the creative chaos scene in the form of the **contract escrow**.

The contract escrow actually involves two escrows.

On the close of the sales escrow, the cash down payment is disbursed to a seller. However, all documents normally recorded, such as a grant deed and a trust deed, are placed in a second "holding" escrow. Nothing is recorded, but the proper documentation has been completed.

The sale of property has been closed for purposes of reassessment, due-on-sale and income tax.

The second contract escrow holds the documents until a written request from the buyer or the seller is received by escrow instructing them to record the grant deed and trust deed.

Since both the seller and the buyer have an insurable interest in the property, two separate policies of **fire and hazard insurance** are frequently obtained — one for the seller and another for the buyer. Alternatively, an agreement is entered into by the buyer and seller giving the buyer an interest in the proceeds of the insurance policy.

The carryback note is often placed on contract collection with the same escrow company.

Unexecuted purchase agreements, extended escrows

Similar in approach to the land sales contract is the transfer of possession to the buyer under an **unexecuted purchase agreement**, as a sales escrow will not be closed for an extended period of time.

Here, a **marketing instrument** is used, such as a regular purchase agreement form. The purchase agreement is turned into a **security device** characteristic of a land sales contract or lease-option. The purchase agreement contains a provision for transfer of possession and buildup of equity by a credit to the purchase price for a portion of the buyer's payments to the seller, called a *lease-purchase sale*.

For example, a buyer and a seller sign a standard purchase agreement.

An escrow is opened. A grant deed, a carryback note, a trust deed, and the down payment are deposited into escrow within 30 to 60 days. However, the closing and disbursement of funds are delayed until after one to three years of timely performance by the buyer. During the extended escrow period, payments are

made to the seller which include credit of a portion of the payment toward the down payment (or price) called for in the purchase agreement. Often, the buyer's payments are sent to the same escrow company that received the down payment and documents.

Since the buyer wants to take possession of the property prior to the close of escrow, he enters into an interim occupancy (lease) agreement with the seller. Neither the lease nor the escrow will extend beyond three years, which would avoid triggering any due-on clauses.

Should the seller enter into a lease for more than three years or apply payments toward the purchase price, the transfer of possession will qualify as a sale, triggering reassessment, profit tax reporting, the lender's right to accelerate the loan, etc. [12 CFR §591.2(b)]

For the buyer to protect any increase in the property's value which occurs by the end of the occupancy period, the buyer must:

- timely close the long-term escrow;
- renew or extend the lease; or
- find a buyer who will purchase his position.

The lease-option sale

Buyers and sellers of real estate must understand that a sale structured as a **lease-option** is still a sale. The form used to structure the sale does not change a buyer's and seller's rights and obligations which are provided by mortgage and contract law.

Moreover, a seller seeking to disguise a sale as a lease-option transaction creates risks that are eliminated by more conventional wraparound formats, like the all-inclusive trust deed (AITD).

A sale documented as a lease and option to purchase typically lacks a **power-of-sale** provision which allows for a trustee's foreclosure — the seller's best remedy to recover the property (title and possession) should the buyer default. [See Figure 3]

The lease-option sale usually is not documented through an escrow, nor is there delivery of a grant deed or a note and trust deed. Instead, the buyer will lease the home with an option to purchase it at a **predetermined price**, not a price based on market value at the time of exercising the option.

The down payment, called *option money,* is applied toward the purchase price of the property, should the option be exercised. Similarly, a portion of the monthly payment, called *rent*, will apply as principal paid toward the price on exercise of the option prior to its expiration. Of course, the expiration of the option is the legal equivalent of a due date for payment of the balance of the purchase price. [See Figure 4]

However, when a tenant receives credit toward the purchase price on payment of his option money or rent, the lease-option is *recharacterized* as a land sales contract, mortgage or trust deed for all purposes. Also, a carryback sale structured as a lease-option will typically be devoid of a trust deed power- of-sale provision, prohibiting the seller from rapidly foreclosing by a trustee's sale and wiping out the equity the buyer has paid for and built up in the property.

Figure 3

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

LAND SALES CONTRACT

All-Inclusive with Power of Sale

Items left blank or unchecked are not applicable.

This Agreement, made this _____ day of _____, 20_____, between _____, as the Vendor, and _____, as the Vendee, whose address is _____, (Number and street) (City) (State) (Zip) regarding the real property in the City of _____, County of _____, California, referred to as

1. Subject to the following trust deeds and notes referred to as Underlying Obligations:

1.1 A trust deed recorded _____, as Instrument No. _____ in Official Records of _____ County, California, executed by _____, as Trustor, in which _____ is Beneficiary, securing a note in the original amount of $_____, with an unpaid balance of $_____ payable in installments of $_____ monthly including _____ % annual interest, ☐ ARM, ☐ plus payments for impounds _____.

1.2 A trust deed recorded _____, as Instrument No. _____ in Official Records of _____ County, California executed by _____, as Trustor, in which _____ is Beneficiary, securing a note in the original amount of $_____, with an unpaid balance of $_____ payable in installments of $_____ monthly including _____ % annual interest, ☐ ARM, all due _____.

1.3 ☐ See attached addendum for additional Underlying Obligations.

1.4 Vendor to remain responsible for and to pay all amounts called for in the Underlying Obligations.

PAGE ONE OF THREE — FORM 168

PAGE TWO OF THREE — FORM 168

2. Vendee hereby purchases the property for the price of . . . . . $_____

2.1 The cash down payment on the price on entering into this agreement is the amount of. . $_____

2.2 The balance of the purchase price is the unpaid sum of. . . . . $_____ bearing interest from date of ☐ agreement, or ☐ _____, on unpaid principal at the annual rate of _____ %, payable in installments of $_____, or more, on the _____ day of each consecutive month beginning on the _____ day of _____ and continuing until _____, 20_____, when the principal is due and payable.

3. Vendor retains legal title for the purpose of securing payment of:

a. The balance of the purchase price;

b. Any additional sums and interest hereafter loaned by Vendor to Vendee, or their assignee, evidenced by a promissory note or notes, referencing this agreement as security for payment;

c. The Vendor's charge for a statement regarding the secured obligations requested by or for Vendee; and

d. The performance of each provision contained in this agreement.

VENDEE AGREES:

4. Condition of Property — To keep the property in good condition and repair; not to remove or demolish any building; to complete and restore any building which may be constructed, damaged or destroyed; to comply with all laws affecting the property or requiring any alterations or improvements to be made; not to commit or permit waste; to cultivate, irrigate, fertilize, fumigate, prune and do all other acts which from the character or use of the property may be reasonably necessary.

5. Hazard Insurance — Vendee will continuously maintain hazard insurance against loss by fire, hazards included within the term "extended coverage," and any other hazards for which the Vendor requires insurance. The insurance shall be maintained in the amounts and for the periods the Vendor requires. The insurance carrier providing the insurance shall be chosen by Vendee, subject to Vendor's approval, which shall not be unreasonably withheld. All insurance policies shall be acceptable to Vendor, and contain loss payable clauses in form acceptable to Vendor. Vendor shall have the right to hold policies and renewals.

In the event of loss, Vendee shall promptly notify the insurance carrier and Vendor. Vendor may make proof of loss if not made promptly by Vendee. Vendor may place the proceeds in a non-interest bearing account to be used for the cost of reconstruction of the damaged improvements. If Vendee fails to reconstruct, Vendor may receive and apply the loan proceeds to the principal debt hereby secured, without a showing of impairment.

6. Indemnity — To appear in and defend any action or proceeding purporting to affect the security, or the rights and powers of Vendor; and to pay all costs and expenses.

7. Taxes and Senior Encumbrances — To pay all taxes and assessments affecting the property, including water stock assessments, at least 10 days before delinquency; all encumbrances, charges and liens, with interest, on the property when due, which are not the responsibility of the Vendor and are or appear to be senior to this agreement; and all expenses of this agreement.

8. Acts and Advances to Protect the Security — If Vendee fails to make any payment or to perform any act provided for in this agreement, then Vendor may, at the option of the Vendor and without notice, and without releasing Vendee from any obligation under this agreement:

a. Make or do the same to the extent necessary to protect the security, Vendor being authorized to enter upon the property to do so;

b. Appear in or commence any action or proceeding purporting to affect the security, or the rights or powers of Vendor;

c. Pay, purchase, contest or settle any encumbrance, charge or lien that appears to be senior to this agreement.

d. In exercising the power of this provision, Vendor may incur necessary expenses and reasonable attorney fees. Vendee to pay immediately all sums expended by Vendor provided for in this agreement, with interest from date of expenditure at the same rate as the principal debt hereby secured.

VENDOR AND VENDEE AGREE:

9. Assignment of Damages — Vendee assigns to Vendor any award of damages made in connection with:

a. Condemnation for use of or injury to the property by the public, or conveyance in lieu of condemnation; or

b. Injury to the property by any third party.

10. Waiver — By accepting payment of any sum due after its due date, Vendor does not waive Vendor's right to either require prompt payment when due of all other sums or to declare default for failure to pay. Vendor may waive a default of any provision of this agreement, by consent or acquiescence, without waiving any prior or subsequent default.

11. Conveyance of Title — Vendor to convey title free of creditor's liens, subject to existing CC&Rs, to Vendee upon Vendee's payment of all sums due to Vendor under this agreement.

11.1 On conveyance of title from Vendor to Vendee on full performance of this agreement by Vendee, the interest of Vendor and Vendee in the property will be insured by a title insurance policy issued by _____ Title Insurance Company, premium to be paid by ☐ Vendor, or ☐ Vendee.

11.2 On Vendee's deposit into escrow of all sums and instruments due to Vendor under this agreement and payment of all customary escrow costs and charges, Vendor to deposit into the escrow all instruments and instructions necessary to convey title and fully perform this agreement.

PAGE TWO OF THREE — FORM 168

PAGE THREE OF THREE — FORM 168

12. Due-on-sale — Should Vendee sell, transfer or convey any interest in the property, legal or equitable, either voluntarily or by operation of law, Vendor may, at Vendor's option, declare all sums secured by this agreement immediately due and payable.

13. Assignment of Rents — Vendee hereby assigns and transfers to Vendor all the rights, title and interest in rents generated by the property, including rents now due, past due or to become due under any use of the property, to be applied to the obligations secured by this agreement.

Prior to a default on the trust deed by Vendee, Vendee shall collect and retain the rents. On default by Vendee, and without the necessity of Vendor to make demand or take possession of the property in person, by agent or by court appointed receiver, Vendor shall immediately be entitled to possession of all unpaid rents.

14. Acceleration — If payment of any indebtedness or performance of this agreement is in default, then Vendor may at Vendor's option, without notice, declare all sums secured immediately due and payable by:

a. Commencing suit for their recovery by foreclosure of this lien; or

b. Delivering to Trustee a written notice declaring default with demand for sale; a written notice of default and election to sell to be recorded.

15. Power of Sale — On default under any obligation of this agreement and acceleration of all sums due, Vendor may elect to proceed with a power of sale by a trustee substituted under Civil Code §2934a, noticed and held in accordance with California Civil Code §2924 et seq.

15.1 The undersigned Vendee requests a copy of any Notice of Default and of any Notice of Sale hereunder be mailed to Vendee at the address herein set forth.

16. Prepayment Penalty — Any principal paid in addition to regular installments will, if so requested by Vendee, be paid by Vendor to holders of Underlying Obligations for a reduction in the principal. If the holders are entitled to a prepayment penalty, Vendee shall pay the amount to Vendor for payment of the penalty. The prepayment penalty will not reduce the unpaid balance of principal or accrued interest on the debt remaining on this agreement.

17. Cure of Default — If Vendor defaults in his performance on this agreement, including payment of the Underlying Obligations, Vendee may cure the default and credit the payments against the principal and interest due under this agreement, or recover from Vendor, on demand, the amount of the payments including interest thereon at the note rate.

18. Successors, Assigns and Pledgees — This agreement is for the benefit of, and binds all parties, their heirs, legatees, devisees, administrators, executors, successors and assigns. The term "Vendor" shall mean the holder and owner of the agreement, or, if the agreement has been pledged, the pledgee.

19. Vendee's Offset Statement — Within 10 days of Vendee's receipt of a written request by Vendor, Vendee shall execute a written estoppel affidavit identifying for the benefit of any assignee or successor in interest of the Vendor: the then owner of the secured property; the terms of the secured debt, including its remaining principal balance; any taxes or assessments due on the secured property; that the secured debt is valid and the Vendee received full and valid consideration for it; and that the Vendee understands the debt and this agreement are being assigned.

20. Final Balloon Payment Notice — This note is subject to Section 2966 of the Civil Code, which provides that the holder of this note shall give written notice to Vendee, or his successor in interest, of prescribed information at least 90 and not more than 150 days before any balloon payment is due.

21. Addenda — The following checked addenda are a part of this agreement: ☐ Impounds rider for taxes and insurance; ☐ Owner-occupancy rider; ☐ Contract collection rider; ☐ _____.

22. Attorney Fees — In any action to enforce this agreement, the prevailing party shall receive attorney fees.

☐ See attached Signature Page Addendum. [ft Form 251]

Vendor: _____

Vendor: _____

☐ See attached Signature Page Addendum. [ft Form 251]

Vendee: _____

Vendee: _____

STATE OF CALIFORNIA

COUNTY OF_____

On _____ before me,

_____ *(Name and title of officer)*

personally appeared _____

_____.

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature _____ *(Signature of notary public)*

(This area for official notarial seal)

FORM 168 **02-08** ©2008 **first tuesday**, P.O. BOX 20069, RIVERSIDE, CA 92516 (800) 794-0494

Except for the absence of legal documentation in the form of a grant deed, note and trust deed, the terms of the lease-option sale have all the **economic characteristics** of a credit sale. There is an agreed-to price, a down payment, monthly rent payments which apply in whole or in part toward principal (the balance being interest) and a due date for the final/balloon payment.

When a buyer in possession of property under an agreement with the seller receives credit toward the purchase price for a portion or all of his payments to the seller, he has built up and established an **equity** in the property. Thus, he has an **ownership interest** which carries with it the *right of redemption* to pay off the seller and get clear title. The buyer's redemption rights can only be terminated by a judicial or nonjudicial foreclosure, or a deed-in-lieu of foreclosure for which the seller (lender) usually needs to pay "key money" to get possession.

A lease-option agreement structured on terms economically consistent with a credit sale (a down payment or credit of payments toward the price) is neither a lease between a tenant and a landlord nor an option to buy. The lease-option sales agreement is a **disguised security device** for credit financing of a sale arranged by a buyer and a carryback seller. [**Oesterreich** v. **Commissioner of Internal Revenue** (9th Cir. 1955) 226 F2d 798]

An actual lease coupled with a separate option to buy is the antithesis of seller financing. A borrower's debt obligations and a lender's foreclosure rights are diametrically opposed to a tenant's leasehold obligations and the eviction rights of a landlord.

Also, all lease-options trigger due-on provisions in trust deeds which encumber property.

Tax aspects

Taxwise, **lease-option sales** are recharacterized by the Internal Revenue Service (IRS), the state Franchise Tax Board (FTB) and the county assessor as carryback financing or land sales contracts.

One reason sellers conceal property sales behind the format of a lease-option is to avoid added tax burdens on a change in ownership. Under an actual option agreement, any option money received by the seller is reported as either **profit or income** when the option is **exercised or expires**, or the property is sold subject to the option.

The seller, disguised as a landlord, will also deduct the amount of the property's annual depreciation to reduce income taxes, until the lease-option is recharacterized by the IRS as a sale.

Buyers are motivated to structure a sale as an unrecorded lease-option to evade property **reassessment** by the county. However, the use of a lease-option to mask a sale has property tax consequences, since the economic characteristics of the transaction constitute a change of ownership, triggering retroactive reassessment when later discovered.

Reverse trust deed

The *reverse trust deed* is often used to provide recorded protection for a buyer's investment in an otherwise unrecorded transfer, such as one involving the two-step contract escrow.

As the name suggests, the economic roles of the buyer and seller in the transaction are reversed.

The buyer documents the amount of the down payment on the property as a loan made to the seller.

Figure 4

LEASE-OPTION
Contract for Deed

NOTE: This form is not for use by an investor acquiring owner-occupied, one-to-four unit residential property in forclosure. [See **ft** Form 156]

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable. References to forms include their equivalent.

FACTS:

1. This lease agreement and option to purchase is entered into by Lessor/Optionor and Lessee/Optionee, regarding property situated in the City of _____, County of _____ California, referred to as _____

Personal property, ☐ see attached Personal Property Inventory [See **ft** Form 256], _____

2. This agreement is comprised of this three page form and the following checked attachments:

☐ Credit Application [See **ft** Form 302]
☐ Residential Earthquake Hazards Report [See **ft** Form 315]
☐ Occupant's Operating Expense Sheet [See **ft** Form 562]
☐ Addendum — General Use [See **ft** Form 250]
☐ Notice of Your Supplemental Property Tax Bill [See **ft** Form 317]
☐ Agency Law Disclosure Statement [See **ft** Form 305]
☐ Natural Hazard Disclosure Statement [See **ft** Form 314]
☐ Financial Disclosure Statement [See **ft** Form 300-2]
☐ Brokerage Fee Addendum [See **ft** Form 273]
☐ Lead-Based Paint Disclosure [See **ft** Form 313]
☐ Condition of Property Disclosure [See **ft** Form 304]

3. Term of Lease:
This lease commences _____, 20_____ and continues until _____, 20_____.

3.1 The lease terminates on the last day of the term without further notice.

3.2 If Lessee holds over, Lessee to be liable for rent at the daily rate of $_____.

4. Rent: Lessee to pay, in advance, a base monthly rent of $_____ due on the _____ day of each calendar month.

4.1 Rent to be paid by: ☐ cash, ☐ check, or ☐ cashiers check, at Lessor's address below.

4.2 Rent to be tendered by: ☐ mail, or ☐ personal delivery.

4.3 Lessee to pay a late charge of six percent of all rent amounts due in the event rent is not received within ten days of the due date.

4.4 Lessee to pay $_____ for each rent check returned for insufficient funds and thereafter pay rent by cash or cashier's check.

5. Additional Rent: In addition to the base monthly rent, Lessee to pay additional monthly rent equal to the increased costs incurred by Lessor after entering into this lease-option, due to:

a. ☐ variable/adjustable interest rate on existing loans secured by the property;
b. ☐ variable/adjustable monthly principal or acceleration of existing loans secured by the property;
c. ☐ property taxes on the property;
d. ☐ fire and extended coverage insurance premiums on the property;
e. ☐ any Homeowners' Association (HOA) assessments;
f. ☐ any special or improvement assessments on the property; and
g. ☐ any other expenditures required of Lessor to protect his interest.

5.1 The additional monthly rent shall be the actual monthly cost increase and 1/12th of any annual cost increase.

5.2 The additional monthly rent is due on, or beginning with, the monthly rent payment next due following notice to Lessee by Lessor.

6. Utilities: Lessee shall pay all costs of public utilities to the property, including any required deposits, installation, or service fees.

7. Maintenance of Premises: Lessee agrees to maintain and perform all necessary repairs to the property during the lease term at his sole expense.

8. Insurance: Lessee shall maintain at his sole expense, naming Lessor as an additional insured:

8.1 ☐ A standard fire insurance policy with extended coverage, vandalism and malicious mischief endorsements, fully covering the replacement cost of all structures on the property during the entire term of the lease; and

8.2 ☐ Public liability and property damage insurance with a single combined liability limit of at least $300,000 and property damage limits of at least $100,000, insuring against all liability of Lessee arising out of Lessee's use or occupancy of the premises.

9. Use of the Property: The property is to be used only as a private residence occupied by Lessee and for no other purpose. Lessee shall comply with all laws regarding the use of the property, and shall not allow any waste or nuisance to occur on the property.

10. Assignment and Subletting: Lessee shall not assign this lease, nor sublet or encumber any interest in the property without the prior written consent of Lessor. Any transfer of an interest in the property by Lessee without the prior written consent of Lessor shall, at the option of Lessor, terminate this lease and call for payment of all sums due.

11. Waiver of Damage: Lessee releases Lessor from liability for loss or damage to Lessee or any property of Lessee caused by water leakage, breaking pipes, theft, vandalism, or any other cause beyond the reasonable control of Lessor.

12. Hold Harmless: Lessee shall indemnify Lessor from liability, damages, and/or expenses arising from the death or injury of any person, including Lessee, or from the damage or destruction of any property, including property owned by Lessee, caused or allegedly caused by some condition of the property, or some act or omission of Lessee or any other person.

OPTION TO PURCHASE:

13. Option Money: Optionor acknowledges receipt of option money in the amount of $_____, given in consideration for this option to purchase the property leased.

14. Option Period: Optionor hereby grants to Optionee the irrevocable option to purchase the Optionor's right, title and interest in the property under the sales terms for a period commencing with the acceptance of this option and expiring on termination of the lease.

15. Exercise of Option: Optionee may exercise this option during the option period by:

15.1 Preparing and signing escrow instructions with _____;

15.2 Depositing cash in Escrow of $_____; and

15.3 Delivering a certified copy of the signed escrow instructions to Optionor within the option period in person or by certified mail.

16. Delivery of Title: Within _____ days after exercise, Optionor and Optionee shall place in Escrow all documents and instruments necessary to close.

17. Sale Terms: The purchase price is $_____, payable:

17.1 ☐ In cash.

17.2 ☐ Down payment in the amount of $_____.

17.3 The cash price or down payment to be credited for $_____ of option money paid, and for _____%, or $_____, of each payment of base monthly rent.

17.4 ☐ Take title subject to, or ☐ Assume, the existing trust deed note with an approximate unpaid balance of $_____, currently payable $_____ monthly, including principal and interest at _____%, ☐ adjustable, monthly impounds being an additional $_____.

17.5 ☐ Take title subject to, or ☐ Assume, a trust deed note with a principal balance of $_____, currently payable $_____ monthly, including principal and interest at _____%, due _____.

17.6 Loan balance differences to be adjusted in: ☐ cash, ☐ §17.8 Note, or ☐ price.

17.7 ☐ Assume bonds or assessment liens of record in the approximate amount of $_____.

17.8 A Note for the balance of the purchase price in the amount of $_____, to be executed by Buyer in favor of Seller and secured by a trust deed on the property, payable $_____ monthly, or more, commencing one month after closing, including interest at _____%, due _____ years after closing.

a. The Note and Trust Deed shall not contain provisions for due-on clauses, prepayment penalties, or late charges.
b. ☐ Optionee to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **ft** Form 412]
c. ☐ The Note is an All-Inclusive Trust Deed Note.
d. As additional security, Optionee to execute a security agreement and file a UCC-1 financing statement on any personal property included in the price.

18. General Provisions:

18.1 Optionee's transfer of any interest in this option terminates the option.

18.2 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

18.3 The prevailing party in any dispute shall be entitled to attorney fees and costs, unless they proceed with litigation without first offering to enter into mediation to resolve the dispute.

19. Power of Sale: Should this document be characterized as a security device, on default of rental payments or failure to exercise the option, the Lessor/Optionor may call all sums due and elect to proceed with a power of sale by a trustee substituted under Civil Code §2934(a), noticed and held in accordance with Civil Code §§2924 et seq.

20. Lessor/Optionor Default: Should the Lessor/Optionor default on any obligation impairing the Lessee/Optionee's interest under this agreement, Lessee/Optionee may cure the default and demand reimbursement from the Lessor/Optionor of the amount advanced, and if not paid, deduct the amount paid from periodic payments and the purchase price due the Lessor/Optionor.

21. Expiration of Option: This option to purchase shall be deemed expired if not exercised during the option period, and if not previously terminated, shall automatically expire/terminate on _____, 20_____.

22. Brokerage Fee: Optionor to pay brokerage fees as follows:

22.1 _____% of the option money on receipt; plus

22.2 _____% of each month's base rent on receipt; and

22.3 $_____ on exercise of the option.

22.4 Optionee's Broker and Optionor's Broker, respectively, to share the brokerage fee _____:_____.

23. _____

Lessee/Optionee's Broker: _____	Lessor/Optionor's Broker: _____
By: _____	By: _____
Is the agent of: ☐ Lessee/Optionee exclusively, or ☐ both Parties	Is the agent of: ☐ Lessor/Optionor exclusively, or ☐ both Parties
I agree to the terms stated above.	**I agree to the terms stated above.**
☐ See attached Signature Page Addendum. [**ft** Form 251]	☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: _____, 20_____	Date: _____, 20_____
Lessee/Optionee: _____	Lessor/Optionor: _____
Signature: _____	Signature: _____
Lessee/Optionee: _____	Lessor/Optionor: _____
Signature: _____	Signature: _____
Address: _____	Address: _____
Phone: _____	Phone: _____
Fax: _____	Fax: _____
Email: _____	Email: _____

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The seller, disguised as an owner borrowing money, signs a note for the amount of the down payment and a trust deed in favor of the buyer. The trust deed appears as the buyer's lien on the very property the buyer is acquiring, hence its name: reverse trust deed.

When escrow closes on the sale, the buyer's reverse trust deed is recorded (naming him as the beneficiary) and the seller receives the net proceeds from the down payment. The buyer takes possession of the property under a lease signed by both the seller (as the landlord) and the buyer (as the tenant).

All other documents regarding the buyer's **actual** purchase of the property — the executed grant deed and any carryback notes or trust deeds — are left unrecorded and placed into a contract or holding escrow. The escrow agent is **instructed** to hold these documents (together with the note and a request for a reconveyance of the reverse trust deed) until the buyer or seller requests they be recorded.

As a result, the record title indicates the seller merely equity-financed his property.

Neither the lender nor the tax assessor are alerted to the transfer as long as the grant deed remains unrecorded and undisclosed. However, both the lender's due-on clause and the assessor's right to reassess have been triggered.

The reverse trust deed takes the place of the Memorandum of Agreement recorded in some contract escrow arrangements.

However, the reverse trust deed does present a degree of financial protection to the buyer. When recorded, it prevents the seller from defeating the buyer's down payment by further encumbering or deeding out the property to a bona fide purchaser (BFP). [**Miller** v. **Cote** (1982) 127 CA3d 888]

Should the seller interfere with the buyer's unrecorded grant deed interest, the buyer can foreclose on the trust deed and wipe out the seller's position.

However, the reverse trust deed is not perfect and has several potentially fatal flaws, both economic and legal.

Economically, price inflation or value appreciation of the property will cyclically outstrip the buyer's ability to protect his equity (due to the historical inflationary monetary policy of the Federal government). Should the buyer ever need to foreclose to recover the amount of his down payment, he will only become the legal owner of the property if he is the successful bidder at a trustee's sale.

Of course, the buyer runs the risk of being overbid by other bidders who appear at the sale. At a minimum, the buyer as the foreclosing beneficiary of the trust deed will get back the amount of his original down payment, plus interest.

Legally, the reverse trust deed is even more disenchanting than lost inflation or appreciation. Even if the buyer could bid high enough at the trustee's sale to acquire title, he still stands to lose the property if the senior lender calls the loan, and if unpaid, forecloses.

If the property is an owner-occupied, one-to-four unit residential property, the owner (meaning the seller, not the buyer) can further encumber and avoid a call under the existing lender's due-on clause only if he **continues to occupy** the property. [12 CFR §591.5(b)(1)(i)]

Thus, the very purpose for using a reverse trust deed (to transfer possession without the risk of the due-on-sale/reassessment) renders it **legally useless**, except to foreclose on the property, since the reverse trust deed does not avoid a call or the recasting of the existing financing or a reassessment when the transaction is discovered by the lender or the county assessor.

Taxwise, a reverse trust deed transaction, unless reported as a sale, exposes the seller to liability for **tax evasion** for deliberately restructuring a sale to appear as a non-taxable event (a loan).

The substance and function of the transaction (the sale of the property) supersedes its recorded form (the trust deed loan).

Also, concealing the sale from the county assessor results in the imposition of stiff property tax penalties by the county tax collector. The seller is also faced with penalties for his failure to report profit to the Internal Revenue Service (IRS) and California's Franchise Tax Board (FTB).

When the grant deed is eventually recorded, its date prepared and notarized will probably alert the assessor to the unrecorded transfer of the property, which occurred a few years earlier. Then the retroactive assessment and tax bills will start arriving — to be paid.

Filing the IRS 1099-S

When a formal sales escrow is not used to handle documents and funds on a sale, the person arranging the sale, generally the broker, is required to report the transaction to the Internal Revenue Service (IRS) on a 1099-S form. [Revenue Regulations §1.6045-4(a)]

The IRS recognizes the sale date to be the earlier of the dates on which:

- title is transferred; or
- the economic benefits and burdens of ownership shift from the seller to the buyer. [Rev. Reg. §1.6045-4(h)(2)(ii)]

Typically, reporting the sale to the IRS with a 1099-S form is incorrectly deferred until the title is conveyed to the buyer through escrow on payoff of the land sales contract, lease-option or other masked security device or off-record handling. Here again, escrow improperly collaborates with the seller, buyer and broker to prevent discovery of the previously masked sale by all persons or agencies, even when escrow closes and reports the closing as the date of the sale.

SECTION E

Lenders

Chapter 36 Conventional financing for a sale

This chapter reviews the procedures used by a transaction agent for obtaining conventional financing to fund the purchase of a principal residence.

Role of the transaction agent (TA)

The ability of a buyer or an owner to obtain financing is an integral component of most real estate transactions, whether the intended use of the loan proceeds is for:

- new property acquisitions;
- tenant improvements (TIs) under a lease;
- construction of buildings; or
- personal-use.

The submission of a *loan application* to a private or institutional lender is the catalyst which sets the machinery of the mortgage industry in motion.

All too often, a buyer needing purchase-assist funding is left to grapple single-handedly with the lender to look out for his own financial interests with no guidance or protective assistance. It is the duty of the **gatekeeper** who brought the buyer into the marketplace, the buyer's selling agent, called by lenders a *transaction agent* (TA), to diligently ensure his buyer negotiates the best financial advantage available to him for the class of loan the buyer seeks.

The TA neither **arranges** nor **makes** a loan. His principal task is to focus on negotiating the real estate transaction, usually between a buyer and seller, but a builder may be involved. However, for the sales transaction to close, and for the TA to get his fee, a loan needs to be arranged with a lender to provide supplemental funding for the buyer's payment of the purchase price. The TA's compensation for negotiating the real estate transaction is only fully earned and payable when he has taken all steps necessary to eliminate the loan funding contingency, the ultimate event allowing escrow to close.

This all-encompassing duty imposed on the TA to diligently serve the buyer's best interests includes policing the:

- loan application submission;
- lender's loan packaging process; and
- funding conditions to vigilantly ensure that all the documents escrow needs to comply with the lender's closing instructions are in order so funding can take place.

Sources of conventional financing

When applying for a **conventional loan**, a buyer has several sources of lenders to choose from, including:

- banks, thrifts and credit unions, called *portfolio lenders*;
- insurance companies and trade association pensions, called *institutional lenders*; and
- mortgage bankers who resell the loan in the secondary loan market, called *warehousing lenders*.

While portfolio and institutional lenders typically service their own loans, they often originate loans for immediate sale as do mortgage bankers, called *warehousing*.

Warehoused loans are sold on the **secondary mortgage market** to investment pools, such as the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Government National Mortgage Association (Ginnie Mae) and Wall Street bankers.

The business of servicing loans is also bought and sold, causing the loan to appear to be changing hands.

Lenders who originate loans for sale in the **secondary market**, called *Real Estate Settlement Procedures Act* (*RESPA) lenders*, evaluate a buyer's borrowing potential based on the ever changing credit and income requirements and property standards set by the secondary market agency or investment pool seeking to buy newly originated loans.

For the buyer, as with any borrower, the greatest risk of loss of savings and overcommitment of future earnings in a real estate transaction occurs when arranging the loan with the lender's loan representative.

The TA is a paid advisor with a duty owed to the buyer to police all facets of the loan process. This obligation includes eliminating the loan contingency by helping the buyer locate and close on the most advantageous loan terms available in the market. No less could be reasonably expected of an agent.

The TA is the buyer's most reliable and knowledgeable ally in the real estate transaction. This alliance extends beyond the moment the purchase agreement offer is accepted to all critical interactions with the lender who will fund the closing.

The lender is not an agent of the buyer, but his sworn **adversary**. As an outsider to the mortgage lending industry, the unassisted buyer is placed in an inherently submissive position to the lender who will instinctively prey on the buyer's ignorance of the classic loan process to increase its profit. Again, no less could be reasonably expected from a lender.

What must be understood by the TA is that the lender's product – money – is unpriced until closing. This holds true in spite of the good faith estimate of costs (GFE) and interest rate disclosures that are given to the buyer within three business days following the lender's receipt of the loan application. [See **first tuesday** Form 204 (DRE 883)]

The most competent TA has experience policing lenders and is aware of the methods they use to glean the highest rates, most points and high-profit garbage fees from the unprotected buyer. If the lender's tactics are anticipated by the TA, the TA will counsel the buyer so he is on guard against any form of lender deceit. By doing so, the TA prevents lenders from pulling the wool over the buyer's eyes, as history has proven they are prone to do.

Before meeting with a lender rep

A buyer's first step toward obtaining a loan requires him to submit a standardized Uniform Residential Loan Application to a lender as a **prospective borrower**. [See Form 203 (FNMA 1003) accompanying this chapter]

The application itself, designed to be completed by the buyer/borrower with the assistance of the TA and the lender's loan representative, establishes the:

- type of mortgage sought by the buyer/borrower and the terms sought for the loan;
- intended use of the loan funds and the property's information [See **first tuesday** Form 203-3];
- buyer's/borrower's (and co-borrower's) information and employment history;
- monthly income and combined housing (personal) expenses [See **first tuesday** Form 207 (FNMA 1020)];
- assets and liabilities [See **first tuesday** Form 207-1];
- details of the transaction and declarations; and
- acknowledgment and signatures.

However, before submitting the application to the lender, the TA needs to inform the buyer about what to expect during the loan application process. By doing so, the buyer is prepared and well-informed to respond defensively during the loan packaging process which is when the financial stakes are at their highest for both the buyer and lender.

Before submitting the application to the lender, the TA needs to inform his buyer of:

- the expectations held and the role of each servicer or affiliate involved in the loan transaction (the lender's loan representative, the lender funding the loan, any mortgage loan broker involved, private mortgage insurance (PMI) carrier, credit agencies, the appraiser, title insurer and escrow company, etc.);
- what is going to take place during the application process (submission of the application, lender disclosures, payment of lender costs, gathering documents, funding requirements, etc.); and
- what to guard against (issues fabricated by lenders to drive up interest rates and fees beyond their initial estimates on unwary buyers without justification prior to closing).

UNIFORM RESIDENTIAL LOAN APPLICATION
(FNMA 1003)

This application is designed to be completed by the applicant(s) with the Lender's assistance. Applicants should complete this form as "Borrower" or "Co-Borrower," as applicable. Co-Borrower information must also be provided (and the appropriate box checked) when ☐ the income or assets of a person other than the Borrower (including the Borrower's spouse) will be used as a basis for loan qualification or ☐ the income or assets of the Borrower's spouse or other person who has community property rights pursuant to state law will not be used as a basis for loan qualification, but his or her liabilities must be considered because the spouse or other person has community property rights pursuant to applicable law and Borrower resides in a community property state, the security property is located in a community property state, or the Borrower is relying on other property located in a community property state as a basis for repayment of the loan.

If this is an application for joint credit, Borrower and Co-Borrower each agree that we intend to apply for joint credit (sign below):

Borrower's signature | Co-Borrower 's signature

I. TYPE OF MORTGAGE AND TERMS OF LOAN

Mortgage Applied for: ☐ VA ☐ FHA ☐ Conventional ☐ USDA/Rural Housing Service ☐ Other (explain):

Agency Case Number | Lender Case Number

Amount $ | Interest Rate % | No. of Months | **Amortization Type:** ☐ Fixed Rate ☐ GPM ☐ Other (explain): ☐ ARM (type):

II. PROPERTY INFORMATION AND PURPOSE OF LOAN

Subject Property Address (street, city, state & ZIP) | No. of Units

Legal Description of Subject Property (attach description if necessary) | Year Built

Purpose of Loan ☐ Purchase ☐ Construction ☐ Other (explain): ☐ Refinance ☐ Construction-Permanent

Property will be: ☐ Primary Residence ☐ Secondary Residence ☐ Investment

Complete this line if construction or construction-permanent loan.

Year Lot Acquired	Original Cost	Amount Existing Liens	(a) Present Value of Lot	(b) Cost of Improvements	Total (a + b)
	$	$	$	$	$

Complete this line if this is a refinance loan.

Year Acquired	Original Cost	Amount Existing Liens	Purpose of Refinance	Describe Improvements ☐ made ☐ to be made
	$	$		Cost: $

Title will be held in what Name(s) | Manner in which Title will be held | Estate will be held in: ☐ Fee Simple ☐ Leasehold (show expiration date)

Source of Down Payment, Settlement Charges, and/or Subordinate Financing (explain)

III. BORROWER INFORMATION

Borrower				Co-Borrower			
Borrower's Name (include Jr. or Sr. if applicable)				Co-Borrower's Name (include Jr. or Sr. if applicable)			
Social Security Number	Home Phone (incl. area code)	DOB (mm/dd/yyyy)	Yrs. School	Social Security Number	Home Phone (incl. area code)	DOB (mm/dd/yyyy)	Yrs. School
☐ Married ☐ Separated ☐ Unmarried (include single, divorced, widowed)	Dependents (not listed by Co-Borrower) no. ages			☐ Married ☐ Separated ☐ Unmarried (include single, divorced, widowed)	Dependents (not listed by Borrower) no. ages		
Present Address (street, city, state, ZIP)	☐ Own ☐ Rent ____No. Yrs.			Present Address (street, city, state, ZIP)	☐ Own ☐ Rent ____No. Yrs.		
Mailing Address, if different from Present Address				Mailing Address, if different from Present Address			

If residing at present address for less than two years, complete the following:

Former Address (street, city, state, ZIP)	☐ Own ☐ Rent ____No. Yrs.	Former Address (street, city, state, ZIP)	☐ Own ☐ Rent ____No. Yrs.

IV. EMPLOYMENT INFORMATION

Borrower			Co-Borrower		
Name & Address of Employer	☐ Self Employed	Yrs. on this job / Yrs. employed in this line of work/profession	Name & Address of Employer	☐ Self Employed	Yrs. on this job / Yrs. employed in this line of work/profession
Position/Title/Type of Business	Business Phone (incl. area code)		Position/Title/Type of Business	Business Phone (incl. area code)	

If employed in current position for less than two years or if currently employed in more than one position, complete the following:

Borrower		IV. EMPLOYMENT INFORMATION (cont'd)		Co-Borrower	
Name & Address of Employer	☐ Self Employed	Dates (from - to)	Name & Address of Employer	☐ Self Employed	Dates (from - to)
		Monthly Income $			Monthly Income $
Position/Title/Type of Business		Business Phone (incl. area code)	Position/Title/Type of Business		Business Phone (incl. area code)
Name & Address of Employer	☐ Self Employed	Dates (from - to)	Name & Address of Employer	☐ Self Employed	Dates (from - to)
		Monthly Income $			Monthly Income $
Position/Title/Type of Business		Business Phone (incl. area code)	Position/Title/Type of Business		Business Phone (incl. area code)

V. MONTHLY INCOME AND COMBINED HOUSING EXPENSE INFORMATION

Gross Monthly Income	Borrower	Co-Borrower	Total	Combined Monthly Housing Expense	Present	Proposed
Base Empl. Income*	$	$	$	Rent	$	
Overtime				First Mortgage (P&I)		$
Bonuses				Other Financing (P&I)		
Commissions				Hazard Insurance		
Dividends/Interest				Real Estate Taxes		
Net Rental Income				Mortgage Insurance		
Other (before completing, see the notice in "describe other income," below)				Homeowner Assn. Dues		
				Other:		
Total	$	$	$	**Total**	$	$

* **Self Employed Borrower(s) may be required to provide additional documentation such as tax returns and financial statements.**

Describe Other Income

Notice: **Alimony, child support, or separate maintenance income need not be revealed if the Borrower (B) or Co-Borrower (C) does not choose to have it considered for repaying this loan.**

B/C		Monthly Amount
		$

VI. ASSETS AND LIABILITIES

This Statement and any applicable supporting schedules may be completed jointly by both married and unmarried Co-Borrowers if their assets and liabilities are sufficiently joined so that the Statement can be meaningfully and fairly presented on a combined basis; otherwise, separate Statements and Schedules are required. If the Co-Borrower section was completed about a non-applicant spouse or other person, this Statement and supporting schedules must be completed about that spouse or other person also.

Completed ☐ Jointly ☐ Not Jointly

ASSETS Description	Cash or Market Value
Cash deposit toward purchase held by:	$

Liabilities and Pledged Assets. List the creditor's name, address, and account number for all outstanding debts, including automobile loans, revolving charge accounts, real estate loans, alimony, child support, stock pledges, etc. Use continuation sheet, if necessary. Indicate by (*) those liabilities, which will be satisfied upon sale of real estate owned or upon refinancing of the subject property.

List checking and savings accounts below		LIABILITIES	Monthly Payment & Months Left to Pay	Unpaid Balance
Name and address of Bank, S&L, or Credit Union		Name and address of Company	$ Payment/Months	$
Acct. no.	$	Acct. no.		
Name and address of Bank, S&L, or Credit Union		Name and address of Company	$ Payment/Months	$
Acct. no.	$	Acct. no.		
Name and address of Bank, S&L, or Credit Union		Name and address of Company	$ Payment/Months	$
Acct. no.	$	Acct. no.		

VI. ASSETS AND LIABILITIES (cont'd)

Name and address of Bank, S&L, or Credit Union		Name and address of Company		$ Payment/Months	$
Acct. no.	$	Acct. no.			
Stocks & Bonds (Company name/ number & description)	$	Name and address of Company		$ Payment/Months	$
		Acct. no.			
Life insurance net cash value Face amount: $	$	Name and address of Company		$ Payment/Months	$
Subtotal Liquid Assets	$				
Real estate owned (enter market value from schedule of real estate owned)	$				
Vested interest in retirement fund	$				
Net worth of business(es) owned (attach financial statement)	$	Acct. no.			
Automobiles owned (make and year)	$	Alimony/Child Support/Separate Maintenance Payments Owed to:		$	
Other Assets (itemize)	$	Job-Related Expense (child care, union dues, etc.)		$	
		Total Monthly Payments		**$**	
Total Assets a.	$	Net Worth (a minus b) ▶	$	**Total Liabilities b.**	$

Schedule of Real Estate Owned (If additional properties are owned, use continuation sheet.)

Property Address (enter S if sold, PS if pending sale or R if rental being held for income) ▼	Type of Property	Present Market Value	Amount of Mortgages & Liens	Gross Rental Income	Mortgage Payments	Insurance, Maintenance, Taxes & Misc.	Net Rental Income
		$	$	$	$	$	$
	Totals	$	$	$	$	$	$

List any additional names under which credit has previously been received and indicate appropriate creditor name(s) and account number(s):

Alternate Name	Creditor Name	Account Number

VII. DETAILS OF TRANSACTION

a.	Purchase price	$
b.	Alterations, improvements, repairs	
c.	Land (if acquired separately)	
d.	Refinance (incl. debts to be paid off)	
e.	Estimated prepaid items	
f.	Estimated closing costs	
g.	PMI, MIP, Funding Fee	
h.	Discount (if Borrower will pay)	
i.	Total costs (add items a through h)	

VIII. DECLARATIONS

If you answer "Yes" to any questions a through i, please use continuation sheet for explanation.

	Borrower Yes	Borrower No	Co-Borrower Yes	Co-Borrower No
a. Are there any outstanding judgments against you? …….....	☐	☐	☐	☐
b. Have you been declared bankrupt within the past 7 years? ……	☐	☐	☐	☐
c. Have you had property foreclosed upon or given title or deed in lieu thereof in the last 7 years? ……	☐	☐	☐	☐
d. Are you a party to a lawsuit? ……..	☐	☐	☐	☐
e. Have you directly or indirectly been obligated on any loan which resulted in foreclosure, transfer of title in lieu of foreclosure, or judgment? ……	☐	☐	☐	☐

(This would include such loans as home mortgage loans, SBA loans, home improvement loans, educational loans, manufactured (mobile) home loans, any mortgage, financial obligation, bond, or loan guarantee. If "Yes," provide details, including date, name, and address of Lender, FHA or VA case number, if any, and reasons for the action.)

VII. DETAILS OF TRANSACTION

j.	Subordinate financing	
k.	Borrower's closing costs paid by Seller	
l.	Other Credits (explain)	
m.	Loan amount (exclude PMI, MIP, Funding Fee financed)	
n.	PMI, MIP, Funding Fee financed	
o.	Loan amount (add m & n)	
p.	Cash from/to Borrower (subtract j, k, l & o from i)	

VIII. DECLARATIONS

If you answer "Yes" to any questions a through i, please use continuation sheet for explanation.

	Borrower Yes	Borrower No	Co-Borrower Yes	Co-Borrower No
f. Are you presently delinquent or in default on any Federal debt or any other loan, mortgage, financial obligation, bond, or loan guarantee? ……. If "Yes," give details as described in the preceding question.	☐	☐	☐	☐
g. Are you obligated to pay alimony, child support, or separate maintenance? ……	☐	☐	☐	☐
h. Is any part of the down payment borrowed? ……....	☐	☐	☐	☐
i. Are you a co-maker or endorser on a note? ……	☐	☐	☐	☐
j. Are you a U.S. citizen? ……	☐	☐	☐	☐
k. Are you a permanent resident alien? ……	☐	☐	☐	☐
l. **Do you intend to occupy the property as your primary residence? …….....** If "Yes," complete question m below.	☐	☐	☐	☐
m. Have you had an ownership interest in a property in the last three years? ……..	☐	☐	☐	☐

(1) What type of property did you own—principal residence (PR), second home (SH), or investment property (IP)?
(2) How did you hold title to the home—solely by yourself (S), jointly with your spouse (SP), or jointly with another person (O)?

IX. ACKNOWLEDGEMENT AND AGREEMENT

Each of the undersigned specifically represents to Lender and to Lender's actual or potential agents, brokers, processors, attorneys, insurers, servicers, successors and assigns and agrees and acknowledges that:

(1) the information provided in this application is true and correct as of the date set forth opposite my signature and that any intentional or negligent misrepresentation of this information contained in this application may result in civil liability, including monetary damages, to any person who may suffer any loss due to reliance upon any misrepresentation that I have made on this application, and/or in criminal penalties including, but not limited to, fine or imprisonment or both under the provisions of Title 18, United States Code, Sec. 1001, et seq.; (2) the loan requested pursuant to this application (the "Loan") will be secured by a mortgage or deed of trust on the property described in this application; (3) the property will not be used for any illegal or prohibited purpose or use; (4) all statements made in this application are made for the purpose of obtaining a residential mortgage loan; (5) the property will be occupied as indicated in this application; (6) the Lender, its servicers, successors or assigns may retain the original and/or an electronic record of this application, whether or not the Loan is approved; (7) the Lender and its agents, brokers, insurers, servicers, successors, and assigns may continuously rely on the information contained in the application, and I am obligated to amend and/or supplement the information provided in this application if any of the material facts that I have represented herein should change prior to closing of the Loan; (8) in the event that my payments on the Loan become delinquent, the Lender, its servicers, successors or assigns may, in addition to any other rights and remedies that it may have relating to such delinquency, report my name and account information to one or more consumer reporting agencies; (9) ownership of the Loan and/or administration of the Loan account may be transferred with such notice as may be required by law; (10) neither Lender nor its agents, brokers, insurers, servicers, successors or assigns has made any representation or warranty, express or implied, to me regarding the property or the condition or value of the property; and (11) my transmission of this application as an "electronic record" containing my "electronic signature," as those terms are defined in applicable federal and/or state laws (excluding audio and video recordings), or my facsimile transmission of this application containing a facsimile of my signature, shall be as effective, enforceable and valid as if a paper version of this application were delivered containing my original written signature.

Acknowledgement. Each of the undersigned hereby acknowledges that any owner of the Loan, its servicers, successors and assigns, may verify or reverify any information contained in this application or obtain any information or data relating to the Loan, for any legitimate business purpose through any source, including a source named in this application or a consumer reporting agency.

Borrower's Signature	Date	Co-Borrower's Signature	Date
X		X	

X. INFORMATION FOR GOVERNMENT MONITORING PURPOSES

The following information is requested by the Federal Government for certain types of loans related to a dwelling in order to monitor the lender's compliance with equal credit opportunity, fair housing and home mortgage disclosure laws. You are not required to furnish this information, but are encouraged to do so. The law provides that a lender may not discriminate either on the basis of this information, or on whether you choose to furnish it. If you furnish the information, please provide both ethnicity and race. For race, you may check more than one designation. If you do not furnish ethnicity, race, or sex, under Federal regulations, this lender is required to note the information on the basis of visual observation and surname if you have made this application in person. If you do not wish to furnish the information, please check the box below. (Lender must review the above material to assure that the disclosures satisfy all requirements to which the lender is subject under applicable state law for the particular type of loan applied for.)

BORROWER ☐ I do not wish to furnish this information	**CO-BORROWER** ☐ I do not wish to furnish this information
Ethnicity: ☐ Hispanic or Latino ☐ Not Hispanic or Latino	**Ethnicity:** ☐ Hispanic or Latino ☐ Not Hispanic or Latino
Race: ☐ American Indian or Alaska Native ☐ Asian ☐ Black or African American ☐ Native Hawaiian or Other Pacific Islander ☐ White	**Race:** ☐ American Indian or Alaska Native ☐ Asian ☐ Black or African American ☐ Native Hawaiian or Other Pacific Islander ☐ White
Sex: ☐ Female ☐ Male	**Sex:** ☐ Female ☐ Male

To be Completed by Interviewer	Interviewer's Name (print or type)	Name and Address of Interviewer's Employer
This application was taken by: ☐ Face-to-face interview ☐ Mail ☐ Telephone ☐ Internet	Interviewer's Signature Date	
	Interviewer's Phone Number (incl. area code)	

CONTINUATION SHEET/RESIDENTIAL LOAN APPLICATION

Use this continuation sheet if you need more space to complete the Residential Loan Application. Mark **B** f or Borrower or **C** for Co-Borrower.	Borrower:	Agency Case Number:
	Co-Borrower:	Lender Case Number:

I/We fully understand that it is a Federal crime punishable by fine or imprisonment, or both, to knowingly make any false statements concerning any of the above facts as applicable under the provisions of Title 18, United States Code, Section 1001, et seq.

Borrower's Signature **X**	Date	Co-Borrower's Signature **X**	Date

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The TA should also assist the buyer in gathering the necessary documents to be submitted in conjunction with the loan application. These documents frequently take the form of W2's and recent pay-stubs to evidence the employment information represented by the buyer in section four of the loan application. [See Form 203 (FNMA 1003)]

Other portions of the loan application will need to be later verified by the lender with supplemental documents, such as:

- an appraisal report to establish the value of the property serving as security, as called for in section two;
- recent bank statements;
- verification of deposit or tax returns to establish the buyer's assets, as called for in section six; and
- a credit report to establish the buyer's liabilities and propensity to repay the loan, also called for in section six. [See Form 203 (FNMA 1003)]

The necessity of separate applications to multiple lenders

When a loan contingency exists in a transaction, which is almost always the case in sales of real estate, the buyer will need assistance when negotiating with the lender to ensure he will end up with the most competitive loan rates and terms available. To best achieve this advantage, the TA needs to advise the buyer to consider submitting separate loan applications to multiple lenders, a minimum of two. This is no different than getting a bid on the purchase price of the same automobile from two car dealers, except that substantially more money (and savings) is involved.

By submitting applications to at least two lenders, the buyer is armed with a fail-safe system to bypass unscrupulous changes by the lender, their representatives, or any mortgage loan brokers involved: if one lender's costs and rates change unreasonably at the time of closing, the buyer has another loan application in process with a different competing lender.

Multiple applications keep the lenders vying for the borrower's business. It is competition which assures they remain competitive to the last minute – the moment of funding.

Lenders, of course, do not like to be competitive, much less controlled by antitrust laws. For this reason they instinctively advise buyers not to submit multiple applications for credit, fabricating the claim that additional applications will interfere with debt ratio analysis during loan processing. Lender representatives have gotten good at this.

However, a buyer who submits applications to two lenders has a bargaining chip against a lender who later:

- loads on the garbage fees at the time of closing; or
- is unable or unwilling to originate the loan on the terms initially represented by it, or at the lower prevailing par rate available in the loan market at the time of closing.

Types of loans

The typical conventional loan for homebuyers is the 30-year mortgage with a **fixed rate** of interest which is based on long-term rates.

The buyer's monthly payment remains the same during the life of the fixed-rate loan since the interest rate remains the same. Fixed-rate loans offer greater long-term stability for the homebuyer than do loans with varying interest rates and payment schedules.

However, the qualified buyer is not restricted to the historical fixed-rate, 30-year mortgage. Other options to consider include:

- adjustable rate mortgages (ARMs) where the interest rate changes periodically based on an index for short-term loans, plus a margin, limited by interest rate and payment caps and floors, which cause the buyer's monthly payment to adjust to continue the loan amortization [See Chapter 7];
- rate buy-downs where the buyer receives an initial interest rate which is periodically increased, with the monthly payment adjusted accordingly, to a fixed rate within a few years, called a *graduated payment loan* (GPM);
- the length of the loan, typically loan terms are 15 or 30 years, although some lenders offer 20-, 25- or 40-year loans based on amortization;
- assumable loans allowing resale to a creditworthy buyer, with or without a rate adjustment;
- bi-weekly mortgagees with payments made every two weeks to reduce the total amount of interest paid on the loan;
- private mortgage insurance (PMI) where a qualifying buyer can obtain a loan with less than a 20% down payment while paying a premium for insurance to cover the lender's risk of loss created by the smaller down payment. [See Chapter 40]; and
- *Interest Only PLUS* (IOP) 35 year program in which only interest is paid for the first five years of the loan, then a set fixed rate of interest is paid for the remaining 30 years.

The submission of a loan application to a lender, much less multiple lenders, does not commit the buyer to any obligation to any lender. A lender may only disclose reasonable and competitive estimates and loan terms before and at the time the initial loan application is submitted in order to lure the buyer to stay with them during the loan packaging process. However, the lender has no obligation not to boost its costs, fees or the interest rate at any later stage in the process, usually reserved to a change just three days before closing.

Within three business days after submitting the loan application to the lender, the lender must hand the buyer the lender's GFE of costs. On this form, the lender discloses all loan related charges to be paid by the buyer, such as origination fees, credit report fees, insurance costs, and prepaid interest it intends to charge or be reimbursed for originating the loan. [See **first tuesday** Form 204 (DRE 883)]

If the estimate of costs and rates worked up by the loan representative prior to submission of the loan application are widely divergent from those furnished in the GFE and accompanying Truth-in-Lending Act (TILA) annual percentage rate (APR) disclosures, the lender's true performance colors are instantly exposed. [See **first tuesday** Forms 204 (DRE 883) and 221]

The buyer, with the proper guidance of the TA, can help determine at the time of the disclosures whether the loan representative gave them straightforward and honest information, or if the initial interview with the loan representative was a fabrication to entice the buyer to apply for a loan with them.

To compound this deception, lenders often change their rates and charges immediately prior to closing. When they do so, they hand the borrower a second "refreshed" GFE and TILA (APR) disclosure with modified (more specifically, *increased*) charges and loan terms, presented to be signed at least three business days before closing. [See **first tuesday** Forms 204 (DRE 883) and 221]

If the buyer has not submitted a backup application with another lender, the borrower has no alternative available to protect himself against the lender going in for extra profits at the last possible opportunity. However, by keeping loan applications in the works with two or more lenders and holding negotiations to establish which lender ultimately offers the best terms and rates, the TA is able to direct the buyer to the lender who offers the superior set of loan costs, terms for payment and interest rates. No less is expected by a buyer of his agent.

Although the second application doubles the buyer's application costs, these costs are de minimis in comparison to the total dollar amounts involved in the transaction. The TA should not let the borrower be dissuaded on these grounds.

Multiple government agencies, both federal and state, promote the practice of submitting multiple applications. To assist the buyer with the task of comparing the products of two or more lenders after multiple applications have been submitted, entities such as the California Department of Corporations, Freddie Mac, the Federal Reserve, and the Federal Trade Commission publish *Mortgage Shopping Worksheets*. These worksheets, designed to be completed by the buyer with the assistance of the TA, contain two columnar itemizations of all the variables commonly occurring at the time of origination and over the life of a loan.

After submitting loan applications to two lenders and receiving the corresponding GFE and TILA (APR) disclosures, the buyer will possess all the information needed to fill in both columns, one for each lender. Once complete, the buyer and TA can clearly compare the terms offered by the competing lenders and proceed to close on the more advantageous offer. The California Department of Corporation's Mortgage Shopping Worksheet can be obtained through their website at www.corp.ca.gov.

Fundamentals of the Uniform Residential Loan Application

The Uniform Residential Loan Application prepared by the buyer, with the professional assistance of his TA, supplies the lender with necessary information about the buyer and the property securing the loan. It also gives the lender authorization to start the loan packaging process, activity necessary for the lender to determine whether the buyer is qualified to obtain a mortgage, and if so, on what terms. [See Form 203 (FNMA 1003)]

Generally, the loan would be sought in a sales transaction by a buyer who requires the money to fund the purchase of a property. However, the loan may also be used by an owner of vacant land to construct

Alternatives to conventional loans

Aside from conventional loans which are available to borrowers with a sufficient down payment and a good credit standing, the agent assisting the buyer to obtain a loan should expose the buyer to other types of available financing, including:

- loans insured by the Federal Housing Administration (FHA) which are available to borrowers with a small down payment and less than perfect credit rating [See Chapter 39];
- loans insured by the Veterans Administration (VA) which are available to military veterans; and
- Cal-Vet loans which are available to military veterans living in California.

Each type of loan has unique advantages and disadvantages.

The agent's ability to explain the different qualification requirements for each alternative type of financing helps the buyer make informed choices from among the lenders and loans available to satisfy the loan contingency and close the purchase without being misled.

a dwelling, or used by a property owner to improve or renovate a property he currently owns, or to refinance an existing mortgage. In some instances, the loan could be sought by a tenant on a long-term lease who has agreed to make **tenant improvements** (TIs) to the property he rents.

As can be inferred by its title, the Uniform Residential Loan Application is intended primarily for use on residential property loans, such as one-to-four unit residential property, condominiums (attached or detached), or rental property of any size which is exclusively residential.

However, as a generic loan application, it can be used to apply for a loan secured by any type of property since it contains all the information required for arranging all types of real estate loans. In practice, the type of property intended to be purchased by the loan proceeds is clear based on the description of the property in the loan application.

Components of the Uniform Residential Loan Application

Once the TA has reviewed the loan process with the buyer, now called the **borrower**, the application must be completed and submitted. The application itself is designed to be completed with the loan representative, though it is crucial that the TA also be present during this critical step of the transaction.

The first section of the Uniform Residential Loan Application calls for the borrower, with the assistance of the loan representative, to enter the **type of mortgage sought**, such as conventional, VA or FHA-insured. The borrower must also indicate the total amount of the loan requested, the anticipated interest rate (fixed or adjustable), the periodic payment schedule (constant or graduated), as well as the amortization period (positive or negative).

In the second section, the borrower identifies the property which will be used to secure the loan, as well as the purpose of the loan, such as purchase-assist, refinance, or personal-use equity loan, and the intended use of the property, be it as a primary residence or for investment purposes. The source of down payment funds and closing costs are also to be entered here.

Information relating to the borrower, such as his **name** and **social security number**, is entered in section three. Here, and in section four, space is left to insert any co-borrower information if the liabilities, income or assets of the co-borrower will be considered for loan qualification purposes. If the liabilities, income or assets of a co-borrower are community property, the borrower is also to mark the appropriate community property box at the top of the form.

California is a *community property* state, meaning most assets and liabilities incurred during the marriage are shared between husband and wife, including real estate interests. If community property is not involved in the transaction for which the borrower is applying for a loan, then the spouse is not a co-borrower and that spouse's separate assets cannot be seized by the lender.

If the assets and liabilities are to be considered **community property** (as is generally the case with home purchases by a husband and wife), then the *borrower* is one spouse and the *co-borrower* is the other spouse.

However, a separate application regarding assets and liabilities must be filled out by the co-bo rower and separately submitted to the lender if:

- the assets and liabilities result from separate property owned by a co-borrower;
- the co-borrower is a necessary party to the transaction as the separate property encumbered will be considered community property; or
- the co-borrower is a co-signer of the note as a primary borrower.

The borrower and co-borrower will prepare the Balance Sheet Financial Statement – Assets, Liabilities and Net Worth, **first tuesday** Form 207-1, if their assets and liabilities are sufficiently joined to make one combined statement viable. If not, each co-borrower is to prepare their separate loan application for individual consideration by the lender.

The borrower may later complete the Statement of Information – For General Index, **first tuesday** Form 401-4, to disclose confidential information to be used by the title company to search the general index (GI) for information on the borrower and any co-borrower regarding judgments and other legal difficulties which might interfere with their taking title or providing the security interest in the property required by the lender.

Section four of the Uniform Residential Loan Application calls for the borrower's (and co-borrower's) **employment information** to determine his source of income. Space is provided for the entry of the position currently held by the borrower, his title, and years spent at that specific job and within that profession. The borrower is to mark the checkbox to indicate if he is self-employed. Lenders use this information to determine the financial stability of the borrower, as well as his ability to repay his debts.

Next, in section five, the borrower is to report his **monthly income** and **combined housing expenses**. A self-employed borrower should submit a profit and loss statement or have a printout of one from his company if it is a major source of his income.

The borrower's **assets** and **liabilities** are entered into section six which establishes his net worth. The lender desires detailed information about the borrower's assets and is entitled to know all of the borrower's liabilities as they affect his ability to repay the loan. However, the borrower may not want to

disclose all his assets. Thus, a balance must be struck between maintaining financial privacy and disclosing enough assets (though all liabilities) to the lender to get creditworthiness clearance so the loan will be funded.

In section seven, spanning pages five and six, the borrower is to enter **details about the transaction** the loan will be funding. Items called for include the purchase price of the property if the loan is purchase assist. The price entered should be the net of any rebates or discounts or other allowances received by the borrower whether directly or indirectly, or from the seller or the brokers involved. Also called for in section seven is the cost of repairs, alterations, or improvements made to the property. If the loan is to be used for a **refinance**, the estimated cost would be entered here at section "d", leaving "a", "b", and "c" blank.

Next, in section eight, the borrower (and any co-borrower) makes a declaration of any relevant **miscellaneous creditworthiness issues** which need to be disclosed to the lender, such as debt enforcement or debt avoidance they have experienced.

The ninth section is **signed by the borrower** (and any co-borrower) to acknowledge and agree to the following conditions:

- the information provided by the borrower (and any co-borrower) is true and accurate, and if it is not, informs the borrower of the penalties of misrepresentation;
- a trust deed lien will be recorded on the property described in the application to secure the loan;
- the property will not be used for any illegal purposes;
- the purpose of the application is to induce the lender to lend funds to the borrower;
- the property will be occupied as represented in the application;
- the lender will retain the application whether or not it decides to fund the loan;
- the borrower will amend the application and resubmit it to the lender if the facts originally stated substantially change;
- if the borrower defaults on the loan, the default will be reported to one or more credit reporting agencies;
- the borrower may assign the loan to others, though the borrower will not be able to sell the property subject to the same rights as the lender to assign its position;
- the lender or any of its affiliates has made no representations about the value of the property which will secure the loan if funded;
- an emailed or faxed version of the loan application is equally valid as the printed copy of the form; and

- the lender is authorized to verify all aspects of the loan application as represented by the borrower.

The bottom of the loan application, section ten, contains a non-mandatory portion specifying the borrower's **ethnicity, race and gender**. This portion of the loan application is used by the federal government to monitor the lender involved and ensure its compliance with fair housing, equal credit opportunity, and home mortgage disclosure laws.

The bottom of section ten is to be completed by the loan representative who assisted the borrower to complete the application. The loan representative is to indicate how the application was taken, whether in a face-to-face interview with the borrower, through the mail, over the phone, or via the internet.

Self-employed buyer exposed

The buyer is to mark the checkbox in section four to indicate if he is self-employed. A self-employed buyer is typically required to provide a lender with:

- a signed Internal Revenue Service (IRS) Form 4506 (Request for Copy of Tax Form); [See **first tuesday** Form 215]

- copies of the buyer's income tax returns for at least the past two years; and

- copies of his financial statements. [See **first tuesday** Forms 207 and 207-1]

With a signed copy of **first tuesday** Form 215 (IRS 4506) and copies of the buyer's tax forms, the lender is authorized to confirm with the IRS the authenticity of income information submitted by the self-employed buyer. The lender may, within one year of the date noted by the signature on Form 215 (IRS 4506), request copies of income tax forms previously filed with the IRS. Thus, to put an end to a lender's later inquiry with the IRS after one year, Form 215 (IRS 4506), must be dated by the buyer.

Also, the Department of Housing and Urban Development (HUD) requires a lender who files Form 215 (IRS 4506) with the IRS to report any discrepancies between the information provided by the buyer and the information received from the IRS.

Self-employed buyers may find HUD's requirements disconcerting, fearing the request will trigger a tax audit for reasons not known to the buyer. However, HUD's regulations were initiated to prevent potential borrowers from presenting lenders with phony, unfilled tax documents as verification of their income.

Editor's note — It can take up to 45 days to receive the tax returns requested with Form 215 (IRS 4506). Thus, lenders rarely use the form prior to closing, but do so on a later default to check for fraud, unless the one year period has run.

A buyer can also use Form 4506 to obtain copies of lost W-2 forms. The Internal Revenue Service does not charge a fee for copies of W-2's.

RESPA and TILA disclosures

The Real Estate Settlement Procedures Act (RESPA) mandates lenders active in the secondary mortgage market must disclose all loan related charges on loans used to purchase one-to-four unit residential properties, such as origination fees, credit report fees, insurance costs and prepaid interest.

On adjustable rate mortgages (ARMs), the lender must inform the buyer not only of the interest rate, but also the index, margin and payment and interest rate caps. [See **first tuesday** Form 320]

The RESPA lender must provide the buyer with the following:

- a good faith estimate (GFE) of all loan related charges listed in Section L of the HUD-1 statement within three days after the lender's receipt of the borrower's loan application [24 Code of Federal Regulations §3500.7; see **first tuesday** Form 204 (DRE 883)];

- a copy of the HUD-published special information booklet, titled Buying Your Home – Settlement Costs and Helpful Information, within three days after the lender's receipt of the borrower's application [24 CFR §3500.6]; and

- a HUD-1 or HUD-1A closing statement detailing all charges. [24 CFR §3500.10(b); see **first tuesday** Form 402]

If the buyer is arranging financing through a mortgage loan broker, the broker, not the lender, must provide a copy of the special information booklet to the buyer. [24 CFR §3500.6(a)(1)]

However, the booklet does not need to be given to the buyer if the loan funds for are for:

- the refinance of an existing mortgage;

- a closed-end loan in which the lender takes a subordinate lien;

- a reverse mortgage; and

- any federally related loan that will not be used for the purchase of a one-to-four unit residential property. [24 CFR §3500.6(a)(3)]

Federal TILA disclosures, given to the buyer along with the GFE by the lender within three business days of receipt of the buyer's loan application, are designed to give the buyer standardized loan information for easy comparison of terms between loans offered by different lenders. [See **first tuesday** Form 221]

Reg Z implements the TILA disclosures required on federally defined consumer financing. Consumer financing, also called Reg Z financing or, more clearly, personal-use financing, arises out of:

- real estate loans, their assumptions or refinance;

- personal property loans; and

- carryback financing by dealers.

Situations requiring Reg Z disclosures by the lender to the buyer include:

1. Purchase-assist loans for buyers to acquire property:

    1.1 One-or two-unit residential properties to be occupied by the buyer as his principal residence. [12 Code of Federal Regulations §226.3(a)(4)]

1.2 A vacation home or second home which will be occupied by the buyer more than 14 days during the coming year. [12 CFR §226.3(a)(3)]

1.3 Recreational land to be acquired for the personal use of the buyer. [12 CFR §226.3(a)(3)]

Editor's note – No Reg Z disclosures are required for business, investment, or agricultural acquisitions or for purchase-assist loans for three or more residential units whether or not the borrower occupies. [12 CFR §226.3(a)(4)]

2. Further encumbrance (equity) loans on any type of property already owned by the buyer:

2.1 Loans funding personal, family, or household uses secured by any type of property. [12 CFR §226.2(a)(12)]

2.2 Loans funding the maintenance and repair of a one-to-four unit residential property owned and occupied by the buyer. [12 CFR §226.3(a)(4)]

2.3 Net proceeds from the loan are for deposit into the buyer's personal account. [12 CFR §226.3 (a)(2)]

Editor's note – All other equity loans are exempt from Reg Z disclosures.

3. Refinance of an existing loan on any type of property:

3.1 A new loan funding the payoff of a loan which was originated or assumed by the owner as a personal-use loan subject to Reg Z. [12 CFR §226.20(a)]

Editor's note – No other refinancing requires Reg Z disclosures, even if secured by the principal residence.

When a loan is subject to both RESPA and TILA, the timing for Regulation Z (Reg Z) disclosures required by TILA are accelerated and included with the RESPA disclosures. The Reg Z disclosures state the terms of the financing and include an itemization of the loan costs incurred by the buyer, including finance charges, interest rates, payment schedules and the APR. [12 CFR §§226.17, 226.18; see **first tuesday** Form 221]

In practice, the RESPA lender originating a personal use mortgage makes the Reg Z disclosures, twice:

- within three days after the lender receives the buyer's loan application; and
- before the buyer signs the loan documents.

The terms of these two disclosures tend to vary from one to another, with the pre-closing disclosure typically containing higher costs and rates than those stated in the lender's original Reg Z disclosure. This inconsistency is the reason a prudent TA should advise his buyer to submit multiple loan applications.

Property appraisal

Once a lender receives a loan application and any processing fee, the property is appraised by a representative of the lender to determine if the property qualifies for a loan. [See **first tuesday** Forms 218 and 228]

The appraisal determines whether the property is of sufficient value to support the amount of financing the buyer requests, principally, whether the loan-to-value (LTV) ratio meets the lender's standards.

Generally, an acceptable LTV for conventional loans is 80% of the property's value, requiring the buyer to make a minimum 20% down payment. A greater LTV compels the prudent lender to require the buyer to obtain private mortgage insurance (PMI).

The lender may reject the loan application by approving a loan of a lower amount if the property value is not adequate to secure the loan amount sought, even if the buyer is qualified to borrow the amount requested. The value limitation is used to limit loan amounts during downturns in the market value of real estate, rather than during a rapidly rising market (as it should). Thus, swings in values throughout an economic cycle are exacerbated by the conduct of lenders.

The loan application package

Once a lender approves property based on an appraisal, a loan package is assembled and sent to a loan committee or underwriting officer for review.

The loan package prepared by the lender includes:

- the loan application [See **first tuesday** Form 207 (FNMA 1020)];
- the property appraisal report [See **first tuesday** Form 200];
- a credit report on the buyer;
- the lender's verifications of the information provided on the loan application [See **first tuesday** Forms 208, 208-1, 209, 210, 210-1, 212, 215, and 215-1];
- the purchase agreement, escrow instructions and condition of property disclosure statement handed to the buyer by the seller and broker [See **first tuesday** Forms 150 and 304]; and
- other documentation needed to support the buyer's request, including operation balance sheets, tax returns, IRS Form 4506, title reports and bank statements.

Post-submission: TA duties still exist

Even after the loan application has been submitted to the lender, the TA's duty to the buyer to continue to oversee the functioning of the lender has not been extinguished.

To program his continued engagement in the transaction, the TA uses the Tracking the Loan Origination Process, **first tuesday** Form 339, to set a schedule with the loan representative for when the loan processing activities are to occur. This form provides the TA with a clear picture of what events are to take place and when, and if they are not timely handled by the lender, provides the TA with the opportunity to get on the phone and remedy the failure and get the process back on track. [See **first tuesday** Form 339]

After submission of the loan application, it is the TA's obligation to police the lender, follow up on his inquiries to the lender's loan representative, and get weekly updates to keep the underlying transaction

on schedule for closing. Since closing the sales transaction is contingent on obtaining a loan, the TA does not want the buyer he represents to lose the deal, and in turn cause the TA to lose his fee, due to any lender inadequacies.

Progress reports from the lender to the TA must be agreed to with the loan representative. This will likely require the buyer to give authority to the lender to discuss the loan handling with the TA. Though the lender will likely resist any attempt to allow oversight of its actions, the buyer's interests are best served by the TA's **continued oversight** of the time set for completion of each stage of the loan packaging process to ensure delays are avoided.

The TA has a duty of care owed to his buyer to protect against known foreseeable harm and loss of money in the form of extra interest and charges taken by the lender.

"Willing and able" to pay

A loan committee or underwriting officer evaluating a loan package considers a buyer's **capacity** and desire to pay. On the loan application, the buyer provides information regarding personal and housing expenses, both current and estimated, and details of the real estate purchase and loan costs.

Generally, the debt-to-income standard for conventional loans, also called the debt-to-income ratio, limits the buyer's:

- monthly payments for the maximum purchase-assist loan, including impounds for hazard insurance premiums and property taxes, to approximately 31% of the buyer's monthly gross income; and

- long-term debt, plus the monthly payments, to approximately 41% of the buyer's gross monthly income. [See **first tuesday** Forms 229-1, 229-2 and 230]

Lenders use debt-to-income ratios to evaluate the buyer's ability to make timely loan payments, called *buyer capacity*. Lenders may approve a higher debt-to-income ratio if a large down payment is made, or the buyer has valuable assets and carries little debt — and when competition between lenders to originate purchase-assist loans intensifies. [See **first tuesday** Form 230]

The buyer's willingness to make his loan payment is evidenced by the credit report. The credit history demonstrates to the lender whether or not the buyer has a propensity to pay, called creditworthiness.

The debt-to-income ratios can be adjusted depending on one or more compensating factors, such as if the buyer has:

- ample cash reserves;

- a low LTV ratio; and

- spent more than five years at the same place of employment.

The buyer's agent should press the lender to his client's advantage if these compensating factors exist.

Loan approval

A loan approval issued by a lender is often conditioned on a buyer providing more necessary information, for example:

- the property's condition may need correction;
- title may need clearing of defects;
- the buyer may be asked to explain or eliminate derogatories on his credit report; or
- the buyer's long- or short-term debt must be reduced.

To obtain final approval and funding, the buyer must correct any problems to the lender's satisfaction.

Once loan conditions are met and verified, the loan is classified as approved. Escrow calls for loan documents and funds, and on funding, the sales transaction is closed.

Agents must constantly remind themselves that what one lender will not accept as a risk presented by the buyer or the property, another will evaluate and set interest rates according to the risk present by the loan requested by the buyer. More often than not, a lender exists who will make a loan of some amount and under some conditions to nearly any buyer. It is the business of lenders to do so.

Chapter 37 A lender's loan commitment

This chapter analyzes a borrower's reliance on a lender's oral or written commitment to fund a loan.

No responsibility for oral or conditional promises

An owner of industrial land and a manufacturing business he operates on his property applies for a loan from an institutional lender to upgrade and expand his production facilities, and construct additional improvements on the property. The owner has a long-standing business relationship with the lender, having borrowed from them several times over the years.

The lender's loan officer, after processing the loan application, **orally assures** the owner they will provide the long-term financing he will need, called a *take out loan*, to pay off short-term interim financing he will obtain to fund the purchase of equipment and cost of construction. Relying on the lender's oral assurances, the owner enters into a series of short-term loans and credit arrangements with other lenders and suppliers, and begins the planned improvements.

The loan officer visits the owner's plant during the construction and placement of equipment. The officer comments favorably on the work in progress and again assures the owner the lender will provide the long-term financing sought by the owner.

When completed, the owner makes a demand on the lender to fund the permanent financing. The lender refuses, informing the owner the business no longer has the value needed to justify the long-term financing since operating costs and a business recession have decreased the value of the owner's facilities.

The owner is unable to obtain refinancing elsewhere, and the business and real estate is lost on default in the short-term financing. The owner seeks to recover his money losses from the lender, claiming the lender breached its commitment to provide financing.

Can the owner recover damages from the lender?

No! The lender never entered into an enforceable **loan commitment**. Nothing was placed in writing or signed by the lender which **unconditionally committed** the lender to the specific terms of a loan.

Even though the lender orally assured the owner a loan would be funded, and despite the owner's reliance on his pre-existing business relationship with the lender to fund his expansion, the owner was not justified in relying on the lender's oral commitment to fund a loan. [**Kruse** v. **Bank of America** (1988) 202 CA3d 38]

Lenders rarely make written loan commitments. When lenders do, they are limited to federally mandated nonbinding disclosures on single family residence (SFR) loans under Regulation Z, also known as the Truth-in-Lending Act (TILA).

Lenders customarily process applications and prepare loan documents, but they are only signed by the borrower. The lender orally advises the borrower whether the loan has been approved, but signs nothing that binds them. The first and only act committing the lender is its actual funding of the loan — at the time of closing.

Thus, until the lender literally delivers funds and a closing has occurred, the lender can back out of its oral commitment at any time, without liability.

As a result, the balance of power is entirely with the lenders. Thus, mortgage borrowers are forced to rely on unenforceable oral promises when making financial decisions in real estate transactions.

When a lender breaches its oral commitment to lend, the borrower's reliance on anything less than an **unconditional written loan commitment** is not legally justified — even though the borrower had no realistic choice other than to rely on the lender's oral promises.

As a result, prudent borrowers and their agents submit loan applications to more than one lender to guard against these sorts of last-minute surprises.

Commitment upon commitment

The only other course of action a borrower could reasonably undertake is to purchase a **written loan commitment**, paying for the assurance funds will be advanced on the borrower's request. However, these commitments, which are *put options,* are always conditional, never absolute. The lender is allowed to deny a loan even after delivering a written loan commitment to the borrower — again, without liability.

Here's why. A borrower seeks a loan to purchase real estate and the business opportunity located on the premises. The borrower pays $10,000 for a **written conditional loan commitment** from a lender — a letter signed by the lender indicating the lender's intention to fund the loan, based on the satisfaction of a number of conditions, including:

- an appraisal of the personal property and real estate which is to secure the loan;
- the seller, who is carrying back a second, must approve the terms of the loan agreement;
- the borrower must deliver copies of all documents affecting the lender's decision, such as security agreements, guarantees, title reports, trust deeds, and leases, for the lender's approval; and
- approval of the loan by the lender's senior committee.

Later, the lender **verbally assures** the borrower the loan will be funded, stating the members of the senior committee have all approved the loan and all other conditions have been met.

However, when the borrower asks the lender to proceed to close the loan, the lender does not waive the conditions. Ultimately, on demand from the borrower for the funds, the lender refuses to fund the loan.

The borrower is able to obtain another loan from his back-up lender, but on less favorable terms than set out in the lender's written commitment. The borrower seeks to recover his money losses from the lender who refused to fund his loan application, claiming the lender breached its written loan commitment.

The lender claims it did not breach its written commitment since the commitment was conditional.

Can the borrower recover his losses from the lender?

No! Even though the borrower paid the lender for a written conditional loan commitment, the lender never agreed to a final and unconditional written commitment. Thus, the lender escapes liability for failure to perform on its commitment, despite oral assurances to the borrower it would fund the loan agreed in writing. [**Careau & Co.** v. **Security Pacific Business Credit, Inc.** (1990) 222 CA3d 1371]

Chapter 38 Referral fees: by lender or escrow

This chapter analyzes redundant charges imposed on buyers and sellers for the basic services necessarily rendered by lenders, escrow companies and title insurance companies to earn the primary fee they charge.

The hidden costs surrounding a loan

A homebuyer's obligation to close escrow on a purchase agreement is typically conditioned by a contract provision requiring the buyer to obtain satisfactory **purchase-assist financing**. The loan contingency provision activates two federal mortgage laws which, in addition to California laws, control the disclosures and charges of all **third-party participants** in the sales transaction, called *service providers.* The charges for services rendered by the **service providers** are called *transactional costs*.

Consider a buyer who needs financing to acquire a home. The buyer's real estate agent, called a *transaction agent* by lenders, refers him to a lender whose loan representative claims its costs for originating a purchase-assist loan, called *settlement costs* or *closing/escrow costs,* are the lowest available. The claim of low costs is rooted in the presumption that **interest quotes** from all lenders are the same — which they are not, some are based on *par rates* and others add a *yield spread premium* (YSP) rate for commissions.

After reviewing the loan representative's written **good faith estimate (GFE)** containing his lender's rates, all loan related charges, and third-party settlement costs, the buyer submits a loan application to that lender as mandated by both state and federal mortgage law. The lender is not paid an upfront fee for processing the loan application. [See **first tuesday** Form 204 (DRE 883)]

Three days after submitting the loan application, the buyer receives a second, *refreshed* GFE and a Truth-in-Lending Act (TILA) **Regulation Z disclosure statement** from the lender as required by federal mortgage law on personal-use loans. The TILA disclosure itemizes the specific **loan terms** offered by the lender to the buyer, such as the annual percentage rate (APR), amount financed, finance charges, and interest rate. [See **first tuesday** Form 221]

The buyer discovers the loan closing costs and interest rate now disclosed by the lender in the refreshed GFE and TILA disclosure are substantially higher than previously quoted by the loan representative in the initial GFE given to the buyer.

The buyer and his agent contact the loan representative and question the increased fees and raised interest rate. The buyer insists the lender honor the costs and rate estimates given in the initial GFE which induced him to submit the loan application, since costs and interest rates have not changed.

The lender's loan representative assures the buyer the second GFE and TILA disclosure represent a legal formality which overestimates the actual closing costs and interest rate so figures for a worst case scenario can be provided to potential buyers/borrowers.

The buyer is **not advised** by his agent to:

- submit a back-up loan application to another lender as a precaution; or

- obtain a written representation from the lender's loan representative reconfirming the lower closing costs then stated in the refreshed GFE and TILA disclosure.

The lender processes the buyer's loan application and eventually qualifies the buyer and the property.

The lender's loan representative advises the buyer the loan documents are ready and must be immediately signed and recorded before the end of the month. The buyer is also informed that if the terms of the loan are unacceptable, the loan offer will expire and the loan process will have to start anew next month. The loan representative warns the buyer of the potential for interest rates to rise.

Contrary to the earlier assurances of the lender's loan representative, the buyer's actual loan costs and interest rate on closing are nearly identical to the higher, refreshed GFE and TILA disclosure given to the buyer three business days after submitting his loan application. The buyer now objects to paying the additional fees and the higher interest rate.

The lender refuses to adjust the closing charges and claims the interest rate is the current market rate, taking into account the buyer's discount (prepaid interest) charge, sometimes called *points*. The buyer then turns to his agent for advice. The agent recommends the buyer pay the lender's fees, suggesting they are **customary costs** for a new loan.

The buyer now needs to close the deal and take possession of the property since his family is committed to the purchase and they are beyond the **point of no return**. Thus, the buyer pays the lender's fees and agrees to the higher interest rate, both of which were measurable greater than orally promised by the loan representative and set out in the initial GFE. The transaction closes and the agent is paid his broker fee through escrow.

Is it reasonable for the buyer's agent to allow his buyer to rely on the loan representative's oral representation about the purpose of the post-application GFE and TILA disclosure made by the lender?

No! The lender may charge the buyer the amounts listed on its post-application GFE and TILA disclosure since no change in those charges were made at the time of closing. More importantly, the lender may at the time of closing alter the various charges by merely issuing an amended TILA disclosure or yet another GFE, without regard to the oral assurances given by the lender or its loan representative.

An oral agreement with a lender or its loan representative is not legally binding, nor is the TILA disclosure or GFE. This includes the first copy given to the buyer to induce him to submit a loan application and the second, refreshed copy given three days after submission of the loan application. [**Kruse** v. **Bank of America** (1988) 202 CA3d 38]

A separate, concurrent loan application submitted to another mortgage lender is the best tool available for a buyer to protect himself against lost expectations and overcharges when finally presented with loan documents at the time of closing. Multiple loan applications pit one lender against another in the mortgage market, reducing the tendency of a lender to increase fees and rates when no competing lender exists at the time of closing.

Par rates used for setting the value of a new loan origination are the rates used by mortgage lenders, and vary little from one lender to the next at any time. It is the commissioned loan representative's YSP, a rate of interest the loan representative tacks onto the loan's **par rate** set by the secondary market to increase his compensation for arranging the loan, which artificially increases the rate of interest on the loan. This increase takes place without the knowledge or consent of the loan representative's borrower, the buyer.

However, additional fees, higher interest rates, and miscellaneous charges sought by different lenders and loan brokers at the time of closing will only begin to evaporate — in spite of the law — when the buyer has submitted multiple loan applications to different lenders.

Duplicate charge for same service

Real estate sales transactions during periods of rising property values are increasingly subject to duplicate charges imposed on both buyers and sellers by brokers, lenders, escrow agencies and title companies. **Duplicate charges** for integral services, called *kickbacks* or *hidden costs* based on who ultimately receives the funds, are redundancies constantly experienced by the buying and selling public, in violation of The Real Estate Settlement Procedures Act (RESPA).

Public policy and sound economics suggest that duplicate charges are improper and make the real estate market less efficient. The charging of garbage fees usually results from the systematic elimination of more competent and less costly competition. Also, **kickbacks** to listing and selling brokers (and builders), which are a violation of federal RESPA laws, are openly undertaken by some mortgage lenders, to say nothing about the conduct of the largest title insurance companies, in an illegal effort to garner a greater share of the available business.

Kickbacks are a **corrupting business policy**. Legitimate operators find it difficult to compete with fraud without also stooping to the same fraudulent actions to meet the corrupt competition. Kickbacks, in the form of referral fees or other indirect financial benefits used to steer or capture business, deliberately interfere with the availability of lower rate loans with fewer charges. The buyer is referred to the lender (or title company) who provides the largest kickback, away from the legitimate non-participating competition who will not take part in the consumer fraud.

All brokers and agents in a sales transaction, called *transaction agents*, are prohibited from accepting a **referral fee** for advising parties to employ a particular service provider. The payment of a referral fee by escrow companies, escrow officers, pest control operators, security installers and title insurance companies is specifically prohibited by state law.

Although it should, California legislation does not prohibit the payment of broker referral fees by lenders, or anyone else who renders closing services as a third party in a real estate transaction, if the broker is already collecting a fee for acting on behalf of a principal. Brokers are now limited to merely disclosing to their principal the amount of the referral fee they are receiving. [Calif. Business & Professions Code §10177.4; see **first tuesday** Form 119]

Real estate agents who are employed by a broker (which they must to act as licensees) face a similar prohibition in real estate transactions. Agents acting under their licenses are not permitted to accept a fee or other benefit from any person other than their employing broker, or to pay a fee to any other broker or agent without first directing the payment through their employing broker. [Bus & P C §10137]

For example, an individual licensee, either a broker or sales agent, refers a prospective client to another agent under an agreement to receive one half of the broker fee paid to the agent. While the broker's agent can agree to split the fee, unless prohibited by his employing broker, the agent does so on behalf of his broker.

Thus, the agent must instruct his employing broker to make the payment of the referral fee to the other agent's broker out of the funds earned by the agent as a result of the referral. The agent may not first receive the fee due him from his broker and then pay the referral fee directly to the referring licensee.

Most importantly, the broker or his agent undertaking the representation of a client **must advise** the client of the dollar amount of any referral fee or other benefit they receive from any provider of services arising out of the client's real estate transaction. If the fee or benefit received as compensation for the referral is not disclosed, this non-disclosure is punishable by suspension or revocation of the employing broker's or the agent's license, or both. [Bus & P C §10176(g); see **first tuesday** Form 119]

Double fees, padded charges, same service

Lenders improperly commingle the labeling of all charges listed on loan disclosure estimates as *fees*. In fact, analysis classifies three types of **lender charges**:

- **fees** for lender-performed services integral to the *administrative process* of originating a loan;

- **costs** incurred and paid by the lender and passed on to the borrower for services performed by third parties (such as appraisers and credit reporting agencies); and

- **prepaid interest** in the form of loan discounts and points paid to buy-down the interest rate from the lender's **par rate** or to produce additional earnings for the lender.

Thus, three forms of lender corruption exist:

- fees **charged twice** for the same loan origination service, usually fragmented into several listed services, the aggregate of which are simply the minimum necessary loan origination activities continuously performed by lenders in every loan transaction;

- **padded charges** which overstate the lender's actual out-of-pocket costs for third party services, or are paid to third parties for steering business to lenders; and

The interest rate game

Another abuse practiced by some lenders, particularly their commissioned loan representatives, during the loan processing period arises out of interest rate "lock-in" agreements.

It is understood that interest rates fluctuate daily during the loan application process. However, at any point in the loan application process, the lender may offer to freeze (lock-in) the interest rate for the buyer.

A rate lock-in is beneficial to the lender when interest rates are in a declining mode. Thus, lenders will advise buyers to lock-in the rate when interest rates are declining, ironically based on the stated logic they will rise again, which of course they will.

Conversely, a buyer who agrees to lock-in the rate in a rising interest rate market should obtain a **written lock-in agreement** from the lender regarding interest and points.

A lender orally promising to lock-in the interest rate (whether it is rising or falling) can later refuse to honor their commitment to the rate since an oral agreement with a lender is unenforceable. [Kruse, *supra*]

- **higher interest rates** charged on loans than the lender's par rate to provide the lender with earnings in the form of a YSP taken through **table funding** or later resale of the loan.

RESPA bars second-fee, same-service scams

All **providers of services** to buyers and sellers to open and close a real estate transaction which involves the origination of a *federally-related loan* must comply with the requirements of RESPA, also known as *Regulation X*.

A **federally-related loan** which triggers the control of costs under RESPA is a loan originated and secured by a trust deed lien on:

- one-to-four unit residential property; or

- manufactured housing;

WHICH IS

- made by a lender who annually invests or originates loans retained in the lender's portfolio totaling over $1,000,000;

- made by a federally insured bank or thrift;

- eligible for purchase in the secondary mortgage market by the Federal National Mortgage Association (Fannie Mae), Federal Home Loan Mortgage Corporation (Freddie Mac) or the Government National Mortgage Association (Ginnie Mae); or

- is insured by the Federal Housing Administration (FHA) or the Veterans Administration (VA). [24 Code of Federal Regulations §3500.2(b)]

For example, RESPA establishes a *no-new-service, no-second-fee* restriction on the earnings a transaction agent, lender, mortgage loan broker, or escrow or title insurer, called a *service provider*, while rendering services on behalf of a buyer or seller in a real estate transaction financed by the origination of a RESPA loan. These transactions are typically single family residences (SFRs) bought with funds from a purchase-assist loan.

Service providers may charge a fee in any amount reasonably related to the bundle of *general services* included in their basic fee, whether the fee is for brokerage, escrowing, loan processing, appraisal reports, pest control or home inspection reports, attorney's fees, or a title search. The basic fee is almost always permitted to be charged, no matter the amount, for these settlement services. Competition among providers offering the same services will keep the buyer, seller or borrower from being overcharged for transactional costs – the goal of RESPA.

For a fee to qualify as a charge for a *settlement service* and be collectible by a broker, escrow or lender from a buyer, seller or borrower in a RESPA transaction (purchase-assist loan on the sale of one-to-four residential units), the services performed by the broker, escrow, or lender must:

- directly benefit the buyer, seller or borrower; or

- be performed at or before the closing. [**Cohen** v. **J.P. Morgan Chase & Co.** (2nd Cir. 2007) 439 F3d 111]

Further, any fee charged in addition to the basic fee for services performed at or before closing can not be a **surcharge** for:

- an itemized service which duplicates any part of the *general services* implicitly rendered in exchange for the **basic** brokerage fee, escrow fee or loan processing fee, and thus increases its price;

- general *administrative costs* of the broker, escrow, or lender for transaction coordinators, bookkeepers, business insurance, furnishings, fee sharing, broker-mandated trade union dues and other operating overhead, costs implicitly covered in the basic brokerage fee, escrow fee or loan processing fee, or activities such as regulatory compliance requiring employee oversight/supervision and file maintenance;

- *improved services* by upgrades in training, online assistance, equipment or graduating office rent to better support the buyer, seller or borrower; or

- *assisting* buyers or sellers *to locate* property or prospective buyers through advertising, discounted fees, referral fee sharing and the like.

Before a broker, escrow, lender or other provider of services may collect a fee for any **separately listed service**, a.k.a. garbage fees or junk fees, paid in connection with the **creation and closing** of a RESPA controlled real estate transaction, an *underlying basis* must exist to support that separate fee. Unless an underlying basis for the fee exists, the service will be barred as a violation of RESPA.

If the service itemized as the additional junk fee is a service the broker, escrow or lender renders to most buyers, sellers or borrowers in the creation or closing of the sales transaction, the additional fee is barred as a **duplicate charge** since the service is implicitly included and thus paid for in the basic fee which, if allowed, would simply increase the price of that service, a prohibited double-pricing activity.

For the additional brokerage/escrow/loan fee with its separately stated service to be collectible, the service itemized must be another and different service – **extra service** – not *normally provided* to most buyers, sellers or borrowers prior to or at the close of the sales transaction. If the itemized service is a service normally performed and integral to the completion of the services the broker/escrow/lender agreed to render, then it is a **basic service** covered implicitly in the basic charge for the services of the provider – the broker, escrow, lender, title company, etc, and is thus uncollectible.

In the end, RESPA merely requires the provider of services, be he the broker, escrow, lender or others, to adjust their basic fee to cover their costs and allow for a profit; not to add miscellaneous junk fees as surcharges to increase the revenues they receive for what actually is part of their basic service.

With **one-tier pricing**, the customer can compare the advertised fee for the list of services to be rendered, one broker's services against another's, without the nickel-and-dime effect of surcharges to add the maze of a "bonus feature," a deceit upon the public.

Consider a prospective buyer who enters into a listing agreement with a selling broker. A 3% broker fee due on closing is negotiated for finding a suitable property for the buyer. The broker locates a suitable one-to-four unit residential property, the purchase of which will be financed by a federally related loan, subjecting the transaction to RESPA.

On closing, the broker charges the buyer an additional fee, a surcharge to defray his overhead costs (transaction agent) in addition to the agreed-to 3% broker fee. The buyer refuses to pay the surcharge fee, claiming it violates RESPA's **no-new-service, no-second-fee** prohibition since no additional, beneficial service was provided by the broker to support the fee.

Can the broker surcharge the buyer a fee for basic services which are normally provided by the transaction agent when representing a buyer?

No! The surcharge fee violates RESPA's no-new-service, no-second-fee regulation since no additional service was provided. Thus, no additional settlement service fee – the surcharge – was "earned" by the broker to be charged the buyer. [**Busby** v. **JRHBW Realty, Inc.** (April 20, 2009) __ F.Supp__]

Further, a lender or mortgage loan broker is prohibited from paying a fee to a commissioned transaction agent who represents the seller or the buyer in a sale which will be funded by a RESPA loan, unless the transaction agent performs significant services on behalf of the lender for which the fee is paid. Thus, a transaction agent (the broker) may **receive** a **second fee** if he renders significant loan origination services which would otherwise be performed by the lender.

A second fee cannot be paid to any transaction agent simply for directing the buyer to the lender who will make the loan. That type of referral fee, a second fee on the same transaction without more than the effort of referring, is illegal to pay or receive.

For example, a broker and his agent are entitled to a **second fee** in a sales transaction if the fee is for their handling the loan escrow or processing the loan application and loan documents. These services are significant since they are not normally performed by a transaction agent (broker) as part of their representation of buyers and sellers. They are additional closing services provided under separate contracts from the listing employments in a sales transaction.

Conversely, the advice and counsel given a buyer or seller as to which lender (or escrow, title insurance company, etc.) to use is part of the assistance and services expected by clients for the basic brokerage fee compensation the transaction agent receives on the sale.

A lender and transaction agent (broker) are in compliance with the no-new-service, no-second-fee rule if the earnings the broker is to receive for the **second service** were due as:

- payment for **goods**; or

- payment for **services rendered**, other than the referral. [12 United States Code §2607(c)]

A transaction agent can be paid and accept an additional fee for a **second service** he performs, such as a fee paid by a lender to the sales broker (or agent). However, the broker or the agent acting as a transaction agent must perform at least **five** loan origination activities normally performed by the lender or a loan broker to justify the fee. Further, if sufficient loan origination activities are performed by the transaction agent, then the second fee must be further *justified* as a dollar amount others would be paid to competitively perform the same services.

A minimum number of **loan origination services** must be performed by the transaction agent before any fee is *justified*. Consider a transaction agent who initiates the performance of loan services by assisting the buyer in the preparation of the loan application to be submitted to the lender. To justify receipt of the second and loan related fee, the transaction agent must perform at least five of the following loan origination services:

- pre-qualify the buyer/borrower to determine the maximum loan amount he can afford by analyzing the buyer's/borrower's income and debt [See **first tuesday** Form 230];

- advise the buyer/borrower on the home-buying and purchase-assist loan process, about the different types of loans available, and the variations in costs, rates, and payments on the various loans;

- gather financial information from the buyer/borrower such as tax returns, profit and loss statements, bank statements, and balance sheets needed to complete the application process;

- order out verifications of employment and cash deposits [See **first tuesday** Forms 208, 208-1 and 209];

- order out requests for loan verification on other debts owed by the buyer/borrower [See **first tuesday** Forms 209, 210, 210-1 and 211];

- order out the appraisal to determine the property's fair market value (FMV) [See **first tuesday** Form 228];

- order out property inspection and engineering reports [See **first tuesday** Form 130];

- review with the buyer/borrower the process for clearing credit problems which might arise;

- apprise the buyer/borrower, broker, and lender of the status of the application, and what further information or documentation each needs to close, by continuing to conduct regular contacts after taking the loan application until the close of the transaction [See **first tuesday** Form 339];

- order out legal documents (statements) which are required for escrow to close, or a policy of title insurance to be issued;

- order out a flood hazard report on whether the property is located in a flood zone; and

- assist as an active participant in the closing of the loan. [HUD Policy Statement 1991-1, Section C]

However, if the five loan origination activities performed are **related only to counseling** (as contrasted to loan documentation efforts), then the sales transaction agent must:

- present and advise the buyer/borrower on the availability of loans from at least three different lenders (to avoid steering the buyer/borrower to a single lender);

- be paid a fee for his counseling services regardless of which lender is ultimately selected by the buyer/borrower; and

- inform the buyer/borrower that the fee paid for the transaction agent's loan origination services is a competitive rate based on the value of the services rendered, and not contingent or based on the loan amount or type of loan originated with the referred lender.

Profit from the yield spread premium (YSP)

Consider a buyer of real estate who contacts a loan broker for a purchase-assist loan. The loan broker assists the buyer in completing the loan application, counsels the buyer on loan programs, requests and gathers financial data on the buyer, analyzes the buyer's debt and income ratios, arranges appraisals and inspections, and prepares and hands the buyer RESPA disclosures, Reg Z disclosures, and other required notices. The loan broker then submits the loan package to a lender for approval and funding. [See **first tuesday** Forms 201 and 202]

For his compensation, the loan broker enters into a listing agreement with the buyer calling for a 1% loan origination fee for his services. The lender who will fund the loan publishes a daily **rate sheet** in which the lender offers to also pay the loan broker a fee.

The amount of the fee from the lender is based on the *present worth* of the **spread** between the lender's par rate quoted for the loan and the note rate the loan broker negotiates with the buyer, a difference in the value of the loan called the *yield spread premium (YSP)*. Total compensation paid by the buyer and the lender to the loan broker is around 2.5% of the loan amount. [See **first tuesday** Form 104]

After closing, the buyer determines the interest rate on his new loan is a little above the rate charged on other loans originated at the same time. The buyer then discovers the loan broker he employed received a kickback from the lender for the value of the YSP, a fact which was not previously disclosed by the loan broker or lender.

The buyer claims the loan broker's compensation which included the YSP was not agreed to and must be returned to the buyer since it constituted a kickback prohibited by RESPA and state agency law – the loan broker had "sold" the buyer a higher loan rate in order to earn an additional undisclosed and unapproved fee.

The loan broker claims the total compensation received for the services rendered to the lender by preparing the loan package was reasonable and not excessive, and thus not a violation of RESPA.

The buyer claims that compensation exceeding the agreed-to 1% origination fee and costs is excessive.

Has the loan broker violated RESPA by collecting a YSP from the lender?

No! The loan broker has provided compensable loan-related services for payment of the YSP. The buyer is unable to show that the loan broker's total compensation, inclusive of YSP, exceeded fees charged by competing loan brokers for the same services at the time. [**Dominguez** v. **Alliance Mortgage Company** (2002) 226 F. Supp2d 907]

However, a loan broker retained by a borrower must, under state agency law, disclose to his borrower all compensation he receives, from any source, when the earnings flow from the employment by his principal, the borrower. If not disclosed, the borrower can recover the entire fee the loan broker received on the transaction. This recovery of all fees paid to the loan broker also applies to a sales broker and his agent who are paid an undisclosed referral fee. [See **first tuesday** Form 119]

The broker-lender knot

This scenario is further aggravated by the conflicting *adversarial relationship* which legally exists between the buyer's selling agent, whose duty of care is owed to the buyer, and the lender, with whom the buyer's agent collaborates in the sales transaction to receive additional earnings. The buyer's agent has an obligation to the buyer to fully disclose any self dealings and additional compensation received in the transaction (such as the referral fee) to avoid violation of state agency law.

In the context of a real estate purchase, the buyer's agent is the buyer's most reliable and knowledgeable ally. This alliance extends beyond the moment the purchase agreement offer is accepted to all critical interactions with the lender who will fund the closing. The lender is not an agent of the buyer, but his **adversary**.

By negotiating a fee arrangement with the mortgage lender, the buyer's agent aligns himself with the lender, who is a hostile third party with a financial interest economically adverse to the buyer in the purchase transaction negotiated by the agent. [Kruse, *supra*]

The only fee a loan broker should charge, in addition to reimbursement for third-party provider costs, is an **administrative/processing fee** for the loan broker's non-interest earning activities performed prior to recording the loan. **Points and discounts** are the prepayment of interest on the loan, not compensation for arranging and making the loan.

Origination activity for which the loan broker charges a processing fee must, by necessity, include all the basic services required of the loan broker to actually arrange a loan, such as review the loan application, underwriting risk analysis, processing loan documents, and funding the loan, in addition to any other services the loan broker customarily performs to originate a loan.

Consider these basic rules: All real estate brokers and their agents are prohibited from knowingly underestimating lender closing costs. A selling broker's silence in the face of known lender misrepresentation to the buyer constitutes a breach of his agency duty. Additionally, it is the **selling (buyer's) agent's duty** to locate the best possible financial advantage readily available to the buyer – his client. [Bus & P C §§10176, 10177]

Yet, ironically, buyers are all too often left by their selling agents to single-handedly wrestle with the only adversarial element remaining at the time of closing, the lender who will fund the closing and has no duty to anyone but itself. [**Drennan** v. **Security Pacific National Bank** (1981) 28 C3d 764]

The selling agent, best fulfills his agency duty to his client by:

- bargaining with multiple lenders rather than forming a solitary alliance with a single lender or allowing only one loan application to be submitted, a condition where the buyer will, out of necessity, have to accept the terms of that lender at the time of closing;

- enlarging the number of lenders he regularly bargains with to obtain the most affordable and advantageous loan package for his clients (commonly called *working the marketplace*); and

- understanding that all oral representations made by lenders or their loan representatives to the agent or the client are worthless, unless put in writing and signed by the lender's representative.

Any of the following fees listed in addition to an administrative fee are **duplicate charges**:

- **document preparation fee**: for preparing the loan documents needed to originate the loan;

- **loan application fee**: for examining the buyer's credit history and determining whether he qualifies for the loan (typically, the charge for this service is part of, or credited to, the loan administrative processing fee rather than charged separately);

- **processing fee**: for the preparation of loan-related documents;

- **underwriting fee**: for lender's risk analysis and loan approval before funding a loan; and

- **warehousing fee**: for the mortgage lender's acquisition of money on a line of credit extended by a bank so it can fund the loan.

Fees for **inflated costs** incurred by the lender and passed on to the buyer include:

- **appraisal fee**: appraisers are paid $250 to $500 by the lender, depending on the value of the property in question, while the lender passes the appraisal cost on to his borrower at an increased amount;

- **credit report fee**: for obtaining the buyer's credit and telecheck report from a credit reporting agency (agencies typically provide credit and telecheck reports for around $10, while lenders generally pass on the charge at $70 or more); and

- **funding/wire fee**: charged by the lender for the transfer of funds from one account to another (the wire transaction itself costs around $15, while the lender generally passes on the charge at $50 to $300).

Lenders occasionally omit or misrepresent fees during the initial GFE prepared to induce a buyer to submit a loan application. Sensing their advantage in real estate transactions where **timing is everything**, lenders later add and increase fees by including them on the final (amended) GFE and TILA disclosure at the time of closing. At that moment in time, it is too late for the buyer to change lenders or successfully challenge the increased fees.

A competent buyer's agent managing the buyer's activity can prevent some of these unscrupulous charges from occurring. What must be understood by the buyer's agent is that the lender's product – money – is unpriced until closing. This holds true in spite of the GFE and TILA interest rate disclosures that are given to the buyer within three business days following the lender's receipt of the loan application. [See **first tuesday** Forms 204 (DRE 883) and 221]

The most competent buyer's agents have experience policing lenders and are aware of the methods they use to glean the highest rates, most points and garbage fees from the unprotected buyer. If the lender's tactics are anticipated by the buyer's agent, he can counsel the buyer to be on guard against any form of deceit. By doing so, the buyer's agent prevents the lender from pulling the wool over the buyer's eyes, as history has proven they are prone to do.

Lender disclosure requirements

A lender who makes a loan which funds the purchase of one-to-four unit residential property must provide the borrower with a **GFE** of all the *transactional costs* as mandated by RESPA within three days after the lender's receipt of the borrower's loan application. [12 CFR §226.19; see **first tuesday** Form 204 (DRE 883)]

Thus, if the loan funds a personal-use loan, such as a purchase assist loan for a principal residence, TILA disclosures regarding the *loan terms* are presented to the borrower by the earlier of:

- three business days after receiving the borrower's loan application (which is set by the time limit for presenting RESPA GFE cost disclosures); or

- prior to entering into a loan agreement, usually the loan escrow instructions. [12 CFR §226.19(a)]

These TILA loan disclosures include statements informing the buyer of:

- any possibility of interest rate or payment adjustments (variable rates);

- the formula used to make these adjustments;

- the manner in which the interest rate and payments will be determined; and

- the frequency of changes in the interest rate. [12 CFR 226.19(b)]

The purpose of TILA disclosure requirements is to promote homeownership through informed use of consumer credit and to discourage unnecessary or hidden costs to be charged to the buyer during a loan transaction. These objectives are accomplished through a comparative analysis by the buyer as provided by the lender's use of a uniform set of disclosures made by all competing lenders. [12 CFR 226.1(b); see **first tuesday** Form 221]

Although federal disclosure requirements are imposed to protect borrowers, the protection afforded is extremely limited.

For example, the lender may still alter the *loan terms* even after the original TILA disclosure has been delivered to the buyer. If the lender later changes the loan terms in a way which affects the interest rate and payments, the lender is merely required to issue a new TILA statement prior to funding the loan.

The **redisclosure requirement** at the time of funding does not apply when the lender alters any other loan terms, such as an increase in service charges for originating the loan. [12 CFR §226.19(a)(2)]

Erroneously, many buyers are not advised by their agents to shop around and contact multiple lenders for purchase-assist loans. Thus, the internet has become the alternative source of brokerage advice for buyers, and provides an expansive source of loan information (also available to curious real estate agents).

Multiple government agencies, both federal and state, promote the practice of submitting multiple applications. To assist the buyer with the task of comparing the costs and rates of two or more lenders, agencies such as the California Department of Corporations, Freddie Mac, the Federal Reserve, and the

Figure 1

ADJUSTABLE RATE MORTGAGE (ARM) DISCLOSURE WORKSHEET

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

This ARM worksheet discloses the terms of a loan plan entitled: _____

from _____ (Lender) by _____ (Loan Rep.)

for property referred to as: _____

INTEREST RATE:

1. The Note Rate of interest for this loan is comprised of a percentage figure from the selected rate index and the life-of-loan percentage margin agreed to. When the rate index figure changes prior to a scheduled adjustment in the note rate, the change will be reflected in an increase or decrease in the note rate on your loan.

2. The Note Rate is adjusted each _____ month(s) with the first adjustment_____.

2.1 Each Note Rate adjustment is ☐ unrestricted, or ☐ capped to increase no more than _____% or decrease no more than _____%.

2.2 During the life of the loan, the interest rate will not exceed _____% (the Note Ceiling Rate) and will not be less than _____% on your loan.

3. The initial interest rate is 1% and is not based on a rate index figure or the lender's margin rate for this loan.

3.1 The initial interest rate is in effect for a period of _____ month(s).

4. *Note rate* for this loan is calculated as follows: (index + margin = Note Rate)

4.1 Rate index name _____

4.2 Rate index percentage figure (current) . . . . . _____%

4.3 Percentage margin offered by lender (constant) . . . . . (+) _____%

4.4 **Note Rate** of interest (current) . . . . . (=) _____%

4.5 The Note Rate will be adjusted if a change occurs in the rate index figure (§4.2 above).

PAYMENT SCHEDULES:

5. ☐ Full amortization at all times during the life of the loan is a feature of this loan.

5.1 The life of this loan is for a term of _____ years.

5.2 Monthly payment due during the initial _____ month(s) of the loan will be $_____.

5.3 The amount of the monthly payment will be adjusted each _____ month(s) during the life of this loan.

5.4 The first adjustment in the amount of the monthly payment will occur _____.

5.5 The amount of the monthly payment at the Current Note Rate (§4.4 above) of _____% would be $_____.

5.6 The amount of the monthly payment at the Note Ceiling Rate (§2.2 above) of _____% would be $_____.

5.7 The amount of the monthly payment on a 15 year amortization payment schedule at the Note Ceiling Rate (§2.2 above) would be $_____.

6. ☐ Interest only payments are a feature of this loan. This interest only payment schedule feature avoids any build up in principal through negative amortization.

6.1 The amount of the monthly payments on this loan will be adjusted each _____ month(s) during the _____ year life of the loan, with the first adjustment to occur _____.

6.2 Interest-only payments may be made on this loan during the initial _____ month(s) of the loan's _____ year term.

6.3 Following the interest-only payment period, the principal balance of the loan will be amortized over the remaining _____ years of its term.

6.4 Monthly payments at the Note Ceiling Rate (§2.2 above) of _____% would be $_____.

7. ☐ Build up of the principal amount borrowed is a feature of this loan. Minimum monthly payments prior to resetting the payment schedule to fully amortize the loan over its remaining life leaves accrued interest unpaid which is added monthly to principal increasing the loan balance upon which interest thereafter accrues.

7.1 The amount of the monthly payment is adjusted each _____ month(s) with the first adjustment on _____, unless the principal balance of the loan previously reached _____% of the loan's original principal amount and reset the amount of the payments.

7.2 Increases in the amount of the monthly payment are ☐ unrestricted, or capped to increase no more than _____% each _____ months, until _____, or the month the principal balance of the loan reaches _____% of the loan's original principal amount, when the monthly payments reset to fully amortize the loan over its remaining term.

7.3 The minimum amount of the initial monthly payment for this loan is $_____ payable until the first adjustment in payments.

7.4 The amount of the monthly payment you would be required to pay to amortize this loan over 27 years at the Note Ceiling Rate (§2.2 above) of _____% when the principal balance reaches _____% of the original loan amount would be $_____.

a. The amount of the monthly payment required to amortize a loan balance of _____% of the original loan amount over 27 years at the Current Note Rate (§4.4 above) of _____% would be $_____.

8. LOAN ASSUMABILITY:

8.1. A due-on-sale clause ☐ does, or ☐ does not, exist in the trust deed.

8.2 Conditions for consent to an assumption on a resale:

_____

_____

_____

_____

_____

_____

9. PREPAYMENT PENALTY:

9.1 A prepayment penalty ☐ does, or ☐ does not, exist.

9.2 If a prepayment penalty exists, for what period does it apply? _____

9.3 The amount of the prepayment penalty may not exceed ☐ six months interest at the Note Rate on the sum of the remaining loan balance less 20% of the original note amount on any payoff within the first five years, or _____.

10. CONVERTIBLE TO A FIXED RATE:

10.1 The loan ☐ does, or ☐ does not, provide for convertibility to a fixed rate loan at the borrower's election.

10.2 If convertibility exists, during what period after origination may the loan be converted?_____

a. What rate index is used to calculate the fixed rate?_____(name)

b. What is the amount of the margin used to calculate the Note Rate on conversion? _____

c. Are there points? _____; fees? _____; or other charges on conversion? _____

11. Borrower's future monthly salary expectation:

11.1 first year: $_____ monthly amount.

11.2 second year: $_____ monthly amount.

11.3 third year: $_____ monthly amount.

12. ☐ A copy of the proposed note is attached.

I have reviewed the loan terms and probable consequences with the buyer.

Buyer's Selling Broker: _____

By: _____

Phone: _____

Fax: _____

Loan Rep: _____

By: _____

Phone: _____

Fax: _____

I have received a copy of this disclosure worksheet and have reviewed and understand the terms of this loan.

Date: _____, 20_____

Buyer's Name: _____

Buyer: _____

Buyer: _____

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Federal Trade Commission publish *Mortgage Shopping Worksheets*. These worksheets are designed to be completed by the buyer with the assistance of the buyer's agent. They contain two columns for itemizing all the variables commonly occurring at the time of origination or over the life of a loan.

After submitting loan applications to two lenders and receiving the corresponding GFE and TILA Reg Z disclosures, the buyer and his agent will possess all the information needed to fill in the columns, one for each lender. Once complete, the buyer and his agent can compare the terms offered by the competing lenders and proceed to act on the more advantageous offer. Information on available terms offered by different lenders can also be gathered from loan representatives and analyzed before submitting applications.

The California Department of Corporation's **Mortgage Shopping Worksheet** can be obtained at www.corp.ca.gov.

Avoiding unnecessary lender fees

A homebuyer can take steps to avoid unnecessary fees and stress caused by the lender, such as:

- seek out financing and pre-approval for a loan by a direct lender prior to entering into a purchase agreement with a seller;
- submit loan applications to **two** lenders on entering into a purchase agreement;
- attempt to advance only the lender's out-of-pocket costs (credit and appraisal reports) prior to funding of the loan, and then only after receiving the lender's GFE disclosure;
- consider offering the seller carryback financing as a less expensive alternative to a new loan; and
- demand signed estimates of interest rates (Reg Z related) and loan origination costs (RESPA related) from the lender's representative. If an adjustable rate mortgage (ARM) is arranged, the buyer must request an ARM disclosure statement be filled out by the lender's representative. [See Figure 1]

By submitting loan applications to **two lenders,** the buyer can:

- select the lender who, through comparative shopping, offers the best loan terms at the time of closing;
- lock-in the interest rate on one loan (in writing) and not lock in the other loan, which is subject to daily interest rate fluctuations; and
- negotiate with the lenders at the time of closing for fewer fees, using pre-application GFEs by the loan representatives as a wedge.

Lenders, of course, do not like to be competitive. Thus, they instinctively advise buyers not to submit multiple applications for credit (which will occur on multiple loan applications), wrongfully claiming additional applications will interfere with debt ratio analysis during the loan processing.

A buyer who submits applications to two lenders has retained a bargaining chip to protect himself against a lender who later:

- loads on the garbage fees at the time of closing; or
- is unable or unwilling to originate the loan on the terms initially represented by it, or at the lower prevailing **par rate** available elsewhere at the time of closing.

The submission of a loan application to one lender, even multiple lenders, does not commit the buyer to any obligation to any lender. Though a lender may disclose reasonable and competitive cost estimates (RESPA) and loan terms (TILA/Reg Z) before and at the time the initial loan application is submitted, luring the buyer to stay with them during the loan packaging process, the lender has no obligation not to boost its costs, fees or the interest rate at any later stage in the process, usually reserving these boosts for three days before closing.

If the estimate of costs and rates worked up by the loan representative prior to submission of the loan application are widely divergent from those furnished in the GFE and accompanying TILA annual percentage rate (APR) disclosures, the lender's true colors are instantly exposed. The buyer, with the proper guidance of the buyer's agent, can determine whether the loan representative gave them straightforward and honest information, or if the initial interview with the loan representative was a fabrication to entice the buyer to apply for a loan.

Although the second application doubles the buyer's application costs, these costs are minimal in comparison to the total dollar amounts involved in the transaction. The buyer's agent should not let the borrower be dissuaded on these grounds as this cost is the premium paid for covering the risk of changes at closing.

Escrow fees for "extras"

Escrow agents are subject to RESPA cost controls when a one-to-four unit residential property is the subject of their sales or loan escrow. Yet escrows have also jumped on the hidden-cost bandwagon by adding fees, but not additional services.

Rather than openly admitting to fee hikes and risk losing business to competitive RESPA compliant escrow officers, escrow companies generally advertise a low rate for **basic services**, and upon closing charge for services proclaimed as *extras*.

Extras are most frequently **fundamental services** necessary to the escrowing of every transaction. These necessary services are often separately itemized as additional charges as though the service was especially unique to this transaction and not a service performed as a necessary step. However, these charges are merely a duplication or redundancy of services necessarily performed as part of the basic service fee since the separately itemized services are an integral part of the services required to be performed by an escrow officer in every escrow.

Some escrow companies are vague with their definition of what services are included in a basic escrow transaction. However, basic escrow service includes any activity required of escrow in the routine services expected and rendered in most every transaction.

Duplicate fees commonly charged by escrow agents include:

- fees for drawing deeds and notes;

- a fee for complying with lender instructions and handling the lender's documents;

- an Internal Revenue Service (IRS) §1099 processing fee charged for filing a tax form (which is also separately prohibited) [Internal Revenue Code §6045(e)(3)]; and

- fees for notarizing signatures (which if allowed are limited to $10 per signature when performed at the escrow office). [Calif. Government Code §8211]

The fundamental events which constitute an escrow include:

- the receipt of funds from the buyer and lender (and, if deposited with a title company instead, any sub-escrow charge should be absorbed by escrow as a deduction from the client's escrow fee since the escrow did not handle the money which is a most normal function of escrow);

- preparation of the seller's grant deed and any carryback note and trust deed; and

- preparation of instructions for escrow's delivery of funds and documents on satisfaction of conditions, called an *escrow.* [Calif. Civil Code §1057]

Thus, the most basic escrow services — after preparing written instructions — are preparing deeds, notes and trust deeds, handling funds and documents from the buyer and the buyer's lender, ordering out reports and statements needed by escrow to comply with instructions and releasing all instruments on the close of escrow. One can recognize inclusive services by reviewing the boilerplate escrow instructions.

An escrow officer should be asked to provide a notary seal at their office. The office-place notary acknowledgment is capped by law at $10 per signature. However, notaries happily prefer to meet at the buyer's place of business or home, and then charge $100.00 or more per signature.

Any escrow company itemizing the above services separately from the basic service is double charging for a single basic service, a RESPA violation when a federally related loan is involved. These services by an escrow agent are simply the minimum activities required to open, process and close an ordinary sales escrow.

Chapter 39 The FHA-insured home loan

This chapter presents the single–family mortgage insurance program administered by the Department of Housing and Urban Development (HUD) and the Federal Housing Administration (FHA).

Enabling renters to become homeowners

A tenant in an apartment housing complex is solicited by a real estate broker to buy a home. The financial future and tax benefits of home ownership are reviewed with the tenant and compared to the corresponding benefits of rental payments currently paid for shelter by the tenant.

As a result, the tenant indicates he is willing to look into the purchase of a home, but has not accumulated enough cash reserves for the down payment needed to qualify for a purchase-assist loan from a conventional lender, with or without private mortgage insurance (PMI).

However, the broker assures the tenant that first-time homebuyers with little cash available for a down payment can buy a home by qualifying for a *purchase-assist loan* insured by the Federal Housing Administration (FHA).

By insuring loans made with less demanding cash down payment requirements than loans originated by conventional lenders, and with high loan-to-value (LTV) ratios of up to 96.5%, the FHA enables prospective buyers, primarily **renters**, to become homeowners.

For example, when a buyer applies for a conventional loan to finance the purchase of a home, a conventional lender will require a down payment ranging from 10% to 20% of the property's purchase price. Additionally, the loan is often an adjustable rate mortgage (ARM) with rates and payment schedules based on formulas which allow the loan amount to increase from month to month, called *negative amortization*.

Conversely, a typical first-time homebuyer is required to make a minimum down payment of at least 3.5% of the purchase price to qualify for an FHA-insured fixed-rate loan. The interest rate on the loan is negotiated between the buyer and the lender. The FHA does not regulate interest rates, leaving the setting of the interest rate to bond market operations in the secondary mortgage market. [24 Code of Federal Regulations §203.20]

The FHA does not lend money to homebuyers. Rather, the FHA insures loans with up to 30-year amortization periods which are originated by approved *direct endorsement* lenders to qualified buyers to assist them in funding the purchase of a home they will occupy as their principal residence.

One-to-four unit mortgage default insurance

The most commonly used FHA insurance program is the Owner-occupied, One-to-Four Family Home Mortgage Insurance Program, Section 203(b).

The purpose of Section 203(b) is to **enable renters to become homeowners** by allowing for a smaller down payment than required for conventional loans from portfolio lenders. For the privilege of making

a **small down payment**, the buyer must pay a mortgage insurance premium (MIP) to FHA of 1.75% of the loan amount on closing and an annual amount of .55% of the loan amount, effectively increasing the annual cost of borrowing as an addition to interest.

Buyers obtaining a Section 203(b) loan must occupy the property as their **primary residence**. Investors are prohibited from using Section 203(b) to purchase property since their intended use of the property would be as a rental, a contradiction of the owner-occupancy purpose of the Section 203(b) program.

Similarly, homeowners with Section 203(b) loans who later sell their home to investors will not receive FHA approval of the sale.

Loan documentation

The following list of documents may be submitted to an FHA–approved Direct Endorsement lender when applying for a loan:

- Uniform Residential Loan Application signed and dated by all buyers and the lender [See **first tuesday** Form 203 (HUD Form 1003)];
- Buyer's Notification and Interest Rate Disclosure Statement signed by both the buyer and the lender [Form HUD-92900-B];
- Credit Analysis Worksheet – LTV and Income Ratios [See **first tuesday** Form 230];
- picture identification and social security number of each buyer;
- Residential Mortgage Credit Report for each buyer;
- verification of employment and most recent pay stub [See **first tuesday** Forms 208 and 208-1];
- verification of deposit and most recent bank statement [See **first tuesday** Form 209];
- federal income tax returns (individual and business) for the past two years for self-employed borrowers [See **first tuesday** Forms 215 and 215-1];
- sales contract containing an amendatory clause, any additional agreements, and the seller's Condition of Property Disclosure – Transfer Disclosure Statement (TDS) [See **first tuesday** Forms 152 and 304];
- verification of payment history of rent payments or mortgages [See **first tuesday** Forms 210 and 210-1];
- Residential Appraisal Report – Detached Single Family Unit or PUD [See **first tuesday** Form 200 (HUD Form 1004)];
- notice to the homeowner regarding possible refunds and MIP; and
- Lead-Based Paint Disclosure signed by the buyer. [See **first tuesday** Form 313]

The public policy rationale behind the Section 203(b) program is based on the proposition that individuals who become homeowners have proven in their later years to be less of a financial burden on the government than the burden imposed by life-time renters. No consideration is given when inducing homeownership to the risks a buyer takes on by the debt burden accompanying an FHA-insured home loan and reduced job mobility during economic downturns.

Under Section 203(b), a loan for the purchase of an **additional residence** will be insured by FHA in the case of hardship to the buyer, such as relocation due to a job. FHA insurance was created to give home sellers the mobility needed to sell and relocate to better jobs. In effect, the mobility of the nation's home-owning work force is not to be hampered for lack of highly leveraged financing. [HUD Mortgagee Handbook 4155.1 Rev-5 Chapter-4 §B.2.d]

FHA loan limits by area

The FHA insures lenders against loss for the full amount of loans made to buyers under the Owner-occupied, One-to-Four Family Home Mortgage Insurance Program, a Section 203(b) mortgage. The maximum FHA-insured loan available to assist a buyer in the purchase of one-to-four unit residential property is determined by:

- the type of residential property; and

Acceptable sources of the cash down payment include:

- **Savings and checking accounts:** Lenders must verify the account balance is consistent with the buyer's typical recent balance and no large increase occurred just prior to the loan application.
- **Gift funds:** The donor of the gift must have a clearly defined interest in the buyer and must be approved by the lender. Relatives or employer unions typically are acceptable donors. Gift funds from the seller or broker are unacceptable kickbacks and are considered an inducement to buy and require a reduction in the sale price.
- **Collateralized loans:** Any money borrowed to meet the down payment requirement must be fully secured by the buyer's marketable assets (i.e., cash value of stocks, bonds, or insurance policies), which do not include the home being financed. Cash advances on a credit card, for example, are not acceptable sources for down payment funds.
- **Broker fee:** If the buyer is also a real estate agent involved in the sales transaction, the commission may be part of the buyer's down payment.
- **Exchange of equities:** The buyer can trade personal property he owns to the seller as the down payment. The buyer must produce evidence of value and ownership before the exchange will be approved.
- **Sale of personal property:** Proceeds from the sale of the buyer's personal property can be part of the down payment if the buyer provides reliable estimates of the value of the property sold.
- **Undeposited cash** is an acceptable source of down payment funds if the buyer can explain and verify the accumulation of the funds. [HUD Handbook 4155.1 Rev-5 Ch-5 §B.1]

- the county in which the property is located.

A list of counties and their specific loan ceilings is available from FHA or an FHA direct endorsement lender, or online from the Department of Housing and Urban Development (HUD) at *http://www.hud.gov*.

Loan-to-value (LTV) ceilings

The FHA sets limitations on the amount of a loan it will insure, based on a percentage of the appraised value of the property, called the *loan-to-value (LTV) limitation* or *ratio*.

The **LTV limitations** on an FHA-insurable loan are capped at 96.5%. Thus, the minimum downpayment is 3.5%. [HUD Mortgagee Handbook 4155.1 Rev-5 Ch-2 §A.2.b]

Additionally, even after including buyer-paid closing costs in the LTV calculations, the insurable loan amount cannot exceed the ceiling of 96.5% of the property's appraised value.

To determine the loan amount the FHA will insure, multiply the appropriate LTV ratio by the lesser of the property's:

- sales price; or
- the appraised value of the property. [HUD Mortgagee Handbook 4155.1 Rev-5 Ch-2 §A.2.a]

Closing costs may not be used to help meet the 3.5% minimum downpayment requirement. Also, closing costs are not deducted from the sales price before setting the maximum loan amount. [HUD Mortgagee Handbook 4155.1 Rev-5 Ch-2 §A.2.d]

Such costs include the lender's origination fee, appraisal fees, credit report charges, home inspection fees, recording fees, survey fees and the cost of title insurance.

The lender's origination fee included in the closing costs is limited to 1% of the loan amount, excluding any competitive discount points and the 1.75% upfront MIP.

Veterans applying for an FHA-insured loan are subject to the same LTV limitations applicable to non-veterans.

Either the buyer or seller can pay the buyer's closing costs, called *non-recurring closing costs*. The lender may also advance closing costs on behalf of the buyer.

Discount points or upfront MIPs are not part of the buyer's closing costs since they are considered pre-paid interest. However, when the seller pays the buyer's loan discount points and MIPs, these amounts are then considered *financing concessions.*

Any closing costs or other financing concession paid by the lender or seller in excess of 6% of the property's sales price is considered an *inducement to purchase* and results in a dollar-for-dollar deduction of the excess from the sales price before applying the appropriate LTV ratio. [HUD Handbook 4155.1 Rev-5 Ch-2 §A.3]

The LTV ratio initially sets the loan amount. However, the loan amount cannot exceed the cap of 96.5% of the appraised property value.

For example, a buyer pays $100,000 for a single family residence (SFR) with an appraised value of $100,000. The buyer must pay the minimum down payment of $3,500 in closing costs (3.5%) from his own funds. Thus, the buyer's cost basis for calculating the loan amount is $100,000. The LTV ratio of 96.5% is then applied to the $100,000 cost basis the buyer will have in the property, resulting in a $96,500 maximum loan.

In a seller's market with too many buyers rapidly driving up prices, the price a buyer might agree to pay occasionally exceeds the appraised value of the property. Thus, the gap is widened between the FHA-insurable loan limit and the purchase price. The buyer then has the right to close the transaction by increasing the down payment amount to cover the **higher-than-appraised price** he is still willing and able to pay for the property, an FHA purchase agreement right called an *amendatory clause*. [See **first tuesday** Form 152 §7.7]

Buyers may add the cost of a solar or wind energy system directly to the loan amount before adding MIPs and after applying the LTV ratio limit. The amount a buyer is permitted to add to the loan amount is the lesser of the solar or wind energy system's:

Programs for investors

Despite HUD's general no-investor policy, FHA will insure loans made to investors for these projects:

Mobilehome parks — Finance construction of mobilehome parks consisting of five or more spaces. The park must be located in a HUD approved location where market conditions show a need for this type of housing. [Section 207]

Multifamily rental housing — Finance construction containing at least five units and all must be rented at reasonable prices. [Section 207]

Housing for the elderly — To finance the construction or rehabilitation of housing consisting of at least five units, all of which must be suited to the elderly or handicapped. Convalescent homes are not included in this section. [Section 231]

Nursing homes — To construct or renovate care facilities which accommodate 20 or more patients who require skilled nursing care. Nursing homes, intermediate care facilities, and board and care homes are acceptable types of care facilities. Major equipment needed to operate the facilities can be included in the loan. [Section 232]

Low-income rental assistance — Investors who own housing occupied by low-income tenants can apply for HUD assistance with tenant's rent payments. Under the Section 8 program, HUD makes up the difference between what a low-income tenant can afford to pay and the approved rent for the unit HUD rental assistance subsidies can be obtained for existing housing occupied by tenants whose income is less than 50% of the median income for the area. In addition to rental assistance to property owners, HUD also provides rental vouchers and rental certificates to tenants. [Section 8]

Summary of available HUD/FHA programs

Section 203(b): This is the most commonly used program sponsored by the FHA. Under this section, the FHA insures loans made by Direct Endorsement lenders to creditworthy buyers who will use the home as their primary residence. The maximum loan amount depends on the type of residential property and the county where the property is located. Investors are prohibited from obtaining a loan insured under this section.

Section 203(k): Under this program, the FHA insures loans to finance the rehabilitation of existing homes, the rehabilitation and refinancing of a home, or the simultaneous rehabilitation and purchase of a home. For example, rehabilitation includes repairs, installing solar energy systems, or expanding dwellings. The maximum loan amount is the same as the amount allowed under Section 203(b).

Section 221: Buyers with low and moderate income can apply for a loan insured under this section. The maximum loan limit is considerably less than the limits under Section 203(b). Special terms apply to families who have been displaced by urban renewal.

Section 223(e): Buyers hoping to purchase property which does not meet the requirements under Section 203(b) may apply for a loan insured under this section if the property is in a declining urban neighborhood. The FHA building standards are more flexible than those under other sections and allow purchases in areas where higher standards are unreasonable.

Section 234: This program is similar to Section 203(b) except it insures loans for the purchase of condominiums. The maximum loan limit for an area established by Section 203(b) applies to the purchase of condominiums. Investors who intend to sell individual units may obtain a loan insured under this section.

Section 245: Buyers who anticipate a substantial increase in income may be insured for a graduated payment mortgage (GPM). This allows a buyer to make small monthly payments initially but increase the size of the payments over time. Large down payments are required to prevent the loan amount from exceeding LTV limits. Buyers are subject to all other rules governing HUD insured loans. Five different GPM plans are available and differ in length and the rate of increase.

Section 251: Under the FHA-insured adjustable rate mortgages (ARM) program, the interest rate and monthly payments vary over the life of the loan. The initial rate and payment are negotiable between the buyer and lender. However, the interest rate may only increase or decrease one percentage point in anyone year. Over the life of the loan, the interest rate may not change more than five percentage points. All creditworthy owner-occupants may qualify for an ARM loan.

Section 255: The FHA allows homeowners who are 62 years of age or older to convert the equity in their homes into a monthly income or a stream of credit. This enables homeowners with sizable equity but small income to turn their equity into spendable dollars.

Title 1: Property Improvement loans can be obtained for the repair or improvement of individual homes, apartment buildings, and nonresidential buildings. Loans can also be obtained to finance construction of nonresidential buildings. The maximum loan on single family home improvement is $25,000 and may extend up to 20 years. HUD's Title I program also insures loans to finance the purchase of manufactured homes and lots. The maximum loan amount is: $48,600 for a manufactured home, $16,200 for a lot, or $64,800 for both a manufactured home and a lot. All creditworthy buyers who are owner-occupants are eligible.

- replacement costs; or
- effect on the property's market value. [HUD Handbook 4155.1 Rev-5 Ch-2 §A.5]

Also, the amount added for a solar or wind energy system may exceed the statutory mortgage limit for the area by an additional 20%. [HUD Handbook 4155.1 Rev-5 Ch-2 §A.5.g]

Credit approval

Before FHA will insure a loan, the lender must determine if at least one of the co-applicants is creditworthy. [24 CFR §203.512(b)]

For a buyer to be creditworthy for FHA mortgage insurance, the following debt-to-income ratios must be met:

- the buyer's **mortgage payment** may not exceed 31% of the buyer's gross effective income, called the *mortgage payment ratio*; and
- the buyer's **total fixed payments** may not exceed 43% of the buyer's gross effective income, called the *fixed payment ratio*. [HUD Handbook 4155.1 Rev-5 Ch-4 §F.2]

A buyer's income consists of his salary and wages. Social security, alimony, child support, and government assistance are factored into the buyer's income to determine his *effective income*. The buyer's **effective income** before any reduction for the payment of taxes is called his *gross effective income*.

The maximum **mortgage payment ratio** of 31% of the gross **effective** income determines the maximum amount of principal, interest, taxes and insurance the buyer is able to pay on the mortgage.

Lenders use the maximum **fixed payment ratio** of 43% of the gross effective income to determine whether a buyer can afford to incur the long-term debt of an FHA-insured mortgage in addition to all other long-term payments he must make.

When computing the fixed-payment ratio, the lender adds the buyer's total mortgage payment to all the buyer's recurring obligations (debts extending ten months or more), such as all installment loans, alimony and child support payments, to ascertain the buyer's total monthly fixed payments. [HUD Handbook 4155.1 Rev-5 Ch-4 §C.4]

However, even if the buyer's ratios exceed FHA requirements, the loan may be approved if the buyer:

- makes a large down payment;
- has a good credit history;
- has substantial cash reserves; and
- demonstrates potential for increased earnings due to job training or education, called *compensating factors*. [HUD Handbook 4155.1 Rev-5 Ch-4 §F.3]

Since **predetermined ratios** may not indicate a particular homebuyer's likelihood for default, lenders may be flexible when applying the qualification ratios.

For example, if the buyer's debt-to-income ratios are above the prescribed maximum, the FHA may still insure the loan based on these compensating factors.

Although FHA considers good credit history and a large down payment to be compensating factors, lenders will not fund a loan in practice based on these two factors alone unless the buyer meets the prescribed payment ratios.

Further, race, religion, sex, handicap, familial status, sexual orientation and ethnicity are not compensating factors for evaluating a loan application.

Conversely, a lender cannot deny the loan application of an African-American buyer in an attempt to exclude African-Americans as buyers of homes located in a particular neighborhood. [**Holmes** v. **Bank of America** (1963) 216 CA2d 529]

However, lenders in California can establish loan programs which promote homeownership in ethnic minorities or low-income neighborhoods, provided the programs comply with the federal Fair Housing Act or similar state and federal laws. [Calif. Health and Safety Code §35810]

Due-on-sale clause

Loans insured by the FHA contain a due-on-sale clause which allows the FHA to accelerate the loan if the property is sold in violation of assumability requirements.

The lender of a Section 203(b) loan cannot impose restrictions on the resale of the property or automatically call the loan due-on-sale.

However, to avoid defaults by future owners, when a homeowner with a Section 203(b) loan sells the home, the lender is allowed to approve the sale if:

- one of the new owners is creditworthy;
- the seller retains an ownership interest; or
- the transfer is through a will.

If an FHA-insured property is sold to an unapproved buyer, such as an investor, the lender may request permission from the FHA to accelerate the loan. Only when the FHA approves a call may the lender call the balance of the loan due-on-sale. The FHA has not called any loans under the due-on-sale clause since the policy was initiated in 1985. [24 CFR §203.512]

Investors will not be approved as buyers of property which is subject to a Section 203(b) loan since the property would be a rental and not the investor's primary residence. However, in spite of the FHA's no-investor policy, once an investor purchases a property subject to a Section 203(b)-insured loan, the FHA only requires the investor to make payments as scheduled.

NOTICE OF RIGHT TO RESCIND

Borrower's Right to Cancel

NOTE: This notice only applies when an equity loan or refinance which funds a personal use will be secured by one-to-four unit residential property presently owner-occupied by the Borrower as his principal residence.

FACTS:

1. This notice is given in a loan transaction under an application or loan numbered _____,

1.1 between you _____, as the Borrower, and

1.2 _____, as the Lender,

1.3 in which _____ is the mortgage loan Broker,

1.4 for an amount borrowed of $_____, which is or will be secured by

1.5 property you own located at _____.

NOTICE:

2. You are entering into a transaction which will result in a lien on your home. You have a legal right under federal law to cancel this transaction, without cost, within three business days from whichever of the following events occurs last:

2.1 the date of this transaction which is _____, 20_____;

2.2 the date you received your Truth in Lending disclosures; or

2.3 the date you received this notice of your right to cancel.

3. If you cancel the transaction, the lien is also cancelled.

3.1 Within 20 calendar dates after we receive your notice, we must take steps necessary to reflect the fact that the lien on your home has been cancelled, and we must return to you any money or property you have given to us or anyone else in connection with this transaction.

4. You may keep any money or property we have given you until we have done the things mentioned above, but you must then offer to return the money or property.

4.1 If it is impractical or unfair for you to return the property, you must offer its reasonable value. You may offer to return the property at your home or at the location of the property. Money must be returned to the address below. If we do not take possession of your money or property within 20 calendar days of your offer, you may keep it without further obligation.

How to Cancel:

5. If you decide to cancel this transaction, you may do so by notifying us in writing, at (creditor's name and business address) _____

_____

6. You may use any written statement that is signed and dated by you and states your intention to cancel, or you may use this notice by dating and signing the cancellation provision below.

6.1 Keep one copy of this notice because it contains important information about your rights.

7. If you cancel by mail or telegram, you must send this notice no later than midnight of _____, 20_____ (or midnight of the third business day following the latest of the three events listed above at §2).

7.1 If you send or deliver your written notice to cancel some other way, it must be delivered to the above address no later than the time stated above.

Borrower acknowledges receipt of two copies of this notice.

Date: _____, 20_____

Borrower's Signature: _____ Borrower's Signature: _____

Notice of Rescission by Borrower:

I hereby cancel this transaction.

Date: _____, 20_____

Borrower's Name: _____ Signature: _____

Borrower's Name: _____ Signature: _____

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RESPA and TILA disclosures

The Real Estate Settlement Procedures Act (RESPA) requires any lender making an FHA-insured loan to deliver *good faith estimates* of **settlement costs** paid to providers of services on the sale of a one-to-four unit residential property and a Housing and Urban Development (HUD) information booklet within three days after receiving the buyer's application. [See **first tuesday** Form 204 (DRE 883)]

The HUD information booklet contains information about real estate transactions, settlement services and consumer protection laws. [24 CFR §3500.6 (a)(3)]

Upon closing a sale, an escrow agent handling the loan must deliver to the buyer and seller a HUD-1 closing statement detailing all loan related charges incurred by the buyer and seller. [24 CFR §3500 et seq.; see **first tuesday** Form 402 (HUD-1)]

Further, the *Truth-in-Lending Act* (TILA), referred to as *Regulation Z*, requires lenders making loans for *personal use* (i.e., the purchase of a personal residence) to disclose details about the **loan terms**, such as the amount funded, direct loan costs, payment schedules, the loan's annual percentage rate (APR), and the interest rate. [See **first tuesday** Form 221]

Loans insured by the FHA under section 203 (b) are subject to both disclosure requirements since they fund personal use loans (TILA) and are federally related loans (RESPA). Thus, RESPA and TILA disclosures on FHA-insured loans are delivered together by the lender within three business days after receiving the buyer's loan application. [12 CFR §226.19]

If the lender adjusts the annual percentage rate (APR) by more than 1/8 (one eighth) of 1% from the rate initially offered after receiving the buyer's loan application, the lender must **redisclose** the new adjusted APR before the buyer signs the loan documents. [12 CFR §226.19(a)(2)]

Lenders are not required to give the three-day right of rescission to buyers obtaining an FHA-insured home loan under the owner-occupied, one-to-four family home mortgage insurance program, Section 203(b), since the right to rescind does not apply to purchase-assist financing of **residential sales,** only to personal-use equity loans secured by any type of property. [12 CFR §226.23(f)(1); see Form 222 accompanying this chapter]

Editor's note — In practice, lenders of residential purchase-assist loans generally give the right of rescission, although they are not obligated to do so. If given the right to rescind by the lender, the buyer may rescind the loan transaction up to three days after signing the loan documents. [12 CFR §226.23]

Before closing, lenders must also hand buyers a prepayment disclosure statement informing buyers they can prepay any or all of the remaining balance of the loan without a **prepayment penalty** on any installment due date. [24 CFR §§203.22(b), 203.558(a)]

The prepayment of loans insured by the FHA should be made on a regular installment due date, since some lenders charge interest on the amount owed through the end of the month if the loan is prepaid during the month between due dates.

Personal liability

When an owner sells his property subject to an existing FHA-insured loan and the buyer takes over the loan, the seller will be released from personal liability for that loan, if:

- he requests a release from personal liability;
- the prospective buyer of the property is creditworthy;
- the prospective buyer assumes the loan; and
- the lender releases the seller from personal liability by use of an FHA-approved form. [HUD Form 92210; 24 CFR §203.510(a); HUD Handbook 4155.1 Rev-5 Ch-7]

If the conditions for release from personal liability are satisfied, but the seller does not **request a release**, he remains liable to the FHA for any default occurring within five years after the sale. [12 USC §1709(r); see Chapter 23]

However, if five years pass from the time the property is resold, the seller is released from personal liability if:

- the buyer assumes the loan with the lender;
- the loan is not in default by the end of the five-year period; and
- the seller requests the release of liability from the lender. [24 CFR §203.510(b)]

Lenders must inform borrowers of the procedure for obtaining the release from personal liability on resale when the loan is originated. [24 CFR §203.510(c)]

Buyer liability on a default

If a buyer defaults on an FHA-insured loan, the FHA covers the lender against loss on the entire remaining balance of the loan, unlike PMI and insurance from the Veterans Administration (VA) which only insures a portion of the total loan amount.

After the lender acquires the property through foreclosure and conveys the property to the FHA, the FHA pays the lender the amount of the remaining original principal on the loan at the time of foreclosure of a property insured by the FHA. If a bidder other than the lender acquires the property at the foreclosure sale, the FHA pays the lender the amount of the unpaid principal balance, minus any amounts the lender receives from the bidder. [24 CFR §203.401]

Before accepting a conveyance from the lender, the FHA requires the lender to confirm the property is in a marketable condition and has not suffered any waste. The FHA then sells the property to recoup the amount it paid to the lender.

Unlike conventional home loans where only a lender is involved, a homebuyer who takes out an FHA-insured loan with a lender is personally liable to the FHA under the mortgage insurance program for any loss the FHA suffers as a result of the homebuyer's default. When the FHA suffers a loss, the FHA can

obtain a money judgment against the homebuyer for the difference between the amount the FHA paid the lender and the price received from the sale of the property. California anti-deficiency mortgage laws do not apply to FHA-insured loans. [24 CFR §203.369]

Chapter 40 Private mortgage insurance

This chapter presents the availability of private insurance (PMI) on high loan-to-value mortgages for the purpose of covering lender losses on a default by the borrower.

Covering lender losses on default

Consider a prospective homeowner who wants to purchase a detached single family residence (SFR) which he intends to occupy as his principal residence. The property is not located within a common interest development (CID), such as a development managed by a homeowners association (HOA). The terms for payment of the price will be a 10% down payment from funds held by the buyer.

The balance of the price will be funded by a conventional fixed-rate purchase-assist loan (FRM) which will not exceed $417,000. Rebates received by the buyer, whether funded directly or indirectly by the seller from the proceeds of the sale or by the broker from the seller-paid broker fees, will not exceed 3% of the price paid for the property.

The buyer is referred to a mortgage lender to arrange for the origination of a conventional loan on an application from the buyer. Thus, the loan will not be guaranteed by the Federal Housing Administration (FHA) or Veterans Administration (VA).

However, the loan will fund 90% of the property's value, a **loan-to-value ratio** (LTV) which exceeds the margin generally considered free from risk of loss should the buyer default. To shift that risk of loss to others, the lender requires private mortgage insurance (PMI). The lender's alternative would be to retain the risk and attempt to cover it with an increase in the rate of interest when the loan amount exceeds 75% to 80% of the property's value.

A mortgage lender may require any borrower to qualify and pay the premium for PMI as a condition for making a trust deed loan. [Calif. Civil Code §2954.6]

Most prudent lenders originating loans for owner-occupant buyers of residential real estate whose down payment is less than 20% of the purchase price will insist the loan be insured by PMI to cover the risk of loss on a default by the buyer.

Thus, a real estate agent involved in a sale, the closing of which is contingent on new conventional financing with an LTV ratio exceeding 80%, will retain control of the transaction's destiny and avoid surprises based on his knowledge of four sets of considerations used by issuers of PMI:

1. The buyer's profile

2. The property purchased

3. Loan terms and conditions

4. Loan processing package

List of authorized California mortgage insurers

- Mortgage Guaranty Insurance Corp.
- MGIC Credit Assurance Corp.
- CMG Mortgage Insurance Co.
- Genworth Residential Mortgage Insurance Corp. of North Carolina
- Genworth Mortgage Insurance Corp.
- Radian Guaranty Inc.
- PMI Mortgage Ins. Co.
- Amerin Guaranty Corp.
- United Guaranty Residential Insurance Co.
- United Guaranty Mortgage Indemnity Co.
- Republic Mortgage Insurance
- Triad Guaranty Insurance Corp.

Protecting the lender from loss

Private mortgage insurance (PMI) indemnifies a lender for financial loss on a loan secured by an interest in real estate when a **borrower defaults**. [Calif. Insurance Code §12640.02]

The lender's recoverable losses include principal on the debt, any deficiency in the value of the secured property, and foreclosure costs, but exclude losses due to flood, earthquake or fire damage, which are separately insurable.

Also, PMI is not mortgage life insurance. Mortgage life insurance pays off the insured loan in the event a borrower dies, becomes disabled, or loses his health or income.

Private mortgage insurers are unrelated to government-created insurance agencies, such as the Federal Housing Administration (FHA) and the Veterans Administration (VA), which also insure or guarantee loans made to qualified trust deed borrowers. [See Chapter 39]

Loans insured by the FHA, VA, and the California Department of Housing and Community Development (HCD) have their own guidelines and are not subject to laws controlling PMI.

Private mortgage insurance coverage

Private mortgage insurance (PMI) insures a percentage of a real estate loan. In turn, the loan amount represents a percentage of the property's value, called the *loan-to-value ratio* (LTV).

Typically, loans insured by PMI, including fixed-rate mortgages (FRMs) and adjustable rate loans (ARMs) for purchase-assist or refinancing, are covered for losses on loan amounts exceeding 67% of the property's value at the time the loan is originated.

The buyer usually pays the PMI premiums, not the lender, although the lender is the insured and holder of the policy.

However, some lenders and PMI carriers offer a Lender-Paid Mortgage Insurance (LPMI) program. If issued by the PMI carrier, the lender will pay the mortgage insurance premium (in a lump sum or on a monthly basis) and in turn charge the borrower a higher interest rate on his principal payments.

Premium rates are set as a percentage of the loan balance and are calculated in the same manner as interest.

When the buyer qualifies for PMI and a policy is issued, the lender must notify the buyer at the time of closing and each year thereafter of the buyer's right to cancel the PMI.

Later, if the buyer is current on his PMI payments and has taken out no other loans on his property, he may request the termination of his PMI when the equity in his property reaches 20% of its value at the time the loan was originated. PMI will be canceled automatically once the buyer reaches 22% equity in his property (unless the loan is a piggyback 80-10-10 loan).

Furthermore, the buyer may cancel his PMI two years after the loan is recorded. However, the buyer may not cancel his PMI until the LTV for the loan balance is 75%, unless the lender has agreed to a higher LTV. Also, if monthly installments on the note during the year prior to the request for cancellation are more than 30 days overdue, or if the buyer has other liens on the property, the lender or private insurer will not terminate the PMI. [Calif. Civil Code §2954.7]

If cancellation of PMI is permissible, the lender under the note may not charge advance PMI payments unless the borrower has incurred more than one late penalty in the past 12 months, or has been more than 30 days late on one or more payments on the note. [Calif. Civil Code §2954.12]

Premiums charged by PMI insurers do not include an up-front fee on origination, only an annual fee calculated as a percentage of the loan balance. During the first half of 2009, the annual PMI rate was .6% of the loan balance, payable monthly, an amount which is added to the principal and interest payments on the loan. In contrast to FHA mortgage insurance premiums (MIP), FHA charges an up-front fee of 1.75% of the loan amount; the FHA annual charge is .55% of the loan balance payable monthly in addition to the principal and interest payments.

During the same period in 2009, interest rates for conventional loans under PMI and FHA insured loans were very different: 30-year fixed rate conventional loans had an average west coast rate of 4.9%; 30-year fixed rate FHA loans had an average west coast rate of 5.6%.

Thus, the monthly combined percentage rate paid on a PMI conventional loan was 5.16%, while the combined rate for an FHA insured loan was 6.15% (plus the 1.75%-of-loan up-front MIP fee). The primary reason for the cost difference is the risk of loss with the 3.5% down for FHA versus the risk with the 10% down for PMI coverage.

California PMI circa 2009: distressed

PMI insurers have labeled five states and numerous metropolitan area across the USA as *distressed areas*. Coupled with the distressed area label are severe limitations on the class of buyer, type of property and terms of a loan which qualify the lender for PMI coverage.

The entire state of California has been classified as distressed for PMI purposes (2009). How many months or years this classification as a distressed area will remain with California will only be known when the real estate market stabilizes and demonstrates property values will not drop further and job losses have ended.

For now, the time for reclassifying California as other than a distressed area appears to be well off into 2012, or 2013 and beyond. However, as foreclosures abate to below 50,000 trustee's sales during any twelve-month period (a foreclosure figure still too high for a normal lender environment or a return to PMI underwriting standards existing prior to the mid-2000 boom years), PMI insurers will know the extent of their present and future losses. They will then be able to neutralize the now stringent parameters for issuing PMI coverage in California.

Further, competition among presently decimated PMI carriers, who will by then have recapitalized by retaining profits and issuing stock, will force the relaxation of underwriting principles which now exclude most properties, buyers, loans, and loan packaging procedures. The FHA has temporarily filled the gap on low-priced properties.

The leveraged buyer and PMI

The individual or couple looking for housing to own and occupy as their primary residence must first compile cash or cash equivalence for a **downpayment** in an amount greater than 20% of the price of the housing they want for shelter. If not, they must be able to qualify and pay for the cost of **default insurance**, called *mortgage insurance*.

If they have accumulated cash for a downpayment of 10% or more, they may be able to qualify for private mortgage insurance (PMI). Thus, they will avoid the more lenient yet more expensive government insured mortgage plans (interest and premiums) available for homebuyers with less than 10% cash accumulated for a downpayment.

The lender making a conventional loan to fund the purchase of a principal residence when the loan will exceed 80% of the property value will require the buyer to meet the qualifications for PMI coverage, not just the lender's qualification requirements. Thus, PMI qualification requirements become the lender's minimum requirements for making the loan.

In California as a *distressed area* for issuance of PMI coverage, the buyer must meet the following standards:

- a minimum credit score of 720 (out of 800) with no exceptions and at least three trade lines supporting the credit score;
- a debts-to-income ratio of no more than 41%;
- two months PITI payments in cash reserves on closing is waived;
- employment full time during the past two years, a current pay stub, written verification by employer (VOE form), and telephone confirmation of employment at closing, unless self-employed;
- if self-employed, financial statements for two prior years and year-to-date, IRS tax returns;
- legal residence in the USA;
- all documents and title vestings to be in the name of the buyer as an individual, as no entities or alternative vestings qualify;
- limit to three loans under PMI coverage in name of buyer;
- completion of a homeowners course of education on mortgage debt obligations;
- no bankruptcy within four years, unless excused by extenuating circumstances in which case the penalty box for ostracizing the buyer (even though otherwise fully qualified) is two years; and

- no prior foreclosure under a mortgage, ever.

Pre-approval letters from a lender will likely be limited to a credit score investigation and, if self-employed, a review of employment or financial statements to workup the debts-to-income (DTI) ratios. The PMI full *documentation efficiency* investigation will take place after submission of a loan application and, as usual, will essentially be limited to verification of all the buyer's representations on the application.

PMI's type of property

The availability of PMI coverage for different types of California real estate is now (2009) severely limited. This condition for coverage will remain until the real estate market is no longer stressed with the prospect of declining property values. Only properties classified as single family residences (SFRs) are now provided with PMI.

Also, SFRs are further categorized as either detached or condos, the distinction reflected in the amount of downpayment required for PMI. Thus, the property type drives the downpayment amount needed before the lender will make a loan on purchases with less than a 20% downpayment.

For California **property to qualify** for PMI coverage, the property must meet the following standards:

- use of the property to be as the principal residence of the buyer on closing;
- vesting of title to the property to be in the name of the individual(s) purchasing the property;
- ownership is not to be for investment (no two-to-four units), no second home or vacation-rental property, and no manufactured housing;

Submitting PMI claim

Consider a lender whose loan is secured by a first trust deed on a personal residence in default.

The lender forecloses on the property by a trustee's sale and acquires the property by bidding the dollar amount of its current fair market value (FMV). The lender then submits its claim to the insurer, including documents showing the price bid at the trustee's sale and a recent appraisal of the property.

If the owner of the property is in default, and the insured lender is willing to work out a short sale, the PMI carrier must be notified immediately of the impending short payoff. PMI will not cover loan discounts on short sales unless the owner is **in default**.

Additionally, PMI policies contain a physical damage exclusion which provides that PMI the carrier can require any damage to the secured property totaling more than $1,500 be repaired before the carrier will pay the lender's claim.

In the event the improvements are totally destroyed due to a catastrophe such as a fire or an earthquake, the PMI carrier is not obligated to pay the lender on a default until the improvements and the lender's LTV prior to the damage have been restored.

- detached SFR property not located within a common interest development (CID/HOA) to be acquired with a minimum 10% downpayment (up to 19%), with a rebate from the seller and brokers limited to 3% of the purchase price for non-recurring closing costs;

- SFR units within a condominium common interest development (CID) which is subject to a homeowners association (HOA) to be acquired with a minimum 15% downpayment (up to 19%), if the HOA meets the following standards:

- cash reserves of amount equal to not less than three months of assessments;

- 10% of assessments have been reserved monthly for capital expenditures and maintenance over the past 12 months;

- maximum of 30% rental of units within the CID;

- maximum of 15% foreclosures within the CID; and

- maximum of 10% ownership of units by any one person.

Thus, investors and speculators are not welcomed; only buyer-occupants of SFRs need apply for PMI, until the competition among PMI insurers heats up, lenders start pushing the PMI insurers around (again) or the market returns to allow the PMI insurer a profit, a restructured capitalization and a firm grip on the rate of losses from foreclosures. The light at the end of that tunnel has not yet come into view (2009).

However, investors acquiring SFR property with the intent to hold long term for income production must be allowed into the PMI market as they benefit families who rent. As for speculators, the hit-and-run flipping-property crowd, neither PMI, FHA, lender nor broker should deal with them. Speculators remove property from the marketplace (not for sale or for rent) only to return it after their activity has driven up the price of property. Not a good thing for stability in any marketplace, and a destructive non-productive allocation of national resources.

Qualifying the loan for PMI

Current economic forces have narrowed the classification of loans PMI insurers will cover based on the likelihood of a foreclosure within different types of loans. Loans favored by PMI insurers include fixed-rate notes (FRMs) for amounts less than 90% of the property value (LTV) which fund the purchase of a detached SFR acquired by a buyer who intends to occupy it as his principal residence. All other loans are disfavored, and are avoided by imposing more stringent requirements to qualify for PMI or refusing them coverage since they present risks insurers are no longer willing to accept for any amount of premium.

For a loan to qualify for PMI, its terms and conditions must include:

- funding of a purchase-assist acquisition of a principal residence by a buyer;

- maximum loan amount of $417,000, as no jumbo loans will be insured;

- a 90% LTV for a detached SFR not located within a CID/HOA;

- an 85% LTV for a unit located within a CID/HOA;

Making PMI Available

Many mortgage bankers and mortgage lenders offer their own mortgage insurance programs.

These private mortgage insurance (PMI) programs tend to have lower underwriting standards and espouse a goal of encouraging less creditworthy, lower income buyers to take part in the "American Dream" of homeownership.

Insurance companies that offer or specialize in mortgage insurance responded to the 1990s crunch by covering loans with 97% loan-to-value ratio (LTVs).

In addition to lowering loan qualification standards, some mortgage bankers and lenders pool PMI-warehoused loans for bidding by private mortgage insurers. Pooling loans allows the mortgage lender to negotiate a better rate and reduce mortgage insurance underwriting requirements.

For example, a borrower is offered an insurance rate on his loan by the mortgage lender. The lender pools together 100 qualified loans and accepts bids from mortgage insurers for the lowest rate. The new lowest rate is passed on to the borrower.

The goal of loosening standards and the practice of pooling loans is to increase consumership when sales and lending suffer from a decline in loan and policy originations.

This is good news for real estate brokers trying to sell in a buyer's market. When buyers are leery of investing in real estate due to a weak market, or when renters want to buy are not quite qualified, PMI makes the purchase of a home increasingly available by reducing the lender's risk of loss on a default.

- maximum 40 year amortization schedule, as no interest-only or option payment loans are insurable;
- fixed rate loans; and
- adjustable rate loans if the rate is fixed for the first five years and on the rollover into an ARM they have no possibility of negative amortization.

Loan packaging for PMI document efficiency

Full documentation in the loan packaging process is fundamental to a lender controlling his risk of loss on each loan he originates. However, during the virtuous cycle of a real estate boom, lenders, PMI insurers, wall street bankers bundling and securitizing loans, government regulators, legislators and builders deliberately relax lending guidelines and standards to let the market rise continue. No one wants to be seen as stopping the party.

Pushed by expediency to close loans during boom times, investigations into credit, source of downpayment funds, verification of loan application representations, restricted interested-party involvement and underwriting review requirements are intentionally reduced, and in some cases eliminated entirely – again to get in on the action. It is in this environment that "no-doc" loans are produced, the antithesis of *document efficiency.*

Fundamentals of mortgage lending call for full documentation, analysis of credit and income, and a review of the completed package by the lender who will end up actually owning the loan and taking the risk.

Selling agents, and of course listing agents, whose clients are most affected by a need for PMI, tend to view loan packaging – including the loan application – as a mysterious activity. Most *transaction agents* – those working a sale as a listing or selling agent – are ignorant of the multiple stages and steps taken to process an application and eventually fund a loan. This lack of knowledge is a disservice to all involved in the sale that is contingent on financing.

A knowledgeable **transaction agent** can and should be able to pre-determine the likelihood of his closing a sale which is contingent on a purchase-assist loan by conducting his own review of a buyer's credit score and source of funds. Only then is he ready to commence the search for suitable property on behalf of a buyer or enter into purchase agreement negotiations with a prospective buyer.

The **loan packaging process** demanded of lenders by PMI insurers includes:

- verification of every material representation of the buyer in the loan application, called *document efficiency* [See **first tuesday** Form 207 through 213];

- acquisition of third party reports, such as the buyer's credit score and appraisal of property value;

- analyzation of the buyer's total debt payments as a percentage of gross income, called the DTI ratio; and

- review of all documents gathered during the due diligence investigation into the loan application representations.

PMI will no longer insure a loan packaged by a mortgage loan broker; only institutional lender packaging is acceptable.

Defaulting borrower and PMI recourse

Most private mortgage insurance (PMI) contracts do not authorize the carrier to seek **indemnity** from the borrower for claims made on the policy by the lender — unlike Federal Housing Administration (FHA) or Veterans Administration (VA) insurance programs which place homeowners at a risk of loss for a greater amount than their down payment.

However, if the loan is recourse such as refinancing, the lender's right to seek a deficiency judgment may be assigned to the PMI carrier. Pursuing a money judgment for a deficiency in the value of the property requires a judicial foreclosure action in lieu of a trustee's foreclosure sale.

However, most insured loans are *purchase-money loans* made to buyer-occupants to acquire their principal residence. Purchase money loans are **nonrecourse obligations**, with recovery on the loan limited to the value of the real estate. [Calif. Code of Civil Procedure §580b]

In the case of fraud on recourse or nonrecourse loans, the PMI carrier is not barred by anti-deficiency statutes and will be able to enforce collection of his losses against the borrower for misrepresentations, such as the property value.

The PMI credit check

To qualify for PMI, the buyer must:

- be a natural person, not a corporation, partnership or limited liability company; and
- take title as the vested owner of the property.

The lender, when qualifying the buyer for a loan to be covered by PMI, relies on the more restrictive PMI insurer's requirements regarding the buyer's:

- liquid assets after closing;
- debt-to-asset ratio;
- debt-to-income ratio; and
- regard for financial obligations.

A buyer required to qualify for PMI before a lender will fund a loan undergoes an in-depth risk analysis based on the PMI carrier's eligibility requirements.

Lenders often turn down applications for loans due to the buyer's inability to qualify for PMI. At a minimum, the buyer will be required to submit documents for review by the PMI insurer, including:

- a copy of the loan application;
- a credit report current within 90 days and covering a minimum of two years; and
- an appraisal of the real estate to be purchased.

However, the PMI carrier may also require additional documentation to verify the loan transaction fulfills the insurer's underwriting requirements, including:

- verification the buyer will occupy the property;
- verification the land value of the property does not exceed 40% of the total value of the property;
- a copy of the signed purchase agreement/sales contract;

- verification of funds for closing;
- verification of the buyer's salary/wages, including overtime and second jobs; and
- verification of employment.

The buyer's credit rating and disposable income must clearly support his ability to make the monthly payments on the low down payment loan.

Chapter 41 Usury and the private lender

This chapter explains the private lender's exemption from usury limitations when the loan is arranged by using a licensed real estate broker.

Broker arranged loans avoid usury

When a loan is made, the lender charges the borrower **interest** for use of the money during the period lent. However, the amount of interest a private, non-exempt lender can charge is regulated by statute and the California Constitution, called *usury laws*. [Calif. Constitution, Article XV; Calif. Civil Code §§1916-1 through 1916-5]

Today, the remaining goal of usury laws is the prevention of **loan-sharking** by private lenders — charging interest at a higher rate than the ceiling-rate established by the usury laws, a *threshold rate of interest* beyond which the non-exempt loan becomes categorized as *usurious*. [CC §1916-3(b)]

Usury exemptions spur competition

Adopted in 1918 as a consumer protection referendum, the first California usury laws set the maximum interest rate at 12% for **all lenders**; no exceptions.

During the Depression, legislators noted the adverse effect the ceiling-rate restriction on interest rates money lenders could charge was having on the money supply and the economy.

So, in 1934, usury laws were constitutionally amended in a trade off — lowering the maximum rate to 10% while exempting several classes of significant lenders entirely.

Lenders such as savings and loan associations (S&Ls), state and national banks, industrial loan companies, credit unions, pawnbrokers, agricultural cooperatives and personal property brokers could lend at whatever rate the market would bear without fear of penalty *by forfeiture of interest earnings*.

Exemptions successfully opened the market by increasing the availability of funds. In turn, interest rates were driven lower due to increased competition.

When money grew tight again in the late 1970s, legislators applied the same strategy to loosen up what had by then become massive amounts of funds held by individuals in savings accounts by initiating a proposition in 1979.

On passage of the 1979 initiative, real estate loans **made or arranged** by real estate brokers were added to the list of usury-exempt lender situations. [Cal. Const. Art. XV]

The 1979 law also gave the legislature the power to exempt other classes of lenders from usury limits. The legislature has since exempted corporate insurance companies and consumer finance lenders, but not CalPers.

Interest paid with goods and services

When a borrower pays interest on a loan, he is really paying rent to the lender for use of his money for a period of time. The money lent is fully repaid during or at the end of the period.

Normally, the amount of interest charged is a fixed or adjustable percentage of the amount of money loaned.

Though interest is commonly paid with money, interest may also be paid with personal property or services. The many **types of consideration** given for making a loan become part of the lender's yield on the loan—interest. [CC §1916-2]

Thus, interest includes the value of all compensation a lender receives for lending money, whatever its form, excluding reimbursement or payment for loan origination costs incurred and services rendered by the lender. [CC §1915]

However, it is common for **non-exempt private lenders** to attempt to evade the usury law restrictions on interest and the payment of taxes by including bogus charges or claiming fees—points for their making the loan.

Any lender can charge the borrower a bonus, commission or discount, or receive services or goods from the borrower. However, charges and receipts are considered interest only when they do not compensate or reimburse the lender for services rendered in the process of originating the loan.

Charges unrelated to loan origination services are added to the interest stated in the note to determine the aggregate yield on the principal. The average annual yield over the life of the loan may not exceed the *threshold rate* which triggers application of the usury laws — unless the loan transaction is exempt. [**Haines** v. **Commercial Mortgage Co.** (1927) 200 C 609]

As long as the service performed or the expense incurred was necessary to the origination of the loan, the charges do not add to the lender's yield and is not considered interest. [**Klett** v. **Security Acceptance Co.** (1952) 38 C2d 770]

Examples of services and expenses not included in the interest yield include:

- appraisal, escrow and recording fees [**Ex Parte Fuller** (1940) 15 C2d 425];
- negotiation and brokerage fees paid to a third party [Ex Parte Fuller, *supra*];
- administrative costs, such as foreclosing on the defaulted loan or reconveyancing [**Penziner** v. **West American Finance Company** (1937) 10 C2d 160];
- attorney fees for legal services relating to the loan, such as preparation or review of loan documents [**Murphy** v. **Wilson** (1957) 153 CA2d 132]; and
- late charges due on loan default or prepayment penalties. [**First American Title Insurance & Trust Co.** v. **Cook** (1970) 12 CA3d 592]

Setting the interest rate

If the proceeds of a loan, including *home equity loans* funded by a non-exempt lender, are earmarked primarily for **personal, family, or household use** by the borrower, then the maximum annual interest rate is 10% per annum, whether secured or unsecured. [Calif. Const. Art. XV §1(1)]

However, loans made to fund the improvement, construction, or **purchase of real estate** when originated by a non-exempt private lender are subject to a different usury threshold rate, which is the greater of:

Determining the Federal Discount Rate

The discount rate set periodically by the Federal Reserve Bank of San Francisco (FRBSF) is the rate the "fed" charges member banks on advances of funds – money lent by the fed.

The discount rate is reviewed no less than once every fourteen days by the Board of Directors of the Federal Reserve Bank of San Francisco. A review can bring a change in the discount rate – depending on how the directors view the economic health of the region, nation and world. For monthly updates of the Discount Rate, see the **first tuesday** Rate Page at http://blog.firsttuesdayjournal.com.

The maximum interest rate allowable beyond the 10% minimum threshold rate for usury limitations is calculated and set for each month. The usury threshold rate set for a particular month applies to only those loan transactions entered into any time during that month, a fixed rate attached to that loan for the life of the loan.

The Federal Reserve discount rate used to calculate the usury threshold rate for loans agreed to during a particular month is the San Francisco Federal Bank rate for the 25th day of the previous month.

A loan transaction falls within a particular month based on the date of the earlier of:

- entering into the agreement to make the loan; or
- the funding of the loan if no prior agreement has been entered into for the non-exempt lender.

For example, a private lender signs loan escrow instructions on April 22, agreeing to fund the loan in two weeks, closing in the month of May. The lender is not a party to any prior loan agreement. The borrower's loan application was received by the mortgage loan broker (MLB) in the prior month of March.

The Federal Reserve discount rate applicable to April is 7%, April being the month the loan escrow instructions (or other loan agreement) were signed – entered into – by all parties.

The interest rate agreed to is 12% -- the maximum yield permitted without triggering the usury threshold rate controlling non-exempt private lenders who make real estate loans entered into in the month of April (7% plus 5%).

However, on April 25th, the Federal Reserve discount rate is 6%, not the 7% it was on the 25th of March. Thus, the FRBSF rate applicable for the month of May is 6%.

Prior to closing in May, the borrower claims his loan interest rate should fall to 11% to reflect the change, because the 12% agreed to in the loan is a usurious yield for loans funded during the month.

However, 7% was the Federal Reserve discount rate in effect on the 25th day of April, the month during which the lender first committed – by signing the loan escrow instructions or other agreement – to make the loan.

Since the commitment to make the loan occurred earlier than the funding, the rate for the month in which the lender's commitment occurred controls – even though the loan was funded in a following month with a different, lower rate for loan commitments made during that month.

Editor's note – Contingent interest, such as increased interest received on an adjustable rate loan (ARM), is not subject to usury limitations, unless the ARM contained a note rate in excess of usury limitations when originated, or the ARM was designed with an intent to evade usury laws [McConnell v. Merrill Lynch, Pierce, Fenner & Smith, inc. (1978) 21 C3d 365]

- 10% per annum; or

- the applicable discount rate of the Federal Reserve Bank of San Francisco (FRBSF), plus 5%.

Usury law and real estate loans

Two basic classifications of private loan transactions exist relating to interest rates private lenders may charge on real estate loans:

- **brokered** real estate loans; and

- **restricted** or **non-brokered** real estate loans.

Brokered real estate loans are exempt from usury restrictions and fall into one of two categories:

- loans **made** by a licensed real estate broker **acting as a principal** for his own account as the private lender who funds the loan; or

- loans **arranged** with private lenders by a licensed real estate broker acting **as an agent** in the loan transaction for compensation.

Restricted real estate loans are all loans made by private party lenders which are neither made nor arranged by a broker.

Editor's note — Private lenders include corporations, limited liability companies and partnerships. These entities would not be exempt from usury limitations unless operating under an exempt classification, such as a personal property broker or real estate broker.

The most common restricted loan involves private party lenders, unlicensed and unassisted by brokers, who make secured or unsecured loans.

For example, a borrower contacts a private lender for a loan. The individual lending the money is a licensed **California real estate broker**. The lender advances the loan funds and the borrower executes a note in favor of the lender, secured by a trust deed on real estate owned by the borrower. The rate of interest called for in the note exceeds the usury threshold.

The borrower timely repays the note and the lender reconveys the trust deed. The borrower then makes a demand on the lender to return all interest paid, claiming the loan was a usurious transaction. The lender rejects the interest refund demand, claiming he is a licensed real estate broker and loans made by him from his own funds as a principal are exempt from usury laws.

Is the borrower entitled to a refund of the interest paid?

No! The loan was made by a person who was a licensed California real estate broker when the loan was originated. Thus, the loan is exempt from usury limitations. [**Garcia** v. **Wetzel** (1984) 159 CA3d 1093]

Although loans made or arranged by brokers are exempt from usury limitations, loans made by an unlicensed private lender to a borrower who is a licensed real estate broker are not exempt, unless a third party who is a licensed broker arranged the loan. [**Stoneridge Parkway Partners, LLC** v. **MW Housing Partners III L.P.** (2007) 153 CA4th 1373]

Exceptions for private parties

Private party transactions involving the creation of a *debt* which avoid usury laws break down into two categories:

- **exempt debts**, being *debts* which involve a loan or a forbearance on a loan and are broker made or arranged; and

- **excluded debts**, being *debts* which do not involve a loan.

The most familiar of the excluded "non-loan" type debts is the seller carryback.

Carryback notes executed by the buyer in favor of the seller of any real estate, secured or unsecured by the property sold or other property, are not loans of money; they are credit sales, also called installment sales.

As the debt credited in a credit sale, the seller carries back a note, secured or unsecured, at an interest rate which may permissibly be in excess of the usury threshold rate. The rate exceeding the usury law threshold is enforceable since the debt is not a loan. Thus, the carryback note is not subject to usury laws. [See Chapter 42]

Penalties for usury

The most common **penalty** suffered by a non-exempt private lender is the forfeiture of **all interest** for the loan. Thus, the lender is only entitled to a return of the principal advanced on the loan. [**Bayne** v. **Jolley** (1964) 227 CA2d 630]

The lender may also have to pay a usury penalty of treble damages. [CC §1916-3]

Treble damages are computed at three times the **total interest paid** by the borrower during the one year period immediately preceding his filing of a suit and the period of litigation until the judgment is awarded.

An award of treble damages as a penalty is normally reserved for a lender the court believes took *grossly unfair advantage* of an unwary borrower. [**White** v. **Seitzman** (1964) 230 CA2d 756]

A borrower who knew at all times a loan interest rate was usurious is not likely to be awarded treble damages. Also, a lender who sets a usurious rate in complete ignorance of the illegality of usury would not be additionally penalized with treble damages.

Usurious loans to a broker/borrower

Consider an owner of real estate who is a licensed real estate broker and negotiates directly with a private lender to obtain a loan secured by his property.

The interest charged for the loan exceeds the usury threshold rate. The loan is negotiated without the services of another real estate broker arranging the loan.

The lender funds the loan escrow. The trust deed is recorded and the note is delivered to the lender. The borrower is handed the net loan proceeds on closing.

When the note becomes due, the owner/broker tenders payment of an amount equal only to the principal advanced by the lender and demands a reconveyance. The owner claims he owes only the principal borrowed and no interest, since the interest rate is usurious.

The private lender claims the loan transaction is exempt from the interest restrictions of California's usury laws since the borrower is a licensed real estate broker.

Is this loan controlled by usury laws if the owner who borrowed the money is a licensed real estate broker?

Yes! The private lender's rate of return on the loan is limited by usury laws, unless;

- the private lender who **made the loan** is a licensed real estate broker; or

- a real estate broker is paid to **arrange the loan** as an agent of at least one of the parties to the loan. [**Winnett** v. **Roberts** (1986) 179 CA3d 909]

Attorneys as brokers

Although attorneys are authorized to perform brokerage activities for compensation in the normal course of the practice of law, an attorney's activities in arranging a loan are not covered by the broker's usury exemption.

For example, a borrower retains an attorney, who is also a licensed real estate broker, to arrange a loan from an unlicensed private lender to be secured by real estate owned by the borrower.

Between the time the attorney/broker is retained by the borrower and the time the loan is arranged, the broker's license held by the attorney expires. The loan transaction closes before the attorney renews his broker's license. The note is payable in monthly installments of interest only, principal being payable as a final/balloon payment on the due date.

After making several interest payments, the borrower defaults and the lender begins foreclosure.

The borrower claims the loan has a usurious rate of interest and is controlled by usury laws since the attorney arranging the loan did not have a valid broker's license on the date the lender committed in writing to make the loan. The lender claims the loan is exempt from usury laws since the attorney is authorized to conduct, for compensation, all activities requiring a broker's license without first obtaining a broker's license.

Can the borrower totally avoid the payment of interest on the attorney-negotiated loan?

Yes! While attorneys may perform acts requiring a broker's license so long as they are rendered in the course of the practice of law, attorneys arranging loans without also being licensed brokers do not bring the private lender loan under the broker's exemption to usury laws. Thus, the loan is usurious since the attorney's broker license formally expired and was invalid on the date the loan was agreed to, barring the private lender's collection of interest from the borrower. All payments now apply to the principal. [**Del Mar** v. **Caspe** (1990) 222 CA3d 1316]

Now, consider a broker who is also a **general partner** in a partnership. The partnership wants to borrow money to improve real estate it owns.

The broker/general partner negotiates with a private non-exempt lender for a loan which is to be secured by real estate owned by the partnership.

The lender funds the loan. The lender receives the partnership's promissory note and trust deed executed in favor of the lender by the general partner on behalf of the partnership. The rate of interest called for in the promissory note exceeds the usury threshold rate.

The partnership timely repays the loan and the lender reconveys the trust deed. The partnership then demands the lender return all interest paid on the loan, claiming the loan was usurious.

Is the partnership entitled to a refund of interest paid on the loan?

Yes! The general partner is not acting in the capacity of a licensed broker when he negotiates a loan on behalf of the partnership, he is acting as its general partner. [**Green** v. **Future Two** (1986) 179 CA3d 738]

*Editor's note — Another California appeals court held in a nearly identical factual situation — tenants in common acting as a group — that the broker acting on behalf of a partnership of which he is a member is considered to be acting for others and thus operating in his licensed capacity. [**Stickel** v. **Harris** (1987) 196 CA3d 575]*

However, the court in Stickel did not have a firm grasp on brokerage law or the rule that tenants in common constitute a tenancy in partnership. The analysis in the case is faulty as its conclusion relies on the erroneous assumption a broker's license is required for a general partner to deal with real estate owned by the partnership.

No broker fee was received or was to be paid to any real estate broker for the act of negotiating the loan for the group. The general partner received only the benefits he would have received as a partner, whether or not this loan was originated. Thus, he did not receive a fee or "arrange" the loan as a broker on behalf of the group as required to qualify it for exemption from usury laws.

Agents and usury

Activities of a licensed real estate sales agent are not within the broker's usury exemption, unless the agent is employed by a broker and the agent's level of participation in the transaction constitutes arranging the loan.

For example, an owner wants to refinance a loan secured by real estate he owns. The owner contacts a broker and they discuss acceptable terms for the loan. A loan application is submitted and loan disclosures are made by the broker.

The broker prepares a loan package and submits it to different lenders, but is unable to find a lender to fund the loan. The broker then informs an affiliate with whom he shares office space about the unfunded loan. The affiliate is a licensed real estate agent who is not registered with the DRE as employed by a broker. The agent locates a private lender who funds the loan. The interest rate called for in the note exceeds the usury threshold rate for the loan.

The agent receives a fee paid directly to him by the borrower. The agent does not split the fee with the broker, but he does use a portion of his income to pay joint office expenses.

The owner makes all payments due on the loan and the lender reconveys. The owner then demands a refund of all interest paid, claiming the loan was usurious since it was arranged by a licensed sales agent, not a broker.

Is the owner entitled to a refund of the interest?

No! The initial terms for the loan were established with the borrower by the broker on a loan application. The broker's involvement in packaging the loan transaction and shopping the loan for placement with a private lender is sufficient for the loan to be considered arranged by a broker.

Although the broker did not receive direct compensation from the owner, he did receive indirect compensation for his involvement since the agent who took a fee contributed to common office expenses. Thus, the loan is exempt from usury limitations. [**Jones** v. **Kallman** (1988) 199 CA3d 131]

Now consider a sales agent who arranges loans for an unlicensed private lender while employed as an agent of a broker. The agent terminates his affiliation with the broker, but does not inform the lender.

Later, a borrower contacts the now **unemployed agent** seeking a loan to be secured by real estate owned by the borrower. The salesman arranges the loan which is funded by the private lender he had contact with while previously employed by a broker.

The borrower executes a note and trust deed in favor of the lender. The interest called for in the note is in exceeds the usury threshold rate. The salesman is paid a fee for arranging the loan. After making several interest-only payments, the borrower defaults and the lender initiates foreclosure.

The borrower claims he owes no interest to the lender, and all interest paid is to be credited to principal, since the loan was not arranged by a licensed real estate broker and the rate of interest on the loan exceeds the usury threshold rate.

Can the borrower avoid paying any interest on the loan since no broker was involved and the real estate salesman was not working with a broker at any time while arranging the loan?

Yes! For a loan arranged by a salesman to be exempt from usury laws, the salesman must be working with a broker while arranging the loan. Since the salesman was not employed by or affiliated with a broker at any time during his arrangement of the loan. The loan is not exempt from usury laws. [**Dierenfield** v. **Stabile** (1988) 198 CA3d 126]

Chapter 42 Usury and the carryback note

This chapter illustrates the continued exclusion of carryback notes from usury laws after modification.

Modified, assigned or unconscionable rates

The maximum rate of interest which can be charged on a **non-exempt loan** secured by real estate is the greater of:

- 10% per year; or
- the aggregate rate comprised of the discount rate at the Federal Reserve Bank of San Francisco (FRBSF) and a margin figure of 5%. [Calif. Constitution Article XV §1]

Consider a buyer and seller who enter into a purchase agreement for the sale of real estate. The purchase agreement calls for a down payment with the balance of the price being evidenced in a note and trust deed in favor of the seller, also called a *carryback sale, credit sale* or *installment sale*.

The terms of the carryback note prepared by escrow and delivered to the seller under the terms of the purchase agreement call for the buyer to make monthly payments of **interest only**. The principal is due one year after the close of escrow. The interest rate negotiated for the carryback note is 20%.

The buyer defaults on the carryback note and trust deed after making payments for several months. The seller begins foreclosure on the real estate under the trust deed.

The buyer claims the seller cannot foreclose since the interest charged on the note is in excess of the rate allowed by usury laws, rendering the interest provisions in the note void. Thus, the buyer claims no payments are due until the principal is due, and all payments made are to apply only to principal.

Can the note carried back by the seller ever, at any rate of interest, be usurious?

No! A carryback debt is the result of a **credit sale** by the seller. It is not a loan or forbearance of a loan made by a lender. Thus, a carryback debt is not subject to the interest limitations of usury laws. [**Verbeck** v. **Clymer** (1927) 202 C 557]

Usury laws apply only to a **loan or forbearance** of money, goods, or contract rights covering *chose in action*. [Calif. Const. Art. XV §1]

Carryback modified at usurious rates

Consider an installment sale of real estate to a buyer on terms which include the execution of a note in favor of the seller for a portion of the sales price. The note includes a due date for a final/balloon payment.

When the due date for payment of the entire remaining principal arrives, the buyer defaults on the carryback note and trust deed.

The buyer and seller agree to extend the note's final due date for payment of the principal owed. In exchange, the buyer agrees to an increase in the note's interest rate, raising the rate above the usury threshold rate. Thus, the seller's yield on the debt after the modification exceeds the rate ceiling set by usury laws.

The buyer makes all payments due on the modified carryback note, including the final/balloon payment.

The buyer then makes a demand on the seller to return all the interest paid after the modification, claiming the seller's modification of the note was a **forbearance** controlled by usury limitations.

Is the buyer entitled to recover the interest paid after the modification in the rate of interest due on the carryback debt?

No! The transaction in which the debt was created was a credit sale, a debt not subject to usury laws. Although the terms of the note evidencing the carryback debt were modified and a **forbearance** (such as a cancellation of foreclosure) did occur, the status of a carryback debt does not change to transform the debt into a loan. Thus, a loan modification of the terms for payment—an interest rate increase—does not subject the debt to usury laws since the debt is not a loan. [**DCM Partners** v. **Smith** (1991) 228 CA3d 729]

Consider a buyer of real estate who acquires the property and takes over an existing trust deed lien which secures a note carried back by a **prior owner** of the property.

Later, the buyer defaults on the carryback note and trust deed. The holder of the note and trust deed initiates foreclosure.

Prior to the foreclosure sale, a pre-foreclosure workout agreement is negotiated between the buyer and the holder of the trust deed. The original carryback note is **canceled** and the trust deed lien is **reconveyed**.

In exchange for canceling the note, the buyer signs and delivers a new note and trust deed in favor of the holder of the canceled carryback note and reconveyed trust deed. The new note is secured by the same property as described in the new trust deed.

The new note is for a greater amount than the principal amount which remained on the carryback debt since the holder of the note was given a bonus for restructuring the debt which was added to the unpaid debt. Also, the interest rate is increased on the new note.

The **higher yield** on the new note resulting from the modified note rate and bonus paid to the holder of the trust deed exceeds the maximum annual average yield allowed over the life of the debt by usury laws.

After paying off the new note, the buyer demands the return of all the interest paid on the new note, claiming it was the result of a **forbearance** which brought the carryback debt under the protection of usury laws.

Is the holder of the new note entitled to retain the interest bargained for and paid on the note?

Yes! The new note evidenced a **restructuring** of the original credit sale debt, and the debt **remained secured** by the property originally sold. As a *rollover* of the debt created in a credit sale into a new note

and trust deed lien on the property sold, the debt retained its original characteristics as a **carryback debt**. Restructuring the carryback debt with a new note and trust deed did not make the debt a loan, and unless the debt is a loan it is not subject to usury laws. [**Ghirardo** v. **Antonioli** (1994) 8 C4th 791]

Loan disguised as a carryback

While the modification of a carryback note on a default does not convert the debt into a loan and thus the debt is not controlled by usury laws, a loan transaction disguised as a carryback sale is subject to usury laws. The documentation for a loan as a carryback transaction is merely a sham, *a masked loan transaction*.

For example, a seller of real estate negotiates with a buyer to **cash out** his equity in the property and assume the existing loan. However, the buyer does not have the cash reserves to cash out the seller's equity.

The buyer is referred to a private lender (who is not licensed as a real estate broker in California). The lender the buyer contacted is willing to lend the buyer the additional money needed to cash out the seller.

However, the rate of interest demanded by the unlicensed private lender exceeds the maximum yield allowed by usury laws.

Rather than lend the money directly to the buyer, the lender requires the sales transaction be restructured as a carryback note executed by the buyer in favor of the seller, payable on terms dictated by the lender. The lender will purchase the note by *assignment* from the seller concurrent with the close of the sales escrow.

Thus, the buyer will cash out the seller's equity in a two-step transaction consisting of the buyer's down-payment funds and the lender's funds structured as payment for the seller's **assignment** of the carryback note to the buyer's lender.

Will the lender's plan to structure his advance of funds as a purchase of a carryback note by an assignment from the seller avoid the interest limitations of usury laws?

No! Although the transaction on its face appears to be a credit sale and an assignment of a carryback note to a trust deed investor, the **initial purpose** for the involvement of the trust deed investor was to loan money to the buyer. As a loan transaction initiated and negotiated by the buyer to obtain purchase-assist funds from an unlicensed private lender without the involvement of a broker in the loan transaction, the transaction is a loan and is subject to usury law limitations on its annual yield. [**Harris** v. **Gallant** (1960) 183 CA2d 104]

Editor's note — One way for the private lender to exempt his loans from the limitation on interest rates imposed by usury laws is to retain a licensed real estate broker to arrange the loan (or become licensed as a real estate broker himself), since all loans ***made or arranged*** *by licensed brokers and secured by real estate are exempt from usury limitations. [Calif. Const. Art. XV]*

The carryback sold to a lender

Consider a buyer and seller in reverse roles from the previous example but with the same goal of cashing out the seller on close of the sales escrow. The seller, not the buyer, is the one who initiates negotiations to sell a carryback note and trust deed to an investor, an unlicensed private lender. The buyer and seller

enter into a purchase agreement calling for the buyer to make a down payment and execute a note and trust deed in favor of the seller for the remainder of the purchase price, closing contingent on the seller assigning the note to a trust deed investor.

From the outset of negotiations, the seller intends to immediately sell the carryback note to a trust deed investor. To assure the note can be sold, the seller (not the buyer in this example) structures the terms of the carryback note for sale to a trust deed investor. A trust deed investor approves the buyer's credit history before the seller waives the contingency for further approval of the buyer's credit. [See **first tuesday** Form 150 §8.5]

The yield the trust deed investor is to receive for the funds he advances to acquire the note and trust deed exceeds the usury limits.

The sales escrow closes concurrent with the trust deed investor funding his purchase of the carryback note by an assignment from the seller.

Later, the buyer claims the note is usurious and he owes no interest to the trust deed investor since the creation and sale of the carryback note was a sham designed to circumvent usury laws.

However, the carryback note evidenced a debt intended by the buyer and seller to arise out of a valid credit sale. The trust deed investor was not brought in by the buyer to make a loan, but was sought out by the seller to purchase the note the seller intended to carryback and resell.

No recharacterization or alteration of the purchase agreement or the sales escrow instructions was required to complete the seller's sale of the carryback note by an assignment of the note to the trust deed investor. Thus, the seller may freely **assign his carryback note** to the trust deed investor, and the assignment does not transform the carryback debt into a loan which would subject the debt to the annual yield limitations of usury laws. [**Boerner** v. **Colwell Company** (1978) 21 C3d 37]

Unconscionable interest rates

Although a carryback note and any modification of the note are exempt from usury laws, there are limits for interest rates which are enforceable.

For example, a buyer with a 5% down payment is able to obtain financing for only 80% of the purchase price. The seller agrees to carry back a second trust deed note for the remainder of the purchase price, but demands an interest of 20% per annum to cover his risk of loss, all due within six months from the close of escrow.

The buyer agrees to the seller's terms for the carryback note since he believes he can obtain the funds necessary to pay it off prior to the due date.

When the due date arrives, the buyer remains unable to obtain funds to pay off the carryback note. The buyer defaults on the note and the seller begin foreclosure proceedings.

Prior to the foreclosure sale, the seller offers to extend the due date of the note for one year, provided the buyer agrees to increase the interest rate to 200%. The buyer, not wanting to lose his equity in the property and with property values having risen, agrees to the increased interest rate.

Interest payments under the restructured carryback agreement are made for six months when the buyer again defaults on the note. As before, the seller begins foreclosure proceedings.

The buyer claims he is not liable for the interest since the note is usurious and the result of an *unconscionable economic advantage* acquired by the seller.

The seller claims the note is not subject to usury laws since it evidences a carryback debt and the voluntary modification of the annual rate of return is justified based on the risk of loss inherent in a 95% loan-to value ratio (LTV) and fast rising mortgage rates.

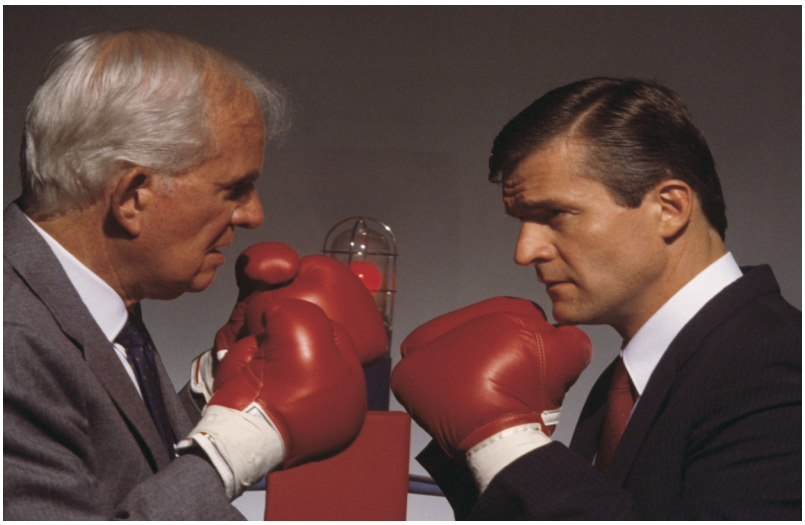
Is the seller correct that this note can avoid the usury issue?

Yes! The carryback note evidences a debt owed to the seller which is secured by the property sold, the result of a *credit sale*. Thus, the debt, modified by the extension and rate increase, is not a loan and is not subject to usury laws.

However, the seller is incorrect on the issue of an **unconscionable rate**. The interest rate provision of the note is so unconscionably high as to be shocking to a court. Thus, as an unconscionable annual rate of return on the debt, the excessive rate is not enforceable by the carryback seller. [**Carboni** v. **Arrospide** (1991) 2 CA4th 76]

SECTION F

Recourse and Nonrecourse Loans



Chapter 43 Anti-deficiency: past, present and future

This chapter discusses the history, purpose and application of anti-deficiency laws as a buyer's defense from lender claims of personal liability for payment of debts secured by real estate.

Are buyers losing their shield?

A buyer of real estate who executes a promissory note for a debt, in favor of either a lender or a carryback seller, agrees to pay the dollar amount owed as promised. This promise, if unsecured, is enforced under basic contract law.

However, while securing the debt by a trust deed lien on real estate does not abolish the buyer's *personal obligation* under his promise to pay, the inclusion of real estate as security places the enforcement of the debt under mortgage law, with dramatically different results from contract law for all involved.

A lender or carryback seller, by accepting real estate as security for the repayment of a debt, alters his method and ability to force the borrower to pay on that promise. When real estate is taken as security, it, not the borrower, becomes the primary source of the lender's recovery should the borrower default. Under mortgage law, a trade-off occurs for giving and getting real estate as security for a debt.

Thus, the lender or carryback seller holding a note secured by real estate is forced to **foreclose** by selling the real estate before attempting any other method of collection to satisfy an unpaid debt on a default. The borrower forces the noteholder to take (read that as buy) the property he has put up as security by merely defaulting on his promise to pay.

A default is the borrower's act of exercising the *put option* contained in the provisions of all trust deeds. On default, the lender is required to take the property in exchange for amounts owed. [Calif. Code of Civil Procedure §726]

A further limitation is placed on a mortgage lender's ability to recover losses incurred in a foreclosure when the property's value is insufficient to satisfy the note and the underlying debt, legally classified as *purchase-money debt*. Examples of **purchase-money debt** include:

- an installment sale – **carryback note** – on the sale of any type of property; and

- the **purchase-assist funding** of a one-to-four unit residential property occupied by the buyer. [CCP 580b]

Editor's note: Purchase-money debt does not include purchase-assist loans which fund the purchase of property other than one-to-four residential units.

Occasionally, the fair market value (FMV) of the secured real estate at the time of the foreclosure sale is insufficient to satisfy the debt. Yet the buyer as **maker** of the promissory note is still *personally responsible* for the amount remaining unsatisfied after foreclosure.

However, to **enforce collection** by obtaining a *money judgment* for losses based on an underbid at the foreclosure sale, the lender or seller holding the note must have structured the transaction to deprive the buyer of an *anti-deficiency defense*. To collect the deficiency in the secured property's value to fully satisfy the debt, the debt must be recourse in nature and the foreclosure must be judicial.

Until the 1930s, the signer of a note evidencing any type of debt secured by any type of real estate remained *personally liable*, not just responsible, Thus, the signer was liable for any deficiency in the property's value and subject to an award of a **money judgment** after either a judicial or nonjudicial (trustee's) foreclosure sale on the property.

For example, a lender in 1929 holds a note which evidences a loan secured by a trust deed lien on the borrower's principal residence, which was purchased by the use of loan funds.

The homebuyer defaults on the note. The lender forecloses by a trustee's sale and recovers the property for **less than its FMV** by entering a credit bid for a fraction of the dollar amount of the secured debt, called an *underbid*.

Prior to the mid-1930s, the lender would then sue the borrower and be awarded a money judgment for the difference between the amount of the **underbid** and the amount due on the note, the value of the property taken by the lender being of no concern.

After the payment of the money judgment, the homebuyer would not be entitled to recover the property. Foreclosure by a trustee's sale barred any later redemption or recovery of the real estate by the wiped-out homebuyer and was not a defense in court to avoid a money judgment.

Thus, in addition to losing the secured real estate, the homebuyer or investor would also remain burdened with the responsibility of paying off the balance of a debt he incurred to buy property he now no longer owns or can recover.

This Great Depression scenario, allowing the lender to acquire the property on an underbid at a trustee's sale and also obtain a money judgment against the borrower for any remaining balance due on the note, came to an end in California in the late-1930s.

Unjust deficiencies eliminated

In the 1920s, the economy was booming. Real estate values were high and rising, and real estate prices and public confidence in the future were even higher, not unlike the giddy mid 2000s.

However, the 1930s ushered in an economic depression which, due in part to the abrasive foreclosure practices of lenders and carryback sellers (as well as a penurious, moral-stricken Federal Reserve), devastated values in the real estate market.

Along with the economy and banks, real estate values plunged, foreclosure sales were rampant and the loss of homeownership escalated out of control.

With the additional burden of an owner's personal liability for a deficiency in his property's value, the chances of financial recovery for most owners who lost property through a trustee's foreclosure were slim. The easiest way to effectively escape from the judgment and the arm of the law was to move to another state.

In the 1930s, to curb the negative impact that the drastic increase in foreclosure sales and the resulting money judgments and displacement of owners was having on the region's economy, the California legislature enacted **anti-deficiency laws** which included:

- a limitation on the **amount recoverable** as a money judgment for debts secured by real estate, set as the difference between the amount due on the note and a court-established fair market value (FMV) of the property (lender's security interest) at the time of a judicially ordered foreclosure sale, called a *deficiency* [CCP §580a];

- a prohibition against money judgments being obtained by lenders and carryback sellers for any deficiency in property value on any type of foreclosure by limiting their recovery solely to the value of the secured property when, 1) the lender's loan funded the purchase and was secured by a one-to-four unit residential property occupied by the borrower as his principal residence, or, 2) the debt was incurred by the buyer as a carryback note on the seller's installment sale of any type of real estate which was the sole security for the debt [CCP §580b]; and

- a bar against any creditor secured by real estate from obtaining a money judgment for a deficiency after completing a **trustee's sale**. [CCP §580d]

The shift in the risk of loss

Anti-deficiency rules used as a defense by a property owner to avoid liability for payment of a *purchase-money* note shift the **risk of loss** for the unpaid loan balance or portion of the price paid for real estate from the buyer to the lender or carryback seller holding the note. **Purchase-money** notes are also called *nonrecourse* notes.

When the real estate securing *purchase-money* paper drops in value, the potential for loss increases for the holder of the paper. Then, on a default, the lender or the carryback seller often minimize their loss through pre-foreclosure workouts. The lender or seller might realistically go so far as to accept a *short payoff* on a sale of the property by the owner, in full satisfaction of the debt.

By accepting the net proceeds from the owner's sale of the secured property in exchange for cancelling the outstanding loan balance — sometimes called a **short payoff** — the lender or carryback seller avoids the costs of both:

- foreclosure; and
- ownership resulting from acquisition of the property at foreclosure.

While prompting lenders and carryback sellers to minimize their potential losses, anti-deficiency rules protect the property owner by balancing the risks of each other's losses during times of economic reversal.

Taxwise, an owner who participates in a short payoff of a **nonrecourse loan** incurs no reportable *discharge-of-indebtedness income* when the owner's original purchase price of the secured property is greater in amount than the principal remaining on the debt prior to the payoff. [**Commissioner of Internal Revenue** v. **Tufts** (1983) 461 US 300]

Overinflated prices for profit

Anti-deficiency laws shift the risk of loss on a note signed by the buyer in favor of a *purchase-money* lender or carryback seller which arises when the value of the secured real estate is inadequate to fully satisfy the debt, a mortgage leveraging condition called *negative equity*.

For example, sellers of property who carry back a note in an installment sale based on an inflated price and secured only by the property sold are financially restrained from recovering all the price they bargained for should the value of the property at the time of the foreclosure sale be less than the amount owed. The sole source of recovery for a carryback seller with no additional security is the property sold. No recourse is available to the buyer's other assets.

Consider a seller of real estate who locates a buyer willing to pay an inflated price for the property, or a situation in which the price was at market but the property later suffers a drop in value.

To help finance the buyer's purchase of the property, the seller carries back a note secured by a trust deed lien on the property he sold.

Later, the buyer defaults on the carryback note, realizing the property is over encumbered for its value and has no equity. The seller forecloses, judicially or nonjudicially, and the property is sold at a foreclosure sale for less than the amount owed on the note.

The seller seeks to recover his loss on the note due to the deficiency in the property's value. Here, the carryback seller is barred by anti-deficiency legislation from enforcing collection of any deficiency in the value of the property at the time of the foreclosure sale, regardless of the type of foreclosure sale employed. The note was for credit extended by the seller on the sale of property and the property sold was the sole security for that debt. [CCP §580b]

The carryback seller whose property's sales price is inflated, or whose property experiences a drop in value after it is sold, will not benefit beyond the price received at the foreclosure sale.

Marketplace drop in property value

The value of the real estate securing a **purchase-money debt** may become inadequate to cover the debt due to falling real estate values caused by a local or general economic downturn, as opposed simply to an unrealistically inflated price at the time of sale.

Here, anti-deficiency laws are intended to ensure that an economic downturn is not aggravated beyond the usual cyclical increase in foreclosure sales. Thus, as a matter of public policy to avoid the deepening of a recession, buyers of any type of real estate on an installment plan are not held personally liable for those purchase-money debts. [**Roseleaf Corporation** v. **Chierighino** (1963) 59 C2d 35]

Also, consider a home buyer who obtains a 30-year purchase-assist loan from a lender which funds the purchase of a one-to-four unit residential property he occupies as his principal residence.

A few years later the local economy becomes depressed, causing the fair market value of the property to drop below the unpaid balance on the loan. The borrower defaults and the lender reacquires the property on an underbid at a foreclosure sale.

The underbid at the foreclosure sale results in an unpaid balance remaining on the debt.

Can the lender who funded the purchase-assist loan secured by the buyer-occupied, one- to-four unit residential property, enforce collection of the unpaid balance remaining on the note?

No! The lender is barred from obtaining a deficiency judgment in any amount, regardless of the type of foreclosure he may pursue, be it judicial or nonjudicial. The purchase-assist loan is classified as a **purchase-money** loan since it funded the purchase of the property and was secured by a one-to-four unit residence which was occupied by the buyer on acquisition. [CCP §580b]

Consider a seller who carries back two notes on the sale of a single parcel of real estate after a 5% down payment. Each note evidences separate amounts due the seller, totaling 95% of the property's total sales price. One note in an amount equal to an 80% loan-to-value (LTV) ratio is secured by a trust deed on the property sold. The other note for 15% of the sales price is secured by a trust deed on other property owned by the buyer. The notes are not *cross collateralized* and a default on one note does not constitute a default on the other under the *dragnet clause* in the trust deeds. [See **first tuesday** Form 154 §4]

The buyer defaults on both notes.

The seller completes a trustee's foreclosure sale under the trust deed he carried back on the property he sold to the buyer. A judicial foreclosure is later initiated against the buyer's other property under the separate note and trust deed in an effort to recover what will be a deficiency in the other property's value at the time of the judicial foreclose sale.

The buyer claims the judicial foreclosure on his other property violates anti-deficiency law since the second foreclosure is an attempt to recover a deficiency on the price the buyer paid for property he no longer owns and the seller recovered by a trustee's sale.

Can the seller foreclose on the buyer's other property under the separate debt (note) and trust deed?

Yes! The foreclosure on the other property does not violate anti-deficiency law. A carryback debt secured by a property other than the property sold is not subject to anti-deficiency law. [**Hodges** v. **Mark** (1996) 49 CA4th 651]

In this example, the buyer, when negotiating to secure the carryback note with a trust deed lien on other property other he owned rather than the property he purchased, should have considered arranging for the inclusion of an *exculpatory clause* in the note. An **exculpatory clause** converts recourse paper into non-recourse paper by eliminating personal liability for any deficiency in the value of the secured property. [See Chapter 6; see Form 418-5 §2.2 accompanying this chapter]

Anti-deficiency waiver barred

Consider a lender or carryback seller attempting to collect on a note which the provisions of a modification agreement converted the debt to a recourse debt.

For example, a carryback seller of unencumbered property bargains for and receives two notes evicencing separate amounts of the sales price remaining to be paid. The notes are separately secured by first and second trust deeds on the real estate he sold, an 80-10-10 financing arrangement called piggyback financing. Later, the buyer arranges for a lender to refinance the balance due on the carryback seller's first trust deed note.

However, as a condition for recording the refinancing, the seller must subordinate his second trust deed to the lender's new trust deed so the refinancing will have priority as a first trust deed lien on the property.

The carryback seller agrees to reconvey his first trust deed and subordinate his second trust deed to the refinancing, if the buyer:

- **personally guarantees** the note he executes; and
- signs a **written waiver** of any anti-deficiency protection.

The buyer agrees and enters into a guarantee agreement and a modification of the second trust deed note. The seller enters into a **specific subordination agreement** allowing his original second trust deed to remain a second, junior in priority to the new trust deed. The lender's trust deed and the subordination agreement are recorded on closing the loan escrow.

The buyer then defaults and the first trust deed lender forecloses on the property, wiping out the second trust deed held by the carryback seller. The carryback seller now seeks to recover the balance due on the second trust deed note since his trust deed interest in the property has been exhausted by the foreclosure on the first trust deed.

The seller claims he is entitled to a money judgment on the purchase money debt since the buyer personally guaranteed the debt and signed a waiver relinquishing his anti-deficiency protection in consideration for the seller subordinating to new financing.

The buyer claims the personal guarantee and the waiver of anti-deficiency protection are unenforceable attempts by the seller to circumvent anti-deficiency law on a carryback debt.

Can the carryback seller enforce collection on the note or under the personal guarantee for the balance due on the note following subordination of his trust deed lien to refinancing?

No! The buyer is not liable on the note or his guarantee. The seller's carryback debt remained secured by a trust deed on the property sold, no additional or other property involved. Any guarantee or agreement under which the buyer purports to waive his anti-deficiency protection without a substitution of property as security is unenforceable. [**Palm** v. **Schilling** (1988) 199 CA3d 63]

Only a third party executing a **guarantee agreement** can be personally liable for amounts due on a purchase-money note. [See Form 439 in Chapter 13]

Consider a seller who carried back a note and trust deed on a property he sold. Later, during a real estate recession, the buyer of the property defaults and is unable to sell the property or borrow funds to pay off the note. The seller commences foreclosure by recording a notice of default (NOD).

Prior to the trustee's sale, the buyer and seller *modify* the note to include a (contract) provision stating the buyer waives his anti- deficiency protection in exchange for the seller canceling the NOD.

Ultimately, the first trust deed holder forecloses, wiping out the seller's second trust deed. The carryback seller seeks to recover the amount owed him on the note since his security interest under the trust deed lien has been *exhausted* by the first trust deed lienholder's foreclosure.

The buyer claims the seller is barred from any recovery on the note since **enforcement of debt** created to pay the seller in an installment sale of real estate is subject to anti-deficiency defenses held by the buyer which cannot, as a matter of *public policy*, be waived.

NOTE ENFORCEMENT PROVISIONS

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to a Promissory Note

1.1 ☐ of same date, or dated _____, 20_____, at _____, California,

1.2 entered into by _____, as the Payor,

1.3 in favor of _____, as the Payee, and

1.4 secured by a trust deed on real estate referred to as _____

_____

_____.

AGREEMENT:

2. In addition to the terms of the above referenced Promissory Note, Payee agrees to the following checked provisions:

2.1 **Guarantee provision**

☐ The Note is guaranteed by _____, under a Guarantee Agreement dated _____, 20_____, at _____, California. [See **ft** Form 439]

2.2 **Exculpatory provision**

☐ Enforcement of the Note and Trust Deed is subject to the purchase money anti-deficiency provisions of Code of Civil Procedure §580b.

2.3 **Governing law provision**

☐ This Note is governed by California law.

Payor's name: _____	Payor's name: _____
Signature: _____	Signature: _____
Payor's name: _____	Payor's name: _____
Signature: _____	Signature: _____

FORM 418-5 04-08 ©2008 **first tuesday**, P.O. BOX 20069, RIVERSIDE, CA 92516 (800) 794-0494

The seller claims the buyer waived his anti-deficiency protection by an agreement in writing which **modified** the note and trust deed in exchange for the seller's forbearance of foreclosure by canceling the NOD.

Can the seller recover on the carryback debt based on the modification and waiver agreement?

No! Recovery on the modified note, which evidences a carryback debt secured only by the property sold, is barred by anti-deficiency rules even though the buyer waived his anti-deficiency protection. Any waiver of anti-deficiency protection by the buyer while the carryback debt remains secured solely by the property sold is unenforceable as against public policy. [**DeBerard Properties, Ltd.** v. **Lim** (1999) 20 C4th 659; CCP §580d]

Deficiency judgment and one year redemption

The public policy objective behind anti-deficiency legislation is to protect property owners and dissipate the "debtor's prison" aura which surrounds defaulting owners who would both lose their property and be subject to a money judgment. [Palm, *supra*]

A lender holding a **recourse note** can foreclose judicially and obtain a deficiency judgment if the fair market value of the secured property at the time of the judicial foreclosure sale has fallen below the amount of the debt. However, the borrower has the right to **redeem the property** within one year after the judicial foreclosure sale by paying the amount of the bid (plus interest) when a money judgment for the deficient value is awarded to the lender. The money judgment is a separate debt, unconnected to the right to redeem the property for the price bid at the foreclosure sale. [CCP §729.030]

As a consequence, a **judicial foreclosure** is costly to the lender both in time and money. Also, the lender faces the risk of a further decline in the property's value during the one-year redemption period after the foreclosure sale, as well as the risk of being unable to recover a money award.

Thus, a trust deed lender holding a recourse (or nonrecourse) note can foreclose quickly and inexpensively through the trustee's sale procedure. The owner's *right to redeem* the property by payment of the debt in full is terminated on completion of the trustee's sale.

To counterbalance the beneficial right of a recourse lender to a swift foreclosure by use of a trustee's sale, the recourse lender is **barred from obtaining** a deficiency judgment after foreclosing nonjudicially on the property. While an owner has no right to redeem the property after a trustee's sale, he does have the right to redeem the property after completion of the judicially ordered sheriff's sale. [CCP §580d]

The reemergence of anti-deficiency law

When faced with an economic downturn, such as the real estate recession which lasted the entire first half of the 1990s, homeowners and installment sale buyers need the protection of anti-deficiency laws against lenders and carryback sellers if they are to continue to live in California and contribute to the state's economy. This same economic scenario looms for the great recessionary period following 2006.

However, signs of the erosion within the long-standing public policy behind the anti-deficiency defense against excess lending on secured debt can be seen in the California legislation which was passed to benefit lenders and carryback sellers in 1994, as well as removal of cramdown authority on single family residences from the federal bankruptcy law in 2005.

Lenders are very good at lending too much money when profits remain *privatized* and later lobbying governments to cover errors in lender judgment by *socializing* their losses.

As a result, lenders and carryback sellers can circumvent California's anti-deficiency defense by requiring borrowers and buyers to provide a *letter of credit* as a condition for financing, unless the financing funds or extends credit for the purchase of an owner-occupied, one-to-four unit residential property. [CCP §§580.5; 580.7]

Although the borrower is ultimately liable for repayment of any amounts drawn by the lender or carryback seller on the **letter of credit**, the lender or carryback seller holding the letter of credit is no longer barred from using it before or after a **trustee's foreclosure** has been completed to recover any deficiency due to an underbid. This procedure is quicker and slicker than the alternative involving a judicial foreclosure, appraisals, a money judgment and pursuit of its collection.

Additionally, a letter of credit has been legislatively re-classified. It may no longer be legally considered a guarantee or additional security, although the economic function of enforcing a letter of credit has the same economic function as the enforcement of a guarantee or pursuit of the additional security.

Unlike a guarantor, the issuer of a letter of credit, usually a banker, does not receive the same protection as would a guarantor signing a guarantee. A guarantor is entitled to a notice of foreclosure and an opportunity to purchase the guaranteed note before the completion of a foreclosure on the property, unless the guarantor waives his right to a notice in writing. [See Form 439 in Chapter 13]

Further, unlike additional security, a letter of credit can be drawn on by a lender or carryback seller before completing a judicial foreclosure. The draw does not then bar the foreclosure for having enforced collection **without first foreclosing on** to the secured property, called the *one-action rule*.

Borrowers currently protected from the letter of credit device are homebuyers, small-time investor/occupants of one-to-four unit residential properties, and those borrowers who refuse to provide a letter of credit that would allow the lender to draw on it at any time.

Ironically, in the 1990s, during the second greatest economic downturn in California during the twentieth century, the state legislature passed laws diminishing the effects of prior legislation designed to protect borrowers and create a viable economic environment which would induce borrowers who have gone bust to remain in California as contributing residents.

A letter of credit is now legislatively considered a **source of payment**, not a form of security, which is available to be called on by the lender at any time. Thus, a borrower defaulting on any debt secured by real estate (excluding an owner-occupied, one-to- four unit residence) and accompanied by a letter of credit, has lost the much needed protection that anti-deficiency law provides against reckless lending, boomtime mentality and dramatic declines in the real estate economy.

Chapter 44 Converting nonrecourse paper into recourse paper

This chapter explains how a nonrecourse note held by a lender or carryback seller becomes recourse paper through later agreements with the property owner.

Eliminating or substituting security

A seller holds a carryback note secured by a third trust deed on real estate he sold, called a *purchase-money* note since a deficiency in the value of its security is not collectible.

The buyer defaults and on investigating the financial feasibility of foreclosing and repossessing the property, the seller decides to forgo foreclosure. [See Form 303 in Chapter 30]

The buyer wants to retain the property, but needs the seller to subordinate his trust deed to a new first trust deed loan.

The seller offers to reconvey the carryback trust deed in exchange for the buyer executing a new note for the debt owed, but secured by a junior trust deed on real estate other than the property sold. The buyer provides security – a trust deed position on other property – which the seller accepts.

By mutual agreement between the buyer and the seller:

- the seller cancels the purchase-money note and reconveys the carryback trust deed; and
- the buyer signs and delivers a new note and trust deed in favor of the seller, secured by other real estate owned by the buyer.

While the buyer **substituted security** for an existing debt owed to the seller, the new note merely evidences the same debt which was represented by the canceled note.

Later, the holder of the first trust deed on the substituted security forecloses, eliminating the seller's trust deed lien from title, called an *exhaustion of the security*.

Since the carryback seller's substituted security interest has been eliminated and the buyer refuses to pay, he sues the buyer to obtain a money judgment for the unpaid amount of the note.

The buyer claims the seller is barred by anti- deficiency rules from collecting on the note since the note evidences a purchase-money debt created between the buyer and the seller to finance the sale of real estate. [Calif. Code of Civil Procedure §580b]

The carryback seller claims anti-deficiency rules no longer bar him from obtaining a money judgment on the carryback debt since the debt became secured by real estate other than the property sold.

Can the seller enforce collection of a carryback debt which became secured, separately or collaterally, by property other than the property sold?

Yes! The seller can obtain a money judgment to enforce collection on the note even though it evidences a carryback debt. Anti-deficiency non-recourse rules no longer apply to a carryback debt when the debt

becomes secured by real estate other than the real estate sold, called a *substitution of security*. The carryback seller was able to sue directly on the note without first foreclosing since his security interest in property other than the property sold was wiped out by the senior trust deed foreclosure. [**Goodyear** v. **Mack** (1984) 159 CA3d 654]

If a seller is barred from obtaining a money judgment to enforce collection of a carryback note, secured by property other than the property sold, the buyer would be improperly allowed to:

- retain the property sold; and
- avoid paying the seller for the property he purchased.

Subordination with an added risk

Construction loans are naturally precarious arrangements due to the risk the improvements may never be completed to create the anticipated property value.

Consider a seller who carries back a trust deed on the sale of a parcel of real estate and later **subordinates** the trust deed to a construction loan.

Should the construction lender foreclose on the property the seller sold and wipe out the now subordinated carryback seller's trust deed lien, the seller can collect on the carryback note by obtaining and enforcing a money judgment.

For example, a carryback seller subordinates his trust deed to a trust deed recorded to secure a construction loan. The loan will fund the cost of improvements to be made on the property he sold. Since the carryback trust deed is subordinated to the loan, the risk of loss due to a failure of the development is thrust upon the seller. To cover the added risk of loss presented by the buyer's need to complete the construction, the note's interest rate is increased and prepaid for the period anticipated for construction.

Here, the trust deed note becomes recourse paper since it was subordinated to the trust deed securing the construction loan. The seller is not expected to assume the risk that the value of the yet-to-be-built improvements may not prove to be adequate security for his carryback note and cause him to suffer a loss.

Thus, the developer/buyer who promises to construct improvements as **additional security** is not protected by anti-deficiency rules from personal liability should the value of the property prove to be inadequate to satisfy the carryback note which is subordinate to a construction loan. As recourse paper, the seller is allowed to collect his losses from the developer if the property value proves insufficient to satisfy the carryback note. [**Spangler** v. **Memel** (1972) 7 C3d 603]

An **agreement to subordinate** a carryback trust deed to a future construction loan does not itself cause the trust deed note to lose its nonrecourse character. [See Form 281 accompanying this chapter]

However, the note becomes recourse paper when the carryback trust deed actually becomes subordinated to a construction loan. [**Jack Erickson and Associates** v. **Hesselgesser** (1996) 50 CA4th 182]

Conversely, the actual subordination of a carryback trust deed to the buyer's purchase-assist trust deed loan, or a later refinancing of the senior trust deed loan, does not present a change in the use or nature of the property, nor provide additional security, which would need to take place in order to convert a nonrecourse note to recourse paper. The physical property remains the same, contrary to the seller's

subordination of his security interest in the property since the seller's loan-to-value ratio (LTV) has been altered by accepting a secured position which over encumbers the property. [**Shepherd** v. **Robinson** (1981) 128 CA3d 615]

When a carryback seller agrees to subordinate his carryback trust deed to purchase-assist financing secured only by the property sold, the subordination does not alter the character of the property sold (no construction promised) or the nonrecourse nature of the seller's (undersecured) purchase-money note. [**Lucky Investments, Inc.** v. **Adams** (1960) 183 CA2d 462]

A seller who carries back a trust deed, secured only by a subordinated interest in the property sold, is charged with knowing the value of the real estate sold and thus the value of the position accepted as security.

For example, should a lack of value exist, or a market-induced reduction in the value of the property sold occur due to overpricing or a recession, the buyer is not personally liable on a seller carryback note secured by the property sold, even if the debt is later subordinated to new financing. [**Brown** v. **Jensen** (1953) 41 C2d 193]

Choice-of-law avoids anti-deficiency rules?

Consider a borrower who executes a purchase-money note secured by a trust deed on California real estate. The note contains a provision which adopts the law of another state to control the legal consequences of the financing.

The borrower and the lender are both domiciled in a state which does not have anti-deficiency laws.

The borrower defaults on the loan. The lender judicially forecloses on the property and is awarded a deficiency judgment.

The borrower claims the lender is barred from recovery by way of a deficiency judgment since the note is secured by California real estate.

The lender claims it is not barred from seeking a deficiency judgment since the transaction is governed by the law of another state which does not prohibit deficiency judgments.

Is the lender entitled to a deficiency judgment?

Yes and no! The yes part: The trust deed contained a choice-of-law provision which controlled enforcement of the California purchase-money note under **out-of-state law**. Since all parties involved were non-residents and located out-of-state, California's public policy regarding anti-deficiency is not adversely affected since no Californians are involved. Thus, the deficiency in the value of the property sold is collectible by a money judgment. [**Guardian Savings and Loan Association** v. **MD Associates** (1998) 64 CA4th 309]

*Editor's note — The no part: The **Guardian** court's holding is limited to the narrow facts of the case, i.e., all parties were non-residents living out-of-state who choose to abide by the laws of a "recourse state." Conversely, to allow **choice-of-law provisions** applying the law of a recourse state to a resident owner of property located in California would impermissibly open the door for out-of-state lenders to circumvent California's anti-deficiency laws designed to protect its residents.*

Letters of credit

A lender might require a borrower to obtain a letter of credit as a condition for funding a **purchase-assist loan**. Also, a seller agreeing to carryback paper might demand a letter of credit as additional security.

The lender or carryback seller can draw on a letter of credit before or after a trustee's sale without violating anti-deficiency statutes or the security first rule. [CCP §580.5(b)]

However, the letter of credit is unenforceable if:

- it is issued to a trust deed beneficiary to cover a future default on the obligation; and
- the obligation is secured by a purchase money trust deed on owner-occupied, one-to-four unit residential property. [CCP §580.7(b)]

Thus, a carryback seller or a purchase money lender on an owner-occupied, one-to-four unit residential property is barred from drawing on a letter of credit at any time.

Reconveying the trust deed

A lender or carryback seller holding a note secured by a trust deed cannot **unilaterally waive and reconvey** the note's security, then proceed against the borrower or buyer as though the now unsecured note was converted to recourse paper by the release of the security.

A *release of the security* must be **mutually agreed to** between the lender and borrower for the secured debt to become a recourse debt.

For example, a carryback seller holds a note for the balance due on the purchase price of real estate. The note is secured by a second trust deed on the property sold.

The property value has decreased below the amount owed on the note, due to a destabilized real estate market, and the buyer defaults.

The carryback seller agrees with the buyer to modify the terms of the note and release the security. He senses the security interest he holds under his trust deed lien on the property has insufficient value to protect should the first trust deed holder foreclose.

As agreed, the carryback seller reconveys the trust deed and the carryback note becomes unsecured. [See Form 472 in Chapter 13]

The Modification of the Promissory Note, executed by the buyer in favor of the seller, is attached to the note as an allonge and states the changes in its terms and the release of the trust deed lien by reconveyance. [See Form 425 in Chapter 55]

Later, the buyer defaults on the now unsecured note held by the carryback seller, who in turn sues the buyer for a money judgment to recover the balance due on the note.

AGREEMENT TO SUBORDINATE

NOTE: This agreement to subordinate results in your security interest in the property becoming subject to and of lower priority than the lien of some other or later security device.

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to the following agreement:
- ☐ Purchase agreement
- ☐ Escrow instructions
- ☐ Trust deed
- ☐ _____

1.1 dated _____, 20_____, at _____, California,

1.2 entered into by _____, as the Buyer/Trustor, and _____, as the Seller/Beneficiary,

1.3 regarding real estate referred to as _____.

AGREEMENT:

2. Provided Trustor is not in default on the Beneficiary's trust deed, Beneficiary shall, on written request of Trustor, subordinate his trust deed to a new first trust deed loan to be obtained by Trustor prior to _____, 20_____.

3. The terms of the new first trust deed loan shall include:

3.1 A principal amount not to exceed $_____.

3.2 An annual rate of interest not exceeding _____%.

3.3 Interest to accrue on the remaining balance at a ☐ fixed rate, or ☐ adjustable rate.

3.4 A term not less than _____ years, not more than _____ years.

3.5 Amortization of the loan payable monthly over _____ years, ☐ until paid, or ☐ with a final balloon payment due in not less than _____ years.

3.6 Origination fees and finance charges to be disbursed from the loan proceeds may not exceed _____ points and $_____, respectively.

3.7 Other _____

4. ☐ Trustor shall use the net proceeds from this loan to improve the real property, both onsite and offsite.
The primary construction to be _____

5. ☐ Trustor shall use the net proceeds from this loan to pay _____

6. Trustor shall receive $_____ cash back from the loan proceeds.
These funds to be used for the following purpose(s) _____

7. ☐ **NOTICE: This subordination agreement contains a provision allowing the person obligated on your real property security device to obtain a loan, a portion of which may be expended on purposes other than improvements on the real property.**

☐ See attached Signature Page Addendum. [**ft** Form 251]	☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: _____, 20_____	Date: _____, 20_____
Buyer/Trustor: _____	Seller/Beneficiary: _____
Buyer/Trustor: _____	Seller/Beneficiary: _____

The buyer claims anti-deficiency rules bar the carryback seller from collecting on the note since the seller's note was a purchase money obligation, created to finance the sale of the property.

However, the anti-deficiency rules no longer apply to the carryback note. The buyer and seller mutually agreed to a reconveyance of the trust deed to release the security.

The carryback seller can pursue the buyer to collect the balance due on the note since the security was released by mutual agreement.

To bar a seller from collecting on an unsecured carryback note — a note which is unsecured by mutual agreement between the seller and the buyer — would not advance the purposes of anti-deficiency rules. The buyer would be able to keep the property and pay less than the agreed-to price.

In contrast, a carryback trust deed note which becomes unsecured by mutual agreement is legally distinct from a carryback note which was **unsecured from the outset** of the sales transaction, even though both are recourse notes.

A seller who carries back an unsecured note on the close of a sales transaction has a *vendor's lien right* which he can impose on the property sold and judicially foreclose (if it is still owned by the buyer). The note was at all times unsecured and represents the amount of the purchase price remaining unpaid, contrary to the note held by the previously secured carryback seller. [Calif. Civil Code §3046]

In addition, a carryback seller or lender who requires a buyer to execute two notes for the **same debt**, one note secured by the real estate purchased, the other purportedly unsecured, is barred from collecting a deficiency. The underlying debt, evidenced in its entirety by each of the two notes, is secured by the property sold. Thus, the debt is a nonrecourse debt which can only be collected from the value of the property sold. [**Freedland** v. **Greco** (1955) 45 C2d 462]

Additional security

Now consider a lender who holds a purchase-money note. The debt is a purchase-assist loan secured by a first trust deed on owner-occupied, one-to-four unit residential property. Local real estate values have become depressed, causing the real estate to no longer be adequate security for the note.

The owner defaults on the note. To cure the default, the lender and owner mutually agree that:

- the terms of the note will be modified; and
- the owner will additionally secure the note by executing a trust deed to create a lien on another property owned by the owner.

Later, the owner defaults again. The lender judicially forecloses on both the owner's personal residence and the additional security, yet a deficiency in value still exists leaving the note unsatisfied.

Can the lender obtain a money judgment to collect the deficiency after judicially foreclosing on both the buyer's residence and the additional security?

Yes! Anti-deficiency rules do not bar the lender from a money judgment when a purchase-money note becomes **additionally secured** by other property. The note no longer is non-recourse, purchase-money paper. [CCP §580b]

However, a lender or carryback seller seeking a money judgment on recourse paper must concurrently foreclose on all of the secured properties in one judicial foreclosure action. No *piecemeal foreclosure sales* are allowed under a judicial foreclosure when multiple properties are the security and a deficiency judgment is sought. [CCP §726(a)]

SECTION G

Default and Foreclosure

Chapter 45 Notice of default, reinstatement, and redemption

This chapter analyzes what constitutes a default on a trust deed which allows the trust deed holder to initiate foreclosure, and an owner's reinstatement and redemption rights after his default.

Nullifying the call during foreclosure

A lender holding a trust deed and note may call the entire principal balance of the note due and immediately payable on any default in the terms of either the note or trust deed. Trust deeds contain a boilerplate provision called an *acceleration clause* that authorizes the lender to call the loan after a material default on the trust deed.

Another provision in the trust deed, called the *power-of-sale provision*, authorizes the beneficiary to instruct the trustee appointed under the trust deed to initiate a non-judicial trustee's foreclosure to sell the property described in the trust deed.

As a result of the tandem effect of the acceleration clause and the power-of-sale provision, the trustee's recording of a *notice of default* (NOD) both initiates the trustee's foreclosure procedures and causes all sums left to be paid on the note and trust deed to become due and immediately payable.

Consider a homeowner who defaults on the payment of principal and interest on the note and property taxes under the trust deed. An NOD is recorded, commencing foreclosure to enforce payment of all sums owed under.

An investor, aware of the NOD, submits a purchase agreement offer to the homeowner which is accepted. The terms include the transfer of ownership to the investor subject to the existing note and trust deed in foreclosure. The owner will pay all delinquencies and foreclosure charges at the close of escrow from equity purchase funds received from the investor.

Escrow is opened and the escrow agent sends a request for a beneficiary statement to the holder of the note and trust deed, called the *beneficiary*. The **beneficiary** is a private party who has commenced foreclosures before on this trust deed and canceled the NODs when the homeowner paid all the foreclosure costs and brought the delinquent payments and late charges current.

The beneficiary responds to escrow's request for a beneficiary statement by sending a payoff demand, not a beneficiary statement. The beneficiary claims he is enforcing the acceleration clause in the trust deed and will only accept payment in full now that the NOD has been recorded, triggering the call.

The NOD states the **amount of the delinquencies**, past, present, and future. Thus, escrow is able to determine the amount due to cure the defaults stated in the NOD. The trustee is contacted and the total of the foreclosure fees and charges incurred by the date scheduled for close of escrow are determined.

The investor deposits closing funds with escrow on escrow's call for funds. Escrow is closed and the delinquencies and foreclosure costs are forwarded to the trustee, payable to the beneficiary in the form of the homeowner's sales proceeds.

The beneficiary rejects the sales proceeds, claiming the entire amount of his note is due as agreed in the trust deed. Further, the beneficiary claims the due-on clause in the trust deed has been triggered by the buyer's failure to obtain the beneficiary's consent to the sales transaction and now requires a full payoff of the note.

Can escrow, by tendering only the amount of the delinquencies and foreclosure costs necessary to cure the defaults, cause the note and trust deed to be brought current and reinstate the trust deed as though a default had not occurred?

Yes! After the NOD has been recorded and prior to five business days before the trustee's sale, the owner (or any junior lienholder or buyer) of the real estate encumbered by the trust deed lien that is in foreclosure can terminate the foreclosure proceedings by paying:

- the delinquent amounts due on the note and trust deed as described in the NOD and foreclosure charges, called *reinstatement* [Calif. Civil Code §2924c]; or

- the entire amount due on the note and trust deed, plus foreclosure charges, called *redemption*. [CC §2903]

Since the call triggered by a violation of the due-on clause based on the unconsented-to transfer to the investor is not stated in the NOD, the due-on call cannot be enforced under this NOD.

Monetary defaults and reinstatement

A trust deed on which a foreclosure has been initiated is considered reinstated when the beneficiary receives:

- all amounts referenced as delinquent in the NOD, including principal, interest, taxes, insurance, assessments, and advances;

- installments that become due and remain unpaid after the recording of the NOD, and any future advances made by the beneficiary after the recording of the NOD to pay taxes, senior liens, assessments, insurance premiums, and to eliminate any other impairment of the security; and

- costs and expenses incurred by the lender to enforce the trust deed, including trustees fee's or attorney fees. [CC §2924c(a)(1)]

After an NOD is recorded, an owner or junior lienholder of an interest in the real estate in foreclosure can bring current any monetary or curable default stated in the NOD prior to five business days before the trustee's sale, called the *reinstatement period*. If the sale is postponed, the reinstatement period is extended, ending the day before the five business days prior to the postponed sale date. [See Figure 1; CC §2924c(e)]

Until the NOD is recorded by a trustee, the tender of all delinquencies must be accepted by the beneficiary.

After recording the NOD, the lender's trustee must allow three months (not 90 days) to pass before advertising and posting notice of the date of the trustee's sale. [CC §2924; see Figure 1]

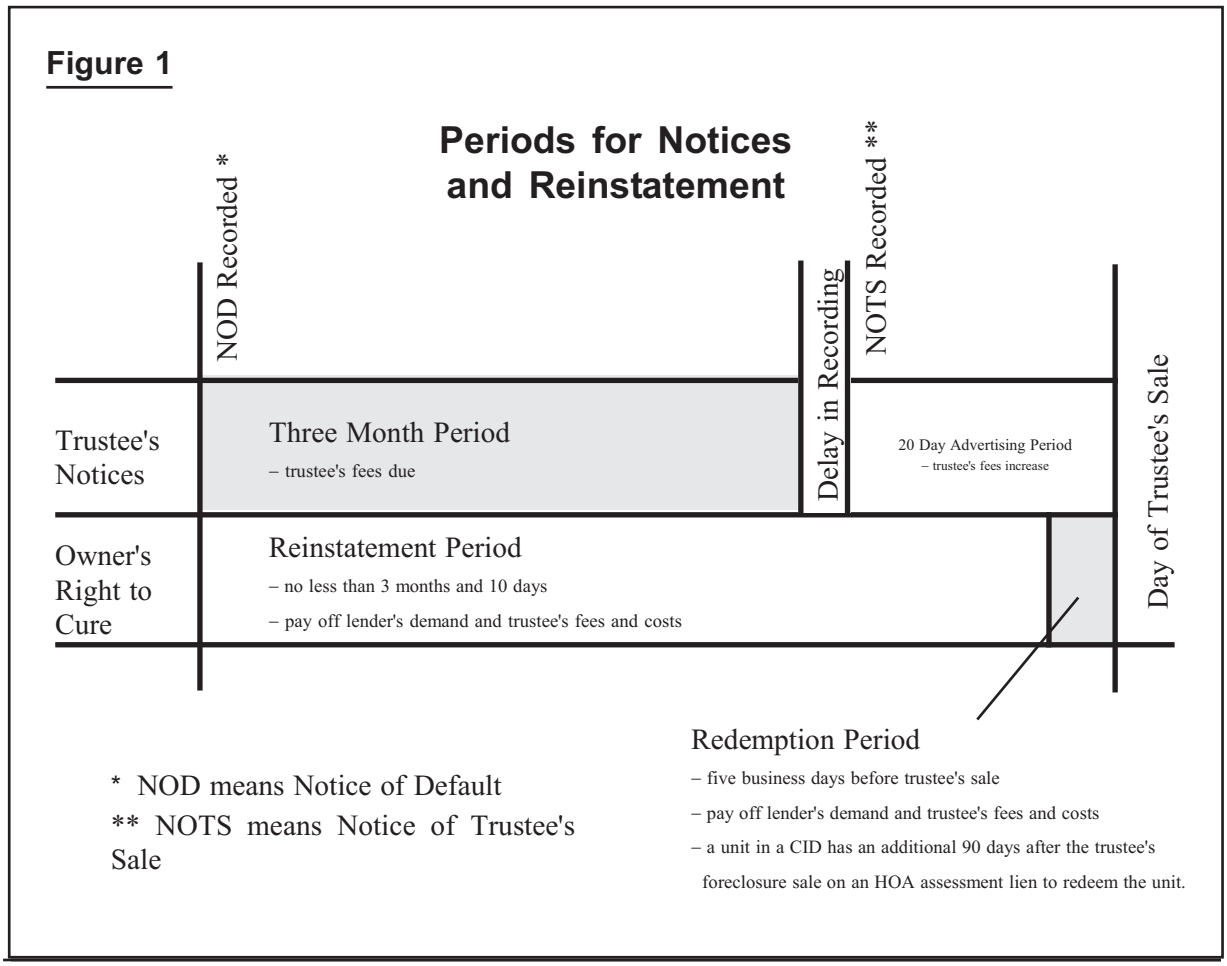
The lender's trustee must begin advertising and post a Notice of Trustees Sale (NOTS) – and any other related notices – at least 20 days before the date of the sale. The property can be sold by the trustee no sooner than the twenty-first day after advertising begins and the posting of notice occurs. [CC §2924f(b); see Figure 1]

Additionally, if the billing address for the borrower is different than the address of the residential property in foreclosure, the NOTS must be accompanied by a notice to the occupants regarding their rights during and after foreclosure. [CC §2924.8]

The owner in foreclosure is not allowed to delay the trustee's sale by requesting a postponement. [CC §2924g]

Thus, the owner, or junior lienholder, has a minimum of approximately 105 days after the recording of the NOD to cure the default and reinstate the note and trust deed to avoid a full payoff or foreclosure sale of the property.

To determine the last day for reinstatement of the note and trust deed, consider a trustee's sale that is scheduled for a Friday. Count back five business days beginning with the first business day prior to the scheduled Friday sale. Since weekends are not business days, the fifth day counting backward from the scheduled trustee's sale is the previous Friday (if no holidays exist).



Thus, the very last day to reinstate the loan is on the Thursday eight calendar days before the trustee's sale.

The lender's failure to identify or include the dollar amount of all known defaults in the NOD does not invalidate the NOTS. Further, the lender can enforce payment of any omitted defaults by recording another, separate NOD. [CC §2924]

On reinstatement of the note and trust deed, the NOD is rescinded by the trustee, removing the recorded default from the title of the property. [CC §2924c(a)(2)]

Any call is eliminated and the loan is returned to installment status when the note and trust deed have been reinstated. Upon reinstatement, the owner continues his ownership of the property as though the loan had never been in default.

Redemption

Failure to cure a default before the reinstatement period expires allows a trust deed holder to require the owner to redeem the property and avoid the trustee's sale by:

- paying all sums due under the note and trust deed; and
- reimbursing the costs of foreclosure prior to completion of the trustee's sale.

The owner's right of redemption exists until the trustee completes the bidding and announces the property has been sold. Any owner, junior lienholder, or other person with an interest in the property may satisfy the debt and redeem the property prior to the completion of the trustee's sale. [CC §2903]

To redeem the property, the owner or junior lienholder is required to pay the principal and all interest charges accrued on the principal, permissible penalties, foreclosure costs, and any future advances made by the foreclosing lender to protect his security interest in the property.

Unless all amounts due on the note and trust deed resulting from the owner's default are paid in full during the redemption period, the owner will lose the property at the trustee's foreclosure sale.

Lender remedies on a default

An owner's default on a trust deed loan encumbering his property can arise under a provision in either the note or the trust deed. A default on the note triggers a default on the trust deed, permitting foreclosure.

When the owner fails to pay installments of principal and interest as they become due under the terms of the note, he is then in **default** on the note. Thus, a default also exists on the trust deed.

The owner's default prompts the trust deed noteholder to immediately call the loan due under the **acceleration clause** in the note and trust deed by recording a NOD that initiates a trustee's foreclosure sale.

Additionally, when the owner fails to meet his obligations regarding the care, use, and maintenance of the secured real estate, he is in default under the *waste provision* in the trust deed. The default on the trust deed exists even though the owner may be current on all payments and the note is not in default.

The owner's failure to pay property taxes, hazard insurance premiums, assessments, and amounts due on senior trust deed liens is considered a default on the trust deed.

The owner's alternatives

Aside from reinstatement and redemption, an owner of property has several other options when faced with losing his property through foreclosure:

1. *Refinance* — The owner obtains a new loan to pay off the one in default.

2. *Foreclosure consultant* — The owner seeks the services of a financial advisor or investment counselor, called a **foreclosure consultant**. For a fee, a foreclosure consultant will:

- prevent a lender from enforcing or accelerating the note;
- help the owner reinstate the loan or receive an extension of the reinstatement period; or
- arrange a loan or an advance of funds for the owner. [CC §2945.1(a)]

However, a property owner grappling with foreclosure can obtain similar services at no cost from a *mortgage counselor* subsidized by the federal government.

3. *Deed-in-lieu* — The owner deeds the property directly to the lender in exchange for cancelling the secured debt. [See Chapter 50]

4. *Litigate* — The owner disputes the validity of the foreclosure by filing an action, restraining and enjoining the foreclosure.

5. *Bankruptcy* — The owner files for bankruptcy protection which automatically stays the foreclosure until a release of the stay is obtained by the lender from the court. [11 United States Code §362(a)]

Unless the owner can make up the default or have the loan amount "crammed down" as part of the reorganization plan, bankruptcy only delays the inevitable foreclosure. Once the automatic stay is lifted, the foreclosure sale may take place no sooner than seven calendar days later. [CC §2924g(d)]

6. *Sale* — The owner sells the property before the trustee's sale.

A recorded notice of default (NOD) must state the owner has the right to sell his property which in foreclosure. [CC §2924c(b)]

In an effort to protect owners from being unlawfully deprived of the equity in their property when selling the property during the foreclosure period, special requirements exist for purchase agreements between owners and **equity purchase investors** on owner-occupied, one-to-four unit residential property in foreclosure. [CC §1695 et seq; see Chapter 46]

However, selling property in foreclosure is difficult for the owner, due to time constraints and the difficulty of finding a buyer able to meet the financing needs to assume existing loans, cure defaults and correct the deferred maintenance on the property.

7. *Walk* — The owner simply vacates the property when the lender completes foreclosure.

This is an economically viable alternative for an owner with little or no cash investment in the property, especially if payments saved during continued occupancy exceed the cash invested and the loan balance exceeds the property's value.

A trust deed noteholder may advance funds to cure a default on the trust deed, such as the owner's failure to pay hazard insurance premiums, and then add the advance to the debt owed by authority of the trust deed's **future advances** provision. The trust deed noteholder may then demand the immediate repayment of the advance from the owner.

Let the grace period run before NOD

Consider a trust deed note held by a carryback seller that calls for installments to be paid by the first day of each month. A provision in the note imposes a late charge when the monthly installments are not received within 10 days after the installment's due date.

The seller consistently receives installments within the 10-day period after the installments become due, but never by the due date itself. Eventually, the carryback seller gives the buyer reasonable advance notice (30 days) that the installment for the following month must be paid by the first day of the month, the payment's actual due date. If it is not paid by the first, the seller advises the buyer he will begin foreclosure proceedings by recording a NOD.

The following month, the buyer fails to deliver the installment by the first. The carryback seller records an NOD beginning foreclosure proceedings within the 10-day no-charge period.

The payment is received by the seller within 10 days after the due date.

The seller claims the monthly installment was delinquent since it was not paid by the first day of the month, thus placing the buyer in default on the second day of the month.

The buyer claims a default did not exist when the NOD was recorded since the NOD was recorded prior to incurring the agreed-to late charge.

Can the carryback seller begin foreclosure proceedings for the past-due monthly installment before the late charge is incurred?

No! The payment, while due, is not yet considered delinquent due to the existence of the late charge provision. Foreclosure proceedings may not be initiated for a past due payment during the period before a late charge is incurred. When a note provision imposes a late charge on the expiration of a specified time period without receipt of the amount due, this extended time for payment without penalty qualifies as a *grace period*.

Since a **grace period** exists, a foreclosure may not be initiated to enforce payment of the installment until after the grace period runs, when the payment becomes delinquent if unpaid. [**Baypoint Mortgage Corporation** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818]

Trust deed defaults and reinstatement

A property owner's ability to **reinstate** a loan by curing a default under a trust deed provision relating to the property and its title depends on the trust deed provision in default.

For example, an owner of real estate encumbered by a trust deed fails to pay property taxes or keep other senior liens on the property current. The trust deed lender records an NOD, describing the delinquent property taxes and other senior liens as the owner's default under the trust deed.

Can the property owner reinstate the loan and retain the property by eliminating the default?

Yes! The default is monetary, entitling the owner to reinstate the loan by simply paying the delinquent property taxes and payments on the senior lien, and the trustee's fees and charges incurred in the foreclosure proceeding.

Also, monetary defaults on trust deed provisions, such as the owner's failure to pay assessments, ground lease rent, senior encumbrances, hazard insurance premiums, or to obtain a hazard insurance policy, may be cured and the loan reinstated on the owner's tender of the full dollar amount of the default. [CC §2924c]

Defaults cured only by redemption

Some trust deed defaults do not allow an installment debt to be reinstated. Reinstatement of the note on those defaults is only available if agreed to by the lender. Defaults triggering a call and requiring redemption of the property by a payoff of the entire debt include a breach of a due-on clause, a waste provision, or a violation of law provision in the use of the property.

Consider real estate that is encumbered by a trust deed that requires the owner to maintain his property in good condition and repair. The owner fails to repair the aging improvements on his property and allows the trees and lawn to die.

The trust deed lender becomes concerned since the owner's activities causing waste have decreased the value of his security, called *impairment*. Due to the owner's failure to maintain the property in good condition (and thus the loan-to-value ratio due to a reduced property value), the lender records an NOD against the property.

Unlike a failure to maintain hazard insurance, here the owner cannot cure the default in the trust deed (waste) by tendering less than the entire remaining balance of the debt. Thus, the owner is unable to reinstate the loan. As a result, the entire foreclosure period becomes the redemption period.

To retain ownership of the property after the loan had been called due to waste, the owner must **redeem** the property by tendering full payment of all sums due, including foreclosure costs, prior to the trustee's sale.

Alternatively, the trust deed gives the lender the authority to cure the waste and add that cost to the principal balance of the note under the future advances clause.

However, when waste by the owner is committed in bad faith, the foreclosing lender must consider an underbid in a dollar amount equal to the property's reduced fair market value should the lender acquire the property at the trustee's sale. With an underbid, the lender can sue the owner to recover the deficient property value below the amount due, which was caused by the bad faith waste, even if the note is a nonrecourse debt. [**Cornelison** v. **Kornbluth** (1975) 15 C3d 590]

Chapter 46 Judicial foreclosure

This chapter outlines the judicial foreclosure process, and presents the rights exercisable by property owners and junior lienholders before and after a judicial foreclosure sale.

Deficient property value; recourse paper

When a trust deed note is in default, the trust deed lender's **collection efforts** are limited to two activities: judicial or non-judicial, both of which are very structured. If the note evidences a **recourse debt**, the lender may elect to recover against both the property and the borrower or just the property.

To initiate either type of collection effort, a trust deed lender must first *exhaust the security* by foreclosing on the real estate described in the trust deed lien. The lender's security interest in a property is exhausted when the lender **forecloses** on the property or when the lender's trust deed is **wiped out** by a senior trust deed holder's foreclosure.

Only when the note evidences a **recourse debt** may the lender pursue a money judgment against the signers on the note for any deficiency in the property's value to fully satisfy the debt owed. [Calif. Code of Civil Procedure §726]

Foreclosure is an activity comprised of notices and an auction to sell real estate to satisfy a debt secured by the security interest held in the property by the lender. Foreclosure of the property eliminates the *right of redemption* held by the owner and any persons holding junior interests in the property.

A trust deed holder can **foreclose** on a property, which is the security for a note, in one of two ways:

- *judicial foreclosure*, under mortgage law, also called a *sheriff's sale* [CCP §725a]; or

- *nonjudicial foreclosure*, under the power-of-sale provision in the trust deed, also called a *trustee's sale*. [Calif. Civil Code §2924]

Judicial foreclosure is the court-ordered sale by public auction of the secured property. The process can last from eight months to multiple years before it is completed.

When a trust deed holder **nonjudicially forecloses** by a trustee's sale, the property is sold by private agreement at a public auction. Trustee's sales can be completed on property other than a one-to-four unit residential property within four months after a buyer defaults. Unlike a judicial foreclosure sale, the completion of a trustee's sale denies the foreclosing lender the opportunity to obtain a money judgment for any unpaid balance remaining on the note after the foreclosure sale due to an *underbid* and *insufficient value* in the secured property. [CCP §580d]

Trustee's sales are considerably less expensive than judicial foreclosures, both in time and money. A judicial sale requires the filing of a lawsuit which includes litigation expenses, appraisals, attorney fees, and a greater length of time then would be required for a nonjudicial foreclosure. [See Chapter 51]

However, when the value of a secured property drops below the balance owed on a *recourse debt*, the lender must consider foreclosing by judicial action, whether or not he ultimately chooses to do so.

A judicial foreclosure, or sheriff's sale, is the only foreclosure method which allows a lender to obtain a money judgment against the borrower for any deficiency in the value of the secured property to fully satisfy a recourse debt. [CCP §580d]

Editor's note — The source of recovery on a default in a trust deed securing a purchase-money debt is limited to the value of the secured property. ***Purchase-money debts*** *include:*

- *carryback notes secured solely by the real estate sold; and*
- *purchase-assist loans secured by buyer-occupied, one-to-four unit residences.*

Anti-deficiency rules preclude a buyer's personal liability for any purchase-money debts. [CCP §580b]

Thus, a carryback seller secured solely by the property sold and a purchase-assist lender secured by a buyer-occupied, one-to-four unit residential property have nothing to gain but much to lose by foreclosing judicially. [See Chapter 43]

Suing to foreclose

As with any lawsuit, the first step in a judicial foreclosure is the filing of a complaint in the Superior Court of the county where the property is located.

The foreclosure complaint must name as defendants the **original borrower** and anyone else holding a recorded interest in the secured property which is junior to the foreclosing lender's trust deed lien. The trustee named in the trust deed does not need to be involved in the lawsuit in any way. A trustee under a trust deed has no interest in the property, is unconcerned wit hthe judicial foreclosure, and thus it is not necessary for him to be involved in the judicial proceedings.

The lender foreclosing judicially must obtain a *litigation guarantee* of title insurance. The policy is comparable to a trustee's guarantee ordered out to assist a foreclosure trustee in the notice process.leading to the auction sale of the property.

The **litigation guarantee** lists all parties with a recorded interest in the property and their addresses of record. The litigation guarantee ensures that persons with a recorded junior interest in the property are named and served, so their interest is eliminated from title by the judicial foreclosure sale.

If a person holding an interest in the propert junior to the lender's trust deed is not named as a defendant:

- his lien is not affected by the outcome of the foreclosure proceedings; and
- his lien on the property being foreclosed remains of record. [CCP §726(c)]

Consider an adjacent property owner who holds an easement and water rights in a parcel of real estate which are subject to a prior trust deed lien. The grant of his easement and water rights occurred after the trust deed was recorded.

The trust deed holder judicially forecloses and acquires the property but fails to name and notify the easement holder of the foreclosure action and judicial sale.

The trust deed holder now seeks to extinguish the easements and water rights held by the easement holder in a separate judicial foreclosure action on the same trust deed lien.

The easement holder claims his rights cannot now be extinguished since the senior trust deed holder already completed a foreclosure and became the owner of the property, and thus no longer holds an interest in the property which has priority to the easement.

Can the senior trust deed holder judicially foreclose again under the same trust deed lien to extinguish the owner's easements and water rights?

Yes! Having already completed a judicial foreclosure, the trust deed holder can later foreclose by another judicial foreclosure action to extinguish the previously omitted junior easements and water rights. However, the junior easement holder retains the same right of redemption (for one year) he would have had in the first foreclosure action had he been named. [**Diamond Benefits Life Insurance Company** v. **Troll** (1998) 66 CA4th 1]

Additionally, when the foreclosing lender intends to seek a deficiency judgment, the original borrowers must be named as defendants, whether or not the borrowers still hold an interest in the property. [**Hutchison** v. **Barr** (1920) 183 C 182]

At the time the lawsuit is filed, the foreclosing lender records a **Notice of Pending Action** against the secured property, called a *lis pendens*.

The **lis pendens** places a cloud on the title of the secured property, giving notice of the judicial foreclosure action and subjecting later acquired interests by buyers, tenants or lenders to the results of the litigation without their being named or served with a lawsuit.

After recording the lis pendens, the title company issuing the litigation guarantee is asked to *date down* the policy through the recording date of the lis pendens to discover any intervening recordings which might affect the proceedings, such as federal tax liens.

Reinstatement

Until the court enters a judgment ordering the sale of the secured property, called a *foreclosure decree*, the borrower has the right to bring the delinquencies in the note and trust deed current. A foreclosure decree brings to an end the period of time called the *reinstatement period*.

The borrower or any holder of an interest in the property junior to the foreclosing lender's security interest may **reinstate** the loan prior to the foreclosure decree by tendering payment of:

- the loan delinquencies;
- accrued interest; and
- the lender's foreclosure costs such as litigation expenses. [CC §2924c]

If the borrower reinstates the delinquent debt, a right enforceable until the court's entry of the foreclosure decree, the lender must abandon its foreclosure attempt and dismiss the lawsuit.

Attorney fees due on a reinstatement are limited in amount by statute. [See Chapter 51]

The junior lienholder

Before entry of a judicial foreclosure decree, a junior trust deed holder or other lienholder may **reinstate** the note by paying the trust deed delinquencies and foreclosure costs, bringing the trust deed note current.

After entry of a **foreclosure decree** ordering the property to be sold, the junior lienholder has until the time the property is sold at the foreclosure sale to **redeem** the property by paying all amounts owed on the debt and foreclosure costs. [CC §2903 et seq.]

Once a property is sold at a judicial foreclosure sale, any liens subordinate to the foreclosing lender's trust deed are wiped out and eliminated from the title. [CCP §§701.630; 729.080(e)]

If the junior lienholder does not reinstate the note or purchase the property at the judicial foreclosure sale, and the owner later **redeems the property**, the junior lienholder will then be able to recover the amount of his lien, plus interest. [CCP §729.060(b)(5)]

A creditor holding an unrecorded lien not actually known to the foreclosing lender does not need to be named or notified of the judicial foreclosure action to have the unrecorded lien extinguished on completion of a recorded lienholder's judicial foreclosure sale. [CCP §726(c)]

Editor's note — If the junior lienholder of record is unnamed or unserved in a judicial foreclosure action by the senior trust deed holder, the junior trust deed holder still has an enforceable trust deed after the first trust deed lender's judicial foreclosure sale.

*Unaffected by the judicial foreclosure for lack of notice, and the lender being time barred from filing another judicial foreclosure action, the junior trust deed holder may initiate his own judicial or trustee's foreclosure proceedings to enforce his trust deed. The junior trust deed holder's interest would be senior to the interest of the high bidder at the first's judicial foreclosure sale. [**Little** v. **Community Bank** (1991) 234 CA3d 355]*

Consider a wiped-out junior trust deed holder whose note evidences a **recourse debt**. The junior lienholder whose security interest in the property has been exhausted sues to collect the debt from the owner who executed the note. Accordingly, the junior lienholder obtains a money judgment on the note since his trust deed has been eliminated and he cannot foreclose on the property.

With a money judgment replacing the now unsecured note, the junior lienholder records an *abstract of judgment.* The recorded **abstract of the money judgment**:

- creates an involuntary lien on all properties vested in the name of the owner; and
- replaces the trust deed note, evidencing a different debt (the money judgment) with different rights than the debt owed under the trust deed.

Should the owner redeem the property, the junior trust deed holder has a lien on the property which he can foreclosure. The junior lienholder can also proceed with a **sheriff's sale** to collect on the money judgment by a foreclosure on other properties which were attached by the recorded abstract. [**O'Neil** v. **General Security Corporation** (1992) 4 CA4th 587]

However, consider a junior lienholder with a recourse debt who postpones his trustee's foreclosure proceedings on the commencement of the senior lienholder's foreclosure and is later wiped-out. The wiped-out junior lienholder may seek a money judgment and is not barred because he started, but did not finish, his foreclosure. [**Bank of America National Trust and Savings Association** v. **Graves** (1996) 51 CA4th 607]

The foreclosure decree

A lender judicially foreclosing on real estate establishes its right to collect the debt and sell the secured property by obtaining a *foreclosure decree* at a summary judgment proceeding or a trial.

A **foreclosure decree** orders the sale of the real estate to satisfy the outstanding debt and cover foreclosure sale expenses incurred by the lender. [CCP § 726(a), (b)]

The foreclosure decree also states whether the borrower will be held personally liable for any deficiency in the property's fair market value to satisfy the debt owed. [CCP §726(b)]

The recovery of attorney fees must be accounted for in the foreclosure decree. Attorney fees incurred after the foreclosure decree are not included in the amount required to redeem the property. [**Hambrose Reserve, Ltd.** v. **Faitz** (1992) 9 CA4th 129]

Notice of Levy

A judicial foreclosure sale is conducted by a court-appointed receiver or sheriff, called a *levying officer*.

After the judicial foreclosure sale is ordered by the court, the foreclosing lender is issued a *writ of sale* by the court clerk which authorizes the receiver or sheriff to record a *notice of levy*. The **writ of sale** and the **notice of levy** describes the property to be sold and states the levy is against the security interest the lender holds in the property under his trust deed lien. [CCP §712.010]

The receiver or sheriff who conducts the sale **records** the writ of sale and the notice of levy in the county in which the property is located. [CCP §700.015(a)]

The receiver or sheriff also mails to the owner, and serves on any occupant of the property, the writ of sale and the notice of levy. [CCP §700.010]

The notice of judicial sale

Similar to the notice of trustee's sale used in a nonjudicial foreclosure, the receiver's or sheriff's notice of sale must state the necessary details as to the date, time and location of the auction sale. [CCP §701.540(a)]

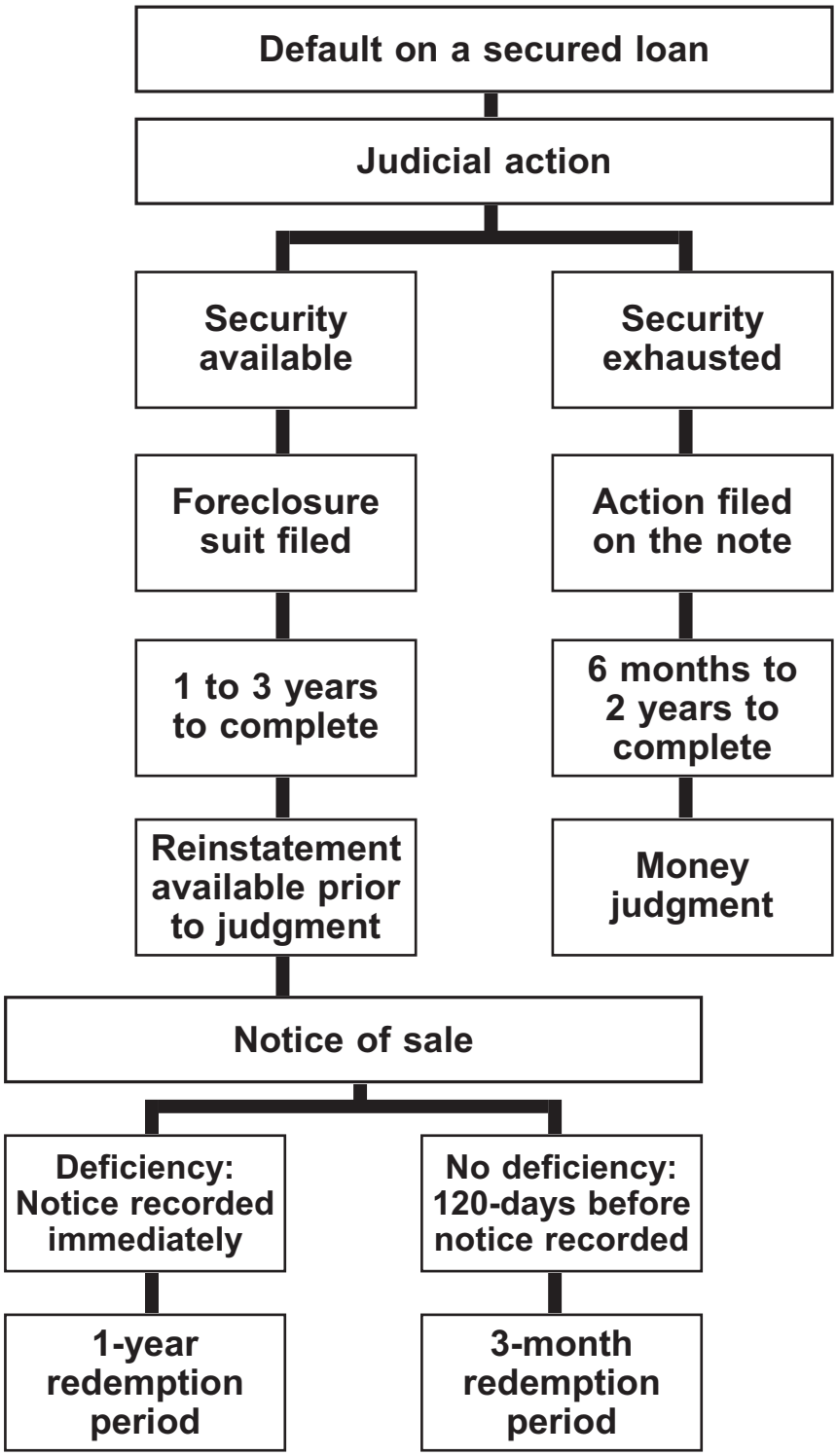
When a deficiency judgment is sought by a lender, the notice of judicial sale also states:

- the property is being sold subject to the borrower's right of redemption; and
- the amount of the secured debt, plus accrued interest and foreclosure costs. [CCP §729.010(b)(1)]

If a money judgment for any deficiency is prohibited, as occurs with a non-recourse debt, the receiver or sheriff must wait at least 120 days after service of the notice of levy before he may notice the judicial sale. [CCP §701.545]

However, if the lender seeks a deficiency judgment, no waiting period applies for noticing the sale. The receiver or sheriff may notice the judicial sale immediately after the decree is issued. [CCP §729.010(b)(2), (3)]

Collecting a recourse debt



At least 20 days before the sale, the notice of judicial sale is:

- served on the borrower personally or by mail [CCP §701.540(c)];
- mailed to any person who has recorded a request for a notice of judicial sale [CCP §701.550(a)];
- posted in a public place in the city or judicial district where the property is located, and on the property itself; and
- published weekly in a local newspaper of general circulation. [CCP §701.540(g)]

Highest bidder acquires the property

The public sale held by a court-appointed receiver or sheriff is conducted as an auction. The property is **sold to the highest bidder**. [CCP §701.570]

Payment at the public sale must be made in cash or by certified check at the time of the sale. However, amounts over $5,000 permit a credit transaction. [CCP §701.590(a), (c)]

If the successful bidder fails to pay the amount bid, the receiver may sell the property to the highest bidder at a subsequent sale. The defaulting bidder is liable for interest, costs and legal fees for his failure to pay his bid. [CCP §701.600]

Often, the foreclosing lender is the highest, or only, bidder at a judicial sale. When intending to seek a deficiency judgment, the lender must **bid no less** than an amount it believes the court will set as the *fair market value* (FMV) of the property. If he allows the property to be bid in at the sale for less than its FMV, the lender incurs an uncollectible loss for the difference. [**Luther Burbank Savings & Loan Assn.** v. **Community Construction, Inc.** (1998) 64 CA4th 652]

Judicial sale completed

A *certificate of sale* is issued to the successful bidder on the completion of a judicial sale.

Although the bidder purchased the property at the public auction, he will not become the owner of the property or be able to take possession of it by removing the owner until the applicable **redemption period** expires. [CCP §729.090]

The **certificate of sale** reflects the owner's continuing right to redeem the property and avoid losing it to the highest bidder. [CCP §729.020]

Redemption follows foreclosure

On a judicial foreclosure, a trust deed which secures a seller carryback note as a lien solely on the property sold, or a lender's purchase-assist loan as a lien on a buyer-occupied, one-to-four unit residence, the property owner:

- is not liable for any deficiency in the property value to fully satisfy the debt [CCP §580b]; and
- has **three months** after the judicial sale to redeem the property by paying off the entire debt and costs. [CCP §729.030]

However, if the owner is liable on a recourse debt for a deficiency in the property's value, the owner has up to **one year** after the judicial sale to redeem the property. [CCP §729.030]

The property can only be redeemed by the owner or the owner's *successor-in-interest* since all junior lienholders are wiped out by the judicial foreclosure sale, ending their period for redemption.

Successors-in-interest to the owner are lienholders or buyers who acquire the owner's interest in the property by deed prior to the judicial foreclosure sale. [CCP §729.020; 15 Calif. Law Revision Commission Reports 2001]

For example, a junior lienholder holds a trustee's foreclosure sale and bids in the property and receives a trustees deed **prior to completion** of the senior lienholder's judicial foreclosure sale. Since the junior lienholder owns the property at the time of the judicial foreclosure sale, he is considered the owner's successor-in-interest.

As the successor-in-interest to the owner, the junior lienholder is entitled to redeem the property after the senior lienholder's later judicial foreclosure sale, subject to the redemption period rights which are available only to the owner. [CCP §729.020]

The successful bidder who purchases the property at the judicial foreclosure sale is not considered the owner's successor-in-interest, but is the **creditor's successor** until the end of the redemption period. [CCP §729.020]

The **redemption price** for the owner (or successor) to recover the property sold at a judicial foreclosure sale is the total of:

- the price paid for the property by the highest bid at the judicial foreclosure sale;
- taxes, assessments, insurance premiums, upkeep, repair or improvements to the property paid by the successful bidder; and
- interest on the above amounts at the legal rate on money judgments (10%) from the date of the payments through the date the redemption amount is tendered in full. [CCP §729.060]

On **redemption**, the owner or his successor is entitled to:

- an offset for any net rents collected by the lender under an **assignment of rents provision** in the trust deed; and
- an offset for the rental value of the premises for any period of time the successful bidder occupied the property following the sale. [CCP §§729.060, 729.090]

If the property is not redeemed by the owner or his successor-in-interest within the owner's redemption period, the receiver issues the bidder a *sheriff's deed* to the property, and the sale is final. [CCP §729.080]

Obtaining a deficiency judgment

The remaining balance owed on a note may be greater than the *fair price* of the lender's security interest in the real estate. The spread when the fair price is higher is the *deficiency* in the value of the property to cover the debt. The **fair price** of the lender's position in title is based on the value of the property at the time of the judicial foreclosure sale.

A money judgment for the deficiency in the property value to fully satisfy the debt is available if not barred by anti-deficiency statutes. The lender will be awarded a money judgment for any deficiency in value at a hearing following the foreclosure sale. At the post-foreclosure hearing, the amount of the deficiency is set by the court — the difference between the fair price of the lender's security interest in the property on the date of the judicial foreclosure sale and the amount of the debt — called a *fair value hearing*. [CCP §§580a, 580b]

A **fair value hearing**, noticed within three months after the foreclosure sale, will set the dollar amount awarded as a deficiency judgment. [CCP §§580a, 726(b)]

The amount awarded as a deficiency judgment is based on the debt owed under the note and trust deed on the date of the judicial foreclosure sale, and the greater of:

- the FMV of the property on the date of the foreclosure sale, minus any amounts owed on liens senior to the trust deed being foreclosed, the result setting the *fair price* of the lender's security interest; or

- the amount **bid** for the property at the judicial foreclosure sale. [CCP §580a]

The lender will be awarded a money judgment for the portion of the debt not covered by the fair price of the lender's secured position on title or the price bid at the sale, which ever amount is higher.

The lender and the borrower present evidence at the fair value hearing to establish the property's FMV. The court may appoint an appraiser, called a *probate referee*, to advise the court on the property's FMV. Thus, evidence consists of the opinions of appraisers (and the owner) about the FMV of the property on the date of the sale. [CCP §§580a, 726(b)]

The formula for a deficiency

Consider a lender who judicially forecloses on the security interest it holds in real estate under a first trust deed lien securing a recourse debt. The property is encumbered by unpaid property taxes, a lien which has priority to the lender's trust deed which the lender has not paid.

At the foreclosure sale, the lender acquires the real estate, subject to the property tax liens. The lender's credit bid is for less than the amount owed on the debt, called an *underbid*. Also, the bid is for less than the *fair price* of the lender's security interest in the property on the date of the foreclosure sale.

At the **deficiency hearing**, the lender is awarded a money judgment calculated as the unpaid amount due the lender less the fair price of the equity under thetrust deed securing the lender's loan on the date of the foreclosure sale (not the amount of the underbid), **plus** the unpaid property taxes.

Within one year after the foreclosure sale, the owner redeems the property for the amount of the underbid entered by the lender, plus interest on that amount from the date of the foreclosure sale.

The redemption amount owed by the owner to recover his property is less than the fair price the court set for the lender's security interest to determine the deficiency owed to the lender. When the lender bids less than the total amount of the debt owed and that bid is also less than the fair price of the lender's trust deed interest in the property, the underbid sets only the redemption price, not the deficiency. As a result, the difference between the lesser amount of the underbid and the greater fair price of the lender's security interest becomes an unrecoverable loss for the lender. The owner both redeemed the property and paid the money judgment, two amounts which do not come up to the FMV of the property.

However, the property is still encumbered by the unpaid property taxes.

The owner claims the unpaid property taxes were improperly added to the deficiency judgment and he will incorrectly have to pay them twice:

- once when the unpaid taxes were added into the amount of the deficiency judgment awarded to the lender; and

- again as a lien which remains on the property the owner redeemed.

Here, the amount set as the deficiency is correct, although the mathematical approach used by the court was not. The trust deed lender's **secured position** on title to the property was subject to property taxes.

Thus, the dollar amount of unpaid taxes (and any other liens with priority) must first be deducted from the property's FMV to set the **fair price** of the lender's interest in the property.

Only after establishing the fair price of the lender's secured position can the amount of the fair price be deducted from the total debt and costs owed the lender to determine the deficiency. That deficiency becomes the amount of the money judgment. [**Luther Burbank Savings and Loan Association** v. **Community Construction, Inc.** (1998) 64 CA4th 652]

The **correct formula** for calculating the deficiency (always a negative amount): **Enter** the FMV of the property, **subtract** both the unpaid tax liens and any other prior liens and the remaining debt owed the foreclosing lender. The result, if negative, is the amount of the deficiency awarded to the lender.

The fair price

A deficiency judgment is awarded to a lender based on the **unencumbered full cash value** of the secured property, a value which is set consistent with current market conditions on the date of the foreclosure sale, called *fair market value* (FMV). [CCP §726]

Clouds on title, such as a junior lien or a lis pendens, which are wiped out at a foreclosure sale do not affect the property's FMV. [**Nelson** v. **Orosco** (1981) 117 CA3d 73]

Editor's note — However, a federal tax lien with a 120-day right of redemption may reduce the price a buyer would pay for the lender's position in the title since the price paid is the amount the Internal Revenue Service (IRS) would pay the buyer to acquire the property.

The bid accepted at the judicial foreclosure sale is not considered when setting the property's FMV. [**Rainer Mortgage** v. **Silverwood, Ltd.** (1985) 163 CA3d 359]

The FMV of property is set without concern for any negative impact the foreclosure sale may have had on the property's value, or the price a prudent buyer would have to pay at the foreclosure sale for the lender's security position on title. [**San Paolo U.S. Holding Company, Inc.** v. **816 South Figueroa Company** (1998) 62 CA4th 1010]

Once the FMV of the property is determined, the amount of the deficiency is determined by subtracting all prior lien amounts and the amount of the debt being foreclosed from the property's FMV.

If the amount remaining is negative, the lender is awarded a deficiency judgment for that negative amount. Thus, any underbid below the fair price for the lender's position in the property results in a loss for the lender. The amount of the difference between the fair price of the lender's position and the underbid is not recoverable in either the deficiency judgment or on redemption by the owner.

Chapter 47 Trustee's foreclosure procedures

This chapter discusses a trustee's statutory duties for publicly conducting a privately agreed-to foreclosure sale of real estate.

Power-of-sale provision

A lender or carryback seller holding a note secured by a trust deed which is in default has **two foreclosure methods** available to enforce collection of the secured debt:

- a *judicial foreclosure sale*, also called a *sheriff's sale* [Calif. Code of Civil Procedure §726]; or
- a *nonjudicial foreclosure sale*, also called a *trustee's sale*. [Calif. Civil Code §2924]

The key to the trust deed holder's ability to **nonjudicially foreclose** by a trustee's sale on the secured real estate is the *power-of-sale authority* and *power-of-sale provision* contained in the trust deed. [See Figure 1]

Other security devices used to create a lien on real estate to secure a debt which may also contain a **power-of-sale provision** include:

- a land sale contract [**Petersen** v. **Hartell** (1985) 40 C3d 102; see Form 165 §15 in Chapter 35];
- a lease-option sale [See Form 163 §19 in Chapter 35];
- a UCC-1 financing statement [**Lovelady** v. **Bryson Escrow, Inc.** (1994) 27 CA4th 25]; or
- the conditions, covenants and restrictions (CC&Rs) of an association for collection of assessments. [CC §1367]

The grant of the power-of-sale provides a private contract remedy for the **recovery of money**, voluntarily agreed to by the owner of the secured property, authorizing the secured creditor on a default in the trust deed to hold a nonjudicial foreclosure sale by public auction, called a *trustee's sale*. [CC §2924]

The lender, carryback seller, homeowners association or other holder of a lien on the real estate with a power-of-sale provision or statutory authority typically forecloses by a trustee's sale. However, if the

Figure 1 *Excerpted from **first tuesday** Form 450— Long Form Trust Deed and Assignment of Rents*

GRANTS TO TRUSTEE IN TRUST, WITH POWER OF SALE

3.6. TRUSTEE'S SALE — On default of any obligation secured by this Deed of Trust and acceleration of all sums due, Beneficiary may instruct Trustee to proceed with a sale of the secured property under the power of sale granted herein, noticed and held in accordance with California Civil Code Sec. 2924 et seq.

secured note evidences a recourse debt with a remaining balance exceeding the *fair price* of the lender's position as the holder of a security interest in the real estate described in the trust deed, the lender may choose a judicial foreclosure and seek a money judgment for any deficiency in the property's value to satisfy the debt. [See Chapter 46]

By foreclosing under the power-of-sale provision, the holder of a lien on real estate avoids a costly court action for judicial foreclosure should the owner default on the trust deed.

Editor's note — When a lender completes a foreclosure by trustee's sale, it cannot then obtain a deficiency judgment against the owner of the secured real estate. On the other hand, the owner cannot redeem the property after the lender's trustee's sale as he can after a judicial foreclosure sale. [See Chapter 43]

Who conducts the sale

A trust deed is a **security device** which by agreement imposes a lien on real estate. It creates a **fictional trust** to "hold title" to the secured real estate for the benefit of the lienholder. Thus, a trust deed has three parties:

- at least one *trustor* (the owner(s) of the secured real estate);
- a *trustee* who need not be named; and
- at least one *beneficiary* (a lender, carryback seller, common interest association or other lienholder).

The trustee's sale is conducted by the **trustee** who is either:

- named in the trust deed; or
- appointed by the beneficiary of the trust deed at the time the beneficiary initiates the foreclosure process.

A broker, attorney, trust deed service, subsidiary of the lender, or the lender itself may be appointed as the trustee. The trustee named in the trust deed, unless replaced by recording a substitution naming another trustee, may process the foreclosure. The trustee begins foreclosure by recording a notice of default (NOD) and ends the process on delivery of the trustee's deed and disbursement of any sales proceeds. [**Bank of America National Trust & Savings Association** v. **Century Land & Water Co.** (1937) 19 CA2d 194; see Figure 2]

Generally, trust deeds prepared and distributed by title or escrow companies name their company as the trustee. However, a trust deed or other security device **need not name** the trustee at all. The beneficiary then simply appoints a trustee to handle the NOD or reconveyance. [See Form 450 in Chapter 14]

Also, the beneficiary may appoint a substitute trustee to replace a named trustee for various reasons, such as:

- the named trustee no longer exists;
- the named trustee is uncooperative; or

Figure 2

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name [ ]

Street Address

City & State [ ]

SPACE ABOVE THIS LINE FOR RECORDER'S USE

NOTICE OF DEFAULT
with SUBSTITUTION OF TRUSTEE
(California Civil Code §2924c)

IMPORTANT NOTICE

IF YOUR PROPERTY IS IN FORECLOSURE BECAUSE YOU ARE BEHIND IN YOUR PAYMENTS, IT MAY BE SOLD WITHOUT ANY COURT ACTION, and you may have the legal right to bring your account in good standing by paying all of your past due payments plus permitted costs and expenses within the time permitted by law for reinstatement of your account, which is normally five business days prior to the date set for the sale of your property. No sale date may be set until three months from the date this notice of default may be recorded (which date of recordation appears on this notice).

This amount is $_____ as of _____, 20_____, and will increase until your account becomes current.

While your property is in foreclosure, you still must pay other obligations (such as insurance and taxes) required by your note and deed of trust or mortgage. If you fail to make future payments on the loan, pay taxes on the property, provide insurance on the property, or pay other obligations as required in the note and deed of trust or mortgage, the beneficiary or mortgagee may insist that you do so in order to reinstate your account in good standing. In addition, the beneficiary or mortgagee may require as a condition to reinstatement that you provide reliable written evidence that you paid all senior liens, property taxes, and hazard insurance premiums.

Upon your written request, the beneficiary or mortgagee will give you a written itemization of the entire amount you must pay. You may not have to pay the entire unpaid portion of your account, even though full payment was demanded, but you must pay all amounts in default at the time payment is made. However, you and your beneficiary or mortgagee may mutually agree in writing prior to the time the notice of sale is posted (which may not be earlier than the end of the three-month period stated above) to, among other things, (1) provide additional time in which to cure the default by transfer of the property or otherwise; or (2) establish a schedule of payments in order to cure your default; or both (1) and (2).

Following the expiration of the time period referred to in the first paragraph of this notice, unless the obligation being foreclosed upon or a separate written agreement between you and your creditor permits a longer period, you have only the legal right to stop the sale of your property by paying the entire amount demanded by your creditor.

PAGE ONE OF THREE — FORM 471

PAGE TWO OF THREE — FORM 471

To find out the amount you must pay, or to arrange for payment to stop the foreclosure, or if your property is in foreclosure for any other reason, contact:

_____
(Name of Beneficiary or Mortgagee)

_____
(Mailing address)

_____
(Telephone)

Beneficiary has contacted and discussed avenues for refinance, etc., as required by California Civil Code §2923.5.

If you have any questions, you should contact a lawyer or the governmental agency which may have insured your loan.

Notwithstanding the fact that your property is in foreclosure, you may offer your property for sale, provided the sale is concluded prior to the conclusion of the foreclosure.

Remember, YOU MAY LOSE LEGAL RIGHTS IF YOU DO NOT TAKE PROMPT ACTION.

NOTICE IS HEREBY GIVEN:

A Deed of Trust dated _____ executed by _____, as the Trustor, in favor of _____, as the Beneficiary, recorded on _____ , as Instrument No. _____, of Official Records in the office of the County Recorder of _____County, California, secures, among other obligations, _____ note(s) in the original amount of $_____.

The beneficial interest under the Deed of Trust is held by the undersigned Beneficiary who HEREBY appoints _____ as Trustee under the Deed of Trust.

A default in the obligations secured by the Deed of Trust has occurred in that payment has not been made of:

_____
_____
_____
_____
_____
_____
_____.

PAGE TWO OF THREE — FORM 471

PAGE THREE OF THREE — FORM 471

Due to the default, the undersigned Beneficiary has signed and delivered to the Trustee a written Declaration of Default and Demand for Sale, and has deposited with the Trustee the Deed of Trust and all documents evidencing the secured obligations, and hereby declares all sums of the secured obligations immediately due and payable and elects to cause the real estate encumbered by the Deed of Trust to be sold to satisfy the secured obligations.

_____
(Signature of Beneficiary)

STATE OF CALIFORNIA
COUNTY OF_____
On _____ before me,
_____
(Name and title of officer)
personally appeared _____
_____,
who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature _____
(Signature of notary public)

(This area for official notarial seal)

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- the beneficiary simply wants to use a different trustee for any reason. [CC §2934a]

The stages of foreclosure

A trustee's actions under a **power-of-sale provision** are strictly controlled by California statutes. To successfully complete a trustee's foreclosure sale of the secured real estate, the trustee and beneficiary of the trust deed must adhere to the procedures fully detailed in the foreclosure statutes for handling a trustee's sale. [**Garfinkle** v. **Superior Court of Contra Costa County** (1978) 21 C3d 268]

For the trustee the foreclosure process and fees are broken down into three stages:

1. Recording and serving a notice of default (NOD);

2. Recording, posting and serving the notice of trustee's sale (NOTS); and

3. Conducting the sale of the real estate, which includes auctioning off the property, executing the trustee's deed and distributing any sales proceeds.

In contrast to the three stages for the trustee's processing of the foreclosure, the owner of the real estate and the beneficiary are concerned primarily with two different periods of time which control payment of the debt:

- the *reinstatement period*, which runs from the recording of the NOD and ends prior to five business days before the trustee's sale; and

- the *redemption period*, which also runs from the recording of the NOD but ends with the completion of the trustee's sale of the secured property. [See Chapter 45]

Pre-foreclosure workout prior to NOD

Before recording an NOD on a trust deed securing a purchase-assist loan as a lien on residential property intended to be the borrower's principal residence, which was recorded during the period of 2003 through 2007, a lender must conduct or attempt to conduct a pre-foreclosure workout with the owner.

By at least 30 days prior to recording an NOD on one of these owner-occupied SFR loans, the lender must have made an initial contact, or attempt to contact, with the borrower to:

- assess the borrower's financial situation;

- explore options for the borrower to avoid foreclosure;

- advise the borrower of his right to an additional meeting within 14 days to discuss his financial options;

- provide borrowers with the toll-free Department of Housing and Urban Development (HUD) phone number to find a HUD-certified housing counseling agency; and

- in the event personal or phone contact cannot be made, the lender must exercise due diligence through further attempts to contact the borrower, including:

    - sending a letter via first-class mail to the borrower/owner containing HUD's toll-free number used to find and contact a HUD-certified counseling agency;

    - after sending the letter, the lender may employ an automated dialing system to telephone the borrower on at least three different days and at different hours, provided a live representative is available if the borrower answers the call; and

    - make at least three attempts to reach the borrower by phone, unless the lender determines all the borrower's telephone numbers on file have been disconnected.

If the lender is unable to make contact with the borrower by these methods, the lender must send the borrower a certified letter, return receipt requested, containing a toll-free number with access to a representative during business hours.

When contacting an owner whose principal residential loan is in default:

- a lender's loss mitigation personnel may participate in any telephonic communication;

- the borrower may select a HUD-certified agent to represent him during any meeting with a lender to discuss ways of avoiding foreclosure; and

- any loan modification or plan to avoid foreclosure offered by the lender is subject to the borrower's approval.

The lender may record an NOD on a loan without complying with any of these 30-day pre-foreclosure requirements when the borrower has:

- surrendered the property to the lender either by letter confirming the surrender or by delivery of the keys to the lending institution;

- contracted with a person who facilitates a borrower's decision to leave their home by extending the foreclosure process and avoiding the lender's enforcement of the loan; or

- filed a bankruptcy petition which is pending.

The NOD controlled by pre-foreclosure work-out rules must, when recorded, include a declaration stating:

- the lender succeeded in contacting the borrower according to the above guidelines;

- the lender was unable to contact the borrower, despite exhausting all due diligence efforts; or

- the borrower has surrendered the property to the lending institution.

To be **due-diligent** compliant, the lender must, before making the initial contact (or attempt to contact) with the borrower to commence the 30-day pre-foreclosure workout for recording the NOD, post a prominent link on the lender's website containing information, including:

- options available for a borrower who is unable to make his mortgage payment and wants to avoid foreclosure;
- a list of financial documents a borrower needs to have when discussing alternatives to foreclosure with the lender;
- a toll-free telephone number for a borrower to call to discuss alternatives to foreclosure with their lender; and
- the toll-free number made available by HUD for the borrower to find and contact a HUD-certified housing counseling agency. [CC §2923.5]

Trustee's sale guarantee

When a trust deed is in default and the beneficiary has chosen to foreclose on the property, the beneficiary delivers a **Declaration of Default and Demand for Sale** to the trustee. The declaration contains instructions directing the trustee to initiate foreclosure on the secured real estate as authorized under the power of sale granted in the trust deed. [See Figure 2]

Even though the trustee may have received the beneficiary's declaration of default, the trustee's foreclosure process does not begin and foreclosure fees are not incurred by the property owner until the trustee or beneficiary records a notice of default (NOD). [**System Investment Corporation** v. **Union Bank** (1971) 21 CA3d 137]

Once the NOD is recorded, the trustee must strictly follow statutory notice requirements. To be assured he serves all the required notices on the proper persons, the trustee orders out a *trustee's sale guarantee* from a title company before or at the time the NOD is recorded.

The trustee's sale guarantee provides **coverage** for the trustee should he fail to service notices on any party of record due to an omission in the guarantee.

The **trustee's sale guarantee** advises the trustee on:

- who must receive a copy of the NOD and notice of trustee's sale (NOTS) — the person(s) entitled to receive notice that the secured obligation is subject to a recorded notice of default (NOD) and the property will be sold nonjudicially at the trustees's sale; and
- the location of the secured real estate where a copy of the NOTS will be posted and in which newspapers the NOTS will be published.

Thus, the trustee's sale guarantee contains:

- the name and address of each person who has recorded a request for a copy of the NOD;
- the name and address of each party with a recorded interest in the real estate securing the obligation in default;

No address for the owner

The trustee must send a copy of the notice of default (NOD) to:

- the owner's address as noted in the trust deed; and
- the address given by the owner in a recorded request for NOD. [CC §2924b(b)(3)]

If the trust deed does not contain a request for NOD, or contains a request for NOD but no address for the owner, the trustee can do one of the following starting within 10 business days after recording the NOD:

- publish the NOD once a week for at least four weeks in a newspaper of general circulation in the county in which the property is located (the trustees sale guarantee issued by the title company advises which newspaper to use);
- personally serve the NOD on the owner; or
- post the NOD in a conspicuous place on the secured property and mail the notice to the last known address of the owner. [CC §2924b(d)]

A trustee is not required to discover an owner's address if the current address is not actually known to the trustee. [**I.E. Associates** v. **Safeco Title Insurance Company** (1985) 39 C3d 281]

Unless the trustee has actual knowledge of the owner's last known physical address, which does not include the use of an email or electronic address, the trustee is not liable if the owner does not receive a copy of the NOD. [CC §2924b(b)(3)]

- any junior (later recorded) easements and to whom the easements were granted;
- the property's legal description;
- a plat map locating the property; and
- the names of the newspapers in general circulation in which the NOTS, and the NOD if necessary, are to be published.

Additionally, the trustee employs the title company as his agent to record documents, such as the NOD, NOTS, rescission of NOD and the trustee's deed.

The notice of default and election to sell

When ordering out a trustee's sale guarantee from a title insurance company, the trustee instructs the title company to **record the notice of default** (NOD) in the office of the county recorder in the county or counties where the secured real estate is located. [CC §2924]

The NOD contains a statutorily mandated statement which sets forth the *monetary default* on the note or other obligation secured by the trust deed. [CC §2924c(b)(1)]

The **monetary default** statement informs the owner:

- he must continue to pay other obligations required of him by the trust deed, such as hazard insurance and property taxes; and

- if he does not make future payments on the obligations in default, the owner is required to make the payments to reinstate the loan. [See Figure 2]

The NOD does not need to state the actual amounts of the monetary defaults on the recurring obligations. However, the NOD must state the nature of the present defaults on the note and the trust deed, such as failure to have paid hazard insurance premiums and property taxes. [CC §2924c(a)(1)(B)]

To determine the amount needed to cure the default, the NOD usually directs the owner or other interested persons seeking to reinstate the trust deed or redeem the property to contact the trustee by listing the trustee's name, address and telephone number after the beneficiary's name on the NOD.

Thus, the trustee insulates the beneficiary from all direct contact with the owner or junior lienholder during the foreclosure process.

If the NOD does not list a default actually known to the beneficiary at the time of recording, the unnamed default does not need to be cured for the loan to be reinstated. [**In re Peters** (9th Cir. BAP 1995) 184 BR 799]

However, the beneficiary may later record a separate NOD to notice the omitted default, and pursue a separate foreclosure based on the omitted default. [CC §2924]

Delivering the NOD

Within 10 business days after recording a notice of default (NOD), **two copies** of the NOD are mailed to each:

- the owner of the property;

- the administrator of a deceased owner's estate; and

- each person who has recorded a request to receive a copy of the NOD. [**Estate of Yates** v. **West End Financial Corporation, Inc.** (1994) 25 CA4th 511; CC §2924b(b)(1)]

One copy of the NOD is sent by registered or certified mail, the other copy is sent by first-class mail. [CC §2924b(b)(1), (e)]

Within one month after recording the NOD, the trustee is required to send a copy of the NOD by registered or certified mail and another copy by first-class mail to holders of a **recorded interest** in the secured property, including:

- the owner's successor-in-interest to the estate or any portion thereof (easements);

- any junior trust deed holder;

- the assignee of a junior trust deed;

Figure 3

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name ⌈ ⌉

Street Address

City & State ⌊ ⌋

SPACE ABOVE THIS LINE FOR RECORDER'S USE

NOTICE OF TRUSTEE'S SALE

IMPORTANT NOTICE

YOU ARE IN DEFAULT UNDER A _____, DATED _____. UNLESS YOU TAKE ACTION TO PROTECT YOUR PROPERTY, IT MAY BE SOLD AT A PUBLIC SALE. IF YOU NEED AN EXPLANATION OF THE NATURE OF THE PROCEEDING AGAINST YOU, YOU SHOULD CONTACT A LAWYER.

On _____, 20_____, at _____, California, _____, as Trustee or Successor Trustee under a Trust Deed dated _____, executed by _____, as the Trustor, for the benefit and security of _____, as the Beneficiary, recorded _____, as Instrument No. _____ in the records of the County Recorder, County of _____, State of California.

YOUR PROPERTY MAY BE SOLD AT PUBLIC AUCTION TO THE HIGHEST BIDDER FOR CASH, A CASHIER'S CHECK DRAWN ON A STATE OR NATIONAL BANK, A STATE OR FEDERAL CREDIT UNION, OR A STATE OR FEDERAL SAVINGS AND LOAN ASSOCIATION/THRIFT DOMICILED IN THE STATE OF CALIFORNIA (payable at time of sale in lawful money of the United States) at _____, all rights, title and interest conveyed to and now held by it under said Trust Deed in the property situated in said County and State referred to as:

— — — — — — — — — — — — — — — — — — — PAGE ONE OF TWO — FORM 474 — — — — — — — — — — — — — — — — — — —

— — — — — — — — — — — — — — — — — — — PAGE TWO OF TWO — FORM 474 — — — — — — — — — — — — — — — — — — —

The street address and other common designation, if any, of the real property described above is purported to be _____.

County assessor's parcel number _____.

THE TRUSTEE DISCLAIMS ANY LIABILITY FOR INCORRECT INFORMATION FURNISHED.
The auction sale is made without covenant or warranty regarding title, possession or encumbrances, or as to insurability of title.

The total amount of the unpaid balance of said obligations together with advances, and estimated costs and expenses, is $_____.

The notice of breach of this obligation and election to sell said real property was recorded as Instrument No. _____, on _____, 20_____, of Official Records in the office of the County Recorder of _____ County, State of California.

Date: _____, 20_____

Address: _____

_____

Phone: _____

Fax: _____

Email: _____

Trustee: _____

By: _____

Title: _____

STATE OF CALIFORNIA
COUNTY OF_____

On _____ before me,

_____
(Name and title of officer)

personally appeared _____

_____.

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature _____
(Signature of notary public)

(This area for official notarial seal)

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Trustee's duties

A trustee under a trust deed has no fiduciary duty to either the noteholder or the property owner since the "trust" purportedly created by a trust deed is not an actual trust. [**Monterey S.P. Partnership** v. **W.L. Bangham, Inc**. (1989) 49 C3d 454]

A trustee under a trust deed has two duties owed to all involved, both of which are regulated by statute:

- *reconvey* the trust deed on satisfaction of the secured debt [CC §2941];
- exercise the *power of sale* on a default in the trust deed. [CC §2924 et seq.; Monterey, *supra*]

- a buyer on a land sales contract;
- a lessee on a lease; and
- the state Office of the Controller, if a **Notice of Lien for Postponed Property Taxes** is recorded against the property. [CC §2924b(c)]

Any person interested in obtaining a copy of the NOD, and who is not listed in the statute as a person who is to automatically receive notice, must record a **request for NOD** to assure they will be notified of the default and sale, such as a request by a tenant under an unrecorded lease or a licensee with signs located on the property. [See Form 412 in Chapter 28]

Proof of service required for mailing

A trustee or person depositing the notice of default (NOD) into the mail must prepare a proof of service form and include a copy of the form with the NOD in each mailing. [CC §2924b(e)]

The completed copy of the proof of service form (held in the trustee's file) conclusively establishes the NOD was mailed to the persons listed in the form, i.e. the parties entitled to receive the NOD. [CC §2924b(e)]

When the statutory rules for mailing, serving, posting or publishing the NOD are met as reflected in the trustee's file, the statutory service requirement is satisfied, even if the current owner of the property or other intended recipients never actually receive the NOD. [CC §2924b(e)]

If the trustee does not meet the statutory service requirements, the trustee's sale may be voidable, depending on whether the foreclosing lender (voidable) or a third party (not voidable) buys the property.

The notice of trustee's sale

A trustee (or beneficiary) may begin noticing the date set for the sale of a property by foreclosure on the day following **three months after** the notice of default (NOD) is recorded. [CC §2924]

The date the sale will be held may be set for any business day, Monday through Friday, between the hours of 9 a.m. and 5 p.m. [CC §2924g(a)]

In general practice, a *date down* of the trustee's sale guarantee issued to the trustee is ordered out from the title company the day before or the day on which the title company, as instructed, records the notice of trustee's sale (NOTS).

The **date down** notifies the trustee of any interests recorded on the title to the property after the NOD is recorded. However, the trustee is not required to give notice of the impending trustee's sale to any person who recorded an interest in the property after the NOD was recorded. [CC §2924b(c)(1)]

The trustee prepares an NOTS which contains:

- the trustee's or his agent's name, street address and telephone number (or toll-fee number if located out of state);
- the street address or common designation of the secured property;
- the county assessor's parcel number of the secured property;
- the dollar amount of the debt in default, including reasonably estimated advances for hazard insurance premiums, property taxes due and foreclosure costs; and
- a statutory statement informing the owner he is in default. [CC §2924f; see Figure 3]

If the property does not have a street address or other common designation, the NOTS must contain:

- a legal description of the property;
- a statement that directions to the property can be obtained from the beneficiary by written request within 10 days from the first publication of the NOTS; and
- the name and address of the beneficiary requesting the sale of the property. [CC §2924f(b)]

If the billing address of the defaulting borrower/owner is different from the secured property's address, then, concurrent with the posting of the notice of trustee's sale (NOTS) on the property, an additional notice must be posted by the new property owner, stating in English and five other mandated languages that any tenant has the right to a 60-day notice to vacate the property.

A copy of this tenant's rights notice must also be mailed at the time of posting as a letter addressed to the "Resident of property subject to foreclosure sale." [CC §2924.8; see **first tuesday** Form 474-1]

The NOD and NOTS in Spanish

If the loan secured by the trust deed was negotiated in Spanish, the trust deed may contain a request for a Spanish-language notice of default (NOD). The trustee is then obligated to serve the owner an NOD translated into Spanish. [CC §2924c(b)(1)]

The trustee does not need to serve the owner of the property with a Spanish-language NOD if:

- the trust deed does not contain a request for a Spanish-language NOD; or

- the trustee does not have actual knowledge the loan was negotiated in Spanish. [CC §2924c(b)(1)]

When a Spanish-language NOD is required to be served and the beneficiary fails to instruct the trustee to serve one when the trust deed failed to request a Spanish-language NOD, the beneficiary will be liable for any money losses incurred by the owner of the secured property for failure to serve a Spanish-language NOD.

When a trust deed is negotiated in Spanish, a notice of trustee's sale (NOTS) served on the owner must be accompanied by a Spanish translation since the NOTS alters the owner's rights and obligations. [CC §1632(d)]

Delivering the NOTS

At least **20 calendar days before** the date selected by a trustee to hold a trustee's sale, the trustee must send two copies of the notice of trustee's sale (NOTS) to each party the trustee previously sent the notice of default (NOD). [CC §2924b(c)(3)]

As with the NOD, one copy of the NOTS is sent by registered or certified mail, while the other is sent by first-class mail. [CC §2924b(b)(2), (e)]

To ensure the sale of the secured property at a public auction is properly advertised, the notice requirements for the NOTS are more comprehensive than the notice requirements for the NOD.

In addition to mailing the notice to all interested parties of record, the trustee must perform all of the following at least **20 calendar days** prior to the sale:

- **post a copy** of the NOTS in one public place in the city of the sale, or if the sale is not to be held in a city, the judicial district in which the property is to be sold;

- **post a copy** of the NOTS in a conspicuous place on the property to be sold (for example, a door if the property is a single family residence); and

- **start publishing a copy** of the NOTS once a week for three consecutive calendar weeks in a newspaper of general circulation in the city where the property is located (the name of the newspaper is provided by the title company in the trustee's sale guarantee.) [CC §2924f(b)(1)]

Editor's note — A "calendar week" means Monday through Saturday. [CC §2924f(a)]

For example, if a sale is set for a Wednesday, advertising the sale for the three consecutive Thursdays occurring prior to the sale date satisfies the publishing requirement.

If the property is not located in a city, or a newspaper is not published in the city, the trustee may publish the notice in an adjudicated newspaper of general circulation in the judicial district where the property is located. [CC §2924f(b)(1)]

The trustee then instructs the title company to record the NOTS in the county where the property is located on a date at least **14 calendar days before** the sale date. [CC §2924f(b)(1)]

For example, the NOTS would have to be recorded **no later than** Wednesday the 14th if the sale date selected was Wednesday the 28th.

No statutory duty to notify the IRS

An Internal Revenue Service (IRS) tax lien recorded within 30 days of the actual trustee's sale is eliminated by the trustee's sale, and the IRS then has no right to its **120 day redemption** of the property after the foreclosure sale.

When a **date down** is ordered on the foreclosure guarantee policy prior to the 20-day advertising period before sale, the trustee may discover an IRS tax lien has been recorded since recording the notice of default (NOD).

To eliminate an IRS tax lien which was recorded more than 30 days before the sale date, but after the NOD was recorded, the IRS must be served notice of the sale postmarked at least **25 days before** the sale date. [Internal Revenue Code §7425]

However, the trustee has no statutory duty to serve the IRS with a notice of trustee's sale (NOTS). [**Diediker** v. **Peelle Financial Corporation** (1997) 60 CA4th 288; CC §2924b(c)(2)]

Additionally, federal statutes do not require the IRS to be notified of any private sale of secured real estate. [IRC §7425(b)]

Thus, a beneficiary **must instruct** the trustee to set the sale date and give the notice needed to eliminate any IRS tax lien recorded after recording the NOD.

The location of the sale

A trustee's sale must be held in the county where the secured real estate is located. [CC §2924g(a)]

If the property or properties being foreclosed are located in two or more counties, the trustee's sale may take place in any one of the counties where the property, or a portion of the property, is located. [CC §2924g(b)]

For example, consider a trustee who is to conduct a foreclosure sale of two properties which secure the same debt by the same trust deed and are located in different counties.

The trustee can sell both properties at one sale, in either county the trustee chooses. Also, the trustee can hold the sale in any area of the chosen county.

Foreclosing a blanket trust deed

If more than one property is security under one trust deed, and the properties are to be sold at the same trustee's sale, the trustee may auction off the properties one at a time. The first property will be sold at the time published in the notice of trustee's sale (NOTS). Each additional property will be sold immediately following completion of the preceding sale(s). [CC §2924g(a)]

If the owner of the property is present at the sale, he may direct the order in which the trustee sells the secured properties, should a certain order of the sales be advantageous to the owner. [CC §2924g(b)]

Unless the trust deed holder or lienholder foreclosing faces an additional risk of loss, the first properties sold should be those which have not been further encumbered with liens junior to the trust deed being foreclosed. The second and any further properties sold should be encumbered with one junior lien, then two liens junior, etc., a procedure called the *inverse order of alienation*. [CC §2899]

When two or more properties are being foreclosed under the same trust deed, the price paid by the highest bidder for the first property frequently does not fully satisfy the sums due under the trust deed. Here, the trustee will immediately begin the sale of the second property. The trustee then continues to sell the properties until enough have been sold to fully satisfy the debt. [CC §2924g(b)]

However, a trustee may sell the secured properties as a whole for one price, if he is authorized to do so under the trust deed. [**In re Affordable Housing Development Corporation** (9th Cir. BAP 1994) 175 BR 324; CC §2924g(b)]

Institutionally created trust deeds typically include language in the **power-of-sale provision** allowing the trustee to sell the secured properties as a whole or individually in any order determined by the trustee, at the discretion of the beneficiary.

*Editor's note — **first tuesday** Form 450 Long Form Deed of Trust and Assignment of Rents, does not contract away a property owner's right to direct the order in which his properties are sold or the rule of inverse order of alienation.*

Postponing the sale

A trustee's sale may be postponed by the trustee at any time prior to the completion of the foreclosure sale. The trustee's sale may be postponed on the instruction of the beneficiary or by the trustee at his own discretion. [CC §2924g(c)(1)]

Consider a trustee conducting a sale of four parcels of real estate who opens bidding on the first parcel to be sold.

An agent of the beneficiary makes a full credit bid on the first parcel being sold. Before the trustee accepts the bid, the owner, who is present at the sale, disrupts the proceedings and declares the sale is over since the beneficiary made a full credit bid on the first parcel.

In response, the trustee announces the sale is to be postponed to a new date.

In this example, the trustee's postponement of the sale is proper since the high bid has not yet been accepted by the trustee. The trustee has **discretionary authority** to postpone the trustee's sale to protect either the owners or the beneficiary's interest in the properties being foreclosed. [**Hatch** v. **Collins** (1990) 225 CA3d 1104]

Also, the postponement of a trustee's sale which has been initiated but not completed cancels the last bid. [CC §2924h(e)]

Thus, the beneficiary's full credit bid on the first parcel of real estate was canceled since the bid had not been accepted by the trustee. The beneficiary's agent bidding at the next trustee's sale will probably underbid on each parcel until he has used up his entire credit bid or acquired all the properties.

To postpone or reschedule a trustee's sale, the trustee gives **notice of postponement** at the time and place stated in the notice of trustee's sale (NOTS) for the sale by a public declaration of:

- the reason for the postponement; and
- the new date and time of the foreclosure sale.

Figure 4

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

MAIL TAX STATEMENTS TO

Name

Street Address

City & State

DOCUMENTRY TRANSFER TAX $_____

☐ Grantee was the foreclosing vendor; consideration $_____; unpaid debt $_____; nonexempt amount $_____;

☐ Computed on the consideration or value of the property conveyed; or

☐ Computed on the consideration or value less liens or encumbrances remaining at time of sale.

_____
(Signature of Declarant or Agent)

APN # _____

TRUSTEE'S DEED UPON SALE

_____, as the Trustee, does hereby grant and convey, but without covenant or warranty, express or implied, to _____ _____, herein called Grantee, the real property in the City of _____, County of _____, State of California, referred to as:

PAGE ONE OF TWO — FORM 475

PAGE TWO OF TWO — FORM 475

This conveyance is made pursuant to the authority and powers vested in said Trustee, as Trustee, or Successor Trustee, or Substituted Trustee, under that certain Deed of Trust executed by _____ _____, as the Trustor, recorded _____ as Instrument No. _____, of Official Records in the Office of the Recorder of _____ County, California; and pursuant to the Notice of Trustee's Sale recorded _____, 20_____, as Instrument No. _____, of Official Records of said County, Trustee having complied with all applicable statutory requirements of the State of California and performed all duties required by said Deed of Trust including, among other things, as applicable, the mailing of copies of the Notices of Sale or the publication of a copy of the Notice of Default or the personal delivery of the copy of the Notice of Default or the posting of copies of the Notice of Sale or the publication of a copy thereof. At the time and place fixed in the Notice of Trustee's Sale, said Trustee did sell said property above described at public auction to said Grantee, being the highest bidder therefor, for $_____ cash, lawful money of the United States.

Dated: _____, 20_____

Trustee: _____

By: _____

Title: _____

STATE OF CALIFORNIA
COUNTY OF_____
On _____ before me,
_____
(Name and title of officer)
personally appeared _____
_____,

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature _____
(Signature of notary public)

(This area for official notarial seal)

TAX STATEMENTS TO BE MAILED AS DIRECTED ABOVE

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The postponed trustee's sale must also be held at the **same place** originally stated in the recorded NOTS. [CC §2924g(d)]

Editors note — Prior to the legislation which required a postponed trustee's sale to be held at the location specified in the recorded NOTS, some lenders and their trustees played chill-bidding games by scheduling sales in locations which were out-of-the-way to ensure the lender was the high bidder on a credit bid. Postponed trustee's sales would be rescheduled at distant, purposefully difficult to find locations to discourage other persons from attending and bidding at the sale.

The trustee may postpone the sale multiple times, postponing it to occur at any time prior to 365 days from the sale date set in the original recorded NOTS. Should the sale be postponed to a date later than the 365 days following the date set in the NOTS, the trustee must renotice the sale by recording, publishing, posting and serving a new NOTS. [CC §2924g(c)(1), (2)]

Postponements of the sale must be made in accordance with any of the following:

- a mutual agreement, written or oral, between the trustor (owner) and the beneficiary;
- a court order;
- a stay caused by operation of law, such as occurs on the filing of a bankruptcy petition; or
- at the discretion of the trustee. [CC §2924g(c)(2)]

Additionally, the sale may be held no sooner than the seventh day after the earlier of:

- the dismissal of an action; or
- the termination or expiration of an injunction, restraining order, or stay. [CC §2924g(d)]

The sale may be held prior to the expiration of the seven day period only if directed by the court. If the sale is scheduled to occur during the seven day period without a court order, the sale must be postponed and a new notice of postponement must be given. [CC §2924g(d)]

The trustee is required to keep records of all postponements and the reason for each postponement. [CC §2924g(d)]

Sold to the highest bidder

A trustee's sale is essentially a **public auction** by private agreement (the trust deed) where the property is sold to the highest bidder. [CC §2924h]

Before the actual trustee's sale begins, the trustee can:

- demand all prospective bidders to show evidence of their financial ability to pay as a precondition to recognizing their bids; and
- hold the prospective bidders' amounts to be bid. [CC §2924h(b)(1)]

NOTICE OF SURPLUS FUNDS FROM TRUSTEE'S SALE

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

Regarding _____

Trustee's foreclosure sale number _____

To _____

_____

_____

1. On _____, 20_____, a trustee's sale took place of the real estate referred to as _____

_____

_____.

2. Excess funds remain from the proceeds of the trustee's sale.

3. You may have a claim to all or a portion of the excess sales proceeds. If so, submit your claim to

Trustee's name _____

Address _____

_____

4. Before Trustee can act on your claim, any claim you submit must be in writing and signed by you under penalty of perjury and include:

4.1. The total amount of your claim to the date of the trustee's sale.

4.2. An itemized statement of the principal, interest of other charges authorized by law for payment.

5. Your claim must be received by Trustee at the address noted in Section 3 above no later than **30 days** from the date of this notice.

This notice has been prepared and posted by

_____

(Foreclosure Officer)

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A bidder can tender his bid amount in U.S. dollars in the form of:

- cash;
- a cashiers check drawn on a state or national bank;
- a check issued by a state or federal thrift, savings and loan association (S&L), savings bank or credit union; or
- a cash equivalent designated by the trustee in the notice of trustee's sale (NOTS), such as a money order. [CC §2924h(b)(1)]

Each bid made at a trustee's sale is an **irrevocable offer** to purchase the property. However, any subsequent higher bid cancels a prior bid. [CC §2924h(a)]

The trustee's sale is considered final and completed on the trustee's **acceptance** of the last and highest bid. [CC §2924h(c)]

Once the highest bid has been accepted by the trustee, the trustee can require the highest bidder to immediately deposit the full amount of the final bid with the trustee, if the trustee is not already holding all the bidders' funds. [CC §2924h(b)(2)]

If the highest bidder tenders payment by a check issued by a credit union or a thrift, the trustee can refrain from issuing the trustee's deed until the funds become available. [CC §2924h(c)]

Failure to deliver payment of a bid

If a high bidder tenders payment by check and the funds are not available for withdrawal:

- the trustee's sale is automatically **rescinded**; and
- the trustee will send the highest bidder a *notice of rescission* for failure of consideration, provided the trustee has the bidder's address. [CC §2924h(c)]

To hold a new trustee's sale auction, the trustee must set a new trustee's sale date and record, serve and publish a new notice of trustee's sale (NOTS), following all statutory requirements.

The highest bidder who fails to tender payment when demanded or cancels the check is liable to the trustee for all damages resulting from the **refusal to tender** payment, including court costs, reasonable attorney fees and the costs for recording and serving the new NOTS. [CC §2924h(d)]

In addition, the bidder who fails to tender payment or cancel the check will be guilty of a misdemeanor punishable by a fine up to $2,500. [CC §2924h(d)]

Consider a buyer who was the highest bidder on real estate at a trustee's foreclosure sale. The buyer paid the bid with cashier's checks.

Before the bank issuing the checks delivered the funds to the trustee, the buyer stopped payment by handing the bank his declaration that the cashier's checks had been lost without being endorsed. The beneficiary made a demand on the buyer for the amount of the bid at the trustee's sale.

The buyer claimed the beneficiary was barred from enforcing the bid since his only remedy for failure of payment was to re-notice the trustee's sale and recover the costs of re-noticing and holding another trustee's sale.

The beneficiary claimed the buyer was liable for the price bid since the declaration to the bank which stopped payment of the cashier's checks tendered in payment of the price bid was wrongful conduct.

Is the buyer liable for the amount of his bid at the trustee's sale?

Yes! Liability is imposed on the buyer for the full amount of his bid at the trustee's sale since his wrongful conduct induced the bank not to pay on the cashier's checks, which interfered with the trustee's receipt of funds for disbursement to the beneficiary. [**California Golf LLC** v. **Cooper** (2008) 163 CA4th 1053]

Bids by the beneficiary

The beneficiary is frequently the only bidder, and thus the highest bidder, at a trustee's sale. The beneficiary may bid, without tendering funds, up to an amount equal to the debt secured by the property being sold, plus trustee's fees and foreclosure expenses, called a *full credit bid*. [CC §2924h(b)]

If the beneficiary is the highest bidder under a **full credit bid**, the trustee retains possession of the beneficiary's note (or other evidence of the secured debt) in exchange for the trustee's deed to the property.

However, the beneficiary is not required to bid the full amount of the indebtedness to acquire the property at the trustee's sale. The beneficiary can bid an amount below the full amount of the debt, called an *underbid*.

For example, a beneficiary commences foreclose on three properties encumbered by a trust deed in default. The balance due on the trust deed note is $90,000. The beneficiary, being the sole bidder at the trustee's sale, bids in each property for $30,000.

As a result, the lender acquires each parcel of secured real estate sold at the trustee's sale.

By **underbidding** on two or more properties being sold, the beneficiary can continue to "bid in" the secured properties, a process called *piecemeal foreclosure*, until:

- the high bids have satisfied the debt; or
- all secured properties have been sold.

Conveyance by a trustee's deed

On the completion of a trustee's sale, the trustee uses a *trustee's deed* to grant title to the property to the highest bidder. [See Figure 4]

When a buyer other than the beneficiary purchases the property at a trustee's sale for value and without notice of any title or trustee's sale defects, the buyer is considered a *bona fide purchaser* (BFP).

The **BFPs** interest in the property sold is *perfected* as of 8 a.m. on the date of the trustee's sale, if the trustee's deed conveying the property to the BFP is recorded:

- within **15 calendar days** after the date of the trustee's sale; or
- the **next business day** following the fifteenth day after the sale if the county recorder in the county where the property is located is closed on the fifteenth day. [CC §2924h(c)]

The title received by the third party BFP bidder at the trustee's sale is clear of any interest claimed by the owner, lienholders or tenants whose interests are junior to the foreclosed trust deed. [**Hohn** v. **Riverside County Flood Control and Water Conservation District** (1964) 228 CA2d 605]

More importantly, the title is taken clear of any **unrecorded prior interests** or **claims** in the property held by persons **not in possession** of the real estate. However, the highest bidder must be a BFP with no *constructive notice* or actual knowledge of those priority claims when acquiring title to the property at the trustee's sale. [CC §§1107, 1214]

Additionally, a *lis pendens* recorded against the real estate prior to the trustee's sale places bidders on constructive notice of a lawsuit involving a claim to a right in title or to possession of the real estate. The claim may have **priority** to the trust deed being foreclosed. If so, the **lis pendens** destroys the BFP status of the highest bidder as to the person asserting the claim, called a *claimant*.

The buyer of real estate, whether or not purchased at a trustee's sale, takes title to the property subject to the **claimant's** rights disclosed by the lis pendens if the claims have priority to the trust deed being foreclosed.

Additionally, unlike other tax liens, property tax liens and improvement district bond liens are not extinguished by the trustee's sale since they have priority over the trust deed being foreclosed. [**Sohn** v. **California Pacific Title Ins. Co.** (1954) 124 CA2d 757]

Surplus funds

The price paid for property by the highest bidder at a trustee's sale occasionally exceeds the amount of debt and costs due under the foreclosed trust deed. The excess amounts are called *surplus funds*. The trustee has a duty to distribute the **surplus funds** to the junior lienholders and the owner(s). The gross proceeds from the trustee's sale are distributed in the following order:

- to pay the costs and expenses of the trustee's sale, including trustee's fees or attorney fees;
- to pay the indebtedness secured by the property which is in default, including advances made by the beneficiary;
- to satisfy the outstanding balance of junior lienholders of the property, distributed in the order of their priority; and
- to the owner, the owners successor-in-interest or the vested owner of record at the time of the trustee's sale. [CC §2924k(a)]

When surplus funds remain after payment of foreclosure costs and satisfaction of the secured debt, the trustee must either:

- send a *notice of surplus funds* by registered or certified first-class mail to all parties who were entitled to receive a notice of default (NOD); or
- file an **interpleader action** and deposit the funds with the court within 30 days after the execution of the trustee's deed. [CC §2924j(a); see Form 479 accompanying this chapter]

The **notice of surplus funds** will state:

- the property has been sold at a trustee's sale;
- the party receiving the notice may have a claim to the sale proceeds;
- any claim made must be in writing, signed under penalty of perjury and submitted to the trustee within 30 days of the date of the notice; and

- the claim must include the amount of the claim and an itemized statement of principal, interest and other charges. [CC §2924j(a)]

If, after exercising due diligence to determine the priority of written claims, the trustee is unable or uncertain how to distribute the sale proceeds, the trustee:

- files a declaration of the unresolved claims with the applicable court in the county where the sale occurred; and

- deposits the proceeds with the clerk of the court. [CC §2924j(c)]

Trustee's fees

Any fee paid by a trustee to an agent employed by the trustee to perform services may not, when combined with other trustee's fees, exceed the total amount the trustee is authorized to receive as payment. [CC §2924d(d); see Chapter 51]

Costs and expenses recoverable by the trustee, in addition to the trustee's fee, are limited to the costs incurred for recording, mailing, publishing and posting notices. The trustee may also charge up to $50 per postponement of the sale, and an insurance premium, the amount of which is not limited, for obtaining a trustee's sale guarantee. [CC §2924c(c)]

Any **kickbacks**, rebates or referral fees to others involving the services provided by the trustee are prohibited. A trustee or other person who violates this rule is liable to the property owner for **three times** the amount of the kickback, rebate or referral fee. [CC §2924h(g)]

The **trustee named** in the trust deed often refers foreclosure requests to other persons who act as professional foreclosure trustees. For this referral, the named trustee cannot legally collect a referral fee. The same prohibition would apply to beneficiaries who appoint a trustee based on a kickback to the beneficiary of a portion of the trustee's fee should a third-party bidder acquire the property at the trustee's sale.

Additionally, the trustee may charge a fee for any costs and expenses incurred in distributing the sale proceeds, including investigating the priority and validity of junior claims. The trustee may charge a fee of no more than $125 for performing the distribution services. [CC §2924k(b)]

Chapter 48 Requests for default and delinquency notices

This chapter discusses a private lender's and a carryback seller's use of recorded requests for notice to protect his security interest in real estate in the event of a delinquency or commencement of foreclosure under a senior trust deed.

Protection of the last resort

A seller who carries back a note and trust deed secured by the property sold or a private money trust deed lender generally holds a trust deed lien which is junior to a pre-existing trust deed lien held by a lender, called a *senior trust deed*.

The carryback seller holding a **second trust deed**, like a private equity lender or long-term tenant, needs to protect himself against the foreseeable risk of the loss of his interest in the property due to a delinquency and foreclosure by the senior trust deed holder. A foreclosure sale of the property by the senior trust deed holder would eliminate the carryback seller's or equity lender's trust deed lien on the property, called *exhaustion of the security*.

Two procedures exist for the carryback seller or private lender whose note is secured by a junior trust deed, or a tenant, to receive notice from the senior trust deed holder regarding **defaults** and **foreclosure** proceedings on the senior trust deed:

- **Request for Notice of Default** (NOD) — notice will be sent to the person recording a request for notice within 10 business days after a senior lienholder initiates foreclosure by recording an NOD; and

- **Request for Notice of Delinquency** (NODq) — notice will be sent to the person requesting the notice within 15 calendar days after four consecutive months of unpaid and delinquent monthly installments on the senior trust deed note.

Anyone, whether or not they hold an interest in the property, such as the carryback seller, private lender, tenant of the property, or participant in any entity holding title, may **record a request** to receive a copy of any NOD which is later recorded under the trust deed identified in the request. The request does not require the consent of the property owner (or anyone else) and may be recorded at any time.

Conversely, the carryback seller or private lender must first obtain the consent of the buyer or owner of the property in order to process a Request for NODq. Consent is best obtained by including a provision in the purchase agreement or loan agreement entered into with the buyer or owner, or on a later modification of a note. [See **first tuesday** Forms 150 §8.3 and 426 §7.6]

The buyer or owner consents to the NODq and the release of information by signing the request form. The request form is then recorded and a copy served on the senior lender through escrow. [See Form 412 accompanying this chapter]

The senior trust deed holder will only release delinquency information if the request form is signed by the buyer or owner who originated or assumed the loan.

Use of the request for an NODq is only available to persons with an ownership interest (tenant or co-owner) or security interest in the property. [Calif. Civil Code §2924e(b)]

The NOD Request

Anyone, however, may record a Request for Notice of Default (NOD). A recorded Request for NOD must identify:

- the person requesting a copy of the NOD, called the *requestor*, by name and address; and
- the trust deed on which a copy of the NOD commencing foreclosure is requested.

To be valid, the Request for NOD only needs to be recorded in the county where the property is located. No service of the request on the lender is required.

To initiate foreclosure by a trustee's sale, the trustee, on instructions from the trust deed holder, records the NOD. The NOD states the nature of an owner's money default, and what can be done (if anything) to bring the loan current, called *reinstatement*.

Within 10 business days following the recording of the NOD, the **trustee must mail** two copies of the NOD to each person who recorded a request for notice: one by registered or certified mail, the other by first-class mail. [CC §§2924b(b)(1), (e)]

A carryback seller or private lender who have not recorded a Request for NOD and whose trust deed is junior to a trust deed on which an NOD has been recorded will still be sent two copies of the NOD **within one month** after the NOD is recorded; one by certified or registered mail, the other by first-class mail. [CC §2924b(c)]

By recording the Request for NOD, the junior lienholder is sent notice of the NOD in 10 days, not 30 days, giving a 20 day head start to either **reinstate** (bring current) the delinquent loan or **redeem** (pay off) the property, if the owner does not.

However, the trustee's **sending** a copy of the NOD, which is the minimum attempt required to effect service, and the requestor's **receiving** a copy of the NOD are entirely different events.

Receiving an NOD

Foreclosure trustees mail a copy of the recorded notice of default (NOD) to the last address of record, or the present address of the property owner or junior lienholders if it is actually known to the beneficiary or trustee. [CC §2924b(b)]

For example, a Request for NOD is recorded by a carryback seller to reflect his **change of address** from the address given in his recorded junior trust deed. The request calls for a copy of any NOD recorded under the senior trust deed identified in the request form to be sent to the carryback seller at the address of his place of business. [See Form 450 §11 in Chapter 14]

Later on, the carryback seller has another change of address, but this time he fails to record another Request for NOD. The buyer's loan payments to the senior lender become delinquent and he fails to bring the loan current.

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

REQUEST FOR NOTICE OF DEFAULT AND NOTICE OF DELINQUENCY

By Junior Trust Deed Beneficiary

Request for Notice of Default

Under Calif. Civil Code §2924b, request is hereby made for a copy of any Notice of Default (NOD) and a copy of any Notice of Sale under the Trust Deed recorded on _____, as Instrument No. _____, Official Records of _____ County, California, executed by _____, as the Trustor, in which _____ is the Beneficiary, and _____ is the Trustee, to be mailed to _____, as the Requester, whose address is _____.

NOTICE: A copy of any Notice of Default and of any Notice of Sale will be sent only to the address contained in this recorded request. If your address changes, a new request must be recorded.

Request for Notice of Delinquency

Under Calif. Civil Code §2924e, request is hereby made for Notice of Delinquency (NODq) under the above described Trust Deed being a lien on property commonly referred to as _____, and being your Loan No. _____, to be mailed to _____, as the Requester, whose address is _____. Requester is Beneficiary under a Trust Deed recorded on _____, as Instrument No. _____, in the Officials Records of _____ County, California, securing a note which will be due_____, 20_____.

Consent of Trustor

As Trustor(s) under the above described Trust Deed, I/we hereby consent to this Request for Notice of Delinquency.

Trustor: _____ Trustor: _____

(Signature) (Signature)

Date: _____, 20_____ Requester: _____

Date: _____, 20_____ Requester: _____

STATE OF CALIFORNIA

COUNTY OF_____

On _____ before me,

_____

(Name and title of officer)

personally appeared _____

_____,

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature _____

(Signature of notary public)

(This area for official notarial seal)

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The trustee records an NOD. A copy of the NOD is mailed to the carryback seller at his new address which was known and provided by the lender. The buyer cures the default during the reinstatement period.

Later, the buyer again becomes delinquent on his loan payments. An NOD and Election to Sell is again recorded on instructions from the same beneficiary, but by his use of a different, substitute trustee.

However, the lender does not provide the substitute trustee with the carryback seller's current address. The substitute trustee sends the NOD and Election to Sell, and later the notice of trustee's sales (NOTS), to the carryback seller's old address which was the last address of record. The notices are returned to the trustee by the postal service as undeliverable, and thus are never sent to the carryback seller at his new address.

The carryback seller learns of the NOD and the NOTS during the five business days preceding the date scheduled for the trustee's sale, after expiration of the reinstatement period. The carryback seller seeks to have the substitute trustee rescind the NOD and cancel the trustees's sale, claiming the failure to send him notice of the NOD and NOTS at his address known to the lender invalidates the foreclosure process.

Did the lender properly follow statutory mailing requirements?

No, the lender did not follow the statutory mailing requirements since it did not provide the foreclosing trustee with the carryback seller's current address, which was known to the lender. However, the substitute trustee did follow the statutory mailing requirements since he sent notification to the carryback seller at his last address of record and reflected in the sale guarantee issued by the title company.

When a beneficiary initiating foreclosure knows an interested party's current address (by correspondence with that address or otherwise), the beneficiary must advise the substitute trustee to mail the notice to that address.

If the trustee's sale does occur, money losses can be recovered by the junior lienholder from the beneficiary for failure to instruct the substitute trustee to mail the notice to the current address of the junior lienholder as known to the beneficiary. [**I.E. Associates** v. **Safeco Title Insurance Company** (1985) 39 C3d 281]

Documents of record often have outdated or incorrect addresses. However, foreclosure trustees themselves are not required to engage in further efforts to investigate **unrecorded information** to see if the notice is mailed to the most current address for the person entitled to notice. In an effort to protect all interested parties, the trustee should inquire into the beneficiary's knowledge of the current address of parties known to hold interests in the property.

Whenever an owner, carryback seller or tenant has a **change of address**, good practice requires that they record a new Request for NOD. When a new Request for NOD is recorded, the trustee foreclosing must send notices to the mailing address given in the new request for notice.

NODq protection

A recorded Request for Notice of Default (NOD) containing a current address assures a carryback seller he will be **sent notice** of the commencement of a trustee's foreclosure sale within 10 days after the NOD is recorded.

However, by the time a senior trust deed lender records an NOD, the loan is often several months in arrears. The amount needed to be advanced by the carryback seller to reinstate the loan may be economically infeasible after a long-standing, continuing default. Delays may occur before an NOD is recorded when lenders are overwhelmed with defaults during recessionary periods. These delays occasionally last a year or more.

Unable or unwilling to reinstate a hugely delinquent first trust deed, the carryback seller loses his second trust deed lien due to the senior lender's foreclosure on the property since it is wiped out, called *exhaustion of the security*.

The Request for Notice of Delinquency (NODq) assures the junior lienholder, who in this scenario is the carryback seller, that he will be notified when a delinquency in installments has existed for no more than **four months and 15 days**. [CC §2924e(c)]

Good brokerage practice when negotiating a carryback note or a private money loan, secured by a second trust deed, includes the buyer's or owner's consent to use a **Request for Notice** form which includes both the NOD and NODq requests. The same advice holds for leasing agents assisting tenants when entering into lease agreements. [See **first tuesday** Form 412 accompanying this chapter]

Recording and receiving a Request for NODq

A Request for Notice of Delinquency (NODq) may be recorded and served on a senior lender, if agreed to by a buyer or owner, when the secured property is:

- a one-to-four unit residential property; or

- any other type of real estate, but the senior lender need not respond by giving notice if his original loan was greater than $300,000. [CC §2924e(a)]

A Request for NODq must include the name and address of a carryback seller or private lender as the *requestor*, his security interest in the property as the beneficiary of a trust deed, and identification of the senior trust deed loan.

The buyer or owner must **consent** to the Request for NODq by signing it as the *trustor* before the lender is required to comply with the request. The consent to the Request for NODq should be bargained for as part of the terms negotiated for the carryback note or loan origination. [See **first tuesday** Forms 150 § 8.3 and 426 §7.6]

The written consent of the buyer or owner can be either in a separate document, such as the Request for Notice form, or included with the request in the body of the carryback trust deed. The latter is a complicated alternative since a copy of the trust deed containing the request must then be served on the senior lender. [CC §2924e(a)]

The properly prepared Request for NODq is served on the lender, together with a $40 fee, by regular mail addressed to the lender at the address where loan payments are received.

For example, if the carryback seller is secured by a third trust deed, the first and the second trust deed holders are each entitled to $40 on their receipt of the Request for NODq.

The Request for NODq is prepared, recorded and served on the lender by escrow under instructions from the buyer and the carryback seller. In the case of a loan escrow, the instructions are from the owner and the private lender. All costs to prepare and record the notice are paid by the buyer or owner.

The Request for NODq is **valid for five years** from the date it is mailed to the lender or recorded, whichever event occurs last. [CC §2924e(b)]

Prior to the five-year expiration of the Request for NODq, it may be **renewed** for five additional years by recording and mailing the senior lender a copy of the original Request for NODq, together with a written statement of renewal and a fee of $15. A renewal of the request may be sent no sooner than six months before the expiration date of the five-year period for the original request. [CC §2924e(b)]

Prompted by a Request for NODq from the carryback seller or private lender, the senior lender will send them a notice by regular mail within 15 days following a four month delinquency in the payments of any monies due the lender which remains unpaid. The notice will include the status of the delinquency and the amount required to cure it. [CC §2924e(c)]

Final considerations

The Request for NODq scheme, with its four month and 15 day delay before delivery of the notice of any delinquency, provides only limited protection. The carryback seller, private lender, or tenant must still maintain sufficient **money reserves** for multiple reasons, including:

- to cover future costs and advances required to reinstate the first trust deed on a default by the owner; and

- to carry the payments on the first trust deed (and any delinquent taxes and insurance premiums) until the carryback seller or private lender can complete a foreclosure or pre-foreclosure workout with the owner.

An additional and more fundamental protection for the carryback seller who is subordinate to a senior trust deed lien is to consider the use of an all-inclusive note and trust deed (AITD). As holder of an AITD, the carryback seller, not the buyer, is obligated to make payments on the first trust deed, provided the buyer pays the carryback seller on the AITD note. [See Forms 421, 442, and 443 in Chapter 34 and Form 450 in Chapter 14]

When an AITD is used, the need for information on delinquencies in underlying, wrapped loans is reversed between the buyer and the seller. It is now the buyer who needs to make the Request for Notice as the **requestor**. Without making the Request for Notice, the buyer will not receive early notice of a default on the first trust deed should the seller fail to meet his obligations under the AITD to make timely payments on the wrapped loan. The same consideration for an NODq must be given to a tenant's interest under a lease with the owner, since the owner implicitly agrees to do nothing to interfere with the tenant's leasehold interest in the property.

Chapter 49 Accepting partial payments after a default

This chapter discusses the lender's right to complete a foreclosure after receipt of an owner's partial payment toward delinquencies.

The lender may continue to foreclose

An owner of real estate encumbered by a trust deed lien loses his primary source of personal income. As a result, the owner is unable to make installment payments called for in the note secured by the trust deed. Negotiations with the lender to restructure the payment schedule in a pre-foreclosure workout are futile and the lender records a Notice of Default (NOD).

On receipt of the NOD, the owner tenders some of the delinquent payments referenced in the notice. However, he does not tender all delinquent installments and foreclosure charges required to *reinstate* the loan and rescind the NOD.

The lender accepts the owner's **partial payments**. Immediately after receipt of the partial payment, the lender sends the owner a letter that notifies him the loan is still in default, the amount needed to cure the default and bring the loan current, and that the property remains in foreclosure, since the owner's partial payments were insufficient to reinstate the loan.

The owner is also informed that the foreclosure will continue until the loan is brought current or the property is sold at a trustee's sale. Ultimately, a trustee's sale is set by posting and recording a Notice of Trustee's Sale (NOTS).

The owner challenges the validity of the NOTS, claiming the lender *waived its right* to complete the foreclosure by accepting the partial payment on the loan after recording the NOD.

The lender claims the foreclosure may proceed to the trustee sale since the owner paid only part of the amount noticed as delinquent in the NOD, and thus the loan remained in default at all times after the NOD was recorded.

Can the lender proceed with the foreclosure sale after accepting partial payments of the delinquent amount noticed in the NOD?

Yes! By accepting partial payments after recording an NOD and then promptly making a written demand on the owner for the additional amounts required to reinstate the loan, the lender **does not waive** its right to complete the foreclosure process. Only the owner's (or a junior lienholder's) **payment in full** of the delinquent amounts and foreclosure charges owed the lender will reinstate the loan. Thus, the lender is not required to rescind the NOD until all amounts noticed in the NOD are paid in full to reinstate the loan. [**Sellman** v. **Crosby** (1937) 20 CA2d 562]

A *non-waiver clause* in the lender's trust deed authorizes the lender to accept partial payments without waiving its right to foreclose since the note and trust deed have not been brought current and a debt remains. [**M.E. Hersch** v. **Citizens Savings and Loan Association** (1983) 146 CA3d 1002; see Form 450 §3.2 in Chapter 14]

Thus, if the lender accepts a partial payment, to clarify its right to continue with foreclosure it must immediately notify the owner regarding:

- the payment does not reinstate the loan, the owner still remains in default and the property is subject to being sold at a foreclosure sale;

- the dollar amount necessary to reinstate the loan and rescind the NOD; and

- the lender retains the right to complete foreclosure on the property if the amount remaining to be paid to cure the default is not tendered prior to the expiration of the **reinstatement period**. [**Hunt** v. **Smyth** (1972) 25 CA3d 807]

If the conduct of the lender leads the owner to believe the default has been cured, which might occur should the lender fail to notify the owner that the amount tendered is insufficient to bring the loan current, the lender will be barred from continuing with the foreclosure. [**Altman** v. **McCollum** (1951) 107 CA2d Supp. 847]

Additionally, when the trust deed contains an assignment of rents provision and the trust deed is in default, the lender is entitled to collect rents from the landlord or the tenants. Rents collected by the lender are then applied toward the amounts called for in the NOD to cure the default. The lender can continue with foreclosure on the real estate until the default is paid in full. [See Chapter 14]

Partial payment on an incurable default

A lender accepting regular installment payments from an owner when the default cannot be cured by a reinstatement of the loan waives its right to foreclose based on that default.

For example, a buyer acquires property which is subject to a trust deed containing a due-on-sale clause. The buyer tenders the regularly scheduled loan payments directly to the lender but does not obtain the lender's waiver of the due-on clause by formally assuming the loan.

The lender, on learning of the change in ownership, proposes a loan **assumption agreement** which would modify the terms of the loan in exchange for the lender waiving its right to call the loan. The buyer rejects the lender's offer. However, the buyer continues to make the regularly scheduled payments to the lender as called for in the note held by the lender. The lender accepts the buyer's payments without qualification.

A year later, the lender sends the buyer a letter *calling the loan* and informing the buyer their further acceptance of loan payments will not constitute a waiver of the call. The buyer fails to pay the loan in full following the call, thus prompting the lender to initiate foreclosure on the buyer's property.

In this example, the lender failed to **promptly enforce** its rights under the due-on-sale clause when it first learned of the transfer of ownership. The lender did not call the loan until one year after it had knowledge of the change in ownership. During that period it accepted regular loan payments from the buyer without first entering into a **Reservation of Rights** agreement.

Thus, the lender by its conduct with the buyer waived its right to enforce its due-on-sale clause on that transfer to the buyer by calling the loan. [**Rubin** v. **Los Angeles Federal Savings and Loan Association** (1984) 159 CA3d 292]

The lender's remedy for a violation of the due-on clause in a trust deed is limited to **calling the loan**. After making the call, the lender may attempt to negotiate a restructuring of the loan with the buyer, if that is its desire.

However, the lender must not accept payments after the call has been made (without first entering into a reservation of rights agreement). A loan which has been called under a due-on clause cannot be reinstated after the call unless the lender permits it, since the call leaves but one payment due in the form of a final/balloon payment.

Take the money and credit the loan

Some lenders return partial payments tendered by an owner after a default in regular monthly payments. But lenders are entitled to take the money and credit it to the amounts due. However, some lenders are under the mistaken belief that acceptance of the payment will bar them from completing their foreclosure on the property.

Lenders should always accept payments tendered by the owner when the owner has the **right to reinstate** the loan, unless the owner imposes a condition upon the tender with an endorsement on the checks regarding a *disputed amount*.

In an attempt to evade the lender's foreclosure rights, property owners occasionally place conditions on the check they tender, stating the amount of the check is intended to fully cure the default or constitutes a rescission of the notice of default (NOD). When this occurs, the lender is not required to accept the owner's *conditional tender*. [Calif. Civil Code §1494]

The lender can return the **conditional tender** and inform the buyer that only a full payment of the amount due will cure the default and terminate the lender's right to proceed with the foreclosure on the real estate.

Consider an owner of real estate who enters into a service contract employing a broker to obtain a lower property assessment for the current and the prior year.

The owner agrees to pay the broker a percentage of the tax savings received as payment for the services rendered. However, the owner believes he will only owe a percentage on one tax year's savings.

The broker obtains reduced assessments for the current and prior years. The owner pays for the broker's services based on the tax savings for only one year and writes an *endorsement* on the back of the check which states, "payment in full for all services."

The broker cashes the check without deleting the owner's **endorsement**. The broker promptly sends a letter to the owner stating the dollar amount of the check does not fully pay for all services performed and makes a claim on the owner for the remaining unpaid amount.

The owner claims the broker is barred from collecting any further amounts for his services since the check was deposited with "payment in full" printed on it.

The broker claims the acceptance of the check promptly followed by his notice to the owner that the amount was insufficient does not constitute payment in full.

Here, the broker's claim for the full payment of services is allowed since the broker promptly communicated with the owner that acceptance of the check did not constitute payment in full. [**In re Van Buren Plaza, LLC.** (1996) 200 BR 384]

Additionally, a lender might be improperly motivated to refuse to accept any partial payment from an owner until the loan is brought current, in an effort to trigger additional monthly late charges — a source of low-cost revenue.

Chapter 50 A deed-in-lieu of foreclosure

This chapter reviews a trust deed holder's acceptance of a deed-in-lieu to avoid the delay and expense of a foreclosure.

Reducing the risk of loss

The trustee's foreclosure sale of property under a junior trust deed held by a creditor, such as a carryback seller or an equity lender, leaves the creditor unable to recover all the monies due on the note when an underbid is accepted or the property value is deficient to recover the loan amount. The same holds true for a first trust deed noteholder with a high loan-to-value ratio (LTV). [See Chapter 30]

Rather than first initiating a trustee's foreclosure when a property owner defaults during periods of declining property values, a prudent lienholder attempting to save the considerable costs and time lost by foreclosing under such economic conditions should consider negotiating with the property owner for a *deed-in-lieu* of foreclosure.

Editor's note — The following deed-in-lieu rules also apply to the termination of the buyer's rights of redemption under ***lease-options sales*** *and* ***land sales contracts****.*

The deed-in-lieu is an exchange

A **deed-in-lieu** is prepared on the same grant deed form used for the conveyance of fee title. [See Form 406 accompanying this chapter]

An owner of property who signs and delivers a deed-in-lieu essentially conveys his property to a carryback seller or lender **in exchange** for the seller or lender canceling debt; the debt evidenced by a note and secured by a trust deed lien on the property.

To complete the exchange, both the deed-in-lieu and a reconveyance of the trust deed are recorded. Thus, the lender-borrower relationship between the holder of the trust deed and the owner of the property is extinguished.

Before completing the exchange, the seller or lender negotiating for a deed-in-lieu of foreclosure must consider:

- title insurance;
- purchase options;
- due-on clauses;
- reassessment; and
- tax aspects of the transfer of title in exchange for cancellation of the debt.

Deed absolute vs. a mortgage

For a deed-in-lieu to function as a *deed absolute*, the transaction must be a **fair exchange** of values; a conveyance by the owner retaining no interest in a property for a trust deed holder's cancellation of a debt. Thus, the owner agrees to a deed-in-lieu of foreclosure when he has little or no measurable dollar amount of net equity in his property in excess of the liens.

Conversely, a deed-in-lieu does not function as a **deed absolute**, but as a *mortgage-in-fact* when the owner executing the deed-in-lieu retains rights to:

- cure his default and have the property reconveyed to him at a later date;
- receive a payment of surplus net proceeds if the lender later resells the property; or
- continue in possession of the property under a lease and purchase option. [See Chapter 19]

A voidable deed-in-lieu

A deed-in-lieu (or *quit claim deed*) handed to a trust deed holder in advance of a default is voidable and can be rendered unenforceable by the owner of the property who signed the deed. If the premature delivery of the deed-in-lieu to the trust deed holder is for the purpose of eliminating the owner's reinstatement and redemption rights under a lien on the property, which is usually the only reason for its existence, the deed-in-lieu will be *set aside* as **void**. [**Hamud** v. **Hawthorne** (1959) 52 C2d 78]

Occasionally, at the time a trust deed lien is recorded or later modified, a deed-in-lieu is concurrently entered into by the owner, then notarized and delivered unrecorded to the lender or carryback seller. The deed-in-lieu will be recorded when a default occurs. However, should the deed in lieu be recorded, it will function as a mortgage, not a conveyance. The recorded deed-in-lieu both replaces and extinguishes the existing trust deed. Thus, the deed-in-lieu becomes a *mortgage-in-fact* providing security for the debt owed under the note, and the debt is no longer subject to the trust deed as its security device.

The delivery of a deed-in-lieu in advance of a default is an *invalid waiver* of the **redemption rights** an owner holds under any debt secured by his real estate. Thus, if a default occurs after a trust deed lienholder has received a deed-in-lieu, and the lienholder then records the deed-in-lieu, the lienholder is forced to complete a judicial foreclosure to clear title in his name. Recording an ineffective deed-in-lieu creates a mortgage without the benefit of a trustee's foreclosure provision. [Calif. Civil Code §2889]

The need for title insurance

On recording a deed-in-lieu, a **title insurance** policy needs to be issued or endorsed to assure the lienholder who is taking title that the title conveyed is clear of liens or other types of encumbrances (easements) which might have attached to the property after the lienholder's trust deed was recorded. Also, the property may have been conveyed by the owner after the lienholder's trust deed was recorded.

When any encumbrance exists on a property which is **junior in time** to the foreclosing seller's or equity lender's trust deed, a deed-in-lieu conveys title subject to that encumbrance.

Thus, a carryback seller cannot accept a deed-in-lieu and reconvey his trust deed if **junior liens** or conveyances which affect title to the property have been recorded after his trust deed was recorded. If the

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

DEED-IN-LIEU OF FORECLOSURE

DATE: _____, 20_____, at _____, California.

1. I/We, _____,

hereby quitclaim to _____

1.1 all of my rights, title and interest in the real property situated in _____ County, California, referred to as _____

_____

_____

_____.

2. This deed is an absolute conveyance in consideration for _____

_____ and

2.1 the cancellation and release of all rights and obligations arising from the document

2.2 entitled _____, dated _____,

2.3 entered into by _____, as the _____, and

2.4 _____, as the _____.

3. Grantor declares that this conveyance was freely and fairly made upon the consideration listed above, and no agreements exist, oral or written, except as contained in this deed, with respect to the described property.

Date: _____, 20_____ _____
(Print Name) (Signature)

Date: _____, 20_____ _____
(Print Name) (Signature)

STATE OF CALIFORNIA
COUNTY OF_____
On _____ before me,
_____
(Name and title of officer)
personally appeared _____
_____,

who proved to me on the basis of satisfactory evidence to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

I certify under PENALTY OF PERJURY under the laws of the State of California that the foregoing paragraph is true and correct.

WITNESS my hand and official seal.

Signature _____
(Signature of notary public)

(This area for official notarial seal)

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title has been further encumbered or conveyed, the carryback seller must foreclose to eliminate these encumbrances and clear title to the property in his name (or the name of the high bidder at the trustee's sale).

Title insurance companies view a deed-in-lieu with suspicion, since the deed may be voidable. Thus, special wording is required to signify the deed is a true conveyance, not a **disguised mortgage** with a lease and option allowing the owner to recover title.

To be insurable, the deed-in-lieu must state the transfer was freely and fairly entered into by the owner for **adequate consideration**. The deed must also state the conveyance either fully or partially satisfies the debt. [See Form 406 accompanying this chapter]

Additionally, the title insurance company may require an *estoppel affidavit* from the owner, containing similar assurances that the deed-in-lieu is a **deed absolute**, not a **mortgage-in-fact**.

Incentive to stay or convey

An owner who defaults on a trust deed is more inclined to agree to deliver a deed-in-lieu of foreclosure when his gross equity in the property is less than 10% of the property's current fair market value. Additionally, the trust deed holder will take a loss on the foreclosure and resale of the property if the owner's equity is less than 10%, possibly even 15%, of the property's current fair market value.

However, when the owner has little or no equity to lose, the trust deed holder may need to offer some greater incentive beyond cancellation of the trust deed note in exchange for title to the property. One incentive the trust deed holder may offer for a deed-in-lieu is a relatively small amount of "move-out" cash — key money — which is acceptable to the owner, in addition to the lienholder erasing the debt.

The incentive to enter into a deed-in-lieu may also include non-cash considerations, such as an agreement which permits the owner to continue occupying the property after the conveyance solely as a hold-over tenant.

Editor's note — An option to repurchase accompanying the right to retain possession of the property under a lease may not be granted to the buyer, as it would convert the deed-in-lieu into a ***mortgage****. [Calif. Code of Civil Procedure §744; see Chapter 19 and 20]*

The trust deed holder must weigh his money expenditures necessary to complete a foreclosure against the amount of cash or other forms of consideration he might offer the owner in order to obtain a deed-in-lieu and possession of the property. It is the price paid to avoid a delay in repossessing the property. [See Form 406]

Due-on-sale triggered

For a junior lienholder, taking title to real estate by a deed-in-lieu has some of the same effects as receiving a trustee's deed on foreclosure, since both trigger any due-on-sale clauses in the senior trust deed.

Whether repossessing property by foreclosure or a deed-in-lieu, the junior carryback seller or equity lender must consider negotiating with the senior lender for a waiver of its due-on-sale enforcement rights before they reinstate the senior lender's trust deed loan. [See Chapter 28]

Profit reporting consequences

Unlike money lenders, carryback sellers who take back the property they sold, either by way of a trustee's sale or deed-in-lieu, cannot report a profit or loss on the exchange of the canceled carryback note for title to the property. The current value of the property is of no concern to the government for tax reporting purposes.

However, the tax consequence of the original sale in which the carryback paper was created is re-analyzed. Taxwise, any portion of the down payment and principal paid in the installments which were not previously taxed are now **taxed on repossession** of the property. [Internal Revenue Code §1038]

Reassessment by the county assessor

Whether a seller obtains title through foreclosure or a deed-in-lieu, a *change of ownership* occurs which calls for a reassessment of the property for determining local property taxes.

The property will be reassessed by the county assessor at its current market value on receipt of a deed-in-lieu or a trustee's deed.

Chapter 51 Trustee's or attorney fees, not both

This chapter presents the maximum amount of trustee's or attorney fees collectible during the different stages of a judicial or nonjudicial foreclosure of a trust deed lien.

The three-stage foreclosure period

A private lender makes a second trust deed loan to an owner of real estate. The amount of the loan equals 10% of the property's value. Together with the amount of the first trust deed loan, the property is encumbered with a total loan-to-value ratio (LTV) of 85%.

The lender is willing to accept the risk of a high LTV ratio on the property in order to receive a higher-than-market interest rate since he perceives the present real estate market to be dynamic enough to support a continuous rise in resale prices beyond the due date of the loan. Additionally, the owner has a significant and liquid net worth independent of his equity in the property.

The owner later defaults on the second trust deed. The private lender pursues recovery of his loan amount from the sale of the secured property by both:

- recording a **Notice of Default** (NOD) using a trustee to initiate a nonjudicial foreclosure; and
- filing a court action to initiate a judicial foreclosure.

No *specific performance action* is filed to appoint a receiver to enforce the collection of rents under the assignment of rents provision in the trust deed.

Prior to the sale of the property by either a judicial or nonjudicial trustee's foreclosure procedure, the private lender orders out an appraisal of the property to determine its present fair market value (FMV). Should the property's FMV be sufficiently high to cover the amount remaining due on the first and second trust deed loans and the costs of the property's resale, the trustee's sale will be completed and the judicial foreclosure action dismissed.

However, the appraisal may indicate the property's FMV is insufficient for the private lender to recover his entire loan balance plus accrued interest and foreclosure/resale costs from the value of the property. Should insufficient value exist, the lender will pursue a money judgment against the owner under the judicial foreclosure action for the deficiency in the property's FMV to cover the debt. On the sale of the property under the judicial foreclosure action, the lender will abandon the trustee's foreclosure by rescinding the NOD.

Prior to entering a foreclosure decree in the judicial foreclosure action, or the expiration of the reinstatement period in the trustee's foreclosure, the owner locates investors who join him as co-owners of the property, contributing capital to fund a reinstatement of the loan.

With the additional capital from the investors' funds, and prior to the expiration of either reinstatement period, the owner tenders the amount owed to reinstate the loan, consisting of:

- the delinquent payments of principal and interest;

- the late charges properly noticed and accounted for;
- any advance made by the lender;
- any delinquent property taxes; and
- trustee's fees provided by foreclosure statutes. [Calif. Civil Code §2924c]

The lender refuses tender of the money, claiming the tender of no more than the **statutory trustees's fees** is insufficient to reimburse the lender for handling the NOD and notice of trustee's sale (NOTS) and attorney fees incurred to litigate the judicial foreclosure action (which collectively exceed the statutory ceiling on foreclosure fees chargeable by trustees or attorneys).

The lender claims the reinstatement statute is unreasonable and should not apply to attorney fees in a judicial foreclosure action, since reasonable fees far exceed the statutory limits set for attorney fees collectible in foreclosure actions.

Is the lender limited to accepting the amount of the statutory ceiling for the total of both the trustee's fees and attorney fees, despite the fact that reasonable attorney fees in the foreclosure action run far in excess of the statutory limit?

Yes! The owner tendered the correct amount to bring the loan current before entry of a foreclosure decree in the judicial action or commencement of the five business day redemption period prior to a trustee's sale. Thus, the loan was reinstated, and no longer in default, by tender of the statutory maximum trustee's fees and all other delinquencies on the loan. The lender's collection of attorney fees incurred to **litigate the judicial foreclosure**, in addition to the trustee's fees, are prohibited since attorney fees are controlled by the statutory limit on both trustee's fees and attorney fees. [**Bruntz** v. **Alfaro** (1989) 212 CA3d 411]

While a double set of fees was reasonably incurred by the lender, the lender is unable to collect both the trustee's fees and the attorney fees from the owner. One or the other is permissible, but not both.

Time periods during foreclosure

The maximum amount of trustee's fees and attorney fees a foreclosing lender may recover in a judicial or trustee's foreclosure proceeding is set depending on the stage of the foreclosure proceeding. The foreclosure stages proceeding the sale of the property are different from the reinstatement and redemption periods following the commencement of a foreclosure. [See Chapter 45]

The lender may foreclose on secured property by filing a judicial action or by instructing the trustee to record a notice of default (NOD), or by initiating both remedies concurrently as previously demonstrated.

If a **lender completes** one of the foreclosure procedures, the lender's other foreclosure procedure is then eliminated. However, commencement of one foreclosure remedy without completion by a foreclosure sale does not preclude the commencement and completion of the other. [**Vlahovich** v. **Cruz** (1989) 213 CA3d 317]

Strategically, lenders may commence foreclosure by both recording a trustee's NOD and filing a judicial foreclosure action. However, **costs recoverable** on the double foreclosure, as distinguished from trustee's fees and attorney fees, are also limited to only one set of costs.

Simultaneous foreclosures

Lenders initiating a foreclosure on a **recourse loan** should consider promptly beginning a trustee's sale by immediately recording a notice of default (NOD) on default to expedite the sale of the property. A delay always works to the disadvantage of the lender.

Then, an appraisal of the property's fair market value (FMV) should be obtained before completing the foreclosure to determine whether the property's value is sufficient to recover the loan amount and related costs. [See Form 303 accompanying this chapter]

If the property's value is insufficient to satisfy the recourse debt and foreclosure/resale costs, the lender needs to then consider delaying the setting of the trustee's sale and filing a judicial foreclosure action to *obtain a decree* ordering the property to be sold by a sheriff.

By resorting to a judicial foreclosure sale and abandoning the trustee's foreclosure, the lender holding a recourse loan is able to pursue a money judgment for any deficiency in the property's FMV at the time the property is sold at the judicially ordered sheriff's sale.

If the value of the property increases prior to the judicial foreclosure sale, or the lender wishes to expedite foreclosure of the property, the trustee's sale can be held and the judicial action can be dismissed.

However, lenders who foreclose by initiating concurrent trustee's and judicial foreclosure proceedings cannot collect the fees incurred to prosecute both foreclosure proceedings when the property owner reinstates the loan or redeems the property by payment in full.

Attorney fees are only collectible in an action for **judicial foreclosure** at two times:

- on the owner's reinstatement of the note and trust deed prior to the foreclosure decree, in the amount allowed by statute for trustee's fees or attorney fees; or

- on completion of the judicial foreclosure, in an amount deemed reasonable by the court. [CC §2924c(d); Calif. Code of Civil Procedure §726(a)]

However, on reinstatement of the loan, the trustee in the concurrent trustee's foreclosure will rescind the recorded NOD and demand payment of trustee's fees from the lender. In the process of reinstatement, the lender will be reimbursed for the trustee's fees but not for the attorney fees. Only the statutory fees are permitted to be recovered by the lender as reimbursement from the property owner.

If the owner fails to reinstate the note and the lender sells the property in a trustee's foreclosure sale, the lender will only recover fees expended for foreclosing nonjudicially. A lender will not be allowed to recover the attorney fees incurred in a concurrent judicial foreclosure action, since if it was allowed, the lender would receive a double recovery of foreclosure fees.

Statutory limits on fees

When a debt secured by real estate is in default and the debt is reinstated during foreclosure, the trust deed holder is limited by statutory fee schedules to reimbursement of a maximum amount for trustee's or attorney fees.

The owner or junior lienholder may **reinstate** a defaulted trust deed lien prior to the earlier of:

- entry of a foreclosure decree in a judicial foreclosure action; or
- five business days before the date set for the trustee's sale. [CC §2924c(e)]

The **foreclosure fee schedule** for trustee's fees (or attorney fees) recoverable by a lender during the stage of a trustee's foreclosure following the recording of a notice of default (NOD) and before recording a notice of trustee's sale (NOTS), is limited to:

- $300 for the first $150,000 of the loan balance; or
- $250 for loans exceeding $150,000 of the loan balance; plus
- 0.5% of the unpaid principal between $50,000 and $150,000; plus
- 0.25% of the unpaid principal between $150,000 and $500,000; plus
- 0.125% of the unpaid principal balance exceeding $500,000. [CC §2924c(d)]

However, after an NOTS in a trustee's foreclosure has been deposited into the mail, the trustee's fee schedule for the maximum trustee's fee changes. The trust deed lender during the **NOTS stage**, which ends with the completion of the trustee's sale of the property, can recover fees limited to:

- $425 if the loan balance is $150,000 or less;
- $360 if the loan balance exceeds $150,000; plus
- 1% of the unpaid principal balance between $50,000 and $150,000; plus
- 0.5% of the unpaid principal balance between $150,000 and $500,000; plus
- 0.25% of the unpaid principal balance exceeding $500,000. [CC §2924d(a)]

When the property is sold at a **trustee's sale**, the maximum increase in statutory trustee's fees or attorney fees is limited to the greater of:

- $425; or
- 1% of the principal balance on the date of the NOD, whichever amount is greater. [CC §2924d(b)]

For **judicial foreclosures**, attorney fees are fixed at the NOD fee schedule for reinstatement until entry of the *foreclosure decree*. As part of the **foreclosure decree**, attorney fees can be awarded for legal services rendered in excess of the statutory limits, so long as a court deems them reasonable. Unless a deficiency is awarded, the extra fee incurred to litigate the judicial sheriff's sale should not be awarded since a trustees sale accomplishes the same end result in less time (and for less money). [CCP §580c]

Attorney fees unrelated to foreclosure

Often, a trust deed lender is required to file a lawsuit to defend his security interest as a lien on title or in maintaining the value of a property. The litigation is separate from any judicial or trustee's sale foreclosure procedures which may be concurrently in process. The attorney fees expended in a separate action are unrelated to the trustee's fees or attorney fees expended to foreclose. Defending the trust deed lender's security interest is not a foreclosure action.

For example, consider an owner who defaults on a trust deed containing an attorney fees provision. The lender initiates a trustee's foreclosure. In response, the owner files a law suit to stop the foreclosure. The owner claims the foreclosure was commenced solely to satisfy the lender's desire to acquire the real estate for investment purposes during a real estate recession at a time when it is impossible for the owner to realize the property's full value by selling it now.

The lender prevails and is allowed to continue with the trustee's foreclosure. In the process, out-of-pocket costs and attorney fees have been incurred by the lender to defend his right to foreclosure on the property.

The attorney fees awarded in the judicial action are added to the property owner's loan balance by the lender as a **future advance** authorized by the trust deed. On a reinstatement demand requested by the owner, the lender requires the attorney fees be paid before the owner can bring the loan current.

The owner claims the attorney fees are limited under reinstatement laws since the lender's attorney fees were incurred during the reinstatement period.

Can the lender collect the full amount of its award for attorney fees incurred in the non-foreclosure action?

Yes! The attorney fees were incurred in litigation initiated to protect the lender's trust deed rights, not to initiate and litigate a judicial foreclosure. Accordingly, and in addition to trustee's fees, the lender can collect the award for attorney fees under the attorney fees provision in the trust deed. The attorney fees are limited to a reasonable and necessary amount. [**Buck** v. **Barb** (1983) 147 CA3d 920]

Attorney fees paid by the lender are considered **future advances** when the fees are incurred to protect the lender's security interest in the property and the fees are secured by the property under the terms of the trust deed. [**Bisno** v. **Sax** (1959) 175 CA2d 714; see Form 450 §§1.3d, 2.3 and 2.5 in Chapter 14]

SECTION H

Tax Aspects of Financing

Chapter 52 Deductions of points by homebuyers

This chapter discusses the income tax deductions a homebuyer or homeowner may take for the loan points and origination fees incurred on a refinance, purchase-assist or improvement loan.

Prepaid interest write-off exception

Interest on a loan **accrues daily** over the life of the loan. In contrast, a lender's penalty charge (bonus) accrues in its entirety on the occurrence or failure of an event, as with a prepayment penalty or a late charge.

Taxwise, **interest**, no matter the form it may take, which has accrued and been paid on a loan can be written off when determining income tax liability if the interest qualifies as either an *expense* or *deduction* from income.

For example, *accrued interest paid* on a loan, the proceeds of which funded a person's **trade or business activities**, is written off as an *operating expense* of the person's business.

Conversely, **accrued interest paid** on a loan that funded the purchase, improvement or carrying costs of a **rental property** is not an **operating expense** incurred by the property. Thus, mortgage debt on a rental property is not considered when establishing the property's net operating income (NOI). However, interest is written off as a **deduction** from the NOI produced by the rental property (which is also the depreciation allowance). [See **first tuesday** Form 352]

Somewhat different from accounting for interest on a business or rental property, accrued interest paid on a loan that funded the purchase, improvement or carrying costs of **portfolio property** held for long-term profit (such as ground leases, management-free, triple-net leases or land held for profit on resale), is written off as a **deduction** against any income and profit from all sources within the portfolio income category.

Then, the income or loss within each of the three different income categories is calculated independent of each other category. As a result, the reportable income or loss within one category is not commingled with income from any other category.

In contrast to loans for business, rental or portfolio purposes, home loans are treated differently. A loan that funds the purchase or improvement of an owner's **principal residence** or **second home** is a *personal use loan*. Accrued interest paid on personal use loans is not tax deductible, with some exceptions. One exception to the non-deductibility rule is interest paid on loans **made in connection with** the principal and second residence beyond providing security for payment of the loan.

Under the **non-deductibility exception**, interest accrued and paid on the first and second home loans is written off as a deduction once the owner's adjusted gross income (AGI) has been set. Thus, the home loan interest becomes part of the schedule A *itemized deductions* from AGI which directly reduce the homeowner's taxable income, not his adjusted gross income. Thus, the amount on which he will pay taxes is reduced.

Editor's note — The greater an individual's AGI, the smaller the total amount of allowable deductions. Itemized deductions on schedule A are phased out for the year as the AGI increases. Eventually, only as little as 20% of the total itemized deductions remains, which includes home loan interest.

The phaseout for 2007 begins for a married couple filing a joint return at a projected threshold of $156,400 in annual gross income. Thus, the total amount of the itemized deductions is reduced by 3% of every dollar the owner reports in AGI over the threshold. For example, if the itemized interest paid is $25,000 and the AGI (in 2007) exceeds $156,400 by $100,000, $3,000 of the $25,000 will be disallowed.

The government *subsidizes* homeownership through interest deductions on home loans which reduces the taxes the homeowner is required to pay. The amount of tax savings range from 10% and 15% for low-income homeowners, to 35% for high-income homeowners on the amount of interest they pay. Thus, the wealthier one is, to a point, the greater the subsidy for homeownership. Limitations on wealthier homeowners are imposed by the itemized deductions phase out and the alternative minimum tax (AMT) restrictions on allowable deductions.

Wealthier homeowners who are subject to the AMT and have encumbered their first or second home with an equity loan or refinancing (and have used the net proceeds for purposes other than the improvement of, or in connection with, the first or second home) are not allowed to deduct the interest paid on these loan amounts which are not connected to the purchase or improvement of the first and second home. [Internal Revenue Code §56(e)(1)]

The sole basis for allowing the personal interest deduction for a mortgage on a first and second residence is the **federal policy** of encouraging homeownership. The social policy is propagandized by the use of the slogan "The American Dream" and implemented through tax incentives and implicit guarantees for loans held by federally chartered lenders such as Freddie Mac or Gennie Mae. The reasons behind the

Home ownership through tax incentives

Income tax law is often used as a tool by the federal government for social engineering. The social purpose for allowing immediate deduction of points is to encourage renters to purchase homes.

However, a tenant compares the amount of his rent payment with the amount of his potential house payment when deciding to take on the status of homeowner. Since the house payment for new homeowners is typically greater than rent in California, the encouragement has little effect.

While the deduction of loan origination points is financial aid during the new homeowner's first year of increased living costs, the homeowner's tax relief in the following years is limited only to the interest included in the monthly payments and property taxes paid.

However, the deduction of points in the year of closing is more effective in inducing sustainable long-term home ownership than other tax incentives. The deduction of points is not a direct subsidy designed to bail out builders and REO lenders, such as a tax credit for buying a newly constructed home. Tax credits often encourage financially unprepared buyers to purchase homes, shifting the risk of ownership from overextended lenders and builders to homeowners.

federal policy are that homeowners generally require less government assistance in their elder years and make more responsible local citizens.

The points of interest

Points paid to a lender to originate a loan are considered *prepaid interest* since points are interest, and the interest has not yet accrued. Points essentially buy down the loan's *par rate* for the life of the loan to the interest rate denominated in the note. No points means a higher *nominal interest rate* will be stated in the note.

As **prepaid interest**, only the fraction of the points paid which accrues each month over the life of the loan, called the *life-of-loan accrual*, may be deducted against that year's income, with exceptions. When the loan amount is fully prepaid, any remaining unaccrued prepaid interest can then be deducted.

As an exception to the **life-of-loan** accrued reporting, the entire amount of the points paid on loans that assist in the purchase or improvement of an individual's **principal residence** (not a second home) is allowed as a *personal deduction* in the year the loan originated. The immediate deduction for all points paid in connection with a loan that finances the purchase or improvement of the taxpayer's primary home is another government subsidy, part of the overall policy to encourage homeownership in lieu of renting. [IRC §461(g)(2)]

The points deduction exception for a principal residence does not include points paid on loans secured by second homes or vacation residences.

Further, the deductibility of the loan points in the year paid, instead of over the life of the loan, depends on **who paid the points**— the buyer, the seller or the lender.

For example, a homebuyer applies for a loan to fund the purchase of property he will occupy as his principal residence. The loan will be secured by the residence. The lender will be paid points (prepaid interest) for making a purchase-assist loan at an interest rate below the **par rate** for the loan. The lender will not withhold the points from the loan proceeds (as a discount) or add them to the loan balance.

The points will be paid by either the homebuyer from his separate funds, or by the seller, under the terms negotiated by the buyer and his agent in the purchase agreement.

In this situation, the homebuyer can write off the points paid to the lender as a **current deduction** from his adjusted gross income (AGI), since:

- the loan proceeds are used to **purchase or improve** the borrower's principal residence;
- the loan is **secured** by the principal residence, with or without any additional security;
- the Uniform Settlement Statement (USS) accounts for the points paid as "points," "loan origination fees," "loan discount" or "discount points", and compute them as a percentage of the loan;
- the points were paid by the seller or from the buyer's separate funds, not as a discount or add-on by the lender;
- the payment of points is an established business practice of lenders in the area; and
- the points paid do not exceed the amount of points generally charged in the surrounding area. [Revenue Procedure 92-12]

Deductible points

To deduct the points in the year they are paid, the purchase-assist or improvement loan must be **secured by** a buyer's or homeowner's principal residence.

When the loan is secured solely by property other than the residence purchased or improved with the loan funds, such as business or rental property owned by the homeowner or others, the points must be deducted over the life of the loan.

Likewise, points paid by a buyer to finance the purchase or improvement loan for a **second residence** must be deducted as they accrue over the life of the loan. For example, points paid on a purchase-assist loan for a vacation home, payable monthly with a 30-year amortization, will be deductible 1/360th for each month of the tax year as the prepaid interest accrues.

Now consider the homeowner who obtains a home improvement loan secured by his **principal residence**.

The homeowner pays 2½ points on the loan from his separate funds. One of the points is called a *loan origination fee* and is a competitive amount.

Here, the points, even when they are called loan origination fees, are considered prepaid interest. An origination fee is fully deductible if the fee is **based on a percentage** of the homeowner's loan amount.

The owner also pays loan charges itemized by the lender to include administrative fees, processing fees, appraisal fees, title expenses and mortgage insurance premiums (MIPs).

Can the owner also deduct these itemized lender charges in the year they are paid?

No! These itemized charges reimburse the lender for **costs incurred** to originate the loan. Lender costs reimbursed by the borrower are not considered prepaid interest and are not deductible either at the time paid or over the life of the loan. [IRC §163; Rev. Proc. 94-27]

Loan costs incurred by the lender and paid by the owner on any type of real estate to originate a purchase or improvement loan are *capitalized* by the owner. Thus, loan costs are added to, and become part of, the owner's **cost basis** in the property and are not deducted or expensed as interest. Loan charges are non-recurring costs incurred to acquire or improve property, not daily recurring interest which can be expensed or deducted as it accrues and is paid or was prepaid. [**Lovejoy** v. **Commissioner of Internal Revenue Service** (1930) 18 BTA 1179]

Capitalized costs for originating a loan on property other than the first and second home are partly recovered by annual depreciation deductions, and fully recovered when the property is sold.

Seller-paid points

Consider a homebuyer who lacks sufficient funds or incentive to pay the points required to originate a home loan. During the buyer's negotiations with a seller, and as a provision in his offer to purchase the property, the seller agrees to pay the points so he can sell the property to the buyer.

In this instance, the homebuyer is allowed to deduct the points paid by the seller to assist the buyer in originating a purchase-assist loan. When the **seller pays the points**, the homebuyer is considered to have received **cash back** from the seller in the amount of the points. The cash is then used to pay the points as though the cash had come from the buyer's *separate funds*. [Rev. Proc. 94-27]

However, when the seller pays the points and the buyer deducts the amount as prepaid interest, the buyer's *cost basis* in the residence must be adjusted to reflect a **reduction in the price paid** by the dollar amount of the seller-paid points. The seller who paid the points expenses the amount as part of his costs of the sale, not as interest paid by the buyer's use of the cash. This tax treatment for the seller makes a financial difference if he is selling his principal residence at a loss, since if it is interest, he can deduct it, and if it is costs of a sale, he cannot take a loss.

Lender-paid points

Consider a homebuyer who lacks sufficient funds to pay the points demanded by a lender for the interest rate sought on a 30-year purchase-assist loan. Additionally, the seller refuses to pay any of the points without first renegotiating the purchase price of the property.

The lender agrees to increase the loan amount and withhold the points from the loan proceeds as a **discount**.

Can the homebuyer deduct the points paid from the loan proceeds in the year the points are paid from loan funds?

No! The homebuyer did not pay the points from separate funds, either his own or funds he received from the seller. The points were paid as a discount, or an add-on, to the loan. The points, being prepaid interest withheld by the lender, must be deducted annually as they accrue over the 360-month life of the 30-year loan.

Deduction of points on refinancing

Consider a homeowner who refinances the existing purchase-assistor improvement loan on his principal residence and pays the points for the refinancing from his separate funds.

Here, the **refinancing** did not fund the purchase or improvement of the residence, even though it funded the payoff of a purchase or improvement loan. Thus, the points on a refinance are annually written off as they accrue monthly over the life of the loan.

However, if a homeowner uses the **excess loan proceeds** from refinancing to make home improvements, a pro rata share of points paid from the homeowner's separate funds (equal to the percentage of the loan funds which paid for improvements) can be deducted in the year the homeowner refinanced his personal residence. [Revenue Ruling 87-22]

When the homeowner sells his residence or refinances again, the unaccrued points remaining on the existing loan are reported (with itemized deductions) as interest paid in the year of the sale, whether the loan is paid off or assumed by a buyer.

Consider a different homeowner who refinances his principal residence to reduce his monthly payment by $500. The monthly savings are then spent on home improvements, such as a roof replacement and remodeling of the kitchen and bathrooms.

The homeowner deducts all the points he paid for refinancing in the year he refinanced as an itemized deduction on his federal income tax return. He claims the refinancing freed up money for the improvements and was thus a property improvement loan.

The Internal Revenue Service (IRS) disallowed the deduction, claiming the refinancing merely funded the payoff of an existing loan on the property with no net loan proceeds for any improvements.

In this scenario, the deduction of all the points paid to refinance the existing loan is permitted. The refinancing was a loan the homeowner incurred **in connection with the improvement** of the property. The reduction in payments caused the homeowner to have funds to pay for the improvements he then made on the property. [Tax Court Summary Opinion 2005-125 (non-precedent)]

Refinancing short-term financing

A homebuyer executes a short-term note with a three-year balloon payment to help finance the purchase of his principal residence. The short-term note, which is secured by the residence, is a sort of swing loan which must be refinanced if the buyer is to continue his ownership of the residence as intended.

When the note becomes due, the homebuyer obtains permanent long-term financing. The short-term note is paid off with the proceeds of the permanent financing.

The homebuyer deducts the entire amount of the points paid on the long-term refinancing in the year paid. He claims the permanent financing was part of his original scheme to finance the long-term ownership of his principal residence, and was not mere refinancing.

The Internal Revenue Service (IRS) claims the homebuyer cannot deduct the points paid on the permanent financing since, to be entitled to an immediate deduction as a loan made in **connection with the acquisition** of the principal residence, the points must be paid on a loan made to directly fund the actual purchase or improvement of the principal residence.

Here, the points paid on the long-term refinancing of a short-term balloon payment note are deductible in their entirety in the year the points are paid.

The existence of a **short-term due date** in the note originated as a purchase-assist loan was evidence that the homebuyer contemplated refinancing the short-term note to retain the residence for long-term ownership. [**Huntsman** v. **Commissioner of Internal Revenue** (8th Cir. 1990) 905 F2d 1182]

The long-term loan, while it did not directly fund the purchase of the residence, was obtained **in connection with the purchase** of the residence. The refinancing occurred within the original term of the short-term balloon payment note, which by its nature compelled the refinancing.

Any indebtedness incurred in connection with the purchase or improvement of the homeowner's principal residence qualifies the points incurred to originate the loan for immediate deduction in the year paid. [IRC §461(g)(2)]

Chapter 53 Home loan interest deductions

This chapter reviews the home loan interest deduction for reporting the tax consequences of financing first and second homes.

Two residences, two deductions

The federal government has a long-standing policy of encouraging **residential tenants** to become homeowners. The incentive provided by the government to individual tenants is in the form of a significant reduction in the income taxes they will be required to pay if they **finance the purchase** of a residence or a vacation home.

For a residential tenant considering his income taxes, the monthly payment on a purchase-assist home loan is not just a substitute for his monthly rent payment, it also reduces his combined state and federal taxes by an amount equal to 20% to 30% of the monthly loan payment.

Real estate agents handling the sale or purchase of single family residences must be able to intelligently discuss this tax reduction incentive with residential tenants if the tenants are to be persuaded to buy based on the full range of homeownership benefits.

Due to the special home loan interest deduction rule for income tax reporting, the interest *accrued and paid* on loans is deductible from income as an itemized expense if:

- the loans funded the **purchase price** or paid for the **cost of improvements** for the owner's principal residence or second home; and

- the loans are secured by either the owner's **principal residence** or **second home**. [Internal Revenue Code §163(h)]

Without the home loan interest deduction rule, interest paid on a loan which funded the purchase or improvement of a principal residence or second home is not deductible. If the loan did not fund the purchase or improvement of the principal residence or other *personal expense*, it funded the acquisition of an investment or business property.

Also, interest paid on **equity loans** secured by the property owner's principal residence or second home is tax deductible under the home loan interest deduction rules, whether or not the loan's net proceeds were used for personal or investment/business purposes.

The loan interest deductions for the first and second home reduces the property owner's taxable income as an *itemized deduction* under both the standard income tax (SIT) and the alternative minimum tax (AMT) reporting rules. In contrast, the real estate **property tax deduction** on the first and second homes applies only to reduce the owner's SIT, not his AMT.

Two categories of loans exist to control the deduction of interest paid on any loans secured by the principal residence or second home, which include:

- interest on the balances of *purchase or improvement loans* up to a combined principal amount of $1,000,000; and

- interest on all other loan amounts up to an additional $100,000 in principal, called *home equity* loans.

Purchase/improvement loans

Interest paid on money loans and carryback credit sales originated to **purchase or substantially improve** an owner's first or second home is fully deductible on combined loan balances of up to $1,000,000 for an individual and for couples filing a joint return if the loan is secured by either home. The loan balance is limited to $500,000 for married persons filing separately.

Thus, if the loan funds are used to acquire, construct, or further improve a principal residence or second home, and the loan funds, collectively exceed $1,000,000, only the interest paid on $1,000,000 of the purchase and improvement loan balances is deductible as purchase/improvement interest. However, interest paid on the excess loan amounts, up to an additional $100,000, qualifies for a deduction as interest paid on a home equity loan.

To qualify home improvement loans for interest deductions, the new improvements must be *substantial*. Improvements are **substantial** if they:

- add to the property's market value;
- prolong the property's useful life; or
- adapt the property to residential use.

Loan funds spent on repairing and maintaining property to keep it in good condition do not qualify as funding for substantial improvements. [IRC §163; Temporary Revenue Regulations §1.163-8T]

Refinancing limitations

If an owner **refinances** a purchase/improvement loan, the portion of the refinancing used to fund the payoff qualifies as a purchase/improvement loan for future interest deductions. However, interest may only be written off as a purchase/improvement loan on the amount of refinancing funds used to pay off the **principal balance** on the existing purchase/improvement loan.

For example, consider an owner who borrows $200,000 to fund the purchase of his principal residence. The loan balance is paid down to $180,000 and the owner refinances the residence, paying off the original purchase/improvement loan. However, the new loan is for a greater amount than the payoff demanded on the old loan.

In this scenario, interest on only $180,000 of the refinancing is deductible as interest paid on a purchase or improvement loan, unless:

- the excess funds generated by the refinance are used to improve the residence; or
- the excess loan amount qualifies as a home equity loan under its separate ceiling of $100,000 in principal.

$100,000 home equity loans

Interest on loan amounts secured by the first or second home may not qualify for the purchase/improvement home loan interest deduction, due either to a different use of the loan proceeds or the $1,000,000 loan limitation. However, the interest on loan amounts which are secured by the first or second residence and do not qualify as purchase/improvement loans is deductible by individuals and those couples filing joint returns as interest paid on additional or other loan amounts up to $100,000 in principal, called *home equity loans*.

For married persons filing separately, the cap for the principal amount of equity loans on which interest can be deducted is limited to $50,000, half of the joint $100,000 ceiling. [IRC §163(h)(3)(C)(ii)]

Home equity loans are typically junior encumbrances, but also include proceeds from a refinance which do not qualify as purchase/improvement funds and purchase/improvement loan amounts which exceed the $1,000,000 ceiling.

The proceeds from home equity loans may be used for any purpose, including personal uses unrelated to the property.

Property value ceiling

Interest paid on any portion of a loan balance which exceeds the *fair market value* of a residence is not deductible. In practice, the fair market value rule applies almost exclusively to home equity loans, including refinancing proceeds of a greater amount than the balance paid off on the purchase/improvement loan that was refinanced. [IRC §163(h)(3)(C)(i)]

The **fair market value** of each residence is presumed to be the original amount of the purchase price plus any improvement costs. Thus, any **future drop in property value** below the balance remaining on purchase-assist loans does not affect the interest deduction. [Temp. Rev. Regs. §1.163-10T]

Editor's note — Consistent with its policy under codes such as §1031, the Internal Revenue Service (IRS) does not perform any appraisal activities. Thus, the IRS has substituted the easily computable original cost of purchase and improvements for the fair market value limitation established by Congress. However, an owner who takes out a home equity loan which, when added to the other loan balances on the residences, exceeds his purchase and improvement costs of the property, can rebut the IRS fair market value presumption of cost with a current fair market value appraisal provided by the lender.

*Thus, on a refinance or origination of a home equity loan, it is advisable for an owner to request and receive a copy of the lender's appraisal to later corroborate the property's increased market value at the time the financing was originated. [See **first tuesday** Form 329]*

Qualifying the principal residence and second home

To qualify for a home loan interest deduction, loans must be secured by the principal residence or second home.

A *principal residence* is defined as an individual's home where the homeowner's immediate family resides a majority of the year, which is close to the homeowner's place of employment and banks which handle the homeowner's accounts, and the address of which is used for tax returns. [IRC §163(h)(4)(A)(i)(I)]

A *second home* is any residence selected by the owner from year to year, including mobile homes, recreational vehicles and boats.

If the second home is **rented out** for portions of the year, the interest qualifies for the home loan interest deduction if the owner occupies the property for more than 14 days or 10% of the number of days the residence is rented, which ever number is greater. [IRC §280A(d)(1)]

If the owner does not rent out his second home at any time during the year, the property qualifies for the home loan interest deduction whether or not the owner occupies it. [IRC §163(h)(4)(A)(iii)]

The rental income on the second home is *investment/portfolio income* if the home qualifies for the interest deduction due to the owner's days in occupancy exceeded the 14-day/10% rule.

If the second home has been rented, but the owner's family occupied the property for more than 14 days or 10% of the days rented thus qualifying the home for the loan interest deduction, the owner is not allowed to treat the property as an investment. Since the property is not an investment, the owner cannot depreciate the home. [IRC §§163(h)(4)(A)(i)(II); 280A(d)(1)]

A second home, when purchased for personal use and held for a profit on resale, also qualifies as investment (like-kind) property for exemption from profit taxes under IRC §1031. [IRC §1221; IRS Private Letter Ruling 8103117]

Taking the deductions

Interest deductions on home loans are only allowed for interest which has **accrued and been paid**, called *qualified interest*. [IRC §163(h)(3)(A)]

Interest on first and second home loans is deducted from an owner's **adjusted gross income** (AGI) as an *itemized deduction*. Further, limitations exists on the total amount of all deductions the homeowner can claim. Conversely, business, rental or investment interest are adjustments that reduce the AGI. Thus, the two types of home loan interest deductions directly reduce the amount of the owner's taxable income (if the interest deductible is not limited by ceilings on the homeowner's itemized deductions).

The inability to reduce the owner's AGI by use of the home loan interest makes a substantial difference for high income earners. The higher an owner's AGI, the lesser the amounts allowed for rental loss deductions, *itemized deduction phaseout* (starting at an AGI of $150,500 for 2006), and any tax credits available to the owner. [IRC §163(a), (h)(2)(A)]

Consider a homeowner who wants to generate funds to use as a down payment to purchase business, rental or investment real estate. His only substantial asset is the $300,000 equity in his home.

If the owner further finances with a home equity loan or refinances the existing loan to net $200,000 in loan proceeds, he will be paying interest which is only partially deductible. The non-purchase/improvement loan amount exceeds the $100,000 home equity loan cap. The interest the owner pays on the portion of home equity loan balance in excess of the $100,000 loan cap is not deductible under the home loan interest deduction rules.

The home as additional security

Consider a homeowner who encumbers the equity in his home to secure a note he executes as the down payment on the purchase of investment property.

The homeowner wants to avoid the home loan interest deduction limitations and be able to write off all the interest paid on the note against future income from the rental or portfolio property he purchased with the loan funds. Accordingly, the homeowner negotiates with the lender or carryback seller for the note to be secured by **two separate trust deeds**; one as a lien on the home and the other as a lien on the property purchased.

The lender or carryback seller is satisfied with the financial risk regarding the loss of principal. The lender or carryback seller receives a trust deed on the home, which he views as his primary source of recovery if the owner defaults on the note.

In addition to the owner's home, the note is secured by the property purchased, to justify writing off the entire interest accrued and paid on the loan against income from the property purchased. The home is merely used as **additional security** under a separate trust deed.

The PMI deduction

Also, mortgage insurance premiums, such as for private mortgage insurance (PMI), is tax deductible. Treated the same as interest on a principal residence, a married couple filing a joint tax return with an AGI up to $100,000 (or an individual filing with an AGI up to $50,000) can deduct 100% of the mortgage insurance premiums paid or accrued on property purchased *after January 1, 2007*.

The amount of mortgage insurance premiums deductible is reduced by 10% with each additional $1,000 of AGI over $100,000 for joint filings up to $110,000, and over $50,000 for individuals up to $55,000. Any amounts paid or accrued *after December 31, 2010* or allocable to any period after that time cannot be deducted. [IRC §163(h)(3)(E)]

Chapter 54 Seller financing diminishes tax impact

This chapter discusses the favorable impact installment sale tax reporting has on a carryback seller who finances the sale of his real estate.

Installment sale defers profit reporting

A seller lists his property for sale with his real estate agent. The listing price for the property is $1,500,000 and it is free of encumbrances. The seller's *cost basis* in the property is $100,000.

The seller's goal is to convert his ownership of the real estate into a relatively management-free, interest-bearing investment. The seller is a lifetime investor and is not inclined to turn his real estate over to a trustee or exchange it for an unsecured annuity.

Consistent with his management-free investment goals, the seller is willing to carry back an interest-bearing installment note to provide financing for a buyer. The monthly payments on the note includes interest which will provide the seller with an income, replacing the **net operating income** (NOI) he currently relies on from the property.

The seller's broker locates a buyer for the property . A full listing offer is made consisting of:

- a 20% down payment; and
- a note payable to the seller for the 80% remainder of the purchase price.

The buyer will tender a $300,000 down payment in cash and execute a note in favor of the seller for the balance of the price, secured by a trust deed on the property. The transaction will close prior to the end of the year. The first installment of the carryback note will be paid in the year following the year of the sale.

The terms of the note carried back by the seller will include:

- $1,200,000 in principal;
- 7% interest;
- monthly payments of $7,983.63 on a 30-year amortization; and
- a 10-year due date for a final balloon payment of $1,029,748.

The listing agent reviews a cost analysis of the sale with the seller, noting the net sales price after payment of around $100,000 in closing costs will be approximately $1,400,000. Then, taking the seller's cost basis of $100,000 into account, the listing agent calculates the profit the seller will realize on the sale to be approximately $1,300,000.

When will the seller have to pay taxes on the $1,300,000 in profit taken on the sale of his property?

The seller will **automatically report** the sale as an *installment sale* on his income tax return. The reporting will **defer payment** of a significant amount of profit taxes to later years when installments on the carryback note are received. The portion of the installment which is principal, represents in part the profit received after the year of sale. [Internal Revenue Code §453]

Deferring the tax on profit

For a seller of real estate, *profit* is the portion of the net sales price remaining after deducting the seller's remaining capital investment (**cost basis**) in the property. The formula is: net price minus basis equals profit. However, a developer's dealer property, such as lots or homes sold by a developer, generates ordinary income, not profit.

When a sale of real estate generates profit, called *gain* by the Internal Revenue Service (IRS), **all profit** taken on the sale is reported in the year of sale, unless the profit is:

- *excluded*, which occurs when the sale of property qualifies as a principal residence for the Internal Revenue Code (IRC) §121 $250,000 profit exclusion per individual home owner;
- *exempt*, which occurs on the sale of business or investment property when the net sales proceeds are used to acquire identified replacement property in an IRC §1031 reinvestment plan, or to replace property taken by eminent domain; or
- *deferred*, which occurs when the profit on a sale is allocated to a note carried back on the sale and reported under the IRC §453 installment method.

Applying the profit-to-equity ratio

Before reporting the profit realized on a sale, the **profit is allocated** between the cash proceeds received from the sale and the carryback note.

To accomplish the allocation, a ratio is established between the **profit and the net sale proceeds** from the seller's equity. The percentage of the net sales proceeds which represents profit on the sale sets the ratio, called the *contract ratio* by the Internal Revenue Service (IRS), or the *profit-to-equity ratio*. Thus, whatever percent of the net equity is profit sets the **profit-to-equity ratio** applied to the cash and carryback note received from the sale.

Continuing with our previous example, the **net proceeds** from the seller's equity in the property are $1,400,000, the sales price ($1,500,000) minus any debt relief ($0), minus closing costs ($100,000).

Thus, the percentage of the $1,400,000 **net sales proceeds** represented by the $1,300,000 in profit is 93% (rounded up from .928571), the **contract ratio** or **profit-to-equity ratio**.

Accordingly, 93% of the net cash proceeds received on closing ($200,000) is reported and taxed as **profit** ($185,720) in the year of the sale. In future years, 93% of the principal in each installment paid on the carryback note and received during the year is reported as profit.

Thus, $14,280 of the cash proceeds from the down payment represents the seller's recovery of a portion of his remaining **cost basis** in the property and is not reported as taxable profit, it is a tax-free return of his invested capital.

Each monthly installment on the seller's $1,200,000 carryback note is $7,983.63.

During the year following the year of sale, the 12 installments received by the seller will include $12,189.72 in principal plus $81,613.84 in interest. Additional interest is also paid to the seller to cover any interest that accrued unpaid in the year of the sale.

The seller will report all the interest received as **portfolio category income** without regard for whether the profit is business category or passive category income.

For profit reporting, the profit-to-equity ratio of 93% is applied to the principal in each installment received on the note. Thus, the carryback seller's reportable profit in the first year (following the year of sale) is $11,319.37, 93% of the $12,189.72 in principal payments the seller will receive.

The 7% remainder of the principal he will receive is untaxed — $870.35 — since it represents a partial return of the seller's original capital investment (remaining cost basis).

Ultimately, the final/balloon payment will be received by the seller. Again, the profit-to-equity ratio of 93% will be applied to the final principal payment of $1,029,748.66 ten years after closing. The profit reported by the carryback seller when the final/balloon payment is received will be $956,224.55, 93% of the principal in the balloon payment.

Since the seller acquired the property as a depreciable long-term investment (capital asset) and actually held the property for at least one reporting period, the profit taken by the seller consists of two types of gains:

- *unrecaptured gain* in the amount of all depreciation taken during the seller's ownership (and taxed at a 25% rate); and
- *long-term gain* in the amount of all remaining inflation-appreciation profit (and taxed at a 15% rate).

The goals in an installment sale

While a carryback seller will pay a profit tax on all of the profit in a down payment, final/balloon payment and principal installments, the seller achieves two financial goals on the installment sale of his real estate:

- the **highest sales price** possible by providing the buyer with financing to facilitate the sale; and
- the **maximum annual income** by earning interest on the principal in the carryback note, principal which includes unpaid and deferred profit taxes on 85% of the sale.

When the seller carries back a *straight note* calling for all the principal to be paid in a final/balloon payment after the year of sale, the sale is also reported as an *installment sale*. Here, the one installment is scheduled to be received after the year of the sale. [IRC §453(b)(1)]

However, a **straight note** due in the year of the sale, but paid delinquently, does not qualify the transaction for **installment sale reporting**.

The seller may structure payments on the carryback note so he will receive all or most of his principal (and thus **profit**) in a designated later year (or in any year on demand), if he anticipates taking a substantial loss in that later year which will offset reportable profit on the principal in his carryback note.

Debt relief, profit and taxes

Consider a seller who is solicited by an agent to list his investment real estate for sale. The seller recently refinanced the property, encumbering it with a note which has a principal balance of $480,000.

Sales terms the seller is willing to accept for the sale of the property include:

- a purchase price of $800,000;
- a 20% down payment of $160,000;
- an assumption of the existing $480,000 trust deed loan by the buyer; and
- a carryback note for the balance of the seller's equity, $160,000.

In a discussion with the seller about his profit on the sale, the agent determines the seller's **remaining cost basis** in the property is $50,000, the improvements having been fully depreciated since the seller's purchase of the property in 1985.

On a sale of the property for $800,000, the *net sales price* will be approximately $720,000 after deducting all transactional costs.

The **net sales price**, besides representing the seller's debt and equity, is a return of his $50,000 remaining cost basis and a $670,000 profit on the sale. The profit is a result of depreciation deductions (*unrecaptured gain*) and an increase in the property's dollar value due to inflation and local appreciation (*long-term gain*) during the seller's years of ownership.

All of the **profit** on the sale, unless deferred, exempt or excluded from taxation, will be taxed in the year of sale as either **unrecaptured gain** (depreciation) at a rate of 25%, or as a **long-term capital gain** (increased value) at the current rate of 15%. The federal income tax bill will require around $125,000 to be paid from the net proceeds of the sale plus tax to the state of California, all totaling nearly 25% of the net sale proceeds.

Although the seller does not want to remain responsible for payments on the existing loan, the listing agent suggests the seller reconsider his requirement that a buyer must assume or refinance the existing loan.

The agent explains to the seller how an **assumption or refinancing** of his existing loan by the buyer on an installment sale would produce an adverse tax consequence.

Existing financing and profit

The calculation of profit on a sale is unaffected by the existence or nonexistence of mortgage debt. Debt encumbering a property plays no role in calculating the profit on a sale.

However, the assumption or refinancing of an existing debt by a buyer in a carryback sales transaction plays a huge role in setting the percentage of the down payment and principal in the carryback note which will be reported as profit and taxed each year as payments are received. The *percentage* is the portion of the seller's **net proceeds** from the sale — cash and paper — which is profit on the sale, the profit-to-equity ratio.

Taxwise, the seller's goal in an installment sale is to structure the net sales proceeds (cash and paper) to produce the **lowest profit-to-equity ratio** possible. The lowest percentage possible in any sale is achieved when the net sales price and the net sales proceeds are the same, as in our opening scenario for

this chapter. This percentage occurs naturally when the property is free of debt, unencumbered by liens. Stated another way, there is *no debt relief* on the installment sale.

For the seller to receive the maximum tax deferral benefits available on an installment sale, **no debt relief** can occur. To entirely avoid debt relief when the property sold is encumbered by a trust deed, the seller must **remain responsible** for the trust deed debt after closing the sale. An all-inclusive trust deed (AITD) carryback or land sales contract accomplishes this debt relief avoidance as an installment sale of property since the buyer does not assume or refinance the seller's existing loan.

Here, the principal amount of the carryback note is the balance due on the **purchase price** after deducting the down payment (as occurs with an AITD note), not for the balance of the equity above the down payment (as occurs with a regular trust deed note and a loan assumption or refinance by the buyer).

For example, the greater the amount of the debt assumed (or paid off on the sale) by the buyer, the smaller the seller's net sales proceeds. The profit on the sale does not vary, regardless of how the sale is financed. Thus, the smaller the seller's net proceeds on the sale (cash and carryback note), the higher the percentage of the profit attributable to the net sales proceeds.

When the amount of the mortgage debt assumed or refinanced by the buyer exceeds the seller's remaining cost basis, the amount of the seller's profit will be greater than the seller's net sales proceeds, a situation called *mortgage over basis*. Thus, all principal received on closing the transaction or by installment payments will be profit, and the profit-to-equity ratio will top out the note as 100% profit. [Revenue Regulations §15A.453-1(b)(2)(iii)]

Loan assumption by the buyer

In our previous loan assumption example, 100% of the net proceeds from the down payment and all the principal in the seller's $160,000 carryback note will be profit, taxable in the years the principal amounts are received by the seller. As always, the tax is deferred only on that portion of the $670,000 profit allocated to the principal in the carryback note ($160,000). On the assumption of a loan by a buyer, the amount of the carryback note is a small portion of the total sales price.

The remaining $510,000 in profit not allocated to the carryback note is taxed in the year of sale. Thus, the 25% and 15% profit tax due to the Internal Revenue Service (IRS) on gains (unrecaptured and long-term) in the year the property is sold would be around $105,000 (plus state taxes).

However, the seller's cash sales proceeds are only $80,000, the $160,000 down payment minus the $80,000 in closing costs.

If the carryback seller allows a buyer to assume the existing debt, the immediate financial result will be disastrous since taxes will greatly exceed the seller's cash proceeds. The seller's only relief on an assumption and carryback sale will come from any substantial losses he may incur from other business or investment sources which will offset these profits, and thus reduce his tax liability.

A far more prudent approach exists. The seller can structure the carryback note on the sale of encumbered property as an all-inclusive trust deed (AITD) note for the balance of the purchase price, not just the amount of equity remaining unpaid after the down payment and assumption of the existing loan. With an AITD note, the total amount of the cash down payment and AITD note will equal the *net sales price*, making the AITD note a substantial 80% portion of the sales price. The resulting profit-to-equity ratio will be the lowest percentage figure available for allocation of profit between the cash proceeds and the carryback note.

The all-inclusive trust deed

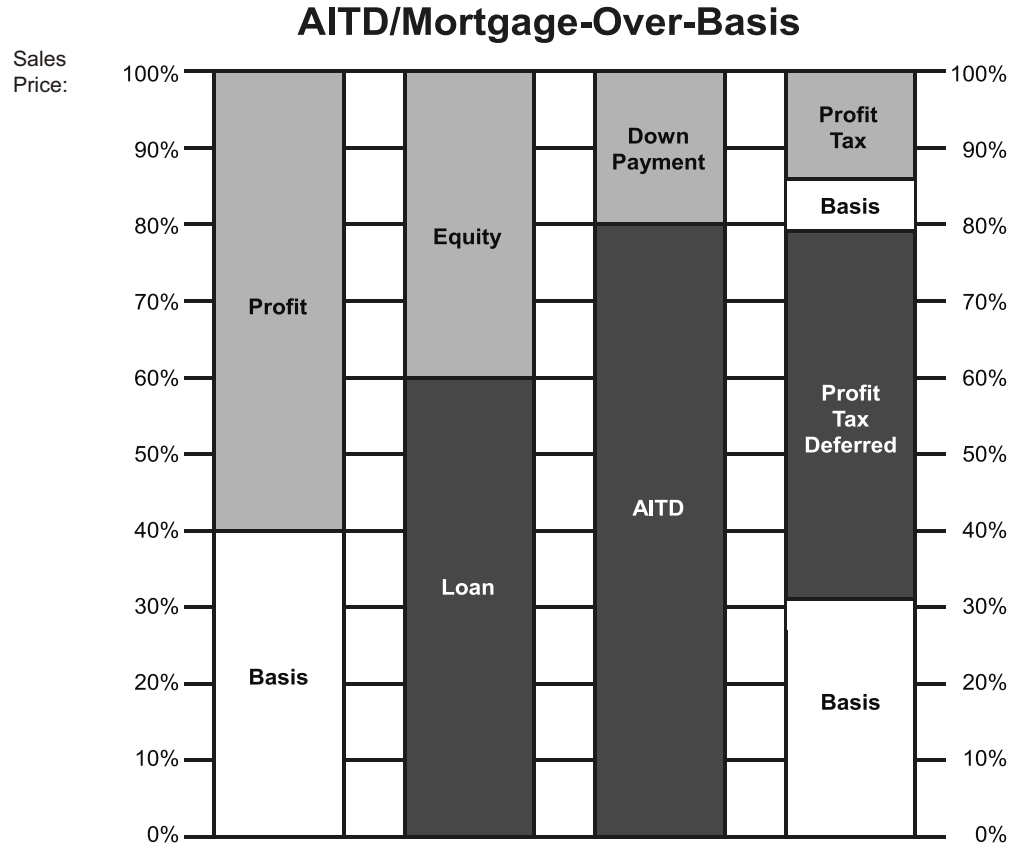
A broker needs to be able to explain to a seller of encumbered property how the carryback of an all-inclusive trust deed (AITD), also called a *wraparound security device*, will:

- reduce the amount of profit allocated to the down payment (and thus reduce the seller's profit taxes in the year of sale); and
- increase the amount of profit allocated to the carryback note (and thus defer to future years the payment of taxes on **all profit** not allocated to the down payment). [See Figure 1]

A necessary arrangement for the seller on the sale of encumbered property is to retain responsibility for all future payments on the trust deed note in order to **avoid debt relief**. To retain responsibility for the loan, the seller must carry back an AITD (or land sales contract) for the **balance of the purchase price** remaining unpaid after the down payment, not a regular note for the balance of his equity after the down payment. Thus, the seller will continue to make payments on the existing loan.

A seller who will remain responsible for a wrapped loan that contains a due-on clause should obtain the **lender's consent** to the carryback sale, called a *reverse assumption*, since the buyer **will not assume** the loan.

Figure 1



The seller may be required to pay an exaction (points and loan modification) to induce the lender to waive the due-on clause and consent to the transfer of title and further encumbrance with the AITD.

Other types of **wraparound financing devices** produce the same tax results as an AITD note. Examples include: land sales contracts, contracts for deed, lease-option sales, and lease-purchase sales agreements. These alternative financing devices also trigger the due-on clause in any trust deed of record (and re-assessment for property taxes), as does any carryback note secured by a trust deed on an encumbered property.

The profit allocated to the AITD note will be sheltered from the payment of profit tax until the seller:

- receives payments of principal on the AITD note;
- hypothecates (pledges) the AITD note; or
- shifts the responsibility for payment of the underlying wrapped loan to the buyer. [**Professional Equities, Inc.** v. **Commissioner** (1987) 89 TC 165]

Continuing with our previous example, the seller's **net sales proceeds** of $720,000 (cash plus the AITD carryback) are the same as the seller's **net sales price** when the seller remains responsible for the existing loan under an AITD carryback.

Since the profit on the sale is $670,000 and the net sales proceeds are $720,000, the profit-to-equity ratio will be 93%, the lowest percentage available on this sales transaction.

In the year of sale, the seller will net $80,000 from the down payment, of which 93% ($74,400) is reportable as profit. All other profit has been allocated to the principal amount of the AITD note. Thus, taxes on all profit not allocated to the down payment are deferred to later years.

The 25% tax on gains from unrecaptured depreciation represented by the $74,400 profit allocated to the down payment is around $18,600. The use of the AITD avoids the $105,000 in taxes the seller would have incurred in the year of sale (as shown before) had the buyer assumed or refinanced the seller's existing loan.

Structuring the carryback sale as an AITD allows the seller to receive **after-tax sales proceeds** of $61,400 from the $80,000 net down payment.

In conclusion, the 93% profit-to-equity ratio will be applied to the principal received in the AITD payments and on the final payoff. The profit-to-equity ratio sets the amount of the profit in the principal on the note which will be taxed when the principal is paid.

AITD later modified to take the profit

Consider a seller who carried back an all-inclusive trust deed (AITD) note on the sale of rental property in a prior tax year. Profit from the sale was allocated to the AITD note, reported and taxed on the installment method.

In the current tax year, the seller sustains either a substantial trade or business loss, or an operating or capital loss in the rental (passive) income category. A portfolio loss on stocks or bonds does not offset the profit taken on a rental property in the passive income category, except for $3,000 annually.

The seller takes no profits this year to offset his loss. The losses, be they business or rental, are of no further tax benefit after the current year since the seller is treated as being in a real estate related business.

However, the seller can shift a portion of the profit from the AITD note into the current year **by negotiating a modification** of the AITD with the buyer. With a modification, the seller can arrange to report a substantial portion of the installment profit in the current year by:

- **shifting responsibility** for the wrapped loan to the buyer by allowing him to assume or refinance the wrapped loan;
- **reducing the principal** balance in the AITD note by the amount of the loan assumed or refinanced by the buyer; or
- **pledge the AITD note as collateral** for a loan of an amount equal to his losses.

The percentage of profit in the principal of the AITD note, as set by the profit-to-equity ratio, is applied to the principal reduction on the AITD note — a reduction equal in amount to the loan assumed or refinanced, or the pledge of the note — to determine the amount of profit to be reported due to the debt relief.

Thus, by **incurring debt relief** by renegotiating the terms of the AITD note and converting it to a regular note, the carryback seller is able to engineer the time for reporting a substantial amount of the profit in his carryback. As a result, the tax on the profit is avoided by the offset provided by the losses from business or rental category operations and sales in the year the AITD is modified.

Pledging carrybacks

A seller who **pledges** his carryback note as collateral for a loan, called *hypothecation*, triggers the reporting of a portion of the profit which was allocated to principal in an amount equal to the amount borrowed. The borrowing and pledging can also be timed to occur in a tax year when a loss on a business or rental activity has occurred, thus offsetting one another. [See **first tuesday** Form 242]

Broker Considerations

When assisting a seller in a carryback sale, the broker should be aware of other tax factors including:

- the **$5 million carryback threshold rule** — a seller who carries back more than $5 million in paper during any one tax year will incur an interest charge on the amount of the deferred tax [IRC §453A];
- **accrual accounting threshold** — if the carryback amount in 2009 is $3,665,500 or more, the seller must use the accrual method of accounting, reporting interest income as it accrues, whether or not payment of interest is actually received [IRC §1274A(c)(2)(A); Rev. Rul. 2008-52]; and
- **minimum interest reporting** — if the carryback amount in 2009 is up to $5,131,700, the interest rate charged must be no less than 9% or the applicable federal rate (AFR). [IRC §1274A(b); Rev. Rul. 2008-52]

If the interest charged on the carryback note is lower than the AFR, the seller must report interest at the AFR rate, called *imputing,* reducing the amount of principal, and thus profit, on the note.

YEAR

2009

Real Estate Withholding Installment Sale Acknowledgement

CALIFORNIA FORM

593-I

(This form can only be completed by the buyer. This is not a remittance document.)

Part I – Buyer's Information **Return this form to your real estate escrow person.**

Name			SSN or ITIN
Spouse's/RDP's Name (if jointly purchased)			Spouse's/RDP's SSN or ITIN (if jointly purchased)
Address (including apt./suite, room, PO Box, or PMB no.)			☐ FEIN ☐ CA Corp no.
City	State	ZIP Code	Daytime telephone number ( )
Property address (if no street address, provide parcel number and county)			

Part II – Seller's Information

Name			SSN or ITIN
Spouse's/RDP's Name (if jointly purchased)			Spouse's/RDP's SSN or ITIN (if jointly owned)
Address (including apt./suite, room, PO Box, or PMB no.)			☐ FEIN ☐ CA Corp no.
City	State	ZIP Code	Installment Withholding Percent ___ ___ . ___ ___% Apply this percent to all installment payments.

Part III – Installment Acknowledgement

Attach to Form 593-I, Real Estate Withholding Installment Sale Acknowledgement, a copy of the signed promissory note. If the seller has elected and certified the Optional Gain on Sale withholding amount, also attach an executed copy of seller's certification of Form 593, Real Estate Withholding Tax Statement, to Form 593-I.

Part IV – Buyer's Acknowledgement to Withhold (Read the "Buyer" information below before you sign.)

I acknowledge that I am required to withhold on the principal portion of each installment payment to the seller for the above shown California real property either at the rate of 3 1/3% of the total sales price or the Optional Gain on Sale withholding percentage, as specified by the seller on Form 593, Real Estate Withholding Tax Statement, of the principal portion of each installment payment. I will complete Form 593 for the principal portion of each installment payment and send one copy of each to the Franchise Tax Board along with the withholding payment, and give one copy of Form 593 to the seller. I will send each withholding payment to the Franchise Tax Board by the 20th day of the month following the month of the installment payment. If the terms of the installment sale, promissory note, or payment schedule change, I will promptly inform the Franchise Tax Board. I understand that the Franchise Tax Board may review relevant escrow documents to ensure withholding compliance. I also understand that I am subject to withholding penalties if I do not withhold on the principal portion of each installment payment and do not send the withholding along with Form 593 to the Franchise Tax Board by the due date, or if I do not send one copy of Form 593 to the seller by the due date.

Buyer's name (if the buyer is not an individual, buyer's agent's name and title) (type or print)_____

Buyer's signature _____ Date: _____

It is unlawful to forge a spouse's/RDP's signature.

Buyer's spouse's/RDP's name (if on title) _____

Buyer's spouse's/RDP's signature (if applicable) _____ Date: _____

Buyer: Make sure you copy both sides so you will have the instructions for withholding on subsequent payments. Give the original, along with copies of the promissory note and seller's certified Form 593, to your real estate escrow person who should mail them to the Franchise Tax Board. Your real estate escrow person will withhold on the principal portion of the first installment payment. You must withhold on the principal portion of **all** subsequent installment payments (including payoff or balloon payments). Complete Form 593, and mail the documents and payment to the Franchise Tax Board for the principal portion of each installment payment.

Real Estate Escrow Person: Make a copy of this Form for your records. Send the original Form 593-I, a copy of the promissory note, and seller's certified Form 593 to the Franchise Tax Board with the required amount of the first installment payment.

For Privacy Notice, get form FTB 1131.

7141093

Form 593-I C2 2008

When a seller pledges a carryback note, the **loan proceeds** are considered to be equivalent to the payment of principal on the note. Thus, profit allocated to the principal is reported and taxed in an amount equal to the loan amount. [IRC §453A(d)(1)]

The percentage under the profit-to-equity ratio, used to allocate profit to the carryback note, is applied to the amount of the loan proceeds to determine the amount of profit to be taxed due to the pledge. [IRC §453A(d)(2)]

Prepayment penalties

On the prepayment of a carryback note, the principal paid to satisfy the note includes profit which is reported and taxed in the year of the premature payoff. [IRC §453(c)]

To assure a seller he will retain his tax advantages of an installment sale until the final/balloon payment becomes due, the listing agent will suggest his client include a *prepayment penalty* clause in the carryback note. [See Chapter 9]

*Editor's note — Statutory limits exist for **prepayment penalties** on carryback notes secured by owner-occupied, one-to-four unit residential properties. [Calif. Civil Code §2954.9]*

However, for all other types of property, a prepayment penalty clause may be structured to compensate the seller for the entire amount of the projected profit tax he would prematurely incur due to the prepayment of principal on the note.

The prepayment penalty must be reasonably related to the actual expenditures likely to be made for the payment of profit taxes on a buyer's early payoff, including:

- **profit taxes**, based on current or reasonably anticipated rates; and
- **maintaining a portfolio yield** during the lag time after early payoff and before the funds are reinvested.

Election out

A seller may elect out of installment sale reporting by voluntarily reporting the profit as taxable in the year of the sale. [IRC §453(a), (d)(1)]

Reporting all the profit on a carryback sale as taxable in the year the property was sold (and escrow was closed) may be advantageous to a seller who during the year of sale has an equivalent offsetting factor such as:

- *trade* or *business loss*, on a real estate brokerage or development business;
- *rental operating loss*, directly offset by the profit on a carryback sale of a rental property;
- *rental operating losses* which reduces the seller's adjusted gross income (AGI) if he is in a *real-estate-related business* activity;
- *capital loss* on the sale of a rental or passive business investment; or
- *capital loss* carried forward or from the sale of investment/portfolio category assets (stocks and bonds) when the installment sale is of an investment/portfolio category property, such as the sale of land held for profit on resale, a second home or a triple-net leased, management-free rental property.

California Franchise Tax Board installment sales rules

Unlike the federal withholding scheme, California requires the buyer, through escrow, to withhold 3 1/3% of the sales price from the seller's proceeds on all sales, unless the transaction is excluded from withholding. **Excluded transactions** include sales by all California-based entities and by any individual who **certifies** that the transaction qualifies for an exclusion from withholding for the Franchise Tax Board (FTB).

For individual sellers entering into an installment sale of their property, the transaction is either:

- *qualified* from withholding by the individual seller certifying it is excluded; or
- *not qualified* and subject to the mandatory withholding of the entire 3 1/3% of the price from the down payment, unless the **buyer agrees to withhold** the 3 1/3% from each installment of principal paid on the price. [See Franchise Tax Board Form 593 I accompanying this chapter]

If the buyer refuses to withhold and forward 3 1/3% of the principal in each periodic payment to FTB, the carryback note may call for installments of interest-only payments and avoid amortization of the principal. Thus, only the final/balloon payment would contain a payment of principal. In this fashion, the buyer's agreement to withhold principal would be limited to the final payoff. Then, the buyer would only be responsible for one filing with the FTB, besides the original filing by escrow which withheld 3 1/3% of the cash proceeds from the down payment, not 3 1/3% of the sales price.

However, the sale may **qualify for exclusion** from California FTB withholding. If the sale is excluded, the issue of buyer cooperation to withhold on every payment of principal is eliminated.

The seller's **transaction is excluded** from FTB withholding on both the down payment and the dollar amount of a carryback note, if:

- the property is the seller's **principal residence**;
- the sale is declared by the seller to be a **Internal Revenue Code (IRC) §1031 reinvestment transaction** (with the carryback note being payable to the buyer's trustee for ultimate assignment as consideration for the purchase of a replacement property);
- the property is **sold at a loss** if the purchase price is less than the remaining cost basis; or
- the property is sold for a **price of $100,000** or less.

Miscellaneous installment rules

A carryback note must qualify for installment sale reporting at the time escrow closes. The seller may not restructure a carryback transaction **after escrow closes** in an attempt to qualify the sale as an installment sale by extending the due date on the carryback note from the year of sale to a date beyond the year of the sale. [Revenue Ruling 56-20]

However, the seller may later restructure a carryback note he has reported as an installment sale by modifying its terms, such as extending its due date, subordinating the trust deed to a new trust deed loan, or accepting substitute security from the buyer.

For builders and developers who sell their *dealer property* on a credit sale, installment sale reporting is not available (with exceptions). Their earnings from the sale of inventory are trade/business income, not profit taken on the sale of a capital asset or property actually used to house or conduct the ongoing trade or business operation. [IRC §453(b)(2)(A)]

However, the **dealer property** exclusion does not apply to the installment sale of farms, vacant residential lots and short-term timeshares, even though they may be classified as dealer property. [IRC §453(l)]

No stepped-up basis on death

Consider a wife who, on her husband's death, becomes the owner of her husband's one-half interest in a carryback note they jointly held from an installment sale in a prior tax year. The note was previously carried back on the sale of community property. The carryback note has been reported and taxed on the installment method, thus, the principal of the note contains untaxed profit.

The wife seeks a **stepped-up basis** on the entire note to its market value on the date of her husband's death since the note is a community property asset which she received on her husband's death.

In this scenario, the carryback note held by the community and received by the wife on her husband's death does not qualify for a step-up in basis. The note at the time of death contained profit which had been **realized** on a prior sale and was yet to be taxed as **recognized**. [**Holt** v. **United States** (1997) 39 Fed. Cl. 525]

Chapter 55 Interest reported on a carryback note

This chapter discusses a seller's annual tax reporting of income from a carryback note at no less than a minimum interest rate.

Charge or impute a note's AFR

A seller of real estate extends credit to a buyer for a portion of the property's sales price, evidenced by a note carried back on the sale, called an *installment sale* or *carryback sale*.

In addition to stating the principal amount owed, the note sets forth the interest rate charged by the seller, the monthly payments of principal and interest, and the due date for the final balloon payment.

Taxwise, the **interest income** portion of each payment is reported by the seller as *portfolio category* income. The interest income is then offset by any losses in the operation or sale of portfolio assets, such as land holdings, ground leases, income property subject to management-free, triple-net leases, loans or stocks and bonds. Any remaining interest earnings are reported and, unless offset by losses from the business or rental income categories and personal deductions, taxed at ordinary income rates, ranging from a floor of 10% to a ceiling of 35% (in 2009).

The **principal amount** of the carryback note represents an allocation of part of the **basis** and an allocation of a portion of the **profit** taken on the sale, when the owner's remaining cost basis in the property is a greater amount than the loan encumbering the property.

The cost basis portion of each payment of principal is a *return of capital*, which is not taxed. On the other hand, the profit portion of the principal is comprised of *gains* to be reported within the **property's income category** (trade/business, rental/passive, portfolio or personal residence) and is taxed, if not offset, by other losses.

The **profits** on the sale of income property are typically composed of *unrecaptured depreciation gains* and *long-term capital gains*. These gains, respectively, will be taxed at a ceiling rate of 25% for unrecaptured depreciation gains and 15% for long-term capital gains, unless offset by:

- capital or operating losses on other properties within the same income category;
- allowable losses from other income categories; or
- itemized deductions.

The dynamics of planning

The 133% spread that exists between the long-term capital gain tax (15%) and the maximum tax on interest (35%) is the dynamic which makes tax planning interesting to brokers, attorneys and accountants.

Sellers can reduce the overall amount of their taxes on an installment sale, while still receiving the same total amount of dollars over the life of the installment sale, by:

- increasing the purchase price of the property sold (thus increasing profits which are taxed at a 15% rate); and

- decreasing the interest rate charged on a carryback note (thus reducing ordinary income which is taxed at higher rates than gains).

To combat this shift in earnings from interest to profits on installment sales, which reduces the overall tax on the entire transaction, the federal government set a floor rate for **minimum interest reporting** on carryback notes. Minimum interest rates limit the extent to which taxes can be reduced, properly called *tax avoidance*.

Conceptually, all sums received by the seller on the carryback note, whether labeled as principal or interest, are subject to a **reallocation of principal to interest** under *imputed interest reporting* rules.

The **rules for imputing** only apply to the seller. The **buyer reports** the principal and the interest as agreed in the carryback note, and the terms of the note remain unaltered by any imputing reported by the seller.

Reallocation of principal

Carryback financing arrangements are subject to the minimum imputed interest rate reporting rules if the terms of the note call for any payments to be due more than six months after the date the transaction closes.

Every debt that is the result of an extension of credit on a sale, such as a note carried back by a seller, has an **Applicable Federal Rate (AFR)** of interest. The note's AFR sets the minimum rate of interest the seller can report over the life of the carryback note. The rate of interest reported is fixed and does not vary during the life of the note, unless the terms of the note are modified.

Figure 1

Example Applicable Federal Rates

June 2009

Short term, not over 3 years:	**AFR**
Monthly	0.75%
Quarterly	0.75%
Semi-annual	0.75%
Annual	0.75%
Medium term, between 3 and 9 years:	**AFR**
Monthly	2.03%
Quarterly	2.03%
Semi-annual	2.04%
Annual	2.05%
Long term, over 9 years:	**AFR**
Monthly	4.20%
Quarterly	4.22%
Semi-annual	4.24%
Annual	4.28%

Each carryback debt and security device, such as a trust deed note, land sales contract, lease-option sale or a lease-purchase agreement, has its own AFR. These security devices used by the seller include the terms for payment of the installment debt owed the seller for the unpaid portion of the purchase price.

Any carryback debt negotiated at an interest rate lower than the note's AFR triggers the reporting of a portion of the note's principal balance as interest. AFR reporting entails an allocation and conversion of principal to interest by the taxpayer, called *imputing*. [Internal Revenue Code §1274(b)]

Taxwise, **imputing decreases** the amount of principal reported on the carryback note. In effect, imputing also reduces the sales price the seller reports for the property sold. Likewise, the **profit** which would have been reported without imputing is decreased. Further, the **interest income** is increased by the amount of principal allocated to interest. [See Figure 1]

The financial result of this shift of funds from profits to interest income is an overall increase in the amount of taxes the seller will pay on the transaction.

The buyer is completely unaffected by the imputing and the seller's income tax reporting.

Applicable Federal Rates

Figures for the Applicable Federal Rates (AFRs) are set monthly by the Internal Revenue Service (IRS). AFR figures are loosely based on the rates of return (yield) on Treasury notes and bills issued by the government.

The figure setting the AFR for a particular carryback note is selected based on three factors, including:

- the **acceptance date** of the purchase agreement;
- the **term of the note**; and
- the note's periodic **payment schedule**.

The first step towards identifying the proper AFR for a note is to locate the AFRs for the **month of acceptance** of the purchase agreement or counteroffer, lease-option or land sales contract. Alternatively, the AFR figure may be selected from the AFRs for either of the two months preceding the date the purchase agreement is accepted. [IRC §1274(d)(2)]

The IRS sets 12 fixed-rate AFRs each month. Thus, based on the **note's due date**, the fixed rates are broken down into **three AFR categories**: short-, medium-and long-term. Further, each category contains four rates, classified as monthly, quarterly, semi-annual and annual **periodic payment schedules**, one of which is selected based on the payment schedule in the carryback note. [See Figure 2]

The second step towards identifying the proper AFR for a note is to select the AFR category in which the note belongs, based on the **term of the note**. The selection of a category is set by the number of years from the closing of the sale to the due date of the note's final payment. The categories are divided as follows:

- notes with due dates of **three years or less** fall into the **short-term** AFR category;
- notes due between **three and nine years** fall into the **medium-term** AFR category; and
- notes due in **over nine years** fall into the **long-term** AFR category. [IRC §1274(d)(1)(A)]

Option periods to renew or extend the note's due date are included when figuring the length of the note's term and selecting the correct AFR category. [IRC §1274(d)(3)]

Figure 2

Reamortization of imputed interest

- ✓ $1,000,000 note at 7% annual interest rate, AFR is 8%
- ✓ $665.30 monthly payments
- ✓ five-year due date
- ✓ Total payments collected equal $134,049.59; $7,983.63 annually in the first years plus $94,131.59 final payment

Principle reduction

Term	7% note balance	8% AFR balance
origination	$100,000	$95,994
end of year 1	98,984	95,678
year 2	97, 895	95,377
year 3	96,727	94,966
year 4	95,475	94,566
Final payoff	**94,131.59**	**94,131.59**

The last step towards identifying the proper AFR for a note is to select the rate within the due date category that matches the note's periodic **payment schedule** (monthly, quarterly, etc.).

9% ceiling up to threshold amount

For all carryback sales entered into in 2009, in an amount no greater than $5,131,700, called the interest threshold, the minimum reportable interest rate is the lesser of 9% or the note's Applicable Federal Rate (AFR). [Revenue Ruling 2003-119]

Thus, 9% compounded semi-annually is the **maximum rate** for imputing carryback notes with a principal balance at or below the threshold amount, even though the AFR may exceed 9% (as it did in the early 1980s). [IRC §1274; Rev. Rul. 2003-119]

The threshold amount for applying the 9% ceiling is **adjusted for inflation** each year by the Internal Revenue Service (IRS), starting from a base amount of $2,933,200 in 1990. [IRC §1274A(d)(2)]

A carryback note with a principal amount greater than the interest threshold must report interest at or above the note's AFR on the entire amount on the note, without regard to the ceiling of 9% and not just on the amount exceeding the threshold. In summary, if the note rate is less than the note's AFR, the principal amount of the note (for reporting only) is reduced to conform to the amortization schedule, due date and the note's AFR, a process which is called *imputing*.

All carryback notes that are part of the same transaction or a series of **related transactions** are considered to have occurred in one sale. The amounts to be paid in principal and interest over the life of all carryback notes in related sales transactions are totaled to determine whether the 9% threshold ceiling or the AFR restrictions apply. [IRC §1274A(d)(1)]

Reamortize and report

The Internal Revenue Service (IRS), in pursuit of a higher tax revenue, introduces an equalizer in the form of a minimum annual **rate of interest** the seller will report on a carryback note. This floor rate for reporting interest income neutralizes the seller's ability to effectively raise the price a buyer will pay in exchange for reducing the interest charges on the carryback note. Thus, the minimum reportable interest rate implicitly affects the maximum sales price of property.

Now consider a seller who agrees in a purchase agreement to carry a note for $100,000 at an interest rate of 7%, payable $665.30 monthly with a $94,131.77 final/balloon payment due in five years. Based on the month the purchase agreement is entered into by all parties, the carryback note's medium-term due date and the monthly principal and interest payment schedule, the fixed Applicable Federal Rate (AFR) which controls for the entire life of the note is 8%, a higher rate than the 7% note rate.

Over the life of the note, the seller is scheduled to receive a total stream of principal and interest payments equal to $134,049.59 — $100,000 in principal and just over $34,000 in interest under the terms of the 7% note.

Each year, the seller will receive principal and interest payments of $7,983.63 which he must first apply to and report as interest at no less than the note's AFR. The amount of the remaining payment is then deducted from the note's principal balance.

The principal received is further broken down into basis and profit on the profit-to-equity ratio for installment sale reporting of profit taxable from year to year. [IRC §453]

Taxwise, the interest rate the buyer is charged is less than the AFR. Thus, interest income is imputed at the AFR figure for the seller's tax reporting. To **calculate the interest** income reported to the IRS, the seller must reamortize the note (based on the amount of the scheduled installments, the final/balloon payment amount and the numbers of months until due) at 8%, which is the note's AFR. These figures will set the amount imputed as interest which in turn reduces the principal amount reported on the note.

This re-analysis of the principal and interest in the note's stream of scheduled installments and payoff amounts at the imputed interest rate **reduces the profit** by reducing the original principal amount of the note and the principal amount contained in each payment. Conversely, a larger portion of each payment than originally agreed to in the note is reported as interest income. [See Figure 1]

Commingling interest and profit

Profits reported on the sale of real estate are taxed at rates ranging from 10% to 25% for various types of *gains* on real estate sales.

Ordinary income is taxed at higher rates than profits, ranging from 10% up to 35%, which sets the rates for taxes paid on interest income.

The objective of imputed interest reporting is to prevent carryback sellers from structuring the price and terms of payment to convert interest income into profit (**gains**) and achieve up to a 60% reduction in taxes on the amount converted to profits over the life of the note.

For example, a carryback seller of rental property compensates for his increased sales price by negotiating a reduced interest rate on his carryback note, resulting in a zero-sum difference in the amount of dollars he will receive over the life of the note. The remaining rentals he owns are highly leveraged and produce annual operating losses.

The interest income will not directly offset the rental operating losses (since it is portfolio category income, not passive rental category income). However, if the seller is classified as being in a real estate related business, he can offset the interest income by the rental losses.

Taxwise, the high sales price generates excessive profits as principal payments are received from year to year on the note. Thus, the large annual reportable operating losses from the seller's highly leveraged rental properties will annually offset the excess profit from the installment sale of a rental which will be reported each year in the passive income category.

Unless the seller can write off the operating losses as resulting from real-estate-related business, the losses will not offset interest income since interest is reported in a separate income category.

The seller will use his annual reportable rental operating losses to shelter his artificial profit received annually on the installment sale of the rental property at an above market price.

The monthly payments received by the seller equals the same amount he would receive in monthly payments on a lesser purchase price with a higher interest rate.

Here, compulsory reporting of imputed interest at minimum rates prevents sellers who are not in a real-estate-related business from commingling investment category interest income with rental category operating losses to offset one another and neutralize taxes. [IRC §469(c), (e)]

Interestingly, no reporting rules exist to govern the opposite process by which the seller reduces the purchase price and, by the terms of the carryback note, converts profit into increased interest earnings. This process would increase portfolio category income (in order to, for example, eat up losses carried forward on stock sales and carrying costs of land ownership).

Consider a "land-poor" seller who has built up substantial investment/portfolio category losses carrying his property. The seller sells his rental category property (with a $1,000,000 fair market value) in the passive income category for $750,000 with a $100,000 down payment.

The seller carries back the balance in an all-inclusive note (AITD) for $650,000 at 15% — significantly above current market interest rates — with a seven year due date. To ensure his high yield for seven years on the note will effectively recover the dollar amount of the $250,000 price reduction, the seller includes a lock-in clause in the note which bars prepayment for seven years.

In case the note is legally payable at any time during the seven year period, a stiff prepayment penalty of 30% on unscheduled principal payments is included to cover the shortfall in total receipts from the sale (interest for seven years) due to an early payoff.

Thus, the seller has effectively converted $250,000 of his profit on the sale of rental property into investment category interest income on the carryback note. A portion of his actual rental profit (converted to interest) is now sheltered by his accumulated investment/portfolio losses carried forward from prior years due to land ownership expenses (or stock market losses).

Threshold for accrual reporting

If the principal amount of a note carried back in 2009 is more than $5,131,700, labeled the *accrual threshold*, the seller must report interest income each year **as the interest accrues** without regard for when payments on the note are received. [Rev. Rul. 2003-119]

For example, a carryback note with a principal amount of $10,000,000 calls for a **graduated interest rate** of:

- 5% the first year;
- 6% the second;
- 7% the third;
- 8% the fourth;
- 9% the fifth; and
- 10% in years six through eight with a **final/balloon payment** due on the eighth anniversary of closing.

The amortization period for the payments is 30 years, with principal and interest payable monthly. Each year the amount of the payment increases as the note is reamortized at that year's graduated rate for the remainder of the amortization period.

To determine if additional interest income will be imputed, one must first establish the amount of the **average annual interest** earned during the eight-year term of the note. To do so, interest earned on the accrual basis must be calculated as a constant (average) annual yield over the eight-year term, taking into account all interest agreed to be paid on the note in the future.

The average **rate of interest** over the eight year period is 8.12%. However, the average interest rate charged is not equalevent to **interest paid**, called the *yield*. The rate of interest is constant over the years of the note while the *amount* of interest paid is reduced each year as the principal balance declines due to amortization. As a result of amortization, the average yield (or interest paid) is 7.75% over the eight-year life of the note. Accrual-threshold notes, such as the $10,000,000 note, are controlled by **accrual reporting**. Thus, the carryback seller reports interest annually at the note's constant **average yield** (in this case 7.75%) over the full term of the note.

In the graduated payment example, this leads the seller to report more interest income than he actually receives in the early years of the note, and less interest income than he actually receives in the later years under the terms of the note.

Additionally, if the average yield on the accrual-reporting note is less than the note's Applicable Federal Rate (AFR), the seller must report interest at the AFR each year.

The straight note

The fundamental difference between annual accrual reporting and cash reporting is best demonstrated by considering a carryback note with principal and interest due in one installment payable after the year of sale, sometimes called a *straight note* or *sleeper trust deed*.

First consider a carryback note for $1,000,000, at 5% interest compounded annually, with principal and interest due in two years. The note's short-term Applicable Federal Rate (AFR) is 7%, compounded semi-annually.

In this example, the seller is entitled to report his profit and interest income from the **straight note** on the **cash method** when he receives the principal. The straight note does not exceed the threshold amount which would require accrual accounting rather than cash accounting. A statement is filed with the seller's tax return in the year of the sale which states that no interest will be reported until the loan is paid in full. [Revenue Regulations §1.1274A-1]

The seller receives $1,102,500 of principal and interest in a final/balloon payment on the due date of the straight note. However, rather than reporting the 5% interest income of $102,500 as stated in the note, the seller must report the interest at the note's AFR. Thus, he will report $140,000 (rather than $102,500) as interest income. The remaining $962,500 of the payment (rather than $1,000,000) is principal which represents profit and a return of capital in amounts based on the equity-to-profit ratio for the original installment sale transaction.

Now consider a carryback **sleeper trust deed** note for $10,000,000, a principal amount that exceeds the accrual threshold and requires annual (accrual) reporting of interest.

The $10,000,000 sleeper trust deed note calls for 5% interest, compounded annually, with a two-year due date for the payment of all principal and interest. The note's short-term AFR is 7%, compounded semi-annually.

The principal amount of the note is first recomputed to impute interest at the note's AFR. Once the principal amount is recomputed, the seller's reportable principal in the note is no longer $10,000,000, but slightly over $9,600,000. Thus, like cash reporting, accrual reporting includes additional interest income of approximately $400,000 **imputed as interest** over the two year period, which reduces the note's principal amount (and profit on the sale).

However, unlike cash reporting, accrual reporting requires interest to be reported annually at the note's AFR, as it **accrues unpaid**.

As a result, nearly $700,000 is reported as portfolio category interest income in the first year, even though the seller receives no payment with which to pay the taxes on the accrued interest income.

Special imputed interest rates and exemptions

Interest on **sale-leaseback financing** arrangements is imputed at 110% of the note's Applicable Federal Rate (AFR). [IRC §1274(e)]

Carryback notes created on the sale of land between **family members** will impute interest at a ceiling rate of no more than 6%, compounded semi-annually, unless the total sales price of all transactions between the same two family members in the same year exceeds $500,000 (the threshold which triggers imputed interest reporting at the note's AFR). [IRC §483(e)]

The following carryback notes are exempt from imputed interest reporting:

- carryback notes with a due date of six months or less [IRC §1274(c)(1)(B)]; and
- notes with a principal amount less than $3,000. [IRC §483(d)(2)]

A carryback note assumed by a buyer does not receive a new AFR at the time of assumption, unless the terms of the note are modified. [IRC §1274(c)(4)]

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Table of Contents

Real Estate Practice Fifth Edition

Table of Forms 7
Introduction. 9

Section A

Agency Issues

Chapter 1 — Brokerage activities: agent of the agent
For, on behalf of, and in place of 10

Chapter 2 — An agent's perception of riches
The broker avoids deception 18

Chapter 3 — Human resources: low-level management by brokers
The entry and exit of agents 24

Chapter 4 — The MLS environment
An industry-wide misconception 29

Chapter 5 — Subagency and dual agency
Agency and fee sharing misconceptions 33

Chapter 6 — Conflict of interest
Professional relationships compromised 37

Chapter 7 — The agency law disclosure
Legislated order 44

Section B

Listings: Employment by the public

Chapter 8 — Types of listings
Listings as employment contracts 53

Chapter 9 — The exclusive right-to-sell listing agreement
When the fee is earned 62

Chapter 10 — The listing's exclusive aspect
A fee earned on any sale 70

Chapter 11 — A fee due on withdrawal or termination
Exercising an alternative 75

Chapter 12 — The safety clause
A fee due after the listing expires 80

Chapter 13 — Greater transparency in marketing
Costs for preparing to sell 90

Chapter 14 — "For Sale" sign regulations
Property owners can display 99

Chapter 15 Operating under a buyer's listing
A prerequisite to representation 102

Chapter 16 The buyer's listing agreement
Analyzing the buyer's listing 111

Chapter 17 Sharing fees on a sale
Buyer's agent or cooperating agent? 116

Chapter 18 The breaching buyer pays
Brokerage fee protection 121

Chapter 19 The seller's interference with fees
The breaching seller pays 124

Chapter 20 Finders: a nonlicensee referral service
Agency relationships in real estate transactions 129

Section C

Property Conditions and Disclosures

Chapter 21 Due diligence obligations
The duty owed to clients 136

Chapter 22 The listing agent and the prospective buyer
General duty to voluntarily disclose 143

Chapter 23 Opinions with erroneous conclusions
When an opinion becomes a guarantee 152

Chapter 24 Condition of property: the owner's disclosures
Mandated on one-to-four residential units 163

Chapter 25 Safety standards for improvements
Disclosing noncompliant improvements 176

Chapter 26 The home inspection report
Transparency by design 180

Chapter 27 Verify property disclosures: retain a home inspector
Protecting the prospective buyer 187

Chapter 28 Natural hazard disclosures by the listing agent
A unified disclosure for all sales 192

Chapter 29 Structural pest control reports and repairs
Pricing and asymmetric information 203

Chapter 30 Environmental hazards and annoyances
Noxious man-made hazards 213

Chapter 31 Lead-based paint disclosures
Crystal clear transparency 220

Chapter 32 Marketing condominium units
Managed housing 225

Chapter 33 Tax aspects advice
Disclosure of known consequences 232

Chapter 34 Prior occupant's use, affliction, and death
When and when not to disclose 239

Chapter 35 Income property operating data
Fundamentals induce offers 242

Chapter 36 Required disclosures on seller carrybacks
Mandated notices 251

Chapter 37 Seller's net sales proceeds estimate
Financial consequences of a sale 258

Chapter 38 Buyer's estimated acquisition costs
The capital to buy 269

Section D

Contract Law

Chapter 39 Making an offer
The intent to contract 284

Chapter 40 Acceptance of an offer
Time and nature of a response 291

Chapter 41 The counteroffer environment
Meeting the seller's objectives 298

Chapter 42 Contingency provisions
Conditioning the close of escrow 304

Chapter 43 The elimination of contingencies
Occur, approve, waive, or exercise 313

Chapter 44 Cancellation excuses further performance
Exercising the option to terminate 320

Chapter 45 Time to perform
Default and cancellation 326

Chapter 46 Cancellation, release, and waiver
Known and unknown claims 337

Chapter 47 The seller's breach
Failure to act or act timely 342

Chapter 48 The breaching buyer's liabilities
First, there must be a monetary loss 352

Chapter 49 Liquidated damages provisions
Windfalls and responsibility for losses 359

Chapter 50 Arbitration: the independent beast
Rights to correct a decision lost 366

Section E

Purchase Agreements

Chapter 51 The purchase agreement
Types and variations 373

Chapter 52 An owner's residence in foreclosure
The equity purchase sales scheme 391

Chapter 53 Income property acquisitions
Investigating a property's worth 404

Chapter 54 A formal exchange
Structuring a comprehensible transaction 419

Chapter 55 Real estate purchase options
An irrevocable offer to sell 426

Section F

Vesting and Escrow

Chapter 56 Vesting the ownership
Possession and transfer rights 435

Chapter 57 Preliminary title reports
An offer to issue title insurance 447

Chapter 58 Title insurance
Identifying an actual loss 450

Chapter 59 Going to escrow
The process of closing a purchase agreement 459

Table of Forms

No.	Form Name	Page
102	Seller's Listing Agreement (Exclusive Right to Sell, Exchange or Option)	64
103	Buyer's Listing Agreement (Exclusive Right to Buy, Lease or Option)	113
107	Listing Package Cost Sheet (Due Diligence Checklist)	91
115	Finder's Fee Agreement	133
119	Compensation Disclosure in a Real Estate Transaction (Calif. Bus & PC §10176(g); DRE Reg. 2904)	138
120	Modification of Listing Agreement	86
121	Release and Cancellation of Employment Agreement	77
122	Identification of Prospective Buyers	82
130	Authorization to Inspect and Prepare a Home Inspection Report	184
133	Authorization to Provide Services (General Services)	94
135	Authorization to Provide CID Documents (Calif. CC §1368)	229
150	Purchase Agreement (One-to-Four Residential Units)	375
156	Equity Purchase Agreement	392
159	Purchase Agreement (Income Property other than One-to-Four Residential Units)	407
160	Offer to Grant an Option (and Option Money Receipt)	428
180	Counteroffer	300
181	Cancellation of Agreement	339
181-1	Notice to Perform and Intent to Cancel	330
182	Waiver of Contingency	315
183	Notice of Cancellation	324
184	Rejection of Offer	293
269	Property Inspection (Request for Repairs)	189
300	Financial Disclosure Statement (For Entering into a Seller Carryback Note)	252
304	Condition of Property (Transfer Disclosure Statement - TDS)	165
305	Agency Law Disclosure	45

No.	Form Name	Page
310	Good Faith Estimate of Seller's Net Sales Proceeds	259
311	Good Faith Estimate of Buyer's Acquisition Costs	272
313	Lead-Based Paint Disclosure (On Sale of Real Estate)	222
314	Natural Hazard Disclosure Statement	193
352	Annual Property Operating Data Sheet (APOD)	247
403	Sales Escrow Worksheet (For Use on Seller-Occupied SFR Properties)	462
460	Affidavit of Death of Joint Tenant	443
504	Agent's Income Data Sheet	19
525	Confirmation Memorandum	50

Introduction

Real Estate Practice is part of the **first tuesday** series of California-specific real estate study materials. Each title in the series has a different topic as its primary content. As part of a comprehensive real estate education program, the series includes Principles of Real Estate, Real Estate Finance, Legal Aspects of Real Estate, and Real Estate Property Management.

first tuesday's real estate series uses plain language and eliminates the extensive overlap of identical course material commonly offered by other publishers. Issues arising in more than one factual setting are referenced as necessary, but are dealt with fully in only one **first tuesday** title.

Real Estate Practice is written for real estate licensees, lenders, attorneys, title officers, buyers, and sellers. This course material is designed to be an educational tool to provide an agent with the guidance needed to prepare the forms used to solicit employment, disclose property and transactional facts, and to enter into contracts to buy and sell real estate. The scope of the materials presented extends beyond a minimum acceptable level of knowledge and professional development.

The objective of this material is to fully develop the real estate professional's understanding of the use and preparation of forms typically used in general brokerage services, ranging from employment agreements and purchase contracts to disclosures and worksheets. **Real Estate Practice** also discusses the effect provisions in the forms will have on different parties involved in a transaction, as well as the advice and counsel to be given to a client when reviewing the forms.

Included, with an explanation for their use, are all the forms and notices required when bringing a buyer and seller together as a match in a real estate sales transaction. Forms are treated as itemized check lists of disclosures by an agent and reviewed with buyers and sellers of real estate.

These forms fully reflect relevant codes, regulations, judicial decisions, and practices in effect on the date of this publication. The forms referenced are developed and published by **first tuesday**.

Chapter 1 Brokerage activities: agent of the agent

This chapter introduces the concept of a licensed real estate sales agent being an agent of a licensed real estate broker and classified as either an employee or independent contractor.

For, on behalf of, and in place of

Historically, as brokerage services in the mid-20th century became more prevalent in California and the public demanded greater consistency and competence in the rendering of these services, the state legislature began standardizing and regulating:

- who could become licensees and offer brokerage services;
- the duties and obligations owed by the licensees to members of the public; and
- the procedures for soliciting and rendering services while conducting licensed activities on behalf of clientele.

The resulting legislation and regulations which now control the brokerage services provided on the sale and purchase of real estate are straightforward and uncomplicated. Collectively, the standards set the minimum level of conduct expected of a licensee when dealing with the public, such as **competency and honesty**. The key to implementing these professional standards is the **education and training** of the licensees.

Individuals who wish to become real estate brokers are issued a broker license by the Department of Real Estate (DRE) only after completing extensive, additional real estate related course work and meeting minimum on-the-job experience requirements. On receiving the license, a broker is presumed to be competent in his skill and diligence, with the expectation that he will conduct himself in a manner which rises above the minimum level of duties owed to clientele and other members of the public.

Therefore, the individual or corporation which a buyer or seller, landlord or tenant, or borrower or lender retains to represent them in a real estate transaction may only be a licensed real estate broker.

To retain a broker to act as his real estate agent, the buyer or seller enters into an employment contract with the broker, called a *listing agreement*.

Broker vs. sales agent

Brokers are in a distinctly different category from sales agents. Brokers are authorized to deal with members of the public to offer, contract for and render brokerage services for compensation, called *licensed activities*. Sales agents are not. [Calif. Business and Professions Code §10131]

A real estate salesperson is strictly an agent of his employing broker. An agent cannot contract in his own name or on behalf of anyone other than his employing broker. Thus, an agent cannot be employed by any person who is a member of the public. This is why an agent's license must be handed to his employing broker, who must retain possession of the license until the agent leaves the employ of the broker. [Bus & P C §10160]

Only when acting as a representative of his broker may the sales agent perform brokerage services which only the broker is authorized to contract for and provide to others, called *clients*. [**Grand** v. **Griesinger** (1958) 160 CA2d 397]

Further, a sales agent can only receive compensation for his real estate related activities from his employing broker. An agent cannot receive compensation directly from anyone else, e.g., the seller or buyer, or another licensee. [Bus & P C §10137]

Thus, **brokers** are the *agents* of the members of the public who employ them, while a broker's **sales agents** are the *agents of the agent* who render services for the broker's clients as the broker's representatives. [Calif. Civil Code §2079.13(b)]

As a result, brokers are responsible for all the activities their agents carry out within the *course and scope* of their employment. [**Gipson** v. **Davis Realty Company** (1963) 215 CA2d 190]

Responsibility for continuous supervision

When a broker employs a sales agent to act on behalf of the broker, the broker must exercise reasonable supervision over the activities performed by the agent. The broker who does not actively supervise his agents risks having his broker license suspended or revoked by the DRE. [Bus & P C §10177(h)]

Here, the employing broker's responsibility to the public includes:

- on-the-job training for the agent in the procedures and practice of real estate brokerage; and
- continuous policing by the broker of the agent's compliance with the duties owed to buyers and sellers.

The sales agent's duties owed to the broker's clients and others in a transaction are equivalent to the duties owed them by the employing broker. [CC §2079.13(b)]

The **duties owed** to the various parties in a transaction by a broker, which may be carried out by a sales agent under the employing broker's supervision, oversight and management, include:

- the *utmost care, integrity, honesty and loyalty* in dealings with a **client**; and
- the use of *skill, care, honesty, fair dealing and good faith* in dealings with **all parties** to a transaction in the disclosure of information which adversely affects the value and desirability of the property involved. [CC §2079.16]

The employing broker's management

To insure that his agents are diligently complying with the duties owed to clientele and others, the employing broker must establish office policies, procedures, rules and systems relating to:

- *soliciting* and obtaining buyer and seller listings and *negotiating* real estate transactions of all types;
- the *documentation* arising out of licensed activities which might affect the rights and obligations of any party, such as agreements, disclosures, reports and authorizations prepared or received by the agent;

- the *filing, maintenance and storage* of all documents affecting the rights of the parties;

- the handling and safekeeping of *trust funds* received by the agent for deposit, retention or transmission to others;

- *advertisements*, such as flyers, brochures, press releases, multiple listing service (MLS) postings, etc.;

- compliance by his agents with all federal and state laws relating to *unlawful discrimination*; and

- the receipt of regular *periodic reports* from agents on their performance of activities within the course and scope of their employment. [Department of Real Estate Regulations §2725]

One method for implementing the need for supervision is for a broker employing agents to develop a **business model**. With it, the broker establishes the means and manner by which listings are produced and serviced, and how purchase agreements are negotiated and closed by his agents. The development of a plan of operations logically starts with an analysis of the conduct required of an agent by establishing categories of administrative and licensed activities. [See Figure 1 accompanying this chapter]

Categories of business and **licensed activities** include:

- *administrative rules*, covering a description of the general business operations of the brokerage office, such as office routines, phone management, sign usage, budgetary allocations for agent-support activities (advertising, farming, etc.), agent interviews, goal setting and daily work schedules;

- *procedural rules*, encompassing the means and methods to be used by agents to obtain measurable results (listings, sales, leases, loans, etc.);

- *substantive rules*, focusing on the documentation needed when producing listings, negotiating sales, leases or loans and fulfilling the duties owed by the broker to clientele and others;

- *compliance checks*, consisting of periodic (weekly) and event-driven reports (a listing or sale) to be prepared by the agent, and the review of files and performance schedules by the broker, office manager or assistants, such as listing or transaction coordinators; and

- *supervisory oversight*, an ongoing and continuous process of training agents and managing their activities which fall within the course and scope of their employment.

The rules and procedures established by the broker to comply with his responsibility to manage and oversee the conduct of his agents when they are acting in his place in dealings with clientele and other members of the public must be agreed to in writing with the agents he employs. A written **employment contract** sets forth the duties of the sales agent and the agent's need to comply with an office manual which contains the broker's policies, rules, procedures and other conduct the broker deems necessary to control the fulfillment of his responsibility for supervision.

Also, the written employment agreement must spell out the **compensation** the agent is to receive for representing the broker in soliciting and negotiating listings, purchase agreements, leases and financing. [DRE Regs. §2726]

The (not so) independent contractor

Most sales agents receive compensation from their brokers based on a negotiated percentage of **contingency fees** received by the brokers for completed sales, leases or loans solicited or negotiated by the agents.

Whether state and federal income tax is withheld depends on the type of employment agreement the broker and agent enter into, i.e., an *independent contractor* (IC) or *employee-employer* (EE) agreement.

A sales agent licensed by the DRE and employed by a broker under an independent contractor agreement, who is paid based on the broker's receipt of a contingency fee, will not be treated as an employee for purposes of income tax *withholding* or *contributions*. [Internal Revenue Code §3508]

The chief advantage for a real estate broker who uses an IC agreement is the simplification of the bookkeeping process. An IC agreement avoids **withholding** for income taxes or medicare and social security benefits from the agent's fee, while also avoiding employer contributions.

In turn, the broker files a 1099 report with the Internal Revenue Service (IRS) naming each agent and stating the fee amount each received as an employee of the broker under a contingent-fee, IC agreement.

To further simplify disbursement of the agent's share of the fee due from the broker, some brokers instruct and authorize escrow to disburse to the agent, from fees accruing to the broker on the close of a sales escrow, the amount of the fee due the agent from the broker. However, this system of payment leaves the broker without adequate records for 1099 and workers' compensation reporting.

For sales agents entering into an IC agreement, they report their fees received from their broker as business income (Schedule C). In turn, the agent expenses all his business-related costs of operation incurred while acting within the course and scope of his employment with the broker, no matter the degree of control the broker actually exercises over the agent's activities.

However, even though the agreement is called an "independent contractor" agreement, the agent is still an agent of his employing broker.

When testing the conduct of an agent while engaged in real estate related activities, the IC provision in his broker-agent employment agreement cannot and will not change the agent's classification as an agent of his broker under California real estate law. [Gipson, *supra*]

Thus, brokers who use an IC agreement must not delude themselves to believe that somehow the agent may permissibly act independent of the broker.

Agent imposes liability on broker

Consider a sales agent who is employed by a broker under an IC agreement. The broker gives the agent *total discretion* in his handling of clientele and documentation of listings and sales.

However, the IC agreement includes a provision calling for the agent to deliver to the broker a binder for liability insurance on the agent's car which names the broker as an insured. The IC agreement also requires all documents and funds received on listings and sales to be entered into and taken in the name of the broker, and all advertising and business cards to identify the agent as acting for the broker as an associate licensee.

Figure 1

Forming a business model

Within each category of activity covering the broker's management of his agents' conduct for producing, servicing and negotiating listings and sales, is a list of items to be considered.

Administrative

- E & O insurance
- workers' compensation insurance
- automobile insurance binder
- general comprehensive business insurance
- agent policy manual (on procedural,substantive and compliance activities)
- new agent qualifications and interview procedures
- institutional advertising franchise affiliation
- trade organization membership
- MLS subscriptions
- employment contracts with sales agents
- agent pay, advances, and escrow disbursements
- production goals
- phone/floor-time coverage
- hours/agents' work schedules
- business cards
- storage of documents (3 years)
- office meetings/ attendance
- agent contribution to expenses
- bank trust accounts
- general business bank accounts

Organizational Procedures

- forms to be used
- use of coordinators
- use of office equipment
- use of affiliated services
- use of controlled businesses
- attorney inquiry/ referral to broker
- trust fund handling (deposit and log)
- e-mail content
- public record inspection
- servicing property listings (MLS, signs, ads, property profiles, open houses, correspondence, showings, checklists, rents, etc.)
- servicing buyers (listings, property profiles, broadcasts, wants, showings, qualifying, checklists, etc.)
- client lists and follow up

Substantive Activities

- taking property listings (addenda and disclosure checklists, deposits, property profiles, further approvals, fee setting, seller profiles, etc.)
- preparing offers (documents/disclosures and addenda checklists, duty checklists, advice on use of arbitration, forfeiture, escrow, title, misc. provisions, fee provisions, etc.)
- FSBO submission of offers (fee arrangements, listings, dual agency, etc.)
- preparation of documents, use of attorneys, added provisions

Compliance

- pay contingent on file audit and completeness
- listing logs
- transaction logs
- trust fund logs
- periodic reports
- listing reports
- sales reports
- schedule of report due dates
- other events which trigger notices or reports to management

Supervision

- continuous daily oversight
- constant follow-up on compliance with procedures and substantive activities
- instructions on propriety of acts within the course and scope of employment
- degree of enforcement being tight and disciplined, or lax and allowing great discretion
- use of assistants to provide oversight

One day, while the sales agent is driving his car to list a property, he collides with another vehicle, injuring the driver. The driver makes a demand on the agent's broker to pay for the driver's money losses incurred due to the agent's negligence.

The broker rejects the demand, claiming the agent is an independent contractor, not an agent (much less an employee) of the broker, and thus the broker has no (vicarious) liability for the losses inflicted on the driver by the agent.

The driver claims the broker is liable for his losses since the agent is a representative of the broker, acting within the *course and scope* of his employment when the injuries occurred.

Can the driver injured by the agent's negligence recover his money losses from the agent's broker?

Yes! The sales agent is the *agent of the broker* as a matter of law, without concern for the type of employment agreement they have entered into.

The IC: an agent of the broker

In spite of the IC employment agreement allowing total discretion to the agent in the conduct of his handling of listings and sales, the agent is **subject to supervision** by his broker. Sales agents are agents of the broker, without regard to their employment agreement. When the injury occurred in the prior scenario, the agent was acting within the course and scope of his agency with the broker. Thus, the broker cannot escape liability for his agent's negligence. [Gipson, *supra*]

The broker hiring agents who use their own cars to conduct brokerage activities by going to and from appointments, meetings, and properties must be a named insured on the agent's car insurance policy. The employing broker also needs to maintain general comprehensive business liability insurance and professional liability coverage (errors and omissions insurance). Claims of tortious conduct of all sorts can arise out of listings and sales transactions solicited and negotiated by their agents and coverage is needed to defend or pay these claims.

Thus, supervision is critical to the reduction of the broker's exposure to liability for their sales agents' failure to inspect, disclose, advise and care for clients.

Unemployment insurance benefits

For the purposes of administering real estate law, a sales agent is considered both an *agent and an employee* when acting within the course and scope of employment with a broker. [Grand, *supra*]

However, as with state and federal income tax withholding, an agent is not always treated as an employee.

For example, licensed real estate sales agents, as well as real estate brokers, are excluded employees for purposes of the **California Unemployment Insurance Law**. Even though a sales agent is considered both an agent and an employee under California real estate law, a broker does not have to contribute to the state unemployment insurance fund on behalf of the agent. In turn, the agent cannot collect unemployment benefits from the state when he is terminated from the employ of the broker.

Receipt of compensation by a licensed real estate agent under an employment agreement, paid as a *contingency fee* for closing transactions, is the **only test required** for the broker to avoid paying unemploy-

ment benefits. When the agent is paid a **contingency fee**, not an hourly wage, the agent will be denied unemployment benefits regardless of the level of supervision and control the broker exercises over the agent's real estate related activities. [Calif. Unemployment Insurance Code §650]

Minimum wage exclusion

A sales agent is entitled to payment of minimum hourly wages from a broker if the agent is classified as an *employee* under California labor laws, a technical condition requiring **constant supervision** and total control by the broker over the agent's **means, manner and mode** of engaging in activities requiring a real estate license.

However, as *agents* of their broker, most agents have a high level of discretion and control in the setting of their schedules, especially during the hours spent outside of their broker's office.

Typically, the agents' time in the office spent at the updesk, or on the phones or floor, rarely take up more than one day a week, usually less than 20% of the time spent on real estate related listings and sales. Little additional time is spent in the office at staff meetings. As a result, agents are rarely considered employees, except for the purpose of judging their conduct as a licensee under California real estate law.

As an *outside salesperson* who regularly works more than half of his time away from his place of employment, selling items or obtaining contracts for services, a real estate sales agent is excluded from collecting a **minimum wage** from his broker. [Calif. Labor Code §1171]

Consider an agent who is employed by a broker under an IC agreement. The broker does not have a policy manual, training program or any requirements as to what forms to use and what duties are to be fulfilled by the agent (a dereliction of the broker's duties of supervision). Once a month, the agent reports to the broker by preparing and presenting a transaction log noting the listings and sales activity the agent has been involved in during the month.

After several months of employment and no sales, the broker terminates the agent. During the employment, the broker disbursed funds to the agent as an advance draw against fees yet to be earned by the agent. Any amounts not reimbursed are payable to the broker on termination. Thus, by agreement, the broker calls due the amounts advanced and unpaid, and makes a demand on the agent for payment.

The agent claims he is entitled to an offset since he is an employee of the broker and thus entitled to a minimum wage in amounts which exceed the advances received from the broker. The agent makes a demand on the broker for unpaid wages at the minimum rate per hour worked.

Here, the agent demanding a minimum wage must demonstrate that his actual working relationship with his broker was more than just that of an independent contractor or an agent of his broker, but that of an employee under the labor code.

Accordingly, the agent must demonstrate that the relationship he actually experienced while employed by the broker included total control by the broker over every **means, manner and mode of conduct** used by the agent to carry out licensed activities on behalf of the broker, such that the agent was nearly without discretion to operate on his own.

Here, the broker's supervision and management of the agent by implementing policies and procedures for the negotiation of real estate transactions were nearly nonexistent.

While the sales agent was an agent of the broker, the sales agent was not under the *common law control* of the broker as required to establish the agent as a *servant* hired to perform under continuous direction.

Thus, the sales agent was not an *employee* for the purposes of the labor law, and therefore could not receive a minimum wage. [CC §2079.13(b); Lab C §1171; **Grubb & Ellis Company** v. **Spengler** (1983) 143 CA3d 890]

The issue of being excluded from collecting a minimum wage based on the agent being classified as an *outside salesperson* never arose in the *Grubb and Ellis Company* case.

However, even if the broker had controlled the agent's activities, hours, scheduling and production of listings and sales, the agent still would most likely have been outside the office more than half of the hours spent working for the broker. Thus, the agent most likely would have been classified as an employee under the labor law, but would definitely have been **excluded** from collecting a minimum wage due to his status as an outside salesperson.

Workers' compensation coverage for employees

For purposes of workers' compensation insurance, the relationship between a broker and his agents is that of an employer and his employees. As a consequence, all real estate brokers in California must provide **workers' compensation insurance** coverage for their sales agents. [Lab C §§3200 et seq.]

A broker who is **illegally uninsured** or forces his agents to carry their own workers' compensation insurance may face:

- a *stop order* from the Department of Industrial Relation's Division of Labor Standards Enforcement (DLSE), preventing the broker from conducting business until proof of insurance is offered up;
- *civil penalties* and fines up to $100,000; and
- *reimbursement claims* from current and former agents for premiums they paid. [Department of Real Estate Bulletin, Fall 2004, Page 10]

For a broker who employs one or more agents, he must, by necessity, be covered by workers' compensation insurance, along with business, vehicle and professional liability insurance (errors and omissions coverage). The coverage provides the broker with a financial safety net against agent-imposed liability by shifting the risk of loss to the insurance companies, whether the sales agents are mere agents or also employees.

Thus, the well supervised real estate brokerage business, as owned and managed by a broker who runs a properly conducted operation, provides an enduring professional environment in which their sales agents should flourish.

Chapter 2 An agent's perception of riches

This chapter examines a worksheet for use by sales agents to analyze the income and expenses they will share or incur during their employment.

The broker avoids deception

An individual receives an original salesperson license from the Department of Real Estate (DRE). The newly licensed agent contacts a real estate broker in response to an advertisement soliciting agents to join his office. The agent will interview this broker, and others, in an effort to find a suitable office in which to work.

Eventually, the agent will select the office he feels is most able to provide the training and guidance he will need to earn a living in real estate sales.

During an *agent interview*, the question of earnings is addressed. The agent is told his employment relationship with the broker will be under an independent contractor (IC) agreement with workers' compensation coverage provided by the broker. No income tax withholding or employer contributions for social security, Medicare or unemployment insurance will exist.

Further, the broker explains the agent will need cash reserves or income from other sources to meet his living and business expenses for six to nine months. Several months will pass before income will be forthcoming from closings in which the agent will have participated. The brokerage office does not make monthly advances against future fees.

To assist the agent in an analysis of his potential earnings, an income and expense data worksheet is prepared by the agent. The agent enters the approximations made by the broker for the various expenses a typical agent should experience during his first year with the brokerage office. [See Form 504 accompanying this chapter]

The agent uses the worksheet to further analyze income, expenses, cash reserves and the sales goal he believes must be met in order to provide an acceptable after-tax income to cover his personal living expenses.

Data underlying an income analysis

As a prerequisite to an agent's use of an income and expense data worksheet, the agent must collect **income data** during his interview with a prospective broker, including:

- the **price range** of property the agent is most likely to list and sell;
- the **number of sales** the agent will likely close in that price range during his first year;
- the **gross brokerage fees** generated by the number of sales during the first year; and
- the **share of the gross brokerage fees** the agent will receive under the fee-sharing schedule proffered by the broker.

AGENT'S INCOME DATA SHEET

NOTE: This income and expense worksheet is used to assist an agent or associated broker in an analysis of the income and expenses now experienced or likely to be experienced while employed by a brokerage office for the coming one-year period and to estimate the entry or change-of-office costs.

DATE: _____, 20_____

Brokerage office: _____

ANNUAL INCOME AND EXPENSES:

1. Gross Brokerage Fees [See instructions at line 11.4] . . . . . $_____		100 %
1.1 Franchise fee disbursement (_____% of § 1.) (–) $_____		
a. Subtotal . . . . . $_____		
1.2 Broker retains _____% of ☐ §1., or ☐ §1.1a. . (–) $_____		
2. Gross Fees due Agent . . . . . $_____		_____%
3. Transaction Deductions by Broker:		
3.1 Less:		
a. E & O premium ($_____ per closing) $_____		
b. Prior client promotion (_____% of fee) . . . . . $_____		
c. Listing/Transaction coordinator . . . . . $_____		
d. Other _____ . . . $_____		
3.2 Total charges withheld . . . . . (–) $_____		_____%
4. Office Expenses:		
4.1 Equipment rent . . . . . $_____		
4.2 Forms & manuals. . . . . $_____		
4.3 Desk space and parking charges . . . . . $_____		
4.4 Membership:		
a. Trade association. . . . . $_____		
b. MLS fees. . . . . $_____		
c. Affiliations . . . . . $_____		
4.5 Supplies/software updates . . . . . $_____		
4.6 Postage/delivering services . . . . . $_____		
4.7 Library/subscriptions. . . . . $_____		
4.8 Photocopies. . . . . $_____		
4.9 Equipment use charge . . . . . $_____		
4.10 Total office expenses: . . . . . (–) $_____		_____%
5. Agent's Business Expenses:		
5.1 Telephone:		
a. Phone/fax . . . . . $_____		
b. Cell phone. . . . . $_____		
5.2 Auto:		
a. Gas/oil. . . . . $_____		
b. Repairs and maintenance/carwash . . . . . $_____		
c. Insurance . . . . . $_____		
d. Loan/lease payment. . . . . $_____		
e. Registration . . . . . $_____		
5.3 Printing:		
a. Farm letters . . . . . $_____		
b. Postage. . . . . $_____		
5.4 Licensing fees and education . . . . . $_____		
5.5 Internet service . . . . . $_____		
5.6 Legal and accounting. . . . . $_____		⇩

5.7 Marketing sessions . . . . . $_____

5.8 Travel/hotel . . . . . $_____

5.9 Entertainment . . . . . $_____

5.10 Insurance (business and health) . . . . . $_____

5.11 Total Business Expenses . . . . . (–) $_____ _____%

6. Marketing and Sales Expenses:

6.1 Printing flyers/mailer for listings. . . . . $_____

6.2 Property ads:

a. Newspaper/magazine . . . . . $_____

b. TV/radio/web . . . . . $_____

6.3 Postage (marketing) . . . . . $_____

6.4 Property preparation. . . . . $_____

6.5 Open house (food/drinks). . . . . $_____

6.6 Gifts on closing . . . . . $_____

6.7 Transactional expenses . . . . . $_____

6.8 Total marketing and sales expenses . . . . . (–) $_____ _____%

7. Agent's Net Income: . . . . . $_____ _____%

7.1 Income, SS & medicare taxes . . . . . (–) $_____ _____%

8. Agent's After-Tax Income . . . . . $_____ _____%

9. Other Income Sources:

9.1 Draw/Advance . . . . . $_____

9.2 Other _____ . . . . . $_____

9.3 Other _____ . . . . . $_____

10. Cost-of-Entry/Change-of-Office Analysis:

10.1 Marketing course . . . . . $_____

10.2 Lock boxes . . . . . $_____

10.3 Open house signs . . . . . $_____

10.4 Stationary/cards . . . . . $_____

10.5 Computer/programs/printer . . . . . $_____

10.6 Office furniture . . . . . $_____

10.7 Photocopier . . . . . $_____

10.8 Phone/fax equipment . . . . . $_____

10.9 Phone installation . . . . . $_____

10.10 Camera/printer . . . . . $_____

10.11 Vehicle . . . . . $_____

10.12 Other _____. . . . $_____

10.13 Other _____. . . . $_____

10.14 **Total Entry/Relocation Costs:** . . . . . $_____

11. Gross Brokerage Fee Projection/Forecast:

11.1 Annual after-tax income desired by agent. . . . . $_____

11.2 Divide by percentage of after-tax income at §8. . . . . (÷)_____%

11.3 Annual Gross Brokerage Fee needed at §1.
to earn the desired after-tax income at §11.1: . . . . . (=)_____

11.4 Analyze the source of Gross Brokerage Fees at §1 by setting the price of the typical transaction Agent will close, the dollar amount Broker will receive as the Gross Brokerage Fee on the typical transaction, and the number of typical transactions Agent must close within one year to attain the Gross Brokerage Fees set as the goal at §11.3.

_____

_____

_____

_____.

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The likely **gross fees** the broker will receive and the agent's share of those fees are entered on the worksheet as a result of the interview. [See Form 504 §§1 and 2]

Ultimately, the **sales goal** set by the agent reflects the amount of after-tax income the agent seeks for himself. [See Form 504 §11]

Until the worksheet is filled out accurately, projecting fees to be received by the agent, estimating expenses to be incurred and attempting to set sales volume goals or probable after-tax earnings is an uneducated guess.

The agent's personal role

The volume of real estate sales closed by new agents during their first year in the business is a "numbers game." Only a percentage of all sales efforts comes to fruition in the form of fees received from closings. Thus, the type of person attracted to real estate sales must have an innate curiosity and enthusiasm for estimating and forecasting income and expenses if he is to succeed.

A prospective agent who is discouraged or daunted by the exercise of completing a worksheet is unlikely to be a prime candidate for employment in the real estate brokerage business.

The broker steps forward

Brokers, by experience, tend to be more organized than agents. Also, brokers who employ agents tend to be better able to anticipate the income and expenses an agent will incur than recently licensed agents. It is the broker who can best draw a conclusion about an agent's future with the broker's office, not the agent who is new to the world of real estate sales or who is now languishing in another office due to inadequate or nonexistent planning.

A broker's primary objective when hiring agents is to increase the gross brokerage fees received by his office without a disproportionate increase in his operating expenses. For the broker to make hiring a productive endeavor, the broker must strive to avoid the constant **turnover of agents** who remain with the office for only a short period of time.

Long-term employment of agents not only contributes to a favorable industry-wide reputation about the broker, but also provides a return to the broker for his time and energy invested with each agent during the employment process and the agent's start-up period. Energy, money, time and enthusiasm all wane fast when the turnover of agents in an office is due to the failure of unrealistic expectations held by the agents.

A broker's full disclosure, upfront and prior to employment, covering the agent's likely income and expenses, and why the sharing and allocations are reasonable, will lead to a realistic expectation of income by the agent. Monthly and quarterly sales goals can then be set at levels designed to meet projected earnings should the agent be employed by the broker.

To control the agent's interview and get long-term results, the broker should initiate the income and expense discussion himself, not wait until the prospective agent takes charge by raising the question of earnings.

To be ready for an interview with a prospective agent, the broker should himself prepare a worksheet by estimating the expenses the agent is most likely to incur. Also, the broker needs to estimate the initial **cash investment** the prospective agent will be required to make to cover one-time, nonrecurring expenditures and carrying costs necessary to get a proper start in real estate sales. [See Form 504 §10]

Once the operating expenses, nonrecurring costs and carrying costs incurred by the typical agent have been established — based on the broker's history with his present agents — what remains is the difficult task of anticipating an agent's gross fees from sales which will close during the first year of employment.

Forecasting gross fees

A couple of approaches for estimating future fees are apparent. For one, the broker can project a range of gross brokerage fee amounts, varying from the earnings generated by a high producer to those of a low producer during their first year with the office. The various gross brokerage fee projections, ranging from low, medium to high, could be entered on separate but duplicate copies of the income and expense worksheet. The agent's expenses estimated for the first year would also be included in the worksheets.

Thus, the prospective agent's after-tax income can be calculated based on various levels of sales.

Another approach for the interview is to discuss the range of gross brokerage fees an agent can generate, without the broker first entering any fees on the income and expense worksheet he hands to the agent. Thus, the agent is left to enter and calculate the income he either believes he can produce or wants to produce to attain the after-tax income he seeks.

Reviewed by the broker and the prospective agent under either approach, or a combination of approaches, the worksheet becomes both a **budget and a sales goal** for the agent. With an open-minded review of the pros and cons of income sharing and expense allocation, the broker encourages the agent to set attainable production goals.

At the same time, the broker confirms whether the prospective agent has the financial capacity to carry his personal and business expenses during the start-up period with the office before the fees from closings come rolling in.

A failure to inform

An employing broker must inform a prospective agent about the operating expenses the agent will most likely incur while employed by the broker. Also, the agent will need to have a vehicle, computer, and instruments and materials required of real estate sales, as well as pay multiple listing service (MLS) fees. An explanation of the net operating income (NOI) from sales the agent can expect to receive cannot be overlooked by the broker. Without these disclosures, an analysis of the agent's long-term potential with the office has not taken place.

At worst, the failure to advise a prospective agent is an omission of facts known to the broker, which, when discovered by the sales agent, will lead to either a termination of employment or dissatisfaction over lost expectations.

Thus, a realistic and relatively accurate disclosure of income, expenses and the initial investment an agent will incur in the employ of the broker will:

- reduce the office turnover of agents;
- reduce the broker's investment of time and energy hiring and training agents; and
- produce a sales staff whose income expectations will be met due to their ability to most likely attain the sales goals each have set for themselves.

Selecting a broker by comparison

After a few years of employment in the business of real estate sales, efficient agents generally want to earn more for the time they spend listing properties, locating buyers and engaging in all the activities surrounding the sale of a parcel of real estate.

Before walking into the broker's or manager's office with a demand for the office to cover more expenses and give the agent a larger share of the brokerage fees, the agent should first do a little **comparative shopping** to determine how other brokers share expenses and fees with their agents.

The first step for the agent interested in renegotiating his current employment arrangement with his broker or moving to another broker's office, is to prepare a worksheet on his current operating conditions. Just what fees the agent has generated, the share of the fees the agent received, the operating expenses paid by the agent and the net income, as well as the after-tax income experienced during the past 12-month period, is a requisite for any comparison.

If the exercise goes no further, the worksheet can act as a **budget** or a basis for forecasting the next 12 months. Further, the variables controlling the amount of income and expenses can be analyzed, adjusted and projected to set sales goals the agent would like to attain during the next 12 months.

The second step is to distinguish the agent's current arrangement with his broker from the earning opportunities available to him with other acceptable brokerage offices. The comparative analysis is accomplished by preparing a worksheet for each prospective office. Information for the worksheet may be gathered from interviews with those brokers or their managers, or agents in those offices who have a handle on their income and expense arrangements with their broker.

On completion of the worksheet for each office, a comparison shows up the distinctions and parallels between the different offices.

Armed with comparisons reflected by the data developed on the worksheets, the agent seeking to renegotiate fee splits and the allocation of expenses with his current broker can structure his request for specific changes based on the market place.

Alternatively, the agent seeking to change offices uses the worksheet to make the same comparisons and size up prospective brokerage offices. Ultimately, the agent hopes to negotiate an income and expense sharing arrangement which satisfies the agent and provides a better opportunity for greater earnings — expectations realized based on comparison shopping and the agent's past sales history.

However, timing is important. The period during which the agent begins negotiations with his current broker or schedules interviews with other brokers can effect his results.

For instance, at the height of a booming market, a broker will be more willing to increase a productive agent's share of the fees since the broker's current overhead is already covered without the fees from additional sales. The agent's advantage of a better fee split and cost allocation would carry over into the inevitable slowdown in sales which follows every boom.

Conversely, a new agent entering an office during a recessionary period just prior to an upswing in sales will benefit from the broker's attention to the care and training of new agents. Also important is the invaluable assistance of experienced agents in the office who will have a little extra time on their hands. All have time in a slower market to assist others, a bonding process important for a successful future in real estate sales in the coming years.

Chapter 3 Human resources: low-level management by brokers

This chapter comments on the rapid and wasteful turnover of entrants into the real estate profession.

The entry and exit of agents

In 2004, 53,530 original real estate salesperson licenses were issued to individuals by the Department of Real Estate (DRE). Four years later, on expiration of all these licenses at the end of 2008, 62% (33,283) of the **agents** originally licensed in 2004 **no longer participated** as licensees rendering services in real estate transactions because they either failed to renew (23,159 or 43%) or renewed as inactive, unemployed licensees (10,124 or 19%).

Thus, of all the agents originally licensed in 2004, only 38% (20,247) **remained active** in the practice of real estate brokerage by 2009, four years on.

The monthly influx of new agents has remained nearly constant since October 2007, between 1,000 and 1,300 monthly.

Agent population movement

Roughly 50% of the individuals coming into real estate as new sales agents will leave the real estate profession by letting their licenses expire at the end of their first four-year license period. Roughly one third of those who renew their sales agent license will not be employed by a broker; they will not be involved in real estate transactions as agents.

Thus, around one third of the 60,000 individuals who received their licenses in 2005 will be actively participating as agents in real estate transactions in 2010. Of the 23,000 licensees remaining after entering in 2005, around 5,000 will have become brokers.

The number of new sales agents entering the real estate profession has stabilized at around 14,000 per year. This trend will likely continue through 2014 until Generation Y finally starts entering the real estate market as first-time homebuyers at ages 30 to 35. Home sales will again rise and peak as Generation Y household formations peak around 2016, 30 years after their parents created the real estate boom of the mid-to late-1980s. This activity will bring an increase in new agents sensing easy money with increasing sales volume and rising prices.

However, the new sales agents entering after 2008 will be of a different mindset and talent than the mostly "hit-and-run" types who entered between 2003 and 2007. This incoming batch will be more dedicated and more likely to possess long-term expectations. Their plans and goals will cause fewer of these future entrants to drop out by the end of their first four years. Many will be from families owning investment property or with brokerage backgrounds, and will enter for far better reasons than to get rich quick.

Sales agents who have upgraded to broker status have already found their sea legs in the real estate industry. Thus, most of them will remain active throughout the remainder of the current California real estate recession.

The emerging consequences

The precipitous decline in the number of real estate agents entering the profession coincides with the decline in sales of real estate. In early 2008, seven percent (1 in 14) of all single family residences (SFRs) in California stood vacant. They were owned by speculators, as second homes (which were also acquired in the height of speculative fervor) or as real estate owned (REO) foreclosure properties.

Many of the **speculators** were first-time agents who were only suited to function in a real estate market during a boom phase. While the current batch of entrants are embracing more sustainable, long-term real estate strategies, the quick-buck type of real estate agent is swiftly exiting the stage and taking with them the artificial support they and other flippers gave and will continue to intermittently give to sales numbers.

The fever to speculate, while never entirely gone, will not likely rise again until around 2015, unless the flood of foreclosed REO properties hitting the market in 2009 and 2010 continues to drive prices down. In the interim, builders and existing homesellers will have to get rational about pricing and listing periods due to the lack of intensive competition between agents which helped push prices up in 2003 through 2005.

Also, the return to the slower-paced fundamental of lending will likely push prices down during 2009 and 2010, particularly in high-end properties. Further, agents intent on flipping are no longer around to load their friends, relatives, and social, civic, or religious contacts with properties. All of these agent interactions contributed to the price "bubble".

Large brokerage office production

In the past, large SFR brokerage operations with branch offices depended largely on the flood of newly-licensed agents to fill their offices by occupying space, called *cubbies*. While the turnover was high due to agents burning through contacts without developing a viable client base, the broker and office managers were able to mitigate the turnover by aggressively soliciting new licensees and quickly bringing in fresh replacements. The source of these list-and-run agents has dropped dramatically from 5,000 new entrants monthly during the peak years of 2004-2006 to 1,300 monthly since October 2007.

When viewed in this context, and not the context of vanished buyers, *economic reality* is forcing brokers operating branch offices to shutter the least productive branches, release the weakest office managers and under-performing agents, and attempt to relocate agents who generate business to other branches.

Even more troubling for large brokerage operations is the bickering arising over their fee-splitting arrangements with their agents who are making fewer sales and at lower prices/fees. Meanwhile, the broker is taking in fewer dollars and shouldering the costs of overhead, promotion, and servicing excessive listings.

Gradually, agents employed by large brokerages consider becoming brokers or teaming up with other agents and a broker in smaller operations in an effort to reduce the fee percentage due the broker. These agents too often do not have the business acumen to set up and operate a brokerage office, even if it is their own one-man operation. They do it believing, rightly or wrongly, that their current broker is getting too large a share of the fees.

Preparing for the next cyclical phase

Large brokerage offices will also need to retrench and develop more efficient operating methods if they are to remain competitive and attract clientele. During boom times, large offices had the luxury of keeping low-producing agents on staff since the broker was earning enough to gamble on the off-chance a low-producing, marginal agent would actually close a sale. With a dearth of newly arriving agents to fill desk space, the nonproductive (and even the under-productive) agents may have to be released.

Brokers who learn to cut overhead and eliminate operating inefficiencies during and following the recessionary years will be in the best position to profit from the up-tick in sales volume which will likely begin in 2012. Planning ahead will be a defining characteristic of brokers who will still be operating in 2011, ready to get in on the action the next time the federal reserve and Wall Street turn money loose on the public, as they will.

Age demographics will supply large numbers of homebuyers between 2012 and 2017, and a hoard of speculators will be right behind them, competing with them to buy properties. All this will push the housing market into another boom, and the prices up, just as if there had never been a bust in 2009.

Solving the dropout problem

The rate of attrition for agents entering the real estate profession suggests that fully one third of the new licensees are not qualified by education, temperament or experience. They should not have been licensed or hired in the first place.

Possibly, the attrition is due to the brokerage community's inability or unwillingness to give new licensees the administrative oversight, technical training, structured routine and organizational support necessary to attract and retain individuals seeking to enter the business of real estate services as a life-long profession.

Also, the disruptive cyclical nature of boom and bust within the real estate industry, reflected in the number of entrants from year to year, is a factor which only aggravates the turnover rate.

Alternatively for those who became licensed in 2004, the DRE guidelines for licensing were too permissive, i.e., the threshold to obtain a license was low.

Becoming licensed as a real estate agent until October 2007 bordered on being a "no-brainer," especially for individuals with a little tenacity. All that was needed to qualify to take the state exam and become licensed was the completion of one course – principles.

However, passing the state licensing exam requires more instruction than just a principles course. Thus, a "boot-camp" style, weekend cram course (or some other equally intense program) designed solely to pass the state exam was needed to supplement the principles course in order for most individuals to pass the state exam.

This preparatory course for the state exam is not education since it does not contribute to the competence of the individual for purposes of acting as a real estate agent on behalf of a broker. The DRE has been criticized by other state agencies for this failure and may change their testing procedure to reflect actual conditions experienced in practice.

Even with the requirements today of three college level courses to become licensed, new real estate agents come to the real estate brokerage world without any practical experience and insufficient effective education to assist, much less advise, the clients who retain the services of their broker.

A step in the right direction would be two years of on-the-job training for a new agent as an assistant, sometimes called a *runner*, to his broker or an experienced agent in the office. The agent then learns the ropes under a high-volume agent in the office, or with the office's transaction coordinator. At some point, the agent's level of competence is sufficient to satisfy the broker to allow them to operate on their own and report directly to the broker or office manager rather than a team leader. Industrial and commercial brokers tend to follow this course of action.

The broker takes charge

To operate a successful brokerage office, the broker must employ viable agents.

It is the quantity and quality of agents that produce the end result sought by brokers to be successful, i.e., brokerage fees.

As in all service businesses, the lynchpin for achieving success is the ability of management to orchestrate the efforts of qualified agents.

However, most brokers employing agents tend not to dedicate sufficient energy to the supervision of their agents. A level of seemingly deliberate neglect prevails in most single family residential brokerage offices. Thus, agents are left to learn the trade by observation or some third-party training, and to hone their skills by trial and error. This is an empirical result based more on the agents' good instincts than on training, procedural policy and constant supervision by the broker.

Brokers need to be more than distant observers limited to providing remote oversight for the agents. They or their administrative assistants and managers must learn to supervise and police the business-related conduct of their agents.

Supervisory conduct includes:

- setting the *production goals* to be attained (listings and sales);
- an analysis of the *agent's income* and expenses [See Form 504 accompanying Chapter 2];
- the setting of fees needed for the agent to become *financially viable* as a real estate agent;
- establishing the personal routines and activities which will likely make the agent productive, i.e., overseeing the agent's *management of time* spent working for the broker; and
- the insistence that *compliance reports* be prepared and delivered periodically to management. [See **first tuesday** Forms 520 through 523-1]

Further, the broker must be actively involved in the agent's fulfillment of the duties the broker owes to clients with whom the agent has contact.

Thus, the agent knows from the beginning just what level of production is expected of him by the broker as a requirement for remaining with the office. Also, the broker will be demonstrating his expectation that the sales agent is to maintain a competitive attitude about producing listings and buyers. Further, an environment will have been created with a greater probability of producing purchase agreements and closings, which spells success for all involved.

The myth of "too much control"

A dilatory broker employing sales agents in his residential brokerage business frequently uses as a customary excuse for his lack of supervision the age-old, pre-1979 myth that a broker cannot tell an agent what to do, where to do it, or the amount of time the agent will spend doing it. As the myth goes, the agents are not employees; they are independent contractors who must operate free from the broker's direction. If not, some unknown but adverse financial, legal or tax result will be visited upon the broker.

Agents are employees as a matter of California real estate law. They and their brokers are excluded as exceptions from benefits and contributions for unemployment insurance and income tax withholding on the **employment** of real estate agents.

Minimum wages for independent contractor agents are only an issue if the agents are desk-bound in the office more than half the time spent working for the broker. The only other employer/employee concern is workers' compensation insurance which every broker employing a sales agent, as an independent contractor or otherwise, must carry. [See Chapter 1]

A broker's efforts during an agent's apprenticeship and start-up period often fail to develop agents who remain in the business. On an agent's failure to remain with the office, the broker should conduct an internal review to determine:

- why the agent should not have been hired; and
- if they should have been hired, what would have made them successful real estate agents.

With adjustments by employing brokers in hiring, training and managing their agents, the broker's human resources will become long-term assets — the arms and legs of his business — not just bodies occupying cubicles and floor space in the office.

Chapter 4 The MLS environment

This chapter discusses the role multiple listing services (MLSs) have had, and continue to have, on the residential brokerage community.

An industry-wide misconception

In everyday practice, sales agents who work with buyers on behalf of their brokers are commonly referred to as "buyer's agents" or "selling agents." However, in legal terms, it is the brokers employed by the buyers who are the **buyer's agents**. [Calif. Civil Code §2079.13(n); see Form 305 §3 accompanying Chapter 7]

Historically, and incorrectly, the broker and his agent who represented a buyer in a sales transaction have been referred to as *subagents* within the residential multiple listing service (MLS) brokerage community. The misnomer was a product of the pre-1980s MLS environment, which held that all brokers (and their agents) who were members of a trade union's MLS were automatically "seller's agents."

The basis for the rationale rested on the premise that the sole purpose of the MLS was to **locate a buyer** for those sellers whose properties were posted in the MLS. Thus, all MLS members were said to be working either as the listing agent or a *subagent* of the seller, **employed to sell** the property listed in the MLS.

Accordingly, the MLS member who produced the buyer was improperly viewed as **appointed** by the listing agent to act on behalf of the seller by virtue of:

- the MLS membership; and
- the authority granted by a **subagency provision** in the listing agreement of the day.

Thus, the buyer of a property published in the MLS was without representation since no member of a trade union MLS could theoretically represent a buyer.

The MLS subagency concept was perpetuated by peer pressure amongst MLS residential brokers to conform to "industry trade standards." Thus, buyers were unable to employ brokers who were MLS members, a situation which often led to an undisclosed dual agency by their agent.

However, the MLS subagency approach to marketing real estate had begun to wane by the early 1980s. By then, brokers who sought to openly represent the best interests of buyers began to classify themselves as *single-agency* brokers. In fact, this single-agency activity was the predecessor of today's openly acknowledged buyer's agent.

The cooperating broker's subagency dilemma

Today, nearly three decades later, the buyer's broker and the broker's agents still sometimes improperly refer to themselves as the *cooperating office* or cooperating agents in a sales transaction.

The term **cooperating** arose out of the old MLS subagency concept whereby the listing broker shared the fee paid by the seller with the buyer's broker. **Fee sharing** is currently authorized by the broker cooperation clause in listing agreements. [See Form 102 §4.2 accompanying Chapter 9]

Originally, under the old MLS application of subagency, the existence of the cooperation clause was **essential to the receipt of fees** by those brokers and sales agents who "produced" a buyer since the agent was without a retainer agreement with the buyer and had to get "cooperation" under a fee-sharing arrangement with the seller's broker in order to get paid.

MLS brokers under the MLS subagency theory were not employed to act as an agent for a buyer. The purchase agreement forms used were devoid of fee arrangement provisions in the buyer's offer. Yet, a fee provision in the offer is needed to provide the buyer's broker with the ability to independently set his fee and, if accepted or some other arrangement is concluded, enforce collection of the fee.

All MLS subagency arrangements came to a stop by the mid-1980s when the real estate agency law was enacted and buyer's listings began to be generally used.

Under a buyer's listing, MLS brokers and their agents could now effectively act on behalf of buyers without negotiating a fee-sharing arrangement with the seller's broker, who is the **adversary** of the buyer and the buyer's broker. As a result, buyer's agents began to set the amount of the fee they were to receive (paid by sellers) without the listing agents dictating, managing or controlling negotiations over the amount of the fee buyers were willing to allow their agents to receive.

Selling agent or buying agent

The term "selling agent" also has its roots in the old subagent/cooperating agent MLS environment. At the time, listings published in MLS books were reviewed by members with the intent of "helping to sell" the properties to buyers.

Thus, the nonlisting broker/agent, under prior MLS logic, was the one "selling the property" to a prospective buyer "produced" by the selling agent. However, the buyer's agent was, and still is, **selling nothing at all**. A selling agent acting on behalf of a buyer is locating property and representing his buyer in the purchase of real estate as a "buying agent."

Today, the term "selling agent" has been codified in real estate agency law, as has the term "buyer's agent."

However, use of the term "selling agent" does not always mean the selling agent is the buyer's broker.

For instance, the buyer's agent is **always defined** as a selling agent. However, the selling agent is **not always the equivalent** of the buyer's agent. The term selling agent is also legally defined to include a listing broker or his agent who is in direct contact with a buyer, whether or not the listing agent has obligated himself as a dual agent to act as the representative of the buyer.

Representing the buyer requires the agent to locate suitable property and to carefully and diligently advise the buyer on the nature of the property. Also, if an agent represents a buyer, he must seek the most advantageous price and terms available to the buyer when negotiating the acquisition of property.

Thus, when no other broker is involved in a sales transaction, the **listing broker** is also legally referred to as the *selling agent*, a situation referred to in practice as "double ending" the sale.

The listing broker who **double ends** a transaction is not the buyer's agent at all. However, the listing agent may undertake the representation of the buyer to locate and advise on the acquisition of suitable property, in which case the broker is also a dual agent. A buyer's agent absolutely represents the best interests of a buyer. This is not always so when classified as a selling agent.

In a real estate sales transaction, the agent identified and referred to as the **buyer's broker** or buyer's agent is known to all persons, be they judges, legislators, sellers, buyers, lenders, escrow officers or even fellow licensees, as the agent exclusively representing the buyer.

The title "buyer's agent" is now, but has not always been, conceded by the real estate profession to be an appropriate reference to the buyer's representative. However, the clarity and ease of its use is both undeniably generic and persuasive, and indicates the *special agency duties* owed by a buyer's agent to the buyer in a sales transaction. This attitude is lost by use of the nebulous and multifaceted term, selling agent.

Competition vs. price fixing

In 1955, a group of California residential MLS brokers agreed the fee to be charged a seller on all home sales was to be 6% of the price paid by a buyer. This 6% rate of compensation met little resistance from anyone for the next 20 years, even though the price fixing scheme of "same-percentage, same-split" arrangements had already been ruled a violation of federal antitrust laws.

However, the unionized residential MLS brokers did not comply with court orders. To enforce the price fixing 6%/50:50 fee split, the residential brokers used the MLS they controlled to require brokers to publish listing information on the MLS. Included was the total fee agreed to by the seller (and it was to be 6%), with a share (3%) to be retained by the listing broker and a share (3%) to be paid to the buyer's broker.

In this fashion, the seller's broker submitting a listing to the MLS was policed by all other brokers and agents for conformance to the 6%/50:50 policy of fixed fees and sharing. If a seller's agent did not comply, all the other (fee-fixing) MLS brokers and their agents were instructed by the trade union to either refuse to deal with the nonconforming office or to unilaterally refuse to share fees (50:50) on the sale of their listings with the offending, nonconforming listing broker.

More financially persuasive, the residential broker's trade union arbitration board would (and did) enforce the 6%/50:50 rule. Thus, after a short period of fellow-broker inflicted financial injury, the fee-cutting (and successfully competitive) listing office, derogatorily called a *discounter*, would eventually capitulate to the 6%/50:50 routine or go out of business. [**People** v. **National Association of Realtors** (1981) 120 CA3d 459]

Enforcement by residential brokers of the 6%/50:50 rule was made possible through *binding arbitration*. The local trade union owned or controlled the MLS. More insidious, compulsory membership in one (the trade association with its binding arbitration agreement) was then a requisite to admission to the MLS.

Thus, when a broker using the MLS violated its price-fixing policies regarding fees, the trade association became the instrumentality used by conforming brokers to enforce the patently illegal **price fixing activity** by a money award in arbitration. The award was followed by an automatic court-ordered money judgment for enforcement against the competitive fee-cutting, discount broker.

In California, MLS subscribers no longer need to become members of a trade association in order to post listings and access the MLS database, even if the MLS is owned by the association. Thus, the MLS subscriber avoids the suppressive instrumentality of trade association membership. [**Marin County Board of Realtors, Inc.** v. **Palsson** (1976) 16 C3d 920]

MLS fees fixed and competition banned

Consider a group of local real estate trade associations who each operate their own multiple listing service (MLS). Each association provides their own MLS support services to their subscribers. They also set the price for these support services independently, based on cost. Some are efficient and very successful at providing these services, incurring less than $10 in total costs per subscriber monthly. Others are inefficient and incur costs of $50 per subscriber monthly to provide their MLS support services.

The associations then form a separate corporation in which they are shareholders in order to create and operate a county-wide MLS. Each association is independently contracted by the corporation to provide MLS support services for the subscribers to the new regional MLS.

To assure the continued financial viability of those associations with disproportionately higher operating costs for their inefficient servicing of their MLS subscribers, the associations collaborate to set the minimum fee all associations will charge at $25 per subscriber monthly. The less efficient associations are paid a fixed monthly **cash subsidy** on top of the support services fee without which they would be providing these services at a loss. With the **fee fixed** for services, the efficient associations agree not to charge less and compete to deprive the less efficient associations of subscribers.

Competitive organizations may **join together** to eliminate their separate MLS database operations in favor of a single county-wide MLS. The resulting MLS is more **effective** — greater regional coverage and more **efficient** — reducing the need of brokers to subscribe to two or more MLS database services.

However, the question then arises as to whether they can *collude:*

- to set the fee charged for the MLS services each MLS will provide; and
- to ban any discounting or rebates by the efficient and more competitively operated associations.

The simple answer is no. Price fixing is illegal!

The fee which reimburses the associations for the cost of their MLS support services cannot be legally set by agreement between the competing associations. This is especially true when the larger, more efficient associations then received millions of dollars from their members in increased MLS support services fees for exceeding the actual cost they incurred to provide those services.

This arrangement provided the large associations with huge financial rewards at the improper expense of their member subscribers. [**Freeman** v. **San Diego Association of Realtors** (9th Cir. 2003) 322 F3d 1133]

It was the likelihood that some of the associations would go out of business under an efficient county-wide MLS which led to the price being fixed at a *supra-competitive* and illegal level in the first place. This led to the banning of competitive pricing for MLS services provided to subscribing brokers by the MLSs agreeing to no discounts or rebates for their broker-subscribers (which would have reflected the actual costs of an association).

However, competition or *economic darwinism* must be allowed to occur by the process of *creative destruction*. Under open market conditions, the more efficient associations would have brought about the demise of the less productive associations to the financial benefit of all the MLS users within the enlarged servicing area.

Chapter 5 Subagency and dual agency

This chapter analyzes the conduct of a subagent in contrast to the conduct of a dual agent, and distinguishes fee-sharing/broker-cooperation arrangements from both.

Agency and fee sharing misconceptions

Payment by a seller or listing broker of the brokerage fee earned by a buyer's broker in a real estate transaction in no way determines the **agency relationship** of the buyer's broker and his agents to either the buyer or the seller.

Thus, neither a *subagency* nor a *dual agency* relationship is created between the seller and the buyer's broker simply because the seller pays the buyer's broker a fee. This fee-agency rule applies whether the seller pays the fee directly to the buyer's broker, or it is paid to him indirectly from the fee received by the seller's/listing broker. [Calif. Civil Code §2079.19]

Conversely, the buyer's broker does become a dual agent should the wording of the seller's acceptance provision in a purchase agreement state the seller **employs** the buyer's broker as part of the seller's provisions for payment of fees.

However, in practice, brokers and agents working for buyers to locate suitable property rarely consider themselves agents of the seller when they show their buyers properties listed with other brokers. They also do not normally conduct themselves as *subagents* of the seller or as *dual agents* representing both seller and buyer.

Subagency: MLS membership myth

The mere membership of a buyer's broker in a multiple listing service (MLS) never creates a dual agency or subagency relationship with any of the sellers represented by other broker-members who publish listings of property for sale in the MLS. Agency, whatever the type, is created either by contract or by the **conduct of each broker** (and his agents) when interacting with a buyer or seller in a transaction, not by trade memberships or the seller's payment of the fee. [CC §2307]

Subagency duties differ greatly from misleading MLS subagency concepts. "MLS subagency" arose out of notions held about the nature of *cooperation* between brokers in fee-sharing arrangements. The focus within the MLS for determining agency relationships was improperly placed on the relationship between the brokers, which overlooked the principal- to-broker relationships in transactions.

For example, when an MLS selling broker (erroneously) believes he is a "subagent" in a transaction on property listed in the MLS by another broker, the critical brokerage facts include:

- the broker working with the buyer is an MLS member;
- the buyer has been assisted by the broker (or the broker's agents) to locate qualifying properties for the purpose of purchasing one which is suitable;
- the buyer has signed a purchase offer prepared by the broker to buy property listed with another broker who is also an MLS member; and

- the brokerage fee due the broker will be paid from funds accruing to the seller based on an agreement made by the listing broker in MLS publications to share his fee with any broker-member who submits an offer from a buyer at the listed price.

Again, the buyer's broker does not become a subagent of the seller due to the sharing of the fee, unless he **conducts himself** as the seller's representative in negotiations without undertaking any agency duties to represent and negotiate on behalf of the buyer.

It is instructive to observe that a buyer's broker shares fees with the listing broker, not duties. The buyer's broker is not mandated to perform a **visual inspection** and disclose his observations on behalf of the seller as required of listing agents, legal subagents and dual agents.

Subagent vs. fee-sharing broker

A seller's listing agreement authorizes the listing broker to cooperate with other brokers and to divide with them any brokerage fee due under the listing. [See Form 102 §4.2 accompanying Chapter 9]

Today, listing agreements no longer include wording which also authorizes the seller's listing broker to delegate to other brokers the authority to **also act** on behalf of the seller as the seller's agent to **locate buyers** and obtain offers to purchase, an activity legally establishing a *subagency* with the seller.

However, should a provision in a listing agreement actually authorize the listing broker to create a subagency, the listing broker may then act on behalf of the seller to employ another brokerage office as a *subagent* to help market the property.

It is beneficial to understand the circumstances under which a buyer is handled when a subagency exists so the multitude of real estate agency roles available in California can be better appreciated.

Subagency facts in a purchase agreement setting typically include:

- two separate brokers, one being a seller's listing broker and the other broker referred to legally as a "selling broker" (since he has contact with a buyer);
- a seller who is exclusively represented by the listing broker; and
- a buyer who is not represented by the selling broker (and may or may not be represented by yet another broker.

Dual agency as an authorized practice

Simply put, a *dual agent* is a broker who is acting as the agent for the **opposing parties** in a transaction, e.g., both the buyer and the seller. [CC §2079.13(d)]

The problem with dual agents is not that dual agency is improper. Dual agency has always been and is proper brokerage practice. However, what is improper is failing to confirm the existence of a dual agency in the agency confirmation provision of a purchase agreement for a one-to-four unit residential property. [CC §2079.17]

Further, a broker on any type of real estate transaction who fails to promptly disclose his dual agency at the moment it arises is subject to:

- the loss of his brokerage fee;

- liability for his clients' money losses; and

- disciplinary action by the Department of Real Estate (DRE). [Calif. Business and Professions Code §10176(d)]

For example, a buyer's agent locates property his buyer is interested in purchasing. The agent then negotiates and receives a written listing agreement from the seller without first disclosing his agency relationship with the buyer. The buyer then makes an offer, which the seller accepts. In the offer, the seller agrees to pay the broker a fee. Again, there is no disclosure of the agency relationship with the buyer.

Before closing, the seller discovers the broker's prior relationship with the buyer and cancels payment of the brokerage fee. The broker demands his fee for locating the buyer.

Here, the broker cannot recover a brokerage fee. The broker intentionally failed to disclose his **dual agency** to the seller at the moment it arose, i.e., at the time he entered into the listing with the seller. [**L. Byron Culver & Associates** v. **Jaoudi Industrial & Trading Corporation** (1991) 1 CA4th 300]

Also, once a broker becomes a dual agent, he (and his agents) too often do not know how to perform as a dual agent, usually due to a lack of training.

Both clients are entitled to advice

A rule of sorts for disclosure of relevant facts about the transaction, which are known or come to the dual agent's attention either before or after acceptance of an offer, is to advise both parties of the facts by written memorandum, and keep a copy of the memo in the client's file.

However, when a dual agency is established in a one-to-four unit residential sales transaction, and both parties are represented by the same broker, the broker (and his agents) may not pass on any information relating to the **price or terms of payment** from one party to the other. What price the buyer may be willing to pay, or the seller may be willing to accept, must remain the undisclosed knowledge of the dual agent, unless authorized to release the information in a writing signed by the principal in question. [CC §2079.21]

Thus, without authorization, the dual agent is now a "secret agent." He must keep secret the minimum pricing sought by the seller and the maximum pricing obtainable from the buyer.

The decision not to release pricing information must be made and maintained from the moment the dual agency arises. The dual agency typically occurs when the buyer who is an existing client is exposed to property listed by the broker — a moment which always occurs before the purchase agreement is prepared and the resulting agency relationships are confirmed.

The written authority needed to advise the seller of the buyer's willingness to pay more, or the seller's willingness to accept less, is best documented on a **modification of listing** form signed by the client whose confidential pricing information is to be released to the other client. The authority would be given to the broker who would retain the document in his file. [See Form 120 accompanying Chapter 12]

Dual agency and diminished benefits

Generally, the clients of a dual agent do not receive the full range of benefits they would have obtained from an exclusive agent. The conflicts which exist in a broker's dual representation rule out aggres-

sive negotiations to obtain the best business advantage for either party. This holds true even if different (listing and selling) agents employed by the **same broker** each work with different parties to the same transaction.

While a broker owes his client the duty to pursue the *best business advantage* legally and ethically obtainable through negotiations and agreements, the dual agent is foreclosed from achieving this advantage for either client. The dual agent cannot take sides with one or the other during negotiations.

Thus, a natural inability exists to negotiate the highest and best price for the seller, and at the same time, negotiate the lowest and best price for the buyer. Further, the broker and his agents, while acting as dual agents, are precluded in sales transactions on one-to-four unit residential property from discussing pricing without prior written approval.

The *legal agent* for a buyer or seller in a transaction is the broker, not the broker's agents or brokers employed by the broker who are in contact with the principal. Inhouse transactions which involve the broker as a dual agent make it particularly difficult for the broker to oversee and supervise dual agency negotiations.

Typically, one agent employed by the broker acquires the listing from a seller while another agent in the broker's employ works separately with a buyer to locate qualifying properties listed with other brokers.

The broker becomes a dual agent the moment the buyer is then shown an in-house listing.

However, an improper tendency in transactions involving only one broker and two of his agents who are separately working with a seller and buyer in a sale is to automatically designate the broker as a dual agent.

In fact, the buyer may well be a party to whom no agency duties are owed by any broker or agent. The buyer may have simply responded to the broker's "For Sale" sign, open house or ads marketing the listed property. And without being shown unlisted properties or properties listed with other brokers, the buyer may make an offer on an "in-house" listing through an agent employed by the broker who is not the listing agent.

When the buyer's inquiry and review of properties is limited to properties listed with the broker, the sale of an in-house listing directly to a buyer who has not retained a broker to represent him does not, without more, create an agency relationship with the buyer. [**Price** v. **Eisan** (1961) 194 CA2d 363]

However, there remains, as always, the listing broker's *general nonfiduciary duty* to disclose material facts about the listed property to all parties, including the non-client buyer. Facts to be voluntarily disclosed include the condition of the property's physical aspects, and the natural and environmental hazards of the location that may have an adverse effect on its value or might otherwise affect the buyer's decision to purchase the property. Further, there are always the disclosures made by the agents in response to any inquiry by the buyer.

Chapter 6 Conflict of interest

This chapter demonstrates a broker's use of a Conflict of Interest Disclosure to avoid breaching the fiduciary duty he owes to his client when he has a bias relating to the opposing party in a transaction, or another, whose interests are in conflict with his client's.

Professional relationships compromised

A conflict of interest arises when a broker or his agent, acting on behalf of a client, has a competing professional or personal bias which hinders his ability to unreservedly fulfill the fiduciary duties he has undertaken to advise and act on behalf of the client.

In a professional relationship, a broker's financial objective of **compensation for services** rendered by the broker is not a conflict of interest. However, fees and benefits derived from professional courtesies, familial favors, and preferential treatment by others toward the broker or his agents is compensation which must be **disclosed** to the client. [See Form 119 accompanying Chapter 21]

Further, the referral of a client to a financially controlled business, owned or co-owned by the broker, must be disclosed by use of an affiliated business arrangement (ABA) form, and is also not a conflict of interest. [See **first tuesday** Form 519]

A **conflict of interest** addresses the broker's personal relationships potentially at odds with the agency duty of care and protection owed the client.

Thus, a conflict of interest creates a fundamental *agency dilemma* for brokers, not a compensation or business referral issue. A **conflict of interest** exists when:

- a broker has a positive or negative *bias* toward the opposing party in a transaction or a person indirectly involved in the client's transaction; and

- that bias in favor of or against the other person might *compromise* the broker's ability to freely recommend action or provide guidance to the buyer or seller, landlord or tenant, or lender or broker he agreed to represent.

This bias regarding an opposing person or a party not directly involved, to whom the broker may or may not also owe an agency duty, must be disclosed if the bias might disrupt the broker's ability to make impartial decisions about the care and protection he owes his client. Unless disclosed and the client consents, the conflict is a breach of the broker's fiduciary duty of good faith, fair dealing, and trust owed to his client should the broker continue to act on the client's behalf. [See Figure 1 accompanying this chapter]

Situations involving a conflict

A conflict of interest, whether patent or potential, is disclosed by the broker at the time or as soon as possible after the conflict arises. Typically, the conflict arises prior to providing a buyer with property information or taking a listing from a seller.

The disclosure creates transparency in the transaction, revealing to the client the bias held by the broker which, when disclosed, allows the client to take the bias into consideration in negotiations. Though the disclosure and consent does not neutralize the *inherent bias* itself, it does neutralize the *element of deceit* which would breach the broker's fiduciary duty if left undisclosed.

Potential overlaps of allegiance or prejudice which cause a **conflict** that a broker or his agent must disclose include:

- the broker or his agent holds a direct or indirect *ownership interest* in the real estate, or are directly or indirectly a buyer of the property in the transaction, including a partial ownership interest in a limited liability company (LLC) or other entity which owns or is buying, leasing, or lending on the property;

- an individual related to the broker or one of his agents by *blood or marriage* holds a direct or indirect ownership interest in the property or is the buyer;

- an individual with whom the broker or a family member has a *special pre-existing* relationship, such as prior employment, significant past or present business dealings, or deep-rooted social ties, holds a direct or indirect ownership, leasehold, or security interest in the property or is the buyer;

- the broker's or his agent's concurrent representation of the opposing party, a *dual agency situation*; or

- an *unwillingness* of the broker or his agent *to work* with the opposing party, or others, or their brokers or agents in a transaction.

Simply, a **conflict of interest** arises and is disclosed to the client when the broker:

- has a *pre-existing relationship* with another person due to kinship, employment, partnership, common membership, religious affiliation, civic ties, or any other socio-economic context; and

- that relationship might hinder his *ability to fully represent* the needs of his client.

Unfortunately, comprehensive rules do not yet exist which establish those instances where a conflict of interest arises and needs to be disclosed. Thus, brokers are left to draw their own conclusions when situations regarding a property or a transaction with or involving third parties arise. In practice, brokers, and especially agents, all too often err on the side of nondisclosure, putting their brokerage fee, if not their license itself, at risk.

Generally, if a broker even questions whether it is appropriate to disclose a potential conflict of interest to a client, he should disclose it. The existence of any concern is reason enough for a prudent broker to be prompt in seeking his client's consent to the potential conflict. By timely disclosing a conflict of interest and obtaining consent, the broker immediately creates an honest working relationship with his client.

The client's tardy discovery of the conflict and their complaint to the Department of Real Estate (DRE) for failure to make the disclosure and obtain consent before continuing to advise or act on behalf of the client can result in the suspension or revocation of the broker's license by the DRE. [Calif. Business and Professions Code §10177(o)]

Fundamentally, a broker who becomes aware he has a conflict of interest but is reluctant to disclose it and seek the client's consent should consider rejecting or terminating the employment with that individual.

Figure 1

CONFLICT OF INTEREST
(Kinship, Position or Undue Influence)

NOTE: Licensed Brokers and Sales Agents when acting on behalf of a client may not act in a manner which might cause the client to conclude that others, or a position held by the Broker or his Agents, can improperly influence or cause the Broker or his Agents to fail to properly act in their fiduciary capacity as an agent without first disclosing to the client the facts which might otherwise lead to that conclusion and obtaining their consent.

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This disclosure is made in connection with the following agreement:

☐ Listing (Employment) Agreement ☐ Purchase Agreement
☐ Escrow Instructions ☐ _____

1.1 ☐ of the same date, or dated _____, 20_____, at _____, California,
1.2 entered into by _____, as the _____, and
1.3 _____, as the _____,
1.4 regarding real estate referred to as _____.

2. The client(s) represented by the undersigned Broker with regard to the above referenced agreement is/are identified as the _____.

DISCLOSURE OF CONFLICT OF INTEREST:

3. Broker provides the following information as a disclosure to the client of relationships or positions held by Broker or his Agents, and their family members, in investments, business activities or real estate interests which present circumstances that might, if not disclosed, appear to be in conflict with the agency duty owed the client to care for and protect the interests of the client.

Check the following items and enter information on facts which are believed might create a conflict of interest for Broker or his Agents in performing their agency duties on behalf of the client.

3.1 ☐ Real estate
Property type: _____
Address: _____
Interest held: _____
Activity creating conflict: _____

3.2 ☐ Government agency
Agency name: _____
Position held: _____
Activity creating conflict: _____

3.3 ☐ Business position
Business name: _____
Goods or services provided: _____
Position held: _____
Activity creating conflict: _____

3.4 ☐ Business investment
Company name: _____
Type of trade or business: _____
Interest held: _____
Activity creating conflict: _____

— PAGE ONE OF TWO — FORM 527 —
— PAGE TWO OF TWO — FORM 527 —

3.5 ☐ Representation of others in transaction
Name of person also owed agency duties: _____
Activity creating conflict: _____

3.6 ☐ Kinship and employee relationships
Name of individual(s): _____
Relationship with Broker or employee: _____
Activity creating conflict: _____

4. Other disclosures of direct or indirect compensation or economic benefits may have previously been made, such as exists for additional compensation and controlled business arrangements. [See **ft** Forms 119 and 519]

BROKER:

5. I certify that the above information is true and correct.

Date: _____, 20_____ Broker's Name : _____
By: _____
Agent's Name: _____

CLIENT: I have received a copy of this disclosure and consent to continue the relationship with the broker as my agent.

☐ See attached Signature Page Addendum [**ft** Form 251]

Date: _____, 20_____

Name: _____ Name: _____
Signature: _____ Signature: _____

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Relative's participation in a transaction

A seller's broker must disclose the broker's acquisition of any direct or indirect interest in the seller's property, or whether a family member, a business owned by the broker, or any other person holding a special relationship with the broker (such as his agents) will acquire an interest in the seller's property. [See **first tuesday** Form 527 §3.6]

For example, a broker's brother-in-law makes an offer to buy property the broker has listed. The purchase agreement states the broker is to receive a fee and that he represents the seller exclusively.

The broker does not disclose to the seller that the buyer is his brother-in-law.

The broker opens two escrows to handle the transaction. The first escrow facilitates the sale and transfers the property from the seller to the broker's brother-in-law.

The second escrow is for the sole purpose of transferring title to the property from the brother-in-law to a limited liability company (LLC) in which the broker holds an ownership interest, a syndicated acquisition. Both escrows close and the broker receives his fee.

The seller discovers the buyer to whom he deeded the property was his broker's brother-in-law and that the true buyer was an entity partially owned by the broker. The seller demands a return of the brokerage fee claiming the broker had a conflict of interest which breached the fiduciary duty he owed to the seller since it was not disclosed and the seller did not consent.

Here, the broker is not entitled to retain the brokerage fee he received from the seller. Further, the seller is entitled to recover any property value at the time of the sale in excess of the price he received, or he can set the sale aside, due to the failure of the broker's agency with the seller.

A broker cannot act for more than one party in a transaction, including himself, without disclosing his **dual role** and obtaining the **client's consent** at the time the conflict arises. [Bus & P C §10176(d); see **first tuesday** Form 527]

Also, a seller's broker has an affirmative duty to disclose to the seller his agency or other conflicting relationship he might have with the buyer, even if the seller fails to inquire into whether the broker has a relationship with the buyer.

Further, failure to disclose a broker's personal interest as a buyer in a transaction when he is also *acting as a broker* on behalf of the seller constitutes grounds for discipline by the Real Estate Commissioner. [**Whitehead** v. **Gordon** (1970) 2 CA3d 659]

In another example, a seller, acting on a broker's advice as to the estimated value of his real estate, retains the broker to find a buyer for the property. [See **first tuesday** Form 318]

The broker and seller enter into a net listing agreement.

Under the **net listing**, the seller agrees to take a fixed sum of money as the net proceeds for his equity should the property sell. Also, the net listing provides for the broker to receive all further sums paid on the price as his brokerage fee.

The broker arranges a sale of the property to his daughter and son-in-law. The seller is not informed of the broker's relationship with the buyer. On the close of the transaction, the broker receives his fully disclosed brokerage fee as the net proceeds remaining from the sale in excess of the net listing price.

On discovery of the broker's relationship with the buyer, the seller demands a return of the brokerage fee claiming the broker's kinship with the buyer is a conflict of interest which was not disclosed, violating the fiduciary duty he owed to the seller. The broker claims the seller cannot recover the brokerage fee no matter who the buyer was since the seller only bargained to receive a fixed amount on the sale of his property under the net listing agreement.

Here, and whenever a broker is employed under any type of listing, he has an obligation to voluntarily disclose to his seller, and do so at the earliest opportunity, any special relationship he may have with the buyer and obtain the seller's consent before proceeding. The seller, unaware of the **family relationship** between his broker and the buyer, can recover the brokerage fee he paid to the broker. [**Sierra Pacific Industries** v. **Carter** (1980) 104 CA3d 579]

A relative owns the property sold

A selling broker employed to act on behalf of a buyer will disclose to his buyer the nature and extent of any direct or indirect interest **he or his agents hold** in any property presented to the buyer.

For example, a licensed broker acting as an agent on behalf of a buyer shows the buyer several properties, one of which is owned by the broker and others, vested in the name of an LLC. The broker promptly informs the buyer he has a listing on the property, but does not inform the buyer of his indirect ownership interest in the property.

The buyer later decides to purchase the LLC property. An offer is prepared on a purchase agreement form with an agency confirmation stating the broker is the agent for both the buyer and seller. The offer is submitted to the LLC. [See Form 159 accompanying Chapter 53]

The broker, aware the buyer will pay a higher price for the property than the initial price offered by the buyer, presents the buyer with a counteroffer from the LLC at a higher selling price. The buyer accepts the counteroffer.

Here, the broker has a duty to promptly disclose his ownership interest in the property to the buyer the moment the conflict arises – the exposure of the buyer to the property. The conflict of interest in the broker's ownership is a material fact requiring disclosure since the buyer's decisions concerning acquisition of the property might be affected.

As a result of the lack of disclosure of the conflicting position of the buyer's broker, the buyer can recover the fee received by the broker and the increase in price under the counteroffer.

Had the buyer known the broker held an ownership interest in the property when it was first presented, he might have negotiated differently when setting the price and terms for payment, or retained a different broker to represent his interests who was not compromised by a conflict of interest.

However, a broker acting solely **as a principal** in the sale of his own property is not restricted in his conduct by compliance with agency obligations. The broker selling or buying property for his own account should act solely as the seller or buyer, rather than pay himself a taxable fee for **also acting as a broker** in the transaction which then exposes him to claims of agency violations. [**Robinson** v. **Murphy** (1979) 96 CA3d 763]

Taking a fee when acting as a principal

When a **broker-seller** receives a brokerage fee on the sale of his own property or on the purchase of property for his own account, he subjects himself to real estate agency requirements.

For example, a broker sells a residence he owns which exists in violation of safety requirements for occupancy due to defects in the foundation known to the broker. The broker does not tell the buyer about the foundation defects.

Out of the proceeds the broker receives on closing the sale of his property, the broker-seller pays himself a brokerage fee, claiming to *exclusively represent himself* (which is not an agency and does not require a license).

The buyer later discovers he must demolish the residence and rebuild it with an adequate foundation. The buyer obtains a money judgment against the broker for breach of his general agency duty owed to all parties in a real estate transaction to disclose known property defects that cause the buyer to take a loss.

The broker is unable to pay the money judgment. The buyer seeks payment from the DRE Recovery Fund.

Recovery is received from the DRE Recovery Fund since the broker held himself out as a**cting as a real estate** broker in the transaction – he received a fee. The broker's license is then suspended. Before the broker can reactivate his license, he must reimburse the DRE Recovery Fund. [**Prichard** v. **Reitz** (1986) 178 CA3d 465]

The licensee acts solely as a principal

A DRE licensee acting solely as a principal on his own behalf when buying (or selling) property need not disclose the existence of his real estate license. The licensee has no conflict due to the **existence of his license** since he is not holding himself out as a broker or agent acting on behalf of another person in the transaction.

Consider a broker who is employed by an owner to arrange a real estate loan. The lender making the loan is the broker's sister.

The broker, however, funds the loan himself by depositing his personal funds into his sister's account. In essence, the broker is the lender.

The owner is not advised of the kinship between the broker and the lender, or of the true source of the loan funds. [See **first tuesday** Forms 205-1 and 205-2]

Here, the broker has a duty owed to the buyer to disclose his **dual capacity** in the loan transaction. He was acting both as a broker arranging the loan on behalf of the owner and as the lender making the loan, a conflict of interest. The broker's actions constitute grounds for discipline by the Real Estate Commissioner. [**Tushner** v. **Savage** (1963) 219 CA2d 71]

Conflicts in real estate syndication

A potential conflict of interest also exists when a broker **manages multiple LLCs** which own like-type properties in the same market area, the result of his syndicating the acquisition of several properties.

For example, consider a broker entrusted with managing two investment groups which own similar apartment projects located within the same market and compete for the same prospective tenants. The broker is paid a management fee by each investment group based on a percentage of the rents received.

When contacted by a prospective tenant, the broker is initially faced with the dilemma of which apartment building to refer the tenant to and thus which investment group will benefit from the tenant's occupancy.

A similar conflict of interest results from parallel transactions in which multiple LLCs managed by the same broker are actively competing to sell or buy property within the same marketplace.

A conflict of interest of this nature must be disclosed to the investors before they agree to participate as members in an LLC the broker manages. This disclosure is contained in first tuesday Form 371, Investment Circular provision 6d, which states:

- The Manager has numerous other business responsibilities and ownership interest which will demand some or most of his time during the LLC's ownership of the property. The Manager's other interests include ownership of projects comparable to the property purchased in this transaction. To the extent his time is required on other business and ownership management decisions, he will not be involved in monitoring or marketing of the LLC's property. [See **first tuesday** Form 371]

With this disclosure, the **broker's allegiance** to multiple projects and investment groups is transparent and can be taken into consideration by all investors at the time they receive the Investment Circular from the Broker – before investing and consenting to the risk.

Compensation and earnings received by the broker

Direct or indirect compensation received by a broker must be disclosed to his client but not as a conflict of interest. A Compensation Disclosure form is prepared, setting forth the amount of compensation, its form and source as additional benefits the broker and his agents anticipate receiving for any other service they provide as a result of the client's entry into a real estate transaction in which the broker is acting as a licensee. [Bus & P C §10176(g); see Form 119 accompanying Chapter 21]

Additionally, a broker listing a property or representing a buyer who refers the owner or buyer to a business or service **provider he owns** or co-owns uses an Affiliated Business Arrangement Disclosure Statement to inform the party of his ownership interest in that company. The disclosure enables the broker to indirectly benefit from the referral and properly share in any profits from the referrals he makes to businesses he controls. [See **first tuesday** Form 519]

Similarly, the Affiliated Business Arrangement Disclosure Statement – Loan Broker form is used by a mortgage loan broker arranging financing when referring a borrower to providers of settlement services whose earnings are shared by the loan broker as a co-owner of the provider. [See **first tuesday** Form 205]

Chapter 7 The agency law disclosure

This chapter sets forth the use of the statutorily mandated Agency Law Disclosure form and its timely presentation to sellers and buyers in order to perfect a broker's right to collect the agreed fee.

Legislated order

As the practice of real estate brokerage developed and matured, rules and regulations were created to keep transactions running smoothly and to channel agency activities toward a broader public good.

However, when the professional misconduct of real estate licensees was overlooked and mishandled by the brokerage community, legislative and judicial forces felt compelled to step into the "power vacuum" created by the lack of proper internal policing. Thus, an agency disclosure law to cure some of these deficiencies was enacted by the California legislature.

The real estate agency law requires two different sets of **agency-related disclosures**:

- an *Agency Law Disclosure* form setting out the "rules of agency" controlling the conduct of real estate licensees in a transaction; and

- an *agency confirmation provision* in purchase agreements to disclose the agency of each broker involved in the transaction.

The legislation created an agency scheme in an attempt to cure a number of previously misleading brokerage practices. In doing so, it established uniform real estate terminology and brokerage conduct covering targeted transactions on one-to-four unit residential property. The Agency Law Disclosure form is a succinct restatement of existing agency codes and codified case law on agency relationships.

Additionally, the legislated real estate agency scheme made changes in how and when each broker must proceed to **confirm** his agency relationship with the principals in targeted one-to-four unit residential sales transactions.

Uniform jargon and agency law

Basically, the Agency Law Disclosure form was created by the legislature for use by brokers and their agents to educate and familiarize clientele (as well as the brokers and their agents) with:

- a uniform jargon for real estate transactions; and

- the various agency roles licensees may undertake on behalf of their principals and other parties in a real estate related transaction.

This information is presented in a two-page form, sometimes referred to as the *Rules of Agency* or the *Agency Law Disclosure*. The exact wording of its entire content is dictated by statute. [Calif. Civil Code §2079.16; see Form 305 accompanying this chapter]

AGENCY LAW DISCLOSURE

Disclosure Regarding Real Estate Agency Relationships

NOTE: This agency disclosure complies with agency disclosures required with property listings and offers to buy, sell, exchange or lease one-to-four residential units and mobile homes. [Calif. Civil Code §§2079 et seq.]

DATE: _____, 20_____, at _____, California.

TO THE SELLER AND THE BUYER: _____

1. **FACTS:** When you enter into a discussion with a real estate agent regarding a real estate transaction, you should, from the outset, understand what type of agency relationship or representation you wish to have with the agent in the transaction.
2. **SELLER'S AGENT:** A Seller's Agent under a listing agreement with the Seller acts as the Agent for the Seller only. A Seller's Agent or a subagent of that Agent has the following affirmative obligations:
   - 2.1 To the Seller:
     - a. A fiduciary duty of utmost care, integrity, honesty and loyalty in dealings with the Seller.
   - 2.2 To the Seller and the Buyer:
     - a. Diligent exercise of reasonable skill and care in performance of the Agent's duties.
     - b. A duty of honest and fair dealing and good faith.
     - c. A duty to disclose all facts known to the Agent materially affecting the value or desirability of the property that are not known to, or within the diligent attention and observation of the parties.
   - 2.3 An Agent is not obligated to reveal to either party any confidential information obtained from the other party which does not involve the affirmative duties set forth above.
3. **BUYER'S AGENT:** A Selling Agent can, with a Buyer's consent, agree to act as the Agent for the Buyer only. In these situations, the Agent is not the Seller's Agent, even if by agreement the Agent may receive compensation for services rendered, either in full or in part, from the Seller. An Agent acting only for a Buyer has the following affirmative obligations:
   - 3.1 To the Buyer:
     - a. A fiduciary duty of utmost care, integrity, honesty and loyalty in dealings with the Buyer.
   - 3.2 To the Seller and the Buyer:
     - a. Diligent exercise of reasonable skill and care in performance of the Agent's duties.
     - b. A duty of honest and fair dealing and good faith.
     - c. A duty to disclose all facts known to the Agent materially affecting the value or desirability of the property that are not known to or within the diligent attention and observation of the parties. An Agent is not obligated to reveal to either party any confidential information obtained from the other party which does not involve the affirmative duties set forth above.
4. **AGENT REPRESENTING BOTH THE SELLER AND THE BUYER:** A Real Estate Agent, either acting directly or through one or more associate licensees, can legally be the Agent of both the Seller and the Buyer in a transaction, but only with the knowledge and consent of both the Seller and the Buyer.
   - 4.1 In a dual agency situation, the Agent has the following affirmative obligations to both the Seller and the Buyer:
     - a. A fiduciary duty of utmost care, integrity, honesty and loyalty in the dealings with either the Seller or the Buyer.
     - b. Other duties to the Seller and the Buyer as stated above in their respective sections.
   - 4.2 In representing both the Seller and the Buyer, the Agent may not, without the express permission of the respective party, disclose to the other party that the Seller will accept a price less than the listing price or that the Buyer will pay a price greater than the price offered.
5. The above duties of the Agent in a real estate transaction do not relieve a Seller or a Buyer from the responsibility to protect their own interests. You should carefully read all agreements to assure that they adequately express your understanding of the transaction. A Real Estate Agent is a person qualified to advise about real estate. If legal or tax advice is desired, consult a competent professional.
6. Throughout your real property transaction, you may receive more than one disclosure form depending upon the number of Agents assisting in the transaction. The law requires each Agent with whom you have more than a casual relationship to present you with this disclosure form. You should read its contents each time it is presented to you, considering the relationship between you and the Real Estate Agent in your specific transaction.
7. This disclosure form includes the provisions of §2079.13 to §2079.24, inclusive, of the Calif. Civil Code set forth on the reverse hereof. Read it carefully.

(Buyer's Broker)	Date	(Buyer's Signature)	Date
(Associate Licensee's Signature)	Date	(Buyer's Signature)	Date
(Seller's Broker)	Date	(Seller's Signature)	Date
(Associate Licensee's Signature)	Date	(Seller's Signature)	Date

§2079.13. As used in Sections 2079.14 to 2079.24, inclusive, the following terms have the following meanings:

(a) "Agent" means a person acting under provisions of Title 9 (commencing with Section 2295) in a real property transaction, and includes a person who is licensed as a real estate broker under Chapter 3 (commencing with Section 10130) of Part 1 of Division 4 of the Business and Professions Code, and under whose license a listing is executed or an offer to purchase is obtained.

(b) "Associate licensee" means a person who is licensed as a real estate broker or salesperson under Chapter 3 (commencing with Section 10130) of Part 1 of Division 4 of the Business and Professions Code and who is either licensed under a broker or has entered into a written contract with a broker to act as the broker's agent in connection with acts requiring a real estate license and to function under the broker's supervision in the capacity of an associate licensee.

The agent in the real property transaction bears responsibility for his or her associate licensees who perform as agents of the agent. When an associate licensee owes a duty to any principal, or to any buyer or seller who is not a principal, in a real property transaction, that duty is equivalent to the duty owed to that party by the broker for whom the associate licensee functions.

(c) "Buyer" means a transferee in a real property transaction, and includes a person who executes an offer to purchase real property from a seller through an agent, or who seeks the services of an agent in more than a casual, transitory, or preliminary manner, with the object of entering into a real property transaction. "Buyer" includes vendee or lessee.

(d) "Dual agent" means an agent acting, either directly or through an associate licensee, as agent for both the seller and the buyer in a real property transaction.

(e) "Listing agreement" means a contract between an owner of real property and an agent, by which the agent has been authorized to sell the real property or to find or obtain a buyer.

(f) "Listing agent" means a person who has obtained a listing of real property to act as an agent for compensation.

(g) "Listing price" is the amount expressed in dollars specified in the listing for which the seller is willing to sell the real property through the listing agent.

(h) "Offering price" is the amount expressed in dollars specified in an offer to purchase for which the buyer is willing to buy the real property.

(i) "Offer to purchase" means a written contract executed by a buyer acting through a selling agent which becomes the contract for the sale of the real property upon acceptance by the seller.

(j) "Real property" means any estate specified by subdivision (1) or (2) of Section 761 in property which constitutes or is improved with one to four dwelling units, any leasehold in this type of property exceeding one year's duration, and mobilehomes, when offered for sale or sold through an agent pursuant to the authority contained in Section 10131.6 of the Business and Professions Code.

(k) "Real property transaction" means a transaction for the sale of real property in which an agent is employed by one or more of the principals to act in that transaction, and includes a listing or an offer to purchase.

(l) "Sell," "sale," or "sold" refers to a transaction for the transfer of real property from the seller to the buyer, and includes exchanges of real property between the seller and buyer, transactions for the creation of real property sales contract within the meaning of Section 2985, and transactions for the creation of a leasehold exceeding one year's duration.

(m) "Seller" means the transferor in a real property transaction, and includes an owner who lists real property with an agent, whether or not a transfer results, or who receives an offer to purchase real property of which he or she is the owner from an agent on behalf of another. "Seller" includes both a vendor and a lessor.

(n) "Selling agent" means a listing agent who acts alone, or an agent who acts in cooperation with a listing agent, and who sells or finds and obtains a buyer for the real property, or an agent who locates property for a buyer or who finds a buyer for a property for which no listing exists and presents an offer to purchase to the seller.

(o) "Subagent" means a person to whom an agent delegates agency powers as provided in Article 5 (commencing with Section 2349) of Chapter 1 of Title 9. However, "subagent" does not include an associate licensee who is acting under the supervision of an agent in a real property transaction.

§2079.14. Listing agents and selling agents shall provide the seller and buyer in a real property transaction with a copy of the disclosure form specified in Section 2079.16, and, except as provided in subdivision (c), shall obtain a signed acknowledgment of receipt from that seller or buyer, except as provided in this section or Section 2079.15, as follows:

(a) The listing agent, if any, shall provide the disclosure form to the seller prior to entering into the listing agreement.

(b) The selling agent shall provide the disclosure form to the seller as soon as practicable prior to presenting the seller with an offer to purchase, unless the selling agent previously provided the seller with a copy of the disclosure form pursuant to subdivision (a).

(c) Where the selling agent does not deal on a face-to-face basis with the seller, the disclosure form prepared by the selling agent may be furnished to the seller (and acknowledgment of receipt obtained for the selling agent from the seller) by the listing agent, or the selling agent may deliver the disclosure form by certified mail addressed to the seller at his or her last known address, in which case no signed acknowledgment of receipt is required.

(d) The selling agent shall provide the disclosure form to the buyer as soon as practicable prior to execution of the buyer's offer to purchase, except that if the offer to purchase is not prepared by the selling agent, the selling agent shall present the disclosure form to the buyer not later than the next business day after the selling agent receives the offer to purchase from the buyer.

§2079.15. In any circumstance in which the seller or buyer refuses to sign an acknowledgment of receipt pursuant to Section 2079.14, the agent, or an associate licensee acting for an agent, shall set forth, sign, and date a written declaration of the facts of the refusal.

§2079.17. (a) As soon as practicable, the selling agent shall disclose to the buyer and seller whether the selling agent is acting in the real property transaction exclusively as the buyer's agent, exclusively as the seller's agent, or as a dual agent representing both the buyer and the seller. This relationship shall be confirmed in the contract to purchase and sell real property or in a separate writing executed or acknowledged by the seller, the buyer, and the selling agent prior to or coincident with execution of that contract by the buyer and the seller, respectively.

(b) As soon as practicable, the listing agent shall disclose to the seller whether the listing agent is acting in the real property transaction exclusively as the seller's agent, or as a dual agent representing both the buyer and seller. This relationship shall be confirmed in the contract to purchase and sell real property or in a separate writing executed or acknowledged by the seller and the listing agent prior to or coincident with the execution of that contract by the seller.

(c) The confirmation required by subdivisions (a) and (b) shall be in the following form:

_____[Do not fill out]_____ is the agent of (check one):
(Name of Listing Agent)

☐ the seller exclusively; or

☐ both the buyer and seller.

_____[Do not fill out]_____ is the agent of (check one):
(Name of Selling Agent if not same as the Listing Agent)

☐ the buyer exclusively;

☐ the seller exclusively; or

☐ both the buyer and seller.

(d) The disclosures and confirmation required by this section shall be in addition to the disclosure required by Section 2079.14.

§2079.18. No selling agent in a real property transaction may act as an agent for the buyer only, when the selling agent is also acting as the listing agent in the transaction.

§2079.19. The payment of compensation or the obligation to pay compensation to an agent by the seller or buyer is not necessarily determinative of a particular agency relationship between an agent and the seller or buyer. A listing agent and a selling agent may agree to share any compensation or commission paid, or any right to any compensation or commission for which an obligation arises as the result of a real estate transaction, and the terms of any such agreement shall not necessarily be determinative of a particular relationship.

§2079.20. Nothing in this article prevents an agent from selecting, as a condition of the agent's employment, a specific form of agency relationship not specifically prohibited by this article if the requirements of Section 2079.14 and Section 2079.17 are complied with.

§2079.21. A dual agent shall not disclose to the buyer that the seller is willing to sell the property at a price less than the listing price, without the express written consent of the seller. A dual agent shall not disclose to the seller that the buyer is willing to pay a price greater than the offering price, without the expressed written consent of the buyer.

This section does not alter in any way the duty or responsibility of a dual agent to any principal with respect to confidential information other than price.

§2079.22. Nothing in this article precludes a listing agent from also being a selling agent, and the combination of these functions in one agent does not, of itself, make that agent a dual agent.

§2079.23. A contract between the principal and agent may be modified or altered to change the agency relationship at any time before the performance of the act which is the object of the agency with the written consent of the parties to the agency relationship.

§2079.24. Nothing in this article shall be construed to either diminish the duty of disclosure owed buyers and sellers by agents and their associate licensees, subagents, and employees or to relieve agents and their associate licensees, subagents, and employees from liability for their conduct in connection with acts governed by this article or for any breach of a fiduciary duty or a duty of disclosure.

The **Agency Law Disclosure** defines and explains, in general terms, many of the words and phrases commonly used in the real estate industry to express:

- the *agency relationships* of brokers to the parties in the transaction;
- *broker-to-broker relationships*; and
- the *employment relationship* between brokers and their agents.

A *buyer's agent* and a *seller's agent* are mentioned but not defined. A "single agent," which is typically a buyer's agent who is paid by the buyer, is not even mentioned.

Legally, an **agent** is a licensed real estate broker. Thus, the word agent, when used in the disclosure, is not a reference to the broker's agents who in fact call themselves "agents." Ironically, in practice, a broker rarely, if ever, refers to himself as an agent, which in law, he is.

However, two sections on the face of the Agency Law Disclosure, entitled "seller's agent" and "buyer's agent," address the duties owed to the seller and buyer in a real estate transaction by these otherwise undefined brokers.

The seller's listing broker is correctly noted as being an agent for the seller. Peculiar to real estate brokerage, the buyer's broker is referred to as the *selling agent*.

One then wonders who is the "buying agent" — an unmentioned phrase, but one more plainly descriptive of the activities undertaken by a broker acting as an agent exclusively on behalf of the buyer.

The Agency Law Disclosure does not mention, much less define, the broker's role as an *exclusive agent* for either the buyer or seller. Yet the separate agency confirmation provision mandated to be included in all purchase agreements used on targeted transactions provides the broker with options to characterize himself as the agent of the "seller exclusively" or the "buyer exclusively."

It is certain these exclusive characterizations of agency have absolutely no relationship to exclusive (employment) listings to sell or to buy property. The listing agent with an exclusive right-to-sell listing needs to understand the prospective buyer may well turn out to be one of his clients, making the broker a "non-exclusive" dual agent.

However, the two sections on the first page of the Agency Law Disclosure entitled "seller's agent" and "buyer's agent" do state, in broad legal terms, generally accepted principles of law governing the conduct of brokers who are acting as agents solely for a seller or a buyer in a transaction. Also presented is the *general duty* of fairness owed the other party and broker in the transaction.

Two categories of **broker obligations** arise in a sales transaction and are properly emphasized in the Agency Law Disclosure:

- the *special agency duties* of an agent which are owed by a broker (and his agents) to his client — being the fiduciary duties of a trustee to his beneficiaries; and
- the *general duties* owed by each broker to all parties in the transaction — to be honest and avoid misleading or deceitful conduct.

Agencies confirmed in the purchase agreement

As part of the same agency disclosure scheme, a separate **agency confirmation provision** is mandated for inclusion in purchase agreement forms used to memorialize targeted transactions. The agency confirmation provision located in a purchase agreement advises the buyer and seller, at the time they sign the purchase agreement or its counteroffer, of any agency relationships each broker has with the parties in the transaction.

The Agency Law Disclosure contains the agency confirmation provision which is required to be included in purchase agreements. However, the provision in the Agency Law Disclosure is not to be filled out or used in lieu of the agency confirmation provision contained in a purchase agreement. The agencies to be confirmed by each broker in the purchase agreement provisions are not even known at the listing stage. Thus, the agency in a future sales transaction cannot be confirmed at the time the seller is first required to be presented with the Agency Law Disclosure form. [CC §2079.17(d)]

The agency confirmation provision in a purchase agreement is filled out to disclose each broker's actual agency relationship, established by the broker's conduct and the conduct of their agents with the buyer and/or seller. The agency relationship confirmed is the broker's **legal determination** of the actual agency created by his and his agent's prior conduct with the parties.

When two brokers are involved in a targeted transaction, each broker must disclose whether he is acting as the agent for the buyer or the seller. Alternatively, when only one broker is involved, he must confirm whether he and his agents are acting as the exclusive agent for one party or as a dual agent for both the buyer and seller. [See Form 150 Signature section accompanying Chapter 51]

A broker (or his agents) prudently includes the agency confirmation provision and attaches the Agency Law Disclosure form to all purchase agreements used in the sale of all types of property, not just as mandated for use on targeted one-to-four unit residential sales or leases exceeding one year. Written disclosures tend to eliminate later disputes over agency, which can become the basis for cancelling a purchase agreement, the payment of a brokerage fee, or both. [**L. Byron Culver & Associates** v. **Jaoudi Industrial & Trading Corporation** (1991) 1 CA4th 300]

Use of the Agency Law Disclosure

The Agency Law Disclosure form is mandated to be presented to all parties, by brokers or their agents, when listing, selling, buying or leasing (for over one year) property containing:

- one-to-four residential units; or
- mobilehomes. [CC §§2079.13(j), 2079.14]

However, not all transactions involving one-to-four unit residential properties are **targeted** to require the attachment of the Agency Law Disclosure or the inclusion of the agency confirmation provision in purchase agreement forms. Arranging the secured interests of lenders and borrowers under trust deeds or as collateral loans, for example, are not targeted transactions.

The sale, exchange or creation of interests in residential property transactions targeted by the agency disclosure law include transfers of:

- fee simple estates in real estate or registered ownerships for mobilehomes;
- life estates;

- existing leaseholds with more than one year remaining, such as ground leases; and
- leases created for more than one year. [CC §2079.13(l)]

The Agency Law Disclosure must be attached to the following documents and signed by all parties in targeted transactions:

- a seller's listing;
- a purchase agreement offer and acceptance;
- an exchange agreement;
- a counteroffer, by attachment or by reference, to a purchase agreement containing the disclosure as an attachment;
- a landlord's authorization to a broker to lease property on his behalf for more than one year; and
- a residential lease agreement for a period exceeding one year. [CC §2079.14]

Negotiations and agreements on one-to-four residential units concerning buyers' listings, property management (unless entry into leases for periods exceeding one year are authorized), purchase options, financing arrangements, one-year leases and month-to-month rental agreements **do not yet require** statutory disclosure of the broker's agency.

Editor's note — However, the Agency Law Disclosure is to be handed to a buyer as an addendum to the buyer's purchase agreement offer.

Agency rules for a seller's listing

A seller's listing, open or exclusive, employing a broker and his agents to sell a one-to-four unit residential property is a targeted transaction requiring the inclusion of the Agency Law Disclosure as an addendum to the seller's listing agreement. [CC §2079.14(a)]

Failure of the listing agent to provide the seller with the Agency Law Disclosure prior to his entering into the listing agreement will result in the broker's loss of his fee on a sale, if challenged by the seller. The loss of the fee is not avoided by a later disclosure made as an addendum to a purchase agreement or escrow instructions. [**Huijers** v. **DeMarrais** (1992) 11 CA4th 676]

The Agency Law Disclosure is also required to be used by agents listing and submitting offers regarding leasehold estates involving one-to-four unit residential property. These transactions occur when a long-term ground lease is being conveyed to a buyer and will be security for any purchase-assist financing. [CC §§2079.13(j), 2079.13(l), 2079.14]

Also, the seller's signature is required on the Agency Law Disclosure to acknowledge receipt of a copy at both:

- the listing stage, as an addendum to the listing; and
- on presentation of a buyer's offer, as an addendum to the purchase agreement. [CC §2079.14]

CONFIRMATION MEMORANDUM

DATE: _____, 20_____, at _____, California.

TO: _____	**FROM:** _____
Company _____	Company _____
Address _____	Address _____
_____	_____
Phone _____ Fax _____	Phone _____ Fax _____
Email _____	Email _____

FACTS:

1. This memorandum confirms our conversation regarding the following contract:

☐ Listing/retainer agreement ☐ Rental/lease agreement

☐ Purchase agreement ☐ Trust deed loan number _____

☐ Escrow number _____ ☐ _____

dated _____, 20_____, at _____, California, entered into by _____, as the _____, and _____, as the _____, regarding real estate referred to as _____ _____.

MEMORANDUM:

2. On _____, 20_____, at approximately _____ ☐ a.m., ☐ p.m., you and I personally spoke ☐ by phone, or ☐ in person at (*place*) _____.

3. We agreed to the following: _____ _____.

4. Your cooperation and commitment are appreciated and will be relied upon.

5. If this memorandum does not accurately state your understanding of our conversation, please contact me immediately to correct or clarify this memorandum.

Signed and mailed this date.

Broker: _____

By (print): _____

Signature: _____

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Thus, the Agency Law Disclosure is to be treated by the listing agent as a preliminary and compulsory listing event since the listing broker expects to collect a brokerage fee on a later sale. The Agency Law Disclosure is signed by the seller and handed back to the broker (or his agent) before settling down to finalize the listing to which it will be attached.

When the broker (or his sales agent) fails to hand the seller the Agency Law Disclosure at the listing stage, the listing, and thus the agency, can be later cancelled by the seller at any time. The seller can cancel even after the transaction sought under the listing agreement is in escrow and the brokerage fee has been further agreed to and the Agency Law Disclosure has been delivered with the purchase agreement and escrow instructions.

On the other hand, the buyer's broker *perfect*s his right to collect his portion of any brokerage fee, if the fee is payable directly to the buyer's broker by the seller, by including the Agency Law Disclosure as a signed addendum to his purchase agreement offer.

However, the buyer's broker might erroneously agree to let the seller's broker receive the entire fee from the seller and then be paid his share of the fee by the seller's broker under a fee-sharing agreement. When the seller's broker fails to obtain a signed Agency Law Disclosure as an addendum to the listing, the seller may legally avoid payment of the agreed fee to the listing broker. In turn, when the seller has not agreed to directly pay the buyer's broker, the seller's refusal to pay for lack of a disclosure leaves the buyer's broker without a fee as agreed from the seller's broker.

For the buyer's broker to protect his fee, the seller must agree in the body of the purchase agreement offer signed by the buyer that the seller will pay both brokers himself. The buyer's broker always takes control over the payment and collection of his fee when the buyer's agent includes a fee provision in the purchase agreement offer made by his buyer.

Documenting a refusal to sign

On occasion, a seller may accept a purchase agreement offer or enter into a counteroffer without signing an Agency Law Disclosure form as requested. If the seller should refuse to return a signed copy of the Agency Law Disclosure, the broker or his agent must document the refusal to preserve the right to receive his fee from the seller. [CC §2079.15]

No particular method of **documenting the refusal** is given by legislation or regulations. However, the facts of the refusal are to be **w**ritten, dated and signed by the broker or his agent. What is to be done with the broker's documentation of the refusal is not mentioned.

However, the objective of these disclosures seems to be to eliminate disputes which might later arise over legal information contained in the Agency Law Disclosure regarding the conduct a seller or buyer might expect of a broker and his agents. Also, if a party claims they were never handed the Agency Law Disclosure, the broker's written documentation, created at the time of the refusal, would dispel such a claim — and preserve the fee.

Accordingly, documentation of the facts surrounding any refusal to sign a **timely presented** Agency Law Disclosure include:

- preparation of a *memorandum* form stating the facts surrounding the refusal;
- *mailing* a copy of the memorandum to all parties — including the party refusing to sign — together with a copy of the Agency Law Disclosure; and

- *retaining* a copy in the broker's records. [See Form 525 accompanying this chapter, *ante*]

Examples of other refusals to sign the Agency Law Disclosure, which do not have an effect on the collectibility of a brokerage fee, but require receipt and acknowledgement of the Agency Law Disclosure, occur when:

- an owner refuses to sign a seller's listing after the interview soliciting the listing;
- a "For Sale by Owner" (FSBO) seller refuses, on presentation of the purchase agreement offer, to accept or counter, or otherwise rejects an offer to purchase; or
- a buyer refuses to sign a purchase offer which is prepared and presented to the buyer by a selling broker for consideration.

Chapter 8 Types of listings

This chapter identifies the listing agreement as an employment contract and reviews the various types of listing agreements available to the real estate industry.

Listings as employment contracts

A listing agreement is a written employment contract between a client and a licensed real estate broker. On entering into a listing agreement, the broker and his sales staff are *retained and authorized* to perform real estate related services on behalf of the client in exchange for a fee. [Calif. Civil Code §1086(f); see Forms 102 accompanying Chapter 9 and 103 accompanying Chapter 16]

The client retaining a broker might hold an ownership interest in real estate, which he seeks to sell, lease or use as collateral to obtain trust deed financing.

Conversely, the client soliciting the services of a broker might be seeking to acquire an interest in real estate as a buyer, tenant or trust deed lender.

The **person employed** by a client to provide real estate services in expectation of compensation will always be a licensed real estate broker. Likewise, if a dispute arises with a client over the client's failure to pay a fee, only the broker employed in a writing (listing) signed by the client may pursue collection.

A real estate agent employed by the broker may have obtained the listing, but the agent did so on behalf of the broker and has no independent right to enforce the listing agreement. An **agent's right to a fee** arises under the agent's written employment agreement with the broker, not a listing agreement with the client. Through the broker-agent employment agreement, the agent is entitled to a share of the fees actually received by the broker on listings or sales in which the agent participated.

A licensed agent represents a broker as an *agent of the broker*. As the broker's agent, the agent performs on behalf of the broker (as well as the client) all of the activities the broker has been retained by the client to provide. Conversely, an agent providing real estate related services on behalf of a client may not do so independent of his broker. Thus, an agent employed by a broker is referred to as "the agent of the (client's) agent." [CC §2079.13(b)]

The listing agreement sets the **scope of the services** the broker is authorized to undertake while representing the client. Also, the listing authorizes the broker to perform brokerage services and to serve as the client's representative in the negotiation of a real estate transaction.

Further, the listing contains the client's promise to pay a fee, a promise given in exchange for the broker's **promise to use diligence** in his efforts to meet the objectives sought by the client in the employment.

Employment to act as an agent

The relationship created between the client and the broker by a *listing agreement* has two distinct legal aspects:

- an *employment relationship*; and
- an *agency relationship*.

The **employment relationship** established on entering into a listing agreement specifies the **scope of activities** the broker and his agents are to undertake in the employment and authorizes the broker to carry them out.

On the other hand, the **agency relationship** is imposed on the broker by law as arising out of the representation authorized by the employment. Agency carries with it the *fiduciary duties* of loyalty and full disclosure owed by the broker (and his sales agents) **to the client**. [See Form 305 accompanying Chapter 7]

As a **fiduciary**, the broker's conduct and the conduct of his agents under the employment are equated to the conduct required of a trustee acting on behalf of his beneficiary. This fiduciary duty, also called *agency*, survives the termination of the employment relationship. [CC §2079.16]

An oral agreement to perform brokerage services on behalf of a client imposes an agency law obligation on the broker and his agents to act as fiduciaries. In contrast, the client's oral promise to pay a fee does not entitle the broker to enforce collection of the fee due from his client. A fee agreement employing a broker to purchase or sell real estate, lease a property for over one year, or arrange trust deed financing is controlled by the rules of contract law. The fee agreement must be in a writing signed by the client before the broker can enforce his right to collect a fee from the client. [CC §1624(a)(4)]

Types of listing agreements

A variety of listing agreements exist, each employing and authorizing a broker to perform real estate related services under different conditions. The variations usually relate to the extent of the representation and type of services to be performed by the broker and his agents, or the event which triggers payment of a fee. [See Forms 102 accompanying Chapter 9 and 103 accompanying Chapter 16; see Figure 1 accompanying this chapter]

Most listing agreements are for the sale or purchase of single-family residential property. Others are for residential-income and nonresidential-income properties, such as industrial, motel/hotel, commercial, office, farm or unimproved properties.

Despite the application of various agreements to the type of property listed, all listings fall into one of two general categories:

- *open;* or
- *exclusive*.

Figure 1

LOAN BROKER LISTING

Exclusive Right to Borrow

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

1. RETAINER COMMITMENTS:

1.1 Owner hereby retains and grants to Broker the exclusive right to locate a lender and arrange a loan to be secured by the property described herein, for the period of this listing beginning on _____, 20_____ and terminating on _____, 20_____.

1.2 Broker to use diligence in the performance of this employment. Owner to cooperate with Broker to meet the objectives of this employment.

1.3 Owner hands $_____ to Broker for deposit into Broker's trust account for application to Owner's obligations under the attached Listing Package Cost Sheet. [See **ft** Form 107]

2. ADDENDA to this agreement include:

2.1 ☐ Credit Application [See **ft** Form 302]

2.2 ☐ Loan Purpose Statement [See **ft** Form 206]

2.3 ☐ Acknowledgement of Changing Conditions [See **ft** Form 203-1]

2.4 ☐ See Addendum for additional provisions [See **ft** Form 250]

2.5 ☐ _____

2.6 ☐ _____

3. BROKERAGE FEE:

NOTICE: The amount or rate of real estate fees is not fixed by law. They are set by each Broker individually and may be negotiable between Client and Broker.

3.1 Owner agrees to pay Broker _____ of the principal amount of the loan sought or obtained, IF:

a. Anyone procures a lender on the terms stated in this agreement, or on any other terms accepted by Owner during the period of this listing.

b. The property is withdrawn as collateral, or title is made unmarketable as collateral by Owner during the retainer period.

c. Owner terminates this employment of Broker during the retainer period.

d. Within one year after termination of this agreement, Owner or his agent enter into negotiations, which later result in a transaction contemplated by this agreement, with a lender whom Broker or a cooperating broker negotiated with during the period of this listing. Broker to identify prospective lenders by written notice to the owner within 21 days after termination of this agreement.

3.2 Should this agreement terminate without Owner becoming obligated to pay Broker a fee, Owner to pay Broker the sum of $_____ per hour of time accounted for by Broker, not to exceed $_____.

4. LOAN TERMS:

4.1 Loan sought is $_____, payable as follows:

a. Interest at an annual rate of no more than _____%, ☐ fixed, ☐ ARM type _____.

b. Payments due ☐ monthly, or ☐ _____, amortized over _____ years.

c. Final/balloon payment due _____, 20_____.

d. Late charge _____

e. Prepayment penalty _____

f. Loan escrow with _____

g. A lender's ALTA policy purchased by Owner in the amount of the loan.

Title Company _____

5. REAL ESTATE SECURING THE LOAN:

5.1 Type _____

Address _____

Referred to as _____

Vesting _____

5.2 The priority for the lien securing the loan sought will be ☐ first, or ☐ second.

5.3 Encumbrances of record:

a. A first loan in the amount of $_____, payable $_____ per month, until paid, including interest at _____%, ☐ ARM type _____, due _____, 20_____, impounds being $_____ monthly.

Lender: _____

b. A second loan in the amount of $_____, payable $_____ per month, until paid, including interest at _____%, ☐ ARM type _____, due _____, 20_____.

Lender: _____

c. Other encumbrance, bond, assessment or lien in the amount of $_____.

Lienholder _____

5.4 My purchase price on _____ was $_____.

Since the purchase of the property, I have invested in repairs and improvements approximately $_____.

5.5 The current fair market value is $_____.

Property taxes for the year 20_____ were $_____.

5.6 The property is occupied by _____ at a rental rate of $_____ per month, under a:

☐ rental agreement; or

☐ lease agreement which expires _____, 20_____.

a. ☐ See attached Rental Income Rent Roll. [See **ft** Form 380]

6. PERSONAL PROPERTY INCLUDED AS COLLATERAL:

6.1 Referred to as: _____

6.2 Encumbered for the amount of $_____, payable $_____ monthly, including interest at _____%, due _____, 20_____.

Lender _____

7. GENERAL PROVISIONS:

7.1 Broker is authorized to disclose, publish, discuss, and disseminate among prospective lenders the financial information supplied by Owner or credit agencies.

7.2 Owner warrants all necessary permits have been obtained for any additions, alterations, repairs, installations or replacements to the structure or its components, except _____.

a. ☐ See attached Condition of Property Disclosure. [See **ft** Form 304]

7.3 Owner authorizes Broker to cooperate with other agents and divide with them any compensation due.

7.4 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

7.5 The prevailing party in any dispute shall be entitled to attorney fees and costs, unless they proceed with litigation without first offering to enter into mediation to resolve the dispute.

7.6 This listing agreement will be governed by California law.

7.7 _____

I agree to render services on the terms stated above.

Date: _____, 20_____

Broker's name: _____

Broker's DRE Identification #: _____

Agent's name: _____

Agent's DRE Identification #: _____

Signature: _____

Address: _____

Phone: _____

Fax: _____

Email: _____

I agree to employ Broker on the terms stated above.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: _____, 20_____

Owner's Name: _____

Signature: _____

Owner's Name: _____

Signature: _____

Address: _____

Phone: _____

Fax: _____

Email: _____

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Open listings

An **open listing**, sometimes called a *nonexclusive listing*, does not grant exclusive rights to the listing broker and his agents to be the **sole representative** of the client, be he a buyer, tenant or borrower, or a seller, landlord or lender. The client can enter into open listings with as many brokers as he wants to without becoming obligated to pay more than one fee.

A brokerage fee under an open listing to sell real estate is due a broker only if the broker or his agent *procures* a ready, willing and able buyer and *presents* the owner with an offer from the buyer to purchase the listed property. The terms contained in the offer must be substantially the same as the terms sought by the owner under the listing, called a *full listing offer*, unless other terms offered by a buyer are accepted by the owner.

For a broker to be entitled to a fee under an **open listing**, the broker or his agents must present the offer to the owner before the property is sold to some other buyer located by another broker or by the owner directly. The offer must be submitted before the listing expires or is revoked by withdrawal of the property from sale or by the termination of the agency. [CC §1086(f)(3)]

The broker employed under an open listing is not obligated to use diligence in his efforts to locate a buyer. The broker only has a *best-effort obligation* since the broker does not "accept" the employment until he produces a buyer for the property. Thus, an open listing is legally classified as an *unilateral contract*. However, the **agency duties** of a fiduciary exist at all times under an open listing, and on locating a buyer the broker must commence his due diligence effort to make disclosures and close the transaction.

The first broker to submit an offer during this open listing period from a ready, willing and able buyer to purchase property on the listed terms, or on other terms accepted by the owner, has earned the agreed fee, unless the property has already been sold. None of the other brokers holding open listings from the owner are entitled to a fee.

Also, an open listing allows the owner to market the property himself. Thus, the owner may compete against the listing brokers to locate buyers himself. If he does, the owner does not become obligated to pay a fee under any open listing he may have agreed to.

A broker may also **represent a buyer** to locate property under an open listing agreement. A broker assisting a buyer to locate a suitable property among multiple listing service (MLS) listings held by other brokers should at least consider asking the **buyer to sign** an open listing should the broker be too reticent to solicit an exclusive representation.

An open listing does not need to contain an expiration date, unlike an exclusive agency or exclusive right-to-sell/buy listing which must have an **expiration date**.

Cancellation of an open listing

However, the owner *revoking* an open listing that contains an **expiration date** owes a fee to the broker should the owner personally consummate a sale with a prospective buyer located by the broker during the listing period, or should the owner revoke the listing for the mere purpose of escaping payment of the agreed fee. [**Heffernan** v. **Merrill Estate Co.** (1946) 77 CA2d 106]

Conversely, an open listing without an expiration date may be terminated by the owner at any time without becoming obligated to pay a fee. No fee is due under an open listing for an unlimited time on the *good-faith withdrawal* of the property from the market or on the premature *termination* of the employment before the broker has submitted a full listing offer. [**Tetrick** v. **Sloan** (1959) 170 CA2d 540]

However, an open listing may contain a provision calling for the owner to pay the listing broker a set amount, at an agreed time, for services other than procuring a buyer, such as the preparation of disclosure documents needed by the owner to sell the property, including:

- property disclosures (transfer disclosure statements, natural hazard disclosures, annual property operating data, etc.) [See Forms 304 accompanying Chapter 24, 314 accompanying Chapter 28, and 352 accompanying Chapter 35];
- carryback financing disclosures [See Form 300 accompanying Chapter 36];
- multiple listing service publications;
- property profiles [See **first tuesday** Form 306];
- termite/well/septic clearances; and
- occupancy certificates. [CC §1089]

Although the broker does not have a due diligence requirement under an open listing, the listing broker owes a **duty to prospective buyers** to make a full disclosure of the property's condition, as known to the broker, based on the broker's **visual inspection** of the property prior to the buyer and seller entering into a purchase agreement.

Exclusive listings

Under the category of **exclusive listings**, a broker receives the **sole right**:

- to represent an owner by marketing the listed property and locating a buyer or tenant; or
- to represent a buyer or tenant by locating property sought by the buyer or tenant.

The sole right to represent an individual or entity does not exist in an open listing.

Exclusive listings require an agent to **use diligence** in his efforts to fulfill his client's objectives to locate a buyer for the property. An exclusive listing must also provide for a **specified period of employment** by including a date for the expiration of the employment, such as 90 or 180 days after its commencement. If an expiration date is not included in an exclusive listing, the broker faces suspension or revocation of his license by the California Department of Real Estate (DRE). [Calif. Business and Professions Code §10176(f)]

Two types of **exclusive employment** agreements exist:

- an *exclusive agency agreement* for a seller or buyer; and
- an *exclusive right-to-sell* or *right-to-buy* listing agreement.

Both types of exclusive listings establish the broker and his agents as the sole licensed real estate representatives of the client (seller or buyer). However, the types are distinguished by whether or not the broker has any right to a fee when the property is sold or located solely by the efforts of the client.

Under the fee provision in an **exclusive agency agreement**, the broker does not earn a fee when the client, acting independently of any other broker or the listing broker, accomplishes the objective of the employment himself, i.e., selling the listed property or locating and buying the property sought.

Conversely, under the **fee provision** in an exclusive right-to-sell/buy agreement, the broker earns a fee no matter who produces the buyer or locates the property sought under the listing, be it the client, another broker or other representative of the client, or the listing broker.

Exclusive agency variations

The **exclusive agency listing** is a hybrid of the open and the exclusive listings. The variation is rarely used by brokers as a practical matter and seems best suited to academic discussion.

Under an exclusive agency listing, the client employs the broker as his *sole agent*, as he does in an exclusive type of listing. Also, the broker is entitled to a fee on any transaction in which he, a finder or another agent produces a buyer. (A finder is an unlicensed agent with no authority to negotiate.)

However, under the exclusive agency listing, an **owner retains the right** to sell the property to any buyer he locates without becoming obligated to pay the broker a fee. Likewise for a buyer under an exclusive agency listing who finds the property sought on his own.

As with open listings, brokers are reluctant to spend much time and energy under exclusive agency circumstances. The bottom line is an obstructed brokerage effort with diminished benefits to both the client and broker.

Exclusive right-to-sell listings

An **exclusive right-to-sell listing** affords a real estate broker the greatest fee protection. This type of listing makes the broker the sole agent of the owner to market the property and negotiate with all potential buyers and their agents to sell the property. The broker is entitled to a fee regardless of who procures the buyer. Under an exclusive right-to-sell agreement, the owner relinquishes his right to list the property with other agents and to defeat the broker's entitlement to compensation by selling the property himself.

An owner of real estate, on entering into an exclusive right-to-sell listing agreement, grants a broker the **right to locate a buyer** for the property prior to the expiration of the period of employment specified in the listing agreement. The broker is entitled to the agreed-to fee in the listing if, during the listing period:

- the property is sold on any terms, no matter who produced the buyer; or
- the broker or his agent presents the seller with a bona-fide offer from a ready, willing and able buyer on terms sought by the seller under the listing, or on other terms accepted by the seller. [CC §1086(f)(1)]

Exclusive right-to-sell listings give a broker and his agents the greatest incentive to work toward attaining the client's goal of locating a buyer. The seller's broker does not compete with his client to sell the property; they work together to achieve the sale.

Buyer's brokers know that sellers who enter into exclusive right-to-sell listings have committed themselves to working with brokers. Also, listed sellers usually have been counseled on prices of comparable properties and current market conditions. Thus, the listed seller is more likely to accept a reasonable of-

fer. Sellers who employ brokers under an exclusive right-to-sell listing are not reserving the right to make their own deal with a buyer and avoid payment of a fee, as is usually the case under exclusive agency or open listing arrangements.

Buyer's brokers are quite comfortable exposing their clients to properties that are listed exclusively. The exchange of information is greater between brokers when the listing broker is authorized to share fees, another primary reason the exclusive right-to-sell listing is the variation most widely used by brokers.

Exclusive right-to-buy listings

For brokers and their agents, an **exclusive right-to-buy listing** creates a positive and contrasting activity from listing and marketing property. A buyer's listing employs the broker to locate qualified properties to be purchased by a potential buyer the broker exclusively represents.

As with an exclusive right-to-sell listing, the right-to-buy variation provides for a brokerage fee if the buyer acquires property during the listing period of the type sought as described in the buyer's listing.

Also, the exclusive right-to-buy listing provides greater incentive for brokers and their agents and imposes a duty to work **diligently and continuously** to meet their buyers' objectives of locating and purchasing suitable real estate.

The buyer as a client benefits under an exclusive right-to-buy listing due to the greater likelihood the broker will find the particular type of property sought. Brokers have continuous access to all available properties and will investigate and qualify properties as suitable before they are presented to the buyer, and will advise the buyer on the pros and cons of each property presented.

A buyer's broker locating properties listed by other brokers does not become a dual agent or lose his status as the buyer's exclusive agent merely because he works with listing brokers and his fee is paid by the seller.

A broker who seeks out and locates properties at the request of the buyer negotiates the purchase terms as the **buyer's agent** regardless of who pays the fee, which is nearly always paid by the seller from the proceeds of the sales price paid by the buyer.

Net listings

A **net listing** is used only with sellers, not buyers, and can be structured as either an open or an exclusive type of listing. The net listing has more to do with the way compensation is calculated than with whether it is exclusive or open.

The broker's fee is not predetermined by, or based on, a percentage of the selling price.

Instead, the seller's net sales price, excluding brokerage fees and closing costs, is established in the listing agreement. As his brokerage fee, the broker will receive whatever amount the buyer pays in excess of the seller's net figure and closing costs.

However, the broker must disclose to the seller the full sales price paid by the buyer and the amount of the broker's residual fee before the seller accepts an offer on a net listing. Failure to **disclose the benefits** the broker receives on any transaction leads to the loss of the entire fee. [Bus & P C §10176(g)]

For example, if the seller enters into a net listing agreement with a real estate broker for a net sale price of $200,000, the broker will not receive a fee if the property sells for $200,000 or less.

On the other hand, if the property sells for $220,000, the broker's fee is $20,000.

Net listings tend to be unpopular with DRE and consumer protection organizations. They have been outlawed in some states.

By their nature, net listings are particularly prone to claims from buyers and sellers that the broker has been involved in misrepresentations and unfair dealings. These claims are generally based on an improper valuation of the property at the time of the listing or a failure to disclose the fee received by the broker when the property sells.

If the seller thinks the broker's fee is excessive, the seller is likely to complain he was improperly advised about the property's fair market value when employing the broker.

Net listings should be used very sparingly, if at all. If a net listing is used, complete disclosures as to the property's value, the price paid by a buyer and the resulting amount of the fee must occur.

Option listing variation

An **option listing** is normally a variation of the exclusive right-to-sell listing.

Its unique feature is the additional element of a grant to the broker of an **option to buy** the property at a predetermined price, if the property does not sell during the listing period.

The broker wears two hats when holding an option listing: one as an agent, the other as a principal.

The temptation for misrepresentation is quite apparent. The concurrent status of agent and principal is a conflict of interest for the broker. As a result, the seller's broker might fail to market the property aggressively, with a view toward buying it himself and reselling it at a profit. Likewise, the broker might neglect to inform the seller about all inquiries into the listed property.

As always, brokers are required to disclose any outstanding offers or other factors affecting the seller's decision to sell when the broker exercises the option. [**Rattray** v. **Scudder** (1946) 28 C2d 214]

The broker's exercise of a purchase option contained in a listing agreement requires the broker to disclose to the seller the full amount of the broker's earnings (profit) and obtain the seller's written consent to the earnings prior to or at the time the broker exercises the option. [Bus & P C §10176(h)]

Should market prices rapidly increase after the listing broker exercises his option to purchase, allowing a quick resale by the broker at a substantial profit, the seller might claim the profit should be his and resort to litigation to recover it under the belief he has been cheated by his agent.

As with net listings, option listings should be used with great care, if at all. Only after full disclosure by the broker about all material facts relating to the property and the identity of all potential buyers and their offers should the option be exercised and the property acquired by the broker from the client.

Guaranteed sale variation

A **guaranteed sale listing** is also usually a variation of the exclusive right-to-sell listing. Brokers have been known to use the guarantee feature to boost sales activity during recessionary periods.

A guaranteed sale listing is distinct from a regular, exclusive right-to-sell listing in that it is the broker who grants the option to his seller. The **seller** is given the right to call on the broker to buy the property at

a predetermined price if the property does not sell during the listing period. In this respect, the guaranteed sale listing establishes a reverse role for the seller from the option listing should the property fail to sell during the listing period.

The difference with the guaranteed sale listing is that the seller, not the broker, has the right to exercise the option by accepting the broker's irrevocable offer (promise) to buy the listed property.

The guaranteed sale variation can be attractive to sellers who, on account of job transfers, sudden unemployment or other financial factors, must sell at all costs. The benefit to the seller is the assurance of a back-up, last-resort sale during recessionary periods of market uncertainty, a risk some brokers are willing to take.

As with the option listing, the broker may tend not to work the listing vigorously if the price he will pay under the guarantee is much lower than the amount the seller would net on a sale at current market prices. Thus, the broker would stand to acquire the property at a bargain price if it does not sell during the listing period.

In practice, if a buyer is not produced during the listing period, a desperate seller may have no choice but to sell to the broker since the seller delegated complete control to the broker to locate a buyer.

The broker's advantage, however, is lessened by a DRE regulation which disallows the inclusion of advance fees in a guaranteed sale listing. [Department of Real Estate Regulations §2970(b)(5)]

As always, the broker must disclose all offers and the status of potential offers during the listing period and at the time the seller exercises his option to sell to the broker.

Other listings

Other listing variations contain provisions for the broker to obtain a tenant for a landlord, lease a property for a tenant, arrange a loan on behalf of a borrower who owns real estate or holds a trust deed note, or find a borrower for a lender seeking to make such a loan. Unimproved real estate, business opportunities and mobile homes can also be the subject of the employment. All of these employment variations can be used with the open or exclusive type of listing agreements.

Chapter 9 The exclusive right-to-sell listing agreement

This chapter presents the seller's exclusive right-to-sell listing agreement along with instructions for an agent's use of the form.

When the fee is earned

A broker's right to a fee for representing his client originates with a written employment agreement, commonly called a *listing*, entered into by the client who employs the broker. [**Crane** v. **McCormick** (1891) 92 C 176]

By entering into an exclusive right-to-sell listing agreement, an owner of real estate employs a broker to act on his behalf to locate a buyer for his property.

The right-to-sell listing agreement grants the broker **sole authority** to market the property, locate a buyer and negotiate a sale. It also specifies the fee amount the seller agrees the broker is to receive and the conditions which must be met by the broker or acted on by the seller for the broker to earn the fee.

For example, an exclusive right-to-sell listing entitles a broker to **collect a fee** from a seller in several instances, including when:

- the broker locates a ready, willing and able buyer and submits the buyer's *full listing offer* to the seller [See Form 102 §3.1(a) accompanying this chapter];
- the seller *accepts an offer* submitted by the broker [See Form 102 §3.1(a)];
- *anyone purchases* the property during the listing period [See Form 102 §3.1(a)];
- the seller *withdraws the property* from the market or interferes with the broker's performance [See Form 102 §3.1(b); see Chapter 11];
- the seller *terminates the agency* of the broker prior to expiration of the listing period [See Form 102 §3.1(c); see Chapter 11];
- a prospective buyer with whom the broker negotiates during the listing period recommences negotiations to purchase the property during the *safety period* following the expiration of the listing. [See Form 102 §3.1(d); see Chapter 12]; or
- the seller *acquires replacement real estate* in a transaction negotiated by the broker. [See Form 102 §3.2]

Analyzing the exclusive employment

The exclusive right-to-sell listing agreement, **first tuesday** Form 102, is used by brokers and their agents to solicit employment by a prospective seller of real estate. It is prepared and submitted as the broker's offer to act as the seller's exclusive real estate agent to market the seller's property, locate a ready, willing and able buyer and negotiate a sale. In exchange, the seller *promises to pay* a fee on any sale of the property entered into during the period of employment.

Formal documentation of an obligation to pay a fee — a written agreement signed by the seller — is the legislatively enacted and judicially mandated requisite to the *right to enforce collection* of a brokerage fee from the seller.

For the listing agent, the seller's listing agreement and its addenda serve as a checklist for the **contents of a listing package** or marketing package on the property to be handed to prospective buyers for review. The package contains information about the property known to the seller or the broker and his listing agent. The marketing process requires information about the property to be handed to prospective buyers before they enter into a purchase agreement with the seller.

Each section in Form 102 has a separate purpose and need for enforcement. The sections include:

1. *Brokerage services:* The employment period for rendering brokerage services, the broker's due diligence obligations and any advance deposits by the seller are set forth in sections 1 and 2.

2. *Brokerage fee:* The seller's obligation to pay a brokerage fee, the amount of the fee and when the fee is due are set forth in section 3.

3. *Conditions:* The broker's authority to receive a purchase offer, accept a good-faith deposit, enter into fee-splitting arrangements with other brokers and enforce the listing agreement is set forth in section 4.

4. *Property description and disclosures:* Identification of the listed real estate and personal property, the terms of existing financing and the conditions of the property are set forth in sections 5, 6, and 7.

5. *Sales terms*: The price and terms sought by the seller for the sale, exchange or option of the property are set forth in sections 8, 9, 10 and 11.

6. *Signatures and identification of the parties:* On completion of entries on the listing form and any attached addenda, the seller and the broker (or his listing agent) sign the document consenting to the employment.

Preparing the seller's listing agreement

The following instructions are for the preparation and use of the Seller's Listing Agreement — Exclusive Right to Sell, Exchange, or Option, **first tuesday** Form 102, with which a seller employs a broker as his exclusive agent to market a property for sale and locate a buyer.

Each instruction corresponds to the provision in the form bearing the same number.

*Editor's note — **Check** and **enter** items throughout the agreement in each provision with boxes and blanks, unless the provision is not intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Document identification:

Enter the date and name of the city where the listing is prepared. This date is used when referring to this listing agreement.

1. **Retainer period:**

   1.1 *Listing start and end date:* **Enter** the date the brokerage services are to commence.

SELLER'S LISTING AGREEMENT

Exclusive Right to Sell, Exchange or Option

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

1. RETAINER PERIOD:

1.1 Seller hereby retains and grants to Broker the exclusive right to market, solicit and negotiate for the disposition of the property, through sale, exchange or option, for the period beginning on _____, 20_____ and terminating on _____, 20_____.

1.2 Broker agrees to use diligence in the performance of this employment.

2. SELLER'S DEPOSIT:

2.1 Seller hands $_____ to Broker for deposit into Broker's trust account for application to Seller's obligations under the attached Listing Package Cost Sheet. [See **ft** Form 107]

3. BROKERAGE FEE:

NOTICE: The amount or rate of real estate fees is not fixed by law. They are set by each Broker individually and may be negotiable between Client and Broker.

3.1 Seller agrees to pay Broker _____ of the price sought or obtained, IF:

a. Anyone procures a buyer, exchanger or optionee on the terms stated in this agreement or on any other terms accepted by Seller during the period of the listing.

b. The property is withdrawn from sale, transferred or leased without Broker's consent, which will not be unreasonably withheld, or otherwise made unmarketable by Seller during the period of the listing.

c. Seller terminates this employment of Broker during the period of the listing.

d. Within one year after termination of this agreement, Seller or his agent enter into negotiations, which later result in a transaction contemplated by this agreement, with a prospective buyer whom Broker or a cooperating broker negotiated with during the period of this listing. Broker to identify prospective buyers by written notice delivered personally or electronically, or mailed to Seller within 21 days after termination of this agreement. [See **ft** Form 122]

3.2 Should Seller acquire replacement property in a transaction in which Broker negotiates, Seller to further compensate Broker on acquisition of the replacement property based on the fee amount stated in §3.1.

3.3 Should this agreement terminate without Seller becoming obligated to pay Broker a fee, Seller to pay Broker the sum of $_____ per hour of time accounted for by Broker, not to exceed $_____.

4. GENERAL PROVISIONS:

4.1 Broker is authorized to place a For Sale sign on the property, inspect the property's condition, verify any operating income or expenses and publish and disseminate property information to meet the objectives of this employment.

4.2 Seller authorizes Broker to cooperate with other brokers and divide with them any compensation due.

4.3 Broker is authorized to accept, on behalf of any buyer, an offer and deposit.

4.4 Offers to purchase received by Broker may be submitted to Seller personally or electronically, or by USPS postage-prepaid mail.

4.5 Buyer shall not have possession of the property before _____.

4.6 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

4.7 The prevailing party in any dispute shall be entitled to attorney fees and costs, unless they proceed with litigation without first offering to enter into mediation to resolve the dispute.

4.8 This listing agreement will be governed by California law.

5. REAL ESTATE:

5.1 Type _____

Referred to as _____

Vesting _____

5.2 Encumbrances of record:

a. A first loan in the amount of $_____, payable $_____ per month until paid, including interest at _____%, ☐ ARM, type _____, impounds being $_____ monthly.

Lender _____

b. A second loan in the amount of $_____, payable $_____ per month, including interest at _____%, due _____, 20_____.
Lender_____

c. Other encumbrance, bond, assessment or lien in the amount of $_____.
Description of debt _____.

6. PERSONAL PROPERTY INCLUDED:

6.1 Referred to as _____

6.2 Encumbered for the amount of $_____, payable $_____ monthly, including interest at _____%, due _____, 20_____.
Lender _____

7. ADDENDA attached to this agreement regarding the listing package include:

a. ☐ Agency Law Disclosure (mandated on one-to-four residential units) [See **ft** Form 305]
b. ☐ Federal Residency Declarations [See **ft** Form 301]
c. ☐ Condition of Property Disclosure. [See **ft** Form 304] Solar Shade Control Notices sent or received by Seller to be handed to Buyer on acceptance.
d. ☐ Ordinance Compliance [See **ft** Form 307]
e. ☐ Natural Hazard Disclosure Statement [See **ft** Form 314]
f. ☐ Lead-Based Paint Disclosure [See **ft** Form 313]
g. ☐ Residential Earthquake Hazards Report [See **ft** Form 315]
h. ☐ Annual Property Operating Data Sheet [See **ft** Form 352, or **ft** Forms 562 and 381 for a SFR]
i. ☐ MLS property profile
j. ☐ Listing Package Cost Sheet [See **ft** Form 107] (See also §2.1)
k. ☐ Criminal Activity and Security Disclosure [See **ft** Form 321]
l. ☐ Right to Enter and Exhibit Unit to Buyers [See **ft** Form 116]
m. ☐ _____

7.1 Additional addenda not part of the listing package include:

a. ☐ Seller's Net Sheet [See **ft** Form 310]
b. ☐ Work Authorization [See **ft** Form 108] (See also §§2.1 and 8.2)
c. ☐ _____

8. SALE TERMS:

8.1 Price sought is $_____, payable:

a. ☐ In cash, or cash to a new loan obtained by Buyer;
b. ☐ Cash to the existing loan(s) and Buyer to assume the loan(s) with Lender(s);
c. ☐ Cash down payment of no less than $_____. Buyer to assume the existing loan(s) with Lender(s) in the amount of $_____, and execute a $_____ note and trust deed to Seller bearing _____% interest with monthly amortization over _____ years, all due _____, 20_____.

8.2 Seller agrees to pay for the following costs on a sale:
(See also §§2.1, 7j and 7.1b)

a. ☐ Property inspection report
b. ☐ Natural hazard disclosure report
c. ☐ Pest control clearance
d. ☐ CLTA title insurance
e. ☐ FHA/VA appraisal fee
f. ☐ Non-recurring loan costs of Buyer
g. ☐ Home warranty policy
h. ☐ Smoke detector and water heater anchor installation
i. ☐ Local ordinance sale or occupancy compliance
j. ☐ Well water quality and quantity reports
k. ☐ _____
l. ☐ _____

9. EXCHANGE TERMS:

9.1 Seller will exchange the property for or reinvest the sales proceeds in the following property:
Type _____
Location _____
Assume or originate financing up to $_____.

10. OPTION TERMS:

10.1 For option money in the amount of $_____, Seller will grant an option to purchase on any of the sale terms stated above, for a period of _____ months.

11. OTHER TERMS:

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____

I agree to render services on the terms stated above.	**I agree to employ Broker on the terms stated above.**
	☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: _____, 20_____	Date: _____, 20_____
Broker's Name: _____	Seller's Name: _____
Broker's DRE Identification #: _____	Signature: _____
Agent's Name: _____	Seller's Name: _____
Agent's DRE Identification #: _____	Signature: _____
Signature: _____	Address: _____
Address: _____	_____
_____	Phone: _____
Phone: _____	Fax: _____
Fax: _____	Email: _____
Email: _____	

Enter the expiration date of the employment period. The expiration must be set as a specific date on which the employment ends since an exclusive listing is being established.

1.2 *Broker's/agent's duty:* **States** the broker and his agents promise to use diligence in their effort to locate a buyer for the listed property. The agency duties a broker and his agents owe the seller are always implied, if not expressed in writing.

2. **Seller's deposit:**

2.1 *Advance fees and costs:* **Enter** the amount of deposit negotiated to commence the brokerage services.

Fill out and **attach** the addendum detailing the services to be rendered or costs to be incurred and charged against the deposit. [See Form 107 accompanying Chapter 13]

3. **Brokerage fee:**

3.1 *Fee amount:* **Enter** the fee amount negotiated to be paid as a percentage of the sales price or a fixed dollar amount. This amount will be paid when any one of the following conditions occur triggering payment:

a. *Fee on any sale*: **States** the brokerage fee is earned and due on 1) presentation during the listing period of an offer for the price and terms sought under the listing, or 2) any sale, exchange or option of the property agreed to by the seller during the listing period. [See Form 102 §3.1(d) for fee due on post-listing period sales]

b. *Fee on withdrawal*: **States** the brokerage fee is earned and due if the seller, without the broker's consent, withdraws the property from the market or significantly interferes with the broker's ability to market the property.

c. *Fee on termination*: **States** the brokerage fee is earned and due if, during the listing period, the seller terminates this employment.

d. *Safety clause fee*: **States** the brokerage fee is earned and due if, within one year after the listing expires, a prospective buyer whom the broker or his agent negotiated with during the listing period and whose name the broker registered with the seller on expiration of the listing, negotiates to buy, exchange for or acquire an option to buy the listed property, and the negotiations culminate in a binding agreement with the seller. Within 21 days after expiration of the listing period, the broker must provide the seller with a list of the prospective buyers. [See Form 122 accompanying Chapter 12]

3.2 *Replacement property fee:* **States** an additional fee is earned and due, based on the same terms as the fee for a sale of the listed property if, through negotiations involving the broker, the seller acquires replacement property, such as occurs in a IRS §1031 tax-exempt transaction.

3.3 *Hourly fee:* **Enter** the negotiated dollar amount for the broker's per-hour fee. The hourly fee is earned for time spent on behalf of the seller if the property is not sold, exchanged or optioned after a diligent effort is made to market the property and locate a buyer. **Enter** the maximum amount the broker can earn on a per-hour basis.

4. **General provisions**:

4.1 *For Sale signs:* **Authorizes** the broker to place *For Sale* signs on the property and publish information (in multiple listing services (MLSs), classified ads, broadcasts, fliers, etc.) regarding the property described in the listing.

4.2 *Authority to share fees:* **Authorizes** the broker to cooperate with other brokers and share with them any fee paid on any transaction.

4.3 *Authority to accept deposits:* **Authorizes** the broker to work with buyers to obtain offers and receive good-faith deposits.

4.4 *Handling offers:* **Authorizes** the broker to deliver offers from buyers to the seller in person, by electronic transmission (fax or email) or by mail.

4.5 *Vacating the property:* **Enter** the date or event on which the seller (or a tenant) will vacate the premises, such as "the close of escrow."

4.6 *Mediation provision:* **Provides** *for the parties to enter into non-binding mediation to resolve a dispute remaining unsolved after 30 days, prior to filing an action.*

4.7 *Attorney fees:* **Entitles** the prevailing party to attorney fees if litigation results from the seller's failure to pay fees or the broker's breach of an agency duty, unless the prevailing party proceeded with litigation without first offering to enter into mediation.

4.8 *Choice-of-law provision:* **States** California law will apply to any enforcement of this employment.

5. **Real estate:**

5.1 *Type of real estate:* **Enter** a brief description of the type of real estate to be sold, such as apartment, commercial, office, industrial, land or single-family residence (SFR), its legal description or common address, and the vesting of its title.

5.2 *Encumbrances of record:* **Enter** all financing of record which are liens on the real estate, including information on amounts, payments, interest rates, impounds, due dates and type of lenders.

Loan information submitted to the MLS or included in a marketing (listing) package gives a prospective buyer the alternative of making an offer which includes the existing loan as part of the purchase price.

6. **Personal property included:**

6.1 *Description:* **Enter** a brief description of any personal property included in the price. If numerous items or inventory are included in the sale, **prepare** and **attach** an exhibit for inventory/personal property and refer to it by **entering** "See attached Personal Property Inventory – Transferred with Real Estate." [See **first tuesday** Form 256]

6.2 *Encumbrances:* **Enter** the balance, terms of payment, interest rate, due date and the name of the lender on any financing secured by the personal property.

7. **Listing package addenda: Check** the appropriate boxes and **attach** each addendum to be prepared or reviewed by the seller for inclusion in the listing package. The addenda will contain the seller's representations about the property needed by the broker to properly market the property to locate and induce prospective buyers to purchase the property.

Editor's note — The Agency Law Disclosure is mandated to be included in the seller's listing agreement regarding one-to-four unit residential property under penalty of a lost fee on the resulting sale. The applicable federal and California residency and withholding disclosures are also most prudently presented at the listing stage since the information is known to the broker and might be of financial concern to the seller. [See Form 305 accompanying Chapter 6]

The other addenda listed are disclosures about the property which are prepared by the seller and received by the broker to be included in the listing package for delivery to prospective buyers so they will be informed of the property's condition before the seller accepts an offer or makes a counteroffer.

7.1 *Non-listing package addenda*: **Check** the appropriate boxes and **attach** each addendum prepared by the broker and reviewed with the seller to disclose the costs the seller will incur on the sale of the property.

8. **Sale terms:**

8.1 *Price/terms sought:* **Enter** the dollar amount of the price sought for the property by the seller.

a. *Cash price*: **Check** the box to provide for the price to be paid in cash on closing. The seller is to discharge and clear all liens from title, either himself or through escrow.

b. *Loan assumption*: **Check** the box if the seller will allow a buyer to pay a cash down payment (to cash out the seller's equity) and assume the loan(s) referenced in section 5.2.

c. *Carryback financing*: **Enter** the amount of the down payment the seller will accept. **Enter** the amount of any existing financing the seller will allow a buyer to assume. **Enter** the amount, terms of payment, interest rate, the number of years for monthly amortization payments, and the due date for carryback financing the seller will accept from a creditworthy buyer.

8.2 *Sale and closing costs:* **Check** the box for each item of expense the seller will incur to market the property. Prudent practice dictates the seller proceed to promptly prepare disclosures and authorize the inspections, reports or clearances needed for the broker to properly market the property and inform prospective buyers about its condition before the seller enters into an agreement to sell the property.

9. **Exchange terms:**

9.1 *Acquisition property:* **Enter** the type of property, its location (city, county or state) and the dollar amount of equity and debt on replacement property the seller is willing to acquire with the net proceeds from a sale of the listed property or by an exchange of its equity.

10. **Option terms:**

10.1 *Seller will option:* **Enter** the amount of option money the seller would accept to grant an option to a buyer. **Enter** the period during which the option may be exercised.

11. **Other terms: Enter** any special provision to be included in the listing.

Signatures

Broker's/Agent's signature: **Enter** the date the listing is signed. **Enter** the broker's name and DRE license number. **Enter** any agent's name and DRE license number. **Enter** the broker's (or agent's) signature. **Enter** the broker's address, telephone and fax numbers, and email address.

Seller's signature: If *additional* sellers are involved, **check** the box, **prepare** a Signature Page Addendum form referencing this listing agreement, and **enter** their names and **obtain** their signatures until all sellers are individually named and have signed. **Enter** the date the seller signs the listing and the seller's name. **Obtain** the seller's signature. **Enter** the seller's address, telephone and fax numbers, and email address.

Chapter 10 The listing's exclusive aspect

This chapter explores the exclusive aspect of a broker's employment as established by the fee provision in a seller's listing agreement.

A fee earned on any sale

An exclusive right-to-sell listing agreement documents the employment of a broker by an owner of real estate. In its **fee provision**, the owner agrees to pay the broker a fee if his property is sold, exchanged or optioned during the listing period, regardless of whether the broker's or his agent's activities brought about the transaction. [**Carlsen** v. **Zane** (1968) 261 CA2d 399]

Consider a broker who is employed under an exclusive listing agreement to locate a buyer for a property. The broker and his listing agent diligently investigate and market the property, but have not located a qualified buyer willing to make an offer.

During the listing period, the property owner enters into a purchase agreement (or an exchange or option to sell agreement) with a buyer represented by another broker. Later, after the listing expires, an escrow is opened and the property is acquired by the other broker's buyer.

On discovery of the sale, the listing broker demands a fee from the owner. The owner claims the listing broker is not owed a fee since another broker **procured the buyer** and the property could not be considered sold until escrow closed — a date after the listing period expired.

Here, an exclusive right-to-sell listing, due to the *exclusive representation clause* in its fee provision, requires the owner to pay the listing broker a fee on any sale, exchange or option of the property entered into during the listing period. The fee is owed regardless of who produced the buyer or when escrow closed. [See Form 102 §3.1(a) accompanying Chapter 9]

However, a broker employed under an exclusive listing must himself, or through his agents, *exercise due diligence* in gathering data on the condition of the property, marketing the property and locating a buyer. The broker will lose his right to a fee under the exclusive representation clause should the owner cancel the listing due to the broker's (or his agent's) failure to exercise due diligence.

Due diligence

Consider an agent who obtains a listing on a form which contains an exclusive representation clause in the listing's fee provision. No effort is made to market the property. Instead, the agent chooses only to place a "For Sale" sign on the property and a listing of the property's availability in a multiple listing service (MLS).

The agent limits his activities to acquiring listings and refuses to assist buyers or their agents, except to make the listed property available for inspection through a lock-box arrangement.

The agent does not prepare disclosures or provide a listing package regarding the condition of the property, hazards, operating cost or other releases of information on the property. He also does not obtain property profiles, inspection reports or pest control reports. All these items are left to a buyer's agent to

obtain or for a buyer to demand in escrow. The listing agent plans to have a *transaction coordinator* (TC) prepare the documents and obtain the seller's signature prior to close of escrow — at an extra charge to the seller for the TC's services.

None of these limitations on the marketing services provided by the agent are disclosed to the seller, except for the cost of the TC to close a sale.

Editor's note — To provide a listing package to market the property, this agent should have retained a "listing coordinator" to order out reports and prepare documents disclosing the property's condition to be handed to prospective buyers and their agents.

No potential buyers are produced by the agent

The seller, dissatisfied with the agent's marketing efforts, cancels the listing without the agent's consent. Another broker is employed by the seller to market the property. The property is sold under the new listing, but during the listing period remaining on the canceled listing.

The listing agent's broker makes a demand on the seller to pay a fee since the property was sold during the original listing period. The seller claims the agent's lack of *due diligence* in marketing the property and locating buyers bars the broker from collecting a brokerage fee.

Is the listing broker entitled to the fee called for in the exclusive listing agreement?

No! The listing agent's efforts to market the property and locate buyers were insufficient to entitle his broker, and thus himself, to a fee on any sale after the seller canceled the listing.

When employed under an exclusive listing agreement, a broker and his agents are obligated:

- to inform the seller about the brokerage services which will and will not be rendered; and
- to diligently perform the agreed-to services in pursuit of buyers who are ready, willing and able to purchase the listed property.

Agents are expected to work in cooperation with other agents who represent buyers and to engage those buyers who are not represented by an agent. Listing agreements authorize the agent to prepare offers and accept deposits from buyers. [See Form 102 §4.3]

A diligent effort is required on the part of the agent to fulfill his agency duty owed under an exclusive listing by making a concerted and **continuing effort** to locate a buyer and do so while performing at a level which meets the owner's reasonable expectations. Otherwise, the owner has *good cause to terminate* the agency and cancel the listing without becoming obligated to pay a fee on cancellation or on a later resale. [**Coleman** v. **Mora** (1968) 263 CA2d 137]

An agent's written (and if not written, implied) promise on entering into an exclusive listing is to *diligently perform* his agency obligations, which includes applying his abilities to investigate, market and negotiate a sale of the listed property.

The **diligent effort** of a broker under an exclusive listing is measured by the conduct and actions taken by the broker and his agents, which include:

- *analyzing the property*, a responsibility imposed on the broker or his agent to gather at the earliest opportunity — before marketing begins — as much information about the listed property as a competent broker would include in a listing package to be handed to prospective buyers, ranging from

inspecting the property, obtaining third-party reports on the property and reviewing a title profile, to reporting its income, expenses and any local information about the surrounding area [**Jue** v. **Smiser** (1994) 23 CA4th 312]; and

- *marketing the property*, which includes advertising in MLSs or other broker-associated publications, making phone calls, putting up "For Sale" signs, distributing fliers, holding open house events if appropriate, broadcasting the property at pitch sessions, etc., and advising prospective buyers and their agents about the property by handing them the information package (disclosures) previously prepared.

An agent must keep records to provide proof he has exercised due diligence in his analysis and marketing of a property if he is to avoid unwarranted cancellation of the listing. Records of all solicitations, contacts, money spent, advertisements placed, buyers contacted, etc., should be maintained on worksheets in a file on the listed property. [See **first tuesday** Forms 520 and 525 accompanying Chapter 6]

A ready, willing and able buyer

Occasionally, during a period of rising real estate prices, a seller who employs an agent to locate a buyer will *reject* a full listing offer submitted by the agent.

Rejection occurs by either:

- the seller's *refusal to accept* the offer; or
- the seller's *counteroffer* on different terms.

Consider an agent under a listing who locates a buyer who makes an offer to buy property on substantially the same terms sought by the seller in the listing, called a *full listing offer*.

The offer is submitted to the seller, who refuses to accept the offer. Instead, the listing agent is instructed to prepare a counteroffer at a higher price, which the seller signs, believing the buyer should pay more for the property than the listed price.

The counter to the full listing offer is submitted to the prospective buyer, who rejects it and terminates negotiations.

The listing agent's broker demands payment of a fee, which the seller refuses to pay. The seller claims a fee is not due the broker since the counteroffer was rejected and a sale of the property did not occur.

Here, the broker has **earned a fee** under any type of listing agreement, open or exclusive, since the broker or one of his agents:

- *located* a financially qualified (able) buyer who was also ready and willing to purchase the property on the terms of sale stated in the listing; and
- brought the buyer and seller together by *submitting* the buyer's offer to the seller and handing the seller a copy of the offer. [**Barnes** v. **Osgood** (1930) 103 CA 730]

The fact the seller rejected the offer by way of a counteroffer (which was not accepted) has no effect on the broker's right to a fee under the listing agreement.

However, to earn a fee for obtaining and submitting a full listing offer, the prospective buyer, on making the offer, must be *ready, willing and able* to perform. Thus, to **earn a fee** the buyer must:

- *make an offer* on substantially the same terms as the seller's listed terms, called *ready*;
- *intend to enter* into a binding purchase agreement with the seller, called *willing*; and
- *qualify financially and legally* to perform on the offer, called *able*.

Once the listing agent has submitted a full listing offer from a buyer who meets each of the ready, willing and able criteria, the listing agent's broker is entitled to a fee from the seller. [**Woodbridge Realty** v. **Plymouth Development Corporation** (1955) 130 CA2d 270]

For example, an owner of real estate enters into a listing agreement employing a broker to locate a buyer who will agree to purchase the property. The price and terms of payment the owner seeks for his property are contained in the listing agreement, as is a brokerage fee provision.

During the listing period, the broker's listing agent locates a financially qualified buyer who makes a written offer to purchase the property on substantially the same terms sought by the owner in the listing agreement. When the offer is submitted to the owner, the owner rejects the offer, opting not to sell his property on the terms listed. The listing agent's broker promptly makes a demand on the owner for his fee based on the brokerage fee provision in the listing agreement. The owner refuses to pay, claiming the broker did not earn his fee since a sale was never completed.

However, the broker did earn his fee. During the listing period, the broker's agent located a financially qualified buyer who offered to purchase the property on the owner's listed terms for a sale.

The broker may enforce collection of his fee at the moment the opportunity to accept a full listing offer, oral or written, is presented to the owner. Whether the offer is accepted or a sale is ever consummated is not a condition of the broker's employment under a listing agreement. Upon fully performing his employment under the listing by producing a ready, willing and able buyer on the listed terms, the broker's recovery of his fee is not barred by the owner's refusal to now sell the property. [**Twogood** v. **Monnette** (1923) 191 C 103]

However, if a buyer offers to purchase the property on terms different from those in the listing agreement, the owner must first accept the buyer's offer before the broker is entitled to a fee, no matter how reasonable the buyer's offer may be. [**Seck** v. **Foulks** (1972) 25 CA3d 556]

Fee for purchase of replacement property

Often, the property listed for sale is held by an owner as an investment, such as rental income property or vacant land, or for use in the owner's trade or business. Thus, the listed property is Internal Revenue Code (IRC) §1031 *like-kind property*. It is not the owner's residence or dealer property, such as lots held by a developer.

If the listed price is greater than the owner's remaining cost basis in the property, the owner is selling the property at a profit, called a *capital gain*.

The listing agent who is alert to an opportunity to render additional services for an additional fee should know the owner can avoid payment of any profit tax on a sale. If the owner **acquires replacement property** which has equal-or-greater *equity* and equal-or-greater *debt*, profit taxes are avoided on the property sold as an exempt (tax-free) transaction.

Thus, the agent should bring to the owner's attention the advantageous §1031 tax exemption treatment available on the sale. Further, the agent should recommend implementation of a §1031 reinvestment plan by the timely acquisition (through the agent) of other like-kind property using the net proceeds from the sale of the listed property.

As in any employment engaging a broker to act on behalf of a client, the authorization to locate replacement property and receive payment for doing so must be in writing to enforce collection of the fee. An exclusive right-to-sell listing accomplishes this objective by containing a *replacement property provision*. [See Form 102 §3.2]

The type of replacement property to be acquired and the amount of debt the owner is willing to incur to purchase the property should be entered in the appropriate places on the listing agreement. [See Form 102 §9.1]

A fee is earned if the broker or his agent is involved in negotiations which lead to the owner's purchase of replacement property. The fee for assisting in the purchase of replacement property is based on the same formula or dollar amount used to set the fee due on the sale of the listed property.

However, to fully protect a listing broker's right to a fee when replacement property is to be purchased, a **buyer's exclusive right-to-buy listing** should also be entered into.

The right-to-buy listing, being more specific, would supersede the replacement property provision in the exclusive right-to-sell listing. The exclusive right-to-buy listing assures the broker that he will receive a fee should the owner acquire replacement property during the right-to-buy listing period, regardless of who brings the property to the owner's attention.

Chapter 11 A fee due on withdrawal or termination

This chapter addresses the events which trigger the withdrawal-from-sale and termination-of-agency clauses in the fee provision of an exclusive listing.

Exercising an alternative

An owner of real estate enters into an exclusive right-to-sell listing agreement, employing a broker to locate buyers and sell the property. The broker's compensation for his and his listing agent's services is set forth in a **fee provision** in the listing agreement. The fee provision contains both a *withdrawal-from-sale* and a *termination-of-agency* clause. [See Form 102 §3.1 accompanying Chapter 9]

The **withdrawal-from-sale** clause entitles the broker to be paid a full listing fee if, during the listing period, the property is:

- withdrawn from the market;
- transferred to others;
- further leased without the broker's consent; or
- made unmarketable by the owner. [See Form 102 §3.1(b)]

Further, the separate **termination-of-agency** clause entitles the broker to collect a full listing fee if the owner cancels the broker's employment during the listing period, with or without the intent by the owner to continue marketing the property for sale.

Withdrawal from sale

On undertaking the obligation of employment imposed by a listing, a listing agent gathers available information about a seller's property and organizes it into a listing package. The package is reproduced and handed to those most likely to make a offer, called *prospective buyers*.

On completing the listing package, multiple listing service (MLS) and newspaper advertisements are placed, and a "For Sale" sign is erected on the property with a box for distribution of informational fliers to interested parties.

Before the listing period expires, the seller withdraws the property from sale. Further, the agent is instructed to remove his "For Sale" sign and lock box, and to cease marketing the property.

The agent confirms the seller's withdrawal in writing and immediately complies with the seller's request. The agent's broker then makes a demand on the seller for payment of a full listing fee, claiming the withdrawal-from-sale clause in the listing agreement entitles him to a fee earned at the moment the seller removes the property from the market during the unexpired listing period.

The seller refuses to pay, claiming the broker is not due a fee since the broker's agent failed to produce a buyer due to the lack of a diligent effort to market the property. The seller also claims the provision for payment of the brokerage fee on the seller's withdrawal of the property from the market is unenforceable as an unfair and **unenforceable penalty** since the property did not sell.

Is the broker entitled to a full listing fee under the withdrawal-from-sale clause?

Yes! The seller became obligated to pay the broker the fee agreed to in the listing when:

- the broker, through his agent, at all times exercised diligence in the marketing of the property; and
- the seller **exercised his right** under the withdrawal-from-sale clause to voluntarily remove the property from the marketplace during the listing period.

Further, the brokerage fee the seller agreed to pay on a withdrawal from sale prior to the expiration of the listing period is not a *penalty payment* or *forfeiture*. The fee due the broker on the seller's withdrawal from the market is a fair amount since the agreed amount preserves the earnings the broker expected to receive by ultimately selling the property. When the seller entered into the listing agreement, the broker and his agent commenced their due diligence efforts to locate a buyer.

On withdrawal, the fee due the broker compensates him for his **lost opportunity**. When the broker loses his authority to market the property and locate a buyer, he has lost his ability to accomplish the objective of the employment, which was to sell the property and earn a fee.

Thus, instead of leaving the property on the market for the entire listing period (and paying a fee if it sells), the seller has exercised one of his **alternative performance options** allowing the seller to either:

- remove the property from the market, in which case a fee is earned and due; or
- terminate the agency by canceling the listing while leaving the property on the market, in which case a fee is also earned and due.

A withdrawal of the property from the market always results in a termination of the broker's agency relationship with the seller. However, a termination of the agency by the seller is not always due solely to a withdrawal of the property from sale.

Termination of agency by seller

A seller of real estate enters into a listing agreement with a broker to sell a property within a three-month period. The listing includes a fee provision which contains a *termination-of-agency* clause entitling the broker to a full fee should the seller terminate the broker's employment, without good cause, prior to expiration of the listing period. [See Form 102 §3.1(c)]

The broker's listing agent promptly commences a diligent marketing effort to properly present the property for sale and locate a buyer who is willing to acquire the property. However, during the listing period and before a buyer is located, the seller terminates the agency by canceling the listing.

The broker makes a demand on the seller for a full listing fee, claiming the termination-of-agency clause in the fee provision of the listing calls for payment of a fee as earned when the seller prematurely terminates the agency. The seller claims the broker is not entitled to a full brokerage fee, but only to money losses based on an accounting for his time, effort and costs incurred to market the property, called *quantum meruit*, since a seller may legally terminate a broker's agency at any time.

Is the broker entitled to collect a full fee from the seller upon the seller's exercise of his legal right to terminate the agency?

Yes! While a seller may terminate the broker's agency at any time, the seller cannot terminate the agency during the listing period and avoid payment of a fee if a termination-of-agency clause exists. The termination-of-agency clause in the listing couples the canceling of the listing with the payment of a fee.

RELEASE AND CANCELLATION OF EMPLOYMENT AGREEMENT

Waiver of Rights

NOTE: This agreement is used to both terminate a listing employment and eliminate any claims which may have arisen during its existence.

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

1. FACTS:

1.1 This mutual release and cancellation agreement with waiver of rights pertains to the following employment agreement:

a. ☐ Seller's Listing Agreement [See **ft** Form 102]
b. ☐ Loan Broker Listing [See **ft** Form 104]
c. ☐ Exclusive Authorization To Lease [See **ft** Form 110]
d. ☐ Property Management Agreement [See **ft** Form 590]
e. ☐ Buyer's Listing Agreement [See **ft** Form 103]
f. ☐ Trust Deed Listing [See **ft** Form 112]
g. ☐ Exclusive Authorization To Locate Space [See **ft** Form 111]
h. ☐ _____

1.2 dated _____, 20_____, at _____, California,

1.3 entered into by _____, as the Broker, and

1.4 _____, as the Client,

1.5 regarding property or real estate services referred to as _____

_____.

2. AGREEMENT:

2.1 Broker and Client hereby cancel and release each other and their agents from all claims and obligations of any kind, known or unknown, arising out of the employment agreement.

2.2 In consideration of Broker's acceptance of this cancellation, Client to pay Broker a brokerage fee of $_____.

2.3 In consideration of Broker's acceptance of this cancellation, Client to pay the brokerage fee set forth in the employment agreement if Client enters into an agreement for any of the following checked events within _____ months after the date of this cancellation agreement:

a. ☐ The property is sold, exchanged or otherwise transferred.
b. ☐ An option to buy or sell the property is created.
c. ☐ The property is relisted with another broker.
d. ☐ The property is refinanced or further financed.
e. ☐ The property is leased.
f. ☐ The property is acquired.
g. ☐ _____.

3. WAIVER:

The parties hereby waive any rights provided by Section 1542 of the California Civil Code which states:

"A general release does not extend to claims which the creditor does not know or suspect to exist in his favor at the time of executing the release, which if known by him must have materially affected his settlement with the debtor."

I agree to the terms stated above.

Date: _____, 20_____

Broker: _____

By: _____

I agree to the terms stated above.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: _____, 20_____

Client's Signature: _____

Client's Signature: _____

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The seller has chosen between:

- continuing to work with the broker under the listing and paying a fee if a buyer is located before expiration of the listing period; and

- terminating the broker's agency and paying the broker his full listing fee, whether or not the property is removed from the market.

No alternatives to breach

Occasionally, both the withdrawal-from-sale and the termination-of-agency clause are excluded from a listing agreement. Without these provisions, a broker will be unable to collect a full brokerage fee on a withdrawal or termination since no amount was agreed to be paid on the occurrence of either event.

Thus, only a *breach* of the listing occurs for lack of **alternative performance provisions** in the exclusive listing agreement. [See Form 102 §§3.1(b) and 3.1(c)]

On a breach by the seller of a listing which does not contain a termination-of-agency clause, the terminated broker will only be entitled to recover:

- the *out-of-pocket costs* incurred to service the listing; and

- the value of the time and effort expended under the listing, called *quantum meruit* recovery. [**Hedging Concepts, Inc.** v. **First Alliance Mortgage Company** (1996) 41 CA4th 1410]

Documenting the cancellation

When a seller, by word or by conduct, clearly indicates he no longer desires to sell the property, the agent should prepare a Release and Cancellation of Employment Agreement form for the seller to review and sign. [See Form 121 accompanying this chapter, *ante*]

Editor's note — This release and cancellation agreement is a new contract between the agent's broker and the seller, effectively replacing the listing agreement.

The **release and cancellation agreement** may call for immediate payment of the full brokerage fee agreed to in the listing in exchange for mutually agreeing to cancel the listing agreement.

Alternatively, it may call for payment at a later date should the property be sold, placed on the market, exchanged, optioned, refinanced (if the broker was retained to arrange new financing) or leased to anyone within a specified time period (for example, one year) after the date of the agreement. A compromise could be the payment of a partial fee with the balance due should the property be sold within the cancellation period.

This release and cancellation agreement is also used when a buyer wants to cancel an exclusive right-to-buy listing. On cancellation, the broker is deprived of the opportunity he acquired under the listing to earn a fee. Thus, he has the right to receive compensation.

In this case, the agreement entitles the broker to a fee if, within the cancellation period, the buyer purchases property similar to that which the broker was retained to locate.

In short, if the client accomplishes on his own what he retained the broker to do, and the client does so during the cancellation period, the broker is entitled to his fee.

Editor's note — The broker cannot require the client to relist with him if he decides to buy or sell within the cancellation period. This coupling of the cancellation to future employment would be an illegal tying arrangement. [Calif. Business and Professions Code §16727]

Reimbursement on cancellation

A cancellation agreement can also call for a client to pay a broker cash compensation for his and his agent's time, effort and expenses expended during the employment under the listing. The client and broker can negotiate an appropriate hourly rate at the time of settlement.

The broker will not later be able to collect a fee should the property sell after the listing is canceled since the broker settled for a lump sum amount to end the relationship and eliminate all claims under the listing agreement.

However, by entering into a settlement on cancellation, the broker would be compensated immediately rather than waiting for a transaction that might not happen. With this agreement, the broker ensures he will not be out-of-pocket on this listing.

If the broker believes the client may use his ser-vices in the future, or will refer other clients, this is a fair alternative.

Chapter 12 The safety clause

This chapter demonstrates the use of a safety clause in a listing to earn a fee after the listing has expired for the time and effort spent with prospective buyers during the listing period.

A fee due after the listing expires

A broker is retained to represent a seller under an employment agreement, commonly called a *listing*. The listing, whether open or exclusive, contains a *safety clause* entitling the broker to the agreed fee, if:

- a person has contact with the broker (or his agent) regarding the property during the listing period, called *solicitations*;
- the broker treats the person as a *prospective buyer* by providing the person with information about the property, legally called *negotiations*;
- negotiations with the person terminate without resulting in a sale;
- on expiration of the listing period, the broker *registers the person* by name with the seller as a prospective buyer; and
- the person and the seller, with or without involving the broker, later commence negotiations within a specified time period following the expiration of the listing, called the *safety period*, and ultimately complete a sale of the property.

For example, during the listing period, a broker's listing agent has contact with prospective buyers. All of the buyers are **handed a listing package** fully disclosing the property's condition.

The agent's discussions with each buyer and the property information given to each buyer, as well as to any buyer's agent, is noted on a File Activity Sheet in the agent's listing file. [See **first tuesday** Form 520]

Also, each prospective buyer's name, address or phone number are added to the list of prospective buyers for the property on a registration form also maintained in the listing file. [See Form 122 accompanying this chapter]

After "follow-up" conversations with the prospective buyers, the agent does not have further contact with any of them. The listing period expires and the property remains unsold.

Perfecting the right to a fee for work done

After the listing expires, the agent sends the seller the **list of prospective buyers** he has entered on the registration form and closes his file on the property. The list includes all those buyers who, during the listing period, were in contact with, and **received information** about the property from the broker, his agents or through the buyer's broker. [See Form 122]

Within the safety period after the listing agreement expires, a buyer registered by the agent on the list of prospective buyers **enters into negotiations** with the seller to purchase the property. Negotiations ultimately result in a completed sale. Neither the broker nor his agent are involved in the renewed negotiations in any way.

On the agent's discovery of the completed sale, the broker makes a written demand on the seller for his fee as earned under the safety clause in the expired listing.

The seller refuses to pay the broker a fee, claiming the broker has no right to a fee since neither the broker nor his agent was the *procuring cause* of the sale, i.e., the broker did not obtain and submit the offer.

The broker claims he does not need to be the procuring cause to be entitled to a fee since a prospective buyer who was provided information about the property during the listing period acquired the property as a result of negotiations commenced during the safety period.

Is the broker entitled to a fee from the seller?

Yes! The seller owes the broker a fee under the safety clause in the listing agreement's fee provision. A prospective buyer, who reviewed information about the property with the broker's agent during the listing period, was **registered with the seller**. After the listing expired, the registered buyer acquired the property as a result of negotiations commenced during the safety period, either directly with the seller or through another broker. Payment of a fee in the listing agreement's fee provision was not limited solely to *procuring* a buyer. [**Leonard** v. **Fallas** (1959) 51 C2d 649]

Contrary to the claims of the seller, a broker will never be the *procuring cause* of a sale when the brokerage fee is earned under the safety clause. The safety clause is always triggered by negotiations which have a "fresh start" after the listing expires.

Negotiations initiated during the listing period, **which continue**, with or without the broker, beyond the expiration date on the listing and result in a purchase agreement being entered into with the seller, are the essence of procuring cause.

The safety net for due diligence

A safety clause in the fee provision of a listing agreement provides an additional period after the listing expires for a broker to earn a fee for the time and money the broker and his listing agent invest during the listing period in their effort to market the listed property and locate a buyer. The clause preserves the broker's and listing agent's expectations of earnings for reviewing the property with prospective buyers during the listing period should the prospective buyer become disinterested, break off negotiations, and then later reappear after the listing expires to buy the property.

Thus, the broker is **assured a fee** under the safety clause if:

- *property information* is provided to prospective buyers during the listing period by his listing agent;
- the *seller is notified* of the identification of the prospective buyers as soon as possible after termination of the listing; and
- the *property is acquired* by a prospective buyer from the list as a result of negotiations commenced during the safety period.

IDENTIFICATION OF PROSPECTIVE BUYERS

On Expiration of Listing

NOTE: Your employment agreement calls for payment of a brokerage fee on transactions with these prospective Buyers or Tenants resulting from negotiations commenced within the one-year period following termination of the agreement. If you employ another Broker to provide similar services for the same property during the one-year period, bring this document and the expired agreement to the Broker's attention.

DATE:_____, 20_____, at _____, California.

TO: _____

Items left blank or unchecked are not applicable.

1. FACTS:

1.1 This is an addendum to the following agreement:

a. ☐ Seller's Listing Agreement [See **ft** Form 102]

b. ☐ Exclusive Authorization to Lease Property [See **ft** Form 110]

c. ☐ _____

1.2 dated _____, 20_____, at_____, California,

1.3 entered into by you and the undersigned Broker regarding real estate referred to as

_____.

2. IDENTIFICATION:

2.1 This addendum registers with you the identities of prospective buyers or prospective tenants the undersigned Broker, directly or through other brokers, solicited and negotiated with for the purchase or lease of the real estate under the above agreement.

2.2 You are obligated under the above agreement to pay a brokerage fee if, within one year after expiration of the agreement, you enter into negotiations which result in the sale or lease of the real estate to any of the following prospective buyers or prospective tenants:

Name_____ Address _____

Name_____ Address _____

Name_____ Address _____

Name_____ Address _____

Name_____ Address _____

Name_____ Address _____

Name_____ Address _____

Name_____ Address _____

Name_____ Address _____

Name_____ Address _____

Name_____ Address _____

Name_____ Address _____

Name_____ Address _____

Name_____ Address _____

Name_____ Address _____

Name_____ Address _____

3. This addendum consists of _____ page(s). (Add pages to name additional prospective buyers.)

This is a true and correct statement.

Broker:_____

By: _____

Address: _____

_____

Phone: _____

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Theoretically, an agent's knowledge of prospective buyers is information the seller is entitled to on expiration of the listing should the seller request the information, with or without a safety clause.

The terms of the safety clause

A safety clause is usually included in the fee provision of a listing agreement. Both the open and exclusive types of seller's and buyer's listing agreements typically contain safety clause provisions. [See Form 102 §3.1(d) accompanying Chapter 9 and Form 103 §5.1(c) accompanying Chapter 16; see Chapter 15 for safety clause in a buyer's listing]

The safety clause imposes an obligation on the seller to pay a fee on a sale which resulted from negotiations with registered prospective buyers commenced by anyone within the safety period.

Like an exclusive listing agreement, the safety clause also contains an expiration date, establishing a time period during which the clause is in effect. Typically, safety clauses are drafted to cover a sufficient and reasonable period of time needed to protect the agent's time and effort spent with prospective buyers on behalf of the seller. The safety clause period **commences on termination** of the listing period.

The **listing is terminated**, commencing both the safety clause period and the period for putting the seller on notice of prospective buyers, upon:

- the seller's *withdrawal of the property* from the market during the listing period;
- the seller's *termination of the agency* before expiration of the listing period; or
- *expiration of the listing* agreement by its own terms.

The seller's premature termination of the broker's agency relationship does not also terminate the listing period in an exclusive listing agreement which fails to contain a termination- of-agency fee provision. [**Century 21 Butler Realty, Inc.** v. **Vasquez** (1995) 41 CA4th 888]

Whether or not the listing contains a termination-of-agency clause, premature termination should be treated as an act which commences the safety clause period. Thus, on **premature termination** of the agency, withdrawal or expiration of the listing period, the agent should send the seller his list of prospective buyers to *perfect his right* to earn a fee under the safety clause should a prospective buyer commence negotiations during the safety period and later buy the property.

Perfecting the safety clause

A broker has the burden of *perfecting* his right to a fee under the safety clause.

Several crucial activities must be performed by the listing agent to **perfect his broker's right** to a fee under the safety clause, including:

- *providing information* about the listed property to any prospective buyers he or buyer's brokers have contact with;
- *documenting dealings* with prospective buyers by maintaining an Activity Report Sheet in a listing file [See **first tuesday** Form 520]; and

- *registering the prospective buyers* with the seller on termination of the listing by providing the seller with a List of Prospective Buyers in a timely manner (e.g., within 21 days). [See Form 122]

Most listing agreements contain **broker cooperation provisions** which authorize brokers to work with and share fees with other brokers who represent buyers interested in the listed property. [See Form 102 §4.2]

Thus, when registering prospective buyers with the seller, the broker whose listing contains a broker cooperation provision should be sure to include any buyers with whom buyer's brokers dealt. If a sale covered by the safety clause occurs, both brokers will be protected and will share the fee.

The disclosure of the prospective buyers by registration with the seller is required to "arm" the safety clause. Thus, by registration, the broker *perfects* his right to earn a fee under the clause. If a prospective buyer registered by the broker or his agent enters into negotiations during the safety period, and as a result acquires the listed property, the broker has earned a fee.

Negotiations which result in a sale do not need to be concluded during the safety clause period to qualify the broker for a fee. Escrow also does not need to be closed prior to the expiration of the safety period. Once negotiations are commenced during the safety clause period, which leads to a sale of the listed property to a registered prospective buyer, the broker has earned his fee. An acceptance of a purchase offer or the close of a sales escrow **relates back** to the date negotiations commenced, a date which, if it falls within the safety clause period, entitles the broker to a fee. [Leonard, *supra*]

Contact with prospective buyers

The **degree of involvement** a broker or his agents must have with a buyer during the listing period in order to qualify the buyer as a *prospective buyer* is set by the terms of the safety clause.

For example, a fee provision may state the broker or his agents are required to **personally introduce** the property to a buyer to qualify the buyer as a prospective buyer, not merely conduct negotiations over the phone. [**Korstad** v. **Hoffman** (1963) 221 CA2d Supp. 805]

For all listings, a buyer is not a prospective purchaser under the safety clause if the buyer's only relationship with the broker is the buyer's observation of a "For Sale" sign on the property or of a published advertisement regarding the property placed by the broker or his agent. [**Simank Realty, Inc.** v. **DeMarco** (1970) 6 CA3d 610]

At the very least, a broker or his listing agent is required to provide the buyer with **information regarding the property** to qualify as having commenced negotiations. The agent does not need to produce a written offer from a buyer for the buyer to be a prospective purchaser.

Consider a broker who is retained by a seller under an exclusive right-to-sell listing agreement which contains a safety clause requiring prospective buyers to have *negotiated* with the broker or his listing agent. [See Form 102 §3.1(d)]

During the listing period, the agent has contact with and provides property information to several individuals. The list of prospective buyers is prepared and delivered to the seller. The listing agent includes the names of people who were not contacted or were not provided with any information about the listed property.

During the safety clause period, a person who was registered, but had no contact with the broker or the listing agent, negotiates to purchase the property directly from the seller (or through another broker). The negotiations result in a sale.

The broker makes a demand on the seller for a fee since a person registered as a prospective buyer acquired the property through negotiations which commenced during the safety period.

The seller refuses to pay a fee, claiming the broker's listing agent never treated the person as a prospective buyer since the listing agent never exposed the person to the property in any way.

Has the broker earned a fee under the safety clause?

No! For the broker to earn a fee under this safety clause, the broker, his listing agent or another agent employed by the broker must have entered into negotiations with the likely buyer. For the listing agent's contact with the buyer to be **equated with negotiations**, the listing agent or another agent of the broker must have handed the buyer information regarding the property, such as its income and expenses, title conditions, property conditions or operating conditions. At no time during the listing period did the listing agent review any aspect of the property with the buyer or the buyer's agent. [**Hobson** v. **Hunt** (1922) 59 CA 679]

Price paid

Now consider a listing agent who markets a property for a seller under a listing which contains a safety clause requiring negotiations with the buyer as one condition for receiving a fee. The listing agent provides detailed information on the property to a likely buyer, including water availability and an estimate of assessments on the property. The agent has several follow-up conversations with the prospective buyer about the property.

The buyer becomes disinterested in the property due to his interest in another property. On expiration of the listing period, the agent registers the buyer with the seller by delivering the agent's list of prospective buyers as required by the safety clause.

During the safety clause period, the buyer is contacted by the seller regarding the property. Negotiations result in the prospective buyer's purchase of the property for less than the listed price.

The listing agent's broker learns of the sale and makes a demand on the seller for a fee.

The seller refuses to pay a fee, claiming the broker is not entitled to a fee since the price paid for the property was less than the full listing price.

The broker claims he has earned a fee since the sale was to a registered buyer who negotiated to purchase the property during the safety clause period and acquired it.

Here, the broker is entitled to the agreed fee under the safety clause since the buyer:

- reviewed the property with the listing agent during the listing period;
- was registered with the seller on expiration of the listing;
- negotiated with the seller (or an agent of the seller) during the time period covered by the safety clause; and

MODIFICATION OF LISTING AGREEMENT

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

1. FACTS:

1.1 This is a modification of the following brokerage agreement:

☐ Seller's Listing Agreement [See **ft** Form 102]
☐ Buyer's Listing Agreement [See **ft** Form 103]
☐ Loan Broker Listing Agreement [See **ft** Form 104]
☐ Trust Deed Listing [See **ft** Form 112]
☐ Exclusive Authorization to Lease Property [See **ft** Form 110]
☐ Exclusive Authorization to Locate Space [See **ft** Form 111]
☐ _____

1.2 dated _____, 20_____, at _____, California,

1.3 entered into between _____, as the Client, and Broker,

1.4 regarding property or real estate services referred to as _____
_____.

2. TERMS OF BROKERAGE SERVICE:

2.1 The agency duties, costs and fees are reaffirmed and, ☐ remain unchanged, or ☐ modified as follows:
_____
_____
_____.

2.2 The brokerage agreement will now expire on _____, 20_____.

3. SALES TERMS:

3.1 The terms of the real estate related sale, purchase, lease or financing are modified as follows:
_____
_____
_____
_____.

4. PROPERTY PROFILE MODIFICATION OR ADDITIONS:
_____
_____
_____
_____

I agree to the terms stated above.

Date: _____, 20_____

Broker: _____

By: _____

I agree to the terms stated above.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: _____, 20_____

Client: _____

Signature: _____

Client: _____

Signature: _____

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- ultimately purchased the property due to the negotiations.

Based on the price paid for the property, the broker earns the percentage of the price paid (or the fixed fee) stated in the listing agreement. [**Delbon** v. **Brazil** (1955) 134 CA2d 461]

Dual liability on relisting

A properly worded and perfected safety clause remains enforceable even when a seller relists the property for sale with another broker after the original listing expires. [See Form 102 §3.1(d)]

Thus, a broker or his agent who enters into a listing must first inquire into the existence of an unexpired safety clause in a prior listing the seller may have had with another broker.

The seller is exposed to **multiple fees** when the property is sold by a new broker to a prospective buyer registered with the seller under the safety clause in an expired listing.

If a safety clause is still in effect, the new listing agent needs to obtain a copy of the list of prospective buyers registered with the seller. Negotiations conducted by the new listing agent with these buyers would expose the seller to liability under the **prior broker's safety clause**. Prior to contacting these registered buyers, the new listing broker needs to negotiate a *fee-sharing agreement* with the prior broker and document the arrangement as part of the listing process. [See **first tuesday** Form 105]

A fee-sharing agreement, also improperly called a *cooperating broker agreement*, allows for both the prior broker and the present broker to share fees, usually 50-50. The fee-sharing agreement broadens the pool of prospective buyers for the new listing agent and clarifies the opportunity of both brokers to earn a fee — for the duration of the safety period.

On expiration of a listing, the seller may avoid the dual liability situation altogether by relisting with the same broker, rather than listing with another broker, a *relisting advantage* held by the original broker. The relisting should be by way of a modification of the expiration date (and any other terms) of the listing. Modification eliminates the need to register prospective buyers until the listing expires under the extension. [See Form 120 accompanying this chapter]

For the seller, re-listing with the same broker avoids any overlap of the prior broker's safety clause period and the new broker's listing period. Re-listing with the same broker also preserves the original listing agent's efforts spent educating the seller while marketing the property.

Safety clause vs. procuring cause

Sellers often confuse the workings of the safety clause with the open-listing or full-listing-offer theories of *procuring cause*. A broker is the procuring cause of a buyer and entitled to a fee when the broker holds an **open listing** and he or his agent is either:

- the *direct cause* of a sale to a buyer; or

- the cause of a *series of events* which result in a sale to the buyer.

Consider a broker who enters into an employment agreement with a lender to locate a person who will syndicate the purchase of trust deed loans *warehoused* by the lender, a process called *securitization*.

The agreement contains a fee provision calling for payment of a fee only if the broker or his agent **initiates a transaction** which is successfully completed. The agreement also contains a ten-year safety clause.

On expiration of the listing, the broker's agent hands the lender a list of several securities firms who create or represent trust deed investment pools which purchase trust deed notes in the secondary money market. None of the investment firms listed as prospective trust deed buyers enter into negotiations with the agent, much less complete a transaction with the lender which was initiated by the agent.

Later, an investment firm registered by the agent buys trust deeds from the lender.

The agent's broker discovers the transaction and demands a fee from the lender. The broker claims he is entitled to a fee since his agent **introduced the lender** to the firm which eventually purchased the loans within the ten-year safety period.

The lender claims the broker is not entitled to a fee since the broker was hired to **initiate and complete** a successful transaction, and he did not do so by merely registering the names of investment firms.

Is the broker entitled to a fee?

No! The broker is not entitled to a fee for merely registering the names of firms which his agent knew bought trust deed notes. The fee provision required the broker or his agent to be the *procuring cause* of a sale, not just naming, soliciting or negotiating with prospects. Payment of a fee is contingent on the broker's **initiation** of a transaction which is **successfully completed**. [**Hedging Concepts, Inc.** v. **First Alliance Mortgage Company** (1996) 41 CA4th 1410]

A fee agreement calling for a broker to be paid only if he is the *procuring cause* of the sale **automatically voids** any safety clause contained in the fee provision of a listing agreement. Thus, a safety clause and a procuring cause clause are inconsistent provisions — one or the other for recovery of a fee, but not both in the same document. [Delbon, *supra*]

The contact remained interested and bought

Now consider a seller who employs a broker under a listing agreement which entitles the broker to a fee if he locates a buyer who eventually acquires the property.

During the listing, the broker or his listing agent has contact with a buyer resulting in the delivery of information on the listed property. The buyer has difficulty arranging purchase-assist financing. After several discussions, the listing agent no longer follows up on the buyer and they engage in no further negotiations.

On expiration of the listing, the property remains unsold. Three months later, the seller contacts the buyer to see if he is still interested in purchasing the property. Negotiations are resumed when the buyer ultimately arranges financing and is able to acquire the property. The listing agent discovers the sale and alerts his broker.

The broker then makes a demand on the seller for a fee, claiming he was the procuring cause of the sale since he presented the property to a buyer who remained interested in the property and eventually purchased it when financing became available.

The seller claims the broker is not entitled to a fee since the buyer acquired the property through negotiations commenced by the seller after the listing expired.

However, the broker is entitled to a fee since he was the **procuring cause** of the sale. The broker's contact with the buyer **set into motion** an uninterrupted chain or series of events, separated only by time, which eventually resulted in a sale. [**E. A. Strout Western Realty Agency, Inc.** v. **Lewis** (1967) 255 CA2d 254]

Editor's note — By including a safety clause in the listing agreement and registering the prospective buyer, this dispute would be avoided.

Chapter 13 Greater transparency in marketing

This chapter digests the marketing assistance a seller provides a listing agent by authorizing investigative reports regarding the listed property before it is marketed.

Costs for preparing to sell

An owner of a single-family residence (SFR) wants to list the property for sale with the brokerage office of an agent known to the owner.

The agent prepares an exclusive right-to-sell listing agreement form for review with the owner.

The agent also prepares an addendum (among others) in which he estimates the cost of third-party **investigative reports** needed to provide prospective buyers with information on the property. The reports are those which are always demanded by prudent buyers and careful buyer's agents for confirmation and approval by the buyer before closing escrow on a purchase of property.

The listing agent will present this listing package cost sheet addendum to the owner as a "seller's budget." As a disclosure, it sets the costs of those third-party reports the owner will most likely incur on a sale.

The cost sheet prepared by the agent estimates the cost of investigative reports prepared by other professionals or government agencies which will help put a face on the property so it can be better **evaluated by prospective buyers**. The recommended reports include an occupancy (transfer) certificate (by local ordinance), natural hazard disclosure (NHD), structural pest control report (and possible clearance), home inspection report, well water report and a septic tank report. [See Form 107 accompanying this chapter]

Once the cost sheet is signed by the seller, the agent can then prepare and deliver various authorization requests to third-party service providers to deliver the mandated reports. [See Form 133 accompanying this chapter; see **first tuesday** Forms 124-136]

The reports will become part of the listing agent's **marketing package** for the sale of the listed property. The agent is aware the best way to market property and expose it to a prospective buyer who will actually enter into a purchase agreement without further negotiations prior to the close of escrow is to fully disclose the condition of the property when first dealing with the buyer.

Staging to set the buyer's expectations

Also, a **buyer's expectations** about the property are legally established based on his impression of the property at the time he enters into a purchase agreement, not later after the price has been set, escrow opened and the true condition of the property revealed to the buyer for the first time. [**Jue** v. **Smiser** (1994) 23 CA4th 312]

Here, the owner has to make a choice as to when he will incur the **expense of third-party reports**, be it:

LISTING PACKAGE COST SHEET

Due Diligence Checklist

DATE:_____, 20_____, at_____, California.

Items left blank or unchecked are not applicable.

1. FACTS:

1.1 This is an addendum to an employment agreement referred to as a Seller's Listing Agreement [See **ft** Form 102]

1.2 ☐ of same date, or dated_____, 20_____, at _____, California,

1.3 entered into by _____, as the Broker, and_____, as the Seller,

1.4 regarding real estate referred to as _____,

1.5 for a period beginning on _____, 20_____ and expiring on _____, 20_____.

2. BROKER'S DISCLOSURE AND PERFORMANCE:

2.1 The items listed below with estimated costs constitute a disclosure of the reports and activities Seller can reasonably expect will be required to either bring about or close a transaction under the employment agreement, and if acquired early, will assist Broker to provide prospective buyers with property information Broker anticipates he will need to effectively perform under the employment agreement.

a. Natural hazard disclosure report . . . . . $_____

b. Local ordinance compliance certificate . . . . . $_____

c. Structural pest control report and ☐ clearance . . . . . $_____

d. Smoke detector and water heater anchor installation . . . . . $_____

e. Property (Home) inspection report . . . . . $_____

f. Association (CID) documents charge . . . . . $_____

g. Lead-based paint report . . . . . $_____

h. Mello-Roos assessment notice . . . . . $_____

i. Listing (transaction) coordinator's fee . . . . . $_____

j. Well water quality and quantity report . . . . . $_____

k. Septic/sewer report . . . . . $_____

l. Soil report . . . . . $_____

m. Survey of property (civil engineer) . . . . . $_____

n. Appraisal report . . . . . $_____

o. Architectural (floor) plans . . . . . $_____

p. Title report: ☐ property profile, ☐ preliminary report, ☐ abstract . . . . . $_____

q. MLS and market session input fees . . . . . $_____

r. Sign deposit or purchase, installation and removal . . . . . $_____

s. Advertising in newspapers, magazines, radio or television . . . . . $_____

t. Information flyers and postage (handout or mailing). . . . . $_____

u. Open house — food and spirits . . . . . $_____

v. Photos or video of the property . . . . . $_____

w. Credit report on prospective buyer . . . . . $_____

x. Travel expenses . . . . . $_____

y. Other _____ . . . . . $_____

z. Other _____ . . . . . $_____

2.2 **TOTAL ESTIMATED COSTS** . . . . . $_____

2.3 ☐ Broker is hereby authorized and instructed to incur on behalf of Seller the cost estimated above.

3. PAYMENT OF COSTS:

3.1 ☐ Seller agrees to pay, on presentation of a billing, those costs estimated above and incurred by Broker.

3.2 ☐ Broker agrees to incur the expenses of the estimated costs set out and authorized in §2.3 during the first 21 days of the employment and to timely pay the charges. Seller agrees to reimburse Broker for the costs Broker incurs, IF:

a. Seller closes a transaction which is the subject of the employment agreement;

b. Seller terminates the employment agreement by cancellation or by conduct before it expires; or

c. Seller retains another Broker on the expiration of the employment agreement to pursue a transaction which is the subject of the employment agreement with Broker.

3.3 ☐ Costs paid by Seller under this addendum shall be credited toward any contingency fee earned by Broker upon closing a transaction which is the subject of the employment agreement.

3.4 Seller herewith hands Broker a deposit of $_____ as an advance for the payment of costs incurred by Broker on behalf of Seller as estimated above.

4. TRUST ACCOUNT: (To be filled out only if a deposit is entered at §3.4 above.)

4.1 Broker will place the advance cost deposit received under §3.4 above into his trust account maintained with _____
at their _____ branch.

4.2 Broker is authorized and instructed to disburse from the trust account those amounts required to pay and satisfy the obligations incurred as agreed.

4.3 Within 10 days after each calendar ☐ month, or ☐ quarter, and upon termination of this agreement, Broker will deliver to Seller a statement of account for all funds withdrawn from the advance cost deposit handed Broker under §3.4 above.

4.4 Each statement of account delivered by Broker shall include no less than the following information:

a. The amount of the advance cost deposit received.

b. The amount of funds disbursed from the advance cost deposit.

c. An itemization and description of the obligation paid on each disbursement.

d. The current remaining balance of the advance cost deposit.

e. An attached copy of any advertisements paid from the advance cost deposit since the last recorded accounting.

f. _____

4.5 On termination of this agreement, Broker will return to Seller all remaining trust funds.

I agree to the terms stated above.	**I agree to the terms stated above.**
Date:_____, 20_____	Date:_____, 20_____
Broker's name: _____	Seller's name: _____
By:_____	Seller's Signature:_____
	Seller's Signature:_____

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- *now*, when he lists the property for sale, so a purchase agreement entered into with a prospective buyer has a greater likelihood of closing due to the prior delivery of the reports to avert claims of deception about the property's existing condition; or

- *later*, after entering into a purchase agreement with a buyer who has already developed expectations about the property which will probably differ from the reports and, unless the owner repairs the defects or adjusts the price, will likely result in the buyer canceling the purchase agreement or closing escrow and demanding a return of the overpayment in price or the cost incurred for repairs. [Jue, *supra*]

The listing agent meets with the owner to review the listing agreement and its addenda. The cost sheet is presented as an integral part of the agent's **marketing plan** to attract buyers willing to buy the property based on their full knowledge of its condition. The disclosures provide a *competitive sales advantage* over other apparently qualified properties which are marketed without reports to corroborate their condition.

Also, agents representing buyers are attracted to properties offered with all investigative third-party reports handed to them in a complete **listing package** (marketing package). With this package, property disclosures made to buyers through the use of third-party **reports reduce**:

- the seller's exposure to liability under his duty to fully disclose his actual knowledge of the property's condition [Calif. Civil Code §1102.4]; and

- the listing agent's exposure to liability under his duty to personally inspect, observe and report his findings about a property's condition. [CC §2079]

Also, closing escrow on the purchase agreement will not be subject to the buyer's further-approval of the property conditions when all reports are delivered to the prospective buyer prior to entering into a purchase agreement.

The primary marketing advantage for the owner who provides prospective buyers with third-party reports is that the sale of the property is *transparent* at its inception. The price agreed to in the purchase agreement is based on property conditions "as disclosed" by the reports.

Avoided is the undisclosed (and prohibited) "as is" sale which leads inevitably to price renegotiations, repairs, or worse yet for all, cancellation of the purchase agreement or litigation for failing to disclose facts about material defects known when the purchase agreement was accepted. [CC §§1102.1, 2079]

Owner's motivation to sell

An owner's reaction to a listing agent's request for the owner to participate in an advantageous marketing plan by incurring the costs of property reports upfront offers the agent an insight into the extent of the owner's motivation to sell the property. The agent's goal, besides getting a listing, is to encourage and receive maximum cooperation from the owner in the sales effort.

An owner can "dress up " the property and enhance its "curb appeal" by cosmetic painting, landscaping and clean up. However, it is a **property's fundamentals** which generate firm offers to purchase. It is to this end the owner is asked not only to list the property, but to be enthusiastic about disclosing the property's fundamentals to prospective buyers at the **earliest opportunity**.

AUTHORIZATION TO PROVIDE SERVICES

General Services

DATE: _____, 20_____. Prepared by _____.

TO:	**FROM BROKER:**
Company name _____	Agent's name _____
ATTN _____	Broker's name _____
Address _____	Address _____
_____	_____
Phone_____ Fax _____	Phone_____ Fax _____
Email _____	Email _____

1. Property address _____.

1.1 Type of property:

☐ single family residence, ☐ condo unit, ☐ two-to-four residential units,

☐ _____

2. Owner's name _____

Address _____

Home Phone _____ Cell Phone _____

Work Phone _____ Extension _____

3. Please provide the following services: _____

_____

_____

_____

_____

_____

4. Should you need a contract to be executed before rendering your services, it will be entered into by ☐ Owner, ☐ Buyer, or ☐ Agent/Broker.

Name _____

Address _____

_____

Phone _____

5. Should you need to access the property to provide your services, your contact for access will be ☐ Agent/Broker, or ☐ Owner.

6. The fee for your services will be paid by ☐ Owner, ☐ Buyer, or ☐ Agent/Broker.

6.1 Please submit the billing as follows:

a. ☐ To Agent/Broker for payment in full on completion of your services and, if applicable, delivery of any reports or documents.

b. ☐ To Escrow, for payment on the closing of the pending sale.

Escrow company _____

Escrow office _____

Escrow number _____

Address _____

Phone _____ Fax _____

6.2 It is anticipated the amount of the fee for your services will be $ _____.

Submitting Agent's Signature: _____

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However, the owner's motivation to sell may have more to do with his lack of available cash for loan payments than his desire to incur the cost of the reports needed to properly market the property. In the case of a financially distressed owner who is unwilling or unable to obtain expert third-party reports, the listing comes with a significant increase in the listing agent's risk of losing a sale due to a buyer's disapproval of contingencies involving in-escrow disclosures.

Also, an owner may not want to disclose the condition of the property until after he accepts a purchase agreement offer from a buyer. He will then make only those concessions necessary to keep the transaction together, or resell the property to a competing back-up buyer who has been fully informed about the property's condition. Such conduct by an owner is deceitful.

Here, the owner knows something fundamental about the property which negatively affects its value and he does not want to tell the buyer before entering into a purchase agreement. He would rather wait to make disclosures after the buyer has committed himself to purchase the property, a type of intentional seller fraud.

The best time for the listing agent to present the owner with the cost sheet is when the listing in entered into. The owner who really wants to sell and not just "test his price" in the market will respond in a positive manner to the agent's advice. If the owner's response is negative, the owner's intentions to quickly enter into a sales transaction with a likelihood of closing are probably suspect.

The owner's negative response to making property disclosures at the earliest opportunity is an indicator of the level of future cooperation in marketing, contracting to sell and closing an escrow which the agent can expect to encounter from the owner.

Brokerage fee considerations

The amount of the brokerage fee sought by a listing agent on a property is implicitly related to:

- the price sought by the owner of the property;
- the time and effort the agent will spend servicing the listing; and
- the probability of actually locating a buyer and closing a sale.

After analyzing these implications, it is the likelihood the property will sell and the broker will receive a fee that causes a broker to agree to a listing in the first place, on terms and for a fee which are reasonable under the circumstances.

Consider a broker who requires his agents to attach a cost sheet to all listings. By including the addendum, the owner will (or will not) authorize the listing agent to order out reports needed to more effectively market the property and screen prospective buyers. The broker requires the cost sheet addendum to increase the productivity of his agents. Property reports reduce the time spent closing a purchase agreement since the purchase agreement has been **preceded by disclosures**, rather than the reverse order of events.

As part of the listing agent's brokerage fee negotiations, the agent is instructed by his broker to get the owner to authorize the immediate purchase of the necessary reports. If the owner concedes the reports are necessary, but wants to wait until a buyer is located, the listing agent might then negotiate terms to acquire the immediate authority to order reports.

As an economic inducement, the broker, through his agent, might offer to **offset the fee** earned on a sale by the amount of the cost of the reports. The broker should never agree to pay the cost of any corrective work undertaken on the owner's property, unless to settle a dispute which exposes the broker to liability. [See Form 107 §3.3]

Alternatively, a reduction in the brokerage fee by one-quarter to one percent, or more, might be offered to induce the owner to assist in the marketing process by paying for the reports now. The reduced fee would reflect the greater likelihood of a successful closing of a sale, devoid of complications before or after closing.

Thus, the fee ultimately agreed to reflects:

- the reduced time and effort necessary to service the listing;
- the reduced risk of loss of the time, effort and money invested in the listing by the broker and the listing agent; and
- a more effective marketing plan, which, on average, will produce more transactions annually for the broker.

Making a sales transaction more transparent for buyers always rewards the brokers and agents for their professionalism in this and future transactions.

Requesting authority

When preparing the cost sheet authorizing the agent to incur the cost for marketing reports, cost estimates will be entered for items which will ultimately be required to close a sale.

An owner who refuses to incur the cost of third- party reports on the sale of his property needs to be advised that a prudent buyer will incur them on the advice of the buyer's agent. In turn, the buyer will inevitably use the reports against the owner as a "punch list" for demanding repairs and replacements to be completed before the buyer will close escrow.

Thus, for an owner selling property, it is best to get the reports sooner rather than later. The same holds true for implementing the listing agent's marketing plan for the property.

It is worth noting that none of the listed items on the **cost sheet** are part of the broker's overhead for maintaining a brokerage office. All the **costs listed**, if incurred, are related solely to establishing the **condition of the property** listed, marketed and sold. They are incurred to establish the condition of the owner's property, not to pay for the services of the broker and the listing agent. Thus, the cost rightly should be paid by the owner and not borne by the broker or the listing agent.

Further, since the reports are of assistance to the listing agent in the marketing of the property, the costs should be incurred by the owner at the time of the listing. Thus, the reports would be received before the listing agent puts the property on the market. It is always helpful to know the nature and condition of the property you are marketing since the knowledge reduces omissions and misstatements. [Jue, *supra*]

Occasionally, a reticent broker or agent will entertain the thought that some brokers do not ask owners for authority to order reports before a property is sold. And since the competition doesn't ask, why should they ask, lest they lose listings to other brokers by asking owners to spend money on property reports. One supposes these reticent brokers and listing agents should then themselves advance the cost of these reports in the hope the property will sell and they receive a fee to cover their advances.

Business cycles in real estate sales may also influence a broker's desire to request authorization to obtain property reports for a listing package. During periods of rising prices, disclosures seem less likely to occur as sellers become greedy and demanding while buyers are anxious and permissive. Both sellers and buyers drop their guard in a deliberate effort to meet their objectives.

Brokers and their agents are too often accommodating of the lax disclosure environment. The failures only lay dormant until the next recession when the inevitable drop in property values bring some of the failures to litigation.

Conversely, during periods of decreased sales volume with buyers more selective and buyer's agents increasingly more protective of their clients, the owner will have to step forward to fund the cost of reports in order to "sell" the property. The listing agent with property reports in hand has a better listing package, and thus a better disclosed and more certain set of property conditions than competing, under-disclosed properties.

When to pay

When filling out the cost sheet, an owner has choices as to when and how he will pay for the cost of the reports.

The owner may agree to pay the charges directly to the third-party vendors when billed, in which case the agent coordinates the arrangements for payment with the vendors. While the owner's check is payable to the vendor, not the broker, if it is handed to the listing agent for delivery to the vendor, the check constitutes *trust funds* which require an entry in the trust fund ledger maintained by the listing agent's broker. [See Form 107 §3.1]

On the other hand, the owner may deposit the estimated cost of the reports with the broker by making the check payable to the broker, called *advance costs*. The broker would then pay the charges from the deposit when billed by the reporting service. [See Form 107 §3.2]

Advance costs as trust funds

Funds advanced by a client directly to a broker belong to the client.

The broker must place all advance deposits received in the broker's name in a trust account, whether they are advances for future costs or fees. [Calif. Business and Professions Code §10146]

The cost sheet authorizes the broker to disburse the client's funds from the trust account only as costs are incurred.

When the listing terminates, the broker must return all remaining trust funds to the client. The broker cannot use trust funds to offset any fees the client still owes him.

At least every calendar quarter, the broker must give the client a statement accounting for all funds held in trust. A monthly mailing of a copy of the client's trust account ledger would create a better business relationship.

A final accounting must be made when the listing agreement expires. Again, if any funds remain in trust, they must be returned to the client with this accounting. [Bus & P C §10146]

The **statement of account** for the trust funds must include the following information:

- the amount of the *deposit* toward advance costs;
- the amount of each *disbursement* of funds from the trust account;
- an itemized *description* of the cost obligation paid on each disbursement;
- the current remaining *balance* of the advance cost deposit; and
- an attached copy of any *advertisements* paid for from the advance cost deposit.

Lastly, the broker must keep all accounting records for at least three years and make them available to the Department of Real Estate (DRE) on request. [Bus & P C §10148]

A broker who fails to place those advance deposits payable to the broker in his trust account, or who later fails to deliver proper trust account statements to his client, is **presumed** to be guilty of *embezzlement*. [**Burch** v. **Argus Properties, Inc.** (1979) 92 CA3d 128]

Chapter 14 "For Sale" sign regulations

This chapter discusses a property owner's right to display signs advertising his property "For Sale".

Property owners can display

Consider an owner of a residential unit in a common interest development (CID), such as a condominium project, who places a "For Sale" sign in the window of his unit.

A neighbor in the project complains about the sign to the homeowners' association (HOA) which manages the project. In response, the HOA makes a demand on the owner to remove the sign claiming the sign is a violation of the conditions, covenants and restrictions (CC&Rs) controlling conduct in the project.

Can an owner place a "For Sale" sign in the window of his unit where it can be seen by others when the display is in violation of the HOA's CC&Rs or policy statements?

Yes! Owners of real estate and their brokers have the right to display "For Sale" signs of reasonable dimension and design on their property, or on property owned by others if they have their **consent**, in spite of title restrictions in the CC&Rs. [Calif. Civil Code §712]

The "For Sale" sign displayed on the property being sold by the owner or his agents, or displayed on other private property with that owner's consent, may contain:

- advertising stating the property is for sale, lease or exchange;
- directions to the property;
- the owner's or agent's name; and
- the owner's or agent's address and telephone number.

However, the sign or location of a "For Sale" sign must not adversely affect public safety or impede the safe flow of vehicular traffic.

Further, any local governmental ordinance which attempts to **bar or unreasonably restrict** the placement of a real estate "For Sale" sign on the property for sale, or private property owned by others who have consented to the placement of a directional "For Sale" sign on their property, is unenforceable. [CC §713]

Reasonably located on-site signs

"For Sale" signs may be reasonably located in plain view for the public to observe. [CC §§712, 713]

For example, in a CID, the boundaries of a unit owned as the separate interest of a member of the CID are the walls, windows, floors and ceilings. If the CC&Rs of the CID do not state otherwise, the interior surface of the perimeter walls, floors, ceilings, windows, doors, outlets and airspace located within a unit are considered the owner's separate interest. All other portions of the walls, floors, ceilings and real estate are part of the common area maintained and managed by the HOA. [CC §1351(l)]

Thus, the owner is entitled to display a "For Sale" sign on the **interior side** of the window of his condominium unit. The interior side of the window belongs to the owner and placing of the sign in the window is reasonable.

However, if the owner seeks to display the sign on the exterior wall or ground area surrounding his unit, the owner must obtain the permission of the HOA since the exterior walls and ground area are part of the common area, **owned by others**, specifically, the undivided ownership interest held by all the owners of units in the CID or the HOA. [CC §712]

Reasonable restrictions

Now consider a city which prohibits the display of all "For Sale" signs to stop perceived white-flight from a racially integrated city.

A property owner and his listing agent claim the ban is an unconstitutional interference with real estate sales, called a *restraint on alienation,* and violates the owner's freedom of speech.

The city claims the sign prohibition is constitutional since it does not prohibit other ways in which to advertise property for sale, only those advertisements located on the property.

Is the city ordinance a reasonable restriction on the display of "For Sale" signs?

No! Prohibiting the display of "For Sale" signs is a violation of the First Amendment freedom of speech right since other methods of advertising real estate for sale are less effective and the ordinance prohibits the free flow of truthful commercial information. [**Linmark Associates, Inc.** v. **Township of Willingboro** (1977) 431 US 85]

Further, cities and counties may not prohibit the placement of "For Sale" signs on private property, be it the property to be sold or property owned by others who consent to a directional sign being placed on their property. However, government agencies may determine the location, shape and dimensions of "For Sale" signs to ensure the signs do not affect public safety, including traffic safety. [CC §713]

Cities and counties restrict the display of "For Sale" signs on private property through ordinances, nuisance laws or building requirements. Restrictions may vary between residential and industrial zones, and among cities. Copies of "For Sale" sign ordinances controlling their use on private property are available through the city and county planning departments.

Additionally, HOAs cannot prohibit owners of units in a CID from displaying "For Sale" signs within the owner's separately owned land areas if the sign complies with state law and local ordinances. [CC §712]

A copy of a HOA's governing documents and CC&Rs controlling the dimensions and design of "For Sale" signs are available from the HOA.

Signs on right-of-ways and alongside public highways

The display or placement of a "For Sale" sign on a private or public right-of-way, such as roadways, may be limited or regulated by local government agencies. [CC §713]

Further, a directional sign advertising real estate for sale, lease or exchange that is located on property other than the property advertised for sale and visible from a highway which is subject to the federal

Highway Beautification Act requires a **special permit** be obtained from the Director of Transportation of the State of California before the sign may be erected. [Calif. Business and Professions Code §§5200 et seq.]

Locating signs off-site

Consider an agent who, on behalf of a seller of real estate, advertises the seller's property by placing a directional "For Sale" sign on a neighbor's property without first obtaining the neighbor's permission.

The neighbor discovers the "For Sale" sign on his property and removes it. However, the seller's agent continues to replace the sign on weekends without permission from the neighbor.

Does the neighbor have recourse against the agent?

Yes! Placing a sign on private property without the **property owner's permission** is a misdemeanor public nuisance. Preventing a public nuisance is the responsibility of local government authorities on a complaint from the owner who does not consent to the placement of directional signs. [Calif. Penal Code §§556.1, 556.3]

Further, if a property owner or a real estate agent places a "For Sale" or a directional sign on public property without permission, such as on a sidewalk right-of-way or at the curbside, the placement is also a misdemeanor public nuisance. [Pen C §556]

Cities and counties often refuse or severely limit the granting of permission for placement of "For Sale" signs on public property, such as street corners, choosing to strictly enforce the penalties allowed by the California Penal Code. [Pen C §556]

When government agencies do allow "For Sale" signs, they are usually by a special permit and payment of use fees, and allowed only for the sale of parcels in a subdivider's development.

Mobilehomes

A mobilehome owner can place a "For Sale" sign:

- in the window of his mobilehome; or
- outside the mobilehome facing the street.

Signs posted outside of the mobilehome can be of an H-frame or A-frame design and must face the street, but cannot extend into the street. [CC §798.70]

Signs in mobilehome parks may be up to 24 inches wide and 36 inches high, and may contain the name, address and telephone number of the mobilehome owner or the owner's agent.

The right to display mobilehome "For Sale" signs extends to brokers, joint tenants, heirs or a representative of a mobilehome owner's estate who acquires ownership of a mobilehome on the owner's death.

Also, mobilehome owners and their agents can display an "open house" sign in the same locations as "For Sale" signs, if the mobilehome park does not prohibit open house signs.

Tubes or holders for leaflets with information on the mobilehome being advertised may be attached to either the "For Sale" sign or to the mobilehome. [CC §798.70]

Chapter 15 Operating under a buyer's listing

This chapter examines the benefits accruing to a buyer and his broker when they enter into an employment agreement authorizing the broker and his agents to act on behalf of the buyer to locate property.

A prerequisite to representation

Most brokers have come to the realization that a signed buyer's listing agreement is the **minimum commitment** necessary from a buyer to produce the maximum financial return for the time, effort and money brokers and their agents invest when assisting buyers as their representative in negotiations.

A buyer's agent need not and should not require a lesser commitment from a buyer than a listing agent requires from a seller for his services. A buyer's brokers needs to assure himself he will be paid a fee for his services before commencing efforts to locate qualifying properties for a buyer.

To accomplish this level of **financial certainty**, a buyer's broker must enter into a written employment agreement with a prospective buyer, called a *buyer's exclusive right-to-buy listing agreement*. [See Form 103 accompanying Chapter 16]

A buyer who refuses to enter into a written listing agreement provides the broker and his agent with a clear understanding that this buyer does not want a representative. What this unlisted buyer wants is someone to act as a **locator** or **finder** of properties without any entitlement to the collection of compensation for the assistance.

An agent who actually assists a buyer who refuses the agent's solicitation to enter into a listing agreement will soon discover the buyer has turned to a friend or relative who is licensed to submit an offer on the property. Alternatively, the buyer may simply submit an offer directly to the listing agent or seller himself.

Without the buyer's written promise to pay a fee, the buyer's broker will not be entitled to receive a fee should the buyer acquire property by "going around" the broker. No fee has been earned which is collectable from anyone, unless a fee-sharing agreement exists with the listing broker registering the buyer's name. [See **first tuesday** Form 105]

More importantly, it is unreasonable for a broker and his agent to expect to receive a fee, no matter who is to pay it, for working with a buyer who acquires property located and presented to him by them, unless the broker has been retained under a written employment agreement with the buyer. [**Phillippe** v. **Shapell Industries, Inc.** (1987) 43 C3d 1247]

The fee-payment bargain

When an agent solicits employment by a prospective buyer of real estate with the intent of generating fees for his broker, and in turn for himself, various working relationships and compensation arrangements may be struck with the buyer.

Some arrangements for the payment of fees are at best tenuous, especially when the buyer's agent fails to obtain any fee commitment from the buyer, oral or written. Others are astutely built on written prom-

ises, signed by the buyer and broker, which call for payment of a fee should the buyer acquire property. Writings, by their nature, are intended by all who enter into them to be enforced, such as a signed buyer's listing calling for payment of a fee when the buyer's objective of acquiring property is met.

Here are several situations which demonstrate the various likelihoods of **collecting a fee** for assisting a buyer:

1. *No listing exists.* Neither the seller nor the buyer have employed a broker. Typically, the real estate involved is other than an owner-occupied residential property. Also, the seller is usually an experienced real estate investor, subdivider, land speculator, REO lender or other well-seasoned owner who is capable of negotiating a real estate transaction without representation.

   The buyer is usually as experienced as the seller, being a builder, developer, syndicator, professional real estate investor or speculator, but may also be an inexperienced buyer of real estate who believes he possesses the business acumen needed to handle the real estate negotiations by himself. Thus, all the principals feel they do not need a broker to represent them and negotiate the sale or purchase of properties. However, they do need someone or some medium to bring them together as a match.

Editor's note — It is this class of buyer who occasionally induces a broker or sales agent to bring properties to their attention. What the buyer lacks, and seeks to get from anyone willing to act, is a locator or finder who will bring him qualifying properties. If asked, the buyer will always orally assure the broker or sales agent their fee will be protected. Unlisted sellers are more blunt, telling the agent to simply bring them offers.

2. *"A one-shot" seller's listing exists.* A buyer is willing to make an offer through the agent who brought a property to the buyer's attention. Both the seller and buyer are typically sophisticated principals.

   Here, the agent fails to ask the buyer to enter into an exclusive right-to-buy listing. Obliquely, the agent solicits and obtains a "one-shot" right-to-sell listing from the seller before the agent will submit the buyer's offer to the seller. The seller's listing contains a promise to pay a fee. Sometimes the separate fee agreement is the one intended to accompany the offer, which is neither identified nor yet submitted.

   This brokerage situation comes about primarily because the purchase agreement the agent is told to use does not include a fee provision requiring someone to pay a fee should the buyer eventually acquire the property.

   Here, the buyer is not solicited to agree to pay a fee under a buyer's listing and the broker has mistakenly instructed his agent to list the seller before submitting an offer.

3. *Customer turned client.* An agent of a broker with several listed properties is contacted by a prospective buyer. The buyer is exposed to all the "in-house" listings, none of which are suitable or of interest to the buyer. Having exhausted the in-house inventory of listings, the agent can either see the buyer off or make arrangements with the buyer to look into qualifying properties listed by other brokers or into unlisted properties For Sale By Owners (FSBOs), and when located, present them to the buyer.

If the buyer agrees to allow the agent to locate qualifying properties, the agent must ask the buyer to sign a buyer's listing agreement if his broker is to be assured payment of a fee when the buyer acquires property. If the buyer refuses to enter into a buyer's listing, the agent might still proceed to assist the buyer to locate property.

Should the buyer later make an offer prepared by the agent, a purchase agreement form must be used which places the fee provision in the body of the buyer's offer if the agent is to protect his fee.

On failing to obtain a signed listing, the buyer's agent should enter into a fee-sharing arrangement with the listing office for the property specifically naming (registering) the prospective buyer so the time and effort of the buyer's agent is protected should the buyer "go around" the agent and acquire the property. [See **first tuesday** Form 105]

4. *A buyer's listing agreement exists*. An agent's broker is employed in writing under a signed exclusive right-to-buy listing agreement to represent the buyer by locating and negotiating the purchase of suitable property of the type sought by the buyer.

   A seller of suitable property may or may not have signed a seller's listing agreement with another broker. Either way, the buyer's broker controls the amount and destiny of the fee he is to be paid when his buyer buys.

Providing expertise without a writing

One should sense, on a review of the four basic fee arrangements available to buyer's brokers and their agents, that the lack of a written fee agreement with a buyer when representing the buyer is a failure to exercise prudent judgment in the management of a brokerage business.

Yet many buyer's agents fail to ask their buyer for a written commitment to assure payment of a fee on the buyer's purchase of property. Occasionally, buyer's agents are inexplicably willing to work for a buyer who, when asked, refuses to enter into a buyer's listing agreement.

Consider a real estate agent who is fairly knowledgeable about subdividable and developable land for the construction and sale of single-family residences. Most of the parcels of land known to the agent are not listed since the sellers are experienced speculators and investors who will not enter into employment contracts with brokers, be they open, exclusive agency or exclusive right-to-sell employment agreements.

The agent contacts prospective buyers. One is a builder who expresses an interest in acquiring land for development. The agent tells the buyer he expects a 10% brokerage fee should the buyer acquire any of the properties presented to him. The buyer agrees he will pay the fee, or see to it that the seller pays the fee. When asked, the buyer refuses to sign a buyer's listing agreement.

Undeterred, the agent exposes the builder to numerous parcels, one of which the builder would like to acquire. The agent assists in the builder's due diligence investigation, gathering significant portions of the data on the property. Correspondence during the due diligence investigation, signed and sent by the agent, reminds the builder of his obligation to pay or protect the 10% brokerage fee if he acquires the property. The builder never once mentions the fee in any of his correspondence to the agent (or in writings to anyone else).

The builder, having had contact with the seller during the initial due diligence investigation, prepares his own purchase agreement offer and submits it directly to the seller. A fee provision is not included in the purchase agreement. The transaction is closed and the agent's broker does not receive a fee.

The broker makes a demand on the builder for payment of the promised fee, which the builder now refuses to pay. The builder claims the broker cannot enforce a promise to pay a brokerage fee unless the buyer who made the promise has signed a writing evidencing his promise to do so.

The broker claims a writing is not necessary to document the builder's promise to pay a fee since the builder induced the broker's agent to enter into an agency relationship with the builder, which the agent faithfully and fully performed. Further, the builder relied on the agent's services with the deceitful intent of benefitting from the services and acquiring the property without payment of a fee.

Can the broker enforce collection of the fee?

No! All **promises to pay** or assurances of the payment of a brokerage fee on a real estate transaction are required by the Statute of Frauds to be reduced to a writing signed by the person who agreed a fee would be paid, regardless of whether the fee would be paid by that person or by another party to the transaction. [Phillippe, *supra*]

Here, the dilemma the broker and his agent face when a buyer refuses to sign a buyer's listing agreement, be it an open or exclusive listing, is the decision to either:

- **terminate the solicitation** of employment by this buyer and locate other buyers willing to agree in writing to pay a fee for the broker's and agent's valuable services; or

- **undertake the representation** of the buyer and hope to finesse the inclusion of a fee provision in a purchase agreement offer should one be prepared by the broker and signed by the buyer.

The agent chose the second approach and lost. The unlisted buyer prepared his own offer and "went around" the agent and his broker.

Buyer's agent lists the property

In an example of a "one-shot" listing, an agent for a broker assists a prospective buyer who wants to acquire nonresidential income property. The agent does not ask the buyer to sign an employment agreement since the agent (mistakenly) believes he may only contract with sellers or listing brokers regarding the payment of his fee.

Further, the agent's broker requires the agent to use purchase agreement forms which fail to include fee provisions in the body of the buyer's offer. Thus, the buyer's agent is left to negotiate the fee arrangements with the seller (or the seller's broker), rather than arranging with the buyer through a provision in the buyer's offer to set the amount the seller will pay.

A seller of real estate who has not listed his property for sale has released information on the property's income and physical condition with the understanding he will "cooperate with brokers" by paying a brokerage fee to any broker who **produces a prospective buyer** who purchases the property.

The buyer's agent brings the property to the attention of his prospective buyer, along with several other properties available for purchase. After further investigation on behalf of the buyer, the seller's property appears suitable for acquisition by the buyer.

However, before preparing a purchase offer for the buyer to sign, the agent believes (or is instructed by his broker) that before submitting an offer, he must first obtain a written fee agreement signed by the seller which employs the broker (and thus himself) so payment of a fee is assured.

As a result, the buyer's agent solicits the seller to sign a "one-day" or "one-shot" listing. The agent does not inform the seller of his efforts as a buyer's agent spent locating property on behalf of the prospective buyer, although an agency law disclosure is attached to the listing.

The seller agrees to the "one-shot" listing and signs a listing agreement prepared by the agent. On obtaining the listing, the agent prepares an offer which his prospective buyer signs. On submission to the seller, the offer is accepted forming a binding purchase agreement. Again, the agency relationship with the buyer is not disclosed to the seller.

Prior to closing the transaction, the seller discovers the prospective buyer was represented by the agent as a client of the broker at the time of the listing.

The seller immediately cancels the supplemental escrow instructions, unsigned by the buyer, which authorizes escrow to pay the agent's broker a fee. The sales escrow is closed and the buyer acquires the property. No fee is received by the broker. In turn, the sales agent receives no fee.

At no time did the buyer agree in writing to the payment by anyone of a fee to the broker. Thus, the buyer does not owe a fee since he did not make a written commitment or interfere with payment of the fee.

The broker makes a demand on the seller for payment of a fee, claiming the broker and his agent had fully performed under the listing. The seller claims he does not owe a fee since, prior to entering into the listing agreement, the broker's agent failed to disclose the **pre-existing agency relationship** with the buyer which was established when the agent assisted the buyer to locate suitable property.

In this situation, can the broker enforce collection of the fee agreed to by the seller in the listing, the purchase agreement and the escrow instructions?

No! Before becoming employed by a seller to negotiate the sale of property with a prospective buyer who is already represented by the broker, the existence of the agency relationship previously created (by conduct) with the prospective buyer to locate suitable property must be disclosed to the seller. It is a fact which might alter the seller's decision to sell or his negotiations with the buyer if he decides to sell.

Here, the seller thought the agent (and his broker) represented only the seller, not both the seller and the buyer. Accordingly, the minimum liability of the broker to the seller for the **undisclosed dual agency** is the loss of his fee for failure to faithfully represent the seller due to an undisclosed conflict of interest. [**L. Byron Culver & Associates** v. **Jaoudi Industrial & Trading Corporation** (1991) 1 CA4th 300]

The proper structuring of a provision and documentation of the brokerage fee by a broker and his agent who are already **assisting a prospective buyer** to locate and acquire property is to either:

- **enter** into a written employment agreement with the buyer, called a buyer's listing; then **prepare** a purchase agreement offer on a form which places the fee provision within the terms of the buyer's offer, stating the exact amount of the fee and who will pay it; and **submit** the purchase agreement offer to the seller for acceptance without ever entering into an employment agreement under any type of listing with the seller; or

- if the buyer refuses to sign a buyer's listing agreement, **prepare**, at the earliest opportunity, an offer to buy on a purchase agreement formatted with the fee provision located within the body of the buyer's signed offer; and **submit** the offer without ever entering into a listing agreement with the seller.

Converting a prospect into a client

A brokerage office which has been marketing its inventory of listed properties is contacted by a buyer who is interested in properties of the type they offer for sale. The properties were listed by several different agents in the office, each called the *listing agent* when referring to the listing they took. The broker's agent contacted by the buyer is referred to as the *selling agent* by the other agents in the office. The selling agent loosely refers to the unlisted buyer as his "customer."

Editor's note — Even though the agent who will provide the prospective buyer with information on "in-house listings" is called the "selling agent," neither the agent nor the broker have yet conducted themselves in a manner which raises the legal stature of their relationship with the buyer to that of the buyer's agent.

The buyer is furnished information on various properties listed by the office. None of the properties attract the buyer's interest. In the process of reviewing data on listed properties with the buyer, the agent has developed a good understanding of the type, price range, price-to-earnings ratios and location desired for property sought by the buyer. Also, the agent has determined the prospective buyer is financially capable of acquiring property and has not yet employed a broker to locate properties and negotiate a purchase on his behalf.

The agent, having made a diligent effort to provide information and sell property listed with his broker, now has to choose between:

- soliciting and establishing a continuing working relationship with the buyer as a *buyer's agent* to locate qualifying properties and assist with the investigation and determination as to whether the property meets the buyer's acquisition standards; or

- restricting his brokerage activities to advising the prospective buyer that he will be contacted when property which fits the parameters of his investment objectives is listed with the agent's broker.

The broker and agent opt to undertake an **agency relationship** with the buyer in order to work diligently to locate and investigate available properties on behalf of the buyer.

The buyer, who has until now been treated as a customer, is now asked to become a **client**. As a client, he authorizes the agent to act on behalf of the buyer to locate and look into properties unlisted, but known to be on the market or listed with other brokers. The buyer agrees.

The agent explains the brokerage office needs written authorization employing them as the buyer's agent in order to contact listing brokers and sellers on the buyer's behalf. Again, the buyer agrees. An exclusive right-to-buy listing agreement is prepared by the agent and signed by the buyer, who now becomes a client entitled to the agent's *utmost care and diligence* in the locating and analyzing of properties for purchase.

Thus, the agent converted a prospective buyer from a **customer** who contacted the office inquiring about property they had listed, into a **client** on whose behalf the entire office of agents can act (under their bro-

ker) as the **buyer's agent**. Thus, the office is assured payment of a fee should the buyer acquire property during the listing period or the following safety clause period, whether the property purchased is located by agents in the office or by anyone else (including the buyer).

Agency duties owed to buyers

The *special agency duties owed* to a buyer when a broker and his agents undertake to locate property on behalf of the buyer first arise when the broker:

- **enters** into an exclusive right-to-buy agreement with the buyer; or
- **presents** property information to an unlisted buyer who they have agreed to assist by locating qualifying properties.

When representing a buyer under a written exclusive right-to-buy employment agreement, the broker (and his agents) have entered into a *bilateral employment agreement*. Such an employment obligates the broker, through his agents, to exercise *due diligence* by way of a constant and continuing search to locate qualifying properties, while keeping the buyer informed of their progress.

Without an exclusive right-to-buy listing, the brokerage duties which exist to locate properties for a buyer are *best-effort obligations* created by an oral (or written) open listing, called a *unilateral employment agreement*. A **best-effort obligation** requires no affirmative action (diligence) on the part of the broker's office to locate property.

However, under a buyer's listing, be it exclusive or open, the act of **delivering property information** to the buyer they are assisting obligates the broker and his agents to use due diligence in their efforts to:

- *gather readily available data* on the property under review;
- *assist in the analysis* of the property data gathered; and
- *advise the buyer* regarding the property and any proposed transaction in a conscientious effort to act honestly, care for and protect the buyer's best interests.

When acting as the buyer's agent regarding the acquisition of a particular property, due diligence includes disclosing facts about the integrity of the property and recommending investigative activity which the agent knows might influence the buyer's conduct in negotiations.

Without an exclusive employment with a buyer on whose behalf the agent is locating properties, the agent is reduced to a mere "locator" or "finder." Worse yet, the agent is burdened with the affirmative agency duties of utmost care and protection owed the buyer when undertaking a review of data on a property with the unlisted buyer.

Provisions for payment of a fee

An exclusive right-to-buy agreement contains the same operative provisions as are found in exclusive right-to-sell agreements. [See Form 103]

In exchange for the broker's promise to use *due diligence* while rendering services to comply with his end of the employment bargain, the buyer promises in the exclusive right-to- buy listing agreement to

pay the broker a specific fee — either a fixed dollar amount or a percentage of the price paid. The fee is earned when the buyer enters into a binding purchase agreement during the (buyer's) listing period to acquire the type of property described in the buyer's listing.

However, buyers, like sellers, often do not enter into a purchase agreement during the period of employment. Thus, on expiration of the listing, the buyer's broker has not earned a fee. An event triggering payment of the promised fee has not yet occurred.

However, the fee provision of a buyer's listing agreement contains a *safety clause*. The clause provides protection to the broker and his agent after the employment expires from the loss of their time, effort and money "invested" during the employment period to assist the buyer. [See Form 103 §5.1(c); see Chapter 12]

Thus, the broker of the buyer's agent will be entitled to a fee if, within an agreed-to period after the expiration of the buyer's listing:

- information specific to the property was provided to the buyer by the buyer's agent during the listing period;
- on expiration of the buyer's listing, the buyer is handed an itemized list which identifies those properties the buyer's agent brought to the buyer's attention, as required to *perfect* the broker's right to a fee [See **first tuesday** Form 123];
- the buyer entered into negotiations with the owner of a registered property; and
- the safety-period negotiations ultimately resulted in the buyer acquiring an interest in the property.

Buyer's liability for the brokerage fee

While the buyer under a listing agreement promises to pay a full brokerage fee on the acquisition of property (typically 6% of the purchase price), the buyer will nearly always close the purchase without directly paying the promised brokerage fee. Further, the buyer's broker will typically **accept a fee** equal to no less than one-half of the fee the buyer agreed to pay under the buyer's listing when the property purchased by the buyer is listed with another broker (who it is presumed has done his half of the work).

Can the broker enforce the fee arrangement in the buyer's listing and recover the remaining 3% from the buyer when the seller pays a lesser fee than the buyer agreed to pay?

No! The buyer's obligation to pay the brokerage fee is **fully satisfied** when the buyer's broker agrees to accept a fee from the seller or the seller's broker, which is nearly always the case. [See Form 103 §5.2]

Benefits for the listed buyer

Like sellers, buyers may resist making a written commitment to exclusively employ one brokerage office as their agent to locate and negotiate the purchase of real estate on their behalf. However, listed buyers reap benefits unavailable to those buyers who are not exclusively represented by a broker and his agents. Without representation, the unlisted buyer is on his own to conduct a random search among available properties to locate a suitable property.

However, brokers and their agents have access to data which is often not made publicly available to buyers, such as multiple listing service (MLS) printouts, new listings, database searches for qualifying properties, property profiles and comparable sales data provided to brokers and agents by title companies and other brokers.

The activities of a buyer's agent also include approving their buyer with a capable lender and advising the buyer on the location of qualifying properties, the socio-economic mix of neighborhoods, schools and their reputations, local bus lines, religious facilities, zoning, and subdivision and common interest development (CID) restrictions on property usage.

Also, agents attend numerous marketing sessions and trade meetings for the sole purpose of sharing information on listed properties and properties sought by buyers.

All this general information is centrally controlled, channelled and best understood by brokers and agents. It is their business. Thus, when entering into a buyer's listing agreement employing a broker and his agents, a buyer bargains for this insider information to help make decisions which will make the ownership of real estate more viable.

Chapter 16 The buyer's listing agreement

This chapter presents the buyer's exclusive right-to-buy listing agreement with instructions for an agent's use of the form.

Analyzing the buyer's listing

The exclusive right-to-buy listing agreement, **first tuesday** Form 103, is used by a broker and his agents to prepare and submit the broker's offer to act as a prospective buyer's *exclusive real estate agent.* Under it, the broker is employed to locate property sought by the buyer in exchange for the buyer's **assurance a fee will be paid** the broker if the buyer acquires the type of property sought during the listing period. [See Form 103 accompanying this chapter]

Formal documentation of an obligation to pay a fee — a written agreement signed by the buyer — is the legislatively enacted and judicially mandated requisite to the right to enforce collection of a brokerage fee through or from the buyer.

Each section in Form 103 has a separate purpose and need for enforcement. The sections include:

1. *Brokerage services:* The employment period for rendering brokerage services and the broker's due diligence obligations are set forth in sections 1 and 2. General provisions for enforcement of the employment agreement and broker fee-splitting arrangements are included in section 3.

2. *Brokerage fee:* The buyer's obligation to either pay a brokerage fee or assure payment of the brokerage fee by the seller or a listing broker, the amount of the fee and when the fee is due are set forth in section 4.

3. *Property sought:* A general description of the type of property to be located for the buyer is then set forth.

4. *Signatures and identification of the parties:* On completion of entries on the listing form and any attached addenda, the buyer and the broker (or his agent) sign the document consenting to the employment.

Preparing the buyer's listing agreement

The following instructions are for the preparation and use of the Buyer's Listing Agreement — Exclusive Right to Buy, Lease or Option, **first tuesday** Form 103, with which a buyer employs a broker as his exclusive agent to locate suitable property for the buyer to acquire.

Each instruction corresponds to the provision in the form bearing the same number.

*Editor's note — **Check** and **enter** items throughout the agreement in each provision with boxes and blanks, unless the provision is not intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Document identification:

Enter the date and name of the city where the listing is prepared. This date is used when referring to this listing agreement.

1. **Retainer period:**

   1.1 *Listing start and end date:* **Enter** the date the brokerage services are to commence.

   Enter the expiration date of the employment period. The expiration must be set as a specific date on which the employment ends since an exclusive listing is being established.

2. **Broker's obligations:**

   2.1 *Broker's/agent's duty:* The broker and his agents promise to use diligence in their effort to locate the property sought by the buyer. The agency duties a broker and his agents owe the buyer are always implied, if not expressed in writing.

   2.2 *Agency Law Disclosure:* **Check** the box if the Agency Law Disclosure – Real Estate Agency Relationships is to be attached as an addendum to this agreement, and if so, **fill out** and **attach** the form. [See Form 305 accompanying Chapter 6]

3. **General provisions:**

   3.1 *Authority to share fees:* **Authorizes** the broker to cooperate with other brokers and share with them any fee paid on any transaction.

   3.2 *Mediation agreement:* **States** *the parties agree to non-binding mediation after 30 days of informal negotiations prior to filing a court action.*

   3.3 *Attorney fees:* **Entitles** the prevailing party to attorney fees if litigation results from the buyer's failure to pay fees or the broker's breach of an agency duty.

   3.4 *Choice-of-law provision:* **States** California law will apply to any enforcement of this employment.

4. **Brokerage fee:**

   4.1 *Fee amount:* **Enter** the fee amount negotiated to be paid as a percentage of the sales price or a fixed dollar amount. This amount will be paid when any one of the following conditions occur triggering payment:

      a. *Fee on any sale*: **States** the brokerage fee is earned and due if the buyer acquires, exchanges for or options property during the listing period. [See Form 103 §5.1(c) for fee due on post-listing period sales]

      b. *Termination fee*: **States** the brokerage fee is earned and due if, during the listing period, the buyer terminates this employment or withdraws from pursuing the purchase of real estate.

      c. *Safety clause fee*: **States** the brokerage fee is earned and due if, within one year after the listing expires, the buyer enters into negotiations for the purchase, option, or exchange of property the broker exposed him to during the listing period. Within 21 days after expira-

BUYER'S LISTING AGREEMENT

Exclusive Right to Buy, Lease or Option

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

1. RETAINER PERIOD:

1.1 Buyer hereby retains and grants to Broker the exclusive right to locate real property of the type described below and to negotiate the terms and conditions for its purchase, lease or option, acceptable to Buyer, for the period beginning on _____, 20_____ and terminating on _____, 20_____.

2. BROKER'S OBLIGATIONS:

2.1 Broker to use diligence in the performance of this employment.

2.2 ☐ See attached Rules-of-Agency Law Disclosure [See **ft** Form 305]

3. GENERAL PROVISIONS:

3.1 Buyer authorizes Broker to cooperate with other brokers and divide with them any compensation due.

3.2 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

3.3 The prevailing party in any dispute shall be entitled to attorney fees and costs, unless they proceed with litigation without first offering to enter into mediation to resolve the dispute.

3.4 This agreement will be governed by California law.

4. BROKERAGE FEE:

NOTICE: The amount or rate of real estate fees is not fixed by law. They are set by each Broker individually and may be negotiable between Client and Broker.

4.1 Buyer agrees to pay Broker _____ of the purchase price of the property sought, IF:

a. Buyer, or any person acting on Buyer's behalf, purchases, leases, exchanges for or obtains a purchase option on real property sought under this agreement during the retainer period.

b. Buyer terminates this employment of Broker during the listing period.

c. Within one year after termination of this agreement, Buyer enters into negotiations which result in Buyer's acquisition of an interest in any property Broker has solicited information on or negotiated with its owner, directly or indirectly, on behalf of Buyer prior to this agreement's termination. Broker to identify prospective properties by written notice to Buyer within 21 days after termination. [See **ft** Form 123]

4.2 Buyer's obligation to pay Broker a brokerage fee is extinguished on Broker's acceptance of a fee from Seller or Seller's Broker of property acquired by Buyer.

4.3 In the event this agreement terminates without Broker receiving a fee under §4.1 or §4.2, Buyer to pay Broker the sum of $_____ per hour of time accounted for by Broker, not to exceed $_____.

TYPE OF PROPERTY SOUGHT:

GENERAL DESCRIPTION _____

LOCATION _____ SIZE _____

RENTAL AMOUNT / TERM _____

I agree to render services on the terms stated above.

Date: _____, 20_____

Buyer's Broker: _____

Broker's DRE Identification #: _____

Broker's Agent: _____

Agent's DRE Identification #: _____

Signature: _____

Address: _____

_____

Phone: _____

Fax: _____

Email: _____

I agree to employ Broker on the terms stated above.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: _____, 20_____

Buyer's Name: _____

Signature: _____

Buyer's Name: _____

Signature: _____

Address: _____

_____

Phone: _____

Fax: _____

Email: _____

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Figure 1

*Excerpt from **first tuesday** Form 123 — Identification of Qualifying Properties*

IDENTIFICATION OF QUALIFYING PROPERTIES

NOTE: Your employment agreement calls for payment of a brokerage fee on transactions with the Owners of these qualifying properties resulting from negotiations commenced within the one-year period following termination of the agreement.

If you employ another Broker during this period to provide similar services, bring this document and the expired listing to the Broker's attention.

DATE: _____, 20_____, at _____, California.

TO: _____, Buyer/Tenant.

Items left blank or unchecked are not applicable.

1. FACTS:

1.1 This is an addendum to the following agreement:

a. ☐ Buyer's Listing Agreement — Exclusive Right to Buy, Lease or Option [See **ft** Form 103]

b. ☐ Exclusive Authorization To Locate Space [See **ft** Form 111]

1.2 dated _____, 20_____, at _____, California,

1.3 entered into by you and Broker regarding the location of real estate generally referred to as _____,

1.4 located within the area of _____.

2. IDENTIFICATION:

2.1 This addendum registers with you the identities of properties qualifying as the type sought by Buyer/Tenant which Broker located, investigated, solicited or negotiated for acquisition by Buyer/Tenant under the above referenced agreement.

2.2 Buyer/Tenant is obligated under the listing agreement to pay a brokerage fee if, within one year after termination of the agreement, Buyer/Tenant enters into negotiations which result in the acquisition or lease of any of the following properties:

Address _____

Address _____

tion of the listing period, the broker must provide the buyer with a list of the qualifying properties reviewed with the buyer during the listing period. [See Figure 1 accompanying this chapter]

4.2 *Fees paid by seller:* The buyer will not owe any fees if the seller pays a fee or the seller's broker shares a fee in an amount acceptable to the broker. If the seller or the seller's broker do not agree to pay or share a fee with the broker, the buyer is to pay the brokerage fee in addition to the purchase price.

4.3 *Hourly fee:* **Enter** the negotiated dollar amount of the broker's per hour fee. The hourly fee is earned for time and effort spent on behalf of the buyer should property not be optioned or acquired by purchase or exchange after a diligent effort is made to locate property.

Type of property sought:

Property description: **Enter** a description of the type of real estate sought by the buyer, including its size, general location, purchase terms, and property requirements.

Signatures

Broker's/Agent's signature: **Enter** the date the listing is signed. **Enter** the broker's name and DRE license number. **Enter** the agent's name and DRE license number. **Enter** the broker's (or agent's) signature. **Enter** the broker's address, telephone and fax numbers, and his email address.

Buyer's signature: If additional buyers are involved, **check** the box, prepare a Signature Page Addendum form, reference this listing agreement, and enter their names and obtain their signatures until all buyers are individually named and have signed. **Enter** the date the buyer signs the listing and the buyer's name. **Obtain** the buyer's signature. **Enter** the buyer's address, telephone and fax numbers, and his email address.

Chapter 17 Sharing fees on a sale

This chapter analyzes the history and current status of fee sharing between seller's agents and buyer's agents on the sale of a home, and the "no-service, no-fee" and controlled business rules for referrals to service providers.

Buyer's agent or cooperating agent?

The characterization of a buyer's agent, in practice, as a cooperating agent is improper. The word "cooperating" lacks descriptive value when the purpose of it is to label the agent or broker involved as the representative of a buyer.

The **plain meaning** of the adjective "cooperating" is of no help in determining any activity other than a collaboration by two brokers to pair their respective clients to make a match for the transfer of property.

For the buyer's agent to tell a buyer, "Oh yes, we cooperate with other brokers on their listings," conveys no thought of fee sharing or the establishment of an agency. The buyer logically only understands that the brokers are **sharing information** in a joint effort to assist the buyer in a decision as to which, of all the prospective properties available, he should buy.

Further, at the judicial level and based on legislation, the *cooperating agent* has been established as the title for a **subagent of the seller**, never a buyer's agent acting exclusively and in the best interests of his buyer. Thus, any use of the title "cooperating (selling) broker" is a legal reference to a subagent acting on behalf of the seller, and if a dual agent, then also on behalf of the buyer.

The codified agency law scheme defines a *cooperating broker* as one acting as a subagent with specific affirmative duties of care **owed the seller**, not the buyer. However, any cooperating broker must deal fairly and in a nondeceitful manner with the buyer, as must also the seller's primary agent. No such severe limitations exists on the duties owed to buyers by a buyer's agent. [Calif. Civil Code §2079.16]

Further, a **subagent** is identified by code as the agent in the sales transaction who *cooperates* with the listing agent **to sell** the property or **to locate** a buyer on behalf of the seller. The real estate agency scheme also labels the subagent as a *selling agent* if, while acting on behalf of the seller, he deals directly with the prospective buyer, there presumably being no buyer's agent. The scheme separates the seller's subagent from any buyer's agent who is engaged by the buyer to locate property. [CC §§2079.13(n), 2079.13(o)]

Thus, the "cooperation" contemplated by the legislature is not the fee-sharing structure employed in the fee-sharing addendum attached to purchase agreements still used by multiple listing service (MLS) residential listing brokers. Brokers and their agents who act exclusively as agents for the buyer and share fees, simply put, are not cooperating brokers.

Unbundled, off-form fee provisions

For a buyer's broker to have **equal ability** to negotiate and collect a fee as a seller's broker:

- the buyer's broker must enter into an employment agreement with their buyer, called a *buyer's listing*, to be assured the buyer will have legal incentive to back up fee demands which the buyer's agent may make on the seller;
- a fee provision must be written into the buyer's *purchase agreement offer*, stating the seller will pay a brokerage fee in an amount set by the buyer's broker and the buyer;
- the fee earned and payable by the seller to the buyer's broker must be *payable directly to the buyer's broker* by the seller, through escrow;
- the seller must agree to pay the fee earned by the brokers should the seller wrongfully *fail to close* the sale so the buyer's broker can pursue collection of his share, no matter the action or inaction to do so by the seller's broker; and
- the buyer must agree to pay the fee earned by the brokers should the buyer unjustifiably *fails to close*, allowing both the seller's broker and the buyer's broker to enforce collection of their respective share of the fee from the buyer.

The payment by the seller of the fee earned by the buyer's broker in no way establishes or indicates an agency with the seller. Thus, no rationale exists to take the payment of the brokers' fees due on the acceptance of a purchase agreement offer "off form," placing it in a separate agreement calling for the seller to pay only the seller's broker. [CC §§2079.16, 2079.19]

However, the buyer's broker may wish to abide by the off-form scheme for payment of his brokerage fee by the listing broker and not the seller directly.

Occasionally, the fee offered by the listing broker through the MLS is less than the amount the buyer's broker feels he is entitled to on the transaction. Here, the buyer's broker is at liberty to negotiate with the listing broker and agree to a different fee schedule than the one offered in the MLS publication, any agreement being in writing.

Thus, on acceptance of the buyer's purchase agreement offer (which is devoid of a fee provision), the buyer's broker is assured that the "off-form" fee agreement will actually provide for the listing broker to pay the agreed share to the buyer's broker. [See **first tuesday** Form 105]

If the buyer's broker does acquiesce to the off-form fee agreement in which he receives his fee from the listing broker, the covert aspect of not letting the buyer know what fees are paid the buyer's broker is a direct violation of the agency rule stating the client is to be informed of all compensation received from all sources by his agent as a result of the representation. [See Form 119 accompanying Chapter 21]

Had the buyer's agent actually been only a *cooperating agent* negotiating the sale of the property to the buyer on behalf of the seller (as a statutory subagent), then the off-form fee arrangement and the non-disclosure to the buyer of the subagent's compensation is of no concern to the buyer. The buyer has no agent, or has his own agent. The seller, as the client of the cooperating (selling) broker, is fully aware of his subagent's compensation since he is agreeing to it.

All distortions and shortcomings in fee arrangements are avoided and the buyer's broker's fee is protected when the buyer's agent simply includes the fee arrangements as a provision in the purchase agreement offer agreed to by the buyer.

A profit, not a referral fee

In times of slowing real estate activity, prudent residential brokers listing a property or representing a buyer can generate additional income by diversifying their brokerage business, becoming *full-service brokers* by referring buyers and sellers to lenders and service providers they own or co-own. These business relationships, called *affiliated business arrangements* or *controlled business arrangements*, properly enable the broker to indirectly benefit by sharing in any profits from the referrals he makes to these controlled businesses.

However, the single-family residential (SFR) broker's ability to **profit from referrals** is regulated by the federal Real Estate Settlement Procedures Act (RESPA) Section 8.

RESPA was enacted to prohibit brokers and lenders from unnecessarily augmenting a buyer's costs when negotiating a transaction involving the origination of a federally related loan on a one-to-four unit residential property. These augmented costs too frequently take the form of illegal *referral fees*; some don't since they are subject to competition.

Referral fees are paid by service providers, which include brokers, for referring business to them so they can perform a service in connection with a real estate purchase agreement or escrow to close a sale. These service providers, essential to the close of a sale, include title and finance companies, credit reporting agencies, home inspection and pest control companies, hazard insurers, escrow companies, and brokers.

The broker receiving a brokerage fee for negotiating the sale or purchase of a one-to-four residential unit which involves the origination of a loan may not receive a **referral fee in addition** to the brokerage fee on the sale as it would then be illegal. However, he can still profit from referring a buyer or seller to a service provider if he is an owner or co-owner of the service provider he recommended. Thus, the broker creates an **affiliated business arrangement**.

Profiting by referral to an affiliate

For the broker to meet conditions to profit from an **affiliated business arrangement**, he must:

- have an *ownership interest* greater than one percent in the business he's recommending to the buyer or seller; and
- hand a *written disclosure* of the affiliation to the person he refers to the controlled business. [See **first tuesday** Form 519]

The referral to an owned or co-owned service provider for profit is an affiliated business arrangement and is not subject to RESPA referral fee regulations. As an owner of the service provider, the benefit the broker receives from the referral is not the payment of a referral fee. Rather, the broker receives an indirect benefit from the referral through any annual profits generated for the co-owners by the operations of the service provider to whom he referred the business.

Thus, when the broker of a listed property refers the owner to a pest control business in which he holds an ownership interest, an affiliated business arrangement is created. If fully disclosed, the broker may benefit by sharing in any end-of-year profit the business realizes on the referral. Conversely, the broker who does not possess an ownership interest in the referred business is not involved in an affiliated business arrangement. Thus, the broker may not receive a referral fee and will receive no financial benefit from the referral.

An individual who accepts a referral fee or fails to disclose the existence of the affiliated relationship as prescribed by RESPA is subject to criminal penalties of $10,000, one year in jail, or both for each offense. Also, the person referred to the service provider may in a civil suit receive up to three times the amount of the improper referral fee received by the broker, plus attorney fees. [12 United States Code §§2607(a), 2607(c)(4)(a), 2607(d)]

However, the broker referring a seller or buyer to a service provider he owns or co-owns must disclose his **ownership interest** in the provider to the seller or buyer on or before referring them to the provider. [24 Code of Federal Regulations §3500.15(b)(1); see **first tuesday** Form 519]

The disclosure includes the nature of the business relationship between the broker and the business providing the settlement services, as well as an estimate of the cost or range of costs to be charged. [24 CFR §3500.15(b)(1)]

Other disclosures for direct or indirect compensation exist and can be used in conjunction with the affiliated business arrangement. The Compensation Disclosure in a Real Estate Transaction form discloses the amount, its form, and the source of compensation and benefits the broker anticipates receiving for any service or from any party or provider as a result of their client's entry into a purchase agreement or other real estate transaction. [See Form 119 accompanying Chapter 21]

No additional service, no additional fee

A return on the ownership interest in a controlled business arrangement is not the only method a SFR broker can use to receive additional compensation in excess of his brokerage fee on the transaction. The broker may receive a second fee if he renders substantial loan origination services otherwise performed by the lender. However, this too is strictly regulated by RESPA.

RESPA established a **no-service**, **no-fee** restriction on real estate brokers and agents who are already acting on behalf of a buyer or seller in an SFR real estate transaction financed by a RESPA loan. A lender is prohibited from paying brokers and their agents a fee of any type when the broker is already receiving a fee on the sale for brokerage services they have rendered on behalf of a buyer or seller, unless the broker performs *significant services* on behalf of the lender. A second fee cannot be paid to the broker by anyone if it is received by the agent for acting only as a *referral agent*.

For example, the broker and his agent are entitled to a second fee in a sales transaction if they handle the loan escrow or process a loan application and loan documents, services which are significantly more involved than the act of a mere referral.

A lender or broker are in compliance with the no-service, no-fee rule if the earnings the broker is to receive for the **second service** were due the broker as:

- payment for **goods**; or
- payment for **services rendered**, other than the referral. [12 USC §2607(c)]

Before a broker and his agent who is to receive a brokerage fee on a sales transaction can accept another fee for an additional **second significant service**, such as a fee paid by a lender to the broker (or agent), the broker or the agent must perform numerous loan origination activities normally performed by the lender. Further, if sufficient loan origination activities are performed by the broker or his agent, then the second fee for loan related services must be justified as a dollar amount others would be paid to competitively perform the same services for the lender.

Duplicate charges for services

Real estate sales transactions are increasingly subject to **duplicate charges** imposed on both buyers and sellers by brokers, lenders, escrow agencies, and title companies during periods of rising property values. Duplicate charges for integral services, called *kickbacks* or *hidden costs* based on who ultimately receives them, are redundant and constantly experienced by the buying and selling public.

Public policy and sound economics suggest that duplicate charges are improper and make the real estate market more inefficient. They usually result from the systematic elimination of more competent and less costly competition. **Kickbacks** to listing and selling brokers (and builders), which are a violation of RESPA, are openly undertaken by some mortgage banks and title companies in an illegal effort to garner a larger share of the available business.

Kickbacks are a **corrupting business policy**. Legitimate operators find it difficult to compete with fraud without also stooping to the same fraudulent actions to meet the corrupt competition. Kickbacks, in the form of referral fees or other indirect financial benefits used to steer or capture business, interfere with the availability of lower rates and fewer charges. The buyer is referred to the lender (or title company) providing the kickback and away from the legitimate competition who will not take part in the consumer fraud.

California legislation does not, but should, prohibit referral fees from lenders or anyone else who renders services as a third-party in a real estate related transaction in which a broker is collecting a fee for acting on behalf of a principal.

Real estate agents who are employed by a broker (which they must be to act as a licensee) face a similar prohibition in real estate transactions. Agents acting under their licenses are prohibited from accepting a fee or other benefit from any person other than their employing broker, or from themselves paying a fee to any other broker or agent without first directing the payment through their employing broker. [Calif. Business and Professions Code §10137]

Chapter 18 The breaching buyer pays

This chapter highlights the collection of a brokerage fee from a buyer under various fee provisions when the buyer breaches the purchase agreement.

Brokerage fee protection

A buyer contacts a real estate sales agent to locate suitable properties for review with the intent to buy. The agent agrees to do so. However, the agent does not discuss or obtain an oral or written commitment from the buyer regarding the payment of a fee to his broker for services provided by him as the buyer's agent.

The agent locates a property suitable for the buyer's purposes. The agent prepares an offer to purchase, which the buyer signs. The offer is prepared on a purchase agreement form which does not contain a brokerage fee provision in the body of the offer above the buyer's signature. However, the seller's acceptance provision following the buyer's signature at the end of the form, outside the buyer's offer, does contain a reference to a separate fee agreement between the seller and his listing agent.

The seller signs the acceptance provision. Concurrently, the seller agrees, directly or indirectly, to pay both brokers a fee on completion of the sale. Should the buyer breach the purchase agreement, the seller's fee provision limits the brokerage fee to one-half of any money damages awarded to the seller in litigation or otherwise collected from the buyer.

Nowhere does the buyer agree to any aspect of the fee arrangement or to pay a fee if he breaches the purchase agreement by failing to close escrow.

The acceptance is returned to the buyer.

The separate fee agreement between the seller and his listing agent is retained by the listing broker. The brokers have or will enter into yet another and separate agreement to share the fee to be paid to the listing broker by the seller.

The buyer, without justification or excuse, later **fails to complete** the purchase. The seller, due to the buyer's breach of the purchase agreement, makes a demand on the buyer for money losses he has incurred due to the buyer's breach.

However, the seller's money losses, if any exist to be recovered, **may not include** the amount of the brokerage fee lost by the brokers. The seller did not incur a loss on the sale by paying the brokerage fees.

Only the buyer's broker collects

Continuing with the above example, the buyer's broker then makes a demand directly on his buyer to pay his fee. The buyer's broker does not wait for the seller to litigate with the buyer, recover his money losses and share them with the brokers. The listing broker does not (and may not) participate in the fee demand made on the buyer by the buyer's broker.

The buyer's broker claims the purchase agreement offer signed by the buyer is subject to an *implied promise* from the buyer to close the transaction so his broker will receive his fee.

The buyer claims his broker is not entitled to a fee. The only fee provision which exists merely entitles the brokers to half the money losses recovered by the seller should the seller pursue collection of losses he incurred due to the buyer's breach. However, the seller's losses on the failed sale do not include the brokerage fee which went unpaid. Thus, the seller cannot recover the fee for the brokers on a claim against the buyer since the seller did not incur a loss by paying the fees.

Can the buyer's broker collect a fee from the defaulting buyer who never agreed, orally or in writing, to pay any fees?

Yes! The buyer **orally retained** the services of the broker, but did not *expressly promise*, orally or in writing, to pay a brokerage fee should the broker's agent locate suitable property for the buyer to purchase. However, on entering into a purchase agreement, the **buyer knew** the seller promised to pay the buyer's broker a fee on closing. Thus, the buyer's offer to purchase the property contained an *implied promise* by the buyer to his broker not to **wrongfully interfere** with the payment of the brokerage fee, part of the client's obligation to his broker due to the principal/agent relationship.

Here, the buyer owes his broker the fee which the seller does not now owe. The payment of the fee by the seller was contingent on the close of escrow, which did not occur. [**Chan** v. **Tsang** (1991) 1 CA4th 1578]

Conversely, the seller's broker has no contractual right to collect a fee from the breaching buyer. The listing broker lacks:

- a client relationship with the buyer which carries with it the *implied promise* to avoid interference with the payment of a fee; and

- a *written agreement* signed by the buyer to pay the fee in lieu of the seller on the buyer's breach.

A **fundamental rule** of real estate practice for judicial enforcement of fee arrangements requires brokerage fee agreements to be **in writing and signed** by the parties responsible for payment.

However, a **common flaw** in the placement of brokerage fee provisions in some purchase agreement forms is the failure to include the fee provision in the body of the buyer's purchase agreement offer, i.e., **above the buyer's signature**, sometimes referred to as "*within the four corners of the contract*."

The fee provision placed within the buyer's offer usually states the seller will pay the fee if the transaction closes, and if it does not close due to a breach, the **breaching party will pay** the fee. Thus, all parties to the purchase agreement have agreed on what amount they owe, when they owe it and to whom it will be paid. [See Form 150 §14 accompanying Chapter 51]

Brokers as beneficiaries

When a buyer and seller both agree in writing to the payment of a brokerage fee, their brokers, by contract, become *third party beneficiaries* to the purchase agreement. Should either the buyer or the seller enforce the purchase agreement contract against the other by *specific performance*, the brokers will be paid on closing as part of the terms contained in the purchase agreement.

However, when the fee provision is located outside the buyer's offer and agreed to only between the seller and the brokers, the transaction can be closed without payment of the fee. The brokers are then left with a claim against a (bankrupt) seller for breach of the **separate fee agreement**. [**In re Munple, Ltd.** (9th Cir. 1989) 868 F2d 1129]

A **third party beneficiary** is a person for whose benefit two other individuals place provisions in an agreement — such as when a buyer and seller under a purchase agreement or escrow instructions mutually provide for the payment of a brokerage fee by the **seller or defaulting party**.

A brokerage fee provision written into the purchase agreement gives both brokers an **enforceable contract right** to collect their entire fee, either as part of the closing or from the breaching party on a failure to close. The shift in assurance is due to the location and wording of the fee provision. [Calif. Civil Code §1559]

Chapter 19 The seller's interference with fees

This chapter comments on a seller's responsibility for payment of a brokerage fee when the seller wrongfully interferes with the close of escrow.

The breaching seller pays

A buyer's agent, agreeing on behalf of his broker to take on the task of locating suitable real estate for a buyer, fails to enter into an exclusive right-to-buy listing agreement with his buyer before starting his search for qualifying properties.

The agent locates a suitable property for sale which is not listed with a broker. An offer to purchase the unlisted property is prepared by the buyer's agent, signed by his buyer and submitted to the seller.

A provision in the purchase agreement form used to prepare the buyer's offer sets the amount of the brokerage fee the buyer agrees the seller will pay the agent's broker should the buyer acquire the property. The fee provision calls for a fixed (or variable) fee, payable on the close of escrow. [See Form 150 §14 accompanying Chapter 51]

The seller rejects the buyer's offer and refuses to sign a counteroffer, stating he will not pay a brokerage fee.

Later, the buyer contacts the seller directly, without involving the buyer's agent. The buyer is willing to pay the seller's price, but feels the agent deserves to be paid something for having brought the transaction to this point.

The buyer expresses concern about the nonpayment of a brokerage fee. The seller points out that neither the buyer nor the seller agreed to pay the broker a fee. The buyer's offer called only for the seller to pay a fee, not the buyer, and the seller rejected the offer.

The seller and buyer eventually enter into a purchase agreement without providing for the payment of a fee to the broker employing the buyer's agent. The transaction closes and the broker is not paid a fee.

A demand on the tortious seller

On the agent's discovery of the buyer's purchase of the property, the agent's broker makes a **demand on the seller** for immediate payment of the fee set out in the buyer's offer previously rejected by the seller. The broker claims the seller is liable for payment of the fee since the seller **knew** the buyer agreed to the fee and then **induced** the buyer to abandon efforts to assure payment of a fee. Thus, the seller has *unlawfully interfered* with the broker's contractual relationship with the buyer and the broker's *prospective economic advantage* as evidenced by the fee provision in the purchase agreement offer submitted.

The seller claims he cannot be held responsible for the payment of any brokerage fee since he rejected the purchase offer containing the fee provision which, if he had accepted, would have required him to pay a fee.

Is the **fee provision** in the rejected purchase agreement offer enforceable *against the seller* who never agreed to it?

No! However, the broker can enforce the contract provision in the rejected offer to collect his fee from the **buyer**. The buyer did sign a writing (the purchase offer) providing for the payment of a brokerage fee on the buyer's purchase of the property, which the buyer did do.

Even though the buyer is obligated to pay the fee, the seller is also responsible for payment of the amount the buyer agreed would be paid. Here, the seller **wrongfully induced** the buyer to breach a provision calling for the payment of a fee contained in a writing signed by the buyer.

Thus, **the seller** also owes the brokerage fee specified in the buyer's offer since the seller:

- *knew* the fee provision existed in the offer signed by the buyer; and
- *induced* the buyer to exclude the brokerage fee with the unjustified and improper intent of interfering with an existing agreement between the buyer and the broker. [**Rader Company** v. **Stone** (1986) 178 CA3d 10]

Editor's note — The legal basis for the broker's recovery against the seller is a tort theory called ***intentional interference with contractual relations****. It is not a recovery based on the* ***seller's breach of a provision*** *in the purchase agreement offer, which is a contract theory. The seller never became a party to the purchase agreement contract in which the broker was a third-party beneficiary for the fees provided for in the contract.*

Conversely, the buyer owes the fee under a contract theory. The buyer breached his written promise that the broker would be paid as called for in the unaccepted purchase agreement offer signed by the buyer. However, the broker, while obtaining a money judgment for his fee against both the buyer and the seller, can only collect the amount of the fee once.

Oral fee agreements

An oral agreement between an agent and a buyer or seller involving the payment of a brokerage fee on the purchase or sale of property is unenforceable by the agent's broker against the buyer or seller promising to pay the fee. However, if the oral fee arrangement is later formalized in a writing signed by the buyer or seller who earlier orally agreed to pay the fee, the broker can enforce the signed written agreement and collect his fee from the person who signed it.

Oral fee agreements are unenforceable even when mentioned in the agent's written correspondence he delivers to the buyer or seller. It is not enough that the agent signs the correspondence containing the oral fee arrangement. The person who is to pay the fee must sign the writing which sets the fee before collection of the fee from that person can be enforced. [**Phillippe** v. **Shapell Industries, Inc.** (1987) 43 C3d 1247]

However, a buyer's broker and his agent need only have an *oral fee agreement* with a buyer for the broker to recover his fee from a seller when:

- the seller is aware of the oral fee agreement between the broker and the buyer; and
- the seller, without proper cause or privilege, acts to interfere with the fee agreement and causes the broker not to receive his fee on the buyer's acquisition of the property.

Thus, when the buyer has arranged for payment of a brokerage fee, either by a signed writing or by an oral agreement, and then the **seller knowingly interferes** with that written or oral arrangement by inducing the buyer to *breach* his promise, the **seller owes** the broker the fee agreed to by the buyer. [**Della Penna** v. **Toyota Motor Sales, U.S.A., Inc.** (1995) 11 C4th 376]

The contingency fee

Fee provisions in purchase agreements and escrow instructions typically state the fee earned is payable out of the sales proceeds due a seller on the close of escrow, called a *contingency fee provision*.

However, escrows do not always close. Thus, a brokerage fee which has been earned might not be paid. However, the contingency fee may be due the broker based on the seller's conduct, even when escrow does not close.

Consider a seller who refuses or is unable to remove liens on the real estate in order to convey title as agreed. No contingency provision exists allowing the seller to cancel for his failure to obtain a release of the liens.

Escrow does not close due to the liens. The broker makes a demand on the seller for payment of his fee, claiming the fee was earned and is now unpaid due to the seller's failure to close escrow as agreed.

The seller claims the broker is not entitled to receive a fee since no sales proceeds were received from which escrow could pay the fee.

Here, the seller cannot avoid paying the brokerage fee by relying on provisions calling for the fee to be paid from funds the seller is to receive on closing. The **seller breached** the purchase agreement by preventing the close of escrow and his receipt of sales proceeds, the events triggering payment of the fee.

The **contingency fee provision** in the purchase agreement and the escrow instructions merely *designates the time* for payment of a fee already earned. It does not defeat the broker's right to compensation he has fully earned simply because the event allowing escrow to pay the fee does not occur due to the seller's unexcused failure to perform on the purchase agreement. [**Steve Schmidt & Co.** v. **Berry** (1986) 183 CA3d 1299]

In a listing agreement, a broker and seller may agree to any legally enforceable condition which must first occur or be satisfied before the broker **earns his fee**. Conditions include locating a ready, willing and able buyer to purchase on the listed terms or any other terms of an offer accepted by the seller.

When the condition for earning the fee occurs as called for in the listing, such as the seller's acceptance of an offer, the fee is immediately due and payable to the broker.

However, most purchase agreements used to write up a buyer's offer include a boilerplate contingency fee provision. The wording of the provision shifts the time for payment of the fee the broker has already earned under the listing agreement from the acceptance of the purchase agreement offer to the time of closing.

Method of payment

Unless altered, fee provisions in purchase agreements set a fixed-dollar or calculable dollar amount which is payable by the seller and due on the close of escrow. Escrow instructions are drawn to provide for the payment of this agreed-to fee.

However, sellers who are given the unilateral ability in escrow instructions to change the terms of the fee they owe brokers and still close escrow, will occasionally try to alter the amount, time or method of payment, or worse, cancel escrow's authorization to pay the fee.

For example, a broker consents to fee arrangements by including a fee provision in the purchase agreement calling for payment in full on closing. Here, the seller cannot enforce contradictory escrow instructions (or cancel instructions) calling for the brokerage fee to be paid in installments, unless the broker consents to the change (or cancellation). [**Seck** v. **Foulks** (1972) 25 CA3d 556]

Escrow instructions for paying the fee

Escrow instructions are the final arrangements for the payment of a brokerage fee. It does not matter which agent dictates instructions, or if they do so by use of a transaction coordinator. Their paramount, co-existing objective is to **eliminate the risk** that the brokers will not be paid on the close of escrow.

The brokerage fee has already been earned on the acceptance of a purchase agreement offer. However, payment of the earned fee is usually delayed and made contingent on the close of the sales escrow, a 30- to 60-day period after the brokers have already earned their fees.

It is during the period of time necessary to close escrow that sellers who have committed themselves to pay the fee sometimes decide they no longer want to pay the fee.

The ability of the seller to interfere with payment of the fee and still close escrow depends totally on the nature of the fee provision dictated by the agents and contained in the escrow instructions.

When dictating escrow instructions regarding the payment of the fee, brokers and their agents have several options which provide various degrees of assurance that their fee will be paid. **Payment arrangements** for brokerage fees include:

- *instructions signed only by the seller,* called *unilateral fee instructions*, which authorize escrow to pay the brokerage fee from the net proceeds due the seller on closing;
- an *assignment accompanied by unilateral fee instructions* from the seller which authorize escrow to pay the brokerage fee from the seller's net proceeds;
- a *lien* on the seller's net proceeds to secure payment of the brokerage fee which is *accompanied by unilateral fee instructions* signed by the seller;
- *instructions signed by the seller and brokers*, but not entered into by the buyer, which authorize escrow to pay the brokerage fee from the seller's net proceeds; and
- *mutual instructions signed by the seller and buyer*, whether or not entered into or approved by the brokers, which authorize escrow to pay the brokerage fee from the seller's net proceeds.

When the agent dictating the instructions fails to specify the type of payment-of-fee provision to be used by escrow, the typical fee provision used by escrow services is a "default fee provision." In it, the seller alone instructs escrow, by way of supplemental (and unilateral) escrow instructions, to pay the brokers from funds accruing to the seller on close of escrow.

Mutual vs. unilateral instructions

Of all the various fee arrangements available to brokers for payment of their fees, the unilateral fee instructions (signed only by the seller) leave the brokers with the least assurance the fee will be paid on close of escrow.

Unilateral fee instructions give the seller the sole and absolute ability to cancel, revoke or alter the brokerage fee instructions and still close escrow. When unilateral instructions are canceled, no conflict arises which would interfere with the escrow officer's ability to close escrow under the mutual instructions.

For example, should a seller cancel his unilateral fee instructions, escrow must close and pay all net proceeds to the seller — including funds originally intended for payment of the brokerage fee. Thus, no funds remain in escrow as a source of recovery by the brokers. [**Contemporary Investments, Inc.** v. **Safeco Title Insurance Co.** (1983) 145 CA3d 999]

The addition of the broker's consent to or approval of the seller's unilateral fee instructions adds no assurance that the seller will not act to cancel, revoke or alter the fee instructions.

When the seller's unilateral fee instructions, whether or not joined in by the brokers, call for either an **assignment** of an amount equal to the brokerage fee or a **lien** on the seller's net proceeds in the amount of the fee, the seller can still cancel, revoke or alter the fee instructions and close escrow without payment of the agreed-to brokerage fee.

The **best protection** a broker has against cancellation, revocation or alteration of the brokerage fee instructions is to dictate *mutual instructions* as the seller's agreement to pay the brokerage fee, signed by both the buyer and the seller. Escrow should not be allowed to relegate the fee to separate, unilateral fee instructions signed only by the seller (and possibly the broker).

Then, for the seller to cancel payment of the brokerage fee payable under mutual instructions, the buyer would have to collaborate with the seller, making the buyer (as well as the seller) responsible for the wrongfully withheld fee.

Further, mutual instructions should call for any change in the fee provision agreed to by the seller and the buyer to be subject to the broker's approval. Thus, the broker "locks in" the payment of his fee by *triangulation*, should escrow close.

Chapter 20 Finders: a nonlicensee referral service

This chapter addresses a broker's or his agent's use of finders to provide them with leads to sellers, buyers, or borrowers under California and federal law.

Agency relationships in real estate transactions

Three classes of **real estate agents** have been established in California:

- *licensed* brokers;
- *licensed* sales agents; and
- *unlicensed* finders.

Licensed brokers and **sales agents** owe *fiduciary duties* to the principals they represent. **Fiduciary duties** require licensees to perform on behalf of their client with the utmost care and diligence.

An **unlicensed finder** has no such fiduciary duty. A finder's function as an "agent" is limited to soliciting, identifying, and referring potential real estate clients or participants to brokers, agents, or principals in exchange for the promise of a fee.

A finder working for a principal is distinguished from a licensed broker working for a principal. Limitations are placed on the **conduct of a finder**. A finder lacks legal authority to participate in any aspect of property information dissemination or other transactional negotiations. [Calif. Business and Professions Code §§10130 et seq.]

Although not licensed by the California Department of Real Estate (DRE) or admitted as members of a real estate trade association, finders are authorized by California statute *to solicit* prospective buyers, sellers, borrowers, lenders, tenants, or landlords *for referral* to real estate licensees or principals. Thus, they **provide leads** about individuals who may become participants in real estate transactions.

Soliciting to place or refer a match

A finder providing referral services in California for a fee may:

- find and *introduce parties*;
- *solicit parties* for referral to others [**Tyrone** v. **Kelley** (1973) 9 C3d 1]; and
- be *employed* by principals or brokers.

A finder may not:

- take part in any negotiations [Bus & P C §10131(a)];
- discuss the price;

- discuss the property; or

- discuss the terms or conditions of the transaction. [**Spielberg** v. **Granz** (1960) 185 CA2d 283]

A finder who crosses into any aspect of negotiation which leads to the creation of a real estate transaction needs a real estate license as he is both **soliciting and negotiating**. Unless licensed, an individual who enters into negotiations (supplying property or sales information) cannot collect a fee for services rendered — even if he calls it a finder's fee. Also, he is subject to a penalty of up to $20,000 and/or a six-month jail term for engaging in brokerage activities without a license. [Bus & P C §§10137, 10139]

In addition, a broker who permits a finder or anyone else in his *employ* (or his agents' employ) to perform any type of "licensed" work beyond solicitation for a referral, may have his license suspended or revoked. [Bus & P C §§10131, 10137]

RESPA limits authority to split fees

The Real Estate Settlement Procedures Act (RESPA) prohibits brokers, with two major exceptions, from giving or accepting a referral fee if the broker or his agent is acting as a *transaction agent* in the sale of a one-to-four unit residential property which is being funded by a purchase-assist, federally-related loan. [24 United States Code §2607(a); 24 Code of Federal Regulations §3500.14(b)]

Thus, a broker and his agents are not involved in a RESPA transaction when negotiating the sale, lease, or encumbrance of any of the following types of properties:

- apartment buildings with five or more units;

- commercial buildings;

- agricultural properties;

- business opportunities;

- vacant land (other than those involving one-to-four unit residential construction loans);

- properties containing 25 or more acres;

- leases and rental agreements;

- all-cash transactions; and

- seller carryback transactions where no federally-related loan is originated. [12 USC §2606(a)(1); 24 CFR §3500.5(b)(1)]

Business development and RESPA

A broker and his agents need to develop methods for **generating business**. If not, their *business model* will not produce sufficient numbers of clientele to provide enough earnings to keep them from being driven out of the real estate brokerage profession.

Many methods for finding and soliciting clientele exist. The source of clients most often discussed, and cherished, is the **referral**. In fact, agents not employed by media/franchise brokers are said to live by referrals alone.

Also, brokers cooperate among themselves, as in agent-to-agent referrals between different segments of the brokerage community, such as the referral of a homebuyer by a property manager to an MLS sales agent and vice versa with a prospective tenant.

Brokers and agents in single family residence (SFR) sales rarely develop a client base of homebuyers sufficiently large enough to sustain a decent standard of living from sales fees generated by transactions handled on behalf of these homebuyer clients. Thus, a **business model** for finding and locating clients on a regular basis must include sources other than clients personally located, i.e., found by the broker.

Many methods exist to generate new clients. Advertising through printed and electronic/digital media to solicit clients is fundamental and universally understood and expected by all. Media advertising is a **general blast** at members of the public in an effort to locate those few among them who, at that moment, need the services of a real estate agent.

On the other hand, finding and locating a client becomes a more focused and arduous task when a broker's business model expands beyond exclusive use of media, which develops name recognition for the broker/agents, into the time consuming task of **personally soliciting** clients. In a personal solicitation effort designed as an additional method for generating clientele, the agent places himself and those he induces to act on his (specifically, his broker's) behalf, directly between the prospective client and the employing broker, e.g., when:

- the employing broker "refers" clients directly to his agent;
- an agent takes "floor time" to solicit new clients who call in response to media advertising and the "brand name" the broker has established;
- an agent canvasses a neighborhood or section of the community in a classic on-going *farming operation* to find and solicit new clientele (for his broker); or,
- an agent extends his reach to potential buyers and sellers of SFRs by inducing both licensed and unlicensed individuals to be "team members" who locate and solicit clientele for the agent (again, read that as for the broker), all being activities which comply with both RESPA and Department of Real Estate (DRE) regulations.

It is the employment of unlicensed *locators* of buyers and sellers to extend the reach of the agent to develop business which will bring his earnings to a level sufficient to sustain the standard of living the agent seeks. This is permissible. State and federal regulations addressing the **relationship** between the finder/locator and the broker/agent, and between the public and the finders/locators acting on behalf of the broker/agent, are straightforward and compliance is relatively easy.

All employees of a broker must be hired under **written contracts** of employment. Licensed agents are hired, administrative staff is hired, and finders are hired by brokers. Written contracts are entered into to delineate the responsibilities each has undertaken and to limit their conduct to that permitted by regulations for their different licensed or unlicensed status.

These employments, the finder included, are not casual relationships which the broker/agent develops over time with friends, neighbors, past clientele, or social contacts, a word-of-mouth network of "viral adverts" generating referrals for which no fee is paid. Employed individuals **generate business** for the broker/agent, the finder being limited by the nature of his employment to locating and soliciting new clientele for the broker/agent.

Fee sharing by a broker under RESPA

RESPA, like a title insurance policy, initially sets out a blanket rule as the starting point for arriving at the final conditions. RESPA's initial statement is that no **referral fee** can be *paid or received* by a settlement service **provider** (broker/escrow/lender) who will be rendering transactional services in exchange for compensation in a RESPA sale (mortgage financing on a one-to-four unit residential sale).

Likewise, a title insurance policy's initial statement proclaims no encumbrance of any type exists on the title being insured. The policy provisions then proceed to list exclusions, exceptions, and conditions which nearly neuter the initial general statement.

Here too, as with all initial statements and generalities, RESPA provides several *exceptions* allowing fee sharing. These exceptions permit the broker to conduct orderly **business development** which does not violate the RESPA principle of avoiding double dipping (referrals among providers) or surcharges. RESPA's goal is to prohibit activity which artificially drives up the cost buyers and sellers pay for services needed to close a sale such as occurs with duplicate fees charged for services implicitly covered by the provider's basic fee.

Two **RESPA exceptions** go to the heart of sourcing new clientele and sharing fees:

- referral fees paid to or received from other brokers, a *horizontal disbursement* from one broker to another, other than by loan brokers or lenders who are or will be involved in a resulting RESPA transaction [24 CFR §3500.14(g)(1)(v)]; and

- fees paid by the broker to the broker-employed licensed sales agents or **unlicensed finders**, a *vertical disbursement* within the broker's office, not paid to providers or third parties connected or to be connected to a resulting RESPA transaction. [24 CFR §3500.14(g)(1)(vii)]

While both of these exceptions to RESPA permit payment of fees under federal law, DRE regulations under California law **limit the conduct** of these individuals when actually rendering services permitted by RESPA.

While the RESPA exceptions allow *fee-splitting* activity, the DRE regulations require the **fee splitting** to be limited exclusively to:

- payments between brokers (who then may split the fee with their agents); or

- payments between a broker and the agents he employs, licensed or unlicensed.

FINDER'S FEE AGREEMENT

NOTE: This form is used by brokers and their agents to employ an unlicensed individual to locate, solicit and refer or identify persons who need the services of the broker and his agents. [Calif. Business and Professions Code §§10130, 10139]

DATE:_____, 20_____, at_____, California.

Items left blank or unchecked are not applicable.

1. In consideration for services to be rendered by Finder, Broker hereby contracts with Finder to refer to Broker a prospective client in need of services as a:

☐ Buyer ☐ Lender ☐ Borrower
☐ Owner/Seller ☐ Tenant ☐ Landlord

2. Finder agrees not to participate in or conduct any negotiations with the prospective client or solicit loans on behalf of the prospective client.

2.1 Finder is not licensed by the California Department of Real Estate.

3. The prospective client is identified as:

Name _____

Address _____

Telephone _____

3.1 Further referrals of other prospective clients may be included in this agreement by an addendum signed by both Broker and Finder. [See **ft** Form 250]

4. The real estate involved, if any, is referred to as

Common address _____

Legal description/Assessor's parcel number _____

_____

_____

5. As compensation for each referral by Finder, Broker agrees to pay Finder the following amount:

a. $_____ for each prospective client.

b. _____% of Broker's fee received on the first transaction with each prospective client.

c. _____% of the purchase price paid on the first transaction with each prospective client on which Broker receives a fee.

d. Other: _____

6. Finder's compensation is earned and payable:

a. ☐ On close of the first transaction involving each prospective client.

b. Other time of payment _____

c. Should the prospective client not enter into a commissionable transaction through Broker within _____ months after the date that prospective client is identified in writing to Broker, Broker shall owe Finder no compensation.

7. Additional terms and conditions: _____

_____

_____.

I agree to the terms stated above.	**I agree to the terms stated above.**
Date:_____, 20_____	Date:_____, 20_____
	Finder's name: _____
Broker:_____	Signature: _____
By:_____	Social Security #: _____
Address: _____	Address: _____
_____	_____
Phone:_____	Phone:_____
Fax: _____	Fax: _____
Email: _____	Email: _____

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While RESPA allows agents and finders who are employed by a broker to receive fees for **generating business**, the DRE regulations (and statutory/case law) set forth the *limits of conduct* each type of employee of the broker may undertake with the clientele.

To **satisfy RESPA**, the employment of a finder must be under an agreement where the employee-finder is obligated to bring to the broker's attention **every prospect** located of the sort the broker is looking for. The employee-finder's sole purpose is to generate business for his broker and does not have the freedom, by contract, to refer a prospect to just any broker. [24 CFR §§3500.2(b), 3500 Appendix B, examples 11 and 12; **Zalk** v. **General Exploration Co.** (1980) 105 CA3d 786; see Form 115 accompanying this chapter]

Three classes of finders exist under RESPA:

- **friends or past customers** who pass on tips to brokers and/or sales agents;
- **individuals** who sell "lead lists" to brokers; and
- **bona fide employees** of brokers who generate business for their employing broker, classified as *financial services representatives* (FSRs). [24 CFR §3500 Appendix B, example 12]

Entitlement to a fee under RESPA

Finders are also entitled to a fee for referrals under RESPA, dependent upon the type of finder they are and whether RESPA controls.

A friend or past customer type of unlicensed finder who is not under contract and therefore not employed by a broker would not be entitled to a finder's fee if the broker to whom a new client was referred provided settlement services on a RESPA-controlled transaction. If RESPA did not control, this type of finder would be entitled to a fee under California law.

A *bona fide employee*, such as a FSR, of a broker is not barred from collecting a fee or salary from his employer-broker since employed individuals are exceptions to RESPA.

A person who sells lead lists are also able to legally collect a fee under both RESPA and non-RESPA transactions. Lead lists are considered "goods" and are perfectly legal in California, as well as under the RESPA exception for goods actually furnished. [24 CFR §3500.14(g)(1)(iv); see DRE Real Estate Bulletin, Spring 2006]

Referral fees to other fiduciaries prohibited

Anyone can be a paid finder, unless barred by professional regulations or code-of-ethics or conflict-of-interest policies controlling an individual's conduct.

For instance, a licensed agent registered with the DRE as an employee of a broker cannot be a finder. The agent is employed to solicit clients on behalf of his broker, not others. In turn, only his broker can receive a fee generated by the agent's real estate licensed activities. On the employing broker's receipt of a fee, the fee is split with the agent under their written employment agreement. [Bus & P C §10132; Department of Real Estate Regulations §2726]

Certified public accountants (CPAs) are barred by regulation from being paid as finders and receiving a fee for the referral of their clients to others. [16 Calif. Code of Regulations §56]

A finder who advertises to locate leads he will place or refer to a broker or principal must not hold himself out as also rendering services which require a broker's license. [Bus & P C §10139]

Thus, a finder may advertise as a "referral service." He may state he will **place** an interested party with a broker or principal, or **refer** a principal to a match sought for a real estate transaction.

The finder's fee bargain

Generally, a **finder's fee** is a lump sum amount or a percentage of the fee received by the broker on a transaction which is closed due to the finder's referral. Only sound economics controls the amount of the fee a broker, agent, or principal should pay a finder for a lead. Also, no limit is placed on the volume of referral business conducted by a finder.

For instance, a broker can compensate his finder with:

- a salary;
- a percentage fee; or
- a lump sum basis per closing. [Zalk, *supra*]

Also, while brokers may, finders may not collect advance fees from principals. **Advance-fee operators**, masking themselves as finders for principals, sometimes collect fees "up front," a prohibited activity for an unlicensed individual. [Bus & P C §10131.2]

Entitlement to a fee under California law

A finder is entitled to a fee as an unlicensed individual if he solicits, locates, places, introduces, or delivers up names of prospective clients to a broker or principal. [Tyrone, *supra*]

A finder's fee agreement entered into between a **finder and a principal** regarding the finder's referral services must be *evidenced in a writing* signed by the principal who employed the finder. If not, the finder cannot enforce his fee agreement with the principal. [Calif. Civil Code §1624(a)(4)]

However, the principal's **use and benefit** of a finder's referral under an oral finder's fee agreement, such as closing a sale with an individual referred by the finder, will substitute for a written agreement. [**Tenzer** v. **Superscope, Inc.** (1985) 39 C3d 18]

Conversely, oral fee agreements between a **broker** (or his agents) **and a finder** are enforceable. No written agreement is required between a broker (or his agents) and a finder. However, a writing memorializes the agreement as documentation against memories to the contrary, and in conformance with DRE regulations. [See **first tuesday** Form 115]

Consider a nonlicensed individual who enters into an oral agreement with a broker to introduce the broker to prospective buyers or sellers in return for 10% of the broker's earnings on any transaction put together with the "lead."

The finder introduces the broker to prospects who close transactions with the broker. The broker refuses to pay the finder the agreed-to compensation since the oral agreement is not evidenced in a writing signed by the broker who retained him.

However, the finder can enforce the broker's oral fee agreement. Oral fee-sharing agreements between brokers or finders are enforceable. [**Grant** v. **Marinell** (1980) 112 CA3d 617]

Chapter 21 Due diligence obligations

This chapter focuses on the due diligent conduct owed a seller or buyer on the exclusive employment of a broker and his sales agents.

The duty owed to clients

Every exclusive listing agreement entered into by an agent on behalf of his broker is an employment which creates a client relationship. The employment imposes **special agency (fiduciary) duties** on the broker and the agent, owed to the client, to use *due diligence* in a continuous effort to meet the objective of the employment, be it to buy, sell, lease or finance an interest in real estate. [See Form 102 §1.2 accompanying Chapter 9]

The promise of **due diligence** is the consideration a broker and his agents give their client to render services in exchange for employment as the *exclusive representative* of the client to locate the "match" sought by the client. If the promise to use diligence in the employment is not stated in the exclusive listing agreement, it is *implied* as existing in the relationship.

The broker with authority to be the exclusive representative of a client must take reasonable steps to promptly gather all *material facts* about the property in question which are *readily available* to the broker or the broker's agent. After gathering factual information about the integrity of the property, the broker's agent proceeds to do every reasonable and ethical thing to pursue, with utmost care, the purpose of the employment.

In contrast to an exclusive listing, a broker and his agents entering into an **open listing** are not committed to render any services at all. The broker and his agents only have a *best-effort obligation* to act on the employment.

However, when an agent holding an open listing enters into preliminary negotiations, such as an exchange of property data, a due diligence obligation arises to provide the utmost care and protection of the client's best interests. Having **acted on the open listing**, the agent must now inspect the property and gather all readily available information on the property under consideration.

Once the agent actually begins to perform services under an open listing entered into by a buyer or seller, the agent has **acted on the employment** and the due diligence standards of duty owed to the client apply to his future conduct.

The listing broker becomes the buyer

Consider an agent employed under a listing agreement to locate a buyer for the listed property.

The agent prepares a purchase agreement naming himself as the buyer and submits it to the seller. The agent states the price offered is the fair market value of the property. Based on this representation, the seller agrees and enters into the purchase agreement.

Prior to the close of escrow on his purchase, and still within the listing period, the agent locates a buyer who agrees to pay the agent for an assignment of the agent's right to buy the property under the purchase agreement entered into with the seller. The amount paid to the agent for the assignment is equal to 10% of the price stated in the purchase agreement.

When the agent asks the seller to consent to the assignment and substitution of a new buyer under the purchase agreement and escrow instructions, the agent tells the seller the buyer is buying the property for no more than the purchase price stated in the purchase agreement. The seller, based on the agent's representation of the amount paid for the property by the substituted buyer, agrees to the assignment of the agent's right to buy the property.

After escrow closes, the seller discovers the buyer paid the agent a higher purchase price in the form of an *assignment* fee on top of the price agreed to in the purchase agreement between the agent and seller.

The seller makes a demand on the agent for the assignment fee, as an undisclosed secret profit, and for a return of the commission paid. The seller claims the agent breached his fiduciary duty since the agent failed to disclose the profit he received as a result of his employment under the listing agreement, depriving the seller of his ability to sell his property for its highest possible value.

The agent claims he had no duty to disclose the profit taken for the assignment since his status under the purchase agreement was as a principal with an interest in the property he could sell.

Does the agent have a duty arising out of the listing agreement to disclose to the seller the profit taken on the assignment of the agent's right to buy the listed property?

Yes! The **agency relationship** created by the listing agreement was *not extinguished* by the purchase agreement entered into by the seller and the agent as the buyer. The agent owed the seller a duty upon entering into a listing agreement to get the seller the highest possible price for the property and to disclose any and all compensation or profit made as a result of becoming the seller's agent.

The agent, due to the listing, owes the seller all of his benefits received on the transaction, including the assignment fee and the brokerage fee he received. Further, the Department of Real Estate (DRE) Commissioner may revoke his license for taking compensation which was not disclosed. [**Roberts** v. **Lomanto** (2003) 112 CA4th 1553; Calif. Business and Professions Code §10176(g); see **first tuesday** Form 401-2; see Form 119 accompanying this chapter]

Diligence includes the advice and counsel the agent gives the client about the property, the market pressures, impending negotiations and their consequences which affect the client's position.

Maintaining the client file

Typically, the agent who produces a listing (and thus his broker's right to a fee) becomes the agent in the broker's office who is responsible to the broker for the care and maintenance of the client's file.

On entering into a listing, a **physical file** must be set up to house information and document all the activity which arises within the broker's office due to the existence of the listing. For example, the file on a property listing should at least contain the original listing agreement, its addenda and all the property disclosure documents the seller and listing agent provide to a prospective buyer before the seller accepts an offer to buy.

The file needs an **activity sheet** for entry of information on all manner of file activity. Any paperwork, notes, messages, billings, correspondence, email printouts, fax transmissions, disclosure sheets, worksheets, advertising copy, tear sheets, copies of offers/counteroffers and rejections, and all other related documentation are to be kept in the file. Nothing occurs as a result of the client employment which is not to be put in and retained in the file.

COMPENSATION DISCLOSURE IN A REAL ESTATE TRANSACTION

(California Business and Professions Code §10176(g), DRE Reg. 2904)

NOTE: A Broker and his agents, when negotiating a real estate transaction, are mandated to disclose to the party they represent (client) the form, total amount, and source of all compensation and economic benefits they anticipate receiving for any service or from any person or provider as a result of their client's entry into a real estate related transaction. This form is used to disclose compensation not disclosed in other documentation held by the client.

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This disclosure is made in connection with the following agreement:
☐ Purchase Agreement ☐ Exchange Agreement
☐ Escrow Instructions ☐ _____

1.1 ☐ of the same date, or dated _____, 20_____, at _____, California,

1.2 entered into by _____, as the Buyer, and

1.3 _____, as the Seller,

1.4 regarding real estate referred to as _____.

2. The client represented by the undersigned Broker with regards to the above referenced agreement is the ☐ Buyer, ☐ Seller, or ☐ both Buyer and Seller.

DISCLOSURE OF COMPENSATION:

3. Broker provides the following information as a disclosure to the client of all compensation and economic benefits to be received as a direct or indirect result of the client's entry into the above referenced agreement and not previously disclosed by Broker and his agents.

Source of compensation (Seller, Lender, etc.)	Form (cash, membership, etc.)	Amount (dollar values)
3.1		$_____
3.2		$_____
3.3		$_____
3.4		$_____

4. Other disclosures of direct or indirect compensation or economic benefits may have previously been made, such as exists for controlled business arrangements and conflicts of interest. [See **ft** Forms 519 and 527]

BROKER:

5. I certify that the above information is true and correct and represents all compensation not previously disclosed that Broker and his agents anticipate receiving in the above referenced transaction.

Date: _____, 20_____ Broker's Name: _____

By: _____

Name: _____ Title: _____

CLIENT: I have received a copy of this disclosure. ☐ See attached Signature Page Addendum [**ft** Form 251]

Date: _____, 20_____

Name: _____ Name: _____

Signature: _____ Signature: _____

If the source of the compensation is connected to the origination of a loan in the above referenced agreement, the other party to the agreement must also acknowledge receipt of a copy of this disclosure.

PARTY other than client: I have received a copy of this disclosure.

Date: _____, 20_____

Name: _____ Name: _____

Signature: _____ Signature: _____

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The file is the **broker's file**, not the listing agent's file, although it will likely remain with the listing agent until close of a sale on the listed property or the listing expires unrenewed. The agent hands the broker the completed file on close of escrow, usually a *condition precedent* to payment of the agent's share of the fee received by the broker.

Guidelines and checklists

Guidelines used to build a file's content are available in the many forms, such as checklists prepared by a broker or his listing coordinator, a transaction coordinator's (TC's) closing checklist, escrow worksheets, work authorization forms, advance fee and advance cost checklists, or income property analysis forms. [See Form 403 accompanying Chapter 59]

Checklists belong in the file to be reviewed periodically by the agent, office manager, TC or employing broker for work which can be done to better service the listing and earn a fee.

This chapter discusses some — but certainly not all — steps a broker and his agent might undertake to fulfill their employment responsibilities owed to the client. They include:

1. A **property profile** of the seller's title from a title company in order to identify all owners needed to list, sell and convey the property.
2. A **condition of property** disclosure sheet (Transfer Disclosure Statement) filled out and signed by the seller. [See Form 304 accompanying Chapter 24]
3. A **home inspection report** (by a home inspector) paid for by the seller and attached to the condition of property statement (TDS) before the listing agent signs the TDS.
4. A **natural hazard disclosure** (NHD) on the property from a local agency or a vendor of NHD reports, paid for by the seller, and reviewed and signed by the seller and the listing agent. [See Form 314 accompanying Chapter 28]
5. An **annual property operating disclosure** (APOD) statement covering the expenses of ownership and any income produced by the property, filled out and signed by the seller, together with a rent roll and copies of lease forms which the owner uses, to be included in the listing package only after reviewing the seller's data. [See **first tuesday** Form 562 and Form 352 accompanying Chapter 35]
6. Copies of all the Covenants, Conditions and Restrictions (CC&Rs), disclosures and assessment data from any **homeowners' association** involved with the property. [See Form 150 §11.9 accompanying Chapter 51]
7. A **termite report** and clearance paid for by the seller.
8. Any replacement or **repair of defects** noted in the home inspection report or on the TDS, as authorized and paid for by the seller.
9. An occupancy **transfer certificate** (including permits or the completion of retrofitting required by local ordinances) paid for by the seller.
10. A statement on the amount and payment schedule for any special district property **improvement bonds** which are liens on the property (shown on the title company's property profile).
11. A **visual inspection** of the property and a survey of the surrounding neighborhood by the listing agent to become informed about readily available facts affecting the marketability of the property.
12. **Advising** the seller about the marketability of the listed property based on differing prices and terms for payment of the price, and for property other than one-to- four residential units, the financial and tax consequences of various sales arrangements which are available by using alternative purchase agreements, options to buy, exchange agreements and installment sales.

13. A **marketing (listing) package** on the property compiled by the listing agent and handed to prospective buyers or buyer's agents before the seller accepts any offer to purchase the property, consisting of copies of all the property disclosures required to be handed to prospective buyers or the buyer's agent by the seller and listing broker.
14. A **marketing plan** prepared by the listing agent and reviewed with the seller for locating prospective buyers, such as by distributing flyers, disseminating property data in multiple listing services, newspapers and periodicals, broadcasts at trade meetings attended by buyer's agents, press releases to radio or television, internet sites, posting "For Sale" signs on the premises, hosting open house events, posting on bulletin boards, mailing to neighbors and using all other advertising media available to reach prospective buyers.
15. A **seller's net sheet** prepared by the listing agent and reviewed with the seller each time pricing of the property is an issue, such as when obtaining a listing, changing the listed price, reviewing the terms of a purchase offer or when substantial changes occur in charges or deductions affecting the net proceeds from a sale since the net sheet discloses the **financial consequences** of the seller's acceptance of a purchase agreement offer. [See Form 310 accompanying Chapter 37]
16. Informing the client of the listing agent's **sales activities** by weekly communications advising what specifically has been done during the past several days and what the listing agent expects to do in the following days, as well as what the seller can do in response to comments taken by the listing agent from buyers and their agents, and to changes in the real estate market.
17. Keeping records in a client file of all activities and documents generated due to the listing.

Duty to DRE to keep records

All records of an **agent's activities** on behalf of a buyer or seller during the listing period must be retained by the agent's broker for three years. [Bus & P C §10148]

The **three-year period** for retaining the buyer's or seller's activity file for Department of Real Estate (DRE) review begins to run from the closing date of a sale or, if a sale does not occur, from the date of the listing.

The records must be available for inspection by the Commissioner of Real Estate or his representative, or for an audit the Commissioner may order.

Advising the seller

An agent, on behalf of his broker, solicits an owner of a run-down (depreciated) single-family residence to list the property for sale.

After gathering and analyzing data on comparable sales, the agent advises the seller that the present condition of the property justifies a listing price of no more than $230,000.

However, the agent believes the property will sell for $300,000, an additional $70,000 in price, if the seller is willing to spend $15,000 to $20,000 to correct deferred maintenance and eliminate some obsolescence.

Also, the agent is aware the current demand by buyers of a residence in this price range consists mostly of individuals who are looking for a ready-to-occupy home, with few speculators looking for "fixer-uppers" they can restore and resell at a profit.

The agent determines the seller has the funds needed to correct the defects and appearance of the property. Based on market demands and housing prices, the agent advises the seller to invest the time, effort and money to fix up the property. However, the seller is not now willing to invest funds to fix up the property.

Rejecting the agent's advice, the seller agrees to list the property for sale at $230,000 and sell it in its present condition, after full disclosure of the property's condition by including a home inspection report.

Since the client has rejected the agent's advice, does the agent now need to explain the reasoning behind his advice?

Yes! Professionals are liable for their failure to explain the **rationale** behind their advice and the **consequences** which can result when advice is rejected. Here, the agent needs to advise the seller (and confirm in a memo) that the resale value of the property after the property has been fixed up for sale will increase. So, when it is fixed up by a buyer and resold at a far greater price, the broker and his agent have evidence they advised the client about the consequences (costs) of this inaction. [**Truman** v. **Thomas** (1980) 27 C3d 285]

Advice and consequences

In a real estate transaction, brokers and their agents must be certain who is their **client**. Likewise, they must determine who is not their client, but is a **customer** with whom the broker is directly negotiating or who is represented by another broker. Only a general duty to deal fairly and honestly is owed to a customer.

For example, the *general duty* owed a perspective buyer by a listing agent regarding property disclosures does not include advice on what investigations, audits or additional reports on the disclosed defects are available, or what reasons the agent may have to believe they should be obtained by a prudent buyer.

Further, a listing agent does not owe a duty to the prospective buyer to explain the consequences of the customer's **failure to further investigate** or analyze adverse facts disclosed by the agent. Investigations and inquiries are the **customer's duty of care** owed to himself to exercise concern for the protection of his own interests.

Also confusing for customers is the purpose behind the brokerage community's use of pre-printed suggestions, recommendations, and disclaimers of responsibilities, few of which are relevant to any one transaction. They are typically handed to each person in a sales transaction by the listing agent with a demand the parties acknowledge receipt of the preprinted, boilerplate and mostly irrelevant advice, called *advisory disclaimers*.

When a listing agent hands these advisory disclaimers to a third-party customer, such as a prospective buyer, the advisory provides a disclosure of the services available to the customer (by other than the listing agent). The advisory disclaimers **recommend** that the buyer independently check out and determine the consequences of the property information disclosed by the listing agent and undertake efforts to protect his interests in the transaction (whether or not he has retained a broker to do so).

Advising the buyer

However, a buyer is entitled to far more assistance from his agent than the naked suggestions or recommendations contained in **advisory disclosures** about the availability of services. The duty of the buyer's selling agent goes well beyond the listing agent's limited disclosure obligations.

If these boilerplate advisory services were contracted for, the buyer would be provided with an independent analysis of the property and the transaction.

Here, the buyer's broker and his agent, acting on behalf of a buyer, must use the advisory statement of recommended investigations as a **checklist** of activities from which the buyer's agent will select those services he believes his buyer should undertake to protect the buyer's interests.

More importantly, services the buyer's agent has **reason to believe** the buyer should engage must be made the subject of *contingency provisions* in the purchase offer. Thus, the buyer's agent allows the buyer (and himself) an opportunity and the time needed to investigate and analyze the agent's concerns prior to closing.

For example, a buyer's agent has an affirmative duty of care to protect his buyer by pointing out why a recommended activity or inquiry needs to be undertaken in a transaction when the activity may uncover a situation which, if it exists, must be dealt with prior to closing. If it were otherwise, the conditions suspected by the buyer's agent to exist would interfere with the buyer's use and successful ownership of the property after closing.

A residential broker and his agents nearly always know more about one-to-four unit residential property conditions and the transactional aspects (legal, financial and tax) which will affect the client than the client does. With this knowledge of facts and inclinations about the property, the parties, available services, the documents involved and the provisions they contain, agents have insight into the need for a particular investigative report. The reports would address problems the agent suspects might exist which would have an adverse impact on the client's sale or use of the property.

The buyer's agent using an advisory statement of recommended activities as a checklist will:

- determine which of the itemized activities his buyer should undertake before closing;
- help the buyer weigh the probability of discovering undisclosed defects or conditions which would have consequences adverse to the buyer's objectives; and
- help the buyer analyze the risk of loss should defects of the type suspected be discovered after closing.

Chapter 22 The listing agent and the prospective buyer

This chapter distinguishes a listing agent's limited, nonfiduciary general duty owed to all prospective buyers from a buyer's agent's special fiduciary agency duties owed to these buyers.

General duty to voluntarily disclose

A listing broker and his agents have a *special fiduciary agency duty*, owed solely to a seller who has employed the broker, to diligently market the listed property for sale. The objective of this employment is to locate a prospective buyer who is ready, willing and able to acquire the property on the listed terms.

On locating a prospective buyer, either directly or through a buyer's agent, the listing agent owes the prospective buyer, and thus also the buyer's agent, a limited, nonclient *general duty* to **voluntarily provide information** on the listed property, called *disclosures*. What is limited about the duty is not the extent or detail to which the listing agent may go to provide information, but the **minimal quantity** of fundamental information and data about the listed property which must be handed to the prospective buyer or the buyer's agent.

The information disclosed need only be sufficient enough in its content to place the buyer on notice of facts which may have an **adverse affect** on the property's value.

Thus, the disclosure obligations of the listing agent to voluntarily inform prospective buyers about the fundamentals of the listed property acts to limit the listing agent's ability to employ any conduct or means at hand to exploit the prospective buyer. The listing agent may not:

- deliver up less than the minimum level of information to put the buyer on notice of the property's fundamentals;
- give unfounded opinions or deceptive responses in response to inquiries; or
- stifle inquires about the property while in the vigorous pursuit of the best financial advantage obtainable for the seller.

Gathering facts on adverse features

The gist of a listing agent's limited general duty owed to a nonclient prospective buyer is to put the prospective buyer or the buyer's agent on notice of facts which might, if known to the prospect, **adversely affect his valuation** of the listed property.

The methods for gathering adverse facts about the property's **fundamental characteristics**, as well as those facts which enhance value, which the listing agent is specifically required to use on a one-to-four unit residential property include:

- conducting a **visual inspection** of the property to observe conditions which might adversely affect the market value of the property and entering any observations on the seller's Condition of Property (Transfer) Disclosure Statement (TDS) if not already noted on the TDS by the seller or if inconsistent with the seller's disclosures, regardless of whether a home inspector's report has been or will be obtained by the seller [Calif. Civil Code §2079];

- assuring **seller compliance** with the seller's duty to deliver statements to prospective buyers as soon as practicable, i.e., disclosing a variety of facts about natural hazards (NHD), the condition of the property (TDS), the local environment (TDS), Mello-Roos liens, lead-based paint, neighborhood industrial zoning, occupancy and retrofit ordinances, military ordnance locations, condo documents, etc., **by providing the seller** with statutory forms at the listing stage to be filled out by the seller, and picking up the seller prepared and signed documents for inclusion in the marketing/listing package to be handed to prospective buyers;
- **reviewing and confirming**, without further investigation or verification by the listing agent, that all the information and data in the disclosure documents received from the seller are consistent with the listing agent's knowledge about the information and data, and if not, correct the information and data, or if the listing agent has reason to believe the information might not be accurate, either investigate and clarify the information or disclose his uncertainty about the information to the seller and the prospective buyer;
- advising the seller on **risk avoidance procedures** by recommending the seller obtain third-party inspections of the property's condition and its components (roof, plumbing, septic, water, etc.), to **reduce the exposure** to claims by a buyer who might discover deficiencies in the property not known to the seller or the listing agent or, worse yet, were known and not disclosed prior to entry into a purchase agreement, and then make a demand on the seller (and the broker) to correct the defects or reimburse the buyer for the costs incurred to correct them; and
- **responding to inquiries** by the prospective buyer or buyer's agent into conditions relating to any aspect of the property with a full and fair answer of related facts known to be or which might be considered detrimental to the value of the property without suppressing further investigation or inquiry by the buyer or the buyer's agent since the inquiry itself makes the subject matter a *material fact* about which the prospective buyer needs more information before completing negotiations or acquiring the property.

The pass-through of filtered information

A listing agent's statutory duty owed to prospective buyers to disclose facts about the integrity of the physical condition of a listed one-to-four unit residential property is limited to his prior knowledge about the property and the observations he made while conducting his **mandatory visual inspection**. To complete the disclosure process, the listing agent serves as a conduit through which property information provided by the seller is filtered before it is passed on to the prospective buyer.

Accordingly, all property information received from the seller must be reviewed by the listing agent for any inaccuracies or untruthful statements **known or suspected to exist** by the listing agent. Corrections or contrary statements by the listing agent must be included before the information may be used to market the property and induce prospective buyers to purchase.

The extent to which disclosures about the physical condition of the property must be made is best demonstrated by what the listing agent is **not obligated** to provide.

Of concern to buyer's agents is the fact listing agents have **no duty to investigate** any of the information or data provided by the seller in an effort to authenticate its accuracy or truthfulness before passing it on to the prospective buyer.

However, before handing a prospective buyer information received from the seller, the listing agent must:

- **review the information** received from the seller;

- **include comments** about the agent's actual knowledge and observations he made during his visual inspection of the property which reflect the inaccuracies, inconsistencies, false nature or omissions in the seller's statements; and
- **identify the source** of the information as the seller.

The dumb agent rule

A listing agent on a one-to-four unit residential property **owes no affirmative duty** to a prospective buyer to gather or voluntarily provide the prospect with any facts about:

- the property's **title conditions**, consisting of encumbrances which a preliminary title report would disclose, such as easements, Covenants, Conditions and Restrictions (CC&Rs), legal descriptions, trust deed provisions, etc., other than assuring compliance by the seller with disclosures about liens for improvement district bonds, such as Mello Roos bonds;
- the **operating expenses** for the property (and any tenant income) the buyer will experience during ownership, such as utilities, sanitation, property taxes, yard and pool maintenance, insurance, etc., except the statutory disclosures the seller must make about any fire hazard clearance requirements which exist due to the property's location (NHD);
- the **zoning** or other **use restrictions** which may affect the buyer's future use of the property, except for the existence of industrial zoning, which affects the property, and nearby ordnance locations;
- the **income tax aspects** of the buyer's acquisition (or seller's disposition) of the property, such as limitations on interest deductions, avoidance of profit tax by exclusion or exemption on the sale of other property (on which the purchase of the listed property may be contingent);
- the **suitability of the property** to meet the buyer's objectives in the acquisition, be they financial, legal, possessory, etc.; and
- information or data on any **mixed use** of the property, such as acreage included in the purchase for use as subdividable lands, groves or other farming operations, or for use for tenant income or as a vacation rental.

Further, the listing agent owes no duty to prospective buyers to give advice, make recommendations, offer suggestions, comment on the extent of the adversity of the (adverse) facts disclosed, offer assistance (locate boundaries), investigate (due diligence), state an opinion or explain the effect on the buyer of any facts about the property's physical, natural or environmental conditions which have been provided by the listing agent.

However, **when asked** by the prospective buyer or a buyer's agent about any aspect, feature or condition which relates to the property or the transaction in some way, the listing agent is duty-bound to respond fully and fairly to the inquiry. The response must include material facts known to the listing agent about the subject matter of the inquiry and be free of half-truths and misleading statements.

Conversely, it is the buyer or the buyer's agent on his behalf who has a **duty to care for and protect** the buyer's best interests in the purchase of property. The buyer's agent, not the listing agent, must determine what due diligence efforts are first required before allowing the buyer to make the decision to purchase or close escrow.

Opinions in lieu of investigations

Consider a listing agent of a residence who is asked by a prospective buyer to point out the location of the boundaries for the lot on which the home is located. The agent does not provide the buyer with the

metes and bounds description contained in subdivision maps or tell the buyer to investigate the location of the boundaries himself. Instead, the agent says the boundaries are represented by a fence which surrounds the property.

The agent does not indicate the source of this opinion, such as the seller, a surveyor or himself. He also does not conditionalize his statement with words such as "the boundaries in this subdivision are usually where the fence has been placed." The agent did not even say, "in my opinion" or "I believe" to state any uncertainty he may have about the location of the boundaries. His statement of the boundary location was absolute — it is the fence.

The buyer further indicates he intends to have a pool built for the use of his family if he acquires the property. The listing agent does not respond to the buyer's statement about the intent to build a pool. The agent has no actual knowledge of easements or zoning ordinances which could **adversely affect** implementation of the buyer's intended future use of the property.

Further, the buyer asks the seller to confirm whether the fences are the outside parameters of the property. The seller indicates the fences demarcate the division line between the properties.

Without further investigation, a purchase agreement is entered into by both the prospective buyer and the seller. In preparation of the purchase agreement offer, the agent does not include a contingency provision to provide the buyer with an opportunity to verify the location of the boundaries or to confirm his ability to obtain a permit to build a pool as a condition for closing escrow.

Prior to closing, the title company is not asked nor is a surveyor brought in to establish the boundaries. Neither the local planning department nor a pool contractor was consulted about the ability to obtain a permit to build a pool.

The actual facts place the location of the rear fence several feet beyond the property line, giving the rear yard the actual appearance of having sufficient room to accommodate a pool, which it will not. Also, an easement for water lines and a sewer line runs across the entire rear of the property, as well as along one side of the home allowing these services to be supplied to a rear, uphill property.

Here, the buyer acted in reliance on the agent's (and seller's) opinion about the location of the boundaries to close escrow. As a result, liability for the boundary discrepancy will be imposed on the agent for his failure to **conditionalize his statement** about the location of the boundaries. Without qualifying his statement, the agent misrepresented the actual location of the boundaries.

Further, the agent, due to his lack of actual knowledge of the easements, has no liability exposure for his failure to disclose the easements which further interfered with meeting the announced interest of the buyer to build a pool. The listing agent did not owe the buyer a duty to advise him of the need to check title for any easements or restrictions which might interfere with the construction of a pool until the buyer made an inquiry.

The listing agent conducted a visual inspection of the property and observed nothing which indicated the existence of an easement. Further, he knew nothing about any such easement and, importantly, had no duty to investigate the condition of title or zoning since they are public records and go beyond observations resulting from a visual inspection.

Reliance on unconditional statements

Since the buyer made an inquiry (boundaries) and announced an intended use of the property (build), the information about the subject matter of the inquiries and the announced use became *material facts*.

When a listing agent responds, as he must, to an inquiry by a prospective buyer and gives information without conditionalizing his statement, **the buyer may rely** on the information and proceed to acquire the property without further confirmation of the accuracy or truthfulness of the information.

Here, due to the inquiry, the listing agent should have included a **contingency provision** in the purchase agreement. Then, the buyer would have been required as a condition of closing to further investigate. Thus, if the results of the due diligence investigation into the feasibility of constructing a pool (and the location of the boundaries) were not satisfactory to the buyer, he could have cancelled the transaction.

Without the inquiry from the buyer, the listing agent would not have volunteered his opinion about the location of the boundaries. Thus, without the inquiry he would not have gone beyond his minimum required disclosures about the physical condition of the property. Once he did respond to the request of the buyer, a contingency provision for further approval of the condition included in the purchase agreement would have avoided the dispute (and possibly the sale).

In response to an inquiry

A listing agent owes no duty to a prospective buyer to address the existence, much less the nature, of an easement located on the listed property. However, when the listing agent responds to an inquiry by the prospective buyer by providing information on the easement, he must state fully and fairly, without deceptive or misleading wording, his knowledge about the easement.

Further, he must **identify the source** of his information if he has not confirmed its accuracy or correctness, or **condition his response** in such a way as to prevent the prospective buyer from justifying any reliance on the information without further investigation.

Consider a prospective buyer who has no experience in real estate matters. The prospective buyer deals directly with the listing agent of a property which seems suitable to the buyer. The prospective buyer observes a 30-foot easement on the subdivision map running the entire width of the frontage to the property. He asks the listing agent what the easement is about. The listing agent responds, explaining it is "for those water lines you find on the curb of the street, it is nothing to worry about."

The prospective buyer decides to buy the property and build a home on it. In escrow, the preliminary title report also reflects the easement. On further inquiry by the buyer, the listing agent again assures the buyer the easement is on the front side of the lot and is not a problem due to the large setbacks.

After close of escrow and commencement of construction of a residence, the local water company digs a ditch 16 feet deep and installs a major waterline. The interference of the easement causes the buyer to relocate his driveway to the side street entrance since placing the driveway over the easement would require the buyer to remove it at his expense should the water company again need to access the easement in the future.

The buyer makes a demand on the listing agent for lost value paid for the property. The buyer had relied on the listing agent's representation that the easement presented no problem to his use of the property, when in fact it did.

Here, the listing agent, having responded to an inquiry from the prospective buyer on the nature of the easement, must be candid in his explanation. The buyer must be informed about the significance of the buyer's limited ability to use the portion of the lot burdened by the encumbrance of the easement. Instead, the listing agent gave evasive answers calculated to stifle and avoid the buyer's further investigation into the true facts about the burden placed on the property by the easement.

Since a material fact is involved, the buyer's inquiry is entitled to a response based on the listing agent's working knowledge of the underlying facts or by identifying the source of the information given. If the listing agent lacks sufficient knowledge to comment, he is duty-bound to say so.

Ads based on seller information

A listing agent may use information obtained from a seller concerning the size of a property in an **advertisement** offering property for sale, such as stating a parcel contains more than one acre or a home contains 5,000 square feet. The listing agent does not need to investigate whether this information is accurate as long as it is not known to the agent to be false. Further, the agent does not need to identify the seller as the source of the data in his advertisement.

As for the advertisement used to locate buyers, the figure given must be consistent with the **observations** made by the listing agent while conducting his visual inspection of the property, e.g., does the property look like it contains more than one acre or look like a 5,000 square foot improvement? However, the listing agent is not required to measure the property or check the public records.

Conversely, in **response to an inquiry** from a prospective buyer expressing an interest or concern about the size of a parcel or improvement, the listing agent must either confirm the accuracy of the area or size, or attribute the information to a source.

For income-producing property, the operating income and expense data received from the seller can be passed on to the buyer or the buyer's selling broker and agent by the listing agent without either confirming its accuracy or disclaiming any responsibility for its correctness.

However, no matter how the data is presented to the prospective buyer, the listing agent is the *conduit for information* received from the seller. The listing agent must first **review it** and, if he has no knowledge the data might be suspect, inaccurate or a misrepresentation, provide it to the prospective buyer and indicate the seller is the source of the data.

By giving the source of the information, the listing agent demonstrates the information does not constitute **the opinion** of the listing agent.

Sufficient notice to alert the buyer

Consider a listing agent of a condominium unit who is aware other units in the project have suffered water intrusion damage. Also, he is aware the homeowners' association (HOA) has filed a lawsuit against the developer to recover the cost of repair for the water intrusion damage in the affected units.

The agent conducts his statutorily mandated visual inspection of the unit, but finds no visible signs of water damage in the unit. The seller claims none exist.

A prospective buyer is located who is not represented by a broker. The seller's Condition of Property (TDS) disclosure on the property's physical condition, which includes the listing agent's observations, is handed to the buyer.

The TDS discloses the seller and the listing agent know of no water intrusion damage in the seller's unit. Further, the listing agent advises the prospective buyer about the existence of HOA litigation over water intrusion damage in other units within the project. The buyer does not further inquire or comment on the HOA litigation or water damages to the project.

The buyer then makes an offer to purchase the property as prepared by the listing agent. The offer contains wording acknowledging the buyer's awareness of the HOA's water intrusion lawsuit and receipt of the TDS, as well as other mandated disclosures.

Later, the listing agent receives newsletters and minutes from the HOA's meetings which further discuss the previously disclosed water intrusion problems. The listing agent also reads the HOA's complaint against the developer. The documents contain no new information and are not brought to the attention of the buyer.

Escrow closes and the buyer moves into the unit. Later, the buyer discovers pre-existing water intrusion damage to the unit.

The buyer claims the listing agent owed him a **general duty** to pass on all documents known to exist concerning the **extent** of the water intrusion damage in the development, such as the newsletters, minutes from the HOA meetings and a copy of the lawsuit filed by the HOA.

Did the seller's listing agent sufficiently inform the buyer about the water intrusion problem to **place the buyer on notice** that a water intrusion problem existed?

Yes! The listing agent disclosed the essential facts necessary to notify the buyer about the water intrusion damage. Once informed of the potential problem within the project, it was the buyer's duty (or the buyer's agent's duty) to exercise reasonable care to protect the buyer.

With notice of the problem, any further details concerning the extent or nature of the water intrusion were **readily ascertainable** by the buyer on request of the listing agent, the HOA or a third-party investigator. It was not the duty of the listing agent to also advise the prospective buyer to investigate the consequences of the facts disclosed before deciding to buy. [**Pagano** v. **Krohn** (1997) 60 CA4th 1]

Also consider a seller who previously received a Solar Shade Control Notice from his neighbor, who subsequently installed a solar energy collector on the neighbor's property.

While the seller is not mandated by law to voluntarily give a copy of the notice to any prospective buyer, the listing agent should have the seller hand the notice to the buyer or the buyer's agent when delivering the TDS. A prudent buyer's agent will likely include a solar shade notice contingency in the purchase agreement. [See Form 150 §11.12 accompanying Chapter 51]

Trees or shrubs which shade more than 10% of a solar energy collector can be deemed a nuisance. Having the seller voluntarily give a copy of the notice to the buyer protects the seller and the listing agent from claims of misrepresentation by omission and gives the buyer sufficient notice to alert him to conditions which might affect the buyer's future use of the property. [Calif. Public Resources Code §25982.1]

Editor's note — If the seller sent notices to neighbors prior to installing a solar energy collector, he should voluntarily provide the buyer who purchases the property with a list of everyone he sent the notice to.

Minimum level of disclosure

A listing agent locating a prospective buyer for his client's one-to-four unit residential property owes a duty to the prospective buyer to conduct a reasonably diligent **visual inspection** of the property for defects which adversely affect the value of the listed property. On completing the inspection, the listing

agent must note on the (seller's) TDS any defects **observable or known** to the listing agent which are not already noted by the seller or are inconsistent with the seller's disclosures. The TDS is to be handed to prospective buyers *as soon as practicable*. [CC §§2079 et seq.]

However, the visual inspection and investigation of one-to-four unit residential property by the listing agent and the disclosure of his knowledge and observations excludes other readily available information, such as:

- the inspection of areas reasonably and normally **inaccessible** to the broker;
- the investigation of **off-site areas** and areas surrounding the property; and
- the inquiry into or review of **public records** or permits concerning title or use of the property. [CC §2079.3]

However, the minimum disclosure rule does not apply to a buyer's broker or his agents, much less limit the buyer's agent's duty to fully and fairly inform and advise on what investigation the buyer should undertake.

Further, the minimum one-to-four unit inspection and reporting requirements imposed on listing agents excludes the **common law duty** still imposed on listing agents of other types of property to further investigate and disclose to buyers or sellers any material facts he discovers regarding:

- title conditions;
- the financial consequences of owning the property, such as the property's operating costs; or
- the tax aspects of the transaction (seller only).

Purpose of inspection

The one-to-four unit disclosure limitation on listing agents serves to set a minimum level of information and data to be disclosed to put the buyer and the buyer's agent on **notice of physical defects** in the property which are **observable or known** to the seller or the listing broker and his agents.

For example, an agent lists a residence located on a hillside. The property is subject to natural geological hazards including a high groundwater level, landslides and a fault line.

A prospective buyer for the property is located by the listing agent. The buyer is informed a neighboring owner has had problems with underground water on his property and that he installed a pump to manage the high water level. The listing agent also tells the buyer the neighbor's property previously suffered landslide damages.

The listing agent provides the buyer with a geological report the seller had acquired regarding the property. The report indicates the property lies within a geological hazard area and is susceptible to landslides and groundwater buildup.

The buyer is also informed a back fence was removed since erosion caused it to slide down the hillside. When asked by the buyer, the seller also discloses the pool is located in the front yard since a fault line runs through the backyard.

After a review of the disclosures, the buyer makes an offer to purchase the property.

The listing agent prudently includes a **further-approval contingency provision** in the purchase agreement. The contingency provision calls for the buyer to further investigate the hazards by obtaining his own geological report and approving it as a condition of closing.

Before closing, the buyer obtains a report which states the property shows signs of instability and confirms that a high groundwater level exists. The report also states the house does not show signs of cracking or distress.

During the escrow period, the listing agent attends a meeting between area homeowners and county officials in which the geological hazards of the properties in the area and possible solutions are discussed.

The listing agent does not inform the buyer of the occurrence of the meeting or the topics discussed since no information previously unknown to the agent and undisclosed to the buyer was released.

Later, after escrow closes, the residence slides down the hillside and is condemned by the county as uninhabitable.

On a complaint filed by the buyer, the Department of Real Estate (DRE) attempts to revoke the listing agent's license claiming the subject matter of the meeting held by county officials was itself a fact which should have been disclosed to the buyer by the listing agent since the mere occurrence of the town hall meeting might have affected the buyer's decision to buy.

However, the listing agent was the **exclusive representative of the seller** of one-to-four residential units and only had a general nonfiduciary duty of disclosure to the buyer, which is limited to:

- providing the buyer with all existing geological reports held by the seller or the agent; and
- disclosing groundwater and landslide problems known to the listing agent which occurred on the property or in the neighboring area.

Here, the listing agent properly disclosed the geological hazards of the property by alerting the buyer to the potential problems. The homeowners' meeting was not required to be brought to the buyer's attention since the meeting was a review of the same geological hazards already known to the agent and disclosed to the buyer. Also, the buyer's independent investigation under the further-approval contingencies did not deter the buyer from proceeding with the purchase of the residence.

Thus, the listing agent did not violate the limited general nonfiduciary duty he owed to the nonclient buyer to disclose sufficient information on adverse property conditions to put a prospective buyer on notice so he (or the buyer's agent) could take steps to protect and care for the buyer's best interests. Thus, the DRE cannot revoke the listing agent's license for limiting his disclosures to the initial notice of the defect in the property without further elaboration. [**Vaill** v. **Edmonds** (1991) 4 CA4th 247]

Chapter 23 Opinions with erroneous conclusions

This chapter discusses how an opinion formed by a broker or his agent, given to a prospective buyer to predict a future event or activity regarding the use and operation of a property, might impose liability should the opinion prove to be erroneous.

When an opinion becomes a guarantee

Occasionally, a buyer will ask either a listing agent or his own agent what the agent "believes, contemplates, anticipates or projects" will occur based on the agent's greater knowledge about the condition of a property.

The response of the **buyer's agent** to the buyer's questions about disclosures made by the listing agent will naturally be limited to the agent's knowledge and expertise on the subject. However, the opinion given in response will speculate, based on the observations, knowledge and beliefs of the agent, on the likelihood an event or condition will occur in the future. These statements by the buyer's agent to his buyer are either:

- couched in words of anticipation, estimation, prediction or projection, denoting it is a **mere opinion** about an uncertain future event; or

- worded as an assurance the events and conditions, as presented, will occur, a response reaching the level of a **guarantee**.

The difference between the wording used by an agent to express either an opinion or a guarantee creates the liability the agent is exposed to when:

- the buyer **acts in reliance** on the information by making an offer to buy or eliminating a contingency and acquiring the property; and

- **the event or condition fails to occur**.

An **opinion** is a statement by a broker or his agent, given as his contemplation concerning an event or condition which has not yet occurred. To be classified as an opinion, the statement must be developed by the agent based on **readily available facts** and his **knowledge** and **expertise** on the subject.

It is the nature of an opinion that the event or conditions speculated to come about need not actually occur. The **speculation** is about an uncertain future event or condition.

In an opinion, the event or condition expressed is not a factual representation. The event or condition expressed has not occurred and does not exist at the time the opinion is given. A **fact** is an existing condition, presently known or knowable by the agent due to the ready availability of data or information. Facts are the subject of disclosure rules, not the rules of opinion.

Special circumstances impose liability

A statement made to a buyer by any agent which **predicts** the future occurrence of an event, activity or condition is an *opinion*. The general rule is that the agent and his broker cannot be held responsible when the prediction given in an opinion does not come to fruition.

However, several **special circumstances** may surround an agent's giving of an opinion and raise his statement to the status of a *misrepresentation*.

If special circumstances exist, the broker and his agent are **exposed to liability** for the losses caused by the failure of the predicted event, activity or condition to occur.

Special circumstances which may cause a failed prediction to be an actionable misrepresentation include:

- an opinion which is given by an agent acting as the representative of the person who relies on the opinion, such as occurs between the listing agent and his seller or the buyer's agent and his buyer, called a *fiduciary agency relationship* [**Ford** v. **Cournale** (1973) 36 CA3d 172];
- an opinion which is given to a buyer by a listing agent who holds himself out as **specially qualified** or possessing **expertise** about the subject matter of the transaction [**Pacesetter Homes, Inc.** v. **Brodkin** (1970) 5 CA3d 206];
- an opinion which is given by a listing agent (or his seller) who has **superior knowledge** on the subject matter of the opinion under circumstances implying the agent (or the seller) has **inside information** not available to the buyer which makes the prediction worthy of reliance [**Borba** v. **Thomas** (1977) 70 CA3d 144]; or
- an opinion which is given to a buyer by a listing agent who **could not honestly hold or reasonably believe** the truth of his opinion due to facts known or readily available to him. [**Cooper** v. **Jevne** (1976) 56 CA3d 860]

An opinion based on facts

An **opinion** is an honestly held belief based on a reasonable (although sometimes faulty) analysis of property information known or readily available to the agent giving the opinion. However, the opinion does not by itself create any liability should the event not occur. A special condition needs to envelope the opinion to impose liability.

Consider a prospective buyer who is interested in acquiring a lot within a subdivision track and building a home on it.

The subdivider's listing agent, based on subdivision maps and discussions with the subdivider, advises the buyer all the lots in the entire tract of land are going to be the same size and subject to the same use restrictions requiring all homes built on the lots to be worth at least $400,000.

The buyer purchases the lot and builds his home in accordance with the use restrictions.

Due to an economic downturn at the end of the current business cycle, the subdivider resubdivides the remaining unsold lots and removes the use restrictions. The resubdividing is intended to increase the marketability of the unsold lots in the tract.

The buyer now seeks to rescind the purchase and recover his entire investment claiming the subdivider's agent made false representations about the subdivision which the buyer relied on to purchase the lot.

The subdivider's agent claims he honestly believed in the truth of his representations that the subdivider would not in the future alter the lots remaining to be sold.

Here, the agent's representations about the lot size and the Covenants, Conditions & Restrictions (CC&Rs) the subdivider would require in the future were made truthfully, with no intent to deceive the buyer. Both the agent and the subdivider had a reasonable basis for believing changes would not be necessary at the time of the purchase. However, a later shift in the economy warranted the changes as necessary to prevent the tract from deteriorating in its marketability.

The listing agent's statements about the future were **honestly entertained**. Thus, his statements qualify as an expression of his opinion.

Further, the buyer **did not reasonably rely** on the listing agent's opinion when he agreed to purchase the property. The buyer did not require the deed from the seller to include a grant of the promised rights that all the lots would be the same size with the same restrictions on minimum value. [**Meehan** v. **Huntington Land & Improvement Co.** (1940) 39 CA2d 349]

Conditional opinions

Special circumstances surrounding the giving of an opinion may create an environment in which the buyer, with good reason, **may rely** on the agent's opinion to make decisions.

Consider a developer of a residential duplex subdivision who provides his listing agent with a schedule of **projected rents**. The agent is instructed to inform prospective buyers these rents are estimates of the amounts obtainable from the duplexes should they buy one.

The developer has not developed properties in the area prior to this project. Also, he has no actual knowledge of the rents a duplex might obtain in the area.

A buyer with minimal investment property experience in the area contacts the agent for information about the duplexes being built.

The buyer is advised by the agent that "if you receive the rents we contemplate, it will be a good investment."

The buyer purchases a duplex, but is unable to locate tenants willing to pay the rental amounts the agent gave in his opinion. Ultimately, the buyer loses the property to foreclosure.

The buyer makes a demand on the agent and the agent's broker for the loss of his invested funds. The buyer claims the agent's statements about the property's future rental income were misrepresentations, which the buyer relied on to purchase the duplex, since the broker, his agent and the developer had **superior knowledge** about rental conditions in the area.

The broker claims the statement his agent made about rental amounts was a mere opinion since it **conditioned success** on collecting these amounts.

Here, the agent's statement was only an estimate or opinion he held about future anticipated rental income for a new development since no operating history existed to draw on when making the projections. Thus, his opinion was based on **all readily available information.**

Also, the buyer's lack of experience as an owner of investment property, the agent's choice of words, i.e., "if" and "contemplate," and the developer's lack of prior rental experience in the area or knowledge of

rents actually attainable by the duplexes made the statement an opinion. Thus, the buyer could not rely on the rent projections given by the adversarial listing agent as a fact which could reasonably motivate his decision to buy. [Pacesetter Homes, Inc., *supra*]

Conclusions drawn from opinions

An opinion given by a listing agent predicting the future occurrence of an event or condition concerning the buyer's use or management of a property does not impose liability on the listing agent for erroneous conclusions when the buyer is or has been made **aware of all the relevant facts** on which the agent's opinion is based.

Also, a buyer who has knowledge of and **equal access** to the same information and documents relied on by the listing agent to form his opinion, and has sufficient **time to conduct** his own independent investigation to ascertain the accuracy of the agent's opinion, cannot later claim he acted in reliance on the listing agent's opinion. This is especially true for buyers who possess the expertise needed to analyze the facts and make their own determination about the likelihood the agent's predictions will occur.

Thus, the buyer cannot ignore his own knowledge of the same facts used by the listing agent to develop the agent's opinion and then claim he relied on the listing agent's opinion as an assurance the prediction would occur.

Consider a leasing agent acting on behalf of a prospective tenant in lease negotiations with an experienced commercial landlord who has not retained the services of a real estate agent.

The leasing agent tells the landlord that "in my opinion" the tenant's annual gross sales receipts will be in excess of $5,000,000. After several months of negotiations conducted between the tenant's leasing agent and the seller's attorney, both of whom are very experienced practitioners, a lease agreement is entered into. The lease rent is a base monthly amount plus a percentage of annual gross sales receipts over $5,000,000. The landlord pays the leasing agent's fee.

A dispute erupts between the landlord and the tenant. The landlord now wants to recover the fee he paid the tenant's agent, claiming the agent actually represented the potential gross sales receipts as $7,500,000, an amount much higher than the sales the tenant would ever experience during the leasing period. Thus, the landlord would receive very little if any percentage rent above the fixed minimum rent.

Here, the tenant's agent prefaced his statements with the words "in my opinion." Also, a landlord cannot reasonably rely on or treat the representation of future gross sales as an event which will actually occur.

Thus, the landlord should have known the gross receipts prediction was just an estimate honestly made by the agent who represented the tenant. He could not treat the estimates of the adversarial agent as fact.

Further, the landlord had ample time and the means to make his own inquiries and analyze his findings. Since the landlord was not represented by a real estate agent, he should have conducted his own due diligence investigation if he intended to eliminate the uncertainties of estimates made on behalf of the tenant by the tenant's agent. [**Foreman & Clark Corporation** v. **Fallon** (1971) 3 C3d 875]

Opinions of the buyer's broker

A **seller's broker** and listing agent, acting exclusively on behalf of a seller, have only a *general non-agency duty* to deal honestly and in good faith with a prospective buyer. As for a buyer, the listing agent's opinions are those of an adversary.

Thus, a listing agent's opinion cannot be reasonably relied upon by a prospective buyer as having a high probability of occurring, unless **special circumstances** surround the agent's act of giving an opinion.

In contrast, a **buyer's broker** and his agent have a *special fiduciary (agency) duty* to handle a buyer with the same level of care and protection a trustee would exercise on behalf of his beneficiary.

This **special agency duty** owed to a buyer raises an opinion given to a buyer by the buyer's broker or his agent to a higher level of reliability than had the same opinion been expressed by a listing agent acting solely on behalf of a seller. Thus, as a fiduciary, the opinion of the buyer's agent becomes an **assurance** that the condition or event which was the subject of the opinion will occur, unless the buyer's agent *conditionalizes* his opinion.

For the buyer's agent to give his opinion to his buyer and keep it from rising to an actionable assurance, the advice given with the opinion must include a **recommendation** to investigate and expertly analyze relevant information in order to confirm the agent's opinion. Further, a **contingency provision** covering the condition or event that is the subject of the opinion needs to be included in any offer the buyer makes and the contingency must be eliminated before closing. [Borba, *supra*]

Assurance of suitability without a contingency

Consider a buyer's agent who represents a prospective buyer looking for rental income property.

The buyer's agent is aware that the buyer's primary purpose for acquiring property is to receive a minimum amount of spendable income from the investment.

The agent locates a multi-unit apartment complex. The agent assures his buyer that:

- monthly vacancies will only be three or four units since the apartment complex is the only complex in the area which allows children and pets;
- the complex will require very little expense to maintain; and
- the buyer will receive the amount of spendable income sought from the investment.

Even though the seller's books and records are **readily available** for inspection, the buyer's agent does not verify the accuracy of the seller's income and expense statements, or confirm the maintenance costs. Without doing so, the agent fills out and hands his buyer an Annual Property Operating Data (APOD) sheet restating the representations already made to the buyer about the agent's projections of future income. [See Form 352 accompanying Chapter 35]

The buyer, in reliance on his agent's predictions about the property's future operations, enters into a purchase agreement with the seller as prepared by his agent. No **contingency provisions** are included to confirm the integrity of the improvements or to investigate the income and expenses experienced by the seller.

After the buyer acquires the property, the buyer encounters higher maintenance costs and significantly lower rental income than represented by his agent. Also, the property has a high turnover rate and a large number of tenants are constantly delinquent in the payment of rent.

The buyer does not receive the sought-after minimum spendable income projected by his agent. Soon, due to persistent negative cash flow, the property is lost to foreclosure.

The buyer makes a demand on his agent for his lost investment, claiming the agent misrepresented the operations of the property. The buyer's agent rejects the demand, claiming his comments on the property's performance were opinions, not guarantees.

Here, the buyer had the **right to rely** on his agent's unconditional statements of facts about the property and treat them as true without concern for their verification since a fiduciary relationship existed between the buyer and his agent.

Thus, the buyer's agent's **predictions were misrepresentations**, the basis for the buyer's recovery of the value of the lost investment. The unfounded and careless predictions of the buyer's agent, given in an opinion as fact, constituted *deceit*, a form of misrepresentation. [Ford, *supra*]

Expertise of the broker or agent

Agents are known to be specialists and often properly hold themselves out as experts with **superior knowledge** about a particular type of transaction, such as high-end residential properties, apartment projects, industrial buildings or land. Prospective buyers, aware of a listing agent's specialty, often ask the agent for his opinion about some anticipated future use or operation of the property.

Due to an agent's experience, special training and education in a particular aspect of a property or type of transaction, agents may find their opinion is given extra weight by a buyer. An agent's **special qualifications** suddenly become *reasonable justification* for the buyer to rely on their opinion as an **assurance** that the predicted event, activity or condition will actually be experienced as stated.

Thus, an agent's wording of his opinion needs to express that the opinion is **only his belief** or his thought on the matter. Having expressed an opinion, the agent then needs to include a further-approval contingency calling for the buyer to confirm information given in the opinion.

Consider a developer who controls a homeowners' association (HOA) which governs a subdivision of homes he is marketing to prospective buyers as having a panoramic view of the countryside.

The developer and his listing agent hold themselves out **as experts** in the establishment and administration of HOAs when questions about HOA operations and the Covenants, Conditions and Restrictions (CC&Rs) are received from prospective buyers.

The listing agent assures prospective buyers that the subdivision's CC&Rs protect the view from each lot, that any future landscaping or fencing requires approval from a special architectural committee, and that the committee will not approve fences or landscaping which interfere with the view. The recorded CC&Rs contain provisions for the committee and view protection which confirm the agent's statements.

However, an architectural committee is never setup. Further, all proposals for fences are reviewed and approved by the developer himself, a fact known to his agent, but not to prospective buyers. A prospective buyer pays a premium for a view lot improved with a home which has a panoramic view.

After acquiring the property, a neighbor erects a fence as approved by the developer. The fence blocks the buyer's view. The buyer makes a demand on the agent for his money losses brought about by a loss in value suffered by his property since the agent's statement on view rights failed to come true.

The listing agent claims his statement about the view rights was his opinion, given as a representative of the seller, a statement which could not be reasonably relied on by the buyer when making a decision to purchase the property.

Here, the agent held himself out as **an expert** on association management and CC&Rs enforcement. The agent then stated the CC&Rs and architectural committee would maintain the view provided by the development.

However, the listing agent knew the committee required to make such decisions had not been created and that the developer himself had full control. Thus, the buyer could pursue the agent to recover his lost value, i.e., the view, due to his false opinion about the HOA's ability to protect the buyer's view rights in the future.

When an agent holds himself out to be *specially qualified* and informed in the subject matter expressed in his opinion regarding future expectations, his opinion becomes a **positive statement of truth** on which a buyer or seller of lesser knowledge can rely. [**Cohen** v. **S & S Construction Co.** (1983) 151 CA3d 941]

Inducing reliance by assurances

All agents give opinions to buyers predicting all sorts of events or conditions the buyer will experience after acquiring a property. However, when the opinion is **coupled with advice** expressing no further need for the buyer, or others on behalf of the buyer, to investigate and confirm the prediction, the opinion is elevated to the level of a *guarantee*.

The level of assurance equivalent to a **guarantee** also arises out of a buyer's indication to an agent that the buyer is relying on the agent:

- to analyze a qualifying property to determine the property's ability to be used or operated as the buyer has indicated; and

- to advise on whether the property is suitable and will meet the buyer's expectations.

Also, any affirmative activities or statements of any agent designed to **suppress the buyer's inspection** of the property, his inquiries of the owner or the owner's manager or agents, or the employment of other experts when the agent knows the buyer will rely on the agent's representations, are considered assurances which make the conclusion drawn in the opinion the equivalent of a fact.

If the predicted event or condition does not come to pass and it was the **buyer's agent** who suppressed the buyer's due diligence activities, the buyer's agent is liable for the lost *benefit of the bargain* he predicted would occur. Recovery includes projected net spendable income, not just the loss of the price paid.

As for the **listing agent's liability** to the buyer under the same circumstances, liability is limited to the loss of the price paid and no future losses such as a profit or other return on the investment are collectable.

Facts not supporting the conclusion

An agent's opinion must be a belief honestly held by the agent if the agent is to avoid liability when the predicted event or condition does not occur. For an agent to hold an **honest belief**, the opinion must be formed based on a due diligence investigation and knowledge of all readily available facts which have a bearing on the probability of the event or condition occurring.

When facts affecting the conclusion drawn by the agent in his opinion are known or readily available to the agent, the test of an *honestly held opinion* is whether the agent giving the opinion **should have known better** than to give such an opinion.

Thus, an agent who fails to conduct a due diligence investigation to determine the facts before expressing an opinion which the investigation would have influenced will be liable for his opinion as a misrepresentation should the event or condition fail to occur, no matter his wording to limit the prediction to a mere speculative opinion.

Without first having the facts on which to base an opinion, the agent's opinion is either an *unfounded guess* or an *unreasonable assumption* about events and conditions he predicts will occur in the future.

Consider a listing agent for a condominium project who advertises "luxury" condos for sale. The agent knows the condos are poorly constructed and that the defects are unobservable to someone not knowledgeable in the field of construction.

A buyer contacts the agent for more information.

The agent tells the buyer that the condos are an "outstanding" investment opportunity. Unaware of the defects, the buyer purchases a condo.

The buyer soon discovers that the building housing the condos is in danger of falling down.

Here, the listing agent (and his broker) are guilty of both *affirmative* and *negative fraud*.

By telling the buyer that the condos were an outstanding investment opportunity, an opinion the agent could not have **honestly held** in light of his knowledge of the construction defects, the agent's representation is an **affirmative fraud**, also called an *intentional misrepresentation*. The agent should have known better than to give such an opinion.

Also, the significant defects in the "luxury" project were **material facts** since they adversely affected the present value and desirability of the condos. Accordingly, the agent is liable for damages caused by his nondisclosure (omission) of the defects which were known to him, but unknown and unobservable by the buyer, an example of a representation which is a **negative fraud**, also called *deceit*. [Cooper, *supra*]

Predicting the conduct of others

The transfer of real estate to a buyer typically involves **third parties** who are not principals or agents in the transaction. Approval, consent, administrative review and other like-type **conduct by others** regarding some event or condition which is to occur before or after closing, cause buyers to be concerned about whether the third party will respond favorably to the proposed transaction. As a result, buyers ask agents what they believe might be the **reaction of others**, such as a HOA, water authority, landlord, contractor, lender, attorney, accountant, planning agency or redevelopment agency.

Consider agricultural land listed for sale. For a buyer to receive water from the Bureau of Reclamation, the buyer must obtain approval of the purchase price from the Bureau, a third party.

The listing agent locates a buyer.

A purchase agreement is drawn up contingent on the Bureau's approval of the purchase price. The agent estimates the approval process will take 30 to 60 days.

The buyer, concerned with meeting the planting deadline for this season, asks the agent about the probability of the Bureau's approval.

The lisgint agent consults with the seller as to whether the transaction would be approved by the Bureau since the seller has dealt with the Bureau over water issues before.

The seller says "he believes" it would.

The agent tells the buyer of the seller's opinion on Bureau approval. The buyer waives the Bureau-approval contingency, stating he will get the approval later. Escrow is closed.

The buyer files for Bureau approval of the sale when the property's natural well caves in.

The Bureau refuses to approve the transaction. Thus, the Bureau will not provide water.

The buyer seeks to recover his losses from the seller, claiming the seller's prediction of a future event (approval by the Bureau) was a fact on which he could rely in his purchase of the property.

However, nothing suggests the seller or his agent held themselves out to be **specially qualified** on the subject of Bureau approval. Thus, the seller's erroneous prediction about the approval was not a misrepresentation of fact, but a mere expression of his opinion.

The seller's access to and awareness of facts concerning the Bureau's approval process or likelihood of approval were either **known or equally available** to the buyer. If the buyer is curious about the details and paperwork needed for the approval, the buyer (or his agent) is duty bound to contact the Bureau himself.

Furthermore, unless a **special relationship** exists between the seller and buyer, the buyer is not entitled to rely on the opinion of the seller (or the listing agent) concerning the future decisions of a public body, in this case, the Bureau of Reclamation. [Borba, *supra*]

When the buyer has ready access to the third party, the **buyer's reliance** on the opinion of the seller's listing agent is *unjustified*. All the buyer need do to answer his own inquiry is contact the person involved and inquire himself.

As for a buyer's agent, his response to his buyer's inquiry may be an opinion on the probability of a positive or negative reaction by the third party, but must be accompanied with the advice to make the offer to purchase conditioned on getting the approval. If the contingency already exists, then get the approval to satisfy the contingency or be disapproved and cancel.

Estimates as projections or forecasts

Estimates presented to prospective buyers by agents are labelled with many titles and arise in a variety of real estate transactions. Every transaction offers agents the opportunity to provide estimates for their clients or the other principals involved. Estimates include approximations, predictions, pro-forma statements, anticipated expenditures and contemplated charges.

Estimates relate to income and/or expenditures, such as exist in:

- seller's net sheets;
- buyer's cost sheets;
- operating cost sheets for owner-occupied properties;
- APODs on income properties;
- loan origination or assumption charges;
- lender impounds;
- rent schedules (rolls);
- repair costs for clearances; and
- any other like-type predictions of costs or charges.

Estimates by their nature are not facts. The amounts estimated have not yet actually occurred. The amount estimated will become certain only by its *occurrence in the future*. The amount actually experienced may or may not equal the amount estimated.

A document entitled an "estimate" is typically based on the actual amount which would currently be experienced. Thus, estimates are expected to be quite **accurate in amount**, not just a guess. Words used in titles such as "contemplated," "pro-forma," "anticipated" or "predicted" indicate something less than an accurate estimate and provide less basis for a client to rely on them as an assurance they will occur.

Distinguish projection from forecasts

Opinions voiced by agents about an income property's future performance fall into one of three general categories:

- *projections*;
- *forecasts*; or
- *unfounded opinions*.

A **projection** is prepared by a listing agent on a property's annual operations using an APOD sheet which will be handed to prospective buyers to induce them to purchase the property. The data entered on the APOD by the agent is a projection based exclusively on the income and expenses **actually incurred** by the owner/seller of the property during the preceding 12-month period.

The amounts experienced by the owner/seller during the past year are **projected to occur** (again) over the next year, *adjusted* by the agent for any trends in income and expenses reflected by information currently available or presently known to the owner or the agent.

Trend information is used in a projection to make mathematical adjustments to income and expenses based on market conditions or implementable rent control increases, and to operating costs known to be increasing (or decreasing) by prior announcements of the providers.

Thus, the past year's operations experienced by the property are anticipated to be repeated, as adjusted, and occur again during the first 12 months of operation by a new owner. No estimations, contemplations

or use of figures other than those experienced by the owner are used to prepare a projection, except for adjustments to reflect changed conditions known (or should be known due to readily available facts). If these adjustments are not included in the projection, the opinion is not honestly held since it would be an opinion not actually held or not reasonably held by the agent or seller preparing the projection.

A **forecast** is an entirely different opinion from a projection, although both are based on beliefs about events and conditions which are honestly believed will likely occur in the future.

A forecast requires the knowledge and analysis of an anticipated change in circumstances (other than trend factors used for projections) which will influence the future income, expenses and operations (use) of a property. Forecasts anticipate **forward changes** in income and expense the preparer of the forecast believes will probably occur under new or developing circumstances.

Changes in circumstances which might affect the income, expenses and debt servicing the buyer **should experience** during the 12-month period following the close of escrow and would be considered in a forecast include:

- new management;
- rent increases up to current market rates;
- elimination of deferred maintenance and replacement of obsolete fixtures/appliances (renovation);
- changes in rent control ordinances;
- new construction adding to the supply of competing income properties;
- foreclosures adding less expensive properties to the market;
- commodity market prices (natural gas, water, fuel oil, electricity, etc.);
- local and state government fiscal demands for revenue and services (taxes);
- federal monetary policy effects on short-term and long-term rates (controlling any ARM loans encumbering the property or refinancing);
- demographics of increasing/decreasing population density in the area immediately surrounding the property (age and appreciation for the location);
- traffic count changes anticipated (due to traffic buildup or diversions);
- zoning changes reducing, altering or increasing the availability of comparable competitive properties;
- government condemnation, relocation or redevelopment actions;
- changes in the local employment base of employed individuals;
- on-site security measures for the prevention of crime;
- the age and condition of the major components of the structure;
- local socio-economic trends; and
- municipal improvement programs affecting the location of the property.

Chapter 24 Condition of property: the owner's disclosures

This chapter identifies the affirmative duty of a seller and his listing agent to disclose their awareness and knowledge about the property's condition to a prospective buyer.

Mandated on one-to-four residential units

A seller of a one-to-four unit residential property must **complete and deliver** to a prospective buyer a statutory form called a *Transfer Disclosure Statement* (TDS), more generically called a Condition of Property Disclosure Statement. [Calif. Civil Code §§1102(a), 1102.3; see Form 304 accompanying this chapter]

The seller must prepare the mandatory TDS with **honesty and in good faith**, whether or not a broker and listing agent is retained by the seller to assist in its preparation. [CC §1102.7]

When preparing the TDS, the seller sets forth any property defects **known or suspected** to exist by the seller.

Any conditions known to the seller which **negatively affect** the value and desirability of the property must be disclosed, even though they may not be preprinted on the TDS. Disclosures to the buyer are not limited to the items preprinted on the form. [CC §1102.8]

Any attempt to have the buyer **waive delivery** of the statutorily-mandated TDS, such as by use of an "as-is" provision in the purchase agreement, is *void* as against public policy. The words "as is" should never be used. The words imply a failure to disclose something known to the seller or the listing agent. [CC §1102.1(a)]

Delivery of the disclosure statement

While it is the seller who must prepare the TDS, it is the agent who obtains the purchase agreement offer from the buyer who must hand the buyer the seller's Condition of Property Disclosure Statement. If the sales transaction is directly between the seller and buyer, without the participation of an agent in negotiations, the seller has the obligation to deliver the TDS to the buyer. [CC §1102.12]

The failure of the seller or any of the agents involved to **deliver** the seller's TDS to the buyer will not invalidate a sale of property which has closed. However, the seller and the listing broker will be liable to the buyer for the amount of actual monetary losses caused by an undisclosed defect known to them, a point of law which has always existed. [CC §1102.13]

For the seller's disclosure statement to be an effective pronouncement, **material defects** in the integrity of the property must be disclosed to the buyer before the price of the property is agreed to by acceptance of an offer or counteroffer.

If the seller's statement is delivered to the buyer of a one-to-four unit residential property after the seller enters into a purchase agreement, the buyer has the right to:

- **cancel** the purchase agreement on discovery of undisclosed defects known to the seller and unobserved by the buyer or the buyer's agent (on an inspection) prior to acceptance [CC §1102.3];

- **make a demand** on the seller to correct the defects or reduce the price accordingly before escrow closes [See Form 150 §11.2 accompanying Chapter 51]; or

- **close escrow** and make a demand on the seller for the costs to cure the defects known to the seller and not disclosed prior to acceptance. [**Jue** v. **Smiser** (1994) 23 CA4th 312]

Buyer's right to cancel

The Condition of Property Disclosure Statement is to be delivered to a buyer *as soon as practicable*, and in any event, before closing a sale. **Delivery** of the seller's TDS to the buyer is deemed to have been met if the TDS is attached to the purchase agreement offer made by the buyer or the counteroffer made by the seller. [CC §1102.3]

If the TDS is belatedly delivered to the buyer — after he enters into a purchase agreement — the buyer may, among other remedies, **elect to cancel** the purchase agreement under a statutory three-day right to cancel. The buyer's statutory cancellation right runs for three days following the day of the in-escrow (in-person) delivery of the disclosure statement (five days if delivered via mail). [CC §1102.3]

However, buyers are not required to cancel the purchase agreement and "go away" on their in-escrow receipt of an unacceptable TDS or home inspection report.

As an alternative to canceling the purchase agreement on receipt and review of the seller's disclosure statement, the buyer may **make a demand** on the seller to cure any material defect (affecting value) which was *known to the seller* and not disclosed or known to the buyer prior to entering into the purchase agreement. The same rule holds for the listing agent who has knowledge of defects and does not disclose the facts to the buyer before the buyer enters into the purchase agreement. [See Form 269 accompanying Chapter 27]

If the seller will not cure the defects, the buyer may close escrow and recover the cost incurred (or valuation lost) to correct the defect. The defects must be **known and undisclosed**, or inaccurately disclosed, by the seller at the time of acceptance of the purchase agreement. [Jue, *supra*]

Another alternative for the buyer is to complete the purchase by tendering a **price reduced** by the cost to repair or replace the defects known to the seller and undisclosed (or unconditionally misrepresented) on the date the purchase agreement was entered into. [See Form 150 §11.2 accompanying Chapter 51]

Reliance limited to seller's awareness

On listing his home for sale, a seller of a one-to-four unit residential property signs and hands his listing agent a completed Condition of Property Disclosure Statement at his agent's request.

A preprinted disclaimer contained in the TDS states the disclosures made by the seller on the form:

- **may not be relied on** by a buyer as a warranty of the actual condition of the property; and

- are **not part of the terms** of the purchase agreement (even though the disclosure statement may be attached).

On the disclosure statement, the seller indicates he is **unaware** of any building code violations on the property. The listing agent adds nothing as he has no knowledge to the contrary and his visual inspection brought nothing to his attention as a violation.

CONDITION OF PROPERTY

Transfer Disclosure Statement (TDS)

This disclosure statement is prepared for the following:

☐ Seller's listing agreement

☐ Purchase agreement

☐ Counteroffer _____

☐ _____

dated _____, 20_____, at _____, California,

entered into by _____,

and _____,

regarding property referred to as _____

_____

_____

_____

_____

_____.

REAL ESTATE TRANSFER DISCLOSURE STATEMENT

THIS DISCLOSURE STATEMENT CONCERNS THE REAL PROPERTY SITUATED IN

THE CITY OF _____, COUNTY OF _____, STATE OF CALIFORNIA,

DESCRIBED AS _____

_____

_____

_____

_____

_____.

THIS STATEMENT IS A DISCLOSURE OF THE CONDITION OF THE ABOVE DESCRIBED PROPERTY IN COMPLIANCE WITH SECTION 1102 OF THE CIVIL CODE AS OF _____, 20_____. IT IS NOT A WARRANTY OF ANY KIND BY THE SELLER(S) OR ANY AGENT(S) REPRESENTING ANY PRINCIPAL(S) IN THIS TRANSACTION, AND IS NOT A SUBSTITUTE FOR ANY INSPECTIONS OR WARRANTIES THE PRINCIPAL(S) MAY WISH TO OBTAIN.

I

COORDINATION WITH OTHER DISCLOSURE FORMS

This Real Estate Transfer Disclosure Statement is made pursuant to Section 1102 of the Civil Code. Other statutes require disclosures, depending upon the details of the particular real estate transaction (for example: special study zones and purchase-money liens on residential property).

Substituted Disclosures: The following disclosures and other disclosures required by law, including the Natural Hazard Disclosure Report/Statement that may include airport annoyances, earthquake, fire, flood, or special assessment information, have or will be made in connection with this real estate transfer, and are intended to satisfy the disclosure obligations on this form, where the subject matter is the same:

☐ Inspection reports completed pursuant to the contract of sale or receipt for deposit.

☐ Additional inspection reports or disclosures: _____

_____

_____

_____

_____

II

SELLER'S INFORMATION

The Seller discloses the following information with the knowledge that even though this is not a warranty, prospective Buyers may rely on this information in deciding whether and on what terms to purchase the subject property. Seller hereby authorizes any agent(s) representing any principal(s) in this transaction to provide a copy of this statement to any person or entity in connection with any actual or anticipated sale of the property.

THE FOLLOWING ARE REPRESENTATIONS MADE BY THE SELLER(S) AND ARE NOT THE REPRESENTATIONS OF THE AGENT(S), IF ANY. THIS INFORMATION IS A DISCLOSURE AND IS NOT INTENDED TO BE PART OF ANY CONTRACT BETWEEN THE BUYER AND SELLER:

Seller ☐ is, ☐ is not, occupying the property.

A. The subject property has the items checked below **(read across):**

☐ Range ☐ Oven ☐ Microwave
☐ Dishwasher ☐ Trash Compactor ☐ Garbage Disposal
☐ Washer/Dryer Hookups ☐ Rain Gutters
☐ Burglar Alarms ☐ Smoke Detector(s) ☐ Fire Alarm
☐ TV Antenna ☐ Satellite Dish ☐ Intercom
☐ Central Heating ☐ Central Air Conditioning ☐ Evaporator Cooler(s)
☐ Wall/Window Air Conditioning ☐ Sprinklers ☐ Public Sewer System
☐ Septic Tank ☐ Sump Pump ☐ Water Softener
☐ Patio/Decking ☐ Built-in Barbecue ☐ Gazebo
☐ Sauna
☐ Hot Tub ☐ Locking Safe Cover* ☐ Pool ☐ Child Resistant Barrier* ☐ Spa ☐ Locking Safe Cover*
☐ Security Gate(s) ☐ Automatic Garage Door Opener(s)* Number of Remote Controls: _____

Garage: ☐ Attached ☐ Not Attached ☐ Carport
Pool/Spa Heater: ☐ Gas ☐ Solar ☐ Electric
Water Heater: ☐ Gas ☐ Braced or Strapped* ☐ Private Utility or Other:_____

Water Supply: ☐ City ☐ Well
Gas Supply: ☐ Utility ☐ Bottled
☐ Window Screens ☐ Window Security Bars
☐ Quick Release Mechanism on Bedroom Windows*

Exhaust Fan(s) in _____220 Volt Wiring in _____
Fireplace(s) in _____ Gas Starter _____
Roof(s): Type _____ Age:_____ (approx.)
Other:_____
_____
_____
_____
_____
_____
_____
_____

Are there, to the best of your (Seller's) knowledge, any of the above that are not in operating condition?
☐ Yes ☐ No
If yes, then describe. (Attach additional pages if necessary): _____
_____
_____
_____
_____ ☐ Addendum attached.

B. Are you (Seller) aware of any significant defects/malfunctions in any of the following? ☐ Yes ☐ No.

If yes, check appropriate boxes below.

☐ Interior Walls ☐ Ceilings ☐ Floor ☐ Exterior Walls ☐ Insulation ☐ Roof(s) ☐ Windows
☐ Doors ☐ Foundation ☐ Slab(s) ☐ Driveways ☐ Sidewalks ☐ Walls/Fences
☐ Electrical Systems ☐ Plumbing/Sewers/Septics
☐ Other Structural Components (Describe): _____

If any of the above is checked, explain. (Attach additional pages if necessary): _____

_____ ☐ Addendum attached.

*This garage door opener or child resistant pool barrier may not be in compliance with the safety standards relating to automatic reversing devices as set forth in Chapter 12.5 (commencing with Section 19890) of Part 3 of Division 13 of, or with the pool safety standards of Article 2.5 (commencing with Section 115920) of Chapter 5 of Part 10 of Division 104 of, the Health and Safety Code. The water heater may not be anchored, braced or strapped in accordance with Section 19211 of the Health and Safety Code. Window security bars may not have quick-release mechanisms in compliance with the 1995 edition of the California Building Standards Code.

C. Are you (Seller) aware of any of the following:

1. Substances, materials or products which may be an environmental hazard such as, but not limited to, asbestos, formaldehyde, radon gas, lead-based paint, mold, fuel or chemical storage tanks, and contaminated soil or water on the subject property . . . . . ☐ Yes ☐ No
2. Features of the property shared in common with adjoining landowners, such as walls, fences, and driveways, whose use or responsibility for maintenance may have an effect on the subject property . . . . . ☐ Yes ☐ No
3. Any encroachments, easements or similar matters that may affect your interest in the subject property . . . . . ☐ Yes ☐ No
4. Room additions, structural modifications, or other alterations or repairs made without necessary permits . . . . . ☐ Yes ☐ No
5. Room additions, structural modifications, or other alterations or repairs not in compliance with building codes . . . . . ☐ Yes ☐ No
6. Fill (compacted or otherwise) on the property or any portion thereof . . . . . ☐ Yes ☐ No
7. Any settling from any cause, or slippage, sliding, or other soil problems . . . . . ☐ Yes ☐ No
8. Flooding, drainage or grading problems . . . . . ☐ Yes ☐ No
9. Major damage to the property or any of the structures from fire, earthquake, floods, or landslides . . . . . ☐ Yes ☐ No
10. Any zoning violations, nonconforming uses, violations of “setback” requirements . . . . . ☐ Yes ☐ No
11. Neighborhood noise problems or other nuisances . . . . . ☐ Yes ☐ No
12. CC&Rs or other deed restrictions or obligations . . . . . ☐ Yes ☐ No
13. Homeowners’ Association which has any authority over the subject property . . . . . ☐ Yes ☐ No
14. Any “common area” (facilities such as pools, tennis courts, walkways, or other areas co-owned in undivided interest with others) . . . . . ☐ Yes ☐ No
15. Any notices of abatement or citations against the property . . . . . ☐ Yes ☐ No
16. Any lawsuits by or against the Seller threatening to or affecting this real property, including any lawsuits alleging a defect or deficiency in this real property or “common areas” (facilities such as pools, tennis courts, walkways, or other areas co-owned in undivided interest with others) . . . . . ☐ Yes ☐ No

If the answer to any of these is yes, explain. (Attach additional pages if necessary.): _____

_____

_____

_____

_____

_____

_____

_____

_____ ☐ Addendum attached.

Seller certifies that the information herein is true and correct to the best of the Seller's knowledge as of the date signed by the Seller.

Seller:_____ Date:_____, 20_____

Seller:_____ Date:_____, 20_____

III

SELLER'S AGENT'S INSPECTION DISCLOSURE

(To be completed only if the Seller is represented by an agent in this transaction.)

THE UNDERSIGNED, BASED ON THE ABOVE INQUIRY OF THE SELLER(S) AS TO THE CONDITION OF THE PROPERTY AND BASED ON A REASONABLY COMPETENT AND DILIGENT VISUAL INSPECTION OF THE ACCESSIBLE AREAS OF THE PROPERTY IN CONJUNCTION WITH THAT INQUIRY, STATES THE FOLLOWING:

☐ Agent notes no items for disclosure.

Agent notes the following items: _____

_____

_____

_____

_____

_____

_____

_____

Listing Broker: _____

(Broker representing Seller — Please print)

By:_____ Date:_____, 20_____

(Associate Licensee or Broker Signature)

IV

AGENT'S INSPECTION DISCLOSURE

(To be completed only if the agent who has obtained the offer is other than the agent above)**:**

THE UNDERSIGNED, BASED ON A REASONABLY COMPETENT AND DILIGENT VISUAL INSPECTION OF THE ACCESSIBLE AREAS OF THE PROPERTY, STATES THE FOLLOWING:

☐ Agent notes no items for disclosure.

Agent notes the following items:_____

_____

_____

_____

_____

_____

_____

Selling Broker: _____

(Broker obtaining the offer — Please print)

By:_____ Date:_____, 20 _____

(Associate Licensee or Broker Signature)

V

BUYER(S) AND SELLER(S) MAY WISH TO OBTAIN PROFESSIONAL ADVICE AND/OR INSPECTIONS OF THE PROPERTY AND TO PROVIDE FOR APPROPRIATE PROVISIONS IN A CONTRACT BETWEEN BUYER(S) AND SELLER(S) WITH RESPECT TO ANY ADVICE/INSPECTIONS/DEFECTS.

A REAL ESTATE BROKER IS QUALIFIED TO ADVISE ON REAL ESTATE. IF YOU DESIRE LEGAL ADVICE, CONSULT YOUR ATTORNEY.

I/WE ACKNOWLEDGE RECEIPT OF A COPY OF THIS STATEMENT.	**I/WE ACKNOWLEDGE RECEIPT OF A COPY OF THIS STATEMENT.**
Date:_____, 20_____	Date:_____, 20_____
Buyer:_____	Seller:_____
Buyer:_____	Seller:_____
Buyer's Broker:	**Seller's Broker:**
Date:_____, 20_____	Date:_____, 20_____
Agent:_____ (Broker obtaining the offer — Please print)	Agent: _____ (Broker representing Seller — Please print)
By: _____ (Associate Licensee or Broker Signature)	By: _____ (Associate Licensee or Broker Signature)

SECTION 1102.3 OF THE CIVIL CODE PROVIDES A BUYER WITH THE RIGHT TO RESCIND A PURCHASE CONTRACT FOR AT LEAST THREE DAYS AFTER THE DELIVERY OF THIS DISCLOSURE IF DELIVERY OCCURS AFTER THE SIGNING OF AN OFFER TO PURCHASE. IF YOU WISH TO RESCIND THE CONTRACT, YOU MUST ACT WITHIN THE PRESCRIBED PERIOD.

A REAL ESTATE BROKER IS QUALIFIED TO ADVISE ON REAL ESTATE. IF YOU DESIRE LEGAL ADVICE, CONSULT YOUR ATTORNEY.

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A buyer is located, a purchase agreement entered into and escrow opened. During the escrow period, the buyer is handed the TDS, which he approves. Prior to closing escrow, a county building inspector contacted by the buyer advises the buyer that building code violations exist on the property.

After closing, the buyer makes a demand on the seller to pay the cost of correcting the code violations. He claims the seller misrepresented the condition of the property since the seller failed to disclose in the Condition of Property Disclosure Statement that building code violations existed on the property.

The seller claims the buyer is not entitled to recover the cost of curing the code violations. The TDS disclosed that the seller **possessed no knowledge** of any code violations when he prepared the disclosure statement received and approved by the buyer.

Here, the seller **disclosed his lack of actual knowledge** of any code violations in the TDS. The disclosure in the statement enables the seller to avoid liability for building code violations which actually existed and were unknown to the seller.

A seller completes the mandatory Condition of Property Disclosure Statement only as a disclosure of the seller's **state of awareness** (actual knowledge) regarding the condition of the property. Thus, the statement does not itself disclose the **actual conditions** which may exist on the property. In a word, it is not a *warranty* of the actual state of the property's condition. Instead, it is a statement of the seller's **awareness** of the property's condition.

The buyer's alternative remedies include:

- canceling the transaction under the statutory seller's disclosure scheme;
- requiring the violations be cured before escrow can close; or
- reducing the price to cover the cost to cure the violations.

Excuse my state of awareness

Serving as a **lack-of-awareness disclosure**, the statutory Transfer Disclosure Statement has become *discredited* as the buyer's primary source of information about the integrity of the physical condition of the property being purchased.

In practice, a listing agent hands the seller's TDS to a prospective buyer (or the buyer's agent) to **induce reliance** on its content to establish the integrity of the property's condition. With the TDS in hand, the buyer establishes the price, terms and conditions on which he will make an offer to purchase the property or close escrow.

The disclosure is not presented to the buyer by the listing agent as a "red flag warning" accompanied by instructions to the buyer to confirm the condition of the seller's state of awareness by obtaining a home inspection report to determine the actual condition of the property before entering into a purchase agreement or closing escrow.

However, the buyer's agent, mindful of the lack-of-awareness limitation on the effectiveness of the TDS, cannot in good faith allow his buyer to give any weight to the seller's disclosure statement, except for the defects actually disclosed.

Thus, the "not-a-warranty" disclaimer in the disclosure statement puts everyone on notice that the TDS is not a part of the purchase agreement. The fact the TDS is an addendum to the purchase agreement to evidence its delivery to the buyer does not make it a representation of the actual condition of the property. The question remains as to just what role the disclosure should play, other than to get the seller on record as to the defects he will disclose.

Buyers and their agents will learn not to use the disclosure handed them by the listing agent as a basis for setting a definitive price and terms of purchase. To everyone's benefit, the well-informed buyer will be induced to rely on **home inspection reports**, whether obtained by the seller or the buyer, to advise the buyer about the actual physical condition of the property.

Include a home inspector

A competent listing agent will aggressively recommend to his sellers that before the property is marketed they retain a **home inspector** to conduct a physical examination to determine the condition of the property and issue a report on his findings. [See Chapter 26]

A home inspector often detects and reports property defects overlooked by the seller and not observed during a visual inspection by the listing agent. Significant defects which remain undisclosed tend to surface after closing as claims against the listing broker for deceit. A home inspector troubleshoots for defects not observable to the untrained eye of a broker and his listing agent. [Calif. Business and Professions Code §7195]

Listing broker's mandatory inspection

A **seller's broker** (or the broker's listing agent) is obligated to personally carry out a *visual inspection* of the property and do so competently. The seller's disclosures on the Condition of Property Disclosure Statement are then reviewed by the broker or the listing agent for discrepancies. They then add any information about their knowledge of material defects which have gone undisclosed by the seller (or the home inspector) and are known to the listing agent or observed during the agent's inspection.

A buyer has **two years** to pursue the seller's broker and listing agent to recover losses caused by the broker's or his agent's **negligent failure** to disclose observable and known defects affecting the physical condition and value of the property. Undisclosed defects permitting recovery are those which would have been observed by a reasonably competent broker during a visual on-site inspection. A listing agent is expected to be as competent in an inspection as his broker would be. [CC §2079.4]

However, the buyer will be unable to recover money from the seller's broker if the seller's broker or listing agent inspected the property and would not have observed the defect and did not actually know it existed. [CC §1102.4(a)]

Following their mandatory visual inspection, the seller's broker or his listing agent might make some of their disclosures on the seller's TDS by relying on **specific items** covered in a home inspector's report. Should the items relied on later be contested by the buyer as incorrect or inadequate, the broker and his agent are entitled to indemnification from the home inspection company issuing the report. [**Leko** v. **Cornerstone Building Inspection Service** (2001) 86 CA4th 1109]

Unconfirmed seller representations

Consider a broker who is acting as a relocation agent for a property owner's employer. The broker takes title to the owner's one-to-four unit residential property since it did not sell during the listing period. After taking title, a buyer is located for the property.

The prospective buyer is handed the previous owner's Condition of Property Disclosure Statement. The statement does not disclose night-time noise conditions which affect the property's value and were known to the owner. The broker does not know of the noise conditions and observes none during his day-time visual inspection of the property. Thus, he does not note the adverse condition on the owner's TDS in the space provided for an agent's comments.

The buyer, on occupying the property, discovers the undisclosed noise conditions. Due to the intensity of the noise, the value of the property is less than the price paid.

The buyer seeks to recover the lost value from the listing broker. The broker claims he is not liable for the lost value since he was unaware of any noise conditions and could not have observed the noise during his day-time visual inspection of the property.

The buyer claims the broker is liable for the lost value since he owed a duty to the buyer to **investigate** and **verify** the prior owner's representations on the TDS for accuracy, not just visually inspect the property.

However, the seller's broker and his listing agent on the sale of a one-to-four unit residential property do not owe a duty to the buyer to **investigate and confirm** the truthfulness of the *owner's representations*. The broker does not represent the buyer. Thus, the listing broker is not liable for the lost value resulting from the undisclosed noise, unless known to the listing broker or his agent.

A listing broker's duty to the buyer is limited to conducting a visual inspection of the property and disclosing any **observations and actual knowledge** the listing broker or listing agent may have of the conditions on or about the property. The listing broker's awareness of conditions did not include the existence of night-time noise. [**Shapiro** v. **Sutherland** (1998) 64 CA4th 1534]

Nondisclosure by the seller

Now consider a residence which has a defect in its foundation. The defect affects the value of the property and is known to the seller, but not readily observable by a buyer.

The seller's Condition of Property Disclosure Statement does not reflect the seller's knowledge of the defective foundation.

A purchase agreement is entered into between the seller and buyer. The TDS is attached to the purchase agreement to acknowledge the buyer's receipt and avoid contingencies. Escrow is opened and the property is conveyed to the buyer on closing.

Within four years after escrow closes, the defective foundation worsens and becomes obvious to the buyer. The buyer makes a demand on the seller for his costs incurred to cure the defect.

Is the seller liable to the buyer for the cost incurred to repair the defective foundation?

Yes! Any seller, whether or not he is represented by a listing broker, has a duty to the buyer to disclose on the statutory Transfer Disclosure Statement all facts **known to the seller** about the condition of the property, which:

- are **not readily observable** by the buyer on an inspection of the property; and
- **affect the value and desirability**, and thus the integrity, of the property in the hands of the buyer. [**Prichard** v. **Reitz** (1986) 178 CA3d 465]

The illegal "as-is" sale

Consider a listing agent who, on conducting his visual inspection of a property, has reason to believe the property fails to conform to building and zoning regulations.

The agent knows a prospective buyer interested in making an offer is not aware of the possible violations, and might view the property's value differently if he learns the violations may exist.

The buyer submits a purchase agreement offer. The agent prepares a counteroffer and includes an **as-is disclaimer provision** which the seller signs. The provision states the agent "makes no representations regarding the property and incurs no liability for any defects, the buyer agreeing to purchase the property "as is." The counteroffer is submitted to the buyer and accepted.

After closing, the city refuses to provide utility services to the residence due to building code and zoning violations.

The buyer makes a demand on the seller's broker and his listing agent for the buyer's money losses due to overpricing and the cost of corrective repairs. The buyer claims the seller's broker and listing agent breached their *general agency duties* owed the buyer. They failed to disclose material defects in the property **known** to the agent, but not the buyer.

The agent claims the buyer waived his right to collect money damages when he signed the purchase agreement with the "as-is" disclaimer.

Does use of an "as-is" disclaimer provision shield a listing broker from liability for the buyer's losses caused by the building and zoning violations which were **suspected to exist** by the broker's listing agent and not known or suspected by the buyer?

No! The seller's broker and listing agent have a **general duty**, owed to all parties in the transaction, to personally conduct a competent visual inspection of the property sold. Based on their inspection, they are to disclose **all known and observable** property conditions which adversely affect the value and desirability of the property which are not already known to the buyer. The breach of this duty by the listing agent's failure to disclose his knowledge or observations about **potential adverse conditions** is not excused by writing an "as-is" disclaimer into the purchase agreement in lieu of factual disclosures. [**Katz** v. **Department of Real Estate** (1979) 96 CA3d 895]

"As is" provisions become unnecessary to explain the condition of the property when information regarding defects is included in the seller's TDS and handed to the buyer. The seller simply discloses the defects, whether he does or does not agree to make repairs.

Further, public policy prohibits the sale of one-to-four unit residential property "as is." All buyers purchase property "as disclosed" by the seller, the seller's broker and the broker's agents, and as actually observed by the buyer **prior to entering** into the purchase agreement. When defects are disclosed prior to entering into a purchase agreement, negotiations may call for the seller to correct some or all of the disclosed defects. If not, the buyer takes the defects *as disclosed*. [CC §1102.1(a)]

Controlled and exempt sellers

Unless a seller is *exempt*, sellers of one-to-four unit residential real estate are required to furnish buyers with a statutory Transfer Disclosure Statement filled out by the seller. [CC §1102]

Listing brokers and their agents are never exempt from:

- conducting a **visual inspection** of a one-to-four unit residential property, sold or acquired on behalf of a seller or buyer [CC §2079]; and

- disclosing their **observations and knowledge** about the property on a TDS form or other separate document, whether or not the seller is exempt from using the form. [CC §1102.1]

Transactions which **exempt the seller** (but not the listing agent) from preparing and delivering the statutory TDS to the buyer include transfers:

- by court order, such as probate, eminent domain or bankruptcy;
- by judicial foreclosure or trustee's sale;
- on the resale of real estate owned property acquired by a lender on a deed-in-lieu of foreclosure, or by foreclosure;
- from co-owner to co-owner;
- from parent to child;
- from spouse to spouse, including property settlements resulting from a dissolution of marriage;
- by tax sale;
- by reversion of unclaimed property to the state; and
- from or to any government agency. [CC §1102.2]

Duty to disclose on exempt sales

A seller who is exempt from the **use and delivery** of the statutory Condition of Property Statement to buyers still has a *common law duty* to prospective buyers to disclose all **known defects**. In exempt transactions, the seller and listing agent can use a separate document to make the disclosures, or they may use the TDS form to list the defects known or suspected by them to exist to avoid deceit. [CC §1102.1(a)]

The best property disclosure tool for exempt sellers is the preparation and delivery of the statutory disclosure form (and a property inspector's report) to prospective buyers or buyer's agents on every type of transaction. If the transaction is exempt or concerns property other than one-to-four residential units, the form should still be used.

Foreclosing lender's silent deceit

Consider a trust deed lender who holds a trustee's foreclosure sale on a one-to-four unit residential property. The lender knows soil defects exist on the property, but does not disclose the defects to the bidders at the trustee's sale — a sale which exempts the seller (lender) from use of the statutory Condition of Property Disclosure Statement. [CC §1102.2(c)]

The high bidder at the trustee's sale later discovers the property's soil defects. The high bidder demands a full return of the sales price from the lender in exchange for return of the property to the lender, a recovery remedy called *rescission and restoration*.

The high bidder claims the lender had a common-law duty to prospective bidders to disclose property defects known to the foreclosing lender which materially affect the value of the property.

The lender claims the exemption of a foreclosing lender's use of the TDS form at a trustee's sale **eliminates any duty** the lender or trustee may have had to disclose defects in the property's condition known to the them. The lender claims the ancient doctrine of *caveat emptor* or "buyer beware" controls the bidding at the foreclosure sale.

Can the high bidder rescind the sale for the lender's failure at the trustee's sale to disclose known material defects in the condition of the property?

Yes! A transaction which exempts sellers from using the statutory TDS form to disclose known defects does not eliminate the foreclosing lender's common-law duty owed to the buyer to make those disclosures. The lender exemption does not also immunize the lender from liability for failing to disclose property defects **actually known** to him which affect the property's value and desirability to prospective buyers. [**Karoutas** v. **HomeFed Bank** (1991) 232 CA3d 767]

What is the "as-is" condition?

Since *Karoutas*, legislation states a lender (or trustee) at a trustee's sale is not in violation of law if bidders are advised the property is being sold "as is." Thus, no *contractual warranties* are given by the lender about the property's condition. [CC §2924h(g)]

By announcing the property is being sold "as is," the lender does not warrant the actual condition of the property to the bidders.

Editor's note — However, even with legislation allowing lenders to sell property "as is" at trustee's sales to avoid a contractual warranty, Karoutas *represents a line of reasoning the courts will continue to uphold. A foreclosing lender will not be sheltered from liability for its intentional misrepresentation and deceit at a public sale when the buyer later discovers a material defect the lender knew existed and failed to disclose.*

The contractual disclaimer stating the property is sold "as is" draws the lender into a web of ***deceit by silence****, called* ***intentional misrepresentation by omission.***

Announcing the property is sold "as is" does not excuse the lender from his common-law duty to disclose those defects actually known to the lender which affect the value and desirability of the property. A lender selling property at a foreclosure sale does not have the listing broker's duty owed to a buyer to conduct a visual inspection (or a home inspector's duty to conduct a physical examination) of the property and disclose its findings to potential bidders.

However, the lender does have and will continue to owe a common-law duty to disclose facts known to him which adversely affect the property's value. Disclosures will remain that way until the legislature states its intention to eliminate the lender's common-law disclosure duty by codifying the reestablishment of the long discredited doctrine of pure capitalism known as caveat emptor.

Chapter 25 Safety standards for improvements

This chapter establishes the need for the seller and listing agent to make disclosures about the property's noncompliance with current safety standards before acceptance of a buyer's offer.

Disclosing noncompliant improvements

A seller of a one-to-four unit residential property, who is solicited by a listing agent, enters into a listing agreement employing the agent's broker to locate buyers and sell the property.

The seller is asked to fill out a Transfer Disclosure Statement (TDS) and return it to the listing agent. When the TDS is filled out by the seller and picked up by the listing agent, the agent will conduct his own **visual inspection** of the property as mandated. On completion of the inspection, the agent will note any defects he observed on the TDS and sign it. [Calif. Civil Code §2079; see Form 304 accompanying Chapter 24]

The seller fills out and signs the TDS and returns it to the listing agent.

The listing agent then conducts his visual inspection of the property to identify components and defects not disclosed by the seller on the TDS. He **observes several safety conditions** which he knows do not meet current building codes. These observations are noted on the seller's TDS in the space provided above the location for the listing agent's signature.

The disclosure statement signed by the seller and listing agent now reveals that the garage door closing mechanism is not equipped with an automatic reversing device, the spa does not have a locking safety cover, the pool does not have barriers restricting access, the water heater is not anchored or braced, and the security bars on the windows in one of the bedrooms do not have a release mechanism — all in violation of current safety standards.

The TDS and all other seller disclosures and property reports are included as part of a listing package the listing agent will hand to prospective buyers and buyer's agents.

At an open house held on the property by the listing agent, a visitor indicates he is interested in possibly buying the property and asks for more information about the property.

By the visitor's request for additional property information, the visitor has begun **negotiations**. Thus, he has become a *prospective buyer*, entitled to a complete set of disclosures from the seller or the seller's agent before any offer is made.

The listing agent responds to the request by handing the prospective buyer the **listing package** which includes a copy of the TDS for the buyer's review.

A purchase agreement offer is then prepared and eventually signed by the prospective buyer, acknowledging receipt of the TDS and all other disclosures mandated for the transaction. The purchase agreement offer does not contain a provision calling for the seller to correct any of the previously disclosed safety defects or to bring the property up to current building standards.

However, prior to closing, the buyer becomes concerned about the existing safety defects. Also, local ordinances may require the safety defects to be eliminated before issuing the buyer a certificate of occupancy.

The buyer makes a demand on the seller to repair, replace or install an automatic reversing device for the garage door, a locking cover for the spa, barriers to restrict access to the pool, a brace or anchor on the water heater and security bar release mechanisms as necessary to meet current safety standards. The buyer claims the seller must cure the safety defects by meeting current construction standards before the seller can require the buyer to close escrow on the sale.

The seller refuses to cure any of the defects, claiming the buyer must close escrow since the **buyer knew** the defects existed before entering into the purchase agreement and the seller never agreed to correct the defects and bring the property up to current building codes.

Can the seller cancel or enforce the purchase agreement when the buyer refuses to close escrow due to the existence of physical defects in the property known to the buyer before the buyer agreed to purchase the property, which the seller has not agreed to cure?

Yes! The buyer knew the precise condition of the property when he agreed to the price he would pay to purchase the property.

Thus, the buyer agreed to acquire the property "as disclosed" in the seller's TDS. The buyer was **on notice** of the defects prior to his agreement to buy the property and did not bargain for the seller to cure the defects as a condition for paying the agreed price.

Automatic garage doors

All automatic garage doors installed after January 1, 1991 are required to have an automatic reverse safety device which meets code. [Calif. Health and Safety Code §19890(a)]

In addition, garage door openers installed after January 1, 1993 are required to have a sensor which, when garage door movement is interrupted or misaligned, causes a closing door to open and prevents an open door from closing. [Health & S C §19890(b)]

The safety standards for garage doors are designed to prevent children from becoming trapped under closing doors. Property constructed before 1993 probably do not meet current safety standards.

Further, when any residential garage door is serviced, the person servicing the garage door must test whether the door reverses on contact with a two-inch high obstacle placed beneath the door.

If the door does not reverse, the repairman must place a warning sticker on the garage door stating the door does not reverse and is not in compliance with current safety standards. [Health & S C §19890(e)]

Child resistant pool barriers

A construction permit issued after 1997 for a pool at a single-family residence requires the completed pool to comply with **at least one** of the following safety requirements, i.e.,:

- the pool is isolated from access to the house by a surrounding fence or barrier at least 60 inches in height;

- the pool incorporates up-to-code removable mesh pool fencing with a self-closing and self-latching gate that is key lockable;
- an approved safety cover is installed for the pool;
- an up-to-code surface motion, pressure, sonar, laser, or infrared swimming pool alarm is installed in the pool that will sound when it detects accidental or unauthorized entrances into the water;
- all the doors of the residence providing access to the pool are equipped with a self-closing, self-latching device with a release mechanism placed no lower than 54 inches above the floor; or
- some other means of protection as determined to be adequate by an approved testing labratory as meeting certain standards. [Health & S C §115922]

These safety requirements do not apply to hot tubs or spas with locking safety covers.

Condominium and apartment projects are not required to maintain safety barriers for pools and spas as their projects are not classified as single-family residences. Also, pools in condos and apartments are considered public facilities.

However, condo projects and apartment buildings must post signs indicating whether or not lifeguard services are available. Lifeguard services are not required, and if not provided, a sign saying so must be posted. [Health & S C §116045]

Public pools and spas are considered environmental hazards to a user's health if the managers do not operate and maintain them in a sanitary, healthful and safe manner. [Health & S C §116040]

If pools and spas in multiple-housing projects are not operated or maintained in a sanitary, healthful and safe condition, the pools and spas are considered a public nuisance and can be shut down by local health inspectors. [Health & S C §116060]

Water heaters

All existing residential water heaters are to be anchored, braced *or* strapped to prevent displacement due to an earthquake. [Health & S C §19211(a)]

A residential seller must state whether the water heater is anchored, braced *or* strapped. [Health & S C §19211(b)]

If the water heater meets safety requirements, the seller notes the compliance by marking the box on the TDS next to "anchored, braced or strapped." No further notice is necessary as it would be redundant and is not required.

If the seller's water heater does not comply, the seller should include a written statement on the TDS disclosing that fact.

When a prospective buyer receives the TDS before entering into a binding purchase agreement, and the TDS notes the water heater is not in compliance with safety standards, the prospective buyer has agreed to accept the property with the defect, unless a provision to the contrary is included in the purchase agreement.

Residential security bars

Security bars on residential property must have release mechanisms for fire safety reasons.

However, the release mechanisms are not required if each bedroom with security bars contains a window or door to the exterior which opens for escape purposes. [Health & S C §13113.9]

Chapter 26 The home inspection report

This chapter introduces the seller's and listing agent's use of a home inspection report to document the present physical condition of the listed property for prospective buyers.

Transparency by design

A seller of a one-to-four unit residential property, on entering into a listing to sell the property, is asked to give the listing agent authority to order out a **home inspection report** (HIR) from a local home inspection company as part of the seller's cost to market the property for sale.

The listing agent explains the HIR will be used to complete the seller's Condition of Property (Transfer) Disclosure Statement (TDS). The report will then be attached to the seller's TDS.

On receipt of the report, the seller could act to eliminate some or all of the deficiencies noted in the home inspection report. On the elimination of any defects, an updated report would be ordered out for use with the TDS.

The seller's TDS, as reviewed by the listing agent and supplemented with the HIR, will be used to inform prospective buyers about the **precise condition** of the property before they make an offer to purchase. Thus, the seller will not be confronted later with demands to correct defects or to adjust the sales price in order to close escrow. The property will have been purchased by the buyer "as disclosed."

The listing agent's marketing role

The task of gathering information about the condition of the property listed for sale and delivering the information to prospective buyers lies primarily with the listing agent. [Calif. Civil Code §2079]

Further, to retain control throughout the process of marketing, selling and transferring ownership, the listing agent should be the one who requests the HIR (on behalf of the seller). The agent will lose control over the marketing and closing process, and expose himself to claims of misrepresentation, when the buyer or the buyer's agent is the one who first orders the HIR.

As part of the listing agent's management of the home inspection activity, the agent should be present while the home inspector carries out his investigation of the property. The agent can discuss the home inspector's observations and whether his findings are **material** in that they affect the desirability, value, habitability or safety of the property, and thus its value to prospective buyers.

If the listing agent cannot be present, then he should request that the home inspector call the agent before the HIR is prepared to discuss the home inspector's findings and any recommendations he may have for further investigation. On receipt and review of the report by the seller and listing agent, any questions or clarifications they may have on its content is followed up by a further discussion with the home inspector, and if necessary, an amended or new report.

Home inspector's qualifications

Any individual who holds himself out as being in the business of conducting a home inspection and preparing a home inspection report on his findings during the inspection of a one-to-four unit residential property is a **home inspector**. No licensing scheme exists to set the minimum standard of competency or qualifications necessary to enter the home inspection profession. [Calif. Business and Professions Code §7195(d)]

However, general contractors, structural pest control operators, architects and registered engineers typically conduct home inspections and prepare reports as requested by sellers, buyers and their agents. The **duty of care** expected of licensed members of these professions by prospective buyers who receive and rely on their reports is set by their licensing requirements and professional attributes, i.e., the skill, prudence, diligence, education, experience and financial responsibility normally possessed and exercised by members of their profession. These licensees are *experts* with a high level of duty owed to those who receive their reports. [Bus & P C §7068]

Home inspectors occaisonally **do not hold** any type of license relating to construction, such as a person who is a construction worker or building department employee. However, they are required to conduct an inspection of a property with the same "degree of care" a reasonably prudent home inspector would exercise to locate material defects during their **physical examination** of the property and report their findings. Prospective buyers who rely on home inspection reports can expect a high level of competence from experts. [Bus & P C §7196]

However, a home inspector who is not a registered engineer cannot perform any analysis of systems, components or structural components which would constitute the practice of a civil, electrical or mechanical engineer. [Bus & P C §7196.1]

Hiring a home inspector

A seller's broker and listing agent can rely on **specific items** in a home inspection report (HIR) to prepare their final TDS. Their reliance on an HIR prepared by an inspector relieves the seller and the listing broker from liability for errors which are unknown to them to exist. However, to rely on the HIR, they must be free of simple negligence in the selection of the home inspector who inspects and prepares the HIR. Thus, the broker must exercise *ordinary care* when selecting the home inspector.

If **care in the selection** of a home inspector is lacking, then reliance on the HIR by the seller and listing agent preparing the TDS will not relieve the broker or the listing agent of liability.

However, use of an HIR by the listing agent does not relieve the agent (or his broker) from conducting their mandatory visual inspection. [CC §1102.4(a)]

Thus, the broker and listing agent must look into or be aware of whether the home inspector who prepares the report is qualified. The home inspector who holds a professional license or is registered with the state as a general contractor, architect, pest control operator or engineer is deemed to be qualified, unless the agent knows of information to the contrary.

When hiring a home inspector, the *qualifications* to look for include:

- educational training in home inspection related courses;

- length of time in the home inspection business or related property or building inspection employment;
- errors and omissions insurance covering professional liability;
- professional and client references; and
- membership in the California Real Estate Inspection Association, the American Society of Home Inspectors or other nationally recognized professional home inspector associations with standards of practice and codes of ethics.

Remember, the reason for hiring a home inspector in the first place is to assist the seller and his listing agent to better represent the condition of the property to prospective buyers, and hopefully reduce the risk of errors.

Reliance by buyers on the report

A listing agent requesting a home inspection report should advise the home inspector that the seller, broker and all prospective buyers of the property will be relying on the report. This disclosure will avoid later (unenforceable) claims by the home inspector that the report was intended for the sole use of the seller, broker or buyer who signed the home inspector's contract. [CC §1102.4(c)]

Consider a buyer under a purchase agreement who requests a home inspection report on the property being purchased. On receipt of the report, the buyer cancels the purchase agreement. Another prospective buyer interested in the property receives the same home inspection report from the listing agent and relies on it to acquire the property.

However, the report fails to correctly state the extent of the defects. The second buyer discovers the errors and makes a demand on the home inspector who prepared the report for the first buyer to cover the cost to cure the defects which were the subject of the errors.

The home inspector claims the report was prepared only for use by the buyer who requested the report and no subsequent buyer can now rely on it, as stated in the home inspection contract under which the report was prepared.

Here, the home inspector knew the listing agent also received the report and should have known that the agent would properly provide it to other prospective buyers if the buyer who ordered the report did not complete the purchase. A home inspection report, like an appraisal-of-value report or a structural pest control report, is not a **confidential document**. Thus, all prospective buyers of the property are **entitled to rely** on the existing home inspection report.

This reliance by other prospective buyers imposes liability on the home inspector for his failure to exercise the level of care expected of a home inspector when examining the property and reporting defects. Liability for the defects is imposed regardless of the fact that the home inspection contract and report contained a provision restricting its use solely to the person who originally requested it. [**Leko** v. **Cornerstone Building Inspection Service** (2001) 86 CA4th 1109]

The home inspection contract

Provisions in a contract with a home inspector and his home inspection company which purport to limit the dollar amount of their **liability for errors**, inaccuracies or omissions in their reporting of defects to the dollar amount of the fee they received for the report are *unenforceable*.

Further, any provision in the home inspection contract or condition in the home inspection report which purports to waive or limit the home inspector's liability for the **negligent investigation** or preparation of the HIR is *unenforceable*. [Bus & P C §7198]

Should the buyer discover an error in the HIR regarding the existence or nonexistence of a defect affecting the value or desirability of the property, the buyer has no more than four years after the **date of the inspection** to file a legal action to recover any money losses. [Bus & P C §7199]

Occasionally, a boilerplate provision in the home inspector's contract or the home inspection report will attempt to limit the buyer's period for recovery to one year after the inspection occurred. However, any such limitation the home inspector places on time periods during which the buyer must discover and make a claim is unenforceable. The statutory four-year period is needed to provide time for buyers to realize the home inspector produced a faulty report. [**Moreno** v. **Sanchez** (2003) 106 CA4th 1415]

The home inspector's malpractice insurance

An agent ordering a home inspection report needs to verify the home inspection company has **professional liability insurance coverage** before allowing the company to conduct an investigation and prepare a report.

Home inspectors who fail to detect and report a material defect or the extent of the defect may cause the buyer to incur costs to correct the significant defects. The buyer will be seriously disadvantaged in any recovery effort against the home inspector and the home inspection company unless insurance is available to pay amounts due the buyer.

Likewise, if the same defect was also missed by the listing agent due to the agent's failure to observe the defect during the agent's mandatory visual inspection, the broker and the listing agent are also liable to the buyer for the costs of curing the defect — separate from the home inspector's liability.

Here, the broker and listing agent will be able to force the home inspector to contribute to the recovery by an *indemnification claim* made by the broker against the home inspector for payment of all or a portion of the buyer's loss. Unless the home inspector has insurance coverage, the ability of the seller's broker to force the home inspection company to pay the home inspector's share of the responsibility for having failed to observe the same defect the listing agent missed will be limited to the home inspector's personal assets. [Leko, *supra*]

The inspection and report

A home inspection is a **physical examination** conducted on-site by a home inspector. The inspection of a one-to-four unit residential property is performed for a *noncontingent fee*.

The purpose of the physical examination of the premises is to identify *material defects* in the condition of the structure and its systems and components. **Material defects** are conditions which affect the property's:

- market value;

AUTHORIZATION TO INSPECT AND PREPARE A HOME INSPECTION REPORT

(Business and Professions Code §7195)

DATE: _____, 20_____, at _____, California.

Home Inspector/Rep. _____	Agent's Name _____
Home Inspection Company _____	Broker's Name _____
Address _____	Address _____
Phone _____	Phone _____
Fax _____	Fax _____
Email _____	Email _____

FACTS:

1. Property address _____

_____

1.1 Type of property _____

_____

2. Owner's name _____

Phone _____

3. The home inspection report is for use in the agent's preparation of a transfer disclosure statement and reporting of the property conditions to prospective buyers.

4. Your contract for inspection and report will be entered into by ☐ the Owner, ☐ the Buyer, or ☐ the Agent.

4.1 ☐ Include a copy of the binder with dates of effectiveness for your professional liability insurance coverage.

5. Call ☐ the Agent, or ☐ the Seller, to set up the day and time for your inspection.

5.1 ☐ The Agent will be present during the inspection.

5.2 If the Agent is not present, call the Agent to discuss your findings before preparing the report.

6. Your inspection and report to include the following items:

6.1 An energy efficiency inspection.

6.2 Any improvements that are not in compliance with building permits or codes and any improvements for which no permit exists.

6.3 The property's compliance with safety codes for child resistant pool barriers, hot tub covers, automatic garage doors, door locks/latches, gas valves, residential security bars and water heaters.

7. Your fee for this service will be paid in full on your delivery of your report to the Agent.

7.1 It is anticipated the amount of your fee will be $_____.

8. You are authorized to open an order and process this inspection.

Submitting Agent's Signature: _____

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- desirability as a dwelling;
- habitability from the elements; and
- safety from injury in its use as a dwelling.

Defects are material if they adversely affect the **price** a reasonably prudent and informed buyer would pay for the property when entering into a purchase agreement. As the report may affect value, the investigation and delivery of the home inspection report to a prospective buyer must precede a prospective buyer's offer to purchase to be meaningful. [Bus & P C §7195(b)]

The **home inspection** is to be a *non-invasive examination* of the mechanical, electrical and plumbing systems of the dwelling, as well as the components of the structure, such as the roof, ceiling, walls, floors and foundations. **Non-invasive** indicates there will not be an intrusion into the roof, walls, foundation or soil by dismantling or taking apart the structure which would disturb components or cause repairs to be made to remove the effects of the intrusion. [Bus & P C §7195(a)(1); see Form 130 accompanying this chapter]

The **home inspection report** is the written report prepared by the home inspector which sets forth his findings while conducting his physical examination of the property. The report identifies each system and component of the structure inspected, describes any material defects the home inspector found or suspects, makes recommendations about the conditions observed and suggests any further evaluation needed to be undertaken by other experts. [Bus & P C §7195(c)]

The listing agent needs to make sure the report addresses the cause of any defect or code violation found which constitutes a significant defect in the use of the property or cost to remedy the defects. The report should also include suspicions the home inspector might have which need to be clarified by further inspections and reports by others with more expertise.

The agent, or anyone else, may also request that the home inspector conduct an inspection on the energy efficiencies of the property and include his findings in the report. On a request for an **energy efficiency inspection**, the home inspector will report on items including:

- the R-value of the insulation in the attic, roof, walls, floors and ducts;
- the quantity of glass panes and the types of frames;
- the heating and cooling equipment and fans;
- water heating systems;
- the age of major appliances and the fuel used;
- thermostats;
- energy leakage areas throughout the structure; and
- the solar control efficiency of the windows. [Bus & P C §7195(a)(2)]

The home inspector's conflicts of interest

The home inspector who prepares a home inspection report, the company employing the home inspector and any affiliated company may not:

- **pay a referral fee** or provide for any type of compensation to brokers, agents, owners or buyers for the referral of any home inspection business;

- agree to accept a **contingency fee** arrangement for the inspection of the report, such as a fee payable based on the home inspector's findings and conclusions in the report or on the close of a sales escrow;

- perform or offer to **perform any repairs** on a property which was the subject of a HIR prepared by them within the past 12 months; or

- inspect any property in which they have a **financial interest** in its sale. [Bus & P C §7197]

Chapter 27 Verify property disclosures: retain a home inspector

This chapter examines the buyer's use of a home inspector to confirm the physical condition of the property, as represented by the seller and listing agent, prior to entering into a purchase agreement.

Protecting the prospective buyer

A buyer, with the assistance of his agent, locates a one-to-four unit residential property suitable for the buyer to purchase. Both the the buyer and his agent walk through the property and confirm the property fits the buyer's needs.

The buyer's agent contacts the listing agent and informs him he has a prospective buyer who is interested in the property. The buyer's agent requests information on the property, including a title profile, a Transfer Disclosure Statement (TDS) and a home inspection report (HIR). The listing agent responds by suggesting the buyer's agent go ahead and submit a purchase agreement offer and that the "necessary disclosures for closing" will be delivered after an offer is accepted by the seller.

The indication the buyer's agent gets is that the listing agent has not prepared a listing package and no information on the property will be made available to prospective buyers until it is time to close escrow.

The buyer agrees with his agent to proceed with an offer at a price and on terms which the agent believes are justified. The agent has checked out comparable sales information provided by the title company, plus he has a working knowledge of properties in the immediate area. They know of no problems presented by the physical condition of the property.

An offer is prepared with contingency provisions regarding the condition of the property. The buyer has no information on the condition of the property except for his walk-through with his agent to determine whether the arrangement of the space within the structure was suitable.

Condition of property contingencies

Contingency provisions included in the purchase agreement, among others, call for:

- the seller to furnish a **HIR** prepared by an insured home inspector showing the land and improvements to be free of material defects [See Form 150 §11.1(b) accompanying Chapter 51];
- the seller and the listing agent to prepare, sign and deliver a **condition of property disclosure** (TDS) [See Form 150 §11.2 accompanying Chapter 51]; and
- the **buyer to inspect** the property twice — once to initially confirm the condition of the property and once again before closing escrow to confirm maintenance has not been deferred and *material defects* discovered after entering into the purchase agreement have been corrected or eliminated. [See 150 §11.4 accompanying Chapter 51]

The offer is submitted and promptly rejected by the seller. Eventually, a purchase agreement is entered into which eliminates the provision calling for the seller to furnish a HIR. No previous offer has been submitted to the seller by other prospective buyers who obtained an HIR on the property.

The buyer authorizes his agent to immediately obtain a HIR, which the buyer's agent orders. The inspection takes place and the HIR is received by the buyer's agent and reviewed with the buyer. The seller and the listing agent have not delivered a TDS or any of the other seller disclosures or inspection reports which both the seller and the listing agent are duty bound to deliver to a prospective buyer. [Calif. Civil Code §§1102, 2079]

The home inspector's written report lists numerous significant defects he has observed during his physical inspection of the property's condition. Repair/replacement costs are estimated at $2,500 to eliminate the defects not disclosed by the seller or observed by the buyer or the buyer's agent on their cursory review of the space within the structure.

Demands follow discovery

The buyer makes a written demand on the seller to cure (repair) the defects discovered by the home inspector based on the terms agreed to in the purchase agreement. [See Form 150 §11.4; see Form 269 accompanying this chapter]

A copy of the HIR and a contractor's estimate of the cost to cure the defects are attached to the buyer's request for repairs. Thus, the buyer substantiates his demand on the seller to cover previously undisclosed defects.

The seller and his agent prepare a TDS and note all the defects listed in the HIR and on the buyer's notice demanding repairs. The seller then refuses to make any of the corrections, claiming he has disclosed the defects in the TDS as agreed in the purchase agreement. Eventually, the buyer is told to either close escrow or cancel.

Can the buyer require the seller to cure the *material defects* found by the home inspector and close escrow?

Yes! The seller must deliver the property to the buyer as disclosed by the seller and the seller's broker and observed by the buyer at the time the buyer's purchase agreement offer was accepted, not in the condition stated in an untimely disclosure made in the seller's TDS during escrow.

The seller's and listing agent's failure to disclose prior to acceptance is an omission of facts, called *negative fraud, deceit* or *misrepresentation by omission*.

The most significant issue arising out of these discoveries concerns the price the buyer agreed to pay in the purchase agreement. The seller and buyer agreed on a price for the property based on the conditions **disclosed and known** to the buyer at the time the offer was accepted.

Thus, the price represents the agreed value of a used, but defect-free property, except for any defects observed by the buyer or disclosed to the buyer prior to entering into the purchase agreement. The price, as it turns out, exceeded the property's fair market value by the amount of the costs which will be incurred to cure the defects and deliver the property "as disclosed" prior to acceptance.

Confirm the seller's disclosures

A seller and his listing broker must disclose to a prospective buyer all known and observable property conditions which adversely affect the value of the property.

PROPERTY INSPECTION
Request for Repairs

DATE:_____, 20_____, at_____, California.

TO SELLER: _____

FACTS:

1. Buyer entered into a purchase agreement with you dated _____, 20_____ agreeing to buy real estate referred to as _____
_____.

2. The purchase agreement calls for an **initial inspection** of the real estate by Buyer, or a representative of Buyer.

2.1 The inspection is to confirm that the condition of the real estate is substantially the condition reasonably expected by Buyer based on observations by Buyer and representations made by Seller or Seller's Agent to Buyer or Buyer's Agent prior to acceptance of the purchase agreement.

3. The purchase agreement calls for Buyer to notify Seller, on completion of Buyer's initial inspection, of any material defects discovered by Buyer which were undisclosed and unknown to Buyer prior to acceptance of the purchase agreement.

4. The purchase agreement further calls for Seller to repair, replace or correct the noticed defects prior to closing the transaction and delivering possession to Buyer.

5. By this notice of material defects in need of repair, replacement or correction, Buyer does not intend to cancel the purchase agreement or avoid Buyer's obligation to perform on the purchase agreement.

5.1 Buyer will close as scheduled or as soon thereafter as any noticed defects have been eliminated by repair, replacement or correction and completion has been verified by Buyer.

THUS:

6. Buyer hereby confirms the condition of the property on the initial inspection satisfies Buyer's expectations of its physical condition regarding both the land and its improvements, **except** for the following itemized material defects in the condition of the property.

6.1 Buyer hereby notifies Seller of the material defects in the condition of the property which were undisclosed and unknown to Buyer prior to acceptance of the purchase agreement and makes a demand on Seller to repair, replace or correct the following itemized defects prior to closing:

_____
_____
_____
_____
_____
_____
_____
_____
_____
_____
_____
_____
_____.

I agree to the terms stated above.	**Seller hereby acknowledges receipt of a copy.**
Date:_____, 20_____	Date:_____, 20_____
Buyer: _____	Seller: _____
Buyer: _____	Seller: _____

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A Transfer Disclosure Statement completed by the seller and listing agent, without the benefit of a HIR, typically does not accurately or fully reveal the significant property defects or code violations which actually exist, whether or not known to the seller or listing agent.

When the seller has not obtained or refuses to authorize the preparation of a HIR prior to entering into a purchase agreement, the buyer should always order one on opening escrow to confirm the condition of the property before the expiration of any cancellation period.

A buyer should undertake an inspection in the interest of avoiding:

- after-closing discoveries of defects which require correction; and
- after-closing claims he may make against the seller to recover the value lost or the costs incurred to correct the defects.

The buyer's discovery of defects after acceptance of the purchase agreement and **prior to closing**, whether by the buyer's investigation or by the seller's tardy disclosure, does not alter the buyer's right to close escrow, acquire the property and pursue the recovery of costs or the loss of value due to *defects known* to the seller or the listing agent and not disclosed prior to entering into the purchase agreement.

Armed with a HIR containing findings of material defects not known to the buyer or disclosed at the time the purchase agreement was accepted, the buyer can then make the necessary demands on the seller. Thus, the buyer ensures the property will be delivered in the condition **as disclosed** by the seller on entering into the purchase agreement, whether or not a TDS was received prior to acceptance of the buyer's offer.

The buyer's remedies for deceit

If a home inspection report reveals property defects unknown and previously undisclosed to the buyer, the **buyer may**:

- *make a demand* on the seller to correct or eliminate the defects, and refuse to close escrow until the seller has either complied or agreed to an adjusted price [See Form 269];
- *refuse to close escrow* for lack of seller compliance to the demand for corrections and enforce the agreement and its price correction provisions by *specific performance*; or
- *close escrow* and make a money demand on the seller for the difference between the purchase price set in the purchase agreement and the price as adjusted for the undisclosed defects as called for in the purchase agreement. [**Jue** v. **Smiser** (1994) 23 CA4th 312]

If the purchase agreement entered into by the seller and buyer contains a **price adjustment provision**, the buyer can, before closing, enforce a reduction of the purchase price. The price adjustment will be for the amount of the costs necessary to bring the property into the condition as disclosed by the seller or the seller's broker and known to the buyer at the time of acceptance. [See Form 150 §11.2(b) accompanying Chapter 51]

Also, by the seller failing to deliver the property in the condition disclosed prior to acceptance, the seller has failed to convey the property as agreed. Thus, the buyer is justified in refusing to close escrow until the seller compensates the buyer for, or corrects, the defects discovered during escrow.

However, if the buyer is made aware of facts about the condition of the property at the time the buyer enters into the purchase agreement, which would cause an ordinary buyer to be put on notice to investigate into their consequences, the buyer has no grounds for claiming a loss for the condition he knew about.

Final pre-closing inspection

A buyer must personally reinspect the property just before close of escrow to confirm:

- the quality of any repairs made by the seller; and
- the general condition and maintenance of the property after entering into the purchase agreement.

The buyer's right to a final pre-closing inspection of the property is agreed to in the purchase agreement. [See Form 150 §11.3(b) accompanying Chapter 51]

On final inspection of the property, the buyer lists any property defects not already addressed, such as equipment and fixture malfunctions or deferred maintenance, on the final walk-through inspection statement. [See **first tuesday** Form 270]

Chapter 28 Natural hazard disclosures by the listing agent

This chapter demonstrates the use of the Natural Hazard Disclosure (NHD) Statement by sellers and listing agents to fulfill their obligations to inform prospective buyers.

A unified disclosure for all sales

Natural hazards come with the **location** of a parcel of real estate, not with the man-made aspects of the property. Locations where a property might be subject to natural hazards include:

- special flood hazard areas, a federal designation;
- potential flooding and inundation areas;
- very high fire hazard severity zones;
- wildland fire areas;
- earthquake fault zones; and
- seismic hazard zones. [Calif. Civil Code §1103(c)]

The existence of a hazard due to the geographic location of a property affects its value and desirability to prospective buyers. Hazards, by their nature, limit a buyer's ability to develop the property, obtain insurance or receive disaster relief.

Whether a seller markets his property himself or lists the property with a broker, the seller must disclose to prospective buyers any natural hazards **known to the seller**, as well as those contained in **public records**.

To unify and streamline the disclosure by a seller (and his listing agent) about those natural hazards which affect a property, the California legislature created a statutory form entitled the *Natural Hazard Disclosure (NHD) Statement*.

The NHD form is used by a seller and his listing agent for their preparation (or acknowledgement of their review of a report prepared by an NHD expert) and disclosure of natural hazard information. The information is both known to the seller and listing agent (and the NHD expert) and available to them as shown on maps in the public records of the local planning department. [CC §1103.2; see Form 314 accompanying this chapter]

Actual use of the NHD Statement by sellers and their agents is **mandated** on the sale of **one-to-four unit residential properties**, called *targeted properties*. Some sellers of targeted properties are excluded from mandatory use of the form, but never their listing agents. Thus, the form, filled out and signed by the seller (unless excluded) and the listing agent, must be included in listing packages handed to prospective buyers on every one-to-four unit residential property.

NATURAL HAZARD DISCLOSURE STATEMENT

NOTE: The seller's listing broker (and the seller) of one-to-four residential units shall prepare a Natural Hazard Disclosure (NHD) and deliver it to prospective buyers prior to making a purchase agreement offer and indicate compliance in the purchase agreement or a counteroffer. If not so disclosed, the buyer has the right to cancel the purchase agreement within three days of delivery of the disclosure in person. [Calif. Civil Code §1103.3]

DATE:_____, 20_____, at_____, California.

This disclosure statement is prepared for the following:

☐ Seller's listing agreement

☐ Purchase agreement

☐ Counteroffer

☐ _____

dated _____, 20_____, at _____, California,

entered into by _____, as the _____,

regarding real estate referred to as _____

_____.

Natural Hazard Disclosure Statement:

Seller and Seller's Agent(s) or a third-party consultant disclose the following information with the knowledge that even though this is not a warranty, prospective buyers may rely on this information in deciding whether and on what terms to purchase the subject property.

Seller hereby authorizes any agent(s) representing any principal(s) in this action to provide a copy of this statement to any person or entity in connection with any actual or anticipated sale of the property.

THE FOLLOWING ARE REPRESENTATIONS MADE BY SELLER AND SELLER'S AGENT(S) BASED ON THEIR KNOWLEDGE AND MAPS DRAWN BY THE STATE AND FEDERAL GOVERNMENT. THIS INFORMATION IS A DISCLOSURE AND IS NOT INTENDED TO BE PART OF ANY CONTRACT BETWEEN BUYER AND SELLER.

THIS REAL PROPERTY LIES WITHIN THE FOLLOWING HAZARDOUS AREA(S): (Check appropriate response)

1. A SPECIAL FLOOD HAZARD AREA (Any type Zone "A" or "V") designated by the Federal Emergency Management Agency.

Yes____ No____ Do not know/information not available from local jurisdiction____

2. AN AREA OF POTENTIAL FLOODING shown on an inundation map pursuant to Section 8589.5 of the Government Code.

Yes____ No____ Do not know/information not available from local jurisdiction____

3. A VERY HIGH FIRE HAZARD SEVERITY ZONE pursuant to Section 51178 or 51179 of the Government Code. The owner of this property is subject to the maintenance requirements of Section 51182 of the Government Code.

Yes____ No____

4. A WILDLAND AREA THAT MAY CONTAIN SUBSTANTIAL FOREST FIRE RISKS AND HAZARDS pursuant to Section 4125 of the Public Resources Code. The owner of this property is subject to the maintenance requirements of Section 4291 of the Public Resources Code. Additionally, it is not the state's responsibility to provide fire protection services to any building or structure located within the wildlands unless the Department of Forestry and Fire Protection has entered into a cooperative agreement with the local agency for those purposes pursuant to Section 4142 of the Public Resources Code.

Yes____ No____

5. AN EARTHQUAKE FAULT ZONE pursuant to Section 2622 of the Public Resources Code.

Yes____ No____

6. A SEISMIC HAZARD ZONE pursuant to Section 2696 of the Public Resources Code.

Yes (Landslide Zone)____ Yes (Liquefaction Zone)____

No____ Map not yet released by state____

THESE HAZARDS MAY LIMIT YOUR ABILITY TO DEVELOP THE REAL PROPERTY, TO OBTAIN INSURANCE OR TO RECEIVE ASSISTANCE AFTER A DISASTER.

THE MAPS ON WHICH THESE DISCLOSURES ARE BASED ESTIMATE WHERE NATURAL HAZARDS EXIST. THEY ARE NOT DEFINITIVE INDICATORS OF WHETHER OR NOT A PROPERTY WILL BE AFFECTED BY A NATURAL DISASTER. BUYER(S) AND SELLER(S) MAY WISH TO OBTAIN PROFESSIONAL ADVICE REGARDING THOSE HAZARDS AND OTHER HAZARDS THAT MAY AFFECT THE PROPERTY.

Check only one of the following:

☐ Seller and their agent represent that the information herein is true and correct to the best of their knowledge as of the date signed by Seller and Seller's Agent.

☐ Seller and their agent acknowledge that they have exercised good faith in the selection of a third-party report provider as required in Civil Code Section 1103.7, and that the representations made in this Natural Hazard Disclosure Statement are based upon information provided by the independent third-party disclosure provider as a substituted disclosure pursuant to Civil Code Section 1103.4. Neither Seller nor their agent has independently verified the information contained in this statement and report or is personally aware of any errors or inaccuracies in the information contained on the statement. This statement was prepared by

Third-Party Disclosure Provider_____ Date _____

Date:_____, 20_____	Date:_____, 20_____
Seller: _____	Seller's Broker:_____
Seller: _____	Agent: _____

Buyer represents that he has read and understands this document. Pursuant to Civil Code Section 1103.8, the representations made in this Natural Hazard Disclosure Statement do not constitute all of Seller's or Seller's Agent's disclosure obligations in this transaction.

Buyer:_____ Date:_____

Buyer:_____ Date:_____

Editor's note — Any attempt by a seller or listing agent to use an "as-is" provision or otherwise provide for the buyer to agree to waive his right to receive the seller's NHD statement is void as against public policy. [CC §1103(d)]

Regarding excluded sellers and sales of property other than one-to-four unit residential property, use of the statutory NHD Statement by sellers and listing agents is an **optional** method for making their disclosure of natural hazard information to buyers.

However, delivery of the information by use of one form or another is not optional. A natural hazard disclosure is **mandated on all types of property**. [CC §1103.1(b)]

All sellers, and any listing or selling agent involved, have an initial common law duty owed to prospective buyers to disclose conditions on or about a property which are **known to them** and might adversely affect the buyer's willingness to buy or influence the price and terms of payment he is willing to offer.

Natural hazards, or the lack thereof, irrefutably affect a property's value and desirability to a prospective buyer. If a hazard is known to any agent (as well as the seller) or noted in public records, it must be disclosed to the prospective buyer before he agrees to purchase the property. If not disclosed, the buyer can cancel the transaction, called *termination*. And if the transaction has closed escrow, the buyer may *rescind* the sale and be **refunded** his investment, called *restoration*. [**Karoutas** v. **HomeFed Bank** (1991) 232 CA3d 767]

Therefore, the need to prepare the seller's NHD statement in advance of locating a prospective buyer **must be anticipated** by the seller and listing agent.

If the need is not anticipated, the NHD will not be prepared, signed and available for delivery to prospective buyers before an offer is accepted or a counteroffer is made, all requisites to delivery of the NHD *as soon as practicable*. [Calif. Attorney General Opinion 01-406 (August 24, 2001); CC §1103.3(a)(2)]

Investigating the existence of a hazard

Natural hazard information must be obtained from the *public records*. If not obtained, the seller and listing agent cannot make their required disclosures.

To obtain the natural hazard information for delivery to prospective buyers, the seller and his listing agent are required to exercise *ordinary care* in gathering the information. They may gather the information themselves or the seller may employ an NHD expert to gather the information. When an expert is employed, he prepares the NHD form for the seller and the listing agent to review, add any comments, sign and deliver to prospective buyers. [CC §1103.4(a)]

Thus, the seller and listing agent may obtain **natural hazard information**:

- directly from the *public records* themselves; or
- by employing a *natural hazard expert*, such as a geologist.

For the seller and the listing agent to rely on an NHD report prepared by others, the listing agent need only:

- **request** a NHD report from a reliable expert in natural hazards, such as an engineer or a geologist who has studied the public records (as some natural hazards clearly do not pertain to engineering or geology);
- **review** the NHD form prepared by the expert and **enter** any actual knowledge the seller or listing agent may possess, whether contrary or supplemental to the expert's report, on the form prepared by the expert or in an addendum attached to the form; and
- **sign** the NHD Statement provided by his NHD expert and **deliver** it with the NHD report to prospective buyers or buyer's agents. [CC §1103.2(f)(2)]

When prepared by an NHD expert, the NHD report must also note whether the listed property is located within 2 miles of an existing or proposed airport, an environmental hazard zone called an *airport influence area* or *airport referral area*.

The buyer's occupancy of property within the influence of an airport facility may be affected by noise and restrictions, now and later, imposed on the buyer's use as set by the airport's land-use commission. [CC §1103.4(c)]

Also, the expert's report must note whether the property is located within the jurisdiction of the San Francisco Bay conservation and development commission.

Broker uses experts to limit liability

The Natural Hazard Disclosure scheme, while not making the practice mandatory, encourages brokers and their agents to use natural hazard experts rather than gather the information from the local planning department themselves. The use of an expert, who himself relies on the contents of the public record to prepare his report, **relieves** the listing agent of any *liability for errors* not known to the agent to exist.

Neither the seller nor any agent, be he the seller's or the buyer's agent, is liable for the erroneous preparation of a NHD Statement they have delivered to the buyer, if:

- the NHD report and form is prepared by an **expert in natural hazards**, consistent with his professional licensing and expertise; and

- the seller and listing agent used **ordinary care** in selecting the expert and in their review of the expert's report for any errors, inaccuracies and omissions of which they have **actual knowledge**. [CC §§1103.4(a), 1103.4(b)]

Neither the seller nor the listing agent need enter into an *indemnification agreement* with the natural hazard expert to avoid liability for errors. By statute, the expert who prepared the NHD is liable for his errors, not the seller or listing agent who relied on the report of a non-negligently selected expert to fulfill their duty to check the public records.

However, if brokers are sued based on the inaccuracy of the expert's report, an indemnity agreement entered into by the expert, given in exchange for the request to prepare a natural hazard report, will cover the cost of any litigation which might unnecessarily haul the broker into court. [See **first tuesday** Form 131]

The listing agent's **dilatory delivery** of an expert's NHD to the buyer or the buyer's agent, after the offer has been accepted, will not protect the broker from *liability* for the buyer's lost property value due to the nondisclosure before acceptance. If the agent **knew or should have known** of a natural hazard based on the readily available planning department's parcel list, he is exposed to liability. Liability exposure includes:

- costs the buyer may incur to correct or remedy the undisclosed hazardous condition; and

- the portion of the agreed price which exceeds the property's fair market value based on the undisclosed hazard. [CC §1103.13]

Further, the agents, seller and expert are not exposed to liability from **third parties** to the sale transaction who might receive their erroneous NHD Statement and rely on it to analyze the risk they undertake by their involvement. Such third parties include insurance companies, lenders, governmental agencies and others who may become affiliated with the transaction. [CC §1103.2(g)]

Documenting compliance with NHD law

Compliance by the seller and listing agent to deliver the NHD Statement to the buyer is required to be documented by a provision in the purchase agreement. [CC §1103.3(b); see Form 150 §11.5 accompanying Chapter 51]

However, should the listing agent fail to disclose a natural hazard and then provide in the purchase agreement for the compliance to be an untimely "in escrow" disclosure, his seller is *statutorily penalized*. The

buyer, on an in-escrow disclosure, is allowed either a three-day right of cancellation should he be handed the NHD Statement, or a five-day right of cancellation should the NHD Statement be mailed to the buyer. [CC §1103.3(c)]

Further, delivery of the NHD after acceptance of an offer, when it could have been previously prepared by the seller or listing agent and timely delivered, imposes liability on the seller and listing agent, but not the buyer's agent. Liability is based on any money losses (including a reduced property value) inflicted on the buyer by the disclosure should the buyer choose not to exercise his right to cancel and instead proceed with the agreement and close escrow. [CC §1103.13; **Jue** v. **Smiser** (1994) 23 CA4th 312]

Delivery of the NHD to the buyer

It is the **buyer's agent** who has the duty to hand the buyer the NHD Statement the buyer's agent receives from the seller or the listing agent, called *delivery*. [CC §1103.12(a)]

The **buyer's agent**, on receiving the NHD form from the listing agent, owes the buyer a special agency duty to care for and protect his buyer's best interest by reviewing the NHD Statement himself for any disclosure which might affect the property's value or its desirability for his buyer. The buyer's agent is then required to deliver the NHD to the buyer and make any *recommendations or explanations* the buyer's agent may have regarding the consequences of its content. [CC §§1103.2, 1103.12]

If the buyer does not have a broker, the seller's agent is responsible for delivering the NHD Statement to the prospective buyer.

However, the listing agent is not required to understand the effect hazards have on the property or the buyer. Also, the listing agent has absolutely no duty to voluntarily explain to a prospective buyer the effect a known natural hazard (which is itself disclosed) might have on the property or the buyer. The task of explaining the consequence of living with a natural hazard is the duty of a buyer's agent.

Delivery may be in person or by mail. Also, delivery is considered to have been made if the NHD is received by the spouse of the buyer. [CC §1103.10]

Sellers occasionally act as "For Sale By Owners" (FSBOs) and directly negotiate a sale of their property with buyers in transactions which exclude brokers and agents. Here, the seller is responsible for preparing or obtaining an NHD statement and delivering the NHD Statement to the prospective buyer.

No warranty, just awareness

A seller's NHD Statement is **not a warranty or guarantee** by the seller or listing agent of the natural hazards affecting the property. The NHD Statement is a report of the seller's and listing agent's (or the NHD expert's) knowledge (actual and constructive) of any natural hazards affecting the property.

However, the NHD Statement is relied on by prospective buyers. The NHD is designed to assist them in their decisions as to whether they should buy the property, and if they do decide to buy, at what price and on what terms. These conditions all need to exist before entering into a purchase agreement to avoid misleading the buyer, called *deceit*. [AG Opin. 01-406]

Disclosures concerning the value and desirability of a property, such as an NHD Statement, are **price-sensitive information**. Thus, the statement must be delivered to the prospective buyer before he enters into a purchase agreement in order to accomplish their intended result. If not timely disclosed, the seller

and listing agent subject themselves to claims for *price adjustments* (offsets) which may be made by the buyer either before or after closing. Alternatively, the buyer may cancel the purchase agreement and have his deposit refunded.

Good brokerage practice would deliver the NHD to the prospective buyer before he makes an offer or accepts a counteroffer, while he is still the prospective buyer. Disclosures should not be delayed until later when the prospect has become the buyer under a purchase agreement and entitled to ownership of the property at the price and on the terms agreed. Properly, the purchase agreement offer would then include a copy of the seller's NHD Statement as an addendum (along with all other disclosures), noting the transaction is in compliance with NHD law.

As for an **escrow officer** handling a sale in which the listing agent fails to provide the buyer's agent or the buyer with the NHD prior to opening escrow, the escrow officer has no duty to the seller or buyer to prepare, order out or deliver the NHD to the buyer. The obligation remains that of the seller and listing agent. However, escrow may accept instruction to perform any of these activities, in which case escrow becomes obligated to follow the instructions agreed to by the escrow officer. [CC §1103.11]

Excluded sellers, not agents

While all sellers of properties must disclose what is known to them about the natural hazards endemic to a property's location, sellers in some transactions **do not need to use** the mandated NHD form to make their disclosures, such as:

- court-ordered transfers or sales;
- deed-in-lieu of foreclosures;
- trustee's sales;
- lender resales after foreclosure or a deed-in-lieu;
- estates on death;
- transfers between co-owners;
- transfers to relatives/spouses; or
- transfers to or by governmental entities. [CC §1103.1(a)]

However, any listing agent involved in an excluded transaction must himself make hazard disclosures, even though he does not need to use the statutory form. [CC §1103.1(b)]

Also, all sellers of any type of property, included or excluded, must, as always, disclose what **they know about any hazards**. Again, the disclosure is best accomplished by use of the NHD Statement on all sales. The NHD expert will definitely include the statement as part of his report. [CC §1103.2(f)(2)]

On properties not mandated to use the form, the listing agent can comply with his and his seller's duty to disclose by ordering a report from a natural hazard expert. On the listing agent's receipt of the expert's report, he will review the report (preferably with the seller), add what they know about hazards which are not included in the expert's report, sign the NHD statement accompanying the report and hand the entire NHD package to prospective buyers before an offer is submitted or a counteroffer made.

Other disclosure statements distinguished

The NHD Statement handed to a prospective buyer of one-to-four unit residential property is an additional disclosure unrelated to the *environmental hazards* and *physical deficiencies* in the soil or improvements located on or about a property as disclosed on the Transfer Disclosure Statement (TDS) or in the purchase agreement. [See Form 304 §C(1) accompanying Chapter 24]

The TDS discloses health risks resulting from **man-made** physical and environmental conditions affecting the use of the property. They are limited to facts known to the seller and listing agent without concern for a review of public records on the property at the planning department or elsewhere. The NHD Statement discloses risks to life and property which exist **in nature** due to the property's location and are known and readily available from the public records (planning department).

Other than one-to-four

Use of the statutory NHD form for hazard disclosures by sellers and their agents is mandated only on the sale of non-exempt, targeted one-to-four unit residential property. [CC §1103]

Thus, sellers and listing agents on all other properties do not need to use and deliver the statutory NHD form to prospective buyers of those properties. However, all sellers and their listing agents still have a duty to disclose hazardous conditions known to them to exist.

Sellers and listing agents of **any type of real estate** must disclose whether the property is located in:

- an area of potential flooding;
- a very high fire hazard severity zone;
- a state fire responsibility area;
- an earthquake fault zone; and
- a seismic hazard zone. [CC §1103.2]

Even though use of the form is not mandated for sales of property other than one-to-four residential units, agents best meet their hazard disclosure duty in all transactions by using the NHD Statement to convey their knowledge and information contained in public records. [CC §1103.1(b)]

Editor's note — The following discussion details the different hazards which must be disclosed on the NHD Statement.

Flood zones

Investigating flood problems was facilitated by the passage of the National Flood Insurance Act of 1968 (NFIA).

The NFIA established a means for property owners to obtain flood insurance with the National Flood Insurance Program (NFIP).

The Federal Emergency Management Agency (FEMA) is the administrative entity created to police the NFIP by investigating and mapping regions susceptible to flooding.

Any flood zone designated with the letter "A" or "V" is a *special flood hazard area* and must be disclosed as a natural hazard on the NHD Statement. [See Form 314 §1]

Zones "A" and "V" both correspond with areas with a 1% chance of flooding in any given year, called 100-year floodplains, e.g., a structure located within a special flood hazard area shown on an NFIP map has a 26% chance of suffering flood damage during the term of a 30-year mortgage.

However, Zone "V" is subject to additional storm wave hazards.

Both zones are subject to mandatory flood insurance purchase requirements.

Information about flood hazard areas and zones can come from:

- city/county planners and engineers;
- county flood control offices;
- local or regional FEMA offices; and
- the U.S. Corps of Engineers.

Additional information concerning flood hazard areas can be obtained in the Community Status Book. The book lists communities and counties participating in the NFIP and the effective dates of the current flood hazard maps available from FEMA.

The Community Status Book can be obtained via the web at: http://www.fema.gov/fema/csb.shtm.

Flood Insurance Rate Maps and Flood Hazard Boundary Maps are all available at the FEMA Flood Map store by calling (800) 358-9616 or via the web at: http://msc.fema.gov/.

Another flooding disclosure which must be made on the NHD Statement arises when the property is located in an area of **potential flooding**. [See Form 314 §2]

An area of potential flooding is a location subject to partial flooding if sudden or total **dam failure** occurs. The inundation maps showing the areas of potential flooding due to dam failure are prepared by the California Office of Emergency Services. [Calif. Government Code §8589.5(a)]

Once alerted by the listing agent to the existence of a flooding condition, the buyer's agent must inquire further to learn the significance of the disclosure to the buyer.

Very high fire hazard severity zone

Areas in the state which are subject to significant fire hazards have been identified as *very high fire hazard severity zones*. If a property is located in a very high fire hazard severity zone, a disclosure must be made to the prospective buyer. [See Form 314 §3]

The city, county or district responsible for providing fire protection have designated, by ordinance, very high fire hazard severity zones within their jurisdiction. [Gov C §51179]

The fire hazard disclosure on the NHD form mentions the need to maintain the property. Neither the seller nor the listing agent need to explain the nature of the maintenance required or its burden on ownership. Advice to the buyer on the type of maintenance and the consequences of owning property subject to the maintenance are the duties of the buyer's agent, if they have an agent.

For example, a buyer occupying a residence located in a very high fire hazard severity zone is advised by his agent that as the new owner, the buyer must, among other things:

- maintain a firebreak around the structure of a distance of no greater than 100 feet, but not past the property line, unless the state or local law requires more; and
- clear dead or dying wood from trees and plants adjacent to or overhanging the structure. [Gov C §51182]

Also, if the property is in a very high fire hazard severity zone or a wildland area, the buyer's agent should inform his client of the possible hardships in obtaining fire or hazard insurance and of the existence of the California Fair Access to Insurance Requirements (FAIR) program which offers a "last-resort" type of policy for properties in these areas. [Calif. Insurance Code §§10095 et seq.]

State Fire Responsibility Areas

If a property is in an area where the financial responsibility for preventing or suppressing fires is primarily on the state, the real estate is located within a *State Fire Responsibility Area*. [Calif. Public Resources Code §4125(a)]

Notices identifying the location of the map designating State Fire Responsibility Areas are posted at the offices of the county recorder, county assessor and the county planning agency. Also, any information received by the county after receipt of a map changing the State Fire Responsibility Areas in the county must be posted. [Pub Res C §4125(c)]

If the property is located within a **wildland area** exposed to substantial forest fire risks, the seller or his listing agent must disclose this fact. If the property is located in a wildland area, it requires maintenance by the owner to prevent fires. [Pub Res C §4136(a); see Form 314 §4]

In addition, the NHD Statement advises the prospective buyer of a home located in a **wildland area** that the **state has no responsibility** for providing fire protection services to the property, unless the Department of Forestry and Fire Protection has entered into a cooperative agreement with the local agency. No further disclosure about whether a cooperating agreement exists need be made by the seller or listing agent. [See Form 314 §4]

However, if property disclosures place the property in a wildland area, the buyer's agent has the duty to advise the buyer about the need to inquire and investigate into what agency provides fire protection to the property.

Earthquake fault zones

To assist seller's agents in identifying whether the listed property is located in an earthquake fault area, maps have been prepared by the State Geologist.

The State Mining and Geology Board and the city or county planning department have maps available which identify special studies zones, called *Alquist-Priolo Maps*. [Pub Res C §2622]

The maps are used to identify whether the listed property is located within one-eighth of a mile on either side of a fault.

Also, the NHD Statement requires both the seller and the listing agent to disclose to a prospective buyer or the buyer's agent whether they have knowledge the property is in a fault zone. [See Form 314 §5]

Seismic hazards

A *Seismic Hazard Zone* map identifies areas which are exposed to earthquake hazards, such as:

- strong ground shaking;
- ground failure, such as liquefaction or landslides [Pub Res C §2692(a)];
- tsunamis [Pub Res C §2692.1]; and
- dam failures. [Pub Res C §2692(c)]

If the property for sale is susceptible to any of the earthquake (seismic) hazards, the seismic hazard zone disclosure on the NHD Statement must be marked "Yes." [See Form 314 §6]

Seismic hazard maps are not available for all areas of California. Also, seismic hazard maps do not show Alquist-Priolo Earthquake Fault Zones. The California Department of Conservation creates the seismic hazards maps.

The seismic hazard maps which exist are on the web at http://www.conservation.ca.gov/cgs/shzp/Pages/Index.aspx.

If the NHD indicates a seismic hazard, the buyer's agent must then determine which type of hazard, the level of that hazard and explain the distinction to the buyer, or see to it that someone else does. The listing agent has no such obligation to the buyer.

For example, property located in Seismic Zone 4 is more susceptible to **strong ground shaking** than areas in Zone 3. But which zone the property is located in is a question the buyer's agent must answer. Most of California is in Zone 4, except for the southwest areas of San Diego County, eastern Riverside and San Bernardino Counties, and most of the Northern California Sierra Counties.

Homes in Zone 4 can be damaged even from earthquakes which occur a great distance away.

Ground failure is a seismic hazard which refers to landslides and liquefaction. Liquefaction occurs when loose, wet, sandy soil loses its strength during ground shaking. Liquefaction causes the foundation of the house to sink or become displaced. The condition is prevalent in tidal basins which are fills.

A **tsunami** is a large wave caused by an earthquake, volcanic eruption or an underwater landslide. Coastal areas are the ones at risk for loss of property and life.

Tsunami inundation maps are available from the National Oceanic and Atmospheric Administration (NOAA) led National Tsunami Hazard Mitigation Program (NTHMP) at: http://nctr.pmel.noaa.gov/inundation_mapping.html.

Also, FEMA's Flood Insurance maps consider tsunami wave heights for Pacific coast areas.

Dam failure results in flooding when an earthquake causes a dam which serves as a reservoir to rupture. The city or county planning department has maps showing areas which will be flooded if a local dam fails.

Areas susceptible to inundation due to dam failure caused by an earthquake are also noted on the NHD Statement as a potential flooding area.

Chapter 29 Structural pest control reports and repairs

This chapter digests the requirements, delivery of, and repercussions of the Structural Pest Control Report.

Pricing and asymmetric information

When a home with wood components goes on the market, the war over the Wood Destroying Pests and Organisms Inspection Report, commonly called a *Structural Pest Control (SPC) Report*, and the repairs begins. As is often the case, custom seems mostly to blame.

First, in one corner is the seller. He will tell the listing agent (and himself) that he has seen neither hide nor hair of anything resembling a termite infestation, so obviously there is no need for either a report or a clearance. And as for repairs, he's all for selling the property in an "as the buyer sees things" condition.

The seller's paladin on this field of battle is his listing agent. Conscientious listing agents will push their sellers to order out the SPC report and fix the repairs now in the name of *transparency*—and an earlier sale.

Armed with a pest control operator's *certificate of clearance*, the listing agent will be better able to get the listing price for the property. Later renegotiations of the sales price due to a delayed, in-escrow disclosure of discoverable material defects (in-fact if not in-law) like wood-destroying infestations and infections is avoided.

Others, of course, would rather do nothing and let sleeping termites lie, just as the sellers want. Thus, the uncertainty of a risk of loss is shifted to the buyer, letting him check out the property to see what he finds.

In the other corner is the prospective buyer. During his observations of the property, he is likely blind to all that moves (like termites/etc.) beneath the surface. He wants to purchase a sound home, but may not know all the right questions to ask, or worse, all the games that the multiple listing service (MLS) gatekeepers have learned to play when working as listing agents on behalf of sellers.

Here, the buyer's champion is his selling agent. It is he who is burdened with the mission of fighting industry-wide **seller bias** by:

- ferreting out the *undisclosed facts known or readily available* to the seller and his listing agent;
- determining the *veracity of the disclosures* they do receive; and
- reviewing a *due diligence checklist* with the buyer to make sure he takes the necessary steps so the buyer's purchase is, among other things, free of termites.

The seller who gets his way

Sellers are occasionally allowed to control the conversation at the listing stage and take a pass on the opportunity to order an SPC report and clearance. When termites are later disclosed to the buyer after acceptance of an offer to purchase, no one wins and ill-will is spread all around.

Consider a SPC report first delivered to the buyer *after* entering into a purchase agreement. It discloses the existence of termites or structural damage due to a termite infestation or a fungi infection which the buyer was not previously aware of. He was not told about their existence and did not observe termite conditions on the various walk-through reviews of the premises prior to the seller accepting the buyer's purchase agreement offer.

Upon finding out, the buyer feels taken, as no doubt he should. The seller is irritated, either at being found out or at not being properly advised by his agent on the inevitable need for a report. To keep the deal together, the two agents must now engage in testy negotiations over who is to pay for the corrections and the issuance of a certificate of clearance, and resolve an issue that need not have existed in the first place.

The real irritation for the buyer is the concept of **buyer responsibility** fostered by the pest control provisions in the real estate trade association purchase agreement forms.

The provisions require the buyer to consider paying for repairs and clean-up in order to get a certificate of clearance—a contingency in the purchase agreement and required for a Federal Housing Authority (FHA)-insured loan. Pest control issues adversely affect the value of the seller's property and the price the buyer will pay.

In **boom times**, sellers get their way since they can demand top dollar, not disclose property defects until just prior to closing, refuse to correct any of those deficiencies, and, by agreement, force buyers to eat the cost if they are going to finance and buy the property. Using a trade association purchase agreement with such termite provisions places the buyer at a disadvantage.

Worse yet, no *contractual relief* exists for the buyer when the seller knows termites exist before accepting a purchase offer, repairs are needed to obtain a clearance, and the seller refuses the buyer's demands for the seller to get a clearance by removing the termites and their damage.

In **bust times**, such as what we're experiencing now and will most likely continue to experience into 2013, it's the buyers who get all they demand. With full transparency at the marketing stage when the prospective buyer is first exposed to the property instead of a belated disclosure of the defects after the buyer's purchase offer has been accepted, the seller avoids all the in-escrow demands to get the defects repaired, the property maintained, and most importantly, the price reduced for any minor dislikes threatening the close of the deal.

Eliminate the risk

Unlike a Transfer Disclosure Statement (TDS) or a Natural Hazard Disclosure (NHD), an SPC Report is not a required disclosure in a California real estate transaction. However, before lending money on a property the FHA will require:

- an **inspection** to be made by a licensed SPC company;
- an **SPC Report** prepared by the SPC company after the inspection is complete; and
- a subsequent **Pest Control Certification** stating no active infestation or infection exists on the property. [HUD Mortgagee Handbook 4155.2 Ch-4, §5.d]

Most conventional lenders will not require a report or clearance.

However, prudent buyers and selling agents alert to the fact they are duty-bound to act in the best interests of their buyers will demand an SPC inspection, report, and certification by placing a straightforward, simple **SPC contingency provision** in the purchase agreement, regardless of the nature of the buyer's purchase-assist financing. [See Form 150 §11.1(a) accompanying Chapter 51]

Seller's listing agents acting in the best interest of their sellers will urge their sellers to authorize a prompt inspection and report upon taking the listing. The report, or better yet the clearance after all recommended repairs are completed, will be included in the listing agent's marketing package.

Disclosure upfront and before accepting offers promotes the profession's need for transparency in a transaction. Transparency avoids personal liability for withholding information known to the seller or the listing agent from prospective buyers about a material fact, conduct called *deceit*.

When to deliver the SPC report

The existence of termites *adversely affects* the value of property, which is why disclosure is compelled before the buyer enters into a purchase contract and sets the price and closing conditions with the seller.

In a transparent real estate market, the report and clearance would be part of the **marketing package** given to any prospective buyer who seeks more information on the property. A request for further information by a prospective buyer constitutes the commencement of negotiations toward the purchase of a property.

Purchase agreements frequently include SPC provisions in the terms of purchase or as a condition of financing (FHA). When a purchase agreement requires a SPC report, a copy of the SPC report must be **delivered to the prospective buyer** or buyer's selling agent by the seller or his listing agent *as soon as practicable* (ASAP). ASAP means prior to entering into the purchase agreement if the SPC report is available.

However, if for lack of a report it is not possible to hand the prospective buyer the SPC report until after the seller's acceptance of the purchase offer, closing is automatically contingent on the buyer's right to cancel the purchase agreement and escrow instructions. [Calif. Civil Code §1099(a)]

The term "as soon as practicable" actually carries the same meaning as does the term "as soon as possible". Thus, ASAP means an existing termite report will be delivered to the *prospective buyer* when the listing agent involved become aware the buyer is going to submit an offer calling for a SPC report or for (FHA) financing which requires an SPC report.

Should the offer be submitted to the seller without prior indication to the listing agent that the buyer or the lender will require a SPC report, a counteroffer should be made. The counteroffer would deliver the SPC report, and if not available, advise the buyer of the termite information known to the seller or the listing agent. [Calif. Attorney General Opinion 01-406 (August 24, 2001)]

A counteroffer could be used solely for the purpose of making the SPC disclosure, even if no need exists for a change in the terms of the buyer's offer. Disclosure is always most *practicable* before the acceptance occurs—ASAP—to determine if the buyer's knowledge of the contents of a report or other knowledge of the termite conditions causes the buyer to reconsider the price or terms of his offer.

The **failure to disclose** before the seller accepts the buyer's offer is the result of one of two situations:

1. No one knows about the existence of termites or the damage they created because the readily available inspection and report was not ordered and the discovery was not made before the property was put under contract with the buyer. OR

2. The seller or the listing agent resorts to deceit as the existence of a condition which adversely affects value is known to the seller or the listing agent and not disclosed before the seller accepts the buyer's purchase offer.

The second situation is fraudulent and allows the buyer to pursue the seller and the listing broker/agent to recover the **cost of repairs**. Contract provisions in the purchase agreement allowing the seller to entirely avoid the cost of termite clearance and repairs are not enforceable when known defects go undisclosed at the time the buyer goes under contract. [**Jue** v. **Smiser** (1994) 23 CA4th 312]

A separated SPC report

The custom brought about by the bifurcated pest control handling through an addendum to purchase agreements supplied by the trade associations causes agents to request the SPC company to prepare a **separated report**. The SPC company is asked to separate their findings and recommendations into two categories:

- **Section I items**, listing items with visible evidence of active infestations, infections, or conditions that have resulted in or from infestation or infection; and

- **Section II items**, listing conditions deemed likely to lead to infestation or infection but where no visible evidence of infestation or infection was found.

However, sellers need to order the inspection and report when the property is listed so any necessary repairs will become known, the cost for any correction ascertained, and any repairs completed before a prospective buyer is located. Misrepresentations of the property's condition cannot then become surprises during escrow. On the other hand, it is the intention of some sellers to contract for the buyer to be responsible for the structural pest control clearance, a situation which easily leads to nondisclosure.

These "defective" conditions of termites and their damage to the property are owned by the seller. In a bust market, the buyer with a selling agent whose duty of care it is to protect his buyer is not about to let the seller pass any sort of deficiency which adversely affects the value of the property onto the buyer.

Thus, requesting a separated report in the current climate is misdirected since the intent of a separated report is to divide: divide the type of conditions, and more importantly, to shift the responsibility which is the seller's alone to an unsuspecting buyer.

More to the point, why risk having prospective buyers walk away from your listing, especially in a buyer's market, just because a termite-free home with a clearance and certainty of risk is available around the corner to the risk-averse buyer?

A certificate of clearance

An active termite infestation or fungus infection is occasionally found on an inspection prior to marketing the property. The seller then needs to consider taking corrective measures to both protect the property from further damage and ready it for a prospective buyer by eliminating the issue of termites.

A **Pest Control Certification**, a statement by the SPC company indicating the property is free of infestation or infection in the visible and accessible areas, will then be issued. This certification is commonly called a termite clearance. However, if any signs of infestation or infection *have not been corrected*, it will be noted in the certification. [Calif. Business and Professions Code §8519]

The FHA when insuring a loan only requires a certificate of clearance stating that Section 1 items have been corrected. However, any Section 2 conditions which may lead to future infestations or infections will be noted on the Pest Control Clearance so the SPC company will not be liable for the costs incurred to eliminate those conditions. Section 2 conditions usually are only observed in homes that do not have a slab foundation and have a crawl space beneath the floor of the structure. [Bus & P C §§8516(d), 8519]

What and when to disclose

Consider a one-to-four unit residential property of wood frame construction listed with a broker who is employed to locate a buyer.

The listing agent explains he wants the seller to order an SPC inspection and report now since any prospective buyer (or his FHA lender) will want an SPC Report and Pest Control Certification before escrow can close.

The listing agent receives **written authorization** from the seller and orders an inspection and separated report from an SPC company known to the listing agent to be competent and diligent. [See **first tuesday** Form 132]

The inspection report received from the SPC company states conditions exist which will likely lead to an active termite infestation (Section II items) and recommends repairs and further inspection into inaccessible areas.

Unhappy with the report and the estimated cost of repairs, the seller has the listing agent get a second opinion from a different SPC company.

The second company states there is an active termite infestation (a Section I item) and lists estimates for repair which are higher than the first company's estimates.

A buyer is located for the property. Deciding to go with the first SPC company's report, the seller completes the repairs recommended by the first company. The listing agent delivers a copy of the first company's inspection report to the buyer (or buyer's selling agent), but does not inform the buyer or his agent of the second inspection report.

Escrow closes and the buyer moves in. The buyer discovers termites and the existence of the second inspection report. The buyer, after paying for extensive repairs and corrective measures, makes a demand on the listing agent for his costs to correct the damage, claiming the listing agent was liable since he knew about the second report and the termite infestation, a material fact he did not disclose.

Is the listing agent liable for the costs the buyer incurred to cure the termite damage since he knew about the second report and the termite damage and failed to disclose the report or its contents?

Yes! The second report stated an active infestation existed which is a material fact requiring disclosure since the condition adversely affected the value and desirability of the property. The seller's agent is responsible to ensure the delivery of all known inspection reports to a buyer. The seller's agent cannot pick and choose which reports to deliver. [**Godfrey** v. **Steinpress** (1982) 128 CA3d 154; Department of Real Estate Bulletin, Summer 2004]

Choosing the right company

When choosing an SPC company, the listing agent needs to protect his client and verify the individual or company's license, the company's registration, and the individual's or company's complaint history by calling the SPC Board at 916-561-8708 (in Sacramento) or 800-737-8188 ext. 2 (outside Sacramento), or at www.pestboard.ca.gov.

The Board maintains a two-year history of complaints against every SPC company and information on the company's bond and insurance. [Bus & P C §8621]

Every company registered with the SPC Board must maintain a $4,000 bond. The bonds are in favor of the State of California for the benefit of any person who, after entering into a contract with a registered, licensed company, is damaged by:

- fraud; or
- dishonesty. [Bus & P C §§8697, 8697.2]

Further, the bonds also protect any person who is damaged as a result of any violation of the SPC Act by a registered and licensed SPC company.

Each company must also have general liability insurance with a minimum of:

- $25,000 for bodily injury; and
- $25,000 for property damage per loss.

The general liability insurance covers financial loss due to:

- property damage;
- public injury; and/or
- illness as a result of the company's actions.

The original inspection and report

The individual or company who does the inspection and issues the report must hold a Branch 3 Wood-Destroying Pest and Organisms License/Registration. Only those with a **Branch 3 license** may:

- **perform inspections** for wood-destroying pests and organisms;
- **issue inspection reports** and completion notices;
- **conduct treatments**; and
- **perform any repairs** recommended on the inspection report.

An inspection will cover all *accessible areas* to determine whether an active infestation or infection exists or if conditions which will likely lead to future infestations or infections exists. *Inaccessible areas* do not need to be covered in an inspection.

An area is considered **inaccessible** if it cannot be inspected without opening the structure or removing the objects blocking the opening. Examples of inaccessible areas are:

- attics or areas without adequate crawl space;
- slab foundations without openings to bathroom plumbing;
- floors covered by carpeting;
- wall interiors; and
- locked storage areas.

All SPC companies use a **standardized inspection report** form. An inspection report includes:

- the inspection date and the name of the licensee making the inspection;
- the name and address of the person ordering the report;
- the name and address of any party in interest;
- the address or location of the property;
- a general description of the building or premises inspected;
- a diagram detailing every part of the property checked for infestation or infections;
- a notation on the diagram of the location of any wood-destroying pests (termites, wood-boring beetles, etc.) or fungus present, and any resulting structural damage visible and accessible on the date of inspection, called *Section 1 items* if a separated report is requested;
- a notation on the diagram of the location of any conditions (excessive moisture, earth-to-wood contact, faulty grade levels, etc.) considered likely to lead to future wood-destroying pest infestations or infections, called *Section 2 items* if a separated report is requested;
- one of the following statements:
    - **"The exterior surface of the roof was not inspected. If you want the water tightness of the roof determined, you should contact a roofing contractor who is licensed by the Contractors' State License Board."**
    - **"The exterior surface of the roof was inspected to determine whether or not wood destroying pests or organisms are present."**
- a statement of which areas have not been inspected due to inaccessibility with recommendations for further inspection of these areas if practicable;
- recommendations for treatment or repair;
- information regarding the pesticide(s) to be used, if necessary;

- that a reinspection will be performed if an estimate for making repairs is requested by the person ordering the original report; and

- the following bold-type statement:

  - **"NOTICE: Reports on this structure prepared by various registered companies should list the same findings (i.e., termite infestations, termite damage, fungus damage, etc.). However, recommendations to correct these findings may vary from company to company. You have a right to seek a second opinion from another company."** [Bus & P C §8516(b); 16 Calif. Code of Regulations §1990]

Further, the following statement must appear prior to the first finding/recommendation on a separated report:

- "This is a separated report which is defined as Section I/Section II conditions evident on the date of the inspection. Section I contains items where there is visible evidence of active infestation, infection or conditions that have resulted in or from infestation or infection. Section II items are conditions deemed likely to lead to infestation or infection but where no visible evidence of such was found. Further inspection items are defined as recommendations to inspect area(s) which during the original inspection did not allow the inspector access to complete the inspection and cannot be defined as Section I or Section II."

The company chosen must furnish the person who ordered the inspection a copy of the report within 10 business days of the inspection. [Bus & P C §8516(b)]

All original inspection reports must be maintained by the SPC company for three years. [Bus & P C §8516(b)]

All SPC companies must post an **inspection** tag in the attic, subarea, or garage on completion of an inspection. The tag must give the company's name and the date of inspection. [16 CCR §1996.1]

Reinspections for corrections made

If an estimate for corrective work is not given in the original inspection report or thereafter, then the company is not required to perform a reinspection. A reinspection will be required if a separated report is requested as an estimate for repairs must be given separately allocating the costs to perform each and every recommendation for corrective measures for Section I and II items.

The **reinspection** is to be performed within 10 days of it being requested. A simple reinspection and certification will occur at that time. However, if more than **four months have passed** since the original inspection and report, a reinspection will not suffice. A full (original) inspection must be completed and a new (original) inspection report must be issued. [Bus & P C §8516(b); 16 CCR §1993]

Work Completion and Certifications

The person who ordered the report is never required to hire the SPC company chosen to inspect the property to also complete any corrective measures. For instance, a second SPC company can be called in to work on the structure. However, this second company will need to send a Branch 3 licensee to inspect the property since they may not rely on the report furnished by the original SPC company to perform repair work. [Bus & P C §8516(b); **Pestmaster Services, Inc.** v. **Structural Pest Control Board** (1991) 227 CA3d 903]

Further, the owner may not want to use a SPC company to perform the **corrective work**. Here, the owner may hire a licensed contractor to remove and replace a structure damaged by wood-destroying pests or organisms the work is incidental to other work being performed or is identified by an SPC inspection report. A licensed contractor cannot perform any work that requires an SPC license to complete. [Bus & P C §8556]

However, if the original SPC company gives an estimate or makes a bid to undertake corrective measures and the owner hires someone else to perform the corrective measures, the original SPC company must *return and reinspect* the property before issuing a certification. The original SPC company will not certify treatments performed by another SPC company without reinspection. [Bus & P C §8516(b)]

An SPC company is required to prepare a **Notice of Work Completed and Not Completed** for any work they undertake on a structure. The notice is given to the owner or the owner's agent within 10 working days after completing any work. The notice includes a statement of the cost of the completed work and the estimated cost of any work not completed. A copy of the Notice of Work Completed and Not Completed is delivered by the seller or seller's agent to the buyer or buyer's selling agent as soon as practicable. [Bus & P C §8518; 16 CCR §1996.2; CC §1099(b)]

If the property is fumigated, the fumigation company (which must hold a Branch 1 license) will issue a certification of fumigation within five days.

After any SPC company completes treatment or repairs, a **completion tag** must be placed next to the inspection tag. The completion tag must display:

- the name of the company;
- the date of completion; and
- the name of any chemicals used. [Bus & P C §8518; 16 CCR §1996.1]

An SPC company is only required to certify its inspection and repair work if requested by the person ordering the report. The company, after completing the inspection or work, will **certify upon request** that:

- the inspection disclosed no evidence of active infestations or infections in the visible and accessible areas;
- the inspection disclosed evidence of active infestations or infections and that they have been corrected; or
- the property is free of active infestations or infections in the visible and accessible areas.

Teaching your seller to "own it"

In a buyer's market and the years immediately following, listing agents are going to need to school their sellers on what a buyer will and will not tolerate. When it comes to the SPC inspection, report, repair, and certification, they all initially belong to the seller. Further, the obligation usually remains with the seller since no buyer's agent worth his salt is going to allow his buyer to purchase termites or their breeding grounds.

In a seller's market, a seller may be able to make a buyer pay for the seller's termite problem, leave conditions that may lead to future infestations and infections unfixed, and still command a price at a multiple of the amount they paid for the property. Those days are over for the foreseeable future.

Listing brokers and agents need to make sure sellers understand that if they don't want to continue "owning" the termites (and the property), they need to fix and maintain the property in a marketable condition. If not, they must be prepared to fight over the price they want for their home, and most likely lose that battle.

Chapter 30 Environmental hazards and annoyances

This chapter presents the environmental conditions located on or in the vicinity of a property which adversely affect occupants of the property due to their injurious effect on the health or sensitivities of humans.

Noxious man-made hazards

Environmental hazards are noxious or annoying conditions which are **man-made hazards**, not natural hazards. As **environmental hazards**, the conditions are classified as either:

- *injurious* to the health of humans; or
- an *interference* with an individual's sensitivities.

In further analysis, environmental hazards are either located on the property or originate from sources located elsewhere which affect the occupant in his **use and enjoyment** of the property.

Environmental hazards **located on the property** which pose a direct health threat on occupants due to construction materials, the design of the construction, the soil or its location, include:

- *asbestos-containing* building materials and products used for insulation, fire protection and the strengthening of materials [Calif. Health and Safety Code §§25915 et seq.];
- *formaldehyde* used in the composition of construction materials [Calif. Civil Code §2079.7(a); Calif. Business and Professions Code §10084.1];
- *radon gas* concentrations in enclosed, unventilated spaces located within a building where the underlying rock contains uranium [CC §2079.7(a); Bus & P C §10084.1];
- *hazardous waste* from materials, products or substances which are **toxic**, **corrosive**, **ignitable** or **reactive** [Health & S C §25359.7; Bus & P C §10084.1];
- *toxic mold* [Health & S C §§26140, 26147];
- *smoke* from the combustion of materials, products, supplies or substances located on or within the building [Health & S C §§13113.7, 13113.8];
- *security bars* which might interfere with an occupant's ability to exit a room in order to avoid another hazard, such as a fire [CC §1102.16; Health & S C §13113.9]; and
- *lead*. [See Chapter 29]

Environmental hazards **located off the property**, but which have an adverse effect on the use of the property due to noise, vibrations, odors or some other ability to inflict harm, include:

- *military ordnance* sites within one mile of the property [CC §1102.15];

- *industrial zoning* in the neighborhood of the property [CC §1102.17];
- *airport influence* areas established by local airport land commissions [CC §§1103.4(c), 1353; Bus & P C §11010(b)(13)]; and
- *ground transportation* arteries which include train tracks and major highways in close proximity to the property.

The effect on value and desirability

Environmental hazards have an *adverse effect* on a property's value and desirability. Thus, they are considered defects which, if known, must be disclosed as *material facts* since the hazards might affect a prospective buyer's decision to purchase the property.

The disclosure of a seller's and listing agent's knowledge of existing environmental hazards is required on the sale, exchange or lease of all types of property.

While the disclosure of an environmental hazard is the obligation of the seller, it is the listing agent who has the agency duty of care and protection owing to his seller to place the seller in compliance with the environmental hazard disclosure requirements.

Further, and more critically, the listing agent also has an additional, more limited duty owed to prospective buyers of the listed property. The listing agent must personally conduct a **visual inspection** of the property for environmental hazards (as well as physical defects), and do so with competence. Then the listing agent by use of the TDS must advise prospective buyers of his observations (and knowledge) about conditions which constitute environmental hazards. [CC §2079]

To conclude the listing agent's disclosure of environmental hazards and eliminate any further duty to advise the prospective buyer about the environmental hazards, the listing agent delivers, or confirms the buyer's agent has delivered, a copy of the **environmental hazard booklet** approved by the California Department of Health and Safety (DHS) to the buyer. Delivery of the booklet is confirmed in writing by use of a provision in the purchase agreement. [See Form 150 §11.6 accompanying Chapter 51; see **first tuesday** Form 316-1, also available at *www.firsttuesday.us*]

However, the listing agent might be subjected to an inquiry by either the prospective buyer or the buyer's agent about environmental hazards on or about the property. Here, the listing agent is duty bound to respond fully and honestly to the inquiry.

Method of disclosure

The notice of any environmental hazard to be delivered to a buyer by a seller must be given in writing. No special form exists for giving the buyer notice of environmental hazards, as is provided for natural hazards. Until the real estate industry or the legislature develops one, the Transfer Disclosure Statement (TDS) and the purchase agreement are currently used as the vehicles for written delivery.

Some environmental hazards are the subject of provisions in the TDS, such as a direct reference to hazardous construction materials and waste, window security bars and release mechanisms, and an indirect reference to environmental noise. [See Form 304 §§A and C accompanying Chapter 24]

All other known environmental hazards can be separately itemized in the TDS. As for environmental hazards emanating from off-site locations, they can be disclosed through provisions in the purchase agreement. [See Form 150 §11.7 accompanying Chapter 51]

*Editor's note — The environmental hazard booklet is not a disclosure of known defects on the property. The booklet merely contains general information on a few environmental hazards, none of which might actually exist on the property. It is voluntarily delivered to the buyer by an agent, but with no legal mandate to do so. [See **first tuesday** Form 316-1]*

Regardless of the vehicle of delivery, the seller's agent is to give the environmental hazard disclosures to the prospective buyer as soon as *practicable*, meaning **as soon as reasonably possible**. As with the disclosure of natural hazards, the legislature intended for the environmental hazard disclosures to be made prior to entry into a purchase agreement. [Attorney General Opinion 01-406 (August 24, 2001)]

Need and motivation for disclosure

For the listing agent to properly anticipate the need to have the disclosures available to deliver to prospective buyers, the effort to promptly gather the information from the seller begins at the moment the listing is solicited and negotiated.

The seller and the listing agent have numerous good reasons to fully comply at the **earliest moment** with the environmental hazard disclosures (as well as all other property-related disclosures). The **benefits of a full disclosure**, upfront and before the seller accepts an offer or makes a counteroffer, include:

- the prevention of delays in closing;
- the avoidance of cancellations on discovery under due diligence investigation contingencies;
- the elimination of having to renegotiate the price or offset corrective costs due to the listing agent's dilatory disclosure or the buyer's discovery during escrow;
- the shortening of the time needed for the buyer to complete his due diligence investigation; and
- control by the seller of remedial costs and responsibilities by terms included in the purchase agreement, not by later offsets or demands by the buyer or a court.

The listing agent needs to document in writing (for his file only) the agent's inquiry of the seller about environmental hazards which are known or should be known to the seller. The agent's list should itemize

- all the environmental hazards which might possibly exist on or about a property and the construction materials which contain them;
- the age or date of construction to elicit a review of probable hazardous construction materials used at the time of construction; and
- information known about the property on disclosures the seller received when he purchased the property or were brought to his attention on any renovation of the property.

Also, the listing agent's inquiry into hazardous materials should precede the seller's preparation of the TDS. Thus, the seller is mentally prepared to release information about his knowledge of defects in the condition of the property. Finally, the listing agent's visual inspection should also be conducted before the seller prepares his TDS so his observations may be discussed.

The seller has **no obligation to hire an expert** to investigate and report on whether an environmental hazard is present on or about the property. The seller is also not obligated to remove, eliminate or mitigate an environmental hazard, unless he becomes obligated under the terms of his purchase agreement with the buyer.

It is the seller's and his listing agent's knowledge about the property which is disclosed on the TDS. The off-site environmental hazards which affect the use of the property are generally well known by the buyer's agent for inclusion in the purchase agreement. If not included in the TDS or the purchase agreement, a counteroffer by the seller is necessary to disclose — as soon as practicable — the seller's and the listing agent's knowledge of environmental hazards located both on and off the property.

Asbestos in construction materials

Asbestos is any of a diverse variety of *fibrous mineral silicates* which are commercially mined from natural deposits in the earth. In the 1940's manufacturers began mixing asbestos fibers with substances commonly used to produce materials for the construction of residential and non-residential real estate improvements, such as cement, plastic, stucco, vinyl, insulation and felt roofing materials. Asbestos fibers added greater tensile strength, insulation qualities and fire protection to the construction materials which included them. [Health & S C §25925]

However, asbestos is a known *carcinogen*. As an occupant of a building continues to inhale asbestos fiber, he increases his risk of developing cancer of the stomach and chest lining (mesothelioma), asbestosis of the lungs, and lung cancer.

Construction materials which contain **friable asbestos** are those that can be crumbled, pulverized or reduced to powder by hand pressure when dry. Examples of friable material include:

- the acoustic popcorn ceilings homes, apartments and offices;
- thermal insulation on pipes and hot water heaters;
- wall texturing compounds; and
- sheet rock joint compounds, called "mud."

Construction materials which contain **non-friable asbestos** cannot be crushed by hand pressure. Examples of non-friable material include vinyl, asphalt or cement items, such as stucco plaster, vinyl tiles and asphalt roofing felts. Of course, on the removal of stucco or plaster, the asbestos may **become friable** since the material is disturbed and broken down for removal, creating particles which may become airborne and inhaled.

Asbestos is only harmful to humans when the fibers are inhaled and accumulate in the lungs producing, over time and with continuous exposure, an increased risk of cancer.

Thus, asbestos-containing material used in the construction of a building is best left undisturbed by avoiding renovation or demolition. If the material is in good condition (not crumbling or deteriorating), it is best to leave it in place when redecorating or renovating a property.

The seller of a property constructed with asbestos-containing building materials is under no obligation to investigate or have a survey conducted to determine the existence of asbestos on the property — whether friable or non-friable.

Further, the seller is not obligated to remove or clean up any adverse asbestos condition. However, the condition **must be disclosed**. As a result, a prospective buyer may well condition the purchase of a property containing friable asbestos on its clean up and removal by the seller.

Asbestos fibers have not been used in molded thermal insulation material in spray applications for textured ceilings since 1978.

From 1940 to 1996, some homes were built with materials containing asbestos mixed with other components, such as vinyl floor tiles, backings for linoleum, HVAC duct wrapping, hot water pipe insulation, cement siding and pipes, stucco, plaster, asphalt roofing felts, ceiling and wall insulation, and taping compounds. Any removal of these components requires notification to the local air quality management district and the use of a registered contractor.

Formaldehyde gas emissions

Formaldehyde is a colorless, pungent gas contained in most organic solvents which are used in paints, plastics, resins, pressed-wood fiberboard materials, urea-formaldehyde foam insulation (UFFI), curtains and upholstery textiles. Gas emitted from these materials and products contains formaldehyde.

Formaldehyde is considered a *probable carcinogen* which is likely to cause cancer in humans who inhale the gas emitted by formaldehyde-containing material.

The use of UFFI occurred in construction during the 1970s and was banned in residential property constructed after 1982. However, formaldehyde emissions decrease over time. As a result, properties built during the 1970s and early 1980s with formaldehyde-containing materials give off levels of formaldehyde no greater than newly constructed homes. Over time, emissions decrease to undetectable levels. However, an increase in humidity and temperature will increase the level of emissions.

Radon gas in the soil

Radon is a naturally-occurring radioactive gas. It is not visible, cannot be tasted and has no odor. Detection is by instruments only. Radon gas is located in soils with a concentration of uranium in the rock, e.g., granite or shale, beneath it.

Radon is a known human *carcinogen*. The health risk for humans is lung cancer. For smokers, the risk of cancer is substantially increased by radon gas exposure.

Radon gas enters a building from the soil beneath the structure, be it a home, apartment building or non-residential improvement. Cracks and openings for plumbing in concrete slabs and the porous nature of concrete block basement walls allow the gas from the soil to enter space at or below ground level. Thus, radon is rare in buildings of two or more floors in elevation, except for the ground floor and underground areas.

Radon is sucked into ground floor residential space by interior heating on cold weather days and the use of exhaust fans in the kitchen and bathrooms since these conditions create a vacuum within the lower area of the structure.

However, California residences rarely experience elevated and harmful levels of radon gas emission. Radon does appear in approximately **one percent of housing** in California. Proper ventilation avoids the build up of harmful concentrations of radon in a home or other enclosed space, a function of its design and operation.

Hazardous waste on site

Waste is hazardous if it has the potential to harm human health or the environment. Hazardous waste is released into the environment, primarily the soil, by the leaking of underground storage tanks, drum containers, poorly contained landfills or ponds, accidental spills or illegal dumping.

Hazardous waste materials include any product, material or substance which are *toxic, corrosive, ignitable or reactive*, such as is generated by oil, gas, petrochemical and electronics industries, and dry cleaner and print shops.

Information is available to prospective buyers on their inquiry into the location and status of hazardous waste sites in the vicinity of a home from the "Cortese list" maintained by the California Environmental Protection Agency (EPA).

Mold: the rogue presently in vogue

Mold produces spores which become airborne. The spores are inhaled by humans who enter or occupy the space within the area generating the spores. There are many different kinds of spores, each having differing effects, if any, on humans. Some may be a mere annoyance, irritating the sensitivities of an individual. Others might be a threat to the health of those who inhale them.

The uncertainty of the toxic nature of mold spores has lead to a sort of intellectual moratorium on determining just what kinds of molds have an adverse or harmful effect on humans.

It has also spawned a number of lawsuits as the unknown nature of "toxic mold" has been allowed by politicians and lawyers to stir the fears of the general public.

Consider an inspection of a residential unit with conditions conducive to mold (prior dampness) which reveals the presence of mold, including an insignificant amount of *toxic mold* varieties.

The tenant occupying the unit goes to a doctor after suffering from a range of health problems. The doctor, on review of the mold report, attributes the ailments to the existence of toxic mold in the unit.

A second inspection is ordered which confirms the first inspection; the preponderance of the mold present is non-toxic and the amount of toxic mold found is typical of normal conditions and is of a level which does not contribute to health problems.

The tenant seeks compensation for his health problems, claiming the landlord neglected his duty to provide a healthful environment since he allowed the development of mold which the doctor says led to the tenant's health issues.

Based on the insignificant amount of toxic mold, is the landlord liable for the tenant's illness?

No! The insignificant amount of toxic mold existing in the unit and the doctor's conclusion that the tenant's health problems are connected to toxic mold do not justify holding the landlord liable. [**Dee** v. **PCS Property Management, Inc.** (May 11, 2009) __CA4th___]

*Editor's note—The holding of the **Dee** case is apparent from the first line of the opinion, which made it clear that mold is everywhere, in every breath we breathe.*

Sellers are, of course, under no obligation to investigate whether the improvements contain mold. If it is known the structure does contain mold, the seller has no obligation to determine if the mold is a threat to human health.

The DHS has not yet set any **standards** for disclosures regarding the existence of mold. **Guidelines** for the remediation of mold threats and the approval and distribution of a **consumer-oriented booklet** on mold have also not yet been created by the DHS.

Until disclosure standards are produced, the prospective buyer will, at best, receive a writing from the seller and the listing agent in the form of a TDS advising the buyer of any awareness or knowledge the seller or the listing agent may have that mold exists on the property. No common knowledge exists for sellers or listing agents to visually distinguish between harmful and benign molds.

The DHS has not and presently has no expectations as to when they will release these standards, guidelines and booklet to inform prospective buyers about any harmful molds. These rules will set the permissible exposure limits for humans to various molds and identify those molds which pose a health threat to humans.

If the seller is aware of mold, regardless of type, he is to disclose his awareness of the mold's existence, as well as any other reports or knowledge he (or his agents) have about the variety of mold which exists.

To produce mold standards, guidelines and the consumer-oriented booklet, the DHS must first assemble a panel of advisors as a **task force** to investigate, review and recommend the content of the standards, guidelines and booklet. But before assembling the task force, the program must be funded ($900,000 plus, and funding has not occurred as of June 30, 2009), a cost which is far less than the costs of litigation brought about by the uncertainties of not having standards and guidelines. [Dee, *supra*]

The DHS anticipates that once the task force is selected, recommendations will not be forthcoming for two additional years. Then, the standards, guidelines and booklet produced by the task force must be adopted or approved by the DHS.

When the DHS does finally act to adopt or approve the rules and booklet, they will not become effective for an additional six to twelve months. Thus, no disclosure based on guidance from the state will likely be available to brokers, agents and sellers to deliver to buyers until well after 2012.

Chapter 31 Lead-based paint disclosures

This chapter evaluates the lead-based paint hazard disclosure mandatory on the sale of all residential housing built prior to 1978 and the risks of accepting a buyer's purchase agreement offer before disclosure.

Crystal clear transparency

An agent, while soliciting an owner of a residential property to employ the agent's broker to market and locate a buyer for the property, gathers facts about the property, its ownership and its likely market value.

The property profile furnished by a title company confirms the agent's suspicion that the structure was built **prior to 1978**. The agent is now aware the property is the target of separate state and federal environmental protection disclosure programs designed to prevent the poisoning of children by the presence of lead-based paint.

The agent sets up a meeting with the owner to review the requisite listing and marketing requirements laid down by his broker, and the owner's expectations for a listing price and an acceptable sales price. To prepare for the meeting, the agent fills out the listing agreement and attaches all the disclosure forms needed to correctly market and sell the property, called a *listing package*.

Among other informational forms, the agent includes two forms which address **lead-based paint conditions** on the property:

- the Federal Lead-based Paint (LBP) disclosure [See Form 313 accompanying this chapter]; and
- the California Transfer Disclosure Statement (TDS). [See Form 304 accompanying Chapter 25]

At the presentation of the listing agreement, the agent explains the **seller's legal obligation**, owed to prospective buyers and their agents, to provide them with all the information known to the owner or known or readily available on an inquiry by the listing agent which might adversely affect the property and its value.

By making the transaction **fully transparent** to prospective buyers from the outset of negotiations, the renegotiation of the purchase agreement, including a demand for a price reduction, cancellation or refund after closing due to further disclosures, is avoided. [**Jue** v. **Smiser** (1994) 23 CA4th 312]

A full disclosure to the prospective buyer about the property by the seller and the listing agent does not entail a review or explanation of the facts disclosed. Application of the facts disclosed and the potential consequences flowing from the facts which may affect the prospective buyer's use, possession or ownership of the property are not among the listing agent's duties of affirmative disclosure.

However, federal LBP rules do require the listing agent to advise the seller of the seller's pre-purchase agreement disclosure requirements. The listing agent must **insure compliance** by or on behalf of the seller before the seller enters into a purchase agreement.

Editor's note — Regarding the LBP disclosures, the owner is properly informed he has no obligation to have his property inspected and have a report prepared on the presence of lead-based paint or any lead-

based paint hazards. Also, the owner is advised he does not have to perform any ***corrective work*** *to clean up or even eliminate the conditions, unless he agrees with the buyer to do so. [24 Code of Federal Regulations §35.88(a); 40 CFR §745.107(a)]*

Thus, the seller needs to cooperate in the LBP disclosure and his agent's marketing efforts by:

- filling out and signing the federal LBP disclosure form required on all pre-1978 residential construction [See Form 313];
- filling out and signing the TDS containing the lead-based paint, environmental and other property conditions [See Form 304];
- making a physical home inspection report available to prospective buyers as an attachment to the TDS form; and
- providing the listing agent with copies of any reports or documents containing information about lead-based paint or lead-based paint hazards on the property.

Lead-based paint and hazards

Lead-based paint, defined as any surface coating containing at least 1.0 milligram per square centimeter of lead, or 0.5% lead by weight, was **banned** by the Federal Consumer Product Safety Commission in 1978. [24 CFR §35.86; 40 CFR §745.103]

A **lead-based paint hazard** is any condition that causes exposure to lead from lead-contaminated dust, soil or paint which has deteriorated to the point of causing adverse human health effects. [24 CFR §35.86; 40 CFR §745.103]

Editor's note — A list of statewide laboratories certified for analyzing lead in hazardous material, including paint, is available from the National Lead Information Center at (800) 424-LEAD. Lists are also available on the web at http://www.leadlisting.com/lead.html and http://www.dhs.ca.gov/childlead.

LBP disclosure content

The **LBP disclosure** form includes the following:

- the *Lead Warning Statement* as written in federal regulations [See Form 313 §1];
- the seller's statement *disclosing the presence* of known lead-based paint hazards or the seller's lack of any knowledge of existing lead-based paint [See Form 313 §2];
- a *list of records or reports* available to the seller which indicates a presence or lack of lead-based paint, which have been handed to the listing agent [See Form 313 §2.2];
- the buyer's statement *acknowledging receipt* of the LBP disclosure, any other information available to the seller and the lead hazard information pamphlet entitled *Protect Your Family From Lead in Your Home* [See Form 313 §3.1; see **first tuesday** Form 316-1];
- the buyer's statement acknowledging the buyer has received a 10-day *opportunity to inspect* the property or has agreed to reduce or waive the inspection period [See Form 313 §3.2];

LEAD-BASED PAINT DISCLOSURE

On Sale of Real Estate

NOTE: For use on the sale of any residential property which was constructed pre-1978.

PROPERTY ADDRESS: _____

Items left blank or unchecked are not applicable.

1. Lead Warning:

1.1 Every Buyer of any interest in residential real property on which a residential dwelling was built prior to 1978 is notified that such property may present exposure to lead from lead-based paint that may place young children at risk of developing lead poisoning. Lead poisoning in young children may produce permanent neurological damage, including learning disabilities, reduced intelligence quotient, behavioral problems, and impaired memory. Lead poisoning also poses a particular risk to pregnant women.

1.2 Seller of any interest in residential property is required to provide Buyer with any information on lead-based paint hazards from risk assessments or inspections in Seller's possession and notify Buyer of any known lead-based paint hazards.

1.3 A risk assessment or inspection for possible lead-based paint hazards is recommended prior to purchase.

2. Seller's Certification:

2.1 Presence of lead-based paint and/or lead-based paint hazards

a. ☐ are known to be present in the housing as explained: _____

_____

_____.

b. ☐ are not known to Seller to be present in the housing.

2.2 Records and reports available to Seller

a. ☐ Seller has provided Buyer with all available records and reports listed below pertaining to lead-based paint and/or lead-based paint hazards in the housing: _____

_____

_____

b. ☐ Seller has no reports or records pertaining to lead-based paint and/or lead-based paint hazards in the housing.

Date: _____, 20_____ **Seller:** _____

Date: _____, 20_____ **Seller:** _____

3. Buyer's Acknowlegement:

3.1 Buyer has received:

a. ☐ Copies of all information listed above.

b. ☐ The pamphlet *Protect Your Family From Lead in Your Home*.

3.2 Buyer:

a. ☐ Will receive a ☐ 10-day, or ☐ _____-day, opportunity from acceptance of the purchase offer to conduct a risk assessment or inspection for the presence of lead-based paint and/or lead-based paint hazards.

b. ☐ Waives the opportunity to conduct a risk assessment or inspection for the presence of lead-based paint and/or lead-based paint hazards.

3.3 I acknowledge that I have read and understood the attached lead warning statement in Section 1 of this form and received all information noted in Section 2 of this form.

Date: _____, 20_____ **Buyer:** _____

Date: _____, 20_____ **Buyer:** _____

4. Broker's Certification (When Applicable):

4.1 Broker certifies to have informed Seller of his/her obligation under 42 U.S.C. §4852d to disclose to Buyer and Broker all information known to Seller regarding the presence of lead-based paint and lead-based paint hazards within this target housing and that all information known to Broker regarding the presence of lead-based paint and lead-based paint hazards within this target housing has been disclosed to Buyer.

4.2 Broker further certifies that Buyer has received the lead hazard information pamphlet *Protect Your Family From Lead in Your Home* and that Buyer has or will be given a 10 calendar day period (unless otherwise agreed in writing) to conduct a risk assessment or inspection for the presence of lead-based paint before becoming obligated under the contract to purchase the housing.

Date: _____, 20_____ **Broker:** _____

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- the listing agent's statement noting the seller has been informed of the seller's disclosure requirements and that the agent is aware of his *duty to ensure* the seller complies with the requirements [See Form 313 §4]; and

- the *signatures* of the seller, buyer and listing agent. [24 CFR §35.92(a)(7); 40 CFR §745.113(a)(7)]

The seller and the listing broker must each keep a copy of the disclosure statement for at least three years from the date the sale is completed. [24 CFR §35.92(c); 40 CFR §745.113(c)]

Whether or not the LBP disclosure form is retained does not have an effect on the statute of limitations for the buyer to pursue misrepresentations or alter the buyer's right to post-contract disclosures. [24 CFR §35.92(c)(2); 40 CFR §745.113(c)(2)]

Also, the disclosure form must be in the language of the purchase agreement. For example, if the purchase agreement is in Spanish, then the LBP disclosure must also be in Spanish. [24 CFR §35.92(a); 40 CFR §745.113(a)]

Opportunity to evaluate risk

A prospective buyer must be notified before he makes an offer that he has the opportunity, by way of a **10-day period** after acceptance, to evaluate the hazardous risks involved due to the presence of lead-based paint in residential housing built prior to 1978. The buyer can agree to a **lesser period of time** or can entirely waive the right to the federally permitted risk evaluation period. However, disclosures about the property cannot be waived by the use of an "as-is" sale provision. [40 CFR §745.110(a); See Form 313]

Pre-contract disclosure avoids cancellation

Consider a prospective buyer who indicates he wants to make an offer to buy pre-1978 residential property. The listing agent hands the prospective buyer a lead-based paint disclosure signed by the owner of the property which discloses that lead-based paint is known to exist on the property.

The prospective buyer is also handed independent reports and documents related to the existence of the lead-based paint on the property.

The prospective buyer enters into a purchase agreement offer, but does not waive the 10-day lead-based paint risk evaluation period, wishing instead to **inspect and confirm** the accuracy of the seller's disclosure since the seller's disclosure of the property condition is not a warranty guaranteeing the actual condition of the property.

After the seller's acceptance of the offer, the buyer has the property inspected. The inspector's report states lead-based paint exists as stated in the seller's disclosure documents. The buyer now seeks to cancel the purchase agreement due to the presence of lead-based paint.

Can the buyer refuse to complete the purchase of the property due to the existence of the lead-based paint as previously disclosed by the seller?

No! The buyer had full knowledge of the presence of lead-based paint and any lead-based paint hazards **prior to the seller's acceptance** of his purchase agreement offer. Thus, the buyer purchased the property **as disclosed** since the purchase agreement did not contain conditions calling for removal or abatement of the lead-based paint. The risk evaluation period only enabled the buyer to cancel had the seller not disclosed the presence of any lead-based paint or lead-based paint hazards prior to acceptance.

Thus, when the buyer entered into the purchase agreement, the buyer was **put on notice** about the presence of lead-based paint and the buyer could not later use the existence of lead-based paint as justification for cancellation.

Foreclosure sale exemption

Exempt from the Federal LBP disclosures are **foreclosure sales** of residential property. [24 CFR §35.82(a)]

Yet, a foreclosing lender still has a **common law duty to disclose known defects** at the foreclosure sale. Thus, even if the property is purportedly sold "as-is" at a foreclosure sale, a foreclosing lender is not protected from liability for intentional misrepresentation (negative fraud by omission) and deceit should the foreclosing lender have knowledge of a defect in the property and fail to disclose the defect at the time of the sale to the highest bidder. [**Karoutas** v. **HomeFed Bank** (1991) 232 CA3d 767]

However, the foreclosure exemption **does not apply** to the resale of housing previously acquired by the lender at a foreclosure sale, commonly called *real estate owned* (REO) property, or to the resale by a third party bidder who acquired the property at a foreclosure sale.

Thus, if a lender or other bidder who acquired property at a foreclosure sale is reselling it, the resale must comply with the lead-based paint disclosure requirements. [61 Federal Register 9063]

Chapter 32 Marketing condominium units

This chapter explores the listing agent's use of condominium association documents to market a unit listed for sale and to inform prospective buyers about the association and the project.

Managed housing

A buyer seeking to acquire a unit in a condominium project, or in any other residential *common interest development* (CID), is **bargaining for** living restrictions and ownership operating costs unlike those experienced in the ownership of a self-managed, single-family residence (SFR).

Ownership of a unit in a condominium project includes compulsory membership in the homeowners' association (HOA). The HOA is charged with *managing and operating* the entire project.

As a common owner of the project and a HOA member, **use and operating restrictions** are placed on most types of conduct, including:

- parking;
- pets;
- guests;
- signs;
- use of the pool, recreational and other like-type common facilities;
- patio balconies;
- care and maintenance of the unit,
- structural alterations; and
- the leasing of the premises.

The implicit bargain in becoming an owner-member is consenting to conform his conduct to meet extensive **use restrictions** in exchange for every other owner-member doing the same. The standards for the conduct consented to are found in the use restriction documents created for the project, such as association bylaws, Covenants, Conditions and Restrictions (CC&Rs) and operating rules.

The HOA has committees and a board of directors, both consisting of owner-members who are appointed to oversee the conduct of all the owner-members and their guests. On a committee's recommendation concerning a member's violation of a restriction, rule or policy of the HOA, the HOA takes steps to enforce compliance, usually by a notice of violation to the offending owner-member.

A fair comparison to the member's occupancy in a **multiple-unit housing project**, such as a condominium development, is a tenant's occupancy in an apartment complex of equal quality in construction, appearance and location. The behavior of a tenant in an apartment is also controlled by use restrictions, operating rules and policies established by a landlord.

However, a landlord is subject to market conditions when establishing guidelines for tenant conduct. Unlike a HOA, a landlord dues not rule by majority vote, committees and directors.

Yet the conduct of tenants is regulated and policed in very much the same way as the conduct of a member of a condo project is policed. In law, *security arrangements* required to be implemented and maintained for condo projects and apartment complexes are the same, i.e., the property is to be maintained so its use is safe and secure from dangerous defects and preventable criminal activity. Both the landlord and the board of directors of a HOA are responsible for the safety of the users of their respective multiple-housing projects. Both are managed housing.

Classification of member obligations

The bargain entered into on acquiring a unit in a CID must be understood by the prospective buyer to include a highly involved **socio-economic relationship** with all other members of the project's HOA. A commonality of interest arising out of CID ownership creates a relationship amongst the members built not only on **use restrictions** and operating rules, but also on **financial commitments** to one another.

Financially, all members collectively provide all the revenue the HOA needs to pay the expenses of present and future repairs, restorations, replacements and maintenance of all components of the structures they own in common or through the HOA.

Thus, the obligations undertaken by a prospective buyer who acquires a unit in a CID, and the HOA's documentation of those obligations, fall into two classifications:

- **use restrictions** contained in the association's articles of incorporation, by-laws, recorded CC&Rs, age restriction statements and operating rules; and

- **financial obligations** to pay assessments as documented in annual reports entitled pro forma operating budgets, a Certified Public Accountant's (CPA's) financial review, an assessment of collections and enforcement policy, an insurance policy summary, a list of construction defects, and any notice of changes made in assessments not yet due and payable.

Assessments generate revenue

Two types of assessment charges exist to fund the expenditures of HOAs:

- **regular assessments**, which fund the operating budget to pay for the cost of maintaining the common areas; and

- **special assessments**, which are levied to pay for the cost of repairs and replacements that exceed the amount anticipated and funded by the regular assessments.

Annual increases in the dollar amount levied as **regular assessments** are limited to a 20% increase in the regular assessment over the prior year. An increase in **special assessments** is limited to 5% of the prior year's budgeted expenses. [Calif. Civil Code §1366(b)]

An extraordinary expense brought about by an emergency situation lifts the limits placed on the amount of an increase in regular and special assessments. **Extraordinary expenses** include amounts necessitated:

- by a court order;
- to repair life-threatening conditions; and
- to make unforeseen repairs. [CC §1366(b)]

The schedule for payment of assessments by a member varies depending on the type of assessment. **Regular assessments** are set annually and are due and payable in monthly installments. **Special assessments** are generally due and payable in a lump sum on a date set by the HOA when making the assessment.

The buyer's expectations about assessments

To better understand the impact of assessment obligations, a prospective buyer of a unit needs to analyze the assessments based on:

- the present and future **annual operating costs** the HOA will incur; and
- the amounts which must be set aside annually as **reserves** for future restoration or replacement of major components of the improvements.

Should the association's reserves be insufficient to pay for major repairs to components of the structure which were foreseeable, a **special assessment** is used by the association to immediately call for additional funds from members to provide revenues to cover these extraordinary or inadequately reserved expenditures.

Arguably, repairs and replacements for which assessment revenues are needed to cover HOA costs are expenses any owner of a SFR would also incur. However, the difference in a CID is the individual member cannot substitute his time, effort and personal judgment for how much will be paid, when the repairs will take place, how repairs might be financed or exactly what repairs or quality of repairs are appropriate. These decisions are left to HOA committees who hopefully vote based on the same concerns and ability to pay as would the prospective buyer of a unit.

Order in the financial house

To determine if a HOA has its finances in order, a prospective buyer should look to the financial reports held by the seller or readily available from the HOA on the seller's request.

The HOA's current **pro forma operating budget** is the starting point for the prospective buyer's analysis of the financial impact the purchase of a unit in the CID will have on his income. Remember, it is the *regular assessments* which will be increased if reserves are inadequate and a *special assessment* which is levied to cover an immediate expenditure for which insufficient cash reserves exist.

The **pro forma operating budget** makes several mandatory disclosures about the state of the HOA's finances, including, but not limited to:

1. An estimate of the revenues from assessments, paid or delinquent, and the **expenses** the HOA anticipates incurring during the fiscal year covered by the budget. The revenues must exceed expenses since the HOA must set aside cash reserves for the future replacement of major components of the structure.

2. A summary of the HOA's **cash reserves** itemizing:

- the estimated repair or replacement cost of each major component of the structure owned by the HOA;

- the amount of cash reserves needed to pay for the repairs or replacements of these major components; and

- the cash reserves actually on hand and available to pay for these repairs or replacements.

3. Any determination or anticipation of the HOA's board of directors as to whether **special assessments** will be required in the future for reserves, repairs, replacements or maintenance. [CC §1365(a)]

On review of the HOA's pro forma operating budget, the prospective buyer can quickly determine whether cash reserve shortages exist. If they do exist, the only way for the HOA to get the funds into reserves or immediately pay for the repairs or replacements is to increase the regular assessments (which are paid monthly) or call for a special assessment (which will be a lump sum amount due and payable when set).

Thus, when setting the purchase price of a unit, the buyer must consider (the present value of) the amount of **deferred assessments** he will have to pay in the future, assessments which should have been levied and paid by the seller.

Some HOAs initially supply only a **summary** of the pro forma operating budget. In this case, the full budget can be requested and will be delivered without further charge.

Further, the prospective buyer needs to review additional HOA documents to fully **determine the value** (price) of the unit he is interested in purchasing and the **financial impact** assessments will have on the buyer's disposable income.

For example, another financial disclosure issued by the HOA, unless the HOA's revenues are $75,000 or less, is a **CPA's review** of the HOA's financial statement (this is not the pro forma operating budget statement). Look for comments in the CPA's review about deficiencies in reserves, delinquent assessments, or unusual accounting procedures. [CC §1365(c)]

HOA assessment enforcement policy

Also available from the HOA is a statement on the HOA's policies for enforcing collection of delinquent payments of assessments. [CC §1365(e)]

At issue for a prospective buyer of a unit is the method used by the HOA to **enforce collection** of assessments, e.g.,:

- does the HOA *record a Notice of Default* and proceed with a trustee's foreclosure on the owner's unit, a default which can be cured by the payment of delinquencies and statutorily limited foreclosure costs; or

AUTHORIZATION TO PROVIDE CID DOCUMENTS
(California Civil Code §1368)

DATE: _____, 20_____, at _____ California.

TO MANAGEMENT OF OWNER'S ASSOCIATION:	**FROM LISTING BROKER:**
Representative's name _____	Agent's name _____
Company name _____	Broker's name _____
Address _____	Address _____
_____	_____
Phone _____ Fax _____	Phone _____ Fax _____
Email _____	Email _____

1. Regarding unit number _____ located in the CID project which you manage known as _____ and subject to a homeowner's association (HOA) named _____.
2. You are kindly requested to provide the Listing Broker identified above within the statutory delivery period with the following checked CID and HOA documents:
   a. ☐ Copies of any notice to Seller of CC&R violations, any list of construction defects, identification of any pending litigation involving the HOA and any assessment charges not yet payable.
   b. ☐ Copies of HOA articles, bylaws, CC&Rs, collection and lien enforcement policies, operating budget, operating rules, CPA's financial review, insurance policy summary and any age restriction statement.
   c. ☐ A statement of Condition of Assessments.
3. You are authorized to supply the Listing Broker identified above the requested copies of CID and HOA documents.
   5.1 Please bill me for the reasonable cost of copying and delivering these requested documents.

Owner's information:	**Signature of HOA member:**
Unit number: _____	
Name: _____	_____
Address: _____	
_____	_____
Phone: _____ Fax: _____	

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- does the HOA *hire an attorney* and *file a lawsuit* requiring a response, a trial and results in a personal money judgment against the owner, all of which has no limit on the dollar amount of costs and attorney fees to defend or prosecute and, if not paid, becomes an abstract of judgment which is a foreclosable lien on all property owned by the owner and collectible by attaching the owner's wages or salary. [CC §§1367, 1367.1]

Also, if a "list of defects" in the structure or a disclosure of any changes already made to regular and special assessments that are not yet due and payable exists, it indicates financial inadequacies the HOA is now attempting to cure or cover. [CC §§1368(a)(6), 1368(a)(8)]

The prospective buyer of a unit in a CID needs to review all readily available HOA information with the buyer's agent **before making an offer**. With this information, the property's fundamentals become more **transparent**, allowing the buyer and his agent to better determine the price the buyer should pay

for the unit and whether or not he has the ability (and desire) to carry the cost of ownership after acquisition. Even FHA insured financing requires the HOA to have maintained reserves and that delinquent assessments and investor ownership of multiple units are limited.

HOA documentation

An **association's participation** in a listing agent's efforts to induce a prospective buyer to enter into a purchase agreement and close escrow on the sale of a unit located within the project is limited to:

- **providing the listing agent**, on written request from the owner of the listed unit, with documents which include items, statements and reviews regarding the permissible use of the unit and the financial condition of the HOA [CC §1368(b); see Form 135 accompanying this chapter];

- **providing escrow**, on written request from the owner of the listed unit, with documents which include notices, statements, lists and disclosures regarding the status of the owner's membership in the HOA; and

- **changing HOA administrative records** to reflect the identification of the new owner should the prospective buyer purchase the unit.

The HOA may charge a **service fee** equal to their reasonable cost to prepare and deliver the documents requested by the owner. A charge in connection with the change of ownership is permitted, but is limited to the amount necessary to reimburse the association for its actual out-of-pocket cost incurred to change its internal records to reflect the new ownership of the unit. [CC §§1366.1, 1368(c)]

Within 10 days after the postmark on the mailing or hand delivery to the HOA of a written request from the owner itemizing the documents sought from the HOA, the **association is obligated** to provide them to the owner. A willful failure to timely deliver up the requested documents subjects the HOA to a penalty of up to $500. [CC §§1368(b), 1368(d)]

The association documents regarding use restrictions and financial data should be delivered by the owner's listing agent to a prospective buyer prior to entering into a purchase agreement. When disclosures are received before agreeing to buy, the buyer does not have a valid reason to later use this information to terminate the purchase agreement.

Status documents are also available from the HOA on request (usually by escrow) prior to closing. Using these documents, the buyer confirms the owner's representations in the purchase agreement about the status of his occupancy and the assessments imposed on the unit he is selling.

Escrow's only concern with HOA documents is the receipt of information for the purpose of prorations made necessary by prepaid or delinquent assessments.

The closing documents needed by escrow and the buyer regarding the owner's status with the HOA include:

- the CID's *statement of condition of assessments* in order for escrow to calculate **prorates and adjustments** on closing; and

- any HOA notices to the owner of CC&R violations, a list of construction defects and any assessment charges not yet due and payable in order for the buyer to **confirm the representations** made by the owner in the purchase agreement.

When a real estate broker or his agents provide a copy of the use restriction documents or the covenants, conditions and restrictions (CC&Rs) of a homeowners' association to any person must use a **cover page or stamp** on the first page of the CC&Rs. The cover page or stamp must state, in at least 14-point boldface type, the following:

> "If this document contains any restriction based on race, color, religion, sex, sexual orientation, familial status, marital status, disability, national origin, source of income as defined in subdivision (p) of Section 12955, or ancestry, that restriction violates state and federal fair housing laws and is void, and may be removed pursuant to Section 12956.2 of the Government Code. Lawful restrictions under state and federal law on the age of occupants in senior housing or housing for older persons shall not be construed as restrictions based on familial status."

However, the requirement to include this declaration does not apply to documents submitted to the county recorder for recordation.

Listing agent's role

Unless a listing agent is remiss, or simply ignorant of his duties owed to prospective buyers, he knows exactly what CID information and documents he needs to gather to properly **market and disclose** to prospective buyers the material facts about a condominium unit he has listed for sale, called *transparency*.

Accordingly, it is at the listing stage that the agent should prepare the **owner's request** to the HOA to deliver up the CID documents concerning use restrictions and HOA finances. The documents are immediately available from the association and will be delivered within 10 days of the posted or hand delivered request. [CC §§1368(a), 1368(b); see Form 135]

The owner is obligated by statute to ensure the disclosures are handed to prospective buyers as soon as practicable (ASAP). It is quite easy for the owner to request and quickly receive the documents from the association. Thus, the ready availability of the documents confirms the disclosures can, as a practical matter, be made available to a prospective buyer before the owner accepts an offer. [CC §1368(a)]

However, once the owner lists the property, it becomes the **listing agent's obligation**, acting on behalf of the owner, to diligently fulfill the owner's obligation to make the association documents available for delivery to prospective buyers, ASAP.

Chapter 33 Tax aspects advice

This chapter clarifies the extent of an agent's duty to inform his client about the tax aspects of a proposed real estate transaction.

Disclosure of known consequences

Consider an owner of an income-producing parcel of improved real estate who intends to hire a brokerage office to market his property and locate a buyer. The owner interviews a few brokers and sales agents to determine who he will employ to list the property for sale.

The owner's primary concern is to hire an agent who is most likely to produce a prospective buyer who will purchase the property. Thus, the **owner's interviews** include an inquiry into:

- the **contents of the listing package** the agent will prepare to market the property;
- the **scope of the advertising** the agent will provide to locate prospective buyers; and
- the **professional relationship** the agent has with other brokers, agents and property owners.

One agent interviewed by the owner inquires about the owner's *intended use of the proceeds* from the sale. The owner indicates he would like to reinvest the funds in developable land, to hold for profit on a later resale to a subdivider or builder.

On further inquiry, the owner provides the agent with *data on the price* he paid for his property, the *debt* now encumbering the property and his depreciated *cost basis* remaining in the property. These three key pieces of data are needed for an agent to assist the owner in his **tax planning** for a sale.

The agent does some quick math (sales price minus basis equals profit) to approximate the amount of profit the owner will realize on a sale. He immediately determines the owner would pay profit taxes at *recapture* (25%) and *long-term* (15%) rates that will equal nearly one fifth of his net proceeds from a sale (plus one twelfth for state taxes). The owner is informed of the agent's initial opinion about the owner's tax liability on a sale.

The agent then informs the owner he can **avoid reporting his profit** and paying income taxes on the sale by buying the land he would like to acquire now. Thus, the sale of his income property and his purchase of land can be linked together to form a **continuing investment** in real estate.

Also, the agent informs the owner that the purchase agreements entered into for the sale of the income property and the purchase of the land should contain **contingency provisions** conditioning the closing of the sale on the owner's purchase of other property.

So as not to mislead the owner about the extent of the **agent's experience** handling §1031 reinvestment plans for clients, the agent informs the owner he has not personally handled a §1031 transaction. However, he lets the owner know he has taken courses on §1031 transactions and has discussed §1031 funding procedures with brokers and escrow officers who do have experience handling §1031 reinvestments.

The agent tells the owner he believes he can properly market the property and locate suitable land for the owner's reinvestment, as well as follow up on procedures for §1031 tax avoidance should the property be listed with his broker.

Conversely, another agent contacted by the owner is reticent about becoming involved in a review of the tax aspects of selling property.

This agent hands the owner a **written statement** attached to a proposed listing agreement advising the owner that the agent:

- has disclosed the extent of his *knowledge* of the tax consequences on the sale of real estate;
- is unable to give *further tax advice* on the rules and procedures involved in a §1031 transaction; and
- has *advised the owner* to seek the advice of his accountant or tax attorney on how to properly avoid the tax on profit from the sale and purchase of real estate.

Did both agents comply with their agency duty to make proper disclosures to the owner about their knowledge and willingness to give tax advice?

Yes! Both agents met the **agency duty** undertaken when soliciting employment since each agent:

- **determined the tax consequences** of the sale might **affect** the owner's handling of the sales transaction, called a *material fact*;
- **disclosed the extent of his knowledge** regarding the possible tax consequences of the sale; and
- **advised on the need for a professional** who would further investigate and advise on the §1031 tax aspects.

The question then remains, "Must a broker, employed by a seller of real estate, give tax advice to the seller?"

The answer lies in the **type of real estate** involved and the client's intended use of the sales proceeds.

An affirmative duty to advise

Consider a listing agent who determines that information about the tax aspects of a sale is *material* to a sales transaction entered into by his client since tax information might affect the client's handling of the transaction. Accordingly, the agent has a duty owed to his client to disclose the extent of his knowledge on the transaction's tax aspects, called an *agency duty* or *fiduciary duty*.

Further, a concerned listing agent will go beyond disclosure of mere tax information and assist his client in structuring the sales arrangement to achieve the best possible tax consequences available.

However, a **statutory exception** to the disclosure duties exists. On one-to-four unit residential dwellings, a listing agent has **no duty to disclose** his knowledge of possible tax consequences, even if the tax consequences are known by the agent to affect the client's decision on how to handle the sale of his property, unless the topic becomes the subject of the client's inquiry. [Calif. Civil Code §2079.16]

Advice and disclosure exception

Consider a seller of a one-to-four unit residential property who enters into a client-agent relationship with a broker, employing the broker (and his agents) to sell the property under a listing agreement.

The listing agreement form used by the broker contains a boilerplate clause stating a real estate licensee is a person qualified to advise on real estate, a statement that is consistent with the training and knowledge of brokers and agents. However, the clause goes on to state that if the seller desires legal or tax advice, he should consult an appropriate professional. [CC §2079.16]

The broker also hands the seller a statutorily mandated **agency law disclosure** form that states: "A real estate agent is a person qualified to advise about real estate. If legal or tax advice is desired, consult a competent professional."

Neither disclaimer requires the broker and his agents to provide tax advice or obligates the seller to employ the other professional to advise on the tax aspects of the transaction before closing escrow. [CC §2079.16]

The broker then locates a buyer who enters into a purchase agreement with the seller to buy the property. The purchase agreement also states the seller should consult his attorney or accountant for tax advice.

Prior to closing the sale of the seller's property, the broker also negotiates the seller's purchase of another one-to-four unit residential property, which involves the broker's preparation of a purchase agreement.

Before the separate escrows close on the sale and purchase transactions, the seller asks the broker about the number of days he has after the sale closes to purchase the replacement property and avoid paying profit tax on the sale. The seller has never been involved in a §1031 reinvestment.

The broker informs the seller he is not sure of the number of days and orally **advises the seller to consult a tax accountant**. The seller does not do so since no contingency provision for further-approval of the tax consequences was in the purchase agreement.

Ultimately, the seller is taxed on the profit from the sale, but not because of the time constraints on his closing of escrow that he inquired about. The profit is taxed because the seller failed to avoid actual and constructive receipt of the sales proceeds. Avoidance is simple, either:

- directly transfer the sales proceeds to the purchase escrow; or
- impound the sales proceeds with a third-party facilitator until the proceeds are needed to fund the purchase escrow for the replacement property.

The seller seeks to recover his losses from the broker. He claims the broker breached the agency duty owed to the seller by failing to disclose that the structure of the seller's transfer of net sales proceeds from the sales escrow to the purchase escrow for the replacement property might result in **adverse tax consequences** due to his actual receipt of the reinvestment funds.

The broker claims he has **no duty to advise the seller on the tax consequences** of the one-to-four unit sale since the listing agreement, the **agency law disclosure** and the purchase agreement all clearly stated:

- the broker did not advise on tax matters; and

- the seller should look to other professionals for tax advice.

Did the listing broker (or his agents) have a duty to advise the seller on the tax consequences of the sale as known to the broker (or his agents)?

No! On the sale of **one-to-four unit residential property**, sellers (and buyers) are expected, as a matter of public policy, to obtain tax advice from competent professionals other than the residential real estate brokerage office handling the transaction. [CC §2079.16]

Further, a broker has no duty to voluntarily disclose any tax aspects surrounding the sale of a one-to-four unit residential property, even if the **information is known** to the broker or the sales agent. However, the listing agreement needs to specify the broker and his agents **do not undertake the duty** to advise the seller on the tax aspects of the transactions. Further, on a **direct inquiry** from the seller (or buyer), the agent must **respond honestly** and to the best of his knowledge. [**Carleton** v. **Tortosa** (1993) 14 CA4th 745]

The agency law disclosure addendum attached to listing agreements and purchase agreements **eliminates the duty** of a broker and his agents to disclose their knowledge about the tax aspects of a sale when a one-to-four unit residential property is involved.

The irony of mandated disclosures

The tax consequences of sales transactions involving the subsequent purchase of replacement property are as material to a seller as is the structuring of carryback financing. Carryback financing arrangements require an agent to make extensive mandated disclosures regarding documentation of the carryback and the rights of the carryback seller. However, carryback arrangements are less frequently encountered during boom times than §1031 reinvestment opportunities.

Further, the financial damage of avoidable taxes often exceeds the risk of loss on an improperly structured carryback note and trust deed transaction. Unlike the agency duty of a broker (and his agents) in §1031 transactions, the agency duty a broker (and his agents) owes to his carryback seller includes full disclosure of information necessary for the seller to make an informed decision about the **financial suitability** of a carryback sale before the seller enters into the transaction. [**Timmsen** v. **Forest E. Olson, Inc.** (1970) 6 CA3d 860]

Avoiding misleading disclaimers

The boilerplate statement included in some listing agreements and purchase agreements used by unionized real estate brokers and their agents incorrectly implies that they are not qualified to give tax advice.

If a broker or agent is not **fully qualified** to handle the sale and purchase aspects of a §1031 transaction, he is at least aware of its beneficial tax aspects available to a seller of property.

Further, real estate brokers and their agents *with tax knowledge* are **duty-bound to advise their client** about their knowledge concerning the tax consequences of the real estate transaction their client is about to enter into — unless a one-to-four unit residential property subject to agency law disclosure statutes is involved.

However, a savvy broker or agent **capitalizes** on the tax knowledge he has spent time acquiring by advising clients on the tax results of their real estate transactions, regardless of the type of property involved. When a broker or agent uses his knowledge to **voluntarily counsel** his client on the transaction's tax consequences, the decision made by the client will be the result of more relevant information.

However, the broker or agent who advises a client on a transaction's tax consequences has a duty to not mislead the client by intentional or negligent misapplication of the tax rules. [**Ziswasser** v. **Cole & Cowan, Inc.** (1985) 164 CA3d 417]

To **avoid misleading the client,** the broker or agent should disclose to his client:

- the full extent of his tax knowledge regarding the transaction;
- how he acquired his tax knowledge; and
- whether the broker or agent intends to further investigate the matter or whether the client should seek further advice from other professionals.

When a broker or agent does give tax advice, he should take steps to involve the **client's other advisors** in the final decision. Input from others who know the client help the broker eliminate future claims arising out of adverse tax consequences due to the **client's reliance** on the agent's (incorrect) opinion.

The most practical (and effective) method for shifting reliance to others or to the client himself when the broker gives a client his opinion on a transaction's tax consequences, is to insert a *further-approval contingency* in the purchase offer or counteroffer.

The **contingency provision** requires the client to initiate his own **investigation** by obtaining additional tax advice and further approval of the transaction's tax consequences from his attorney or accountant before allowing escrow to close.

An oral or written warning, or **general advice** to further investigate, is not sufficient. Advisory statements do not require the client to act, and worse, they do not explain why the broker or agent believes the client should act to protect himself. A further-approval contingency provision makes the advice an *opinion*, to be confirmed by the client before closing. [**Field** v. **Century 21 Klowden-Forness Realty** (1998) 63 CA4th 18]

Tax advisor's further approval

In an exchange agreement (or purchase agreement), the purpose for including a further approval contingency regarding the transaction's tax consequences is to allow a client to confirm that the transaction does qualify for §1031 tax-exempt status as represented by his agent. If the tax status cannot be confirmed, the client may terminate the transaction by delivery of a notice of cancellation. [See **first tuesday** Form 171 §5.2j]

In other words, the client is **not relying** on the agent's opinion if he decides to enter into an exchange agreement with the intent to close escrow only after he has further confirmation of the tax consequences.

However, a purchase agreement or exchange agreement that contains a written contingency provision calling for a third party's approval of some aspect of the transaction, such as the transaction's qualification as an Internal Revenue Code (IRC) §1031 reinvestment plan, also contains an unwritten *implied covenant*

provision. Under the implied covenant provision, before a client can cancel a transaction, he is required to "act in good faith and with fairness" in his efforts to obtain a third party's approval, such as submitting data on the transaction for confirmation from his attorney or accountant.

Thus, the **implied covenant provision** compels the client to actually submit documentation on the transaction to the third party, and to do so within the time period called for after the date of acceptance.

Here, the client's agent usually steps into the chain of events by contacting the third party and providing the paperwork sought to review the transaction for its §1031 tax-exempt status. On review, procedural changes may need to be made to meet the client's objectives and satisfy the objections of the third party. In response, the agent sees to it the changes are made, unless the changes would be inconsistent with the intent of his client regarding his acceptance of the replacement property.

Since fair dealing and reason are implied in every agreement and applied to the conduct of all parties, a termination of the exchange agreement due to the disapproval of an activity or occurrence subject to a contingency provision must be based on a **justifiable reason**.

On a potential disapproval and possible termination due to reasons expressed by the client or his advisor, the agent may well be able to cure the defect that gave rise to the reason for disapproval or to demonstrate that the third party's concern is unfounded, i.e., if it is, in fact or in law, an erroneous conclusion. [**Brown** v. **Critchfield** (1980) 100 CA3d 858]

Tax aspects: a material fact

All real estate in the hands of a seller is classified as either his principal residence, like-kind (§1031) property or dealer property.

An inquiry as to what the seller of property other than a personal residence or dealer property intends to do with the sales proceeds often opens a *window of opportunity*, allowing the agent to review his **tax knowledge** with the seller.

When representing sellers of real estate that, on a sale, would qualify for the §1031 profit reporting exemption, an agent should use a purchase agreement containing a §1031 cooperation provision. [See Form 159 §10.6 accompanying Chapter 53]

A **§1031 cooperation provision** is not an advisory disclaimer by which a broker or agent attempts to relieve himself of his responsibility to give tax advice. Instead, the provision *puts the seller on notice* he is able to avoid profit reporting on the sale and has bargained for the buyer's cooperation should the seller decide to act to qualify his profit for a §1031 exemption.

Again, an agent who is not knowledgeable about the handling required for a §1031 reinvestment can initially avoid a discussion of tax aspects by including the §1031 cooperation provision in the purchase agreement. The §1031 cooperation provision conveys to the seller the seller's need to consider, plan for and inquire about the tax consequences of the sale.

Knowledge of basic tax aspects

Technical questions posed by a seller that go beyond a listing agent's knowledge or expertise requires a truthful response from the agent. In response, the **listing agent** has several ways he can respond, including:

- *disclosing* the extent of **his knowledge** to the seller and *advising* the seller to seek any further advice they may want from another source;

- *associating* with a more knowledgeable broker, a tax attorney or accountant who provides the seller with the advice; or

- *learning* how to handle §1031 reinvestments and giving the advice himself.

Escrow officers are of great assistance to an agent who is aware he has a potential §1031 transaction. Some escrow officers and agents advertise their expertise in handling §1031 tax- deferred reinvestments to broadcast their competitive advantage over other escrow officers and agents.

Ideally, every broker and agent handling the sale of real estate used in the seller's business or held for investment (like-kind property) should, as a **matter of basic competency**, possess an understanding of several fundamental tax concepts, such as:

- the principal residence owner-occupant's $250,000 profit exclusion;

- the separate income and profit categories for each type of real estate;

- the §1031 profit reporting exemption;

- interest deductions on real estate loans;

- depreciation schedules and deductions;

- the $25,000 deduction and real-estate-related business adjustments for rental property losses;

- the tracking of rental income/losses separately for each property;

- profit and loss spillover on the sale of a rental property;

- standard and alternative reporting and tax bracket rates; and

- installment sales, deferred profit reporting.

All of these tax aspects are basic to the sale or ownership of real estate commonly listed and sold by agents. When applicable, they have significant financial impact on sellers and buyers of real estate. Any agent with a working knowledge of the tax aspects of real estate can and should consider offering a wider range of services, including tax advice, when competing to represent buyers and sellers.

Also, giving a seller tax advice concerning a §1031 reinvestment plan when the seller follows the advice always leads to a second fee for negotiating the purchase of the replacement property and coordinating the transfer of funds.

Chapter 34 Prior occupant's use, affliction, and death

This chapter discusses the disclosure of a prior occupant's death or affliction with AIDS.

When and when not to disclose

A real estate broker and his listing agent are employed by a seller to locate a buyer for his real estate. The listing agent soon locates a buyer who wants to purchase the property.

Prior to making an offer, the listing agent hands the buyer the seller's Transfer Disclosure Statement (TDS) disclosing the seller's and agent's knowledge about the present **physical condition** of the property. All other mandatory disclosures are made.

The buyer does not inquire into any deaths which might have occurred on the property. Ultimately, the buyer acquires and occupies the property.

Later, the buyer is informed a prior occupant died on the property from AIDS or HIV. This death occurred **more than three years** before the buyer submitted the offer to purchase the property.

The buyer discovers the listing agent knew of the prior occupant's AIDS affliction and death on the property. The buyer claims the listing agent breached his agency duties by failing to voluntarily disclose this information to the buyer.

Here, a real estate agent has no *affirmative duty* to **voluntarily disclose** information to a potential buyer regarding a prior occupant:

- whose *death*, from any cause, occurred on the real estate **more than three years prior** to the purchase offer; or
- who was *afflicted* with the HIV virus or afflicted with **AIDS**. [Calif. Civil Code §1710.2(a)]

*Editor's note — Deaths on the property which occurred **within three years** of the offer are treated differently.*

Disclosure on inquiry

Consider a buyer who asks the listing agent if any deaths have ever occurred on the property.

On direct inquiry by the buyer or his agent, the listing agent must **disclose his knowledge** of any deaths on the real estate, no matter when they occurred. [CC §1710.2(d)]

An intentional misrepresentation or concealment by any agent in the real estate transaction after a buyer makes a **direct inquiry** is:

- a breach of the listing agent's *general duty* owed to the buyer to truthfully respond when the listing agent represents the seller exclusively; or
- a breach of the buyer's agent's *agency duty* owed the buyer since the agent is the buyer's representative in the transaction. [CC §1710.2(d)]

Further, an **inquiry** by the buyer into deaths indicates that a death on the premises is a fact which might affect the buyer's use and enjoyment of the property, a *material fact*. Thus, an affirmative duty is imposed on the **buyer's agent** to either investigate or recommend an investigation by the buyer before an offer is made, unless the offer includes a contingency on the subject of death.

An agent who discloses, on inquiry, that he does not know if a death occurred on the real estate, or has limited information which he does disclose, should hand the buyer a memorandum stating:

- the buyer has made an inquiry about deaths on the property;
- the agent has disclosed all his knowledge concerning the inquiry; and
- whether the agent will further investigate any deaths on the property.

Deaths affecting market value

An agent's duty to disclose facts known to them which may adversely affect the property's value, called *material facts*, is not limited to disclosures of the property's physical condition.

Consider a buyer who enters into a purchase agreement negotiated by an agent, acting either as the buyer's agent or the listing agent. The offer includes the seller's TDS disclosures about the condition of the property as an attachment. However, the buyer is unaware multiple murders occurred on the property more than three years before the buyer's purchase offer.

The agent **conceals his knowledge** of the murders from the buyer. The agent is aware that the notoriety of the murders *adversely affects* the market value of the property, placing its value below the price the buyer is agreeing to pay.

The transaction closes and the buyer occupies the property. The buyer learns of the murders and sues the agent to collect his price-to-value money losses. He claims the agent had a duty to disclose the deaths since the agent knew the property's market value, due to the stigma of the deaths, was **measurably lower** than the purchase price paid.

The agent claims he does not have a duty to disclose the deaths since they occurred over three years ago and were not required to be disclosed on the TDS.

Did the agent have an affirmative duty to disclose the deaths?

Yes! The deaths had an **adverse affect** on the property's market value and were **material facts** intentionally concealed from the buyer.

Thus, every agent has an affirmative duty to disclose prior deaths when the death **might affect the buyer's valuation** or desire to own the property. [**Reed** v. **King** (1983) 145 CA3d 261]

Desirability based on prior events

Consider a buyer's agent who is aware a death occurred on the real estate **within three years** of a buyer's purchase offer. The value of the property is **not adversely affected** by the death. Thus, the knowledge is not a material fact about the property which needs to be disclosed.

The buyer does not ask his agent if any deaths have occurred on the property.

After closing, the buyer learns of the death and is deprived of the pleasurable use and enjoyment of the property — an **idiosyncracy** of the buyer about death which was unknown to his agent.

The buyer claims his agent breached his special agency duty by failing to disclose the death since it inflicted an intangible harm on the buyer, preventing him from occupying the real estate.

Here, the buyer's agent probably should have inquired of the buyer to determine if a known death might affect the buyer's decision to purchase the property. The buyer's agent does have a greater agency duty to care for and protect the buyer than does a listing agent. Thus, a buyer's agent should disclose any death occurring on the property within three years, especially if he believes the death might affect the buyer's decision to make a purchase agreement offer.

It is the buyer's agent's duty to **investigate and disclose** material facts about the property and the transaction, placing a greater burden on the buyer's agent to know and understand his client, a sort of **know-your-client rule**.

Conversely, the **buyer has a duty** of care, owed to himself, to *inquire and discover* facts to protect his personal interests.

However, whether or not a buyer's agent will be subject to any liability or penalties for not disclosing a death which occurred on the property within three years of the buyer's purchase offer, when the agent was **unaware of the buyer's idiosyncracy** and the death was not a material fact affecting the value of the property, has yet to be reported.

Chapter 35 Income property operating data

This chapter focuses on the data a listing agent needs from a seller on any type of income producing property before the listing agent is able to diligently market the property to prospective buyers.

Fundamentals induce offers

It is said about an income property's operating data that it is both the commencement and conclusion of a transaction.

An income producing property's operating data is gathered and entered on an Annual Property Operating Data (APOD) sheet by the seller or listing agent. The purpose of preparing an APOD is to provide information about the property to prospective buyers or their agents.

By design, the APOD is **intended to induce** prospective buyers to rely on its content to buy the property. Thus, with the presentation of an APOD to a prospective buyer, negotiations have begun.

If negotiations are successful, a prospective buyer enters into a purchase agreement with the seller. The conclusionary act by the buyer and the buyer's agent is the completion of their due diligence investigation into the accuracy of the income data contained in the APOD.

To do so, the buyer's agent reviews the operating expenses, rent rolls, leases and tenant estoppel certificates. If the certificates are substantially the same as the data contained in the APOD and the leases, and the expenses are verified, the transaction closes.

Thus, on close of the transaction, the income and expenses experienced by the property and presented on an APOD by the listing agent have come full circle. The buyer's receipt of the APOD on **introduction** to the property has been tied to the **confirmation** of the APOD figures and the transaction has closed.

Honest start equals strong finish

The price an investor will pay for income producing real estate is set by a property evaluation analysis of data based on different appraisal techniques, one of which is the *income approach*. When another evaluation approach sets a value different than set by the income approach, the lesser of the values should greatly influence the investor's decision on pricing.

This chapter is concerned primarily with the **income approach to valuation** since income is initially used by investors to determine a property's fair market value (FMV) and the ability of the rents to service debt. Here, comparable sales or depreciated replacement cost approaches are of secondary concern.

Rental income and operating expenses produce a property's *net operating income* (NOI). In turn, the property's NOI represents the annual return the property delivers to the owner, which is accounted for as:

- a **return of** the owner's original capital investment, called *depreciation*, (evidenced in part by the principal reduction on purchase-assist loans); and
- a **return on** the owner's capital investment, called a *yield*, (including NOI used to service interest payments on the purchase-assist loans).

Since the NOI represents the investor's annual returns, the information and data entered in an APOD are the **fundamentals** upon which an income property investment is initially judged for setting its market value. Thus, the APOD prepared by the listing agent must contain accurate representations of either:

- **current operations**, as experienced by the seller; or
- an **opinion honestly held** by the agent about future income and expenses which an investor will likely experience as owner of the property.

Thus, a prospective buyer of income property is buying a **future flow** of income (NOI) for which he is willing to pay a price today. This price is the **discounted, present worth** of the property's NOI over the coming years. Further, this is the maximum price the prospective buyer would agree to pay for the property.

By the listing agent's use of an APOD, the prospective buyer is *induced to rely* on the APOD figures to evaluate the property, enter into negotiations, and sign a purchase offer. If the figures hold up under an investigation, the buyer will acquire ownership of the property.

For the listing agent to avoid deceitful and dishonest activities in the inducement, the figures entered in an APOD must have some close relationship to the income and expenses the property actually does or will likely produce. The only known **sources of data** for the APOD figures which the listing agent can draw on are the owner's actual operating records of the property and the operations of comparable properties. Both are readily available to agents on inquiry.

The need for forecasts

Data from comparable properties might demonstrate that the listed property's current operations are producing less rental income and greater expenses than experienced by owners of other properties.

The comparison may justify the preparation of an APOD using figures which are decidedly not reflective of the property's current operating income and expenses. Instead, the APOD figures represent the listing agent's opinion about the property's probable future operations based on the income and expenses experienced by both the listed property and comparable properties.

Here, the listing agent must have a reasonable basis for developing a **rational opinion** about the property's future potential by estimating the anticipated income and expenses. The estimate is the listing agent's *forecast* of income and expenses which the listing agent **honestly believes** has a reasonable likelihood of actually occurring under new ownership.

Thus, two entirely different NOI estimates could logically be presented to a prospective buyer regarding the listed property:

- one based on **current operations** as continuing without a significant change in anticipated income and expenses, properly called a *projection*; and
- the other being an **opinion** of potential income and expenses likely to be experienced in the future, properly called a *forecast*.

The difference in the NOI produced by these two estimates of the property's future annual operations has a profound **financial impact** for the property's value. A $10,000 potential increase in annual NOI over the current NOI experienced by the seller converts, by the financial process of *capitalization of income*, into an increase in value ranging from $80,000 to $120,000. The range depends on the rate of return expected in the marketplace at the time of sale. It is in the best interest of the seller for the listing agent to put forward on an APOD the best set of figures which the listing agent honestly believes an owner could actually achieve.

However, the listing agent must be certain the buyer does not rely on the APOD figures as a *warranty* or anything more than the listing agent's **honestly held belief** that the NOI estimated has a reasonable likelihood of occurring. Listing agents must accompany their optimistic forecasts on APODs with a statement indicating the figures are *opinions* and nothing more.

If the buyer receives positive assurances from the listing agent that the APOD figures are **attainable**, the buyer can rely on the APOD as a *guarantee* of what will occur. Then, the buyer may rely on the data unconditionally presented by the listing agent without further investigation to confirm whether or not the assurances will occur. [**In re Jogert, Inc.** (9th Cir. 1991) 950 F2d 1498]

A contingency provision in the purchase agreement calling for the buyer's further approval of the income and expenses would be prudent to demonstrate that the buyer is not relying on the agent's APOD estimates as a guarantee.

Seller's good-faith assistance

To assist a listing agent to marshall information about a property's operations and prepare an APOD to determine the property's current NOI, the seller must, *in good faith*, provide the listing agent with printouts of his monthly, year-to-date and past 12 months income and expense statements. Either the seller, the property manager or resident manager have or can generate this operating information for the listing agent.

An owner, having employed a listing agent to market his income property and locate a buyer willing to pay the listed price, owes a duty to the listing agent to make a good-faith effort to cooperate and assist the agent to meet the objectives of the employment. Otherwise, the seller *wrongfully interferes* with the agent's ability to successfully market the property (and earn a fee). Without accurate operating data, income property cannot be honestly marketed to prospective buyers.

In turn, the listing agent's duty as the seller's agent is to deliver to his seller the best business advantage **legally achievable**. This duty is tempered by the listing agent's *general duty* owed to prospective buyers to provide them with accurate factual information about the integrity of the property which may adversely affect the value of the property, and to do so before the buyer enters into a purchase agreement.

To meet this affirmative disclosure duty owed to prospective buyers, the listing agent must provide prospective buyers or their agents with information **known or readily available** to the seller or listing agent. These disclosures include information about the operations of the property which **might affect** the decisions of a reasonably prudent buyer regarding acquisition of the property. As a result, the listing agent must present known facts to a prospective buyer in a manner which will not mislead or deceive the buyer by omitting factors adversely affecting the property's value.

If the seller or his property manager are the source of the information on the property's operations, and the listing agent has no reason to believe the data is false, the listing agent has no duty to prospective buyers to investigate the truthfulness (accuracy) of the information. However, the **source of the data** must be disclosed.

The APOD

An APOD, prepared by a listing agent and handed to a prospective buyer, provides operating information on the property, including:

- the **estimated NOI**, for setting the price to be paid and the loan amounts which can be serviced by the income generated by the property;

- the **spendable income**, for providing a cash-flow cushion reflected by the amount of the NOI remaining after servicing the mortgage financing (including information on trust deed balances, monthly payments, interest rates and any due dates); and
- the **income tax consequences** the prospective buyer will likely experience during the first year of ownership due to allowable deductions of interest on trust deed loans and standard depreciation schedules.

In the comment's section of the APOD form, the listing agent enters local trends and factors **known to the listing agent** which may not be observable by a prospective buyer or the buyer's agent when viewing the property, or discoverable by them when reviewing the marketing package. Local trends and factors include currently evolving economic or regulatory conditions which might affect the property's future income or expenses, and thus, impact the prospective buyer's decision to buy or use the property.

Economic impacts include:

- population demographics in the location of the property as decreasing, static or increasing in density;
- the local population's future effect on the appreciation or depreciation of the property's value;
- whether the quality and location of the property will, in the future, support the APOD's income and expense analysis; and
- the rents and expenses experienced by comparable property in the area.

Income property expense ratios

Expenses, as a percentage of scheduled income, are calculated on the APOD in the center column. Percentages are obtained by dividing each expense item by the (100%) scheduled income. [See Form 352 accompanying this chapter]

The percentage calculated for each operating expense alerts the prospective buyer and his agent to data which varies from a range typically experienced by the type of income property involved.

For example, if the percentage allocated to utility expenses is abnormally high compared to other properties, this cost should be evaluated to determine:

- what can be done to bring the utility expenses within the normal percentage range; and
- what effect the expense has on the value of the property, other than reducing the NOI.

Information which needs to be separately disclosed to a prospective buyer so he can determine the property's worth includes recent "spikes" in expense items, such as:

- utilities;
- evictions necessitated by delinquencies;
- security re-evaluations needed due to incidents of crime on the premises;
- loss of a local industry which employs a significant percentage of area tenants;
- assumable or locked-in financing;
- rent control adjustments; and
- loan commitments.

Loan payments

Loan payments entered on the APOD should reflect only the principal and interest payment, separate from any impounded (escrowed) funds deposited with the lender as part of the monthly payment. Impounds, however, should be disclosed elsewhere in the APOD.

Impounds are merely a **reserve** for some of the owner's fixed operating expenses (already figured into the NOI), such as property taxes, improvement district assessments, and the hazard insurance premium. The lender will pay these expenses on behalf of the owner using the impounded funds.

Deposits into an impound account are not a loan charge or an operating expense. However, the lender's later disbursements from the impound account represents payment of the owner's operating expenses.

The amount of any monthly impound deposit will change on transfer of the property's ownership, typically due to an increase in property taxes triggered by reassessment due to the change of ownership. The buyer's agent calculates the increase in the impounds and enters the estimated future impound payment on the APOD, not the seller's present impound payment.

Data approved for release

As a service to his seller, a listing agent can prepare the APOD if all the verifiable rents and expenses are made known to the agent by the seller. Unless a seller is willing to "lay open" the books on the property to the listing agent so its operations are sufficiently transparent to **provide verifiable data** for a prospective buyer, this listing goes nowhere.

Before the listing agent can effectively market the property, the APOD has to be prepared for delivery to prospective buyers. Again, the APOD can be prepared to reflect either:

- the property's **current operations**, which implicitly infers that the figures given will more than likely occur during the following year; or
- the property's **potential future operations**, influenced by income and expenses now experienced by comparable properties and trends in rents and operating expenses in the surrounding area.

When the APOD is completed to the satisfaction of the listing agent and the seller, the seller should **sign a copy** for the listing agent's file. Thus, the seller acknowledges his approval of the contents of the APOD and consents to the release of the figures.

With a seller-approved APOD in the listing file, the APOD becomes the centerpiece of the listing agent's marketing (listing) package to be presented to prospective buyers or buyer's agents.

Duties owed the buyer

A listing agent owes a **general duty** to a prospective buyer and buyer's agent to gather together readily available information on the property and make it available to them without investigation into its accuracy, called **putting the buyer on notice**.

In turn, the **special agency duty** owed the buyer by a buyer's agent is to review the skeletal property information received from the seller and listing agent and advise the buyer as to the inquiry or investigation needed to understand and appreciate the ramifications of the disclosures.

In essence, the seller's listing agent literally hands off to the buyer's agent the decision as to which points raised by the APOD figures need to be checked out to get the remainder of the story and an accurate picture of the property's earning power.

ANNUAL PROPERTY OPERATING DATA SHEET

APOD

DATE: _____, 20_____, at _____, California.

1. PROPERTY TYPE: _____

1.1 Location _____

1.2 APOD figures are estimates reflecting:

a. ☐ Current operating conditions.

b. ☐ Forecast of anticipated operations.

c. Prepared by _____

			%
2. INCOME:			
2.1 **Scheduled Rental Income**	$_____		**100 %**
a. Less: Vacancies, discounts and uncollectibles	– $_____		_____%
b. Less: Credit card charges	– $_____		_____%
2.2 **Effective Rental Income** [Lines 2.1 less 2.1 a and b]	$_____		_____%
a. Other income	+ $_____		_____%
2.3 **Gross Operating Income**	$_____		_____%
3. EXPENSES:			
3.1 Electricity	$_____		_____%
3.2 Gas	$_____		_____%
3.3 Water	$_____		_____%
3.4 Rubbish	$_____		_____%
3.5 Insurance	$_____		_____%
3.6 Taxes	$_____		_____%
3.7 Management Fee	$_____		_____%
3.8 Resident Manager	$_____		_____%
3.9 Office Expenses/Supplies	$_____		_____%
3.10 Advertising	$_____		_____%
3.11 Lawn/Gardening	$_____		_____%
3.12 Pool/Spa	$_____		_____%
3.13 Janitorial	$_____		_____%
3.14 Maintenance	$_____		_____%
3.15 Repairs and Replacements	$_____		_____%
3.16 CATV/Phone	$_____		_____%
3.17 Accounting/Legal Fees	$_____		_____%
3.18 _____	$_____		_____%
3.19 _____	$_____		_____%
3.20 **Total Operating Expense** [Lines 3.1 to 3.19]	– $_____		_____%
4. NET OPERATING INCOME: [Line 2.3 less 3.19]	$_____		**_____%**

5. SPENDABLE INCOME (annual projection):

5.1 **Net Operating Income** (enter from section 4). . . . . $_____ _____%

5.2

	Loan	Principal Balance Amount	Monthly Payment	Rate	Due Date
a.	1st	$_____	$_____	_____%	_____
b.	2nd	$_____	$_____	_____%	_____
c.	3rd	$_____	$_____	_____%	_____

5.3 Total Annual Debt Service [Lines 5.2 a, b and c] . . . . . – $_____ _____%

5.4 **Spendable Income** [Lines 5.1 less 5.3] . . . . . $_____ _____%

6. PROPERTY INFORMATION:

6.1 Price $_____; Loan amounts $_____; Owner's equity $_____.

6.2 Current vacancy rate or vacant space _____%.

6.3 Assessor's allocations for depreciation schedule:
Improvements _____%; Land _____%; Personal property _____%.

6.4 Property disclosures:

a. ☐ Rental Income Rent Roll available; [See **ft** Form 380] ☐ need confidentiality agreement.

b. ☐ Rent control restrictions.

c. ☐ Condition of improvements available: ☐ by owner [See **ft** Form 304-1], ☐ by inspector.

d. ☐ Environmental report available.

e. ☐ Natural Hazard Disclosure Statement available. [See **ft** Form 314]

f. ☐ Soil report available.

g. ☐ Termite report available.

h. ☐ Building specification available.

i. ☐ _____

j. ☐ _____

7. REPORTABLE INCOME/LOSS (annual projection): For Buyer to fill out.

7.1 **Net Operating Income** (NOI) (enter from section 4) . . . . . $_____

7.2 Deductions from NOI

a. Annual interest expense . . . . . $_____

b. Annual depreciation deduction . . . . . $_____

c. Total deductions from NOI . . . . . – $_____

7.3 **Reportable Income/Loss** (annual projection) . . . . . $_____

Broker: _____
Address: _____
_____
Phone: _____ Cell: _____
Fax: _____
Email: _____

I have reviewed and approve this information.
Date: _____, 20_____

Owner's name: _____
Signature: _____
Signature: _____

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For example, the APOD and rent roll sheets may not give **critical details** about leases, such as whether or not any leases might include;

- *free-rent incentives* for a period of time preceding the commencement period stated in the written lease;
- a *downward gradation* in the amount of rent after a six or eight month occupancy on month-to-month tenancies as an incentive for a tenant to remain in possession; or
- an *option to extend* the lease at a fixed rate which might be inconsistent with the prospective buyer's expectations of rental income.

Thus, the terms of occupancy, provisions in the leases, discounts, incentives, options or first-refusal rights to additional space, etc., must be part of the buyer's inquiry, triggered by the disclosure of the fact tenants hold leases and rental agreements.

Quite possibly, the buyer's agent, on completion of the inquiry into the facts behind the numbers on the listing agent's APOD, will himself fill out an APOD form to reflect his own belief about the future operating potential of the property. For the buyer's agent, the APOD prepared as his forecast must be presented as his opinion of what likely will be the performance of the property in the hands of the prospective buyer.

No assurances by the agent equals no guarantees. However, the APOD figures given as an opinion must represent a belief, **honestly held** by the buyer's agent, that the figures have a fair chance of actually occurring in the future.

Due diligence by the buyer's agent

Once the listing agent informs the prospective buyer and the buyer's agent about the property's operating facts by delivery of an APOD, issues concerning the rent and expenses need to be investigated and analyzed by the buyer's agent. Thus, the buyer is assisted in a determination of the probability that the APOD figures will actually be experienced in the future. This **investigation or recommendation** for further inquiry includes:

- a review of any *tenant files*, including lease or rental agreements, application for rent, deposits received, credit report printouts, criminal or other background checks, photocopies of driver's licenses, credit card information for payment of monthly rent and payment history [See **first tuesday** Form 352-1];
- discovering if any units or spaces in the project have a *chronic vacancy* or turnover history requiring a downward adjustment in the price paid for the property;
- a *confirmation of expenses*, by getting quotes if necessary, on what amounts the buyer will be charged, not what the seller has been able to arrange and be charged, for hazard insurance premiums, taxes based on the price to be paid, improvement district assessments, professional management fees, and the management's opinion of APOD projections;
- determining the date of the *last rental increase*, the amount of the increase and the seller's rent increase policy employed during the past few years;
- establishing who has been providing *maintenance*, and what charges can the new owner anticipate (as well as questions on intentionally deferred maintenance);
- a confirmation of the *utilities paid* by the owner and any price fluctuations, past or anticipated;

- a review of any *criminal activity* on the premises as confirmed by the local police department and by inquiry of a few tenants;
- ascertaining the number of *unlawful detainers* (UDs) filed during the past 12 months and why those tenants had to be evicted;
- a review of any *rent control activity*, if the units are locally controlled, and a check with the local agency to determine the property's compliance and the buyer's ability to maintain or attain market rates; and
- a confirmation of any *miscellaneous income* to be received from on-site vending machines, such as laundry room equipment and supplies, food and beverage dispensers and furnishings rented to occupants.

When the buyer's agent is not willing to conduct this due diligence investigation, the agent needs to inform the buyer about the agent's knowledge concerning the data. Further, the buyer's agent needs to advise the buyer on the investigations the agent believes should be undertaken for the buyer to protect the buyer's interest.

Buyer's homeownership expenses

Consider a prospective buyer of a single-family residence (SFR) who intends to occupy the property as his principal residence. The buyer is not concerned about the rent the property will command in the rental market.

However, the buyer is interested in getting information from the seller about the **cost of owning** and operating the SFR he will occupy.

The best way for the buyer to get this data is for the buyer's agent to include a provision in the buyer's purchase agreement calling for the seller to prepare and hand the buyer an occupant's property operating cost sheet. Thus, the seller **discloses the monthly expenses** which have been incurred by the seller as the owner of the property. [See **first tuesday** Form 306 and Form 150 §11.8 accompanying Chapter 51]

Chapter 36 Required disclosures on seller carrybacks

This chapter introduces the financing disclosures agents must make to buyers and sellers in carryback transactions.

Mandated notices

A seller is willing to help **finance the sale** of his one-to-four unit residential real estate by carrying back a note and trust deed, sometimes called an *installment sale* or *credit sale.*

The seller's listing agent locates a qualified prospective buyer. The agent prepares an offer on a purchase agreement form and presents it to the buyer for his approval and signature since the buyer is not represented by an agent.

The terms offered for payment of the purchase price include a note and trust deed, to be signed by the buyer in favor of the seller, for the amount of the price remaining to be paid after the down payment and an assumption of the existing loan on the property.

A **Seller Carryback Disclosure Statement** is attached to the purchase agreement as an addendum. The addendum, prepared by the agent, contains numerous statements on the financial, legal and risk-of-loss aspects of the carryback note and trust deed. [See Form 300 accompanying this chapter]

The information entered in the carryback disclosure statement is based on the terms of the purchase offer, the title conditions, the activities to be undertaken in escrow and information obtained from the buyer.

The agent's completion and presentation of the carryback disclosure form does not address disclosures regarding other important aspects of the carryback paper, which if disclosed, might affect the transactional decisions of the buyer or the seller.

The form contains only the **minimum disclosures** legislatively mandated for inclusion in the carryback disclosure statement.

Both the listing agent and the buyer's agent must be assured their respective clients, in addition to receiving the disclosure statement, understand and appreciate the *risks and consequences* which rise out of the **financial, legal and tax aspects** of the carryback transaction.

Controlled carryback transactions

All brokered transactions for the purchase of **one-to-four unit residential property** involving seller carryback financing are controlled by statute. For one-to-four unit residential properties, a written carryback disclosure statement is required to be presented to both the buyer and seller for their review and signatures. [Calif. Civil Code §§2956 et seq.]

Even the use of a *masked security device*, such as a land sales contract, lease-option and unexecuted purchase agreement with interim occupancy, requires the written carryback disclosures. The written carryback disclosures inform the buyer and the seller about the seriousness of the risks presented by failing to use grant deeds, notes and trust deeds to evidence an installment sale when the buyer takes possession. [See Form 300 and **first tuesday** Forms 300-1 and 300-2]

FINANCIAL DISCLOSURE STATEMENT

For Entering into a Seller Carryback Note

NOTE: This statement is required to be prepared when the seller carries back a note executed by the buyer as part of the sales price for property containing four-or-less residential units. [Calif. Civil Code §2956]

This statement is to be prepared by the broker who obtains the signature of the person who first offers or counteroffers to buy, sell, exchange or option on terms which include a carryback note.

Both the buyer and the seller shall be handed a copy of this statement and sign it to acknowledge they have read and received a copy.

DATE:_____, 20_____, at_____, California.

Items left blank or unchecked are not applicable.

1. This is an addendum to the following agreement:

☐ Purchase Agreement ☐ Option to Purchase (with or without lease)

☐ Counteroffer ☐ Exchange Agreement

1.1 dated _____, 20_____, at _____, California,

1.2 entered into by_____, as the Buyer,

1.3 and_____, as the Seller.

2. This addendum was prepared by _____.

DISCLOSURES:

3. GENERAL INFORMATION CONCERNING THE TERMS OF PAYMENT:

3.1 The Note to be executed by Buyer is in the original amount of $_____, payable in constant monthly _____ installments of $_____ to include _____% per annum interest, with a final/balloon payment due on _____, 20_____, in the approximate amount of $_____.

3.2 The note will be secured by a trust deed on the property referred to as_____ _____.

3.3 Should the Note contain a FINAL/BALLOON PAYMENT, the debt is not fully amortized. When the remaining balance of the Note is due and payable, there can now be no assurance that refinancing, modification or extension of the balloon payment will then be available to Buyer.

3.4 Unless stated and explained in an attached ARM addendum, the Note contains a fixed rate of interest with no variable or adjustable interest rates which would increase payments or result in a negative amortization of the debt. [See **ft** Form 155-1]

3.5 Unless otherwise agreed, the original amount of the Note will be adjusted by endorsement at the close of escrow to reflect differences in the then remaining balance of any underlying trust deed obligation(s) being assumed or obtained.

3.6 ☐ The Note and trust deed to be carried back by Seller is of the all-inclusive variety, and will contain provisions passing through to Buyer any prepayment penalties, late charges, due-on sale or further encumbrance acceleration and future advances due on the underlying wrapped loans.

4. SPECIAL PROVISIONS AND DISCLOSURES CONCERNING THE CARRYBACK NOTE AND TRUST DEED:

4.1 ☐ The all-inclusive Note and trust deed to be carried back by Seller contains provisions calling for Seller to place the Note on contract collection with any institutional lender or real estate broker, other than Seller, and the collection agent will be instructed to first disburse funds on payments due senior encumbrances. **NOTE: Inclusion of this provision may cause adverse income tax consequences for Seller.**

4.2 A joint protection policy of title insurance will be delivered to Buyer and Seller insuring their interests in title on the close of escrow.

4.3 The trust deeds and grant deeds to be executed will be recorded with the county recorder at the close of escrow.

4.4 Seller will be named, through escrow, as a loss payee under the hazard and fire insurance obtained by Buyer.

4.5 A tax reporting service ☐ will, or ☐ will not, be obtained by Buyer for Seller. If not obtained, Seller will assure himself that real estate taxes have been paid while he holds the Note.

4.6 ☐ Requests for Notice of Default and Notice of Delinquency under California Civil Code Sections 2924b and 2924e will be recorded and served on behalf of Seller on encumbrancers senior to the carryback.

4.7 Seller is aware that in the event of a default under the carryback Note and trust deed, his sole source of recovery is limited to the net proceeds from a foreclosure sale or his subsequent resale of the real estate; and he is not entitled to rental value for Buyer's occupancy or a deficiency money judgment under the Note. [Calif. Code of Civil Procedure §580b]

4.8 Buyer ☐ shall, or ☐ shall not, receive net proceeds or cash back upon the close of escrow. Amount to be received is $_____; source of funds _____; reason for receipt _____.

4.9 The Note shall include the following provision: "This note is subject to Section 2966 of the Civil Code, which provides that the holder of this note shall give written notice to the trustor, or his successor in interest, of prescribed information at least 90 and not more than 150 days before any balloon payment is due."

5. ENCUMBRANCES SENIOR AND PRIOR TO SELLER'S CARRYBACK TRUST DEED AND NOTE:

5.1 Conditions of encumbrances, with priority over Seller's carryback Note and trust deed, which will remain or be placed of record at time of closing are as follows:

	First Trust Deed	Second Trust Deed
Original balance	$_____	$_____
Current balance	$_____	$_____
Interest rate	_____% ☐ ARM	_____% ☐ ARM
	Type: _____	Type: _____
Monthly payments	$_____	$_____
Due date	_____, 20____	_____, 20____
Balloon payment	$_____	$_____
Current defaults	$_____	$_____

5.2 If any of the senior encumbrances contain a due date, it may be difficult or impossible to refinance, modify or extend the balloon payment in the conventional mortgage marketplace.

6. BUYER CREDIT INFORMATION (SUPPLIED BY BUYER):

6.1 Buyer to hand Seller a completed credit application on acceptance. [See **ft** Form 302]

6.2 Seller may terminate the agreement within _____ days of receipt of the credit application by delivering to Buyer, Buyer's Broker or Escrow written Notice of Cancellation based on Seller's disapproval of Buyer's credit. [See **ft** Form 183]

7. BROKER DISCLOSURES:

7.1 Credit data is supplied by Buyer. Broker knows of no falsity or omission concerning Buyer's credit information.

7.2 This statement and its contents are statutorily required disclosures and do not limit Broker's duties to disclose other material facts about Seller to Buyer or Seller about the carryback financing arrangements and which are known to Broker or his agent.

7.3 Buyer and Seller are not to sign this statement until they have read and understood all of the information in it. All parts of the form must be completed before signing below.

7.4 ☐ See attached addendum for additional disclosures which are part of this disclosure. [See **ft** Form 250]

8. OTHER: _____

_____

Date:_____, 20_____	Date:_____, 20_____
Buyer's Broker: _____	Seller's Broker: _____
By: _____	By: _____
I have read and received a copy of this statement.	**I have read and received a copy of this statement.**
Date:_____, 20_____	Date:_____, 20_____
Buyer: _____	Seller: _____
Buyer: _____	Seller: _____

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On a sale, any credit extended by the seller to accommodate the buyer's deferred payment of the purchase price for a one-to-four unit residential property requires a written carryback disclosure statement when the credit extended to the buyer includes:

- interest or other finance charges;
- five or more installments running beyond one year;
- an installment land sales contract;
- a purchase lease-option or lease-option sale;
- credit (note) to adjust equities in an exchange of properties; or
- an all-inclusive note and trust deed (AITD). [CC §2957]

Further, carryback transactions creating straight notes which do not bear interest or include finance charges are **not controlled**. However, the carryback disclosures should be included as a matter of good brokerage practice since the risks and issues for the buyer and seller remain much the same.

Now consider a real estate agent who is acting as a property manager or leasing agent negotiating a lease for the landlord of a single-family residence (SFR).

A prospective tenant makes an offer to lease which contains an **option to buy** the property. The terms for payment of the price under the proposed option include:

- a carryback note, to be executed on exercise of the purchase option (on expiration of the lease) for the balance of the seller's equity in the property after a down payment; and
- part or all of the lease payments applying as a **credit toward the price** or down payment.

Here, the tenant's offer to lease under a purchase option **builds up an equity** in the property due to the rent credit to the price. Thus, the agent is required to make the mandated carryback financing disclosures on a written form as an addendum to the lease-option. [See **first tuesday** Form 300-2]

Who prepares the disclosure

The carryback disclosure statement must be **prepared and submitted** to all parties in a carryback transaction on one-to-four unit residential property by:

- the real estate broker, or his agent, **negotiating** the carryback sales transaction and preparing the buyer's purchase offer on behalf of a buyer or seller for a fee; or
- the buyer or seller if either one is a real estate licensee or attorney, when neither the buyer nor the seller is represented by a broker. [CC §2957(a)(2)]

When both the buyer and seller are represented by different brokers, the carryback disclosure statement is prepared by the broker or his agent who prepared the buyer's offer.

Offer includes disclosures

As a minimum requirement, the carryback disclosure statement is to be signed by the buyer and seller **prior to closing** the carryback sales escrow. [CC §2959]

However, after a purchase agreement has been entered into, and until the carryback disclosure statement is approved by the buyer and seller in a one-to-four unit transaction, a **statutory contingency** exists in favor of the buyer allowing the buyer to cancel the transaction. The contingency does not arise if the carryback disclosure statement is attached as an addendum to the offer or counteroffer.

If the buyer has a reasonable basis for disapproval of the carryback disclosures he receives after entering into a purchase agreement, the buyer may cancel the transaction and terminate his obligation to purchase the property.

However, the buyer may not arbitrarily cancel the sale when he is presented with the carryback disclosure statement for his acknowledgment and approval during escrow. To cancel, the buyer must act in good faith, by showing the carryback disclosures are inconsistent with his **reasonable expectations** when he entered into the purchase agreement.

After closing, the only legal remedy available to the buyer or seller for inadequate or nonexistent financial disclosures is to pursue the broker for any money losses actually incurred as a result of the nondisclosure. The judicial remedy for failure of the broker or his agent to make mandated carryback disclosures would be no less than a return to the injured party of brokerage fees received on the transaction, based on a failure of agency duties.

Thus, the best policy for the **buyer's agent** is to eliminate the need for further approval of the statutory carryback disclosures by preparing and attaching the carryback disclosure statement as an addendum to the purchase agreement. If it is not attached, it would be prudent for the **listing agent** to include it as an addendum to a counteroffer.

When neither agent prepares and includes the disclosures as an addendum in the offers, the buyer's agent becomes responsible for preparing the disclosures and obtaining both the buyer's and seller's approval before closing.

Contingency to confirm expectations

Consider a buyer and seller of a single-family residence who enter into a purchase agreement. The terms call for carryback financing in the principal amount of $50,000 with an interest rate of 9%, monthly payments on a 30-year amortization and a five-year due date.

The purchase agreement does not state the amount of the balloon payment due on the carryback note at the end of five years. The risks imposed and the consequences of a five-year due date are not discussed.

A carryback financial disclosure statement is not presented to the buyer or seller for their signatures as part of the purchase agreement or counteroffer. Thus, closing is automatically contingent on the buyer's and seller's **further approval** of the financial and legal aspects of the carryback note and trust deed as presented in the carryback disclosure statement.

Prior to closing, the buyer is handed the carryback disclosure statement. He discovers his final balloon payment at the end of five years will be approximately $48,300. The buyer is now concerned about the financial risks of loss of ownership five years after closing. He has no assurance he will be able to refinance, modify or extend the note, much less have the ability to accumulate funds for payoff of the final/balloon payment.

The buyer cancels the purchase agreement and escrow, claiming he did not previously realize the extent of the financial risk created by the due date in the carryback financing. He is now aware he could be forced, by the due date, to either sell the property or lose it to foreclosure should he be unable to arrange refinancing or an extension of the carryback note.

Can the buyer cancel the transaction prior to closing?

Yes! The buyer did not sign the carryback disclosure statement prior to agreeing to buy — a failure which triggers the **statutory further-approval contingency**. The risk of loss imposed by the amount of the due date payoff is far greater than the buyer realized when entering into the purchase agreement. Thus, the buyer has justification for exercising his right to cancel.

Buyer's ability to pay

A buyer's ability to meet the terms and conditions of the carryback note is of great importance to a seller who is carrying back a note on a sale. Thus, the listing agent must alert his seller to facts about the buyer's financial condition which are known to the broker and not previously disclosed to his seller.

For example, a listing agent locates a buyer willing to purchase his seller's property.

The agent advises the seller that the buyer is financially qualified to handle the large cash down payment, but will require carryback financing for the remainder of the purchase price.

Believing his agent's representations regarding the buyer's financial qualifications, the seller agrees to carry paper to finance the sale.

Before escrow closes, the buyer tells the agent he does not have the cash down payment and will need to obtain a loan. The listing agent does not disclose the buyer's lack of capital to the seller. Further, the listing agent makes the buyer a money loan to help fund the down payment.

Escrow closes and the buyer takes title to the property. Soon the buyer defaults on the carryback note and trust deed held by the seller. The seller suffers a total loss on his carryback note due to a foreclosure sale on the first trust deed.

The seller then discovers his listing agent made a separate loan to the buyer for the down payment. The seller also discovers the agent knew the buyer was financially unstable prior to closing.

Here, the listing agent has an agency duty to advise the seller about the buyer's reduced financial capability to repay the carryback note, a significant fact which **came to the agent's attention** prior to closing. Thus, the listing agent and the agent's broker are liable to the seller for the seller's money losses on the carryback note since the listing agent failed to disclose his knowledge of the buyer's revised or altered financial status. [**Ziswasser** v. **Cole & Cowan, Inc.** (1985) 164 CA3d 417]

A seller willing to carry back paper needs to know if the prospective buyer will be able to make the payments and pay the operating costs incurred as owner of the property. As carryback financing becomes more prevalent during periods experiencing a declining real estate market or tight mortgage money conditions, more unqualified buyers are produced with whom agents must contend.

As part of the carryback disclosures, the listing agent has an **affirmative duty** to obtain a written financial statement from the buyer and hand it to the seller of one-to-four unit residential property. [See Form 300 §4 and **first tuesday** Forms 207 and 208]

The primary purpose of the carryback disclosure statement is to inform the seller the risks he was exposed to as an owner are far different from those being a lender. Owners and lenders are bound by different rules based on the respective ownership and security interests they hold in the real estate. [See **first tuesday** Form 202]

For example, while the buyer is concerned with paying no more than the *fair market value* (FMV) for a property, the carryback seller is concerned with his *loan-to-value (LTV) ratio*, whatever may be the price, since he will become a "financier" on the close of escrow.

Typically, a seller wants to receive the highest sales price negotiable for his real estate. However, the seller as a "carryback lender" wants assurance the buyer's down payment is a large enough percentage of the purchase price to establish adequate equity value in the real estate to allow for a full recovery of the carryback note in the event of a default which requires the seller to foreclose.

Chapter 37 Seller's net sales proceeds estimate

This chapter instructs on the listing agent's use of a checklist to prepare an estimate and disclose the expenses a seller will likely incur to fix up the property for marketing, provide reports to prospective buyers, and close a sale.

Financial consequences of a sale

Probably the most pressing concern sellers of real estate have about selling is the amount of money they will receive for their property on a sale. Seller's know the net amount they receive on closing is **not the full amount** of the purchase price. However, the amount they will receive is a **calculable part** of the price.

A seller may not straight out ask the listing agent what amount escrow will hand him in exchange for conveying his property to a buyer. However, the serious nature of the unspoken concern the seller has about the amount of money he will carry away from the closing is implicit. Sellers always want to know the amount of money they will **actually receive** as *net sales proceeds* for transferring ownership.

The sole reason for employing an agent is to convert the **seller's equity** into cash by selling the property at the highest possible price.

Significantly, a seller on listing his property for sale has a **motive** which drives his decision to acquire cash, if only for the opportunities cash makes available to him. The motives range from the disposal of real estate no longer of use or in foreclosure, to the need for cash to accomplish a personal, business or investment objective. The seller may want to acquire a replacement home or a premises for his trade or business, invest in equities, bonds, or commodities markets, or simply put the cash into savings.

However, the ordinary seller has little idea how to figure the dollar amount of net proceeds a sale of his property will bring. A seller's initial belief is that the net sales proceeds will be roughly equal to his equity in the property, less a brokerage fee. The notion of retrofitting property and complying with governmental safety regulations, as well as lender payoff penalties or buyer's demands for repairs, is not known to most sellers — until disclosed.

Further, the asking price is unadjusted for the need to fix up the property and to clear the property of structural pests and accumulated defects so the property can be properly marketed.

On the other hand, agents have a working understanding of all the expenses a seller is most likely to be confronted with to market, sell and close escrow on a property.

A reasonable estimate of the likely net sales proceeds on any sale should be first prepared on a **seller's net sheet** at the listing stage and again when reviewing offers or updating the net sheet figures when changes become known. [See Form 310 accompanying this chapter]

For a listing agent, a down side always exists when making disclosures regarding net sales figures. The information might cause a prospective client to decide not to sell, or cause a seller of listed property to reject an offer and counter at a price needed by the seller but unacceptable to a buyer. It is for these pricing decisions that the net sheet information is a **material fact** requiring an *affirmative disclosure* by the listing agent of the figures which comprise the seller's net sheet and the seller's bottom line.

GOOD FAITH ESTIMATE OF SELLER'S NET SHEET PROCEEDS

On Sale of Property

NOTE: This net sheet is prepared to assist the Seller by providing an estimate of the amount of net sales proceeds the Seller is likely to receive on closing, based on the price set in the agreement, the estimated amount for expenses likely to be incurred to market the property and close a sale, and any adjustments and pro rates necessitated by the sale.

The figures estimated in the net sheet may vary at the time each is incurred due to periodic changes in charges for professional services, administration fees and work enforcement made necessary by later inspections, and thus constitute an opinion, not a guarantee by the preparer.

If the property disposed of is IRC §1031 property and the seller plans to acquire replacement property, use a §1031 Profit and Basis Recap Sheet to compute the tax consequences of the Seller's §1031 Reinvestment Plan. [See **ft** Form 354]

DATE: _____, 20_____, at _____, California.

1. This is an estimate of the fix-up, marketing and transaction expenses Seller is likely to incur on a sale, and the likely amount of net sales proceeds Seller may anticipate receiving on the close of a sale under the following agreement:

☐ Seller's listing agreement ☐ Purchase agreement ☐ Counteroffer

☐ Escrow instructions ☐ Exchange agreement ☐ Option to buy

1.1 dated _____, 20_____, at _____, California,

1.2 entered into by _____, as the Seller, and

1.3 _____, as the Buyer,

1.4 regarding real estate referred to as _____.

1.5 The day of the month anticipated for closing is _____.

2. SALES PRICE:

2.1 Price Received. . . . . (+)$_____

3. ENCUMBRANCES:

3.1 First Trust Deed Note . . . . . $_____

3.2 Second Trust Deed Note . . . . . $_____

3.3 Other Liens/Bonds/UCC-1 . . . . . $_____

3.4 TOTAL ENCUMBRANCES: [Lines 3.1 to 3.3] . . . . . (–)$_____

4. SALES EXPENSES AND CHARGES:

4.1 Fix-up Cost . . . . . $_____

4.2 Structural Pest Control Report . . . . . $_____

4.3 Structural Pest Control Clearance . . . . . $_____

4.4 Property/Home Inspection Report . . . . . $_____

4.5 Elimination of Property Defects . . . . . $_____

4.6 Local Ordinance Compliance Report . . . . . $_____

4.7 Compliance with Local Ordinances . . . . . $_____

4.8 Natural Hazard Disclosure Report . . . . . $_____

4.9 Smoke Detector/Water Heater Safety Compliance . . . . . $_____

4.10 Homeowners' (HOA) Association Document Charge . . . . . $_____

4.11 Mello-Roos Assessment Statement Charge . . . . . $_____

4.12 Well Water Reports . . . . . $_____

4.13 Septic/Sewer Reports . . . . . $_____

4.14 Lead-Based Paint Report . . . . . $_____

4.15 Marketing Budget. . . . . $_____

4.16 Home Warranty Insurance. . . . . $_____

4.17 Buyer's Escrow Closing Costs . . . . . $_____

4.18 Loan Appraisal Fee . . . . . $_____

4.19 Buyer's Loan Charges . . . . . $_____

4.20 Escrow Fee. . . . . $_____

4.21 Document Preparation Fee . . . . . $_____
4.22 Notary Fees . . . . . $_____
4.23 Recording Fees/Documentary Transfer Tax . . . . . $_____
4.24 Title Insurance Premium. . . . . $_____
4.25 Beneficiary Statement/Demand . . . . . $_____
4.26 Prepayment Penalty (first). . . . . $_____
4.27 Prepayment Penalty (second). . . . . $_____
4.28 Reconveyance Fees . . . . . $_____
4.29 Brokerage Fees . . . . . $_____
4.30 Transaction Coordinator Fee . . . . . $_____
4.31 Attorney/Accountant Fees . . . . . $_____
4.32 Other _____ . . . . . $_____
4.33 Other _____ . . . . . $_____
4.34 TOTAL EXPENSES AND CHARGES [Lines 4.1 to 4.33] . . . . . (–)$_____

5. ESTIMATED NET EQUITY: . . . . . (=)$_____

6. PRO RATES DUE BUYER:
6.1 Unpaid Taxes/Assessments . . . . . $_____
6.2 Interest Accrued and Unpaid . . . . . $_____
6.3 Unearned Rental Income . . . . . $_____
6.4 Tenant Security Deposits . . . . . $_____
6.5 TOTAL PRO RATES DUE BUYER [Lines 6.1 to 6.4] . . . . . (–)$_____

7. PRO RATES DUE SELLER:
7.1 Prepaid Taxes/Assessments . . . . . $_____
7.2 Impound Account Balances . . . . . $_____
7.3 Prepaid Association Assessment . . . . . $_____
7.4 Prepaid Ground Lease . . . . . $_____
7.5 Unpaid Rent Assigned to Buyer . . . . . $_____
7.6 Other _____ . . . . . $_____
7.7 TOTAL PRO RATES DUE SELLER [Lines 7.1 to 7.6]. . . . . (+)$_____

8. ESTIMATED PROCEEDS OF SALE: . . . . . (=)$_____

8.1 The estimated net proceeds at line 8 from the sale or exchange analyzed in this net sheet will be received in the form of:
a. Cash . . . . . $_____
b. Note secured by a Trust Deed. . . . . $_____
c. Equity in Replacement Real Estate. . . . . $_____
d. Other _____ . . . . . $_____

I have prepared this estimate based on my knowledge and readily available data.	**I have read and received a copy of this estimate.**
Date: _____, 20_____	Date: _____, 20_____
Broker: _____	Seller's Name: _____
Agent: _____	Signature: _____
Signature: _____	Signature: _____

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Costs of sale as a material fact

A **material fact** is information which, if known to a client, might affect the client's decisions, such as a seller's decision to enter into a listing or accept an offer to buy.

If the information, such as sales expenses, closing costs or the net proceeds of a sale, is known to the seller, the listing agent has no obligation to disclose it. However, if the information may affect a decision to be made by the seller and the information about sales **costs is not fully known** to the seller or is **more readily available** to the listing agent than to the seller, the costs must be disclosed to the seller to meet the listing agent's obligations under his *special agency duties* owed to his client.

It is best to prepare and review a net sheet with a seller, regardless of whether the seller requests or even declines to review a net sheet. The time and effort needed to prepare a net sheet is a small premium to pay to assure the agreed fee is not attacked at the time of closing should the seller claim he thought he was to receive a greater amount as net proceeds.

Analyzing the net sheet estimates

A listing agent prepares a Good Faith Estimate (GFE) of Seller's Net Sales Proceeds, **first tuesday** Form 310, to inform his client about the expenses the seller will likely incur on the disposition of his real estate by sale.

The estimates entered on the form by the seller's broker or listing agent must be based on information **known** by them or **readily available** to them on the inquiry of others or on minimal investigation about each item of expense they anticipate the seller will incur. Thus, the figures entered as estimates reflect the listing agent's **honestly held belief** that the amounts estimated will likely be experienced by the seller.

Brokerage events triggering a listing agent's preparation of the net sheet and a review of its contents with the seller for the sale of property include:

- soliciting or entering into a seller's listing agreement;
- submitting a buyer's purchase agreement offer;
- entering into a counteroffer; and
- entering into an exchange agreement offer or acceptance.

The net sheet is used by a listing agent for the purpose of disclosing to the seller the crucial financial information surrounding expenditures required to:

- put the property in a condition attractive to the greatest number of prospective buyers;
- comply with local retrofit ordinances and current safety standards;
- eliminate defects and infestation; and
- provide the listing agent with reports for delivery to prospective buyers which contain information on the physical condition of the property, the nature of the property's location, the expenses of ownership and any other aspects regarding the integrity of the property that have a measurable impact on the property's value.

The GFE of Seller's Net Sales Proceeds form consists of four sections, each serving an entirely separate purpose in the setting of the amount of net proceeds to be received by a seller on a sale. The sections list:

- the **encumbrances** of record, including any improvement district bonds, trust deeds and possible abstracts of judgment or tax liens to be assumed, reconveyed or released;
- the **expenses** of a sale, including repair and renovation expenditures, fees for investigative reports and closing charges paid by the seller;
- **adjustments and pro rates** for unpaid or prepaid items and any tenant deposits to be taken over by the buyer; and
- the **net proceeds** remaining after deducting all sales-related expenses, fees and charges, as well as the form of the net proceeds.

Preparing the seller's net sheet

The following instructions are for the preparation and use of the Good Faith Estimate of Seller's Net Sales Proceeds – On Sale of Property, **first tuesday** Form 310, with which a seller's agent may prepare an estimate for an analysis of the costs the seller will likely incur in the preparation, marketing and sale of the property. The disclosure of this data to the seller is necessary for the seller to make an informed decision regarding whether to sell, and if so, on what terms and conditions.

Each instruction corresponds to the number given each item in the form.

*Editor's note — **Enter** figures throughout the net sheet in the blanks provided, unless the item is not intended to be included in the final estimate, in which case it is left blank.*

Document identification:

Enter the date and name of the city where the net sheet is prepared. The date is used when referring to this form.

1. **Check** the appropriate box to indicate the underlying agreement which is the subject of this disclosure. **Enter** the identification date, the name(s) of the parties to the underlying agreement, the address or parcel number identifying the property for sale, and the day of the month on which escrow is to close for pro rations and adjustments.

2. **Sales price:**

   2.1 *Price received:* **Enter** the amount of the sales price to be paid by the buyer.

3. **Encumbrances:**

   3.1 *First trust deed note:* **Enter** the dollar amount of the principal balance remaining due on any first trust deed loan of record as noted on loan payment records held by the seller, whether the loan is to be assumed or paid off on closing.

   3.2 *Second trust deed note:* **Enter** the dollar amount of the principal balance remaining due on any second trust deed loan of record as noted on loan payment records held by the seller, whether the loan is to be assumed or paid off on closing.

3.3 *Other liens/bonds/UCC-1:* **Enter** the total dollar amount of the principal balance and any accrued unpaid interest on any judgment liens, tax liens and improvement district bond liens encumbering the property, and any UCC-1 liens on any personal property which are part of the sale, whether the liens will be assumed or paid off on closing.

Editor's note — Some purchase agreements, in their provisions for handling improvement district bond liens, omit any accounting on the transfer of title subject to a lien for the balance of an improvement district bond with annual installments. Annual installments on the improvement bond lien are treated in these purchase agreements as pro rates of both the principal and interest installment amounts, without concern for an accounting of the principal balance which remains unpaid.

3.4 *Total encumbrances:* **Add** the figures entered in sections 3.1 through 3.3. **Enter** the total as the dollar amount of debts encumbering the property, whether assumed by the buyer or paid off on closing.

4. **Sales expenses and charges:**

4.1 *Fix-up cost:* **Enter** the dollar amount estimated to cover the costs it is anticipated the seller will incur to ready the property for previews by other agents, caravans, walk-throughs by prospective buyers and open house viewings, such as the cost to add color to the landscaping, paint outside trim and any interior walls showing wear and tear, and replace any plumbing or electrical fixtures which are beyond repair or of unacceptable appearance.

4.2 *Structural pest control report:* **Enter** the dollar amount of the fee a pest control operator will charge to conduct a physical inspection and submit a report on his findings and provide an estimate of the costs of repairs necessary to eliminate any infestation and repair any existing damage or condition allowing for infestation. These are property conditions most buyers do not want to acquire.

4.3 *Structural pest control clearance:* **Enter** the dollar amount estimated to cover the cost it is anticipated the seller will incur for fumigation or to correct damage from an infestation or conditions supporting an infestation. The amount estimated will need to be reviewed and updated on receipt of the structural pest control report.

Also, the amount estimated should be considered when setting any ceiling in a counteroffer on the costs the seller might be willing to incur to correct the adverse condition of his property.

4.4 *Property/home inspection report:* **Enter** the dollar amount of the fee a home inspection company will charge to conduct a physical inspection of the property and submit a report on their observations of defects existing on the property.

4.5 *Elimination of property defects:* **Enter** the dollar amount estimated to cover the cost it is anticipated the seller will incur to eliminate, by repair or replacement, any conditions not up to building or safety codes, such as malfunctioning or defective components, e.g., the roof, electrical wiring, plumbing, heating, the foundation, walls, fences, doors, and appliances. The amount estimated will need to be reviewed and updated on receipt of a property/home inspection report.

Also, the amount estimated should be considered when setting any ceiling in an offer or counteroffer of the amount of costs the seller might be willing to incur to correct the condition of his property for transfer.

4.6 *Local ordinance compliance report:* **Enter** the dollar amount of the fee a local government agency charges to inspect the property and submit a report on its findings and the corrections required to be completed before transfer of ownership and occupancy may occur.

4.7 *Compliance with local ordinances:* **Enter** the dollar amount estimated to cover the cost it is anticipated the seller will incur for retrofitting, curative permits, and any repairs necessary to meet local ordinance standards as a requisite to a change in ownership or occupancy. The amount estimated will need to be reviewed and updated on receipt of the local agency's compliance report.

4.8 *Natural Hazard Disclosure report:* **Enter** the dollar amount of the fee charged by a third party for a review of the county records and the preparation and submission of a report on the natural hazards the property is subjected to due to its location.

4.9 *Smoke detector/water heater safety compliance:* **Enter** the dollar amount of the cost it is anticipated the seller will incur to install smoke detectors and the water heater anchors or bracing which are necessary to comply with safety standards.

4.10 *Homeowners' association (HOA) document charge:* **Enter** the dollar amount of the fees charged by any owners' association connected to the property for their delivery of a complete marketing packet of documents comprised of restrictions, operations, budgets, insurance and other documents mandated to be handed to the prospective buyer, and their delivery to escrow of their statement of condition of assessments.

4.11 *Mello-Roos assessment statement charge:* **Enter** the dollar amount of the fee charged for a statement of assessments to be provided by any improvement district which holds a lien on the property to secure the repayment of bonds issued by the improvement district.

4.12 *Well water reports:* **Enter** the dollar amount of the combined fees which will be charged by a licensed well-drilling contractor to test and certify the capacity of any well on the property, and by a licensed water testing lab to test and report on the quality of the water produced by the well.

4.13 *Septic/sewer reports:* **Enter** the dollar amount of the fee charged by a licensed plumbing contractor to test and certify the function of the sewage disposal system, and if it contains a septic tank, whether it is in need of pumping.

4.14 *Lead-based paint report:* **Enter** the dollar amount of the fee charged by an environmental testing company to investigate and report on the lead content of paint on the premises.

4.15 *Marketing budget:* **Enter** the dollar amount of any contribution (to be) made by the seller toward the expenses of marketing the property and locating prospective buyers.

4.16 *Home warranty insurance:* **Enter** the dollar amount of the premium the seller agrees to pay as charged by a home warranty insurance company to issue a policy to the buyer.

4.17 *Buyer's escrow closing costs:* **Enter** the dollar amount of the combined escrow closing costs incurred by the buyer which the seller agrees to pay.

4.18 *Loan appraisal fee:* **Enter** the dollar amount of any loan appraisal fee the seller will agree to pay which will be charged to determine the property's qualification for the purchase-assist loan which will be applied for by the buyer.

4.19 *Buyer's loan charges:* **Enter** the dollar amount of any loan charges the seller will agree to pay which the buyer will incur for the purchase-assist loan needed to fund the price to be paid for the property. These loan charges are also referred to as non-recurring loan charges.

4.20 *Escrow fee:* **Enter** the dollar amount of the charge the seller will incur for escrow services to process the closing of the sale.

4.21 *Document preparation fee:* **Enter** the dollar amount of the charge the seller will incur, usually with escrow, for a third party to prepare the documents necessary for the seller to convey the property, such as grant deeds and bills of sale.

4.22 *Notary fees:* **Enter** the dollar amount of the charge the seller will incur for services provided by a notary to acknowledge the seller's signature on documents which are to be recorded to accomplish the transfer of the property (grant deed, spousal quit claim deed, release of recorded instruments, power-of-attorney, etc.).

4.23 *Recording fees/documentary transfer tax:* **Enter** the dollar amount of the combined recording charges and transfer taxes collected by the county recorder and paid by the seller to convey title.

4.24 *Title insurance premium:* **Enter** the dollar amount of the premium the title insurance company will charge for issuance of a policy of title insurance conveying the seller's conveyance of the property.

4.25 *Beneficiary statement/demand:* **Enter** the dollar amount of the combined fees the trust deed lender of record will charge for delivering a beneficiary statement or payoff demand to escrow which is needed to either confirm the loan balance on an assumption or subject-to transaction, or the amount of a payoff of the loan on closing a sale.

4.26 *Prepayment penalty (first):* **Enter** the dollar amount of any penalty the first trust deed lender will charge on a payoff of the loan on close of a sale.

4.27 *Prepayment penalty (second):* **Enter** the dollar amount of any penalty the second trust deed lender will charge on a payoff of the loan on close of a sale.

4.28 *Reconveyance fees:* **Enter** the dollar amount of reconveyance fees and recording fees the trustees on the trust deeds of record will charge to release the trust deed liens from the record title to the property sold.

4.29 *Brokerage fees:* **Enter** the dollar amount of the fees earned by the brokers which will be paid by the seller on the close of escrow for the sale of the property.

4.30 *Transaction coordinator fee:* **Enter** the dollar amount of the fee charged the brokers which the seller will pay for a third party to assist the listing agent in the preparation of the listing package and the sales package to provide all the documentation necessary to close the transaction.

4.31 *Attorney/accountant fees:* **Enter** the dollar amount estimated as the attorney fees and accounting fees the seller will incur as a result of their advice and assistance in the sale.

4.32 *Miscellaneous expense:* **Enter** the name of the further expense. **Enter** the dollar amount of the expense.

4.33 *Miscellaneous expense:* **Enter** the name of the further expense. **Enter** the dollar amount of the expense.

4.34 *Total expenses and charges:* **Add** the figures entered in sections 4.1 through 4.33 **Enter** the total as the dollar amount of the expenses and charges on the sale.

5. **Estimated net equity: Subtract** the figures entered in sections 4.4 and 4.34 from the figure entered at section 2.1 **Enter** the difference as the dollar amount of the estimated net equity, an amount against which s and adjustments are next made to calculate the estimated net sales proceeds generated by the sale.

6. **Pro rates due buyer:**

6.1 *Unpaid taxes/assessments:* **Enter** the dollar amount of those real estate taxes and improvement district bond assessments which have accrued and have not been paid by the seller if they are to be pro rated without a credit to the price for the remaining principal due on bonds under section 3.3.

Taxes have not been paid for one of two reasons: they are not yet due to be paid to the tax collector or they are past due and delinquent. If they are not yet due, the taxes which accrued during the seller's ownership will be paid by the buyer at a later date. Thus, taxes are pro rated as a credit to the buyer through the **last day prior** to the date of closing. The pro ration is calculated as a daily amount of the annual tax based on a 30-day month. The current tax bill or, if it is not yet available, the past year's amounts are used (and adjusted for up to 2% inflation, etc.) to arrive at the daily amount of the pro ration.

Editor's note — For example, if escrow is scheduled to close September 16, the tax billing has not yet been received and (if it has been) it has not been paid. Thus, 75 days of accrued taxes/assessments at the daily rate are credited to the buyer (and charged to the seller).

6.2 *Interest accrued and unpaid:* **Enter** the dollar amount of interest accrued and unpaid on loans assumed under sections 2.1 through 3.3 for the number of days during the month the seller will remain the owner prior to closing. The pro ration will be calculated as a daily amount of interest paid in monthly installments based on a 30-day month. The daily amount of interest accruing is credited to the assuming buyer for each day of the month prior to the day scheduled for closing since interest on loans is paid after the running of the monthly accrual period. Thus, the current installment will become the obligation of the buyer, unless the installment is disbursed by escrow and charged pro rata to each the seller and the buyer.

6.3 *Unearned rental income:* **Enter** the portion of the dollar amount of rent from the rent rolls, both prepaid and unpaid, which will remain unearned on the day scheduled for closing. The buyer is entitled to a credit of the unearned portion as a pro ration. The day of closing is the first day of ownership by the buyer and entitles the buyer to unearned rents for the entire day. The pro ration is calculated as a daily amount of the rent roll earned (accrued) based on a 30-day month.

Editor's note — For example, if the rents are $30,000 monthly, the daily pro ration for earned rents would be $1,000 and be multiplied by the number of days remaining in the month, beginning with and including the day of closing. If closing is on the 16th, the dollar amount of pro rated rents credited to the buyer from funds accruing to the seller's account on closing would be $15,000, the 16th being day one of the remainder of the 30-day month.

For unpaid delinquent rents shown on the rent roll, see section 7.5 for an offset charge to the buyer by an adjustment.

6.4 *Tenant security deposits:* **Enter** the dollar amount of all the security deposits held by the seller (as landlord) which belong to the tenants as disclosed on the seller's rent roll information sheet. This credit is an **adjustment in funds**, not a pro ration, which is due the seller on closing since the buyer on transfer of ownership will be the landlord (by assignment of the leases and rent agreements) and responsible for the eventual accounting to the tenants for any deposit held by the seller.

Editor's note — Include any interest accrued and unpaid on the security deposits from the date of the seller's receipt of the deposits if mandated by rent control or landlord-tenant law.

6.5 *Total pro rates due buyer:* **Add** the figures estimated in sections 6.1 through 6.4. **Enter** the total as the dollar amount of all the "credits" the buyer can anticipate due to pro rations and adjustments.

7. Pro rates due seller:

7.1 *Prepaid taxes/assessments:* **Enter** the dollar amount of real estate taxes and improvement assessments prepaid by the seller which have not yet accrued. The calculations are made in the same manner as explained in section 6.1.

Editor's note — For example, the seller has paid all installments of taxes/assessments for the entire fiscal year (July through June). A closing of the buyer's transaction on January 2 requires a pro ration charge to be paid by the buyer for one-half year's taxes and assessments since they have been prepaid, but will not accrue until after the buyer closes escrow.

7.2 *Impound account balances:* **Enter** the dollar amount of any impounds held by the lender on loans assumed under sections 3.1, 3.2 or 3.3. The information is readily available as an "escrow account" item on the lender's monthly statement of the loan's condition received by the seller from the lender servicing the loan.

7.3 *Prepaid association assessment:* **Enter** the dollar amount of the prepaid and unaccrued portion of the seller's current installment for any owners' association assessment. The pro ration charge is based on a 30-day month for those days remaining in the month beginning with the day of closing as day one of the days remaining in the month.

7.4 *Prepaid ground lease:* **Enter** the dollar amount of the prepaid and unaccrued portion of rent the seller has paid on the ground lease if the property interest being purchased is a leasehold interest transferred by assignment, not a fee interest transferred by grant deed.

7.5 *Unpaid rent assigned to buyer:* **Enter** the portion of the dollar amount of delinquent unpaid rents to be charged to the buyer if the seller will not collect the rent before the close of escrow. These unpaid rents belong to the buyer on closing due to the seller's assignment of the leases to the buyer, unless other arrangements are made for an accounting of the uncollected rents. Typically, a closing after the tenth of the month will not experience the need for a delinquent rent adjustment. (Rents have been pro rated in section 6.3.)

7.6 *Miscellaneous pro rates and adjustments:* **Enter** the name of other items to be d or adjusted in the transaction. **Enter** the dollar amount charged to the buyer.

7.7 *Total pro rates due seller:* **Add** the figures estimated in sections 7.1 through 7.6. **Enter** the total as the dollar amount of all the "charges" the buyer is likely to experience due to pro rations and adjustments.

8. *Estimated proceeds of sale:* **Add** the figures in sections 5 and 7.7, and then **subtract** the figure in section 6.5 from the sum. **Enter** the difference as the total dollar amount of the estimated net proceeds generated by the sale.

8.1 *Form of net sales proceeds:* **Enter** the dollar amount of the net sales proceeds estimated in section 6 allocated to cash, carryback note, equity received in exchange or other form of consideration the seller will be receiving on the sale.

Signatures:

Broker's/Agent's signature: **Enter** the date the seller's net sheet is signed, the broker's name and the agent's name. **Enter** the broker's (or agent's) signature.

Seller's signature: **Enter** the date the seller signs and the seller's name. **Obtain** the seller's signature.

Chapter 38 Buyer's estimated acquisition costs

This chapter presents the use of a checklist by a buyer's agent to identify, analyze, and disclose the funding requirements a buyer undertakes when agreeing to acquire property.

The capital to buy

During every real estate business cycle, a time comes when buyers collectively refuse or become unable to pay ever higher prices. Gone then are the back-up buyers and forgotten are the previously ever-present multi-offer auctions surrounding nearly every fresh listing of property.

Thus begins a multi-year descendency of real estate prices. The drop in prices is usually brought about by the end of a cyclical real estate bubble, evidenced by excessive asset inflation and low mortgage rates.

It is during this evolving buyer's market of descending prices and ever more anxious sellers that real estate agents have difficulty attracting buyers, either as clients they will represent or as prospective buyers of properties they have listed. For agents, a **clientele of buyers** becomes financially more rewarding during the transition into a buyer's market than a pile of property listings.

However, buyers are reticent about buying while this corrective phase of the real estate business cycle is taking place. With its soft prices and plentiful supply of inventory for buyers to consider, this **period of price correction** will eventually reflect sales-to-listing ratios indicating less than 25% of the existing listings are selling each month (with a bottom of less than 10% sold during the period of 2008 and 2009).

Agents generally face a decline in overall sales activity until prices stabilize and begin to rise. In the interim, the less ingenious and most disconnected agents will fail to maintain a livelihood in real estate sales. They will pursue employment elsewhere.

Disclosures as confidence builders

To reverse the trend in buyer apathy toward acquiring real estate during these corrective transitions, the "sales" approach used by agents needs to be altered. Buyers can no longer be rushed to purchase since they have no sense of urgency when prices are dropping. Valuations placed on properties by seller's now seem pricey to buyers, yet listing agents tend to defend against any thought of a price reduction as though their job was that of a "marketmaker," not "matchmaker."

Buyers under these market conditions will not **first jump** into a purchase agreement contract and sort out the facts later, conduct typical during the run up to the peak of a real estate sales bubble. They now want the **facts first**, and will not act until they have them.

To combat an oversold real estate market, sellers and their listing agents must be more forthcoming with property information when placing a property on the market, rather than stalling until they have a buyer in escrow at an agreed price.

Buyer's agents adjust more quickly than listing agents to the cyclical shift from a seller's market long on buyers to a buyer's market long on sellers and inventory. They simply marshall information on a property and analyze it **before making an offer,** rather than doing so later as is too often the case when competition between buyers is keen.

To accommodate individuals who are hesitant about buying now, or to encourage others, such as tenants, who have not previously considered buying real estate, the initial step taken by an agent striving to become a buyer's representative is to **financially qualify** the individual as both a mortgage borrower and prospective buyer.

An individual buyer must have **access to cash** to pay the price and costs of acquiring property. Beyond the cash available in savings or readily liquidated investments (stocks/bonds), arranging purchase-assist mortgage financing is nearly always a requisite to establishing what price and costs of acquisition an individual will be able to pay.

With financing comes lender, mortgage banker and loan broker charges to originate the loan. Loan origination charges greatly exceed the costs of all other services required to buy property, except for brokerage fees.

Amount and source of funds

To document the cash a prospective buyer can bring together from all his available sources to **fund the purchase** of a property, the buyer's agent uses a worksheet, called a *buyer's cost sheet*. The worksheet helps the agent identify and itemize the estimated-in-good-faith costs of acquisition and financing, as well as the buyer's sources of funding. The buyer's agent then reviews the completed form with the prospective buyer. [See Form 311 accompanying this chapter]

The **maximum price** a prospective buyer can offer to pay for a property is determined by the amount of available funds from all sources which remains after deducting the acquisition costs. It is this residual amount of funds available for payment of a property's price which sets the value of a property to the buyer, not the seller's listing price. Sellers and their listing agents tend to ignore this reality as interest rates rise, but take full advantage of the rule when rates fall.

Obviously, the primary source of cash for nearly all buyers of any type of real estate is a purchase-assist loan from a mortgage lender. Before a cost sheet review with the buyer can go beyond identifying the various sources of cash available to the buyer, the agent must arrange a conference with a mortgage banker's representative.

The objective of the conference with a mortgage banker is two fold:

- to determine the maximum gross dollar amount of purchase-assist, fixed-rate loan funds the buyer will be *pre-approved* to borrow (if the property qualifies); and

- the lender's (good-faith) cost estimate of the dollar amount of all costs the buyer will incur to originate the maximum fixed-rate loan he is qualified to borrow.

These two dollar amounts (the loan and its costs) are treated as mutually exclusive amounts, separately analyzed on the buyer's cost sheet. The lender's estimated costs of borrowing will be entered on the agent's cost worksheet to document the amount of funds the buyer will need to pay for all transactional and financing costs. Separately, the total amount of the loan the buyer qualifies to borrow will be entered on the buyer's cost worksheet as cash available from a purchase-assist loan source.

During the conference with the mortgage banker, the buyer's agent needs to inquire about any restrictions the lender may place on the loan commitment. For example, a loan-to-value ratio may require a minimum down payment by the buyer of up to 20% of the price paid for a property.

Also, limitations might be placed on the seller's payment of the buyer's nonrecurring transactional and financing costs, such as permitting the seller's payment of all, a ceiling amount or none at all.

With knowledge of any lender restrictions, the buyer's agent can structure purchase agreement offers to shift large amounts of transactional and financing charges to the seller. Thus, the charges will be paid by the seller out of funds the seller receives from the buyer, not paid by the buyer, which would reduce the funds he has available to buy property. Here, the buyer can acquire a more valuable property since he will have more funds for payment of the purchase price.

Certainty of costs builds confidence to buy

Having determined the prospective buyer's costs of financing and the transactional charges he will incur to acquire a property, a high level of certainty about the price he can pay and the amount of the buyer's nonrecurring acquisition and financing costs he will incur is made known to the buyer. What remains for the buyer's agent to do is locate suitable properties and write up a purchase agreement offer agreeable to the buyer.

Buyers combat declining prices and alleviate their tendency to wait before buying by making an offer at a price they feel comfortable paying for a property. Thus, pricing is based on their knowledge the real estate market is in a descendency, the property's condition, and their capacity to arrange for payment of the negotiated price and bear the costs of financing and closing escrow.

The task of complying with the agent's duty to **care for and protect** the buyer begins with the gathering of data to complete the preparation of the cost sheet. The process ends by making offers to come up with the match the buyer wants.

Cost of carrying property

While a review of the costs of acquisition is under way, many other related disclosure situations will come to the attention of the buyer's agent.

For example, a separate cost analysis involves the ongoing **operating expenses** any buyer will likely incur as the owner of property. Operating expenses are obtained from the listing agent or compiled by the buyer's agent from data readily available to the seller, and reviewed with the prospective buyer. [See **first tuesday** Form 562]

Also, a drop in prices is usually a loss in the present worth of a property brought about by an increase in long-term interest rates. Prices and mortgage rates eventually move in opposite directions. Important to buyers during times of rising long-term interest rates is the understanding that the **price paid and costs** incurred to acquire property are *unalterable* in the future once escrow closes on the purchase.

This is not true for **interest rates**. A high interest rate on a loan required to finance payment of the purchase price of a property can be reduced by *refinancing* during later periods of cyclically lower interest rates. The original purchase price paid, if too high, is unalterable.

GOOD FAITH ESTIMATE OF BUYER'S ACQUISITION COSTS

On Acquisition of Property

NOTE: This cost sheet is prepared to assist the buyer to estimate the total cost of acquisition for a property to anticipate the amount of funds likely needed to close, and the source of these funds.

The figures estimated in this cost sheet may vary at the time of closing due to periodic changes in lender demands, escrow fees, other charges and prorates, and thus constitute an opinion, not a guarantee of the preparer.

If acquiring IRC §1031 replacement property, also use a §1031 Profit and Basis Recap Sheet to compute the income tax consequences of the transaction. [See **ft** Form 354]

DATE: _____, 20_____, at _____, California.

1. This is an estimate of acquisition costs and the funds required to close the following transaction:

☐ Purchase Agreement ☐ Exchange agreement ☐ Counteroffer ☐ Escrow Instructions ☐ Option

1.1 entered into by _____,

1.2 dated _____, 20_____, at _____, California,

1.3 regarding real estate referred to as _____

_____.

2. EXISTING FINANCING ASSUMED:

2.1 First Trust Deed of Record . . . . . $_____

2.2 Second Trust Deed of Record . . . . . $_____

2.3 Other Encumbrances/Liens/Bonds . . . . . $_____

2.4 TOTAL Encumbrances Assumed [lines 2.1 to 2.4] . . . . . (+)$_____

a. If loan balance adjustments are to be made in cash, the total funds required to close escrow at §10 and §12 will vary.

3. INSTALLMENT SALE FINANCING:

3.1 Seller Carryback Financing . . . . . (+)$_____

4. NEW FINANCING ORIGINATED:

4.1 New Loan Amount . . . . . (+)$_____

4.2 Points/Discount . . . . . $_____

4.3 Appraisal Fee . . . . . $_____

4.4 Credit Report Fee . . . . . $_____

4.5 Miscellaneous Origination Fees . . . . . $_____

4.6 Prepaid Interest . . . . . $_____

4.7 Mortgage Insurance Premium . . . . . $_____

4.8 Lender's Title Policy Premium . . . . . $_____

4.9 Tax Service Fee . . . . . $_____

4.10 Loan Brokerage Fee . . . . . $_____

4.11 Other _____ . . . . . $_____

4.12 TOTAL New Financing Costs [lines 4.2 to 4.11] . . . . . (+)$_____

5. PURCHASE COSTS AND CHARGES:

5.1 Assumption Fees (First) . . . . . $_____

5.2 Assumption Fees (Second) . . . . . $_____

5.3 Escrow Fee . . . . . $_____

5.4 Notary Fee . . . . . $_____

5.5 Document Preparation Fee . . . . . $_____

5.6 Recording Fee/Transfer Taxes . . . . . $_____

5.7 Title Insurance Premium . . . . . $_____

5.8 Property Condition Reports . . . . . $_____

5.9 Cost of Compliance Repairs . . . . . $_____

5.10 Other _____ . . . . . $_____

5.11 Other _____ . . . . . $_____

5.12 TOTAL Closing Costs [lines 5.1 to 5.11]. . . . . (+)$_____

5.13 Down Payment on Price . . . . . (+)$_____

6. TOTAL ESTIMATED ACQUISITION COST [lines 2.4, 3.1, 4.1, 4.12, 5.12 and 5.13] . . . . . (=)$_____

6.1 No post-closing repairs or renovation cost are included here.

7. FUNDS REQUIRED TO CLOSE ESCROW:

7.1 Down Payment On Price (From line 5.13) . . . . . (+)$_____

7.2 Closing Costs (From line 5.12) . . . . . (+)$_____

7.3 New Loan Proceeds (From line 4.1) . . . . . (+)$_____

7.4 New Financing Costs (From line 4.12). . . . . (+)$_____

7.5 Impounds for New Financing . . . . . (+)$_____

7.6 Hazard Insurance Premium . . . . . (+)$_____

8. PRORATES DUE BUYER AT CLOSE:

8.1 Unpaid Taxes/Assessments . . . . . $_____

8.2 Interest Accrued and Unpaid . . . . . $_____

8.3 Unearned Rental Income. . . . . $_____

8.4 Tenant Security Deposits . . . . . $_____

8.5 TOTAL Prorates Due Buyer [lines 8.1 to 8.4] . . . . . (-)$_____

9. PRORATES DUE SELLER AT CLOSE:

9.1 Prepaid Taxes/Assessments . . . . . $_____

9.2 Impound Account Balance. . . . . $_____

9.3 Prepaid Homeowners' Assessment . . . . . $_____

9.4 Prepaid Ground Lease Rent . . . . . $_____

9.5 Unpaid Rents assigned to Buyer . . . . . $_____

9.6 Other _____. . . . . $_____

9.7 TOTAL Prorates Due Seller [lines 9.1 to 9.6] . . . . . (+)$_____

10. TOTAL FUNDS REQUIRED TO CLOSE ESCROW: [lines 7.1 to 7.6, less 8.5 plus 9.7]. (=)$_____

10.1 See §2.4.a. adjustments.

11. SOURCE OF FUNDS REQUIRED TO CLOSE ESCROW:

11.1 New First Loan Amount (From line 4.1) . . . . . $_____

11.2 New Second Loan Amount (Net loan proceeds). . . . . $_____

11.3 Third-Party Deposits . . . . . $_____

11.4 Buyer's Cash . . . . . $_____

12. TOTAL FUNDS REQUIRED TO CLOSE ESCROW: (Same as line 10). . . . . (=)$_____

I have prepared this estimate based on my knowledge and readily available data.	**I have read and received a copy of this estimate.**
Date: _____, 20_____	Date: _____, 20_____
Broker: _____	Buyer's Name: _____
Agent: _____	Signature: _____
Signature: _____	Signature: _____

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Reducing and shifting the costs

Taxwise, a further source of an additional minimal amount of cash to cover the costs of acquiring property is available to buyers who **itemize deductions** on their federal tax returns. Loan origination fees or points incurred to finance the purchase can be deducted (even if paid by the seller) to reduce the buyer's taxable income (and thus the amount of taxes paid) for the year of purchase. As a result, more funds are freed by a tax refund (or reduced payment).

For example, payment to the lender of 2% of the loan amount for **origination fees** will produce a rebate (or subsidy) to the buyer by way of a reduction in federal income taxes equal to 1/3 to 2/3 of a percent of the purchase price paid for the property. The amount of the refund depends on the buyer's low-income (10%-15%) or high-income (28%-35%) tax bracket status and the amount of the buyer's adjusted gross income.

Also, buyers who finance their purchase under government-insured finance programs can attend **homeownership classes** and earn credits which will cut their costs of acquiring financing. In a buyer's market, potential first-time buyers, such as tenants, can be encouraged to consider homeownership by attending one of these lender-provided classes. The purpose is to learn about the benefits and obligations of owning real estate. The financing costs charged by the lender will be reduced when the prospective buyers decide to purchase after completing such a course.

Sellers, in an effort to maintain price, often are willing to extend credit in some form of **carryback financing,** a method for the buyer to finance the purchase price. For a buyer, seller carryback financing avoids all the costs of new financing.

If the **interest rate** charged by the seller on the carryback is low enough (below market), the price paid can be above market. The buyer's reduced long-term carrying costs arguably justify payment of the above-market price, one offsetting the other based on the dollar amount saved in interest. However, the buyer should always ask for, and hopefully receive, an option to pay off the carryback early and at a discount to keep the purchase price realistic should the buyer later decide to sell or refinance the property.

During the early stages of a buyer's market, and continuing until prices bottom out and become stable, buyers who make offers must be prepared to have their offers rejected. Historically, sellers and listing agents are slow to acknowledge that prices have in fact stopped rising on comparable properties.

When sellers finally recognize that market values are declining, they tend to panic by accepting huge price reductions. At some point they realize that buyers are entering the market in increasing numbers and the bottom of the price cycle has arrived.

Once buyers become addicted to the possibilities of price and cost reductions, buyer's agents will need to be ever more creative to keep costs down as sales volume increases. One maneuver for shaving a sizeable dollar amount off the price of property is for buyer's agents to track suitable properties by the date the listing expires. On expiration of the listing, an inquiry of the seller by the buyer's agent for the sole purpose of submitting an offer, not for soliciting a dual agency listing, is likely to open up a price advantage for the buyer.

Here, the advantage for the buyer amounts to a price paid of around 3% less for the property (than the previously listed price). The buyer's agent will still receive the same amount for a fee as he would have received had a higher price been paid under a listing and the brokerage fee been shared with the listing agent (who did not locate a buyer).

Motivating individuals to own

The objective of agents in a buyer's market of declining prices, increasing inventory and fewer sales is to **create buyers**, not sales.

No longer can agents concentrate primarily on listing property and be successful. Primary attention must now be given to potential and prospective buyers, to educate them and demonstrate why they should be represented by a buyer's agent.

Thus, **locating buyers** is no longer best accomplished by listing and marketing property for sale. Individuals who are qualified to be a buyer of real estate must be attracted to the market by inducements other than publishing property listings and holding auctions or open houses.

Most potential buyers are tenants occupying apartments, condominium units or single-family residences. They have a job and thus can qualify for a purchase-assist loan to enter into ownership. These tenants are sought out by agents through business, social, civic, athletic and religious networks.

New arrivals to the community should be contacted by advertisements located in airports, train stations and bus terminals to convert the new arrivals to homeownership. A kiosk in a shopping mall (or airport) manned by an agent might solicit tenants to fill out a homeownership application for the agent to review and advise on the homeownership available to the tenant.

Finally, the issue of the agent's need to enter into an **employment agreement** before the agent undertakes the representation of an individual needs to be addressed.

Whether the need for a written employment is broached with the potential buyer **before making** a thorough loan qualification analysis and a review of the costs of acquisition or **afterward**, when the prospective buyer's financial capability and price range have been established, a buyer's listing agreement certainly should be obtained before commencing a search for qualified properties the buyer might deem suitable to own.

Analyzing the cost sheet estimates

The Good Faith Estimate of Buyer's Acquisition Costs, **first tuesday** Form 311, is used by buyer's brokers and their agents to inform a prospective buyer about the cost of acquiring a particular parcel of real estate they have located and feel is suitable for acquisition by the buyer. The form contains a checklist of bookkeeping items typical of most purchases, including acquisition costs, financing charges, prorations, funds required for acquisition and the buyer's probable sources for these funds.

The **estimates** entered on the form by the buyer's agent must be based on information about transactional costs and financing charges both known to him or readily available to him on an inquiry of others or on minimal investigation. Thus, the figures entered must reflect the agent's **honestly held belief** that the estimated amount will likely be experienced by the buyer should the buyer acquire the property under consideration.

The cost sheet is used to disclose the crucial **financial information** the buyer needs to know about the acquisition of a property. With it, the buyer's agent provides the buyer with a high level of **transparency** about the costs of acquisition. Thus, the prospective buyer is able to make an informed decision about the financial commitment needed to purchase the property.

The events triggering the buyer's agent's preparation of a cost sheet and a review of the costs with the prospective buyer include:

- entering into a buyer's listing agreement;
- pre-qualifying for a maximum loan amount; and
- entering into a purchase agreement offer or accepting a counteroffer.

The cost sheet is also used to **solicit tenants**, residential or nonresidential, to consider the purchase of property. With it, the agent can demonstrate whether the tenant has the financial capability to occupy a comparable property as an owner instead of as a tenant, be it a home or business premises.

Each section in Form 311 has a separate purpose. The sections cover:

- the **acquisition costs** of the property (cost basis);
- the **closing charges** (including prorations and adjustments); and
- the buyer's **source of funds** (savings, gifts, loans, etc.).

Preparing the buyer's cost sheet

The following instructions are for the preparation and use of the Good Faith Estimate of Buyer's Acquisition Costs – On Acquisition of Property, **first tuesday** Form 311, with which the buyer's broker and his agent can prepare an estimate for an analysis of the buyer's ability to pay the price and all the costs and charges related to the purchase.

Each instruction corresponds to the provision in the form bearing the same number.

*Editor's note — **Enter** figures throughout the cost sheet in the blanks provided, unless the items left blank are not intended to be included in the final estimate.*

Document identification:

Enter the date and name of the city where the cost sheet is prepared. This date is used when referring to this form.

1. **Check** the appropriate box indicating the underlying agreement which is the subject of this disclosure of costs.

   1.1 **Enter** the name(s) of the parties to the agreement.

   1.2 **Enter** the date of the agreement and place of preparation.

   1.3 **Enter** the address or parcel number identifying the property involved.

2. **Existing financing assumed:**

   2.1 *First trust deed of record:* **Enter** the dollar amount of the first trust deed loan balance if the buyer is to take over the loan.

   2.2 *Second trust deed of record:* **Enter** the dollar amount of the second trust deed loan balance if the buyer is to take over the loan.

2.3 *Other encumbrances/liens/bonds:* **Enter** the dollar amount of the principal balance remaining on any other money obligations which the buyer is to take over, such as liens for improvement district bond assessments (Mello Roos, 1915 Act, etc.), abstracts of judgment, UCC-1 security agreements (on personal property/improvements included in the purchase) or other debts to be assumed by the buyer.

2.4 *TOTAL encumbrances assumed:* **Add** the figures estimated in sections 2.1, 2.2 and 2.3. **Enter** the total as the dollar amount of the principal balance on debts to be assumed or otherwise taken over by the buyer as part of the price.

a. *Funds to close escrow will vary*: Each estimated figure may vary by the time of closing, depending on the accuracy of the estimates, principal reduction on existing loans and changing service charges, fees and premiums. Also, if the difference in amounts is to be adjusted into the cash down payment, the amount of funds required to close escrow at sections 10 and 12 will vary. Adjustments into price, such as in an equity purchase transaction, merely adjust the total consideration paid to the seller, not the amount of the down payment or any carryback note and trust deed. Likewise, adjustments for the differences into any seller carryback leaves the price and down payment unaffected, but will alter the amount of the carryback note at section 3.1 by the time escrow closes.

3. **Installment sale financing:**

3.1 *Seller carryback financing:* **Enter** the dollar amount of the note the buyer is to execute in favor of the seller. This amount will vary if adjustments at closing are to be made into the carryback note, and not into the down payment or the price.

4. **New financing originated:**

4.1 *New loan amount:* **Enter** the dollar amount of the new trust deed loan the buyer is to originate with a lender to provide purchase-assist funds to close escrow. The total amount of the loan is entered without reduction for any lender discounts, costs, fees or charges.

4.2 *Points/discount:* **Enter** the dollar amount of the points to be paid or the discount charged to originate the new loan, a figure usually calculated as a percentage of the new loan amount.

4.3 *Appraisal fee:* **Enter** the dollar amount the new lender will charge for an appraisal of the property to be purchased. Upon request, the buyer is entitled to a copy of the appraisal from the lender. [See **first tuesday** Form 200-3]

4.4 *Credit report fee:* **Enter** the dollar amount of the credit report fee charged by the lender for ordering the report and analyzing the buyer's creditworthiness.

4.5 *Miscellaneous origination fees:* **Enter** the total dollar amount of all other fees charged by the lender to process the loan, including fees labelled as escrow set-up fees, administrative fees, processing fees, origination fees, wire fees, document preparation fees, etc., which are **not itemized** in sections 4.2 through 4.11.

4.6 *Prepaid interest:* **Enter** the dollar amount of prepaid interest the new lender will demand for closing before the last day of the calendar month. The interest charge will be a daily amount due for each day following closing through the last day of the month in which the sale closes. This prepayment of interest allows for the first installment on the loan to be due on the first day of the first month falling more than 30 days after closing.

4.7 *Mortgage insurance premium:* **Enter** the dollar amount of any private mortgage insurance (PMI), mortgage insurance premium (MIP) or other insurance premium to be paid by the buyer to guarantee payment for losses the lender may suffer on a default. The amount is a quote by a corporate or government insurer based on the loan-to-value ratio and the amount of the loan. A further creditworthiness risk review of the buyer is conducted by the insurer, which could alter the premium or the availability of the insurance.

4.8 *Lender's title policy premium:* **Enter** the dollar amount of the premium charged by the title company to issue a separate lender's policy of title insurance (in addition to the owner's policy at section 24) to cover the existence of the security interest in the property as evidenced by the lender's trust deed lien.

4.9 *Tax service fee:* **Enter** the dollar amount charged by a separate service company which informs the lender when the buyer has not paid the property taxes.

4.10 *Loan brokerage fee:* **Enter** the dollar amount of any fees due a loan broker for arranging the new loan for the buyer. Do not include any financial benefit (kickback/referral fee) paid the brokers or sales agents by the lender since they are paid from increased fees or above-market interest rates the lender charges the buyer.

4.11 *Miscellaneous loan charges:* **Enter** the name of any other loan charge to be incurred by the buyer due to the new loan origination. **Enter** the dollar amount of the charge.

4.12 *TOTAL new financing costs:* **Add** the figures estimated in sections 4.1 through 4.11. **Enter** the total as the dollar amount of all the expenditures anticipated to be incurred by the buyer to originate a new loan.

5. **Purchase costs and charges:**

5.1 *Assumption fees (first):* **Enter** the dollar amount of the anticipated assumption fees the existing first trust deed lender will likely demand if the lender's consent is required for the buyer to take over the loan.

5.2 *Assumption fees (second):* **Enter** the dollar amount of the anticipated assumption fees the existing second trust deed lender will likely demand if the lender's consent is required for the buyer to take over the loan.

5.3 *Escrow fee:* **Enter** the dollar amount of the service charge the buyer will incur for an escrow to handle the closing of the purchase agreement.

5.4 *Notary fee:* **Enter** the dollar amount of the charges the buyer will incur for notary services to acknowledge the buyer's signature on documents which are to be recorded to purchase the property (trust deeds, power of attorney, spousal quit claim deeds, declaration of homestead, release of recorded instruments, request for NOD/NODq, UCC-1 filing, etc.).

5.5 *Document preparation fee:* **Enter** the dollar amount of any additional miscellaneous fees charged by escrow for providing escrow-related services.

5.6 *Recording fee/transfer taxes:* **Enter** the dollar amount of charges imposed or collected by the county recorder and paid by the buyer for recordings which are necessitated by the transfer.

5.7 *Title insurance premium:* **Enter** the dollar amount of the title insurance premium the title company will charge for issuing a policy to the buyer if the buyer is to pay the premium. Typically, the seller pays the premium to acquire the insurance which covers the seller's conveyance to the buyer.

5.8 *Property condition reports:* **Enter** the total dollar amount of fees and charges it is anticipated the buyer will incur to investigate and confirm the condition of the property (its land, improvements and components) as known to the buyer by both the buyer's observations and disclosures made by the seller or the listing agent prior to entering into the purchase agreement.

Editor's note — The seller's broker or listing agent has a statutory duty, owed to prospective buyers on the sale of one-to-four residential units, to personally conduct a ***visual inspection*** *of the property and enter on the mandated seller's Transfer Disclosure Statement (TDS) any* ***observations*** *he may have contrary to the seller's disclosures. The TDS is to be made available to prospective buyers at the earliest opportunity during the negotiating stage. The first opportunity to disclose rarely occurs later than at the time a purchase agreement offer is accepted.*

However, the listing agent too often deliberately delays an investigation or certification of a property's condition until after the buyer has committed himself to purchase the property (in its undisclosed condition). Thus, the buyer, in a effort to confirm the property is all he has been lead to believe it is, must himself obtain the reports and certifications to discover the conditions which were known (or should have been known) and not disclosed by the seller or the listing agent prior to entering into the purchase agreement, a form of fraud called ***negative deceit.***

Such reports, clearances and certificates include pest control reports, local occupancy certificates, sewer/septic certificates, home inspection reports, well water condition certificates, hazard reports, safety compliances, etc. It is the buyer's agent, not the seller's listing agent, who is duty bound to see to it his buyer has been informed about inspections and investigations readily available to the buyer, and explain which he believes the buyer should use to check out the property.

5.9 *Cost of compliance repairs:* **Enter** the dollar amount of the costs it is anticipated the buyer will incur to correct, retrofit or eliminate defects in the property prior to or immediately after closing, which will not be eliminated by the seller.

5.10 *Miscellaneous closing costs:* **Enter** the name of any additional costs it is anticipated or believed the buyer will incur to acquire the property prior to or immediately after closing. **Enter** the dollar amount estimated as likely to be incurred.

5.11 *Miscellaneous closing costs:* See instructions for section 5.10.

5.12 *TOTAL closing costs:* **Add** the figures estimated for sections 5.1 through 5.11. **Enter** the total as the dollar amount of all costs it is anticipated the buyer will incur to close escrow.

5.13 *Down payment on price:* **Enter** the dollar amount of the down payment the buyer has agreed to pay the seller through or outside of escrow, whether the funds are from the buyer's cash reserves, gifts and bonuses from third parties, or a brokerage fee credited to the buyer's account due to the buyer's participation as a licensee in the transaction.

Editor's note — This sum of money for the down payment does not include any loan funds to be paid over to the seller from the new loan under section 4.1, or charges, prorations and adjustments reflected in section 10.

6. **Total estimated acquisition cost: Add** the figures from sections 2.4, 3.1, 4.1, 4.12, 5.12 and 5.13. **Enter** the total as the approximate dollar amount of monetary commitments in cash or loan amounts which the buyer will be committing himself to pay.

   6.1 *Post-closing repairs:* This cost figure does not include any capital contribution to be made by the buyer to pay for the cost of any renovation, rehabilitation or reconstruction of any part of the property to be incurred immediately after closing, which will become part of the buyer's cost of acquisition for tax reporting purposes.

7. **Funds required to close escrow:**

   7.1 *Down payment on price:* **Enter** the dollar amount from section 5.13.

   7.2 *Closing costs:* **Enter** the dollar amount from section 5.12.

   7.3 *New loan proceeds:* **Enter** the dollar amount from section 4.1.

   7.4 *New financing costs:* **Enter** the dollar amount from section 4.12.

   7.5 *Impounds for new financing:* **Enter** the dollar amount of the deposit of buyer's funds into the lender's loan escrow account the lender will demand if the new loan under section 4.1 is to be impounded for the future payment of property taxes, assessments and hazard insurance premiums.

Editor's note — When disbursed by the lender, these expenditures from the impound account become the operating expenses of the buyer. They are not, now or then, a cost of acquiring the property (but are nonetheless an out-of-pocket advance made prior to closing).

   7.6 *Hazard insurance premium:* **Enter** the dollar amount of the premium the buyer will be advancing for hazard insurance coverage on the property.

Editor's note — This is not a cost of acquisition. It is an operating expense.

8. **Prorates due buyer at close:**

   8.1 *Unpaid taxes/assessments:* **Enter** the dollar amount of those real estate taxes and improvement district bond assessments which have accrued and have not been paid by the seller if they are to be prorated and are not credited to the price under section 2.3.

   They have not been paid for one of two reasons: they are not yet due to be paid to the tax collector or they are past due and delinquent. If they are not yet due, the buyer will at a later date be paying those property taxes which accrued during the seller's ownership. Thus, they are prorated as a credit to the buyer through the last day prior to the date of closing. The proration is calculated as a daily amount of the annual tax and assessment amounts based on a 30-day month. The current tax bill or, if it is not yet available, the past year's amounts are used (and adjusted for inflation, etc.) to arrive at the daily amount of the proration.

Editor's note — If escrow is scheduled to close September 16, the tax billing has not yet been received and the current taxes have not been paid. Thus, 75 days of accrued taxes/assessments at the daily rate are credited to the buyer (and charged to the seller).

   8.2 *Interest accrued and unpaid:* **Enter** the dollar amount of interest accrued and unpaid on loans assumed under sections 2 through 2.3 for the number of days during the month the seller will

remain the owner prior to closing. The proration will be calculated as a daily amount of interest paid in monthly installments based on a 30-day month. The daily amount of interest accrued is credited to the buyer for each day of the month prior to the day scheduled for closing since interest on loans is paid following the month of accrual. Thus, the next installment will become the obligation of the buyer, unless the installment is disbursed by escrow and charged pro rata to the seller and the buyer.

8.3 *Unearned rental income:* **Enter** the portion of the dollar amount of rent from the rent rolls, both prepaid and unpaid, which remains unearned on the day scheduled for closing. The buyer is entitled to a credit of the unearned portion of rent as a proration. The day of closing is the first day of ownership by the buyer and entitles the buyer to unearned rents for the entire day on which escrow closes. The proration is calculated as a daily amount of the rent roll unearned based on a 30-day month.

Editor's note — If the rents are $30,000 monthly, the daily proration for earned rents would be $1,000, which is multiplied by the number of days remaining in the month, beginning with and including the day of closing. If closing is on the 16th, the dollar amount of prorated rents credited to the buyer from funds accruing to the seller's account on closing would be $15,000, the 16th being day one of the remainder of the 30-day month.

For unpaid delinquent rents shown on the rent roll, see section 9.5 for an offset charge to the buyer by an adjustment.

8.4 *Tenant security deposits:* **Enter** the dollar amount of all the security deposits held by the seller (as landlord) which belong to the tenants as disclosed on the seller's rent roll information sheet. This credit is an *adjustment*, not a proration, in funds due the seller since the buyer on transfer of ownership will be the landlord (by assignment of the leases and rent agreements) and responsible for accounting to the tenants for any deposit held by the seller.

Editor's note — Include any interest accrued and unpaid on the security deposits from the date of the seller's receipt of the deposits if mandated by rent control or landlord-tenant law.

8.5 *TOTAL prorates due buyer at close:* **Add** the figures estimated in sections 8.1 through 8.4. **Enter** the total as the dollar amount of all the "credits" the buyer can anticipate due to prorations and adjustments.

Editor's note — The debits charged to the buyer by proration are calculated in the following sections.

9. **Prorates due seller at close:**

9.1 *Prepaid taxes/assessments:* **Enter** the dollar amount of real estate taxes and improvement assessments prepaid by the seller which have not yet accrued. The calculations are made in the same manner as explained in section 8.1.

Editor's note — For example, the seller has paid all installments of taxes/assessments for the entire fiscal year (July through June). A closing of the buyer's transaction on December 31 requires a proration charge to be paid by the buyer for one-half year's (180 days') taxes/assessments since they have been prepaid, but will not accrue until after the buyer closes escrow.

9.2 *Impound account balance:* **Enter** the dollar amount of the impounds held by the lender on each loan assumed under sections 2.1, 2.2 or 2.3. The information is readily available from the monthly accounting of the loan's condition received by the seller from the lender servicing the loan.

9.3 *Prepaid homeowners' assessment:* **Enter** the dollar amount of the prepaid and unaccrued portion of the seller's current installment for any homeowners' association (HOA) assessment. The proration charge is based on a 30-day month for those days remaining in the month, beginning with the day of closing as day one of the days remaining in the month.

9.4 *Prepaid ground lease rent:* **Enter** the dollar amount of the prepaid and unaccrued portion of rent the seller has paid on the ground lease if the property interest being purchased is a leasehold interest transferred by assignment and not a fee interest transferred by grant deed.

9.5 *Unpaid rents assigned to buyer:* **Enter** the dollar amount of delinquent unpaid rents to be charged to the buyer if the seller will not collect the rent before the close of escrow. These unpaid rents belong to the buyer on closing due to the seller's assignment of the leases to the buyer, unless other arrangements are made for an accounting of the uncollected rents. Typically, a closing after the tenth of the month will not experience the need for a delinquent rent adjustment. (All rents have been prorated in section 8.3.)

9.6 *Miscellaneous prorates and adjustments:* **Enter** the name of other prorates or adjustments which may be required. **Enter** the dollar amount charged to the buyer.

9.7 *TOTAL prorates due seller:* **Add** the figures estimated in sections 9.1 through 9.6. **Enter** the total as the dollar amount of all the "charges" the buyer is likely to experience due to prorations and adjustments.

10. **Total funds required to close escrow**:

Add the figures from sections 6, 7.1 through 7.6, 9.7, and then **subtract** the figure from section 8.5 from the total. **Enter** the difference as the dollar amount of funds the buyer will need to close escrow.

10.1 See section 2.4a adjustments.

11. **Source of funds required to close escrow:**

11.1 *New first loan amount:* **Enter** the dollar amount of the new loan estimated in section 4.1.

11.2 *New second loan amount:* **Enter** the dollar amount of any second trust deed loan to be originated. If the costs of originating the second have not been entered in section 4.2 through 4.12, then **enter** only the estimated amount of the net proceeds generated by the second loan here.

11.3 *Third-party adjustments:* **Enter** the dollar amount of any funds received from third parties which the buyer expects to use to fund the purchase of the property. For example, families make gifts, employers give bonuses and equity sharing and other co-ownership arrangements contribute cash.

11.4 *Buyer's cash:* **Subtract** the figures in sections 11.1 through 11.3 from the figure in section 10. **Enter** the result as the dollar amount of funds the buyer needs to presently hold or have in reserves (savings/readily convertible securities and certificates) to meet the expenditures anticipated by the estimates in this opinion given by the buyer's broker or his selling agent.

12. **Total funds required to close escrow**:

Add the figures estimated in sections 11.1 through 11.4. **Enter** the total as the amount of funds needed by the buyer to acquire the property.

Editor's note — The amount here in section 12 will be the same as the amount arrived at in section 10.

Signatures:

Broker's/Agent's signature: **Enter** the date the cost sheet is signed, the broker's name and the agent's name. **Obtain** the broker's (or agent's) signature.

Buyer's signature: **Enter** the date the buyer signs and the buyer's name. **Obtain** the buyer's signature.

Chapter 39 Making an offer

This chapter sets forth the elements of a contract and fully examines the first stage of the real estate purchase agreement process, i.e., the intent of a buyer to make an offer to purchase.

The intent to contract

A **contract** is an agreement between persons binding them to do or not to do something. [Calif. Civil Code §1549]

Persons include individual people and those entities qualified to contract within the state of California.

To form a contract, the agreement must be accompanied by the following elements:

- an **offer**;
- an **acceptance**;
- **consideration** — a bargained-for exchange;
- **capable parties**; and
- a **lawful purpose**. [CC §1550]

While oral agreements are valid contracts, most agreements involving real estate or real estate services must be formalized in a **writing** to be judicially enforceable. [CC §§1622, 1624]

The elements needed to form an agreement and the numerous rules for contracting must be viewed in light of typical real estate transactions.

For example, a sales transaction involving a broker acting on behalf of a buyer or seller is structured on a variety of contracts, including:

- a **listing agreement** employing the broker;
- a **purchase agreement**, option or exchange agreement documenting the sales transaction;
- **escrow instructions** to close the sales transaction;
- interim or holdover **occupancy agreement** between the buyer and seller;
- a **note and trust deed** executed by the buyer;
- **service agreements** for investigations, reports, repairs and coordinators; and
- **insurance policies** for title, home warranty, hazards and personal liability.

The buyer, seller and broker have separate rights and obligations under the different contracts, in addition to duties owed to themselves and others in the transaction. Also, their obligations to sign or perform one contract, such as escrow instructions and deeds, often depends on having agreed to perform under a prior agreement, such as a purchase agreement.

Life cycle of a contract

The life cycle of a real estate purchase agreement is divided into four stages of activity:

- the **formation** (offer and acceptance) stage;
- the **conditions** (contingencies) stage;
- the **performance** (closing) stage; and
- the **failure of performance** (breach) stage. [See Figure 1 accompanying this chapter]

During the **formation stage**, offers are made between a buyer and a seller. Negotiations commence and eventually, one of the (counter) offers may be accepted.

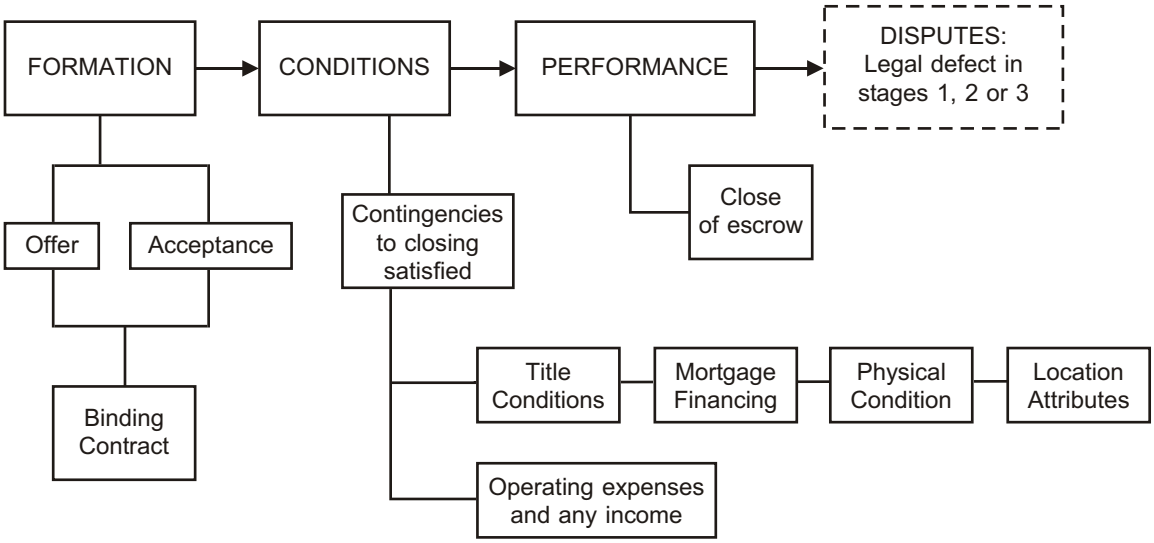
The acceptance of an offer forms a *binding* agreement. However, the agreement may not be enforceable by actual performance yet due to conditions contained in the agreement.

Actual performance of the agreement cannot be enforced until the second stage, the conditions stage, is completed.

During the **conditions stage**, the contingencies contained in the purchase agreement must be satisfied or waived before the sale can move toward closing. These contingencies are called *conditions precedent*.

Figure 1

Life cycle of standard real estate contract



Contingencies address the clearance of significant conditions prudent buyers and sellers have regarding the transaction, including:

- financial conditions (mortgage availability, price corroboration by appraisal, etc.);
- operating conditions (expense of ownership, tenant leases/income, etc.);
- title and zoning conditions (Covenants, conditions and restrictions, use ordinances, etc.);
- physical conditions (home inspection/certification, energy efficiency, environmental analysis, utilities, etc.); and
- location-related conditions (ordnances, green belts, neighbors, natural hazards, etc.).

Also, the buyer or seller must complete their **mutual performance** duties, called *conditions concurrent*, during the conditions stage, prior to closing. Mutual performance duties of one party are to be completed independent of and without concern for the other party first performing their mutual performance duties.

For example, a seller's obligation to deliver a deed to escrow is independent of, and not conditioned on, the buyer's obligation to deposit closing funds into escrow.

In contrast, a **condition precedent** calls for the satisfaction or waiver of an act or event by one party before the other party must perform.

A purchase agreement has arrived at the **performance stage** when all the contingencies and independent activities to close escrow have been cleared, i.e., all closing documents have been signed and delivered and funds have been handed to escrow in full performance of the contract by all parties.

Failure to close escrow

Should there be a failure to perform or if a deficiency has arisen in one of the first three stages of the contract's life, the transaction has unfortunately moved into the **breach stage**.

For example, there may be:

- a defect in the contract's formation (e.g., invalid acceptance, incapacity of a person to contract, uncertain terms, lack of essential terms, etc.);
- a failure of one party to eliminate a contingency provision allowing the other party to avoid further performance by cancellation of the contract; or
- a defense to closing has arisen (e.g., misrepresentation of the physical, title or income of the property, untimely performance, etc.).

If the defect in the agreement is serious enough, a compromise, legally called an *accord and satisfaction*, may be negotiated by the broker or his agents between the parties, or the dispute may be resolved by court order.

Disputes are usually resolved through negotiation handled by the brokers and agents.

However, it is this stage that produces the court cases which decide and flesh out our application of real estate contract law.

Forming a contract

A contract is formed when an **offer** to enter into an agreement is made and accepted.

The party who makes the offer is called the *offeror*. The party to whom the offer is directed is called the *offeree*.

In real estate sales transactions, the buyer typically makes an offer to the seller. Thus, the buyer becomes the *offeror*. However, the offeror can be the seller.

For example, a buyer makes an offer which is unacceptable to the seller. The seller counters with an offer to sell on different terms than those offered by the buyer.

Here, the seller has **terminated** the buyer's offer by *rejection*. He has done so by making a *new offer* back to the buyer, called a *counteroffer*. The seller has now become the offeror.

The buyer, as the offeree under the counteroffer, must now decide whether to accept or reject the seller's offer to sell.

To a large extent, the terms *offeror* and *offeree* are useless in practice. The cast of characters in a real estate transaction are better viewed by their more common names, such as:

- buyer and seller;
- landlord and tenant;
- lender and owner; and
- broker and client.

Once each person is identified by the title given their position in a transaction (buyer, seller, etc.), then the offer or acceptance conduct each person engages in sets the rules for their conduct under a purchase agreement offer or counteroffer — as the *offeror* or *offeree*.

What is an offer?

To be valid, **an offer** must:

- show a serious *intent to enter* into an agreement;
- be *definite and certain* in detailing the essential elements, such as price, terms of payment, property identification and conditions for performance; and
- be *communicated* to the person who can accept the offer.

The buyer's signing of a purchase agreement form which has been properly filled out will satisfy the first two conditions of intent and terms.

However, consider a seller who puts his real estate up for sale without contracting for the services of a listing broker.

A buyer responding to the "For Sale By Owner" sign writes the seller a letter expressing an interest in buying the property, so long as a broker is not used. The buyer asks what price the seller **expects to receive**.

The seller writes back, stating:

"As long as your offer would be in cash, I see no reason why we could not deal directly .... I expect to receive $450,000 for the property. Please let me know what you decide."

The buyer responds:

"Have agreed to buy your real estate on your terms ... would appreciate a contour map as we are desirous of building at once ...."

The seller refuses to convey the property claiming a binding contract was never entered into since his letter to the buyer was a mere invitation for an offer — a *solicitation* by the seller for an offer from the buyer — not a **serious intent** by the seller to enter into a sales agreement.

Does the seller's letter stating the cash price he **expected to receive** constitute an offer to sell which the buyer could accept?

No! The letter did not show a serious intent to contract. Rather, the letter was an **invitation** to the buyer to make an offer. Since the letter lacked words of an offer to sell, a reasonable buyer could not have believed the letter was intended to be an offer capable of acceptance. [**Richards** v. **Flower** (1961) 193 CA2d 233]

Similarly, the following communications with respect to the purchase of real estate are not offers:

- listing agreements;
- offers made in jest [Restatement 2d Contracts §18];
- advertisements;
- letters of intent (LOI) to contract [Rest.2d Contracts §26]; or
- preliminary negotiations or letters of proposal.

Terms and conditions

For an offer to be accepted and a binding contract formed, the offer's terms of payment and conditions of the performance must be **definite and certain**.

Should a breach of an agreement occur and litigation be pursued, a court must be able to glean from the agreement what the parties intended, and whether enough terms exist to enforce performance of the agreement or determine a party's losses.

For example, a landlord and tenant sign a lease giving the tenant the option to renew the lease. The amount of rent due on exercise of the renewal option are to be "agreed on" at the time the option is exercised.

An **option** is an offer which has not yet been accepted. It is irrevocable for a period of time during which it can be accepted, called *exercise*.

Here, the option given the tenant to renew the lease does not specify an essential term (i.e., the rental rate, which is the price to be paid for the use of the property).

Later, the tenant tries to *exercise* (accept) the option (irrevocable offer). The landlord refuses to comply, claiming the option is unenforceable as the rent terms are too vague.

Is the option to renew too vague to be enforced?

Yes! The purported renewal option was merely an "agreement to agree" regarding an intent to change the rent to be charged under the lease, which leaves the option unenforceable. [**Ablett** v. **Clauson** (1954) 43 C2d 280]

To be definite and certain in its terms and conditions for enforcement, an offer must set forth the **essential elements** of the transaction, such as:

- the *identity* of the parties;
- a *description* of the real estate;
- the *price* and the form in which it will be paid; and
- the *time for performance*. [**King** v. **Stanley** (1948) 32 C2d 584; CC §1550]

The offer does not need to be on a standardized form to be enforceable. In fact, an offer can even be made on the back of a business card.

Finally, the offer must be **communicated** to the person who is intended to be able to accept the offer.

The offer can only be accepted by the intended offeree. In real estate transactions, the buyer almost always makes the initial offer to buy on terms set forth in a purchase agreement form signed by the buyer. The offer to buy is intended to be accepted by the owner of the property, a person known but not usually identified by name in the offer.

Regular offers

To be certain an offer exists, brokers and their agents in the real estate industry use regular checklist-type forms to transmit offers between buyers and sellers.

A "Real Estate Purchase Agreement" form is used in the purchase and sale of fee simple and existing leasehold estates, such as ground leases, long-term leases or master leases. [See Form 150 accompanying Chapter 51]

The California real estate industry has an extensive variety of *boilerplate contracts* for practically any contractually negotiated real estate situation.

The use of a **regular form** in lieu of independently drafted forms to make an offer to buy or sell real estate is justified for two reasons.

First, regular forms satisfy the writing requirements mandated by the Statute of Frauds. [CC §1624]

Second, a regular form gives the agreement between the buyer and seller clarity of meaning and more uniformity than typically results from individually drafted contracts.

However, regular forms are not a cure-all. Regular merely decreases the potential for error or omission by limiting brokers and their agents to the task of filling in blanks and checking the boxes to indicate the provisions included in the contract.

The phrase "all forms are not created equal" becomes most apparent as each publisher's regular purchase agreement manifests its **inherent prejudice** when the form is put to use.

Purchase agreements at work

Regular purchase agreements set forth the essential terms and conditions of an offer to make it enforceable, complete and clear in meaning.

Specifically, purchase agreements contain clauses for:

- the identities of the parties;
- the location of the real estate sold, leased or encumbered;
- the time for acceptance and performance;
- the time for opening and closing escrow;
- the price and financing;
- title conditions and vesting;
- the physical condition of the property;
- the property's natural hazards and environmental conditions;
- tax planning; and
- the brokerage fee.

A variety of purchase agreements exist with the terms and contingencies needed for different types of properties and transactions. Thus, a purchase agreement becomes a grand **checklist of provisions** to be considered for inclusion in the final contract by filling in the blanks and checking boxes, or leaving them blank and not a part of the contract.

Chapter 40 Acceptance of an offer

This chapter applies the rules of acceptance and rejection to an offer or counteroffer to buy or sell real estate.

Time and nature of a response

A person making an offer, intending to enter into a **binding agreement** on the terms in the offer, will not have an agreement until:

- the offer is *submitted* to the person with whom he intends to contract, called the *offeree*; and
- that person indicates his intention to enter into an agreement on the same terms contained in the offer by delivering an *acceptance* to the person who made the offer, called the *offeror*.

An **acceptance** is the response to an offer which agrees, without qualification or condition, to the terms of the offer.

Acceptance of an offer in which rights are created and obligations are imposed between two people forms a **binding contract**, also called an *agreement*. A "meeting of the minds" has occurred based on the terms offered and unconditionally accepted, resulting in the agreement.

When an offer is **received** by a person, called *communicated* or *submitted*, the offer can either be:

- **accepted** prior to its *termination*; or
- **rejected**.

No alternative responses to an offer exist. Thus, any response to an offer must fall into one of these two categories.

The process for an **acceptance** of an offer includes several considerations, such as:

- whether the acceptance called for is a promise to perform an act or the actual performance of the act, distinguished as *bilateral* or *unilateral* agreements, respectively;
- who may accept and their identification;
- what documentation is necessary to formalize an acceptance;
- what method or medium is to be used to deliver the acceptance to the offeror, called *communication*;
- what inquiries of clarification need to be made and included as terms in the offer before acceptance; and
- whether to accept prior to termination of the offer.

The other response to an offer is a **rejection**. When a rejection is submitted to the person making the offer, the offer is **terminated**. Thus, on communication of a rejection, an offer no longer remains to be accepted.

Issues affecting an offer which might terminate the offer by **rejection** include:

- a *counteroffer* to the offer [See Form 180 accompanying Chapter 41];
- formal *disapproval* or unacceptability of the terms offered [See Form 184 accompanying this chapter];
- inquiries regarding *clarification* and the inclusion of terms not rising to a rejection;
- *qualifications* or conditions imposed on the offer by a purported acceptance;
- whether a rejection has been submitted; and
- an attempt to accept the offer after a rejection.

To give a promise or to act

All offers to enter into a contract fall into one of two categories based on the **manner of acceptance** called for in the offer, i.e.:

- the **giving of a promise** agreeing to perform as stated in the offer, called a *bilateral contract*, which, for example, exists in exclusive listings and purchase agreements; or
- the **performance of the act** called for in the offer, called a *unilateral contract*, which, for example, exists on the exercise of an option to buy and the taking of an open listing.

Offers made by buyers in real estate purchase agreements signed and submitted to the owner of the described properties form **bilateral contracts** when accepted.

A buyer's purchase agreement offer promising to buy calls for the seller of the real estate to accept by merely **promising to transfer** the property to the buyer on terms set out in the offer. While the seller's acceptance forms the bilateral contract, performance of the actual acts of conveying title and delivering possession as promised by the seller on acceptance will not occur until closing.

Conversely, an option to buy real estate is a **unilateral contract**. An option to buy gives a buyer the **power to accept** the seller's irrevocable offer (to sell) contained in the option granted to the buyer by the owner of the described property.

To accept the irrevocable offer to sell, called *exercise of the option*, the buyer must do an act, usually the opening of an escrow and the deposit of all funds necessary to close the purchase. Until exercise of the option, the buyer has not promised to buy the property. After the buyer exercises the option, the only act then remaining to be performed is the conveyance of title and delivery of possession promised by the owner in the option agreement.

The buyer (or assignee of the right to buy) cannot accept the irrevocable offer contained in the option by merely promising to open escrow and deliver funds, as is required to form a bilateral contract. To accept, the buyer must actually perform all acts required to exercise the option agreement.

REJECTION OF OFFER

DATE: _____, 20_____, at _____, California.
TO: _____

Items left blank or unchecked are not applicable.

FACTS:

1. This is a response to an offer entitled:

☐ Purchase Agreement
☐ Escrow
☐ Exchange agreement
☐ Counteroffer
☐ _____

1.1 dated _____, 20_____, at _____, California,
1.2 entered into by _____
1.3 regarding real estate referred to as _____
_____
_____
_____
_____.

STATEMENT:

2. The referenced offer has been submitted to me as the offeree for review and consideration.
3. The terms of the referenced offer are hereby rejected.
4. No counteroffer will be forthcoming.

Offeree's Broker: _____
By: _____

I agree to this statement.
Date: _____, 20_____
Offeree's Name: _____
Signature: _____
Offeree's Name: _____
Signature: _____

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Submit the offer; relay the acceptance

Real estate purchase agreements identify the buyer making the offer, but rarely name the seller who is the person to whom the offer will be submitted. The offer describes the property on which the offer to purchase is made.

Thus, the only person who can accept the offer, though unnamed within the buyer's offer, is the person who can deliver title and possession of the described property. Usually, this person is the vested owner of the property, but it might be someone who holds an option to buy the property.

Real estate agreements are nearly always reduced to a writing and signed by all parties due to the mandates of the Statute of Frauds for their enforcement. Thus, it follows that a buyer seeking to enter into an enforceable agreement with a seller will submit his offer to purchase in a writing signed by the buyer.

Further, pre-printed purchase agreement forms all contain acceptance provisions which are devoid of qualifying or conditional language which would destroy any attempt at an acceptance.

Accordingly, the only documentation required of an owner of real estate who accepts an offer submitted by a buyer is to place his signature in the space provided beneath the acceptance provision on the purchase agreement form without adding to or deleting a word in the purchase agreement.

Once the acceptance provision has been signed by the seller, the acceptance must be **submitted** to the buyer who made the offer, called *communication of the acceptance*. When submitted, the process of the seller's acceptance is complete and a binding contract is formed.

Again, real estate related agreements are all in writing and nearly all are on pre-printed forms.The provision in the form authorizating an acceptance of the offer instructs the person accepting about what he must do to accept. Besides signing the **acceptance statement** at the end of the agreement, the acceptance provision requires a copy of the document bearing the acceptance signatures to be *delivered* to the person making the offer, or that person's real estate agent. [See Form 150 §10.1 accompanying Chapter 51]

In the case of a seller making an offer which is a counteroffer to an unacceptable offer from a buyer, the buyer begins the process of accepting the seller's offer by signing the acceptance provision in the counteroffer form. Typically, the signed counteroffer is then handed to the buyer's agent. At this point, the process of acceptance is still incomplete — the acceptance has not been communicated to the seller as instructed in the acceptance provision of the counteroffer.

To form a binding contract, a copy of the counteroffer signed as accepted by the buyer must be delivered to the listing broker (or his agent) or the seller himself, if he does not have a broker.

If the buyer's broker is also the seller's listing broker, the counteroffer has been accepted on the buyer's handing the signed acceptance to the broker, unless the acceptance provision requires other steps before acceptance is complete.

When the seller has a listing broker, delivery to the listing broker of a copy of the counteroffer containing the buyer's signature accepting the offer completes the acceptance process. A binding contract is formed at that moment of delivery, even if the listing broker fails to further hand it to the seller, unless the broker is required to do so in the acceptance provision to form a contract.

If the seller is not represented by a broker, delivery by handing or faxing the seller a copy of the counteroffer signed by the buyer forms a binding contract.

Clarifying or refining the offer

On a seller's review of an offer submitted on the described property, the seller advises his listing agent the offer as written needs clarification or possible changes to contain all the terms desired by the seller. Such items might address the escrow period, the note or trust deed provisions in a carryback, a condition or contingency in the offer, or the inclusion of seller and broker disclosures which should be acknowledged in the offer to eliminate exposure to liability.

Thus, the seller seeks to have the offer "cleaned up" or "redrafted" before he accepts it.

Here, the seller considering an offer which can be accepted within three days could instruct the listing agent to either:

- contact the buyer's agent (or the buyer if he has no agent) and ask if the buyer's offer could be clarified or possibly altered to include the seller's suggestions; or

- prepare a counteroffer containing the suggested alterations or clarifications which the seller signs and submits to the buyer.

Without preparing and submitting a counteroffer, an inquiry can be made into the buyer's willingness to include the suggestions. The inquiry for clarifications or changes is not a counteroffer or any other type of rejection of the buyer's offer which would terminate the offer and make a later acceptance impossible.

The seller is merely attempting to get the offer cleaned up, by inducing change or clarification, and doing so apart from and without any disapproval or counteroffer. Should the buyer refuse to clarify or alter his offer, the seller must then decide whether to accept or reject the offer.

However, had an acceptance been attempted which altered the terms of the buyer's purchase agreement offer by *interlineation* prior to signing the acceptance provision, the change of the terms in the offer on acceptance by the seller is a *counteroffer* to perform on different terms. It is a rejection which terminates the offer.

Further, once a rejection (by counteroffer or a change of terms on acceptance) has been communicated by delivery to the buyer, the seller cannot then accept the original offer by signing and delivering a signed copy of the unaltered purchase agreement offer to the buyer — even if the days stated for the acceptance period have not yet expired.

Acceptance period for contracting

An offer is considered revoked:

- by the lapse of time for acceptance stated in the offer; or

- if no time limit exists, by the lapse of a reasonable time without communication of an acceptance. [Calif. Civil Code §1587(2)]

All offers to buy or sell real estate terminate at some point in time, after which the power to create a contract by accepting the offer no longer exists. Thus, an acceptance, if there is to be one, must be *communicated* to the person who made the offer **during the acceptance period** to form a binding contract on the terms offered.

If the time period for acceptance is not entered or checked in a purchase agreement or counteroffer, the acceptance can be submitted any time during a reasonable period after the offer was submitted. A reasonable period could be any time period ranging from a few days to a week or more, depending entirely on the circumstances surrounding the negotiations.

In nearly all real estate purchase agreements or counteroffer situations, a date or the occurrence of an event is given as the expiration of the acceptance period. Thereafter, no offer remains to be accepted.

Should the buyer's purchase agreement offer expire by its terms, such as three days from the date of the offer, and the seller later signs the acceptance provision and delivers a signed copy to the buyer, the buyer may act on the "late-acceptance effort" to form a contract by taking steps to **acknowledge the late**

acceptance. With the buyer's acknowledgment of the seller untimely acceptance by the opening of an escrow, the seller becomes bound to the agreement since the buyer's positive response to a late acceptance is considered a *waiver* of the expiration period for acceptance.

However, the buyer is under no obligation to respond to a tardy attempt to accept. No offer remains to be accepted and no obligation can be imposed on the buyer by the late attempt to accept. The provision for expiration of the acceptance period is solely for the benefit of the person (buyer) making the offer.

Consider a seller who contacts a broker to sell his property. The broker's agent locates a buyer who makes an offer to purchase the property.

The offer contains a provision stating the offer will be deemed revoked unless accepted in writing within five days after the date of the offer.

The agent is unable to present the offer to the seller until six days following the date of the offer. The seller signs his acceptance of the buyer's offer and the acceptance is handed to the buyer. The buyer does not respond by a writing "accepting the acceptance."

However, the buyer's agent dictates escrow instructions which are prepared, signed by the buyer and returned to escrow. The seller refuses to sign his copy of the escrow instructions or proceed with the transaction.

The seller claims his signature accepting the offer does not constitute an acceptance since the buyer's offer had expired by its provisions for revocation, and a late acceptance becomes a counteroffer which the buyer never accepted.

Did the seller's untimely submission of his acceptance of the purchase agreement constitute a counteroffer?

No! A counteroffer is an offer which replaces or qualifies a term or condition in the original offer. A late acceptance is not a counteroffer since it does not substitute new or different terms for the terms originally offered. It is just a late acceptance of all the terms and conditions of the offer.

Here, the buyer, by opening escrow, acted to **waive** the acceptance period time limit. Time for acceptance is a condition placed in the offer solely for the benefit of the buyer to eliminate his future exposure to contract liabilities. However, when a buyer acts on a late acceptance by having escrow instructions prepared and signing them, a binding agreement between the buyer and seller is formed. Thus, the seller must close escrow. [**Sabo** v. **Fasano** (1984) 154 CA3d 502]

Events terminating the offer

Other events **terminating an offer** contained in a purchase agreement or counteroffer include:

- *death* of either person before acceptance;
- *destruction* of the real estate before acceptance;
- *revocation* of the offer by the person who made the offer by sending a *notice of withdrawal* of the offer by mail, phone, fax, email or agent to the person who could accept, and do so before an acceptance is submitted;

- *rejection* of the offer by the person who could accept, such as occurs on a qualified or conditional acceptance by *interlineation* on the purchase agreement or a formal counteroffer, since the communication of these actions terminate the offer which now ceases to exist and cannot be accepted after a rejection; or

- a *prior sale* of the property to another buyer during the acceptance period for the seller's counteroffer, notice of which is either placed in the mail to the buyer (whether or not received) or hand delivered to the buyer before a copy of the buyer's signed acceptance of the seller's counteroffer is submitted to the seller, the listing agent or other authorized agent for acceptance.

Chapter 41 The counteroffer environment

This chapter examines the seller's response to an unacceptable purchase offer by countering with an offer which consists of terms different from the terms of the purchase offer being rejected.

Meeting the seller's objectives

The preparation of a counteroffer is an occasion when a listing agent and seller have an opportunity to take control of negotiations which a prospective buyer has commenced by the submission of a written purchase agreement offer. For the listing agent, the **counteroffer** is his moment:

- *to care for and protect* the seller by addressing property disclosures to be made by the seller to perfect any agreement the seller may enter into with the prospective buyer; and

- *to clarify* any uncertainties about the buyer's ability to close escrow.

Essentially, a counteroffer allows the listing agent to actually eliminate contingencies regarding disclosures which serve only to cancel or reprice the sale for the seller. At the same time, the listing agent can take steps to establish the buyer's qualifications for any purchase-assist financing and the source of any other funds needed by the buyer to close the transaction.

The environment surrounding the listing agent's analysis of the buyer's offer and the agent's later review of the offer with the seller is nearly always within the control of the listing agent, as it should be.

A prompt, initial review of the offer by the listing agent, alone and before advising the seller it has been received, is necessary to prepare the agent to handle his call to the seller to set an appointment for a review of the buyer's offer.

On hearing the listing agent has received an offer, the seller's first comments generally tend to focus on the price, transactional costs, the buyer's ability to close escrow and when the seller will be handed the net sales proceeds.

Conversely, the listing agent is primarily concerned with:

- the seller's obligation to the prospective buyer to disclose his knowledge about the property which, if disclosed after entering into a purchase agreement contract, may well affect the price the buyer may then be willing to pay for the property, lead to the buyer's cancellation of the purchase agreement, or reduce the seller's net proceeds should the seller have to eliminate undisclosed conditions exposed by a late disclosure which are unacceptable to the buyer; and

- the agent's preparation for his appointment with the seller which will cover information needed to be reviewed by the seller before a decision can be made to accept or reject (by a counteroffer) the buyer's purchase agreement offer.

The diligent listing agent

A **listing agent's duty** owed to his seller on the submission and review of a prospective buyer's offer includes:

- advice on the *seller's obligations* to disclose property conditions and obtain clearances or eliminate defects triggered by the buyer's due diligence investigation;
- a review of the agent's concerns about the acceptability or modification of *contingency provisions* which affect closing;
- disclosure of the likely *net sales proceeds* the offer will generate; and
- if the property is other than the seller's personal residence, the agent's knowledge about the profit *tax liability* the seller will most likely incur on the sale.

For example, an agent representing a prospective buyer submits a purchase agreement offer without first obtaining a copy of the listing agent's marketing package on the property. The package contains all the required seller disclosures the seller and listing agent are required to deliver to prospective buyers.

Thus, the buyer does not take into consideration the adverse property conditions **disclosed** in the marketing package when the buyer made his decision about the price and terms on which he is willing to buy the property. However, the buyer will discover these conditions when the disclosures are eventually handed over.

Accordingly, the listing agent's advice to the seller on submitting and reviewing the offer is to counter the offer and include as addenda all the required disclosures. The disclosures, at the agent's insistence when listing the property, have already been prepared and are available for the prospective buyer to approve before entering into a purchase agreement.

Thus, the pre-contract disclosures will eliminate most of the contingencies which affect the price, the amount of the seller's transactional expenses and the buyer's ability to cancel the purchase agreement, all of which concern the listing agent.

By a thoughtful analysis of the buyer's offer prior to meeting with the seller, the listing agent prepares himself to advise the seller on the use of a counteroffer to best respond to the offer. Thus, the agent seeks to reduce the uncertainties about the consequences of an unmodified acceptance of an offer.

Various responses to an offer

Several procedures exist for a seller to respond to an unacceptable offer, especially an offer which, with a few minor changes, would be acceptable to the seller. However, minor changes regarding the selection of the escrow company, the deadline for loan approval, verification of downpayment funds, or the sale or purchase of other property constitute a counteroffer.

The listing agent handling negotiations for a change in the terms of the buyer's purchase offer should reduce the seller's (counter)offer to a writing signed by the seller before it is submitted to the buyer. The seller's signed counteroffer manifests his intent to be bound by his offer to sell, if the buyer accepts.

The seller's counter to an unacceptable purchase agreement offer can be written up by the listing agent and submitted to the buyer using any one of the following formats:

COUNTEROFFER

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is a counteroffer to an offer entitled:

☐ Purchase agreement

☐ Exchange agreement

☐ Counteroffer

☐ _____

1.1 dated _____, 20_____, at _____, California,

1.2 entered into by _____, as the _____,

1.3 regarding real estate referred to as _____,

_____.

AGREEMENT:

2. The undersigned includes all the terms and conditions of the above referenced offer in this Counteroffer, **subject to** the following modifications:

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____

3. This Counteroffer will be deemed revoked unless accepted in writing and delivered to the undersigned or their broker prior to the time of _____ on _____, 20_____.

Buyer's Broker: _____	Seller's Broker: _____
By: _____	By: _____
I agree to purchase this property as stated above.	**I agree to sell this property as stated above.**
☐ See attached Signature Page Addendum. [**ft** Form 251]	☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: _____, 20_____	Date: _____, 20_____
Buyer's Name: _____	Seller's Name: _____
Signature: _____	Signature: _____
Buyer's Name: _____	Seller's Name: _____
Signature: _____	Signature: _____
Address: _____	Address: _____
_____	_____
Phone: _____ Fax: _____	Phone: _____ Fax: _____
Email: _____	Email: _____

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1. Prepare the seller's offer on a **new purchase agreement form**, possibly on a different and more appropriate form for the transaction than the form used by the buyer's agent. No reference is made in the seller's new offer to the rejected purchase agreement offer previously submitted by the buyer. This new original offer prepared by the listing agent will be signed first by the seller and listing agent, then submitted to the buyer for the buyer's acceptance or rejection.

2. Prepare the seller's offer on a **counteroffer form** which includes, by reference, all the terms and conditions of the buyer's offer. Modifications are then entered on the counteroffer form stating the terms and conditions sought by the seller which are different from those in the buyer's offer which are unacceptable to the seller. [See Form 180 accompanying this chapter]

3. Dictate **escrow instructions** based on an agreement orally negotiated with the buyer (or buyer's agent) to resolve the seller's dissatisfaction regarding the terms and conditions in the buyer's offer. The instructions are submitted to the seller and buyer for signatures. On receipt by escrow of copies of the instructions containing the signatures of all parties, the escrow instructions then become the only agreement entered into by both the buyer and seller. Here, the escrow company becomes a sort of secretarial service used by agents who do not take the time to prepare a written counteroffer themselves.

4. **Alter the original written offer** the buyer has already signed by deleting unacceptable provisions from the face of the document and entering the differing provisions sought by the seller, a process called *deface and interlineate*. The altered purchase agreement is then signed by the seller in the acceptance provision and returned to the buyer as the seller's counteroffer. This counteroffer and acceptance procedure is called *change and initial*, and is used when a counteroffer form is not made available and prepared by the listing agent.

5. Set up an **auction environment** (if the current market is composed of too many buyers for too little inventory) by calling for the submission of all offers on a date and at a time set for the seller to accept the best offer of all those presented by prospective buyers, or by creating some other auction situation short of the seller signing multiple counteroffers, an awkward (and typically misguided) response to the receipt of multiple purchase offers.

6. **Orally advise** the buyer's agent about the changes required before the buyer's offer will be acceptable to the seller. If the buyer is interested in the property based on those changes, the buyer's agent is asked to prepare and submit a new purchase agreement offer signed by the buyer for the seller to consider. This situation requires the buyer to "negotiate with himself," while the seller remains uncommitted to sell on any terms. Here, either the listing agent does not take the time to prepare a counteroffer stating the terms and conditions on which the seller will sell or the seller wants to remain uncommitted.

7. Let the **offer expire**, then resume negotiations with the buyer and his agent if the buyer still has an interest in the property.

The counter is an offer

The rules for preparing and submitting a counteroffer and those for accepting a counteroffer to buy and sell real estate are the same rules applied to determine whether an offer made by a seller has been submitted to the buyer or an acceptance by the buyer has occurred to form a binding contract.

Real estate agents instinctively consider submitting written offers from a buyer to a seller to comply with the rule requiring a written agreement, signed by the buyer and seller to form a real estate contract. Likewise, they should automatically submit written counteroffers from sellers to buyers when the seller will not accept the buyer's offer.

For example, on the buyer's receipt of a seller's counteroffer, the buyer may be unwilling to accept the terms stated, but be willing to submit an offer on different terms. In essence, a counter to the counter. The buyer's agent also uses a counteroffer form to prepare the buyer's new offer.

The buyer's counteroffer, by reference, includes all the terms and conditions of the seller's counteroffer (which itself may reference and include all the provisions in the buyer's original offer). These referenced terms are then modified by entry on the counteroffer form of terms and conditions contrary to those sought by the seller.

Alternatively, the buyer's agent could draft an entirely fresh purchase agreement offer setting forth the terms agreeable to the buyer.

Forms for entering into agreements usually are flexibly worded for the signatories to merely reflect, "I agree to the terms stated above." The wording eliminates concern about whether the buyer or seller must first sign the document to make an offer or counteroffer.

Defacing a signed document

Listing agents sometime delete terms or provisions in a signed purchase agreement they have received by lining them out with a pen or covering them with white-out, called *defacing*. The agent then adds copy to the document to replace the deleted material, called *interlineation*.

The seller then signs the altered document agreeing to the terms of the offer as modified, a counteroffer technique called *change and initial*. However, it is improper conduct for anyone to in any way alter the contents of an original document once it has been signed.

Consider the plight of a buyer's agent who is industriously working to locate unimproved land for a client. He contacts the owners of several suitable properties by mail, soliciting information as to whether they will consider selling their property. One absentee owner who responds indicates he would entertain an offer from the agent's buyer.

The agent prepares an offer which his buyer signs, agreeing to purchase the land on an installment sale arrangement payable over a ten-year period. The signed purchase agreement is sent to the absentee seller. On receipt, the seller calls the buyer's agent to discuss some changes he wants by way of an increase in price and an earlier payoff. The terms discussed are acceptable to the buyer.

The buyer's agent prepares another purchase agreement offer reflecting the changes sought by the seller, which the buyer signs as a fresh, new offer. The offer is sent to the seller. On his receipt, the seller calls the buyer directly. They orally negotiate a cash price payable in 20 days.

To write up the new terms, the seller makes extensive changes to the buyer's second purchase agreement offer by **striking out** the price, terms of payment, closing date, title changes, due diligence investigation contingency provision, etc. On the face of the document, the seller then enters the terms and conditions which replace the strickened ones.

The seller signs the purchase agreement indicating he "agrees to all the terms stated" and returns it to the agent. The changes correctly reflect the changes the buyer agreed to by phone. To accept the modified

purchase agreement, the buyer then **initials** all the significant changes made by the seller, but does not initial every minute and minor entry made by the seller. No changes or additions to the document are made by the buyer. The buyer does not re-sign the original purchase agreement in addition to his initializing the changes.

The purchase agreement with the buyer's initials throughout is returned to the seller, who receives it. The agent dictates escrow instructions which are prepared reflecting the final terms as agreed to in the changed-and-initialed counteroffer. The buyer signs and returns his copy of the instructions; the seller does not.

The agent calls the seller asking him to sign and return the escrow instructions and the deed. The seller says they have no deal since the buyer did not initial each and every entry made by the seller on the purchase agreement. The seller claims the failure to initial each minute change he made was a *qualified acceptance* which did not form a binding agreement.

Here, the seller and buyer did enter into a binding and enforceable purchase agreement. The **essential terms** needed as a minimum to provide the certainty and clarity required to establish an enforceable real estate purchase agreement between them existed and were initialled.

Further, and significantly, the buyer did not make any changes or add any wording to the offer. By returning the initialed and unaltered counteroffer, the buyer indicated he intended to accept of the seller's (counter)offer as submitted by the seller.

Also, the failure to initial minor and nonessential provisions was inadvertent and not necessary to determine the performance required of the seller to deliver a deed in exchange for cash. [**Kahn** v. **Lischner** (1954) 128 CA2d 480]

In retrospect, had the buyer's agent been directly involved in the final counter-proposal made by the seller, he would have prepared yet another new original purchase agreement offer. It would have been signed by the buyer and sent to the seller to sign and return.

However, the seller did commit himself in his counteroffer to sell on terms which were certain. The buyer should have again signed his name at the end of the agreement and dated it to demonstrate he "agreed to the terms stated above," which on signing would have included all the changes made by the seller on the face of the document.

Had the seller been represented by an agent, his agent properly would have prepared the counteroffer on either a counteroffer form or a new purchase agreement form for the seller to sign. The prepared form would have contained those terms the seller entered by interlineation into the buyer's original purchase agreement offer.

Then, the buyer's acceptance of the counter would have been simple. He would agree to buy on the terms stated in the seller's counteroffer by simply signing the seller's (counter)offer and delivering the counteroffer with the signed acceptance.

Chapter 42 Contingency provisions

This chapter highlights the inclusion of contingency provisions in purchase agreements to allow buyers and sellers to either confirm their expectations and meet objectives or avoid closing the transaction.

Conditioning the close of escrow

The contents of a purchase agreement is a collection of provisions generally called terms and conditions. While **terms** focus on the price and the (terms for) payment of the price, **conditions** address:

- the *performance* of acts by the buyer and seller respectively; and
- *occurrence of events* in the process of closing escrow on the transaction.

Thus, each condition addressed in a provision must either be shown to exist or come into existence, by its occurrence or approval, before the purchase agreement can be enforced and escrow closed. Alternatively, the condition can be *waived* as though never part of the purchase agreement.

Thus, all purchase agreements contain one or more provisions "conditioning" closing on the "elimination of a contingency."

When conditions are the subject of *contingency provisions*, the **conditions** are initially distinguished by whether they:

- do *occur* (events and activities), called *event-occurrence contingencies*; or
- are *approved* (information, data, documents and reports), called *further-approval* or *personal-satisfaction contingencies*.

These **contingency provisions** grant the buyer or seller, or both, the *power to terminate* any further performance of the purchase agreement should an identified activity or event fail to occur or a condition be disapproved.

Also, provisions containing **conditions** are further classified by the sequence or order in which they will be performed by the buyer or seller. Thus, the occurrence or approval called for is either:

- a *condition precedent* to the performance of an activity by the other person; or
- a *condition concurrent* to be performed without concern for the other person's activities.

Categorizing conditions still further, some conditions **must be performed**, making the failure to perform them and close escrow a *breach* of the purchase agreement. Other conditions are the subject of contingency provisions and **might not occur or be approved**, in which case the failure of one or both parties to further perform and close escrow is *excused*.

Thus, under any type of contingency provision, the buyer or seller benefitting from the contingency holds an **option** to "do away with" any further performance of the purchase agreement and escrow instructions, called *cancellation*.

Conditions precedent and concurrent

While all contingency provisions are conditions, it must be well understood that not all conditions agreed to in the provisions of a purchase agreement are contingencies. Contingency provisions authorize the cancellation of the purchase agreement and *excuse* any further performance. Other conditions must be met since they are not contingencies, in which case a failure becomes a *breach*.

For analysis, the two classifications of conditions which exist in purchase agreements, distinguished by whether or not the other person must perform or is excused due to the failure of the identified event to occur or condition (information) to be approved, are:

1. *Conditions precedent*, which consist of contingency provisions calling for the occurrence or approval of an event or condition which **may or may not occur**. Examples include the buyer obtaining a written loan commitment, the recording of a purchase-assist loan, approving due diligence investigations, etc. Here, the contingency provision may be *eliminated* and the transaction can proceed toward closing. Alternatively, if the event or approval is not forthcoming, the person authorized to cancel may *exercise* his right to terminate the transaction, doing away with any **further performance** of the purchase agreement and escrow instructions, called *cancellation*; and

2. *Conditions concurrent*, which consist of noncontingent, mandatory performance provisions calling for the buyer or seller to perform some activity which **must occur**. If the activity does not occur, the purchase agreement has been *breached* by the person who promised to perform or was obligated to cause the activity or event to come about. Examples include the failure of the seller to produce promised information, data, documents and reports on the property or deliver a clearance, grant deed or title insurance policy as agreed. The failure to deliver is a *breach* which allows the other person to either terminate the transaction by notice of cancellation or pursue specific performance of the purchase agreement.

Before escrow can proceed on to closing, contingency provisions must be *eliminated*. Contingency provisions (conditions precedent) included in purchase agreements are **eliminated** by either:

- *satisfaction* of the condition by either an **approval** of the data, information, documents or reports identified as the subject of the provision by the person holding the right to terminate the transaction, or by the **occurrence** of the event called for in the provision; or

- *waiver* (or expiration) of the right to cancel the transaction by the person authorized to cancel, if the identified condition or event has not been satisfied by its approval or occurrence.

Thus, the buyer or seller who does not have the right to terminate the transaction under a provision and avoid closing the transaction must perform all his remaining obligations on the contract, called *conditions concurrent*. He must act without concern for the other person's performance under the purchase agreement, unless the other person must first perform some activity before he is able to comply. For example, the seller providing a Natural Hazard Report before the buyer can review it and approve its contents. [See Form 150 §11.5 accompanying Chapter 51]

The obligation of a buyer or seller to complete noncontingent (concurrent) activities required of him to close escrow exists in spite of the fact the other person may not have yet fully performed, or that the other

person has a right to later cancel the purchase agreement. Examples include the inability of a buyer to originate a purchase-assist loan (or cancel) after the seller has fully performed by delivering all closing documents to escrow.

Content of a contingency provision

Regardless of the type of contingency involved, agents must make sure the contingency provision is in writing, even though oral contingencies are generally enforceable. Written contingencies avoid confusion over content, enforceability and forgetfulness.

Specifically, a written contingency should include:

- a description of the event addressed in the contingency (i.e., what is to be approved or verified);
- the time period in which the event called for in the contingency provision must occur;
- who has the right to cancel the purchase agreement if the event does not occur (i.e., whether the buyer, the seller or both can enforce the contingency provision by canceling the transaction);
- any arrangements to avoid cancellation if the contingency is not satisfied or waived (i.e., offsets to the price or time to cure the failure or defect); and
- the method for service of the notice of cancellation on the other person.

Provisions for uncertainties

An agent includes contingency provisions in a purchase agreement in an effort to protect his client from agreeing absolutely to do or cause to occur that which may not occur. The goal at closing is to avoid being forced to accept a situation inconsistent with the client's original expectations or ability to perform when he entered into the purchase agreement.

Without **authority to terminate** the agreement on the failure of the client's expectations, such as the buyer's inability to record a purchase-assist loan or to confirm the seller's representations, the client's inability or refusal to continue to further perform under the purchase agreement and close escrow would be a *breach*. Thus, the client due to his breach would be liable to the other person, unless the client's nonperformance was justified by some pre-contract misrepresentation (or omission) of facts which led to the client's lost expectations, called *deceit*.

To avoid a **breach** and be **excused** from closing escrow an exit strategy must be agreed to in the purchase agreement. When events and conditions develop during escrow which do not meet the expectations or anticipations of the client, his agent must have foreseen the need to *conditionalize* the client's continued performance by including contingency provisions in the purchase agreement.

Due to the inclusion of a contingency provision, the client is **authorized to terminate** the agreement and avoid closing escrow on failure of the identified event to occur or due to the unacceptability of data, information, documents or reports. [See Form 159 §11 accompanying Chapter 53]

But before lacing a purchase agreement with contingency provisions, or allowing the client to enter into one, a prudent agent will first attempt to clear uncertainties the client may have about the property or the transaction before entering into the contract.

Use of contingency provisions

It is the buyer's agent who, along with buyers, is the primary user of contingency provisions in purchase agreements. From a buyer's point of view, and thus the buyer's agent's perspective, every activity, event or condition which is the responsibility of the buyer to approve or cause to occur prior to closing should be the subject of a contingency provision in the purchase agreement. [See **first tuesday** Forms 260 through 279]

Also for buyers, the period for exercise of the right to cancel should be as long as possible. Thus, the right to cancel should be structured to expire no earlier than the date scheduled for the close of escrow. The possibility always exists that the event or approval needed by the buyer to close escrow may never occur.

These conditions range, for example, from applying for purchase-assist financing or retaining consultants for advice on the value or integrity of the property, to making the down payment or providing personal identity information to the title insurance company.

When preparing the purchase agreement, the buyer's agent must rely on his experience to decide which events and approvals the buyer is responsible for and thus need to be the subject matter of a contingency provision. Then, if the event does not occur, such as the recording of mortgage financing, or are unacceptable, such as the failure of the property on a due diligence investigation to meet expectations, the buyer may cancel and be excused from proceeding. Thus, he can act to avoid closing and not be in default (breach) on the purchase agreement (or end up in a dispute claiming he has been misled by the seller or the listing agent).

Many events and disclosures are the subject of contingency provisions contained in stock forms used by agents. [See Form 159 §11]

However, the boilerplate wording of pre-printed contingency provisions varies greatly regarding:

- the time for the gathering and delivery of data, information, documents and reports;
- the time period for review of the material received or the occurrence of an event (such as a loan commitment or sale of other property);
- the date set for expiration of the right to cancel the transaction after failure of the event or approval to occur;
- whether a written waiver is to be delivered evidencing the elimination of the contingency provision, without which the other party may then cancel;
- the requirement of a written notice of cancellation should the right to cancel be exercised on failure of an event or condition; and
- the time period for the other person's response to a notice of cancellation to cure the defect or failure, and thus avoid a termination of the purchase agreement.

Typically, several contingency provisions are included in a purchase agreement. Thus, a **uniform method** for terminating the agreement is employed. Termination provisions call for a written notice of cancellation, and how and to whom it is to be delivered, including instructions to escrow. [See Form 150 §10.5]

Also, approval notices or waiver of contingency provisions need not be called for in purchase agreements. Contingency provisions are considered to be the grant of an **option to terminate** a transaction by exercise of the right to cancel prior to the *expiration* of the option period.

Thus, the person authorized to cancel or otherwise benefit from the inclusion of the contingency provision, but does not need to use the provision to cancel the purchase agreement, need do nothing. He simply allows the "option period" for cancellation to expire.

The contingency is eliminated by the expiration of the right to cancel. Thus, a need never exists to approve or waive the contingency in order to do away with the right to cancel and proceed to close escrow, unless the purchase agreement wording states an approval or waiver is required to keep the contract alive. [**Beverly Way Associates** v. **Barham** (1990) 226 CA3d 49]

Conditions not contingent

The condition of the property, namely the physical integrity of the land and improvements, is frequently not disclosed to the buyer before entering into a purchase agreement. Most delayed disclosures fail to comply with the statutory mandates imposed on sellers and listing agents to hand the information to prospective buyers as soon as reasonably possible.

The listing agent has a mandated duty, owed to the public, to visually inspect the listed property and note his observations and awareness of property conditions adversely affecting the value on the seller's statutory disclosure document, called a Condition of Property or Transfer Disclosure Statement (TDS).

Not only is it **reasonably possible** for the listing agent to deliver the TDS before his seller enters into a purchase agreement with a buyer, it is mandated by case law and the economic imperatives of *transparency* to deliver property disclosures before a price is set in property transactions.

However, some stock purchase agreement forms convert the failure of the listing agent to deliver a TDS before the acceptance of an offer into a contingency, the result of a statutorily imposed penalty placed on the seller for his tardy disclosures. As the subject matter of a contingency, the buyer is granted the right to cancel the transaction when the TDS is belatedly received.

If on review of the tardy disclosures the property conditions do not meet the expectations held by the buyer at the time he entered into the purchase agreement, the buyer may cancel the purchase agreement all due to the dilatory and misleading conduct of the listing agent, a type of fraud called *deceit*.

If not cancelled, the buyer would become the owner of property which is not in the condition and of the value he was *lead to believe* and to think existed when he entered into the purchase agreement.

Now applying the same disclosure of facts, consider a diametrically opposed purchase agreement provision written to handle the listing agent's dilatory in escrow delivery of the TDS without establishing a contingency containing the buyer's right to cancel.

Rather, the TDS provision calls for the buyer to review the seller's and listing agent's post-acceptance property disclosures. The provision grants no one the authority to cancel should the property's conditions be unacceptable or less than expected when entering into the purchase agreement. Instead, it requires **continued performance by all**.

Any significant discrepancies in the property's condition disclosed in the TDS and not observed or known to the buyer before entering into the purchase agreement allows the buyer **to notify** the seller

of the defects and make a demand on the seller to cure them by repair, replacement or correction. If the buyer fails to give notice, he has let his right expire to demand the correction of previously undisclosed defects noted in the TDS and must proceed to close escrow. [See Form 269 accompanying Chapter 27]

However, if the buyer makes a demand on the seller to cure those defects first discovered by the buyer on his in-escrow review of the TDS, the seller is required to make the corrections before closing or suffer a reduction in the price equivalent to the cost to cure the noticed defects. Of course, the disclosure of the property's condition before the purchase agreement is accepted relieves the seller (and the buyer) of the need to activate this performance provision regarding repairs. [See Form 150 §11.2]

The time set for delivery of data, information, documents and reports under a contingency provision so they can be approved or disapproved, as well as the date set for delivery of a notice of cancellation given for any valid reason, is always subject to *time-essence rules*. [**Fowler** v. **Ross** (1983) 142 CA3d 472]

Failure to close is a breach, unless excused

Frequently, a contingency provision calls for two events to occur in tandem, i.e., a condition concurrent, which **must occur**, followed by a condition precedent (approval), which **may or may not occur**.

For example, a seller of a condominium unit is to first provide documents on the homeowners' association (HOA) to the buyer (the condition concurrent) for what then becomes the buyer's review (the condition precedent). Here, the seller **must deliver** the HOA documents as a prerequisite to the buyer's review of their content for approval or disapproval. The seller must obtain the documents or otherwise cause them to be handed to the buyer. If he does not, the seller has *breached* the contingency provision and the purchase agreement. [See Form 150 §11.9]

As for the buyer who receives the HOA documents, he must then enter upon a *good-faith review* of the document's content under his further-approval contingency provision. After the review and completion of any further inquiry or investigation into the HOA document's content, the buyer is to either express his approval by waiving or letting the right to cancel expire. However, if he has good reason and an honest belief that he cannot approve of their content, disapprove the documents by canceling the transaction.

Here, the seller is initially obligated to get the documents and deliver them to the buyer without concern for what steps the buyer may or may not be taking to perform any of his obligations under the purchase agreement, such as applying for a loan, providing a credit report or approving disclosures he has received.

Consider another **tandem-events provision** in which the buyer will execute a promissory note in favor of the seller in a carryback transaction. The buyer, in a *further-approval contingency provision*, agrees to prepare and hand the seller a credit application. On receipt, the seller is to review and then approve or cancel the transaction if the seller has a reasonable basis for disapproving the buyer's creditworthiness.

The buyer's obligation to deliver the credit application is a compulsory event he is required to perform. The failure to deliver the credit application is a *breach* of the further-approval provision since the buyer's delivery of the application is not conditioned on anyone (read the seller) first doing something. [See Form 150 §8.4]

On the other hand, the seller on receipt of the credit application is required to review the buyer's creditworthiness. However, he is not required to approve the buyer's creditworthiness, and if disapproved based on reasonable grounds, the seller is *excused* from closing escrow by canceling the transaction. [See Form 150 §8.5]

Act to close without concern

Other contingency provisions require one person, such as the buyer, to first enter upon an activity (such as signing and returning escrow instructions) without concern for whether the other person, such as the seller, is performing his required obligations, such as obtaining a pest control clearance, an occupancy certificate, the release or reconveyance of liens on title, etc.

For example, a purchase agreement contains a contingency provision calling for the buyer to obtain and record a purchase-assist loan. Should the buyer fail to originate the loan as anticipated, the buyer may cancel the transaction and be *excused* from further performing.

However, the buyer is obligated to promptly initiate the loan application process without concern for whether the seller has commenced any performance of the seller's obligations, such as signing and returning the seller's escrow instructions, providing a deed or ordering out inspections and reports required to be obtained by the seller. [**Landis** v. **Blomquist** (1967) 257 CA2d 533]

A person's performance of an activity which **must occur**, versus his undertaking to bring about an event or approve a condition which **may or may not occur**, is an important distinction to be made. One is a *breach* of the purchase agreement should the activity not occur; the other *excuses* any further performance by cancellation should the described event not occur. Both failures permit the purchase agreement to be canceled by the opposing party, but a breach carries with it **litigation and liability exposure**.

For example, the buyer of a nonresidential income property is willing to purchase the property only if the seller cancels a disadvantageous lease held by a tenant. The buyer's agent prepares a purchase agreement with a provision calling for the seller to deliver title and assign all existing leases except the one the buyer is unwilling to accept.

While the seller believes he can negotiate a cancellation of the lease, the listing agent does not want his seller committed to delivering title and then fail to be able to negotiate the cancellation of the lease. To accept the purchase agreement with the provision calling for delivery of the title clear of the lease would place the seller in breach if he could not negotiate a cancellation of the lease. Thus, the seller would be exposed to liability for the decrease in the value of the property resulting from the lease remaining as a defect (i.e., an unapproved encumbrance) on the title.

Here, the seller should submit a counteroffer prepared by the listing agent calling for the delivery of title to be contingent on the seller's termination of the lease, an **event-occurrence contingency provision**.

Thus, the seller will only become obligated to make a good-faith effort to negotiate the cancellation of the lease. Should he fail to be able to deliver title clear of the lease, he may cancel the transaction and be *excused* from any further performance, and, importantly, be free of any liability for the failure to deliver title as agreed.

Performing without concern

Many contingency provisions authorize the buyer to exercise his right to cancel at any time up to and including the date scheduled for closing should the identified condition or event fail to occur. In the in-

terim, the seller must fully perform all of his obligations to deliver to escrow all documents needed from the seller to close. After the seller has fully performed, the buyer, at the time of closing, may then cancel on failure of the condition or event.

The **rights of a seller** in the buyer's contingency provision include assurances that:

- the buyer must act on any cancellation before the *right to cancel expires*; and
- the cancellation is the result of a good-faith effort by the buyer to act reasonably to *satisfy the contingency* so the transaction can close.

Consider a purchase agreement with terms for the payment of the purchase price which include having the buyer obtain a purchase-assist loan. The close of escrow is contingent on the buyer recording the loan since the buyer has the right to cancel if payment of the price cannot be funded by a purchase-assist loan. [See Form 150 §10.3]

However, the seller has not handed escrow any of the documents or information requested by escrow, the receipt of which is needed to close escrow. The buyer then refuses to submit his loan application and fees to his lender until the seller has fully performed all his obligations for escrow to close. The buyer claims it is futile for him to proceed if the seller has not performed.

In turn, the seller cancels the transaction, claiming the buyer has breached his duty to make a good-faith effort to eliminate the loan contingency by applying for the loan.

Here, the buyer's obligation to take steps to satisfy the loan contingency and the seller's obligation to deliver deeds, termite clearances, etc. to escrow are **independent obligations**, called *conditions concurrent*. Thus, the buyer and seller must each perform their part of the closing activities without concern for whether the other person has or is performing.

Also, the seller must, prior to the date scheduled for close of escrow, have fully performed all the acts required of the seller for escrow to close, and perform them in a timely manner for escrow to close on the date scheduled. The seller must comply even though the buyer's right to terminate the transaction can be exercised by canceling the escrow as late as the date scheduled for closing. [Landis, *supra*]

Sellers who agree to loan contingency provisions for buyers often require a separate and specific time-essence contingency provision to assure themselves that the buyer will act promptly to arrange a loan. In the provision, the buyer authorizes the seller to cancel the transaction if the buyer does not produce a loan commitment or a statement from a qualified lender by a specific date demonstrating that the buyer is qualified for a loan in the amount sought. [See Form 150 §4.1]

Now, if the buyer fails to timely act on an application to negotiate a loan and arrange for a statement of his creditworthiness to be handed to the seller by the deadline for satisfaction of the condition, the seller may cancel the transaction.

Purchase agreement as binding

The existence of an oral or written contingency provision in a purchase agreement does not render the agreement *void*, as though it were a mere illusory contract which never was binding.

On the contrary, when an offer is accepted, a *binding agreement* is formed. The overriding issue on forming a binding purchase agreement which contains a contingency provision is whether the purchase agreement will ever **become enforceable** by the elimination of contingencies as satisfied or waived.

For example, the board of directors of a corporation decides the company needs to purchase a warehouse to store inventory. To meet the corporate objectives, the president, on behalf of his corporation, employs a broker who locates a suitable building. It appears the property will be sold to another person before board approval can be obtained authorizing the corporation to enter into a purchase agreement to acquire it.

As the agent authorized to bind the corporation to perform under a purchase agreement, the president, on behalf of the corporation, submits a signed purchase agreement offer to the listing agent agreeing to buy the real estate, conditioned on the **further approval** of the board of directors within 20 days of acceptance.

The seller accepts the offer after his listing agent explains the purchase agreement will not be enforceable until the board of directors approves the purchase, and thus *eliminates* the contingency.

The corporation, based on the offer submitted by its president and the seller's acceptance, has effectively taken the seller's property off the market while the president completes his due diligence investigation. Further, the board gets a "free look" by controlling the property before deciding on the property's suitability as a warehouse, or whether the terms of the purchase agreement are acceptable.

Here, the seller has a binding commitment from the corporate buyer to purchase the real estate, subject to presenting the purchase agreement and the property selection to the board for approval or rejection and cancellation under the contingency provision. [**Moreland Development Company** v. **Gladstone Holmes, Inc.** (1982) 135 CA3d 973]

However, the officers and board of directors of any corporate buyer or seller must act in *good faith* when exercising a contingency provision by cancellation. Accordingly, the officers need to submit the purchase agreement transaction to the board. The board then needs to review the purchase agreement. If conditions are unacceptable, the board should reject the purchase agreement in a resolution stating a reasonable basis for exercising the corporation's rights under the contingency provision to disapprove of the property selection or the terms of purchase and cancel the transaction. [**Jacobs** v. **Freeman** (1980) 104 CA3d 177]

Chapter 43 The elimination of contingencies

This chapter discusses conditions which must be eliminated before a purchase agreement becomes enforceable.

Occur, approve, waive, or exercise

As a result of negotiations over the content of a purchase agreement, buyers and sellers frequently include provisions in the agreement which place **conditions** on their duty to close escrow, called *contingencies*. Contingency provisions placed in a purchase agreement grant the authority, which may only be **used for good cause**, to terminate the buyer's duty to pay the purchase price or the seller's duty to deliver title.

Contingencies describe an **event or condition** which the buyer or seller feels must occur or be approved before the purchase agreement transaction can proceed to closing. These contingencies need to be *eliminated* before a binding purchase agreement becomes fully enforceable, obligating the buyer and seller to close the transaction.

Contingency provisions contained in purchase agreements are **eliminated** by either:

- *satisfaction* of the contingency provision by the occurrence of an event or by someone's approval of the conditions contained in information, data, documents or a report; or

- *waiver* or *expiration* of the contingency provision.

On the occurrence or approval as described in a contingency provision, the condition is said to be *satisfied*, such as the buyer's receipt of a loan commitment or approval of disclosures.

If a condition is not satisfied, the **person authorized or benefitting** from the contingency can either:

- *cancel* the transaction by serving the other person with a Notice of Cancellation [See Form 183 accompanying Chapter 44]; or

- *waive* the contingency and proceed with the transaction by notifying the other person the contingency has been waived or by allowing the time period for cancellation to expire. [See first tuesday Form 182 accompanying this chapter]

Satisfaction or cancellation

If the **event or approval** called for in the contingency provision does not come about, the person with the right to cancel may *waive* the contingency provision or allow it to expire and proceed to closing. If the contingency provision is not waived or allowed to expire on failure of the event or approval to occur, the purchase agreement transaction can be terminated by the person with the right to cancel.

The person with the right to cancel may only *exercise* the right if they have a **reasonable basis** for the cancellation. If a reasonable basis exists, they can avoid enforcement of the purchase agreement by the other person.

To exercise the right to cancel, a notice of cancellation must be delivered to the other person during the period for timely exercise of the right to cancel and in the manner set out in the cancellation provision. [See Form 150 §10.5 accompanying Chapter 51]

Colorful jargon in the real estate industry has **tagged contingency provisions** with such titles as "weasel clauses," "escape clauses" or "back-door provisions." These titles suggest a misunderstanding of the ability to use contingency provisions to cancel and avoid buying or selling the property when the person wishing to cancel merely have a change of heart about proceeding with the transaction.

He who benefits may waive bye-bye

Consider a buyer who agrees to purchase property for a price acceptable to the seller. The terms for payment call for the buyer to fund part of the price by obtaining a purchase-assist loan at a particular interest rate with a specific monthly amortization schedule, until paid, e.g., a loan amount of no less than $200,000 at a fixed rate no greater than 6.5% amortized by monthly payments over a 30-year period.

Included in the purchase agreement is a provision stating the close of escrow is "contingent on" the buyer obtaining the purchase-assist loan, an *event-occurrence contingency provision*. [See Form 150 §10.3]

The buyer discovers that mortgage lenders are raising rates, encouraged by a national monetary policy aimed at dampening an *asset inflation* bubble reflected in fast rising property values. As a result, one loan commitment received by the buyer comes in at a higher fixed rate of interest and a lesser loan amount than sought. Another is for the amount sought, but with a variable rate of interest. Neither commitment falls within the parameters of the terms set for the purchase-assist loan in the purchase agreement. [See Form 150 §4]

The seller is advised the loan commitments do not satisfy the terms called for in the purchase agreement. At the same time, the buyer either hands the seller a notice of waiver of the contingency or lets the right to cancel expire, as called for in the loan contingency provision.

When the seller receives confirmation the loan commitments do not satisfy the contingency provision, the seller cancels the transaction. The seller claims the failure of the loan commitments to meet the conditions set for the loan gives him the power to terminate any further performance of the purchase agreement or escrow.

However, the power to cancel a transaction due to the failure of a contingent event can only be exercised by the person who **benefits** from the inclusion of the contingency provision in the purchase agreement.

Here, the seller has agreed to a **cash transaction**. On closing, the seller will receive net proceeds consisting of cash; nothing else. Thus, while the loan will help the buyer fund the sales price, the existence or nonexistence of the purchase-assist loan has no effect on the seller's ability to perform or the seller's net proceeds. The loan contingency does not benefit the seller.

If financing is not available and the buyer could not otherwise fund the close of escrow, the buyer would be in breach of the purchase agreement, unless he had the right to cancel the transaction and be excused from closing. Thus, the event-occurrence contingency provision calling for the recording of a purchase-assist loan was solely for the benefit of the buyer.

Accordingly, only the buyer held the right to cancel the transaction or waive the contingency. The buyer did neither. He did not exercise his right to cancel by **stating he disapproved** of the loan commitment or

WAIVER OF CONTINGENCY

DATE:_____, 20_____, at_____, California.

TO: _____

Items left blank or unchecked are not applicable.

FACTS:

This waiver pertains to contingencies in the following contract:

☐ Purchase agreement

☐ Exchange agreement

☐ Counteroffer

☐ Escrow

☐ _____

dated _____, 20_____, at _____, California,

entered into between _____, as the _____,

and _____, as the _____,

regarding real estate referred to as _____

_____

_____

_____.

AGREEMENT:

The undersigned hereby waives the following contingency: _____

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____.

I agree to perform the agreement on its remaining terms and conditions.

Date:_____, 20_____

Signature:_____

Signature:_____

RECEIPT OF WAIVER:

I acknowledge receipt of a copy of this waiver.

Date:_____, 20_____

Signature:_____

Signature:_____

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by delivering a notice of cancellation (as required by the contingency provision). The seller's attempt to usurp the benefits of the provision by canceling had no legal effect on the continued enforceability of the purchase agreement. [**Wesley N. Taylor, Co.** v. **Russell** (1961) 194 CA2d 816]

Mutually beneficial further-approval contingencies

Now consider a buyer who agrees to purchase and develop real estate.

The seller agrees to carry back a purchase-money note secured by a trust deed which is *subordinate* to a construction loan the buyer is to originate to fund his development of the property. It is agreed the loan is to be approved and insured by the Federal Housing Authority (FHA). Neither the seller nor the buyer are given the written right to cancel if the approval is not forthcoming, although closing is contingent on recording the loan.

The FHA fails to approve the development project for mortgage insurance. As an alternative, the buyer obtains financing for the project elsewhere and notifies the seller he *waives* the FHA-approval contingency. [See Form 182]

On receipt of the buyer's notice of waiver of the FHA further-approval contingency, the seller hands escrow a notice of cancellation and refuses to close escrow. The seller claims the failure to obtain FHA approval excuses the seller's performance as he did not waive his right to an FHA approval.

Can the seller enforce his cancellation of the purchase agreement and escrow instructions when the buyer's application for FHA approval was rejected?

Yes! Here, the FHA approval benefits both the carryback seller and the buyer. Thus, one or the other can cancel the transaction on the failure of the FHA approving the project since the contingency provision did not note who had the right to waive the provision or cancel on failure of the event to occur. Thus, each party who benefits from the inclusion of a contingency provision has the power to exercise the right of cancellation.

The buyer benefits under the contingency since FHA insurance will induce a lender to make a construction loan so he can fund the project.

However, the seller also benefits. An FHA-approved and insured project is additional security (protection) and provides a reduced risk of loss for his subordinated carryback trust deed note.

Thus, the contingency was included for the **mutual benefit** of both the buyer and seller, and cannot be waived — except by mutual consent — and either the buyer or seller may cancel on failure of the buyer to obtain FHA approval. [**Spangler** v. **Castello** (1956) 147 CA2d 49]

Waiver implied by conduct

When a buyer's **conduct** leads a seller to believe a contingency benefitting the buyer has been waived and the seller then relies on the buyer's indications by taking steps to complete his performance under the purchase agreement, the contingency is deemed to have been *waived*.

For example, a buyer enters into a purchase agreement with a builder to buy a lot on which the builder will construct a single-family residence (SFR) for the buyer. The purchase agreement contains a provision conditioning the close of escrow on the sale of the buyer's current residence, an *event-occurrence contingency provision*.

However, the buyer does not want to market his current residence for sale and locate a buyer until just before the completion of construction, as he has no other place to live.

The buyer instructs the builder to begin construction based on plans and specifications approved by the buyer for the new home. During construction, the buyer continually reviews the progress of the construction with the builder. Also, the buyer orders changes in the plans and specifications during construction, with which the builder complies. The buyer never tells the builder to stop construction, nor does he advise the builder his current residence has not yet been sold.

On completion of construction, the builder makes a demand on the buyer to fund and close escrow.

The buyer then cancels the purchase agreement and refuses to perform. The buyer claims the contingency provision calling for the sale of other property has not been satisfied, which triggers his right to cancel since the sale of the current residence has not occurred.

The builder claims the buyer's conduct constituted a *waiver* of the contingency, which now requires the buyer to perform.

Here, the buyer, by his conduct in changing the construction specifications and remaining silent concerning the lack of activity on the sale of his current residence during his inspections into the progress of construction, *reasonably induced* the builder into believing the "sale-of-other property" contingency had been considered by the buyer to be waived.

Thus, the buyer's failure to close the transaction was a breach of the purchase agreement since the power to exercise the right of cancellation authorized by the sale-of-other property contingency provision no longer existed after the waiver. [Noel v. Dumont Builders, Inc. (1960) 178 CA2d 691]

Satisfaction by occurrence or approval

Events or **conditions** identified in contingency provisions, which if not forthcoming allow the transaction to be terminated, fall into two categories:

- those which are satisfied by *occurrence*, consisting of event-occurrence contingency provisions which are dependent on the existence, completion or outcome of an activity or event for their elimination; and
- those satisfied by *approval*, consisting of further-approval and personal-satisfaction contingency provisions calling for the receipt and review of information, data, documents and reports as the conditions to be approved, waived or disapproved by others or by the person authorized to terminate the transaction.

Event-occurrence contingencies

Event-occurrence contingency provisions address the **occurrence** of activities and events, such as:

- the sale or acquisition of other property or the cancellation of a prior sale;
- the recording (or approving) of a lot split or subdivision map;
- rezoning;
- the issuance of a use permit or a variance;
- the approval of building permits;

- the issuance of subdivision reports;
- the documentation from off-record spouses;
- the availability of utilities;
- the availability of hazard/fire insurance;
- the elimination of title conditions, or the release of encumbrances, such as liens or leases;
- building permit compliance;
- providing warranties on appliances;
- a loan commitment;
- the recording of a loan; and
- the deposit of equity financing funds for the down payment.

Further-approval contingencies

Further-approval contingency provisions address the right of a party to the purchase agreement or a third party to cancel the transaction should they disapprove or find the following unacceptable:

- disclosures and inspection reports concerning the physical integrity and natural and environmental hazards of the property sold;
- due diligence investigative reports;
- title reports;
- leases and estoppel certificates;
- rent control restrictions;
- service contracts;
- operating income and expense statements;
- the financial suitability of a carryback note;
- credit reports;
- appraisals;
- tax aspects;
- surveys;
- utilities, well water and sewage conditions;
- use feasibility reports;
- engineering reports on land use;
- existing plans and specifications for building;
- ingress and egress;

- loan commitments; and
- the availability of equity financing.

The buyer or seller with the right to cancel based on a further-approval contingency has a duty to fairly evaluate the condition to be approved or disapproved prior to canceling the transaction, called *acting in good faith*.

The buyer or seller who attempts to terminate a purchase agreement under a right-to-cancel contingency without first acting to satisfy the contingency is taking an unfair advantage of the provision. To not undertake ativities necessary to make an informed decision about a condition would allow the transaction to be terminated "at will," simply because a contingency existed in their agreement.

Personal-satisfaction contingencies

A personal-satisfaction contingency allows the buyer or seller to avoid performance of the purchase agreement if they are not *personally satisfied* with an aspect of the transaction referenced in the contingency provision.

Personal-satisfaction contingencies are identical to further-approval contingencies, except the buyer or seller is the one who approves or disapproves the subject matter of the contingency — **not a third party**.

Since the personal-satisfaction contingencies are essentially the same as the further-approval contingencies, they are judged by the same reasonableness standard when used to cancel a transaction.

Thus, a buyer or seller must have a *reasonable basis for disapproving* a personal-satisfaction contingency before a cancellation of the agreement is permitted.

Approval by waiver

The objective of a buyer's agent when he includes a contingency provision in a purchase agreement for the benefit of his buyer is to provide the buyer with the ability to cancel the transaction should the **event** fail to occur or the **condition** be disapproved.

If the contingency is to be **eliminated** by approval (waiver) or expiration of the right to cancel, or exercised by cancellation of the purchase agreement prior to the date scheduled for the close of escrow, the buyer is to act by giving the **appropriate notice** to the seller as called for in the purchase agreement.

If the condition reviewed is acceptable or the event occurs, the buyer's agent may be required by the wording of the provision to prepare a **notice of waiver** to eliminate the contingency. It is then signed by the buyer and handed to the seller, escrow or the seller's agent, as called for in the contingency provision. [See Form 182]

The buyer may also *waive* the right to cancel and, while neither approving nor disapproving the situation, *eliminate* the contingency provision as called for in the purchase agreement. Here, the buyer's agent uses the same notice of waiver form used for an unequivocal approval, if the buyer is required by the purchase agreement to notify the seller of the buyer's intention not to cancel, but to continue with the further performance and closing of the transaction. [See Form 182]

Chapter 44 Cancellation excuses further performance

This chapter evaluates the conduct of a buyer or seller under a contingency provision in a purchase agreement which cancels their transaction and excuses any further performance of the agreement.

Exercising the option to terminate

Consider a seller who has agreed to carry back a note which is secured by a second trust deed junior to the existing trust deed note the buyer is to assume. The purchase agreement entered into with the buyer contains a **further-approval contingency provision** which grants the right to cancel the transaction to:

- the seller if the buyer's *creditworthiness* is unacceptable to the seller [See Form 150 §8.5 accompanying Chapter 51]; and

- both the buyer and the seller if either one disapproves of the existing trust deed lender's *terms for an assumption* of the loan by the buyer should the terms exceed the loan parameters agreed to in the purchase agreement. [See Form 150 §§8.6 and 10.3]

On the seller's receipt of the buyer's credit application form, the listing agent orders and receives a report on the buyer's creditworthiness from a credit reporting agency.

The seller, on review of the information with his agent, expresses concern about the buyer's payment history. The listing agent asks the buyer for more information regarding the buyer's income and net worth. Specifically, the agent asks for a **balance sheet** listing assets and liabilities and an end-of-year **financial statement** on the buyer's income and expenses for the past two calendar years.

The buyer promptly supplies the additional financial data. Meanwhile, the listing agent learns the buyer is going to use a line of credit at a bank to finance the down payment called for in the purchase agreement. As this information may affect the carryback seller's decision to exercise his right to cancel the transaction under the credit approval contingency, the listing agent relays the information to the seller.

With all the relevant credit information readily available and known to the listing agent now in the hands of the seller, the seller determines he has *justification* for exercising his option to terminate the purchase agreement transaction and cancel escrow. However, the seller has not yet decided what to do about allowing the transaction to continue.

Gather facts and timely respond

The listing agent is mindful of the upcoming expiration date of the seller's right to cancel and of his duty to protect the interests of the seller. Seeing his client's inaction, the agent advises the seller that if he does nothing to cancel by the expiration of his right he will have lost his ability to be *excused* from completing the transaction, whether or not the buyer's credit is acceptable.

The seller understands he must serve a notice of cancellation on the buyer before the expiration date set in the contingency provision, unless he intends to let the period for cancellation expire and proceed to close escrow.

On the expiration date of the seller's right to cancel, he decides to do nothing. The seller is willing to undertake the additional risks, including the possible need to foreclose, presented by the buyer's insufficient creditworthiness.

In the meantime, the lender has processed the buyer's application to assume the loan and forwarded assumption documents to escrow for the buyer to sign and return. The terms for an assumption demanded by the lender include a modification of the interest rate, a new amortization schedule for payments and a due date not previously included in the note. However, these terms exceed and are more financially burdensome than the loan assumption parameters agreed to in the purchase agreement.

The buyer promptly signs the loan documents and returns them to escrow, together with the assumption fee demanded by the lender. Thus, the buyer, by conduct inconsistent with his right to cancel granted him by the loan assumption contingency provision, has *waived* his right to cancel the transaction. The buyer now no longer has the authority to terminate the purchase agreement for failure of the terms for an assumption to fall within the parameters agreed to in the purchase agreement. [See Form 150 §10.3]

The seller on learning that the terms for assumption and modification of the existing first trust deed note determines they exceed the parameters of the loan assumption terms agreed to in the purchase agreement. He instructs his listing agent to prepare a notice of cancellation to terminate the transaction and escrow. The notice is immediately signed by the seller and delivered to the buyer and escrow.

Here, the risks of loss presented by the loan modification accompanying the assumption agreement is greater than the risks presented by the terms agreed to in the purchase agreement. Thus, the seller has a valid reason for refusing to subordinate to terms which would put his carryback note at a greater risk of loss of his security than agreed.

The seller's cancellation now allows the seller (as well as the buyer) to avoid any *further performance* of the purchase agreement or escrow since all obligations to close escrow have been *excused*.

An authorized unilateral cancellation

Cancellation of a real estate purchase agreement and escrow is due either to a *breach* of the agreement by the other party or the *failure* of an event to occur or a condition to be approved as called for in a contingency provision. The act of canceling is a *unilateral agreement* since the cancellation of the purchase agreement is undertaken by one person only. Cancellation **does away with** whatever remains to be performed under the purchase agreement, called *termination of the contract*.

Terminated is the right to buy or sell the property and close escrow by enforcing the further performance of the agreement. Thus, a cancellation affects the *future enforcement* of the agreement from the moment of cancellation. However, the cancellation of a purchase agreement does not affect the legal consequences and liabilities for activities and *events which preceded* the cancellation.

Conversely, *rescission* of either an unexecuted purchase agreement (i.e., escrow has not yet closed) or of a completed real estate transaction (i.e., escrow has closed) is a *bilateral agreement* in which both the buyer and seller, acting in concert, **retroactively annul** the purchase agreement from the moment it was entered into.

While a **cancellation** merely brings a purchase agreement to a standstill, a **rescission** returns the buyer and seller to their respective positions **prior to entering into** the purchase agreement, as though they had never agreed to the transaction. The retroactive return to their former, pre-contract positions is called *restoration*.

When both the buyer and seller enter into a rescission agreement, the **restoration** of the buyer and seller to their pre-contract positions eliminates all claims they may have had against each other for conduct which occurred after entering into the purchase agreement and prior to its rescission. A rescission is voluntarily accomplished as part of a mutual agreement to eliminate the purchase agreement, called a *release and waiver agreement*. [See Form 181 accompanying Chapter 46]

Distinguished from a cancellation of the purchase agreement is the unilateral or mutual cancellation of only the **escrow instructions**, without including any reference to cancellation of the purchase agreement. Often, due to a dispute or failure of a contingency, escrow will not close. Here, escrow will issue instructions calling for the return of funds and documents to the party who deposited them in escrow.

These cancellation-of-escrow instructions, signed by both the buyer and seller, need not also call for a cancellation of the purchase agreement. If the purchase agreement is **not also canceled**, the cancellation instructions handed escrow do not interfere with any rights the parties may have to enforce the purchase agreement. Escrow instructions are a separate contract from the purchase agreement.

The purchase agreement remains intact to be enforced to buy, sell or recover money losses. [Calif. Civil Code §1057.3(e)]

Cancellation for a valid reason

A seller or buyer who refuses to hand escrow the instruments (funds and documents) needed to close the transaction or otherwise comply with the escrow instructions has breached the agreement, unless his nonperformance is *excused*.

Nonperformance is **excused**, and the refusal to act is not a breach of the purchase agreement, if:

- a contingency *provision exists authorizing* the buyer or seller or the person benefitting from the contingency to terminate the purchase agreement on the failure of an event to occur or on disapproval of data, information, documents or reports;
- the *event fails* to occur or the condition reviewed is disapproved; and

Figure 1

*Excerpt from **first tuesday** Form 159 —*
Purchase Agreement — Income Property other than One-to-Four Residential Units

11. ACCEPTANCE AND PERFORMANCE:

11.1 This offer to be deemed revoked unless accepted in writing ☐ on presentation, or ☐ within _____ days after date, and acceptance is personally delivered or faxed to Offeror or Offeror's Broker within this period.

11.2 After acceptance, Broker(s) are authorized to extend any performance date up to one month.

11.3 On failure of Buyer to obtain or assume financing as agreed by the date scheduled for closing, Buyer may terminate the agreement.

11.4 Buyer's close of escrow is conditioned on Buyer's prior or concurrent closing on a sale of other property, commonly referred to as _____.

11.5 Any termination of the agreement shall be by written Notice of Cancellation timely delivered to the other party, the other party's Broker or escrow, with instructions to escrow to return all instruments and funds to the parties depositing them. [See ft Form 183]

11.6 Both parties reserve their rights to assign and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow on either party's written notice. [See ft Form 171 or 172]

11.7 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

11.8 Should Buyer breach the agreement, Buyer's monetary liability to Seller is limited to $_____.

- the person authorized or benefiting from the contingency provision *acts to terminate* the agreement by delivering a notice of cancellation prior to the expiration of his right to cancel. [See Form 183 accompanying this chapter]

When a **valid reason** exists which triggers the buyer's or seller's right to *exercise* their option to cancel, and they choose not to serve a notice of cancellation on the other party, their option to be *excused* from further enforcement **expires**.

Conduct less than disapproval

Consider a buyer who has entered into a purchase agreement and later receives a property operating cost sheet from the seller for his review and approval, called an *income and expense statement* or an *Annual Property Operating Data* (APOD) sheet. Receipt commences a **period of review** by the buyer to determine whether to exercise his right of disapproval and cancellation of the purchase agreement under a contingency provision. [See Figure 1 accompanying this chapter, *ante*]

The data tends to confirm the general information received by the buyer before making the offer. However, the breadth and depth of the information seems inadequate for a large, long-term investment. Thus, the seller is asked by the buyer's agent to supply additional data and information, including access to all supporting documentation regarding the property's operating history.

The seller claims the information he has already handed over sufficiently discloses the property's operating history and the buyer's request for more data and documents constitutes a disapproval of the information and acts as a cancellation. Thus, the seller says the deal is dead.

Has the buyer, by seeking additional information, disapproved of the condition of the income and expenses, and thus exercised his right to terminate the agreement?

No! The buyer's **request for additional data** on the property's operations is an expression of concern, not a disapproval. Implicit in a request for more information is the notion that a decision of any type has not yet been made.

Further, the seller has not fulfilled his obligation to deliver sufficient information to allow the buyer to complete his review and make an informed decision about the acceptability of the property's operations.

Before an agreement is terminated by a buyer exercising a contingency provision, the buyer's conduct must rise to the level of an *unequivocal disapproval* of the condition presented by the data, information, documents and reports supplied by the seller.

For a termination of the purchase agreement to occur, the buyer must either deliver a notice of cancellation, as called for to exercise the right granted to terminate the agreement, or otherwise communicate an *unequivocal rejection* of the disclosed condition to the seller.

Any inadequacy of information perceived by the buyer may result in the buyer's inquiry into the apparent failure or possible unacceptability of the conditions disclosed. A request for more information is to be complied with by the seller as his obligation under the contingency provision.

The seller who fails to comply with a reasonable request for more information made in good faith to assist the buyer in the decision making process of approval or disapproval of the condition under review has breached his obligation under the contingency provision to hand over data, information, documents and reports.

NOTICE OF CANCELLATION

Due to Contingency or Condition

DATE: _____, 20_____, at _____, California.

TO: _____

Items left blank or unchecked are not applicable.

FACTS:

This is a notice of cancellation and termination of the following contract:

☐ Purchase agreement

☐ Escrow instructions

☐ Exchange agreement

☐ Counteroffer

☐ _____

dated _____, 20_____, at _____, California,

entered into by you and the undersigned, regarding real estate referred to as _____

_____.

CANCELLATION AND TERMINATION:

The above referenced contract and any underlying agreements are hereby cancelled and terminated.
This cancellation is based on:

1. _____

_____

2. _____

_____

3. _____

_____

4. And further, is cancelled for any other legally sufficient grounds not here mentioned.

5. If approved by all parties, the real estate broker(s) and escrow agent(s) are hereby instructed to return all instruments and funds to the parties depositing them.

I agree to this notice and instructions.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: _____, 20_____, at _____, California.

Signature: _____

Signature: _____

RECEIPT AND CONSENT TO CANCELLATION

I acknowledge receipt of a signed copy of this notice and agree to this cancellation and instructions.

Date: _____, 20_____, at _____, California.

Signature: _____

Signature: _____

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Thus, the seller has **defaulted** on his obligations, a *breach* which excuses the buyer's further performance until the seller complies with the requests. Further, the seller's breach of the provision allows the buyer to either cancel the agreement or pursue enforcement by a *specific performance* suit.

Post-cancellation waiver attempt

Consider a prospective buyer of nonresidential property who includes a further-approval contingency in his purchase agreement offer calling for his approval of a survey to be furnished by the seller. The seller accepts the offer and a survey is conducted.

The surveyor's observations are delivered to the buyer as agreed in the contingency provision. On the buyer's review of the survey and accompanying report, the buyer discovers the location of structures does not conform to building permits. Thus, the buyer has a reasonable basis for exercising his right to cancel the transaction under the contingency provision.

However, the buyer's agent does not prepare a notice of cancellation form for the buyer to sign and deliver to the seller as required by the purchase agreement for a termination of the transaction. Instead, the buyer advises the seller of his disapproval of the survey in letter form. However, the buyer does not state he is canceling the transaction due to his disapproval.

The seller does not respond to the buyer's disapproval letter in an effort by the seller to work out the discrepancies found in the survey and resolve the differences by an approval of the survey or a waiver of the contingency.

Prior to the date originally scheduled for escrow to close, the buyer's agent prepares a notice of waiver of the further-approval contingency which the buyer signs. On the seller's receipt of the notice of waiver, the seller has escrow prepare unilateral cancellation instructions which the seller signs and hands escrow. The buyer then demands a conveyance of the property as agreed in the purchase agreement, which the seller rejects.

The seller claims the letter disapproving the survey *terminated* the transaction and *excused* the seller (and the buyer) from further performing on the purchase agreement or escrow.

The buyer believes his communication did not cancel the transaction, but merely disapproved of the survey without exercising the contingency provision which has now been waived and no longer affects the enforceability of the purchase agreement.

Here, the buyer **unequivocally disapproved** the conditions disclosed by the survey. As a result, his rejection of the survey by the disapproval was itself an *exercise* of the buyer's right under the contingency provision to terminate the purchase agreement and escrow. The disapproval is as effective as though he had signed a notice of cancellation and delivered it to the seller.

Thus, on disapproval of the survey, the buyer terminated the purchase agreement. The buyer is left without any contract, much less a right to cancel which he may later attempt to waive. [**Beverly Way Associates** v. **Barham** (1990) 226 CA3d 49]

Chapter 45 — Time to perform

This chapter looks into the enforceability of one person's right to cancel a transaction when the other person fails to perform by an appointed date.

Default and cancellation

The short, seemingly harmless *time-is-of-the-essence provision* stands alone amongst the boilerplate provisions of some, but not all, stock purchase agreement forms used to buy and sell real estate in California. By its plain words, the existence of a time-essence provision **gives notice** to the buyer and seller that their compliance by the date scheduled for an event to occur or a condition to be met as called for in the purchase agreement or escrow instructions is **essential to the continuation** of the transaction.

Thus, the bargain built into the purchase agreement by the presence of the **time-essence provision** gives the buyer or seller the right to **immediately cancel** the transaction on the failure of an event to occur or the other person to approve a condition by the appointed date.

By virtue of the multiple number of tasks a typical buyer undertakes to close a transaction, contrasted with the very few tasks imposed on a seller to close, the time-essence clause "stacks the odds" of losing a transaction against the buyer. This condition exists even though the buyer and all the third parties involved on their behalf may have acted with diligence at all times.

Further, for a vast majority of agents who work diligently to clear conditions and close a transaction, the time-essence clause places a **risk of cancellation** on a transaction which is not helpful. Foreseeable delays in closing a transaction exist in all real estate sales.

Worse yet, the time-essence clause has, over the years, consistently demonstrated an ability to **produce litigation** over rights to money or ownership which have been lost or forfeited by a cancellation that is typically initiated by the seller.

*Editor's note — **first tuesday** purchase agreement forms do not contain a time-essence clause. Instead, the purchase agreements authorize agents to extend performance dates by up to one month. [See Form 150 §10.2 accompanying Chapter 51]*

Purpose of the time-essence provision

The "common understanding" said to exist as the purpose for including a time-essence clause in a purchase agreement is to **protect the seller from delays** in the buyer's payment of the sales price. Delays "tie up" both the seller's ownership of the real estate and receipt of the net sales proceeds beyond the date or period fixed for the transfer of ownership.

Another less logical theory for enforcing appointed dates as deadlines for the occurrence of events or the approval of the conditions called for in agreements containing a time-essence clause is the purported inability of courts to estimate the compensation owed a seller for losses resulting from a delay in the close of escrow due to the buyer's failure to perform.

However, delays in closing of a few days or even a few weeks or more, while inconvenient, rarely cause any compensable loss of money, property value, rights or property for the person attempting to cancel due to the passing of a performance deadline. Typically, the cancellation by a seller is motivated not by time, but by greater profits to be had elsewhere, i.e., "money is of the essence."

Even if a money loss is incurred due to a delay in performance, the loss is usually sustained by the seller and is easily calculable. Seller losses typically consist of lost rental value (or carrying costs of the property) for the period beyond the appointed closing date to the actual date of closing. An infrequent exception which occurs and causes the seller an incalculable (and uncollectible) loss arises out of the seller's actions in different transactions, such as the seller's reliance on the closing of a sale (not his entry into the sale) to complete some other transaction.

As for the buyer, his losses on a seller's default usually arise out of a missed closing deadline which he needed to meet in order to receive tax benefits or a locked-in (low) interest rate loan.

Termination of rights

An effective **Notice of Cancellation** interferes with the completion of a transaction as initially envisioned by the buyer and seller at the time they entered into the purchase agreement and escrow instructions.

On a proper cancellation, the person terminating the purchase agreement transaction **does not need to further perform** any act called for, including the close of escrow. Further, the transaction has been terminated and the obligations of both the buyer and seller to further perform no longer exist. [See Form 183 accompanying Chapter 44]

For example, the person who **properly cancels** a purchase agreement has the unfettered right:

- in the case of a seller, **to retain ownership** or resell the property to other buyers at a higher price; and

- in the case of a buyer, *to keep his funds* or use them to purchase other property on a better bargain.

These rights to act, free of purchase agreement and escrow obligations, are the very objectives met by canceling the purchase and escrow agreements. The alternative to canceling both agreements is an attempt to keep the transaction together by determining the additional time reasonably needed by the other person to perform as originally contemplated, and then granting an extension of time in which to do so.

Should the "grace period" of additional time be granted, and then expire without compliance, a cancellation for failure to then perform is most understandable by all involved, and enforceable. [**Fowler** v. **Ross** (1983) 142 CA3d 472]

Still, an effective **cancellation** by one person *forfeits the rights* held by the other to close the transaction and receive the benefits bargained for on entering into the purchase agreement. Further, on an effective cancellation, the agents, escrow, lender and title company are all adversely affected by the cancellation's ripple effects since they all lose the time and effort they invested to get the transaction closed.

For example, when a seller cancels, the buyer loses, by *forfeiture*, his contract right to become the owner of the property. Conversely, if the buyer cancels, the seller loses the right to receive funds and be relieved of the obligation of ownership.

Thus, a cancellation by either the buyer or the seller, if proper and enforceable, is the "final moment" in the life of a purchase agreement and escrow. Cancellation spells the end to all expectations held by everyone directly or indirectly affiliated with the sale who would have benefitted by the closing of the transaction.

Editor's note — For simplicity's sake, the following discussion will mostly refer to the timing of a seller's cancellation. However, the discussion fully applies to a buyer's cancellation as well.

Cancellation factors

For a seller to successfully cancel an escrow based on the failure of an event to occur or a condition to be approved, the **purchase agreement** or escrow instructions should contain:

- a clear *description of the event* which is to occur or the condition to be approved;
- an appointed date or *expiration of a time* period by which the event or approval described is to occur; and
- a written provision stating in clear and unmistakable wording, understandable to the buyer, that the seller has the *right to cancel* the transaction as the consequence of a failure of the event or the approval to occur by the appointed date.

If provisions in the purchase agreement or escrow instructions meet all of the above criteria, then the seller will only be **allowed to cancel** if:

- the seller has performed all acts which must precede, by agreement or necessity, the event or approval triggering the cancellation (in other words, the seller cannot be in default);
- the event or approval *fails to occur* by the appointed date; and
- the seller *performs or stands ready***,** willing and able to perform all other acts necessary on the part of the seller to close the transaction on the appointed date for the failed event or approval.

The notice given by the existence of the time-essence provision advises the buyer that his performance of the event which is to occur or be brought about by the date scheduled is **critical to the continuation** of the purchase agreement and escrow instructions. Thus, the time-essence provision sets the buyer's reasonable expectations of the consequences of his failure to perform, i.e., the risk that the seller may cancel the transaction and the buyer's right to buy the property will be forfeited.

However, the consequences of the failure of the buyer to perform or for an approval or event to occur depend upon the type of **time-related provision** contained in the purchase agreement and escrow instructions. The different provisions which might be included are:

- a *time-essence provision*, which gives the seller the right to cancel should the event or approval of a condition called for not occur by an appointed date;
- a *seller-may-cancel contingency* provision, which authorizes the seller to cancel should the condition or event not occur, whether or not a time-essence clause exists;

- an *authorization-to-extend* provision, which grants the agents the power to extend performance dates up to 30 days (or other wording indicating an accommodation for delays), whether or not a time-essence clause or a seller-may-cancel clause exists [See Form 150 §10.2]; and

- an *extension of time granted* by the seller, typically in supplemental escrow instructions, with wording imposing strict adherence to the new performance deadlines and authorizing the seller to cancel on expiration of the extension should the event or approval not be forthcoming.

Elements of a default

Before either a buyer or seller can effectively cancel a transaction, they must "place the other person in default." Thus, in order for a person to exercise the right to cancel, that person cannot also be in default themselves on the date scheduled for the other person's performance or the event to occur.

For the buyer or seller to place the other in default, three transactional facts must exist:

- a date crucial to the continuation of the transaction must have passed;

- the condition called for in the purchase agreement did not occur by the scheduled date; and

- the person canceling must have fully performed all activities required of him in order for the other person to perform by the scheduled date, called *conditions precedent*, and have performed or be ready, willing and able to perform, at the time of cancellation, all activities he was obligated to perform in order to close escrow, called *conditions concurrent*.

Was the cancellation timely

The **setting of a time** for an act or event to occur does not, by itself, automatically allow a purchase agreement transaction to be terminated by one person when the appointed date has passed and the other person has not yet performed.

To permit a cancellation immediately following the expiration of the appointed time for performance, the purchase agreement or escrow instructions must clearly state it is the intention of both parties that the failure by one or the other person to perform by the appointed day will subject his contract rights to forfeiture.

Thus, clear cut wording throughout the purchase and escrow documents must consistently manifest an intent to **make time for performance crucial** to the continued existence of the transaction. If not so worded, the appointed date has insufficient significance to justify instant cancellation.

For example, sometimes the only wording regarding any right to cancel a transaction appears in the escrow instructions. Escrows are nearly always instructed to close at any time after the date scheduled for closing if escrow is in a position to do so, provided escrow has not yet received instructions to cancel escrow and return documents and funds.

Thus, in this example, neither the purchase agreement nor the escrow instructions contain a clause stating "time is of the essence in this agreement." Further, no clear, unequivocal or unmistakable wording in any contingency provision shows an intent on the part of the buyer and seller to make time of the essence, such as wording giving the seller or buyer the "right to cancel" on the failure of either the other person to perform a described activity or for an event to occur by a scheduled date.

NOTICE TO PERFORM AND INTENT TO CANCEL

NOTE: This form is used by a party to a transaction who has performed to advise another party who has not performed as agreed to perform by a specified date or expect the transaction to be cancelled.

DATE: _____, 20_____, at _____, California.

1. This notice regards the performance of a Purchase Agreement

1.1 entered into between _____, as the Seller, and _____, as the Buyer,

1.2 dated _____, 20_____, at _____, California,

1.3 regarding real estate referred to as _____, and

1.4 escrowed with _____, escrow number _____, under instructions dated _____, 20_____.

NOTICE TO PERFORM:

2. Demand is hereby made on you under the above referenced agreement and escrow instructions to perform

2.1 on or before _____, 20_____,

2.2 as follows: _____

_____.

3. It is the intent of the undersigned to cancel this transaction should the performance demanded of you in this notice not occur during the time period given.

I agree to this notice.

Date: _____, 20_____

By: _____

Signature: _____

By: _____

Signature: _____

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Under these examples, which lack time-essence provisions, the time appointed for the delivery of such items as loan commitments, termite reports, funds for closing or clearance of encumbrances from title is merely a "target date" preliminary to establishing the right to cancel.

Time to close extended by notice

To establish the **right to cancel** when time is not stated or established in the purchase agreement or escrow instructions as crucial, the person in default must be *given notice* that the date set as the "new deadline" will be strictly adhered to.

Further, the person in default must be given a realistic opportunity (period of time) after being given a notice to perform before any cancellation would be effective. Continued nonperformance past the new deadline date will be treated as a **default** and escrow can be immediately canceled. [See Form 181-1 accompanying this chapter]

For example, a purchase agreement calls for a buyer to close escrow within 45 days after acceptance. No time-essence clause, cancellation provisions (other than the *implied right* to cancel exercisable on a failure of the other person to perform) or agent authorization to extend performance dates exists. [See Form 150 §12.2]

The seller agrees with the buyer's request to extend the date of performance (closing) an additional 30 days during which the buyer is to complete his arrangements to close escrow. Two days after the extension expires, the seller cancels the transaction.

Is the seller's cancellation of the transaction effective?

Yes! The 30-day extension was a **reasonable amount of time** for the buyer to perform before the seller *exercised* his right to cancel. A further unilateral extension of time is not needed for the cancellation to be reasonable and effective. [Fowler, *supra*]

Now, consider an example of strict compliance with performance dates as "deadlines," after which the purchase agreement and escrow can be terminated by cancellation for failure of the described activity or event to take place. The **purchase agreement** contains a simple time- essence clause. Authority is not granted to the agents to extend performance dates should the appointed date for performance prove to be an inadequate amount of time for either the buyer or seller to complete or bring about all of their closing activities.

Consistent with the time-essence clause in the purchase agreement, **escrow instructions** provide for an interference with closing of the escrow after the date initially targeted for closing. The instructions authorized escrow to close at anytime after expiration of the escrow period, unless escrow received instructions calling for the return of documents and funds.

One day after the passing of the date scheduled for closing, the buyer cancels escrow. Twelve days later, the seller, using diligence at all times, is able to clear title and close. The seller challenges the buyer's cancellation as premature and ineffective, claiming the buyer is required to grant him the additional time needed to close escrow before the buyer can *forfeit the seller's right* to enforce the buyer's promise to purchase the property.

Is the seller entitled to the additional time he needs to close escrow?

No! The seller was **on notice** by the existence of the time-essence clause in the purchase agreement and the wording of the escrow instructions that the buyer had the right to cancel on failure of escrow to close by the date scheduled. No provision in any document expressed an intent which was contrary to the time-essence provision in the purchase agreement.

Thus, the buyer's cancellation, one day after the appointed closing date, was in accordance with the **intent stated** in the purchase agreement and escrow instructions, i.e., that timely performance was essential to the continuation of the agreement.

More importantly, **escrow was authorized** to return the money and instruments on the demand of either the buyer or seller should the closing not occur on or before the date set for closing. Thus, the buyer was not required to grant the additional time reasonably necessary for the seller to close the transaction. [**Ward** v. **Downey** (1950) 95 CA2d 680]

Intent in conflict with time-essence clause

Consider a sale under a purchase agreement (or escrow instructions) which contains a provision **authorizing the agents to extend** the time for performance of any act for a "period not to exceed one month." The purchase agreement also includes a boilerplate provision that "time is the essence of this agreement."

Escrow is for a 60-day period, the end of which is the appointed date for closing the transaction. As usual, the escrow instructions state escrow may close at any time after the date scheduled for closing, unless instructions to the contrary have been received.

On the date scheduled for closing, escrow is not in a position to close due to the buyer's inability to immediately record his purchase-assist loan. The seller immediately cancels escrow in an attempt to terminate the transaction, claiming time was of the essence by agreement.

Can the seller cancel without giving an extension of time when both a time-essence and an authority-to-extend provision exist?

No! The bargain struck by the conflicting provisions controlling performance dates did not contemplate time for the occurrence of activities or events by their appointed dates to be so essential that the transaction could be canceled on the mere passing of the appointed date. The use of a purchase agreement (or escrow instructions) containing wording that "time is of the essence" does not allow for the forfeiture of contract rights on a failure to perform within the agreed time period when **other provisions express a contrary intent**.

When logically possible, courts ignore boilerplate time-essence clauses and enforce the original bargain, if no financial harm results from the delay.

Here, the purchase agreement (or escrow instructions) gave the agents the unconditional right to extend performance dates. Thus, being able to close by the date set for closing escrow could hardly be considered crucial to the continued viability of the transaction. Accordingly, the seller must give the buyer a **reasonable amount of time** to close escrow, i.e., the additional days needed for the agent to record the buyer's loan, before the buyer's failure to perform justified exercising any cancellation rights. [See Form 181-1]

Editor's note — The fact the agents do not exercise the authority granted them to extend the time for performance is of no concern. It is the mere existence of the agents' unrestricted right to extend performance dates by up to 30 days which requires the person canceling to allow the other person a reasonable, additional time period in which to perform before cancellation can occur.

Default needed to justify cancellation

Before a buyer or seller may consider canceling a transaction, the other person must have *defaulted* on his completion of an activity or an event has failed to occur.

For example, a seller cancels a 30-day escrow the day after the date it is scheduled to close. The purchase agreement granted the agents authorization to extend performance dates, including the date for closing, up to 30 days. [See Form 150 §10.2]

Thirty-three days later, for a total of 63 days from the date of acceptance, the buyer, using diligence in the pursuit of a loan, obtains final loan approval and has all the funds needed to close escrow.

Is the seller's cancellation effective without first giving an extension of additional time for closing when the buyer has not performed by the date scheduled for the close of escrow?

No! The buyer is not yet in default. Sixty-three days is a reasonable period of time for the buyer to obtain the purchase-assist mortgage funds agreed to in the purchase agreement. Most importantly for the buyer and agents, time for closing was not made crucial to the continuation of the agreement.

Thus, a reasonable period of time must pass before the buyer is in default. Only when the buyer is in default may the seller *exercise* his right to cancel. [**Henry** v. **Sharma** (1984) 154 CA3d 665]

Now, consider an agent who prepares a purchase agreement and inadvertently fails to set a fixed time period for the opening of escrow. However, the purchase agreement does state an appointed date for closing escrow as 60 days from the date the purchase agreement was entered into.

The buyer fails to sign and return escrow instructions to open escrow.

The seller cancels the transaction 12 days after the date escrow was scheduled to close.

Was the buyer in default at the time of cancellation?

Yes! The buyer was in default for his failure to sign and return escrow instructions. The buyer had an obligation to open escrow within an unstated period of time. Since the time for opening escrow was not agreed to, a **reasonable period of time** for opening escrow is allowed.

A reasonable period for opening escrow is a date sufficiently in advance of the date set for the close of escrow to give escrow enough time to perform its tasks by the date scheduled for closing. The cancellation 12 days after the closing date was effective to terminate the transaction. A reasonable period for the buyer to open escrow ended well before the scheduled closing date.

The buyer, having failed to open escrow before the closing date, was in default on the closing date. Thus, the buyer lost his right to buy the property since he did not cure the default by opening escrow before the date set for closing and the seller's cancellation. [**Consolidated World Investments, Inc.** v. **Lido Preferred Ltd.** (1992) 9 CA4th 373]

However, a one day delay by a buyer before signing and delivering instructions to open escrow does not allow a (remorseful) seller to cancel the transaction and avoid closing escrow. Reasonably, a **one day delay in opening escrow** is not a default at all, even when time is unequivocally declared to be of the essence in the purchase agreement.

To cancel you must first perform

Consider a seller who wants to cancel a transaction since the **buyer is in default** under the purchase agreement or escrow instructions. Before the seller may cancel, **the seller must**:

- *perform all acts* and cause all events to occur which, by agreement or necessity, are the seller's obligation and must occur before the buyer becomes obligated to perform or can perform, called *conditions precedent*, such as delivering disclosures, reports, etc., or completing repairs requiring the buyer's approval;

- *fully perform all activities* and obligations imposed on the seller which are to **occur at the same time** as the buyer's performance, without concern for whether the buyer has performed, called *conditions concurrent*, such as handing escrow a grant deed and all other information and items required of the seller for escrow to clear title and close; and

- *perform or demonstrate* he can perform all other activities or bring about events which are the obligation of the seller for closing the transaction, whether or not the buyer ever performs, called *conditions subsequent*, such as meeting any requirements of the buyer's lender for repairs or clearances.

Thus, while the buyer may have failed to perform by the time agreed, the seller may not cancel until the seller has performed or stands ready, willing and able to perform under the above three conditions (precedent, concurrent and subsequent), conditions which exist in most purchase agreements and escrow instructions.

When failure to fund is not a default

On the date set for the close of escrow, buyers often have not deposited their down payment funds into escrow as called for in the purchase agreement and escrow instructions. When the deposit of closing funds or the lender's wire of loan funds does not occur as scheduled, the buyer clearly has not yet performed his obligation to close escrow. However, the failure to fund does not necessarily mean the buyer is in default.

The question which arises for a seller who is attempting to cancel when time has been established as essential and the buyer or the buyer's lender has not delivered closing funds, is whether the buyer is either in **default** or is **not yet obligated** to deposit funds.

Escrow, as a matter of custom, will not call for a wire of closing funds from the mortgage lender or the buyer until **escrow is in a position to close**. Escrows, as an entirely practical matter, do not want closing funds sitting in an escrow which is not yet ready to close.

Specifically, before escrow calls for closing funds, the seller must have already fully performed by providing documents (deeds, releases, reconveyances, title clearances, etc.) so the conveyance of title can be insured and property clearances, prorates and adjustments can be delivered and accounted for as called

for in the escrow instructions. If the seller has not delivered instruments so escrow can be in a position to close by the date scheduled for closing, escrow will not make a demand on the buyer (or lender) for funds. The deposit of closing funds would be premature since escrow cannot yet close.

Further, when the closing is contingent on the buyer recording a purchase-assist loan, escrow, as a matter of *commercial necessity*, does not call for the buyer's funds until the lender is ready to fund.

Thus, the buyer has no obligation to deposit any money into escrow and is not in default until escrow has received the lender's documents and requests the buyer's funds, which the buyer **then fails to deliver**. Until the buyer is in default due to a failure to timely respond to escrow's request for funds, any attempt by the seller to cancel is premature and ineffective.

Escrow instructions usually state the buyer is to deposit funds for use by escrow **provided the seller has performed**. Thus, the obligation of the buyer to deposit closing funds is subject to the seller first performing, called a *condition precedent* to the buyer's performance. Therefore, the buyer's "failure" to deposit funds before escrow is in a position to close is *excused*. The seller has failed to hand escrow documents and information sufficiently in advance of the scheduled closing date for escrow to close by the appointed date. [See Form 150 §12.2]

Consider a seller who is unable to convey title to a buyer and deliver a title insurance policy by the closing date called for in the purchase agreement and escrow instructions. The title company cannot issue a policy as ordered due to encumbrances affecting title, such as abstracts, trust deeds, leases, tax liens, assessments, etc., which have not been released and the amounts needed for discharge and payoff have not yet been determined.

Here, the time for closing has arrived and the seller cannot deliver a marketable title as agreed. Thus, until the seller obtains title insurance for his deed, the buyer is not in default for not yet depositing his funds.

Cancellation right waived by conduct

Even when the date scheduled for a buyer or seller to perform is established as crucial, thus allowing one person to immediately cancel on the other's default, **inconsistent conduct** by the person entitled to cancel constitutes a *waiver* of his right to cancel. Once the right to immediately cancel has been waived, the person who failed to perform by the agreed deadline is **no longer in default**. Until the person who failed to perform is placed in default again, the right to cancel cannot be exercised.

For example, the date set for escrow to close arrives. The seller has not yet handed escrow (or the buyer) clearances which are required before escrow may close.

A few days after escrow is scheduled to close, the seller deposits the clearances with escrow. The buyer then deposits his closing funds on a call from escrow.

Two days later, the seller cancels escrow, claiming the buyer was in default since he failed to deposit his funds by the appointed date.

Here, the cancellation is ineffective and the buyer is entitled to close escrow. The seller *waived his right* to cancel, time having been of the essence, by conducting himself without concern for the passing of the appointed date for closing. The seller failed to deliver up documents or information sufficiently in advance for escrow to meet the deadline. [**Katemis** v. **Westerlind** (1953) 120 CA2d 537]

However, a **waiver by inaction** does not occur simply because a person's right to cancel the transaction is not immediately exercised on the failure of the other person to perform or an event to occur. **Affirmative conduct must occur** by the person entitled to cancel, not just mere inaction, before the right to cancel under a time-essence situation is waived.

After a waiver of a date scheduled for approval of a condition or occurrence of an event, time must be **reinstated as crucial** to the continuance of the transaction, or a reasonable, additional period of time must have passed after waiver of the right to cancel, before the transaction can be canceled.

Time is best reinstated as essential to the continuation of the transaction by notifying the person who needs to perform that he must perform by the end of an additional period of time, set with sufficient duration as is needed to provide him with a realistic opportunity to perform.

If performance is not forthcoming during the additional period of time, the transaction may be promptly canceled since *strict compliance* with the extension is now enforceable.

Chapter 46 Cancellation, release, and waiver

This chapter analyzes the use of cancellation agreements containing release and waiver of rights provisions as a method of eliminating future liability exposure in disputes arising out of listings and purchase agreements.

Known and unknown claims

The vocation of providing real estate brokerage services to members of the public is, in the long run, a rewarding profession. Inevitably, however, the occupational **hazard of a dispute** with a client or another party to a transaction will eventually surface. Disputes arise even though the licensed brokers and sales agents have fulfilled all of their agency duties, acted diligently and cooperated fully with the client and other parties.

Unless the conflict with the client or other party is resolved at the earliest possible moment, the continuing aggravation will take a toll on the agent's time and effort, and possibly on his cash reserves as well.

Also, disputes with a client tend to make the continued representation of the client less effective. At some point in an extended dispute, the broker or agent may well be rendered incapable of logically making normal discretionary decisions in the course of fulfilling agency obligations owed the client.

The unreasonable interference of an uncompromising client, who either claims to have all the right answers or is listening to other advisors who are not privy to the circumstances surrounding the dispute, creates a stressful condition which can easily lead to errors in an agent's judgment.

As always, disputes need to be put to rest quickly, lest they turn into correspondence with attorneys or worse, litigation. When a settlement is not promptly worked out and the agency relationship clarified so the employment can continue on sound footing, the relationship should be terminated.

To terminate an agency relationship due to a dispute, a *release and waiver* must be entered into by all concerned to put an end to an otherwise unresolvable disagreement.

Agency disputes arise during one of three periods in the representation of a client, i.e.:

- the *marketing period* beginning on the agent's entry into an authorization to sell, locate, finance, lease or manage a property and ending on the client's entry into an agreement to sell, buy, finance or lease the property in question;

- the *escrow period* beginning on the client's entry into a purchase agreement, loan agreement or lease and ending on the close of escrow, the transfer of possession or the failure of the transaction to close; or

- the *post-closing period* following the closing of the purchase agreement, loan or lease transaction.

Marketing period disputes

Misunderstandings sometimes occur regarding the extent of the marketing services a client expects out of his broker and the broker's agents. The client's extraordinary expectations might have existed before

entering into the employment agreement or have come about when the agent explained what will be done to market or locate property. Also, outside influences during the marketing period, by others or by a change in the real estate market, may cause the client to believe the agent should be doing more.

Conversely, a seller may become uncooperative in the marketing of the property or simply refuse to hand over property information needed by the listing agent to succeed in his effort to locate a buyer willing to make an offer to buy the property.

For example, a listing agent's **marketing efforts** to present the current status and integrity of a property to prospective buyers are interfered with when the **seller refuses to cooperate** or make reports available. Reports to be provided include home inspection reports, natural hazard disclosures, common interest development documents, local ordinance compliances, property operating expense sheets and rental income data.

Without proper disclosures, prospective buyers cannot readily, if ever, ascertain the value of the property and distinguish it from other properties they are considering.

To resolve disputes when a compromise has been attempted and is unattainable, it becomes prudent to consider *terminating the agency*. If the client decides to unilaterally withdraw the property from the market, cancel the employment (listing/management) or continue to interfere in the sales effort, the client owes the broker the fee called for in the employment agreement. Of course, the listing agent must have diligently performed the brokerage services owed the seller under the listing, whether or not a buyer has been found.

Here, a cancellation agreement form should be prepared and entered into to end the relationship forever. The broker might agree to a mutual cancellation of the listing in exchange for the client's payment of the brokerage fee.

The **consideration for cancellation** ranges from payment of the entire fee to some lesser arrangement. For example, the client might agree to pay a fee should the client relist the property with another broker or sell the property, lease it, etc., during a fixed period of months after the mutual cancellation of the listing. [See Form 121 accompanying Chapter 11]

Further, the broker, on entering into a cancellation, release and waiver agreement, eliminates his exposure to future claims based on a purported failure of agency duties.

Escrow period disputes

After opening a sales escrow for the purchase of real estate, disputes which arise do so under two types of conditions. Either one may ultimately require the termination of relationships. One set of disputes is of the type classified as *agency disputes*.

Agency disputes arise between the agent and his client after the client has entered into a purchase agreement. The agency, if the dispute cannot be resolved and the representation continued, is terminated in the same manner as the listing period disputes discussed in the previous section.

The other set of disputes is classified as *principal disputes*. **Principal disputes** develop between the buyer and seller and result in a refusal of one or the other to act further to close escrow. The refusal to proceed with the transaction might be excused, justified or constitute a breach of the purchase agreement.

Negotiations to resolve the misunderstandings or differences and close escrow might not be successful. If the escrow dispute becomes unresolvable, the agents should consider recommending that the buyer

CANCELLATION OF AGREEMENT

Release and Waiver of Rights

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This mutual cancellation and release agreement with waiver of rights pertains to the following agreement:

☐ Purchase agreement

☐ Exchange agreement

☐ _____

1.1 dated _____, 20_____, at _____, California,

1.2 entered into by _____, as the Buyer, and _____, as the Seller,

1.3 whose real estate brokers (agents) are

Buyer's Broker_____

Seller's Broker _____,

a. If an exchange is involved, the first and second parties to the exchange are here identified as Buyer and Seller, respectively.

1.4 regarding real estate referred to as _____ _____.

1.5 Escrow Agent _____ Escrow Number _____

AGREEMENT:

2. Buyer and Seller hereby cancel and release each other and their agents from all claims and obligations, known or unknown, arising out of the above referenced agreement.

3. The real estate broker(s) and escrow agent(s) are hereby instructed to return all instruments and funds to the parties depositing them.

4. Costs and fees to be disbursed and charged to ☐ Seller, or ☐ Buyer.

4.1 $_____ to _____

4.2 $_____ to _____

4.3 _____

_____

_____

_____

_____

_____

5. The parties hereby waive any rights provided by Section 1542 of the California Civil Code, which provides: "A general release does not extend to claims which the creditor does not know or suspect to exist in his or her favor at the time of executing the release, which if known by him or her must have materially affected his or her settlement with the debtor."

I agree to the terms stated above.	**I agree to the terms stated above.**
☐ See attached Signature Page Addendum. [**ft** Form 251]	☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: _____, 20_____	Date: _____, 20_____
Buyer's Name: _____	Seller's Name: _____
Signature: _____	Signature: _____
Buyer's Name: _____	Seller's Name: _____
Signature: _____	Signature: _____

and seller terminate the purchase agreement. At the same time the buyer and seller cancel the transaction, they should release each other from any claims they may have against one another, by entering into a *cancellation, release and waiver agreement*. [See Form 181 accompanying this chapter]

As for the agent's concern about his liability exposure for any type of claim the disgruntled buyer or seller may assert against each other or the broker, the cancellation, release and waiver agreement entered into by the buyer and seller also **releases everyone involved** in the transaction. Thus, any *liability exposure* the agents and client may have due to the transaction is eliminated.

Post-closing disputes

After closing a transaction, brokers and their agents are occasionally brought into *annoyance disputes* by buyers disgruntled over the condition of the property, its improvements, the neighborhood, hazards of the location, zoning, easements held by neighbors, fence locations, operating expenses, tenant problems, etc. The expectations of a buyer are always high, as with any new owner of property. The condition of a property is almost never as rosy as it appeared before taking possession.

Buyers, believing they have gotten less than they bargained for, often attempt to **shift responsibility** for payment of expenses they have incurred to cure typically insignificant obsolescence, deterioration, wear and tear or inadequacies in electrical or plumbing needs. Worse yet, they may seek to recover a portion of the purchase price on a claim the property value received was measurably less than the price they paid.

In context, the listing broker is not the guarantor of any obligation the seller may owe the buyer for defects. However, it usually is the broker who is the first person put upon by a disgruntled buyer to "cure the problem."

Brokers and agents often pay some of these claims to permanently remove themselves from the disputed purchase. However, on the first payment by anyone in a settlement to resolve a dispute in a closed transaction, the broker should demand a *release and waiver agreement*. Once the buyer has "raided the cookie jar," he may well be back for more. This agreement puts an end to it. [See **first tuesday** Form 546]

The documentation

A mutual **cancellation agreement**, which does not include a release of claims or a waiver of rights, merely serves to *terminate* any further activity under the existing agreement or agency relationship. Thus, all parties are *excused* from further performing since the agreement and relationship have been terminated.

In essence, the cancellation "does away with" the remainder of the purchase agreement that has not yet been performed. A cancellation, by itself, does not affect the responsibilities of the buyer, seller, brokers or agents, for their activities which proceeded the cancellation.

Conversely, a *rescission and restoration* agreement returns the parties to the respective positions they held before entering into the terminated agreement, more commonly called a *release and waiver of rights*.

A *release agreement*, signed by all parties to a transaction as part of a cancellation agreement, retroactively extinguishes all **known claims** in disputes the parties have between themselves. Thus, the release agreement is general in that it ends all liability between the parties for those claims **actually known** to the parties to exist in the dispute.

However, a **general release** does not affect unknown claims later uncovered. [Calif. Civil Code §1542]

Thus, a category of claims remain unresolved, i.e., those which might exist, come into existence or be later established and are unknown to the parties on entering into a general release, called *unknown and unsuspected claims*. To eliminate these unknown claims, a **waiver** of the right to later pursue these claims must be included with a general release and made part of the mutual cancellation agreement. [CC §1542]

A written, signed release agreement does not require new consideration to be paid for the cancellation, release and waiver to be enforceable as a bar to further claims. [CC §1541]

Chapter 47 The seller's breach

This chapter illustrates the conduct of a seller which constitutes a breach of the purchase agreement and imposes liability on the seller for any increase in property value, the buyer's expenses and interest on the amounts recovered.

Failure to act or act timely

On occasion, a buyer's agent in a real estate sales transaction will be confronted with conduct by the seller which interferes with the close of escrow. The seller's conduct is inconsistent with or contrary to those activities the seller is required to perform before escrow can close.

Examples of **seller interference** with a buyer's acquisition of property include the seller's failure to (timely):

- return escrow instructions;
- deliver closing documents;
- provide escrow with information on the existing lenders so payoff demands, beneficiary statements or assumption papers can be ordered on existing loans;
- deliver seller identification information for title insurance purposes;
- eliminate agreed-to defects and previously undisclosed property defects known to the seller and unacceptable to the buyer;
- arrange or permit inspection of the property by the buyer, appraiser, home inspector, city inspector, etc.; or
- close escrow.

Thus, the seller is not fulfilling the objectives of the purchase agreement he entered into with the buyer to **voluntarily perform** under the escrow instructions. As a result, the buyer is either unable to proceed toward closing or has fully performed (or his further performance is excused due to a cancellation by the buyer), and escrow cannot close due to a failure on the part of the seller to act.

Typically, the seller's refusal or failure to timely act under the purchase agreement and close escrow arises during dramatic increases in the value of the type of property he has just agreed to sell to the buyer. Thus, a better bargain can be had by the seller with other buyers since the seller has either agreed to a below market price or the market value was or has risen dramatically above the price agreed to in the purchase agreement.

As a result, "seller remorse" has set in, manifested by his efforts to trigger a default by the buyer which will justify terminating the purchase agreement.

Faced with the failure of escrow to close, due to the seller's *nonperformance or obstruction* of the buyer's efforts to close escrow and the inability of the buyer and agents to induce the seller to **voluntarily close escrow**, the buyer must make a pivotal decision regarding his bargained-for ownership of the property.

The decisions available to the buyer, called *remedies*, when the seller breaches the purchase agreement or escrow instructions include:

- **abandoning the transaction** by entering into a mutual cancellation of the purchase agreement and escrow instructions with the seller, agreeing to do nothing further to enforce the right to purchase the property or seek a money recovery from the seller, other than a return of the buyer's good-faith deposit;

- **acquiring the property** by pursuing enforcement of the purchase agreement and escrow instructions;

- **pursuing the recovery of money** when the buyer **wants to acquire** the property but cannot now do so due to the seller's conveyance of the property for a measurably higher price to another person who was unaware of the pre-existing purchase rights held by the buyer; and

- **pursuing the recovery of money** when the buyer can, but **no longer wants to acquire** the property, and the value of the property was measurably higher on the date the seller canceled escrow than the price the buyer agreed to pay.

An unsuspecting buyer who acquires the ownership of real estate without actual knowledge or recorded notice (constructive knowledge) of a pre-existing enforceable purchase agreement held by another buyer regarding the same property is referred to as a *bona fide purchaser* (BFP). As a BFP, the buyer pays consideration for the acquisition of property and takes title without knowledge of a claim to the property held by the other buyer. [Calif. Civil Code §3395]

Economic motives in a rising market

Market conditions surrounding a seller's refusal to voluntarily cooperate with a buyer and transfer property under a purchase agreement usually consist of:

- seller pricing power (due to too little inventory for too many prospective buyers);

- cyclically moderate to low mortgage interest rates; and

- a generally recognized trend in price increases, commonly referred to as a "hot (seller's) real estate market."

It is during these economic "boom" or "bubble" periods of fast upward movement in real estate prices that sellers often agree to sell property before checking out their property's value.

The failure to ascertain the value of the property before the seller enters into a purchase agreement sometimes results in his later discovery (prior to closing) that the sales price agreed to is significantly below the present worth of the property. It is then that the seller determines additional money can be had by simply canceling what is now viewed as a "bad bargain" and reselling the property to another buyer at a higher price.

The end game for all sellers of real estate is to net the most money possible on a sale under current market conditions. However, when a seller decides to cancel a sale so he can position himself to resell the property at the higher market value, he merely encourages the buyer to pursue the same end game for himself, i.e., the recovery of money from the seller equal to the increase in price received on a resale by the seller.

Thus, if the seller is pursued by the buyer for the difference in price, the seller will be unable to retain the financial advantage he sought to attain by breaching and reselling at a higher price.

Misplaced reliance on an adverse party

Consider an owner of nonresidential real estate who lives out of the area. The absentee owner is solicited by a buyer's agent seeking to locate properties suitable for his buyer. The owner responds indicating he will sell the property, but does not know its value. He requests an indication of its value from the buyer's agent.

The owner is a sophisticated and intelligent individual capable of understanding that the buyer and the buyer's agent are his adversaries in negotiations.

After phone calls and correspondence exchanging information about the property, the buyer's agent states he does not want to express an opinion of value on someone else's property, but has shown his buyer **similar properties** offered at $200,000. The owner does not indicate what he believes the value of his property might be, but acknowledges he knows the market value of nonresidential property is on the rise.

The buyer's agent prepares a purchase agreement offer for a cash price of $250,000. The buyer signs the offer and it is faxed to the owner.

The owner accepts the offer and the buyer's agent promptly dictates escrow instructions, which the buyer signs and returns. The buyer, on receiving and reviewing the preliminary title report, advises escrow he will place the balance of the cash price into escrow when escrow calls for funds. The owner does not return escrow instructions or the deed for conveyance of the property.

The owner then visits the community where his property is located. For the first time, the owner inquires into the worth of his property by contacting some local agents. On his initial superficial inquiry, the owner finds that the property is worth considerably more than the price he has agreed to receive.

The owner quickly determines he has entered into an extremely bad bargain concerning the price the buyer has agreed to pay. Another buyer is located and a price of $750,000 is agreed to. Escrow is opened with the new buyer and closed immediately.

Meanwhile, the original buyer is involved in a futile attempt to close his escrow with the owner. When asked by escrow to sign and return the escrow instructions and the deed, the owner claims the agreement he entered into with the buyer was never a binding contract due to the buyer's **misrepresentation of the property's value** and the owner's reliance on the valuation to set the sales price. Thus, he explains, they have no deal.

The original buyer decides he no longer wants the property (or will not pursue acquiring it since the new buyer is a BFP).

Aware he has lost his ability to buy the property under the purchase agreement, the original buyer makes a demand on the owner for $500,000, the difference between the price agreed to and its worth on the owner's breach based on the price the seller received on the resale of the property.

The owner refuses to pay the demand claiming his refusal to close escrow at the agreed price was *justified* since the property's value was known to the buyer and the buyer's agent, but not to the owner. Thus, he claims, they took advantage of his ignorance of the property's true value, called *misrepresentation*.

Here, the owner owes the buyer the difference between the price agreed to with the buyer and the value of the property on the date the seller breached ($500,000).

Misrepresentation and deceit

Ordinarily, misrepresentation of a property's value by a prospective buyer and his agent does not, by itself, justify an owner's cancellation of the purchase agreement. Estimates of value made by prospective buyers and their agent's are usually mere expressions of their opinion, not facts to be relied upon by sellers since the buyer and the buyer's agent are **known adversaries** of any seller.

More importantly, the owner in the above example was neither induced or persuaded by the buyer or the buyer's agent to forego an independent investigation into his property's value, nor was the owner in a situation where he could not reasonably undertake an investigation into value.

For a representation of value by the buyer or his agent to be deceitful, the representation made to the owner must be coupled with *some other misfeasance*, bad action or false representation. Further, the owner was neither *gullible or ignorant*, nor unable to protect and care for himself as against the buyer or agent who he claims took unconscionable advantage of his ignorance of the property's value. Thus, his reliance on their expressions of value to set an acceptable price did not justify his cancellation.

The owner should have taken the opportunity, as he later did, to retain a broker (and pay him a fee) to determine the value of the property before agreeing to accept a price. [**Kahn** v. **Lischner** (1954) 128 CA2d 480]

Recover money, not the property

A buyer who seeks to recover money from a breaching seller, in lieu of title to the property, does so based on **monetary claims** which must fall within three categories of money losses:

- *general damages*, being money **directly expended** in the transaction;
- *consequential or special damages*, being money **collaterally lost** due to the seller's breach; and
- *prejudgment interest* on all monies recovered. [CC §3306]

General damages are monetary losses incurred by the buyer due to his expenditures and loss of value (price increase) that were **directly related** to his acquisition of the property, which he will not now acquire, including:

- **money advanced** by the buyer toward the price of the property, such as deposits held by the agent or escrow, or previously released to the seller;

- **expenses incurred** examining title conditions, inspecting the property, verifying operating income and expenses, and obtaining financing, escrow services, engineering and improvement plans, etc., all called *transactional expenses*;

- **move-in expenses incurred** preparing the property to take possession; and

- the **price-to-value difference** between the price agreed to in the breached purchase agreement and the value of the property on the date of the seller's breach.

Value-over-price on date of breach

Consider a buyer of real estate who enters into a purchase agreement to acquire one of two adjacent lots held by the owner. The purchase agreement contains a provision granting the buyer a *right of first refusal* to acquire the adjacent lot, also called a *preemptive right to buy*.

The right-of-first-refusal provision sets the price of the adjacent lot at $400,000, but does not state an expiration date for the right to buy it. Thus, the buyer believes he has the right to buy the adjacent lot should the owner decide to sell it at anytime during the owner's lifetime. A further, more formal, memorialization of the right of first refusal is not entered into. No memorandum of the right is recorded. The transaction closes.

Many years later, the owner conveys the adjacent lot to another person for $880,000. The person who acquires the adjacent lot has no knowledge of the outstanding right of first refusal which was triggered by his purchase. Thus, the buyer holding the right of first refusal is unable to exercise his preemptive right and acquire ownership of the adjacent lot. The person who acquired the adjacent lot is a *bona fide purchaser* (BFP), barring any recovery of the lot by the buyer.

The buyer claims the owner has breached the right-of-first-refusal provision in their purchase agreement. Thus, the buyer makes a demand for the monetary value of the lost right to buy since he no longer has the ability to acquire the adjacent lot.

The buyer's demand on the owner is for the sum of $480,000. The money demand is based on the difference between the price set in the right of first refusal provision and the *value of the property* on the **date of the breach**, plus interest at 10% (the legal rate) on the demand from the date of the breach until the demand is paid.

The owner refuses to pay the demand claiming the right of first refusal he granted at the time of the purchase of the first lot *expired* prior to the owner's sale of the lot since the provision did not contain an expiration date and a reasonable period of time for the right to continue in existence has long ago passed.

Can the buyer recover money equal to the **price-to-value difference** several years later at the time of the sale of the lot covered by the right of first refusal?

Yes! The right of first refusal which the owner granted did not express a date of expiration. Thus, the date of expiration becomes the date of the death of the owner who granted the right.

More importantly, the right to buy held by the buyer had not previously been triggered. Thus, the right could not have been exercised by the buyer until the owner triggered the right to buy by deciding to sell the property. It is the owner's decision to sell that provides the buyer, on notice of the decision (which he did not get), with his first *opportunity to exercise* the right by deciding to buy the property at the price and on the terms stated in the provision granting him the preemptive right to buy.

It is the length of the period **following the notice** of the owner's intent to sell which controls the buyer's actions. Delivery of the notice sets the period during which the buyer may *exercise* his right to buy. If this **period for exercise** is not stated in the right-of-first-refusal provision, it is limited to a *reasonable period* of time which begins to run when the buyer receives notice from the owner of his decision to sell.

Thus, it is the period **after the notice** which expires, not the grant of the right to buy, unless the right-of-first-refusal provision limits the term of the grant.

Accordingly, the buyer's **money recovery** of the value-over-price is the difference between:

- the *value of the property* on the date of the breach, here set by the price the owner received for the property on the resale (the event which triggered the right to buy); less

- the *price agreed* to in the right of first refusal provision as the amount the buyer was to pay for the property on exercise of the right to buy. [**Mercer** v. **Lemmens** (1964) 230 CA2d 167]

Preparing to take possession

Consider a buyer who enters into a purchase agreement with a builder to construct a new home. The buyer purchases appliances and upgrades the fixtures, which the builder installs.

Later, the builder substantially alters the construction plans for the exterior without the buyer's approval. The buyer demands the builder complete construction under the plans and specifications as agreed. The builder refuses since he has prospective buyers for the property at a significantly higher price.

The buyer decides he no longer wants the new home due to his conflict with the builder. He unilaterally cancels the purchase agreement since the builder has breached the agreement. The buyer now seeks to recover money from the builder, not the property.

Here, the actual **money losses** the buyer may recover from the builder include:

- funds advanced toward the purchase price, including good-faith deposits and monies released to the seller;

- the value-over-price difference between the price the buyer agreed to pay in the purchase agreement and the resale value of the property at the time of the builder's breach;

- expenses incurred to prepare the property for possession (to the extent they exceed the value-over-price difference), i.e., the expenditures made by the buyer for the additional appliances and upgraded fixtures; and

- interest from the date of the breach on all amounts of money recovered.

A buyer is allowed to recover expenditures incurred to prepare a property so he can take possession. The buyer and seller must intend for the expenditures to be incurred by the buyer as a condition in their purchase agreement. Recovery of construction costs advanced by a buyer for upgrades and additions gives the buyer the *benefit of the bargain* contemplated by both the buyer and seller when they entered into their agreement. However, the buyer cannot enjoy a double recovery for the upgrades he paid for when the price-to-value increase exceeds the cost of the upgrades.

Excluded from recovery are any expenditures by the buyer to purchase furnishings for the new home. The recovery of these expenses are typically not agreed to under a purchase agreement and are not related to the acquisition of real estate. Also, a seller cannot reasonably foresee these **collateral expenses** for home furnishings as becoming his obligation should he breach the purchase agreement.

Consequential damages, naturally

A buyer whose seller has breached their purchase agreement is also entitled to **recover expenses** incurred by the buyer *after the breach*, if the expenditures are the *natural result* of the seller's breach, called *consequential damages*.

For the buyer to recover post-breach expenditures, the seller on entry into the agreement must have known or should have known the expenses would be incurred by the buyer as a **natural and unavoidable result** of the seller's breach of the purchase agreement.

For example, consider a buyer who enters into an agreement to purchase a lot from a builder. The builder also agrees to complete the construction of improvements on the lot and convey the property by an agreed-to date.

Before the builder enters into the purchase agreement agreeing to sell the property and construct improvements, the builder is informed of the adverse tax consequences the buyer will be subjected to if the construction is not completed and the property conveyed by the date scheduled for closing. Thus, **time for performance** by completion of construction and close of escrow is known by the builder on entering into the agreement to be a prerequisite to the buyer's avoidance of profit taxes.

The buyer has sold real estate he used in his trade or business and needs to acquire ownership of a replacement property within 180 days after the sale closed. The time constraint must be met to qualify the sale as an IRC §1031 exempt transaction and avoid reporting profits and incurring state and federal tax liability for the tax on the profits.

However, the builder fails to complete construction and convey the property prior to the date set for closing. Thus, due to the builder's breach, the buyer is unable to avoid payment of the profit tax on the sale of his trade or business property. Also, the buyer is forced to rent another property (and incur moving expenses) until the construction the builder promised is completed.

Here, the **consequential damages** recoverable by the buyer in the form of a *money award* include:

- the full amount of the profit tax the buyer paid;
- the rent paid for the temporary facilities until the improvements were completed (plus the cost of additional moving expenses); and
- interest at 10% from the date the amounts of rent and profit tax were paid by the buyer. [**Walker** v. **Signal Companies, Inc.** (1978) 84 CA3d 982]

Interest due from date of loss

A buyer who recovers money losses is also entitled to recover **interest** at the **(legal) rate of 10%**, commencing on the date of the seller's breach, on amounts recovered for:

- the value-over-price money differential recovered;

- money paid toward the purchase price, whether held by the seller or as a deposit in escrow, until the date released to the buyer;

- funds expended on title examination and other transaction expenses incurred preparing to take title;

- expenses incurred preparing the property to take possession; and

- *consequential losses,* but only accruing from the date of their disbursement. [**Al-Husry** v. **Nilsen Farms Mini-Market, Inc.** (1994) 25 CA4th 641]

Consider a buyer who enters into a purchase agreement on a one-to-four unit residential property with a seller. The buyer opens escrow and deposits funds in accordance with the purchase agreement.

Meanwhile, the seller has received a better offer from another buyer. The seller, without telling the his original buyer, conveys the property to the second buyer.

The first buyer, whose purchase agreement has now been breached by the seller's conveyance to the second buyer, is **entitled to recover**:

- the increased value of the property on the date of the breach over his purchase price, with **interest on the difference** at the legal rate (10%) from the date of the breach; and

- the refund of his deposits held either in escrow or by the seller, plus **interest on the deposits** from the date of the breach to the date the deposits are returned to the buyer. [**Rasmussen** v. **Moe** (1956) 138 CA2d 499]

Nonrecoverable losses

A buyer's expenses and losses which are unrelated to the real estate and not intended to be incurred by the buyer based on the buyer's entry into the purchase agreement are not the responsibility of the breaching seller. Losses and expenses **too remote and speculative** to be foreseen by the seller when entering into the purchase agreement as his obligations should he breach are **not recoverable** from the seller.

For example, a buyer enters into a purchase agreement to acquire an unimproved parcel of commercial property. The seller knows the buyer plans to develop the property. Before escrow closes, the seller determines he can get a higher price for the property from other prospective buyers and cancels escrow.

Here, the buyer can recover any increase in the value of the land on the date of breach over the agreed-to purchase price, as may be reflected by the seller's resale of the property.

However, the buyer is **not entitled** to recover the **profits** he would have earned had he been able to acquire and develop the land. Lost profits for the **anticipated use** of the property to be purchased are unrelated to the sale and too speculative to be recoverable by the buyer. [**Stewart Development Co.** v. **Superior Court for County of Orange** (1980) 108 CA3d 266]

Also, lost income from rents a buyer would have received had he acquired property subject to a long-term lease are not recoverable. The recovery of rents is barred on a different legal theory from consequential losses since rents are related to the property.

Rent produced by income property is a factor used to establish the property's **present value**. To allow the buyer to collect *future rents* from a breaching seller when the buyer does not buy the property and the

buyer is awarded a money recovery for the *increase in the resale value* (which by definition is established by the future flow of rents) would be double recovery, i.e., present value of the future flow of rent, plus those future rents. Thus, the buyer would be improperly placed in a **better position** than had the seller performed by conveying the property.

Further, interest serves the same economic function as rents. Both are a *return on capital*. Thus, when a buyer receives interest on the amount of his recovery, the further receipt of future rent would also be an **impermissible double recovery**. [**Stevens Group Fund IV** v. **Sobrato Development Co.** (1992) 1 CA4th 886]

Commercial reality of a call for funds

Consider a buyer and seller who enter into a purchase agreement which sets the date scheduled for the close of escrow. However, the purchase agreement does not contain a performance date by which the seller is to deliver documents to escrow. Escrow is opened.

The buyer obtains a commitment letter from a lender for a purchase-assist loan. The lender issuing the commitment informs escrow it will prepare loan documents and fund escrow within five days after its receipt of an estimated closing statement from escrow.

On the day scheduled for closing, escrow is still not in a position to prepare an estimated closing statement or call for closing funds from the lender or the buyer. The seller has not yet submitted a current rent roll statement needed by escrow to prepare the estimated closing statement.

Later that day, the seller submits a current rent roll statement to escrow, completing his performance of all conditions imposed on the seller by the date set for closing. On learning that the buyer has not yet deposited his funds into escrow, the seller hands escrow a written notice of cancellation.

The buyer makes a demand on the seller to convey title as soon as the lender is in a position to fund the loan. The buyer claims his failure to fund escrow by the closing date is excused due to the seller's **untimely delivery** of the rent roll statement to escrow.

Here, the buyer's failure to fund escrow when he had otherwise fully performed was *excused* by the seller's dilatory delivery of closing document to escrow. The seller must now allow escrow to close.

Escrow is a process which depends on the orderly receipt of documents to close the transaction, a process the seller must honor. Thus, as a matter of *commercial reality*, escrow will not call for closing funds from either the buyer or the lender until escrow is in a position to close. In turn, neither the buyer nor the lender will deposit or wire funds until they receive a call from escrow for funds.

Since escrow was not in a position to call for funds due to the seller's untimely performance, the buyer's delivery of funds by the date scheduled for closing was excused and the seller must allow escrow to close. [**Ninety Nine Investments, Ltd.** v. **Overseas Courier Service (Singapore) Private, Ltd.** (2003) 113 CA4th 1118]

The seller's obligation to deliver documents and the buyer's obligation to fund escrow are considered mutually exclusive *concurrent conditions*. Thus, they must be independently performed by the buyer and seller on or before the date scheduled for closing. However, in actual practice, escrows require receipt of all documents needed by escrow to close before they will **call for funds**.

Even with all the buyer's and seller's documents in hand, lenders generally need five to seven days to prepare, forward and receive signed loan documents before they will fund.

A provision might not exist in a purchase agreement calling for the seller to deliver documents to escrow prior to the date set for closing. However, the existence in all real estate contracts of an *implied covenant of good faith and fair dealing* imposes a duty on the seller to timely perform by taking action to avoid frustrating the buyer's right to receive the benefits of the contract, i.e., allow time for the buyer and his lender to fund escrow and for the buyer to receive title to the property. [See Form 150 §12.2 accompanying Chapter 51]

Chapter 48 The breaching buyer's liabilities

This chapter digests a buyer's liabilities to a seller arising out of the buyer's breach of a purchase agreement for property value decreases, operating and carrying costs, and losses on a resale.

First, there must be a monetary loss

Consider a prospective buyer of a residence who is informed the seller has already entered into a purchase agreement to acquire a replacement residence. The seller is relying on the sale of his current residence to fund his purchase of the replacement residence.

The prospective buyer makes a written offer agreeing to pay cash for the seller's equity and assume the existing trust deed loan, called a *cash-to-loan transaction*. The seller accepts the offer. Escrow instructions are prepared and signed, and the buyer's good-faith deposit is placed in escrow.

Later, as agreed, the buyer deposits additional funds in escrow. Although escrow is not yet ready to close, the buyer agrees to release some of the downpayment money held in escrow so the seller can close his purchase of the replacement residence. The funds are released and the seller acquires his new residence.

The seller vacates the old residence he has *sold* and moves his family and belongings into the new residence.

To consent to the buyer's application to assume the seller's existing loan, the lender demands a modification of the interest rate and payment schedule, and an assumption fee. The buyer refuses to proceed with the loan assumption and cancels escrow.

The buyer makes a demand on the seller to return all funds the buyer deposited into escrow, which the seller rejects.

The seller then makes a demand to be paid the funds remaining in escrow. The seller claims the buyer has *forfeited* all funds since he breached the purchase agreement by not assuming the loan.

The seller promptly relists the property and it is **resold** for the same price, but on terms calling for payoff of the existing loan, requiring the seller to pay a prepayment penalty. The seller also agrees to pay the new buyer's nonrecurring closing costs and one point on new financing to be obtained by the new buyer. On closing the resale transaction, the seller's **net proceeds are less** than he would have received on the sale to the original buyer under the breached purchase agreement.

Can the seller recover any money from the original buyer by either:

- retaining all the funds deposited by the buyer; or
- accounting for offsets against the buyer's deposits for the seller's losses?

Here, the seller is entitled to recover his losses. However, he must **account for his actual money losses** caused by the buyer's breach since a *forfeiture of deposits* is not allowed, no matter the wording or initialing of forfeiture provisions.

Depending on the amount of the seller's **total recoverable losses** on the resale, the buyer's deposit will be partially or totally offset by the amount of the seller's losses caused by the breaching buyer. [**Allen** v. **Enomoto** (1964) 228 CA2d 798]

Recoverable seller losses

A seller's **total recoverable losses**, summarized here and analyzed in detail in this chapter, include:

- the *operating and carrying costs* of trust deed interest payments, taxes, insurance, maintenance and utilities, which were incurred by the seller during the period between the date of the breach and the date escrow closed on the resale;

- the *increased closing costs* due to the seller's payment of the new buyer's nonrecurring closing costs and financing fees on the resale which reduced the seller's net proceeds compared to the net proceeds the seller would have received from the breaching buyer;

- the *additional resale costs* of the prepayment penalty demanded by the lender on the loan pay-off; and

- *interest* on the seller's net equity from the date escrow was to close to the date of closing on the resale.

Resell or retain the property

A seller of real estate who is faced with a **breaching buyer** and the failure of the sales transaction must first decide whether to:

- *enforce* the purchase agreement and have a court order the buyer to close escrow, called *specific performance*;

- *remarket* the property for sale promptly and diligently seek to locate a buyer; or

- *retain the property* and postpone or entirely forego any resale effort.

Editor's note — This chapter illustrates money losses recoverable by the seller who chooses either to retain the property or resell it. Thus, the specific performance remedy is not considered here.

Only a money loss is recoverable

A buyer, due to his breach of the purchase agreement, owes the seller **actual money losses**, called *damages*, which are classified as:

- **general damages**, also called *normal damages*, being the dollar amount of any decline in the property's fair market value as of the date of the buyer's breach below the price agreed to in the purchase agreement;

- **special damages**, also called *consequential damages*, being:

1. transactional costs incurred by the seller while preparing to close under the breached purchase agreement;
2. marketing expenses, increased closing costs, and ownership and operating costs incurred to remarket and sell the property; and
3. any further drop in property value after the buyer's breach for so long as the buyer interferes and stalls the seller's resale effort; and

- **interest** from the date of the buyer's breach to the closing date of a resale of the property on all money and any carryback note the seller was to receive [Calif. Civil Code §3307]; less

- **offsets or credits** due the buyer for

1. any rent received from tenants or the *implicit rent* for the owner's use of the property;
2. the amount of any price increase on the resale; and
3. the amount of any reduction in the seller's expenses on the resale, so the seller will not be placed in a better financial position than he would have been in had the breaching buyer fully performed. [**Smith** v. **Mady** (1983) 146 CA3d 129]

Price-to-value as a money loss

When a seller decides to resell the property after the buyer breaches their purchase agreement and the property's value has declined below the price set in the purchase agreement, the seller has incurred a **loss in value** which is recoverable from the buyer. However, the amount of future value decline recoverable after the buyer's breach is limited to two time periods:

- the initial decline in value below the purchase price during the period **before the breach**, which is recoverable as *general damages* or more commonly called a *price-to-value loss*; and

- any further decline in value **after the breach**, which is recoverable only if the buyer **interferes** with the seller's resale effort, also called *special damages* or more commonly called *additional damages*, damages being money. [CC §3307]

The price-to-value loss on the date of breach is recoverable by the seller whether the property is retained, remarketed or resold by the seller.

During periods of reduced regional economic activity, the boom-bust cyclical nature of real estate sales typically causes California property values to drop dramatically below the price the buyer agreed to pay just a few months earlier.

Further, the intangible impacts on a property's market value, due to its "shop-worn" listing status and the "fall-out syndrome" of a lost sale, give the property an aura in the local real estate market which negatively affects some buyers and their brokers. This aura is often reflected in a further dampening of the property's value on the date of breach. [**Bouchard** v. **Orange** (1960) 177 CA2d 521]

To limit the breaching buyer's liability, the seller's loss on a resale at a price lower than the price agreed to by the breaching buyer is limited to the amount of the value decline which occurs by the date of the buyer's breach, not the date of resale. Any further decline in value after the date of breach to the date of resale (or trial, if the property is not yet resold) is recoverable only if the buyer interferes with the seller's diligent resale efforts.

Same or greater price on resale

When property is resold for the same price agreed to by a breaching buyer, or more, and the net proceeds from the resale are the same or the cash equivalent, or more, the price-to-value decline on the date of breach is no longer recoverable. With equal or greater net proceeds on a resale, the seller incurs no money loss, called *general damages*, since he has no loss of value to recover.

To set the dollar amount of the *price-to-value loss* on the date of breach, any "noncash" terms for payment of the purchase price by the breaching buyer and any "noncash" terms for payment of the resale price are adjusted to their **cash equivalency**.

For example, if terms for payment of a sale price include a seller carryback note, the principal amount of the carryback note is adjusted downward to reflect any discount required to convert the carryback paper to its cash equivalent, i.e., its present worth in cash.

Interfering with the resale

A seller might **diligently remarket** the property and still be unable to resell it due to interference from the breaching buyer. Buyer interference with resale efforts usually consists of filing a *specific performance action* and recording a *Notice of Lis Pendens*, or taking possession and refusing to vacate.

When the **breaching buyer interferes** with the resale, the seller recovers any decline in the property's value after the date of breach until the buyer stops interfering with the seller's resale efforts.

For example, a buyer sues a seller seeking specific performance of the purchase agreement. The seller claims the buyer breached the purchase agreement by failing to satisfy contingencies as scheduled. The buyer claims the seller breached when he canceled, thus *excusing* the buyer from further performing. The buyer sues to recover the property and records a **Notice of Lis Pendens**, which *clouds* the marketability of title.

Ultimately, the buyer is held to have breached the agreement and the lis pendens is removed from the record, called *expungement*.

A seller, whether he attempts to resell the property or retains it, generally bears the risk of any fluctuation in the value of the property after the buyer breaches. The breach is the cutoff date for recovery of a decline in value, unless the buyer later interferes.

However, the risk of loss due to a decline in value after the date of breach is shifted to the buyer until the date title is cleared of the recorded lis pendens if the recording interferes with the seller's prompt and diligent efforts to resell the property. [**Askari** v. **R & R Land Company** (1986) 179 CA3d 1101]

Natural-consequence expenses

A seller who takes the property off the market or is not prompt and diligent in his efforts to remarket and resell it after the buyer's breach is limited in his recovery of money to his **actual transactional expenses** and any **operating expenses** incurred to fulfill the seller's performance under the purchase agreement up to the time of the buyer's breach.

Recoverable money losses the seller might incur as **transactional expenditures** include:

- escrow and title charges;

- lender charges for beneficiary statements or payoff demands;

- lender or carryback seller charges to process the buyer's credit clearance, loan application or loan assumption; and

- other expenses and property reports incurred in reasonable reliance on the buyer's full performance of the purchase agreement.

However, **ownership and operating expenses** incurred by a seller who chooses to either retain the property or delay reselling the property are not recoverable. The seller, as the owner of the property, remains responsible for the expenses of carrying and maintaining the property since these expenses are not incurred by the seller due to a buyer's agreement to purchase or a breach by the buyer. These expenses are incurred because the seller owns the property.

However, some **operating losses** incurred by a seller due solely to his *compliance* with the terms of a purchase agreement are recoverable, including:

- the seller's *relocation expenses* to reoccupy the property if he vacated after all contingencies allowing the buyer to cancel were eliminated;

- rental income lost after the breach on *units left vacant or vacated* by the terms of the purchase agreement;

- a *crop revenue loss* due to the planting season having passed at the time of the buyer's breach; and

- a price drop on the *late harvest* of a crop due to the buyer's breach. [**Wade** v. **Lake County Title Company** (1970) 6 CA3d 824]

Replacement property

Consider a buyer who enters into a purchase agreement knowing the seller intends to acquire replacement real estate with the net proceeds from the sale. After all the buyer's contingencies are eliminated and no uncertainties remain about the buyer's full performance, the seller enters into a purchase agreement to buy replacement property without conditioning his purchase on the "sale of other property."

The buyer then breaches and the seller is unable to complete his purchase of the replacement property. The seller incurs expenses and losses to avoid liability for having unconditionally agreed to purchase the replacement property.

Expenses incurred on the replacement property transaction are recoverable since:

- the buyer knew when he entered into the purchase agreement that the seller intended to contract to purchase replacement property based on the buyer's agreement to purchase; and

- the seller agreed to purchase other property in reasonable reliance on his buyer closing the sales escrow since all contingencies had been removed and no obstacles to closing existed, except for the breach. [**Jensen** v. **Dalton** (1970) 9 CA3d 654]

Operating losses during the resale period

A seller who, after his buyer breaches, promptly takes steps to diligently remarket the property for sale may recover his operating expenses and carrying costs of the property incurred **after the date of breach**, subject to offsets for rent credit, owner's use, etc.

Recoverable operating losses and carrying costs are limited to those the seller incurs during the period beginning on the buyer's breach and ending on the earlier of:

- the date a **resale closes**;
- the **trial** judgment on the breach; or
- the date of **withdrawal** of the property from the resale market.

The seller who decides to promptly resell the property and then recover any losses from the buyer has a duty to the breaching buyer to limit the operating and ownership losses, called *mitigation of damages*. To do so, the seller must take immediate steps to market the property for resale within the shortest possible time. [**Spurgeon** v. **Drumheller** (1985) 174 CA3d 659]

To begin calculating the seller's net loss, the seller's costs of maintaining his ownership are totalled. However, the recoverable operating expenses and carrying costs of the property incurred by the seller during the resale period are limited to operating and ownership expenses understood by the buyer to exist at the time he entered into the purchase agreement.

However, the buyer is **due a credit** for the rental value of the seller's occupancy, called *implicit rent*, and any rental income received by the seller from the property after the buyer's breach.

Thus, for a seller to recover on-going losses incurred to carry the ownership of the property before resale or trial, a full accounting of income, expenses and the carrying costs of financing is required.

Interest on recovered losses

A seller is also **entitled to interest** on the losses and expenditures he recovers for the decline in the property's value, expenses of the breached transaction, resale related expenses and the carrying costs of the property during the resale effort. [CC §3307]

Unless the purchase agreement states otherwise, the interest is collectable at the legal annual rate of 10%, accruing from the date the recoverable loss or expenditure was incurred, called *prejudgment interest*. [CC §3289(b)]

If the seller **retains the property**, no property operating or value losses after the breach are recoverable on which interest can accrue.

For the seller who **diligently remarkets** the property for resale, recoverable resale costs and out-of-pocket carrying costs of the property not offset by rental income or the rental value of the seller's use of the property accrue interest from the date of each expenditure.

Had the buyer performed and closed escrow, the seller would no longer own the property. The seller would have received the net sales proceeds for his equity in the property.

Since escrow did not close and the seller did not receive the net sales proceeds for his equity, the question of whether he is entitled to interest on his **net equity** turns on the seller's use of the property at the time the purchase agreement was entered into.

For example, a **seller's use** of the subject property falls into one of two categories:

- **income-producing property** used as the seller's residence or to house the seller's trade or business (implicit rent) or held out as a residential or nonresidential rental; or

- **nonincome-producing property**, such as vacant land or the seller's vacant residence.

Rents received from income producing property are the *economic equivalent* of **interest** on the dollar amount of the equity. Thus, for the seller to also receive interest on his equity in income-producing property until it resells would be a nonrecoverable windfall, a double recovery on his equity in the form of both interest and rent, which are **economic equivalents**.

The seller who occupies the property until it is resold is charged for the value of his use, called *implicit rent.* The amount of **implicit rent** is an offset against all money recoverable from the breaching buyer, including interest on the seller's equity.

For vacant unused land or the seller's vacant residence, a breach by the buyer again fails to convert the seller's equity into cash or cash equivalent. Thus, the seller temporarily retains ownership of the equity, which may be increasing, decreasing or remaining the same depending on price fluctuations for the property's market value until it is resold.

Since the resale seller cannot recover his equity in vacant property from the breaching buyer (except by specific performance), can interest be collected on the equity?

First, any interest due on the dollar amount of the net equity can only accrue from the **scheduled closing date** of the breached contract — the date the benefits from the breached sale in the form of cash for the seller's net equity would have been received by the seller — up to and ending on the **date of resale or trial**. Any interest due accrues at the legal rate of 10%. However, if the seller agreed to an installment sale, the note rate for the carryback paper would be the controlling rate.

Next, if the breached purchase agreement contains a provision limiting the dollar amount of losses the seller can collect, the losses recoverable would be controlled by the agreed-to limit, except for the accrual of interest which would be an additional amount. [See Form 150 §10.8 accompanying Chapter 51]

Thus, when the buyer breaches an agreement to purchase vacant, nonincome-producing property, interest is due on the net sales proceeds the seller would have received on the sale, until the property is resold.

Chapter 49 Liquidated damages provisions

This chapter is a survey of the unenforceability of liquidated damages provisions in real estate purchase agreements and the limitation on a breach to the recovery of actual money losses.

Windfalls and responsibility for losses

Everyone, by the time they reach the age of capacity to contract, understands the fundamental premise that when you wrongfully cause another person to lose money, you are responsible for *repayment* of the loss. This economic concept was codified for real estate transactions in 1872 and remains intact today. [Calif. Civil Code §3307]

However, an equally fundamental premise holds that windfalls are abhorred by all since they are unearned.

These two precepts are frustrated by the inclusion of a **liquidated damages provision** in a purchase agreement. Use of a liquidated damages provision is an attempt:

- to *limit a buyer's responsibility* for payment of losses he inflicts on another; and
- to *provide the seller with a windfall* at the buyer's expense.

The contractual liquidated damages provision creates aberrations in the natural expectations held by everyone in the transaction.

For instance, a seller expects to lose nothing of value in exchange for what is the buyer's good-faith deposit should the buyer fail to close the transaction. However, the buyer expects a refund of his good-faith deposit if he does not acquire the property.

Ironically, the listing agent looks at the liquidated damages provision in the purchase agreement as a way to be paid a small fraction of the fee he earned. Erroneously, brokers do not bargain for payment of a full fee by the buyer when the buyer breaches the purchase agreement. All of these expectations are without concern for the amount of money the seller and agents lost, or that the breaching buyer caused the losses and should reimburse them.

A **listing agent**, being charged with a *duty of care* for his seller, needs to understand the contractual and financial nature of his seller's position under a purchase agreement so he can properly advise the seller when the purchase agreement is breached by a buyer. When the buyer breaches and the seller cancels the purchase agreement, the seller still **owns the property**, although with no further claim by the buyer of a right to acquire it.

Also, the **good-faith deposit**, even if released to the seller after contingencies have been removed, is the buyer's money until:

- the buyer *receives consideration* (the property); or
- the deposit is *offset by reimbursement* to the seller for his **actual money losses** suffered due to a breach by the buyer.

The seller's purported loss of prospective buyers and prior market synergies and the infliction of seller frustration and inconvenience, all due to the buyer's breach, are not *money losses*. Thus, these ancillary or collateral situations leave the seller with nothing to collect.

However, the seller's agent properly focuses on **resolving a breached** and failed sales transaction by immediately turning his attention to assisting his client to "clear out" the transaction so the property can be remarketed to another prospective buyer. The listing agent is still obligated to locate buyers under the seller's exclusive right-to-sell agreement, unless it has expired.

Thus, cancellation instructions need to be given to escrow to terminate the breached purchase agreement and escrow instructions, unless the resale value of the property has dropped or the seller has reason to pursue a specific performance action and forego reselling or retaining the property. [See Chapter 48]

Money losses reimbursed

What is the listing agent to do about a buyer's good-faith deposit when the buyer breaches a purchase agreement?

While a listing agent's knee-jerk reaction may well be to get the buyer's funds to the seller so half of the deposit will be earned as a brokerage fee, the first reasonable step to be taken by the agent is to analyze the extent of the seller's loss of money now that the sales escrow is dead. The buyer owes the seller the seller's actual money losses since they are expenditures which will not be reimbursed by a resale. Thus, the seller has a *claim* on the buyer's good-faith deposit as the **primary source for recovery** of the losses.

Fortunately for all, the seller's recoverable losses are quite straightforward for calculating the amount of the demand to be made on the buyer. Getting all the figures for the demand will take time and effort. Presuming, as the listing agent must, that the seller will not interfere with the listing and allow the agent to locate a new prospective buyer, the property will be resold in the near future.

A seller's net sheet used to lay out the net proceeds received on the closing of a **resale**, when compared to a seller's net sheet estimating the net proceeds the seller would have received on the **canceled sale**, will present a fairly accurate representation of the money losses the seller incurred due to a decline in property value and the transactional costs not reimbursed by the resale.

The ongoing operating and carrying costs, if the property remains **rented or used** by the owner prior to resale, generally are not recoverable expenses. The actual or implicit rent usually exceeds the operating expenses and carrying costs of the property until the closing of the resale. Also, operating income and expenses usually are not altered due to the terms of the purchase agreement. Hence, little loss, if any, exists for the seller to recover on his continued ownership of the property.

Demands, challenges and limitations

The seller making a demand on a breaching buyer for the deposit is confronted with a decision as to when to make the demand. The seller may **make a demand** for all or a portion of the good-faith deposit at either:

- the *time of the breach*; or
- *after closing a resale* of the property when a loss, if any, is known.

To analyze the demand process, first look to the provisions of the purchase agreement used for the sale of a **one-to-four unit residential property** to a **buyer-occupant**. If a liquidated damages (forfeiture) provision is included in the purchase agreement and the buyer and seller both initialed the provision, they have actually agreed that the buyer's good-faith deposit is to be forfeited to the seller on a breach by the buyer.

However, liquidated damages provisions are initially enforceable by a seller only to **set the limit** of the buyer's liability to the seller. Liquidated damages provisions place a ceiling on the seller's recovery at the amount of the deposit agreed to be forfeited.

For example, if the buyer demands the deposit be refunded, the seller becomes obligated to provide an accounting showing his losses **equaled or exceeded** the amount of the deposit in order to keep the entire deposit. Should the losses be **less**, the seller is not entitled to the entire deposit. Thus, the seller can recover the money he has lost up to the total amount of the deposit referenced in the agreed liquidated damages provision, no matter the amount of the deposit.

When a liquidated damages provision exists, the proper initial reaction of the seller and the listing agent is to make a demand on the buyer for the entire good-faith deposit if it does not exceed 3% of the price since this amount of forfeiture is *presumed valid*.

Once the demand for the forfeiture has been made on the buyer — and it will be made without concern for the actual money losses the seller may have experienced or will experience on a resale — the seller merely waits for the buyer's response. If it is positive and the funds are released to the seller, the seller has won the war. Hopefully for the seller, the buyer will not later realize that the seller's actual money losses were less than the amount released and then make a demand for a refund.

However, if the buyer's agent and the buyer are as well informed as the seller and listing agent, the buyer will **challenge** the liquidated damages provision as *voidable* and demand a return of his deposit. Thus, the provision as a forfeiture is unenforceable since the provision's validity is a *rebuttable presumption*.

The seller must have sufficient losses to justify his retention of the entire liquidated damages deposit. In other words, the amount of the deposit, always being arbitrary in amount and coincidental to the price paid, has no relationship to the losses the seller might suffer on the buyer's breach.

Calculating his losses

If challenged, the seller, confronted with the buyer's challenge that the liquidated damages provision is **voidable**, is back to square one. Namely, the seller must now calculate his losses on the resale and his permissible interim operating and carrying costs of the property prior to a resale as though:

- no liquidated damages provision existed in the purchase agreement;
- the amount of the deposit for liquidated damages was more than 3% and thus initially presumed invalid;
- the liquidated damages or liability limitation provision placed a ceiling on the buyer's liability for the seller losses; and
- no provision limiting recovery existed in the purchase agreement restricting the seller's right to recover all his losses.

- Under any of the above scenarios, the seller is to itemize his money losses, which include:
- any decline in the property's value by the time of the buyer's breach;
- the seller's transactional costs incurred on the lost sale which are not recoverable on a resale; and
- any increased operating costs or rent losses caused by the purchase agreement with the buyer and incurred prior to the resale.

The buyer will cover these itemized losses from the good-faith deposit up to any dollar limitation set by a liquidated damages or liability limitation provision in the purchase agreement.

The seller who seeks to **recover losses caused by the breaching buyer** when the buyer asserts his right to pay only the seller's actual money losses, needs to:

- proceed to resell and close a resale of the property rather than retain the property;
- calculate the total amount of the price-to-value loss, lost transactional expenses and the loss of nonvalue-added improvements or repair expenditures;
- make a demand on the buyer for the amount of the itemized money losses; and
- if not paid, pursue collection of the lost money and a release of the amount from the buyer's deposit, subject, of course, to any agreed limitation on the dollar amount of the buyer's liability for his breach.

Challenging the validity of a forfeiture

A buyer and his agent, when the seller demands any of the **buyer's good-faith deposit**, need to understand:

- the funds *belong to the buyer* until escrow closes, which will not occur due to the buyer's breach;
- the seller has a *claim against the deposit* for recoverable losses; and
- the buyer is to make a demand on the seller for a statement of *itemized losses* before the buyer will pay any compensable losses incurred by the seller.

Thus, when a liquidated damages provision exists on the sale of a one-to-four unit residential property which is initialed by both the seller and buyer, the buyer's demand for an itemization of the seller's money losses constitutes a *legal challenge* which rebuts the presumed validity of a forfeiture provision for deposits not exceeding 3% of the purchase price.

On making the request of the seller for an accounting, the buyer awaits the seller's response. If the seller fails to respond with an accounting, he either did not incur a recoverable loss or waived any claim he may have to recover his losses.

Limiting the breaching buyer's liability

Without a liquidated damages provision or contract liability limitation provision in the purchase agreement, a seller is entitled to recover the entire amount of his money losses caused by the buyer's breach.

Conversely, the seller is limited in his recovery to the amount of the forfeitable deposit should the purchase agreement (for the sale of one-to- four residential units to a buyer-occupant) include an initialed liquidated damages provision or a contract liability limitation provision.

In either case, if an **accounting** is sought by the buyer for the seller's recoverable money losses, the seller must present an accounting in order to be reimbursed for them.

When an initialed liquidated damages provision is included in a purchase agreement, the breaching buyer avoids the forfeiture called for by challenging the *presumed validity* of any amount **up to 3%** of the purchase price.

However, for the seller to enforce a forfeiture of any portion of a deposit **exceeding 3%** of the purchase agreement price, the seller must challenge the *presumed invalidity* of the excess by demonstrating in an accounting that his losses on the sale exceeded 3% of the purchase price.

Thus, the liquidated damages provision has a "split-personality" aspect. The responsibility for challenging the *presumed validity* of a forfeiture of 3% or less is the buyer's, and the responsibility for challenging the *presumed invalidity* of a forfeiture of more than 3% is the seller's.

In general, liquidated damages provisions, other than on the sale of one-to-four residential units to a buyer-occupant, are presumed to be *valid*. However, they are classified as *forfeitures* and are unenforceable if they do not provide an amount which bears some **reasonably close relationship** to the actual losses the seller will incur due to harm inflicted by the buyer on a default.

When the amount of the forfeiture exceeds the seller's losses, the buyer can **void** the provision as unreasonable. Thus, the liquidated damages provision is *voidable* as it is only presumed to be valid if the amount is reasonably close to actual losses.

Liability ceiling or forfeiture

If a buyer and seller do not agree to either a liquidated damages provision or a contract liability limitation provision, then the buyer who enters into such a purchase agreement and breaches will be liable for an **unlimited amount of losses** incurred by the seller due to the buyer's breach. In the economic environment of a stable resale market for homes or one of generally rising or fast rising prices little risk is taken by a buyer when entering into a purchase agreement without a ceiling on his liability exposure.

However, it is for buyers in a static market or one following a peak in prices when mortgage rates rise that the buyer's agent needs to take *utmost care* to explain the need for a **ceiling on liability** exposure.

As for the listing agent, he should advise his seller in times of weak or weakening pricing power to avoid agreeing to a ceiling on the buyer's liability and to get a huge deposit.

Seller breach by refusal to refund

Consider a buyer of a single family residence who has entered into a purchase agreement containing an initialed, liquidated damages provision.

Prior to closing, the buyer waives all contingencies and releases his original and additional good-faith deposit to the seller in an amount in excess of 3% of the agreed price. At the time of closing, the buyer decides not to close escrow on the purchase of the property.

The seller promptly remarkets the property, accepts an offer and quickly closes a resale of the property, but at a slightly lower price. The buyer then makes a **demand on the seller** to return that portion of the deposit now held by the seller which exceeds the seller's losses. The breaching buyer is willing to cover the seller's loss due to the reduced amount of net proceeds on the resale.

The seller rejects the buyer's demand for a refund, claiming the funds released were option money which he is entitled to keep as consideration for his *irrevocable offer* to sell the property to the buyer, which the buyer did not exercise by closing escrow.

However, the liquidated damages provision in the purchase agreement indicates the agreement is bilateral. The purchase agreement called for a forfeiture of the deposit should the buyer fail to close escrow, the antithesis of an option agreement which is unilateral and by its nature contains no forfeitures. Thus, the seller's defense for keeping the buyer's deposits as option money consideration for granting an option is a non-starter.

Also, the seller did not attempt to show that his losses caused by the buyer's breach equaled or exceeded the buyer's deposits. The seller did not produce closing statements for either the lost sale or the resale, lost transactional expenses, nonvalue-adding expenditures for repairs or maintenance, or any recoverable operating costs for carrying the property or lost rental value until the close of the resale.

Here, the liquidated damages provision becomes a **promise by the seller** to refund the portion of the deposit which exceeds the seller's recoverable losses, due to either:

- a buyer's challenge of the forfeiture's reasonableness; or
- the forfeiture amount being in excess of 3% of the purchase price.

Thus, the seller's failure to refund (or release) the amount exceeding his losses is a **breach by the seller** of the liquidated damages provision and the purchase agreement. [**Allen** v. **Smith** (2002) 94 CA4th 1270]

Had the purchase agreement not contained a liquidated damages provision or other contractual liabilities limitation, the seller would still have been **limited to collecting** no more than his actual losses. Thus, the excess amount of the buyer's deposit over the seller's losses must always be refunded by the seller or released from escrow to the buyer.

Court-ordered forfeiture not enforced

Consider a buyer and seller of a one-to-four unit residential property who enter into a court-ordered settlement agreement to resolve a dispute over their purchase agreement by agreeing to close escrow. The settlement agreement contains a forfeiture provision calling for the release of the buyer's good-faith deposit to the seller if the buyer does not complete the sale as agreed.

However, the buyer is unable to secure purchase-assist financing and cancels escrow, a breach of the settlement agreement since closing escrow was not contingent on his obtaining a loan.

The seller seeks to recover the buyer's good-faith deposit. However, the seller has incurred no loss due to the buyer's failure to perform.

The buyer claims the seller cannot enforce the forfeiture provision in the court-ordered settlement agreement since any provision agreeing to the forfeiture of the good-faith deposit is limited by contract law to a **provable loss**.

The seller claims the forfeiture provision is enforceable without a proof of loss since the provision is contained in a court-ordered settlement agreement between the buyer and seller, not in a privately negotiated real estate purchase agreement.

Here, as in all forfeitures of money arising out of any real estate transaction, the seller may not enforce the forfeiture provision and recover the buyer's good-faith deposit without a showing of his actual money losses. The court-approved settlement agreement is a contract agreed to by the buyer and seller and contract law prohibits the enforcement of liquidated damages provisions in real estate purchase agreements, unless the seller incurs a loss and limits recovery of the loss. [**Timney** v. **Lin** (2003) 106 CA4th 1121]

Chapter 50 Arbitration: the independent beast

This chapter presents the adverse impacts created by agreeing to a binding arbitration clause in a real estate listing or purchase agreement.

Rights to correct a decision lost

The trend among real estate agents regarding dispute resolution, encouraged since 1978 by trade unions, arbitration associations and the courts, has been to avoid the California court system by agreeing to resolve disputes involving the purchase or leasing of real estate and agency relationships through *binding arbitration*. The wisdom of this trend in real estate related contracts is under increasing attack.

Many pre-printed brokerage and purchase agreements include a boilerplate **arbitration provision**. The arbitration provision included in a purchase agreement, listing or lease agreement **forms a contract** with an arbitrator. Thus, the provision forms an agreement between the person who initials the provision and the arbitrator, an agreement separate from the purchase agreement which contains the provision. [**Prima Paint Corporation** v. **Flood & Conklin Mfg. Co.** (1967) 388 US 395]

To be enforceable, the arbitration provision must be initialed by the person against whom the provision is being enforced. Thus, an arbitration provision is enforceable against any person who initials the provision, even if the person is the only one to initial it. [**Grubb & Ellis Company** v. **Bello** (1993) 19 CA4th 231]

*Editor's note — **first tuesday's** purchase agreements and addenda do not contain either an arbitration provision or an attorney fee provision as a matter of policy to reduce disputes by making them less economically feasible.*

An **arbitration provision** in a real estate purchase agreement, listing or lease:

- is an arbitration agreement between the arbitrator and each person who agrees to be bound by the provision [Calif. Code of Civil Procedure §1297.71]; and
- defines the arbitrator's powers and the limitations on those powers.

The rights of the person agreeing to arbitration are established by the incorporation in the provision of arbitration statutes, applicable law limitations and discovery policies. Also controlling are the rules adopted by the arbitrator named in the provision, such as the American Arbitration Association.

Unless the arbitration provision states an arbitration award is "subject to judicial review," the award resulting from arbitration brought under the clause is **binding and final**. Without judicial review of an award in an arbitration action, the parties cannot be assured the award will be either **fair or correct**.

Arbitration's hype

Arbitration proceedings are reputed to be swifter and less costly than trials. Also, arbitrating disputes rather than litigating them eases the burden on the court system, and thus the taxpayer. Further, a public airing of "dirty laundry" produced in court filings and proceedings is avoided.

However, arbitration does not much live up to its reputation for being inexpensive or expedient. Filing fees for arbitration are high compared to filing fees for litigation. Unlike judges who are paid by the taxpayer, the arbitrator's charges must be paid by the loser. Additionally, the winner's attorney fees are paid by the loser when an attorney fee provision exists in the purchase agreement, lease or listing agreement involved.

Arbitration proceedings draw out for years when the dispute becomes complicated, just as in litigation. Also, a legitimate disagreement with the arbitrator's award as inconsistent with controlling California law, when called for in the powers granted the arbitrator by the arbitration provision, frequently leads to litigation in an effort to get the result attainable had the action been filed in a court of law in the first place.

Bizarre results not correctable

Consider a seller who contacts a brokerage office to list his property for sale. The sales activity is delegated to the broker's agent who procured the listing, customarily called the *listing agent*.

The seller and listing agent sign a listing agreement containing a provision calling for disputes to be submitted to binding arbitration — no judicial oversight permitted.

A buyer is located and an offer is obtained by another agent employed by the same broker, customarily called the *selling agent*. Both the agents and the broker are aware the buyer is financially unstable and may encounter difficulties closing the transaction.

However, confirmation of the buyer's creditworthiness and net worth are not made the subject of a contingency provision by the selling agent who prepared the offer for the buyer. A contingency would have authorized the seller to cancel the purchase agreement if the buyer's credit had been found to be unsatisfactory.

When the listing agent, acting alone, submits the buyer's offer to the seller, the buyer's financial status is not discussed or disclosed, orally or in writing. The supervising broker fails to catch or correct the oversight.

The seller accepts the purchase agreement offer which provides for payment of a fee to the broker. Each agent will receive a share of any fee their broker may receive on the sale. Each agent's share is based on formulas agreed to in their respective written employment agreements with the broker.

Later, the buyer fails to close the transaction due to his disabling financial condition. The seller discovers that the listing agent, broker and selling agent all knew of the buyer's financial condition and failed to advise him of this fact. The seller makes a demand on the broker and both agents for his losses on the failed transaction, claiming the buyer's financial condition was a material fact in the transaction which the agents and broker knew about and failed to disclose.

The dispute is submitted to binding arbitration since a court action is barred by the arbitration provision in the listing agreement.

The arbitrator awards money damages to the seller based on the professional misconduct of the listing agent and employing broker for failure to disclose their knowledge of the buyer's unstable financial status — the broker being **vicariously liable** as the employer of the listing agent who failed to disclose.

Further, the arbitrator issues the seller a money award against the selling agent ruling the selling agent and the listing agent were "partners" since they would share in the fee the broker was to receive on the transaction. Thus, the selling agent is held **liable as a partner** of the listing agent for the seller's money damages resulting from the misconduct of the listing agent.

The selling agent then seeks to vacate the portion of the arbitration award holding him liable as a "partner" of the listing agent, claiming the arbitrator incorrectly applied partnership law to a real estate agency and employment relationship.

Can the award against the selling agent be corrected by a court since the arbitrator wrongfully applied partnership law?

No! An arbitrator's award, based on an erroneous application of law, is **not subject to judicial review** since a judicial review of the arbitrator's award was not included as a condition of an award in the arbitration provision. The arbitrator acted within his powers granted by the arbitration provision, even though he applied the wrong law and produced an erroneous result.

A court of law confronted with a binding arbitration agreement cannot review the arbitrator's award for **errors of fact or law** even if the error is obvious and causes substantial injustice. [**Hall** v. **Superior Court** (1993) 18 CA4th 427]

Grounds for correction

Any defect in an arbitrator's award resulting from an error of fact or law, no matter how flagrant, is neither reviewable nor correctable, unless:

- the arbitrator **exceeded his authorized powers**;
- the arbitrator **acted with fraud** or corruption;
- the arbitrator **failed to disclose** grounds for his disqualification;
- the award was **procured by corruption**, fraud or other misconduct; or
- the refusal of the arbitrators to postpone the hearing substantially **prejudiced the rights** of the party. [CCP §1286.2]

An arbitrator, unlike a judge in a court of law, is **not bound by the rules of law** when arbitrating a dispute. Even when the arbitrator agrees to follow applicable California law, his erroneous award, unlike an award of a court, cannot be corrected by any judicial review. The arbitrator's award is final and binding on all parties, unless:

- the parties have agreed the arbitrator's award is subject to "judicial review;" or
- the arbitrator applied the wrong law and in so doing exceeded his powers which had been limited to applicable law by the arbitration provision.

Otherwise, no judicial oversight exists, by petition or appeal, to correct an arbitrator's erroneous award.

The arbitrator's award

Consider a buyer and seller of real estate who enter into a purchase agreement on a form which contains an arbitration clause. They **both initial** the provision.

Prior to closing, the seller discovers the property has significantly greater value than the price the buyer has agreed to pay in the purchase agreement, a condition brought about by a sharply rising real estate market.

Motivated by his belief the property's value will continue to rise to price levels other buyers will be willing to pay, the seller refuses to close the sale.

The buyer files a "demand for arbitration" with the arbitrator, claiming the seller breached the purchase agreement. The buyer seeks only to recover his **money losses** amounting primarily to the difference between the purchase price he agreed to pay for the property and the increased value of the property on the date of the seller's breach, called *money damages*.

The buyer no longer wants the property and does not seek *specific performance* of the purchase agreement, even though the seller still owns the property.

Prior to completion of the arbitration hearings, the value of the property drops significantly due to a cyclical local economic downturn.

The arbitrator then issues an award in favor of the buyer.

However, the arbitrator does not award the buyer his money losses as asked for by the buyer. The arbitrator is aware the property's current value has fallen below the sales price agreed to in the purchase agreement as well as the increased value at the time of the seller's breach.

Instead of the requested money award, the arbitrator's award grants the buyer the **right to purchase the property** for a price equal to its current fair market value.

The buyer now petitions the court to vacate the arbitration award and remand the case for a money award as requested in the arbitration. The buyer claims the arbitrator exceeded his powers by awarding a result not contemplated by the purchase agreement nor sought by the parties, i.e., the right to acquire the property at a different price even though the buyer does not want to acquire the property.

Did the arbitrator exceed his powers, act corruptly or prejudice the rights of the parties by awarding an *equitable remedy* (specific performance) which was in conflict with the purchase agreement (different price) and beyond any expectations of either the buyer or the seller?

No! The arbitrator was not corrupt and did not exceed his powers in awarding the buyer the right to purchase the property at its current market value. The erroneous award was drawn from the arbitrator's **(mis)interpretation** of the purchase agreement and the law.

Basically, the remedy awarded a buyer by an arbitrator in binding arbitration is **not reviewable by a court of law**, as long as the remedy has "some remotely conceivable relationship" to the contract. [**Advanced Micro Devices, Inc.** v. **Intel Corporation** (1994) 9 C4th 362]

When individuals enter into a purchase agreement, each person has expectations about his and the other person's performance as defined by the terms of the agreement and set by existing law.

Yet by agreeing in the purchase agreement to binding arbitration, not only is a person **forced to accept** an arbitrator's incorrect application of law, he is forced to proceed with arbitration and accept **an award impossible to predict**.

As the dissent in *Advanced Micro Devices, Inc.* points out, a bizarre interpretation by an arbitrator of the agreement underlying a dispute, coupled with a blatant error of law, might result in an arbitration award "ordering the marriage of the disputing parties' first-born children."

An arbitrator has great latitude in making decisions since he may use his own discretion and does not need to follow the mandates of regulations, case decisions and codes.

Arbitrator's authority to enforce

Consider two partners in a real estate venture whose partnership agreement contains a boilerplate arbitration clause stating any dispute arising out of the agreement will be submitted to binding arbitration without judicial review.

On dissolution of the partnership, a dispute arises regarding disposition of the property, which is arbitrated. On issuing the award, the arbitrator includes the appointment of a receiver to supervise the sale of the partnership's property, rather than an award limited to calling for the property to be sold.

One of the partners seeks to vacate the arbitration award claiming the arbitrator exceeded his powers by appointing a receiver to sell the partnership's property.

Did the arbitrator exceed his powers by appointing a receiver to enforce his award?

Yes! The portion of the arbitration award appointing the receiver is invalid. An arbitrator lacks authority to **enforce his award** for the sale of the property, which is what the appointment of the receiver is designed to do.

The arbitration award must first be **reduced to a court-ordered judgment** before enforcement. On issuing an award, the person receiving the award files a petition with the court to **confirm** the award. On confirmation at a hearing on the petition, judgment is entered in conformance with the award.

It is the **judgment** which is enforced, not the arbitrator's award.

Although an arbitrator is not bound to follow the law when issuing an award, an arbitrator **exceeds his powers** when he attempts to also enforce his award — conduct reserved for a court of law after the award has been reduced to a judgment by the court. [**Marsch** v. **Williams** (1994) 23 CA4th 238]

An arbitrator also exceeds his powers when he **imposes fines** on a party to an arbitration for failure to comply with the arbitration award. An arbitrator does not have the power to impose **economic sanctions**, such as penalties and fines.

However, had the arbitration agreement authorized the arbitrator to appoint a receiver or impose fines, the arbitrator then has the power to do so, despite the general prohibition barring arbitrators from enforcing their awards. [**Mastrobuono** v. **Shearson Lehman Hutton, Inc.** (1995) 514 US 52]

Attorney fees as a power

Now consider a buyer and seller who enter into a real estate purchase agreement containing both an arbitration provision and an attorney fee provision. The attorney fee provision entitles the buyer or seller who prevails in an action to be awarded his attorney fees.

The buyer terminates the purchase agreement and seeks to recover all his transactional costs, claiming the seller has breached the agreement. As agreed, the dispute is submitted to binding arbitration. The arbitrator rules in favor of the seller, but denies the seller's request for attorney fees as called for under the attorney fee provision in the purchase agreement.

The seller seeks a correction of the arbitration award in a court of law claiming the arbitrator exceeded his powers by denying an award of attorney fees as agreed in the purchase agreement.

Here, the arbitrator did exceed his powers by failing to award attorney fees. The seller as the prevailing party was entitled to an award of attorney fees by a provision in the purchase agreement which was the subject of the arbitration. If the agreement underlying the dispute contains an attorney fee provision, the arbitrator must award attorney fees to the prevailing party. [**DiMarco** v. **Chaney** (1995) 31 CA4th 1809]

The attorney fee dilemma has a flip side. Not only must the arbitrator award attorney fees to the winner if the recovery of fees is called for in the purchase agreement, the arbitrator must determine the amount of the attorney fees to be awarded, an amount which is not subject to court review. [DiMarco, *supra*]

Avoiding arbitration

Consider a broker or agent who becomes a member of a local trade association. As part of the **membership agreement**, he agrees to binding arbitration for disputes arising between himself and other association members.

The arbitration panel who hears and decides disputes between members is composed of other members of the local association who have little to no legal training.

These local arbitration panels frequently base their decisions on moral or social beliefs and local customs they have personally adopted, rather than on controlling legal principles. Preference and bias towards a particular member of the association is more likely since the members of the arbitration panel are acquainted with or know about the members involved in the dispute. Yet, these panels are to consist of "neutral" arbitrators.

The panels are also very much aware the decisions they render are not appealable or reversible. Their award is final and binding.

However, the primary problem with **arbitration proceedings** heard by a local association's arbitration panel is the feeling held by most brokers and agents who are compelled to arbitrate that they are being railroaded through a process that disregards their rights, whether or not they are violated.

Further, by becoming a member of a local trade association, brokers and agents are forced to relinquish their rights to a court trial and an appeal to correct an erroneous decision rendered in disputes with other members.

However, brokers and agents employed by a broker who is an association member can avoid the complications imposed on them by membership. To do so and still comply with their broker's need to satisfy

the local trade association's annual monetary demands arising out of their association with the broker, they can pay "nonmember dues" and become "paid nonmembers." [**Marin County Board of Realtors, Inc.** v. **Palsson** (1976) 16 C3d 920]

Mediation

Instead of immediately resorting to the costly and adversarial process of litigation, in recent years the trends in real estate sales indicate disputants favor the use of *mediation*.

Many listing and purchase agreements contain binding arbitration agreements as an alternative method of litigation. [See Form 150 §10.7 accompanying Chapter 51]

However, arbitration is final and unappealable. Thus, it is a double-edged sword as disputants have no assurance the arbitrator's award will be fair or correct. Only with mediation's familiar arena of offer and counteroffer beween the feuding parties, as encouraged by the mediator, do they have the ability to come to a mutually crafted and agreed-to solution, the main psychological advantage mediation has over actions in litigation or arbitration.

Litigation is, at its heart, a deeply adversarial process which ends with a spurned "loser" who can then move on to draw out the dispute in a time-consuming and costly appeals process. **Arbitration** is a similar action, shunting the disputants into "winner" and "loser" roles. In arbitration, all the power of the decision is placed upon the arbitrator. Even if the arbitrator bases his decision on an incorrect interpretation of the facts or the law, neither party has recourse to change the erroneous decision. [Hall, supra]

The cost of **mediation** has been deemed another major benefit of the process. Consider also the time involved in mediation versus the time involved in litigation or arbitration. Litigation can be drawn out for years with various pre-trail, discovery, and appeal processes, all while the attorney's billable hours soar. Arbitration may also last years and in addition to contracted-for attorney fees, the loser is responsible for paying the arbitrator's fees.

However, mediation is typically a quick process lasting a few hours to a few months, depending on the number of disputants and the complexity of the dispute. There are no lengthy waits for court hearings or the need for witnesses since the resolution is in the hands of the disputants themselves.

In addition to these benefits, the use of mediation also provides a solution to a dispute without adding to and falling subject to the backlog of cases burdening the legal system.

Most importantly, mediation works. The Los Angeles Superior court system reports that 63% of cases ordered into mediation are resolved. Nationwide, the mediation success rate ranges between 60%-90%. [Final Report of Colorado Governor's Task Force on Civil Justice Reform, Exhibit 7]

Mediation does have its **limits**. In real estate matters, mediation is limited to resolving disputes involving buyers and sellers. Landlord-tenant disputes and trust deed defaults are largely based on very specific statutory requirements for performance which are either satisfied or unsatisfied, leaving little room for negotiation. Mediation is a tool best used by disputants in sales of property and agency disputes.

Chapter 51 The purchase agreement

This chapter covers the use and preparation by an agent of a purchase agreement entered into by buyers and sellers of real estate to document the terms and conditions of their transactions.

Types and variations

A newcomer's entry as a real estate agent into the vocation of soliciting and negotiating real estate transactions typically begins with the marketing and locating of single-family residences (SFRs) as listing and selling agents.

However, an agent often branches out and begins handling other types of property and interests.

Other properties the agent may begin handling include one-to-four unit residential properties, apartments and other nonresidential income properties like office buildings, commercial units, industrial space or unimproved parcels of land.

Interests which might be negotiated by the agent include leasehold tenancies when acting as a property manager or leasing agent of the landlord or prospective tenant, or financing arranged as a loan broker for an owner, buyer or tenant.

For sales, the **primary document** used to negotiate the transaction between a buyer and seller is a **purchase agreement form**. As different types of properties exist, so too do different types of purchase agreements exist, each with the provisions necessary to negotiate the sale of that particular type of property.

Three basic categories of purchase agreements exist for the documentation of real estate sales. The categories are influenced primarily by legislation and court decisions addressing the handling of the disclosures and due diligence investigations in the marketing of properties. The three **categories of purchase agreements** are for:

- one-to-four unit residential property sales transactions;
- other than one-to-four unit residential property sales transactions, such as for residential and nonresidential income properties and owner-occupied business/farming properties; and
- land acquisition transactions.

Within each category of purchase agreements, several variations exist. The variations cater to the specialized use of some properties, the diverse arrangements for payment of the price, and to the specific conditions which affect a property, particularly within the one-to-four unit residential property category.

For example, purchase agreement variations for **one-to-four unit residential sales** transactions include purchase agreements for:

- negotiating the conventional financing of the purchase price [See Form 150 accompanying this chapter];

- negotiating a short sale [See **first tuesday** Form 150-1];

- negotiating a cash to new or existing loan, or a seller carryback note [See **first tuesday** Form 150-2];

- negotiating for separate brokerage fees paid each broker by their client [See **first tuesday** Form 151];

- negotiating the government insured financing (FHA/VA) of the purchase price [See **first tuesday** Forms 152 and 153];

- negotiating the sale of an owner-occupied residence-in-foreclosure to an investor, called an *equity purchase agreement* [See Form 156 accompanying Chapter 52];

- negotiating an equity purchase short sale [See **first tuesday** Form 156-1];

- direct negotiations between principals (buyers and sellers) without either party being represented by a real estate agent [See **first tuesday** Form 157]; and

- negotiating highly specialized transactions using a "short-form" purchase agreement which does not contain boilerplate provisions setting forth the terms for payment of the price, which allows the agent to attach specialty addenda to set the terms for payment (a carryback ARM, equity sharing addenda, etc.). [See **first tuesday** Forms 155-1 and 155-2]

Variations among purchase agreements used in **income property** and **owner-occupied business property** sales transactions include purchase agreements for:

- the conventional financing of the purchase price [See Form 159 accompanying Chapter 53]; and

- the downpayment note financing of the purchase price. [See **first tuesday** Form 154]

Finally, a variation exists for land sales of a parcel of real estate which has no improvements in the form of buildings. [See **first tuesday** Form 158]

Escrow instructions provide yet another variation on the purchase agreement. A buyer and seller who have entered into escrow instructions without first entering into a real estate purchase agreement are bound by the escrow instructions as though it was a purchase agreement. [See Form 401 accompanying Chapter 59]

Attached to all these various purchase agreements are one or more **addenda**, regarding:

- disclosures about the property;

- the financing of the price paid for the property;

- agency relationship law; and

- special provisions called for by the needs of the buyer or seller.

PURCHASE AGREEMENT

One-to-Four Residential Units (Conventional and Carryback Financing)

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. Received from _____, as the Buyer(s),

1.1 the sum of $_____, evidenced by ☐ personal check, or ☐ _____, payable to _____, for deposit only on acceptance of this offer.

1.2 Deposit to be applied toward Buyer's obligations under this agreement to purchase property

1.3 situated in the City of _____, County of _____, California,

1.4 referred to as _____,

1.5 including personal property, ☐ see attached Personal Property Inventory. [See **ft** Form 256]

2. This agreement is comprised of this five-page form and _____ pages of addenda/attachments.

TERMS: Buyer to pay the purchase price as follows:

3. Cash payment through escrow, including deposits, in the amount of . . . . . $_____

3.1 Other consideration paid through escrow _____ . . . $_____

4. Buyer to obtain a ☐ first, or ☐ second, trust deed loan in the amount of . . . . . $_____ payable approximately $_____ monthly for a period of _____ years. Interest on closing not to exceed _____%, ☐ ARM, type _____. Loan points not to exceed _____.

4.1 ☐ Unless Buyer, within _____ days after acceptance, hands Seller satisfactory written confirmation Buyer has been pre-approved for the financing of the purchase price, Seller may terminate the agreement. [See **ft** Form 183]

5. ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by _____ with an unpaid principal balance of . . . . $_____ payable $_____ monthly, including interest not exceeding _____%, ☐ ARM, type _____, plus a monthly tax/insurance impound payment of $_____. _____

5.1 At closing, loan balance differences per beneficiary statement(s) to be adjusted into: ☐ cash, ☐ carryback note, or ☐ sales price.

5.2 The impound account to be transferred: ☐ charged, or ☐ without charge, to Buyer.

6. ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by _____ with an unpaid principal balance of . . . $_____ payable $_____ monthly, including interest not exceeding _____%, ☐ ARM, type _____, due _____, 20 _____.

7. Assume a tax bond or assessment lien with an unpaid principal balance of . . . . . $_____

8. Note for the balance of the purchase price in the amount of. . . . . $_____ to be executed by Buyer in favor of Seller and secured by a trust deed on the property junior to any above referenced financing, payable $_____ monthly, or more, beginning one month after closing, including interest at _____% per annum from closing, due _____ years after closing.

8.1 This note and trust deed to contain provisions to be provided by Seller for: ☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐ _____.

8.2 A Carryback Disclosure Statement is attached as an addendum. [See **ft** Form 300]

8.3 Buyer to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **ft** Form 412]

8.4 Buyer to hand Seller a completed credit application on acceptance. [See **ft** Form 302]

8.5 Within _____ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness.

8.6 Seller may terminate the agreement on failure of the agreed terms for priority financing. [See **ft** Form 183]

8.7 As additional security, Buyer to execute a security agreement and file a UCC-1 financing statement on any property transferred by Bill of Sale. [See **ft** Form 436]

9. Total Purchase Price is . . . . . $_____

10. ACCEPTANCE AND PERFORMANCE:

10.1 This offer to be deemed revoked unless accepted in writing ☐ on presentation, or ☐ within _____ days after date, and acceptance is personally delivered or faxed to Offeror or Offeror's Broker within this period.

10.2 After acceptance, Broker(s) are authorized to extend any performance date up to one month.

10.3 On failure of Buyer to obtain or assume financing as agreed by the date scheduled for closing, Buyer may terminate the agreement.

10.4 Buyer's close of escrow is conditioned on Buyer's prior or concurrent closing on a sale of other property, commonly referred to as _____.

10.5 Any termination of the agreement shall be by written Notice of Cancellation timely delivered to the other party, the other party's Broker or escrow, with instructions to escrow to return all instruments and funds to the parties depositing them. [See **ft** Form 183]

10.6 Both parties reserve their rights to assign and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow on either party's written notice. [See **ft** Forms 171 or 172]

10.7 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

10.8 Should Buyer breach the agreement, Buyer's monetary liability to Seller is limited to ☐ $_____, or ☐ the deposit receipted in Section 1.

11. PROPERTY CONDITIONS:

11.1 Seller to furnish prior to closing:

a. ☐ a structural pest control inspection report and certification of clearance of corrective conditions.

b. ☐ a home inspection report prepared by an insured home inspector showing the land and improvements to be free of material defects.

c. ☐ a one-year home warranty policy:
Insurer _____
Coverage _____

d. ☐ a certificate of occupancy, or other clearance or retrofitting, required by local ordinance for the transfer of possession or title.

e. ☐ a certification by a licensed contractor stating the sewage disposal system is functioning properly, and if it contains a septic tank, is not in need of pumping.

f. ☐ a certification by a licensed water testing lab stating the well supplying the property meets potable water standards.

g. ☐ a certification by a licensed well-drilling contractor stating the well supplying the property produces a minimum of _____ gallon(s) per minute.

h. ☐ _____

i. ☐ _____

11.2 Seller's Condition of Property Disclosure – Transfer Disclosure Statement (TDS) [See **ft** Form 304]

a. ☐ is attached; or

b. ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may either cancel the transaction based on a reasonable disapproval of the disclosure or deliver to Seller or Seller's Broker a written notice itemizing any material defects in the property disclosed by the statement and unknown to Buyer prior to acceptance. [See **ft** Form 269] Seller to repair, replace or correct noticed defects prior to closing.

c. On Seller's failure to repair, replace or correct noticed defects under §11.2b or §11.4a, Buyer may tender the purchase price reduced by the cost to repair, replace or correct the noticed defects, or close escrow and pursue available remedies. [See **ft** Form 183]

11.3 Seller's Transfer Fee Disclosure Statement [See **ft** Form 304-2]

a. ☐ is attached; or

b. ☐ is to be handed to Buyer on acceptance for Buyer's review. Withing ten days after receipt, Buyer may terminate this agreement based on a reasonable disapproval of the Transfer Fee Disclosure.

c. Seller to pay any transfer fees arising out of the transaction.

11.4 Buyer to inspect the property twice:

a. An **initial property inspection** is required on acceptance to confirm the property's condition is substantially the same as observed by Buyer and represented by Seller or Seller's Agents prior to acceptance, and if not substantially the same, Buyer to promptly notify Seller in writing of undisclosed material defects discovered. [See **ft** Form 269] Seller to repair, replace or correct noticed defects prior to closing; and

b. A **final walk-through inspection** is required within five days before closing to confirm the correction of any noticed defects under §11.2b and §11.4a and maintenance under §11.14. [See **ft** Form 270]

11.5 Seller's Natural Hazard Disclosure Statement (NHD) [See **ft** Form 314] ☐ is attached, or ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days of Buyer's post-acceptance receipt of the NHD, Buyer may terminate the agreement based on a reasonable disapproval of hazards disclosed by the statement and unknown to Buyer prior to acceptance. [See **ft** Form 182 and 183]

11.6 Buyer acknowledges receipt of a booklet and related Seller disclosures containing ☐ *Environmental Hazards: A Guide for Homeowners, Buyers, Landlords and Tenants* (on all one-to-four units), ☐ *Protect Your Family from Lead in Your Home* (on all pre-1978 one-to-four units) [See **ft** Form 313], and ☐ *The Homeowner's Guide to Earthquake Safety* (on all pre-1960 one-to-four units). [See **ft** Form 315]

11.7 The property is located in: ☐ an industrial use area, ☐ a military ordnance area, ☐ a rent control area, or ☐ airport, farmland, or San Francisco Bay area, see attached Notice Addendum. [See **ft** Form 308]
☐ _____

11.8 On acceptance, Seller to hand Buyer the following property operating information:

a. ☐ Property Operating Cost Sheet for Buyer's review within ten days of receipt; Buyer may terminate the agreement during the review period based on a reasonable disapproval of the information received. [See **ft** Form 306]

b. ☐ See attached Leasing and Operating Addendum for additional conditions. [See **ft** Form 275]

11.9 If a **Homeowners' Association** (HOA) is involved, ☐ Buyer has received and approves, or ☐ Buyer on acceptance to be handed, copies of the association's Articles, Bylaws, CC&Rs, collection and lien enforcement policy, operating rules, operating budget, CPA's financial review, insurance policy summary and any age restriction statement.

a. No association claims for property defects or changes in regular or special assessments are pending or anticipated. Current monthly assessment is $_____.

b. Seller is not in violation of CC&Rs, except _____.

c. Seller to pay association document and transfer fees.

d. Buyer to approve the association's statement of condition of assessments and confirm representations in subsection 11.9a above as a condition for closing escrow.

e. Within ten days of Buyer's post-acceptance receipt of the association documents, Buyer may terminate the agreement based on a reasonable disapproval of the documents. [See **ft** Form 183]

11.10 Seller's Criminal Activity and Security Disclosure Statement [See **ft** Form 321]

a. ☐ is attached, or

b. ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may terminate this agreement based on a reasonable disapproval of the Criminal Activity and Security Disclosure Statement.

11.11 Smoke detector(s) and water heater bracing exist in compliance with the law, and if not, Seller to install.

11.12 If this property or an adjoining property contains a solar collector authorized by the Solar Shade Control Act (California Public Resources Code §25980 et seq.) and notice of its existence has been sent or received by Seller, then on acceptance, Seller to hand Buyer copies of the notices sent or received by Seller or provided to Seller by prior Owners of the property for Buyer's review. Buyer may, within ten days after receipt, terminate this agreement based on a reasonable disapproval of the conditions disclosed by the solar shade control notices.

11.13 Possession of the property and keys/access codes to be delivered: ☐ on close of escrow, or ☐ as stated in the attached Occupancy Agreement. [See **ft** Forms 271 and 272]

11.14 Seller to maintain the property in good condition until possession is delivered.

11.15 Fixtures and fittings attached to the property include, but are not limited to: window shades, blinds, light fixtures, plumbing fixtures, curtain rods, wall-to-wall carpeting, draperies, hardware, antennas, air coolers and conditioners, trees, shrubs, mailboxes and other similar items.

11.16 Notice: Pursuant to Section 290.46 of the Penal Code, information about specified registered sex offenders is made available to the public via an Internet Web site maintained by the Department of Justice at www.meganslaw.ca.gov. Depending on an offender's criminal history, this information will include either the address at which the offender resides or the community of residence and ZIP code in which he or she resides.

12. CLOSING CONDITIONS:

12.1 This transaction to be escrowed with _____.
Parties to deliver instructions to escrow as soon as reasonably possible after acceptance.

a. ☐ Escrow holder is authorized and instructed to act on the provisions of this agreement as the mutual escrow instructions of the parties and to draft any additional instructions necessary to close this transaction. [See **ft** Form 401]

b. ☐ Escrow instructions, prepared and signed by the parties, are attached to be handed to escrow on acceptance. [See **ft** Form 401]

12.2 Escrow to be handed all instruments needed to close escrow on or before _____, 20_____, or within _____ days after acceptance. Parties to hand Escrow all documents required by the title insurer, lenders or other third parties to this transaction prior to seven days before the date scheduled for closing.

a. Each party to pay its customary escrow charges. [See **ft** Forms 310 and 311]

12.3 Buyer's title to be subject to covenants, conditions, restrictions, reservations and easements of record. _____.

12.4 Title to be vested in Buyer or Assignee free of encumbrances other than those set forth herein. Buyer's interest in title to be insured under a policy issued by _____ title company on a(n) ☐ Homeowner(s) policy (one-to-four units), ☐ Residential ALTA-R policy (vacant or improved residential parcel), ☐ Owner's policy (other than one-to-four units), ☐ CLTA Joint Protection policy (also naming Carryback Seller or purchase-assist lender), or ☐ Binder (to insure resale or refinance within two years).

a. Endorsements _____

b. ☐ Seller, or ☐ Buyer, to pay the title insurance premium.

12.5 Buyer to furnish a new fire insurance policy covering the property.

12.6 Taxes, assessments, insurance premiums, rents, interest and other expenses to be pro rated to close of escrow, unless otherwise provided.

12.7 Bill of Sale to be executed for any personal property being transferred.

12.8 If Seller is unable to convey marketable title as agreed, or if the improvements on the property are materially damaged prior to closing, Buyer may terminate the agreement. Seller to pay all reasonable escrow cancellation charges. [See **ft** Form 183]

13. NOTICE OF YOUR SUPPLEMENTAL PROPERTY TAX BILL:

California property tax law requires the Assessor to revalue real property at the time the ownership of the property changes. Because of this law, you may receive one or two supplemental tax bills, depending on when your loan closes.

The supplemental tax bills are not mailed to your lender. If you have arranged for your property tax payments to be paid through an impound account, the supplemental tax bills will not be paid by your lender. It is your responsibility to pay these supplemental bills directly to the Tax Collector.

If you have any questions concerning this matter, please call your local Tax Collector's Office.

14. BROKERAGE FEE:

14.1 Parties to pay the below mentioned Broker(s) a fee now due of _____ as follows:

a. Seller to pay the brokerage fee on the change of ownership.

b. The party wrongfully preventing this change of ownership to pay the brokerage fee.

14.2 Buyer's Broker and Seller's Broker, respectively, to share the brokerage fee _____:_____.

14.3 Attached is the Agency Law Disclosure. [See **ft** Form 305]

14.4 Broker is authorized to report the sale, its price and terms for dissemination and use of participants in brokerage trade associations or listing services.

15. _____

Buyer's/
Selling Broker: _____
Broker's DRE Identification #: _____
Selling Agent: _____
Agent's DRE Identification #: _____
Signature: _____
Is the agent of: ☐ Buyer exclusively.
☐ Both Seller and Buyer.
Address: _____
_____
Phone: _____
Fax: _____
Email: _____

Seller's/
Listing Broker: _____
Broker's DRE Identification #: _____
Listing Agent: _____
Agent's DRE Identification #: _____
Signature: _____
Is the agent of: ☐ Seller exclusively.
☐ Both Seller and Buyer.
Address: _____
_____
Phone: _____
Fax: _____
Email: _____

I agree to the terms stated above.

☐ See Signature Page Addendum. [**ft** Form 251]

Date: _____, 20_____
Buyer: _____
Signature: _____
Buyer: _____
Signature: _____

I agree to the terms stated above.

☐ See Signature Page Addendum. [**ft** Form 251]

Date: _____, 20_____
Seller: _____
Signature: _____
Seller: _____
Signature: _____

REJECTION OF OFFER

Undersigned hereby rejects this offer in its entirety. No counteroffer will be forthcoming.

Date: _____, 20_____
Name: _____
Signature: _____
Name: _____
Signature: _____

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However, the focus here is limited to the needs of the newly licensed agent who will be negotiating single-family real estate sales. Thus, this chapter discusses the purchase agreement used in SFR sales transactions structured for the conventional financing of the purchase price.

Analyzing the purchase agreement

The conventional purchase agreement, **first tuesday** Form 150, is used to prepare and submit the buyer's **written offer** to purchase one-to-four unit residential property. Terms for payment of the price are limited to conventional financing, an assumption of existing loans and a carryback note. Form 150 is also properly used by sellers in a counteroffer situation to submit their **fresh offer** to sell the real estate.

The purchase agreement offer, if accepted, becomes the binding written contract between the buyer and seller. Its terms must be complete and clear to prevent misunderstandings so the agreement can be judicially enforced. Thus, Form 150 is a comprehensive "boilerplate" purchase agreement which serves as a **checklist**, presenting the various conventional financing arrangements and conditions a prudent buyer would consider when making an offer to purchase.

Each section in Form 150 has a separate purpose and need for enforcement. The sections include:

1. *Identification:* The date of preparation for referencing the agreement, the name of the buyer, the amount of the good-faith deposit, the description of the real estate, an inventory of any personal property included in the transfer and the number of pages contained in the agreement and its addenda are set forth in sections 1 and 2 to establish the facts on which the agreement is negotiated.

2. *Price and terms*: All the typical variations for payment of the price by conventional purchase-assist financing or an assumption of existing financing are set forth in sections 3 through 9 as a checklist of provisions. On making an offer (or counteroffer), the terms for payment and financing of the price are selected by checking boxes and filling blanks in the desired provisions.

3. *Acceptance and performance:* Aspects of the formation of a contract, excuses for nonperformance and termination of the agreement are provided for in section 10, such as the time period for acceptance of the offer, the broker's authorization to extend performance deadlines, the financing of the price as a closing contingency, procedures for cancellation of the agreement, a sale of other property as a closing contingency, cooperation to effect a §1031 transaction and limitations on monetary liability for breach of contract.

4. *Property Conditions:* The buyer's confirmation of the physical condition of the property as disclosed prior to acceptance is **confirmed** as set forth in section 11 by the seller's delivery of reports, warranty policies, certifications, disclosure statements, an environmental, lead-based paint and earthquake safety booklet, any operating cost and income statements, and any homeowners' association (HOA) documents not handed to the buyer prior to entry into the purchase agreement, as well as by the buyer's initial inspection, personally or by a home inspector, and final inspection at closing to confirm the seller has eliminated defects known, but not disclosed, prior to acceptance.

5. *Closing conditions:* The escrow holder, escrow instruction arrangements and the date of closing are established in section 12, as are title conditions, title insurance, hazard insurance, prorates and loan adjustments.

6. *Notice of supplemental property tax:* Notifies the buyer he will receive one or two supplemental property tax bills he is to pay when the county assessor revalues the property after a change in ownership, as set forth in section 13.

7. *Brokerage and agency:* The release of sales data on the transaction to trade associations is authorized, the brokerage fee is set and the delivery of the agency law disclosure to both buyer and seller is provided for as set forth in section 14, as well as the confirmation of the agency undertaken by the brokers and their agents on behalf of one or both parties to the agreement.

8. *Signatures:* The seller and buyer bind each other to perform as agreed in the purchase agreement by signing and dating their signatures to establish the date of offer and acceptance.

Preparing the purchase agreement

The following instructions are for the preparation and use of the Purchase Agreement – One-to-Four Residential Units, **first tuesday** Form 150. Form 150 is designed as a checklist of practical provisions so a broker or his agent can prepare an offer for a prospective buyer who seeks to purchase conventionally financed, one-to-four unit residential property located in California.

Each instruction corresponds to the provision in the form bearing the same number.

*Editor's note — **Check** and **enter** items throughout the agreement in each provision with boxes and blanks, unless the provision is not intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Document identification:

Enter the date and name of the city where the offer is prepared. This date is used when referring to this purchase agreement.

Facts:

1. *Buyer, deposit, and property*: **Enter** the name of each buyer who will sign the offer.

   1.1 **Enter** the dollar amount of any good-faith, earnest money deposit. Check the appropriate box to indicate the form of the good-faith deposit. Enter the name of the payee (escrow, title company or broker).

1.2-1.3 **Enter** the name of the city and county in which the property is located.

   1.4 **En**ter the legal description or common address of the property, or the assessor's parcel number (APN).

   1.5 **Check** the box to indicate personal property will be included in the sale. The seller's trade fixtures to be purchased by the buyer must be listed as inventory if they are to be acquired by the buyer. [See **first tuesday** Form 256]

2. *Entire agreement*: **Enter** the number of pages comprising all of the addenda, disclosures, etc., which are attached to the purchase agreement.

Terms for payment of the purchase price:

3. *Cash down payment*: **Enter** the dollar amount of the buyer's cash down payment toward the purchase price.

   3.1 *Additional down payment*: **Enter** the description of any other consideration to be paid as part of the price, such as trust deed notes, personal property or real estate equities (an exchange). **Enter** the dollar amount of its value.

4. *New trust deed loan*: **Check** the appropriate box to indicate whether any new financing will be a first or second trust deed loan. **Enter** the amount of the loan, the monthly principal and interest (PI) payment, the term of the loan, and the rate of interest. **Check** the box to indicate whether the interest will be adjustable (ARM), and if so, **enter** the index name. **Enter** any limitations on loan points.

4.1 *Buyer's loan qualification*: **Check** the box to indicate the seller is authorized to cancel the agreement if the buyer is to obtain a new loan and fails to deliver documentation from a lender indicating he has been qualified for a loan. **Enter** the number of days the buyer has after acceptance to deliver written confirmation of his qualification for the loan.

5. *First trust deed note*: **Check** the appropriate box to indicate whether the transfer of title is to be "subject to" an existing loan or by an "assumption" of the loan if the buyer is to take over an existing first trust deed loan. **Enter** the lender's name. **Enter** the remaining balance, the monthly PI payment and the interest rate on the loan. **Check** the box to indicate whether the interest is adjustable (ARM), and if so, **enter** the index name. **Enter** any monthly impound payment made in addition to the PI payment.

   5.1 *Loan balance adjustments*: **Check** the appropriate box to indicate the financial adjustment desired for loan balance differences at the close of escrow.

   5.2 *Impound balances*: **Check** the appropriate box to indicate whether the impound account transferred to the buyer will be with or without a charge to the buyer.

6. *Second trust deed note*: **Check** the appropriate box to indicate whether the transfer of title is to be "subject to" an existing loan or by an "assumption" of the loan if the buyer is to take over an existing second trust deed loan. **Enter** the lender's name. **Enter** the remaining balance, the monthly PI payment and the interest rate on the loan. **Check** the box to indicate whether the interest is adjustable (ARM), and if so, **enter** the index name. **Enter** the due date for payment of a final/balloon payment.

7. *Bond or assessment assumed*: **Enter** the amount of the principal balance remaining unpaid on bonds and special assessment liens (such as Mello-Roos or 1915 improvement bonds) which will remain unpaid and become the responsibility of the buyer on closing.

Editor's note — Improvement bonds are obligations of the seller which may be assumed by the buyer in lieu of their payoff by the seller. If assumed, the bonded indebtedness becomes part of the consideration paid for the property. Some purchase agreements erroneously place these bonds under "property tax" as though they were ***ad valorem taxes****, and then fail to prorate and charge the unpaid amount to the seller.*

8. *Seller carryback note*: **Enter** the amount of the carryback note to be executed by the buyer as partial payment of the price. **Enter** the amount of the note's monthly PI payment, the interest rate and the due date for the final/balloon payment.

   8.1 *Special carryback provisions:* **Check** the appropriate box to indicate any special provisions to be included in the carryback note or trust deed. **Enter** the name of any other special provision to be included in the carryback note or trust deed, such as impounds, discount options, extension provisions, guarantee arrangements or right of first refusal on the sale or hypothecation of the note.

   8.2 *Carryback disclosure:* **Fill out** and **attach** a Seller Carryback Disclosure Statement as an addendum. [See Form 300 accompanying Chapter 36]

Editor's note — Further approval of the disclosure statement in escrow creates by statute a buyer's contingency allowing for cancellation until time of closing on any purchase of one-to-four unit residential property.

8.3 *Notice of Delinquency:* **Requires** the buyer to execute a Request for Notice of Deafult and Notice of Delinquency and pay the costs of recording and serving it on senior lenders since they will have priority on title to the trust deed securing the carryback note. [See **first tuesday** Form 412]

8.4 *Buyer creditworthiness*: **Requires** the buyer to provide the seller with a completed credit application. [See **first tuesday** Form 302]

8.5 *Approval of creditworthiness*: **Enter** the number of days within which the seller may cancel the transaction for reasonable disapproval of the buyer's credit application and report.

8.6 *Subordination*: **Provides** for the seller to terminate this transaction if the parameters agreed to for financing by an assumption or origination of a trust deed loan with priority on title to the carryback note are exceeded. [See Form 183 accompanying Chapter 44]

8.7 *Personal property as security*: **Requires** the buyer on the transfer of any personal property in this transaction to execute a security agreement and UCC-1 financing statement to provide additional security for any carryback note. [See **first tuesday** Form 436]

9. *Purchase price:* **Enter** the total amount of the purchase price as the sum of lines 3, 3.1, 4, 5, 6, 7 and 8.

10. **Acceptance and performance periods:**

10.1 *Delivery of acceptance:* **Check** the appropriate box to indicate the time period for acceptance of the offer. If applicable, **enter** the number of days in which the seller may accept this offer and form a binding contract.

Editor's note — Acceptance occurs on the return delivery to the person making the offer (or counteroffer) or to his broker of a copy of the unaltered purchase agreement offer containing the signed acceptance.

10.2 *Extension of performance dates*: **Authorizes** the brokers to extend the performance dates up to one month to meet the objectives of the agreement — time being of a reasonable duration and not the essence of this agreement as a matter of policy. This extension authority does not extend to the acceptance period.

10.3 *Loan contingency*: **Authorizes** the buyer to cancel the transaction at the time scheduled for closing if the financing for payment of the price is not obtainable or assumable.

10.4 *Sale of other property:* If the closing of this transaction is to be contingent on the buyer's receipt of net proceeds from a sale of other property, **enter** the address of the property to be sold by the buyer.

10.5 *Cancellation procedures:* **Provides** the method of cancellation required to terminate the agreement when the right to cancel is triggered by other provisions in the agreement, such as contingency or performance provisions. [See Form 183]

10.6 *Exchange cooperation:* **Requires** the parties to cooperate in an IRS §1031 transaction on further written notice by either party. **Provides** for the parties to assign their interests in this agreement. [See **first tuesday** Forms 171 and 172]

10.7 *Mediation provision*: **Provides** for the parties to enter into non-binding mediations to resolve a dispute remaining unsolved after 30 days of informal settlement negotiations.

10.8 *Liability limitations:* **Provides** for a dollar limit on the buyer's liability for the buyer's breach of the agreement. **Check** the first box and **enter** the maximum dollar amount of money losses the seller may recover from the buyer or **check** the second box to indicate the buyer's monetary liability is limited to the good-faith deposit tendered with the offer to buy.

Editor's note — Liability limitation provisions avoid the misleading and unenforceable forfeiture called for under liquidated damage clauses included in most purchase agreement forms provided by other publishers of forms.

11. **Property Conditions:**

11.1 *Seller to furnish*: **Check** the appropriate box(es) within the following subsections to indicate the items the seller is to furnish prior to closing.

a. *Pest control*: **Check** the box to indicate the seller is to furnish a structural pest control report and clearance.

b. *Home inspection report*: **Check** the box to indicate the seller is to employ a home inspection company and furnish the buyer with the company's home inspection report.

c. *Home warranty*: **Check** the box to indicate the seller is to furnish an insurance policy for home repairs. **Enter** the name of the insurer and the type of coverage, such as for the air conditioning unit, etc.

d. *Local ordinance compliance*: **Check** the box to indicate the seller is to furnish a certificate of occupancy or other clearance required by local ordinance.

e. *Sewer or septic certificate*: **Check** the box to indicate the seller is to furnish a certificate of the condition of the sewage disposal system stating it is functioning properly.

f. *Potable well water*: **Check** the box to indicate the seller is to furnish a certificate stating the well supply meets water standards.

g. *Well water capacities*: **Check** the box to indicate the seller is to furnish a certificate stating the amount of water the well supplies. **Enter** the number of gallons per minute the well is expected to produce.

h. *Other terms*: **Check** the box and **enter** any other report, certification or clearance the seller is to furnish.

i. *Other terms*: **Check** the box and **enter** any other report, certification or clearance the seller is to furnish.

11.2 *Property condition(s)*: **Check** the appropriate box within the following subsections to indicate the status of the seller's Condition of Property Disclosure – Transfer Disclosure Statement (TDS).

a. *Attached TDS*: **Check** the box to indicate the seller's TDS has been prepared and handed to the buyer, and if so, **attach** it to this agreement. Thus, the property's condition is accepted by the buyer upon entering into the purchase agreement offer.

Editor's note — Use of the TDS form is mandated on one-to-four unit residential property. [See Form 304 accompanying Chapter 24]

b. *Later delivered TDS*: **Check** the box to indicate the TDS is to be **delivered later** to the buyer to confirm the condition of the property is as disclosed prior to entry into the purchase agreement. On receipt of the TDS, the buyer may either cancel the transaction for failure of the seller or the listing agent to disclose known property defects prior to acceptance of the purchase agreement (or counteroffer), or give notice to the seller of the defects known and not disclosed prior to acceptance and make a demand on the seller to correct them prior to closing.

c. *Repair of defects*: **Authorizes** the buyer to either cancel the transaction or adjust the price should the seller fail to correct the defects noticed under sections 11.2b or 11.4a. [See Form 183]

11.3 *Transfer Fee Disclosure Statemen*t: **Check** the appropriate box within the following subsections to indicate the status of the seller's Transfer Fee Disclosure Statement (TFDS). [See **first tuesday** Form 304-2]

a. *Attached TFDS*: **Check** the box to indicate the seller's Transfer Fee Disclosure Statement has been prepared and handed to the buyer, and if so, **attach** it to this agreement.

b. *Later delivered TFDS:* **Check** the box to indicate the TFDS is to be **delivered later** to the buyer to confirm the existence of a transfer fee as disclosed prior to entry into the purchase agreement. On receipt of the TFDS, the buyer may terminate this agreement based on a reasonable disapproval of the TFDS.

c. *Transfer fee:* **Requires** the seller to pay any transfer fees arising out of this transaction.

11.4 *Buyer's inspection*: **Authorizes** the buyer to inspect the property twice during the escrow period to verify its condition is as disclosed by the seller prior to the time of acceptance.

a. *Initial property inspection*: **Requires** the buyer to inspect the property immediately after acceptance to put the seller on notice of material defects to be corrected by the seller prior to closing. [See Form 269 accompanying Chapter 27]

b. *Final walk-through inspection*: **Requires** the buyer to inspect the property again within five days before closing to confirm repairs and maintenance of the property have occurred. [See **first tuesday** Form 270]

11.5 *Seller's Natural Hazard Disclosure Statement (NHD)*: **Check** the appropriate box to indicate whether the NHD statement disclosing the seller's knowledge about the hazards listed on the form has been prepared and handed to the buyer. If it has been received by the buyer, **attach** a copy to the purchase agreement. If the NHD will be handed to the buyer after acceptance, the buyer has ten days after the buyer's receipt of the NHD statement in which to approve it or cancel.

Editor's note — Disclosure by the seller is mandated on one-to-four unit residential property. [Calif. Civil Code §1103]

11.6 *Hazard disclosure booklets*: **Check** the appropriate box(es) to indicate which hazard booklets have been received by the buyer, together with the seller's prepared and signed disclosures accompanying each booklet.

11.7 *Other property disclosures*: **Check** the appropriate box(es) to indicate other disclosures made by the seller regarding the location of the property. **Enter** a reference to any local (option) ordinance disclosure statement attached as an addendum to the purchase agreement and **attach** it. [See **first tuesday** Forms 307 and 308]

11.8 *Operating costs and rents*: **Check** the appropriate box(es) to indicate the information the seller is to disclose regarding the operating expenses of ownership and tenancies affecting title.

a. *Operating cost sheet*: **Check** the box to indicate the seller will prepare and hand the buyer an Operating Cost Sheet on acceptance of this offer. The buyer may cancel the purchase agreement and escrow if the operating expenses disclosed are unacceptable. [See **first tuesday** Form 306]

b. *Leasing and Operating Addendum:* **Check** the box to indicate the Leasing and Operating Addendum is attached to confirm the buyer is taking title subject to the tenancies disclosed. [See **first tuesday** Form 275]

11.9 *Homeowners' association (HOA)*: **Check** the appropriate box to indicate whether the HOA documents have been or are to be delivered to the buyer.

a. *Monthly payments*: **Enter** the dollar amount of the monthly payments assessed by the HOA.

b. *CC&Rs*: **Enter** the nature of any violation of the CC&Rs by the seller.

c. *HOA charges*: **Provides** for the seller to pay all HOA charges on the transaction.

d. *Condition of assessments*: **Provides** for the buyer to approve the HOA's condition of assessments statement prior to closing.

e. *Disapproval of HOA documents*: **Authorizes** the buyer to terminate this purchase agreement within ten days after his receipt of HOA documents when the disclosures are made after entering into the purchase agreement. Disclosure of HOA conditions in escrow trigger a statutory contingency allowing the buyer to cancel the purchase agreement.

11.10 *Criminal Activity and Security Disclosure*: **Check** the appropriate box within the following subsections to indicate the status of the seller's Criminal Activity and Security Disclosure Statement. [See **first tuesday** Form 321]

a. *Attached disclosure*: **Check** the box to indicate the seller's Criminal Activity and Security Disclosure Statement has been prepared and handed to the buyer, and if so, **attach** it to this agreement.

b. *Later delivered disclosure:* **Check** the box to indicate the Criminal Activity and Security Disclosure Statement is to be **delivered later** to the buyer. On receipt of the disclosure, the buyer may terminate this agreement based on a reasonable disapproval.

11.11 *Safety compliance:* **Requires** smoke detectors and water heater bracing to exist or be installed by the seller.

11.12 *Solar Collector Notice:* **States** *the seller will hand a copy of the notice received from any neighbor to the buyer. If the seller sent neighbors a notice, a list of everyone who was sent a notice is to be handed to the buyer. The buyer is authorized to terminate this purchase agreement for cause within ten days after receipt.*

11.13 *Buyer's possession:* **Check** the appropriate box to indicate when possession of the property will be delivered to the buyer, whether at closing or under an **attached** buyer's interim occupancy or seller's holdover agreement. [See **first tuesday** Forms 271 and 272]

11.14 *Property maintenance:* **Requires** the seller to maintain the present condition of the property until the close of escrow.

Editor's note — See section 11.4b for the buyer's final inspection to confirm maintenance at closing.

11.15 *Fixtures and fittings:* **Confirms** this agreement includes real estate fixtures and fittings as part of the property purchased.

*Editor's note — Trade fixtures are personal property to be listed as items on the Personal Property Inventory at section 3. [See **first tuesday** Form 256]*

11.16 *Sex offender disclosure:* **Complies** with requirements that the seller disclose the existence of a sex offender database on the sale (or lease) of one-to-four residential units.

Editor's note — By the existence of the disclosure in the form, the seller and brokers are relieved of any duty to make further disclosures regarding registered sex offenders.

12. **Closing conditions:**

12.1 *Escrow closing agent:* **Enter** the name of the escrow company handling the closing.

a. *Escrow instructions*: **Check** the box to indicate the purchase agreement is to also serve as the mutual instructions to escrow from the parties. The escrow company will typically prepare supplemental instructions they will need to handle and close the transaction. [See **first tuesday** Form 401]

b. *Escrow instructions*: **Check** the box to indicate escrow instructions have been prepared and are attached to this purchase agreement. **Prepare** and **attach** the prepared escrow instructions to the purchase agreement and **obtain** the signatures of the parties. [See **first tuesday** Form 401]

12.2 *Closing date:* **Enter** the specific date for closing or the number of days anticipated as necessary for the parties to perform and close escrow. Also, prior to seven days before closing, the parties are to deliver all documents needed by third parties to perform their services by the date scheduled for closing.

a. *Escrow charges*: **Requires** each party to pay their customary escrow closing charges, amounts any competent escrow officer can provide on inquiry.

12.3 *Title conditions:* **Enter** wording for any further-approval contingency provision the buyer may need to confirm that title conditions set forth in the preliminary title report will not interfere with the buyer's intended use of the property, such as "closing contingent on buyer's approval of preliminary title report."

12.4 *Title insurance:* **Provides** for title to be vested in the name of the buyer or his assignee. **Enter** the name of the title insurance company which is to provide a preliminary title report in anticipation of issuing title insurance. **Check** the appropriate box to indicate the type of title insurance policy to be issued on closing.

a. *Policy endorsements*: **Enter** any endorsements to be issued with the policy.

b. *Payment of premium*: **Check** the appropriate box to indicate whether the buyer or seller is to pay the title insurance premium.

12.5 *Fire insurance:* **Requires** the buyer to provide a new policy of hazard insurance.

12.6 *Prorates and adjustments*: **Authorizes** pro rations and adjustments on the close of escrow for taxes, insurance premiums, rents, interest, loan balances, service contracts and other property operating expenses, prepaid or accrued.

12.7 *Personal property:* **Requires** the seller to execute a bill of sale for any personal property being transferred in this transaction as called for in section 1.

12.8 *Property destruction:* **Provides** for the seller to bear the *risk of loss* for any casualty losses suffered by the property prior to the close of escrow. Thus, the buyer may terminate the agreement if the seller is unable to provide a marketable title or should the property improvements suffer major damage. [See Form 183]

13. *Supplemental property tax bill:* **Notifies** the buyer he will receive one or two supplemental property tax bills he is to pay when the county assessor revalues the property after a change in ownership.

14. **Brokerage fee:**

14.1 *Fee amount:* **Enter** the total amount of the fee due all brokers to be paid by the seller. The amount of the fee may be stated as a fixed dollar amount or as a percentage of the price.

a. *Seller paid:* **Provides** that the seller will pay the brokerage fee on the change of ownership.

b. *Wrongful prevention:* **Provides** that the party wrongfully preventing the change of ownership will pay the brokerage fee.

Editor's note — The defaulting party pays all brokerage fees and the brokerage fee can only be altered or cancelled by mutual instructions from the buyer and seller.

14.2 *Fee sharing:* **Enter** the percentage share of the fee each broker is to receive.

Editor's note — The percentage share may be set based on an oral agreement between the brokers, by acceptance of the listing broker's MLS offer to a selling office to share a fee, or unilaterally by an agent when preparing the buyer's offer.

14.3 *Agency law disclosures:* **Attach** a copy of the Agency Law Disclosure addendum for all parties to sign. [See Form 305 accompanying Chapter 7]

Editor's note — The disclosure is mandated to be acknowledged by the buyer with the offer and acknowledged by the seller on acceptance as a prerequisite to the brokers enforcing collection of the fee when the property involved contains one-to-four residential units. [See Form 305]

14.4 *Disclosure of sales data:* **Authorizes** the brokers to report the transaction to trade associations or listing services.

15. *Other terms:* **Enter** any special provision to be included in the purchase agreement.

Agency confirmation:

Buyer's broker identification: **Enter** the name of the buyer's broker and his DRE license number. **Enter** the name of any selling agent and his DRE license number. **Obtain** the signature of the buyer's broker or the selling agent acting on behalf of the buyer's broker. **Check** the appropriate box to indicate the agency which was created by the broker's (and his agents') conduct with the parties. **Enter** the buyer's broker's address, telephone and fax numbers, and email address.

Seller's broker identification: **Enter** the name of the seller's broker and his DRE license number. **Enter** the name of any listing agent and his DRE license. **Obtain** the signature of the seller's broker or the listing agent acting on behalf of the seller's broker. **Check** the appropriate box to indicate the agency which was created by the broker's (and his agents') conduct with the parties. **Enter** the seller's broker's address, telephone and fax numbers, and email address.

Signatures:

Buyer's signature: If *additional* buyers are involved, **check** the box, prepare a Signature Page Addendum form referencing this purchase agreement, and **enter** their names and **obtain** their signatures until all buyers are individually named and have signed. **Enter** the date the buyer signs the purchase agreement and the buyer's name. **Obtain** the buyer's signature.

Seller's signature: If *additional* sellers are involved, **check** the box, prepare a Signature Page Addendum form referencing this purchase agreement, and **enter** their names and **obtain** their signatures until all sellers are individually named and have signed. **Enter** the date the seller signs the purchase agreement and the seller's name. **Obtain** the seller's signature.

Rejection of offer:

Should the offer contained in the purchase agreement be rejected instead of accepted, and the rejection will not result in a counteroffer, **enter** the date of the rejection and the names of the party rejecting the offer. **Obtain** the signatures of the party rejecting the offer.

Observations

As a policy of the publisher to provide users of **first tuesday** forms with maximum loss reduction protection, this purchase agreement **does not contain** clauses which tend to increase the risk of litigation or are generally felt to work against the best interests of the buyer, seller and broker. **Excluded provisions** include:

- an *attorney fee provision*, which tends to **promote litigation** and inhibit normal contracting;
- a *time-essence clause*, since future performance (closing) dates are, at best, estimates by the broker and his agents of the time needed to close and are too often **improperly used** by sellers in

rising markets to cancel the transaction before the buyer or broker can reasonably comply with the terms of the purchase agreement [See Chapter 45];

- an *arbitration provision*, since arbitration decisions are **final and unappealable**, without any assurance the arbitrator's award will be fair or correct [See Chapter 50]; and

- a *liquidated damages provision*, since they **create wrongful** expectations of windfall profits for sellers and are nearly always forfeitures and unenforceable. [See Chapter 49]

Chapter 52 An owner's residence in foreclosure

This chapter examines the equity purchase restrictions which must be known and applied by all investors buying owner-occupied, one-to-four unit residential property during foreclosure.

The equity purchase sales scheme

An equity purchase (EP) transaction takes place when an owner-occupied, one-to-four unit residential property in foreclosure is acquired for **rental, investment or dealer purposes** by a buyer, who is called an *EP investor*. Conversely, an EP transaction *does not occur* and the EP rules *do not apply* if the buyer acquires the property for use as his **personal residence**.

Equity purchase statutes apply to all buyers who are EP investors regardless of the number of EP transactions the investor completes. The investor does not need to be in the business of buying homes in foreclosure for the statutes to apply to him. [**Segura** v. **McBride** (1992) 5 CA4th 1028]

Both the EP investor and his agent must comply with EP law or be subject to drastic penalties.

Also, all agents need to be aware that the EP agreement signed by an EP investor must be printed in **bold type**, ranging from at least 10-point to 14-point font size, and be in the **same language** used during negotiations with the seller-in-foreclosure. [Calif. Civil Code §§1695.2, 1695.3, 1695.5]

Thus, the EP investor and all the agents involved in the transaction must use a written agreement containing statutory EP notices. Failure to use the correct forms subjects the EP investor and the agents to liability for all losses incurred by the seller-in-foreclosure, plus harsh penalties. [Segura, *supra*]

*Editor's note — **first tuesday's** Equity Purchase Agreement, Form 156, complies with all statutory requirements and properly sets forth the right of the seller-in-foreclosure to cancel. [See Form 156 accompanying this chapter]*

Cancellation within five business days

Prior to closing a sale, a seller-in-foreclosure has a **statutory five-business-day right to cancel** the EP agreement he has entered into with an EP investor. Thus, the seller can avoid the sale entirely, with or without cause.

The EP investor's compliance with the requirement of a written purchase agreement incorporating the EP rules grants the EP seller the automatic five-business-day right to cancel the agreement before a closing can take place. If the seller cancels within the period, the sale under the purchase agreement cannot be closed.

When the notice of the seller-in-foreclosure's cancellation rights are properly contained in the EP agreement, the seller's **cancellation period ends** at:

- midnight (12:00 a.m.) of the **fifth business day** following the day the seller enters into any type of purchase agreement with an EP investor; or

- 8:00 a.m. of the day scheduled for the **trustee's sale**, if it is to occur first. [CC §1695.4(a)]

EQUITY PURCHASE AGREEMENT

NOTE: For use by Buyers of one-to-four residential units which are owner-occupied and in foreclosure when the Buyer does not intend to occupy the property. [Calif. Civil Code §1695]

DATE: _____, 20_____, at _____, California.
Items left blank or unchecked are not applicable.
FACTS:

1. Received from _____, as the Buyer(s),
1.1 the sum of $_____, evidenced by ☐ personal check, or ☐ _____, payable to _____, for deposit only on acceptance of this offer.
1.2 Deposit to be applied toward Buyer's obligations under this agreement to purchase property
1.3 situated in the City of _____, County of _____, California,
1.4 referred to as _____,
1.5 including personal property, ☐ see attached Personal Property Inventory. [See ft Form 256]

2. This agreement is comprised of this six-page form and _____ pages of addenda/attachments.

TERMS: Buyer to pay the purchase price as follows:

3. Cash payment through escrow, including deposits, in the amount of. . . . . $_____

4. Buyer to obtain a ☐ first, or ☐ second, trust deed loan in the amount of . . . . . $_____ payable approximately $_____ monthly for a period of _____ years. Interest on closing not to exceed _____%, ☐ ARM, type _____.

5. ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by _____ with an approximate unpaid principal balance of . . . . $_____ payable $_____ monthly, including interest not exceeding _____%, ☐ ARM, type _____, plus a monthly tax/insurance impound payment of $_____. _____
5.1 The unpaid amount includes delinquent payments, late charges and foreclosure costs to be the responsibility of Buyer in the amount of $_____, including unpaid delinquent monthly payments beginning with the payment due _____, 20_____.
5.2 The impound account to be transferred without charge.

6. ☐ Take title subject to, ☐ or Assume, an existing second trust deed note held by _____ with an approximate unpaid principal balance of. . . . . $_____ payable $_____ monthly, including interest not exceeding _____%, ☐ ARM, type_____, due _____, 20_____.
6.1 The unpaid amount includes delinquent payments, late charges and foreclosure costs to be the responsibility of Buyer in the amount of $_____, including unpaid delinquent monthly payments beginning with the payment due _____, 20_____.

7. At closing, loan balance differences from those stated above as disclosed by beneficiary statement(s) to be adjusted into the purchase price unless the balances exceed the amount stated, in which case the difference is to be adjusted into the cash payment.

8. Assume a tax bond or assessment lien with an unpaid principal balance of. . . . . $_____

9. Note for the balance of the purchase price in the amount of . . . . . $_____ to be executed by Buyer in favor of Seller and secured by a trust deed on the property junior to any above referenced financing, payable $_____ monthly, or more, beginning one month after closing, including interest at _____% per annum from closing, due _____, 20_____, after closing.
9.1 This note and trust deed will not contain provisions for due-on-sale, prepayment penalty or late charges.
9.2 A Carryback Disclosure Statement is attached as an addendum. [See ft Form 300]

10. Total Purchase Price is . . . . . $ 0.00

11. ACCEPTANCE AND PERFORMANCE:

11.1 This offer to be deemed revoked unless accepted in writing ☐ on presentation, or ☐ within _____ days after date, and acceptance is personally delivered or faxed to Offeror or Offeror's Broker within this period.

11.2 After acceptance, Broker(s) are authorized to extend any performance date up to one month.

11.3 On failure of Buyer to obtain or assume financing as agreed by the date scheduled for closing, Buyer may terminate the agreement.

11.4 Buyer's close of escrow is conditioned on Buyer's prior or concurrent closing on a sale of other property, commonly referred to as _____.

11.5 Any termination of the agreement shall be by written Notice of Cancellation timely delivered to the other party, the other party's Broker or escrow, with instructions to escrow to return all instruments and funds to the parties depositing them. [See ft Form 183]

11.6 Both parties reserve their rights to assign and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow on either party's written notice. [See ft Form 171 or 172]

11.7 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

11.8 Should Buyer breach the agreement, Buyer's monetary liability to Seller is limited to $_____.

12. PROPERTY CONDITIONS:

12.1 Seller to furnish prior to closing:

a. ☐ a structural pest control inspection report and certification of clearance of corrective conditions.

b. ☐ a home inspection report prepared by an insured home inspector showing the land and improvements to be free of material defects.

c. ☐ a one-year home warranty policy:
Insurer _____
Coverage _____

d. ☐ a certificate of occupancy, or other clearance or retrofitting, required by local ordinance for the transfer of possession or title.

e. ☐ a certification by a licensed contractor stating the sewage disposal system is functioning properly, and if it contains a septic tank, is not in need of pumping.

f. ☐ a certification by a licensed water testing lab stating the well supplying the property meets potable water standards.

g. ☐ a certification by a licensed well-drilling contractor stating the well supplying the property produces a minimum of _____ gallon(s) per minute.

h. ☐ _____

i. ☐ _____

12.2 Seller's Condition of Property Disclosure —Transfer Disclosure Statement (TDS) [See ft Form 304]

a. ☐ is attached; or

b. ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may either cancel the transaction based on a reasonable disapproval of the disclosure or deliver to Seller or Seller's Broker a written notice itemizing any material defects in the property disclosed by the statement and unknown to Buyer prior to acceptance. [See ft Form 269] Seller to repair, replace or correct noticed defects prior to closing.

c. On Seller's failure to repair, replace or correct noticed defects under §12.2b or §12.4a, Buyer may tender the purchase price reduced by the cost to repair, replace or correct the noticed defects, or close escrow and pursue available remedies. [See ft Form 183]

12.3 Seller's Transfer Fee Disclosure Statement [See ft Form 304-2]

a. ☐ is attached; or

b. ☐ is to be handed to Buyer on acceptance for Buyer's review. Withing ten days after receipt, Buyer may terminate this agreement based on a reasonable disapproval of the Transfer Fee Disclosure.

c. Seller to pay any transfer fees arising out of the transaction.

12.4 Buyer to inspect the property twice:

a. an initial property inspection is required on acceptance to confirm the property's condition is substantially the same as observed by Buyer and represented by Seller or Seller's Agents prior to acceptance, and if not substantially the same, Buyer to promptly notify Seller in writing of undisclosed material defects discovered. [See ft Form 269] Seller to repair, replace or correct noticed defects prior to closing; and

b. a final walk-through inspection is required within five days before closing to confirm the correction of any noticed defects under §12.2b and §12.4a and maintenance under §12.14. [See ft Form 270]

12.5 Seller's Natural Hazard Disclosure (NHD) Statement [See ft Form 314] ☐ is attached, or ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days of Buyer's post-acceptance receipt of the NHD, Buyer may terminate the agreement based on a reasonable disapproval of hazards disclosed by the Statement and unknown to Buyer prior to acceptance. [See ft Forms 182 and 183]

12.6 Buyer acknowledges receipt of a booklet and related seller disclosures containing ☐ *Environmental Hazards: A Guide for Homeowners, Buyers, Landlords and Tenants* (on all one-to-four units), ☐ *Protect Your Family from Lead in Your Home* (on all pre-1978 one-to-four units) [See ft Form 313], and ☐ *The Homeowner's Guide to Earthquake Safety* (on all pre-1960 one-to-four units). [See ft Form 315]

12.7 The property is located in: ☐ an industrial use area, ☐ a military ordnance area, ☐ a rent control area,or ☐ airport, farmland, or San Francisco Bay area, see attached Notice Addendum. [See ft Form 308] ☐ _____

12.8 On acceptance, Seller to hand Buyer the following property information for Buyer's review: ☐ Property Operating Cost Sheet [See ft Forms 306], ☐ _____

a. Within ten days of receipt, Buyer may terminate the agreement based on a reasonable disapproval of the property information received.

12.9 If a Homeowners' Association (HOA) is involved, ☐ Buyer has received and approves, or ☐ Buyer on acceptance to be handed, copies of the association's Articles, Bylaws, CC&Rs, collection and lien enforcement policy, operating rules, operating budget, CPA's financial review, insurance policy summary and any age restriction statement.

a. No association claims for defects or changes in regular or special assessments are pending or anticipated. Current monthly assessment is $_____.

b. Seller is not in violation of CC&Rs, except _____.

c. Seller to pay association document and transfer fees.

d. Buyer to approve the association's statement of condition of assessments and confirm representations in §12.9a as a condition for closing escrow.

e. Within ten days of Buyer's post-acceptance receipt of the association documents, Buyer may terminate the agreement based on a reasonable disapproval of the documents. [See ft Form 183]

12.10 Seller's Criminal Activity and Security Disclosure Statement [See ft Form 321]

a. ☐ is attached, or

b. ☐ is to be handed to Buyer on acceptance for Buyer's review. Within ten days after receipt, Buyer may terminate this agreement based on a reasonable disapproval of the Criminal Activity and Security Disclosure Statement.

12.11 Smoke detector(s) and water heater bracing exist in compliance with the law, and if not, Seller to install.

12.12 If this property or an adjoining property contains a solar collector authorized by the Solar Shade Control Act (California Public Resources Code §25980 et seq.) and notice of its existence has been sent or received by Seller, then on acceptance, Seller to hand Buyer copies of the notices sent or received by Seller or provided to Seller by prior Owners of the property for Buyer's review. Buyer may, within ten days after receipt, terminate this agreement based on a reasonable disapproval of the conditions disclosed by the solar shade control notices.

12.13 Possession of the property and keys/access codes to be delivered: ☐ on close of escrow, or ☐ as stated in the attached Occupancy Agreement. [See ft Forms 271 and 272]

12.14 Seller to maintain the property in good condition until possession is delivered.

12.15 Fixtures and fittings attached to the property include but are not limited to: window shades, blinds, light fixtures, plumbing fixtures, curtain rods, wall-to-wall carpeting, draperies, hardware, antennas, air coolers and conditioners, trees, shrubs, mailboxes and other similar items.

12.16 Notice: Pursuant to Section 290.46 of the Penal Code, information about specified registered sex offenders is made available to the public via an Internet Web site maintained by the Department of Justice at www.meganslaw.ca.gov. Depending on an offender's criminal history, this information will include either the address at which the offender resides or the community of residence and ZIP code in which he or she resides.

13. CLOSING CONDITIONS:

13.1 This transaction to be escrowed with _____.
Parties to deliver instructions to escrow as soon as reasonably possible after acceptance.

a. ☐ Escrow holder is authorized and instructed to act on the provisions of this agreement as the mutual escrow instructions of the parties and to draft any additional instructions necessary to close this transaction. [See ft Form 401]

b. ☐ Escrow instructions, prepared and signed by the parties, are attached to be handed to escrow on acceptance. [See ft Form 401]

13.2 Escrow to be handed all instruments needed to close escrow on or before _____, 20_____, or within _____days after acceptance. Parties to hand escrow all documents required by the title insurer, lenders or other third parties to this transaction prior to seven days before the date scheduled for closing.

a. Each party to pay its customary Escrow charges. [See ft Forms 310 and 311]

13.3 The amount of any taxes, liens, bonds, assessments or other encumbrances on the property not referenced are, at Buyer's option, to remain of record and be deducted first from the cash payment and then from any carryback note.

13.4 Buyer's title to be subject to covenants, conditions, restrictions, reservations and easements of record.

_____.

13.5 Title to be vested in Buyer or Assignee free of encumbrances other than those set forth herein. Buyer's interest in title to be insured under a policy issued by _____ title company on a(n) ☐ Homeowner(s) policy (one-to-four units), ☐ Residential ALTA-R policy (vacant or improved residential parcel), ☐ Owner's policy (other than one-to-four units), ☐ CLTA Joint Protection policy (also naming Carryback Seller or purchase-assist lender), or ☐ Binder (to insure resale or refinance within two years).

a. Endorsements _____

b. ☐ Seller, or ☐ Buyer, to pay the title insurance premium.

13.6 Buyer to furnish a new fire insurance policy covering the property.

13.7 Taxes, assessments, insurance premiums, rents, interest and other expenses to be pro rated to close of escrow, unless otherwise provided.

13.8 Bill of Sale to be executed for any personal property being transferred.

13.9 If Seller is unable to convey marketable title as agreed, or if the improvements on the property are materially damaged prior to closing, Buyer may terminate the agreement. Seller to pay all reasonable escrow cancellation charges. [See ft Form 183]

14. Buyer's Broker and sales agent hereby confirms under penalty of perjury that:

14.1 ☐ he holds a valid, current California real estate license;

14.2 ☐ he has provided proof of his license to the seller-in-foreclosure by attaching:

a. ☐ a copy of his license as issued by the DRE; or

b. ☐ a printout of the DRE's Current License Status for the licensee; and

14.3 ☐ he holds adequate coverage via bond, errors and omissions insurance, or whatever other means which may become required by Equity Purchase laws.

15. FURTHER CONDITIONS: _____

_____

_____

_____

16. NOTICE OF YOUR SUPPLEMENTAL PROPERTY TAX BILL:

California property tax law requires the Assessor to revalue real property at the time the ownership of the property changes. Because of this law, you may receive one or two supplemental tax bills, depending on when your loan closes.

The supplemental tax bills are not mailed to your lender. If you have arranged for your property tax payments to be paid through an impound account, the supplemental tax bills will not be paid by your lender. It is your responsibility to pay these supplemental bills directly to the Tax Collector.

If you have any questions concerning this matter, please call your local Tax Collector's Office.

17. BROKERAGE FEE:

17.1 Parties to pay the below mentioned Broker(s) a fee now due of _____ as follows:

a. Seller to pay the brokerage fee on the change of ownership.

b. The party wrongfully preventing this change of ownership to pay the brokerage fee.

17.2 Buyer's Broker and Seller's Broker, respectively, to share the brokerage fee _____:_____.

17.3 Attached is the Agency Law Disclosure. [See ft Form 305]

17.4 Broker is authorized to report the sale, its price and terms for dissemination and use of participants in brokerage trade associations or listing services.

18. CANCELLATION PERIOD:

18.1 Seller has the below noticed right to cancel this agreement until midnight of the fifth business day following the day Seller signs this agreement, or until 8 a.m. on the day scheduled for a trustee's foreclosure sale of the property, whichever occurs first.

NOTICE REQUIRED BY CALIFORNIA LAW:

Until your right to cancel this contract has ended,

_____(Buyer)

or anyone working for

_____(Buyer)

CANNOT ask you to sign or have you sign any deed or any other document.

You may cancel this contract for the sale of your house, without any penalty or obligation at any time before _____:_____, _____.m. on _____, 20_____.

See attached Notice of Cancellation form for an explanation of this right.
(To be filled out by Buyer)

Buyer's/ Selling Broker: _____

Broker's DRE Identification #: _____

Selling Agent: _____

Agent's DRE Identification #: _____

Signature: _____

Is the agent of: ☐ **Buyer exclusively.** ☐ **Both Seller and Buyer.**

Address: _____

_____

Phone: _____

Fax: _____

Email: _____

Seller's/ Listing Broker: _____

Broker's DRE Identification #: _____

Listing Agent: _____

Agent's DRE Identification #: _____

Signature: _____

Is the agent of: ☐ **Seller exclusively.** ☐ **Both Seller and Buyer.**

Address: _____

_____

Phone: _____

Fax: _____

Email: _____

I agree to the terms stated above.	**I agree to the terms stated above.**
☐ See Signature Page Addendum. [ft Form 251]	☐ See Signature Page Addendum. [ft Form 251]
Date: _____, 20_____	Date: _____, 20_____
Buyer: _____	Seller: _____
Signature: _____	Signature: _____
Buyer: _____	Seller: _____
Signature: _____	Signature: _____

NOTICE OF CANCELLATION
(To be filled out by Buyer)

Seller signed the Equity Purchase Agreement on _____, 20_____.
You may cancel this contract for the sale of your house, without any penalty or obligation, at any time before _____:_____, _____.m. on _____, 20_____.
To cancel this transaction, personally deliver a signed and dated copy of this cancellation notice, or send a telegram to _____ (Buyer)
at _____ (Business Address)
NOT LATER THAN _____:_____, _____.m. on _____, 20_____.

I hereby cancel this transaction.
Date: _____, 20_____
Seller's Signature: _____
Seller's Signature: _____

NOTICE OF CANCELLATION
(To be filled out by Buyer)

Seller signed the Equity Purchase Agreement on _____, 20_____.
You may cancel this contract for the sale of your house, without any penalty or obligation, at any time before _____:_____, _____.m. on _____, 20_____.
To cancel this transaction, personally deliver a signed and dated copy of this cancellation notice, or send a telegram to _____ (Buyer)
at _____ (Business Address)
NOT LATER THAN _____:_____, _____.m. on _____, 20_____.

I hereby cancel this transaction.
Date: _____, 20_____
Seller's Signature: _____
Seller's Signature: _____

The seller-in-foreclosure's five-business-day right to cancel does not begin to run until proper notice of the cancellation period is given to the seller. [CC §1695.4(b)]

The first and proper time for giving the seller-in-foreclosure the notice is in the EP agreement. Failure to do so allows the seller to *cancel* the sales agreement and escrow, even to *rescind* the sale after closing, until the notice is ultimately given and the five business days have run without cancellation.

A **business day** is any day except Sunday and the following business holidays: New Year's Day, Washington's Birthday, Memorial Day, Independence Day, Labor Day, Columbus Day, Veterans' Day, Thanksgiving Day, and Christmas Day. Thus, Saturday is considered a business day under EP law, unless it falls on an enumerated holiday. Many state holidays are not included as holidays. [CC §1695.1(d)]

Until expiration of the right of the seller-in-foreclosure to cancel the transaction, the EP investor may not:

- **accept or induce a conveyance** of any interest in the property from the seller;
- **record any document** regarding the residence signed by the seller with the county recorder;
- **transfer an interest** in the property to a third party;
- **encumber any interest** in the residence; or
- **hand the seller** a "good-faith" deposit or other consideration. [CC §1695.6(b)]

However, escrow can be opened on acceptance, and deeds and funds deposited with escrow, since the seller-in-foreclosure is not delivering a conveyance (to the buyer) and will not receive funds until the close of escrow.

In negotiations with the seller-in-foreclosure, the EP investor, as with any buyer or agent, may not make false representations or misleading statements about:

- the value of the property in foreclosure;
- the net proceeds the seller will receive on closing escrow [See Form 310 accompanying Chapter 37];
- the terms of the purchase agreement or any other document the EP investor uses to induce the seller to sign; or
- the rights of the seller in the EP transaction. [CC §1695.6(d)]

Cancellation of the purchase agreement by the seller-in-foreclosure is **effective on delivery** of the signed written notice of cancellation to the EP investor's address in the purchase agreement. [CC §1695.4(b)]

When the EP investor receives the seller-in-foreclosure's written notice of cancellation, he must return, without condition, any original contract documents, such as the EP agreement bearing the seller's signature, to the seller within ten days following receipt of the notice. [CC §1695.6(c)]

Accordingly, the EP investor should not place funds in escrow before expiration of the cancellation period and a request for funds is made by escrow since an EP investor is not permitted to couple the release of funds to the return of documents on cancellation.

When the cancellation period expires for lack of a cancellation, the purchase agreement becomes enforceable and escrow can be closed, unless other contingencies exist.

Brokers limited to listing property

Equity purchase (EP) legislation regulates brokers when they act as a **buyer's agent** for EP investors who attempt to buy an owner-occupant's home that is in foreclosure.

The broker **representing an EP investor** must, when negotiating an EP transaction, deliver to all the parties to the transaction a written **EP disclosure statement** that the buyer's agent representing the EP investor is a **licensed** real estate broker.

The broker must also provide **proof of licensure** to the seller-in-foreclosure showing the broker holds a current, valid California real estate license. [CC §1695.17(a)]

If the buyer's agent fails to deliver either the EP disclosure statement or the proof of licensure to the relevant parties, the EP agreement is **voidable** at the discretion of the seller any time before escrow closes.

Also, the EP investor is liable to the seller-in-foreclosure for any **losses arising** out of the buyer's agent's nondisclosure of licensing requirements. [CC §1695.17(b)]

However, the EP investor would be entitled to *equitable indemnity* from his agent, a reimbursement for the seller's losses caused by the agent's nondisclosure. Equitable indemnity is available to the EP investor who, without active fault on his part, is forced by legal obligation to pay for losses created by his agent's nondisclosure. [**San Francisco Examiner Division, Hearst Publishing Company** v. **Sweat** (1967) 248 CA2d 493]

Broker as principal

The EP legislation does not restrict the ability of an individual, who may coincidentally be licensed as a broker or sales agent, to act solely as a **principal** purchasing property as an investor in an EP transaction.

Thus, a licensed real estate broker or agent may himself be the EP investor, eliminating use of the agency law disclosure as well as avoiding licensee disclosure and proof requirements. The licensed real estate broker or agent, acting solely as an EP investor, is a buyer who merely happens to hold a real estate license — a fact which does not need to be disclosed to the seller-in-foreclosure since the licensee is not also acting as an agent for anyone in the transaction.

Conversely, if a real estate broker **employed** as the listing broker by a seller-in-foreclosure decides to directly or indirectly buy his client's property, he **must disclose** to his seller-client that he is **also acting as a principal** in the transaction. [Calif. Business and Professions Code §§10176(d), 10176(g), 10176(h)]

Representing the seller

Prudent brokers and agents are inclined not to solicit or accept an exclusive right-to-sell listing from a seller-in-foreclosure. Property in foreclosure must be sold and escrow closed before the date of the trustee's foreclosure sale to have fully performed the employment and be entitled to a fee.

Unless the delinquent loan is brought current prior to five business days before the trustee's sale or paid in full before the sales date, the home will be sold at the trustee's sale. [CC §§2924c(e), 2903]

The listing agent for a seller-in-foreclosure usually needs extra time to find a buyer and close escrow since the frequency of foreclosures is inversely related to the volume of sales. The time constraints imposed on the listing agent by a trustee's sale date, before which the listing agent must close any sale of the property, place extra pressure on the broker employed under an exclusive listing agreement to locate a buyer.

As always, the listing agent acting under an exclusive listing must perform his agency duties owed the seller by properly marketing the property with care and diligence. As a further complication, the seller-in-foreclosure expects the broker to save his equity by negotiating a sale of the property and closing escrow before the property is lost to the foreclosing lender.

If the insolvent seller loses his equity, he may claim a lack of due diligence or unprofessional conduct on the part of the broker to locate a buyer and close an escrow — a risk the broker and his agents take when listing a home which is in foreclosure.

Two-year right of rescission

A Notice of Default (NOD) is recorded on a homeowner's personal residence after several months of unpaid installments.

The homeowner, now in foreclosure, is willing to sell on almost any terms to salvage his remaining credit and equity in the property.

The property is listed with a broker. The broker's listing agent markets the property primarily to buyers who will occupy the property as their personal residence.

However, an offer is submitted directly to the seller-in-foreclosure by an EP investor, acting on his own account, without broker representation. Under the EP offer, the seller-in-foreclosure will receive cash for his equity. Additionally, the EP investor will cure the seller's loan delinquencies.

The seller-in-foreclosure contacts his listing broker who, after reviewing the offer, recommends the seller accept the EP investor's offer and, if an acceptable backup offer is received within the cancellation period, accept the backup offer and cancel the EP agreement.

The agent advises his client he has five business days after his acceptance of the EP offer to cancel the sale since the sale involves the seller's home, which is in foreclosure.

The seller-in-foreclosure accepts the EP investor's offer. The five-day cancellation period expires without receiving a backup offer and escrow is opened on the EP agreement. The EP transaction is later closed and the property conveyed.

Does the EP investor receive good title when he accepts the grant deed?

No! The EP investor's title remains subject to the seller-in-foreclosure's *right of rescission* for two years after closing. If at any time during the two years following the close of escrow and the recording of the grant deed conveyance the seller believes the **EP investor's conduct** and the **price paid** gave the EP investor an *unconscionable advantage*, the seller may attempt to rescind the transaction and recover the home he sold. [CC §1695.14]

The unconscionable advantage

The two-year rescission period only allows a seller-in-foreclosure to recover property if he can demonstrate the EP investor took *unconscionable advantage* of him when negotiating the purchase of the property.

Showing the existence of an unconscionable advantage in the **EP investor's conduct** is problematic for both the seller-in-foreclosure and the EP investor. The legislature has not defined what exactly constitutes an act of unconscionable advantage by the buyer.

What was a reasonable sales price under the circumstances surrounding the seller-in-foreclosure when the transaction was entered into might appear to be unconscionable to the seller in the future due to market factors and inflation, not the conduct of the EP investor. Thus, an EP investor assumes the risk that a rising economy may provoke the seller into attempting to rescind (for the wrong legal reason).

If real estate values rise rapidly and significantly, the "greed factor" may set in, turning a formerly desperate seller-in-foreclosure into an astute rescinding seller.

However, any **increase in the value** of the property after acceptance of the EP investor's offer may not be considered. The test of unconscionable advantage is not based on events occurring after the seller-in-foreclosure enters into the purchase agreement.

Market circumstances existing at the time of the negotiations or when the parties entered into the agreement are the economic considerations which form one of the two elements for testing unconscionable advantage. [**Colton** v. **Stanford** (1890) 82 C 351]

Unconscionability has two aspects:

- the lack of a *meaningful choice* of action for the seller-in-foreclosure when negotiating to sell the home to the EP investor, legally called *procedural unconscionability*; and

- a purchase price or method of payment which is *unreasonably favorable* to the EP investor, legally called *substantive unconscionability*.

The **price paid**, like any other provision in a purchase agreement, can be considered unconscionable. When determining the unconscionability of the purchase price, justification for the price at the time of the sale and the terms of payment will be examined.

An **unconscionable method of payment** could include:

- carryback paper with an unreasonably low interest rate, long amortization or a due date on the note that bears no relationship to current market rates and payment schedules; or

- an exchange of worthless land, stock, gems or zero coupon bonds at face value with a 20-year maturity date.

A form of payment which is uncollectible, unredeemable and with no present value would be unconscionable.

However, the existence of unreasonable pricing and payment alone is not enough to show the unconscionable advantage needed to rescind a closed transaction. Both the lack of a **meaningful choice** and **unreasonably favorable** (advantageous) terms must exist to show *unconscionability* existed.

The un-American low price

Any procedures used or conduct employed by an EP investor as a misfeasance or misrepresentation made to deprive the seller-in-foreclosure of a reasonable choice between the EP investor's offer and offers from other buyers must exist to establish the lack of a meaningful choice or alternative to the EP investor's offer.

An **unconscionable advantage** occurs if the EP investor *exploits* an element of *oppression or surprise* and exacts an unreasonably low and favorable purchase price or terms of payment.

Oppression by the EP investor exists when the inequality in bargaining power between the investor and the seller-in-foreclosure results in no real negotiations between them — a "take it or leave it" environment deliberately removed from competing buyers. The foreclosure environment itself often presents a one-sided bargaining advantage for the EP investor to exploit should be decide he does not want his offer "shopped around" and used to solicit a better deal from other buyers during the five-business-day cancellation period.

Surprise occurs due to the post-closing discovery of terms which are hidden in the lengthy provisions of the agreement. The price and how it will be paid is not a surprise. The price is well known to the seller-in-foreclosure and, on any rescission action by the seller, will likely be the only term of the agreement contested by the seller.

The greater the marketplace oppression or post-closing surprise discovery in the transaction, the less an unreasonably favorable price paid by an EP investor will be tolerated. [**Carboni** v. **Arrospide** (1991) 2 CA4th 76]

Structuring the EP agreement

An investor, not intending to be an owner-occupant buyer, wants to purchase single family residences (SFRs) for investment purposes.

The investor locates an owner-occupied SFR encumbered by a trust deed on which a Notice of Default (NOD) has been recorded, commencing a trustee's foreclosure.

Because the seller occupies the residential property and an NOD has been recorded, the **investor realizes** he must comply with California's EP laws when preparing and submitting an offer to purchase the property.

The EP investor is willing to purchase the SFR for a price of $140,000 on the following terms:

- **pay** $10,000 cash to the seller-in-foreclosure for his equity in the property;
- **take over** the existing loan with a total of $130,000 due the lender in unpaid principal, delinquent installments and foreclosure costs; and
- **pay** the delinquent installments of principal, interest, taxes and insurance (PITI) and the foreclosure costs of approximately $7,400 — all of which are included in the $130,000 owed the lender on the loan.

The EP agreement calls for a $10,000 cash down payment. [See Form 156]

Also, the EP investor will take title to the property "subject to" the existing first trust deed with a 28-year amortization remaining.

The conditions of the trust deed note are:

- $122,600 of remaining principal (after the delinquent payments have been brought current);
- 6.5% interest;
- $802.30 monthly principal and interest payments;
- $150 monthly taxes/insurance impounds payments;
- current five month delinquencies on PITI of $4,761.50; and
- foreclosure costs of $1,316.80.

The first trust deed is a loan insured by the Federal Housing Administration (FHA) subject to the Department of Housing and Urban Development (HUD) due-on-sale rules controlling investor purchases. However, only HUD, not the lender, has the right to call a HUD-insured loan. The likelihood of HUD calling any loan which is kept current is remote. Thus, the loan may be taken over by the EP investor "subject to" with minimal interference from the lender, i.e., assumption fees and loan modification are avoided.

The seller-in-foreclosure will not be carrying back a portion of the purchase price since this is a cash-to-loan transaction. As an alternative method for payment of the purchase price, negotiations could have included provisions for the seller to carryback paper in the EP transaction.

The seller-in-foreclosure is five months delinquent in payments. The EP investor will bring the $4,761.50 in delinquent PITI payments current, which includes $326.66 in principal reduction.

Taxwise, the payment of the delinquent principal and interest (PI) payments (not the impounds) is part of the EP investor's original **costs of acquisition**. The interest paid by the EP investor which accrued **before acquiring** the property is an expense of the seller-in-foreclosure, not the EP investor. Thus, the payment of the seller's debts must be capitalized by the EP investor as part of his *cost basis* in the property. [Internal Revenue Code §1012]

The EP investor's cost basis on acquisition of the property will be the purchase price of approximately $140,000, which includes the seller-in-foreclosure's delinquent (PI) installments, foreclosure costs and the principal balance on the loan, less the impound account balance.

A prudent EP investor will determine the total cash funds needed to close escrow before making an offer. **Cash expenditures** of the EP investor on closing include:

- a down payment of $10,000.00;
- delinquent principal, interest, taxes and impounds of $4,761.50;
- foreclosure costs of $1,316.80;
- escrow fees and charges of $300.00; and
- a total cash investment of **$16,378.30**.

Chapter 53 Income property acquisitions

This chapter distinguishes the purchase agreement used for acquiring income property from purchase agreements used for other purposes and reviews its use as a checklist for due diligence investigations.

Investigating a property's worth

At an investment property marketing session, an agent looking for properties to acquire on behalf of his client picks up a mini-package on a property listed for sale by another agent. The package contains an Annual Property Operating Data (APOD) sheet. On review of the APOD, the property appears to match the income property requirements of his client.

The client is contacted. Both the agent and the client drive by the property. The building's exterior appearance is acceptable. The area surrounding the property looks stable. The property seems properly located for a project of its size and type. It is agreed the agent will gather more information on the property.

The agent obtains a profile on the property from a title company. The title is consistent with information received from the listing agent regarding trust deeds and vesting.

To begin an analysis of the property, the agent contacts the listing agent for more **fundamentals** on the property, asking him to produce:

- a **rent roll** spread sheet covering each unit (type, size, tenant, commencement of occupancy, expiration of lease, rent amount and any discount/free rent, payment history, furnishings, etc.);
- a two-year **occupancy history** on each unit;
- information regarding **security arrangements** and criminal activity on or around the property during the past year;
- a **property manager** or resident manager who is available for an interview;
- information regarding **maintenance procedures** and the repair services used;
- a copy of schedule "B" (CC&R exclusions) to the owner's policy of **title insurance**;
- the lender's name and the balance, payments, interest rates and due date on each **existing loan**; and
- any available information relating to the integrity of the **property's condition** and the nature of the property's location which might adversely affect the property's value.

The prospective buyer's agent asks for all this information knowing the seller and the listing agent **owe a duty to inform** all prospective buyers and their agents of all facts about the property that are *known or*

readily available to them which might have an adverse impact on its market value. Hopefully, the listing agent has already gathered all the fundamental property information and has it ready in a complete listing or marketing package.

If the listing agent has not yet gathered the facts which are available to him, he will likely insist the information is not necessary for a prospective buyer to submit an offer. However, price negotiations should not commence until disclosures of **all readily available** property data and information have been handed over by the seller or his listing agent since the confirmation of the **veracity of these disclosures** is what due diligence investigations prior to closing are all about.

The prospective buyer is advised the seller or the seller's agent may insist he enter into a **confidentiality agreement** before some of the information requested of the seller's agent will be released. Thus, the buyer may need to identify himself to the seller before the seller will release information on the tenants, their leases and property operations, which the buyer needs to determine the property's worth and set the price and terms, before making an offer.

When the information is received and reviewed, if it warrants a further investigation into the suitability of the property for acquisition, the buyer's agent and prospective buyer will then personally inspect the premises and any vacant units, and thoroughly discuss operations with those who manage the property.

After receiving these initial disclosures and conducting a minimal investigation, the buyer's agent will prepare a purchase agreement if the property still appears to be suitable to the prospective buyer. By submission of the purchase agreement offer, they will **commence negotiations** on the price to be paid and the conditions which must be met so the prospective buyer can complete a due diligence investigation to confirm his initial expectations about the property. Any counteroffer by the seller will sort out the seller's willingness to permit the prospective buyer to corroborate the property's worth.

Analyzing the income property purchase agreement

The income property purchase agreement, **first tuesday** Form 159, is used to prepare and submit the buyer's **written offer** to purchase income property, excluding one-to-four unit residential property. Terms for payment of the price are limited to conventional financing, an assumption of existing loans and a carryback note. Form 159 is also properly used by sellers in a counteroffer situation to submit their **fresh offer** to sell the real estate. [See Form 159 accompanying this chapter]

The purchase agreement offer, if accepted, becomes the binding written contract between the buyer and seller. Its terms must be complete and clear to prevent misunderstandings so the agreement can be judicially enforced. Thus, Form 159 is a comprehensive "boilerplate" purchase agreement which serves as a **checklist**, presenting the various conventional financing arrangements and conditions a prudent buyer would consider when making an offer to purchase.

Each section in Form 159 has a separate purpose and need for enforcement. The sections include:

1. *Identification*: The date of preparation for referencing the agreement, the name of the buyer, the amount of the good-faith deposit, the description of the real estate, an inventory of any personal property included in the transfer and the number of pages contained in the agreement and its addenda are set forth in sections 1 and 2 to establish the facts on which the agreement is negotiated.

2. *Price and terms*: All the typical variations for payment of the price by conventional purchase-assist financing or an assumption of existing financing are set forth in sections 3 through 9 as a checklist of provisions. On making an offer (or counteroffer), the terms for payment and financing of the price are selected by checking boxes and filling blanks in the desired provisions.

3. *Acceptance and performance*: Aspects of the formation of a contract, excuses for nonperformance and termination of the agreement are provided for in section 10, such as the time period for acceptance of the offer, the broker's authorization to extend performance deadlines, the financing of the price as a closing contingency, procedures for cancellation of the agreement, a sale of other property as a closing contingency, cooperation to effect a §1031 transaction and limitations on monetary liability for breach of contract.

4. *Due diligence contingencies*: Contingencies for the buyer's due diligence investigations into income and expense records, rental income statements, hazard disclosures, property condition disclosures, and other relevant information to be delivered by the seller are set forth in section 11.

5. *Property Conditions*: The buyer's confirmation of the physical condition of the property as disclosed prior to acceptance is **confirmed** as set forth in section 12 by the seller's delivery of reports, warranty policies and certifications not handed to the buyer prior to entry into the purchase agreement.

6. *Closing conditions*: The escrow holder, escrow instruction arrangements and the date of closing are established in section 13, as are title conditions, title insurance, hazard insurance, prorates and loan adjustments.

7. *Brokerage and agency*: The release of sales data on the transaction to trade associations is authorized, the brokerage fee is set and the delivery of the agency law disclosure to both buyer and seller is provided for as set forth in section 15, as well as the confirmation of the agency undertaken by the brokers and their agents on behalf of one or both parties to the agreement.

8. *Signatures*: The seller and buyer bind each other to perform as agreed in the purchase agreement by signing and dating their signatures to establish the date of offer and acceptance.

Preparing the income property purchase agreement

The following instructions are for the preparation and use of the Income Property Purchase Agreement, **first tuesday** Form 159. Form 159 is designed as a checklist of practical provisions so a broker or his agent can prepare an offer for a prospective buyer who seeks to purchase conventionally financed, other than one-to-four unit, income property located in California.

Each instruction corresponds to the provision in the form bearing the same number.

*Editor's note — **Check** and **enter** items throughout the agreement in each provision with boxes and blanks, unless the provision is not intended to be included as part of the final agreement, in which case it is left unchecked or blank.*

Document identification:

Enter the date and name of the city where the offer is prepared. This date is used when referring to this purchase agreement.

PURCHASE AGREEMENT

Income Property other than One-to-Four Residential Units

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. Received from _____, as the Buyer(s),

1.1 the sum of $_____, evidenced by ☐ personal check, or ☐ _____, payable to _____, for deposit only on acceptance of this offer.

1.2 Deposit to be applied toward Buyer's obligations under this agreement to purchase property

1.3 situated in the City of _____, County of _____, California,

1.4 referred to as _____,

1.5 including personal property, ☐ see attached Personal Property Inventory. [See **ft** Form 256]

2. This agreement is comprised of this four-page form and _____ pages of addenda/attachments.

TERMS: Buyer to pay the purchase price as follows:

3. Cash payment through escrow, including deposits, in the amount of . . . . . $_____

3.1 Other consideration paid through escrow _____ . . . . $_____

4. Buyer to obtain a ☐ first, or ☐ second, trust deed loan in the amount of . . . . . $_____ payable approximately $_____ monthly for a period of _____ years. Interest on closing not to exceed _____%, ☐ ARM, type _____. Loan points not to exceed _____.

4.1 ☐ Unless Buyer, within _____ days after acceptance, hands Seller satisfactory written confirmation Buyer has been pre-approved for the financing of the purchase price, Seller may terminate the agreement. [See **ft** Form 183]

5. ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by _____ with an unpaid principal balance of . . . . $_____ payable $_____ monthly, including interest not exceeding _____%, ☐ ARM, type _____, plus a monthly tax/insurance impound payment of $_____. _____

5.1 At closing, loan balance differences per beneficiary statement(s) to be adjusted into: ☐ cash, ☐ carryback note, or ☐ sales price.

5.2 The impound account to be transferred: ☐ charged, or ☐ without charge, to Buyer.

6. ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by _____ with an unpaid principal balance of . . . $_____ payable $_____ monthly, including interest not exceeding _____%, ☐ ARM, type _____, due _____, 20 _____.

7. Assume a tax bond or assessment lien with an unpaid principal balance of . . . . . $_____

8. Note for the balance of the purchase price in the amount of. . . . . $_____ to be executed by Buyer in favor of Seller and secured by a trust deed on the property junior to any above referenced financing, payable $_____ monthly, or more, beginning one month after closing, including interest at _____% per annum from closing, due _____ years after closing.

8.1 This note and trust deed to contain provisions to be provided by Seller for: ☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐ _____.

8.2 ☐ A Carryback Disclosure Statement is attached as an addendum. [See **ft** Form 300]

8.3 ☐ Buyer to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **ft** Form 412]

8.4 Buyer to hand Seller a completed credit application on acceptance. [See **ft** Form 302]

8.5 Within _____ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness.

8.6 Seller may terminate the agreement on failure of the agreed terms for priority financing. [See **ft** Form 183]

8.7 As additional security, Buyer to execute a security agreement and file a UCC-1 financing statement on any property transferred by Bill of Sale. [See **ft** Form 436]

9. Total Purchase Price is . . . . . $_____

10. ACCEPTANCE AND PERFORMANCE:

10.1 This offer to be deemed revoked unless accepted in writing ☐ on presentation, or ☐ within _____ days after date, and acceptance is personally delivered or faxed to Offeror or Offeror's Broker within this period.

10.2 After acceptance, Broker(s) are authorized to extend any performance date up to one month.

10.3 On failure of Buyer to obtain or assume financing as agreed by the date scheduled for closing, Buyer may terminate the agreement.

10.4 Buyer's close of escrow is conditioned on Buyer's prior or concurrent closing on a sale of other property, commonly referred to as _____.

10.5 Any termination of the agreement shall be by written Notice of Cancellation timely delivered to the other party, the other party's Broker or escrow, with instructions to escrow to return all instruments and funds to the parties depositing them. [See **ft** Form 183]

10.6 Both parties reserve their rights to assign and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow on either party's written notice. [See **ft** Forms 171 or 172]

10.7 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

10.8 Should Buyer breach the agreement, Buyer's monetary liability to Seller is limited to ☐ $_____, or ☐ the deposit receipted in Section 1.

11. DUE DILIGENCE CONTINGENCIES:

Within _____ days after receipt or occurrence of any of the following conditions, Buyer may terminate the agreement based on Buyer's reasonable disapproval of the condition.

11.1 Income and expense records, leases, property management and other service contracts, permits or licenses affecting the operation of the property which Seller will make available to Buyer on acceptance.

11.2 Rental Income Rent Roll Statement itemizing, by unit, the tenant's name, rent amount, rent due date and delinquencies, deposits, rental period and expiration, and any rental incentives, bonuses or discounts signed by Seller and handed to Buyer on acceptance. [See **ft** Form 380]

11.3 Seller's Natural Hazard Disclosure Statement to be signed by Seller and handed to Buyer on acceptance. [See **ft** Form 314]

11.4 Condition of Commercial Property Disclosure — Commercial TDS to be signed by Seller and Seller's Broker and handed to Buyer on acceptance. [See **ft** Form 304-1] Solar Shade Control Notices sent or received by Seller to be handed to Buyer on acceptance.

11.5 Inspection of the property by Buyer, his agent or consultants within _____ days after acceptance for value and condition sufficient to justify the purchase price.

11.6 Preliminary title report for the policy of title insurance, which Seller will cause escrow to hand Buyer as soon as reasonably possible after acceptance.

11.7 An estoppel certificate executed by each tenant affirming the terms of their occupancy, which Seller will hand Buyer prior to seven days before closing. [See **ft** Form 598]

11.8 Criminal Activity and Security Disclosure Statement prepared by Seller setting forth recent criminal activity on or about the property relevant to the security of persons and their belongings on the property, and any security arrangements undertaken or which should be undertaken in response. [See **ft** Form 321]

11.9 ☐ See attached Due Diligence Contingencies Addendum for additional conditions. [See **ft** Form 279]

12. PROPERTY CONDITIONS:

12.1 Seller to furnish prior to closing:

a. ☐ a structural pest control inspection report and certification of clearance of corrective conditions.

b. ☐ a home inspection report prepared by an insured home inspector showing the land and improvements to be free of material defects.

c. ☐ a one-year home warranty policy:
Insurer _____
Coverage _____

d. ☐ a certificate of occupancy, or other clearance or retrofitting, required by local ordinance for the transfer of possession or title.

e. ☐ _____

f. ☐ _____

12.2 Smoke detector(s) and water heater bracing exist in compliance with the law, and if not, Seller to install.

12.3 Seller to maintain the property in good condition until possession is delivered.

12.4 Fixtures and fittings attached to the property include, but are not limited to: window shades, blinds, light fixtures, plumbing fixtures, curtain rods, wall-to-wall carpeting, draperies, hardware, antennas, air coolers and conditioners, trees, shrubs, mailboxes and other similar items.

12.5 New agreements and modifications of existing agreements to rent units, or to service, alter or equip the property, will not be entered into by Seller without Buyer's prior written consent, which will not be unreasonably withheld.

13. CLOSING CONDITIONS:

13.1 This transaction to be escrowed with _____.
Parties to deliver instructions to escrow as soon as reasonably possible after acceptance.

a. ☐ Escrow holder is authorized and instructed to act on the provisions of this agreement as the mutual escrow instructions of the parties and to draft any additional instructions necessary to close this transaction. [See **ft** Form 401]

b. ☐ Escrow instructions, prepared and signed by the parties, are attached to be handed to escrow on acceptance. [See **ft** Form 401]

13.2 Escrow to be handed all instruments needed to close escrow on or before _____, 20_____, or within _____ days after acceptance. Parties to hand escrow all documents required by the title insurer, lenders or other third parties to this transaction prior to seven days before the date scheduled for closing.

a. Each party to pay its customary escrow charges. [See **ft** Forms 310 and 311]

13.3 Title to be vested in Buyer or Assignee free of encumbrances other than those set forth herein. Buyer's interest in title shall be insured by _____ title company on a(n) ☐ CLTA standard, ☐ ATLA owner's, or ☐ ALTA binder, policy of title insurance.

a. Endorsements _____

b. ☐ Seller, or ☐ Buyer, to pay the title insurance premium.

13.4 Buyer to furnish a new fire insurance policy covering the property.

13.5 Taxes, assessments, insurance premiums, rents, interest and other expenses to be pro rated to close of escrow, unless otherwise provided.

a. ☐ Attached is a notice of your Supplemental Property Tax Bill. [See **ft** Form 317]

13.6 Bill of Sale to be executed for any personal property being acquired.

a. ☐ A UCC-3 Condition of Title Report to be ordered from the Secretary of State and approved by Buyer prior to close of escrow.

13.7 Seller to assign, and title to be subject to, all existing leases and rental agreements. [See **ft** Form 595]

a. Seller to notify each tenant of the change of ownership on or before the close of escrow. [See **ft** Form 554]

13.8 Security deposits held by Seller to be handed to Buyer on close of escrow. Seller to notify each tenant of the transfer of the security deposit on close of escrow, with a copy of each notice to Buyer through escrow. [See **ft** Form 586]

13.9 Delinquent unpaid rent to be treated as paid. Any recovery by Buyer of Seller's portion of delinquent rent and pro rated delinquent rent credited to Buyer shall be refunded to Seller on collection by Buyer.

13.10 Service and equipment contracts to be assumed by Buyer include _____
_____

a. Contracts assumed by Buyer to be pro rated to close of escrow.

13.11 Possession of the property and keys/access codes to be delivered on close of escrow.

13.12 If Seller is unable to convey marketable title as agreed, or if the improvements on the property are materially damaged prior to closing, Buyer may terminate the agreement. Seller to pay all reasonable escrow cancellation charges. [See **ft** Form 183]

14. NOTICE OF YOUR SUPPLEMENTAL PROPERTY TAX BILL:

California property tax law requires the Assessor to revalue real property at the time the ownership of the property changes. Because of this law, you may receive one or two supplemental tax bills, depending on when your loan closes.

The supplemental tax bills are not mailed to your lender. If you have arranged for your property tax payments to be paid through an impound account, the supplemental tax bills will not be paid by your lender. It is your responsibility to pay these supplemental bills directly to the Tax Collector.

If you have any questions concerning this matter, please call your local Tax Collector's Office.

15. BROKERAGE FEE:

15.1 Parties to pay the below mentioned Broker(s) a fee now due of _____ as follows:

a. Seller to pay the brokerage fee on the change of ownership.

b. The party wrongfully preventing this change of ownership to pay the brokerage fee.

15.2 Buyer's Broker and Seller's Broker, respectively, to share the brokerage fee _____:_____.

15.3 ☐ Attached is the Agency Law Disclosure. [See **ft** Form 305]

15.4 Broker is authorized to report the sale, its price and terms for dissemination and use of participants in brokerage trade associations or listing services.

16. _____

_____

_____

_____

Buyer's/ Selling Broker: _____	Seller's/ Listing Broker: _____
Broker's DRE Identification #: _____	Broker's DRE Identification #: _____
Selling Agent: _____	Listing Agent: _____
Agent's DRE Identification #: _____	Agent's DRE Identification #: _____
Signature: _____	Signature: _____
Is the agent of: ☐ Buyer exclusively. ☐ Both Seller and Buyer.	Is the agent of: ☐ Seller exclusively. ☐ Both Seller and Buyer.
Address: _____	Address: _____
Phone: _____	Phone: _____
Fax: _____	Fax: _____
Email: _____	Email: _____

I agree to the terms stated above.	**I agree to the terms stated above.**
☐ See Signature Page Addendum. [**ft** Form 251]	☐ See Signature Page Addendum. [**ft** Form 251]
Date: _____, 20_____	Date: _____, 20_____
Buyer: _____	Seller: _____
Signature: _____	Signature: _____
Buyer: _____	Seller: _____
Signature: _____	Signature: _____

REJECTION OF OFFER

Undersigned hereby rejects this offer in its entirety. No counteroffer will be forthcoming.

Date: _____, 20_____

Name: _____

Signature: _____

Name: _____

Signature: _____

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Facts:

1. *Buyer, deposit and property*: **Enter** the name of each buyer who will sign the offer.

   1.1 **Enter** the dollar amount of any good-faith, earnest money deposit. **Check** the appropriate box to indicate the form of the good-faith deposit. **Enter** the name of the payee (escrow, title company or broker).

1.2-1.3 **Enter** the name of the city and county in which the property is located.

   1.4 **Enter** the legal description or common address of the property, or the assessor's parcel number (APN).

   1.5 **Check** the box to indicate personal property will be included in the sale. The seller's trade fixtures to be purchased by the buyer must be listed as inventory if they are to be acquired by the buyer. [See **first tuesday** Form 256]

2. *Entire agreement*: **Enter** the number of pages comprising all of the addenda, disclosures, etc., which are attached to the purchase agreement.

Terms for payment of the purchase price:

3. *Cash down payment:* **Enter** the dollar amount of the buyer's cash down payment toward the purchase price.

   3.1 *Additional down payment:* **Enter** the description of any other consideration to be paid as part of the price, such as trust deed notes, personal property or real estate equities (an exchange). **Enter** the dollar amount of its value.

4. *New trust deed loan:* **Check** the appropriate box to indicate whether any new financing will be a first or second trust deed loan. **Enter** the amount of the loan, the monthly principal and interest (PI) payment, the term of the loan and the rate of interest. **Check** the box to indicate whether the interest will be adjustable (ARM), and if so, **enter** the index name. **Enter** any limitations on loan points.

   4.1 *Buyer's loan qualification:* Check the box to indicate the seller is authorized to cancel the agreement if the buyer is to obtain a new loan and fails to deliver documentation from a lender indicating he has been qualified for a loan. Enter the number of days the buyer has after acceptance to deliver written confirmation of his qualification for the loan.

5. *First trust deed note:* **Check** the appropriate box to indicate whether the transfer of title is to be "subject-to" an existing loan or by an "assumption" of the loan if the buyer is to take over an existing first trust deed loan. **Enter** the lender's name. **Enter** the remaining balance, the monthly PI payment and the interest rate on the loan. **Check** the box to indicate whether the interest is adjustable (ARM), and if so, **enter** the index name. **Enter** any monthly impound payment made in addition to the PI payment.

   5.1 *Loan balance adjustments:* **Check** the appropriate box to indicate the financial adjustment desired for loan balance differences at the close of escrow.

   5.2 *Impound balances:* **Check** the appropriate box to indicate whether the impound account transferred to the buyer will be with or without a charge to the buyer.

6. *Second trust deed note:* **Check** the appropriate box to indicate whether the transfer of title is to be "subject-to" an existing loan or by an "assumption" of the loan if the buyer is to take over an existing second trust deed loan. **Enter** the lender's name. **Enter** the remaining balance, the monthly PI payment and the interest rate on the loan. **Check** the box to indicate whether the interest is adjustable (ARM), and if so, **enter** the index name. **Enter** the due date for payment of a final/balloon payment.

7. *Bond or assessment assumed:* **Enter** the amount of the principal balance remaining unpaid on bonds and special assessment liens (such as Mello-Roos or 1915 improvement bonds) which will remain unpaid and become the responsibility of the buyer on closing.

Editor's note — Improvement bonds are obligations of the seller which may be assumed by the buyer in lieu of their payoff by the seller. If assumed, the bonded indebtedness becomes part of the consideration paid for the property. Some purchase agreements erroneously place these bonds under "property tax" as though they were ***ad valorem taxes****, and then fail to prorate and charge the unpaid amount to the seller.*

8. *Seller carryback note:* **Enter** the amount of the carryback note to be executed by the buyer as partial payment of the price. **Enter** the amount of the note's monthly PI payment, the interest rate and the due date for the final/balloon payment.

8.1 *Special carryback provisions:* **Check** the appropriate box to indicate any special provisions to be included in the carryback note or trust deed. **Enter** the name of any other special provision to be included in the carryback note or trust deed, such as impounds, discount options, extension provisions, guarantee arrangements or right of first refusal on the sale or hypothecation of the note.

8.2 *Carryback disclosure:* **Check** the box to indicate a Seller Carryback Disclosure Statement is attached as an addendum. [See Form 300 accompanying Chapter 36]

Editor's note — Further approval of the disclosure statement in escrow creates by statute a buyer's contingency allowing for cancellation until time of closing on any purchase of one-to-four unit residential property.

8.3 *Notice of Delinquency:* **Check** the box to indicate the buyer is to execute a Request for Notice of Delinquency and pay the costs of recording and serving it on senior lenders since they will have priority on title to the trust deed securing the carryback note.

8.4 *Buyer creditworthiness:* **Requires** the buyer to provide the seller with a completed credit application.

8.5 *Approval of creditworthiness:* **Enter** the number of days within which the seller may cancel the transaction for reasonable disapproval of the buyer's credit application and report.

8.6 *Subordination:* **Provides** for the seller to terminate this transaction if the parameters agreed to for financing by an assumption or origination of a trust deed loan with priority on title to the carryback note are exceeded.

8.7 *Personal property as security:* **Requires** the buyer on the transfer of any personal property in this transaction to execute a security agreement and UCC-1 financing statement to provide additional security for any carryback note.

9. *Purchase price:* **Enter** the total amount of the purchase price as the sum of lines 3, 3.1, 4, 5, 6, 7 and 8.

10. **Acceptance and performance periods:**

10.1 *Delivery of acceptance:* **Check** the appropriate box to indicate the time period for acceptance of the offer. If applicable, **enter** the number of days in which the seller may accept this offer and form a binding contract.

Editor's note — Acceptance occurs on the return delivery to the person making the offer (or counteroffer) or to his broker of a copy of the unaltered purchase agreement offer containing the signed acceptance.

10.2 *Extension of performance dates:* **Authorizes** the brokers to extend the performance dates up to one month to meet the objectives of the agreement — time being of a reasonable duration and not the essence of this agreement as a matter of policy. This extension authority does not extend to the acceptance period.

10.3 *Loan contingency:* **Authorizes** the buyer to cancel the transaction at the time scheduled for closing if the financing for payment of the price is not obtainable or assumable.

10.4 *Sale of other property:* If the closing of this transaction is to be contingent on the buyer's receipt of net proceeds from a sale of other property, **enter** the address of the property to be sold by the buyer.

10.5 *Cancellation procedures:* **Provides** the method of cancellation required to terminate the agreement when the right to cancel is triggered by other provisions in the agreement, such as contingency or performance provisions.

10.6 *Exchange cooperation:* **Requires** the parties to cooperate in an IRS §1031 transaction on further written notice by either party. **Provides** for the parties to assign their interests in this agreement.

10.7 *Mediation provision:* **Provides** for the parties to enter into non-binding mediations to resolve a dispute remaining unsolved after 30 days of informal settlement negotiations.

10.8 *Liability limitations:* **Provides** for a dollar limit on the buyer's liability for the buyer's breach of the agreement. **Check** the first box and **enter** the maximum dollar amount of money losses the seller may recover from the buyer or **check** the second box to indicate the buyer's monetary liability is limited to the good-faith deposit tendered with the offer to buy.

Editor's note — Liability limitation provisions avoid the misleading and unenforceable forfeiture called for under liquidated damage clauses included in most purchase agreement forms provided by other publishers of forms.

11. **Due Diligence Contingencies:**

11.1 *Approval period*: **Enter** the number of days the buyer has to approve or disapprove and cancel this agreement after the buyer's receipt of each item listed below. This section calls for the buyer to complete a due diligence investigation to confirm the representations of the seller and the seller's broker and the pre-contract expectations of the buyer about the property. If the buyer is unable to confirm his expectations, he may waive the requirements or cancel the transaction.

11.2 *Operating records:* **Requires** the seller to make income and expense records and supporting documents available to the buyer for inspection as soon as possible after acceptance of the offer.

11.3 *Rents and deposits:* **Requires** the seller to prepare a detailed rent roll profile on each occupancy and deliver it to the buyer as soon as possible after acceptance.

11.4 *Natural Hazard Disclosure (NHD) Statement:* **Requires** the seller to prepare and deliver to the buyer a NHD Statement disclosing the seller's knowledge of the hazards listed on the form.

11.5 *Condition of property:* **Requires** the seller to prepare and deliver a statement disclosing the physical condition of the property as known to the seller.

11.6 *Valuation inspection:* **Enter** the number of days after acceptance in which the buyer is to investigate the market value of the property to confirm its value justifies the price the buyer has agreed to pay.

11.7 *Title report:* **Requires** the seller to deliver a preliminary title report to the buyer for review to confirm the condition of title allows the buyer to use the property as he intended.

11.8 *Tenant Estoppel Certificate:* **Requires** the seller to produce Tenant Estoppel Certificates prior to seven days before the date scheduled for closing to confirm the tenants' acquiescence to the terms stated in the certificate.

11.9 *Tenant security:* **Requires** the seller to prepare and deliver a statement disclosing criminal activity affecting individuals on the property and any crime prevention undertaken or which should be undertaken.

11.10 *Due diligence contingencies:* **Check** the box to indicate the due diligence contingencies addendum for additional conditions is attached.

12. **Property Conditions:**

12.1 *Seller to furnish:* **Check** the appropriate box(es) within the following subsections to indicate the items the seller is to furnish prior to closing.

a. *Pest control:* **Check** the box to indicate the seller is to furnish a structural pest control report and clearance.

b. *Home inspection report:* **Check** the box to indicate the seller is to employ a home inspection company and furnish the buyer with the company's home inspection report.

c. *Home warranty:* **Check** the box to indicate the seller is to furnish an insurance policy for home repairs. **Enter** the name of the insurer and the type of coverage, such as for the air conditioning unit, etc.

d. *Local ordinance compliance:* **Check** the box to indicate the seller is to furnish a certificate of occupancy or other clearance required by local ordinance.

e. *Other terms:* **Check** the box and **enter** any other report, certification or clearance the seller is to furnish.

f. *Other terms:* **Check** the box and **enter** any other report, certification or clearance the seller is to furnish.

12.2 *Safety compliance:* **Requires** smoke detectors and water heater bracing to exist or be installed by the seller.

12.3 *Property maintenance:* **Requires** the seller to maintain the present condition of the property until the close of escrow.

12.4 *Fixtures and fittings:* **Confirms** this agreement includes real estate fixtures and fittings as part of the property purchased.

Editor's note — Trade fixtures are personal property to be listed as items on an attached inventory at section 1.

12.5 *Leasing and lease modifications:* **Requires** the seller to obtain the buyer's consent (which will not be unreasonably withheld) to any new tenancies or modifications of existing tenancies entered into during the escrow period.

13. **Closing conditions:**

13.1 *Escrow closing agent:* **Enter** the name of the escrow company handling the closing.

a. *Escrow instructions*: **Check** the box to indicate the purchase agreement is to also serve as the mutual instructions to escrow from the parties. The escrow company will typically prepare supplemental instructions they will need to handle and close the transaction. [See Form 401 accompanying Chapter 59]

b. *Escrow instructions*: **Check** the box to indicate escrow instructions have been prepared and are attached to this purchase agreement. **Attach** the prepared escrow instructions to the purchase agreement and **obtain** the signatures of the parties. [See Form 401]

13.2 *Closing date:* **Enter** the specific date for closing or the number of days anticipated as necessary for the parties to perform and close escrow. Also, prior to seven days before closing, the parties are to deliver all documents needed by third parties to perform their services by the date scheduled for closing.

a. *Escrow charges*: **Requires** each party to pay their customary escrow closing charges, amounts any competent escrow officer can provide on inquiry.

13.3 *Title insurance*: **Provides** for the title to be vested in the name of the buyer or their assignee. **Enter** the name of the title insurance company which is to provide a preliminary title report in anticipation of issuing title insurance. **Check** the appropriate box to indicate the type of title insurance policy to be issued.

a. *Policy endorsements*: **Enter** any endorsements to be issued with the policy.

b. *Payment of premium*: **Check** the appropriate box to indicate whether the buyer or seller is to pay the title insurance premium.

13.4 *Fire insurance:* **Requires** the buyer to provide a new policy of hazard insurance.

13.5 *Prorates and adjustments:* **Authorizes** prorations and adjustments on the close of escrow for taxes, insurance premiums, rents, interest, loan balances, service contracts and other property operating expenses, prepaid or accrued.

a. *Supplemental property tax:* **Check** the box to indicate a notice of supplermental property tax bill has been prepared and attached.

13.6 *Personal property:* **Requires** the seller to execute a bill of sale for any personal property being transferred in this transaction at section 1.

a. *Personal property report*: **Check** the box to indicate escrow is to order a UCC-3 from the Secretary of State on any personal property located on the real estate which is to be transferred by bill of sale to the buyer.

13.7 *Assignment of leases:* **Requires** the seller to assign all leases and rental agreements to the buyer on closing. [See **first tuesday** Form 595]

a. *Ownership notice*: **Requires** the seller to notify each tenant of the change of ownership. [See **first tuesday** Form 554]

13.8 *Tenant security deposits:* **Requires** the seller to credit or pay the buyer on the close of escrow for security deposits held by the seller under the existing occupancies. **Requires** the seller to notify each tenant of the transfer of the security deposit. [See **first tuesday** Form 586]

Editor's note — Proper notice to the tenant regarding the security deposit transfer to the buyer eliminates all future liability the seller may have had due to the seller's original receipt of the deposits.

13.9 *Rent due and unpaid at closing:* **Treats** delinquent unpaid rent as paid for purposes of prorations. The buyer is credited for his share of paid and unpaid rents for the month of the closing. On any later recovery by the buyer of delinquent prorated rent, the buyer is to forward the entire amount received to the seller.

13.10 *Service contracts:* **Enter** the name of the providers of services under contracts the buyer is to assume.

a. *Prorations*: **Authorizes** the proration of amounts prepaid or unpaid on the service contracts.

13.11 *Buyer's possession:* **Requires** the seller to deliver possession of the property to the buyer on the close of escrow.

13.12 *Property destruction:* **Provides** for the seller to bear the *risk of loss* for any casualty losses suffered by the property prior to the close of escrow. Thus, the buyer may terminate the agreement if the seller is unable to provide a marketable title or should the property improvements suffer major damage.

14. *Supplemental property tax bill*: **Notifies** the buyer he will receive one or two supplemental property tax bills he is to pay when the county assessor revalues the property after a change in ownership.

15. **Brokerage fee:**

15.1 *Fee amount:* **Enter** the total amount of the fee due all brokers to be paid by the seller. The amount of the fee may be stated as a fixed dollar amount or as a percentage of the price.

a. *Seller paid:* **Provides** that the seller will pay the brokerage fee on the change of ownership.

b. *Wrongful prevention:* **Provides** that the party wrongfully preventing the change of ownership will pay the brokerage fee.

Editor's note — The defaulting party pays all brokerage fees and the brokerage fee can only be altered or cancelled by mutual instructions from the buyer and seller.

15.2 *Fee sharing:* **Enter** the percentage share of the fee each broker is to receive.

Editor's note — The percentage share may be set based on an oral agreement between the brokers, by acceptance of the listing broker's MLS offer to a selling office to share a fee, or unilaterally by an agent when preparing the buyer's offer.

15.3 *Agency law disclosures:* **Check** the box to indicate a copy of the Agency Law Disclosure addendum for all parties to sign is attached. The disclosure is mandated to be acknowledged by the buyer with the offer and acknowledged by the seller on acceptance as a prerequisite to the brokers enforcing collection of the fee when the property involved contains one-to-four residential units. [See Form 305 accompanying Chapter 7]

15.4 *Disclosure of sales data:* **Authorizes** the brokers to report the transaction to trade associations or listing services.

16. *Other terms:* **Enter** any special provision to be included in the purchase agreement.

Agency confirmation:

Buyer's broker identification: **Enter** the name of the buyer's broker and his DRE license number. **Enter** the name of any selling agent and his DRE license number. **Obtain** the signature of the buyer's broker or the selling agent acting on behalf of the buyer's broker. **Check** the appropriate box to indicate the agency which was created by the broker's (and his agents') conduct with the parties. **Enter** the buyer's broker's address, telephone and fax numbers, and email address.

Seller's broker identification: **Enter** the name of the seller's broker and his DRE license number. **Enter** the name of any listing agent and his DRE license. **Obtain** the signature of the seller's broker or the listing agent acting on behalf of the seller's broker. **Check** the appropriate box to indicate the agency which was created by the broker's (and his agents') conduct with the parties. **Enter** the seller's broker's address, telephone and fax numbers, and email address.

Signatures:

Buyer's signature: If *additional* buyers are involved, **check** the box, prepare a Signature Page Addendum form referencing this purchase agreement, and **enter** their names and **obtain** their signatures until all buyers are individually named and have signed. **Enter** the date the buyer signs the purchase agreement and the buyer's name. **Obtain** the buyer's signature.

Seller's signature: If *additional* sellers are involved, **check** the box, prepare a Signature Page Addendum form referencing this purchase agreement, and **enter** their names and **obtain** their signatures until all sellers are individually named and have signed. **Enter** the date the seller signs the purchase agreement and the seller's name. **Obtain** the seller's signature.

Rejection of offer:

Should the offer contained in the purchase agreement be rejected instead of accepted, and the rejection will not result in a counteroffer, **enter** the date of the rejection and the names of the party rejecting the offer. **Obtain** the signatures of the party rejecting the offer.

Observations

As a policy of the publisher to provide users of **first tuesday** forms with maximum loss reduction protection, this purchase agreement **does not contain** clauses which tend to increase the risk of litigation or are generally felt to work against the best interests of the buyer, seller and broker. **Excluded provisions** include:

- an *attorney fee provision*, which tends to **promote litigation** and inhibit normal contracting;
- a *time-essence clause*, since future performance (closing) dates are, at best, estimates by the broker and his agents of the time needed to close and are too often **improperly used** by sellers in rising markets to cancel the transaction before the buyer or broker can reasonably comply with the terms of the purchase agreement [See Chapter 45];
- an *arbitration provision*, since arbitration decisions are **final and unappealable**, without any assurance the arbitrator's award will be fair or correct [See Chapter 50]; and
- a *liquidated damages provision*, since they **create wrongful** expectations of windfall profits for sellers and are nearly always forfeitures and unenforceable. [See Chapter 49]

Chapter 54 A formal exchange

This chapter explains a §1031 transaction where the ownership of properties is exchanged between two persons.

Structuring a comprehensible transaction

An **exchange of properties** is an arrangement structured as an agreement and entered into by two or more owners of real estate who agree to transfer the ownership of their properties between themselves in consideration for the value of the equity in the property received. Economic adjustments are made for any difference in the valuations given to the equities in the properties exchanged.

Thus, the owners of real estate, on entering into a written exchange agreement, agree to **sell and convey** their property to the other party. However, unlike a sale under a purchase agreement, the down payment is not in the form of cash. Instead, the down payment is the **equity in property** each owner will receive. The dollar amount of the down payment is the value given to the equity in the property to be received in exchange.

In an exchange of equities, as in the sale of property with a cash down payment, the **balance of the price** remaining unpaid, after deducting the equity downpayment and loan assumed, must be paid in some form of consideration. If a sales price is to be paid in cash, the balance of the price after the down payment is typically funded by a purchase-assist loan.

Unlike a sale calling for a cash down payment and an assumption of the loan of record, any balance remaining to be paid on the price is usually deferred, evidenced by a carryback note. The carryback note in a cash down payment sale presents no different *adjustment* situation than the carryback note in an "equity down payment" situation, called *balancing of equities*. The **equity adjustment** occurs in an exchange when an equity in one owner's property is used as a down payment toward the purchase of another property with a larger equity.

Also, unlike a cash sale which "frees up" the capital investment in real estate by converting the equity to cash proceeds on closing, an exchange is a clear manifestation of the owner's desire to **continue his investment** in real estate. In an exchange, the owner disposes of a property he no longer wants and acquires one he wants.

The owner might use his equity in an estate building plan to move up into property of greater value (and greater debt leverage), or simply to consolidate several properties the owner has that he exchanges to acquire a single, more efficiently operated property.

A contrast in thought and style

The **hallmarks of an exchange transaction**, in contrast to the common features of a sales transaction, include:

- the **exchange of equities** in real estate in lieu of a cash down payment;

- no **good-faith deposit** as cash is rarely used in an exchange of equities, except for prorations, adjustments (such as security deposits), transactional expenditures or as a "sweetener" to encourage an acceptance of the exchange offer, since the signature of each party binds them to perform on the exchange agreement and is the only consideration needed from each party to form a contract;

- a take-over of **existing financing** by an assumption of the loans or a transfer of title subject to the loans, rather than refinancing and incurring expenses that greatly increase the cost of reinvesting in real estate;

- **adjustments** brought about by the difference in the value of the equities exchanged, a balancing that requires the owner with the lesser valued equity to cover the difference in cash installments evidenced by the execution of a promissory note or the contribution of additional personal property or real estate of value;

- joint or **tandem escrows**, interrelated due to the conveyance of one property as consideration for the conveyance of the other property, similar in effect to a cash sale of a property when the closing is contingent on the sale of other property to obtain the funds needed to close escrow, a contingency that does occur in some delayed §1031 reinvestment plans;

- two sets of **brokerage fees**, one for each property involved in the exchange, rather than the receipt of a single fee as occurs in a cash-out sale of property;

- one party simultaneously selling and buying, a **coupling of two properties** consisting of a sale of one and purchase of the other, motivated primarily by the tax compulsion to remain invested in business or investment real estate, called *like-kind properties*, rather than cash out on the sale of one and later separately locate, analyze and purchase a replacement property with the cash proceeds of the sale, as occurs in a delayed "sell now/buy later" §1031 reinvestment plan; and

- **tax advice** from a real estate broker counseling on the profit tax avoidance of a coordinated, simultaneous reinvestment of the owner's equity in business or investment category real estate in a replacement property, thus avoiding the need to first locate a cash buyer to convert the equity to cash and then scramble to locate replacement property so the sales proceeds can be reinvested within a specific time period while avoiding receipt of the proceeds.

Commonality with a sale

The **common features** found in the acquisition of real estate by either a cash purchase or an exchange of equities include:

- a **disclosure** by the owner and listing broker of the conditions known to them about the property improvements, title, operation and natural hazards of the location which adversely affect the property's market value or the buyer's intended use of the property; and

- a **due diligence investigation** by the buyer acquiring title concerning his ownership, use and operation of the property.

As in all real estate transactions, a form is used to **prepare the offer** and commence written negotiations. The objective of a written agreement is to provide a comprehensive checklist of boilerplate provisions for the parties to consider in their offer, acceptance and counteroffer negotiations.

Also, the terms of an exchange agreement must be sufficiently complete and clear in their wording to prevent a misunderstanding or uncertainty over what the parties have agreed to do should the agreement require enforcement by one or the other party.

Once the brokerage process of locating a suitable replacement property has produced a property the owner is willing to acquire in exchange for the property he wants to dispose of, the broker prepares an exchange agreement on a preprinted or computer generated form. When prepared, the terms are reviewed with the owner, signed by the broker and the owner, and submitted to the owner of the replacement property for acceptance. [See **first tuesday** Form 171]

An exchange agreement form will only be used when an owner's equity in a property is offered as a **down payment** in exchange for replacement property. An owner who has already entered into a purchase agreement to sell his property to a cash buyer will make a separate offer to purchase a replacement property by using a purchase agreement form to reinvest the proceeds from his sale.

Locating properties for exchange

Taxwise, a client making an offer to exchange *like-kind* real estate usually plans to complete a fully qualified §1031 reinvestment. Thus, he will acquire real estate with **greater debt** and **greater equity** than exists in the property he now owns, a *trade-up* arrangement for estate building, not a piecemeal liquidation of his asset for a partial §1031 exemption.

When the exchange is a fully qualified §1031 reinvestment, all the profit in the property sold or exchanged is tax exempt.

Thus, the profit on the sale of the property is literally transferred, untaxed, to the replacement property since the entire cost basis in the property transfered (sold) is always carried forward to the replacement property acquired in the exchange.

In the quest to locate suitable replacement properties for a client, the listing broker marketing the client's property needs to locate properties which are owned by a person who will consider acquiring the client's property. In essence, the broker attempts to arrange a transaction which will **match two owners** and their properties, a somewhat daunting task requiring a constant search for properties whose owners are willing to take other property in exchange.

To locate such an exchange-minded owner who is willing to consider owning the client's property, the listing broker is nearly always limited to those owners known to the broker to have acceptable replacement property or have listed their properties with other brokers. Hopefully, the other brokers have **counseled their clients** on an exchange of properties.

The most productive environment for locating owners of qualifying properties who have an interest in acquiring the client's property seems to exist at marketing sessions attended by licensed brokers and agents. At these meetings, they "pitch" their listings and advise attendees about the types of property their clients will accept in an exchange.

Multiple listing service (MLS) printouts, websites and large brokerage firms with income property sales sections also help in the process of locating qualifying properties. However, the agent considering an exchange usually needs to make a personal contact with the agent who represents the owner of suitable property to determine the likelihood of that owner entering into an exchange.

To get an initial response from other brokers and agents regarding the inclination of their owners to exchange, a preliminary inquiry about a **possible match up** of properties and owners can be made in the

form of a written proposal. The proposal should precede any analysis or investigation into the property listed by the other broker, and include only its type, size and location to qualify it as a potential match for the client.

Prudently, an offer to exchange would not be prepared and submitted before getting a reading on the other owner's willingness to consider an exchange of properties, and more particularly, an exchange for a property of the type owned by the client.

To inquire of another broker or agent into the possibility of an exchange and at the same time document the inquiry for further reference, a **preliminary proposal form** is often prepared and personally handed or faxed to the other broker or agent. The proposal will note the type of properties involved, their equities and debt, and arrange for the exchange of information or a discussion between the agents before preparing an exchange agreement. [See **first tuesday** Form 170]

The preliminary proposal is not an offer and does not contain contract wording. The clients are not involved in the proposal, only the brokers. Their effort is to locate properties to be submitted to their clients for exchange consideration. Only after the probability of actually entering into an exchange is established will an exchange agreement offer be prepared, signed by the client and submitted for acceptance.

Equity valuation adjustments

Once replacement property is located and its owner has indicated a willingness to consider an exchange of properties, the dollar amount of the market value of each property must be established. Once the market value of each property is established, the value of the equity in each can be set. **Valuation** is the single most important task in negotiating an agreement to exchange.

Until a consensus exists between the owners about the value of the equity in each owner's property, negotiations tend not to go forward. Without an agreement on valuation, it follows that the amount of the **adjustment** for any difference between the equities in each property to the exchange cannot be set. Property disclosures and due diligence investigations tend to fall in place only when the values of the equities have been agreed to.

The broker begins negotiations to set the dollar amount of equity each owner has in his property by preparing an **exchange agreement offer**. The offer is based on the owner's and the broker's analysis of valuations, including:

- the **market value** (price) of each property to be exchanged [See **first tuesday** Form 171 §1.3 and 2.3];

- the **loan amounts** encumbering each owner's property, whether or not they are to remain of record; and

- the **equity valuations** calculated as the market value of each property less the amount of loans of record.

Having stated the present value of the equity in each property (as viewed by the owner), adjustments need to be entered in the offer to cover the difference between the equity valuations in each property.

Since the equities in properties exchanged rarely are of the same dollar amount, adjustments will nearly always have to be negotiated. Thus, a contribution of **money** (cash or carryback promissory notes) or **other property**, collectively called *cash boot*, must be given by the owner of the property with the lesser amount of equity value, a consideration paid in a process called *adjusting* or *balancing the equities*.

Thus, the owner of the property with the larger amount of equity will receive one or more **cash items** as consideration for the adjustment, including:

- cash;
- carryback note; or
- other property, either real or personal, with a dollar amount of value.

Regarding the existence of financing which encumbers the properties being exchanged, negotiations may call for the loans to remain of record or be paid off and reconveyed.

Refinancing of the replacement property may be necessary to generate cash funds for the payoff and reconveyance of the loans now encumbering the property. A contingency provision for new financing is needed if additional cash for the payoff of loans is required.

Cultivating an exchange environment

Consider an agent who has a working knowledge of income property transactions in the region surrounding his office. The agent regularly attends marketing sessions and visits with brokers and agents whose clients have properties they would like to convert to cash or exchange for other properties.

An investor who is an acquaintance of the agent is known to the agent to be unhappy with the management aspect of a smaller residential rental property he owns. The investor would prefer to own a single-user property requiring little of his time to oversee maintenance and repairs.

Discussions the agent has with the investor about selling the units and locating a more suitable property to meet the investor's ownership objectives culminates in a listing of the property with the agent (on behalf of his broker).

A *reinvestment provision* is included in the listing calling for the location and acquisition of replacement property to provide the continuing investment in real estate required to qualify the sale for the Internal Revenue Code (IRC) §1031 exemption from any profit tax. The investor has owned the property for quite some time and his basis is low compared to the property's present market value.

Soon the agent locates an industrial property which is owned by a businessman whose company occupies the entire building. The property is listed with another broker who explains his client would be willing to lease back the property from the buyer rather than move to other premises. The businessman's broker knows his client's objective is to reduce his debt so he can enlarge the credit line for his business.

On inquiry as to whether the businessman would take residential income units (with a much smaller loan) in exchange for his property, the agent gets a positive response. It happens the businessman owns other residential properties and their management does not pose a problem for him.

Preliminary due diligence investigation

Information on the properties is exchanged. The investor's units are priced at $600,000 with a debt of $200,000 and an equity valued at $400,000. The industrial building belonging to the businessman is listed at $1,200,000 subject to a loan of $700,000 with an equity of $500,000.

When data on the industrial property is reviewed with the investor as a probable replacement property under a net lease with the owner/occupant, the investor indicates it is just the situation he is looking for. He will be acquiring a property with a higher value to add to his investment portfolio and the demands on management will be minimal. The flow of rental income will cover payments on the loan and generate spendable income. The agent then conducts preliminary investigations into the property and the loan encumbering it.

The agent prepares an exchange offer. Besides the routine due diligence investigation into each property and typical contingencies and closing provisions, the agent needs to negotiate the **adjustment** for the $100,000 difference between the equities in the two properties and the **terms of a lease** for the businessman's continued occupancy of the industrial building.

Thus, the consideration the investor will offer to pay the price of $1,200,000 for the industrial property includes:

- the $400,000 equity in his residential units;
- an assumption of the $700,000 loan on the industrial building; and
- execution of a $100,000 note in favor of the businessman, the adjustment necessary to balance the equities between the two properties exchanged.

Thus, the total consideration offered by the investor to buy the industrial building is $1,200,000.

Conversely, the consideration the investor wants from the businessman in exchange for the investor's residential units and the investor's execution of a carryback note in favor of the businessman includes:

- the $500,000 equity in the industrial property;
- an assumption of the $200,000 loan on the residential units; and
- a $100,000 **offset** by the investor's execution of a carryback note to be secured by the industrial property.

Thus, the total consideration the businessman will pay for the residential units on acceptance of this offer is $600,000.

The **leaseback arrangements** offered by the investor are based on the market value of the industrial property and rents paid for comparable properties. The terms of the lease are set out in an addendum attached to the exchange agreement offer.

The offer is submitted to the broker representing the businessman. In turn, a counteroffer is submitted to the investor based on all the terms of the exchange agreement, modified as follows:

- the carryback note provision is deleted; and

- the amount of $100,000 in cash is to be paid to adjust the equities.

Ultimately, escrow is opened based on an adjustment in the amount of $90,000; comprised of a $50,000 note and $40,000 in cash and a price reduction for the $10,000 difference. Talented Californian real estate agents can be clever when pushed to be creative.

Chapter 55 Real estate purchase options

This chapter demonstrates the use and effect of option-to-buy agreements in real estate sales.

An irrevocable offer to sell

A real estate syndicator searching for investment-grade, income-producing real estate locates a property which appears to be financially suitable for a group investment, a real estate brokerage activity called *syndication*.

However, the syndicator will not commit himself to the purchase of the property until he has **fully investigated** the condition of the improvements, the property's operations and the availability of mortgage financing, an effort called *due diligence*.

Further, on completing his due diligence investigation, and if conditions are found to be acceptable, the syndicator will need additional time to prepare an **investment memorandum** and to **locate investors**. The memo will contain his narrative report on the significant information he has gathered concerning the worth of the property. The report will be circulated among equity investors as a solicitation to form a group to fund the acquisition of the property for long-term ownership.

First, before the syndicator begins his in-depth analysis of the property, he needs to enter into an enforceable purchase agreement with the seller. Without an agreement to acquire the property, the property may be sold to someone else before he can complete his investigation and determine the property is suitable for acquisition. For the same reasons, the syndicator chooses not to engage in the use of a letter of intent. [See **first tuesday** Form 185]

To acquire the right to buy the property without unconditionally committing himself to purchase the property, the syndicator submits an offer which calls for the occurrence of several events before he becomes committed to the purchase of the property in provisions called *contingency provisions*.

The **contingency provisions** include approval of the property's physical condition, its leasing income and operating expenses, available mortgage financing, title and zoning restrictions on use, and the existence of equity investors to fund the closing.

The seller fully understands the contingencies are designed primarily to enable the syndicator to confirm his understanding of the property's condition as represented by the seller and to obtain the mortgage and equity financing needed to fund the close of escrow. However, the seller is concerned the syndicator's inability to satisfy and remove the contingencies could interfere with the seller's ability to promptly cancel the agreement should the syndicator fail to close or cancel the transaction by the date scheduled for closing.

The seller decides not to accept the syndicator's purchase offer due to uncertainty regarding the syndicator's timely performance.

The option to buy as a counteroffer

However, the seller is willing to grant the syndicator an **option to buy** the property at the same price and for the same time period sought by the syndicator in his offer to purchase. Thus, the seller counters the offer.

Here, a counteroffer form will not be used to respond to the syndicator's offer. A counteroffer would incorporate the terms of the syndicator's purchase offer, subject to any modifications stated in the counteroffer.

In this situation, the seller simply prepares and hands the syndicator an **offer to grant an option**. Thus, the seller *rejects* the syndicator's offer in its entirety. [See Form 160 accompanying this chapter]

The seller's offer to grant an option requires the syndicator to accept the offer and the terms of the proposed option agreement before the seller is bound to deliver the signed option agreement. To accept the seller's offer to grant an option, the syndicator must sign the acceptance provision in the offer and return it to the seller. Of course, the acceptance must occur before expiration of the seller's offer to grant the option.

For the syndicator, his purchase of an option to buy property imposes no obligation on him to open escrow and purchase the property. Unlike a real estate purchase agreement, the buyer holding an option to buy has **no obligation to purchase** the property.

Conversely, the option contains the seller's irrevocable offer which **obligates the seller to sell** the property on the terms stated in the option agreement should the syndicator decide to buy the property within a set period of time, called the *option period*. The syndicator only agrees to buy the property when he **timely accepts** the seller's irrevocable offer to sell, an acceptance called *exercising the option*.

In exchange for the seller granting an option on the property, the syndicator will pay the seller *option money*. The amount of option money is the price the syndicator pays to **buy the option** and "tie up" the property by removing it from the market. [See Figure 1 accompanying this chapter]

Thus, the option agreement allows the syndicator to control the property without committing himself to purchase it until he exercises the option, if ever. His completion of the property analysis and solicitation of investors will indicate whether he will exercise the option or not.

However, when the syndicator exercises the option, a *bilateral sales contract* is automatically formed, no differently than had he accepted an offer from the seller to sell the property under a purchase agreement containing nearly identical terms. Thus, on exercise, both parties become obligated to perform as agreed and must proceed with closing the sale since no contingencies exist. [**Caras** v. **Parker** (1957) 149 CA2d 621]

Should the syndicator let the option period expire without exercising the option, the seller will be able to sell the property to another buyer, unaffected by the option since the seller's irrevocable offer to sell represented by the option has expired.

In an option agreement, the owner is referred to as the *optionor* and the potential buyer is referred to as the *optionee*. They become the seller and buyer, respectively, on exercise of the option.

Editor's note — An option granted to a buyer is to be distinguished from an exclusive right-to-sell listing granted to a broker. On entering into a listing, the seller incurs no obligation to sell the property to anyone.

OFFER TO GRANT AN OPTION

and Option Money Receipt

NOTE: Recommended for use with **ft** Form 161 or 161-1.

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. On acceptance of this offer, _____, as the Optionor,

1.1 to grant, _____, as the Optionee,

1.2 an option to purchase property on terms and conditions set forth in the attached option agreement,

1.3 regarding property situated in the City of _____, County of _____, California,

1.4 referred to as _____.

TERMS:

2. This offer is conditioned on the tender of option money by Optionee in the sum of $_____, evidenced by: ☐ cash, ☐ cashier's check, ☐ personal check, ☐ _____, payable to Optionor to be held by Broker, undeposited, until delivery to Optionee of the option agreement signed by Optionor.

3. ☐ Parties to sign attached carryback disclosure statement which is a part of this agreement. (Mandatory if under the terms of the option, Optionor is to carry back paper on four-or-less residential units.) [See **ft** Form 300]

3.1 ☐ Optionee to hand Optionor a completed credit application on acceptance. [See **ft** Form 183] Optionor may terminate this agreement within _____ days of acceptance by delivering to Optionee, Optionee's Broker or Escrow, a written Notice of Cancellation based on disapproval of Optionee's credit. [See **ft** Form 183]

4. Seller's *Natural Hazard Disclosure Statement* [See **ft** Form 314] ☐ is attached, or ☐ is to be handed to Buyer on acceptance for Buyer's review, in which case Buyer may terminate the agreement within ten days of receipt based on a reasonable disapproval of hazards disclosed by the statement and unknown to Buyer prior to acceptance of this offer. [See **ft** Form 183]

5. On acceptance of this offer, the below mentioned Broker(s) are to be paid a fee of _____ by ☐ Optionor, or ☐ Optionee. Optionor's Broker and Optionee's Broker, respectively, shall share the fee on the following ratio _____:_____.

6. This offer for option shall be deemed revoked unless accepted in writing by signing this offer and its attachment(s) and delivering same to the party making this offer or their broker on or before _____, 20_____.

OPTIONOR'S BROKER: _____	**OPTIONEE'S BROKER:** _____
Broker's DRE Identification #: _____	Broker's DRE Identification #: _____
Agent's Name: _____	Agent's Name: _____
Agent's DRE Identification #: _____	Agent's DRE Identification #: _____
Signature: _____	Signature: _____
Is the agent of: ☐ Optionor exclusively. ☐ Both Optionor and Optionee.	Is the agent of: ☐ Optionee exclusively. ☐ Both Optionor and Optionee.
Address: _____	Address: _____
Phone: _____ Fax: _____	Phone: _____ Fax: _____
Email: _____	Email: _____

OPTIONOR:	**OPTIONEE:**
I agree to grant this option on the terms stated above.	**I accept this option on the terms stated above.**
☐ See attached Signature Page Addendum. [**ft** Form 251]	☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: _____ 20_____	Date: _____, 20_____
Signature: _____	Signature: _____
Signature: _____	Signature: _____

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The owner has only employed the broker as his agent to find a buyer and represent the seller in negotiations. The broker has not received the power-of-attorney authority needed to commit the seller to a sale of the property and the listing is not an offer to sell anything.

Granting an option

Consider a broker who is employed by a seller under a listing agreement which states the broker will receive a fee if he negotiates a sale, exchange or the grant of an **option to purchase** the seller's property. [See Form 102 §10 accompanying Chapter 9]

An agent of the broker locates a qualified buyer. The seller grants the buyer, also called an *optionee*, an option on the receipt of *option money* paid by the buyer. The broker receives no fee on the grant of the option, although he is entitled to a fee under the listing. Also, the option does not contain a fee provision.

After the listing expires, the buyer exercises the option and acquires the property.

The broker makes a demand on the seller for a fee under the listing agreement. The seller refuses, claiming the broker is not entitled to a fee since the buyer exercised the option after the listing agreement expired and the option did not provide for a fee on its exercise.

Here, the broker did earn a fee. During the listing period, the seller granted the buyer an option to buy the property, which the buyer later exercised to acquire the property. [**Anthony** v. **Enzler** (1976) 61 CA3d 872]

Thus, when an option is exercised, the sale relates back to the **time the option was granted**, i.e., during the listing period. This *relation back* is roughly comparable to entering into a purchase agreement or opening an escrow during the listing period, and closing the transaction after the listing expires.

Alternatively, consider a seller who agrees to pay a broker a partial fee on the granting of an option without any reference to payment of a further fee on the exercise of the option. To avoid the lost expectations of the payment of a further fee on exercise, the broker or his agent must then include a fee provision in the body of the option. [See Form 160 §6]

Benefits for opposing positions

An option agreement provides benefits for both buyer and seller.

A **buyer** should consider acquiring an option when:

- he does not yet want to commit himself to buy;
- he is speculating in a depressed market that values will soon rise;
- he needs time to investigate and determine whether the property will operate profitably;
- he needs time to do promotional work such as syndicating, subdividing, rezoning, obtaining permits or loan commitments, or to complete a §1031 reinvestment; or
- he is a tenant and may want to own the leased premises some day.

A **seller** should consider granting an option when:

Figure 1

STANDARD OPTION TO PURCHASE
Irrevocable Right-to-Buy

DATE: _____, 20_____, at _____, California.
Items left blank or unchecked are not applicable.

1. **OPTION MONEY:**
Optionor herewith receives from Optionee option money in the amount of $_____, evidenced by: ☐ cash, ☐ check, or ☐ _____, given in consideration for this option to purchase real property.

2. **REAL PROPERTY UNDER OPTION:**
Address _____
Legal description/Assessor's parcel number _____

3. **ADDITIONAL CONSIDERATION:**
As further consideration for this option, Optionee is to obtain at his expense and deliver to Optionor prior to expiration of this option the following checked items regarding the property:
☐ Property survey report by licensed California surveyors
☐ Architectural plans and specifications
☐ Zoning ordinance request
☐ On-site engineering plans
☐ Application for a parcel map or waiver
☐ Off-site improvement plans
☐ Soil engineer's report
☐ Land use study
☐ Application for a conditional use permit
☐ _____

4. **OPTION PERIOD:**
Optionor hereby grants to Optionee the irrevocable option to purchase the Optionor's right, title and interest in the property on the terms stated, for a period commencing with the acceptance of this option and expiring _____, 20_____, or ☐ on termination of the optionee's leasehold interest in the property.

5. **EXERCISE OF OPTION:**
Optionee may exercise this option during the option period by:
5.1 Signing escrow instructions identical in provisions to those attached as **Exhibit A** and delivering the instructions to escrow [See **ft** Form 401];
5.2 Depositing cash in escrow of $_____; and
5.3 Delivering an escrow-certified copy of the signed escrow instructions to Optionor within the option period, in person or by both certified and regular mail.

6. **ESCROW CONTRACT:**
In the event this option is exercised, the transaction shall be escrowed with _____.
6.1 Escrow shall close within _____ days after exercise.

7. **DELIVERY OF TITLE:**
On Optionee's exercise of this option, Optionor shall timely place all documents and instruments into escrow required of the Optionor as necessary for escrow to close as scheduled.

8. **BROKERAGE FEE:**
Optionor agrees to pay a brokerage fee of $_____, or _____% of the selling price, IF:
8.1 This option is exercised;
8.2 Within one year after expiration of option period and any extension or renewal, Optionor enters into an agreement to option, sell, lease or exchange with Optionee, or their assigns or successors; or
8.3 Optionor wrongfully prevents the exercise of this option;
8.4 Payable to Broker(s) _____

OPTIONOR'S BROKER: _____	**OPTIONEE'S BROKER:** _____
Broker's DRE Identification #: _____	Broker's DRE Identification #: _____
Agent's Name: _____	Agent's Name: _____
Agent's DRE Identification #: _____	Agent's DRE Identification #: _____
Signature: _____	Signature: _____
Is the agent of: ☐ Optionor exclusively. ☐ Both Optionor and Optionee.	Is the agent of: ☐ Optionee exclusively. ☐ Both Optionor and Optionee.
Address: _____	Address: _____
Phone: _____ Fax: _____	Phone: _____ Fax: _____
Email: _____	Email: _____

9. **SALE TERMS:**
Price of $_____ payable as follows:
9.1 ☐ All cash.
9.2 Cash down payment in the amount of $_____.
9.3 ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by _____, with an unpaid principal balance of $_____, payable $_____ monthly, including interest not exceeding _____%, ☐ ARM, type _____, plus a monthly tax/insurance impound payment of $_____. _____
a. At closing, loan balance differences per beneficiary statement(s) to be adjusted into: ☐ cash, ☐ carryback note, or ☐ sales price.
b. The impound account to be transferred: ☐ charged, or ☐ without charge, to Optionee.
9.4 ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by _____, with an unpaid principal balance of $_____, payable $_____ monthly, including interest not exceeding _____%, ☐ ARM, type _____, due _____, 20_____.
9.5 A note for the balance of the purchase price in the amount of $_____ to be executed by Optionee in favor of Optionor and secured by a trust deed on the property junior to the above referenced financing, payable $_____ monthly, or more, beginning one month after closing, including interest at _____% per annum from closing, due _____ years after closing.
a. This note and trust deed to contain provisions to be provided by Optionor for: ☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐_____
b. ☐ The attached Carryback Disclosure Statement is an addendum to this agreement (mandatory on four-or-less residential units). [See **ft** Form 300]
c. ☐ Optionee to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **ft** Form 412]

10. **GENERAL PROVISIONS:**
10.1 ☐ **See attached addendum for additional provisions.** [See **ft** Form 250]
10.2 Attached as addenda are the following checked disclosures mandated on four-or-less residential units:
a. ☐ Condition of Property Disclosure — Transfer Disclosure Statement (TDS) [See **ft** Form 304]
b. ☐ Natural Hazard Disclosure Statement [See **ft** Form 314]
c. ☐ Disclosure of sexual predator database [See **ft** Form 319]
d. ☐ Hazard Disclosure Booklet, and related Optionor disclosures, containing Environmental Hazards, Lead-based Paint and Earthquake Safety [See **ft** Forms 313 and 315]
e. ☐ Documentation on any Homeowners' Association (HOA) involved.
f. ☐ Notice of Supplemental Property Tax Bill [See **ft** Form 317]
10.3 Possession of the property to be delivered on: ☐ close of escrow, or ☐ see attached Occupancy Agreement. [See **ft** Forms 271 and 272]
10.4 Both parties reserve their rights to assign, and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow, on either party's written notice.

11. **EXPIRATION OF OPTION:**
This offer to sell shall be deemed expired if not accepted by exercise during the option period.
11.1 This option contract shall automatically terminate by expiration on _____, 20_____.

I hereby grant this option and agree to the terms stated above.	**I hereby accept this option and agree to the terms stated above.**
Date: _____, 20_____	Date: _____, 20_____
Optionor: _____	Optionee: _____
Signature: _____	Signature: _____
Signature: _____	Signature: _____
Address: _____	Address: _____
Phone: _____ Fax: _____	Phone: _____ Fax: _____
Email: _____	Email: _____

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- he wants to retain ownership rights to the property for a fixed period into the future (for tax purposes);
- he wants to sell at a price based on higher future market values;
- he needs to provide an incentive to induce a prospective tenant to lease the property; or
- he wants to give a promoter incentive to work up a marketing or use plan and buy the property.

Multiple option periods

Developers require a longer initial option period, or the right to extend the option period, to provide time in which to study a property, obtain government clearances and locate financing for development. If these objectives are met, the developer will be able to purchase the property on a previously agreed set of terms.

Thus, it is foreseeable a developer may need **additional time** beyond the initial option period to complete his due diligence and approval process before committing himself to the purchase of the "optioned" property. Here, the option agreement should include the right to buy one or more extensions of the option period on the payment of additional option money before the expiration of the preceding option period. [See **first tuesday** Form 161-1]

The developer who determines he will be unable to develop or to successfully market a development of the property will simply not exercise the option.

Lease with option

The other significant use of an option to buy relates to residential and nonresidential leasing arrangements. Prospective tenants might want the ability to later acquire ownership of the property they will be occupying.

Tenants often need to invest substantial dollar amounts in tenant improvements to tailor the property to the tenant's needs. Whether contracted for by the tenant or the landlord, the tenant pays for the improvements either by a lump sum, upfront expenditure or by payments amortized over the initial life of the lease as part of the monthly rent.

Also, installation of racks, cabinets, shelving, trade fixtures, lighting and other interior improvements will be needed to make the premises fully compatible for the tenant's occupancy. These too will be paid for by the tenant. Always, a degree of "goodwill" is built up with customers due to the location of the business on the property. Thus, the location becomes part of the value of the tenant's business so long as he remains at the location.

All these opportunities will be lost if the landlord refuses to extend the lease or his demands for increased rent under an option to extend the lease compels the tenant to relocate. A tenant with even a small degree of insight into his future operations at the location will attempt to negotiate some sort of option to purchase the property. At least an option to renew at lesser rental rates should be negotiated, as the tenant improvements (TIs) have been paid for by the tenant and the landlord has fully recovered any costs he may have incurred.

A lease with an option to purchase must be distinguished from the purchase rights held by a tenant under a right of first refusal agreement or a buyer under a lease-option sales arrangement. [See **first tuesday** Forms 163 and 579]

Option money as the consideration needed

An option agreement is not enforceable unless a seller receives some sort of consideration. Unless the seller is given something in exchange for the right he has *surrendered* to revoke his offer to sell or to sell the property to others, the option fails for *lack of consideration*. Without the payment of consideration, the agreement is merely an offer to sell which may be **withdrawn at any time** by the seller. [**Kowal** v. **Day** (1971) 20 CA3d 720]

While consideration is needed to create an option agreement which is binding on the seller, the **amount of the consideration** paid for an option may be a minimal amount. An enforceable option can be created for as little as 25 cents paid by a buyer.

Also, the consideration given for the option does not need to be in cash. For instance, when an option to purchase is granted to a tenant who enters into a lease, the consideration given for the grant of the option rights is the tenant's signature obligating the tenant to perform on the lease.

In the case of a syndicator or developer using an option to control property he is not yet certain he wants to purchase, the consideration is the option money paid to the seller to grant the irrevocable offer to sell. The option money is typically set at an amount which will compensate the seller for the time the property is kept off the market, similar to a payment of rent or interest (less any actual and implicit income produced for the owner by the property).

Often a small amount of option money is paid for a short initial option period, sometimes called a "free-look" period. The term of the free-look option may be twenty to thirty days, granted on the payment of a small amount of option money, such as $100.

If the buyer is given extensions to continue the option after the free-look period, he usually is required to put up a more substantial amount of option money.

Any number of additional option periods may be agreed to, one following the expiration of another. The number of extensions depends only on the seller's willingness to grant the extensions and the buyer's willingness to put up more option money to pay for those extensions. [See **first tuesday** Form 161-1]

Sufficiency of terms for enforcement

While consideration is necessary for a purchase option to be enforceable, a method for payment of the **purchase price** or a **closing date** are not.

Consider an owner and a tenant who sign a lease agreement granting the tenant an option to purchase the leased property.

The option includes the identities of both parties, a description of the property, and the price to be paid, but is silent on the escrow period for delivery of the price and deed after exercise of the option.

The tenant timely exercises the option and escrow is opened.

The owner responds by placing conditions on the escrow period not included in the option, negotiating to prolong the close of escrow until he locates a §1031 exchange replacement property.

The tenant counters, attempting to resolve the owner's demand for an **extended escrow** and his need to record a purchase-assist loan to fund the purchase price.

The owner then refuses to perform, claiming the option cannot be enforced since ongoing negotiations to resolve the time for payment of the price and delivery of the deed are essential terms and did not exist in the option.

Does the lack of terms regarding time for payment of the price and the delivery of the deed make the purchase option unenforceable?

No! An option agreement need only identify the parties involved, the property in question, and the price to be paid. When the option does not state the method for payment of the price or the length of the escrow period, the method for payment of the price is *implied* to be cash through escrow, and the time for payment of the price in exchange for the deed is *implied* to be of a **reasonable time period** (60 days) after exercise of the option. [**Patel** v. **Liebermensch** (2008) 45 C4th 344]

Exercising the option

Unless a particular **manner for exercising** the option is specified in the option agreement, any communication from a buyer to a seller of his intention to exercise the option is sufficient. [**Riverside Fence Co.** v. **Novak** (1969) 273 CA2d 656]

However, if the option agreement requires the buyer to take specific steps to exercise the option, the buyer must follow the **conditions set** in order to exercise the option and acquire the property. [**Palo Alto Town & Country Village, Inc.** v. **BBTC Company** (1974) 11 C3d 494]

For instance, an option agreement should require a buyer to sign escrow instructions and deposit cash in escrow to exercise the option. If the instructions are not signed, or if signed and the deposit is not made, the option has not been exercised. Thus, the buyer has not exercised his right to acquire the property.

Proposed escrow instructions should be prepared and attached as an addendum to the option agreement to avoid any conflict over the content of the instructions required to be entered into to exercise the option. The instructions will remain unnumbered, undated and unsigned until exercise of the option. [See Form 401 accompanying Chapter 59]

The escrow opened to exercise an option should call for escrow to close within a short period of time, i.e., the number of days required to prepare documents, order title reports and close. Unless an option agreement requires the buyer to sign escrow instructions, deposit funds and close escrow within a short period of time, the buyer's exercise of the option merely creates an enforceable bilateral purchase agreement with no escrow, funds or clear closing date.

Recording the option

When a purchase option or **memorandum** of the option is recorded, it becomes part of the property's chain of title, imparting *constructive notice* of the outstanding option rights to anyone later obtaining an interest in the property. A buyer, lender or tenant acquiring an interest in the property with **actual or constructive notice** of the existence of an option to purchase the property takes his interest in the property **subject to** the buyer's option rights.

Conversely, a buyer, lender or tenant who does not have actual knowledge of an unrecorded and unexpired option, takes his interest in the property free of the option.

For example, a seller grants a buyer an option to purchase property. Before the option is recorded or the buyer takes possession, the seller conveys the property to a second buyer. The second buyer did not have actual knowledge of the first buyer's option on the property.

The buyer who was granted the option later exercises the option by depositing the full amount of the purchase price into an escrow he has opened as agreed in the option agreement.

However, the seller who granted the option is no longer the owner of the property. Thus, he has no interest in the property to convey. Also, the option agreement is not enforceable against the second buyer since the second buyer, who is now the owner of the property, had no knowledge of the first buyer's option when he acquired ownership.

Thus, the conveyance of the property to the second buyer without notice of the unexpired option wiped out the first buyer's right to buy the property under the option. [**Utley** v. **Smith** (1955) 134 CA2d 448]

A recorded option **ceases to constitute constructive notice** of a buyer's option rights when:

- six months have run after the expiration date stated in the recorded option agreement or memorandum without the prior recording of an *exercise* or *extension* of the option; or

- six months have run after the option or memorandum was recorded should the expiration date not be stated in the recorded option agreement or memorandum. [Calif. Civil Code §884.010]

The purpose for the extinguishment of the recorded option from title is to protect buyers and sellers of property from old, unexercised and expired option rights which are of record. No such statutory scheme exists for the "outlawing" of unrecorded options which have expired.

Chapter 56 Vesting the ownership

This chapter introduces the various vestings for holding title, the ownership rights reflected by the vestings, and their termination by any right of survivorship on death of a co-owner.

Possession and transfer rights

All parcels of real estate have a recorded history. California's real estate history began with its admittance into the Union, when the United States of America became the initial owner of all the land. Titles were "proven up" by individuals in federal courts or with government agencies who issued *certificates of title* based on comparable rights held by the individuals under prior Spanish, Mexican or California sovereign law.

Thus began the **recorded history of title** to each parcel in California. Parcels are now identified by the assessor of each county by a parcel number.

A conveyance by the vested owner of a parcel effectively transfers title to the next owner if the person conveying "title" holds title under a prior conveyance transferring title into his name. Thus, for each parcel a linkage exists in title from the beginning of the state of California to the present. The "chain of title" for a parcel reflects a conveyance by each person who previously took title to the property, from themselves to the next vested owner of title, and on to the present holder of title.

The initial focus for an analysis of a transfer of title in a sales transaction is on the person who is conveying title, not the new owner who is taking title. If the person conveying does not hold a good and **marketable (insurable) title** to the property and have the authority to convey it, the transfer to the new owner is defective, if not ineffective.

Today, the ability of the current owner to transfer title is the concern of the title companies. Title insurers issue policies covering the risk regarding whether the transfer of the ownership interest bargained for by the new owner has occurred. Title company analysis of this *conveyancing risk* is based on the nature and validity of the **present owner's vesting**, usually established when that owner took title.

The vesting used to take title when a person acquires ownership establishes the rules controlling his later conveyance of an interest in the property to another.

Thus, the text of this chapter focuses on the **vesting used to acquire** an interest in real estate under a deed, lease or trust deed.

The time for setting the vesting

Consider a buyer who has entered into a purchase agreement and escrow instructions. The purchase agreement states the buyer will take title in the condition agreed and as insured by a title insurer under a policy of title insurance. The **precise vesting** the buyer will use does not need to be stated in the purchase agreement.

However, escrow will include the exact wording of the vesting to be used by the buyer in the mutual instructions signed by both the seller and buyer.

The **vesting chosen** by the buyer is never a condition of the purchase agreement or escrow. The vesting on conveyance may be chosen (or unilaterally altered) by the buyer at any time prior to closing (but in sufficient time for preparation of the deed, signature by the sellers and acknowledgement by a notary prior to the date scheduled for closing).

Escrows prefer to draft the deed to be signed by the seller when escrow instructions are prepared. Thus, an early decision by the buyer about his vesting is necessary to accommodate the escrow process.

Hence, the buyer's agent needs to possess a working **knowledge of vestings** to be able to advise the buyer on the vestings available to the buyer so the agent is able to aid in the selection of the vesting desired before dictating instructions to escrow.

A person or persons take title

Real estate is owned by a *person* or *persons*, who by definition is either an **individual** (or individuals) or an **entity**, such as a corporation, limited liability company (LLC) or partnership. Trusts are not entities in California unless they have been qualified as a corporation by the Department of Corporations. Thus, the **beneficiary** of the trust relationship, be it an individual or an entity, is the *owner* of the real estate in spite of the vesting being in the name of a third person as trustee.

Further, **ownership** by an individual or entity is classified as either:

- a *sole ownership*, legally called an *ownership in severalty* [Calif. Civil Code §681]; or
- a *co-ownership* of two or more persons.

Sole ownership is reflected by use of a vesting naming an individual or entity as the one person entitled to ownership of the entire property described in the conveyance transferring title to that person. The **one person named** in this vesting context could be a married individual who owns property as the separate property of the married individual.

Co-ownerships exist for *individuals* in two fashions:

- as *vested co-owners* on title; or
- as *co-owners* of an **entity**, which is itself the vested owner holding title to the property.

Co-owners vest title in their individual names under one of only four types of ownership available for property located in California:

- as joint tenants;
- as tenants in partnership;
- as tenants in common; and
- as community property, with or without the right of survivorship. [CC §§682, 683]

No other co-ownership vesting exists for individuals. Thus, the **trust vestings** which exist provide for one person as *trustee* to hold title for the true owner(s) who are named as *beneficiary(ies)* under a title holding agreement the owner has entered into with the trustee. The trust agreement spells out owner-

ship arrangements which are either the same as one of the four co-ownership interests provided by the vestings listed above or distinguishable from them, such as a subordinated ownership interest, priority distributions, allocation of tax benefits, etc., typical of co-ownership arrangements for an entity.

Finally, **community property ownership** has two available vestings:

- husband and wife as community property; and
- husband and wife as community property with the right of survivorship.

The community property vestings are only available to married couples.

Possessory rights of co-owners

Each co-owner of property has the right to:

- **possess** the entire property himself, to the extent it is not already possessed or leased to others by another co-owner;
- **lease** his possessory right to occupy and use the entire property to a tenant, except for community property since the lease is subject to being set aside by a nonconsenting spouse within one year after its commencement;
- **sell** his ownership interest in the property without the need for prior notice to or the consent of the other co-owners, except for community property or a co-owner who has agreed to the contrary; and
- **encumber** his ownership interest in the property without the consent of his co-owners, except for community property or when prohibited by a co-ownership agreement.

On the other hand, a co-owner has obligations to other co-owners not to:

- **exclude other** co-owners from their right to possession of any part of the property [**Oberwise** v. **Poulos** (1932) 124 CA 247]; or
- **create an easement** on the property against a co-owner.

Tenancy in common

Should the type of vesting not be stated when two or more persons take title to real estate, the co-owners are presumed to be *tenants in common*, a sort of **default vesting** attributed to their ownership. However, if the co-owners are husband and wife and title is not vested as a tenancy in common, the property is presumed to be *community property*. Also, if the conduct of the co-owners is in fact that of partners, the property ownership is subject to the rights of a tenancy in partnership. [CC §686]

Thus, a tenancy-in-common vesting is the form of ownership used by two or more persons, with an **equal or disproportionate share** of ownership in the property as the separate property of each, when they do not intend their relationship to be that of joint tenants on death or of partners for profit. Further, the property is not acquired as a community property asset. [CC §685]

If the fractional co-ownership interest held by each co-owner was transferred to them at the same time, by the same deed and in equal shares, e.g., 1/3, 1/3 and 1/3, on the recording of one deed, then the only distinction between vesting the co-ownership as a tenancy in common or a joint tenancy is the right of survivorship attached to the joint tenancy vesting.

Thus, the person vested as a tenant in common **retains control** over the destiny of his ownership interest on death. The control is exercisable by will or by vesting the co-owner's interest in the name of his inter vivos trust. The survivors in an ownership arrangement vested as tenants in common will not take the deceased's interest as would have occurred on their death under a joint tenancy vesting.

As tenants in common, co-owners retain the ability on death to transfer their interests in real estate to individuals other than the remaining co-owners of the property. Children jointly taking property on the death of a parent or relative will typically be designated as tenants in common or automatically be classified as tenants in common for failure of the will or trust agreement to state the nature of their co-ownership.

Tenancy in partnership

Groups of investors numbering just a few individuals often acquire property as co-owners, to hold and operate as income-producing property. They often take title to the real estate as **tenants in common**. However, the venture necessitates a joint effort for the **collective benefit** of all the individual co-owners. Thus, a *tenancy in partnership* exists for ownership purposes and a California partnership has been formed for operating purposes. [CC §682(2); Calif. Corporations Code §§16202(a), 16204(c)]

The group, as co-owners of property which requires day-to-day management, jointly operate a business venture. The management is conducted either directly by one or more of the co-owners in a coordinated effort or indirectly through a property manager. However, to be common-law tenants in common, the co-owners must intend not to act as a group, an issue for avoiding tax partnership treatment.

Property vested in the names of **profit-sharing, co-venturing co-owners** as tenants in common is property owned by their "partnership," not property fractionally owned and separately managed and operated by each co-owner individually. [Corp C §16203]

Thus, even though title is vested in all the individual co-owners as tenants in common, each co-owner actually holds title as a *trustee* on behalf of their **informal partnership** since the property's operation requires a coordinated or **centralized-management** effort. [Corp C §16404(b)(1)]

Nature of a joint tenancy

Although most **joint tenancies are created** between a husband and wife, a joint tenancy can be created between persons other than a married couple, such as between other family members. In contrast, the community property vestings, of which there are two, are only available to a married couple.

Also, the number of joint tenants holding title is not limited to two, as is the case for a married couple's ownership of community property. Any number of co-owners can, under one deed, take title to real estate as joint tenants so long as they **share equally in ownership**.

The joint tenancy vesting has been and is an estate planning tool used for the orderly transfer of ownership between family members on death. The vesting is rarely used in a business environment, except for community-owned enterprises or investments.

Traditionally, the creation of a joint tenancy requires the conveyance of *four unities*:

- *unity of title*, meaning the joint tenants take title to the real estate through the **same instrument**, such as a grant deed;

- *unity of time*, meaning the joint tenants receive their interest in title at the **same time**;

- *unity of interest*, meaning the joint tenants own **equal shares** in the ownership of the property; and

- *unity of possession*, meaning each joint tenant has the **right to possess** the entire property.

Today, a joint tenancy is loosely based on these four unities. For example, a joint tenancy is defined as ownership by two or more persons in **equal shares**. Thus, the joint tenancy co-ownership incorporates the unity of interest into the statutory definition. [CC §683]

Similarly, a joint tenancy must be created by a **single transfer** to all those who are to become joint tenants. Thus, the historic unity of title (same deed) and unity of time (simultaneous transfers) required under common law have been retained in one event, typically being the recording of the conveyance transferring title to the joint tenants.

A joint tenancy ownership in real estate may be created by any of the following transfers, each being **a single conveyance** to all joint tenants, if the conveyance states the co-owners take title "as joint tenants":

- a transfer by grant deed, quitclaim deed or assignment, from an owner of the fee, leasehold or life estate, to himself and others;

- a transfer from co-owners vested as tenants in common to themselves; or

- a transfer from a husband and wife holding title as community property, tenants in common or separately, to themselves. [CC §683]

For the small percentage of joint tenants who are not husband and wife, typically family members or lifelong friends, a valid joint tenancy is created when all co-owners take title under the same deed as joint tenants, without stating their **fractional interest** in ownership. Their actual fractional ownership, if severed or transferred to others, is a function of the number of individuals who took title as joint tenants.

Joint tenant's right of survivorship

The sole advantage of a joint tenancy vesting for co-owners is the *extinguishment* of a co-owner's entire co-ownership interest in the property on his death. **On death**, the interest of the deceased co-owner is absorbed by the surviving joint tenant(s). Thus, the ownership interest previously held by the deceased co-owner avoids probate procedures since no interest remains to be transferred.

The same results occurs on death if a married couple uses the community property with right of survivorship vesting to hold title to real estate or personal property.

Other than the *right of survivorship*, a joint tenancy vesting neither adds nor diminishes the legal or tax aspects of the ownership interest held in the real estate by each co-owner.

For example, whether the interests held by the co-owners are separate property or community property, a joint tenancy vesting neither enlarges nor reduces the nature of the ownership interest, until death.

Thus, the right of survivorship is the distinguishing feature of a joint tenancy vesting and is legally referred to a *jus accrescendi*. The right of survivorship is a doctrine developed by case law and now codified in California.

The right of survivorship only becomes operative at the **time of the death** of a joint tenant. On death, the right of survivorship extinguishes the deceased's interest and leaves the **remaining joint tenant(s)** with the entire ownership of the property to *share equally* among the surviving joint tenants.

Ultimately, on the death of all other joint tenants, the last surviving joint tenant becomes the sole owner of the property originally owned by all the joint tenants.

The mesh of ownership rights

Joint tenancy rights and community property rights held by married couples **overlap** in California law when community property is placed in a joint tenancy vesting. This overlap is a by-product of California legal history.

Joint tenancy, with its inherent right of survivorship, arises out of the English common law, and is called a *common law estate*.

Community property, with its implicit partnership aspect, is a creation of Spanish civil law, dating from the time California was a Spanish colony.

Older cases treated community property and joint tenancy as mutually exclusive, i.e., holding real estate as community property meant it could not be held in a joint tenancy vesting and retain its community property status. Thus, a *transmutation* from community property to the separate property of each the husband and wife occurred by a transfer into a joint tenancy, comparable to vesting community property in a tenancy in common vesting today. [**Tomaier** v. **Tomaier** (1944) 23 C2d 754]

However, this "mutually exclusive" rule, which controlled legal results by the type of vesting and not by the community nature of the ownership between husband and wife, was eliminated in 1975.

Today, a joint tenancy vesting is merely a vesting used by co-owners solely **to avoid probate**. The joint tenancy vesting provides no other advantage to the co-owners. The underlying community or separate property character of the real estate is not affected when a husband and wife vest their co-ownership as joint tenants.

For instance, a husband and wife who take title as joint tenants do not by the vesting *transmute* their community property into separate property owned 50:50 by the husband and wife.

However, a joint tenancy vesting allows a husband and wife to **renounce the community property presumption** should they claim they intended the joint tenancy vesting to establish separate property interests in the real estate. Thus, the community property presumption can be rebutted by either spouse, and is occasionally exercised by the husband and wife to deter creditors. [**Abbett Electric Corporation** v. **Storek** (1994) 22 CA4th 1460]

A similar result altering community property rights occurs in federal **bankruptcy** proceedings when a husband and wife hold title as joint tenants. The interest of each spouse vested as a joint tenant is treated in bankruptcy as separate property in order to attain the objective of federal bankruptcy law to free individuals of onerous debt.

Thus, a spouse's one-half interest in community property vested as joint tenants is **not liable in bankruptcy** for debts which were incurred solely by the other spouse and not on behalf of the community. [**In re Pavich** (1996) 191 BR 838]

Unless the couple intends by the joint tenancy vesting to transmute their community property into separate property when they take title to their community assets as joint tenants, the property is **presumed** to be a community asset without concern for the joint tenancy vesting.

Conveying community property

Both spouses must consent to the sale, lease for more than one year, or encumbrance of the community real estate no matter how it is vested. [Calif. Family Code §1102]

If one spouse, without the consent of the other, sells, leases for more than one year or encumbers community real estate, the nonconsenting spouse may either *ratify* the transaction or have it *set aside*. The nonconsenting spouse has **one year** from the recording of the nonconsented-to transaction to file an action to set the transaction aside.

However, if the other party to the transaction — the buyer, tenant or lender — has no notice of the marriage, actual or constructive, the transaction cannot be set aside by the nonconsenting spouse who has failed to make the community interest known. [Fam C §1102]

Conveying community property as joint tenants

The ability of a married joint tenant to sell, lease or encumber his interest in the real estate depends on whether the real estate interest vested in the individual is his *separate property* or the *community property* of the individual's marriage.

When community real estate is vested in joint tenancy, both spouses' signatures are required to execute an enforceable purchase agreement or trust deed lien, or to enter into a lease agreement with a term exceeding one year. [Fam C §1102]

Thus, a sale, long-term lease or encumbrance of the community property executed by only one spouse is *voidable* since the transaction may be set aside by the **nonconsenting spouse** if acted upon within one year after commencement.

Further, a purchase agreement for the sale of community property entered into by only one spouse may not be enforced in any part by the buyer through an action for specific performance.

Thus, a purchase agreement entered into by one spouse to sell only his one-half interest in the community property is unenforceable unless consented to by the other spouse. Community property **may not be conveyed**, leased or encumbered without the consent of both spouses. [**Andrade Development Company** v. **Martin** (1982) 138 CA3d 330]

However, if **record title** to the community real estate is in the name of **one spouse only**, a sale, lease or encumbrance executed solely by the title-holding spouse is presumed valid if the buyer, tenant or lienholder has no actual or constructive knowledge of the marriage. This includes any knowledge of the agent representing the buyer, landlord or lender, about the owner's marital status. [Fam C §1102(c)]

Separate property joint tenancy vestings

When real estate held in a joint tenancy vesting is the **separate property** of each joint tenant, such as three siblings or a parent and child, each joint tenant can sell or encumber his interest in the real estate **without the consent** of the other joint tenants.

Also, when the real estate owned by a joint tenant is his separate property, the joint tenant may **lease** out the entire property since a lease is a transfer of possession, and each joint tenant has the *right to possession* of the entire property.

However, consider a husband and wife who own real estate which is **community property**. They hold title as joint tenants. The husband enters into an agreement to lease the property to a tenant for a term of over one year. The wife does not enter into the lease agreement with the tenant.

Under joint tenancy rules, any joint tenant acting alone may lease the entire property to a tenant. However, under community property rules (which apply to property acquired during the marriage with community assets), both spouses must execute a long-term lease agreement for the tenant to avoid challenges to set aside the lease for failure of both the husband and wife to sign the lease.

This one-spouse leasing scenario is an example of the misunderstanding created by the overlay and **superiority of community property rights** when community property is placed in a joint tenancy vesting.

Although no case or statute addresses this set of leasing facts, existing case law suggests the joint tenancy vesting should be viewed as controlling the landlord-tenant relationship. Thus, the joint-tenant husband or wife indivdually is allowed to lease the property.

Also, the *doctrine of ratification* would influence the result (in favor of the tenant) if the nonconsenting spouse knowingly enjoyed the benefits of the lease before attempting to set the lease aside. [CC §2310]

The agent's role and listings

A broker and his agents who represent a married person in the sale, lease or financing of community real estate must know whether the performance by the married person of a promise to pay a fee under a listing or to close escrow on a purchase agreement can be legally avoided by asserting **community property defenses**, thereby inflicting a loss on the broker.

For example, a broker obtains an exclusive right-to-sell listing signed only by the wife. The real estate listed is vested in the name of the husband and wife either as community property or as joint tenants.

During the listing period, the couple acting independent of the broker sell the property without the payment of a fee to the listing broker. The listing entitles the broker to a fee, payable by the person who signed the listing, if the property is sold by anyone during the listing period. [See Form 102 accompanying Chapter 9]

The broker claims both the husband and wife are liable for the brokerage fee since the actions of the wife committed the community to the payment of a fee and the property was sold during the listing period.

The wife claims the listing is unenforceable without the husband's signature since no part of the property listed can be sold and conveyed without her husband's written consent.

Is the broker entitled to his fee?

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

AFFIDAVIT OF DEATH OF JOINT TENANT

DATE: _____, 20_____, at _____, California.

_____,

is the deceased named in the attached certified copy of Certificate of Death and the same person named as one of the joint tenants vested as owner of the following property situated in the County of _____, California, referred to as:

APN# _____

I have personal knowledge of the facts in this affidavit.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date: _____, 20_____ _____
(Print Name) (Signature)

Date: _____, 20_____ _____
(Print Name) (Signature)

STATE OF CALIFORNIA
COUNTY OF _____
SUBSCRIBED and SWORN to (or affirmed) before me on this _____ day of _____, 20_____,
by _____,
proved to me on the basis of satisfactory evidence to be the person(s) who appeared before me.

_____
(Seal)

_____
(Signature)

(This area for official notarial sel)

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Yes! The wife, separate from the husband, is liable for the fee since she signed the listing agreement **employing the broker**. The broker can enforce collection of his fee due under the listing in an action for money against the wife. However, the husband, who did not sign the listing agreement, is not personally liable for the brokerage fee. [**Tamimi** v. **Bettencourt** (1966) 243 CA2d 377]

Further, on recording the broker's abstract of the judgment against the wife for the brokerage fee, the judgment becomes a **lien on all community** real estate owned by the couple. The husband's **separate property**, however, is not liened and remains unaffected by the abstract which attaches as a lien to both the wife's separate property and their community property.

In contrast to a listing employing a broker to locate a buyer, an action for specific performance by a buyer to enforce a real estate purchase agreement signed only by the wife will not be successful. An **agreement to sell** community real estate requires both spouses' signatures. *Management and control* is in both, not just one co-owner, when the property is community real estate, no matter how vested.

Severing a right of survivorship

A husband and wife are the vested owners of a parcel of real estate which is community property. The vesting provides for the right of survivorship under either a community property with right of survivorship vesting or a joint tenancy vesting.

However, every co-owner vested as a joint tenant or community property with right of survivorship has the right to *unilaterally sever* the right of survivorship. The severance by a co-owner *terminates* the right of survivorship in that co-owner's interest, whether his interest in the real estate is separate or community property. The separate or community property **nature of the co-owner's interest** in the property remains the same after severing the right of survivorship from the co-owner's interest.

A co-owner terminating the right of survivorship in his interest is not required to first **give notice** or seek consent from the other co-owner(s). [**Riddle** v. **Harmon** (1980) 102 CA3d 524]

To *sever* the vesting, the co-owner prepares and signs a deed from himself "as a joint tenant" or "as community property with right of survivorship," back to himself. On recording the deed, the right of survivorship is severed by having merely *revested* the co-owner's interest. The deed revesting title should include a statement noting that the transfer is intended to sever the prior vesting. [CC §683.2(a)]

Alternatively, the co-owner could transfer title to himself as trustee under the co-owner's revocable inter vivos (living) trust agreement. The conveyance into **the trust vesting** would also sever the right of survivorship. By the conveyance, the trust vesting would also avoid the probate process while gaining **control over succession** of the co-owner's interest on death. Again, community property remains community property even though vested in the living trust of the individual husband or wife.

Further, any transfer of a joint tenant's interest in the joint tenancy property to a third party, such as from a joint tenant parent to a child, **automatically severs** the joint tenancy.

Termination of interest on death

Again, when the co-ownership of property is vested as joint tenants or community property with right of survivorship, the death of a co-owner *automatically extinguishes* the deceased co-owner's interest in the real estate. Thus, the surviving co-owner(s) becomes the sole owner(s) of the property.

However, **title** to the deceased co-owner's interest in the property must be cleared away before the surviving co-owner(s) will be able to properly sell, lease or encumber the property as the owner(s).

The enlarged ownership interest of a surviving joint tenant, clear of the deceased's interest, is documented by simply recording an *affidavit*, signed by anyone, declaring the death of a joint tenant who was a co-owner and describing the real estate. [See Form 460 accompanying this chapter; Calif. Probate Code §210(a)]

Likewise, the half interest in **community property** held by the deceased spouse at the time of death vested "as community property with right of survivorship" is *extinguished* by the same affidavit procedure used to eliminate the interest of a joint tenant. However, the surviving spouse (or the surviving spouse's representative) is the only one authorized to make the declaration. [See **first tuesday** Form 461]

Judgment against a spouse

Now consider a husband who encumbers community property with a trust deed, executed by the husband alone and without the consent of the wife. The trust deed secures a note which evidences a debt or other monetary obligation undertaken by the husband.

Later, the trust deed lien is set aside in a judicial action by the wife since the wife did not consent to the encumbrance of the community property.

The husband defaults on the now unsecured loan. The lender obtains a money judgment against the husband individually and records an abstract of the judgment **naming only the husband** as the judgment debtor.

On **recording the abstract**, the judgment debt attaches as a lien to all community property in which the husband presently has an interest, as well as the husband's separate property interests in other real estate. The wife's separate property is unaffected by the recorded abstract.

Now, the same community property which had been previously encumbered by the judicially voided trust deed lien is now encumbered by the judgment which attached as a lien by recording the abstract.

Later, the couple's marriage is dissolved and the wife is awarded sole ownership of the community property, now her separate property.

The wife claims the money judgment lien did not attach to the property since the debt which became the money judgment had been secured by the same property under a trust deed the court declared void.

Here, the recording of the abstract of judgment against the husband created a **valid lien** on all community property owned by the couple, including the property which later became property solely owned by the wife. The judgment against the husband attached to the property while it was still community property, before a property settlement conveyed the property or the marriage had been dissolved. [**Lezine** v. **Security Pacific Financial Services, Inc.** (1996) 14 C4th 56]

Joint tenancy tax aspects

Taxwise, the main question raised for a husband and wife when the surviving spouse becomes the sole owner of what was community property at the time of death, no matter how vested by them, is: What is the surviving spouse's **cost basis** in the property as the sole owner on the death of the spouse?

The surviving spouse who becomes the sole owner of community real estate on the death of a spouse receives a "fully" **stepped-up cost basis** to the property's *fair market value* on the date of the death which terminated the community.

Thus, the surviving spouse is entitled to a fully stepped-up basis in real estate previously owned by the community without concern for whether the **community property** was vested as community property, as joint tenants or in a revocable inter vivos trust. State law controls how marital property will be characterized for federal tax purposes. Federal law is unconcerned with "... the form in which title is taken" to community property. [IRS Revenue Ruling 87-98]

By California law, all property acquired by a husband and wife during marriage is community property, regardless of the vesting, if it is acquired, managed and operated as a community asset by the couple. [Fam C §760]

Thus, the real estate owned by a husband and wife (unless vested as tenants in common) is community property for federal income tax purposes. Accordingly, the surviving spouse on receiving the property receives a cost basis stepped-up to the property's **fair market value** on the date of death, the result of becoming the sole owner of property previously owned by the community.

Chapter 57 Preliminary title reports

This chapter addresses the use of a preliminary title report by a buyer to review the condition of title to eliminate contingency provisions, and by escrow to prepare closing documents.

An offer to issue title insurance

An investor enters into an agreement to purchase real estate from a financially distressed seller.

Closing of the transaction is contingent on the investor's receipt and review of a preliminary title report (prelim) to confirm the property is subject only to the loans and other liens disclosed by the seller. Any taxes or monetary liens of record which are not disclosed in the purchase agreement are to remain of record. However, the amount of any undisclosed lien will be deducted from the cash down payment.

Escrow is opened with instructions to order a prelim from a title insurance company for approval of the condition of title by the investor. To keep acquisition costs to a minimum, escrow is instructed to close without obtaining a policy of title insurance.

The prelim received by escrow indicates the title is clear of all encumbrances, except those disclosed by the seller. Believing the title condition is as represented by the seller, the investor waives the further-approval contingency regarding approval of the prelim.

Escrow closes on receiving a "date-down" on the prelim from the title company — without the issuance of a policy of title insurance.

However, the preliminary title report failed to disclose a recorded abstract of judgment against the seller which had attached to his title as a judgment lien. Later, the judgment creditor enforces the judgment lien by commencing a foreclosure on the property.

The investor clears title of the lien and makes a demand on the title company for the amount of the payoff since they prepared an erroneous prelim. The investor claims the title company is liable for his losses since it failed to disclose the judgment lien on the preliminary title report, a misrepresentation of title.

Can a buyer, escrow officer, broker or agent rely on a prelim as assurance the title condition is "as represented" in the preliminary title report?

No! A preliminary title report is not a representation of the condition of title or a policy of title insurance. Unlike an *abstract of title*, a prelim cannot be relied on by anyone.

A title insurer has no duty to accurately report title defects and encumbrances on the preliminary title report (shown as exceptions in the proposed policy). [**Siegel** v. **Fidelity National Title Insurance Company** (1996) 46 CA4th 1181]

A preliminary title report is no more than an **offer to issue** a title insurance policy based on the contents of the prelim and any modifications made by the title company before the policy is issued. [Calif. Insurance Code §12340.11]

Use of the prelim

A preliminary title report typically discloses the current vesting, as well as the general and special taxes, assessments and bonds, covenants, conditions and restrictions (CC&Rs), easements, rights of way, encumbrances, liens and any interests of others which may be reflected on the public record as affecting title, collectively called *encumbrances*.

The closing of many purchase escrows is conditioned on the buyer's approval of the prelim. The buyer, his agent and escrow review the report on its receipt for defects and encumbrances on title inconsistent with the terms for the seller's delivery of title in the purchase agreement and escrow instructions.

Buyer's agents in a sales transaction check the prelim prior to closing for title conditions. Buyers' agents are looking for title conditions which might interfere with any **intended use or change in the use** of the property contemplated by the buyer. Interferences could be in the form of unusual easements or use restrictions which obstruct the buyer's announced plans to make improvements.

Finally, escrow relies on the prelim to carry out its instructions to record grant and trust deeds, leaseholds, or options which will be insured.

Typically, escrow instructions call for closing when the deed can be recorded and insured, subject only to taxes, CC&Rs and other encumbrances specified in the instructions.

Ultimately, it is the escrow officer who, on review of the prelim, must advise the seller of any need to eliminate defects or encumbrances on title which interfere with closing as instructed.

The prelim and a last-minute *date-down* of title conditions are used by escrow to reveal any title problems to be eliminated before closing and, as instructed, obtain title insurance for the documents being recorded (deeds, trust deeds, etc.).

Should the date-down of the prelim reveal defects or liens not previously reported in the prelim, either by error or by later recording, the title company can **withdraw its offer** under the prelim and issue a new prelim, an offer to issue a policy on different terms.

Prelim vs. abstract of title

Title companies have long been aware of the public's reliance on the prelim. This reliance was consistently reinforced by the California courts which held title companies liable for their erroneous reports. However, legislation drafted by the title insurance industry was introduced and enacted in 1981 to eliminate liability for their preparation of faulty preliminary title reports.

Prelims were once compared to abstracts of title. An **abstract of title** is a written statement which may be relied on by those who order them as an accurate, factual representation of title to the property being acquired, encumbered or leased. [Ins C §12340.10]

An abstract of title is a **statement of facts** collected from the public records. An abstract is not an insurance policy with a dollar limit on liability set by the policy. Since the content of an abstract is intended by the insurance company to be relied upon **as fact**, the insurer is liable for all money losses of the policy holder flowing from a failure to properly prepare the abstract. [**1119 Delaware** v. **Continental Land Title Company** (1993) 16 CA4th 992]

In an effort to shield title companies from an *abstractor's liability* on the issuance of a defectively prepared prelim, the prelim has been legislatively redefined as being neither an abstract of title nor a representation of the condition of title. The prelim is now defined as a report furnished in connection with **an application** for title insurance. [Ins C §12340.11]

The prelim has become and is simply an **offer** by a title company to issue title insurance. The prelim is merely a statement of terms and conditions on which the title company is willing to issue a policy — subject to last minute changes prior to issuing the policy of title insurance.

Chapter 58 Title insurance

This chapter discusses title insurance and the different types of policies available.

Identifying an actual loss

A policy of title insurance is the means by which a title insurance company *indemnifies* — reimburses or holds harmless — a person who acquires an interest in real estate against a monetary loss caused by an **encumbrance on title** that:

- is not listed in the policy, which if listed is called an *exception*; and
- the insured was unaware of when the policy was issued. [Calif. Insurance Code §12340.1]

A policy of title insurance is issued on one of several forms which are the prototypes used by the entire title insurance industry in California. The policies are typically issued to **buyers** of real estate, **tenants** acquiring long-term leases and **lenders** whose loans are secured by real estate.

A title policy is a contract since it is an **indemnity agreement**. The terms of coverage in the policy set forth the extent of the title insurance company's obligation, if any, to indemnify the named insured for a *money loss* caused by an **encumbrance on title** which is not listed in the policy's exceptions. [Ins C §12340.2]

An insured lender or buyer cannot recover a **loss of profits** due to an unlisted defect in title as lost profits are not covered by title insurance. The title policy only indemnifies the insured against a **reduction in the value** of the property below the policy limits, not a reduction in future profits on either a foreclosure or resale of the property. [**Karl** v. **Commonwealth Land Title Insurance Company** (1993) 20 CA4th 972]

Unknown and undisclosed encumbrances

Almost all losses due to the reduction in value of real estate below the policy limits arise out of an encumbrance. An encumbrance is any condition which affects the ownership interest of the insured, whether the interest insured is a fee, leasehold, life estate or the security interest of a lender.

The word encumbrance is all encompassing. Any right or interest in real estate held by someone other than the owner which diminishes the value of the real estate is an encumbrance.

Encumbrances on title include:

- covenants restricting use;
- restrictions on use;
- reservations of a right of way;
- easements;
- encroachments;
- trust deeds or other security devices;

- pendency of condemnation; and
- leases. [**Evans** v. **Faught** (1965) 231 CA2d 698]

Use of property not covered

Physical conditions on the property itself are not encumbrances affecting title since they are uses which exist and are visible (open and notorious) on the property, such as:

- canals;
- highways;
- irrigation ditches; and
- levees.

Accordingly, title policies do not insure against observable physical conditions which exist on the property. Observable physical conditions are not encumbrances. A buyer is always presumed to have contracted to acquire property subject to physical conditions on the property which impede its use or impair its value. In the case of encumbrances, recorded or not, no such presumption exists.

A buyer under a purchase agreement contracts to acquire title from the seller free of all encumbrances except those agreed to in the purchase agreement. Even if the buyer has notice of an encumbrance affecting title and he has not agreed in the purchase agreement to take title subject to the encumbrance, the seller is liable to the buyer for its removal, extinguishment or compensation.

However, for title insurance purposes only, the buyer's knowledge of an encumbrance affecting title at the time of closing **removes the known encumbrance** from coverage. Thus, the insured buyer assumes the risk of loss due to the known encumbrance.

Lost value recovered, not lost profits

A title insurance policy is not an *abstract of title*. Thus, a policy of title insurance does not *warrant* or *guarantee* the nonexistence of title encumbrances, as does an abstract. Instead, the insured is *indemnified*, up to the policy's dollar limits, against a money loss caused by a title condition not listed as an exception or exclusion in the policy.

Under a title insurance policy, the title company only assumes (covers) the risks of a **monetary loss** caused by an encumbrance which is not listed as an exception to coverage, and was unknown to the insured buyer or lender at the time of closing. The title company has no obligation to clear title of the encumbrance.

Consider an owner who discovers the size of an easement was understated in the title policy.

Due to the actual dimensions of the easement, the owner cannot develop the property.

The owner makes a claim on the title company for the **lost value** of the property based on its potential for development as allowed by the understated easement, not for his loss of value on the price he paid for the property (which is the dollar amount of the title policy limits).

Instead, the title company only pays the owner an *inflation adjusted price* based on the price the owner paid for the property — an amount set by the policy limits and the inflation endorsement.

The owner claims the title company's *negligence* in the disclosure of the easement caused a loss in property value equal to the difference between the purchase price paid and the potential value of the property for development.

However, the title company is not liable under a policy for lost profits in the unrealized potential value of the property. It was the easement that caused the loss of profits, not the issuance of a title insurance policy. [**Barthels** v. **Santa Barbara Title Company** (1994) 28 CA4th 674]

Introduction to title policy forms

Title insurance is bought to assure real estate buyers, tenants and lenders the **interest in title** they acquire is what they bargained for from the seller, landlord or borrower. While title insurance is not a guarantee of the condition of title acquired, it does provide a **monetary recovery** up to the policy's dollar limits for the conveyance of any lesser interest due to unlisted exceptions than the interest insured.

On closing a real estate transaction, a policy of title insurance is issued on one of several forms used throughout the entire title insurance industry in California. The policies are typically issued to **buyers** of real estate, **tenants** acquiring long-term leases and **lenders** whose loans are secured by the real estate.

Two basic forms exist which are the industry prototypes for:

- insuring the condition of record title only, accomplished by the issuance of a *California Land Title Association (CLTA) policy*; and
- insuring both the record title and observable on-site activities which affect title, accomplished by the issuance of an *American Land Title Association (ALTA) policy*.

In analysis, a **policy of title insurance** is broken down into six operative sections, including:

- the risks of **loss covered**, called *insuring clauses*, which are based on the unencumbered title at the time of the insured transfer;
- the risks of **loss not covered**, comprised of encumbrances arising after the transfer or known to or brought about by the insured, called *exclusions*, which are a boilerplate set of title conditions;
- **identification** of the insured, the property, the vesting, the estate in the property, the dollar amount of the coverage, the premium paid and the policy (recording) date for the conveyance insured, called *Schedule A*;
- the **recorded interests**, i.e., any encumbrances affecting title and any observable on-site activities which are **listed as risks** agreed to and assumed by the insured and not covered by the policy, called *exceptions*, which are pre-printed for CLTA coverage and itemized for all types of coverage in *Schedule B*;
- the **procedures**, called *conditions*, for **claims made** by the named insured and for *settlement* by the insurance company on the occurrence of a loss due to any encumbrance on title which is not an exclusion or exception to the coverage granted by the insuring clauses; and
- any **endorsements** for additional coverage or removal of exclusions or pre-printed exceptions from the policy.

Insuring clauses

The coverage under the broadly worded **insuring clauses** of a policy of title insurance indemnifies the named insured for risks of loss **related to the title** due to:

- anyone making a claim against title to the real estate interest;
- the title being unmarketable for sale or as security for financing;
- any encumbrance on the title; and
- lack of recorded access to and from the described property.

Exclusions from coverage

All title insurance policies, in their **exclusions section**, excludes from coverage those losses incurred by the insured buyer, tenant or lender due to:

- **use ordinances** or (zoning) laws;
- **unrecorded claims known** to the insured, but not to the title company;
- encumbrances or adverse **claims created** or attaching **after** the date of the policy;
- claims arising out of **bankruptcy** laws or due to a **fraudulent conveyance** to the insured;
- police power and **eminent domain**; and
- **post-closing events** caused by the insured.

Schedule A data

All policies of title insurance in their Schedule A set forth:

- the property interest the insured acquired (fee simple, leasehold, life estate, security, etc.);
- the legal description of the insured property;
- the date and time the insured conveyance or lien recorded and coverage began;
- the premium paid for the policy; and
- the maximum total dollar amount to be paid for all claims settled.

Exceptions to coverage

In addition to the policy exclusions, a policy's coverage under its "no-encumbrance" insuring clause is further limited by Schedule B exceptions in the policy. The **exceptions section** contains an itemized list of recorded and unrecorded encumbrances which are known to the title company and affect the insured title. While the existence of these known encumbrances are insured against in the insuring clauses, they are removed by Schedule B as a basis for recovery under the policy.

In addition to the itemized **list of exceptions**, a CLTA policy includes a set of pre-printed exceptions setting forth risks assumed by the insured buyer, tenant or lender, which include:

- taxes, assessments, liens, covenants, conditions and restrictions (CC&Rs), or any other interests, claims or encumbrances which have not been recorded with the county recorder or tax collector on the date of closing;
- any unrecorded and observable on-site activity which includes conflicts regarding boundary lines, encroachments or any other facts which a correct survey would disclose;
- unpatented mining claims; and
- all water rights.

Claims and settlements

Lastly, a policy of title insurance includes a **conditions section** which outlines the procedures the named insured must follow when making a claim for recovery under the policy. Also set forth are the settlement negotiations or legal actions available to the title company before they must pay a claim.

Owner's policies for buyers

Several types of title coverage are available for a buyer to choose from when entering into a purchase agreement with the seller, including:

- a CLTA standard policy;
- an ALTA owner's extended coverage policy;
- an ALTA residential (ALTA-R) policy; and
- an ALTA homeowner's policy.

When making an offer, a prospective buyer is informed by his agent about the coverage each type of policy provides. The buyer's need for title coverage must be reviewed when the buyer enters into a purchase agreement since the agreement's title insurance provision calls for the buyer to designate the type of title insurance policy on closing and states who will pay its premium.

The CLTA standard policy

The CLTA standard policy is purchased solely by buyers, carryback sellers and private lenders, not institutional lenders or builders who generally need extended coverage.

The CLTA standard policy insures against all encumbrances affecting title to the property which can be discovered by a search of **public records** prior to issuance of the policy. Any encumbrance not recorded, whether or not observable by an **inspection or survey** of the property, is not covered due to the CLTA policy exclusions and standard exceptions.

Public records include those records which impart *constructive notice* of encumbrances affecting title to the property.

For example, a deed conveying a parcel of real estate which is actually **recorded and indexed** by the county recorder's office imparts constructive notice to buyers and lenders who later acquire an interest in the property. [Calif. Civil Code §1213]

Also, the CLTA standard policy (as well as the ALTA policy) protects the buyer against:

- the unmarketability of title or the inability to use it as security for financing;
- lack of ingress and egress rights to the property; and
- losses due to the ownership being vested in someone other than the buyer.

All title insurance policies provide coverage forever after the date and time the policy is issued, limited in recovery to the dollar amount of the policy, which is generally adjusted for inflation. Coverage is further limited by the **exclusions, exceptions and conditions on claims**.

The CLTA standard policy (as well as the ALTA policy) contains Schedule A *exclusions to coverage* which bar recovery by the buyer or joint protection carryback seller for losses due to:

- zoning laws, ordinances or regulations restricting or regulating the **occupancy, use or enjoyment** of the land;
- the character, dimensions or location of any **improvement erected** on the property;
- a **change in ownership** or a parceling or combining of the described property by the insured buyer;
- **police power**, eminent domain or violations of environmental protection laws, unless a notice or encumbrance resulting from the violation was recorded with the county recorder before closing;
- encumbrances **known** to the insured buyer or lender which are not recorded or disclosed to the title company;
- encumbrances which do not result in a **monetary loss**;
- encumbrances which are created or become encumbrances **after issuance** of the policy;
- encumbrances resulting from the buyer's payment of **insufficient consideration** for the property or delivery of improper security to the lender also insured under the policy; and
- the unenforceability of the insured trust deed lien due to the lender's **failure to comply** with laws regarding usury, consumer credit protection, truth-in-lending, bankruptcy and insolvency.

The CLTA standard policy contains **pre-printed exceptions** listed in the policy as Schedule B, also called *standard exceptions* or *regional exceptions*. It is the inclusion of these pre-printed boilerplate exceptions which makes the CLTA policy a standard policy. An ALTA owner's policy does not contain pre-printed exceptions, only the typewritten exceptions listing the encumbrances which are known to the title company and affect title to the property.

The **pre-printed standard exceptions** in Schedule B of the CLTA standard policy eliminate coverage for losses incurred by the buyer due to:

- taxes or assessments not shown as existing liens in the records of the county recorder, the county tax collector or any other agency which levies taxes on real property;
- unrecorded rights held by others which the buyer could have discovered by an inspection of the property or inquiry of persons in possession;
- easements or encumbrances which are not recorded and indexed by the county recorder;
- unrecorded encroachments or boundary line disputes which would have been disclosed by a survey; and
- recorded or unrecorded, unpatented mining claims or water rights.

A lower premium is charged to issue a CLTA policy since the title company undertakes a lower level of risk for indemnified losses due to the CLTA pre-printed exceptions as compared to the extended risks covered by the more expensive ALTA owner's policy.

The ALTA owner's policy

Most policies issued today are of the ALTA variety. The CLTA policy format with pre-printed standard exceptions does not provide protection for **unrecorded encumbrances or claims** to title.

The ALTA owner's policy provides greater coverage (and premiums) than the CLTA policy since the exceptions in Schedule B do not include the pre-printed standard exceptions. If the pre-printed excep-

tions are included in Schedule B and attached to the ALTA policy, the policy becomes an ALTA standard policy, comparable in cost and coverage to the CLTA standard policy since unrecorded encumbrances will not be covered.

The ALTA owner's policy covers **off-record matters** not covered under the CLTA standard policy. As a result, the title company may require the parcel to be surveyed, and those in possession to be interviewed or estopped, before the title company will issue an ALTA policy. Unrecorded interests in title are most often observable by an on-site inspection of the property.

Typewritten exceptions for existing encroachments or boundary conflicts are occasionally added to the ALTA policy (Schedule B) based on the survey.

The ALTA residential policy

For buyers of parcels containing one-to-four residential units, an ALTA residential (ALTA-R) policy is available in lieu of the ALTA owner's or homeowner's policies. Parcels insured include lots and units in common interest developments (CIDs), such as condominiums.

The ALTA-R is referred to by the title companies as the "plain language" policy. The ALTA-R is written using wording which avoids legalese. The policy is structured and written to be easily read and understood by the buyer. The ALTA-R form policy contains a **table of contents** and an **owner's information sheet** which outlines the policy's features.

The coverage, exclusions and exceptions in the ALTA-R policy are similar to the ALTA owner's policy. In addition, the ALTA-R policy covers losses due to:

- mechanic's liens incurred by someone other than the buyer; and
- the inability of the buyer to occupy the property should the single family residence violate the CC&Rs listed in the Schedule B exceptions in the policy or existing zoning.

The premium for an ALTA-R form policy is priced lower than the premium for an ALTA owner's policy since the policy is usually issued only on parcels in an existing subdivision or CID which has no known problems with easements, encroachments or access.

The ALTA homeowner's policy

A homeowner's policy now exists to provide **more coverage** than the ALTA owner's or the ALTA-R policies. In addition to the risks covered by the ALTA owner's and ALTA-R policies, the homeowner's policy covers several risks to ownership which could arise **after closing**, including:

- the **forging** of the buyer's signature on a deed in an attempt to sell or encumber the buyer's property;
- the construction on an adjoining parcel of a structure which **encroaches** onto the buyer's property, excluding a boundary wall or fence;
- the recording of a document which prevents the buyer from obtaining a secured loan or selling the property;
- claims of **adverse possession** or **easement by prescription** against the buyer's property; and
- claims by others of a right in the buyer's property arising out of a lease, contract or option **unrecorded and unknown** to the buyer at the time of closing.

The ALTA homeowner's policy also covers losses arising out of a lack of vehicular and pedestrian access to and from the property. Other owner's policies only cover losses resulting from the lack of a legal right to access, not a practical means of access which is covered by the ALTA homeowner's policy.

Also covered by the ALTA homeowner's policy are losses incurred due to many other risks which may exist at the time of closing, including:

- the correction of any pre-existing violation of a CC&R;
- the inability to obtain a building permit or to sell, lease or use the property as security for a loan due to a pre-existing violation of a subdivision law or regulation;
- the removal or remedy of any existing structure on the property if it was built without obtaining a building permit, excluding a boundary wall or fence;
- damage to existing structures due to the exercise of a right to maintain or use an easement;
- damage to improvements due to mineral or water extraction;
- the enforcement of a discriminatory CC&R;
- the assessment of a supplemental real estate tax due to construction or a change of ownership or use occurring before closing;
- an incorrect property address stated in the policy; and
- the map attached to the policy showing the incorrect location of the property.

Binders when contemplating a resale

An investor who buys property and plans on reselling the property within two years after his purchase should be advised by the buyer's agent to consider a binder, also called a *commitment to issue.*

A binder entitles the buyer to title insurance coverage until the buyer requests a policy be issued to a new buyer on resale of the property or to a new lender on a refinance, such as occurs when a relocation agent (broker) temporarily takes title to a residence before it is resold to the ultimate buyer.

With a binder, the resale policy will be at no further charge, except for additional liability coverage requested for any increase in the resale price.

Lender's policies

The CLTA and ALTA form title policies available to insure the priority of the lien a lender holds to secure their loan, include:

- a CLTA standard joint protection (JP) policy; and
- an ALTA loan policy.

The CLTA standard JP policy

A lender or a seller who carries back a note and trust deed for part of the sales price has options when calling for title insurance.

The lender or carryback seller can either:

- be named as an additional insured on a CLTA standard JP title insurance policy with the buyer; or

- request a separate ALTA loan policy as a sole named insured.

The JP policy enables one or more individuals or entities to be named as insured.

However, the JP policy is only available under a CLTA standard policy. If either the buyer or the lender in a cash-to-new-loan transaction requests ALTA coverage, a separate ALTA loan policy will be issued to each at approximately double the cost.

The ALTA lender's policy

An institutional lender will usually require its trust deed lien on a parcel of real estate to be insured under an ALTA loan policy as a condition for making a loan secured by real estate.

The ALTA loan policy insures against money losses incurred by lenders and carryback sellers due to the loss of priority of the insured trust deed lien, unless listed in the exceptions, to encumbrances such as:

- a mechanic's lien, if the work was commenced prior to recording the trust deed (which is the same date and time as the date of the policy) and the trust deed did not secure a loan to pay for the construction;
- a mechanic's lien arising out of work financed by proceeds from the construction loan secured by the insured trust deed, if no part of the construction work was commenced before the trust deed was recorded; and
- assessments (Mello-Roos) for street improvements under construction or completed prior to recording the trust deed.

The ALTA loan policy comes at a higher (and separate) premium than the CLTA standard JP policy due to the extended mechanic's lien and assessment coverage. The buyer who borrows to finance his purchase usually pays the premium for the lender's policy.

Endorsements

Endorsements of great variety can be added to the form policies to provide coverage for title conditions and use or economic conditions not covered by the proto-typical policies. Endorsements are usually issued only to lenders, though modified endorsements can be used in owner's policies as well, particularly for developers and builders.

Endorsements cover losses incurred due to violations of CC&Rs, damage from extraction of water or minerals, mechanic's liens, encroachments (conditions covered in an ALTA-R policy) and the effects of inflation. Endorsements are also issued to remove an exclusion or exception which is an unwanted boilerplate provision in a policy.

Chapter 59 Going to escrow

This chapter explores the use of checklists and pre-printed instructions by agents to better prepare for opening escrow.

The process of closing a purchase agreement

Escrow is a process employed to **facilitate the closing** of a real estate transaction entered into between two parties, such as a buyer and a seller, who have agreed to the transfer of real estate, typically under a primary agreement, e.g., a purchase agreement. An **escrow consists of**:

- *one person*, such as a seller of real estate, who delivers written instruments or money to an escrow company for the purpose of the person fully performing his **obligations owed another person** under an agreement previously entered into for the sale, encumbrancing or leasing of real estate; and

- *the escrow company*, who **delivers** the written instruments and money **to the other person**, such as the buyer, on the occurrence of a specified event or the performance of prescribed conditions, such as the issuance of title insurance. [Calif. Financial Code §17003(a)]

For an individual to engage in the business of acting as an **escrow agent**, he must himself be licensed and employed by a corporation also licensed by the California Commissioner of Corporations, unless exempt.

Individuals exempt from the escrow licensing requirements include:

- a *licensed real estate broker*, either individual or corporate, who represents a party to a transaction in which the broker will perform escrow services;

- a *licensed attorney* who is not actively engaged in conducting (holding himself out as) an escrow agency;

- a *bank*, trust company, savings and loan association (thrift) or insurance company; and

- a *title insurance company* whose principal business is preparing abstracts or making searches of title used for issuing title insurance policies.

Duties of an escrow officer include:

- receiving funds and collecting necessary documents, such as appraisals, disclosure statements and title reports called for in escrow instructions;

- preparing documents necessary for conveyancing, encumbrancing and evidencing the creation of debts required for escrow to close;

- calculating prorations and adjustments; and

- disbursing funds and transferring documents when all conditions for their release have been met.

Opening escrow

Consider a buyer and seller who enter into a purchase agreement for the sale of the seller's one-to-four unit residence. As agreed, escrow now needs to be opened to handle the closing of the transaction.

In modern real estate practice, **opening escrow** simply means establishing a depository for the deed, the money and other items, called *instruments*, with accompanying instructions signed by all necessary parties authorizing escrow to transfer or hand those items to the parties or others on closing.

Before accepting any instruments as an escrow holder for a transaction, the escrow officer will need to be informed, i.e., *dictated instructions,* by an agent of one of the parties regarding precisely when and under what circumstances the documents and monies deposited with escrow are to change hands. The escrow officer notes all the tasks to be undertaken to manage and close escrow by preparing a "take sheet" before drafting escrow instructions.

Any number of details (preparation, receipt and transfer of monies and documents) must be attended to by the escrow holder before the transaction can be completed, called a *closing or settlement*.

As a checklist for "going to escrow," a worksheet helps the sale agent to organize the collection of facts and supporting papers the escrow officer will need to immediately draw instructions and be able to clear the conditions and close escrow. [See Form 403 accompanying this chapter]

The documents work together

Modern real estate sales transactions depend on both the purchase agreement and the escrow instructions working in tandem to close a transaction.

Both the purchase agreement and the escrow instructions are *contracts* regarding interests in real estate. To be enforceable under the Statute of Frauds, both documents must be **in writing**. [Calif. Civil Code §1624; Calif. Code of Civil Procedure §1971]

A **purchase agreement** sets forth the sales price and terms of payment, together with conditions to be met before closing.

Escrow instructions constitute an additional agreement between the buyer and seller which is entered into with an escrow company, but it **does not replace the purchase agreement**. Escrow instructions are merely directives which an escrow agrees to comply with to carry out the terms of the purchase agreement by coordinating a closing on behalf of both the buyer and the seller. [See Figure 1]

However, escrow instructions occasionally add exactness and completeness, providing the enforceability sometimes lacking in purchase agreements as prepared by brokers or their agents.

The purchase agreement is the primary underlying document in a real estate sales transaction and is considered the original contract. All further agreements, including the escrow instructions, must comply with the primary document, unless **intended to modify** the original agreement.

The agents negotiating a transaction, and their brokers, are responsible for ensuring the escrow instructions, whether prepared or dictated by themselves or others, **conform to the purchase agreement**.

To provide for a smoother, timely closing, the agent dictating instructions needs to collect and hand escrow, at his earliest opportunity, all of the information the escrow officer needs to prepare the instructions and documents. The agent should use a **checklist** to mark off the items and information escrow might need in order to process the transaction.

The escrow officer will prepare the instructions from information provided by the agent. Thus, the agent **dictates the instructions**.

Of note, an escrow officer does not have an obligation to notify the parties of any suspicious fact or circumstance detected by the officer before close of escrow, unless the **fact affects closing**. However, as is the policy of many an escrow officer selected by the agent to handle the closing, the officer will alert the agent to potential problems that lie outside the escrow instructions which have been brought to the attention or been observed by the officer. [**Lee** v. **Title Insurance and Trust Company** (1968) 264 CA2d 160]

To avoid confusion when dictating instructions, the broker must consider the type of transaction (sale, loan, exchange or lease) which is being escrowed, scheduled dates for the elimination of any contingencies the escrow officer must act upon and the final date scheduled for close of escrow.

If the escrow instructions drafted and signed are vague or incomplete on any point, the underlying purchase agreement must be analyzed by the agents and the parties before dictating amended instructions. The **terms of the purchase agreement supersede** any inconsistencies between the purchase agreement and the escrow instructions not intended to be a modification of the original purchase agreement.

If the point in dispute is not addressed in the purchase agreement, then it is not part of the contract and must, if agreeable, be added to the escrow instructions by amendment.

Naturally, amended instructions adding terms which are modifications of the purchase agreement should note they modify the purchase agreement.

Escrow instructions which **modify** the intentions stated or implied in the purchase agreement must be **written, signed and returned** to escrow by both parties. Proposed modifications signed by some but not all parties are **not binding on a party** who has not agreed to the modifications.

Before closing escrow, an agent may discover an aspect of the escrow instructions which is in conflict with the intentions expressed in the purchase agreement or the expectations of the buyer or seller. The agent on making the discovery is duty-bound to immediately bring these discrepancies to the attention of the escrow officer and his client.

On notification of an error in instructions or a need for clarification, the escrow officer must hold up the close of escrow until the discrepancy is clarified and corrective escrow instructions have been prepared, signed by the buyer and seller, and returned to escrow. [**Diaz** v. **United California Bank** (1977) 71 CA3d 161]

Required escrow disclosures

All written escrow instructions signed by a buyer or seller **must contain a statement**, in not less than 10-point type, which includes the licensee's name and the name of the department issuing the license or granting the authority under which the person conducting the escrow is operating.

SALES ESCROW WORKSHEET

For Use on Seller-Occupied SFR Properties

DATE: _____, 20_____, at _____, California.

BY: _____

1. PARTIES, PROPERTY AND PRICE:

1.1 Date escrow to close _____

1.2 Property address _____

_____

Parcel number _____

City _____ County _____, California.

1.3 Price $_____

Down payment $_____

Initial deposit into escrow $_____

Loan amount on closing $_____

1.4 Seller's name _____

Address _____

_____

Phone _____ Fax _____ Email _____

Seller's Broker _____

1.5 Buyer's Name _____

Address _____

_____

Phone _____ Fax _____ Email _____

Buyer's Broker _____

2. LIENS RECORD:

	First Trust Deed	Second Trust Deed
Original amount	$_____	$_____
Current balance	$_____	$_____
Interest rate	_____% ☐ ARM	_____% ☐ ARM
	Type _____	Type _____
Monthly payments	$_____	$_____
Due date	_____	_____
Assumed or reconveyed	_____	_____
Loan number	_____	_____

Lender(s) name and address(es) _____

_____

2.1 Bond or assessment lien balance of $_____, payable $_____ annually, including interest at the rate of _____%.

District Name _____

Address _____

_____

Phone _____ Fax _____ Email _____

2.2 New Trust Deed loan in amount of $_____, payable approximately $_____ monthly, including interest at the annual rate of _____% ☐ fixed; ☐ ARM.

Loan charges to be paid by _____.

2.3 Seller Carryback Note and Trust Deed $_____ payable $_____ monthly, or more, including annual interest of _____%, all due _____ years from close.
First payment due _____, 20_____.

☐ Contract collection clause [See **ft** Form 442 §3]
☐ 90-day balloon payment notice provision (mandatory on one-to-four residential units) [See **ft** Form 418-3]
☐ Late charge of $_____ after _____ days [See **ft** Form 418-1]
☐ Prepayment penalty [See **ft** Form 418-2]
☐ Due-on-sale clause
☐ All-inclusive Note and Trust Deed addendum [See **ft** Form 442 or 443]
☐ Tax reporting service charge to be paid by _____
☐ Request for Notice of Default/Delinquency on senior Trust Deed [See **ft** Form 412]

3. DISCLOSURES CHECKED ARE YET TO BE MADE TO BUYERS:

3.1 Lead-based paint disclosure for pre-1978 residences — right to inspect/waiver. [See **ft** Form 313]
☐ Buyer's receipt ☐ Seller's compliance
☐ Buyer's Broker acknowledgement ☐ Listing Broker acknowledgement

3.2 Condition of Property — Transfer Disclosure Statement (TDS). [See **ft** Form 304]
☐ Buyer's receipt ☐ Seller's compliance
☐ Buyer's Broker visual inspection ☐ Listing Broker visual inspection

a. Environmental Hazards Guide for Homeowners and Buyers.
☐ Buyer's receipt

b. Home Energy/Rating Information Booklet.
☐ Buyer's receipt ☐ Seller's compliance report
☐ Buyer's Broker acknowledgment ☐ Listing Broker acknowledgment

3.3 Natural Hazard Disclosure Statement — three-day right to cancel. [See **ft** Form 314]
☐ Buyer's Receipt ☐ Seller's compliance ☐ Listing Broker acknowledgement

a. Homeowner's Guide to Earthquake Safety (pre-1960 housing, woodframe, no slab). [See **ft** Forms 315 and 316]
☐ Buyer's receipt ☐ Seller's compliance

b. Commercial Guide to Earthquake Safety for pre-1975 housing (unreinforced masonry, woodframe roof or floors).
☐ Buyer's receipt ☐ Seller's compliance
☐ Buyer's Broker acknowledgment ☐ Listing Broker acknowledgment

3.4 Mello-Roos bond conditions — Notice of Special Tax [District _____].
☐ Buyer's receipt

3.5 Criminal activity and security statement. [See **ft** Form 319]
☐ Buyer's receipt ☐ Seller's compliance

3.6 Certificates for
☐ Well Water ☐ Septic System
☐ Buyer's approval ☐ Seller's compliance

3.7 Tax withholding disclosures. [See **ft** Forms 301 and 301-1]
☐ Seller's compliance ☐ State ☐ Federal ☐ Escrow's Receipt

3.8 Homeowners' association (HOA) documentation: articles, by-laws, CC&Rs, current and approved/additional assessments and unpaid assessments, fines, charges on Seller, unenforceable age restrictions, notice of Owner's violation, list and status of property defects, operating budget, operating rules, CPA's financial statements, insurance policy summary, notice of litigation, and collection and lien enforcement policies.
☐ Buyer's receipt ☐ Seller's compliance

3.9 Financial Disclosure Statement — For Entering into a Seller Carryback Note. [See **ft** Form 300]
☐ Buyer's receipt ☐ Seller's receipt
☐ Buyer's Broker acknowledgment ☐ Listing Broker acknowledgment

3.10 Estimated closing statement — approved prior to closing. [See **ft** Form 402]
☐ Buyer's approval ☐ Seller's approval

3.11 Ordinance Compliance — Local Option Disclosure: city occupancy report, water conservation, retrofit. [See **ft** Form 307]
☐ Buyer's receipt ☐ Seller's compliance
☐ Buyer's Broker acknowledgment ☐ Listing Broker acknowledgement

3.12 Property operating data. [See **ft** Form 352]
☐ Buyer's receipt ☐ Seller's compliance

4. SELLER COMPLIANCE:

4.1 ☐ Termite report and clearance
4.2 ☐ Water heater strapping/bracing installed
4.3 ☐ Smoke detector installed/operative
4.4 ☐ Home warranty policy
insurer _____
coverage _____
4.5 ☐ Payoff demand
☐ Seller's approval [See **ft** Form 429-2]
4.6 ☐ Beneficiary Statement approval by Buyer [See **ft** Form 415]
4.7 ☐ Bill of sale on personal property sold [See **ft** Form 408]
4.8 Holdover Occupancy Agreement [See **ft** Form 272]
☐ Buyer's receipt ☐ Seller's receipt
4.9 ☐ Release of Recorded Instrument [See **ft** Form 409]
4.10 ☐ _____

5. BUYER COMPLIANCE:

5.1 ☐ Preliminary title report approval ☐ Buyer's receipt
5.2 New financing approval.
☐ Buyer's receipt ☐ Seller's receipt
5.3 Interim Occupancy Agreement (pre-closing occupancy). [See **ft** Form 271]
☐ Buyer's compliance ☐ Seller's compliance
5.4 Submission of credit application for carryback note. [See **ft** Form 302]
☐ Seller approval ☐ Buyer's compliance
5.5 ☐ Beneficiary statement on loan takeover or assumption
☐ Buyer's approval
5.6 ☐ Fire/hazard insurance agent _____
☐ Carryback Seller as loss payee
5.7 ☐ Appraisal of property's fair market value
☐ Buyer's approval
5.8 ☐ Home inspector's report [See **ft** Form 269]
☐ Buyer's approval
5.9 ☐ Final pre-closing walk-through inspection [See **ft** Form 270]
☐ Buyer's approval ☐ Seller's compliance
5.10 ☐ _____

6. PRO RATES, ADJUSTMENTS AND MISC. INSTRUCTIONS:

6.1 Impound account on loan takeover to be:
☐ Charged to Buyer and credited to Seller.
☐ Transferred without adjustments.
6.2 Pro rates and credits from ☐ date of closing, or ☐ other date _____:
☐ Property taxes and Mello-Roos type bonds ☐ Rents/Security deposits
☐ Balance/Interest on loan takeover ☐ Association assessments
6.3 ☐ _____

7. TITLE POLICY:

7.1 Seller's vesting _____

7.2 Buyer's vesting _____

Taking title as:
☐ Joint tenants
☐ Separate property
☐ Community property with right of survivorship
☐ Community property
☐ An individual
☐ Tenants in common
☐ An unmarried person

7.3 Title company _____

7.4 Title policy _____

☐ ALTA
☐ ALTA-R
☐ Joint protection
☐ CLTA
☐ Homeowners(s) (one-to-four units)
☐ Lenders
☐ Abstract
☐ Binder
☐ Owners (other than on-to-four units)

Premium to be paid by _____

7.5 Other title conditions _____

8. BROKERAGE FEES: ☐ in mutual instructions ☐ in supplemental Seller instructions

$_____ to _____ paid by _____

$_____ to _____ paid by _____

Agent: _____ Date:_____, 20_____

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In addition, all escrow transactions for the purchase of real estate where a **policy of title insurance will not be issued** to the buyer must include an **advisory notice** prepared in a separate document and signed by the buyer. The notice must state:

"IMPORTANT: IN A PURCHASE OR EXCHANGE OR REAL PROPERTY, IT MAY BE ADVISABLE TO OBTAIN TITLE INSURANCE IN CONNECTION WITH THE CLOSE OF ESCROW SINCE THERE MAY BE PRIOR RECORDED LIENS AND ENCUMBRANCES WHICH AFFECT YOUR INTEREST IN THE PROPERTY BEING ACQUIRED. A NEW POLICY OF TITLE INSURANCE SHOULD BE OBTAINED IN ORDER TO ENSURE YOUR INTEREST IN THE PROPERTY THAT YOU ARE ACQUIRING." [CC §1057.6; see **first tuesday** Form 401-1]

Finally, escrow has a duty to advise the buyer in writing of the Franchise Tax Board requirements for withholding 3 1/3% of the price paid the seller, unless the seller certifies he is exempt from state income tax withholding. [Calif. Revenue and Taxation Code §18662(e)(3)(B)]

Use of the escrow worksheet

In practice, the sales escrow worksheet, **first tuesday** Form 403, is used as a checklist to assist agents in gathering the information and documents needed to dictate instructions to the escrow officer. It is used again to check the completed instructions for compliance with the terms of the purchase agreement. Thus, the agent who dictates the instructions keeps control of the events which must take place to close the transaction.

As with all checklists, the sales escrow worksheet is designed to address activities which are to be considered, but may or may not be applicable to the transaction at hand. Since it is a checklist, the form is not

to be used to create an agreement between the buyer and seller. Also, the worksheet serves as the agent's personal control sheet (or that of his transaction coordinator) and is to be maintained in the client's file to act as a reminder of those activities yet to be completed to close the transaction.

Preparing the sales escrow worksheet

The following instructions are for the preparation and use of the sales escrow worksheet, **first tuesday** Form 403. Form 403 is for an agent to make entries and notations in preparation for dictating escrow instructions to close a sale he has negotiated.

Each instruction corresponds to the provision in the form bearing the same number.

Document identification:

Enter the date, name of the city where the worksheet is prepared, and name of the preparer.

1. **Parties, property and price:**

    1.1 **Enter** the date escrow is scheduled to close.

    1.2 **Enter** the address, assessor's parcel number (APN) and location of the property sold.

    1.3 **Enter** the sales price, down payment, any deposits toward the price/closing costs and the amount of the loan to be assumed or originated by the buyer for the balance of the purchase price.

    1.4 **Enter** the name, address, telephone and fax numbers, and email address for each seller. **Enter** the name of any broker representing the seller.

    1.5 **Enter** the name, address, telephone and fax numbers, and email address for each buyer. **Enter** the name of any broker representing the buyer.

2. **Liens record: Enter** the loan amount and terms for payment of each existing loan if the loan will remain of record. **Enter** the words "paid off" or "assumed" to note whether an existing trust deed loan is to be reconveyed or is to remain of record. **Enter** the lender's name, address and loan number.

    2.1 *Bonded indebtedness:* **Enter** the remaining balance, the payment schedule and interest rate on any bonded improvement liens, such as Mello-Roos bonds. **Enter** the district name, address, phone and fax numbers, and email address.

    2.2 *New loan:* **Enter** the amount, the limitations on the terms of any new loan to be recorded by the buyer and who is to bear the loan charges. **Check** the appropriate box to indicate whether the loan rate is fixed or adjustable.

    2.3 *Seller carryback:* **Enter** the amount of the principal, payment, interest, due date and the first payment date for any carryback note to be executed by the buyer. **Check** the applicable boxes for special provisions to be included in the note or trust deed. **Check** whether a tax reporting service or request for Notice of Default/Delinquency has been agreed to.

3. **Disclosures to buyers: Check** the appropriate box(es) to indicate the items listed in Section 3 which have yet to be prepared, reviewed or received by a principal or a broker.

3.1 *Lead-based paint:* If the residence was constructed before 1978, **check** the box(es) indicating the principals and agents who have not yet prepared, reviewed or received the disclosure. [See Form 313 accompanying Chapter 31]

Editor's note — If the buyer does not receive the disclosure before his offer is submitted, he may cancel and renegotiate the purchase agreement. [40 Code of Federal Regulations §745.107]

3.2 *Condition of Property (TDS):* If this disclosure has not yet been given to the buyer, **check** the box(es) indicating the principals or agents who have not yet prepared, reviewed or received the disclosure. [See Form 304 accompanying Chapter 24]

Editor's note — If the buyer does not receive this disclosure before his offer is accepted, he may cancel the purchase agreement at any time prior to three days after delivery in person of the disclosure or five days after delivery by deposit in the mail. [CC §1102.3]

a. *Environmental Hazards Booklet*: If this booklet has not yet been given to the buyer, **check** the box calling for the buyer's receipt.

Editor's note — The seller and listing agent must disclose in the Condition of Property Statement any environmental hazards known to them to exist on the property. However, delivery of the booklet eliminates any affirmative duty of the seller or listing agent, but not the buyer's agent, to give additional information on environmental hazards. [CC §2079.7]

b. *Home Energy Booklet*: If this booklet has not yet been given to the buyer, **check** the box(es) indicating the principals who have not yet prepared, reviewed or received the disclosure.

Editor's note — The seller and agents must disclose in the Condition of Property Statement any home energy programs known to them which might affect the property. However, delivery of the booklet to the buyer eliminates any affirmative duty of the seller or agents to give additional energy rating information. [CC §2079.10]

3.3 *Natural Hazard Disclosure Statement:* If this disclosure has not yet been given to the buyer, **check** the box(es) indicating the principals or agents who have not yet prepared, reviewed or received the disclosure.

Editor's note — If the buyer does not receive this disclosure before his offer is submitted, he may cancel the purchase agreement at any time prior to three days after delivery in person of the disclosure or five days after delivery by deposit in the mail. [CC §1103.3(c)]

a. *Homeowner's Earthquake Safety Guide*: If the guide has not been given to the buyer, **check** the box(es) indicating the principals or agent who have not yet prepared, reviewed or received the disclosure.

Editor's note — The seller and agent must disclose in the Natural Hazard Disclosure Statement any earthquake hazards known to them which affect the property. Delivery of the guide to the buyer eliminates any duty of the seller or listing agent, but not of the buyer's agent, to provide additional earthquake information. [CC §2079.8]

b. *Commercial Earthquake Safety Guide*: If this guide has not been given to the buyer on the purchase of an unreinforced masonry residence consisting of a woodframe roof or floors, **check** the box(es) indicating the principals or agents who have not yet prepared, reviewed or received the guide.

Editor's note — The seller and listing agent must disclose in the Natural Hazard Disclosure Statement any earthquake hazards known to them which might affect the (masonry) property. Delivery of the guide eliminates any duty of the seller or listing agent to provide additional earthquake information. [CC §2079.9]

3.4 *Mello-Roos bond:* If the property is subject to a Mello-Roos bonded assessment lien and the buyer has not been given a Notice of Special Taxes issued by the assessment district, **enter** the name of the district and **check** the box calling for the buyer's receipt of the notice.

Editor's note — The seller and listing agent must disclose in the purchase agreement, as the assumption of bonded indebtedness (or tax obligations), any Mello-Roos liens known to them.

3.5 *Criminal activity*: If this disclosure has not yet been given to the buyer, **check** the box(es) indicating the principals or agents who have not yet prepared, reviewed or received the disclosure.

3.6 *Certificates for well water and septic systems*: If these disclosures have not yet been given to the buyer, **check** the box(es) indicating which disclosure has not been given and the principals or agents who have not yet prepared, reviewed or received the disclosure.

3.7 *Tax withholding disclosure*: If the buyer and seller have not given each other their federal residency declarations for the seller's exemption, and the buyer has not been given the seller's Federal Tax Board's (FTB's) real estate withholding certificate exempting the buyer from tax withholding (from the seller's funds through escrow), **check** the box(es) indicating the principals who have not yet prepared or received the declarations and certificates, and the documents not received. [Internal Revenue Code §1445; Rev & T C §18662]

3.8 *Homeowners' association (HOA) documentation:* If a common interest development (CID) or condominium is being acquired and the buyer has not been given copies of all the mandated disclosures, statements and documents, **check** the box(es) indicating the principals who have not yet prepared, delivered or received the documents and **circle** the items not yet delivered. [CC §1368]

3.9 *Seller carryback financing:* If the buyer or seller have not been given a carryback disclosure statement prepared by the agent who obtained the buyer's offer, **check** the box(es) indicating the principals and agents who have not yet prepared, reviewed or received the agent's disclosures. [CC §2956]

3.10 *Estimated closing statement:* If the buyer or seller wants to or should review an estimate of the closing debits and credits prior to closing to confirm their financial expectations on the purchase agreement, **check** the box(es) indicating the principals who have to approve the statement prior to closing.

3.11 *Local option disclosures:* If local ordinances or conditions surrounding the property require additional information to be provided to the buyer by the seller or the agents, and the disclosures have not been made, **check** the box(es) indicating the principals and agents who have not yet prepared, reviewed or received the disclosures. [See **first tuesday** Form 307]

3.12 *Property operating data*: If the seller is to disclose the operating costs incurred in the ownership of the property, **check** the box(es) indicating the principals who have not yet prepared or received the disclosure.

4. **Seller compliance:** This section lists the conditions to be satisfied, approved or waived by the seller prior to closing. **Check** the box(es) indicating each activity to be performed by the seller before escrow can close.

Editor's note — The seller is required to install or make operable smoke detectors on the sale of the property. [Calif. Health and Safety Code §13113.8]

Also, the water heater must be strapped, braced or anchored on the sale of the property. [Health & S C §19211]

5. **Buyer compliance:** This section lists the conditions to be performed, approved or waived by the buyer prior to closing. **Check** the box(es) indicating each activity the buyer must perform or approve before escrow can close.

6. **Prorates and adjustments:** This section **accounts** for the debits and credits called for in the purchase agreement to be made by escrow on closing.

6.1 *Impound account:* If the existing loan on the property is being assumed by the buyer or taken over "subject to," **check** the box which conforms to the purchase agreement.

6.2 *Prorates:* **Check** the box to indicate the date for making miscellaneous prorates and adjustments — usually the date scheduled for "close of escrow", but if not, **enter** a date — and **check** the box(es) indicating each item to be accounted for by escrow.

6.3 *Other:* **Check** the box and enter any additional pro rates, adjustments or miscellaneous instructions to be included.

7. **Title policy information:** This section **addresses** the vestings and title policy on the transfer of the property.

7.1 *Seller's vesting:* **Enter** the current vesting for the seller. Alternatively, provide escrow with a copy of the recorded conveyance transferring title to the seller. The deed is part of a "title profile" report prepared by a title company without charge.

7.2 *Buyer's vesting:* **Enter** the name(s) of the buyer(s) as they are to appear of record on acquisition. **Check** the box to indicate the type of vesting.

Editor's note — The purchase agreement allows the buyer to assign the purchase rights to a substitute buyer, in which case the name and vesting should reflect the assignee's preferences.

7.3 *Title company:* **Enter** the name of the title company who is to insure the conveyance.

7.4 *Title policy:* **Check** the box(es) to indicate the type of policy to be issued to the buyer, carryback seller or new lender, and **enter** who is to pay the premium.

Figure 1

ESCROW INSTRUCTIONS
Buyer and Seller Instructions

DATE: _____, 20_____.
Items left blank or unchecked are not applicable.
Escrow number _____
Escrow/Brokerage company _____
Licensed by the Department of _____, State of California, license # _____
Escrow officer _____
Address _____

Phone number _____
Fax _____
Buyer _____
Seller _____

An escrow administrative fee will be charged each principal for postponement of closing by two months or more beyond the originally scheduled closing date in these instructions or on cancellation of these instructions, due to acts or omissions of either principal.

Postponement Fee . . . $_____
Cancellation Fee . . . . $_____

Buyer's Initials	Seller's Initials
_____ _____	_____ _____

TERMS OF SALE: (for escrow use only)
$_____ TOTAL Consideration Seller to receive from Buyer
$_____ Assessment Bond paid with property taxes
$_____ 1st Trust Deed of Record
$_____ 2nd Trust Deed of Record
$_____ Trust Deed to record
$_____ Trust Deed to record
$_____ Cash through Escrow
$_____ Other Consideration _____

1. You, the escrow officer, are authorized and instructed as follows:
1.1 Buyer deposits herewith the sum of $_____.
1.2 On or before _____, 20_____, the date set for closing, Buyer will deposit with You on your request the additional sum of $_____, to make a total deposit of $_____.
1.3 Buyer will deliver to You prior to the date set for closing any additional funds and instruments required which You request.
1.4 You may thereafter use these funds and instruments until such time as You have received written instruction not to do so. Brokers are authorized to extend any performance date up to one month.
1.5 Close of escrow is the date instruments are recorded.

2. Upon the use of these funds and instruments, You are to obtain the following policy of title insurance, with the usual title company exceptions, in the following checked type and form:
Title to be vested in Buyer or Assignee free of encumbrances other than those set forth herein. Buyer's interest in title to be insured under a policy issued by _____
as a(n) ☐ Homeowner(s) policy (one-to-four units), ☐ Residential ALTA-R policy (vacant or improved residential parcel), ☐ Owner's policy (other than one-to-four units), ☐ Joint Protection policy (also naming the Carryback Seller or Purchase-assist Lender), or ☐ Binder (to insure resale or refinance within two years).
Endorsements _____
_____
2.1 With title insurance in the amount of $_____ covering the following described real property, commonly known as _____
and legally described as _____
_____
_____
_____,
2.2 Showing title vested in _____

2.3 Subject to the following only:
a. All General and Special taxes for the _____ fiscal year, including any special district taxes or personal property taxes collected with the ad valorem taxes.
b. Assessments and Bonds with an unpaid balance of $_____.
c. Any covenants, conditions, restrictions, reservations, rights, right of ways and easements of record, or in deed to record, and EXCEPTIONS of water, minerals, oil, gas, and kindred substances, on or under said real property, now of record, or in deed to record.
d. First encumbrance now of record with an unpaid balance of $_____, payable $_____ monthly, including interest of _____% per annum. ☐ ARM
e. Second encumbrance now of record with an unpaid balance of $_____, payable $_____ monthly, including interest of _____% per annum, all due and payable _____, 20_____.
f. Deed of Trust to record in the amount of $_____.
Execution of loan documents under §2.3f or §2.3g shall be Buyer's approval of their terms. Should Seller carry back under §2.3h, You are to obtain Seller's written approval of the loan terms for any Deed of Trust to record.
g. Deed of Trust to record in the amount of $_____.
h. Purchase money Deed of Trust with Assignment of Rents on standard form, executed by Buyer securing a note for $_____ in favor of Seller as their interests appear on the preliminary title report, with interest at _____ % per annum from close of escrow, principal and interest payable in installments of $_____, or more, each on the same day of every calendar month, beginning one month from ☐ close of escrow, or ☐ _____, 20_____, and continuing until _____.
You, as escrow holder, are instructed to prepare the note and Deed of Trust and insert the correct principal amount and correct first payment date, interest accrual date and due date as soon as they can be determined. The address for deliver of note payments is _____
_____.

3. You are to obtain at Seller's expense beneficiary statements on the Deed(s) of Trust (or mortgage) now of record (§2.3d and §2.3e above). If the principal balances shown by the statements are more or less than the amount shown above, You are to make adjustments as checked below:
☐ cash through escrow, ☐ total consideration, or ☐ purchase-money Deed of Trust.
3.1 You are to deliver to Buyer for Buyer's approval prior to close of escrow a copy of the beneficiary statement for each Deed of Trust to remain of record on closing.
3.2 You are to deliver to Seller prior to close of escrow, any payoff demand necessary to eliminate encumbrances so You can comply with conditions in §2.3 for title insurance.

4. You are to obtain at Seller's expense a UCC-3 clearance on the following described personal property
_____
_____
_____
and cause title thereto to be vested in Buyer subject to the following UCC-1 financing statements:
a. A UCC-1 obligation in the approximate amount of $_____, payable $_____ per month, including an annual percentage rate of _____%, all due and payable _____, 20_____.
b A UCC-1 form in favor of Seller at Buyer's expense as additional security for any note carried back under §2.3h above.

5. Prior to close of escrow, Buyer is to hand You a sufficient hazard insurance policy. In the event Seller carries back under §2.3h above, then Seller is to be named as additional loss payee. The policy is to be in an amount sufficient to cover all lien balances or the coverage demanded by the new lender if greater in amount.

6. ☐ Prior to the close of escrow and at Seller's expense, Seller to hand You a structural pest control clearance on the subject property.

7. ☐ Prior to close of escrow and at Seller's expense, You are to obtain a one-year policy of homeowner's warranty issued by _____, in favor of Buyer, covering _____.

8. Prior to the close of escrow and at Seller's expense, You are to obtain from the homeowners' association (HOA) of any common interest development which includes the described property the following checked item(s) for Buyer's approval:
8.1 ☐ A statement of condition of assessments;

8.2 ☐ Copies of the association's articles, bylaws, CC&Rs, collection and lien enforcement policies, operating budget, operating rules, CPA's financial review, insurance policy summary and any age restriction statement;

8.3 ☐ Copies from the association of any notice to Seller of CC&R violations, any list of construction defects, and any assessment charges not yet payable.

9. ☐ You are authorized and instructed to prepare assignments for all existing lease/rental agreements.

10. The following checked prorations and adjustments shall be computed by You on a monthly basis of 30 days as of ☐ close of escrow, or ☐ _____, 20_____, on which date Buyer is to be treated as the owner for the entire day:

a. ☐ Taxes, based on latest tax statement available and Seller warrants that no reassessment or reassessment activity has since occurred

b. ☐ Hazard (fire) insurance premium

c. ☐ Interest on existing note(s) and Deed(s) of Trust

d. ☐ Rents and deposits based on rental statement handed to You and approved by Buyer and Seller prior to close of escrow

e. ☐ Impounds, under §2.3d or §2.3e above, together with an assignment of these impounds to Buyer through escrow

f. ☐ Association assessments for any common interest development which includes the property

g. ☐ _____

10.1 You are to account for the above prorations and adjustments into the item checked below:
☐ cash through escrow, ☐ total consideration, or ☐ purchase-money Deed of Trust.

11. You are to promptly obtain and hand Buyer a preliminary title report on the property from title company for Buyer's approval or disapproval and cancellation of this transaction within _____ days of receipt by Buyer or Buyer's Broker of the report.

12. The Grant Deed to state the tax statements are to be mailed to _____
_____
at _____.

13. Escrow is herewith handed a purchase agreement dated _____, 20_____ and (a) counteroffer dated _____, 20_____, entered into by Buyer and Seller regarding the sale of the property which authorizes and instructs escrow to act on the provisions of the agreement as mutual escrow instructions to close this transaction.

13.1 Any inconsistencies between the provisions in the purchase agreement and provisions in the instructions prepared by escrow shall be controlled by the instructions prepared by escrow.

14. The close of escrow and disbursement of funds can be affected based on the form of the deposit with escrow. Funds deposited in cash or by electronic payment allow for closing and disbursement on or after the business day of deposit with the escrow's financial institution. Funds deposited by cashier's check allow for closing and disbursement on or after two business days after deposit with the escrow's financial institution. All other forms of deposit cannot be disbursed and thus, the closing cannot occur until the funds are made available to escrow by the escrow's financial institution.

15. Buyer is required to withhold 10% of each Seller's share of the sales price for payment of Seller's federal income taxes on this transaction, unless Seller meets one of the following conditions:

15.1 Each Seller provides Buyer with their taxpayer identification number and declares under penalty of perjury to be a citizen of the United States or a resident alien [**ft** Form 301];

15.2 Buyer declares under penalty of perjury the property will be used as their residence and the sales price is $300,000 or less [**ft** Form 301]; or

15.3 Seller requests and obtains a withholding certificate from the Internal Revenue Service (IRS) authorizing a reduced amount or no amount be withheld.

16. Buyer is required to withhold 3⅓% of each Seller's share of the sales price for payment of Seller's California income taxes on this transaction, unless one of the following exemptions exists:

16.1 Seller executes a real estate withholding certificate, FTB form 593-C, declaring the sale is exempt due to:

a. The property sold is or was last used as Seller's principal residence;

b. The property sold was the decedent's principal residence;

c. The property was sold as part of an IRC §1031 exchange;

d. The property was taken by involuntary conversion and will be replaced under IRC §1033; or

e. The property was sold at a taxable loss.

16.2 Buyer is also exempt from withholding 3⅓% of Seller's share of the sales price if:

a. The property was sold for less than $100,000;

b. Buyer is acquiring the property by a deed-in-lieu of foreclosure; or

PAGE THREE OF FOUR — FORM 401

c. Seller is a bank acting as a trustee under an agreement other than a Deed of Trust.

16.3 On an installment sale, Buyer may agree to withhold on each payment on the carryback note and thus defer withholding. [FTB Forms 593-I and 597]

17. In the event You become involved in litigation between Buyer and Seller arising out of this transaction, Buyer and Seller shall pay a reasonable fee for attorney services which You may be required to incur.

17.1 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

18. You are authorized to use Seller's instruments when You hold and can deliver to Seller the money and instruments to be delivered to Seller under these instructions.

18.1 You are authorized to pay and charge Seller for the following checked item(s):

a. ☐ Bonds, assessments, taxes and other liens of record to show title as called for.

b. ☐ Documentary transfer taxes as required.

c. ☐ Brokerage fees: $_____ to _____
$_____ to _____
$_____ to _____

d. ☐ Transaction coordinator's fees:
$_____ to _____
$_____ to _____

e. ☐ Title insurance premium on the policy to be issued to Buyer.

f. ☐ Costs of recording Seller's Grant Deed.

g. ☐ Escrow fees for your services and any charges incurred by escrow on Seller's behalf.

h. ☐ Payables submitted to escrow for payment by Seller or Seller's Broker.

i. ☐ Attorney fees: $_____ to _____

j. ☐ _____

19. You are authorized to pay and charge Buyer for the following checked item(s):

a. ☐ Escrow fees for your services and any charges incurred by escrow on Buyer's behalf.

b. ☐ Costs of and lender's charges for recording or assuming any Deed of Trust, including a policy of title insurance for any new lender.

c. ☐ Attorney fees: $_____ to _____

d. ☐ Brokerage fees: $_____ to _____

e. ☐ Title insurance premium on the policy to be issued to Buyer.

f. ☐ _____

20. _____
_____
_____

I hereby agree to perform all acts called for above to be performed by Seller.	**I hereby agree to perform all acts called for above to be performed by Buyer.**
Date: _____, 20_____	Date: _____, 20_____
Seller: _____	Buyer: _____
Signature: _____	Signature: _____
Seller: _____	Buyer: _____
Signature: _____	Signature: _____
Address: _____	Address: _____
_____	_____
Phone: _____	Phone: _____
Fax: _____	Fax: _____
Email: _____	Email: _____

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8. **Brokerage fee: Check** the box to indicate whether the disbursement provisions for the brokerage fees are to be located in the mutual instructions signed by all principals or in a supplemental instruction signed only by the principal who is paying the fees. **Enter** the amount of the fee paid to each broker involved, and who is to pay the fee.

Preparer:

Enter the name of the agent who prepared this worksheet and date it.

Use of the escrow instructions

The sales escrow instructions, **first tuesday** Form 401, contains all the typical provisions expected in a **set of instructions** prepared by an independent escrow company for a sales transaction.

The instructions may be used as an **addendum** to the purchase agreement for the sales transaction. Both the escrow instructions and the purchase agreement are to be prepared by the agent and signed by each party at the same time. Thus, the need to dictate instructions to the escrow officer and wait for it to be prepared before it can be submitted to the seller and buyer for signatures is avoided. [See Figure 1 accompanying this chapter]

Preparing the sales escrow instructions

The following instructions are for the preparation and use of the sales escrow instructions, **first tuesday** Form 401. Form 401 is designed so it **can be prepared** by an escrow officer, the buyer or the broker or agent who negotiated the sales transaction.

Each instruction corresponds to the provision in the form bearing the same number.

Identification:

Enter the date the instructions are prepared and the loan escrow number. The date and escrow number are used when referring to this document.

Enter the name of the escrow company, the escrow's licensing agency, its license number, the escrow officer, the address of the escrow company and the escrow officer's phone and fax numbers.

Enter the name of each buyer and each seller.

Enter the postponement fee to be charged for delaying closing more than two months beyond the scheduled closing date. **Enter** the cancellation fee to be charged on cancellation of these instructions. The buyer and seller are to **enter** their initials below.

Terms of Sale:

Enter the price to be paid by the buyer as the total consideration the seller is to receive.

Enter the terms for payment of the price, i.e., the assessment bond balance, the trust deeds of record to be taken over by the buyer, the trust deeds to be recorded by the buyer to assist in funding the price, and the cash or other consideration paid as a down payment on the price by the buyer.

Editor's note — The terms of sale entered here are general and for the escrow's use only to reference the financing of the price. The specific terms of the price and conditions for its payment follow.

1. **Instructions to Escrow:**

   1.1 **Enter** the dollar amount of the buyer's deposit accompanying the purchase agreement offer and handed to escrow.

   1.2 **Enter** the closing date set for the buyer to make any additional deposit agreed to in the purchase agreement, the dollar amount of the deposit and the total deposit escrow is to receive (prior to requesting any further funds needed for closing).

   1.3 **Obligates** the buyer to deliver funds and instructions required by escrow to close.

   1.4 **Authorizes** escrow to close any time after the date set for the buyer to fully perform, unless instructions have been received to the contrary.

   1.5 **States** escrow is considered closed on the date the instruments are recorded.

2. **Title conditions: Enter** the name of the title insurance company agreed to in the purchase agreement to issue the buyer's title insurance policy. **Check** the appropriate box to indicate the type of title policy to be issued. **Enter** any endorsements to be issued with the policy.

   2.1 *Coverage:* **Enter** as the dollar amount of title insurance coverage the total dollar amount of consideration the buyer is paying for the property. **Enter** the common address and the legal description for the property.

   2.2 *Vesting:* **Enter** the names of the individuals or entities who will be taking title, the type of vesting and the percentages of ownership, if applicable.

   2.3 *Title insurance:* **Authorizes** title insurance is to be issued reflecting the following title conditions.

      a. **Enter** the fiscal year for any taxes assumed by the buyer.

      b. **Enter** the dollar amount of any specific assessment bonds to be assumed by the buyer.

      c. **States** title is to be subject to covenants, conditions and restrictions (CC&Rs) of record.

      d. **Enter** the dollar amount of any first trust deed of record to be assumed by the buyer, its monthly payment and the rate of interest on the note. **Check** the box to indicate whether the interest is adjustable (ARM).

      e. **Enter** the dollar amount of any second trust deed of record to be assumed by the buyer, its monthly payment, the rate of interest on the note and any due date.

      f. **Enter** the dollar amount of any first trust deed loan to be recorded by the buyer.

      g. **Enter** the dollar amount of any second trust deed loan to be recorded by the buyer.

      h. **Enter** the dollar amount of any note and trust deed to be executed by the buyer in favor of the seller, the note's interest rate, the amount of the monthly installments, the date for payment of the first installment and the date the note is due. **Enter** the address to which the buyer is to send the installments.

3. *Beneficiary statement:* **Check** the appropriate box to indicate whether adjustments on any loan assumption for differences in the loan balance between the amounts stated in the purchase agreement and the beneficiary statements are to be made into cash, price or the carryback trust deed.

   3.1 **Authorizes** the buyer's further-approval of the beneficiary statement. A buyer assuming the loan needs to confirm the loan conditions before closing.

   3.2 **Requires** escrow to submit any lender demand for payoff of an existing loan to the seller. The seller needs to review the demand for accuracy.

4. *Personal property lien:* **Enter** the description of any personal property being transferred to the buyer. Escrow is to obtain a title clearance on the personal property.

   a. **Enter** the dollar amount of any note to be assumed by the buyer that is secured by a UCC-1 financial statement on personal property to be transferred to the buyer, the amount of monthly installments, the note's interest rate and the due date.

   b. **States** any carryback trust deed note to be executed by the buyer in favor of the seller is to be additionally secured by any personal property to be transferred to the buyer.

5. *Hazard insurance policy:* **Requires** the buyer to provide coverage for the property transferred.

6. *Pest control clearance:* **Check** the box to indicate whether the seller is to provide a structural pest control clearance on the property prior to closing.

7. *Home warranty policy:* **Check** the box to indicate whether the seller is to provide the buyer with a home warranty policy. **Enter** the name of the insurance company issuing the policy and the coverage agreed to in the purchase agreement.

8. *Homeowners' association (HOA) documents:*

   8.1 **Check** the box to indicate whether the buyer is to further approve a statement of condition of assessments from any HOA involved.

   8.2 **Check** the box to indicate whether the buyer is to further approve the documents listed and to be obtained from any HOA involved.

   8.3 **Check** the box to indicate whether the buyer is to further approve any HOA Notice of Violation by the seller, construction defects and any charges in assessments not yet payable.

9. *Tenant leases transferred:* **Check** the box to indicate the existence of tenants and to instruct escrow to prepare assignments of the leases to the buyer.

10. *Prorations and adjustments:* **Check** the box or **enter** the date for escrow to compute adjustments and prorates. **Check** the appropriate box(es) for subparagraphs a. through f. to indicate the prepaid or accrued taxes, premiums, interest, rents/deposits, loan impounds, etc. on obligations taken over by the buyer.

    10.1 **Check** the appropriate box to indicate whether the adjustments and prorates are to be made into the down payment, the price or a carryback note.

11. *Preliminary title report:* **Enter** the number of days after the buyer's receipt of a preliminary title report during which the buyer may approve or disapprove the condition of title.

12. *Mailing address:* **Enter** the name of the buyer(s) and the address of the buyer(s) to which the grant deed is to be mailed.

13. *Purchase agreement instructions:* **Enter** the date of the purchase agreement and any counteroffers entered into by the buyer and seller if the purchase agreement also contains instructions to escrow.

    13.1 *Modification of the purchase agreement:* **Provides** that any inconsistencies between escrow instructions and purchase agreement provisions are to be controlled by the instructions as a modification of the purchase agreement.

14. *Form of deposit:* **Advises** the buyer about the time periods needed after escrow's receipt of various forms of funding before escrow can close.

15. *Federal withholding:* **Discloses** the federal IRS income tax withholding required by the buyer (handled by escrow) on transactions with non-resident, alien sellers who have not obtained an IRS withholding certificate.

16. *California withholding:* **Discloses** the California FTB income tax withholding of the seller's sales proceeds required by the buyer (handled by escrow) on all transactions, unless an exemption exists among those listed in sections 16.1, 16.2 and 16.3.

17. *Attorney fees provision:* **States** escrow is entitled to attorney fees they may incur due to any future litigation between the seller and the buyer.

18. *Authority to close:* **Authorizes** escrow to use the seller's deed when all monies and instruments due the seller as called for in the instructions can be delivered to the seller.

    18.1 **Check** the appropriate box(es) and **enter** the dollar amount(s) and to whom they will be paid for subparagraphs a. through j. to indicate whether the items are to be charged to the seller by escrow on closing.

19. *Buyer's charges:* **Check** the appropriate box(es) and **enter** the dollar amount(s) and to whom they will be paid for subparagraphs a. through f. to indicate whether the items are to be charged to the buyer by escrow on closing.

20. *Additional provisions:* **Enter** any additional provisions.

Signatures:

Seller's signature: **Enter** the date the seller signs the escrow instructions and each seller's name. **Obtain** each seller's signature on the escrow instructions. **Enter** the seller's address, telephone and fax numbers, and email address.

Buyer's signature: **Enter** the date the buyer signs the escrow instructions and each buyer's name. **Obtain** each buyer's signature on the escrow instructions. **Enter** the buyer's address, telephone and fax numbers, and email address.

CITE THIS READING MATERIAL

THUS:

first tuesday

Real Estate Property Management

4th Edition

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Table of Contents

for Online and CD-ROM versions

Table of Forms 7
Introduction. 9

Section A

Ownership and Possession

Chapter 1 — Fee vs. leasehold
A matter of possession 10

Chapter 2 — License to use land
A personal right to use another's property 16

Chapter 3 — Types of tenancies
Know your tenancy or lose time. 23

Chapter 4 — Landlord's right to enter
Conflict with tenant's right to privacy 32

Chapter 5 — Leasehold improvements
Real estate or trade fixtures 45

Chapter 6 — Options to buy and the right of first refusal
Purchase rights held by tenants 56

Section B

Property Management and Agency

Chapter 7 — Property management licensing
When is a DRE license required? 65

Chapter 8 — Property management agreement
Authority to operate the rental property 69

Chapter 9 — Property manager's responsibilities
An evolving standard of conduct 75

Chapter 10 — Resident managers
Employees: not independent contractors, not tenants 88

Chapter 11 — Identification of landlord or property manager
Notice to tenant of agent-for-service 96

Chapter 12 — Exclusive authorization to lease
Leasing agent's bargain for fees 100

Chapter 13 — Exclusive authorization to locate space
A broker and his nonresidential tenant 111

Chapter 14 — Cost of operating in leased space
Disclosures by leasing agents 118

Chapter 15 *Tenant profiles*
Get the negotiations rolling *123*

Chapter 16 *Offers to lease*
Negotiating the nonresidential lease *131*

Section C

Rents and Deposits

Chapter 17 Residential tenant credit checks
Protection for landlords and brokers *137*

Chapter 18 Nonresidential tenant screening
Qualified to stay and pay *144*

Chapter 19 Security deposits and pre-expiration inspections
Residential and nonresidential rules *148*

Chapter 20 Recovery of residential turnover costs
The security deposit plays no role *161*

Chapter 21 Accepting partial rent
Rights of residential and nonresidential landlords . . *167*

Chapter 22 Changing terms on a month-to-month tenancy
Landlord's 30-day notice *174*

Chapter 23 Lease guarantees and small claims actions
Recovery amount limited *178*

Section D

Enforcing Rents; Forfeiting Tenancies

Chapter 24 Forfeiture of the lease
Lease agreement obligations survive *184*

Chapter 25 Delinquent rent and the 3-day notice
Forfeit possession in three days *192*

Chapter 26 Three-day notices to quit
Curable and incurable nonmonetary breaches *201*

Chapter 27 Proof of service
Diligence to locate a tenant is not required *214*

Chapter 28 Other amounts due under 3-day notices
Know what the judge will allow *220*

Chapter 29 Notices to vacate
Termination of periodic tenancies *226*

Chapter 30 Surrender cancels the lease agreement
Lost ability to recover future rents *233*

Chapter 31 Notice of belief of abandonment
An alternative forfeiture *238*

Chapter 32 Personal property reclaimed by tenant
Reclaim it or lose it on notice 244

Chapter 33 Constructive eviction cancels the lease
Interference forces tenant to vacate 253

Chapter 34 Retaliatory eviction defense
Shackling vengeful wayward landlords 261

Section E

Maintenance and Security

Chapter 35 Defective building components
Liability for neglect, not strict liability 266

Chapter 36 Care and maintenance of property
Tenant's obligations and remedies 269

Chapter 37 Implied warranty of habitability
Minimum quality low-income housing 278

Chapter 38 Fire safety programs
Smoke detectors, security bars and safety information 287

Chapter 39 Security to prevent crimes
security measures and warnings 290

Chapter 40 Dangerous on-site and off-site activities
Duty to all to remove on-site dangers 295

Section F

Nonresidential Lease Provisions

Chapter 41 Nonresidential lease agreement
The conveyance of a leasehold 304

Chapter 42 Rent provisions in nonresidential leases
The landlord's future return 320

Chapter 43 Adjustable rent provisions
Economic goals of nonresidential landlords 327

Chapter 44 Rent increases and the CPI
Coping with inflation 332

Chapter 45 Percentage lease rent provisions
Rental income driven by gross sales 340

Chapter 46 Nonresidential use-maintenance provisions
Shifting ownership obligations 345

Chapter 47 Lease renewal and extension options
Don't forget to exercise 354

Chapter 48 Lease assignments and subleases
Consent conditioned on exactions 363

Chapter 49 Nonresidential rent control prohibited
Legislative purpose 372

Section G

Residential Rental and Lease Agreements

Chapter 50 Residential rental and lease agreements
Fixed-term or periodic tenancy 376

Chapter 51 Foreign-language residential leases
A written translation addendum. 385

Chapter 52 Lead-based paint disclosures
Pre-contract disclosure for pre-1978 housing 387

Chapter 53 Permitting pets and waterbeds
Role of the security deposit 393

Chapter 54 Civil rights and fair housing laws
Property rights cannot be based on status. 400

Chapter 55 Adults-only policies prohibited in housing
Familial status is protected 412

Chapter 56 Seniors-only housing
California's fair housing laws 417

Chapter 57 Residential rent control
Police power and rent control 420

Section H

Lender Considerations

Chapter 58 Leaseholds as security for loans
Financing business expansions 424

Chapter 59 Attornment clauses in nonresidential leases
Altering priorities for lenders 429

Chapter 60 Tenant estoppel certificates
Protection for buyers and lenders 439

Chapter 61 Due-on-leasing regulations
Rising interest rates bring lender interference 446

Chapter 62 Gaining possession after foreclosure
Nothing required to remove occupants 451

Appendix A DRE — Anti-discrimination statutes 457

Table of Forms

for Online and CD-ROM versions

No.	Form Name	Page
570	30-Day Notice of Change in Rental Terms	176
573	30-Day Notice to Quit Due to Foreclosure (To Holdover Residential Tenant)	453
569	30-Day Notice to Vacate (For Use by Residential Landlord)	230
572	30-Day Notice to Vacate (From Tenant)	228
554	Change of Owner or Property Manager (Addendum to Rental or Lease Agreement)	97
561	Condition of Furnishings Addendum (and Inventory)	273
560	Condition of Premises Addendum	270
302	Credit Application (Individual)	138
110	Exclusive Authorization to Lease Property	102
111	Exclusive Authorization to Locate Space	113
566	Exercise of Option to Renew/Extend Lease	358
439-L	Guarantee Agreement (For Lease)	179
557	Lead-Based Paint Disclosure (For Renting or Leasing Residential Property)	389
552	Nonresidential Lease Agreement (Commercial, Industrial or Office)	305
581	Notice of Belief of Abandonment (Residential and Nonresidential Property)	242
567	Notice of Intent to Enter Dwelling	34
597	Notice of Nonresponsibility (Civil Code §3094)	53
587	Notice of Right to Reclaim Personal Property (To Others with an Interest in Property Left by Tenant)	251
584	Notice of Right to Reclaim Personal Property (To Tenant After Termination of Tenancy)	249
567-1	Notice of Right to Request a Joint Pre-Expiration Inspection	153
582	Notice to Landlord to Surrender Personal Property (For Use by Residential Tenants Only)	246
562	Occupant's Operating Expense Sheet (Ongoing Operating Costs)	120
556	Offer to Lease (And Receipt of Deposit)	132

No.	Form Name	Page
565	Option to Renew/Extend Lease	356
558	Partial Payment Agreement (Nonresidential)	169
559	Partial Payment Agreement (Residential)	171
563	Pet Addendum	395
580	Proof of Service	218
590	Property Management Agreement	71
550	Residential Lease Agreement	378
591	Resident Manager Agreement	89
579	Right of First Refusal to Buy (Addendum)	58
116	Right to Enter and Exhibit Unit to Buyers (For Residential and Nonresidential Rentals)	38
585	Security Deposit Deposition On Vacating Residential Premises	158
161	Standard Option to Purchase (Irrevocable Right-to-Buy)	62
567-3	Statement of Deficiencies on Joint Pre-Termination Inspection	155
598	Tenant Estoppel Certificate	441
555	Tenant Lease Worksheet	125
575	Three-Day Notice to Pay Rent or Quit	194
576	Three-Day Notice to Perform or Quit	203
577	Three-Day Notice to Quit	205
564	Waterbed Addendum	397

Introduction

Real Estate Property Management is part of the **first tuesday** series of California-specific real estate study materials. Each title in the series has a different topic as its primary content. As part of a comprehensive real estate education program, the series also includes Principles of Real Estate, Real Estate Practice, Legal Aspects of Real Estate and Real Estate Finance.

first tuesday's real estate series uses plain language and eliminates the extensive overlap of identical course material commonly offered by other publishers. Issues arising in more than one factual setting are referenced as necessary, but are dealt with fully in only one **first tuesday** title.

Real Estate Property Management is written for California brokers, agents, landlords, resident managers and attorneys. This course material is designed to be an educational tool for understanding landlord/tenant relationships in residential and nonresidential rental properties located in California. The scope of the material presented extends beyond a minimum acceptable level of knowledge and professional development.

The objective of this material is to fully inform the reader of federal, state and local landlord/tenant rights and obligations, and of the well-developed nature of interests held in real estate by landlords and tenants. **Real Estate Property Management** examines and applies the detailed and exacting rules of leasing and renting for both residential and nonresidential income properties. Hundreds of examples vividly present and resolve landlord/tenant situations encountered by owners and tenants, and real estate licensees who manage income property or perform services as leasing agents.

Included, with an explanation of their use, are all the forms and notices required by California law to establish leasing and management agencies; to create, alter and terminate tenancies; and to preserve rent obligations for later enforcement after evictions.

These forms fully reflect relevant codes, judicial decisions and practices in effect on the date of this publication. Forms referenced are developed and published by **first tuesday**.

Chapter 1 Fee vs. leasehold

This chapter examines the entitlement to possession of real estate held by owners of different interests in a parcel of real estate.

A matter of possession

A parcel of real estate is located by circumscribing its *legal description* on the "face of the earth." Based on the legal description, a surveyor locates and sets the corners and **surface boundaries** of the parcel.

The legal description is contained in deeds, subdivision maps or government surveys relating to the property.

However, a parcel of real estate is three dimensional, reaching beyond the surface boundaries. In addition to the surface area within the boundaries, real estate consists of the soil below the surface to the core of the earth as well as the air space above it to infinity.

All permanent structures, crops and timber within this *inverse pyramid* are also a part of the parcel of real estate.

A **parcel of real estate** is often mistakenly thought of as a plot of unimproved land. Also mistaken is the notion any improvements can be treated as personal property, unless they are to be removed from the land.

Real estate, sometimes legally called *real property*, consists of:

- the land;
- the improvements and fixtures attached to the land; and
- all rights incidental or belonging to the property. [Calif. Civil Code §658]

Real estate includes buildings, fences, trees, watercourses and easements within the parcel's boundaries.

Anything below the surface, such as water and minerals, or above the surface in the air space, such as crops and timber, is part of the real estate.

The rental of a boat slip includes the water and the land below it, both of which comprise the real estate. Thus, landlord/tenant law controls the rental of the slip. [**Smith** v. **Municipal Court of San Mateo County** (1988) 202 CA3d 685]

In the case of a condominium unit, the air space enclosed within the walls is the real estate conveyed and held by the owner of the unit. The structure, land and air space outside the unit are the property of the homeowners' association, creating what is called a *common interest development (CID)*. [CC §1351(f)]

Possessing interests in real estate

The **ownership interests** a person may hold in real estate are called *estates*. Four kinds of estates exist in real estate:

- fee estates, also known as inheritance or perpetual estates;

- life estates;
- leasehold estates, sometimes called estates for years; and
- estates at will. [CC §761]

In practice, these estates are separated into three categories: fee simple estates, leasehold estates and life estates. Estates at will are part of the leasehold estates controlled by landlord/tenant law.

A **life estate** terminates on the death of the owner of the life estate or the death of another person named in the deed which conveys or reserves the life estate to the owner.

Leasehold interests in the real estate exist for a specific period of time. The interest will terminate when the period of time expires.

An **estate at will**, unlike a leasehold, is not conveyed in an exchange for value, called *consideration* or rent. Estates at will terminate at the discretion of the fee owner, subject to proper advance notice. Possession of real estate under leasehold interests and estates at will is controlled primarily by landlord/tenant law.

Fee ownership

A fee owner has the right to possess and control his property indefinitely. A fee owner's possession is exclusive and absolute. Thus, the owner has the right to deny others permission to cross his boundaries. No one can be on the owner's property without his consent, otherwise they are trespassing. The owner may recover any money losses caused by the trespass.

A fee owner has the exclusive right to use and enjoy the property. As long as local ordinances such as building codes and zoning regulations are obeyed, a fee owner may do as he pleases with his property. A fee owner may build new buildings, tear down old ones, plant trees and shrubs, grow crops or simply leave the property unattended.

A fee owner may *occupy, sell, lease* or *encumber* his parcel of real estate, give it away or pass it on to his heirs or to anyone he chooses on his death. The fee estate is the interest in real estate transferred in a real estate sales transaction, unless a lesser interest is noted.

A fee owner is entitled to the land's surface and anything permanently located above or below it. [CC §829]

The ownership interests in one parcel may be separated into several fee interests. One person may own the mineral rights beneath the surface, another may own the surface rights, and yet another may own the rights to the air space. Each solely owned interest is held in fee in the same parcel.

Underground oil and gas reserves have a tendency to flow from one place to another. However, the right to extract oil and gas can be separately conveyed by the fee owner of the real estate. The drilling rights separated from the fee ownership are called *profit a prendre*. [**Gerhard** v. **Stephens** (1968) 68 C2d 864]

Profit a prendre is the right to remove profitable materials from property owned and possessed by another.

Consider a fee owner who grants separate fee interests in his property to two individuals. One individual receives the land's surface and air space rights. The other individual receives the subsurface oil and mineral rights.

The surface owner claims the title to the entire parcel of real estate should be vested — *quieted* — in his name.

The subsurface owner objects, claiming the surface owner's real estate interest is less than the entire fee estate in the property.

Here, the surface owner's fee interest in the parcel of real estate is separate from the subsurface ownership and possession of the oil and mineral rights. Also, they are not co-owners of the real estate. Both owners hold an individual fee estate in mutually exclusive and divided portions of the same parcel. [**In re Waltz** (1925) 197 C 263]

In most cases, one or more individuals own the entire fee and lease the subsurface rights to others to remove underground oil or minerals. Thus, a fee owner can convey a leasehold interest in the oil and minerals while retaining the fee interest.

Life estates and the life tenant

A life estate is an interest in a parcel of real estate lasting the lifetime of the *life tenant*. Life estates are granted by a deed entered into by the fee owner, an executor under a will or by a trustee under an inter vivos trust.

Life estates are commonly established by a fee owner who wishes to provide a home or financial security for another person during that person's lifetime, called the *controlling life*.

Life estates terminate on the death of the controlling life. Life estates may also be terminated by agreement or by merger of different ownership interests in the property.

For example, an owner of a vacation home has an elderly aunt who needs a place to live. The owner grants her a life estate in the vacation home for the duration of her lifetime. The aunt may live there for the rest of her life, even if she outlives the fee owner who granted her the life estate.

Although the aunt has the right to exclusive possession of the entire parcel of real estate, the owner retains title to the fee. Thus, the conveyance of a life estate transfers a right to possession which has been "carved out" of the fee, comparable to possession under a leasehold interest since it is conveyed out of a fee. Unlike a lease, a life estate does not require rent to be paid.

On the aunt's death, possession of the property *reverts* to the fee owner, his successors or heirs since the right to possession under the life estate is extinguished on the aunt's death.

The holder of a life estate based on his life has the right of possession until death, as if he were the owner in fee. The holder of a life estate is responsible for taxes, maintenance and a reasonable amount of property assessments. [CC §840]

However, the holder of a life estate may not impair the fee interest. [CC §818]

For instance, the holder of a life estate may not make alterations which decrease the property's value, such as removing or failing to care for valuable plants or demolishing portions of the improvements or land.

Conversely, the owner of the life estate has the right to lease the property to others and collect and retain all rents produced by the property during the term of the life estate. Profit on the sale of the life estate can be taken in addition to rental income.

For example, a life estate tenant enters into a lease with a logging company allowing it to remove trees from the property.

The property value increases after the trees are removed since the property's best use is as a farm. Additional crops can be planted on the cleared land, making the parcel more productive and able to generate greater rents.

The fee owner claims the life tenant did not have the right to remove the trees, which were improvements.

However, the life tenant did not injure the fee interest by diminishing its value, called *impairment*. The life estate tenant is entitled to the profits from selling any timber located on the parcel, provided the property's value is not impaired by the removal of the trees. [**Sallee** v. **Daneri** (1942) 49 CA2d 324]

Also, a life tenant is entitled to be reimbursed by the fee owner for the fee owner's share of the costs to improve the property.

For example, a city inspector notifies a life tenant the city will order the property demolished unless the property is renovated to bring it up to health and safety codes.

The life tenant has a duty, owed to the fee owner, not to impair the property's value. Thus, the life tenant must prevent the demolition of the property.

To do so, the life tenant improves the property, satisfying code requirements and increasing the property's value, all at considerable expense.

Here, the fee owner is liable to the life tenant for any increase in the value of the fee ownership in the property resulting from the improvements made by the life tenant. [**Eastman** v. **Peterson** (1968) 268 CA2d 169]

The rights of a life tenant as against a fee owner are quite different from those of a leasehold tenant against a fee owner (landlord).

Leasehold interests held by tenants

Leasehold interests are the result of rights *conveyed* to a tenant by a fee owner (or life estate tenant or master lessee) to possess a parcel of real estate. Leaseholds are created when the landlord and the tenant enter into a lease or a rental agreement that conveys a possessory interest in the real estate to the tenant.

The tenant becomes the owner of a leasehold with the right to possess and use the entire property until the lease expires. The title to the fee interest in the property remains with the landlord (or his successor) throughout the term of the leasehold, subject to the tenant's right to possession, which is carved out of the fee on the fee owner's entry into the lease agreement.

In exchange for the right to occupy and use the property, the landlord is entitled to rental income from the tenant during the period of the tenancy.

Types of leaseholds

Four types of leasehold interests exist and can be held by tenants. The interests are classified by the length of their term:

- a fixed-term tenancy, simply known as a *lease* and legally called an *estate for years*;

- a periodic tenancy, usually referred to as a *rental*;
- a tenancy-at-will; and
- a tenancy-at-sufferance, commonly called a *holdover tenancy*.

A **fixed-term tenancy** lasts for a specific length of time agreed to in a lease between a landlord and tenant.

On expiration of the lease, the tenant's right to possession automatically terminates unless an agreement, such as an option which is exercised, extends the expiration date or renews or establishes an entirely new tenancy.

Periodic tenancies also last for a specific length of time, such as for a week or a month. However, in the creation of a periodic tenancy, the landlord and tenant agree to automatic successive rental periods of the same length of time, such as in a month-to-month tenancy.

A **tenant-at-will** has the right to possession of property with the consent of the owner. Tenancies-at-will can be terminated at any time by an advance notice from either party or as set by agreement. Tenancies-at-will do not have a fixed duration, are usually not in writing and a rent obligation generally does not exist.

Leaseholds conveyving special uses

In addition to the typical residential and nonresidential leases, leases exist which serve special purposes.

Oil, gas, water and **mineral leases** convey the right to use mineral deposits below the earth's surface.

The purpose of an oil lease is to discover and produce oil or gas. The lease is a tool used by the property owner to develop and realize the wealth of his land. The tenant provides the money and machinery for exploration and development.

The tenant pays the landlord rent, called a *royalty*, and keeps any profits from the sale of oil or minerals he extracts from beneath the surface of the parcel.

A **ground lease** on a parcel of real estate is granted to a tenant in exchange for the payment of rent. Rent is based on the rental value of the portion of the parcel called land, whether the parcel is vacant or improved. The lease is a financing tool for fee owners of vacant, unimproved land to induce others in acquiring an interest in the property and developing the property.

Ground leases are common in more densely populated areas. Developers often need financial assistance from owners to avoid massive cash outlay to acquire unimproved parcels. Also, owners of developable property often refuse to sell, choosing to become landlords for the long-term rental income they will receive.

An original tenant under a ground lease constructs his own improvements. Typically, the tenant encumbers his ground lease with a trust deed lien to provide security for a construction loan.

Master leases benefit owners who want the financial advantages of renting fully improved property, but do not want the day-to-day obligations and risks of managing the property.

For instance, an owner of a shopping center and a prospective owner-operator agree to a master lease.

As the master tenant, the owner-operator will collect rent from the many subtenants, address their needs and concerns and maintain the property. The master tenant is responsible for the rent due the landlord under the master lease, even if the subtenants do not pay their rents to the master tenant.

The master lease is sometimes called a *sandwich lease* since the master tenant is "sandwiched" between the fee owner (the landlord on the master lease) and the many subtenants with their possession under subleases.

The **master lease** is a regular, nonresidential lease agreement form with the deletion of any clause prohibiting assignments and subletting. A **sublease** is also a regular, nonresidential lease agreement with an additional clause referencing the attached master lease and declaring the sublease subject to the terms of the master lease. [See **first tuesday** Form 552]

Another type of special-use lease is the **farm lease**, sometimes called *cropping agreements* or *grazing lease*. Here, the tenant operates the farm and pays the landlord either a flat fee for rent or a percentage of the value of the crops or livestock produced on the land.

Chapter 2 License to use land

This chapter distinguishes a license to use land from a tenant's leasehold and an easement on land.

A personal right to use another's property

The purpose of a *license*, like an easement and a lease, is to grant the right to use property owned by another person. A **license** is similar in this essential purpose to an easement and a lease, yet it is neither.

Similar to an easement or a lease, a license is an agreement. Instead of being placed in writing, a license is often oral. Unlike an easement, a license does not have a perpetual life, nor does it have a specific expiration date like a lease.

Also similar to an easement, a property burdened with a license is referred to as the *servient tenement*. Unlike an easement, which benefits the owner of another (adjacent) parcel of real estate, called the *dominant tenement*, and is an appurtenant right transferred with the conveyance of that property, a license has no **dominant tenement** (adjacent property) which benefits from the license. A license is not appurtenant to any property since it is personal, called *in gross*.

Unlike an easement or a lease, a license is a **personal privilege** held by an individual, not an appurtenant right remaining with a property for future owners to use. Since a license is not an appurtenant right and does not benefit a property, the right given by the license cannot be transferred to another individual.

A holder of a license does not typically pay rent for the right to use the burdened property. If consideration for the license exists, it is in the form of an expenditure of time and money by the licensee to improve or maintain the use authorized on the burdened property, such as an irrigation ditch, roadway, fence, etc.

Due to the fact that there is no right to exclusive possession of a burdened property (the **servient tenement**) for an authorized use, a license, like an easement and unlike a lease, permits only the nonexclusive use of the property by the licensee.

Unlike either a lease agreement or an easement deed, which are conveyances of an interest in real estate, a license agreement **conveys no interest** in real estate. The right to use a property granted by a license is a mere personal privilege, held by an individual under an agreement with the owner of the burdened property. The license is **revocable** by the owner of the burdened property at any time, unless revocation would be unfair to the holder of the privilege, called a *licensee*.

Typically, a license agreement arises between a property owner and a neighbor or friend as the result of a property owner's acceptance of an informal offer by an individual to jointly or separately make use of the owner's property for a specific activity. The individual given the license generally agrees to maintain or improve the property for the agreed-to use.

Use as a personal privilege

A broker wants to increase the exposure of his business to the public by billboard advertising.

The broker has a friend and business acquaintance who owns vacant property adjacent to a highway. The property owner is willing to allow the broker to place a billboard on his vacant land.

The broker and property owner enter into an oral understanding allowing the broker to put up a billboard for his use only. It is agreed the broker may enter and exit the property at his will to install and maintain the billboard.

A time limitation is not specified for maintaining the billboard on the property, nor is any fee or other compensation established. However, the property owner does not relinquish any control over the real estate since he does not give the broker any other right to use the property.

Have the broker and property owner established a landlord/tenant relationship or an easement?

Neither! The broker has only been given a **license** to use the owner's property.

Unlike a landlord/tenant relationship or an easement, a license to use real estate is a **personal privilege**, unattached to any property owned by the broker. Thus, the use is generally non-assignable to others by the broker and, unless agreed to the contrary, is revokable by the property owner at any time.

A license to use

A license is the **nonexclusive right** given to an individual to use a space or area within a parcel of real estate, or its improvements, that belong to another person. The right to use is held by an individual under an agreement, without the rights to assign or to privacy. A license is subject to termination by the owner of the burdened property at will, unless it has become irrevocable.

Consider a property owner who contracts for development work to be done on his property. The owner allows the construction company to store excess dirt on vacant lots he owns until they can haul it away.

While the dirt remains on the vacant lots, an adventurous dirtbiker enters the property and is injured. The injured dirtbiker claims the construction company is a licensee who is not in possession of the real estate and thus is liable for his injuries. The construction company claims they have a recreational use immunity since they have an interest in the property as a licensee with a right to use it for the agreed-to purpose.

In this example, the holder of any interest in the property is exempt from liability for injuries incurred by others arising out of the **recreational use** of private property. The property interest exempt from liability can be either possessory or nonpossessory.

Since a licensee has a nonpossessory interest in the property, he also has recreational user immunity even though the owner remains in possession and control of the land and the licensee has only a nonexclusive personal right to use the property. [Calif. Civil Code §846]

Thus, the construction company is not liable for injuries which occur during the dirtbiker's recreational use of the property since the construction company holds an interest in the property under their license to use.

License vs. lease

A license is often confused with a lease. A **lease** conveys a possessory interest in real estate which allows the tenant to **exclusively occupy** the leased premises in exchange for rent, called a *leasehold estate* or a *lease*. [CC §761]

A **license-to-use** another person's real estate, called a *servient tenement*, is a personal privilege held by an individual. A license is neither personal property nor real property, and it is neither owned by a person nor is it an appurtenance to adjoining real estate. Thus, a license, not being property or capable of ownership, cannot be transferred to the licensee's successors or assignors. [**Beckett** v. **City of Paris Dry Goods Co.** (1939) 14 C2d 633]

Characteristics which distinguish a license from a lease include:

- no writing to formalize the agreement;
- no rental payments;
- no specific location on or within the property where the use will occur;
- no intent to convey a leasehold estate;
- no right to exclude others;
- no termination date; and
- termination at the owner's will, unless the license is irrevocable.

In our previous example, the broker can use his business acquaintance's property to set up his billboard and leave it in place on the property. Also, the broker (or his representative) has the right to go back and forth across the property to maintain or repair the billboard. Thus, the property is a **servient tenement** subject to the terms of the license held by the broker. However, no **dominant tenement** exists since no property benefits from the license; only the broker benefits as the licensee.

Thus, the owner of the property can demand removal of the broker's billboard from the property at any time, and the broker must immediately remove it.

A common thread which runs through both a lease and license is the right to use the property. The glaring distinction between the two is that the license does not include the **right to exclude** any other person from possession as does a lease.

Continuing with our example, the broker cannot fence off, lock out or quarantine in any way the ground under or around his billboard from the property owner or any other person. The license affords the broker no greater right to be on the property than anyone else the owner might allow to concurrently use his property.

License distinguished from a lease

When an agreement with a property owner gives another person exclusive right to possession of the property against all others, including the owner, it is a lease agreement or periodic rental agreement — a leasehold estate, not a license.

Conversely, when the agreement confers only the privilege to use property which remains under the owner's day-to-day control, it is a **license**. [**Von Goerlitz** v. **Turner** (1944) 65 CA2d 425]

For example, an owner of a packing company enters into an agreement to purchase raw materials from a wholesale merchant. The wholesale merchant is to supply the packing company with raw materials over a three-year period. In exchange, the packing company will pay the agreed-to price for the materials, as well as allow the wholesale merchant the right to use an unlocked storage unit for temporary stockpiling of his materials and desk space in an office at the packing facility to conduct business.

The agreement does not designate the exact spaces to be used by the merchant. Also, the packing company will concurrently use the same space to be used by the merchant.

Two years into the arrangement, the packing company is sold. The new owner demands the wholesale merchant to move out immediately. The wholesale merchant claims a lease existed between himself and the previous owner, allowing him to remain on the property until the lease expires.

However, no dollar rental amount had been established. Also, the wholesale merchant did not have exclusive possession of the spaces he occupied.

Instead of a lease, the wholesale merchant held a license agreement to use space under which the packing company had a superior possessory right to the premises. Thus, the wholesale merchant's use of unlocked space, concurrently occupied by the original owner, was not a lease.

The mere permission of an owner to let someone use and occupy unidentified space in a structure in a **non-exclusive manner** when the owner retains possession and total control over the premises constitutes a license. [**Caldwell** v. **Gem Packing Co.** (1942) 52 CA2d 80]

Terms implying a lease

The stated intentions in a written agreement between an owner and another person may be to enter into a license agreement. However, the actual language and provisions of the agreement may render it a lease which is improperly titled as a license.

For example, an optometrist enters into a written agreement with an operator of a store to establish an optical department on the premises. The written agreement is entitled a license.

The agreement allows the store to determine the space the optometrist will occupy, set the rent at a percentage of the optometrist's total sales and require the optometrist to make nightly deposits of receipts with the store's cashier. Also, the optometrist has the exclusive right to manage and operate his trade within his space. The agreement prohibits the optometrist from assigning his business and the occupancy to another without the store's consent.

The agreement is for a term of three years, at which time the optometrist agrees to surrender the premises in good condition.

Two years after commencement of the agreement, the store hands the optometrist a notice of cancellation of their agreement (rather than a three-day notice to perform or quit) for his failure to deposit his daily cash receipts with the store cashier.

The optometrist refuses to vacate, claiming he is a tenant of the store under the written agreement. The store contends the agreement was a license, terminable at any time and the optometrist must leave.

However, the terminology in their agreement and the payment of rent is more in line with a lease than a license, indicating the parties created a landlord/tenant relationship by their arrangements.

Similar to a lease, the provision **prohibiting assignment** is only applicable to the ownership of an interest in real estate since a license is non-assumable as nothing is actually owned for the licensee to assign. Also, the optometrist was given **exclusive possession** of a designated space within the store for a fixed period of time which eliminates the owner's right to enter the optometrist's space at any time.

Thus, the arrangement by the content of the written agreement was a lease. The right to exclude others from entry for a stated term, coupled with assignment rights and rent, are characteristics of a landlord/tenant relationship, not a license. [Beckett, *supra*]

If an occupancy agreement contains words or phrases like **lease, rental, demise** or **good tenantable condition**, the agreement will be construed to be a lease rather than a license.

Consider a corporation which owns 150 units in a resort condominium and sells time-share memberships in the resort. A member can purchase up to four one-week time share interests.

However, a member is not entitled to reserve any particular unit in advance of occupancy. The assignment of units for actual occupancy during the time period selected is left up to the discretion of the corporation's board of directors.

A *restraining order* is issued by the Department of Real Estate (DRE) stopping sales of these time-share memberships because a permit and a public report to sell **fractional interests in real estate** was not first obtained from the DRE by the corporation.

The corporation contends the memberships are mere licenses held by the members to use unidentified space and are not a lease or other conveyance of space to the members which would require a permit and public report. The corporation further contends the members do not hold an interest in the real estate since they do not have exclusive right to the possession of any specific unit.

However, the occupancy rights held by the members constitute a lease. The units to be occupied are identical, the duration of occupancy is specific and each member has the right to **exclusive occupancy** of a unit. [**Cal-Am Corporation** v. **Department of Real Estate** (1980) 104 CA3d 453]

Recharacterization of a license

A *license* is usually oral with very few terms agreed to except the permission to use or conduct an activity on a property while the owner remains in actual possession and retains the right to exclude others, including the licensee. Above all else, a **license** does not carry with it the right to exclude anyone from the property.

However, with every additional condition agreed to between an owner and user, a license begins to recharacterize itself more and more into a lease.

For example, a broker has an office with unoccupied desks. The broker wants to operate alone and avoid commitments to manage and supervise associate licensees. However, he is willing to share space in the office with other brokers.

The broker offers another broker the use of an office, desk space, a telephone line and secretarial services. The brokers orally agree each will pay their own proportionate share of utilities, secretarial services and rent.

A time period for the use is not specified. The office space selected by the other broker is unlocked and open to the entire office.

In this instance, the original broker may terminate this "rent-a-space" relationship at any time without prior notice or cause since the other broker has been given no more rights than a licensee to use office space.

Conversely, when a broker offers space in his office under a written agreement providing for lockable office space and a specific period for occupancy, the agreement is a lease. With a lease (or a month-to-month rental agreement) in hand, the broker has created a landlord/tenant relationship, not a license.

By specifying more and more terms regarding the right to exclude others — such as the locked door prohibiting entry by others for a period of time — what started out as a mere license to use has been restructured to constitute a lease.

A license coupled with a lease

On some occasions, a **license and a lease co-exist** and are held by the same person.

A person can be a tenant with exclusive occupancy to part of the space on the premises of a shopping center and hold a license to use an adjacent portion of the premises as well.

For example, a retail tenant leases space in a shopping center. The tenant has exclusive possession of his store space controlling who may enter. However, the tenant shares use of the sidewalks and parking lots with other shopping center tenants and all the customers of the shopping center.

The tenant has no right to exclusive possession of the sidewalk and parking area, only the space enclosed within his unit. Thus, the tenant holds a license for access and non-exclusive use of the parking area and a lease for the space within the shopping center.

An irrevocable license

When an individual makes substantial expenditures to improve or maintain his use of another person's property for a long period of time in reliance on his oral agreement with the owner of that property, the license becomes *irrevocable* and cannot be terminated at will by the property owner.

An **irrevocable license** grants an individual the right to enter and use property as long as the specific activity for which the license was granted is feasible.

For example, if a neighbor expends money, or its equivalent in labor, on the on-going maintenance of a road (which provides access from his property to a main road) through the property owned by another person in reliance on an oral agreement with that property owner, the neighbor by his agreement has an irrevocable license to use the road. [**Cooke** v. **Ramponi** (1952) 38 C2d 282]

Consider the construction of a privacy wall along the entire length of a common property line between adjacent lots. The lots are located on a hillside, one above the other. Each lot is flat with a graded slope between them to adjust for the difference in the elevation. Each lot is improved with a residence.

The boundary between the lots is located at the bottom of the slope. However, for a wall to give the owner of each lot privacy, the wall must be located at the top of the slope, entirely on the uphill parcel and several feet from the boundary line.

The owner of the uphill lot agrees to allow the neighbor below to construct a masonry wall with its foundation on the top of the slope. The owner and the neighbor agree on the height of the wall and that the neighbor may **use the slope** between the wall and the property line.

The owner orally agrees to an easement for the encroachment, which is never reduced to writing so no easement was created.

The neighbor constructs the masonry wall at the top of the slope. He also builds a gazebo within the slope area between the fence and property line.

The owner of the uphill lot sells the property to a buyer. The buyer surveys the lot and demands the neighbor to remove the wall and gazebo since they encroach on what is now the buyer's property.

The neighbor claims he has an irrevocable license to maintain the encroachments and use the slope since he spent considerable time and money to construct the encroaching structure in reliance on the prior owner's oral agreement which allowed him to build the wall and use the top of the slope.

The buyer claims he should not be estopped from revoking the license since he had no notice the license existed and the use was not reduced to an enforceable easement.

However, the license became irrevocable since substantial effort or expenditures were made in reliance on the oral agreement with the property owner allowing the use. Further, the buyer — as a successor owner of the property burdened with the use allowed by the oral license agreement — need not have any knowledge of the **irrevocable license** to be barred from denying the neighbor's continual use to maintain the existing wall and gazebo under the oral agreement. [**Noronha** v. **Stewart** (1988) 199 CA3d 485]

Chapter 3 Types of tenancies

This chapter discusses the different types of tenancies and how each is established.

Know your tenancy or lose time

A landlord and tenant enter into a lease agreement without including an option to renew or extend the term of the occupancy on expiration of the lease.

Several months before the lease expires, they begin negotiations to enter into a new lease agreement extending the term of occupancy. An agreement is not reached before the original tenancy expires. The tenant remains in possession on expiration of the lease — an unlawful detainer of the premises, commonly called a holdover, unless agreed to.

The landlord and tenant continue lease negotiations. Meanwhile, the tenant pays monthly rent at the same rate he was paying when the lease expired, which the landlord accepts.

Ultimately, they fail to agree on the terms for a new lease. The landlord then serves a 30-day notice on the tenant to either **stay and pay** a substantially higher monthly rent or **vacate** and forfeit the right to possession. [See **first tuesday** Forms 569, 571 or 579; see Chapter 29]

The tenant does neither; he remains in possession and does not pay the increased rent.

Can the landlord file an unlawful detainer (UD) action and proceed to evict the tenant on expiration of the 30-day notice and without further notice?

Yes! The tenant went from a fixed-term tenancy (the lease) to a tenancy-at-sufferance on expiration of the lease (a holdover) to a periodic (month-to-month) tenancy on the landlord's acceptance of rent for occupancy after the lease expired. The right to possession under the periodic tenancy ended due to the expiration of the notice and the tenant's failure to pay rent (set by the notice).

However, the type of notice to quit used when the landlord decides to terminate the tenant's right to possession will change depending on the **type of tenancy** that exists and the purpose of the notice.

Tenancies as leasehold estates

Tenancies are possessory interests in real estate, called *leasehold estates*.

Four types of tenancies exist:

1. Fixed-term tenancies.
2. Periodic tenancies.
3. Tenancies-at-sufferance.
4. Tenancies-at-will.

To initially establish a tenancy, a landlord must somehow **transfer to the tenant** — either in writing, orally or by his conduct — the right to occupy the real estate. If the landlord does not transfer the right to occupy, the occupant who takes possession is a *trespasser*.

All tenancies have an agreed-to termination date or are capable of termination by notice. Termination of a fixed-term tenancy held by the tenant, which was conveyed by the **lease-agreement**, occurs on the expiration date stated in the lease and without further notice.

A month-to-month rental agreement conveys an automatically renewable periodic tenancy, which is terminated by service of a 30-day notice to vacate at any time or a 3-day notice to vacate on a breach of the rental agreement. [See Chapters 26 and 29]

A tenant's possessory interest in real estate can shift from one type of tenancy to another due to:

- a notice;
- expiration of a lease; or
- by conduct.

Thus, before a landlord can file a UD action and proceed with the eviction process based on an unlawful detainer of the premises by the tenant, the tenant's **right to possession** under his tenancy must be terminated by the proper notice to vacate (quit), unless the tenant holdover is under an expired lease.

In our opening example, the tenant traversed three types of **tenancies**:

- *fixed-term* (lease);
- *sufferance* (no agreed-to holdover); and
- *month-to-month* (acceptance of monthly payments), also called a *periodic tenancy*.

The tenant entered into his occupancy under a fixed-term tenancy, a leasehold estate commonly called a *lease*. During the term of the lease, the tenant can only be evicted for cause — and then only after the service of a 3-day notice to cure the breach or vacate (quit) the property. [See **first tuesday** Form 576]

On expiration of a lease, the tenant who remains in possession without an agreement or acceptance of rent by the landlord for the extended occupancy becomes a holdover tenant, legally called a *tenant-at-sufferance*. The landlord does not have to serve a notice to vacate on the holdover tenant before filing a UD action to evict the tenant. [Calif. Code of Civil Procedure §1161(1)]

However, if the landlord accepts monthly rent from a tenant in payment for his continued occupation after expiration of the lease, a month-to-month tenancy is established on the terms and conditions of the expired lease agreement, unless a renewal or extension option exists. When an option to renew or extend exists, the lease is renewed or extended by the post-expiration acceptance of the rent called for in the option. [Calif. Civil Code §1945]

To terminate a month-to-month tenancy which was created by acceptance of monthly rent after expiration of a lease which is not in default, the landlord must serve the tenant with a 30-day notice to vacate before filing a UD action. [**Colyear** v. **Tobriner** (1936) 7 C2d 735]

Fixed-term tenancy

A **fixed-term tenancy**, also known as an *estate for years* or more commonly as a *leasehold*, is the result of an agreement between the landlord and the tenant for a fixed time period, typically called a *lease*. [CC §761]

The occupancy under a lease agreement must have a beginning date, called the *commencement date*, and an ending date, called the *expiration date*. If the rental period is longer than one year, the lease arrangements must be in writing and signed by the landlord and tenant to be enforceable, called a *lease agreement*, and sometimes loosely referred to as *the lease*. [CC §1624]

In a fixed-term tenancy, the tenant has an exclusive right to possession of the premises for the term of the occupancy stated in the lease agreement. On expiration of the lease, the tenancy automatically terminates. The tenant is not entitled to any notice to vacate other than the notice provided by the tenancy's expiration date stated in the lease agreement. [CCP §1161(1)]

For example, a landlord and tenant orally agree to a six-month lease. At the end of six months, the landlord and tenant orally agree to another six-month lease.

At the end of the second term, the tenant refuses to vacate. The tenant claims the landlord must first serve him with a notice to vacate.

Here, the tenant is not entitled to any further notice beyond the agreed-to termination date. The oral occupancy agreement was not a periodic tenancy, such as a month-to-month rental agreement, even though it contained monthly rent payments. Instead, the occupancy agreement was a fixed-term lease with a set expiration date.

Thus, the tenant's right to possession terminates on expiration of the orally agreed-to six-month period. The oral lease agreement is enforceable since it was for a term of less than one year. [**Camp** v. **Matich** (1948) 87 CA2d 660]

A **fixed-term tenancy** provides a tenant with several advantages:

- the right to occupy for the fixed term;
- a predetermined rental amount; and
- limitations on termination or modification.

However, some disadvantages also exist for the fixed-term tenant:

- the tenant is liable for the total amount of rent due over the entire term of the lease (subject to the landlord's duty to mitigate losses); and
- the tenant may want to vacate prior to expiration of the leasing period and assign or sublet the premises to a new tenant to cover rent obligations, but cannot due to prohibitions in the lease against his transfer of possession, called *restraints on alienation*.

Periodic tenancy

If the landlord finds a fixed-term tenancy too restrictive or inflexible for his financial purposes or use requirements, a periodic tenancy may be more suitable.

A periodic tenancy automatically continues for **successive periods**, each for the same length of time, until terminated by a notice to vacate. The length of each successive period of time is determined by the interval between scheduled rental payments.

Examples of **periodic payment** intervals include:

- annual rental payments, indicating a year-to-year tenancy;
- monthly rental payments, indicating a month-to-month tenancy; and
- weekly rental payments, indicating a week-to-week tenancy.

Consider a property manager who rents an apartment to a tenant under a fixed-term lease. At the end of the leasing period, the tenant retains possession and continues to pay rent monthly, which the property manager accepts.

Later, the tenant is served with a 30-day notice to vacate. On the running of the 30 days, the tenant refuses to vacate. The tenant claims he is now a tenant-at-will and entitled to an additional 3-day notice to vacate before he is unlawfully detaining the property since the notice to vacate served on him merely terminated his right to possession and made him a tenant-at-will on expiration of the notice.

However, an occupancy agreement for an **indefinite term** with a monthly rent schedule is a month-to-month tenancy. Thus, a tenant is only entitled to one notice to vacate before a UD action may be filed to evict him. [**Palmer** v. **Zeis** (1944) 65 CA2d Supp. 859]

The flexibility of a periodic tenancy allows the landlord and the tenant to terminate a month-to-month tenancy by giving the appropriate notice to vacate to the other party. [CC §1946; see Chapter 29]

Also, the operator of a **residential hotel** may not require a resident to change units or to check out and re-register in order to avoid creating a month-to-month tenancy and falling under landlord/tenant law. A residential hotel operator violating this rule is liable for a $500 civil penalty and attorney fees. [CC §1940.1]

Tenancy-at-sufferance

When a fixed-term (lease) or periodic (month-to-month) tenancy terminates by prior agreement or notice, the tenant who remains in possession — a *tenant-at-sufferance* — unlawfully detains the property from the landlord.

A tenant-at-sufferance is more commonly called a *holdover tenant*. A holdover tenant retains possession of the premises without any contractual right to do so, a situation called an *unlawful detainer.*

A **holdover tenant** no longer owes rent under the expired lease or terminated rental agreement since he no longer has the right to possession. However, the rental or lease agreement usually calls for a penalty rate of daily rent owed for each day the tenant holds over. Without a holdover rent provision, the tenant owes the landlord the *reasonable rental value* of the property, a daily rate owed for each day the tenant holds over in possession after expiration of his tenancy.

Holdover rent is due **after** the tenant vacates or is evicted, when the holdover period is known and the amount owed can be determined.

The landlord's acceptance of "holdover" rent **prior** to the tenant vacating or being evicted establishes a periodic tenancy on receipt of the rent.

For example, a tenant with a fixed-term lease holds over after the lease agreement expires. The lease agreement contains no provisions for the amount of rent due during any holdover period.

On the tenant's failure to vacate, the landlord serves the tenant a 30-day notice to either pay a rent amount substantially higher than rental market rates or vacate. The tenant refuses to pay any rent or vacate.

The landlord files a UD action seeking payment of rent at the rate stated in the notice to pay or quit since the tenant did not vacate.

At the UD hearing, the landlord is awarded the reasonable market rental value for the entire time the tenant held over, not the higher rent demanded in the notice to pay or quit. The tenant never paid nor agreed to pay any amount of rent after the lease expired. Thus, a periodic tenancy was not established.

The higher rental amount demanded in the notice to pay or quit was not accepted by the holdover tenant since he refused to pay it. Thus, a UD court will only award a reasonable rental value for the time period the tenant held over since he is a tenant-at-sufferance in unlawful possession of the property. Also, the notice to (pay or) quit was not needed to evict the tenant on expiration of the lease. [**Shenson** v. **Shenson** (1954) 124 CA2d 747]

Expired first refusal becomes a holdover

Now consider a tenant who enters into a fixed-term lease for the second floor of a building.

Without a charge for additional rent, the tenant will also take and retain possession of the third floor until the landlord secures a *bona fide* tenant. The tenant has the **right of first refusal** to rent the third floor should the landlord find a tenant. If the tenant does not exercise his right of first refusal to rent the third floor, his right to possession of the third floor ends.

The tenant moves into the second and third floors of the building. Later, the landlord locates a prospective tenant to rent the third floor.

The landlord notifies the tenant he must immediately exercise his right of first refusal or vacate the third floor.

The tenant does not exercise his right of first refusal and refuses to move. The tenant claims he is a tenant-at-will with the right to receive a notice to vacate before his right to occupancy can be terminated.

However, the tenant's lease of the third floor had a *specific termination date* — the date the tenant fails to exercise his right of first refusal. Thus, he is a tenant for a fixed-term and not a tenant-at-will since his occupancy ended on expiration of his right of first refusal.

The tenant, now a holdover, becomes a *tenant-at-sufferance* on expiration of his right of first refusal. Thus, the tenant is not entitled to any further notice to quit before his unlawful detainer of the premises is established. The tenant's notice of the date of termination of the occupancy was his failure to exercise his right of first refusal prior to its expiration. [**Vandenbergh** v. **Davis** (1961) 190 CA2d 694]

For the tenant with a right of first refusal to also be entitled to an additional period of lawful occupancy and a notice to vacate after expiration of a lease, a provision so stating must be included in the lease agreement or the right of first refusal agreement.

A **tenancy-at-sufferance** also arises when a resident manager's compensation includes the right to occupy a unit rent-free. When the landlord terminates the employment and the resident manager fails to vacate immediately, a tenancy-at-sufferance exists.

For example, a landlord hires a caretaker to do general maintenance work around an apartment complex in exchange for rent-free possession of a unit in the complex.

Several months later, during a dispute with the landlord, the tenant refuses to work, which results in his dismissal as an employee.

The landlord delivers a notice to the tenant to immediately pay rent (as demanded in the notice) or quit. The tenant does neither and the landlord files a UD action.

The tenant contends he is a tenant-at-will, entitled to a notice to vacate before the landlord can establish an unlawful detainer and file his UD action.

However, the tenant's right to occupancy ended when his employment ended, the expiration of a fixed-term lease. Thus, the tenant became a **holdover tenant** who was not entitled to notice, other than the notice from the landlord terminating the employment, before the landlord could commence a UD action to evict him. [**Karz** v. **Mecham** (1981) 120 CA3d Supp. 1]

If the employee is to receive notice and time to pay or vacate on termination of his employment (and right to occupancy), his employment agreement must provide for it.

Under rent control ordinances, a tenant-at-sufferance must receive a notice to vacate. However, courts in rent-controlled areas have exempted employee-tenants from rent control protection by classifying them, for purposes of rent control, as licensees rather than tenants.

Yet, employee-tenants clearly are not licensees (for any other purpose) since they have exclusive rights to occupy the unit assigned to them. [**Chan** v. **Antepenko** (1988) 203 CA3d Supp. 21]

Tenancy-at-will

The characteristics of a *tenancy-at-will* include:

- possession delivered to the tenant with the landlord's knowledge and consent;
- possession for an indefinite and unspecified period; and
- no provision for the payment of rent.

For a **tenancy-at-will**, a written notice to vacate or pay rent is required to make any change in the right to occupy the premises. However, the parties can always agree to a shorter or longer notice period. [CC §§789, 1946]

For example, an owner-occupant agrees to sell his office building under a purchase agreement providing for him to retain the **free use and possession** of the property after closing until he can occupy an office building he is constructing. Thus, a tenancy-at-will is created.

The buyer agrees in the purchase agreement to give the seller a 90-day written notice to either vacate the property or pay rent.

The buyer resells the property to a new owner. The new owner demands the tenant-seller pay rent or vacate immediately. The new owner claims he is not subject to the prior owner's **unrecorded agreement** to give a 90-day notice.

However, the new owner acquired the property subject to the rights held by the tenant in possession. Thus, the new owner is charged with *constructive knowledge* of the unrecorded agreement regarding notices and took title subject to the terms of the agreement.

Until the tenant-at-will receives the appropriate notice to vacate, he is not unlawfully detaining the property and the owner/landlord cannot proceed with a UD action to recover possession. [**First & C. Corporation** v. **Wencke** (1967) 253 CA2d 719]

However, a tenancy-at-will is automatically terminated if the tenant **assigns or sublets** his right to occupy the property to another tenant. The new tenant becomes a tenant-at-sufferance or a trespasser. [**McLeran** v. **Benton** (1887) 73 C 329]

Also, the tenancy-at-will terminates on the **death** of either the landlord or tenant, unless an agreement to the contrary exists. [**Dugand** v. **Magnus** (1930) 107 CA 243]

Other situations giving rise to a tenancy-at-will include:

- when a tenant with the right to indefinitely occupy the property in exchange for making improvements fails to make the improvements [**Carteri** v. **Roberts** (1903) 140 C 164];
- when a tenant takes possession of the property under an unenforceable lease agreement (e.g., the written lease with terms orally agreed to was never signed by any of the parties) — unless rent is accepted, which establishes a periodic tenancy [**Psihozios** v. **Humberg** (1947) 80 CA2d 215]; or
- when a tenant is given possession of the property without the payment of rent while negotiations on the lease provisions are still in progress. [**Miller** v. **Smith** (1960) 179 CA2d 114]

Terminating a tenancy

A landlord's primary concern when terminating a tenancy is the type of notice to vacate he must deliver to establish an unlawful detainer under the different **types of tenancies**, including:

- a *fixed-term tenancy*, in which case the landlord does not need to deliver any notice to vacate prior to commencing a UD action against a holdover tenant after expiration of the lease since the tenancy automatically expires by the terms of the lease [CCP §1161(1)];
- a *periodic tenancy*, in which case the notice to vacate must be for a period at least as long as the interval between scheduled rental payments, but need not exceed 30 days. [CC §1946; see Chapter 29];
- a *tenancy-at-sufferance*, in which case the holdover tenant is not entitled to any further notice prior to commencing eviction proceedings since a lease has expired or a periodic tenancy has been terminated by notice [CCP §1161];
- a *tenancy-at-will*, in which case a 30-day notice to vacate or otherwise alter the tenancy-at-will is required [CC §789; see Chapter 29];
- a rent-controlled tenancy of *residential property*, in which case termination of the right to possession is restricted by local ordinances; and
- a *tenancy-at-will in a mobilehome park*, in which case a 60-day written notice is required to be delivered to the tenant. [CC §798.55(b)]

Further, a landlord and tenant by agreement can establish a shorter or lengthier notice period, but not less than seven days, industrial and commercial tenants typically require three months minimum notice due to the time lost receiving and responding to a notice since it must first go through multiple tiers of corporate management. [CC §1946]

Changing the type of tenancy

A landlord, by using an improper notice, can end up with a different tenancy relationship from the one he initially conveyed to a tenant. When an existing tenancy is altered, in writing or by conduct, the tenancy may have been converted into another type of tenancy.

A classic example involving a change in the type of tenancy arises when a holdover tenant (a tenancy-at-sufferance) becomes a month-to-month tenant (a periodic tenancy).

A landlord who accepts any rent from a holdover tenant under an expired lease, in payment for a period of occupancy after the lease expired, has elected by his conduct to treat the continuing occupancy as a periodic tenancy. [**Peter Kiewit Sons Co.** v. **Richmond Redevelopment Agency** (1986) 178 CA3d 435]

Thus, a proper notice to vacate, a requisite to a UD eviction, must be served on the holdover tenant who paid rent for the continued occupancy, which was accepted by the landlord. [Colyear, *supra*]

When the tenant holds over after a fixed-term tenancy expires and the landlord accepts rent for the hold-over period while the tenant is in possession, the expired lease agreement is *renewed* on the same terms except for the period of occupancy, which is now periodic. [CC §1945]

On expiration of a fixed-term lease, the landlord's continued acceptance of rental payments does not **renew** the tenancy for another term equal to the term of the original lease. Rather, the tenancy is extended as a periodic tenancy for consecutive periods equal to the interval between rent payments — being one month if rent is paid monthly. [CC §1945]

For example, a landlord and tenant agree in writing to a three-year lease with rent paid annually in advance. At the end of the three-year lease, the tenant holds over without further agreement. The tenant tenders an annual rent payment which the landlord accepts.

The landlord's acceptance of rent extends the expired three-year lease for a period of one year since the rent paid was for an annual period. Without a written agreement to the contrary, the tenancy is extended only for the period of the prepaid rent even though the term of the original lease, which controlled the terms of the extended one-year occupancy, was for a three-year period. [**Hagenbuch** v. **Kosky** (1956) 142 CA2d 296]

Transient occupancies and removals

An occupant of a vacation property, hotel, motel, inn, boardinghouse, lodginghouse, tourist home or similar sleeping accommodation for a period of 30 days or less is classified as a **guest**, also called a *transient occupant*.

A transient guest occupies property known as *lodging, accommodation* or *unit*. The property is not called a rental which is a landlord/tenant characterization of their relationship.

The guest's occupancy of the accommodations contracted for is labeled a *stay*, not possession. During a guest stay in the lodging, the owner or manager of the property is entitled to enter the unit at check-out time even though the guest may not yet have departed.

The contract entered into for the lodging is usually called a **reservation agreement**, but never a rental agreement or lease agreement. [See **first tuesday** Form 593]

Also, guests pay a **daily rate**, not a daily or weekly rent, and they *arrive* at a pre-set date and time for *check-in*, not for commencement of possession. Likewise, guests *depart* at an hour on a date agreed to as the *check-out time*. Unlike a tenant, a guest does not vacate the premises, they check out.

When a guest fails to depart at the scheduled check-out hour on the date agreed, no holdover tenancy is created as occurs under a tenancy for occupancy conveyed by a rental agreement or lease. Thus, a UD action or court involvement is not required to remove the guest. [CC §1940(b)]

However, for the owner or manager to avoid the UD eviction process, the guest, when checking in, must have signed a notice stating:

- the unit is needed at check-out time for another guest who has been promised the unit; and
- if he has not departed at check-out time, the owner or manager may enter, take possession of the guest's property, re-key the doors and clean up the unit for the next guest. [CC §1865; see **first tuesday** Form 593]

To **remove a guest** who fails to timely depart the unit and remains in the unit after a demand has been made to leave, the police can be called in by the manager if his own intervention might cause a breach

of the peace, called self-help. The police or the sheriff will assist, without the need for a court order, to remove the guest and prevent a danger to persons or property during the re-keying, removal of possessions and clean up for the arrival of the next guest. [Calif. Penal Code §§602(r); 803.1(a)(3)]

Transient occupancies include all occupancies that are taxed as such by local ordinance or could be taxed as such by the city or by the county. Taxwise, the occupancy is considered a *personal privilege*, not a tenancy. Time share units, when occupied by their owners, are not transient occupancies and are not subject to these ordinances and taxes. [Calif. Revenue and Taxation Code §7280]

Transient units do not include *residential hotels* since the occupants of residential hotels treat the dwelling they occupy as their *primary residence*. Also, the occupancy of most individuals in residential hotels is for a period of more than 30 days.

A broker or any other person or entity who manages "vacation rental" occupancies for owners of single-family homes, units in a common interest development (condominium project), units in an apartment complex or any other residence subject to a local transient occupancy tax, must maintain **accounting records**.

Further, the property manager must send a monthly accounting statement to each owner he represents and make the records available for inspection and reproduction by the owner, as well as comply with the transient occupancy tax regarding collection, payment and record keeping. [CC §1864]

Chapter 4 Landlord's right to enter

This chapter addresses resolutions to conflicts between a tenant's right to privacy within his rented space and the landlord's need to access the space.

Conflict with tenant's right to privacy

Unknown to a residential landlord, a tenant changes the locks on the door to his unit. Several months later, the tenant is arrested by law enforcement officers as he steps out of his apartment. The tenant is hastily escorted away, leaving on lights and his pet inside, but locking the door.

The landlord becomes aware of the tenant's dilemma. Fearful the gas stove was also left on, he attempts, but is unable to enter with his passkey.

The landlord **calls the police** and asks them to witness his entry so he can inspect the apartment to make sure it is in a safe and secure condition. The landlord then enters the apartment through a window. The police are let in to observe the landlord's conduct. They proceed to make a visual inspection of the apartment.

Unfortunately for the tenant, the police find illegal possessions in plain view casually lying around the kitchen and dining area of the apartment.

Did the landlord have the right to enter the apartment? Did he have the right to allow the police to come in?

Yes to both! The landlord had the right to enter since he reasonably believed the safety of his other tenants and the building could have been in jeopardy.

Also, the officers were present at the **request of the landlord** to act as an eyewitness so the tenant could not legitimately claim the landlord removed any of his possessions. [**People** v. **Plane** (1969) 274 CA2d 1]

In contrast, consider the landlord who permits the police to enter and search a tenant's garage at the **request of the police,** but without a warrant. The police have reason to believe the tenant is manufacturing drugs, an illegal use of the premises and of concern to the landlord.

May a landlord collaborate and allow the police to enter a tenant's garage?

No! The landlord has no right to possession when the tenant's right to possession has not expired or been terminated, even though the tenant has vacated and only a day remains under a 30-day notice to vacate. Thus, the landlord has no possessory right allowing him to enter the property or let the police enter the premises since he has leased it to the tenant, even if he suspects the tenant of using the premises to commit a crime. The police must first obtain a search warrant to legally authorize them to come onto the premises occupied by the tenant when the landlord has no right to entry. [**United States** v. **Warner** (9th Cir. 1988) 843 F2d 401]

However, a landlord does have the right to allow police to enter a unit abandoned or vacated by the tenant as determined by state law rules of abandonment or surrender since the tenancy has been terminated. [**United States** v. **Sledge** (9th Cir. 1981) 650 F2d 1075; see Chapter 31]

Further, "lock-box" entry by the police in collaboration with a multiple-listing service (MLS) member to check out a crime is prohibited without a warrant. The entry violates the purpose of a listing broker's agency and his lock-box authority. The broker may enter only to show the premises to prospective tenants who accompany him (or other authorized agents), not the police since they are not prospective tenants. [**People** v. **Jaquez** (1985) 163 CA3d 918]

Landlord's right to enter

A landlord's right to enter a residential or nonresidential unit during the period of the tenant's right to occupy the premises is severely limited. The possessory rights to occupy the property have been **conveyed to the tenant** and are no longer held by the landlord, until a *reversion* of possession occurs on termination of the tenancy.

For example, a residential landlord may enter the tenant's actual dwelling space during the lease or rental term only in limited circumstances, namely:

- in an emergency;
- to make repairs, alterations, improvements, or supply services that are either necessary or previously agreed to by the tenant;
- to complete a pre-termination inspection for deficiencies which would result in a deduction from the security deposit [See Chapter 19];
- to show the unit to prospective or actual buyers, lenders, tenants or repairmen and contractors;
- when the tenant has vacated the premises and his right to occupy terminated by *surrender* or *abandonment*; or
- under a court order allowing entry. [Calif. Civil Code §1954]

A property manager's entry into a tenant's unit out of concern for the safety of the property or other tenants constitutes an *emergency* allowing entry without the tenant's knowledge and permission. The property manager may properly enter the unit for the limited purpose of dealing with the emergency. [Plane, *supra*]

Consider a nonresidential lease agreement that prohibits any tenant violations of government laws and regulations.

The landlord asks the tenant for permission to come onto the property to conduct tests and investigate whether the leased property contains any contamination from hazardous waste. The tenant refuses to give the landlord permission to conduct the investigation, claiming the landlord does not have a right to determine whether contamination exists until the lease expires.

Here, the landlord, on advance notice to the tenant, has the right to access the property to determine if contamination has or is occurring on the property since hazardous waste contamination is a **violation of law** and a breach of the lease provision prohibiting unlawful activities adversely affecting the value of the property. [**Sachs** v. **Exxon Company, U.S.A.** (1992) 9 CA4th 1491]

NOTICE OF INTENT TO ENTER DWELLING

DATE:_____, 20_____, at _____, California.

NOTICE: A landlord may enter a tenant's unit during normal business hours after giving twenty-four (24) hours prior notice of intent to enter. [Calif. Civil Code §1954]

Items left blank or unchecked are not applicable.

FACTS:

1. You are a Tenant under a rental or lease agreement

1.1 dated: _____, at_____California,

1.2 entered into by _____, Tenant,

and _____, Landlord,

1.3 regarding real estate referred to as: _____

_____.

NOTICE TO TENANT:

2. The landlord will enter the above premises at or about the normal business hour of _____, on _____, 20_____ for the following checked purposes:

2.1 ☐ To make necessary or agreed repairs of _____

_____

2.2 ☐ To decorate the unit by_____

_____

2.3 ☐ To alter or improve the unit by _____

_____

2.4 ☐ To supply necessary or requested services of_____

_____

2.5 Other _____

_____

3. You are not required to be on the premises during this entry. A passkey will be used in the event of your absence.

Date: _____, 20_____

Landlord/Agent: _____

Signature: _____

Address: _____

_____

Phone:_____

Fax: _____

E-mail: _____

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Notice of entry for repairs

Before a residential landlord proceeds with any maintenance or services which require entry into a tenant's unit, the tenant must be given a **written notice** of the landlord's intent to enter. Maintenance includes all routine or non-emergency repairs, decorations, alterations, improvements, replacements or services, whether or not agreed to by the tenant. [CC §1954; see Form 567 accompanying this chapter]

The written notice must give the tenant a **reasonable period of time** in which to prepare for the entry. A 24-hour notice is considered reasonable, unless extenuating circumstances known to the landlord or his property managers, such as the tenant's vacation or business trip, indicate the tenant needs more time to actually receive the notice and prepare for the entry.

Service of a 24-hour **notice of entry** in advance of the entry is accomplished by any one of the following methods:

- handing a written notice to the tenant personally;
- handing the notice to an occupant of the unit who appears of suitable age and discretion to relay the notice to the tenant; or
- posting the notice on or near the usual entry door or under the door so it will be discovered by the tenant on his return.

Alternatively, the notice may be mailed, but at least six days must pass after mailing before the intended entry can be scheduled to occur. [CC §1954]

The time of day for the entry must only be during normal business hours, emergencies excepted. If the entry is after business hours, the tenant's consent must be obtained "at the time of entry," even if previously arranged to occur after business hours.

The notice of entry procedures should never be used to harass a tenant in a retaliatory or abusive manner. [CC §1954]

A tenant in a community apartment project or a homeowner in a condominium project, collectively called *common interest developments* (CIDs), must receive at least 15 days but no more than 30 days written notice when the management or association needs the occupants to vacate the project in order to treat termites. [CC §1364(d)(2)]

Entry for pre-termination inspection

A residential landlord may enter a tenant's unit when the tenant requests a joint pre-termination inspection of the premises in response to the landlord's mandatory notice to the tenant of the tenant's right to request the joint inspection. [See Chapter 19]

The purpose of the pre-termination inspection prior to expiration or termination of the tenancy is to advise the tenant of any deficiencies in the condition of the premises so the tenant can correct or eliminate them before vacating. Thus, the tenant may take steps to avoid deductions from the security deposit.

Before the residential landlord may enter to conduct the agreed-to pre-termination inspection, the tenant must be given a 48-hour written notice stating the date and time for the inspection. [CC §1950.5(f)(1)]

Service of the 48-hour notice of entry is accomplished in the same manner as for the 24-hour notice of advance entry to complete repairs. However, the tenant may waive the 48-hour notice if both he and the landlord sign a written waiver. [CC §1950.5(f)(1)]

Entry during "For Sale" period

Real estate brokers who list residential or nonresidential property for sale which is **occupied by a tenant**, called a *rental*, need to inform the seller about the **seller's right** to coordinate inspections of the property by buyers under one of two notice procedures. [CC §1954]

To avoid surprises when the tenant is contacted and advised to prepare the premises for an inspection by a prospective buyer, two procedures exist for the **listing agent** to enter the unit with the buyer.

A **24-hour advance written notice** of the intended entry may be served by the seller or his manager:

- on the tenant personally; or
- on an occupant of the unit of suitable age and ability to inform the tenant of the notice; or
- by posting the notice on or near the entrance to the unit or leaving it under the door. [CC §1954(d)(1)]

If instead it is mailed by regular or certified mail, six days must pass before the time for entry can occur. [CC §1954; see **first tuesday** Form 567]

The seller's alternative to the 24-hour written notice is a **120-day "For Sale" notice**. The "For Sale" notice may be given to the tenant personally or by regular mail at any time after the seller enters into a listing to sell the property. [CC §1954(d)(2); see Form 116 accompanying this chapter]

The "For Sale" notice commences a 120-day period during which the seller or the seller's listing agent may, on a 24-hour **notice by phone** to the tenant, enter the unit during normal business hours with a prospective or actual buyer to conduct an inspection of the unit.

Prior to the time for entry, the tenant must receive no less than **24 hours advance notice by phone** or in person of the actual entry date and time. The actual entry is conditioned on the listing agent leaving a written note in the unit regarding the entry and completion of the inspection.

Here, the giving of the 24-hour notice by phone, during the 120-day period following service of the written "For Sale" notice, is exclusively the right of the seller and his listing agent. The agent representing a buyer must arrange for the listing agent to give the 24-hour advance telephonic notice. The buyer's agent may not be given authority to notify the tenant, unless he is also the listing agent.

Thus, on taking a listing to sell property occupied by tenants, the listing agent needs to inform the seller of the two notice procedures for entry to present the unit to prospective buyers or buyers under contract. Once resolved as to which notice procedure, if any, the seller is willing to authorize in the listing agreement, the information is shared with buyer's agents through the MLS publication of information on the listed property under "showing instructions," such as "call the listing office (LO) or listing agent (LA) to arrange for 24-hour telephonic (or alternative written) notice of entry."

The purpose of the advance notice of entry is to eliminate the element of surprise which would leave the tenant unprepared to ready the unit for inspection and to deal with the inspection on a later 24-hour telephonic notice.

Once informed of the procedure for entry and inspection, some sellers may restrict inspections of the property to **qualified buyers** who have entered into a purchase agreement. Thus, sellers might not allow prospective buyers to preview the premises until they have entered into a purchase agreement and been financially qualified as capable buyers.

Sellers often do not feel tenants should be involved in the marketing process. The weaker the real estate market, with its lessened likelihood of a sale and abundance of units for rent, the greater the seller's concern will be to keep the tenant uninvolved until the agents have a buyer under contract who is ready to conduct his due diligence investigation before closing escrow.

Entry on surrender or abandonment

A landlord or his manager may enter a unit when the tenant has vacated the unit and his right to possession has been terminated by expiration of a lease (or rental agreement by a 30-day notice to vacate), surrender, notice of abandonment or 3-day notice containing a declaration of forfeiture.

Neither a surrender nor an abandonment of the tenant's right to possession, called the lease, ever automatically takes place simply because the tenant vacates the unit. The landlord must react to the vacating by terminating the tenant's leasehold right to possession — by establishing a surrender, abandonment or forfeiture of possession.

By a *surrender*, the tenant who breaches the lease and vacates the premises while conducting himself in a manner which indicates to the landlord the tenant's desire to both:

- **terminate possession** by a return of the premises to the landlord; and
- **cancel the lease agreement** obligations owed to the landlord.

If the landlord agrees to the termination of the tenant's possession and a cancellation of the rental or lease agreement, or if the landlord's conduct on taking possession constitutes his acceptance of the tenant's offer to vacate in exchange for canceling the lease agreement, a *surrender* has occurred. Thus, the tenancy is terminated (and the lease agreement canceled). The landlord may then enter and take possession of the unit, by mutual agreement or conduct. [See Chapter 30]

As an alternative to accepting possession and canceling the lease agreement and any right to collect future rents by a surrender, the landlord may serve the tenant with a 3-day notice to pay or quit and **declare a forfeiture** of the tenant's right to possession. Thus, on expiration of the 3-day notice, the tenant's right to possession has been eliminated.

If the tenant has vacated the property and the 3-day notice expired, the landlord or his agents may then enter and reoccupy or relet the premises since the right to **possession reverted** to the owner. In the process, the lease agreement remains fully enforceable, except for the occupancy provisions.

An *abandonment* requires the premises to be vacated by the tenant and a **breach** of the lease agreement. Like a surrender, an **abandonment** requires that the tenant never intends to return to the premises. However, a tenant intending to abandon the leased premises cannot unilaterally terminate (reconvey) his leasehold right of possession to the landlord. The transfer of possession to the landlord requires the landlord to act before the right to possession is terminated by abandonment.

However, unlike the cancellation of the lease agreement when both the tenant and the landlord agree to a surrender, the lease agreement is *not canceled* on the landlord's notice of abandonment (or forfeiture on a 3-day notice to quit). Only the leasehold interest (right to possession) in the real estate is terminated.

Abandonment versus forcible entry

To establish an **abandonment** by a tenant who has breached his lease agreement and vacated, the landlord must serve the tenant with a *notice of abandonment*. On expiration of the notice and without the tenant denouncing the abandonment, the tenant's leasehold interest is terminated without need for the

RIGHT TO ENTER AND EXHIBIT UNIT TO BUYERS
(For Residential and Nonresidential Rentals)

DATE:_____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. You are a Tenant under a rental or lease agreement
1.1 Dated: _____, at_____,California.
1.2 entered into by _____, Tenant, and _____, Landlord,
1.3 regarding real estate referred as: _____
_____

NOTICE:
For 120 days after notice to a tenant, a landlord or his listing agent may enter the leased premises during normal business hours to exhibit the unit to buyers after giving the tenant at least twenty-four (24) hours telephonic notice of their intent to enter [Calif. Civil Code §1954]

NOTICE TO TENANT:

2. You are hereby advised the premises you occupy has been placed on the real estate market "For Sale".

3. During the period of 120 days following the date of this notice, the landlord or his authorized listing agent for the sale of the property may need to enter your unit during normal business hours for the purpose of exhibiting the premises for review by prospective or actual buyers.

4. At lease 24 hours prior to entry for this purpose, you will be given telephonic or personal notice of our intent to enter.

5. You are not required to be present on the premise during the entry and review. A passkey will be used should you be absent.

6. On departing the premises, the real estate agents will leave a written note identifying themselves and indicating they have entered and completed their exhibiting of the unit to the buyers.

Date:_____, 20_____
Landlord: _____
Listing Agent:_____
Signature: _____
Address:_____
_____
Phone: _____
Fax: _____
E-mail: _____

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landlord's further action. Importantly, the landlord retains the right to collect future rents due under the unexpired (and uncancelled) rental or lease agreement. [See Chapter 31]

Without proof of the termination of the tenancy by the process of abandonment (or an alternative process) by expiration of the statutory notice of abandonment served on the tenant, the landlord taking possession could be faced with an angry tenant claiming *forcible entry* — and money damages — or a financially detrimental surrender with its elimination of the lease agreement.

For example, a manager rents an apartment to a couple who are expecting a child.

The husband, needing further training for his job, moves to another county for several months. His wife remains in the apartment, intending to live their until her husband returns.

Later, the expectant wife leaves the unit and travels to visit her husband. She posts a note on the unit's front door. It is addressed to her brother who checks in on her from time to time. The note states her

destination, but makes no mention whether she will return. The payment of rent is not delinquent. The manager reads the note, misconstrues its meaning and re-rents the unit on removing the tenant's possessions.

On the wife's return she discovers new tenants living in the unit and confronts the manager. The wife is reduced to retrieving the family possessions from the storage unit where the resident manager placed them. Shortly afterwards, she suffers pregnancy-related medical complications from the physical and emotional stress of relocating.

Here, the property manager's entry into the unit and the subsequent re-renting was unjustified. The tenant's right to continued possession had not been terminated by the landlord or his manager. Thus, the property manager, as well as the landlord, is liable for all losses caused by the property manager's actions, called a *forcible entry*. [**Richardson** v. **Pridmore** (1950) 97 CA2d 124]

Alternatives to abandonment include:

- acceptance of a surrender terminating the possession and canceling the rental or lease agreement; or
- service of a 3-day notice to cure the breach (pay) or quit (vacate) with a provision declaring the forfeiture of the right to possession.

On expiration of the notice of abandonment or the statutory 3-day notice and the vacating of the space by the tenant, the landlord or his agents may enter and occupy or relet the vacated premises. By this process, the landlord retains the right to collect future rents due under the rental or lease agreement breached by the tenant.

Entry by court order

A landlord often has the right to recover possession of the premises due to a forfeiture declared in a 3-day notice to quit or expiration of the rental or lease agreement. However, he may only enforce his right to recover possession from the tenant who remains on the property by using **legal** means to evict the tenant — self-help is absolutely unacceptable.

For example, in an unlawful detainer (UD) action, a landlord obtains an unlawful detainer judgment against a tenant due to the tenant's failure to promptly answer the UD lawsuit. Before the eviction is carried out under the court order, the court "sets aside" the judgment. The court-ordered eviction order is now invalid.

The landlord acts on what he now knows is an *invalid* eviction order. The landlord privately enlists two uniformed county marshals who, without knowing the eviction order is invalid, appear at the tenant's door demanding the tenant vacate the unit.

The tenant leaves the unit immediately and the landlord takes possession. Later, the tenant seeks a money judgment against the landlord claiming the conduct of the landlord was a *forcible entry and detainer* of the premises.

The landlord claims his conduct cannot be considered a forcible entry and detainer since his method for evicting the tenant did not lie entirely outside the law. The landlord obtained a court order (although he knew it was invalid) and did not personally evict the tenant (he used law enforcement officers instead).

However, the landlord is liable for forcible entry and detainer. He caused the tenant to be evicted by using a judgment which he knew to be invalid. The landlord's use of uniformed law officials to carry out

the entry and removal of the tenant does not excuse his use of a known invalid eviction order. Thus, the landlord is still using self-help methods to attain access to and possession of the premises since the eviction was not court ordered. [**Bedi** v. **McMullan** (1984) 160 CA3d 272]

Now consider a nonresidential landlord who obtains a **money judgment** against his tenant for unpaid rent. A *writ of possession* is erroneously issued by the clerk of the court and the tenant is evicted by the sheriff.

The tenant now seeks to recover possession since the money judgment did not award the landlord possession of the premises or include an eviction order. The court later recalls the writ as having been erroneously issued, but refuses to order the landlord to surrender possession of the property to the tenant.

The tenant seeks to recover his money losses for the eviction claiming the landlord is liable for forcible entry and detainer since the landlord had him removed without his consent under an invalid writ of possession.

The landlord claims he is not liable for forcible entry or detainer since he relied on court authorization — the writ of possession erroneously issued by the clerk of the court — to evict the tenant and recover possession of the premises.

Here, the landlord is not liable for the tenant's money losses since imposing liability on landlords relying on a properly issued court order which is erroneous and later recalled, would undermine the *public policy* favoring orderly judicial process (instead of self-help) by opening up landlords to liability when acting under the authority of the court. [**Glass** v. **Najafi** (2000) 78 CA4th 45]

Tenant's right to privacy

Rental and lease agreements occasionally contain an unenforceable provision giving the landlord the *right of re-entry* for the purpose of **retaking possession** of the premises should the tenant breaches any provision in the rental or lease agreement. However, a default alone does not constitute a **forfeiture** or **conveyance** of the leasehold and its possessory rights to the landlord.

For example, a tenant **defaults** in rent under a lease agreement, with or without a provision allowing the landlord to take possession on a default in rent.

Statutory notice requirements of service and expiration of a 3-day notice to pay or quit, together with a declaration of forfeiture of the lease, must be completed while a tenant occupies the space in order to terminate the tenant's right to possession (except for a holdover on expiration of a lease). Self-help by the landlord's taking possession without the tenant's consent at or after the time of the breach constitutes a forcible entry, imposing liability on the landlord for the tenant's money losses. [**Lamey** v. **Masciotra** (1969) 273 CA2d 709]

A tenant's right to possession arises out of his ownership of a leasehold estate in the property, often also called a *lease*. To have an enforceable transfer of the right of possession before it is terminated or expires, the tenant's possessory interest (the leasehold) must be voluntarily *conveyed* by the tenant at or after the time of the breach in exchange for cancellation of the lease (or some other consideration for its conveyance), such as occurs by a surrender or under a deed-in-lieu of foreclosure on a fee simple ownership interest in a property. [CC §1953(a)(l)]

Consider an owner who goes on an extended overseas vacation. He rents his home for the duration of his trip. The rental agreement provides for the tenant to vacate immediately on the owner's return.

The owner returns from his trip, but the tenant refuses to immediately relinquish possession of the house. While the tenant is at work, the owner enters the house, removes the tenant's belongings and retakes possession of the property based on the authority given him by a right of re-entry provision in the rental agreement.

Can the owner use self-help to dispossess the tenant?

No! The tenant's occupancy includes the tenant's right to exclude others from possession, including the owner, as exists for all occupancies granting an exclusive right to possession, such as held by a tenant under a rental or lease agreement. An owner, even though entitled to possession by agreement, cannot re-enter the premises without first obtaining a court order when the tenant wrongfully denies the owner possession.

Forcible entry

Forcible entry by a landlord or property manager is conduct consisting of:

- peaceable entry by open doors, windows or other parts of the premises *without permission, prior notice*, or *justification*;
- entry by any kind of *violence* or *threat of terror*; or
- entry by peaceable means, *after which threats, force* or *menacing conduct* is used to dispossess the tenant. [Calif. Code of Civil Procedure §1159]

Actions by a landlord, property manager or resident manager construed as forcible entry include:

- entry resulting from any physical acts of force or violence;
- entry through a window and removal of the tenant's belongings in the occupant's absence [**Bank of California** v. **Taaffe** (1888) 76 C 626];
- entry under the false pretense of making an inspection and then taking over possession from the tenant [**White** v. **Pfieffer** (1913) 165 C 740];
- entry by unlocking the door of the unit in the tenant's absence [**Winchester** v. **Becker** (1906) 4 CA 382];
- entry accomplished by a locksmith who opens the door during the tenant's absence [**Karp** v. **Margolis** (1958) 159 CA2d 69]; and
- entry by breaking locks. [**Pickens** v. **Johnson** (1951) 107 CA2d 778]

Tenant's possessions as security

Some lease agreements contain an unenforceable clause purporting to give the landlord the right to take or hold the tenant's **personal property as security** should the tenant default in the payment of money owed to the landlord under the agreement.

For example, a tenant enters into a lease agreement and occupies the unit. The agreement authorizes the landlord to re-enter the unit on the tenant's default in the payment of rent and take the tenant's personal possessions as security until the rent is paid.

The tenant fails to pay rent and it becomes delinquent. To enforce the security provision in the lease, the landlord uses his key to enter the unit in the tenant's absence and remove the tenant's possessions. The landlord then refuses to allow the tenant to re-enter the unit until the rent is paid.

Here, the landlord may not enter or interfere with the tenant's continued access to the premises based on the tenant's default on the lease agreement without first obtaining a court order, no matter how peaceably the entry is accomplished, called *forcible entry and detainer*. [**Jordan** v. **Talbot** (1961) 55 C2d 597]

Forcible entry by others

Forcible entry into premises leased to a tenant occurs whenever **anyone enters** the tenant's premises without the tenant's *present consent.*

Consider a hotel operator who encumbers his leasehold interest in a hotel with a trust deed to provide security for a loan. The trust deed states the lender may appoint a trustee to take possession of the real estate and operate and manage the hotel should the hotel operator default on repayment of the loan.

The operator defaults on the loan. The lender appoints a trustee in compliance with the trust deed provisions. The trustee goes to the hotel to remove the hotel operator from the premises as agreed by a provision in the trust deed.

The trustee, although not entering the premises by force, breaks and replaces locks on the storage cabinets, raids cash registers and threatens to harm the hotel operator if he refuses to relinquish possession of the hotel.

Is the trustee guilty of forcible entry onto the property even though the trustee was appointed under a trust deed provision agreed to by the operator and used non-violent means to enter onto the premises?

Yes! The trustee holds the same status as the secured lender and has no more right to possession than the lender, in spite of prior agreements granting authority to the trustee to take possession on default. Thus, the trustee's right to possession, like that of a landlord, could only be lawfully obtained by judicial process — a receivership or foreclosure (judicial or by trustee's sale) — against the interest in the property encumbered by the trust deed, and a UD action following service and expiration of a notice to vacate. [**Calidino Hotel Co. of San Bernardino** v. **Bank of America Nat. Trust & Savings Ass'n** (1939) 31 CA2d 295]

Forcible entry by the tenant

Even a tenant can be guilty of a forcible entry.

Consider a prospective tenant who enters into a rental agreement but since it is presently occupied does not first inspect the condition of the premises.

When he is to take possession, he discovers the physical condition of the premises is unacceptable and refuses to take possession. As a result, the landlord does not give the tenant a key or any other means of access to the premises.

The landlord, realizing he will not be able to rent the property until the premises is restored, renovates the improvements. On the landlord's completion of the renovations, the would-be tenant climbs through an open window in the landlord's absence and takes possession of the premises, claiming he holds a rental agreement granting him the right to possession of the unit.

Here, the tenant did not have authority from the landlord to occupy the premises. The rental agreement he entered into has been previously canceled by the tenant's conduct when he refused to accept delivery of possession and was not given access to the premises. The tenant's occupancy was gained only by his unauthorized and peaceful entry, legally called *forcible entry*. [**McNeil** v. **Higgins** (1948) 86 CA2d 723]

Landlord as co-tenant

Consider the owner of a single-family residence who rents rooms to individuals, called *roommates*.

Soon, the owner spends less and less time residing on the property. However, the owner continues to maintain his mailing address at the residence.

After a week-long absence, the owner returns and discovers the locks on all the doors have been changed. He breaks a window and enters the property. The roommates claim the owner is guilty of forcible entry since he broke into the property.

Did the owner's roommates have the exclusive right to possession barring the owner from entering the property without prior notice?

No! The owner was not attempting to regain possession. Rather, he was a co-occupant in **actual possession** of the premises with others at the time of his entry.

The owner and his roommates had joint possession. No one roommate had been given exclusive possession against any other roommate. As a joint possessor with the right to occupy the premises concurrently with others, the owner is not liable for forcible entry. [**Bittman** v. **Courington** (1948) 86 CA2d 213]

Losses due to wrongful dispossession

A tenant wrongfully removed from his premises by a landlord or property manager is entitled to be returned to possession of the premises for the duration of the lease, called *restitution*. The tenant also has additional remedies against the landlord and the property manager. [CCP §1174(a), (b)]

Besides recovery of possession, a tenant may recover all money losses caused by the landlord's wrongful entry. However, the amount of money the tenant may collect is limited to losses incurred during the time period the tenant was dispossessed but retained a legal right to possession, prior to the expiration or termination of his tenancy under a rental or lease agreement. [**Orly** v. **Russell** (1921) 53 CA 660]

For example, a nonresidential tenant is served a 30-day notice to vacate to terminate his month-to-month tenancy.

Later, prior to the expiration of the notice to vacate and due to a default, the landlord bars the tenant from entry to his premises. The tenant is unable to continue operating his business from the property. The tenant does not regain possession of the premises before his right to possession is terminated by the expiration of the notice to vacate.

The tenant wants to recover for the landlord's unlawful detention of the property and for loss of business income.

However, recovery of the tenant's losses is limited to the net operating income (NOI) which could have been earned during the balance of the unexpired term. [Orly, *supra*]

Damages to the *goodwill* of a tenant's business are also evaluated. If the tenant has built up goodwill with the customers of his business, the remaining days of his period of tenancy are used to advise customers of his expired lease and new location.

The landlord who forcibly enters the leased premises during the remaining period of the tenancy is liable for the tenant's money losses due to lost earning power when the tenant is deprived of transferring customers to his new location, called *business goodwill*. [**Schuler** v. **Bordelon** (1947) 78 CA2d 581]

A tenant whose possession has been interfered with can recover his money losses due to:

- lost profits [**Stillwell Hotel Co.** v. **Anderson** (1935) 4 C2d 463];
- rental value of the lost use of the premises [Stillwell Hotel Co., *supra*];
- loss of **business goodwill** (earning power of the business) [Schuler, *supra*]; and
- emotional distress caused by the landlord or property manager's conduct towards the tenant. [**Newby** v. **Alto Riviera Apartments** (1976) 60 CA3d 288]

Also, the tenant may collect up to three times his actual money losses for the landlord's wrongful entry as punishment judicially inflicted on the landlord, if the landlord willfully or maliciously took possession from the tenant, called *punitive damages*.

For example, a landlord seeking to collect a debt owed by his tenant bars his tenant's employees from the leased premises, changes the locks and refuses to allow the tenant access to records and personal property.

Here, the landlord is acting with malice and the tenant has the right to recover trebled damages. [**Civic Western Corporation** v. **Zila Industries, Inc.** (1977) 66 CA3d 1]

Additionally, a landlord or property manager using actual force or violence to enter a leased unit is guilty of a misdemeanor. [Calif. Penal Code §418]

Chapter 5 Leasehold improvements

This chapter discusses improvements made by a tenant on leased property and the landlord's rights regarding them.

Real estate or trade fixtures

A retail business owner enters into a nonresidential lease agreement to occupy commercial space as a tenant. The leased premises does not contain *tenant improvements* (TIs) since the building is nothing more than a shell.

The tenant agrees to make all the **tenant improvements** needed for him to occupy the premises and operate his business (i.e., walls, flooring, carpeting, lighting, plumbing, telephone and electronic wiring, etc.). The tenant will also install *trade fixtures* on the premises.

The lease agreement provides for the property to be delivered to the landlord on expiration of the lease "in the condition the tenant received it", less normal wear and tear.

However, no other provision in the lease agreement addresses whether tenant improvements will remain with the property or if the property is to be restored to its original condition when the lease expires.

On expiration of the lease, the tenant strips the premises of all improvements he made and vacates. The building is returned to the landlord in the condition it was found by the tenant, an empty shell, less wear and tear. In order to relet the space, the landlord replaces nearly all the tenant improvements that were removed.

Is the tenant liable for the landlord's costs to replace the tenant improvements for the next tenant?

Yes! Improvements made by a tenant that are **permanently affixed** to real estate become part of the real estate to which they are attached. Improvements remain with the property on expiration of the tenancy, less normal wear and tear, unless the lease agreement provides for the property to be *restored* to its original condition by removal of tenant improvements. [Calif. Civil Code §1013]

However, the landlord's right to improvements added to the property by the tenant depends upon:

- the permanent or temporary nature of the tenant improvements (i.e., built-in or free standing); and
- any provisions in the lease agreement relating to the tenant's removal of improvements and restoration of the premises.

With the exception of **trade fixtures**, improvements attached to the building become part of the real estate. [CC §660]

Examples of improvements that become part of the real estate include:

- built-ins (i.e., central air conditioning or heating, cabinets and stairwells);
- fixtures (i.e., electrical and plumbing);
- walls, doors and dropped ceilings; and
- attached flooring (i.e., carpeting, tile or linoleum).

Leasehold improvement provisions

Nonresidential lease agreements typically contain a *further-improvements* provision allowing the landlord to either:

- retain tenant improvements and alterations made by the tenant; or
- require restoration of the property to its original condition on expiration of the lease. [See **first tuesday** Form 552 §9]

Further-improvement provisions usually include clauses stating:

- who will make the improvements (landlord or tenant);
- who will pay for the improvements (landlord or tenant);
- the landlord's consent is required before the tenant makes improvements;
- any mechanic's liens due to improvements contracted by the tenant will be removed;
- the condition of the premises on expiration of the lease; and
- whether the improvements are to remain or be removed on expiration of the lease.

Failure to make improvements

Consider a landlord who, under a lease agreement, obligates himself to make improvements. Once agreed to, the landlord must complete the improvements in a *timely* manner so the tenant may use them or the tenant may cancel the lease agreement. [See **first tuesday** Form 552 §10]

For example, a landlord agrees to make all the improvements necessary to convert a ranch into a dairy farm for a tenant who operates a dairy.

The landlord obligates himself to construct a barn and several sheds that are essential to the operation of the tenant's dairy business.

The tenant moves into the property before the improvements begin. Several months pass and the landlord does not begin construction on the promised improvements. The tenant vacates the property since it is impossible to conduct his dairy business without the dairy barn.

Here, the landlord's failure to make the promised improvements is a breach of the lease agreement.

Since the landlord has breached an essential provision of the lease, the tenant may vacate the property and cancel the lease agreement without obligation to pay further rent. [**Souza** v. **Joseph** (1913) 22 CA 179]

Now consider a landlord who agrees to construct the shell of a building for a tenant. The tenant agrees to install all other improvements and fixtures required to occupy and use the property.

Before the building is completed by the landlord, the building code is changed to require the installation of a sprinkler system. The tenant demands the landlord pay the cost of installing the sprinkler system since he cannot occupy the premises without the sprinkler system.

The landlord refuses to pay the additional cost to install the sprinkler system, claiming the lease agreement calls for him to build the structure, not to make it ready for occupancy.

Is the tenant responsible for the cost of the sprinkler system?

Yes! It is the tenant's responsibility to make the alterations or improvements required to bring the building into compliance with use (occupancy) ordinances since the tenant agreed to make all improvements within the structure needed to take occupancy. [**Wong** v. **DiGrazia** (1963) 60 C2d 525]

Conversely, lease agreement provisions can obligate a tenant to improve vacant, unimproved property with buildings, such as occurs with ground lease arrangements.

Improvements promised by the tenant

A tenant must complete improvements he has agreed to construct or install on the leased premises within the time period agreed to in the lease agreement, or within a reasonable period of time if no commencement or completion date for construction is specified in the lease agreement. [CC §1657]

However, if the tenant fails to make or complete mandated improvements prior to expiration of the lease and the improvements were to remain with the property, the tenant is liable to the landlord for the cost incurred by the landlord to complete the agreed-to improvements.

For example, a tenant agrees to construct additional buildings on a leased property in lieu of paying rent for one year. When the lease expires, the improvements will remain with the property since the lease agreement does not call for restoration of the premises.

The tenant fails to construct the buildings during the term of the lease. The tenant claims the lease provision calling for construction is *permissive*, not mandatory, since he only had to build if he needed to do so for the operation of his business.

Here, the improvements were agreed to in exchange for rent. Accordingly, the tenant is required to make the improvements since the landlord **bargained for them** in the lease agreement. Thus, the landlord is entitled to recover an amount equal to the cost of the improvements the tenant failed to construct. [**Simen** v. **Sam Aftergut Co.** (1915) 26 CA 361]

Additionally, if the tenant agrees to but does not complete the construction of improvements that are to remain with the property on expiration of the lease, the landlord may complete those improvements. The tenant is then financially responsible for the landlord's expenditures to construct the improvements the tenant agreed to construct. [**Sprague** v. **Fauver** (1945) 71 CA2d 333]

The landlord is also entitled to recover lost rent and expenses arising after the expiration of a lease resulting from the tenant's failure to construct the improvements as promised.

Consider a landlord who enters into a lease agreement calling for the landlord to construct a building on the leased property. After the foundation is laid, the landlord and tenant orally modify the construction provisions. The tenant agrees to finish construction of the building in exchange for the landlord forgoing his construction profit.

The tenant then breaches the *oral modification* of the written lease agreement by failing to complete the construction. The breach places the landlord in financial jeopardy as he now must complete the building himself. The landlord terminates the tenant's right to occupancy, evicts the tenant and completes the construction promised by the tenant.

Here, the tenant is not only responsible for the landlord's costs of construction, he is also liable for future rents under the lease agreement and any expenses the landlord incurs to relet the property since the landlord's conduct did not cancel the lease agreement. [**Sanders Construction Company, Inc.** v. **San Joaquin First Federal Savings and Loan Association** (1982) 136 CA3d 387]

Landlord's consent to improvements

Lease provisions often allow a tenant to make improvements to the leased premises. However, further-improvement provisions typically call for the landlord to approve the planned improvements before construction is commenced.

For example, a tenant wishes to add a room to the premises he leased for use in the operation of his business. The tenant begins construction without the landlord's prior approval as mandated in the lease agreement. The addition is located in space outside the area described as the leased premises in the lease agreement, an encroachment of the tenant's improvements on other land owned by the landlord.

In the past, the landlord had approved tenant improvements. This time, however, the landlord refuses to give consent and complains about the construction the tenant has begun and the encroachment.

The landlord continues to accept rent while he negotiates with the tenant regarding the approval of the addition and the modification of the lease agreement to include use of the area subject to the encroachment.

Ultimately, after a few years of negotiations without resolution, the landlord declares a *forfeiture of the lease* based on both the breach of the provision requiring his prior consent to construction and the encroachment of the unapproved improvements.

The tenant now claims the landlord *waived* his right to declare a forfeiture of the lease since the landlord continued to accept the rental payments after the breach of the tenant-improvement provision and encroachment.

As long as negotiations to resolve the breach continue, a landlord may accept rent from the tenant without waiving his right to consent to additional improvements. [**Thriftimart, Inc.** v. **Me & Tex** (1981) 123 CA3d 751]

Likewise, when a tenant with an option to buy makes improvements with the expectation of ultimately becoming the owner of the property under the option to buy, and the lease agreement requires approval of the improvements by the landlord, the landlord's consent is needed before any improvements can be made since the tenant is not yet the owner.

Further, the tenant is not entitled to reimbursement for the cost of his improvements, whether or not the landlord consents to the improvements. The improvements will not become the tenant's unless he exercises his option to buy and becomes the owner of the property. [**Whipple** v. **Haberle** (1963) 223 CA2d 477]

Permissive improvements by the tenant

Some lease agreement provisions allow a tenant to make improvements as deemed necessary by the tenant, but do not specifically mandate that he do so or do so in lieu of rent, called *permissive improvements*. Here, the tenant has not obligated himself to make the improvements, but is merely authorized to do so without the need for further consent from the landlord.

For example, a landlord and tenant sign a long-term lease agreement. Its further improvements provision authorizes the tenant to demolish an existing building located on the property and construct a new one in its place without first obtaining the landlord's consent. The rent is based solely on the current value of the premises.

The further-improvements provision does not state a specific time period for demolition or construction.

The tenant makes no effort to tear down the old building or erect a new one. Ultimately, the landlord claims the tenant has breached the lease agreement for failure to demolish the existing building and construct a new one.

Here, the tenant has not breached the lease agreement. The agreement contained **no promise** by the tenant to build and the rental amount was not based on the construction. The tenant was not obligated to build and was merely authorized to build without need for the landlord's approval.

Thus, the tenant was granted a privilege to make improvements. Further improvements on the tenant's part were not mandatory, they were permissive. [**Kusmark** v. **Montgomery Ward and Co.** (1967) 249 CA2d 585]

A further-improvements provision that requires a tenant to construct improvements on a vacant parcel he leases, at a rental rate reflecting the value of the land, has different consequences. If a date is not specified for completion of the improvements, the tenant must complete construction within a reasonable period of time since construction of improvements is mandated to occur.

For example, a landlord leases unimproved land to a developer who is obligated to build improvements, contingent on obtaining a construction loan. A time period is not set for commencement or completion of the construction. However, a cancellation provision gives the tenant/developer the right to cancel the lease agreement within one year if financing is not found to fund the construction. No provision authorizes the landlord to terminate the lease if the required construction is not completed.

The tenant is unable to arrange financing within the one-year period but he does not exercise his right to cancel the lease agreement and avoid payment of future rents. Instead, the tenant continues his good faith effort to locate and qualify for construction financing. Ultimately, financing is not located and construction is not commenced.

The landlord terminates the lease a few years later, claiming the lease agreement has been breached since the promised construction was not completed.

The tenant claims the landlord cannot terminate the lease as long as the tenant continues his good faith effort to locate financing and remains solvent to qualify for the financing.

Here, the tenant has breached the lease agreement. He failed to construct the intended improvements within a *reasonable period of time*. The original purpose of the lease was to have buildings erected without specifying a completion date. Following the expiration of the right to cancel, the landlord gave the tenant/developer a reasonable amount of time in which to commence construction before terminating the lease.

When the original purpose for the lease was the development of the land by the tenant, a landlord cannot be forced to leave the property unimproved forever. [**City of Stockton** v. **Stockton Plaza Corporation** (1968) 261 CA2d 639]

Surrender of improvements

All tenant improvements are to remain with the leased property on termination of a lease unless a provision in the lease agreement **permits** or **mandates** their removal by the tenant as a restoration of the premises.

Most lease agreements merely provide for the property to be returned in *good condition*, minus ordinary wear and tear for the years of the tenant's occupancy.

Thus, the tenant is not required to **restore** the property to its actual condition when he took possession. A provision calling for ordinary care of the premises during the lease does not mean the tenant must remove his improvements or renovate the improvements to eliminate deterioration, obsolescence and normal wear and tear due to the use permitted to the tenant. [**Kanner** v. **Globe Bottling Co.** (1969) 273 CA2d 559]

Now consider a landlord and tenant who enter into a lease of nonresidential property. The lease agreement contains a provision requiring the tenant, if the landlord at his option so demands, to **restore the premises** to the original condition received by the tenant, less normal wear and tear.

The tenant makes all the tenant improvements necessary to operate his business, such as installation of a concrete vault, the removal of partitions and a stairway, and the closing of two entrances into the premises.

On expiration of the lease, the tenant vacates the premises. The landlord exercises his right to require removal of tenant improvements by making a demand on the tenant to **restore** the premises, which the tenant rejects.

The landlord incurs costs to prepare the premises for reletting to a new tenant.

The landlord claims the tenant is liable for the costs he incurred to restore the premises since the tenant's improvements radically altered the premises and made it unrentable to others.

The tenant claims he is not liable for the landlord's costs to remove the improvements and restore the premises to its original condition since the alterations became part of the real estate and were beneficial to the property.

Is the tenant liable for the landlord's costs to restore the premises to a rentable condition?

Yes! On expiration of the lease, the tenant becomes obligated to restore the premises to its original condition, less normal wear and tear, when the landlord exercised his option to call for removal of the improvements since the lease agreement provides for restoration by the tenant on a demand from the landlord. The tenant improvements made the premises less desirable and unsuitable for other occupants. On the tenant's failure to restore the premises, the landlord was forced to incur restoration costs to relet the premises. The tenant is liable for the landlord's expenditures to restore and relet the premises to a new tenant. [**Masonic Temple Ass'n. of Sacramento** v. **Stockholders Auxiliary Corporation** (1933) 130 CA 234]

In another example, a lease agreement states a tenant will return the property in *good repair* and *restore the premises* to its original condition, less normal wear and tear.

The tenant modifies the premises to operate his business. After the lease expires, the tenant moves out and leaves all his improvements and structural modifications on the property. As a result, the landlord is unable to relet the premises in the condition left by the tenant.

Here, the tenant is liable for the reasonable costs incurred by the landlord to restore the premises to its original condition and for lost rental income for the period of time required to make the repairs.

Lease provisions calling for **restoration** of the premises to its original condition require the tenant to remove his improvements and restore the property to its original condition, minus any normal deterioration due to the passage of time and use of the premises as permitted. [**Iverson** v. **Spang Industries** (1975) 45 CA3d 303]

If a lease does not require the tenant to **restore the property** to the condition it was in when received, the tenant may only remove his personal improvements, called trade improvements or trade fixtures.

The tenant only needs to leave the property and tenant improvements in good condition. [**Formosa Corp.** v. **Rogers** (1951) 108 CA2d 397]

Reimbursement for TIs on eviction

What compensation may be due to a tenant who has improved the property and is evicted prior to expiration of a lease?

A tenant who is evicted is entitled to reimbursement for the **rental value** of his improvements for the remainder of his unexpired lease term. The tenant is not, however, entitled to reimbursement for the market value or cost of the improvements. Without reimbursement, the landlord receives a windfall profit for his use of the tenant's improvements until they would have reverted to the landlord on expiration of the original lease.

Thus, an evicted tenant is limited to collecting the reasonable value for the landlord's use of the improvements during the remainder of the term on the original lease. [**Asell** v. **Rodrigues** (1973) 32 CA3d 817]

Real estate fixtures vs. trade fixtures

Two types of fixtures exist distinguishing improvements installed on a building located on a parcel of real estate:

- *real estate fixtures*; and
- *trade fixtures*.

A **real estate fixture** is personal property that is **attached** to the real estate. It becomes part of the real estate it is attached to and is conveyed with the property. [CC §§660; 1013]

For example, if a tenant rents an office and builds bookshelves into the wall rather than merely anchoring them to the wall, the bookshelves become part of the improvements located on the real estate.

When the lease expires, real estate fixtures become the landlord's property. The landlord takes possession of the real estate fixtures as part of the real estate forfeited or surrendered to the landlord, unless the lease agreement provides for restoration or permits removal by the tenant. The passage of real estate fixtures from tenant to landlord on expiration of the lease is a conveyance called *reversion*. [**City of Beverly Hills** v. **Albright** (1960) 184 CA2d 562]

Conversely, **trade fixtures** do not revert to the landlord on expiration of the lease. A trade fixture is an improvement that is attached to the real estate by the tenant and is unique to the operation of his business, not the use of the building.

Consider a tenant who leases property to operate a beauty salon. The tenant moves in work-related furnishings (i.e., mirrors, salon chairs, wash stations and dryers), necessary to run the business. The items are attached to the floor, walls, plumbing and electrical leads.

On expiration of the lease, the tenant removes the fixtures that were used to render the services offered by the business. The landlord claims the fixtures are improvements to his property and cannot be removed since they became part of the real estate when installed.

However, furnishings unique to the operation of a business are considered trade fixtures even though the furnishings are attached and built into the structure. Trade fixtures are removable by the tenant.

A tenant may, at the end of or anytime during the lease term, remove any fixture used for trade purposes if the removal can be done without damaging the premises. [**Beebe** v. **Richards** (1953) 115 CA2d 589]

Fixtures that have become an integral part of the building structure due to the way they are attached or the general purpose they serve cannot be removed. Examples of fixtures not used to render services include toilets, air conditioners, vent conduits, sprinkler systems and lowered ceilings. [CC §1019]

Trade fixtures as security

Lease agreements often contain a default provision prohibiting the tenant from removing the trade fixtures when the agreement is breached. The tenant (and his unsecured creditors) no longer have a right to the trade fixtures under a default provision.

Consider a tenant who signs a commercial lease agreement to use the premises to operate a frozen packaging plant. The lease agreement states all fixtures, trade or leasehold, belong to the landlord if the lease is terminated due to a breach by the tenant.

The tenant later encumbers his existing trade fixtures by borrowing money against them. The tenant then defaults on his lease payments. While in default on the lease, the tenant surrenders the property to the landlord, including all trade fixtures.

Does the lender on the loan secured by the trade fixtures have a right to repossess them?

No! The tenant lost his ownership right to remove the trade fixtures under the terms of the lease agreement that was entered into before he encumbered the trade fixtures. Any right to the fixtures held by the secured lender is similarly lost since the lender is junior in time and thus subordinate to the landlord's interest in the fixtures under the lease agreement.

However, if the trade fixtures installed by the tenant are owned by a third party, or if a third party had a lien on them at the time of their installation, the landlord has no more right to them than the tenant. [**Goldie** v. **Bauchet Properties** (1975) 15 C3d 307]

Notice of Nonresponsibility

A landlord may find himself paying for improvements made by the tenant if he does not:

- **post** a notice on the premises of his intention to avoid subjecting his property to a lien for the improvements, called a *Notice of Nonresponsibility*; and
- **record** the notice with the county recorder. [See Form 597 accompanying this chapter]

Tenants occasionally contract for improvements to be constructed on the premises they have leased. Any mechanic's lien by a contractor for nonpayment initially attaches to the tenant's leasehold interest in the property. [CC §3128]

However, the mechanic's lien for unpaid labor and materials may also attach to the *fee simple* interest held by the landlord if:

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

NOTICE OF NONRESPONSIBILITY

(Civil Code §3094)

DATE:_____, 20_____, at _____, California.

NOTICE IS HEREBY GIVEN:

1. _____ is the vested and legal owner of real property located in the County of _____, State of California, identified as:

1.1 Common address:_____

1.2 Legal description:

2. _____ is:

2.1 ☐ The buyer of the property under a purchase agreement, option or land sales contract, or

2.2 ☐ The tenant under a lease of the property.

3. Within 10 days before the posting and recording of this notice, the undersigned owner or agent of the owner obtained knowledge that a work of improvement has commenced on the site of the property involving ☐ construction, ☐ alteration, or ☐ repair.

4. The owner will not be responsible for any claim arising out of this work of improvement.

5. I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date:_____, 20_____

Signature:_____

☐ Owner, or ☐ Agent of the owner.

STATE OF CALIFORNIA
COUNTY OF_____
On _____ before me,
_____
(name of notary public)
personally appeared _____
_____,
(name of principal)
personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.
WITNESS my hand and official seal.

Signature: _____
(Signature of notary public)

(This area for official notarial seal)

- the landlord or his property manager learns the construction is taking place; and
- fails to post and record a Notice of Nonresponsibility.

A **Notice of Nonresponsibility** is a written notice that must be:

- posted in a conspicuous place on the premises within ten days after the landlord (or his agent) initially learns of the construction; and
- recorded with the county recorder's office within the same ten-day period. [CC §3094]

A landlord who becomes aware of the construction and fails to post and record the Notice of Nonresponsibility does not become personally liable to the contractor. Rather, the contractor can only lien the landlord's interest in the real estate and then foreclose on his lien to collect for unpaid labor and materials delivered to improve the property under contract with the tenant. [**Peterson** v. **Freiermuth** (1911) 17 CA 609]

Further, a mechanic's lien can attach to the landlord's interest even when he has posted and recorded a Notice of Nonresponsibility if the lease agreement requires the tenant to make improvement — mandatory improvements.

For example, a lease agreement requires the tenant to make certain improvements as a condition of renting the property. Since the improvements are not permissive, the tenant is deemed to be the **landlord's agent** when he contracts for the construction of the mandated improvements.

Since the lease mandated the tenant to construct improvements, the mechanic's lien incurred by the tenant will attach to both the tenant's and the landlord's interest in the property despite any posting and recording of a Notice of Nonresponsibility. [**Los Banos Gravel Company** v. **Freeman** (1976) 58 CA3d 785]

Had the lease agreement merely *authorized* the tenant to make permissive improvements, whether they may be made with or without the landlord's prior consent, the tenant is not acting as an agent for the landlord. Thus, the landlord's interest in the property will not be subject to a mechanic's lien if the Notice of Nonresponsibility is timely posted and recorded on discovery of the tenant improvements. [**Baker** v. **Hubbard** (1980) 101 CA3d 226]

Also, a **mechanic's** lien cannot be recorded against the landlord if the improvements are removed by the contractor recording the lien.

For example, a tenant contracts to have air conditioning installed in the building. The contractor sells the equipment to the tenant on a conditional sales contract. The contractor retains title to the equipment as security until monies due on the sales contract are paid by the tenant.

The landlord's consent to the improvements is not obtained by the tenant, but the landlord has knowledge the work has commenced. The landlord does not post a Notice of Nonresponsibility.

Later, after the air conditioning units are installed, the tenant vacates the property.

The contractor is not paid and files a mechanic's lien against the landlord's fee interest in the property. Further, the contractor repossesses the air conditioning units and resells them at a loss, which he now seeks to recover under his lien.

However, by his election to repossess the units, the contractor waived his right to enforce the mechanic's lien and foreclosure since his equipment is no longer a **fixture** on the real estate. Whether the air conditioning units are considered a removable fixture due to the financing or a property improvement

permitting the recording of a mechanic's lien is no longer an issue once they have been removed by the contractor.

As authorized by the conditional sales contract, the contractor removed the air conditioning units and chose to treat the units as personal property, not real estate fixtures. Thus, the contractor lost his lien rights against the real estate for nonpayment. [**Cornell** v. **Sennes** (1971) 18 CA3d 126]

Consider a tenant who leases a property with tanks for holding gasoline. The tenant negotiates a reduced rental payment in exchange for installing fuel pumps free of any liens.

The tenant purchases the pumps on credit and the pumps are installed. The supplier of the pumps does not receive a UCC-1 financing statement from the tenant, and thus does not file a UCC-1 with the Secretary of State, a requisite to perfecting the supplier's lien on the pumps.

Later, the pump supplier claims title to the pumps due to an unpaid installation debt and seeks to repossess them.

However, the landlord owns the pumps as fixtures that became part of the real estate when they were installed since he gave consideration in the form of reduced rent to acquire the pumps and the pump supplier failed at the time the pumps were installed to perfect its lien with a UCC-1 to establish his priority interest in the pumps. [**Southland Corp.** v. **Emerald Oil Company** (9th Cir. 1986) 789 F2d 1441]

Chapter 6 Options to buy and the right of first refusal

This chapter distinguishes the tenant's exercisable right to buy under the owner's irrevocable offer to sell from the tenant's preemptive right to buy should the owner decide to sell.

Purchase rights held by tenants

A prospective tenant is negotiating to lease a single-user property. An offer to lease or letter of intent (LOI) is prepared by the tenant's leasing agent calling for the owner to grant the tenant an **option to purchase** the property, an irrevocable right to later buy the property at the *tenant's discretion*. If the owner agrees to grant an option to buy, he will be obligated to sell the property on the terms of the option if the tenant decides to buy.

However, the owner rejects the offer to lease because he is not willing to sell the property.

While negotiating a counteroffer with the landlord, the leasing agent discovers the owner is willing to grant the tenant a **right of first refusal** for the term of the lease, called a *preemptive right*. Thus, if the owner decides to sell the leased premises before the lease expires, the tenant could exercise the right to buy the property.

To exercise the right of first refusal, the tenant must accept the terms of sale the owner presents or match an offer made by another buyer.

Should the tenant decide not to exercise his right of first refusal, the lease remains in effect and he retains possession. If the property is sold to another person, however, ownership is transferred subject to the tenant's leasehold interest. On the owner's completion of the sale, the lease agreement will no longer include the preemptive right to acquire the property since the right of first refusal expired unexercised. [**Manasse** v. **Ford** (1922) 58 CA 312]

Option to buy vs. right of first refusal

An owner and tenant may agree to a tenant's option to buy the property under provisions that grant the tenant either:

- an **irrevocable right to purchase** the property within a specific time period, called an *option to buy*; or
- a **pre-emptive right to purchase** the property if the owner later decides to sell the property, called a *right of first refusal*.

The option to buy is typically evidenced by an agreement separate from the lease agreement, since the option includes the terms of purchase which are unrelated to the lease. The option to buy is usually referenced in the lease and attached as an addendum. [See **first tuesday** Form 161 accompanying this chapter]

Conversely, the right of first refusal is a provision included in the body of the lease agreement, or by an addendum, since the provision rarely contains the terms of a sale. [See Form 579 accompanying this chapter]

Unlike the right of first refusal, an **option to buy** must contain all terms needed to form an enforceable agreement to sell the real estate. The tenant holding an option to buy has the discretionary right to buy or not to buy on the sales terms stated in the option, and to do so within an agreed-to time period. No variations are allowed.

To buy the property under an option, the tenant *exercises* his right to buy through acceptance of the *irrevocable offer to sell* granted by the option. Thus, the decision to buy or not to buy the property rests at all times with the tenant, the owner having already agreed to sell.

Conversely, when an owner grants his tenant a **right of first refusal**, the tenant only acquires the right to buy or not to buy the property if the owner later decides to sell. However, once the tenant is notified of the owner's intent to sell, the right of first refusal becomes an option to buy on the terms offered by the landlord.

When the owner presents his offer to sell, the tenant has the right to accept the offer and buy the property within the fixed period of time for exercise by the right of first refusal provision. [See Form 579 §3.1]

The owner's motives

An owner who desires to sell his property often uses the option to buy or a right of first refusal to induce a tenant to buy the property, rather than rent it.

The timing of a sale by the use of options and the right of first refusal provisions may reflect:

- the tenant's present inability to buy;
- the tenant's desire to buy;
- the owner's inability to find a buyer; or
- the owner's desire to sell later, not now.

The owner's motives for delaying the decision to sell the leased property when the prospective tenant would rather buy include:

- tax benefits, available by delaying the sale and reporting profit in a year when profit taxes will be lower or the profit can be offset by losses on the sale or operations of other properties;
- financial incentives flowing from delaying the sale to obtain the highest price possible in a rising market, the elimination of neighborhood obsolescence, the re-zoning of the property, or avoiding locked-in financing on property which prohibits a current sale;
- legal problems hindering the sale (and value) of the property, such as a *lis pendens* or toxic clean-up;
- personal concerns interfering with any desire to sell the property due to health, estate planning or family considerations.

Also, an owner may grant a right of first refusal even though he has no intention of ever selling the property. The tenant may request a right of first refusal on theory that the owner may change his mind or die and the successor will sell.

The right of first refusal serves the same purpose for the owner as an option serves for the tenant — to avoid entering into an enforceable commitment to, respectively, sell or buy real estate.

RIGHT OF FIRST REFUSAL TO BUY

Addendum

DATE:_____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to a lease/rental agreement

1.1 dated _____, 20_____, at_____, California,

1.2 entered into by: _____and_____

1.3 regarding real estate referred to as:_____

_____

AGREEMENT:

In addition to the terms of the above referenced agreement, the undersigned agree to the following:

Right of first refusal to buy:

2. Landlord hereby grants tenant a right of refusal to purchase the leased premises, for a term commencing _____, 20_____, and expiring _____, 20_____, or ☐ on termination of the right of occupancy.

3. Should landlord decide to sell the premises during the term of the tenant's right of first refusal, landlord shall notify tenant of the terms on which landlord is willing to sell.

3.1 Tenant shall have the option for a period of _____days after receiving written notice to purchase the premises on terms stated in the notice.

3.2 Should tenant fail to exercise the option within the option period, landlord shall have the right to sell the premises to a third party on the same terms stated in the notice to tenant.

3.3 Any sale on different terms reinstates the tenant's right of first refusal.

4. If the landlord has not closed a sale of the property within six (6) months after tenant's receipt of notice, the tenant's right of first refusal is reinstated.

5. _____

_____

_____

_____

Tenant: I agree to the terms stated above.	**Landlord: I agree to the terms stated above.**
Date:_____, 20_____	Date:_____, 20_____
Name: _____	Name: _____
Signature: _____	Signature: _____
Name: _____	Name: _____
Signature: _____	Signature: _____

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Consideration for granting an option

To create an enforceable option to buy or right of first refusal agreement, a condition called *mutuality of obligation* must exist between the owner and the tenant. The owner and the tenant must legally commit themselves to one another in some way before the tenant can enforce the agreement against the owner. [**Kowal** v. **Day** (1971) 20 CA3d 720]

The **owner commits** to be bound by the agreement by *signing* a document granting the tenant the option to buy or the right of first refusal. To create an enforceable option to buy or right of first refusal, the tenant must make a commitment in return. These commitments to one another are called *consideration.*

When the option or right of first refusal is negotiated concurrently as an addendum to the lease, the **tenant's commitment** is his promise to pay rent and perform under the lease he *signs* concurrent with receiving the option or right of first refusal.

However, if the option to buy or right of first refusal is later added to an existing lease, additional consideration must be negotiated and delivered to the owner since the tenant is not committing himself to do anything new or different in exchange for the new rights. Here, the **tenant's commitment** could be agreeing to a modification of the terms in the existing lease, the settlement of a dispute with the landlord or the payment of a sum of money.

The option agreement

Under an option agreement, the tenant is not obligated to buy the leased property. The tenant is merely given the right to buy if he so chooses, a type of *call option*.

For the option to be enforceable, the purchase price of the property and terms of payment on exercise of the option must be included in the option agreement. Therefore, if not set as a dollar amount, the purchase price may be stated as the fair market value of the property at the time the option is exercised.

The right to buy must be exercised by the tenant within a specified time period, called the *option period*. The option period often runs until the right to occupy (lease) expires or is terminated. [See Form 161 §4]

If the option is not exercised precisely as agreed during the option period, the option period expires of its own accord. Thereafter, the option no longer exists and the tenant has no right to acquire the property. [**Bekins Moving & Storage Co.** v. **Prudential Insurance Company of America** (1985) 176 CA3d 245]

When options to renew or extend are included in the lease, the **expiration** of the option to buy is tied by agreement to either:

- the expiration of the initial lease term; or
- the expiration of any renewal or extension.

For example, a tenant rents space under a ten-year lease with an **option to extend** the term of the lease. The tenant also holds an option to buy the leased property. The option references the lease term — until expiration or termination of the lease — as the period for exercise of the option to buy.

If the lease is later extended, the option period is automatically extended with the extension of the lease since the option to buy allows the tenant to exercise the option *during the lease term*, the period of occupancy provided by the lease agreement. [**In re Marriage of Joaquin** (1987) 193 CA3d 1529]

Now consider a lease agreement which contains an **option to renew**, not to extend. The renewal option requires the preparation and signing of a new lease agreement on *identical terms* to the original lease agreement. The initial lease agreement, by way of a referenced attachment, provided the tenant with an **option to buy** which can be exercised *prior* to the expiration of the lease.

On renewal of the lease agreement, the tenant must ensure the option to buy is not left to expire at the end of the initial lease term. The new lease agreement must also reference the option to buy (as part of the identical terms of the original lease) since a new lease is not an *extension* of the original lease. [In re Marriage of Joaquin, *supra*]

Right of first refusal

To trigger the tenant's right of first refusal, the owner does not need to first agree to sell the leased property by entering into a purchase agreement with another person, with the provision it is "subject to the tenant's right of first refusal."

Any indication of the owner's decision to sell the property is sufficient to activate the right to buy, including:

- listing or advertising the property for sale;
- offering the property to a buyer;
- accepting an offer or making a counteroffer involving a buyer; and
- granting a purchase option to another person.

For example, a buyer of income property contacts the owner of leased commercial property to acquire it. The buyer is informed the major tenant holds the right to buy the property under a right of first refusal provision in the lease.

The buyer attempts to circumvent the right of first refusal by negotiating an option to buy the property, exercisable only after the tenant's right of first refusal expires. The owner grants the buyer an option to buy the property. The granting of the option now binds the owner unconditionally to sell the property if the option is exercised.

Here, the owner's granting of the option to sell the property is a clear indication of his intention to sell, triggering the right of first refusal. The tenant is now allowed to purchase the property on the same terms as contained in the option. [**Rollins** v. **Stokes** (1981) 123 CA3d 701]

*Editor's note — The right of first refusal is not triggered by conveyance of the property to the owner's heirs on his death. The heirs take title subject to the right of first refusal. However, the right of first refusal is triggered by a sale of the property ordered by the probate court or entered into by the heirs. To exercise the right of first refusal, the tenant must match the highest offer submitted in open bidding and approved by the court, or the listing or sale of the property by an executor. [**Estate of Patterson** (1980) 108 CA3d 197]*

Once the owner's decision to sell is manifested, the right of first refusal becomes an option to buy. Control of the transaction then passes to the tenant holding the right of first refusal, converting the tenant position under the right of first refusal to that of an optionee.

The owner may not now retract his decision to sell the property without breaching the right of first refusal provision.

Matching the back-up offer

The owner subject to a **right of first refusal** held by a tenant is obligated to notify the tenant of the terms of any sales listing, option to buy, offer to purchase, counteroffer or acceptance of an offer to purchase which triggers the tenant's right to buy under the right of first refusal provision.

The tenant must then agree to match the sales terms within the time period set in the right of first refusal provision or he has waived the right to buy for failure to *exercise* the right.

Consider a tenant who holds a right of first refusal on the industrial property he leases. A buyer makes an offer to purchase the property. The terms for the payment of the price in the buyer's offer include cash and an assumption of the existing first trust deed on the property.

The property is also encumbered with a nonrecourse second trust deed (carried back by a prior owner) to be paid off and reconveyed on closing under the terms of the buyer's offer. The owner accepts the offer and notifies the tenant, giving the tenant the opportunity to match the buyer's offer under the right of first refusal provision in the lease agreement.

The tenant exercises his right of first refusal by agreeing to purchase the property at the same price, but by assuming both the existing first trust deed and nonrecourse second, paying the remainder of the price in cash.

The owner rejects the tenant's conditions and refuses to sell to the tenant.

Here, the owner must comply with the tenant's terms for payment of the price since they are the financial equivalent of the proposed sale. The tenant need merely provide the **same net financial result** to the owner as the offer being matched — a cash-out of the owner's equity in the property. The tenant's performance under the right of first refusal does not need to be identical in all aspects to the buyer's offer.

Thus, the owner must sell on the tenant's exercise of his right of first refusal since the owner's net proceeds, economic benefits and liabilities resulting from the sale on terms set by the tenant would be the same as those he would experience under the purchase offer which triggered the right of first refusal. [**C. Robert Nattress & Associates** v. **CIDCO** (1986) 184 CA3d 55]

Now consider a buyer who offers to purchase property leased under a right of first refusal held by the tenant. The terms of purchase include a cash down payment and a note executed by the buyer for the balance of the owner's equity which is secured by a trust deed on other property which has adequate value as security. The owner accepts the offer and notifies the tenant, who agrees to match the buyer's offer.

However, the value of the property offered by the tenant as security is inadequate, causing the owner to refuse to accept it.

Here, due to the inadequate value of the security offered by the tenant for an identical note, the tenant's offer is not **financially equivalent** to the terms of the buyer's offer since the risk of loss on default has been increased. The landlord is not obligated to accept the tenant's deficient exercise of his preemptive right, which constitutes a waiver of the tenant's right to buy. The owner may now sell the property to the buyer — but only on the same terms. [**McCulloch** v. **M & C Beauty Colleges** (1987) 194 CA3d 1338]

STANDARD OPTION TO PURCHASE

Irrevocable Right-to-Buy

DATE:_____, 20_____, at_____, California.

Items left blank or unchecked are not applicable.

1. OPTION MONEY:

Optionor herewith receives from Optionee option money in the amount of $_____ evidenced by ☐ cash, ☐ check, or ☐ _____, given in consideration for this option to purchase real property.

2. REAL PROPERTY UNDER OPTION:

Address:_____

_____

Legal description/Assessor's parcel number: _____

_____

3. ADDITIONAL CONSIDERATION:

As further consideration for this option, Optionee is to obtain at his expense and deliver to Optionor prior to expiration of this option the following checked items regarding the property:

☐ Property survey report by licensed California surveyors.
☐ Architectural plans and specifications.
☐ Zoning ordinance request.
☐ On-site engineering plans.
☐ Application for a parcel map or waiver.
☐ Off-site improvement plans.
☐ Soil engineer's report.
☐ Land use study.
☐ Application for a conditional use permit.
☐ _____

4. OPTION PERIOD:

Optionor hereby grants to Optionee the irrevocable option to purchase the Optionor's rights, title and interest in the property on the terms stated, for a period commencing with the acceptance of this option and expiring _____, 20_____, or ☐ on termination of the optionee's leasehold interest in the property.

5. EXERCISE OF OPTION:

Optionee may exercise this option during the option period by:

5.1 Signing escrow instructions, identical in provisions to those attached as **Exhibit A**, and delivering the instructions to escrow [**ft** Form 401]; and

5.2 Depositing cash in escrow of $_____; and

5.3 Delivering an escrow certified copy of the signed escrow instructions to Optionor, within the option period, in person or by both certified and regular mail.

6. ESCROW CONTRACT:

In the event this option is exercised, the transaction shall be escrowed with:_____

_____

Escrow shall close within _____ days after exercise.

7. DELIVERY OF TITLE:

On Optionee's exercise of this option, Optionor shall timely place all documents and instruments into escrow required of the Optionor as necessary for escrow to close as scheduled.

8. BROKERAGE FEE:

Optionor agrees to pay a brokerage fee of $_____, or _____ percent of the selling price, IF:

8.1 This option is exercised;

8.2 Within one year after expiration of option period and any extension or renewal, Optionor enters into an agreement to option, sell, lease or exchange with Optionee, or their assigns; or

8.3 Optionor wrongfully prevents the exercise of this option,

8.4 Payable to Broker:_____

Address: _____

_____

Phone:_____ Fax: _____

9. SALE TERMS:

Price of $_____ payable as follows:

9.1 ☐ All cash.

9.2 Cash down payment in the amount of $_____.

9.3 ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by_____ with an unpaid principal balance of $_____, payable $_____ monthly, including interest not exceeding _____%, ☐ ARM, type _____, plus a monthly tax/insurance impound payment of $_____. _____

a. At closing, loan balance differences per beneficiary statement(s) to be adjusted into: ☐ cash, ☐ carryback note, or ☐ sales price.

b. The impound account to be transferred: ☐ charged, or ☐ without charge, to Optionee.

9.4 ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by _____ with an unpaid principal balance of $_____, payable $_____ monthly, including interest not exceeding _____%, ☐ ARM, type _____, due _____, 20_____.

9.5 A NOTE for the balance of the purchase price in the amount of $_____ to be executed by Optionee in favor of Optionor and secured by a trust deed on the property junior to the above referenced financing, payable $_____ monthly, or more, beginning one month after closing, including interest at _____% per annum from closing, due _____ years after closing.

a. This note and trust deed to contain provisions to be provided by Optionor for: ☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐_____

b. ☐ The attached Carryback Disclosure Statement is an addendum to this agreement (mandatory on four-or-less residential units). [**ft** Form 300]

c. ☐ Optionee to provide a Request for Notice of Delinquency to senior encumbrancers. [**ft** Form 412]

10. GENERAL PROVISIONS:

10.1 ☐ **See attached addendum for additional provisions.** [**ft** Form 250]

10.2 Attached as addenda are the following checked provisions mandated on four-or-less residential units:

a. ☐ Condition of Property (Transfer) Disclosure statement [**ft** Form 304]

b. ☐ Natural Hazard Disclosure Statement [**ft** Form 314]

c. ☐ Disclosure of sexual predator database [**ft** Form 250]

d. ☐ Hazard Disclosure Booklet, and related Optionor disclosures, containing Environmental Hazards, Lead-based Paint and Earthquake Safety. [**ft** Forms 313 and 315]

e. ☐ Documentation on any Homeowners' Association involved.

f. ☐ Notice of Supplemental Property Tax Bill [**ft** Form 317]

10.3 Possession of the property to be delivered on: ☐ close of escrow, or ☐ see attached Occupancy Agreement. [**ft** Forms 271 and 272]

10.4 Both parties reserve their rights to assign, and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow, on either party's written notice.

10.5 **Expiration of Option:**

This offer to sell shall be deemed expired if not accepted by exercise during the option period.

a. This option contract shall automatically terminate by expiration on _____, 20_____.

I hereby grant this option and agree to the terms stated above.	**I hereby accept this option and agree to the terms stated above.**
Date:_____, 20_____	Date:_____, 20_____
Optionor: _____	Optionee:_____
Signature: _____	Signature: _____
Signature: _____	Signature: _____
Address: _____	Address: _____
_____	_____
Phone:_____ Fax:_____	Phone:_____ Fax:_____
E-mail: _____	E-mail: _____

Reinstatement of the right of first refusal

A right of first refusal provision automatically carries with it the *reinstatement* of the right when:

- the owner agrees to sell the property on terms different from those terms offered to the tenant; or
- the property remains unsold after the running of an agreed-to period of time following the tenant's waiver of the right to buy. [See Form 579 §4]

Consider an owner who, under a right of first refusal, notifies his tenant of the purchase terms on which he has listed the property for sale. The tenant chooses not to exercise his option to buy at the price and on the terms offered.

The owner later modifies the listing by lowering the sales price or altering the terms for payment of the price.

The price reduction or modification of terms automatically **reinstates** the tenant's right of first refusal obligating the owner to notify of the new terms for purchase of the property. The tenant only waived his right of first refusal for a sale based on the terms originally given to him by the owner, not on the different price or set of terms.

Should a buyer purchase the property on terms other than those offered to the tenant, the buyer takes title subject to the tenant's preemptive right to purchase which is reinstated due to the sale on different terms. Thus, the buyer must sell to the tenant on the same price and terms he paid since the buyer is on notice of the tenant's rights to acquire the property due to the tenant's possession.

Chapter 7 Property management licensing

This chapter reviews the licensing requirements for property managers and resident managers, and their employees.

When is a DRE license required?

An individual owns and operates income-producing real estate. As the owner-operator, he locates and qualifies tenants, prepares and signs occupancy agreements, contracts for property maintenance, collects rent, serves any notices and initiates any unlawful detainer (UD) actions to evict tenants.

Does the owner-operator need a real estate broker's license to perform these activities?

No! The owner of income-producing real estate does not need a real estate broker license to operate **as a principal**. The owner-operator is not acting **on behalf of someone else** as an agent when he is managing his own property. [Calif. Business and Professions Code §10131(b)]

On the other hand, if the owner-operator decides to hire an individual to take over the general management of the apartment complex, the individual he employs to act as his property manager must be licensed as a California real estate broker.

A real estate broker license must be held by an individual or corporation that, with expectation of a fee, offers to or performs any of the following services *for another individual*:

- list real estate for rent or lease;
- market listed property and locate prospective tenants;
- list prospective tenants for the rental or lease of real estate;
- locate property to rent or lease;
- sell, buy or exchange existing leasehold interests in real estate;
- manage income-producing properties; or
- collect rents from tenants of real estate. [Bus & P C §10131(b)]

An individual employed by the broker to act as his agent to perform any of the **services requiring a license** must also be licensed by the Department of Real Estate (DRE), either as a broker or sales agent, with the exception of agents employed by a broker to handle **residential units**. [Bus & P C §10131.01(a)(3)]

For licensing purposes, the activities of an individual employed by a real estate broker to act as his agent in the rental and leasing of **residential complexes**, other than single units, are categorized as either:

- *licensed employee activities*, such as **landlord-related** solicitations, listings and rental or lease negotiations, care and maintenance of the property, marketing of the listed space and accounting; or
- *unlicensed employee activities*, such as **tenant-related** negotiations, such as showing properties, giving out leasing information and screening applications, and accepting rental or lease agreements, rent and deposits.

For **licensed employee activities** performed by an agent of the broker who solicits or has entered into a property management agreement or a leasing agent agreement, the agent must also be licensed as a broker or sales agent. Activities requiring licensing relate to contacts with the owner, not the tenant, and decisions about the leasing, care of the property and accounting.

Unlicensed employee activity

While under the supervision and control of a licensed broker, administrative and **non-discretionary duties** carried out by employees on behalf of the broker who is managing transient housing or apartment complexes are *exempt* from real estate licensing requirements. [Bus & P C §10131.01(a)]

Tenant negotiations that can be performed by unlicensed agents on behalf of a broker who has been retained to manage an apartment complex building, complex or court include:

- showing rental units and facilities to prospective tenants;
- providing prospective tenants with information about rental rates and rental and lease agreement provisions;
- providing prospective tenants with rental application forms and answering questions regarding their completion;
- accepting tenant screening fees;
- accepting signed lease and rental agreements from tenants; and
- accepting rents and security deposits. [Bus & P C §10131.01(a)(1)]

Power-of-attorney exemption

Also exempt from licensing is an individual who has been given authority to act as an "attorney in fact" under a power of attorney to **temporarily manage** an owner's property. [Bus & P C §10133(a)(2); see **first tuesday** Form 447]

However, a power of attorney cannot be used as authority to continuously manage real estate and cannot substitute for a broker's license.

Consider a landlord who can no longer handle the responsibilities of managing his property due to illness. The landlord grants a power of attorney to a friend to manage the property. The landlord pays his friend for performing property management tasks, including locating tenants, negotiating leases and collecting rent.

After the landlord's recovery from his illness, he continues to employ his friend to perform these management tasks.

Does the landlord's friend need a real estate broker's license to perform property management tasks on a regular, on-going basis in exchange for a fee, even though the landlord has given him a power of attorney?

Yes! The power-of-attorney exemption may only be used in situations where the landlord is compelled by necessity, such as a vacation or illness, to authorize another person to complete a specific or isolated transaction.

Any person receiving a fee for the continuous performance of property management tasks requiring a broker's license cannot rely on the power-of-attorney exemption to avoid licensing requirements. [**Sheetz** v. **Edmonds** (1988) 201 CA3d 1432]

Apartment resident managers

Apartment building management has special licensing rules distinguishing resident managers from nonresident property managers.

A resident manager is employed by either the landlord or the broker who is the property manager of the apartment building or complex. The resident manager lives on the premises as a requirement of his employment.

A resident manager and his employees do not need a real estate license to manage the apartment complex. [Bus & P C §10131.01(a)(1)]

However, a resident manager of one apartment complex is barred from being the property manager of a separate apartment complex unless he is licensed, even if both properties are owned by the same landlord. The resident manager would be a nonresident property manager of the other complex. Thus, he would need to be licensed. [Bus & P C §10131(b)]

Editor's note — Apartment complexes with 16 or more units must have a resident manager. [25 Calif. Code of Regulations §42]

Other licensing exceptions

A person is not required to have a real estate broker's license when he is acting:

- as an attorney performing management as part of his legal services [Bus & P C §10133(a)(3)]; or
- under court appointment, such as a receiver or bankruptcy trustee. [Bus & P C §10133(a)(4)]

These exceptions are usually short-term and refer to specific properties. A person whose business is advertised or held out as including property management for others must comply with the licensing laws.

Individuals managing property without a license and without qualifying for an exemption will not be able to enforce collection of the fee they were to receive. [Bus & P C §10137]

Contingent fees and bonus awards

If a landlord is a corporation, limited liability company (LLC) or partnership, any officer of the entity may manage the entity's property without a broker's license. However, the unlicensed officer may not receive any contingent fees or extra compensation based on achievement, production or occupancy factors during his management of the property. [Bus & P C §10133(a)(1)]

For example, a corporation owns a shopping mall managed by an officer of the corporation. The officer's duties include maintaining the premises, locating tenants and collecting rents.

As the manager, the corporate officer is paid an annual salary as a base pay. Whenever a vacancy occurs in the mall, the manager locates a new tenant and negotiates the lease for the corporation. For each new tenant, the manager receives an *incentive fee* over and above his corporate salary, a **bonus** for his successful efforts.

Here, the manager must be licensed as a broker even though he is an officer and employee of the corporation that is the owner of the property. His earnings include extra compensation based on his performance of real estate management activities requiring a license.

The manager's receipt of an incentive bonus payment for leasing space, called a *contingency fee*, establishes that the manager is acting as a broker, not merely as a salaried officer of the corporate owner. If the corporation holds a DRE corporate license, then the individual only needs to be a licensed salesperson employed in writing by the corporation as his broker. The exclusion of employees from licensing in residential rentals for tenant-related contacts does not apply to nonresidential leasing.

Similarly, where a LLC owns the property, the manager of the LLC does not need to be licensed to manage the property — provided fees are not paid based on the quantity of leases he negotiates or the LLC's rental income. [Bus & P C §10133(a)(1)]

If the LLC manager receives a percentage of gross rents as compensation, the compensation is considered a *contingent fee* unless all the members of the LLC receive the same percentage.

A property manager paid on a **contingent fee** basis, or any other employee or officer whose pay is structured as a contingency fee, of an office building, shopping center, industrial park, apartment building or other income property will need a broker's license if his duties include recruiting tenants, negotiating leases or collecting rents. However, employees of a broker dealing exclusively with prospective tenants for units in apartment complexes are not required to possess a license. [Bus & P C §10131(b)]

Bonus, award, commission, incentive or contingency fee programs in excess of a base salary require the person receiving them to be licensed by the DRE, whether they are resident managers, assistant resident managers or maintenance personnel. Examples of these programs include:

- a flat dollar fee for each month without a UD filing;
- a flat dollar fee for each new tenant;
- a monthly flat dollar fee for keeping operating expenses below projections;
- a percentage fee based on increases in rents; and
- a percentage of monthly gross rents if rents collected for the month exceed a percentage (for example, 97%) of scheduled income.

Chapter 8 Property management agreement

This chapter discusses the function of a property management agreement and the landlord's and property manager's rights and responsibilities under the agreement.

Authority to operate the rental property

A property manager's authority to take control of income-producing real estate and manage its leases, rents and expenses in expectation of a fee is established in a property management agreement. [See Form 590 accompanying this chapter]

A property management agreement sets out the specific rights, responsibilities and expectations of both the property manager and the landlord, including authorized activities, performance standards and expense limitations.

Landlord responsibilities include handing the property manager the information and files necessary in managing the property and its tenants, such as all rental or lease agreements, service and maintenance contracts and utilities. Information on hazard and worker's compensation insurance is also needed to cover the activities of the property manager and his employees.

The management agreement **authorizes** the property manager to locate tenants, enter into leases and rental agreements, collect rents, incur operating expenses and disburse funds to pay expenses, loan payments and management fees.

Further, the management agreement includes written authorization that is required for the property manager to enter into and sign leases and bind the landlord to leases for a term of over one year. [Calif. Civil Code §1624(a)(3)]

Short-form vs. long-form agreements

Brokers who manage property should enter into highly detailed property management agreements, not generalized "short-form" management agreements.

Short-form agreements neither specifically identify nor clarify the performance and expectations of both the property manager and the landlord. Instead, short-form agreements *imply industry customs* will be followed — whatever those customs might be or become.

These implied standards, while familiar to the broker, are often misunderstood or unknown to the landlord. Disputes usually result when landlords have high expectations and then receive less than they believe they bargained for when they employed the property manager.

Management obligations detailed in a long-form agreement, which spells out what conduct the landlord can expect from his broker, more fully protect a broker from claims he has breached his duties to the landlord. Surprises are eliminated and client expectations are more realistic.

Property managed "as is"

Some landlords want their property maintained at a below-standard level. A broker taking on the management must document the maintenance he recommends by using either an addendum to the manage-

ment agreement or estoppel letters sent from time to time stating the situation and his recommendations with a request for authority to act on the recommendations.

For example, a property manager should document a landlord's refusal to trim back overgrown and top-heavy landscaping needed to prevent damage from occurring to the structure or injury to the tenants.

Also, a property manager should note any advice given, explained and then rejected by the landlord regarding the installation or maintenance of security systems, lighting or other maintenance or installation work needed to eliminate dangerous conditions.

Handling rents and expenses

Property management agreements authorize the property manager to handle, on behalf of the landlord, all income received and expenses incurred in the operation of the property.

The property manager's responsibilities regarding the property's income and expenses include:

- collecting rents and other amounts due, such as common area maintenance charges (CAMs) and assessments for property insurance and real estate taxes;
- collecting, accounting for and refunding security deposits;
- paying expenses and loans owed by the landlord from rent paid by tenants; and
- complying with any local rent control ordinances.

A written management agreement spells out which operating expenses, insurance premiums, utilities, loan payments and taxes are to be paid by the property manager, and which are to be paid by the landlord.

Trust accounts

The receipt and accounting for cash reserves, security deposits, rent and other amounts received from tenants and coin-operated machines will be handled as *trust funds* owned by the landlord. **Trust funds** of this nature must be deposited into a trust account in the name of the property manager.

Accounting provisions in the management agreement:

- authorize the property manager to pay, out of the income and reserve funds held in the trust account, obligations incurred in the management and ownership of the property;
- specify the bank to be used; and
- call for remaining funds held on behalf of the landlord to be disbursed to him periodically and on termination of the property management agreement.

The management agreement sets the amount of cash reserves the landlord will deposit in the property manager's trust account as a minimum balance to cover operating expenses and fees.

Periodic accounting by the manager

A landlord is entitled to a *statement of accounting* at least once a quarter and when the property management agreement is terminated. [Calif. Business and Professions Code §10146]

The management agreement sets forth the time periods for when the property manager must deliver the **statement of accounting** to the landlord.

PROPERTY MANAGEMENT AGREEMENT

DATE:_____, 20_____, at _____, California.

Items left blank and unchecked are not applicable.

1. RETAINER PERIOD:

1.1 Owner hereby retains and grants Broker the exclusive right to lease, rent, operate and maintain the property as property manager, commencing _____, 20_____, and continuing for one year and thereafter until terminated.

2. RECEIPT OF SECURITY DEPOSITS:

2.1 Owner hands $_____ to Broker for deposit into the trust account towards Owner's security deposit obligation to tenants.

3. RECEIPT OF CASH RESERVE:

3.1 Owner hands $_____ to Broker as a deposit towards Owner's obligation under the agreement.

3.2 Owner to maintain a minimum cash reserve, in addition to any security deposits, in the amount of $_____. On request from Broker, Owner will advance additional funds to maintain this minimum balance.

3.3 The cash reserve may be used to pay costs diligently incurred by Broker or due Broker in fulfilling Broker's obligations.

4. BROKERAGE FEE:

NOTICE: The amount or rate of real estate fees is not fixed by law. They are set by each broker individually and are negotiable between Owner and Broker.

4.1 Broker compensation to be:

a. _____% of all rents collected and deposited by Broker during the month, except for any first month's rent for which a broker fee is paid under §4.1 b as follows;

b. _____% of the first month's rent collected and deposited under ☐ rental agreements, and ☐ leases;

c. All sums remaining from credit check fees in excess of credit report expenses; and

d. ☐ Late payment charges and returned check charges paid by a tenant.

5. TRUST ACCOUNT:

5.1 Broker will place Owner's deposit for costs and security deposits into

☐ Broker's trust account, or ☐ separate trust account for Owner, maintained with _____ at their _____branch.

a. This account shall be ☐ non-interest bearing, or ☐ interest bearing.

5.2 All funds received by Broker for the account of Owner will be placed in the trust account.

5.3 Amounts to pay and satisfy the obligations incurred by Broker may be disbursed from the account after payment is due.

5.4 On termination of this agreement, Broker will return to Owner all remaining trust funds belonging to Owner.

6. PERIODIC ACCOUNTING:

6.1 Within ten days after each calendar ☐ month, or ☐ quarter, and on termination of this agreement, Broker will deliver to Owner a Statement of Account for all receipts and expenditures, together with a check to Owner for any funds in excess of minimum reserves under §3.2.

6.2 Amounts to compensate Broker under §4 may be withdrawn from the trust account.

6.3 Each Statement of Account delivered by Broker shall include no less than the following information for the period:

a. Amount of security deposits received or refunded.

b. Amount of rent or receipts, itemized by unit.

c. An itemized description of disbursements.

d. End of month balance of the income, expense and security deposit trust accounts.

6.4 ☐ Broker to reserve and disburse from the trust account any property and employee taxes, special assessments, insurance premiums, loan payments and other payments required to be made by the owner.

6.5 Advertising costs incurred to locate new tenants to be: ☐ paid by Owner, or ☐ paid by Broker.

7. TITLE CONDITION AND LOANS:

7.1 The property is referred to as: _____

_____

_____

_____

7.2 Owner's interest in the property is:

☐ Fee simple, ☐ Other_____.

7.3 Loan payments are to be timely disbursed by Broker to:

a. Lender:_____

Address:_____

_____

_____

Phone: _____

Payment of $_____, due on the _____ day and delinquent on the _____ day of each month.

b. Lender:_____

Address:_____

_____

_____

Phone: _____

Payment of $_____, due on the _____ day and delinquent on the _____ day of each month.

8. BROKER AGREES TO:

8.1 Use diligence in the performance of this employment.

8.2 Continuously maintain a California real estate broker's license.

8.3 Collect all rents, security deposits or other charges and expenses due Owner, and timely refund tenants' security deposits, less allowable deductions and including any interest due tenants.

8.4 Prepare and place advertisements for prospective tenants.

8.5 Show property to prospective tenants, obtain credit reports and confirm creditworthiness of tenants before executing leases or rental agreements.

8.6 Execute, renegotiate or cancel rental agreements or leases with tenants.
No lease to exceed _____ months.

8.7 Serve rent collection and other notices, file unlawful detainer and money damage actions, recover possession of premises or settle with delinquent tenants.

8.8 Inspect the property monthly and each unit when tenants vacate.

8.9 Maintain and periodically confirm the inventory of personal property on premises.

8.10 Evaluate leases and rental agreements periodically for income, expense and provision updates.

8.11 Contract for utilities, services and equipment to operate and maintain the property and safeguard the tenants.

8.12 Contract for any repairs, maintenance or improvements needed to lease or rent the property. Owner to approve all repairs in excess of $_____.

8.13 Obligate Owner to no unauthorized agreement or liability.

8.14 Protect and enhance the goodwill of Owner's rental business and keep confidential and secure any knowledge of Owner's business activities acquired during this employment.

8.15 Hire, supervise and discharge: ☐ a resident manager, and ☐ an assistant resident manager.

8.16 Inspect and take any action necessary to comply with federal, state, county or municipal safety and building codes affecting the property.

8.17 Notify Owner of any potential hazards to the tenants or property, and Owner to respond within seven (7) days. Should an emergency situation arise placing the tenants or property in jeopardy, Broker may immediately remedy the situation without further authority from Owner.

9. OWNER AGREES TO:

9.1 Hand Broker all keys and entry codes to the property, and copies of leases and rental agreements with existing tenants.

9.2 Hand Broker (if Broker is to disburse) loan payment coupons/envelopes, property tax bills, insurance premium billings and _____.

9.3 Indemnify Broker for the expense of any legal action arising out of Broker's proper performance of this agreement.

9.4 Provide public liability, property damage and worker's compensation insurance sufficient in amount to protect Broker and Owner, naming Broker as an additional insured.

Owner's insurance agent is: _____

_____

9.5 _____

_____

10. TERMINATION:

10.1 This agreement shall continue until terminated by mutual written agreement or until either party, for legally justifiable cause, serves a written Notice of Termination.

10.2 Owner may terminate this agreement at any time during the initial one-year term by paying Broker a fee equal to three times Broker's management fee earned during the month preceding termination.

10.3 On termination, Owner will assume the obligation of any contract entered into by Broker under this agreement.

11. GENERAL PROVISIONS:

11.1 Broker is authorized to place a for rent/lease sign on the property and publish and disseminate property information.

11.2 Owner authorizes Broker to cooperate with other brokers and divide with them any compensation due.

11.3 The authorized agent-for-service is ☐ Broker, ☐ Owner, ☐ _____

11.4 If an action is instituted to enforce this agreement, the prevailing party shall receive reasonable attorney fees.

11.5 ☐ **See attached addendum(s) for additional terms.**

11.6 _____

_____

Broker: **I agree to render services on the terms stated above.**	**Owner:** **I agree to employ Broker on the terms stated above.**
Date:_____, 20_____	Date:_____, 20_____
Broker: _____	Owner:_____
By:_____	Signature: _____
Address: _____	Address: _____
_____	_____
Phone:_____	Phone:_____
Fax:_____	Fax:_____
E-mail:_____	E-mail:_____

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The accounting provision indicates the property manager will disburse to the landlord, with each accounting, any funds exceeding the minimum balance to be held for reserves.

The property manager's authority to withdraw his management fee from the trust account is included.

Brokerage fee enforcement

Property managers cannot enforce collection of their management fees without a written agreement.

When the landlord and property manager orally agree to the payment of management fees, the property manager is unable to enforce collection of his fees for services rendered if the landlord fails to pay. [**Phillippe** v. **Shapell Industries Inc.** (1987) 43 C3d 1247]

Thus, the property management agreement sets forth the fees due the property manager.

An accounting is provided at the end of the employment period, usually each month, since trust account balances for each client must be reconciled by the broker at least once a month. [Department of Real Estate Regulations §2831.2]

A property manager who fails to give the landlord a timely and accurate accounting faces loss of his real estate broker's license. [**Apollo Estates Inc.** v. **Department of Real Estate** (1985) 174 CA3d 625]

The property manager must also keep all documents, such as his management and accounting files, for each activity connected with any transaction requiring a real estate broker's license for three years. [B & P C §10148]

Management of CIDs

Brokers may be retained by condominium homeowners' associations (HOAs) or other common interest developments (CIDs) to manage membership, exercise control over the common areas and structures and account for assessment revenues, expenses and reserves. Brokers seeking such employment are called *prospective managing agents*.

Before a broker acting as a prospective managing agent enters into a management agreement with a CID, the broker must disclose:

- the names and addresses of the owners of the brokerage company if it is an entity;
- the relevant licensing of the owners, such as for architectural design, construction, engineering, real estate or accounting, and the effective dates of the licensees; and
- the relevant professional designations held by the owners, what organizations issued the designation, the issuance dates and any expiration dates. [CC §1363.1]

The benchmark professional certification is called the Certified Community Association Manager and is issued by the California Association of Community Managers.

Funds received by the managing agent belong to the HOA. If the HOA does not have a bank account, the manager will maintain a separate trust fund account as trustee for the HOA. Extensive statutory controls are placed on the handling of the trust fund account held for CIDs. [CC §1363.2]

Chapter 9 Property manager's responsibilities

This chapter examines a property manager's responsibilities in his management of income property on behalf of an owner.

An evolving standard of conduct

Property management is an economically viable and personally rewarding real estate service an individual can provide to others. Serious brokers and agents often turn their interests from residential sales to the specialized industry of property management.

A broker's primary objective as a property manager is to oversee the maintenance of rental property, rent to suitable tenants, collect rent and account to the owner. Thus, a property manager must have time to actively oversee all rental properties entrusted to his management.

To conduct business in California as a property manager acting on behalf of others for a fee, an individual must hold a valid California real estate broker's license. [Calif. Business and Professions Code §§10130, 10131(b)]

The duty of care a property manager owes an owner is the same duty of care a broker in real estate sales owes his sellers and buyers. As a property manager, the broker is an agent acting as a trustee on behalf of the owner. Sales agents acting on behalf of the broker perform property management services as authorized by the broker.

A property manager's real estate license may be revoked or suspended if he demonstrates negligence or incompetence in performing his management tasks, including the supervision of his employees, such as his agents. [Bus & P C §§10177(g), 10177(h)]

Requisite competence to manage

To be successful in the property management field, a broker must first acquire the minimum knowledge and experience required to successfully perform his tasks. His level of competence must be equivalent to or exceed the competence an owner could expect of a broker who holds himself out as a property manager in the community where the property is located.

A broker acquires a property manager's expertise through:

- courses required to qualify for and maintain a real estate license [Bus & P C §§10153.2, 10170.5];
- on-the-job training as an agent;
- experience as a landlord;
- practical experience in the business management field; or
- exposure to related or similar management activities.

Owners should view the aptitude of a broker's management skills as the measure of how capable, and thus successful, a broker will be at handling their properties. Most owners look to hire an experienced property manager with well-earned credentials who will hopefully perform to the owner's expectations.

Indicators an owner might best rely on to determine whether a property manager can successfully handle rental property include:

- prior experience handling and reporting trust account activities;
- an adequate computer system to record and track activity on each property to be managed by the property manager; and
- a competent staff to perform office and field duties and to quickly respond to both the landlord's and the tenants' needs.

Management obligations

A property manager's obligations to a landlord include:

- holding a broker's license;
- diligently performing his employment;
- handling and accounting for all income and expenses produced by the property;
- contracting for services, repairs and maintenance on the property;
- monitoring utility services provided by the landlord;
- advertising for prospective tenants;
- showing the property and qualifying tenants;
- negotiating and executing rental and lease agreements;
- responding in a timely manner to the needs of the tenants;
- evaluating rental and lease agreements periodically;
- serving notices on tenants and filing unlawful detainer (UD) actions as needed;
- performing regular periodic property inspections; and
- keeping secure any personal property.

In addition to these tasks, the property manager must also:

- confirm or obtain general liability and workers' compensation insurance sufficient to protect the landlord, naming himself as an additionally insured;
- obligate the landlord to only authorized agreements;
- maintain the property's earning power, called *goodwill*;
- hire and fire resident managers and other on-site employees as needed;
- comply with all applicable codes affecting the property; and
- notify the landlord of any potentially hazardous conditions or criminal activities affecting the health and safety of individuals on or about the property.

The "prudent investor" standard

A property manager must employ a higher standard of conduct regarding the operation of a property than a typical resident owner or investor might apply. This standard is called the *prudent investor standard*.

A **prudent investor** is a person who has the knowledge and expertise to determine the wisest conduct for reasonably managing his property. The *prudent investor standard of conduct* is the minimum level of competency which can be expected of a property manager by a landlord, whether or not the landlord would apply the standard or even know about it.

The standards exemplified by resident owners may not necessarily be based on obtaining the maximum rental income and incurring only those minimal expenses needed to maintain the income flow from rents.

A resident owner is more apt to maintain the property in a condition which satisfies himself, not necessarily sound economic principles. Also, resident owners are not often concerned about the effect of the marketplace on their property's value until it is time to sell or refinance.

Likewise, the resident owner may not have the knowledge or expertise to effectively manage the property himself. Most owners of rental income property pursue unrelated occupations which leave them very little time to concentrate on the management of their properties.

However, the property manager is employed to manage the property as his primary occupation. A landlord's primary business reason for hiring a property manager is to have the property manager maintain the condition of his investment and income.

Thus, decisions regarding the property should be made by the property manager based on the need to generate a reasonable income from the property and incur expenses necessary to preserve the habitability of the property, provide a safe and secure environment for persons on the property and maintain the property's condition so it will support the income.

Property analysis

To conduct property operations in compliance with the **prudent investor standard of care**, a property manager should consider the following factors at the outset of employment:

- the type of the property and its niche in the market;
- the socioeconomic mix in the area surrounding the property's location;
- the competition currently existing in the local market;
- the current physical condition of the property; and
- the existing financing on the property, called *capitalization*.

The competition in the marketplace includes the manager's ability to locate ready, willing and able tenants to rent at rates sought by the manager.

For example, if there are more tenants seeking space than units available to rent, the property manager can increase the rent and still maintain occupancy levels, excluding residential units covered by rent control ordinances.

Conversely, if the number of rental units or spaces available exceeds the quantity of tenants available in the area to occupy them, a property manager may have to initiate programs to better retain tenants and attract new ones to keep his units at optimum levels of occupancy.

The current physical condition of the property — known as *curb appeal* — reflects the attitude of the ownership towards tenants. A property manager must analyze the repairs, maintenance, landscaping and improvements presently needed so the property's visual appearance and ambiance has a positive impact on tenants.

A prospective tenant's immediate concern when viewing rental property will be the lure of the landscaping, the freshness of interior and exterior paint and the overall care and tidiness of the premises. More importantly, existing tenants stay or leave based on these observances.

Liens affect nonresidential tenants

Along with the condition of the property, a property manager on nonresidential property must take a close look at the landlord's trust deed liens on the property. Both the property manager and the tenants are ultimately affected by the burden existing financing places on the landlord's cash flow.

A property manager cannot perform economic miracles for a landlord when payments on the financing encumbering the property interfere with the property's capacity to generate a positive cash flow or, worse yet, to maintain the premises or pay management fees.

Further, a prudent property manager, aware of the existing financing on the property, will apprise the landlord when the opportunity arises to refinance the property with more advantageously structured loans. The property manager can charge an additional fee for soliciting or arranging such financing.

As for a tenant, his right to possession of the property is usually junior and subject to the existing lender's right to foreclose on any default by the owner on the lender's trust deed. A nonresidential tenant's move-in costs and tenant improvements are at risk of loss if the pre-existing lender forecloses.

Title profile analysis

It is in the property manager's best interest to do a cursory title check on the property he intends to manage.

A title check, commonly called a *property profile* is obtained from a title company and will confirm:

- how ownership is vested and who has authority to retain management;
- all outstanding liens and encumbrances on the property; and
- any use restrictions affecting tenants.

Any discrepancy in information provided by the landlord and a property profile report should be cleared up with the owner prior to taking over management of the property.

Due diligence and the paper trial

A property manager's efforts to locate tenants should be documented on a **file activity sheet** maintained for each property. The paper trail a property manager leaves shows he has diligently pursued activities leading to the renting of the property. Thus, the property manager reduces the risk that claims will be made that he failed to diligently seek tenants for the property.

For example, any advertisements placed by the property manager should focus on and clearly identify the property to be rented. Since the advertisement identifies the property, the owner can be properly billed for the expense of the advertisement. Whenever an advertisement is placed, a purchase order should be prepared, whether or not it is given to the publisher or printer.

As in any business, a purchase order will contain the dates the advertisement is to run, the advertising copy, which vendor (newspaper or printer) it was placed with and the property to be charged. When the billing is received referencing the purchase order, the property manager has it as a written reminder of his activity and which owner to charge. Computer programs for bookkeeping provide for the entry, control and printout of this data.

The goal in property management is to make a diligent effort to locate a tenant and rent the property as quickly as possible.

Therefore, marketing nonresidential property by remaining in the office or failing to set or keep appointments to meet with prospective tenants is inexcusable negligence. As prospective tenants respond to an advertisement, the property manager must make himself available to show them the property, unless the property has a resident or on-site manager.

When the property manager cannot timely perform or complete the management tasks undertaken, he needs to delegate some of his work load to employees or resident managers, keeping in mind he must maintain constant oversight as their supervisor and employer.

Handling UD actions

A property manager may file a small claims action on behalf of the owner to recover amounts due and unpaid under a lease or rental agreement, such as rent or late charges, if:

- the owner has not retained the property manager under a property management agreement solely to represent the owner in small claims court; and
- the claim relates to the rental property. [Calif. Code of Civil Procedure §116.540(h)]

A property manager may also file small claims actions on behalf of a homeowners' association (HOA) created to manage a common interest development (CID). [CCP §116.540(i)]

However, in order for the property manager to represent the owner in a small claims action, the court requires property managers to file a declaration stating the property manager:

- is authorized by the owner to appear on his behalf under a property management agreement; and
- is not employed solely to represent the owner in small claims court. [CCP §116.540(j)]

Consider a licensed real estate broker who operates his property management business as a sole proprietorship, not as a corporation.

The broker manages an apartment complex for an owner under a property management agreement.

The management agreement gives the broker all care and management responsibilities for the complex, including the authority to:

- enter into leases and rental agreements as the landlord;
- file UD actions; and
- hire an attorney to handle evictions, if necessary.

The broker signs all lease and rental agreements in his own name **as the lessor** since his management contract gives him this authority. The owner's name does not appear on any lease or rental agreement.

A tenant of the complex fails to pay his rent under a rental agreement entered into with the broker. A 3-day notice to pay rent or quit the premise is served on the tenant by the broker. [See **first tuesday** Form 575]

The tenant does not pay the delinquent rent within three days and remains on the premises. The broker files a UD action to recover possession by an eviction of the tenant, **naming himself** as the plaintiff on the UD complaint.

The tenant defends against the eviction by claiming the broker cannot maintain a UD action to evict him since the broker is not the owner of the real estate or the owner's attorney.

Can the broker file and maintain a UD action against the tenant in his own name?

Yes! The broker may file the UD action even though he is not the owner. The broker entered into the lease agreement and delivered possession as the lessor, and is now recovering possession from the tenant in his own name. [**Allen** v. **Dailey** (1928) 92 CA 308]

As the lessor under the lease, the property manager has the **greater right to possession** of the premises than the tenant, even though the owner is known to be the true landlord, a situation legally entitled *jus tertii*.

Thus, as the lessor named on the lease, the property manager can maintain the UD action against the tenant and recover possession of the premises.

Property inspections by the manager

A property manager's frequent, well-documented inspections of property he manages are nearly as important as his accurate accounting of income and expenses through his trust account. Inspections determine the physical condition of the property, availability of habitable units or commercial spaces and the use of the leased premises by existing tenants.

Several key moments when a property manager should make an inspection include:

1. *When the property manager and landlord enter into a property management agreement.*

Any deferred maintenance or defects which would interfere with the renting of the property should be discussed with the landlord. Resolve the discrepancy by either correcting the problem or noting it is to be left "as is," except for conditions which would endanger the health and safety of tenants and their guests.

2. *When the property manager rents to a tenant.*

A walk-through should be conducted with a new tenant prior to giving them occupancy. The property's condition should be noted on a condition of premises addendum form and signed by the tenant. [See **first tuesday** Form 560]

3. *During the term of the lease.*

While the tenant is in possession, the property should be periodically inspected by the property manager to make sure it is being properly maintained. Notes on the date, time and observations are made in the property management file. File notes are used to refresh the property manager's memory of his last inspection, order out maintenance and evidence his diligence.

4. *Two weeks prior to the tenant vacating.*

Residential property must be inspected prior to termination of possession if the tenant requests a joint pre-termination inspection after receiving the mandatory landlord's notice of right to a wear and tear analysis. [See Chapter 22]

5. *When the tenant vacates.*

The property's condition should be compared against its condition when first occupied by the tenant. Based on differences in the property's condition as documented by the property manager, the reasonable amount of deductions from the tenant's security deposit for corrective repairs can be documented when accounting for the return of the deposit.

6. *When the broker returns management of the property back to the landlord or over to another management firm.*

   Documenting all property inspections helps avoid disputes with the landlord or tenants regarding just what was the condition of the property when possession or management was transferred to and from the property manager.

The property's condition should be noted on a form, such as a condition of property disclosure and be approved by the property manager and the landlord. Also, the property manager should keep a copy in the property's file as part of the paper trail maintained on the property. [See **first tuesday** Form 304]

Inspections at the time of key events help to establish who is responsible for any deferred maintenance and upkeep, or for any damage to the property.

Periodic review of the leases

On entering into a **management agreement**, a broker and landlord should conduct a comprehensive review of all rental and lease agreement forms used by the landlord, including proposed changes and the use of other forms.

Also, the property manager must be aware of the dates of all lease expirations, rent adjustments, tenant sales reports, renewal or extension deadlines, and grace periods for rent payments and late charges. Computer programs have made this tracking easier.

Periodic evaluations by the property manager of his existing rental and lease agreements is important. Vacant units should be evaluated to determine the type of tenant and tenancy desired (periodic versus fixed-term), how rents will be established and which units consistently underperform.

The amount of rental income receipts is directly related to the property manager's evaluation of the rents charged and implementation of any changes. A **re-evaluation** of rents includes the consideration of factors which influence the amount to charge for rent, including:

- market changes, such as a decrease or increase in tenants competing for a greater or lesser availability of units;
- the physical condition and appearance of the property; and
- the property's location, such as its proximity to employment, shopping, transportation, schools, financial centers, etc.

A property manager must keep abreast of the market changes which might affect the property's rental rates in the future, then make the necessary changes when negotiating leases and rental agreements. The more curious and perceptive the property manager is about future trends, the more protection his landlord's investment will likely receive against loss.

Maintenance and repairs

Obtaining the highest rents available requires constant **maintenance and repair** of the property. The property manager is responsible for all the maintenance and repairs on the property while he is managing it, whether he retains or delegates responsibility to tenants in lease agreements.

Thus, the property manager's knowledge of the property's condition prior to entering into a management agreement is a must in order to properly ascertain what maintenance and repairs need to be made or will be deferred.

The responsibility for maintenance includes:

- determining necessary repairs and replacements;
- contracting for repairs and replacements;
- confirming completion of repairs and replacements;
- paying for completed repairs and replacements; and
- advising the landlord about the status of repairs and replacements in the monthly report.

Different types of property require greater or lesser degrees of maintenance and upkeep.

A commercial or industrial tenant who occupies the entire (nonresidential) property may agree in their lease to perform all maintenance and upkeep of the property. The broker, as the property manager, then has a greatly reduced role in the care and maintenance of the property — that of oversight to confirm the tenant is caring for the property and otherwise fully performing the terms of the lease agreement.

On the other hand, if the property manager is responsible to an owners' association (HOA), he will exercise a high degree of control over the maintenance and upkeep of the property and the security of the occupants.

Usually, landlords set a ceiling on the dollar amount of repairs and maintenance the property manager has authority to incur on behalf of the landlord. The property manager should not exceed this dollar ceiling without the landlord's consent even though the landlord receives a benefit from the expenditure.

Profits from all sources disclosed

If maintenance or repair work is done by the property manager's staff or he stands to additionally benefit financially by the materials purchased or services performed, the property manager must disclose his financial involvement to the landlord.

Thus, the property manager should prepare a **repair and maintenance disclosure addendum** and attach it to the management agreement to cover information such as:

- types of repairs and maintenance his staff will perform;
- hourly charges for jobs performed;
- costs of workers' compensation and method for charging the landlord;
- any service or handling charges for purchasing parts, materials or supplies (usually a percentage of the cost);
- whether the staff will perform work when they are available and qualified, in lieu of contracting the work out (i.e., no bids will be taken); and
- to what extent repairs and maintenance will generate net revenue for the management company so as to constitute additional income to the property manager.

Due to the risk of accepting *undisclosed profits*, the property manager must give written disclosure of any ownership interests or fee arrangements he may have with vendors performing work, such as landscapers, plumbers, etc. Any undisclosed profit received for work performed by the property manager or others on the landlord's property is improperly received and must be returned to the landlord.

Additionally, the landlord can recover any other brokerage fees he has already paid when the property manager improperly or intentionally takes an undisclosed profit while acting as his agent. [**Terry** v. **Bender** (1956) 143 CA2d 198]

Goodwill as value

A property and how it is operated develops a reputation among tenants, called *goodwill*. Economically, goodwill equates to the earning power of the property. A property manager in the ordinary course of managing property will concentrate on increasing the intangible image — goodwill — of the property.

Goodwill is maintained, and hopefully increased, when the property manager cares for the appearance of the property, maintains an appropriate tenant mix (without employing prohibited discriminatory selection) and gives effective and timely attention to the tenants' concerns.

A prudent property manager makes recommendations to the landlord about maintaining the property to eliminate any accumulated wear and tear, deterioration or obsolescence. Thus, he helps enhance the property's "curb appeal."

The manager who fails to promptly complete necessary repairs or correctly maintain the property may be impairing the property's goodwill built up with tenants and the public. Allowing the property or the tenancies to deteriorate will expose the property manager to liability for the decline in revenue.

Reserves for the trust account

To accommodate the flow of income and expenditures from the properties he manages, the property manager maintains a trust account in his name, as trustees, at a bank or financial institution. [10 Calif. Code of Regulations §2830]

Generally, a property manager receives a cash deposit from the owner, which includes a "start-up" fee, a cash reserve for costs and the tenants' security deposits.

A **start-up fee** is usually a flat, one-time management fee charged by the property manager. The **cash reserves** are used to pay the operating expenses preliminarily incurred on the property.

The **cash reserve** is a set amount of cash the owner agrees to maintain as a minimum balance in the broker's trust account. The cash reserve will be used to pay costs incurred should costs and loan payments exceed income. Security deposits are in addition to the client's cash reserves.

The property manager should insist all **security deposits** previously collected from existing tenants are handed over to him for his control and management through his trust account. Eventually, due to legislation, interest must be paid on some security deposits, comparable to interest paid by lenders on escrow accounts for impound advances by property owners.

The security deposit should, but does not need to be accounted for separately from other funds in the trust account. Security deposits belong to the tenant and must be used or returned to a residential tenant with an accounting within 21 days after the tenant's departure, or 30 days for nonresidential occupancies. [Calif. Civil Code §1950.5(g)(1); 1950.7(c)(1)]

On receipt of security deposits, rents, cash reserves, start-up fees, etc., the property manager is required to deposit these funds into a trust account within three business days. [Bus & P C §10145(a); Department of Real Estate Regulations §2832]

Separate ledger for each landlord

All accounts must be maintained in accordance with standard accounting procedures. These standards are best met by using computer software designed for property management. [DRE Reg. §2831]

Also, withdrawals from the trust fund account cannot be made by the landlord, only by the property manager.

However, the property manager can give written consent to make withdrawals from the trust account to a licensed agent under his employ or to an unlicensed employee who is bonded. [DRE Reg. §2834(a)]

No matter who the property manager authorizes to make the withdrawal, he alone is responsible for the accurate daily maintenance of the trust account. [DRE Reg. §2834(c)]

The property manager's bookkeeping records for **each trust account** maintained at a bank or thrift must include entries of:

- the amount, date of receipt and source of all trust funds deposited;
- the date the trust funds were deposited in his trust account;
- the date and check number for disbursements of trust funds previously deposited in the trust account; and
- the daily balance of the trust account. [DRE Reg. §2831(a)]

Entries in the **general ledger** for the overall trust account must be in chronological order and in a column format. Also, the ledgers may be maintained in a written journal or one generated by a computer software program. [DRE Reg. §2831(c)]

In addition to the general ledger of the entire trust account, the property manager must maintain a separate **subaccount ledger** for each owner he represents, to account for all trust funds deposited to or disbursed from his trust account for their accounts.

Each separate, individual subaccount ledger must identify the parties to each entry and include:

- the date and amount of trust funds **deposited**;
- the date, check number and amount of each related **disbursement** from the trust account;
- the date and amount of any **interest earned** on funds in the trust fund account; and
- the total amount of trust **funds remaining** after each deposit or disbursement from the trust account. [DRE Reg. §2831.1]

Like the general ledger for the entire trust account, entries in each client's subaccount record must also be in chronological order on a written, columnized journal/ledger or one generated by a computer software program. [DRE Reg. §2831.1(b)]

Manager's trust account supervision

Any behavior on the part of the property manager or his employees to delay the proper maintenance of the trust account places the property manager's broker license at risk of loss or suspension for violation of his duty to the landlord to maintain the trust account.

To avoid activities that may jeopardize the status of the property manager's license due to his handling of the trust account, the property manager must:

- deposit the funds received, whether in cash, check or other form of payment, within three business days [DRE Reg. §2832];
- keep trust fund account records for three years after the transaction [Bus & P C §10148];
- keep a separate ledger or record of deposits and expenditures itemized by each transaction and for each landlord [DRE Reg. §2831.1]; and

- keep accurate trust account records for all receipts and disbursements. [DRE Reg. §2831]

Handling of trust account funds

When a property manager places funds into his trust account, he must then **diligently manage** the account to avoid claims of mishandling, misappropriation or commingling of the landlord's funds with his personal funds.

Consider a landlord who hires a broker to act as his property manager. In addition to paying for expenses and costs incurred, the property manager is instructed and authorized to pay the monthly mortgage payments.

The property manager locates a tenant and collects the initial rent and security deposit.

After depositing the funds in his bank trust account, but prior to disbursing the loan payment, the property manager withdraws both his leasing fee for locating the tenant and his monthly property manager's fee. Both fees are due the property manager for work completed under his property management contract.

However, the withdrawal of the property manager's fees leaves insufficient funds in the trust account that are needed to make the loan payment. The property manager then issues a check on funds held in one of his personal accounts to make the landlord's mortgage payment. However, this account also has insufficient funds.

Meanwhile, the lender sends the landlord a late payment notice for the delinquency. The landlord immediately contacts the property manager regarding the delinquent payment. The property manager says he will cover it and does so.

Three months later, the landlord informs the broker he no longer wants him to manage the property. The property management agreement is terminated by the landlord.

The property manager sends a closing statement on the account containing some erroneous deductions.

Prior to the closing statement, the landlord received no other accounting since retaining the broker.

More than three months passed between collecting funds and sending an accounting. After discussion with the landlord, the property manager corrects the errors, issues the landlord a check for the remaining balance, closes the account and destroys (deletes) the landlord's file.

Later, the landlord files a complaint with the Department of Real Estate (DRE) regarding the property manager.

The DRE contends the property manager breached his agency duties. The property manager issued a check for a loan payment from an account other than the trust account, an activity that automatically constitutes *commingling* of the property manager's personal funds with trust funds. Also, the property manager knew he had insufficient funds when he issued the check, a dishonest act.

In addition, the property manager failed to accurately, and no less than quarterly, account for funds taken in or expended by him on behalf of the landlord.

Finally, the property manager destroyed the records prior to the three-year limitation. Thus, it is proper for the DRE to revoke the property manager's real estate broker license. [**Apollo Estates Inc.** v. **Department of Real Estate** (1985) 174 CA3d 625]

Accounting to the landlord

Tied to the property manager's duty to properly maintain his trust account is the duty to account to the landlord.

All landlords are entitled to a *statement of accounting* no less than at the end of each calendar quarter (i.e., March, June, September and December).

The **accounting** is to include the following information:

- the name of the property manager;
- the name of the landlord;
- a description of the services rendered;
- the identification of the trust fund account credited;
- the amount of funds collected to date;
- the amount disbursed to date;
- the amount, if any, of fees paid to field agents or leasing agents;
- the overhead costs; and
- a breakdown of the advertising costs, a copy of the advertisement, the name of the newspaper or publication and the dates the advertisement ran.

Also, the property manager must give a full accounting when the management agreement expires or is terminated. Any discrepancy or failure by the property manager to properly account for the trust funds will be resolved against him and in favor of the landlord. Even if the property manager's only breach is sloppy or inaccurate accounting, he is responsible as though **misappropriation** and **commingling** occurred.

Although the property manager is only required to account each calendar quarter, a monthly accounting should be undertaken. He may then rightly collect his fee at the end of each month after he has fully performed and his fee is due. In this way, the property manager can avoid the receipt of advance fees for which the use of a DRE-approved form is required. [Bus & P C §10146]

Management fees

Property managers structure management fee schedules in several different ways:

1. *A percentage of the rents collected.*

The property manager is entitled to charge a set percentage of the rents collected as a fee (customarily between 5% to 10%), usually payable monthly. The percentage fee is not paid on security deposits since deposits are not rents. A percentage fee is a proper method for establishing the amount of fees.

2. *Fixed fee.*

The property manager and landlord agree in advance to a set dollar amount to be charged monthly for the management services. The amount stays constant whether or not the units are rented. This method, while proper, lacks the motivational incentive to induce the property manager to generate maximum rental income.

3. *Fixed fee per unit.*

Usually applied to large apartment complexes or condominium associations, a set dollar amount is charged for each unit in the complex managed by the property manager. In addition to the basic fee, property managers often charge a one-time fee each time a unit is re-rented.

4. *A percentage of the first month's rent.*

A front-end fee paid to the property manager is called a leasing or origination fee. If the landlord agrees, a fee can be charged for exercise of an option to renew or extend, or when a new lease is entered into with an existing tenant.

Fees are to be negotiated and set between each individual property manager and landlord. [Bus & P C §10147.5]

However, no matter how customary and prevalent it is in the real estate industry to charge a particular percentage fee, fees may not be set by agreement **between brokers** or as a result of *conscious parallelism* and peer pressure among brokers to maintain equivalent fees; conduct which still permeates the brokerage industry. [**People** v. **National Association of Realtors** (1984) 155 CA3d 578]

Conflicts with sales operations

A broker who operates a real estate sales office, in conjunction with a property management operation, has a potential conflict of interest that may need to be disclosed to his clients.

For example, a creditworthy prospective tenant might be swayed by the broker's sales staff to purchase a residence instead of renting. Sales fees are typically greater than leasing fees for the time spent. Conversely, sales fees are one-shot fees, not continuously recurring fees.

Any active attempt to convert a prospective tenant to a buyer when the prospect has responded to a rental advertisement that has been paid for by a landlord or provided as part of the property management services, suggests improper conduct. The broker's conduct may range from "bait and switch" techniques to diverting the landlord's business opportunities (tenants) established through efforts expended on behalf of landlords he represents.

A broker must be careful to keep his sales and management operations sufficiently separate from one another and to diligently pursue leases or rental agreements with creditworthy tenants who apply to rent.

The landlord comes first; the broker's concern for greater fees comes second.

Chapter 10 Resident managers

This chapter discusses the hiring of a resident manager, the pay and reporting regulations and the termination of the resident manager's employment and occupancy.

Employees: not independent contractors, not tenants

A broker, retained as a property manager, hires an individual as an on-site resident manager to handle the daily operations of an apartment building comprising 16 or more residential units. The resident manager enters into an employment contract with the property manager. [See Form 591 accompanying this chapter]

Under the **employment contract**, the resident manager:

- acknowledges he is an employee of the property manager; and
- agrees to vacate the property on termination of employment.

The resident manager's job is to show vacant units, run credit checks, negotiate and sign leases, collect rents, supervise repairs and maintenance, serve three-day and 30-day notices, etc.

In exchange for his services, the resident manager receives the use of an apartment rent-free.

Later, the property manager terminates the resident manager's employment.

The landlord demands the resident manager immediately vacate the premises and relinquish possession of the unit to the property manager.

However, the resident manager claims he is a tenant and does not need to vacate until he is served a notice to vacate, not just a notice terminating his employment. [See Chapter 29]

Is a resident manager who holds the right to occupy and use a residential unit as compensation for managing an apartment complex entitled to a notice to vacate?

No! A resident manager who occupies a unit after termination of employment is a *tenant-at-sufferance* — a holdover tenant who does not have a right to a notice to vacate since the term of his occupancy was fixed in the resident manager agreement until the date of termination of employment. [**Roberts** v. **Casey** (1939) 36 CA2d Supp. 767]

On termination of employment, a resident manager is not entitled to retain possession of the unit since the term of **occupancy expires** on termination of his employment. Possession of the unit is part of his compensation and the compensation ends, as agreed, with the employment.

Also, the resident manager who is being evicted by an unlawful detainer (UD) action cannot defend his possession by asserting a good cause must exist for terminating his employment or by relying on local rent control ordinances. [**Tappe** v. **Lieberman** (1983) 145 CA3d Supp. 19]

The property manager may begin eviction proceedings against the resident manager on termination of the employment without serving any notices, other than the notice terminating the employment which then terminates the occupancy as agreed in the resident manager employment agreement.

RESIDENT MANAGER AGREEMENT

DATE:_____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

1. RETAINER PERIOD:

1.1 Employer hereby employs _____, Employee, as Resident Manager of the rental property referred to as:

_____

located at _____ in _____ California, commencing _____, 20_____ and continuing until terminated.

2. EMPLOYEE AGREES TO:

2.1 Collect all rents, security deposits or other charges due the Owner and maintain collection records.

2.2 Advertise available rental units.

2.3 Screen and select tenants.

2.4 Show rental units to prospective tenants.

2.5 Negotiate, execute or cancel lease/rental agreements with tenants. No lease is to exceed _____ months.

2.6 Serve three-day notices as needed.

2.7 Clean, repair and maintain the rental real estate, inside and outside, as needed to promote the occupancy of the units.

2.8 Inspect daily the structure, grounds, parking lots, garages, and vacant units of the rental property for cleanliness and repairs.

2.9 Maintain receipt books, key racks and petty cash records in good order.

2.10 Conduct all minor maintenance and repairs not exceeding $_____ in cost. All materials to be purchased out of petty cash.

2.11 Contact the material and labor suppliers retained by the Employer to conduct all major repairs and maintenance. Employer to approve all repairs in excess of $_____.

2.12 Notify Employer immediately of any potential hazards to the tenants or property. Should an emergency situation arise placing tenants or property in jeopardy, Employee may immediately take action without further authority from Employer.

2.13 Conduct no other business on the premises nor solicit the tenants for any business other than the rental of the property.

3. BANKING:

3.1 Employee will place all rents, security deposits, and other funds received for the benefit of the Owner into an account maintained by Employer with _____ at their _____ branch.

3.2 On depositing funds into the Employer's Account, Employee shall deliver to Employer a copy of the bank deposit identifying the itemized deposits by the unit from which they were collected.

4. COMPENSATION OF EMPLOYEE AND HOURS WORKED:

4.1 As compensation for services, Employee shall be paid a total monthly salary, from all sources, of $_____.

4.2 In part, Employee's salary shall be in the form of possession to rental unit _____, which must be occupied as a condition of employment. The rental credit is $_____. The fair monthly rental value of the unit is $_____. The utilities including gas, electricity, and trash removal ☐ are, ☐ are not, included with the occupancy.

4.3 The balance of the Employee's salary shall be paid ☐ monthly, ☐ semi-monthly, on the _____ of each calendar month.

4.4 Employee will not work more than _____ hours per day and _____ hours per week.

4.5 Employee to have _____ days off weekly being the weekdays of _____.

4.6 Employee agrees to obtain Employer's consent if the hours required to carry out duties exceeds the agreed-to hours.

4.7 Employee will notify Employer within 48 hours of additional hours worked in an emergency situation.

4.9 Employee acknowledges he is not a tenant, but is an employee for purpose of occupancy of the unit provided for his on-site residency.

4.10 _____

_____

_____

_____

_____

_____

5. EMPLOYER AGREES TO:

5.1 Hand Employee all keys and entry codes to the property, and copies of leases/rental agreements with existing tenants.

5.2 Provide public liability, property damage and worker's compensation insurance sufficient in amount to protect the Employee and Employer.

5.3 Hand to Employee $_____ to be accounted for as petty cash to pay costs incurred in performing Employee's duties, and to replenish this amount on Employee's request.

5.4 Withhold all Employee's social security, federal and state income taxes, and disability insurance from cash salary paid.

5.5 Pay all federal and state unemployment insurance, worker's compensation and Employer's social security payments.

EMPLOYEE:

I agree to perform on the terms stated above.

Date:_____, 20_____

Employee: _____

Address:_____

_____

Phone: _____

Fax: _____

E-mail: _____

By: _____

EMPLOYER:

I agree to employ on the terms stated above.

Date:_____, 20_____

Employer:_____

Address:_____

_____

Phone: _____

Fax: _____

E-mail: _____

By: _____

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However, occupancy is not terminated if the resident manager employment agreement provides for the creation of tenancy following the termination of employment, as a monthly payment of rent after termination. [Calif. Code of Civil Procedure §1161(1)]

Resident manager activities

A resident manager is a person who lives in a residential unit, on either residential rental property or nonresidential property, as an employee managing the **daily operations** of the property, including:

- screening tenants and negotiating leases;
- cleaning vacated units;
- supervising landscaping, maintenance and repairs;
- serving notices; or
- attending to tenant inquiries.

Apartment buildings with 16 or more units must have an owner, resident manager or responsible caretaker living on the premises to manage the property. [25 Calif. Code of Regulations §42]

Resident managers do not need to be licensed as a real estate broker to negotiate leases or collect rents. However, the nonresident property manager, other than the landlord himself, must be a licensed real estate broker. [Calif. Business and Professions Code §10131.01; see Chapter 6]

Hiring a resident manager

Brokerage activities of concern to a property manager when employing an on-site resident manager include:

- selecting and hiring the resident manager;
- overseeing the resident manager; and
- terminating the resident manager's employment.

The resident manager's status as an employee is established in the employment agreement.

Any family members of the resident manager should be listed in the employment agreement as living with the resident manager, noting they are not tenants. They are employees **required to reside** in a unit on site.

References to the parties in the employment agreement identify the property manager/landlord as "employer" and the resident manager as "employee." [See Form 591 §4.9]

Payment for services

Depending on the size of the complex, the resident manager may receive occupancy of a unit in the complex as **compensation** for his services based on:

- a reduced rent in exchange for the value of the resident manager's services;
- free rent for services; or
- free rent plus a monthly salary.

On the resident manager employment agreement, the **salary** paid to the resident manager is stated as a monthly amount. The fair rental value of the resident manager's unit is deducted from his salary. After the rent deduction, the resident manager is paid the balance of his salary. Utilities may also be included

as part payment for the resident manager's services and as a deduction from the agreed-to salary. [See Form 591 §4]

As an **employer**, the property manager/landlord has the responsibility to withhold all proper federal and state income taxes, as well as to make required payments for social security, unemployment insurance and disability insurance. [Calif. Unemployment Insurance Code §13020]

The property manager or landlord must carry workers' compensation insurance to cover resident manager injuries on the job.

As a result of the degree of control the property manager retains over a resident manager, a resident manager does not qualify as an independent contractor to avoid tax withholding, employer contributions and workers' compensation premiums.

Rental value is not income

Consider the property manager who hires a resident manager to run a large apartment complex. As part of his salary, the resident manager receives a unit rent-free plus a fixed monthly salary.

Is the value of the unit occupied by the resident manager in exchange for services considered **taxable income** which the resident manager must declare for state or federal tax reporting?

No! Taxwise, the value of the apartment is not income to the resident manager and is not declared as income when the unit occupied by the resident manager is:

- located on the premises managed;
- for the property manager's or landlord's convenience; and
- occupied by the resident manager as a condition of his employment. [Revenue Regulations §1.119-1(b)]

Minimum wage requirements

A resident manager's employment is subject to minimum wage laws even though the portion of the wages paid by a reduction in rent or free rent is not taxable as income. [Calif. Labor Code §1182.8]

Strict minimum wage requirements apply to resident managers since they **carry out the instructions** of the property manager or landlord, rather than having the authority to make their own independent decisions about management policies. [8 CCR §11050(1)(B)(1)]

A **rent credit** may be used as all or part of the wages received per hour of work performed by a resident manager to establish the amount earned per hour for minimum pay requirements. However, a cap exists limiting the rent credit toward hourly wages at two thirds of the fair rental value of the unit, not to exceed $381.20 per month. Should a couple be employed as resident managers, the rent credited toward hourly pay cannot exceed $563.90 per month. [8 CCR §11050(10)(C)]

The property manager should require the resident manager to prepare time cards, limit the number of hours per week the resident manager may work so wages per hour do not drop below the minimum, and make provisions for the payment of any overtime permitted.

Weekly work reports by the resident manager and a review of the reports by the property manager or landlord are to confirm the total compensation exceeds the minimum wages for time spent on the job. These reports will help avoid any resident manager's claim he worked excessive hours in relation to his salary and maximum rent credit. [See Form 591 §4]

Thus, all work requiring additional hours, except emergency work, must be approved by the property manager prior to being performed by the resident manager.

For example, a resident manager who is provided with a base salary, plus a unit, is required to **remain on the premises** at all times, but only performs five hours of daily work as limited by the resident manager employment agreement.

The resident manager claims he is entitled to overtime pay for the hours he is required to be on the premises.

However, the resident manager is only entitled to receive compensation for the time he actually performed work agreed to in the resident manager employment agreement, not for the time he was required to remain on the premises doing no work at all. [**Brewer** v. **Patel** (1993) 20 CA4th 1017]

Mismanaged managers

A resident manager is an employee of the property manager or the landlord who hires him.

As an employer, it is the landlord or property manager who is liable to others who are injured due to the improper conduct (negligence) of the resident manager in the course and scope of the resident manager's employment. [Calif. Civil Code §2338]

To avoid liability for negligent violations of law or personal injuries to others, the conduct of resident managers must be **closely supervised** by the property manager or landlord.

Termination

A resident manager employment agreement creates an agency with the property manager or landlord, which is an *at-will* relationship. Thus, the employment of the resident manager may be terminated at any time and without prior notice.

While a landlord or property manager does not need to have a good reason to terminate a resident manager, they may not have an improper reason.

For instance, a resident manager has managed a large complex for many years as an agent for the property manager. The resident manager is over 62 years of age.

The property manager hires a new, younger resident manager and relegates the old resident manager to a lesser position.

The property manager constantly suggests to the older manager that he should retire and demotes him to even lesser positions while dramatically reducing his compensation.

Has the property manager discriminated against the older resident manager?

Yes! The property manager's basis for demoting the older resident manager was not substandard performance, but age.

As a result, the property manager is responsible for money damages for emotional distress and attorney fees. A property manager or landlord cannot terminate the resident manager or otherwise harass him because of race, creed, color, gender or age. [**Stephens** v. **Coldwell Banker Commercial Group, Inc.** (1988) 199 CA3d 1394]

Terminating the occupancy

Consider a resident manager employment agreement that provides for a property manager to receive immediate possession of the unit occupied by the resident manager on termination of his employment.

The resident manager employment agreement must avoid creating any landlord/tenant relationship in the resident manager's occupancy of a unit, or requiring that prior notice be given to the resident manager before his occupancy can be terminated.

For example, the owner of an apartment complex hires a resident manager to run the complex. In exchange for his services, the resident manager receives an apartment rent-free and a monthly salary.

Under the resident manager's employment agreement, he agrees to vacate the apartment unit on termination of his employment. Thus, the right to possession is extinguished on being terminated.

The owner terminates the resident manager's employment. The owner then serves the resident manager with notice to **immediately vacate** and relinquish possession of the unit, or **stay and pay** monthly rent.

The resident manager remains in possession of the apartment, but fails to pay the monthly rent called for in the notice to vacate. Without further notice, the owner begins UD proceedings to regain possession of the apartment from the terminated resident manager.

The resident manager claims he is now a tenant and the owner must serve him with a notice to vacate to establish his unlawful detainer of the unit.

The landlord claims the resident manager is a holdover tenant who has been unlawfully detaining the premises since the termination of his employment.

Is the resident manager entitled to a notice to vacate?

Yes! The resident manager's occupancy was converted to a month-to-month tenancy when the owner served the resident manager with a notice to vacate that included an offer to remain in possession, which the former resident manager did.

Here, the resident manager's continued occupancy of the apartment constituted **acceptance** of the new tenancy offered by the owner. Thus, the failure to pay rent is a breach of the new tenancy agreement noted in the notice to stay and pay. The owner's UD action cannot be filed until a three-day notice to vacate is given to terminate the resident manager's new tenancy for failure to pay rent. [**Karz** v. **Mecham** (1981) 120 CA3d Supp. 1; CC §1946]

On termination of his employment, the resident manager should not have been served any notice to pay or vacate. If the terminated resident manager remains in possession, he is unlawfully detaining the property and can be evicted.

Neither the landlord nor the property manager should at any time enter into a separate lease/rental agreement with a resident manager.

Rather, the occupancy arrangement should be written as part of the resident manager employment agreement, even if the management services do not equal the unit's rental value and the resident manager pays the difference as a reduced monthly rent charged for the unit. [Form 591 §4]

To avoid creating a tenancy that continues on termination of the resident manager's employment, the resident manager employment agreement must state:

- possession is incidental to his employment;
- possession automatically ends concurrent with termination of his employment; and
- failure to perform managerial duties constitutes a breach of the employment agreement and is grounds for immediate termination and eviction.

Chapter 11 Identification of landlord or property manager

This chapter addresses the disclosures required to be given to residential tenants identifying the landlord or the landlord's agent-for-service, his property manager and the resident manager.

Notice to tenant of agent-for-service

A residential landlord, under a property management agreement,employs a broker to manage his property. The broker will manage and care for the property, as well as assume all contact with the tenants, which includes the decision to enter into all future rental and lease agreements.

One of the landlord's objectives is to become as anonymous as possible and avoid giving the tenants any personal information.

The landlord is advised he can avoid being identified to the tenants by appointing another individual to act as his *agent-for-service of process*, such as the broker or the landlord's attorney. The **agent-for-service**, acting on behalf of the landlord, will accept service of legal documents and notices initiated by tenants. [Calif. Civil Code §1962(a)(1)(B)]

Here, when the landlord appoints an agent-for-service, the landlord's name and address do not need to be disclosed to any tenant, even if the tenant demands it to sue the landlord. Serving the agent-for-service with the lawsuit is the same as serving the landlord. [CC §1962(a)(1)(B)]

Editor's note — The identity of a landlord is easily located by a search of the county records. If title to the property is vested in the name of a limited liability company (LLC), corporation, or other entity, a review of other records with the Secretary of State may be required to locate the manager of the entity.

Appointing the agent-for-service

A landlord may himself accept service of notices and legal documents from a tenant. However, a residential landlord may appoint any individual, including his property manager or his attorney, to be his agent-for-service and avoid personal service on himself.

The property manager may be appointed as the landlord's agent-for-service by including an **agent-for-service clause** in the property management agreement employing the broker. [See Figure 1 accompanying this chapter]

As the landlord's *agent-for-service*, the broker accepts personal service of legal documents on behalf of the landlord, such as notices and lawsuits initiated by tenants. However, both the broker and the landlord must first consider whether the broker should act as the landlord's agent-for-service.

The broker's additional responsibility of accepting service of tenant complaints on the landlord's behalf conflicts with his main responsibilities of managing and caring for the landlord's property. Litigation could result from the broker's purported mismanagement of the property. A landlord might prefer to appoint an attorney as his agent-for-service to avoid the potential conflict of interest.

CHANGE OF OWNER OR PROPERTY MANAGER

Addendum To Rental Or Lease Agreement

DATE:_____, 20_____, at _____, California.

To Tenant: _____

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to the ☐ lease, ☐ rental agreement dated _____, at_____, California, entered into by

1.1 Landlord _____, and

1.2 Tenant(s)_____

1.3 recorded on _____, as Instrument No. _____ in _____County Records, California,

1.4 regarding real estate referred to as:_____

_____

AGREEMENT:

2. This notice is to advise you of a change in ownership or management of the premises you occupy as checked below:

2.1 ☐ The ownership of the real estate you lease or rent has been transferred.

2.2 The new property management broker is: _____

Address: _____

Phone:_____

2.3 The new resident manager is: _____

Address: _____

Phone:_____

3. Beginning _____, 20_____, your monthly rent due is to be paid by ☐ check, ☐ credit card, ☐ cash, or ☐ cashier's check, made payable to: _____.

3.1 Rent may be tendered by ☐ mail, or ☐ personal delivery,

to:

_____
(Name)

_____
(Address)

_____

_____
(Phone)

a. Personal delivery of rent will be accepted during the hours of _____ am to _____ pm on the following days: _____

3.2 Rent may also be paid by deposit into account number _____

at: _____
(Financial Institution)

_____
(Address)

_____

3.3 If rent is to be paid by credit card, the credit card number is _____/_____/_____/_____ issued by _____ which landlord will charge each month for the rent due.

3.4 Your current monthly rent is $_____.

3.5 Your rent has been paid up to and including _____, 20_____.

4. Your security deposit of $_____

4.1 has been transferred to the new owner.

4.2 has been transferred to the new property manager.

5. No breach of your lease or rental agreement by Landlord or Tenant currently exists, except: _____

6. Any notices or demands on the owner by Tenant, including service of process, may be served on:

Name: _____

Address: _____

Phone: _____

7. All terms and conditions of your lease and rental agreement remain in effect.

I agree to the terms stated above.	**I agree to the terms stated above.**
Date:_____, 20_____	Date:_____, 20_____
Landlord: _____	Tenant: _____
Agent: _____	Tenant: _____
Signature: _____	Signature: _____
Address: _____	Signature: _____
_____	Address: _____
Phone: _____	_____
Fax: _____	Phone: _____
E-mail: _____	Fax: _____
	E-mail: _____

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Who is identified to the tenant?

The names and addresses of the following individuals must be disclosed to all residential tenants:

- the landlord or other individual appointed by the landlord as his agent-for-service;
- any property managers; and
- any resident managers. [CC §1962(a)]

The addresses given for the manager and agent-for-service must be *street* addresses where legal notices can be **personally** served on the individual. A post office box will not suffice. [CC §1962(a)(1)]

The individual responsible for making the disclosures is:

- the landlord; or
- the individual authorized to enter into rental and lease agreements on behalf of the landlord, such as the property manager or resident manager. [CC §1962(a)]

Delivery of the notice

The names and addresses of the landlord's manager and agent-for-service may be disclosed in:

- the rental and lease agreements entered into with tenants; or
- a notice posted on the property. [CC §§1962(a); 1962.5(a)]

Figure 1 *Excerpt from **first tuesday** Form 590 — Property Management Agreement*

11.3 The authorized agent-for-service is ☐ Broker, ☐ Owner, ☐_____

When the disclosure notice is posted, the notice must be posted in two conspicuous places on the property. [CC §1962.5(a)(2)]

If the rental property contains an elevator, the written notice must be posted in:

- every elevator in the building; and
- one other conspicuous place on the property. [CC §1962.5(a)(1)]

An oral residential rental or lease agreement requires a written statement containing the name and address of the manager and agent-for-service to be provided to tenants. [CC §1962(b)]

Change in ownership and management

The landlord, property manager or resident manager responsible for entering into rental and lease agreements must notify all tenants of the name and address for service of a notice or complaint initiated by the tenant and do so within 15 calendar days after any change in:

- the manager(s) of the property;
- the owner(s), unless the new owner appoints an agent-for-service; or
- the landlord's agent-for-service. [CC §1962(c); see Form 554 accompanying this chapter, *ante*]

To disclose a change in ownership or management, the broker or resident manager responsible for leasing should:

- prepare the notice of change of ownership or property management as an addendum to each existing rental or lease agreement and provide it to each tenant to sign and return [See Form 554]; or
- post the property with the name and address of the manager and landlord's agent-for-service.

The notice must also include information regarding how and when rent will be paid.

Failure to give notice

A broker, acting as property manager for a residential landlord, or the landlord's resident manager responsible for leasing, must disclose the name and address of the landlord or agent-for-service.

If the name and address of the landlord or his agent-for-service is not disclosed, then the individual who enters into rental agreements on behalf of the landlord:

- automatically becomes the landlord's agent-for-service of process and agent for receipt of all tenant notices and demands [CC §1962(d)(1)]; and
- will be treated as the landlord and be liable for performing of all obligations described under rental and lease agreements with tenants. [CC §1962(d)(2)]

When the person signing the rental or lease agreement for the landlord fails to make the disclosures, the tenant may have no indication the person signing is not the landlord.

However, the landlord is not relieved of any liability to tenants if the name and address of the owner or agent-for-service is not disclosed. [CC§1962(e)]

Chapter 12 Exclusive authorization to lease

This chapter discusses a broker's right to collect his fee from a nonresidential landlord who employs the broker as his exclusive leasing agent.

Leasing agent's bargain for fees

A nonresidential property is offered for lease by an owner, also called the landlord. A broker makes an appointment with the owner to discuss the possibility of becoming his leasing agent.

During the discussion, the broker explains he can best help lease the property if he is operating under a signed exclusive authorization to lease, also called a *listing*. Under the listing, the broker, on the owner's behalf, will be able to:

- market the space and locate prospective tenants, called *users*, as the owner's sole representative [See Form 110 §1 accompanying this chapter];
- disclose the terms under which a user can actually lease and occupy the space [See Form 110 §10];
- assure other brokers the owner has agreed to pay a fee that can be shared in cooperation with brokers who represent users [See Form 110 §5.2]; and
- conduct negotiations with users and their brokers, and accept deposits with offers to lease the space. [See Form 110 §5.3]

The broker will not be managing the property, only locating prospective tenants and leasing space.

Right to compensation for services

The exclusive authorization listing assures the broker he will receive a fee for his efforts if anyone procures a tenant during the listing period, either on:

- the leasing terms sought in the listing; or
- other terms accepted by the owner.

However, the owner is reluctant to give up his ability to lease the property himself. Further, he would like to avoid employing the broker and paying a brokerage fee.

On the other hand, the owner feels he has a better chance of finding a tenant on acceptable terms in the current market if he is represented by a member of the local brokerage community of leasing agents.

Ultimately, the owner orally agrees to employ the broker. He confirms he will work exclusively with the broker to market the space and locate a user. The owner does not, however, believe it is necessary to have a written agreement — a handshake and his word should do the job.

The broker explains an exclusive authorization must be written and signed by the owner for the broker to be entitled to collect a fee — no signed writing, no services.

Is the broker correct in his analysis?

Yes! A written agreement in writing signed by the client is the only way a broker can protect his right to compensation for services and strengthen his resolve to perform, whether representing a tenant or a landlord.

An oral fee agreement between a broker and his client, be he a tenant or an owner, **without a later writing** signed by the client, is unenforceable by the broker.

Oral fee agreements to lease space are unenforceable even when the broker documents the oral agreement by referencing the fee and terms of payment in written correspondence sent to and acted on by the client. [**Phillippe** v. **Shapell Industries, Inc.** (1987) 43 C3d 1247]

Thus, a broker best protects his right to collect a fee for acting on behalf of an owner by entering into an exclusive authorization, signed by the owner, before performing any services.

*Editor's note — If a broker is employed to renegotiate an existing lease (rather than originate one), his employment agreement does not need to be in the form of a signed written agreement. Fees promised a broker for his negotiation of modifications, space expansions, extensions or renewals of existing leases are not required to be written to be enforceable since the lease has already been created. [**Shell** v. **Darnell** (1984) 162 CA3d 957]*

Exclusive authorization

An exclusive authorization to lease operates like an exclusive right-to-sell listing agreement.

The leasing agent is employed to "sell the use," a leasehold interest, by **locating a user** for the owner's property, rather than "sell the ownership" by locating a buyer for the property.

The broker owes the same obligations and duties to the owner under an exclusive leasing authorization as he would owe to a seller under an exclusive right-to-sell listing. The primary obligation owed an owner seeking tenants is the broker's duty to use diligence in his effort to continuously and conscientiously market the property and locate qualified tenants.

Conversely, a broker's performance under an open listing requires only his **best efforts**, not constant diligence in the search for a tenant as is required under an exclusive listing.

An open listing sets the leasing agent in competition with the owner and other brokers to be the **first to locate** a tenant and be entitled to collect a fee.

To best secure his time, energy and money invested (and provide incentive) to locate a tenant and lease the premises on behalf of an owner, a leasing agent uses an exclusive authorization to lease form. [See Form 110]

The provision in an exclusive authorization to lease calls for a fee schedule to be prepared and attached. The fee schedule references leasing situations which trigger the earning of formulated fees, such as 5% of the total rents for the first five years and 3% of the total rents for the balance of the lease. The schedule includes fees for extensions, renewals and other continuing leasehold and purchase arrangements which might be entered into in the future by the tenant and the owner. [See **first tuesday** Form 113]

The fee amount established in the fee schedule is **earned and due** on the occurrence of any one of the following events:

EXCLUSIVE AUTHORIZATION TO LEASE PROPERTY

DATE:_____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

1. RETAINER PERIOD:

1.1 Landlord hereby retains and grants to Broker the exclusive and irrevocable right to solicit prospective tenants and negotiate for the lease of the property for the period:
beginning on _____, 20_____ and terminating on _____, 20_____.

1.2 Broker to use diligence in the performance of this agreement.

2. ADDENDUMS to this agreement:

a. ☐ Title Report, or ☐ Title Policy

b. ☐ Work Authorization [**first tuesday** Form 108] (Also see §3.1b)

c. ☐ Property Operating Data [**ft** Form 562]

d. ☐ Agency Law Disclosure Addendum [**ft** Form 305]
(Mandated for one-to-four residential units if lease exceeds one year.)

e. ☐ Lead-based Paint Disclosure [**ft** Form 557]
(Mandated for one-to-four residential units constructed before 1978.)

f. ☐ _____

g. ☐ _____

h. ☐ _____

3. LANDLORD'S DEPOSIT:

3.1 Landlord hands $_____ to Broker for deposit into Broker's trust account for application to obligations under this agreement and the following attachments:

a. ☐ Advance Fee Addendum [**ft** Form 106]

b. ☐ Advance Cost Addendum [**ft** Form 107] (Also see §2b)

4. BROKERAGE FEE:

NOTICE: The amount or rate of real estate fees is not fixed by law. They are set by each Broker individually and may be negotiable between the Client and Broker.

4.1 Landlord agrees to pay Broker ☐ see attached fee schedule [**ft** Form 113], or

☐ _____ as compensation for services rendered, IF:

a. Anyone procures a tenant on the terms stated in this agreement, or any other terms acceptable to Landlord, during the period of this agreement.

b. The property is withdrawn from the rental market or made unmarketable by Landlord during the period of this agreement.

c. The Landlord terminates this employment of the Broker during the period of this agreement.

d. Within one year after termination of this agreement, Landlord or his agent commences negotiations which later result in a transaction contemplated by this agreement with a tenant with whom the Broker, or a cooperating broker, negotiated during the period of this agreement. Broker to identify prospective tenants by written notice to the Landlord within 21 days after termination of this agreement. [**ft** Form 122]

4.2 Should this agreement terminate without Landlord becoming obligated to pay Broker a fee, Landlord to pay Broker the sum of $_____ per hour of time accounted for by Broker, not to exceed $_____.

4.3 If Broker procures a tenant who purchases the property during the term of tenant's lease or any modification, extension or renewal of the lease or other continuing occupancy of leased property, Landlord agrees to pay Broker a fee of ☐ see attached fee schedule [**ft** Form 113], or

☐ _____.

5. GENERAL PROVISIONS:

5.1 Broker is authorized to place a For Lease sign on the property and publish and disseminate property information to meet the objectives of this employment.

5.2 Landlord authorizes Broker to cooperate with other agents and divide with them any compensation due.

5.3 Broker is authorized to receive, on behalf of any tenant, an offer and deposit.

5.4 The Landlord's acceptance of any tenant's offer to lease to be contingent on approval of the tenant's creditworthiness and management capabilities.

5.5 In any action to enforce this agreement, the prevailing party shall receive attorney fees.

5.6 This agreement will be governed by California law.

6. REAL ESTATE:

6.1 Type: _____

Address: _____

Described as: _____

_____

_____

_____

_____

Vesting: _____

6.2. Encumbrances of record:

a. A first loan in the amount of $_____ payable $_____ per month until paid, including interest at _____%, ☐ ARM, type _____, impounds being $_____ monthly.

Lender: _____

b. A second loan in the amount of $_____ payable $_____ per month, including interest at _____%, due_____, 20_____.

Lender: _____

c. Other encumbrance, bond, assessment or lien in the amount of $_____.

d. Any defaults: _____

7. PERSONAL PROPERTY INCLUDED:

7.1 Described as: _____

_____

_____

_____

_____

8. CONDITION OF TITLE:

8.1 Landlord's interest in the property is:

☐ Fee simple

☐ Leasehold

☐ _____

8.2 Landlord warrants there are no unsatisfied judgments or actions pending against him, no condemnation/eminent domain proceedings or other actions against the property, and no unrecorded deeds or encumbrances against the property.

9. LEASE TERMS:

9.1 The lease term sought is for a period of _____.

9.2 Occupancy to be available _____, 20_____.

9.3 Initial rent shall be $_____ payable on the _____ day of each month, with annual adjustments based on _____.

9.4 A total deposit of $_____, being $_____ advance rents and $_____ security deposit.

9.5 A late charge of $_____ to be incurred _____ days after the rent is due, plus interest at _____% per annum beginning from the due date for the delinquent rent.

9.6 Tenant to pay for and maintain:

- ☐ Water
- ☐ Gas
- ☐ Electricity
- ☐ Heat/Air Conditioning
- ☐ Public liability insurance
- ☐ Property damage insurance
- ☐ Plate glass insurance
- ☐ Other:_____

9.7 Landlord to maintain: _____

_____

9.8 Tenant may not assign, lease or sublet any portion of the property without written consent of the Landlord.

9.9 The lease form sought to be used by Landlord is form #_____ published or drafted by _____.

9.10 Other terms:_____

_____

_____

_____

I agree to render services on the terms stated above.

Date:_____, 20_____

Broker:_____

By: _____

Signature: _____

Address: _____

_____

Phone:_____

Fax: _____

E-mail:_____

I agree to employ Broker on the terms stated above.

Date:_____, 20_____

Landlord: _____

Signature: _____

Address: _____

_____

Phone:_____

Fax: _____

E-mail: _____

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- an exclusive *right-to-collect* clause assures payment of the agreed-to fee if the broker, another broker, the owner or anyone else procures a tenant on the terms stated in the listing or on any other terms accepted by the owner [See Form 110 §4.1a];
- an *early-termination option* assures payment of the fee should the owner withdraw the property from the rental market during the listing period [See Form 110 §4.1b];
- a *termination-of-agency* clause assures payment of the fee if the owner cancels the employment without cause before it expires under the listing [See Form 110 §4.1c]; and
- a *safety clause* assures payment of the fee if, within a year after termination of the exclusive authorization, the owner enters into negotiations resulting in the leasing or selling of the property to a prospective tenant the broker negotiated with during the listing period. [See Form 110 §4.1d]

Ready, willing and able tenant

Now consider a broker who is employed by a landlord under an *exclusive authorization* to lease.

The **authorization** states the landlord will pay the broker a fee if the broker, or anyone else including the landlord, produces a tenant ready, willing and able to lease the property on the same terms specified in the exclusive authorization agreement. [See Form 110 §4.1a]

The broker produces a creditworthy tenant who is financially capable of leasing the premises on the terms set forth in the exclusive authorization agreement. [See Form 110 §10]

The broker prepares and submits the tenant's offer to lease on terms substantially identical to the leasing terms in the authorization, called a full listing offer. [See **first tuesday** Form 556]

The landlord refuses to accept the offer, disclosing to the broker he now wants a higher rental rate.

The broker claims he is entitled to his fee since he produced a tenant who is ready, willing and able to lease the property on the terms stated in the exclusive authorization agreement.

The landlord claims the broker is not entitled to a fee since the property was never leased.

Here, a written fee agreement exists under which the broker only needs to **locate a tenant** ready, willing and able to lease the landlord's property *on the terms listed* for the broker to earn and be entitled to immediate payment of his fee. [**Twogood** v. **Monnette** (1923) 191 C 103]

An exclusive right to collect

Now consider a broker whose **exclusive authorization** to lease contains a fee provision that states he is entitled to a fee if the landlord rents the space during the listing period, called a right-to-collect clause. It is the right-to-collect clause which makes an exclusive listing exclusive. The clause states "a fee is due if anyone procures a tenant." [See Form 110 §4.1a]

The broker, as part of his efforts to locate a tenant, places a "For Lease" sign on the premises. The sign is seen by a prospective tenant.

Without contacting the broker, the prospective tenant contacts the landlord of the premises.

Before the exclusive authorization period expires, the prospective tenant and landlord enter into a lease agreement, though the terms are different from those specified in the broker's exclusive authorization.

Even though the landlord's broker had no contact with the prospective tenant (other than the sign exposure), the broker is earned to his fee. A tenant's offer to lease was accepted by the landlord during the exclusive authorization period.

Further, the broker receives his fee even though the final terms agreed to by the landlord and the tenant differed from the terms of the listing since the tenant's terms were accepted by the landlord during the exclusive authorization period. [**Carlsen** v. **Zane** (1968) 261 CA2d 399]

Early termination by landlord

A typical exclusive authorization agreement contains boilerplate wording in the fee provision stating the landlord will pay the broker the agreed-to fee if the property is:

- withdrawn from the rental market;
- transferred or conveyed;
- leased without the broker's consent; or
- made unrentable by the landlord, called an *early-termination clause*. [See Form 110 §4.1b]

An early-termination clause protects the broker from loss of his time and money spent in a diligent effort to locate a tenant should the landlord's conduct actually or effectively remove the property from the rental market before the listing expires. When the landlord interferes with the objective of the employment of the broker — to produce a ready, willing and able tenant on the terms stated — a fee has been earned and is immediately due.

Consider a broker and a landlord who enter into an exclusive authorization to lease that expires in six months. The agreement contains a fee provision with an **early-termination clause**.

The broker diligently attempts to locate a tenant for the landlord's property.

During the listing period, the landlord notifies the broker the property is no longer for lease. The broker is instructed to stop marketing the property. In compliance with his client's instructions, the broker takes the property off the market.

The broker then makes a demand on the landlord for a full listing fee. The broker claims the early-termination clause in the exclusive listing provides for payment of the broker's fee by the landlord when the landlord withdraws the property from the rental market before the listing period expires.

The landlord claims the broker cannot collect a fee under the early-termination clause since it calls for a lump sum payment on the landlord's breach of the employment agreement, called a *liquidated damages provision*.

Is the broker entitled to his fee on the client's termination of the broker's employment?

Yes! The broker is entitled to his fee since the early-termination clause gives the landlord the **option to cancel** the exclusive authorization agreement in exchange for paying the broker a fee instead of allowing the listing to expire without interference with the broker's marketing efforts. The landlord exercises the right to cancel by conduct which interferes with the broker's ability to lease the property, such as taking the property off the market.

The landlord does not breach the exclusive authorization to lease when he withdraws the property from the rental market. He merely exercises his option to do so as provided by the early-termination clause. Thus, the amount due is not liquidated damages for a breach. [**Blank** v. **Borden** (1974) 11 C3d 963]

However, the landlord did ultimately breach the exclusive authorization agreement. The landlord failed to compensate the broker for the fee earned and due when he exercised his option to take the property off the market.

*Editor's note — See **first tuesday** Form 121 for an agreement to cancel an exclusive authorization during the listing period.*

Safety clause covers prospects

A landlord's broker needs to provide protection for his time and effort spent locating a tenant during the listing period when the effort produces results after the listing expires. The inclusion of a safety clause in the fee provisions of an exclusive authorization to lease assures this result. [See Form 110 §4.1d]

The **safety clause** commits the landlord to pay the broker the scheduled fee if, within **one year after** the exclusive authorization expires, the landlord enters into negotiations during the safety clause period (one year) which later result in a lease of the premises to a tenant who was located and exposed to the property by the broker or his agents during the listing period.

Consider a broker and a landlord who enter into an exclusive authorization to lease containing a fee provision with a safety clause.

On expiration of the listing period, the broker, as agreed in the safety clause, supplies the landlord with the **names of tenants** he has had contact with and who **received information** regarding the property, an activity called *negotiations* even though no proposal or offer is submitted by the prospective tenant.

Thus, the name of each prospective tenant contacted by the broker or a cooperating broker, who was provided with information about the property, is "registered" with the landlord. [See **first tuesday** Form 122]

Residential agency disclosures

Before a landlord enters into an exclusive authorization to lease residential property, a property manager or leasing agent is required to hand a landlord a Rules-of-Agency Disclosure if:

- the lease will be for a term of more than one year; and
- the premises is a one-to-four unit residential property or a mobilehome. [Calif. Civil Code §2079.13(j)]

The rules-of-agency should be disclosed by attaching an Agency Disclosure Addendum to the exclusive authorization. [See **first tuesday** Form 305]

If the broker fails to make the rules-of-agency disclosure prior to signing the exclusive authorization:

- the fee agreement is unenforceable; and
- the broker is not entitled to a fee even if agency disclosures are made later with the offer to lease or in the lease. [**Huijers** v. **DeMarrais** (1992) 11 CA4th 676]

After the listing expires, the landlord employs a second broker without discussing the terms of the prior listing.

Within the one-year period after expiration of the first broker's authorization, the second broker arranges a lease of the premises to a tenant registered by the first broker, but without the first broker's participation in negotiations or the fee.

Here, the landlord owes the first broker the entire amount of the agreed-to fee even though the property was leased while listed exclusively with another broker.

The exclusive authorization entered into by the landlord and the first broker promised the first broker his fee if, within one year after expiration of the listing, the landlord **enters into negotiations** which result in a lease with a prospective tenant located and registered by the first broker. [**Leonard** v. **Fallas** (1959) 51 C2d 649]

As a "safety net" for brokerage services rendered, the clause discourages the landlord from attempting to avoid payment of the broker's fee by:

- waiting until the exclusive authorization agreement expires and then directly or indirectly approaching a prospective tenant located and solicited by the broker; or
- making special fee arrangements with another broker which re-ignite negotiations with a prospective tenant located and exposed to the property by the broker.

Contingency fees

Offer-to-lease forms typically contain a provision stating the broker's fee is payable on the transfer of possession to the tenant, called a *contingency fee clause*. [See Form 556 §15]

Sometimes, the lease agreed to in the offer to lease is never entered into by the landlord and prospective tenant. Without a lease, the agreed-to change of possession triggering payment of the fee earned by the broker does not occur due to a breach of the offer to lease by the landlord. As a result, the earned brokerage fee is not paid. The condition for payment of the fee — occupancy — did not occur.

However, a broker may recover contingency fees contained in offers to lease even when, due to a breach by either the landlord or the tenant, the lease agreed to in the offer is not later entered into and possession is not transferred.

Consider a landlord who accepts an **offer to lease** submitted by a broker on behalf of a prospective tenant. The signed offer to lease contains a fee provision which states the broker's fee is payable by the landlord on change of possession.

Later, the landlord wrongfully refuses to enter into a lease agreement and convey the leasehold estate (occupancy) as agreed in the offer to lease. The broker makes a demand on the landlord for payment of a fee.

The landlord claims the broker is not entitled to receive a fee since the right to possession was never conveyed to the prospective tenant, i.e., the lease agreement contracted for in the offer to lease was never entered into.

Is the broker entitled to his fee?

Yes! The landlord cannot avoid paying the fee the broker has **already earned** by claiming the transfer-of-possession contingency was not satisfied (no lease). Here the **landlord's breach** of the agreement to

lease prevented the transfer of occupancy to the tenant. The landlord failed to deliver the lease and possession as agreed to in the offer to lease. Thus, the failure to enter into the lease triggers payment of the fee previously earned when the landlord accepted the tenant's offer to lease.

The contingency fee provision included in the offer to lease merely **designates the time** for payment of a fee which the broker previously earned on locating a tenant or the acceptance of the tenant's offer. The contingency fee provision in the offer does not defeat the broker's right to be compensated simply because the landlord later wrongfully refused to enter into the agreed-to lease. [**Steve Schmidt & Co.** v. **Berry** (1986) 183 CA3d 1299]

The contingency fee provision in an agreement to lease, as in a purchase agreement, shifts the **time for payment** of the fee from the time the fee is earned (and due) under an exclusive authorization agreement to the time a lease is entered into in the agreement to lease.

Also, unless the listing broker approves, the landlord cannot include and enforce a fee provision in the offer to lease that is unacceptable to the broker and contrary to the terms of the fee schedule agreed to by the landlord and the broker in the exclusive authorization agreement.

For instance, the landlord cannot unilaterally insert and enforce a provision in a leasing document for the broker's fee to be paid in installments unless the broker agrees. Under the exclusive authorization or offer to lease, the broker has only agreed to accept payment of his fee in cash at the time an offer or lease is entered into by the landlord. [**Seck** v. **Foulks** (1972) 25 CA3d 556]

Additional fees on extension of lease

Exclusive authorization agreements have fee schedules attached which contain formulas for calculating the brokerage fee earned based on the length of the lease negotiated with the tenant. Further, they usually state the broker will receive an **additional fee** for any extension, renewal or modification of the tenant's occupancy under the original lease. [See **first tuesday** Form 113]

For example, a broker operating under the authority of a written listing procures a tenant who signs a ten-year lease. The broker is paid the fee called for in the listing agreement fee schedule.

The fee schedule also provides for a percentage fee to be paid on any future leasehold arrangements entered into between the landlord and the tenant for **continued occupancy**of the premises on the expiration of the original lease.

On expiration of the original lease, the landlord and tenant negotiate a new lease for the tenant's **continuing occupancy and use** of the premises. A brokerage fee is not paid for the tenant's continued occupancy.

The broker makes a demand for an additional fee under the original listing agreement claiming the new lease, which he did not negotiate, earned him a fee.

The landlord claims he does not owe the broker a fee since the new lease is a separate agreement, not an extension, renewal or modification of the original lease.

However, the landlord must pay the broker the additional fee agreed to in the original listing based on a percentage of the total rent due under the new lease since the new lease constitutes a renewal of the original lease.

Here, the tenant located by the broker **continued in possession and use** of the premises on expiration of the original lease. The listing agreement stated the broker was to be paid a fee on this event. The form of documentation (new lease agreement) was used to permit the continued occupancy of the premises is of no importance. [**John B. Kilroy Company** v. **Douglas Furniture of California, Inc.** (1993) 21 CA4th 26]

Chapter 13 Exclusive authorization to locate space

This chapter explains the benefits enjoyed by a broker and a prospective nonresidential tenant when the tenant employs the broker to locate space under an exclusive authorization listing.

A broker and his nonresidential tenant

An owner of a nonresidential property holds an open house attended by brokers who are leasing agents to encourage them to locate tenants for his vacant space.

Leasing agents who are in attendance and representing tenants are handed the owner's brochure on available space. The information includes a schedule of brokerage fees the owner will pay if a broker procures a tenant for the property, called a *user*. The informational handout also includes a tenant registration form.

One of the brokers who received a brochure inspects the property with a prospective tenant.

The broker completes the tenant registration form which identifies the broker and the prospective tenant. The registration form does not reference the fee schedule or any amount payable to the broker as a fee.

The registration form is handed to the owner, or the owner's employee, who signs it and returns a copy to the broker.

Later, the broker prepares an **offer to lease**, which is signed by the tenant and submitted to the landlord. The offer to lease form contains a provision stating the tenant will pay the brokerage fee in the event the landlord does not agree to pay the broker a fee. [See Form 556 §15]

The offer to lease is not accepted by the landlord. The landlord does not make a counteroffer. However, without contacting the broker, the landlord and the tenant engage directly in lease negotiations. Later, they enter into a lease which does not provide for a fee to be paid to the broker. In the lease, the landlord agrees to be responsible for payment of any brokerage fee due as a result of the lease, called a *hold harmless provision*.

On discovering the tenant's occupancy, the broker seeks payment of his fee from the tenant, not the landlord. The broker claims the tenant breached the brokerage fee provision in his offer to lease by failing to provide for payment of the fee he earned when the tenant leased the property.

The tenant claims he is not liable for payment of the brokerage fee since the landlord agreed to pay the brokerage fee under the hold harmless provision in the lease.

Can the broker recover his fee from the tenant?

Yes! The offer to lease **signed by the tenant** contains a fee provision which states the broker will receive compensation for his efforts if the tenant leases the premises.

Thus, the broker is able to enforce collection of a fee from the tenant. The tenant signed an offer regarding the leasing of the property. The offer contained a **brokerage fee provision** calling for the broker to be paid a fee. The buyer breached that fee provision in the offer, and in doing so incurred liability for the fee. [**Rader Company** v. **Stone** (1986) 178 CA3d 10]

Conversely, a broker who does not have an agreement signed by a tenant containing provisions for the payment of a fee if the tenant leases property — such as a tenant listing agreement or offer to lease — is unable to enforce collection of a fee from the tenant. An oral agreement to pay a brokerage fee is unenforceable against the client making the oral promise. [**Phillippe** v. **Shapell Industries, Inc.** (1987) 43 C3d 1247]

Written fee agreements

A leasing agent has the opportunity to enter into a written fee agreement signed by either the tenant or the landlord on at least four occasions during lease negotiations:

1. When the leasing agent solicits a **nonresidential landlord** for authorization to represent the landlord as his leasing agent to locate users and negotiate a lease agreement acceptable to the landlord, called an *exclusive authorization to lease*. [See **first tuesday** Form 110; see Chapter 12]
2. When the leasing agent solicits (or is solicited by) a **nonresidential tenant** for authorization to act as the tenant's leasing agent to locate suitable space and negotiate a lease agreement acceptable to the tenant, called an *exclusive authorization to locate space*. [See Form 111 accompanying this chapter]
3. When the leasing agent prepares a **tenant's offer to lease** by including a brokerage fee provision in the offer.
4. When the leasing agent prepares the **lease agreement** by including a fee provision.

These opportunities are listed in the order of a leasing agent's declining ability to negotiate.

The employment agreement

A broker approached by a prospective tenant to locate space should ask for and enter into an **employment agreement** with the tenant before analyzing the tenant's needs, locating space or exposing the tenant to available space not listed with the broker. [See Form 111]

The exclusive authorization assures the broker he will be paid for his time and effort spent locating and investigating available space if the tenant ultimately leases space of the type and in the area noted in the authorization. Through the exclusive authorization, the tenant commits himself to work with the broker to accomplish the objective of the employment — to rent space.

The exclusive authorization form is similar in structure and purpose to a buyer's listing agreement and includes:

- the term of the retainer period;
- the formulation for calculating the broker's compensation [See **first tuesday** Form 113];
- a description of the type and location of space or property sought by the tenant; and
- identification of the broker as the agent and the tenant as the client.

The description of the property in the exclusive authorization specifies the space requirements, location, rental range, terms and other property conditions sought by the tenant.

Based on the fee provisions in an exclusive authorization to locate space, the broker has earned a fee if the tenant enters into a lease agreement for space similar to the space sought under the exclusive authorization. The fee is collectible no matter who — the tenant's broker, another broker or the tenant himself — negotiates the lease agreement, due to the *exclusive clause* in the lease agreement. [See Form 111 §5.1a]

EXCLUSIVE AUTHORIZATION TO LOCATE SPACE

DATE:_____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

1. RETAINER PERIOD:

1.1 Tenant hereby retains and grants to Broker the exclusive right to locate space of the type described below and to negotiate terms and conditions for its rental acceptable to the Tenant, for a retainer period beginning on _____, 20_____, and terminating on _____, 20_____.

2. BROKER'S OBLIGATIONS:

2.1 Broker to use diligence in the performance of this employment.

2.2 ☐ Attached is the Agency Law Addendum. [**first tuesday** Form 305]

3. TENANT'S DEPOSIT:

3.1 Tenant hands $_____ to Broker for deposit into Broker's trust account for application to Tenant's obligations under this agreement and the following attachments:

a. ☐ Advance Fee Addendum [**ft** Form 106]

b. ☐ Advance Cost Addendum [**ft** Form 107]

4. GENERAL PROVISIONS:

4.1 In any action to enforce this agreement, the prevailing party shall receive attorney fees.

4.2 Tenant authorizes Broker to cooperate with other agents and divide with them any compensation due.

4.3 This agreement will be governed by California law.

5. BROKERAGE FEE:

NOTICE: The amount or rate of real estate commissions is not fixed by law. They are set by each broker individually and may be negotiable between the Tenant and the Broker.

5.1 Tenant agrees to pay Broker ☐ see attached fee schedule [**ft** Form 113], or ☐ _____ _____ of the rental price of the space located, IF:

a. Tenant, or any person acting on Tenant's behalf, leases space located during the retainer period.

b. Tenant terminates this employment of the Broker during the retainer period.

c. Within one year after termination of this agreement, Tenant or his agent commences negotiations which later result in a transaction contemplated by this agreement with a landlord with whom the Broker, directly or indirectly, negotiated during the period of this agreement. Broker to identify prospective properties by written notice to Tenant within 21 days after termination of this agreement. [**ft** Form 123]

5.2 Should this agreement terminate without Tenant becoming obligated to pay Broker a fee, Tenant to pay Broker the sum of $_____ per hour of time accounted for by Broker, not to exceed $_____.

5.3 Should the Landlord of space leased to Tenant agree to pay a fee acceptable to the Broker, Tenant's obligation to pay a brokerage fee will be satisfied.

TYPE OF SPACE SOUGHT:

GENERAL DESCRIPTION:_____

SIZE:_____

LOCATION:_____

RENTAL AMOUNT AND TERMS: _____

_____

I agree to render services on the terms stated above.

Date:_____, 20_____

Tenant's Broker: _____

By:_____

Address: _____

_____

Phone:_____ Fax:_____

E-mail:_____

I agree to employ Broker on the terms stated above.

Date:_____, 20_____

Tenant:_____

Signature: _____

Address: _____

_____

Phone:_____ Fax:_____

E-mail:_____

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Also, a fee provision containing a *safety clause* allows the broker to collect a fee if property located by the broker and disclosed to the tenant during the retainer period is later leased by the tenant in negotiations commenced during the one-year period after the exclusive authorization expires.

If the tenant decides not to lease space during the exclusive authorization period, the fee provision is structured so the broker can include payment of a fee on an hourly basis for the time spent locating rental property, called a *consultation fee*.

Benefits of exclusive authorization

An exclusive authorization to locate space is mutually beneficial to a prospective tenant and a broker since it commits a nonresidential tenant and broker to work together to accomplish a single objective — the leasing of space.

Typically, an unrepresented tenant is at the mercy of the leasing agent employed by the owner. Agents employed by owners owe the employing owner an **agency duty** to use diligence in seeking the most qualified tenant and negotiating terms for a lease most favorable to the landlords.

Conversely, only a **general duty** is owed to a non-client tenant to avoid misleading the tenant when making disclosures by including all material facts about the property, without explanation, which might adversely affect its rental value.

The exclusive authorization to locate space is an *employment agreement*. It imposes on the broker an agency duty to use diligence in locating suitable space and negotiating the best leasing terms available for the tenant in exchange for a fee — even though the fee may be paid by the owner.

The prospective tenant who exclusively authorizes a competent broker to locate space is saving time and money since he has retained a professional advisor to conduct the search and handle negotiations to lease property on his behalf.

With property information readily available, the tenant's broker will be able to locate qualifying properties for review with the tenant.

However, a the tenant who works directly with an owner's broker will initially (and properly) only be shown space the broker has been employed by the owner to lease.

In a rising market, owners have superior negotiating power. Thus, it is in the tenant's best interest to employ a broker as his exclusive representative.

Curiously, when the market allows owners to control negotiations in real estate transactions and when prospective tenants and buyers most need representation, brokers tend to avoid entering into employment agreements with prospective tenants and buyers. It seems to be easier, during periods of rapidly rising prices and rents, to list property and wait for the inevitable user to contact the owner's broker, instead of the reverse activity of locating property on behalf of a prospective tenant or buyer.

However, in a falling market, when tenants and buyers have more negotiating power than owners due to the increasing availability of space and properties, brokers are prevented from easily obtaining written employment agreements from prospective tenants than during periods of short supply of space.

Also, when the market position of owners weakens, owners become more flexible in lease negotiations and are more apt to employ brokers to locate tenants and fill vacant space, particularly builders and developers.

Residential agency rules and confirmation of representation

A broker acting on behalf of a residential tenant is required to provide both the tenant and the landlord with a Rules-of-Agency Disclosure if:

- the lease will be for a term of more than one year; and
- the premises is a one-to-four unit residential property or a mobilehome. [Calif. Civil Code §§2079.13(j), 2079.14]

The rules-of-agency form is to be handed to the tenant prior to the tenant's signing of an offer to lease for more than one year by attaching a Rules-of-Agency Disclosure to an offer to lease residential property. [CC § 2079.14(d); see **first tuesday** Form 305]

If the tenant's broker did not prepare the offer to lease himself, the broker should provide the tenant with the rules-of-agency no later than the next business day after the tenant hands him the signed offer to lease. [CC §2079.14(d)]

The landlord is to be provided with the rules-of-agency when the prospective tenant's offer to lease is presented. [CC §2079.14(b)]

If a residential landlord's broker fails to deliver the Rules-of-Agency Disclosure prior to or concurrent with signing the exclusive authorization to lease for more than one year:

- the authorization is unenforceable; and
- the broker is not entitled to a fee. [**Huijers** v. **DeMarrais** (1992) 11 CA4th 676]

Further, when a tenant signs an offer to lease a residence for a period exceeding one year, the broker must provide the tenant with an Agency Confirmation Statement. [See **first tuesday** Form 306]

The Agency Confirmation Statement discloses any agency relationships the broker may have with the landlord or the prospective tenant, disclosing whether the agency is exclusive, dual or nonexistent.

Interference with economic advantage

Consider a nonresidential landlord who **orally promises** a broker he will pay a fee if the broker locates a prospective tenant who leases space. A prospective tenant is located by the broker. The tenant is orally advised by the broker that the landlord has agreed to and will pay his fee.

The tenant, after seeing the property and before signing an offer, contacts the landlord directly to negotiate a lease. Ultimately, the tenant and landlord enter into a lease agreement. The documentation does not contain provisions for a brokerage fee.

Here, the broker cannot enforce collection of his fee from the landlord who orally promised to pay.

Thus, the broker makes a demand on the tenant for the brokerage fee claiming the tenant knew about the landlord's oral promise to pay him and interfered.

The tenant claims the broker is not entitled to recover anything from him since a written fee agreement does not exist to evidence the fee agreement with the landlord.

Is the tenant liable for payment of the broker's fee which was known by the tenant to be orally agreed to by the landlord?

Yes! The tenant is liable for the brokerage fee the landlord promised to pay since the tenant:

- was actually aware the landlord had promised to pay the broker a fee if the broker located a tenant; and
- excluded the broker from lease negotiations with the intent of avoiding payment of the fee. [**Buckaloo** v. **Johnson** (1975) 14 C3d 815]

When a tenant (successfully) induces a landlord not to pay the brokerage fee agreed to by the landlord, the tenant becomes liable for the fee the landlord promised to pay the broker whether or not the employment agreement between the broker and the landlord is **oral or written**. The broker does not pursue the person who orally agreed to pay the fee. [**Della Penna** v. **Toyota Motor Sales, U.S.A., Inc.** (1995) 11 C4th 376]

Understanding dual agency

Now consider a broker engaged in locating space for a prospective tenant. The broker does not ask for and is not employed under an exclusive authorization to locate space. The broker extends his search to space that he does not have listed.

The broker locates space acceptable to the tenant. However, it is space the owner does not have listed with a broker.

To assure payment of a fee, the broker enters into a so called "one-time" or "one-party" listing agreement with the owner.

The broker does not advise the owner about his agency relationship with the prospective tenant, which was established due to his efforts to locate suitable space on behalf of the tenant.

On listing the property, the broker presents the owner with the tenant's signed offer or letter of intent (LOI) to lease. The owner rejects the offer or LOI by making a counteroffer. Again, no disclosure or *confirmation* of the agency relationship with the tenant is made to the owner.

Negotiations conducted by the broker between the tenant and the owner ultimately result in an agreement to lease. The agreement contains a provision stating the brokerage fee will be paid by the owner.

The owner then discovers the broker was also acting as an agent on behalf of the tenant, a dual agency relationship which was not disclosed to the owner when he was induced to employ the broker under the listing. The owner refuses to pay the broker his fee.

The broker makes a demand on the owner for payment of the agreed-to fee claiming he acted as the exclusive agent of the tenant at all times and undertook no agency duty to act on behalf of the owner by entering into the "one-party" listing required to collect a fee.

The owner claims the broker is not entitled to his fee since the broker failed to disclose he was representing both parties as a *dual agent*.

Can the broker enforce collection of his fee?

No! The broker is not entitled to a fee. He was an **undisclosed dual agent** in the transaction.

The broker became the **tenant's agent** when he undertook, by an oral agreement, the task of locating and submitting all available space to the tenant, including space not listed with the broker, which might be suitable for the tenant.

On entering into the listing agreement with the owner, the broker also became employed as the **owner's agent**. The result was a conflicting employment, i.e., control over the negotiations on behalf of both parties, which imposed a duty to disclose the resulting dual agency to both the owner and tenant. [**L. Byron Culver & Associates** v. **Jaoudi Industrial & Trading Corporation** (1991) 1 CA4th 300]

To avoid losing the right to collect a fee on the transaction, the broker should have asked the tenant, rather than the owner, to enter into a written employment agreement before undertaking the agency duty of locating space on behalf of the tenant.

Thus, an agency relationship with the owner would not have arisen had the tenant's offer to lease been submitted without first entering into a listing with the owner. The owner may agree to pay the fee in an LOI, offer to lease or the lease agreement without ever employing the broker as his agent. Thus, the issue of a dual agency does not arise.

No written authorization from tenant

Now consider a broker who represents a tenant without the tenant's written authorization. The broker locates space and prepares an LOI or an offer to lease. The space is listed with another broker.

Here, the broker should first enter into a written or oral *cooperative fee-splitting agreement* with the owner's broker. [See **first tuesday** Form 105]

A cooperative fee-splitting agreement assures the broker he will receive a fee on any lease his tenant may enter into for the space listed with the other broker. **Oral agreements** between brokers to share fees are enforceable. [**Century 21 Butler Realty, Inc.** v. **Vasquez** (1995) 41 CA4th 888]

Brokers all too often undertake the agency duty to locate space on behalf of a nonresidential tenant without first asking for and obtaining a written authorization granting the broker the right to represent the prospective tenant.

However, without a signed, written authorization to act as the agent for a prospective tenant, the broker has no assurance he will be paid by the owner or the tenant for his services rendered on behalf of the tenant until either the tenant or the owner signs a document calling for someone to pay his fee.

Chapter 14 Cost of operating in leased space

This chapter analyzes the leasing agent's use of a property's operating costs data as a disclosure to assist prospective tenants in the selection of suitable space.

Disclosures by leasing agents

The availability of a property's data and the advice brokers give to assist prospective tenants, also called *users*, who are making decisions about leasing property, has increased dramatically since these data are now more readily accessible on inquiry.

As a result, consumer expectations when leasing property have risen. Unlike other industries, competition among brokers for clientele has not been the primary force behind rising consumer expectations.

Industry-wide, consumers have taken hits for failure to receive property information. This failure has prompted the legislature to take action pressuring brokers into making more disclosures of known and knowable facts about a property which adversely affect its value. Brokers are charged with knowing readily available features comprising the property they are marketing. [**Jue** v. **Smiser** (1994) 23 CA4th 312]

A greater burden which requires investigation and advice is placed on brokers who represent **users** as opposed to the lesser burden carried by an owner's broker when dealing with perspective tenants. A user's broker must know his client's needs and capacities if the broker is to make better use of his time spent locating space best suited to meet his client's needs and objectives.

Upon locating a qualifying property, disclosures and representations about the property provided by the user's broker must be based on that broker's investigations, not conjecture, unless the representations are credited to another source and not known or believed in any way to be false by the owner's broker. [**Field** v. **Century 21 Klowden-Forness Realty** (1998) 63 CA4th 18]

As new expectations are placed on brokers by users of real estate, the issue as to whether brokers have a **duty to respond** to the consumer's expectations is judicially resolved. Resolution is based on the agency environment surrounding the gathering and delivery of information to the prospective user, and the degree of availability of the information to brokers.

Also, as the expectations of real estate consumers are reviewed by the courts, the *level of competency* imposed on brokers and the extent to which landlords and brokers must disclose information (and its source) becomes clearer.

As couriers of information and the "gatekeepers" for almost all real estate transactions, brokers are retained by consumers to inform them of relevant conditions surrounding a property.

As for an owner and his broker, their role in marketing space has been reduced to avoiding misleading disclosures. The duty owed to users by the owner's broker to **avoid misleading** a user does not include enlightening prospective users by also advising them about the consequences of the disclosed facts. The advice about the **risks and uncertainty** surrounding the disclosed facts is for the user to seek out so he can make an informed decision when selecting the premises best suited from all available properties.

It is the role and burden of the user's leasing agent, as his duty owed to the user, to ascertain a property's essential facts (or advise the tenant on what they should do to get the facts), and make relevant recommendations to assist the tenant to meet his goals.

The factual information available to brokers about properties and the assistance brokers can offer to users who are leasing space fall into three general categories for analysis:

1. The property's **physical aspects** (square footage, shipping facilities, utilities, HVAC units, tenant improvements, sprinkler system, condition of the structure, soil, geologic hazards, toxic or noise pollution, parking, etc.);
2. The conditions affecting the **use and enjoyment** of the property, i.e., facts available on request from title companies (CC&Rs, trust deeds and vesting), planning departments (uses permitted), redevelopment agencies, business tax rates, police and fire departments (response times), security, natural hazards and conditions of the neighborhood surrounding the location; and
3. The **cost of operating** the leased premises when put to the expected use.

Operating costs disclosed

A property's operating costs are part of the property's signature. Operating costs distinguish the property from other available properties. A property's operating costs are gathered and set forth on the *occupant's cost sheet* which is handed to perspective users to induce them to rent the space. [See Form 562 accompanying this chapter]

Property related expenditures which will be incurred by a user during the leasing period, other than the payment of rent and any tenant debt the tenant secures by the leasehold, fall into two categories:

- recurring operating expenses; and
- nonrecurring deposits or charges.

Users, their leasing agents and property managers **compare the costs** a user will incur to occupy and operate in a particular space against the costs to operate in other available space, a type of *comparative cost analysis*.

The user's cost analysis is even more relevant to negotiations during periods of economic slowdown when vacancy levels increase due to overbuilding or a decline or consolidation in the number of users who traditionally occupying this type of space.

When users search for space without the pressure of high occupancy levels with the attendant scarcity of space experienced during periods of peak economic activity, they are more likely to compare properties based on operating costs or the cost of improvements the owner or tenant will provide, rather than rent alone.

Also, owners renting for less than the competition should be subjected to requests for information and history on the operating costs the user will incur in addition to the rent. The below-market rent may be suspect due to the excessive operating costs or local taxes the tenant will pay, security, requirements, etc.

The nondisclosure of a property's operating costs a user will incur under a net or modified *gross rent* lease agreement leaves the perspective user to speculate on what will be the amount of monthly operating costs (in addition to rent) he will experience.

OCCUPANT'S OPERATING EXPENSE SHEET

Ongoing Operating Costs

DATE:_____, 20_____, at _____, California.

Occupant (Buyer or Tenant): _____

Property type: _____

Address: _____

Items left blank or unchecked are not applicable.

FACTS:

This cost sheet demonstrates the cash expenditures the Occupant should initially experience while owning or leasing the property.

These amounts are: ☐ figures currently experienced operating the property.

☐ estimates and not amounts confirmed by the owner or former occupant.

OPERATING EXPENSES:

Electricity . . . . . $_____

Gas . . . . . $_____

Water . . . . . $_____

Rubbish . . . . . $_____

Sewage and misc. included . . . . $_____

CATV . . . . . $_____

Phone . . . . . $_____

DSL/T1/Cable modem, etc. . . . . $_____

Insurance . . . . . $_____

Taxes . . . . . $_____

General obligation bonds . . . . . $_____

Lawn/Gardening . . . . . $_____

Pool/Spa . . . . . $_____

Janitorial/Maids . . . . . $_____

Maintenance and repair . . . . . $_____

Common Area Maintenance . . . . $_____

Other_____ $_____

Other:_____ . . $_____

Total Operating Expenses . . . . $_____

Monthly Loan or Lease Payment . $_____

TOTAL Monthly Expenditures . . $_____

DEPOSITS:

Rental Security Deposit . . . . . $_____

Water Deposit . . . . . $_____

Sewage and Rubbish Deposit . . . $_____

Gas Service Deposit . . . . . $_____

Phone Service Deposit . . . . . $_____

Other:_____ . . $_____

Other:_____ . . $_____

TOTAL Deposits . . . . . $_____

I have read and approve this information:

Date:_____, 20_____

Seller/ Landlord: _____

Seller/ Landlord: _____

Date Prepared: _____, 20_____

Broker:_____

Agent: _____

Phone:_____

Fax: _____

I have read and received a copy of this estimate.

Date: _____, 20_____

Occupant's Signature: _____

Occupant's Signature: _____

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The nondisclosure of operating costs is more likely to occur during tight rental markets when owners and their brokers are less responsive (or uncooperative) in the release of information to users and their leasing agents.

At the very least, the user's leasing agent has the obligation to **bring the availability** of the data to the user's attention. Then, if the user wants the information, it can be obtained during negotiations or to clear contingencies before taking occupancy. At his best, the user's leasing agent not only advises, but investigates and reports to his client on the data he collects, and provides analysis and recommendation.

The owner either knows, or can easily obtain from his property manager, the actual costs of operating his property for the intended use. Thus, property's operating data is readily available to the owner. If the owner or the owner's broker refuses to supply the data to the user, the user's broker can research the history of expenses the prior users have experienced.

Leases on nonresidential properties often include charges for common area maintenance (CAMs) — expenses incurred by the owner and paid by the user as additional rent to the base rent, adjustments and percentages. The prospective user and his agent should insist on the seller providing an operating cost sheet estimating the monthly charge for the user's share of the CAMs he would incur in this space.

Since information about the amount of CAMs paid by the prior occupant of the space might affect the user's negotiations and rental commitment, it is a *material fact* essential to the user's decision-making process. During a tight leasing market with reduced availability of unoccupied space, owners increase their net income by adding fixed amounts of CAM charges instead of directly raising rents. Thus, they fractionalize the rent to distract the prospective user from what initially appears to be the rent.

A broker has a duty to disclose all conditions or aspects of a property which might affect a user's decision to lease, called *material facts*. [**Ford** v. **Cournale** (1973) 36 CA3d 172]

Accurate estimates by brokers

Disclosing the costs the user will incur while occupying and operating the property imposes on the user's broker a duty to disclose the actual costs which have been incurred in the space. If not available and estimates are prepared and provided by the user's broker, they must be reasonably accurate and state they are estimates — they cannot be guesstimates.

Also, the user's broker must **identify the source** of the data provided to the user and the reliability of the source as known to the broker. If a need exists for confirmation of the data due to questionable or unknown reliability, the offer to lease needs to include a further-approval contingency. The contingency provision allows the user time to check out and confirm his expectations brought about by the disclosure or cancel the offer for their failure to be verified. [Ford, *supra*]

The proper brokerage activity for disclosing the operating costs and deposits incurred to occupy and operate leased space include:

- the preparation of an operating cost sheet by the owner (or property manager) of each available space, with or without the assistance of a leasing agent, which is **signed** by the owner;
- a comparison by the user and the user's broker of the costs to operate in this space against the cost of operating in other space; and
- a review of the economic (cost) impact of the rent and other operating expenses for this space against operating costs and rent incurred in other qualifying space.

With documentation and a comparative analysis of rent and operating costs completed, the user and the user's broker can intelligently negotiate the best lease arrangements for the user.

Occasionally, a property owner may want to be "tight-lipped" about the operating data due to various different arrangements with numerous tenants. Thus, the owner (or his broker) will insist a **confidentiality agreement** be entered into by the prospective tenant before any data is released.

Chapter 15 Tenant profiles

This chapter details a tenant's needs and desires to be considered by a broker when locating space for the tenant.

Get the negotiations rolling

A broker negotiating a nonresidential lease on behalf of a client needs to possess a high level of knowledge and expertise regarding the aspects of leasing, including:

- the economic and financial attributes of lease agreements;
- the legal consequences of each document affecting the right to possession, called the *lease*; and
- the tax implications of the lease transaction.

These aspects of leasing arrangements are separate but in addition to the physical condition or operating costs a tenant incurs.

The level of the broker's **technical expertise** sets his ability to ascertain the needs and requirements of a client to attain the client's objectives, whether the client is a landlord or a tenant. On comprehension of the objectives, the broker can either locate a suitable tenant, called a *user*, or property, called *space* or *premises*, and begin lease negotiations.

Most nonresidential tenants are completely consumed by their business. They usually do not have sufficient time to devote to the decisions to be made in real estate leasing transactions. Further, the amount of rent a tenant pays for space is generally between 1.5% and 4% of their gross revenue, with the exception of high-traffic retail locations.

Most landlords are concerned primarily with efforts to get vacant space rented. Consequently, landlords and tenants rely on brokers as their leasing agents to put the lease package together, consisting of property data and lease documents.

The final lease agreement negotiated by a leasing agent will be the result of:

- the relative bargaining strength of the landlord and tenant in the current market conditions;
- the time the landlord and tenant are willing to devote and the urgency given to negotiating the leasing details;
- the expertise exercised and attention given to details by their respective leasing agents; and
- local market conditions affecting demand for the property and rent amounts.

The broker typically gets the negotiations started with a an offer or letter of intent (LOI). Once negotiations are underway, the broker's advice helps shape the final terms. The broker generally drafts the LOI, the lease agreements and closes the transaction. Landlords with larger leasing operations often prepare their own documents "in house," or retain legal counsel to do so.

A leasing agent best determines the **tenant's intentions** for leasing property by preparing:

- a *tenant lease worksheet* to assess the tenant's space requirements and, with financial statements, the financial condition of the tenant's business [See Form 555 accompanying this chapter]; and

- an *offer to lease* to commit the tenant so an acceptance by the landlord will bring about an enforceable contract set by the terms of a lease agreement. [See **first tuesday** Form 556]

A LOI will probably precede the tenant's actual offer in an effort to "feel out" the landlord.

List the tenant

With or without a written retainer agreement with a tenant, the leasing agent who undertakes the task of locating space for the tenant assumes **agency obligations** to act on behalf of, and in the best interest of, the tenant.

However, without a written agreement, the prospective tenant is not obligated to the leasing agent (broker) to pay, or see to it he is paid, a brokerage fee. [**Phillippe** v. **Shapell Industries, Inc.** (1987) 43 C3d 1247]

Thus, the prudent leasing agent only undertakes the duty to represent a tenant when the tenant enters into and signs an exclusive authorization to locate space. [See **first tuesday** Form 111]

Under a tenant's exclusive authorization to locate space, the broker is formally retained as the tenant's representative. Thus, the broker will be paid a leasing fee, either by the landlord or the tenant, if the tenant enters into a lease for the type of property described in the tenant's exclusive authorization agreement.

Tenant conferences

A leasing agent should investigate and confirm for himself **why the tenant wants to move** if he is to better understand the user's needs.

For example, the tenant's existing space may have become too large or too small for his current or future needs. Alternatively, the tenant may be arguing with his current landlord over:

- the rent, common area maintenance charges (CAMs) or assessments when renewing a lease;
- the tenant's current space requirements that conflict with space provided for under an option to renew or extend; or
- a lease assignment or sublease of a portion of the leased space.

By uncovering the precise reasons for moving, the broker is better able to find a suitable new location and premises, or negotiate a renewal or extension of the tenant's current lease.

When a prospective tenant is starting a new business, the leasing agent must get information on the tenant's **business projections** at the outset. A tenant's new business projections may be overly optimistic. He may want space that is simply too large or in too expensive a location. The tenant may have to settle for incubator space in a less desirable location which accepts "start-up" business tenants. Rent might be paid by the landlord accepting a fractional participation in the ownership of the tenant's business.

Conversely, a tenant may underestimate the potential future growth of his business. The premises he favors may be too small to absorb his growth, frustrating later attempts to expand. The tenant will be forced to relocate again prematurely. Options or the right of first refusal on additional space, or a lease cancellation or buyout provision to vacate the premises, may be the answer.

Also, overprojection of the potential income of a business under a percentage-rent lease will reduce the landlord's projected rental income. Unless the leasing agent considers the space needs and gross income

TENANT LEASE WORKSHEET

1. GENERAL INFORMATION:

Tenant's name: _____

Business Address: _____

Phone: _____ Fax: _____

E-mail: _____

Type of business: _____

2. Information on space presently occupied by tenant:

2.1 Type of building: ☐ Multi-tenant ☐ Free-standing

2.2 Location: ☐ Good ☐ Poor ☐ Adequate

2.3 Suitability to business: ☐ Good ☐ Poor ☐ Adequate

2.4 Square feet: _____ determined by: _____

2.5 Tenant utility costs:

a. ☐ Lighting/electrical . . . . . $_____

b. ☐ Gas . . . . . $_____

c. ☐ Water . . . . . $_____

d. ☐ Other: _____ . . . . . $_____

Total . . . . . **$**_____

2.6. Tenant operating costs:

a. ☐ CAMs . . . . . $_____

b. ☐ Casualty insurance . . . . . $_____

c. ☐ Use fees . . . . . $_____

d. ☐ Real property taxes . . . . . $_____

e. ☐ Maintenance . . . . . $_____

f. ☐ Assessments . . . . . $_____

g. ☐ Property management . . . . . $_____

h. ☐ Janitorial services . . . . . $_____

i. ☐ Parking . . . . . $_____

j. ☐ Fire insurance . . . . . $_____

k. ☐ Other: _____ . . . . . $_____

l. ☐ Other: _____ . . . . . $_____

Total . . . . . **$**_____

2.7 Rooms/offices:

☐ Offices . . . . . _____

☐ Reception area . . . . . _____

☐ Storage rooms . . . . . _____

☐ Kitchen . . . . . _____

☐ Conference rooms . . . . . _____

☐ Lab/R&D rooms . . . . . _____

☐ Rest rooms . . . . . _____

☐ Dressing rooms . . . . . _____

☐ Computer rooms . . . . . _____

☐ Hallways . . . . . _____

☐ Lunch room . . . . . _____

☐ Other . . . . . _____

2.8 Tenant improvements and trade fixtures: _____

_____

3. Information on space sought by tenant:

3.1 Type of building: ☐ Multi-tenant ☐ Free-standing

3.2 Location preference: ☐ Downtown ☐ Suburbs ☐ Rural

City: _____ County: _____

3.3 Access needed:

☐ Residential	☐ Legal/civic centers	☐ Shopping centers
☐ Agricultural	☐ Hotels	☐ Restaurants
☐ Industrial	☐ Libraries	☐ Redevelopment areas
☐ Mountain areas	☐ Universities/colleges	☐ Government-state
☐ Freeways	☐ Financial services	☐ Government-federal
☐ Public transit	☐ Warehouses	☐ Publishing houses
☐ Parking	☐ Office centers	☐ Manufacturing centers
☐ Airports	☐ Convention centers	☐ Disposal facilities
☐ Coastal	☐ Sports facilities	☐ Trains
☐ Shipyards	☐ Near competition	☐ Other
☐ Trucking	☐ Medical/hospital	

3.4 Space needs:

a. Square feet: _____

b. Rooms/offices:

☐ Offices	_____	☐ Storage rooms	_____
☐ Conference rooms	_____	☐ Rest rooms	_____
☐ Computer rooms	_____	☐ Lunch rooms	_____
☐ Reception area	_____	☐ Kitchen	_____
☐ Lab/R&D rooms	_____	☐ Dressing rooms	_____
☐ Hallways	_____	☐ Other	_____

3.5 Physical plant needs:

☐ Signs	_____	☐ Ceilings	_____
☐ Stairwells	_____	☐ Walls	_____
☐ Finishing	_____	☐ Floors	_____
☐ Partitions	_____	☐ Painting	_____
☐ Carpeting	_____	☐ Ramps/parking	_____

3.6 Utility needs:

☐ Lighting/electrical	_____	☐ Computer	_____
☐ Water	_____	☐ Gas	_____

4. Tenant business goals:

4.1 Short term (3-5 years):

_____

_____

_____

_____

4.2 Long term (5-10 years):

_____

_____

_____

_____

5. Lease terms on space now occupied by tenant:

5.1 Type: ☐ Office ☐ Shopping center ☐ Retail ☐ Industrial ☐ Light business

5.2 Term: _____ Expiration date: _____/_____/_____

5.3 Base rent $_____ payable_____

5.4 Current rent $_____ payable _____

5.5 Rent based on: ☐ Per sq. ft. ☐ Percent gross sales

5.6 Rental adjustments based on: ☐ CPI ☐ Other index
☐ Graduated ☐ Fixed ☐ Reappraisal

5.7 Security deposit:. . . . . $_____

5.8 Prepaid rent: . . . . . $_____

5.9 Options to renew/extend: ☐ Yes ☐ No

5.10 Option to buy: ☐ Yes ☐ No

5.11 Option to lease additional space: ☐ Yes ☐ No

5.12 Lease assignment: ☐ Freely ☐ Landlord consent

5.13 Other terms: _____

5.14 Landlord's name:_____

Business address:_____

Phone:_____ Fax:_____

Agent's name: _____

Phone:_____ Fax:_____

6. Lease terms sought:

6.1 Desired monthly base rent: $_____

6.2 Rent based on: ☐ Per sq. ft. ☐ Percent gross sales

6.3 Rental adjustments based on:
☐ CPI ☐ Other index
☐ Graduated ☐ Fixed ☐ Reappraisal

6.4 Landlord responsibility for utilities:
☐ Lighting/electrical ☐ Gas
☐ Water ☐ Other

6.5 Landlord responsibility for operating costs:
☐ Maintenance ☐ Insurance
☐ Property mgmt. ☐ Parking
☐ Use fees ☐ Janitorial
☐ Taxes ☐ Other

6.6 Common area maintenance provision cap:
☐ _____ per sq. ft. ☐ _____% per year

6.7 Security deposit: . . . . . $_____

6.8 Prepaid rents: . . . . . $_____

6.9 Options to renew: ☐ Yes ☐ No

6.10 Option to buy: ☐ Yes ☐ No

6.11 Option to lease additional space: ☐ Yes ☐ No

6.12 Lease assignment: ☐ Freely ☐ Landlord consent

6.13 Miscellaneous information: _____

_____

_____

_____

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of a user, the leasing agent's long-term service to either the landlord or tenant is limited. Thus, the leasing agent needs to develop a system to match up the right landlord with the right tenant.

Using a tenant lease worksheet

Consider a tenant who runs an insurance agency that has more employees and files than the premises it now occupies will accommodate. The tenant has three agents and a support staff of eight people, including secretaries, an office manager and a full-time computer technician and webmaster.

The tenant expects the business to continue to grow and require a larger space to meet his present and expanding needs.

The tenant contacts a leasing agent to locate a new facility with tenant improvements suitable for his staff to occupy the space. The leasing agent explains he is the leasing agent for a number of landlords in the area and should be able to find suitable space for the tenant. If needed, planners are available to design the use of the space and specify the tenant improvements for occupancy.

The leasing agent prepares a *tenant lease worksheet*. [See **first tuesday** Form 555]

The **worksheet** itself covers three key areas the leasing agent must consider and analyze:

- the tenant's current lease conditions and existing space;
- the tenant's current and future needs for leased space; and
- the tenant's financial condition and creditworthiness.

Regarding the tenant's existing space, the leasing agent will determine:

- the type of building;
- the square footage;
- the monthly operating and utility costs; and
- the tenant improvements and trade fixtures.

A necessary review of the tenant's current lease includes:

- the expiration date;
- monthly rent and period adjustments and assessments;
- the obligation to continue to occupy the premises;
- the obligation to restore the premises or remove fixtures;
- options to extend or renew the lease or buy the premises;
- the tenant's ability to assign or sublease; and
- the amount of the security deposit.

These facts will help the leasing agent determine the tenant's rights and obligations under his present lease. When representing the tenant, the leasing agent must point out and explain, to the best of his ability, his knowledge of the beneficial or detrimental effect any lease provisions have on the tenant.

When representing an owner, the leasing agent will advise him which **terms** the tenant is unhappy with and which lease provisions are "throw away" clauses, designed for negotiations, since they are of little or no concern to the owner and are used as bargaining chips.

Locating new space

Next, the leasing agent ascertains the tenant's needs and goals for the new space.

Regarding the space requirements, the leasing agent will need to uncover the tenant's:

- current square footage needs;
- future square footage needs;
- phone, utilities and computer facility needs;
- heating and air conditioning requirements;
- parking, docking, turn-around and shipping requirements;
- access to freeways, airports and other public transportation;
- access to civic, financial, legal, governmental or other "downtown" facilities;
- response time for police and fire departments;
- access to housing areas; and
- any needs peculiar to the tenant.

Some tenants may focus on specific **geographic locations** in the business market or population centers. Others may need the **lowest rent** possible, regardless of location.

On completing a tenant lease worksheet, the leasing agent discovers the tenant wants to:

- stay in the same community because of his many strong business and social ties to the area;
- keep his rent fixed or have predictable (fixed) annual adjustments over the next three to five years; and
- move closer to the freeway for quick access to customers in outlying areas.

The tenant currently needs 4,000 square feet to accommodate:

- four private offices;
- a computer room;
- a reception area;
- a conference room;
- a storage room;
- restrooms;
- a lunch room; and
- areas for sales staff and secretaries.

Financially, the business is profitable, but the tenant wants to keep rent at a minimum. Additionally, the tenant is concerned future inflation will mount. Thus, he does not want his rent adjustments tied to the Consumer Price Index (CPI). If they must be, then a ceiling needs to be set on any annual rise in the CPI.

Also, the leasing agent might suggest negotiating for an **option to lease** additional space if the tenant's business increases, requiring more space for expansion (and an additional fee for the leasing agent if exercised).

Finally, the leasing agent and the tenant need to discuss the rental terms available in the leasing market. Several provisions in leases have a financial impact, favorable or not, on the landlord and the tenant. **Financial provisions** in a lease agreement include:

- base monthly rent;
- periodic rental adjustments (CPI, percentage or rollover);
- responsibility for maintenance expenses (CAMs);

- assessments of real estate taxes and insurance premiums;
- government ordered retrofitting;
- structural, roofing and HVAC maintenance;
- lease assignability and subletting authority;
- options to renew or extend, or to buy;
- personal guarantees or letters of credit; and
- tenant improvements.

Chapter 16 Offers to lease

This chapter discusses the importance of written negotiations when entering into a nonresidential lease.

Negotiating the nonresidential lease

Once a leasing agent locates suitable premises for a prospective tenant, the agent must bring the landlord and tenant together through negotiations to develop the terms of a lease acceptable to all.

The role the broker plays in negotiations and his duties as a leasing agent depends on who he represents in the transaction: the landlord, the tenant or both. How aggressive a role a broker may play depends on the bargaining power given to the landlord or tenant during the current phase of the cyclical market conditions.

When representing the tenant, the broker must initially determine his client's need for space and the rental amount he is willing and able to pay for the space. This information is gathered on the tenant lease worksheet reviewed and prepared when first interviewing the tenant. [See **first tuesday** Form 555; see Chapter 16]

When representing the landlord, the broker must know the rental terms and leasing conditions sought by the landlord to rent the space. Usually, this data is set out in the exclusive authorization to lease property. [See **first tuesday** Forms 110 and 590]

The offer to lease

Whether a broker represents the tenant or the landlord, the broker initiates negotiations most efficiently by preparing an **offer to lease** form for the tenant to review and consider for signing. [See Form 556 accompanying this chapter]

The tenant enters into the offer to lease much like a buyer reviews and signs an offer to purchase real estate.

For example, a **tenant** under an offer to lease, which is accepted by a landlord, acquires a right to possession which the landlord agrees to *convey* to the tenant for a set period of time under the lease.

Likewise, a **buyer** of a real estate interest under a purchase agreement acquires either an existing leasehold (held by and being sold by an existing tenant) or fee title (from the owner), which will be conveyed to the buyer by an assignment or deed.

Thus, like a sales transaction, the arranging of a lease transaction has two phases:

- the offer and acceptance (agreement to lease); and
- the drafting and signing of the lease agreement and delivery of funds and possession (the conveyance of the leasehold interest on closing).

In the leasing situation, the broker, the landlord or the landlord's attorney prepares and handles all the closing instruments, such as the lease agreement and transfer of funds.

OFFER TO LEASE
And Receipt of Deposit

DATE:_____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

Received from _____

the sum of $_____evidenced by ☐check, or_____☐,payable to _____,

to be held undeposited until acceptance of this offer as a deposit toward the leasing of the following premises:

_____

The following checked addendums are part of this offer to lease:

☐ Plat of the premises ☐ Tenant's credit application [**ft** Form 302] ☐ Tenant's financial statements

☐ Right of first refusal to buy ☐ lease agreement form ☐ Option to renew/extend [**ft** Form 565]

☐ Option to buy [**ft** Form 161] ☐ _____

TERMS:

1. The commencement date of the lease to be _____, 20_____, and the expiration date to be _____, 20_____.

2. The monthly rent to be payable in advance as follows:

2.1 ☐ Monthly rent to be fixed at $_____ until expiration of the lease. Holdover rent to be $_____ daily.

2.2 ☐ Monthly rent to be adjusted from a monthly base rent for the first year of $_____. On each anniversary date of the lease, the monthly base rent shall be adjusted upward only based on the annual increase in the Consumer Price Index for All Urban Consumers (CPI-U) for:

☐ Los Angeles-Anaheim-Riverside ☐ San Diego ☐ Other index _____

☐ San Francisco-San Jose-Oakland ☐ National ☐ Capped at a _____% annual increase

2.3 ☐ Monthly rent to be graduated on each anniversary under the following schedule:

a. Base year monthly rent of $_____, and on each anniversary month an upward adjustment, to the monthly rent of _____% over the prior year's monthly rent; or _____

_____

b. Base Year: $_____ Second Year:$_____ Third Year: $_____

Fourth Year: $_____ Fifth Year: $_____ Sixth Year: $_____

2.4 ☐ Rent to be the greater of _____% of monthly gross sales/receipts or the total of other rents, taxes insurance and common area maintenance (CAMs) checked in this offer.

2.5 ☐ Monthly base rent to be adjusted upward to current market rental value every _____ years.

3. The utility expenses for the space leased to be paid as follows:

Tenant to pay: _____

Landlord to pay: _____

4. ☐ Common Area Maintenance (CAMs) costs for maintaining and operating of the common areas are to be paid by Tenant based on his proportionate share of the total space leased on the premises, or _____% of the CAMs. The CAMs charge shall be assessed: ☐ monthly, or ☐ quarterly, and payable within 10 days. The CAM change will not exceed ☐ _____% of the rent; ☐_____ cents per square monthly, or _____.

5. Real estate taxes and assessments on the real estate shall be paid by ☐ Landlord, or ☐ Tenant.

5.1 Any taxes and assessments paid by Tenant to be capped at a _____% annual increase.

6. A security deposit of $_____ to secure the performance under Tenant's lease to be paid on signing of the lease.

7. ☐ Tenant to have the option to renew or extend the lease as set forth in the attached option to renew/extend. [**ft** Form 565]

8. Tenant may assign, sublet or encumber the leasehold interest subject to Landlord's consent:

9. Tenant's intended use of the premises includes:_____

_____

10. Landlord to make improvements prior to the time Tenant is to take possession as follows: _____

_____

11. Tenant to make improvements as follows: _____

_____

_____

12. Tenant may exercise the right to lease additional space from Landlord as follows (note the premises, rent, terms, and period): _____

_____

13. Tenant to maintain insurance on the premises to cover any casualty loss in the amount of $_____.

14. Landlord and Tenant to sign a lease to be prepared by ☐ Tenant, or ☐ Landlord on a form entitled _____ published by _____

15. Parties to pay Broker(s) a fee of ☐ see attached fee schedule [**ft** Form 113], or ☐ _____ _____, as follows: Landlord to pay the brokerage fee on transfer of possession. The party wrongfully preventing a examples of possession to pay the brokerage fee. Landlord's Broker and Tenant's Broker, respectively, to share the brokerage fee _____:_____.

16. This offer shall be deemed revoked unless accepted in writing and personally delivered to Tenant or Tenant's Broker on or before _____, 20_____.

17. _____

_____

_____

_____

_____

_____

_____

Landlord's Broker: _____	Tenant's Broker: _____
By: _____	By: _____
Is the agent of: ☐ Landlord exclusively, or ☐ both Landlord and Tenant.	Is the agent of: ☐ Tenant exclusively, or ☐ both Landlord and Tenant.
I agree to the terms stated above.	**I agree to the terms stated above.**
Date: _____, 20_____	Date: _____, 20_____
Landlord: _____	Tenant: _____
Agent: _____	Tenant: _____
Signature: _____	Signature: _____
Address: _____	Signature: _____
_____	Address: _____
Phone: _____	_____
Fax: _____	Phone: _____
E-mail: _____	Fax: _____
	E-mail: _____

Leasing is usually accomplished without the benefit of a formal escrow. If documents are to be recorded, such as occurs in a long-term leasing transaction, a title officer and title insurance company become involved with a title search and issuance of a policy of leasehold title insurance.

Contents of the offer

An *offer to lease* sets forth the crucial elements of the leasing arrangements. [See Form 556]

An **offer to lease**, like an offer to purchase, contains four sections:

1. Identification of the parties and premises.
2. Rental payment schedules and period of occupancy.
3. Property maintenance and terms of possession (use).
4. Signatures of the parties.

A floor plan or common description of the premises is usually attached by a reference to it in the identification section.

The tenant should be asked to include a good faith deposit as would be asked of a fee simple buyer under a purchase agreement. The check for the deposit should be made payable to a broker involved, not the landlord.

The section of the offer setting forth the rental payment schedule is a **checklist** of various rental arrangements which can be selected by the tenant to pay rent, including:

- the duration/term of the initial leasing period;
- the monthly base rent for the first year;
- any rental adjustments during the leasing period for inflation and appreciation;
- responsibility for payment of utilities;
- any common area maintenance charges (CAMs);
- any assessment for insurance or taxes;
- the amount of the security deposit; and
- options to renew or extend the leasing period or to buy the property.

It is good brokerage practice to reference and attach a copy of the proposed lease agreement form to the offer as it includes boilerplate provisions covering:

- the **responsibility** for property operating and maintenance expenses;
- the **right to sell**, sublet or encumber the lease; and
- **default remedies**.

In the offer's miscellaneous leasing provisions, the tenant and landlord further agree to other terms peculiar to leasing, including:

- the tenant's proposed use;
- the lease agreement form to be used;
- responsibility for tenant improvements;
- any alterations by the tenant;
- brokerage fees; and
- the time and manner for accepting the offer to lease.

Some landlords initially present prospective tenants with fully prepared but unsigned lease agreements, a condition which generally works to the landlord's advantage. The parties then orally negotiate the final terms.

To better clarify negotiations, the broker should write up the offer to lease (and counteroffers) and, within the offer-counteroffer context, develop acceptable terms based on signed offers and counteroffers. Expectations are properly reached and negotiations are memorialized in writing to avoid later conjecture (and litigation).

The final section of the offer to lease is the signature section where the landlord and tenant sign and agree to the terms stated in the offer.

Offers to lease vs. proposals

By signing an offer to lease prepared by a broker, a prospective tenant initiates the negotiations in earnest. The landlord's acceptance concludes the search for space.

The key difference between an offer and a **proposal to lease** or letter of intent (LOI) is that the offer can be *accepted* to form a binding contract and the proposal is a mere *solicitation* and inquiry into the landlord's intentions binding on no one.

Solicitations, such as a proposal or LOI sent to the landlord or his leasing agent by the tenant's agent, require the landlord, should he respond, to "negotiate with himself" or to clarify his previously announced terms and conditions. No offer exists for the landlord to accept or counter. If the landlord responds, he should make an offer in writing, which forces the leasing agents to submit the offer to lease to the tenant for an acceptance, counteroffer or rejection.

A proposal merely evidences a tenant's or landlord's intent to gather and provide leasing information. The tenant and the landlord are not yet ready to make a binding commitment, otherwise an offer would be submitted by one or the other.

Leasing agents who use their accumulated knowledge and skills can and should do better than proposals, unless the tenant is not yet ready to be bound due to concurrent negotiations with other landlords.

Counteroffers focus on negotiations

To form a binding agreement to lease, an offer or counteroffer must be accepted in its entirety and without qualification or alteration. [Calif. Civil Code §1582]

When the landlord or tenant conditions his acceptance of an offer to lease by changing or adding specific terms, acceptance does not occur and a binding agreement to lease is not formed. [CC §1585]

The added conditions or changes establishes a rejection of the offer and creates a *counteroffer*. To avoid alteration of a signed document (the offer or lease), a counteroffer form referencing the signed document should be prepared, signed and submitted for the other party to then accept, reject or further counter.

Thus, if the offer to lease is not acceptable to the landlord (or the tenant), he can counter by using a counteroffer form to state terms which are acceptable. [See **first tuesday** Form 180]

As the negotiations in writing continue, an acceptable set of terms develops by the use of counteroffer forms. Written counteroffers keep the parties focused on the remaining unnegotiated details and demon-

strate serious consideration by all — as indicated by a deposit and credit application delivered with the offer.

After acceptance of the offer or counteroffer to lease, only the preparation of the lease agreement (and other closing documents), transfer of possession and the payment of the security deposits and initial rent remain to close the lease transaction (tenant improvements notwithstanding).

Interference with negotiations

Consider a landlord who is currently negotiating with the CEO of a company to enter into a lease agreement. A competing landlord (or his broker) actively solicits officers and board members of the company to lease space from him instead.

Ultimately, the company enters into a lease agreement with the competing landlord.

The landlord who lost out seeks to recover lost rent from the competing landlord, claiming the competing landlord *intentionally interfered* with his prospective economic advantage. The landlord claims the competing landlord induced the officers and board members to consider and accept the competing landlord's proposal while he was **completing negotiations** with the company's CEO.

However, a competing landlord has a right to solicit a tenant who he knows is negotiating with another landlord as a *privilege of competition*. The competing landlord did not engage in unlawful interference since the company had not yet finalized negotiations by entering into an enforceable agreement to rent space from another landlord.

A landlord who has not yet entered into a binding offer to lease or lease agreement does not hold an economic advantage (in the form of a binding contract) with which a competing landlord may not interfere. [**San Francisco Design Center Associates** v. **Portman Companies** (1995) 41 CA4th 29]

Chapter 17 Residential tenant credit checks

This chapter delves into the background check a landlord or property manager should complete to analyze a prospective tenant's creditworthiness.

Protection for landlords and brokers

A landlord's and property manager's initial analysis of the capability and willingness of a prospective residential tenant to meet obligations imposed by a rental or lease agreement is based on information obtained by:

- a completed **credit application** from the tenant [See Form 302 accompanying this chapter];
- a **credit clearance** through a credit reporting agency as authorized on the credit application; and
- an **unlawful detainer (UD) clearance** through a consumer reporting agency.

Besides relying solely on financial ratios and formulas to analyze the suitability of an individual as a tenant, a residential landlord on receipt of an application to rent should:

- call prior landlord(s) to confirm the amount of the prospective tenant's prior rent, payment history and personal conduct as an occupant on the premises;
- call the current employer to confirm the employment data on the application;
- confirm other sources of income, expenses and amount of indebtedness disclosed in the credit application; and
- determine whether the prospective tenant can afford the payments.

The investigation and analysis of the credit information received on prospective tenants is critical to a landlord's or property manager's successful operation of residential rentals in the high mobility environment of California rental residents, especially when they lack longevity in the community or with an employer.

Collecting relevant information

Accurate credit and background information is needed on each prospective tenant to properly analyze the business risk of collecting payments from the prospective tenant and that the tenant will properly use and maintain the property.

Owners and property managers of income-producing property need information to make decisions to accept or reject prospective tenants, such as the existence of prior evictions, late rent payments, bounced checks or other breaches of lease agreements.

A conclusion on creditworthiness is drawn from the tenant's **credit history** and **financial statements**.

Credit information is easily and inexpensively obtained. While readily available, it does take some time and concentration to collect and confirm the information.

A property manager in the course of his brokerage business makes decisions and advises landlords on the ability (income) and willingness (payment history) of tenants to pay rent and care for the premises.

CREDIT APPLICATION

Individual

DATE:_____, 20_____, at _____, California.

THIS CREDIT APPLICATION is for the amount of $_____, for ☐ rental, ☐ purchase, or ☐ borrowing.

Property address: _____

Received from Applicant(s) $_____, ☐ cash, or ☐ check, for a consumer credit report which is a non-refundable cost and not a deposit.

Received from Applicant(s) $_____, ☐ cash, or ☐ check, as a deposit toward the first month's rent on landlord's acceptance of the applicant's creditworthiness.

Applicant(s):

Applicant 1: _____
(Last Name) (First Name) (Middle Name) (Sr., Jr., etc.)

Social Sec.#: _____ Drivers Lic.#:_____State:_____

Applicant 2: _____
(Last Name) (First Name) (Middle Name) (Sr., Jr., etc.)

Social Sec.#: _____ Drivers Lic.#:_____State:_____

Additional Occupant(s): Name:_____

Name: _____

Rental History: Have you ever been party to an eviction? ☐ Yes ☐ No Filed bankruptcy? ☐ Yes ☐ No

Present Address:_____

City: _____Zip:_____

Length of Residency:_____ Monthly Rent $_____

Landlord/Agent: _____

Address:_____

City:_____ Zip:_____ Phone:_____

Reason for Moving: _____ Moving Date ____/____/____

Previous Address:_____

City: _____Zip:_____

Length of Residence:_____ Monthly Rent $_____

Landlord/Agent: _____

Address:_____

City:_____ Zip:_____ Phone:_____

Employment:

Applicant 1:

Employer:_____

Address:_____

City:_____ Zip:_____ Phone:_____

Length of Employment:_____ Position:_____Wages:_____

Pay Period:_____ Union: _____

Previous Employer:_____

Address:_____

City:_____ Zip:_____ Phone:_____

— — — — — — — — — — — — — — — *PAGE ONE OF TWO — FORM 302* — — — — — — — — — — — — — —

Applicant 2:

Employer:_____

Address:_____

City:_____ Zip:_____ Phone: _____

Length of Employment:_____ Position:_____ Wages:_____

Pay Period:_____ Union: _____

Previous Employer:_____

Address:_____

City:_____ Zip:_____ Phone: _____

Additional Income: Amount $_____ Source _____

Recipient: _____

General Credit Information:

Automobile 1 Make: _____

Year:_____ Model:_____ Lic.#/State: _____

Lender:_____

Automobile 2 Make: _____

Year:_____ Model:_____ Lic.#/State: _____

Lender:_____

Bank/branch: _____

Check Acc.#:_____ Savings Acc.#: _____

Bank/branch: _____

Check Acc.#:_____ Savings Acc.#: _____

Credit References

1: _____

Address:_____

Account #:_____ Balance due: $_____ Phone: _____

2: _____

Address:_____

Account #:_____ Balance due: $_____ Phone: _____

Personal Reference: _____

Address:_____ Phone: _____

Personal Reference: _____

Address:_____ Phone: _____

Nearest Relative (name/relationship): _____

Address:_____ Phone: _____

We declare all information given in this application is true and correct. We authorize your credit reporting agency to obtain and verify a complete consumer report and supply the information obtained to you. This information is not privileged.

Date:_____, 20_____

Name:_____

Signature: _____(Applicant 1)

Name:_____

Signature: _____(Applicant 2)

I acknowledge receipt of a copy and accompanying payment.

Landlord:_____

Signature:_____

Phone: _____

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Property managers advising landlords on the creditworthiness of tenants will find it necessary to subscribe to the services available from a *credit reporting agency* (CRA). Apartment owners' associations obtain credit information for their membership from the same private tenant screening services directly available to landlords.

One such service is the **Tenant Screening Center, Inc.** at 140 Wikiup Drive, Santa Rosa, CA 95403, 1-800-523-2381, info@tsci.com.

An initial subscription fee and a minimum charge for credit reporting services is common. In any event, the cost is passed on to the tenant either in an up-front nonrefundable credit screening fee or as a cost of doing business covered by the monthly rent.

Acquiring credit data

A credit report on an individual does not guarantee performance of the rental or lease agreement entered into by the prospective tenant or establish the prospect's ability to pay rent in the future.

However, it does reveal the prospect's previous performance in paying debts he has incurred, such as money owed on finance contracts, utility services or professional services, and whether he has incurred late penalty charges on consumer credit accounts, or been subjected to judgments or tax liens. Thus, the report gives an indication as to whether the tenant will pay rent, and do so timely.

Property managers seeking credit information must identify themselves to the credit reporting agency (CRA), state their purpose for seeking the information and certify to the CRA that the information will be used for no other purpose than stated. [Calif. Civil Code §1785.14(a)]

Even if a broker is approved by a CRA, the agency will not provide a broker credit information on just anyone. A broker seeking information on a prospective tenant will be refused service unless the tenant signs a release form for the information. [See Form 302]

The requirement that the tenant authorize the release of credit information is often waived if the broker is a member of an agency's credit association. Membership is open only to applicants who allow the agency to make a full investigation of their own creditworthiness and professional integrity. Abuse of the credit reporting service leads to termination of the service.

For a one-time membership fee and minimum monthly billing, an agency provides its members with credit reports at a pre-set cost per request.

Credit report contents

Consumer credit reports are limited to specific factual information on a prospective tenant's creditworthiness standing or capacity. **Consumer credit reports** are used to establish eligibility for:

- credit to be used for personal, family or household purposes;
- employment purposes; and
- the rental of a dwelling unit. [CC §1785.3(c)]

A *telecredit check* reviews the tenant's check writing history. The broker will be informed if the tenant has written checks on insufficient funds in the past.

The credit report includes references to the status of existing liens, loan and finance contracts, charge accounts, delinquencies, rental histories and payments, skips, damages and monies owed landlords and other creditors.

Information not available on a credit report includes:

- bankruptcies pre-dating the report by more than ten years;
- judgments pre-dating the report by the longer of seven years or the governing statute of limitations;
- unlawful detainer (UD) actions in which the landlord did not receive a *final judgment* by default, summary judgment or trial;
- paid tax liens and accounts on collection pre-dating the credit report by more than seven years; and
- criminal activity or other adverse information pre-dating the report by more than seven years. [CC §1785.13(a)]

UD reporting services

A prudent property manager uses a service which provides records on unlawful detainer (UD) actions in which the landlord prevailed by receiving a final judgment.

Some specialty credit services constantly obtain UD information from the municipal courts and landlords who subscribe to their service. These credit reporting agencies (CRAs) sell landlords information gathered from public records regarding UD evictions, and from landlords on particular tenants who have had adverse relationships with the landlords. The broker obtains more information on these tenants by contacting the landlord giving the adverse activity to the CRA.

In the early 1990s, CRAs were singled out and prohibited from disclosing the UD information needed by the landlords to analyze their risks. The prohibition was based on the claim the state had an interest in maintaining the availability of rental housing to all individuals, despite their adverse credit history. However, without the information, landlords are unable to analyze the risk they undertake by renting to a particular prospect.

Today, credit agencies may collect and report UD evictions since the statute prohibiting credit agencies from reporting UD actions is unenforceable since it violates the First Amendment rights of landlords. [**U.D. Registry, Inc.** v. **State** (1995) 34 CA4th 107]

However, a tenant, on request, is entitled to a clarification by the agency of the disposition of the UD action if the initial report, while technically true, is misleading or incomplete. [**Cisneros** v. **The U.D. Registry, Inc.** (1995) 39 CA4th 548]

Investigative reports go further

Investigative consumer reports provide information on a tenant's character, reputation, personal characteristics and mode of living.

This information is obtained through personal interviews with neighbors, friends and associations of the tenant.

Investigative consumer reports can be used for:

- insurance or employment purposes; and
- the rental of a dwelling unit. [CC §1786.12(d)]

Editor's note — Investigative consumer reports are commonly used by landlords when hiring a property manager or resident manager, or entering into a percentage lease with a tenant. Before obtaining an

investigative consumer report, a landlord must notify and receive written permission from the prospective employee or tenant to retrieve and use the investigative consumer report for employment or leasing purposes. [CC §1786.12; 15 USC §1681b]

Prior rental history inquiries

Additional information on the tenant's creditworthiness and character is readily available to property managers by contacting the tenant's previous landlord. Critical questions to be asked of the prior landlord include:

1. Did the tenant cause any damage to the rental property?
2. Was the rent paid on time every month? Were partial payments made?
3. Were any late charges incurred, and if so, were they demanded and did the tenant pay the late charges?
4. Was the tenant ever served a 3-day notice?
5. Did the tenant leave on friendly terms?
6. Did the tenant care for and maintain the premises?
7. Did the tenant abide by restrictions in the lease (i.e., pets, guests, building policy, etc.)?
8. Did the tenant interfere with or endanger other tenants?

If, after investigating a prospective tenant's background, it seems likely the tenant will mismanage his use of the property, damage or contribute to the deterioration of its physical appearance or otherwise diminish its value for other tenants, a prudent landlord or property manager may not be willing to lease to the prospect or consent to his assumption of an existing lease.

Evaluating credit information

Once a property manager has obtained the necessary credit information on the tenant, the data must be **evaluated**.

Information provided on forms filled out by the tenant, brokers and landlords must not be used to discriminate against any tenant based on his race, color, religion, sex, sexual orientation, marital status, national origin, ancestry, familial status or disability. [Calif. Government Code §12955]

However, when applying **income-to-debt** or **income-to-rent** ratios as guidelines to determine a tenant's creditworthiness, each tenant should be treated individually. A tenant who does not meet an income ratio is not necessarily a credit risk if they have a strong balance sheet (assets and net worth).

However, a landlord or property manager may analyze a prospective tenant's capability to pay the amount of rent sought by the landlord by applying a ratio or formula, such as a "three-to-one" income-to-rent ratio, as the only basis for determining the tenant's creditworthiness. [**Harris** v. **Capital Growth Investors XIV** (1991) 52 C3d 1142]

Income-to-debt ratios and percentage income-to-rent standards assume all prospective tenants who do not meet the ratio or percentage are unable to pay simply because they do not meet an arbitrary mathematical formula adopted by the landlord or property manager. However, the exclusive use of qualifying ratios to qualify prospective tenants sacrifices a thoughtful review of a prospective tenant's ability to pay rent and maintain the premises.

A more thorough review based on the tenant's financial statements and occupancy history, rather than a quick, mechanical test of the tenant's financial ability, will often yield tenants of better financial capacity than those who are merely employed.

Denied due to bad credit

Any tenant refused occupancy or subjected to increased rent or security deposit due to the risks posed by the information contained in a credit report must:

- be **told** so by the landlord or property manager relying on the credit report; and
- be given the **name of the service** who issued the credit report. [CC §1787.2]

Any consumer who is denied credit, i.e., refused as a tenant for lack of creditworthiness, must be informed he is entitled to a written statement from the landlord or property manager of the reasons for the denial. [CC §1787.2(b)(2)(i)]

Nonrefundable fees for credit reports

A residential landlord may charge a prospective tenant a nonrefundable *credit screening fee* to cover the costs of obtaining information about the prospective tenant. [CC §1950.6(a)]

The information requested by the landlord for which the fee may be charged includes personal reference investigative and credit reports.

The amount of the applicant **screening fee** may not exceed $38.97 (for 2007) or the lesser amount of:

- out-of-pocket costs for gathering the information; and
- the costs of the landlord's time in obtaining the information. [CC §1950.6(b)]

The screening fee ceiling is adjusted annually based on increases in the Consumer Price Index (CPI). The base year is 1997 and the amount was set at $30. The CPI figure for 1997 is 158.7 (from December 1996).

For the year 2007, the maximum amount of the applicant screening fee is $38.97, a 29.9% increase from the amount set for 1997. This amount reflects the increase in the CPI from 1997 (158.7) to the figure of 206.2 from December 2006 used to compute the 2007 maximum screening fee amount. The West Urban CPI is used in this example although the statute does not specify which CPI a landlord or property manager must use. [CC §1950.6(b)]

The landlord has an affirmative duty to provide the prospective tenant with an itemized receipt of the out-of-pocket expenses and the time spent to obtain and process the tenant's credit information. [CC §1950.6(d)]

If a personal reference check is not performed or a consumer credit report is not ordered, the landlord must refund any amount of the screening fee not used. [CC §1950.6(e)]

Further, **on request** from the prospective tenant, the landlord must provide the prospective tenant with a copy of the consumer report obtained by the landlord. [CC §1950.6(f)]

An applicant screening fee may not be charged when a rental unit is presently unavailable or will not be available within a reasonable period of time. [CC §1950.6(c)]

Editor's note — A reasonable time is probably the time period required to notice the termination of a tenancy, such as under a notice to vacate.

Chapter 18 Nonresidential tenant screening

This chapter explores the inquiry a landlord or property manager should make into a prospective nonresidential tenant's background before agreeing to let space.

Qualified to stay and pay

An owner's leasing agent, when reviewing an application to rent from a prospective nonresidential tenant, has a duty to the owner to review the tenant's qualifications from much the same standpoint a commercial lender would review a person's qualifications to borrow money.

Like lending money, leasing real estate is an extension of credit. Rent paid for the use of property is comparable to interest paid for the use of money. Both financial arrangements have the same economic function since each generates a rate of return — one called rent, the other called interest.

Further, the owner conveys to the tenant the right to use the property, comparable to a lender advancing money for use by a borrower. Both are on loan. Finally, property let to a tenant must be returned to the owner, just as money lent to a borrower must be returned to the lender.

Thus, the leasing agent and landlord analyze the creditworthiness of the prospective tenant as if they were arranging and making a commercial loan for the same period of time. In other words, is the prospective tenant *qualified* to take possession of the property, pay for its use in a timely manner and return it undiminished as agreed?

A *credit report* provides only partial information on a nonresidential tenant's creditworthiness, information which is publicly available. Credit reports do not evaluate the tenant's managerial ability to successfully operate his trade or business, nor do they consider the tenant's assets (net worth) or the profitability of the business. However, *investigative reports* carry this type of information.

A tenant, on inquiry from a leasing agent, can provide *financial statements* on his company. The tenant's business income, expenses and net operating income (NOI) are disclosed in the tenant's *profit and loss statement*, a type of **financial statement**. The tenant's *balance sheet* is a separate financial statement which sets forth the tenant's net worth (assets) and liabilities (debts).

In the unlikely event a tenant does not have a computer generated financial statement for his company, such as occurs with a start up company, financial statement forms are available from institutional lenders and publishers of forms for tenant's to fill out.

The information contained in financial statements supplied voluntarily by the tenant should be confirmed by the owner or his leasing agent. Most credit agencies will perform this activity for a fee. The credit application usually supplies the name and address of banks and creditors of the tenant's company.

Leasing agents can also check out the property currently occupied (leased or owned) by nonresidential tenants to see if a failure to care for or maintain the property occurred during the tenant's occupancy. A diminished property value on the tenant's return of possession is what an owner wants to avoid. Investigating the tenant's behavior before entering into a leasing agreement will help establish a better level of certainty about what risk the tenant poses for the owner.

For managers of nonresidential property, the added dimension of the tenant's business operations and conduct must be considered. The tenant's business acumen and style of marketing from the premises will have an affect on occupants of adjacent space.

Also, the leasing agent's review of a substitute tenant who is seeking the owner's consent to allow him to assume an existing tenant's nonresidential lease and occupy the premises must be given the same review the owner would give a prospective tenant negotiating a new lease on the space.

Tenants who seek possession of a property under a sublease or by an assignment of an existing lease which contains an alienation provision calling for the owner's consent "on the condition it will not be unreasonably withheld," must be subjected to no different standards for consent to assume the lease than are used to qualify new tenants.

The use of different qualifying standards represents an unreasonable interference with the nonresidential tenant's right to sell his business and transfer the leasehold with the right of the substitute tenant to continue to occupy the premises for the remaining term.

Purpose of background checks

A nonresidential manager, leasing agent or owner conducts a **background check** on a new tenant to determine his:

- credit history (evidence of debt and payment as agreed);
- financial status (income, expenses, disposable income, assets, liabilities and net worth);
- business track record and proposed business plans;
- compatibility in terms of the tenant's business conduct with other tenants and class of clientele; and
- ability to manage his business and maintain the property's value.

Credit and financial history

Before a prospective tenant's credit and financial history can be analyzed by the owner, the prospective tenant must complete a *credit application*, also called an *application to rent*. On receiving the tenant's **credit application**, the owner and his leasing agent can begin the process of verifying the tenant's payment history based on the information supplied by the tenant and reports ordered out from credit agencies. [See **first tuesday** Form 302; see Chapter 20]

Specifically, the owner or his leasing agent should contact the tenant's past landlords to ascertain the tenant's:

- rental payment record;
- day-to-day upkeep and appearance of the leased space;
- clientele profile and compatibility with clientele of other tenants; and
- ability to cooperate with other tenants.

Any possible adverse information, such as foreclosures, bankruptcies, tax liens, evictions, violations of use ordinances or records of arrests, should be given weight when analyzing the tenant's acceptability. Litigious and troublesome tenants are to be shunned since they come with baggage and attitudes adverse to problem-free landlord-tenant relationships.

Business track record

Extensive financial data on the prospective tenant's business is readily available to the owner on an inquiry of the tenant. Financial information on the tenant's business operations are typically provided through financial statements, including:

- profit and loss, income and operating statements for the current and preceding year; and
- a balance sheet for the last day of the prior month to the application to rent.

Attention should be focused on the tenant's:

- prior work experience;
- business or professional licenses;
- familiarity with his proposed use of the property;
- degree of responsibility;
- managerial skills;
- vocational or educational experience;
- business acumen and survivability;
- name recognition and length of time in the community; and
- civic and community involvement.

The prospective nonresidential tenant's income statement and balance sheet statement should be examined for:

- income, expenses and net operating income (NOI) ratios;
- ability to maintain or increase sales;
- budget and income projections (and rent percentage of gross income);
- net cash flow;
- age of accounts payable;
- amortization periods and due dates of debts;
- cash reserves;
- ownership and control; and
- product performance and service satisfaction.

Future plans and business goals

The **tenant's future plans** for the space they have applied for to lease and their business objective or goal to be accomplished by the relocation are legitimate concerns of an owner. Some entrepreneurial owners become so involved they actually participate in the business of a prospective tenant by accepting stock or other share ownership in the tenant's company in lieu of rent for the leased space, particularly with business start-ups.

Regardless of the form in which rent will be paid, questions arise about the nature and substance of the **tenant's operations**, including:

1. Is the tenant consolidating or expanding his operations?
2. Do his income and expense projections make sense?
3. Does the business require the infusion of capital to relocate to new space?
4. Does the tenant need to increase or reduce his debt or annual debt service?

5. For tenants who are a corporation or limited liability company (LLC), is a stockholder or a member willing to personally guarantee the lease agreement or provide security?
6. Will the activities of the tenant pose any zoning, ordinance or insurance coverage problems?
7. Will the tenant's operations and the type of clientele it attracts enhance or impair the future value of the real estate?

Chapter 19 Security deposits and pre-expiration inspections

This chapter discusses the variety of rules for residential and nonresidential landlords who receive and refund security deposits, and the residential tenant's right to a pre-expiration inspection.

Residential and nonresidential rules

An investor in nonresidential income-producing properties acquires his first residential rental property. The residential rental property is a large apartment complex consisting of furnished and unfurnished units.

The investor retains a broker with experience managing apartment buildings of comparable size and quality in the local rental market. As the property manager, the broker makes an initial **inspection** of the units. The impact of the local residential rental market on rents and security deposits in this property are reviewed with the investor.

As a result, rents and security deposits to be charged are re-established based on the size of the units, the maximum number of occupants for the various sizes of units, amenities each unit offers, the unit's location within the complex and whether or not the units are furnished.

The investor is aware he must rent to families with children whose credit and background qualify them as tenants. However, the investor is concerned about the excessive wear and tear children could cause to the units. The investor is advised any excessive wear and tear brought on by a tenant which remains unrepaired when the tenant vacates is a breach of the lease, called a *default*. Any additional clean-up expenses incurred by the landlord are recoverable from that tenant.

If a unit will be occupied by a family with children whose family size or background check indicates they will likely place an excessive burden on the unit, the broker can recommend either the unit not be rented to them or the rent be adjusted upward to cover the additional wear and tear brought about by the burdensome increase in the number of occupants.

However, the investor would like to impose a larger security deposit equal to one-half month's rent for each child who will occupy a unit since the increased deposit would either discourage large families from renting or provide funds to restore the unit for re-renting when they vacate.

The property manager informs the investor that security deposits charged to tenants of residential units who fall into a *protected class* of people, such as families, are controlled by statute and call for *nondiscriminatory, equal treatment*.

Thus, the investor is cautioned he cannot require higher security deposits for tenants with children than for tenants without children. Any increase in a security deposit for larger versus smaller families is a prohibited **discriminatory** practice. [Calif. Government Code §12955(a); 24 Code of Federal Regulations §100.65; see Chapter 44]

Also, other limitations are placed on the tenant's upfront advance for rent and security deposits. In addition to the collection of one month's advance rent, the **further amount** which a residential tenant may

be required to pay as a **security deposit** to cover defaults during the period of occupancy is limited to an amount equal to:

- two months' rent for unfurnished units; and
- three months' rent for furnished units. [Calif. Civil Code §1950.5(c)]

If permitted by competition in the local rental market, the investor may require all tenants in an unfurnished unit an advance payment of no more than:

- the first month's rent and the last month's rent and a security deposit equal to one month's rent; or
- the first month's rent and a security deposit equal to two months' rent.

The property manager informs the investor a security deposit equal to one month's rent, together with one month's advance rent, is all the market will currently sustain for his units. If he demands more, the units will not readily rent since prospective tenants will likely be unwilling or unable to pay that amount up front.

Security against nonperformance

Both nonresidential and residential landlords traditionally require tenants to deposit funds with the landlord in addition to the first month's rent. [See **first tuesday** Forms 550 §1.1 and 552 §1.2]

The additional funds provide **security** for the tenant's future performance of those obligations he agrees to in the rental or lease agreement if the tenant defaults. Tenant obligations include paying rent, reimbursing the landlord for expenses incurred due to the tenant's conduct, maintaining the premises during the occupancy and returning the premises in the same level of cleanliness existing when leased to the tenant, less ordinary wear and tear.

For **residential rentals**, all monies paid to the landlord in addition to the first month's rent, screening fee and waterbed administrative fee is considered a security deposit. **Security deposits** include any funds received for the purpose of covering defaults by the tenant under the rental or lease agreement, no matter the name given to the funds by the landlord, such as a nonrefundable deposit, cleaning charge or last month's rent. [CC §§1940.50, 1950.5(b), (c); 1950.6]

Thus, any funds legally recharacterized as a security deposit are **refundable** when the tenant vacates, less deductions for unpaid rent and recoverable costs incurred by the landlord for the repair of damages caused by the tenant or for the cleaning of the premises to return cleanliness to its condition when leased to the tenant. [CC §§1950.5(b), 1950.7(c)]

For nonresidential tenancies, a small services firm may pay an amount equal to one month's rent as a security deposit, while a photography studio which uses chemicals in its film processing may be asked to pay an amount equal to two month's rent.

Editor's note — A photography studio tenant or other users of chemicals must also be required to provide ***insurance coverage.***

In a market downturn, aggressively competitive landlords are less likely to require a security deposit in exchange for maintaining current rental income (occupancy), exposing themselves to an increased risk of loss if the tenant defaults.

Like all other terms in a nonresidential lease, the amount of the security deposit is negotiated between the nonresidential landlord and the tenant prior to entering into the lease.

Unlike nonresidential tenants, residential tenants, as a matter of public policy, are perceived as lacking bargaining power when they negotiate a lease or rental agreement. Thus, limits are imposed by law on the amount of security deposit a residential landlord may require.

The problematic last month's rent

When the availability of unfurnished residential units is low, residential landlords often require prospective tenants to advance the maximum permissible amount of rent and security deposit allowed. For unfurnished units the maximum advance payment includes the first and last month's rent, plus a security deposit equal to one month's rent. The landlord's do so to eliminate the less solvent tenants from renting their units.

Editor's note — Payment of the first and last month's rent is recharacterized on residential rentals as one month's advance rent for the first month of the occupancy and a security deposit equal to the amount paid for the last month's rent, plus any advances called a security deposit. [CC §1950.5(c)]

Nonresidential landlords also typically require an advance payment of both the first and last month's rent on a lease, the last month's prepayment being a security deposit until the last month arrives.

Now consider a residential tenant who pays the first month's rent and a security deposit equal to one month's rent on entering into his lease or rental agreement.

When the last month's rent becomes due, the tenant does not pay it. The tenant knows the defaulted payment of rent will be deducted from his security deposit, a permissible use of the security deposit by the landlord.

On expiration of the lease, the tenant vacates the unit. Due to excess wear and tear on the unit inflicted by the tenant, repairs and replacements are required before the unit can be re-rented.

However, after deducting the unpaid last month's rent from the security deposit, no security deposit remains to reimburse the landlord for the cost of the repairs.

The recovery of the **repair costs** is limited to a demand on the tenant for payment, and if unpaid, a small claims court action to enforce collection.

A similar demand for payment of repair costs occurs when the landlord requires advance payment of the first and last month's rent, but no security deposit.

Residential deposits

A residential landlord must require the same security deposit for all units, such as an amount equal to one month's rent, or base the amount of the security deposit on each tenant's creditworthiness.

Editor's note — A landlord should set the amount of the security deposit based on a tenant's creditworthiness — the greater or lesser risk of a loss posed by the prospective tenant's likely failure to perform on lease provisions. However, clear and precise standards for setting the different levels of creditworthiness and equal application of each level's creditworthiness standard to all prospective tenants who fall into that level of credit must exist. Lenders set levels of creditworthiness and charge different rates of interest for each level. [24 CFR §100.60(b)(4)]

Any money handed to a residential landlord by a tenant on entering into a lease or rental agreement must be **characterized** as one of the following:

Deferring the first month's rent

Consider a landlord who locates a creditworthy tenant for his residential property.

In addition to the advance payment of the first month's rent, the landlord requires a security deposit equal to one month's rent.

The tenant asks the landlord if he can pay half the security deposit up front and the other half with the second month's rent.

The tenant is unable to pay the security deposit in full until he receives his security deposit refund from his current landlord.

The landlord wants this applicant as a tenant, and is willing to arrange further credit.

However, the landlord structures receipt of the funds as payment of the entire security deposit and half of the first month's rent.

The tenant will pay the remaining half of the first month's rent with payment of the second month's rent.

Thus, should the tenant fail to pay the second month's rent, or the remainder of the first month's rent:

- the landlord may serve a three-day notice to pay rent or quit; and
- the amount can be deducted from the security deposit, as a source of last resort.

Conversely, consider a landlord who allows a tenant to allocate his funds first to rent and spread payment of the security deposit over two or more months.

A tenant's failure to pay the second installment of the security deposit will not be a material breach, which is necessary for an eviction based on service of a three-day *notice to perform*. A security deposit is not rent.

A tenant's breach must be material and go to the root of the lease or rental agreement, such as a failure to pay rent, to justify service of a three-day notice. A **minor breach** of the lease will not justify serving a three-day notice to forfeit the tenant's right to possession. [**Baypoint Mortgage Corp.** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818]

- a *tenant screening fee* for processing an application; [See Chapter 19]
- a *waterbed administrative fee*; [See Chapter 53]
- *rent*; or
- a *security deposit*. [CC §§1940.5(g), 1950.5(b), 1950.6(b)]

A residential landlord has limited authority to require an additional **pet deposit** if the tenant is permitted to keep one or more pets in the unit.

However, the total amount of advance funds received from a tenant **with a pet** may not exceed one month's rent plus an amount equal to two month's rent for an unfurnished unit or three month's rent for a furnished unit. [See Chapter 43]

However, these security deposit limitations may be exceeded when a tenant maintains a **waterbed on the premises**. The residential landlord of an unfurnished unit may then require, in addition to the first months' rent:

- an amount equal to **one-half month's rent**, in addition to the maximum security deposit; and
- a **reasonable fee** to cover administrative costs of processing the waterbed arrangements. [CC §1940.5(g); see Chapter 53]

Also, if the term of a residential lease is six months or more, the landlord and tenant may then agree to an advance payment of six months' rent, or more, instead of one month's rent. [CC §1950.5(c)]

Thus, advance payment of an amount equal to only two to five months' rent is prohibited.

Should the landlord and tenant agree to an advance payment of six months' rent on the lease of an unfurnished unit, the landlord may also require the maximum security deposit of two months' rent.

Holding security deposits

Funds advanced by a tenant and held by residential and nonresidential landlords to cover defaults in the tenant's performance of his obligations on the lease or rental agreement, are called security deposits. The funds belong to the tenant who advanced them to the landlord. [CC §§1950.5(d), 1950.7(b)]

However, while the security deposit belongs to the tenant, a landlord may **commingle** the funds with other monies in a general business account. No trust relationship is established when a landlord holds a tenant's security deposit. [**Korens** v. **R.W. Zukin Corporation** (1989) 212 CA3d 1054]

Without a trust relationship, the landlord's receipt of a security deposit does not obligate him to pay **interest** on the security deposit for the period held. However, some local rent control ordinances require residential landlords to pay interest to tenants on their security deposits — and the legislature is contemplating extending this to all residential landlords.

For example, the city of San Francisco requires residential landlords to pay simple interest to tenants on security deposits held by the landlord for one year or more as long as the rent is not subsidized by any government agency. [San Francisco Administrative Code §49.2]

Joint pre-expiration inspection

A residential landlord must **notify a tenant** in writing of the tenant's **right to request** a joint inspection of his unit within two weeks prior to the date the tenancy expires due to:

- expiration of the lease term; or
- a 30-day notice to vacate initiated by either the landlord or the tenant. [CC §1950.5(f)(1); see Form 567-1 accompanying this chapter]

The requirement of notice does not apply to tenants who are unlawfully remaining in possession after the expiration of a 3-day notice to pay/perform or quit for failing to pay rent, failing to perform terms and conditions of the rental agreement, or committing waste or a nuisance on the property,

The purpose for the **joint pre-expiration inspection**, legally called an *initial inspection*, is to require the landlord to advise the tenant of the repairs or conditions the tenant needs to perform to **avoid deductions** from the security deposit.

NOTICE OF RIGHT TO REQUEST A JOINT PRE-EXPIRATION INSPECTION

DATE:_____, 20_____, at _____, California.

NOTICE: Residential tenants may request a joint pre-expiration inspection of the premises they occupy. At the inspection they will receive a statement of deficiencies itemizing the repairs and cleaning necessary to be remedied or eliminated by the tenant to avoid a deduction of their costs from the security deposit. [Civil Code §1950.5(f)]

To Tenant: _____

Items left blank or unchecked are not applicable.

FACTS:

1. You are a Tenant under a rental or lease agreement

1.1 dated _____, at_____, California,

1.2 entered into by _____, Tenant,

and _____, Landlord,

1.3 regarding real estate referred to as: _____

1.4 which tenancy expires _____, 20_____.

NOTICE:

2. You are hereby advised of your right to request and be present at a pre-expiration inspection of the premises you occupy, and at the time of the inspection, be given the Landlord's itemized statement of deficiencies specifying repairs and cleaning which will be the basis for deduction from your security deposit.

2.1 The purpose for the inspection and the statement of deficiencies is to give you the opportunity to remedy or eliminate the itemized deficiencies before vacating to avoid a deduction of their cost from your security deposit.

2.2 The inspection, if requested by you, may be scheduled no earlier than two weeks before the expiration of your tenancy, and is separate from the Landlord's final inspection and accounting for your security deposit within 21 days after you vacate.

2.3 If you do not request a pre-expiration inspection, no inspection will be made prior to the final inspection after you vacate.

3. You may request an inspection at any time after you are given this notice by preparing the form attached to this notice and giving it to the Landlord or his agent.

3.1 On the Landlord's receipt of your request, the Landlord will attempt to set a mutually agreeable date and time for the inspection.

3.2 On the Landlord's receipt of your request, you will be given a written 48-hour notice of entry advising you of the date and time scheduled by the Landlord for the inspection.

4. On completion of the scheduled inspection, whether or not you are present, the Landlord or his agent will hand you or leave on the premises a copy of an itemized statement of deficiencies specifying repairs and cleaning which will be the basis for deductions from your security deposit, unless you remedy or eliminate them prior to your vacating on or before your tenancy expires.

4.1 Once you have requested an inspection you may withdraw the request at any time prior to the inspection.

Date:_____, 20_____

Landlord/Agent:_____

Signature: _____

Address: _____

_____

Phone:_____

Fax:_____

E-mail:_____

REQUEST FOR JOINT PRE-EXPIRATION INSPECTION

DATE:_____, 20_____, at _____, California.

To Landlord:

1. I, the Tenant, hereby request an inspection at the earliest possible date and time during the two-week period prior to the expiration or expiration of my tenancy.
2. The dates I prefer for an inspection during normal business hours include: _____

   _____

3. I understand you will give me a 48-hour notice prior to the inspection.

   Address of the premises: _____

   Tenant's name: _____

   Signature:_____

   Daytime telephone number:_____

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If a residential tenant requests the pre-expiration inspection in response to the notice of his right to the inspection, the landlord or his agent must complete the inspection no earlier than two weeks before the tenant is to vacate the unit.

Ideally, the notice advising the tenant of his right to a joint inspection is given to the tenant at least 30 days prior to the end of the lease term or, in the case of a lease agreement, immediately upon receiving or serving a 30-day notice to vacate. A period of 30 days will allow the tenant time to request the inspection and provide two full weeks to prepare for the inspection and then two weeks to remedy any repairs or uncleanliness the landlord observes during the inspection which might constitute a deduction from the security deposit.

On the landlord's receipt of the tenant's request for an inspection, the landlord must serve a written 48-hour **notice of entry** on the tenant stating the purpose of entry, date and time of the pre-expiration inspection. If the date and time cannot be mutually agreed to, they are to be set by the landlord.

However, if a mutually acceptable time for the inspection is within 48 hours, a written waiver of the notice of entry must be signed by both the landlord and tenant. [CC §1950.5(f)(1); see **first tuesday** Form 567-2]

When the waiver is signed, the landlord may proceed with the inspection, whether or not the tenant is present at the premises, unless the tenant has previously withdrawn his request for the inspection.

On completion of the pre-expiration inspection, the landlord must give the tenant an itemized statement of deficiencies specifying any repairs or cleaning necessary to be completed by the tenant to avoid deductions from his security deposit. Also, itemized statement of deficiencies must contain the contents of subdivisions (b) and (d) of Civil Code §1950.5. [See Form 567-3 accompanying this chapter]

STATEMENT OF DEFICIENCIES ON JOINT PRE-EXPIRATION INSPECTION

DATE:_____, 20_____, at _____, California.

To Tenant: _____

Items left blank or unchecked are not applicable.

FACTS:

1. On this date, a pre-expiration inspection was conducted by the Landlord on the premises and appurtenances which are the subject of a rental agreement or lease agreement.

1.1 dated _____, at _____, California,

1.2 entered into by_____, Tenant(s),

and_____, Landlord,

1.3 regarding real estate referred to as: _____

_____

1.4 ☐ The Tenant was present and given a copy of this statement prepared and signed by the Landlord or his agent.

1.5 ☐ The Tenant was not present and a copy of this statement prepared and signed by the Landlord or his agent was left inside the premises.

2. The tenancy under the rental agreement or lease expires on _____, 20_____ by which date you are to vacate the premises.

3. NOTICE TO TENANT:

3.1 You have until the date for expiration of your tenancy to remedy or eliminate the repairs and cleaning specified in this Statement of Deficiencies to avoid the deduction from your security deposit of the cost to repair and clean the identified deficiencies.

3.2 Unobservable conditions or conditions which occur after the pre-expiration inspection, requiring repair and cleaning will be deducted from your security deposit after the final inspection by the landlord or his agent.

STATEMENT OF DEFICIENCIES:

4. The following itemized list of identified deficiencies in repairs and cleaning will be the basis for deductions from your security deposit, unless remedied or eliminated by you prior to vacating and later confirmed by the Landlord or his agent during a final inspection after you vacate.

4.1 Damage to the premises and appurtenances caused by the Tenant or their guests, other than ordinary wear and tear, which needs to be repaired are listed as follows: _____

_____

_____

_____

_____

_____

_____

4.2 Cleaning which needs to be performed to bring the premises up to the level of cleanliness which existed on commencement of the tenancy is listed as follows: _____

_____

_____

_____

_____

_____

_____

5. The following recitals are excerpts from Civil Code §1950.5 regarding security deposits:

5.1 1950.5(b) As used in this section, "security" means any payment, fee, deposit or charge, including, but not limited to, any payment, fee, deposit, or charge, except as provided in Section 1950.6, that is imposed at the beginning of the tenancy to be used to reimburse the landlord for costs associated with processing a new tenant or that is imposed as an advance payment of rent, used or to be used for any purpose, including, but not limited to, any of the following:

(1) The compensation of a Landlord for a Tenant's default in the payment of rent.

(2) The repair of damages of the premises, exclusive of ordinary wear and tear, caused by the Tenant or by a guest or licensee of the tenant.

(3) The cleaning of the premises upon termination of the tenancy necessary to return the unit to the same level of cleanliness it was in at the inception of the tenancy. The amendments to this paragraph enacted by the act adding this sentence shall apply only to tenancies for which the Tenant's right to occupy begins after January 1, 2003.

(4) To remedy future defaults by the Tenant in any obligation under the rental agreement to restore, replace, or return personal property or appurtenances, exclusive of ordinary wear and tear, if the security deposit is authorized to be applied thereto by the rental agreement.

5.2 1950.5(d) Any security shall be held by the Landlord for the Tenant who is party to the lease or agreement. The claim of a Tenant to the security shall be prior to the claim of any creditor of the Landlord.

Date:_____, 20_____

Landlord/Agent: _____

Signature: _____

Address: _____

_____

Phone: _____

Fax:_____

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The landlord's **pre-expiration inspection statement** must be delivered to the tenant by either:

- handing the statement directly to the tenant if he is present at the inspection; or
- leaving the statement inside the premises at the time of the inspection if the tenant is not present. [CC §1950.5(f)(2)]

The purpose for the inspection and statement of deficiencies in repairs or cleanliness is to give the tenant time in which to remedy the identified repairs before vacating the premises.

Alternatively, the tenant may choose not to request a pre-expiration inspection, in which case the landlord or his agent will not have to conduct an inspection or prepare and give the tenant a statement of deficiencies before the tenancy expires and the tenant vacates. However, the notice of the tenant's right to request a pre-expiration inspection **must** be given to the tenant.

If the tenant chooses to withdraw his request for an inspection after submitting it, the landlord should send a memo to the tenant confirming the tenant's decision to withdraw. [See **first tuesday** Form 525]

Editor's note — The completion of a pre-expiration inspection statement by the landlord does not bar the landlord from deducting other costs from the security deposit for:

- *any damages noted in the joint pre-expiration inspection statement which are not cured;*
- *any damages which occurred between the pre-expiration inspection and termination of the tenancy; or*

- *any damages not identified during the pre-expiration inspection due to the tenant's possessions being in the way. [CC §1950.5(f)]*

Regardless of whether the tenant requests a pre-expiration inspection, the final inspection after the tenant vacates and the itemized statement for the refund of the security deposit (less any deductions) must still be completed and mailed within 21 days after the **tenant vacates** the residential unit. [CC §1950.5(g)]

Residential refund requirements

Within a window period of **21 days** after a residential tenant vacates, but not before 60 days prior to the expiration of the lease or before the notice of termination under a rental agreement, the residential landlord must:

- refund the security deposit, less reasonable deductions; and
- provide the tenant with an **itemized statement of deductions** taken from the security deposit. [CC §1950.5(g); see Form 585 accompanying this chapter]

Also, the landlord must **attach copies** of receipts, invoices and/or bills to the itemized statement showing charges incurred by the landlord and deducted from the security deposit. [CC §1954]

If landlord repairs are not completed and the costs are unknown within 21 days after the tenant vacates, the landlord may deduct a **good faith estimated amount** of the cost of repairs from the tenant's security deposit. This estimate is stated on the itemized security deposit refund statement, disclosing the name, address and telephone number of any person or entity providing repair work, materials or supplies. [CC §1954]

Within 14 days after the **completion of repairs** or the receipt of bills, invoices and/or receipts for the repairs and materials, the landlord must deliver the final itemized security deposit refund statement with attached receipts and invoices to the tenant. [CC §1954]

It is not necessary for the landlord to provide copies of receipts, bills and/or invoices for repair work or cleaning to the tenant if:

- the total deduction from the security deposit to cover the costs of repairs and cleaning does not exceed $125; or
- the tenant signs a waiver of his right to receive bills at the time or after notice to terminate his tenancy is given. [CC §1954]

A residential tenant may request copies of receipts, bills or invoices for repair work or cleaning within 14 days after receipt of the itemized security deposit refund statement, and the landlord is to provide copies of the documents within 14 days after the tenant's request [CC §1954].

Reasonable deductions from a residential tenant's security deposit include:

- **delinquent rent**;
- **costs to clean** the premises after the tenant vacates — if the tenant agreed to and failed to leave the unit in the same level of cleanliness as existed when he took occupancy;
- **costs of repairs** for damages caused by the tenant, excluding ordinary wear and tear; and
- **costs to replace or restore** furnishings provided by the landlord if agreed to in the lease. [CC §1950.5(b)]

SECURITY DEPOSIT DISPOSITION ON VACATING RESIDENTIAL PREMISES

DATE:_____, 20_____, at _____,California.

NOTICE: This itemized statement of the security deposit's disposition, including documentation of charges deducted, must be given to the tenants by the landlord within 21 days after a tenant vacates residential property. [California Civil Code §1950.5(f)]

Use of this form in a timely and proper fashion avoids landlord liability for 2% monthly penalty on any portion of the security deposit wrongfully retained.

To Tenant: _____

Items left blank or unchecked are not applicable.

FACTS:

1. This is notice to the tenant of any Landlord deductions from the security deposit under the following agreement:

☐ Residential lease agreement ☐ Occupancy agreement

☐ Month-to-month residential rental agreement ☐ Other:_____

1.1 dated _____,20_____, at _____,California,

1.2 entered into by _____,Landlord,

and _____, Tenant,

1.3 regarding residential premises referred to as: _____

DISPOSITION OF DEPOSIT:

2. Under the above referenced agreement, Tenant handed Landlord a security deposit in the amount of . . . . . $_____

3. The following deductions have been made by Landlord from the security deposit:

3.1 Repair of damages — Cost

a. _____ $_____

b. _____ $_____

3.2 Necessary cleaning of the premises — Cost

a. _____ $_____

b. _____ $_____

3.3 Delinquent or holdover rent — Amount

a. From:_____To:_____ $_____

3.4 Replacement/repair of lost or damaged furnishings — Cost

a. _____ $_____

3.5 TOTAL deductions from security deposit . . . . . (-)$_____

4. BALANCE DUE TENANT:

4.1 Balance of security deposit remaining after deductions (line 2 less line 3.5) . . . . . $_____

4.2 Interest on the security deposit from _____ to _____

at _____% per annum . . . . . (+)$_____

4.3 Balance due Tenant herewith refunded is the amount of (line 4.1 plus 4.2) . . . . . $_____

by Landlord/Agent's check #_____.

5. ☐ **AMOUNT DUE LANDLORD:**

5.1 The amount due Landlord after deductions (line 2 less line 3.5). . . . . $_____

5.2 Less interest on the security deposit from _____ to _____

at _____% per annum . . . . . (-)$_____

5.3 Tenant to hand or mail Landlord/Agent the balance due of (line 5.1 less line 5.2) . . . . . $_____

This statement is true and correct:

Date:_____, 20_____

Landlord/Agent: _____

Signature:_____

Address:_____

_____

Phone:_____ Fax:_____

By: _____

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Unpaid late charges incurred on a proper demand may be deducted from the security deposit since they are a **form of rent** in that they are **amounts due** the landlord under the lease agreement. [See Chapter 15]

The landlord may not deduct from a tenant's security deposit the costs he incurs to repair defects in the premises which existed prior to the tenant's occupancy. [CC §1950.5(e)]

Tenants seeking to recover security deposits retained by landlords may make unfounded claims that the excessive wear and tear existed when they took possession of the property. To best avoid claims of pre-existing defects, a joint inspection of the unit (landlord and tenant) and written documentation of any defects should be completed **before possession** is given to the tenant. [See **first tuesday** Form 560]

Itemized security deposit statements

When a residential tenant vacates, the landlord itemizes the deductions from the tenant's security deposit on a security deposit disposition statement. [See Form 585]

If a landlord is required by local rent control ordinances (or state law) to pay interest on security deposits, the landlord may also use the itemized statement to account for interest accrued on the security deposit. [See Form 585 §3.2]

A residential landlord who, in bad faith, fails to comply with security deposit refund requirements may be subject to statutory penalties of up to twice the amount of the security deposit. [CC §1950.5(l)]

A residential or nonresidential landlord also delivers an itemized statement to tenants on the **sale of the property**, indicating the amount of the security deposits, any deductions and the name, address and telephone number of the buyer. The notice shifts liability for the future return of the security deposit to the buyer. [CC §§1950.5(h), 1950.7(d); see **first tuesday** Form 586]

Nonresidential refund requirements

A nonresidential lease does not need to set forth:

- the circumstance under which a tenant's security deposit will be refunded; and
- a time period within which a landlord will refund a tenant's security deposit.

Other than its receipt, a nonresidential lease does not even need to contain a provision addressing when the security deposit will be returned. [See **first tuesday** Form 552]

If a refund period is not agreed to and the nonresidential landlord does not take any deductions from the security deposit, the landlord must refund the security deposit within a reasonable time period.

A nonresidential landlord must return the remainder of the security deposit within **30 days** from the date he receives possession including any permissible deductions from the security deposit for unpaid rent, cost of cleaning or repairs. Thirty days is considered a reasonable refund period since the landlord is allotted 30 days to determine whether repairs are needed. After 30 days, no good reason exists to continue to hold the deposit.

However, if the security deposit **exceeds** the combined amount of the first and last month's rent and the only deduction from the deposit is delinquent rent, the landlord must, within two weeks after he takes possession of the property, return the remaining amount of the security deposit after deducting delinquent rent and an additional amount equal to one month's rent. The additional amount retained must be returned within 30 days after the landlord takes possession. [CC §1950.7]

Unlike the residential landlord, the nonresidential landlord is not required to provide tenants with an itemized statement of deductions when the security deposit is refunded. However, a prudent nonresidential landlord provides tenants with an itemized statement when they vacate, unless a full refund is made.

An accounting avoids the inevitable demand for documentation which arises when a tenant does not receive a full refund of his security deposit. A nonresidential landlord who, in bad faith, fails to comply with the refund requirements is liable to the tenant for up to $200 in statutory damages. [CC §1950.7(f)]

Chapter 20 Recovery of residential turnover costs

This chapter reviews how rent is a residential landlord's sole source for funds to pay for tenant turnover costs.

The security deposit plays no role

A landlord of an apartment complex is determined to reduce or offset the costs of tenant turnover by shifting the costs to tenants.

An increasing number of his tenants are staying for ever shorter periods of time. On vacating, the units are re-renting quickly, keeping lost rent due to "turn-around" at a minimum.

However, each tenant turnover requires expenditures to:

- **refurbish** the unit to eliminate the cumulative effect of normal wear and tear, such as painting the walls, deep-cleaning the carpet and dry-cleaning the drapery;
- **advertise** the unit's availability to locate a tenant;
- pay for time and effort spent **showing** the unit and clearing prospective tenants; and
- pay the property manager's **tenant-origination fee**.

Since the rate of tenant turnovers is exceeding normal expectations, the landlord's *net operating income* (NOI) is being reduced by the excessive refurbishing and reletting costs. [See **first tuesday** Form 352]

From the landlord's point of view, the NOI consists of the remaining amounts of rental income generated by the property after deducting expenses incurred in operating the property — prior to deductions for interest paid on purchase and improvement loans and depreciation as well as principal reduction on the loans.

The landlord is concerned about the economics used since the *value* of the property for establishing its net worth (equity), maximum loan amount and sales price is based on the NOI. Also, *spendable income* slips due to increasing turnover costs.

To increase the property's NOI and net spendable income, the landlord chooses to add a *stay-or-pay* clause to his month-to-month rental agreements.

The **stay-or-pay clause** calls for the residential tenant to forego a return of his security deposit if he moves within six months after taking occupancy. [See Figure 1 accompanying this chapter]

The landlord believes the stay-or-pay clause will dissuade month-to-month tenants from moving for at least six months.

If a tenant is unpersuaded and vacates the premises within the first six months, the stay-or-pay clause states the landlord can recover his "prematurely incurred" turnover costs from the tenant's security deposit.

Can the landlord enforce the stay-or-pay clause in his rental agreements claiming they are based on sound economic policies?

No! The stay-or-pay clause is unenforceable. It is an illegal forfeiture of the security deposit.

If the tenant has not breached the lease or rental agreement and on expiration of proper notice returns the unit in the condition it was received, normal wear and tear excepted for the use allowed, the security deposit must be fully refunded, regardless of how long the unit remains vacant.

The security deposit **may not** be used to cover rent lost for the period of the vacancy or costs incurred to eliminate normal wear and tear and refurbish the unit for the next tenant. [Calif. Civil Code §1950.5(e)]

Thus, the landlord cannot use the stay-or-pay clause in tandem with the security deposit to provide more revenue (rent) to cover his operating costs. Revenue for operating expenses must come from rents, not a one-time lump sum advance payment, a *cost-plus* (profit) pricing imperative.

Classifying the receipt of tenant funds

Funds received from a tenant by a **residential landlord** fall into only four classifications of receipts:

- tenant screening fees;
- waterbed administration fees;
- rent; and
- security deposits.

The amount of the **tenant screening fee** may not exceed $38.97 for 2007 as annually adjusted from an original statutory amount of $30 in 1997 based on the Consumer Price Index (CPI).

Further, the tenant screening fee is limited to:

- the out-of-pocket cost (money) for gathering the information; and
- the cost of the landlord's or property manager's time spent obtaining the information and processing an application to rent. [CC §1950.6(b)]

Rent is compensation, usually periodic, received as revenue by a landlord in exchange for the tenant's use, possession and enjoyment of the property. [**Telegraph Ave. Corporation** v. **Raentsch** (1928) 205 C 93]

Rent also includes the tenant's payment of any late charges agreed to and demanded on the delinquent payment of periodic rent. [**Canal-Randolph Anaheim, Inc.** v. **Moore** (1978) 78 CA3d 477]

A charge for any purpose other than rent, a tenant screening fee or a waterbed administration fee is, by elimination, a refundable security deposit, regardless of any other name or form given to the funds received. [**Granberry** v. **Islay Investments** (1984) 161 CA3d 382]

Figure 1 *(an unenforceable provision)*

A stay-or-pay clause minimum tenancy

If the tenancy is terminated during the six-month period following commencement of this agreement, tenant shall forfeit tenant's security deposit.

A **security deposit** is any advance payment designed to be used as security for the tenant's future performance of his obligations agreed to in a rental agreement or lease.

Security deposit deductions

When one month's rent is collected in advance from a residential tenant, the **security deposit is limited** to an amount equal to:

- two months' rent for an *unfurnished unit*; or
- three months' rent for a *furnished unit*. [CC §1950.5(c)]

A residential landlord may deduct from the security deposit those amounts reasonably necessary to:

- cure tenant defaults in the payment of rent;
- repair damages to the premises caused by the tenant;
- clean the premises except for normal wear and tear; and
- dispose of abandoned personal property. [CC §1950.5(b)]

Any amount of security deposit remaining after taking allowable deductions must be refunded to the residential tenant within three weeks after the tenant moves out. [CC §1950.5(g)(1)]

A residential landlord's retention of any portion of a security deposit in violation of the deduction rules subjects the landlord to statutory penalties of up to twice the amount of the security deposit, in addition to actual damages. [CC §1950.5(l)]

Is it extra rent or a screening fee?

A landlord funds the care and maintenance expenses of a property from rents, not from an initial lump sum amount paid in addition to rent.

Consider a residential landlord who requires new tenants to prepay one month's rent and a refundable security deposit in an amount equal to one month's rent before entering into a lease or rental agreement.

The landlord also charges an additional one-time, nonrefundable, new-tenant fee, membership fee or tenant application expense reimbursement fee.

The purported purpose of the **nonrefundable fee** is to cover administrative expenses and services related to **processing** the tenant's application to rent the unit.

A tenant seeks to recover the one-time extra charge, claiming it is a nonrefundable security deposit since the one-time, lump-sum charge covers expenses that must be recovered through amounts collected as rents, thus making it a security deposit.

Can the tenant recover the one-time extra charge imposed by the landlord as a masked security deposit?

No, not as a security deposit! The one-time charge for administrative costs incurred by the landlord to process the tenant's rental application is not a security deposit. A security deposit is imposed and collected to secure the landlord against future tenant defaults under the lease or rental agreement by providing a source of recovery for any loss caused by the default. [**Krause** v. **Trinity Management Service, Inc.** (2000) 23 C4th 116; CC §§1950.5, 1950.6]

However, a "nonrefundable upfront fee" is controlled by the tenant screening fee statute which limits the amount of the application processing fee to $38.97 for 2007. The difference is refundable as an excess screening fee charge which is neither rent nor a security deposit.

Unenforceable liquidated damages

Consider a residential landlord who includes a *liquidated damages* provision in the rental agreement in an effort to reduce or offset his tenant turnover costs. [See Figure 2 accompanying this chapter]

In addition to the first month's rent, the landlord properly collects a security deposit from the tenant in an amount equal to one month's rent to cover any future breach of the rental agreement by the tenant.

Before the completion of six months, a tenant hands the landlord a 30-day notice to vacate and then vacates the unit.

Within **21 days after vacating**, the landlord sends the tenant an itemized accounting for the security deposit, deducting one month's rent as the liquidated damages owed agreed as due to the early (and proper) termination of the month-to-month rental agreement.

The tenant claims he is entitled to a refund of the security deposit since a **liquidated damages** provision in a rental agreement or lease is unenforceable as a *forfeiture penalty*.

Is the liquidated damages provision unenforceable?

Yes! A liquidated damages provision is unenforceable in residential rental agreements and leases. The amount of recoverable losses a residential landlord incurs when a tenant vacates a unit, such as the lost rent and the maintenance costs of labor and materials to cover excess wear and tear, is readily ascertainable. [CC §1671(d)]

A liquidated damages provision may only be enforced when conditions make it extremely difficult or impracticable to determine the amount of actual money losses. This is never the case in real estate rentals. [CC §1671(d)]

Further, liquidated damages do not represent a recovery of **actual money losses** incurred by the landlord, losses which without calling for a forfeiture may be deducted from the security deposit. The purpose of the landlord's liquidated damages provisions is not to recover money lost due to unpaid rent owed or excessive wear and tear, but to increase his NOI and spendable income.

Even if the landlord does not deduct the liquidated damages amount agreed to from the security deposit, he will not be able to recover the liquidated damages from the tenant in a civil action.

Figure 2 *(an unenforceable provision)*

A liquidated damages minimum tenancy provision

Should the tenant choose to terminate this tenancy during the six-month period beginning on commencement of this tenancy, the tenant shall pay as liquidated damages, and not as a penalty or forfeiture, an amount equal to one month's rent in consideration for exercising the right to vacate prematurely.

Covering tenant turnover costs

Recovery of a landlord's turnover costs must come from the periodic rents bargained for and received from his tenants — an expense of operations deducted from income.

The costs of refurbishing a unit to eliminate normal wear and tear so it can be re-rented in a "fresh" condition are known, or readily available on inquiry, in advance. Financially, the amount of the refurbishing costs must be amortized over the length of each tenant's probable occupancy period so the costs can be recovered as a component of the periodic rent charged to a tenant.

However, since the local rental marketplace determines rent ceilings, a landlord is limited in the amount he can charge for rent and successfully compete for tenants.

Thus, a landlord's most logical cost recovery approach is to stretch out each tenant's term of occupancy to an optimal length of time to reduce the frequency of tenant turnover and increase net spendable income.

The lease reduces costs

The landlord's best method for recovering turnover costs is to rent to creditworthy tenants on a lease agreement with a one year term or longer, local rental market permitting. Rent may require a reduction to induce the longer period of occupancy.

A lease agreement allows the landlord to amortize the **anticipated costs of refurbishing** the unit over the maximum term negotiable. Also, a lease agreement reduces the frequency of move-outs and provides a schedule for turnover maintenance since tenants under a lease agreement tend to remain in possession until the lease term expires.

Although the market limits the amount a landlord can charge for rent, different rental rates exist for rental and lease agreements in most local markets.

Month-to-month tenancies typically give the landlord less time over which he can amortize his turnover costs. A landlord with month-to-month tenants must also deal with the likelihood of frequent turnovers requiring the investment of his time and effort to constantly re-rent vacant units.

As compensation, a landlord is able to charge **higher rents** for month-to-month tenancies which reflects the cost-push of higher and more frequent turnover expenses than occur under a lease.

In contrast, a lease agreement locks a tenant into a fixed period of occupancy, such as one year or longer. Lease agreements reduce the **tenant turnover rate**, and in turn, reduce operating costs and lost rent due to vacancies. Thus, the landlord can amortize his anticipated turnover costs over a greater period of time.

As a result, the lower rent usually received on lease agreements is a reflection of lower overall refurbishing expenses, reduced annual vacancy rates, less management time and effort, and usually less risk of lost rents.

Tiered rents for time in occupancy

A rental or lease agreement structured with tiered rents for future periods of occupancy provide for a slightly higher rent for months included in the first-tier period — such as the first six months of the periodic tenancy — than in the following months should the tenant remain in possession.

If the month-to-month tenant continues in occupancy after the first-tier period, the rental agreement calls for a lower rent during a second-tier period or for the remainder of the occupancy, both rates being consistent with the marketplace.

Tiered rents which decrease after a period of time encourage tenants to stay longer since their rent will be lower.

As a result, the landlord's turnover costs are fully amortized and "reserved" through the higher periodic rent charged during the first tier.

If the month-to-month tenant does vacate on 30 days notice before the period of higher first-tier rent ends, less of the landlord's turnover costs prematurely incurred due to the early vacancy are left unamortized.

However, tiered rents will only avoid the security deposit limitations if:

- a security deposit of a customary amount to cover credit risks is charged;
- the higher monthly rent is consistently charged over a long enough period so as not to be characterized as a disguised or delayed receipt of a security deposit, application processing (screening) fee, cleaning fee or forfeiture; and
- the tenancy is month-to-month.

It is not certain that tiered rents will never be construed as a disguise for a nonrefundable security deposit, but it has become far less likely. [Krause, *supra*]

The same economics and amortization logic applies to the cost of **tenant improvements** (TIs) made by a nonresidential landlord (or a tenant himself). For example, if the TIs are recovered by the landlord over the first four years of a lease as part of the rent amount, the rent thereafter (second tier) could be reduced to an amount which reflects the elimination of the TI charges in order to induce the tenant to stay for a greater period of time.

Chapter 21 Accepting partial rent

This chapter distinguishes the rights held by residential and nonresidential landlords to file or continue an unlawful detainer (UD) action after receipt of partial rent.

Rights of residential and nonresidential landlords

A **nonresidential tenant**, also called a *commercial or industrial tenant*, experiences cash flow difficulties due to a business downturn. As a result, the tenant becomes delinquent in the payment of rent.

Discussions between the landlord and tenant follow. To enforce collection of the rent, the landlord eventually serves the tenant with a **3-day notice** to pay rent or quit the premises. [See **first tuesday** Form 575]

Prior to the filing of an unlawful detainer (UD) action, the tenant offers to hand the landlord a *partial payment* of the delinquent rent. Further, the tenant wants to pay the balance of the delinquent rent by a specific date if the landlord will agree in writing to defer any filing of a UD action, called a **partial payment agreement**. [See Form 558 accompanying this chapter]

The partial payment agreement specifies the amount of **deferred rent** remaining unpaid, the date for its payment and the consequences of nonpayment — eviction by a UD action without further notice. If the deferred rent is not paid as rescheduled, the nonresidential landlord has the agreed-to **right to file** a UD action to evict the tenant without repeating the 3-day notice requirement for filing a UD action.

Here, the partial payment agreement has only temporarily delayed the nonresidential landlord from moving forward with the eviction process commenced by the service of the 3-day notice on the tenant.

Under the partial payment agreement, the nonresidential landlord retains his right to proceed, based on the service of the 3-day notice, by filing a UD action to evict the tenant if the deferred payment for the balance of the delinquency is not received as rescheduled.

The tenant fails to pay the deferred balance of the delinquent rent on the date scheduled for payment. Without further notice to the tenant, the landlord files a UD action.

The nonresidential tenant seeks to prevent the landlord from proceeding with the UD action, claiming the landlord's acceptance of the partial rent payment invalidates the 3-day notice since the notice now states an amount of rent which is no longer due.

Can the nonresidential landlord accept a payment of partial rent after serving a 3-day notice and later file a UD action against the tenant without serving another 3-day notice for the remaining unpaid rent?

Yes! A **nonresidential landlord** can accept a partial payment of rent after serving a 3-day notice and before filing a UD action. Without further notice to the tenant, the nonresidential landlord can commence a UD action and evict the tenant. [Calif. Code of Civil Procedure §1161.1(b)]

Further, on accepting a partial payment of delinquent rent, a nonresidential landlord does not need to agree to a due date for the remaining rent. He also does not need to enter into any agreement regarding his acceptance of the partial payment if the tenant has previously received a reservation of rights from

the landlord, called a *nonwaiver provision* (which appears as a provision in nonresidential leases). [See **first tuesday** Form 552 §22]

However, the nonresidential landlord who memorializes his acceptance of the partial rent payment and the due date for payment of the unpaid balance eliminates any conflicting claims the tenant may make in a UD action concerning the tenant's expectations based on the landlord's acceptance of partial payment of rent.

Residential property distinguished

Consider the same situation involving residential property instead of nonresidential property. As for serving a 3-day notice and later accepting partial payment of the delinquent rent, a huge distinction exists in the separate unlawful detainer rules for residential and nonresidential tenancies.

A **residential landlord** who accepts any amount of rent from a tenant after serving a 3-day notice waives his right to file a UD action based on that 3-day notice. A residential landlord must re-serve the tenant a notice for the amount now remaining unpaid. [**EDC Associates, Ltd.** v. **Gutierrez** (1984) 153 CA3d 167]

Residential vs. nonresidential landlords

Acceptance of a **partial payment** toward delinquent rent is within the discretion of the landlord. A landlord may be willing to accept partial payments when:

- the partial payment is at least equal to the rent accrued at the time the tenant offers the payment;
- the tenant is creditworthy;
- the tenant has an adequate payment history; and
- the tenant is one the landlord wants to retain.

Both residential and nonresidential landlords may accept a partial payment of delinquent rent, then immediately serve the tenant with a 3-day notice demanding payment of the balance due or quit.

However, a landlord could agree in a partial payment agreement not to serve a 3-day notice after receipt of the partial payment of rent on the condition the balance will be received on or before a specified date. [See Forms 558 and 559 accompanying this chapter]

Residential rent paid after notice

If a **residential landlord** files a UD action and later accepts a partial payment of rent, the UD action cannot go forward to eviction. The reason lies in the different amounts of rent demanded in the notice to pay and the amount actually remaining delinquent at the UD hearing. In residential UD actions the amounts must be the same. This rule does not apply to nonresidential tenancies.

Once the residential landlord accepts a partial payment of delinquent rent, the 3-day notice served on the tenant and used to prove up a UD action no longer states the correct amount which must be paid by the tenant to avoid losing his right to possession.

Any 3-day notice served on a residential tenant overstating the amount of delinquent rent due at the **time of trial** on the UD action is invalid. The UD action in a residential eviction based on an overstated amount in the 3-day notice must fail. [**Jayasinghe** v. **Lee** (1993) 13 CA4th Supp. 33]

PARTIAL PAYMENT AGREEMENT

Nonresidential

DATE:_____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

This partial payment agreement pertains to the collection of past due rent under a nonresidential rental or lease agreement dated _____, at _____, California, regarding leased premises referred to as: _____

_____

AGREEMENT:

1. Tenant has not paid delinquent rent for the periods of_____.

2. Landlord hereby accepts partial payment on delinquent rent in the amount of . . . . . $_____

3. The balance of the delinquent rent owed is . . . . . $_____

3.1 Plus late charge for delinquency of . . . . . $_____

3.2 Plus a deferred rent processing charge of . . . . . $_____

3.3 **Total deferred rent** due, including additional charges, is the sum of . . . . . $_____

4. Tenant to pay the total deferred rent on or before _____, 20_____.

4.1 Rent to be paid by ☐ cash, ☐ check, or ☐ cashier's check, made payable to Landlord.

4.2 Rent may be tendered by ☐ mail, or ☐ personal delivery, to:

_____ (Name)

_____ (Address)

_____ (Phone)

a. Personal delivery of rent will be accepted during the hours of _____am to _____pm on the following days:_____.

4.3 Rent may also be paid by deposit into account number _____

at: _____ (Financial Institution)

_____ (Address)

_____

4.4 No grace period for payment of the deferred rent is granted to Tenant.

4.5 Delinquent payment of the deferred rent incurs a late charge of $_____

5. If deferred rent is paid when due, any outstanding three-day notice to pay rent or quit is no longer valid.

6. If the deferred rent is not paid when due, Landlord reserves the right to:
(Check one box only)

6.1 ☐ Serve Tenant with a three-day notice to pay the remaining balance of the rent due or quit the premises.
(Check if a three-day notice has not been served)

6.2 ☐ Commence, without further notice, an unlawful detainer action to evict Tenant from the premises.
(Check if a three-day notice has been served)

6.3 ☐ Continue with the unlawful detainer action on file to evict Tenant from the premises.
(Check if unlawful detainer action has been filed)

7. No provision of the lease agreement or rental agreement is affected in this agreement.

8. _____

_____

I agree to the terms stated above.	**I agree to the terms stated above.**
Date:_____, 20_____	Date:_____, 20_____
Landlord: _____	Tenant:_____
Agent: _____	Tenant:_____
Signature: _____	Signature: _____
Phone:_____	Signature: _____
Fax: _____	Phone:_____Fax: _____

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Upon acceptance of a partial payment of rent, the residential landlord must serve another 3-day notice demanding payment of the remainder due on unpaid delinquent rent, and, if not paid, file a new UD action.

Nonresidential nonwaiver requirements

However, should a **nonresidential landlord** file a UD action and later accept a partial payment of rent, he must then provide or have previously provided the tenant with notice that the acceptance of rent does not waive the landlord's rights, called a *nonwaiver of rights provision* or *reservation of rights*. When the tenant receives a nonwaiver of rights on or before the landlord's acceptance of partial rent, the landlord may continue with the UD action and recover possession of the premises. [CCP §1161.1(c)]

Nonresidential lease agreements include the necessary **nonwaiver of rights** provision, stating the landlord's acceptance of partial rent does not constitute a waiver of the landlord's right to enforce any remaining breach of the lease. [See Form 552 §22]

Now consider a nonresidential tenant who defaults on a rent payment under a lease agreement containing a nonwaiver provision. He is served with a 3-day notice to pay or quit, but fails to pay the rent before it expires. The 3-day notice to pay does not contain a provision for nonwaiver of rights on acceptance of rent.

The nonresidential landlord files a UD action. He then accepts a partial payment of rent without entering into any agreements, except to receive the amount paid as rent.

The tenant now claims the landlord cannot proceed with a UD hearing since neither the 3-day notice nor the landlord's receipt of the partial rent payment include a nonwaiver of rights provision.

Here, the nonresidential landlord may proceed with the UD action after receipt of partial rent. The nonwaiver provision in the lease agreement gives the tenant notice that the landlord's acceptance of any rent does not waive the landlord's rights. One such right is the right to proceed with a previously filed UD action. [**Woodman Partners** v. **Sofa U Love** (2001) 94 CA4th 766]

A nonwaiver provision in a 3-day notice or partial payment agreement provides the landlord with the same right to proceed with the UD action as though the provision existed in the lease agreement.

On accepting a partial payment of rent after a UD action has been filed, the nonresidential landlord amends the UD complaint to reflect the partial payment received and the remaining amount now due from the tenant. [CCP §1161.1(c)]

Get it in writing

Without a written partial payment agreement, the tenant could claim the landlord who accepted partial rent:

- treated acceptance of partial rent as an *accord and satisfaction* of all the rent due in a purported dispute over the amount of rent actually owed;
- by his conduct *waived* the right to continue eviction proceedings, sometimes called *estoppel*; or
- permanently *modified* the lease agreement, establishing a semi-monthly rent payment schedule.

When a residential or nonresidential landlord accepts a partial payment of rent, the use of the partial payment agreement is evidence that bars the tenant from later claiming the landlord waived valuable rights by accepting rent.

PARTIAL PAYMENT AGREEMENT

Residential

DATE:_____, 20_____, at_____, California.

Items left blank or unchecked are not applicable.

FACTS:

This partial payment agreement pertains to the collection of past due rent under a residential rental or lease agreement dated _____, at _____, California, regarding leased premises referred to as:_____

_____

AGREEMENT:

1. Tenant has not paid the full rent due for the months of _____.

2. Landlord hereby accepts partial payment on the past due rent in the amount of . . . . . $_____

3. The balance of the unpaid rent owed by Tenant is . . . . . $_____

3.1 Plus a late charge for delinquency of. . . . . $_____

3.2 Plus a deferred rent processing charge of . . . . . $_____

3.3 **Total deferred rent** due, including additional charges, is the sum of . . . . . $_____

4. Tenant to pay the total deferred rent on or before _____, 20_____.

4.1 Rent to be paid by ☐ cash, ☐ check, or ☐ cashier's check, made payable to Landlord.

4.2 Rent may be tendered by ☐ mail, or ☐ personal delivery,
to: _____ (Name)
_____ (Address)
_____
_____ (Phone)

a. Personal delivery of rent will be accepted during the hours of _____ am to _____ pm on the following days: _____.

4.3 Rent may also be paid by deposit into account number _____
at: _____(Financial Institution)
_____(Address)
_____
_____(Phone)

4.4 No grace period for payment of the deferred rent is granted to Tenant.

4.5 Delinquent payment of the deferred rent incurs a late charge of $_____

5. If the deferred rent is not paid when due, a three-day notice to pay rent or quit may be served at any time.

6. No provision of the lease agreement or rental agreement is affected by this agreement.

7. _____
_____
_____

I agree to the terms stated above.	**I agree to the terms stated above.**
Date:_____, 20_____	Date:_____, 20_____
Landlord: _____	Tenant:_____
Agent: _____	Tenant:_____
Signature: _____	Signature: _____
Address: _____	Signature: _____
_____	Address: _____
Phone:_____	_____
Fax: _____	Phone:_____
	Fax: _____

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Residential partial payment agreement

The partial payment agreement entered into by a residential landlord and tenant on acceptance of a portion of the rent due memorializes:

- the landlord's receipt of partial rent;
- the tenant's promise to pay the remainder of the rent on or before a rescheduled due date; and
- notification of the landlord's right to serve a 3-day notice on failure to pay the remaining balance. [See Form 559]

While the partial payment agreement does state the amount of the deferred portion of the delinquent rent owed by the tenant and the date it is to be paid, the notice is not what is required to establish an unlawful detainer and evict the tenant.

Consider a **residential tenant** who informs the landlord he will be unable to pay the monthly rent within the grace period after it is due, before the payment becomes delinquent. The tenant offers to pay part of the rent prior to delinquency and the remainder ten days later.

Since the tenant is creditworthy, has not been seriously delinquent in the past and the landlord wishes to retain the tenant, the residential landlord agrees to accept the partial payment.

However, to **avoid disputes** regarding the amount of remaining rent due and when it will be paid, the residential landlord prepares and the tenant signs a partial payment agreement formalizing their understanding.

Now consider a residential landlord who serves a 3-day notice and then accepts a partial payment of rent before the notice expires. By accepting a partial payment, the residential landlord has rendered the 3-day notice invalid.

When the rent was accepted the residential landlord required the tenant to enter into a partial payment agreement stating the date the balance owed was due. The partial payment agreement will avoid any claims by the tenant about when the balance is due and when a 3-day notice can be served if the balance is not paid.

Nonresidential partial payment agreement

The eviction rights reserved by a nonwaiver provision allowing a nonresidential landlord to accept partial rent are far less restricted by law than for a residential landlord.

Before service of a 3-day notice to pay rent or quit on a **nonresidential tenant** who is delinquent in his rent payment, the nonresidential landlord can:

- accept partial payment of rent; and
- then or later serve a 3-day notice, or agree not to serve a 3-day notice unless the remainder of the rent is not paid as rescheduled. [See Form 558 §6.1]

When a 3-day notice has been served on a nonresidential tenant and the landlord later accepts a partial payment of rent, the partial payment agreement they enter into to acknowledge receipt of partial rent contains:

- the due date for payment of the delinquent rent remaining unpaid; and
- notice of the nonresidential landlord's right to file a UD action on nonpayment.

More importantly, a nonresidential landlord who **files a UD action** and later accepts a partial payment of rent under a partial payment agreement notifies the tenant that the landlord has not waived his right to continue the UD action and recover possession under the existing UD action in spite of the payment of rent. As a variation, the nonresidential landlord could agree to reinstate the tenant's right to possession if the remainder of the delinquent rent is paid prior to the UD hearing date.

However, no agreement is necessary on acceptance of partial rent from a nonresidential tenant to preserve the landlord's rights. The landlord can accept partial payment and immediately proceed with his next step in the eviction process — service of a 3-day notice, filing of the UD action or the UD hearing — if a nonwaiver provision is in a prior document, such as the lease agreement.

Chapter 22 Changing terms on a month-to-month

This chapter reviews the requirements for a landlord's 30-day notice to alter the terms in a tenant's month-to-month rental agreement.

Landlord's 30-day notice

A landlord and tenant enter into a month-to-month tenancy under a rental agreement which contains an option to purchase the property. The option **expires on termination** of the tenancy.

Later, the landlord serves the tenant with a 30-day Notice of Change in Rental Terms, stating the option to purchase will now expire in 30 days, unless exercised by the tenant. [See Form 570 accompanying this chapter]

After the 30-day notice expires, the tenant, who is still in possession, attempts to exercise the option. However, the landlord refuses to sell the property under the option, claiming the tenant's right to exercise the option to purchase no longer exists as the option expired due to the 30-day notice.

The tenant claims the option to purchase is binding for the duration of the tenancy, and the month-to-month rental agreement has not been terminated.

Can the tenant enforce the option to purchase?

No! The option expired unexercised on the running of the 30-day notice of change in rental terms which altered its expiration date.

The option to purchase was part of the rental agreement. Thus, on expiration of the 30-day notice canceling the option, the option — as a set of terms in an addendum attached to the month-to-month rental agreement — was eliminated.

Like any other provision contained or referenced in a month-to-month rental agreement, the option to purchase is part of the month-to-month tenancy, subject to change on 30 days' written notice from the landlord. [**Wilcox** v. **Anderson** (1978) 84 CA3d 593]

30-day notice to change rental terms

All covenants and conditions in a residential or nonresidential month-to-month rental agreement, also called *provisions, clauses, terms, conditions, addendums, etc.*, may be changed on 30 days' written notice by the landlord. [Calif. Civil Code §827]

For example, a residential or nonresidential landlord under a month-to-month rental agreement can increase the rent or shift repair and maintenance obligations to the tenant by serving a 30-day Notice of Change in Rental Terms. [See Form 570]

To be enforceable, the 30-day notice must be served in the same manner as a 3-day notice to pay rent or quit. [See Chapter 28]

However, only the landlord may unilaterally change the terms in a rental agreement. [CC §827]

A month-to-month tenant has no ability to alter the terms of his rental agreement, other than to terminate the tenancy and vacate. [CC §1946]

In rent control communities, a landlord or property manager must be fully apprised of how rent control ordinances affect their ability to alter provisions in leases and rental agreements.

30-day notice to increase rents

A landlord or property manager may serve a notice of change in rental terms under a periodic (month-to-month) rental agreement on **any day** during the rental period.

Once a notice of change in rental terms is served on a month-to-month tenant (or other periodic tenancy), the new terms stated in the notice immediately become part of the tenant's rental agreement. [CC §827]

However, the new rental terms stated in the notice do not take effect until expiration of the 30-day notice.

For example, a property manager prepares a 30-day notice of change in rental terms to be served on a month-to-month tenant to **increase the rent**. The due date for the payment of rent is the first day of each month.

The tenant is properly served with the 30-day notice on the 10th of June. The tenant intends to remain in possession at the new rental rate.

Since June 11th is the first day of the 30-day notice period, the rent will not **begin to accrue** at the increased rate until July 11th — the day after the 30-day notice expires. However, rent for all of July is payable **in advance** on the first of the month, including the number of days (21) affected by the rent increase.

The rent due and payable in advance for the calendar month of July is prorated as follows:

- the old rate for the first ten days of the month; and
- the new rate for the remaining 21 days in the month of July.

Pro rata rent will be determined based on the number of days in the calendar month, unless the rental agreement contains a provision prorating rent on a 30-day month. [CC §14]

Tenant's response to a change

On being served with a 30-day notice of a change in rental terms, the month-to-month tenant has three options:

- remain in possession and comply with the new rental terms;
- serve the landlord with a 30-day notice of intent to vacate and pay pro rata rent on the next due date for days remaining unpaid during the month through the end of the 30-day period to vacate; or
- remain in possession, refuse to comply with the rental terms and raise defenses, such as retaliatory eviction, in the resulting unlawful detainer (UD) action.

Editor's note — To prevail on a defense of retaliatory eviction, circumstances showing retaliation for the exercise of rights must exist.

30-DAY NOTICE OF CHANGE IN RENTAL TERMS

DATE:_____, 20_____, at _____, California.

NOTICE: A landlord must furnish the tenant with a written 30-day notice of any change in the terms of a month-to-month tenancy. If rent is raised more than 10% within a 12-month period on a residential tenant, a 60-day notice of the increase is required. [Calif. Civil Code §827; See **first tuesday** Form 574]

To Tenant: _____

Items left blank or unchecked are not applicable.

FACTS:

You are a Tenant under a rental agreement or expired lease

dated _____, at _____, California,

entered into by _____, as the Tenant,

and_____, as the Landlord,

regarding real estate referred to as: _____

_____

NOTICE:

Thirty (30) days after service of this notice on you, the terms of your tenancy on the real estate are hereby changed as indicated below:

1. Rent shall be $_____ payable ☐ monthly, or _____, in advance, and due on the _____ day of the month.

1.1 Rent to be paid by ☐ cash, ☐ check, or ☐ cashier's check, made payable to Landlord.

1.2 Rent may be tendered by ☐ mail, or ☐ personal delivery,

to: _____ (Name)

_____ (Address)

_____ (Phone)

a. Personal delivery of rent will be accepted during the hours of _____ am to _____ pm on the following days: _____.

1.3 Rent may also be paid by deposit into account number _____

at: _____ (Financial Institution)

_____ (Address)

2. The common area maintenance charge shall be $_____ per month, payable with each payment of rent.

3. Utilities now paid by Landlord to be paid by Tenant as checked:

☐ Gas ☐ Electricity ☐ Sewage and Rubbish ☐ Water ☐ Cable TV

4. ☐ Tenant to maintain and properly care for the lawns, gardens, tree, shrubs and watering system.

5. An additional security deposit of $_____ is payable with the next rent payment.

6. _____

_____

7. This notice affects no other terms of your tenancy.

Date:_____, 20_____

Landlord/Agent: _____

Signature:_____

Phone: _____

Fax: _____

E-mail: _____

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Consider the tenant who receives the landlord's notice but does not wish to comply with changes in the rental terms. Accordingly, the tenant serves the landlord with a 30-day Notice of Intent to Vacate. [See **first tuesday** Form 572]

If the change in terms is a rent increase, the tenant is liable for pro rata rent at the new rate for the days after the rent increase becomes effective until the tenant's notice to vacate — payable in advance on the due date for the next scheduled payment of rent, usually the first.

Rent control restrictions

Most rent control ordinances allow a landlord or property manager to increase the rent to:

- obtain a fair return on his investment;
- recover the cost of capital improvements to the property; and
- pass through the cost of servicing the debt on the property.

Thus, without further authority from the rent control board, a landlord can make general adjustments to rents in one of three ways:

- increase rent by the maximum percentage set by ordinance;
- increase rent by the maximum percentage of the consumer price index (CPI) as set by ordinance; or
- increase rent by the maximum amount previously set by the rent control board.

Landlords of newly constructed units or individual units (single family residences/condos) held out for rent may establish their own rental rates, within limitations, if they are subject to rent control ordinances established prior to 1995. [See Chapter 57]

Chapter 23 Lease guarantees and small claims actions

This chapter discusses the use of lease guarantees and limitations on small claims court awards against a guarantor.

Recovery amount limited

Three young prospective tenants are seeking to rent their first apartment as roommates. The prospective tenants lack any rental history or independent source of income.

A landlord agrees to lease to the tenants on the condition a creditworthy parent of one of the tenants signs a *lease guarantee agreement*. A **lease guarantee** is entered into by the parents of one of the tenants. Under the lease guarantee, the parents are responsible for all monies due the landlord on the lease agreement to be entered into by the tenants should the tenants fail to pay. [See Form 439-L §3 accompanying this chapter]

The tenants enter into a one-year lease. However, before the lease expires, the tenants stop paying rent.

A 3-day notice to pay rent or quit is served on the tenants.

A copy of the notice is sent to the guarantor as required to enforce the guarantee agreement, called a *condition precedent*. [See Form 439-L §3.1]

The rent remains unpaid and the landlord files an unlawful detainer (UD) action. As a result, the tenants are evicted.

When the landlord regains possession, he discovers the tenants and their guests have damaged the property. The walls have holes, the carpet and drapes are destroyed, screens are missing, a window is broken, the kitchen formica is burned, parts are missing from the range and oven, door jambs are broken, a bathroom fixture is cracked, and the carport assigned to the tenants has been damaged by a vehicle.

The landlord incurs $4,500 in losses due to the cost of preparing the unit for leasing and rents lost before reletting the unit.

Since the recovery sought under the lease agreement is less than $5,000 and possession is no longer an issue, the landlord files a small claims court action against the tenants who signed the lease agreement and the parents who signed the guarantee.

However, at trial, the small claims judge advises the landlord that any award against the parents who guaranteed the lease is limited to $2,500. The landlord is then asked if he wants:

- a $2,500 judgment against the guarantors, which would bar any further recovery from the guarantors; or
- a dismissal of the case against the guarantors, which would allow the landlord to file a superior court action against the guarantors to recover on the guarantee.

Is the small claims court judge correct in limiting the landlord's recovery from the parents under the guarantee agreement?

GUARANTEE AGREEMENT

For Lease

DATE:_____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This Guarantee Agreement (Guarantee) is entered into by:

1.1 _____, Guarantor,

1.2 and _____, Landlord,

1.3 as an addendum to a Lease Agreement for real estate dated:_____, 20_____

between _____, Lessee,

and _____, Landlord,

for real estate described as: _____

_____.

2. The Lease Agreement is entered into by Landlord in reliance on this Guarantee and the financial statements provided by Guarantor.

3. LANDLORD AGREES:

3.1 To notify Guarantor of any notices served on Lessee for proceedings to enforce the Lease.

3.2 To apply to the Lease Agreement obligations, in any reasonable manner and in its sole discretion, any payments or recoveries from Lessee or from Guarantor.

3.3 Any refund to Lessee by Landlord of any payment received by Landlord on the guaranteed Lease Agreement shall remain fully guaranteed.

3.4 Any recovery by Landlord from any other Guarantor or an insurer shall first be credited to the portion of the indebtedness of Lessee to Landlord which exceeds the maximum liability under this Guarantee.

4. GENERAL PROVISIONS:

4.1 Any communication or notice under this Guarantee is to be in writing and is effective only if delivered by personal service or mailed by registered or certified mail, postage prepaid return receipt requested.

4.2 This Guarantee is binding on Guarantor, his successor and assigns and inures to the benefit of Landlord and its successors and assigns.

4.3 No provision of this Guarantee or right of Landlord can be waived, nor can Guarantor be released from his obligations except in writing signed by Landlord.

4.4 If Guarantor is a corporation or partnership, each individual executing this Guarantee on behalf of Guarantor represents and warrants he is duly authorized to execute this Guarantee on its behalf.

4.5 In any action to enforce this agreement, the prevailing party shall receive attorney fees.

4.6 This Guarantee shall be governed by the laws of California.

5. GUARANTOR AGREES:

5.1 To guarantee to Landlord the payment of rent or any other monetary obligation arising under the Lease Agreement.

5.2 To continue liability under this Guarantee, notwithstanding:

a. Any modification of the Lease Agreement;

b. Any waiver or failure to enforce the Lease Agreement;

c. Any release or modification of any security for the Lease Agreement, including other guarantees for performance of the Lease Agreement;

d. Any unenforceability of part or all of the provisions of the Lease Agreement.

5.3 To file all claims against Lessee in bankruptcy or other proceeding on any indebtedness of Lessee to Guarantor, and to assign to Landlord all Guarantor's rights on any such indebtedness. If Guarantor fails to file any claim, Landlord is authorized to do so in the name of Guarantor or as Guarantor's attorney-in-fact.

5.4 To subordinate any of Guarantor's claims against Lessee to the Lease Agreement obligations of Lessee to Landlord.

5.5 ☐ The Guarantee is secured by a trust deed.

6. GUARANTOR WAIVES:

6.1 All right of subrogation to Landlord's rights against Lessee.

6.2 All notices to Guarantor or other persons of the creation, modification, renewal or accrual of any obligations under the Lease Agreement or any other related matter, except under §3.1 of this Guarantee Agreement.

6.3 Any failure to timely enforce the Lease Agreement.

6.4 Any statute of limitations.

6.5 Any duty of Landlord to disclose to Guarantor any facts known or discovered about Lessee which materially increase Guarantor's risks of liability.

6.6 Any circumstances which constitute a legal or equitable discharge of Guarantor.

6.7 The right to require Landlord to first proceed against Lessee and enforce Lessee's obligations under the Lease Agreement or to pursue any remedy or to enforce any right before proceeding on this Guarantee.

6.8 Any Lessee defenses to Landlord's exercise of any of its rights under the Lease Agreement.

I agree to the terms stated above.	**I agree to the terms stated above.**
Date:_____, 20_____	Date:_____, 20_____
Landlord's Signature: _____	Guarantor's Signature:_____
Landlord's Signature: _____	Guarantor's Signature:_____
Address: _____	Address: _____
_____	_____
Phone: _____	Phone: _____
Fax:_____	Fax:_____
E-mail:_____	E-mail:_____

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Yes! The small claims court only has **jurisdiction over a person** who is liable as a guarantor for the obligations of another if the amount awarded is $2,500 or less. [Calif. Code of Civil Procedure §116.220(c)]

Thus, if the landlord wants a judgment against the guarantors for the full amount of his losses, the landlord must dismiss the small claims action against the parents (or never file it against the guarantors in the first place) and seek recovery on the guarantee agreement in a superior court action.

If the landlord had known the small claims court limitations from the beginning, he could have considered seeking recovery against the guarantor and the tenants in a superior court action by either representing himself, called *in pro per*, or being represented by an attorney licensed in California. Under some property management situations, the broker managing the property can handle the court action to recover possession and money losses. [See Chapter 9]

Partners and officers as guarantors

Now consider a corporate tenant who enters into an agreement to lease an office building to be occupied by the corporation. The president of the corporation signs the lease agreement on behalf of the corporation, acting in his agency capacity as its president as authorized by the board of directors, to bind the corporation to the lease agreement.

Appearing on the owner's behalf

A licensed real estate broker retained solely to manage an owner's rentals, not to represent the owner in a small claims court action, may appear on the owner's behalf in all small claims court actions related to the rental property the broker manages. [CCP §116.540(g)]

However, if the owner seeks to collect amounts which exceed the small claims court's limitations, the action must be filed in a municipal court. In a municipal court action, the broker cannot represent the owner.

Only the individual owner or an attorney licensed in California can represent the owner in a municipal court action. Also, entities must be represented by an attorney in these courts.

In conjunction with the lease agreement, the corporate vice president agrees to personally guarantee, as an individual, the corporation's performance under the lease agreement. The guarantee agreement to be signed by the vice president identifies the guarantor as an individual. The guarantee agreement does not contain a description of the guarantor's relationship to the corporation as a corporate officer.

Further, the guarantee agreement describes the obligation of the guarantor as a personal obligation. The vice president also supplies the landlord with a financial statement itemizing his personal assets.

The vice president signs the guarantee agreement and places the words "Vice President" next to his signature.

The corporation breaches the lease agreement and files for bankruptcy. The landlord then seeks to enforce the guarantee agreement against the vice president, as an individual, to collect his money losses under the lease agreement.

The vice president claims the guarantee agreement cannot be enforced against him personally since, by identifying himself as the vice president of the corporation on the guarantee agreement, he was executing the guarantee on behalf of the corporation which entered into the lease agreement, not himself.

In this example, the guarantee agreement contains words which bind the vice president personally. The fact the words "Vice President" were entered along with his signature does not change the character of the person signing the guarantee agreement.

The words "Vice President" were merely a description of the individual as a corporate officer and the guarantee agreement did not indicate he was acting as an agent of the corporation, rather than on his own behalf, when he signed it.

The nature of the guarantee agreement identifying the individual and the inclusion of his personal financial statement indicated the vice president was binding himself personally as an individual. [**Sebastian International, Inc.** v. **Peck** (1987) 195 CA3d 803]

Had the vice president signed the guarantee agreement on behalf of the corporation (as the guarantor of its obligation to pay on the lease agreement), the guarantee agreement would be redundant and surplusage. The corporation is already bound by the terms of the lease agreement.

Co-signers on the lease

Now consider a landlord who insists on a creditworthy *co-signer* on a lease agreement before he will lease property to a couple who lack sufficient credit and net worth. He wants a third party to hold him harmless if the actual tenant defaults.

A **co-signer** signs the lease agreement but may or may not be identified in the lease agreement as an additional lessee to whom the leasehold is conveyed. The co-signer does not sign a separate guarantee agreement. However, the co-signer is not listed as a tenant who will occupy the unit. The co-signer does not occupy the unit or receive any benefit from the landlord or the property for signing the lease agreement.

The tenants default and vacate the property. The landlord now seeks to recover more than $2,500 in damages and unpaid rent from the co-signer. The landlord files a small claims court action against the co-signer to collect lost rent and the cost to repair excess wear and tear to the unit.

The co-signer claims the landlord's recovery is limited to $2,500 since the co-signer was not intended to be a tenant, did not take possession of the property and received no benefit from the leasing transaction.

Here, the co-signer signed the lease agreement merely to assure payment of the rent owed by the tenants. Thus, the co-signer claims he is liable for the actions of the tenants as a *guarantor*.

While case law does not exist regarding the co-signer's guarantor defense, state law does limit a small claims recovery to $2,500 from a defendant who is required to respond to claims by paying for losses based on the default, actions or omissions of another person.

The negotiations prior to entering into the lease agreement establish the separate legal nature of the co-signer's involvement in the leasing transaction as that of a **guarantor**. Negotiations demonstrate the purpose of the co-signer's involvement was to assure payment of the prospective tenants' commitment to pay rent, not to enforce possession or other benefit for the landlord conveying a leasehold interest to the tenants.

Editor's note — The co-signer argument is similar to the co-signer of a note who receives no benefit from the loan proceeds and merely co-signs the note.

As a corollary to the co-signing of a note, the co-signer on a lease agreement would claim his activity of co-signing the lease agreement creates a contact obligation similar to an ***accommodation party*** *under California's Commercial Code, and thus, assures payment of a debt (rent) owed by another person (the occupying tenant).*

Under the Commercial Code, an accommodation party is an individual who:

- *signs a note to include liability for a debt evidenced by the note; and*
- *receives no direct benefit from the debt. [Calif. Commercial Code §3419(a)]*

The co-signer would claim the lease agreement should be viewed as a note since it is evidence of a debt (rent) owed for letting the premises, a debt economically equivalent to interest owed on principal lent (and evidenced by a note). Also, due to the fact the co-signer was not to take possession under the lease agreement, the co-signer is not primarily liable for payment of the rent and should be considered the equivalent of an accommodation party. [Com C §3419]

An accommodation party's liability is secondary and similar to a guarantor's. Thus, the co-signer would argue the landlord's recovery in a small claims court action is limited to $2,500.

In spite of the reference in the lease agreement to the co-signer as a (non-occupying) tenant, the intent and sole purpose behind the co-signer's execution of the lease was to assure payment of the rent owed by others — the occupying tenants. Thus, the co-signer entered into a guarantee agreement on signing the lease agreement.

Further, and to distinguish the landlord's obligations owed to a guarantor when co-signing the lease agreement versus those owed under a guarantee agreement, the guarantor under a guarantee agreement waives his rights to notices and consent to material changes in the lease agreement allowing the landlord to terminate the tenancy and pursue collection from the tenant before ever making a demand on the guarantor. [See Form 439-L §6]

Chapter 24 Forfeiture of the lease

This chapter discusses the effect a termination of the right to occupy, the lease, has on the tenant's obligation to pay future rent under a residential or nonresidential lease agreement.

Lease agreement obligations survive

A tenant occupies real estate under a lease agreement with a *default remedies provision* stating that once the tenant's right to possession — the lease — is terminated due to a default by the tenant, the landlord may collect rents for the remaining unexpired term of the lease. [See **first tuesday** Forms 551 and 552 §23]

The tenant fails to pay the rent, but does not vacate the premises. The landlord serves the tenant with a 3-day notice to pay rent or quit.

In the notice, the **landlord declares** the lease to be *forfeited* if the tenant does not pay rent by expiration of the third day following service. If the tenant fails to pay during the three-day period, his right to possession, the lease, is forfeited and the tenant must vacate or he will be evicted in an unlawful detainer (UD) action. [See **first tuesday** Form 575 §3]

The tenant does not pay the rent within the three-day period and remains in possession of the property, called a *holdover occupancy* or *UD* . The tenant's leasehold, called the *lease*, has been **terminated** due to the expiration of three days after service without payment since the 3-day notice included a **forfeiture declaration**. [Calif. Civil Code §1174(a)]

The landlord does not file a UD action to regain possession of the property, even though the tenant's continued possession is now unlawful and the tenant pays no further rent.

Editor's note — The landlord may benefit by choosing not to evict the tenant when no other tenant is immediately available to occupy the space. The rent earned during the holdover is the holdover rate set in the lease agreement, which usually greatly exceeds the current rental rate for the space. Further, occupancy is often required by insurance carriers to qualify for hazard coverage.

The tenant later voluntarily vacates the property prior to expiration of the lease.

The landlord then files a civil action against the tenant to **collect rent** for:

- the period prior to termination of the right to possession by forfeiture as declared in the 3-day notice;
- the holdover (unlawful detainer) period after the forfeiture of possession and prior to vacating; and
- the remaining period under the lease agreement after the tenant vacated until *expiration* of the lease.

The tenant claims the landlord cannot collect rent called for in the lease agreement for any period after expiration of the 3-day notice since:

- the election to forfeit the lease contained in the 3-day notice to pay or quit canceled the lease agreement, not just terminated the right to occupancy (the lease); and

- the landlord's failure to evict the tenant on cancellation of the lease agreement converted the tenant's continued occupancy into a periodic month-to-month tenancy — for which only reasonable rent is due, not the scheduled rent for a holdover as called for in the lease agreement.

Can the landlord collect all rent unpaid during the tenant's occupancy as well as future rent due during the remaining term of the lease even though the lease was forfeited in the 3-day notice?

Yes! A 3-day notice to pay or quit that declares an election to forfeit the lease on failure to pay rent does not also cancel the lease agreement. The **forfeiture election** only terminates the tenant's **right to possession** under the lease that was conveyed to the tenant by the landlord upon entering into the lease agreement. [**Danner** v. **Jarrett** (1983) 144 CA3d 164]

Here, a distinction must be made between the **lease** held by the tenant, called a *leasehold*, and the **lease agreement** which is a contract also occasionally referred to as *the lease*.

Further, the holdover occupancy does not convert the unlawful possession after expiration of the 3-day notice into a month-to-month tenancy, unless monthly rent is **tendered and accepted** by the landlord for occupancy during the holdover period.

Also, a landlord need not first evict the holdover tenant in a UD action before filing a separate money action to recover future rents called for in the lease agreement. The right to possession, inherent in the lease conveyed to the tenant, and the rights and obligations agreed to in the lease agreement are separately enforceable.

However, the tenant's leasehold **right to possession** must first be terminated, which occurs under the forfeiture declaration and expiration of the 3-day notice (or by an eviction in a UD action or abandonment), before the landlord can demand and recover holdover rents and **unearned future rents** under the lease agreement. [**Walt** v. **Superior Court** (1992) 8 CA4th 1667]

First terminate the lease on default

"Termination of the lease" by forfeiture refers to the termination of the tenant's *right to possession* conveyed to the tenant when he entered into the lease agreement with the landlord.

If a breach of the lease agreement by the tenant is curable, the landlord terminates the tenant's right to possession on expiration of a 3-day notice period (without performance by the tenant) by including a *forfeiture-of-lease clause* in the 3-day notice served on the tenant. [**In re Windmill Farms Inc.** (9th Cir. 1988) 841 F2d 1467]

The tenant's possession becomes unlawful when the tenant continues in possession without permission after the leasehold has been terminated by forfeiture, called an *unlawful detainer (UD), holdover tenancy* or *tenancy at sufferance*.

With the right to possession terminated by the declaration of forfeiture in the 3-day notice, the landlord may file a UD action and recover possession without concern for the tenant *reinstating* the lease and being *restored* to possession after trial. [Calif. Code of Civil Procedure §§1161.2, 1174(c)]

One purpose of the UD action is for a court to determine whether the termination of the right to possession under the 3-day notice was proper. If proper, the landlord is awarded possession and the tenant evicted.

But what if a declaration of forfeiture does not exist in the notice? Without a declaration of forfeiture, the lease is not terminated — forfeited — until a *five-day reinstatement period* has passed after entry of judgment. If the terms of the UD judgment are not met for reinstatement, the lease is forfeited and the tenant evicted. [CC §1174(c); see Chapter 22]

Rent earned and unpaid up to the time of entry of the UD judgment may be awarded in the UD action along with an eviction order. The UD award for money due from rent applies only to periods before the UD trial, including:

- the period before termination of the lease for delinquent, unpaid rent at the rate set by the lease agreement; and
- during the holdover period after termination of the lease up to trial for rent of a **reasonable amount** which is set by the court, not by prior agreement under a holdover rent provision.

A UD award may not include future, unearned rent. Future rents are only collectible through a separate money action, filed after the tenant has been evicted and mitigation of losses undertaken.

3-day notice without a forfeiture

A landlord who needs to evict a tenant by a court order in a UD action is entitled to recover possession based on either:

- terminating the lease by a declaration of forfeiture in the 3-day notice; or
- leaving the lease intact by excluding the forfeiture declaration from the 3-day notice and leave it to the court to terminate the lease on expiration of the five-day reinstatement period following a UD award. [CC §1174(a),(c)]

On termination of the lease and all tenant rights to the unexpired term of the tenancy, the landlord can reoccupy the property for his own account (if the tenant has vacated or been evicted). The tenant has no continuing right to occupy the real estate after the 3-day notice expires due to the declaration of forfeiture. [CCP §1174(a)]

However, the landlord may not want to terminate the tenancy on evicting the tenant. The landlord might rather retake possession on the tenant's behalf, acting as the tenant's agent to relet the property for the account of the tenant, not himself.

Here, the landlord omits, by deletion, the declaration of forfeiture from the 3-day notice since the tenant's lease is to remain intact and the landlord will take possession on behalf of the tenant. Although dispossessed, the tenant still **owns the leasehold** estate under the unexpired lease, now managed by the landlord on the tenant's behalf.

Also, a landlord with a tenant under an unexpired lease whose only breach is the **failure to pay rent** may want to give the tenant every opportunity, including the five-day reinstatement period, to bring the rent current and remain the otherwise good tenant he has been.

Faced with delinquent rent (and failed promises to bring the rent current), the landlord can serve the tenant with a 3-day notice to pay rent or quit from which the declaration of forfeiture provision has been deleted.

Relief from forfeiture

When a lease with an original term of **more than one year** is declared to be forfeited in a 3-day notice and the landlord is awarded possession in a UD action, the tenant who wishes to remain in possession

must, within 30 days of the forfeiture, make an application on a petition to the court for *relief from forfeiture*. If granted, the tenant's right to possession under the lease is *restored*. [CCP §1179]

The **relief from forfeiture** is sought primarily by nonresidential tenants who have long-term leases and are prepared to cure any defaults.

Only a court order, or a mutual agreement with the landlord, can **restore** the tenant's right to possession since the declaration of forfeiture in the 3-day notice **terminated** the tenant's lawful right to possession on expiration of the three days without the tenant curing the breach. The tenant has no ability to unilaterally restore his right to possession under the lease after the lease has been terminated by forfeiture.

A tenant's relief from forfeiture and the court ordered reinstatement of the lease are based on the degree of *hardship* the tenant would suffer if evicted. The application for relief and reinstatement of the lease agreement and restoration of the tenant to possession can be filed anytime within 30 days after termination of the tenancy and before the removal of the tenant by the sheriff and the return of possession to the landlord.

The court's grant of the tenant's petition for relief from forfeiture will be:

- conditioned on the payment of all amounts due the landlord, including **full payment** of the rent due; and
- **full performance** of all rental or lease agreement conditions, whether oral or written.

Also, whether the right to possession has already been terminated by a declaration of forfeiture in the 3-day notice does not concern the court when hearing the tenant's petition for relief from forfeiture. [CCP §1179]

If an attorney appears on behalf of the tenant seeking relief from the forfeitures, a copy of the application for relief and petition for the hearing must be served on the landlord or property manager filing the UD action at least five days prior to the hearing. [CCP §1179]

At the UD trial, the landlord needs to be prepared to defend against a motion for relief of forfeiture (i.e., why relief from the forfeiture would be unfair to the landlord, and if fair, the amounts owed and lease/rental conditions to be cured, etc.). The court in a UD action may initiate an inquiry on its own into whether the tenant is entitled to relief from forfeiture.

If the tenant is *in proper*, the tenant can make an oral request of the court at the UD trial in the presence of the landlord (or other plaintiff) to be relieved of the forfeiture and allowed (on conditions) to remain in possession.

The obligation to pay future rent

On termination of the tenant's lease under a declaration of forfeiture in any 3-day notice or at trial by statute, the landlord is entitled to:

- file a UD action to physically remove the defaulting tenant from actual possession, called *eviction*, and enforce collection of rent earned and unpaid through entry of the UD judgment; and
- file a separate action to recover money due during the remaining term of the lease, called *future rents*, and any prior unpaid rent earned but not included in the UD judgment.

The landlord's right to collect rent for the remaining unexpired period of the lease after the tenant has been evicted is **independent and separate** from the issue of whether the tenant has the right to occupy

the property. One is a *contract right* (to collect money) and the other is a *real property right* (to occupy the property). Different rules of law apply and each right is separately enforced. [Walt, *supra*]

In a money action to **collect future rents**, the landlord is entitled to recover:

- all unpaid rent earned under the lease agreement up until the right to possession is terminated [CC §1951.2(a)(1)];
- reasonable per diem rent from the termination of the right to possession, until entry of the judgment for rent [CC §1951.2(a)(2)];
- all unearned rent called for in the lease agreement for the remaining unexpired term of the lease, subject to *loss mitigation*, default remedies in the lease agreement, the prior reletting of the premises, and the discounted *present worth* of the future rent [CC §1951.2(a)(3)];
- costs incurred by the landlord as a result of the tenant's breach [CC §1951.2(a)(4)]; and
- attorney fees incurred if the lease agreement contains an attorney fees provision. [CC §1717]

The separate money action to recover future rents can be filed immediately after the tenant has vacated or been evicted and his right to possession terminated.

Of course, double recovery of rent is not allowed. If the landlord, in his UD action, is awarded (or denied) rents accrued prior to the UD award, the landlord cannot again seek to recover those amounts in the separate money action for rents.

For the landlord to recover future rents under a lease agreement after an early termination of possession, the landlord must either:

- have **reserved his right** to collect future rent payments by a provision in the lease agreement, called a *default remedies clause* [See Figure 1 accompanying this chapter]; or
- **relet the property** in good faith prior to being awarded the future rent if the lease agreement does not contain a default remedies clause, called a *statutory recovery*. [CC §1951.2(c)]

Collecting future rents after eviction

Now consider a tenant who breaches the lease agreement by failing to pay the rent when due.

The lease agreement contains a **default remedies clause** stating the landlord may collect all remaining unpaid rents due under the lease agreement after an early termination of possession. [See Figure 1]

The landlord serves the tenant with a 3-day notice to pay rent or quit that includes a forfeiture provision. On expiration of the three days and failure of the tenant to either pay or quit, the landlord brings a UD action to evict the tenant. The landlord is awarded possession. The UD judgment also includes an award for rent earned and unpaid for the periods prior to entry of the UD judgment, and attorney fees.

The landlord later brings a separate money action to recover the unpaid rent due over the remaining term of the lease.

The tenant claims the landlord is barred from recovering the unpaid rent since a forfeiture of the lease was declared.

However, the declaration of the forfeiture only terminates the tenant's right to cure the breach after the 3-day notice expires, unless the tenant can show *hardship* and fully performs on the lease agreement. [CCP §§1174.5, 1179]

Here, even if the lease agreement does not contain a default remedies clause, statutory provisions permit the landlord to recover future rents after termination of the tenant's right to possession. However, without a default remedies clause, the landlord must first **relet the premises** before seeking recovery of the future rent. [CC §1951.2(a)(3), (c)]

Loss mitigation affects future rents

With or without a default remedies clause in a lease agreement, the landlord who seeks to recover future rents is compelled to *mitigate his loss* of rent after the tenant vacates or is evicted.

If the landlord does not act to reduce his loss of future rental income, a tenant has the right to offset any future rent due under his lease by the amount of rent the landlord could have reasonably collected by reletting the space. [CC §1951.2(c)]

Consider the tenant who fails to pay rent as scheduled in the lease agreement.

Ultimately, a UD judgment is entered in the landlord's favor, and the tenant is evicted by the sheriff under a *writ of possession* issued by the court.

Having repossessed the property, the landlord, in an effort to mitigate his losses, takes steps to relet the property. The property is listed with a real estate broker to locate a tenant for the property.

During the effort to relet, the evicted tenant offers to lease the property at the old rental rate. The owner refuses the evicted tenant's offer, opting to relet the property to a more creditworthy tenant at a lower rental rate.

The landlord then seeks to recover his money losses from the evicted tenant for the difference between the lesser amount of rent the new tenant has agreed to pay — the offset — and the greater amount of rent due and unpaid through the expiration of the evicted tenant's lease.

The evicted tenant claims the landlord is barred from collecting any unpaid future rent since the landlord could have recovered the full amount of rental payments if the landlord had accepted his offer to lease.

Is the evicted tenant liable for the deficiency created by the difference between all rent remaining unpaid on his lease and the amount of rent the new tenant has agreed to pay?

Yes! The tenant owes the deficiency remaining in future rents on the terminated lease after reletting the premises. The landlord's effort to mitigate the loss of rents by reletting the property was in good faith and reasonable.

The reasonableness of the landlord's conduct undertaken to relet the space is determined based on the **actions actually taken** by the landlord, not by evaluating available courses of action the landlord could have taken to mitigate damages (such as re-renting to the evicted tenant).

Here, the landlord actively sought a new tenant and was unable to get the full amount of the rent the evicted tenant had agreed to pay through the expiration of his lease. [**Zanker Development Co.** v. **Cogito Systems, Inc.** (1989) 215 CA3d 1377]

A landlord must pursue a course of action that is likely to reduce the amount of future rent the tenant owes under the lease agreement after the tenancy (lease) is terminated.

Otherwise, the tenant is permitted to offset future rents by showing the landlord's efforts (or lack thereof) to relet the property were unreasonable efforts to *mitigate* the loss of rent.

Discounted future rent and interest

The landlord who is entitled to recover **future rent** under an unexpired lease agreement will only be awarded the *present value* of the unearned future rents.

To determine the **present value** of unearned rent at the time of the court's money award, the future rents will be **discounted** (to their present value) at the annual rate of 1% over the Federal Reserve Bank of San Francisco's discount rate. The bank's discount rate during late 2006 was 6.25%. Thus, the discount rate for calculating the present worth of future rent on an award at that time would be 7.25%. [CC §1951.2(b)]

From the time the tenant defaults on the payment of rent to the time the unpaid rent is awarded, the landlord is entitled to **recover interest** on unpaid amounts of back rent.

The interest accrued prior to judgment is calculated at the rate agreed to in the lease agreement. If the interest rate is not stated in the lease agreement, the interest will accrue at 10% per annum from the date of default to entry of the money judgment. After judgment is awarded for back rent or discounted further rent, interest accrues at 10% on the money judgment until paid. [CC §§1951.2(b), 3289]

Costs to relet

Since the landlord has a duty to mitigate rental losses over the remaining term of a lease following abandonment or eviction, the landlord is also entitled to recover all **reasonable costs** he incurs to relet the property in his effort to mitigate the loss of rental income after the tenant is no longer in possession. [CC §1951.2(a)(4)]

Costs are expenses incurred to relet the property, including:

- costs to clean up the property;
- brokerage and legal fees to find a new tenant;
- permit fees to construct necessary improvements or renovations; and
- any other money losses incurred as a result of the tenant's breach, such as depreciation of the property's market value. [**Sanders Construction Company, Inc.** v. **San Joaquin First Federal Savings and Loan Association** (1982) 136 CA3d 387]

Cancellation of the lease agreement

Future rents will become uncollectible if the landlord and tenant agree the right to possession (under real estate law) and the tenant's obligation to pay rent (under contract law) are **both terminated**, called a *surrender* or *cancellation* of the lease agreement. [See Chapter 30]

Figure 1 *Excerpt from **first tuesday** Form 552 — Nonresidential Lease Agreement*

23. Default Remedies:

23.1 If the Tenant breaches any provision of this lease, the Landlord may exercise its rights, including the right to collect future rental losses after forfeiture of possession.

Conversely, *termination of the lease* refers only to the landlord's or court forfeiture of the tenant's right to possession under the leasehold conveyed to the tenant by the landlord on entering into the lease agreement.

To avoid a surrender, the landlord must ensure all 3-day notices and other communication, including those of his agents, state the landlord's only intent is to declare a *forfeiture* of the lease (leasehold), not a *cancellation* of the lease agreement.

A cancellation of the lease agreement results in a termination of the tenant's contract obligation to pay future rent. The cancellation is comparable to an owner's deed-in-lieu of foreclosure, giving ownership and possession to a lender, in exchange for the lender's cancellation of the debt owed on a trust deed note.

Chapter 25 Delinquent rent and the 3-day notice

This chapter discusses the requirements and consequences for the use of the 3-day notice to pay rent or quit in residential and nonresidential income properties.

Forfeit possession in three days

A tenant, residential or nonresidential, fails to pay the agreed rents on the *due date* and prior to expiration of the *grace period*. The rent is now *delinquent*. The property manager *serves* the tenant with a 3-day notice to pay rent or quit the premises. [See Form 575 accompanying this chapter]

The 3-day notice states the **exact amount** of delinquent rent and any other amounts owed the landlord that are delinquent, the **monetary aspect** of the rental or lease agreement entered into by the tenant. [See Chapter 20]

Further, the notice contains a **lease forfeiture clause** stating the landlord had *elected to forfeit the lease*, the tenant's possessory interest in the property granted by the rental or lease agreement held by the tenant. In the event the tenant fails to pay the delinquent rent before the notice expires, the landlord is entitled to recover possession of the property.

After the 3-day notice expires, the tenant remains in possession and tenders payment of the delinquent rent to the landlord, attempting to cure the default in the lease agreement. The landlord refuses to accept the payment. The tenant refuses to voluntarily vacate.

The landlord files an unlawful detainer (UD) action seeking to evict the tenant and regain possession of the premises. The landlord claims the tenant's possessory right to the property was terminated by the expiration of the 3-day notice and election to forfeit the tenant's right to occupy the property and, as a result, the lease cannot now be *reinstated* by the tenant's tender of delinquent rent.

Can the landlord evict the tenant even though the tenant tendered the delinquent rent in full after expiration of the 3-day notice and before the UD trial?

Yes! The tenant's **right to possession** was terminated by expiration of the 3-day notice since the notice contained a declaration of the landlord's **election to forfeit** the lease (that's the occupancy, not the lease agreement). Thus, the tenant's occupancy became unlawful on expiration of the 3-day notice containing the declaration of forfeiture. [Calif. Code of Civil Procedure § 1174(a)]

On expiration, the landlord is no longer obligated to accept delinquent rent payments and allow the occupancy and the **rental or lease agreement** to be *reinstated* when:

- the landlord **does not actually receive payment before** the notice expires; and
- the landlord declares in the 3-day notice his **election to forfeit** the tenant's right to possession on expiration of the notice. [CCP §§ 1161(2), 1174(a); see **first tuesday** Form 575 §4]

Default, notice, cure or vacate

A tenant *defaults* on his rental or lease agreement by failing to:

- pay rent and any other **amounts due** called for in the rental or lease agreement; or

- perform nonmonetary obligations called for in the rental or lease agreement.

On a tenant's default, the landlord may make a demand on the tenant to cure the default or quit (vacate) the premises.

However, only a *material breach* allows for the landlord to forfeit of the tenancy.

Failure to pay rent or perform other significant obligations called for in the rental or lease agreement is a *material breach*. Conversely, the tenant's failure to pay late charges, interest penalties, bad check charges or security deposits are *minor breaches*,which alone do not justify a demand to cure or quit under a 3-day notice. [**Keating** v. **Preston** (1940) 42 CA2d 110]

A failure to increase the security deposit by paying an additional sum as agreed is not a failure to pay *rent*. Rent must be delinquent before a 3-day notice can be served to collect all other dollar amounts due and unpaid which are minor breaches. A security deposit is *security* for the payment of rent. A security deposit is not rent. Thus, failure to make a security deposit payment is not a basis for a 3-day notice since it is not rent.

Some nonmonetary defaults by a tenant cannot be cured, such as waste to the premises, alienation of the leasehold or significant criminal activity which has occurred on the property, called *incurable breaches*. The landlord's remedy for an incurable breach is to serve notice on the tenant to quit the premises within three days after service, leaving no alternative but to vacate. Here, a lease forfeiture clause accompanying the 3-day notice is unnecessary and ineffective since the failure cannot be cured and the tenancy cannot be reinstated. [CCP §1161(4)]

Three days between notice and UD

When a tenant does not *timely pay* rent, the landlord may serve the tenant with a written notice demanding the tenant pay all amounts due or vacate the premises within three days, called a *3-day notice to pay rent or quit*.

A tenant has three calendar days, day one being the **day after service** of the notice, in which he may pay the delinquent rental amounts and avoid forfeiture of his possession and eventual eviction. [Calif. Civil Code §10]

The tenant cures the default, retaining his right to possession by paying the amount stated before the 3-day notice expires. [CCP §1161.5]

During the three-day notice period, the tenant may **tender payment** of the rent and cure the default in the same manner the tenant made past rental payments — by personal or company check, money order, cashier's check, cash or electronic transfer. [**Strom** v. **Union Oil Co.** (1948) 88 CA2d 78]

A tenant's rent that is paid by check and received on time by the landlord sometimes becomes delinquent when the check is returned to the landlord due to the tenant's lack of sufficient funds with his bank. Since the rent is delinquent, the landlord can now serve a 3-day notice to pay or quit. However, he cannot now limit his demand for payment to cash or a money order in the 3-day notice since the tenant has been paying rent by check.

A rent check received by the landlord during the 3-day notice period must be paid by the tenant's bank to cure the delinquency. If it is returned for lack of sufficient funds (or otherwise), the delinquent rent has not been paid, the notice has expired and the tenant's right to possession terminated by reason of the declaration of forfeiture.Thus, the landlord may file a UD action if the tenant remains in possession.

THREE-DAY NOTICE TO PAY RENT OR QUIT

With Rent-Related Fees

DATE:_____, 20_____, at _____, California.

NOTICE:A tenant who fails to pay the amounts due under a lease/rental agreement, must, within three (3) days after service of written notice of the breach, either pay the amount due or vacate and deliver possession of the premises to the landlord. [California Code of Civil Procedure §1161(2)]

To Tenant: _____

Items left blank or unchecked are not applicable.

FACTS:

1. You are a Tenant under a rental or lease agreement

1.1 dated _____, at_____, California,

1.2 entered into by _____, Tenant,

and _____, Landlord,

1.3 regarding real estate referred to as: _____

_____

NOTICE:

2. You are in breach of the payment of amounts due under the lease or rental agreement.

3. Within three (3) days after service of this notice you are required to either:

3.1 Pay rent and other amounts now due and unpaid in the **Total Amount** of . . . . . $_____ representing rent for the periods of:

_____, 20_____ to _____, 20_____. . . . . Amount $_____

_____, 20_____ to _____, 20_____. . . . . Amount $_____

_____, 20_____ to _____, 20_____. . . . . Amount $_____

and amounts due for:

☐ returned check fees of . . . . . $_____

☐ late charge fees of . . . . . $_____

☐ common area maintenance of . . . . . $_____

☐ association assessments of . . . . . $_____

☐ property taxes of . . . . . $_____

☐ interest on delinquent rent of . . . . . $_____

The **Total Amount** due may be paid in one of the following manners:

a. By personal delivery to: _____ (Name)

_____ (Address)

_____

_____ (Phone)

Personal delivery of the Total Amount due which will be accepted at the above address during the hours of _____a.m. to _____p.m. on the following days:_____

b. By deposit into account number _____

at: _____ (Financial Institution)

_____ (Address)

_____

c. By the electronic funds transfer previously established between Landlord and Tenant.

OR

3.2 Deliver possession of the premises to the Landlord or _____

_____

4 If you fail to pay the Total Amount due, or to deliver possession of the premises within three (3) days, legal proceedings will be initiated against you to regain possession of the premises and to recover the amounts owed, treble damages, costs and attorney fees.

5. The Landlord hereby elects to declare a forfeiture of your Right to Possession if you fail to pay the Total Amount demanded above.

5.1 Landlord reserves the right to pursue collection of any future loss of rent allowed by Civil Code §1951.2.

Date:_____, 20_____

Landlord/Agent:_____

Signature: _____

Address: _____

Phone:_____ Fax:_____

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Editor's note — Consider a tenant under a month-to-month rental agreement whose rent checks are returned due to insufficient funds. To modify the method of payment, the landlord must serve the tenant with a written 30-day notice advising the tenant he now is to pay rent by cash or cashier's check. [CC §827]

One year rent limitation

Unpaid rents that **became due** more than one year before service of a 3-day notice may not be included in the 3-day notice. If delinquent rents due for more than one year are included in the 3-day notice, the notice is defective and will not terminate the right to possession. More rent has been demanded than will be awarded by a court in a UD action. Thus, any UD action based on a notice demanding rent for delinquencies more than one year on will fail. [**Bevill** v. **Zoura** (1994) 27 CA4th 694]

However, the landlord may recover those rents and other amounts delinquent for more than one year by pursuing collection in a separate civil action, but not in an eviction (UD) action. The time period for a landlord's recovery of due and unpaid amounts in a separate money action from a UD action is four years, due to a *statute of limitations*. [CCP §337]

Before a landlord or his property manager serves a tenant with a 3-day notice to pay rent or quit, the following questions must be answered:

- Is the rent delinquent?
- What amounts are due and unpaid?
- When can rent earned be estimated in the 3-day notice?
- What is a reasonable estimate of delinquent rent?
- When does the 3-day notice expire?
- When does the tenant's right to possession terminate? and
- How are subtenants evicted?

The holdover tenant

When a lease contains a holdover provision, the landlord's failure to evict the tenant after serving a three-day notice does not create a month-to-month tenancy with rent due as stated in the holdover provision. [**Walt** v. **Superior Court** (1992) 8 CA4th 1667]

Similarly, a three-day notice is not required once a 30-day notice to vacate served on a tenant has expired since a 30-day notice also establishes an unlawful detainer. [CC §1946]

A holdover occurs when a tenant remains in possession after the agreed lease term expires, not when the three-day notice expires. When a tenant holds over, the landlord may immediately file a UD action without serving any notice. [CCP §1161(1)]

However, a landlord under an expired lease should only seek to recover possession, not rent, in a UD action filed against the holdover tenant.

Then in a separate action, the landlord can recover money losses under the holdover provision for the period of the tenant's unlawful detainer.

Typically, holdover rent exceeds fair rental value and will not be the basis for rent awards in a UD action.

When is the rent delinquent?

Rent must be *delinquent* before a 3-day notice to pay or quit may be served.

Rent becomes **delinquent**:

- the day following the last calendar day of the *grace period* established in the rental or lease agreement; or
- the day following the due date, when the rental or lease agreement does not provide for a *grace period*.

However, when the last day scheduled for payment of rent falls on a legal holiday, the payment may be *tendered* on the next business day. A *legal holiday* is every Saturday, Sunday and any other day designated by the state as a holiday, which includes federal holidays. [CCP §§10, 12a]

Likewise, if the last day of a *grace period* for payment of past due rent (which could be the due date) falls on a Saturday, the tenant's rent payment is not delinquent if it is received by the landlord on the first business day following the legal holiday, which would be Monday unless it is designated a federal holiday. [CCP §13; Calif. Government Code §6706]

Thus, when the final day of the 3-day notice falls on a holiday such as a Saturday, Sunday or legal holiday, the 3-day notice expires on the next business day. [**Lamanna** v. **Vognar** (1993) 17 CA4th Supp. 4; CCP §12a]

Unlike the service of documents in civil actions, mailing of the 3-day notice for failure of attempts at personal service does not extend the three-day notice period an additional five days. [**Losornio** v. **Motta** (1998) 67 CA4th 110]

To initiate the **rent collection process** against a tenant who is in possession, the landlord serves the tenant with a 3-day notice to pay rent or quit. The notice may be served on any day after the grace period has expired without receipt of the rent, called a *delinquency*.

A **grace period** is stated in a rental or lease agreement as a set time period following the due date during which rent may be paid without incurring a *late charge*. While rent may be unpaid and past due, it is not *delinquent* until the grace period expires and a late charge may be demanded.

Consider a landlord and tenant who enter into a lease agreement that states rent is due on the first day of each month, the *due date*. The lease agreement also contains a **late charge provision** imposing an additional charge if rent payments are not *received* on or before the tenth of the month. A grace period is not mentioned in the lease agreement.

Each month, the tenant pays his rent after the date for incurring a late charge. The landlord accepts the tenant's late rental payments every month, but makes no demand for payment of the late charge. [See **first tuesday** Form 569]

Finally, on receipt of yet another late payment, the landlord informs the tenant all future rent payments, including the next month's rent which is due in a few days, must be received by the landlord prior to the date for incurring a late charge.

The next month, the late charge period runs and rent has not been paid. On the day the late charge is incurred, the 11th, the landlord serves the tenant with a 3-day notice to pay rent or quit that includes a declaration of forfeiture provision. The tenant does not pay rent before the 3-day notice expires. The landlord files a UD action.

As in the prior months, the tenant tenders the rent payment to the landlord after the late charge period has expired. However, unlike in prior months, the landlord refuses to accept the payment, claiming the tenant is now unlawfully occupying the premises.

Has the landlord established an unlawful detainer on expiration of the 3-day notice?

No! The 3-day notice is premature and useless. The tenant's rent had not yet become **delinquent**. Rent is not delinquent until the grace period — including *extensions* authorized by the conduct of the landlord's prior acceptance of late payments— has run.

When the lease agreement called for an additional charge after the tenth, a **grace period** was established since, by agreement, payments received after the tenth are delinquent. Further, the conduct of the landlord by consistently accepting rent payments after the grace period *without demanding the late charge* by notice, extended the grace period. [**Baypoint Mortgage** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818]

Thus, the tenant's tender of rent after the written grace period ran, but on or before the extended date set by the landlord's conduct, was timely.

For the landlord to **re-establish his ability** to enforce the grace period provision in the rental or lease agreement, the landlord must first give the tenant 30-days' advance notice of the change in terms of payment to reinstate and enforce the written grace period. [See **first tuesday** Form 570]

The 30-day notice of a change in terms used to reinstate the grace period should state all rent payments due following the expiration of the 30 days must be received within the written grace period, prior to delinquency. If payment is not received, a 3-day notice will be served and the late charge imposed for the agreed-to amount.

Collecting late charges

Late charges demanded and unpaid are properly included in a three-day notice to pay rent or quit since delinquent late charges are sums due under the lease. [**Canal-Randolph Anaheim, Inc.** v. **Moore** (1978) 78 CA3d 477]

However, in a UD action, many municipal court judges, as a matter of discretion, will declare invalid a three-day notice which includes any late charges. [See Chapter 28]

Conversely, a UD action based solely on the failure to pay late charges, bad check fees, accrued interest or the deposit of additional security will not stand. [See Chapter 28]

To collect unpaid late charges other than by a deduction from the security deposit, the landlord may file a small claims or municipal court action. A UD action based solely on the delinquency of late charges will not stand. [See Chapter 23]

A property manager retained by a landlord to manage his residential or nonresidential rental property may represent the landlord in small claims court to recover money due under a rental or lease agreement related to the property managed. [CCP §116.540(h)]

Editor's note — For payments made on loans secured by single-family, owner-occupied residential dwellings:

- *the borrower is given a statutory ten-day grace period; and*
- *the amount of the late charge is limited to the greater of 6% of the installment due or $5. [CC §2954.4(a)]*

No statutory grace period or late charge limitations exist for rent payments made by tenants. The legislature should provide residential tenants with similar statutory protection (and landlord guidance) to establish consistent expectations among residential tenants and their landlords in California.

Accurate residential rent demands

To be valid, the 3-day notice to pay rent or quit served on a **residential tenant** must state the *exact amount* of money due which has not been paid. Conversely, **nonresidential rent** may be *estimated* when the exact amount cannot be accurately ascertained.

A residential tenant is not required to pay more than the amount due and unpaid to retain his possessory right under his rental or lease agreement. Likewise for nonresidential tenants, even if the rent they pay is erroneously estimated at a higher amount than the amount due.

However, if the amount stated in a 3-day notice served on a **residential tenant** exceeds the amounts actually due and unpaid at the time of the UD trial, the notice is invalid. [**Jayasinghe** v. **Lee** (1993) 13 CA4th Supp. 33]

For both residential and nonresidential tenants, if the amount stated in the 3-day notice is less than the actual amount due and unpaid,the tenant may pay the amount stated and avoid eviction. To collect any amounts omitted in a 3-day notice, the landlord must serve another 3-day notice to pay the balance or quit.

Estimated nonresidential rent

When the property leased is nonresidential, the 3-day notice may include an *estimate* of the amounts due if:

- the notice states the amount due is an estimate; and
- the amount estimated is reasonable. [CCP §1161.1(a)]

Failure to indicate in the 3-day notice that an estimate of the amount due is **an estimate** renders the 3-day notice invalid.

Further, if the landlord knows the **exact amount** of the delinquent rent and other monies owed, and then states a different amount as the amount due in the 3-day notice and declares it an estimate, the landlord will be unable to evict the tenant. The notice is defective for terminating the tenant's right to possession since the exact amount of the delinquency is known to the landlord.

Also, including amounts in the 3-day notice that are not yet due, such as unbilled common area maintenance expenses (CAMs), is not a reasonable estimate of *delinquent amounts*. [**WDT-Winchester** v. **Nilsson** (1994) 27 CA4th 516]

An estimate of rent owed in a 3-day notice is **considered reasonable** if:

- the actual amount owed is truly in question; and

- the delinquent amount demanded is neither 20% **more or less** than the amount determined due at the UD hearing. [CCP §1161.1(e)]

Estimating known amounts

Consider a tenant who leases nonresidential property. The lease agreement states the tenant will pay his proportionate share of the property taxes and assessments to reimburse the landlord for his payment of the taxes.

Rent provisions in the lease agreement state the landlord will first pay all property taxes and assessments on the premises before making a written demand on the tenant for reimbursement of the tenant's proportionate share.

Before the landlord pays the property taxes, he makes a written demand on the tenant for payment of the tenant's portion of the unpaid property taxes. The tenant does not pay his share of the taxes demanded by the landlord and also fails to make his regular monthly rental payment.

The landlord serves the tenant with a 3-day notice to pay rent or quit. The 3-day notice states the amount due includes unpaid rent and the tenant's proportionate share of the property taxes. The total amount does not exceed 20% of the periodic rent payment, and the notice indicates the amount is an **estimate**.

The tenant neither pays the amount stated in the notice nor vacates the premises. The landlord files a UD action.

The tenant claims the 3-day notice is invalid and does not terminate his possessory interest and establish an unlawful detainer since he did not yet owe property taxes on the date the notice was served. The landlord claims the 3-day notice is valid since the estimated amount was within 20% of the actual amount due — the rent.

Is the 3-day notice valid?

No! The 3-day notice to pay rent or quit is invalid. It is not reasonable for the landlord to estimate rents when he knows the **exact amount** owed by the tenant. [WDT-Winchester, *supra*]

Further, the portion of taxes demanded from the tenant as additional rent was not yet due, much less delinquent. The landlord had not yet paid the property taxes and billed the tenant, an agreed-to requisite to a demand for reimbursement.

(Guess)timating unknown amounts

Now consider a nonresidential tenant who takes possession of property on entering into a percentage lease agreement.

The rent provisions in the lease agreement state:

- the rent is payable annually on the anniversary of the commencement of the lease in an amount equal to 20% of the gross sales proceeds; and
- the tenant is to provide the landlord with the amount of his gross sales proceeds.

The tenant fails to furnish the landlord with the amount of sales proceeds or make the annual rental payment. The landlord serves the tenant with a 3-day notice to pay rent or quit. The notice states:

- the amount of rent which is due and unpaid in an amount equal to 20% of the tenant's gross sales proceeds; and

- only the tenant knows the amount of the sales proceeds.

The tenant does not pay the rent before the 3-day notice expires. The landlord files a UD action. The tenant claims the 3-day notice is invalid since the notice did not state the dollar amount of rent due.

Can the landlord evict the tenant even though the 3-day notice did not state the dollar amount of the unpaid and delinquent rent?

Yes! The tenant cannot prevent the landlord from enforcing his right to receive rent or recover possession by failing to provide the landlord with the means needed — the amount of his sales proceeds — to determine the rental amount and then claim the 3-day notice is defective.

The purpose of a 3-day notice is to give a tenant the opportunity to avoid forfeiture of his leasehold estate by paying the delinquent rent. [**Valov** v. **Tank** (1985) 168 CA3d 867]

Rent estimates by nonresidential tenants

On receiving a 3-day notice stating the rental amount due is an estimate, the nonresidential tenant may respond by tendering the amount of rent the **tenant estimates** is due. [CCP §1161.1(a)]

If the amount the tenant estimates and tenders is equal or greater than the rent due, the tenant will retain his right to possession in a UD action. Likewise, when the amount estimated and tendered by the tenant is less than the amount actually due and was a reasonable estimate, the tenant retains possession by paying the additional amount and other sums awarded the landlord within five days after entry of the UD judgment. [CCP §1161.1(a)]

Subtenant evictions by the owner

For an owner to regain possession when the (master) tenant defaults and a subtenant occupies the premises, the 3-day notice must also **name** the subtenant as a tenant in default and be served on the subtenant. [CCP §1161]

Serving a subtenant with a copy of the 3-day notice that only names the master tenant will result in the subtenant retaining his right to possession. [**Briggs** v. **Electronic Memories & Magnetic Corporation** (1975) 53 CA3d 900]

Conversely, an owner who wishes to evict a defaulting master tenant but retain the subtenant may do so. The owner is not required to serve the subtenant with a 3-day notice when only the master tenant is being evicted. [**Chinese Hospital Foundation Fund** v. **Patterson** (1969) 1 CA3d 627]

For example, an owner consents to a sublease which contains an *attornment provision*. Should the master tenant default and his right to possession be forfeited, the owner may enforce the sublease after his exercise of the attornment clause. [See Chapter 59]

Under the sublease's **attornment provision**, the subtenant has agreed to recognize the owner as his landlord in lieu of the master tenant if the owner elects to forfeit the master tenant's leasehold and recognize the subtenant as the owner's tenant.

However, a subtenant who takes possession of the premises after the master tenant has been served with a 3-day notice will be evicted on the owner's successful completion of a UD action. [CCP §1164]

Chapter 26 Three-day notices to quit

This chapter reviews the proper 3-day notice to serve on a tenant for a material breach of a lease, other than for past due amounts of money.

Curable and incurable nonmonetary breaches

On a routine inspection of an apartment complex, the property manager observes a pet in one of the units. All the rental and lease agreements with tenants residing in the complex prohibit housing of a pet on the premises.

As a courtesy, the tenant of the unit is asked, both orally and by a personal note left with the tenant, to remove the pet. However, the tenant retains the pet. [See Chapter 28]

To enforce the pet provision in the tenant's lease agreement, the property manager prepares a 3-day notice to **perform or quit**. The notice is served on the tenant. The notice gives the tenant an ultimatum — either remove the pet (the performance required) or vacate the unit within three days (the alternative performance). [See Form 576 accompanying this chapter]

The tenant fails to remove the pet from the premises and remains in the unit after the 3-day notice expires.

Can an unlawful detainer (UD) action be maintained to evict the tenant for failure to either remove the pet or vacate under the 3-day notice?

Yes! On expiration of the 3-day notice to perform by removing the pet or vacating, the tenant may be evicted if one of the alternative conditions has not been met. The tenant has breached the provision in his lease agreement that prohibits keeping a pet on the premises. [Calif. Code of Civil Procedure §1161(3)]

However, had the tenant breached a provision in his rental or lease agreement that the tenant could not perform within three days, the landlord or property manager would serve a 3-day **notice to quit** the premises, giving no alternative to perform and remain on the premises. [CCP §1161(3)]

Types of 3-day notices

The 3-day notice served on a tenant must be the correct type before the tenant's unlawful detainer, holdover, of a premises can be established and the tenant evicted.

Depending on the nature and extent of the tenant's breach, one of the following types of **3-day notices** may be served:

- a 3-Day Notice to **Pay Rent or Quit** [See **first tuesday** Form 575];
- a 3-Day Notice to **Perform or Quit** [See Form 576 accompanying this chapter]; or
- a 3-Day Notice to **Quit**. [See Form 577 accompanying this chapter]

When a tenant's breach is the **failure to pay** rent or other money obligation which is due, the tenant is served with a 3-day notice *to pay rent or quit*.

When the lease provision breached is not for rent or other money obligation, called a *nonmonetary breach*, and the breach can still be quickly corrected by the tenant, the tenant is served with a 3-day notice *to perform or quit*. [See Form 576]

However, a tenant who is in default on both the payment of money and a curable nonmonetary provision in the lease, such as the obligation to maintain the landscaping, a 3-day notice to perform or quit is used. The demand to pay rent is listed as an additional (monetary) breach to be cured under the notice to perform or quit.

A 3-day notice *to quit* containing no alternative and requiring the tenant to vacate is served on a tenant when the tenant's breach is:

- impossible to cure in three days [**Matthew** v. **Digges** (1920) 45 CA 561]; or
- a statutory breach, such as an unauthorized subletting of the premises, nuisance or unlawful use of the premises. [CCP §1161(4); see Form 577]

Notice to perform or quit

The 3-day notice to **perform or quit** requires the tenant to either:

- **perform** under the breached lease provision; or
- **vacate** the premises. [CCP §1161(3)]

The tenant's breach of the rental or lease agreement must be a *significant breach*, called a *material breach*, to justify serving a 3-day notice to perform or quit. A minor or trivial breach by the tenant will not support a 3-day notice. [**Baypoint Mortgage** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818]

In order for the tenant to avoid a forfeiture of his right to occupy the property, he must be given an opportunity to *reinstate* the rental or lease agreement — if the breach can be cured in three days.

The 3-day notice to perform or quit will specify the provision breached and the action required to cure the breach. When the tenant cures the breach before the 3-day notice expires, the rental or lease agreement is *reinstated* and possession continues as though no breach occurred.

To eliminate the tenant's right to also **reinstate** the rental or lease agreement after the 3-day notice expires, a reinstatement period to avoid eviction that runs on the fifth day after the UD trial, the notice must clearly state the landlord's **election to terminate** the tenant's right to possession if the tenant fails to perform, called a *lease forfeiture clause*. [CCP §1174(a)]

The tenant who vacates instead of performing forfeits his **possessory right** to occupy the leased premises. Further, the tenant cannot reinstate the right to possession after expiration of the 3-day notice to perform or quit when the landlord declares his election to terminate possession by declaring a forfeiture in the notice. [See Form 576 §4]

In spite of the forfeiture of the right to possession, the lease agreement, including provisions imposing obligations on the tenant to pay money, remains fully enforceable by the landlord after the tenant's leasehold interest is terminated. The lease agreement was not canceled.

The tenant's failure to either cure the breach by performance or vacate within the three days following service of a notice and election to forfeit allows the landlord to initiate a UD action and have the tenant removed without the right to reinstate possession after the 3-day notice expires. [CCP §1161(3)]

THREE-DAY NOTICE TO PERFORM OR QUIT

DATE:_____, 20_____, at _____, California.

NOTICE: A tenant who fails to perform any terms of the rental or lease agreement which can be performed or rectified must within three (3) days after service of written notice of the breach either cure the breach or vacate and deliver possession of the premises to the landlord. [California Code of Civil Procedure §1161(3)]

To Tenant: _____

Items left blank or unchecked are not applicable.

FACTS:

You are a Tenant under a rental agreement or expired lease agreement

dated _____, at _____, California,

entered into by _____, Tenant,

and _____, Landlord,

regarding real estate referred to as _____

_____

NOTICE:

1. You are in breach of the terms of your rental or lease agreement as follows:_____

_____

_____

2. Within three (3) days after service of this notice, you are required to either:

2.1 Perform or rectify the breach by _____

_____

OR

2.2 Deliver possession of the premises to Landlord or _____

_____

3. If you fail to cure the breach or to deliver possession within three (3) days, legal proceedings may be initiated to regain possession of the premises and recover the rent owed, treble damages, costs and attorney fees.

4. Landlord hereby elects to declare a forfeiture of your lease if you fail to cure the breach noted above.

4.1 Landlord reserves the right to pursue collection of any future rental losses allowed by Civil Code §1951.2.

Date:_____, 20_____

Landlord/Agent:_____

Signature: _____

Address: _____

_____

Phone:_____

Fax:_____

E-mail:_____

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Curable nonmonetary breaches

A tenant operates a retail business on leased premises. The lease agreement requires the tenant to periodically provide the landlord with a list of his sales merchandise in inventory. Also, the landlord is permitted to examine the tenant's business records.

Upon the landlord's request, the tenant does not provide the inventories or permit the landlord to examine his business records.

The landlord serves the tenant with a 3-day notice to quit the premises — no alternative performance is given to allow the tenant to rectify the failures and stay. The tenant does not vacate the premises.

The landlord files a UD action, seeking to evict the tenant since he breached a material lease obligation.

The tenant claims he cannot be evicted since the 3-day notice did not give the tenant the alternative to perform under the rent provisions by delivering inventory lists and records to avoid a forfeiture of possession.

Can the landlord maintain a UD action against the tenant based on the 3-day notice to quit?

No! The 3-day notice served on the tenant must be in the alternative — perform or quit — since the tenant could have handed over an inventory to the landlord and given the landlord access to the business records, all within three days. [**Hinman** v. **Wagnon** (1959) 172 CA2d 24]

A landlord must allow a tenant to cure a material breach, monetary or nonmonetary, within three days after notice when the tenant is capable of performing under the breached lease provision within three days. [CCP §1161(3)]

Notice to quit; no alternatives

If the lease provision violated by the tenant calls for or prohibits an activity that constitutes a material breach and cannot be performed or rectified within three days, the tenant may be served with a 3-day notice to quit. No alternative activity need be stated in the notice as nothing can or remains to be done which the tenant can do (or stop doing) within three days. [CCP §1161(3); see Form 577]

For example, possession can be recovered by service and expiration of a 3-day notice to quit based on **statutory forfeitures** when a tenant:

- maintains a *nuisance* on the premises;
- uses the premises for an *unlawful purpose*; or
- *assigns, sublets* or *commits waste* to the premises in breach of a lease provision. [CCP §1161(4)]

The 3-day notice to quit does not need to indicate the provision breached or the activity of the tenant constituting the breach, such as an unlawful use, nor does it need to include a lease forfeiture declaration by the landlord. The right to possession — the lease — is *automatically forfeited* by the breach, not by the running of the 3-day notice. The tenant's right to possession may not be reinstated unless the landlord chooses to waive the forfeiture.

The landlord serves a 3-day notice to quit only because the notice is a requisite to the recovery of possession in a UD action, as a forfeiture of the lease has already occurred by statute due to these enumerated events. [CCP §1161(4)]

THREE-DAY NOTICE TO QUIT

DATE:_____, 20_____, at_____, California.

NOTICE: A tenant must vacate and deliver possession to the landlord within three (3) days after service of written notice for breach of any terms of the rental or lease agreement which cannot be performed or rectified. [California Code of Civil Procedure §1161(4)]

To Tenant: _____

Items left blank or unchecked are not applicable.

FACTS:

You are a Tenant under a rental and lease agreement

dated _____, at _____, California,

entered into by _____, Tenant,

and _____, Landlord,

regarding real estate referred to as: _____

_____

NOTICE:

1. You are in breach of the terms of your rental or lease agreement as follows:

_____

_____

_____

_____

_____

_____

_____

_____

2. Within three 3-day after service of this notice you are required to vacate and deliver possession of the premises to Landlord or: _____

3. If you fail to vacate and deliver possession of the premises within three (3) days, legal proceedings may be initiated to regain possession of the premises and to recover the rent owed, treble damages, costs, and attorney fees.

4. Landlord hereby elects to declare a forfeiture of your lease.

4.1 Landlord reserves the right to pursue collection of any future rental losses allowed by Civil Code §1951.2

Date:_____, 20_____

Landlord/Agent: _____

Signature: _____

Address: _____

_____

Phone: _____

Fax: _____

E-mail: _____

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Quit! The breach cannot be undone

Consider a tenant who leases agricultural property. The lease agreement states the tenant's use of the property is limited to grazing sheep. However, the tenant plants a crop on the property, a breach of the use provision in the lease agreement.

Based on the tenant's **unauthorized use** of the premises, the landlord initiates the eviction process by serving a 3-day notice to quit on the tenant.

The tenant's use of the property to raise a crop, instead of the single agreed-to use as a pasture, is an *incurable nonmonetary breach* of the lease agreement. The tenant cannot reverse the effects of raising the crop on the soil since the activity has already occurred. [**Harris** v. **Bissell** (1921) 54 CA 307]

Consider a tenant of agricultural property improved with an orchard of trees. The lease obligates the tenant to poison squirrels on the property to control the agricultural pest.

The tenant does not poison the squirrels as required by the lease agreement and the premises becomes infested with squirrels.

The landlord serves the tenant with a 3-day notice to quit the premises based on the tenant's failure to eradicate the squirrels with poison.

The tenant does not vacate the premises. The landlord files a UD action to evict the tenant. The tenant claims he cannot be evicted since the proper notice to serve for the failure to poison the squirrels is a 3-day notice to perform or quit, allowing the tenant to cure his breach.

However, the 3-day notice to quit is the proper notice. The elimination of squirrels by poisoning could not be performed within three days — before the 3-day notice to quit would expire. [Matthews, *supra*]

Breach of statutory prohibitions

A tenant may be evicted for maintaining a *nuisance or unlawful use* of the premises, even if these activities are not prohibited by the lease agreement. [CCP §1161(4)]

A **nuisance** includes anything which:

- is *injurious to health*, such as contamination of the property's soil;
- is *offensive to the senses*, such as excessive noise levels or obnoxious fumes; or
- *obstructs the use and enjoyment* of surrounding property. [Calif. Civil Code §3479]

For example, a tenant in a multi-unit property maintains a nuisance on the premises, such as excessive late-night noise, which interferes with another tenant's **use or enjoyment** of his premises. As a result, the landlord may serve a 3-day notice to quit on the interfering tenant.

Also, a tenant who illegally sells, grows or manufactures controlled substances on the premises, has by his actions, triggered an *automatic forfeiture* of the leasehold. The tenant may be served with a notice to quit for **maintaining a nuisance**, and if he does not vacate, be evicted by a UD action. [CCP §1161(4)]

A tenant's **unlawful use** of the premises under the statute includes violations of local laws or ordinances affecting the property, such as noncompliance with zoning ordinances restricting the use of the premises. Again, the leasehold is forfeited automatically due to the violation. The 3-day notice is required only as a requisite to a UD action should the tenant remain in possession. [**Haig** v. **Hogan** (1947) 82 CA2d 876]

However, before the unlawful use **justifies** service of a notice to quit, the use must:

- threaten the physical safety of the property;
- stigmatize the premises; or
- impair the landlord's continued receipt of rent.

For example, a tenant's lease agreement contains a provision stating the tenant will not use the premises for any unlawful purpose or to violate any laws, a provision that restates the statute.

The tenant's business, which is authorized to operate on the premises, is penalized for conducting the pricing of its services and goods in violation of federal anti-trust laws. The landlord seeks to evict the tenant for unlawful use of the premises in violation of the lease.

Here, the landlord may not evict the tenant. The tenant's violation of anti-trust laws is the unlawful conduct of his **lawful business**, not an unlawful use of the premises. [**Deutsch** v. **Phillips Petroleum Co.** (1976) 56 CA3d 586]

When a tenant's activity is considered a nuisance or an unlawful use, a 3-day notice to quit may be served on the tenant even if the tenant is able to cure the breach by terminating or eliminating the activity within three days. The mere occurrence of the unlawful and endangering activity **automatically forfeits** the lease, leaving nothing for the tenant to do except vacate or be evicted based on the 3-day notice to quit.

Forfeiture on assigning or subletting

Consider a lease provision prohibiting the tenant from *assigning* the lease or *subleasing* the premises without first obtaining the landlord's written consent. Unknown to the landlord or his property manager, the tenant subleases the premises. The property manager discovers the premises is occupied by a subtenant.

The property manager names and serves both the **tenant and subtenant** with a 3-day notice to quit. The subtenant does not vacate the premises, and a UD action is filed to regain possession from both the tenant and the subtenant.

The tenant claims his leasehold interest cannot be terminated by the 3-day notice to quit since the landlord cannot unreasonably withhold his consent to a sublease of the premises.

Can the landlord serve a 3-day notice to quit on a tenant who subleased without his consent and evict the tenant?

Yes! The landlord can proceed to evict the subtenant based on a 3-day notice to quit. The tenant failed to request the landlord's consent prior to subletting the premises. Thus, the tenant breached the lease agreement, immediately forfeiting his right to possession without the landlord's need to declare the forfeiture.

The tenant cannot avoid the forfeiture of his leasehold due to the subletting by claiming the landlord cannot unreasonably withhold consent when the landlord was not given the opportunity to grant or withhold his consent. [**Thrifty Oil Co.** v. **Batarse** (1985) 174 CA3d 770]

When provisions in a lease agreement prohibit assignment of the lease or subleasing by the tenant without the landlord's consent, and the tenant assigns or subleases without obtaining consent, a 3-day notice to quit may be served on the tenant to recover possession. By statute, the act is an incurable activity that terminates the lease, leaving no alternative to vacating. [CCP §1161(4)]

However, the landlord need not consider the lease terminated when the tenant assigns the lease or sublets the premises or assigns the lease without the landlord's consent. The landlord can waive the statutory forfeiture of possession.

Thus, a 3-day notice to **perform or quit** may be served on the tenant requiring the tenant to remove the subtenant from the premises — within three days — and retain his right to possession. [CCP §1161(3)]

Waste forfeits the lease

Waste to the leased premises by a tenant is a breach that cannot be cured. Thus, the right to possession has been terminated. The tenant must vacate if the landlord serves a 3-day notice to quit.

However, *waste* is grounds for eviction only when the **value** of the leased premises is substantially or permanently y diminished — *impaired* — due to the tenant's conduct.

Waste occurs when a tenant:

- *intentionally damages* or destroys the leased premises; or
- neglects the premises and *impairs its value* by failing to care for and maintain it as agreed.

Consider a tenant in an office building. The tenant's lease agreement obligates the tenant to follow all building rules. The building rules prohibit tenants from adjusting the temperature controls. The tenant's employees adjust the temperature controls, resulting in damage to the thermostat.

The landlord serves the tenant with a 3-day notice to quit the premises. The tenant does not vacate. The landlord then files a UD action, claiming the tenant committed waste to the premises since adjusting of the temperature controls damaged the building's thermostat.

The tenant cannot, however, be evicted for waste. The damage to the thermostat was minor and reparable within three days. Also, the landlord was unable to demonstrate the tenant's conduct *substantially diminished* the property's market value. [**Rowe** v. **Wells Fargo Realty, Inc.** (1985) 166 CA3d 310]

Now consider a landlord who discovers a tenant's pets have damaged the wooden floors, doors and plastered walls of the tenant's apartment unit. Unsanitary conditions also exist in the unit.

A 3-day notice to quit is served based on the tenant's waste to the unit.

Again, the landlord is unable to evict the tenant for waste. The tenant's failure to maintain the unit has not significantly nor permanently lowered the market value of the unit. The damage created by the tenant's pets could be repaired, and the unit quickly returned to a marketable condition. Thus, a 3-day notice to perform or quit was appropriate. [**Freeze** v. **Brinson** (1991) 3 CA4th Supp. 1]

Waiver of breach by conduct

Consider a tenant of nonresidential property who wants to add further improvements to the leased premises. The lease agreement requires the landlord's written consent before the tenant may make improvements to the premises.

The tenant submits a request to the landlord for approval of additional improvements he wants to make. The landlord does not respond to the tenant's request.

Without the landlord's consent, the tenant begins construction of the improvements. The landlord is aware of the construction. Further, the landlord knows the construction extends beyond the area of the leased premises and encroaches onto other property owned by the landlord.

The landlord demands the tenant remove the improvements he has constructed. As a result, the landlord and tenant commence lease negotiations to expand the leased premises to include the property on which the improvements now encroach.

During negotiations, the landlord accepts all rent payments made by the tenant. Ultimately, the landlord and tenant are unable to reach an agreement and the unauthorized construction remains unresolved. The landlord then serves a 3-day notice to quit followed by a UD action to evict the tenant.

The tenant claims the landlord's acceptance of rent payments waived the landlord's right to terminate the tenant's possession based on the tenant's failure to obtain the landlord's consent before improving the property.

Can the landlord evict the tenant?

Yes! The landlord did not waive his right to terminate the tenant's possession by accepting rent addressed in the lease agreement since the landlord **continuously objected** and never acquiesced to the construction of the improvements.

While the landlord accepted rent payments, the landlord demonstrated to the tenant that he did not intend for the tenant to construct the improvements and continue to occupy the premises on the terms of the existing lease agreement. [**Thriftimart, Inc.** v. **Me & Tex** (1981) 123 CA3d 751]

Many lease agreements contain an enforceable provision that states a waiver by the landlord of a tenant's breach of the lease is not a waiver of similar, subsequent breaches or other breaches by the tenant, called a *nonwaiver provision*. [See Chapter 28]

When a **nonwaiver provision** is in the lease agreement, the landlord's acceptance of rent does not constitute a waiver of his right to evict the tenant for a separate later breach of the provision, such as a further assignment of the lease. [**Karbelnig** v. **Brothwell** (1966) 244 CA2d 333]

Consider a tenant who operates a concession stand on leased property. The lease agreement prohibits camping on the premises and contains a nonwaiver provision.

The tenant is unable to stop campers from using the premises. The tenant installs a sign stating camping is not allowed and erects fences to keep overnight campers off the premises. On a demand from the landlord, the tenant takes down the sign and fences.

On removal of the fence, the tenant advises the landlord of his inability to prevent campers from using the premises without maintaining the sign. The landlord does not respond, but continues to accept rent.

After an extended time, the landlord serves a 3-day notice to quit for breach of the lease agreement provision prohibiting camping on the premises. The landlord files a UD action to evict the tenant.

Can the landlord evict the tenant?

No! When a landlord's conduct leads a tenant into believing the **breaching conduct** is no longer a concern of the landlord, the landlord is prevented from processing an eviction based on tenant activity autho-

Covering your bases with alternatives

A tenant's failure to comply with building rules or to maintain the premises in a clean and sanitary manner are breaches of a lease agreement which generally can be performed within three days.

The landlord who serves a 3-day notice to **perform or quit** provides the tenant with the opportunity to comply with building rules or clean the premises and stay. Should the tenant's breach remain uncured after three days and the tenant remain in possession, the landlord may file a UD action to evict the tenant if he so chooses.

For example, the tenant whose authorized pets damage his unit may be unable to replace wood floors and replaster walls within three days. If the tenant fails to perform, the landlord can evict him.

Consider again the tenant who could not be evicted for waste since his failure to follow building rules did not permanently lower the market value of the premises.

A tenant whose breach results from the failure to follow building rules may stop the activity constituting a violation on receiving a 3-day notice to perform or quit. Should the tenant perform the notice to comply with building rules within the three-day period, the tenant cannot be evicted.

However, the tenant might later resume the breaching activity. The tenant's repeat conduct may then constitute a *nuisance*, perhaps obstructing the ability of the landlord or other tenants to enjoy the use of the building due to the constant interference.

The tenant will likely contest a 3-day notice to quit for nuisance. The landlord will then be forced to show how the tenant's conduct constitutes a *continuing nuisance*.

A 3-day notice to quit results in a forfeiture of the tenant's right to possession, as no alternative exists — a harsh result courts do not favor.

Thus, if the tenant's breach is non-statutory and can be cured within three days, a 3-day notice to perform or quit is the proper notice to serve.

When uncertainty exists whether or not the breach can be cured within three days or a tenant's conduct meets the requirements for serving a 3-day notice to quit, a 3-day notice to perform or quit will either:

- cause the tenant to cure the breach within three days; or
- support the landlord's UD action to evict the tenant.

rized by the landlord, even if the lease agreement contains a nonwaiver provision. [**Salton Community Services District** v. **Southard** (1967) 256 CA2d 526]

Once the tenant's actions breaching a lease agreement provision have been condoned by the landlord, the landlord has *waived* the nonwaiver provision and must take reasonable steps if he intends to *reinstate* the nonwaiver provision so he can enforce it.

A reasonable step to reinstate enforceability would be a written 30-day notice to the tenant stating the landlord intends to enforce the nonwaiver provision in the lease agreement on expiration of the 30-day notice, if 30 days is sufficient time to provide a reasonable opportunity for the tenant to cure the breach. [See **first tuesday** Form 570]

If the tenant continues to breach after expiration of the period for reinstating the provision, the landlord may serve a 3-day notice to perform or quit.

For example, the due date and grace period for rent payments are waived by the landlord when he consistently accepts late payments without demanding a late charge or serving a 3-day notice to pay or quit. A waiver of the late charge provision occurs in spite of the existence of a nonwaiver provision in the lease.

Thus, the late charge provision must be reinstated by a 30-day notice of change in terms before it can be enforced. The landlord's conduct acting inconsistent with written provisions in the lease agreement sets tenant expectations which can be returned to the terms of the written agreement by the notice.

Service of notice

Statutory requirements must be strictly followed when preparing and serving a 3-day notice. [See Chapter 24]

If the 3-day notice is incorrectly or inaccurately prepared, or improperly served on the tenant, the notice is invalid. To evict the tenant, a new 3-day notice must be correctly prepared and properly served. [**Lamey** v. **Masciotra** (1969) 273 CA2d 709]

A proof of service form must be filled out and signed by the person who serves the 3-day notice. Without a proof of service, a UD action cannot be maintained. [See **first tuesday** Form 580]

Concurrent service of two notices

When concurrently serving both a 3-day notice to pay (perform) or vacate and a 30-day notice to vacate or change the terms of a month-to-month tenancy under an expired rental or lease agreement, the notices must not be attached to one another and must be served separately from one another. If attached to one another or combined in any way other than in time, they may be reasonably confused as one. The confusion would properly defeat any UD action based on the 3-day notice.

Also, each notice must be accompanied by its own separate *proof of service* to clarify their independent existence. [See **first tuesday** Form 580]

For example, a tenant on a month-to-month tenancy again breaches his obligation to maintain the premises. The landlord concurrently serves the tenant with both a 3-day **notice to perform** or quit and a 30-day notice to vacate. Each notice stands alone, unattached to the another, and is separately, but concurrently, handed to the tenant. Each service is returned by the server accompanied by a separate proof of service.

The tenant fails to maintain the premises under the 3-day notice to perform and remains in possession. The landlord files a UD action based on the service of the 3-day notice and it's proof of service.

At the UD hearing, the tenant claims he thought he did not have to vacate within three days since the 30-day notice did not mention a breach and gave him 30 days to vacate.

The court, under the "reasonable man" analysis, on examining the content of the separate notices, grants the tenant **relief from forfeiture** of possession under the 3-day notice to perform. Confusion may have caused the tenant not to protect his interest in the property. The tenant is allowed to stay, **on the condition** he immediately perform the maintenance addressed in the 3-day notice. [CCP §1179]

Thus, regardless of any confusion he may have, the tenant will either:

- retain the right to possession after the UD proceedings on the 3-day notice (subject to the outstanding 30-day notice to vacate) on the condition he immediately perform the maintenance called for in the notice; or
- be evicted from the property if he fails to perform the maintenance called for in the notice.

Now consider a tenant who is at the same time served with both a 3-day notice and a separate 30-day notice, each with its own proof of service statement.

The **3-day notice** to pay or quit requires the tenant to pay amounts due and delinquent, within three days after service of written notice of the breach, or vacate and deliver possession to the landlord.

The **30-day notice** to vacate states the tenant is required to vacate and deliver possession of the premises to the landlord within 30 days after service of the notice. [See Chapter 21]

The 30-day notice does not request that the tenant pay any delinquent rent which is due, only the amount which will become due within 30 days on the first of the next calendar month. The tenant pays the rent before the three-day period expires.

Later, at the end of the 30-day period, the tenant refuses to leave. The landlord initiates a UD action on the 30-day notice to vacate. At the UD hearing, the tenant claims he believed that when he paid the delinquent rent under the 3-day notice, the 30-day notice no longer was applicable, since the notices all related to his difficulty in paying rent on time.

Again, the court will apply the *reasonable man test* — examining the contents of both notices and determining if confusion could occur in the mind of the tenant.

The court also must enforce the *legislative scheme* to make sure the landlord followed all statutory requirements regarding the contents and service of the notice. If the landlord is in compliance, the court must award the landlord the relief available under the **legislative scheme**.

Here, the contents of the notices show they are mutually exclusive of one another. The 30-day notice makes no mention of the delinquent rent owed or, that if rent is paid, that the tenancy will continue beyond 30 days.

Also, while served concurrently, the landlord did serve the notices separate from one another. Both notices followed their respective statutory schemes:

- one for collecting delinquent rent; and
- the other for terminating the month-to-month tenancy.

Thus, a court should find that the tenant's purported confusion is not a legal excuse for failing to vacate.

Retaliatory eviction

A landlord concurrently serves a tenant with a 3-day notice to pay or quit and a 30-day notice to vacate — merely because the tenant continuously fails to timely pay rent and is again delinquent. The tenant claims the 30-day notice was served to terminate his tenancy **in retaliation** for being late with the rent, which is true, although the reason for the termination of the occupancy was not and need not be stated in the 30-day notice.

However, a **retaliatory eviction** does occur in residential properties when the tenant:

- exercises his right to file a complaint with an appropriate agency regarding the *habitability* of the premises;
- orally complains to the landlord about the *habitability* of the premises;
- files documents to initiate a judicial or arbitration proceeding regarding the *habitability* of the premises;
- *organizes or participates* in a tenant association or an association for tenant's rights; or
- lawfully exercises any rights, such as the refusal to authorize credit reports or personal investigation after vacating the premises. [CC §1942.5]

Here, the tenancy was not terminated in retaliation for complaints about the habitability of the premises or for a legal right exercised by the tenant. Instead, the tenant was being evicted for his delinquency in rent payments — a breach by the tenant of the month-to-month rental agreement.

A landlord convicted of a retaliatory eviction is liable for punitive damages up to $2,000 for each act of retaliation. [CC §1942.5]

Chapter 27 Proof of service

This chapter explains the proper service of a 3-day notice, or other notice, on a tenant.

Diligence to locate a tenant is not required

Rent owed by a residential tenant under a rental or lease agreement has become delinquent. In a final effort to collect the delinquent rent, the landlord (or property manager or unlawful detainer (UD) service) prepares a **3-day notice** to pay rent or quit for *service* on the tenant.

The individual serving the notice, called a *process server*, attempts to personally serve the tenant at the tenant's residence. The tenant is not present at the residence and the tenant's place of business is unknown to the landlord.

However, a 16-year-old who responds to the **process server** at the premises is handed the 3-day notice. The process server believes the 16-year-old is of suitable age and discretion to accept service of the notice and pass it along to the tenant without the process server having to post the notice on the property.

A copy of the 3-day notice is also mailed on the same day to the tenant at the residence address since a business address is unknown.

The 3-day notice expires without the tenant paying the delinquent rent or vacating. A UD action is filed to evict the tenant.

At the UD hearing, the tenant defends his occupancy, by claiming the 3-day notice was improperly served. The tenant claims he cannot be evicted since a person of suitable age and discretion to accept service must be at least 18 years old.

Is handing a copy of a 3-day notice to an apparently intelligent 16-year-old on the premises and mailing a copy to the tenant proper service to terminate the occupancy and establish an unlawful detainer of the property on its expiration?

Yes! The tenant's unlawful detainer is established without personal service of the notice on the tenant. After an attempt at personal service, *substituted service* is authorized. Proper **substituted service** of a 3-day notice includes delivery of a copy to an intelligent and mature 16-year-old on the leased premises. Thus, having been served, the tenant can be evicted. [**Lehr** v. **Crosby** (1981) 123 CA3d Supp. 1]

If the tenant is not available for personal service at his residence, or his place of business if known to the landlord, the 3-day notice may be:

- handed to any person who is of **suitable age and discretion** at either location; and
- copied and mailed to the tenant at his residence. [Calif. Code of Civil Procedure §1162(2)]

The rules for serving a 3-day notice do not specify a person of suitable age and discretion must be at least 18 years old.

A younger person who appears to be of suitable age and discretion, such as a guest or family member at the tenant's residence or an employee at his place of business, is a person who may be handed the notice as part of the substituted service on the tenant.

Editor's note — A person of suitable age and discretion to accept substituted service of a 3-day notice must, on questioning, be able to understand their responsibility to hand the notice to the tenant. If the responsibility is not understood, then the process server must post the notice at the property and mail a copy to the tenant.

Serving a 3-day notice

To establish the UD of a tenant or subtenant, a requisite to a UD action, statutory requirements must be strictly followed when **preparing and serving** a 3-day notice. [**Lamey** v. **Masciotra** (1969) 273 CA2d 709]

Both residential and nonresidential property are subject to the same 3-day notice and service rules.

When a rental or lease agreement is breached, one of the following statutory 3-day notices is **served on the tenant**, depending on the type of activity or inaction which is the breach:

- a 3-Day Notice to Pay Rent or Quit [See **first tuesday** Form 575];
- a 3-Day Notice to Perform or Quit [See **first tuesday** Form 576]; or
- a 3-Day Notice to Quit. [CCP §1161; see **first tuesday** Form 577]

Service by elimination of methods

The 3-day notice can be served on the tenant by:

- personal service;
- **leaving a copy** with a person of suitable age and discretion at the premises **and mailing** a copy to the premises if the tenant is not personally served at his residence or place of business, called *substituted service*; or
- **posting** the notice on the leased premises **and mailing** a copy to the premises if the tenant is not available for personal service at his place of business or residence address if known, or a person could not be found to be served at the tenant's residence or place of business. [CCP §1162]

The **first attempt** at serving a 3-day notice must be by personal delivery of a copy to the tenant, called *personal service*. [CCP §1162(1)]

Personal delivery can be made wherever the tenant can be located. Personal service must be attempted at both the tenant's residence and place of business, if known. These two attempts to personally serve the notice are a prerequisite to an attempt at substituted service.

Secondly, if the attempt to personally serve the tenant fails because he is absent from both his residence and place of business (if known), a copy of the 3-day notice may then be:

- handed to a person of suitable age and discretion at either the tenant's residence or place of business; and
- mailed to the tenant at his residence, called *substituted service*. [CCP §1162(2)]

Thirdly, if both the tenant's residence and place of business are unknown, which is rare, or the tenant cannot be found for personal service at either the residence or business addresses, or a person of suitable age and discretion cannot be found for substituted service at either place, the 3-day notice may be:

- posted on the leased premises; and
- mailed to the tenant at the address of the leased premises, loosely deemed service by *nail and mail*. [CCP §1162(3)]

Typically, a landlord's resident manager or property manager is responsible for preparing and serving a 3-day notice as part of their employment by the landlord. [See **first tuesday** Forms 590 and 591]

The attorney or UD service handling the anticipated eviction often prepares and causes the notice to be served.

Documenting service

The individual who serves the 3-day notice must complete a form confirming he served the notice and the type of service completed, called a *proof of service*. [See Form 580 accompanying this chapter]

If a UD action is filed to evict a tenant, a completed proof of service must be produced at trial, evidencing service of the 3-day notice.

If the 3-day notice is **personally served** on the tenant, the individual serving the notice must verify he made the personal service at the address served. [See Form 580 §5.1]

When the server completes a **substituted service**, he verifies:

- his attempts to personally serve the tenant at both addresses were unsuccessful;
- the notice was handed to a person of suitable age and discretion at the tenant's residence or business address; and
- the 3-day notice was mailed to the tenant at his residence. [See Form 580 §5.2]

If the notice is served by **posting** on the premises, the server verifies:

- no person of suitable age or discretion was available at the tenant's residence and business addresses, or the addresses are unknown; and
- the 3-day notice was mailed to the tenant at the address of the leased premises. [See Form 580 §5.3]

Full compliance on each attempt

When serving a 3-day notice, the landlord must first attempt to personally serve the tenant before resorting to substituted service. [**Nourafchan** v. **Miner** (1985) 169 CA3d 746]

Personal service occurs when the 3-day notice is handed to the tenant, whether or not the notice is:

- accepted by the tenant; or
- dropped at the tenant's feet after the tenant refuses to accept the notice.

Failure to attempt **substitute service** at both the tenant's residence and place of business, if known, before service of the notice by posting the property results in defective service. The landlord will be unable to maintain a UD action against the tenant should the tenant challenge the service of the 3-day notice.

When attempting substituted service, merely showing, and not handing, a copy of the 3-day notice to a person on the premises and mailing a copy to the address is not proper service. [**Kwok** v. **Bergren** (1982) 130 CA3d 596]

When leaving a copy with a suitable person or posting a 3-day notice on the leased premises, service is completed only if the notice is also mailed to the tenant. [**Jordan** v. **Talbot** (1961) 55 C2d 597]

The notice, when required to be mailed, may be mailed by first-class, registered or certified mail.

However, the **lone mailing** of a 3-day notice is not itself a proper service. For service to be effective when mailed, the notice must first (following attempts at personal service) be either handed to an individual of suitable age and discretion or, if such an individual is not available, posted on the premises. [**Liebovich** v. **Shahrokhkhany** (1997) 56 CA4th 511]

No diligence required to locate

Personal service must first be attempted before resorting to substituted service, but *reasonable diligence* is not required in the attempt to locate the tenant so he can be personally served.

For example, consider a property manager of an apartment building who prepares a 3-day notice for service on a tenant. The property manager is unaware of any business address for the tenant. No business address is listed on the application to rent.

The property manager attempts to serve the 3-day notice on the tenant at his unit.

The property manager receives no response after ringing the doorbell and knocking on the door of the premises. Thus, no personal or substituted service can be made. The property manager posts the 3-day notice to the door with tape (or a nail) and mails another copy addressed to the tenant at the apartment unit by first-class mail.

The tenant does not pay the delinquent rent or vacate before the 3-day notice expires. A UD action is filed and served on the tenant.

The tenant claims improper service of the 3-day notice since the property manager made no effort to locate the tenant's business address in order to personally serve him before serving the 3-day notice by posting the property and mailing him the notice.

However, the property manager is not required to use diligence, much less investigate the location of the tenant when attempting personal service of a 3-day notice. A review of the property management files and personal knowledge will suffice.

The property manager's use of the post-and-mail alternative for service was proper. When the landlord or property manager is unaware of any address for the tenant other than the leased premises:

- no attempt to ascertain the tenant's other address is necessary; and
- service by posting the premises and mailing to the leased premises is sufficient when no suitable person for substituted service is found at the premises. [**Hozz** v. **Lewis** (1989) 215 CA3d 314]

Consider an individual who leases space in a retail center to operate his business.

The tenant fails to pay his rent, and the property manager prepares a 3-day notice for service on the tenant. The property manager does not know the tenant's residential address.

The property manager attempts to personally serve the tenant with the 3-day notice at the leased premises, his place of business, but the tenant is absent from the business.

The property manager hands the 3-day notice to an employee of the tenant and mails a copy to the tenant at the premises.

Is the method of service used by the property manager proper?

PROOF OF SERVICE

1. I am over 18 years of age.

2. On _____, 20_____, at _____, California.

I served the following checked items:

☐ 3-Day Notice to Pay Rent or Quit

☐ 3-Day Notice to Perform or Quit

☐ 3-Day Notice to Quit for Breach

☐ 30-Day Notice to Terminate/Vacate

☐ 30-Day Notice of Change in Rental Terms

☐ 60-Day Notice of Change in Rental Terms

☐ Other:_____

3. Regarding tenancy of property commonly known as: _____

_____

4. On Tenants (name):_____

5. Manner of service (check the proper box):

5.1 ☐ By personally delivering a copy to each named Tenant;

a. ☐ at Tenant's residence;

b. ☐ at Tenant's place of business.

5.2 ☐ By delivering a copy to a person of suitable age and discretion;

a. ☐ at the Tenant's residence; or

b. ☐ at Tenant's place of business, as the named Tenant was absent from each location;

and

mailing [by first-class postage prepaid] a copy to each named Tenant at his residence.

5.3 ☐ By posting a copy for each named Tenant in a conspicuous place on the property described in the notice as no person of suitable age or discretion was found at the Tenant's residence or place of business;

and

mailing [by first-class postage prepaid] a copy to each named Tenant at the address of the leased property.

I declare under penalty of perjury that the foregoing is true and correct.

Date:_____, 20_____

Name:_____

Signature:_____

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Yes! Since reasonable diligence is not required when attempting personal service, the property manager need not make a second effort, such as returning to the premises or looking in a directory or voting records, to discover the tenant's residential address. [Nourafchan, *supra*]

Personal receipt of certified mail

Even if the attempted service is defective, the tenant's **admitted receipt** of the 3-day notice establishes *personal service*. Thus, the defective service is no longer an issue. [**Valov** v. **Tank** (1985) 168 CA3d 867]

For example, a property manager sends a 3-day notice by certified mail. It is the property manager's only attempt to notify the tenant. No personal service is attempted, no copy of the notice is left with a person of suitable age and discretion on the premises, and no notice is posted on the premises.

However, the tenant personally signs the postal receipt accepting the certified mail. Thus, the tenant personally receives the 3-day notice on the date he acknowledges receipt. The tenant's acknowledgement of receipt confirms he has been **personally served** (by the post office) with the 3-day notice on the date he acknowledged receipt.

The mailing of the notice by the property manager did not constitute service of the 3-day notice on the tenant — even though certified mail was used. However, the **tenant's signing** of the postal receipt is proof the tenant was handed the 3-day notice by a post office employee — which is personal service.

The tenant who fails to pay the delinquent rent within the three-day period following acknowledgment of his receipt of the 3-day notice by mail is unlawfully detaining the premises and can be evicted.

Editor's note — If any person other than the tenant signs acknowledging the receipt of the mail, personal service is not accomplished. [Liebovich, *supra*]

An evasive tenant might not pick up certified mail addressed to him when his rental payment is delinquent.

If personal service cannot be accomplished, the three-day notice period begins to run the day the notice is either served by substituted service and mailed, or posted and mailed. The day following service is day one of three. If the third day is a Saturday, Sunday or holiday, the 3-day period continues through the first business day which follows.

Chapter 28 Other amounts due under 3-day notices

This chapter discusses the inclusion of amounts of money due the landlord under a lease agreement other than "rent" in a 3-day notice to pay or quit.

Know what the judge will allow

A lease agreement between a landlord and his tenant contains a rent provision with a clause calling for the **accrual of interest** on any amount of rent from its due date if the payment becomes delinquent, a type of *late payment clause*.

The tenant fails to pay rent before it becomes delinquent. The landlord then prepares a 3-day notice to pay or quit and serves the notice on the tenant. [See **first tuesday** Forms 575 and 575.5]

The 3-day notice itemizes the amounts of delinquent rent and daily interest accrued that are due and unpaid on the date the notice is prepared. The tenant fails to pay or quit during the 3-day period. The landlord files an unlawful detainer (UD) action asking the court to order the removal of the tenant from the premises.

At the UD hearing, the tenant claims the landlord cannot terminate his possession of the premises under the 3-day notice since the notice demands payment of an amount greater than the **rent due** under the lease agreement, and thus is defective as the demand includes *other amounts due* the landlord.

May the 3-day notice include amounts due under monetary provisions in the lease agreement in addition to the rent itself?

Yes! **Monetary amounts due** under rent provisions in the rental or lease agreement that may be demanded in the 3-day notice to pay or quit are not limited to the scheduled amount of periodic rent which is delinquent.

While the notice to pay may not be served until rent is delinquent, the notice itself is all-inclusive allowing it to state the *total amount which is due*, not only the delinquent amount entitled rent. Thus, the notice may include all sums of money which are **due and unpaid** under the rental or lease agreement at the time the notice is served, including the delinquent rent. [**Canal-Randolph Anaheim, Inc.** v. **Moore** (1978) 78 CA3d 477]

Examples of amounts of money due periodically under a rental or lease agreement, in addition to scheduled rent, include:

- common area maintenance charges (CAMs);
- association charges;
- pro rata insurance premiums, property taxes and assessments;
- late payment and bad check charges;
- expenses incurred by the landlord to cure waste or failure to maintain the property, called *future advances*; and
- other amounts of money properly due as compensation or reimbursement of expenses arising out of the occupancy.

A 3-day notice to pay or quit form provides for the itemization of rent and other amounts due which are unpaid and delinquent. [See **first tuesday** Form 575]

Lump sum late charges

Under a nonresidential lease agreement entered into by a tenant, rent is typically due and payable on the first day of each month, called the *due date*. The lease agreement contains a late charge provision stating the tenant agrees to pay a charge in the amount of $150 if the rent is not **received by** the landlord on or before the fifth day of each month, called a *grace period* [See **first tuesday** Form 552 §3.9]

Under the lease agreement, rent is *delinquent* the day after the grace period runs, the sixth day of the month. The delinquency triggers the landlord's right to demand payment of the late charge, or do nothing and waive it.

The lease agreement also provides for the tenant to pay $25 for each rent check returned for insufficient funds (NSF). [See **first tuesday** Form 552 §3.10]

During one month, the landlord receives the rent after the grace period expires. As he must, the landlord accepts the rent since the right to possession, the lease, has not been terminated by a declaration of forfeiture or expiration of the lease. The landlord then notifies the tenant in writing that he is imposing a late charge, payable with the following month's rent, as provided in the lease agreement. [See Form 569 accompanying this chapter]

The following month the landlord receives the regularly scheduled rent within the grace period. However, the tenant does not also tender the late charge the landlord demanded due to the prior month's delinquent payment.

Landlord's options for collection

On the tenant's failure to pay additional charges, the landlord's options to enforce payment, viable or not, include:

- returning the rent check to the tenant as insufficient payment for the total amount due;
- serving the tenant with a 3-day notice to pay or quit;
- deducting the additional charge from the security deposit on written notice to the tenant; or
- filing an action against the tenant in small claims court to collect the late charge.

Returning the rent check to the tenant will result in one of the following scenarios:

- The tenant will submit another check which includes rent and payment of the late charge (which payment will be delinquent and arguably incur another late charge); or
- The tenant will retain the rent check as having been properly tendered and therefore legally paid, and do nothing more until he sends a check for the following month's rent.

A tenant who fails to pay rent or otherwise *materially breaches* the lease agreement, may be served with the appropriate 3-day notice. The 3-day notice based on a material breach properly includes a demand for late charges and any other monetary *amounts past due* [Canal-Randolph Anaheim, Inc., *supra*]

If the tenant fails to cure the breach within three days following service of the notice and remains in possession, the landlord may file an unlawful detainer (UD) action to regain possession. [Calif. Code of Civil Procedure §1161]

However, a landlord will not succeed in a UD action when the landlord's refusal to accept the tenant's timely tender of a rent check is based solely on the tenant's refusal to pay late charges. Failure to pay the agreed late charge after notice is a *minor breach*. [Canal-Randolph Anaheim, Inc., *supra*]

Thus, the landlord has two **viable options** for the collection of unpaid late charges from the tenant:

- accept the rent check, deduct the amount of the unpaid late charge from the security deposit and advise the tenant of the deduction; or
- accept the rent check and file an action in court for the unpaid late charge amounts.

The financially practical action the landlord can take when the tenant refuses to pay a demand for a late charge is to accept the rent and deduct the late charge from the tenant's security deposit.

A UD action cannot be maintained if the sole existing breach of the lease agreement is the failure to pay the late charges. A *material breach* is required to support a UD action, such as a delinquency in the scheduled rent and other scheduled periodic compensation for occupancy and use of the property. A late charge is properly sought when pursuing delinquent rent, but alone, a late charge (or bounced check charge) is a *minor breach* and will not independently support a UD action. [**Baypoint Mortgage** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818]

Late charges

To be enforceable, late charges must be *reasonably related* to:

- the actual costs of collecting the delinquent rent (the time and effort involved); and
- the delay in its receipt (loss of use, such as interest).

A lump sum late charge becomes an unenforceable *liquidated damages provision* if the amount of the late charge is significantly greater than the actual **out-of-pocket losses** suffered by the landlord due to the tenant's late payment of rent, in which case the charge is labeled a penalty and is unenforceable. [**Garrett** v. **Coast and Southern Federal Savings and Loan Association** (1973) 9 C3d 731]

Editor's note — Some may argue any lump sum late charge on residential property is void as a liquidated damage since out-of-pocket money losses due to a late payment are readily ascertainable, especially in a residential real estate transaction.

A **liquidated damages** provision in a residential lease is void, unless the loss covered is impracticable or nearly impossible to calculate (which it is not), or the amount agreed to is a reasonable estimate of the landlord's out-of-pocket expenses for the collection effort. [Calif. Civil Code §1671(d)]

When setting the amount of a late charge for a residential tenant's failure to timely pay rent under a rental or lease agreement, consider charging an amount equivalent to the late charge allowed by the legislature on a residential loan since the amount is a good indicator of *reasonableness*.

The late charge amount allowed for a delinquent payment on a loan secured by residential property is controlled by statute. This is not the case for rent.

For example, the lump sum late charge allowed on a loan secured by an owner-occupied, single-family residence cannot exceed 6% of the delinquent payment (principal and interest only). [CC §2954.4(a)]

Rent is the *economic equivalent* of interest. For purposes of late charges, rent payments should be treated no differently than interest payments.

Late charges as liquidated damages

A lump sum late charge set forth as a dollar amount in a lease agreement is a *liquidated damages* provision. The charge is a one-time, predetermined fixed amount intended by its nature to reimburse the landlord for the **delay in receipt** of the rent money and his **costs and effort** spent to collect the delinquent amount. [CC §1951.5]

A late charge provision calling for *interest to accrue* at a predetermined annual percentage rate on amounts earned and unpaid (delinquent rent) is not a liquidated damages provision and is fully enforceable. [Canal-Randolph Anaheim, Inc., *supra*]

However, some landlords wrongfully view late charges as a means for **coercing tenants to pay** rent on time. Thus, landlords set the late charge at an amount exceeding his actual losses, a **penalty assessment** that is unenforceable.

A lump sum late charge provision in a nonresidential lease agreement is valid unless the tenant can show the amount of the late charge is an unreasonable reimbursement for the delay in receipt of the rent and costs of collection efforts. [CC §1671(b)]

A late charge is unenforceable if the charge is so great in comparison to actual losses that it *imposes a penalty* on the tenant for his late rent payment. [Garrett, *supra*]

An appropriate late charge provision in a lease agreement for single-user residential or nonresidential property encumbered by a loan is the amount of the late charge imposed on the owner when a monthly payment on the loan is delinquent. The owner is simply "passing through" the loss incurred by his late receipt of the tenant's rent payment.

However, in a residential lease agreement, a late charge provision setting a fixed amount is void unless the losses suffered by the landlord due to late payment are impracticable to calculate. [CC §1671(d)]

Editor's note — Determining money losses suffered due to late payments in any real estate transaction, especially in a residential lease, is not impracticable to calculate since it is merely an accounting of known amounts incurred as expenses in the collection and lost use of the funds until received.

Imposing the late charge

A late charge is **not automatically due** and payable by the tenant when the landlord fails to receive the rent payment within the grace period.

The landlord must first make a **written demand** on the tenant for payment of the late charge and include the date when the charge is payable before the collection can be enforced.

Thus, a written billing demanding payment of the late charge with the next month's rent is delivered to the tenant to ensure the late charge agreed to is imposed. [See **first tuesday** Form 568]

The **late charge notice** advises the tenant the landlord is entitled to enforce collection of the unpaid late charge by:

- deducting the unpaid late charge amount from the tenant's security deposit; or
- filing a small claims or municipal court action for unpaid late charge amounts.

Too late to collect

Within one year from the date rent became delinquent, or some other *material breach* of a monetary provision in the lease or rental agreement occurred, the landlord must serve a 3-day notice on the tenant to be able to enforce collection of the amounts sought in a UD action. [CCP §1161(2)]

As an alternative to seeking a recovery of money in a UD action with its one-year limitation, the landlord can file a separate money action within four years of the breach to collect unpaid late charges, returned check handling charges and any other amounts due under the lease agreement. [CCP §337]

Ultimately, the landlord can deduct the late charges from the tenant's security deposit as payment of unpaid amounts due the landlord under the lease agreement. [CC §§1950.5(b)(1), 1950.7(c)]

The UD court problem

While the enforcement of lump sum late charges for the recovery of collection efforts has not been the subject of reported cases, the court in *Canal-Randolph Anaheim, Inc.* ruled an interest-rate late charge on delinquent rent to cover the loss of use of the payment can be included as *amounts due* under a rental or lease agreement.

Canal-Randolph Anaheim, Inc. clarified that a landlord may include any sums due under the lease as **amounts due** in the 3-day notice.

Also, no statutes exist that forbid (or limit) the collection of a late charge in a rental or lease agreement. However, cases do limit the charge to an amount reasonably calculated to cover the losses inflicted by late payment. [Garrett, *supra*]

Further, not all trial judges will concede late charges are part of the *amount due* under a 3-day notice. Despite the holding of *Canal-Randolph Anaheim, Inc.*, some judges declare late charges are not *rent*, the delinquency of which triggers use of a 3-day notice to pay or quit. [CCP §1161(2)]

These judges hold a late charge or bad check charge cannot be included in the 3-day notice as part of the *amount due*. If included, the demand would bar an eviction before those judges.

Before a landlord or a property manager includes any late charge (or other *amounts due* besides technical rent) in a 3-day notice as part of the total amount due, it should first be determined if the judge presiding over UD actions in the landlord or property manager's jurisdiction will allow a demand for late charges.

Judges vary in their approach to late charges:

- some allow *masked late charges* cloaked as a forgiveness of 6% to 10% of the scheduled rent, if paid before the rent (including the masked late charge) is considered delinquent — within five to 10 days after it is due;
- some allow a late charge of up to 6% of the delinquent rent as a reasonable amount;
- some disallow late charges as an unenforceable penalty for being delinquent;
- some disallow late charges as a forfeiture of money (since the amount exceeds the costs of collection); and
- some just disallow late charges altogether as an exercise of their discretion.

Information on the treatment given by the local trial court judge can be obtained from an attorney or other landlords who have experience appearing in front of the judge in question.

If the judge will not allow the late charge as part of the amount due from the tenant, the landlord should leave it out of the 3-day notice. Instead, either deduct the late charge from the security deposit (if any remains when refunded), or pursue collection in a separate action for money, both of which avoid the issue of demands placed in the 3-day notice. Investigate the judge's behavior first to eliminate the risk of getting an erroneous judicial determination that late charges or other amounts due were improperly included in the 3-day notice and therefore a denial of the eviction requiring an appeal or renewal of the 3-day notice and UD process without the late charge.

Editor's note — An obvious solution to the inconsistent rules applied to late charges would be ***public policy*** *legislation defining the nature of late charges and acceptable limits on time and amounts for recovery of the cost of collecting delinquent rent — guidance for all involved in the UD process.*

Late charges for rent should be treated like late charges on mortgages. Both serve the same economic function — recovery of costs incurred due to the delay of receipt of funds and resulting collection efforts. Also, the number of homeowners with mortgage payments is almost equal to the number of renters with rental payments in California. Both mortgage payments and rental payments are part of the cost of occupancy and entitled to equivalent legislative controls.

Chapter 29 Notices to vacate

This chapter presents the 30-day notice to vacate used by landlords and tenants to terminate month-to-month tenancies other than by use of 3-day notice to quit.

Termination of periodic tenancies

A tenant enters into occupancy of a single family residential property under a lease agreement obligating the tenant to maintain the property's landscaping.

The landlord soon receives complaints from surrounding property owners about excessive noise and a high number of visitors at the property late at night. On more than one occasion, the police have responded to calls from neighbors regarding the noise. Also, the city ordinance compliance department has given notice for the removal of disabled vehicles from the property. On a drive-by inspection, the landlord discovers the landscaping and lawn have deteriorated since the tenant has not watered.

Although the tenant consistently pays the rent on time, the landlord feels the tenant must be evicted even though several months remain on the term of the lease. The tenant is creating a *nuisance* by interfering with his neighbors' use and enjoyment of their property and *waste* by failing to maintain the leased premises, both are justification to terminate the tenancy.

The landlord prepares and serves the tenant with a 30-day **notice to vacate** to avoid stating his reasons for terminating the tenancy. [California Civil Code §1946; see Form 569 accompanying this chapter]

The tenant remains in occupancy of the premises after the 30-day notice expires and tenders the next rent payment on time. The landlord refuses to accept the rent payment and files an unlawful detainer (UD) action to evict the tenant.

Can the landlord, subject to an unexpired lease that the tenant has breached, evict the tenant from the premises with a 30-day notice to vacate?

No! The tenant occupies the property under an unexpired lease. The landlord cannot terminate the tenant's right to possession by using a notice to vacate, much less use the notice to vacate to establish an unlawful detainer when an unexpired lease exists.

A residential or nonresidential 30-day notice to vacate the premises is only effective when used by a landlord or tenant to terminate a periodic tenancy, such as a month-to-month tenancy or a continuing occupancy after a lease expires. The term of the periodic tenancy (weekly, monthly, annually) does not matter, unless the property is **nonresidential** and the rental agreement calls for a greater or lesser period for notice than 30 days, but not less than seven days. [CC §1946]

If agreed, a provision in a residential or nonresidential lease agreement may allow the tenant to terminate his occupancy prior to expiration of the lease on 30 days' notice, or any other period for notice, conditioned on the payment of a penalty for canceling the lease agreement and vacating prematurely, sometimes called a *cancellation provision*.

Periodic tenancies extended/terminated

Unlike the extension of a lease, the 30-day rental period under a **month-to-month rental agreement** is *automatically extended* for the same period and on the same terms, until the right to extend is terminated by a 30-day notice to vacate.

Any landlord under a month-to-month rental agreement (or for any other period) may **interfere at any time** with the automatic renewal of the rental agreement and terminate the tenancy by serving a 30-day notice to vacate on the tenant.

Likewise, any tenant under a month-to-month rental agreement may, at any time, stop the automatic renewal process and terminate the tenancy by giving the landlord a 30-day notice of the tenant's intent to vacate the premises. [CC §1946; see Form 572 accompanying this chapter]

A notice to vacate on a month-to-month tenancy, whether given by the tenant or the landlord, establishes a tenant's unlawful detainer (UD) when it expires and the tenant remains in possession. [**Palmer** v. **Zeis** (1944) 65 CA2d Supp. 859]

Once the notice to vacate expires and the tenant does not vacate, the landlord may file a UD action to evict the month-to-month tenant without further notice. [Code of Civil Procedure §1161(5)]

Lease becomes a periodic tenancy

Consider a tenant entering into a one-year lease of a unit in a residential or nonresidential building. After expiration of the lease, the tenant remains in possession of the unit, an unlawful detainer of the premises. However, the tenant continues to pay rent monthly, which the landlord accepts.

Later, the landlord serves the tenant with a 30-day notice to vacate the property and the tenant refuses. The landlord files a UD action to evict the tenant.

The tenant claims he cannot be evicted based on a 30-day notice to vacate since he holds possession of the unit under a lease agreement, which was automatically extended for the same period as the term of the original lease by the landlord's acceptance of rent after the lease expired.

Here, the 30-day notice to vacate is effective to terminate possession and the tenant can be evicted. The landlord's acceptance of monthly rent after the lease expired, when the lease agreement does not provide the tenant with an option to renew or extend the lease, establishes a month-to-month tenancy on the same conditions stated in the lease agreement. [CC §1945]

Landlord's intent to evict

A landlord, residential or nonresidential, terminates a month-to-month tenancy by preparing and serving the tenant with a 30-day notice to vacate. However, if a **material breach** exists in the payment of amounts due or performance of provisions in the occupancy agreement, a 3-day notice to quit is used. [See **first tuesday** Forms 571 and 579; see Chapter 26]

A 30-day notice to vacate form used by a landlord contains:

- the name of the tenant;
- the address of the premises;
- a reference to the rental agreement or expired lease;
- a statement that the unit must be vacant within 30 days after service of the notice;

30-DAY NOTICE TO VACATE

From Tenant

DATE:_____, 20_____, at _____, California.

NOTICE: Unless otherwise agreed, a Tenant may terminate a month-to-month tenancy by giving thirty (30) days written notice to the landlord. [California Civil Code §1946]

To Landlord: _____

Items left blank or unchecked are not applicable.

FACTS:

1. I am a Tenant under a rental agreement or expired lease agreement

1.1 dated _____, at _____, California,

1.2 entered into by_____, Tenant,

and _____, Landlord,

1.3 regarding real estate referred to as: _____

_____

NOTICE:

2. Within thirty (30) days after service of this notice, I will vacate and deliver possession of the premises to Landlord or_____.

3. This notice is intended as a Thirty-Day Notice to terminate my month-to-month tenancy.

4. I understand:

4.1 I will owe prorated daily rent for any days in the 30-day period I have not prepaid rent.

4.2 I have previously given Landlord a security deposit of $_____.

a. I acknowledge, if I am a residential tenant, that I have the right to request an inspection of the premises, and be present, to be conducted within two weeks of expiration of this notice to vacate for the purposes of the landlord providing me with an itemized statement of deductible charges for repairs and cleaning to allow me the opportunity to remedy these deficiencies and avoid a deduction from my security deposit. [California Civil Code §1950.5(f)]

b. Within 21 days after I vacate, Landlord will furnish me a written statement and explanation of any deductions from the deposit, and a refund of the remaining amount. [California Civil Code §1950.5(g)]

4.4 Landlord may deduct only those amounts necessary to:

a. Reimburse for Tenant defaults in rental payments;

b. Repair damages to the premises caused by Tenant (ordinary wear and tear excluded);

c. Clean the premises, if necessary;

d. Reimburse for Tenant loss, damage or excessive wear and tear on furnishings provided to Tenant.

4.5 Landlord may show the premises to prospective tenants by giving reasonable notice as called for in the rental or lease agreement. Twenty-four (24) hours will be presumed to be reasonable notice. Showings will only occur during normal business hours.

5. The reason for termination is _____.
(optional)

6. I have served this notice on Landlord or Manager ☐ personally, or ☐ by certified or registered mail.

This statement is true and correct.

Date:_____, 20_____

Tenant:_____

Signature: _____

Forwarding Address:_____

_____

Phone:_____

Fax: _____

E-mail: _____

For Landlord/Agent's use:

Date Received _____:

- the dollar amount of pro rata rent to be paid when rent is next due;
- a statement regarding the security deposit and its disposition; and
- a statement informing the tenant of his right to request a joint inspection of the premises in order to avoid deductions from his security deposit.

A *forfeiture provision* is not properly included in any 30-day notice to vacate since no right to possession exists to be forfeited on expiration of the rental agreement — the tenancy merely terminates by its own terms when the notice expires.

Due to its contents, the landlord's 30-day notice to vacate eliminates any confusion as to the amount of pro rata rent to be paid and when the rent is due. [See Form 571 §3]

Tenant's intent to vacate

A tenant, residential or nonresidential, who intends to vacate and avoid further liability under a month-to-month rental agreement or expired lease must give 30-days advance notice to the landlord of the **tenant's termination** of the tenancy. The notice may be in the form of a letter personally delivered to the landlord or his agent, or sent by certified or registered mail. [CC §§1946]

Some landlords are willing to accept oral notice of the tenant's intent to vacate without reducing the notice to a writing signed by the tenant.

However, both the tenant and the landlord are better served when the landlord hands the tenant a 30-day Notice to Vacate form when entering into a rental agreement or, at worst, when the tenant gives oral notice of his vacating the space. The tenant will then have the correct paperwork to complete and deliver documentation to the landlord or property manager. Use of a form lends certainty to the tenant's understanding of a critical event. [See **first tuesday** Form 572]

A tenant's 30-day notice to vacate acknowledges:

- the tenancy is terminated on expiration of 30 days after service of the notice on the landlord or his manager;
- the tenant's intent to pay pro rata rent;
- the amount of the security deposit and the tenant's right to request a pre-termination inspection and receive an itemized statement of maintenance and cleaning deficiencies for any potential deductions from the security deposit; and
- a security deposit statement and refund based on any deductions for cleaning and repairs on a final review of the premises by the landlord or property manager; and
- the landlord's right to show the premises to a prospective tenant on 24 hour notice.

Service of the notice to vacate

A 30-day notice to vacate may be served at any time during the month.

However, a **nonresidential landlord** and tenant may limit the right to serve the notice at any time by agreeing in the rental agreement that the 30-day notice to vacate cannot be served during the last six days of the month. This is not true for residential tenancies since service can occur at any time to begin the 30-day period. [CC §§1946]

To be effective, the 30-day notice to vacate from a **nonresidential tenant or landlord** must be served:

- in the same manner as a 3-day notice (in person, by substitution or post and mail); or

30-DAY NOTICE TO VACATE

(For Use by Residential Landlord)

DATE:_____, 20_____, at _____, California.

NOTICE: A residential landlord may terminate a month-to-month tenancy by giving at least thirty (30) days' written notice to the tenant unless the tenant has resided on the property for one year or more. [Calif. Civil Code §§1946,1946.1]

To Tenant: _____

Items left blank or unchecked are not applicable.

FACTS:

1. You are a Tenant under a rental agreement or expired lease agreement

1.1 dated _____, at _____,California,

1.2 entered into by _____, Tenant,

and _____, Landlord,

1.3 regarding real estate referred to as: _____

_____

NOTICE:

2. This notice is intended as at least a thirty (30) day notice prior to termination of your month-to-month tenancy.

3. On or before _____, 20_____, a date at least thirty (30) days after service of this notice, you will vacate and deliver possession of the premises to Landlord or:_____

_____

4. Rent due prior to the date to vacate includes prorated rent of $_____, payable on or before _____, 20_____.

5. Landlord acknowledges the prior receipt of $_____ as your security deposit.

5.1 Notice: You have the right to request an inspection of the premises, and be present, to be conducted within two weeks of expiration of this notice to vacate for the purposes of providing you with an itemized statement of deductible charges for repairs and cleaning and allowing you the opportunity to remedy these deficiencies and avoid a deduction from your security deposit. [Calif. Civil Code §1950.5(f)(i)]

5.2 Within 21 days after you vacate, Landlord will furnish you with a written statement and explanation of any deductions from the deposit, and a refund of the remaining amount. [Calif. Civil Code §1950.5(g)(i)]

5.3 Landlord may deduct only those amounts necessary to:

a. Reimburse for Tenant defaults in rental payments;

b. Repair damages to the premises caused by Tenant (ordinary wear and tear excluded);

c. Clean the premises, if necessary;

d. Reimburse for Tenant loss, damage or excessive wear and tear on furnishings provided to Tenant.

6. Landlord may show the leased premises to prospective tenants during normal business hours by first giving you written notice at least 24 hours in advance of the entry. The notice will be given to you in person, by leaving a copy with an occupant of suitable age and discretion, or by leaving the notice on or under your entry door.

7. If you fail to vacate and deliver possession of the premises by the date set for you to vacate, legal proceedings may be initiated to regain possession of the premises and to recover rent owed, treble damages, costs and attorney fees.

8. The reason for termination is _____

(required by rent control ordinance or Section 8 housing)

Date:_____, 20_____

Landlord/Agent: _____

Signature: _____

Address:_____

_____

Phone: _____

Fax: _____

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- by certified or registered mail, a method of service not available for 3-day notices to quit. [CC §1946; see Chapter 26]

Conversely, a **residential landlord or tenant** must serve a 30-day notice to vacate by:

- personally delivering the notice to either the landlord or tenant; or
- **leaving a copy** of the notice either at the residence or the tenant's place of business with a person of appropriate age, **posting the notice** in a conspicuous place on the property and mailing, by certified or registered mail, a copy addressed to the tenant in the unit. [CCP §§ 1161a, 1162]

The date of service to a nonresidential tenant is the date the notice is first:

- personally served;
- handed to a person of suitable age and discretion and mailed;
- posted on the leased premises and mailed; or
- mailed by certified or registered mail.

The 30-day minimum period within which the tenant must vacate begins to run the day after the date of service, which is day one of the 30-day period. [CC §10]

If the day for expiration of the notice is a Saturday, Sunday or federal holiday, the tenant is not required to vacate until the next business day. [CCP §12a]

Most notice to vacate forms, when filled out by the property manager, give a **specific date** by which the tenant must vacate, at least 30 days after service of the notice. Thus, the day is not left to chance and, as a practical matter, not set as a weekend day or holiday.

Rent control limitations on eviction

When a residential rental property is located in a **rent control community**, the landlord is limited in his discretionary ability to terminate the tenancy and evict the tenant on a 30-day notice.

Typically, the termination of a tenancy and evictions are allowed in rent control communities when:

- the tenant fails to pay rent or otherwise materially breaches the lease agreement;
- the tenant creates a nuisance;
- the tenant refuses to renew a lease;
- the tenant uses the residence for an illegal purpose; or
- the landlord or a relative will occupy the unit.

A landlord and property manager for properties subject to rent control and his property manager must make themselves aware of the local restrictions imposed on the eviction of tenants.

Good reason to evict exception

A landlord is not required to state his reasons in a notice to vacate, or even have good cause, for evicting a month-to-month tenant. [CC §1946]

Rent control and Section 8 housing are exceptions to the general rule that does not require good cause. The exceptions require the giving of a good-cause condition as the reason for terminating these tenancies. Thus, the tenant is given notice so he can prepare his defense to avoid eviction.

However, under no condition may a landlord evict a tenant for the wrong reason.

The landlord terminating a tenancy for the wrong reason may find himself not only unable to evict the tenant, but defending against the tenant's claim the eviction is:

- **retaliation** for the tenant making official complaints about the property or against the landlord;
- based on **discriminatory reasons**, such as the tenant's ethnicity or marital status; or
- **improper** because of the failure to maintain the property in a habitable condition.

When a tenant's rent is subsidized by the Department of Housing and Urban Development's (HUD) Section 8 housing program, the landlord must set forth *good cause* as the reason for the termination in the 30-day notice to vacate. [**Mitchell** v. **Poole** (1988) 203 CA3d Supp. 1]

Chapter 30 Surrender cancels the lease agreement

This chapter explains the differences in the right to collect future rent between a surrender and other landlord remedies when a tenant breaches and voluntarily vacates the leased premises.

Lost ability to recover future rents

Before a nonresidential lease expires, the tenant closes out his business operations and vacates the premises, paying no further rent. The landlord serves the tenant with a 3-day notice to pay rent or quit. [See **first tuesday** Form 575]

The notice includes a forfeiture clause declaring a *forfeiture of the lease* if the tenant fails to pay rent within three days following service of the notice.

The tenant responds to the notice by letter, stating he elects not to pay future rent and accepts the landlord's offer to terminate the lease. The key to the premises is returned to the landlord with the letter.

The landlord responds by letter stating:

- neither the landlord nor the tenant owe each other any further obligations under the lease; and
- the tenant is to pay all rent due up to the date the tenant returned the key to the landlord.

The landlord then attempts to relet the premises, but without success.

Later, the landlord makes a demand on the tenant for payment of rents called for in the lease agreement for the entire remaining term of the lease since the landlord declared a **forfeiture of the lease** in the 3-day notice which terminated the tenant's right to possession but did not **cancel the lease agreement**.

The tenant claims the landlord is not entitled to any future rents called for in the lease agreement since the landlord agreed to a **surrender of the premises** by their communications, waiving any rights the landlord had to collect future rents otherwise allowed on the declaration forfeiting the lease.

The landlord claims entitlement to collect all future rents due under the lease agreement after the tenant vacated, since his right to future rents is preserved by the declaration of forfeiture in the 3-day notice and he undertook reasonable efforts to relet the premises and mitigate his loss of rent.

Can the landlord recover future rents from the tenant based on the lease agreement, notices and letters?

No! The lease agreement was no longer enforceable having been canceled by the communications agreeing to terminate all obligations under the lease agreement **in exchange for possession**, called a *surrender*. [**Desert Plaza Partnership** v. **Waddell** (1986) 180 CA3d 805]

The tenant's letter "electing to pay no future rent" coupled with the return of the key (possession) to the landlord initiated a surrender, an implied **offer to cancel** the lease agreement.

The landlord's letter in response foregoing future rents released the tenant from further liability on the lease agreement. The landlord's conduct constitutes **acceptance** of the *offer to surrender* initiated by the tenant. The landlord failed to stand on his right to collect rents remaining due for the duration of the

uncancelled lease agreement, rights statutorily reserved to him by use of the lease forfeiture clause in the 3-day notice. [Calif. Civil Code §1951.2]

The tenant forfeited his right to possession, the *lease*, by not paying the rent within three days. However, he negotiated a cancellation of the lease agreement that would have remained enforceable after forfeiture of the lease.

Surrender on failure to forfeit

A *surrender* also occurs when the tenant breaches the lease agreement and voluntarily vacates without being served with a notice to quit and election to forfeit, and then the landlord acts inconsistently with the tenant's unforfeited right to possession.

A **surrender** results in the:

- **termination** of the tenant's right to possession; and
- **cancellation** of the lease agreement.

When a breaching tenant vacates the premises, the landlord may fail to **declare a forfeiture** of the tenant's right to possession, or lease, for the period remaining on the lease which he can accomplish by service of either a 3-day notice to pay or quit with election to forfeit the lease or a notice of abandonment.

If the landlord then takes possession and relets the premises, he is acting inconsistent with the tenant's outstanding right to possession that has not been terminated. Thus, the landlord has acted to **cancel the lease agreement** — the landlord's right to recover future rents under the lease agreement is eliminated by his own adverse conduct.

Any rent lost due to the landlord's inability to relet the premises after a surrender is not collectible from the former tenant, and becomes part of the market risks any landlord assumes as the owner of vacant rental property. [Desert Plaza Partnership, *supra*]

Editor's note — Only ownership of real estate and personal property may be forfeited. Conversely, a lease agreement is not property, it is a contract (as well as a conveyance). A contract is evidence of rights and obligations and is not subject to forfeiture.

Vacated space and a breached lease

When a tenant breaches his lease agreement and vacates the premises without service of a 3-day notice to quit, the **landlord responds** in one of four ways:

1. Terminate the tenant's right to occupancy and cancel the lease agreement by a *surrender*, then relet or occupy the premises himself.
2. Terminate the tenant's leasehold by a declaration of *forfeiture* (3-day notice or notice of abandonment) and relet the premises to mitigate losses.
3. Take possession of the premises and relet it on the *tenant's behalf*.
4. Enforce any *tenant-mitigation* provision in the lease agreement, leaving the tenant in possession to relet the premises.

Surrender is an interaction between the tenant and the landlord, residential or nonresidential, causing a termination of the tenant's right to possession and cancellation of the lease agreement.

A **surrender** occurs and cancels the lease agreement by either:

- *mutual consent* of the landlord and the tenant [CC §1933(2)]; or
- *operation of law*, a surrender implied due to the conduct of the landlord.

Surrender by mutual consent

Consider a tenant who makes a written offer to his landlord to surrender the premises — to vacate and return possession in exchange for cancellation of the tenant's obligations under the lease agreement.

The landlord believes a new tenant, who will pay more rent for the space than the current tenant, can be easily located.

Still, the landlord demands an early-termination penalty equal to three months' rent to cancel the lease agreement. The tenant pays the fee and the landlord cancels the lease. A surrender has occurred.

Editor's note — Mid-term leases sometimes contain an ***early-termination provision*** *for a surrender, allowing the lease agreement to be canceled in exchange for a fee, usually in the amount of two to six months' unearned rent — a type of prepayment penalty or contract liability limitation provision.*

Here, a surrender functions like a deed-in-lieu of foreclosure that conveys the real estate to the lender (possession returned to the landlord) in exchange for the lender's cancellation of the note obligations (cancellation of the lease agreement).

Surrender by operation of law

Now consider a tenant on a lease with a ten-year term. A few years after entering into the lease agreement, the tenant vacates the premises. The tenant removes all of his personal property and returns the key to the landlord. The tenant has no intention of returning and has breached the lease agreement by failing to pay rent.

Knowing a surrender would cancel his right to future rents due under the lease agreement, the landlord informs the tenant he will not accept the tenant's return of possession to the premises as a surrender. He will enforce the collection of future rent called for in the lease agreement.

Without prior notice to the tenant, the landlord retakes possession, refurbishes the vacated space and re-rents it to a replacement tenant. A lease agreement is entered into with the replacement tenant at a lower rental rate for the unexpired term remaining on the breached lease. The landlord notifies the prior tenant he has leased the premises to mitigate his loss of rent.

The landlord makes a demand on the prior tenant for the payment of rent, the amount being the difference between:

- the total amount of rents remaining unpaid over the remaining unexpired term of the prior tenant's lease; and
- the amount of rent to be paid during the same period under the new lease by the replacement tenant.

Can the landlord recover the lost rent from the prior tenant who vacated the premises and returned possession to the landlord?

No! Before entering the space to prepare for reletting the premises, the **landlord failed** to:

- *terminate the tenancy* by serving a 3-day notice with a declaration of forfeiture or a notice of abandonment; or

- *notify the tenant* he was taking possession of the premises as an agent acting on the tenant's behalf.

The conduct of the landlord at the time he unilaterally took possession to relet the premises violated the **tenant's unforfeited right** to possession. Although the landlord did not intend to accept a surrender, he acted to take possession on his own behalf without first forfeiting the tenant's leasehold or advising the tenant of the landlord's intent to act on the tenant's behalf to relet the premises.

A surrender by *operation of law* occurred due to the landlord's actions adverse to the tenant's right to possession. Taking possession without authority to do so is inconsistent with the tenant's remaining possessory interest under his lease (which had not been terminated) and constituted an acceptance of an implied offer to surrender initiated by the tenant's vacating the premises. The landlord's activities, inconsistent with the tenant's outstanding right to reoccupy, terminated the tenancy and canceled the lease agreement as a *surrender*. [**Dorcich** v. **Time Oil Co.** (1951) 103 CA2d 677]

Re-possession on the tenant's behalf

To act on behalf of the tenant when the tenant's right to possession has not been terminated, the landlord who intends to take possession and act on the tenant's behalf to relet the premises as his agent must twice notify the tenant:

- once before taking possession of the premises; and
- again when the premises is relet.

Even though a tenant fails to pay rent, removes all of his personal property, vacates the leased premises and has no intention of returning, the tenant does not and cannot *unilaterally terminate* his right to possess the premises, the leasehold, or escape his rent obligations under the lease agreement.

Until the tenant's right to possession is terminated on a declaration of forfeiture by the landlord, no person other than the tenant has the right to occupy the premises, unless the landlord acts as the tenant's agent or to preserve the landlord's reversionary interest from waste.

Thus, a landlord interferes with the tenant's right to possession and cancels the lease agreement by a surrender when the landlord takes possession of the vacated premises before either:

- terminating the tenancy by forfeiture or abandonment; or
- notifying the tenant he is taking possession to relet the premises as an agent acting on behalf of the tenant. [**Respini** v. **Porta** (1891) 89 C 464]

Inconsistent behavior while reletting

Consider a landlord notifying a tenant who has breached the lease agreement and vacated the premises that the landlord will enter the premises, take possession and relet the premises as an agent acting on the tenant's behalf.

The landlord relets the premises for **less rent** and for a period extending **beyond the expiration** of the term remaining on the tenant's lease. The landlord notifies the tenant he has relet the premises on the tenant's behalf.

A demand is made on the tenant for the loss in rent resulting from the reletting of the premises at a reduced rent. The tenant refuses to pay, claiming a surrender occurred, canceling the lease agreement since the terms and conditions of the new lease agreement exceeded the term of the tenant's remaining right to possession under the breached lease agreement.

Here, a tenant's right to possession runs only until the expiration of the period fixed by his lease agreement. Had the vacating tenant sought to sublet the premises himself, the term of the sublease could not extend beyond the date set for expiration of the tenant's right to occupy the property.

Thus, the landlord who does not terminate the tenant's lease and then acts to relet the premises as the tenant's agent for a **longer term** than the unexpired term remaining on the lease:

- is not renting the premises on behalf of the tenant; and
- has worked a *surrender* — a cancellation of the lease agreement — since his conduct is inconsistent with the vacating tenant's unexpired and unterminated right to possession. [**Welcome** v. **Hess** (1891) 90 C 507]

Now consider a landlord who, on notice to a vacating tenant, takes possession on behalf of the tenant. The landlord maintains and cares for the vacated premises while attempting to relet the premises.

The tenant claims the landlord's care and maintenance of the property constitutes a surrender since the landlord exercised independent control over the premises by his maintenance activity.

Here, the landlord's care and maintenance is conduct entered into on the tenant's behalf. Care and maintenance of the property is activity consistent with the landlord's agency duty owed the tenant, when acting on the tenant's behalf, to perform the tenant's obligation under the lease agreement to care for and maintain the property.

As the agent of the vacated tenant, the landlord must make a good faith effort to lease the premises, called *mitigation of losses*. The landlord, as would the tenant, will be unable to lease the premises in a dilapidated, ill-maintained condition. [**B.K.K. Company** v. **Schultz** (1970) 7 CA3d 786]

In an attempt to avoid all these adverse legal consequences (for failure to know or abide by the rules), some lease agreements contain a remedies provision with a clause stating a surrender can occur only if the tenant enters into a written cancellation and waiver agreement. [See **first tuesday** Form 552 §20]

However, the landlord's **improper conduct** in response to a tenant's breach of the lease agreement and vacating of the premises, acting alone and without a writing, results in a cancellation of the lease by surrender. The landlord's conduct supersedes the lease agreement provisions requiring a written agreement to cancel the lease. Landlord/tenant law controls the result, barring application of contract law principles that would have ignored the landlord's conduct.

Chapter 31 Notice of belief of abandonment

This chapter presents the notice procedure by which a landlord confirms a tenant has abandoned the premises and terminates the tenant's right to possession.

An alternative forfeiture

A tenant who is **delinquent** in rent payments due under his lease agreement has vacated the premises. The tenant has not been served a notice to quit. Here, the landlord may respond in one of several ways, including:

- treat the tenant's right to possession as terminated and the lease agreement as canceled, called a *surrender*;
- treat the tenant's right to possession as terminated by service of a *3-day notice to pay or quit* and a *declaration of forfeiture of the right of possession*, or service of an **abandonment notice**, and proceed to enforce the tenant's financial obligations for rent and other amounts due under the lease agreement;
- take possession on notice, without terminating the lease, to relet the property as the tenant's agent; or
- treat the lease as continuing, if the lease agreement contains a statutory *tenant-mitigation* provision, and recover rent as it becomes due without repossessing or reletting the property. [Calif. Civil Code §§1941.2; 1951.4]

Statutory abandonment notice

The abandonment rules, like surrender rules, apply to both residential and nonresidential property. The commonality between surrender and abandonment is the tenant's breach of the lease and vacating of the premises. They differ, however, on the methods for termination of the tenant's possessory rights and cancellation of contract rights regarding future rent. A surrender is a mutual termination and an abandonment is a unilateral termination by forfeiture delivered by the landlord.

Further, abandonment is to be distinguished from a 3-day notice and forfeiture declaration, as methods of retaining the lease agreement and terminating the tenant's right to possession, by the difference in time after serving the notices until the landlord can retake possession.

An abandonment can be processed when a tenant:

- **voluntarily vacates** the leased premises with no intention to reoccupy; and
- **fails to pay rent** with no intention to further perform his obligations on the lease agreement.

However, the tenant's act of breaching the lease and vacating the premises **does not terminate** the tenant's leasehold ownership in the property or his obligations under the lease agreement. Thus, the landlord must act to terminate the leasehold in response to the **breach and vacating** of the property by the tenant if the landlord is to retake possession.

For the landlord to proceed with the abandonment process, he must confirm the tenant's *intent to abandon* the property and terminate his right to possession. The landlord confirms the tenant's intent by serving a statutory abandonment notice on the tenant. [See Form 581 accompanying this chapter]

A **Notice of Belief of Abandonment** may be served on a tenant only when:

- the tenant has vacated the premises;
- the tenant's rent payment is due and unpaid (no receipt of any amounts) for a period of at least 14 days prior to service of the Notice of Belief of Abandonment [CC §1951.3(b)]; and
- the landlord reasonably believes the tenant has abandoned the premises.

If the tenant's rent is due on the first of the month and has become delinquent and no portion has been paid in the interim, the landlord may serve the notice on the 15th day of the month if the tenant no longer occupies the premises. (A 3-day notice would have already terminated the tenancy and allowed the landlord to enter and take possession of the space.)

The notice of abandonment may be served on the tenant by either:

- personal service; or
- by first-class mail sent to the tenant's last known address and any other addresses known to the landlord where the tenant might reasonably receive the notice. [CC §1951.3(c)]

If the abandonment notice is **personally served** on the tenant, the tenant has 15 days after the date of service to respond before the notice expires. If the abandonment notice is **served by mail**, the notice expires 18 days after the date the notice is deposited in the mail. [CC §1951.3(b)]

When personal service cannot be made, the service requirements for the Notice of Belief of Abandonment are different from service requirements for 3-day notices. [See Chapter 27]

Once served, the notice of abandonment will expire in 15 days unless in the interim:

- the tenant tenders all or partial payment of rent; or
- rejects the abandonment in writing.

On expiration of the notice, in 15 or 18 days, depending on the type of service, the tenant's right to **possession is terminated**.

Having terminated the tenancy by expiration of the abandonment notice, the landlord may:

- enter the premises to **remove** any personal property left behind by the tenant and **relet** the premises as the landlord [CC §1954]; and
- collect past and future rents from the tenant as provided in the lease agreement. [CC §1951.2(a)]

Tenant's response ends abandonment

After the tenant has been served with a notice of abandonment, the tenant may reoccupy the premises. After service of the notice, reoccupying at any time will not stop the abandonment procedure or avoid termination of the tenant's right to possession on expiration of the notice. Once served, further steps must be taken by the tenant to nullify the abandonment procedure. [CC §1951.3(e)]

After an abandonment notice has been served, the tenant can only **disavow an abandonment** and avoid the termination of his right to possession by doing one of the following:

- showing the landlord could not justifiably believe the tenant had abandoned the premises when the notice was served;
- proving rent was not due prior to 14 days before service of the notice or, if due, was not yet delinquent at the time the notice was served;

- proving some or all of delinquent rent was received by the landlord during the 14-day period preceding the service of the notice;
- paying some or all of the past due rent prior to expiration of the notice; or
- handing a written notice to the landlord before the abandonment notice expires stating the tenant has no intention to abandon the premises and including an address for service on the tenant by certified mail of an unlawful detainer (UD) action. [CC §1951.3(e)]

Thus, if a portion or all of the delinquent rent is tendered, or a statement of no intent to abandon is delivered to the landlord by the tenant prior to the expiration of the abandonment notice, a UD action based on abandonment must fail.

Once the notice is served and the tenant reoccupies the premises, before or after expiration of the notice and without payment of rent or a statement of no intent to abandon, the tenant can be evicted by a UD action on expiration of the abandonment notice.

Concurrent service with 3-day notice

Both a 3-day notice to pay or quit (with forfeiture election) and a notice of abandonment may be served **concurrently** under separate proof of service statements. [See Chapter 26]

Since both notices terminate the leasehold on their expiration, a tenant who **reoccupies** or, on a nonresidential property tenders only a partial payment of rent that the landlord accepts, can be dealt with quickly by filing a UD action on expiration of the 3-day notice.

However, under a UD action based on a 3-day notice, the **landlord must prove** his case for eviction, loosely referred to as "having the burden of proof."

Conversely, at a UD trial based on a notice of abandonment where the tenant has reoccupied, the **tenant must prove** he may remain on the premises by showing:

- no delinquency existed when the notice was served;
- A portion or all of the rent was paid within four weeks prior to the expiration of the notice; or
- he delivered the landlord a written statement of his intent to occupy.

Abandoned personal property

Tenants who vacate the leased premises occasionally leave significant personal property behind. When a landlord is confronted with a unit or space vacated by the tenant, but loaded with abandoned personal property, he may find the notice of abandonment an efficient way to terminate the tenant's right to possession. Thus, he can take possession on termination of the tenancy without concern for claims by the tenant.

Before serving a notice of abandonment, a residential landlord may **temporarily enter** the vacated premises to establish his reasonable belief the tenant abandoned the premises. [CC §1954(c)]

Even if the tenant has left personal items behind, a landlord's observations while inside the unit or space may lead him to *reasonably believe* the premises is abandoned. [CC §1951.3(e)(2)]

If the landlord exercises his right to temporarily enter the unit when a tenant appears to have abandoned it, the landlord may **inventory the personal property** so it can be itemized in the abandonment notice. [CC §1983]

Abandoned personal property poses a problem regarding its removal (by the landlord) and recovery (by the tenant). When personal property is left behind by a tenant who has vacated, the landlord is responsible for notifying the tenant of his *right to reclaim* the personal property. [CC §1983]

Notice of the tenant's right to claim personal property can be included in the notice of abandonment. [CC §1991; see Form 581]

When combined in one form, the notice of right to reclaim personal property and the abandonment notice expire simultaneously.

The combined abandonment and right to reclaim property notices are appropriate when the landlord chooses to leave the tenant's personal property on the premises until abandonment of the real estate and the personal property is established by expiration of the notices.

Thus, moving the tenant's belongings twice, or even once if the tenant picks them up, is avoided by the abandonment notice, rather than by preparing both a 3-day notice to pay and a later notice to reclaim personal property.

On termination of the tenancy by expiration of the notice of abandonment, the landlord is entitled to possession of the premises. The landlord may then **enter the unit** to take possession, refurbish it and relet it to a new tenant without concern for the tenant's terminated possessory rights. [CC §1954]

The landlord must not remove personal items, begin refurbishing the premises or relet the premises during the unexpired term of the rental or lease agreement **without first terminating** the tenant's right to possession by a 3-day notice, 30-day notice to vacate or abandonment notice. If the tenant's right to possession is not first terminated, the landlord has interfered with the leasehold estate held by the tenant to occupy the space or unit.

Thus, the landlord who does not first act to terminate the unexpired tenancy before removing personal items or reletting the premises may find himself on the wrong end of a viable forcible detainer action. [Calif. Code of Civil Procedure §1160]

Tenant-mitigation provision

If the tenant's lease agreement, residential or nonresidential, contains a statutory *tenant-mitigation provision*, the landlord may:

- treat the lease rights as continuing without the landlord taking possession; and
- enforce his right to recover rent as it becomes due under the lease agreement. [CC §1951.4]

When a residential or residential tenant breaches his lease agreement and vacates the leased premises, the **tenant-mitigation remedy** can be enforced if:

- the tenant-mitigation remedy is included as a provision in the lease agreement; and
- the assignment and subletting (alienation) provision in the lease agreement does not prohibit the tenant's subletting or assignment of the leasehold interest. [CC §1951.4(b)]

The landlord may treat the lease as continuing and recover rent as it becomes due if the lease agreement contains a provision worded substantially as follows:

"The lessor has the remedy described in California Civil Code Section 1951.4 (lessor may continue lease in effect after lessee's breach and abandonment and recover rent as it becomes due, if lessee has right to sublet or assign, subject only to reasonable limitations)." [CC §1951.4(a)]

NOTICE OF BELIEF OF ABANDONMENT

(Residential or Nonresidential Property)

DATE:_____, 20_____, at _____, California.

To Tenant: _____

Items left blank or unchecked are not applicable.

FACTS:

You are a Tenant under the rental or lease agreement dated _____, entered into by _____, Tenant, and _____, Landlord, regarding real estate referred to as: _____

NOTICE: If the tenant does not respond to this notice and the notice expires, the property, real and personal, has been abandoned and the tenancy terminated. The landlord may then dispose of itemized unclaimed property. [CC §§1951.3; 1991]

YOU ARE HEREBY INFORMED:

Rent on the leased property has been due and unpaid for 14 consecutive days or more, **AND** Landlord believes you have abandoned the property. Personal property remains on the premises as described in Section 5.

NOTICE:

1. This notice expires unless you respond by _____, 20_____, which date is at least:

☐ 15 days after this notice was personally served on you; or

☐ 18 days after this notice was sent by first class mail, postage prepaid, to your last known address.

2. On expiration of this notice, the property will be considered abandoned, your right to possession terminated, and all remaining personal property will be disposed of [under Section 7 below].

2.1 Landlord reserves the right to collect future rent losses allowed by California Civil Code §1951.2.

3. **YOU MAY AVOID THIS NOTICE,** if before it expires and at the address below, Landlord receives your written notice stating:

3.1 Your intent not to abandon the real estate, **AND**

3.2 An address where you may be served by certified mail in any action for unlawful detainer of the real property.

4. **YOU MAY AVOID DISPOSAL OF PERSONAL PROPERTY** by doing the following before expiration of this notice:

4.1 Pay the reasonable cost of storage for all the personal property, **AND**

4.2 Take possession of the personal property.

5. The personal property remaining is described as:_____

_____

_____

6. The personal property may be claimed at:_____

_____

7. **The personal property to be claimed or disposed of is valued as:**

7.1 ☐ Worth more than $300. If you fail to reclaim the property, it will be sold at a public sale after published notice of the sale. You have the right to bid on the property at this sale. After the property is sold and the cost of storage, advertising and sale are deducted, the remaining money will be handed to the county. You may claim the remaining money within one year after the county receives the money.

7.2 ☐ Worth less than $300. This property is believed to be worth less than $300. Therefore, it may be kept, sold or destroyed without further notice if you fail to reclaim it prior to expiration of this notice. [CC §1988]

8. You are required by agreement to pay past due rent. Failure to pay can lead to court proceedings against you.

Date:_____, 20_____

Landlord/Agent: _____

Signature:_____

Address:_____

_____

Phone: _____ Fax:_____

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A landlord's use of the tenant-mitigation remedy **shifts the responsibility** for mitigating his losses under the lease agreement to the tenant when the tenant vacates the premises and breaches the lease agreement. Instead of the landlord mitigating his loss of rents by reletting the space as a requisite for qualifying to collect future rents, the tenant must take steps to **mitigate his liability** to the landlord.

When the landlord chooses to enforce the tenant-mitigation remedy, **landlord activities** that do not constitute a termination of the tenant's right to possession or a surrender of the lease agreement include:

- maintenance to preserve the premises from waste;
- appointment of a receiver (by a court) to protect the tenant's interest; or
- the reasonable withholding of consent to an assignment or subletting. [CC §1951.4(c)]

The landlord who includes the tenant-mitigation remedy clause in his lease agreement usually is an absentee owner who enters into long-term, triple-net leases with creditworthy, well-established users.

The landlord entering into a long-term triple net or pure-net lease intends to receive his rent payments without expending time and energy managing the property.

Assignment or subletting restrictions

Now consider a nonresidential lease agreement containing the statutory **tenant-mitigation provision**.

The lease agreement also contains a subletting or assignment provisions calling for the landlord's **consent**, which will not be unreasonably withheld. The assignment provision also calls for the payment of money as a condition for the landlord's consent.

A lease cancellation provision in the lease agreement permits the landlord to cancel the lease agreement on his receipt of a request from the tenant to consent to an assignment.

The tenant stops paying rent and vacates the property.

The landlord elects the remedy available to him under the statutory tenant-mitigation provision in the lease agreement.

The tenant, being responsible for reletting the premises, locates a replacement tenant. The tenant notifies the landlord of his intent to assign the lease and requests the landlord's consent.

On receiving the request for consent to assign, the landlord sends the tenant a notice canceling the lease agreement under the lease cancellation provision.

The tenant claims the landlord cannot terminate the lease since the landlord's ability to refuse consent by exercising his option to terminate the tenant's right of possession is subject to a standard of reasonableness due to the tenant-mitigation provision.

However, the landlord's cancellation of the lease under the lease cancellation provision is neither reasonable nor unreasonable. The lease cancellation provision, when exercised by the landlord on receipt of a request to assign, **relieves the tenant** who has vacated the premises and breached the lease of any further responsibility under the tenant-mitigation provision in the lease. Cancellation of the lease agreement terminates the tenant's right to possession and with it his ability to assign his leasehold interest, a "catch-22" for the tenant. [**Carma Developers, Inc.** v. **Marathon Development California, Inc.** (1992) 2 C4th 342]

Chapter 32 Personal property reclaimed by tenant

This chapter explains the procedural steps residential and nonresidential landlords must take when confronted with personal property left by a tenant who has vacated.

Reclaim it or lose it on notice

A tenant vacates a rental property, residential or nonresidential, leaving behind personal belongings.

The tenant's right to possession of the premises has been **forfeited** by notice from the landlord due to the tenant's breach of the lease agreement. The space is immediately re-rented and needs to be made ready for the new tenant.

The landlord removes the tenant's belongings from the leased space and stores them in a place of safe-keeping. The value of the personal property is determined by the landlord to be less than $300.

The landlord immediately mails the tenant a notice, called a *Notice of Right to Reclaim Personal Property*, which:

- describes each item or lot of personal property left on the premises; and
- advises the tenant that the personal property will be discarded if not reclaimed by the tenant within 18 days of mailing the notice. [Calif. Civil Code §1983; see Form 584 accompanying this chapter]

The tenant does not respond to the notice and it expires. The landlord and his property manager dispose of the tenant's belongings.

Later, the tenant sends the landlord a letter requesting the landlord arrange for him to pick up the property. The landlord ignores the tenant's late response and does nothing. The tenant then demands payment for the value of the items left behind.

Here, the landlord is not liable for the value of the personal property left in the unit and unclaimed by the tenant. The landlord followed the statutory procedure for notice and disposal of property estimated to be worth less than $300. [CC §§1982, 1984]

The **statutory notice** procedure:

- provides the tenant with time in which to reclaim his personal property; and
- protects the landlord from liability on disposition of the personal property if the tenant fails to respond prior to expiration of the notice to reclaim.

Removal of personal property

Before removing a tenant's personal property from a vacant unit, a landlord must first be legally entitled to enter and take possession of the unit.

The landlord can enter, take possession and dispose of a tenant's personal property when the tenant has vacated and the tenant's right to possession of the premises has been *terminated*. [See Chapters 29 and 32]

Returning personal property

Two separate statutory procedures exist for the return of personal property left on the premises by a tenant. One is initiated by the landlord, the other by the tenant.

Residential and nonresidential landlords may initiate (and control) the process of returning or disposing of the tenant's personal property. A notice prepared by the landlord is personally served or mailed to the tenant who vacated and left the personal property advising him of his right to **reclaim or abandon** the personal property, called the *landlord-initiated disposition procedure*. [See **first tuesday** Form 581 and Form 584]

The other procedure allows a residential tenant acting within 18 days of vacating the premises to initiate a return of personal property he left behind by handing or mailing to the landlord or the property manager a *request to surrender* personal items he left behind, called the *tenant-initiated recovery procedure*. [CC §1965; see Form 582 accompanying this chapter]

The landlord is not required to use the landlord-initiated procedure when confronted with the disposition of the tenant's personal property. [CC §1981]

However, a landlord who sells or disposes of a tenant's personal property by any procedure other than established by these two procedures can be challenged for his handling of the belongings by the tenant. The statutory procedures are sometimes called *safe harbor rules*.

For example, a tenant claims his personal property was left behind inadvertently, not abandoned. Thus, the landlord would not be entitled to sell or dispose of the property unless the landlord first establishes the tenant's actual intent is not to reclaim the property, but to abandon it.

On the tenant's abandonment of property, the preferred method for establishing the tenant's intent not to reclaim property left behind, so the landlord may dispose of the property, is the landlord-initiated disposition procedure. The tenant is notified of his right to reclaim the property he left behind and his need to respond to avoid its disposal. [See **first tuesday** Form 581 and Form 584]

Residential tenant-initiated recovery

Only a residential tenant may deliver to the landlord or the landlord's agent a written request for the return of personal property left in the vacated unit, called a *Notice to Landlord to Surrender Personal Property.* [See Form 582]

The **tenant's request** for the release of his belongings by the landlord, called *surrender*, must:

- be written;
- be mailed or handed to the landlord within 18 days after he vacates the unit;
- include the tenant's current mailing address;
- contain an identifiable description of the personal property left behind;
- be received by the landlord while the landlord or his agent is in control or possession of the personal property; and
- be received by the landlord or his agent before they have mailed to him a notice to reclaim the personal property, commencing the landlord-initiated disposition. [CC §1965(a)]

In response to receipt of the tenant's notice of surrender, the **landlord's response** must be a written demand on the tenant for reasonable removal and storage costs that:

NOTICE TO LANDLORD TO SURRENDER PERSONAL PROPERTY

(For Use by Residential Tenants Only)

DATE:_____, 20_____, at _____, California.

To Landlord:

Items left blank or unchecked are not applicable.

FACTS:

I am a former Tenant under a residential rental or lease agreement dated _____, at _____ _____, California, entered into by _____, Tenant, and _____, Landlord, regarding real estate referred to as: _____ _____

NOTICE:
If the landlord has not initiated the abandonment remedy, the tenant by this request may reclaim personal property from vacated residential rental premises within 72 hours after payment of removal and storage fees. [Calif. Civil Code §1965]

NOTICE:

1. Within eighteen (18) days prior to mailing or handing this notice to the Landlord, I vacated and delivered possession of the premises to Landlord or

2. This notice is a request for Landlord to surrender to me or personal property not owned by Landlord and described below which was left on the vacated premises.

3. I understand:

3.1 This notice must be mailed within eighteen (18) days after I vacated the premises.

3.2 Landlord or the landlord's manager must have control or possession of the personal property at the time the Landlord actually receives this notice.

3.3 I will pay all reasonable costs actually incurred by Landlord for the removal and storage of the personal property as a condition for the release and return of the personal property.

3.4 Landlord will provide a written itemized demand for payment of reasonable removal and storage fees within five (5) days of actual receipt of this notice unless the property is first returned. The demand for payment of removal and storage fees will be mailed to the address given below or handed to me personally.

3.5 I will claim and remove the personal property at a reasonable time mutually agreed upon by Landlord and myself to occur within 72 hours after my payment of reasonable removal and storage fees demanded by landlord.

4. Description of personal property to be reclaimed: _____

_____

_____

_____

_____

_____

This statement is true and correct.

Date:_____, 20_____

Tenant:_____

Signature: _____

Current mailing address: _____

_____

Phone:_____

Fax: _____

E-mail: _____

For Landlord/Manager's use:

Date Received:_____

By: _____

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- the landlord will mail or hand to the tenant within five days after the landlord receives the tenant's request to surrender the property; and
- itemizes any costs for removal and storage to be paid before the tenant can remove the property. [CC §1965(a)(3); see **first tuesday** Form 588]

It is then incumbent upon the tenant to contact the landlord and arrange a mutually agreeable date, time and location for the tenant to claim and remove his personal property. However, the tenant or the tenant's agent must remove the personal belongings within 72 hours **after the tenant pays** storage charges demanded by the landlord. [CC §1965(a)(4)]

After a tenant mails the landlord a request to surrender personal property, the landlord might receive **another request** for the same items from the tenant's roommate, a secured creditor or other person with an interest in the property.

The first request received by the landlord controls the return of the property left behind. [CC §1965(d)]

The landlord is not obligated to the roommate or anyone else who makes a later request for the same personal belongings.

Which process controls

The tenant-initiated process for residential rentals does not apply if the **landlord first mails** or personally delivers the notice to reclaim personal property to the tenant before he receives the tenant's notice to surrender. [CC §1965(c)]

But what if the landlord's notice to reclaim property and the tenant's request to surrender the property pass in the mail?

Here, the landlord-initiated process begins the moment the landlord deposits the notice of the tenant's right to reclaim property in the mail (first-class, postage prepaid). The tenant-initiated process does not begin until the landlord or his agent personally receives the tenant's request.

The landlord who neglects to mail the notice before actually receiving a tenant's request must respond to the tenant's request since, under abandonment rules, the landlord no longer controls disposition.

Conversely, if the landlord can show he or his agent deposited either the Notice of Belief of Abandonment or the notice to reclaim personal property in the mail before they actually received the tenant's notice to surrender, the tenant must abide by the landlord-initiated disposition procedure.

Residential landlord violations

Consider a residential tenant who has vacated and timely hands the landlord a notice to surrender personal items he left behind without the landlord acting first.

The landlord makes a demand on the tenant to pay removal and storage costs. The tenant promptly pays the removal and storage costs.

Should the landlord fail to hand over the items within 72 hours after the tenant (or tenant's agent) pays storage and removal fees, the landlord is liable for:

- damages for the value of the personal items;
- $250 for each violation; and
- attorney fees. [CC §1965(e)]

This tenant-initiated procedure is entirely avoided if the landlord merely sends by first-class mail either the notice of abandonment (both real estate and personal property) or a notice to reclaim personal property before he receives the tenant's notice to surrender the property. [See **first tuesday** Form 581 and Form 584]

Landlord-initiated abandonment

On mailing or personally delivering the notice of abandonment to the tenant, and any other possible **owner or creditor known** to have an interest in the belongings, a residential or nonresidential landlord commences the landlord-initiated disposition process. [See **first tuesday** Form 581]

The notice to dispose of the tenant's property must be delivered to the tenant by either:

- personal service; or
- first-class mail to the tenant's last known address with a duplicate notice mailed to the address of the vacated premises. [CC §1983(c)]

Notice should be given promptly on termination of the tenancy, but may be given at any time after the tenant has vacated the premises. [CC §1983]

As a matter of practice, the tenancy should first be terminated before entering the premises and determining whether the tenant left personal property, unless the abandonment procedure is used. [See Chapter 31]

Abandonment notices

A landlord may combine the abandoned personal property notice with the notice of abandonment of the premises. [See Chapter 23]

The landlord combines the two notices when he believes the tenant has abandoned both the personal property and the premises, and the landlord **chooses to terminate** the tenant's right to possession by establishing an abandonment of the premises in stead of using a 3-day notice and declaration of forfeiture. [CC §1991; see **first tuesday** Form 581]

Both abandonment notices from the landlord to the tenant must include:

- a description of each item;
- notice that reasonable storage costs will be charged;
- the location where the property may be reclaimed;
- expiration of the notice — the date by which the tenant must reclaim his property;
- notice the property will be kept, sold or destroyed if the value is estimated at less than $300; and
- notice the property will be sold by public sale if it is worth $300 or more and is not reclaimed. [CC §§1983(b), 1984(b)]

If the notice is personally served on the tenant, the notice may expire no less than 15 days after service. If the notice is mailed, the notice may expire no less than 18 days after posting in the mail. [CC §1983(b)]

When personal property worth less than $300 is not reclaimed by a tenant before the notice expires, the landlord may keep, sell or destroy the property without further notice to the tenant. [CC §1984]

NOTICE OF RIGHT TO RECLAIM PERSONAL PROPERTY

(To Tenant After Termination of Tenancy)

DATE:_____, 20_____, at _____, California.

TO FORMER TENANT:

Name:_____

Address:_____

_____

Items left blank or unchecked are not applicable.

NOTICE:
This notice may be given to a residential and nonresidential tenant who left personal property on the premises which remains after he vacated the premises and his tenancy terminated. On expiration of this notice, the landlord may dispose of the unclaimed property. [CC §1983]

FACTS:

You were a Tenant under a rental or lease agreement dated _____, at _____, California, entered into by _____, Tenant, and _____, Landlord, regarding real estate referred to as: _____

_____

NOTICE:

1. This notice expires unless you respond by _____, 20_____, which date is at least:
- ☐ 15 days after this notice was personally served, or
- ☐ 18 days after this notice was deposited in the mail.

2. When you vacated the premises referenced above, the following personal property remained:

_____

_____

_____

_____

3. You may claim the personal property at: _____

_____

4. **YOU MAY AVOID DISPOSAL OF PERSONAL PROPERTY** by doing the following before expiration of this notice:
- 4.1 Pay the reasonable cost of removal and storage of all the personal property; **AND**
- 4.2 Take possession of the personal property.

5. **The personal property to be claimed or disposed of is valued as:**
- 5.1 ☐ Worth more than $300. If you fail to reclaim the property, it will be sold at a public sale after published notice of the sale. You have the right to bid on the property at this sale. After the property is sold and the cost of storage, advertising and sale are deducted, the remaining money will be handed to the county. You may claim the remaining money within one year after the county receives the money.
- 5.2 ☐ Worth less than $300. This property is believed to be worth less than $300. Therefore, it may be kept, sold or destroyed without further notice if you fail to reclaim it prior to expiration of this notice.

This statement is true and correct.

Date:_____, 20_____

Landlord/Agent: _____

Signature: _____

Address:_____

_____

Phone: _____

Fax: _____

E-mail: _____

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Notice to third-party owners

Under the landlord-initiated procedure, the landlord must also notify any other persons he **reasonably believes** may have any ownership interest in the personal property left on the premises. [CC §1983(a); see Form 587 accompanying this chapter]

For example, if a landlord is aware a co-tenant or guest left behind some personal property, the landlord must notify the co-tenant or guest as well as the tenant.

The *reasonable belief* of ownership of the abandoned personal property imposed on a landlord means the **actual knowledge** a prudent person in the landlord's (or property manager's) position would have without making an investigation, unless such an investigation is of probable value and reasonable cost. [CC §1980(d)]

The landlord is not required to investigate public records unless it is likely he will find information pertinent to locating the owner of the personal property.

Also, if a landlord notices a name or phone number inscribed on the personal items, such as a furniture rental company, the landlord will not be protected from liability for failure to investigate the name or phone number.

Identification of personal property

First, the identification of the personal property in notices to reclaim initiated by the landlord should list every significant item or "lot of items" left behind.

Although the landlord may choose to describe only a portion of the personal property left behind, he is protected from liability only for those items he identifies.

A landlord may identify items as simply as a "bundle," a "lot" or a "box" of items, or the landlord may look inside the bundle or boxes to determine the contents and their worth. The **total value** of the bundled, boxed or lot of similar items will determine the method the landlord must employ to dispose of them.

The landlord, property manager or resident manager should use a witness to inventory the items and confirm their estimated worth. The witness will assist the landlord should the tenant claim the landlord confiscated or damaged items.

The landlord may use his reasonable belief to estimate the value of the items.

Storage and release of property

As in the tenant-initiated procedure for reclaiming items, the landlord may charge the tenant for the **cost of removal and storage** of the property. The landlord may store the personal property in the unit, or remove it to another place of safekeeping, for which he may charge a fee.

While the landlord must exercise care in storing the property, he may be held liable only for damages caused by his intentional or negligent treatment of the items when removing and storing them. [CC §1986]

The landlord **must release** the personal property to the tenant, or the person who first notifies the landlord of his right to reclaim, within 72 hours of payment of the storage costs.

NOTICE OF RIGHT TO RECLAIM PERSONAL PROPERTY

(To Others with an Interest in Property Left by Tenant)

DATE:_____, 20_____, at_____, California.

TO: Name: _____

Address: _____

_____

Items left blank or unchecked are not applicable.

NOTICE:

This notice may be given to persons who are believed to own or hold a security interest in personal property left on residential or nonresidential premises by a tenant who has vacated and whose tenancy has been terminated. On expiration of this notice, the landlord may dispose of itemized unclaimed property [CC §1983]

NOTICE:

1. This notice to claim personal property you may have an interest in expires on _____, 20_____, which date is at least:
   - ☐ 15 days after this notice was personally served on you; or
   - ☐ 18 days after this notice was sent by first class mail, postage prepaid, to your last known address.
2. When our former tenant named _____, vacated premises known as _____

   _____,

   the following personal property remained: _____

   _____

   _____

   _____

   _____

   _____.
3. If you have an interest in any of this personal property, you may claim it at:

   _____

   _____
4. You must pay the cost of storage on or before taking possession of the personal property you claim. [**first tuesday** Form 588]
5. Unless you take possession of the personal property you have an interest in prior to the expiration of this notice, the personal property not claimed will be sold at a public sale by competitive bidding. [CC §1988]

This statement is true and correct.

Date:_____, 20_____

Landlord/Agent:_____

Signature: _____

Address: _____

_____

Phone:_____

Fax: _____

E-mail: _____

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The tenant or owner reclaiming the personal items is responsible for storage costs. Any owner other than the tenant is responsible only for the storage costs of property he claims. The landlord may not, however, charge more than one party for storage of any one item. [CC §1990]

Sale of the abandoned property

If the total worth of the abandoned personal items is $300 or more, they must be sold at a public sale by the landlord. [CC §1988(a)]

If the abandoned personal property notice states the property (because of its value) is **subject to public sale**, the landlord must surrender the personal property to the tenant any time prior to the sale, even after the date specified for expiration in the notice of abandonment. [CC §1987]

However, the tenant or the owner must then pay advertising and sale costs in addition to storage costs. [CC §1987]

The landlord must advertise the public sale prior to its scheduled date in a local county newspaper of general circulation. [CC §1988(b)]

The **notice of sale** must appear twice — once each week for two consecutive weeks. The last advertisement may not be later than five calendar days before the date of the public sale. The notice of sale must specify the date, time and location of the sale. Also, the notice of sale must sufficiently describe the personal property to allow the owner to identify the property as his.

The timetable before the sale becomes the combination of the 15 or 18-day period for the notice of abandonment and the 12 days of advertising. The highest bidder (including the tenant or landlord) may buy the property.

Any proceeds from the sale, minus the costs of sale, advertising and storage, are given to the county treasurer within 30 days of the sale. Once the remaining proceeds have been given over to the county treasurer, the tenant or owner of the personal property has one year to claim the proceeds. [CC §1988]

Chapter 33 Constructive eviction cancels the lease

This chapter reviews the tenant's remedies when a landlord breaches a nonresidential lease agreement.

Interference forces tenant to vacate

A nonresidential tenant occupies a building in which he operates his restaurant business. The tenant's lease agreement obligates the landlord to make all necessary repairs to the exterior walls and roof during the term of the lease.

During the tenancy, the roof begins to leak. The tenant notifies the landlord about the leaks and the need for repairs. The landlord makes several personal attempts to repair the roof. However, the roof is never properly repaired and the leaks persist each year during the rainy season.

The leaking water damages the interior walls. During rain storms, water runs along beams and down walls, forming puddles on the floors creating hazardous conditions for employees and patrons.

Fed up, the tenant **vacates the premises**.

The tenant then makes a demand on the landlord to recover his security deposit and business losses. The tenant's losses include lost income from business operations, loss of goodwill, relocation expenses, employee medical expenses and water damage to furnishings and equipment.

Also, the tenant claims the lease agreement has been **canceled** due to the landlord's interference with the tenant's occupancy since the landlord failed to meet his contractual obligation by repairing the roof, resulting in untenantable conditions and caused him to vacate the leased premises, called a *constructive eviction*.

The landlord claims his failure to repair the roof was not conduct so intrusive as to result in a constructive eviction, but was merely an inconvenience to the tenant for which the tenant is only entitled to money for his losses, not a cancellation of the lease agreement and obligation to pay rent.

Here, the landlord's failure to meet his obligation to repair the roof under the terms of the lease agreement was conduct that *terminated* the tenant's right to possession and *canceled* the lease agreement. The leaking roof significantly interfered with the tenant's ability to use the premises to operate a restaurant as stated in the lease agreement.

Collectively, the landlord's **failure to maintain** the property and the tenant **vacating the premises** in response constituted a *constructive eviction* allowing the tenant to recover the security deposit and any money losses caused by the landlord's interference with possession. [**Groh** v. **Kover's Bull Pen, Inc.** (1963) 221 CA2d 611]

A tenant is not obligated to continue to occupy the premises and pay rent if the premises can no longer be used as intended due to the landlord's conduct.

Conversely, if the landlord's **failure to repair** the premises does not *substantially deprive* the tenant of his intended use of the premises, the tenant's right to possession and obligations under the lease agreement remain intact, including the obligation to pay rent.

Further, the tenant's recovery of his money losses incurred due to the landlord's failure to repair or correct conditions that do not significantly interfere with the tenant's use of the premises, sufficient to justify vacating as a constructive eviction, or if they do and the tenant does not vacate, must be pursued in a separate action, not as an offset to rent.

Editor's note — The constructive eviction could easily have been avoided in Groh *had the landlord hired a competent contractor to promptly and properly repair the roof.*

Landlord's breach terminates possession

Both the landlord and the tenant must perform their contractual obligations under the provisions contained or implied in their lease agreement. If either the landlord or tenant fail to fully perform, they breach the lease. A breach by the landlord or tenant for failure to perform as agreed is either a *minor breach* or a *material breach*.

A **minor breach** of a lease agreement provision by either the landlord or the tenant is not a justifiable basis for terminating the lease. Examples of minor breaches include the landlord's failure to maintain landscaping or tenant's failures which could be corrected under a 3-day notice to perform or quit, or the refusal to pay late charges.

However, a **material breach** of the lease agreement by either the tenant or landlord justifies a termination of the tenant's right to possess the premises — his lease in the property.

A landlord's failure to meet significant obligations imposed on him by the lease agreement which substantially interfere with the occupancy is a material breach and **allows the tenant** to:

- terminate his possession of the leased premises, causing his possessory interest in the property to revert to the landlord; and
- cancel the lease agreement, including all future rent obligations.

Constructive eviction

A **constructive eviction** occurs when:

- the landlord or his agent *substantially interferes* with the tenant's use and enjoyment of the premises during the term of the tenancy held by the tenant as intended by the lease purpose provision; and
- the *tenant vacates* the premises due to the interference.

A constructive eviction due to the landlord's interference does not occur until the tenant vacates. An eviction does not exist when the tenant remains in possession.

Examples of **substantial interference** by the landlord that justify the tenant's vacating the premises include:

- a material breach of the lease, such as failing to repair and maintain the leased premises to accommodate and avoid interference with the use intended by the lease [Groh, *supra*];

- extensive alteration of the leased premises that is not authorized in the lease agreement or by the tenant and interferes with the intended use [**Reichhold** v. **Sommarstrom Inv. Co.** (1927) 83 CA 173];
- the sale of adjacent property owned by the landlord without reserving the tenant's parking and water rights given to the tenant as part of the lease [**Sierad** v. **Lilly** (1962) 204 CA2d 770]; or
- the failure to abate a sanitation, noise or safety nuisance over which the landlord, but not the tenant, has control. [**Johnson** v. **Snyder** (1950) 99 CA2d 86]

In a constructive eviction, neither a 3-day notice nor an unlawful detainer (UD) action is used to force the tenant to vacate. [Reichhold, *supra*]

Tenant's losses and remedies

Every month-to-month rental and lease agreement contains an **implied covenant**, an unexpressed lease provision, prohibiting the landlord from interfering with the tenant's agreed use and possession of the property, called the *covenant of quiet enjoyment*. [Calif. Civil Code §1927]

When a landlord breaches the *implied covenant of quiet enjoyment*, or other significant provision in the lease agreement, the tenant can:

- **vacate** the leased premises, recover his money losses incurred and cancel the lease agreement along with his obligation to pay future rents based on his constructive eviction; or
- **retain possession**, continue to pay rent and sue for any income lost or expenses incurred due to the landlord's interference.

The **losses** a tenant may recover when the tenant vacates due to a constructive eviction include:

- advance payments of rent and security deposits [Groh, *supra*];
- the cost of removing trade fixtures [Reichhold, *supra*];
- relocation expenses; and
- loss of business goodwill. [Johnson, *supra*]

The breaching landlord's remedies

A tenant who fails to pay rent and later vacates the premises due to a constructive eviction owes the landlord rent for the period of occupancy prior to vacating.

However, any unpaid back rent the landlord is entitled to collect is offset by money losses the tenant incurs due to the constructive eviction. [**Petroleum Collections Incorporated** v. **Swords** (1975) 48 CA3d 841]

Breach of anti-competition clause

The landlord's breach of an anti-competition provision in the lease agreement is a material breach. The tenant may respond by vacating the premises as a constructive eviction.

Consider a nonresidential lease containing an *anti-competition clause* stating the landlord will not lease other space in the commercial complex to competitors of the tenant.

The lease agreement also contains a *remedies provision* stating the landlord may relet the premises **without notifying** the tenant should the tenant vacate prior to the lease expiration date.

Later, the tenant holds a sale to liquidate his stock. The tenant closes down his business operations, vacates the premises and returns the keys to the landlord with instructions to find another tenant. The tenant's lease does not expire for a few years.

The landlord does not respond by entering into an agreement to cancel (surrender) the lease, nor does he take possession of the premises. Further, the landlord does not take **steps to forfeit** the tenant's right to possession (by an abandonment or 3-day notice).

The tenant pays no further rent and the landlord makes no demand on the tenant for delinquent rent. The landlord tries to locate a new tenant, but is unable.

Several months after closing the business, the tenant re-enters the premises and prepares to reopen for business since his lease of the premises has not been terminated. Meanwhile, the landlord leases another space in the building to a competitor of the tenant.

On discovering a competitor will now occupy the same commercial complex, the tenant vacates the premises. The landlord is notified the tenant has elected to cancel the lease since the landlord breached the anti-competition clause in the lease agreement by renting another space in the building to his competitor.

The landlord makes a demand for all rents due until the expiration of the lease agreement, claiming the obligation to pay rent has not been canceled.

The tenant claims he is liable only for the rents due prior to his vacating the premises (the second time) since the landlord's breach of the anti-competition provision in the lease agreement constituted a constructive eviction.

Can the tenant cancel the lease agreement and terminate his obligation to pay rent for the remaining term of the lease?

Yes! The tenant's right to possession under the lease has been terminated and the tenant's obligation to pay rent under the lease agreement canceled due to the **landlord's interference** with the tenant's use of the premises and the **tenant vacating** the premises. The landlord's breach of the anti-competition clause is a material breach of the lease agreement, justifying the tenant vacating the premises and canceling the lease agreement. [**Kulawitz** v. **Pacific Woodenware & Paper Co.** (1944) 25 C2d 664]

Failure to forfeit may lead to a breach

The landlord in the prior scenario failed to terminate the tenant's right to occupy the premises by declaring a forfeiture of the leasehold estate when the tenant first vacated the premises and became delinquent on rent payments. Due to the landlord's administrative error, the tenant retained all his leasehold interests and lease agreement contract rights.

The landlord could have terminated the lease when the tenant closed his business and delivered the keys to the landlord by:

- a surrender (accepting the possession of the premises in exchange for cancellation of the lease agreement and loss of the right to future rents); or
- a 3-day notice to pay rent or quit with a declaration of forfeiture of the leasehold (or a notice of abandonment).

Without a termination of the tenant's leasehold rights, the tenant's right to possession as agreed to in the lease agreement remained in effect throughout the delinquency and while out of possession.

Since the tenant's right to possession (use of the property) had not been terminated, the landlord's obligation to the tenant to abide by the anti-competition clause in the lease agreement remained in effect.

A landlord cannot reasonably expect to recover rents remaining due for the unexpired duration of a lease agreement that he has breached, causing the tenant to vacate as a constructive eviction.

Independent obligations to perform

Now consider a tenant who leases a gas station. A modular sign on the premises advertising the service station can be seen from a nearby freeway.

However, the sign was previously installed without a permit. The city orders the removal of the sign since its proximity to the gas tanks constitutes a fire hazard.

The landlord removes the sign, replacing it with a billboard that cannot be seen from the freeway. The tenant demands the landlord provide a sign visible from the freeway, and of comparable likeness to the one removed.

When the landlord fails to provide a similar sign, the tenant stops paying rent, but remains in possession of the premises. Months later, the lease agreement is canceled by the mutual agreement of the landlord and tenant. The tenant then vacates the premises.

The landlord now makes a demand on the tenant to pay rent for the months the tenant did not pay rent prior to vacating the premises.

The tenant claims he is not liable for rent during his period of occupancy after removal of the sign since the landlord's conduct of removing the sign constructively evicted him from the premises, a breach of the covenant of quiet enjoyment and use of the property as contemplated by the use provision in the lease agreement.

Is the tenant liable for the unpaid back rent during the period he remained in occupancy?

Yes! The tenant is liable for the agreed-to rent for the period of his occupancy. A constructive eviction — which relieves the tenant of his rent obligation by canceling the lease agreement — cannot occur until the tenant **actually vacates** the premises (and thus owes no more rent). [Petroleum Collections Incorporated, *supra*]

While the landlord's failure to replace the sign that could be seen from the freeway with a similar sign significantly interfered with the tenant's use of the property as intended by the lease agreement, the fact the tenant remained in possession after the breach without first negotiating a modification of the lease agreement obligated the tenant to pay rent.

A tenant owes rent under the lease agreement in exchange for his use and possession of the leased premises. Rent at the agreed price is due even though the use may be diminished by the landlord's interference.

Thus, when the tenant remains in possession and **fails to pay rent**, the interfering landlord who himself has breached the lease may forfeit the tenant's right to occupy the property by use of a 3-day notice to pay rent and declaration of forfeiture.

Quiet enjoyment waiver

A tenant leases space in a retail center under a nonresidential lease agreement containing a **remedies provision** stating:

- the tenant may not terminate the lease agreement on any failure of the landlord to fully perform on the lease; and
- the tenant may only recover money losses if the landlord breaches the lease.

The landlord leases the adjoining space to a dry cleaning business. The dry cleaning business emits fumes that enter the ventilation system and permeate the tenant's premises, negatively impacting his employees and business operations. The landlord is notified of the interference but fails to remedy the ventilation problems over which he has control.

The tenant stops paying rent and vacates the premises, claiming the dry cleaning fumes were noxious and endangered his employees' health.

The landlord makes a demand on the tenant to pay rent for the remainder of the lease term. The tenant rejects the demand, then seeks to recover his lost profits, relocation expenses and employee medical expenses from the landlord.

The tenant claims the landlord's failure to prevent the fumes from invading his leased premises is a breach of the implied covenant of quiet enjoyment and constitutes a constructive eviction, canceling the lease agreement when he vacated.

The landlord claims the tenant is liable for the remaining rent whether or not the tenant vacated since the lease contains a remedies provision, waiving the tenant's right to terminate the lease.

Is the tenant liable for the rent due for the remaining term of the lease?

Yes! The nonresidential tenant is liable for the rent remaining unpaid on the lease. Here, the tenant was constructively evicted. However, he remains liable for all future unpaid rent under the lease agreement since the tenant contracted to limit his remedies on the landlord's material breach to a demand for money. The tenant's claim for money losses is separate from the rent due under the lease. [**Lee** v. **Placer Title Company** (1994) 28 CA4th 503]

Thus, the tenant is obligated by the **remedies provision** in his lease agreement to:

- remain in possession (and care) of the premises even though he has been constructively evicted;
- continue paying the agreed rent for the entire duration of the lease; and
- sue the landlord to recover any money losses caused by the landlord's breach of the lease agreement.

Editor's note — For residential tenants, any waiver or limitation on the remedies for breach of the covenant of quiet enjoyment is void as against public policy; not so for nonresidential tenants. [CC §1953]

However, when the landlord's conduct prevents, not just interferes with, the tenant from operating his business on the property and forces him to vacate, then the value of the tenant's leasehold interest has been completely diminished.

While the nonresidential tenant waived his right to terminate the lease on the landlord's breach of the covenant of quiet enjoyment, he may vacate the property and sue for money, including:

- a 100% offset against future rents due on the lease for money losses occurring after the breach and until the landlord performs or the lease term expires; and
- lost profits, relocation expenses, rent for the replacement space and loss of goodwill.

Landlord interference with subtenants

A tenant may convey a portion of his leasehold rights to possess part or all of the leased premises to a subtenant by entering into a *sublease*. However, most lease agreements held by single-user tenants prevent the tenant from subleasing (or assigning) without the landlord's permission.

On entering into a sublease agreement, the subtenant becomes a third-party beneficiary to the lease agreement entered into by the landlord, referred to as the *master lease*. The benefits received by the subtenant under the master lease include the implied covenant of quiet enjoyment, when:

- the master lease agreement permits subleasing; or
- the landlord consents to a sublease under a restraint on alienation provision in the master lease agreement.

The master lease agreement should be attached to the sublease agreement as an exhibit, as the rights of the subtenant are limited by the terms of the master lease.

*Editor's note — Both the master lease and the sublease are of the same form and thus contain the same provisions, except the lease agreement with the subtenant references the lease agreement held by the tenant. [See **first tuesday** Form 552 § 1.3]*

Thus, when a landlord's conduct interferes with the subtenant's use of the premises under the sublease agreement (as limited by the referenced master lease), the subtenant may vacate and recover losses from the landlord for a constructive eviction. [**Marchese** v. **Standard Realty and Development Company** (1977) 74 CA3d 142]

When a subtenant has been constructively evicted by the landlord, the **master tenant** may:

- vacate the entire premises, cancel the lease agreement and recover losses from the landlord for a constructive eviction of the master tenant; or
- remain in possession and recover money losses for breach of the implied covenant of quiet enjoyment.

Constructive eviction vs. the warranty of habitability

Constructive eviction of either a residential or nonresidential tenant is distinct from the implied warranty of habitability enforceable only against residential landlords. Constructive eviction requires the tenant to vacate or pay the entire rent; the warranty of habitability requires neither.

Both residential and nonresidential lease agreements contain written conditions that, if breached by the landlord, result in termination of the tenant's possession — constructive eviction.

However, the warranty of habitability is not a written provision, it is implied; it is judicially and legislatively considered to exist in all residential rental and lease agreements.

The implied warranty of habitability requires a landlord to maintain safe and sanitary conditions in his residential units. On the landlord's failure to maintain habitable conditions, the residential tenant may remain in possession and pay a reduced rent that will be set by the court. Thus, a constructive eviction has not taken place since the residential tenant remains in possession. [**Green** v. **Superior Court of the**

City and County of San Francisco (1974) 10 C3d 616; Calif. Code of Civil Procedure §1174.2; see Chapter 37]

However, both residential and nonresidential tenants can vacate the premises based on the landlord's significant interference with possessory rights and recover any losses from their landlords that flow from the constructive eviction.

Consider a nonresidential landlord who fails to meet his obligations under a lease agreement to maintain the property for the intended use. The nonresidential tenant retaliates by refusing to pay rent. However, the tenant does not vacate the premises.

The landlord files a UD action to evict the tenant for his failure to pay rent after service of a 3-day notice to pay or quit. At trial, the tenant is unable to raise the defense of a breach of the implied warranty of habitability since his lease is nonresidential. Thus, the nonresidential tenant is without a legal excuse for his failure to pay rent for the period of his actual occupancy, and will be evicted in spite of the landlord's material breach of lease agreement provisions. [**Schulman** v. **Vera** (1980) 108 CA3d 552]

Chapter 34 Retaliatory eviction defense

This chapter discusses a landlord's attempt to evict a tenant in retaliation for the tenant's exercise of his legal rights to the detriment of the landlord.

Shackling vengeful wayward landlords

A tenant occupies a residential unit under a month-to-month rental agreement.

The unit has many defects which are in need of elimination. The tenant requests that the landlord make repairs to correct the defects. The landlord does not make the requested repairs.

The tenant complains to the landlord several more times about the need for repairs and the lack of suitable living conditions in his unit. Finally, the tenant threatens to exercise his right to perform the **repairs and deduct** the costs from the rent. [See Chapter 37]

Before any repairs are made, the landlord serves the tenant with a notice to vacate the premises. [See **first tuesday** Form 569 and 569.5]

The tenant remains in possession after the notice expires. Rent is tendered but refused by the landlord. The landlord files an unlawful detainer (UD) action to evict the tenant.

The tenant defends against the UD action, claiming the landlord seeks to evict him in retaliation for his repeated requests for repairs and the complaints about the habitability of the unit.

The landlord claims the tenant cannot raise the defense of retaliatory eviction since the tenant did not file a complaint with a government agency regarding the habitability of the unit or undertake to make the repairs himself under the statutory repair and deduct remedy.

To successfully defend against a UD action, must the tenant first file a complaint with a government agency or make the repairs himself before claiming the UD action is a retaliatory eviction?

No! The tenant need not file a complaint regarding the habitability of his residential unit or repair the defects himself as a prerequisite to raising the defense of retaliatory eviction in the UD action.

Here, the residential landlord is prevented from evicting the tenant. The landlord's conduct indicated he sought to evict the tenant in retaliation for complaining about the need for repairs. [**Kemp** v. **Schultz** (1981) 121 CA3d Supp. 13]

The retaliatory eviction defense

A landlord's sole purpose for filing an unlawful detainer (UD) action is to recover possession from a tenant.

In addition to the landlord's recovery of possession from the tenant, the **UD award** against the tenant may include:

- any unpaid delinquent amounts of rent accrued prior to the forfeiture of possession by a declaration in the 3-day notice to quit or as granted at the UD trial;

- the reasonable rental value of the premises during the tenant's unlawful detainer which follows the date of forfeiture of the right to possession; and
- up to $600 in addition to the rent for the tenant's malicious behavior. [Calif. Code of Civil Procedure §1174(b)]

Accordingly, UD proceedings are intended to be brief — from the use of notices to quit or vacate to establish an unlawful detainer to the inability of the tenant to bring up frivolous defenses.

Thus, **residential tenants** are allowed to raise only two defenses in a UD action:

- a breach of the warranty of habitability [CCP §1174.2; see Chapter 37]; and
- retaliatory eviction.

Residential tenants include mobilehome owners who rent or lease space in a mobilehome park. [**Rich** v. **Schwab** (1998) 63 CA4th 803]

For **nonresidential tenants**, the only defense allowed in a UD action is the defense of retaliatory eviction. [**Custom Parking, Inc.** v. **Superior Court of the County of Marin** (1982) 138 CA3d 90]

A claim of retaliatory eviction is allowed as a **tenant's defense** in nonresidential evictions, not based on the statutory defense which exists for residential tenants, but on the equivalent, long-standing common law defense of retaliatory eviction. The public policy enforced by courts entitles all tenants to exercise their legal rights against a landlord since the activity outweighs the public's interest in preserving the summary nature of UD hearings provided for landlords. [**Barela** v. **Superior Court of Orange County** (1981) 30 C3d 244]

Further, a residential tenant may sue the landlord to recover money losses incurred due to a landlord's retaliatory acts, such as an unfair rent increase. [**Aweeka** v. **Bonds** (1971) 20 CA3d 278]

Under a notice to vacate, a landlord may evict a tenant for any reason, or no reason at all (except rent control and Section 8 properties), but he may not evict a tenant for an improper reason. [**S.P. Growers Association** v. **Rodriguez** (1976) 17 C3d 719]

In rent control communities, ordinances require a residential landlord to state his reasons for evicting a tenant in the notice to vacate. Also, a landlord providing Section 8 housing must state a good reason in a notice to vacate before he can evict the tenant. [**Mitchell** v. **Poole** (1988) 203 CA3d Supp. 1]

Retaliatory reaction to complaints

Actions by a residential landlord to increase rent, decrease tenant services or evict are considered **retaliatory acts** if initiated by the landlord after a tenant:

- complains to the landlord or a government agency regarding the habitability of the premises;
- exercises the statutory repair and deduct remedy [Calif. Civil Code §1942.5(a)(1)];
- organizes or becomes a member of a tenants' association or tenants' rights group [CC §1942.5(c)]; or
- exercises any other legal rights held by the tenant, such as notifying the police about the landlord's criminal activity. [CC §1942.5(c); Barela, *supra*]

Editor's note — If a landlord fails to make repairs within 30 days after the tenant notifies him of the need for repairs, the tenant may make the repairs himself and deduct the cost from the rent, called the ***repair and deduct remedy****. [CC §1942; see Chapter 37]*

In addition, a residential landlord is **prohibited** from increasing the rent, decreasing tenant services or requiring the tenant to vacate **within 180 days** after any of the following events:

- the tenant's notice to the landlord of the need for repairs, or complaint to the landlord about the habitability of the premises;
- the tenant's filing of a written or oral complaint with a government agency regarding the habitability of the premises;
- an inspection or issuance of a citation resulting from the tenant's complaint to a government agency;
- the filing of documents to initiate an action involving the habitability of the premises; or
- the entry of a judgment or issuance of an arbitration award adverse to the landlord. [CC §1942.5(a)]

Enforcing the 180-day protection rule

Consider a residential tenant holding possession under a month-to-month rental agreement who prevails in an unlawful detainer (UD) action brought by a landlord. The tenant is permitted by the court to remain in possession of his unit.

Four months (120 days) after the UD judgment, the landlord serves the tenant with a notice to vacate. The notice will expire before the 180-day protective period has run.

The tenant tenders an amount of rent on the next due date representing rent due for a rental period extending beyond the expiration of the notice to vacate. The landlord refuses to accept the rent and returns it undeposited.The tenant remains on the premises after the notice to vacate expires.

The landlord next files a UD action to evict the tenant since the tenant retained occupancy after the notice to vacate expired. The UD trial is set for a date more than 180 days after the date of the prior UD trial at which the tenant prevailed.

As a defense to the current UD action, the tenant claims the landlord is barred from evicting him since a notice to vacate cannot be served within 180 days after the tenant prevailed on the prior UD judgment.

The landlord claims he is not barred from evicting the tenant since the current UD trial occurs after the 180-day protective period expired.

In this example, the UD action is barred. The tenant **cannot be required to vacate** the premises within the 180-day protection period. Since the UD action is based on the expiration of a notice to vacate, and under the notice the tenant is required to vacate during the 180-day protection period or be guilty of unlawfully detaining the premises, the landlord cannot use a UD action to evict the tenant. The date set for the return of the premises by a notice to vacate was within the 180-day protection period. [**Kriz** v. **Taylor** (1979) 92 CA3d 302]

However, the landlord is not barred from serving a notice to vacate or a notice of change in rental terms within the 180-day period, as long as the notice does not expire within that period. Thus, the tenant confronted with a hostile landlord has 180 days after exercising lawful rights which antagonize the landlord to voluntarily relocate and avoid the seemingly inevitable notice to vacate or change in terms of the occupancy.

Nonresidential retaliatory eviction

Consider a nonresidential tenant who occupies property under a month-to-month tenancy. The rental agreement (or expired lease) requires the landlord to care for and maintain the exterior walls and roof of the building during the occupancy.

The roof leaks, causing damage to the tenant's personal property. On more than one occasion, the tenant notifies the landlord of the leak, and requests that the landlord repair the roof.

Several months later, the roof leaks again, and the tenant suffers more losses. The tenant repairs the roof himself and makes a demand on the landlord for reimbursement. The landlord rejects the demand.

The tenant does not deduct the cost of the repairs from the monthly rent since the space rented is nonresidential and the "repair and deduct" remedy available to residential cannot be used by nonresidential tenants. The tenant pays the rent as it becomes due.

The tenant sues the landlord to recover the cost of repairing the roof. The landlord immediately serves the tenant with a 30-day notice to vacate. The tenant remains in possession after the 30-day notice expires, and the landlord files an unlawful detainer (UD) action to evict the tenant.

The nonresidential tenant defends the UD action, claiming the landlord is attempting to evict him for an improper reason — in retaliation for the tenant's enforcement of the landlord's obligations by suing the landlord to enforce the rental agreement (or expired lease).

The landlord claims the tenant cannot raise the defense of retaliatory eviction since the defense is statutory and available only to residential tenants. [CC §1942.5]

Here, the common law retaliatory eviction defense, equivalent to the statutory residential tenant defense, is available to the nonresidential tenant as a matter of *public policy* enforced by the courts. The eviction sought by the landlord is in retaliation against the tenant because the tenant exercised a legal right.

Simply put, when a landlord has an improper motive to evict a tenant, the tenant, residential or nonresidential, may raise the common law defense of retaliatory eviction. [Custom Parking, Inc., *supra*]

A nonresidential tenant has a legal right to recover money due from a landlord who has breached the lease agreement causing the tenant to incur expenses. However, when the landlord refuses to voluntarily reimburse the tenant after a demand, the tenant must proceed with litigation and obtain a money judgment, not deduct the expense from the rent due the landlord.

Losses recovered by tenant

Occasionally, a residential landlord will include a provision in his lease or rental agreements in which the residential tenant purports to waive his right to raise the defense of retaliatory eviction, or sue a landlord for retaliatory acts. However, a waiver of legal rights by a residential tenant is void. [CC §1942.5(d)]

If a residential landlord is attempting to evict a tenant in retaliation for any lawful activity by the tenant, the tenant is entitled to recover:

- the tenant's actual money losses incurred due to the landlord's retaliatory activity [CC §1942.5(f)(1)]; and

- punitive damages of no less than $100 and no more than $1,000 for each retaliatory act where the landlord or his agent is guilty of fraud, oppression or malice with respect to the retaliation. [CC §1942.5(f)(2)]

More financially frightening for a residential landlord whose conduct subjects him to statutory punitive damages is the tenant's right to bring a class action suit to recover for the landlord's retaliatory act of increasing the rents on all tenants who participate in forming a tenant association to prevent rental increases and petition the city for rent control. [**Rich** v. **Schwab** (1984) 162 CA3d 739]

Further, the prevailing party in an action brought by a residential tenant seeking to recover losses from a landlord for retaliatory eviction is entitled to reasonable attorney fees. [CC §1942.5(g)]

Chapter 35 Defective building components

This chapter analyzes a landlord's lack of liability for injuries caused by defects in components installed on the property that were supplied by manufacturers, distributors and retailers.

Liability for neglect, not strict liability

A tenant of a residential rental unit slips and falls in the bathtub, sustaining injuries. The bathtub does not have an anti-skid surface and is very slippery when wet.

The tenant claims the landlord is liable for his injuries since the bathtub without an anti-skid surface is defective.

Is the landlord liable to the tenant for the injuries caused by the defective bathtub surface?

No! Landlords are not liable for tenant injuries caused by a defective bathtub surface. To be liable for another's injuries without concern for fault, called *strict liability*, the landlord must be part of the **chain of distribution** for the installation of the equipment or fixture that caused the injury.

It is unreasonable to extend strict liability to hotel operators and residential landlords for defects in products that are used in the construction of the property, but are manufactured and marketed by others. [**Peterson** v. **Superior Court** (1995) 10 C4th 1185]

Strict liability

Strict liability for an injury caused by a product applies primarily to the manufacturer of the product, since it is the manufacturer who places the product on the market and knows it will not be inspected for defects before it is used. Thus, the manufacturer is liable for defects.

The primary **social purpose** of strict liability is to impose on the manufacturer, not the injured user, the costs of injuries caused by its products when used as intended.

Strict liability for defect-related injuries also extends to distributors and retailers who are part of the "stream of commerce" in marketing products for use by the end user, the customer. Distributors and retailers are considered to be in the best position to **assert influence** over the manufacturer to create a product that is free of defects.

Strict liability is imposed on retailers and distributors since the added liability exposure is considered an incentive for their attention to the safety of the products retailers and distributors purchase from manufacturers for resale to the public.

However, the social goal of imposing strict liability on all involved in the manufacturing, distribution and resale of a product to the consumer is not to **ensure the safety** of the product. The goal is to distribute the risks and costs of injury due to **lack of safety** in the product's use among those most able to bear the burden of the costs.

Previous strict liability rulings

The *Peterson* case barring tenants from pursuing landlords and hotel operators for strict liability for injuries resulting from dangerous and defective construction materials and fixtures overruled a previous California Supreme Court decision. The court previously held a residential landlord was strictly liable for injuries caused by hidden defects in components that were part of the construction of the property. [**Becker** v. **IRM Corporation** (1985) 38 C3d 454]

In *Becker*, a tenant slips in the shower and is injured when the shower door shatters — the door was defective since it was made from untempered glass.

The tenant claims the landlord's use of the product caused his injuries and, under the strict liability doctrine, the landlord is responsible.

The landlord claims he is not liable for the injuries since the defect in the shower door was hidden, and the accident unforeseeable since similar accidents had not occurred, putting the landlord on notice of the defect.

In *Becker*, which is no longer law, the landlord was held strictly liable for the tenant's injuries caused by the latent (hidden) defects in materials and fixtures installed in the unit, regardless of whether the landlord was aware of the defect, since the landlord was in the business of renting property.

However, *Peterson* overruled *Becker*. The *Peterson* court held the theory of strict liability could not be extended to residential landlords. Landlords are not distributors or retailers. Landlords and hotel operators, unlike distributors and retailers, cannot exert influence over the manufacturer to make a product safe. For the most part, landlords and hotel operators are not builders and do not have a business relationship with the manufacturer or the suppliers of the defective product.

Once the product is purchased and installed by the builder, the product leaves the stream of commerce — distribution and resale has come to an end. The later use of the product by occupants, be they tenants or guests, does not transform the landlord and hotel operator into a retailer of the product.

Editor's note — Peterson *refused to decide whether strict liability can be imposed on a landlord or a hotel operator who participates in the construction of the building. Specifications established by planners, designers and construction contractors will play a role in deciding whether strict liability will be imposed on owner-builders of rental and hotel units.*

Duty to correct known defects

It is the residential landlord's inaction when confronted with a **known dangerous** condition, called *negligence*, that gives rise to liability for injury to others. Thus, a residential landlord who fails to cure known dangerous defects will be liable under general *tort principles of negligence* for injuries caused by the breach of his duty to correct known defects.

Tenants should be able to rely on the landlord's inspection of the rented space and his correction of all visible and known defects. Residential landlords are in the business of leasing property for human occupancy.

The residential landlord must provide a clean, safe and habitable premises during the term of the lease. Further, the landlord is obligated to repair all known patent or latent defects, unless the tenant agrees to undertake repairs and maintenance. [Calif. Civil Code §1942]

Thus, the residential landlord is personally liable to the tenant for injuries occurring on the rental property as a result of the landlord's **failure to inspect**, locate and repair defective and dangerous property conditions that are known or should be known to the landlord. [CC §1941]

The residential landlord is obligated to repair uninhabitable conditions which could affect the tenant's health and safety, and to make these repairs immediately. [See Chapter 37]

Editor's note — The tenant will be able to recover from the landlord if the tenant can show the landlord could have reasonably foreseen the accident.

*A landlord or hotel operator who is aware of injuries caused by latent defects in products used on the premises will be liable if other similar latent defects are not cured, since it is reasonably foreseeable injuries caused by similar defects throughout the project will occur. [**Sturgeon** v. **Curnutt** (1994) 29 CA4th 301]*

Chapter 36 Care and maintenance of property

This chapter outlines the respective duties of the landlord and tenant to care for and maintain leased property, and the tenant's remedies if the landlord fails to perform.

Tenant's obligations and remedies

A landlord and a tenant enter into a lease agreement for a furnished unit in an apartment complex. The lease agreement contains a provision stating the landlord will maintain the premises and common areas in a **safe and sanitary condition**, and comply with all applicable ordinances and regulations. [See **first tuesday** Form 550 §6.2]

The lease agreement further provides for the tenant to keep the unit clean and sanitary, and properly operate all electrical, gas and plumbing fixtures. [See **first tuesday** Form 550 §§5.3, 5.4]

Before the tenant takes possession, the resident manager and the tenant conduct a "walk-through" of the unit. They agree on the condition of the premises. The tenant and the resident manager complete a condition of premises form which is attached as an addendum to the lease agreement and signed by the tenant. [See Form 560 accompanying this chapter]

On the condition of premises form, the tenant notes any defects existing on the premises. For example, the tenant marks if appliances are dented, screens have holes or are missing from windows, plumbing fixtures are broken or leaking, linoleum is peeling or damaged, carpeting has stains, chipped paint, etc.

Since the unit is furnished, the tenant and the resident manager also complete a condition of furnishings addendum during the "walk-through." [See Form 561 accompanying this chapter]

The tenant records any defects in the furniture on the condition of furnishings form, such as tears or burns in upholstery or scratches in wood furniture.

No minor or major defective conditions are observed by the tenant or the landlord during the "walk-through."

Later, before the tenant vacates the unit, the tenant and the resident manager will conduct a **pre-expiration inspection** to determine if the unit and the furnishings have sustained any damage other than normal wear and tear during the tenant's occupancy. The tenant will be handed a **statement of deficiencies**, listing any conditions which must be corrected to avoid a deduction of the corrective costs from the security deposit. [See Chapter 19]

The purpose of the condition of premises and condition of furnishings forms is to determine if any defective conditions exist in the rental unit and to repair them before the tenant takes possession.

When the tenant vacates, the landlord wants to be able to recover the cost of any damage to the unit or the furnishings caused by the tenant. The completed forms **document the condition** of the unit and its furnishings at the time of occupancy.

On the other hand, the tenant wants to avoid liability for damage he did not cause.

CONDITION OF PREMISES ADDENDUM

DATE:_____, 20_____, at _____, California.

Items left blank or unchecked are not applicable

FACTS:

This is an addendum to the following referenced document:

- ☐ Lease agreement
- ☐ Rental Agreement
- ☐ Occupancy agreement

dated:_____, 20_____

entered into by_____,Landlord,

and_____,Tenant,

regarding real estate premises referred to as:

_____

_____

_____

AGREEMENT:

1. Landlord and Tenant have jointly inspected the premises and common areas and agree the premises and unchecked items such as fixtures, appliances, and furnishings are in a satisfactory and sanitary condition.

2. Check only those items which are unsatisfactory and state why in "REMARKS."

EXTERIOR/COMMON AREAS:

☐ Garage/parking lot	☐ Garbage facilities	☐ Storage area	☐ TV antenna
☐ Pool/spa	☐ Satellite dish	☐ Patio/decks	☐ CATV hookup
☐ Stairs/railings	☐ Garage door openers	☐ Hallway/lobby	☐ Laundry area
☐ Fencing	☐ Roof	☐ Exterior lighting	☐ Eaves/gutters
☐ Sprinklers/hose	☐ Mailbox	☐ Walkways	☐ _____

ENTRY:

☐ Door	☐ # of keys _____	☐ Doorbell/knocker	☐ Closet
☐ Intercom/security	☐ Shelves	☐ Locks	☐ _____

KITCHEN:

☐ Range	☐ Trash compactor	☐ Oven	☐ Water purifier
☐ Refrigerator	☐ Counters/laminate	☐ Garbage disposal	☐ Cabinets/drawers
☐ Exhaust fan(s)	☐ Pantry/shelves	☐ Dishwasher	☐ Tile/linoleum
☐ Microwave	☐ Sink/faucets		

BATHROOM:

☐ Sink	☐ Tile/linoleum	☐ Faucets/hardware	☐ Closet/shelves
☐ Toilet	☐ Exhaust fan(s)	☐ Shower	☐ Shower enclosure
☐ Tub	☐ Medicine cabinet		

ELECTRICAL:

☐ Outlets	☐ Lighting	☐ Switchplates	☐ Thermostat
☐ Fixtures	☐ Furnace	☐ Smoke detectors	☐ Ventilation
☐ Air conditioning	☐ _____		

PLUMBING:

☐ Water heater	☐ Washer	☐ Hot/cold water	☐ Dryer
☐ Gas hookups	☐ _____		

INTERIOR:

☐ Wall coverings	☐ Floor coverings	☐ Ceilings	☐ Walls
☐ Draperies	☐ Rods/tracks	☐ Glass doors	☐ Windows
☐ Doorknobs	☐ Fireplace	☐ Hardware/fittings	☐ Paint
☐ Floors	☐ Baseboards/trim	☐ Doors	☐ Shades
☐ Closets	☐ Screens	☐ Sills/jambs	☐ Kickplates/stops
☐ Chimney/flue	☐ _____		

REMARKS:

REPAIRS PROMISED:

1. _____

Completion date: _____

2. _____

Completion date: _____

I agree to the terms stated above.	**I accept the premise as stated above.**
Date:_____, 20_____	Date:_____, 20_____
Landlord/Manager: _____	Tenant:_____
Signature: _____	Signature: _____
Address: _____	Signature: _____
_____	Address: _____
Phone:_____	_____
Fax: _____	Phone:_____
E-mail:_____	Fax: _____
	E-mail:_____

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Tenant's duty to maintain

A tenant must repair all deterioration and damage to the premises caused by his failure to use ordinary care in his use of the premises. Thus, normal wear and tear on the unit need not be avoided or eliminated by the tenant. [Calif. Civil Code §1929]

Further, a residential tenant has a **duty of care** and maintenance in the use of the leased premises which includes:

- keeping the premises occupied by the tenant clean and sanitary;
- disposing of all rubbish, garbage and waste in a sanitary manner;
- properly operating all electrical, gas and plumbing fixtures, and keeping them clean and sanitary;
- allowing no person who is on the premises with the tenant's permission to intentionally destroy, damage, waste or remove any part of the premises or the facilities, equipment or appurtenances; and
- occupying and using the premises for the purpose it is intended to be used. [CC §1941.2]

The landlord can agree to be responsible for the cleanliness of the common areas, and the disposal of garbage and rubbish, for example the hiring of a sanitation service. [CC §1941.2(b)]

The tenant breaches his duty to care for and maintain the premises when the tenant:

- contributes substantially to the dilapidation of the premises; or
- substantially interferes with the landlord's duty to maintain the premises. [CC §1941.2(a)]

For example, a tenant does not notify his landlord of a leak in the roof that is causing damage to the ceiling of the rental unit. Eventually, the ceiling falls down, causing damage to the tenant's personal property, the walls and the floor coverings.

Here, the tenant interfered with the landlord's duty to maintain the property since the tenant failed to:

- notify the landlord of the leak in the roof; or
- repair the leak himself.

Also, the landlord is not liable for any damage to the tenant's personal property resulting from the falling ceiling, since the **tenant neglected to report** the water seepage. Conversely, the tenant is liable for the cost of the damage to the rental unit for failure to report the need for repairs on the first sign of leakage.

A landlord can recover the cost of repairs made to correct excessive wear and tear by deducting the cost of repairs from the security deposit and demanding payment for any deficiency in the deposit to cover the expenses. [CC §1950.5(b)]

If the tenant fails to pay any charges remaining unpaid after deductions from the security deposit, the landlord can file an action against the tenant to recover amounts not covered by the security deposit. [CC §1950.5(m)]

Landlord's duty to maintain

A residential landlord has a *general obligation* to:

- put a residential unit in a condition fit for occupancy **prior to leasing**; and
- repair all unsafe and unsanitary conditions that occur **during occupancy** that would render the unit uninhabitable. [CC §1941]

Further, all residential rental and lease agreements automatically contain an implied *warranty of habitability*. The unwritten warranty imposes a contractual duty on a landlord to repair and maintain his residential units so the units are fit for human occupancy at all times. [**Green** v. **Superior Court of the City and County of San Francisco** (1974) 10 C3d 616; see Chapter 32]

Both the landlord's statutory obligation to maintain his residential units and the implied warranty of habitability require the landlord to correct **major defects** interfering with the tenant's ability to live on the property, such as a lack of hot water or a leaky roof.

While the residential landlord has an obligation to care for and maintain all major and structural components of residential rental units, the landlord is further obligated to repair **minor defects**. Minor defects include such conditions as leaky faucets, faulty electrical switches and failed locks or latches. Typically, a residential landlord agrees in the rental or lease agreement to care for and maintain the property, which includes the repair of minor defects. [See **first tuesday** Form 550 §6.2]

CONDITION OF FURNISHINGS ADDENDUM

and Inventory

DATE:_____, 20_____, at _____, California.

FACTS:
This is an addendum to the following:

- ☐ Lease agreement
- ☐ Rental agreement
- ☐ Occupancy agreement
- ☐ Other

dated: _____, 20_____

entered into by:

Landlord: _____

Tenant: _____

regarding real estate referred to as: _____

_____

AGREEMENT:

1. Landlord and Tenant have jointly inspected the furniture and furnishings, and agree they are in satisfactory and sanitary condition.
2. Only those items checked are unsatisfactory and explained under "REMARKS."
3. The quantity of furnishings entered on this form are accepted by the Tenant.
4. Reimbursement for any loss damage or excess wear and tear on furnishings provided to the Tenant will be deducted from Tenant's security deposit.

LIVING ROOM:

- ☐ Carpet
- ☐ Draperies
- ☐ Window coverings
- ☐ Wall coverings
- ☐ Couch #_____
- ☐ Pictures #_____
- ☐ Chairs #_____
- ☐ End tables #_____
- ☐ Coffee tables #_____
- ☐ Lamps #_____
- ☐ Shelves
- ☐ _____

KITCHEN:

- ☐ Tile/linoleum
- ☐ Window coverings
- ☐ Refrigerator
- ☐ Table #_____
- ☐ Chairs #_____
- ☐ Range
- ☐ Cabinets
- ☐ _____

BEDROOM:

- ☐ Double bed #_____
- ☐ Single bed #_____
- ☐ Headboards #_____
- ☐ Mattress #_____
- ☐ Box springs #_____
- ☐ Bed frame #_____
- ☐ Night stands #_____
- ☐ Lamps #_____
- ☐ Bureau #_____
- ☐ Pictures #_____
- ☐ Mirror #_____
- ☐ _____

SECOND BEDROOM:

- ☐ Double bed #_____
- ☐ Single bed #_____
- ☐ Headboards #_____
- ☐ Mattress #_____
- ☐ Box springs #_____
- ☐ Bed frame #_____
- ☐ Night stands #_____
- ☐ Lamps #_____
- ☐ Bureau #_____
- ☐ Pictures #_____
- ☐ Mirror #_____
- ☐ _____

BATHROOM:

- ☐ Medicine cabinet
- ☐ Shelves/fittings
- ☐ Toilet
- ☐ Shower/tub
- ☐ Shower enclosure
- ☐ _____

REMARKS:

_____

I agree to the terms stated above.

Date:_____, 20_____

Landlord/Agent:_____

Address: _____

_____

Phone:_____

Fax: _____

Signature: _____

I agree to the terms stated above.

Date:_____, 20_____

Tenant:_____

Address: _____

Phone:_____

Fax: _____

Signature: _____

Signature: _____

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The landlord's failure to repair or replace minor defects constitutes a breach of provisions in the rental or lease agreement. The landlord who breaches the lease agreement by failing to make minor repairs must reimburse the tenant for reasonable costs incurred by the tenant to cure the defects.

Minor repairs and habitability

During his occupancy, a residential tenant discovers the electrical wiring for the garbage disposal under the kitchen sink is exposed. The tenant asks the landlord to correct the faulty wiring. The landlord does nothing.

Other minor repairs later become necessary in the unit. A roof leak develops, staining a bedroom ceiling, and the water closet on the toilet bowl leaks, requiring repair or replacement. The tenant notifies the landlord of the need for the repairs. Neither the landlord nor the tenant correct any of the minor defects.

Frustrated with the landlord's lack of cooperation, the tenant stops paying rent. The landlord serves the tenant with a 3-day notice to pay rent or quit. [See **first tuesday** Form 575]

The tenant still refuses to pay rent, and the landlord files an unlawful detainer (UD) action.

The tenant defends his nonpayment of rent by claiming the landlord breached the *warranty of habitability* since he failed to repair the numerous defective conditions on the premises.

Here, the landlord did not breach the **warranty of habitability** and the tenant is ordered evicted for non-payment of rent. The defective conditions did not interfere with the tenant's ability to live on the premises for the purposes intended, despite the inconveniences.

A landlord breaches the warranty of habitability only when he fails to provide and maintain residential rental units in a habitable, that is, **safe and sanitary**, condition. [Green, *supra*]

Tenant's option to repair

When a residential landlord fails to repair minor defective conditions on the property, the tenant may exercise one of three remedies:

- repair the defect and deduct the costs of contracting for the repair from the rent [CC §1942(a)];
- make the repairs, continue to pay rent and sue the landlord to recover the cost of repairs; or
- vacate the premises. [CC §1942(a)]

However, if the premises are so unsafe and unsanitary they qualify as *uninhabitable*, the tenant can remain in occupancy and withhold payment of the rent. In an ensuing UD action, the tenant would raise the defense of the landlord's breach of the implied warranty of habitability to force the landlord to make the necessary repairs to eliminate the unsafe and unsanitary condition.

The court would then set the amount of rent due during the period of nonpayment of rent based on the percentage of uninhabitability, usually determined in the tenant's favor.

The repair-and-deduct remedy

If the leased premises is in need of repair, whether minor or major, the tenant must notify the landlord orally or in writing of the condition.

After advising the landlord of the need for repairs, the tenant can make the repairs himself and deduct the cost of the repairs from the next month's rent if:

- the landlord fails to make the necessary repairs within a *reasonable time*; and
- the cost of repairs does not exceed the amount of one month's rent, called *the repair-and-deduct remedy*.

The tenant cannot exercise the repair-and-deduct remedy more than twice in any 12-month period. [CC §1942(a)]

Also, any agreement by the tenant to waive or modify his right to repair and deduct the costs from the rent is unenforceable. [CC §1942.1]

A **reasonable time** for the landlord to repair after notice is 30 days, unless the need to repair is urgent and requires more immediate attention. [CC §1942(b)]

The repair-and-deduct remedy is not available to the tenant when the need for repair is created by the tenant's conduct. [CC §1942(c)]

Repairs exceeding one month's rent

If the cost of repairs exceed one month's rent, the tenant, while continuing to occupy and pay rent, may make the necessary repairs and file an action against the landlord to recover the cost of the repairs.

However, it may be impossible for the tenant to make the necessary repairs when the tenant:

- rents a unit in a large complex; or
- is unable to cover the cost of repairs.

If the nonresidential tenant is unable or does not want to cover the cost of repairs that the landlord failed to make, the tenant can **vacate the premises** and is relieved of any further obligation under the lease called a *constructive eviction* [CC §1942(a); see Chapter 29]

Maintaining property with care

Just as a residential landlord has a duty to repair and maintain the leased premises, a **nonresidential landlord** who retains responsibility for maintenance and repair under the lease agreement also has a duty to use care in doing so.

Consider a tenant, residential or nonresidential, who notifies his landlord a window is broken and will not stay open. The landlord begins work to repair the window, but does not complete the work. The tenant gives the landlord permission to enter the premises when the tenant is out to finish the repairs, which the landlord does not do.

Finally, the window falls, injuring the tenant.

Here, the landlord is responsible for the injuries. Once a landlord of residential or nonresidential premises undertakes to make repairs on the premises to correct a dangerous condition, the landlord must complete the repairs in a timely and proper manner. [**Minoletti** v. **Sabini** (1972) 27 CA3d 321]

Landlords of both residential and nonresidential property are also responsible to tenants, guests of tenants and members of the public for injuries caused to them by the landlord's lack of ordinary care or skill in the maintenance of his property. [CC §1714]

Nondelegable duty to repair

Now consider a nonresidential landlord who hires a contractor to repair the roof on leased property. A tenant is injured as a result of the contractor's negligence while performing the repair.

The tenant claims the landlord is liable for his injuries since the landlord is responsible for maintaining the property, and the maintenance undertaken created a dangerous condition which injured the tenant.

The landlord claims he is not liable since it was the roofing contractor's negligence while on the job which caused the tenant's injury, not the landlord.

Is the landlord liable for injuries to a tenant caused by a contractor hired by the landlord to perform repairs?

Yes! A landlord's duty to exercise care (not to be negligent) in the repair and maintenance of a leased premises is a *nondelegable duty* — it cannot be transferred or assumed by another person, such as a property manager or contractor. [**Srithong** v. **Total Investment Company** (1994) 23 CA4th 721]

Thus, the landlord is liable for injuries caused to persons (excluding the contractor's employees) during the fulfillment of the landlord's duty to maintain the property, whether the maintenance is accomplished by the landlord or by contractors he or his property manager employs.

Penalty for failure to maintain

A landlord is aware of felony crimes recently occurring in the common areas of his apartment complex and parking garage.

The tenants of the complex complain to the landlord about the crimes. The tenants request the broken doors, gates and locks be repaired and adequate lighting be provided as security to prevent the crimes from reoccurring.

The landlord fails to make the repairs or provide the security measures requested. Later, while in a common area, a tenant is assaulted and suffers injuries.

The tenant seeks to recover losses from the landlord for his injuries, as well as *punitive damages*. The injured tenant claims the landlord breached his duty to protect him from known criminal activity in the complex by **failing to maintain** and provide adequate security measures in the common areas. Further, the tenant claims the landlord is liable for breaching the warranty of habitability.

First, can the tenant recover punitive damages from the landlord?

Yes! The landlord was aware of the dangerous condition created by the lack of maintenance. By failing to correct the deferred maintenance, the landlord conducted himself with a conscious disregard for the rights or safety of his tenants. The landlord's deliberate **failure to maintain** the premises by eliminating the dangerous conditions which were known to him and over which he alone had the power to correct, exposes him to liability for punitive damages. [**Penner** v. **Falk** (1984) 153 CA3d 858]

Also, a landlord is liable for punitive damages for **failure to disclose** a dangerous condition to tenants about which he has actual knowledge. [**O'Hara** v. **Western Seven Trees Corporation Intercoast Management** (1977) 75 CA3d 798]

However, the landlord is not liable for breaching the warranty of habitability. The living quarters were habitable, and the housing complied with local codes.

Thus, the defense of uninhabitable premises for failure to pay rent based on a lack of security will fail and the nonpaying tenant will be evicted. [Penner, *supra*]

Chapter 37 Implied warranty of habitability

This chapter examines the purpose of the implied warranty of habitability and its effect on residential landlords.

Minimum quality low-income housing

A landlord, aware an apartment complex he owns is in a state of disrepair, does nothing to correct the defective conditions on the property. Due to the location of the property and its below market rents, the landlord is able to rent out units in the complex without repairing any of the defective conditions.

A tenant, fully aware of the unsafe and unsanitary conditions, enters into a lease agreement with the landlord. Soon after occupying, the tenant asks the landlord to exterminate the rodents and cockroaches in his unit. The tenant also requests that plumbing blockages, exposed electrical wiring and the collapsing bathroom ceiling in the unit be repaired.

The landlord does not correct or repair any of the defective conditions. In retaliation, the tenant stops paying rent but continues to occupy the unit.

The landlord serves a 3-day notice for nonpayment of rent and declares a forfeiture of the tenant's right to possession. The notice expires without payment and the landlord files an unlawful detainer (UD) action to evict the tenant.

The tenant defends his right to occupy, claiming the landlord failed to maintain the premises in a habitable condition, permitting the tenant to:

- retain possession; and
- pay a reduced rent set by the court.

Even though he failed to make repairs, the landlord claims the tenant must pay the agreed amount of rent since the tenant must either:

- quit the premises; or
- make the repairs himself and deduct the cost of the repairs from his rent as authorized by law.

Can the tenant continue to occupy the premises and pay a reduced court-ordered rent to the landlord?

Yes! The landlord's failure to maintain the premises in a habitable condition constitutes a breach of the *implied warranty of habitability* which all residential rental and lease agreements are subject to regardless of the provisions in the lease agreement. Not so for nonresidential properties.

Also, the **court-ordered reduced rent** will remain for as long as the landlord fails to make the necessary corrections or repairs. [**Green** v. **Superior Court of the City and County of San Francisco** (1974) 10 C3d 616]

Editor's note — Nonresidential leases do not contain an implied warranty of habitability. [See Chapter 33]

However, if the nonresidential landlord fails to make the significant repairs he is obligated to make under the lease agreement, the nonresidential tenant has two options:

- *pay for the repairs himself, demand reimbursement from the landlord, and if unpaid, file an action against the landlord to recover the cost of the repairs; or*
- *vacate the premises and file an action against the landlord for losses resulting from a constructive eviction.*

Implied warranty of habitability

The typical residential tenant under a lease agreement acquires a leasehold interest in the leased property to occupy it for a specific period of time. The tenant expects the premises and appurtenances (e.g., common areas, parking and storage) available to him to be fit for the purpose leased — to be a sanitary place in which he may safely reside.

However, a residential tenant, especially an apartment dweller, is not just acquiring an interest in real estate, he is *contracting* for, and is entitled to, a **safe and sanitary** place to live, called a *habitable dwelling*. [See **first tuesday** Form 550 §6.2]

The implied warranty requires the residential landlord to care for the premises by maintaining habitable conditions — the minimum level of living conditions for a safe and sanitary dwelling unit permitted by law. [**Hinson** v. **Delis** (1972) 26 CA3d 62; Calif. Code of Civil Procedure §1174.2]

Residential property which is not in a habitable condition cannot be rented or leased "as-is," even though defective property conditions have been fully disclosed and the substandard conditions consented to by the tenant.

The implied warranty applies to the space rented by the tenant as housing and also to common areas the tenant may use, such as laundry facilities, parking, recreational areas and storage spaces, called *appurtenances*. [Hinson, *supra*]

The public policy establishing the warranty of habitability was legislated due to landlords overreaching due to the scarcity of available low-cost housing. This economic situation left residential tenants in lesser socioeconomic neighborhoods without the bargaining power possessed by more affluent and mobile tenants when negotiating with landlords for better property conditions.

Thus, market forces cannot prevail over the higher public policy requiring safe and sanitary housing. The warranty of habitability serves to punish slumlords and discourage slum-like conditions in low-income housing.

A landlord who invests money in real estate must maintain his property. Otherwise, the value of his investment will eventually disintegrate due to competitive pressures in the rental market and court orders.

Landlord's warranty

The landlord breaches the implied warranty of habitability when the landlord fails to comply with building and housing code standards that *materially affect* health and safety. [CCP §1174.2(c)]

A habitable place to live is a dwelling free of **major defects**, not mere inconveniences, which would interfere with the tenant's ability to use the premises as a residence.

A residential dwelling is **uninhabitable** if any features of the dwelling are not properly maintained or do not **substantially comply** with building and housing codes, including:

- effective waterproofing and weather protection of roof and exterior walls, including unbroken windows and doors;

- plumbing and gas facilities;
- a hot and cold running water system with appropriate fixtures which are connected to a sewage disposal system;
- heating facilities;
- electrical lighting; and
- floors, stairways and railings. [Calif. Civil Code §1941.1]

In applying these guidelines, a leaky faucet would not render a residential unit uninhabitable, despite the inconvenience. However, a lack of running water, or no hot water, is a significant defect that materially interferes with the tenant's ability to live on the property.

At the time the rental or lease agreement is entered into, the building grounds and appurtenances, such as a pool, laundry facilities, storage areas and parking structures, must be clean, sanitary and free from all accumulations of debris, filth, rodents and vermin to meet habitability guidelines. [CC §1941.1(f)]

Further, the landlord must provide an adequate number of garbage and rubbish receptacles in clean condition and good repair. [CC §1941.1(g)]

A residential tenant in an apartment complex is not typically expected to make repairs to major components of the complex, such as a central heating system, an electrical or plumbing system or the roof.

If a residential landlord fails to make necessary repairs, and the cost of the repair is less than one month's rent, the tenant may order out and pay for the needed repairs and deduct the cost from the rent, called the *repair and deduct remedy*. [CC §1942; see Chapter 36]

However, the **repair-and-deduct remedy** is not often feasible in apartment dwellings since areas where repairs must be made are in the possession and control of the landlord.

Thus, the residential tenant must resort to other remedies, such as:

- vacating the premises, called a *constructive eviction* [See Chapter 33];
- stop paying rent and, in any ensuing UD action, prove the landlord breached the implied warranty of habitability; or
- raise and prove the defense of retaliatory eviction.

Pre-leasing maintenance program

Before renting a residential unit in a building intended for human habitation, the landlord, in addition to maintaining habitability, must:

- install and maintain an operable **dead bolt lock** on each main entry door of a unit, unless the door is a horizontal sliding door;
- install and maintain operable **security or locking devices** for windows which are designed to be opened, unless the window is a louvered window, casement window, or more than 12 feet vertically or six feet horizontally from the ground, roof or other platform; and
- install **locking mechanisms** on the exterior doors leading to common areas with access to dwelling units in an apartment complex — installation of a door or gate is not required if none existed on January 1, 1998. [CC §1941.3(a)]

A tenant is responsible for promptly notifying the landlord of an inoperable dead bolt lock, window security or locking device in the unit. The landlord will only be liable for injuries caused by his failure to

correct the defect within a reasonable period of time after being notified or becoming aware of the defect. [CC §1941.3(b)]

A residential landlord failing to comply with required security measures entitles the tenant to:

- repair and deduct the cost from rent;
- vacate the premises;
- recover money losses incurred due to the condition of an uninhabitable building;
- recover losses caused by any landlord retaliation;
- file an action for breach of contract; or
- seek injunctive relief to stop the landlord from keeping an uninhabitable building. [CC §1941.3(c)]

Warranty of habitability defense

In a UD action, a tenant who successfully raises the *habitability defense* on the landlord's breach of the implied warranty of habitability by the landlord will be allowed:

- to **retain possession** of the premises;
- to **pay a reduced amount** of rent based on the uninhabitable condition of the property; and
- to **recover attorney fees** and costs of litigation. [CCP §1174.2(a)(1)]

To retain possession, the tenant must pay the rent awarded to the landlord, offset by the tenant's attorney fees, within:

- five days of the entry of judgment; or
- ten days, if the UD judgment is served on the tenant by mail. [CCP §1174.2(a)]

If the tenant fails to pay the rental amounts set by the court in a timely manner, the landlord is awarded possession of the premises. [CCP §1174.2(b)]

The landlord may or may not be ordered in the UD judgment to make all repairs necessary to return the premises to a safe and sanitary condition. When a landlord is **ordered to correct** the uninhabitable conditions by returning the premises to a safe and sanitary condition:

- the tenant remaining in possession must pay the reasonable monthly rental value of the premises in its uninhabitable condition until the repairs are completed; and
- the court retains control to oversee compliance by the landlord. [CCP §1174.2(a)]

The tenant who raises the habitability defense instead of paying the rent **takes the risk** of being evicted. The landlord's failure to make repairs may not rise to the level of a *substantial breach* of the warranty of habitability if the repairs are minor and are judged to create only an inconvenience or annoyance to the tenant.

If the landlord has not substantially breached the warranty of habitability:

- the landlord is awarded the right to possession; and
- the tenant is liable for rent accrued through the date of judgment. [CCP §1174.2(b)]

Further, the prevailing party in a UD action is entitled to his **attorney fees**, even if the rental or lease agreement does not contain an attorney fees provision. Whomever is awarded possession of the premises is the prevailing party. [CCP §1174.2(a), (b)]

Determining reasonable rental value

To calculate the **reasonable rental value** of the premises when a breach of the implied warranty of habitability exists, the court will:

- establish the percentage attributable to the tenant's diminished habitability or use of the premises due to the substandard living conditions; and
- use the percentage to reduce the agreed-to monthly rental payment. [**Cazares** v. **Ortiz** (1980) 109 CA3d Supp. 23]

When determining the percentage of habitability or useability lost caused by the landlord's failure to maintain, the criteria includes:

- the *area* of the rental unit affected;
- the *duration* of the tenant's exposure to the defect;
- the *degree of discomfort* the defect imposes on the tenant;
- whether the defect is *health-threatening* or intermittently annoying; and
- the extent to which the defect caused the tenant to find the premises *uninhabitable*. [Cazares, *supra*]

If the agreed-to monthly rent is already below market rent due to the condition of the premises, the landlord who has breached the warranty of habitability may receive only a minimal amount of rent from the tenant. The court-ordered rent properly may be so minimal as to result in a financial penalty to the landlord.

*Editor's note — While this penalizing rental amount actually may be unfair to the landlord until he repairs the premises, the courts are unsympathetic. [*Cazares, *dicta]*

The purpose of the warranty of habitability is to prevent illegal, substandard housing from having any market rental value and to encourage landlords to maintain their premises in a condition where market rents can be charged and actually enforced in a UD action.

Landlord's breach on full disclosure

The mere existence of unsafe and unsanitary conditions, whether or not they are known to the tenant, establishes the landlord's breach of the implied warranty of habitability.

Consider a prospective tenant who contacts a property manager to rent a unit in an older apartment building. The tenant inspects the unit and notices wall cracks and broken windows.

Considering the condition of the unit and the tenant's financial condition, the tenant offers to rent the premises in exchange for a reduced rent. The landlord agrees, and the property manager rents the unit.

The tenant takes possession. Soon afterwards, the tenant notifies the property manager of an inoperable heating system, electrical fixtures with exposed wiring, no hot water, and that the unit is infested with rodents and cockroaches.

The property manager advises the landlord of the need for repairs and pest control. The landlord does not give the property manager the necessary authority to correct the defective conditions in the unit.

The tenant remains in possession but refuses to pay any rent, claiming his unit has substandard living conditions making the unit uninhabitable. The tenant is served with a 3-day notice to pay or quit. The tenant still does not pay, and a UD action is filed.

The tenant claims he is not obligated to pay rent since the landlord breached the implied warranty of habitability by failing to maintain his apartment unit in habitable condition.

The landlord claims the tenant is barred from claiming a breach of the warranty of habitability by the landlord since the tenant was fully aware of the extent of the defective conditions at the time he took possession.

Here, the landlord is not relieved of his duty under the implied warranty of habitability even though the tenant was **fully aware** of unsafe and unsanitary conditions when he took possession. The state of the premises constitutes a breach of the implied warranty of habitability, not the state of the disclosures about the existence of defective uninhabitable. [**Knight v. Hallsthammer** (1981) 29 C3d 46]

Unlike the sale of property, when a landlord fails to care for and maintain his residential property in a habitable condition, he cannot rent the property "as-is" and escape liability for having fully informed the tenant about the conditions.

Landlord has no time to respond

The warranty of habitability does not entitle a residential landlord to a reasonable period of time after a tenant takes possession in which he may repair unsafe and unsanitary living conditions before the tenant takes other action, such as withholding rent.

The landlord should not allow a tenant to take possession until the premises is fully repaired.

The **warranty of habitability** is breached when the need for repairs is:

- **known** by the landlord, either through notice from the tenant or by the physical state of the property at the time it is rented; and
- the landlord fails to **immediately correct** the defective conditions.

Landlords have a duty to inspect and maintain their property and improve or correct known substandard conditions before renting it. The "no notice" and "no reasonable time to repair" rules imposed on landlords by the warranty of habitability are based on the notion that landlords are or should be aware of the condition of the physical components of the premises at the time the unit is rented. [CC §1714]

Now consider a tenant who rents a single family residence that is in a safe and sanitary condition when he takes possession. The condition of the premises is documented at the time possession is transferred.

During the tenant's occupancy, the toilet begins to leak and the linoleum floor does not repel the water. On noticing the leak, the tenant has a duty to notify the landlord and give him a reasonable amount of time to make the repairs before taking other action. [CC §1942]

However, the tenant **fails to notify** the landlord of the need for repairs. The bathroom floor rots due to the toilet leak, weakening the subfloor and eventually creating a hole. When the rent is due the tenant notifies the landlord of the unsafe and unsanitary bathroom conditions, but does not pay the rent.

Due to his refusal to pay rent, the tenant is promptly served with a 3-day notice to pay rent or quit. The landlord begins repairs on the unit. The 3-day notice expires and a UD action is filed and served on the tenant. The landlord completes the repairs prior to the UD hearing.

At the UD hearing, the tenant claims the landlord breached the implied warranty of habitability, allowing the tenant to pay only a reduced rent to be set by the court since the rental was in an unsafe and unsanitary condition.

The landlord claims the warranty of habitability has not been breached since he did not have notice of the need for repairs until the tenant complained and refused to pay rent.

Has the landlord breached the implied warranty of habitability?

No! The tenant brought about the unsafe and unsanitary condition by failing to **promptly notify** the landlord of the need for repairs. [CC §1942]

New landlord steps into the breach

Consider a landlord of an apartment building whose tenants notify him of seriously **unsafe living conditions** in the units.

The owner is financially incapable of paying for the repairs needed and sells the complex. The new landlord inspects the building and is aware of defective and substandard conditions in the units. The new landlord proceeds to correct the conditions by renovating the building.

The new landlord notifies the tenants of the complex's change in ownership and an increase in their monthly rent to amortize his costs of renovation.

A tenants' association is organized. The tenants refuse to pay rent due to the ongoing state of disrepair in the units. The landlord serves 3-day notices on the tenants who fail to pay the agreed rent. Unlawful detainer actions are filed, and the tenants raise the breach of the implied warranty of habitability as a defense to avoid eviction and reduce rents.

The landlord claims he is not breaching the warranty of habitability since the previous owner breached the warranty of habitability, not him.

The tenants claim the change in ownership did not terminate their right to raise the warranty of habitability defense since the breach was a condition of the property that continued after the new landlord took possession, whether or not he knew of the breach or is renovating the property to eliminate the adverse conditions.

Can the tenants raise the **warranty of habitability** defense against a new owner who did not cause the existing unsafe conditions?

Yes! The tenants have a valid implied warranty of habitability defense that justifies their failure to pay rent since:

- the premises were uninhabitable during the new landlord's ownership; and
- the new landlord is attempting to evict the tenants for rental amounts due under his ownership. [Knight, *supra*]

Even though the landlord did not cause the premises to become uninhabitable and began rehabilitating the property when he purchased it, the tenants can still refuse to pay the agreed-to rent and avoid eviction.

Duty to avoid foreseeable injury

A tenant can recover more than a rent adjustment when the landlord breaches the implied warranty of habitability.

For example, a tenant inspects a rental unit and enters into a month-to-month rental agreement with the landlord. When he takes occupancy of the unit, the tenant discovers faulty electrical wiring, a clogged kitchen sink and a leak in the roof, later damaging the tenant's personal property.

The tenant notifies the landlord (and the county health department) of the **defective property conditions** and asks the landlord to make the necessary repairs.

The landlord fails to make any repairs. The tenant continues to reside on the premises. Eventually, the county health department issues a notice condemning the building as unfit for occupancy. The tenant relocates.

The tenant then makes a demand on the landlord for water damage to his personal property and the cost of relocating to a new residence since the landlord breached his duty of care to repair the defective conditions.

Here, the landlord owes a *duty of care* to the tenant, apart from the warranty the premises be up to minimum standards of habitability, to properly maintain the premises to avoid the risk of a foreseeable financial loss suffered by the tenant and caused by the landlord's failure to maintain the property.

Thus, the landlord is liable for the costs incurred by the tenant to replace damaged personal property and relocate. The costs the tenant incurred were a result of the landlord's breach of his duty of care by failing to make the necessary repairs to eliminate unsafe and uninhabitable conditions. [**Stoiber** v. **Honeychuck** (1980) 101 CA3d 903]

Additionally, the tenant can recover excessive rent paid for periods of his occupancy when the unit was uninhabitable.

Even if a residential tenant fails to raise the warranty of habitability defense in a UD action and is evicted or otherwise vacates, the tenant can later recover any excessive rent paid during the period the landlord failed to maintain the unit in a habitable condition. [**Landeros** v. **Pankey** (1995) 39 CA4th 1167]

Conditions creating a nuisance

Now consider a tenant of an apartment unit forced to relocate due to unsafe flooring and unsanitary conditions, causing the local health department to issue an order condemning the apartment complex.

The tenant makes a demand on the landlord to pay his **relocation expenses**, claiming the defective conditions in the rental unit constitute a *nuisance* since he is deprived of the safe and healthy use and enjoyment of the leased unit.

The tenant also seeks the recovery of *punitive damages* from the landlord. The tenant claims the landlord's failure to correct the defective conditions that created the nuisance was intentional and malicious.

The landlord claims the tenant cannot recover losses based on a nuisance, much less receive a punitive award for money, since his interference with the tenant's use and enjoyment of the unit is a breach of the contractual warranty of habitability implied in the lease agreement, not the tortious creation of a health nuisance.

Besides breaching the habitability warranty, the landlord has, by the same conduct, also created a **nuisance for the tenant**. The landlord's failure to make repairs and properly maintain the rental unit *substantially interfered* with the tenant's continuing **use and enjoyment** of the unit. [Stoiber, *supra*]

A **nuisance** is any condition that:

- is injurious to health;
- obstructs the free use of property; or
- interferes with the comfortable enjoyment of property. [CC §3479]

Further, the landlord's continued failure to maintain and repair the premises in a safe condition during the health department's investigation and condemnation action indicates the landlord **intentionally maintained** a nuisance on the premises — an ongoing disregard for the safety and health of the tenant.

Besides recovering his out-of-pocket losses to relocate, the tenant is entitled to an award for an additional sum of money, called *punitive damages*, since the landlord maintained a nuisance due to his intentional failure to repair. [Stoiber, *supra*]

Further, the landlord's liability to the tenant for creating a nuisance is additional to any refunds of rent and rent reduction for breaching the warranty of habitability in the rental agreement.

The tenant can also recover from the landlord any medical expenses and personal injury due to an intentional infliction of **mental distress** if the landlord's failure to maintain the unit in a habitable condition is the result of the landlord's extreme and outrageous conduct. [Stoiber, *supra*]

Chapter 38 Fire safety programs

This chapter discusses fire safety requirements for landlords, including smoke detectors, posting fire safety information and security bars.

Smoke detectors, security bars and safety information

A residential apartment building contains state-approved smoke detectors in each individual unit and in the common areas.

A tenant informs the landlord the smoke detector in his unit does not operate, even with new batteries. The landlord and his manager do not repair or replace the broken smoke detector. Later, a fire breaks out in the tenant's unit.

The tenant is injured in the fire and his property is damaged due to the defective smoke detector. The tenant claims the landlord is liable for his losses since the landlord has a duty to repair or replace the defective smoke detector on notice from the tenant.

Is the landlord liable for property damage and personal injuries caused by the defective smoke detector?

Yes! On receiving notice that the **smoke detector** is inoperable, the landlord is required to **promptly repair** or replace it. [Calif. Health and Safety Code §13113.7(e)]

Further, a landlord will be subject to a $200 fine for each failure to:

- install a smoke detector in each unit and in common areas as required; and
- repair or replace a faulty smoke detector on notice from the tenant. [Health & S C §13113.7(f)]

Tenant's duty to notify

Smoke detectors must be installed and maintained in all dwelling units intended for human occupancy, including single-family residences, duplexes, apartment complexes, hotels, motels, condominiums and time share projects. [Health & S C §§13113.7(b), 13113.8]

The smoke detector must be in operable condition at the time the tenant takes possession of the unit. [Health & S C §13113.7(e)]

If a smoke detector does not work when tested by the tenant, the **tenant is responsible** for notifying the landlord or property manager. The landlord is not obligated to investigate whether detectors are operable during the tenant's occupancy.

If the tenant does not notify the landlord about an inoperable smoke detector and the landlord is unaware of the condition, the landlord is not responsible for injuries caused by the faulty smoke detector. [Health & S C §13113.7(e)]

To repair or replace a faulty smoke detector, the landlord may enter the unit 24 hours after serving a written notice on the tenant of his intent to enter, unless the tenant gives permission for an earlier entry. [Health & S C §13113.7(e); see **first tuesday** Form 567; see Chapter 4]

Duty to install and maintain

An ordinary battery-operated smoke detector installed according to the manufacturer's instructions satisfies the requirement for both single-and multiple-unit dwellings, unless another type is required by local ordinances. [Health & S C §13113.7(a)]

For example, some local ordinances require the smoke detector to receive its power from the building's electrical system.

To determine the smoke detector requirements for a property, the landlord can contact the **local fire department** or the county fire planning department.

In apartment units and other multiple-unit dwellings, such as condominiums, smoke detectors must also be installed in the common stairwells. The apartment landlord and his property manager are responsible for **installing and maintaining** smoke detectors in both the common stairwells and the individual units. [Health & S C §13113.7(c)]

Posting fire safety information

The landlord of an apartment building must provide emergency fire safety information to all tenants if the building consists of:

- two or more stories;
- three or more units; and
- a front door that opens into an interior hallway or lobby area. [Health & S C §13220(c)]

The information must be on signs using **international symbols**. The signs must be located:

- at every stairway and elevator landing;
- at the intermediate point of any hallway exceeding 100 feet in length and all hallway intersections; and
- immediately inside all public entrances. [Health & S C §13220(c)(1)]

Further, the landlord must provide fire information to all tenants through brochures, pamphlets or videotapes, if available, or conform to adopted State Fire Marshal regulations. [Health & S C §13220(c)(2)]

If the landlord negotiates the rental or lease agreement in a language other than English, the required information provided to the tenant must be in English, international symbols and the four most common foreign languages in California. [Health & S C §13220(c)(3)]

Editor's note — A consumer-oriented brochure in English, international symbols and the four most common foreign languages is available from the State Fire Marshal. [Health & S C §13220(d)]

The State Fire Marshal has adopted California Code of Regulations Title 19 §3.09 concerning the dissemination of fire information to tenants in hotels, motels, office buildings and high-rises. Health and Safety Code §13220 addresses these issues for tenants in apartment complexes. However, information does not exist as to which four languages will be used to translate fire information.

Further, if the landlord has any questions about the enforcement or the requirements for posting and informing tenants of fire information, he should contact his local fire department or the county fire planning department. The codes and regulations are enforced on a local level, and each county or city may have different requirements for complying with the fire information regulations.

Emergency procedures for office buildings

Emergency procedures and information for office buildings of two or more stories must be provided to the building's occupants. [Health & S C §13220(a)]

The **emergency procedures information** for an office building of two or more stories may be published in the form of **literature** (pamphlets, etc.), and must be available to all persons entering the building as well as located immediately inside all entrances to the building. [19 California Code of Regulations §3.09(a)(1)]

In lieu of literature, a **floor plan** describing emergency procedures must be posted at every stairway landing, elevator landing, and immediately inside all public entrances. [19 CCR §3.09(a)(2)]

For **high-rise structures**, fire safety requirements include:

- posting emergency procedures on a floor plan at every stairway landing, elevator landing, and immediately inside all public entrances; and
- appointing a Fire Safety Director to coordinate fire safety activities, train employees in the building, develop an emergency plan, etc. (which is also required of operators of hotels, motels and lodging houses). [19 CCR §3.09(c), (d)]

A high-rise structure is a building rising more than 75 feet above the lowest floor level providing access to the building. [Health & S C §13210(b)]

Release mechanism in security bars

Security bars on residential property must have release mechanisms for fire safety reasons. The release mechanisms are not required if each bedroom with security bars contains a window or door to the exterior which opens for escape purposes. [Health & S C §13113.9]

Also, the owner of an apartment house must **install exit signs** that can be felt or seen near the floor of the exit. [Health & S C §17920.8]

Editor's note — Any questions concerning fire safety requirements or whether an owner has properly complied with the requirements should be directed to the local fire department or the county fire planning department. Some departments provide checklists of requirements that must be met.

Chapter 39 Security to prevent crimes

This chapter focuses on the responsibility of the landlord to reduce the risk of crime through prevention when he has knowledge of criminal activity on the leased premises.

Security measures and warnings

A landlord of an apartment complex is aware of recent assaults on tenants in the common areas of the property. The landlord has also received a composite drawing of the criminal and a description of the criminal's mode of operation released by the local police.

The landlord does not undertake any of the security steps available to reduce the risk of a recurrence of the same or similar criminal activities.

The landlord later rents a unit to a prospective tenant. The landlord does not disclose the recent criminal assaults or the criminal's mode of operation. The tenant is not given a copy of the composite drawing of the perpetrator developed by the police. Further, the landlord represents the complex as safe and patrolled by security.

Later, the tenant is assaulted by the same perpetrator inside the tenant's apartment unit, not in the areas open to the public. The tenant seeks to recover his money losses caused by the assault from the landlord. The tenant claims the landlord failed to disclose the prior assaults and misrepresented the safety of the apartment complex to induce the tenant to rent and occupy the unit.

The landlord claims he is not liable for the tenant's injuries since the assault occurred within the tenant's apartment unit and not in the common areas where the prior attacks occurred.

Here, the landlord is liable for injuries suffered by the tenant inside the apartment unit. The **landlord knew** of criminal activity on the premises and thus **owed a duty** to care for and protect the tenant by either:

- providing security measures in the common areas; or
- warning the tenant of the prior assaults. [**O'Hara** v. **Western Seven Trees Corporation Intercoast Management** (1977) 75 CA3d 798]

Based on the prior occurrences of criminal incidents, the likelihood of similar future assaults on tenants is *reasonably foreseeable*. When criminal activity is **reasonably foreseeable** due to known prior criminal activity, the landlord has a duty to take reasonable measures **to prevent harm** to persons on the property from future similar criminal activities.

The landlord's conduct — failure to warn the new tenant about **known criminal activity** or provide adequate security — creates a risk that a tenant may be injured. Due to the landlord's further failure to put security measures in place to prevent harm, the landlord must compensate the injured person by the payment of money, called *damages*.

Alternatively, the landlord could be liable for the tenant's losses based on his intentional misrepresentation to the tenant regarding the safety of the apartment complex.

Editor's note — Like a landlord, a homeowners' association (HOA) has a duty to maintain the common areas since it has exclusive control over the maintenance of the common areas.

*A HOA will be liable for money losses due to any injury caused by a dangerous condition created or allowed to exist by the association when it or its agents knew or should have known of the dangerous condition and the injury suffered was reasonably foreseeable. [**Frances T.** v. **Village Green Owners Association** (1986) 42 C3d 490]*

Degree of foreseeability of harm

Consider a landlord of a shopping center who has exclusive control over the maintenance and repair of the common areas. Burglaries and purse snatchings have recently occurred on the premises. However, the landlord is unaware of this criminal activity in the shopping center.

At tenant association meetings, concerns about the lack of security in the center are addressed. The tenant association decides not to hire security guards on account of the expense. The tenants do not discuss or bring their security concerns to the attention of the landlord.

Later, a tenant's employee is physically assaulted and injured on the leased premises. The employee claims the landlord is liable for his injuries since the landlord failed to provide security guards to protect employees of tenants from an unreasonable risk of harm.

The landlord claims he is not liable since the assault on the tenant's employee was a type of crime that was unforeseeable.

Here, the landlord has no duty to provide security guards in the common areas. The prior crimes (theft) were not of a similar nature that would have made a physical assault foreseeable. [**Ann M.** v. **Pacific Plaza Shopping Center** (1993) 6 C4th 666]

The landlord's duty to provide protection is determined in part by balancing the foreseeability of harm against the **burden imposed** on the landlord to remove or prevent the harm. A high degree of foreseeability is necessary to impose a duty on a landlord or HOA to hire security guards.

Unless prior incidents of **similar crimes** are brought to the landlord's attention, the high degree of foreseeability required to impose a duty on the landlord to take steps to prevent or eliminate future injury does not exist.

However, **prior similar incidents** are not always required to find that a landlord has a duty to take measures to prevent future criminal activity. The *foreseeability of an injury* is determined by the circumstances surrounding the injury and its occurrence, such as the nature, condition and location of the premises, and any prior incidents of similar or related activity in and around the premises. [Ann M., *supra*]

For example, consider a landlord of an office building and parking structure located in a neighborhood known to be a high-crime area. Many petty thefts and acts of vandalism have occurred on the premises, but no assaults have taken place. The security system maintained by the landlord to monitor the parking structure is in disrepair and does not function.

A visitor returning to his car enters the parking structure while an armed robbery is taking place. The visitor is shot and killed.

The visitor's spouse seeks to recover money losses from the landlord, claiming the death of the spouse was reasonably foreseeable and could have been prevented by the landlord. The spouse also claims the

landlord, who was aware of criminal activity on the premises, breached his duty to take measures to prevent further criminal activity.

The landlord claims the injury was not reasonably foreseeable since the prior criminal acts were not similar to the act causing the visitor's death.

Is the landlord liable for failing to provide adequate security in the parking structure?

Yes! The landlord's failure to properly maintain existing security features in light of prior criminal activity and the nature of a public parking structure is a breach of the duty of care the landlord owes to persons who enter the structure. Although the foreseeability of the type of criminal activity causing the death is low, the landlord is liable since the burden on him to maintain the existing security system is minimal.

Not only was the landlord aware of vandalism and thefts regularly occurring in the parking structure, the landlord knew the parking structure was located in a high-crime area. Further, parking structures by their dark and private nature tend to invite criminal activity. Thus, death resulting from a visitor's accidental disruption of an armed robbery is reasonably foreseeable, even though no other armed assaults had previously occurred on the premises. [**Gomez** v. **Ticor** (1983) 145 CA3d 622]

No liability if not foreseeable

The extent of the security measures a landlord is required to provide is dictated by the degree of foreseeability of any future harm to others. [Ann M., *supra*]

If an injury is not foreseeable since the **nature, condition and location** of the leased premises do not indicate a person entering or using the property is at risk, a landlord is not liable if an injury, which security measures may have prevented, occurs on the premises.

Consider an apartment complex where previous criminal activity has not occurred. However, the community where the complex is located is generally known as a high-crime area.

The light bulb installed at the entrance to a tenant's apartment burns out. The tenant asks the landlord to replace the light bulb. The lighting in the common area is functional.

Before the landlord replaces the bulb, the tenant is assaulted in his unit, suffering injuries. The tenant claims the landlord is liable for his injuries since the landlord has a duty to provide adequate lighting as a security measure.

The landlord claims he is not liable since the light bulb outside the tenant's unit is for the tenant's convenience, and is not intended as a security measure to protect tenants.

Here, the landlord is not liable. Prior criminal activity had not occurred on the premises that would put the landlord on notice of foreseeable risks. Thus, the landlord has no duty to take security precautions against criminal activity. Further, **lighting alone** is not considered an adequate security measure for deterring crime. [**7735 Hollywood Boulevard Venture** v. **Superior Court** (1981) 116 CA3d 901]

On-site, not off-site prevention

Tenants occupying an apartment complex have been victimized by numerous assaults and robberies in the garage area and courtyard. The landlord is aware of the criminal activity **on the premises**. In response to tenants' complaints, he promises to install additional lighting.

A tenant parks on the street instead of in the garage due to the inadequate lighting in the common areas. One night, while parking on the street, the tenant is attacked and injured. The tenant claims the landlord is liable for his injuries since the landlord's failure to provide adequate on-site lighting created a dangerous condition, forcing him to park on the street.

Is the landlord liable for the tenant's injuries that occurred on a public street?

No! The landlord does not have a duty to protect a tenant from criminal acts committed by others that injure the tenant when he is not on the leased premises. [**Rosenbaum** v. **Security Bank Corporation** (1996) 43 CA4th 1084]

While the landlord's conduct may have caused the tenant to park in the street, the tenant's decision to park on the public street imposes no duty on the landlord to also eliminate dangerous off-premises conditions. A landlord's **duty of care** is to prevent harm to others in the maintenance and management of the leased premises, not adjoining properties. [Calif. Civil Code §1714]

Prevent dangers within your control

The landlord's duty of care is derived from his *ability to prevent* the existence of dangerous conditions from existing on the **property he controls**, not adjacent properties or public right of ways over which he has not taken control. A duty of care toward tenants is owed by the landlord only when a **connection exists** between the harm suffered by the tenant and the landlord's care and maintenance of his property and any adjacent property over which he takes control.

The landlord's failure to remove or prevent the risk of injury caused by a dangerous condition over which the landlord has control must contribute to the injuries suffered by a tenant or visitor before liability for injuries will be imposed on the landlord.

While the landlord in *Rosenbaum* failed to exercise care in the maintenance and repair of his premises, the landlord **exercised no control** over the public street, nor did he create or permit the dangerous condition in the street which caused the tenant's injury.

The purpose for providing adequate lighting in the common areas of a leased premises is to help protect tenants or others against the risk of criminal attacks **on the leased premises**, not on a public street where the responsibility for lighting and security lies with government agencies. Thus, the lack of adequate lighting in the apartment complex was not the cause of the attack suffered by the tenant on the public street; it only caused the tenant to use the street. [Rosenbaum, *supra*]

Ability to control is not control

Now consider a landlord who is aware of criminal activity occurring on public property adjacent to the leased premises. A visitor leaves the leased premises at night via a public sidewalk adjacent to the premises. Lighting is not installed on the public side of the premises to illuminate the sidewalk.

While walking on the public sidewalk, the visitor is assaulted and injured. The visitor makes a demand on the landlord to recover money losses incurred due to his injuries. The client claims the landlord has a duty to protect patrons of tenants from criminal assaults on public sidewalks that provide access to the premises.

The visitor contends the landlord knew criminal activity had occurred on the sidewalk and **had the power** to exert control over the sidewalk by installing lights on the outside of the building — the sidewalk was the means of ingress and egress to the building.

Is the landlord liable for the client's injuries due to a dangerous condition on adjacent property?

No! The landlord does not owe a duty of care to anyone to take control over adjoining property and remove or prevent injury from dangerous conditions existing on the adjoining property. The landlord is not liable for failing to take steps to prevent possible injuries from occurring on a public sidewalk adjacent to the leased premises that are regularly used by tenants for access to their units. [**Donnell** v. **California Western School of Law** (1988) 200 CA3d 715]

The landlord's failure to provide lighting for a public sidewalk that the landlord **does not own or control** did not create the dangerous condition that caused the assault against the tenant's client. The fact the landlord can influence or alter the condition of the public sidewalk by voluntarily adding lighting in no way indicates he has control over the sidewalk, which would impose liability for failure to provide off-site security. [Donnell, *supra*]

Chapter 40 Dangerous on-site and off-site activities

This chapter presents the duty of care a landlord has to others, on or off the property, for dangerous on-site and off-site activities.

Duty to all to remove on-site dangers

A landlord, but his exercise of *reasonable care* in the management of his property, must prevent **foreseeable injury** to all others who may, for whatever reason, be on the leased premises. [**Rowland** v. **Christian** (1968) 69 C2d 108; Calif. Civil Code §1714]

If a person — a tenant, guest, invitee or trespasser — is injured due to the landlord's breach of his duty of care to remove or correct a known dangerous on-site condition, the landlord is liable for the person's money losses the injured person incurred due to the injury. [CC §1714]

The duty of care for others owed by the landlord **applies to all persons** on the property whether they enter the premises with or without permission or are mere social guests, unless the person is committing a felony on the property.

Conditions imposing responsibility

To **impose liability** on a landlord for an injury suffered by any person on the leased premises, several factors must be considered, including:

- the *foreseeability* of the type of injury suffered by the individual;
- the closeness of the *connection* between the landlord's conduct and the injury suffered;
- the *moral blame* attached to the landlord's conduct;
- the *public policy* of preventing future harm;
- the extent of the *burden* on the landlord and the *consequences* to the community of imposing a duty to exercise care to prevent the injury suffered; and
- the availability, cost, and prevalence of *insurance* for the risk involved. [Rowland, *supra*]

For example, the landlord with knowledge of a dangerous situation created by the presence of a tenant's dog is liable for injuries inflicted on others by the dog based on many of these factors. The landlord's failure to remove the dangerous condition from his property created by the dog is **closely connected** to injuries inflicted by the dog.

The landlord is sufficiently aware of the dangerous condition created by the presence of the dog to **reasonably foresee** the possibility of injury to others. Also, the landlord has the **ability to eliminate** or reduce the dangerous condition and prevent future harm by serving on the tenant a 3-day notice to remove the dog or vacate. [**Uccello** v. **Laudenslayer** (1975) 44 CA3d 504]

Landlord's duty to inspect

The landlord must use reasonable care in the repair and maintenance of the leased premises to **prevent harm** to others. To accomplish this level of safety through prevention of harm, the property must be inspected by the landlord whenever **entry is available** to the landlord.

Thus, each time a landlord enters into, renews or extends a rental or lease agreement, a *reasonable inspection* of the leased premises for dangerous conditions must be completed as part of his duty of care to prevent injury to others. If the landlord fails to inspect when the opportunity exists, the landlord will be **charged with knowledge** of any dangerous condition that he should have discovered had he undertaken an inspection.

Consider a landlord and tenant who enter into a nonresidential lease agreement.

The lease agreement allows the landlord to enter the premises for **yearly inspections**. Also, the tenant is required to obtain the landlord's approval before making any improvements.

With the landlord's consent, the tenant builds a roadside marketing structure and operates a retail produce business. The structure's concrete floor is improperly constructed and unfinished. Produce is often littered on the floor.

More than a year after construction, a customer slips and falls on produce littered on the floor, injuring himself. The customer claims the landlord is liable for his injuries since the landlord's right to inspect the property puts him on notice of the dangerous condition created by produce falling on the improperly constructed and unfinished concrete floor.

The landlord claims he is not liable for the customer's injuries since he had no actual notice of the dangerous condition created by the temporary deposit of produce on the floor.

However, the landlord is liable for the customer's injuries if the construction of the concrete floor:

- is a dangerous condition; or
- poses a dangerous condition when littered with produce from a permitted use. [**Lopez** v. **Superior Court** (1996) 45 CA4th 705]

A landlord is required to **conduct an inspection** of the leased premises for the purpose of making the premises safe from dangerous conditions when:

- a lease is executed, extended or renewed; and
- the landlord exercises any periodic right to re-enter or any other control over the property, such as an approval of construction. [**Mora** v. **Baker Commodities, Inc.** (1989) 210 CA3d 771]

Here, the landlord would have observed the condition of the floor had he conducted the yearly inspection of the premises called for in the lease agreement. Thus, the landlord is liable for *slip and fall* injuries when the condition of the floor is determined to be dangerous. [Lopez, *supra*]

A reasonable inspection

A landlord has a duty to inspect the leased premises when he **enters the premises** for any single purpose, such as maintenance, water damage or some other exigency causing him to make an emergency visit.

While a landlord may enter the premises during the lease term, he is not required to make a thorough inspection of the entire leased premises. However, the landlord who enters will be charged with the knowledge of a dangerous condition if the condition would have been observed by a reasonable person. [Mora, *supra*]

A landlord of a leased premises containing **areas open to the public** will be liable for injuries caused by a dangerous condition in the public area if the condition would be discovered during a landlord inspection.

However, if the landlord is not responsible under the lease agreement for repair and maintenance of **nonpublic areas**, the landlord will not be liable for failing to discover a dangerous condition occurring in nonpublic sections of a leased premises. The landlord is not required to expend extraordinary amounts of time and money constantly conducting extensive searches for possible dangerous conditions. [Mora, *supra*]

For example, a triple-net, management-free lease agreement usually transfers all responsibility for maintaining and repairing the property to the tenant.

Under a triple-net lease agreement, the landlord will not be liable for injuries to persons caused by a dangerous condition on the leased premises if:

- the dangerous condition came about after the tenant takes possession; and
- the landlord has no actual knowledge of the dangerous condition.

Editor's note — Landlords concerned about tenant maintenance of a leased premises will often reserve the right to enter the premises every six or 12 months. However, frequent inspections of a leased premises create a greater potential of liability for the landlord.

Landlords often reserve the right to conduct frequent inspections to assure that the tenant is not damaging or wasting the premises and reducing its market value. The right to enter brings with it the **obligation to inspect** for dangerous conditions. Also, the landlord may erroneously tend to overlook possible dangerous conditions he can control that are connected to the tenant's use, not maintenance, of the property.

Knowledge of dangerous conditions

Consider a landlord and tenant who enter into a residential rental agreement giving the tenant permission to keep a German Shepherd dog on the premises.

After the tenant takes possession of the property, the landlord never visits the premises and has never seen the dog.

Licensed property managers

Often, landlords employ real estate licensees as property managers.

When acting as an agent for the landlord, the licensed property manager has a duty to notify the landlord of his activities regarding the maintenance and management of the landlord's property. [CC §2020]

However, the landlord is considered to have the same knowledge about the property's condition as does the property manager with regard to the landlord's property. [CC §2332]

Further, since the property manager is the landlord's representative, the landlord will be liable for the property manager's actions performed in the scope of his representation. [CC §2330]

However, the landlord is entitled to indemnity from the property manager should the landlord be liable for the property manager's failure to properly perform his duties.

The licensed property manager will be liable to the landlord for breach of his agency duty. [CC §3333]

Later, an employee from a utility company enters the yard and suffers injuries when he is attacked by the tenant's dog.

The utility company employee seeks to recover money from the landlord as compensation for the injuries inflicted on him by the tenant's dog. The employee claims the landlord should have known the dog is dangerous since German Shepherds are a breed with the propensity for viciousness.

Is the landlord liable for the employee's injuries?

No! The landlord did not have knowledge the tenant's dog was vicious and presented a danger to others. [**Lundy** v. **California Realty** (1985) 170 CA3d 813]

A landlord's obligation to prevent harm to others arises only when the landlord is aware of or *should have known* about the dangerous condition and failed to take preemptive action.

For example, the landlord receiving complaints from neighbors about the behavior of a tenant's dog may deduce the dog creates a dangerous condition, even if the dog has not yet injured anyone.

Editor's note — The landlord's duty to protect others from an injury inflicted by a dog does not yet include asking the tenant if his dog is dangerous.

However, it is feasible the legislature could enact a law or the courts could impose a duty of inquiry on landlords when authorizing the tenant to keep a dog on the premises.

The pet authorization provision in the rental or lease agreement could include a declaration that the authorized pet is not dangerous.

Further, the owner of a dog is neither civilly nor criminally liable for a dog bite suffered by a person who enters the dog owner's property, lawfully or otherwise, unless the person is invited onto the property by the owner of the dog, is an employee of a utility company, a police officer or a U.S. mailman. [CC §3342(a)]

Landlord should have known

Now consider a landlord who leases nonresidential property to a tenant who operates a retail sales business on the property. The tenant keeps a dog on the premises and posts a "Beware of Dog" sign. A newspaper article written about the dog's vicious temperament is also posted on the premises. The landlord visits the leased premises several times a year and knows the dog is kept in the public area of the premises.

After the lease is renewed, a delivery man is attacked and injured by the dog. The delivery man claims the landlord must compensate him for his injuries since the landlord has a duty to inspect the property, ensuring safety for members of the public to enter.

The landlord claims he is not liable since he was personally unaware the dog was dangerous.

Is the landlord liable for the delivery man's injuries?

Yes! The landlord owes a duty to the delivery man as a member of the public to:

- exercise reasonable care in the inspection of his property **to discover** dangerous conditions; and
- remove or otherwise **eliminate** the dangerous condition that may be created by the presence of a vicious dog.

The injured person can recover when the landlord is **personally unaware** of the dog's vicious propensities since a reasonable inspection of the premises on renewal of the lease would have revealed to the landlord the newspaper article and the "Beware of Dog" sign. [**Portillo** v. **Aiassa** (1994) 27 CA4th 1128]

Also, it is foreseeable that a guard dog kept on a premises during business hours could injure someone.

Further, the landlord's failure to require the tenant to remove the dog from the premises on discovery that the dog constitutes a dangerous condition is closely connected to the delivery man's injuries.

The landlord had control over the condition since he could serve a 3-day notice on the tenant, requiring the tenant to either remove the dog from the premises during business hours or vacate the premises.

Editor's note — In Portillo, *the court held* ***moral blame*** *is attached to the landlord's conduct because of his failure to remove a condition he should have known was dangerous and over which he had control.*

Also, a landlord can often remove a dangerous condition by merely exercising his responsibility to make repairs that will eliminate the condition. However, a dangerous condition caused by a tenant's activity may require a 3-day notice ordering the tenant to correct or remove the dangerous condition, or vacate the premises. [See **first tuesday** Form 576]

On-site danger leads to off-site injury

Now consider a landlord and tenant who enter into a rental agreement for a residential dwelling. The agreement allows the tenant to keep dogs on the premises.

After the tenant occupies the residence, the landlord visits the premises monthly to collect the rent payments. During his visits, the landlord observes the dogs. The landlord is aware of the dogs' vicious nature.

One day, a neighbor and his dog are attacked and injured by the dogs tenant's two blocks away from the leased premises. The neighbor demands the landlord pay for losses resulting from the injuries. The neighbor claims the landlord owes him a duty of care to prevent injuries arising from dangerous animals the tenant keeps on the landlord's premises.

The landlord claims he is not liable since the injuries occurred off the leased premises.

Here, the landlord is **liable** for the **off-site injuries** since the landlord:

- was *aware* of the vicious propensities of dogs housed on his premises; and
- had the ability to remove the dangerous condition by serving a 3-day notice on the tenant to remove the dogs or vacate the premises. [**Donchin** v. **Guerrero** (1995) 34 CA4th 1832]

The landlord's liability for injuries inflicted by a tenant's dog off the premises is the same as his liability for injuries inflicted by the dog that occur on the premises.

While the landlord did not have control over the property where the injury occurred, the landlord did have control over the tenant's right to keep and maintain a known dangerous condition — the dogs — on the premises.

The landlord's failure to have dangerous dogs removed from the premises caused the injuries suffered by the neighbor. The injury would not have occurred if the landlord had not allowed the dogs, which he knew to be vicious, to remain on the premises he controlled. [Donchin, *supra*]

Tenant's dangerous on-site activity

Consider a landlord who is aware the tenant of his single-family rental unit occasionally discharges a firearm in the backyard. One day, a bullet fired by the tenant enters the backyard of the neighboring residence and kills the neighbor.

The neighbor's spouse makes a demand on the landlord for her financial loss resulting from her husband's death. The spouse claims the landlord breached his duty to individuals on neighboring property by failing to exercise care in the management of his property when he did not remove the known dangerous activity from the premises.

Is the landlord liable for the neighbor's death that occurred off the premises?

Yes! Even though the injury occurred off the leased premises, the landlord is liable since the landlord:

- knew of the dangerous on-site activity carried on by the tenant which inflicted the injury; and
- had the ability to eliminate the dangerous condition by serving a 3-day notice on the tenant to refrain from discharging the gun or quit the premises. [**Rosales** v. **Stewart** (1980) 113 CA3d 130]

Thus, the landlord had a duty to prevent the tenant from continuing to fire the gun on the premises. The landlord is liable for an injury resulting from a known dangerous condition or activity occurring on his property that he has the ability to remove, regardless of whether the injury from the on-site activity is suffered on or off the leased premises.

However, had the tenant left the landlord's premises with his gun and then shot and killed an individual, the landlord would not be liable. [**Medina** v. **Hillshore Partners** (1995) 40 CA4th 477]

Failure to avoid obvious dangers

Some dangerous conditions are obvious to persons entering or using the premises that impose a **duty of care** on that person to avoid injury to themselves.

For example, a person wearing cleats walks on a concrete path alongside of which is a rubber walkway for use to prevent slip and fall injuries. The person wearing cleated shoes walks on the concrete path and slips, injuring himself in the fall. A sign does not exist explaining the danger of the person's activity.

Here, a landlord has no duty to warn or guard others against a dangerous condition that is obvious. [**Beauchamp** v. **Los Gatos Golf Course** (1969) 273 CA2d 20]

While a landlord must compensate others for injuries caused by his failure to use skill and ordinary care in the management of his property, the liability has its limits.

A person, who willfully or by his own **lack of ordinary care** to protect himself brings an injury upon himself, exonerates the landlord, wholly or in part, from liability. [CC §1714]

Thus, a person has a duty of care to himself to be sufficiently observant and keep himself out of harm's way.

When the injured person's lack of care for himself contributes to his injury, recovery for his losses is limited to the percentage of the negligence attributed to him, called *comparative negligence*. The money losses recoverable by the injured person will be diminished in proportion to the percent of negligence attributable to the injured person for causing his own harm by failing to care for himself. [**Li** v. **Yellow Cab Company of California** (1975) 13 C3d 804]

Consider a trespasser who illegally enters into or onto property and fails to conduct himself with care to avoid harming himself, called *negligence*.

When the trespasser is negligent in exercising care in his conduct to prevent harm to himself while entering or moving about the property, any losses recoverable by the injured trespasser will be reduced by the percentage amount of negligence attributed to him for causing his injury. [**Beard** v. **Atchison, Topeka and Santa Fe Railway Co.** (1970) 4 CA3d 129]

Further, the landlord's liability will be limited if the trespasser was in the process of committing a felony on the property when he was injured. [CC §847]

Not a dangerous condition

Now consider a person who enters leased nonresidential property and wants to look inside the building.

Next to the building, below a window, stands a vat of acid maintained by the business authorized to operate on the leased premises. The vat is covered with plywood for the purpose of keeping out dirt and dust.

In order to see through the window, the person climbs up and steps onto the plywood cover which immediately collapses. The person falls into the vat, suffering injuries.

The injured person attempts to recover money from the landlord for losses resulting from his injury.

Here, the landlord is not liable for the person's injuries since the vat is not a **dangerous condition** that presents a risk of harm. The vat of acid is an integral part of the business run on the leased premises and is not a danger to any person who conducts himself with care around the vat.

Thus, the injured person **undertook the risk** of harm to himself by climbing on top of the vat and creating the dangerous situation leading to his injuries. [**Bisetti** v. **United Refrigeration Corp.** (1985) 174 CA3d 643]

Editor's note — In Bisetti*, the injured person happened to be a trespasser.*

Consider a landlord of an apartment complex used by gang members as a hangout and base from which they commit criminal offenses when off the premises. One of the gang members is a named tenant on the rental agreement.

The tenants and law enforcement officials complain to the landlord about the gang. However, the gang members do not harm or pose a threat of danger to the tenants.

Later, a pedestrian walking past the complex in the public right of way is chased by the gang members. One of the gang members, who is not the tenant, shoots and kills the pedestrian on a street adjacent to the complex.

The spouse of the pedestrian claims the landlord is liable for the death since he failed to remove the dangerous condition, the presence of gang members, from his premises.

However, the landlord does not have a duty to protect members of the public using adjacent public streets from assaults by gang members who congregate on his leased premises. [Medina, *supra*]

The congregation of gang members on the leased premises is not itself a dangerous condition. The gang members do not pose a physical threat to others of which the landlord is aware.

Thus, the landlord's failure to take steps to prevent the gang members from congregating on the leased premises is not the cause of the off-site shooting of a pedestrian by one of the gang members.

Again, the landlord is not liable for injuries that occur off the leased premises, since the landlord has **no control over the activities** of individuals or tenants while they are on public property, only when they are acting on his property. [Medina, *supra*]

Dangerous off-site conditions

Now consider a landlord who leases a residence to a tenant. The residents of the neighboring property own a dog the landlord knows to be vicious. The neighbor brings his leashed dog onto the leased premises. The neighbor invites the tenant's child to pet the dog.

The dog breaks free from the leash and attacks the child, causing injuries. The tenant claims the landlord is liable for his child's injuries since the landlord failed to warn him of the dangerous condition created by the neighbor's vicious dog.

Is the landlord liable for injuries inflicted on-site by the neighbor's dog, which he knew was vicious?

No! The dangerous condition was not maintained on the leased premises. Thus, the landlord has no control or authority himself to remove the dangerous condition from the neighbor's property. [**Wylie** v. **Gresch** (1987) 191 CA3d 412]

While a landlord owes a duty to others to remove a dog from his property that he knows to be dangerous, he does not have a duty to warn his tenants of the presence of vicious animals located on other properties in the neighborhood over which he has no control.

The landlord's failure to protect the tenant by warning him about the neighbor's dog did not create a dangerous condition on the leased premises that caused the tenant to be injured. A landlord's duty to correct or prevent injury from dangerous conditions does not extend to the dangerous conditions that exist off the premises. [Wylie, *supra*]

While the landlord has a duty to make the leased premises safe by removing dangerous on-site conditions and properly maintaining the premises, he is not the insurer of the tenant's safety from off-site hazards. [**7735 Hollywood Boulevard Venture** v. **Superior Court** (1981) 116 CA3d 901]

Off-site injuries under landlord control

The public right of way for a street fronting a leased premises includes part of the front lawn, located between the street curb and the property line. The landlord maintains the entire lawn up to the curb.

A water meter is located on the lawn in the street right of way. Several tenants inform the landlord the water meter box is broken and needs repair.

A tenant trips on the broken water meter box and suffers injuries. The tenant makes a demand on the landlord for losses caused by his injuries, claiming the landlord has a duty to eliminate dangerous conditions located in the public right of way within the lawn maintained by the landlord.

The landlord claims he is not liable since the water meter box is not located on his property and the landlord does not own or control the meter box.

However, the landlord is liable for the injuries suffered by the tenant caused by dangerous conditions — the broken water meter box — located in a public right of way surrounded by a lawn created and maintained by the landlord. [**Alcaraz** v. **Vece** (1997) 14 C4th 1149]

Also, a landlord or other property owner who installs and maintains trees adjacent to or in the lawn area between the public sidewalk and the street-side curb owes a duty of care to avoid injuring pedestrians by hazards created by the trees he maintains.

For example, trees planted and maintained by the property owner grow and eventually produce roots that extend under the sidewalk and crack and uplift it. The owner is aware of the hazard created by the tree roots but undertakes no steps to have the hazardous condition repaired or replaced.

Here, the owner has taken control over the off-site area containing the public sidewalk and will be liable to any pedestrian who is injured due to the hazard created by the roots of trees he maintains since the trunks of the trees are located on his property. [**Alpert** v. **Villa Romano Homeowners Association** (2000) 81 CA4th 1320]

Chapter 41 Nonresidential lease agreement

This chapter reviews a nonresidential lease agreement as the conveyance of a leasehold interest in real estate, with a term and subject to conditions for maintenance of the property.

The conveyance of a leasehold

A lease agreement is a **contract** entered into by a landlord and tenant for payment of money and care of real estate. The lease agreement also acts to **convey a possessory interest** in real estate, called a *leasehold estate*, or simply a *lease*. [Calif. Civil Code §761(3)]

By entering into a lease agreement and delivering up possession to the tenant, the landlord conveys to the tenant the **exclusive right to occupy** a parcel of real estate, or space in a parcel, for a fixed period of time. The continued right to occupancy of the real estate, the lease, *is conditioned* on the tenant's performance under provisions in the lease agreement, the contract, calling for the payment of rent and maintenance of the property delegated to the tenant.

On **expiration** of the term of the lease, the right of possession to the real estate reverts to the landlord. During the term of the lease, the landlord, as the fee owner, holds only a *reversionary interest* in the leased parcel or space.

When the lease agreement has been entered into and the tenant takes occupancy, the landlord's and tenant's **right to possession** of the leased real estate is controlled by landlord/tenant law, not contract law.

On the other hand, the rent provisions in the lease agreement **evidence the debt** the tenant has contracted to pay to the landlord over the term of the lease. The lease agreement also contains other contractual provisions establishing the responsibilities of the tenant or landlord to pay the operating costs and provide for the **care and maintenance** of the property.

The landlord may prematurely regain possession of the real estate by **forfeiting**, or terminating, the tenant's leasehold interest and right to possession, if the tenant fails to comply with, or **breaches**, provisions of the lease agreement. Under a declaration of forfeiture in a 3-day notice, the failure prior to expiration of the tenancy to either pay rent, maintain the property, or fully perform under some other material provision in the lease agreement, terminates the tenant's right to possession.

However, on forfeiture of the right to possession, the lease agreement **remains uncancelled** and in effect as a contract requiring the tenant to pay rent and other amounts for the duration of the original term of the lease. [See Chapter 20]

Conversely, the tenant's obligation to pay can be canceled prior to expiration of the term of the lease by a misunderstanding of the forfeiture provision in the notice to quit and the landlord's conduct, called a *surrender*. [**Desert Plaza Partnership** v. **Waddell** (1986) 180 CA3d 805; see Chapter 22]

Validity of the lease agreement form

A lease agreement conveying a term of occupancy exceeding one year must be written to be enforceable, a requirement of the *statute of frauds*. [CC §1624(a)(3)]

NONRESIDENTIAL LEASE AGREEMENT

Commercial, Industrial or Office

DATE:_____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

1. FACTS:

1.1 The Landlord, _____,
leases to Tenant(s), _____,
the real estate referred to as _____
_____.

1.2 The Landlord acknowledges receipt of $_____ to be applied as follows:

☐ Security deposit $_____

☐ Last month's rent $_____ ☐ First month's rent $_____

1.3 The following checked addendums are made a part of this nonresidential lease:

☐ Additional terms addendum [**first tuesday** Form 250] ☐ Property Description
☐ Authority to Sublease/Assign ☐ Option to Buy [**ft** Form 161]
☐ Brokerage Fee Addendum [**ft** Form 273] ☐ Option to Lease Additional Space
☐ Condition of Premises [**ft** Form 560 ☐ Building rules ☐ Plat of leased space
☐ Operating Expense Sheet [**ft** Form 562] ☐ Other:_____

2. TERM OF LEASE:

2.1 The lease commences _____, 20_____, and expires _____, 20_____, the month of commencement being the anniversary month.

2.2 The lease terminates on the last day of the term without further notice.

2.3 If Tenant holds over, Tenant to be liable for damages at the daily rate of $_____.

2.4 ☐ This lease agreement is a sublease of the premises which is limited in its terms by the terms and condition of the attached master lease.

3. RENT:

3.1 Tenant to pay rent monthly, in advance, on the first day of each month, including rent for any partial month prorated at 1/30th of the monthly rent per day.

3.2 ☐ Monthly rent for the entire term is fixed at the amount of $_____.

3.3 ☐ Monthly rent, from year to year, is graduated on each anniversary month as follows:

Initial year's monthly rent to be . . . . . $_____, and

a. _____% increase in monthly rent over prior year's monthly rent; or

b. First anniversary monthly rent . . . . . $_____

Second anniversary monthly rent. . . . . $_____

Third anniversary monthly rent . . . . . $_____

Fourth anniversary monthly rent . . . . . $_____

3.4 ☐ Monthly base rent for the initial 12 months of the term is the amount of $_____, adjusted annually on the first day of each anniversary month by increasing the initial monthly base rent by the percentage increase between the applicable CPI-U index figures published for the third month preceding the month of commencement and the third month preceding the anniversary month.

a. The applicable CPI-U Index (Consumer Price Index for All Urban Consumer)(1982-1984 = 100) is:

☐ Los Angeles-Anaheim-Riverside, ☐ San Francisco-Oakland-San Jose,

☐ San Diego, ☐ National, ☐ Other: _____.

b. Rent increases under CPI-U adjustments are limited for any one year to an increase of _____%.

c. On any anniversary adjustment, should the CPI-U have decreased below the CPI-U for the prior twelve-month period, the monthly rent for the ensuing 12 months shall remain the same as the rent during the prior 12 months.

d. If the CPI-U is changed or replaced by the United States Government, the conversion factor published by the Government on the new Index shall be used to compute annual adjustments.

3.5 ☐ Additional percentage rent equal to _____% of gross sales made from the premises during each calendar year, less credit for other rent, real estate taxes, insurance and common area maintenance (CAM) charges paid for the calendar year.

a. The percentage rent shall be computed and paid for each month of the lease with a signed written statement of the gross income and percentage computation by the tenth day of the following month.

b. The additional percentage rent payable monthly to be credited for other rent, taxes, insurance, and CAMs paid by Tenant for the month.

c. Within one month after each calendar year and on expiration of the lease, Tenant shall compute and deliver a written statement of sales and the percentage rent due for the calendar year, less credit for rent, taxes, insurance and CAMs paid for the calendar year, to annually adjust the percentage rent remaining due from Tenant or to be refunded to Tenant by Landlord, which difference will be paid on delivery of the annual statement.

d. Gross sales includes all money or equivalent received by Tenant, subtenant, licensees or concessionaires, in the ordinary course of business, whether wholesale or retail, cash or credit, less credit for goods returned by customer or merchandise returned by Tenant or transferred to tenant-affiliated stores.

e. Landlord has the right, on reasonable notice, to audit Tenant's books regarding sales information.

3.6 ☐ Every _____ years after commencement, including extensions/renewals, the monthly base rent will be adjusted, upward only, to current market rental rates for comparable premises, and computation of any future CPI-U adjustments will treat the year of each current market adjustment as a commencement year for selecting the Index figures.

a. The monthly rent during any year shall not be less than the previous year's monthly rent.

b. Landlord to reasonably determine and advise Tenant of the adjusted rental rates prior to three months before the adjustment becomes effective.

3.7 Rent to be paid by:

a. ☐ cash, ☐ check, or ☐ cashier's check, made payable to Landlord.
Personal delivery of rent to be at Landlord's address during the hours of _____ am to _____ pm on the following days: _____.

b. ☐ credit card #_____/_____/_____/_____ issued by _____, _____which Landlord is authorized to charge each month for rent due.

c. ☐ deposit into account number _____ at:
_____(Financial Institution)
_____(Address)

3.8 Tenant to pay a charge of $_____ as an additional amount of rent, due on demand, in the event rent is not received within five days of the due date.

3.9 If any rent or other amount due landlord is not received within five days after it's due date, interest will thereafter accrue on the amount at 12% per annum until paid. On receipt of any past due amount, landlord to promptly make a written demand for payment of the accrued interest which will be payable within 30 days of the demand.

3.10 Tenant to pay a charge of $_____ as an additional amount of rent, due on demand, for each rent check returned for insufficient funds, and thereafter to pay rent by cash or cashier's check.

4. OPERATING EXPENSES:

4.1 Tenant is responsible for payment of utility and service charges as follows: _____
_____

4.2 Landlord is responsible for payment of utility and service charges as follows: _____
_____

4.3 Tenant to pay all taxes levied on trade fixtures or other improvements Tenant installs on the premises.

4.4 Should Landlord pay any charge owed by Tenant, Tenant shall pay, within 10 days of written demand, the charge as additional rent.

4.5 As additional rent, Tenant to pay _____% of all real property taxes and assessments levied by governments, for whatever cause, against the land, trees and building containing the leased premises, within 30 days after written computation and demand from Landlord.

4.6 As additional monthly rent, Tenant to pay _____% of the common area maintenance (CAM) incurred each month, within 10 days of written statement and demand for payment.

a. Common area maintenance is the cost of maintaining and operating the "Common Areas," including all sidewalks, corridors, plazas, hallways, restrooms, parking areas, interior and exterior walls and all other open areas not occupied by tenants.

b. Common area maintenance includes "all charges" for garbage removal, janitorial services, gardening, landscaping, printing/decorating, repair and upkeep, utilities and other operating costs, including charges for property management of the common area maintenance.

5. POSSESSION:

5.1 Tenant may terminate the lease if Landlord does not deliver up possession within 10 days after commencement of the lease.

5.2 Landlord is to recover and deliver possession of the premises from the previous tenant. Tenant will not be liable for rent until possession is delivered.

5.3 If Landlord is unable to deliver possession of the premises, Landlord will not be liable for any damages.

6. USE OF THE PREMISES:

6.1 The Tenant's use of the premises shall be: _____

6.2 No other use of the premises is permitted.

a. Tenant may not conduct any activity which increases Landlord's insurance premiums.

6.3 Tenant will not use the premises for any unlawful purpose, violate any government ordinance or building and tenant association rules, or create any nuisance.

6.4 Tenant shall deliver up the premises together with all keys to the premises on expiration of the lease in as good condition as when Tenant took possession, except for reasonable wear and tear.

7. APPURTENANCES:

7.1 Tenant shall have the right to use Landlord's access of ingress and egress.

7.2 Tenant shall also have the use of _____ parking spaces for the running of its business.

8. SIGNS AND ADVERTISING:

8.1 Tenant will not construct any sign or other advertising on the premises without the prior consent of Landlord.

8.2 ☐ Landlord will maintain a directory in the lobby of the premises displaying the name and suite number of Tenant. Landlord has the right to determine the size, shape, color, style and lettering of the directory.

8.3 ☐ Landlord will provide a sign to be placed on the primary door to Tenant's suite. The fees for the cost and installation will be paid by Tenant.

9. TENANT IMPROVEMENTS/ALTERATIONS:

9.1 Tenant may not alter or improve the real estate without Landlord's prior consent.

a. Tenant will keep the real estate free of all claims for any improvements and will timely notify Landlord to permit posting of notices for nonresponsibility.

9.2 Any increases in Landlord's property taxes caused by improvements made by Tenant shall become additional rent due on demand.

10. REPAIR AND MAINTENANCE:

10.1 The premises are in good condition, except as noted in an addendum.

10.2 Tenant shall maintain and repair the premises, except for the following which are Landlord's responsibility:
☐ Plumbing and sewers ☐ Structural foundations ☐ Exterior walls ☐ Heating and air conditioning
☐ Store front ☐ Plate glass ☐ Roof ☐ Parking areas ☐ Lawns and shrubbery ☐ Sidewalks
☐ Driveways/right of ways ☐ Electrical ☐ Other: _____

11. RIGHT TO ENTER:

11.1 Tenant agrees to make the premises available on 24 hours notice for entry by Landlord for necessary repairs, alterations, or inspection of the premises.

12. WASTE:

12.1 Tenant will not destroy, damage, or remove any part of the premises or equipment, or commit waste, or permit any person to do so.

13. LIABILITY INSURANCE:

13.1 Tenant shall obtain and maintain commercial general liability and plate glass insurance covering both personal injury and property damage to cover Tenant's use of the premises insuring Tenant and Landlord.

13.2 Tenant shall obtain insurance for this purpose in the minimum amount of $_____.

13.3 Tenant shall provide Landlord with a Certificate of Insurance naming the Landlord as an additional insured. The Certificate shall provide for written notice to Landlord should a change or cancellation of the policy occur.

13.4 Each party waives all insurance subrogation rights it may have.

14. FIRE INSURANCE:

14.1 Tenant shall obtain and maintain a standard fire insurance policy with extended coverage for theft and vandalism to the extent of 100% of the replacement value of all personal property and the restoration of Tenant improvements.

15. HOLD HARMLESS:

15.1 Tenant shall hold Landlord harmless for all claims, damages or liability arising out of the premises caused by Tenant or its employees or patrons.

16. DESTRUCTION:

16.1 In the event the premises are totally or partially destroyed, Tenant agrees to repair the premises if the destruction is caused by Tenant or covered by its insurance.

16.2 The lease shall not be terminated due to any destruction.

16.3 Landlord shall repair the premises if the cause is not covered by the tenant's insurance and is covered by Landlord's policy.

16.4 Landlord may terminate the lease if the repairs cannot be completed within 30 days, the cost of restoration exceeds 70% of the replacement value of the premises, the insurance proceeds are insufficient to cover the actual cost of the repairs, or the premises may not be occupied by law.

17. SUBORDINATION:

17.1 Tenant agrees to subordinate to any new financing secured by the premises which does not exceed 80% loan-to-value ratio, and interest of two percent over market, and not less than a 15-year monthly amortization and five-year due date.

18. TENANT ESTOPPEL CERTIFICATES:

18.1 Within 10 days after notice, Tenant will execute a certificate stating the existing terms of the lease to be provided to prospective buyers or lenders.

18.2 Failure to deliver the certificate shall be conclusive evidence the information contained in it is correct.

19. ASSIGNMENT, SUBLETTING AND ENCUMBRANCE: [Check only one]

19.1 ☐ Tenant may not assign this lease or sublet any part of the premises, or further encumber the leasehold.

19.2 ☐ Tenant may not transfer any interest in the premises without the prior consent of Landlord.

a. ☐ Consent may not be unreasonably withheld.

b. ☐ Consent is subject to the attached conditions. [**ft** Form 250]

20. SURRENDER:

20.1 Tenant may surrender this lease only by a written cancellation and waiver agreement with Landlord.

21. EMINENT DOMAIN:

21.1 Should a portion or all of the premises be condemned for public use, Landlord may terminate the lease and Tenant's possession. If the lease is not terminated, Tenant shall receive a rent abatement for the actual reduction (if any) in the value of the lease.

21.2 Tenant waives the right to any compensation awarded from the condemning authority for the whole or partial taking of the premises.

21.3 Any Tenant's damages shall come solely from the condemning authority.

22. WAIVER:

22.1 Waiver of a breach of any provision in this lease shall not constitute a waiver of any subsequent breach. Landlord's receipt of rent with knowledge of Tenant's breach does not waive Landlord's right to enforce the breach.

23. DEFAULT REMEDIES:

23.1 If Tenant breaches any provision of this lease, Landlord may exercise its rights, including the right to collect future rental losses after forfeiture of possession.

24. BROKERAGE FEES:

24.1 ☐ Landlord and Tenant to pay Broker fees per the attached schedule of leasing agent's fee. [**ft** form 113]

25. MISCELLANEOUS:

25.1 ☐ See attached addendum for additional terms. [**ft** Form 250]

25.2 In any action to enforce this agreement, the prevailing party shall receive attorney fees.

25.3 This lease shall be binding on all heirs, assigns and successors except as provided in section 19.

25.4 This lease shall be enforced under California law.

25.5 This lease reflects the entire agreement between the parties.

25.6 ☐ This lease is secured by a trust deed. [**ft** Form 451]

25.7 ☐ The performance of this lease is assured by a guarantee agreement. [**ft** Form 439]

I agree to let on the terms stated above.

Date:_____, 20_____

Landlord: _____

Agent: _____

Signature: _____

Address: _____

_____

Phone: _____

Fax: _____

E-mail: _____

I agree to occupy on the terms stated above.

Date:_____, 20_____

Tenant: _____

Tenant: _____

Signature: _____

Signature: _____

Address: _____

_____

Phone: _____

Fax: _____

E-mail: _____

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The provisions contained in a written lease agreement fall into one of three categories of activities:

- **conveyance** of the leasehold interest;
- the **lease debt**, called *rent*; and
- responsibility for **care and maintenance** of the leased premises. [See Form 552 accompanying this chapter]

To be valid, a lease agreement must:

- designate the **size and location** of the leased premises with *reasonable certainty*;
- set forth a **term** for the tenancy conveyed; and
- state the **rental amount**, and its time, place and manner of payment. [**Levin** v. **Saroff** (1921) 54 CA 285]

Offers to lease and lease agreements

A broker, whether he represents the landlord or the tenant, should use a letter of intent (LOI) or an *offer to lease* to initiate and document lease negotiations prior to entering into the lease agreement itself. [See **first tuesday** Form 556]

An **offer to lease** entered into by both the tenant and the landlord is also referred to as an *agreement to lease*. The preparation and signing of the actual lease agreement remains to be done after its terms and conditions have been negotiated and agreed to in the offer to lease.

Consider a prospective tenant who signs an offer or letter of intent to lease property that is submitted to the landlord. The offer calls for the landlord to erect a building on the property for use in the tenant's business, but does not attach a copy of a proposed lease agreement or reference the form to be used.

The landlord accepts the offer to lease, agreeing to lease the premises to the tenant, occupancy to be delivered on the completion of the improvements by the landlord as they come due. The offer to lease also states the tenant will lease the premises for five years, commencing on completion of the improvements, when he will begin making the agreed-to monthly rental payments.

After building construction is completed, the tenant takes possession of the premises and makes monthly rental payments to the landlord as they become due. A formal lease agreement is not prepared or entered into by the landlord and tenant. Both the landlord and the tenant perform according to the terms stated in the offer to lease, except for their failure to enter into the lease agreement.

Later, the property becomes the subject of an action for inverse condemnation. Persons with an interest in the property are entitled to money, which includes the tenant's leasehold interest.

The landlord claims the tenant is not entitled to any amount from the condemnation award since the tenant has no interest in the property as he lacks a signed lease agreement **conveying** a leasehold interest to him.

The tenant claims he has a leasehold interest in the property under the offer to lease and is entitled to recover his losses resulting from the condemnation of the property.

Here, the tenant will participate in the condemnation award since he owns a leasehold (estate) interest in the property that was not limited by agreement. The written agreement entered into by the landlord and the tenant — an offer to lease on the terms stated — becomes the lease agreement when the tenant takes possession of the premises without entering into a formal lease agreement. [**City of Santa Cruz** v. **MacGregor** (1960) 178 CA2d 45]

The agreement to lease, signed by the owner, contains all the essential terms needed to create a lease, including:

- a *description of the premises* to be leased and its location — a building on the premises;
- a *lease term* — five years; and
- the *amount of periodic rent* and when it will be paid.

Since all the elements necessary to create a lease are agreed to in writing, the landlord's act of delivering possession to the tenant **conveys** the agreed five-year leasehold interest to the tenant. No part of the agreements entered into reference or limit the tenant's condemnation rights.

To record or not to record

A lease agreement need not be recorded. Between the landlord and the tenant, and all other parties who have *knowledge* of the lease, the agreement is enforceable whether or not it is recorded. [CC §1217]

Thus, an unrecorded lease agreement with a term exceeding one year in length is only void as against a *bona fide purchaser* (BFP). [CC §1214]

To qualify as a BFP, the buyer or lender must lack *knowledge* that the lease agreement exists or a tenant is in possession, and purchase the leased real estate for valuable consideration or accept the real estate as security for a debt.

However, when a tenant occupies the property at the time it is purchased or further encumbered, the purchaser or secured lender is *charged with knowledge* of the tenant's leasehold interest — whether or not the lease agreement is recorded. Thus, the tenant's occupancy puts the purchaser and lender on **constructive notice** a lease (or some other arrangement with the occupant) exists. [**Manig** v. **Bachman** (1954) 127 CA2d 216]

However, when a lease agreement is recorded, the content of the recorded agreement may be relied on by a purchaser or lender as containing **all the rights** of the tenant. The need for a tenant estoppel certificate to establish the tenant's rights in the property is eliminated by the recording.

Editor's note — An unrecorded option held by a tenant to buy the leased property or extend the lease cannot be enforced against a buyer or lender who later acquires an interest in the property when the ***lease agreement is recorded,*** *if:*

- *the buyer or lender have no actual knowledge of the option;*
- *the option to extend the lease or buy the property itself is not recorded; and*
- *the unrecorded options are not referenced in the recorded lease. [**Gates Rubber Company** v. **Ulman** (1989) 214 CA3d 356]*

The contents of a lease agreement

A nonresidential lease agreement form has five main sections:

- *identification* of the parties and the premises, and the conveyance and term of the lease;
- the *rent* and terms for payment of amounts owed;
- the *care and maintenance* of the leased property;
- *miscellaneous provisions* for circumstances peculiar to the transaction; and
- the *signatures* of the parties.

The **identification section** of a real estate lease agreement includes:

- the names of the landlord and the tenant;
- a description of the leased premises;
- words of conveyance of the leased property;
- a receipt for prepaid rents and the security deposit; and
- a list of the addenda which contain exhibits or additional terms. [See Form 552 §1]

The leasehold conveyance

The lease agreement includes words of transfer by which the landlord conveys a leasehold interest (lease) in the property to the tenant upon signing the agreement and delivery of possession to the tenant. [See Form 552 §1.1]

The **conveyance** of a lease is typically achieved with the words "landlord . . . **leases to** . . . tenant the real estate referred to as . . . ." [See Form 552 §1.1]

However, consider an owner of a department store who enters into an agreement with a tenant to occupy space in the store for three years. The tenant will use the space to conduct his business.

The agreement states the space to be occupied by the tenant will be designated by the owner at the time of occupancy. The agreement also:

- outlines the formula for the monthly **rent** to be paid for the space;
- gives the tenant the sole and **exclusive right** to conduct his business in the store without competition;
- **restricts transfer** of the tenant's right to occupy the space without the owner's consent; and
- requires the tenant to **surrender** the occupied premises on the last day of the rental term.

After the tenant takes possession, and before the term for occupancy expires, the owner notifies the tenant he is terminating the agreement and the tenant must vacate the premises. The tenant does not comply with the owner's notice to vacate.

As a result, the landlord removes the tenant's fixtures, equipment and inventory, and bars the tenant from entering the premises.

The tenant claims the owner can neither terminate the occupancy nor remove his possessions, without first filing a UD action and obtaining a judgment to recover possession since the occupancy agreement constitutes a lease which **conveyed a leasehold interest** in the occupied space to the tenant.

The owner claims the occupancy agreement is a mere *license* to conduct business in the store and is not a lease since **no defined space** was described in the agreement to identify the location of the leased premises.

Here, the agreement to occupy the space conveyed a lease, not a license to use. While the agreement itself does not identify the space to be occupied by the tenant or contain words of conveyance, the agreement becomes a lease on the tenant's occupancy of the **premises designated** by the landlord since the agreement states:

- possession of the premises is to be delivered to the tenant for his **exclusive use** in exchange for monthly rent;
- the lease cannot be **assigned** without the consent of the landlord; and
- the premises need not be delivered up to the landlord until the end of the rental term. [**Beckett** v. **City of Paris Dry Goods Co.** (1939) 14 C2d 633]

The agreement entered into by the landlord does not contain the words "landlord . . . leases to . . . tenant" as words of conveyance. However, the contents of the agreement indicate the landlord's intention to convey a lease to the tenant, and the **act of delivering possession** to the tenant of space designated by the store owner is the conveyance.

Conversely, an occupancy agreement does not automatically convey a lease just because it uses words of leasehold conveyance. The *economic function* of a "lease transaction" may actually be something quite different, that of a sale which has been recharacterized by the parties under the guise of a lease.

For instance, a lease-option agreement that allocates option money or a portion of each rental payment, or both, toward the purchase price or down payment to be made on the purchase of the property is not a lease at all. The lease-option agreement is a *disguised security device* since it evidences a credit sale by a carryback seller. Further, the lease-option agreement as a sale requires taxable profits in the down payment to be reported when it is received, and not deferred under option rules. [**Oesterreich** v. **Commissioner of Internal Revenue** (9th Cir. 1955) 226 F2d 798]

Proper identification of the parties

Each party to a lease agreement must be properly **identified**. On the lease agreement form, the identification of the tenant should indicate how his ownership of the lease conveyed will be vested, such as community property, community property with right of survivorship, joint tenancy, tenancy-in-common, sole ownership, as a trustee for himself or for someone else, or as a business entity.

When the ownership interest of the landlord is community property, both spouses must consent to agreements leasing the community property for a fixed term exceeding one year. If not, the community is not bound by the lease agreement, and, if challenged within one year after commencement by the nonconsenting spouse, the tenant cannot enforce the conveyance of the lease. [Calif. Family Code §1102]

Business entities, excluding DBAs, individuals and their trusts, that own or lease property include:

- corporations and out-of-state entities qualifying as a corporation such as business trusts;
- limited liability companies (LLCs);
- partnerships, general or limited;
- real estate investment trusts (REITs);
- nonprofit organizations; and
- governmental agencies.

When the landlord or tenant is a partnership, the lease agreement should indicate:

- whether the partnership is a limited, general or limited liability partnership (LLP);
- the partnership's state of formation, and if out of state, whether it is qualified to do business in California; and
- the name of the partner(s) authorized to bind the partnership.

With information on the partnership, the landlord and any title company insuring the leasehold can confirm through a review of recorded documents the authority of the general or managing partner to bind the partnership, such as an LP-1 for a limited partnership, or the managing member to bind an LLC.

Whether a corporation is the landlord or tenant, the full corporate name and the state of incorporation must be **disclosed**, as well as the name and title of the officer who will be signing the lease agreement.

The corporate information, along with a *resolution* from the board of directors authorizing the corporate officers to enter into the lease in the name of the corporation, will allow for confirmation of:

- the corporation's good standing to operate in the state; and
- the officers registered with the state to act on behalf of and bind the corporation under resolution by the corporation's board of directors.

Premises identified with certainty

The nonresidential lease agreement must describe the premises to be leased so the premises can be located with *reasonable certainty*. While the description may not itself be "definite and certain" as worded, an imperfectly worded description to be **reasonably certain** need only furnish a "means or key" for a surveyor to identify the parcel's location on the earth's surface or within a building. [**Beverage** v. **Canton Placer Mining Co.** (1955) 43 C2d 769]

If the premises is a building or a space in a building, the common street address, including the unit number, is a sufficient description to identify the premises.

If the premises is not easily identified by its common address, a plot map or floor plan should be included as an addendum to the lease agreement, with the space to be rented highlighted or otherwise identified. A plot map or floor plan eliminates confusion over the location of the leased parcel or space in the building, and initially establishes the parameters of the leased space.

An attached floor or plot plan noting square footage is useful if rent is calculated based on square footage occupied by the tenant, or on the percentage of square footage within a project leased to the tenant.

Also, an inaccurate or incomplete description of the leased premises will not prevent a landlord from conveying, and the tenant from accepting, a leasehold interest in a parcel of real estate for lack of certainty.

A sufficient description

A tenant signs and hands the landlord an **offer to lease** together with the proposed lease agreement for space in a retail commercial center. Attached to the proposed lease agreement is a plot plan outlining the location of the leased premises.

The lease agreement contains a provision stating the exact legal description of the premises will be prepared as an addendum to the lease agreement no sooner than 30 days after the leased premises as identified in the plot plan is occupied by the tenant.

After submitting the offer to lease, the tenant decides he would rather lease space at another location. The tenant mails a revocation letter to the landlord for the withdrawal of his offer.

However, the tenant receives the signed offer and lease agreement from the landlord before the landlord receives the tenant's revocation letter. The lease agreement does not include a copy of the plot plan addendum that was attached to the proposed lease.

The tenant refuses to perform under the lease agreement, claiming the lease agreement is unenforceable since the landlord failed to deliver the plot plan addendum that designated the size of the leased premises.

The landlord seeks to enforce the tenant's performance of the lease agreement.

Here, a lease has been entered into which is **enforceable**. The precise size of the leased premises is not crucial to the lease transaction since the location of the premises is known due to the plot plan attached to the proposed lease agreement and the lease agreement states the exact size of the premises identified on the plot plan will be determined after the tenant takes possession. [**Mabee** v. **Nurseryland Garden Centers, Inc.** (1978) 84 CA3d 968]

Also, when the premises described in a lease agreement is incomplete or inaccurate, the tenant's actual possession of the premises will set the boundaries. [Beckett, *supra*]

Further, an incomplete or inaccurate description of the leased premises which the tenant has occupied does not release a tenant from liability under the lease for the space he actually occupied. [City of Santa Cruz, *supra*]

Addenda to the lease agreement

The terms common to all nonresidential leases are contained in the provisions of a regular lease agreement form.

However, the terms and conditions peculiar to the leasing of a particular type of nonresidential tenancy, such as commercial, industrial, office, farming operation or hotel, or provisions unique to the parties and their advisors, should be handled in an *addendum* attached to the lease agreement.

The use of an **addendum** to house extraordinary and atypical provisions not in common use avoids the element of a later unpleasant (and litigious) surprise. Extraordinary provisions occasionally go unnoticed at the time the lease agreement is entered into because they are buried in preprinted copy.

Also, any handwritten or typewritten provisions added to an agreement control over conflicting pre-printed or boilerplate provisions. Should inconsistencies arise between provisions in the pre-printed lease agreement and an attached addendum, the provisions in the addendum control. [**Gutzi Associates** v. **Switzer** (1989) 215 CA3d 1636]

The use of addenda for making changes or additions to leasing provisions allows parties to tailor the lease agreement to meet their needs in the transaction, while retaining the integrity of the contents of the lease agreement form.

Addenda occasionally attached to a nonresidential lease agreement include:

- terms unique to the type of property leased;
- a property description addendum, such as a plot map or site plan;
- a structural or tenant improvement agreement;
- a condition of premises addendum [See **first tuesday** Form 560];
- a building rules addendum;
- an option or right of first refusal to renew or extend [See **first tuesday** Form 566];
- a brokerage fee addendum [See **first tuesday** Form 273];
- a tenant leasehold subordination agreement regarding a future loan;
- a non-disturbance and attornment provision;
- a signage or tenant association agreement;
- an option or right of first refusal to lease additional space;
- authority to sublease or assign; and
- an option or right of first refusal to buy. [See **first tuesday** Forms 161 and 579]

If the lease agreement is for a sublease of the premises, a copy of the master lease should be attached and noted in the agreement. [Form 552 §2.4]

The lease term

A nonresidential lease agreement is an agreement to rent real estate for a fixed term, conveying a type of leasehold estate called a *tenancy for years*. [CC §761(3)]

The lease agreement should clearly indicate the dates on which the lease term, occupancy, commences and expires. [See Form 552 §2.1]

Delivery and acceptance of possession are addressed separately from the date of the lease agreement since the transfer of possession operates independently of the date identifying the lease agreement. [See Form 552 §5]

On expiration of the lease term on the date stated in the lease agreement, the lease (right to possession) automatically terminates and the tenant must have vacated without further notice by either the landlord or tenant. [CC §1933]

On expiration of a lease, a holdover tenancy, called a *tenancy-at-sufferance*, is created when:

- the tenant remains in possession after the lease term expires; and
- the landlord refuses to accept further rent payments.

The holdover tenancy ends when the tenant vacates or is evicted, or the landlord accepts rent during the holdover period permitting the occupancy.

The lease agreement contains a holdover rent provision calling for a set dollar amount of rent due for each day the tenant holds over. The rent is due and payable when the tenant vacates or is evicted. The daily rent should be significantly higher than the fair market rate, although an excessive amount is unenforceable in a UD action since it is unreasonable. [See Form 552 §2.3]

If the amount of holdover rent is not set in the lease agreement, a fair market rate will be recoverable during the holdover (which is also the ceiling for rent awarded in a UD action for the holdover).

The landlord can initiate UD proceedings to evict the holdover tenant immediately after the lease expires. [CCP §1161(1)]

However, the landlord who accepts rent for any period of occupancy falling after the lease expires and before the tenant vacates creates a periodic tenancy. To terminate the resulting periodic tenancy, the landlord must serve the tenant with a 30-day notice to vacate the premises before he can evict the tenant. [**Palmer** v. **Zeis** (1944) 65 CA2d Supp 859; see **first tuesday** Form 571]

Delivery and acceptance of possession

Provisions in a lease agreement pertaining to the date for delivery of the leased premises to the tenant address the landlord's failure to deliver up the premises to the tenant. [See Form 552 §5]

The tenant is given the opportunity to terminate the lease agreement if possession is not delivered within an agreed-to number of days after commencement of the lease term. [See Form 552 §5.1]

A landlord sometimes fails to deliver possession to the tenant due to his inability to recover the premises from a previous tenant. To cover the risk, the lease agreement should state the tenant will not be liable for rent payments until possession is delivered. [See Form 552 §5.2]

Further, the lease agreement should state the landlord will not be liable for damages if he is unable to deliver possession. [See Form 552 §5.3]

Eminent domain

A tenant can contract away his right to receive any compensation awarded to the landlord in a condemnation action. [**New Haven Unified School District** v. **Taco Bell Corporation** (1994) 24 CA4th 1473]

Thus, nonresidential leases drafted by landlords or trade associations typically reserve for the landlord all rights to any condemnation award under the *eminent domain provision*. [See Form 552 §21]

Also, the landlord may reserve his right to terminate the lease in the event of a partial condemnation. If the landlord does not choose to terminate the lease when a **partial taking** occurs, the tenant is entitled to a rent abatement for the reduction in value of the leasehold interest.

A tenant under a lease has a right to receive compensation for his leasehold interest if his lease is terminated due to a condemnation proceeding. [CCP §1265.150]

Since the lease provisions eliminate the tenant's rights to any compensation awarded to the landlord, the tenant must look to the condemning authority to recover other losses, such as:

- relocation costs;
- loss of goodwill;
- bonus value of the lease (due to below market rent); or
- severance damages if a partial taking occurred.

Brokerage fees

Initially, the responsibility for paying any brokerage fees for leasing services is controlled by employment provisions in an authorization to lease or property management agreement entered into by the tenant or the landlord and their respective brokers.

Second, and of equal effect as a separate underlying fee agreement, is the placement of a brokerage fee provision within the tenant's offer to lease or LOI signed by the tenant.

Lastly, a provision for payment of the broker fees is included in the lease to allow enforcement in case the broker failed to obtain a prior written commitment from either the tenant or the landlord to pay the leasing agent's fee or to pay fees which will later be earned on lease extensions or purchase of the property by the tenant. [See Form 552 §24.1]

Miscellaneous provisions

An *attorney fee provision* is essential in a lease agreement if the landlord is to recover costs incurred to enforce payment of rent or evict the tenant. Regardless of how an **attorney fee provision** is written, the prevailing party, if any, is entitled to his fee. [CC §1717(a); see Form 552 §25.2]

The *heirs, assigns and successors clause* binds those who later take the position of the landlord or tenant, by grant or assignment (privity of estate), or by an assumption (privity of contract). [**Saucedo** v. **Mercury Savings and Loan Association** (1980) 111 CA3d 309; see Form 552 §25.3]

A *choice-of-law provision* assures application of California rules of law should a dispute arise with a tenant regarding the lease. [See Form 552 §25.4]

Application of California law in disputes over property located in California adds stability to the legal expectations of the landlord and tenant under the lease, produces greater commercial certainty in real estate transactions and stabilizes property values.

Also, the lease agreement must reflect the entire agreement between the parties and should be modified only in writing.

An *entire agreement clause* serves two key purposes. An entire agreement clause limits:

- the tenant's ability to imply terms into the lease based on oral statements **made before entering** into the lease agreement; and
- the **later oral modification** of lease terms and the attendant disputes over "just what are" the terms of the oral modification.

The tenant's performance of lease obligations may also be *secured* by a trust deed encumbering real estate owned by the tenant (or others) or be guaranteed by a corporate user's officer or another person. [See **first tuesday** Form 451; see Form 552 §§25.6 and 25.7]

If the tenant fails to pay rent or otherwise breaches the lease, the landlord can evict the tenant and, after a demand for payment, foreclose under the performance trust deed to recover rent due under the lease, attorney fees and costs of the trustee's sale. [**Willys of Marin Company** v. **Pierce** (1956) 140 CA2d 826]

Signatures on behalf of the parties

Individuals who sign a lease agreement on behalf of the landlord or the tenant must have the capacity and the authority to act on behalf of and bind the landlord or tenant. [CC §§2304, 2307]

When a corporation enters into a lease, the officers signing the lease agreement are given authority to bind the corporation by a *corporate resolution* from the board of directors of the corporation. [Calif. Corporations Code §300]

Unless the landlord is aware that the persons signing do not have authority to enter into a lease on behalf of the corporation, the lease entered into by a corporate tenant is valid if it is signed by:

- the chairman of the board, president or the vice president; and
- secretary, any assistant secretary, chief financial officer or assistant treasurer. [Corp C §313]

However, a corporate resolution is the best evidence of the corporate officers' authority to act on behalf of the corporate tenant.

When a LLC or LLP enters into a lease agreement, the **manager** signing on behalf of the LLC or LLP to bind the entity to the lease must be the person named as the manager in the LLC-1 or LLP-1 certificate filed with the Secretary of State and recorded with the local county recorder.

However, an LLP or an LLC will be bound to a lease agreement if a partner or member, other than the general partner or manager, signs the lease agreement and the landlord believes the partner or member is acting with the authority of the entity due to their title as chairman or president. [Corp C §17154(c)]

The economics of nonresidential leases

Nonresidential lease agreements are used in transactions involving industrial, commercial, office and other types of nonresidential income-producing property.

A tenant who acquires a leasehold interest in nonresidential real estate agrees to be obligated for none, some or all of the operating costs of the real estate, as rent due in addition to payment of the base rent and periodic adjustments.

Editor's note — A residential lease agreement usually provides for the tenant to assume no care and maintenance responsibilities for the property except for excess wear and tear which may occur during his occupancy.

Typically, the longer the term of the nonresidential lease, the more extensive the shift of ownership costs and responsibilities to the tenant, including:

- property operating expenses;
- all or future increases in real estate taxes, called *ad valorem taxes*;
- hazard insurance premiums;
- repair and maintenance; and
- the risk of an increase in interest payments on an adjustable rate loan encumbering the property.

When a long-term lease obligates the tenant to pay for all expenses incurred in the ownership and operation of the property, the tenant incurs the expenses in one of two ways:

- directly, where the tenant contracts for services and pays the cost, including taxes and insurance premiums; or
- indirectly, when the landlord incurs the expenses and then bills the tenant for payment, such as common area maintenance charges (CAMs).

The responsibility for the payment of operating costs is reflected in the reference to nonresidential leases as **gross** or **net**, with variations on each.

Leasing agents have no universally accepted definitions or guidelines for titles they use to identify the economics of a lease, and the classifications for leases are forever changing. Often, agents must clarify with each other the type of lease their clients intend to enter.

A nonresidential lease is typically called a *gross lease* if the tenant pays for his utilities and janitorial fees, but is not responsible for any other care, maintenance or carrying costs of the property.

In a lease for space in an office building, when the landlord retains the responsibility for payment of all costs of care and maintenance, including the tenant's utilities and janitorial services, the lease used is referred to as a *full-service gross lease*.

Conversely, a nonresidential lease that transfers to the tenant the obligation to pay some or all of the costs and responsibilities of ownership, in addition to utilities and janitorial services, is referred to as a *modified gross lease* or *net lease*.

A lease becomes more *net* (and less gross) for the landlord as he shifts more ownership responsibilities and operating costs to the tenant.

The modified gross or net lease is the most commonly used lease agreement in nonresidential properties, other than for multiple tenant office buildings or large multi-tenant industrial projects.

When a lease passes on the responsibility for all costs and maintenance of the property to the tenant, either directly or through CAMs, leaving the landlord responsible for capital improvements only, such as structural repairs or replacement, the lease is referred to as a *net-net-net* or *triple-net* lease in the industry.

When a tenant assumes absolutely all ownership duties under a lease agreement, and the landlord merely collects rent payments without concern for his management of the property, the lease is called a *pure net lease*.

Reformation of the lease agreement

During lease negotiations, a landlord orally assures a tenant he will enter into a lease for an initial term of five years with two five-year options to renew. Written offers to lease or LOIs are not prepared.

However, the lease agreement the landlord prepares and hands to the tenant sets the lease term at 15 years. Without reviewing the lease agreement, the tenant signs the lease agreement and takes possession of the premises.

The business operated by the tenant on the leased premises later fails, and the tenant defaults on the rent payments. The tenant then discovers for the first time the length of the lease term is 15 years. The landlord seeks to collect the unpaid rent for the 15-year period under the lease agreement (subject to any mitigation and present-worth discounting).

The tenant seeks to *rescind* the lease agreement due to the landlord's oral misrepresentation about the length of the lease term. The tenant claims the lease provisions contradict the oral agreement made by him and the landlord before the lease was entered into.

Can the tenant rescind the lease agreement?

No! The landlord's oral representations regarding the lease term prior to execution of the lease agreement do not render the lease unenforceable. The terms of the lease set forth in the written lease agreement control over prior oral understandings. [**West** v. **Henderson** (1991) 227 CA3d 1578]

Rescission of lease agreements is rare since intentional misrepresentation or other *fraud in the inducement* must be shown.

Now consider a landlord who accepts a tenant's written **offer to lease**. A lease agreement called for in the tenant's offer is prepared by the landlord. However, the lease term stated in the lease agreement differs from the term set forth in the written offer to lease. The tenant accepts the lease without review.

Later, the tenant discovers the discrepancy between the two documents. Instead of attempting to *rescind* the lease, the tenant *reforms* the lease by court order to conform it to the underlying written offer to lease on which the lease was to be based, called a *reformation action*.

Another reason for *reformation* of lease provisions arises when a significant difference exists between the square footage contained in the leased space and the square footage given in the lease for calculating rent.

Chapter 42 Rent provisions in nonresidential leases

This chapter examines the principles and application of rent provision formulas, inflation and market appreciation adjustments, and reimbursement of operating expenses in nonresidential lease agreements.

The landlord's future return

By entering into a lease agreement, a landlord conveys to the tenant a possessory interest in real estate for a period of time, called *the lease*, in exchange for a tenant's promise to make dollar payments in the future, called *rent*.

Residential leases usually are for one year and their agreements provide for a **fixed amount** of monthly rent paid in dollars during the term of the lease. In contrast, nonresidential leases are for longer periods and their agreements contain rent adjustment clauses to ensure the landlord will receive the maximum future return available in the rental market for his income property, even if the lease is negotiated during an economic downturn.

The economic function of a long-term nonresidential lease agreement for the landlord is similar to that of a note and trust deed carried back by a seller of real estate or held by a lender. The documentation in both cases, lease agreements and note and trust deeds, is almost exclusively concerned with the debt owed and the maintenance of the real estate.

Just as a trust deed note evidences the debt owed a carryback seller or a lender, rent provisions in a lease agreement evidence the debt owed to the landlord. Both the lender and the landlord are creditors of the person holding the right to possession of the real estate. The lender holds a security interest in the property until he is paid in full while the landlord holds a right of reversion until he is paid in full.

The lender's trust deed outlines the responsibilities of the borrower for the care and maintenance of the secured real estate, as the care and maintenance provisions in a landlord's lease agreement do for the tenant.

If the owner of the real estate encumbered by the trust deed fails to pay on the trust deed note or breaches the care and maintenance provisions in the trust deed, the creditor forecloses. The owner loses his interest in the real estate due to his uncured default.

Likewise, if the tenant fails to pay rent or breaches the care and maintenance provisions in the lease agreement, the landlord terminates the tenant's right to possession of the property, and the tenant loses his interest in the property if the default is not cured.

The termination of these possessory rights held by tenants or owners in nonresidential real estate can be accomplished without extinguishing or canceling the tenant's or the owner's obligation to pay any loss incurred under the lease agreement or the trust deed note. [Calif. Civil Code §1951.2; Calif. Code of Civil Procedure §725a]

Rent provisions and the NOI

The base monthly rent and all other monies paid to the landlord under the lease, except security deposits, are considered rent payments.

The rent payments a landlord receives from all tenants constitute his *actual gross income* from the property.

The rental amounts and the terms of their future payment as set by the rent provisions greatly influence:

- the *market value* of the real estate;
- the availability of *long-term financing*;
- the property's attractiveness to *potential buyers*; and
- the landlord's *future return* on his investment.

The *market value* of nonresidential income property is based primarily on its net operating income (NOI). A property's NOI is composed of the property's gross income less operating expenses. Without rental income flow, improved real estate has little value.

The present and projected NOI is relied on extensively by buyers and lenders when evaluating a property.

The NOI is capitalized at the current yield sought, and sets the property's fair market value for the price (present worth) a buyer will pay, and the amounts a lender will lend.

Lenders limit loan amounts lent on property based on, among other conditions:

- the real estate's NOI; and
- the financial strength of the tenants to meet their obligations.

Likewise, buyers determine what purchase price will be offered based on, among other things:

- the property's NOI;
- a review of the tenants' financial track records; and
- the controllability of the landlord's operating costs.

Thus, the leasing agent or property manager negotiating a nonresidential lease on behalf of the landlord must make certain the landlord has considered whether the *economics of the lease* will produce rents and control costs effectively to produce maximum returns now and in the future.

Setting the rent

Various rent formulas exist to meet the economics of the marketplace and the financial needs of the landlord and tenant. In all nonresidential lease agreements, a minimum amount of monthly rent is agreed to for payment, called *base rent*. [See **first tuesday** Form 552 §3.4]

Typically, the base rent is the monthly amount paid during the first year of the lease, except for percentage leases. However, in many short-term leases — two to five years — the base rent is paid during the entire term of the lease, without an adjustment.

A lease agreement which sets monthly rent payments at a specific dollar amount over the entire life of the lease results in what is called a *fixed-rent lease*. [See Figure 2 §3.2 accompanying this chapter]

In a rising local economy or period of general price inflation, a fixed rate of rent on a long-term lease will prove to be a financial disaster for the landlord. Fixed rent shifts the inflation hedge appreciation in the property's value to the tenant for so long as the fixed rent continues.

However, a landlord may be forced to accept fixed-rent provisions in lease agreements negotiated during an economic downturn or static rental market, if he is to keep the space occupied. To avoid a potential loss of return under a fixed rate lease during the ensuing economic recovery, a short-term lease or month-to-month tenancy should be negotiated by the landlord.

When leasing space in larger, multi-tenant retail properties, landlords often negotiate a rent provision that calculates the total amount of rent the tenant will pay as a percentage of the tenant's gross sales, called a *percentage lease*. The tenant, under a **percentage lease**, annually pays the greater of the base rent or the percentage rent. [See **first tuesday** Form 552 §3.5]

Many nonresidential lease agreements contain provisions under which the **base rent** is adjusted periodically, usually on each anniversary of the lease commencement and again every four to six years, to reflect changes in:

- **annual price inflation** affecting the property's rental value due to conditions reducing the purchasing power of the U.S. dollar, called a *Consumer Price Index (CPI) clause*; and
- **periodic property appreciation** due to economic changes in local market conditions, such as population density, age demographics, traffic count, visitors or personal income and spending habits, that increase demand and the rental value of the property, called an *appreciation clause*. [See **first tuesday** Form 552 §§3.4, 3.6]

As an alternative to the CPI, the base rent can be adjusted annually based on an agreed percentage or dollar amount over the prior year's rent, called *graduated rent*. [See **first tuesday** Form 552 §3.3]

The lease agreement rent provisions must precisely state any rent adjustment formulas to be enforced by the landlord.

Setting the grace period and late charge

The nonresidential lease agreement must, as the minimum terms of rent for enforcement, indicate:

- the **dollar amount** of the rent;
- the **time** for payment;
- the **place** for payment; and
- the **manner** of payment. [**Levin** v. **Saroff** (1921) 54 CA 285]

For the landlord to receive rent in advance, namely prepaid at a time before it *accrues*, the lease agreement must include a provision stating the tenant will pay rent in advance. [CC §1947; see Form 552 §3.1]

Rent payments not paid as they become due are not delinquent until the time has passed for a late charge to be incurred, called a *grace period*. When a late fee is not agreed to in the note, a grace period does not exist. Rent is delinquent if not paid on or before the due date, usually the first day of the month. In nonresidential (and residential) lease agreements, the grace period is negotiable by the landlord and the tenant without legal restriction regarding its length in time. [See **first tuesday** Form 552 §3.8]

Having agreed to a grace period, the landlord cannot serve a 3-day notice to pay until the grace period expires. [See Chapter 26]

The grace period may be:

- the time period stated in the lease agreement; or
- a time period set by the landlord's conduct of consistently accepting rent on a date later than the expiration date for the grace period without demanding payment of a late charge. [**Baypoint Mortgage** v. **Crest Premium Real Estate Investments Retirement Trust** (1985) 168 CA3d 818]

The landlord may provide for a late charge to reimburse himself for his collection efforts due to the delinquency of rent. The charge must be reasonably related to the landlord's out-of-pocket money losses incurred during collection efforts or the delay in receipt of the untimely payment.

Late charges are typically assessed in leases as either a percentage of the rent due or a flat rate charge. The flat rate charge should approximate the costs incurred to enforce collection and the loss of use of the rent money. In addition to dollar amounts equivalent to reimbursement of collection costs, the accrual of interest on any delinquent amount is often included to cover the loss of use of the rent. [See **first tuesday** Form 552 §3.9]

Place and manner of payment

Rent is paid in United States dollars at a set location, such as at the landlord's or leasing agent's office, either personally or by mail. [See **first tuesday** Form 552 §3.7]

However, rent does not have to be paid with money. Rent can be paid by the delivery of crops, precious metals, services, or currencies or assets other than those denominated in United States dollars. [**Clarke** v. **Cobb** (1898) 121 C 595]

The manner of rent payment also is set forth, typically cash, check, credit card, electronic transfer or other means of transmitting funds.

For checks returned for insufficient or unavailable funds, the lease agreement must include a flat rate charge in order for the landlord to shift this expense item to the tenant. [See **first tuesday** Forms 552 §3.10]

If the tenant develops a history of writing checks on insufficient funds, the landlord can require, on a written 30-day notice, payment of rent in cash or by money order. [See **first tuesday** Form 552 §3.10]

Square footage sets the rent

In nonresidential leases for industrial, commercial, office and retail space, the dollar amount of the base rent is generally agreed to as a result of multiplying the total number of square feet rented by a per-square-foot rate.

For example, a tenant leases 4,000 square feet at $2 per square foot. The base rent is set for the lease as $8,000 payable monthly.

The per-square-foot rent formula is used to negotiate the specific dollar amount of rent stated in the lease agreement. The per-square-foot formula used in negotiations usually is not mentioned in the lease agreement unless the footage is uncertain at the time the lease is entered into.

When either the base rent or additional rent, such as common area maintenance (CAMs) expenses, is based on square footage stated in the lease, the space attributable to the leased premises should be clearly defined and accurately measured. Rents determined per square foot exist in many office, commercial and industrial projects.

To avoid disputes, the landlord and tenant must agree on how the square footage will be measured:

- from the interior walls;
- from the middle of the walls;
- from the exterior of the walls; or
- to include a portion of the common hallways, lobby, restrooms or other interior areas of the structure.

Lease audits undertaken by existing tenants often establish a lesser square footage amount than the footage represented by the owner and relied on by the tenant to set the rent and share of operating costs.

The standard for determining how the square footage will be measured is negotiated through the offers and counteroffers to lease, and the competitive availability of space.

Additional rent and other sums due

As additional rent to the base rent or as future periodic adjustments in the base rent, the tenant may agree to pay some or all of the operating expenses of the leased property, called a *common area maintenance* (CAMs) clause. [See Figure 1 §4.6 accompanying this chapter]

The objective for the landlord in seeking CAMs is to provide a constant monthly **net income flow** on his investment in the property — a steady flow of income despite fluctuations in the cost of operating the property.

Property operating expenses typically include:

- utilities;
- property management;
- repairs and maintenance;
- hazard insurance premiums;
- security; and
- real estate taxes and assessments. [See **first tuesday** Form 352]

The allocation of the responsibility for operating expenses depends on:

- the type of property and its use;
- the relative bargaining positions of the landlord and tenant in the current real estate market;
- the financial objectives of the landlord and tenant; and
- the length of the lease term.

The landlord and tenant can agree the property operating expenses will be paid by the tenant directly to the provider or creditor, or indirectly to the landlord as a reimbursement.

Taxes and assessments

Tenants with long-term leases often agree to pay some or all of the real estate taxes, insurance premiums and special assessments when the leased premises is an industrial or single-use building.

Property is reassessed by the county assessor when the landlord sells his interest, even if the tenant remains in possession. [Calif. Revenue and Taxation Code §60]

Should the landlord sell the leased property and cause the tenant to face higher real estate taxes due to reassessment, the increase is caused by the owner's conduct, not by the tenant's use of the property. [See Figure 1 §4.5]

Figure 1 *Excerpted from **first tuesday** Form 552 — Nonresidential Lease Agreement*

4. **OPERATING EXPENSES:**

4.1 Tenant is responsible for payment of utility and service charge as follows: _____

4.2 Landlord is responsible for payment of utility and service charge as follows:_____

4.3 Tenant to pay all taxes levied on Tenant trade fixtures installed on the premises.

4.4 Should Landlord pay any charge owed by Tenant, Tenant shall pay, within ten days of written demand, the charge as additional rent.

4.5 As additional rent, Tenant to pay _____% of all real property taxes and assessments levied by governments, for whatever cause, against the land, trees and building containing the leased premises, within 30 days after written computation and demand from Landlord.

4.6 As additional monthly rent, Tenant to pay _____% of the Common Area Maintenance (CAM) incurred each month, within ten days of written statement and demand for payment.

a. Common Area Maintenance is the cost of maintaining and operating the "Common Areas," including all sidewalks, corridors, plazas, hallways, restrooms, parking areas, interior and exterior walls and all other open areas not occupied by tenants.

b. Common Area Maintenance includes "all charges" for garbage removal, janitorial services, gardening, landscaping, printing/decorating, repair and upkeep, utilities and other operating costs, including charges for property management of the Common Area Maintenance.

A savvy tenant will demand a **cap on any rent** increases due to reassessment caused by the landlord. When a cap is agreed to in the lease, such as a 2% annual increase, the landlord is responsible for any property tax increases exceeding the ceiling. However, the tenant should always be held responsible for the payment of assessments and taxes caused by his own improvements and trade fixtures. [See Figure 1 §4.3]

Common area maintenance

The landlord and tenant can also agree to allocate some or all of the landlord's cost of maintaining the common areas to the tenant for reimbursement to the landlord. [See Figure 1 §4.6]

The cost of maintaining the common areas when reimbursed by the tenant is **additional rent**, called *CAM charges*. Customarily, CAM charges are based on the ratio between the space leased by the tenant and the total rentable space in the project.

The term "common areas" is broadly defined to include sidewalks, corridors, plazas, halls, restrooms, parking facilities, grounds, etc.

The term "maintenance" is defined to include garbage removal, janitorial services, gardening and landscaping, repairs and upkeep, utilities and other specified operating costs.

Utility charges

The utilities provision covers the cost of utilities used in the space leased by the tenant, as opposed to the utilities required to operate the common areas. [See Figure 1 §§4.1 and 4.2]

To protect against the increased cost of utilities consumed by the tenant, the landlord who pays for utilities can negotiate to pass the responsibility on to the tenant. The landlord can determine the tenant's pro rata share, or have each leased premises privately metered to determine the charge for the tenant's consumption.

Tenants who use a lot of energy and utilities should be required to contract with the utility companies themselves.

As a practical matter, the landlord should avoid paying the utilities whenever possible, except, perhaps, for water. However, if the landlord pays the utilities and charges the tenant, the charge is additional rent to all other rent agreed to be paid.

Chapter 43 Adjustable rent provisions

This chapter discusses the various adjustable rent clauses used in nonresidential leases.

Economic goals of nonresidential landlords

Rent works to provide a yield on an investment in real estate, as does dividends and interest on stocks and bonds. A lender receives *interest* for the use of money lent for a specific period of time. Likewise, a landlord receives *rent* for the use of property let for a specific period of time.

At the end of the respective right-to-use periods, both the money and the real estate are returned.

Like interest provisions in a note, **rent provisions** in a nonresidential lease agreement should anticipate future market changes that will affect the investment (value, income, expenses and debt) by structuring the rent provisions to conform the rent income to match the anticipated changes.

Fixed-rent leases do not anticipate future changes in the investment's fundamentals. However, variable or adjustable-rent leases do anticipate changes negatively affecting the owner's net operating income or spendable income, unless shifted to the tenant by way of an equal increase in rent.

Types of adjustable rent

The three basic types of rent adjustment provisions found in nonresidential leases, sometimes called *rent escalation clauses*, are:

- *graduated rent* provisions [See Figure 1 accompanying this chapter];
- *inflation adjusted rent* provisions [See Figure 2 accompanying this chapter]; and
- *appreciation adjusted rent* provisions. [See Figure 3 accompanying this chapter]

The **economic goals** a leasing agent must review with his nonresidential landlord-client when negotiating provisions for future rents include:

- adjustments for the lost purchasing power of the dollar due to future *price inflation*;
- adjustments in rent to reflect the *rate of appreciation* on comparable properties (beyond the rate of inflation); and
- the absorption or pass-through of increased expenditures for operating expenses and interest adjustments on mortgage debt.

To protect the property's income, and in turn its value, against a loss in the **US dollar's purchasing power** due to inflation, rent can be periodically adjusted based on a price inflation clause in the lease agreement. An inflation clause calls for periodic rent increases based on figures from an inflation index, such as the Consumer Price Index (CPI) or the Cost of Funds Index. [See Figure 2]

Further, and to attain rents which reflect an increase in the property's dollar value brought about by **local appreciation**, rent can also be adjusted periodically (for example, every three years) to rent amounts received by comparable properties. [See Figure 3]

Also, increased **operating and ownership costs** can be absorbed directly or indirectly by the nonresidential tenant by passing on the responsibilities for:

- all the operating expenses, or only future increases in the expenses, by including a clause calling for the tenant to pay specific expenses; or
- a pro rata share of **common area maintenance** expenses (CAMs), property taxes and hazard insurance premiums. [See Chapter 37]

Future increases in the cost of carrying debt on the property due to **variable interest rate** mortgage financing can also be passed on to the tenant as increased rent to provide the landlord with a triple-net or pure-net lease.

With knowledge and understanding about the economic and financial consequences of the terms submitted by a tenant in an **offer to lease** or letter of intent (LOI), the landlord can make an informed financial decision whether to accept, counter or reject the tenant's offer to lease.

Graduated rents from year to year

Rents bargained for during periods of high vacancies and few prospective tenants are often below market for the initial year or two of a lease, comparable in purpose (and timing) to the initial *teaser* or *qualifying* rates for adjustable rate loans (ARMs) and graduated payment loans (GPMs).

Likewise, a **graduated rent** clause increases the initially low, monthly rent semi-annually or annually in pre-set increments. The amount of the periodic upward adjustment is set at a specific dollar amount or a percentage of the initial rent or rent paid during the prior period. [See Figure 1]

Graduated rent adjustments are not determined by use of index figures or formulas dependent on data from other sources at the time of the adjustment. The rent amounts are negotiated and set on entering into the lease agreement.

Also, any below-market rents paid in the early years are often picked up in future rents that will exceed market rents, as though the lease had a negative amortization feature taken from ARM loans.

For example, the base monthly rent might be increased, or graduated, each year on the anniversary of the lease by:

Figure 1 *Excerpted from **first tuesday** Form 552 — Nonresidential Lease Agreement*

3.3 ☐ Monthly rent, from year to year, is graduated on each anniversary month as follows:

Initial year's monthly rent to be $_____, and

a. _____% increase in monthly rent over prior year's monthly rent; or

b. First anniversary monthly rent.....$_____

Second anniversary monthly rent.....$_____

Third anniversary monthly rent.....$_____

Fourth anniversary monthly rent.....$_____

- a pre-selected dollar amount; or
- 5% of the base rent set forth in the lease agreement for the first year.

A graduated payment provision with annual rent increases can also be structured based on a *percentage* increase over the prior year's monthly rent, a *compounding of rents*.

For example, the monthly payment during the last year of a graduated payment plan would become the base rent for annual CPI inflation adjustments to set rates annually for the remaining term of the lease.

Future rent increases after the graduated rents have reached the projected market rent amount will be set under a price inflation clause.

Percentage rents and the base rent

Now consider a tenant operating his business in a premises under a **percentage lease**. The **base rent** is a fixed monthly dollar amount during the first 12 months of the lease.

The calculations for the **alternative minimum annual rent** is set at 7% of the tenant's gross sales. The tenant will pay a total rent equal to the greater amount of the base rent or the alternative percentage rate.

The landlord and tenant also agree the base rent for each year will be increased by 2% of the base rent for the previous year, called a *compounded base rent*. Alternatively, the base rent could (and should) be increased by agreement at the rate of inflation which took place during the period prior to the adjustment. A **price inflation adjustment** to the base rent increases the floor for the least amount due as rent each year.

Thus, the annual adjustment to the base rent provides a *floor rent* for a minimum rate of return on the landlord's investment throughout the lease term should the tenant's business suffer a downturn or a drop in annual gross receipts.

Price inflation adjustments

To annually adjust the base rent to compensate for price inflation due to the dollar's continuing loss of purchasing power, a *price inflation clause* or *CPI clause* can be included in the lease agreement. [See Figure 2]

Inflation adjustments are usually made on each anniversary of the commencement of the lease. Adjustments are based on the annual percentage change in figures from the CPI for the region in which the real estate is located.

The CPI clause can be used to establish the annual rent adjustment in one of two ways:

- a base-year to current-year increase; or
- a year-to-year increase for a compounding effect.

The unpredictable cyclical movement of future price inflation both lulls and infuriates landlords. Thus, for landlords, the rent inflation clause should be boilerplate in every lease running for a period of more than three or four years — if the competitiveness of the marketplace allows for its inclusion.

Occasionally, landlords will ignore the CPI as a basis for inflation adjustments and use a set annual percentage increase of 3% or 4% in its place, which of course is back to graduated rent schedules in an effort to either out-guess or exceed inflation rates.

Figure 2 *Excerpt from **first tuesday** Form 552 — Nonresidential Lease Agreement*

3.4 ☐ Monthly base rent for the initial 12 months of the term is the amount of $_____, adjusted annually on the first day of each anniversary month by increasing the initial monthly base rent by the percentage increase between the applicable CPI-U index figures published for the third month preceding the month of commencement and the third month preceding the anniversary month.

a. The applicable CPI-U Index (Consumer Price Index for All Urban Consumer)(1982-1984 = 100) is:

☐ Los Angeles-Anaheim-Riverside, ☐ San Francisco-Oakland-San Jose,

☐ San Diego, ☐ National, ☐ Other: _____.

b. Rent increases under CPI-U adjustments are limited for any one year to an increase of _____%.

c. On any anniversary adjustment, should the CPI-U have decreased below the CPI-U for the prior twelve-month period, the monthly rent for the ensuing 12 months shall remain the same as the rent during the prior 12 months.

d. If the CPI-U is changed or replaced by the United States Government, the conversion factor published by the Government on the new Index shall be used to compute annual adjustments.

Periodic appreciation adjustments

If the CPI is the only rent adjustment provision used by the landlord over the life of a long-term lease, the landlord risks loss of any increase in rents in excess of the CPI that is enjoyed by comparable properties, called *appreciation*. The same risk of lost rent increases for appreciation exists when exclusively using graduated rent clauses (which tend only to cover inflation).

Value increase by appreciation is a local phenomenon, not a monetary one as is inflation. To reflect rent increases brought about by **local rental market** conditions, the landlord should consider a clause calling for periodic rent adjustments that increases the rent to meet current market rates, called an *appreciation* or *fair market rent clause*. [See Figure 3]

To make the rent adjustment, the base monthly rent is, as agreed-to in the lease, adjusted to a *reasonable amount* by the landlord every three to five years to reflect local market trends in comparable properties, or as otherwise agreed for adjustment by appraisal in the appreciation clause.

Thus, a lease agreement containing both an inflation clause and an appreciation clause assures the landlord will receive:

- an annual inflation adjustment increasing the amount of rent paid during the entire term of the lease to maintain the **purchasing power** of the rent amount received at the inception of the lease [See Figure 2]; and

Figure 3 *Excerpt from **first tuesday** Form 552 — Nonresidential Lease Agreement*

3.6 ☐ Every _____ years after commencement, including extensions/renewals, the monthly base rent will be adjusted, upward only, to current market rental rates for comparable premises, and computation of any future CPI-U adjustments will treat the year of each current market adjustment as a commencement year for selecting the Index figures.

a. The monthly rent during any year shall not be less than the previous year's monthly rent.

b. Landlord to reasonably determine and advise Tenant of the adjusted rental rates prior to three months before the adjustment becomes effective.

- a periodic adjustment in the amount of rent to reflect any future increases in rents for comparable properties exceeding the rate of inflation. [See Figure 3]

A provision can be included in the lease agreement for an appraisal process to set the amount of the appreciated rent if the tenant is concerned about his remedies if the amount set by the landlord as the appreciation adjustment is considered unreasonable.

Setting fair market rents

Consider a nonresidential lease agreement with a **use provision** calling for the tenant to operate a movie theater on the premises for ten years.

The lease agreement contains a rent appreciation clause stating the landlord will adjust the base rent in five years to reflect the then current *fair market rent*.

At the time for the appreciation adjustments five years later, the landlord determines the fair market rent for the property by using rent amounts received by comparable properties put to higher and better uses than a movie theater.

The tenant disputes the amount of the adjusted rent demanded by the landlord.

The tenant claims the fair market rental value of the premises should be based on the present use of the property as intended by the lease, since the lease agreement does not provide for the landlord to adjust the rent to reflect a return on the fair market value of comparable properties that have been put to a higher and better use.

Here, the lease agreement states the tenant will use the property to operate a movie theater for the term of the lease. Thus, the rent can only be adjusted to reflect the fair market value of the property based on its use as a movie theater. [**Wu** v. **Interstate Consolidated Industries** (1991) 226 CA3d 1511]

Chapter 44 Rent increases and the CPI

This chapter examines a landlord's use of rent adjustment provisions to shift the effects of inflation to the tenant.

Coping with inflation

A long-term investment goal of an owner of rental property is to generate income in the future sufficient to keep the property's value in line with market values of comparable properties, whether his property is residential or nonresidential.

Not only must the highest rate of occupancy be maintained to generate the maximum rental income, lease agreements entered into by the landlord must contain rent provisions calling for periodic rent adjustments which will maintain his **future rents** at market level during the terms of the lease.

For example, rent adjustments can be set to match the annual *price inflation* experienced in the region. Thus, rental income will increase from year to year to maintain the original purchasing power of the property's rental income over the term of the lease and extensions.

For decades prior to the mid-1970s, rent adjustments were of little concern as inflation and appreciation rates were more predictable. The 1980s saw marked increases in rents and operating costs to reflect the excessive inflation of the 1970s.

Then, rents declined and appreciation rates in California reversed in the early 1990s, stabilizing during the late-1990s. After the turn of the century, rents again began to increase, exceeding the rate of inflation as reflected in the *Consumer Price Index* (CPI), with the exception of locations with high concentrations of the information technology industry. By 2007, rent increases began to stabilize in all areas and on all types of properties, as the real estate boom years of the mid-2000s came to an end.

Unlike *appreciation* of a property which is based on the demographics of its location, consumer *inflation* is a decline in the quantity of a consumer item (square footage of space) a dollar will buy (rent) due to a general price increase for the same item (comparable space).

Inattentive landlords and those who fail to anticipate trends in inflation often saddle themselves with long-term lease agreements containing rent provisions which do not adjust rent for **inflation** or **appreciation**. Since future rents are formulated in lease agreement rent provisions, the worth of the property, and thus its equity, can be calculated at any time during the term of the lease based on the capitalization rate applied by investors at that time. [See **first tuesday** Form 552 §3]

Lease provisions establishing future rents can be economically disastrous in long-term leases and in leases with renewal options unless rent is periodically increased in a dollar amount equal to the rate of both dollar inflation and local domestic appreciation.

However, a number of methods exist to keep pace with price inflation, property value appreciation and increases in the landlord's *operating and ownership costs* occurring over the term of a lease.

CPI covers price inflation

The best method for coping with the uncertain impact of **future inflation** is to tie the amount due as future rents to figures published in the federal government's *Consumer Price Index* (CPI).

Nonresidential lease agreements typically set a base monthly rent which is constant for the first year. For the following years, annual rent is adjusted by factoring in the annual change in local or regional CPI figures. For residential rent increases, most rent control communities use a form of the CPI to allow for the amount of automatic annual rent adjustments permitted by ordinance.

Residential leases rarely exceed one year. Thus, most residential lease agreements do not need to address an adjustment in monthly rents to compensate for inflation. Rent increases are negotiated at the end of the leasing period and set based on comparable market rates or, in noncompetitive communities, as dictated by rent control.

CPI and its regions

Consumer Price Index (CPI) figures are published monthly, bi-monthly or semi-annually by the U.S. Bureau of Labor Statistics for numerous metropolitan areas across the states. The CPI is the most widely used indicator of inflation.

The CPI measures the overall price change from month to month, up or down, for a "basket" of consumer goods and services that everyday people are believed to buy or consume. The CPI-U is based on the price of food, clothing, shelter, fuel, transportation fares, charges for doctors and dentists, drugs and other goods bought for day-to-day living.

Real estate lease agreements with provisions for annual adjustments based on the **rate of inflation** most commonly use inflation figures from the regional CPI-U, the CPI for the area's urban consumers. A regional CPI-U covers the buying habits of approximately 80% of the population within the designated area.

The three CPI regions within California are:

- Los Angeles-Anaheim-Riverside (issued monthly);
- San Francisco-Oakland-San Jose (issued bi-monthly); and
- San Diego (issued semi-annually).

If property does not fall within or near one of the regions, a landlord may also use the CPI-U for a larger geographical area such as:

- the West Region CPI-U; or
- the U.S. City Average CPI-U.

Issuance date for the CPI figure

Every ten years, the Consumer Price Index (CPI) program undergoes major revisions. Part of the revisions, which last became effective January 1998, included a change from the monthly issuance date for the San Francisco-Oakland-San Jose CPI-U.

The San Francisco-Oakland-San Jose CPI-U is now issued bi-monthly covering consumer expenditures for two months — the month of issuance and the preceding month. The bi-monthly CPI-U for the San Francisco area is issued on even-numbered months such as February, April, June, etc.

Thus, the landlord with an adjustment index tied to the January CPI-U for the San Francisco-Oakland-San Jose area uses the CPI-U which comes out in February.

However, the landlord who chooses the San Francisco-Oakland-San Jose CPI-U may instead wish to switch to a larger geographical area CPI-U index which is issued on a monthly basis. For example, the landlord can consider using the West Region CPI-U.

If the landlord seeks to switch to a different index during the life of a lease, the landlord and tenant must agree to the use of the new index.

Inflationary cycles and the CPI

A few basic principles of real estate economics need to be considered when using Consumer Price Index (CPI) figures to adjust rent to reflect the effect of inflation on the purchasing power of rental income.

First, real estate values tend to increase in excess of inflation during periods with low rates of inflation and the accompanying low long-term interest rates (and capitalization rates set by buyers) such as existed during the real estate boom of 2004 to 2006.

In contrast, real estate values go flat or decrease during periods of increasing and high rates of inflation due to the accompanying and inevitable higher short term interest rates and investment capitalization rates.

The longer the period of low or high inflation, the more distorted real estate **valuations** become, up or down, contrary to the movement of inflation and long-term interest rates, closely comparable to the effect of inflation on the bond market.

When interest rates and inflation stay high, market rents tend to rise, initially tempered by any excessive construction or speculation in the preceding 18 to 24 months. This holds true even though the property's value remains static or drops, usually due to an upward revision in capitalization rates for returns sought by investors in an effort to maintain a *real rate* of return, a margin of earnings beyond inflation.

Conversely, when rising interest rates and inflation top off and decline (generally heralding the end of a rescission), rents flatten out and tend to drop. During the following business recovery period, property resale values tend to rise, unless held down by an extended regional recession as occurred in California during the mid-1990s. The late 2000s will most likely see interest rates and rental rates receding over the short term from the 2006 levels as vacancies and foreclosures greatly increase.

Two reasons exist for a parallel movement of rent and inflation.

First, **higher long-term interest rates** which initially result from rising inflation, excessive construction and slowing real estate sales. In response, investors and brokers turn their attention to the more efficient management of existing properties which then produce more income (since the properties cannot now be sold at the price sought).

Second, since high interest rates and inflation stifle new construction, the supply of **new space** available for occupancy is cut off. Fewer starts ultimately cause rents to increase if the population remains static or increases, unless serious overbuilding has occurred which outpaced the demand for housing by households, space for nonresidential occupancy and speculators. Dramatically rising foreclosure rates throughout the state which began in 2006 will displace many households and leave even more property vacant to be purchased or rented by households.

The key to the management of rental property in times of increased inflation and higher interest rates is to produce earnings from **net operating income** (NOI), not profits on immediate resale.

On the other hand, when interest rates and inflation top off and begin to decline, real estate sales increase and less attention is paid to a property's income production. Historically, California real estate owners and brokers, driven by increasing population, tend to focus more on profit-taking from increasing values than on the efficient management of a property's income flow and operating expenses.

The long real estate recession in the 1990s up to 1996 with its declining values altered the focus from sales to property management, probably temporarily due to a general lack of hindsight among households and speculators about home ownership as evidenced during the 2004-2006 real estate boom.

When prices rise during periods of lower capitalization rates, reduced inflation and falling interest rates as happened after September 11, 2001, owners become increasingly more inclined to put their property on the market for sale, rather than bring rents into line.

How CPI works

Rent cannot be increased during the term of a lease absent an adjustment provision in the lease agreement. For instance, rent payments under a **fixed-rent lease** remain constant over the life of the lease. In contrast, rent under a month-to-month rental agreement can be increased by serving a notice of change in the terms of tenancy, which is limited in amount in cities burdened with residential rent control. [Calif. Civil Code §827]

To increase rents annually for inflation, the lease must provide a formula for calculating the rent increases.

A lease provision that calls for adjustments based on the Consumer Price Index-Urban (CPI-U) may be worded to provide a base-to-current year increase or a year-to-year increase. The resulting rent amount is the same under either calculation.

CPI provision checklist

When the landlord decides to use the CPI method to raise rents, some basic guidelines should be followed:

- set, in advance, a base rent payable monthly during the first year of the lease which will be the "minimum" rent (floor) below which the rent will never fall;
- indicate the exact index to be used (e.g., the Los Angeles-Riverside-Anaheim CPI-U);
- indicate an alternative index should the one selected be discarded or altered;
- note the CPI beginning month for computing annual adjustments (often the third month before the commencement month and anniversaries of the lease);
- state the actual date for the adjusted annual graduations (e.g., September 1); and
- include provisions to cover future changes in the property's appreciated value and operating costs (e.g., reappraisal, CAMs, etc.).

Choosing the beginning CPI month

Regardless of the method of adjustment, base-to-current year or year-to-year, the landlord will need to select a beginning Consumer Price Index-Urban (CPI-U) month.

The best month to select for the CPI-U figure to be used to compute adjustments is the **third month preceding** commencement of the lease and each anniversary of the commencement. The CPI-U figure for the third month prior to the adjustment is readily available by the time the rent adjustment needs to be calculated and the tenant is advised of the adjusted amount of rent due.

Otherwise, if the CPI-U figure chosen is for the month in which the rent will be adjusted, the landlord will need to estimate the CPI-U figure at the time of the adjustment. The actual CPI-U figure for the anniversary month to make the adjustment called for in the lease will not be available for another two months. Computation of the annual adjusted rent is either by base year CPI-U-to-current year CPI-U, or by year-to-year CPI-U.

Base-to-current year adjustment

Consider a lease rent provision which provides for a *base-to-current* year adjustment. [See Figure 1]

The lease commenced on January 1, 2005. The base rent is $5,000 per month for the first year. The rent is to be adjusted each January and the Consumer Price Index-Urban (CPI-U) index to be used is the Los Angeles-Anaheim-Riverside index.

Figure 1

*Excerpt from **first tuesday** Form 552 — Nonresidential Lease Agreement*

3.4 ☐ Monthly base rent for the initial 12 months of the term is the amount of $_____, adjusted annually on the first day of each anniversary month by increasing the initial monthly base rent by the percentage increase between the applicable CPI-U index figures published for the third month preceding the month of commencement and the third month preceding the anniversary month.

a. The applicable CPI-U Index (Consumer Price Index for All Urban Consumer)(1982-1984 = 100) is:

☐ Los Angeles-Anaheim-Riverside, ☐ San Francisco-Oakland-San Jose,

☐ San Diego, ☐ National, ☐ Other: _____.

b. Rent increases under CPI-U adjustments are limited for any one year to an increase of _____%.

c. On any anniversary adjustment, should the CPI-U have decreased below the CPI-U for the prior twelve-month period, the monthly rent for the ensuing 12 months shall remain the same as the rent during the prior 12 months.

d. If the CPI-U is changed or replaced by the United States Government, the conversion factor published by the Government on the new Index shall be used to compute annual adjustments.

The CPI-U figure for the October prior to January, the month of adjustment, is selected as the base month figure for rent adjustments. The CPI-U figure for the third month preceding commencement will be available to calculate the amount of the adjusted rent before the January rent is due. The CPI-U for October 2004 is 196.3, the base month figure.

In January 2006, the first rent adjustment takes place. The CPI-U for October 2005 is 206.9.

To calculate the base-to-current year adjustment, the formula is — the current CPI-U divided by the base CPI-U multiplied by the base rent: (current CPI-U ÷ base CPI-U) × base rent.

For the second year (2006) of the lease, the rent is $5,270 — (206.9 ÷ 196.3) ×$5,000.

For 2007, the third year of the lease, the October 2006 CPI-U is 211.4. Thus, in January 2007, the rent adjusts to $5,385 — (211.4 ÷ 196.3) × $5,000.

Year-to-year adjustment

Under *year-to-year* rent adjustment provisions, the prior year's rent, not the base year's rent, is used to set the adjusted rent. The base year's Consumer Price Index-Urban (CPI-U) is not used to make the future adjustment.

Thus, the year-to-year adjustment formula is the current CPI-U divided by last year's CPI-U, multiplied by the current rent: (current CPI-U ¸ last year's CPI-U) ´ current rent.

CPI advantages

Three advantages are provided by using the Consumer Price Index (CPI) as a basis for rent adjustments. The first and most obvious advantage is that the CPI is universally known and **easily understood**. Little room exists for the parties to disagree over the amount of a rent increase if it is tied to a government published index.

Second, the CPI is inexpensive to administer. It only takes a few minutes and a calculator to adjust the rents each year.

Third, the CPI is a widely published and recognized index.

CPI limitations on yield

Despite the advantages, the Consumer Price Index (CPI) has its limitations. The CPI bears little to no relationship to changes in the property's actual market value or rental value. The CPI only measures overall **consumer prices**, not asset values which are forged by a combination of local demographics, government programs, interest rates and supply of available units or space.

Each parcel of real estate is a unique asset. It is the location of a property which makes the primary difference since no two locations have exactly the same desirability factors affecting value.

An individual property can increase or decrease in value for a number of reasons other than inflation, including:

- traffic counts and access to the property;
- tenant demand and changes in the size and wealth of the surrounding population;
- operating expenses;

- mortgage interest rates and investor capitalization rates; and
- construction starts.

The regional CPI takes none of these local economic factors into consideration. Interest rates *charged* to home buyers are indirectly included in the CPI by using *implicit rent* as the cost of home ownership, but the *opposing effect* of interest rates on real estate values is not included. Cyclically, and in the short term, values run opposite to the direction interest rates move. When interest rates go down (decelerating the CPI), values of real estate (and other assets) accelerate even if rents remain the same, and vice versa.

Also, the CPI does not mirror actual variations in the landlord's operating costs. An owner who does nothing to maintain his property thereby reducing his operating expenses can, in a high demand location, enjoy rent increases due to the public's appreciation for the property's desirable location.

Astute tenants insist on an annual cap when rent increases are linked to CPI. For example, if the rise in the CPI figure is greater than 4% in any year, a 4% cap would limit the increase despite a greater increase in the CPI.

The key is to analyze where inflation is headed (an activity routinely performed by holders of ten year treasury notes). If inflation is expected to rise in the future, then the CPI will initially benefit the landlord. Conversely, when inflation has topped off and is dropping, the CPI will appear to benefit the tenant. Also, a shock to local rental market conditions, such as overbuilding or the exodus of a rental age or business group, can completely eliminate inflationary and interest rate effects on rent.

Alternatives to the CPI

Again, the Consumer Price Index (CPI) is a good method for controlling the inflationary reduction of the *purchasing power* of the U.S. dollar received in payment of rent.

But inflation's effect on rent amounts covered by the annual CPI adjustments is not the only concern of the property manager. Property **appreciation** and increased **operating costs** need to be managed to increase, or at worst maintain, the property's net operating income (NOI).

It is advisable to add a **reappraisal** and **rent adjustment provision** to long-term leases rather than rely solely on the CPI. However, reappraisal methods are costly, time consuming and not always without argument. Managers may feel it is too involved to reappraise the property every few years to set the new rents.

However, appraisal provisions usually call for a reappraisal and recast of the rent schedule at three-to-five year intervals or on exercise of renewal options. [See **first tuesday** Form 552 §3.6]

Some leases allow the landlord to use his judgment to set the rent for the adjustment, which must be exercised reasonably.

A provision for the periodic adjustment of rents to current rental rates is good insurance for a landlord to capture any upward shifts in rents paid in the local rental market beyond those brought about by inflation.

This periodic recast of the rent payment is economically comparable to the rollover feature some lenders include in their three-or five-year adjustable rate or rollover loans.

In addition to base rents, CPI adjustments and rollover features, **percentage rent provisions** also capture the increase in rents due to appreciation based on a change in local demographics. [See Chapter 45]

If the property is in an outstanding location, or promoted by the landlord to attract an ever greater number of consumers, which results in an increase in the tenant's gross income, the landlord should consider negotiating a percentage rent adjustment provision to "cash in" on the draw of the property's location.

Many nonresidential leases include an **additional rent provision** to reimburse the landlord for his operating expenses. Rent can be adjusted to include the operating expenses and any taxes and assessments incurred by the property, called *common area maintenance* (CAM) expenses. [See **first tuesday** Form 552 §4.6]

CAM provisions obligate the tenant to pay a pro rata share of the costs to maintain the common areas of the property including:

- utilities (water, gas, heat, etc.);
- air conditioning and venting;
- sewage;
- garbage;
- janitorial services;
- landscaping;
- security;
- insurance;
- management fees; and
- real estate taxes.

The more items included, the closer the lease comes to a triple-net lease.

Chapter 45 Percentage lease rent provisions

This chapter discusses percentage rent provisions used in lease agreements for space in high traffic retail locations.

Rental income driven by gross sales

A landlord of a newly constructed commercial building negotiates a percentage lease with a prospective tenant who intends to operate a franchised restaurant on the premises. The prospective tenant prepares an estimate of the amount of gross sales anticipated for the first 12 months of operations, based on:

- the traffic count and traffic patterns at the location of the premises;
- the volume of anticipated sales; and
- the nature of the product and service to be offered by the restaurant.

The rent to be paid by the tenant comprises a *base rent* and *additional rent*.

The landlord and tenant agree the base rent for the first year, payable monthly, will be based on 6% of the tenant's **estimated annual gross sales**. The lease agreement sets a specific dollar amount for the monthly **base rent**. The amount of the monthly base rent will be annually adjusted to conform to the rate of inflation reflected by figures from the Consumer Price Index (CPI).

Since it is a percentage lease, the lease agreement also calls for **additional rent** to be paid annually if a percentage of the tenant's gross annual sales is an amount greater than the base rent paid during the preceding 12 months.

The percentage rate used to calculate the additional rent for each consecutive 12-month period of the lease is set at 6% of the first $2,000,000 in gross annual sales and 7% on any greater amounts during the period.

Further, the additional rent to be paid will be the difference between the monthly base rent paid and the sum of the percentages of gross annual sales. The additional rent will be paid annually, within 45 days after the end of each 12-month period.

At the end of the first 12 months of business operation, the percentage rental rates are applied to the tenant's gross sales for the first year of occupancy. If the percentage amount is greater than the base rent paid, the tenant pays as additional rent, also called **percentage rent**, which is the difference between:

- the agreed-to percentage of the tenant's gross annual sales, if it is greater than the base rent paid; and
- the base rent paid each month during the preceding 12-month period.

Base vs. percentage rent

The amount of rent paid for retail space in multiple tenant shopping complexes or other **high traffic locations** is typically based on a percentage of the tenant's gross sales. Lease agreements containing a percentage rent clause are called *percentage leases*.

A prudent landlord negotiating a percentage lease includes a clause in the rent provision calling for payment of a **base rent**, a floor amount that serves as a minimum monthly rent a tenant pays during each year of the lease. Base rent is payable without regard to any amount of rent called for under the percentage rent clause. [See Figure 1 accompanying this chapter]

Generally, the base rent is set by landlord/tenant negotiations and either:

- calculated as a percentage of the estimated gross sales the tenant should receive during the first year of operations; or
- based on current rents paid for comparable premises.

The monthly **base rent** is adjusted upward on each anniversary of the lease by either pre-set increments, called *graduated rent*, or adjustments based on CPI figures, called *adjustable rent*. [See Chapter 44]

The amount of rent the tenant will actually pay monthly, quarterly or annually for the percentage rent, is the greater of either the base rent or the percentage rent.

Typical percentage rent rates for satellite tenants in a large shopping complex are 4% or 10% of the tenant's gross sales. However, the percentages for gradations of sales depend largely on the type of merchandise and services sold by the tenant, the pricing and volume of these sales and the traffic count at the location. Well known heavy advertisers, called **anchor tenants**, pay lesser rates than satellite tenants who surround the large anchor tenants.

Figure 1

*Excerpted from **first tuesday** Form 552 — Nonresidential Lease Agreement*

3.5 ☐ Additional percentage rent equal to _____% of gross sales made from the premises during each calendar year, less credit for other rent, real estate taxes, insurance and common area maintenance (CAM) charges paid for the calendar year.

a. The percentage rent shall be computed and paid for each month of the lease with a signed written statement of the gross income and percentage computation by the tenth day of the following month.

b. The additional percentage rent payable monthly to be credited for other rent, taxes, insurance, and CAMs paid by Tenant for the month.

c. Within one month after each calendar year and on expiration of the lease, Tenant shall compute and deliver a written statement of sales and the percentage rent due for the calendar year, less credit for rent, taxes, insurance and CAMs paid for the calendar year, to annually adjust the percentage rent remaining due from Tenant or to be refunded to Tenant by Landlord, which difference will be paid on delivery of the annual statement.

d. Gross sales includes all money or equivalent received by Tenant, subtenant, licensees or concessionaires, in the ordinary course of business, whether wholesale or retail, cash or credit, less credit for goods returned by customer or merchandise returned by Tenant or transferred to tenant-affiliated stores.

e. Landlord has the right, on reasonable notice, to audit Tenant's books regarding sales information.

A tenant who retails small ticket items at high volume in a high traffic area, such as a kiosk in the center of a mall, will have a high percentage rental rate, as high as 20% to 30% of sales.

Conversely, a tenant who retails big ticket items in low volume, such as an antique furniture store, will have a lower percentage rental rate.

When is percentage rent paid?

Typically, the tenant pays the additional percentage rent after the rental period has ended.The additional amount of the percentage rent is normally due within ten days after the end of the period used to calculate the percentage rent.

Landlords and tenants agree to a monthly, quarterly, semi-annual or annual **accounting period** for payment of the percentage rent depending on:

- whether the tenant's sales tend to be constant or seasonal; and
- the financial strength of the tenant.

Further, percentage rent paid more than once a year is typically adjusted annually in a **final accounting** to determine if any percentage rent remains due or is to be refunded to the tenant for the preceding 12 months of rental payments.

A landlord must initially rely on his tenant to, in good faith, provide an accurate accounting of his gross sales for the period.

However, in the lease agreement, the landlord should **reserve the right to**, on reasonable notice, audit the tenant's books regarding sales information and sales tax reports to the State Board of Equalization (SBOE). [See Figure 1]

Gross sales defined

The landlord and tenant must also negotiate which sales will be the subject the percentage rental rate.

Gross sales is the actual price received for all merchandise or services sold, leased, licensed or delivered in or from the premises by the tenant, for cash or on credit, as well as "layaway" sales at the time of the layaway transaction.

For the sale of **lottery tickets**, the tenant receives a 5% fee which is included in the gross sales, rather than the sales price received from the customer. [Calif. Government Code §8880.51]

Gross sales also include any sums received by the tenant for the licensing of vending machines, pay telephones, public toilet locks, etc.

If the tenant gives a vending machine operator the right to install vending machines on the leased premises for a one-time fee, called a *license*, the sums generated through the machine's sales are not included in gross sales since the tenant does not receive the sales proceeds.

Also, a periodic licensing fee received by a tenant from a vending machine operator for a license to use space is correctly considered part of the tenant's gross sales generated as a result of subleasing the premises. [**Herbert's Laurel-Ventura** v. **Laurel Ventura Holding Corporation** (1943) 58 CA2d 684]

Further, money received by the tenant from which he will receive no benefit, such as Medi-Cal funds received for direct disbursement to the staff as additional subsidized pay, is not included in the gross

sales under a percentage lease. The funds did not increase the tenant's business, the tenant received no additions to sales and the funds were not for the tenant's use. [**Western Medical Enterprises, Inc.** v. **Albers** (1985) 166 CA3d 383]

The same exclusion rule applies to tips received by employees.

Items customarily excluded from gross sales in a percentage lease include:

- the selling price of merchandise returned for full credit;
- sums and credits received in the settlement of claims for damage to or loss of merchandise;
- sales tax;
- proceeds from the sale of fixtures, trade fixtures or other personal property used in the tenant's trade or business that are not merchandise;
- sales made to employees at a discount;
- refundable deposits; and
- uncollectible debts charged off by the tenant.

In practice, gift certificates are not considered part of the gross sales until they are redeemed and a sale is recorded.

Finance charges or interest on accounts receivable held by the tenant may or may not be included, depending on negotiations between the landlord and tenant, and whether the receivables are administered on or off the premises.

A fair rent for failure to use

A landlord enters into a percentage ground lease with a tenant who will build and operate a gas station on the premises. No provision requires the tenant to actually operate a gas station on the premises. The base monthly rent is set at $1,000 for the life of the lease without CPI or graduated adjustment. The percentage rent is set at 6.5% of gross sales.

The tenant builds and operates the gas station on the premises and pays additional rent since the amount of percentage rent always exceeds the base rent.

However, before the lease expires, the tenant closes the gas station. Then, the tenant pays only the base monthly rent since no sales exist. The base rent is significantly less than the percentage rent the tenant paid during the last year of operation.

The landlord claims the tenant owes him the percentage rent the tenant would have paid had the tenant continued to operate his business on the premises.

The tenant claims he owes no more than the monthly base rent since the lease agreement does not contain a provision requiring the tenant to operate the gas station at all times during the term of the lease.

Is the tenant liable to the landlord for the percentage rent the landlord would have received had the tenant continued operations on the premises?

Yes! An *implied covenant* exists in a percentage lease as a promise to continue to use the premises as anticipated by the lease agreement, when:

- the base monthly rent does not represent a fair return to the landlord; and

- the tenant decides not to operate his business on the property. [**College Block** v. **Atlantic Richfield Company** (1988) 206 CA3d 1376]

By entering into a percentage lease, the tenant is expected to continually operate his business during the lease term.

However, due to changes in market conditions, demographics, traffic patterns or other economic factors, the base monthly rent originally negotiated in a percentage lease may not always represent a fair return to the landlord — a fair rental value for the premises.

The landlord relies on the percentage rent to provide a yield on his investment that will keep pace with local rental conditions in the future.

When a tenant ceases to use the property to operate the business as anticipated by the use provision in a percentage lease, the percentage rent owed will be determined based on the amount of gross sales the tenant would have experienced had the tenant continued to use the property as permitted by the lease agreement.

The landlord should include a **use provision** in a percentage lease requiring the tenant to operate the business for the entire term of the tenancy.

Chapter 46 Nonresidential use-maintenance provisions

This chapter examines the provisions in nonresidential leases that establish the landlord's and tenant's rights and obligations regarding the use and care of the leased premises.

Shifting ownership obligations

A nonresidential lease agreement contains two basic categories of provisions establishing the tenant's obligations to the landlord:

- *rent provisions* for the payment of amounts owed; and
- *use-maintenance provisions* for the use, care and preservation of the grounds and improvements.

Rent provisions evidence the promise to pay money owed the landlord by the tenant given in exchange for the possession of the leased premises over a specific period of time. This monetary obligation is **separately enforceable** from the use and maintenance provisions.

Use-maintenance provisions in a nonresidential lease agreement establish the rights and obligations of the landlord and tenant regarding who is responsible for performing the care and maintenance of the premises during the lease term. [See **first tuesday** Form 552]

Use-maintenance obligations are unrelated to the payment of rent. Instead, they identify who will perform or contract for the repairs and maintenance of the leased premises — the landlord or the tenant.

If the landlord retains the majority of the maintenance obligations, the base rent the tenant will pay will likely be higher than otherwise. If the tenant assumes the majority of the maintenance obligations, the base rent the tenant pays will likely be lower.

Just as a tenant breaches a lease agreement by failing to pay rent, he also breaches the lease agreement when he fails to perform or acts in violation of a use-maintenance provision.

The tenant's breach of an essential use-maintenance obligation is followed by either a 3-day notice to **perform or quit** stating precisely what must be done by the tenant within three days, or a 3-day notice to **quit** if the breach is incurable, such as a use violation, the maintenance of a nuisance or waste to the property.

If the noticed breach **can be cured** and the tenant fails to cure it after notice, he loses the right to possession if a declaration of forfeiture of the leasehold interest is made in the notice. When the breach is **incurable**, as under a notice to quit, the tenant automatically loses any right to continue in possession and must vacate the premises within three days after notice.

A breach of the use-maintenance provisions by the landlord or the tenant, and the remedies available for the breach, can be litigated under contract law since the lease agreement is a contract. Not so for the separate right to possession. When the landlord involves the tenant's possessory rights in the property as part of his remedy on a breach by the use of a forfeiture election to terminate the tenancy, landlord/tenant law controls. [**Kendall** v. **Ernest Pestana, Inc.** (1985) 40 C3d 488]

Which use-maintenance provisions to include

The contents of each provision in a nonresidential lease agreement are fully negotiable when agreeing to enter into a lease transaction. The results of negotiations depend on the respective bargaining power of the landlord and the tenant, as tempered by market conditions affecting rental properties.

Also, lease provisions vary due to the type of property involved, including:

- the intended use of the property;
- delegation of operating costs and responsibility for the property's physical conditions;
- the length of the lease term.

Occasionally, the landlord or the tenant will use a lease agreement form especially prepared by their respective attorneys for repeated use, i.e., when the landlord has many properties to let or the tenant leases many locations (such as franchisors).

However, landlords more frequently use regular form lease agreements that contain provisions basic to nonresidential leases. They then attach addendums for provisions not already included in the form or contrary to provisions in the form. [See **first tuesday** Form 552 §1.3]

*Editor's note — The following discussion of use-maintenance clauses refers to provisions in **first tuesday** Form 552* — Nonresidential Lease Agreement *accompanying Chapter 41.*

Use of the premises

On entering into a nonresidential lease agreement, a landlord and tenant agree the premises will be used by the tenant for a single, **specified purpose**, such as a retail clothing store or an auto mechanics shop, called a *use-of-premises provision*. [See **first tuesday** Form 552 §6]

If a lease provision does not restrict or specify the tenant's use of the leased premises, the premises may be used for any lawful purpose. [Calif. Civil Code §1997.210(b)]

Conversely, a lease may prohibit any change in use or set *standards* or *conditions* to be met before a change from the use specified in the use-of-premises provision may be implemented. [CC §1997.230]

If the use provision requires the landlord's consent to a change in use, but gives no *standard* or *condition* to be applied or met for the consent, the landlord must have a commercially reasonable basis for withholding his consent to the new proposed use sought by the tenant. [CC §1997.250]

The standard of reasonableness applied to the landlord's consent is the same as applied to assignment restrictions calling for the landlords consent.

In the use-of-premises provision, the tenant agrees to deliver up the premises on expiration of the lease in as good condition as it was when he took possession, less reasonable wear and tear.

Even if the tenant's use of the leased premises is unrestricted, the tenant cannot impair the premises by damaging it, creating a nuisance, engaging in illegal activities or subjecting the premises to greater wear and tear than the use contemplated when the lease was entered into.

In addition to the use allowed, the tenant agrees not to conduct any activities on the property which would:

- increase the landlord's liability or hazard insurance premiums; or

- violate any laws, building ordinances or tenant association rules, called a *compliance-with-laws clause*.

Appurtenances

Any use coupled with but not located on the leased premises for the benefit of the tenant's leasehold interest, i.e., reasonably necessary for the use and enjoyment of the leased premises, is called an *appurtenance*. [CC §662]

Leasehold **appurtenances** include rights in real estate owned by the landlord that are located outside the leased premises, such as:

- a right of way for vehicular travel through an industrial or office complex;
- parking for employees and customers;
- storage space, lobbies and restrooms; and
- access of ingress and egress from public roads to the leased premises, such as a road or driveway.

Signs and advertising

A landlord maintains the integrity of the building's physical and aesthetic appearance, and is assured all signs, advertising and addresses placed about the premises will comply with local ordinances and the landlord's policies by including a *signage provision* in the lease agreement. [See **first tuesday** Form 552 §8]

Under the **signage provision**, the landlord retains control over the size, style, content and location of signs constructed or installed on the premises to advertise the location or existence of the tenant's business.

The cost of sign installation can be charged to either the landlord or tenant as negotiated and stated in the terms of the lease.

Tenant improvements and alterations

A tenant's right to make alterations or further improve the premises **during the tenancy** is governed by the lease provision called a *tenant improvements and alterations clause*, or more simply a TI clause. [See From 552 §9]

To ensure the landlord retains control over the structures on or about the leased premises, the tenant agrees not to alter or further improve any part of the building without first obtaining the landlord's written consent. Should the landlord later consent to alterations or further improvements by the tenant, the tenant will pay all costs incurred in the construction, unless agreed to the contrary in an addendum or modification of the lease agreement.

A lease agreement for retail space, especially in malls, should include provisions which require the tenant to renovate his storefront and interior every number of years. Renovations by tenants every four to six years will help maintain a fresh appearance which is vital to the overall success of retail shopping centers.

When the landlord later consents to alterations by the tenant, the tenant must promptly notify the landlord of the commencement of construction so the landlord can post and record a *notice of nonresponsibility*. [See Chapter 5]

The **notice of nonresponsibility** is a form, releasing the landlord from responsibility for any claims made by contractors for improvements they construct on the leased premises under their contract with the tenant. [CC §3094; see **first tuesday** Form 597]

The notice bars mechanic's liens on the fee simple in the real estate and denies recovery from the landlord by unpaid contractors employed by the tenant.

Any increase in property taxes due to alterations made by the tenant are the responsibility of the tenant and will be paid to the landlord on demand.

Unless otherwise agreed, the tenant's improvements become the property of the landlord at the end of the lease term and cannot be removed by the tenant, with the exception of the tenant's trade fixtures. [**Wolfen** v. **Clinical Data, Inc.** (1993) 16 CA4th 171]

Further, when the tenant alters or improves the premises resulting in a new and different use of the premises, the tenant must, separate from the contractual duty imposed by a compliance-with-laws clause, comply with all building code requirements. If the tenant's installation of improvements violate building codes and ordinances, the tenant will be liable for the landlord's cost of conforming the new improvements to codes and ordinances. [Wolfen, *supra*]

Repair and maintenance

Of equal financial importance and effect as the amount of rent to be paid under a nonresidential lease agreement are the responsibilities for the payment of the **cost of maintenance** and repair of the premises. Ultimately, the tenant must bear them, either directly by incurring the costs himself or indirectly through the payment of basic rent or additional rent in the form of common area maintenance charges (CAMs).

The extent of the maintenance and repair obligations assumed by the tenant typically depends on the type of space leased and the length of the lease term.

The longer the lease term, including renewal options, the more likely the obligations for maintenance will be shifted to the tenant, with the exception of multi-tenant commercial and office space. The shift will be even more likely if the premises is a single-user building, such as a warehouse or bank building as opposed to a multi-tenant project.

The nonresidential tenant has a duty during the leasing period to notify the landlord of those repairs which are needed and are the responsibility of the landlord.

Some net lease agreement forms contain a *compliance-with-laws provision* requiring the tenant to make any **government-ordered repairs**, such as asbestos removal or seismic retrofitting.

If the term of the lease under a lease agreement containing a compliance clause is short, the landlord will be the primary beneficiary of the government-ordered repairs. In spite of the wording in the lease agreement placing the financial responsibility on the tenant, the landlord may be responsible for making and paying for government-ordered repairs. [**Hadian** v. **Schwartz** (1994) 8 C4th 836]

Right to enter

Once a tenant acquires a leasehold interest in a nonresidential premises, the landlord no longer has the right to enter the premises for any reason, unless agreed to the contrary or an emergency exists. However, the landlord might **reserve the right** to enter and make any necessary repairs, alterations or inspections of the premises, called a *right-to-enter* provision in the lease agreement. [See Form 552 §11]

A landlord may need to enter the premises when:

- the landlord makes necessary or agreed-to repairs or alterations, or is supplying necessary services to the tenant;
- the landlord shows the premises to a prospective tenant;
- the tenant has abandoned or surrendered the premises;
- the tenant requests a pre-termination inspection [See Chapter 19];
- a court order was issued allowing the landlord to enter; or
- an emergency exists which endangers the property. [See Chapter 3]

Waste

As would be expected in a lease agreement, the tenant agrees not to destroy, damage or remove any part of the premises or equipment, or commit waste on the premises or permit anyone else to do so, called a *waste provision*. [See **first tuesday** Form 552 §12]

If the tenant or a person permitted on the premises by the tenant commits waste on the property, the tenant commits an *incurable breach* of the lease agreement and automatically forfeits his right to possession. [See Chapter 26]

The landlord can serve the tenant who has committed or permitted waste to the property with a 3-day notice to quit, and initiate an unlawful detainer action to evict the tenant if he does not vacate. [Calif. Code of Civil Procedure §1161(4)]

Liability insurance

A landlord and tenant may agree the tenant will purchase a liability insurance policy to cover losses which might occur on the premises, including:

- property damage; and
- bodily injury.

The lease agreement should set the policy limits or minimum amount of liability insurance the tenant must obtain. These limits should be set as a result of the landlord's discussion and analysis with an insurance agent.

Typically, a tenant's obligation to maintain liability insurance under a lease is covered under the tenant's commercial general liability insurance policy which the tenant purchases to insure the business he will operate on the premises.

To protect the landlord from any dissipation of insurance proceeds by the tenant, the landlord should be **named** as an additional insured on liability and hazard insurance policies obtained by the tenant to cover the leased premises.

To be assured the landlord is named, the lease agreement should require the tenant to provide the landlord with a certificate of insurance from the carrier naming the landlord as an additional insured. [See Form 552 §13]

Under the insurance provision, both the landlord and the tenant waive any insurance subrogation rights each might have against the other. Thus, an insurance carrier cannot seek to recover from the landlord or tenant who was the cause of the injury or property damage. [**Gordon** v. **J.C. Penney Company** (1970) 7 CA3d 280]

Hazard insurance

In a multi-tenant building, a landlord obtains a hazard insurance policy and passes the cost of the premiums through to the tenant, generally by way of the monthly base rent or CAM expenses.

The landlord and tenant can agree the tenant will purchase a standard hazard insurance policy for fire losses, which also covers theft and vandalism of all personal property and the restoration of tenant improvements, including the destruction of plate glass windows.

Requiring the tenant to maintain a hazard insurance policy assures the landlord that the tenant will be in the financial position necessary to continue to operate his business if fire, theft or vandalism occurs during the term of the lease.

When the tenant is required to maintain an insurance policy for property damage resulting from fire, theft or vandalism, the landlord must be named by the carrier as an additional insured so the landlord can control the use of any insurance proceeds.

In a long-term, triple-net lease where the tenant has assumed all obligations and duties of ownership, the lease agreement shifts to the tenant:

- the obligation to maintain hazard insurance; and
- the burden of repairing any destruction of the real estate, regardless of the cause.

Hold harmless

The *hold harmless provision* covers the landlord for liability from injuries occurring on the premises which:

- arise out of the tenant's negligent use of the premises; and
- are caused by the tenant, his employees or customers due to the tenant's negligence.

Nonresidential lease agreements often favor the landlord by including a **hold harmless provision** through which the tenant holds the landlord harmless for all claims, damages or liability arising from any cause, including the landlord's negligence.

When a hold harmless clause is included in a lease agreement, the tenant needs to purchase liability insurance coverage for the risk of loss he has agreed is his — his contractual liability under the lease agreement. [See Form 552 §13]

Contractual liability insurance is separate from general liability insurance covering bodily injury and property damage.

Regardless of the type of hold harmless provision used, the landlord cannot shift responsibility to the tenant for any liability arising from his landlord's *intentional misconduct* or violation of law. [CC §1668]

For example, a landlord cannot escape liability to others for injuries occurring on the leased premises due to the landlord's failure to maintain the premises as obligated by the lease agreement, including abatement of any known dangerous conditions. [See Chapter 40]

Destruction

Initially, the responsibility for the costs of making repairs to nonresidential property when the leased premises is partially or totally destroyed lies with the landlord.

Government-ordered repairs

When determining whether the landlord or the tenant is responsible for government-ordered repairs, the terms of the lease agreement do not always control.

Six factors are applied to the lease transaction to determine if the burden of complying with any government-ordered, curative actions to correct or eliminate deficiencies in the leased premises falls on the tenant or the landlord.

The six burden-of-compliance factors are:

- the ratio of the cost of repairs to the amount of rent due over the life of the lease;
- the length of the lease, including renewal options;
- whether the landlord or the tenant will benefit more from the repairs in terms of the useful life of the building and the remaining term of the lease;
- whether the repairs are structural or nonstructural;
- whether or not the repairs will substantially interfere with the tenant's enjoyment of the premises; and
- whether or not the government-ordered repairs were foreseeable at the time the lease agreement was entered into by the landlord and the tenant.

Each burden-of-compliance factor is weighed based on the circumstances surrounding the execution of the lease, the text of the lease provisions and the economic realities of the lease transaction.

For example, a landlord and a tenant enter into a 15-year nonresidential net lease agreement.

Boilerplate use-maintenance provisions transfer to the tenant all ownership duties, including structural repairs.

Less than two years into the 15-year lease, the county discovers friable asbestos on the premises and issues an abatement order to the tenant. Neither the landlord nor the tenant had previous knowledge that asbestos existed on the premises, as it was a pre-existing condition of the building.

On receiving the compliance order, the tenant seals off the contaminated area and conducts business out of another section of the building.

The costs of repairing the building is a sum roughly equal to 5% of the aggregate amount of rent due over the entire life of the lease.

Here, the provisions in the lease agreement and the circumstances under which the lease was entered into imply the duty to comply with the government order was transferred to the tenant since:

- the cost of repairs amounted to less than 5% of the aggregate amount of rent due over the life of the lease;
- the lease was for 15 years, and thus the cost of repairs could easily be amortized by the tenant during the remaining tenancy;
- the asbestos removal would most benefit the tenant since the contamination was discovered less than two years into the lease;
- the repairs are structural and the lease clearly transfers structural repairs to the tenant;
- the tenant's use of the premises would not be greatly interfered with during the abatement; and
- neither the tenant nor the landlord had reason to believe asbestos existed on the premises, yet the tenant was experienced in retail leasing and elected not to investigate the premises. [**Brown** v. **Green** (1994) 8 C4th 812]

Now consider a landlord and a tenant who enter into the same nonresidential net lease agreement but for a term of three years with an option to renew for five additional years.

The net lease contains boilerplate compliance with laws and maintenance and repairs provisions which shift all the duties of ownership to the tenant, including structural repairs.

After the tenant exercises his option to renew the lease for five years, the landlord receives a compliance order from the city requiring the leased premises to be earthquake-proofed.

The cost of quake-proofing the building roughly equals 50% of the aggregate amount of the rent due over the entire life of the lease, which is now in its fourth of eight years.

Here, even though the lease shifted the major burdens of ownership from the landlord to the tenant, an application of the six-factor test determines the landlord must bear the burden of the quake-proofing costs since:

- the cost of quake-proofing the premises was roughly equal to 50% of the aggregate rent due over the total eight-year term of the lease;
- the eight-year lease was short-term with little time remaining for the tenant to amortize the cost or the repairs; and
- the quake-proofing primarily benefits the landlord because of the short term remaining on the lease. [Hadian, *supra*]

Thus, when entering into a nonresidential net lease agreement, a landlord should consider including a provision calling for the tenant to assume the cost of compliance orders that do not regulate the tenant's use of the premises — government-ordered retrofitting or renovation.

Yet the landlord must be aware, if the economic realities of the lease agreement are not in accord with the text of the lease agreement, the landlord may still be liable for government-issued compliance orders.

However, some or all of the responsibilities can be shifted to the tenant or allocated between the landlord and the tenant by a clause in the lease agreement, called a *destruction provision*.

In the **destruction provision**, the tenant agrees to repair and pay for any destruction to the premises:

- caused by the tenant;
- covered by insurance policies held by the tenant; or
- required by other lease provisions, such as the repair and maintenance clause.

When the tenant is obligated to carry insurance to pay for the cost of repairs, the landlord is assured the disbursement of any insurance proceeds under the tenant's policy will be used to pay for the repairs if he is named as an additional insured on the tenant's policy. [See **first tuesday** Form 552 §14]

On the other hand, the landlord agrees to repair and pay for any damage to the premises which:

- is not caused or covered by the tenant's insurance policies;
- is insured only by the landlord's policy; or
- is not insured by any policy. [See **first tuesday** Form 552 §16.3]

A destruction clause typically states the lease will not terminate due to any destruction of the premises, unless the landlord chooses to terminate it under specified conditions, such as:

- the repairs cannot be completed within 30 days;
- the cost of restoration exceeds 70% of the replacement value of the premises;
- the insurance proceeds are insufficient to cover the actual cost of the repairs; or
- the premises may not be occupied by law.

Thus, the landlord may opt to terminate the lease if the casualty is underinsured.

However, if the landlord fails to begin repairs which are his responsibility or, alternatively, terminates the lease within a reasonable time, the tenant can:

- abandon the premises due to a *constructive eviction* and be excused from further performance under the lease [CC §1942; see Chapter 29]; or
- pay rent and recover from the landlord any losses suffered due to the landlord's failure to repair. [**Ng** v. **Warren** (1947) 79 CA2d 54]

Chapter 47 Lease renewal and extension options

This chapter introduces a landlord's irrevocable offer for a tenant to remain in possession beyond the expiration of a lease.

Don't forget to exercise

A broker, acting as a leasing agent or property manager for an owner, arranges for a tenant to lease improved nonresidential real estate. The lease is for a three-year term and contains options to renew the lease for additional three-year periods.

The lease renewal options require the tenant to **exercise each renewal option** in writing at least three months before the lease term expires. Thus, renewal options, unless exercised, expire three months before the lease itself expires.

During occupancy, the tenant's business improves. As a result, he makes substantial improvements to the building with the owner's consent.

Business demands require the tenant to also lease an adjacent building. The two buildings are operated as one complex by the tenant. The cul-de-sac street fronting the building is even renamed after his business.

As the expiration date for exercise of the renewal option approaches, the tenant installs new air conditioning units, again with the owner's consent.

However, the tenant fails to give the owner the written notice required to exercise his option to renew the lease before the renewal option expires.

After the option expires, but before the lease expires, the tenant attempts to exercise the renewal option.

The owner will not waive or extend the expiration date of the option to renew. The tenant is told he must vacate at the end of the current three-year term since the renewal option expired unexercised.

The tenant claims his tenant improvement activity was sufficient to place the owner on notice of his intent to exercise the renewal option since his improvements were inconsistent with vacating the premises on expiration of the lease.

When the option to renew expires unexercised as agreed, does the lease *automatically* expire at the end of its term?

Yes! The tenant's further improvements of the premises just prior to expiration of the renewal option is not proper notice to the owner of the tenant's intent to renew. An option is an *irrevocable offer*, an agreement independent of the lease agreement, whether it is a provision in the lease agreement or an addendum to it. The option expires by its own terms, as does any offer, if acceptance is not given during the option period by exercise as specified in the option agreement. [**Bekins Moving & Storage Co.** v. **Prudential Insurance Company of America** (1985) 176 CA3d 245]

The lease term

Absent an agreement to the contrary, a lease terminates *automatically*, without further notice, on expiration of the lease term stated in the lease agreement. [Calif. Civil Code §1933(1)]

A tenant who remains in possession after the lease term expires is commonly referred to as a *holdover tenant*, legally called a *tenant at sufferance.*

A landlord subjected to a holdover may initiate an unlawful detainer proceeding to evict the holdover tenant immediately after expiration of the lease — no notice to quit is necessary. [Calif. Code of Civil Procedure §1161(1)]

Alternatively, when a renewal option does not exist and the tenant continues in occupancy and tenders rent which the landlord accepts, a month-to-month tenancy is created. Consequently, the landlord must serve the tenant with the appropriate notice to vacate to terminate the periodic tenancy created by the acceptance of rent for any period after the lease expired. [CC §§1945, 1946]

Options to renew/extend

Frequently, lease agreements contain provisions or addendums which allow the tenant to continue in lawful possession after the initial lease term expires. A prior agreement allowing continued occupancy is called an *Option to Renew/Extend the Lease*. [See Form 565 accompanying this chapter]

For a tenant, a **lease renewal/extension option** can be financially advantageous. The tenant has time during the option period to examine whether the economic and financial conditions of his trade or business at this location favor an exercise of the option and continued possession. If not, the tenant is under no obligation to exercise the option. If he does not exercise the option, he must vacate the premises on expiration of the lease.

Thus, the well-informed tenant will consider negotiating one or more renewal/extension options when entering into a lease agreement for a short term.

On the other hand, the landlord may not share the tenant's enthusiasm for a renewal/extension option since the only decision remaining seems to benefit the tenant — to renew or not to renew. With the granting of a renewal/extension option, the landlord is left in a somewhat uncertain future position as he does not know who will occupy the premises in the future. Meanwhile, the tenant is left to decide whether to exercise the option and extend the occupancy or vacate on expiration of the lease.

One solution to the landlord's anxiety about the future uncertainty of locating a new tenant is to set the **expiration** of the renewal/extension option several months before the lease expires. Thus, the expiration of the option unexercised will give the landlord sufficient time in which to locate a replacement tenant.

On the flip side of the uncertainties, the landlord also benefits from an option to renew/extend. A renewal option encourages a tenant to enter into the lease in the first place since the tenant has the right to continue in possession if the property proves beneficial to his business. Additionally, the renewal/extension option **encourages improvements** and promotion of the location by the tenant in anticipation of being able to remain in possession.

Consider a lease agreement that grants a tenant an option to renew the lease every three years at the same rental rate, without stating a date for expiration of the continuing option renewal periods. When the tenant attempts to exercise the renewal option, the landlord claims the lease is unenforceable since the lease

OPTION TO RENEW/EXTEND LEASE

DATE:_____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

This option to renew or extend is an addendum to the lease agreement entered into by Landlord and Tenant, dated _____, 20_____, at _____, California, recorded _____, 20_____, as Instrument No. _____, in _____ County, California, regarding real estate referred to as: _____

_____

AGREEMENT:

1. Landlord hereby grants to Tenant the following option(s) to ☐ renew, or ☐ extend, the term of the lease agreement referenced above.

1.1 The first option is for a term beginning on expiration of the original term of the lease and ending _____ year(s) thereafter.
The rental payment schedule during the term of this renewal/extension to be:
_____
_____

1.2 The second option is for a term beginning on expiration of the immediately preceding term and ending _____ year(s) thereafter.
The rental payment schedule during the term of this renewal/extension to be:
_____
_____

1.3 The third option is for a term beginning on expiration of the immediately preceeding term and ending _____ year(s) thereafter.
The rental payment schedule during the term of this renewal/extension to be:
_____
_____

1.4 Other: _____
_____

2. Each option to renew/extend the lease expires _____months prior to the expiration of the lease term which immediately precedes the renewal/extension period provided by the option.

3. A written notice of Exercise of Option to Renew/Extend must be delivered prior to expiration of the option exercised and no sooner than _____months before expiration of the option exercised. [See **ft** Form 566]

3.1 Exercise of each option to be delivered to Landlord by certified mail or personal delivery, or by personal delivery to broker/property manager who is: _____
Address: _____

3.2 Tenant's failure to timely exercise any option will cause the lease to expire unrenewed and unextended.

4. This addendum's provisions supersede any inconsistent provisions contained in the lease agreement.

5. Other provisions: _____

I agree to the terms stated above.	**I agree to the terms stated above.**
Date:_____, 20_____	Date:_____, 20_____
Landlord: _____	Tenant: _____
Agent: _____	Tenant: _____
Signature: _____	Signature: _____
Address: _____	Signature: _____
_____	Address: _____
Phone: _____	_____
Fax: _____	Phone: _____
E-mail: _____	Fax: _____
	E-mail: _____

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agreement and the option grant the tenant the right to renew the lease forever — a violation of the rule against *perpetuities*.

However, the lease is valid. Nonresidential lease transactions are no longer controlled by laws governing **perpetuities**. The total term of the nonresidential lease, including extensions or renewals, if not limited by its terms, is limited to 99 years by statute. [**Shaver** v. **Clanton** (1994) 26 CA4th 568]

Renew vs. extend

A technical, but obvious, processing distinction exists between a *renewal* and an *extension* of a lease.

An **extension** is a stretching out of the original lease term by retaining the original lease agreement and *modifying* its expiration date, extending the term for an additional period. On the other hand, a **renewal** requires the execution of a new lease on identical conditions to the original lease agreement, not a continuation of the old lease. [**In re Marriage of Joaquin** (1987) 193 CA3d 1529]

A renewal involves the preparation and signing of a new lease which creates an entirely new tenancy. The new tenancy is subject to any change in law affecting the rights and obligations of the landlord or the tenant and subordinate to any encumbrances which occurred during the term of the prior lease.

Alternatively, an extension merely **modifies** the original lease by extending its expiration date. Thus, the modified lease would not be subject to changes in the law or encumbrances occurring after the term of the original lease.

Quite often, however, everyone involved uses the terms interchangeably, neglecting to maintain clarity of purpose, legal rights and the paperwork involved.

For instance, a lease agreement granting the tenant an "option to renew" which does not specify the manner or method for exercise of the option and does not call for the signing of a new lease is considered an **extension** of the original lease agreement. As a result, the provisions of the original lease apply on exercise of the option, but with a new expiration date. [In re Marriage of Joaquin, *supra*]

Exercise of the option

To exercise a lease renewal/extension option, the tenant must notify the landlord of his unqualified intention to renew or extend the lease. The notice of exercise must be timely delivered to the landlord, unequivocal and precise in its terms for the specific period offered in the option. If not, the notice of exercise is ineffective and may be ignored by the landlord.

Consider a tenant who enters into a lease agreement which includes a provision or an attachment granting the tenant an option to renew the lease for an additional two-year period.

During the window period for exercise of the renewal option, the tenant notifies the landlord of his intention to renew the lease, but for only one year.

In this example, the tenant's notice to renew was an ineffectual attempt to exercise the option to renew the lease. The tenant's notice was a mere **proposal** to renew for a different period than the period stated in the option.

Thus, the notice was not an *acceptance* of the option to renew. The communication was an attempt to alter the original terms of the option. Here, the communication constitutes a *rejection* of the offer in the original option since it is a counteroffer calling for an alternative performance by the tenant, not an un-

EXERCISE OF OPTION TO RENEW/EXTEND LEASE

DATE:_____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

A lease agreement dated _____, 20_____, at _____, California,

entered into by _____, Landlord, and _____, Tenant,

recorded _____, as Instrument No._____, in _____County, California,

regarding real estate referred to as:_____

_____

_____

provides for renewal or extension of its term, or is subject to an option to renew or extend this lease granted by the landlord and dated _____, 20_____.

NOTICE TO LANDLORD

1. Tenant hereby elects to exercise the option to renew or extend the term of this lease following expiration of the current lease term for the additional period and on the conditions stated in the option.

2. Landlord is hereby requested to respond in writing to the Tenant regarding any further actions necessary on the part of the tenant to exercise this renewal/extension option, or implement this election to exercise the option, and result in a binding agreement for the additional term.

3. _____

_____

_____

_____

_____

_____

_____

_____

Date:_____, 20_____

Tenant: _____

Signature:_____

Address:_____

_____

Phone: _____

Fax: _____

E-mail: _____

Title: _____

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equivocal acceptance. [**Hayward Lumber & Investment Co.** v. **Construction Products Corp.** (1953) 117 CA2d 221]

Also, when the renewal/extension option agreement specifies the steps to be taken and the time period in which they are to occur to exercise the option, the tenant must **strictly comply** if he intends to exercise the option. [Bekins Moving & Storage Co., *supra*]

Usually, the tenant is required to give written notice of his exercise of the option several months before the current term of the lease expires (usually three to six months).

Advance notice requirements give the landlord ample time to locate a new tenant should the present tenant elect not to renew/extend the lease.

The option should state the method for delivery of the tenant's notice of his intent to exercise the option to renew/extend. Notice of exercise should be required in writing and personally handed or sent by certified mail to the landlord within a specific window period of time, such as three months, which closes three to six months prior to the expiration of the lease.

If notice is to be delivered by certified mail, the risk of the notice being lost in the mail is on the landlord. When a receipt for certified mail is issued by the post office, the tenant is no longer responsible for its physical delivery to the landlord. It is unnecessary to request a return receipt. [**Jenkins** v. **Tuneup Masters** (1987) 190 CA3d 1]

Failure to **timely comply** with delivery of a written notice of exercise within the window period for exercise of the option causes the lease to automatically expire at the end of its term. To prevent an **unintended expiration** of a lease, the tenant's broker should prepare and hand the tenant an exercise of option to renew/extend lease form or make one available to the tenant during the window period for exercise of the option before the option itself expires. [See Form 566 accompanying this chapter]

An exercise of option to renew/extend lease form provides the tenant with the paperwork needed to exercise the option. The notice of exercise states the tenant's intent to exercise the renewal/extension option on its terms and conditions, without qualification or equivocation.

Typically, the broker's fee arrangement on the original lease calls for a fee on any extension or renewal. Not only is the exercise as intended by the tenant protecting the tenant, the leasing agent benefits by the exercise of the option. [See **first tuesday** Form 113]

Continued possession as exercise

A renewal option should, but need not, set forth the time period and manner for its exercise.

For example, a renewal option is silent as to the time and manner for exercise. The tenant constructs substantial improvements on the property and remains in possession throughout the entire lease term.

The lease term expires without the tenant giving any notice to the landlord of his intent to renew the lease, yet the tenant **remains in possession**. The tenant then tenders the correct amount of rent as though he had already exercised his renewal option. The landlord refuses the tender of rent.

The landlord serves a notice to quit on the tenant claiming the tenant did not take steps to exercise the option to renew prior to the expiration of the lease and is unlawfully detaining the premises.

Does the tenant's continued possession of the property after the lease expires constitute exercise of the renewal option when delivery of a notice of intent to exercise is not called for in the option?

Yes! When the tenant has a renewal option and the time and manner for exercise is not specified, the tenant's continued possession and timely tender of rent indicates his election to renew. [**ADV Corp.** v. **Wikman** (1986) 178 CA3d 61]

Waiver of notice to exercise

A tenant is bound by the terms for exercise of the renewal/extension option, unless the landlord has, by his conduct, waived the requirements for exercise — acceptance of the option's offer to renew or extend. [**Simons** v. **Young** (1979) 93 CA3d 170]

A **waiver** is the relinquishment by the landlord of a known right, claim or privilege, such as the tenant's delivery of a notice to exercise the option to extend, by the conduct of the landlord since he holds or benefits from the right.

For example, a tenant fails to exercise his option to renew the lease as called for in the renewal option since he does not notify the landlord in writing of his intent to renew prior to expiration of the option.

On expiration of the lease, the tenant remains in possession and tenders rent to the landlord at the new rate called for in the option to renew. The landlord accepts the rent.

Later, the landlord serves a 30-day notice to vacate on the tenant. The tenant claims the renewal option has been exercised and the renewed lease bars the landlord's use of the 30-day notice to vacate to terminate possession since the landlord accepted rent called for in the renewal option.

Is the landlord's acceptance of rent when the tenant continued in possession a waiver of the written notice to exercise?

Yes! The landlord's **acceptance of rent** at the renewal rate after expiration of the lease waived his right to object to the tenant's prior failure to exercise the renewal option as agreed. [**Leonhardi-Smith, Inc.** v. **Cameron** (1980) 108 CA3d 42]

Now consider a tenant whose long-term lease contains options to extend the lease. The options will expire unless exercised in writing during a two month window period expiring 60 days prior to the expiration of the lease.

The lease agreement is entered into and dated two years prior to transfer of possession to the tenant (due to construction). The lease term is set to expire on the fifth anniversary of the date of the lease agreement.

Five years pass after the date of the lease agreement and the tenant remains in possession paying the rent due during the original term of the lease. The tenant then gives the landlord written notice to extend the lease 60 days prior to expiration of five years after the date of possession, not the date of the lease agreement as called for.

The tenant then remains in possession and pays rent at the increased amount called for in the option to extend. The landlord does not object to the notice of intent to exercise the option to extend and continues to accept rent payments.

Later, a new owner becomes the landlord.

The new landlord serves the tenant with a 30-day notice to vacate. The landlord claims the tenant's occupancy under the lease is a periodic month-to-month tenancy which can be terminated at the will of the landlord since the original lease expired without being extended due to the untimely notice to exercise the renewal option.

The tenant claims the acceptance by the prior landlord of the tardy notice of exercise of the renewal option and the rent called for in the option waived the landlord's right to enforce the conditions for exercise of the option.

Did the tenant exercise his option to extend due to a *waiver* of the notice requirement by the prior landlord when the landlord accepted rent after the lease expired and failed to object to delivery of the notice of exercise?

Yes! The prior landlord's receipt of the untimely exercise and acceptance of the rent without objection **waived compliance** by the tenant of the notice requirement for the exercise of the extension option. Thus, the lease and all its terms remained in effect for the period of extension, barring any attempts by the landlord to terminate the tenant's occupancy as a month-to-month tenancy. [**Oxford Properties & Finance LTD** v. **Engle** (9th Cir. 1991) 943 F2d 1150]

For the landlord to avoid waiving the requirement of a timely and unconditional written notice to exercise an option to extend, thus effectively extending the expiration of a lease when the tenant remains in possession and pays rent, the property manager and landlord must not accept rent from the holdover tenant unless the rent is paid under a newly negotiated lease agreement unrelated to the expired lease.

If the tenant refuses to vacate or refuses an offer of terms for a new and different tenancy, the landlord may, without further notice, begin an unlawful detainer action to remove the holdover tenant.

When the tenant neglects to properly exercise the renewal option (e.g., allowing the window period for exercise of an option to expire), the lease term will itself expire without renewal or extension. The property manager may evict the holdover tenant and relet the premises since the lease has expired and no new arrangement for continued occupancy has been agreed to, in writing or by the conduct of accepting rent for a period after expiration of the lease. [Simons, *supra*]

Finally, to exercise the lease renewal option, the tenant must be in full compliance with all conditions of the lease. Thus, the tenant cannot be in **default on rent** payments or allow any other material breach of the lease to exist at the time of his exercise of the option.

The payment of rent which is due is an implied condition which must be satisfied, in addition to any other conditions in the lease agreement, before the renewal option may be exercised. When the tenant is in default, his right to exercise his option is suspended. [**Nork** v. **Pacific Coast Medical Enterprises, Inc.** (1977) 73 CA3d 410]

Notice of option's expiration

A leasing agent who negotiates a renewal option **on behalf of a tenant** should arrange for the inclusion of a notice provision in the option provision that requires the landlord to give the tenant notice of the option's expiration 60 to 180 days prior to the expiration of the option.

This notice from the landlord to the tenant of expiration of the option eliminates the element of surprise for both landlord and tenant.

The tenant's inadvertent failure to exercise the lease renewal option can prove disastrous for the tenant who plans to continue in occupancy.

If the landlord will re-rent to the existing tenant despite the tenant's failure to exercise a renewal/extension option, the tenant will be forced to negotiate the terms of a new lease under the then existing market conditions. Thus, the landlord may be in a position, if availability of space is extremely tight, to take *unconscionable advantage* of the tenant, a situation the landlord must be careful to avoid. [See Chapter 48]

Renegotiation of rent and lease terms on expiration of a lease can result in increased rental rates, higher common area maintenance fees and other landlord charges, or changes in responsibilities being imposed on the tenant should the landlord choose to negotiate a lease with the holdover tenant whose option to renew expired unexercised. [Bekins Moving & Storage Co., *supra*]

Thus, a tenant's broker should inform the client as to when and how the renewal option must be exercised, and then provide the tenant with the necessary forms.

Again, if for no other reason, the leasing fee due on renewal should be a sufficient incentive to incite the broker to take action and assist the buyer to exercise the option.

Chapter 48 Lease assignments and subleases

This chapter presents the standards for a landlord's consent and the conditions for exactions under alienation provisions in lease agreements restricting leasehold assignments and subletting by tenants.

Consent conditioned on exactions

A landlord and tenant enter into a nonresidential lease agreement. The agreement contains an assignment and subletting provision, called a *restriction-on-transfer* or a *restraint-on-alienation* provision.

The **assignment and subletting** provision may either prohibit transfer of the tenant's interests or it may require the tenant to obtain landlord consent prior to assigning the lease or subletting (or further encumbering) the tenant's leasehold interest. If the provision permits an assignment or subletting, it:

- states the landlord's consent will not be unreasonably withheld; or
- fails to state a standard for objecting and withholding consent. [See Figure 1 accompanying this chapter]

Further, the lease agreement contains a *cancellation provision* allowing the landlord to cancel the lease agreement and terminate the occupancy on his receipt of the tenant's written request seeking the landlord's consent under the assignment or subletting provision.

After taking occupancy, the tenant vacates the premises and relocates his operations to another property with no intention of returning to the leased premises. The tenant finds a user who will pay rent at current market rates for the space, an amount that exceeds the rent owed the landlord on the lease, called *overriding rent*.

The tenant makes a request for the landlord's consent to **sublease** to the user. The landlord responds by canceling the lease agreement under the cancellation provision.

The landlord, having terminated the tenant's leasehold by cancellation of the lease agreement, negotiates directly with the user. The landlord enters into a lease of the premises with the user at current rental rates.

The tenant makes a demand on the landlord for the overriding rent he lost due to the landlord's refusal to consent to the sublease, claiming the landlord's consent was unreasonably withheld since no *conditions* for the consent were agreed to that entitled the landlord to the overriding rent.

The landlord claims his cancellation of the lease is valid, even though cancellation is an absolute restraint on the proposed transfer of the tenant's leasehold interest, since the tenant and landlord bargained for the cancellation provision that was triggered upon activation of the provision by the tenant's request for the landlord's consent to an assignment.

Can the landlord cancel the lease agreement even though he agreed not to unreasonably withhold his consent or condition consent on the exaction of the excess rents?

Yes! The two provisions in the lease, the consent-to-assignment provision and the cancellation provision, are mutually exclusive alternatives authorizing the landlord to take either of two separate courses of action when confronted with a request for consent to an assignment.

On receipt of the tenant's request for consent, the landlord exercised the cancellation provision, relieving the tenant of any further obligation under the lease — as well as terminating his tenancy and any potential profit from the property's appreciated rental value.

Thus, the issue as to whether the landlord refused his consent never arises. The landlord canceled the lease as agreed, thus nullifying any need to consider the request for consent.

Should the landlord choose not to cancel the lease agreement and terminate the tenancy on the tenant's request for consent to an assignment, the landlord is then **left to analyze** whether or not to consent. As a result, he is required to be **reasonable** about any objection he may have to the assignment since no other standard was set in the lease.

The cancellation provision in the lease agreement is bargained for and not the unconscionable result of an interference with an assignment of the lease. The prospective tenant did not have to enter into the lease agreement he signed or lease this premises.

Since the tenant's leasehold right to obtain higher rent had been contracted away by inclusion of the cancellation provision, the landlord did not unreasonably interfere with the tenant's right to assign or sublet by canceling the lease agreement. [**Carma Developers, Inc.** v. **Marathon Development California, Inc.** (1992) 2 C4th 342]

Transfer of any interest

An assignment or subletting provision in a lease agreement typically calls for the tenant to acquire consent from the landlord before the tenant may *transfer* his leasehold interest. [Calif. Civil Code §1995.250]

A **transfer** by the tenant includes an *assignment, sublease* or *further encumbrance* of the leasehold. [CC §1995.020(e); see Figure 1]

An **assignment** of the lease agreement transfers the original tenant's entire interest in the property to a successor tenant, leaving no interest held by the original tenant. However, the original tenant named on

Figure 1 *Excerpted from **first tuesday** Form 552 — Nonresidential Lease Agreement*

19. **ASSIGNMENT, SUBLETTING AND ENCUMBRANCE**: [Check only one]

    19.1 Tenant may not assign this lease or sublet any part of the premises, orfurther encumber the leasehold.

    19.2 Tenant may not transfer any interest in the premises without the priorconsent of Landlord.

    a. Consent may not be unreasonably withheld.

    b. Consent is subject to the attached conditions. [**ft** Form 250]

the lease agreement remains liable for the successor tenant's performance on the lease, even though the landlord consents to the assignment and the successor tenant becomes primarily responsible for the lease obligations, called an assumption.

For the original tenant to be **released of his liability** under the lease agreement on an assignment, a *novation* must be negotiated and entered into by the landlord and both tenants, sometimes called a *substitution of liability*. [**Samuels** v. **Ottinger** (1915) 169 C 209]

On the other hand, when entering into a **sublease** with a subtenant, the original (master) tenant transfers to the subtenant less than all of the master tenant's interest in the property. Also, **possession reverts** back to the master tenant on expiration of the sublease.

The master tenant granting the sublease remains obligated to perform on the master lease agreement. The subtenant does not assume liability of the master lease. However, the subtenant may not act in any way that would constitute a breach of the master lease agreement, a copy of which is attached to the sublease.

The **further encumbrance** of a tenant's leasehold interest occurs when the tenant places a lien on his leasehold to secure a loan, such as a trust deed or the delivery of a collateral assignment.

Editor's note — For simplicity's sake, the following discussion will only refer to an assignment of a lease. However, the discussion fully applies to any sublease or further encumbrance transaction.

Various alienation provisions

Leases include various types of assignment provisions, also called *alienation clauses*, which may:

- entirely prohibit any assignment of the lease [CC §1995.230];
- require the landlord's consent prior to an assignment without containing approved standards or placing any monetary conditions for the withholding of the landlord's consent [CC §1995.260];
- require the landlord's consent prior to an assignment, stating consent will not be unreasonably withheld [CC 1995.250(a)];
- require the landlord's consent, subject to *conditions* first being met by the tenant, e.g., payment to the landlord of all or part of the tenant's gains on the assignment, a higher rental rate and an assignment fee, and an assumption by the tenant of maintenance and utility expenses [CC §1995.250(b)]; or
- contain *conditions* for a valid assignment without requiring any consent at all, such as the landlord is entitled to all or part of the consideration the tenant receives for the assignment in excess of rent due on the lease. [CC §1995.240; see Figure 1]

Standards lay out the analytical process imposed on the landlord which he must apply when making a judgment whether or not to withhold consent.

Conditions are sums of money or leasing terms that must be met by the tenant as a requisite to consent should the landlord consent to the assignment.

No standards for withholding consent

Consider a lease agreement with an assignment provision calling for the landlord's consent prior to the tenant's assignment, but devoid of any standard or condition for consent, such as consent "will not be unreasonably withheld" or that fees must be paid.

Thus, the assignment provision does not set a standard for consent or exactions to be paid as a condition for granting or withholding consent. Here, for lack of agreement to the contrary, the standards and conditions for the landlord's consent are set by law.

A lease agreement entered into on or after September 23, 1983, with **no standard** agreed to for the landlord to consent to an assignment, requires the landlord to have a **commercially reasonable basis** for his denial should he choose to withhold consent. The landlord cannot deny consent arbitrarily.

Also, **no conditions** for an exaction can be demanded when granting the consent, such as a higher rental rate, unless bargained for as a condition for consent and included in the lease agreement. [**Kendall** v. **Ernest Pestana, Inc.** (1985) 40 C3d 488]

Commercial reasonability standards

Commercial reasonability standards relate to the landlord's ability to:

- **protect his ownership interest** from property waste and financial deterioration due to the successor tenant's propensity to care for and make suitable use of the property under the use-maintenance provisions in the lease; and
- **ensure the future performance** of the lease by an assignment to a creditworthy tenant.

Commercially reasonable objections for withholding consent to an assignment include:

- the successor tenant's financial responsibility, or net worth, prior operating history and creditworthiness;
- the successor tenant's intended use, care and maintenance of the property;
- the suitability of the successor tenant's use, product marketing and management style for the property; and
- the need for tenant alterations to the premises. [Kendall, *supra*]

For example, a use provision in a lease agreement gives a tenant the right to operate a service business in a shopping center in which the landlord operates a retail business outlet. The lease agreement restricts the tenant's use to an "office use related to the business" of the tenant.

The lease alienation provision in the lease agreement requires the tenant to obtain the landlord's prior consent to an assignment of the lease agreement. The alienation provision sets **no standard** for withholding consent and provides for **no conditions** to be met (paid) by the tenant for the consent if it is granted.

Later, the tenant seeks to transfer the lease to a successor who will operate a retail business from the premises. The successor tenant's retail business will be in direct competition with the landlord's retail outlet.

Since it calls for a change in the use of the premises, the landlord refuses to consent to the assignment.

The tenant claims the landlord's refusal is commercially unreasonable since it amounts to *economic protectionism* unrelated to the landlord's ownership and operation of the rental property.

Here, the landlord's refusal is a commercially reasonable application of the use restriction in the lease agreement. He sought only to retain the use originally intended by the lease. The refusal is not due to improper economic protectionism in the management and operation of the real estate since the landlord did not seek an increase in rent or other economic benefits to enhance himself as a *condition* for his con-

sent to the assignment of the lease. [**Pay 'N Pak Stores, Inc.** v. **Superior Court of Santa Clara County** (1989) 210 CA3d 1404]

Also, the landlord can reasonably refuse his consent to a trust deed lien the tenant seeks to place on the leasehold interest when the proceeds of the loan are not used to improve the property. [**Airport Plaza, Inc.** v. **Blanchard** (1987) 188 CA3d 1594]

Reasonable increases in rent

Consider a nonresidential tenant who agrees to pay a percentage of his gross sales as rent, but not less than a base monthly amount, called a *percentage lease*.

An alienation provision in the lease agreement requires the tenant to obtain the landlord's consent before assigning the lease. The provision does not include standards or conditions for the landlord's consent to an assignment.

The tenant enters into an agreement to sell his business and assign the lease to a new operator. The operator buying the lease (and the business) is to pay the tenant a monthly premium over the remaining life of the lease, called *overriding rent*.

The tenant requests the consent of the landlord to the assignment of the lease agreement. On investigation, the landlord determines the operator will manage the business in a manner that will not generate gross sales at the same level as the current tenant. Thus, under the percentage lease, the new operator will not become obligated to pay the amount of rent currently being paid by the tenant seeking consent.

However, the landlord agrees to consent to the assignment **conditioned** on the landlord receiving the **overriding rent premium** the tenant is to be paid for the assignment.

The tenant claims the landlord cannot condition consent on exacting the rent premium since no standards or conditions for consent exist in the lease and thus cannot now be imposed.

Here, the landlord can **condition** his consent to the tenant's assignment of the lease on the landlord's receipt of the monthly rent premium to be paid by the new tenant even though he did not contract in the lease agreement for the premium.

The landlord's conditional consent to the assignment is **commercially reasonable**. When granting consent, the landlord is entitled to preserve the rental income he currently receives from the existing tenant. The landlord does not need to accept the certain risk of a lower monthly percentage rent from the assignee while the original tenant receives a monthly premium. [**John Hogan Enterprises, Inc.** v. **Kellogg** (1986) 187 CA3d 589]

Proceeds from assignment demanded

Now consider a nonresidential lease agreement that contains an assignment provision authorizing the landlord to demand all the consideration the tenant will receive for an assignment of the lease as a *condition* for his consent to the assignment.

The landlord using the lease does not bargain for any other exaction, such as a portion of the purchase price the tenant will receive on a sale of the business that the tenant operates from the premises.

Later, the tenant agrees to assign the lease to a new operator as part of the sale of his business. The operator will pay the tenant a lump sum for the lease as part of the purchase price since rent due under the lease agreement is below market rates.

The landlord demands the tenant pass on the price paid for the lease as a condition for his consent to the assignment, which the tenant rejects.

The tenant claims the landlord's demand in exchange for consent is commercially unreasonable, and thus unenforceable, since the landlord has no lawful justification for the premium or additional rent they agreed to in the lease.

Here, the landlord may condition consent on his receipt of the payment made for the assignment of the lease.

Nonresidential lease agreements granting the landlord the right to receive any consideration the tenant is to receive related (and limited) to the *value of the lease* to be assigned are enforceable. [CC §1995.240]

Absent unconscionable or discriminatory provisions, nonresidential landlords and tenants are free to place *commercially reasonable* restrictions limited to the value of the leasehold on any assignment of the lease. [Carma Developers, Inc., *supra*]

More than rental value demanded

Again, a nonresidential lease agreement may provide for the landlord to receive all consideration the tenant receives for the assignment of the lease in exchange for his consent since these amounts are considered commercially reasonable. [CC §1995.240]

However, the consideration the landlord may receive for his consent to an assignment is limited to financial benefits directly related to the **value of the lease** assigned.

For example, a tenant occupies nonresidential property under a lease agreement.

The lease agreement includes a *profit-shifting clause* calling for the tenant to pay the landlord, in exchange for his consent to an assignment, 25% of the consideration the tenant receives for goodwill on the sale of the tenant's business which operates from the premises. Both agree it is the location of the leased property which will give the tenant's business its goodwill value.

The tenant's business is a success and the tenant locates a buyer for the business and the remaining term on the lease. The tenant seeks the landlord's consent for an assignment of the lease.

As agreed, the landlord demands 25% of the consideration the tenant will receive for his business goodwill. The tenant refuses to meet the demand and the landlord refuses to consent to the assignment.

As a result, the sales transaction does not close. The tenant makes a demand on the landlord for 100% of his lost profits on the sale.

The tenant claims the landlord's demand for a share of the profits on the sale of the business as agreed to in the lease agreement was a commercially unreasonable and unenforceable condition for granting consent to the assignment.

The landlord claims the profit-shifting provision is enforceable since all consideration received by the tenant on a transfer of the lease, even in excess of the value of the lease, can be agreed to and taken in exchange for consent.

Here, the landlord's right to receive the consideration the tenant is to receive for the sale of a business and an assignment of the lease as agreed is limited to the consideration the tenant receives for the **increased value** of the lease. For the landlord to demand the amount the tenant receives on his sale of his leasehold as consideration for the landlord's consent it must be agreed to in the alienation provision in the lease agreement to be enforceable. [**Ilkhchooyi** v. **Best** (1995) 37 CA4th 395]

Unconscionable advantage situations

Now consider a subtenant who must negotiate a new lease with the landlord or be evicted. The master tenant's lease agreement has been terminated by the landlord due to no fault of the subtenant.

The landlord submits a proposed lease agreement to the subtenant which differs significantly in its terms and conditions from the wiped out sublease agreement the subtenant held with the master tenant. When the subtenant attempts to negotiate a reasonable rent based on "comps" and eliminate unacceptable provisions, the landlord tells the subtenant to "take it or leave it." The subtenant is told he will be evicted if the proposed lease agreement is not signed.

The proposed lease agreement includes an alienation clause calling for a 200% increase in rent as a condition to be met before the landlord will consent to an assignment of the lease.

The subtenant signs the lease. Later, the subtenant seeks the landlord's consent to an assignment of the lease on his sale of his business. The landlord demands a modification of the rent provision to reflect the 200% increase in monthly rent as agreed, which the subtenant's buyer refuses to sign.

The landlord claims the alienation clause is enforceable since the clause was freely bargained for.

The tenant claims the provision was the result of an *unconscionable advantage* held by the landlord when they negotiated the terms of the lease since the tenant was in no position to bargain with the landlord. When the lease was negotiated, the tenant could not refuse to rent due to the goodwill he had built up for his business through a heavy investment in advertising at this location. In light of his negotiating advantage, the conduct of the landlord was unconscionable.

Can the tenant avoid enforcement of the profit-shifting clause?

Yes! The alienation clause agreed to was the result of the landlord taking *unconscionable advantage* of the subtenant's situation. The subtenant was in possession under a wiped out sublease without any power to freely bargain. He was already in possession and operating a business that had developed goodwill that would be lost if he vacated.

Collection of future rents so hugely excessive as to **effectively shift profits** from the sale of the business to the landlord for his consent to an assignment of a lease was overreaching on the landlord's part. Thus, the profit-shifting assignment provision was unenforceable as the product of unconscionable demands resulting from the advantage held by the landlord over the subtenant. [Ilkhchooyi, *supra*]

Also, any consideration the landlord seeks which is beyond the **value of the leasehold interest** or the landlord's interest in the real estate is not reasonable, whenever or however bargained for.

Proceeds from the sale of a business, or a rent amount so large in its increase as to reduce the goodwill value of the business occupying the premises, reach beyond the economics (rental value) of the lease.

Thus, the demands agreed to unlawfully shift profits that are unrelated to the value of the leasehold. The right to freely bargain is not intended to give the landlord the right to freely fleece a tenant in the name of freedom of contract. [Ilkhchooyi, *supra*]

Tenant-mitigation provisions

When a nonresidential lease agreement contains a tenant-mitigation provision and the tenant breaches the lease, the landlord may treat the lease as continuing and recover rent for the life of the lease. The provision shifts to the tenant the responsibility for leasing the property to **mitigate losses** when the tenant vacates and breaches the lease.

Under a tenant-mitigation provision, the landlord and tenant agree the tenant has a duty to find a replacement tenant, pay for any tenant improvements (TIs) and collect rent when the tenant breaches the lease and vacates the premises. [CC §1951.4]

On the tenant's breach of a lease agreement with a tenant-mitigation provision, the landlord does not have the duty to mitigate his rental losses by **repossessing and reletting** the space himself (or as an agent of the tenant) before enforcing collection of future rents due under the lease agreement.

However, if the lease agreement also provides for the landlord's prior consent to a transfer, the tenant-mitigation provision is enforceable only if the landlord's consent to an assignment is not unreasonably withheld. [CC §1951.4(b)(3)]

A landlord who prohibits assignments or unreasonably withholds consent retains the duty to mitigate his loss of rents on the tenant's breach.

Broker's role

Assignment (alienation) provisions restricting the transfer (assignment) of the leasehold interest held by a tenant become a concern of the bus-op or industrial broker when:

- negotiating the assignment of a lease in a *bus-op sale* (or negotiating a sublease or a further encumbrance);
- *relocating* a tenant whose current lease has not yet expired; or
- negotiating the origination of any lease.

A broker handling a **bus-op sale** or **relocation** of a business or industrial tenant must determine the tenant's ability and under what standards or conditions the tenant is allowed to assign the existing lease to a buyer of the business operation or other successor tenant.

The broker starts the analysis by ascertaining the type of assignment clause the landlord's proposed lease agreement contains. The broker can then determine the tenant's assignment rights.

Now consider a leasing agent who is **negotiating a lease** on behalf of a prospective tenant. The tenant's agent should limit the wording of an assignment provision to include:

- the landlord's consent "will not be unreasonably withheld"; and
- any exaction to be paid for the consent is limited to any increased rental value of the premises received by the tenant.

Any prohibition against assignment should be eliminated by including the "with consent" provision.

Conversely, the landlord's leasing agent who arranges a lease should review the assignment provision in the proposed lease agreement and include any consideration the tenant is to pay the landlord as a condition for his consent to an assignment.

For example, as compensation for consent to an assignment, the landlord may want to:

- adjust rents to current market rates;
- receive fees and costs incurred to investigate the successor tenant's credit and business conduct so he can analyze his risk of loss should he consent to the assignment;
- receive any overriding rent or lump sum payment the tenant receives that is attributable to the value of the lease;
- require the successor tenant to pay operating expenses as additional rent such as maintenance, utilities, insurance and taxes; or
- alter the terms of the lease agreement and any options to extend/renew the lease or buy the property.

Any exactions the landlord may expect or later seek for his consent must be agreed to and set forth in the lease agreement, and be related to the value of the lease to be enforceable.

Chapter 49 Nonresidential rent control prohibited

This chapter discusses the prohibition of nonresidential rent control and the narrow powers agencies have to regulate facets of business location, development and occupancies.

Legislative purpose

Residential landlords and apartment builders in California have battled local rent control ordinances since the mid-1970s.

Some judicial support for de-control is taking root since the societal objectives underlying the enactment of rent control ordinances are not being met. [**152 Valparaiso Associates** v. **City of Cotati** (1997) 56 CA4th 378]

Further, the California legislature enacted a scheme which will gradually lead to a phaseout of all residential rent control. The economics of rent control in the long term are not kind to tenants or the surrounding neighborhoods, while investment capital is unharmed since it simply locates elsewhere. [Calif. Civil Code §1954.52; see Chapter 57]

Most major metropolitan areas in California, including Los Angeles, San Francisco, Oakland and San Jose, have some form of residential rent control.

However, the city of Berkeley went beyond attempts to control only residential income properties. The city passed further rent control ordinances placing restrictions on the amount of rent landlords of nonresidential properties could change.

The stated objective supporting the Berkeley nonresidential rent ordinances was to preserve the city's older business neighborhoods without change or evolvement. Inefficient owners with improperly located shops saw their rents rise dramatically as their space was sought by better capitalized and more effective businessmen, a process called *Economic Darwinism* or *creative destruction*. Simply put, the landlords were willing to rent to more efficient and productive businesses willing to pay a higher rent.

Local historical preservation advocates asserted rent control was the only way to protect "mom-and-pop" shops which otherwise are no longer financially viable operations. Conversely, landlords felt they should be allowed to rent the space to any tenant whose business operation conforms to existing zoning ordinances.

Local community leadership is caught politically between making a policy commitment to protect inefficient, small shop owners in historic business districts or fostering an environment that encourages the growth of existing businesses or their replacement by fresh, energetic businesses in the same or newly constructed structures.

However, no California city, county or other public agency may pass and enforce nonresidential rent control ordinances. [CC §1954.25]

The California legislature felt nonresidential rent control was **economically improper** since it:

- discouraged commercial development and open market competition;
- benefitted one business enterprise over another; and

- hampered business expansion. [CC §1954.25]

Rental limit ban

The ban on nonresidential rent control also covers actions by all *public entities* who act as landlords, as well as private landlords. [CC §1954.27(a)]

A **public entity** includes:

- the state;
- all cities and counties;
- all public authorities and agencies; and
- all political subdivisions and public corporations. [Calif. Government Code §811.2]

Thus, no public entity can **control** or **limit** nonresidential rental rates, directly as owners or indirectly by ordinances. Using the power of *eminent domain* to control rents is improper.

Nonresidential real estate includes all real estate except:

- dwelling units;
- residential hotels; and
- mobilehome parks. [CC §1954.26(d)(4)]

Thus, the marketplace of available space for rent, managed by the brokers as the gatekeepers, is left to sort out **who will occupy** the space without government interference. [CC §1954.26(f)]

To meet these ends, public agencies are prohibited from designating a specific tenant with whom a landlord must negotiate to create, extend or renew a **nonresidential lease**. Any tenant may rent any nonresidential space based on negotiations unfettered by governmental interference. [CC §1954.26(f)]

The prohibition against nonresidential rent control covers all actions by local governments, whether by charter, ordinance, resolution, administrative regulations or policy statements. [CC §1954.26(f)]

Local rent control ordinances cannot establish or dictate any of the terms which might be negotiated in a nonresidential lease agreement or in the renewal or extension of the lease.

However, not all local government powers have been curbed. What has ended is government interference with nonresidential **lease negotiations** between landlords and tenants.

Remaining local powers

Local governments can still regulate all facets of business **location** and **development** such as:

- exercising eminent domain powers [CC §1954.28(a)];
- abating nuisances [CC §1954.28(b)];
- establishing zoning (use) and business licenses (policing) [CC §1954.29(a)]; and
- protecting historical resources. [CC §1954.28(e)]

Also, the ban on nonresidential rent control does not apply to **redevelopment contracts** entered into by a developer and a public agency.

Under redevelopment agreements, the developer rents to local businesses at a set or **reduced rate** in exchange for participation with the public agency. [CC §1954.28(d)]

Negotiation notice to landlord

Public agencies may establish a notice procedure for an existing nonresidential tenant to **make an offer** to the landlord, or **solicit an offer** from the landlord, negotiating for a renewal or extension of the lease.

However, the agency's action cannot interfere with rights held under an existing lease agreement. Thus, they cannot alter the lease expiration date or the attendant obligation of the tenant to vacate on expiration or be evicted. [CC §1954.31]

For example, a lease agreement exists which does not grant an option to the tenant to renew or extend the term of the lease, called a *term-only lease*.

However, the local governing agency can by ordinance create a procedure allowing the tenant to deliver a *negotiation notice* to the landlord. In the **negotiation notice**, the tenant makes or solicits an offer to negotiate an extension of the term of the lease. [CC §1954.31(a)(1)]

A tenant who has *materially breached* a significant provision in the lease agreement is not eligible to use the negotiation notice scheme. [§1954.31(b)(1)]

The negotiation notice acts as the **tenant's offer** to acquire an extension or renewal of the lease, an activity a tenant could carryout without the existence of an enabling ordinance. Of course, the tenant does not need to use a negotiation notice to contact his landlord. [CC §1954.26(j)(2)]

On the landlord's receipt of the negotiation notice, the landlord is required to respond if the notice is sent to the landlord within 270 days before the expiration of the lease. [CC §1954.31(a)(2)(A)]

However, whether or not the landlord receives a negotiation notice from the tenant, the landlord and the property manager have no duty to notify the tenant the lease is expiring at the end of the term stated in the lease agreement.

Impasse notice to tenant

If the tenant delivers the negotiation notice within 270 days before the lease expires, the landlord either:

- enters into negotiations to renew or extend the lease with the tenant; or
- delivers an *impasse notice* to the tenant no more than 180 days before the lease expires, within a time period after receipt of the negotiation notice as set by the local agency. [CC §1954.31(a)(2)(B)]

An **impasse notice** advises the tenant the lease will expire as called for in the lease and no modification of the lease will be entered into. [CC §1954.26(i)]

For example, a city passes an ordinance requiring a landlord to respond to an impasse notice within 30 days of receiving a negotiation notice, but not prior to 180-days before the lease expires.

However, if the negotiation notice is received 150 days prior to expiration of the lease, the landlord must respond within 30 days or he will be acting in **bad faith**.

The landlord is also required to send an impasse notice when he or his agent have received a negotiation notice and entered into renewal or extension negotiations with the tenant which are later broken off. The impasse notice indicates the lease will not be renewed or extended.

Also, negotiation and impasse notice ordinances cannot force the landlord to deal with a tenant or to make a counteroffer to the tenant. A landlord is not required to negotiate an additional or new term with the existing tenant and may reject the tenant's offer by use of the impasse notice.

One purpose served by the tenant's notice to the landlord and the landlord's response is to allow the tenant time to negotiate a new or extended lease with their landlord or find alternative space before the lease term expires. In practice, tenants have always knowingly borne these burdens as their possessory interest draws to an end.

On its face, and without conjecture as to unintended consequences, these ordinances appear to add nothing to the leasing environment except for the landlord's written impasse notice in response to a prior written offer from the tenant to negotiate.

However, the notice rules do not provide guidance for landlords who commence negotiations which become prolonged and continue beyond the response period set by ordinances for delivery of an impasse notice. If the landlord breaks off negotiations after the response period for delivery of the impasse notice has passed, it is too late to deliver an impasse notice unless the ordinance extended the time in which to respond.

The safest conduct for the landlord who receives a tenant's negotiation notice is to deliver an impasse notice within the response period set by the local ordinance and before entering into negotiations. If negotiations result in an extension or renewal, the notice becomes irrelevant. If negotiations fail, the landlord complied with the negotiation/impasse ordinance.

Failure to deliver notices

A landlord or property manager who fails to deliver an impasse notice and does not enter into negotiations after the timely receipt of the tenant's negotiation notice may have acted in *bad faith*. A non-response subjects the landlord or property manager to liability for the tenant's actual money losses incurred due to the **bad faith** failure to deliver the impasse notice. [CC §1954.31(a)(3)]

When confronted with a bad faith claim, the landlord should immediately deliver an impasse notice and extend the expiration of the lease to a date after delivery of the impasse notice which represents the period of time the tenant would have been given prior to expiration of the lease had an impasse notice been timely delivered. The extension avoids loss of the tenant's reasonable expectations, induced by the notice ordinance, of up to a 180-day period to relocate after receipt of an impasse notice.

Chapter 50 Residential rental and lease agreements

This chapter distinguishes residential lease agreements from month-to-month rental agreements.

Fixed-term or periodic tenancy

Residential landlords and tenants enter into either a lease agreement or a periodic rental agreement when the landlord transfers the right to occupy property to the tenant, called *leasing* or *renting* property. Periodic rental agreements are nearly always structured as month-to-month rental agreements.

Other than the **expiration** of the tenancy conveyed by each agreement and the duration of originally agreed rights and obligations, residential lease agreements and rental agreements grant and impose on the landlords and tenants the same rights and obligations. It is the expectation of continued occupancy and the obligation to pay rent which differs.

Provisions agreed to which are not included as boilerplate provisions in the pre-printed forms used by landlords are included in an addendum to the rental or lease agreement. The provisions are entered on the addendum, and the addendum is referenced in the body of the rental or lease agreement to which it is attached.

Additional terms and conditions placed in addendums include authorization for the tenant to maintain items on the premises such as a pet, fish tank or liquid-filled furniture, or the landlord's grant to the tenant of an option to buy the property or to renew or extend the term of the lease.

A month-to-month **rental agreement** runs for an indefinite period of time since it automatically renews monthly, and on the same terms, until modified or terminated by notice. [See **first tuesday** Form 551 §2]

Month-to-month tenancies, a variety of *periodic tenancies* created by entering into a **rental agreement**, can be terminated by either the landlord or the tenant on 30 days written notice. [Calif. Civil Code §1946; see Chapter 33]

On the other hand, a **lease agreement** creates a tenancy that continues for a fixed period, called its *term*, such as six months or one year, at the end of which the tenant's right to occupy expires. [See Form 550 §2 accompanying this chapter]

Also, the lease terminates at the end of its fixed term without further notice by either the landlord or the tenant, called *expiration* of the lease. Unlike a periodic tenancy, no renewal of a lease occurs on expiration of its term, unless agreed to in an option to renew or extend.

Unlike the required use of a 30-day notice to vacate to bring a month-to-month tenancy to termination, the lease agreement contains the only notice the tenant or the landlord is entitled to receive that the lease terminates. The expiration provision in the lease agreement sets forth the day the right to occupy expires, automatically reverting the right of occupancy to the landlord.

Rental market influences

The population of tenants and the number of properties competing for these tenants, as well as the comparison of a property's location and its amenities to competing properties, create the **rental market**. It is the rental market which sets the amount of rent a residential landlord is able to charge on any given day.

Generally, tenants on month-to-month rental agreements pay higher amounts of rent for a unit than do tenants with lease agreements. Month-to-month tenants pay a premium for the privilege of being able to vacate the premises on 30 days' notice, without liability exposure for future rents. This privilege held by the tenant contributes to the landlord's uncertainty about his income and costs of tenant turnover, hence the premium rent.

Tenants typically pay lower rents when they enter into a lease. In stable rental markets, the longer the lease, the lower the rent. Rent is, however, subject to adjustments for future inflation.

Also, landlords offer lower rents on leases to persuade tenants to **commit** themselves to longer periods of tenancy. A landlord entices tenants to enter into lease agreements as part of a strategy to stabilize his income, reduce the vacancy rate and minimize turnover costs.

However, during market periods of generally high vacancy rates, price-competitive landlords favor using month-to-month rental agreements rather than leases. Therefore, when rents begin to rise landlords can adjust rents accordingly.

Just as a month-to-month rental agreement can be terminated on 30 days' notice, the amount of rent can be increased to current market rates on 30 days' written notice (except for a 60-day notice to increase rents on residential units by 10% or more within a 12-month period, and for rent control properties). [CC §827]

Lease negotiations on expiration

Conversely, a landlord cannot alter the terms of a lease agreement during the life of the lease without **consideration** and the tenant's **consent**.

The landlord desiring to keep the tenant with an impending lease expiration should contact the tenant and offer to enter into another lease agreement or a month-to-month rental agreement. Unless contacted (and the lease is renewed or extended), the tenant knows he is expected to vacate the premises on expiration of the lease.

If the tenant desires to remain in possession when his lease expires, the amount of rent a landlord can demand is limited only by negotiations and the availability of other rentals and tenants.

On expiration of a lease, the tenant has no lawful right to possession of the unit. If the tenant remains in possession and refuses to pay the amount of rent demanded by the landlord, he may be evicted immediately without further demand for possession. [Calif. Code Civil Procedures §1161(1)]

A better initial plan for retaining tenants includes the landlord entering into a lease agreement, giving the tenant an option to renew or extend the lease for a set period of months at the **prevailing rent**.

RESIDENTIAL LEASE AGREEMENT

DATE:_____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This lease agreement is entered into by _____, as the Landlord, and _____,as the Tenant(s),

1.1 regarding residential real estate referred to as: _____

_____

1.2 including the following:

☐ Garage/parking space #_____

☐ Storage space #_____

☐ Furnishings:

1.3 The following checked attachments are part of this agreement:

☐ Condition of premises [**first tuesday** Form 560]

☐ Tenant's credit application [**ft** Form 302]

☐ Condition/Inventory of furnishings [**ft** Form 561]

☐ Rent control disclosures

☐ Brokerage fee addendum [**ft** Form 273]

☐ House/Building rules

☐ Option to renew/extend lease [**ft** Form 566]

AGREEMENT:

2. DEPOSIT:

2.1 Landlord acknowledges receipt of $_____ as a security deposit.

2.2 The deposit is security for the diligent performance of Tenant's obligations, including payment of rent, repair of damages, reasonable repair and cleaning of premises on termination, and any loss, damages or excess wear and tear on furnishings provided to Tenant.

2.3 No interest will be paid on the deposit, and Landlord may place the deposit with his own funds, except where controlled by law.

2.4 Within 21 days after Tenant vacates, Landlord to furnish Tenant with a security deposit statement itemizing any deductions, with a refund of the remaining amount.

3. TERM OF LEASE:

3.1 This lease will begin on _____, 20_____, and continue until _____, 20_____.

3.2 The lease terminates on the last day of the term without further notice.

3.3 If Tenant holds over, Tenant to be liable for rent at the daily rate of $_____.

4. RENT:

4.1 Tenant to pay, in advance, $_____ rent monthly, on the _____ day of each month.

4.2 Rent to be paid by:

a. ☐ cash, ☐ check, or ☐ cashier's check, made payable to Landlord or his agent and delivered to: _____
(Name)

_____
(Address)

_____

_____
(Phone)

Personal delivery of rent to be accepted at Landlord's address during the hours of _____ am to _____pm on the following days: _____

b. ☐ credit card #_____/_____/_____/_____ issued by _____, which Landlord is authorized to charge each month for rent due.

c. ☐ deposit into account number _____

at: _____
(Financial Institution)

_____
(Address)

_____

4.3 Tenant to pay a charge of $_____ as an additional amount of rent, due on demand, in the event rent is not received within five days after the due date.

4.4 If any rent or other amount due Landlord is not received within five days after its due date, interest will thereafter accrue on the amount at 12% per annum until paid. On receipt of any past due amount, Landlord to promptly make a written demand for payment of the accrued interest which will be payable within 30 days of the demand.

4.5 Tenant to pay a change of $_____ as an additional amount of rent, due on demand, for each rent check returned for insufficient funds, and thereafter pay rent by cash or cashier's check.

5. POSSESSION:

5.1 Tenant will not be liable for any rent until the date possession is delivered.

5.2 If Landlord is unable to deliver possession, Landlord will not be liable for any damage, nor will this lease terminate.

5.3 Tenant may terminate this lease if Landlord fails to deliver possession within five days of commencement.

5.4 Only the above-named Tenant(s) to occupy the premises.

5.5 Tenant will not assign this lease agreement or sublet, or have boarders or lodgers.

5.6 Tenant(s) will have no more than _____ guests staying the greater of no more than 10 consecutive days or 20 days in a year.

5.7 Except as noted in an addendum, Tenant agrees the premises, fixtures, appliances and furnishings are in satisfactory and sanitary condition. [**ft** Form 561]

5.8 Landlord to make any necessary repairs as soon as possible after notification by Tenant. If Landlord does not timely make necessary repairs, Tenant may have the repairs made and deduct the cost, not to exceed one month's rent.

6. TENANT AGREES:

6.1 To comply with all building rules and regulations and later amendments or modifications.

6.2 To pay for the following utilities and services: _____

_____

_____

landlord to pay for: _____

6.3 To keep the premises clean and sanitary and to properly dispose of all garbage and waste.

a. ☐ Yard maintenance included in tenant obligations.

6.4 To properly operate all electrical, gas and plumbing fixtures and pipes, and keep them clean and sanitary.

6.5 To make the premises available on 24 hours notice for entry by Landlord to make necessary repairs, alterations or services, or to exhibit the premises to prospective purchasers, tenants, employees or contractors.

a. In case of emergency or Tenant's abandonment of premises, Landlord may enter the premises at any time.

6.6 Not to disturb, annoy, endanger or interfere with other occupants of the building or neighboring buildings.

6.7 Not to use the premises for any unlawful purpose, violate any government ordinance, or create a nuisance.

6.8 Not to destroy, damage or remove any part of the premises, equipment or fixtures or commit waste, or permit any person to do so.

6.9 Not to keep pets or a waterbed on the premises without Landlord's written consent.

a. See attached ☐ pet addendum [**ft** Form 563], ☐ waterbed addendum. [**ft** Form 564]

6.10 Not to make any repairs, alterations or additions to the premises without Landlord's written consent.

a. Any repairs or alterations shall become part of the premises.

6.11 Not to change or add a lock without written consent.

7. GENERAL PROVISIONS:

7.1 Tenant agrees to hold Landlord harmless from claims, demands, damages or liability arising out of the premises caused by or permitted by Tenant, Tenant's family, agents employees and guests.

a. ☐ Tenant to obtain insurance for this purpose naming Landlord as an additional insured.

7.2 Landlord to maintain the premises and common areas in a safe and sanitary condition and comply with all applicable ordinances and regulations.

7.3 Waiver of a breach of any provision shall not constitute a waiver of any subsequent breach. Landlord's receipt of rent with knowledge of Tenant's breach does not waive Landlord's right to enforce the breached provision.

7.4 In any action to enforce this agreement, the prevailing party shall receive attorney fees.

7.5 Notice: Pursuant to Section 290.46 of the Penal Code, information about specified registered sex offenders is made available to the public via an Internet Web site maintained by the Department of Justice at www.meganslaw.ca.gov. Depending on an offender's criminal history, this information will include either the address at which the offender resides or the community of residence and ZIP code in which he or she resides.

7.6 ☐ See attached addendum for additional terms and conditions. [**ft** Form 250]

7.7 ☐ See attached Notice of Illegal Controlled Substance. [**ft** Form 583]

8. _____

_____

_____

_____

_____

_____

_____

_____

I agree to let on the terms stated above.

Date:_____, 20_____

Landlord: _____

Agent: _____

Signature: _____

Address: _____

_____

Phone:_____

Fax: _____

E-mail:_____

I agree to occupy on the terms stated above.

Date:_____, 20_____

Tenant:_____

Tenant:_____

Signature: _____

Signature: _____

Address: _____

_____

Phone:_____

Fax: _____

E-mail:_____

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Requisites to accepting tenants

On locating a prospective tenant for a residential unit, the landlord requires him to complete a credit application so the prospect's creditworthiness can be established before entering into either a rental or lease agreement. [See **first tuesday** Form 302]

The credit application should be referenced and attached as an addendum to any rental or lease agreement entered into by the landlord and tenant. The application is part of the leasing process which persuades the landlord to accept the applicant as a tenant.

Initially, the landlord uses the authorization provided by the tenant on the application to verify the tenant's rental history, employment, credit standing and check writing history.

If a prospective tenant has a poor credit rating or no credit rating at all, yet meets the landlord's income requirements, the landlord might seek assurances in addition to the maximum security deposit allowed, such as:

- a co-signer on the lease; or
- a guarantee agreement executed by a creditworthy individual. [See **first tuesday** Form 439-L]

Then, if the tenant defaults in rent payments or damages the premises, the landlord can hold the co-signer liable or collect his losses from the guarantor should the security deposit prove insufficient to cover lost rents and maintenance charges.

Condition of premises addendum

Residential landlords and tenants have a statutory duty to, respectively, maintain the property and refrain from damaging the premises. [CC §§1941, 1941.2]

To avoid disputes over who is responsible for any damage to the premises, the residential landlord and tenant should complete and sign a *condition of premises addendum* **before** the tenant is given possession. [See **first tuesday** Form 560; see Chapter 20]

Before a tenant takes possession, the landlord or his manager needs to inspect the unit with the tenant, called a *walk-through*. Together, the landlord (or resident manager) and the tenant will use a condition of premises addendum to confirm:

- the premises is in satisfactory condition;
- if there is any existing damage to the premises; and
- if there are any repairs the landlord is to make to the premises.

If the unit is furnished, the landlord and tenant will complete and sign an additional form on their walk-through called a *condition of furnishings addendum*. [See **first tuesday** Form 561]

The **condition of furnishings addendum** confirms:

- the inventory of furnishings located in the unit;
- the current condition of the furnishings; and
- the tenant's acceptance of the furnishings.

At the pre-expiration inspection to be provided residential tenants, the originally prepared condition of premises form is reviewed to help establish tenant responsibility for excess wear and tear to the unit rented.

Pet addendum

Generally, a lease agreement or month-to-month rental agreement prohibits a tenant from keeping pets on the premises.

Some landlords do allow pets, but often:

- impose restrictions on the type or size of the pet; and
- require the landlord's written consent to keep the pet on the premises. [See Form 550 §5.9 and **first tuesday** Form 551 §5.9]

Editor's note — A landlord cannot prohibit a disabled person from keeping a dog on the premises which is specially trained to assist the person. [CC 54.1(b)(5); see Chapter 53]

The landlord and tenant can sign and attach a pet addendum that states:

- the type of pet and its name;
- the security deposit to be charged for the pet; and
- the tenants agreement to hold the landlord harmless for any damage caused by the pet. [See **first tuesday** Form 563]

Waterbed addendum

Lease agreements and month-to-month rental agreements also prohibit a tenant from keeping a waterbed or other liquid-filled furnishings on the premises without the landlord's written consent. [See Form 550 5.9 and **first tuesday** Form 551 5.9]

When a tenant has a waterbed, the landlord should require the tenant to sign a *waterbed addendum*. [See **first tuesday** Form 564]

The **waterbed addendum** indicates:

- the additional security deposit the tenant will be required to provide for keeping a waterbed on the premises; and
- the tenant's agreement to maintain an insurance policy to cover potential property damage should the waterbed leak or burst. [See Chapter 19]

Brokerage fee addendum

A broker who is retained under an exclusive authorization to lease property is due a fee if the landlord rents the premises to a tenant during the listing period. [See **first tuesday** Form 110; see Chapter 12]

Likewise, a broker is entitled to a fee when a tenant has retained the broker under an exclusive authorization to locate space and the tenant rents space during the listing period. If the tenant does not provide for the landlord to pay the fee, the tenant will owe the broker the fee. [See **first tuesday** Form 111; see Chapter 13]

However, brokers often fail to insist on a written fee agreement from either the landlord or the tenant before rendering services. To be assured a fee when a prior written fee agreement does not exist, the broker should include a fee agreement as part of an offer to lease or letter of intent, lastly as an addendum to the proposed rental or lease agreement prepared for the tenant to sign. [See **first tuesday** Form 273]

Other addenda

Other information handed to a residential tenant which is made a part of a rental or lease agreement includes:

- house or building rules; and
- any rent control disclosures required by local rent control ordinances.

Also, a tenant entering into a lease agreement may have negotiated for an option to renew or extend the lease when it expires. Provisions for the option to renew or extend would be included in an addendum attached to the lease agreement. [See **first tuesday** Form 565]

A residential landlord seeking to sell the property may grant the tenant an option to purchase the property. [See **first tuesday** Form 161; see Chapter 6]

However, no portion of the option money or rent should ever be applied to the purchase price. When the terms of the lease agreement or option agreement provide for any credit to be applied toward the purchase price, or to a down payment on the purchase price, the tenant has acquired an *equitable ownership* interest in the property.

A transaction involving a lease and a purchase option calling for rent or option money payments to be applied toward the purchase price is called a *lease-option sale*, and is a sale of the property for all purposes, and not a leasing arrangement at all.

Terms of residential occupancy

On executing a residential lease agreement or month-to-month rental agreement, a landlord conveys the right to possession of the unit to a tenant, called a *leasehold estate*, or simply a *lease*.

Also, a lease agreement or month-to-month rental agreement sets forth the respective rights and obligations of the landlord and tenant for the use, care and maintenance of the property during the tenants occupancy.

A **security deposit** is usually received from the tenant to cover the cost to clean the unit or remedy any damage caused to the unit by the tenant beyond reasonable wear and tear. [See Form 550 §1 and **first tuesday** Form 551 §1; see Chapter 19]

In return for the use and possession of the premises, the tenant pays the landlord **rent** until expiration of the lease, or periodic tenancy, and possession is then returned to the landlord.

The tenant agrees to pay a **late charge** if rent is not paid within a fixed period of time after it is due, called a *grace period*. [See Form 550 §3 and **first tuesday** Form 551 §3]

Also, the number of **guests** the tenant may have in his unit and the period of time over which his guests may visit is limited. [See Form 550 §4.6 and **first tuesday** Form 551 §4.6]

The tenant agrees to comply with all building or project **rules** and **regulations** established by CC&Rs or the landlord. [See Form 550 §5.1 and **first tuesday** Form 551 §5.1]

The landlord and tenant agree who will pay or how they will share the financial responsibility for the unit's **utilities**. Landlords of apartment buildings or complexes often retain the responsibility of providing water to the units. [See Form 550 §5.2 and **first tuesday** Form 551 §5.2]

In both a rental and lease agreement, the tenant agrees to hold the landlord harmless from all liability for damages caused by the tenant or his guests. [See Form 550 §6.1 and **first tuesday** Form 551 §6.1]

Statutory rights and duties

Residential lease agreements and month-to-month rental agreements often contain provisions that restate the landlord's and tenant's statutory rights and duties.

For example, the rental agreement reiterates the landlord's statutory obligation to furnish a tenant with:

- a security deposit refund;
- notice of the right to a joint pre-expiration inspection of the unit and delivery of an itemized statement of repairs/cleaning; [CC 1950.5(f)] and
- a statement of security deposit accounting within 21 days after the tenant vacates which itemizes any deductions. [CC 1950.5(g)(1); see Form 550 §1.4 and **first tuesday** Form 551 §1.4; see Chapter 19]

Also, rental agreements often advise tenants of their limited statutory right to make necessary repairs to the premises and deduct the cost from the rent should the landlord fail to make the repairs that were noticed by the tenant. [CC 1942; see Form 550 §6.2 and **first tuesday** Form 551 §6.2; see Chapter 36]

A rental or lease agreement may prohibit a tenant from:

- using the premises for an unlawful purpose;
- creating a nuisance; and
- committing waste. [See Form 550 §§5.7, 5.8 and **first tuesday** Form 551 §§5.7, 5.8]

More importantly, a tenant who either uses the premises for an unlawful purpose, creates a nuisance or commits waste even if these activities are not prohibited by the tenant's lease or rental agreement may be evicted with a 3-day written notice to quit. [CCP 1161(4); see Chapter 26]

Chapter 51 Foreign-language residential leases

This chapter addresses California's translation requirements for real estate leases negotiated in languages other than English.

A written translation addendum

A bilingual real estate broker (or his agent), acting as an agent for a landlord of a dwelling unit located in California, negotiates a residential lease with a Spanish-only speaking tenant. The lease has an initial term which exceeds one month. Thus, it is not a month-to-month rental agreement.

While negotiations between the broker and the prospective tenant are in Spanish, the lease agreement entered into is on a form written in English.

The tenant signs the English-language lease and takes occupancy. The tenant does not receive a written Spanish translation of the significant provisions in the lease.

Later, the tenant decides to relocate to another landlord's property. However, the lease entered into with the broker obligates the tenant to occupy and pay rent for its remaining term.

The tenant hands the broker a *notice of rescission* of the lease agreement and vacates the unit. The tenant claims the lease is void since the tenant did not receive a written Spanish-language translation when he entered into the english-language lease.

Can the tenant **rescind** the lease and avoid future rent obligations based on the broker's failure to provide a written Spanish-language translation with the written English-language lease?

Yes! A written translation is required to be delivered to the tenant in the language used to negotiate a residential real estate lease at the time and place the agreement is signed by the tenant if the occupancy agreement:

- is a **residential lease** agreement for an initial term which exceeds one month; and
- is negotiated primarily in **Spanish, Chinese, Tagalog, Vietnamese or Korean** by a broker, landlord, resident manager, their employee or a person (interpreter) provided by them.

The written translation requirement to deliver a non-English language translation applies only to leases, not month-to-month or shorter periodic rental agreements, on a residential dwelling, apartment, mobile-home or other residential unit. [Calif. Civil Code §1632(b)(3)]

The **only remedy available** to a tenant who does not receive the required written Spanish, Chinese, Tagalog, Vietnamese or Korean language translation is a **rescission** of the lease. No money losses are recoverable based on the lack of a written translation. Simply put, the tenant is not bound by the lease agreement. [CC §1632(k)]

Transactions exempt from written translations

A written translation of a lease is not required if it is the tenant's interpreter who assists in negotiating the lease.

However, the tenant's interpreter must:

- be 18 years of age or older;
- be fluent in both English and the language in which the lease is negotiated; and
- not be employed or located by the broker or landlord (or their employees) involved in the negotiations. [CC §1632(h)]

Also, other real estate transactions **exempt** from the written translation requirement include:

- real estate purchase agreements;
- real estate loans, except for small private lender loans brokered under California Business and Professions Code §10245 which have their own translation requirements;
- month-to-month rental agreements; and
- home improvement agreements. [CC §1632]

Also, *addenda* ordinarily attached to leases do not need to be translated when referenced in the lease. Ordinary **addenda** include documents for the rules and regulations for the occupancy, inventories for furnishings, brokerage fees, the condition of the premises and furnishings, and waterbed and pet addenda.

Reliance on the English agreement

The terms of a lease agreement written in English set and control the **rights and obligations** of a landlord and tenant, not the Spanish, Chinese, Tagalog, Vietnamese or Korean translation of its significant provisions.

The written translation of the lease provided to the non-English speaking tenant may only be used to void (*rescind*) the English lease agreement if **substantial differences** exist between the two documents regarding **significant terms** and conditions of the English-language lease. [CC §1632(g)]

When the lease is **rescinded** by the tenant, the tenant must return the premises to the landlord and the landlord must refund any unearned rent and the security deposit to the tenant. Thus, on rescission the landlord loses a tenant, but incurs no liabilities beyond the refund.

Subsequent notices to the tenant

When a lease controlled by the translation rule is negotiated, documents later delivered to the tenant which **alter the rights** and obligations of the tenant, such as 3-day and 30-day notices, must be accompanied by a written translation in the language the lease was negotiated, whether Spanish, Chinese, Tagalog, Vietnamese or Korean. [CC §1632(d)]

However, documents authorized by the original agreement which will be delivered after entering into the original agreement and do not alter the rights and obligations of the parties do not need to be translated, such as receipts, changes in rules and regulations of occupancy and notices to enter for repairs. [CC §1632(d)]

Chapter 52 Lead-based paint disclosures

This chapter examines the entitlement to possession of real estate held by owners of different interests in a parcel of real estate.

Pre-contract disclosure for pre-1978 housing

An owner of a residential property built before 1978 retains a broker to locate a tenant. The property is not a vacation rental, hotel, motel or elderly housing, and it is not certified as lead-based paint free.

The broker informs the owner that leasing residential property built before 1978 requires disclosure to prospective tenants regarding lead-based paint hazards that may exist on the property or are known to the owner or the broker before entering into a lease of the premises.

Based on discussions with the landlord, the broker prepares a lead-based paint disclosure form to be reviewed and signed by the owner. The lead-based paint disclosure is attached to the authorization to lease or to the property management agreement entered into by the broker and the owner. The disclosure will be handed to prospective tenants interested in renting the property.

Here, the broker has properly informed the owner, who is acting as a residential landlord, of the lead-based paint disclosures mandated by federal regulations. Lead-based paint disclosures must be provided to prospective tenants of any residential property built before 1978, other than transient and elderly housing. [24 Code of Federal Regulations §35.82; 40 CFR §745.101]

Thus, **before a prospective tenant** enters into an agreement to rent or lease a pre-1978 residential unit, unless it is exempt housing, the landlord must provide the tenant with the following:

- a **lead-based paint disclosure statement** attached to the lease or rental agreement, disclosing the presence of any known lead-based paint or related hazards on the property [See Form 557 accompanying this chapter];
- any **information available** regarding lead-based paint hazards known to the landlord or broker to exist, such as any reports determining lead-based paint exists on the property, including common areas and other residential dwellings in a multi-family housing development, if the other housing units were part of an evaluation or reduction of lead-based paint in the building; and
- an EPA-approved lead hazard information **pamphlet** entitled, *Protect Your Family From Lead in Your Home*, or an equivalent pamphlet approved for use in California by the EPA. [24 CFR §35.88(a); 40 CFR §745.107(a)]

If the disclosure occurs after an application to rent or lease has been received from a prospective tenant, the landlord must provide the disclosures to the prospect **prior to accepting** the lease application.

The tenant must be given an opportunity to either abandon the application or further negotiate in light of the newly disclosed information on the property's lead-based paint condition. [24 CFR §35.88(b); 40 CFR §745.107(b)]

However, the mandated lead-based paint disclosure laws **do not obligate** the landlord:

- to conduct an inspection to determine whether any lead-based paint exists; or
- to abate or remove any lead-based paint. [24 CFR §35.88(a); 40 CFR §745.107(a)]

Brokers involved in residential leasing transactions are obligated as agents to ensure the landlord complies with the **pre-contract disclosure** regulations. Thus, it is required of brokers to know federal rules, prepare the disclosures and inform all parties involved of known or possible existence of lead-based paint — all done before rental applications are prepared or accepted.

Lead-based paint hazards

Lead-based paint was **banned** by the Federal Consumer Product Safety Commission in 1978.

Lead-based paint is defined as paint or other *surface coating* that contains lead equal to at least 1.0 milligram per square centimeter or 0.5% by weight. [24 CFR §35.86; 40 CFR §745.103]

A **lead-based paint hazard** is any condition that causes *exposure to lead* from lead-contaminated dust, soil or paint which has deteriorated to the point of causing adverse human health effects. [24 CFR §35.86; 40 CFR §745.103]

Exempt residential rentals

Now consider an owner, broker or vacation rental operator who provides lodging on a **vacation property** for a stay of less than 100 days by a guest, called a *transient occupancy*.

Further, the occupancy agreement does not provide for an extension or renewal. At the end of the stay, the guest must depart.

The owner is concerned about the disclosure requirements of lead-based paint since the vacation property is residential real estate built before 1978.

Is the vacation owner, operator or broker required to provide the occupant of the vacation rental with the lead-based paint disclosure?

No! The lead-based paint disclosure requirements do not apply to any occupancy agreement for a period of 100 days or less, where renewal or extension of the occupancy has not been provided for. [24 CFR §35.82(c); 40 CFR §745.101(c)]

By definition, a transient occupancy by a guest automatically terminates on the expiration (departure) date and time of day stated in the occupancy agreement.

Federal Pamphlets

A copy of Protect Your Family From Lead in Your Home can be obtained from the National Lead Information Center and Clearinghouse (NLIC) at http://www.epa.gov/opptintr/lead/nlic.htm or by calling (800) 424-LEAD. Requests may also be sent by fax to (301) 588-8495 or by e-mail to ech@cais.com.

Bulk copies of the pamphlet are available from the Government Printing Office (GPO) at http://bookstore.gpo.gov/ or by calling (202) 512-1800. Refer to the complete title or GPO stock number 055-000-00632-6. The price is $50.50 for a pack of 50 copies.

Alternatively, the pamphlet may be reproduced for use or distribution if the text and graphics are reproduced in full. Camera-ready copies of the pamphlet are available from the NLIC.

LEAD-BASED PAINT DISCLOSURE

For Renting or Leasing Residential Property

NOTE: For use on the lease or rental of residential property which was constructed pre-1978.

1. Lead Warning:

Housing built before 1978 may contain lead-based paint. Lead from paint, paint chips, and dust can pose health hazards if not managed properly. Lead exposure in housing is especially harmful to young children. Before renting pre-1978 housing, landlords must disclose the presence of lead-based paint and/or lead-based paint hazards in the dwelling. Tenants may also receive a federally approved pamphlet on lead poisoning.

Items left blank or unchecked are not applicable.

2. Landlord's Certification:

2.1 Presence of lead-based paint and/or lead-based paint hazards:

☐ a. Are known to Landlord to be present in the housing (explain): _____

_____

_____

☐ b. Are not known to Landlord to be present in the housing.

2.2 Records and reports available to Tenant:

☐ a. Landlord has provided Tenant with all available records and reports pertaining to lead-based paint and/or lead-based paint hazards in the housing listed as follows: _____

_____

_____

☐ b. Landlord has no reports or records pertaining to lead-based paint and/or lead-based paint hazards in the housing.

Date: _____, 20_____ Landlord's Signature: _____

3. Tenant's Acknowledgement:

3.1 Tenant has received:

☐ a. Copies of all information listed above.

☐ b. The pamphlet *Protect Your Family From Lead in Your Home.*

Date: _____, 20_____ Tenant's Signature: _____

Date: _____, 20_____ Tenant's Signature: _____

4. Broker's Certification: (When Applicable)

4.1 Broker certifies to have informed the landlord of his/her obligation under 42 USC §4852(d) to disclose to the tenant and agent all information known to the landlord regarding the presence of lead-based paint and lead-based paint hazards within this target housing and that all information known to the agent regarding the presence of lead-based paint and lead-based paint hazards within this target housing has been disclosed to the tenant.

4.2 Broker further certifies that the tenant received the lead hazard information pamphlet *Protect Your Family From Lead in Your Home*.

Date:_____, 20_____ Broker's Signature:_____

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Thus, the federal regulations **exempt** all vacation rentals, hotels and motels due to their short-term transient lodging arrangements.

However, if the stay in the vacation rental is intended to extend beyond 100 days, the owner and his broker must comply with lead-based paint disclosure requirements.

Further, all landlords entering into month-to-month **rental agreements** for non-exempt residential property must comply with the lead-based paint disclosure requirements.

Month-to-month rental agreements are automatically renewable as they are open-ended tenancies. Thus, rental agreements to not require the tenant to vacate in less than 100 days since a month-to-month rental agreement will automatically continue beyond the 100-day period, unless previously terminated.

Also exempt from the lead-based paint disclosures are housing for the elderly or disabled when no child under the age of six is expected to live on the property. **Elderly housing** includes retirement communities or other housing required to be occupied by one or more individuals over the age of 62. [24 CFR §35.86; 40 CFR §745.103]

Also exempt is any **zero-bedroom dwelling**, defined as a residential dwelling in which the living room is not separated from the sleeping area. Examples include studio apartments, dormitories or the rental of an individual room in residential housing. [24 CFR §35.86; 40 CFR §745.103]

Broker compliance

All brokers who represent the landlord of a non-exempt pre-1978 residential structure must ensure the landlord complies with the lead-based paint requirements. [24 CFR §35.94(a); 40 CFR §745.115(a)]

However, residential landlords who are not represented by brokers are themselves required to make the disclosures.

A landlord's broker should begin by preparing the lead-based paint disclosures for the landlord's signature when the property management or leasing agent authorization is entered into.

Further, a landlord owes a duty to the broker to disclose any known lead-based paint hazards to the broker. A broker will not be held liable for failing to disclose lead-based paint hazards if:

- the landlord knows of the hazards and fails to inform the broker by an entry in the disclosure statement required by the broker; and
- the broker has no independent knowledge of the hazardous condition, such as the structure being a pre-1978 construction. [24 CFR §35.94(b); 40 CFR §745.115(b)]

Use of the disclosure statement

All lease agreements and month-to-month rental agreements for non-exempt pre-1978 residential property must include the lead-based paint disclosure form as an attachment. [24 CFR §35.92(b); 40 CFR §745.113(b); see Form 557]

The disclosure form must be in the **same language** as the lease agreement or rental agreement. [24 CFR §35.92(b); 40 CFR §745.113(b)]

The disclosure form must include:

- the Lead Warning Statement [See Form 557 §1];

- the landlord's disclosure of any known lead-based paint hazards or the fact the landlord is unaware of any hazards [See Form 557 §2.1];
- a list of all records or reports available to the landlord concerning lead-based paint on the property, the location of the lead-based paint and the condition of the painted surfaces [See Form 557 §2.2];
- a statement by the tenant affirming receipt of the lead-based paint information and pamphlet [See Form 557 §3];
- a statement by the landlord's broker indicating the broker is aware of his duty to comply with the disclosure requirements [See Form 557 §4]; and
- the signatures of the landlord, tenant and broker. [24 CFR §35.92(b); 40 CFR §745.113(b)]

The landlord and the landlord's broker are required to keep a copy of the disclosure statement for a period of no less than three years from the commencement of the lease or rental agreement. [24 CFR §35.92(c); 40 CFR §745.113(c)]

Rentals certified as lead-based paint free

A landlord may take steps to have his pre-1978 property certified as free of lead-based paint.

Pre-1978 residential property is considered lead-based paint free housing if no lead-based paint exists on the property. [24 CFR §35.86; 40 CFR §745.103]

The landlord of pre-1978 property does not need to provide lead-based paint disclosures with the lease agreement or rental agreements when:

- the property is inspected by an inspector certified under the federal certification program or a federally accredited state or tribal certification program; and
- the inspector has determined the property to be lead-based paint free. [24 CFR §35.82(b); 40 CFR §745.101(b)]

Editor's note — A list of statewide laboratories certified for analyzing lead in hazardous material, including paint, is available from the California Department of Health Services Environmental Lab Accreditation Program at (510) 620-3155, or from the National Lead Information Center and Clearinghouse at (800) 424-LEAD. Lists are also available on the web at http://www.dhs.ca.gov/childlead.

Lease renewal triggers disclosure

If an existing lease is **extended or renewed** and the lead-based paint disclosures were not previously handed to the tenant, the landlord must then make the disclosure to the tenant at the time of the extension or renewal.

The landlord does not need to provide new disclosures when existing leases are renewed or extended if:

- the landlord previously supplied the lead-based paint disclosures; and
- the landlord has not received any new information concerning lead-based paint on the property. [24 CFR §35.82(d); 40 CFR §745.101(d)]

When a lease expires and the tenant remains in possession as a month-to-month tenancy controlled by the old lease agreement, the lease agreement is not considered to have been extended or renewed. However, if the landlord and tenant change some aspect of the tenancy other than the extension of the occupancy, such as a rental rate, then the disclosure must be made. [61 Federal Register 9068]

Once a change in the terms of a lease occurs, other than the right to remain in occupancy, the lead-based paint disclosure rules require the landlord to then disclose any new information he may have obtained on the hazard since the original disclosure was handed to the tenant.

Failure to disclose

A failure of the landlord or the broker to comply with the pre-contract disclosure requirements does not affect the enforceability of the lease or rental agreement. However, an **intentional violation** of the lead-based paint disclosure rules by the landlord or the broker will subject him to:

- liability to the tenant for three times the amount of the tenant's actual money losses caused by the existence of the hazard, called *trebled damages*;
- civil penalties;
- court costs and attorney fees; and
- civil and criminal sanctions. [24 CFR §35.96; 40 CFR §745.118]

Chapter 53 Permitting pets and waterbeds

This chapter reviews the handling of rental applications received from tenants with pets or liquid-filled furniture.

Role of the security deposit

Landlords and their property managers are frequently confronted with acceptable, prospective tenants who own pets or liquid-filled furniture which might not be so acceptable.

However, landlords cannot automatically refuse to rent to a prospective tenant whose furnishings include liquid-filled furniture or deny an existing tenant the use of liquid-filled furniture, such as a waterbed, on the premises.

On the other hand, landlords can automatically, as a matter of policy, refuse to accept all tenants who want to occupy a unit with their pet, unless the tenant is **disabled and uses**:

- a *guide dog,* which is a seeing-eye dog trained by a licensed person to aid a blind person;
- a *signal dog,* trained to alert a deaf or hearing-impaired person to intruders or sounds; or
- a *service dog,* trained to aid a physically disabled person by protection work, pulling a wheelchair or fetching dropped items. [Calif. Civil Code §54.1(b)(6)]

Disabled persons accompanied by a specially trained dog must keep the dog **leashed and tagged** as a specially trained dog by an identification tag issued by the county clerk, animal control department or some other authorized agency.

The disabled tenant accompanied by a tagged guide, signal or service dog cannot be required by the landlord to **pay any extra** rent, charge or security deposit for the dog to be kept on the premises.

However, the owner of a guide, signal or service dog is liable for the cost to repair any damages brought about by the dog's activities. [CC §54.2(a)]

Any **public agency owning** and operating rental accommodations must permit any person over 60 years of age to keep two pets or less (i.e., dog, cat, bird or fish). The **elderly pet owner** is responsible for any damages caused by the pets. [Calif. Health and Safety Code §19901]

Pet addendum

A property manager allowing a tenant to occupy a unit with a pet should reduce the arrangement to a writing in the form of a Pet Addendum and attach it to the rental or lease agreement. [See Form 563 accompanying this chapter]

The pet addendum establishes the responsibilities of the pet owner and the acceptable behavior standards for the pet. To avoid misunderstandings as to size, type and number of pets allowed on the premises, a careful description of the pet should be given on the form.

The property manager can charge an **additional security deposit** for the pet to offset any expenses or losses caused by the pet, unless the rules for disabled persons and their trained dog apply or the security deposit ceiling would be exceeded. A typical deposit for a pet is one-third of the first month's rent, with

an extra $100 to $200 for each additional pet, limited to the ceiling amount for residential security deposits. [See Chapter 13]

Thus, the **total security deposit** for an unfurnished residential unit, including the pet deposit, cannot exceed an amount equal to two months' rent (in addition to the first month's rent).

For a furnished unit, the security deposit, including the pet deposit, cannot exceed three months' rent (in addition to the first month's rent). [CC §1950.5(c)]

Also, if a pet's behavior does not conform to the terms of the pet addendum, the rental or lease agreement has been breached by the tenant. The property manager can serve a 3-day notice to the tenant to correct the activity or vacate the premises, called a *3-day notice to perform or quit*. [Calif. Code of Civil Procedure §1161(3); see Chapter 26]

Landlord liability for pets

A landlord permits a residential tenant to keep a dog on the premises. The landlord is not unaware the dog is vicious. No "Beware of Dog" notice is posted by the tenant.

A utility serviceman properly enters the backyard to check the meter. The dog attacks and injures the serviceman. The serviceman attempts to recover his losses due to the injury from the landlord.

Can the serviceman recover his losses from the landlord since the landlord allowed the tenant to keep a pet that was actually dangerous?

No! The landlord is not responsible for injury caused by dangerous domestic pets when he has no actual **knowledge of their ferocity**. Also, the landlord has no *duty to investigate* or inspect the rental unit to determine if the pet is dangerous. [**Lundy** v. **California Realty** (1985) 170 CA3d 813; see Chapters 46 and 48]

However, if the landlord has actual knowledge of the dangerousness of a tenant's pet and fails to serve the tenant with a 3-day notice to remove the pet or to vacate the unit, then the landlord is liable for injuries inflicted by the dangerous pet. [**Uccello** v. **Laudenslayer** (1975) 44 CA3d 504]

Also, a landlord has no responsibility to warn a prospective tenant of a dangerous pet located on a **neighboring property**, even when the landlord has knowledge of the ferocity of the neighbor's pet. [**Wylie** v. **Gresch** (1987) 191 CA3d 412]

Qualifying to maintain a waterbed

The use of waterbeds or other liquid-filled bedding in a rental unit cannot be grounds for refusal to rent to a prospective tenant. [CC §1940.5]

If the prospective tenant is otherwise qualified to rent, the landlord must rent to the tenant if the **waterbed is qualified** to be placed in the unit. For a waterbed to qualify, the landlord may establish conditions for the use of the waterbed on the premises, as long as the conditions meet the standards set by California waterbed state law.

These requirements are itemized in the waterbed addendum that is attached to the rental or lease agreement. [See Form 564 accompanying this chapter]

The **waterbed conditions** a landlord can impose on the tenant to qualify his waterbed include:

PET ADDENDUM

DATE:_____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

This is an addendum to the following:

☐ Residential lease agreement

☐ Residential rental agreement

☐ Other:_____

dated _____, 20_____

regarding real estate referred to as:_____

The above referenced agreement prohibits pets without Landlord's prior written consent.

AGREEMENT:

1. Landlord agrees the Tenant may keep the following pet:

_____

2. Landlord hereby acknowledges receipt of $_____ as a security deposit, from which the Landlord may offset any expenses or losses caused by the pet. On termination of the above referenced agreement, the security deposit shall be refunded to Tenant with an itemization of its disposition.

3. Tenant agrees:

3.1 Pet will not damage premises or annoy, endanger or inconvenience other tenants.

3.2 The Tenant shall hold the Landlord harmless for any damages caused by the pet.

3.3 To comply with all laws pertaining to the keeping and leashing of the pet.

3.4 Pet is not known to be dangerous or to have injured individuals.

3.5 _____

_____

_____

_____

_____

I agree to the terms stated above.	**I agree to the terms stated above .**
Date:_____, 20_____	Date:_____, 20_____
Landlord/Agent:_____	Tenant:_____
Signature: _____	Signature: _____

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- an insurance policy against property damage;
- a special waterbed frame;
- specific methods of installation and maintenance;
- a written receipt of installation by the manufacturer, retailer or movers;
- an increase in the maximum security deposit permitted; and
- requiring the tenant to comply with specific methods of installation or to remove the bed on 3-day written notice to perform (remove it) or quit. [CC §1940.5]

The floor of any residence has a limited capacity for weight centralized in one area.

Since a waterbed is considerably heavier than a regular bed, the weight of the waterbed must not exceed the weight limitation of the floor, especially if it is on an upper level.

Also, to ensure proper distribution of the weight, the tenant is required to provide an adequate bed frame specially designed to support and distribute the weight of a waterbed. [CC §1940.5(b)]

Waterbed addendum

When a tenant qualifies to maintain a waterbed on the premises, the landlord may increase the tenant's security deposit up to an additional one-half month's rent. The waterbed deposit is **in addition to** the maximum security deposit otherwise allowed. [See Chapter 19]

The landlord may also charge a reasonable **administrative fee** to cover the time, effort and money expenditures necessary to process the waterbed paperwork, such as $50 to $100. [CC §1940.5(g)]

The amounts of both the additional security deposit and administrative charges are set forth in the waterbed addendum. [See Form 564 §§2; 3]

The tenant can be required to provide the landlord with a waterbed insurance policy or certificate of insurance for property damage caused by the waterbed. The policy should name the landlord as an additional insured to eliminate any question over the disbursement of funds from a claim.

The waterbed insurance policy must be accepted by the landlord if several conditions are met, including:

- the policy is issued by a company licensed in California;
- the company possesses a Best Insurance Report rating of B or better; and
- the policy offers coverage of no less than $100,000. [CC §1940.5(a)]

The tenant must ensure the policy remains valid and enforceable throughout the period the waterbed is located on the premises. The landlord has the right to demand proof of insurance from the tenant at any time. If the tenant fails to provide proof of insurance when requested, a 3-day notice to perform or quit should be served on the tenant to deliver up the policy, remove the furniture or vacate.

Consider the insurance policy a tenant holds on his waterbed expiring two months before he vacates. The tenant does not renew the policy since he will soon be moving. The landlord fails to purchase coverage and charge the tenant for the premium or serve the tenant with a 3-day notice to get insurance, remove the bed or vacate.

Sometime after the policy expires, a liner patch from a prior leak fails. The liner ruptures, releasing its water contents. The whole apartment is flooded causing hundreds of dollars in damages as well as causing damage to the units and personal property on lower floors.

WATERBED ADDENDUM

DATE:_____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

Possession in a rental of liquid-filled furniture is controlled by law. A tenant may keep and use liquid-filled furniture on the premises by complying with statutory conditions demanded by the landlord. [Calif. Civil Code §1940.5]

FACTS:

This is an addendum to the following:

☐ Residential lease agreement

☐ Residential rental agreement

dated:_____, 20_____.

prohibiting waterbeds and other liquid-filled furniture without the written consent of Landlord.

regarding a residential unit referred to as: _____

AGREEMENT:

1. Tenant may keep and use on the premises the following liquid-filled furniture:

☐ Waterbed described as:_____

_____

☐ Other:_____

2. Landlord acknowledges receipt of $_____ as an additional security deposit, to be used to offset any expenses or losses caused to the landlord by the furniture.

2.1 Within 21 days after removal of the furniture the security deposit shall be refunded to Tenant with an itemization of its disposition.

3. Landlord acknowledges receipt of $_____ as an additional fee to cover administrative costs incurred due to this agreement.

4. Tenant agrees:

4.1 To maintain an insurance policy on the furniture for no less than $100,000 to cover property damage, naming landlord as an additional insured.

a. To cause Landlord to receive at least 10 days prior written notice of cancellation or non-renewal of the insurance policy.

b. To accept responsibility for property damage caused by the furniture should the policy expire unrenewed.

4.2 To install the furniture according to manufacturer specifications, to operate properly all heaters and safety items, and to dispose of the liquid in a safe and sanitary manner.

a. To give Landlord 24 hours notice of intent to install, move or remove the furniture.

b. To provide Landlord with a written installation receipt stating the installer's name, address, and place of business when the furniture is installed, moved or removed by anyone other than Tenant.

4.3 To strictly abide by the maintenance and safety precautions specified in the owner's manual supplied by the manufacturer of the furniture.

4.4 Landlord may enter Tenant's residence on 24 hours notice to inspect the furniture to ensure it is being properly maintained.

a. On lack of tenant's reasonable care and maintenance of the furniture Landlord may serve Tenant with a Three-day Notice to Perform or Quit regarding correction of the deficient care and maintenance or the removal of the furniture.

5. Other conditions: _____

6. Landlord's failure to enforce these conditions does not waive his right to an insurance claim.

I agree to the terms stated above.	**I agree to the terms stated above.**
Date:_____, 20_____	Date:_____, 20_____
Landlord: _____	Tenant:_____
Signature: _____	Signature: _____

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The landlord repairs the damages and demands payment from the tenant for all of his losses caused by the waterbed. The tenant claims the landlord had the responsibility to obtain coverage if the tenant did not.

Can the landlord collect the losses from the tenant?

Yes! Any damage resulting from the waterbed that is not covered by an insurance policy is the responsibility of the tenant. The landlord has no obligation to procure coverage even though he has authority to do so on the tenant's failure to provide coverage.

Further, if for some reason the tenant's waterbed liability policy is canceled, expires or is not renewed, the tenant is obligated to give the landlord a ten-day notice of cancellation or nonrenewal of the insurance policy. [CC §1940.5(a)]

The notice is automatically given to the landlord by the insurer if the landlord is an additional insured on the waterbed policy — as the landlord should be.

Installation and care of the waterbed

It is the tenant's responsibility to ensure the waterbed is properly installed and maintained.

The tenant must give the property manager 24 hours' notice if he intends to move, install or remove a waterbed.

If anyone other than the tenant installs the waterbed, specifically the manufacturer, a retailer or a moving company, the tenant must provide the landlord with a written receipt that contains the installer's name, address and place of business. [CC §1940.5(c)]

To ensure safety at all times, the tenant must comply with the manufacturer's specifications for proper use of the bed. [CC §1940.5(e)]

When a landlord suspects the tenant is not meeting the provisions in the waterbed addendum, he has the right to enter the residence to inspect the waterbed and ensure it is being maintained properly. However, he must give the tenant a 24-hour notice of entry before his inspection. [CC §§1940.5(f); 1954; see **first tuesday** Form 567; see Chapter 2]

The landlord may give the tenant a 3-day notice to either comply with installation and maintenance standards or remove the bed from the premises (or vacate) if:

- the landlord finds the waterbed is not being properly maintained; or
- the waterbed has not been properly installed. [CC §1940.5(f)]

The landlord may serve a 3-day notice to perform or quit on the tenant, as long as the tenant is **given the option** of either curing the installation defects or removing the bed as performance in lieu of vacating. If the tenant fails to perform either alternative within three days, he must vacate the premises. [See Chapter 26]

In lieu of the notice to perform or quit, the landlord could serve an "advisory" letter giving notice to perform.

However, the landlord would have to later serve a 3-day notice to perform or quit if the tenant fails to either repair or remove the bed.

Finally, the landlord does not lose his right to make an insurance claim if he fails to exercise any of his rights to police the tenant's care and maintenance of the waterbed. [CC §1940.5(h)]

Chapter 54 Civil rights and fair housing laws

This chapter outlines the federal and California anti-discrimination laws and how the laws affect the management of residential and nonresidential rental property.

Property rights cannot be based on status

All citizens of the United States have the right to rent real estate, regardless of race, under the Civil Rights Act. [42 United States Code §1982]

Further, **all persons** within the United States, legally or illegally, are given the same rights to make and enforce contracts (rental and lease agreements), sue, be sued, enjoy the full benefits of the law and be subject to the same punishments, penalties, taxes and licenses, regardless of race. [42 USC §1981]

The *Federal Civil Rights Act* applies to race discrimination on the rental of all types of real estate, both residential and nonresidential.

Thus, the right of an individual to lease real estate is protected by giving all persons the right to make and **enforce contracts**, regardless of race. *Racially motivated activities* in any real estate leasing transaction are prohibited.

Federal protection against racial discrimination given under the Civil Rights Act applies to discrimination in all activities between persons, and is much broader than the protection given under the *Federal Fair Housing Act*, which is limited to dwellings.

Anti-discrimination in residential property

Unlawful discrimination in the rental or advertisement of dwellings for rent is based on status and prohibited under the *Federal Fair Housing Act (FFHA)*. [42 USC §§3601 et seq.]

A **dwelling includes** any building or structure that is occupied, or designed to be occupied, as a residence by one or more families composed of one or more people. Also included is any vacant land offered for lease for residential dwelling purposes, such as property that would hold a mobilehome unit. [42 USC §3602(b)]

Discriminatory actions of a landlord or property manager *prohibited* under FFHA are any actions a landlord or property manager may take in the negotiations or handling of a residential rental, based on a person's:

- race or color;
- national origin;
- religion;
- sex;
- familial status; or
- handicap. [42 USC §3602]

Familial status refers to the group of occupants of a residence comprised of one or more individuals who are under the age of 18 years and:

- a parent or person having legal custody of those under 18; or
- a person having written permission of the parent or legal custodian of those under 18 as the designee of the parent or custodian. [42 USC §3602(k)]

Handicapped persons refer to individuals who have:

- a physical or mental impairment which substantially limits the person's life activities; or
- a record of, or are regarded as having, a physical or mental impairment. [42 USC §3602(h)]

The term *handicap* does not include the current illegal use of a controlled substance. However, alcoholics and individuals who are considered "recovering or recovered addicts" are protected as handicapped. [**United States** v. **Southern Management Corporation** (4th Cir. 1992) 955 F2d 914]

Qualifying and processing tenants

A landlord or property manager is prohibited under FFHA **from unlawfully discriminating** during negotiations and handling of the rental of a dwelling. [42 USC §3604(a)]

Thus, a landlord or property manager may not:

- *refuse to rent* a dwelling or to negotiate the rental of a dwelling for unlawful discriminatory reasons;
- impose *different rental charges* on a dwelling for unlawful discriminatory reasons;
- use *different qualification criteria* or different procedures for processing applications in the rental of a dwelling to unlawfully discriminate; or
- *evict tenants* or the tenant's guests for unlawful discriminatory reasons. [24 Code of Federal Regulations §100.60(b)]

Different criteria for tenant qualification or processing of rental applications include a landlord or property manager using different credit standards and tenant screening approval procedures in the negotiations or handling of the rental of a dwelling. [24 CFR §100.60(b)(4)]

For example, a broker is hired by a residential apartment owner to perform property management activities. One of the broker's duties as a property manager is to locate tenants to fill vacancies.

A tenant from a religious minority group contacts the broker about the availability of an apartment.

The broker (or his agent) informs the prospective tenant of the monthly rent — a rate which is higher than the rent nonminority tenants are asked to pay for similar apartments.

When the prospective minority tenant asks the broker for an application, the broker informs the tenant a nonrefundable screening fee is charged to process the application. The creditworthy minority tenant fills out the application, pays the fee and is told the processing will take several days.

In the meantime, a nonminority tenant inquires about the rental of the same or similar apartment. The monthly rental rate the broker quotes the nonminority is lower than the rental rate the minority tenant was quoted. Further, the nonminority tenant is not charged a screening fee with his application. The apartment is immediately rented to the nonminority tenant, even though the nonminority tenant is not as creditworthy as the minority tenant.

The broker's actions, be they his own or his agents, are a violation of the FFHA. The representations made to the minority tenant are construed to be racially or religiously motivated. The broker misrepresented the availability of the apartment based on the tenant's religion by using different procedures and

qualification standards in accepting and processing the tenant's application. [**United States** v. **Balistrieri** (7th Cir. 1992) 981 F2d 916]

Different terms, different privileges

A landlord or property manager may not unlawfully discriminate against a person by setting different terms, conditions or privileges for his rental of a dwelling, or by providing substandard services and facilities for the dwellings. [42 USC §3604(b)]

For example, a prospective tenant who is a member of a protected class (race, ethnicity, etc.) responds to an ad concerning the rental of a residence in a new housing development.

The property manager shows the prospective tenant the residence. The prospect informs the broker he is interested in renting the property.

The prospective tenant is then informed he cannot rent this particular unit. Due to the prospect's minority status, the property manager and the owner believe it would become more difficult to rent the remaining units in the development with this tenant occupying a unit.

The property manager offers to show the tenant a unit in another area of the development.

Here, the property manager has discriminated against the prospective tenant. The property manager improperly refused to rent the unit to the tenant due to the tenant's status as a member of a protected class of people, such as race, religion, handicap, etc. [**United States** v. **Pelzer Realty Company, Inc.** (5th Cir. 1973) 484 F2d 438]

Prohibited **selective reduction** of tenant privileges, conditions, services and facilities offered protected individuals in the rental of a dwelling includes:

- providing for different terms in a lease, such as the rental charge, security deposit and the term of the lease;
- delaying or failing to perform maintenance;
- limiting use of privileges, services or facilities to different classes of individuals; or
- refusing or failing to provide services or facilities due to a person's refusal to provide sexual favors. [24 CFR §100.65(b)]

Further, the landlord or property manager may not discriminate based on a person's status by representing that a dwelling is not available for rent in order to *steer the individual* to a particular Section 8 project or neighborhood, when the dwelling is available.

Steering involves the restriction of a person seeking to rent a to rent a dwelling in a community, neighborhood or development, in a manner that perpetuates segregated housing patterns. [42 USC §3604(d); 24 CFR §100.70]

Discrimination in advertisement

A broker making a notice, statement or advertisement when handling the rental of a dwelling unit is barred from using any wording that *indicates a discriminatory preference or limitation* against individuals of protected classes of people. [42 USC §3604(c)]

The prohibition against unlawful discriminatory advertisements applies to all oral and written statements.

Notices and statements includes any applications, flyers, brochures, deeds, signs, banners, posters and billboards used in the rental of a dwelling.

Blockbusting for exploitation

A residential landlord or property manager may not induce or attempt to induce a person to rent a dwelling to ensure the entry of certain classes of people into the neighborhood can be used to exploit discrimination, called *blockbusting*. [42 USC §3604(e)]

Further, the actual receipt of an profit is not necessary to establish discrimination provided profit was a motive for the landlord's or broker's **blockbusting** activity. [24 CFR §100.85(b)]

Examples of blockbusting activities by a broker or his agent include:

- encouraging an **owner-occupant to offer** a dwelling for rent by insinuating that a neighborhood is undergoing or is about to undergo a change in the race, color, religion, sex, handicap, familial status or national origin of its residents; or
- discouraging an **owner-occupant from renting** a dwelling by claiming the entry of persons of a particular race, color, religion, sex, familial status, handicap or national origin will result in undesirable consequences for the neighborhood or community, such as an increase in criminal activity or a decline in schools and other facilities. [24 CFR §100.85(c)]

Aiding in discriminatory activities

Landlords and their agents may not coerce, intimidate, threaten or interfere with any person from a protected class of people in their occupancy or enjoyment of a dwelling. [42 USC §3617]

For example, a mobilehome park is allowed to operate as a *de facto* "adults-only" park under local rent control ordinances. However, the park owner never legally declares the park exempt from the FFHA as a *de jure* senior citizens housing development.

Later, local rent control ordinances are amended, allowing the park management to rent vacated spaces to new residents without rent amount restrictions. The park owner then decides to open the park by renting newly vacated units to families with children.

Senior tenants currently renting mobilehome spaces in the park file an application with the city seeking a rent reduction, claiming families with children cause a reduction in available services. The city awards the tenants the reduction in rent they sought.

The park owner claims the city violated the FFHA since the rent reductions for existing tenants was a prohibited discriminatory interference since the action inhibited the owner's decision to rent to families with children.

The city claims it did not violate the FFHA since the park met the requirements of a senior citizen housing project, and was therefore exempt from the FFHA.

However, the city did interfere with the owner's rental of the mobilehomes to families with children in violation of the FFHA. The older tenants are not entitled to a reduction in rent based on the occupancy of spaces by families.

The owner's rental of mobilehome spaces to families with children cannot be the basis for reducing rent paid by tenants who do not have children. Further, only an owner, not a governmental agency, can claim

the park is exempt from the FFHA under the senior housing exemption. [**United States** v. **City of Hayward** (9th Cir. 1994) 36 F3d 832]

Exemptions for some discrimination

FFHA-prohibited discrimination in the rental of a residential dwelling **does not** apply to a single-family house rented by a landlord who:

- does not own more than three single-family homes;
- does not use a real estate licensee to negotiate or handle the tenant; and
- does not use a publication, posting or mailing for any discriminatory advertisement. [42 USC §3603(b)(1)]

Thus, the FFHA prohibitions apply to all notices, statements and advertisement in the rental of a dwelling by anyone, be they an owner or a broker, who are in the business of renting dwellings. [42 USC §3603]

A person is in the **business of renting dwellings** if the person:

- has participated within the past 12 months **as a principal** in three or more transactions involving the rental of any dwelling or interest in a dwelling;
- has participated within the past 12 months **as an agent**, negotiating two or more transactions involving the rental of any dwelling or interest in a dwelling, excluding the agent's personal residence; or
- is **the owner** of a dwelling structure intended to be occupied by five or more families (larger than a fourplex). [42 USC §3603(c)]

If a broker is the agent for either the landlord or the tenant in a residential rental transaction, the anti-discrimination rules of the FFHA apply.

However, attorneys, escrow agents, title companies and professionals other than brokers who are employed by a landlord to complete a transaction do not bring the transaction under the FFHA, unless they **participate in negotiations** with the tenant. [42 USC §3603(b)(1)(B)]

Also exempt from discrimination prohibition rules in the rental of a dwelling is a one-to-four unit residential property in which one of the units is **occupied by the owner**. [42 USC §3603(b)(2)]

Religious organizations who limit the rental or occupancy of dwellings to individuals of the same religion are also exempt, provided the dwelling is owned for **noncommercial reasons**. No religious exemption exists if the religion is restricted to persons of a particular race, color or national origin. [42 USC §3607(a)]

Also exempt are **private clubs** that are not open to the public and provide their members with residential dwelling space for noncommercial purposes may limit rental or occupancy of the dwellings to members.

Finally, **housing qualified for older citizens** which excludes children is not considered unlawful discrimination against tenants with children based on familial status. However, the housing must first qualify as housing for the elderly. [42 USC §3607(b)]

Failure to comply with the FFHA

An **aggrieved person** under FFHA is any individual who claims he has been injured by an unlawful discriminatory housing practice or believes he will be injured by a prohibited discriminatory housing practice. [42 USC §3602(i)]

The aggrieved individual may file a complaint with the Secretary of Housing and Urban Development (HUD), alleging a discriminatory housing practice. The complaint must be filed within one year of the alleged discriminatory housing practice. [42 USC §3610(a)]

The Secretary will **attempt to resolve** the dispute by having the parties enter into an agreement after informal negotiations. [42 USC §3610(b)]

However, a judicial action may be required to resolve the issue of discrimination if the Secretary concludes judicial involvement is necessary. The dispute will then be resolved by an administrative law judge.

Any party to the complaint may elect to have the claims decided in a civil action before a court of law. [42 USC §3612(a)]

When a real estate broker subjected to a judicial action is ruled to have committed discriminatory housing practices, the Secretary is to notify the DRE and recommend disciplinary action. [42 USC §3612(g)(5)]

When a court determines discriminatory housing practices have taken place, actual and punitive amounts of money awards may be granted and an order issued preventing the landlord or broker from engaging in any future discriminatory housing practice. [42 USC §3613(c)(1)]

Further, if the Attorney General commences a civil action against a person for prohibited discriminatory housing practices, the court may award:

- relief preventing further discriminatory housing practices such as an injunction or restraining order;
- money losses; and
- civil penalties of no more than $50,000 for the first violation and no more than $100,000 for any subsequent violation. [42 USC §3614(d)]

The State Civil Rights Act

California's *Unruh Civil Rights Act*, an anti-discrimination law, specifically prohibits discrimination by a **business establishment** based on numerous status classifications, including: a person's sex, race, color, religion, ancestry, national origin, disability or medical condition. [Calif. Civil Code §§51, 51.2, 51.3]

However, age is a legitimate discrimination as long as the restriction is in a project that qualifies as a senior citizen housing development.

The Unruh Civil Rights Act applies to anyone in the **business of providing housing**. Brokers, developers, apartment owners, condominium owners and single-family residential owners are considered to be in the business of providing housing.

As business establishments, landlords may not boycott, blacklist, refuse to lease or rent because of the race, creed, religion, color, national origin, sex, disability or medical condition of a person, or that person's business partners, members, stockholders, directors, officers, managers, agents, employees, busi-

ness associates or customers. Further, a prospective tenant may not be blacklisted or boycotted for prohibited discriminatory reasons. [CC §51.5]

Full and equal access guaranteed

A **blind prospective tenant** has a guide dog and seeks to rent an available unit in a multi-unit residential dwelling structure.

The landlord refuses to rent a unit to the blind tenant, claiming the guide dog violates the building's pet restriction in the covenants, conditions and restrictions.

The blind tenant claims the landlord is discriminating against him under California law due to his **disability** since the landlord denied him housing on account of the guide dog.

A landlord may not refuse to rent residential property to a blind tenant because of the tenant's guide dog. Landlords are also prohibited from discriminating against tenants with dogs specially trained to assist deaf and other disabled persons. [CC §54.1(b)(6)]

Fair housing for disabled persons

Disabled persons are protected from discrimination when renting or leasing California residential real estate. A disabled person anyone who:

- has a physical or mental impairment which significantly limits major life activities;
- has a record of a disability; or
- is regarded as being disabled. [CC §54(b)]

People with disabilities are entitled to full and equal access to housing accommodations offered for rent. [CC §54.1(b)(1)]

The only exception is the rental of no more than one room in a single-family residence. [CC §54.1(b)(2)]

The examples of the blind tenant and his seeing-eye dog illustrate how a landlord might attempt to avoid anti-discrimination laws. While the landlord claims to justify his behavior based on his equal application of a single pet restriction rule to pet owners (a non-protected class of people), the refusal to rent to a disabled tenant based on his reliance on a trained dog to conduct life activity is an unlawful discrimination.

Now consider a disabled tenant dependent on his spouse for financial support. The disabled tenant and his spouse seek to rent an apartment and will both sign the lease agreement. The spouse's income meets the landlord's minimum requirement to qualify to pay the rent.

However, the landlord refuses to rent an apartment to the couple, claiming the disabled tenant does not also meet minimum income requirements.

Here, the landlord may not deny housing to the disabled tenant based on the tenant being financially dependent on his spouse. The **combined incomes** of the tenant and his spouse meet the landlord's minimum income requirements for the payment of the rent amount.

The landlord's refusal to rent an apartment to the disabled tenant based on the tenant's dependency on his spouse's income is unlawful discrimination. If one tenant qualifies to rent a unit, both tenants are qualified. [CC §54.1(b)(7)]

Accommodating the disabled

A landlord is not required to structurally modify existing residential rental property to meet the special needs of disabled tenants. [CC §54.1(b)(4)]

Although he is not required to modify the structure for a disabled tenant, the landlord must allow the tenant to make reasonable modifications himself or pay the landlord to do so. The landlord may require the tenant to restore the property to its original condition when the tenancy is terminated. [Calif. Government Code §12927]

Anti-discrimination laws require new residential properties consisting of four or more units per building to be **built to allow** access by disabled persons. Required improvements include kitchens and bathrooms designed to allow access to disabled tenants in addition to wheelchair ramps.

Failure to provide the disabled with access to a newly constructed residential property with four or more units is considered unlawful discrimination. [Gov C §12955.1]

Remedies

An individual's primary remedy for discrimination based on his physical disability is to seek an injunction to stop the discriminatory activity. The injunction may be sought by the disabled person being discriminated against, or by the city attorney, district attorney or Attorney General. [CC §§55, 55.1]

Property owners who unlawfully discriminate against disabled persons are further liable for the disabled person's money losses. In addition to actual money losses, treble that dollar amount may be awarded as punitive damages, along with attorney fees. The minimum award of money damages for discrimination against a disabled person is $1,000. [CC §54.3]

Discriminatory practices, exemptions and remedies

An ethnic or religious minority tenant seeks to rent an apartment. The landlord informs the prospective tenant he cannot rent the apartment until he completes a credit check. The landlord also declines to accept a deposit from the tenant.

Later the same day, a nonminority tenant seeks to rent the same apartment. The landlord agrees to rent the apartment to the nonminority tenant without first requiring a credit check, and immediately accepts the tenant's check for a deposit on the apartment. The minority tenant is informed the apartment has been rented to another person.

The minority tenant files a complaint against the landlord, claiming the landlord discriminated against him based on his ethnicity or religion by refusing to rent him an apartment. The landlord claims no discrimination occurred since he was entitled to require a credit check of prospective tenants.

However, requiring a credit check of minority tenants, but not nonminority tenants, an unlawful discriminatory practice which allows the minority tenant to recover his money losses. [**Stearns** v. **Fair Employment Practice Commission** (1971) 6 C3d 205]

Prohibited discrimination

California law prohibits discrimination in the sale or rental of housing accommodations based on race, color, religion, sex, sexual orientation, marital status, national origin, ancestry, familial status, source of income or disability. This list of protected persons is more extensive than all others.

Discriminatory activities and conduct include:

- making a written or oral **inquiry into** the race, sex, disability, etc. of any person seeking to rent housing;
- ads or notices for rental of housing which state or infer **preferences or limitations** based on any of the prohibited discrimination factors;
- a broker **refusing to represent** an individual in a real estate transaction based on any prohibited factor; and
- any other practice that denies housing to a member of a protected class. [Gov C §12955]

The denial of housing based on the landlord or broker's *perception* that a prospective tenant, or any associates of the prospective tenant, has any of the protected characteristics is absolutely prohibited. [Gov C §12955(m)]

Income standards for tenants

Standards of conduct that a broker applies *equally to all individuals* which do not discriminate against a **protected group of individuals** are considered reasonable, and permitted to be used.

To qualify a tenant for occupancy based on his creditworthiness, a landlord or property manager may establish income ratios or standards to determine a tenant's ability to pay the rent. The higher the standard or ratio of income to rent, the less the risk of loss of rent borne by the landlord. The lower the standard, the greater the risk of loss of rent. Once set, the standard must be **applied to all equally**.

However, when renting to two or more individuals who desire to live in the same unit, whether related or unrelated, married or not, the **income of all tenants** must be considered as the total income used by the landlord to determine their collective eligibility to qualify to pay the rent amount sought.

Separately, each prospective tenant may be unable to qualify by meeting the income standard. However, if **aggregating the income** of all who intend to occupy the unit and enter into the rental or lease agreement results in total income sufficient under the ratio or standard applied to qualify a tenant or tenants for occupancy, the tenants qualify. [Gov C §12955(n)]

Also, under rent subsidy programs, such as Section 8 housing arrangements, the landlord or property manager must consider the tenant's income when assessing whether the tenant qualifies to pay their portion of the rent that is not subsidized. [Gov C §12955(o)]

The *source of income* for each occupant also includes any income claimed to be the tenant's that is lawfully received by the tenant and verifiable, whether it is directly received by the tenant or received by a representative of the tenant. [Gov C §12955(p)]

Familial status

Familial status in anti-discrimination laws refers to children under the age of 18 living with a parent or guardian. [Gov C §12955.2]

Rental policies excluding children under the age of 18 are classified as unlawful discrimination, unless the property qualifies as senior citizen housing. [Gov C §12955.9]

As with senior citizen housing, an exemption exists for religious groups. Religious organizations may give preference to other members of the same religious group when providing residential property for

noncommercial purposes unless membership is restricted on account of race, color or national origin. [Gov C §12955.4]

Marital status

Consider a landlord who refuses to rent an apartment to an unmarried couple based on his religious beliefs.

The couple files a complaint with the Fair Employment and Housing commission, claiming the landlord violated fair housing laws that prohibit discrimination based on marital status.

The landlord claims he is exempt since renting to an unmarried couple violates his religious beliefs regarding the cohabitation of unmarried couples.

However, the landlord's refusal to rent to unmarried couples violates the fair housing laws since the landlord's religious beliefs do not also require him to participate in the business of renting property.

Thus, the fair housing laws prohibiting discrimination based on marital beliefs do not interfere with the practice of the landlord's religion, since he can go into a business that does not violate his religious convictions. [**Smith** v. **Fair Employment and Housing Commission** (1996) 12 C4th 1143]

Guidelines for broker conduct

The Department of Real Estate (DRE) has enacted regulations prohibiting discriminatory practices by real estate brokers. A broker or agent engaging in discriminatory business practices may be disciplined by the DRE. [Department of Real Estate Regulations §2780]

Prohibited practices include any situation in which a broker, while acting as an agent, discriminates against anyone based on race, color, sex, religion, ancestry, disability, marital status or national origin. Examples of discriminatory practices include:

- refusing to negotiate for the rental of real estate;
- refusing to show property or provide information, or steering clients away from specific properties;
- refusing to accept a rental listing;
- publishing or distributing advertisements that indicate a discriminatory preference;
- any discrimination in the course of providing property management services;
- agreeing with a client to discriminate when leasing the client's property, such as agreeing not to show the property to members of particular minority groups;
- attempting to discourage the rental of real estate based on representations of the race, sex, disability, etc. of other inhabitants in an area; and
- encouraging or permitting employees to engage in discriminatory practices.

For example, a broker is aware a licensed care facility for disabled people is located in a single-family residence near a residence the prospective tenant is interested in renting.

The presence of the facility might influence the tenant's decision to rent the property. However, for the broker or his agents to inform the tenant of the facility would be unlawful discrimination. The broker may not attempt to influence the tenant's decision based on representations of the disability of other inhabitants in the area. [73 Ops. Cal. Atty. Gen. 58 (1990)]

However, on a direct inquiry from a tenant, the broker or agent must respond based on his knowledge of the existence of a care facility.

Broker's duty to manage employees

A broker has a **duty to advise** his agents and employees of anti-discrimination rules, including DRE regulations, the Unruh Civil Rights Act, the California Fair Employment and Housing Act, and federal Fair Housing Act. [DRE Reg. §2725(f)]

The broker is not only responsible for his own conduct, but he must also ensure his employees follow anti-discrimination regulations when acting as agents on his behalf.

Disclosure of HIV/AIDS

A property manager locates a rental for a prospective tenant. The prior occupant of the property was afflicted with AIDS. Neither the property manager nor the landlord disclose the prior occupant's AIDS affliction, whether or not asked by the prospective tenant.

The tenant rents the property and later discovers the prior occupant was afflicted with AIDS while residing on the property. The tenant claims the property manager had a duty to disclose the prior occupant had AIDS.

However, the tenant has no claim against the property manager for the property manager's failure to disclose any prior occupant was infected with the HIV virus or afflicted with AIDS. No duty exists to disclose the prior tenant's affliction. [CC §1710.2(a)]

Further, California public policy prohibits a broker from responding to a tenant's inquiry for disclosure of a prior occupant's affliction with AIDS. [CC §1710.2(d)]

Also, individuals afflicted with the HIV virus are considered handicapped and are protected by the Federal Fair Housing Act. [24 CFR §100.201]

Disclosing death from AIDS

Unless the tenant makes a **direct inquiry**, the landlord's or property manager's affirmative duty to voluntarily disclose material facts to the tenant in a lease transaction does not extend to the **death** of a prior occupant occurring **more than three years before** the lease of a property.

Consider a tenant who asks the property manager if any AIDS-related deaths occurred on the property. On direct inquiry, the property manager must disclose his knowledge of the facts concerning a death on the real estate. [CC §1710.2(d)]

If the property manager is aware an AIDS-related death occurred on the property, he has a duty on direct inquiry from the tenant to disclose:

- the prior occupant's death; and
- the death was AIDS-related.

If the property manager has no knowledge of any AIDS-related deaths occurring on the property, he must disclose:

- his lack of knowledge; and

- whether or not he intends to undertake an investigation to determine if an AIDS-related death occurred on the property.

However, consider a property manager who is aware a death, from any cause including AIDS, occurred on the property **within three years** of the commencement of a tenant's lease agreement. The tenant has not inquired if any deaths have occurred on the property.

Here, the property manager will need to determine if the death on the property is a *material fact*, one which might affect the tenant's decision to lease and occupy the property.

The property manager should disclose **any death** occurring on the property within three years if he believes the fact might affect the tenant's decision to lease. On inquiry from the tenant, the property manager must disclose his knowledge of any death, including AIDS-related deaths, which occurred on the property within the last three years.

Chapter 55 Adults-only policies prohibited in housing

This chapter discusses unfair discriminatory practices in renting residential units based on familial status, and the tenant's remedies.

Familial status is protected

The landlord of a residential property may not adopt an "adults-only" or "no children" policy, regardless of the number of units on the property, unless the housing development qualifies as senior housing. A development qualifies as **senior housing** if:

- the housing units are occupied solely by persons 62 years of age or older; or
- the housing units are intended and operated for occupancy by persons 55 years of age or older and at least 80% of the occupied units have one or more people at least 55 years old. [42 USC 3607(b)(2); see Chapter 44]

To comply with state and federal anti-discrimination laws, a landlord's screening policies must not serve to prevent children from living in his rentals, called *familial status*. A screening policy must be **children neutral**, as it must also be mutual based on race, religion, nationality, etc. Conversely, senior citizen housing is exempt from unlawful discrimination based on familial status provided it meets the senior housing criteria. [Calif. Civil Code §51.2(a); see Chapter 54]

Rental policies or conduct that work to exclude pregnant women or families that contain one or more children under the age of 18 discriminate against a tenant based on *familial status*. Thus, residential policies that result in "adults-only" tenants are unlawful.

An individual submitting an application to rent cannot be discriminated against if the individual is the parent, legal custodian or a person authorized by written permission to take care of a child who will reside with the individual on the premises. [Calif. Government Code §12955.2; 42 United States Code §3602(k); see **first tuesday** Form 302]

The *Federal Fair Housing Act (FFHA)* also prohibits a landlord from using rental screening policies that discriminate against a tenant based on his familial status. [42 USC §3602]

Further, the *California Fair Employment and Housing Act (FEHA)* prohibits landlords from using discriminatory rental policies to avoid renting to a tenant based on familial status. [Gov C §12955(k)]

Additional California law, the *Unruh Civil Rights Act*, prohibits a *business establishment* from discriminating in the rental of housing based on a tenant's age, unless the property is qualified as senior housing. [Calif. Civil Code §51.2(a)]

Each of these schemes provides a variety of remedies and recoveries for a tenant who, since he resides with a child, has been discriminated against by a landlord. With the exception of senior housing, discrimination in the rental of housing based on familial status violates all three acts, and, for a landlord, property manager or resident manager, can result in civil liability, civil penalties and suspension of a real estate license.

Discrimination prohibited

Consider an owner of a two-bedroom residential unit that he rents. The unit is vacant and is advertised for rent in the local newspaper.

A prospective tenant contacts the landlord regarding the rental unit. Before agreeing to show the tenant the property, the landlord asks the tenant how many family members will occupy the unit (an inquiry which may or may not be made for discriminatory purposes).

The prospective tenant informs the landlord his spouse and child will occupy the unit with him. The landlord informs the tenant he does not qualify to rent the unit. The landlord explains families with children increase his maintenance costs by causing excessive wear and tear to the property. The tenant is forced to look elsewhere for housing.

Has the landlord unlawfully discriminated against the tenant by refusing to rent a single-family residence to the tenant based on, among other reasons, his familial status as including a child?

Yes! A residential landlord unlawfully discriminates against a potential tenant when he refuses to rent a residential unit to a tenant based solely on the fact a child will occupy the unit — a violation of FEHA. [Gov C §§12955(a), 12955(k)]

Also, FEHA prohibits a residential landlord from inquiring, as part of the screening process, into whether a prospective tenant even has children, if the purpose of the inquiry is to exclude families. [Gov C §12955(b)]

However, a landlord who targets families with children as prospective tenants is not necessarily acting in a prohibited discriminatory manner when he inquires about children. He may be intending to push advantages his property offers to tenants who have children, such as playground facilities or day care.

Whether or not an inquiry into familial status was made with discriminatory intent is shown by the landlord's **subsequent behavior**, i.e., refusal to rent, a higher security deposit, an increase in rent to anyone with children or the "steering" of families to other units or facilities.

The Unruh Act and the FFHA

The California Unruh Act prohibits a *business establishment* from discriminating in the rental of housing based on an occupant's age. [CC §51.2(a)]

Owners of apartment complexes and condominium associations fall under the definition of a business establishment for purposes of unlawful discrimination. [CC §51.2(b)]

*Editor's note — Landlords of one-to-four units fall under California's FEHA, as well as the state's Unruh Act. The term business establishment under the Unruh Act applied in the broadest reasonable manner. [**O'Connor** v. **Village Green Owners Association** (1983) 33 C3d 790]*

However, California's Unruh Act does not control mobilehome park owners. [**Schmidt** v. **Superior Court** (1989) 48 C3d 370]

A mobilehome park owner discriminating against tenants based on familial status violates federal law and California's FEHA, unless the mobilehome park is operated as qualified senior citizen housing. [CC §798.76; Gov C §12955.9; 42 USC §3607(b)]

Discrimination based on familial status does not occur under any law when the housing qualifies as senior citizen housing. [CC §§51.2, 51.10; Gov C §12955.9; 42 USC §3607(b)(1)]

Rental discrimination under the FFHA

Landlords, property managers and resident managers regularly and properly engage in discrimination for **legitimate purposes** when screening potential tenants for their rental units.

For example, a potential tenant's income, credit rating and rental and employment history are carefully considered for creditworthiness and an analysis of the landlord's risk of lost rent before a unit is rented to the tenant. In economic downturns, landlords tend to be more lenient in their rental practices by lowering rental deposits and rates, and relaxing credit requirements to keep their rental units full. They tend to accept less-qualified tenants than they would otherwise accept in better economic times. In other words, landlords become less (or more) discriminatory when analyzing creditworthiness and risk over a period of time.

Conversely, when activity in the real estate rental market turns up, landlords become more selective in the screening process to reduce the risk they take with a tenant. Landlords raise rental rates and tighten up credit standards during a strong demand for units.

However, as credit standards are raised, they must be equally applied to all prospects. Some landlords may overstep the law by cultivating an exclusive living atmosphere desired by older, more wealthy tenants, similar to criteria used in the screening process that tends to prevent families with children from renting.

Prohibited **discriminatory rental practices** toward families include both the direct refusal to rent, and the use of different rental or credit analyses or qualification criteria between competing tenants, such as:

- using different income standards;
- applying a different credit analysis;
- using different tenant screening and approval procedures; or
- imposing different rental charges. [24 Code of Federal Regulations §100.60]

Thus, a landlord cannot require tenants with children to have a higher family income or a better credit rating than tenants without children.

Also, a landlord who rents to a tenant with children cannot include different terms in the lease or rental agreements when children are involved, such as requiring higher security deposits or rental rates. [24 CFR §100.65(b)]

Any rental practice or policy that has the effect of *discouraging* or *preventing* families with children from renting a dwelling violates federal and state discrimination laws. [**Marina Point, Ltd.** v. **Wolfson** (1982) 30 C3d 721]

Discriminatory intent not required

A landlord cannot refuse to rent to families with children or adopt rental policies that **result in discrimination** against families with children. [24 CFR §100.60(b)]

Consider a landlord of an apartment complex who has a policy limiting occupancy of units to two persons. Each unit has two bedrooms and two baths. A prospective tenant contacts the property manager of the apartment complex. The tenant intends to rent a unit for himself, his spouse and two children.

The property manager advises the prospective tenant an application will not be processed even though units are available, since the complex has a policy limiting occupancy of each unit to two persons. The prospective tenant is not shown any of the units in the complex.

The tenant files an action against the landlord to recover money losses incurred in his extended search for housing, claiming the landlord violated the Fair Housing Act since he refused to rent a two-bedroom apartment to a family of four.

The landlord claims his two-or-less occupancy restriction was not discriminatory since the restriction was **even-handedly applied** to all rental applicants with the intent of preventing excessive wear to the units in an effort to reduce maintenance costs and increase the property's value.

Is the landlord liable for the costs incurred by the tenant to find new housing since the landlord's refusal to rent was based on a two-tenant occupancy restriction?

Yes! The landlord's occupancy restriction limiting use of a two-bedroom residential unit to two persons automatically results in discrimination against families with children.

A landlord's intent to discriminate against children is not necessary for him to violate the Fair Housing Act if the application of an **occupancy restriction** discriminates against families with children. [**Fair Housing Council of Orange County, Inc.** v. **Ayres** (1994) 855 F.Supp. 315]

While an occupancy restriction limiting the number of persons allowed to reside in the unit is enforceable if applied equally to all tenants, the restriction becomes an unlawful discriminatory housing practice when it has a *negative effect* on the availability of suitable rental units for families with children.

For example, a mother and her child locate a one bedroom unit she would like to rent in an apartment complex. The apartment complex has a longstanding practice of only renting one bedroom units to a single occupant out of concern for the lack of parking in the complex. Thus, the property manager refuses to show the prospective tenant the available unit. The local zoning ordinances require a minimum of 250 square feet for two persons in a unit and one bedroom unit had 650 square feet.

Here, the occupancy standard of the owner, which applied to all prospective tenants equally, violated the Fair Housing Act since it results in an **adverse impact** on a protected class of people, *family groups*. Thus, the restrictions denied the family housing for impermissible reasons — parking availability for the second occupant who was the child. [**United States** v. **Badgett** (8th Cir. 1992) 976 F2d 1176]

Number-of-occupants restriction

Now consider an owner of several single-family residences which he operates as rentals. The owner imposes a five-person occupancy restriction on some of his rentals.

On one rental unit he has a four-person restriction since it has a small yard and 1,200 square feet of living space which includes two modestly-sized bedrooms, a den opening onto the living room, a large kitchen and one large bathroom.

The unit becomes vacant and is advertised for rent by the owner's property manager. A prospective tenant is shown the rental. The prospective tenant completes a rental application, makes a deposit and passes the credit screening.

The property manager informs the owner he has located a family of five as tenants for the unit. The landlord advises the property manager he will only rent this unit to a family of four and rejects the application, claiming the family is too large to occupy the property. The tenant files a complaint with the Secretary of Housing and Urban Development, claiming the landlord discriminated against him since he had children.

The landlord claims the occupancy restriction is not intended to and does not discriminate against families with children, but is the result of a business decision necessary to prevent excessive wear and tear to property which is not designed to accommodate a family larger than three or four members.

Is the landlord liable for the tenant's losses and the civil penalty because of his occupancy restriction?

No! The landlord must only show his occupancy restriction does not unreasonably limit or exclude families with children. The landlord's occupancy restriction based on the size of the residence is a reasonable means of preventing the dilapidation of the property without barring families. [**Pfaff** v. **U.S. Department of Housing and Urban Development** (1996) 88 F3d 739]

The landlord can properly impose a reasonable numerical occupancy restriction since the purpose of limiting the number of occupants is to preserve the economic value of a property designed to house fewer occupants, occupants which may include families with children.

Chapter 56 Seniors-only housing

This chapter covers acceptable and unacceptable age discrimination in California housing.

California's fair housing laws

A landlord of an apartment complex with an **adults-only** rental policy enters into a lease agreement with a pregnant tenant. The lease contains an exclusion provision prohibiting individuals under 18 years of age from residing in the leased unit.

The tenant gives birth to a child prior to the expiration of the lease.

The landlord immediately serves the tenant with a 3-day notice to remove the child from the premises or vacate. The tenant does neither.

The landlord files an unlawful detainer action to evict the tenant since the tenant remains in possession and has failed to perform under the notice.

The tenant claims she cannot be evicted since the adults-only policy is an unlawful discriminatory practice and violates the child's civil rights.

Can the tenant avoid the landlord's adults-only policy agreed to in the lease agreement and remain in the unit with the child?

Yes! The landlord cannot refuse to rent to an individual based on age unless the individual can be excluded under senior citizen housing laws. The landlord's **adults-only** policy violates California's Unruh Civil Rights Act. [**Marina Point, Ltd.** v. **Wolfson** (1982) 30 C3d 721]

Civil rights and fair housing laws prohibit landlords, property managers and leasing agents from practicing any discrimination which is prohibited because of the *protected* status of an individual when they are locating, negotiating with or handling tenants for property, whether residential or nonresidential. [See Chapter 54]

However, discriminatory standards practiced by landlords, property managers and leasing agents which are not based on an individual's **societal status** protected by law are valid and enforceable.

Discriminatory standards not based on a protected status include ensuring the tenant:

- is financially able to pay the rent based on equally applied creditworthiness standards;
- will not damage the property based on prior conduct as a tenant or owner of property; or
- will properly conduct himself in the use and enjoyment of the leased premises.

Senior citizen housing

Any lease or rental agreement provision that prohibits the use or occupancy of real estate based on an individual's actual or perceived age, sex, race, color, religion, ancestry, national origin, disability, marital status or sexual orientation, is *void*. [Calif. Civil Code §§51, 53]

However, if the lease provision relates to the age of occupants in qualified *senior citizen housing*, age discrimination is allowed within specific age parameters.

Senior citizen housing is housing:

- intended for occupancy only by individuals 62 years of age or older; or
- intended for occupancy by at least one person of 55 years of age or older. [CC §51.3(b)(1); 42 United States Code §3607(b)]

Landlords and owners of qualified retirement communities or senior citizen apartment complexes **can exclude children** to meet the particular needs of older individuals.

To qualify as **senior citizen housing**, the development or renovation project must have at least 35 dwelling units and obtain a public report issued by the Department of Real Estate (DRE). [CC §51.3(b)(4)]

For a housing development to qualify as **senior citizen housing** with the DRE, the project must provide:

- access throughout for individuals using a wheelchair;
- railings or grab-bars in common areas;
- bright common area lighting for individuals with difficulty seeing;
- access throughout without the need to use stairs;
- a common room and open space for social contact; and
- compliance with the Federal Fair Housing Act (FFHA) and Americans with Disabilities Act (ADA). [CC §51.2(d)]

Qualified senior citizen housing

Qualified senior housing is allowed to limit occupancy to individuals who are 62 years of age or older under an exemption from federal anti-discrimination law.

A housing project qualifies as **senior housing** by limiting the occupancy exclusively to individuals 62 or older. [24 Code of Federal Regulations §100.303(a)(1), (2)]

A housing project still qualifies for senior housing even though management employees and their families living on the premises are under 62 years of age. To be classified as employees, the **employees** must perform substantial duties directly related to the management or maintenance of the housing. [24 CFR §100.303(a)(3)]

The 62-or-older restriction excludes all individuals under the age of 62, even if one spouse is 62 or older and the other is not. [24 CFR §100.303(b)]

If a project owner elects not to qualify or cannot qualify for the 62-or-older exemption, the project may still qualify under the broader 55-or-older exemption.

The 55-or-older 80% rule

To qualify for the federal 55-or-older exemption, the housing project must have 80% of the units occupied by at least one individual 55 years of age or older. [24 CFR §100.304(b), (c)]

For newly constructed projects, the 80% occupancy requirement does not apply until the real estate is 25% occupied. [24 CFR §100.304(b)]

Development or renovation of an existing residential complex for senior citizen housing must have been put to use as senior citizen housing immediately after development or renovation to qualify as senior citizen housing. [CC §51.3(f)]

Underage occupants

An **underage individual** may occupy a residential unit in a seniors-only project, other than a mobile-home park, if the individual:

- resides with a senior citizen prior to the senior's death, prolonged absence or their divorce; and
- is at least 45 years of age, a cohabitant, or an individual providing primary economic or physical support for the senior citizen. [CC §51.3(b)(2)]

A family member or hired individual may reside with the senior citizen if they provide assistance with necessary daily activities or medical treatment. [CC §51.3(b)(7)]

Also, a child or grandchild who is disabled or who has a disabling illness or injury and needs to live with the senior citizen on account of the child's disabilities may live with the senior citizen. [CC §51.3(b)(3)]

Also, a mobilehome park cannot discriminate against a 55-or-older tenant who is or is not married to a younger occupant. Federal law does not allow any discrimination when one occupant is at least 55 years of age. [CC §798.76]

Penalties for discrimination

A leasing agent found guilty of discrimination may be liable for damages of no less than $4,000 and no more than three times the amount of the actual damages and any attorney fees. [CC §52(a)]

Chapter 57 Residential rent control

This chapter describes the nature of local rent control ordinances and California phase-out rules.

Police power and rent control

A city's or county's ability to establish rent control by passing ordinances comes from its authority as a "police power."

Police power is the basis for enacting local ordinances such as zoning, traffic, health and safety regulations, and rent control, as long as the ordinances enacted are for the public's benefit. [Calif. Constitution Article XI §7]

To be valid, *rent control ordinances* must be reasonably related to the prevention of excessive rents and maintaining the availability of existing housing. No case has yet found an ordinance lacking in purpose, no matter its inability to attain, much less come close to, its stated purposes. [**Santa Monica Beach, Ltd.** v. **Superior Court** (1999) 19 C4th 952]

Application for rent increases

Before increasing rent on residential rentals located within rent control communities, a prudent property manager must determine:

- Is this rental unit subject to any rent control ordinances?
- Does the unit fall within an exemption?
- What type of rent adjustment does the ordinance allow?

Units covered by controls

Frequently, rent control ordinances do not cover all the rental units in a city. Examples of the types of property that may be exempt from a rent control ordinance in a city include:

- owner-occupied buildings;
- single-family residences and duplexes;
- luxury apartments;
- condominiums; or
- substantially rehabilitated buildings.

Rent control ordinances may also exempt newly constructed units from regulations to stimulate construction of additional housing.

Types of rent control

Despite the complexity and variety of rent control ordinances, two primary types exist:

- strict rent control; and
- vacancy decontrol.

Under **strict rent control**, rent increases are limited across the board. The restrictions on rent amounts apply to landlords renting to either new or existing tenants. Even when a tenant vacates and a new one moves in, the rent restrictions continue to apply to the unit.

The more common type of rent regulation is *vacancy decontrol*. Under vacancy decontrol, the rent ceilings apply only to existing tenants as long as they choose to remain in occupancy of the unit. When the tenant vacates, the landlord may raise the rent and charge the new tenant market level rents.

Rent adjustment standards

Once the property manager determines a unit is governed by a rent control ordinance, the manager must then determine the type of rent adjustments allowed, *general* or *individual*.

Under a **general adjustment**, rents in all rental units in the city are adjusted using:

- an amount tied to an economic index, such as the Consumer Price Index (CPI);
- a maximum annual percentage rate increase; or
- an amount determined at the discretion of the rent control board.

However, in most rent control cities, a landlord or property manager may also seek an **individual adjustment** from the rent control board. The individual adjustment is usually determined at a hearing before a rent control board.

Adjustments are sought when the general adjustment fails to provide a fair return on the residential property.

Rent increases may be based on:

- cash flow requirements to cover mortgage payments and operating expenses;
- a percentage of the net operating income; or
- a set return on value.

Also, almost all rent control cities allow individual adjustments for capital improvements made to upgrade the units.

Reasonable expenses recovered as rent

When a rent control ordinance bases rent increases for existing tenants on net operating income, the owner's operating expenses include fees and costs incurred by the owner for professional services he used to seek the rent increases. Thus, the cost of the procedures for getting the increase in rent are paid for by the tenant through higher rents. [Calif. Civil Code §1947.15(b)]

Reasonable fees incurred by the owner in successfully obtaining a **judicial reversal** of an adverse administrative rent control decision on a petition for upward adjustment in rents will be paid by the public agency that issued the adverse decision, not by the tenant. Unrecovered fees cannot be used to calculate the net operating income on the property. [CC §1947.15(c)]

If the owner's appeal of an adverse administrative decision is frivolous, the public agency will be awarded its reasonable expenses, including attorney fees, incurred to defend against the owner's action. [CC §1947.15(h)(2)]

When an owner's petition for a rent increase is without merit and the owner is assisted by attorneys or consultants, the tenant will be awarded a reduction in the rent to compensate for the costs he incurred to defend against the owner's petition. [CC §1947.15(h)(1)]

Eviction restrictions

In addition to restricting rent increases, rent control ordinances restrict the landlord's **ability to evict** existing tenants.

In communities free of rent control, the landlord does not need to give a reason for serving a 30-day notice to vacate on a month-to-month tenant. [CC §827]

Conversely, in rent control communities, the landlord may only evict a tenant for just cause. Valid reasons for terminating a rental or lease agreement are set forth in the rent control ordinances.

Common situations that justify termination include:

- breach of the rental or lease agreement by the tenant;
- failure to pay rent;
- creating a nuisance; or
- owner occupancy of the unit.

Most other reasons (or no reason) for termination are prohibited or severely limited.

Phase-out of rent control

When a city's rent control laws conflict with state law, state law controls.

The Legislature enacted rent control *phase-out measures* to provide a more economically efficient statewide housing policy than allowed by local rent control.

The economics of local rent control have generally debilitated investment in new and existing apartments, depriving local markets of necessary housing for lack of a competitive return on investments burdened with rent control.

Since state law overrides local rent control ordinances, landlords of residential rental property may establish rent for each unit, provided the unit:

- was a newly constructed unit exempt from rent control on or **before** February 1, 1995;
- was issued a certificate of occupancy **after** February 1, 1995; or
- is a separately described parcel of real estate (single-family residence or condominium unit) or a unit in a community apartment project, stock operative or limited-equity housing cooperative. [CC §1954.52(a)]

Consider a landlord of a residential rental unit that has a separate legal description from any other lot or unit and was subject to a rent control ordinance on January 1, 1995.

The unit is now occupied by a tenant who was an occupant on January 1, 1999 under a rental or lease agreement entered into on or after January 1, 1996. Here, the landlord may establish rental rates for the existing tenant without concern for rent control. [CC §1954.52(a)(3)(C)(i)]

Also, the landlord of a single-family residence (SFR) or condominium unit can set rental rates for all new tenancies if the **prior tenant's occupancy** was entered into on or **before** December 31, 1995. [CC §1954.52(a)(3)(C)(ii)]

However, the landlord of a SFR or condo unit may not set the rental rates even though the previous tenant occupied before 1996, if:

- that previous tenancy was terminated by a 30-day notice to vacate or a 30-day notice of change of rental terms; or
- if it is a condominium unit that has not yet been sold by the subdivider. [CC §1954.52(a)(3)(B)]

Further, when any residential tenant vacates (other than on a 30-day notice to vacate from the landlord), abandons or is evicted, the landlord may establish the rental rate without concern for rent control.

A landlord who maintains a unit that has been previously cited for violations of health, fire or building codes, may not increase the rent charged to new tenants if the violation is not corrected at least six months before the unit is vacated. [CC §§1954.52(d), 1954.53(f)]

Further, the landlord may not set new rental rates if he has contracted with a local agency to establish low income housing. [CC §1954.52(b)]

State law allowing landlords to set rental rates in rent control communities does not apply to rental units that were **sublet** under a rental agreement entered into before January 1, 1996. [CC §1954.53(d)]

Demolition of residential rentals

A landlord who wants to demolish a rental building, whether or not it is under rent control, must apply to a local governmental agency for a demolition permit.

A landlord is entitled to demolish his unit since he cannot be compelled to continue to provide residential rentals if he chooses to *withdraw* his property from the market. [Calif. Government Code §7060(a)]

Before applying for a demolition permit, the residential landlord must first give a written notice of his intent to apply for a permit to all tenants in the structure he desires to demolish. [CC §1940.6(a)(2)]

A residential landlord who has applied for a demolition permit must give a written notice to prospective tenants about his application for a demolition permit before he accepts an application to rent, a screening or other fee, or enters into a rental or lease agreement, whichever comes first. [CC §1940.6(a)(1)]

The notice of intent to demolish the residential rental structure to be given to the existing and prospective tenants includes the *earliest possible approximation* of the date the demolition is to occur and the *approximate date* the tenants' occupancy will be terminated by the landlord. [CC §1940.6(b)]

Chapter 58 Leaseholds as security for loans

This chapter discusses a tenant's encumbrancing of a leasehold with a lien by granting a security interest to a lender.

Financing business expansions

A nonresidential tenant holding a long-term lease on real estate needs financing to fund the construction of tenant improvements and the purchase of equipment to accommodate his expanding business.

As a condition for making the loan, a commercial **lender wants security** in the form of:

- the new equipment;
- the tenant's inventory, tools and trade fixtures;
- existing equipment, furniture and accounts receivable; and
- a lien on the real estate.

The tenant's real estate broker assisting in arranging the loan advises the tenant to offer the lender a trust deed lien on his leasehold interest in the premises since it will have far greater value on completion of the improvements. The tenant thought only fee ownership interests in real estate could be encumbered by a trust deed as security for a loan.

The broker explains any marketable interest in real estate can be given as security for a loan, including a tenant's leasehold interest in the premises he occupies, such as a *ground lease*.

Can a loan be secured by a trust deed lien on a nonresidential tenant's leasehold interest in the premises where he conducts his business?

Yes! A fee estate is not the only real estate interest which can be encumbered by a trust deed. **Any marketable interest** in real estate which is transferable can be used to secure a loan. [Calif. Civil Code §2947]

The two operative documents used in real estate mortgage financing, also called *real estate secured transactions*, are the *note* and *trust deed*.

The **note** is evidence of an obligation to pay money to a creditor — usually a lender or carryback seller. The **trust deed** secures the money obligation by encumbering some marketable interest in real estate, be it the fee, a leasehold or a life estate, with a lien in favor of the lender.

Of course, the lender will need to determine whether the market value of the tenant's remaining term under the lease, on completion of improvements, has sufficient value as security to satisfy the lender's loan condition of a trust deed lien on the tenant's interest in the real estate.

Estates as a transferable interest

The phrase "transferable interest in real estate" is applied broadly. An interest in real estate which is transferable includes the right to exclusive possession and is legally called an *estate*.

Each **estate** in property is fully capable of being encumbered with a lien by the owner of the estate. [CC §2947]

In California, **four recognized estates** exist in real estate:

- fee simple (simply called a fee);
- life estates;
- leaseholds; and
- estates at will. [CC §761]

Each estate can be **vested** as one's sole property, or in a co-ownership such as:

- a tenancy-in-common;
- joint tenancy;
- community property, with or without the right of survivorship; or
- a limited liability company (LLC), corporation, real estate investment trust (REIT) or partnership entity vestings. [CC §682]

The fact the ownership of the estate has been fractionalized between **several concurrent co-owners** does not automatically destroy each co-owner's ability to encumber his interest in the real estate. The separately vested interests can be individually encumbered unless it is community property or property used in a partnership for the mutual benefit of all the co-owners, such as the occupancy of property by a business they co-own.

Tenants in common are often partners who hold title for the benefit of the group venture. No co-owner may individually encumber partnership assets they hold in their name.

Also, a spouse with a vested interest in title cannot encumber that interest if it is community property unless the other spouse consents. [Calif. Family Code §1102]

Even contract rights to buy an ownership interest in real estate, such as an option to buy, can be encumbered by placing a lien on the option. [**Chapman** v. **Great Western Gypsum Co.** (1932) 216 C 420]

Encumbering real estate interests

A trust deed lien on real estate encumbers only the interest in the real estate held by the person executing the trust deed.

A trust deed describing a parcel of real estate which is signed by the tenant who occupies the property under a lease **creates a lien** only on the tenant's leasehold interest in the property. The trust deed can not attach as a lien to the landlord's fee interest in the described real estate — unless the landlord also signs the trust deed and the description does not exclude his fee.

When the tenant defaults on a loan secured by his leasehold, the lender forecloses on the tenant's leasehold estate by a trustee's sale or judicial foreclosure sale in order to repossess the right to possession owned by the tenant under the lease. The foreclosing lender, as the successful bidder at the foreclosure sale, becomes the tenant entitled to occupy the property since the lender is the new owner of the leasehold interest which was security for his trust deed lien.

The lender, as the new tenant, is required to make the lease payments and otherwise fully perform under the lease to avoid a forfeiture of the leasehold interest by the landlord on a default. The lender who is now the tenant may retain the leasehold interest, sell the lease to a user of the property, or sublet the property

since the lender now owns the leasehold interest, subject to the provisions in the lease agreement limiting alienation.

Occasionally a tenant holds an option to buy the leased real estate. Should a tenant with a trust deed lien on his leasehold later acquire fee title to the real estate, the fee acquired becomes security for the loan. The two possessory interests in the real estate, the leasehold and the fee, being owned by the same individual, *merge* into the greater interest, the fee. Thus, the leasehold is extinguished and the lender automatically becomes secured by the fee. [Chapman, *supra*]

On **merger**, the lender's security interest attaches to the fee since the fee is the only interest remaining in the property held by the trustor who signed the trust deed describing the real estate. [CC §2930]

Leases as security for financing

Nonresidential tenants encumber their leasehold interest with a trust deed when borrowing funds to:

- acquire an existing business opportunity together with the lease to the premises occupied by the business;
- construct improvements on vacant ground or in airspace controlled by the tenant under a long-term lease;
- expand the tenant's existing business and facilities on the leased premises; or
- acquire a home or investment property under a ground lease.

For example, an investor wants to acquire the current master tenant's leasehold position in the ownership of a shopping center.

To finance the acquisition, the investor arranges a purchase-assist loan just as if he were buying the shopping center under a grant deed conveyance.

At the close of the purchase escrow, the tenant under the master lease, acting as the seller, *assigns* his leasehold ownership interest in the center to the investor.

The investor delivers loan documents to the lender which includes a trust deed to encumber the leasehold interest the investor will acquire by assignment. The lender funds the purchase-assist loan.

The tenant and lender obtain separate American Land Title Association (ALTA) title insurance policies on their respective interests in the recorded leasehold estate.

The tenant defaults on the loan and the lender forecloses. The successful bidder at the trustee's sale becomes the new master tenant since he purchased ownership of the leasehold estate at the trustee's sale.

The foreclosure does not wipe out the fee ownership interest which remains unaffected. The fee was not security for the loan.

However, the successful bidder at the lender's foreclosure sale of the leasehold **steps into the shoes** of the leasehold tenant (as of the date the trust deed was recorded). The tenant's interest in the real estate, the right to possess and sublet to users of the premises, was sold to the highest bidder as authorized by the tenant under the trust deed's power of sale provision.

Restricting the right to encumber

A landlord can restrict a tenant's right to encumber the lease with a trust deed lien or, alternatively and less practical for the creditor, collaterally assign the lease as security for a loan. If **encumbrance restric-**

tions are not written into the lease, the tenant may assign or encumber his leasehold as he chooses. [CC §1995.210]

To restrict or control a tenant's ability to encumber his leasehold interest, a landlord includes a provision in the lease which defines the conditions under which the tenant may encumber the lease, called an *alienation provision*. [See Chapter 48; see **first tuesday** Form 552 §19]

In the **alienation provision** in the lease, the landlord may:

- prohibit the tenant from encumbering the leasehold [CC §1995.230; see first tuesday Form 552 §19.1];
- allow the tenant to encumber the leasehold subject to previously agreed conditions, such as the payment of a fee or higher rent [CC §1995.240; see **first tuesday** Form 552 §19.2]; or
- require the landlord's consent before the tenant may encumber the leasehold. [CC §1995.250; see **first tuesday** Form 552 §19.2]

If the lease requires the landlord's consent to encumber the leasehold, conditions for the payment of money contained in the alienation provision must be met before the landlord needs to grant consent. If no conditions for the landlord's consent are stated in the lease, consent must be granted unless a *commercially reasonable basis* exists for the denial of consent. [CC §1995.260; see Form **first tuesday** 552 §19.2]

Conversely, a tenant may require the landlord's consent to be subject to the standard of reasonableness by writing a provision into the lease. [CC §1995.250(a)]

It is **commercially reasonable** for the landlord to withhold consent when the encumbrance interferes with his interest, such as the tenant's:

- poor business track record;
- lack of creditworthiness;
- damage to property; or
- inadequate management skills.

Financing a business expansion

Consider a nonresidential tenant who borrows money to expand his business. The **security devices** available to secure the loan include:

- a trust deed;
- a collateral assignment of the lease; or
- a lease hypothecation, such as a UCC-1 financing statement.

When a lender agrees to accept a lease as security, the trust deed is the preferred security device used to document the lender's lien on the real estate. The secured lender or carryback seller of a leasehold interest who uses a trust deed as the security device can foreclose on the leasehold estate by a trustee's sale.

Use of any type of security device that does not contain a **power of sale provision** will require judicial foreclosure if the tenant defaults. [CC §2924]

Financing a business opportunity purchase

Consider a buyer of a business opportunity who makes a down payment on the price. The seller carries back the balance of the price on a note secured by the business equipment and furniture, the trade fixtures, and the lease on the premises.

The buyer signs a **UCC-1 financing statement** to impose a lien on the personal property (equipment, furniture, trade fixtures and accounts receivable) and a **collateral assignment** of the lease on the premises (or a trust deed). The documents are delivered to the seller as security for the carryback note.

Later, the buyer defaults on the note. The lease and the business have no remaining value. The seller sues directly on the promissory note to enforce collection without concern for the lien of the leasehold.

Can the seller waive the leasehold as security and sue directly on the note?

No! The seller cannot first sue on the note since the debt is secured by an interest in real estate (the leasehold). The seller must first foreclose on the lease (unless it has been *exhausted* by termination of the leasehold estate on a forfeiture declared by the landlord). The lease of the premises, being an interest in real estate, requires the lender holding the lease as security to foreclose judicially to enforce collection of the loan before a money judgment can be awarded, called the *one-action rule*. [CCP §726]

Chapter 59 Attornment clauses in nonresidential leases

This chapter reviews attornment, subordination and nondisturbance clauses in nonresidential lease agreements, and their use by landlords and lenders to alter the priorities of leases and trust deeds.

Altering priorities for lenders

A lender holds a recorded trust deed lien on the fee ownership interest in nonresidential income-producing real estate. The trust deed contains a due-on provision that states the owner may not sell, lease or encumber the secured property without the prior written consent of the lender, also called a *transfer clause* or *alienation clause*.

The lender has advised the owner it will consent to new leases under the due-on clause on the condition the lease agreement contain an *attornment clause* and a *lender subordination clause*.

A tenant enters into a lease agreement with the landlord that contains an attornment clause. The lease agreement is approved by the lender.

The **attornment clause** states the tenant will recognize a buyer of the property at a foreclosure sale as the new landlord under the lease if the buyer exercises his right under the attornment clause to enforce the lease agreement. [See Figure 1 accompanying this chapter]

Later, the owner defaults on the first trust deed. The lender notices a foreclosure sale and acquires the property with a credit bid.

After the lender acquires the property, the lender mails a written notice to the tenant stating:

- the lender is the new landlord **under the lease agreement**; and
- the tenant is to pay rent to the lender.

The tenant does not pay rent and vacates the premises.

The lender claims the tenant is required to accept the lender as the new landlord under the attornment clause in the tenant's lease agreement with the prior owner since the lender purchased the property at the foreclosure sale and declared himself to be the landlord under the lease.

The tenant claims the attornment clause is unenforceable since the lease agreement that contained the clause was junior to the lender's trust deed and was eliminated by the lender's foreclosure sale.

Is the tenant required to accept the lender as the new landlord and perform under the lease?

Yes! While the leasehold interest, the *lease* held by the tenant, was eliminated from title by the foreclosure sale, the lease agreement remains enforceable. Thus, on notice from the lender, the tenant is required to recognize — attorn to — the lender as the **substitute landlord** under the lease.

The lease is *restored and reattached* to title after the foreclosure sale when the lender (or other purchaser at the foreclosure sale) exercises the right given under the attornment clause to enforce the lease agree-

Figure 1

Attornment clause

In the event Tenant's estate is exhausted by a disposition of Landlord's estate, Tenant will recognize the new owner who acquires Landlord's estate as Landlord under this lease should the new owner, within 30 days of acquisition, notify Tenant in writing of the new owner's election to be substituted as Landlord under this lease.

ment as the new substitute landlord. [**Miscione** v. **Barton Development Company** (1997) 52 CA4th 1320]

The attornment clause contracts around the permanent elimination of a junior leasehold interest on completion of a foreclosure sale by a senior trust deed lender. The clause allows the purchaser at the lender's foreclosure sale to restore the *extinguished* lease as though it were unaffected by the foreclosure sale.

Priority on foreclosure

A tenant's lease, whether or not recorded, has **priority on title** over an interest in the property held by another person, such as a trust deed lien or abstract of judgment, when:

- the lease agreement is **recorded** before the other interest (a trust deed) is recorded or, if unrecorded, is actually known to the person holding the other interest [Calif. Civil Code §1214]; or
- the tenant takes **possession** before the other interest (a trust deed) is recorded or the tenant's right to possession is actually known to the person holding the other interest. [**Gates Rubber Company** v. **Ulman** (1989) 214 CA3d 356]

For example, a trust deed recorded junior in time to a tenant's occupancy of the secured real estate is foreclosed. The tenant's lease, being prior in time, is undisturbed by the foreclosure — the tenancy held by the tenant under terms contained in the lease agreement remains in full effect.

Thus, the buyer at the foreclosure sale of a junior trust deed acquires title "subject to" the lease. Since the lease held by tenant has priority, the buyer must perform the landlord's obligations under the lease agreement if the tenant seeks to enforce them.

Now consider a lease acquired by a tenant after a trust deed or judgment lien is recorded on the property. Later, the trust deed or judgment lien is foreclosed.

Here, the tenant's lease is wiped out by the foreclosure of the trust deed lien or judgment lien since the tenant's leasehold interest in title is junior in time and subordinate to the lien.

On elimination of a junior lease by a foreclosure sale of the premises, the tenant loses his right to possession of the premises. [**Hohn** v. **Riverside County Flood Control and Water Conservation District** (1964) 228 CA2d 605]

After foreclosure by the senior lienholder, the tenant's continued use and possession of the property is an unlawful detainer (UD) and the tenant can be evicted. A 3-day notice to quit due to foreclosure is required to be served and expire before a UD action can be filed and the occupant, should he remain in possession, be evicted. [See **first tuesday** Form 578]

Altering the priorities

A tenant can agree in a lease agreement to allow the landlord or the secured lender to **act unilaterally** in the future to alter the priority of the tenant's lease and the lender's trust deed liens on the property. [**Dover Mobile Estates** v. **Fiber Form Products, Inc.** (1990) 220 CA3d 1494]

Nonresidential lease agreements often contain boilerplate provisions, such as an *attornment clause*, a *lender subordination clause*, a *future subordination clause* and a *nondisturbance clause*. These provisions relate to the priority of the lease against trust deeds, present and future.

The **attornment clause** allows an owner-by-foreclosure to unilaterally avoid the automatic elimination and unenforceability of a junior lease by a foreclosure sale.

The **lender subordination clause** gives a trust deed lender the right to unilaterally subordinate the lender's trust deed to a previously junior lease by written notice to the tenant. Thus, the lease would not be wiped out by a foreclosure of the lender's trust deed since the trust deed has been subordinated and the lease has priority.

Under a **future subordination clause**, the tenant agrees to subordinate his lease to a trust deed to be recorded in the future. Here, the tenant remains involved since he must sign a *specific subordination agreement* to give the trust deed priority to his lease.

The **nondisturbance clause** is coupled with the future subordination clause. The clause entitles the tenant to receive a signed writing from a new trust deed lender agreeing that the lease will remain in effect for its full term in spite of the fact the tenant concurrently signs a specific subordination agreement giving the lender's trust deed priority.

Thus, by the nondisturbance agreement, the tenant will be restored with the rights he would otherwise lose on the lender's foreclosure due to the subordination and will be able to enforce the lease agreement against the new lender.

Further, by a lender exercising its rights under the *due-on clause* in its trust deed, a lender is able to also control the terms of all future leasing of the property, except for those leases with a term of three years or less.

As a condition for the lender to give consent to each lease agreement entered into by the landlord, a knowledgeable lender will require the landlord's lease agreements to include both a lender subordination clause and an attornment clause.

The attornment clause and foreclosure

Attornment is the tenant's agreement to acknowledge the purchaser at a foreclosure sale under a trust deed senior to his lease as a *substitute landlord* who may elect to enforce the tenant's lease agreement.

To enforce a wiped-out lease, the owner-by-foreclosure notifies the tenant he has elected to be the substitute landlord under the tenant's lease. However, the new owner need not do so, leaving the wiped-out tenant with no interest in the property.

A nonresidential landlord has good financial justification to include an attornment clause in a lease agreement. Should a senior trust deed lender foreclose, it is essential for the landlord to maintain the property's value and reduce the potential of a deficiency judgment. [See Figure 1]

A financially advantageous lease agreement, enforceable by new owners after a foreclosure, will help maintain the value of the property. On the other hand, if a financially advantageous lease agreement does not contain an attornment clause, the property's market value will be lower than it would be had the owner-by-foreclosure been able to enforce the lease.

If an owner-by-foreclosure elects to enforce a lease agreement containing an attornment clause, the lease agreement remains in full effect for the remainder of its term. Thus, the owner-by-foreclosure who makes the attornment election becomes the substitute landlord and must perform the obligations of the landlord under the lease. [Miscione, *supra*]

Before the foreclosing lender or other purchaser at a foreclosure sale substitutes himself as the successor landlord, he must consider whether the leases will generate rents at or above market rates. To help make the attornment decision, the new owner should first:

- obtain the equivalent of a Tenant Estoppel Certificate (TEC) from each tenant to discover any breach of their lease agreement by the prior landlord [See Chapter 41]; and
- inspect the property to be assured its physical condition is acceptable to the new owner.

Subleases and attornment

Lease agreements allowing a tenant to sublet portions of the property to occupants of separate spaces, also called *subtenants*, contain restraint-on-alienation clauses, also called *transfer restrictions* or *assignment and subletting provisions*.

The landlord's consent is needed in order for the tenant to sublet. When setting up the guidelines for consenting to a subletting, the landlord should require an **attornment provision** to be included in the lease agreement with the subtenant. If the landlord ever terminates the master tenant's right to possession under a three-day notice and forfeiture, a process that automatically eliminates the subtenant's right to possession, the landlord may enforce the sublease agreement under the attornment clause.

The landlord electing to enforce the sublease agreement is substituted as the landlord (sublessor) under its attornment provision. Due to the election, the subtenant will continue paying rent as agreed, but to the new landlord.

No assurance of continued occupancy

Conversely, an attornment clause does not give the tenant the reciprocal right to enforce the lease agreement against the buyer at the foreclosure sale. The attornment agreed to by the tenant to recognize the buyer as his landlord is not exercised until the buyer elects to enforce the provisions.

Thus, a tenant who enters into a lease agreement with an attornment clause, whose lease is junior to a lender's trust deed, has no assurance the lease will be restored or that he will be able to remain in possession after a foreclosure sale.

Yet tenants, when agreeing to an attornment clause as a provision in their lease agreements, believe the clause states the obvious — the tenant will perform on the lease for anyone who becomes the new owner of the property. The tenant views it as a nondisturbance agreement with the lender, but it is not. The lender is not a party to the lease agreement.

However, when a junior lease is eliminated at a foreclosure sale, the new owner is unlikely to elect to enforce the lease agreement if:

- the new owner acquired the property to occupy it as a user; or

- the rents due under the exhausted lease are significantly less than the rents available in the market.

Further, a tenant will regret the inclusion of an attornment clause if rents called for in the lease agreement exceed market rates at the time of foreclosure, or if the location or premises are no longer desirable for the tenant when a foreclosure sale occurs and the attornment clause is enforced to restore the lease.

All these events typically converge during economically depressed times for all involved.

For a tenant to avoid the unilateral adverse economic impact of an attornment clause upon entering into a long-term lease under an agreement containing the clause, the tenant should:

- obtain an abstract of title or lessee's policy of title insurance to ascertain the trust deeds and other liens of record and the risk of loss they present to the tenant;
- obtain a beneficiaries statement on the loans/liens of record;
- record a Request for Notice of Default; and
- record a Request for Notice of Delinquency on the lender. [See **first tuesday** Form 412]

With the information from these documents, the tenant can take steps to protect his interest if the landlord defaults on senior liens or the underlying ground lease, long before any foreclosure sale occurs.

Notifying the tenant

A lender or other high bidder who acquires a property at a foreclosure sale, which wipes out a tenant's leasehold interest in the property, **elects to enforce** the tenant's lease agreement under its attornment clause by giving the tenant a written notice:

- stating the owner-by-foreclosure is exercising his right to enforce the lease agreement provided him by the attornment clause; and
- instructing the tenant to make all future rent payments due under the lease agreement to the buyer. [Miscione, *supra*]

A specific time period should be stated in the attornment clause within which the owner-by-foreclosure must notify the tenant of his election to enforce the attornment agreement, such as within 30 days after the foreclosure sale. [See Figure 1]

The new owner loses the right to enforce the attornment clause if:

- no time period for enforcing recognition of the new owner as landlord is specified in the clause; and
- the new owner does not elect to enforce the lease within a *reasonable period of time*.

No right to continued occupy

The owner-by-foreclosure may choose not retain the extinguished nonresidential lease by enforcing the tenant's lease agreement containing an attornment clause. Instead, he may cause the tenant to vacate. To notify the tenant to vacate and be able to evict him through an unlawful detainer action should he not vacate, a three-day notice to quit due to foreclosure must be served on the tenant. [Calif. Code of Civil Procedure §1161a(b); see **first tuesday** Form 578]

The three-day notice should be served as soon as possible to avoid conduct by the landlord or property manager that could be construed as an enforcement of the lease (by attornment) or the establishment of an unintended periodic tenancy.

For example, a new owner who elects not to enforce the lease should not accept rent from the tenant until he enters into a new written rental or lease agreement.

Accepting rent in the amount called for in the extinguished lease agreement may indicate the new owner intends to accept the lease under its attornment clause, regardless of the new owner's actual intent. [**Rubin** v. **Los Angeles Federal Savings and Loan Association** (1984) 159 CA3d 292]

If the owner-by-foreclosure accepts rent payments from a tenant when an attornment clause does not exist in the extinguished lease, a periodic tenancy is created. As between themselves, neither the tenant nor the new owner can enforce the lease agreement since the lease has been extinguished. [**Colyear** v. **Tobriner** (1936) 7 C2d 735]

Lender subordination clauses

A nonresidential lender requiring an attornment clause in a lease agreement entered into by the owner after the lender's trust deed is recorded will also require the owner to include a *lender subordination clause* in the lease agreement. The lender subordination clause allows the lender to elect, at any time during the life of its trust deed, to subordinate his trust deed lien to leases the landlord enters into with tenants after the trust deed is recorded. [See Figure 2 accompanying this chapter]

A lease agreement containing both a lender subordination clause and a tenant attornment clause allows the lender the **maximum flexibility** for preserving an advantageous lease by either:

- electing to subordinate his trust deed to the lease **before the foreclosure sale**; or
- **completing a foreclosure sale** and electing to enforce the lease agreement within the attornment election period.

Some attornment clauses are worded to state the lender must acquire the premises "subject to" the lease at the time of the foreclosure sale.

However, while an attornment clause in a lease agreement may literally state the lender is to acquire the property "subject to" the lease, the attornment clause cannot automatically subordinate the trust deed to the lease when a foreclosure sale occurs since the lender is not a party to the lease agreement. The lender did not agree to the terms of the lease agreement, even if the lender previously reviewed it and waived his due-on clause enforcement by consenting to the lease.

When the lender notifies the tenant prior to the foreclosure sale of his election to subordinate his trust deed lien to the tenant's lease, the election **need not be recorded** to give public notice. The change in priority only affects the lender, the tenant and their successors who are aware of the agreement since they are parties to it, not third parties. [CC §1217]

Figure 2

Lender subordination clause

Any master lessor or holder of a lien on the leased premises may elect to subordinate its interest in the premises to this lease by service of written notice on the tenant of the election, and thereafter the lease shall have priority regardless of the priorities set by law.

A trust deed that becomes senior to a lease by the lender's election to subordinate gives the lease priority over the trust deed. Thus, the lease is **not eliminated from title** by the foreclosure sale.

If the lease is not wiped out at the foreclosure sale because of the lender's prior election to subordinate, a later election under the attornment clause after foreclosure becomes unnecessary. When a lender elects to subordinate his trust deed to the lease, the high bidder at the foreclosure sale acquires the property "subject to" the lease since the lease has priority over the trust deed.

After the foreclosure sale, by either a prior election by the lender to subordinate or a later election to have the tenant attorn to the new owner, the lease agreement becomes **enforceable by both** the tenant and the new landlord. [Miscione, *supra*]

Electing to subordinate

Now consider a lender holding a first trust deed on nonresidential real estate. After the trust deed is recorded, the owner leases the property.

The lease agreement contains a lender *subordination clause* to satisfy the lender's conditions for waiver of the due-on clause in his trust deed.

During the term of the lease, the owner defaults on the lender's trust deed. The lender records a notice of default (NOD), initiating a trustee's foreclosure sale. The lender has the property appraised and discovers the rent due over the remaining term of the tenant's lease exceeds current prevailing rental rates.

For the same economic reasons that cause the lender wants to preserve the lease agreement, the tenant wants out of the lease agreement.

The lender hears of negotiations between the owner and the tenant to modify the lease agreement. The lender does not want the landlord to alter the agreement prior to foreclosure and an attornment. The lender serves written notice on the tenant of his election to **subordinate** his trust deed to the tenant's lease, altering their priorities.

After receipt of the notice of subordination, the tenant and the landlord modify the lease agreement, granting the tenant the right to terminate the lease agreement at any time on 30 days' written notice, in exchange for the tenant paying the landlord a modification fee.

The trustee's sale is held and the lender acquires the property. The tenant is notified by the lender that he is now the owner of the property and all rent payments under the lease are to be made to the lender. The tenant notifies the lender in writing of his election to terminate the lease and cancel the lease agreement on 30 days' notice.

The lender claims the tenant cannot terminate the lease or cancel the lease agreement since the modification agreement, but not the original lease agreement, was eliminated by the foreclosure sale.

Can the tenant terminate the lease by canceling the lease agreement under the conditions stated in the lease modification entered into prior to the owner's loss of the property?

No! The original terms of the lease agreement remained unaffected by the foreclosure sale since the lender elected to subordinate the trust deed to the lease prior to the tenant entering into the lease modification agreement. Thus, the agreement modifying the lease became unenforceable by the tenant after the foreclosure sale. The modification agreement was junior in time to the subordination of the trust deed.

Thus, the lease became a senior (unrecorded) encumbrance on title to the property with priority to the lender's trust deed and could not be altered without the lender's consent.

Thus, the modification of the lease agreement, but not the pre-existing lease agreement, was eliminated by the lender's foreclosure. [**In re 240 North Brand Partners, Ltd.** (9th Cir. BAP 1996) 200 BR 653]

By subordination of the lender's trust deed to the lease, the lender acted to maintain the property's value based on rents under the lease. Subordination allows the lender to avoid the effect of any later modification of the lease prior to foreclosing and acquiring ownership at the trustee's sale.

In the event the lender proceeds with a judicial foreclosure, the landlord would normally prefer the property to remain encumbered by a financially advantageous lease agreement following a **judicial foreclosure** sale to avoid a deficiency in the property's value and its inability to satisfy the loan.

Thus, the risk of loss due to a deficiency in the value of the property at the time of the remaining judicial foreclosure sale is reduced for both the lender and the landlord, but the tenant must pay.

Future subordination clauses

A **landlord's ability** to further encumber or refinance his property during the term of a lease is greatly diminished unless the lease agreement contains a *future subordination clause*. [See Figure 3 accompanying this chapter]

Like the attornment clause and lender subordination clause, a future subordination clause is an agreement to **alter priorities** on title. Under a future subordination clause, the tenant agrees to subordinate his lease (right to possession) and the lease agreement to a trust deed to be recorded by the landlord sometime in the future.

Thus, the tenant agrees to place his lease in a financially lesser or worse position on title, whether or not the lease agreement is recorded, than he enjoyed at the time he enters into the lease agreement. The tenant's lease will be subordinated to a new trust deed loan based on the terms of a new loan agreed to in the future subordination clause.

For a **future subordination clause** to be enforceable at the time the landlord arranges a new trust deed loan, the clause must specify:

- the use of the loan proceeds, such as refinancing existing encumbrances or improving the property;
- the dollar amount of the loan on the loan-to-value ratio of the financing;
- the payment schedule;
- the interest rate; and
- the due date. [**Handy** v. **Gordon** (1967) 65 C2d 578]

The clause must also contain any other terms that might be unique to the future financing that would, if agreed to by the tenant, further impair the tenant's lease.

When the landlord later arranges financing for the property on terms within the parameters agreed to in the subordination clause, the tenant is obligated to sign a *specific subordination agreement*. A title company will not insure the priority of the new trust deed over the tenant's lease without the tenant executing an agreement setting out the specifics of the loan and the subordination.

However, the tenant may refuse to sign a subordination agreement if the financing terms are not substantially similar or within the parameters of the subordination clause in his lease agreement. The tenant has not agreed to subject his lease to the uncertainties of a greater risk of loss than the risks established by the terms of the subordination clause.

Editor's note — When the landlord wants to record a new trust deed to secure a loan and the tenant refuses to sign a specific subordination agreement, the landlord's primary recourse is to serve a 3-day notice to perform or quit. If performance is not forthcoming, rather than evict, the landlord may file an action against the tenant for declaratory relief and specific performance of the future subordination clause in the tenant's lease agreement.

Nondisturbance clauses

A **nondisturbance clause** gives the tenant the right to require a new trust deed lender to enter into a written agreement with the tenant, called a *nondisturbance agreement*. The agreement states the tenant's lease agreement will remain in effect for its full term after the lease is subordinated to a new loan.

A nondisturbance clause is included in a lease agreement only if the lease agreement also contains a *future subordination clause*. The tenant is the primary beneficiary of the nondisturbance clause.

A nondisturbance clause is typically used by the landlord and leasing agents to avoid negotiating the terms of a subordination clause with the tenant while hammering out the terms of the lease.

When the nondisturbance clause and an enforceable future subordination clause are included in a lease agreement, the tenant can refuse to sign a subordination agreement unless the lender provides the tenant with a nondisturbance agreement. Any standoff between the tenant and the lender would pose a serious problem for the landlord's attempt to record financing.

Informed lenders are not likely to provide a tenant with a nondisturbance agreement when originating a loan secured by a first trust deed on property.

A nondisturbance agreement **negates** the effect of the subordination agreement by reversing the very priorities agreed to by subordinating the lease to the trust deed, a sort of *self-destruct provision*. The lease will not in effect be subordinate to the lender's trust deed if the lender agrees to recognize the continued existence of the lease after a foreclosure of the trust deed.

A knowledgeable landlord, contrary to the needs of a tenant, does not want a nondisturbance clause in his lease agreements — he wants an enforceable future subordination clause.

Unlike the purpose of an attornment clause, a lease that is subject to a nondisturbance agreement will not be eliminated by foreclosure nor need to be later restored by election of the owner-by-foreclosure.

Figure 3 *Excerpt from **first tuesday** Form 552 — Nonresidential Lease Agreement*

17. **SUBORDINATION:**

    17.1 Tenant agrees to subordinate to any new financing secured by the premises which does not exceed 80% loan-to-value ratio, and interest of two percent over market, and not less than a 15-year monthly amortization and five-year due date.

The nondisturbance agreement states the lease will remain in effect for its full term without regard to foreclosure.

Since the lease by agreement with the lender cannot be extinguished by foreclosure, it cannot also be junior to the trust deed.

Thus, a subordination of the lease to the trust deed never truly occurs because of the lender's concurrent entry into a nondisturbance agreement.

Also, when a lender executes a nondisturbance agreement, an attornment clause serves no purpose. Like many clauses in some lease agreements, it becomes superfluous.

The tenant's possession and lease agreement when subject to a nondisturbance agreement remains undisturbed and continuously enforceable by both the tenant and the new owner after the foreclosure sale.

By entering into a nondisturbance agreement, the lender is **forced to become** the landlord under the lease if the lender forecloses and acquires the property.

However, a prudent lender probably wants the choices afforded him by the lender's loan subordination and attornment clauses, to accept or reject the lease either prior to or after the foreclosure.

Here, the landlord eliminates the need for a nondisturbance clause in a lease agreement by negotiating an enforceable future subordination clause outlining the loan parameters acceptable to both the landlord and the tenant when entering into the lease.

Chapter 60 Tenant estoppel certificates

This chapter explains an owner's use of a Tenant Estoppel Certificate provision in lease agreements when leased property is refinanced or sold.

Protection for buyers and lenders

A real estate broker representing an owner who wants to sell or refinance his income-producing property customarily prepares an annual property operating data (APOD) form to be included in the marketing package. The completed APOD will be handed to prospective buyers and lenders to persuade them to enter into a transaction with the owner. [See **first tuesday** Form 352]

A thoughtfully prepared APOD provides buyers and lenders with an accurate summary of financial information on the operating income and expenses generated by a property, as well as loans encumbering the property.

Buyers and lenders who rely on APOD figures should corroborate the income and other leasing arrangements prior to closing. A strategic method is to condition the closing on their receipt and further approval of *Tenant Estoppel Certificates* (TEC), one signed and returned by each tenant occupying the property. [See Form 598 accompanying this chapter]

The TEC summarizes the **financial and possessory terms** of the lease agreement, and whether the landlord and tenant have fully performed their obligations.

The objective of the TEC is to confirm the current status of:

- rent schedules;
- security deposits;
- possessory and acquisition rights; and
- the responsibility for maintenance and other operating or carrying costs.

Thus, the TEC will reveal any option or first refusal rights held by the tenant to:

- extend or renew the lease;
- buy the property;
- lease other or additional space; or
- cancel the lease on payment of a fee.

Figure 1 *Excerpt from **first tuesday** Form 552 — Nonresidential Lease Agreement*

18. TENANT ESTOPPEL CERTIFICATES:

18.1 Within 10 days after notice, Tenant will execute a certificate stating the existing terms of the lease to be provided to prospective buyers or lenders.

18.2 Failure to deliver the certificate shall be conclusive evidence the information contained in it is correct.

However, before the owner can require a tenant to sign and return a TEC to confirm the leasing arrangements, the lease agreement must contain a Tenant Estoppel Certificate provision. [See Figure 1 accompanying this chapter; see **first tuesday** Form 552 §18]

The **TEC provision** calls for the tenant to:

- *sign and return* a TEC, which has been filled out and sent to them, within a specific period of time after its receipt; or
- *waive his right* to contest its contents if the tenant fails to sign and return the TEC submitted for his signature.

Tenant response to receipt of a TEC

In addition to information regarding the rent schedule and the rights and responsibilities of the tenant, a TEC includes a statement indicating a buyer or lender will rely on the information provided by the TEC when making a decision to lend or purchase. [See **first tuesday** Form 598 §10]

The tenant's *acknowledgment* of the accuracy of the TEC contents by his signed response, or *waiver* of the right to contest the accuracy of the contents of the TEC by nonresponse, can be relied on by a buyer or lender as establishing the contents of the TEC as complete and correct statements on the terms and condition of the lease. [Calif. Evidence Code §623]

Should a dispute later arise between the buyer (or a lender) and the tenant regarding conditions covered in a TEC, the properly submitted TEC prevents any later claims made by the tenant that are in conflict with the contents of the TEC.

A buyer or lender asserts his right to rely on and enforce the terms stated in the TEC by presenting the tenant's TEC as a defense to bar contrary claims made by the tenant, called *estoppel*. Thus, the tenant is *estopped from denying* the truth of the information in the TEC or later claiming conflicting rights.

Security deposits confirmed

When lease agreements are assigned to a buyer on closing a sale, the buyer requires the seller, through escrow, to account for any security deposits collected from the tenants. The amount of the remaining security deposits to the buyer as part of the escrow process, called *adjustments*.

With a TEC, the tenant confirms the accounting and dollar amount of security remaining on deposit with the seller. Thus, the TEC avoids the transfer of insufficient amounts of security deposits on closing and establishes the extent of the buyer's liability for refunds.

If the buyer does not require a TEC to confirm the current amount of the security deposits claimed to be held by the seller and transferred to the buyer, the buyer may find himself paying tenants more than the security deposit amounts he received from the seller on closing. [Calif. Civil Code §1950.5(i)]

Any deficiency in the amount of credit the buyer received for security deposits owed to the tenants that the buyer may later be required to pay is recovered by pursuing the seller.

TEC substantiates prior representations

Use of an APOD form to present an accounting summary of the operating data on a property's income and expenses is a representation of the income flow and operating expenses a prospective buyer can expect the property to generate in the immediate future.

TENANT ESTOPPEL CERTIFICATE

DATE:_____, 20_____, at _____, California.
Items left blank or unchecked are not applicable.

FACTS:

This certificate pertains to terms and conditions under the following agreement:
☐ Lease agreement ☐ Month-to-month rental agreement ☐ Other: _____
dated:_____, 20_____, at _____, California,
entered into by_____, as the Landlord, and
_____, as the Tenant,
regarding real estate premises referred to as: _____
_____

STATEMENT:

Tenant certifies as follows:

1. The lease or rental agreement is:
☐ Unmodified and in effect.
☐ Modified and in effect under a modification agreement dated _____, 20_____.

2. Tenant is in possession of the premises, and has not assigned or sublet any portion of the premises, except:
_____

3. If the agreement is a lease, the current term is for _____ years, ending _____, 20_____.
3.1 Lease renewal/extension option term(s) run until _____, 20_____.
3.2 The Tenant holds no privilege to terminate the lease prior to it's expiration.

4. The amount of monthly rent is $_____.
4.1 No incentives, bonuses, free rent, discounts or refunds on the rental amount were given Tenant, except:
_____
4.2 Rent is paid through the period ending _____, 20_____.
4.3 Tenant has not prepaid future rent, except the amount of $_____ for the rental period of:
_____
4.4 No Tenant liens, claims, offsets or charges exist against Landlord, except _____
_____

5. A security deposit of $_____ is held by Landlord to cover any expenses or losses caused by Tenant's breach of the agreement.

6. Personal property in the tenant's possession and owned by the landlord includes: _____
_____

7. Any improvements required to have been made by Landlord or Tenant have been satisfactorily completed.

8. No breach of the agreement by Landlord or Tenant presently exists, except _____
_____

9. Tenant holds no contract, option or right of first refusal or other right to buy any interest in the real estate.
8.1 Tenant holds no right to lease additional or substitute space in the real estate.

10. Tenant has caused no lien or encumbrance to attach to the leasehold interest in the property.

11. Tenant understands this certificate will be relied on by a buyer of the property or a lender secured by the real estate.

12. _____
_____
_____

BY TENANT: I certify the above is true and correct.
Date:_____, 20_____
Name: _____
Signature: _____
Phone:_____ Fax: _____

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To establish, **prior to closing**, the rent and expenses the buyer can reasonably expect the tenants to pay, the buyer must:

- review and analyze all the lease agreements the owner has with the tenants;
- compare the results of an analysis of rent and maintenance provisions in the lease agreements to the figures in the APOD received before the offer was submitted; and
- confirm the rent schedules, possessory rights, maintenance obligations and expiration of the leases by serving TECs on the tenants and reviewing their responses.

Close on receipt of TECs

When signed and delivered to the buyer, the TEC statement reflects only the financial and possessory arrangements existing at the time the tenant signs and returns the TEC.

Consider a tenant who signs and returns a TEC that is reviewed and approved by the buyer. However, before escrow closes, the seller breaches, modifies or enters into other leasing arrangements with the tenant.

The seller's post-TEC activities are not noted on the TEC, and will be unknown to the buyer when escrow closes unless brought to the buyer's attention. Thus, on receiving the TECs, a buyer or lender should review them and close the transaction **as soon as possible** to avoid a change in conditions in the interim.

Consequence of no TEC

A buyer or lender may be confronted at the time of closing with a tenant who has not signed and returned a TEC. Before closing, it is good practice for the buyer and his agent to **investigate** whether differences actually exist between the owner's representations on the TEC and the tenant's expectations under the lease agreement.

Even though the buyer or lender can legally rely on the contents of an unreturned TEC when the tenant's lease agreement contains a TEC clause, an inquiry by the buyer or his agent into the tenant's failure to return the TEC is a prudent measure of prevention against future surprises.

Consider an owner of income-producing real estate who needs to generate cash. He will do so by borrowing money using the equity in his property as security for repayment of the loan.

Tenants occupy the property under lease agreements that include options to renew at fixed rental rates. The lender does not condition the origination of the loan on the lender's receipt and approval of TECs from each tenant. The lender makes the loan based on the value of comparable properties without regard for a schedule of the tenants' rent. [See **first tuesday** Form 380]

The owner defaults. The lender forecloses and is the successful bidder at the trustee's sale. As the new owner, the lender (or anyone else who purchases the property at the trustee's sale) reviews the rent being paid by the tenants.

The new owner decides to increase the rents to current market rates in order to bring the property's market value up to prices recently received on the sale of comparable properties. However, the tenants who occupied the premises before the lender's trust deed was recorded claim their lease agreements, which provide options to extend at old rental rates, are enforceable.

The lender claims his foreclosure sale wiped out the owner's rights and establishes him as a new title holder with priority over the leases and, further, the lease agreements are not recorded.

Can the tenants who occupied the property prior to the recording of the lender's trust deed enforce their renewal options even though their pre-existing lease agreements are not recorded?

Yes! The lender originating the loan on income-producing property he now owns following foreclosure, recorded the trust deed *after* the tenants were in possession of the property. Thus:

- the tenants' rights and obligations under lease agreements *held by pre-existing tenants*, recorded or not, retain priority over the lender's trust deed lien; and
- the lender is bound by the rent schedules in the pre-existing lease agreements and renewal/extension options because of the seniority of the leases. [CC §1214]

The tenants' occupancy of the premises prior to originating the loan puts the lender on *constructive notice*, i.e., the lender is charged with knowledge of the lease agreements, renewal options and rent schedules. [**Evans** v. **Faught** (1965) 231 CA2d 698]

Status of the lease

The TEC verifies the following:

- whether possession is held under a lease or rental agreement;
- the current monthly amount of rent and the basis for rent increases;
- the date rent is paid each month;
- the date to which rent has been paid;
- any incentives given to obtain the tenant;
- whether the tenant has prepaid any rents;
- the term of the lease and whether an early cancellation privilege exists;
- whether and in what manner the lease/rental agreement has been modified;
- whether the tenant holds any options to renew or extend, acquire additional or substitute space, or a right of first refusal to rent vacated space;
- whether the tenant holds any options to buy the real estate;
- the amount and status of any security deposit;
- any improvements the tenant must or can remove on vacating the premises;
- any landlord commitments to further improve the premises;
- whether the landlord or tenant is in breach of the lease or the rental agreement; and
- whether the tenant has assigned or sublet the premises, or liened his leasehold interest.

The requirement for lender approval of a TEC from each tenant would have informed the lender of the tenants' rights and obligations to occupy and pay rent and other amounts under their lease agreements.

To be assured the owner's scheduled future income represents amounts the tenants expect to pay, every buyer or lender acquiring an interest in income-producing real estate should require tenant approval of TECs based on lease arrangements the owner/seller purports to hold with each tenant.

Signing an erroneous TEC

Consider a tenant who signs and returns a TEC on the landlord's sale of nonresidential property. The TEC is erroneously prepared, stating an expiration date earlier than the date for termination provided in the lease agreement.

The buyer relies on the TEC and purchases the property. The tenant remains in possession of the premises after the expiration date stated in the TEC. The buyer seeks to enforce the expiration date in the TEC by filing an unlawful detainer (UD) action to evict the tenant.

The tenant claims the buyer cannot enforce the expiration date in the TEC by a UD action since the TEC was not a written agreement modifying the lease, binding him to a different expiration date than actually stated in the lease agreement. The buyer claims the tenant is barred from contradicting the expiration date stated in the TEC.

Here, the new landlord can enforce the expiration date in the TEC and evict the tenant by a UD action. The TEC is a statement signed by the tenant certifying facts with respect to the lease which were relied on by the buyer. Thus, the tenant is barred from later using the contrary provision in the lease agreement to contradict the TEC, called *estoppel*. [**Plaza Freeway Limited Partnership** v. **First Mountain Bank** (2000) 81 CA4th 616]

The erroneous, unsigned TEC

Now consider a purchase agreement for nonresidential rental property that requires the seller to provide the buyer with TECs for the buyer's further approval or cancellation of the purchase agreement.

One tenant's lease agreement does not state the rent amounts but contains a formula for calculating rent. The seller instructs the buyer on how to calculate the rent due from the tenant based on the provisions in the tenant's lease agreement.

The seller enters the rent amounts on the TEC based on the same calculations given the buyer and sends it to the tenant to be signed and returned to the buyer.

The tenant refuses to sign the TEC since the tenant is not obligated under his lease agreement to provide a TEC. The seller hands the buyer a copy of the tenant's unsigned TEC to satisfy the purchase agreement condition, which the buyer accepts without further investigation and confirmation.

After escrow closes, the buyer discovers the tenant's actual rent is significantly lower than the seller's estimate. The buyer makes a demand on the seller for the difference between the actual rent paid by the tenant under the lease and the rent amounts calculated by the seller as the rent to be paid by the tenant.

Is the seller liable for the difference in the rent?

Yes! The buyer **recovers lost rent** from the seller in the amount of the difference between the seller's calculated estimate of rent and the actual amount owed by the tenant. The seller is obligated under the

purchase agreement to provide the buyer with an accurate TEC, and the buyer based his decision to purchase the property on representations made by the seller, not on the rent provisions in the lease agreement. [**Linden Partners** v. **Wilshire Linden Associates** (1998) 62 CA4th 508]

A seller avoids liability for errors in the TEC prepared and sent to tenants by including a TEC clause in the tenant's lease agreement, calling for the tenant to sign and return a TEC on request. The failure of the tenant to provide the TEC as called for in the lease agreement is conclusive evidence any contrary information contained in the TEC is correct. [See Figure 1]

Thus, a tenant's refusal to sign a TEC when a TEC clause exists in the lease agreement results in the tenant, not the seller, being liable for the erroneous rent amount stated in the TEC prepared by the seller.

Chapter 61 Due-on-leasing regulations

This chapter discusses the rights of a lender under a due-on clause in a trust deed when the landlord leases any portion of the secured property to a tenant.

Rising interest rates bring lender interference

Real estate encumbered by a first trust deed containing a *due-on clause* is offered for sale or lease. A user for the property is located and enters into a two-year lease agreement with an option to purchase the property.

Does the lease agreement and option to buy trigger the due-on clause in the trust deed allowing the lender to call the loan the trust deed secures?

Yes! A due-on clause in a trust deed is triggered by a **lease agreement** that is coupled with the grant to the tenant of an option to buy the property. Thus, the trust deed lender may call the loan **on discovery** of the lease-with-option transaction, and foreclose if not paid in full. [12 Code of Federal Regulations §591.2(b)]

Interference under federal mortgage law

The **transfer** of any interest in real estate encumbered by a trust deed containing a due-on clause allows the lender to enforce the clause under federal mortgage law. Thus, by *preemption*, Californians are deprived of their state law right to lease, sell or further encumber real estate free of lender interference, subject to the lender's clearance of the buyer's or tenant's creditworthiness and property maintenance attributes. [12 United States Code §1701j-3; Calif. Civil Code §711]

For the landlord of property encumbered by a trust deed, leasing the property for a period of more than three years or entering into a lease agreement for any period of time coupled with an option to buy, **triggers due-on enforcement**.

On discovery of these leasing arrangements by the trust deed lender, the lender may either:

- **call the loan**, demanding payment in full of all remaining unpaid sums, also known as *acceleration*; or
- **recast the loan**, requiring a modification of the terms of the loan and payment of fees as a condition for the lender's consent to the triggering event, called a *waiver*.

Economics of the due-on clause

In times of rising and sustained high interest rates, lenders seize on any event that legally triggers the due-on clause as an opportunity to increase the interest yield on their portfolio. Federal policy favors this interference with the home-selling population as justified to maintain lender solvency, in spite of a shift in the risk of loss to the property owner due to the increase in payments.

As a condition for a trust deed lender to waive his due-on enforcement and allow the owner to enter into lease agreements, the lender may require the loan to be recast at current interest rates, the owner to pay a fee, or both.

Real estate interests, be they the owner's fee simple or simply the tenant's leasehold estate, when encumbered by due-on trust deed become increasingly difficult to transfer to new owners and tenants when interest rates are rising. Lender interference is then virtually guaranteed in the relentless cyclical pursuit of lenders to increase their portfolio yield and remain solvent during prolonged periods of rising or higher interest rates.

The rising inability of owners to flexibly lease their properties and retain existing financing has an adverse economic effect on real estate sales, equity financing and long-term leasing. Ultimately, as rates and lender interference rise, many buyers, equity lenders and long-term tenants are driven out of the market. The result is an increase in depressed property values due to the reduced ability to sell, lease, assign a lease or encumber real estate interests.

Unless the existing lender's consent is obtained, the possibility of due-on enforcement and a call creates uncertainty for the landlord when leasing property for more than a three-year period. The uncertainties of a call rise as interest rates increase.

To best represent landlords and tenants, leasing agents must understand which events trigger the lender's *due-on clause*, which do not, and how to avoid or handle the lender's consent.

Due-on-leasing clauses

The **due-on clause**, better known as a due-on-sale clause, is triggered when the owner of property secured by a due-on trust deed enters into:

- a lease with a term over three years; or
- any lease with an option to purchase. [12 CFR §591.2(b)]

Consider an owner with a short-term interim construction loan on nonresidential rental property who obtains a conditional loan commitment from a lender for long-term, **take-out financing**. The refinancing will pay off the construction loan when the construction is completed, providing permanent financing for the owner.

Funding of the take-out loan is conditioned on the property being 80% occupied by tenants with initial lease terms of at least five years.

The owner locates tenants for 80% of the newly constructed property, all with lease terms of five years or more. The condition is met and the lender funds the loan. The loan, containing a due-on clause, is secured by a first trust deed on the property.

The five-year leases already entered into to qualify for the refinancing precede the refinancing. Thus, the leases do not trigger the due-on clause in the new lender's trust deed.

However, after recording the trust deed, the owner continues to lease space on his property for terms exceeding three years. None of the new leases are submitted to the lender for approval. Thus, no waiver of the due-on clause is obtained before entering into these leases.

After interest rates rise, an officer of the lender visits the property or requests a rent roll and discovers new tenants. The officer learns the new tenants have leases with terms of more than three years.

The lender soon sends the owner a letter informing him the lender is **calling the loan** since "It has recently come to our attention..." that the owner has entered into lease agreements with terms over three years without first obtaining the lender's consent, an **incurable violation** of the due-on clause in the trust deed.

The owner claims the lender cannot call the loan since the lender required medium-term leases as a condition for funding the loan. Thus, the lender is *estopped* from invoking the due-on clause when five-year leases are later entered into.

Can the lender call the loan due or demand a recast of its terms?

Yes! By requiring leases with terms exceeding three years are a condition for funding the loan, the lender did not waive his right to later call or recast the loan under its due-on clause when leases with a term exceeding three years are entered into after the trust deed is recorded.

The owner should have either obtained consent from the lender before leasing, leased the property for a three-year period with options to renew for three-year periods, or negotiated the elimination of the due-on clause from the trust deed when borrowing the funds.

Assignment or modification of the lease

An **assignment** or **modification** of an existing lease agreement does not trigger the due-on clause in a trust deed encumbering the owner's fee simple, unless the modification extends the term beyond three years from the date of modification or a purchase option is added.

For example, consider an owner of real estate who enters into a lease agreement with a tenant. Later, the owner takes out a loan secured by a trust deed containing a due-on clause.

After the trust deed is recorded, the tenant assigns the lease with the owner's approval, as provided for in the lease agreement.

Here, the lender's due-on clause is not triggered by the lease assignment. The lender's trust deed only encumbers the landlord's fee, subject to the outstanding lease. The trust deed does not encumber the leasehold interest owned by the tenant. Thus, the tenant's assignment of his unencumbered leasehold does not trigger the lender's due-on clause since the leasehold assignment was not a transfer of an interest in the fee which is the lender's security and the lease provided for the assignment.

However, consider a landlord who enters into a release of liability with the original tenant, releasing the tenant from all liability under the lease agreement as part of an assumption of the lease by a new tenant. A trust deed with a due-on clause encumbers the landlord's ownership interest, whether the trust deed is junior or senior to the lease.

Here, the release of the original tenant from the lease agreement coupled with an assumption of the lease agreement by the new tenant creates a *novation*. The novation legally cancels the original lease agreement and establishes a new lease agreement with the owner conveying an interest in the secured property to the new tenant on the same terms. [**Wells Fargo Bank, N.A.** v. **Bank of America NT & SA** (1995) 32 CA4th 424]

The concurrent *release* of the former tenant from liability and *assumption* of the lease agreement by the new tenant is a two step arrangement which constituting the present transfer by the owner of an interest in the encumbered real estate to the new tenant. If the lease assumed by the tenant on the release of the original tenant from liability has a remaining term of over three years or includes an option to purchase, the lender's due-on clause has been triggered and a call of the loan is allowed.

Negotiations and conduct as waiver

Under federal regulations, lenders have the power to dictate the fate of most long-term real estate leasing transactions since most real estate is encumbered by trust deeds containing due-on clauses.

However, an owner intending to lease his real estate and avoid lender interference should consider:

- eliminating the due-on clause from the trust deed or placing some limitation on its use by the lender when negotiation the origination of the loan; or
- negotiating a *waiver* of the lender's due-on rights when entering into a lease.

Waiver agreements are basically trade-offs. The lender will demand some consideration in return for waiving or agreeing to an elimination or limitation of its future due-on rights, such as increased points on origination, additional security, increased interest, a shorter due date or an assumption fee on each consent. [See **first tuesday** Form 410]

The lender's waiver of its due-on rights would apply only to the current lease transaction under review for consent. Unless additionally agreed, any later leasing of the property will again trigger the due-on clause, allowing the lender to call or recast the loan again, due in part to the nonwaiver provision in the trust deed.

Besides obtaining a written waiver agreement, waiver of the lender's due-on rights may occur **by conduct**. By failing to promptly enforce its due-on rights when the lender has knowledge of a leasing transaction, the lender may lose his right to later enforce the clause based on that lease.

For example, a landlord enters into a lease agreement with a term exceeding three years on property encumbered by a loan secured by a trust deed containing a due-on clause. The lender is informed of the leasing arrangements by letter or during an annual audit.

The lender then calls the loan under its due-on clause based on the lease transaction disclosed or delivered. However, the lender accepts payments from the owner for 12 months after the call, stating he is unilaterally reserving his due-on rights, the landlord agrees to nothing with the lender.

Here, the lender **by his conduct waived** the right to enforce his due-on clause. The lender **accepted payments** from the owner for an extended period of time after calling the loan, leaving but one payment to be made — the amount of the call. [**Rubin** v. **Los Angeles Federal Savings and Loan Association** (1984) 159 CA3d 292]

Broker liability for due-on avoidance

Again, a lender can call the loan only when it **discovers a lease agreement** of more than three years in duration or a lease with an option to buy.

If the tenant's option to purchase is not recorded and the lease agreement is for a term under three years, the lender might not discover any transfer of an interest in the real estate has taken place that triggered its due-on clause.

However, if the lender later discovers the lease with its option to purchase, the lender's only remedy against the owner or the tenant is to call the loan due, or agree to recast the loan as a condition for retroactively waiving its right to call. The lender cannot recover any retroactive interest differential (RID) from the owner or tenant for a higher rate they would have charged for the period beginning on commencement of the lease, the triggering event, until paid. Also, if he lender calls the loan, it cannot add

additional back interest (RID) to the loan payoff amount. [**Hummell** v. **Republic Fed. Savings and Loan Assn.** (1982) 133 CA3d 49]

However, an advisor, such as a leasing agent or attorney, assisting the owner or tenant to hide the lease and option to purchase from the lender for the **primary purpose** of avoiding due-on enforcement, may have wrongfully interfered with the lender's legal right to call or recast the loan. Thus, the advisor may be held liable for the lender's losses, called tortious interference with *prospective economic advantage*.

The advisor's liability is dependent upon the extent to which the advisor's actions were intended to conceal the lease agreement and prevent a call by the lender, and with the foresight that the lender would likely incur losses due to the concealment. [**J'Aire Corporation** v. **Gregory** (1979) 24 C3d 799]

The **lender's losses** caused by the advisor's wrongful interference are calculated based on the interest differential between the note rate and the market rate at the time the lease commenced, retroactive to the date of the commencement. Hence, the title of interest rate differential (RID).

Chapter 62 Gaining possession after foreclosure

This chapter presents the notices to vacate served on occupants whose possessory interest in the property has been eliminated by a foreclosure.

Notice required to remove occupants

A residential income property is encumbered by a recorded trust deed. Tenants occupy the property under rental and lease agreements entered into after the trust deed was recorded.

Payments on the trust deed note are delinquent, causing the lender to initiate a trustee's foreclosure.

Prior to the foreclosure sale, the lender employs a broker (or appraiser) to inspect the physical condition of the improvements and determine the property's fair market value for immediate resale.

Based on the broker's inspection and market review, he advises the lender to:

- complete the foreclosure proceedings;
- evict all tenants;
- renovate the property;
- relet the property to creditworthy tenants at market rates; and
- sell the property.

The lender acquires the property at the trustee's sale.

To meet the resale objectives recommended by the broker, the lender, now classified as an *owner-by-foreclosure*, wants the tenants to immediately vacate the property. The property now owned by the lender is referred to as real estate owned, or *REO property*.

The broker has each tenant served with a 30-day notice to quit due to foreclosure. [See Form 573 accompanying this chapter]

Have the tenants been properly notified and thus required to vacate the premises?

Yes! The **residential tenants** whose unexpired month-to-month rental or lease agreements were junior (in time) to the recording of the trust deed, and thus *eliminated* by the foreclosure sale, are entitled to 30 days written notice to vacate. [Calif. Code of Civil Procedure §1161a(c)]

After the expiration of the 30-day notice to vacate, a residential tenant under a month-to-month rental or lease agreement who does not vacate the foreclosed property, may be evicted by the owner-by-foreclosure in an unlawful detainer (UD) action. This general rule does not apply to rent controlled or section 8 properties.

Evicting occupants after foreclosure

A rental or lease agreement entered into after a trust deed is recorded is wiped out on completion of a foreclosure sale on the trust deed.

If a prior owner or occupant under a junior rental or lease agreement remains in possession after a foreclosure sale, the new owner-by-foreclosure can serve the appropriate notice to **quit due to foreclosure** and remove the occupants, **residential or nonresidential**, in a UD eviction action.

An *owner-by-foreclosure* is defined as a buyer of real estate which is sold at:

- a sheriff's sale on a judgment lien;
- a judicial foreclosure sale; or
- a trustee's foreclosure sale. [CCP §1161a(b)]

An owner-by-foreclosure can evict all occupants remaining in possession of the foreclosed property under a wiped-out lease or month-to-month rental agreement. However, tenants living in Section 8 housing or rent control communities are protected from unqualified termination of their occupancy after a foreclosure sale.

The appropriate period of notice to vacate due to foreclosure depends on whether:

- the property is *residential or nonresidential*; and
- the occupants are *former tenants or former owners*.

Length of notice to be given

After a foreclosure sale on a senior trust deed, a **residential tenant** is entitled to a written notice to quit for a period of no less than his prior tenancy, but no greater than 30 days. Thus, a 30-day notice will always suffice. [CCP §1161a(c)]

For example, if the foreclosed property is a residential hotel where units are let on a weekly basis, the owner-by-foreclosure is required to give each tenant no less than one week's written notice to vacate the property.

Residential tenants under wiped-out month-to-month rental or lease agreements are entitled to no less than 30s' days notice.

Unlike a residential tenant, a **nonresidential tenant** whose junior lease is wiped-out by a foreclosure is entitled to only a 3-day written notice to quit, regardless of whether the tenant paid rent monthly, quarterly or annually. [CCP §1161a(b)(3)]

A **former owner** who remains as an occupant is entitled to only a 3-day notice to quit, whether the property is residential or nonresidential. [CCP §1161a(b)(4)]

Thus, to remove a nonresidential tenant or the former owner of a residential or a nonresidential property, the owner-by-foreclosure serves them with a 3-day notice to **quit due to foreclosure**. On expiration of the three days after service of the notice and the failure of the prior owner or the tenant to vacate, a UD has been established and they can be evicted by court order. [See **first tuesday** Form 578]

Service of notice

A notice to quit due to foreclosure must be served in the same manner as a 3-day notice to pay rent or quit. [CCP §1161a(b); see Chapter 26]

An attempt at *personal service* on the occupant must first be made at both the occupant's residence and place of business, if known. [CCP §1162(1)]

30-DAY NOTICE TO QUIT DUE TO FORECLOSURE

To Holdover Residential Tenant

DATE:_____, 20_____, at _____, California.

To Former Residential Tenant: _____

NOTICE:
A holdover residential tenant must vacate and deliver possession to an owner-by-foreclosure or his agent within thirty (30) days after service of written notice to the tenant. [Calif. Code of Civil Procedure §1161a(c)]

Items left blank or unchecked are not applicable.

FACTS:

You were a residential Tenant under a rental or lease agreement

dated _____, at _____, California,

entered into by _____, Tenant,

and _____, Landlord,

regarding real estate referred to as: _____

_____

NOTICE:

1. On _____, 20_____, the real estate you occupy was sold at a foreclosure sale which extinguished your interest in the property.
2. Within thirty (30) days after service of this notice, you are required to vacate and deliver possession of the premises to the new owner-by-foreclosure or: _____

   _____
3. If you fail to vacate and deliver possession within thirty (30) days, legal proceedings will be initiated to regain possession of the premises, and to recover money damages for wrongful possession and costs.

Owner-by-forclosure:

Date:_____, 20_____

Name: _____

Signature: _____

Address: _____

_____

Phone:_____

Fax: _____

E-mail: _____

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If the occupant cannot be located for personal service, the server may leave the notice with a person of suitable age and discretion at the occupant's residence or business address, and mail the notice to the occupant's residence, called *substituted service*. [CCP §1162(2)]

Finally, if no person of suitable age or discretion is available at either the occupant's residence or place of business, the server may post the notice on the leased premises and mail a copy to the premises, called service by *nail and mail*. [CCP §1162(3)]

The day after the notice is served is day one of the period during which the occupant must vacate. [Calif. Civil Code §10]

UD award of rental value

In an unlawful detainer (UD) action, an owner-by-foreclosure is entitled to recover rent from the occupant in an amount equal to the *reasonable rental value* of the property for the period that the occupant resides on the property after the foreclosure sale. [CCP §1174(b)]

The secured lender who acquires the premises at the foreclosure sale cannot collect unpaid pre-foreclosure rents in the UD action.

However, any rents which were due and unpaid by a tenant before the foreclosure sale belong to the lender under an *assignment of rents provision* in the lender's trust deed. These unpaid rents are collectable in a separate action unrelated to the UD action, called specific performance of the assignment of rents provision.

Since a landlord/tenant relationship does not exist between an owner-by-foreclosure and an occupant, a tenancy does not exist, unless the owner-by-foreclosure and occupant agree that money paid prior to foreclosure is **advance rent** for continued or future occupancy.

A matter of priority

When a tenant takes possession and records his lease agreement after a trust deed, abstract of judgment or tax lien is recorded, the tenant's leasehold interest in real estate is junior to these liens. Thus, pre-existing liens have priority and are called *senior encumbrances*.

All junior liens and junior possessory interests of the owners and tenants in the real estate are *extinguished* when a lienholder under a senior trust deed, abstract of judgment or tax lien forecloses on the real estate. [**Hohn** v. **Riverside County Flood Control and Water Conservation District** (1964) 228 CA2d 605]

On proper notice, the tenant under the wiped-out lease can be evicted. Thus, a junior lease held by a tenant is unenforceable against an owner-by-foreclosure, unless the owner-by-foreclosure makes an **attornment election** to enforce the lease. [See Chapter 59]

A tenant's leasehold interest with priority to a lien on the owner's fee title is not eliminated by the foreclosure of that junior lien.

The owner-by-foreclosure who acquires title at the foreclosure sale of a junior lien takes title **subject to** the rental or lease agreement and must perform the landlord's obligations under the agreement.

On occasion, a lender may elect to alter priorities (before a foreclosure sale) under a **lender subordination clause** in the lease agreement to preserve the terms of the lease if they are advantageous. On subordination, a junior nonresidential **lease is given priority** over the lender's previously recorded trust deed lien. [See Chapter 59]

Priority is rarely an issue for leases of residential property since **residential leases**:

- are typically entered into for periods not exceeding one year; and
- those existing at the time a lender records his trust deed will have likely expired prior to completing a foreclosure.

No tenancy for wiped-out occupants

An occupant of property whose leasehold or ownership interest has been eliminated by foreclosure has no right to possession and is not a tenant.

Any landlord/tenant relationship under the rental agreement or lease which was junior to the foreclosing lienholder is wiped out at the foreclosure sale.

No tenancy in real estate is recognized for occupants who lost their possessory interest due to a foreclosure.

The wiped-out occupant, whether he is a prior owner or held a tenancy interest in the property, is not a holdover tenant, and thus is not a tenant-at-sufferance.

Also, the occupant is not a tenant-at-will since he did not occupy the property with the owner-by-foreclosure's consent.

Even though no landlord/tenant relationship exists, an owner-by-foreclosure is permitted to remove occupants from the foreclosed property by evicting them in an unlawful detainer (UD) action. [CCP §1161a(b)]

However, a buyer at an foreclosure sale does not qualify as an owner-by-foreclosure for a UD eviction of a prior occupant when the property is purchased at:

- a federal or state tax lien sale;
- a property tax lien sale; or
- a Mello-Roos sale or sale under other improvement bonds or government agency assessments.

Purchasers of property at tax sales or improvement bond sales which are occupied:

- are not permitted to remove occupants by filing a UD action; and
- are limited to filing an *ejectment action* against the occupant to recover possession of the premises.

While an **action in ejectment** and a UD action are alternative remedies for recovering possession from occupants, the UD action is faster and less expensive, and thus more desirable for the owner-by-foreclosure.

UD action as a remedy, not a right

When residential income property subject to local rent control ordinances or a Section 8 contract is acquired by an owner-by-foreclosure, the owner-by-foreclosure must comply with the ordinances and Section 8 rules.

Consider a trust deed lender who forecloses on residential rental units by a trustee's sale and acquires the property at the foreclosure sale. The lender wants to remove the occupants who are former tenants under wiped out rental or lease agreements. The lender intends to renovate the property and resell it.

The lender, now the owner-by-foreclosure, serves each tenant with a statutory 30-day notice to quit due to foreclosure. However, the property is located in a rent control community.

The occupants claim they cannot be evicted by the lender since the rent control ordinance does not permit eviction on a change of ownership. The rent control ordinances limit the circumstances which are cause

for a tenant to be evicted. Change of ownership for any reason is not a permitted basis for eviction for a tenant protected by rent control.

The lender claims the tenants can be evicted due to foreclosure since the local ordinance is *preempted* by state law allowing a tenant to be evicted after a foreclosure sale.

Can the tenants be evicted by the lender since the lender is an owner-by-foreclosure?

No! Residential tenants protected under rent control ordinances cannot be evicted after a foreclosure, except as permitted by local ordinances. The 30-day notice requirement for evicting a residential tenant after a foreclosure sale in a UD action does not preempt the local rent control ordinance.

The UD notice-and-eviction process merely provides a legal *remedy* for a lender who has *grounds* to recover possession from the tenants, in lieu of using self-help to remove tenants. Under rent control, it is the ordinance which establishes the **grounds for the eviction** of a tenant. [**Gross** v. **Superior Court** (1985) 171 CA3d 265]

Appendix A

The following represents sections of the Commissioner's Ethics and Professional Conduct Code and the Fair Employment and Housing Acts prohibiting discrimination in housing and real estate brokerage.

DRE — Anti-discrimination statutes

DRE Regulation 2780
Discriminatory Conduct as the Basis for Disciplinary Action

Prohibited discriminatory conduct by a real estate licensee based upon race, color, sex, religion, ancestry, physical handicap, marital status or national origin includes, but is not limited to, the following:

(a) Refusing to neotiate for the sale, rental or financing of the purchase of real property or otherwise making unavailable or denying real property to any person because of such person's race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

(b) Refusing or failing to show, rent, sell or finance the purchase of real property to any person or refusing or failing to provide or volunteer information to any person about real property, or channeling or steering any person away from real property, because of that person's race, color, sex, religion, ancestry, physical handicap, marital status or national origin or because of the racial, religious, or ethnic composition of any occupants of the area in which the real property is located.

(c) Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin against any person in the sale or purchase or negotiation or solicitation of the sale or purchase or the collection of payment or the performance of services in connection with contracts for the sale of real property or in connection with loans secured directly or collaterally by liens on real property or on a business opportunity.

(d) Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin against any person in the terms, conditions or privileges of sale, rental or financing of the purchase of real property.

(e) Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin against any person in providing services or facilities in connection with the sale, rental or financing of the purchase of real property, including but not limited to: processing applications differently, referring prospects to other licensees because of the prospects' race, color, sex, religion, ancestry, physical handicap, marital status or national origin, using with discriminatory intent or effect, codes or other means of identifying minority prospects, or assigning real estate licensees on the basis of a prospective client's race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

(f) Representing to any person because of his or her race, color, sex, religion, ancestry, physical handicap, marital status or national origin that real property is not available for inspection, sale or rental when such real property is in fact available.

(g) Processing an application more slowly or otherwise acting to delay, hinder or avoid the sale, rental or financing of the purchase of real property on account of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of a potential owner or occupant.

(h) Making any effort to encourage discrimination against persons because of their race, color, sex, religion, ancestry, physical handicap, marital status or national origin in the showing, sale, lease or financing of the purchase of real property.

(i) Refusing or failing to cooperate with or refusing or failing to assist another real estate licensee in negotiating the sale, rental or financing of the purchase of real property because of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of any prospective purchaser or tenant.

(j) Making any effort to obstruct, retard or discourage the purchase, lease or financing of the purchase of real property by persons whose race, color, sex, religion, ancestry, physical handicap, marital status or national origin differs from that of the majority of persons presently residing in a structural improvement to real property or in an area in which the real property is located.

(k) Performing any acts, making any notation, asking any questions or making or circulating any written or oral statement which when taken in context, expresses or implies a limitation, preference or discrimination based upon race, color, sex, religion, ancestry, physical handicap, marital status or national origin; provided, however, that nothing herein shall limit the administering of forms or the making of a notation required by a federal, state or local agency for data collection or civil rights enforcement purposes; or in the case of a physically handicapped person, making notation, asking questions or circulating any written or oral statement in order to serve the needs of such a person.

(l) Making any effort to coerce, intimidate, threaten or interfere with any person in the exercise or enjoyment of, or on account of, such person's having exercised or enjoyed, or on account of such person's having aided or encouraged any other person in the exercise or enjoyment of any right granted or protected by a federal or state law, including but not limited to: assisting in any effort to coerce any person because of his or her race, color, sex, religion, ancestry, physical handicap, marital status or national origin to move from, or to not move into, a particular area; punishing or penalizing real estate licensees for their refusal to discriminate in the sale or rental of housing because of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of a prospective purchaser or lessee; or evicting or taking other retaliatory action against any person for having filed a fair housing complaint or for having undertaken other lawful efforts to promote fair housing.

(m) Soliciting of sales, rentals or listings of real estate from any person, but not from another person within the same area because of differences in the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of such persons.

(n) Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin in informing persons of the existence of waiting lists or other procedures with respect to the future availability of real property for purchase or lease.

(o) Making any effort to discourage or prevent the rental, sale or financing of the purchase of real property because of the presence or absence of occupants of a particular race, color, sex, religion, ancestry, physical handicap, marital status or national origin, or on the basis of the future presence

or absence of a particular race, color, sex, religion, ancestry, physical handicap, marital status or national origin, whether actual, alleged or implied.

(p) Making any effort to discourage or prevent any person from renting, purchasing or financing the purchase of real property through any representations of actual or alleged community opposition based upon race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

(q) Providing information or advice to any person concerning the desirability of particular real property or a particular residential area(s) which is different from information or advice given to any other person with respect to the same property or area because of differences in the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of such persons.

(r) Refusing to accept a rental or sales listing or application for financing of the purchase of real property because of the owner's race, color, sex, religion, ancestry, physical handicap, marital status or national origin or because of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of any of the occupants in the area in which the real property is located.

(s) Entering into an agreement, or carrying out any instructions of another, explicit or understood, not to show, lease, sell or finance the purchase of real property because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

(t) Making, printing or publishing, or causing to be made, printed or published, any notice, statement or advertisement concerning the sale, rental or financing of the purchase of real property that indicates any preference, limitation or discrimination because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin, or any intention to make such preference, limitation or discrimination.

(u) Using any word, phrases, sentences, descriptions or visual aids in any notice, statement or advertisement describing real property or the area in which real property is located which indicates any preference, limitation or discrimination because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

(v) Selectively using, placing or designing any notice, statement or advertisement having to do with the sale, rental or financing of the purchase of real property in such a manner as to cause or increase discrimination by restricting or enhancing the exposure or appeal to persons of a particular race, color, sex, ancestry, physical handicap, marital status or national origin. This subdivision does not limit in any way the use of an affirmative marketing program designed to attract persons of a particular race, color, sex, religion, ancestry, physical handicap, marital status or national origin who would not otherwise be attracted to the real property or to the area.

(w) Quoting or charging a price, rent or cleaning or security deposit for a particular real property to any person which is different from the price, rent or security deposit quoted or charged to any other person because of differences in the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of such persons.

(x) Discriminating against any person because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin in performing any acts in connection with the making of any determination of financial ability or in the processing of any application for the financing or refinancing of real property.

(y) Advising a person of the price or value of real property on the basis of factors related to the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of residents of an area or of residents or potential residents of the area in which the property is located.

(z) Discriminating in the treatment of, or services provided to, occupants of any real property in the course of providing management services for the real property because of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of said occupants.

(aa) Discriminating against the owners or occupants of real property because of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of their guests, visitors or invitees.

(bb) Making any effort to instruct or encourage, expressly or impliedly, by either words or acts, licensees or their employees or other agents to engage in any discriminatory act in violation of a federal or state fair housing law.

(cc) Establishing or implementing rules that have the effect of limiting the opportunity for any person because of his or her race, color, sex, religion, ancestry, physical handicap, marital status or national origin to secure real property through a multiple listing or other real estate service.

(aa) Assisting or aiding in any way, any person in the sale, rental or financing of the purchase of real property where there are reasonable grounds to believe that such person intends to discriminate because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

Calif. Business and Professions Code §125.6
Refusal to perform licensed activity

Every person who holds a license under the provisions of this code is subject to disciplinary action under the disciplinary provisions of this code applicable to such person if, because of the applicant's race, color, sex, religion, ancestry, disability, marital status, or national origin, he or she refuses to perform the licensed activity or aids or incites the refusal to perform such licensed activity by another licensee, or if, because of the applicant's race, color, sex, religion, ancestry, disability, marital status, or national origin, he or she makes any discrimination, or restriction in the performance of the licensed activity.

Nothing in this section requires a person licensed pursuant to Division 2 (commencing with Section 500) to permit an individual to participate in, or benefit from, the licensed activity of the licensee where that individual poses a direct threat to the health or safety of others. For this purpose, the term "direct threat" means a significant risk to the health or safety of others that cannot be eliminated by a modification of policies, practices, or procedures or by the provision of auxiliary aids and services.

"Disability" means any of the following with respect to an individual:

(a) A physical or mental impairment that substantially limits one or more of the major life activities of the individual.

(b) A record of such an impairment.

(c) Being regarded as having such an impairment.

Calif. Business and Professions Code §10177
Grounds for suspension or revocation of a real estate license

The commissioner may suspend or revoke the license of any real estate licensee, or may deny the issuance of a license to an applicant, who has done any of the following:

(1) Solicited or induced the sale, lease or the listing for sale or lease, of residential property on the ground, wholly or in part, of loss of value, increase in crime, or decline of the quality of the schools, due to the present or prospective entry into the neighborhood of a person or persons of another race, color, religion, ancestry or national origin.

Calif. Civil Code §51
Unruh Civil Rights Act

All persons within the jurisdiction of this state are free and equal, and no matter what their sex, race, color, religion, ancestry, national origin, or disability are entitled to the full and equal accommodations, advantages, facilities, privileges, or services in all business establishments of every kind whatsoever.

A violation of the right of any individual under the Americans with Disabilities Act of 1990 (Public Law 101-336) shall also constitute a violation of this section.

Calif. Civil Code §54.1
Unlawful discrimination due to physical disability

(b)(1) Individuals with disabilities shall be entitled to full and equal access, as other members of the general public, to all housing accommodations offer for rent, lease, or compensation in this state subject to the conditions and limitations established by law, or state or federal regulation, and applicable alike to all persons.

(6)(A) It shall be deemed a denial of equal access to housing accommodations within the meaning of this subdivision for any person, firm, or corporation to refuse to lease or rent housing accommodations to an individual who is blind or visually impaired on the basis that the individual uses the services of a guide dog, an individual who is deaf or hearing impaired on the basis that the individual uses the services of a signal dog, or to an individual with any other disability on the basis that the individual uses the services of a service dog, or to refuse to permit such an individual who is blind or visually impaired to keep a guide dog, an individual who is deaf or hearing impaired to keep a signal dog, or an individual with any other disability to keep a service dog on the premises.

Calif. Government Code §12940
Unlawful employment practices

It shall be an unlawful employment practice, unless based upon a bona fide occupational qualification, or, except where based upon applicable security regulations established by the United States or the State of California:

(g) For an employer, because of the race, religious creed, color, national origin, ancestry, physical handicap, medical condition, marital status, or sex of any person, to refuse to hire or employ the person or to refuse to select the person for a training program leading to employment, or to bar or to discharge the person from employment or from a training program leading to employment,

or to discriminate against the person in compensation or in terms, conditions or privileges of employment.

(c) For any person to discriminate against any person in the selection or training of that person in any apprenticeship training program or any other training program leading to employment because of the race, religious creed, color, national origin, ancestry, physical handicap, medical condition, marital status, or sex of the person discriminated against.

(d) For any employer or employment agency, unless specifically acting in accordance with federal equal employment opportunity guidelines and regulations approved by the commission, to print or circulate or cause to be printed or circulated any publication, or to make any non-job-related inquiry, either verbal or through use of an application form, which expresses, directly or indirectly, any limitation, specification, or discrimination as to race, religious creed, color, national origin, ancestry, physical handicap, medical condition, marital status, or sex, or any intent to make that limitation, specification or discrimination.

(f) For any employer, labor organization, employment agency, or person to discharge, expel, or otherwise discriminate against any person because the person has opposed any practices forbidden under this part or because the person has filed a complaint, testified, or assisted in any proceeding under this part.

(h) For an employer, labor organization, employment agency, apprenticeship training program or any training program leading to employment, or any other person, because of race, religious creed, color, national origin, ancestry, physical handicap, medical condition, marital status, sex, or age, to harass an employee or applicant.

Calif. Government Code §12941

(i) It is an unlawful employment practice for an employer to refuse to hire or employ, or to discharge, dismiss, reduce, suspend, or demote, any individual over the age of 40 on the ground of age, except in cases where the law compels or provides for such action.

Calif. Government Code §12955
Housing discrimination

It shall be unlawful:

(j) For the owner of any housing accommodation to discriminate against any person because of the race, color, religion, sex, marital status, national origin, or ancestry of such person.

(k) For the owner of any housing accommodation to make or to cause to be made any written or oral inquiry concerning the race, color, religion, sex, marital status, national origin, or ancestry of any person seeking to purchase, rent or lease any housing accommodation.

(f) For any owner of housing accommodations to harass, evict, or otherwise discriminate against any person in the sale or rental of housing accommodations when the owner's dominant purpose is retaliation against a person who has opposed practices unlawful under this section, informed law enforcement agencies of practices believed unlawful under this section, or has testified or assisted in any proceeding under this part.

(l) To discriminate through public or private land use practices, decisions, and authorizations because of race, color, religion, sex, familial status, marital status, disability, national origin, or ancestry.

Discrimination includes, but is not limited to, restrictive covenants, zoning laws, denials of use permits, and other actions authorized under the Planning and Zoning Law (Title 7 (commencing with Section 65000)), that make housing opportunities unavailable.

Calif. Health and Safety Code §35810
Unlawful discrimination by lenders

(m) No financial institution shall discriminate in the availability of, or in the provision of, financial assistance for the purpose of purchasing, constructing, rehabilitating, improving, or refinancing housing accommodations due, in whole or in part, to the consideration of conditions, characteristics, or trends in the neighborhood or geographic area surrounding the housing accommodation, unless the financial institution can demonstrate that consideration of these conditions in the particular case is required to avoid an unsafe and unsound business practice.

(n) Nothing in this section shall be construed to prohibit any financial institution from establishing a special loan program designed to engender equality in housing in accordance with the federal Fair Housing Act (42 U.S.C. Secs. 3601 et seq.) or similar state and federal laws, so long as the program promotes housing opportunities in ethnic minority or low-income neighborhoods.

Calif. Health and Safety Code §35811

No financial institution shall discriminate in the availability of, or in the provision of, financial assistance for the purpose of purchasing, constructing, rehabilitating, improving or refinancing housing accommodations due, in whole or in part, to the consideration of race, color, religion, sex, marital status, national origin, or ancestry.

Calif. Health and Safety Code §35812

No financial institution shall consider the racial, ethnic, religious, or national origin composition of a neighborhood or geographic area surrounding a housing accommodation or whether or not such composition is undergoing change, or is expected to undergo change, in appraising a housing accommodation or in determining whether or not, and under what terms and conditions, to provide financial assistance for the purpose of purchasing, constructing, rehabilitating, improving, or refinancing a housing accommodation. No financial institution shall utilize appraisal practices that are inconsistent with the provisions of this part.

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Forming Real Estate Syndicates

Second Edition

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Table of Contents

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Table of Forms 5
Introduction. 6

Section A

Organization

Chapter 1 — A chronology for syndication
Guidelines for forming a group 7

Section B

Property Selection

Chapter 2 — Selection and acquisition of property
The benefits of group investments 9

Chapter 3 — The economics of income property
Advantage in high-value property 18

Section C

Competent Management

Chapter 4 — The reduction of investment risks
First, be a capable syndicator 22

Chapter 5 — The syndicator's professional services
Licensing as a legitimizing force 36

Chapter 6 — Conflict of interest
Professional relationships compromised 39

Chapter 7 — Retaining a real estate attorney
Choosing the right one. 46

Chapter 8 — Selecting suitable investors
Profiling for investment longevity 51

Section D

Sharing Earnings

Chapter 9 — The distribution of income
Contributions set share of ownership 56

Chapter 10 — Sharing through services and capital contributions
The tradeoff in priority distributions 58

Section E

Taxation

Chapter 11 — The tax treatment of a syndicator's earnings
Property rights, services or both 67

Chapter 12 — Tax benefits for co-owners
Capital recovery, operating income, losses 73

Chapter 13 Tenants in common or tax partners
§1031 fractional ownerships 77

Section F

Securities Risks

Chapter 14 Securities aspects of syndication
Economic risks of real estate excluded 95

Chapter 15 Trust deed investment for groups
Fractionalizing a trust deed 104

Section G

The LLC

Chapter 16 An overview of the LLC
The LLC vs. a limited partnership 119

Chapter 17 Liens against individuals
Vesting to shield assets from others 133

Chapter 18 LLC membership buy outs
Assigning or terminating a member's interest 138

Chapter 19 Documenting the LLC investment program
Birth and expectations of an LLC 147

Section H

Marketing

Chapter 20 A checklist for an investment circular
An agency duty to disclose 152

Section I

Investment Circular

Chapter 21 The investment circular
Sample of a typical investment circular 159

Table of Forms

No.	Form Name	Page
159	Purchase Agreement — Income Property other than One-to-Four Residential Units	174
235-1	Lender/Purchase Disclosure Statement (DRE Form RE851A)	111
311	Good Faith Estimate of Buyer's Acquisition Costs	183
314	Natural Hazard Disclosure Statement	187
350	Client Profile	52
352	Annual Property Operating Data Sheet	189
352-1	Rental Income Rent Roll	191
370	Supplemental Assignment Instructions	11
371	Investment Circular	159
372	Operating Agreement	199
373	Subscription and Agreement to Invest	208
374	Amendment to Operating Agreement	142
375	Assignment of Interest	144
376	Buyer's Syndication Addendum	13
401	Escrow Instructions	178
545	Multi-Lender Transaction Notice (DRE Form RE860)	107
590	Property Management Agreement	193
State Forms		
LLC-1	Articles of Organization	121
LLC-12	Statement of Information	127
LLC-4/8	Short Form Certificate of Cancellation	129

Introduction

Forming Real Estate Syndicates is part of the **first tuesday** series of California-specific real estate study materials. Each title in the series of advanced study has a different topic as its primary content. As part of a comprehensive real estate education program, the series includes Real Estate Matters; Landlords, Tenants and Property Management; Tax Benefits of Ownership; The §1031 Reinvestment Plan; Creating Carryback Financing; Buying Homes in Foreclosure; and Due Diligence and Disclosures.

first tuesday's real estate series uses plain language and eliminates the extensive overlap of identical course material commonly offered by other publishers.

Forming Real Estate Syndicates is written for real estate licensees, attorneys and investors. This course material is designed to be an educational tool for use in the classroom and as a technical research and reference tool on group investments in California.

The objective of this material is to fully provide the real estate professional, acting as a syndicator, with the knowledge needed to use the limited liability company (LLC) entity in group investment programs. **Forming Real Estate Syndicates** also discusses syndication activities and their chronology, the laws governing LLCs, the use of investment circulars to solicit investors, and LLC operating agreements for management of the investment group. Also analyzed in this material are investment activities that present a risk of loss controlled by securities law and tenant-in-common co-ownerships.

Included, with an explanation for their use, are all the forms and notices required when bringing investors together for real estate syndication. Forms are treated as itemized checklists of disclosures by an agent and reviewed with buyers and sellers of real estate.

These forms fully reflect relevant codes, judicial decisions and practices in effect on the date of this publication. The forms referenced are developed and published by **first tuesday**. Unless a form cited in the book says, "See Form 150 *accompanying this chapter"* [emphasis added], it is not in the book. However, you can view the form on the Forms-on-CD, which contains the book, or online on the **first tuesday** Forms Download page.

Monthly updates of this text, including errata and recent developments, are available on your Student Homepage at *firsttuesday.us*.

Chapter 1 A chronology for syndication

This chapter sets out a chronological list of the steps taken to select and acquire property for a group investment program to be formed and operated as a limited liability company (LLC).

Guidelines for forming a group

A real estate broker who gathers investors into a group for the purpose of jointly buying, operating and ultimately selling an income-producing property is involved in a process known as *syndication* or *syndicate brokerage*. The broker who arranges the acquisition of property and organizes the group is known as a *syndicator* or *manager*.

Unlike sophisticated real estate investors who tend to operate alone, individuals who join together in syndication programs are generally uninformed and inexperienced about:

- the legal aspects and accounting of co-ownership;
- the economic factors that influence the movement of real estate rents and values;
- the responsibilities of property management; and
- the compensation a syndicator or manager is entitled to receive.

However, the broker acting as a syndicator undertakes the agency duty of fully informing each individual prospective investor of all aspects of the property and the investment program that might influence a prudent investor's decision to contribute funds.

A chronological list of activities the syndicator should review and consider adopting when forming a limited liability company (LLC) for the acquisition and ownership of an income-producing property includes:

1. Researching available residential or nonresidential rental properties and selecting one to be investigated and confirmed as suitable to purchase. (Non-income-producing property acquired by an LLC will require modification of the documents in this material.) [See **first tuesday** Form 185 or 279]

2. Analyzing the property selected, including its physical condition, the economic risks, environmental and natural hazards of the property's location, personal security, title conditions and property operating data. [See **first tuesday** Forms 304, 314, 321, 324, and 352]

3. Contracting to purchase the property in the name of the syndicator under a purchase agreement, an option to purchase or escrow instructions with a vesting provision allowing the syndicator to assign his right to purchase the selected property to the LLC. [See **first tuesday** Forms 161, 161-1, 401, and 159 §§10.6 and 13.3]

4. Opening escrow in the name of the syndicator, not the LLC, as the buyer. Prior to closing and after the LLC has been formed, the syndicator will assign his right to buy the property to the LLC. [See **first tuesday** Form 401]

5. Completing a due diligence analysis and confirming the seller's disclosures regarding the condition of the property's improvements, operations, location and title.

6. Applying for new financing or an assumption of the existing financing as called for in the purchase agreement.

7. Reviewing plans for the formation and management of an LLC entity with competent legal and accounting advisors.

8. Preparing the investment circular, subscription agreement, LLC-1 (Articles of Organization) and LLC operating agreement, along with their exhibits and addenda, naming the syndicator as manager of the LLC. [See **first tuesday** Forms 371, 371-1, 372, and 372-1]

9. Delivering copies of the investment circular to prospective investors to solicit them to become members and fund the LLC so escrow can close and the property be acquired.

10. Obtaining the signature of each investor on a separate subscription agreement and the signature page of the LLC operating agreement, and delivering their funds to the syndicator or escrow. [See **first tuesday** Form 373]

11. Entering into a property management agreement to employ the syndicator to manage the day-to-day operations of the property. This agreement must be signed by each investor who became a member of the LLC. [See **first tuesday** Form 590]

12. Arranging mortgage financing and signing loan documents for an assumption of an existing loan(s) or the origination of a purchase-assist loan, either in the name of the syndicator or on behalf of the LLC, as demanded by the lender.

13. Filing the LLC-1 (Articles of Organization), prepared and signed by the syndicator, with the California Secretary of State.

14. Assigning the syndicator's right to purchase the property to the LLC in an amendment to the escrow instructions, vesting title to the property in the name of the LLC on closing. [See **first tuesday** Form 370 or 401-2]

15. Funding the purchase price and closing costs from cash contributions received from the members of the LLC and mortgage financing.

16. Closing escrow and taking possession of the property.

17. Sending copies of all closing documents to each member.

18. Filing an LLC-12 with the Secretary of State within 90 days after filing the LLC-1 and biennially thereafter, and identifying the name and address of the manager as the agent for service.

19. Operating the property on behalf of the LLC during the LLC's ownership of the property and distributing earnings to the members.

20. Reselling the property when ownership of the property no longer meets the objectives of the investment group or when the initial goal was to sell or exchange the property after a period of time. The manager will negotiate the sale and the net proceeds will be distributed to the members on closing.

Chapter 2 Selection and acquisition of property

This chapter outlines the contractual provisions involved in an agreement to purchase real estate for syndication.

The benefits of group investments

For syndication purposes, real estate can be broken down into five basic categories:

- existing residential and nonresidential income-producing properties, called *rental property*;
- yet-to-be-built *construction* and subdivision projects;
- *pre-builder land*;
- *agricultural* land; and
- remote, generally *unusable land*.

This discussion presumes a limited liability company (LLC) will be formed to acquire an existing income-producing property, the category of property most prudent for real estate investment groups to own.

The benefits derived from the co-ownership of *existing rental property* include:

- an initial capital investment without the expectation of future additional contributions;
- minimal involvement by the investor;
- spendable income distributed periodically;
- equity buildup due to amortization of the loan amount through monthly payments paid from rental income;
- an increase in value resulting from monetary inflation and asset appreciation; and
- tax benefits provided by depreciation deductions and reinvestment on a sale of the property.

The other four categories of real estate investment properties do not offer all of these advantages.

Group investments in **construction projects** and **agricultural** or **business opportunities** contain additional inherent risks of loss classified as *corporate securities risks*. These "quasi-real estate" investment programs require the expertise of the manager in an ongoing business-related service or trade. The manager, or others, promise to **create value** for the co-owners after acquisition of the property through development, improvements or husbandry and sale of crops before a return on or of the investment can be expected.

However, the co-ownership and operation of **existing rental properties** does not contain corporate securities risks. The investors in a rental property receive an ownership interest in land and existing improvements. The asset they acquired as a group provides them with *full present value* for their contributions at the time of closing — the moment their funds are first placed at risk of loss.

Further, rental property acquired with a downpayment sufficient in size to give rise to spendable income can be held without the foreseeable need of additional capital contributions. The risk that co-investors might default on periodic advances needed to maintain ownership is eliminated by buying a "net cash flow" property.

Yet-to-be-built construction projects expose the investors' contributions to all the risks inherent in a real estate development. The need to complete the value-creating activity of construction to achieve success is a risk of loss controlled by securities law, not the workings of the marketplace.

An infinite number of persons and factors — contractors, subcontractors, laborers, material suppliers, architects, construction lenders, government agencies, insurance, costs, etc. — must be coordinated to **complete the improvements** before the investment program can enter the market, much less succeed.

On the other hand, **remote, unusable land** is not as flexible as an investment as other types of property. However, the co-ownership of land to hold for resale does not create a securities risk. Unusable land is purchased merely to be held for profit on resale. Remote, fallow land is unlikely to see its value increased by surrounding development or economic activity any time in the near future.

Also, remote land can be difficult to own. Since the land lacks any use and generates no income, investment groups tend to grow tired of the constant contributions for insurance premiums, taxes and loan payments required of owners of unusable property.

Undeveloped land located near existing development is more likely than remote land to be successful as a group investment. However, the syndicator must correctly anticipate that the land will appreciate in value due to local economic conditions and surrounding development.

The members of an LLC invested in undeveloped land must be willing to make periodic contributions of additional funds to carry ownership of the property since undeveloped land generates no income. If the LLC is formed to purchase undeveloped land, the operating agreement will need to include a provision requiring members to make additional cash contributions based on assessments set by the manager.

Escrow period

After entering into a purchase agreement to acquire property for syndication, the time period for closing escrow should be 120 days or more. A typical 120-day **timetable of events**, following the syndicator's entry into a letter of intent or purchase agreement to acquire an existing income-producing property, is comprised of the following periods of activity:

1. First 30 days: The completion of a due diligence investigation of the property and clearance of contingencies regarding the property.

2. Next 15 days: The completion of the investment circular with its exhibits, articles of organization (LLC-1) and LLC operating agreement.

3. Next 45 days: The solicitation of investors and full subscription of membership in the LLC.

4. Remaining 30 days: Extra time, if needed, to fund and close escrow.

SUPPLEMENTAL ASSIGNMENT INSTRUCTIONS

Assignment of Purchase Rights to LLC

DATE:_____, 20_____, at _____, California.

To _____

_____

_____

Escrow Number _____

Date _____, 20_____

1. You are hereby authorized and instructed to:

1.1 Prepare a grant deed showing vesting in _____, a California Limited Liability Company; and

1.2 Receive third party deposits for the account of the limited liability company.

2. Buyer hereby assigns to this limited liability company all his interest in your escrow including any funds deposited by Buyer.

3. The limited liability company hereby assumes and agrees to meet all the obligations of Buyer in your escrow.

4. Seller hereby releases original Buyer(s) from all obligations under the escrow instructions and any underlying purchase contracts, and accepts the limited liability company as the substitute Buyer in these escrow instructions.

_____ (Seller)

_____ (Buyer)

_____ (Seller)

_____ (Assignee, LLC)

By _____ (Manager)

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If the LLC is not fully subscribed within 45 days after the investment circular is first presented to investors, it thereafter becomes increasingly unlikely that the LLC will ever be fully subscribed. Without investors, the syndicator will not be able to close the purchase escrow.

Taxwise, escrow should be opened in the name of the syndicator for the same reason the syndicator makes the offer to purchase in his name: to further establish his ownership of **property rights** created by entering into an agreement to purchase real estate in his name. Before closing, the syndicator will file an LLC-1 with the California Secretary of State and assign his purchase rights, tax-free, to the newly formed LLC. [Internal Revenue Code §721]

To accomplish the assignment and funding, the syndicator should consider opening two separate escrows. The first escrow is the *purchase escrow*, in which the syndicator as an individual is initially named as the buyer. During the **purchase escrow** period, the syndicator's right to purchase the property is as-

signed to the LLC in exchange for a Class B membership interest with a percentage of co-ownership in the LLC. [See Form 370 accompanying this chapter]

Thus, the purchase escrow is opened by the syndicator (as an individual) and closed by the LLC. Title to the real estate will be vested in the LLC.

However, neither the LLC nor the members should deposit funds in the purchase escrow until it is actually ready to close. The **deposit of funds** is the function of a second escrow, known as a *funding escrow*. The sole purpose of the **funding escrow** is to keep the funds contributed by the LLC members separate from the purchase escrow until the purchase escrow can be closed.

At closing, escrow is instructed to transfer the funds deposited in the funding escrow to the purchase escrow. The transfer will be made when the purchase escrow can close and vest title to the property in the LLC.

The purpose of the two escrows is to allow for the unrestricted return of the investors' contributions in the event any complications interfere with the closing of the purchase escrow. The funds deposited in the funding escrow are at liberty to be returned to the investor without the consent of the seller in the purchase escrow.

Alternatively, investors can deposit funds directly into the purchase escrow for the benefit of the LLC if the escrow used will provide for a *unilateral return* of those funds to the investors. Escrow may receive funds directly from each investor under a "receipt of third-party deposit" arrangement, stating the conditions for use or return of the funds. The investors are third parties, the seller and the LLC (by assignment from the syndicator) being the contracting principals.

Another arrangement the syndicator can provide to hold the investors' funds is an interest-bearing bank account in the name of the LLC. The account will hold the investors' funds from the time they are received until they need to be transferred to the purchase escrow at closing.

Controlling the property

Consider a syndicator who locates an income-producing property that appears suitable for an LLC investment program. It is available on advantageous terms if the due diligence investigation is successful.

Initially, the syndicator will not enter into a purchase agreement that commits him to the unconditional purchase of the property. Only after he has been able to fully investigate and be satisfied with the condition of the improvements and operations of the property, called a *due diligence review*, will he be willing to unconditionally commit to the purchase of the property. For permission to conduct a due diligence review, syndicators often use a Letter of Intent arrangement, but it provides no contractual control over the property should the syndicator later decide to buy it. [See **first tuesday** Form 185]

Further, the syndicator needs time to prepare an investment circular (IC). The IC will be distributed to investors to solicit their subscription and contribution to the purchase and joint ownership of the property.

To control a property without unconditionally committing himself to its purchase (and avoid use of a Letter of Intent), the syndicator has a variety of contract situations to choose from, including:

- a purchase agreement with contingencies;
- an option to purchase the property; or

BUYER'S SYNDICATION ADDENDUM

Equity Financing Contingency

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This is an addendum to the following agreement:

☐ Purchase Agreement ☐ Counteroffer

☐ Escrow Instructions ☐ _____

1.1 ☐ of same date, or dated _____, 20_____, at _____, California,

1.2 entered into by _____, as the Buyer, and

1.3 _____, as the Seller,

1.4 regarding real estate referred to as _____

_____.

AGREEMENT:

In addition to the terms of the above referenced agreement, Buyer and Seller agree to the following:

2. Close of escrow is conditioned on Buyer funding the down payment on the price from contributions made by investors Buyer solicits who subscribe to membership interests in a limited liability company (LLC) (or co-ownership interests as tenants in common) which will close escrow as the assignee of Buyer.

2.1 On acceptance of this offer, Buyer to promptly undertake his due diligence investigation and complete his analysis of the property in a timely manner.

2.2 Buyer to promptly prepare an investment circular on satisfaction of his due diligence investigation at which time Buyer will solicit investors to contribute to the LLC (or as tenants in common).

3. Buyer may terminate the above referenced agreement on or before closing should Buyer be unable to sell sufficient LLC membership interests (or tenant-in-common interests) to fund the close of escrow on this transaction. [See **ft** Form 183]

4. _____

_____

_____

_____

I agree to the terms stated above.	**I agree to the terms stated above.**
☐ See attached Signature Page Addendum. [**ft** Form 251]	☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: _____, 20_____	Date: _____, 20_____
Buyer: _____	Seller: _____
Signature: _____	Signature: _____
Buyer: _____	Seller: _____
Signature: _____	Signature: _____

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- escrow instructions with contingencies, without first entering into an underlying purchase agreement or option to purchase.

A *contingency* is a provision in a purchase agreement identifying a **condition** that must be satisfied or waived by the syndicator for the agreement to become enforceable by the seller. If the condition is not *satisfied*, the syndicator may cancel the agreement and avoid any obligation to purchase the property.

Contingency provisions requiring the syndicator's approval (or cancellation of the purchase agreement) should include, among other items, a review of the condition of the property improvements, leasing income and operating expenses, financing, title, the property's location and natural hazards surrounding the property. [See **first tuesday** Forms 279 and 159 §11]

The syndicator should also consider including a contingency provision in the purchase agreement or escrow instructions allowing him to cancel and avoid closing escrow if he is unable to fully subscribe an LLC investment program to fund the acquisition of the property. [See Form 376 accompanying this chapter]

Escrow instructions entered into in lieu of first entering into an option or purchase agreement must include contingency provisions necessary to protect the syndicator. When a written purchase agreement does not exist and written escrow instructions are the only documents entered into by the syndicator and the seller, the escrow instructions take the place of a purchase agreement or option as the contract binding the syndicator and seller. [**Tuso** v. **Green** (1924) 194 C 574]

Thus, when an underlying written purchase agreement does not exist, any contingencies in the escrow instructions have the same effect as contingencies in a purchase agreement. However, if a purchase agreement exists, the contingencies stated in it do not need to be restated in the escrow instructions unless they are of concern to the escrow officer's performance. Escrow instructions merely authorize a third party (escrow) to carry out the actions required of each party to close the transaction on the terms and conditions agreed to in the purchase agreement (and as amended in the escrow instructions).

As the initial buyer, the syndicator should also include in all purchase agreements he enters into a vesting provision which allows him to **assign his rights** under the purchase agreement to the LLC. The right to assign requires the seller's cooperation to deed the property directly into the LLC vesting. [See **first tuesday** Form 159 §§10.6 and 13.3]

Purchase options

Some sellers are uncomfortable with purchase agreements loaded with contingencies. The contingencies can interfere with the seller's ability to cancel the transaction should the syndicator be unable to close the purchase by the scheduled date and unwilling to enter into a mutual cancellation of the transaction.

Also, a seller might not want his property subjected to a binding purchase agreement that may ultimately be rendered unenforceable by the syndicator's use of contingency provisions to cancel the transaction.

An acceptable alternative for both the seller and buyer is for the seller to grant the syndicator an option to purchase the property. In an option agreement, the seller grants the syndicator an irrevocable right to purchase the property. To form a binding contract, the syndicator simply exercises his right to purchase within a fixed time period, called the *option period*. [See **first tuesday** Forms 161 and 161-1]

After the **option period** expires, the seller will be able to sell the property to another buyer, unaffected by the expired option. If the option is recorded, the option will not expire as a *cloud on title* until six months after either:

- the expiration date stated in the recorded option agreement or memorandum; or
- the date the option or memorandum of the option is recorded if the recording does not contain an expiration date. [Calif. Civil Code §884.010]

For the syndicator seeking to buy suitable property, an option to buy imposes no obligation on him to purchase the property. Conversely, the seller *is* obligated to sell, but only if the syndicator decides to buy the property by **exercising the option** during the option period. The exercise of an option is an acceptance of the seller's irrevocable offer to sell contained in the option.

In exchange for the seller's grant of an irrevocable offer to sell the property, the syndicator pays the seller consideration, called *option money*. The option has not been purchased and is not enforceable unless the seller receives some consideration, although the amount of the consideration may be as little as $100. [**Kowal** v. **Day** (1971) 20 CA3d 720]

Syndicators typically buy options with short option periods — three to six months — long enough to satisfy their need to reserve the property. Time is needed for the syndicator to complete his investigation of the property and form an investment group to fund the purchase. The option money might be set at an amount that will compensate the seller for his inconvenience since the property will be "off the market" during the option period. [See **first tuesday** Form 161]

Often, an insignificant amount of option money is paid for a short, initial option period, sometimes called a "free-look" period, which takes place under most letters of intent. During this period the syndicator completes his due diligence investigation. The term of the typical free-look option is 30 to 60 days for an **option money** payment of as little as $100.

However, the syndicator will need more time after the free-look period if he decides to acquire the property. Here, the syndicator should consider negotiating an option with one or more extensions following the expiration of the initial option period. More option money as agreed is paid to extend the closing date to provide more time to close escrow. [See **first tuesday** Form 161-1]

Any number of additional option periods may be agreed to, each following the expiration of the prior period. The number of option periods depends only on the seller's willingness to agree to grant extensions for compensation and the syndicator's willingness (and ability) to put up more option money.

In exchange for granting an option, the seller not only receives the option money but is able to keep it after the option period expires, since no forfeiture is involved as is often attempted under purchase agreements. Also, he is assured the syndicator will no longer have the right to acquire the property if the option period expires and the option is not exercised, even if the option is recorded.

Liquidated damages, liability limitations

A purchase agreement without contingency provisions allowing for cancellation exposes a syndicator to liability for money losses incurred by the seller for the syndicator's unexcused failure to close the transaction.

Usually, the only monetary loss a seller of income property incurs on a syndicator's breach and failure to close the transaction is a decline in the resale value of the property below the purchase price at the time of the syndicator's breach.

Money lost by the seller is generally reflected as a reduction in net proceeds received on a prompt resale of the property below the amount he would have received from the syndicator's transaction had the syndicator not breached.

Two types of money-damage provisions in purchase agreements address the seller's losses on the syndicator's wrongful cancellation or unexcused failure to close:

Figure 1 *Excerpt from **first tuesday's** Form 159 — Purchase Agreement for Income Property other than One-to-Four Residential Units*

10.8 Should Buyer breach the agreement, Buyer's monetary liability to Seller is limited to ☐ $_____, or ☐ the deposit receipted in Section 1.

- a *liquidated damages clause*, better described as a *forfeiture provision*; and
- a *liability limitation provision*.

A **liquidated damages clause** sets out a fixed sum of money the syndicator will pay the seller in the event the syndicator breaches the purchase agreement. The syndicator agrees to pay the amount whether or not the seller lost money due to the breach.

While initially presumed valid, liquidated damages clauses are unenforceable by sellers in real estate transactions beyond recovering money actually lost due to the breach. Liquidated damages constitute a forfeiture unless equal or greater money losses actually exist. However, without actual money losses, forfeitures are barred by law as an unjustified windfall to the seller since to enforce them would allow the seller to keep both his property and the deposit. [CC §3275]

To recover money damages on a wrongful cancellation or unexcused failure to close, the seller with a liquidated damages provision who is challenged by a buyer (the syndicator) must prove he sustained actual money losses (the amount he may recover) as a result of the syndicator's breach. A liquidated damages clause literally states in plain words that a seller may claim money without having to prove he sustained any losses. However, by law, the clause is unenforceable as written when contested by a buyer in a real estate transaction. What the seller may recover are his money losses, using the deposit as a source for recovery.

As an alternative to a liquidated damages clause, the syndicator and the seller may agree to limit the syndicator's liability in the event the syndicator breaches the agreement.

If agreed upon by both parties, the purchase agreement used will contain a **liability limitation provision** setting forth the maximum dollar amount of seller losses the syndicator is liable for. [See **first tuesday** Form 159 §10.8; see Figure 1]

With a **liability limitation provision**, the seller can recover his money losses incurred due to the syndicator's breach, limited to the agreed-to ceiling amount.

Thus, if the property's value drops below his purchase price by the time the syndicator wrongfully cancels or fails to close escrow, the ceiling on the syndicator's liability has already been set, no matter how far the property value declined by the time of his breach.

A purchaser's lien for the deposit's return

A syndicator generally makes a cash deposit, called a *good faith deposit*, with his offer to purchase a property. Occasionally, the deposit is in the form of a post-dated check or promissory note, payable into escrow at a future date, after due diligence contingencies are eliminated and the syndicator intends to close escrow.

If the syndicator deposits funds into escrow and later breaches the purchase agreement, he is entitled to recover the deposit, less money losses actually sustained by a seller due to the breach.

For example, a syndicator breaches a purchase agreement at a time when the property's value is still equal to or greater than the price agreed to by the syndicator in the purchase agreement. Thus, the seller has not lost money due to a decline in property value at the time of the breach. The seller is entitled to recover nothing unless the purchase agreement called for him to make an alteration of the property's occupancy resulting in a reduction of rents.

Since escrow is not going to close, the syndicator demands the return of his deposit. The seller refuses to authorize the release of the syndicator's funds, claiming the deposit is forfeited, as agreed, due to the syndicator's failure to close escrow.

Since forfeitures in real estate transactions are barred by law and the seller will not return the syndicator's funds, the syndicator is entitled to a purchaser's lien on the seller's property for the amount of the good-faith deposit. The purchaser's lien is enforced by filing a judicial foreclosure action and recording a lis pendens on the property. [CC §3050]

Chapter 3 The economics of income property

This chapter presents an overview of the economic benefits a rental property provides for syndicate investors.

Advantage in high-value property

The greatest benefits a syndicator and his group of investors are able to receive from an investment come from the ownership and operation of multi-million dollar, income-producing properties. All other investment fundamentals being constant, higher-valued properties are generally more efficient and thus yield greater returns over longer periods of time than do lesser-valued properties.

Investing in a multi-million dollar property gives the syndicator and his group an economic advantage over most individual investors. A syndicator pools capital from several investors. Pooling leverages the investors into property more valuable than most individual investors can afford by themselves.

Also, the syndicator's compensation, typically based on the price of the property acquired and its flow of rental income, is far greater when his time and effort is spent on high-value properties.

However, less experienced syndicators should initially stick with low-value properties; these are less tricky to syndicate. Multi-million dollar properties are more difficult to investigate and manage. Errors due to lack of experience and knowledge are dramatically compounded on larger, more expensive properties. Thus, the money and effort required to correct an error are more costly.

Earnings from rental property

Residential or nonresidential rental properties generate annual returns for co-owners based on four financial aspects of ownership, listed here in order of economic importance:

- net spendable income;
- loan reduction;
- increased property value; and
- tax benefits. [See Chapter 12]

Net spendable income

The rents received from tenants make up a property's *gross operating income*. Operating expenses and loan payments are paid out of the **gross operating income**. If rental income is insufficient to cover expenses and loan payments, members are called upon by the manager to contribute additional funds, a property condition called *negative cash flow*.

Conversely, any income remaining after payment of operating expenses and loan installments is referred to as the property's *net spendable income*. When a property generates a **spendable income**, the property is said to have a **positive cash flow**. Spendable income is the primary source of cash for distributions to

investors, called *cash-on-cash income*. Spendable income acts as a cushion mitigating the risk of negative cash flow brought about by a drop in the property's net operating income (NOI). NOI is rents minus expenses.

Spendable income generated by the investment is a return to the investor and the syndicator, calculated and referred to as a percentage of capital contributions. It is roughly comparable to interest received on money-market accounts and dividends paid on common stock. Thus, returns vary from time to time due to inflationary pressures on the pricing of goods and services and the Federal Reserve's management of the money supply. Other influences on rental income do exist, such as local economic stability.

The expectation of receiving a flow of spendable income without having to be involved in the day-to-day management of a property is a major inducement motivating investors to participate as contributing members in a limited liability company (LLC) investment program.

Loan reduction

Due to the systematic amortization of the debt built into the loan's payment schedule, the dollar amount of the annual principal reduction on a trust deed loan is a return of invested capital. However, the amount of the loan reduction is commonly calculated for investors as a percentage yield on their cash investment, not a return of their borrowed capital.

This loan reduction is a significant but **secondary source of earnings** since it functions as an *equity buildup* adding to the property's net worth. However, **equity buildup** cannot be distributed to investors until the property is refinanced or sold.

The annual debt reduction is best viewed as a *return of capital.* The loan amount originally funded part of the total capital the co-owners invested in the property. Taxwise, the amount of the annual depreciation deduction represents the tax-free return of the total of all forms of invested capital, cash savings and purchase-assist loan funds.

Typically, the depreciation deduction more than "shelters" from taxation that portion of the rental income used to reduce mortgage debt through loan payments for approximately two thirds of the life of a 30-year loan.

The principal balance of a long-term real estate loan is systematically reduced by constant periodic loan payments, a process called *amortization*. The reduction in the loan amount increases the property's equity by an equal amount (a "build up" in equity) as long as the dollar value of the property remains at or above the original purchase price throughout the life of the loan.

Thus, a **recapitalization** of the investment occurs during each month of ownership when the amount of the loan principal is reduced by installments paid from rent (or additional contributions). While the property's value remains the same, the equity in the property increases by the amount of the monthly debt reduction, an ongoing restructuring of invested capital (debt paid versus cash withdrawn).

When monthly installments due on purchase-assist financing are paid from the rental income received from the tenants, investors do not need to make further capital contributions to cover loan payments.

On resale of the property, the equity built up by the amortized reduction of debt is cashed out, generating taxable profits (unrecaptured gain due to depreciation deductions) and a tax-free return of capital for any loan reduction greater than depreciation deductions (since taxes have already been paid on the capital).

Typically, the investment circular contains a yield schedule that charts the annual dollar amount of loan reduction over a ten-year ownership period. The annual equity buildup attributable to the loan reduction during each of the ten years is presented as an average annual **percentage return on** the investors' original cash contributions.

A property's net worth over time

The **equity** in a property represents the property's *net worth*. By extension, a property owner's net worth includes the equity in the property. Equity is not equivalent to profits and is unrelated to cost basis, which pertains to the tax aspects of ownership.

Equity in a property is calculated as the difference between the property's market value and the principal balance remaining on any financing or other monetary liens that encumber the property.

The **owner's equity** in a property is the result of:

- *cash invested* to purchase or improve the property, an amount that does not include cash contributed to cover any negative cash flow during the ownership of the property (unless used to reduce debt);
- *loan reduction* through amortized loan payments and any additional payments of principal, called *equity buildup*; and
- *increased market value* of the property due to inflation, appreciation or management, called *growth factors*.

An increase in property value

Real estate located in areas experiencing population and wage growth tends to increase in value over time. This increase is due to a combination of monetary *inflation*, local appreciation and efficient management of income and expenses, called *growth factors*. Meanwhile, proper maintenance keeps the physical aspects of the property unmarred by obsolescence and deterioration.

Inflation is a decline in the purchasing power of the dollar, measured by the federal government and reported through the consumer price index (CPI). Thus, over time, more dollars are required to purchase the same property in the same condition, called *monetary inflation*. Inflation is a reflection of changes to the dollar, not the property.

Inflation is reported as the percentage of periodic increase in the dollar price paid for goods and services — real estate — not in the logical alternative as a decrease in the quantity or quality of goods and services a dollar will buy. Over the years, the dollar value of properly maintained real estate tends to keep pace with inflation, so long as:

- the location of the property has a static or increasing population and employment base; and
- the per capita income (earnings) of potential tenants increases annually at a rate no less than the rate of inflation.

To reap the "benefits" of real estate as a *hedge against inflation*, the manager of a property does not need to do anything more than maintain the property by:

- repairing it to remove wear and tear; and

- replacing fixtures to eliminate physical obsolescence.

Periodically, property **increases in value** at an annual rate greater than the rate of inflation. The rate exceeding inflation is classified as *appreciation* since events beyond the devaluation of the dollar are driving the additional increase in value.

Appreciation in property values is the result of favorable local economic conditions, e.g., consumer demand for the location leading to an increase in the local population density — more people per square mile — or the wealth of the local population.

It is the goal of a syndicator to acquire a property that is in an appreciable location. Thus, it is likely to increase in value beyond the annual rate of inflation to deliver to investors a *real return*.

To garner this future increase in the property's market value at a rate greater than the rate of inflation, the syndicator selects property located where conditions within its immediate vicinity will likely bring about an increase in local population density (or per capita income). Thus, the property will experience an increase in both demand and the rents paid for residential and nonresidential rental space.

Finally, an even greater increase in property value beyond the effects of inflation or appreciation may be achieved by the syndicator's **management capabilities** to reduce operating costs and increase rental income.

Efficient management and attention to the amenities of a property tend to increase a property's NOI. As a result, the value of the property also tends to increase since capitalization rates for setting a property's value are applied to the property's NOI.

Chapter 4 The reduction of investment risks

This chapter looks at the syndicator credentials that indicate the investment opportunity offered is more likely to succeed than fail.

First, be a capable syndicator

A broker must have credentials to engage in the activities of a syndicator. Credentials include the abilities to:

- select suitable property for the right *price*, on the right *terms*, at the right *time* and in the right *location*;
- enter into purchase agreements;
- conduct a due diligence investigation and analysis;
- arrange purchase-assist financing;
- determine the proper vesting for title;
- manage the landlord-tenant relationship;
- preserve the property's value by repair, maintenance and replacements; and
- account for income, expenses and mortgage payments.

Properly honed, the composite of these abilities represents an expertise sufficient to cope with the foreseeable challenges presented by the ownership of income-producing real estate. The broker possessing these qualities demonstrates he is qualified to manage a real estate investment program for himself or a group.

Without a background of education, training and experience in the acquisition, ownership and disposition of income property, a broker is not fully qualified to lead a group of unsophisticated investors into the co-ownership of income-producing real estate.

The investor's point of view

To analyze his *risk of loss* when investing capital, a prudent investor must begin by judging the capabilities and competence of the syndicator. Since success is dictated by property selection, financing and management, the greater the syndicator's credentials, experience and talents, the less the risk of failure.

To see an investment program through to fruition, the syndicator must have an evident sense of purpose, i.e., a consistency of behavior, determination and focus. Without a showing of his finely-honed competence for buying, owning and selling real estate over a long period of time, solicited investors will instinctively be put off by a syndicator's lack of experience. They will sense the existence of an increased risk of losing capital due to the syndicator's lack of drive, dedication and experience.

A syndicator must be able to present himself as a manager able to see his way through the difficult stages of an investment and emerge successful at the end of the process, in spite of local economic upheavals that will cyclically beset the property.

Experience selling income properties, either on behalf of an owner or when acting as a principal, is evidence the syndicator understands the challenge of selling property. Operating a property month after month, then selling it during the short window of maximum liquidity for a resale opportunity in a real estate business cycle is a difficult task.

In application, the **price paid** for a property becomes the initial indicator as to whether a profit will likely be realized on its resale. Further, the **terms for payment** of that price — the financing — must reflect the local economy's future stress on rental income and cash flow from the property, all of which affect the ability to retain ownership.

The **timing of a purchase** is best understood by a syndicator who has gone through at least one full real estate business cycle — from bust to boom and back. This provides a personal grasp of the difference between the concept of historical equilibrium trends in property values and the reality of price movement during a business cycle, with its excessive rise and fall in real estate prices.

Selecting the correct phase of a business cycle — preferably the end of the recessionary phase after a bust — as the time to select and buy property to assure a profit on its resale is an absolute necessity for getting an advantageous price.

However, few buyers are willing or able to acquire property at any price during recessionary lulls in the real estate resale market. Thus, the syndicator, by choice, is a "market maker" of sorts. He prudently goes into the market to buy at a time when few others are willing and able to compete. To do so, he creates a buyer in the form of himself and a limited liability company (LLC) full of cash investors who would otherwise be unlikely or unwilling to individually buy property in or at the end of a recession.

Thus, a syndicator promotes the acquisition of property in a market following the height of foreclosure and real estate owned (REO) action where few sales exist and when speculating buyers are sparse. In timing acquisitions for long-term investment, the syndicator must take advantage of the temporary (cyclical) dearth of buyers in the marketplace at the time sales volume begins to increase (based on fundamentals, not speculator activity) but before prices start to pick up. This is typically a 12-to-18 month window period and occurs long after the current cycle's recession has been declared as ended.

During a well-developed buyer's market of greatly reduced sales volume and the second off-loading of properties held by speculators, the syndicator is better able to negotiate a price and terms for its payment that will help insulate against the risk of a loss of invested capital.

By taking advantage of market prices that drop below the equilibrium trend, a built-in profit is realized the instant the period of ownership moves into the recovery phase of the business cycle. Prices then begin to rise in a trajectory pushed upward ever faster by the recovering demand and fueled by increasing numbers of "fair weather" investors and the ever-recurring flow of first-time speculators.

A local track record of achievements

The *personal achievements* of a syndicator also lend credence to his syndication efforts. Investors sense a greater probability of success in an investment selected and managed by an accomplished individual — one with power — when his credentials include:

- at least three years' experience as a property manager, operating his own income properties or properties on behalf of others;
- at least three years' experience as an appraiser or as a broker providing opinions on value;
- creditworthiness sufficient to qualify for loans himself without relying on a co-signer or guarantor;
- cash reserves for emergencies, separate from funds used for investment;
- accumulated wealth, preferably in the form of equities in real estate;
- community service, such as involvement in civic affairs — social and political;
- longevity as a resident in the community;
- higher education and studies in real estate and business;
- licensing in related trades, such as construction, appraisal, real estate, lending, etc.;
- personal accomplishments of merit; and
- existing income from sources other than up-front fees for the current syndication of property.

Risk avoidance for equity investors

The primary financial purpose for the syndication of a property by a broker is to raise funds from passive investors for the down payment on the purchase of property that the broker will co-own with the investors. Thus, as the syndicator, the broker's fractional ownership interest in the property is l00% financed by mortgage money from a lender and equity capital provided by investors.

The syndicator's claim on the property's income and profits for his fractional ownership interest is junior only to the mortgage financing encumbering the property (as are the investors' ownership interests) if the syndicator's percentage of ownership participation is not subordinated to the ownership interests held by the investors, called *parity participation*.

However, without *subordination* of the syndicator's co-ownership interest to those claims on income held by the investors, the dollar value of the investors' percentage of ownership on closing will be less than the down payment they have funded to acquire the property, a condition called *watered stock*.

Accordingly, the fractional ownership interests acquired by most syndicators are, as a matter of practice, subordinated and junior to both:

- the mortgage financing (the first claim on the property's value); and
- the equity financing provided by the cash investors (the second claim on the property's value).

The syndicator whose fractional ownership interest in an LLC is a Class B subordinated ownership interest (the third claim on value) has financed the acquisition of his ownership interest through *mortgage financing* (lender) and *equity financing* (passive investors). This arrangement constitutes "double leverage" and provides 100% financing of his ownership interest.

From the income aspect, the syndicator's ownership claims dissipate the **earning power** of the investors' cash contributions, whether or not his ownership interest is subordinated.

Apart from earnings, the investors' **risk of loss** of their investment is analyzed based on the distinction between parity or the subordination of his co-owners' interests.

For example, investors typically are asked to put up at least 100% of the cash (equity financing) needed to acquire the property. When doing so, they agree to the "watering down" of their share participation in any future increase in the property value. They agree to receive less than 100% of the property's future increase in value in exchange for distributions of spendable income and net proceeds of refinancing or a sale that has priority to the syndicator's claims.

Thus, the investors dilute the earning power of their cash by sharing future growth with a non-cash investor, the syndicator, but do not increase their risk of loss or create a moral hazard by doing so.

Further, due to the dilution of the investors' earning power, on a resale of the property the syndicator *receives the first profits* resulting from an increase in the property's value over the price originally paid to acquire the property. The amount of this initial distribution of profits to the syndicator is limited to the dollar value given to his Class B interest. When subordinated to investor claims on profits, distribution to the syndicator from sales proceeds is based solely on an increase in property value.

Depreciation and book value (adjusted cost basis) of the asset only plays a role in tax reporting, not the sharing of spendable income or net proceeds of refinance or resale.

Conversely, the priority return of the investors' cash contributions is distributed based on the price paid for the property, before considering any increase in the property's value. Also, any minimum annual yield owed to the cash investors, which may have accumulated unpaid due to deficient spendable income in the past, has priority over any disbursement of sales proceeds to the syndicator.

After the initial pay out of net sales proceeds to Class A and Class B members to return their capital contributions with an annual minimum rate of return, any remaining sales proceeds are typically shared by all members on a pro rata basis — share and share alike. Thus, a Class A member's participation in the remaining profits is again diluted by the ratio of sharing between Class A and Class B members.

While Class A members are assured a priority return of their cash and a minimum annual return, to avoid the moral risk created by parity sharing, the syndicator, through his Class B ownership, imposes a dilution of the participation by the Class A members in profits on the sale — the trade-off investors make to enjoy a flow of income and full return of their cash contributions before the syndicator participates as a co-owner.

Funding the purchase

Like mortgage financing, **equity financing** provided by cash investors is primarily meant to fund the purchase of property, not to compensate the syndicator for the time and effort he spends contracting to acquire the property. Thus, equity financing is not generally considered a primary or major source of funds to compensate the syndicator for his acquisition activities. He receives an ownership participation for these pre-syndication efforts.

If the syndicator is to **remain solvent**, he needs to be reimbursed for all of his out-of-pocket expenditures related to the purchase of the property. Further, he needs to receive a **reasonable fee** for the organizational time and effort spent performing syndication activities, such as preparing the investment circular, soliciting investors and forming the LLC.

Also, the syndicator's time and effort spent locating the property, entering into a purchase agreement, conducting the due diligence investigation, arranging for the assumption or origination of purchase-assist loans and opening and closing escrow relates to the acquisition of the property. These real estate-related transactional activities warrant the receipt of consideration (a percentage of ownership) separate from the fee paid to the syndicator for services rendered to form the LLC and organize the investors.

Analyzing the risk of loss

Basic market factors common to all real estate transactions pose risks of loss no matter who owns the property or whether it is a single family residence, income property or vacant land. Commonly acknowledged **risks of ownership**, understood by even the most ill-informed investor, include:

- the purchase price;
- the down payment;
- mortgage financing;
- costs of ownership;
- the property's location;
- occupancy and rent;
- the maintenance of the property; and
- recovery of cash on a resale.

To provide a "comfort zone" sufficient for prospective investors to look further into the attractiveness of a syndicator's investment program, the syndicator must adequately address each of these market-related risk factors. His analysis of these risks must neutralize the initial fear of loss common to most individuals who consider a major financial move.

These market risks are the latent economic concerns of any investor. If not addressed by the syndicator, the typical candidate for group investment is probably unable or unwilling to ask questions on his own about real estate. Thus, an investor's gut reaction toward the investment will remain apprehensive, most likely barring a commitment to contribute as a co-owner.

Justifying the price and down payment

The first marketplace question that comes to the mind of every investor is whether the **purchase price** to be paid for the property is a proper amount. The syndicator must justify the price as below-market if he is to entice investors to look further into the investment's profitability on a resale. An appraisal report prepared by a credentialed and licensed fee appraiser stating the property's value at a dollar amount greater than the price the syndicator has agreed to pay for the property is a huge advantage.

Logical explanations as to why a seller will accept a below-market price include:

- the lack of a brokerage fee (typically 6%) on the transaction;
- a price based on earlier sales at lesser prices; or
- a price reduction that was vigorously pursued by the syndicator through offers, counteroffers and inducements of a substantial down payment or cooperation in meeting the seller's tax exemption goals.

A direct comparison by the syndicator (or the appraiser) to a recent sale on similar terms of a closely comparable property located in the immediate vicinity of the syndicated property provides evidence of good value in the syndicated property.

Since nearly all of the cash funds contributed by investors are going towards the **down payment**, an investor's instinct to avoid being "ripped off" is satisfied. The remainder of the cash funds, after distributing a small cash amount to the syndicator for LLC organizational efforts and costs, are held as *reserve funds*. This way the investor reduces his innate concerns about creating a moral risk of a loss by a diversion to the syndicator of funds borrowed or contributed to the investment.

The investor, aware of the percentage of ownership the syndicator is receiving, does not want to also pay the syndicator cash to help him acquire that ownership interest when the syndicator's percentage of ownership already dilutes the earning power of the downpayment cash contributed by the investor.

Also, the greater the amount of the down payment as a percentage of the price, the less the risk of loss on the investment and the greater the amount of spendable income. Further, a mortgage lender originating a loan with a lower loan-to-value ratio offers better rates and payment schedules since the lender can reduce his risk premium in the interest rate.

Recovery of contribution on resale

After a syndicator confirms that the present worth of the property is equal to or greater than the investor's cash savings being transferred to the real estate investment (and the mortgage amount), the investor needs assurance that the funds will be recovered on a sale of the property. Thus, it must appear to the investor that **market trends** will support the original cash investment and likely result in an increase in its value over the long term.

Clearly, a syndicator can offer his *opinion of value*, his expectations about future market trends, movements in property values and the presence of future buyers willing to purchase the property, as long as he has a reasonable basis for his opinion.

Documentation showing the direction of sales volume and prices of comparable properties during the six-month period preceding the purchase will help demonstrate whether prices are rising, dropping or flat. Given the constant recurrence of business cycles and their effect on the volatility of real estate sales and prices, the syndicator can rationally demonstrate what he believes will occur regarding an increase or decrease in the future willingness of buyers to buy and the likelihood of a respective rise or fall in prices and rents.

It is necessary to remind investors that inherent in the nature of a successful real estate investment is **long-term ownership**. To cash out on a resale, they must await a peak in prices during a business cycle — hopefully accompanied by a handsome profit for having acquired the property at the right price.

The benefits of the **monetary inflation** inherent in the hedge of real estate ownership take time to develop, as do the additional profits from **property appreciation** brought about by growth in the local population and their wages. These national monetary policies (inflation) and local demographic trends (population) drive up rental income over the period of a business cycle. With rising rents, the value of the property increases by a corresponding percentage if the capitalization rate for setting property values remains the same and operating costs do not rise faster than the rate of inflation.

An investor's fear of loss is probably best alleviated if the price paid for the property is less than the fair market value by at least the amount of the brokerage fees avoided on the purchase. The logic is that the property, if resold today for its fair market value, was purchased at a price that would generate net sales proceeds sufficient to return all the investors' funds — after payment of a full brokerage fee.

Purchase-assist mortgage financing

When an investor is solicited by a syndicator to participate in a real estate investment, the investor automatically reflects on what he has come to believe is helpful or harmful in a mortgage. Thus, investors are fairly comfortable talking about interest rates on real estate loans (fixed or variable) and the merits of a future refinance. An investor's background experience with mortgages aids in persuading him to subscribe to an investment, as long as the syndicator explains why the rate of interest he has agreed to for purchase-assist financing is good for the investor's future ownership.

Investors need to be advised on aspects of the purchase-assist financing, including:

- why a loan was arranged with a particular lender; and
- what fees, charges and yield spread premium the syndicator was able to avoid by negotiating the loan directly with the lender at the par rate.

If the interest rate is above *par rates* at the time of origination, the spendable income will be less than it would have been had the loan rate been at par — a huge unnecessary shift in wealth to lenders and loan brokers.

When unnecessary loan fees, charges and yield spread premiums are paid to a mortgage loan broker to negotiate the loan in lieu of direct lender negotiations by the syndicator, the amounts of both the debt underlying the down payment and the cash disbursed to others outside the investment group are greater than they should be. Here, the earning power of the invested cash is diluted and the risk of loss is greater than it needs to be.

The mortgage financing arranged for the purchase is either a *fixed rate mortgage* (FRM) or an *adjustable rate mortgage* (ARM). Whichever it is, the rate must be no greater than the current rate charged by lenders in the national secondary mortgage market.

Property values (prices) are inextricably and conversely tied to interest rates on mortgages. As marketplace mortgage rates rise or fall, the market value of all real estate moves in the opposite direction. This effect is comparable to the movement of rates and pricing in the bond market, but with a delay due to the stickiness of seller pricing.

Further, the type of interest rate (depending on whether the financing arranged was a FRM or an ARM) selected to help finance the acquisition has an impact on:

- the future worth of a property;

- the amount of spendable income remaining after monthly loan payments; and

- the ability to retain ownership.

A participating investor should be informed that when rates for purchase-assist mortgages and assumed loans increase, the pace of sales slows and the price paid for property declines.

Fixed rate mortgages

As real estate prices trend downward due to a rise in fixed rates on purchase-assist loans, lenders and sellers duel in a trade-off for the dollars paid initially and monthly by the buyer to own the property. As interest rates rise, prospective investors acquiring income-producing property insist on an increased **rate of return** (cap rate) on their cash invested in the property, after payment of operating costs and interest on the mortgage. Cash becomes king.

Operating expenses are difficult for management to reduce and rents are unlikely to be substantially raised on acquisition of a property. Also, older investors will not likely invest in an income-producing property without an annual cash return (from spendable income). Thus, the investors' annual cash-on-cash return requirements are met from the *net operating income* (NOI) remaining after payments on the mortgage — spendable income.

When market interest rates increase for new fixed rate loans, a reduction takes place in the amount of mortgage money the property can carry, thus the amount a syndicator can borrow to finance its purchase is also reduced. Mortgage loan amounts are based on the NOI available from a property to service interest and principal payments. The resulting loan amount (lower as interest rates rise), plus the down payment, establishes the maximum price a prudent investor (syndicator) pays for a property, not the price prayed for by the seller as the listing price.

Thus over time, mortgage lenders charge higher rates to earn more money while the seller's property loses value in a compensating amount. The lost property value represents the present worth of the increase in the *real rate* of interest earned by the lender. Thus, a shift in wealth from the seller to the lender occurs during periods of rising rates — if the seller chooses to sell.

Prospective investors, on the other hand, will experience no short- term benefits from the reduced price and no harm from the increased interest rates they pay. The price paid is the equalizer for the buyer.

Consider the fact that investors cannot lower (and the seller cannot raise) the price paid to the seller for the property once the purchase escrow has closed. Further, the lender funding a fixed-rate loan cannot increase the principal balance or the rate of interest agreed to by the investors. However, the investors **can refinance** in the future and reduce the rate of interest on their mortgage financing, often dramatically.

On refinancing the original purchase-assist loan in future years at lower rates, the spendable income generated by the investment will increase. The increase will equal the difference between payments on the old loan and payments on the new loan. Thus, a windfall of additional spendable income occurs. Also, the value of the investment is strengthened since the risk of loss inherent in any future decrease in rent or increase in operating costs is reduced by advantageous refinancing.

Adjustable rate mortgages

Using an ARM loan to finance a syndicated property complicates the syndicator's disclosures when reviewing the adverse effects of ARM mortgage financing. The syndicator needs to demonstrate that the ARM loan was selected because the *note rate* on the ARM, while variable, will most likely decline in the future.

The ARM **note rate** is different from and always greater than the initial qualifying or teaser rate. Thus, by taking on an ARM loan the syndicator is gambling that the note rate will drift lower rather than higher. However, it is an unlikely economic scenario that allows rents to rise and cover increasing payment of ARM rates since short-term interest rates are rising at the same time.

An ARM loan is tied to an index of **short-term loan rates**, not long-term mortgage rates. High, short-term consumer rates are set by the U.S. central bank (the Federal Reserve) to fight inflation. In doing so, the bank causes ARM rates to rise and the domestic economy to slow, placing it in an informal recession — a business slow down. Conversely, a drop in short-term rates allows the economy to pick up (through more employment to increase production of goods and services), which in turn generates more real estate sales (and tenants).

As short-term rates drop, a decline in ARM rates follows, eventually reducing the dollar amount of monthly ARM payments and producing more spendable income (or reducing the negative cash flow). Also, sales volume increases to re-commence price increases, all triggered by lowering short-term rates to or below inflation rates.

When ARM financing is employed to fund the purchase of property, the ARM will eventually need to be refinanced, replaced with a lower fixed-rate loan for the duration of the group ownership. Any investor who grasps the math of the future buildup in a property's value and the increase in spendable income over years of ownership under a fixed-rate loan can handle the math of these loan arrangements.

Analysis of operating costs

Operating costs incurred during the ownership of a property are generally not of concern to the typical passive investor in syndication. No formulas, rules of thumb or guidance exist for syndicate investors to use to make a quick analysis of value — just look at pricing in the *real estate investment trust* (REIT) market. Further complicating an analysis of operating costs, each property is unique. Also, expenses for repair, maintenance and general care of a property vary hugely from property to property due to causes that are better understood by first preparing a structural engineer's report or completing a due diligence investigation of the property.

However, if operating costs are temporarily increased to cure **deferred maintenance** and **accumulated obsolescence** or amenities, these costs are suddenly a subject of great positive interest to investors. They are a benefit to investors. The end result is increased value due to the one-time event called *sweat equity*, and more spendable income due to a one-shot increase in rental income.

A temporary increase in costs to cure deferred maintenance on the property, increase or upgrade security for the tenants or add facilities and amenities to keep and attract a better class of tenants generates increased rents. In addition to reducing the investors' risk of loss, these activities tend to increase the NOI and thus the spendable income distributions they will receive. Without a change in capitalization rates, the property's value will increase by the same percentage as the increase in NOI, the *sweat equity*.

Occasionally, rents are below-market and can be raised without significant cost. A reasonable plan for executing any rent increases proposed in the investment circular needs to be prepared and presented to the investors.

A detailed plan is especially necessary if scheduled income is forecast based on rents that are anticipated to be greater than the rents tenants now pay. Some units will be on leases with rents that cannot be altered until expiration of the leases, thus interfering with the timing of the increases. Others are under rental agreements or expired leases that allow for increases after service of appropriate 30- or 60-day notices.

A timetable needs to be prepared on a spreadsheet and presented to the investors. It should list each unit, when and how much each tenant now pays in rent, and the rent amount he will be required to pay in the future.

Distributions based on priority returns

Consider a syndicator who, on entering into a purchase agreement and confirming the property's suitability, places a dollar value of $100,000 on the assignment of his purchase rights to the LLC.

The valuation of a syndicator's assignment often represents roughly 6% of the present fair market value of the property, a brokerage fee in any other sale of the property. If he were to sell his contract right to purchase the property to another buyer, that buyer should be willing to pay $100,000 for the syndicator's position, in addition to paying the price the seller has agreed to in the purchase agreement.

The price paid under the purchase agreement calls for a down payment of $250,000, approximately 17% of the purchase price. The syndicator intends to fund the down payment by raising $60,000 from each of five investors, a total of $300,000 in cash. The $50,000 in surplus cash will provide funds for a $10,000 fee to be paid to the syndicator as compensation for organizing the investment group and $40,000 to be held by the LLC as **cash reserves** and additional working capital.

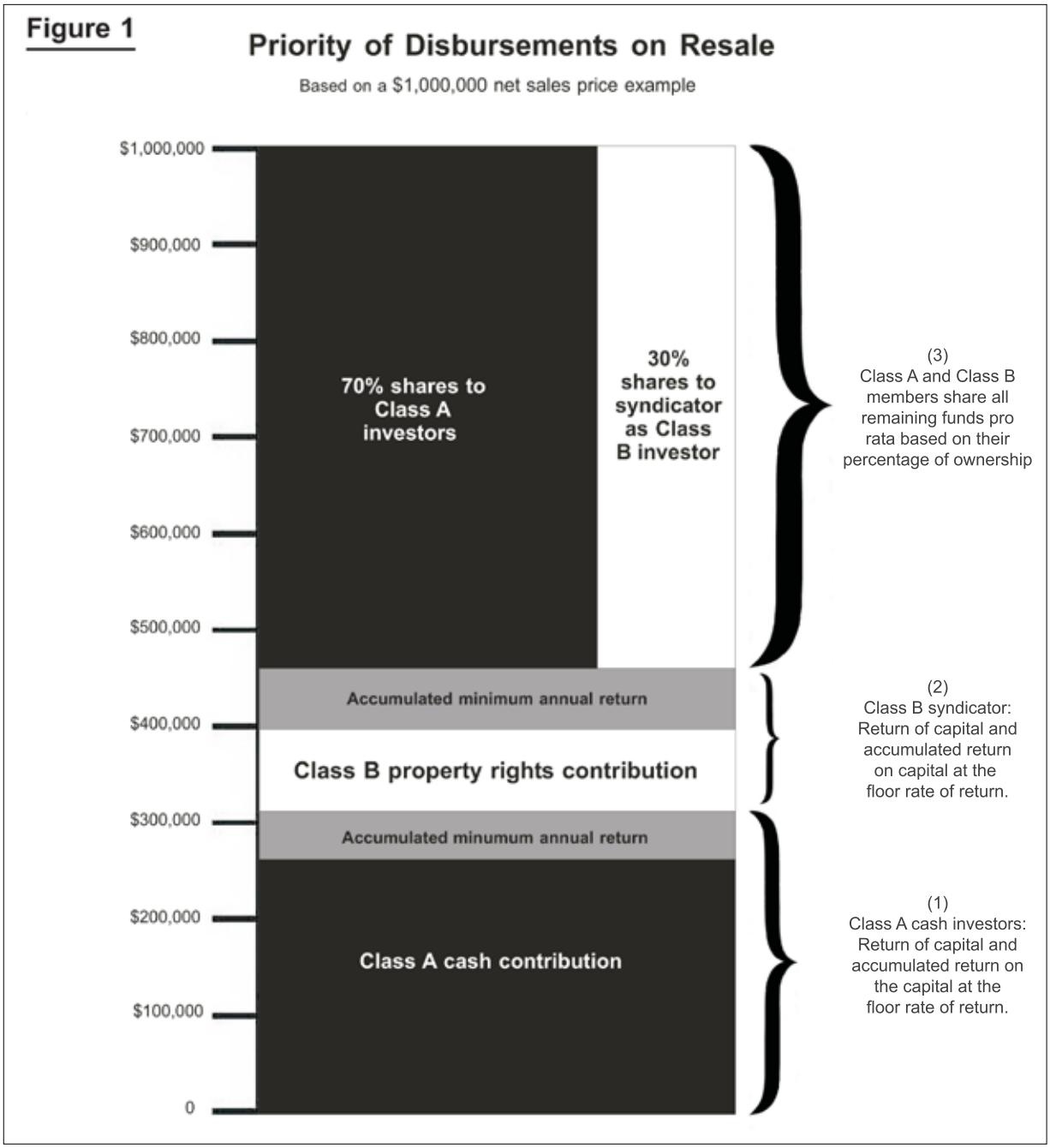
The syndicator will not be paid cash for assigning his contract rights under the purchase agreement to acquire the property. Instead, he will receive a $100,000 Class B interest in the LLC as a co-owner with the cash investors (Class A members).

Thus, the combined amount of all capital contributions ($400,000), comprising the cash raised from the investors ($300,000) and the value set for the assignment of the syndicator's purchase rights ($100,000), becomes 100% of the capital contributions. Each co-owner's percentage **share of earnings** from rents and sale of the property is initially set as the percentage their contribution represents the total dollar amount of all forms of contributions made by all co-owners, Class A and Class B.

Thus, the investors will collectively hold a 75% co-ownership interest in the LLC as Class A members for their $300,000 cash investment. The syndicator will hold a 25% co-ownership interest as a Class B member for his contribution of his right to buy the property.

However, cash investors do not typically consider the syndicator's contribution of his purchase rights as equivalent to their hard-earned (after-tax) cash contributions. Investors consider a syndicator's efforts as promotional, illiquid and untaxed since his interest has not been reduced to cash by a resale of the property.

Unless restrictions and limitations are imposed on the syndicator's share, all members will share earnings from spendable income and the proceeds of a sale (or refinance) equally, a *parity distribution* of funds.



Parity (equality) among all co-owners places the cash investors and the syndicator on equal footing. Thus, the investors' funds are in eminent danger of a partial loss if the property does not resell for a price exceeding 10% more than the price the group paid for the property.

When sharing spendable income and sale proceeds, priority for the claim of cash investors as **Class A members** over the syndicator's claims as a **Class B member** must be a condition of the sharing arrangements. If not, it is unlikely the syndicator will attract investors since they may doubt the likelihood their cash investment will be returned.

Front-end earnings for the syndicator's sake

Arguably, a syndicator's assignment of his contract right to purchase the property has a present cash value equal to the dollar amount of the membership interest he will receive in exchange. Typically, the valuation of the syndicator's ownership interest is either:

- equal to a cash commission a listing broker would have received on a sale of the property; or
- the difference between the reasonable fair market value of the property and the lesser price paid for the property.

In either case, why should the syndicator's percentage share ownership be on a subordinated basis to the cash investors, and not on a "share and share alike" arrangement for distributions of all earnings?

The answer lies in moral risk: instinctively, investors hold feelings that the syndicator's participation on a parity basis (or worse yet a full commission as their agent) leaves the syndicator with *significantly reduced* incentives to properly structure the acquisition and manage the property than had he not received cash up front. Instead, he should receive a fully subordinated share of earnings.

If the syndicator receives an ownership interest with a participation in earnings equal to the cash investors' earnings, he has less motivation to:

- make the best selection of property and acquire it on the most advantageous financial terms;
- pay constant attention to the management of the property and tenants; and
- pick the right time to sell the property at the maximum market value.

To **shift the risk of loss** posed by the potential failure of the syndicator's motivation, the syndicator's interest must be subordinated to eliminate the equal treatment of parity distributions. When subordinated, the syndicator first shoulders the *risk of loss* if the property does not live up to his cash flow expectations.

Also, the value he claims his Class B membership is worth will not be achieved on a resale if the property does not increase in value. When the syndicator acts to protect the value of his Class B interest in the investment, his own self-interest automatically provides protection for the financial interests of the investors in the property as well.

However, the investors' payment of a cash fee to the syndicator in a small amount on acquisition of the property is appropriate. It is fair to assume a syndicator who does not "sell the property" to the group he forms, but seeks investors to "join with him" to jointly own the property, has an operating overhead and personal expenses.

A real estate broker in the business of creating investment groups to acquire property in which he takes an ownership position will soon be out of **cash reserves** unless he generates cash income during his first three or four years syndicating properties. Services rendered in organizational efforts to form a group are separate from the efforts involved locating property, negotiating the purchase contract, and arranging to close escrow. Thus, the syndicator logically merits a cash fee for the organizational services rendered to the LLC and investors prior to closing.

Distribution during ownership

The payment of **management fees** to a syndicator for managing the leasing, ongoing care and maintenance of the property and rendering the services commonly expected by tenants is a diversion of a portion of the rental income to the syndicator. However, it is a necessary and proper one, comparable to the payment of other operating expenses. A third-party broker with expertise in property management would otherwise be employed to manage the operations of the property, and a fee would be paid.

In order for the syndicator who manages the property to legitimize the amount of his fee, he must show it is *fair and reasonable*. Justification is needed since he has literally hired himself to manage his property and will receive a fee for doing so.

Further, the payment of a management fee before a return is distributed to investors has economic justification. The cost of supplies, labor and management are paid from income (rents) as expenses of ownership before funds remain for disbursement to the co-owners as spendable income (a return of capital, dividends, etc.).

As further justification, the syndicator receiving a management fee does not receive any portion of the spendable income until the co-owners have first received a **minimum annual rate of return** on their invested capital. Only if distributable funds then remain can the syndicator share as a subordinated co-owner. [See Figure 1 accompanying this chapter]

Typically, the minimum rate for the investor's annual yield is *cumulative*. If spendable income is not available for disbursement in the full amount of the minimum annual rate of return on investment, the unpaid amount accumulates. The unpaid accumulation will receive priority disbursement in later years when funds from any source become available for distribution.

After spendable income has been disbursed at the minimum rate of return to both the priority (Class A) and subordinated (Class B) co-owners, any spendable income then remaining is distributed on a parity basis between all co-owners, Class A and B, without concern for priorities.

Occasionally, a **ceiling rate of return** is set for total annual participation in the spendable income by cash investors (Class A members). When a ceiling exists on earnings that limits their annual return from rents, the balance of spendable income is distributed to the syndicator under his Class B membership (not as a management fee).

The nature of the cash investors' Class A participation is similar to the ownership of cumulative preferred stock issued by a corporate entity. The investors receive an annual rate of return. Any remaining earnings go to the common stockholders, represented here by the syndicator's subordinated Class B ownership interest. Further, the syndicator's rights are often coupled with buy- out provisions containing options to acquire the member's interests or the property.

When the equity in a property is cashed out, in part or entirely, by a refinance or sale of the property, the net proceeds represent a *return of capital* to the co-owners. Funds from a refinance or sale are not operating income generated from rents. Again, any fees paid to a syndicator acting as a loan broker in arranging a refinance or further encumbrancing of the property, or negotiating the sale as a broker, is a proper diversion of proceeds that initially belong to all co-owners.

As always, a fee received by the syndicator must be justified as both necessary and reasonable in amount. Here, the nature of the brokerage services provided must be shown as necessary to the operation of the property, and the amount of the fee must be shown as competitive and comparable to fees charged by brokers who provide the same service in the local market.

The net proceeds from a refinance or a sale, being a *return of capital*, are first disbursed to the cash investors as a priority. The cash investors receive an amount equal to their original cash investment, plus a minimum annual rate of return, less any amounts previously disbursed to them from any source, such as spendable income or the net proceeds of a prior refinance or sale of a portion of the property.

Any proceeds then remaining from the financing or sale of the property after the priority distributions to the cash investors are next disbursed to the syndicator. He receives:

- the dollar amount set as the value of his Class B co-ownership interest that he received in exchange for the assignment of his purchase rights; plus
- his minimum annual rate of return; **less**
- any amounts disbursed to him as a co-owner (not for service as a manager) from spendable income and net proceeds of a prior refinance or sale of a portion of the property.

After all priority and subordinated co-owners have received a return of their original investment and the minimum annual floor rate of return on that investment, the remaining net proceeds are distributed to all co-owners on a parity basis, usually based on their percentage of ownership.

However, members may agree to a different ratio for sharing the remaining funds between Class A and Class B members, for example, 50% to Class A members and 50% to Class B members.

Occasionally, the parity claims of the investors are limited to their original investment and a maximum annual rate of return from all sources. Thus, the syndicator receives all sales proceeds remaining in excess of this maximum-ceiling annual rate of return for the cash investors.

Chapter 5 The syndicator's professional services

This chapter presents a syndicator's use of his real estate broker's license to render professional services as a syndicator and manager of real estate.

Licensing as a legitimizing force

Consider an individual, licensed as a broker, who has been earning a decent living from the fees he earns for handling the sale of income-producing properties and the purchase of developable land for builders. However, his net wealth is minimal, consisting of his home, two cars and a duplex. He acquired all these assets with little or no down payment and they are all encumbered with manageable debt. His credit is excellent, he maintains a minimal amount of consumer debt, has modest cash reserves and files income tax returns.

The broker is concerned about building his future net worth. He wants to attain a better quality of living and a higher civic status for himself and his family. To accomplish these personal objectives, the broker decides he needs to supplement the fees he is presently earning. He believes he can do so by acquiring the ownership of income-producing properties.

Being constantly exposed to income properties that come onto the market for sale, he begins to analyze the probabilities for his owning and operating a few of these properties. To achieve this goal he will need to co-own any acquisition with investors who will put up all the cash needed to acquire them.

The broker's efforts locating, contracting for and fully investigating the acquisition of property is a task at which he is experienced. Rather than a brokerage fee for packaging the property for an investor, he will take an *ownership interest* with one or more investors. The investors will invest enough funds to cover all his expenses related to the acquisition. Also, as an economic necessity, they will contribute enough funds to pay a modest front-end fee for his efforts spent soliciting the investors and forming a limited liability company (LLC) to own the property. He will be the manager — chief operating officer (CEO) — of the LLC.

On acquiring a property in an LLC, the broker will then become the *property manager*. As the manager, he will oversee any on-site resident managers, coordinate locating tenants and negotiate leasing arrangements and arrange for the care and maintenance required to protect and improve the value of the property. For these services, he will receive the same competitive management fees any other competent property manager would receive.

The amount of the management fee will be based on a percentage of the *gross rental income* produced by the property. Thus, the broker has incentive to attain the highest possible rents for the property. The greater the amount of rents, the greater the amount of his management fees, and in turn, the more valuable the property.

As a co-owner, the broker will share in the *spendable income* produced by the property. Also, the value of his **percentage ownership interest** will inflate and appreciate over time. During the LLC ownership, he will receive fees for *brokerage services* rendered if the property is refinanced or sold, or if a co-owner decides to resell his fractional ownership interest, all commissionable events.

Thus, the broker sees a way to accomplish both of his personal objectives in one activity: syndication for the acquisition of an ownership interest in income property with cash investors. Through the syndication of income-producing property, he will build up his net worth as a landlord and receive additional flows of income from fees for management services and distributions of spendable income.

Is it permissible for a broker, acting as a syndicator, to receive contingency or percentage-based fees for rendering real estate brokerage services to a group of co-owners when he is himself a co-owner of the property acquired, operated and eventually sold?

Yes! The syndicator holds a California real estate broker license. A licensed broker acting as an asset manager on behalf of the co-owners (or the LLC) may charge fees that are **based on a percentage** and **contingent** on the rents collected, the price received on a resale of the property or the amount of any loan he arranges. As a co-owner who is a broker, the syndicator is not restricted to a salary or a fixed dollar amount paid periodically as compensation without regard to the rents collected, loan amounts or the resale price. [California Business and Professions Code §10131]

However, the fees the syndicator expects as payment for future services must be agreed to in either the LLC operating agreement or a written management agreement. These agreements are entered into when forming the LLC. A separate listing agreement should not be used and is not needed for the syndicator to be able to enforce collection of the fees. Further, any compensation the broker will receive, whether acting as a principal in ownership or as a broker rendering services, must be disclosed in the investment circular (IC) used to solicit investors.

An unlicensed person may manage the property for the co-owners with compensation based on a fixed monthly fee or salary. However, the unlicensed manager may not receive **incentive-based amounts** for compensation, such as a percentage-based fee tied to the amount of rent collected, an occupancy rate, minimum spendable income or other production-based formula. [Bus & P C §10133(a)(1)]

The advantages of being licensed

A real estate broker who forms investment groups needs to analyze the long-term role syndication will play in their professional career. Syndication is a source of mixed income: part of the income comes from the ownership of fractional interests in real estate and part comes from fees for brokerage services. However, the licensee negotiating the purchase of property and soliciting investors for that purchase will soon experience an indirect benefit for having earned a license and the right to conduct business as a broker. He will be viewed as having achieved the necessary credentials to authorize his activities.

Members of the public who have accumulated cash savings and are considering other investments generally understand that a person licensed as a broker has been in the real estate business for some time, and is not a newcomer seeking a quick buck or learning at the expense of unwitting investors. They presume the broker has attained some advanced level of technical training and education to qualify for a broker license — as he has.

When a prospective investor is solicited by a broker to join him in the co-ownership of a property, the investor presumes the broker is a licensed professional who has experience working with fellow licensees:

- locating property;
- negotiating purchase agreements;

- arranging financing and leasing; and
- managing property.

These points of expertise are frequently taken for granted as being part of the qualifications requisite to becoming a licensed broker.

Thus, a broker has **something to lose** if he is incompetent — or worse — fraudulent in his representation of the values and attributes of property. A broker's exposure to loss of his license for improper conduct greatly reduces the investor's risk of the moral hazard of investing with a syndicator who does not invest his own cash and would not otherwise suffer if the investment fails for known, readily discoverable or avoidable defects.

Further, brokers carry, or should carry, professional **malpractice insurance**, called *errors and omissions coverage*. The coverage should be disclosed to their investors. Coverage for negligent misrepresentations, available to syndicators who are brokers but not to unlicensed syndicators, further places the investor's mind at ease about the integrity of the syndicator. The coverage provides a source of recovery beyond the investment if the investment is ill-fated for reasons of negligence in conducting a due diligence investigation, providing management services or tending to the care and protection of the property.

Holding a license also authorizes the broker to collect fees paid from the investor's initial contribution of capital, rental income, proceeds from the refinance or resale of the property, and for the professional services he provides.

The syndicator's task then is to live up to the **investors' expectations** by:

- negotiating the most advantageous price and terms for payment of the purchase price that are possible for the acquisition of income property;
- fully analyzing the property and documenting every aspect of a competent due diligence investigation;
- preparing a thorough representation of the advantages and disadvantages of the property that affect its value; and
- having the management experience needed to operate the property as a reasonably well-informed and prudent owner would.

For a syndicator, a broker license lends credibility and stature to his investment program.

Chapter 6 Conflict of interest

This chapter demonstrates a broker's use of a Conflict of Interest Disclosure to avoid breaching the fiduciary duty he owes to his clients when he has a bias relating to other parties whose interests are in conflict with his clients'.

Professional relationships compromised

A conflict of interest arises when a broker or his agent, acting on behalf of a client, has a competing professional or personal bias which hinders his ability to unreservedly fulfill the fiduciary duties he has undertaken to advise and act on behalf of the client.

In a professional relationship, a broker's financial objective of *compensation for services* rendered by the broker is not a conflict of interest. However, fees and benefits derived from professional courtesies, familial favors and preferential treatment by others toward the broker or his agents is compensation which must be *disclosed* to the client. [See **first tuesday** Form 119]

Further, the referral of a client to a financially controlled business, owned or co-owned by the broker, must be disclosed by use of an affiliated business arrangement (ABA) form, and is also not a conflict of interest. [See **first tuesday** Form 519]

A *conflict of interest* addresses the broker's personal relationships potentially at odds with the agency duty of care and protection owed the client.

Thus, a conflict of interest creates a fundamental *agency dilemma* for brokers, not a compensation or business referral issue. A **conflict of interest** exists when:

- a broker has a positive or negative *bias* toward the opposing party in a transaction or a person indirectly involved in the client's transaction; and

- that bias in favor of or against the other person might compromise the broker's ability to freely recommend action or provide guidance to the buyer or seller, landlord or tenant, or lender or broker he agreed to represent.

This bias regarding an opposing person or a party not directly involved, to whom the broker may or may not also owe an agency duty, must be disclosed if the bias might disrupt the broker's ability to make impartial decisions about the care and protection he owes his client. Unless disclosed and the client consents, the conflict is a breach of the broker's fiduciary duty of good faith, fair dealing and trust owed to his client should the broker continue to act on the client's behalf. [See Figure 1 accompanying this chapter]

Situations involving a conflict

A conflict of interest, whether patent or potential, is disclosed by the broker at the time or as soon as possible after the conflict arises. Typically, the conflict arises prior to providing a buyer with property information or taking a listing from a seller.

The disclosure creates transparency in the transaction, revealing to the client the bias held by the broker which, when disclosed, allows the client to take the bias into consideration in negotiations. Though the disclosure and consent does not neutralize the *inherent bias* itself, it does neutralize the *element of deceit* which would breach the broker's fiduciary duty if left undisclosed.

Potential overlaps of allegiance or prejudice which cause a **conflict** that a broker or his agent must disclose include:

- the broker or his agent holds a direct or indirect *ownership interest* in the real estate, or are directly or indirectly a buyer of the property in the transaction, including a partial ownership interest in a limited liability company (LLC) or other entity which owns or is buying, leasing or lending on the property;

- an individual related to the broker or one of his agents by *blood or marriage* holds a direct or indirect ownership interest in the property or is the buyer;

- an individual with whom the broker or a family member has a *special pre-existing relationship*, such as prior employment, significant past or present business dealings, or deep-rooted social ties, holds a direct or indirect ownership, leasehold or security interest in the property or is the buyer;

- the broker's or his agent's concurrent representation of the opposing party, a *dual agency situation*; or

- an *unwillingness* of the broker or his agent *to work* with the opposing party, or others, or their brokers or agents in a transaction.

Simply, a **conflict of interest** arises and is disclosed to the client when the broker:

- has a **pre-existing relationship** with another person due to kinship, employment, partnership, common membership, religious affiliation, civic ties or any other socioeconomic context; and

- that relationship might hinder his *ability to fully represent* the needs of his client.

Unfortunately, comprehensive rules do not yet exist which establish those instances where a conflict of interest arises and needs to be disclosed. Thus, brokers are left to draw their own conclusions when situations regarding a property or a transaction with or involving third parties arise. In practice, brokers (and especially agents) all too often err on the side of nondisclosure, putting their brokerage fee, if not their license itself, at risk.

Generally, if a broker even questions whether it is appropriate to disclose a potential conflict of interest to a client, he should disclose it. The existence of any concern is reason enough for a prudent broker to be prompt in seeking his client's consent to the potential conflict. By timely disclosing a conflict of interest and obtaining consent, the broker immediately creates an honest working relationship with his client.

The client's tardy discovery of the conflict and their complaint to the Department of Real Estate (DRE) for failure to make the disclosure and obtain consent before continuing to advise or act on behalf of the client can result in the suspension or revocation of the broker's license by the DRE. [Calif. Business and Professions Code §10177(o)]

Fundamentally, a broker who becomes aware he has a conflict of interest but is reluctant to disclose it and seek the client's consent should consider rejecting or terminating the employment with that individual.

Figure 1

CONFLICT OF INTEREST
(Kinship, Position or Undue Influence)

NOTE: Licensed Brokers and Sales Agents when acting on behalf of a client may not act in a manner which might cause the client to conclude that others, or a position held by the Broker or his Agents, can improperly influence or cause the Broker or his Agents to fail to properly act in their fiduciary capacity as an agent without first disclosing to the client the facts which might otherwise lead to that conclusion and obtaining their consent.

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This disclosure is made in connection with the following agreement:

☐ Listing (Employment) Agreement ☐ Purchase Agreement
☐ Escrow Instructions ☐ _____

1.1 ☐ of the same date, or dated _____, 20_____, at _____, California,
1.2 entered into by _____, as the _____, and
1.3 _____, as the _____,
1.4 regarding real estate referred to as _____.

2. The client(s) represented by the undersigned Broker with regard to the above referenced agreement is/are identified as the _____.

DISCLOSURE OF CONFLICT OF INTEREST:

3. Broker provides the following information as a disclosure to the client of relationships or positions held by Broker or his Agents, and their family members, in investments, business activities or real estate interests which present circumstances that might, if not disclosed, appear to be in conflict with the agency duty owed the client to care for and protect the interests of the client.

Check the following items and enter information on facts which are believed might create a conflict of interest for Broker or his Agents in performing their agency duties on behalf of the client.

3.1 ☐ Real estate
Property type: _____
Address: _____
Interest held: _____
Activity creating conflict: _____

3.2 ☐ Government agency
Agency name: _____
Position held: _____
Activity creating conflict: _____

3.3 ☐ Business position
Business name: _____
Goods or services provided: _____
Position held: _____
Activity creating conflict: _____

3.4 ☐ Business investment
Company name: _____
Type of trade or business: _____
Interest held: _____
Activity creating conflict: _____

— *PAGE ONE OF TWO — FORM 527* —
— *PAGE TWO OF TWO — FORM 527* —

3.5 ☐ Representation of others in transaction
Name of person also owed agency duties: _____
Activity creating conflict: _____

3.6 ☐ Kinship and employee relationships
Name of individual(s): _____
Relationship with Broker or employee: _____
Activity creating conflict: _____

4. Other disclosures of direct or indirect compensation or economic benefits may have previously been made, such as exists for additional compensation and controlled business arrangements. [See **ft** Forms 119 and 519]

BROKER:

5. I certify that the above information is true and correct.

Date: _____, 20_____ Broker's Name : _____
By: _____
Agent's Name: _____

CLIENT: I have received a copy of this disclosure and consent to continue the relationship with the broker as my agent.

☐ See attached Signature Page Addendum [**ft** Form 251]

Date: _____, 20_____

Name: _____ Name: _____

Signature: _____ Signature: _____

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Relative's participation in a transaction

A seller's broker must disclose the broker's acquisition of any direct or indirect interest in the seller's property, or whether a family member, a business owned by the broker or any other person holding a special relationship with the broker (such as his agents) will acquire an interest in the seller's property. [See **first tuesday** Form 527 §3.6]

For example, a broker's brother-in-law makes an offer to buy property the broker has listed. The purchase agreement states the broker is to receive a fee and that he represents the seller exclusively.

The broker does not disclose to the seller that the buyer is his brother-in-law.

The broker opens two escrows to handle the transaction. The first escrow facilitates the sale and transfers the property from the seller to the broker's brother-in-law.

The second escrow is for the sole purpose of transferring title to the property from the brother-in-law to a limited liability company (LLC) in which the broker holds an ownership interest, a syndicated acquisition. Both escrows close and the broker receives his fee.

The seller discovers the buyer to whom he deeded the property was his broker's brother-in-law and that the true buyer was an entity partially owned by the broker. The seller demands a return of the brokerage fee claiming the broker had a conflict of interest which breached the fiduciary duty he owed to the seller since it was not disclosed and the seller did not consent.

Here, the broker is not entitled to retain the brokerage fee he received from the seller. Further, the seller is entitled to recover any property value at the time of the sale in excess of the price he received, or he can set the sale aside, due to the failure of the broker's agency with the seller.

A broker cannot act for more than one party in a transaction, including himself, without disclosing his *dual role* and obtaining the client's consent at the time the conflict arises. [Bus & P C §10176(d); see **first tuesday** Form 527]

Also, a seller's broker has an affirmative duty to disclose to the seller his agency or other conflicting relationship he might have with the buyer, even if the seller fails to inquire into whether the broker has a relationship with the buyer.

Further, failure to disclose a broker's personal interest as a buyer in a transaction when he is also *acting as a broker* on behalf of the seller constitutes grounds for discipline by the Real Estate Commissioner. [**Whitehead** v. **Gordon** (1970) 2 CA3d 659]

A relative owns the property sold

A selling broker employed to act on behalf of a buyer will disclose to his buyer the nature and extent of any direct or indirect interest he or his agents hold in any property presented to the buyer.

For example, a licensed broker acting as an agent on behalf of a buyer shows the buyer several properties, one of which is owned by the broker and others, vested in the name of an LLC. The broker promptly informs the buyer he has a listing on the property, but does not inform the buyer of his indirect ownership interest in the property.

The buyer later decides to purchase the LLC property. An offer is prepared on a purchase agreement form with an agency confirmation stating the broker is the agent for both the buyer and seller. The offer is submitted to the LLC. [See **first tuesday** Form 159]

The broker, aware the buyer will pay a higher price for the property than the initial price offered by the buyer, presents the buyer with a counteroffer from the LLC at a higher selling price. The buyer accepts the counteroffer

Here, the broker has a duty to promptly disclose his ownership interest in the property to the buyer the moment the conflict arises – the exposure of the buyer to the property. The conflict of interest in the broker's ownership is a material fact requiring disclosure since the buyer's decisions concerning acquisition of the property might be affected.

As a result of the lack of disclosure of the conflicting position of the buyer's broker, the buyer can recover the fee received by the broker and the increase in price under the counteroffer.

Had the buyer known the broker held an ownership interest in the property when it was first presented, he might have negotiated differently when setting the price and terms for payment, or he might have retained a different broker who was not compromised by a conflict of interest to represent his interests.

However, a broker acting solely as a principal in the sale of his own property is not restricted in his conduct by compliance with agency obligations. The broker selling or buying property for his own account should act solely as the seller or buyer, rather than pay himself a taxable fee for *also acting as a broker* in the transaction which then exposes him to claims of agency violations. [**Robinson** v. **Murphy** (1979) 96 CA3d 763]

Taking a fee when acting as a principal

When a broker-seller receives a brokerage fee on the sale of his own property or on the purchase of property for his own account, he subjects himself to real estate agency requirements.

For example, a broker sells a residence he owns which exists in violation of safety requirements for occupancy due to defects in the foundation known to the broker. The broker does not tell the buyer about the foundation defects.

Out of the proceeds the broker receives on closing the sale of his property, the broker-seller pays himself a brokerage fee, claiming to *exclusively represent himself* (which is not an agency and does not require a license).

The buyer later discovers he must demolish the residence and rebuild it with an adequate foundation. The buyer obtains a money judgment against the broker for breach of his general agency duty owed to all parties in a real estate transaction to disclose known property defects that cause the buyer to take a loss.

The broker is unable to pay the money judgment. The buyer seeks payment from the DRE Recovery Fund.

Recovery is received from the DRE Recovery Fund since the broker held himself out as a**cting as a real estate broker** in the transaction – he received a fee. The broker's license is then suspended. Before the broker can reactivate his license, he must reimburse the DRE Recovery Fund. [**Prichard** v. **Reitz** (1986) 178 CA3d 465]

The licensee acts solely as a principal

A DRE licensee acting solely as a principal on his own behalf when buying (or selling) property need not disclose the existence of his real estate license. The licensee has no conflict due to the **existence of his license** since he is not holding himself out as a broker or agent acting on behalf of another person in the transaction.

Consider a broker who is employed by an owner to arrange a real estate loan. The lender making the loan is the broker's sister.

The broker, however, funds the loan himself by depositing his personal funds into his sister's account. In essence, the broker is the lender.

The owner is not advised of the kinship between the broker and the lender, or of the true source of the loan funds. [See **first tuesday** Forms 205-1 and 205-2]

Here, the broker has a duty owed to the buyer to disclose his **dual capacity** in the loan transaction. He was acting both as a broker arranging the loan on behalf of the owner and as the lender making the loan, a conflict of interest. The broker's actions constitute grounds for discipline by the Real Estate Commissioner. [**Tushner** v. **Savage** (1963) 219 CA2d 71]

Conflicts in real estate syndication

A potential conflict of interest also exists when a broker manages multiple LLCs which own like-type properties in the same market area, the result of his syndicating the acquisition of several properties.

For example, consider a broker entrusted with managing two investment groups which own similar apartment projects located within the same market and compete for the same prospective tenants. The broker is paid a management fee by each investment group based on a percentage of the rents received.

When contacted by a prospective tenant, the broker is initially faced with the dilemma of which apartment building to refer the tenant to and thus which investment group will benefit from the tenant's occupancy.

A similar conflict of interest results from parallel transactions in which multiple LLCs managed by the same broker are actively competing to sell or buy property within the same marketplace.

A conflict of interest of this nature must be disclosed to the investors before they agree to participate as members in an LLC the broker manages. This disclosure is contained in **first tuesday** Form 371, Investment Circular provision 6d, which states:

- The Manager has numerous other business responsibilities and ownership interest which will demand some or most of his time during the LLC's ownership of the property. The Manager's other interests include ownership of projects comparable to the property purchased in this transaction. To the extent his time is required on other business and ownership management decisions, he will not be involved in monitoring or marketing of the LLC's property. [See **first tuesday** Form 371]

With this disclosure, the broker's allegiance to multiple projects and investment groups is transparent and can be taken into consideration by all investors at the time they receive the Investment Circular from the Broker – before investing and consenting to the risk.

Compensation and earnings received by the broker

Direct or indirect compensation received by a broker must be disclosed to his client but not as a conflict of interest. A Compensation Disclosure form is prepared, setting forth the amount of compensation, its form and source as additional benefits the broker and his agents anticipate receiving for any other service they provide as a result of the client's entry into a real estate transaction in which the broker is acting as a licensee. [Bus & P C §10176(g); see **first tuesday** Form 119]

Additionally, a broker listing a property or representing a buyer who refers the owner or buyer to a business or service provider he owns or co-owns uses an Affiliated Business Arrangement Disclosure Statement to inform the party of his ownership interest in that company. The disclosure enables the broker to indirectly benefit from the referral and properly share in any profits from the referrals he makes to businesses he controls. [See **first tuesday** Form 519]

Chapter 7 Retaining a real estate attorney

This chapter reviews the process for locating, interviewing and retaining an attorney to advise and render services in real estate disputes confronting broker-syndicators.

Choosing the right one

Oftentimes in syndication activities, it is necessary or advisable for the syndicator, the investors or the LLC as a group to seek the legal counsel of an attorney.

Consider a syndicator faced with a dispute arising out of his activities as a manger/investor in a real estate syndicate. He requires advice from an attorney with legal expertise in the analysis and resolution of real estate conflicts.

The broker has never sought out the professional advice of an attorney and does not know how to go about locating or selecting a qualified one.

What steps should the broker take to select a competent attorney? What law office procedures should he look for when first meeting with an attorney? What can he expect to encounter when retaining an attorney?

Selecting an attorney

To initiate the attorney **selection process**, the broker should talk to several active real estate brokers in the area where the affected real estate is located. The brokers should be asked for the names of three or four real estate attorneys they are familiar with and feel confident referring someone to for advice on real estate and agency matters, especially of the type confronting the broker.

The broker should further inquire into the different areas of real estate law each attorney appears to be engaged in, the types of cases they handle and the competence demonstrated by the attorney as observed by the brokers he contacts. The recurrence of the name of one attorney who is consistently recommended by the brokers contacted is generally a helpful indication of the most qualified attorney.

While attorney referral services and media advertising may be helpful in the initial selection stage, it is difficult to obtain objective recommendations or criticism from these typically biased sources.

It may even be necessary to locate an out-of-area attorney who specializes in the particular type of legal situation confronting the broker due to the sensitivity of local attorneys.

Regardless of locale, at least two or more attorneys should be selected and phone or office conferences should be arranged.

Before (and after) selecting an attorney, it is both proper and prudent for the broker to contact yet another attorney and hold a telephone conference as a “brainstorming session.” This would provide a second opinion — and an additional or alternative advisor. The cost of conferencing with another attorney should be considered the premium paid for assurance that the broker and his selected attorney are on the right track, called *risk reduction*.

A client's expectations

When meeting with an attorney, the broker should consider many aspects of the attorney's law office, including:

- the compatibility of the attorney's personality with his own;
- the attorney's conversational skills;
- the efficiency and professionalism of the attorney's work habits;
- the law office's appearance (for example, does it appear organized and well equipped?);
- the courtesy, productivity and helpfulness of the secretarial staff; and
- the competency of the attorney's law clerks or legal assistants to follow up on fact investigation, legal research, calendaring of events and related details.

The initial conference

During the initial conference with the selected attorney, the broker will discuss his real estate dispute as well as interview the attorney. This contact is the initial step to determine whether or not the broker feels this attorney is the best one for him to retain.

Relevant topics which should be discussed during the initial interview include:

- the attorney's professional background and the types of legal disputes which make up his practice;
- the attorney's previous experience with cases similar to the broker's;
- whether his practice regularly calls for his appearance in the court which will hear the broker's case;
- the attorney's initial grasp and assessment of the facts and laws controlling the case;
- the outlook or probability of prevailing in the case;
- the different procedural stages, including negotiations, filing, discovery, trial and possible appeal;
- whether the dispute is covered by any insurance policies held by the broker;
- the potential liability exposure on an adverse result of the litigation;
- whether the prevailing party can collect his attorney fees from the other party;
- the attorney's hourly fee and required *retainer deposit*;
- the estimated cost of handling the various stages in the resolution of the dispute; and
- the tax reporting permitted for the payment of the attorney fees.

At the same time, the attorney will also be deciding whether or not he wants to represent the broker.

Additionally, bearing on the broker's decision to retain the attorney are factors including:

- the attorney's own knowledge and experience with this particular type of case, and his rapport with the broker;
- whether or not, and why, the attorney believes he can obtain a favorable result for the broker; and
- whether the attorney has a conflict based on his other cases and clients.

The broker will typically be billed for this initial consultation on a per hour basis. Attorneys' hourly rates generally range from $150 to $400 per hour, depending on their location and expertise. Any time spent counseling with the attorney will cost the broker money.

The broker must also determine whether the attorney will handle the case himself or delegate the analysis and decision-making process to a subordinate or partner. If delegated, to whom and how closely will the attorney supervise the handling of the case?

The broker also needs to interview any associate attorney who will work on or actually handle his case. A prudent broker will include any associate attorney in the conference to avoid double billing.

The broker must be certain the attorney or associate he is going to employ has the broker's best interests in mind.

An attorney has the basic duty to respond promptly to any status inquiries by the broker and keep the broker reasonably well informed, monthly if possible, on matters relating to the case. [Calif. Business and Professions Code §6068(m)]

If the attorney interviewed is not retained to represent the broker, the attorney still has the duty to maintain confidentiality of the information exchanged between him and the broker. [Bus & P C §6068(e)]

Retainer agreements

Once an attorney has been chosen, the broker will be asked by the attorney to enter into a *retainer agreement* employing the attorney. The attorney has a statutory right to collect a fee for his legal services. [Calif. Code of Civil Procedure §1021]

The attorney should fully explain the amount of fees or basis for their computation before the fee agreement is signed by the broker. To be enforceable, fee agreements for attorney services must be in writing when it is known the attorney fees will exceed $1,000. [Bus & P C §6148(a)]

Thus, written **retainer agreements** must contain:

- the hourly rate and other rates, fees and applicable charges;
- the nature of the services to be provided; and
- the respective responsibilities of the attorney and broker in performance of the retainer agreement. [Bus & P C §6148(a)(1-3)]

All billings for services must be itemized by naming the activity performed, clearly state the amount due and contain the hourly rate or basis of calculation used to determine the fees. [Bus & P C §6148(b)]

If a *contingency fee* agreement is negotiated, the agreement must be in writing and contain:

- a statement of the **contingency fee** rate;
- a statement addressing how disbursements and costs incurred in connection with prosecuting or settling the case will affect the amount of the contingency fee and the broker's recovery;
- a statement addressing what extent, if any, the broker could be required to pay attorney fees for related matters not covered in the fee agreement; and
- a statement the fee is negotiable and not set by law. [Bus & P C §6147(a)(1-5)]

A duplicate copy of the contingency fee agreement signed by the attorney and broker must be given to the broker. Failure to provide this information will render the retainer agreement voidable at the option of the broker. [Bus & P C §6147(b)]

Later, if the broker has grounds and chooses to void the contingency fee agreement, the attorney will be entitled to collect a reasonable fee from the broker based on the time spent on the case. [Bus & P C §§6147(b), 6148(c)]

The retainer agreement can also be signed by and given to a representative of the broker, such as his office manager. [Bus & P C §6147(a)]

Written fee agreements are confidential contracts between the attorney and his client, in this example the broker. [Bus & P C §6149]

Deductibility of legal fees

Deductibility of legal fees for tax reporting is determined by the activity causing the expense. If not deductible, the legal fees are either **personal losses** or a **capital investment** added to the cost basis of the property involved.

Legal fees fall into four federal tax reporting categories:

- personal expenses;
- business expenses;
- real estate rental (passive) expenses; or
- investment portfolio expenses.

Legal fees incurred for consultation on a broker's business-related matter are fully deductible as an expense of earning brokerage fees, the trade for which he holds a broker's license.

Legal fees incurred in the management, conservation or maintenance of income-producing real estate — rentals — or for the production or collection of rents, are **deductible** from rental income, a passive income category activity, as an expense. [Internal Revenue Code §212]

However, legal fees incurred in connection with zoning battles, title defenses, condemnation or acquisition must be *capitalized*, not expended. These expenditures are added to the property's basis as they are considered **capital expenditures**, not operating costs. [**Soelling** v. **Commissioner** 70 TC 1052]

Legal expenses incurred to preserve ownership or defend title to an owner's personal residence are **non-deductible** personal expenses.

When employing an attorney, it is prudent for the broker to ask for his advice on the tax deductibility of his fees and, in contingency cases, the reporting of the attorney's share of any recovery.

Itemized billings

The broker should ask for and review a typical or prototypical billing statement used by the attorney.

The billing statement should be itemized, describing each legal activity or service provided by the attorney or his staff, the date the service was performed, the time spent rendering the service and the fee charged or the cost of each item.

The statement should also state the amount due and the hourly rate or other basis for calculating the fees. [Bus & P C §6148(b)]

Should the broker request a billing at any time, the attorney must provide one within ten days following the request. [Bus & P C §6148(b)]

The broker is entitled to receive invoices at intervals of no less than 30 days following his initial request for a billing statement. [Bus & P C §6148(b)]

The attorney's failure to meet these requirements will render the fee agreement voidable at the option of the broker. However, if the broker elects to void the retainer agreement, the attorney will be entitled to collect a reasonable fee. [Bus & P C §6148(c)]

Other factors influencing selection

Additional factors the broker should consider before selecting an attorney to represent him include:

- the attorney's familiarity with real estate law and how up to date he is on any statutory, case law and regulatory changes;
- if the attorney will review the file on a monthly or other periodic basis;
- if the attorney will automatically provide the broker with copies of all correspondence, documents and papers related to the case, and at what cost;
- if the attorney will consult with the broker on any substantial issues which may arise before he makes a decision or takes action; and
- if the attorney will review insurance policies (i.e., homeowner's policies, business insurance, errors and omissions insurance) to determine if legal fees are covered.

If the dispute is covered by insurance, the insurance carrier may reserve its right to choose the broker's attorney. However, in some circumstances involving the insurance company's issuance of a reservation of rights, the broker is allowed to select his own attorney in addition to the attorney selected by the insurance carrier.

Chapter 8 Selecting suitable investors

This chapter analyzes a syndicator's need to associate with a few congenial investors who desire a long-term investment and appreciate the ownership risks of a cyclical investment.

Profiling for investment longevity

Investors do some amount of background investigations and are fairly selective when they consider entrusting a real estate syndicator with the on-going management of the capital they contribute.

Likewise, a syndicator should collect information regarding the attributes of each potential investor he solicits to join in the investment with him. An analysis of **character types** for selection and solicitation of qualified investors allows the syndicator to enhance his chances for long-term success in his investment programs.

Personal information on potential investors is typically compiled by the syndicator over time. It is then retained on an investor profile form prepared on each potential investor. The completed forms are placed on file in a database of prospective investors. [See Form 350 accompanying this chapter]

Before soliciting investors for a particular property acquisition, the syndicator must set a limit on the **number of members** he would like to participate. Three to six cash investors seem to be the preferred range. The more investors brought into a group, the more likely there will be difficulties communicating with each member and managing co-ownership issues when they arise.

To maintain equilibrium of influence within the group, the amount contributed by each investor should be nearly the same amount as contributed by the other investors. Thus, no one investor has implicit undue influence to dominate the conduct of group activities. A general rule suggests no one investor should have more than twice as much invested as any other single investor. Ideally, all investors should make identical amounts of cash contributions to the investment. All investors will then be more likely to treat each other equally.

When soliciting investors, the syndicator should consider each individual's financial capacity and long-term propensity to stay with an investment in real estate. If a prospective investor has cash but is not creditworthy, he may be unreliable as a long-term participant due to potential future demands on his invested capital by creditors.

Also, if additional contributions are later needed to carry the limited liability company (LLC) through a cyclical negative cash flow period, the financially unstable investor may be unable or unwilling to further contribute.

An individual's negative creditworthiness condition usually results from a failure to look ahead at the consequences of his doing nothing, a prelude to lost opportunities for all connected with him in an investment program. Especially trying for some erstwhile investors is the stress of the local economy moving through a cyclical recessionary period when property underperforms.

When selecting prospective investors, be skeptical of any investor who appears to be disinclined to compensate the syndicator for his promotional and administrative activities. The individual probably views

CLIENT PROFILE

Confidential Personal Data Sheet

NOTE: Use of this form assists in collecting information about an individual's personal traits, family obligations, composition of wealth, community integrity and accomplishments to better inform the Broker/Agent about the individual's wants and needs.

DATE: _____, 20_____, at _____, California.

1. Personal information:

1.1 Name _____

a. Address _____

b. City _____ State _____ Zip _____

c. Phone _____ Fax _____ Email _____

d. Age _____ General health _____

e. Length of time in the community _____

f. Personal achievements _____

1.2 Occupation _____

a. Professional designations & licenses _____

_____

b. Business address _____

c. City _____ State _____ Zip _____

d. Business phone _____ Fax _____ Email _____

1.3 Marital status _____

a. Spouse's name _____

b. Spouse's occupation _____

c. Children – names & ages _____

_____

1.4 Membership in cultural or civic organizations _____

a. Religious preference/time dedicated _____

2. Financial information:

2.1 Gross annual income . . . . . $_____

2.2 Interest income . . . . . $_____

2.3 Dividend income . . . . . $_____

2.4 Spendable income (real estate) . . . . . $_____

2.5 Approximate net worth
(excluding home, car and furnishings) . . . . . $_____

Cash on deposit . . . . . $_____

Liquid stocks & bonds . . . . . $_____

Net equity in real estate . . . . . $_____

2.6 Investor can make additional capital
contributions in the annual amount of . . . . . $_____

Source of funds _____

2.7 Cash value of life insurance . . . . . $_____

3. Investment background:

3.1 Stocks, bonds or commodities _____

_____

_____

3.2 Real estate owned other than residence _____

_____

_____

3.3 Investor involvement in partnership(s) _____

_____

_____

4. Investment needs (explain briefly):

4.1 Tax benefits _____

4.2 Spendable income, loan reduction or increased value _____

4.3 Short-term investment goals (less than 5 years) _____

4.4 Long-term investment goals (five or more years) _____

5. Investor's advisors:

5.1 Accountant _____

5.2 Insurance broker _____

5.3 Banker _____

5.4 Attorney _____

5.5 Stockbroker _____

5.6 Real estate broker _____

6. Educational background:

6.1 Degrees and majors _____

6.2 Real estate or law courses studied _____

7. Investor's special interests (hobbies, clubs, etc.):

_____

8. Personality traits:

8.1 Positive and decisive? ☐ Yes ☐ No

8.2 Negative and evasive? ☐ Yes ☐ No

8.3 Passive and compliant? ☐ Yes ☐ No

9. Relationship with broker:

9.1 Brief description of previous relationships (business, social, civic) with investor: _____

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the syndicator as suspect. As a member in an LLC, the suspicious investor is more likely to later blame the syndicator for an adverse shift in local market conditions and be unwilling to remain in the investment or contribute additional capital on a call from the syndicator.

Investor uniformity

Investors who are selected by the syndicator should be:

- *objective* in their approach to problem solving and not prone to act on their emotions;
- *goal-oriented* when analyzing the syndicator's expectations for ownership of the property and looking forward into the economic future for the property;

- *willing to commit* their capital and share earnings (or losses) of ownership as a group, an acknowledged joint effort from the start;

- *willing to leave* the day-to-day management of the program to the syndicator, as authorized by the operating agreement and the property management agreement; and

- *willing to provide* the syndicator with a fair and competitive amount of compensation in ownership and cash for his acquisition and management efforts.

A group of investors from **comparable backgrounds** is more likely to produce a smooth running investment program in spite of cyclical shifts in the economy. Socioeconomic similarity between investors safeguards against inconsistent investment attributes and expectations. To ensure investor uniformity, a syndicator should consider the following:

- location of their residence (preferably within the same community);

- age group — younger investors are more likely to accept and absorb high risk investments, whereas older, more stable investors who have accumulated their net worth over a long period of time are less likely to take such risks;

- extent of their personal achievements;

- economic standards (similar personal net worth, annual income and family needs);

- business background, occupational experience and creditworthiness;

- level of formal education;

- longevity of their family in the community; and

- prior investment, civic and social activities.

The geographic location of the investor is a consideration in choosing an investor. However, in the increasingly global economy, it should not be taken for granted that investors from different locations may also have the required temperament, experience and other characteristics necessary to undertake California real estate investments. No restrictions exist which prohibit domestic or foreign nonresidents from owning a membership interest in California real estate syndicates. There are, however, additional tax considerations when involving nonresident members in an LLC. [See Chapter 16]

The weeding process

Some prospective investors possess characteristics that are not accommodating or desirable in an LLC syndication program. The syndicator should avoid prospective investors who demonstrate:

- an *improper emotional makeup* to remain in a long-term investment;

- a suspicious or nit-picking (micro-managing) *attitude that conflicts* with the profit-sharing, joint-venture theme of a group investment program, manifested by asking detailed questions about the syndicator's day-to-day operations of the property that appear designed to "catch" him in inconsistent explanations rather than honestly trying to better understand the long-term risks of loss the real estate or the economy may present for the investment; or

- an *excessive concern* for the *modus operandi* of the syndicator, making inquiries with the apparent intention of learning enough from the syndicator about his property selection analysis and the organizational requirements for forming an investment group to enter the real estate investment field himself as a promoter and micro-manager of capital raised from his acquaintances.

Chapter 9 The distribution of income

This chapter reviews each member's ownership share in the limited liability company based on the percentage their capital contribution represents of the total of all forms of member contributions.

Contributions set share of ownership

Consider a limited liability company (LLC) that is initially capitalized at $500,000–$400,000 in **cash** contributed by the investors and $100,000 in the value of the syndicator's contribution by **assignment** of his right to purchase the property acquired by the LLC.

The cash investors receive Class A *priority* membership interests in the LLC set at $400,000. In contrast, the syndicator receives a Class B *subordinated* membership interest in the LLC set at $100,000 for the **property rights** he assigned to the LLC.

The combined capital contributions of all members is $500,000, comprised of the cash contributions ($400,000) of the Class A cash investors and the Class B contribution ($100,000) of the syndicator. The ratio of each member's contribution to the total of all contributions to the LLC sets his percentage of ownership in the LLC. Thus, the Class A members collectively hold an 80% participation in ownership; the syndicator, a 20% participation.

The vesting of ownership to the property purchased will be in the name of the LLC, not the members or the syndicator. The members own the LLC, not the real estate, unless the stated purpose of the LLC is to hold title in trust for the members as tenants in common who then co-own the real estate.

From the $400,000 in cash contributions, $340,000 is used as a down payment to fund the acquisition of the property — funds the LLC needs to close the purchase escrow and acquire title.

Also from the cash contributions, $30,000 is placed in a reserve account the LLC maintains. From the reserve, the LLC pays miscellaneous closing costs, attorney fees, accounting fees, printing costs and other out-of-pocket **transactional expenses** incurred to create the LLC and purchase the property. The balance remaining unused in the reserve account after payment of transactional costs serve as a contingency fund for unexpected operating expenses that typically confront a new owner of property.

The remaining $30,000 is paid to the syndicator as a fee to compensate him for his **time and effort** spent soliciting investors to become members and fund the LLC. The cash fee is in addition to his 20% subordinated membership interest received in exchange for the assignment of his contract right to purchase the property.

The syndicator's contribution and share

Typically, a syndicator is not also a cash investor. The dollar amount of the **membership share** he receives in the LLC is based on the dollar value the syndicator places on the contract right he assigns to the LLC to purchase the property. In exchange for the assignment, the syndicator receives a dollar amount of Class B subordinated interest in the LLC, the requisite to establishing his percentage share of membership.

The cash investors — one of whom could be the syndicator if he also contributes cash — hold Class A memberships. As cash contributors, Class A investors receive a **priority distribution** of earnings under the LLC operating agreement, including:

- **spendable** income from operations; and
- **net proceeds** from the refinance or resale of the property.

For example, the operating agreement entitles the Class A members to first receive a distribution of annual spendable income generated by the property. Only then may the syndicator (and any other Class B member) receive spendable income. This priority distribution to Class A members is limited in amount to an annual percentage on their cash contribution, a *cash-on-cash* return comprising capital (due to depreciation deductions) and ordinary income.

The spendable income the syndicator receives as his **subordinated distribution** is the same annual percentage return on the dollar amount of his contribution as the Class A investors have received on theirs.

Any spendable income then remaining is next distributed among all the members pro rata, based on the percentage share they hold in the LLC without concern for priorities or subordination, called a *parity distribution*.

However, a different ratio of sharing between classes is occasionally established for these parity distributions. For example, the spendable income remaining after priority distributions might be distributed 50% to Class A members and 50% to Class B members.

Thus, the syndicator has greater incentive to increase spendable income, since he will share in spendable income disproportionately to ownership and for his greater benefit. This self interest in increasing spendable income in turn increases the property's value. Over time, and due to inflation's effect of driving up rents and spendable income, these alternative percentages for sharing can shift great wealth to the syndicator.

Distribution of the net proceeds from a refinance or sale of the LLC property follows a similar priority format for sharing. The Class A members receive the first distribution of proceeds from a refinance and sale up to the dollar amount of their original contributions, plus any unpaid minimum annual distributions. Any portion of the annual minimum rate of return that is not distributed during prior periods of ownership accumulates and is distributed as funds from any source become available.

Next, the Class B syndicator receives a distribution from the refinance and resale proceeds up to the dollar amount of his capital contribution, plus any annual minimum rate of return that has not been distributed and has accumulated unpaid.

Any proceeds that remain are typically distributed on a parity basis to all members. For example, the agreement may call for the remaining funds to be distributed to all members based on their percentage of membership, or on a different ratio, such as a 50-50 split between the Class A and Class B members or any other ratio agreed to.

Finally, the manager, as a licensed real estate broker, may receive a fee on the management, refinance, and sale of the property. The right to a fee must be contracted for in the operating agreement. As payment for services, the distribution of brokerage fees has priority over distribution to capital investors.

Chapter 10 Sharing through services and capital contributions

This chapter presents the compensable activities of a syndicator, the methods for payment of that compensation and arrangements for sharing income and profits with the co-owners.

The tradeoff in priority distributions

An income property produces an annual *net operating income (NOI) or loss* during any given time period, no matter how well managed it may be. During the same period, the property will experience an annual rise or fall in the dollar amount of its fair market value. Value fluctuations are triggered by national price inflation and local appreciation for the property, again with no correlation to the management of the property.

For the owner, the NOI and any rise in value make up the sum of the earnings generated by the property during any given period of time.

When an income property is co-owned by investors and a syndicator, the earnings produced annually by rental income and rising property value are shared between them. Any increase in one co-owner's share of the earnings, such as the syndicator's share, produces an **equal decrease** in the earnings remaining available to the other co-owners, such as the investors, a perfect example of a *zero-sum game*.

Here, in the environment of a syndicated investment, that portion of the property's earnings (NOI and value) taken by the syndicator reduces the amount of rental income and property value available for disbursement to cash investors. On the other hand, a **priority allocation** of spendable income, loan reduction and increased property value to cash investors draws down the earnings available for distribution to the syndicator. Thus, all co-owners share, under one form or another, in an **absolute sum** of dollars represented by the NOI remaining after interest expenses and any rise in value generated by the property.

Share and share alike

Consider the amount of $300,000 as a down payment a syndicator has negotiated for the purchase of a property. The down payment is funded by contributions of $50,000 from each of six investors who join with the syndicator to co-own the property. The syndicator receives a $50,000 share in ownership for locating the property and contracting to purchase it. The total capital contribution from all members and in all forms is $350,000.

Any percentage of the income and profits the syndicator is to receive for his share of ownership reduces the earnings available to the cash investors who funded the entire down payment made to acquire the property.

Here, the cash investors put up 100% of the funds needed to buy the property, but receive only 86% of the ownership. The syndicator's $50,000 co-ownership valuation represents 14% of the total $350,000 capitalization of the investment group. Thus, the purchasing power of the investor's cash has been diluted by the percentage of ownership held by the syndicator, referred to as *watered stock*.

The property is acquired by the group at its current fair market value. Further, the syndicator receives no part of the down payment from the seller or anyone else, such as a lender, the listing broker (or seller), a title company or other provider of services for the purchase transaction. Thus, the syndicator

receives no compensation or benefits for his efforts, other than the percentage of co-ownership he was able to justify to the satisfaction of the cash investors as the value of his purchase rights assigned to the limited liability company (LLC). He will receive 14% of all distribution of income and profits.

The moral hazard in parity sharing

To continue, consider the sale of the same income property by the group one year later. The price received reflects an increase in value equal to the transactional costs incurred to sell the property (an increase of approximately 6%). Thus, the net proceeds from the resale are $300,000.

On distribution of the net sales proceeds to the investment group composed of the syndicator and the six investors, the syndicator will receive his piece of the action: 14%, or $42,857. The investors will receive the 86% remainder of the proceeds, or $258,000. Thus, each of the investors who funded the entire down payment will receive $42,857 as the return of their $50,000 investment, resulting in a cash loss on the sale exceeding $7,000 apiece.

Here, the investors acquired *parity ownership* with the syndicator. Parity allows the syndicator to share and share alike with the investors all the net cash on the resale, creating a *risk of loss* known as a **moral hazard.** The syndicator will receive cash on any sale without concern for the quality of the property selected, the day-to-day operations, care of the property or the effective marketing of the property to obtain the highest resale price.

A syndicator who shares in the net sales proceeds is on a **parity basis** with the investors. His compensation is not contingent on his performance or subject to a priority return of the investors' cash contributions. The **risk of loss** situation created by parity participation allows the syndicator to merely sit and wait for a sale in order to benefit financially from his initial syndication efforts.

The likelihood of a financial return

Investors need to be provided with a reasonable likelihood their invested capital will be returned to them together with the income and profits they have been led to anticipate on their investment. To attain these objectives, the investment program needs to include a mix of:

- cash distributions based on a mix of priorities, subordination and parity participation between all co-owners;
- front-end reimbursement of the syndicator's out-of-pocket expenditures for acquisition (transactional) costs, LLC organizational expenses and purchase agreement deposits;
- participation by the syndicator as a co-owner in lieu of a cash payment for the assignment of his purchase rights to the LLC;
- fees for services performed by the syndicator to form the LLC, prepare an investment circular (IC), locate investors and for property management during ownership of the property;
- cumulative minimum annual earnings on contributions;
- separate classes of ownership for the different tiers of sharing arrangements; and
- fees and earnings due the syndicator based on graduated percentages for achieving higher levels of income and profit.

Also encouraging for investors is an investment program that lacks:

- parity participation between the investors and the syndicator in distributions [See Chapter 9]; and

- up-front fees to the syndicator exceeding the reimbursement of his out-of-pocket costs for LLC organization and transactional costs of property acquisition.

The phases of a syndicated investment

As a prerequisite to structuring the sharing of earnings and wealth flowing from a property, a dollar value must be placed on the syndicator's participation in ownership. Once the dollar value is set, the **percentage** of each co-owner's contributions to the total of all contributions made establishes the basis for participation in income, profits and the return of capital.

The following outline chronicles the activities that go on during the three phases of the **syndicator's participation** in a syndicated investment program:

Phase 1. The pre-acquisition period

1.1 Search for and locate suitable property.

1.2 Select a property that appears suitable to acquire based on unconfirmed seller disclosures.

1.3 Enter into a letter of intent or an agreement to purchase the property at a price (which includes a brokerage fee payable to the syndicator for his services).

1.4 Complete a due diligence investigation and either terminate negotiations and cancel the agreement, or proceed to perform the purchase agreement.

1.5 Dictate and execute escrow instructions to process the closing of the purchase agreement.

1.6 Deposit good-faith money in escrow and arrange mortgage financing.

1.7 Prepare an IC.

1.8 Prepare the LLC (or tenancy-in-common) operating agreement, setting the ratios and formulas for investor and syndicator participation in earnings.

1.9 Solicit commitments from investors to contribute cash.

1.10 Record the LLC articles when the investment is fully subscribed.

1.11 Assign the syndicator's right to purchase the property to the LLC.

Phase 2. The ownership period

2.1 The syndicator receives a share ownership in the LLC in exchange for an assignment of his purchase rights to the LLC, and the investors receive a share for their cash contributions.

2.2 Manage the property.

2.3 Experience equity buildup due to the amortization of the loan amount through monthly payments.

2.4 Distribute spendable income to the co-owners.

2.5 Refinance the existing loan and distribute any net loan proceeds and any resulting increase in spendable income to co-owners.

2.6 Buy out the investors on a right of first refusal or purchase option held by the syndicator.

Phase 3. The disposition period

3.1 Vote of the co-owners, authorizing the sale of the property.

3.2 Employ the syndicator as the listing broker to locate a buyer.

3.3 Prepare a marketing (listing) package for delivery of disclosures and representations about the property to prospective buyers.

3.4 Enter into a purchase agreement to sell the property and open escrow.

3.5 Assist the buyer in his due diligence investigation and close the sale.

3.6 Disburse brokerage fees to the syndicator from the net sales proceeds.

3.7 Distribute the remaining net sales proceeds to the co-owners.

3.8 Record the dissolution of the LLC.

The syndicator's earnings

An analysis that focuses on the economic nature of the syndicator's activities as **capital events** or **services rendered** is needed throughout this chronology of events. This economic analysis is a must when setting priorities, parities or accumulation of earnings and fees for sharing the property's rental income and rise in value.

To begin an analysis of the economic aspects of sharing, the syndicator's activities, which generate earnings during each phase of a real estate syndication, are broken down and categorized based on their nature as **capital contributions** to the LLC or **services rendered** on behalf of the LLC, differentiated as follows:

1. The syndicator's ownership activities acting as a principal:

1.1 *Acquisition phase:*

a. Enter into a purchase agreement in his own name (as the syndicator).

b. Open escrow to purchase the property in his own name.

c. Fund the good-faith deposit into escrow.

d. Transfer the rights to purchase the property by an assignment to the LLC.

1.2 *Ownership phase:*

a. Participate as a member who co-owns a share in the LLC.

b. Participate in the equity buildup in the property by the monthly amortized reduction in debt.

c. Share spendable income on its distribution to co-owners.

d. Share the net proceeds from a refinance on their distribution to co-owners.

e. Exercise the right of first refusal or option to buy the property or fractional ownership interests granted to the syndicator by the investors.

1.3 *Marketing and resale phase:*

a. Vote as a co-owner to sell the property.

b. Enter into a purchase agreement and escrow to sell the property.

c. Share the net sales proceeds on their distribution to co-owners.

d. Complete the dissolution of the LLC.

2. The syndicator's services rendered to the LLC acting as a broker:

2.1 *Acquisition phase:*

a. Prepare an IC to market LLC shares.

b. Arrange to assume or originate mortgage financing.

c. Solicit investors to contribute capital and enter into an LLC operating agreement.

d. Form the LLC by preparing, signing and recording the LLC-1.

2.2 *Ownership phase:*

a. Manage the property under a property management agreement with the LLC (or the investors).

b. Arrange any refinancing or further encumbrancing of the property.

c. Locate substitute co-owners on resale of an existing co-owner's fractional interest.

2.3 *Marketing and resale phase:*

a. Market the property for sale and locate a buyer under a listing agreement.

b. Prepare a marketing package to deliver property disclosures to prospective buyers.

c. Cooperate with prospective buyers during their due diligence investigations.

Rationale for sharing profits

When a syndicator decides to proceed with acquiring the property on completion of his due diligence investigation, an **IC** must be prepared. The IC will be used for marketing fractional ownership interests when soliciting contributions from cash investors. [See Chapter 20]

The IC includes an LLC **operating agreement** that authorizes the employment of the syndicator to manage the day-to-day operation of the property and the distribution of the earnings, profits and capital to co-owners.

However, before preparing the operating agreement, the syndicator must determine the nature and extent of his participation in the income and the earnings generated by the property and his management. To spur interest in the investment opportunity among prospective investors, the syndicator must demon-

strate that the formulas for sharing the earnings will, as a matter of priority distributions, deliver to the investors a minimum annual spendable income and a respectable portion of the profits on a refinance or resale of the property.

Collectively, the property's condition and income-sharing formulas must be sufficiently attractive to induce enough prospective investors to commit the funds needed to fully capitalize the investment, called *equity financing*.

For the risk of loss in an investment to be at an acceptable level for prospective investors, the syndicator must use substantially all the cash contributions to fund the down payment or the purchase of the property. To avoid creating moral hazards in his decisions, the fees or earnings due the syndicator must encourage him to work for results that exceed **minimum performance standards**. To do this, his ownership must be subordinated to disbursements to the investors from spendable income and net proceeds from a refinance or sale of the property.

Further, the syndicator must make his case that the dollar amount of his contribution to ownership, when set as the value of the **purchase rights** he will assign to the LLC, is reasonable and based on objective standards of evaluation. He must also show that the fee he will be paid for his **organizational services** to form the LLC, solicit investors and bring together the co-owners is fair to the investors and competitive with fees charged by others who provide those services, such as attorneys.

Further, the **property management fee** he has bargained for must be shown as fair for the quality, quantity and reliability of his services, as compared to charges for like services provided by competitive property managers.

The syndicator must also provide his rationale for the minimum rate of return the investors will receive before he participates in any spendable income or profits generated by the property. It is he who will initially absorb the investment's risk of loss, as losses are first borne by him as a result of the priority distributions to investors.

Floors and ceilings on returns

Earnings are shared between the syndicator and the investors under various formulas. Sharing arrangements take into consideration priority and parity sharing, ratios for sharing, a minimum annual return that accumulates if unpaid, contingency fees, the dollar value of the syndicator's contribution and buy-out options. Collectively, these arrangements **place a ceiling** on the total return the cash investors receive over the life of the investment.

The following outline analyzes the various arrangements for sharing:

1. Structuring an LLC's capitalization and sharing by co-owners:

1.1 *The investors' contribution of cash provides for:*

a. A percentage of ownership in the LLC as Class A members.

b. A periodic distribution of spendable income between Class A and Class B members.

1) Initial priority distribution to Class A members.

2) Initial distribution as a minimum rate of return.

c. A supplemental distribution of remaining spendable income.

1) Parity distribution to members of all classes of any spendable income remaining after initial distributions to Class A and B members at the minimum rate of return.

2) Parity sharing by all members is based on percentage of ownership or another agreed ratio, such as 50:50 between classes.

3) Distribution of spendable income to Class A members may be capped at a maximum annual rate of return.

4) Spendable income remaining after distributions to Class A members at the maximum annual rate is distributed to Class B members.

d. An initial distribution of the net proceeds from a refinance or sale of the property.

1) Priority distribution to Class A members.

2) Initial priority distribution to Class A members limited to the dollar amount of their contributions and a minimum annual rate of return, less all distributions they have previously received.

e. Supplemental distribution of net proceeds remaining from the refinance or sale of the property after initial priority distributions.

1) Parity sharing between classes based on percentage of ownership or another agreed ratio, such as 50:50.

2) Distribution of the remaining net proceeds to Class A members may be capped at a maximum annual rate of return on their original capital contributions, such as a rate equal to the consumer price index (CPI) for the term of the investment and an annual percentage rate, such as 10% or 15%.

1.2 *The syndicator's contribution of purchase rights provides for:*

a. A dollar amount of ownership in the LLC as a Class B member.

1) The dollar value the syndicator places on his Class B membership received for his contract right to purchase the property establishes his percentage of ownership in the LLC.

b. A periodic distribution of spendable income to Class B members.

1) Distribution is subordinated to the annual floor rate of return initially distributed to Class A members.

2) The distribution is initially limited to an annual floor rate of return identical to the rate of return for priority distribution of spendable income to Class A members.

c. A supplemental distribution of remaining spendable income.

1) Parity sharing of spendable income between all classes.

2) The ratio for parity sharing is based on percentage of ownership or another agreed ratio, such as 50:50.

3) The parity distribution of spendable income to Class A members may be capped at a maximum annual rate of return.

d. A distribution of all remaining spendable income.

1) After initial and parity distributions to Class A and B members, any remaining undistributed spendable income is distributed solely to Class B members.

e. A subordinated distribution of proceeds from a refinance or a sale of the property.

1) Distribution to Class B members is subordinated to the initial priority distribution to Class A members.

2) Distribution to Class B members is limited to the dollar amount of their contributions and an annual minimum rate of return identical to the rate of return for priority distributions of proceeds to Class A members, less all distributions Class B members have previously received.

f. Supplemental distribution of net proceeds remaining from the refinance or sale of the property.

1) Parity distribution of proceeds between classes may be based on percentage of ownership or another agreed ratio, such as 50:50.

2) The amount of the parity distribution of proceeds to Class A members may be capped at an annual ceiling rate of return on their original capital contributions, such as a rate equal to the CPI for the term of the investment and an annual rate of return, such as 10% or 15%.

g. A distribution solely to Class B members of net proceeds remaining undistributed after priority and parity distributions to Class A and Class B members.

1.3 *Buy-out provisions represent:*

a. A right of first refusal granted to the syndicator in the operating agreement to acquire, at a formulated price, a co-owner's fractional interest on the co-owner's withdrawal, death, etc.

b. An option granted to the syndicator in the operating agreement to acquire the interests of the Class A members at a formulated price, comparable to a preferred stock arrangement by which a corporation pays off the stockholder. Alternatively, an option may be granted to the syndicator to buy the property from the LLC.

2. Fees and benefits for services rendered to the LLC by the syndicator:

2.1 *Acquisition fee or listing fee:*

a. Paid directly to the syndicator by the LLC out of cash contributions for brokerage services the syndicator rendered to negotiate the purchase, or less prudently, paid indirectly to the syndicator by the seller of the property out of the down payment.

b. Received by the syndicator in lieu of a percentage of ownership. [See §1.2a]

2.2 *Organizational or formation fee:*

a. Received by the syndicator from the LLC for services the syndicator rendered to prepare an IC, solicit cash investors and form the LLC entity.

b. Paid on the LLC's acquisition of ownership from cash contributions.

2.3 *Property management fees:*

a. Paid to the syndicator as a licensed broker at the end of each month in an amount based on a percentage of the rents collected.

b. Received by the syndicator as a licensed broker rendering services under a property management agreement.

c. Payment of the fee may be contingent on the sufficiency of rents to cover operating expenses and mortgage payments.

d. Payment of the fee may be further subordinated to the distribution of a minimum annual rate of return to the Class A members (an economically unsound treatment) and, if the fee is unpaid, will accumulate and be payable in later years when spendable income is available.

2.4 *Loan brokerage fee:*

a. Received by the syndicator as a licensed broker for arranging the refinancing or further financing of the property.

2.5 *Miscellaneous income and financial benefits:*

a. Received by the syndicator as reimbursement for expenses he incurred in the management of the LLC and the investors, other than the management of the property.

b. Received by the syndicator for providing services which are not obligations of the LLC under the leases. These services are paid for by tenants separate from the rent through common area maintenance fees (CAMs), a tenant association, laundry equipment and supplies or vending machines.

c. Profits from a maintenance company, controlled by the syndicator, that provides services for the care and maintenance of the LLC property.

d. Rent-free or rent-reduced occupancy of vacant space by the syndicator for his personal or business use, whether or not it is coupled with the management of the property.

2.6 *Sales fees or listing fees received by the syndicator as a real estate broker from the net proceeds on a sale of the property, paid by the LLC.*

3. A *master lease* held by the syndicator on the property acquired by the LLC:

3.1 *Rent paid to the LLC:*

a. Rent under the master lease is the sole source of a periodic return on the co-owners' invested capital.

3.2 *Right to buy:*

a. Rights of first refusal, buy-out options and options to purchase the property at a gain for the investors (in addition to rent) are granted to the syndicator to buy the property or buy out the cash investors.

Chapter 11 The tax treatment of a syndicator's earnings

This chapter reviews the taxation of a syndicator's earnings received in the form of an ownership participation or cash fees, structured as property rights or services rendered.

Property rights, services or both

A distinction exists between the income a syndicator derives from his *contribution of capital* to a limited liability company (LLC) and from *services rendered* on behalf of the LLC. The difference in the amount of taxes the syndicator will pay on earnings from **contributions** versus taxes on **services rendered** and when they will be due exemplifies the contrasts.

The syndicator's personal tax objective when structuring various syndication activities is to maximize his earnings from syndication activities while minimizing the tax impact they have.

For instance, the **profit taxes** the syndicator will pay "max out" at 15% (in 2009) on the resale of ownership interest the syndicator originally received for an assignment of his right to purchase the property. In contrast, the **ordinary income tax** on compensation the syndicator receives for services rendered while acting as an agent of the LLC max out at 35%, plus 15.3% in self-employment taxes and 9.55% in California state taxes.

As a result of the huge distortion in tax consequences, the syndicator's tax goal is to **contractually structure** his activities to attain the lowest allowable tax. The income he receives during the life of the investment program, from inception to resale of the property, is given the most favorable tax treatment if it is structured as a return on capital (profit), and not payment for services (ordinary income).

Rights created and exchanged

A syndicator packaging an investment opportunity establishes **property rights** when he enters into a binding contract to buy, finance or develop real estate in his own name. To contract, he uses purchase agreements, options, loan applications, construction permits or escrow instructions.

Property rights created and held by a syndicator are considered **capital interests**. Services rendered acting on behalf of another produces self-employed business income, which occurs when a syndicator negotiates a purchase agreement entered into in the name of the LLC and signed by the syndicator as its manager.

When a syndicator who creates and holds in his name a contract right to purchase a property assigns that right to an LLC in exchange for a membership interest in the LLC, that assignment is a tax-exempt transaction. Thus, the value of his property rights, established in his name as the buyer in the purchase agreement or option, is not taxed at the time the right to buy is transferred to the LLC. [Internal Revenue Code §721]

In exchange for the syndicator's contribution of his purchase rights by assignment, he may receive a *priority, parity or subordinated* ownership interest in the LLC. The tax consequences of a tax-deferred exchange of a capital interest for any priority of ownership interest in the LLC remain the same. How-

ever, the syndicator's contributions of his promotional or organizational services (time and effort) **spent on behalf** of the LLC for a participation in ownership are not tax exempt. Priorities are a huge concern when contributing services.

Consider a syndicator, acting as the named buyer, who enters into a purchase agreement (or option) to purchase property. The purchase agreement provisions allow the syndicator to assign his contract rights to purchase the property. Escrow instructions are then prepared and signed, naming the syndicator as the buyer.

On completion of his due diligence investigation and satisfaction of contingencies regarding the property's condition, the syndicator forms the LLC that will acquire the property. Through escrow, he then assigns his purchase rights to the LLC. In exchange, he takes **a percentage ownership** in the LLC.

The percentage of ownership he will receive in the LLC is based on the dollar value he places on the contribution of his right to buy the property by assignment. The dollar amount placed on his contribution then represents a percentage of the total of all forms of capital contributions to the LLC.

The syndicator's receipt of a membership share in payment for his assignment is a tax-exempt exchange transaction. [**Ungar** v. **Commissioner** (1963) 22 TCM 766]

Consider another property rights example. A syndicator-developer controls ground leases and loan commitments under contracts he entered into in his name. Before development begins, he forms an LLC and assigns it all his rights to purchase the leases, obtain the construction loan and develop the property.

The ground leases and loan commitments were the syndicator's assets, part of the net worth he developed for himself since they were initially created or controlled in his name, not the name of the LLC. The syndicator's contribution of these valuable property rights for an ownership interest in his newly formed LLC is a tax-free exchange. [**United States** v. **Stafford** (1984) 727 F2d 1043]

*Editor's note — A syndicator may purchase and assign property rights to a named LLC before the LLC is created. [**02 Development LLC** v. **607 South Park, LLC** (2008) 159 CA4th 609]*

Services rendered for a participation

Services rendered to the LLC include the syndicator's **time and effort** spent *on behalf of* the LLC to locate property and solicit investors to fund its purchase. Generally, the syndicator providing services to an LLC negotiates the purchase of property and enters into a purchase agreement or option — all in the name of the LLC. The syndicator signs the purchase agreement as the manager of the LLC.

The syndicator then sets a dollar value on his time and effort rendering services. His services are then contributed to the LLC in exchange for a membership interest with an equal dollar amount. He does not act in his own name as a principal for his own account at any time.

Here, the receipt of the membership interest is compensation characterized and taxed as ordinary personal income received for time and effort spent rendering services as an agent of the LLC.

Contributions of services to the LLC in exchange for a membership interest are not tax-free transactions. Compensation for services does not receive the same tax-exempt treatment given the exchange of a syndicator's **contract rights** for a share ownership in the LLC. [IRC §721]

The *cash value* of the LLC membership interest received by the syndicator in exchange for the brokerage and organizational (promotional) services he renders on behalf of the LLC (or the seller as a listing agent) is reported to the Internal Revenue Service (IRS) and the Franchise Tax Board (FTB) as part of the syndicator's brokerage business income. [IRS 1040 Schedule C]

The dollar figure given the membership interest the syndicator receives for his services is the amount he receives as his fee. However, for tax purposes, he reports as his business income from his services the *cash-equivalent value* of the membership interest he receives, not the dollar figure he sets as his contribution.

The **cash-equivalent value** of the membership interest the syndicator receives for his services is taxable in the year received, unless it is *subordinated* to cash investors. To be classified as subordinated, the syndicator's membership interest must be so lacking in **parity** with the interests held by the cash investors that its cash value is entirely speculative. Thus, his membership interest cannot be determined to have a present value other than zero.

When the syndicator receives an *unsubordinated* interest in the LLC, he is on a parity basis with the cash investors. An **unsubordinated** membership interest received for promotional and organizational services is treated as equivalent to the syndicator's receipt of cash. Thus, the dollar amount set for the syndicator's parity co-ownership interest will be taxable in the year he receives his co-ownership interest, and reported as ordinary income for his professional services at the dollar figure placed on his membership interest.

However, a Class B subordinated interest received by the syndicator in exchange for services rendered has no present value. Subordination limits his membership participation to **future income and profits** that may be generated by the property acquired by the LLC. The cash investors holding Class A membership interests receive a **priority return** of their capital investment. They share first in the income and profits before distributions of any remaining income or profits to a Class B member, i.e., the syndicator.

The taxable value of his services will not be established until the syndicator sells his interest or the property is sold and his interest liquidated. [**Campbell** v. **Commissioner of Internal Revenue** (1991) 943 F2d 815]

For example, a syndicator receives a subordinated Class B membership interest in the LLC in exchange for services he rendered acquiring property as the manager of the LLC. The membership interest the syndicator receives in the LLC need not be reported and taxed until he receives funds on a resale or refinance of the property, or he sells his subordinated interest.

The syndicator's services are not taxed when he initially receives a **subordinated interest** in the LLC, even though the share of ownership he receives represents ordinary income for services he rendered on behalf of the LLC to locate and acquire property. [**Vestal** v. **United States** (1974) 498 F2d 487]

In a related example, a syndicator receives a subordinated interest in the LLC in exchange for his promotional or organizational time and effort. Later, before the LLC sells the property, the syndicator sells his interest.

On the transfer of his subordinated interest, his time and effort — services previously rendered but not previously reported and taxed — are given cash value equal to the dollar amount he received for transferring his ownership interest in the LLC. The cash received on his sale of the fractional interest he received for services is taxed at ordinary income rates since no prior value was reported and taxed to convert it to capital under §83. [**Diamond** v. **Commissioner of Internal Revenue** (1974) 492 F2d 286; IRC §83]

Editor's note — While the Vestal *and* Diamond *cases relate to limited partnerships, the treatment is fully applicable to LLCs. LLCs automatically qualify with the Internal Revenue Service (IRS) for partnership reporting. [IRC §7701(a)(2)]*

For either a pre-existing LLC or a yet-to-be-created LLC, the alternative to the contribution of time and effort performing brokerage services is the exchange of property rights, created or controlled by the syndicator in his name, for an ownership interest in the LLC.

Converting services to capital

The subordinated ownership interest received by a syndicator for his services has no ascertainable cash value at the time of closing. Thus, his earnings for the services rendered are not taxed at the time of closing since what he received as compensation has a value of zero. However, when the property or the syndicator's Class B interest is sold, the money he receives is then taxed at ordinary income rates for services he previously rendered.

This adverse taxation at **ordinary income rates** can be avoided if, at the time the ownership interest was received, an *election* was made to convert it to capital from its income-for-services status.

The syndicator may elect to place a value, albeit small and certainly only a fraction of the value placed on his Class B contribution, on the ownership interest he receives for his services and report it as earnings received. He will then pay the income tax due on the declared earnings as his business income.

The value he gives the ownership interest as the amount received and reported for his services under the election becomes the *cost basis* for his ownership interest. When the interest is liquidated by a sale of the interest or the property, the price received is reported as the sale of a capital asset at a profit — the cost basis having been set by the income election valuation. Thus, capital gains rates apply to the sale, not ordinary income rates.

To accomplish the election, an §83(b) Election Statement is filed with the IRS within 30 days after the close of escrow on the purchase of the syndicated property (and receipt of the Class B subordinated ownership in exchange for services instead of an assignment of property rights). Another copy is addressed to the LLC since it issued the Class B interest for the services. A copy is also later attached to the syndicator's 1040 tax return for the year.

The §83(b) Election Statement describes the interest received, the terms of the subordination (restrictions), the value placed on it for the election (even though the interest has no present cash value) and any amount paid for the interest (such as including the value of the property right assigned together with the services). [IRC §83(b)]

Exchange of both services and rights

To further clarify his intentions to create and assign property rights, a syndicator will:

- contribute his purchase rights to acquire property in exchange for a membership interest in the LLC; and
- render services for the promotion and formation of the LLC that the LLC will pay for in cash.

Services rendered include the time and effort spent forming the LLC and soliciting investors to provide equity financing for the acquisition of property. Conversely, **property rights** held in the name of the syndicator, embodied in the purchase agreement or option to purchase the property, are assigned to the

LLC for a membership interest. The property rights exist as a capital interest even when his sole purpose in contracting to buy the real estate is to syndicate the equity financing and assign his purchase rights prior to closing escrow. No holding period exists in tax-free exchanges.

Exclusive of contracting to buy property, the task of syndication — forming the group investment — includes originating the LLC entity, creating the investment circular, soliciting investors and gathering their funds. These efforts are on behalf of the LLC, not part of the negotiations with the seller and investigations into the property's conditions. Arguably, the syndicator is selling shares in an LLC which he created and owns, constituting a short-term capital gain or inventory of his business, both taxed at ordinary rates but with an additional self-employed tax (15.3%) on the business earnings.

An all-services tax challenge (or an arbitrary partial allocation) by the IRS arising out of the syndicator's exclusive use of the Internal Revenue Code (IRC) §721 tax exemption to report all of his front-end earnings in a syndicated transaction can be avoided. To do so, the syndicator needs to separate his contract rights from his compensation for services and evaluate them individually. To establish the value of each before closing, a syndicator should:

- receive a cash fee for his organizational services, reported and taxed in the year the LLC acquires the property; and

- assign his purchase rights to the LLC for a membership interest, an exchange that is a tax-exempt transfer of his contract rights.

Consider a syndicator-developer who has maps, engineering and plans prepared for a property he now has under contract as the buyer. To close escrow and take title to the property, the syndicator forms an LLC to equity finance the acquisition. He contributes the subdivision plans to the LLC for a membership interest in the LLC.

Here, the plans are considered **property** he produced for himself, not the product of **services** rendered on behalf of someone else. The value created by the development of maps, engineering and plans the syndicator contracted for and owns in his name is not taxed when assigned to the LLC.

In addition to creating the real estate maps and plans in his own name when acting as a principal for his own account, the syndicator performs services on behalf of the LLC: he prepares the investment circular, forms the LLC and solicits investors. The syndicator is compensated for these organizational services in cash. Thus, the value of the services — cash — will be reported as business category income in the year received. [**United States** v. **Frazell** (1964) 335 F2d 487]

By delivering to the LLC services and property rights, and setting the value of each in agreements prior to closing, the syndicator's receipt of cash for his services greatly reduces the risk of losing a portion of the IRC §721 tax-exempt treatment allowed on the transfer of his contract right to acquire real estate in exchange for a membership interest in the LLC.

Self-employment taxes

In addition to paying income tax, the syndicator will pay 15.3% self-employment taxes on the income he receives for services rendered forming the investment group and the LLC. Self-employment taxes are imposed on the net income produced by the syndicator in his **trade or business**, namely, on monies paid to the syndicator less expenses for forming and funding the LLC and for his ongoing property management services. [26 Code of Federal Regulations §1.1402(a)-1]

The share of spendable income he receives on a distribution to all members — including himself — is **rental income**. The self-employment tax is not imposed on earnings generated for members by the operation of the LLC's real estate. Rental income is passive category income, not trade or business category income. [26 CFR §1.1402(a)-4]

The ownership and operation of a rental property is **not a business**, even though the ownership is structured as an LLC, which is a business entity.

Members are not liable for self-employment tax on rental income since the LLC has no trade or business income — unless it owns land which it holds for development in a resale program (dealer property).

Also, the self-employment tax is imposed on the income of the owner-operator of a hotel, motel or vacation rental, since the average occupancy is for a period of **30 days or less** and thus, as does dealer property, constitutes business category income for material participants. [26 CFR §1.1402(a)-4(c)]

In contrast, the earnings generated by the owner-operator of income-producing real estate are reported as rental income or losses in the *passive income category* if the average occupancy of all tenants is more than 30 days.

Accordingly, the manager escapes the self-employment tax for any distributions based on his pro rata ownership interest acquired in the LLC for services rendered. However, the manager's income for services rendered under a **property management contract** with the LLC or its members is considered trade or business income subject to the self-employment tax.

Chapter 12 Tax benefits for co-owners

This chapter applies income tax reporting rules to the co-owners' capital investment and their share of operating income or losses during ownership.

Capital recovery, operating income, losses

The relief from income taxes provided for owners of real estate is merely an incidental source of earnings. The incentive of tax relief is minor in amount and least in importance when compared to earnings generated by the property, including:

- spendable income;
- loan reduction; and
- growth in property value.

An investment analysis based on a property's fundamentals historically used to set its market value does not include the income tax consequences of its ownership. Income tax consequences of ownership do not impact the analysis of a property. The taxes a co-owner pays depend on the tax status of the co-owner, not the property, except for the duration of depreciation schedules.

The major income tax benefit derived by an owner of improved real estate is the annual **tax-free return** of a portion of his invested capital, called a *depreciation deduction allowance*. The deduction provides an accounting method for the recovery of the owner's invested capital — the cash down payment and funds from a purchase-assist loan or debt assumed — without incurring a tax when the capital is returned.

In theory, the return of capital recovered tax-free from the property's rental income is justified since the recovery of the annual loss in value of the improvements due to deterioration, obsolescence and wear brings an improvement to a statistical useful end after a period of 27.5 to 40 years. However, the experience of ownership in most of California demonstrates that well-maintained property actually increases in value over time, a value tracking the growth of the local population and increase in its wealth. Thus, the annual tax-free recovery of capital from rents is a windfall for most property located in California.

The tax-free return of capital is the result of the annual depreciation allowance an investor is permitted to write off based on the cost of improvements acquired as part of the real estate. The annual amount of depreciation is deducted from the property's net operating income (NOI) before arriving at the amount of the rental income that is reported and subject to income taxes.

The rental income sheltered by the depreciation allowance is often calculated for investors over the initial ten-year period of ownership, as an annual yield on their cash contributions. Technically, the amount sheltered from taxes by the depreciation deduction is not a **return on** the capital invested (from rental income), but a **return of** the invested capital (originally contributed).

Consider an income-producing property with an annual gross operating income of $120,000 and operating expenses of $40,000. The property's NOI is the difference, $80,000.

To determine the annual reportable operating income or loss for the ownership of the property, the interest paid on loans and the depreciation allowance are deducted from the NOI. *Interest* is the cost of borrowing additional capital to fund the purchase of the investment. *Depreciation* is the owner's recovery of all of his invested capital allocated to improvements. [See **first tuesday** Form 352]

Suppose the annual interest payments amount to $60,000, and the depreciation deduction is $20,000. Thus, the property has no reportable operating income (or loss), since the total amount of interest paid and depreciation deductions ($80,000) equals or exceeds the NOI ($80,000).

In a separate analysis, the NOI includes *spendable income*, the title given to the amount of rents remaining after deducting the loan payments of principal and interest from the NOI. Here, principal and interest payments amount to $67,000 annually, which is paid out of the $80,000 NOI. The remaining $13,000 is spendable income that is distributable to the co-owners.

Thus, depreciation is not a factor when determining the amount of spendable income a property produces, since it is not an expense. Taxwise for the owner, spendable income comprises ordinary income, a return of capital or a mix of both, depending on the size of the depreciation deduction and the amount of the principal reduction on loans, neither of which relate to operating the property.

Here, the property does not produce reportable income, but does generate spendable income. Since the owners borrow capital to buy the property, no part of the spendable income is taxed in the first year of ownership. The amount of spendable income (and loan reduction through the payment of principal) is "sheltered" by the depreciation deduction. Technically, the spendable income becomes classified as a tax-free return of invested capital, not as income or profit.

However, rents sheltered by depreciation deductions are often casually viewed as an additional source of income for the investors — as though it were a yield on the original investment — even though rental income, to the extent it is offset by depreciation, is a **return of capital**, not a yield at all.

The rationale that allows the return of capital to be viewed as income is that real estate market values are not perceived to be negatively affected by the deterioration and wear of improvements. This dismissal of an improvement's aging seems justified due to the offsetting effect on value brought about by inflation, appreciation, maintenance and proper management of income and expenses.

Losses offset income in three ways

For each limited liability company (LLC) co-owner, a rental property's reportable losses from annual operations are first applied to offset any reportable income the co-owner may have from other rental properties and passive business investments. Both sources of income are reported in the *passive income category* on Schedule E of each owner's 1040 tax return.

However, rental **operating losses** (including the allowance for depreciation) greater than the co-owner's income from all passive-income category investments do not then disappear. The annual operating losses from the property are reported by each co-owner on his 1040 return to offset income and profits within other categories.

Depending on the co-owner's level of involvement in management, his adjusted gross income and whether the LLC files a return, he can offset his income from other categories in one of the following ways:

1. If the co-owner qualifies as being in a *real estate related business* and further qualifies as a *material participant* in the management of this property, the amount of the loss on Schedule E **lowers** the amount of the co-owner's adjusted gross income (AGI).

2. If the co-owner qualifies as *active management*, the amount reported as the loss on Schedule E is **deducted from** the co-owner's AGI to determine his taxable income, called the *$25,000 rental loss deduction*.

3. If the co-owner does not qualify for the adjustment to AGI or the rental loss deduction, the amount of the loss on Schedule K-1 or E is carried forward by the co-owner for use in future years to offset income or profits from the property incurring the loss, called *suspended losses*.

Services rendered as a material participant

For a co-owner to qualify to write off his share of the property's operating loss (in the passive income category) offsetting his income from trade or business category or portfolio category income and **reduce his AGI**, he must be classified as a *material participant* by rendering services in real estate related business activities.

Businesses in which a co-owner might be involved in rendering real estate related services include:

- the acquisition, development or construction of real estate;
- the management of income properties in which he owns an interest (as a landlord); and
- any real estate brokerage services performed on behalf of others as a real estate licensee.

When a co-owner is involved in real estate related businesses and intends to write off his rental operating losses by reducing his AGI, he must also qualify as a *material participant* in those businesses by:

- spending at least 750 hours per year rendering real estate related services; and
- providing real estate services for more than half of all his time spent rendering services of all types, including other types of professional, business or investment services.

The syndicator acting as both the manager and a co-owner will most likely qualify as a material participant in real estate related businesses since he will probably render no other type of service than real estate related, such as acquisition, management and sales of real estate, for himself or for others in this and other properties.

As for the other co-owners, they will need to be involved in real estate businesses other than their investment in the syndicated property in order to qualify to write off this property's operating loss against sources of income other than passive business opportunity investments and rental properties and reduce the AGI.

The $25,000 rental loss deduction

Consider a co-owner who does not qualify as a material participant in real estate related businesses. He cannot directly offset income from other categories and reduce his AGI by the amount of his share of the operating loss. Here, he may qualify to **deduct** the operating loss from the AGI (instead of reduce the AGI), called the *$25,000 rental loss deduction*. To do so, the co-owner must be *actively involved* as an owner who authorizes the syndicator to act as the property management under contract to the co-owner.

For a co-owner to avoid automatic disqualification as an **inactive co-owner**, the LLC or tenant-in-common (TIC) vesting cannot file a partnership return. Thus, the co-owner will not receive or file a K-1

Schedule with his 1040 tax return. It is the K-1 that identifies a co-owner as an inactive co-owner of the real estate. Instead, he will file a Schedule E with his 1040 tax return to report his share of the operating loss. [Internal Revenue Code §469(i)(6)(C)]

An LLC can avoid filing a partnership return with the IRS under the small partnership exemption when ten-or-less co-owners (husband and wife are counted as one) are involved or the co-owners are TIC co-owners and number no more than 35. [See Chapter 15]

Several limitations are placed on an LLC co-owner's use of the operating loss under the **$25,000 rental loss deduction**, including:

1. The co-owner's fractional ownership interest must make up a minimum of 10% of all interests in the LLC. [IRC §469(i)(6)(A)]

2. The co-owner cannot report a rental loss above $25,000.

3. For each dollar the co-owner's AGI exceeds $100,000, there must be a 50% reduction in every dollar of the deductible operating loss amount, which eliminates any deduction of a rental operating loss if the co-owner's AGI exceeds $150,000. [IRC §469(i)(3)]

4. A co-owner must personally enter into the property management agreement (with the other co-owners) which employs, for a period not in excess of one year, a property manager to enter into leases with tenants. The LLC's operating agreement must also state the LLC's purpose is to hold title on behalf of the co-owners, all of whom are classified as TIC co-owners, and operate the property in the name of the property manager, not the LLC.

When a co-owner is unable to use the operating loss under the $25,000 rental loss deduction (or as a real estate related business), the losses are retained on the co-owner's books as *suspended losses.* Suspended loss is carried forward to be used in future years when reportable operating income is generated by the property or a profit is taken on a sale of the property.

Chapter 13 Tenants in common or tax partners

This chapter presents the arrangements an owner of a fractional interest in a real estate investment must undertake to qualify his separate sale or purchase of that individual co-ownership interest as §1031 property.

§1031 fractional ownerships

For the profit taken on the sale (or exchange) of an ownership interest in real estate to be exempt from taxes under Internal Revenue Code (IRC) §1031, the interest sold must be an **ownership in property** that qualifies as *like-kind property*, commonly called §1031 property. Following in tandem, the ownership interest acquired in the replacement real estate must be §1031 property.

Thus, in any §1031 reinvestment plan, both "legs" of the plan — the property sold and the property acquired — must qualify as the investor's **ownership** of §1031 property. §1031 property is initially classified as property held either for **investment** or **productive use** in a business. [Internal Revenue Code §1031]

When an entity such as a partnership or limited liability company (LLC) sells a parcel of real estate held either for investment or productive use and replaces it by purchasing another parcel it will hold for investment or productive use, the entity has completed a §1031 tax-exempt transaction. The co-owners of the partnership or LLC then separately report their pro rata share of the gain passed through to them on the §1031 transaction as exempt from taxes — *non-recognition* of profits. The group moved the owners from one property to another as an entity — selling and buying as one *person*.

However, an investor's fractional ownership interest in a group does not qualify as §1031 property if the interest is a **co-ownership interest** in an entity, such as an limited partnership (LP), LLC, corporation or other co-ownership (such as a tenancy in common) arrangement calling for the alienation of the property or fractional interest by less than unanimous consent. It is the entity that owns the real estate.

An investor's sale of his percentage of co-ownership in the entity, independent of the sale of the real estate by the group, does not qualify for the §1031 exemption. The individual co-owner's reinvestment plan includes the sale or purchase of a fractional ownership interest in an entity classified as a *tax partnership*.

Further, a co-owner vested as a tenant in common (TIC) with a group of co-owners is considered a *tax partner* in the co-ownership of §1031 property if he has **agreed to restraints** on his common law rights as a tenant in common to freely manage his interest in the property, independent of control by other co-owners and as he sees fit.

Once classified as a **tax partner** for income tax reporting, the TIC investor is considered a co-owner of an interest in a *tax partnership*, not a co-owner holding an ownership interest directly in the real estate (even though title is vested in his name with others). As a result, and for tax purposes only, the tax partnership is treated as the sole owner of the §1031 property. The TIC co-owners are partners who merely own a personal property interest in the partnership, not the real estate.

When a TIC co-owner, by agreement or by definition, is a *tax partner* with others, none of the profit taken on the separate sale of his fractional interest qualifies as exempt from taxes. To avoid being a tax partner on the sale or purchase of a fractional interest in a group which presently owns §1031 real estate, the fractional interest sold or acquired must be shown to be an **independently manageable** ownership interest held directly in the real estate, not the investor's mere ownership of an interest in a TIC partnership. A partnership operates separate from each TIC and it is the partnership that **controls the ownership rights** in the real estate for all co-owners.

A tax partnership vs. a California partnership

The **coordinated conduct** of co-owners in the exercise of *ownership rights* to operate the investment real estate they co-own is viewed differently under federal income tax law than under California partnership law.

Basically, if co-owners **share** the income, profit and losses generated by a joint investment in real estate and operate under an unincorporated ownership arrangement, California partnership law (which broadly defines a partnership) classifies the profit-sharing group as a partnership. Thus, California imposes *agency obligations* on each co-owner to act in concert for the mutual benefit of the group from the first moment of discussions about a syndicated investment. Thus, anarchy within the group of co-owners is legally avoided as public policy in California.

Conversely, federal tax law places emphasis on TIC law to establish co-owner rights. TIC ownership does not rise to tax partner status unless the co-owners are operating as either:

- a declared partnership;
- an LLC; or
- a cooperating TIC.

To avoid federal tax partnership status, each co-owner vested as a TIC must have the unrestricted common law right to independently *alienate* his fractional interest without the prior consent of other co-owners. Further, each co-owner must also have the unrestricted right to independently block any *alienation* of the entire property co-owned by the group.

Alienation of the entire property refers to its sale, further encumbrance or lease for a period exceeding one year.

Taxwise, the ownership of a TIC interest that retains its common law right of alienation in real estate is viewed as being the ownership of a fractional interest in the real estate itself. Thus, the TIC is not the owner of an interest in a partnership, but actually owns the property.

Further, TIC co-ownership arrangements may provide for **cooperation among the co-owners** in the ongoing management and operation of the property. Operating the property by *centralized management* does not violate the requirement of unanimous approval for the alienation of property. Thus, the alienation rights inherent in ownership are distinguished from the day-to-day operations of the property.

An understanding of the distinctions between federal tax law, which defines §1031 property investments as excluding fractional interests held by *tax partners*, and California's partnership law, which controls joint ventures and profit sharing ownerships, is helpful to all individuals involved in investment groups, such as:

- **syndicators** structuring the ownership for acquisition of property by an investment group they are forming;

- **investors** acquiring or withdrawing a fractional interest from a syndicated real estate investment; and

- **brokers** (or other advisors) representing a person who is buying into or withdrawing from a syndicated real estate investment.

Knowing the parameters for activities that establish a partner under California partnership law versus activities that establish a tax partnership for federal income tax reporting avoids unintended and unexpected results under either set of laws, or worse, the loss of a transaction because of insufficient knowledge.

Accordingly, this chapter contains an analysis and application of the overlapping partnership laws controlling the syndication of real estate investments (state law) and the exemption of profits from taxes (federal law) on a sale or purchase of a fractional interest in a syndicated investment with §1031 money.

We cooperate in California

A group of investors acquire income-producing property located in California. Title is taken as TICs, naming each investor and stating his percentage or fractional share of undivided ownership in the property.

The property is occupied by tenants under short-term leases and periodic rental agreements that provide for the landlord to care for and maintain the premises.

The co-owners orally agree:

- to divide annual operating income (or losses) and resale profits pro rata based on their percentage of ownership;

- to hire the broker who organized the group to manage the property with authority to locate tenants, enter into short-term lease and rental agreements, collect rents, contract for the repair, maintenance, utilities and security to be provided by the landlord under the lease agreements, pay operating expenses and mortgage payments and distribute spendable income to the co-owners quarterly;

- to grant each other a right of first refusal on a resale of their fractional TIC interest; and

- to grant the syndicator the option to purchase the property at its fair market value.

Are the co-owners conducting themselves as partners under California partnership law despite the TIC vesting placing each co-owner on title?

Yes! Co-owners of California real estate vested as TICs, when engaged in the business of jointly operating the property on terms calling for them to share income and profits, are conducting themselves as partners. Thus, they are considered agents of one another, charged as fiduciaries with the duty to cooperate in the ownership of the property. [Calif. Corporations Code §§16202(a), 16202(c)(3)]

A TIC vesting does not control the possessory rights of the co-owners when the co-ownership in fact constitutes a state law partnership. For example, a partner may use or possess partnership property only on behalf of the partnership, while a TIC co-owner (at common law) may use, possess or lease the property himself, without regard to any other co-owner. [Corp C §16401(g)]

Further, TIC co-owners who conduct themselves as joint operators of a property, such as occurs with a rental property, are not co-owners of the real estate. They are partners who co-own their partnership. Thus, the partnership owns the property without concern for the type of vesting the group of investors has chosen.

As a partner, the vested co-owner does not hold a right to an interest in the property that he can independently possess or separately transfer by leasing the property to a tenant without concern for the other co-owners.

The only transferable interest the TIC owns is his fractional interest in the partnership. The partnership interest entitles him to share profits and receive distributions. Thus, the co-owner's fractional interest, vested as a TIC interest, is no more than a personal property share of ownership in a California partnership. [Corp C §16502]

Trustees for one another, by law

Although title to an income-producing property held by co-owners for profit is vested in the names of all the co-owners, each co-owner actually holds title as a trustee on behalf of all the TIC co-owners, collectively called a partnership. [Calif. Civil Code §682; Corp C §16404(b)(1)]

As co-owners and operators of a rental property, they have formed a partnership, holding title in the most troublesome of all California co-ownership vestings: a TIC.

Thus, the conveyance of a co-owner's TIC interest to another person conveys nothing more than the co-owner's interest in the partnership's equitable ownership of the property. The partnership's title to the property is held in trust, in the name of each co-owner for the benefit of all co- owners.

The defining acts of partners

Prior to California's 1949 enactment creating tenancies in partnership, TICs that owned rental property requiring centralized management did not constitute a partnership. Before 1949, no agency relationship existed between TIC co-owners to protect the common interests of the co-owners to share profits. The federal tax law defining TIC interests remains the same today as the prior California law controlling TICs. [**Johnston** v. **Kitchin** (1928) 203 C 766]

Since 1949, a California partnership exists when two or more investors join together to carry on a business for income and profit in California. A California business includes every trade, occupation or profession. [Corp C §16101(1)]

While landlording is not a trade or business category activity for federal income tax purposes (since the property is a passive rental operation or a portfolio asset), landlording by a syndicated group is an occupation under California partnership law. A co-ownership is a California partnership if the co-owners are involved in sharing earnings and profits from rental operations, refinancing and resale of the property they own. [Corp C §§16202(a), 16202(c)(3)]

Also, the receipt of income (from operations) and profits (from a sale) by co-owners from their joint investment is considered evidence of a California partnership, unless the earnings are received by a co-owner in payment:

- of an installment note, including one given in consideration for the sale of goodwill or property;
- for wages or rent due the co-owner;
- on an annuity to a surviving spouse, representative or deceased co-owner; or
- as interest on a loan. [Corp C §16202(c)(3)]

The TIC partnership

With a TIC vesting, the sharing of income and profits earned by each co-owner's separate use of the property — such as occurs with the extraction of minerals from the property by each co-owner for their own separate use — does not in itself create a California partnership. It takes more than the sharing of use and possession by co-owners to constitute conduct on the level of a partnership. [Corp C §16202(c)(1)]

It is the interaction and coordinated conduct of the co-owners while directly or indirectly managing or operating the investment that determines whether a state law partnership relationship exists between them. Once the conduct of co-owners in a coordinated ongoing operation of the property constitutes a joint and mutually beneficial activity, an agency relationship exists between the co-owners.

With the agency relationship comes fiduciary duties owed to partners, which obligates each prospective or actual co-owner to act in the best interest of the group, not to act independently on the investment opportunity before them. [Corp C §16404; **Leff** v. **Gunter** (1983) 33 C3d 508]

Thus, co-owners of rental property who are vested as TICs and who act collectively to manage the property or authorize a property manager to operate the property on their behalf, hold ownership to the real estate under what has been best entitled a tenancy in partnership. Each co-owner is a tenant in partnership with all other co-owners.

By the sharing of income among co-owners who are vested as TICs, a tenancy-in-common partnership is established. Each co-owner is subjected to the rights and obligations of a partner, such as:

- the duty to hold title to the real estate as a trustee for the benefit of the partnership [Corp C §16404(b)(1)];
- the right of each co-owner to use and possess the real estate — but only for group purposes [Corp C §16401(g)];
- nontransferability of the right to use and possess the real estate, unless all co-owners collectively transfer the partnership's right to possession of the property [Corp C §§16203, 16501]; and
- acknowledgement that the property co-owned by the group is not subject to attachment or execution on a judgment against an individual co-owner, only on claims against the partnership. [Corp C §§16201, 16501]

Even when co-owners do not characterize their mutual working relationship in a profit-sharing investment as a partnership, they are still obligated to act on behalf of the group as though they were partners in a partnership. [Corp C §16202(a)]

Under state law, TIC co-owners hold no interest in the real estate they co-own that they can legally transfer, voluntarily or involuntarily, independent of the rights of the resulting California partnership. [Corp C §16502]

However, federal tax law for determining the tax partner status of TICs disregards state laws to the contrary. [Revenue Procedure 2002-22]

A tax partner's profits disqualified

The penalty for a TIC co-owner who is federally classified as a tax partner in the ownership of either the property sold or the property acquired in a §1031 reinvestment plan is the loss of the entire §1031 tax exemption for profit taken on the property sold.

Thus, the arrangements or activities a co-owner, other co-owners, a property manager, syndicator or lender agree to between themselves which would make them co-owners and tax partners, are of great concern to investors in syndicated real estate investments programs.

When a co-owner of investment real estate is classified by the Internal Revenue Service (IRS) as a partner, the real estate is considered to be owned by a tax partnership. Classified as a partner, the co-owner's ownership interest is that of a share in a partnership and the share does not qualify as §1031 property.

To avoid tax partner status, a co-owner in a real estate investment does not want to be financially coupled with a co-owner or manager who provides the tenants with services that are unrelated to the operation of the property, such as linen service, maid service, meals, etc.

Thus, an investor with after-tax cash he has accumulated or §1031 money to reinvest who makes a capital contribution to a group being formed to jointly own and operate an income-producing parcel of real estate must be assured no co-owner is sharing in any income from tenants other than rent. Co-owners who occasionally provide tenants with business or professional services for a fee separate from rent, or share in the income received by others providing services to tenants that go beyond the customary services required under a lease, establish tax partner status.

Co-owners or partners

Tax partner status is of no concern to a co-owner, unless and until the co-owner:

- withdraws from a group to separately invest on his own; or
- desires to exchange his sole ownership in real estate (or the cash from its sale) for a fractional ownership in a replacement property.

To understand the **federal distinction** between a co-owner's non-partner status and tax partner status in the co-ownership of an investment in real estate, it is instructive to know the purposes behind the different income categories. Each category has been established to report and account for income, profits and losses from the ownership and sale of real estate, put to different uses by the owner.

Three income categories have been established for reporting income. The source or nature of the income, profit or loss determines the income category in which the income, profit or loss will be reported, such as:

- *trade or business income category*, which includes real estate occupied and used by the property owner for a business he owns and operates, including residential housing with an average occupancy of less than 30 days, such as motels, hotels, vacation rentals, and other transient housing and boarding facilities that provide occupants with services unrelated to the care and maintenance of the property;

- *passive income category*, which includes residential and nonresidential rental properties with an average occupancy of 30 days or more, but with a tenancy less than a triple net (master or ground) lease, during which the owners provide the tenant with the repair, maintenance, security, utilities and management of the property typically provided or required by state law in exchange for rent; and

- *portfolio income category*, which includes income-producing real estate subject to long-term lease agreements which shift the responsibility for the care, maintenance, repair and operation of the property and the payment of expenses of ownership such as property taxes, assessments and insurance premiums to the tenant (as in a master lease, ground lease or other type of management-free triple-net lease), and includes other like-type flows of management-free income such as bonds, stocks, interest on loans (trust deed investments) and vacant, unimproved real estate held for profit on a resale (not as dealer property).

Thus, income-producing real estate *held for investment* and leased to tenants is classified as either:

- rental (passive income) property requiring **management services** related to the tenancies; or

- portfolio income property requiring no **tenant-related services** to be provided by management.

Land held for investment that does not require any management services, except for the annual payment of taxes, assessments, insurance premiums and the like, is classified as portfolio property. However, land held for development, subdivision and resale by the owner or a co-owner is trade or business category inventory.

Stated another way, rental (passive income) property and portfolio income property are not business property. On the other hand, a motel or hotel is a business property since services unrelated to rental property operations are provided.

And as a further distinction, the co-ownership arrangements relating to the management of rental or portfolio properties consists of services customarily provided for tenants by a landlord directly, or through an agent. The **landlord's services** provided for tenants are not business-related services, such as maid services, food, laundry pickup and delivery, towels or linens, which are provided to more transient occupants of trade or business category property, such as hotels, motels, transient housing or vacation rentals.

Thus, negotiations with prospective tenants to lease units or space within the property, limited to providing customary landlord services, such as the collection of rent, evictions, repairs and maintenance of the property, utilities, security and other real estate related services typically included in the rent, is not a business. Obviously, the property is not a business income category asset which provides **business-related service**, as an operator of a hotel, motel, boarding house or vacation rental property does.

Without being coupled to a business service, the capital contribution of a co-owner and landlord services the co-owner provides in the form of rental property operations for the care and operation of the property as a rental or portfolio asset, do not make the co-owner a tax partner. None of the co-owners are involved rendering *additional services* to the tenants through a business, enterprise or joint venture in which one or more of the co-owners share profits or losses in trade or business services offered to tenants.

A property manager and his authority

Co-owners can join together to own and operate income-producing property and will not be considered tax partners when they hire a broker (who may be a co-owner) as an independent property manager. The manager may be given all the authority he needs to do all acts necessary to provide services for tenants which are customary under regular leasing arrangements.

However, the manager may not be given the authority to enter into long-term leases (more than one year), sell or encumber the property. These are the rights of *alienation* held by each co-owner which must remain unrestrained and require unanimous approval by all co-owners to be exercised.

The authority co-owners may give a property manager without becoming tax partners is extensive, and includes the authority to:

- act on behalf of the co-owners to negotiate and enter into leases and rental agreements with prospective or current tenants;
- collect deposits, rents and other amounts due from tenants and deposit them into a common bank account maintained for (but not in the name of) the co-owners;
- contract for all services customarily provided to tenants under similar circumstances as part of the rent, including normal repair and maintenance of the property, utilities, garbage/trash pickup, a resident manager and security;
- pay from rents (and additional funding by co-owners made necessary due to insufficient rental income) the charges for all services the manager contracts for as authorized, including the payment of property taxes, assessments, insurance premiums, mortgage payments and management fees;
- at least every quarter, disburse to the co-owners their share of spendable income; and
- prepare annual statements for each co-owner setting forth his share of income, expenses, interest and depreciation. [IRS Revenue Ruling 75-374]

Thus, co-owners are merely limited to the classic relationship between a property manager and an owner of income-producing property. No co-owner, directly or indirectly through another person, will carry on or share profits in a trade or business which will provide additional services to the tenants beyond those customarily provided under common leasing arrangements in exchange for rent.

However, each co-owner will be considered a tax partner who is carrying on a trade, business, financial operation or venture in a tax partnership if:

- he renders the additional **business-related service** to tenants; or

- the property manager renders the additional business services and one or more co-owners (including the co-owner manager) **share in the income** the manager receives for providing the business-related service to the tenant.

Thus, the **tax partnership** includes the person rendering the business-related services whose income for those services provided is shared with one or more of the co-owners of the real estate. It does not matter that the person rendering the services (such as the property manager) may have no claim to the spendable income from the rental operation, proceeds from a refinance or net proceeds from its resale.

The property manager hired by the co-owners may not be a tenant and must be on a short-term management agreement not to exceed one year. The management agreement may only be extended or renewed for a period not to exceed one year, and only by a unanimous vote of the co-owners (or by a failure to vote). The property manager's pay must be comparable to fees paid brokers in the area for managing similar properties and providing similar real estate related management services.

While the manager may not be a tenant, a long-term lease, pre-existing or unanimously agreed to by all the co-owners, could provide for a **lessee** to care for, operate and incur at his expense all the typical services (sub-)tenants may need to occupy the premises, including the right to sublet the property, an arrangement called a *master lease*.

Also, the property manager may be granted an option to purchase the property. However, the price to be paid for the property on exercise of the option must be set as the **fair market value** of the property at the time of purchase.

The devolution of TIC control

Some flexibility exists regarding the annual unanimous consent of the TIC co-owners to renew property management agreements and the extent of authority they may grant management to enter into long-term leases of portions of the property. [IRS Private Letter Ruling 2005-13010]

Each long-term lease must be unanimously approved by all TIC co-owners to qualify each individually owned fractional ownership interest as §1031 property. This unanimous approval is satisfied by an **annual unanimous approval** of a set of long-term leasing guidelines for management. Management would then follow the guidelines in the exercise of the leasing authority unanimously given by the property management agreement.

Thus, the authority given in the leasing guidelines is viewed as a method by which each TIC co-owner retains direct control over his right to disapprove and bar entry into a proposed lease. The parameters set in the guidelines place a limit on management's flexibility in the discretionary leasing of the property.

The IRS example for leasing guidelines include the typical standards any landlord sets for qualifying prospective tenants and structuring the terms and conditions of lease provisions. Guidelines for leasing include the tenant's and landlord's obligation to care for and maintain the property, selection of the type of tenants, tenant creditworthiness, a range of rent amounts to charge tenants, the term of the lease and the content of lease provisions.

Interestingly, the syndicator managing the property is allowed, as outlined in the IRS letter ruling, to bar any TIC co-owner from altering the guidelines during the year following their approval since the unilateral change would be less than unanimous approval. Until the next annual approval of leasing guidelines

occurs, each TIC co-owner agrees not to alter the guidelines by exercising his ownership rights to lease the property, himself or through a competitive leasing agent, on conflicting, and possibly more advantageous long-term arrangements. [PLR 2005-13010]

Also, while the requirement for unanimous annual approval of the property management agreement is an anarchic condition detrimental to current management, apparently automatic one-year approval by **mere silence** at the time of the annual renewal is deemed a sufficient exercise of a TIC co-owner's right to approve or disapprove the renewal of an annual contract with management.

For example, a TIC operating agreement entered into by all TIC co-owners calls for **automatic annual renewal** of the property management agreement. Should all TIC co-owners **fail to object** to any provisions submitted by the management team in a *notice of renewal* of the management agreement, management is approved for another year — by silence. Thus, a TIC co-owner exercises his right to control his interest in the property by objecting to the renewal. However, if he does object he will be penalized.

The conduct of management permitted in the letter ruling gives co-owners who agree with management the right to buy out the objecting co-owner's interest. If not bought out, the objecting co-owner is limited to hiring his own property manager. However, for doing so, he will alone bear the cost of the manager he hires. Further, his manager will only be an advisor to the current management, unable to exercise any objection he or his employing co-owner may have. Could management have it any better? You bet they can!

As a final detriment for objections to the current management's unaltered or continued involvement, a co-owner's objection triggers an option for a buy out of the objecting co-owner's TIC interest (without a corresponding option to buy out his non-objecting co-owners' interests if they do not purchase his interest). The option price to be paid for the objecting co-owner's TIC interest is his fractional portion of the property's fair market value (set by an appraiser chosen by a majority vote of TIC co-owners). The buy out provision places a co-owner at risk of a loss on his investment if he should object to the renewal in a down market.

Normally, a co-owner objecting to management has a reasonable basis for doing so, namely that management procedures and policies are deteriorating the future worth of the property, requiring new management to take corrective action to preserve and build up equity in the property.

Hence, the property's present fair market value at the time of a co-owner's objection, especially in syndicated property which attracted §1031 monies, is an amount less than the price paid by the group to acquire the property (usually from the syndicator or a related entity) since poor management has deteriorated its worth.

Accordingly, if the non-objecting TIC co-owners exercise their option to purchase the objecting TIC co-owner's co-ownership interest, they will most likely be able to pay an amount less than the price paid by the objecting co-owner when he initially acquired his fractional interest in the property.

Resale by an individual TIC as §1031 property

Consider a syndicator who seeks to bring together several property owners and cash investors to form a group to co-own an income-producing property located by the syndicator. They will take title as **TICs**, each for their fractional share of undivided ownership, based on the pro rata value of their contribution to the purchase price.

The entire property is or will be leased to a single tenant. The tenant will be either a single user of the property or a master tenant with the right to sublet portions of the premises. Either way, the lease is a triple-net lease which imposes no responsibility on the co-owners for maintenance of the property or the supplying of any tenant services.

The co-ownership agreement places no restrictions on each co-owner's ability to sell or encumber their individual TIC interest. Also, **no voting** is established to sell, release or encumber the whole of the property. Thus, any *alienation* of the entire ownership of the real estate requires **unanimous approval** of all the co-owners — the essence of the conduct required for a TIC ownership to avoid the status of a tax partnership.

Based on these co-ownership arrangements, the syndicator requests of the IRS an **advance ruling** stating the arrangements for the TIC investment do not establish the investors as tax partners or members in an entity. On receipt of the IRC ruling, the fractional interest of a co-owner vested as a TIC can be acquired or sold as like-kind property.

Thus, an investor's acquisition of a fractional interest in a TIC investment group (with §1031 monies), which is the subject of an IRS advance ruling that the group is not a tax partnership, allows the profits an investor realizes on the sale of his property to qualify for the §1031 profit tax exemption by buying replacement property. [Rev. Proc. 2002-22]

The advance ruling for audits

To receive an **advance ruling**, the syndicator of a TIC co-ownership arrangement must, as a minimum, present extensive documentation to the IRS. In particular, the syndicator must demonstrate the following conditions exist:

1. Title will be vested in the name of all co-owners as TICs to their fractional or percentage ownership based on their proportionate contribution to the purchase of the property.

2. The co-owners will share in the income, profit and losses based on their percentage ownership.

3. No more than 35 participants will be co-owners, with husband and wife considered one participant.

4. The co-owners will not file a joint partnership return, will not operate the property under a common business name and the co-ownership agreement will not classify the co-owners as shareholders, members or partners.

5. The co-ownership agreement may provide for a right of first refusal to anyone (co-owner, manager, syndicator or lessee) to acquire a co-owner's fractional interest should the co-owner decide to sue for a partition and sale of the property. The fractional interest will be sold at a price set as the fair market value of the property at the time the right to purchase is exercised.

6. Any sale, encumbrance, lease, management or release agreement may only be entered into by unanimous approval of all co-owners (and no one related to the investment may hold a co-owner's power of attorney to act on his behalf).

7. Each co-owner may sell, encumber or lease his fractional ownership interest in the real estate without any prior restraints or approvals needed to permit the transfer. Should a transfer occur, a right of first refusal may exist in favor of any co-owner, the syndicator or the tenant to purchase the fractional interest transferred (based on the current market value of the entire property).

8. Any advances made by any other co-owner, the syndicator or manager to cover a co-owner's failure to meet a call for additional funds must be recourse and due within 31 days.

9. A co-owner may grant an option to purchase his interest to anyone. The price to be paid is the co-owner's fractional share of the whole property's fair market value on the date the option is exercised, however, no guaranteed buy out (put option) can be held by a co-owner to sell to anyone involved in the investment or the property.

10. A property manager may be hired for a period of no more than one year, with the contract renewable by unanimous agreement of the co-owners. He may be anyone except a lessee of the property, may collect rents, pay expenses incurred for the services to be provided to tenants as part of the rent, make distributions to co-owners from one bank account, prepare annual profit and loss statements for each co-owner's proportionate share of income, expenses, interest and depreciation, place insurance, negotiate leases to be executed only by unanimous approval of the co-owners and receive a fee in an amount comparable to fees received by competitive brokers. This fee cannot be based on a percentage of distribution to co-owners.

11. No lender providing funds for the investment program may be a related person to the co-owners, the syndicator, manager or lessee.

12. The syndicator may not sell any co-owner an interest in the property for less than the fractional interest's proportionate share of the whole property's fair market value (and services rendered by the syndicator to form the group), and no promotional fee or contribution by a co-owner may be contingent on the financial success of the investment program. [Rev. Proc. 2002-22]

However, in spite of all these threshold arrangements to obtain a ruling, the IRS provides **no rules or guidelines** for the syndicator's actual formation of a group of co-owners outside the confines of a ruling. Further, the IRS provides **no guidance** for their audit on a co-owner's sale or exchange of a fractional co-ownership interest which is not the result of an advance ruling. The IRS only provides a procedure for requesting an advance ruling by a syndicator based on a very limited set of facts.

As a legal complication, an investment program designed to qualify for an advance ruling from the IRS and sold to investors in California most likely creates a risk of loss for the co-owners which is controlled by *California's securities law* and the *Subdivided Lands Act (SLA)*. Ironically, both laws require more protection for investors than is required by the IRS for the TIC to qualify for an advance ruling regarding the non-partner status of a fractional co-ownership interest sold or acquired in a §1031 reinvestment plan.

The dilemma of an entity

An LLC or LP entity is typically used in **real estate syndications** to structure the co-ownership by investors of real estate. The use of an entity is both a more practical and prudent title holding arrangement than a TIC vesting.

For example, California's property tax laws cause a **reassessment** of the property vested in an LLC or LP only when more than 50% of the ownership of the LLC or LP is assigned to others by the original members of the LLC or LP.

Conversely, when title for the same co-owners is vested as TICs, each co-owner who conveys his TIC interests to others (including other co-owners), triggers reassessment of the fractional portion he conveyed. Thus, property taxes rise on each conveyance of a fractional interest, not just the 100% reassessment when a change of more than 50% of the original ownership in an LLC or LP eventually occurs.

Also, a **voluntary conveyance** or encumbrance by a co-owner of his interest in the property (as required to be allowed without restraint to receive federal non-partner status) may not concern other co-owners. However, a judgment lien imposed by a creditor on a vested co-owner's interest in title and a foreclosure by way of a judicial sale of the interest becomes an **involuntary conveyance** of the co-owner's interest to another person.

The creditor foreclosing or another party will acquire the debtor's co-ownership interest in the property. On acquisition as the highest bidder, they will in all likelihood file for the partition and eventual sale of the entire property, i.e., a forced sale by a creditor which an LLC or LP vesting avoids.

Another issue for vested co-owners is the release of their names to tenants as required on acquisition or change of management unless they appoint an agent for service of process. An LLC or LP vesting avoids the **public release** of their names since the co-owners are secreted behind a title holding entity they have formed — the LLC or LP vesting — to either own or simply hold title in trust for the co-owners.

Most important of all, the co-owner is *shielded from liability* by the use of an entity for any uninsured obligation he may incur as an owner of the property.

Thus, LLC or LP vestings are preferable for those co-owners not concerned about managing their profit tax avoidance when they invest or withdraw their investment from the group.

Acquiring a fractional interest

Consider an investor who sells his ownership interest in §1031 real estate. The investor is either the sole owner of the property or the owner of a fractional interest in property co-owned by a group. The investor has located a replacement property with an equity far greater than the net proceeds from his sale.

The seller of the replacement property is unwilling to sell on terms consisting of a purchase-money note carried back for the balance due the seller after a down payment. Further, the investor is unwilling (or unable) to commit additional cash funds himself.

However, the investor has solicited another investor who will join with him as a co-owner and contribute the additional funds needed to cash out the seller's equity and purchase the property.

A purchase agreement is entered into to acquire the property. On closing, the two investors take title to the property as TICs, each to an undivided fraction of the title in proportion to their contribution of cash toward the purchase.

They enter into a co-ownership agreement to spell out the arrangements they have agreed to between themselves regarding:

- the **management and operation** of the ongoing rental of the property; and

- the management of their **ownership interest** in the property to sell, encumber or lease (long-term) their interests or the entire property.

The co-ownership agreement addresses their **arrangements for management** of the entire property, as well as each individual's management of their fractional ownership interest, as follows:

1. Title will be vested as a tenancy in common.

2. The property will be managed by one of the investors (or a broker) as the property manager for a one-year period with authority to locate tenants, enter into and enforce short-term leases and rental agreements in his own name, provide normal and customary tenant services, repair and maintenance of the property and maintain a bank account in the manager's name for deposits or receipts from the tenants and disbursements for expenses, mortgage payments and distributions to the co-owners.

3. The co-owners will share income, profits and losses in proportion to their fractional ownership share in the property.

4. Each co-owner will maintain separate tax reporting for his share of operating data and cost basis in his ownership interest and depreciation deductions. Each will report their income and losses on his Schedule E with no partnership return to be filed.

5. Any sale, encumbrance, long-term lease or property management contract for the property will be unanimously approved by the co-owners.

6. The right of each co-owner to sell, encumber or partition their fractional ownership interest in the property will be unrestrained by any approval or consent by the other co-owner.

An **option to purchase** either another co-owner's fractional interest or the whole property may be granted to a co-owner or the syndicator who packaged the investment program.

Also, a **right of first refusal** may be granted to co-owners (or the syndicator) to be exercised on another co-owner's decision to sell, encumber or partition his fractional interest in the property.

The price paid on the exercise of the purchase rights is a pro rata amount of the fair market value of the entire property based on the co-owner's fractional ownership interest in the property.

Does the co-ownership agreement establish a *tax partnership* which would disqualify the sale of a co-owner's TIC interest from use of the §1031 profit tax exemption?

No! Neither co-owner is entering into a business relationship with any tenant by providing services unrelated to the rent paid for the property, nor are they sharing income received by a third party who is operating a business providing tenants with services unrelated to operating the rental, such as laundry, food, maid service or towels and linens.

Further, as TIC co-owners, they **unanimously approve** the hiring of a property manager who has authorization to carry out only those managerial steps necessary to operate the rental property, including customary landlord services and the repair and maintenance necessary to protect the property's improvements and conserve the property's value.

Thus, the co-owner has not relinquished his common law right of a TIC to act independently of the other co-owner to sell, encumber, enter into long-term leases and partition the property. No trade name, no joint operating (bank) account and no partnership agreement have been used or entered into to coordinate any sale, further encumbrance or long-term lease of the property.

The only "pooling" by the co-owners is the capital investment and its income, operating expenses and mortgage obligations of the ongoing ownership. Each co-owner has retained the ultimate property right to unilaterally withdraw from the investment by sale, encumbrance or partition without the consent of the other co-owner.

An alternative available for the vesting of a co-owner's interest is the use of a wholly owned, one-man LP or LLC for the **vesting** of his fractional interest. Title to his fractional ownership interest would be held in the name of his LP or LLC as a TIC with all other co-owners. Such a vesting for his undivided fractional interest would be considered by the IRS as title held by a *disregarded entity*. [26 Code of Federal Regulations §301.7701-3]

As a **disregarded entity**, an individual co-owner's use of his solely-owned LLC for the vesting of his fractional share of ownership would have absolutely no tax impact on the *non-partner status* of the co-owner's undivided interest.

If title to the entire property is vested in an entity such as an LP or LLC, the co-owners' arrangements must be limited so the entity is merely **holding title** for each individual co-owner, as TICs. Further, the entity and the co-owners will not file a partnership return (as ten or less are already excused from doing so). The operating agreement for the LP or LLC needs to establish the entity holding title has no ownership interest in the property, and is acting solely as a trustee holding title for the co-owners. [Rev. Rul. 79-77]

A vesting change to benefit a partner

A multiple-unit, income-producing real estate project is owned and operated by an investment group as an unincorporated association structured as an LP or LLC.

A broker operates the property as the property manager, locating tenants, entering into leases, contracting for routine repairs and maintenance, depositing all rents into his trust account, disbursing funds for payment of operating expenses and mortgage payments and distributing spendable income to the co-owners.

The investment group (ten or less) does not file an IRS 1065 return and a K-1 information statement on annual operating income, expenses, interest, and depreciation is not handed to the co-owners, since these filings are not required. [Rev. Proc. 84-35]

Each co-owner separately reports his fractional share of each year's rental operations on Schedule E of his return based on information provided him by the property manager.

One of the co-owners is now selling his fractional interest to another co-owner or an outside party.

The price or value the co-owner receives for his fractional interest exceeds his adjusted cost basis remaining in this investment. Thus, the co-owner will take a profit on the sale or exchange, which for tax purposes must be reported, unless *exempt* or *excluded*. [IRC §1001]

While the co-owner desires to get out of the investment, he does not want to report the profit and pay taxes. He needs all the net proceeds from the sale, undiminished by taxes, to invest in his personal trade or business.

The co-owner locates other property which he will acquire for his own account and use as the premises which houses his business.

The property the co-owner wants to buy will be used in the co-owner's *trade or business* (or rented to his corporate business). Thus, the property he will acquire qualifies as §1031 property since it will be *held for productive use* in his trade or business. [IRC §1231]

Editor's note — If the property acquired is rented to the co-owner's corporate business, it will then be a rental classified as §1031 investment property, not §1031 business property. [IRC §1221]

To structure the sale of his fractional co-ownership interest in the investment group as the first leg of a §1031 reinvestment plan, the LLC or LP will convey to the co-owner by grant deed an undivided interest in the real estate equal to the co-owner's percentage share in the partnership.

Thus, a **liquidation** of the co-owner's interest in the partnership occurs as a *distribution in kind* of the partnership asset — conveyance of his pro rata share in title, a non-taxable event. As a result of the conveyance, the partnership becomes a TIC with the prior partner who now holds title to a fractional interest in the real estate as a TIC. As a TIC, the co-owner by the TIC agreement is given all the rights to alienate his TIC interest, unrestrained, while agreeing to the centralized management of the property's maintenance and customary tenant-related services for a short period of time (not more than one year).

Now, as owner of a TIC interest in real estate and no longer a partner in the partnership, the co-owner immediately sells (or exchanges) and conveys by grant deed his newly acquired TIC interest to a third party. The cash receipts of the sale are used to acquire the real estate he has located as the replacement property to complete his §1031 reinvestment plan.

Has the co-owner held ownership to the TIC interest for a sufficient length of time and for the right reasons to qualify the TIC ownership for the §1031 profit tax exemption?

Yes! The co-owner acquired ownership of the TIC interest with **no intention of liquidating** his investment in real estate by "cashing out." Thus, the co-owner held the TIC interest, unrestrained by the need for prior consent from the co-owners on his sale of his interest. The co-owner's only intent is to make money by remaining **continuously invested** in real estate.

The duration of his ownership in any one particular property, such as his ownership of the TIC interest, is not of concern. It is that the ownership must be held either for productive use in a trade or business or for investment. Since it was so held, the continuation of his investment after a sale by acquiring an ownership interest in replacement property (no matter it be for a long or short period of time) demonstrated the intent required to **remain unliquidated** in real estate investments. [**Bolker** v. **Commissioner** (9th Cir. 1985) 760 F2d 1039]

Editor's note — For property used in a trade or business to qualify as §1031 property, ownership must be retained for a period of one year. [IRC §1231]

The §1031 by a twist of Schedule E

A lack of understanding seems to exist among taxpayers, CPAs and drafters of IRS forms regarding the consequences of IRC partnership classification for fractional ownership interests, 1065/K-1 co-ownership reporting forms, the exemption from filing by partnerships comprising ten or less members and Schedule E filing by co-owners.

Thus, an **unintended application** of the §1031 exemption from profit tax reporting permits the profit taken on the sale of a fractional interest in a group investment which would otherwise be classified as a *tax partnership* to go unreported.

For example, when co-owners in an investment group file their individual returns, they report the operating data for rental properties on Schedule E, attached to their annual 1040 return. The partnership does not file a return nor provide K-1 reports.

Schedule E lists the co-owners' proportionate share of income, expenses, interest and depreciation separately. No reference is made (unless volunteered) to the aggregate data generated by the combined ownership of the real estate described in Schedule E.

The property data itemized by the individual co-owner on his Schedule E are but an **undisclosed fraction** of the income, expenses and deductions of the property identified on the co-owner's Schedule E. So far, so good during the ownership of the property.

But on the sale of the ownership interest in real estate listed in Schedule E, the IRS does not know (without an audit or a gratuitous disclosure) whether the interest sold is:

- an ownership **interest in a tax partnership** and thus excluded from tax-free treatment [IRC §1031(a)(2)(D)]; or
- a TIC ownership **interest in the asset** itself which, if unrestrained in its alienation rights, qualifies as §1031 property.

Thus, Schedule E fails to request information from the taxpayer on whether:

- the property ownership is connected by arrangement to additional tenant services paid for separate from rent; or
- the interest listed is a fractional interest.

Likewise, the IRS §1031 disclosure form does not inquire into whether the interest sold or exchanged:

- is a fractional interest in property;
- a fractional ownership interest in a partnership which owns the property; or
- a sole ownership interest in the property. [See IRS Form 8824]

Thus, a co-owner's annual reporting of his fractional interest on Schedule E (or F or C), and the sale and replacement of the interest on a §1031 disclosure form, does not trigger automatic audit or disallowance by the IRS. As a result, the exemption from profit taxes declared by the taxpayer is cleared, without a question about the possible tax partner status of the owner whose fractional interest is sold or acquired.

Editor's note — A school of thought holds the view that these deficiencies in the IRS forms produce the result intended by a more friendly and lenient IRS. However, this might not be the case. [Rev. Proc. 2002-22]

Chapter 14 Securities aspects of syndication

This chapter discusses the securities risks that exist in real estate development, lending and business operations co-owned as group investments.

Economic risks of real estate excluded

When a group of investors are brought together by syndication, whether structured to own real estate as a limited liability company (LLC) or other form of co-ownership — tenancies-in-common (TICs), corporations, limited partnerships (LPs), etc. — the syndicator must have an understanding of the social purpose underlying state and federal securities laws if he is to avoid **promotional activities** controlled by securities law.

The classic federal definition of a *security* relationship is:

- an **investment** of money;
- a **common enterprise** based on the mutual success or failure of the group in its investment goals; and
- an **expectation of profits** produced by the **efforts of others**, not just by the property. [**Securities and Exchange Commission** v. **W. J. Howey Co.** (1946) 328 US 293]

In application, the purchase and ownership of real estate by any group of investors involves both the elements of an **investment** and a **common enterprise**. Thus, the syndicator's formation of a group for an investment in real estate has the potential for creating a *securities risk*.

However, to create a security, the investment program must contain the third element — profit that is produced by others through an activity that *creates value* in the property. A **securities risk** arises when the investor releases control of his cash contribution, and it remains under the syndicator's or someone else's control until the promised value-creating activity is completed.

The risk created by a person's promise to perform an activity that **creates value** in a property is distinguished from a group investment that does not present a securities risk and remains outside the securities law.

To be a security, the investment program sold to the group of investors must provide for a **return of the original investment** based on a promise, by the syndicator or someone else, of future physical development or other change of use for the real estate acquired, that must be completed before the investment goal can be attained.

However, the mere formation of a group of investors by a syndicator to purchase and operate an existing income-producing real estate project for income (or to hold land for profit on resale), does not involve a securities risk. Here, the expectation of a return is based on the performance of the property in the marketplace, subject to economic conditions that affect all properties. The investors are not counting on the efforts of the syndicator or any other person to produce improvements or to develop a use for the property after the invested money has been released from the investor's further control.

Also, LLC ownership is merely a **business structure** used as a form of group ownership of the asset acquired in a real estate investment program. Thus, soliciting and offering cash investors fractional membership interests in an LLC (or as tenants in common) formed to fund the acquisition of an existing income-producing property is not, without analyzing other activities in the investment program, the offering of a security.

Conversely, an investment group formed to develop real estate or undertake an ongoing resale marketing program, farming operation or business opportunity, regardless of the entity or form of vesting chosen for the group, contains securities risks. To create a corporate securities risk the investors' capital must be placed at a **risk of loss** through the need to complete significant value-adding activities after the acquisition of the property. Also, the syndicator's selection of a property for acquisition after the investor relinquishes control of his cash, called a *blind pool*, is an activity controlled by the securities law.

A group investment program containing an activity that constitutes a securities risk imposes a duty on the syndicator soliciting investors' capital to comply with the securities law. Exemptions exist that remove some investment programs containing securities risks from control under the securities law.

Unless exempt, the syndicator first reports to the appropriate government agency:

- the California Department of Corporations (DOC) to comply with state securities rules and to qualify for a permit; or

- a registration with the Securities Exchange Commission (SEC) to comply with federal law.

Failure to qualify or register the sale of non-exempt corporate securities exposes the syndicator who creates the securities risk to civil and criminal liability.

A prudently selected property in a structured investment program avoids ownership activities that place the investors' capital at a risk of loss, such as after-closing development, blind pool asset selection or collective post-acquisition coordination with others (rental pooling). These ownership activities create a relationship between the investors and the syndicator, or others, that is classified as a *corporate security*.

Existing asset vs. securities risks

A group of investors purchases a newly constructed, but unoccupied apartment building. The syndicator who solicited the investors to become co-owners serves as manager for the group and the property. The investors have the right to cancel the property management agreement with the syndicator by removing him as the manager on 30 days' notice.

The investment program eventually fails to be a financial success. The local economy and its exploitation by the syndicator does not produce enough tenants to occupy the property. Thus, the amount of rental income received is insufficient to pay operating expenses and installments on the purchase-assist loan. The investment fails and is liquidated by foreclosure or other sale.

The co-owners make a demand on the syndicator for a return of their investment funds, plus the legal rate of interest (10%). They claim the purchase of the complex, when coupled with the property management agreement, creates a corporate security that was neither exempt from the securities law nor qualified by the DOC. The co-owners claim they relied on the syndicator's **management expertise** to rent out units in the newly constructed building and create a *return on the capital* they invested in the LLC.

Does the syndicator who merely manages property in competition with other like-type properties impose a liability on himself for the return of the co-owner's capital?

No! A corporate security is not created by the existence of property management activity or the promise or expectation of an annual return on their investment. Members of an LLC or TIC **retain control** over the management of the property. They have the right to terminate any property management agreement and the manager by a vote of the co-owners. Further, they can replace management with other management, as it is a service readily available in the local brokerage community.

Here, the investors did not place their capital at risk in reliance on the skill and effort of another to **create value** in the property. Instead, they acquired a fully-improved, existing asset in exchange for the funds invested, on the chance the rental market place will allow their investment to prosper.

Also, they retained ultimate control over management since they could change management at any time. The investors bought the property as the investment, not the syndicate manager or his management expertise (which was, instead, the subject of the property management agreement). [**Fargo Partners** v. **Dain Corp.** (8th Cir. 1976) 540 F2d 912]

Now consider a syndicator who sells small parcels of agricultural land planted with citrus trees to individual investors. Under a **service agreement** attached to each purchase agreement, the syndicator is to care for the trees and harvest and market the fruit produced by all the properties under his management. The term of the service agreement is 10 years.

The syndicator manages the groves on all the separate parcels by coordinating the ownership and operations of all the parcels as a single, large-scale farming operation. The syndicator has the knowledge and equipment required to conduct a successful farming operation and **produce and sell** the crop. Each investor is to receive a share of the net operating income from the syndicator's crop production based on their pro rata ownership of all parcels farmed under the service agreement, called a *pooling arrangement* or *horizontal commonality* investment.

In contrast to an apartment building co-owned by several investors with the syndicate manager locating tenants and renting existing units, an investment in a parcel of agricultural land operated as a farming business, coordinated and managed by the syndicator or others, contains a corporate securities risk. The investors rely solely on the expertise of the syndicator to **create a return** of their invested funds (capital) by **producing a crop**, then harvesting and selling it. As a further securities risk, he agreed to do so in cooperation with owners of other properties in a **pooling arrangement**.

Here, an investor who cancels the service agreement with the syndicator will not be able to independently operate his parcel of land and its grove with any economy to be successful. Operating separately from the owners of other parcels he will not be able to readily hire another operator to coordinate farming operations with the owners of other parcels as a *collective* to produce and market crops. The **financial success** of the operation requires all the parcels in an economy of scale to be operated as one, using special equipment and skills possessed by the syndicator.

Thus, even though the transaction was structured as a sale of a parcel of real estate to an individual purchaser combined with a service agreement, the series of related transactions display the critical elements of a corporate security — a group investment with an expectation of profits and success inextricably interwoven with the efforts of others to **produce a crop** and market it to generate an income and, ultimately, a return of the investment. [W. J. Howey Co., *supra*]

Protecting the investor

The state and federal corporate securities laws exist to protect investors who risk their capital in **asset-creating investment schemes** offered by others. The social purpose is to give investors a reasonable opportunity to realize profits on their investment.

A securities risk is created under California securities law whenever:

- an investor places his funds at risk of loss; and
- assumes a passive role, giving control of essential asset selection, development, pooling or resale decisions exclusively to the syndicator or others.

A security is created when the syndicator or others promise to perform an activity that **creates value** after the close of the purchase. Unless the creative activity is completed successfully, value will not be added to the property and the expected return of capital will not occur.

In essence, the investor did not invest in an existing asset, but in the skill of someone else to create that valuable asset in the future. The expenditure of invested funds is no longer controlled by the investor, but by the syndicator or others. Activities that occur after closing and create a **securities risk** include:

- locating and selecting a property for acquisition, called a **blind pool**;
- obtaining government approval or permits for zoning or a higher and better use of the property;
- making further improvements or significant alterations to the property; or
- operating a business or farming operation that requires expenditures for inventory, production or sales.

Thus, for a security to exist, the syndicator must undertake an ongoing investment activity that continuously places the investor's capital at risk of loss until the promised value-adding activity is completed. The securities risk is contained in the management of money, whether obtained from the investors or borrowed funds, to improve the property, create the crop or obtain agency approvals for a new use to fulfill the purpose of the group investment.

Examples of activities that include a securities risk for investors in syndicated real estate transactions include:

- subdividing, improving or reselling the real estate (dealer activities);
- operating a business on the premises acquired rather than merely managing the rental of the real estate or the ownership of vacant land; and
- investing in trust deed notes.

The California securities law is designed to give investors a fair chance of realizing investment objectives promised to be performed and completed by others. The syndicator is responsible for returning the investor's capital if promises of development are not fulfilled by completing after-closing activities that create the significant value necessary to provide for a return of the investors' contributions. [**Silver Hills Country Club** v. **Sobieski** (1961) 55 C2d 811]

Controlled investments

The securities issue for the syndicate manager is to determine which investment activities include risk situations that trigger the application of the securities law.

The existence of a security is a matter of the *substance* of the transaction, not the *form* it has been given. The economic function of the transaction, rather than the title the transaction bears or the type of business form used, determines whether a securities risk exists.

Editor's note — An exception to the substance-over-form rule is the issuance of ***stock****. Any transaction that involves the issuance or transfer of investment certificates, which are formally called stock, is a controlled security, regardless of the economic substance of the investment in the stock. [****Landreth Timber Company*** *v.* ***Landreth*** *(1985) 471 US 681]*

For example, the citrus grove investment program reviewed above was structured as a sale of a parcel of improved agricultural property. Each investor became the sole owner of an individual parcel of land — a real estate sales situation that, without further development after the acquisition, does not contain a securities risk.

However, each owner has no reasonable ability to **independently control** or operate the property and produce and market a crop in the farming business they bought into. Success was entirely in the hands of the syndicator to create value for a return of their invested funds through the husbandry, production, marketing and sale of the crop, and the coordination by *pooling* with other owners.

Next, consider an investor who purchases a condominium unit through a real estate broker. Normally, the purchase of a residential unit does not constitute a corporate security (other than as controlled by the subdivision law.) However, the broker also arranges for the buyer to enter into a *rental pooling agreement* (RPA) with a vacation rental management company for the ongoing operation of the property. The broker has no connection to the management company employed in the RPA and receives no kickback or fee for the referral.

Under the RPA, the management company oversees a rental operation within the entire project in which the investor's unit is located. The property manager distributes spendable rental income to the investors of individual units based on their pro rata share of ownership participation in the RPA, not based on the actual performance of their separate units, an activity called *rental pooling*.

The RPA is a major inducement for the investor to purchase the condominium unit. The pooling arrangement enables him to locate tenants, rent the unit and collect rental income without being personally responsible for the day-to-day management of his unit. Critical to the investment is the sharing of these investment risks; he will share the income and expenses with everyone else within the "pool." More strategically, the investor plans to cover his monthly mortgage payments and assessments on the condominium out of the rental income.

Ultimately, due to market forces, not management, the unit fails to produce the level of rental income the investor expected. The investor seeks to recover his investment from the broker, claiming the purchase of the condominium coupled with the RPA was a *corporate security*, since the investor relied on the management efforts of others in the **joint operation** of several individually owned units to produce a return of his investment.

The broker claims he did not create a corporate security since the investor was not required to enter into the RPA as part of the agreement to purchase the condominium. Further, the broker was not in control of the management of the property.

Did the broker create a corporate security by arranging an RPA for the investor?

Yes! The purchase of the condominium unit coupled with the RPA was presented to the investor as two separately controlled components of a single investment scheme. The investor was induced by the broker to invest his funds in the common enterprise based on an **expectation of profits** produced by the efforts of others in a *pool and split* program — even though the broker himself was not the person responsible for coordinating the rental pooling effort.

Since the broker arranged for the investor to place his funds at risk on the close of escrow in anticipation of a future return generated by the efforts of others — the pooling and management of several separately owned properties under the RPA — a **securities risk** was created. [**Hocking** v. **Dubois** (9th Cir. 1989) 885 F2d 1449]

Subdivided parcels sold to groups

Now consider a developer who acquires numerous acres of real estate for the development of a planned community. The developer sells parcels within the planned development to groups formed as LLCs (or TICs). The parcels are advertised as being suitable for development as part of the planned community.

The developer does not promise to develop the parcels sold to the LLCs or to produce profits for the LLCs based on the development of the entire project, adjacent parcels, off-site infrastructure or any profit pooling arrangement.

One group of investors who acquired a parcel makes a demand on the developer and his broker for a return of their investment, claiming a security was created since they relied on the developer to complete the development of the planned community, which did not occur.

However, the group of investors had complete control over the parcel it acquired from the developer — nothing remained to be done after acquisition, except for the investors to wait for the market to deliver a profit or loss. Thus, no securities risk was created, only an economic risk. The transaction was merely a sale of real estate to the LLC, to hold for a profit on resale or later development as the group saw fit. [**De Luz Ranchos Investment, Ltd.** v. **Coldwell Banker & Company** (9th Cir. 1979) 608 F2d 1297]

Risk capital tests

State and federal courts apply slightly different tests to determine whether a securities risk exists in an investment program. In California, courts apply what is called the *risk capital test* to determine whether the investors in a syndicated real estate transaction benefit from securities law protection.

The California risk capital test requires the investors' capital to simply be placed at risk in a value-adding activity, **whether or not a profit** is expected or intended. Compared to federal securities law, the California securities law is further-reaching and covers more investment conduct.

The federal risk capital test, on the other hand, revolves around the element of the expectation of a profit on the investment in a value-adding activity. For a security to exist under the federal **risk capital test**, the investors must be induced to join the program by, among other activities, a promise that they will profit from their capital investment.

Personal use coupled with development

Under the California risk capital rule, a syndicator's mere promise of future profits does not create a securities risk unless it is accompanied by the promise to perform an activity that creates value, such as development.

For example, a developer sells memberships in a yet-to-be-built country club to investors. Later, when the developer fails to complete construction of the country club, the investors make a demand on the developer for their investment to be returned. They claim the developer violated California securities law since the club memberships sold were unqualified and non-exempt securities in a construction project.

The developer claims the country club memberships are not controlled by California securities laws since the memberships merely provide for personal recreation and involve no expectation of a profit.

However, unlike federal securities law with its profit-driven test, an expectation of profit is not of concern to the California securities law. Here, the sale of memberships was coupled with a securities risk. The investors risked their capital on a "yet- to-be-built" project, relying on the developer to **complete the construction** of the country club after the members released their investment funds to acquire membership in the group's ownership of the property. [Silver Hills Country Club, *supra*]

Promised returns without development

To avoid creating a security under California's risk capital test, the selection of a specifically **identified parcel** of real estate for acquisition must exist before the release of invested funds. Even then, the only business that may be conducted after acquiring the property is either the location of tenants and rental of the property or the ultimate resale of the unaltered property at a profit.

If, on closing a purchase escrow, the investor receives **full value** for his investment in the form of a fixed asset, such as a share ownership in an existing parcel of real estate and a guarantee of a minimum profit, no security is created. The investor's capital is no more at risk than if he had purchased the asset outright, with or without a promise of profits. [**Hamilton Jewelers** v. **Department of Corporations** (1974) 37 CA3d 330]

In another example, a syndicator completes his due diligence investigation on a property he located and decides it is suitable for syndication. A detailed **investment circular** is prepared. The circular states the real estate will not be further developed or improved, but simply owned and operated for what it is — a rental income property.

The investors solicited by the syndicator know they will receive an existing fixed asset for their money. The property will not be altered, further improved or converted to another use after acquisition. Thus, their capital is not subjected to a securities risk — only the **economic risks** of locating tenants and incurring expenses in the rental marketplace, activities experienced by all property owners.

All money invested in real estate is, to some extent, at risk of loss due to fluctuating property values brought about by economic conditions, natural hazards, etc., called *marketplace risks*. However, marketplace risks merely affect the level of income, profit or loss. Income and profits (or losses) from ongoing rental operations in the local economy are not the concern of securities laws.

Exemptions when securities risks exist

A large number of investments that contain a securities risk are *exempt* by statute from control under the securities laws.

Investment programs offered by banks and savings and loans (S & Ls) are exempt from securities law, as are *nonpublic offerings* by individuals.

The **nonpublic offering exemption** is the most useful exemption available to syndicators who put together an investment program which includes an activity containing a securities risk. The nonpublic offering exemption, called the *35-or-less interrelationship rule*, applies if:

- the investors do not number more than 35 (husband and wife counting as one);
- all investors have a meaningful, pre-existing business or personal relationship with the syndicator;
- the investors will not resell or distribute the interests they acquire; and
- the solicitation of investors does not involve public advertising. [Calif. Corporations Code §25102(f)]

Thus, when an investment program does contain securities risks, such as exist in a construction or development project, the syndicator does not need to be further concerned with the securities law if his program meets the requirements of the **35-or-less interrelationship rule** for the nonpublic offering of a security.

If a securities risk does not exist in the investment program, the **solicitation of investors** by public advertising is not an activity which places the investors' funds at risk.

Consider an LLC that seeking investors for a California property yet to be developed. The LLC files paperwork with the SEC granting it the ability to sell an unlimited amount of memberships in the LLC, which are to be structured as limited private placement offerings. Under a federal securities law exemption, these type of offerings can only be made to *accredited investors*. [17 Code of Federal Regulations §230.501]

The LLC solicits a small business owner with whom it has no prior relationship to invest in the LLC, without qualifying the business owner under the restrictions for a limited private placement offering.

The California DOC issues the LLC a desist and refrain order, claiming the LLC violated state securities law by publicly offering a membership with the LLC in a value-adding venture without the LLC being qualified or registered with the DOC.

The LLC sought to dismiss the desist and refrain order, claiming the DOC's authority was preempted by the LLC's filing with the SEC as a non-securities offering.

Is the LLC exempt from the DOC's desist and refrain order due to its filing with the SEC as a non-securities offering?

No! Here, the state securities law controls since the LLC did not adhere to the federal exemption requiring it to contact only **accredited investors**. Thus, it fell outside the scope of the SEC limited private placement filing and was subject to state securities law. [**Consolidated Management Group, LLC** v. **Department of Corporations** (2008) 162 CA4th 598]

Disclosure of securities and limitations on recovery

Consider a syndicator whose investment program contains a securities risk activity such as conversion or development. To solicit investors, he posts his offering in the recreational rooms of condominium projects and *mobilehome* parks he has an interest in. He does not obtain a permit nor does he register the sale of the investment program with the DOC or SEC.

Here, the syndicator publicly offered his investment opportunity containing a securities risk to anyone visiting the recreational rooms. Thus, his investment program was a **non-exempt offering** of a security. As a result, any investor in the program can recover the full amount of his investment from the syndicator, plus 10% interest from the date of investment, less any distributions the investor has received. [Corp C §25503]

However, the investor's recovery of his investment under California securities laws is subject to a time constraint, called a *statute of limitations*. The limitation places a time deadline beyond which an investor is barred from filing a claim for the recovery of money. An action to recover the investor's funds must be filed within the earlier of:

- two years after the date the investor funds the investment; or
- one year after the investor discovers the securities law violation. [Corp C §25507]

If the syndicator, as part of his investment memorandum, discloses securities permits have not been obtained, the investor will be aware of the potential violation from the beginning. Thus, the investor's recovery under the California securities law will be subject to the one-year statute of limitations for filing his complaint.

Until the one-year limitations period expires, the investor in an investment program that contains a securities risk and does not qualify for an exemption or was not qualified for investors by the DOC, may unilaterally withdraw his investment funds at any time (plus interest and less any distribution of earnings). However, when the one-year period has expired following disclosure and the close of escrow, the syndicator is no longer liable for any claims to money for securities violations.

Realistically, if an investor is willing to contribute his funds to a real estate syndication in the first place, he is unlikely to withdraw and file an action within one year. Real estate investments are unlikely to be observed as having gone sour within one year.

Thus, even if the syndicator is certain his investment program contains no activities that are securities risks that place the investors' funds at risk of loss after acquisition of the property, a disclosure that no permit exists limits the syndicator's exposure to civil monetary liability by commencing the one year statute of limitations. [See **first tuesday** Form 372 §1.7]

Chapter 15 Trust deed investment for groups

This chapter discusses the documentation necessary for a syndicator to publicly solicit multiple investors to make or purchase a trust deed loan.

Fractionalizing a trust deed

A borrower retains a loan broker to solicit and arrange a large loan to be secured by real estate. The borrower and the broker enter into a loan agreement contingent on the broker locating trust deed investors with sufficient cash reserves to fund the loan.

To locate trust deed investors, the broker runs newspaper advertisements soliciting private investors with modest amounts of funds to form a trust deed investment group consisting of **ten or less investors**. The loan is too large for any one of the investors to handle alone or prudently carry the entire risk of loss.

As investors respond to the advertisements and subscribe, their funds are placed in a loan escrow trust account set up specifically for this loan, until sufficient funds accumulate to fund the loan. When fully funded, the borrower signs and delivers his note and trust deed to the loan escrow. Both documents reflect the fractional ownership of the note and trust deed by the numerous contributing investors named as beneficiaries, based on their proportional investments.

The broker concurrently enters into a **collection and servicing agreement,** signed by each of the investors, to service the note and trust deed as their collection agent. The broker is authorized by the agreement to:

- advance payments to the investors from his own funds to cover any delinquent installments; and
- bid in the property for his own account in the event of a foreclosure under the investors' trust deed.

Has the broker created an investment risk that is regulated by California corporate securities law?

Yes! The broker's *singular activity* of fractionalizing the investment in a note and trust deed among multiple private investors creates a corporate security. [**People** v. **Schock** (1984) 152 CA3d 379]

A loan broker syndicating trust deeds creates a *corporate security* if:

- he accepts money from an investor or executes promissory notes **before locating** the trust deed investment, called a *blind pool investment* [See Chapter 14]; or
- the trust deed is **fractionalized** among multiple investors rather than acquired by one trust deed investor for his own account.

However, a broker can package *multiple-lender* trust deed investments and avoid securities violations, provided his conduct falls within one of two readily available exemptions from the securities law.

Securities exemptions

When fractionalizing a trust deed investment and thus creating a securities risk, a syndicator has two options for complying with the securities law.

The first is the **nonpublic offering exemption**, called the *35-or-less interrelationship rule*. To use this exemption, the syndicator must have a meaningful, pre-existing business or personal relationship with investors he privately solicits for the trust deed investment. [See Chapter 14]

However, trust deed investment groups need not be limited to persons with a pre-existing relationship with the loan broker. A loan broker may publicly solicit trust deed investors by filing a *notice permit* with the Department of Real Estate (DRE) under the second claim of exemption option, called the *ten-or-less trust deed investment plan*.

The ten-or-less rules and reporting

The ten-or-less trust deed investment scheme allows a loan broker to publicly solicit investors to acquire a fractional interest in a trust deed note. To qualify for this ten-or-less exemption, the loan broker must comply with the following rules and guidelines:

1. A **multi-lender transaction notice** form, also called a *notice permit* or *claim of exemption,* is prepared and filed with the DRE within 30 days after:

    1.1 the loan broker **originates or sells** the first trust deed note made or acquired by ten-or-less investors he solicited from the public [See Form 545 accompanying this chapter];

    1.2 any change to the information in the original notice filed with the DRE, called an amendment [Calif. Business & Professions Code §10238(a)]; or

2. **Advertising** for trust deed investors must:

    2.1 include the name of the broker and his license identification;

    2.2 comply with sections 260.302 and 2848 of California Regulations, Title 10, regarding advertising criteria, wording and disclosures; and

    2.3 include no reference to compliance with the DRE notice permit procedure since it infers merit or approval by the DRE. [Bus & P C §10238(c)]

3. The **trust deed** securing the note includes:

   3.1 California real estate in which the broker, directly or indirectly, has no ownership interest or right to acquire an ownership interest [See §5 below];

   3.2 no agreement for the future subordination of the trust deed; and

   3.3 priority as a first trust deed if it is security for a **construction loan**, with funds disbursed as construction progresses; including ten percent retention until expiration of the mechanic's lien period, and covered by title insurance providing priority against mechanic's liens. [Bus & P C §10238(d)]

4. The note must not be a *promotional note* secured by a junior trust deed, or a trust deed subject to a future subordination agreement, executed on:

   4.1 lots in a subdivision;

   4.2 unimproved property; or

   4.3 newly constructed, unsold property. [Bus & P C §10238(d)]

5. The fractional interests may be sold by a real estate broker, acting as either a **principal** or an **agent,** to finance:

   5.1 his acquisition of real estate at a foreclosure sale under a trust deed he is servicing or one that he originally sold to investors; or

   5.2 the broker's resale of real estate he acquired at a foreclosure sale under a trust deed he was servicing or originally sold to investors. [Bus & P C §10238(e)]

6. The fractional interests are **sold to ten or less investors**. [Bus & P C §10238(f)]

   6.1 An unlimited number of persons may be publicly solicited to purchase an interest. [Bus & P C §10238(f)(2)]

   6.2 A husband and wife, or any retirement funds or entity wholly owned by an individual and/or their spouse, that acquire a fractional interest are treated as one investor. [Bus & P C §10238(f)(3), §10238(f)(4)]

   6.3 Any organization, such as a partnership, limited liability company (LLC) or corporation that was not specifically formed for the purpose of investing in the fractional interest is treated as one investor. [Bus & P C §10238(f)(5), §10238(f)(6)]

   6.4 Each investor must sign a statement indicating he meets minimum income or net worth standards. [See **first tuesday** Form 373]

   In it he must state his total investment in the trust deed note from all sources (directly or through his spouse, retirement fund or controlled entity) represents:

   a. ten percent or less of his net worth (excluding cars, home and furnishings); or

   b. ten percent or less of his current or prior year's adjusted gross income (AGI) for his Internal Revenue Service (IRS) 1040 tax return. [Bus & P C §10238(f)(1)]

MULTI-LENDER TRANSACTION NOTICE
(RE 860)

GENERAL INFORMATION

- This notice is filed pursuant to Section 10238 of the Business and Professions Code.
- AN AMENDED NOTICE MUST BE FILED BY THE BROKER WITHIN 30 DAYS OF ANY MATERIAL CHANGE IN THE INFORMATION REQUIRED TO BE SET FORTH HEREIN.
- Mail completed notice to:
  Mortgage Loan Section
  2201 Broadway
  P.O. Box 187000
  Sacramento, CA 95818-7000

MULTI-LENDER TRANSACTION NOTICE

CHECK ONE

☐ ORIGINAL NOTICE ☐ AMENDED NOTICE

1. NAME OF BROKER CONDUCTING TRANSACTION UNDER SECTION 10237

2. BROKER LICENSE ID#	3. MONTH FISCAL YEAR ENDS	4. BROKER'S TELEPHONE NUMBER

5. FIRM NAME (IF DIFFERENT FROM 1)

6. STREET ADDRESS (MAIN LOCATION)

CITY	STATE	ZIP CODE

7. MAILING ADDRESS (IF DIFFERENT FROM 6)

CITY	STATE	ZIP CODE

8. SERVICING AGENT — IDENTIFY BY NAME, ADDRESS, AND TELEPHONE NUMBER THE PERSON OR ENTITY WHO WILL ACT AS THE SERVICING AGENT IN TRANSACTIONS PURSUANT TO SECTION 10229 (INCLUDING THE UNDERSIGNED BROKER IF THAT IS THE CASE)

9. TOTAL NUMBER OF MULTI-LENDER NOTES ARRANGED	10. TOTAL NO. OF INTERESTS SOLD TO INVESTORS ON THE MULTILENDER'S NOTES

11. INSPECTION OF TRUST ACCOUNT — BEFORE ANSWERING THIS QUESTION, REVIEW THE PROVISIONS OF PARAGRAPH (3) OF SUBDIVISION (K) OF SECTION 10238. ***(See reverse.)***

CHECK ONLY ONE OF THE FOLLOWING:

☐ The undersigned broker is (or expects to be) required to file reports of inspection of its trust account(s) with the Real Estate Commissioner pursuant to paragraph (3) of subdivision (k) of Section 10238.

- Amount of multilender payments collected last fiscal quarter:
- Total number of investors due payments last fiscal quarter:

☐ The undersigned broker is NOT (or does NOT expect to be) required to file reports of inspection of its trust account(s) with the Real Estate Commissioner pursuant to paragraph (3) of subdivision (k) of Section 10238.

Certification	SIGNATURE »	DATE
The contents of this notice are true and correct.	TYPED NAME OF BROKER	
	SIGNATURE OF BROKER OR DESIGNATED OFFICER OF CORPORATE BROKER »	
	TYPED NAME OF PERSONS SIGNING THIS NOTICE	

Section 10238(k) of the Business and Professions Code

(k) The notes or interests shall be sold subject to a written agreement that obligates a licensed real estate broker, or a person exempted from the licensing requirement for real estate brokers under this chapter, to act as agent for the purchasers or lenders to service the note or notes and deed of trust, including the receipt and transmission of payments and the institution of foreclosure proceedings in the event of a default. A copy of this servicing agreement shall be delivered to each purchaser. The broker shall offer to the lenders or purchasers the services of the broker or one or more affiliates of the broker, or both, as servicing agent for each transaction conducted pursuant to this article. The agreement shall require all of the following:

(1) (A) That payments received on the note or notes be deposited immediately to a trust account maintained in accordance with this section and with the provisions for trust accounts of licensed real estate brokers contained in Section 10145 and Article 15 (commencing with Section 2830.1) of Chapter 6 of Title 10 of the California Code of Regulations.

(B) That payments deposited pursuant to subparagraph (A) shall not be commingled with the assets of the servicing agent or used for any transaction other than the transaction for which the funds are received.

(2) That payments received on the note or notes shall be transmitted to the purchasers or lenders pro rata according to their respective interests within 25 days after receipt thereof by the agent. If the source for the payment is not the maker of the note, the agent shall inform the purchasers or lenders of the source for payment. A broker or servicing agent who transmits to the purchaser or lenders the broker's or servicing agent's own funds to cover payments due from the borrower but unpaid as a result of a dishonored check may recover the amount of the advances from the trust fund when the past due payment is received. However, this article does not authorize the broker, servicing agent, or any other person to issue, or to engage in any practice constituting, any guarantee or to engage in the practice of advancing payments on behalf of the borrower.

(3) If the broker or person who is or becomes the servicing agent for notes or interests sold pursuant to this article upon which the payments due during any period of three consecutive months in the aggregate exceed one hundred twenty-five thousand dollars ($125,000) or the number of persons entitled to the payments exceeds 120, the trust account or accounts of that broker or affiliate shall be inspected by an independent certified public accountant at no less than three-month intervals during the time the volume is maintained. Within 30 days after the close of the period for which the review is made, the report of the accountant shall be forwarded as provided in paragraph (6) of subdivision (j). If the broker is required to file an annual report pursuant to subdivision (o) or pursuant to Section 10232.2, the quarterly report pursuant to this subdivision need not be filed for the last quarter of the year for which the annual report is made. For the purposes of this subdivision, an affiliate of a broker is any person controlled by, controlling, or under common control with the broker.

(4) Unless the servicing agent will receive notice pursuant to Section 2924b of the Civil Code, the servicing agent shall file a request for notice of default upon any prior encumbrances and promptly notify the purchasers or lenders of any default on the prior encumbrances or on the note or notes subject to the servicing agreement.

(5) The servicing agent shall promptly forward copies of the following to each purchaser or lender:

(A) Any notice of trustee sale filed on behalf of the purchasers or lenders.

(B) Any request for reconveyance of the deed of trust received on behalf of the purchasers or lenders.

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7. Each investor is given all the **rights of a lender** and each interest sold to investors is on the same terms.

   7.1 The investor's interest in the trust deed as a named beneficiary will be recorded before a release of the funds from escrow. [Bus & P C §10238(g)]

8. Based on the combined principal amounts of the fractionalized note and any prior encumbrances (bonds and trust deeds), as well as the current market value of the real estate as stated in a written **opinion of value** by an appraiser or the broker, the loan-to-value (LTV) ratio must not exceed the greater of:

   8.1 80% for owner-occupied, single family residences;

   8.2 75% for non-owner-occupied, single family residences;

   8.3 65% for commercial and income-producing property;

   8.4 65% for single-family, residential-zoned lots or parcels;

   8.5 50% for undeveloped property zoned for commercial or residential use;

   8.6 35% for other real estate; or

   8.7 the percent of value set by any private mortgage insurance (PMI) coverage issued for the fractionalized note. [Bus & P C §10238(h)(1); see **first tuesday** Form 234]

Editor's note — If unique circumstances exist, the broker may exceed the statutory LTV ratios if he can justify in writing his reasons for exceeding the limits. However, the LTV ratio must never exceed 80% of improved real property or 50% of unimproved property, except for single family, residentially zoned lots or parcels, for which the LTV ratio cannot exceed 65%.

The broker must keep the statement containing the justification for exceeding the LTV limits in his files. Also, he must provide the investors with a copy of the LTV statement with the lender disclosure statement. [Bus & P C §10238(h)(2); see Form 235-1 accompanying this chapter]

9. The beneficiaries' operating agreement provides:

   9.1 a default on the note or trust deed is a default on all the investors' interests in the note; and

   9.2 a vote of investors holding more than 50% of the ownership interests in the note controls the action taken on a default in the trust deed and the selection of the broker, servicing agent or other persons who will act on behalf of the investors. [Bus & P C §10238(i)]

10. The broker must disclose to the investors the **identity** of the specific trust deed note he is under contract to arrange or buy, thus eliminating the formation of **blind pool trust deed investments** under the ten-or-less notice of exemption. [Bus & P C §10238(j)]

    10.1 On the sale of fractional interests, the investors' funds must be deposited in a neutral escrow and disbursed on the recording of the investors' individual interests as named beneficiaries in the trust deed and note. [Bus & P C §10145(b)]

    10.2 The broker must maintain records of the loan transaction, clearly identifying the manner of the receipt and disbursement of the investors' funds. [Bus & P C §10238(j)(3)]

11. A **servicing agreement** for managing the trust deed investment is entered into by the investors, in which the broker (or other licensed person) agrees to receive payments on the note, disburse the payments received to the investors and begin foreclosure proceedings on a default in the trust deed. [See **first tuesday** Form 237]

    The trust deed loan collection agreement contains provisions for:

    11.1 the deposit of payments into the broker's trust account on their receipt;

    11.2 notice that payments deposited will not be commingled with any other funds, and will not be used for any purpose other than the servicing of the trust deed;

    11.3 the disbursement to the investors of their pro rata share of the payments within 25 days of receipt;

    11.4 notice to the investors if the source of payments is other than the borrower;

    11.5 no guarantee or advance of funds for payments by the broker, unless the advance is due to the borrower's check being dishonored;

    11.6 filing a request for notice of default (NOD) on prior encumbrances; and

    11.7 sending investors a copy of any notice of trustee's sale (NOTS), filed on their behalf, or a request for reconveyance. [Bus & P C §10238(k); see **first tuesday** Form 237]

12. **Material facts** will be disclosed to the investors on a DRE designed form.

    12.1 The terms of the sale of undivided interests in the trust deed note include:

    a. if it is an **origination** of a trust deed loan, the name and address of the escrow holder, date for closing and an itemized list of the costs incurred by the borrower and the investors on the origination [Bus & P C §10238(l)(1)(B); see Form 235-1];

    b. if it is the acquisition of **an existing note**, its sale price, any premium or discount on the principal balance and unpaid interest, the effective rate of return, name and address of the escrow holder and the itemized costs incurred by the seller and the investors on the sale [Bus & P C §10238(l)(1)(A); see **first tuesday** Form 235-2]; or

    c. if the note is secured by a **blanket trust deed** as a lien on more than one parcel of real estate, additional disclosures of the identification and value of each parcel, the dollar amount of equity in each property after an apportionment of the amount of the trust deed note to each parcel and the resulting LTV ratio for each parcel. [Bus & P C §10238(l)(1)(C); see **first tuesday** Form 235-4]

    12.2 All other relevant material facts affecting the sale of the trust deed note.

13. On request from an investor, the broker must notify the investor of the names and addresses of all other investors in the note. [Bus & P C §10238(m)]

14. The broker is prohibited from acquiring, directly or indirectly, an **option to buy** the interests of the investors in the note or to acquire the real estate as part of the initial transaction to acquire, originate

LENDER/PURCHASER DISCLOSURE STATEMENT

(Loan Origination) (RE851A)

DISCLOSURE STATEMENT SUMMARY

Note: If this is a multi-lender transaction and more than one property secures the loan, you should also refer to the attached Lender/Purchaser Disclosure Statement Multi-Property (Cross Collateralization) Addendum (RE 851D).

AMOUNT OF THIS LOAN *(SEE PART 3)*	MARKET VALUE OF PROPERTY (SEE PART 8)	TOTAL AMOUNT OF ENCUMBRANCES SENIOR TO THIS LOAN *(SEE PART 9)*
$ 0.00	$ 0.00	$ 0.00
TOTAL AMOUNT OF ENCUMBRANCES ANTICIPATED OR EXPECTED TO BE JUNIOR TO THIS LOAN *(SEE PART 9)*	PROTECTIVE EQUITY (MARKET VALUE MINUS THIS LOAN AND TOTAL SENIOR ENCUMBRANCES)	TOTAL LOAN TO VALUE (SEE PART 10G)
$ 0.00	$ 0.00	0.00 %

PART 1 BROKER INFORMATION

NAME OF BROKER	REAL ESTATE LICENSE ID#
BUSINESS ADDRESS	TELEPHONE NUMBER

NAME OF BROKERS REPRESENTATIVE

PART 2 BROKER CAPACITY IN TRANSACTION

THE BROKER IDENTIFIED IN PART 1 OF THIS STATEMENT IS ACTING IN THE FOLLOWING CAPACITY IN THIS TRANSACTION: (CHECK AS APPLIES)

☐ A. Agent in arranging a loan on behalf of another

☐ B. Principal as a borrower of funds from which broker will directly or indirectly benefit other than through the receipt of commissions, fees and costs and expenses as provided by law for services as an agent.

☐ C. Funding a portion of this loan. *(Multi-lender transactions are subject to Business and Professions Code Section 10238.)*

IF MORE THAN ONE CAPACITY HAS BEEN CHECKED, PROVIDE EXPLANATION HERE.

IF B HAS BEEN CHECKED, THE BROKER INTENDS TO USE FUNDS FROM THE LENDER/PURCHASER IN THIS TRANSACTION FOR:

PART 3 TRANSACTION INFORMATION

(CHECK IF APPLICABLE)

☐ THERE IS MORE THAN ONE PROPERTY SECURING THE LOAN. IF MULTI-LENDER LOAN, YOU SHOULD ALSO REFER TO ATTACHED RE 851D.

TERM OF LOAN	PRIORITY OF THIS LOAN (1ST, 2ND, ETC.)	PRINCIPAL AMOUNT	YOUR SHARE IF MULTI-LENDER TRANS.
		$	$
INTEREST RATE % ☐ VARIABLE ☐ FIXED	(CHECK ONE) ☐ AMORTIZED ☐ PARTIALLY AMORTIZED	☐ INTEREST ONLY	***THE TRUST DEED WILL BE RECORDED.***
PAYMENT FREQUENCY ☐ MONTHLY ☐ WEEKLY	APPROXIMATE PAYMENT DUE DATE	AMOUNT OF PAYMENT $	YOUR SHARE IF MULTI-LENDER TRANS. $
BALLOON PAYMENT ☐ YES ☐ NO	APPROX. BALLOON PAYMENT DUE DATE	AMOUNT OF BALLOON PAYMENT $	YOUR SHARE IF MULTI-LENDER TRANS. $

Balloon Payment „ A balloon payment is any installment payment (usually the payment due at maturity) which is greater than twice the amount of the smallest installment payment under the terms of the promissory note or sales contract.

The borrower/vendee may have to obtain a new loan or sell the property to make the balloon payment. If the effort is not successful it may be necessary for the holder of the note/contract to foreclose on the property as a means of collecting the amount owed.

There are subordination provisions. ..... ☐ Yes ☐ No

If YES, explain here or on an attachment.

PART 4 MULTI-LENDER TRANSACTIONS

NAME OF ESCROW HOLDER

ANTICIPATED CLOSING DATE

ADDRESS OF ESCROW HOLDER

ESTIMATED LENDER COSTS

_____ $ _____

_____ $ _____

_____ $ _____

TOTAL $ 0.00

ESTIMATED BORROWER COSTS

Broker will provide you a copy of the "mortgage loan disclosure statement" given to the borrower or a separate itemization of borrower's costs.

TOTAL $ _____

Servicing

You will be a joint beneficiary with others on this note and you should request a list of names and addresses of the beneficiaries as of the close of escrow from the broker or servicing agent. The beneficiary(ies) holding more than 50% interest in the note may govern the actions to be taken on behalf of all holders in the event of default or other matters. See Civil Code Section 2941.9.

Loan To Value

GENERALLY the aggregate principal amount of the notes or interests sold, together with the unpaid principal amount of any encumbrances upon the real property senior thereto, shall not exceed the following percentages of the current market value of the real property as determined in writing by the broker or qualified appraiser.

Single-family residence, owner-occupied 80%

Single-family residence, not owner-occupied 75%

Commercial and income-producing properties 65%

Single-family residentially zoned lot or parcel which has installed off-site improvements including drainage, curbs, gutters, sidewalks, paved roads, and utilities as mandated by the political subdivision having jurisdiction over the lot or parcel 65%

Land which has been zoned for (and if required, approved for subdivision as) commercial or Residential development 50%

Other real property 35%

The percentage amounts specified above may be exceeded when and to the extent that the broker determines that the encumbrance of the property in excess of these percentages is reasonable and prudent considering all relevant factors pertaining to the real property. However, in no event shall the aggregate principal amount of the notes or interests sold, together with the unpaid principal amount of any encumbrances upon the property senior thereto, exceed 80 percent of the current fair market value of improved real property or 50 percent of the current fair market value of unimproved real property, except in the case of a single-family residentially zoned lot or parcel as defined above, which shall not exceed 65% of current fair market value of that lot or parcel. A written statement shall be prepared by the broker that sets forth the material considerations and facts that the broker relies upon for his or her determination which shall be disclosed to the lender or note purchaser(s) and retained as a part of the broker's record of the transaction.

NOTE: If more than one property secures this loan, you should also refer to attached RE 851D.

PART 5 SERVICING ARRANGEMENTS

If the loan is to be serviced by a real estate broker you must be notified within ten (10) days if the broker makes any advances on senior encumbrances to protect the security of your note. Depending on the terms and conditions of the servicing contract, you may be obligated to repay any such advances made by the broker. (Note: There must be a servicing agent on multi-lender transactions.) The broker may not guarantee or imply to guarantee, or advance any payments to you unless a securities permit is obtained from the Department of Corporations.

CHECK APPROPRIATE STATEMENTS

☐ THERE ARE NO SERVICING ARRANGEMENTS *(Does not apply to multi-lender transactions.)*
☐ BROKER IS THE SERVICING AGENT
☐ ANOTHER QUALIFIED PARTY WILL SERVICE THE LOAN
☐ COPY OF THE SERVICING CONTRACT IS ATTACHED

IF BROKER IS NOT SERVICING AGENT, WHAT IS THE RELATIONSHIP BETWEEN THE BROKER AND SERVICER?

COST TO LENDER FOR SERVICING ARRANGEMENTS *(EXPRESS AS DOLLAR AMOUNT OR PERCENTAGE)*

PER ☐ MONTH ☐ YEAR ☐ *PAYABLE* ☐ MONTHLY ☐ ANNUALLY

NAME OF AUTHORIZED SERVICER, IF ANY

BUSINESS ADDRESS | TELEPHONE NUMBER

PART 6 BORROWER INFORMATION

SOURCE OF INFORMATION

☐ BORROWER ☐ BROKER INQUIRY ☐ CREDIT REPORT ☐ OTHER (DESCRIBE)

NAME	CO-BORROWER'S NAME
RESIDENCE ADDRESS	CO-BORROWER'S RESIDENCE ADDRESS
OCCUPATION OR PROFESSION	CO-BORROWER'S OCCUPATION OR PROFESSION
CURRENT EMPLOYER	CO-BORROWER'S CURRENT EMPLOYER
HOW LONG EMPLOYED? / AGE	HOW LONG EMPLOYED? / CO-BORROWER'S AGE

SOURCES OF GROSS INCOME *(LIST AND IDENTIFY EACH SOURCE SEPARATELY.)*	MONTHLY **AMOUNT**	CO-BORROWER SOURCES OF GROSS INCOME (LIST AND IDENTIFY EACH SOURCE SEPARATELY.)	MONTHLY AMOUNT
Gross Salary	$	Gross Salary	$
OTHER INCOME INCLUDING: Interest	$	*OTHER INCOME INCLUDING:* Interest	$
Dividends	$	Dividends	$
Gross Rental Income	$	Gross Rental Income	$
Miscellaneous Income	$	Miscellaneous Income	$

TOTAL EXPENSES OF ALL BORROWERS ***(DO NOT COMPLETE IF BORROWER IS A CORPORATION)***

Payment of Loan being obtained	$	Spousal/Child Support	$
Rent	$	Insurance	$
Charge Account/Credit Cards	$	Vehicle Loan(s)	$
Mortgage Payments *(include taxes and property insurance)*	$	Other *(federal & state income taxes, etc.)*	$
TOTAL GROSS MONTHLY INCOME OF BORROWER(S) $ 0.00		TOTAL MONTHLY EXPENSES OF BORROWER(S) $ 0.00	

The borrower has filed for bankruptcy in the past 12 months. ☐ Yes ☐ No

If YES, the bankruptcy has been discharged or dismissed. ☐ Yes ☐ No

❖ ***THE FOLLOWING STATEMENTS ONLY APPLY IF THE BORROWER IS A CORPORATION, PARTNERSHIP OR SOME OTHER FORM OF OPERATING BUSINESS ENTITY.***

Copies of a balance sheet of the entity and income statement covering the indicated period have been supplied by the borrower/obligor and are attached. If no, explain on addendum. ☐ Yes ☐ No

If YES, Date of balance sheet _____

Income statement period *(from-to)* _____

Financial Statements have been audited by CPA or PA. ☐ Yes ☐ No

Additional information is included on an attached addendum ☐ Yes ☐ No

PART 7 PROPERTY INFORMATION

Identification of property which is security for note. *(If no street address, the assessor's parcel number or legal description and a means for locating the property is attached.)*

(CHECK IF APPLICABLE)

☐ THERE IS MORE THAN ONE PROPERTY SECURING THE LOAN. IF MULTI-LENDER LOAN, YOU SHOULD REFER TO ATTACHED RE 851D.

STREET ADDRESS			OWNER OCCUPIED ☐ NO ☐ YES
ANNUAL PROPERTY TAXES $ ☐ ACTUAL ☐ ESTIMATED	ARE TAXES DELINQUENT? ☐ NO ☐ YES		IF YES, AMT. REQUIRED TO BRING CURRENT $
SOURCE OF TAX INFORMATION			

PART 8 APPRAISAL INFORMATION

Estimate of fair market value is to be determined by an independent appraisal, copy of which must be provided to you prior to you obligating funds to make the loan. Note: You may waive the requirement of an independent appraisal, in writing, on a case by case basis, in which case the broker must provide a written estimate of fair market value. The broker must provide you, the investor, with the objective data upon which the broker's estimate is based. **In the case of a construction or rehabilitation loan, an appraisal must be completed by an independent, qualified appraiser in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP).**

(CHECK IF APPLICABLE)

☐ THERE IS MORE THAN ONE PROPERTY SECURING THE LOAN. IF MULTI-LENDER LOAN REFER TO ATTACHED RE 851D.

FAIR MARKET VALUE (ACCORDING TO APPRAISER) $ *(Place this figure or brokers estimate of fair market value on line "F" of Part 10.)*	DATE OF APPRAISAL
NAME OF APPRAISER (IF KNOWN TO BROKER)	PAST AND/OR CURRENT RELATIONSHIP OF APPRAISER TO BROKER (EMPLOYEE, AGENT, INDEPENDENT CONTRACTOR, ETC.)
ADDRESS OF APPRAISER	
DESCRIPTION OF PROPERTY/IMPROVEMENT	IS THERE ADDITIONAL SECURING PROPERTY? ☐ YES IF YES, SEE ADDENDUM. ☐ NO

AGE	SQUARE FEET	TYPE OF CONSTRUCTION

IF THE PROPERTY IS CURRENTLY GENERATING INCOME FOR THE BORROWER/OBLIGOR:

ESTIMATED GROSS ANNUAL INCOME $	ESTIMATED NET ANNUAL INCOME $

PART 9 ENCUMBRANCE INFORMATION

Information is being provided concerning senior encumbrances against the property, to the extent reasonably available from customary sources (excluding the note described on page 1 Part 3). **Note:** You have the option to purchase a policy of title insurance or an endorsement to an existing policy of title insurance to insure your interest. You are entitled to a copy of a written loan application and a credit report to obtain information concerning all encumbrances which constitute liens against the property. This information may help determine the financial standing and creditworthiness of the borrower.

(CHECK IF APPLICABLE)

☐ THERE IS MORE THAN ONE PROPERTY SECURING THE LOAN. IF MULTI-LENDER LOAN, YOU SHOULD REFER TO ATTACHED RE 851D.

SOURCE OF INFORMATION

☐ BROKER INQUIRY ☐ BORROWER ☐ OTHER *(EXPLAIN)*

Are there any encumbrances of record against the securing property at this time?..... ☐ YES ☐ NO

A. Over the last 12 months were any payments more than 60 days late? ..... ☐ YES ☐ NO

B. If YES, how many? ..... _____

C. Do any of these payments remain unpaid? ..... ☐ YES ☐ NO

D. If YES, will the proceeds of subject loan be used to cure the delinquency? ..... ☐ YES ☐ NO

E. If NO, source of funds to bring the loan current. ..... _____

Encumbrances remaining and/or expected or anticipated to be placed against the property by the borrower/obligor after the close of escrow (excluding the note described on page 1).

ENCUMBRANCE(S) REMAINING *(AS REPRESENTED BY THE BORROWER)*

PRIORITY (1ST, 2ND, ETC.)	INTEREST RATE %	PRIORITY (1ST, 2ND, ETC.)	INTEREST RATE %
BENEFICIARY		BENEFICIARY	
ORIGINAL AMOUNT $	APPROXIMATE PRINCIPAL BALANCE $	ORIGINAL AMOUNT $	APPROXIMATE PRINCIPAL BALANCE $
MONTHLY PAYMENT $	MATURITY DATE	MONTHLY PAYMENT $	MATURITY DATE
BALLOON PAYMENT ☐ YES ☐ NO ☐ UNKNOWN	IF YES, AMOUNT $	BALLOON PAYMENT ☐ YES ☐ NO ☐ UNKNOWN	IF YES, AMOUNT $

ENCUMBRANCES EXPECTED OR ANTICIPATED *(AS REPRESENTED BY THE BORROWER)*

PRIORITY (1ST, 2ND, ETC.)	INTEREST RATE %	PRIORITY (1ST, 2ND, ETC.)	INTEREST RATE %
BENEFICIARY		BENEFICIARY	
ORIGINAL AMOUNT $	MATURITY DATE	ORIGINAL AMOUNT $	MATURITY DATE
MONTHLY PAYMENT $		MONTHLY PAYMENT $	
BALLOON PAYMENT ☐ YES ☐ NO ☐ UNKNOWN	IF YES, AMOUNT $	BALLOON PAYMENT ☐ YES ☐ NO ☐ UNKNOWN	IF YES, AMOUNT $

Additional remaining, expected or anticipated encumbrances are set forth in an attachment to this statement. ..... ☐ Yes ☐ No

PART 10 LOAN TO VALUE RATIO

(CHECK IF APPLICABLE)

☐ THERE IS MORE THAN ONE PROPERTY SECURING THE LOAN. IF MULTI-LENDER LOAN, YOU SHOULD REFER TO ATTACHED RE 851D.

A. Remaining encumbrances senior to this loan *(from part 8)*..... $ 0.00

B. Encumbrances expected or anticipated senior to this loan *(from part 9)* ..... + $ _____

C. Total remaining and expected or anticipated encumbrances senior to this loan ..... = $ 0.00

D. Principal amount of this loan from page 1 part 3 ..... + $ 0.00

E. Total all senior encumbrances and this loan ..... = $ 0.00

F. Fair market value from page 4 part 8 ..... ÷ $ 0.00

G. Loan to value ratio ..... = _____ %

Note: See Part 4 if multi-lender transaction.

BROKER VERIFICATION

The information in this statement and in the attachments hereto is true and correct to the best of my knowledge and belief.

SIGNATURE OF BROKER OR DESIGNATED REPRESENTATIVE	BROKER/CORPORATION ID#	DATE
➢		

ACKNOWLEDGMENT OF RECEIPT

The prospective lender/purchaser acknowledges receipt of a copy of this statement signed by or on behalf of the broker.

SIGNATURE OF PROSPECTIVE LENDER/PURCHASER	DATE
➢	

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For licensing information, please refer to the Department of Real Estate's Web site located at www.dre.ca.gov.

or

You may call the DRE licensing information telephone number at 877-373-4542.

or service a fractionalized note. However, the broker, after completing the syndication of the note or entering into a service agreement, may later enter into an agreement to purchase an interest in the note or the real estate if it is negotiated at the time of his purchase. [Bus & P C §10238(n)]

15. If the broker sells, originates or services fractionalized notes, and the amount of payments received from all sources in any **three-month period** exceeds $125,000, or the number of all investors participating during a three-month period exceeds 120, the broker must:

    15.1 have his **trust account** inspected by a certified public accountant (CPA) and forward the CPA's trust account inspection report to the DRE within 30 days after the period in review [Bus & P C §10238(k)(3); see **first tuesday** Form 546];

    15.2 file an **annual report** on the status of the **trust account** with the DRE [Bus & P C §10238(o); see **first tuesday** Form 548]; and

    15.3 file an **annual report** of his **trust deed sales, originations** and **servicing** with the DRE. [Bus & P C §10238(p); see **first tuesday** Form 547]

No blind pools with Notice Permit

A trust deed broker receives funds from investors that he will later place in trust deed notes he will originate or select. To evidence his receipt of the funds, the broker executes interest-bearing promissory notes in favor of the investors.

As agreed with the investors, the broker later uses the funds handed him by the investors to purchase trust deed notes he selects. The broker collaterally assigns the notes and trust deeds to the investors to secure the promissory notes he previously executed.

An investor who loses money on the scheme demands the return of his funds, plus 10% interest from the date he delivered the funds to the broker. The investor claims the broker's trust deed investment program violates the securities law since the individual promissory notes issued to evidence the receipt of funds were not registered or qualified as corporate securities.

The broker claims no corporate securities risk exists since the notes became fully secured by the collateral assignment of trust deeds.

Has the conduct of the broker created a **corporate securities risk** that placed the transactions under the control of the securities law, requiring the broker to obtain a permit or qualify for an exemption?

Yes! The broker placed the investor's capital at risk of loss by an activity controlled by the securities law. The funds were handed to the broker in reliance on the broker's skill in the **later selection** and delivery of trust deed notes. The success of the investment was inextricably bound to the broker's **managerial expertise** in selecting a suitable investment after the investor released his funds by handing them to the broker without treatment as trust funds. The investor had no choice in the selection of the trust deed note acquired before his funds were put at risk. [**Underhill** v. **Royal** (9th Cir. 1985) 769 F2d 1426]

The mere acquisition or origination of one trust deed note by one investor, arranged by a trust deed broker and fully identified to the investor before he releases his funds, is **not** conduct that creates a security under the California risk capital test. When the investor advances funds through an escrow to purchase or originate a specifically identified trust deed note, the investor receives the full value of his investment by an absolute assignment or execution of the note, secured by a trust deed on real estate of sufficient current value.

However, a trust deed investment program does contain a securities risk when:

- funds are handed to the broker for release without first identifying the specific trust deed note and security interest to be acquired in real estate; and

- the investor relies on the skill and judgment of the broker to later locate and deliver a suitable trust deed investment for the funds he previously placed with the broker.

In a **blind pool investment**, the investor puts up his money before a trust deed is located for purchase. In practice, the funds will then be readily available to the broker for funding the acquisition of a trust deed note when he later locates one he deems to be of suitable investment quality.

The investor does not initially invest his capital in a trust deed, but in the **broker's expertise** to conduct due diligence investigations and to analyze and select a future trust deed investment. The broker is given carte blanche to use the investor's funds as he sees fit.

The securities risk is not in a trust deed, but in the performance of the **broker's promise** to later select and deliver to the investor a suitable trust deed note. Thus, lacking specificity of the investment, a corporate securities risk is created in the investment program entered into by this investor.

Chapter 16 An overview of the LLC

This chapter examines the formation and taxation of a limited liability company, and the conversion of an existing limited partnership to a limited liability company.

The LLC vs. a limited partnership

A limited liability company (LLC) is a hybrid business entity. It combines limited liability advantages of a corporation under state law with the federal income tax treatment of a partnership. [Calif. Corporations Code §§17000 et seq.; Calif. Revenue and Taxation Code §§17941 et seq.]

Like a limited partnership, the LLC itself does not pay federal income taxes. Instead, all reportable income, profits and losses of the LLC are **passed through** to the members for individual tax reporting. The members, as individuals, pay federal and state income tax on their share of any LLC income and profits. California imposes a $900 flat fee on gross income of $250,000 to $499,999 from rentals. [Rev & TC §17942]

The LLC is an entity comparable to a limited partnership, but without a general (liability) partner. Limited liability in an LLC extends to all members, including the manager. Conversely, the managing general partner in a limited partnership is personally liable for the partnership's debts.

The syndicator in a limited partnership sometimes seeks to limit his liability by forming a one-man corporation to act as general partner for the partnership, rather than naming himself as the general partner. A **sole, corporate general partner** in a limited partnership creates a liability limitation situation for the managing syndicator similar to the LLC, with its limited liability extended also to the manager.

Taxwise, however, a limited partnership with a sole, corporate general partner is a co-ownership structure that is more regulated than an LLC. For instance, all partnerships with the same corporation as the sole general partner are taxed as corporations unless the corporate general partner owns assets with a net worth of at least 15% of the partners' contributions to all the partnerships, limited to $250,000 for total investor contributions up to $2,500,000. When contributions exceed $2,500,000, the net worth of the corporate general partner must be at least 10% of total contributions by partners. [Revenue Procedure 72-13]

Also, a limited partnership structured with a corporate general partner is unable to take advantage of the exemption from tax reporting available to small partnerships. Partnerships with ten or less partners are exempt from filing the Internal Revenue Service (IRS) 1065 return, but only if all partners are individuals. [Internal Revenue Code §6231(a)(1)(B)]

Taxwise, the LLC also resembles an S corporation. An LLC is essentially a small corporation (because of its state law corporate liability structure) that is treated as a partnership for income tax purposes. However, an LLC has fewer operating restrictions imposed on the participants and their investments than in an S corporation.

For example, the shareholders in an S corporation must be individuals (or estates, organizations or trusts in limited circumstances), and an S corporation may have no more than 100 shareholders. [IRC §1361(b)]

The members of an LLC, on the other hand, may include any type of legal entity, such as corporations, partnerships and other LLCs, along with individuals. Also, no limit is imposed on the number of members. [Corp C §17001(ae)]

For real estate syndication purposes, the LLC also resembles a real estate investment trust (REIT). REITs are unincorporated organizations formed for the purpose of group investment primarily in real estate. REITs provide limited liability for investors and pass-through of income for state and federal tax reporting by the investor. [Corp C §23000; IRC §856]

However, the REIT is not an appropriate syndication vehicle for group investments in local real estate. The LLC offers far more management flexibility and the same tax results for the participants.

For example, to qualify for federal tax reporting as a real estate investment trust, the REIT must have at least 100 shareholders and 75% of the REIT's business activities must be restricted to investments in real estate, trust deed notes, cash or government securities. [IRC §856(c)(4)]

No such restrictions apply to the LLC.

Further, an REIT must always qualify its investment program with the California Department of Corporations (DOC). Conversely, an LLC only needs to qualify its investment program if a securities risk exists for its members and no exemption applies. [Corp C §23000(b)]

Formation by filing articles

To form an LLC, the syndicator signs and files *Articles of Organization* using an LLC-1 form issued by the Secretary of State, the equivalent of the LP-1 used for limited partnership filings. The filing fee is $70. [Calif. Government Code §12190(b); see LLC-1 accompanying this chapter]

The $70 LLC-1 fee is for documents filed by mail. The Secretary of State charges an additional $15 counter fee for any LLC documents delivered in person.

The person signing the LLC-1 does not need to be a shareholding member of the LLC. In a typical real estate investment program, the LLC-1 will be signed by the syndicator acting alone. The syndicator then typically designates himself or an entity he controls as the managing member.

The LLC-1, when filed with the Secretary of State along with the $70 fee, establishes the LLC as a **legal entity** in the state of California. The filing provides limited liability for its members and manager. No further recording with the county is necessary. However, a certified copy of an LLC-1 and any other addenda or documents is typically recorded with the county recorder in the county where the LLC will hold title to real estate. [Corp C §17052(f)]

When recorded in county records, those dealing with the LLC, such as title companies, lenders, sellers, buyers, escrows, brokers and others, do not need to look any further than the LLC-1 in the county records to determine who to deal with — the manager, a group of managers or a majority in interest of members.

The LLC-1 form can be obtained from the Secretary of State's Sacramento office, from the branch offices of the Secretary of State or downloaded from the Secretary of State's website at *sos.ca.gov/business/be/forms*.

LLC-1

File # _____

State of California
Secretary of State

LIMITED LIABILITY COMPANY ARTICLES OF ORGANIZATION

A $70.00 filing fee must accompany this form.

IMPORTANT – Read instructions before completing this form.

This Space For Filing Use Only

ENTITY NAME (End the name with the words "Limited Liability Company," or the abbreviations "LLC" or "L.L.C." The words "Limited" and "Company" may be abbreviated to "Ltd." and "Co.," respectively.)

1. NAME OF LIMITED LIABILITY COMPANY

PURPOSE (The following statement is required by statute and should not be altered.)

2. THE PURPOSE OF THE LIMITED LIABILITY COMPANY IS TO ENGAGE IN ANY LAWFUL ACT OR ACTIVITY FOR WHICH A LIMITED LIABILITY COMPANY MAY BE ORGANIZED UNDER THE BEVERLY-KILLEA LIMITED LIABILITY COMPANY ACT.

INITIAL AGENT FOR SERVICE OF PROCESS (If the agent is an individual, the agent must reside in California and both Items 3 and 4 must be completed. If the agent is a corporation, the agent must have on file with the California Secretary of State a certificate pursuant to Corporations Code section 1505 and Item 3 must be completed (leave Item 4 blank).

3. NAME OF INITIAL AGENT FOR SERVICE OF PROCESS

4. IF AN INDIVIDUAL, ADDRESS OF INITIAL AGENT FOR SERVICE OF PROCESS IN CALIFORNIA | CITY | STATE | ZIP CODE

CA

MANAGEMENT (Check only one)

5. THE LIMITED LIABILITY COMPANY WILL BE MANAGED BY:

- ☐ ONE MANAGER
- ☐ MORE THAN ONE MANAGER
- ☐ ALL LIMITED LIABILITY COMPANY MEMBER(S)

ADDITIONAL INFORMATION

6. ADDITIONAL INFORMATION SET FORTH ON THE ATTACHED PAGES, IF ANY, IS INCORPORATED HEREIN BY THIS REFERENCE AND MADE A PART OF THIS CERTIFICATE.

EXECUTION

7. I DECLARE I AM THE PERSON WHO EXECUTED THIS INSTRUMENT, WHICH EXECUTION IS MY ACT AND DEED.

_____ DATE

_____ SIGNATURE OF ORGANIZER

_____ TYPE OR PRINT NAME OF ORGANIZER

LLC-1 (REV 04/2007) APPROVED BY SECRETARY OF STATE

Editor's note — Although LLC forms can be obtained from any branch office or downloaded from the Secretary of State's website, only the Document Filing Support Unit in the Secretary of State's Sacramento office will accept LLC forms for filing.

The LLC-1 is a very limited and fairly simple document, intended mainly to:

- register the LLC with the state;
- establish it as a legal entity in order to provide limited liability to all managers and members (and a minimum tax of $800 annually to the state); and
- notify the public of the individual with the authority to bind the LLC by entering into agreements on its behalf.

In an addendum to the LLC-1, the syndicator might include an **alienation-restriction provision.** Such a provision assures members that the real estate vested in the name of the LLC cannot be sold, encumbered or subjected to a long-term lease without the consent of a majority in interest of the members. The provision serves to limit the manager's activities to the designated purpose of the LLC — to **own and operate** the real estate for the benefit of the members.

An LLC is commonly thought of as having two or more members. However, a single person can form and operate an LLC by filing **Articles of Organization** with the California Secretary of State. [Corp C §17050]

A one-man limited liability company is disregarded for purposes of federal income tax reporting by the sole owner of the LLC. [26 Code of Federal Regulations §301.7701-3]

Limited liability

The liability limitation for members of an LLC is slightly less extensive in its protection from debts than it is for limited partners in a limited partnership. The limited liability protection for the members of an LLC is the same as for the shareholders in a corporation, not limited partners in a limited partnership. [Corp C §17101(b)]

For example, the liability of a partner in a limited partnership is absolutely limited to the amount of their capital contribution. However, corporate shareholders — as well as members in an LLC — can be held generally liable for the debts of the corporation or LLC if it can be proven that the corporation or LLC exists solely to shield the shareholders from liability for their debts or actions.

In a limited partnership, the limited partners escape liability beyond the amount of their contributions. However, the general partner of the limited partnership is then personally liable for all partnership debts.

In a corporation or LLC, no member, officer or shareholder is generally liable for any of the entity's debts. Without personal liability for debts incurred by the LLC, an individual can use a corporate or LLC business entity to shield themselves from liability in the conduct of the investment. Conversely, some individuals carry on their personal activities behind a corporation or LLC that is merely a facade, called an *alter ego*, causing the shareholder to lose his liability shield.

A corporation, and thus an LLC, is considered an **alter ego** of a controlling shareholder if:

- the corporation or LLC is entirely dominated by a single individual or by a small group of shareholders or members;
- the economic interests of the corporation or LLC are indistinguishable from the interests of the shareholders or members; and
- an injustice would result from treating the shareholders' or members' acts as the acts of the corporation or LLC and not as their own. [**Stark** v. **Coker** (1942) 20 C2d 839]

Also, a corporation or LLC that is **undercapitalized** to meet its reasonably anticipated demands for cash is often considered an alter ego of the shareholders. If a corporation or LLC is not funded with a sufficient amount of capital when created, it will not have sufficient assets to pay off the debts it incurs in the **ordinary course** of business.

Sufficient capitalization is rarely an issue in real estate transactions since all funds needed to own the property, in the form of cash and mortgage money, must be raised before the property can be acquired.

If undercapitalized, a corporation or LLC is regarded as existing in name only, created to shield the shareholders or members from liability for personal debts incurred in the entity's name. [**Automotriz del Golfo de California S. A. de C. V.** v. **Resnick** (1957) 47 C2d 792]

Taxation by the FTB

To maintain the limited liability of its members as permitted by state law, the LLC must report and pay annual taxes and fees to the state.

Every LLC must pay an annual $800 minimum franchise tax, a tax also imposed on corporations and limited partnerships (LPs). [Rev & T C §§17941, 23153(d)(1)]

In addition to the minimum franchise tax, an LLC with over $250,000 in annual gross income (rents) is assessed an additional annual fee by the Franchise Tax Board (FTB) based on its gross income for that year. The fees, in addition to the $800 entity tax, are:

- $900 for a total gross income of $250,000 to $499,999;
- $2,500 for gross income of $500,000 to $999,999;
- $6,000 for gross income of $1,000,000 to $4,999,999; and
- $11,790 for gross income of $5,000,000 or more. [Rev & T C §17942(a)]

If applicable, these additional taxes are to be paid on or before the 15th day of the sixth month of the taxable year. Underpayment of these additional taxes due will result in an extra fee equal to 10% of the underpaid amount. [Rev & T C §17942(d)(1-2)]

An LLC formed solely for real estate syndication purposes that acquires income-producing property with a scheduled gross income of less than $250,000 will not be concerned with the additional tax. Thus, ownership of income property valued at roughly $1,500,000 to $2,000,000 based on gross income (and cost of operations) would not be subject to the annual "rental tax."

The LLC name

A syndicator selects a name for an LLC, which must end with the words "Limited Liability Company," or the initials "LLC" or "L.L.C." The words "Limited" and "Company" may be abbreviated to "Ltd." and "Co." [Corp C §17052(a)]

As a practical matter, the name selected for the LLC should reference the property purchased and operated by the LLC, such as the property's name or street address. The name of the LLC should **not** include the name of the manager or any of the members, in order to avoid making their ownership interests in the LLC easily traceable.

Also, the name may not include the words "bank," "insurance company," "insurer," "trust," "trustee," "incorporated," "inc.," "corporation" or "corp." [Corp C §17052(d)]

For example, a typical LLC name, created from the property's address, might be "Main Street Properties, a California Limited Liability Company."

An LLC name may be reserved by applying to the Secretary of State with a Name Reservation Request Form. For a fee of $10, the name is **reserved** for 60 days. An additional $10 counter fee will be charged if the form is delivered in person to the Secretary of State's public counter. [Corp C §17053; Gov C §12190(a); see LLC Name Reservation Request Form]

Alternatively, a syndicator can use a private filing service to reserve the LLC name or file the LLC forms. These companies charge a fee for these services. One such company is:

Corporation Service Company, 2711 Centerville Road, Wilmington, DE 19808, (800) 927-9800, *www.incspot.com*.

Preparing the LLC-1 articles

The LLC-1 Articles of Organization includes a space for stating whether the LLC will be managed by all members or by one or more *appointed managers*. For real estate syndication purposes, the syndicator will, in most cases, check the box indicating the LLC has one manager — the syndicator himself. Thus, he alone will be able to bind the LLC to buy, sell, encumber or lease real estate.

Also, the LLC syndicator must designate an agent for the service of process on the LLC-1 with an address in California, as is required of any statutory entity. The agent may be an individual or an entity. [Corp C §17057(b)]

For real estate syndication, the agent for service of process is usually the syndicator or his attorney.

In addition to the appointed manager, the LLC's operating agreement may provide for the appointment of officers such as president, secretary, treasurer, chief executive officer (CEO), chief financial officer (CFO), chief operating officer (COO) and so on. [Corp C §17154]

The officers do not need to be members or managers of the LLC. For example, an accountant or bookkeeper who is not a member of the LLC can be hired as treasurer or the CFO.

The LLC must have an office in the state of California where it maintains its records. LLC records include the names and addresses of all members and managers, copies of the articles of organization (LLC-1) and the operating agreement, copies of state and federal tax returns, financial statements and the

books and records of the current and past four fiscal years. A true copy of business records relevant to the amount, cost and value of all property owned, claimed, possessed or controlled within the county must be made available upon the request of the county assessor. [Corp C §§17057, 17058]

The LLC-12 Statement of Information must first be filed **within 90 days** after filing the articles of organization for the LLC. It must state the name and address of the LLC, its manager, agent for service of process and the type of business it conducts. The statement is then filed every two years thereafter during the calendar month in which the articles of organization were first filed. A $20 filing fee is required each time the LLC-12 is filed. [Corp C §17060; Gov C §12190(k); see LLC-12 accompanying this chapter]

If the information required in the filing has not changed since the previous year, the LLC may simply file the form, stating no changes have been made. [Corp C §17060(b)]

LLCs are not permitted to be licensed as real estate brokers. The Limited Liability Company Act prohibits LLCs from offering professional services to others in the name of the LLC for a fee, which includes the services of accountants, attorneys, physicians and real estate brokers. Some professions may conduct business and provide services under a parallel entity called a limited liability partnership (LLP), but not real estate brokers.

However, an LLC manager who is licensed as a real estate broker may act as the real estate agent representing the LLC as its broker, and collect a brokerage fee on transactions handled on behalf of the LLC. Also, an LLC can act as a principal in any real estate related transaction, with the same powers as a corporation, partnership or individual, to conduct any business, buy, sell, finance and lease property, sue or be sued, enter into agreements, etc. [Corp C §17003]

FTB tax reporting

LLCs are considered partnerships for tax reporting purposes, except for the annual California franchise tax and tax on rental income. [Rev & T C §28.5]

An LLC is required, like a partnership, to submit a state information return annually to the FTB. The form for filing an LLC information return is FTB Form 568. [Rev & T C §18633.5]

An LLC reporting as a partnership for federal income tax purposes is required to file a 1065 return annually with the IRS, unless the LLC qualifies for the ten-or-less small partnership exemption.

Additionally, if an LLC has nonresident members, it must file an FTB Form 3832, the Limited Liability Company Nonresident Members' Consent form. All nonresidents (both domestic and foreign) must sign Form 3832 to show consent for having their share of the distributed income from the LLC taxed in California. Each nonresident member must then file a California income tax return. [Rev & T C §18633.5(e)(1)]

If an LLC fails to obtain a nonresident member's signature on Form 3832, the LLC will be responsible for paying California taxes for that nonresident member at the highest marginal tax rate. The LLC may recover any taxes paid on the nonresident member's behalf from that nonresident member. [Rev & T C §18633.5(e)(1)]

Form 3832 must be filed with the information return:

- the first taxable period during which the LLC had nonresident members; or

- any taxable period during which the LLC had non-signing nonresident member. [Rev & T C §18633.5(f)]

An LLC must withhold taxes from income distributions made to nonresident members. Nonresident withholdings must be reported quarterly, as well as annually. [Rev & T C §18633.5(e)(1); see FTB Forms 592, 592-A and 592-F]

Federal small partnership exemption

Although it does not pay income taxes, a partnership — including LLCs since they automatically qualify as partnerships — is required, unless exempt, to file an information return with the IRS, reporting the income and losses passed through to the partners. [IRC §6031]

In addition, if an LLC has foreign national members, it must withhold federal taxes for any income distributions made to foreign nonresident members and remit taxes due from foreign nationals to the IRS on a quarterly basis. [IRC §1446]

The tax form for filing the LLC information return is the IRS Form 1065. The IRS 1065 return informs the IRS of the LLC's income and losses and identifies each member along with his share of the income and losses.

An LLC automatically qualifies as a partnership for federal income tax purposes. Thus, an LLC can avoid filing an IRS 1065 return if it qualifies under the *small partnership exemption*. [IRC §7701, IRS Letter Ruling 9543017]

An LLC or partnership with ten or less participants, all of whom are natural persons or estates (husband and wife are treated as one), is not required to file an IRS 1065 Form. [IRC §6231(a)(1)(B)]

The IRS has imposed further restrictions beyond the number of participants for the exemption. Even if the LLC has ten or less members, the IRS has ruled an LLC is not exempt from filing a 1065 return if:

- it has significant holdings;
- it is a "tier" entity, in which a parent entity holds interests in one or more sub-entities;
- each member's interest in the capital and profits is not owned in the same proportion; or
- all items of income, deductions and credit are not allocated in proportion to the owner's percentage of membership. [Revenue Procedure 81-11]

Generally, most small investment groups do not have significant holdings and do report income and losses based on their percentage of ownership. Despite the additional restrictions imposed by the IRS, an LLC formed for real estate syndication with ten or less members can avoid filing the IRS 1065 return. Each member reports his share of income, expenses, interest and depreciation in a schedule attached to his 1040 return, such as a Schedule E for rental ownership reporting although he was a tenant-in-common co-owner.

Converting a LP to an LLC

Many general partners who manage existing LPs convert their LPs to LLCs. A syndicator, as manager of an LLC, has a limited liability that stands in dramatic contrast to his general liability for property operations and loans as the general partner in an LP.

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State of California
Secretary of State

STATEMENT OF INFORMATION
(Limited Liability Company)

Filing Fee $20.00. If amendment, see instructions.

IMPORTANT — READ INSTRUCTIONS BEFORE COMPLETING THIS FORM

1. **LIMITED LIABILITY COMPANY NAME** (Please do not alter if name is preprinted.)

This Space For Filing Use Only

DUE DATE: [For forms preprinted by the Secretary of State.]

FILE NUMBER AND STATE OR PLACE OF ORGANIZATION

2. SECRETARY OF STATE FILE NUMBER	3. STATE OR PLACE OF ORGANIZATION

COMPLETE ADDRESSES FOR THE FOLLOWING (Do not abbreviate the name of the city. Items 4 and 5 cannot be P.O. Boxes.)

4. STREET ADDRESS OF PRINCIPAL EXECUTIVE OFFICE	CITY AND STATE		ZIP CODE
5. CALIFORNIA OFFICE WHERE RECORDS ARE MAINTAINED **(DOMESTIC ONLY)**	CITY	STATE	ZIP CODE
		CA	

NAME AND COMPLETE ADDRESS OF THE CHIEF EXECUTIVE OFFICER, IF ANY

6. NAME	ADDRESS	CITY AND STATE	ZIP CODE

NAME AND COMPLETE ADDRESS OF ANY MANAGER OR MANAGERS, OR IF NONE HAVE BEEN APPOINTED OR ELECTED, PROVIDE THE NAME AND ADDRESS OF EACH MEMBER (Attach additional pages, if necessary.)

7. NAME	ADDRESS	CITY AND STATE	ZIP CODE
8. NAME	ADDRESS	CITY AND STATE	ZIP CODE
9. NAME	ADDRESS	CITY AND STATE	ZIP CODE

AGENT FOR SERVICE OF PROCESS (If the agent is an individual, the agent must reside in California and Item 11 must be completed with a California address. If the agent is a corporation, the agent must have on file with the California Secretary of State a certificate pursuant to Corporations Code section **1505** and Item 11 must be left blank.)

10. NAME OF AGENT FOR SERVICE OF PROCESS

11. ADDRESS OF AGENT FOR SERVICE OF PROCESS IN CALIFORNIA, **IF AN INDIVIDUAL**	CITY	STATE	ZIP CODE
		CA	

TYPE OF BUSINESS

12. DESCRIBE THE TYPE OF BUSINESS OF THE LIMITED LIABILITY COMPANY

13. THE INFORMATION CONTAINED HEREIN IS TRUE AND CORRECT.

TYPE OR PRINT NAME OF PERSON COMPLETING THE FORM	SIGNATURE	TITLE	DATE

LLC-12 (REV 03/2007) APPROVED BY SECRETARY OF STATE

To convert an LP to an LCC, the general partner and his partners must approve a plan of conversion which includes:

- the terms and conditions of the conversion, including any desired effective date of the conversion;
- the places of organization of both the LP and the LLC to which the LP will be converted;
- the name of the newly-created LLC after conversion;
- the manner of converting the LP's interests into the interests of the LLC. Each partner of the LP must receive a percentage interest in the profits and capital of the newly-created LLC in an amount equal to his percentage interest as a partner at the time of the conversion [Corp C §15911.02];
- the Articles of Organization and the operating agreement for the new LLC; and
- any other details requested by the LP partners or required by law. [Corp C §15911.03(a)]

Unless the partnership agreement provides for a greater or lesser percentage for approval, this plan of conversion must be approved by:

- all of the LP's general partners; and
- a majority of the LP's limited partners. [Corp C §15911.03(b)]

After the conversion plan has been approved by the partners, the LP must file with the California Secretary of State a statement of conversion on the LLC's Articles of Organization, which includes:

- the name and Secretary of State file number for the LP;
- a statement that the conversion plan was approved by the required percentage of general and limited partners, with a specification of each class required to vote and the percentage needed;
- the form of the converted entity (in our case, an LP); and
- the mailing addresses of the LP's:
    - agent for service of process; and
    - chief executive officer. [See LLC-1A]

This statement of conversion must be signed by all general partners. Additional signatures may be provided on a 8 ½ x 11 sheet of paper attached to the LLC-1. [See **first tuesday** Form 251]

The cost of filing the LLC-1A with the Secretary of State is $70. An additional $15 fee is charged for LLC-1A filings made in person at the Secretary of State's Sacramento office.

Once the LLC-1A is filed with the Secretary of State, the LP ceases to exist as a separate entity. The LLC succeeds to all the property, debts, and liabilities of the "disappearing" LP. No further act or documentation is required to transfer the partnership's real or personal property to the LLC. [Corp C §15911.06(c)]

LLC-4/8

State of California
Secretary of State

LIMITED LIABILITY COMPANY
SHORT FORM CERTIFICATE OF CANCELLATION

There is no fee for filing a Short Form Certificate of Cancellation.

IMPORTANT – Read instructions before completing this form.

This Space For Filing Use Only

FILE NUMBER	**ENTITY NAME** (Enter the exact name of the domestic limited liability company.)
1. Secretary of State File Number	2. Name of Limited Liability Company

REQUIRED STATEMENTS (The following statements should not be altered.)

3. a) This Short Form Certificate of Cancellation is being filed **within twelve (12) months** from the date the Articles of Organization were filed with the Secretary of State;

   b) The limited liability company does not have any debts or other liabilities, except as provided in Item 3(c);

   c) A final franchise tax return, as described by Section 23332 of the Revenue and Taxation Code, or a final annual tax return, as described by Section 17947 of the Revenue and Taxation Code, has been or will be filed with the Franchise Tax Board, as required under Part 10.2 (commencing with Section 18401) of Division 2 of the Revenue and Taxation Code.

   d) The limited liability company has not conducted any business from the time of the filing of the Articles of Organization; and

   e) Payments received by the limited liability company for interests from investors, if any, have been returned to those investors.

ASSETS (Check the applicable statement. Note: Only one box may be checked.)

4. ☐ The known assets of the limited liability company remaining after payment of, or adequately providing for, known debts and liabilities have been distributed to the persons entitled thereto.

   ☐ The limited liability company has acquired no known assets.

DISSOLUTION (Check the applicable statement. Note: Only one box may be checked.)

5. ☐ A majority of the members or managers of the limited liability company named in Item 2 has voted to dissolve the limited liability company. The undersigned constitutes a majority of the members or a majority of the managers.

   ☐ There are no members or managers. The sole person or a majority of the persons who signed the Articles of Organization of the limited liability company named in Item 2 has voted to dissolve the limited liability company. The undersigned constitutes the sole person or a majority of the persons who signed the Articles of Organization.

EXECUTION (If additional signature space is necessary, the acknowledged signature(s) may be made on an attachment to this certificate. Any attachments to this certificate are incorporated herein by this reference.)

6. I declare I am the person who executed this instrument, which execution is my act and deed.

Signature of Member, Manager or Organizer	Date	Type or Print Name of Member, Manager or Organizer
Signature of Member, Manager or Organizer	Date	Type or Print Name of Member, Manager or Organizer
Signature of Member, Manager or Organizer	Date	Type or Print Name of Member, Manager or Organizer

RETURN TO (Enter the name and the address of the person or firm to whom a copy of the filed document should be returned.)

7. NAME

   FIRM

   ADDRESS

   CITY/STATE/ZIP

LLC-4/8 (REV 09/2006) APPROVED BY SECRETARY OF STATE

Editor's note — If an effective date was designated in the conversion plan, the conversion is not deemed completed until after that date has passed. [Corp C §15911.04(a)(3)]

If required by a title insurer on a refinance or sale, the change of vesting to the real estate can be documented by recording a copy of the LLC-1A with the county recorder of the county where the property is located. [Corp C §15911.07(a)(1)]

A copy of the LLC-1A, certified by the Secretary of State and recorded in the county recorder's office, serves as a notice of the transfer of property ownership to the LLC. [Corp C §15911.07(c)]

Also, the LP is dissolved automatically on filing the LLC-1A, without having to file a certificate of cancellation (LP-4/8). [Corp C §15911.06(c)]

The syndication program itself remains identical after the conversion. The investors retain the same proportional interests, rights and obligations in the LLC as in the LP as long as the LLC operating agreement is a mirror image of the LP agreement.

The conversion is little more than a change in the entity's surname and the titles given co-owners of the entity. The LP becomes an LLC, the limited partners become members and the general partner becomes the manager. Property operations and tax reporting remain the same.

The significant difference is the limited liability the former general partner gains as the syndicator of the newly-formed LLC. However, the syndicator's liability limitation does not extend to his liability for debts existing before the LP was merged into the LLC. [Corp C §15911.09]

Editor's note — These rules are specifically for a California LP converting to a California LLC. For requirements of other business entity conversions, please see the DRE's Conversion Information document located at www.sos.ca.gov/business/be/forms/convchrt.pdf.

The drawbacks of conversion

The conversion from a limited partnership to an LLC does not qualify as a change of ownership that triggers **reassessment** of the partnership's property, as long as all the members retain the same proportional interests in the LLC as in the extinguished partnership. [Rev & T C §62(a)(2)]

However, the conversion of a limited partnership to an LLC is a transfer of the limited partnership's property that triggers the due-on-sale clause in any security device, such as a trust deed, encumbering the property. [12 United States Code §1701j-3(a)]

Although the **due-on-sale clause** is technically triggered by the conversion due to the automatic statutory transfer of the partnership's property to the LLC, notice to the lender is avoided if the conversion document (LLC-1A) is not recorded with the county recorder.

However, no county recording is necessary to transfer the property to the LLC. The LLC automatically succeeds to all rights and obligations of the partnership solely by filing the LLC-1A with the Secretary of State. Title to the real estate, tax billings and insurance policies can remain in the partnership's name since the LLC, even though the LLC-1A is not recorded in the county, is still the successor-in-interest to the partnership.

If the LLC-1A is not recorded, and since a grant deed to the LLC does not exists, nothing on record will indicate a transfer of the property has taken place.

Of course, in order to obtain title insurance for a refinance or sale of the property, the LLC-1A will have to be recorded with the county recorder. However, delaying the recording interferes with the lender's ability to discover the transfer and call the loan due until the property is actually sold.

Also, an LLC is not liable for its first year franchise tax if its tax year is 15 days or less and it does not do business during that tax year. Thus, the creation of an LLC and the merger should occur during the last 15 days of December. [Rev & T C §17946]

LLC-12 information statements

Within 90 days after recording an LLC-1A form with the state of California, called a *filing*, the LLC syndicator, as manager, must fill out an LLC-12 **Statement of Information** form and send it, along with a check for $20 payable to the Secretary of State, to:

Secretary of State
Statement of Information Unit
P.O. Box 944230
Sacramento, CA 94244-2300

Failure to file the LLC-12 within the 90-day period following the filing date of the LLC-1 results in a $250.00 penalty. The LLC-12 form is available online at sos.ca.gov/business/be/forms.htm. There, it can be viewed, filled out and printed from your computer for preparation prior to mailing to the state. [Corp C §§17651(b), 17653; Rev & T C §19141; see LLC-12]

In addition, every two years after filing the LLC-1 (or LLC-1A), an LLC-12R statement of information form must be mailed to the Secretary of State for filing, along with a payment of the $20.00 processing fee. The period for filing the LLC-12R is every two years during the month in which the LLC-1 (or LLC-1A) was originally filed, or in the five months preceding the original month of filing. The duty of filing the LLC-12R continues until the LLC files an LLC-4/8 form for cancellation of the LLC entity.

Cancellation of the LLC-1 (or LLC-1A)

Within 12 months after creating an LLC by filing the LLC-1 (or LLC-1A) with the Secretary of State, a syndicator may need to or want to cancel the LLC. Cancellation eliminates the LLC entirely and terminates any further assessment of the annual $800 franchise tax on the entity.

Frequently, an LLC entity is formed solely to hold title to real estate for an individual who is the true owner of the property. For federal tax reporting purposes, the LLC solely owned by one taxpayer is considered a *disregarded entity*. As a result, an individual's personal tax handling of real estate vested in his "one-man" LLC is unaffected. [26 CFR §301.7701-3]

The individual creates his one-man LLC by preparing, signing and filing the LLC-1. He takes on no co-owner, acts as the sole owner of the LLC, and does not report to the IRS, but does report to the California FTB and pay the annual California LLC franchise tax.

While the individual vests his property in the name of the LLC, he may want to retain the LLC vesting but cancel the entity to eliminate the annual franchise tax (and of course end the right of the LLC to sue or be sued and his right to limited liability for obligations of the LLC). Following the cancellation of the entity, title will remain in the LLC vesting. Bank accounts established in the name of the LLC will be retained.

If the individual needs to encumber or convey the property on a refinance or sale, the LLC-1 remains on record with the county recorder, authorizing the individual to encumber or convey real estate vested in the name of the LLC, even though it, as an entity, has been formally canceled with the state of California. Conveying is different from suing someone in the name of the LLC since maintaining a lawsuit is not permitted after cancellation of the LLC-1. However, the individual is unaffected by the cancellation and is able to sue in his own name.

Occasionally, a syndicator files an LLC-1 in anticipation of acquiring a property by forming an investment group, but is unable to close escrow and take title in the name of the LLC. The syndicator may have encountered difficulty clearing contingencies and, as a result, cancels the purchase agreement and escrow instructions. Possibly he failed to solicit sufficient commitments from investors to fund the closing.

Either way, the LLC now exists as an entity and the LLC-12 must be filed within 90 days after filing the LLC-1 or a $250 penalty is incurred. The syndicator must pay the ongoing annual $800 franchise tax as long as the LLC-1 remains uncancelled. Thus, within 12 months after filing the LLC-1, a syndicator who creates an LLC and no longer needs it, can prepare and file an LLC-4/8 form to rid himself of further liability and the continued existence of the LLC as an entity. No charge is incurred for filing an LLC-4/8. Any filing by mail should be sent Certified Mail Return Receipt Requested.

Before filing the LLC-4/8 cancellation, a final tax return must be filed with the Franchise Tax Board. However, a return does not need to be filed with the IRS if a return has not previously been filed.

Chapter 17 Liens against individuals

This chapter explores an owner's use of a limited liability company to avoid use of the owner's name in the vesting of title to a property.

Vesting to shield assets from others

A broker/owner of a high volume real estate office with several sales agents has continuous access to real estate entering the market for sale. Occasionally the broker acquires property to own as a principal.

Due to the business activities of the sales agents employed by the broker, the broker is aware he has liability exposure for their professional errors and misconduct. Even though he has incorporated his real estate office and has errors and omissions coverage, his role as the licensed broker who qualifies the corporation for its broker's license exposes him to liability.

As the *designated officer* of the corporation, the broker bears the sole responsibility for the constant supervision of the sales agents employed by the corporation. The broker manages the office and sales agents, and occasionally meets with clients handled by agents.

The broker is cognizant of his need to personally maintain a low financial profile to avoid the appearance of a "deep pocket" which might trigger litigation. As a result, he vests all the real estate he acquires personally in limited liability companies (LLCs) he creates.

However, the broker's conflicting ownership interest between his brokerage office and any acquisitions handled in the office on behalf of his LLC vestings is fully disclosed to any seller or buyer with whom he or his corporate brokerage office or its sales agents have any relationship.

Later, an error occurs. The broker is faced with a potentially dangerous lawsuit arising out of a previous sales agent's misconduct while acting on behalf of the broker, unrelated to any of the broker's personal real estate acquisitions.

The broker needs assurance that the pending litigation, which seeks a money judgment against him personally, will not interfere with his ability to manage, sell or lease his real estate vested in the LLC.

Will a money judgment or lien against an individual member who is an owner of an LLC interfere with the real estate vested in the LLC?

No! Ultimately, only the broker's ownership interest in the LLC can be affected. Further, his interest as owner of the LLC is personal property. Thus, any liens or judgments against the broker will not affect the real estate vested in the LLC, only his interest as owner of the LLC. [Calif. Corporations Code §17300]

A lien or money judgment against an individual who is a general member, limited member, manager or member is unrelated to the real estate vested in either a membership or LLC.

Only after a judicial procedure, called a *charging order,* is processed can a money judgment against an individual attach to the individual's ownership interest as a member in an LLC. [Corp C §17302]

Interest in the LLC

An individual who is a member of an LLC has no interest in the real estate owned by the LLC. A member's ownership interest in the LLC is *personal property*. [Corp C §17300]

While a member has no interest in any LLC property, he is entitled to his share of the LLC's operating income, sales proceeds and assets should the LLC be dissolved. [Corp C §17353]

Creditors, judgments, and liens

A member in an LLC may have an outstanding debt he owes due to:

- a money judgment (i.e., lawsuit liability); or
- a local, state, or federal tax lien.

Once recorded, these money judgments or liens automatically attach to any real estate **interests vested** in the individual's name or the name of his trust.

However, a money judgment against a member which does not name the member's LLC entity as a judgment debtor can only be satisfied by foreclosing on the member's *ownership interest* in the LLC, not the real estate owned by the LLC.

Thus, a LLC entity remains unaffected by a lawsuit against a member. The entity carries on its normal business activities without interference from a member's creditor seeking to enforce its collection rights under a judgment. [Calif. Code of Civil Procedure §§708.310, 708.320]

Charging orders to attach a share

Through a money judgment against a member in an LLC, the member's **ownership interest** in the LLC may be attached to satisfy the judgment. This judicial procedure involves the use of an attachment device called a **charging order**. [CCP §708.310]

A creditor must first locate the LLC interests held by a judgment debtor. Once discovered, the creditor must apply to the court for an order to charge (lien) the ownership interest in the LLC held by the individual member for payment of the judgment. [Corp C §17302]

Notice of the hearing on the charging order must be given to the debtor member and all other members of the LLC. [CCP §708.320]

A creditor of an individual member has two options to enforce a money judgment:

- appoint a receiver to receive the debtor's share of the income and profits; or
- foreclose under the charging order lien on the member's interest in the LLC. [Corp C §17302]

Under a charging order lien, the **appointment of a receiver** is restricted to accepting the benefit of the individual member's interest in the LLC. The creditor acquires no greater rights than the debtor member had under the LLC Articles of Organization or the LLC operating agreement. [Corp C §17301(a)]

A creditor with a judgment has the judicial means to go after a member's *economic interest* only. However, the reality of obtaining an individual member's interest may be more of a hassle than it is worth. The interest the creditor obtains from the debtor member is a non-voting interest which prohibits interference with the LLC activities requiring a vote.

Further, the LLC operating agreement may provide for removal of the debtor member from the LLC if a charging order against the debtor member's interest is not immediately removed. [See **first tuesday** Form 372 §6.2(d)]

Buy-out provisions triggered

One or all of the members in a LLC may terminate a debtor member's interest in the LLC on the notice of a charging order without causing the LLC to be dissolved by:

- purchasing the debtor member's interest using assets of one or more of the other members [Corp C §17302(c)(2)];
- offering a buy-out exchange of LLC property assets (such as a specific piece of real estate) for the debtor's interest with the consent of all members [Corp C §17302(c)(3)]; or
- prior agreement under the terms of the *buy-out provisions* of the LLC agreement.

Buy-out provisions in a LLC agreement between members is the most common method used for the elimination of a member and his creditor. Additionally, the terms of buy-out provisions are usually advantageous to the remaining members.

Most buy-out provisions in LLC agreements call for the termination of the attached interest held by the debtor member. [See **first tuesday** Form 372 §7]

Fraudulent conveyances by debtors

The transfer of property by an owner of real estate to **evade a creditor** is considered fraudulent when:

- the owner actually intends to defraud his creditors [Calif. Civil Code §3439.04(a)]; or
- a reasonably **equivalent value** is not received by the owner in exchange for the property transferred and the owner is or will be insolvent (i.e., debts exceed assets) on the transfer. [CC §3439.05]

Any property transfer made for the purpose of avoiding creditors can be set aside or invalidated as a *fraudulent conveyance*. [CC §§3439 et seq.]

However, if the full value or a reasonably equivalent value is received by an owner for a transfer, the transaction cannot be invalidated. The creditor is then left to chase down and attach the proceeds received by the owner (debtor).

A fraudulent conveyance is indicated when an individual knows of pending litigation or claims then transfers his real estate without receiving fair value.

For example, an LLC consisting of three members is formed. Later, a judgment is obtained against two of the members in their individual capacities.

A creditor obtains a charging order against the members' individual interests in the LLC. All three members receive notice of the proceedings.

Prior to the enforcement of the charging order, the members act to dissolve the LLC. The two debtor members each transfer their ownership interest to the third member, who is unnamed in the judgment, for a minimal sum. The transfer is fraudulent since the third member was aware of the charging order and did not pay a fair value for the transfer.

If a transfer is made by an owner without a fair exchange of value to a "buyer" who knew the transfer would diminish the creditor's claim, the "buyer" becomes liable for the creditor's losses. [**Taylor** v. **S & M Lamp Co.** (1961) 190 CA2d 700]

Thus, the fraudulent conveyance of a debtor's "wealth" beyond the reach of a creditor will be subject to disciplinary action from the court.

Fraudulent conveyance and lis pendens

Consider a creditor who receives a money judgment against an owner of real estate vested in his name. The owner conveys his interest in the real estate by a quitclaim deed to a relative before title is liened by the creditor's abstract of judgment.

The creditor seeks to set aside the transfer as a fraudulent conveyance and records a lis pendens, which clouds the title to the property conveyed.

The relative holding title claims the lis pendens is improper and must be expunged since the fraudulent transfer claim by the creditor is an attempt to recover a money judgment, not an action affecting title to real estate.

However, the lis pendens is proper since the fraudulent transfer action concerned title to the real estate and is separate from any action to enforce the money judgment. [**Hunting World, Incorporated** v. **Superior Court** (1994) 22 CA4th 67]

The LLC asset shield

The use of an LLC to hold real estate assets was neither designed nor intended to be employed as a place to hide an individual's personal wealth. Rather, it is a means to allow real estate vested in the LLC to remain undisturbed in the face of an individual member's adversity.

Consider an owner who places his ownership of real estate into a LLC and receives a percentage or all of the ownership interests in the LLC for the conveyance.

In this instance, the conveyance is not fraudulent. The owner has merely exchanged his interest in the real estate for an interest in the LLC. Full value is received and no tax liability is incurred on the exchange. [Internal Revenue Code §721]

In essence, the owner has substituted his real estate vesting for a position in the LLC. The owner still owns a value equal to the equity in the real estate he transferred, only in a different form. Thus, the value of the owner's interest was not diminished since he received an equivalent value for the property. The nature of his ownership interest merely changes from one of real property to one of personal property.

However, this simple change in vesting inherently makes it more difficult to locate and attach the debtor's assets. The individual owner (debtor) on a recorded abstract of judgment is not the vested owner of any real estate.

Further, the change in vesting makes the real estate, now the asset of an LLC, much more difficult for the creditor to reach due to the charging order process. As the creditor is attempting to locate and attach the debtor's assets, the LLC can continue its business of renting, selling or encumbrancing the property and distributing proceeds to the judgment debtor who is now a member in the LLC.

Chapter 18 LLC membership buy outs

This chapter reviews the provisions in a limited liability company's operating agreement which allow for the buy out of one member by others.

Assigning or terminating a member's interest

Consider an investor who acquires a fractional ownership interest in a limited partnership which owns real estate. Later, the partnership is *converted* to a limited liability company (LLC) to eliminate the general partner's exposure to future liabilities. [See Chapter 16]

An LLC *operating agreement*, nearly identical to the prior partnership agreement, is entered into by all parties involved. Each investor's ownership interest in the limited partnership is **converted** to a *member's interest* in the LLC, and the general partner is given the title *manager*.

The investor now wants to sell his fractional **membership interest** in the LLC.

However, the LLC **operating agreement** restricts the **assignability** of a member's interest, as did the limited partnership agreement. This *restraint* on assignability exists to prevent the admission of outsiders who might later interfere with the LLC's investment objectives and operations.

The LLC's operating agreement permits a member to **sell and assign** his membership interest in the LLC if:

- the manager or another member of the LLC exercises his *right of first refusal* to buy and acquire the investor's interest;
- the other members **waive** their *right to terminate* a member's interest should it be sold without their approval; or
- a voting majority of the members in interest **consent** to the sale and assignment of the member's interest.

The investor first offers to sell his membership interest to the manager under the **right of first refusal** given to the manager in the LLC operating agreement.

The manager declines the offer since he is forming new investment groups to amass his own future wealth and has no interest in repurchasing or marketing fractional interests held by investors in existing investment groups. The manager would rather put investors into fresh deals which add fees and participation in ownership to the manager's portfolio.

Next, the investor offers to sell his fractional interest to other members of the LLC, who also decline.

The investor locates an outside buyer who is interested in buying his membership interest.

The other members pose no objection to the investor selling and assigning his interest and agree to *waive their right* to terminate the investor's membership interest on a sale to a buyer.

However, the other members are unwilling to also approve an assignment of the investor's membership interest and accept the buyer as a *substitute member*.

Buy-out provisions restrict assignments

By the terms of the operating agreement, a member's interest may be terminated by the remaining members if the existing member transfers his interest without the prior approval of the remaining members, unless they have *waived their right* to do so. On termination, the remaining members have the **right to buy out** the selling member's interest at what is usually an advantageous, predetermined price.

To continue with our previous example, while a waiver of termination rights allows the investor to freely dispose of his interest, the refusal of the other members to accept the investor's buyer as a member reduces the value of the investor's fractional interest.

The investor claims the LLC cannot impair his right to sell and assign his fractional membership interest in the LLC to a buyer.

However, the **assignability**, and thus marketability, of a member's interest can be controlled by the LLC operating agreement. [Calif. Corporations Code §§17301, 17303]

Thus, while the investor may assign his interest to the buyer, the assignment cannot be freely made due to the restraint on a transfer agreed to in the LLC operating agreement. Even if a waiver is obtained from the other members, an assignment does not substitute the buyer as a new member.

The remaining members must **approve** of the buyer as a *substitute member* and **release** the investor from the LLC before the **right of membership** can be transferred to the buyer. [Corp C §17303]

Consent to the assignment of a membership interest by the remaining members is accomplished by a vote of a majority in interest of the members in the LLC, unless the operating agreement calls for a different voting percentage. [Corp C §17303]

Until approved as a **substitute member**, the buyer by an assignment of the investor's interest is a *non-voting member* of the LLC. [Corp C §17301]

Assignable interests in an LLC

No member of an LLC has an ownership interest in the LLC's real estate. [Corp C §17300]

Rather, a member owns a **personal property** interest as a shareholder in the LLC which owns the real estate. [Corp C §17300]

Two **assignable interests** exist in an LLC:

- the ownership interests held by members; and
- the manager's administrative interest.

All of the fractional **ownership interests** in the LLC are held by its members only. The shares of ownership are based on the value of each member's contributions to capital, be they contributions in the form of cash (by investors) or assignment of purchase rights (by syndicators).

Figure 1 *Excerpt from **first tuesday's** Form 372 — LLC Operating Agreement*

5. **ASSIGNMENT OF INTEREST, SUBSTITUTED MEMBER:**

   5.1 Assignment of Interest: A member may assign his membership interest to any other member at any time after he has first given the manager 10 days' notice to buy his interest on the same terms agreed upon with another member.

   5.2 Invalid Assignment of Interest: All other assignments or transfers of members' interests are terminated according to the method under Section 6.

6. **TERMINATION OF MEMBERSHIP INTERESTS:**

   6.1 Termination of Manager: The termination of the Manager does not terminate any of the Manager's rights as a member.

   a. Events Causing Termination of a Member: A member may be terminated if any of the following events occur:

   b. He dies, unless survived in interest by a joint tenant;

   c. He is adjudged insane or incompetent, or is committed to a mental institution;

   d. He transfers his interest to a non-member under Section 5.2 without obtaining prior consent from each remaining member;

   e. He fails to immediately remove a charging order against his interest;

   f. He files for bankruptcy;

   g. He voluntarily retires, withdraws or resigns as a member;

   h. He is expelled by court order or by all of the remaining members; or

   i. He fails to contribute capital to the Limited Liability Company as agreed to in Section 2.1.

   6.2 Notice of Termination: Service upon the member to be terminated of a written notice stating the cause for termination and the effective date of termination terminates all of his powers and his right to share in Limited Liability Company profits as of the effective date. The effective date is 30 days after service of the notice. Each remaining member shall be served under Section 13.2 both a copy of the notice of termination and a notice of the option rights held by the remaining members under Section 7.

7. **OPTION TO PURCHASE:**

   7.1 Option to Purchase Upon Termination: Upon the termination of a member's interest under Section 6, the remaining members may:

   a. Dissolve and liquidate the Limited Liability Company under Section 10.1; or

   b. Buy the terminated member's entire interest. Where more than one member exercises his option, those exercising shall purchase their pro rata share based on their aggregate ownership interest.

   7.2 Notice of Exercise of Option:

   a. When a member dies, notice of the option shall be given to the deceased's representative within 120 days after the representative's appointment.

   b. When a member's interest is terminated under Section 6, notice of the exercise of the option shall be given to the terminated member before the effective date of termination, and in the way a notice of termination is given under Section 6.3.

Unlike a standard member, the **manager's position** carries with it the administrative responsibility to operate the LLC and manage the real estate acquired with the capital contributed by the members. The manager is the **administrator** who oversees the day-to-day operations.

Additionally, the manager, like the president of a corporation, can be terminated and a new manager appointed at the will of the members. The **members govern** the LLC, like shareholders and directors of a corporation, since the members hold the voting rights over the *alienation* of the LLC's ownership interest in the real estate it owns.

Any capital interest also held by the manager of the LLC is vested in his name as a participating member with a percentage of ownership in the LLC. Thus, the contributing manager would be both the manager and a member.

The manager's individual membership share as a co-owner of the LLC typically arises out of his *assignment* to the LLC of his right to purchase the property which the LLC acquired, although he may have also contributed cash.

Assignee's rights to participate

The **assignment** of a member's ownership interest, with or without the approval of the other members of the LLC, does not *dissolve* the LLC. The LLC continues to operate without concern for the assignment. [Corp C §17301(a)(2)]

While the member's economic interest in the LLC is assignable, the sale and assignment of the member's interest does not automatically entitle the buyer of the fractional interest to governing rights held by a **voting member**. [Corp C §17301(a)(2)]

Without the remaining members' waiver of their **right to terminate** the selling member's interest, the selling member's assignment may result in his interest being terminated and bought out by the manager and remaining members.

If the remaining members neither buy out the interest assigned nor consent to the assignment, the buyer of the fractional interest is only entitled to an **accounting** of the distributions of income, profit or loss the selling member would have regularly received. [Corp C §17301(a)(3)]

Additionally, without acceptance as a member by a majority vote of the remaining members in interest, the buyer acquiring a member's fractional interest is not entitled to vote or participate in the governing of the LLC or exercise the rights of a member, unless the operating agreement states otherwise. [Corp C §17301(a)(2)]

Likewise, a judgment creditor of a member can *involuntarily acquire* that member's ownership interest in the LLC through a charging order and sheriff's sale of the member's fractional interest to satisfy a money judgment owed by the individual member.

However, on acquiring the fractional interest of a member at a judicially ordered sale of that interest, the foreclosing judgment creditor only receives the rights of an **assignee** as a nonvoting member of the LLC. The distributions of income, profit or loss the original member would have received are all the creditor is entitled to. [Corp C §17302]

A buyer or creditor who is assigned or forecloses on a member's interest and is not approved as a member receives only the member's **economic interest** in the LLC and assumes no duty or liability to the LLC or its other members. [Corp C §17301(b)]

AMENDMENT TO OPERATING AGREEMENT

of Limited Liability Company

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. This amends the Operating Agreement of _____, a California Limited Liability Company,

1.1 dated _____, 20_____, at _____, California,

1.2 formed under a Certificate of Limited Liability Company (LLC-1) filed with the California Secretary of State on _____, _____, as document number _____, and

1.3 recorded on _____, _____, as document number _____, with the county recorder of _____ County, California.

AGREEMENT:

The Operating Agreement of Limited Liability Company is amended as follows:

2. _____ is substituted as the new Manager in the place of _____, who is released of all rights and obligations under the Operating Agreement. The new Manager shall immediately file an LLC-2 Amendment to Certificate of Limited Liability Company with the Secretary of State and record the same with the office of the county recorder where the Limited Liability Company's real estate is located.

3. _____ is substituted as a new Member in the place of _____, who is released of all rights and obligations under the Operating Agreement. An assignment of the Member's interest is attached. [See **ft** Form 375]

4. The Limited Liability Company has acquired the ownership interest in the Limited Liability Company held by _____, who is released of all rights and obligations under the Operating Agreement. An assignment of the Member's interest is attached. [See **ft** Form 375]

5. _____ is added to the Limited Liability Company as an additional Member for the agreed capital contribution of $_____, payable in cash or _____, for a percentage ownership in the Limited Liability Company of _____%.

6. The Members agree to contribute additional capital to the Limited Liability Company in the amount of $_____, as set forth in Exhibit "A" of the Operating Agreement – LLC [**ft** Form 372] attached to this amendment.

7. Other _____

_____

_____

I agree to the terms of this amendment.

☐ See attached Signature Page Addendum. [**ft** Form 251]

(Member)	(Member)	(Member)
(Member)	(Member)	(Member)

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Substitute member's obligations

The buyer of a member's fractional interest may be admitted as a *substitute member* by a majority vote of the remaining members as controlled by the operating agreement. When substituted, the new member takes on all the **rights and responsibilities** of the selling member, including all capital contributions assessed against that member's fractional interest. [Corp C §17303(b)]

Additionally, on approving an assignment to a **substitute member**, the remaining members must vote to amend the LLC to substitute and release the selling member from future liability to the LLC, called a *novation*. Without a release of liability, or **novation**, the selling member remains obligated to the LLC under the operating agreement he originally entered into. [Corp C §17303(c); see Form 374 accompanying this chapter]

*Editor's note — After he has transferred his interest, the selling member cannot later interfere with the LLC's objectives. The selling member's withdrawal does not release him from all obligations owed to the remaining members. A **fiduciary** duty among members still remains in regard to investment opportunities and operations which are known to the released member and are of value to the LLC. [**Leff** v. **Gunter** (1983) 33 C3d 508]*

The same fiduciary duty is owed to the LLC by the substitute member who becomes a voting member.

Documenting the transfer

An *assignment* of a withdrawing member's interest and *substitution* of the buyer as a new member are completed by:

- a written **assignment** from the withdrawing member to the buyer; and
- an **amendment** to the operating agreement by a vote of the remaining members.

With an **assignment**, the withdrawing member transfers all his right, title and interest in LLC to the buyer who is acquiring his fractional interest. [See Form 374]

If the remaining members elect to accept the buyer as a substitute member, the operating agreement is **amended** to *substitute* the new member (buyer) for the withdrawing member. [See Form 375 accompanying this chapter]

For the amendment to be effective on the substitution of a member, it must be signed by the remaining members holding the percentage of ownership interest called for in the operating agreement, usually a super-majority (e.g., 75%).

Should the operating agreement not state the percentage of ownership interest required to consent to a substitute member, then a majority in interest of the members must sign the amendment. [Corp C §17303(a)]

The LLC does not need to prepare and file an Limited Liability Company Certificate of Amendment (LLC-2) on the assignment of a member's interest. [See FTB Form LLC-2]

However, when admitted to the LLC as a substitute member, the substitute member's name must be added to the list of current members which is required to be kept at the LLC office maintained by the manager. [Corp C §17100(b)]

ASSIGNMENT OF INTEREST
In Limited Liability Company

DATE: _____, 20_____, at _____, California.
Items left blank or unchecked are not applicable.

FACTS:

1. This assignment is of a member's interest in _____, a California Limited Liability Company (LLC), organized under an operating agreement dated _____, 20_____, at _____, California, and formed under a Certificate of Limited Liability Company (LLC-1)

1.1 filed with the California Secretary of State on _____, as document number _____,

1.2 recorded on _____20_____, as document number _____ with the county recorder of _____ County, California.

FOR VALUE RECEIVED:

2. I, _____, as the Assignor, hereby sell, assign and transfer to _____, as the Assignee, all my rights, title and interest as a member in _____, a California LLC,

2.1 which interest is identified as Class "_____" and represents _____% of the voting ownership of the LLC, and

☐ is represented by the attached Certificate of Interest in Limited Liability Company (if one exists).

3. Assignor hearby authorizes _____, as the Manager of the LLC, to reflect this assignment on the books of the LLC.

4. This assignment is subject to any restrictions on the transfer of an ownership interest provided in the Operating Agreement of LLC for the LLC.

4.1 Any necessary notices and approval of this assignment by the LLC or members and any right of first refusal or option to purchase the interest assigned held by the remaining members ☐ have, or ☐ have not, been consented to or waived by them.

5. Assignee hereby assumes and agrees to timely perform all Assignor's obligations under the operating agreement of the LLC.

Assignor:	**Assignee:**
☐ See attached Signature Page Addendum. [**ft** Form 251]	☐ See attached Signature Page Addendum. [**ft** Form 251]
Date: _____, 20_____	Date: _____, 20_____
Signature: _____	Signature: _____
Signature: _____	Signature: _____

FORM 375 02-08 © 2008 **first tuesday**, P.O. BOX 20069, RIVERSIDE, CA 92516 (800) 794-0494

Manager's assignments

The assignment of an LLC's manager's interest is more complex than the **assignment of a member's interest**. It is accomplished by:

- a written assignment by the manager or notice of termination by the members;
- a vote amending the operating agreement to identify the new (substituted) manager; and
- a filing with the Secretary of State and recording with the county recorder of n LLC-2 form naming the substitute manager. [Corp C §17054(c)(2)]

The withdrawing manager's interest is assigned to a substitute manager and the operating agreement is amended by preparing the same documents used to substitute members. [See Forms 374 and 375]

Whenever a manager is substituted or removed, the LLC must notify the Secretary of State of the change by filing the LLC-2. [Corp C §17054(c)(2)]

An LLC-2 is a government form issued by the Secretary of State's office to amend or correct the Limited Liability Company Articles of Organization (LLC-1) which is on file with the Secretary of State. [See LLC-2]

After the LLC-2 is filed with the Secretary of State, the prior manager's authority to act on behalf of the LLC is terminated by recording the LLC-2 in the county where the LLC's real estate is located. [Corp C §17052(f)]

Due-on and reassessment

Two further consequences must be considered when assigning a selling member's fractional interest in an LLC.

First, the rights of trust deed lenders to call on a transfer should be considered. The manager and remaining members must review each provision in the trust deeds encumbering the real estate owned by the LLC for the existence of a *due-on clause* since the buy out of a co-owner's fractional interest may trigger the lender's **right to call or recast** the terms of the loan.

If a **due-on clause** exists which contains wording relating to the transfer of fractional ownership interests in the entity vested in title, the clause may be triggered by the assignment. The remaining members must then decide whether to notify the lender of the "off-record" buy out.

Second, the remaining members must ascertain whether the assignment of the selling member's interest is classified as a **change in ownership** which would trigger *reassessment* by the county assessor and result in higher property taxes.

The transfer of 50% or less of the ownership interests held by members during the life of the LLC does not constitute a change in ownership and does not trigger reassessment of real estate vested in the name of the LLC. Conversely, the transfer by members of more than 50% of the member's ownership of the LLC does trigger reassessment of the LLC's property. [Calif. Revenue and Taxation Code §64(a)]

Additionally, when a member with a minority interest in an LLC acquires enough ownership interests to hold a majority interest (more than 50%), a *change of ownership* occurs, triggering reassessment of the entire parcel of real estate owned by the LLC. [Rev & T C §64(c)(1)]

An LLC manager must sign and submit a change of ownership statement to the State Board of Equalization (SBOE) within 45 days of the earlier of the 50% change in ownership or SBOE request for the statement. Failure to timely file the change of ownership statement results in a penalty of 10% of the taxes due on the new full cash value of the change in control of real estate owned by the LLC. [Rev & TC §482(b)]

Membership vesting is estate planning

Vesting co-owned real estate in an LLC instead of as tenants in common eliminates any interference with title to the real estate on the death of an LLC member (and provides limited liability for members and the manager).

By filing the LLC-1 (or LLC-1A), entering into an operating agreement to create an LLC and vesting real estate in the name of the LLC, the death of a member (co-owner) does not create chaos for the management of the real estate. This is in contrast to what occurs on the death of a co-owner when he is vested on title as a tenant in common.

The membership interest held in the LLC by a deceased member is transferred on or after death according to how he vested his ownership interest, similar to a transfer of real estate interest on death.

Six **types of vestings** are available for ownership interests held by individuals in real estate or personal property (shares in the LLC) located in California:

- joint tenancy;
- community property;
- community property with right of survivorship;
- tenancy in common;
- sole and separate ownership (single, unmarried, spouse); and
- revocable living (inter vivos) trusts or other title holding arrangements.

Vesting not only provides evidence of the ownership of an interest in property, vesting is a method of estate planning since it states the nature of the ownership (community or separate) and intended distribution of the interest on the owner's death (by the right of survivorship, will or trust).

Two or more individuals may vest the percentage of LLC membership interest they jointly own in "joint tenancy," such as "husband and wife as to a 20% interest, as joint tenants."

On the death of one of the joint tenant members, the surviving joint tenant who co-owned the interest with the deceased automatically succeeds as owner to the entire membership interest they had jointly held in the LLC.

The **sole advantage** of a joint tenancy vesting for a co-owned interest is the avoidance of probate. The same results occur when the husband and wife vest their co-ownership as community property with the right of survivorship.

Managing a deceased member's interest

When an LLC member dies, the member's legal representative, such as an executor, administrator or trustee, may exercise all of the member's rights in the LLC for the purpose of administering and securing the deceased member's estate. [Corp C §17304(a)]

LLC operating agreements typically include provisions allowing the remaining members to **terminate a member's interest** upon his death, unless the deceased member's interest is held by a surviving joint tenant who co-owned the interest with the deceased.

Thus, the remaining members can purchase the deceased member's terminated interest under the buy/sell provisions in the LLC operating agreement.

If the option to buy out the deceased member's interest is not exercised, the remaining members are under no obligation to approve the deceased's legal representative as a new member of the LLC. If they do not, the representative or any other successor of the deceased's interest may not vote or become involved in the governing of the LLC or the manager's administration of the LLC and its property.

Chapter 19 Documenting the LLC investment program

This chapter introduces the documentation needed to solicit funds, form and manage a limited liability company to own and operate income-producing real estate.

Birth and expectations of an LLC

The formation and funding of a limited liability company (LLC) requires four documents — two to form the LLC itself and two to solicit investors to fund the LLC.

The documents needed to form an LLC include:

- the LLC-1 **Articles of Organization** form (or the LLC-1A if the LLC was created in a conversion from an LP), the LLC law counterpart to the LP-1 for a limited partnership, issued by the California Secretary of State for use by the syndicator to establish and operate an LLC in California [See Chapter 16]; and

- the **operating agreement**, similar to most co-ownership agreements in its management, income- and profit-sharing, voting and buy-out provisions. [See **first tuesday** Form 372]

The funding documents include:

- the **investment circular**, a narrative disclosing all the material aspects of the investment to prospective co-owners, prepared as the product of the syndicator's due diligence investigation and analysis of the property [See **first tuesday** Form 371]; and

- the **subscription agreement**, the investor's agreement with the syndicator to contribute funds in exchange for an ownership share in the LLC. [See **first tuesday** Form 373]

The articles of organization

By stating the syndicator is the sole manager, the articles of organization (LLC-1) gives the syndicator the **power to bind** the LLC by entering into agreements following a vote by the members to buy, sell, finance and lease property, or to contract for management, services, labor and materials to operate the real estate acquired by the LLC. [Calif. Corporations Code §17157; see Chapter 20]

The operating agreement

The document that authorizes the operations of the LLC is the **operating agreement**. It also states the rights and duties of the syndicator, as manager, and the co-owners.

The operating agreement for an LLC must contain all the fundamental boilerplate provisions that lay out the working relationships between the syndicator and the co-owners. Provisions include profit-sharing and buy-out arrangements, comparable to those used in any other co-ownership agreement, such as limited partnership, tenants in common (TIC), and stockholder co-ownership agreements.

The operating agreement is signed by all investors at the same time they sign the subscription agreement agreeing to invest.

A written operating agreement is not required to evidence the agreement between the co-owners and the syndicator forming an LLC. However, it is prudent to form a group investment program based on a written operating agreement, not an oral one. [See **first tuesday** Form 372]

The governing principles for the ongoing operations and co-ownership in the LLC as stated in the operating agreement include:

- business purposes and objectives;
- capital contributions and percentage ownership;
- co-owners' participation in the distribution of income and profit from operations, financing, and sale;
- establishment of different classes of members (i.e., Class A membership shares granting priority distributions to cash investors and Class B membership shares granting a subordinated right to earnings held by the syndicator);
- officers, management, compensation and accounting; and
- assignment of interests, termination of a co-owner and buy-out options; and
- dissolution and termination of the LLC.

The operating agreement designates the syndicator as the manager of the LLC. As the manager, the syndicator may give himself any title he wants to use, such as president, chief executive officer (CEO) or general manager. As the lone manager, he is solely responsible for conducting the business affairs of the LLC.

In addition to the manager, the operating agreement may provide for the appointment of other officers, such as a secretary, treasurer and so on, as in a corporate management structure. The officers do not need to be co-owners. For instance, an accountant who is not a co-owner could be named as treasurer should the syndicator deem the position is appropriate to provide oversight for the cash flow from the investment program. [Corp C §17154(a)]

The operating agreement for an LLC is fundamentally a **profit-sharing agreement**. It spells out when and how all the co-owners will participate in the rents and profits generated by the property acquired with the funds they invested in the LLC.

To best understand the nature of the earnings generated for the co-owners by their investment in the LLC, a return **on** capital must be distinguished from a return **of** capital.

The **return on capital** is the ongoing, annual net earnings from rents generated by the operation of an income-producing property. Return on capital takes the form of some or all of the spendable income.

The return from operating the property is generally expressed in terms of an annual percentage yield based on the co-owners' original cash contributions. The classic example of a return on capital is the interest paid on a savings account. In real estate investments, it is that portion of the rents paid by tenants that remains after paying expenses and interest on borrowed capital.

Conversely, the **return of capital** is simply the return to the investors of the funds they originally contributed. In the case of a real estate investment, the return of capital includes that portion of the loan

reduction and spendable income sheltered from taxes by the annual depreciation deduction, as well as the net proceeds from a refinance or resale of the property — up to the amount of the original contributions.

Profits taken by a refinance or sale are the result of capital growth due primarily to dollar inflation and property appreciation. While profits are a return on capital, they are not a return from operations (annual income) or a return of the original capital investment.

The investment circular for solicitation

The **investment circular**, also known as a *prospectus* or *memorandum*, is prepared by the syndicator. He uses it to solicit prospective investors to buy a share ownership in his LLC investment program.

The purpose of the investment circular is to present investors with the material facts about the investment opportunity, giving as much breadth in scope and as much detail as is necessary for a prudent investor to be able to make a well-informed decision based on a review of its content. [See Chapter 20]

Information provided in the investment circular includes:

- the business and investment objectives of the LLC;
- a full description of the property to be purchased, including the condition of the improvements, natural and man-made (environmental) hazards, location, title and operation of the property;
- the proposed operating budget of the LLC;
- projected earnings for co-owners;
- a disclosure of the risks of loss involved;
- the background and qualifications of the syndicator;
- the compensation and duties of the syndicator as manager of the LLC; and
- copies of the LLC-1 articles, operating agreement and subscription agreement.

Generally, the syndicator will hand the investment circular to prospective investors to induce them to contribute funds to the LLC at a non-negotiable, set price for participating as a co-owner member.

The commitment to subscribe

An investor fills out the **subscription agreement** he has received with the investment circular. He signs it and returns it to the syndicator, committing himself to contribute funds as a member of the LLC.

The subscription agreement is broken down into three parts:

- the investor's offer to contribute funds to the LLC;
- the investor's acknowledgment of his receipt and review of the syndicator's transactional disclosures and declarations made in the investment circular; and

- the investor's income and net worth disclosures made to the syndicator for a determination as to whether the investor is a suitable candidate for co-ownership in the LLC.

Editor's note — "Certificates of interest" may be issued to the co-owners to evidence their ownership of a share in the LLC, but the shares in the LLC must not be called ***stock****. Any transaction or investment program that involves the issuance of shares entitled stock is automatically considered a corporate security, regardless of whether the economic realities of the transaction include a risk of loss of the promotional reliance variety that constitutes a corporate security. [****Landreth Timber Company*** *v.* ***Landreth*** *(1985) 471 US 681]*

Also, by signing the subscription agreement, the investor indicates he understands the nature and risks inherent in the LLC investment program as disclosed by the syndicator in the investment circular.

Finally, the investor provides general information on his net worth and income along with other relevant matters such as prior investment experience and educational background. Since the investors are entitled to receive detailed information on the syndicator, the syndicator presents his profile in the investment circular.

Before accepting any investor's offer to become a co-owner, the syndicator uses the information provided in the subscription agreement to determine the LLC investment program's financial suitability for the investor.

After reviewing the investor's subscription agreement offer to invest and his credentials, the syndicator accepts the investor's offer to buy a fractional interest by signing a copy of the agreement and returning it to the investor.

Power of attorney authority

Operating agreements for LLC investment programs consisting of a large group of investors often call for the members to give the manager a **power of attorney**. This authority allows the manager to act on behalf of the co-owners to exercise their voting rights under the LLC operating agreement.

A power of attorney is a written document separate from the operating agreement. It is entered into by an individual member, granting another person — the manager — the authority to enter into agreements and act on the individual's behalf. [Calif. Probate Code §4022; see **first tuesday** Form 447]

Granting the manager a power of attorney to act on behalf of an investor is not necessary when forming an LLC. Typically, the investor will sign all documents requiring his signature at one time, including the subscription agreement to invest, the operating agreement and his check to fund his contribution.

However, the power of attorney may be useful when activities of the LLC must be approved by the co-owners under the voting provisions in the operating agreement, such as voting to admit a new or substitute co-owner, or to continue the LLC after an event occurs causing dissolution.

The power of attorney should not be used to eliminate the need for co-owners to approve significant non-recurring ownership events, such as the *alienation of property rights*. Authority to alienate would allow the syndicator to reorganize the investment (through a refinance or exchange of properties), a transfer of possession by entering into a long-term lease or the disposition (sale) of all or part of the investment property.

Thus, the scope of the authority granted to the manager under any power of attorney should be limited to the short-term, on-going operation of the LLC and the property. For example, the power of attorney might properly authorize the manager to vote on the co-owners' behalf to continue the LLC after a dissolution, but not to amend the operating agreement or refinance or sell the LLC's real estate.

Chapter 20 A checklist for an investment circular

This chapter reviews the material facts to be considered for inclusion in documentation used for soliciting investors to fund the purchase of property.

An agency duty to disclose

An **investment circular** (IC) is a disclosure prepared by the syndicator and presented in pamphlet form to potential cash investors. The purpose of the IC is to explain to the investor, as fully and clearly as possible:

- the nature of the investment program;
- the significant features and aspects of the property to be acquired; and
- the risks and financial consequences of the investment.

The more information provided by the IC, the more effective the syndicator's demonstration of the thoroughness of his research of properties, due diligence investigations and analysis of the property's worth as an income-producing asset with long-term profit potential.

A well-organized and comprehensive review of the selected property's attributes in an IC gives the prospective investor information on:

- the property's physical condition;
- its operating history of income and expenses;
- a forecast of its future operations under the syndicator's management;
- title conditions;
- conditions affecting the property due to its location and the surrounding neighborhood; and
- the rental competition and resale market trends.

Goals of an investment circular

The IC must be readable and visually attractive to a prospective investor. The information contained in an IC must allow a prospective investor to move effortlessly from page to page. The copy needs to have an open feeling, be clean in appearance and contain short sentences and paragraphs.

A syndicator creating an IC must avoid using encoded real estate lingo and legal terms which are not easily comprehensible to a layperson. Instead, use words of plain meaning and in common use that are easily understood and absorbed. If the copy puts the reader off, he will not carry through to contribute cash to the investment.

An IC is presented in a chronological manner, instructive and reasonable in its conclusion and worded as a vivid presentation of the investment program. Then, in response to any question a prospective investor poses, a mutual review of relevant sections of the IC will contain the answer.

An investment program which seeks to acquire and operate property for the same purpose the property is currently serving (such as the acquisition of an existing income-producing property acquired to be operated as a rental property), does not contain a corporate securities risk. Thus, the co-ownership operation of the property contains no risk of loss beyond the economic risks imposed on all landlords, tenants, sellers and buyers in the marketplace.

Marketplace risks do not come within the purview of the securities laws. They are controlled by the laws of economics. Without the presence of a risk of loss such as the need to rehabilitate the property for the rental market, to change its use (such as through subdivision for resale, development or construction) or to change the zoning or obtain a conditional use permit, the investment program is not a security and does not fall within the securities law controlling the solicitation of investors to contribute. [See Chapter 14]

Also, any method or means used to locate and solicit investors to join the co-ownership of real estate does not of itself present a risk of loss within the securities law, and does not turn a non-security into a security. Advertising to solicit investors does not create a securities risk.

In contrast, the use of the IC to market a real estate investment opportunity that includes the inherent risk of loss present in a securities risk requires some rewording and additional provisions in the LLC operating agreement and IC, such as the business purpose and future contributions provisions. The transaction that includes a securities risk, such as a conversion to condominiums, construction of improvements, or other change-of-use activity that adds value to the property by the efforts of persons other than the investor, falls within the control of the securities law.

When the investment program is controlled by the securities law, exemptions are available that allow the nonpublic solicitation of investors. If not exempt, a securities permit must be obtained to publicly solicit investors. Whether the transaction is or is not a security, to be devoid of deceit the syndicator still must provide a full disclosure of the investment program — the primary purpose of an IC.

Further, if a securities risk exists, the solicitation of investors under the *nonpublic offering exemption* does not allow any information about the availability of the investment to be published as an **advertisement to the general public**. [See Chapter 14]

The syndicator's duty to prepare and present an IC to each prospective investor for a syndicated real estate investment program is imposed by agency law. A syndicator must, due to his **agency relationship** with all prospective investors, make a full disclosure of all material facts since they affect the value of the property and relationships between investors.

The duty to disclose goes far beyond a listing agent's duty owed to a buyer when presenting a marketing package on a property he has for sale. The syndicator's agency duty is to care for and protect the prospective investors, and provide the information they need to make a decision whether to invest. Thus, the IC is the best method for making the disclosures and documenting that they have been made.

Land investments

The operating agreement for an limited liability company (LLC) formed to invest in undeveloped land for later resale must contain a clause allowing the syndicator to call for and collect periodic future con-

tributions from the co-owners to pay the carrying costs of owning the property, such as loan installments, taxes, and insurance.

Also, no spendable income is expected from the acquisition and ownership of unimproved real estate, only a profit on resale. Accordingly, the wording regarding the distribution of expected earnings and profits in the IC and operating agreement must be redrafted.

Trust deed investments

For an LLC investing in trust deeds, the purpose clause in the operating agreement is modified to state the LLC is being formed to purchase a particular note secured by specific real estate, rather than to purchase the real estate itself.

Also modified is the spendable income clause, since distributable income in a trust deed investment is not generated by the operations of rental property, but by interest paid on the note (unless the LLC is later forced to foreclose and becomes the owner-operator of the real estate securing the note).

If the note is secured by income-producing property, the trust deed IC will include much of the same real estate disclosures made for an investment in income-producing property. Thus, a trust deed IC requires additional disclosures. [See Chapter 19]

The IC discloses the condition of the note to be acquired — the loan-to-value ratio (LTV), the trust deed's priority on title, terms of payment, payment history, interest rate, due date, borrower's creditworthiness and so on.

Also, the IC must disclose the special risks of trust deed investments, such as the possibility of foreclosure and ownership of the real estate due to a default.

Finally, ownership of a trust deed investment, whether structured as an LLC or a tenancy in common (TIC), is classified as a security. Thus, as an LLC investment in a trust deed, the nonpublic offering exemption (or a permit) must be obtained. If structured as a TIC ownership by investors, a notice permit on a claim of exemption allowing public soliciting of investors is available to syndicators.

Checklist for the investment circular

The investment circular states the name and business address of the LLC, identifies the syndicator, explains the objectives and risks of the investment program and includes major documentation.

Introduction to the investment circular

This investment circular (IC) checklist is designed to help the syndicator of an LLC investment program fulfill his agency duty owed to prospective investors. He must disclose all factors affecting an investment in an existing, fixed asset with a present value at least equal to the price paid for the property. The securities risks existing in a controlled investment must be included in this checklist for analysis and full disclosure in an IC prepared for such an investment.

Editor's note — The bold-faced items in the checklist represent headings in the table of contents for the investment circular. The indented items in the checklist are to be considered for inclusion under each heading.

Investment objectives and policies

- A return of capital, income, profits or losses that will result from the operation and eventual resale of the property
- Co-owners will participate in the benefits of group ownership of the real estate, but will not be responsible for day-to-day management

Summary of property purchase and financing

- Purchase agreement
- Terms of the agreement
- Vesting of the real estate
- Contingencies and options
- Investors' funds returned if the LLC is not fully subscribed
- Title insurance
- Liability and hazard insurance
- Property taxes
- Seller's name, address, and relationship to the syndicator
- Terms of financing
- Fee appraisal report

Capitalization of the LLC

- Total cash to be raised
- Number of shares offered for investment and dollar amount of each
- Syndicator exchanges purchase rights for Class B membership
- Additional contributions if the investment property is undeveloped land or a negative cash flow income property

Use of the contribution proceeds

- Cash down payment on purchase price
- Acquisition and organizational expenses
- Reimbursement of syndicator for funds advanced
- Fee for syndicator's organizational services
- Reserve funds

Risk factors

- All group investments involve a degree of risk

- The co-owners' ability to transfer their interests in the LLC is restricted
- Assignment of a majority of shares triggers reassessment and a change in property tax
- Changes in economic conditions will affect income and profits
- Treatment of income and losses from operations or sale for co-owner tax reporting is subject to federal and state tax codes and regulations
- Co-owners might default on their obligation to contribute capital
- Disclosure of the manager's interest in competing properties [See Chapter 6]

Description of the real estate

- Fee simple/leasehold
- Location
- Present use, zoning, rent control and use restrictions
- Acreage/square footage
- Condition of improvements, building inspection report
- Environmental hazards report
- Natural hazards report
- Neighborhood surrounding the property
- Criminal activity and personal security aspects

Compensation of the manager

- Disclosure of earnings and profits from the property
- Fee on yield spread premium (YSP) received for arranging the purchase-assist financing
- Commissions paid by seller on acquisition
- Ownership interest held as a member
- Monthly property management fee
- Fee on refinance or resale of the property
- Beneficial interest in real estate financing
- Relationship to the seller

Operation and management of the property

- Property management agreement
- Management fee
- Bank accounts
- Manager's fidelity bond
- Statement of manager's qualifications
- Operating history of the improvements

- Anticipated future operating performance, as referenced in the annual property operating data (APOD) form
- Anticipated distributions to co-owners
- Priority and subordinated interests
- CPA audits

Qualification of syndicator

- Describe the educational and business background of the syndicator, and previous experience in acquisition, sales property management and real estate syndication

The LLC operating agreement

- Terms of the operating agreement
- Restrictions on the alienation rights of members
- Death or withdrawal of a co-owner
- Distribution of earnings
- Management provisions
- Additional assessments on co-owners to cover taxes, insurance, loan payments, etc.
- Power of attorney held by manager

Reports to investors

- Reports on acquisition of property
- Copies of LLC formation and operating documents
- Copy of title insurance policy
- Closing statement
- Balance sheet
- Annual reports

Other reports

- Annual report to Secretary of State (LLC-12)
- Annual tax information, allocation of income and expenses
- Availability of fee appraisal report
- Existing litigation in which the syndicator or the property is presently involved

Federal income tax consequences

- LLC reports to tax agencies
- Taxation of co-owners' interest
- Opinions of advisors
- Attorney and CPA for LLC [See Chapter 7]

- Tax opinions
- Aspects of an LLC
- Description and explanation of LLC entity
- All co-owners' liability limited to amount of contribution
- Partnership or TIC tax treatment
- Minimum California franchise tax
- Agent for service of process
- One year statute of limitations for unanticipated securities violations

Exhibits

- Articles of Organization (LLC-1)
- Operating agreement
- Subscription agreement
- Opinion of counsel
- APOD for rental property
- Preliminary title insurance report
- Plat map of property

Chapter 21 The investment circular

This chapter presents the entire contents of a typical investment circular as prepared by a syndicator for solicitation of investors to contribute and become members of a limited liability company. An editable version of the investment circular, ***first tuesday*** *Form 371-1, is available online at firsttuesday.us and on the Forms-on-CD.*

INVESTMENT CIRCULAR

Dated: _____, 20_____

To: _____

From: _____, the Manager of

_____, LLC,

a California Limited Liability Company.

Re: Investors with $ _____ cash available for placement in an income-producing real estate investment program.

You are kindly requested to consider this investment opportunity.

$_____ cash will be raised for a down payment, closing costs, and reserve funds to purchase income-producing real estate.

The property to be acquired is a(n) _____ building located at _____, in _____ California.

The purchase price of this income property is $_____.

The mortgage financing on the property is the total principal amount of $_____.

Group ownership of this property will create the following advantages for the investors:

1. A high-yield priority return on invested funds from spendable income, equity build-up, and increase in property value;
2. No additional capital contribution;
3. Management of the property and accounting to be handled by the LLC manager; and
4. Individual co-owner tax benefits.

Please review the specially prepared investment circular accompanying this letter for the details of these and other advantages.

My deadline for funding the close of the purchase escrow is _____, 20_____.

Please call me at _____ if you desire any further information.

Sincerely,

_____

INVESTMENT OPPORTUNITY

_____, LLC,

a California Limited Liability Company,

offers investors a

$_____ cash

investment program

consisting of _____

$_____ Class A membership units

in the ownership of

income-producing real estate

valued at $_____

This Investment Circular is dated: _____, 20_____

INVESTMENT CIRCULAR

Presented by _____, LLC,

a California Limited Liability Company
Offering Class "A" investment units at
$_____ per unit.

The investment program is designed to raise cash in the sum of $_____, for use by the Limited Liability Company (LLC) to acquire and operate, as a long-term investment, an existing income-producing _____ property. The investment is designed to deliver to the investor:

- spendable income;
- equity build-up by monthly amortized loan reduction;
- an inflationary hedge and appreciation in value;
- tax benefits of annual depreciation deductions;
- minimum management requirements;
- priority distribution of income and profits;
- liability limited to capital invested; and
- debt leveraged ownership serviced by rental income.

The investment program is limited to investors meeting minimum financial and suitability standards.

Other than filing articles of organization for the LLC, this investment program has not been qualified or registered with any governmental agency, as no qualification or registration is required by law. No permits of any kind have been sought or received prior to offering this investment program to prospective investors.

INVESTMENT CIRCULAR SUMMARY

_____, LLC, a California Limited Liability Company, offers _____ investment units of $_____ each, as a long-term investment program involving a degree of risk.

The LLC is newly organized and has no operating history. It holds the contract rights to purchase income-producing real estate commonly referred to as _____, in the City of _____, _____County, California. The property current fair market value is $_____.

The LLC shall hold title to the property subject to a loan(s) totaling $_____. The purpose of this offering is to raise capital funds for the down payment on the purchase of the income-producing real estate, pay an organizational fee to the manager and establish a reserve fund.

The material set forth in this circular is a presentation of this investment program and solicitation of investors. In the investment circular, the Manager has set out all available material facts and data for presentation to prospective investors.

This investment does contain risk factors, as it is more speculative than insured interest-bearing accounts or real estate owned clear of any mortgage financing.

The investors' interests in this LLC will not be acquired with the intent to resell. The interests offered will be difficult to market or resell, and liquidation of any individual member's interest will likely result only from resale of the property by the Manager. [See Section 6, Risk Factors]

The units offered may be subscribed to by investors who meet financial and suitability standards, and who are sufficiently well informed in real estate investments to discern for themselves the risks inherent in the offering.

If for any reason the subscription of sufficient investors fails to be completed by _____, 20_____, the investor's funds will be returned in full without reduction in amount, together with any interest earned thereon.

The minimum financial suitability standards set by the Manager for this investment program require investors to have a minimum adjusted gross income of $_____ and a net worth of $_____, exclusive of personal residence, automobile, and personal property. The intention to purchase and hold a membership share in the LLC for long-term investment purposes rather than for resale is also a necessary requisite.

The Class A membership interests offered have not been registered with the Securities Exchange Commission (SEC) nor qualified with the California Department of Corporations (DOC), and no permits have been obtained from any governmental agency. This investment program is to capitalize the purchase and ownership of an existing asset, to be held for income from rents and profit on resale. No future improvement or development of any kind to create or complete this investment is anticipated, and the investment requires no reporting under any securities laws, state or federal.

INVESTMENT CIRCULAR

TABLE OF CONTENTS

SECTIONS: **Page**

1. Investment Objectives and Policies . . . . . ___
2. Summary of Property Purchase . . . . . ___
3. Real Estate Financing . . . . . ___
4. Capitalization of the Limited Liability Company . . . . . ___
5. Use of the Contribution Proceeds . . . . . ___
6. Risk Factors . . . . . ___
7. Description of the Real Estate . . . . . ___
8. Projected First-Year Operating Budget . . . . . ___
9. Projected Financial Benefits to Members. . . . . ___
10. Benefits Received by Members . . . . . ___
11. Compensation and Duties of the Manager. . . . . ___
12. The Manager . . . . . ___
13. Reserve Fund Account. . . . . ___
14. The Limited Liability Company Aspects . . . . . ___
15. Reports to Investors. . . . . ___

EXHIBITS:

A. Purchase Agreements . . . . . ___
B. Escrow Instructions and Assignment Supplement . . . . . ___
C. Copy of Grant Deed into LLC . . . . . ___
D. Buyer's Cost Sheet . . . . . ___
E. Preliminary Title Report, Schedule “B” . . . . . ___
F. Condition of Property (Building Inspection Report) . . . . . ___
G. Natural Hazards and Environmental Disclosures. . . . . ___
H. Annual Property Operating Data Sheet (APOD) . . . . . ___
I. Rental Income Rent Roll . . . . . ___
J. Area Map of City/County . . . . . ___
K. Property Management Agreement . . . . . ___
L. Property Value Appraisal . . . . . ___

ADDENDA:

A. LLC-1 with Transfer Addendum . . . . . ___
B. LLC Operating Agreement with Exhibits . . . . . ___
C. Subscription and Agreement to Invest . . . . . ___

_____, LLC,

a new California Limited Liability Company

formed for a group of investors

to acquire a(n) _____ building

located in_____, California.

SECTION 1. INVESTMENT OBJECTIVES AND POLICIES

The Limited Liability Company (LLC) will purchase and operate, for long-term investment advantages, an existing _____, located at _____, in _____, California. The project is more commonly referred to as_____.

The objectives of the LLC are to provide Class A members with:

- spendable income;
- equity build-up by monthly amortized loan reduction;
- an inflationary hedge and appreciation in value;
- tax benefits of annual depreciation deductions;
- minimum management requirements;
- priority distribution of income and profits;
- liability limited to capital invested; and
- debt leveraged ownership serviced by rental income.

Local and national conditions should allow the LLC to attain all these objectives. However, there can be no assurance these objectives will be fully attained.

The Manager will direct the acquisition of the real estate. Income, profits and return of invested capital from the LLC property will be the result of spendable income generated by property operations, proceeds of refinance or resale of the property, and annual tax benefits, in any.

The Manager will diligently conduct the affairs of the LLC to achieve these investment objectives.

Information presented in this investment circular is intended to provide a prospective investor with sufficient facts concerning the proposed investment to make an informed decision to invest. Estimates of income and expenses incurred by the LLC are based on existing facts and the best estimates of the manager and his advisors, and are not intended as guarantees or warranties to the investor.

Any real estate investment is speculative in nature and includes some degree of risk. It is suggested that a prospective investor contact his accountant, attorney or investment counselor for additional advice concerning this investment's suitability.

SECTION 2. SUMMARY OF PROPERTY PURCHASE

A contract to purchase the real estate has been entered into by _____, an individual, as the Buyer. These purchase rights will be assigned to the LLC for its acquisition of the property prior to closing, in exchange for Class B membership interests valued at $_____.

The Seller, who has contracted to sell the property, is _____. The purchase contract is dated _____, 20_____. An escrow has been opened with _____, escrow number _____, dated _____, 20_____.

The purchase contract and escrow instructions are attached to this investment circular as Exhibits "A" and "B". These documents are the only purchase contracts involved in this transaction.

The terms of the purchase price are:

Cash down payment	$_____
Existing debt taken over	$_____
New loan to record	$_____
Note carried back by Seller	$_____
TOTAL Purchase Price	$_____

The amount of the cash down payment includes the return to the Manager of his deposit toward the down payment on the purchase price.

The purchase price is not the total cost to the LLC to acquire the property. Pro rations and adjustments for the Landlord/Tenant obligations are also included, as well as transactional closing costs. A completed Buyer's Cost Sheet for acquisition of the property by the LLC is set forth in Exhibit "D".

SECTION 3. REAL ESTATE FINANCING

The financing, its balance, interest rates, monthly payments, due dates and other facts are as follows:

The first trust deed encumbrance secures a note in the remaining balance of $_____, payable $_____ monthly, including interest at the rate of _____%, until paid _____.

The seller's carryback note, secured by a second trust deed on the property, is in the amount of $_____, payable $_____ monthly, including interest at the annual rate of _____%, all due and payable on _____ 20_____, with a final/balloon payment of $_____.

SECTION 4. CAPITALIZATION OF THE LIMITED LIABILITY COMPANY

The amount of capital to be raised by cash contributions from prospective investors is $_____. To obtain this amount, _____ Class A units at $_____ per unit are offered to investors.

Each subscribing investor may purchase a minimum of _____ units and a maximum of _____ units. Subscriptions are to be accompanied by full payment.

Should the total amount of capital to be raised not be received prior to the cancellation of the purchase escrow on the real estate, or _____, 20_____ if sooner, the subscription will terminate and all funds received from prospective investors will be returned promptly with any interest earned.

SECTION 5. USE OF THE CONTRIBUTION PROCEEDS

The capital cash contributions of $_____ from investors with Class A interests will be deposited and disbursed as follows:

1. $_____ shall be deposited in escrow as the additional funds required to close the real estate purchase.
2. $_____ shall be disbursed to the Manager to reimburse him for his cash deposit in escrow toward the down payment on the purchase price.
3. $_____ shall be disbursed to the Manager as an organizational fee.
4. $_____, approximately, will be deposited with any other funds remaining in the LLC bank account as a reserve fund to be used by the Manager at his discretion for expenditures which were or will be incurred for the organization of the LLC and the acquisition of the property, including costs related to a title search.

SECTION 6. RISK FACTORS

An investment in the Class A units offered involves some risk of loss of the capital invested. Potential investors are to carefully consider each of the following factors.

A. LLC Operations

This LLC is newly organized and has no operational history. The Manager will devote to the LLC's affairs such time as he, in his discretion, deems necessary and diligent.

This investment circular is intended to provide prospective investors with all the facts concerning the proposed investment which might affect his decision to invest. Estimates of income and operating costs, debt service and cash returns are based on existing facts and the best estimates of the Manager and his advisors. However, they are not intended as guarantees or warranties to the investor.

Many of the factors which may affect the LLC and its affairs are subject to change, or are not within the control of the LLC, its Manager, or its members. The extent to which such factors could restrict LLC activities or affect the value of the LLC properties is not currently ascertainable.

Factors which might affect the LLC include environmental controls, rent controls and government restrictions, adverse use of adjacent or neighboring real estate by its owners, changes in the demand for or supply of competing properties, changes in state or local tax rates and assessments, rapid depreciation in the value of the property, unexpected expenditures for repairs and maintenance, dramatic changes in general or local economic conditions, shortages or reductions in available resources or energy, acts of God or other calamities. The LLC will not be able to obtain insurance against most of these ownership risk factors.

B. Mortgage Risks

Should the LLC's revenues prove insufficient to service its loan(s) and pay property taxes and operating costs, the LLC will be required to use reserve funds. Should reserve funds be insufficient, the LLC will seek additional funds in the form of loans. If loans are unavailable or imprudent, the members will be called upon to vote and approve additional capital contributions to raise the needed funds. If additional contributions are not approved, the investor's initial capital will be placed at risk of loss should the LLC default on its obligations.

C. Tax Consequences

Limited liability companies qualify for treatment as partnerships for income tax purposes. On the sale of the property by the LLC, any sums distributed in excess of the investor's adjusted basis are presently taxed as capital gains, not ordinary income. However, no assurance can be made that capital gains tax rates will be available, or even apply.

D. Conflicts of Interest

The Manager has numerous other business responsibilities and ownership interests which will demand some or most of his time during the LLC's ownership of the property. The Manager's other interests include ownership of projects comparable to the property purchased in this transaction. To the extent his time is required on other business and ownership management decisions, he will not be involved in monitoring or marketing of the LLC's property.

SECTION 7. DESCRIPTION OF THE REAL ESTATE

A. Area Map

A map of the area immediately surrounding the property is set forth in Exhibit "J".

B. Property Profile

1. Improvements: _____
2. Zoning: _____ zoning under ordinance from the City of _____, allowing _____.
3. Dimensions: _____
4. Size: _____ square feet of net ground, exclusive of streets and rights of ways.
5. Soil: _____
6. Utilities: _____
7. Topography: _____
8. Street: _____
9. Improvements: _____

_____

C. Legal Description

The legal description of the parcel of property being purchased is set forth in the Grant Deed in Exhibit "C".

D. Title Condition

The property's title has been searched and a copy of Schedule "B" from the preliminary title report, prepared for issuance of title and affecting use of the property, is set forth in Exhibit "E".

E. Property Condition

A checklist itemizing the many features of the property and their condition is set forth in Exhibit "F".

F. Fair Market Value

The real estate to be acquired by the LLC has been appraised at a fair market value of $_____, as of _____, 20_____. A copy of the relevant portions of the detailed fee appraisal and valuation report prepared by _____ is attached to this circular as Exhibit "L". The appraiser's fee for research and preparation of the report and opinion was $_____. The entire appraisal is available from the Manager on the request of any prospective investor.

SECTION 8. PROJECTED FIRST-YEAR OPERATING BUDGET

A 12-month annual budget has been prepared and is attached as Exhibit “H”. The budget is referred to as an Annual Property Operating Data Sheet (APOD).

The budget estimates the probable gross rental income likely to be received and operating expenses expected to be incurred in the operations and management of the property. By an analysis of the APOD as a budget, it demonstrates the cash flow for the next 12-months of ownership by the LLC, not for a calender or tax year, which will vary.

The gross operating income on the budget represents the rents and other income anticipated to be collected and deposited to cover disbursements of operating expenses and loan payments. The gross operating income is estimated by first establishing the scheduled rental income for all units and space available to be rented, whether or not they are now rented.

A vacancy factor will always exist due to turnover of tenants, if for no other reason, such as lack of demand, oversupply of units or other fluctuations in the local or national economy. The vacancy factor is set forth on the budget and deducted from the gross scheduled income to set the gross operating income.

Actual rents will differ slightly from the budget analysis since the demand for rental and security of vacant units varies from month to month.

Presently, tenants under written rental and lease agreements occupy approximately _____% of the scheduled rental space. An itemized rent roll of tenants, the unit of space they occupy, and the rent they pay is set out on the dated rental income statement in Exhibit “I”.

Spendable income calculated on the budget is for a 12-month period. The spendable income consists of rental income remaining for reserves and distribution to co-owners after payment of all operating expenses and loan payments.

The spendable income provides a cushion against unexpected increases in operating costs and any decrease in rental income. As projected on the budget, the vacancy factor would have to rise to _____% before the cushion of spendable income would be eliminated.

Taxwise, the budget projects the reportable income or loss from ownership operations anticipated to be experienced during the first year of operation. All operating expenses are deducted from the gross rental income, resulting in the net operating income (NOI). The government’s depreciation schedule allows a non-cash deduction from the NOI as well as a deduction from NOI for interest accrued and paid on purchase/improvement loans.

Each co-owner will report their pro rata ownership share of the actual end-of-year reportable income or loss on their Federal Income Tax Form 1040, Schedule “E”. The LLC, under the small partnership exemption, will not report on a Federal Income Tax Form 1065 and will not prepare a Schedule K-1.

SECTION 9. PROJECTED FINANCIAL BENEFITS TO MEMBERS

This income property investment program, under the budget presented and explained in Section 8, will deliver the members the following economic benefits:

1. Spendable income;
2. Equity build-up by monthly amortized loan reduction;
3. An inflationary hedge and appreciation in value; and
4. Tax benefits of annual depreciation deductions.

Typically, based on the budget, a _____% member would receive the following dollar amounts of benefit and percentage yield under the previous four categories:

Item:	Annual Amount	____% Member's Amount	____% Member's Percentage Yield
1. Spendable Income	$_____	$_____	_____%
2. Loan Reduction	$_____	$_____	_____%
3. Value Increase			
(____% annual rise)	$_____	$_____	_____%
4. Tax Savings	$_____	$_____	_____%
TOTAL Annual Benefits	**$_____**	**$_____**	**_____%**

These projections are, at best, estimates of the dollar and percentage amounts expected from the property's first 12 months of operations and will differ from the end-of-year report since it will be for only a portion of the calender year. Also, the dollar amount of each of the benefits received will vary.

Spendable income will be disbursed quarterly beginning ____ months after closing. Earnings represented by the annual loan reduction and increased property value will be cashed out and distributed when a refinance or resale of the property occurs. Tax benefits from reportable losses result in a reduced income tax payment for the member who qualifies when filing his return.

SECTION 10. BENEFITS RECEIVED BY MEMBERS

The LLC shall be comprised of ownership interests held by Class A Members and Class B Members. Cash investors shall hold Class A interests; _____ shall hold Class B interests.

Class A Members shall have priority over Class B Members' interests on all cash disbursements made to members by the LLC.

Class A Members shall receive the following benefits:

1. _____% annual cash disbursements from the net spendable income projected to be earned. Net spendable income consists of those funds remaining from gross rental income after payment of all operating expenses, management fees, and debt service. Disbursements of unreserved spendable income will commence beginning with spending income generated for the _____ quarter of operations. Any net spendable income received during the interim period will be placed in the reserve account and used for its purposes.

   Spendable income will be first distributed to the Class A Members until they have received the amount of their cumulative annual percentage, then next to the Class B Members until they have received the amount of their cumulative annual percentage. Any funds then remaining will be distributed between all members in proportion to their percentage of ownership.

2. Equity build-up results from loan reduction due to the amortization of the mortgage financing encumbering the property. This equity build-up is converted to cash and distributed on refinance or resale of the property.

3. Sale and refinance proceeds remaining after payment of all costs and mortgages on the sale/refinance and repayment of loans made by members will be first distributed to Class A Members until they have received their contributions, plus _____% annually thereon from the date of contribution, less any disbursements received.

   Next, proceeds then remaining will be distributed to the Class B Members until they have received their contributions plus _____% annually thereon from the date of contribution, less any disbursements received.

   Then, any proceeds remaining will be distributed to all members to be shared in accordance with their percentage of ownership.

4. Depreciation deductions will be taken by each individual member on his capital contribution and pro rata share of purchase-assist or improvement loans. The depreciation schedule shall be chosen by the member and his accountant under the appropriate government-issued depreciation schedule.

SECTION 11. COMPENSATION AND DUTIES OF THE MANAGER

The Manager will receive no compensation from any aspect of this transaction, other than those set forth in this section.

A. Contribution to the LLC

A contract to purchase the real estate has been entered into by _____, an individual, as the Buyer. The purchase rights created by entering into this contract will be assigned to the LLC for its acquisition of the property prior to closing. In exchange for the assignment, the above named individual is receiving Class B membership interests valued at $_____.

The Manager will receive a fee of $_____ cash for services in the creation and formation of the LLC entity, solicitation of members and accompanying time and effort.

B. Management of the Property

The LLC and the members shall employ _____
to manage the LLC property. The property Manager shall receive a fee of _____
_____
[See Property Management Agreement, Exhibit "K"]

All members will sign the property management agreement to provide for themselves a form for qualifying for the federal income tax rental loss deduction.

Should a later resale of the property occur, the Manager is to receive _____% of the price of any resale, and in the event of a refinance, _____% of the refinancing, if he is the procuring cause of the resale or refinance.

SECTION 12. THE MANAGER

The Manager of this LLC shall be _____.
The Manager shall be responsible for supervising the LLC's operations, including compliance with legal and regulatory requirements, and the preparation and forwarding of periodic reports to the members. [See Section 15, Reports to Investors]

The Manager has the ultimate authority in all matters affecting the ongoing business affairs of the LLC and establishes guidelines with respect to the LLC's investment.

SECTION 13. RESERVE FUND ACCOUNT

A reserve fund will be established from contributions remaining after expenditures made in the acquisition of the real estate payment and payment of organizational fees. These expenditures are estimated to total $_____. [See Section 5, Use of the Contribution Proceeds]

Also, during the first _____ quarters of operations, all net spendable income will be deposited into this account. The account will be maintained at a bank in an interest bearing account in the name of the LLC.

The purpose of this reserve fund is to cover any unforeseen and unforseeable emergency costs. Business reversals due to local and national economic conditions occasionally occur and cannot be determined in advance. The reserve fund will cover any deficit cash flow which might occur, with the expectation of avoiding the need for additional capital contriubtions from the investors. The fund is to be handled at the sole discretion of the manager, for the general benefit of the LLC.

SECTION 14. THE LIMITED LIABILITY COMPANY ASPECTS

The operating agreement, which each subscribing Class A investor agrees to by signing duplicate copies of its signature page, is attached to this investment circular as Addendum "B". Set forth in the operating agreement are all the terms for sharing the income and losses from the operation of the property, the obligations of the manager, the rights of the members and the buy-out provisions should an event occur which terminates a member's interest. Some of the more important aspects are reviewed in this section.

For tax purposes, the ownership is intended to be treated as a partnership. There should be no taxation of the LLC, except for the California annual franchise tax. The LLC will not report on a Federal Income Tax Form 1065, since 10 or fewer members will participate in the program. Each member will include in his individual tax return on Schedule "E" his pro rata share of income and expenses from operations, including interest. Members will choose their own depreciation schedules.

The operations of the real estate will be supervised by the Manager. Should he die or be terminated as the Manager by a majority vote in ownership, then another Manager will be appointed by the members.

Buy-out provisions cover the termination of members' interests due to events ranging from death, bankruptcy or withdrawal, to expulsion by court order or by all the remaining members. Should one member be terminated, the other members have the option to purchase his interest.

The operating agreement calls for the LLC to terminate on any of these events. However, the remaining members may vote to continue after an event occurs which causes the LLC to terminate.

Two processes are provided for determining the price to be paid to a terminated member should the member be bought out by the remaining members. The real estate's full current value is received only by those persons whose interest is held by their estate. Those members terminated for "voluntary" events such as judgment debtor attachments, bankruptcy, withdrawal, etc., will receive only a return of their invested capital. No interest or additional value will be received.

The interests held by the members are not readily marketable. No market exists for the resale of membership interests in LLCs, and one will not likely develop. Liquidity is further restricted as the Manager has the right of first refusal to purchase any member's interest which is offered for sale. If he chooses not to do so, the remaining members have the right to purchase the interest sold. Should all members not exercise their right to purchase, any sale to a non-member which the remaining members do not approve is also cause for termination of the interest sold. The value of the buy out option on such a sale to a third party is the return only of the capital invested.

The liability of all members, including the Manager, will be limited to the amount of their capital contributions. The Manager will file articles of organization for the LLC with the Secretary of State to establish this limitation on liability.

SECTION 15. REPORTS TO INVESTORS

Periodic reports to investors will include:

1. On closing of the property acquisition:
   - a copy of the recorded LLC-1 (articles of organization) of the limited liability company;
   - a copy of the operating agreement signed by all members and setting forth each member's percentage of ownership;
   - a copy of the recorded grant deed to the LLC;
   - a copy of the policy of title insurance on the LLC's ownership of the property; and
   - a copy of the beginning LLC balance sheet on acquisition of the property.
2. After the end of each calendar quarter:
   - an itemized income statement on year-to-date rental income, operating expenses and interest and principal payments on the loan(s).
3. After the end of each calendar year:
   - a balance sheet showing the LLC's end-of-year net worth and financial position; and
   - an itemized income and loss statement on end-of-year rental income, operating expenses and interest and principal payments on loan(s).

NOTICE: The LLC will not report on a Federal Income Tax Form 1065, and a K-1 Schedule for the members will not be prepared or filed:

Reports available for inspection or copying at the office of the LLC include:

- rental or lease agreements with tenants;
- monthly operating statements;
- bank account records; and
- the LLC file.

NOTICE: Your accountant will need some of the annual reports and the initial costs of acquisition to prepare your annual 1040 federal income tax return and a Schedule "E", for rental income, expenses, interest and depreciation.

Exhibit "A"

PURCHASE AGREEMENT

Income Property other than One-to-Four Residential Units

DATE: _____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

1. Received from _____, as the Buyer(s),

1.1 the sum of $_____, evidenced by ☐ personal check, or ☐ _____, payable to _____, for deposit only on acceptance of this offer.

1.2 Deposit to be applied toward Buyer's obligations under this agreement to purchase property

1.3 situated in the City of _____, County of _____, California,

1.4 referred to as _____,

1.5 including personal property, ☐ see attached Personal Property Inventory. [See **ft** Form 256]

2. This agreement is comprised of this four-page form and _____ pages of addenda/attachments.

TERMS: Buyer to pay the purchase price as follows:

3. Cash payment through escrow, including deposits, in the amount of . . . . . $_____

3.1 Other consideration paid through escrow _____. . . . $_____

4. Buyer to obtain a ☐ first, or ☐ second, trust deed loan in the amount of . . . . . $_____ payable approximately $_____ monthly for a period of _____ years. Interest on closing not to exceed _____%, ☐ ARM, type _____. Loan points not to exceed _____.

4.1 ☐ Unless Buyer, within _____ days after acceptance, hands Seller satisfactory written confirmation Buyer has been pre-approved for the financing of the purchase price, Seller may terminate the agreement. [See **ft** Form 183]

5. ☐ Take title subject to, or ☐ Assume, an existing first trust deed note held by _____ with an unpaid principal balance of . . . . $_____ payable $_____ monthly, including interest not exceeding _____%, ☐ ARM, type _____, plus a monthly tax/insurance impound payment of $_____. _____

5.1 At closing, loan balance differences per beneficiary statement(s) to be adjusted into: ☐ cash, ☐ carryback note, or ☐ sales price.

5.2 The impound account to be transferred: ☐ charged, or ☐ without charge, to Buyer.

6. ☐ Take title subject to, or ☐ Assume, an existing second trust deed note held by _____ with an unpaid principal balance of . . . $_____ payable $_____ monthly, including interest not exceeding _____%, ☐ ARM, type _____, due _____, 20 _____.

7. Assume a tax bond or assessment lien with an unpaid principal balance of . . . . . $_____

8. Note for the balance of the purchase price in the amount of. . . . . $_____ to be executed by Buyer in favor of Seller and secured by a trust deed on the property junior to any above referenced financing, payable $_____ monthly, or more, beginning one month after closing, including interest at _____% per annum from closing, due _____ years after closing.

8.1 This note and trust deed to contain provisions to be provided by Seller for: ☐ due-on-sale, ☐ prepayment penalty, ☐ late charges, ☐ _____.

8.2 ☐ A Carryback Disclosure Statement is attached as an addendum. [See **ft** Form 300]

8.3 ☐ Buyer to provide a Request for Notice of Default and Notice of Delinquency to senior encumbrancers. [See **ft** Form 412]

8.4 Buyer to hand Seller a completed credit application on acceptance. [See **ft** Form 302]

8.5 Within _____ days of receipt of Buyer's credit application, Seller may terminate the agreement based on a reasonable disapproval of Buyer's creditworthiness.

8.6 Seller may terminate the agreement on failure of the agreed terms for priority financing. [See **ft** Form 183]

8.7 As additional security, Buyer to execute a security agreement and file a UCC-1 financing statement on any property transferred by Bill of Sale. [See **ft** Form 436]

9. Total Purchase Price is . . . . . $ 0.00

10. ACCEPTANCE AND PERFORMANCE:

10.1 This offer to be deemed revoked unless accepted in writing ☐ on presentation, or ☐ within _____ days after date, and acceptance is personally delivered or faxed to Offeror or Offeror's Broker within this period.

10.2 After acceptance, Broker(s) are authorized to extend any performance date up to one month.

10.3 On failure of Buyer to obtain or assume financing as agreed by the date scheduled for closing, Buyer may terminate the agreement.

10.4 Buyer's close of escrow is conditioned on Buyer's prior or concurrent closing on a sale of other property, commonly referred to as _____.

10.5 Any termination of the agreement shall be by written Notice of Cancellation timely delivered to the other party, the other party's Broker or escrow, with instructions to escrow to return all instruments and funds to the parties depositing them. [See **ft** Form 183]

10.6 Both parties reserve their rights to assign and agree to cooperate in effecting an Internal Revenue Code §1031 exchange prior to close of escrow on either party's written notice. [See **ft** Forms 171 or 172]

10.7 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

10.8 Should Buyer breach the agreement, Buyer's monetary liability to Seller is limited to ☐ $_____, or ☐ the deposit receipted in Section 1.

11. DUE DILIGENCE CONTINGENCIES:

Within _____ days after receipt or occurrence of any of the following conditions, Buyer may terminate the agreement based on Buyer's reasonable disapproval of the condition.

11.1 Income and expense records, leases, property management and other service contracts, permits or licenses affecting the operation of the property which Seller will make available to Buyer on acceptance.

11.2 Rental Income Rent Roll Statement itemizing, by unit, the tenant's name, rent amount, rent due date and delinquencies, deposits, rental period and expiration, and any rental incentives, bonuses or discounts signed by Seller and handed to Buyer on acceptance. [See **ft** Form 380]

11.3 Seller's Natural Hazard Disclosure Statement to be signed by Seller and handed to Buyer on acceptance. [See **ft** Form 314]

11.4 Condition of Commercial Property Disclosure — Commercial TDS to be signed by Seller and Seller's Broker and handed to Buyer on acceptance. [See **ft** Form 304-1] Solar Shade Control Notices sent or received by Seller to be handed to Buyer on acceptance.

11.5 Inspection of the property by Buyer, his agent or consultants within _____ days after acceptance for value and condition sufficient to justify the purchase price.

11.6 Preliminary title report for the policy of title insurance, which Seller will cause escrow to hand Buyer as soon as reasonably possible after acceptance.

11.7 An estoppel certificate executed by each tenant affirming the terms of their occupancy, which Seller will hand Buyer prior to seven days before closing. [See **ft** Form 598]

11.8 Criminal Activity and Security Disclosure Statement prepared by Seller setting forth recent criminal activity on or about the property relevant to the security of persons and their belongings on the property, and any security arrangements undertaken or which should be undertaken in response. [See **ft** Form 321]

11.9 ☐ See attached Due Diligence Contingencies Addendum for additional conditions. [See **ft** Form 279]

12. PROPERTY CONDITIONS:

12.1 Seller to furnish prior to closing:

a. ☐ a structural pest control inspection report and certification of clearance of corrective conditions.

b. ☐ a home inspection report prepared by an insured home inspector showing the land and improvements to be free of material defects.

c. ☐ a one-year home warranty policy:
Insurer _____
Coverage _____

d. ☐ a certificate of occupancy, or other clearance or retrofitting, required by local ordinance for the transfer of possession or title.

e. ☐ _____

f. ☐ _____

12.2 Smoke detector(s) and water heater bracing exist in compliance with the law, and if not, Seller to install.

12.3 Seller to maintain the property in good condition until possession is delivered.

12.4 Fixtures and fittings attached to the property include, but are not limited to: window shades, blinds, light fixtures, plumbing fixtures, curtain rods, wall-to-wall carpeting, draperies, hardware, antennas, air coolers and conditioners, trees, shrubs, mailboxes and other similar items.

12.5 New agreements and modifications of existing agreements to rent units, or to service, alter or equip the property, will not be entered into by Seller without Buyer's prior written consent, which will not be unreasonably withheld.

13. CLOSING CONDITIONS:

13.1 This transaction to be escrowed with _____. Parties to deliver instructions to escrow as soon as reasonably possible after acceptance.

a. ☐ Escrow holder is authorized and instructed to act on the provisions of this agreement as the mutual escrow instructions of the parties and to draft any additional instructions necessary to close this transaction. [See **ft** Form 401]

b. ☐ Escrow instructions, prepared and signed by the parties, are attached to be handed to escrow on acceptance. [See **ft** Form 401]

13.2 Escrow to be handed all instruments needed to close escrow on or before _____, 20_____, or within _____ days after acceptance. Parties to hand escrow all documents required by the title insurer, lenders or other third parties to this transaction prior to seven days before the date scheduled for closing.

a. Each party to pay its customary escrow charges. [See **ft** Forms 310 and 311]

13.3 Title to be vested in Buyer or Assignee free of encumbrances other than those set forth herein. Buyer's interest in title shall be insured by _____ title company on a(n) ☐ CLTA standard, ☐ ATLA owner's, or ☐ ALTA binder, policy of title insurance.

a. Endorsements _____

b. ☐ Seller, or ☐ Buyer, to pay the title insurance premium.

13.4 Buyer to furnish a new fire insurance policy covering the property.

13.5 Taxes, assessments, insurance premiums, rents, interest and other expenses to be pro rated to close of escrow, unless otherwise provided.

a. ☐ Attached is a notice of your Supplemental Property Tax Bill. [See **ft** Form 317]

13.6 Bill of Sale to be executed for any personal property being acquired.

a. ☐ A UCC-3 Condition of Title Report to be ordered from the Secretary of State and approved by Buyer prior to close of escrow.

13.7 Seller to assign, and title to be subject to, all existing leases and rental agreements. [See **ft** Form 595]

a. Seller to notify each tenant of the change of ownership on or before the close of escrow. [See **ft** Form 554]

13.8 Security deposits held by Seller to be handed to Buyer on close of escrow. Seller to notify each tenant of the transfer of the security deposit on close of escrow, with a copy of each notice to Buyer through escrow. [See **ft** Form 586]

13.9 Delinquent unpaid rent to be treated as paid. Any recovery by Buyer of Seller's portion of delinquent rent and pro rated delinquent rent credited to Buyer shall be refunded to Seller on collection by Buyer.

13.10 Service and equipment contracts to be assumed by Buyer include _____

_____

a. Contracts assumed by Buyer to be pro rated to close of escrow.

13.11 Possession of the property and keys/access codes to be delivered on close of escrow.

13.12 If Seller is unable to convey marketable title as agreed, or if the improvements on the property are materially damaged prior to closing, Buyer may terminate the agreement. Seller to pay all reasonable escrow cancellation charges. [See **ft** Form 183]

14. NOTICE OF YOUR SUPPLEMENTAL PROPERTY TAX BILL:

California property tax law requires the Assessor to revalue real property at the time the ownership of the property changes. Because of this law, you may receive one or two supplemental tax bills, depending on when your loan closes.

The supplemental tax bills are not mailed to your lender. If you have arranged for your property tax payments to be paid through an impound account, the supplemental tax bills will not be paid by your lender. It is your responsibility to pay these supplemental bills directly to the Tax Collector.

If you have any questions concerning this matter, please call your local Tax Collector's Office.

15. BROKERAGE FEE:

15.1 Parties to pay the below mentioned Broker(s) a fee now due of _____ as follows:

a. Seller to pay the brokerage fee on the change of ownership.

b. The party wrongfully preventing this change of ownership to pay the brokerage fee.

15.2 Buyer's Broker and Seller's Broker, respectively, to share the brokerage fee _____:_____.

15.3 ☐ Attached is the Agency Law Disclosure. [See **ft** Form 305]

15.4 Broker is authorized to report the sale, its price and terms for dissemination and use of participants in brokerage trade associations or listing services.

16. _____

_____

_____

_____

Buyer's/ Selling Broker: _____	Seller's/ Listing Broker: _____
Broker's DRE Identification #: _____	Broker's DRE Identification #: _____
Selling Agent: _____	Listing Agent: _____
Agent's DRE Identification #: _____	Agent's DRE Identification #: _____
Signature: _____	Signature: _____
Is the agent of: ☐ Buyer exclusively. ☐ Both Seller and Buyer.	Is the agent of: ☐ Seller exclusively. ☐ Both Seller and Buyer.
Address: _____	Address: _____
Phone: _____	Phone: _____
Fax: _____	Fax: _____
Email: _____	Email: _____

I agree to the terms stated above.	**I agree to the terms stated above.**
☐ See Signature Page Addendum. [**ft** Form 251]	☐ See Signature Page Addendum. [**ft** Form 251]
Date: _____, 20_____	Date: _____, 20_____
Buyer: _____	Seller: _____
Signature: _____	Signature: _____
Buyer: _____	Seller: _____
Signature: _____	Signature: _____

REJECTION OF OFFER

Undersigned hereby rejects this offer in its entirety. No counteroffer will be forthcoming.

Date: _____, 20_____

Name: _____

Signature: _____

Name: _____

Signature: _____

 ©2009 first tuesday, P.O. BOX 20069, RIVERSIDE, CA 92516 (800) 794-0494

Exhibit "B"

ESCROW INSTRUCTIONS

Buyer and Seller Instructions

DATE: _____, 20_____.

Items left blank or unchecked are not applicable.

Escrow number _____

Escrow/Brokerage company _____

Licensed by the Department of _____, State of California, license # _____

Escrow officer _____

Address _____

Phone number _____

Fax _____

Buyer _____

Seller _____

An escrow administrative fee will be charged each principal for postponement of closing by two months or more beyond the originally scheduled closing date in these instructions or on cancellation of these instructions, due to acts or omissions of either principal.

Postponement Fee . . . $_____

Cancellation Fee . . . . $_____

Buyer's Initials	Seller's Initials
_____ _____	_____ _____

TERMS OF SALE: (for escrow use only)

$_____ TOTAL Consideration Seller to receive from Buyer

$_____ Assessment Bond paid with property taxes

$_____ 1st Trust Deed of Record

$_____ 2nd Trust Deed of Record

$_____ Trust Deed to record

$_____ Trust Deed to record

$_____ Cash through Escrow

$_____ Other Consideration _____

1. You, the escrow officer, are authorized and instructed as follows:

1.1 Buyer deposits herewith the sum of $_____.

1.2 On or before _____, 20_____, the date set for closing, Buyer will deposit with You on your request the additional sum of $_____, to make a total deposit of $_____.

1.3 Buyer will deliver to You prior to the date set for closing any additional funds and instruments required which You request.

1.4 You may thereafter use these funds and instruments until such time as You have received written instruction not to do so. Brokers are authorized to extend any performance date up to one month.

1.5 Close of escrow is the date instruments are recorded.

2. Upon the use of these funds and instruments, You are to obtain the following policy of title insurance, with the usual title company exceptions, in the following checked type and form:

Title to be vested in Buyer or Assignee free of encumbrances other than those set forth herein. Buyer's interest in title to be insured under a policy issued by _____

as a(n) ☐ Homeowner(s) policy (one-to-four units), ☐ Residential ALTA-R policy (vacant or improved residential parcel), ☐ Owner's policy (other than one-to-four units), ☐ Joint Protection policy (also naming the Carryback Seller or Purchase-assist Lender), or ☐ Binder (to insure resale or refinance within two years).

Endorsements _____

_____

2.1 With title insurance in the amount of $_____ covering the following described real property, commonly known as _____

and legally described as _____

_____

_____

_____,

2.2 Showing title vested in _____

2.3 Subject to the following only:

a. All General and Special taxes for the _____ fiscal year, including any special district taxes or personal property taxes collected with the ad valorem taxes.

b. Assessments and Bonds with an unpaid balance of $_____.

c. Any covenants, conditions, restrictions, reservations, rights, right of ways and easements of record, or in deed to record, and EXCEPTIONS of water, minerals, oil, gas, and kindred substances, on or under said real property, now of record, or in deed to record.

d. First encumbrance now of record with an unpaid balance of $_____, payable $_____ monthly, including interest of _____% per annum. ☐ ARM

e. Second encumbrance now of record with an unpaid balance of $_____, payable $_____ monthly, including interest of _____% per annum, all due and payable _____, 20_____.

f. Deed of Trust to record in the amount of $_____.
Execution of loan documents under §2.3f or §2.3g shall be Buyer's approval of their terms. Should Seller carry back under §2.3h, You are to obtain Seller's written approval of the loan terms for any Deed of Trust to record.

g. Deed of Trust to record in the amount of $_____.

h. Purchase money Deed of Trust with Assignment of Rents on standard form, executed by Buyer securing a note for $_____ in favor of Seller as their interests appear on the preliminary title report, with interest at _____ % per annum from close of escrow, principal and interest payable in installments of $_____, or more, each on the same day of every calendar month, beginning one month from ☐ close of escrow, or ☐ _____, 20_____, and continuing until _____.
You, as escrow holder, are instructed to prepare the note and Deed of Trust and insert the correct principal amount and correct first payment date, interest accrual date and due date as soon as they can be determined. The address for deliver of note payments is _____ _____.

3. You are to obtain at Seller's expense beneficiary statements on the Deed(s) of Trust (or mortgage) now of record (§2.3d and §2.3e above). If the principal balances shown by the statements are more or less than the amount shown above, You are to make adjustments as checked below:

☐ cash through escrow, ☐ total consideration, or ☐ purchase-money Deed of Trust.

3.1 You are to deliver to Buyer for Buyer's approval prior to close of escrow a copy of the beneficiary statement for each Deed of Trust to remain of record on closing.

3.2 You are to deliver to Seller prior to close of escrow, any payoff demand necessary to eliminate encumbrances so You can comply with conditions in §2.3 for title insurance.

4. You are to obtain at Seller's expense a UCC-3 clearance on the following described personal property

_____

_____

_____

and cause title thereto to be vested in Buyer subject to the following UCC-1 financing statements:

a. A UCC-1 obligation in the approximate amount of $_____, payable $_____ per month, including an annual percentage rate of _____%, all due and payable _____, 20_____.

b A UCC-1 form in favor of Seller at Buyer's expense as additional security for any note carried back under §2.3h above.

5. Prior to close of escrow, Buyer is to hand You a sufficient hazard insurance policy. In the event Seller carries back under §2.3h above, then Seller is to be named as additional loss payee. The policy is to be in an amount sufficient to cover all lien balances or the coverage demanded by the new lender if greater in amount.

6. ☐ Prior to the close of escrow and at Seller's expense, Seller to hand You a structural pest control clearance on the subject property.

7. ☐ Prior to close of escrow and at Seller's expense, You are to obtain a one-year policy of homeowner's warranty issued by _____, in favor of Buyer, covering _____.

8. Prior to the close of escrow and at Seller's expense, You are to obtain from the homeowners' association (HOA) of any common interest development which includes the described property the following checked item(s) for Buyer's approval:

8.1 ☐ A statement of condition of assessments;

8.2 ☐ Copies of the association's articles, bylaws, CC&Rs, collection and lien enforcement policies, operating budget, operating rules, CPA's financial review, insurance policy summary and any age restriction statement;

8.3 ☐ Copies from the association of any notice to Seller of CC&R violations, any list of construction defects, and any assessment charges not yet payable.

9. ☐ You are authorized and instructed to prepare assignments for all existing lease/rental agreements.

10. The following checked prorations and adjustments shall be computed by You on a monthly basis of 30 days as of ☐ close of escrow, or ☐ _____, 20_____, on which date Buyer is to be treated as the owner for the entire day:

a. ☐ Taxes, based on latest tax statement available and Seller warrants that no reassessment or reassessment activity has since occurred

b. ☐ Hazard (fire) insurance premium

c. ☐ Interest on existing note(s) and Deed(s) of Trust

d. ☐ Rents and deposits based on rental statement handed to You and approved by Buyer and Seller prior to close of escrow

e. ☐ Impounds, under §2.3d or §2.3e above, together with an assignment of these impounds to Buyer through escrow

f. ☐ Association assessments for any common interest development which includes the property

g. ☐ _____

10.1 You are to account for the above prorations and adjustments into the item checked below:
☐ cash through escrow, ☐ total consideration, or ☐ purchase-money Deed of Trust.

11. You are to promptly obtain and hand Buyer a preliminary title report on the property from title company for Buyer's approval or disapproval and cancellation of this transaction within _____ days of receipt by Buyer or Buyer's Broker of the report.

12. The Grant Deed to state the tax statements are to be mailed to _____

_____

at _____.

13. Escrow is herewith handed a purchase agreement dated _____, 20_____ and (a) counteroffer dated _____, 20_____, entered into by Buyer and Seller regarding the sale of the property which authorizes and instructs escrow to act on the provisions of the agreement as mutual escrow instructions to close this transaction.

13.1 Any inconsistencies between the provisions in the purchase agreement and provisions in the instructions prepared by escrow shall be controlled by the instructions prepared by escrow.

14. The close of escrow and disbursement of funds can be affected based on the form of the deposit with escrow. Funds deposited in cash or by electronic payment allow for closing and disbursement on or after the business day of deposit with the escrow's financial institution. Funds deposited by cashier's check allow for closing and disbursement on or after two business days after deposit with the escrow's financial institution. All other forms of deposit cannot be disbursed and thus, the closing cannot occur until the funds are made available to escrow by the escrow's financial institution.

15. Buyer is required to withhold 10% of each Seller's share of the sales price for payment of Seller's federal income taxes on this transaction, unless Seller meets one of the following conditions:

15.1 Each Seller provides Buyer with their taxpayer identification number and declares under penalty of perjury to be a citizen of the United States or a resident alien [**ft** Form 301];

15.2 Buyer declares under penalty of perjury the property will be used as their residence and the sales price is $300,000 or less [**ft** Form 301]; or

15.3 Seller requests and obtains a withholding certificate from the Internal Revenue Service (IRS) authorizing a reduced amount or no amount be withheld.

16. Buyer is required to withhold 3⅓% of each Seller's share of the sales price for payment of Seller's California income taxes on this transaction, unless one of the following exemptions exists:

16.1 Seller executes a real estate withholding certificate, FTB form 593-C, declaring the sale is exempt due to:

a. The property sold is or was last used as Seller's principal residence;

b. The property sold was the decedent's principal residence;

c. The property was sold as part of an IRC §1031 exchange;

d. The property was taken by involuntary conversion and will be replaced under IRC §1033; or

e. The property was sold at a taxable loss.

16.2 Buyer is also exempt from withholding 3⅓% of Seller's share of the sales price if:

a. The property was sold for less than $100,000;

b. Buyer is acquiring the property by a deed-in-lieu of foreclosure; or

c. Seller is a bank acting as a trustee under an agreement other than a Deed of Trust.

16.3 On an installment sale, Buyer may agree to withhold on each payment on the carryback note and thus defer withholding. [FTB Forms 593-I and 597]

17. In the event You become involved in litigation between Buyer and Seller arising out of this transaction, Buyer and Seller shall pay a reasonable fee for attorney services which You may be required to incur.

17.1 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

18. You are authorized to use Seller's instruments when You hold and can deliver to Seller the money and instruments to be delivered to Seller under these instructions.

18.1 You are authorized to pay and charge Seller for the following checked item(s):

a. ☐ Bonds, assessments, taxes and other liens of record to show title as called for.

b. ☐ Documentary transfer taxes as required.

c. ☐ Brokerage fees: $_____ to _____
$_____ to _____
$_____ to _____

d. ☐ Transaction coordinator's fees:
$_____ to _____
$_____ to _____

e. ☐ Title insurance premium on the policy to be issued to Buyer.

f. ☐ Costs of recording Seller's Grant Deed.

g. ☐ Escrow fees for your services and any charges incurred by escrow on Seller's behalf.

h. ☐ Payables submitted to escrow for payment by Seller or Seller's Broker.

i. ☐ Attorney fees: $_____ to _____

j. ☐ _____

19. You are authorized to pay and charge Buyer for the following checked item(s):

a. ☐ Escrow fees for your services and any charges incurred by escrow on Buyer's behalf.

b. ☐ Costs of and lender's charges for recording or assuming any Deed of Trust, including a policy of title insurance for any new lender.

c. ☐ Attorney fees: $_____ to _____

d. ☐ Brokerage fees: $_____ to _____

e. ☐ Title insurance premium on the policy to be issued to Buyer.

f. ☐ _____

20. _____

_____

_____

I hereby agree to perform all acts called for above to be performed by Seller.	**I hereby agree to perform all acts called for above to be performed by Buyer.**
Date: _____, 20_____	Date: _____, 20_____
Seller: _____	Buyer: _____
Signature: _____	Signature: _____
Seller: _____	Buyer: _____
Signature: _____	Signature: _____
Address: _____	Address: _____
_____	_____
Phone: _____	Phone: _____
Fax: _____	Fax: _____
Email: _____	Email: _____

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Exhibit “C”

Grant Deed

(Include a copy of the grant deed from the seller to the LLC, available from escrow.)

Exhibit "D"

GOOD FAITH ESTIMATE OF BUYER'S ACQUISITION COSTS

On Acquisition of Property

NOTE: This cost sheet is prepared to assist the buyer to estimate the total cost of acquisition for a property to anticipate the amount of funds likely needed to close, and the source of these funds.

The figures estimated in this cost sheet may vary at the time of closing due to periodic changes in lender demands, escrow fees, other charges and prorates, and thus constitute an opinion, not a guarantee of the preparer.

If acquiring IRC §1031 replacement property, also use a §1031 Profit and Basis Recap Sheet to compute the income tax consequences of the transaction. [See **ft** Form 354]

DATE: _____, 20_____, at _____, California.

1. This is an estimate of acquisition costs and the funds required to close the following transaction:

☐ Purchase Agreement ☐ Exchange agreement ☐ Counteroffer ☐ Escrow Instructions ☐ Option

1.1 entered into by _____,

1.2 dated _____, 20_____, at _____, California,

1.3 regarding real estate referred to as _____

_____.

2. EXISTING FINANCING ASSUMED:

2.1 First Trust Deed of Record . . . . . $_____

2.2 Second Trust Deed of Record . . . . . $_____

2.3 Other Encumbrances/Liens/Bonds . . . . . $_____

2.4 TOTAL Encumbrances Assumed [lines 2.1 to 2.4] . . . . . (+)$_____0.00

a. If loan balance adjustments are to be made in cash, the total funds required to close escrow at §10 and §12 will vary.

3. INSTALLMENT SALE FINANCING:

3.1 Seller Carryback Financing . . . . . (+)$_____

4. NEW FINANCING ORIGINATED:

4.1 New Loan Amount . . . . . (+)$_____

4.2 Points/Discount . . . . . $_____

4.3 Appraisal Fee . . . . . $_____

4.4 Credit Report Fee . . . . . $_____

4.5 Miscellaneous Origination Fees . . . . . $_____

4.6 Prepaid Interest . . . . . $_____

4.7 Mortgage Insurance Premium . . . . . $_____

4.8 Lender's Title Policy Premium . . . . . $_____

4.9 Tax Service Fee . . . . . $_____

4.10 Loan Brokerage Fee . . . . . $_____

4.11 Other _____ . . . . . $_____

4.12 TOTAL New Financing Costs [lines 4.2 to 4.11] . . . . . (+)$_____0.00

5. PURCHASE COSTS AND CHARGES:

5.1 Assumption Fees (First) . . . . . $_____

5.2 Assumption Fees (Second) . . . . . $_____

5.3 Escrow Fee . . . . . $_____

5.4 Notary Fee . . . . . $_____

5.5 Document Preparation Fee . . . . . $_____

5.6 Recording Fee/Transfer Taxes . . . . . $_____

5.7 Title Insurance Premium . . . . . $_____

5.8 Property Condition Reports . . . . . $_____

5.9 Cost of Compliance Repairs . . . . . $_____

5.10 Other _____ . . . . . $_____

5.11 Other _____ . . . . . $_____

5.12 TOTAL Closing Costs [lines 5.1 to 5.11]. . . . . (+)$ 0.00

5.13 Down Payment on Price . . . . . (+)$_____

6. TOTAL ESTIMATED ACQUISITION COST [lines 2.4, 3.1, 4.1, 4.12, 5.12 and 5.13] . . . . . (=)$ 0.00

6.1 No post-closing repairs or renovation cost are included here.

7. FUNDS REQUIRED TO CLOSE ESCROW:

7.1 Down Payment On Price (From line 5.13) . . . . . (+)$ 0.00

7.2 Closing Costs (From line 5.12) . . . . . (+)$ 0.00

7.3 New Loan Proceeds (From line 4.1) . . . . . (+)$ 0.00

7.4 New Financing Costs (From line 4.12). . . . . (+)$ 0.00

7.5 Impounds for New Financing . . . . . (+)$_____

7.6 Hazard Insurance Premium . . . . . (+)$_____

8. PRORATES DUE BUYER AT CLOSE:

8.1 Unpaid Taxes/Assessments . . . . . $_____

8.2 Interest Accrued and Unpaid . . . . . $_____

8.3 Unearned Rental Income. . . . . $_____

8.4 Tenant Security Deposits. . . . . $_____

8.5 TOTAL Prorates Due Buyer [lines 8.1 to 8.4] . . . . . (-)$ 0.00

9. PRORATES DUE SELLER AT CLOSE:

9.1 Prepaid Taxes/Assessments . . . . . $_____

9.2 Impound Account Balance. . . . . $_____

9.3 Prepaid Homeowners' Assessment . . . . . $_____

9.4 Prepaid Ground Lease Rent . . . . . $_____

9.5 Unpaid Rents assigned to Buyer . . . . . $_____

9.6 Other _____. . . . . $_____

9.7 TOTAL Prorates Due Seller [lines 9.1 to 9.6] . . . . . (+)$ 0.00

10. TOTAL FUNDS REQUIRED TO CLOSE ESCROW: [lines 7.1 to 7.6, less 8.5 plus 9.7]. (=)$ 0.00

10.1 See §2.4.a. adjustments.

11. SOURCE OF FUNDS REQUIRED TO CLOSE ESCROW:

11.1 New First Loan Amount (From line 4.1) . . . . . $ 0.00

11.2 New Second Loan Amount (Net loan proceeds). . . . . $_____

11.3 Third-Party Deposits . . . . . $_____

11.4 Buyer's Cash . . . . . $_____

12. TOTAL FUNDS REQUIRED TO CLOSE ESCROW: (Same as line 10). . . . . (=)$ 0.00

I have prepared this estimate based on my knowledge and readily available data.	**I have read and received a copy of this estimate.**
Date: _____, 20_____	Date: _____, 20_____
Broker: _____	Buyer's Name: _____
Agent: _____	Signature: _____
Signature: _____	Signature: _____

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Exhibit “E”

Preliminary Title Report

(Obtain and include Schedule “B” from Preliminary Title Report to set forth the taxes, CC&Rs and encumbrances of record on the property.)

Exhibit “F”

Condition of Property

(If available, include a copy of a Building Inspection Report.)

Exhibit "G"

NATURAL HAZARD DISCLOSURE STATEMENT

NOTE: The seller's listing broker (and the seller) of one-to-four residential units shall prepare a Natural Hazard Disclosure (NHD) and deliver it to prospective buyers prior to making a purchase agreement offer and indicate compliance in the purchase agreement or a counteroffer. If not so disclosed, the buyer has the right to cancel the purchase agreement within three days of delivery of the disclosure in person. [Calif. Civil Code §1103.3]

DATE:_____, 20_____, at_____, California.

This disclosure statement is prepared for the following:

☐ Seller's listing agreement

☐ Purchase agreement

☐ Counteroffer

☐ _____

dated _____, 20_____, at _____, California,

entered into by _____, as the _____,

regarding real estate referred to as _____

_____.

Natural Hazard Disclosure Statement:

Seller and Seller's Agent(s) or a third-party consultant disclose the following information with the knowledge that even though this is not a warranty, prospective buyers may rely on this information in deciding whether and on what terms to purchase the subject property.

Seller hereby authorizes any agent(s) representing any principal(s) in this action to provide a copy of this statement to any person or entity in connection with any actual or anticipated sale of the property.

THE FOLLOWING ARE REPRESENTATIONS MADE BY SELLER AND SELLER'S AGENT(S) BASED ON THEIR KNOWLEDGE AND MAPS DRAWN BY THE STATE AND FEDERAL GOVERNMENT. THIS INFORMATION IS A DISCLOSURE AND IS NOT INTENDED TO BE PART OF ANY CONTRACT BETWEEN BUYER AND SELLER.

THIS REAL PROPERTY LIES WITHIN THE FOLLOWING HAZARDOUS AREA(S): (Check appropriate response)

1. A SPECIAL FLOOD HAZARD AREA (Any type Zone "A" or "V") designated by the Federal Emergency Management Agency.

Yes____ No____ Do not know/information not available from local jurisdiction____

2. AN AREA OF POTENTIAL FLOODING shown on an inundation map pursuant to Section 8589.5 of the Government Code.

Yes____ No____ Do not know/information not available from local jurisdiction____

3. A VERY HIGH FIRE HAZARD SEVERITY ZONE pursuant to Section 51178 or 51179 of the Government Code. The owner of this property is subject to the maintenance requirements of Section 51182 of the Government Code.

Yes____ No____

4. A WILDLAND AREA THAT MAY CONTAIN SUBSTANTIAL FOREST FIRE RISKS AND HAZARDS pursuant to Section 4125 of the Public Resources Code. The owner of this property is subject to the maintenance requirements of Section 4291 of the Public Resources Code. Additionally, it is not the state's responsibility to provide fire protection services to any building or structure located within the wildlands unless the Department of Forestry and Fire Protection has entered into a cooperative agreement with the local agency for those purposes pursuant to Section 4142 of the Public Resources Code.

Yes____ No____

5. AN EARTHQUAKE FAULT ZONE pursuant to Section 2622 of the Public Resources Code.

Yes____ No____

6. A SEISMIC HAZARD ZONE pursuant to Section 2696 of the Public Resources Code.

Yes (Landslide Zone)____ Yes (Liquefaction Zone)____

No____ Map not yet released by state____

THESE HAZARDS MAY LIMIT YOUR ABILITY TO DEVELOP THE REAL PROPERTY, TO OBTAIN INSURANCE OR TO RECEIVE ASSISTANCE AFTER A DISASTER.

THE MAPS ON WHICH THESE DISCLOSURES ARE BASED ESTIMATE WHERE NATURAL HAZARDS EXIST. THEY ARE NOT DEFINITIVE INDICATORS OF WHETHER OR NOT A PROPERTY WILL BE AFFECTED BY A NATURAL DISASTER. BUYER(S) AND SELLER(S) MAY WISH TO OBTAIN PROFESSIONAL ADVICE REGARDING THOSE HAZARDS AND OTHER HAZARDS THAT MAY AFFECT THE PROPERTY.

Check only one of the following:

☐ Seller and their agent represent that the information herein is true and correct to the best of their knowledge as of the date signed by Seller and Seller's Agent.

☐ Seller and their agent acknowledge that they have exercised good faith in the selection of a third-party report provider as required in Civil Code Section 1103.7, and that the representations made in this Natural Hazard Disclosure Statement are based upon information provided by the independent third-party disclosure provider as a substituted disclosure pursuant to Civil Code Section 1103.4. Neither Seller nor their agent has independently verified the information contained in this statement and report or is personally aware of any errors or inaccuracies in the information contained on the statement. This statement was prepared by

Third-Party Disclosure Provider_____ Date _____

Date:_____, 20_____	Date:_____, 20_____
Seller: _____	Seller's Broker:_____
Seller: _____	Agent: _____

Buyer represents that he has read and understands this document. Pursuant to Civil Code Section 1103.8, the representations made in this Natural Hazard Disclosure Statement do not constitute all of Seller's or Seller's Agent's disclosure obligations in this transaction.

Buyer:_____ Date:_____

Buyer:_____ Date:_____

Exhibit "H"

ANNUAL PROPERTY OPERATING DATA SHEET

APOD

DATE: _____, 20_____, at _____, California.

1. PROPERTY TYPE: _____

1.1 Location _____

1.2 APOD figures are estimates reflecting:

a. ☐ Current operating conditions.

b. ☐ Forecast of anticipated operations.

c. Prepared by _____

			%
2. INCOME:			
2.1 **Scheduled Rental Income**	$_____		100 %
a. Less: Vacancies, discounts and uncollectibles	– $_____		_____%
b. Less: Credit card charges	– $_____		_____%
2.2 **Effective Rental Income** [Lines 2.1 less 2.1 a and b]	$	0.00	_____%
a. Other income	+ $_____		_____%
2.3 **Gross Operating Income**	$	0.00	_____%
3. EXPENSES:			
3.1 Electricity	$_____		_____%
3.2 Gas	$_____		_____%
3.3 Water	$_____		_____%
3.4 Rubbish	$_____		_____%
3.5 Insurance	$_____		_____%
3.6 Taxes	$_____		_____%
3.7 Management Fee	$_____		_____%
3.8 Resident Manager	$_____		_____%
3.9 Office Expenses/Supplies	$_____		_____%
3.10 Advertising	$_____		_____%
3.11 Lawn/Gardening	$_____		_____%
3.12 Pool/Spa	$_____		_____%
3.13 Janitorial	$_____		_____%
3.14 Maintenance	$_____		_____%
3.15 Repairs and Replacements	$_____		_____%
3.16 CATV/Phone	$_____		_____%
3.17 Accounting/Legal Fees	$_____		_____%
3.18 _____	$_____		_____%
3.19 _____	$_____		_____%
3.20 **Total Operating Expense** [Lines 3.1 to 3.19]	– $	0.00	_____%
4. NET OPERATING INCOME: [Line 2.3 less 3.19]	$	0.00	_____%

5. SPENDABLE INCOME (annual projection):

5.1 **Net Operating Income** (enter from section 4). . . . . $ 0.00 _____%

5.2

	Loan	Principal Balance Amount	Monthly Payment	Rate	Due Date
a.	1st	$_____	$_____	_____%	_____
b.	2nd	$_____	$_____	_____%	_____
c.	3rd	$_____	$_____	_____%	_____

5.3 Total Annual Debt Service [Lines 5.2 a, b and c] . . . . . – $ 0.00 _____%

5.4 **Spendable Income** [Lines 5.1 less 5.3] . . . . . $ 0 _____%

6. PROPERTY INFORMATION:

6.1 Price $_____; Loan amounts $_____; Owner's equity $_____.

6.2 Current vacancy rate or vacant space _____%.

6.3 Assessor's allocations for depreciation schedule:
Improvements _____%; Land _____%; Personal property _____%.

6.4 Property disclosures:

a. ☐ Rental Income Rent Roll available; [See **ft** Form 380] ☐ need confidentiality agreement.

b. ☐ Rent control restrictions.

c. ☐ Condition of improvements available: ☐ by owner [See **ft** Form 304-1], ☐ by inspector.

d. ☐ Environmental report available.

e. ☐ Natural Hazard Disclosure Statement available. [See **ft** Form 314]

f. ☐ Soil report available.

g. ☐ Termite report available.

h. ☐ Building specification available.

i. ☐ _____

j. ☐ _____

7. REPORTABLE INCOME/LOSS (annual projection): For Buyer to fill out.

7.1 **Net Operating Income** (NOI) (enter from section 4) . . . . . $ 0.00

7.2 Deductions from NOI

a. Annual interest expense . . . . . $_____

b. Annual depreciation deduction . . . . . $_____

c. Total deductions from NOI . . . . . – $ 0.00

7.3 **Reportable Income/Loss** (annual projection) . . . . . $ 0.00

Broker: _____
Address: _____
_____
Phone: _____ Cell: _____
Fax: _____
Email: _____

I have reviewed and approve this information.
Date: _____, 20_____

Owner's name: _____
Signature: _____
Signature: _____

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Exhibit "I"

RENTAL INCOME RENT ROLL

DATE:_____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

FACTS:

This is an addendum to the following:

☐ Purchase agreement ☐ Listing agreement for sale or financing

☐ APOD (Annual Property Operating Data) ☐ Counteroffer

☐ Escrow Instructions ☐ _____

☐ of same date, or dated_____, 20_____, at _____, California, entered into by _____ and _____, regarding real estate referred to as _____

_____.

This rental income rent roll contains _____ page(s).

Unit #	Tenant's Last Name	Rent Amount (monthly)	Date Rent Due	Rental Term	Date Tenancy Expires	Security Deposit	Rental Incentives, Bonuses or Discounts	Delinquent Rent Amount
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
		$				$		$
Totals For This Page:	TOTAL:	$0.00			TOTAL:	$0.00	TOTAL:	$0.00

I certify the above is true and correct.

Date Prepared:_____, 20_____

Owner:_____

Prepared By: _____

Owner:_____

Exhibit "J"

Area of City/County

(Include a copy of the area map surrounding the property location.)

Exhibit "K"

PROPERTY MANAGEMENT AGREEMENT

DATE: _____, 20_____, at _____, California.

Items left blank and unchecked are not applicable.

1. RETAINER PERIOD:

1.1 Owner hereby retains and grants Broker the exclusive right to lease, rent, operate and maintain the property as Property Manager, commencing _____, 20_____, and continuing for one year and thereafter until terminated.

2. RECEIPT OF SECURITY DEPOSITS:

2.1 Owner hands $_____ to Broker for deposit into the trust account towards Owner's security deposit obligation to Tenants.

3. RECEIPT OF CASH RESERVE:

3.1 Owner hands $_____ to Broker as a deposit towards Owner's obligation under the agreement.

3.2 Owner to maintain a minimum cash reserve, in addition to any security deposits, in the amount of $_____. On request from Broker, Owner will advance additional funds to maintain this minimum balance.

3.3 The cash reserve may be used to pay costs diligently incurred by Broker or due Broker in fulfilling Broker's obligations.

4. BROKERAGE FEE:

NOTICE:The amount or rate of real estate fees is not fixed by law. They are set by each Broker individually and are negotiable between Owner and Broker.

4.1 Broker compensation to be:

a. _____% of all rents collected and deposited by Broker during the month, except for any first month's rent for which a Broker fee is paid under §4.1 b as follows,

b. _____% of the first month's rent collected and deposited under ☐ rental agreements, and ☐ leases,

c. All sums remaining from credit check fees in excess of credit report expenses, and

d. ☐ Late payment charges and returned check charges paid by a tenant.

5. TRUST ACCOUNT:

5.1 Broker will place Owner's deposit for costs and security deposits into
☐ Broker's trust account, or ☐ separate trust account for Owner, maintained with
_____ at their _____ branch.

a. This account shall be ☐ non-interest bearing, or ☐ interest bearing.

5.2 All funds received by Broker for the account of Owner will be placed in the trust account.

5.3 Amounts to pay and satisfy the obligations incurred by Broker may be disbursed from the account after payment is due.

5.4 On termination of this agreement, Broker will return to Owner all remaining trust funds belonging to Owner.

6. PERIODIC ACCOUNTING:

6.1 Within ten days after each calendar ☐ month, or ☐ quarter, and on termination of this agreement, Broker will deliver to Owner a Statement of Account for all receipts and expenditures, together with a check to Owner for any funds in excess of minimum reserves under §3.2.

6.2 Amounts to compensate Broker under §4 may be withdrawn from the trust account.

6.3 Each Statement of Account delivered by Broker shall include no less than the following information for the period:

a. Amount of security deposits received or refunded.

b. Amount of rent or receipts, itemized by unit.

c. An itemized description of disbursements.

d. End of month balance of the income, expense and security deposit trust accounts.

6.4 ☐ Broker to reserve and disburse from the trust account any property and employee taxes, special assessments, insurance premiums, loan payments and other payments required to be made by the owner.

6.5 Advertising costs incurred to locate new tenants to be paid ☐ by Owner, or ☐ by Broker.

7. TITLE CONDITION AND LOANS:

7.1 The property is referred to as _____

_____

_____

_____.

7.2 Owner's interest in the property is:

☐ Fee simple, ☐ _____

7.3 Loan payments are to be timely disbursed by Broker to:

a. Lender _____

Address _____

_____

_____

Phone _____

Payment of $_____, due on the _____ day and delinquent on the _____ day of each month.

b. Lender _____

Address _____

_____

_____

Phone _____

Payment of $_____, due on the _____ day and delinquent on the _____ day of each month.

8. BROKER AGREES TO:

8.1 Use diligence in the performance of this employment.

8.2 Continuously maintain a California real estate broker's license.

8.3 Collect all rents, security deposits or other charges and expenses due Owner, and timely refund tenants' security deposits, less allowable deductions and including any interest due tenants.

8.4 Prepare and place advertisements for prospective tenants.

8.5 Show property to prospective tenants, obtain credit reports and confirm creditworthiness of tenants before executing rental or lease agreements.

8.6 Execute, renegotiate or cancel rental or lease agreements with tenants.
No lease to exceed _____ months.

8.7 Serve rent collection and other notices, file unlawful detainer and money damage actions, recover possession of premises or settle with delinquent tenants.

8.8 Inspect the property monthly and each unit when tenants vacate.

8.9 Maintain and periodically confirm the inventory of personal property on premises.

8.10 Evaluate rental and lease agreements periodically for income, expense and provision updates.

8.11 Contract for utilities, services and equipment to operate and maintain the property and safeguard the tenants.

8.12 Contract for any repairs, maintenance or improvements needed to rent or lease the property.
a. Owner to approve all repairs in excess of $_____.

8.13 Obligate Owner to no unauthorized agreement or liability.

8.14 Protect and enhance the goodwill of Owner's rental business and keep confidential and secure any knowledge of Owner's business activities acquired during this employment.

8.15 Hire, supervise and discharge ☐ a resident manager, and ☐ an assistant resident manager.

8.16 Inspect and take any action necessary to comply with federal, state, county or municipal safety and building codes affecting the property.

8.17 Notify Owner of any potential hazards to the tenants or property, and Owner to respond within seven (7) days. Should an emergency situation arise placing the tenants or property in jeopardy, Broker may immediately remedy the situation without further authority from Owner.

9. OWNER AGREES TO:

9.1 Hand Broker all keys and entry codes to the property, and copies of rental and lease agreements with existing tenants.

9.2 Hand Broker (if Broker is to disburse) loan payment coupons/envelopes, property tax bills, insurance premium billings and _____.

9.3 Indemnify Broker for the expense of any legal action arising out of Broker's proper performance of this agreement.

9.4 Provide public liability, property damage and workers' compensation insurance sufficient in amount to protect Broker and Owner, naming Broker as an additional insured.

9.5 Owner's insurance agent is _____

_____

10. TERMINATION:

10.1 This agreement shall continue until terminated by mutual written agreement or until either party, for legally justifiable cause, serves a written Notice of Termination.

10.2 Owner may terminate this agreement at any time during the initial one-year term by paying Broker a fee equal to three times Broker's management fee earned during the month preceding termination.

10.3 On termination, Owner will assume the obligation of any contract entered into by Broker under this agreement.

11. GENERAL PROVISIONS:

11.1 Broker is authorized to place a For Rent/Lease sign on the property and publish and disseminate property information.

11.2 Owner authorizes Broker to cooperate with other brokers and divide with them any compensation due.

11.3 The authorized agent-for-service is ☐ Broker, ☐ Owner, ☐ _____

11.4 Broker may have or will contract to represent Owners of comparable properties or represent Tenants seeking comparable properties during the retainer period. Thus, a conflict of interest exists to the extent Broker's time is required to fulfill the fiduciary duty owed to others he now does or will represent.

11.5 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

11.6 The prevailing party in any dispute shall be entitled to attorney fees and costs, unless they proceed with litigation without first offering to enter into mediation to resolve the dispute.

11.7 ☐ **See attached addendum(s) for additional terms.** [See **ft** Form 250]

11.8 _____

_____

Broker:
I agree to render services on the terms stated above.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: _____, 20_____

Broker's Name: _____

Broker's DRE Identification #: _____

Agent's Name: _____

Agent's DRE Identification #: _____

Signature: _____

Address: _____

_____

Phone: _____

Fax: _____

Email: _____

Owner:
I agree to employ Broker on the terms stated above.

☐ See attached Signature Page Addendum. [**ft** Form 251]

Date: _____, 20_____

Owner: _____

Signature: _____

Owner: _____

Signature: _____

Address: _____

_____

Phone: _____

Fax: _____

Email: _____

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Exhibit “L”

Property Value Appraisal

(If available, include a copy of the appraiser’s opinion of value from the Appraisal Report.)

LLC-1

File # _____

State of California
Secretary of State

LIMITED LIABILITY COMPANY ARTICLES OF ORGANIZATION

A $70.00 filing fee must accompany this form.

IMPORTANT – Read instructions before completing this form.

This Space For Filing Use Only

ENTITY NAME (End the name with the words "Limited Liability Company," or the abbreviations "LLC" or "L.L.C." The words "Limited" and "Company" may be abbreviated to "Ltd." and "Co.," respectively.)

1. NAME OF LIMITED LIABILITY COMPANY

PURPOSE (The following statement is required by statute and should not be altered.)

2. THE PURPOSE OF THE LIMITED LIABILITY COMPANY IS TO ENGAGE IN ANY LAWFUL ACT OR ACTIVITY FOR WHICH A LIMITED LIABILITY COMPANY MAY BE ORGANIZED UNDER THE BEVERLY-KILLEA LIMITED LIABILITY COMPANY ACT.

INITIAL AGENT FOR SERVICE OF PROCESS (If the agent is an individual, the agent must reside in California and both Items 3 and 4 must be completed. If the agent is a corporation, the agent must have on file with the California Secretary of State a certificate pursuant to Corporations Code section 1505 and Item 3 must be completed (leave Item 4 blank).

3. NAME OF INITIAL AGENT FOR SERVICE OF PROCESS

4. IF AN INDIVIDUAL, ADDRESS OF INITIAL AGENT FOR SERVICE OF PROCESS IN CALIFORNIA | CITY | STATE | ZIP CODE

CA

MANAGEMENT (Check only one)

5. THE LIMITED LIABILITY COMPANY WILL BE MANAGED BY:

- ☐ ONE MANAGER
- ☐ MORE THAN ONE MANAGER
- ☐ ALL LIMITED LIABILITY COMPANY MEMBER(S)

ADDITIONAL INFORMATION

6. ADDITIONAL INFORMATION SET FORTH ON THE ATTACHED PAGES, IF ANY, IS INCORPORATED HEREIN BY THIS REFERENCE AND MADE A PART OF THIS CERTIFICATE.

EXECUTION

7. I DECLARE I AM THE PERSON WHO EXECUTED THIS INSTRUMENT, WHICH EXECUTION IS MY ACT AND DEED.

_____ DATE

_____ SIGNATURE OF ORGANIZER

_____ TYPE OR PRINT NAME OF ORGANIZER

LLC-1 (REV 04/2007) APPROVED BY SECRETARY OF STATE

Addenda to Articles of Organization (Form LLC-1) of

_____, LLC

1.7 No document or instrument purporting to convey an interest in or create lien upon the real estate of the limited liability company shall be of any force or effect without the prior written approval of a majority in interest of the members of the limited liability company.

OPERATING AGREEMENT

for

_____, LLC

a California Limited Liability Company

1. FORMATION:

1.1 Date of Agreement: _____, 20_____.

1.2 Name of Limited Liability Company: _____, LLC, a California Limited Liability Company.

1.3 Place of Business: The address of the Limited Liability Company is _____ _____.

The address may be changed by the Manager by giving at least 10 days' prior written notice to the members.

1.4 Management: Management of the Limited Liability Company shall be vested in a single Manager. The Manager of the Limited Liability Company shall be _____.

1.5 Members: See Exhibit "A".

1.6 Applicable Law: The Limited Liability Company is formed under the part of the California Corporations Code known as the Beverly-Killea Limited Liability Company Act.

1.7 No Permits Obtained: The membership interests in the Limited Liability Company have not been registered with any government agency, and no permits have been obtained.

1.8 Articles of Organization: The Manager shall file articles of organization for the Limited Liability Company (Form LLC-1) with the California Secretary of State.

1.9 Purpose: The Limited Liability Company's purpose is to hold title and operate as a long-term investment the real estate described in Exhibit "B".

1.10 Term of the Limited Liability Company: The Limited Liability Company starts on the date of this agreement and will end 30 years from the date unless terminated earlier.

1.11 Limited Liability: No member or Manager shall be liable for any Limited Liability Company losses greater than his capital contribution.

2. CAPITAL CONTRIBUTIONS AND DISTRIBUTIONS OF FUNDS:

2.1 Capital Contributions: The Limited Liability Company's capital shall be:

_____dollars ($_____) as set forth in Exhibit "A".

2.2 Loans to Limited Liability Company: A member may only lend money to the Limited Liability Company with the Manager's approval. The loan shall be kept in a separate account.

2.3 Definition of "Spendable Income": "Spendable Income" means net receipts remaining from ownership of assets by the Limited Liability Company after deductions for all expenditures on operating expenses, reserves, interest and loan reduction, excluding depreciation schedules.

2.4 Distribution of Spendable Income: Spendable Income is to be distributed first to the Class A members in a sum equal to _____% a year, cumulative, of their original contributions; then to Class B members in a sum equal to _____% a year, cumulative, of their original contributions. Any remaining Spendable Income shall be distributed pro rata to all members based on their ownership interest.

2.5 Participation in Proceeds of Refinance/Sale: Net proceeds from the sale or refinance of all or some of the Limited Liability Company property shall be distributed first to the Class A members, until they have received their capital contributions, plus _____% a year on their original capital contribution since the date of contribution, less any disbursements received; then to Class B members until they have received their capital contributions plus _____% a year on

their original capital contribution since the date of contribution, less any disbursements received. All remaining funds shall be distributed pro rata to all members based on their ownership interest.

2.6 Depreciation Allocation: Should the Limited Liability Company file a Federal Income Tax Form 1065 with the Internal Revenue Service (IRS), depreciation shall be taken on the shortest straight-line method permitted and allocated to the members pro rata based on their ownership interest.

3. MANAGEMENT, COMPENSATION, DUTIES AND POWERS:

3.1 Management of Limited Liability Company Property: The Manager has full charge of the management of the Limited Liability Company property, subject to Section 11.2.

3.2 Compensation: No member or Manager shall be paid for working for the Limited Liability Company or for being a member, except as this section provides.

3.3 Real Estate Fees: The Manager will receive a fee of $_____ cash for services in the creation and formation of the Limited Liability Company. On a later resale of the property, the Manager is to receive _____% of the price of any resale, and in the event of a refinance, _____% of the refinancing, if he is the procuring cause of the resale or refinance.

3.4 Management Fee: The Manager shall receive a fee for his management of the Limited Liability Company property of _____.

3.5 Duties: The Manager shall do what is needed to conduct the Limited Liability Company business.

3.6 Indemnification: Except for a breach of fiduciary duty to the Limited Liability Company and its members, the Limited Liability Company shall indemnify the Manager and officers against judgments, settlements, penalties, fines or expenses of any kind incurred as a result of acting as an agent of the Limited Liability Company.

3.7 Other Officers (Titles, Duties and Compensation): _____
_____.

4. ACCOUNTS AND ACCOUNTING:

4.1 Inspection of Limited Liability Company Records: The Limited Liability Company shall maintain accurate books at its principal office on the cash method of accounting. All members may inspect such books at reasonable times upon reasonable notice. A separate income and capital account shall be maintained for each member.

4.2 Annual Audit and Report to Members: The Manager shall audit the books and deliver to each member, within 30 days after the end of each calender year, a balance sheet and annual operating statement showing each member's capital account, the distributions to each member, and each member's allocation, by percentage of ownership, of all income, expenses and interest received or paid in the ownership and operation of the property. A majority interest of the members may order an audit of the Limited Liability Company books, at the Limited Liability Company's expense, by an accountant named by a majority of members in ownership.

4.3 Annual Income Tax Returns: If the Limited Liability Company is comprised of 10 or fewer members, husband and wife holding an interest together being one, the company shall file no federal partnership income tax returns (Federal Income Tax Form 1065 and Schedule K-1) and each member shall individually report his pro rata allocation of gross income, operating expenses and interest, and calculate his own depreciation and reportable income or loss from operations.

The Limited Liability Company shall file a Limited Liability Company return (Franchise Tax Board Form 568) annually with the California Franchise Tax Board.

5. ASSIGNMENT OF INTEREST, SUBSTITUTED MEMBER:

5.1 Assignment of Interest: A member may assign his membership interest to any other member at any time after he has first given the manager 10 days' notice to buy his interest on the same terms agreed upon with another member.

5.2 Invalid Assignment of Interest: All other assignments or transfers of members' interests are terminated according to the method under Section 6.

6. TERMINATION OF MEMBERSHIP INTERESTS:

6.1 Termination of Manager: The termination of the Manager does not terminate any of the Manager's rights as a member.

6.2 Events Causing Termination of a Member: A member may be terminated if any of the following events occur:

a. He dies, unless survived in interest by a joint tenant;

b. He is adjudged insane or incompetent, or is committed to a mental institution;

c. He transfers his interest to a non-member under Section 5.2 without obtaining prior consent from each remaining member;

d. He fails to immediately remove a charging order against his interest;

e. He files for bankruptcy;

f. He voluntarily retires, withdraws or resigns as a member;

g. He is expelled by court order or by all of the remaining members; or

h. He fails to contribute capital to the Limited Liability Company as agreed to in Section 2.1.

6.3 Notice of Termination: Service upon the member to be terminated of a written notice stating the cause for termination and the effective date of termination terminates all of his powers and his right to share in Limited Liability Company profits as of the effective date. The effective date is 30 days after service of the notice. Each remaining member shall be served under Section 13.2 both a copy of the notice of termination and a notice of the option rights held by the remaining members under Section 7.

7. OPTION TO PURCHASE:

7.1 Option to Purchase Upon Termination: Upon the termination of a member's interest under Section 6, the remaining members may:

a. Dissolve and liquidate the Limited Liability Company under Section 10.1; or

b. Buy the terminated member's entire interest. Where more than one member exercises his option, those exercising shall purchase their pro rata share based on their aggregate ownership interest.

7.2 Notice of Exercise of Option:

a. When a member dies, notice of the option shall be given to the deceased's representative within 120 days after the representative's appointment.

b. When a member's interest is terminated under Section 6, notice of the exercise of the option shall be given to the terminated member before the effective date of termination, and in the way a notice of termination is given under Section 6.3.

8. VALUATION OF LIMITED LIABILITY COMPANY INTEREST:

8.1 Dead, Incompetent or Insane Members: If an election is made to purchase the interest of a member terminated because of death, incompetency or insanity, the value of the interest shall equal:

a. The sum of:

1. The member's capital contributions less distributions; and
2. The balance of the member's income account;

b. Less:
   1. All unpaid assessments due;
   2. All other debts to the Limited Liability Company;

c. Plus the member's interest in the “additional value” of the Limited Liability Company assets, determined as follows:
   1. Each member has a pro rata ownership share of the additional value;
   2. Within 30 days after the close of each calendar year, the members shall execute an “Agreement of Additional Value” (Exhibit “C”). The Agreement shall state an amount set by the members as the increased value of the Limited Liability Company assets over the members’ invested capital and purchase and improvement loan balances;
   3. The additional value set within two years before the termination of a deceased, incompetent or insane member binds the remaining members and their successors in interest;
   4. If additional value was not set within two years before the termination of the deceased, incompetent or insane member, it shall be set by arbitration under Section 13.5.

8.2 Other Members: If an election is made to buy the interest of a member who is terminated for reasons other than death, incompetency or insanity, the value of the membership interest shall equal the amount described in Section 8.1, excluding any “additional value.”

9. PAYMENT FOR PURCHASE PRICE:

9.1 Dead, Incompetent or Insane Members: Payment of the amount described in Section 8.1 shall be made in _____ equal annual installments including interest of _____% a year. The first installment is due _____ (_____) days after the death, incompetency or insanity of the member. The amount owed shall be evidenced by a promissory note having an alienation-acceleration clause and an attorney fees clause, which shall be executed by all members exercising the option. The note shall be secured by a pledge of the interest purchased.

9.2 Other Members: The amount described in Section 8.2 shall be due and payable upon sale of the Limited Liability Company’s property. It shall be evidenced by a non-interest bearing promissory note which shall be executed by all members exercising the option, and shall be secured by a pledge of the interest purchased.

10. DISSOLUTION OF LIMITED LIABILITY COMPANY AND DISTRIBUTION OF CAPITAL:

10.1 Dissolution:
   a. The Limited Liability Company shall be dissolved when all the members agree, or upon the death, withdrawal or termination of any member.
   b. If the Limited Liability Company is dissolved due to death, withdrawal or termination of a member, the Limited Liability Company may continue by a vote of the remaining members under Section 12 within 90 days of the event causing the dissolution.

10.2 Accounting: Upon dissolution, the Manager shall take account of Limited Liability Company assets and liabilities. The assets shall be sold quickly and for fair value.

10.3 Termination of Business: The Limited Liability Company shall do no further business after dissolution other than that needed to wind up the business and distribute the assets.

10.4 Distribution of Proceeds: Proceeds from the liquidation of Limited Liability Company assets and non-liquidated assets shall be distributed as follows:
   a. All Limited Liability Company liabilities shall first be paid;
   b. All debts owed to members shall be paid;
   c. All remaining funds are to be distributed according to the method described in Section 2.5.

10.5 After Dissolution: The members shall continue to divide assets and liabilities after dissolution according to the method provided in Section 10.4.

11. LIMITATIONS ON MEMBERS' AUTHORITY:

11.1 Manager: Unless all members consent in writing, the Manager may not violate this agreement, make it impossible to perform the Limited Liability Company's business, or confess to judgment against the Limited Liability Company.

11.2 Members: No member may engage in the management or control of the Limited Liability Company business, except as required under a property management contract with the Manager, signed by each member, to produce the necessary control factor over operations of the property for federal income tax rental loss deductions by members reporting individually under Section 4.3.

11.3 Members: No member may withdraw or reduce his contribution to the capital of the Limited Liability Company except as allowed by the buy and sell provisions of this agreement. No member may sue the Limited Liability Company for partition. No member may demand property other than cash or notes in return for his contribution. No member has priority over any other member, except as provided in this agreement for Class A memberships. No member shall have the power or right to cause the termination and dissolution of the Limited Liability Company, except as set forth in this agreement.

11.4 Other Ventures: Any member may have an interest in any other business venture. Neither the Limited Liability Company nor any other member has any right, by this agreement, in any such venture or to its income or profits.

12. VOTING:

12.1 Unanimous Votes: The following matters shall require an unanimous vote of the members of the Limited Liability Company:

a. The assignment of a member's interest to a person who is not a member of the Limited Liability Company; and

b. A decision to continue the Limited Liability Company after the Limited Liability Company is dissolved due to death, withdrawal or termination of any member.

12.2 Majority Vote: In all other matters in which a vote is required, a vote of a majority in interest of the members shall be sufficient.

12.3 Amendments: A majority in interest of the members may vote to amend the articles of organization or the operating agreement of the Limited Liability Company.

12.4 Removal of Manager: A majority in interest of the members may vote to remove the Manager of the Limited Liability Company and substitute a new Manager.

13. MISCELLANEOUS PROVISIONS:

13.1 Validity: If any part of this agreement is invalid, the validity of the remainder of the agreement will not be affected.

13.2 Notice: All notices shall be written and personally delivered or sent by regular mail and registered, or by certified mail, return receipt requested, postage prepaid, to the parties and to the Limited Liability Company at the address stated herein.

13.3 Survival of Rights: This agreement binds the parties and their successors in interest.

13.4 Paragraph Headings: The paragraph headings do not affect the meaning of this agreement.

13.5 Before any party to this agreement files an action on a dispute arising out of this agreement which remains unresolved after 30 days of informal negotiations, the parties agree to enter into non-binding mediation administered by a neutral dispute resolution organization and undertake a good faith effort during mediation to settle the dispute.

13.6 Arbitration: Any dispute between any member and the Limited Liability Company, or regarding any activities of the Manager that cannot be settled by the Manager or by mediation, shall be arbitrated under the rules of the American Arbitration Association.

I AGREE TO THE TERMS OF THIS OPERATING AGREEMENT

Date: _____, 20_____ MANAGER: _____

Exhibit "A"

ADDENDUM TO OPERATING AGREEMENT

for

_____, LLC,

a California Limited Liability Company

Members

	Amount of Capital Contribution	Nature of Contribution	Percentage of Interest
MANAGER:			
_____	-0-	Not Applicable	-0-
_____	-0-	Not Applicable	-0-
CLASS A MEMBERS:			
_____	$_____	_____	_____%
_____	$_____	_____	_____%
_____	$_____	_____	_____%
_____	$_____	_____	_____%
_____	$_____	_____	_____%
_____	$_____	_____	_____%
_____	$_____	_____	_____%
_____	$_____	_____	_____%
_____	$_____	_____	_____%
_____	$_____	_____	_____%
_____	$_____	_____	_____%
CLASS B MEMBERS:			
_____	$_____	_____	_____%
_____	$_____	_____	_____%
_____	$_____	_____	_____%
_____	$_____	_____	_____%
TOTALS:	**$** 0.00		0 **%**

Exhibit "B"

ADDENDUM TO OPERATING AGREEMENT

for

_____, LLC,

a California Limited Liability Company

Legal Description

The real property in the County of _____, State of California, described as follows:

_____

_____

_____

_____

_____

_____

_____

_____

_____

_____.

Exhibit "C"

ADDENDUM TO OPERATING AGREEMENT

for

_____, LLC,

a California Limited Liability Company

Provisions for Additional Value

The operating agreement contains provisions at Section 8.1(c) for "additional value" and requires, within 30 days after each calendar year, that the parties to the operating agreement agree upon any additional valuation then existing.

It is agreed this _____ day of _____, 20_____, as follows:

The additional valuation as of this date is $_____. This figure is exclusive of loans, if any, which exist against the interest held by the Limited Liability Company and exclusive of all capital contributions.

This amends the operating agreement to include this additional valuation.

I agree to the terms stated above.

Date: _____, 20_____ _____
(MEMBER)

Date: _____, 20_____ _____
(MEMBER)

Date: _____, 20_____ _____
(MEMBER)

Date: _____, 20_____ _____
(MEMBER)

Date: _____, 20_____ _____
(MEMBER)

Date: _____, 20_____ _____
(MEMBER)

SIGNATURE PAGE FOR OPERATING AGREEMENT

By Manager and Members

I hereby agree to purchase Class A membership interest(s) in _____ _____, a California Limited Liability Company in the sum of $_____. Enclosed herewith is my check for the total sum made payable to _____ _____.

The undersigned hereby executes this page as part of the operating agreement.

METHOD OF TITLE

I desire to hold legal title to my ownership interest in the Limited Liability Company as:

- ☐ Joint Tenants with _____
- ☐ Tenants in Common with _____
- ☐ Separate Property _____
- ☐ Community Property with _____
- ☐ Community Property with Right of Survivorship with _____
- ☐ Revocable Intervivos Trust, entitled _____

MEMBER

Name: _____ Signature: _____

Address: _____

_____

Telephone: (_____)_____

Social Security: _____–_____–_____

ACCEPTED:

_____ _____, 20_____.
(Manager) (Date)

SUBSCRIPTION AND AGREEMENT TO INVEST

DATE: _____, 20_____, at _____, California.
From: _____, as the Subscriber/Investor.
To: _____, a California Limited Liability Company.

1. SUBSCRIPTION:

1.1 I hereby offer to invest $_____ as a Class "A" member of this California Limited Liability Company (LLC).

1.2 Receipt is hereby acknowledged of my deposit in the amount of $_____ toward the investment.

1.3 I will deliver the balance of the purchase price:

a. ☐ on presentation to me of the signature page of the LLC operating agreement for execution; or

b. ☐ on or before _____, 20_____.

2. GENERAL REPRESENTATIONS:

Check all that apply:

2.1 ☐ I am purchasing the LLC membership interest for my own account, or in a fiduciary capacity for the account and benefit of a person or entity, for long-term investment, and not to resell or distribute to any other person.

2.2 ☐ I understand that the membership interests in this LLC have not been registered with the Securities Exchange Commission, nor qualified as corporate securities with the California Department of Corporations or any other state or federal government agency, and no permits have been obtained.

2.3 ☐ I have studied the investment circular and the LLC operating agreement and I understand the speculative nature of the proposed investment program.

2.4 ☐ I have had unrestricted access to all information concerning the proposed investment and have received no representations or warranties regarding the investment not contained in the investment circular.

2.5 ☐ I have personally carried out a visual inspection of the property being acquired by the LLC.

3. SUITABILITY REPRESENTATIONS:

3.1 My investment in the transaction does not exceed 10% of one or both of the following:

a. ☐ my net worth, exclusive of home, furnishings, and automobiles;

b. ☐ my adjusted gross income for federal income tax purposes for my last tax year or, in the alternative, as estimated for the current year.

3.2 I have known the manager of this LLC personally or in business as follows: _____
_____.

3.3 I have had the following investment experience: _____
_____
_____.

3.4 I have had the following occupational experience: _____
_____
_____.

3.5 I have attained the following education level: _____
_____
_____.

☐ See attached Signature Page Addendum. [**ft** Form 251]

INVESTOR'S SIGNATURE: _____ Date: _____, 20_____.
Address: _____ City: _____, California, Zip: _____
Phone number: _____ Social Security Number: _____.

ACCEPTED BY THE LIMITED LIABILITY COMPANY

MANAGER'S SIGNATURE: _____ Date: _____, 20_____.

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Legal Aspects of Real Estate

4th Edition

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Table of Contents

for Online and CD-ROM versions

Table of Forms 7
Introduction. 8

Section A

Sources of Real Estate Law

Chapter 1 — Origins of California real estate law
The English and Spanish influence 9

Chapter 2 — Understanding real estate law
The role of the federal Constitution 15

Chapter 3 — Understanding the court system
Federal and state 24

Chapter 4 — Judicial and political systems in action
Toying with rights. 31

Chapter 5 — How to read and use legal cites
Fundamentals underpinning real estate activities . . . 36

Section B

Real Estate Interests

Chapter 6 — The real estate exists
Physical and legal aspects 40

Chapter 7 — Fee vs. Leasehold
A matter of possession 49

Chapter 8 — Leasehold improvements
Ownership rights 55

Chapter 9 — Types of tenancies
Know your tenancy or lose time. 65

Chapter 10 — License to use land
A personal right to use another's property 74

Chapter 11 — Water rights
Water is used, not owned 81

Chapter 12 — Navigable waters in public trust
For the use and benefit of the people 90

Section C

Adjacent Owner Issues

Chapter 13 — Boundary Disputes
Doctrine of agreed boundaries 97

Chapter 14 — Common boundary structures
Shared rights and responsibilities 102

Chapter 15 Encroachments — crossing the line
Boundaries violated, hardships balanced 106

Chapter 16 Tree encroachment
The root of the problem 111

Chapter 17 Government-owned trees
Maintenance and liability 115

Chapter 18 Trespass: a violation of possession
Ejectment, liabilities and title risks 119

Chapter 19 Nuisance: offensive, unhealthful or obstructive
Interference with use and enjoyment 126

Chapter 20 Easements, running or personal
Rights in another's property. 135

Chapter 21 Creating an easement
By grant, reservation or implication 140

Chapter 22 Interference and termination of easements
Burdens and benefits exceeded. 150

Chapter 23 Covenants, conditions and restrictions
Right-to-use limitations 154

Chapter 24 Private road maintenance costs
Repairs: who pays and how much? 160

Section D

Title and Vesting

Chapter 25 A deed as a transfer
Elements of a valid conveyance 164

Chapter 26 Delivery, acceptance and validity deeds
Need for delivery, not a recording 177

Chapter 27 Grant deed vs. quitclaim deed
The deeds of conveyance 187

Chapter 28 Preliminary title reports
An offer to issue title insurance 200

Chapter 29 Title insurance
Identifying an actual loss 203

Chapter 30 Real estate can be stolen
Adverse possession becomes ownership 219

Chapter 31 Community property rights
Brokers have a role to play 226

Chapter 32 The revocable title holding trust
A review of vestings 230

Chapter 33 Tenants in common as a vesting
We cooperate in California 240

Chapter 34 The right of survivorship among co-owners
Vesting reflects estate planning 247

Section E

Limited Liability Company

Chapter 35 Overview of the LLC
A limited partnership vs. the LLC 259

Chapter 36 LLC membership buyouts
Assigning or terminating a member's interest 274

Chapter 37 Securities aspects of LLC syndication
Excludes the economic risks of real estate. 284

Section F

Liens/ Lis Pendens

Chapter 38 The statutory purchaser's lien
Foreclosing on the seller's property. 292

Chapter 39 Unsecured carryback sellers
Vendor's lien allows foreclosure 297

Chapter 40 Mechanic's liens and foreclosures
Obligation to pay for work performed. 304

Chapter 41 Clearing a lien-clouded title
Negotiate a release to create equity. 312

Chapter 42 The lis pendens
Clouding the title with a notice 319

Chapter 43 Liens against individuals
Vesting to shield assets from others 327

Chapter 44 Automatic and declared homesteads
Home-equity shield against judgments 332

Section G

Real Estate Remedies

Chapter 45 Slander of title
False statements, oral or written 342

Chapter 46 Forcing co-owners out
Divide, sell or buy out 350

Chapter 47 Quiet title to clear title
The cloud of adverse claims removed 358

Section H

Contract Remedies

Chapter 48 — Specific performance, loan commitments and attorney fees
Future shock in a recovery 371

Chapter 49 — Declaratory relief prevents more costly litigation
Disputes resolved before closing 375

Chapter 50 — Rent skimming by buyers
Five or more is a crime 381

Chapter 51 — Getting out of litigation gracefully
Good faith settlement ends broker liability 387

Chapter 52 — Attorney fees reimbursed
By agreeement, by statute or by both 390

Chapter 53 — Retaining a real estate attorney
Choosing the right one 403

Appendix A — DRE — Anti-discrimination statutes 408

Table of Forms

for Online and CD-ROM versions

No.	Form Name	Page
460	Affidavit for Death of Joint Tenant	252
474	Amendment to Operating Agreement of Limited Liability Company	279
475	Assignment of Interest of Limited Liability Company	281
448	Declaration of Homestead	337
390	Declaration of Revocable Living Trust	236
404	Grant Deed	189
597	Notice of Nonresponsibility	309
405	Quitclaim Deed	191
409	Release of Recorded Instrument	316
378	Protective Refund Claim — For LLC Gross Receipts Tax	264
State of California Forms		
LLC-1		261
LLC-2		282
LLC-4/8		272
LLC-12		266

Introduction

Legal Aspects of Real Estate is part of the **first tuesday** series of California specific real estate study materials. Each title in the series has a different topic as its primary content. As part of a comprehensive real estate education program, the series also includes Principles of Real Estate, Real Estate Practice, Real Estate Property Management and Real Estate Finance.

first tuesday's real estate series uses plain language and eliminates the extensive overlap of identical course material commonly offered by otherpublishers. Issues arising in more than one factual setting are referenced as necessary, but are dealt with fully in only one **first tuesday** title.

Legal Aspects of Real Estate is written for California brokers, sales agents, attorneys, title attorneys, title officers, property owners and buyers and sellers of real estate. The course material is designed to be an educational tool for use in the class room and as a current technical research reference.

Legal Aspects of Real Estate presents a selection of working examples covering issues pertaining to real property estates, vestings, disputes involving neighboring properties, water rights, and restrictions on property use. Also discussed are property title conditions and insurance, conveyancing, involuntary liens, the enforcement of real estate rights, and remedies for financial recovery in a transaction gone awry. Special emphasis is placed on influential court cases which shape real estate law.

Legal Aspects of Real Estate will take the reader far be yond a minimum acceptable level of subject matter awareness and give them a crucial edge in the excit ing and lucrative California real estate industry.

Chapter 1 Origins of California real estate law

This chapter reviews the two primary historical sources of California real estate interests and conveyances.

The English and Spanish influence

Historically, California real estate law has been influenced by two key sources of human conduct:

- the English legal system, or *common law*; and
- the Spanish legal system, or *civil law*.

The **common law** of England has been the predominate influence and was officially adopted by California soon after obtaining statehood in 1850. [Calif. Civil Code §22.2]

The **civil law** of Spain, while less influential, has nevertheless left a significant impact on California real estate law.

For example, California's *community property law*, which governs property ownership between husband and wife, is derived solely from Spanish civil law.

Also, many land titles in California are based on Spanish and Mexican land grants, as are water rights.

Predominant force

The English common law system began with William the Conqueror's Norman invasion of England in 1066.

During that period, England was a fractionalized island since various invaders had established settlements, including the Angles, Saxons, Celts and even the Vikings.

Naturally, these distinctive peoples spoke different languages and settled legal disputes based on their own unique local customs.

William the Conqueror's goal was to create one uniform or **common** language and one **common** law for all of England.

The "common" law

The entire English common law system was placed in the king's court, called the *Curia Regis*.

Under the common law, legal disputes were decided on a case-by-case basis before a judge. Even today, the common law is often called "judge-made" law.

As the English language became the established language, the legal decisions of importance were written into year books.

When similar legal disputes arose, the judges would refer back to these earlier decisions written in the year books as a basis to decide current cases.

The reliance on an earlier decision to decide a current case is called *stare decisis*. The earlier case relied on is called *precedent*. The decision making process of **stare decisis** is fully applied in California today.

Common law real estate

In addition to implementing one common language and legal system, William the Conqueror is credited for creating real property law. However, private ownership as it is understood today never existed in feudal England.

Under the feudal system, the King of England was the highest source of the law and all right to the use of land had to be traced to an authorization from the king. Individuals were divided into freemen and nonfreemen, corresponding to the *freehold estates* and *nonfreehold estates* they held in real estate.

Only freemen, who usually obtained their status based on bloodline, could own and hold title to real estate. Today, an owner of a **freehold estate** owns the *fee title* to a parcel of real estate.

Ordinary individuals, called *nonfreemen*, could not own real property. They could only own personal property, called *chattels*. A nonfreeman could only possess and occupy the real estate of another. This is legally called *tenure*, from which the word "tenant" is derived.

In today's law, a **nonfreehold estate** consists of a landlord and tenant relationship. However, these estates are real estate interests, not personal property. [CC §761]

The English common law legal system was brought over to the United States during America's colonial period. To encourage colonization, the King of England granted the right to use land to tenants as long as the land was worked somehow for the crown's benefit, usually agriculture.

After the American Revolution, the United States permitted a tenant to acquire title to the real estate he occupied.

The influence of English common law in California began in earnest when the United States acquired California in 1848 after the Mexican-American War.

Spanish influence

The influence of the Spanish legal system on California began in 1542 when Juan Cabrillo landed on the beaches of San Diego Bay.

The source of Spain's legal system is traced directly to Roman civil law. **Civil law** attempts to settle legal disputes by establishing elaborate statutes to address the issues in advance of the disputes, rather than on a case-by-case basis.

The only state in the United States which retains a good deal of the civil law today is Louisiana; the source of its civil law is traced back to France.

Historical ownership

When first discovered, California was called *Alta* (or *"Upper"*) *California*.

Interestingly, the name "California" has its source in a piece of Spanish literature, *Las Sergas de Esplandian*. In the work, "California" is a mysterious island west of the Indies inhabited by giants.

Actual Spanish colonization of **Alta California** did not begin until 1769, over two hundred years after Spanish discovery.

Under the rule of Spain, all of California's real estate belonged to the King of Spain. All real estate obtained through colonization was acquired on behalf of the king. The right to use real estate came from the king's political or military agencies.

To expedite colonization, Spain established four grants of rights in land under its *Law of the Indies*:

- *missions* (religious settlements);
- *presidios* (military settlements);
- *pueblos* (civilian settlements); and
- *ranchos* (private grants).

The missions

Missions were essentially religious outposts for the Catholic Church which were operated by the Franciscans. The King of Spain granted use of the land to the Church to convert natives to Catholicism and assimilate them into the Spanish culture and way of life.

A total of 21 missions were established as settlements in Alta California along what was called *El Camino Real*, or *"The Royal Highway"*. The Catholic Church was permitted to use and occupy the land for the proposed benefit of the Native Americans. As such, the Catholic Church was considered a *trustee* of the land by the King of Spain.

After completing their colonial objectives, the missions were secularized and the land was converted into civilian settlements, called *pueblos*.

The missions did not involve many parishes and they became well established settlements. Their operations, while crude, became profitable, thus prompting the land to be highly desired by Spanish military leaders seeking to acquire private grants of land.

A majority of the missions were established at pre-existing Native American villages, called *rancherias*. Due to their locations, the missions acquired use and control over some of the best farming and grazing land in California. Naturally, once the missions were established and successful, the Catholic Church was reluctant to give up the operations of the missions.

To head off the private acquisition of the real estate surrounding the missions, the Catholic Church staked claims to the use of lands between each mission even if the land was not directly occupied for mission purposes.

Conflict between the Catholic Church and the private landowners ensued. The result was the secularization and removal of the mission operations which began under Spanish rule, but was completed under Mexican control.

The Native Americans were not given any real property rights while the real estate was managed by the missions.

The presidios

A *presidio* was a military outpost for the Spanish government established to protect the missions and pueblos and to discourage other nations from encroaching on Spain's territory.

Spain established four **presidios** in California, one in each: San Diego, Santa Barbara, Monterey, and San Francisco. The operations of the presidios were run entirely by the Spanish military.

The presidios were far less prosperous than the missions. They were established at strategic military locations without regard for good farming or ranching conditions.

However, like the missions, the presidios became established settlements of agricultural lands, grazing lands and home sites for officers and settlers. In fact, the presidios were recognized as **pueblos** by the United States government when California was acquired as a territory in 1848.

The military commander of each presidio had authority from the King of Spain to convey real estate to occupy and use within a four square *league* area around the presidio for the settlers, retired officers and traders. A **league** was approximately 4,400 acres.

Presidio lands did not prove to be the best for establishing long-term colonial settlements due to poor economic locations. Naturally, the Spanish military began to covet the prime mission land for private grants of land.

The private land grants came from the Spanish King's governor of California, who during the Spanish and Mexican rule was also the supreme military commander.

Thus, members of the military became the primary beneficiaries of the governor's private land grants (**ranchos**) of unused real estate outside the presidios, missions and pueblos.

The pueblos

A *pueblo* was an established **civilian** community separate from the Catholic Church and Spanish military. The **pueblos** were to become the urban centers in California.

Two of the key pueblos established were Los Angeles and San Jose. The Spanish government induced Spanish settlers to colonize and occupy the lands of California by offering lots of real estate for occupancy within the pueblos.

Similar to a military commander at a presidio, the mayor of a pueblo had the authority to convey four square leagues surrounding the settlement.

Settlers were granted house lots, farm lots or grazing lots by the Spanish government in exchange for improving the lots. Additionally, the settlers were granted tax benefits for working the lands. Profits from the lands were then given to the government as consideration for the conveyances.

The primary purpose of the pueblos was to solidify Spain's control of California by creating long-term communities.

However, without the ability to obtain absolute ownership of real estate, the settlers were not sufficiently motivated to work the lands. Without the motivation of ownership, the pueblos struggled. When the United States acquired California in 1848, the pueblo claims were recognized as being owned by the municipality itself, not by individual lot owners. No fee ownership could be traced to the individual citizens under Spanish or Mexican law.

The United States considered the arrangement of pueblos as Spain holding real estate in trust for the citizens. California acquired the pueblos under this *trust theory*.

Ultimately, the pueblos were given city *charters* by the new State of California. The new municipalities then conveyed fee ownership interests in the lots to the citizens who could prove they had occupied the lots.

Mexican rule

In 1821, Mexico obtained independence from Spain. After independence was declared, Mexico recognized the Spanish rancho concessions as valid private grants of land.

More importantly, the Mexican government fully secularized the missions and sought to develop the vast, unused mission lands as additional ranchos by issuing land grants.

However, Mexican rule was short-lived as the United States obtained California as a result of the Mexican-American War in 1848 — only one year before gold was struck in California.

Ranchos

A *rancho* was a private grant of land outside the missions, presidios and the pueblos. **Ranchos** were the beginning of private property ownership under the Spanish rule of California. The owner of a rancho was called a *ranchero*.

Ranchos were reserved for military leaders or heroes, high government officials or the affluent in order to encourage further development of the unused land.

Technically, the owner of a ranchero still did not have absolute ownership, but he had the *right to use and produce* off the land.

Legally, this right to use the land was called an *usufruct*. Today, California water rights are the subject of these **usufruct** rights.

Rancho grants

Under Spanish and Mexican procedures, a rancho was obtained by a written petition to the Spanish governor, along with a map and approximate legal description of the real estate in question. Legal descriptions were based on identifiable natural monuments such as trees, rocks, bodies of water, etc.

The Spanish governor would send an official to survey the proposed rancho and physically inspect the real estate to verify any other claims to possession.

Once the written petition was approved by the governor, the Spanish/Mexican government would issue a grant subject to the final approval by the provincial legislature.

The original petition, the official's survey report and a copy of the governor's grant were affixed together and stored with the California secretary's office. The grant and collective documents were called an *expediente*.

The original grant was returned to the ranchero for his own records.

American rule

The Mexican-American War ended with the signing of the Treaty of Guadalupe Hidalgo.

Under the treaty, the United States agreed to acknowledge the existing land grants conveyed by the Spanish and Mexican governments.

The United States set up a *land commission* to document the validity of the land grants. The land commission established land titles and created the chain of title still used for all California real estate today.

After confirmation of a valid land grant, the land was surveyed by the federal government and conveyed to the rightful owner by a United States *patent deed*.

All land not under a valid claim became part of the public domain of the United States.

In 1850, the United States granted part of the unclaimed real estate to the State of California. The balance was retained by the federal government.

While the **land commission** worked in a proficient and fair manner, the United States government was slow to approving many claims. Many rancheros had to wait years, even decades, before receiving a **patent deed** from the United States government.

Survey delays and protracted litigation were the prime culprits for the demise of the last ranchos. Additionally, Spain and Mexico had no recording or land indexing system to perfect and identify title to real estate.

During the appeal time, the real estate was unmarketable since most buyers did not want to take the risk of purchasing real estate with unprotected title.

Many rancheros, faced with financial ruin, sold off to Yankee speculators.

With Yankee speculators buying, or lending and foreclosing on the lands, the Spanish influence on California real estate law came to an abrupt end.

Editor's note — The primary source for material in this chapter came from the text: ***Land in California: the story of mission lands, ranchos, squatters, mining claims, railroad grants, landscrip, homesteads.****, by W.W. Robinson, The University of California Press, 1948.*

Chapter 2 Understanding real estate law

This chapter presents the powers to regulate real estate given to the state and federal governments under the United States Constitution. Also reviewed are the constitutional guarantees given to real estate owners when the government abuses its powers.

The role of the federal Constitution

All real estate law can be traced to a statute or a court decision. Consequently, to understand real estate law, it is essential to understand the source of our statutes and case law which shape current real estate practice.

The United States Constitution is the supreme law of the United States. [United States Constitution, Article VI, clause 2]

All powers which the state and federal governments possess are derived from the United States Constitution.

The United States Constitution enumerates (lists and explains) the powers of the federal government. All other powers not given to the federal government rest with the individual states or **with the people**. [U.S. Const., Amend. X]

The form of government in which individual states share powers with a national or central government is called *federalism*.

Federalism is based on the belief that certain legal problems are best handled nationally, while others are best dealt with on the state or local level. The boundary between state and federal rights is ambiguous and in constant flux.

Under federalism, the individual states remain independent (sovereign) and regulate matters within their own borders which are not controlled by the federal government.

In fact, each state has its own constitution similar to the United States Constitution to regulate state matters remaining under their control.

Still, the United States Constitution remains the basis for all rights in the country. However, a state may provide more constitutional protection than the federal government if it chooses, but it cannot provide less.

Federal and state constitutions

To illustrate the dynamic between the state and federal government, consider the following situation.

An owner operates a shopping center in a state other than California. The owner does not permit any tenant or visitor to distribute leaflets or express any public opinions on the premises unrelated to advertising the businesses located in the mall.

A political group comes onto the mall to obtain signatures to protest a government activity. The tenants of the shopping center complain the political group is driving away business.

The owner orders the political group off the premises. However, the political group believes the shopping center is a **public gathering place** and the owner cannot prohibit the expression of free speech under the United States Constitution.

The owner claims the shopping mall is **private property** and visitors who do not comply with any of the shopping center rules and regulations may be ejected.

Can the owner keep the political group out of his shopping center under the United States Constitution?

Yes! The owner may eject the political group since a shopping center is considered private property under the United States Constitution. [**Lloyd Corp., Ltd.** v. **Tanner** (1972) 407 US 551]

Freedom of speech rights provided by the United States Constitution do not extend to private property, unless the private property has been dedicated to the public.

California's expanded protection

Consider the same political activity, except with the shopping center **located in California**.

Instead of using the United States Constitution, the political group claims the **California Constitution's** freedom of speech clause (essentially identical to the federal clause) permits public protest in a shopping center.

The political group is aware an attack based on the United States Constitution is futile due to existing case law. [Lloyd, *supra*]

Can the political group, under the California Constitution, peacefully obtain signatures to protest a government activity on the premises?

Yes! The political group cannot be removed or prohibited from obtaining signatures in the shopping center. Although private property, the shopping center is open to the public. Owners of purely private property can prohibit political groups from coming onto the premises, but owners of private property open to the public cannot. [**Robins** v. **Pruneyard Shopping Center** (1979) 23 C3d 899]

Thus, these two court decisions appear to be in conflict. However, the two cases are not. California can afford **more constitutional protection** for freedom of speech on private property than the federal government under the United States Constitution does.

The United States Supreme Court recognizes California's right to extend more constitutional protection for free speech. [**Pruneyard Shopping Center** v. **Robins** (1980) 447 US 74]

Separated powers

Both the federal and state governments created under the United States Constitution are separated into three branches:

- the *legislative* [U.S. Const., Art. I];
- the *executive* [U.S. Const., Art. II]; and
- the *judicial* [U.S. Const., Art. III].

In theory, the **legislative branch** makes the law, the **executive branch** enforces and carries out the law, and the **judicial branch** interprets and settles disputes under the law.

The state and federal **legislatures** enact the *codes and statutes* which regulate some aspects of real estate.

The **executive** polices the law and establishes *regulations* to carry out the administration of government as established by the legislature.

The **judiciary** settles disputes and issues *case opinions* regarding the application of the law and regulations.

No branch may exercise a power given to another branch. However, as will be later illustrated, all three branches of the government actually make law.

This chapter focuses primarily on the legislative branch of the government. The following chapter discusses the function of the judicial branch.

Authority to legislate

The federal and state legislatures and local governments can only enact laws if they have been given the power to do so by the United States Constitution or the California Constitution. [U.S. Const., Art. I]

The authority of the California legislature to enact laws regulating real estate activities comes from three main constitutional powers:

- the police power;
- the power of eminent domain; and
- the power to tax.

The United States Constitution confers on California the right to enact laws to protect the public health, safety and welfare. [U.S. Const., Amend. X]

The California Constitution confers an equal power to local cities and counties to likewise protect the public good. [California Constitution, Article XI §7]

This power to protect the public well-being is called *police power*. **Police power** is the source of the state or local government's authority to act.

The police power is the basis for laws governing such things as highway construction and maintenance, rent control, zoning and traffic. [**Village of Euclid, Ohio** v. **Ambler Realty Co.** (1926) 272 US 365]

A statute or ordinance passed under the government's constitutional police power and affecting real estate related activity will be valid as long as the law:

- is fair and reasonable;
- reaches a legitimate state interest;
- does not unreasonably burden the flow of interstate commerce; and
- does not conflict with related federal law.

Eminent domain

The second key power of the state to regulate real estate is the power of *eminent domain*. [Calif. Const., Art. 1 §19]

Eminent domain is the right of the government to *take* private property for public use.

However, the government must pay the owner the fair market value of the property taken. [**Loretto** v. **Teleprompter Manhattan CATV Corp.** (1982) 458 US 419]

The process of using the power of eminent domain is called *condemnation*.

Examples of eminent domain include condemning property to provide highways and roads, establish parks, construct flood control levees and provide land for redevelopment.

Inverse condemnation

The government's exercise of police power may actually become a **taking** of an owner's real estate.

For example, an owner demolishes his beachfront bungalow. The owner intends to rebuild a better home and submits an application to the coastal commission which has been given jurisdiction over the use of beachfront property by the legislature.

A public beach is located nearby, but not directly adjacent to the owner's real estate.

The costal commission wants the owner to grant access to the public beach across his beachfront property to allow people to reach the public beach by walking on the beachfront located on his property.

The costal commission claims its goal is to allow better public viewing of the coastline.

The costal commission grants the owner a permit to build, conditioned on the owner granting to the public a frontage easement across his beachfront property.

The owner refuses the condition unless the costal commission pays for the easement. The costal commission denies the owner's application and permit to build, claiming it is reasonably exercising its police power.

Does the costal commission have to pay for the easement across the owner's beachfront?

Yes! The costal commission has not merely restricted the owner's use of his land, it has required him to deed an interest away in the form of a frontage easement. [**Nollan** v. **California Coastal Commission** (1987) 483 US 825]

Had the costal commission condemned and taken the easement by its power of eminent domain, it would have had to pay for the strip.

Thus, conditioning a permit to build on the granting of an easement to the public is a taking which also requires **reimbursement** to the owner from the governmental agency. In this case, the costal commission could not show the requirement of the easement related to a legitimate state interest.

However, most California inverse condemnation cases filed by owners fail. California courts do not want to burden local governments with the obligation of paying for any diminution of property values which result each time it regulates or downgrades the use of real estate. [**First English Evangelical Lutheran Church of Glendale** v. **County of Los Angeles** (1989) 210 CA3d 1353]

The power to tax

A crucial power for the state and local government to regulate is the **power to tax** real estate activities to generate revenue to fund state and local governmental functions. [Calif. Const., Art. XIII D §6]

The power to tax is frequently used to fund and implement the goals of the state and local governments under its police power.

For example, a city passes an ordinance which imposes an **inspection fee** on all landlords renting residential properties based on a flat rate per unit, not current property values.

A landlord subject to the ordinance claims the ordinance is unenforceable since the city must have voter approval before adopting an ordinance which would impose a regulatory fee on property.

The city claims the ordinance is enforceable without voter approval since the fee is imposed on a **use** of the property — renting — not on the mere ownership of the property, which would require voter approval.

Here, the ordinance imposing the inspection fee on landlords based on a flat rate is enforceable. Voter approval is only required when fees and taxes are imposed on owners simply because they own real estate. Fees and taxes imposed on the owner's exercise of his uses and rights which come with owning the property do not require voter approval. [**Apartment Association of Los Angeles** v. **City of Los Angeles** (2001) 24 C4th 830]

Federal authority to regulate

The federal government's authority to regulate real estate also comes from the United States Constitution.

Like the state, the federal government has the power to tax and the power to take private property for public use. [U.S. Const., Amend. XVI; Calif. Const., Art. 1 §19]

However, the federal government has no police power. In its place, the federal government has a very powerful clause to regulate areas of federal concern, called the *commerce clause*.

The federal government has the right to regulate all commercial enterprises which affect **interstate commerce**.

Originally, the clause was designed to combat attempts by local states to pass protectionist laws under their police powers which would inhibit the flow of goods in interstate commerce. [**Gibhons** v. **Ogden** (1824) 22 US 1]

The **commerce clause** was at one time commonly called the *interstate commerce clause*.

Today, the clause also applies to local and intrastate activities which have an indirect effect on the flow of goods, services and people from state to state.

For example, an owner runs a motel located off a state highway occupied by travelers visiting in-state. The motel owner refuses to rent to minorities.

The federal government sues the owner, claiming his conduct violates the federal Civil Rights Act.

The owner claims his motel business is purely local and Congress (the federal legislative branch) has no constitutional authority to regulate his entirely local business.

The federal government claims its authority is derived from the commerce clause and the owner's refusal to rent to minorities inhibits the flow of interstate commerce — which includes the mobility of people.

Does the federal government have the right to regulate local business that may only have a slight impact on interstate commerce?

Yes! The federal government's interest in the flow of commerce between states outweighs the owner's right to exclude minorities. [**Heart of Atlanta Motel, Inc.** v. **United States** (1964) 379 US 241]

The ability of the federal government to regulate a purely local activity even extends to local real estate brokers' activities within their associations.

For example, a broker sues the local association of realtors for federal **antitrust violations**, claiming the association **fixes rates** charged by its members for their services.

The association ostracizes brokers who refuse to comply with the fee-setting policy which are established by the association to maintain a minimum acceptable level of income for real estate professionals.

The association claims its activities are totally local and the federal government cannot regulate the activities as their services are purely local and do not affect interstate commerce.

Do the federal antitrust laws cover local brokerage activities?

Yes! The association's fee-setting of the charges for their members' services affects housing locally, which in turn affects the desire to live in the area, which in turn affects interstate commerce. [**McLain** v. **Real Estate Board of New Orleans, Inc.** (1980) 444 US 232]

Editor's note — California has its own antitrust laws covering price fixing by California real estate brokers and their associations. Thus, suits could be brought under state or federal law, another example of overlapping applications within the federal system. [Calif. Business and Professions Code §16600; ***People*** *v.* ***National Association of Realtors*** *(1984) 155 CA3d 578]*

Federal and state law conflicts

The states have the sovereignty to regulate within their own borders. At the same time, the federal government has the right to regulate local activities affecting commerce.

What happens when federal and state law conflict? Consider the following example.

An airport is established under the Federal Aviation Act of 1953. The airport expands its number of late night and early morning flights. The residents around the airport complain of the noise during late and early hours.

The city where the airport is located passes an ordinance restricting the number of flights between 11 p.m. and 7 a.m.

The airport objects, claiming it was established under the sole jurisdiction of federal law and the Federal Aviation Act of 1953 set forth by the Federal Aviation Administration (FAA) which has no restriction on flights between 11 p.m. and 7 a.m.

Does the federal law *preempt* (supersede) state law?

Yes! The goals of national flight service and the role of the FAA outweigh local laws inhibiting flight times. [**City of Burbank** v. **Lockheed Air Terminal, Inc.** (1973) 411 US 624]

A federal law will **preempt** state and local statutes and ordinances when:

- the federal interests outweigh local interests;
- the federal law is so pervasive as to exclude inconsistent state law; and
- inconsistent treatment nationwide would result if state law controls.

Thus, it is possible for federal and state law to regulate the same real estate activity.

For example, there are federal and state fair housing laws prohibiting discrimination. Both the state and federal governments can regulate **fair housing**. The state may provide more but cannot afford less protection than the federal law. [Calif. Civil Code §51]

Constitutional guarantees

The United States Constitution gives owners guarantees when the federal or state government attempts to usurp their powers.

Two key constitutional guarantees exist for real estate owners:

- the *due process clause*; and
- the *equal protection clause*.

Under the **due process clause**, the government must deal fairly with real estate owners.

Even if the owner does not win his case, the courts will oversee that he will be treated fairly by the government.

The due process clause covers both:

- the content of laws, called *substantive due process*; and
- how the government procedurally applies those laws, called *procedural due process*.

For example, a city places a tax on parking lot owners to fund traffic services.

The parking lot owners feel the tax is excessive and an unfair burden on their business. The parking lot owners claim the tax violates the due process clause of the United States Constitution.

The city claims the parking lot tax is a reasonable exercise of its police power.

If the tax itself is unreasonably high and burdensome, it violates the due process clause in the United States Constitution and would be invalid. [**City of Pittsburgh** v. **Alco Parking Corp.** (1974) 417 US 369]

However, if the tax does not overly burden owners, the tax survives a **substantive due process** attack.

Procedural due process

Procedurally, an owner must be given **notice** of any government action or law and an **opportunity** to be heard on the matter. [**Mullane** v. **Central Hanover Bank & Trust Co.** (1950) 339 US 306]

For example, a city passes a zoning ordinance restricting the extent to which a newsstand can block a city sidewalk. Additionally, the city delegates to itself the authority to seize and close newsstands it feels violate the ordinance.

A newsstand owner's business is closed by the city government without warning to the owner. The city claims it may do so since the ordinance exists.

Does the city's seizure and closing of the owner's newsstand violate the owner's due process rights?

Yes! The city did not provide the newsstand owner with a notice of the violation or an opportunity to be heard before his business was closed. [**Kash Enterprises, Inc.** v. **City of Los Angeles** (1977) 19 C3d 294]

Equal protection

Equal protection laws provide for similarly situated persons to be treated similarly under the law.

For example, a subdivision's covenants, conditions and restrictions (CC&Rs) contain a restriction limiting sales to nonminorities only.

A minority couple seeks to purchase a home, but the CC&R restriction is enforced by the association governing the subdivision.

Does the restriction violate the couple's rights to **equal protection** under the law?

Yes! Enforcement of the restriction would unfairly separate buyers into arbitrary and suspect classifications. [**Shelley** v. **Kraemer** (1948) 334 US 1]

Judicial decisions

The preceding discussion addressed the legislative authority to enact laws.

However, the other two branches of government (the executive and judicial) also create law. In theory, only the legislative branch can enact laws and no branch of the government may exercise the powers of another.

Every time a judge interprets a statute or a prior case decision, a new **common law** is created by the opinion produced in his decision. It is as if the legislature introduced and passed an amendment into existing law, and the governor signed the amendment into law.

For example, each time the Civil Rights Act is analyzed and applied to the facts of a case before a judge, the opinion is written in light of prior case law *interpreting* the Civil Rights Act.

Administrative agencies

As general real estate law becomes more specialized, the role of administrative agencies become increasingly important.

Many **administrative agencies** are given the powers of all three branches of the government: legislative, executive and judicial.

For example, consider a rent control board established by a local city council under *rent control ordinances*.

The board is given authority to enact regulations to implement the **rent control ordinance**. This enactment of regulations is a legislative activity.

The board is also given the power to hear disputes between tenants and landlords, and dispense penalties for a landlord's failure to comply with the law. This is a judicial activity.

In this way, the administrative rent control board has the authority to enact regulations (entailing legislative authority) and hear disputes and administer penalties for noncompliance (entailing judicial authority).

A landlord can always go to court to determine whether the board has overstepped its power and gone too far.

The trend with the courts is to continue to give administrative agencies the necessary powers to judge cases involving their own regulations. Thus, the courts themselves are relieved of processing and resolving these disputes.

Chapter 3 Understanding the court system

This chapter contrasts the federal and state court systems, the basic structure of each and the interplay between the two systems.

Federal and state

The durability of a market-place society depends largely on the laws it has established for the ownership of property, the enforcement of contracts and the independent operations of courts and their judges to resolve disputes. Without courts, no system of governance can endure.

Thus, two separate and mutually exclusive court systems have been established to hear disputes arising in California: the **state courts** and the **federal courts**.

Whether a legal dispute belongs in the state or federal court system depends on whether the court has *jurisdiction*.

Jurisdiction is the power of a court to hear a case and rule on a legal matter. Jurisdiction is granted to a court by the state or federal Constitution, the state legislature or Congress.

Two types of jurisdiction exist within each court system:

- jurisdiction over the **subject matter** of the lawsuit, such as the ownership of real estate; and
- jurisdiction over the **parties** to the lawsuit, such as a buyer and seller.

State court jurisdiction

The state of California has a three-tiered court system: trial courts, appellate courts and the Supreme Court. The trial court in the California state court system is named the *superior court*. [California Constitution, Article VI §4]

Prior to June 1998, California's trial courts consisted of both municipal and superior courts. The municipal and superior courts were unified in June 1998 as the superior court. Today, all legal disputes, both civil and criminal, are filed in **superior court** unless jurisdiction has been given by statute to a separately established court. [Calif. Const., Art. VI §10]

One superior court exists in the State of California, with courthouses in each county, totaling 58. In practice, each county is referred to as having its own superior court, for example, the San Benito Superior Court.

Within the superior court system, proceedings where the amount in controversy is more than $25,000 are classified as *unlimited civil actions*. [Calif. Code of Civil Procedure §§86, 88]

Limited civil actions involve legal disputes of $25,000 or less and dispense some equitable remedies. [CCP §86]

For example, foreclosure of *mechanic's liens* for a dollar amount less than $25,000 may be brought as a limited civil action in superior court. [CCP §86(a)(6)]

Additionally, a limited civil action can *rescind or reform* contracts as long as any money dispute is $25,000 or less, called *equitable remedies*. [CCP §86(a)(3)]

An **equitable remedy** is a **non-money remedy** and is based on issues of fairness. Specific performance of a purchase agreement or an injunction ordering a nuisance to be stopped are examples of equitable remedies.

To better allocate the caseload of the superior court, each superior court contains a *small claims* division. [CCP §116.210]

The **small claims** division of each superior court has jurisdiction over disputes involving $5,000 or less. [CCP §116.220(a)]

Small claims courts are very informal, barring the use of an attorney to represent a party. The court's rules are designed for quick resolutions of minor legal disputes.

The small claims courts have the authority to issue equitable remedies including rescission, restitution, reformation and specific performance. [CCP §116.610]

A superior court limited civil action may be filed in a small claims court if it falls within the small claims jurisdiction. In this event, small claims court rules govern. [CCP §87]

Venue in the county of the land

Selecting the branch (county) of the superior court which is the proper location to hear a legal dispute depends on *venue*, not jurisdiction.

Venue is often confused with *jurisdiction*. **Jurisdiction** is concerned with which **type of court** is empowered to hear the subject matter of a dispute, such as the superior court or the small claims division within it, or whether the case will be heard in state or federal court.

Venue determines the physical **location of the court** which has jurisdiction and is the correct forum to hear the matter. [CCP §§392 et seq.]

In other words, jurisdiction refers to the **power** of a court to decide a case, venue in the state court refers to the **location** of the court by county.

For example, the proper venue for suits involving real estate is in the county where all or part of the real estate is located. [CCP §392(a)(1)]

For contracts, the appropriate venue is where the contract was entered into or is to be performed, or where the defendant resides. [CCP §395(a)(1)]

Most promissory notes indicate where payment is to be made to establish where the contract (the note) is to be performed.

Federal jurisdiction of limited use

The federal courts are constitutionally established courts of *limited jurisdiction*. [United States Constitution, Article III §2]

Thus, the federal courts are strictly limited in the types of cases they can hear and decide. On the other hand, the state courts are considered courts of *general jurisdiction* as they are not limited to certain types of controversies.

Unless a party suing can show his case belongs in federal court, it must be brought in a state court. [Federal Rule of Civil Procedure 8(a)(1)]

For the purposes of real estate law, a federal court has jurisdiction over two types of cases:

- disputes involving questions of federal law; or
- legal disputes between citizens of different states.

A federal law case is any case arising under the United States Constitution or the laws or treaties of the United States, regardless of the dollar amount of the lawsuit. [28 United States Code §1331]

Thus, a suit under federal antitrust law, federal securities law or federal fair housing law may be brought in federal court without regard for the amount of monetary loss involved.

However, most suits involving federal law do not have to be brought in federal court. The action is permitted in state court.

It is up to the defendant to remove a federal law case to the federal courts if originally brought in a state court, called *removal*.

The federal courts can refuse to hear a case otherwise properly heard in federal court if a legitimate state interest is involved and the federal court believes the state courts should resolve the issue. [**Burford** v. **Sun Oil Co.** (1943) 319 US 315]

For example, a federal court can refuse to hear a case under a federal law claim if the state has an elaborate regulatory scheme covering the issue, such as in water rights. [**National Audubon Society** v. **Department of Water & Power of the City of Los Angeles** (9th Cir. 1988) 858 F2d 1409]

Additionally, the federal court may require the parties to exhaust their state court rights before suing on federal court grounds, such as interfering with lake front views. [**Sinaloa Lake Owners Association** v. **City of Simi Valley** (9th Cir. 1989) 882 F2d 1398]

In some cases, the federal courts have *exclusive jurisdiction*, such as in admiralty, patent law, or bankruptcy cases, which state courts cannot decide.

Some government agencies are granted the authority to create and enforce federal regulations, such as the U.S. Food and Drug Administration (FDA) and U.S. Environmental Protection Agency (EPA). After Congress passes a law, these agencies create *regulations* designed to implement and enforce the new law. General notice of the proposed regulation is published in the Federal Register and interested persons are given the right to challenge the regulation. [5 United States Code §553]

An *Administrative Law Judge* (ALJ) hears the dispute. The ALJ and is granted authority by the Administrative Procedures Act (APA) to regulate the course of the hearing, rule on offers of proof, receive relevant evidence, subpoena witnesses and records, and make or recommend legislation. [5 USC §556(c); 1305]

Once a regulation is implemented, it is published in the Federal Register and the Code of Federal Regulations (CFR).

ALJs also exist on the state level and hear disputes amongst government agencies, such as the California Department of Consumer Affairs, over matters such as environmental protection or labor management relations.

Interstate citizens have diversity

Legal disputes between citizens of different states can also be brought in federal court as long as the dollar value is $75,000 or more, excluding interest and costs. [28 USC §1332]

These cases are called *diversity of citizenship* cases. **Diversity of citizenship** also applies to suits involving disputes between citizens of the United States and foreigners or foreign nations. [28 USC §1332(a)]

A party filing an action in federal court based on diversity of citizenship must first establish whether the court has jurisdiction to hear the matter. [FRCP Rule 8 (a)(1)]

The theory behind a diversity of citizenship case is to prevent one party from obtaining an unfair "home court advantage" in one state against a party from another state.

State/federal court strategies

When a federal court accepts a case between citizens of different states it must decide which state law to apply. Ordinarily, the court will apply the state law where the federal court is located. [**Erie R. Co.** v. **Tompkins** (1938) 304 US 64]

However, the court will weigh the interests of each state on the result of the case. The question of which state law applies occasionally determines the success or failure of a case.

Consider an Arizona resident who owns real estate in Arizona. He decides to sell his real estate and believes buyers in California would be interested in his property.

The Arizona seller lists the property with a California broker who is not licensed in Arizona. The seller signs the listing agreement at his residence in Arizona.

The broker locates a buyer in California and prepares an offer to purchase the property. The seller accepts the offer in Arizona and opens an escrow in California.

The broker performs all his brokerage activities related to the transaction in California. The broker does not cooperate with an Arizona broker.

Later, when the purchase agreement can no longer be unilaterally terminated by either party, the buyer and seller collusively agree to cancel the transaction.

The broker demands his fee from the seller for producing a ready, willing and able buyer.

The Arizona seller denies any brokerage fee is owed since the real estate is located in Arizona and the broker does not hold an Arizona real estate broker license and did not cooperate with an Arizona broker.

For the purpose of protecting its residents, Arizona law requires a broker to have an Arizona license to enforce collection of a fee in Arizona courts. For the same reason, California law requires a broker to have a California license to enforce collection of a fee in California courts.

Where is the best place for the broker to sue the seller for his fee?

California! The broker is licensed in California and performed all his brokerage activities in California. The broker's best chance to enforce collection of the brokerage fee is in a California superior court. [**Cochran** v. **Ellsworth** (1954) 126 CA2d 429]

Legal maneuvers and choice of law

What legal maneuvers could the seller use to avoid paying the brokerage fee based on subject matter jurisdiction of the federal courts?

Procedurally, the Arizona seller must get the case out of the California court system as California will apply California law and award the California broker his fee.

Strategically, the Arizona seller wants the case removed to Arizona to increase the broker's costs of bringing the suit.

However, it is unlikely the case would be properly removed to Arizona as California has a vested interest in the legal result since the broker and escrow are controlled by legislation relating to their conduct, and the transaction was to be performed (escrowed) in California. [**University Financing Consultants, Inc.** v. **Barouche** (1983) 148 CA3d 1165]

Thus, the seller should attempt to remove the case to federal court, if the fee exceeds $75,000, since the suit involves citizens of different states.

However, even if the seller is able to remove the case to federal court, it would not be advantageous for the seller as the federal court would be located in California and would likely apply California law, resulting in the broker receiving his fee.

The seller's next step is to transfer the case from the federal district court in California to a federal district court in Arizona based on *venue*. [28 USC §1404]

If the federal courts have jurisdiction over the dispute, the next question is which federal district court is the proper **venue**.

Naturally, the Arizona seller would claim the Arizona federal district court is most appropriate since:

- the seller is a resident of Arizona;
- the seller signed the listing agreement employing the broker in Arizona; and
- the real estate is located in Arizona.

On the contrary, the broker will claim California is the proper forum since:

- the brokerage activities justifying payment of the fee occurred in California;
- the sale was escrowed in California; and
- the buyer is a Californian.

A federal court judge decides the correct forum to resolve the dispute. [**Consul Limited** v. **Solide Enterprises, Inc.** (9th Cir. 1986) 802 F2d 1143]

However, one final issue remains no matter which court, state or federal, hears the dispute: which state law applies, Arizona or California?

Naturally, the Arizona seller wants Arizona law to apply. No brokerage fee is owed under Arizona law unless the California broker is also licensed in Arizona or worked on the transaction in cooperation with an Arizona broker.

If the state law to be applied is not agreed to in the listing agreement, then the state law applied will be based on the state with the greater interest in the result.

Brokers with interstate practices eliminate this uncertainty by inserting a California *choice-of-law* clause in the listing agreement. With a **choice-of-law** clause, the parties agree in advance which state's law will apply if a dispute arises. Had the California broker entered into a listing agreement calling for Arizona law to apply, he would have been agreeing the fee provisions in his listing agreement were unenforceable. [See **first tuesday** Form 102 §4.7]

Jurisdiction over a person's fate

In addition to subject matter jurisdiction, a court must have jurisdiction over the person being sued, called *personal jurisdiction*. [CCP §410.10]

For *constitutional due process* purposes, a person being sued in California must have at least *minimum contacts* with the state. [**International Shoe Co.** v. **State of Washington, Office of Unemployment Compensation and Placement** (1945) 326 US 310]

California has interpreted **minimum contacts** to include:

- residence in the state;
- a legal appearance to defend the legal action [**RCA Corporation** v. **Superior Court of City and County of San Francisco** (1975) 47 CA3d 1007];
- doing business in the state [**McGee** v. **International Life Insurance Company** (1957) 355 US 220];
- torts committed within the state;
- torts committed outside the state which directly affect activities inside the state [**Buckeye Boiler Company** v. **Superior Court of Los Angeles County** (1969) 71 C2d 893];
- contracts entered into, negotiated or to be performed in the state [**Beirut Universal Bank S.A.L.** v. **Superior Court for County of Los Angeles** (1969) 268 CA2d 832];
- ownership or use of real estate within the state; or
- availing oneself of the benefits of California laws. [**Quattrone** v. **Superior Court for County of Los Angeles** (1975) 44 CA3d 296]

The **long-arm** of California's **personal jurisdiction law** tends to extend quite far, long enough to haul out-of-state or out-of-country defendants into the state to defend themselves.

The out-of-state or out-of-county defendant must receive proper service of process (notice of the lawsuit) to implement personal jurisdiction. [CCP §§413.10 et seq.]

Trial and appellate courts

Both the federal and the California courts have a three-tiered system: trial courts, appellate courts and one Supreme Court.

As previously discussed, the principal trial court in California is the superior court, with its jurisdiction divided between *limited* and *unlimited civil cases* as well as a *small claims* court division.

The main trial court in the federal system is called the *district court*.

Other trial courts exist in the federal system to hear claims in particular areas of law, such as the:

- United States Bankruptcy Court;
- United States Tax Court; and
- United States Claims Court.

The principal task of the federal trial courts is to decide what are the facts of a case and apply the proper rules of law to resolve the dispute.

A lawsuit is filed then evidence is presented and testimony is given at trial. The facts of the case are determined by the trial court judge (or jury) after everyone has presented their case.

The trial court applies the relevant rules of law to the facts it has determined to exist, and a judgment is handed down as the judge's decision in the case.

In the state courts, the trial court opinions are not published. However, a limited number of opinions in federal trial court cases are published.

The losing party on the trial court level can appeal the judgment to the appellate court.

The appellate court has the authority to review whether the trial court:

- used the appropriate law to decide the case; and
- properly applied the law.

Determining the facts of a case when the evidence is in dispute is the exclusive domain of the trial court. Thus, the appellate court does not have the authority to decide which facts to believe as long as some substantial evidence exists to support the facts.

The appellate court selects which opinions are published to become the basis of future trial court decisions.

Supreme Court petitions over errors

The final court for appeals in both the state and federal court systems is the *Supreme Court* of each.

With the exception of certain criminal law cases and procedural cases, the **Supreme Court's** review of most appellate decisions is entirely discretionary.

The losing party before an appellate court may *petition* the Supreme Court by asking the court to review the appellate court decision for its correctness.

The **petition** is accepted or rejected by the United States Supreme Court or California Supreme Court.

If the case is accepted, the court is said to grant *certiorari* to review the case.

Only a very small percentage of the cases appealed to the Supreme Courts are ever accepted and heard.

As a result, the opinions of the appellate courts most often become the final statement of the law.

Supreme Court decisions are also published and become the highest statement on the law, to be followed by all of the lower courts within their jurisdiction.

Chapter 4 Judicial and political systems in action

This chapter reviews the constitutional and real estate principles employed to expand mortgage law and diminish ownership rights during the 1980s by use of the judicial and political systems.

Toying with rights

To understand the inter-relationships of the federal and state court systems, and the three branches of each of these governments, several evolution-of-law scenarios must be considered.

For example, in 1975, a buyer with the help of his real estate broker locates a single family residence (SFR) to occupy as his home. The buyer wants to acquire the real estate by taking over the seller's advantageous, low-interest 30-year loan.

The buyer makes an offer to take over payments on the seller's existing loan. The buyer will take title *subject to* the lender's trust deed. However, a **due-on clause** exists in the lender's trust deed, also called an *alienation clause*.

On the transfer of ownership to the buyer, the lender calls the loan. The lender claims the due-on clause gives it the legal opportunity when the owner transfers the property to either:

- adjust its loan **portfolio yield** upward to current market levels; or
- call the loan.

The lender notifies the buyer he is qualified to assume the loan, but only on the condition the **loan is modified** — recast to reflect current market interest rates — which is exactly what the buyer is trying to avoid by taking over the seller's advantageous loan.

Thus, the stage is set for a legal dispute between the buyer and the lender — their goals and objectives being mutually irreconcilable:

- the buyer wants to purchase the real estate subject to the seller's existing loan without the lender interfering with his purchase; and
- the lender wants to increase its portfolio yield by recasting the loan to the current, higher interest rates on the purchase.

Unable to exact its demands for a loan assumption when the buyer becomes the owner of the property, the lender calls the loan. The buyer refuses to pay the loan in full and foreclosure is commenced.

Codified common law to the rescue

For relief from lender interference, the buyer engages the primary source of California's **real estate law** — the *common law*. **Common law**, as adopted by California in the 1872 codes, prohibits any **unreasonable interference** with the transfer of a real estate interest, a legal rule called *conditions restraining alienation.* [Calif. Civil Code §711]

The buyer, based on California's codified common law, claims the lender is **unreasonably interfering** with his purchase and ownership of the real estate.

The lender claims **contract law** principles control, not real estate law, since trust deed provisions permit the lender to call the loan due on any sale.

The California Supreme Court holds the lender must permit the buyer to assume the existing loan, unless the buyer is *uncreditworthy* or poses an unnecessary risk of *impairment* to the real estate, such as would an insolvent arsonist. California real estate law, which pre-existed the trust deed agreement, prohibits enforcement of the terms of any agreement which unreasonably interfere with an owner's right to sell, buy, lease or encumber real estate. [**Wellenkamp** v. **Bank of America** (1978) 21 C3d 943]

The rationale for the rule against **conditions restraining alienation** is to keep unfettered and commercially available interests in real estate which have value in the marketplace — a foremost concern to buyers, sellers and brokers.

Wellenkamp, with its facts of an institutional lender holding a first trust deed on a single family, owner-occupied property, was next applied to a private lender's second trust deed loan on income-producing real estate.

As a result, the same due-on rule applies to all types of real estate interests, all types of lenders and all interests which have priority to the ownership. [**Dawn Investment Co., Inc.** v. **Superior Court of Los Angeles County** (1982) 30 C3d 695]

However, for lenders operating in California, the legal battle over interferences with the transfer of ownership interests in real estate did not end with the California courts.

Federal law interplay

Lenders in California were then faced with a dilemma: how could they avoid California's due-on rules prohibiting the adjustment of portfolio yields by recasting fixed rate loans and payment schedules on the sale of the secured real estate, and still make loans in California? Politically, an important fact to remember is nearly 30% of all mortgage funds lent in the United States are lent in California.

The lenders' solution to the due-on problem was to attack the seller's sale by applying **federal** law, since a federal law covering the same legal issue supersedes state law to the contrary, called *preemption*. [United States Constitution, Article VI, clause 2]

Now consider the same facts as our previous example, except the lender is a federally chartered savings and loan (S&L), now called a *thrift*.

In 1976, what is now the Office of Thrift Supervision, a federal agency under which federally chartered thrifts operate, adopted a regulation permitting federally chartered S&Ls to automatically accelerate a loan based on the sale of the secured real estate.

The owner transfers the property subject to the federal S&L loan after the federal regulation is adopted and the lender calls the loan.

The legal dispute is heard in a California appellate court. The court holds the federal regulation does not supersede state law since the regulation requires the S&L to follow state real estate law which preserves the lender's security in the real estate. [**de la Cuesta** v. **Fidelity Federal Savings and Loan Association** (1981) 121 CA3d 328]

Meanwhile, other federal S&Ls attempted to fight the battle in federal courts. From the S&Ls' point of view, the federal courts will prevent the application of the paramount California ownership law since the dispute would be decided on the federal S&Ls' "home court."

However, the federal appellate court refuses to hear the cases, sending the due-on disputes back to the state court system, called a *removal*, citing the legitimate state law interest involved. [**Nalore** v. **San Diego Federal Savings and Loan Association** (9th Cir. 1981) 663 F2d 841]

Under California's state law analysis, the federal S&Ls were required to comply with California's due-on rules like all other lenders. A further appeal by the federal S&Ls was made. The United States Supreme Court accepted the federal S&Ls' appeal for relief. [de la Cuesta, *supra*]

The legal drama was reaching its climax after four years (1978 to 1982) of decisions adverse to lenders under California state law.

As a result, the United States Supreme court held federal S&Ls could enforce their due-on-sale clauses — even if the buyer is creditworthy and poses no risk to the lender's security interest in the real estate. The 1976 federal mortgage regulation was declared to supersede conflicting state rights under real estate ownership laws. [**Fidelity Federal Savings and Loan Association** v. **de la Cuesta** (1982) 458 US 141]

Legally, this federal S&L decision left the remaining financial world in an uproar. All other lenders, including state S&Ls, banks and private lenders could not unreasonably enforce the due-on-sale clause under state law by calling a loan while the federal S&Ls could under federal law (which depressed the rates charged by federal S&Ls).

The state S&Ls, private lenders and banks had no federal regulation to rely on to preempt the state law due-on application designed to protect ownership, unless the transfer impaired their security.

The solution for all lenders

In response, lenders induced Congress — the legislative branch of the federal government — to enact a federal law which would apply to all types of real estate lenders, permitting them to retroactively enforce the due-on-sale clause since the federally chartered S&Ls now could.

As a result, Congress enacted laws establishing a level playing field for all lenders on all types of real estate and mobilehomes based on the rights of federal S&Ls, not state's rights, called the *Garn St. Germain Federal Depository Institutions Act of 1982* (Garn Act). [12 United States Code §1701j-3]

Congress then delegated its authority to the Federal Home Loan Bank Board (FHLBB) to enact regulations to implement the *Garn Act* controlling the due-on conduct of all private and institutional real estate lenders. [12 Code of Federal Regulations §591]

The legal cycle was complete

All lenders on California real estate with a due-on-sale clause in their trust deeds could now enforce the due-on clause without regard to state law or to the creditworthiness of the buyer.

In little more than four years following 1978 (plus a restrictive three-year phase-out, phase-in period) there was a complete turnaround in the law. The lender's power brokers (lobbyists) in the halls of Congress had the last word, not real estate brokers.

Thus, an owner who sold his real estate in 1978 subject to a trust deed with a due-on-sale clause (held by a non-federal S&L) could avoid the lender's interference with his sale to a legitimate buyer.

However, if the same owner elected to wait until 1983 to sell the same real estate subject to the same trust deed, he was exposed to the lender's interference with his sale. This change in the law resulted in a shift in wealth, from equity in real estate to interest payments on loans. As a result, homeownership slumped for the next 20 years.

State legislative changes

The *political exploitation* by lenders and owners of the three branches of government is equally relevant for California state law issues.

For example, in 1982, a tenant in a commercial complex wants to sell his business opportunity.

The rental rate under the tenant's long-term lease is far below current market rates. The landlord failed to anticipate the inflation of future operating costs and local market demands when negotiating rent provisions in his lease agreement with the tenant.

The lease permits a transfer of the tenant's interest in the lease, but only with the landlord's prior consent. Further, the business opportunity buyer has good credit and a strong financial statement and operating history.

The landlord wants to block the transfer and bring in a new tenant at market rates, or permit the proposed transfer on an adjustment of the rent to current market rates. Thus, the landlord refuses to consent to the transfer.

The tenant claims the landlord's refusal to consent is an **unreasonable restraint on alienation**, which is an application of the *Wellenkamp* doctrine to the transfer of other types of ownership interests (leasehold estates) in real estate besides the fee. A leasehold assignment, like a sale and conveyance of the fee, is a transfer of an interest in real estate. [CC §761]

The California Supreme Court held a landlord could not block the sale and transfer of the tenant's leasehold interest unless the landlord has a **commercially justifiable reason** — the same rationale used to block lender interference on sales of fee interests in real estate. [**Kendall** v. **Ernest Pestana, Inc.** (1985) 40 C3d 488]

California landlords could not contractually limit the transfer of nonresidential leases by the tenant. The market place for the sale and assignment of real estate leasehold interest remained open and unfettered by interferences by landlords and lenders.

The landlord's solution to shift wealth

Lobbyists induced the passage of state legislation to eliminate the *Kendall* decision and allow landlords to interfere with leasehold assignments for economic gain. The legislation shifted wealth from tenants to landlords by reducing the value of the business opportunity and increasing the rent paid to the landlord.

Landlords, like lenders, sought and obtained special legislation to reach their economic objectives – to shift wealth their way as a change in any civil law is meant to do.

Now, by contracting for a clause prohibiting an assignment of the lease or subletting of the premises, landlords can arbitrarily refuse consent or totally prohibit the transfer of the tenant's interest in a lease. [CC §§1995.210 et seq.]

Real estate dynamics in a democracy

This review of lender interference is not to be interpreted as an indictment or criticism of the legal and political systems real estate owners and brokers operate under. Rather, this review is intended to illustrate how legal and political systems function.

Legal and political decisions about real estate are not made in a vacuum — state residents are affected. As a result of legal and political decisions, the law is not static. Thus, the law of real estate is driven by economic forces and forged by the political process.

The dynamic and ever changing nature of mortgage and real estate law is often taken captive by the desire to shift wealth and change opportunities. The result for real estate brokers is a destabilizing constriction in the resale of real estate and volatility in real estate market values when interest rates rise.

These past judicial and political events, as well as the processes through which our legal and political system works, provide an insight into the real estate laws of the future. These deep-rooted and conflicting lender-ownership issues, like a pendulum, return to be readdressed and altered again and again, subject to the political and economic winds of the time.

Chapter 5 How to read and use legal cites

This chapter reviews the use of code and case indexes as tools for further research and study, as well as the use of legal citations to locate the law applied to a particular real estate activity.

Fundamentals underpinning real estate activities

Every aspect of real estate conduct is influenced, if not fully controlled by, a case, statute or regulation called a *citation*, or *cite* for short. **Citations** refer to California and federal laws and are classified by cases, statutes and regulations. Judicially, the relevant citations are applied to the facts in dispute before the court.

To obtain the maximum benefit from this study material, the reader must understand:

- the purpose for our use of cites;
- the location in this study material of other writings based on the cites;
- where to obtain copies of the cites; and
- how to apply these **case rulings**, **statutes** and **regulations** to daily real estate activities.

Prudent readers truly interested in real estate should know how to locate copies and read the important cases, statutes and regulations which affect their real estate business and holdings.

The primary study purpose for our use of citations is to provide the reader with a **legal reference** for the point of law reviewed. By obtaining and reading a copy of the cited material, the reader can acquire more information and background about the subject matter.

Case and code indexes located in the back of this study material are useful tools in the search for additional information provided in this study material. Also, if the reader is using the included Course Materials CD to view the study materials, the search feature provides an efficient method for locating topics and their related cites. Instructions for the use of the search feature are contained in the CD on the "How to Use the Course Materials CD" page.

For example, before meeting with a client, an attorney, or an accountant to review the best handling for a real estate activity, the reader might look up the topic in our topical index or use the CD search feature, then turn or scroll to the referenced page and read about it. The reader should then note any cases or codes which cover the activity to be reviewed.

Next, the reader may locate more information about the case or code he made note of by looking up the cite in our case or code index. Listed with the cite are page numbers of related writings. Our other writings can then be read to confirm, expand or correct the reader's understanding.

Then, the reader can bring these cites to the attention of the client, attorney or accountant to demonstrate the reader's concern — along with a copy of the chapter or related writings if appropriate.

When a chapter covers a point of greater interest to the reader, the reader might obtain a copy of the cites which are intriguing and study them. Such a review will help the reader to better understand and appreciate the development and application of the rules under which owners, lenders, landlords, tenants,

investors and brokers operate. Case opinions, written by the judges who decide a case, are rich in the history and evolution of real estate law and are invaluable educational tools.

The citation of statutes

California **statutes**, often called *codes* or *legislation*, are categorized and printed in volumes by topic. The topics of categorized codes range from Business and Professions to Welfare and Institutions. All state legislation governing activities in the State of California are contained in these volumes, as are regulations issued by governmental agencies such as the Department of Real Estate (DRE).

Statutes from the Civil Code, a code dealing extensively with **real estate law**, are frequently cited in this study material. For example, [Calif. Civil Code §2349] denotes the code book to pull (California Civil Code) and the section to reference (2349).

On our first code reference in a chapter, the word "Calif." is placed in front of the code name and section. Further references to the code drop the "Calif." and abbreviate the code name. Thus, [Calif. Civil Code §2349] is further cited in the same chapter as [CC §2349].

The citation of regulations

Also cited in this study material are *regulations* created under statutory authority given to administrative agencies of the state government, such as the Department of Real Estate (DRE). For example, a DRE regulation is cited: [DRE Reg. §2972(f)].

This cite denotes:

- the Department of Real Estate (DRE);
- regulation (Reg.);
- regulation number (2972); and
- one subsection (f).

California **regulations** are published within the California Code of Regulations, formally called the California Administrative Codes, and cited in this way: [10 Calif. Code of Regulations §2972(f)]. This code cite parallels the DRE regulation cite structure analyzed above. However, the number at the beginning of the cite (10) is the "title" or "volume" of California Codes in which the regulation is located.

The organization of federal codes is similar to that of California codes, i.e., with volumes for each category of legal topics. The volume is noted first and the section number last, such as: [42 USC §1125].

However, **federal statutes** are usually cited by their more specific names, such as the Internal Revenue Code. For example: [IRC §469(e)(1)] denotes Internal Revenue Code (IRC), the section number (469) and the subsections (e)(1).

Regulations created by federal administrative agencies are also cited in this study material in this manner: [42 Code of Federal Regulations §1442]. Abbreviated, the cite becomes: [42 CFR §1442].

Frequently used regulations are cited by their familiar names, such as the Treasury Regulations under the Internal Revenue Code. The regulations of the Internal Revenue Service (IRS) contain direct references to the code section they relate to.

The words **et seq.** after a code citation indicate the reader researching the cite must consider the entire chapter in which the code is located, starting with the code section listed.

The citation of cases

California court **cases** are cited according to the court level which heard the case. For example, the California Supreme Court case of [**Wellenkamp** v. **Bank of America** (1978) 21 C3d 943] is broken down like this:

- the name of the case (**Wellenkamp** v. **Bank of America**);
- the year it was decided (1978);
- the volume it is published in (21);
- which court gave the ruling (C);
- the series of published volumes (3d); and
- the beginning page of the case in the volume (943).

A California appellate court cite is basically the same: [**Winnett** v. **Roberts** (1986) 179 CA3d 909]. In this example, "CA" indicates the California Court of Appeal.

Federal case citations follow the same format as the state citation system, with "US" indicating United States Supreme Court cases, "F" for federal appellate court cases, and "F. Supp." for Federal District Court opinions.

For example: [**Fidelity Fed. S&L Assn.** v. **de la Cuesta** (1982) 458 US 141] denotes a United States Supreme Court decision.

Federal citations usually indicate the circuit of the appellate court which heard the case. There are eleven circuits in the United States and California is in the Ninth Circuit. For example: [**Simon** v. **United States** (9th Cir. 1985) 756 F2d 696]

A tax court case is cited in this way: [**The Shaker Blvd. Co.** v. **Simon** (1961) 36 TC 198]. This indicates the case name, the date it was decided, the published volume where the case is found, that it is a tax court (TC) decision, and the page number where it can be located.

On the first reference to a case in a chapter, the full citation is printed. Further references will list only the name of the first party (the plaintiff) followed by the word *supra*. Thus, the citation [**Wellenkamp** v. **Bank of America** (1978) 21 C3d 943] on the second reference within a chapter is abbreviated as [Wellenkamp, *supra*].

Use of case, code and regulation indexes

To look up a code or regulation in our **code index**, the reader must understand how the code index is organized. The code index contains separate sections for state and federal codes and regulations. The codes are further divided into topics and listed alphabetically (i.e. Business and Professions, Civil, Code of Federal Regulations, United States Constitution) with the code sections being listed numerically. To the right of the code section will be the page(s) in the study material where more information about the code may be found.

For a reader to find more information related to a cite in a chapter, the reader would turn to the appropriate code index, locate the code topic and section then turn to the noted page.

Locating copies of citations

Copies of case and code cites can be obtained in multiple ways, such as:

- law libraries;
- attorneys; and
- the Legislative Bill Room or a legislator.

Additionally, case cites can be obtained online by subscribing to such services as *Shepard's*, available through *LexusNexus*®, or *FindLa*w®. California codes can be accessed online on the official website for California legislative information, *www.leginfo.ca.gov*.

An opinion of a case published in a bound volume contains two sections. The first is merely a publisher's commentary of the case facts and law applied. These comments should be considered only as secondary information.

The second section is the court's opinion and decision, which is the reader's **primary source** of information. The opinion is the court's interpretation and application of the law controlling the dispute before it.

Chapter 6 The real estate exists

This chapter discusses the physical aspects of real estate, the many legal interests which can be held in real estate, and the use of real estate interests.

Physical and legal aspects

For a majority of people, the term *property* means a physical or tangible **thing**; something which is owned, such as land, a car or a share certificate. However, **property** is more broadly defined, focusing on the *rights* which arise out of the object. Thus, property is sometimes referred to as a **bundle of rights** in a thing, which for the purposes of this material is specifically real estate.

Additionally, **property** is anything which can be owned. In turn, *ownership* is the **right to possess** the property owned and use it to exclude others from entry. [Calif. Civil Code §654]

The **right to possess** and use property includes the right to:

- occupy;
- sell or dispose;
- encumber; or
- lease the property.

Next, the **types of property** are divided into two primary categories:

- real estate, sometimes called *real property* or *realty*; and
- personal property, sometimes called *personalty*. [CC §657]

Real estate, or real property, is characterized as **immovable**, whereas personal property is **movable**. [CC §§655, 658]

Personal property is defined, by way of exclusion, as all property which is not classified as real estate. [CC §§658, 663]

In fact, personal property was once called *chattel*, a word derived from the word "cattle", cattle being a movable thing.

While the distinction between real estate and personal property seems apparent at first glance, the difference is not always so clear.

Cutting up the real estate

Real estate can be physically cut up by *severance* of a part of the earth (i.e., removal of minerals). *Title* to real estate can also be cut up in terms of time, providing *sequential ownership*.

For example, fee ownership can be conveyed to one person for life, and on their death, transferred by the fee owner to another. Time sharing is another example of the allocation of ownership by time, such as the exclusive right to occupy a space for three weeks during the year.

Title to real estate can also be *fractionalized* by concurrently vesting title in the name of co-owners, such as tenants in common who each hold an undivided (fractional) ownership interest in the real estate.

Possession to real estate can be cut out of the fee ownership for a period of time. For instance, the fee owner of real estate acting as a landlord conveys possession of the property to a tenant under a lease agreement for the term of the lease, called a *leasehold estate* or, simply, a *lease*. When the tenancy expires or is terminated, possession of the property will *revert* to the landlord. The landlord retains fee title to the real estate at all times.

Possession can also be cut up by creating *divided interests* in a property, as opposed to undivided interests. For example, an owner can lease a portion of his property to a tenant. The tenant, in turn, can sublease a portion of his space to yet another person. Another example of *divided interests* is the co-ownership of a property which gives each co-owner the exclusive use of a specific portion of the real estate they jointly own.

Other interests in real estate can be created, such as *liens*. **Liens** are interests in real estate which secure payment or performance of a debt or other monetary obligation. A trust deed loan or a local property tax are examples of liens. On nonpayment of a lien amount, the lienholder can force the sale of the real estate to pay off and satisfy the lien.

Thus, an owner's rights in a parcel of real estate extend beyond the mere physical aspects of the land, airspace and improvements located within the legally described boundaries of the property.

Real estate components

Consider a real estate lender who is concerned about the interest he will hold in a parcel of real estate as security for his loan, such as is provided by a trust deed lien on the entire fee, the fee subject to outstanding leaseholds, or a lien on only the tenant's leasehold interest.

Also, consider a tenant who makes improvements or adds fixtures to his leased premises who is concerned about whether he may or must remove the additions on termination of his tenancy, or whether they must remain as part of the real estate.

The **physical components** of real estate include:

- the land;
- anything affixed to the land;
- anything appurtenant (incidental rights in adjoining property) to the land; and
- anything which cannot be removed from the land by law. [CC §658]

Real estate includes buildings, fences, trees, watercourses and easements within a parcel's horizontal and vertical boundaries. Anything below the surface, such as water and minerals, or above the surface in the air space, such as crops and timber, is part of the real estate.

For example, the rental of a boat slip includes the water and the land below it, both of which comprise the total of the rented real estate. Thus, landlord/tenant law controls the rental of the slip. [**Smith** v. **Municipal Court** (1988) 202 CA3d 685]

In the case of a condominium unit, the air space enclosed within the walls is the real estate. The structure itself, land and air space outside the unit are the property of the association or all the owners of the separate parcels of air space within the condominium project, creating what is called a *common interest development (CID)*. [CC §1351(f)]

A parcel of real estate is located by circumscribing its *legal description* on the face of the earth. Using the property's legal description, a surveyor locates and sets the corners and *horizontal boundaries* of the parcel.

The **legal** and **horizontal boundary** description of the real estate is contained in deeds, the public records of the county in which the parcel is located, subdivision maps or government surveys relating to the property.

However, real estate is three dimensional and reaches perpendicular to the horizontal boundary. In addition to the surface area between boundaries, the classic definition of real estate consists of the soil below to the core of the earth as well as the air space above to infinity. All permanent structures, crops and timber within this *inverse pyramid* are also a part of the parcel of real estate. The three dimensional aspect of real estate has its source in the English common law. [CC §659]

However, in the modern world, the common law definition of real estate has been radically altered to conform to the changing demands of society.

Land

The first component of real estate is *land*. **Land** includes:

- soil;
- rocks;
- other materials of the earth; and
- the reasonable airspace above the earth. [CC §659]

The soil and solid materials, such as ores and minerals, are considered land while they remain undisturbed as a part of the earth.

For example, unmined gold dormant in the earth is real estate.

However, when the gold is mined and removed from its surrounding rock, it becomes personal property since it is no longer embedded in the earth. The gold has been converted from something relatively immovable — part of the rock below the soil — to something movable.

Minerals in the soil are *severable* from the earth. Also, fee ownership to the soil and minerals can be conveyed away from the ownership of the remainder of the land.

When ownership to minerals in a parcel of land is transferred, the transfer establishes two fee owners of the real estate located within the legal description — an owner of the surface rights and an owner of the mineral rights beneath the surface. They are not co-owners of the real estate, but are owners of separate vertically located portions of the same real estate.

Both fee owners are entitled to reasonable use and access to their ownership interest in the real estate.

For example, an owner sells and conveys the ownership right to extract minerals to a buyer. On conveyance, there now exists a surface owner and a mineral rights owner.

Later, the surface owner conveys the real estate to a developer. The developer subdivides the parcel of real estate and plans to construct homes on the lots.

The mineral rights owner objects to the construction, claiming the homes, if built, would completely interfere with his right to enter the property and remove his minerals.

Is the mineral rights owner entitled to enter the property to remove the minerals?

Yes! But only as is reasonably necessary to use his mineral rights. The rights of the surface owner and the mineral rights owner are balanced to determine the precise surface location to be used to extract the minerals. [**Callahan** v. **Martin** (1935) 3 C2d 110]

The right to enter the property to remove minerals exists even if the documents conveying the mineral rights fail to provide for the right of entry. [**Wall** v. **Shell Oil Company** (1962) 209 CA2d 504]

The right to remove minerals from another's real estate is called a *profit a prendre.*

Oil and gas

Unlike solid minerals which are stationary, oil and gas are mobile. Legally, oil and gas are referred to as being *fugacious matter*, since they are transitory.

Oil and gas are perpetually escaping and percolating under the earth's surface. Due to their fleeting nature, a real estate owner does not hold title to the physical oil and gas situated under the surface of his real estate.

At any given time, a real estate owner will have more or less oil or gas depending on gravity and the earth's movements. The ownership interest in the oil and gas unremoved is legally referred to as a *corporeal hereditament*.

In California, oil and gas are incapable of being owned until they are actually possessed — that is, when they have been removed, thus becoming personal property. [Callahan, *supra*]

A fee owner has the exclusive **right to drill** for oil and gas on his premises, unless that right has been conveyed away to others.

Rather than owning the physical oil and gas, the fee owner has a right, called an *incorporeal hereditament*, to remove the oil or gas for his own purposes. [**Gerhard** v. **Stephens** (1968) 68 C2d 864]

Frequently, the right to remove minerals, including oil and gas, is conveyed by sale or lease to another in consideration for the payment of royalties on excavation.

Removing oil and gas

An owner of land has the right to extract all the oil and gas brought up from his real estate even if taken from an underground pool which extends into an adjoining owners' real estate. [**Alphonzo E. Bell Corporation** v. **Bell View Oil Syndicate** (1938) 24 CA2d 587]

Oil and gas, being *fugacious*, move in and out of the below surface portion of a parcel of real estate. However, an owner cannot slant drill onto another's property to reclaim the oil or gas that has flowed from his property. [Alphonzo E. Bell Corporation, *supra*]

Slant drilling is a trespass on the adjoining landowner's real estate. The trespasser is responsible to account for profits derived from the slant drilling. [Calif. Code of Civil Procedure §349¾]

Airspace

Land also includes the airspace above the surface of a property. Under traditional English common law, the right to airspace continued to infinity. However, modern technological advances have altered the legal view on airspace.

For example, an owner runs a farm near a military airport. Planes frequently fly over the owner's real estate on their ascent from or descent to the airport.

The government decides to expand the military base by extending the runway and using more advanced (and louder) aircraft at the base. The aircraft, on their approach to the airport, now fly directly over the farmer's barn, scaring the animals and causing the farmer financial loss.

The farmer sues the government for trespass on his real estate since the airspace is being occupied by others — the military.

Can the owner keep the aircraft from flying into his real estate?

No! The common law doctrine regarding the ownership of airspace to the edge of the universe is obsolete. The owner only owns the airspace necessary to allow him a reasonable use of his real estate. The farm owner's real estate extends only so far above the surface of the earth as can be reasonably occupied or used in connection with the land. [**United States** v. **Causby** (1946) 328 US 256]

In fact, the United States Congress has declared the airspace above a landowner's real estate to be a public highway for the navigation of airplanes, helicopters, satellites and spacecraft. [49 United States Code §40110]

However, when the flight of airborne vehicles intrudes upon an owner's use and enjoyment of his real estate below, the intrusive entry may constitute a *taking* of the real estate. The continued noise and disturbance of low-flying aircraft which impairs the enjoyment or value of land by causing disruption has effectively **taken** something from the owner. Thus, the owner must be compensated for his loss. [Causby, *supra*]

Other blue sky to be sold

The airspace portion of land has also been modernized with the concept of the condominium, a subdividing of the airspace which creates a relationship between the owners of separate adjacent air spaces classified as a corporate security (cooperatives) but now controlled as a *common interest development* (CID) in real estate.

An owner of a condominium unit legally owns the right to occupy the **parcel of airspace** he has acquired which is enclosed between the walls, ceilings and floors of the structure. Included in these ownership rights are incidental rights of ingress and egress, called *appurtenances*, and exclusive right to use other portions of the real estate for storage and parking, plus an undivided fractional interest in the common areas, directly or through an owner's association. [CC §1351(f)]

Also, the installation of active solar collectors has led to the right of access to sunlight and air which passes through airspace above property owned by others. This right of access to the sun for a solar collector is considered, by statute, an *easement*. [Calif. Public Resources Code §§25980 et seq.; CC §801.5(a)(1)]

Water

Water in its natural state is considered land since it is part of the material of the earth. While water is real estate, the right to use water is an *appurtenant* (incidental) right to the ownership of real estate.

Three key rights in water must be separately understood and appreciated by brokers.

First, the **right to use** water is called a *riparian right*. **Riparian rights** refer to the rights of a real estate owner to take surface water from a running water source contiguous to his land, such as a river or stream. [Calif. Water Code §101]

Second, the **right to take** water can be acquired by *appropriation*. The appropriator of water diverts or **appropriates** water from a river or watercourse to his real estate and puts it to reasonable use. [**In re Water of Hallett Creek Stream System** (1988) 44 C3d 448]

Third, an individual may obtain *prescriptive rights* in water by wrongfully appropriating nonsurplus water openly and adversely under a claim of right for an uninterrupted period of at least five years. [**City of Barstow** v. **Mojave Water Agency** (2000) 23 C4th 1224]

However, all water in the state of California belongs to the people, under state auspices, based on a *public trust doctrine*. Riparian, appropriation, and prescriptive rights are subject to the state's interest in conserving and regulating water use. [Wat C §101]

Under the **public trust** theory, the state controls any unclaimed water rights for the highest and most beneficial use of the water. The State Water Resources Control Board determines the respective water rights of individuals and makes decisions based on the public interest and the needs of the individuals. [Wat C §2501; see Chapter 8]

Affixed to the land

Real estate also includes things which are affixed to the land.

Things may be **affixed to the land** by:

- roots (e.g., shrubs and trees);
- embedment (e.g., walls);
- permanently resting (e.g., structures); or
- physically attached (e.g., by cement or nails). [CC §660]

Things attached to the earth naturally are real estate. Natural fixtures to the land include trees, shrubs, grass, etc. and are called *fructus naturales*.

However, natural items which are planted and cultivated for human consumption and use are fruits of labor, called *fructus industriales*.

Fructus industriales include such things as crops and standing timber. Crops and timber are ordinarily considered real estate. However, industrial crops and standing timber sold under a purchase agreement and scheduled to be removed are considered personal property. [Calif. Commercial Code §9102(a)(44)]

Crops and timber sold separately under a purchase agreement are treated as *constructively severed* even though actual removal has not yet occurred. [**Wilson** v. **White** (1911) 161 C 453]

Fixtures

A fixture is a personal property item which has become permanently attached to real estate so as to become part of the real estate. [CC §660]

When personal property becomes a fixture, it is part of the real estate and is thereafter conveyed with the real estate.

Factors which determine whether an item is a fixture or improvement include:

- relationship of the parties;
- agreement between the parties;
- intention of the parties;
- manner of attachment; and
- adaptability of attachment to the real estate's use. [**San Diego Trust & Savings Bank** v. **San Diego County** (1940) 16 C2d 142]

Individuals most likely to dispute whether an item is a fixture include:

- buyers and sellers;
- landlords and tenants;
- a builder and an owner;
- a lender and an owner; and
- the county assessor and an owner.

The most important factor when determining whether an item is a fixture or improvement is the **intent of the parties**.

Intent to make an item a permanent part of the real estate as a fixture is determined by:

- the manner of attachment; and
- the use and purpose of the item in dispute.

When an item is attached to real estate by bolts, screws, cement or the like, the item is a fixture and part of the real estate. However, an item need not be attached to the real estate in this manner to be a fixture. Items of such weight and size that gravity maintains them in place is sufficient to give the item the character of permanence and affixation to be real estate.

Also, the item may be *constructively attached* when the item is a necessary, integral or working part of improvements on the real estate.

Another factor used to determine whether an item was intended by the parties to be a fixture is the *adaptability test*, which considers the circumstances under which the real estate is used. The **adaptability test** determines whether the item makes the real estate peculiarly valuable in its use by the owner or a tenant.

For example, a tenant enters into a lease which entitles him to use a wharf facility designed for handling cargo containers. Two container cranes, weighing 750 tons each, stand 100 feet high and operate on railbeds embedded in the land. The cranes are not attached to the land, but are on massive rollers.

The cranes are assessed by the county and a property tax lien is imposed on the real estate based on the assessed value of the cranes.

The tenant pays the tax and makes a demand on the county for a tax refund, which the county rejects.

The tenant claims the cranes are personal property and not part of the real estate since the cranes are not attached to the land, can be moved, and are not essential to the use and purpose of the land.

The county claims the cranes are fixtures and part of the real property since the weight of the cranes gives them the character of permanency and affixation to the land, the cranes comprise an integral and working part of the rails which are attached to the property, and the cranes are also an integral part of the facility specifically constructed for handling cargo containers.

In this scenario, the tenant is not entitled to a refund. The cranes, by virtue of their size and relationship to the purpose for ownership of the land, were intended to become a part of the real estate. [**Seatrain Terminals of California, Inc.** v. **County of Alameda** (1978) 83 CA3d 69]

In another example, a bank updates its accounting equipment by purchasing a state-of-the-art computer system.

A bank, as a service organization, does not pay personal property taxes assessed by the county, only local real estate taxes.

The bank installs computers in a building which are attached to cables installed throughout the building for hook-ups. The bank networks the various computers together.

The county assessor claims the computers have become a fixture since they are permanently attached to the building. If the computer system is considered part of the real estate and is no longer personal property, the bank must pay *ad valorem* property taxes on the value of the equipment.

The bank claims the computers are personal property since they are merely attached to the building by cords and can be readily removed, making them separate pieces of office equipment.

Are the computers, detachable by computer cables affixed to the building, also part of the real estate?

No! The bank never intended for the computers to become a permanent part of the real estate. [**Crocker National Bank** v. **City and County of San Francisco** (1989) 49 C3d 881]

Trade fixtures

Fixtures which are used to render services or make products for the trade or business of a tenant are called *trade fixtures*.

Trade fixtures are to be removed by the tenant on termination of the tenancy, unless agreed to the contrary with the landlord. The removal must not unduly damage the real estate. [CC §1019]

Thus, trade fixtures are considered personal property.

The removal of trade fixtures is often negotiated between a landlord and tenant to confirm who has ownership of the fixtures on expiration of the tenancy. [**City of Beverly Hills** v. **Albright** (1960) 184 CA2d 562]

To be considered a trade fixture, a fixture must be an essential part of the tenant's business and its removal must not substantially damage the real estate. An example of trade fixtures would be mirrors, sink bowls, dryers and installed wash stations in a beauty salon. [**Beebe** v. **Richards** (1953) 115 CA2d 589; see Chapter 6]

Substantial damage by removal

A tenant installs a refrigeration unit in a building it uses to operate a grocery store.

When the tenant's long-term lease expires, the tenant wants to remove the refrigeration unit to use at his new location. However, removal of the unit would put a large hole in the ceiling and cause structural damage which would subject portions of the building to collapse.

Is the refrigeration system a trade fixture, permitting the tenant to remove the unit on expiration of the lease?

No! The damage to the building caused by the removal would be too substantial. [**Goldberg** v. **Stanton** (1927) 84 CA 665]

Landlords frequently require tenant improvements to remain a part of the real estate after the tenant vacates.

For example, a landlord may agree to reduce rent in exchange for the tenant's installation of gas tanks, noting the gas tanks are not trade fixtures, but belong to the landlord and will remain after the tenant vacates the property. [**Southland Corporation** v. **Emerald Oil Company** (9th Cir. 1986) 789 F2d 1441]

Appurtenant rights

Real estate also includes any **incidental rights** to the real estate which are not located on the real estate nor reflected on its title, called *appurtenant rights*. **Appurtenant rights** include the right of ingress and egress across adjoining properties. [CC §662]

An *appurtenant easement* is an interest held by an owner of one parcel of real estate to use adjoining real estate.

Under an **appurtenant easement**, an owner's **right to use** adjoining real estate is part of his real estate, although not reflected on the title to his real estate, and is automatically conveyed with the real estate when he sells it.

Appurtenant easements are said to *run with the land*. Thus, these easements are not personal to the owner of the real estate entitled to use them. They cannot be severed or retained by an owner when he sells the real estate since the right of an owner to use an easement is part of the real estate. Appurtenant rights are incidental rights which remain with the real estate they benefit and do not transfer from person to person.

Other appurtenant rights to real estate include the right to the *lateral and subjacent support* provided by the existence of adjoining real estate. For example, the owner of real estate cannot remove soil from his land so as to cause the adjoining real estate to subside or collapse.

Appurtenant rights which benefit an owner cannot be located in the public records by a search of the legal description for the real estate he owns. Appurtenant rights held by an owner of one property are a recorded encumbrance on title to the adjacent property burdened by the appurtenant rights, such as an easement.

Chapter 7 Fee vs. Leasehold

This chapter examines the entitlement to possession of real estate held by owners of different interests in a parcel of real estate.

A matter of possession

The **ownership interests** a person may hold in real estate are called *estates*. Four kinds of **estates** in real estate exist:

- *fee estates*, sometimes referred to as *inheritance* or *perpetual estates*;
- *life estates*;
- *leasehold estates*, sometimes called *estates for years*; and
- *estates at will*. [CC §761]

In practice, these estates are separated into three categories: fee simple estates, leasehold estates and life estates.

A **life estate** terminates on the death of the owner of the life estate or the death of another person named as the controlling life in the deed conveying or reserving the life estate.

Leasehold interests held by a tenant in the real estate exist for a fixed period of time. The leasehold interest terminates when the period of time expires.

An **estate at will**, unlike a leasehold interest, is not conveyed in an exchange for value, called *consideration*. Estates at will terminate at the discretion of the fee owner, subject to proper advance notice.

Possession of real estate under leasehold interests and estates at will is controlled primarily by landlord/tenant law.

The fee as three dimensional

An owner of a **fee interest** in real estate has absolute ownership of all the real estate for an *indefinite duration*.

A fee owner may do what he wants with his property as long as he acts within the laws affecting the use of his real estate interest. A fee owner is entitled to the land's surface and anything permanently located above or below it. [CC §829]

A fee owner may occupy, sell, lease or encumber his parcel of real estate. He may also give it away or pass it to his heirs or to anyone he chooses on his death. The fee estate is the interest in real estate typically transferred in a real estate sales transaction.

It is possible to separate one parcel of real estate into several fee interests, though it is infrequently done. One person may own the mineral rights beneath the surface of a property, someone else may own the surface rights, and yet another can own the rights to the air space — each interest being held in fee.

Consider a fee owner who sells and grants separate fee interests in his property to two individuals. One individual receives the land's surface and air space rights. The other individual receives the subsurface oil and mineral rights.

The surface owner claims the title to the entire parcel of real estate should be vested — *quieted* — in his name.

The subsurface owner objects, claiming the surface owner's real estate interest is less than the entire fee estate in the property.

In this scenario, the surface owner's fee interest in the parcel of real estate is separate from the subsurface ownership and possession of the oil and mineral rights beneath the surface of the parcel. They are not **co-owners** of any interest in the real estate even though both owners hold a fee estate in the same parcel. Their ownership interests are mutually exclusive, each owning separate portions of the same parcel. [**In re Waltz** (1925) 197 C 263]

Life estates until death

A **life estate** is an interest in a parcel of real estate lasting the lifetime of a *life tenant* or someone else, called the *controlling life*. Life estates are granted by deed from the fee owner, or created by a court order under a will or a trustee under an inter-vivos (living) trust.

Life estates are commonly established by a fee owner who wishes to provide a home or financial security for someone else during that person's lifetime (or someone else's lifetime).

Life estates are *terminated* by:

- death of the controlling life;
- agreement; or
- merger of different commonly held ownership interests in a property.

For example, an owner of a vacation home has an elderly aunt who is in need of a decent place to live. The owner grants her a life estate in the vacation home for the duration of her lifetime. Thus, she may live in, rent or sell the property for the remainder of her life, even though the fee owner might predecease her.

Although the aunt has the right to exclusive possession of the entire parcel of real estate, the owner retains title to the fee. Thus, a life estate transfers a right to possession which has been "carved out" of the fee, comparable to possession under a lease which is conveyed out of the fee. Unlike a lease, a life estate does not require rent to be paid to own the life estate.

On the aunt's death, possession of the property reverts back to the fee owner or his heirs since the tenancy of the life estate is extinguished by the aunt's death.

The holder of a life estate based on his life has the right of possession until his death, as if he were the owner in fee. The holder of a life estate is responsible for taxes, maintenance and a reasonable portion of property assessments, such as improvement district bonds. [CC §840]

The holder of a life estate may not *impair* the fee interest. [CC §818]

For example, the holder of a life estate may not make alterations which decrease the property's value, such as removing valuable plants, improvements or land.

Conversely, the holder of a life estate has the right to lease the property and collect and retain any rents during the term of the life estate. Profit on the sale of the life estate may be taken in addition to rental income.

For example, a life estate tenant enters into a lease with a logging company to harvest trees from a property.

The property value is increased by the removal of the trees since the property's best use is as a farm and additional crops can be planted on the cleared land.

The fee owner claims the life tenant had no right to remove or sell the trees since they are improvements.

However, the life tenant did not injure the fee interest since he did not diminish its value, called *impairment*. The life estate tenant is entitled to the profits from selling timber or any other crops, provided the property's value is not impaired by their removal. [**Sallee** v. **Daneri** (1942) 49 CA2d 324]

A life tenant may be entitled to *reimbursement* from the fee owner for necessary costs of improving or retrofitting a property.

For example, a city inspector notifies a life tenant the property is not up to health and safety codes and will be demolished unless improvements and retrofitting occur.

The life tenant improves the property, satisfying code requirements since the life tenant has a duty not to impair the property's value by allowing its demolition. Due to the retrofitting and improvements, the property's value increased.

The life tenant makes a demand on the fee owner for his contribution to the cost of improvements, which the fee owner rejects.

In this instance, the fee owner is liable to the life tenant for the increased value of the fee ownership in the property, the result of the improvements to the property made by the life tenant. [**Eastman** v. **Peterson** (1968) 268 CA2d 169]

Leaseholds conveyed out of the fee

Leaseholds denote the rights *conveyed* to a tenant by a fee owner (or life estate tenant or master lessee) to possess a parcel of real estate. Beyond possession, leaseholds are created by conveyance (in the lease agreement) of an interest in real estate.

A leasehold is an estate in real property. The tenant owns the leasehold estate. Leaseholds are created when the landlord and tenant enter into a lease or a rental agreement.

As the owner of a leasehold, the tenant has the right to possess and use the entire property until the lease term expires. Title to the fee interest in the property remains with the landlord (or his successor) throughout the term of the leasehold, subject to the tenant's possession *carved out of the fee* by the lease.

In exchange for the tenant's right to occupy the property, the landlord receives rental income for the period of the tenancy. Also, the tenant may encumber his leasehold interest with a trust deed as security for a loan. [CC§§2920, 2924 et seq.]

Types of leaseholds by their term

Four types of **leasehold interests** exist which can be held by tenants. The interests are classified by the length of their term:

- a *fixed-term tenancy*, simply known as a *lease* (distinguishable from the document entitled a lease agreement) and legally called an *estate for years*;
- a *periodic tenancy*, usually referred to as a *rental agreement*;
- a *tenancy-at-will*; and
- a *tenancy-at-sufferance*, commonly called a *holdover tenancy*.

A **fixed-term tenancy**, an estate for years, lasts for a specific length of time agreed to in a lease agreement between a landlord and tenant.

When the lease expires, the lease with its right to possession terminates automatically — unless an agreement, such as an option right which is exercised, extends or sets a new expiration date.

A **periodic tenancy** also lasts for a specific length of time. However, in the creation of a periodic tenancy, a landlord and tenant agree to successive rental periods of the same length, such as in a month-to-month tenancy. The tenancy continues until terminated by notice from either the tenant or the landlord to the other.

A **tenant at will** has the right to possession of property with the consent of the owner. Tenancies at will are terminated at any time by notice from either party or by agreement. Tenancies at will have no fixed duration, are not usually in writing and no rent obligation exists.

Special uses of leaseholds

In addition to typical residential and nonresidential leases, other leases exist which serve specific purposes.

Oil, gas, water and mineral leases convey the right to others to use mineral deposits below the earth's surface.

The purpose of an oil lease is to discover, extract and produce oil or gas. The oil lease is a tool used by the property owner to develop and realize the full value of his land. The tenant provides the money, machinery and man-power for exploration and development under the surface of the property. The tenant pays the landlord rent, called a *royalty*, and keeps any profits from the sale of the oil or minerals he extracts from beneath the surface of the parcel.

A **ground lease** is granted in exchange for the payment of rent, an amount which is based on the rental value of the part of the real estate called land, whether the parcel is vacant or improved. A lease is a *financing tool* for fee owners to induce others to acquire an interest in the property and develop it with improvements.

Ground leases are common in densely populated areas since developers need financial assistance from owners to avoid massive cash outlay to acquire unimproved land.

Owners of developable property who refuse to sell can become landlords for the long-term rental income they will receive from the property. The rental income is calculated as an annual percentage return, based on the value of the land, and usually paid monthly. Under a ground lease, the tenant constructs his own improvements. Both the owner and tenant own an interest in the same real estate.

A **master lease** benefits an owner who wants the financial advantages of renting fully improved property occupied by multiple tenants but does not want the day-to-day burdens and uncertainties of managing the property.

For instance, an owner of a shopping center and a prospective owner-operator agree to a master lease.

As the master tenant, the operator will collect rent from the many subtenants, and address their needs and concerns. The master tenant is responsible for the rent due under the master lease — even if the subtenants do not pay their rents.

This type of lease is sometimes called a *sandwich lease*, since the master tenant is "sandwiched" between the fee owner and the many subtenants.

A **master lease** is written up on a regular nonresidential lease agreement form with the deletion of the clause prohibiting assignments and subletting. A **sublease** is also a regular nonresidential lease agreement with the addition of a clause referencing the attached master lease and specifying the sublease is subject to the terms of the master lease.

Another type of special use lease is the *farm lease*, sometimes called *cropping agreements* or *grazing leases*. A tenant will operate a farm and pay the landlord either a flat fee for rent or a percentage of the value of the crops produced on the land.

Fee ownership right to exclude

A fee owner has the right to possess and control his property. A fee owner's possession is exclusive and absolute. Thus, he has the right to deny others permission to cross his boundaries. No one may be on the owner's property without his consent. Should others enter the property without the owner's consent, they are guilty of a trespass. The owner may recover any money losses from the trespassers caused by a trespass.

A fee owner has the *exclusive right to use* and enjoy his property. As long as local ordinances such as building codes and zoning regulations are observed, a fee owner may do as he pleases with his property. A fee owner may build new buildings, tear old ones down, plant trees and shrubs, grow crops or simply leave the property unattended, unless agreed to the contrary in the covenants, conditions and restrictions (CC&Rs) or a trust deed.

As a landlord, the fee owner may receive rents for allowing others to use and occupy his property by leasing some or all of it to them.

Fee owners also have the *right of disposition*. Fee owners may retain ownership, occupy the property, lease it, encumber it, sell it, give it away, grant a life estate or pass it on to their heirs.

While an owner can dispose of property as he wishes, the document conveying or authorizing the conveyance of his interest, such as a will, inter vivos trust agreement or deed, must conform to the legal standards governing the conveyance intended.

The rights of others in a property

Easements and *use licenses* are not real estate but they give a holder of the rights a limited and **nonexclusive use** of someone else's property. [See Chapter 20]

An **easement** is a *right to use* another's property for a specific purpose. An easement is an interest in someone else's real estate, as it grants its holder the right to limit the activities of others on the property which is burdened by the easement. [CC §§801 et seq.]

For example, a landowner holds an easement allowing him to construct and have access to a pipeline across his neighbor's property. The neighbor's right to develop his own property is limited since he may do nothing to interfere with the easement owner's access to the pipeline.

A *license* grants its holder a personal privilege to use property, but no right to occupy it to the exclusion of others. Unlike easements, **licenses** are not exclusive rights — an owner may give many licenses to perform the same or different activity in the same area. [See Chapter 10]

Unlike an easement, a license may be revoked at the will of the person who grants it, unless agreed to the contrary or it has become irrevocable.

For example, a landowner wishes to enjoin a neighbor from continuing to use a roadway across the landowner's property that the prior owner of the neighboring property used for ingress and egress to his property. The landowner claims the right to pass is a license, not an easement. The neighbor contends the grant of the right to use the road created an easement.

The landowner claims only a revocable license to use the road was created, as the previous neighbor was only granted a personal *in gross* right to use the road and that right is not assignable to the current neighbor.

Although the previous owner is mentioned, the document creating the right to use a roadway contains the crucial phrase "*his heirs or assigns*" when referring to the prior neighbor's right to use the roadway.

Thus, when the neighbor bought the property he obtained the irrevocable right to use the road as part of his ownership rights. The easement is an *appurtenant right* running with his land since it is physically located on the property of another and is an encumbrance on that property's title.

The roadway document created an easement which entitled the new owner of the neighboring property to cross the adjacent property for ingress and egress to his property from the main road. [**Eastman** v. **Piper** (1924) 68 CA 554]

Covenants, conditions and restrictions (CC&Rs), collectively called *encumbrances*, are recorded against title to a property and limit an owner's right to use his property. By recording restrictions against the title to real estate on a sale, a seller may prohibit certain uses of the property, or require the property be used for specific purposes only.

Regulations governing how a condominium owner may use his unit and the rights and responsibilities of the common interest development (CID) are typically contained in a declaration of CC&Rs filed with the condominium subdivision plan.

The CC&Rs bind all future owners to comply with the CC&Rs since the use restrictions they contain run with the land.

Chapter 8 Leasehold improvements

This chapter discusses improvements made by tenants on leased property and the landlord's rights to these improvements.

Ownership rights

A retail business owner, as a tenant, enters into a nonresidential lease agreement for commercial space. The leased premises does not contain *tenant improvements* since the building is nothing more than a shell.

In the lease, the tenant agrees to make all the **tenant improvements** necessary for him to occupy the premises and operate his business (i.e., interior walls, flooring, carpeting, lighting, plumbing, telephone and electronic wiring, etc.). The tenant will also install trade fixtures on the premises.

The lease agreement provides for the property will be delivered to the landlord on *expiration* of the lease "in the condition the tenant received it" less normal wear and tear.

However, no other provision in the lease addresses whether:

- improvements made by the tenant will remain with the property; or
- the property will be restored to its original condition when the lease expires.

On **expiration** of the lease, the tenant strips the premises of all the improvements he made and vacates. The building is returned to the landlord in its original condition, a shell, less wear and tear. The landlord replaces nearly all the tenant improvements removed in order to relet the space and make a demand on the tenant for their replacement costs.

Is the tenant liable for the landlord's costs to replace the tenant improvements for the next tenant?

Yes! Improvements made by a tenant which are **permanently affixed** to real estate become *fixtures*, part of the real estate to which they are attached. **Fixtures** are to remain with the property on expiration of the tenancy, unless the landlord and the tenant agree to the contrary in the lease agreement. [Calif. Civil Code §1013]

With the exception of *trade fixtures*, improvements attached to the building become part of the real estate. [CC §660]

Tenant improvements, fixtures and removal

A landlord's right to an improvement is conditioned on:

- the permanent or temporary nature of the improvements made by the tenant (i.e., built-in or free standing); and
- any lease provisions relating to the tenant removal of improvements or the *restoration* of the premises.

Examples of improvements which become part of the real estate include:

- built-ins (i.e., central air conditioning or heating, cabinets and stairwells);

- fixtures (i.e., electrical and plumbing);
- walls, doors and dropped ceilings; and
- flooring which is attached (i.e., carpeting, tile or linoleum).

On expiration of the lease, the landlord is entitled to property improvements and alterations made by the tenant, unless agreed to the contrary.

Leasehold improvement provisions

Nonresidential leases do or should contain a *further-improvement* provision allowing the landlord to either retain tenant improvements and alterations made by the tenant or require **restoration** of the property to its original condition on expiration of the lease. [See **first tuesday** Form 552 §9]

The **further-improvement** provision usually includes clauses regarding:

- who will make the improvements (landlord or tenant);
- who will pay for the improvements (landlord or tenant);
- the landlord's consent is required before the tenant makes improvements;
- any mechanic's liens due to improvements contracted by the tenant will be removed;
- the condition of the premises on expiration; and
- whether the improvements are to remain or be removed on expiration of the lease.

Improvements to be made by landlord

Consider a landlord who obligates himself under a lease to make improvements. Once agreed to, the landlord must complete the improvements in a *timely manner* so the tenant may use them or the lease may be terminated by the tenant.

For example, a landlord agrees to make all the improvements necessary to convert a ranch into a dairy farm for a tenant who operates a dairy.

The landlord is to construct a barn and several sheds which are essential to the operation of the tenant's dairy business.

The tenant moves into the property before the improvements begin. Several months pass and the landlord does not start construction on the promised improvements. The tenant vacates the property since it is impossible to conduct his dairy business without the barn and sheds.

In this example, the **landlord's failure** to make the promised improvements is a breach of the lease agreement.

Since the landlord has breached an essential provision of the lease, the tenant may vacate the property and terminate the lease without any obligation to pay further rent. [**Souza** v. **Joseph** (1913) 22 CA 179]

Now consider a landlord who agrees to construct the shell of a building for a tenant. The tenant agrees to install all other improvements and fixtures required to occupy and use the property.

However, before the building is completed by the landlord, the building code is changed to require the installation of a sprinkler system. The tenant demands the landlord pay the cost of installing the sprinkler system since he cannot occupy the premises without the sprinkler system.

The landlord refuses to pay the additional cost to install the sprinkler system claiming the lease agreement calls for him to build the structure, not to make it ready for occupancy.

Is the tenant responsible for the cost of the sprinkler system?

Yes! It is the tenant's responsibility to make the alterations or improvements required to bring the building into compliance with use (occupancy) ordinances since the tenant agreed to make all improvements to the structure needed in order to take occupancy. [**Wong** v. **DiGrazia** (1963) 60 C2d 525]

Alternatively, lease provisions can obligate a tenant to improve vacant, unimproved property, such as occurs with ground lease arrangements.

Improvements promised by the tenant

A tenant must complete the improvements he has agreed to construct or install on the leased premises within the time period agreed to in the lease or in a **timely manner** if no commencement or completion date for construction is agreed to in the lease. [CC §1657]

However, if the tenant fails to make or complete mandated improvements prior to expiration of the lease and the improvements were to remain with the property on expiration of the lease, the tenant is liable to the landlord for the cost incurred to complete the agreed-to improvements.

For example, a tenant agrees to construct additional buildings on leased property in lieu of paying rent for a one-year period. When the lease expires, the improvements will remain with the property.

The tenant fails to construct the buildings during the term of the lease. The tenant claims the lease provision calling for construction is permissive, not mandatory, since he only had to build if he needed to do so for the operation of his business.

However, the improvements were agreed to in *exchange for rent*. The tenant is obligated to make the improvements since the landlord bargained for them in the lease agreement. Thus, the landlord is entitled to recover an amount equal to the cost of the improvements the tenant failed to construct. [**Simen** v. **Sam Aftergut Co.** (1915) 26 CA 361]

Additionally, if the tenant agrees to and does not complete the construction of improvements which are to remain with the property on expiration of the lease, the landlord may complete the improvements. The tenant is then responsible for the landlord's expenditures to construct the improvements he agreed to construct. [**Sprague** v. **Fauver** (1945) 71 CA2d 333]

The landlord is also entitled to recover lost rent and expenses incurred after the expiration of a lease resulting from the tenant's failure to construct the promised improvements.

Consider a landlord who enters into a lease and agrees to construct a building for the tenant. However, after the foundation is laid, the landlord and tenant orally modify the construction arrangement. The tenant agrees to finish construction of the building in exchange for the landlord relinquishing his construction profit.

The tenant breaches the *oral modification* of the written lease by failing to complete the construction of the building. The breach places the landlord in financial jeopardy since he now must complete the building himself and relet it. The landlord terminates the lease, evicts the tenant and completes the construction promised by the tenant.

In this example, the tenant is not only responsible for the landlord's costs of construction, he is also liable for lost future rents and any expenses the landlord incurs to relet the property. [**Sanders Construction Company, Inc.** v. **San Joaquin First Federal Savings and Loan Association** (1982) 136 CA3d 387]

Landlord's consent to improvements

Lease provisions often allow a tenant to make improvements to the leased premises. However, further-improvement provisions typically call for the landlord to approve the planned improvements before construction is started.

For example, a tenant wishes to add a room to his leased premises to operate his business. The tenant begins construction without the landlord's prior approval as called for in the lease. The addition is located in space outside the area described in the lease as the leased premises, resulting in an encroachment on other land owned by the landlord.

In the past, the landlord has approved other improvements made by the tenant. However, this time the landlord refuses to give consent and complains about the tenant's construction and the encroachment.

The landlord continues to accept rent while he negotiates with the tenant regarding the approval of the addition and the modification of the lease to include the area subject to the encroachment.

Ultimately, after a few years of negotiations without a resolution, the landlord declares a *forfeiture of the lease* based on both the breach of the provision requiring his prior consent to construction and the encroachment of the unapproved improvements.

The tenant claims the landlord has *waived* his right to declare a **forfeiture of the lease** since the landlord continued to accept the rental payments after the breach and encroachment.

However, a landlord does not waive his right to consent to additional improvements by accepting rent from the tenant as long as negotiations to resolve the breach continue. [**Thriftimart, Inc.** v. **Me & Tex** (1981) 123 CA3d 751]

Likewise, when a tenant with an option to buy makes improvements with the expectation he will ultimately become the owner of the property, the landlord's consent to improvements called for in the lease is needed before any improvements can be made.

Further, the tenant is not entitled to reimbursement for the cost of improvements, whether or not the landlord consents to the improvements. The improvements will not become the tenant's unless he exercises his option to buy. [**Whipple** v. **Haberle** (1963) 223 CA2d 477]

Permissive improvements by the tenant

Some lease provisions allow a tenant to make improvements, but do not specifically mandate that he do so.

For instance, a landlord and tenant sign a long-term lease. A lease provision authorizes the tenant to demolish an existing building located on the property and construct a new one in its place without obtaining the landlord's prior consent. The rent is based on the current value of the premises.

However, the lease provision does not state a specific time period for demolition or construction.

The tenant does not make an effort to tear down the old building or erect a new one. Ultimately, the landlord claims the tenant has breached the lease for failure to demolish the existing building and construct a new one.

However, the tenant has not breached the lease. The tenant was not obligated to build since the lease contained no promise by the tenant to build. The tenant was merely *authorized to build* without the need for further consent.

Thus, the tenant was granted a **privilege** to make improvements. Further improvements on the tenant's part were not mandatory, they were permissive. [**Kusmark** v. **Montgomery Ward and Co.** (1967) 249 CA2d 585]

Now consider a lease provision requiring that a tenant construct improvements on a vacant parcel he has leased. A date is not specified for completion of the improvements. Since construction of improvements is mandated to occur, the tenant must complete construction within a reasonable period of time.

For example, a landlord leases unimproved land to a tenant who is a developer. The tenant is obligated to build improvements, contingent upon his ability to obtain a construction loan. A time period is not set for commencement or completion of the construction. Also, no provision authorizes the landlord to terminate the lease if the required construction is not completed.

However, the lease gives the tenant the right to terminate the lease after one year if financing is not found to fund the construction.

The tenant does not find financing within the one-year period. However, the tenant does not exercise his right to cancel the lease and avoid the payment of future rents. Instead, the tenant continues his good faith effort to locate and qualify for construction financing. Ultimately, financing is not located and construction is not commenced.

A few years after commencement of the lease, the landlord claims the lease has been breached for lack of the promised construction.

The tenant claims the landlord cannot terminate the lease as long as the tenant continues his good faith effort to locate financing and remains solvent to qualify for the financing.

In this example, the tenant breached the lease. He failed to construct the intended improvements within a **reasonable period of time**. The original purpose of the lease was to have buildings erected without specifying a completion date. However, the landlord did give the tenant a reasonable amount of time — forty months — in which to procure financing for the transaction before terminating the lease.

A landlord cannot be forced to leave the property unimproved forever when the original intention under the lease was to develop the land. [**City of Stockton** v. **Stockton Plaza Corporation** (1968) 261 CA2d 639]

Surrender of improvements

All tenant improvements and alterations are to remain with the leased property on expiration or other termination of the lease, unless a lease provision exists **permitting** or **mandating removal** by the tenant.

Most leases merely provide for the property to be returned in *good condition*, less normal wear and tear for the years of the tenant's occupancy.

Thus, the tenant is not required, much less allowed, to *restore* the property to the actual condition he received it in when he took possession. The covenant for ordinary care of the premises during the lease does not mean removal of tenant improvements or renovation to eliminate deterioration, obsolescence or wear and tear due to the use permitted to the tenant. [**Kanner** v. **Globe Bottling Co.** (1969) 273 CA2d 559]

Consider a landlord and tenant who enter into a lease of nonresidential property. The lease agreement contains a provision requiring the tenant, if the landlord at his option so demands, to *restore* the premises to the original condition received by the tenant, less normal wear and tear.

The tenant makes all the tenant improvements necessary to operate his business, such as installation of a concrete vault, the removal of partitions and a stairway, and the closing of two entrances into the premises.

On expiration of the lease, the tenant vacates the premises. The landlord exercises his right to require removal of tenant improvements by making a demand on the tenant to **restore** the premises, which the tenant rejects.

The landlord incurs costs to restore most of the premises to prepare it for reletting to a new tenant.

The landlord claims the tenant is liable for costs he incurred to restore the premises since the tenant's improvements radically altered the premises and made it unrentable to others.

The tenant claims he is not liable for the landlord's costs to remove the improvements and restore the premises to its original condition since the alterations are beneficial to the property.

Is the tenant liable for the landlord's costs to restore the premises to a rentable condition?

Yes! On expiration of the lease, the tenant is obligated to restore the premises to its original condition, less normal wear and tear. The lease provided for restoration by the tenant on a demand from the landlord. The tenant improvements made the premises less desirable and unsuitable for other occupants.

On the tenant's failure to restore the premises, the landlord was forced to incur restoration expenses to relet the premises. Thus, the tenant is liable for the landlord's expenditures to restore the premises in order to relet it to a new tenant. [**Masonic Temple Ass'n. of Sacramento** v. **Stockholders Auxiliary Corporation** (1933) 130 CA 234]

In another example, a lease states a tenant will return the property in *good repair* and *restore* the premises to its original condition, less normal wear and tear.

The tenant modifies the premises to run his business. After the lease expires, the tenant moves out and leaves all his improvements and modifications on the property.

The landlord is unable to relet the premises in the condition left by the tenant.

In this example, the tenant is liable for the reasonable costs incurred by the landlord to restore the premises to its original condition and for lost rental income for the period of time it takes to make the repairs.

Thus, lease provisions requiring **restoration** of the premises to its original condition require the tenant to restore the property to its original condition, minus any normal deterioration due to time and use of the premises as permitted. [**Iverson** v. **Spang Industries** (1975) 45 CA3d 303]

If a lease does not require the tenant to **restore the property** to the condition it was in when received, the tenant may only remove his personal improvements, called *trade improvements* or *trade fixtures*.

The tenant need only leave the property and tenant improvements in good condition. [**Formosa Corp.** v. **Rogers** (1951) 108 CA2d 397]

Evicted tenant reimbursed for improvements

Compensation may be due to a tenant who has improved his property and is evicted prior to expiration of the lease.

A tenant who is evicted is entitled to the **rental value** of his improvements for the remainder of his unexpired lease term.

The tenant is not, however, entitled to reimbursement for the market value or cost of the improvements. Since reimbursement for costs is not required, the landlord receives a windfall profit for his use of the tenant's improvements until they revert to him on expiration of the original lease.

Thus, an evicted tenant is limited to collecting the reasonable value for the **landlord's use** of the improvements during the remainder of the term on the original lease. [**Asell** v. **Rodrigues** (1973) 32 CA3d 817]

Real estate fixtures vs. trade fixtures

Two types of **fixtures** exist to distinguish improvements installed on buildings located on a parcel of real estate:

- *real estate fixtures*; and
- *trade fixtures*.

A **real estate fixture** is personal property which has become **attached** to the real estate. It becomes part of the real estate it is attached to and is conveyed with the property. [CC §§660, 1013]

In other words, if a tenant rents an office and builds bookshelves into the wall rather than merely anchoring them to the wall, the bookshelves become part of the improvements located on the real estate.

When the lease expires, real estate fixtures are the property of the landlord. The landlord takes possession of the real estate fixtures as part of the real estate surrendered to the landlord, **unless the lease provides for restoration** or permits removal of the improvements by the tenant. The passage of real estate fixtures from tenant to landlord on expiration of the lease is a conveyance called *reversion*. [**City of Beverly Hills** v. **Albright** (1960)184 CA2d 562]

However, *trade fixtures* do not revert to the landlord on expiration of the lease.

A **trade fixture** is an improvement which is attached to the real estate by the tenant that is peculiar to the operation of his business.

For example, a tenant leases property to operate a beauty salon. The tenant moves in work-related furnishings (i.e., mirrors, salon chairs, wash stations, dryers and the security system) which are needed to run the business. The items are attached to the floor, walls, plumbing and electrical leads.

On expiration of the lease, the tenant removes the fixtures which were used to render the services offered by the business. The landlord claims the fixtures are improvements to his property and cannot be removed since they have become part of the real estate.

However, furnishings which are unique to the operation of the business are considered trade fixtures even though the furnishings are attached and built into the structure. Thus, they are removable by the tenant.

A tenant may remove any trade fixtures at the end of or anytime during the lease term if the removal can be done without damaging the premises. [**Beebe** v. **Richards** (1953) 115 CA2d 589]

Fixtures that have become an integral part of the building structure due to the way they are attached or the general purpose they serve cannot be removed. Examples of fixtures not used to render services include toilets, air conditioners, vent conduits, sprinkler systems and lowered ceilings. [CC §1019]

Trade fixtures as security

Lease agreements often contain a default provision prohibiting a tenant from removing trade fixtures when he breaches the lease. The tenant (and a tenant's unsecured creditors) no longer have a right to the trade fixtures under a default provision.

Consider a tenant who signs a commercial lease agreement to use the premises to operate a frozen packaging plant on the premises.

The lease states all fixtures, trade or leasehold, will belong to the landlord should the lease be terminated due to a breach by the tenant.

The tenant later encumbers his trade fixtures by borrowing money against them. The tenant later defaults on his lease payments.

While in default on the lease, the tenant surrenders the property to the landlord, including all trade fixtures.

Does the lender secured by the trade fixtures have a right to repossess them?

No! The tenant lost his ownership right to remove the trade fixtures under the lease. Any right to the fixtures held by the secured lender is similarly lost since the lender is junior in time and thus subordinate to the landlord's interest in the fixtures under the lease.

However, if the trade fixtures installed by the tenant are owned by a third party, or if a third party had a lien on them at the time of their installation, the landlord has no more right to them than the tenant. [**Goldie** v. **Bauchet Properties** (1975) 15 C3d 307]

Notice of Nonresponsibility

A landlord may find himself paying for improvements made by the tenant if he fails to:

- **post** a notice on the premises of his intention not to be responsible for the improvements, called a *Notice of Nonresponsibility*; and
- **record** the notice with the county recorder. [See **first tuesday** Form 597 accompanying chapter 40]

Tenants occasionally contract for improvements to be constructed on the premises they have leased. Any **mechanic's lien** by a contractor for nonpayment initially attaches to the tenant's leasehold interest in the property. [CC §3128]

However, the mechanic's lien for unpaid labor and materials may also attach to the *fee simple* interest held by the landlord if the landlord or his property manager:

- acquires knowledge the construction is taking place; and
- fails to post and record a Notice of Nonresponsibility.

A **Notice of Nonresponsibility** is a written notice which must be:

- posted in a conspicuous place on the premises within ten days after the landlord or his property manager first has knowledge of the construction; and
- recorded with the county recorder's office within the same ten-day period. [CC §3094]

However, the landlord who becomes aware of the construction and fails to post and record the nonresponsibility notice is not personally liable to the contractor. Rather, the contractor can only lien the landlord's interest in the real estate and then foreclose on his lien to collect for unpaid labor and materials delivered to improve the property under contract with the tenant. [**Peterson** v. **Freiermuth** (1911) 17 CA 609]

Further, a mechanic's lien can attach to the landlord's interest even when he has posted and recorded a Notice of Nonresponsibility if the lease requires the tenant to make improvements.

For example, a lease states the tenant is to make certain improvements as a condition of renting the property. Since the improvements are not permissive, the tenant is deemed to be the **landlord's agent** when he contracts for the construction of the mandated improvements.

Thus, the mechanic's lien incurred by the tenant will attach to both the tenant's and the landlord's interest in the property despite any posting and recording of a Notice of Nonresponsibility. The lease mandated the tenant to construct improvements. [**Los Banos Gravel Company** v. **Freeman** (1976) 58 CA3d 785]

Had the lease merely authorized the tenant to make nonmandatory (permissive) improvements or make improvements subject to or without the landlord's prior consent, the tenant is not then acting as an agent for the landlord. Thus, the landlord's interest in the property will not be subject to a mechanic's lien if the Notice of Nonresponsibility is timely posted and recorded on discovery of the tenant improvements. [**Baker** v. **Hubbard** (1980) 101 CA3d 226]

Additionally, a mechanic's lien cannot be recorded against the landlord if the improvements are removed by the contractor recording the lien.

For example, a tenant contracts to have air conditioning installed in his building. The contractor sells the equipment to the tenant under a conditional sales contract. The contractor retains title to the equipment as security until the sales contract debt is paid.

The landlord's consent to the improvements is not obtained by the tenant, but the landlord has knowledge the work has commenced. The landlord does not post a **Notice of Nonresponsibility**.

Later, after the air conditioning units are installed, the tenant vacates the property.

The contractor is not paid and files a mechanic's lien against the landlord's fee interest in the property. Further, the contractor repossesses the air conditioning units and resells them at a loss, which he now seeks to recover under his lien.

However, by his election to repossess the units, the contractor waived his right to pursue the mechanic's lien to foreclosure.

Whether the air conditioning units are considered a removable fixture due to the financing, or a property improvement permitting the recording of a mechanic's lien, is no longer an issue after their removal.

The contractor removed the air conditioning units as authorized by the conditional sales contract and chose to treat the units as personal property, not real estate fixtures. Thus, the contractor lost his lien rights for nonpayment. [**Cornell** v. **Sennes** (1971) 18 CA3d 126]

Consider the tenant who leases a property containing tanks for holding gasoline. The tenant negotiates a reduced rental payment in exchange for installing fuel pumps free of any liens.

The tenant purchases the pumps on credit and the pumps are installed. The supplier of the pumps does not receive a Uniform Commercial Code (UCC-1) financing statement from the tenant, and thus does not file a UCC-1 with the Secretary of State, a requisite to *perfecting* the supplier's lien on the pumps.

Later, the pump supplier claims title to the pumps due to the unpaid installation debt and seeks to repossess them.

However, the landlord owns the pumps as fixtures which became part of the real estate. He gave consideration in the form of reduced rent to acquire the pumps. More importantly, the pump supplier failed to perfect its lien on installation of the pumps. [**Southland Corp.** v. **Emerald Oil Company** (9th Cir. 1986) 789 F2d 1441]

Chapter 9 Types of tenancies

This chapter presents the different types of tenancies and how each is established.

Know your tenancy or lose time

A landlord and tenant enter into a lease agreement without including an **option to renew** or extend the term of the occupancy on expiration of the lease.

Several months before the lease expires, they begin negotiations to enter into a new lease agreement extending the term of occupancy. An agreement is not reached before the original tenancy expires. The tenant remains in possession on expiration of the lease — an unlawful detainer of the premises, commonly called a holdover, unless agreed to.

The landlord and tenant continue lease negotiations. Meanwhile, the tenant pays monthly rent at the same rate he was paying when the lease expired, which the landlord accepts.

Ultimately, they fail to agree on the terms for a new lease. The landlord then serves a notice on the tenant to either **stay and pay** a substantially higher monthly rent or **vacate** and forfeit the right to possession. [See **first tuesday** Forms 569, 571 and 579]

The tenant does neither; he remains in possession and does not pay the increased rent.

Can the landlord file an unlawful detainer (UD) action and proceed to evict the tenant on expiration of the notice and without further notice?

Yes! The tenant went from a fixed-term tenancy (the lease) to a tenancy-at-sufferance on expiration of the lease (a holdover), then to a periodic (month-to-month) tenancy on the landlord's acceptance of rent for occupancy after the lease expired. The right to possession under the periodic tenancy ended due to the expiration of the notice and the tenant's failure to pay rent (set by the notice).

Tenancies as leasehold estates

Tenancies are possessory interests in real estate, called *leasehold estates*.

Four types of tenancies exist:

1. Fixed-term tenancies.
2. Periodic tenancies.
3. Tenancies-at-sufferance.
4. Tenancies-at-will.

To initially establish a tenancy, a landlord must somehow **transfer to the tenant** — either in writing, orally or by his conduct — the right to occupy the real estate. If the landlord does not transfer the right to occupy, the occupant who takes possession is a *trespasser*.

All tenancies have an agreed-to termination date or are capable of termination by notice. Termination of a **fixed-term tenancy** held by the tenant, which was conveyed by the **lease agreement**, occurs on the expiration date stated in the lease and without further notice.

A month-to-month rental agreement conveys an automatically renewable periodic tenancy, which is terminated by service of a notice to vacate at any time or a 3-day notice to vacate on a breach of the rental agreement.

A tenant's possessory interest in real estate can shift from one type of tenancy to another due to:

- a notice;
- expiration of a lease; or
- by conduct.

Thus, before a landlord can file a UD action and proceed with the eviction process based on an unlawful detainer of the premises by the tenant, the tenant's **right to possession** under his tenancy must be terminated by the proper notice to vacate (quit), unless the tenant holdover is under an expired lease.

In our opening example, the tenant traversed three types of **tenancies**:

- *fixed-term* (lease);
- *sufferance* (no agreed-to holdover); and
- *month-to-month* (acceptance of monthly payments), also called a *periodic tenancy*.

The tenant entered into his occupancy under a fixed-term tenancy, a leasehold estate commonly called a *lease*. During the term of the lease, the tenant can only be evicted for cause — and then only after the service of a 3-day notice to cure the breach or vacate (quit) the property. [See **first tuesday** Form 576]

On expiration of a lease, the tenant who remains in possession without an agreement or acceptance of rent by the landlord for the extended occupancy becomes a **holdover tenant**, legally called a *tenant-at-sufferance*. The landlord does not have to serve a notice to vacate on the holdover tenant before filing a UD action to evict the tenant. [Calif. Code of Civil Procedure §1161(1)]

However, if the landlord accepts monthly rent from a tenant in payment for his continued occupation after expiration of the lease, a month-to-month tenancy is established on the terms and conditions of the expired lease agreement, unless a renewal or extension option exists. When an option to renew or extend exists, the lease is renewed or extended by the post-expiration acceptance of the rent called for in the option. [Calif. Civil Code §1945]

To terminate a month-to-month tenancy which was created by acceptance of monthly rent after expiration of a lease which is not in default, the landlord must serve the tenant with a proper notice to vacate before filing a UD action. [**Colyear** v. **Tobriner** (1936) 7 C2d 735]

Fixed-term tenancy

A **fixed-term tenancy**, also known as an *estate for years* or more commonly as a *leasehold*, is the result of an agreement between the landlord and the tenant for a fixed time period, typically called a *lease*. [CC §761]

The occupancy under a lease agreement must have a beginning date, called the *commencement date*, and an ending date, called the *expiration date*. If the rental period is longer than one year, the lease arrangements must be in writing and signed by the landlord and tenant to be enforceable, called a *lease agreement*, and sometimes loosely referred to as *the lease*. [CC §1624]

In a fixed-term tenancy, the tenant has an exclusive right to possession of the premises for the term of the occupancy stated in the lease agreement. On expiration of the lease, the tenancy automatically ter-

minates. The tenant is not entitled to any notice to vacate other than the notice provided by the tenancy's expiration date stated in the lease agreement. [CCP §1161(1)]

For example, a landlord and tenant orally agree to a six-month lease. At the end of six months, the landlord and tenant orally agree to another six-month lease.

At the end of the second term, the tenant refuses to vacate. The tenant claims the landlord must first serve him with a notice to vacate.

Here, the tenant is not entitled to any further notice beyond the agreed-to termination date. The oral occupancy agreement was not a periodic tenancy, such as a month-to-month rental agreement, even though it contained monthly rent payments. Instead, the occupancy agreement was a fixed-term lease with a set expiration date.

Thus, the tenant's right to possession terminates on expiration of the orally agreed-to six-month period. The oral lease agreement is enforceable since it was for a term of less than one year. [**Camp** v. **Matich** (1948) 87 CA2d 660]

A **fixed-term tenancy** provides a tenant with several advantages:

- the right to occupy for the fixed term;
- a predetermined rental amount; and
- limitations on termination or modification.

However, some disadvantages also exist for the fixed-term tenant:

- the tenant is liable for the total amount of rent due over the entire term of the lease (subject to the landlord's duty to mitigate losses); and
- the tenant may want to vacate prior to expiration of the leasing period and assign or sublet the premises to a new tenant to cover rent obligations, but cannot due to prohibitions in the lease against his transfer of possession, called *restraints on alienation*.

Periodic tenancy

If the landlord finds a fixed-term tenancy too restrictive or inflexible for his financial purposes or use requirements, a periodic tenancy may be more suitable.

A periodic tenancy automatically continues for **successive periods**, each for the same length of time, until terminated by a notice to vacate. The length of each successive period of time is determined by the interval between scheduled rental payments.

Examples of **periodic payment** intervals include:

- annual rental payments, indicating a year-to-year tenancy;
- monthly rental payments, indicating a month-to-month tenancy; and
- weekly rental payments, indicating a week-to-week tenancy.

Consider a property manager who rents an apartment to a tenant under a fixed-term lease for one year. At the end of the leasing period, the tenant retains possession and continues to pay rent monthly, which the property manager accepts.

Later, the tenant is served with a notice to vacate. On the running of the notice, the tenant refuses to vacate. The tenant claims he is now a tenant-at-will and entitled to an additional 3-day notice to vacate

before he is unlawfully detaining the property since the notice to vacate served on him merely terminated his right to possession and made him a tenant-at-will on expiration of the notice.

However, an occupancy agreement for an **indefinite term** with a monthly rent schedule is a month-to-month tenancy. Thus, a tenant is only entitled to one notice to vacate before a UD action may be filed to evict him. [**Palmer** v. **Zeis** (1944) 65 CA2d Supp. 859]

The flexibility of a periodic tenancy allows the landlord and the tenant to terminate a month-to-month tenancy by giving the appropriate notice to vacate to the other party. [CC §1946]

Also, the operator of a **residential hotel** may not require a resident to change units or to check out and re-register in order to avoid creating a month-to-month tenancy and falling under landlord/tenant law. A residential hotel operator violating this rule is liable for a $500 civil penalty and attorney fees. [CC §1940.1]

Tenancy-at-sufferance

When a fixed-term (lease) or periodic (month-to-month) tenancy terminates by prior agreement or notice, the tenant who remains in possession — a *tenant-at-sufferance* — unlawfully detains the property from the landlord.

A tenant-at-sufferance is more commonly called a *holdover tenant*. A holdover tenant retains possession of the premises without any contractual right to do so, a situation called an *unlawful detainer.*

A **holdover tenant** no longer owes rent under the expired lease or terminated rental agreement since he no longer has the right to possession. However, the lease or rental agreement usually calls for a penalty rate of daily rent owed for each day the tenant holds over. Without a holdover rent provision, the tenant owes the landlord the *reasonable rental value* of the property, a daily rate owed for each day the tenant holds over in possession after expiration of his tenancy.

Holdover rent is due **after** the tenant vacates or is evicted, when the holdover period is known and the amount owed can be determined.

The landlord's acceptance of "holdover" rent **prior** to the tenant vacating or being evicted establishes a periodic tenancy on receipt of the rent.

For example, a tenant with a fixed-term lease holds over after the lease agreement expires. The lease agreement contains no provisions for the amount of rent due during any holdover period.

On the tenant's failure to vacate, the landlord serves the tenant a notice to either pay a rent amount substantially higher than rental market rates or vacate. The tenant refuses to pay any rent or vacate.

The landlord files a UD action seeking payment of rent at the rate stated in the notice to pay or quit since the tenant did not vacate.

At the UD hearing, the landlord is awarded the reasonable market rental value for the entire time the tenant held over, not the higher rent demanded in the notice to pay or quit. The tenant never paid nor agreed to pay any amount of rent after the lease expired. Thus, a periodic tenancy was not established.

The higher rental amount demanded in the notice to pay or quit was not accepted by the holdover tenant since he refused to pay it. Thus, a UD court will only award a reasonable rental value for the time period the tenant held over since he is a tenant-at-sufferance in unlawful possession of the property. Also, the

notice to (pay or) quit was not needed to evict the tenant on expiration of the lease. [**Shenson** v. **Shenson** (1954) 124 CA2d 747]

Expired first refusal as a holdover

Now consider a tenant who enters into a fixed-term lease for the second floor of a building.

Without a charge for additional rent, the tenant will also take and retain possession of the third floor until the landlord secures a *bona fide tenant*. The tenant has the **right of first refusal** to rent the third floor should the landlord find a tenant. If the tenant does not exercise his right of first refusal to rent the third floor, his right to possession of the third floor ends.

The tenant moves into the second and third floors of the building. Later, the landlord locates a prospective tenant to rent the third floor.

The landlord notifies the tenant he must immediately exercise his right of first refusal or vacate the third floor.

The tenant does not exercise his right of first refusal and refuses to move. The tenant claims he is a tenant-at-will with the right to receive a notice to vacate before his right to occupancy can be terminated.

However, the tenant's lease of the third floor had a *specific termination date* — the date the tenant fails to exercise his right of first refusal. Thus, he is a tenant for a fixed-term and not a tenant-at-will since his occupancy ended on expiration of his right of first refusal.

The tenant, now a holdover, becomes a *tenant-at-sufferance* on expiration of his right of first refusal. Thus, the tenant is not entitled to any further notice to quit before his unlawful detainer of the premises is established. The tenant's notice of the date of termination of the occupancy was his failure to exercise his right of first refusal prior to its expiration. [**Vandenbergh** v. **Davis** (1961) 190 CA2d 694]

For the tenant with a right of first refusal to also be entitled to an additional period of lawful occupancy and a notice to vacate after expiration of a lease, a provision so stating must be included in the lease agreement or the right of first refusal agreement.

Sufferance for the fired tenant-employee

A **tenancy-at-sufferance** also arises when a resident manager's compensation includes the right to occupy a unit rent-free. When the landlord terminates the employment and the resident manager fails to vacate immediately, a tenancy-at-sufferance exists.

For example, a landlord hires a caretaker to do general maintenance work around an apartment complex in exchange for rent-free possession of a unit in the complex.

Several months later, during a dispute with the landlord, the tenant refuses to work, which results in his dismissal as an employee.

The landlord delivers a notice to the tenant to immediately pay rent (as demanded in the notice) or quit. The tenant does neither and the landlord files a UD action.

The tenant contends he is a tenant-at-will, entitled to a notice to vacate before the landlord can establish an unlawful detainer and file his UD action.

However, the tenant's right to occupancy ended when his employment ended, the expiration of a fixed-term lease. Thus, the tenant became a **holdover tenant** who was not entitled to notice, other than the notice from the landlord *terminating the employment*, before the landlord could commence a UD action to evict him. [**Karz** v. **Mecham** (1981) 120 CA3d Supp. 1]

If the employee is to receive notice and time to pay or vacate on termination of his employment (and right to occupancy), his employment agreement must provide for it.

Under rent control ordinances, a tenant-at-sufferance must receive a notice to vacate. However, courts in rent-controlled areas have exempted employee-tenants from rent control protection by classifying them, for purposes of rent control, as licensees rather than tenants.

Yet, employee-tenants clearly are not licensees (for any other purpose) since they have exclusive rights to occupy the unit assigned to them. [**Chan** v. **Antepenko** (1988) 203 CA3d Supp. 21]

Tenancy-at-will

The characteristics of a *tenancy-at-will* include:

- possession delivered to the tenant with the landlord's knowledge and consent;
- possession for an indefinite and unspecified period; and
- no provision for the payment of rent.

For a **tenancy-at-will**, a written notice to vacate or pay rent is required to make any change in the right to occupy the premises. However, the parties can always agree to a shorter or longer notice period. [CC §§789, 1946]

For example, an owner-occupant agrees to sell his office building under a purchase agreement providing for him to retain the **free use and possession** of the property after closing until he can occupy an office building he is constructing. Thus, a tenancy-at-will is created.

The buyer agrees in the purchase agreement to give the seller a 90-day written notice to either vacate the property or pay rent.

The buyer resells the property to a new owner. The new owner demands the tenant-seller pay rent or vacate immediately. The new owner claims he is not subject to the prior owner's **unrecorded agreement** to give a 90-day notice.

However, the new owner acquired the property subject to the rights held by the tenant in possession. Thus, the new owner is charged with *constructive knowledge* of the unrecorded agreement regarding notices and took title subject to the terms of the agreement.

Until the tenant-at-will receives the appropriate notice to vacate, he is not unlawfully detaining the property and the owner/landlord cannot proceed with a UD action to recover possession. [**First & C. Corporation** v. **Wencke** (1967) 253 CA2d 719]

However, a tenancy-at-will is automatically terminated if the tenant **assigns or sublets** his right to occupy the property to another tenant. The new tenant becomes a tenant-at-sufferance or a trespasser. [**McLeran** v. **Benton** (1887) 73 C 329]

Also, the tenancy-at-will terminates on the **death** of either the landlord or tenant, unless an agreement to the contrary exists. [**Dugand** v. **Magnus** (1930) 107 CA 243]

Other situations giving rise to a tenancy-at-will include:

- when a tenant with the right to indefinitely occupy the property in exchange for making improvements fails to make the improvements [**Carteri** v. **Roberts** (1903) 140 C 164];
- when a tenant takes possession of the property under an **unenforceable lease agreement** (e.g., the written lease with terms orally agreed to was never signed by any of the parties) — unless rent is accepted, which establishes a periodic tenancy [**Psihozios** v. **Humberg** (1947) 80 CA2d 215]; or
- when a tenant is given possession of the property without the payment of rent while negotiations on the lease provisions are still in progress. [**Miller** v. **Smith** (1960) 179 CA2d 114]

Terminating a tenancy

A landlord's primary concern when terminating a tenancy is the type of notice to vacate he must deliver to establish an unlawful detainer under the different **types of tenancies**, including:

- a *fixed-term tenancy*, in which case the landlord does not need to deliver any notice to vacate prior to commencing a UD action against a holdover tenant after expiration of the lease since the tenancy automatically expires by the terms of the lease [CCP §1161(1)];
- a *periodic tenancy*, in which case the notice to vacate must be for a period at least as long as the interval between scheduled rental payments, but need not exceed 30 days or 60 days, depending on the length of occupancy for a residential tenant [CC §1946];
- a *tenancy-at-sufferance*, in which case the holdover tenant is not entitled to any further notice prior to commencing eviction proceedings since a lease has expired or a periodic tenancy has been terminated by notice [CCP §1161];
- a *tenancy-at-will*, in which case a 30-day or 60-day notice to vacate or otherwise alter the tenancy-at-will is required [CC §789];
- a rent-controlled tenancy of *residential property*, in which case termination of the right to possession is restricted by local ordinances; and
- a *tenancy-at-will in a mobilehome park*, in which case a 60-day written notice is required to be delivered to the tenant. [CC §798.55(b)]

Further, a landlord and tenant by agreement can establish a shorter or lengthier notice period, but not less than seven days. Industrial and commercial tenants typically require three months minimum notice due to the time lost receiving and responding to a notice since it must first go through multiple tiers of corporate management. [CC §1946]

Changing the type of tenancy

A landlord, by using an improper notice, can end up with a different tenancy relationship from the one he initially conveyed to a tenant. When an existing tenancy is altered, in writing or by conduct, the tenancy may have been converted into another type of tenancy.

A classic example involving a change in the type of tenancy arises when a holdover tenant (a tenancy-at-sufferance) becomes a month-to-month tenant (a periodic tenancy).

A landlord who accepts any rent from a holdover tenant under an expired lease, in payment for a period of occupancy after the lease expired, has elected by his conduct to treat the continuing occupancy as a periodic tenancy. [**Peter Kiewit Sons Co.** v. **Richmond Redevelopment Agency** (1986) 178 CA3d 435]

Thus, a proper notice to vacate, a requisite to a UD eviction, must be served on the holdover tenant who paid rent for the continued occupancy, which was accepted by the landlord. [Colyear, *supra*]

When the tenant holds over after a fixed-term tenancy expires and the landlord accepts rent for the hold-over period while the tenant is in possession, the expired lease agreement is *renewed* on the same terms except for the period of occupancy, which is now periodic. [CC §1945]

On expiration of a fixed-term lease, the landlord's continued acceptance of rental payments does not **renew** the tenancy for another term equal to the term of the original lease. Rather, the tenancy is extended as a periodic tenancy for consecutive periods equal to the interval between rent payments — being one month if rent is paid monthly. [CC §1945]

For example, a landlord and tenant agree in writing to a three-year lease with rent paid annually in advance. At the end of the three-year lease, the tenant holds over without further agreement. The tenant tenders an annual rent payment which the landlord accepts.

The landlord's acceptance of rent extends the expired three-year lease for a period of one year since the rent paid was for an annual period. Without a written agreement to the contrary, the tenancy is extended only for the period of the prepaid rent even though the term of the original lease, which controlled the terms of the extended one-year occupancy, was for a three-year period. [**Hagenbuch** v. **Kosky** (1956) 142 CA2d 296]

Transient occupancies and removals

An occupant of a vacation property, hotel, motel, inn, boardinghouse, lodginghouse, tourist home or similar sleeping accommodation for a period of 30 days or less is classified as a **guest**, also called a *transient occupant*.

A transient guest occupies property known as *lodging, accommodation* or *unit*. The property is not called a rental which is a landlord/tenant characterization of their relationship.

The guest's occupancy of the accommodations contracted for is labeled a *stay*, not possession. During a guest stay in the lodging, the owner or manager of the property is entitled to enter the unit at check-out time even though the guest may not yet have departed.

The contract entered into for the lodging is usually called a **reservation agreement**, but never a rental agreement or lease agreement. [See **first tuesday** Form 593]

Also, guests pay a **daily rate**, not a daily or weekly rent, and they *arrive* at a pre-set date and time for *check-in*, not for commencement of possession. Likewise, guests *depart* at an hour on a date agreed to as the *check-out time*. Unlike a tenant, a guest does not vacate the premises, they check out.

When a guest fails to depart at the scheduled check-out hour on the date agreed, no holdover tenancy is created as occurs under a tenancy for occupancy conveyed by a rental agreement or lease. Thus, a UD action or court involvement is not required to remove the guest. [CC §1940(b)]

However, for the owner or manager to avoid the UD eviction process, the guest, when checking in, must have signed a notice stating:

- the unit is needed at check-out time for another guest who has been promised the unit; and
- if he has not departed at check-out time, the owner or manager may enter, take possession of the guest's property, re-key the doors and clean up the unit for the next guest. [CC §1865; see **first tuesday** Form 593]

To **remove a guest** who fails to timely depart the unit and remains in the unit after a demand has been made to leave, the police can be called in by the manager if his own intervention might cause a breach of the peace, called self-help. The police or the sheriff will assist, without the need for a court order, to remove the guest and prevent a danger to persons or property during the re-keying, removal of possessions and clean up for the arrival of the next guest. [Calif. Penal Code §§602(r); 803.1(a)(3)]

Transient occupancies include all occupancies that are taxed as such by local ordinance or could be taxed as such by the city or by the county. Taxwise, the occupancy is considered a *personal privilege*, not a tenancy. Time share units, when occupied by their owners, are not transient occupancies and are not subject to these ordinances and taxes. [Calif. Revenue and Taxation Code §7280]

Transient units do not include *residential hotels* since the occupants of residential hotels treat the dwelling they occupy as their *primary residence*. Also, the occupancy of most individuals in residential hotels is for a period of more than 30 days.

A broker or any other person or entity who manages "vacation rental" occupancies for owners of single-family homes, units in a common interest development (condominium project), units in an apartment complex or any other residence subject to a local transient occupancy tax, must maintain **accounting records**.

Further, the property manager must send a monthly accounting statement to each owner he represents and make the records available for inspection and reproduction by the owner, as well as comply with the transient occupancy tax regarding collection, payment and record keeping. [CC §1864]

Chapter 10 License to use land

This chapter distinguishes a license to use land from a tenant's leasehold and an easement on land. .

A personal right to use another's property

The purpose of a *license*, like an easement and a lease, is to grant the right to use property owned by another person. A **license** is similar in this essential purpose to an easement and a lease, yet it is neither.

Similar to an easement or a lease, a license is an agreement. Instead of being placed in writing, a license is often oral. Unlike an easement, a license does not have a perpetual life, nor does it have a specific *expiration date* like a lease.

Also similar to an easement, a property burdened with a license is referred to as the *servient tenement*. Unlike an easement, which benefits the owner of another (adjacent) parcel of real estate, called the *dominant tenement*, and is an appurtenant right transferred with the conveyance of that property, a license has no **dominant tenement** (adjacent property) which benefits from the license. A license is not appurtenant to any property. It is personal, called *in gross*.

Unlike an easement or a lease, a license is a **personal privilege** held by an individual, not an appurtenant right remaining with a property for future owners to use. Since a license is not an appurtenant right and does not benefit a property, the right given by the license cannot be transferred to another individual.

A holder of a license does not typically pay rent for the right to use the burdened property. If consideration for the license exists, it is in the form of an expenditure of time and money by the licensee to improve or maintain the use authorized on the burdened property, such as an irrigation ditch, roadway, fence, etc.

Due to the fact that there is no right to exclusive possession of a burdened property (the **servient tenement**) for an authorized use, a license, like an easement and unlike a lease, permits only the *nonexclusive use* of the property by the licensee.

Unlike either a lease agreement or an easement deed, which are conveyances of an interest in real estate, a license agreement **conveys no interest** in real estate. The right to use a property granted by a license is a mere personal privilege, held by an individual under an agreement with the owner of the burdened property. The license is **revocable** by the owner of the burdened property at any time, unless revocation would be unfair to the holder of the privilege, called a *licensee*.

Typically, a license agreement arises between a property owner and a neighbor or friend as the result of a property owner's acceptance of an informal offer by an individual to jointly or separately make use of the owner's property for a specific activity. The individual given the license generally agrees to maintain or improve the property for the agreed-to use.

Use of land as a personal privilege

A broker wants to increase the exposure of his business to the public by billboard advertising.

The broker has a friend and business acquaintance who owns vacant property adjacent to a highway. The property owner is willing to allow the broker to place a billboard on his vacant land.

The broker and property owner enter into an oral understanding allowing the broker to put up a billboard for his use only. It is agreed the broker may enter and exit the property at his will to install and maintain the billboard.

A **time limitation** is not specified for maintaining the billboard on the property, nor is any fee or other compensation established. However, the property owner does not relinquish any control over the real estate since he does not give the broker any other right to use the property.

Have the broker and property owner established a landlord/tenant relationship or an easement?

Neither! The broker has only been given a **license** to use the owner's property.

Unlike a landlord/tenant relationship or an easement, a license to use real estate is a **personal privilege**, unattached to any property owned by the broker. Thus, the use is generally non-assignable to others by the broker and, unless agreed to the contrary, is revokable by the property owner at any time.

A license for non-exclusive use

A license is the **nonexclusive right** given to an individual to use a space or area within a parcel of real estate, or its improvements, that belong to another person. The right to use is held by an individual under an agreement, without the *rights to assign* or to privacy. A license is subject to termination by the owner of the burdened property at will, unless it has become irrevocable.

Consider a property owner who contracts for development work to be done on his property. The owner allows the construction company to store excess dirt on vacant lots he owns until they can haul it away.

While the dirt remains on the vacant lots, an adventurous dirtbiker enters the property and is injured. The injured dirtbiker claims the construction company is a licensee who is not in possession of the real estate and thus is liable for his injuries. The construction company claims they have a *recreational use immunity* since they have an interest in the property as a licensee with a right to use it for the agreed-to purpose.

In this example, the holder of any interest in the property is exempt from liability for injuries to others arising out of their **recreational use** of private property. The property interest exempt from liability can be either possessory or nonpossessory.

Even though a licensee only has a nonpossessory interest in the property, he also has recreational user immunity while the owner remains in possession and control of the land since the licensee has a nonexclusive personal right to also use the property. [Calif. Civil Code §846]

Thus, the construction company is not liable for injuries which occur during the dirtbiker's recreational use of the property since the construction company holds an interest in the property under their license to use.

License vs. lease and the dominant tenant

A license is often confused with a lease. A **lease** conveys a possessory interest in real estate which allows the tenant to **exclusively occupy** the leased premises in exchange for rent, called a *leasehold estate* or a *lease*. [CC §761]

A **license-to-use** another person's real estate, called a *servient tenement*, is a personal privilege held by an individual. A license is neither personal property nor real property, and it is neither owned by a person nor is it an appurtenance to adjoining real estate. Thus, a license, not being property or capable of ownership, cannot be transferred to the licensee's successors or assignors. [**Beckett** v. **City of Paris Dry Goods Co.** (1939) 14 C2d 633]

Characteristics which distinguish a license from a lease include:

- no writing to formalize the agreement;
- no rental payments;
- no specific location on or within the property where the use will occur;
- no intent to convey a leasehold estate;
- no right to exclude others;
- no termination date; and
- termination at the owner's will, unless the license is irrevocable.

In our previous example, the broker can use his business acquaintance's property to set up his billboard and leave it in place on the property. Also, the broker (or his representative) has the right to go back and forth across the property to maintain or repair the billboard. Thus, the property is a **servient tenement** subject to the terms of the license held by the broker. However, no **dominant tenement** exists since no property benefits from the license; only the broker benefits as the licensee.

Thus, the owner of the property can demand removal of the broker's billboard from the property at any time, and the broker must immediately remove it.

A common thread which runs through both a lease and license is the right to use the property. The glaring distinction between the two is that the license does not include the **right to exclude** any other person from possession as does a lease.

Continuing with our example, the broker cannot fence off, lock out or quarantine in any way the ground under or around his billboard from the property owner or any other person. The license affords the broker no greater right to be on the property than anyone else the owner might allow to concurrently use his property.

License distinguished from a lease

When an agreement with a property owner gives another person exclusive right to possession of the property against all others, including the owner, it is a lease agreement or periodic rental agreement — a leasehold estate, not a license.

Conversely, when the agreement confers only the privilege to use property which remains under the owner's day-to-day control, it is a license. [**Von Goerlitz** v. **Turner** (1944) 65 CA2d 425]

For example, an owner of a packing company enters into an agreement to purchase raw materials from a wholesale merchant. The wholesale merchant is to supply the packing company with raw materials over a three-year period. In exchange, the packing company will pay the agreed-to price for the materials, as well as allow the wholesale merchant the right to use an unlocked storage unit for temporary stockpiling of his materials and desk space in an office at the packing facility to conduct business.

The agreement does not designate the exact spaces to be used by the merchant. Also, the packing company will concurrently use the same space to be used by the merchant.

Two years into the arrangement, the packing company is sold. The new owner demands the wholesale merchant to move out immediately. The wholesale merchant claims a lease existed between himself and the previous owner, allowing him to remain on the property until the lease expires.

However, no dollar rental amount had been established. Also, the wholesale merchant did not have exclusive possession of the spaces he occupied.

Instead of a lease, the wholesale merchant held a license agreement to use space under which the packing company had a superior possessory right to the premises. Thus, the wholesale merchant's use of unlocked space, concurrently occupied by the original owner, was not a lease.

The mere permission of an owner to let someone use and occupy unidentified space in a structure in a **non-exclusive manner** when the owner retains possession and total control over the premises constitutes a license. [**Caldwell** v. **Gem Packing Co.** (1942) 52 CA2d 80]

Terms imply a lease exists

The stated intentions in a written agreement between an owner and another person may be to enter into a license agreement. However, the actual language and provisions of the agreement may render it a lease which is improperly titled as a license.

For example, an optometrist enters into a written agreement with an operator of a store to establish an optical department on the premises. The written agreement is entitled a license.

The agreement allows the store to determine the space the optometrist will occupy, set the rent at a percentage of the optometrist's total sales and require the optometrist to make nightly deposits of receipts with the store's cashier. Also, the optometrist has the exclusive right to manage and operate his trade within his space. The agreement prohibits the optometrist from assigning his business and the occupancy to another without the store's consent.

The agreement is for a term of three years, at which time the optometrist agrees to surrender the premises in good condition.

Two years after commencement of the agreement, the store hands the optometrist a notice of cancellation of their agreement (rather than a three-day notice to perform or quit) for his failure to deposit his daily cash receipts with the store cashier.

The optometrist refuses to vacate, claiming he is a tenant of the store under the written agreement. The store contends the agreement was a license, terminable at any time and the optometrist must leave.

However, the terminology in their agreement and the payment of rent is more in line with a lease than a license, indicating the parties created a landlord/tenant relationship by their arrangements.

Similar to a lease, the provision **prohibiting assignment** is only applicable to the ownership of an interest in real estate since a license is non-assumable as nothing is actually owned for the licensee to assign. Also, the optometrist was given **exclusive possession** of a designated space within the store for a fixed period of time which eliminates the owner's right to enter the optometrist's space at any time.

Thus, the arrangement by the content of the written agreement was a lease. The right to exclude others from entry for a stated term, coupled with assignment rights and rent, are characteristics of a landlord/tenant relationship, not a license. [Beckett, *supra*]

If an occupancy agreement contains words or phrases like **lease, rental, demise** or **good tenantable condition**, the agreement will be construed to be a lease rather than a license.

Consider a corporation which owns 150 units in a resort condominium and sells **time-share memberships** in the resort. A member can purchase up to four one-week time share interests.

However, a member is not entitled to reserve any particular unit in advance of occupancy. The assignment of units for actual occupancy during the time period selected is left up to the discretion of the corporation's board of directors.

A restraining order is issued by the Department of Real Estate (DRE) stopping sales of these time-share memberships because a permit and a public report to sell **fractional interests in real estate** was not first obtained from the DRE by the corporation.

The corporation contends the memberships are mere licenses held by the members to use unidentified space and are not a lease or other conveyance of space to the members which would require a permit and public report. The corporation further contends the members do not hold an interest in the real estate since they do not have exclusive right to the possession of any specific unit.

However, the occupancy rights held by the members constitute a lease. The units to be occupied are identical, the duration of occupancy is specific and each member has the right to exclusive occupancy of a unit. [**Cal-Am Corporation** v. **Department of Real Estate** (1980) 104 CA3d 453]

License recharacterized as a lease

A license is usually oral with very few terms agreed to except the permission to use or conduct an activity on a property while the owner remains in actual possession and retains the right to exclude others, including the licensee. Above all else, a license does not carry with it the right to exclude anyone from the property.

However, with every additional condition agreed to between an owner and user, a license begins to recharacterize itself more and more into a lease.

For example, a broker has an office with unoccupied desks. The broker wants to operate alone and avoid commitments to manage and supervise associate licensees. However, he is willing to share space in the office with other brokers.

The broker offers another broker the use of an office, desk space, a telephone line and secretarial services. The brokers orally agree each will pay their own proportionate share of utilities, secretarial services and rent.

A time period for the use is not specified. The office space selected by the other broker is unlocked and open to the entire office.

In this instance, the original broker may terminate this "rent-a-space" relationship at any time without prior notice or cause since the other broker has been given no more rights than a licensee to use office space.

Conversely, when a broker offers space in his office under a written agreement providing for lockable office space and a specific period for occupancy, the agreement is a lease. With a lease (or a month-to-month rental agreement) in hand, the broker has created a landlord/tenant relationship, not a license.

By specifying more and more terms regarding the right to exclude others — such as the locked door prohibiting entry by others for a period of time — what started out as a mere license to use has been restructured to constitute a lease.

A license coupled with a lease

On some occasions, a license and a lease co-exist and are held by the same person.

A person can be a tenant with exclusive occupancy to part of the space on the premises of a shopping center and hold a license to use an adjacent portion of the premises as well.

For example, a retail tenant leases space in a shopping center. The tenant has exclusive possession of his store space controlling who may enter. However, the tenant shares use of the sidewalks and parking lots with other shopping center tenants and all the customers of the shopping center.

The tenant has no right to exclusive possession of the sidewalk and parking area, only the space enclosed within his unit. Thus, the tenant holds a license for access and non-exclusive use of the parking area and a lease for the space within the shopping center.

An irrevocable license

When an individual makes substantial expenditures to improve or maintain his use of another person's property for a long period of time in reliance on his oral agreement with the owner of that property, the license becomes irrevocable and cannot be terminated at will by the property owner.

An **irrevocable license** grants an individual the right to enter and use property as long as the specific activity for which the license was granted is feasible.

For example, a neighbor expends money, or its equivalent in labor, on the on-going maintenance of a road (which provides access from his property to a main road) through property owned by another person. The work is done in reliance on an oral agreement with that property owner. Here, the neighbor by his reliance on an oral agreement when doing the work has an irrevocable license to use the road. [**Cooke** v. **Ramponi** (1952) 38 C2d 282]

Consider the construction of a privacy wall along the entire length of a common property line between adjacent lots. The lots are located on a hillside, one above the other. Each lot is flat with a graded slope between them to adjust for the difference in the elevation. Each lot is improved with a residence.

The boundary between the lots is located at the bottom of the slope. However, for a wall to give the owner of each lot privacy, the wall must be located at the top of the slope, entirely on the uphill parcel and several feet from the boundary line.

The owner of the uphill lot agrees to allow the neighbor below to construct a masonry wall with its foundation on the top of the slope. The owner and the neighbor agree on the height of the wall and that the neighbor may **use the slope** between the wall and the property line.

The owner orally agrees to an easement for the encroachment, which is never reduced to writing so no easement was created.

The neighbor constructs the masonry wall at the top of the slope. He also builds a gazebo within the slope area between the fence and property line.

The owner of the uphill lot sells the property to a buyer. The buyer surveys the lot and demands the neighbor to remove the wall and gazebo since they encroach on what is now the buyer's property.

The neighbor claims he has an irrevocable license to maintain the encroachments and use the slope since he spent considerable time and money to construct the encroaching structure in reliance on the prior owner's oral agreement which allowed him to build the wall and use the top of the slope.

The buyer claims he should not be estopped from revoking the license since he had no notice the license existed and the use was not reduced to an enforceable easement.

However, the license became irrevocable since substantial effort or expenditures were made in reliance on the oral agreement with the property owner allowing the use. Further, the buyer — as a successor owner of the property burdened with the use allowed by the oral license agreement — need not have any knowledge of the irrevocable license to be barred from denying the neighbor's continual use to maintain the existing wall and gazebo under the oral agreement. [**Noronha** v. **Stewart** (1988) 199 CA3d 485]

Chapter 11 Water rights

This chapter presents an overview of the rights of landowners and water producers to remove and use surface and ground water.

Water is used, not owned

Water is characterized, based on its physical location relative to a parcel of real estate, as belonging in one of two categories:

- *surface water*, consisting of watercourses, lakes, springs, marshes, ponds, sloughs, and any other water flowing over the surface of the earth caused by rain, snow, springs or seepage; or
- *ground water*, consisting of percolating, subterranean bodies of water located in underground *basins*. [Restatement of the Law 2d Torts §§841, 845, 846]

Holders of rights to withdraw **surface waters** are said to have *riparian rights*, and are called *riparian landowners*.

Holders of rights to pump **ground water** are said to have *overlying rights*, and are called *overlying landowners*.

Legal rights to extract and use water are based on priorities and are classified as:

- *landowner's rights* consisting of both riparian and overlying rights;
- *appropriative rights* to withdraw water under license from the state; and
- *prescriptive rights* to withdraw water legally entitled to be used by others.

Riparian rights refer to a landowner's incidental property right, appurtenant to his property, to withdraw water from an adjacent river or lake for beneficial use on his riparian land.

Overlying rights refer to a landowner's right to the use of ground water below the surface of his land. An overlying landowner has rights to an allotment of water which is measured by the ground water in the **basin** over which his land is located. Overlying landowners have equal rights against other overlying landowners to a basin's ground water percolating underneath their land, subject to their *reasonable use* of the water.

Overlying and riparian rights are legally analogous to one another, except for the limitations placed on overlying landowners to use ground water and riparian landowners to use surface water. [**City of Barstow** v. **Mojave Water Agency** (2000) 23 C4th 1224]

A landowner's use of water in the exercise of his riparian or overlying water rights has *priority* over water rights held by appropriators licensed by the state.

Riparian and overlying water rights are part of the ownership of land, and are *appurtenant* to the land and run with the title to the land when it is sold. Water rights are not personal property which can be assigned or used for the benefit of other property.

Land entitled to water rights

Riparian land is a parcel of real estate located both adjacent to a water source with surface water and within the *watershed* (basin) of the surface water.

The amount of frontage in actual contact with the surface water of a river or lake does not determine whether a parcel is considered riparian land. A parcel is considered riparian land if it:

- touches the surface water; or
- was part of a larger riparian parcel and retained its riparian rights by reassignment when parceled.

For example, a 40-acre tract of land, of which only 250 feet abuts a stream, is considered riparian land. [**Joeger** v. **Mt. Shasta Power Corp.** (1932) 214 C 630]

To constitute riparian land, a property must also be located within the **watershed** surrounding the watercourse. Should a portion of riparian land extend outside the watershed, only the portion within the watershed is entitled to use the water from the watercourse.

The logic for the watershed rule limiting the use of surface river or lake water to land located within its watershed is that the water will eventually return to the watercourse, minus the water consumed, in a natural process called *percolation*. Additionally, rain falling on lands within the watershed of a watercourse feeds the watercourse. Thus, a riparian land owner can only divert water to the portion of his land which will allow the water through **percolation** to return to the watercourse.

For example, a tributary enters a creek above the confluence of the creek with a river. An owner of land within the watershed draining into the tributary, but not located within the watershed of the river which the tributary joins, begins to divert water from the river for use in the irrigation of his land.

A riparian land owner who owns land fronting on the river and within the watershed seeks to bar the owner of the land located outside the river's watershed from diverting water.

The owner of the land in the tributary's watershed claims he is entitled to divert water from the river for use on his land since the watershed of the tributary is located within the general watershed of the river.

The riparian landowner claims the owner of the land within the tributary's watershed cannot pump water from the river since the land within the watershed of the tributary is not riparian to the river and the pumping deprives him of his riparian rights.

In this scenario, the owner of the land within the watershed of the tributary is not entitled to divert water from the river. When two bodies of water (tributaries, creeks, rivers) unite, each is considered separate and within separate watersheds.

Land lying within the watershed of one stream above the point where the two streams unite, called a *confluence*, is not considered to be riparian to the other. Further, the surface flow (river) **below the confluence** of two streams is a new and entirely different watershed, justifying a new name for the river below the confluence (as is the practice in Mexico to distinguish the watershed). [**Anaheim Union Water Co.** v. **Fuller** (1907) 150 C 327]

Riparian rights are appurtenant

The right to use riparian water is an *appurtenant* (incidental) right which is attached to and transferred with the ownership of real estate. [Calif. Civil Code §§658, 662]

Each riparian landowner is entitled to a *reasonable use* of the natural flow of stream water running through or adjacent to his land. However, the quantity of the water withdrawn is subject to an upstream riparian landowner's **priority** right to *first withdraw* water for reasonable use on his upstream riparian land.

Additionally, a riparian landowner cannot divert stream water to nonriparian lands, even if he is entitled to use the water on his riparian land, but does not, since he is subject to the rules of percolation within the watershed. The landowner's riparian right to use the surface water is appurtenant to the land bordering the stream, not other lands which are not bordering the stream. [**Gould** v. **Eaton** (1897) 117 C 539]

Reasonable use and domestic priorities

Riparian rights are limited by the requirement that water taken from a stream must be put to a **reasonable and beneficial use**. Water is a state resource which, if used under a legal right, must, to the fullest extent possible, be put to reasonable and beneficial use. No one has a protectable interest in the unreasonable use of water. [Calif. Constitution, Article X §2]

Reasonable and beneficial uses include domestic uses and agricultural irrigation. Whether a particular use of water is reasonable and beneficial is determined on a case by case basis. [Calif. Water Code §106]

Consider two landowners with riparian rights to the water in a creek. Both owners use the creek water for domestic purposes. The owner who is upstream begins to divert all of the creek's water with a dam to his riparian land for use in his domestic consumption and agricultural irrigation.

The downstream owner removes the diversion dam and starts to draw water flowing in the creek to his property again. The upstream owner seeks to bar the downstream owner from preventing the diversion of the creek water.

The upstream owner claims his diversion of the creek water may not be prevented by the downstream owner since the upstream owner by his location on the creek has priority and is entitled to first use of the water for domestic and irrigation uses as a riparian owner.

The downstream owner claims he may prevent the diversion of the creek water since the upstream owner's diversion is completely depriving him of his riparian right to the water for domestic use.

In this scenario, the downstream owner is entitled to satisfy his domestic water needs before the upstream owner can use the water for agricultural irrigation. It would be unreasonable for the upstream owner to use water for irrigation before the domestic uses of the downstream owner are satisfied. [**Drake** v. **Tucker** (1919) 43 CA 53]

While riparian landowners hold the same classification of legal rights to water, they must share the water, giving priority to domestic uses over other uses, including agricultural irrigation.

The **sharing** of water between riparian landowners, with priority to upstream owners, is based on a tiered variety of priority and subordinate uses across the entire group of riparian owners, called *correlative rights*. Each landowner holds correlative rights within the riparian class of water rights.

Water rights are usufructuary

Owners of land and water providers (appropriators) who hold water rights do not legally **own** water. Those with legal rights to water only own rights to the **reasonable use** of the water. Their right-to-use is

subject to change when circumstances controlling the use of water change, called *usufructuary rights*, a sort of "here today, gone tomorrow" approach to access and possession.

If a riparian land owner is not using water, downstream riparian land owners are entitled to the full flow of the water, subject to the upstream riparian owner's future reasonable use. Thus, the lack of use of the appurtenant right to water is not lost by mere nonuse alone.

However, an upstream riparian owner who is not using his **allotment of water** may not divert water to nonriparian land since the water would not percolate into the watershed. The upstream riparian owner's right to use the water is appurtenant to the riparian land and does not include any ownership of the water allowing the landowner to transport the water out of the watershed. [Gould, *supra*]

Competing water rights and allotments

In 1943, California established the **State Water Resources Control Board (Board)**. The Board acts as a referee for all disputes over water rights. As a **referee**, the Board advises the court on the appropriate water allotment each of the disputing parties is entitled to take. Also, on a request from holders of water rights, the board itself may hear legitimate disputes between the parties to determine the water allotment each party is entitled to take. [Wat C §§2000, 2501]

When the Board determines the allotment of water to each holder of riparian rights, the needs of all riparian landowners (within the watershed) are taken into account since riparian rights in water are *correlative*. The amount of water allocated to a riparian owner is determined case by case based on, among other factors, the need for domestic use, irrigation and generating power.

For an example which applies to **correlative rights**, an upstream owner of 66 acres of riparian land suitable for profitable irrigation, a reasonable riparian need, is entitled to a smaller proportion of the water from a watercourse running through his land than a downstream owner of 96 acres of riparian land also suitable for profitable irrigation. [**Half Moon Bay Land Co.** v. **Cowell** (1916) 173 C 543]

Riparian rights not lost by disuse

An owner of riparian land has water rights which are "part and parcel" of his land, called *appurtenant rights*. As an **appurtenant right**, riparian water rights cannot be lost by disuse.

For example, co-owners of riparian land partition the land, providing each with separate ownership of a pro rata portion. The partition is made by deeds which grant each owner his pro rata share of the original parcel's riparian right to the stream flow running through the parcels. Concurrently, the co-owner receiving the southern (baja) parcel is given an easement across the northern (central) parcel to construct a pipeline to divert his share of the water from the stream to his parcel.

The southern owner never builds the pipeline and never diverts the water. Later, the northern owner begins to divert all the water from the stream to his parcel above (alta) the point where the pipeline easement meets the stream.

The southern owner claims the northern owner cannot divert all the water from the stream since, as a riparian owner, the southern owner is entitled to his pro rata share of the stream's flow, whether or not he uses his share.

The northern owner claims he can divert all of the stream water since the rights of the southern owner to divert the water were contingent on the construction of the pipeline and the diversion of the water, which was never done.

However, the northern owner cannot interfere with the southern owner's riparian right to his reasonable share of the stream's flow. The riparian rights of the southern owner are "part and parcel" of his land, an appurtenant right which cannot be lost by disuse alone. The pipeline easement also cannot be lost by disuse alone. [**Parker** v. **Swett** (1922) 188 C 474]

Consider two appropriators who have no riparian rights appurtenant to any land but are allowed to withdraw water up to a set amount in the river. Additionally, both appropriators are entitled to take water unused by senior appropriators.

The senior appropriator fails to take his entitled amount of unused water during a five-year period. The junior appropriator seeks to reduce the amount of the senior appropriator's entitlement to the amount actually used each month during the prior five years, claiming the senior appropriator's nonuse forfeited the unused portion of his entitlement.

The senior appropriator claims he did not forfeit his right by nonuse since the amount of unused water available is unpredictable and therefore can not be forfeited. Did the senior appropriator forfeit the unused portion of his entitlement to unused water?

Yes! The senior appropriator's nonuse forfeited his right to take unused water, entitling the junior appropriator to take the unused water up to the amount of his entitlement. [**North Kern Water Storage District** v. **Ken Delta Water District** (2007) 146 CA4th 555]

Public dedication by allowing use

A riparian landowner diverts water from a river for public use. The water diversion adversely affects the water rights of another riparian landowner. However, the other riparian landowner allows the interference to continue unabated. In this situation, the **conduct** of the adversely affected landowner causes his riparian rights to be *dedicated* to the public use. Once **dedicated**, the landowner can only seek compensation for the loss of his riparian rights and cannot get his rights back.

For example, a downstream riparian owner constructs a canal to divert a large portion of a river's flow. The water is diverted for the domestic and irrigation uses of towns which were established and grew in reliance on the diverted water. The extent of the diversion is known to an upstream owner who allows the diversion to continue uninterrupted for several years.

Later, the upstream owner begins to take water from the river for irrigation of his lands, diminishing the amount of water available for the public use. The downstream owner seeks to bar the upstream owner from diverting the water, claiming the diversion upstream now deprives the downstream riparian owner of the water he was accustomed to diverting for the public use.

The upstream riparian owner claims he is entitled to divert the water for irrigation of his riparian lands since, as a riparian owner, he is entitled to use a reasonable share of the river water.

The downstream riparian owner claims the upstream riparian owner is not entitled to divert water for irrigation since the water taken by the downstream owner is devoted to public use in reliance on the upstream owner's disuse.

In this instance, the upstream riparian owner may not now interfere with the downstream diversion of water. The diversion of water for public use was allowed to continue unchecked for a period of years. This non-interference conduct constituted a dedication of the upstream owner's water rights to public

use. The upstream riparian owner's only recourse is to seek compensation for his lost riparian rights from the downstream owner. [**Miller & Lux** v. **Enterprise Canal & Land Co.** (1915) 169 C 415]

Termination of riparian rights

Consider riparian land fronting on a river or lake which is subdivided or parceled. One of the parcels created has no frontage on the watercourse. The parcel is later conveyed without a provision in the deed transferring the riparian rights.

In this example, the parcel conveyed without reference to its riparian rights loses its riparian land status forever. The parcel remains nonriparian even when the parcels which made up the original riparian parcel are later brought together under one ownership.

For example, a riparian tract of land is subdivided into parcels. A parcel without frontage on the watercourse running through the original tract is conveyed to a buyer without conveying the riparian rights which were appurtenant to the original tract.

The buyer later sells the parcel which has no frontage on the watercourse to the owner of an adjoining parcel which was a part of the original tract and has frontage on the watercourse. The owner then begins to irrigate the newly acquired parcel with water from the watercourse.

A downstream riparian owner seeks to bar the upstream owner from irrigating the adjoining nonriparian parcel since the adjoining parcel was conveyed out of a riparian tract without an accompanying transfer of riparian rights.

In this scenario, the upstream riparian landowner is not entitled to irrigate the adjoining, nonriparian parcel with water from the watercourse. The conveyance of a parcel, severed from a larger parcel which has riparian rights, terminates the conveyed parcel's riparian rights unless the rights are transferred by the deed which severed the parcel. Even if the severed parcel is eventually conveyed to waterfront owners of portions of the original riparian tract, the severed parcel's status remains nonriparian. [Anaheim Union Water Co., *supra*]

Appropriation by non-riparian owners

The right to the use of water located within the state of California may be acquired by *appropriation*. [Wat C §102]

A person who diverts water from surface or ground waters without possessing riparian or overlying rights to the water he is diverting is called an *appropriator*.

Waters flowing underground or surface waters flowing in natural channels in excess of the entitlement of riparian, overlying and previously appropriated water rights are considered the **public water of the State of California**. These excess waters are subject to appropriation by anyone. [Wat C §1201]

Appropriation permit process

The first step in appropriating water is to apply for a **permit** from the State Water Resources Control Board (Board). [Wat C §1250 et seq.]

The application for the permit must include the following information:

- the name and address of the applicant;

- the source of the water supply to be appropriated;
- the nature and the amount of the proposed use of the appropriated water;
- the location of any proposed ditches, canals or other works being constructed;
- the date of commencement of any construction works;
- the date of completion of any construction works;
- the proposed place of the water diversion;
- the location where the diverted water is to be used;
- the time for the complete application of the appropriated water to the proposed use;
- information about the affect the appropriation would have on native fish and wildlife, along with a statement of any measures which would be taken to protect fish and wildlife during the process of appropriation; and
- information to demonstrate that unappropriated water is available for the proposed use. [Wat C §1260]

Next, the district attorney and the board of supervisors for the county where the appropriation will take place are notified of the diversion. The public is notified of the appropriation by postings throughout the county where the diversion will take place. [Wat C §§1300, 1301, 1320]

If the proposed appropriation is more than three cubic feet per second or 200 acre-feet per year of storage, the appropriator must publish a notice of application in a newspaper in the county where the diversion will take place. [Wat C §1310 et seq.]

Any person interested in protesting the proposed appropriation may file a written protest against the diversion with the Board. [Wat C §1330]

When deciding whether to issue the permit for appropriation, the Board will consider if the proposed use is the best use for the water in relation to other uses such as:

- domestic use or irrigation;
- preservation and enhancement of fish and wildlife;
- recreational purposes;
- municipal purposes;
- mining and power purposes; or
- use in any water quality control plan. [Wat C §1257]

On the approval of an application for an appropriation permit by the Board, the permit is issued granting the appropriator the right to use water only to the extent and for the purpose described in the permit. [Wat C §1381]

The construction of the diversion and the use of water as specified in the permit must be performed with due diligence or the appropriation permit may be revoked. [Wat C §§1396, 1410]

Licensing the appropriation

Once the construction of a diversion under a permit issued by the State Water Resources Control Board (Board) has been completed, the Board issues the appropriator a license for the continued use of the water specified in the permit. [Wat C §§1600 et seq.]

The license to appropriate water is effective for as long as the appropriated water is needed for the beneficial use stated in the permit. [Wat C § 1627]

Rights of appropriator against others

An appropriator's rights against other appropriators are based on the "first in time, first in right" theory. Thus, prior appropriators may divert all the water allotted for use under their permit before later appropriators may divert water, a tiered condition called *priority*. [CC §1414]

The excess water previously allotted to later (junior) appropriators may not now exist after prior (senior) appropriators take their allotment, leaving no water to be taken by junior appropriators. Correlative rights to a parity share do not exist among appropriators since they are not riparian or overlying landowners.

Additionally, landowners possessing riparian and overlying rights have water rights with are superior to the rights of appropriators, called *priority rights*. Appropriators may only appropriate water which is not presently being used by a riparian or overlying landowner and has not already been appropriated by anyone else, called *surplus water*.

In the event of a water shortage, appropriators must yield to riparian and overlying landowners since landowners have priority rights to divert or pump water. These rights are appurtenant to their property. [City of Barstow, *supra*]

When a person licensed to appropriate water fails to use the water for a period of five years, his appropriative rights terminate and the water allocated to the appropriator reverts back to the public. Once the water reverts to the public, it is once again regarded as unappropriated. [Water C §1241]

Prescriptive rights by converting water

Prescriptive rights to the use of water can be established when a person wrongfully appropriates non-surplus water **openly and adversely** for a uninterrupted period of five years, and does so without documentation or evidence of a legal right, called a *claim of right*. Essentially, an adverse user is *converting* water, which riparian or overlying landowners have the right to withdraw, to his use without a good faith belief he holds any legal rights to its use.

Riparian and overlying owners may interrupt anyone trying to obtain prescriptive rights by continuing to use their allotment of water. Holders of riparian and overlying rights lose priority to those who obtain prescriptive rights to water, since their water rights have been lost to the extent taken by prescription. [City of Barstow, *supra*]

For example, an upstream riparian owner builds a dam which stops the flow of a stream to a downstream riparian owner. The downstream riparian owner is aware of the dam and allows the upstream owner to divert the flow of the stream for over five years.

Later, the downstream riparian owner seeks to stop the upstream riparian owner from diverting the flow of the stream, claiming he is entitled to a portion of the stream's flow since he is a riparian owner.

The upstream riparian owner claims the downstream riparian owner cannot now stop him from diverting the stream since he has been openly and adversely diverting the water for over five years and now holds prescriptive rights in the water which cannot be taken from him.

In this situation, the downstream riparian owner cannot stop the upstream riparian owner from diverting the stream. The upstream riparian owner has been adversely diverting the water with the downstream riparian owner's knowledge for over five years. Thus, the upstream riparian owner now has prescriptive rights in the water which are superior to the riparian rights of the downstream riparian owner. [**Sibbett** v. **Babcock** (1954) 124 CA2d 567]

Prescriptive rights, like appropriative rights, may also be lost by abandonment after five years. [CC §811]

Regulation of water rights by Board

The state government regulates the use of water in California when disputes arise between riparian/overlying landowners and appropriators.

Riparian, overlying and appropriation rights are subject to the state's interest in conserving and regulating water use. [Wat C §101]

The state government, under its State Water Resources Control Board (Board), controls unclaimed water rights and partitions water for the highest and most beneficial use.

The Board determines the respective water rights of individuals and makes decisions by weighing the public interest versus the needs of individuals. [Wat C §2501]

Consider a city whose water supply is experiencing a shortage since the underground water basin is being overdrawn. A resolution is adopted by the city calling for those landowners and appropriators who agree to be bound by the solution to give up their water rights in exchange for an allotment of water. Each user agreeing to the allotment is given an amount he can pump without charge. The amount of the allotment is based on the highest quantity of water the user consumed annually during the last five years. A fee will be charged to pay for the purchase and replacement of water used beyond the allotted amount.

Additionally, the terms of the resolution are imposed on all landowners with overlying water rights even if they do not agree to the resolution, thus eliminating their priority water rights.

An overlying landowner subjected to the resolution claims a taking of his priority water rights has occurred without compensation since the city's allocation solution elevates the rights of appropriators and those without any water rights to the status of riparian owners.

The city claims placing the owner under the city's water resolution is not a taking since the state Constitution requires the water supply to be made available to the largest number of users the water supply can reasonably support.

However, placing the overlying landowner under the city's water resolution does constitute a **taking**. The city can impose a water resolution to achieve a practical allocation of water among those with competing interests in the water. However, the city's resolution may not ignore priority rights of overlying landowners who assert them, change priorities among the class of holders of water rights, nor eliminate vested water rights. Thus, the overlying landowners have priority over appropriators to the ground water and can pump to satisfy their domestic and agricultural irrigation needs which are reasonable and beneficial. [City of Barstow, *supra*]

Chapter 12 Navigable waters in public trust

This chapter looks into the multiple purposes of the public trust and the powers the state holds as trustee to regulate and control property subject to the public trust.

For the use and benefit of the people

Navigable waterways are held in a *public trust* by the State of California as trustee for the use and benefit of the people for navigation, commerce, fishing, recreation and retention of its natural condition. [Calif. Constitution, Article X §4]

Title to the land under navigable waters within the borders of California is vested in the state as *trustee* of the public trust. California acquired title to the lands as trustee when it was admitted to the Union in 1850 under the *equal footing doctrine*. [Calif. Civil Code §670]

Although title to the lands beneath navigable waters is held by California as trustee, navigable waterways and the right of access to navigable waters are subject to a superior *federal navigation servitude* — an easement — reserved by the federal government on establishing California as a state in the Union. [**Gibson** v. **United States** (1897) 166 US 272]

The **federal navigation servitude** can only be exercised to aid navigation and is grounded in the commerce clause of the United States Constitution. It is not grounded in the ownership of navigable waterways which is held by the State of California. [United States Constitution, Article I §8, clause 3]

Although the state's power to manage its navigable waters is subject to the federal government's exercise of its navigation servitude easement, the state can **regulate and control** waters and lands held in the public trust in any manner consistent with the improvement of commerce, navigation, and other public trust interests.

California's right to regulate public waterways extends to property outside the public trust lands.

Property subject to the public trust

Navigable waterways, in addition to tidelands, shore zones and nonnavigable tributaries of navigable waters, are all subject to state regulation and control for purposes of the public trust.

Navigable waterways are owned by the state as trustee of the public trust and include waterways which were used or were susceptible to use in their ordinary condition as a highway for commerce (trade or travel). [Calif. Harbors and Navigation Code §100]

However, waterways **created after** California's 1850 admission to the Union, either natural or by man-made, are not vested in the state. However, if these post-1850 waterways are navigable, they are subject to regulation and control by the state under the public trust.

A privately owned waterway is considered navigable if, in its ordinary condition, the waterway affords a channel for useful commerce and navigation. Thus, the private ownership is limited in its use of the property.

For example, an owner's land is permanently flooded by a river when a nearby levee breaks.

The general public begins using the waters over the property owner's land for boating, commercial transportation and other public trust uses, by entering and leaving the flooded property through the breaks in the levee.

The property owner attempts to bar access to the waters over his land claiming the waterway is not navigable and thus not subject to the public trust since the waterway is only three to seven feet deep in most places and does not contain a clearly defined channel.

The boating public seeks to restrain the owner from interfering with boating on his property since rowboats and small skiffs frequently navigate the property owner's waterway.

Are the waters covering the property owner's land navigable and therefore subject to the public trust?

Yes! The waterway is navigable since it is available for use by the public. **Navigability** does not depend on the type of commercial or recreational use the property is susceptible to, or the difficulty in navigating the waterway. Thus, the owner's flooded property is subject to regulation and control by the state as part of the public trust and the owner cannot bar public access to the water even though he holds title to the underlying land as a private property owner. [**Bohn** v. **Albertson** (1951) 107 CA2d 738]

Additionally, *tideland* is considered public trust property vested in the state as trustee. **Tideland** is all land located between the mean low tide mark and the mean high tide mark of property subject, respectively, to the ebb and flow of the tide from an ocean or sea. [CC §670]

Privately owned *shore zone* property also falls under the control of the public trust. **Shore zone** property is all land located between the low water mark and the high water mark of navigable nontidal waterways, including rivers and lakes. Shore zone land is subject to management by the state for purposes of the public trust. [**State** v. **Superior Court of Lake County** (1981) 29 C3d 210]

Although a landowner retains title to the shore zone, all of the practical incidents of use and ownership are reserved to the public. The owner holds a *nonexclusive right* to use the **shore zone** consistent with the public's use of the property for purposes allowed by the public trust.

Nonnavigable rivers controlled as tributaries

Nonnavigable waterways are not technically subject to the public trust. However, the public trust regulation and control of navigable waters of necessity must regulate the obstruction, extraction of water and the dumping of debris into **nonnavigable tributaries** which feed into navigable waterways. These activities interfere with navigation, recreation or preservation — trust purposes — of downstream navigable waterways.

For example, an owner of a hydraulic mine dumps and discharges debris composed mostly of sand, gravel and boulders into a nonnavigable stream which empties into a downstream navigable river, a process called *placer mining*.

Due to the impact on the stream, the mining debris raises the bed of the downstream navigable river, thus impairing its navigability.

The state, in the name of the people, seeks to permanently enjoin the owner of the hydraulic mining operation from dumping debris into the stream, claiming the dumping is an invasion of the rights of the public to navigate the river.

The mine owner claims the public cannot stop him from dumping debris into the stream since the stream is nonnavigable and therefore not subject to state regulation and control under the public trust.

Can the mine owner continue to dump debris into the nonnavigable stream?

No! The owner of the placer mining operation is barred from dumping and washing debris into the nonnavigable stream since its waters, along with the debris, flows into and adversely affects the public use of a navigable river which is subject to state regulation and control under the public trust. [**People** v. **Gold Run Ditch & Mining Co.** (1884) 66 C 138]

Property not subject to the public trust

The title of much privately owned property is derived from an original *Mexican land grants* issued under Mexico or the Law of the Indies before 1848. If a land grant was later confirmed by issuance of a *federal patent* (deed) and did not *reserve waterway rights*, the property is not subject to regulation and control by California for purposes of the public trust.

For example, an owner holds fee title to land under a navigable waterway which became part of the United States following the Mexican War of 1848.

The predecessors-in-interest of the current landowner had their pre-war interest in the waterway confirmed in a federal patent (deed) issued after California attained statehood in 1850. However, the patent was issued under federal legislation which implemented the Treaty of Guadalupe Hidalgo (signed in 1848). The legislation, as mandated by the treaty, validated claims to lands in California based on Mexican law.

At the time ownership was confirmed by the federal patent (deed), California was considered a state. However, California did not assert a public trust interest in the waterway at the confirmation hearing (in federal court) determining the land grant ownership. Thus, no reservation for the public trust was made in the patent (deed) issued by the federal government on confirmation of ownership.

The state now seeks to subject the landowner's waterway to the state's control under the public trust since all navigable waterways were previously transferred to the state as part of the public trust when California was admitted into the Union in 1850, leaving no waterway ownership to be later confirmed or conveyed by federal patent (deed).

The landowner claims the state cannot now assert a public trust interest in his property since his interest was previously confirmed without any mention of the public trust.

Is the property subject to the public trust?

No! Under most circumstances, tidelands located within the state cannot be conveyed to a private individual by a federal patent (deed) since the United States previously conveyed all tidelands in trust to the state on its admission to the Union.

However, property subject to confirmation of ownership and issuance of a federal patent (deed) under the Treaty of Guadalupe Hidalgo in 1848 was *reserved* to the United States at the time California was admitted to the Union in 1850. For the United States to discharge its international duty to Mexico under the treaty with respect to the conveyance of tidelands to land grant owners, the reservation was mandated since tidelands were not owned by the government under Mexican law. [**Summa Corp.** v. **California** (1984) 466 US 198]

The public trust has purpose

The objectives of the public trust have evolved with the changing public perception of the values and uses of waterways.

Traditionally, the uses of land and water held or subject to public trust regulation encompassed navigation, commerce and fishing. However, the definition of public uses to which waterways, tidelands and shore zones are subject is sufficiently flexible to encompass changing public needs.

Recreational uses by the public, such as boating or fishing and the retention of waters and lands in their natural state, are also counted as being public rights protected in waterways and lands owned or controlled by the public trust. California, as trustee, has a duty to protect the people's common heritage of waterways, lakes and tidelands within the ownership or control of the public trust.

For example, one of the most important public uses of the tidelands, due to current public recognition, is the **preservation of tidelands** in their **natural state**. Preserved, the tidelands serve as ecological properties for scientific study, open space for public enjoyment and wildlife environments which favorably affect the native species, scenery and climate of the area. [**Marks** v. **Whitney** (1971) 6 C3d 251]

Powers of the state as trustee

Some management powers the state possesses to regulate and control the use of properties owned or subject to the public trust include the right to:

- grant rights and convey public trust property to private parties;
- revoke those same rights and conveyances;
- destroy the navigability of certain waters for the benefit of others;
- control nonnavigable tributaries which feed into navigable waterways;
- build structures across or along waterways; and
- deepen or change the channels of waterways.

The state may also order the removal of an owner's improvements from public trust property at any time, even if the improvements have been erected under license or consent from the state, a condition called *usufructuary*. To order the removal, the improvements must substantially interfere with navigation or commerce, such as machinery for the prospecting of oil and gas which hinders water traffic and local fisheries, or be encroachments upon public rights or the appropriation to private use of uses which belong to the public, called *purprestures*. [**Boone** v. **Kingsbury** (1928) 206 C 148]

In short, the state, as trustee and owner of all navigable waters and the lands beneath them, has the power to use those waterways and the lands subject to the public trust in any manner consistent with the purposes of the trust.

However, the state's power as trustee over navigable waters and the lands under them cannot be abdicated to other governmental agencies. Trust powers may be **delegated** to a municipality or other governmental body, but the state always retains the right to revoke those powers at any time and exercise them itself. Thus, the lands under navigable waterways cannot be placed entirely beyond the (usufructuary) direction and control of the state. [**Illinois Central Railroad Company** v. **People of the State of Illinois** (1892) 146 US 387]

Conveying public trust property

The state, as the manager of lands subject to the public trust, has the right to transfer ownership of public trust property to a **private party**. Additionally, the state has the power to revoke previously granted rights in public trust property at any time, thus exercising the **usufructuary** aspect of property rights.

While conveying ownership, the state cannot completely convey away the public's right to the use of the navigable waters flowing over the land conveyed. [Gold Run Ditch & Mining Co., *supra*]

Accordingly, any conveyance of public trust property to an individual is subject to the public's rights under the public trust.

However, the state as trustee has the authority to convey absolute title to land under navigable waters to private persons only if the purpose of the conveyance is to promote navigation, commerce or other public trust purposes. [Illinois Central Railroad Company, *supra*]

In this respect, even grants of absolute fee title to private parties of trust property still serve the public interest. However, such grants to private parties, even if made for public trust purposes, do not vest absolute title in a private party until the improvements called for by the state to enhance the public use for trust purposes are actually completed.

For example, the state dedicates a navigable canal, held as public trust property, to a city for public use as a free dock for ships. As part of the dedication, the state requires the city to deepen the waterway and extend streets and drawbridges over the canal to improve the public trust purposes of navigation and commerce.

The city does not make the improvements required by the state.

The state then revokes the dedication of the canal claiming it has the right under the public trust to revoke the dedication since the city did not complete the improvements.

The city claims the state cannot revoke the dedication and reclaim jurisdiction over the canal since the waterway has already been dedicated to the city to hold and use for the purposes of the trust.

Can the state revoke its dedication of the canal to the city?

Yes! The dedication of the canal to the city for the purpose of deepening and improving the waterway was only an offer to dedicate conditioned on the city building the improvements. The state had the right to withdraw the offer in whole or in part at any time prior to the city's acceptance of the canal by completing the improvements. Until acceptance, the dedication was not complete since the public did not get to use the canal in the manner intended by the state as trustee of the property. [**People** v. **Williams** (1884) 64 C 498]

Compensation for a public trust taking

If the state retakes title to public trust property previously conveyed to a private party, the party must be compensated for the taking. Compensation must also be paid to a private property owner when the state erects improvements which are **permanent physical encroachments** on privately owned property which is not subject to regulation or control by the public trust.

However, the state may, without compensation, erect improvements to aid navigability or other public trust purposes on state owned public trust property and private properties which are under navigable waters held in public trust.

For example, a property owner operates a beach resort on land fronting on a navigable bay.

The state uses its public trust powers to construct a permanent breakwater in the bay near the resort owner's property to create a harbor for pleasure yachts and fishing boats.

However, the breakwater stops the normal flow of sand carried to the beach, causing the gradual *erosion* of all of the sandy beach on the resort owner's property.

The resort owner claims the state has taken his property by **inverse condemnation** since the erection of the breakwater resulted in a taking of his property for public use due to the erosion of his shoreline.

The state claims it does not owe the resort owner compensation for any damage to his shoreline on the bay, called *littoral rights*, caused by the erection of the breakwater since the resort owner's **littoral right** to enjoy sandy accretions is not perpetual and is always subordinate to the state's right to improve navigation for purposes of the public trust.

Does the state owe the resort owner compensation for taking his shoreline property?

No! The damage to the resort owner's property due to the loss of the sandy shoreline was an incidental consequence of the state's management (as trustee) of navigable waterways and not a taking by inverse condemnation. The state did not owe the resort owner compensation since the breakwater constructed by the state was not a direct physical encroachment on the resort owner's property.

Through the exercise of its public trust powers, the state always has the **right to impair** rights appurtenant to property fronting on navigable waters, called *riparian property* if it banks on a river or stream, or *littoral property* if it banks on the shore of a lake, bay, sea or ocean. [**Miramar Co.** v. **City of Santa Barbara** (1943) 23 C2d 170]

Usufructuary licenses for appropriation of water

The state, acting through the State Water Resources Board (Board), may permit an individual, called an *appropriator*, to take water, a process called *appropriation*, under a *usufructuary license* which is retrievable by the state without compensation. Usufructuary licenses may be granted even though the appropriation may unavoidably harm public trust uses. [Calif. Water Code §104]

However, the Board, while planning and allocating water resources within the state, is required to take public trust interests into account. [Wat C §§1243, 1257]

Accordingly, when granting the **usufructuary right** to take water, the Board must consider the effect such diversions will have on the public trust's interest in navigable water and reasonably attempt, as far as feasible, to avoid or minimize any harm to those interests.

After the Board has approved the appropriation of water by an individual, the state has a duty to continue its supervision over the appropriator's removal and use of the appropriated water. In exercising its public trust powers to manage navigable waters, the state is not bound by past allocation decisions which may now be wrong in light of current knowledge or current needs.

For example, a river is the only supply of water flowing into a navigable lake subject to control and management under the public trust.

The Board grants a usufructuary license to a city to divert the entire flow of the river for domestic use without considering the diversion's effect on the public's interests in the lake.

As a result of the diversion, the water level of the lake drops significantly, diminishing the lake's economic, recreational and scenic value.

The people of the state ask the Board to review the city's appropriation of water from the river claiming the diversion is harming interests protected by the public trust.

The city claims its right to divert water from the river is superior to the public's rights under the public trust since the use of water for domestic purposes is the highest use of water.

Can the Board review its past allocation decision and modify the city's diversion of water to take into account public trust interests?

Yes! The state may **review and revoke** water use licenses at any time using its usufructuary rights, as the state's supervisory authority bars any party from claiming a vested right to divert water once it becomes clear that such diversion significantly harms interests in navigable waters protected by the public trust. [**National Audubon Society** v. **Superior Court of Alpine County** (1983) 33 C3d 419]

Chapter 13 Boundary disputes

This chapter applies the agreed-boundary doctrine as a method of settling boundary disputes.

Doctrine of agreed boundaries

A parcel of real estate is divided into two equally sized parcels by a recorded survey. Later, a fence is erected between the two that is not located on the common boundary line. Thus, one parcel appears to be physically larger than the other.

The owner of the parcel which appears smaller (that has the fence located on it within its boundary) sells his parcel. The new owner hires a surveyor to determine the location of the boundary between the properties.

The survey sets the boundary at the location described in recorded documents. The survey shows the fence is not located on the legally described boundary between the adjacent properties.

The owner of the smaller parcel seeks to recover possession of the strip of land located on the other side of the fence, within his legal description, by removing the fence.

The neighboring owner of the larger parcel claims the fence is the agreed boundary since the fence has stood for so many years that it is reasonable to infer the previous owners agreed the location of the fence to be their common boundary.

The owner of the smaller parcel claims the *agreed-boundary doctrine* does not apply since a recorded legal description of the boundary is available and the true boundary can be located.

Is the owner of the smaller parcel correct in relying on the legal description of the property to establish the actual boundary location?

Yes! The doctrine of title by agreed boundaries, commonly referred to as the **agreed-boundary doctrine**, does not apply since:

- the exact boundary location can be readily located; and
- the owner of the larger parcel defending the fence as the boundary cannot show the prior owners were **uncertain** as to the true boundary description and then, to resolve their uncertainties of location, **agreed** the fence would mark the boundary. [**Bryant** v. **Blevins** (1994) 9 C4th 47]

Elements of the ancient doctrine

To establish a boundary line under the *agreed-boundary doctrine*, the following facts must exist:

- **uncertainty** as to the boundary's exact location;
- an **agreement** between the owners to set the boundary line; and
- **acquiescence** to the boundary line for a period of at least five years; or
- a **substantial loss** would be suffered due to a change in the location of the boundary line to the legally described location. [**Ernie** v. **Trinity Lutheran Church** (1959) 51 C2d 702]

The **agreed-boundary doctrine** developed during a time when less advanced surveying techniques, or lack of surveyors or monuments, made it too difficult or expensive to locate the boundary line described in the deeds.

Thus, the more practical way to set a boundary line in rural and relatively unpopulated areas with lower land values was often for owners of adjacent parcels to agree between themselves on the location of a common marker, such as a fence, to set the agreed boundary.

However, surveying techniques have significantly improved. Now, if a deed is clear and a competent surveyor is available, the true boundary line can easily be established to eliminate the uncertainty of the boundary's location. Thus, the ancient agreed-boundary doctrine has been reduced to the status of a legal last resort.

In the absence of an oral or written agreement between an owner and his neighbor to set the boundary line at some place other than a well-surveyed and documented deed line, the boundary line described in their deeds remains as the boundary. [**Armitage** v. **Decker** (1990) 218 CA3d 887]

Agreeing to the boundary

Once owners of adjacent properties uncertain over the true boundary actually agree to establish the location of their common lot line, the location they set will replace the legal line, regardless of how inaccurate it is, provided either the five-year statute of limitations runs or substantial loss would result from the boundary line being moved to the legally described location.

For example, two neighbors own adjacent parcels of real estate and each farm their respective parcels.

When their real estate was originally surveyed decades earlier, the federal government placed a five-inch section post to mark the boundary line. The neighbors search but cannot locate the section post to help them set their property lines. Instead of surveying their parcels, they mutually erect a fence intending it to set the boundary between their properties.

The fence is eventually taken down, but the owners continue to farm up to the spot where the fence had been located.

Over five years later, each owner sells their respective property to different buyers. The new buyers continue to farm their parcels within the parameters set by the original owners.

Later, one of the new owners surveys his parcel, locates the federally placed post and marks the legally described property line. The location of the post reveals the owner's neighbor has been farming 2½ acres on his side of the property line described in the public records.

The owner sues to quiet title to the 2½ acres and reclaim possession. The neighbor claims the fence line became the boundary line when the original owners set the fence as the property line between the adjacent parcels.

Is the fence line the true boundary line?

Yes! When the owners of adjacent real estate are **uncertain** where their boundary is located, they can agree to set a new boundary line. Further, the **agreed-to boundary** which remains in place for more than five years is binding on subsequent owners even though the recorded legal description is different. [**Joaquin** v. **Shiloh Orchards** (1978) 84 CA3d 192]

Uncertain boundaries

Uncertainty over the exact location of a boundary line may arise in a number of circumstances.

For example, where natural markers, such as trees, boulders or a creek, were used to mark a beginning or ending point for a boundary line, the location of the markers may have changed or the markers may have disappeared over time.

Section posts and other surveyor's monuments which indicate boundary lines are also subject to earth movement, climatic changes and human activity. Also, the legal descriptions for parcels of real estate may be conflicting or simply fail to correctly set a boundary line, or the descriptions do not coincide with another line or boundary.

An actual dispute over a boundary's location need not exist between the owners of adjacent parcels. Instead, owners must merely be in doubt over the location of the true boundary and agree to the location of the boundary when they set it.

Usually, it is not the original owners who squabble over title or possession based on the agreed-to boundary line, it is the later owners.

However, when the boundary line in a recorded deed is readily ascertainable by a surveyor, the description in the record controls, unless the landowner defending the location of the line as the common boundary provides cogent proof the boundary line as located settles an actual, not implied, boundary dispute. [Bryant, *supra*]

Agreement to make certain

An agreement to mark a boundary line may be oral, written or result from the conduct of neighboring property owners. Oral or written agreements on the boundary's location are called *express agreements* since they are not implied.

Written expressions are best since they formally document the mutual intentions of the owners. However, they usually exist only in the case of a lot line adjustment map.

Unlike the conveyance of real estate, owners do not have to put their boundary agreement in writing for it to be enforceable. With the setting of an agreed boundary, neither owner is conveying real estate to the other. Instead, the owners are agreeing to what land constitutes their own property. [Ernie, *supra*]

The element of duration

Owners must acquiesce to the agreed boundary for a period of at least five years, the *statute of limitations* for the recovery of real estate. [Calif. Code of Civil Procedure §318]

The statute of limitations requires the adjacent owners to resolve a dispute within the five-year period. If disputes are not settled within this period, the claims are put to rest. Thus, an owner who fails to object to a boundary line during the statute of limitations period is presumed to have agreed to the boundary set by the adjacent property owner.

However, an agreed boundary can be established even if the **five-year period** has not run. An exception to the five-year rule arises if substantial loss will be caused by the movement of the agreed boundary to the true lot line.

For example, when an adjacent owner builds improvements near the line established in reliance on an agreement that it is the boundary, the new boundary will be allowed without the enforcement of the five-year period. However, the new boundary will only be allowed if the adjacent owner can show moving the boundary will result in substantial loss due to the existence of improvements. [**Roman** v. **Ries** (1968) 259 CA2d 65]

Marking the line

When a writing setting the boundary is not available, subsequent owners must look to the prior owner's activities for an **implication** that an agreement existed as to the location of the boundary line.

For example, the construction of a fence may imply an agreement to set a boundary. However, in order for the fence to control in an agreed-boundary dispute, the owner relying on the fence as a boundary must present evidence to show the fence was erected to resolve a **boundary uncertainty known** to previous owners.

For example, a fence is erected between two parcels of real estate by the owners of the parcels. Both parcels are later sold.

The new owner of one of the parcels commissions a survey based on the legal description of the property in recorded documents. The survey reveals the 20-year old fence dividing the owner's property and the neighboring property is actually located on his property.

The owner builds a new fence on the actual boundary line located by the survey.

The neighbor then seeks to remove the new fence and obtain possession to the real estate up to the old fence line. The neighbor claims the agreed-boundary doctrine sets the boundary at the original fence line since the fence existed for 20 years without dispute.

The owner claims the agreed-boundary doctrine does not apply since the previous landowners did not agree to erect the fence based on any uncertainty as to the location of the true boundary. Can an agreement be implied to set the boundary line at the old fence?

No! The mere acquiescence to the placement of a fence, absent evidence of uncertainty and an agreement to resolve the uncertainty, is not enough to establish a boundary under the agreed-boundary doctrine. The agreed-boundary doctrine does not apply since the previous owners did not erect the fence to resolve uncertainty as to the location of the boundary. [**Mehdizadeh** v. **Mincer** (1996) 46 CA4th 1296]

Fences are built for a variety of reasons, one of which is to establish a boundary. Other reasons for erecting fences include controlling animals, aesthetics or to prevent children from wandering off a property.

Further, the location and condition of a fence may be influenced by the topography of the property, the terrain on which it is placed, requirements of an animal enclosure, or the loss of lateral and subjacent support. [Bryant, *supra*]

While a fence or wall is evidence of a line for something, a fence does not necessarily set the property boundary.

Limitations of the doctrine

The agreed-boundary doctrine has limitations. The doctrine cannot be used to convey property. Further, the agreed-boundary doctrine can only set a boundary, the exact location of which is unknown to the adjacent owners without a survey or litigation.

Any attempt to convey a portion of a lot to the owner of an adjacent property by use of the agreed-boundary doctrine violates the Statute of Frauds which requires a writing stating the intent to convey land.

Thus, the agreed-boundary doctrine cannot be used to make *lot line adjustments*. In a **lot line adjustment**, the adjacent owners are moving an already existing line, the location of which is known to them.

Lot line adjustments require planning commission approval. [Calif. Government Code §66469 et seq.]

Chapter 14 Common boundary structures

This chapter is a digest of the rights and obligations of owners in common boundary disputes.

Shared rights and responsibilities

Most properties have three property lines which set the **common boundary** with adjacent properties owned by other people. A fourth property line usually sets the frontage on a public right of way, such as a street.

The location of the common property lines might be represented by an improvement which acts as a demarcation of the property line, called a *common boundary improvement*.

A common boundary improvement may be a:

- party wall;
- boundary fence;
- tree line;
- driveway; or
- ditch.

Prospective buyers interested in a property should be concerned about the ownership of any common boundary improvements and who is responsible for their maintenance.

The rights of the adjacent property owners when setting up, maintaining or removing common boundary improvements depend on the type of improvement which exists.

Party walls are owned by both

Common boundary improvements, other than trees, located on a property line between adjacent properties are called *party walls*.

A **party wall** may be in the form of a wall, fence or building which is co-owned by the adjacent property owners.

The use and ownership of a party wall should be set forth in a written agreement between adjacent property owners. The agreement defines each owner's responsibility for **sharing the cost** of maintaining the party wall. However, these written agreements rarely exist.

A prudent prospective purchaser should ask about and review any party wall agreement to determine what rights or obligations have been established regarding the party wall. However, an agreement does not need to exist, and a boundary improvement does not need to be located on the boundary for an improvement to be a party wall.

Consider an owner's building and a neighbor's building, both of which are supported by a common party wall as a part of their structure. The party wall is located entirely on the owner's property. No agreement exists regarding the use and ownership of the party wall.

The neighbor begins construction of a second story which requires raising the height of the party wall. The construction does not weaken the support of the party wall.

The owner claims the neighbor cannot raise the height of the party wall since the party wall is located on the owner's property.

However, even though the party wall is located entirely on the owner's property, it is owned by both the owner and the neighbor since it supports both of their buildings. Thus, the neighbor can construct a second story and heighten the party wall since the construction does not weaken or interfere with the use of the existing party wall. [**Tate** v. **Fratt** (1896) 112 C 613]

Similarly, an adjoining property owner cannot **remove or destroy** a party wall without the consent of the other owner since each has an interest in the party wall.

An owner can alter a party wall, such as installing cosmetic ornamentation on his side of the wall, as long as he does not injure the wall or interfere with the adjoining property owner's use of the party wall. [**McCarthy** v. **Mutual Relief Ass'n of Petaluma** (1889) 81 C 584; Tate, *supra*]

Boundary fences and cost contributions

For security and privacy purposes, many properties are fenced in by a *boundary fence*. A **boundary fence** may be a party wall co-owned by the adjacent property owners.

Adjacent property owners have a mutual obligation to maintain the fences between them, except for an owner who allows his land to lie otherwise unfenced. [Calif. Civil Code §841(1)]

If an owner who leaves his land unfenced later decides to enclose it by using the existing fence as part of the enclosure, he must compensate the neighbor who built the fence for the pro rata value of the neighbor's fence used by the owner. [CC §841(2)]

An owner entitled to a contribution for the construction of a fence can enforce his rights through a lawsuit. [**Reusche** v. **Milhorn** (1933) 218 C 696]

Line trees, a trunk with common owners

Trees are solely owned, government owned or commonly owned. A tree's **ownership** is determined by the location of its trunk.

Solely owned trees belong to the owner of the property on which the trunk is growing. [CC §833]

Trees growing on government-owned parcels, such as a right of way for streets and sidewalks, belong to the local government.

However, shrubbery or trees whose trunks stand partly on the land of two adjacent property owners belong to the adjacent owners as **tenants in common**. These trees are called *line trees* or *common boundary trees*. [CC §834]

Adjacent owners who own line trees as tenants in common are jointly responsible for maintaining the trees. [CC §841]

Sharing boundary trees

Co-owners of boundary trees, as adjoining property owners, both enjoy the use of the trees.

For example, **use** of a boundary tree by adjacent property owners includes trimming and maintaining the trees. The co-owner who trims the tree must carry away and dispose of the tree trimmings. The co-owner must also take care not to damage the tree or interfere with the other co-owner's use of the tree.

The use allowed a co-owner of boundary trees is the same as the use allowed the owner of solely-owned trees, as long as the use does not interfere with the other co-owner's use and enjoyment of the trees.

However, consider two adjacent property owners whose parcels are separated by a row of eucalyptus trees planted on the boundary line.

One parcel of real estate contains a citrus tree grove. The adjoining parcel of real estate contains a walnut tree grove.

The walnut grove parcel lies downwind from the adjoining parcel containing citrus trees. The boundary row of eucalyptus trees shelters the walnut trees by breaking up the prevailing wind.

The eucalyptus tree branches overhang several feet into the citrus grove. The **branches** from the boundary trees are reducing the production of fruit from the citrus trees by blocking out the morning sunlight, producing a cooling effect.

The **roots** from the eucalyptus trees extend several yards into the citrus grove soil, choking out the roots of the citrus trees and depleting the soil of its nutrients within close proximity of the eucalyptus trees.

The citrus grove owner, as co-owner of the row of eucalyptus trees, wants to trim the offending branches and roots back to the property line and lower the height of the trees.

However, the walnut grove owner does not want the citrus grove owner to cut back or modify any part of the eucalyptus trees in any way that inhibits their use to him as a shelter from the wind.

Can the walnut grove owner stop the citrus grove owner from cutting down or trimming the trees?

Yes! Although both adjoining property owners have a tenants-in-common ownership interest in the boundary trees, one property owner may not alter the boundary trees to the extent that he destroys the boundary trees' **function as a shelter** to the other property. [**Anderson** v. **Weiland** (1936) 12 CA2d 730]

Additionally, an adjacent property owner cannot remove line trees without the consent of the co-owner. A co-owner is liable to the other co-owner for any losses suffered by the removal of line trees since **unilateral removal** is not a legitimate enjoyment of a tenancy-in-common ownership interest in the trees. [**Scarborough** v. **Woodill** (1907) 7 CA 39]

Remedies

To avoid disputes, adjacent property owners can enter into an agreement detailing how they will handle the maintenance and upkeep of boundary trees.

If a boundary tree injures the *health and safety* of a property owner or prevents him from enjoying his property, the tree may constitute a **nuisance** and can be removed. [CC §3479]

A co-owner of a boundary tree might refuse to consent to the removal of a boundary tree. If the tree constitutes a nuisance, an abatement of the nuisance is allowed.

For example, boundary trees may be a nuisance if their branches or the trees themselves continually fall, threatening the safety of people using the adjacent property or damaging improvements on the adjacent property. [**Parsons** v. **Luhr** (1928) 205 C 193]

Thus, one of the property owners may have to remove or modify the offending trees at the common co-owners' expense.

Chapter 15 Encroachments—crossing the line

This chapter presents the rights of neighboring property owners when improvements on one owner's property encroach on the adjacent owner's property.

Boundaries violated, hardships balanced

After the purchase of an unimproved parcel of real estate, an owner discovers his neighbor's garage extends two feet over the boundary line onto his property, called an *encroachment*.

The owner demands the neighbor remove the **encroachment**. When the neighbor refuses, the owner seeks to compel the neighbor's removal of the two foot portion of the garage which encroaches on his property.

The neighbor claims the owner is not entitled to a removal of the improvement since:

- the encroachment was unknown to the neighbor and unintentional;
- the square footage of the owner's property affected by the encroachment is minor; and
- the cost to remove the encroaching garage would far exceed the monetary loss to the owner if the encroachment were allowed to continue.

Can the owner obtain a court order, called an *injunction*, which forces the neighbor to remove the encroaching garage?

No! The encroachment is unintentional and minor in its effect on the burdened owner. Thus, the burden to the owner does not justify an order requiring the neighbor to undertake an expensive reconstruction activity to remove the encroachment.

Instead, the owner is awarded **money damages** representing the rental value for the lost use of his property. The neighbor is granted an **easement** over the owner's property for the life of the encroaching garage, called *balancing hardships* or *balancing the equity*. [**Christensen** v. **Tucker** (1952) 114 CA2d 554]

For the neighbor to be allowed to maintain the encroachment, he has to act in *good faith* when constructing the improvements, i.e., without knowledge the improvements encroach on the owner's property. If the neighbor had not constructed the improvements in **good faith**, the owner would be entitled to an injunction forcing the removal of the encroaching structure, no matter how minor the encroachment.

For an owner to recover money losses due to an encroachment, he must act within the three-year period of the *statute of limitations*. If the owner delays too long in making his claim, the encroaching neighbor has earned the right to maintain the encroachment without compensation to the owner. The **statue of limitations** period does not run from the owner's discovery of the encroachment or his acquisition of the property, it runs from the date the encroachment was created.

Additionally, if the seller knew the encroachment existed but failed to disclose this fact, the buyer could recover his money losses from the seller. The loss would be based on the diminished value of the property and the excess purchase price paid.

Encroachment, trespass and nuisance

An **encroachment** is an improvement on real estate, such as a building, fence, driveway or tree, which extends onto real estate belonging to another person without his consent.

Encroachment is closely related to *trespass*, *nuisance* and *boundary disputes*. All involve a nonconsensual interference with another's property rights.

Any encroachment qualifies as a **nuisance**. A nuisance can be classified as either *permanent* or *continuing*. Broadly defined, a nuisance is any obstruction of another's use and enjoyment of his real estate. [See Chapter 19]

An encroachment also qualifies as a *trespass* since the encroaching improvement actually rests on land which is the neighbor's property. [See Chapter 18]

However, the actual title given to an interference is unimportant. An owner may recover for an **unauthorized interference** with his property rights on one theory or another.

An encroachment on whose rights?

It is not only a fee owner of real estate who can take action to stop an encroachment. Any person holding rights in real estate may protect those rights against outside interference. **Rights affected** by an encroachment include:

- *leasehold* interests [**Brown Derby Hollywood Corporation** v. **Hatton** (1964) 61 C2d 855];
- *deed restrictions*, such as limitations on the height of improvements [**Seligman** v. **Tucker** (1970) 6 CA3d 691];
- *setback* requirements [**Morgan** v. **Veach** (1943) 59 CA2d 682];
- *easements* [**City of Dunsmuir** v. **Silva** (1957) 154 CA2d 825]; and
- *prescriptive easements*. [**Warsaw** v. **Chicago Metallic Ceilings, Inc.** (1984) 35 C3d 564]

For example, consider an owner who uses a strip of his neighbor's property for access — ingress and egress — to a commercial building located on the owner's property. After the owner uses the strip for more than five years, the neighbor constructs a warehouse on the strip of land, restricting the owner's access to his building.

Here, the owner's use of the strip of his neighbor's land matured into an **easement by prescription** due to the passage of five years time. Thus, the owner is able to obtain an injunction against the warehouse improvements since they encroach on his easement rights. [Warsaw, *supra*]

Drawing the line not to be crossed

The existence of an encroachment is easily determined by a survey to establish the location of the property line. An encroachment is present if an improvement on one parcel extends over the line onto an adjacent parcel.

Occasionally, neighboring owners disputing the existence of an encroachment rely on contradictory surveys to establish the property line. If the owners cannot agree on the location of the property line, the boundary dispute must be resolved before any encroachment remedy — if one exists — can be granted.

The resolution of the boundary dispute frequently amounts to no more than a court determining which of the competing surveys is more accurate. [**Iacovitti** v. **Fardin** (1954) 127 CA2d 348]

Once an **encroachment** has been determined, the remedies available to the owner include:

- an *injunction* ordering the removal of the encroaching structure; or
- *money damages* for the diminished value of the property subject to the encroachment.

Balancing the hardships

The conditions for **balancing the hardships** — allowing an encroachment to continue versus its removal — include:

- the owner of the property burdened by the encroachment must not suffer an **irreparable injury** due to the continued existence of the encroachment;
- the neighbor who owns the encroaching structure must have acted in **good faith** when building the encroachment; and
- the **cost** to the neighbor of removing the encroachment must greatly exceed the damage done to the owner. [Christensen, *supra*]

For example, a neighbor's residence is located close to the property line. The eaves of the neighbor's house and a bay window extend over the property line. The encroaching portions of the house can be removed without great expense or loss of value.

The owner seeks an injunction ordering the removal of the encroaching structures. The neighbor claims removal is not appropriate since the encroachment is minimal.

Since the encroachment is minimal and the cost of removing it is equally small, the encroaching portion of the residence must be removed. [**Harland** v. **Noto** (1951) 105 CA2d 740]

Additionally, an encroachment need not be removed if its removal would adversely affect a large segment of the public.

For example, a reservoir constructed by a water company encroaches on an owner's property. The owner seeks to remove the encroachment. However, the encroaching reservoir may remain since it supplies water to many homes. [**Ukhtomski** v. **Tioga Mut. Water Co.** (1936) 12 CA2d 726]

Good faith and innocence in an overstep

The *good faith* of a neighbor who constructs improvements which encroach on the land of another must exist before any balancing of the hardships can take place. The **good faith** requirement prevents an *intentional exploitation* of the balancing hardships rule.

For example, an unimproved parcel of real estate is subject to setback requirements. The owner of the parcel begins building a residence on the property. Soon after construction commences, the owner's neighbor notices the residence is being constructed too close to the property line and is within the setback. The neighbor informs the owner he is violating the setback requirements. The neighbor also threatens legal action unless the owner complies with the setback requirements.

Despite the neighbor's warnings, the owner completes the construction knowing the improvements violate the setback requirements. The neighbor seeks to enforce the setback requirements by forcing the removal of the structure from within the setback. The cost to the owner of moving the residence far exceeds the damage to the neighbor.

However, the owner built the residence with full knowledge of both the setback violation and the neighbor's objection. Thus, the owner did not complete the construction in good faith and the portion of the

structure within the setback must be removed. Had the owner innocently violated the setback requirements, the removal request would probably be denied. [Morgan, *supra*]

The encroachment easement

When the continuance of an encroachment on an owner's property is allowed, the encroaching neighbor is granted an *equitable easement* to maintain the improvement on the owner's property. The easement lasts for the lifetime of the encroachment.

For example, an encroaching neighbor sought fee title to a portion of the property covered by his encroachment. However, to grant title to the neighbor would be excessive. Instead, an **equitable easement** is granted since an easement is sufficient to protect the neighbor's right to maintain the encroaching improvements and avoid *lot line adjustment* laws. [Christensen, *supra*]

Limitations and delay

Under most circumstances, an owner seeking to terminate an encroachment or recover his money losses is subject to a **three-year statute of limitations** running from the commencement of the encroachment. [**Bertram** v. **Orlando** (1951) 102 CA2d 506]

The limitations period for an encroachment is the same as for a *permanent nuisance* since the damage to the owner is complete and certain as soon as the encroachment is created.

The **creation date** of the encroachment is critical. Whether an owner has *knowledge* an encroachment exists does not affect the statute of limitations. The limitations period runs from the creation of the encroachment, not its discovery. [**Castelletto** v. **Bendon** (1961) 193 CA2d 64]

However, in the rare case where the losses resulting from an encroachment are progressive over time, the three-year statute of limitations does not begin to run from the date the encroachment was created.

For example, an owner's building is damaged when a neighbor's building leans on it, due to a poorly compacted fill. The degree of the tilt, and the resulting damage, increases over time.

More than three years after the damage commences, the owner seeks to recover his monetary losses from the neighbor. The neighbor claims the owner is barred from recovering damages by the running of the three-year limitations period.

However, the intrusion onto the owner's building is continuous and progressive. As with a **continuing nuisance**, a new claim accrues each time the loss increases. Thus, while the three-year statute of limitations does apply, it does not begin to run on the commencement of the encroachment, but runs from the date of the last increase in money losses caused by the *progressively increasing* interference of the encroachment. [**Kafka** v. **Bozio** (1923) 191 C 746]

In addition to barring relief by the running of the statute of limitations before filing a claim, an action seeking money damages or an injunction against an encroachment can be barred by the equitable doctrine of *laches*, also called *prejudicial delay* or *detrimental reliance*.

For example, an owner discovers his neighbor is constructing a potential encroachment. However, he refrains from voicing his concerns to the owner or taking any action to resolve the potential encroachment until the construction is completed. Here, his inaction bars him from enforcing the removal of the encroachment. The encroaching neighbor has, in part, relied on the owner's acquiescence in undertaking and completing the construction. [**Rankin** v. **De Bare** (1928) 205 C 639]

Finally, an owner who allows a known encroachment on his property to continue for over five years risks losing property rights through a prescriptive easement since the adverse use of the owner's property by the encroaching neighbor is known to the owner and continuous.

Thus, an owner must promptly enforce his right to remove an encroachment or receive compensation for lost value when a neighbor's improvements first encroach on his property.

Chapter 16 Tree encroachment

This chapter discusses the encroachment of solely-owned trees and encroachment resolutions.

The root of the problem

A property owner's tree has grown so large its **branches and roots** extend into the ground and air space of his neighbor's property. The neighbor's concrete driveway and patio are damaged by the force of the expanding roots.

The roots also interfere with the natural growth of the neighbor's lawn, and fruit trees near the property line have diminished in their annual production.

Leaves and debris from the tree continually litter the neighbor's house and yard, requiring the rain gutter to be cleared regularly. The large branches of the tree hang so far over the neighbor's house they break shingles loose during windstorms and cause cosmetic damage.

The neighbor wants to hire a tree trimming service to cut the branches and roots of the property owner's tree back to the property line.

However, the owner of the tree claims his neighbor has no right to cut any part of his tree since its trunk is located on his property, not on the neighbor's property.

Can the neighbor cut overhanging tree branches and invading roots which enter his property without the permission from the property owner who owns the tree?

Yes! The neighbor may resort to *self-help* by cutting the encroaching branches and roots off the neighbor's tree. [**Bonde** v. **Bishop** (1952) 112 CA2d 1]

However, the neighbor may not cut beyond the property line. [**Fick** v. **Nilson** (1950) 98 CA2d 683]

Additionally, the extent of the removal of branches and roots is controlled by a reasonable need to remove them.

Who owns the tree?

Trees are *improvements* and thus are considered a part of the real estate. **Ownership** of a tree is determined by the location of the trunk, not the position of the branches or roots. [Calif. Civil Code §§833, 834]

Trees whose trunks grow on a boundary line separating two adjoining parcels of real estate are called *common boundary trees* or *line trees*. **Common boundary trees** are jointly owned by the adjoining property owners. [CC §834; see Chapter 14]

Trees whose trunks are planted on one side of a boundary line belong solely to the owner of the property on which the trunks grow. [CC §833]

A solely-owned tree *encroaches* on a neighboring property when its branches or roots reach past the boundary line, sometimes called the *contiguous line* or *common property line* with the adjacent property.

A property owner confronted with **encroaching branches and roots** from a neighbor's tree has three potential remedies:

- recover his *money losses* from the neighbor;
- *use self-help* to eliminate the encroachment; and
- obtain a *mandatory injunction* ordering the neighbor to remove the encroachment.

The remedy available depends on the extent of the encroachment.

An **encroachment** can be either:

- a *permanent encroachment*; or
- a *continuous encroachment*. [**Tracy** v. **Ferrera** (1956) 144 CA2d 827]

An example of a **permanent encroachment** is the construction of a building which lies partly on a neighbor's property. Also, **physical damage** caused to the neighbor's property by an encroaching tree is considered a permanent encroachment, not a trespass. The neighbor may recover **money losses** from the adjoining property owner for the cost of repairing the physical damage to his property caused by the encroaching tree. [Bonde, *supra*]

For example, if a tree's branches fall on a neighbor's parked car and damage it, the neighbor may recover the money losses from the owner of the tree for the cost of repair or lost value.

A neighbor seeking a court award to recover his money losses caused by a permanent encroachment must file an action within three years of the time he discovers the damage caused by the permanent encroachment, if he has not yet settled the dispute with the owner of the tree. [Calif. Code of Civil Procedure §338]

Self-help tree trimming service

If an encroachment can be *abated* (discontinued), it is considered a *continuous encroachment*. For example, a tree that does not cause physical damage, but only encroaches on a neighbor's property by its overhanging branches or invading roots, is a **continuous encroachment**.

A neighbor subjected to a continuous tree encroachment may resort to **self-help** by cutting the offending branches and roots back to the property line. [**Grandona** v. **Lovdal** (1886) 70 C 161]

A neighbor who cuts off overhanging branches from an encroaching tree may keep or discard any firewood or fruit from the overhanging branches. [**Grandona** v. **Lovdal** (1889) 78 C 611]

A neighbor may also recover reasonable costs for the self-help from the owner of the encroaching tree. [**City of Berkeley** v. **Gordon** (1968) 264 CA2d 461]

However, a neighbor cannot cut the encroaching branches or roots beyond the boundary line, kill the tree or enter the adjoining owner's property without his permission. [Fick, *supra*]

A neighbor's self-help efforts must occur on his own property. A neighbor who exercises self-help beyond his property boundary without permission is trespassing. If this happens, the **trespassing neighbor** is liable to the tree's owner for any damage caused to the tree. Further, any trespassing neighbor judged

to have acted maliciously will be responsible for a penalty amount equal to triple the damages. [Fick, *supra*]

A neighbor may only exercise self-help if a reasonable **need to remove** the encroachment exists.

For example, an owner's tree roots encroach upon a neighbor's property. The neighbor removes the roots up to the property line. As a result, the tree becomes unstable and unsafe and its owner has to remove it.

The owner of the tree seeks money damages, claiming the neighbor unnecessarily removed roots which caused serious injury to his tree. The neighbor claims he has an absolute right to remove the encroachments up to the property line.

However, the neighbor does not have an absolute right to remove encroachments up to the property line unless a **reasonable need** exists to remove the encroaching roots. Further, the roots must be removed without unreasonable injury to the tree. [**Booska** v. **Patel** (1994) 24 CA4th 1786]

A continuous nuisance

Another type of continuous encroachment is a *nuisance*. A **nuisance** is any condition which prevents a neighbor's free use or enjoyment of his property or is injurious to his health. [CC §3479; see Chapter 16]

For example, a property owner's land is improved with a row of eucalyptus trees planted several feet inside the boundary line.

His neighbor's property contains a grove of pecan trees. The eucalyptus tree roots extend beyond the property line and into the soil of the neighbor's property, depleting the soil's nutrients.

Can the owner of the eucalyptus trees be ordered to remove or modify his trees by a mandatory injunction?

Yes! The owner of the encroaching eucalyptus trees may be ordered to abate the condition either by *modifying or removing* the trees if they are deemed to be a nuisance. [**Crance** v. **Hems** (1936) 17 CA2d 450]

The mandatory injunction remedy to remove the encroaching branches or roots is only available when the encroachment constitutes a nuisance. [Bonde, *supra*]

If a tree is not judged to be a nuisance, the owner will not be required to eliminate the encroaching roots and branches. The neighbor will then be limited to his own self-help methods. [Grandona (1886), *supra*]

Additionally, a tree owner will not be required to take corrective action to prevent interferences with a merely speculative future use of a neighbor's property.

For example, a neighbor cannot require a landowner to remove his trees simply because the trees might stunt the growth of crops the neighbor may eventually grow near the property line in the future. [Grandona (1886), *supra*]

Air and sunlight obstructions are insufficient interferences to warrant the elimination of trees as nuisances.

For example, a property owner has several eucalyptus trees which he has allowed to grow so large they shade his neighbor's south-facing windows from the winter sun. The neighbor had his house specifically constructed with extra south-facing windows to expose as much of the interior of the house to winter sunlight, using solar energy for heat.

The neighbor contends the trees are a nuisance since they prevent him from using and enjoying his property. The neighbor seeks a court order requiring the owner to trim or remove the trees.

Can the owner maintain the trees even though they are an obstruction of the neighbor's sunlight?

Yes! Property owners will not be ordered to give their neighbor air or light easements. Shading a home from passive solar heat, such as heat received through extra windows, is not considered a nuisance. [**Sher** v. **Leiderman** (1986) 181 CA3d 867]

However, an owner who installs *active solar collectors* is provided a **light easement** under the Solar Shade Control Act. A property owner may not plant or maintain trees or shrubs which will shade a neighbor's preexisting **active solar collector** between 10 a.m. and 2 p.m. (standard time). [Calif. Public Resources Code §25982]

Active solar collectors

A **solar collector** which receives protection under the Solar Shade Control Act must be a *fixed device*, or part of a fixed device used to gather solar energy.

Thus, south-facing windows installed for the purpose of bringing in more sunlight do not qualify as active solar collectors. [Pub Res C §25981]

The Solar Shade Control Act does not apply to timberland trees or agricultural land.

Additionally, if a tree or shrub has been growing before a neighbor installs an active solar collector, the owner of the property containing the tree or shrub may replace it if it dies subsequent to the installation of the solar collector. [Pub Res C §25984]

Broker responsibility

A listing broker for a single family residence must diligently inspect a property and disclose adverse information on the property's condition which might affect a prudent buyer's decision to acquire the property. [**Easton** v. **Strassburger** (1984) 152 CA3d 90]

The listing broker's **visual inspection** of the property should include his observation of the surface roots and branches of trees located both on the listed property and on the neighboring properties which may encroach on the listed property in the future. If the listing broker observes an encroachment or believes one is likely to occur, the information must be given to the prospective buyer.

The listing broker should further inform the buyer of the steps he or the seller can take against **encroaching trees** should the buyer decide to purchase the property.

Chapter 17 Government-owned trees

This chapter covers the legal nature of trees as real estate and focuses on government-owned trees.

Maintenance and liability

A tree stands in a public right of way, its trunk located in the frontage area between a property owner's parcel of real estate and the curb of the street. A property owner believes he owns everything in front of his house up to the street curb and has unlimited free use and enjoyment of all the land between his home and the street curb.

The owner considers the tree unsightly and removes it. The city's Parks and Recreation Commission discovers the tree has been removed and fines the property owner for unlawfully removing the city's tree.

Can the city control the planting, removal and maintenance of trees located in the area between the street curb and the property line?

Yes! The land from the owner's front property line to the middle of the street belongs to the city. The front property line divides the owner's parcel of real estate from the city owned right of way. In this sense, the owner and the city are adjoining property owners.

The city's right of way includes:

- the street or highway (usually surfaced with asphalt);
- the curb and gutter;
- the sidewalk (usually made of concrete) which may be adjacent to the property line or along the street curb;
- street light poles; and
- street side plots of soil or grassy areas with trees.

Although a property owner typically maintains grass in the area between the curb and his property line, he may not remove the trees located in the right-of-way area without city permission. Thus, a property owner must treat the trees as property of another, even though the trees grow in front of his parcel of real estate. [See Chapter 10]

City-owned trees pose two main problems for a property owner:

- maintenance, modification or removal of the tree; and
- damage from the tree to the owner's property or to users of the owner's property.

Maintenance of city-owned trees

A city may adopt a *tree policy* authorized by the state legislature. However, a city is not required to implement and use the statutory tree policy. If the city adopts the state's tree policy, the city cannot apply provisions from any other policy. [Calif. Streets and Highways Code §22002]

However, if the city charter and the statutory tree policy are in conflict, a city's charter will control.

Under state guidelines, a city may set up a board of one or more persons and call it the Tree Department, the City Parks and Recreation Commission or any similar name it desires. This board will oversee the maintenance, planting, removal and care of trees, parks, shrubs and vegetation within the city. [Str & H C §22008]

The board can create and enforce ordinances that comply with state guidelines for trees growing on city-owned property. [Str & H C §22031]

The city may impose a penalty for the illegal removal of its trees. If a property owner wants a city-owned tree removed, he must comply with the city's ordinances controlling those trees. For example, a city can allow an owner to obtain a permit to remove offending trees by himself, or it can permit the removal of city trees only by persons authorized by the board.

It is essential for a property owner to be sure he is complying with city ordinances before he removes or modifies trees growing in the city's right of way. The owner will need to ascertain which department of the city has authority to oversee and enforce the tree policy.

For example, a city board supervising the tree policy may be a division within the city's Parks and Recreation Commission.

The board can order the removal of any tree or tree part likely to fall which is posing a danger or obstructing public travel, whether the tree is on city or private property. [Str & H C §22060]

If a tree is growing on private property, the board must provide the property owner with written notice ten days before removing the tree, unless the tree is an immediate threat to public safety. [Str & H C §22061]

The property owner has seven days to file an objection to the tree's removal with the board. If the owner files an objection, the board may not cut down the tree until it provides the owner with an opportunity to be heard, or until an agreement is reached regarding the tree's removal. [Str & H C §22062]

When the board decides to plant, maintain or remove trees growing along city streets, it may tax the parcels of land affected by the improvements. The board is also authorized to use money from the city's general fund appropriated for the tree policy, which it generally does. [Str & H C §22034]

Government liability for its trees

The ability of a person injured on public property to recover money losses from the government agency owning the property depends on the condition of the property at the time of the injury.

For the purpose of determining a government agency's liability for injuries to others on its property, the property is classified as either:

- unimproved property in its natural state; or
- improved property altered by the agency's ownership of the property.

If a tree growing on city property is left in its natural and unimproved state and as a result injures a person using the property, the city is not liable for the injury. A person using unimproved public property takes on the risk of injury while enjoying the benefits of using the property in its natural condition. [Calif. Government Code §831.2]

Unimproved property does not necessarily have to be in its original, pristine condition. Evidence of maintenance and preservation of public property will not render the property improved for the purpose of determining whether or not a city or government agency is liable for injuries occurring on the property.

However, owners of real estate adjacent to **unimproved public property** who are injured by trees growing on the public property are able to recover their losses from the city or government agency. Government immunity only applies when the injured person is a user of the city property.

Consider a property owner who lives next to an unimproved city park. Several large eucalyptus trees in the city park grow near the adjoining property owner's house.

One of the eucalyptus trees falls on the owner's house, destroying the roof and causing the property owner emotional distress. The owner makes a demand on the city to recover his money losses.

The city claims it is immune from liability since the park is unimproved public property.

Can the owner recover his losses from the city?

Yes! *Government immunity* from injuries suffered on unimproved public property applies only to users of the property, not property owners whose real estate lies adjacent to or near the city property. [**Milligan** v. **City of Laguna Beach** (1983) 34 C3d 829]

Injury on unimproved government land

Liability does exist for injuries to users of **improved public property**. Improved public property is property altered by humans with artificial conditions or improvements in selected areas of the property.

For example, a park with a restroom and picnic facilities would be considered improved public property. However, a user of a city park with improvements installed only in some areas of the park may not recover money losses from the city for injuries he suffered while using an unimproved portion of the park. [**Fuller** v. **State** (1975) 51 CA3d 926]

A city is not liable for injuries to users of either improved or unimproved city property if the city voluntarily undertakes activity to protect users of the property but fails to warn the public about dangerous conditions the city knows or should have known about.

For example, a city beach is unimproved. The city provides lifeguards for an area designated for swimming. A swimmer drowns when he is caught up in a riptide. The swimmer's family claims the city is liable for the swimmer's wrongful death since it provided lifeguard services, implying a duty of care owed to users of city property. The city claims it is immune from liability for the swimmer's drowning because the beach is unimproved public property in its natural condition.

Is the city liable for the swimmer's death?

No! Public beaches have been designated as unimproved and exist in their **natural condition**. The city's placement of lifeguards on the beach does not alter its natural condition and does not eliminate the city's immunity. Citizens cannot hold cities liable for failing to warn swimmers of a natural condition such as a riptide. [Gov C §831.21]

Additionally, when a city employs staff to supervise and maintain its property, it is not necessarily undertaking a duty of care for users of the property.

Consider a group of teenagers who enter a city's unimproved park to drive their all-terrain vehicles (ATVs).

The city has not altered the property, but it employs park rangers who help **maintain and supervise** the property and **enforce** the city's park policies.

One of the teenagers becomes paralyzed as a result of an accident that occurs while he is driving his ATV in the park. The injured teenager claims the park ranger should have warned him about any dangerous conditions existing in the park. The teenager also claims the city is liable for his injuries since it voluntarily provided the area for park users since the city employed rangers to supervise the park.

Is the city liable for the teenager's injuries?

No! The park rangers were hired to care for the property, not people. Thus, the city has not assumed responsibility for persons injured while using the **unimproved property**. [**Mercer** v. **State** (1987) 197 CA3d 158]

Chapter 18 Trespass: a violation of possession

This chapter examines the activities which constitute trespasses on real estate and lists the available remedies.

Ejectment, liabilities and title risks

A *trespass* is any wrongful and unauthorized entry onto real estate in the possession of another.

Thus, a **trespass** is an interference with another's **possession** of real estate, which is distinct from any interference with **title** or an **ownership interest**. [**Brenner** v. **Haley** (1960) 185 CA2d 183]

The person entitled to stop a trespass is not necessarily the fee simple owner or the owner's agent. Anyone in possession of the property, such as the fee owner, a life estate owner, a tenant or even a person in wrongful possession, has the right to stop a trespass. [**Allen** v. **McMillion** (1978) 82 CA3d 211]

A fee owner can even trespass on the property he owns in fee simple when the property is in the legal possession of another person, such as a tenant.

For example, a landlord who enters a leased premises without a tenant's permission (except after giving proper notice, or in an emergency) is liable for a trespass, called *forcible detainer*. A landlord has no possessory rights in the property during the term of a rental or lease agreement, only a **reversionary interest**.

Privileged entries protect landlords and others against liability for **trespass**, such as entering property possessed by another in case of an emergency, to abate a nuisance or to serve legal papers.

For example, a property owner is authorized by statute to enter a neighbor's property to abate a nuisance if that nuisance affects him, such as a fire hazard. Any owner who enters his neighbor's property to *abate a nuisance* must first give notice and on entry conduct himself in a peaceable manner. [Calif. Civil Code §§3502, 3503]

Trespasser liability for harm done

When an entry is not privileged, it is considered a trespass. A trespasser incurs **civil liability** for the monetary amount of any losses or injury he causes to the occupant's person, real estate or personal property.

An occupant of property, who might be someone other than the fee owner, can recover his money losses for injuries resulting from a trespass. Conversely, damage to the fee owner's property caused by the person who is in rightful possession, such as a tenant, is not a trespass, it constitutes *waste* since he has impaired the property's value. [**Smith** v. **Cap Concrete** (1982) 133 CA3d 769]

Editor's note — Although the test for who can stop a trespass or recover money losses is possession, not ownership, the term "owner" will be used for convenience throughout this chapter. Bear in mind that the owner seeking to stop a trespass could also be a tenant, licensee, transient guest or other occupant.

An owner may bring an action for trespass against a trespasser even when the trespasser caused no actual injury by his presence in the owner's property. If no injury has occurred, the owner may only recover *nominal money damages* from the trespasser. **Nominal money damages** are awarded when a wrong has

been committed under the law but has not resulted in a money loss. [**Staples** v. **Hoefke** (1987) 189 CA3d 1397]

To recover *actual money damages* for a trespass, an owner must sustain an actual loss. **Actual money damages** recoverable for a trespass are based on:

- injury to the real estate;
- lost use of the property;
- personal injury; and
- injury to the occupant's personal property.

Indirect trespass

A trespass does not require the trespasser's direct physical presence on the property. A trespass can result from an **indirect entry** into another's property, sometimes called *trespass on the case*.

For example, one can be liable on a trespass for damages caused by activities such as:

- depositing dirt or debris on another's property [**Armitage** v. **Decker** (1990) 218 CA3d 887];
- leaving toxic waste on another's property [**Mangini** v. **Aerojet-General Corporation** (1991) 230 CA3d 1125];
- leaving personal property on real estate belonging to another [**Herond** v. **Bonsall** (1943) 60 CA2d 152];
- diverting a river or surface waters across another's property [**Salstrom** v. **Orleans Bar Gold Mining Co.** (1908) 153 C 551];
- starting a fire and negligently allowing the fire to move onto a neighbor's property [**Elton** v. **Anheuser-Busch Beverage Group, Inc.** (1996) 50 CA4th 1301]; or
- allowing one's animals to wander across another's property. [**Montezuma Improvement Co.** v. **Simmerly** (1919) 181 C 722]

Money losses of value and rents

An owner who is completely deprived of the use of his property by a trespasser is entitled to recover the **rental value** for the use of the property during the period of the trespass. [CC §3334(b)]

For example, a tenant who leases property for the purpose of running a restaurant leaves restaurant equipment on the premises after the lease expires. Due to the presence of the equipment, the owner is unable to use the property. Thus, the owner can recover the rental value of the premises from the former tenant for as long as the equipment remains on the premises. [Herond, *supra*]

The amount of money damages recoverable for injuries to the real estate caused by a trespasser can be based on either **lost property value** or the **cost of restoring** the property to its condition prior to the trespass. Under most circumstances, an owner of real estate damaged by a trespass will be awarded the lesser of the two amounts or a dollar amount most appropriate to cover his loss. [Armitage, *supra*]

The most straightforward recovery situation arises when a trespasser inflicts an injury to a property which diminishes its value, since the owner simply recovers the amount of the lost property value. For example, an owner may recover the lost value of his property from a neighboring property owner who diverts water across his property, washing away soil and crops. [Salstrom, *supra*]

However, many trespasses involve more than a simple loss in property value. An owner is not required to accept any changes to his property caused by a trespasser without his consent, and may recover **costs of restoration** regardless of any change in the value of the property.

For example, a neighbor builds a road across an owner's property without the owner's consent, destroying a number of trees in the process. The construction of the road actually increases the value of the owner's property, but the owner prefers the trees for their aesthetic value. Thus, the owner is able to recover the reasonable cost of restoring the property to its condition before the trespass i.e., replacing the trees. [**Heninger** v. **Dunn** (1980) 101 CA3d 858]

Reasonable means the restoration costs must be balanced against the lost value **actually suffered** by the owner. In Heninger, the owner did not recover the cost of restoring the property to its **exact** condition before the trespass, since the cost to replace trees of the same growth would have been several hundred thousand dollars more than the value of the real estate itself. The reasonable cost of restoration was limited to planting new trees which would grow over time.

Additionally, for an owner to recover money from a trespasser for the restoration of a property to its pre-trespass condition, out-of-pocket money losses must have actually been spent by the owner on the restoration. [Heninger, *supra*]

Aside from the money losses sustained by the owner, a trespasser has liability exposure for **punitive damages** if the trespass and resulting property damage is intentional and malicious. [CC §3294]

For example, if a property owner's neighbor trespasses and is intentionally malicious, such as trampling flower beds or removing plants from the property, the neighbor is liable for punitive damages, a judicial money award constituting a penalty. [**Griffin** v. **Northridge** (1944) 67 CA2d 69]

Injunction to abate a trespass

Besides recovering money losses, an owner can obtain a court ordered **injunction** to stop a person who is a continuing trespasser.

A single isolated trespass is not a basis for an injunction. However, if seeking money damages would not prevent a trespass from being repeated in the future, the rightful occupant can obtain an injunction against the trespasser. [**Standard Lumber Co.** v. **Madarys Planing Mill** (1921) 54 CA 107]

Trespass on livestock land

An owner of real estate attempts a controlled burn of brush on his property.

Due to the owner's negligence, the fire spreads onto a neighboring property which is used for raising livestock. The fire damages plant life on the neighboring property which served as fodder for his livestock. The owner is found liable for money losses sustained by the neighbor due to the fire.

The neighbor claims he is entitled to attorney fees since the fire was a trespass. The owner claims attorney fees are not recoverable since the fire was not a trespass.

In this example, the fire, which was started by the owner and moved onto the neighbor's property, constitutes a trespass. Thus, the neighbor whose property is used to raise livestock and was damaged by the escaping fire is entitled to attorney fees. [Elton, *supra*]

When a trespass occurs on real estate which is under cultivation or is intended or used to raise livestock, the owner of the real estate is entitled to attorney fees for the action in addition to the damages caused by the trespass. [Calif. Code of Civil Procedure §1021.9]

Physical damage by invasive conduct

Consider a property owner's residence which is adjacent to a public utility easement. Powerlines which emit electromagnetic fields (EMFs) are located on the easement.

The owner claims the utility company is liable for trespass since the EMFs are a **physical invasion** of the owner's property which renders it uninhabitable and has diminished the property's value.

Is the utility company liable for trespassing on the owner's property due to the EMFs?

No! The utility company is not liable for trespass since the EMFs are an **intangible intrusion**, a condition which does not physically damage the property or its occupants. [**San Diego Gas and Electric Company** v. **Superior Court** (1996) 13 C4th 893]

Criminal trespass on refusal to leave

In addition to the liability for property damages, a trespasser may also incur **criminal** liability. Trespassing becomes a **misdemeanor** when the trespasser:

- *refuses to leave the property* on foot or in a vehicle when requested by the owner, the owner's agent, a person in lawful possession of the property or a law enforcement officer acting on request from the person entitled to possession [Calif. Penal Code §602(k), (n)];
- enters and *occupies the property* without the rightful owner's consent [Pen C §602(m)];
- *refuses to leave a transient occupancy* establishment (hotel/motel/vacation property) on the request of the owner or manager [Pen C §602(s)];
- *enters a private dwelling* [Pen C §602.5]; or
- *enters industrial property* (such as an oil field, a gas or electric plant or a railroad yard) where posted signs forbid trespassing. [Pen C §554]

A crime is not committed by merely entering another's property, except when the property is a private residence or posted industrial property.

For example, a group of individuals who camped for one night on an owner's property without his permission are arrested for trespassing at the request of the owner. The owner claims the campers have committed a misdemeanor since they occupied the property without his consent.

However, the mere *transient use* of a property for a campsite does not constitute occupation of the property, resulting in a criminal trespass. Criminal occupancy requires an ongoing *continuing possession*. Thus, the campers committed no crime. [**People** v. **Wilkinson** (1967) 248 CA2d Supp. 906]

Removing trespassers by ejectment

An owner's first course of action when confronted with a trespasser is to simply request the trespasser to leave. If the trespasser does not **leave when requested**, he commits a *misdemeanor*. [Pen C §602(l)]

An owner himself may not **forcibly eject** a trespasser. To discourage disturbances of the peace caused by self-help, California law allows both tenants and trespassers to recover damages from the landlord or

property owner for **forcible entry and detainer** — a forcible interference with an individual's peaceful possession of a property, even if that individual's possession is wrongful. [CCP §§1159, 1161, 1172]

An owner may only recover possession of his property from a trespasser through a court action, except when the trespasser is a transient occupant who failed to depart as agreed. The type of action brought to recover property depends on the type of possession held in the property.

For example, the action to recover possession of a property from a tenant in default on his lease obligations is an *unlawful detainer* (UD) action. In the case of a trespasser occupying property, the legal remedy is an *ejectment* action.

Ejectment is similar to a UD action but has less stringent proof of trespass requirements. The trespasser in an ejectment action, unlike the tenant in a UD action, never has to have legal possession of the property for an owner to have the trespasser legally removed.

In an action to eject a trespasser, an owner (or other occupant) must prove he has a superior right to possession of the property. The owner may then obtain a court order for the removal of the trespassers from his property, called a *writ of possession*. The court order is carried out by the sheriff, not the owner. [CCP §715.010]

In the case of trespass on **public lands**, the state stands in the role of the owner or occupant of the property for the purposes of ejecting trespassers and recovering money losses. [Calif. Public Resources Code §§6224.1, 6302, 7992]

Transient occupants removed by police

Guests who have checked into a hotel, motel, vacation rental or similar establishment are called *transient occupants*. The owner or operator of the establishment is called an *innkeeper*.

A **transient occupant** who refuses to leave the premises when requested to do so by the **innkeeper** is guilty of a *misdemeanor* for lodging without permission. A transient occupant is also committing a misdemeanor if he obtains accommodations and then refuses to pay or leave the premises at check-out time. [Pen C §602(s), 647]

In both cases, the innkeeper may call the police for assistance in removing the person who has become a trespasser.

Once the police officer arrives, if the transient occupant continues to **refuse to leave** the property, the occupant by refusing to leave is committing a crime in the presence of the officer. The officer then has the authority to arrest the occupant as a trespasser and remove him from the premises. [Pen C §836(a)(1)]

Owner's risk of liability or lost rights

Even if an owner is not troubled by trespassers who use his property, he must consider his risk of:

- liability for *injuries to trespassers* entering into his property; and
- *losing* some or all of his *property rights* through prescription or adverse possession.

Every property owner must take reasonable precautions to prevent injuries to others on his property, since he is liable for injuries to others, even trespassers, caused by unsafe conditions on the property. [CC §1714]

The ownership liability applies whether the injured person is a trespasser or an invited guest on the owner's property. [**Rowland** v. **Christian** (1968) 69 C2d 108]

An exception to ownership liability applies to property owners who permit others to use their property for **recreational purposes**. A property owner is not liable for injuries to persons using his property for recreational purposes, unless he:

- invites the users onto his property, rather than merely permits the use;
- charges consideration for entry; or
- intentionally or maliciously fails to warn or protect against a known hazardous condition. [CC §846]

Owners frequently seek to use the **recreational activity immunity** as a defense against liability for injuries occurring on their property. For example, a child is injured while riding a bicycle on a *construction site*. The owner of the property claims he is exempt from liability for the injury since the child was using the property for recreational purposes.

However, to enjoy immunity from liability for injuries to recreational users, an owner must prove his property is suitable for recreational use. Since a construction site is not suitable for recreational purposes, the owner is not immune from liability. [**Paige** v. **North Oaks Partners** (1982) 134 CA3d 860]

The prescription in an on-going trespass

Prescription is a process for acquiring property rights to use another's property, such as an easement, through adverse use hostile to the rights of the owner. [See Chapter 20]

An adverse user of real estate, hostile to the owner's rights, is a **trespasser**. If allowed to continue long enough without interruption, a trespass matures into a property right through prescription. An owner must take steps to avoid the risk of a trespasser establishing permanent prescriptive rights to his property.

One easy solution for an owner is to grant a trespasser a **revocable right** to use his property. When an owner gives **permission** for someone to use his property, the use is not adverse, and thus a prescriptive right to use cannot be established.

Additionally, an owner can post signs on his property stating the right to pass is by permission, subject to revocation and the control of the owner. No prescriptive easement can be established based on the period of time after the revocable permission signs are posted. [CC §1008]

Finally, to best protect his property rights, an owner should record a notice stating permission to use his property is revocable. [CC §813]

Adverse possession and owner inattention

A trespasser who occupies property without the consent of the owner can be ejected by a court order at any time, and can also be charged with a misdemeanor. [Pen C 602]

However, a trespasser can **acquire title** to the entire property by **adverse possession** if he can manage to maintain exclusive possession of the property as a trespasser for a period of five years. To establish title by adverse possession, the trespasser's possession must be open and known to the owner, and the trespasser must pay all property taxes. [**Gilardi** v. **Hallam** (1981) 30 C3d 317]

Adverse possession differs from prescription in that it is a claim for **title** to the real estate. Conversely, prescription merely involves a **right to use** another's property.

Similar to prescription, one safeguard against adverse possession is to grant the occupant permission to use the property.

However, merely granting permission will not prevent adverse possession in all cases. For example, possession of a property might be based on **color of title**, meaning the occupant has a deed which is defective for some reason (such as forgery) and a good faith belief he owns the property (he paid the purchase price and received title insurance). Granting permission will not affect a claim for adverse possession based on color of title. [See Chapter 27]

The most prudent remedy against a trespasser seeking to establish adverse possession is an action for ejectment. Conversely, when the trespasser occupies under color of title, a quiet title action is required to clear title of the cloud created by the color of title.

Chapter 19 Nuisance: offensive, unhealthful, or obstructive

This chapter defines a nuisance, distinguishes it from trespass and describes a property owner's remedies to stop it.

Interference with use and enjoyment

A nonresidential tenant stores hazardous materials on leased property as permitted in his lease agreement. The agreement requires the tenant to return the property to the landlord in its **original condition** on the expiration of the lease.

The hazardous materials maintained on the leased property by the tenant contaminate the soil. When the lease expires, the tenant vacates the premises without cleaning up the contamination.

Several years after the tenant leaves, the landlord discovers the contamination and incurs cleanup costs, called *damages*. The landlord then seeks to recover **damages** from the tenant, claiming he created a *nuisance* by leaving the property contaminated with hazardous materials.

The tenant claims he is not liable for a **nuisance** since:

- a nuisance is an activity created or carried out on one property and affecting another property, not an activity occurring solely on the property affected;
- he no longer has a possessory interest in the property; and
- the landlord consented to his use of the property to store hazardous materials.

Is the tenant liable for losses incurred by the landlord caused by the nuisance he created?

Yes! The tenant does not escape liability to the landlord for the cleanup costs since:

- a nuisance is any harmful or obnoxious activity which obstructs an owner's use of his property, regardless of where the nuisance arises;
- the person who creates a nuisance does not need to have a possessory interest in the property to be liable; and
- the landlord did not consent to the tenant leaving contamination on the property after the lease expired. [**Mangini** v. **Aerojet-General Corporation** (1991) 230 CA3d 1125]

What is a nuisance?

A *nuisance* is anything which:

- is **offensive** to the senses;
- is **injurious** to health; or
- **obstructs** the use of property. [Calif. Civil Code §3479]

Thus, a nuisance is any activity which interferes with the **use and enjoyment** of property, including conditions which are unhealthy or offensive to the senses.

The common law definition of a nuisance was limited to conduct on one property which interferes with the use and enjoyment of a different property. However, a nuisance is now broadly interpreted to encompass a wide variety of activities.

Consider a residential landlord who maintains his rental units in an **unsafe condition**. In addition to being a breach of the implied warranty of habitability, the tenants may also pursue an action against the landlord for maintaining a nuisance. A **residential landlord** maintains a *nuisance* by failing to care for and maintain his units, and he is liable to the tenants for their losses, including relocation expenses. [**Stoiber** v. **Honeychuck** (1980) 101 CA3d 903]

A nuisance does not need to be offensive to the senses or injurious to health to constitute a nuisance. A **nuisance** only needs to interfere with the *use and enjoyment* of a property right in some **physical manner**.

Consider an owner of a business operating on premises located next to an airport. Above-ground fuel storage tanks are located on the airport property approximately 500 feet from the business premises.

The business owner claims the tanks are a nuisance since he fears he will die if the tanks rupture or explode due to an accident, and that fear interferes with his use and enjoyment of his property.

However, the proximity of the fuel storage tanks is not a nuisance. An occupant's fear of future invasion does not constitute a physical interference with his use and enjoyment of his land. [**Koll-Irvine Center Property Owners Association** v. **County of Orange** (1994) 24 CA4th 1036]

Similarly, electro-magnetic fields (EMFs) emitted by power lines located on an easement next to an owner's property are not a nuisance. No study has found conclusive scientific proof that EMFs are a health hazard. [**San Diego Gas and Electric Company** v. **Superior Court** (1996) 13 C4th 893]

Neighboring property owners inevitably create some degree of **annoyance or inconvenience** for each other, but not every annoyance rises to the level of a nuisance.

An activity becomes a nuisance based on either:

- a statutory provision identifying conduct that is a *nuisance per se*; or
- a balancing of the conflicting rights and interests of the neighboring property owners.

Nuisance per se by statute

A *nuisance per se* is any activity specifically declared by statute to be a nuisance. If an activity is a statutory nuisance, it can be enjoined without proof of its harmful or offensive effect.

The list of **nuisances per se** is wide and diverse, including:

- fences of excessive height unnecessarily exceeding ten feet, called *spite fences* [CC §841.4];
- the illegal sale of controlled substances [CC §3479];
- fire hazards [Calif. Public Resources Code §4171]; and
- swimming pools which do not comply with statutory health and safety standards. [Calif. Health and Safety Code §116060]

Conversely, some activities are declared by statute not to be nuisances.

Activities done or maintained under the express authority of a statute, called *statutory authority*, cannot be nuisances. For example, the activities of a commercial agricultural processing plant are maintained under **statutory authority** and cannot constitute a nuisance. [CC §§3482, 3482.6]

However, the side effects of statutorily authorized activities are not exempt from nuisance liability. For instance, a city waste treatment plant near an owner's residence produces offensive and unhealthy odors. The adjacent property owner seeks to abate the nuisance.

The city claims the owner cannot have the nuisance abated since it has the statutory authority to operate a waste treatment plant.

However, the statutory authorization for the operation of a waste treatment plant does not also authorize the city to produce a noxious and unhealthy stench. Thus, the odors constitute an abatable nonexempt nuisance, even while the treatment plant creating them is exempt. [**Varjabedian** v. **City of Madera** (1977) 20 C3d 285]

Similarly, an activity authorized by a **zoning ordinance** limits the possible remedies for nuisance. Any activity carried out under a zoning ordinance does not constitute a nuisance and cannot be stopped by an injunction. [Calif. Code of Civil Procedure §731a]

However, *zoning immunity* does not extend to activities which are conducted in an unnecessarily or excessively offensive manner.

Consider, a property owner who operates a music studio in a building as permitted by zoning. However, the structure housing the music studio does not contain soundproofing. Also, loud music is played on the property late into the night with the windows and doors open.

The studio owner's neighbors complain of the noise and seek an injunction against the owner's operation of the music studio. The owner claims the neighbors are barred from obtaining an injunction since his property is zoned for use as a music studio.

However, the owner of the music studio is not entitled to disturb his neighbors by creating excessive noise beyond the permitted use. Thus, the owner is enjoined from operating the music studio at noise levels and during hours which unreasonably disturb the neighbors. [**Gelfand** v. **O'Haver** (1948) 33 C2d 218]

Balancing rights: inconvenient or improper

When an activity is not a nuisance per se, to determine whether a **nuisance** exists, a *balancing of the rights* of the neighboring property owners is applied.

Every owner is entitled to use his property for any lawful purpose. However, an owner is limited in his conduct since his permitted use may not unreasonably interfere with the right of others to use and enjoy their property. [CC §3514]

An owner's use of his property often creates some degree of inconvenience for the occupants of neighboring properties. However, to constitute a nuisance, the inconvenience created by an owner's use of his property must be serious enough to be an **improper interference** with another's use and enjoyment of his property.

Whether an activity is a nuisance is determined on a case-by-case basis. An activity which is a nuisance in one set of circumstances may not be a nuisance in another, depending on such factors as:

- the frequency and time of day of the activity;
- the number of inhabitants in the area; and

- the injury or inconvenience caused to occupants of surrounding property by the activity. [**McIntosh** v. **Brimmer** (1924) 68 CA 770]

For instance, the typical day-to-day use of a family-occupied residence inevitably creates noise which is audible to the neighbors. However, production of family noise, within reasonable limits, is not a nuisance.

Consider a homeowner who constructs a basketball court in his backyard for recreational use. The court is only used during the afternoon and never for more than one hour on any day.

The owner's neighbor complains of the noise from the basketball games and claims the owner is maintaining a nuisance. The neighbor seeks an injunction to prevent the owner from playing basketball on his court.

In this instance, the owner's use of the basketball court is well within reasonable limits. Basketball noise, so long as it is not excessive, is not a nuisance. Thus, an injunction to abate reasonable amounts of game noise can not be obtained by the neighbor. [**Schild** v. **Rubin** (1991) 232 CA3d 755]

In a similar case the with opposite outcome, basketball playing was enjoined as a nuisance since very noisy and rancorous games were repeatedly carried on late at night. [**Alexander** v. **McKnight** (1992) 7 CA4th 973]

Public vs. private nuisance

A **nuisance** may be a public nuisance, a private nuisance or both.

A *public nuisance* is a nuisance which affects an entire neighborhood or segment of the public. [CC §3480; Calif. Penal Code §370]

Stopping a **public nuisance** is the responsibility of state or local government authorities. Officials may seek to abate or enjoin the nuisance, recover money damages or bring criminal misdemeanor charges against the offender responsible for the nuisance. [Pen C §372]

A private property owner may not stop a public nuisance unless the public nuisance especially obstructs the owner's use of his property, making the interference a private nuisance as well. [CC §3493]

For a private owner to abate a public nuisance by an injunction, he must sustain injuries to himself or to his property which are **different in kind** from the interference or injuries sustained by the public at large.

A difference in the **degree of interference** alone does not make a public nuisance a private nuisance. [**Venuto** v. **Owens-Corning Fiberglas Corporation** (1971) 22 CA3d 116]

Continuing with our previous example, consider the owner of property located 500 feet from aboveground fuel storage tanks at an adjacent airport. The property owner claims the fuel tanks are a private nuisance since the tanks diminish his property's value, raise insurance premiums and reduce the usefulness of his business premises.

However, the owner is unable to abate the public nuisance himself since he did not suffer an **injury different in kind** from any other member of the public. [Koll-Irvine Center Property Owners Association, *supra*]

Now consider an owner of real estate which is contaminated by hazardous waste dumped by a previous owner. The current owner conducts tests and discovers the hazardous waste has contaminated not only his property, but neighboring properties as well.

In this instance, the owner can recover cleanup costs from the previous owner for maintaining both a public and private nuisance. The owner's cost of testing his property is an injury which the **public did not also suffer** by the nuisance. [Mangini, *supra*]

Remedies of suppression or money

The remedies for a public or private nuisance are:

- abatement, by suppression or termination of the interference [CC §3495]; and
- a civil action for an injunction and money losses. [CC §§3501, 3493]

An owner has the right to take self-help actions to reduce or put an end to a private nuisance affecting his property if he can do so without creating a disturbance of the peace or causing injury. [CC §3502]

For instance, **self-help abatement** of a private nuisance typically occurs when an owner cuts off the limbs of a neighbor's tree which encroach onto his property. [See Chapter 16]

A **civil action** to end a nuisance involves seeking an **injunction** (to stop the activity or condition creating the nuisance), *money losses* from those responsible for the nuisance, or both.

The **money losses** an owner seeks to recover for a neighbor's nuisance are based on either:

- actual money losses for injury or loss of value to his real estate, or for injury to himself; or
- intangibles, such as emotional distress and personal discomfort.

For example, a homeowner affected by noxious odors emanating from a neighboring sewage treatment plant may recover **money damages** based on:

- diminution in the property's value caused by the odors; and
- personal discomfort resulting from the odors, including nausea and burning eyes. [Varjabedian, *supra*]

Additionally, an owner may recover **punitive damages** for the willful or malicious creation of a nuisance.

Consider a homeowner's neighbor who uses his property for the excavation of sand and gravel.

The owner fears his neighbor's excavation will damage his property due to the lack of lateral support and complains to the neighbor. Also, the city informs the neighbor the excavation violates zoning laws. The neighbor continues the excavation despite the protests.

After a portion of the owner's property subsides due to the neighbor's excavation, the owner sues the neighbor for maintaining a nuisance.

In addition to his money losses for the diminished value of his property, the owner recovers punitive damages. The neighbor continued excavating after the owner and the city complained, and had full knowledge of the potential damage he might inflict on the owner's property. [**McIvor** v. **Mercer-Fraser Co.** (1946) 76 CA2d 247]

Nuisance vs. trespass

Nuisance and trespass are closely related. The two categories overlap since both involve injury to, or interference with, the property rights of another. The distinction is based on whether a physical entry onto another's property occurs.

Trespass requires a **physical entry** on another's property which can be direct or indirect — i.e., the trespasser can either personally enter the property or deposit materials indirectly, such as dirt and debris from construction activity.

In contrast, a nuisance is an **outside interference** with an owner's or tenant's use and enjoyment of his property resulting from a condition or activity which physically remains outside the property.

Thus, trespass is based on an **interference with the possession** since it affects the real estate. A nuisance is an **interference with the enjoyment** of property since it affects the senses of the applicants.

For instance, **noise is a nuisance** to occupants of another property if the noise is loud, annoying and continuous. Noise is not a trespass since no physical invasion of property occurs, except for sound waves which *affect the senses*, not the property. The noise creates no interference with the possessory rights in another's property and thus is not a trespass. [**Wilson** v. **Interlake Steel Company** (1982) 32 C3d 229]

However, the distinction between nuisance and trespass does not mean the categories are mutually exclusive. Nuisance is broadly defined by statute as anything which is injurious to health or obstructs the use of property, regardless of whether the condition exists on or off the affected property. Thus, an invasion of property which qualifies as a trespass is also a nuisance if the trespass rises to an unhealthful or offensive condition.

For example, consider a tenant who leaves behind hazardous materials which contaminate the leased property after the lease expires. The **contamination** is both:

- a *trespass*, since it interferes with the landlord's possession of his property; and
- a *nuisance*, since it is harmful to the public's health. [Mangini, *supra*]

Once a nuisance is **fully abated**, the property subjected to the nuisance is freed from any *loss in value*. Thus, the basis for calculating the recovery of money for the pre-existing nuisance no longer exists since the nuisance no longer exists.

Consider an owner of real estate who discovers a contamination from a neighboring property has intruded into his property. The contamination is a nuisance which is fully abatable since it can be cleaned and completely removed from the property.

The owner claims he is entitled to recover the future loss of the property's market value from the neighbor since a stigma will remain with the property after the contamination is removed.

However, the owner is unable to recover any loss of market value since the *nuisance* which impaired his property will **no longer exist** once the contamination is fully removed. [**Santa Fe Partnership** v. **Arco Products Company** (1996) 46 CA4th 967]

Remedies held by local government

Any public body or officer authorized by law may take steps to abate a public nuisance. [CC §3494]

When an agency succeeds in any action or proceeding against an owner of real estate to abate a nuisance, the owner responsible for the nuisance is liable to the agency for their costs of abatement, including administrative costs, abatement expenses and court costs. [Calif. Government Code §25845(b)]

Additionally, the owner will be liable for the agency's attorney fees if a local ordinance allows for recovery of attorney fees in an action to abate a nuisance. [Gov C §25845(c)]

A local governmental agency may choose one of two methods to collect abatement expenses from an owner of real estate:

- record a *nuisance abatement lien* against the property for the amount of the abatement expenses [Gov C §38773.1]; or
- add the abatement expenses to the property's tax bill as a *special nuisance abatement tax assessment*. [Gov C §38773.5(a)]

A **nuisance abatement lien** may be foreclosed by a governmental agency as a judgment lien. [Gov C §38773.1(c)(3)]

Should a **nuisance abatement tax assessment** remain unpaid for three years, the assessed property can be sold by the tax collector. [Gov C §38773.5]

Permanent or continuing nuisance

The type of money losses an owner can recover for property damage caused by a nuisance depends on whether the nuisance is *permanent* or continuing. A **permanent nuisance** exists when the nuisance cannot be abated at a reasonable cost and by reasonable means. [**Mangini** v. **Aerojet-General Corporation** (1996) 12 C4th 1087]

Conversely, a **continuing nuisance** exists if the nuisance can be reduced or terminated at any time and at a reasonable expense.

The money losses inflicted by a permanent nuisance are determined at the time the permanent nuisance is created. Losses inflicted by a continuing nuisance are limited to the actual injuries suffered prior to termination of the nuisance. [**Spar** v. **Pacific Bell** (1991) 235 CA3d 1480]

Permanent nuisance remedies

A **permanent nuisance** cannot be abated at a reasonable expense or by reasonable means. Thus, an owner's only remedy is a recovery of *money losses* calculated as the diminished value of his property caused by the nuisance.

For instance, a building on a neighbor's property encroaches on the adjacent owner's property. The **encroachment** is a permanent nuisance since it perpetually obstructs the use and enjoyment of the owner's property and cannot be removed at a reasonable cost to the neighbor.

In balancing the rights of the adjacent owner and the encroaching neighbor, the cost to the neighbor to abate the nuisance by removing the encroaching improvements far exceeds the loss of the owner's use. Thus, the owner is entitled to monetary compensation for the lost use of the portion of his property hindered by the encroachment, but he cannot abate the encroachment itself. [**Christensen** v. **Tucker** (1952) 114 CA2d 554]

Additionally, a **permanent nuisance** may be permitted as an *easement*.

For example, an airport acquires a prescriptive easement on the airspace over a neighboring owner's property since aircraft entering and exiting the airport have used the same flight path over the property for more than five years.

The noise from aircraft flying over the owner's property is a permanent nuisance, but the owner is barred from recovering any money losses since the airport now holds an easement permitting the (noisy) use of the airspace. [**Institoris** v. **City of Los Angeles** (1989) 210 CA3d 10]

Continuing nuisance remedies

In the case of a **permanent nuisance**, an owner can recover *money losses* equal to the permanent decline in his property's value caused by the nuisance.

However, recovery for a **continuing nuisance** cannot include lost property value since the nuisance can be entirely eliminated. The condition causing the diminished value will no longer exist once the nuisance is removed. Thus, no permanent loss in value occurs to be recovered. [Alexander, *supra*]

The primary remedy for a **continuing nuisance** is an *abatement* to remove the nuisance or an *injunction* ordering the nuisance to be stopped. However, an owner can also recover the costs he incurs to remedy the damage done by the nuisance to his real estate.

Consider a property owner who discovers contaminated soil on his real estate which presents a continuing hazard. Thus, the contamination of the soil is not permanent but will continue until it is cleaned up.

The prior owner of the property operated a business on the property which caused the soil contamination.

The owner claims the prior owner is liable for cleanup costs since he maintained a continuing nuisance on the property. The prior owner claims he cannot be liable for a continuing nuisance since he had the right to contaminate the property while he owned it.

In this instance, the prior owner is liable for the current owner's **cleanup costs** since the contamination creates a **continuing unhealthy condition** on the property. [**KFC Western, Inc.** v. **Meghrig** (1994) 23 CA4th 1167]

In addition to an injunction, other money losses which can be recovered by the owner are limited to:

- the lost use of the property until the nuisance is abated, such as rental value;
- the cost of cleanup or repairs necessary to eliminate the nuisance; and
- any expenses incurred due to personal injury or emotional distress caused by the nuisance.

Statute of limitations on recovery

The status of a nuisance as *permanent* or *continuing* affects recovery under the three-year statute of limitations barring further claims based on the nuisance. [CCP §338]

For instance, an action on a **permanent nuisance** must be brought within **three years** after the nuisance becomes permanent. However, in the case of a **continuing nuisance**, a new cause of action accrues and the three-year statute of limitations begins to run anew each day the nuisance continues, or when further damage is inflicted on the property.

Consider a tenant who discharges gasoline onto the leased real estate, contaminating the soil. Later, a buyer acquires the property. The buyer discovers the soil contamination and cleans it up.

Less than three years after the clean up is complete, the buyer seeks to recover the cleanup costs from the tenant who created the nuisance.

The tenant claims the buyer's recovery is barred by the three-year *statute of limitations*. The buyer claims recovery is not time barred since the contamination is capable of being removed, making it a *continuing nuisance*.

The buyer's action for nuisance is not barred by the three-year statute of limitations since the contamination is a continuing nuisance and the limitations statute does not begin to run until the contamination is completely removed. [**Wilshire Westwood Associates** v. **Atlantic Richfield Company** (1993) 20 CA4th 732]

An owner can take steps to abate a continuing nuisance at any time during the existence of the nuisance, regardless of when the nuisance was first created.

However, an owner cannot recover money for losses spent to eliminate a continuing nuisance which he incurred more than three years before filing the action.

Chapter 20 Easements running or personal

This chapter presents the various types of easements and the rights and obligations unique to each.

Rights in another's property

An *easement* is the right of one property owner **to use** the property of another. A typical **easement** is used for *ingress and egress*, which is a right of way allowing one property owner to traverse a portion of another's land (the easement) to access his property.

Consider a right-of-way easement which is maintained as a road over an owner's property. The easement provides **access** thorough the owner's property from a public street to an adjoining neighbor's property.

The owner builds a fence on his property line, blocking the neighbor's use of the road and access to the public street.

The neighbor, as the owner of property benefitting from the easement, claims the easement gives him the right to use the roadway, a use the owner cannot interfere with by fencing the perimeter of his property to exclude the neighbor.

The neighbor demands the unobstructed use of the road and seeks to recover money losses incurred due to the owner's obstruction.

Is the owner wrongfully blocking his neighbor's use of the road?

Yes! The neighbor holds a valuable **property right** in the owner's property which entitles him to use the right-of-way easement, classified as an *appurtenance* to the neighbor's property.

When an owner whose property is burdened by an easement interferes with the use of the easement by a neighbor whose property benefits from the easement, the neighbor is entitled to have the use of the easement reinstated, either by removal, relocation or modification of the interference.

Further, the neighbor who holds the easement is entitled to compensation for his money losses caused by the owner's obstruction of the neighbor's use of the easement. [**Moylan** v. **Dykes** (1986) 181 CA3d 561]

Benefits and burdens of ownership

An easement creates a relationship between two parcels of real estate since it:

- **benefits** one property, referred to as the *dominant tenement*, whose owner is entitled to use the easement; and
- **burdens** another property, referred to as the *servient tenement*, the owner's use of which is subject to the easement.

Appurtenant or in gross: does it run?

An easement burdening an owner's property as an *encumbrance on his title* is classified as either:

- an **appurtenant easement**, since the allowed use belongs to and benefits an adjacent property and *runs with the land* as an interest held in the burdened real estate; or
- an **easement in gross**, which belongs to an individual, not land, as his *personal right* in the burdened real estate.

For example, a development company sells parcels in a subdivision, reserving a right-of-way easement over each of the parcels. The deed creating the easement does not state the easement is *appurtenant* to other parcels.

Later, the successor to the developer attempts to build a road on the easement. The owners of the burdened property claim the easement is **in gross**, a benefit held only by the original developer.

Is the easement in gross (personal) since the grant deed does not specify the easement is appurtenant?

No! When the document creating an easement does not indicate whether the easement is appurtenant or in gross, the easement is classified as *appurtenant* if it **benefits a property** other than the burdened property. [**Elliot** v. **McCombs** (1941) 17 C2d 23]

Runs with title to the benefitting property

An *appurtenant easement* is incidental to the title of the property which benefits from its use. An easement is not reflected as a recorded interest on the title to the parcel of land it benefits, nor is it a personal right held by a particular individual who may now or have previously owned the land benefiting from the easement.

Accordingly, an **appurtenant easement** is recorded as an encumbrance on title to the burdened property. The easement remains on the property's title after either the benefitting or burdened property are conveyed to new owners. To be enforceable, the easement does not need to be referenced in the grant deed conveying either property to new owners since it runs with the land. [Moylan, *supra*]

Conversely, an *easement in gross* benefits a person, not the real estate owned by that person. An easement in gross is personally held only by the individual who may use the easement. No parcel of real estate can benefit from an easement in gross since only the individual holding the easement can benefit.

For example, an easement held by a public utility company is an **easement in gross**. The utility company has the right to enter onto a property to install and maintain its equipment (power lines, gas or water pipes, etc.). In no way does the real estate owned by the utility company benefit from the easement.

While an easement in gross is a **personal right** which is not transferred with the sale of any real estate owned by the holder of the easement, the right can be *transferred* by the easement holder to another person by a writing — unless the transfer of the easement in gross is prohibited by a provision in the document creating the easement. [**LeDeit** v. **Ehlert** (1962) 205 CA2d 154]

Easements for light, air or view

A property owner has no automatic right, and can not acquire a prescriptive right, to air, light or an **unaltered view** over neighboring properties.

However, a property owner can hold an easement created by a grant which restricts a neighbor's ability to erect or maintain any improvement interfering with the owner's right to air, light or view. The easement might be the result of conditions, covenants and restrictions (CC&Rs) which blanket several properties with use restrictions on height, etc.

Consider a seller who conveys a parcel of real estate to a buyer before the invention of television. The seller retains ownership of an adjoining parcel improved with an apartment complex. The seller, by a provision in the grant deed conveying the parcel, **reserves an easement** for light, air and an unobstructed view over the property sold to the buyer.

Later, the buyer of the burdened property erects a television antenna. The seller, as the owner of the adjacent apartment complex, demands the buyer remove the antenna, claiming the antenna interferes with the unobstructed view easement he reserved.

The buyer claims the seller could not have intended to preclude the use of a television antenna since the easement was created before the invention of television.

Is the buyer obligated to remove the antenna from the space established as a view easement?

Yes! The easement precludes the buyer of the burdened property from erecting or maintaining **any type of improvement** obstructing the seller's (the apartment complex owner's) right to light, air or view. [**Petersen** v. **Friedman** (1958) 162 CA2d 245]

Easements for light, air and view can only be established by *written agreement* between neighboring owners, not by implication or prescription. [Petersen, *supra*]

Solar easements and shady neighbors

A relatively recent type of easement is the *solar easement*. **Solar easements** were established with the intent of encouraging, as public policy, the productive use of solar energy systems.

A solar easement granted in a written instrument must state:

- the measured angles by which sunlight must pass;
- the hours of the day during which the easement is effective;
- the limitations on any object which would impair the passage of sunlight through the easement; and
- the terms for terminating or revising the easement. [Calif. Civil Code §801.5]

Solar easements are similar to easements of light, air or view since they restrict an owner's ability to maintain any improvements interfering with a neighbor's solar energy system.

Consider a restrictive covenant which limits the height of improvements within a housing development. A property owner's tree exceeds the height limitation and his neighbor successfully enforces the restrictive covenant requiring the owner to maintain the tree below the designated height.

In this instance, had the neighbor installed a solar collector on his property, he would have received an incidental benefit from the height restriction since it limits the height of improvements which could hinder the passage of sunlight to his solar collector. [**Ezer** v. **Fuchsloch** (1979) 99 CA3d 849]

A neighboring property owner who installs an *active solar collector* is, by his conduct, granted a solar easement across an adjacent property under the Solar Shade Control Act without the need for a writing. The adjacent property owner may not later plant and maintain trees or shrubs which will shade between 10 a.m. and 2 p.m. (standard time) an **active solar collector** previously installed by a neighboring property owner. [Calif. Public Resources Code §25982]

For easements created on an owner's property by a neighbor's conduct under the Solar Shade Control Act, trees or shrubs growing on the owner's property prior to the neighbor's installation of a solar collector may remain and are not subject to height restrictions. They were in place before the neighbor's solar collector was installed. Thus, no height limit on preexisting trees or shrubs exist, unless established by a recorded height restriction on improvements. [Pub Res C §§25980 et seq.]

Additionally, if a tree or shrub has been growing before a neighbor installs an active solar collector, the owner of the property containing the tree or shrub may replace it if it dies after the solar collector is installed. [Pub Res C §25984]

Conservation easements

A *conservation easement* is a voluntary conveyance — by an owner of real estate to a conservation organization or government agency — of the right to keep the land in its natural, scenic, historical, agricultural, forested or open-space condition. A **conservation easement** can be created in the form of an easement, covenant, condition or restriction (CC&Rs), by use of a deed, will or other instrument to convey the easement. [CC §815.1]

Conservation easements are *perpetual* in duration and thus are binding on all successive owners of the property burdened by the conservation easement. [CC §§815.1, 815.2(b)]

Conservation easements can only be granted to organizations established to acquire and hold a conservation easement, namely:

- a tax-exempt, nonprofit organization qualified to do business in the State of California whose primary purpose is to preserve, protect or enhance land in its natural, scenic, historical, agricultural, forested or open-space condition or use;
- a state or a governmental entity authorized to acquire and hold title to real estate, as long as the conservation easement is voluntarily conveyed; and
- a federally recognized California Native American tribe or a nonfederally recognized California Native American tribe on the contact list of the Native American Heritage Commission. [CC §815.3]

Consider a conservation easement recorded by the California Costal Commission (Commission) on a parcel of real estate in an environmentally sensitive area. The owner of the parcel built a highly visible three-hole golf course on the property without notifying the Commission, violating the conservation easement.

20 years later, the owner sold the property to a buyer without disclosing the existence of the conservation easement. Also, the title insurance company did not reveal the easement to the buyer.

On discovering the existence of the golf course on the property protected by the conservation easement, the Commission ordered the buyer to return his property to its natural state. The buyer refused, claiming the Commission was prohibited, or *estopped*, from enforcing the easement since the Commission failed to act on the long-standing violation when the prior owner built the golf course, leading the buyer to believe no violation existed. The Commission claimed it was not **estopped** from enforcing the conservation easement since its inaction was based on the belief the parcel was in compliance.

Can the buyer be forced to comply with the conservation easement even though he was not aware of its existence?

Yes! The Commission's inaction was based on the belief the parcel was in compliance with the easement, not an intent to mislead the buyer. Additionally, the public interest in the conservation easement superseded the buyer's right to maintain a golf course on his property. [**Feduniak** v. **California Costal Commission** (March 27, 2007) __CA4th__]

Editor's note — The title insurance company and the prior owner may be liable to the buyer for the loss of value caused by the undisclosed easement.

Public registry for conservation easements

Conservation easements held by the state will be listed in a central public registry maintained by the Secretary of the Resources Agency.

Information included with each conservation easement listed in the registry will include:

- the county recorder's document number;
- the date the easement was recorded;
- the purpose of the easement;
- the location of the easement, identified by county and nearest city;
- the identity of the easement holder; and
- the size of the easement in acres.

This registry will be available to the public on the internet by January 1, 2009 and updated biennially.

Chapter 21 Creating an easement

This chapter presents the methods used to create an easement.

By grant, reservation or implication

The basic method for creating an easement is by a writing. Any document which may be used to convey a legal interest in real estate may be used to create an easement.

An easement can be created between the benefitting and burdened properties in an easement agreement, will, grant deed, easement deed, quitclaim deed, lease, order of the court or covenants, conditions and restrictions (CC&Rs).

While the document creating an easement does not have to be recorded, an *unrecorded easement* is no longer enforceable when the owner of the burdened property sells it to a buyer who has no knowledge of the easement, called a *bona fide purchaser (BFP)*.

An **easement** is created in a *conveyance* either by:

- *grant*; or
- *reservation*.

For example, the owner of adjacent parcels of real estate can sell one parcel to a buyer and further **grant** the buyer an easement on the parcel retained by the owner.

Alternatively, an owner of adjacent parcels may sell a parcel, and in the grant deed conveying the parcel, **reserve** an easement on the parcel conveyed for the benefit of the parcel retained.

Creative wording and certainty of purpose

Whether created by grant or reservation, uncertainties due to **omissions** and **ambiguities** in the words creating an easement are often the cause of most disputes involving easements created by a conveyance. To avoid uncertainties, the instrument creating the easement should fully state:

- the names of the grantor and grantee of the easement;
- a description of the property burdened by the easement;
- the legally described location of the easement granted or the portion reserved by exception;
- the intended use for the easement; and
- whether the easement is *appurtenant* or *in gross*.

Easement or fee title conveyed by deed

The terms *reservation* and *exception* in conveyances of real estate are used to distinguish whether the legally described reservation or exception is, respectively:

- created for the benefit of another property, such as an *easement by reservation*; or
- retained as the property of the seller, an *exception for land* which is not transferred with the title conveyed.

The terms **reservation** and **exception** are often mistakenly used interchangeably. However, their meanings and operative effects are very different.

For example, when a grantor conveys one of two adjoining parcels he owns, **reserving** the **right to use** a road on the property conveyed, the grantor has created an *easement by reservation*.

In contrast, if the grantor conveys the property by **excepting** the road, he has not conveyed title and retains ownership to the portion of the property described as the road.

The difference between a **reservation** and an **exception** is apparent in the manner that title insurance companies write a policy on the transfer of title.

If property is conveyed *reserving* a road, the title insurance policy will insure title to the **entire parcel**, then state the title is subject to the easement created by the reservation.

Alternatively, if the property is conveyed *excepting* the road, the portion of the parcel described as the road **is not part** of the legally described property covered by the title insurance policy. The excepted portion did not become the buyer's property. Ownership of the described portion containing the road is retained by the seller as an **exception** to the parcel conveyed.

Consider a subdivider who sells a parcel of real estate to a buyer, "saving and excepting" a strip of the parcel for use as a future road.

The subdivider later claims he may build a railroad on the strip since the strip is his property, having been excepted from the legal description of the neighboring owner's parcel.

The buyer of the parcel containing the strip claims the subdivider cannot build a railroad on the strip since it is reserved as a roadway easement.

Did the subdivider except the strip and thus retain ownership to the roadway portion of the parcel sold?

No! The subdivider's deed describing the roadway strip as an exception with the further reference to the **use of the exception** for roadway purposes creates an *ambiguity*. The ambiguity establishes an uncertainty as to whether or not fee title was retained by the subdivider.

When an **ambiguity** exists as to whether the seller has reserved an easement or excepted a portion of the property from the sale, the seller is presumed to have conveyed all the property and created an easement by reservation. Thus, a roadway easement exists since title to a portion of the parcel was not retained as an exception in the conveyance. [**Coon** v. **Sonoma Magnesite Co.** (1920) 182 C 597]

Conduct creates an implied easement

An easement can be created by conduct without any prior agreement between the owner and the user, called an *implied easement*.

Implied easements exist when the circumstances surrounding an owner's *division of his property* and sale of a portion of the property imply the owner (grantor) and the buyer (grantee) intended either:

- the grant of an easement on the portion retained by the owner; or
- the reservation of an easement by the owner on the portion sold. [Calif. Civil Code §1104; **Palvutzian** v. **Terkanian** (1920) 47 CA 47]

For example, an owner conveys a parcel of real estate to a buyer which is served by a network of irrigation pipes extending from a well on an adjacent parcel retained by the owner.

The grant deed conveying the parcel sold does not mention any right to use the well water. No other water source is readily available to the parcel sold.

The buyer takes possession and commences to use the water to irrigate his use of the property. Later, the owner refuses to allow the buyer to continue using the well as his source of water.

Is the buyer as the new owner of the parcel entitled to the continued use of the well?

Yes! All the requirements establishing an **implied easement** to use the well for water are present:

- a prior *common ownership* of adjoining parcels;
- a *transfer of one* of the adjoining parcels;
- an obvious and apparent *prior use* of one parcel for the benefit of the other parcel during the period of common ownership — evidenced by the well and irrigation pipes running from the adjoining parcel to the parcel sold; and
- a *reasonable necessity* for creating the easement since there is a lack of available water. [**Greene** v. **Fickert** (1942) 49 CA2d 511]

The following sections review and apply these four elements of an implied easement.

Prior common ownership of parcels

A transfer of one of two or more adjoining parcels by a **common owner** is required to create an implied easement.

For example, an implied easement may arise when a **co-ownership** of a property is terminated and the property is divided and parcelled out to the individuals who were the co-owners.

Consider a network of irrigation ditches from a well which provides water throughout a property held by co-owners. The property is partitioned and distributed in kind to the individual co-owners without mention of the water rights.

In this instance, each co-owner's parcel is entitled to an implied easement for both the flow of water through the irrigation ditches from the parcel with the well, and the use of the well which is the source of the water since the co-ownership of the partitioned property was a common ownership. [**Anaheim Union Water Co.** v. **Ashcroft** (1908) 153 C 152]

Additionally, an implied easement may arise on the distribution of property under a will or trust.

For example, a beneficiary receives a parcel of real estate which is accessible only by a road over an adjoining parcel conveyed to another beneficiary under a will or inter vivos (living) trust which does not provide for an easement.

In this scenario, a right-of-way easement is created by implication since the common ownership of the adjoining parcels is the estate or trust. [**Cheda** v. **Bodkin** (1916) 173 C 7]

Division by transfer

An owner of property who uses a portion of his property for the benefit of another portion of the same property does not create an easement on his own property.

An easement is a right to **use another's land**, or **prevent another** from a particular use of his land. Thus, an owner cannot hold an easement over his own land. [CC §805]

Only the division of commonly owned parcels by the transfer of a parcel triggers the creation of an implied easement.

Beneficial use of commonly owned parcels

The prior use of one parcel for the benefit of an adjacent commonly owned parcel must be *obvious* and *permanent* for the new owner of one of the parcels to establish the right to an implied easement to use the other parcel.

To establish an implied easement, the **prior use** by the common owner must have been:

- either *known* to both the common owner (original grantor) and the buyer (grantee), or so obvious their knowledge can be presumed;
- *regularly used* during the common ownership before the transfer; and
- *intended* to be permanent.

The purpose for creating an implied easement is to establish the right to continue an existing use a buyer and seller intend to permanently maintain, but fail to mention.

Thus, an implied easement is not created when the common owner of adjacent parcels and the buyer of one parcel do not intend for an easement to exist on the adjoining parcels.

For example, a subdivider sells a parcel. The subdivider retains an adjacent parcel which has a heating plant with heat and water pipes running to the parcel sold.

At the time of the sale, the subdivider and the buyer enter into a service agreement providing for the buyer to receive the heat and water in exchange for payment of a service fee.

Later, the subdivider refuses to allow the buyer the continued use of the heat and water pipes on the subdivider's property.

The buyer seeks to establish an easement for the use of the pipes claiming an implied easement was created on the transfer of the parcel to the buyer by the subdivider.

Has an implied easement been created?

No! Although the criteria for an implied easement appears to be present, the written agreement charging a **fee for the use** of the pipes between the subdivider and buyer indicates the permanent benefits of an implied easement appurtenant to the property sold were not intended. [**Warfield** v. **Basich** (1958) 161 CA2d 493]

Reasonable necessity to use another's

Finally, for an implied easement to exist, the easement must be *reasonably necessary* for the beneficial use of the parcel whose owner is seeking to establish the easement.

Consider a owner who sells and conveys a parcel containing a driveway. The owner uses the driveway to access an adjoining parcel he owns which is improved by his residence. The owner does not reserve an easement for use of the driveway in the conveyance to the buyer. The owner's residence fronts on a pub-

lic road. However, the driveway through the buyer's parcel is the only improved access to the owner's residence.

On closing, the buyer refuses to allow the owner to use the driveway over the parcel sold to him.

The owner claims he is entitled to an implied easement over the parcel sold to the buyer since, prior to the sale, the driveway provided access to the adjoining property he retains.

The buyer claims the owner is not entitled to an implied easement since he can build a new driveway to the public road at a reasonable cost.

Is the owner entitled to an implied easement to use the buyer's driveway?

No! An implied easement (by reservation) is not reasonably necessary to the owner's beneficial use of the adjacent property he retained since the owner can build a new driveway to the public road at a reasonable cost. [**Leonard** v. **Haydon** (1980) 110 CA3d 263]

Thus, an implied easement is created for the benefit of property only if a **reasonably convenient alternative** is not available to the property and a reasonable necessity for the easement exists.

Implied grant vs. implied reservation

Although California codes only refer to implied grants of an easement, case law has established an *implied reservation* of an easement on property sold. [CC §1104]

For instance, a seller maintains irrigation ditches to control the flow of water on two adjoining parcels of real estate he owns and operates for agricultural purposes.

The seller conveys the parcel containing the water source to an investor and the adjoining parcel to a farmer. The deeds do not make mention of irrigation or water easements.

The investor eliminates the irrigation ditches on his property, blocking the farmer's only access to the source of his water.

The farmer claims he has an implied easement for the use of the irrigation ditches for the flow of water.

Is the farmer entitled to an implied easement over property conveyed to the investor under a deed which does not reference an irrigation or water easement?

Yes! An implied reservation is created as though the easement had been reserved by the seller in the grant deed to the investor. The seller's *pre-existing use* of the irrigation ditches on the property acquired by the investor is apparent, and the ditches were constructed to be *permanent* and are the only source of water to the parcel acquired by the farmer. [Palvutzian, *supra*]

Thus, the same criteria is used to establish an implied easement by either grant or reservation.

However, if a buyer does not have knowledge of the previous use of a parcel of real estate from the county records, or the existing use is not obvious on an inspection of the property, the buyer will be considered a *bona fide purchaser* (BFP) and will take title to the property without the easement.

Implied easement by reference to map

When a landowner records a subdivision map and offers to dedicate the roadways depicted on the map to a public use, a *public easement* is created on the **government's acceptance** of the right of ways legally described on the subdivision map. [Calif. Government Code §§66410 et seq.]

Similarly, when a recorded subdivision map lays out acreage into parcels and streets and sells the lots by reference to the subdivision map, the buyers of the lots have easements in the streets adjoining their lots. [**Danielson** v. **Sykes** (1910) 157 C 686]

However, consider an owner of contiguous parcels who sells one of the parcels. The grant deed to the buyer describes the parcel conveyed by reference to a parcel map. The parcel map depicts a roadway crossing the parcel conveyed. No reference is made on the map to a road, easement or exception to the parcel in favor of the owner.

After closing, the owner grades a lane on the roadway across the buyer's parcel for use as a private road. The buyer refuses to allow the owner to use the roadway.

The owner claims he has reserved an implied easement for the use of the roadway since the grant deed conveying the property references the parcel map which depicts the road.

The buyer claims an easement does not exist since the reference to the parcel map in the grant deed is not sufficient notice of the owner's intent to reserve an easement over the roadway.

Does the owner have an implied easement over the roadway?

No! An implied easement in favor of the owner does not exist. Referencing the parcel map in the grant deed as part of the legal description of the property conveyed does not put the buyer on notice of the owner's undisclosed intent to reserve an easement across the parcel at the location of a roadway depicted on the map. [**Mikels** v. **Rager** (1991) 232 CA3d 334]

Implied is appurtenant

Regardless of how an *implied easement* is created, it is always a **burden** on one parcel of land for the **benefit** of another parcel. Thus, an implied easement is always an *appurtenance* allowing the owner of the property benefitting from the easement to use the property of another which is burdened by the easement.

Most disputes over implied easements occur after the property benefitting from the easement has been deeded out to one or more new owners.

To be entitled to an implied easement, the new owner must establish the implied easement is a right of use in another property which existed when one of the parcels was deeded out to the new owner by the common owner of both parcels.

Easements by necessity

An *easement by necessity* is a variation of an implied easement. The demand for an **easement by necessity** arises when property is **landlocked**. Access to and from a public roadway across all adjacent properties is denied in land locked property for the lack of the ability to create an easement by agreement or prior conduct.

Since public policy favors the productive use of land, an easement by necessity will be created when property is landlocked. [**Reese** v. **Borghi** (1963) 216 CA2d 324]

However, to establish an easement by necessity, the user must:

- show *strict necessity*; and
- defend against any claim that the property was **intended to be landlocked**.

Strict necessity requires the easement to be the only possible means of access. [**Zunino** v. **Gabriel** (1960) 182 CA2d 613]

Additionally, an easement by necessity lasts only as long as the necessity exists. Thus, if a public road is built or an existing adjacent road is dedicated to the public, an easement by necessity is terminated since the need is terminated.

No *time limitations* exist for bringing a quiet title action to establish an easement by necessity since the easement legally exists as long as the necessity exists.

Even if an easement is strictly necessary to access property (i.e., landlocked), an easement will not be created contrary to the intent of the original grantor dividing and transferring the parcel.

For example, a subdivider sells one parcel and retains another parcel which is landlocked. The deed for the parcel sold does not make mention of an easement to provide access to the landlocked parcel. Also, physical roadways do not exist.

Later, a potential buyer inquires about purchasing the landlocked parcel. The subdivider advises the buyer an easement does not exist to provide access to the landlocked parcel he is buying.

The buyer closes the purchase transaction assuming he will be able to establish an easement for access at a later time. The neighboring property owners refuse to grant the buyer an easement.

Is the buyer entitled to an easement by necessity so he can access and make use of his property?

No! An easement by necessity across the neighboring parcels does not exist since the subdivider:

- did not intend for the property to be accessible; and
- advised the buyer that an easement does not exist which provides access to the property. [**Hewitt** v. **Meaney** (1986) 181 CA3d 361]

Consider an owner whose property is landlocked and surrounded by other property with no access to the highway.

Originally, the federal government held title to all the properties involved. The federal government previously granted the State of California the property now held by the owner.

The parcels surrounding the owner's property were bought from the federal government by the owner's neighbor. A dispute arises when the owner asserts an easement by necessity exists across the surrounding property.

The neighbor who owns the surrounding property claims an easement by necessity does not exist over his property since the state never exercised the power of eminent domain to establish an access route when it owned the property.

The owner claims an easement by necessity exists since the federal government, being the prior common owner, did not intend the property to be landlocked.

However, strict necessity no longer exists once the surrounding property owned by the federal government is conveyed to the neighbor. The state owning the land-locked parcel has the power of eminent domain and no necessity for an easement exists where eminent domain exists.

Thus, when the state conveyed the property to the owner, the easement by necessity requirements could not be met since the parcels were not owned by the same owner at the time of conveyance. [**Moores** v. **Walsh** (1995) 38 CA4th 1046]

To acquire the easement, the owner's purchase should have been contingent on the state condemning an easement and then conveying the property.

Prescription: easement by adverse use

Consider a property owner who has used a roadway on an adjoining property to access his vacation home for over five years. The owner has never received permission from the neighbor to use the roadway.

The neighbor sells his property to a buyer who informs the owner he can no longer use the roadway.

The owner claims his open and continuous use of the road to access his property for more than five years entitles him to a **right-of-way easement** over the adjoining property.

Is the owner entitled to a roadway easement over the adjoining property owned by the buyer?

Yes! A *prescriptive easement* is established by the **adverse use** of another's property for a period in excess of five years. [**Thomson** v. **Dypvik** (1985) 174 CA3d 329]

An easement created by **prescription** is similar to acquiring land by adverse possession. The difference is prescription establishes the right to **mere use** of another's property, whereas adverse possession is an actual taking of **exclusive possession** under a claim of ownership and the payment of **property taxes**.

To meet the legal requirements for acquiring an **easement by prescription**, the adverse use must be:

- *obvious* enough to give the owner of the property notice of the use;
- a *continuous* and uninterrupted pattern of use;
- a use *unauthorized* by the owner of the property;
- used under a *claim of right*; and
- used for a period of *five-or-more* years without the owner acting to terminate the adverse use.

The five-year requirement of uninterrupted use continues with the transfer of the benefitting property to new owner(s) as long as the new owner(s) continue the same unauthorized use of the burdened adjoining property established by the previous owner, called *tacking*.

Tacking refers to the use of another's property by successive owners of a property. The periods of use by each successive owner are tacked together to make up the continuous period of time required by the statute of limitations to establish an easement for the current owner. [**Jones** v. **Young** (1957) 147 CA2d 496]

Prescriptive easement, not adverse possession

A prescriptive easement cannot bar an owner of property burdened by the easement from all use of his land. To obtain the **exclusive use** and possession of real estate, a claim for adverse possession must be pursued which, unlike a prescriptive easement, requires the payment of liens and taxes on the property by the adverse possessor.

For example, a neighbor builds a woodshed knowing a portion of the shed encroaches on an adjacent owner's property.

Over five years later, the owner seeks to have the neighbor remove the encroaching woodshed and return possession of the property.

The neighbor claims he is entitled to an exclusive prescriptive easement to maintain the woodshed since it has been openly occupied in a hostile manner for over five years.

Here, the neighbor is not entitled to an exclusive prescriptive easement to maintain the woodshed. An **exclusive prescriptive easement** would completely prohibit the owner from any use of his property.

Further, the owner is not entitled to a mandatory injunction requiring the neighbor to remove the woodshed. Instead, the owner is entitled to **monetary relief** from the neighbor for the lost value of the portion of his property subject to the encroachment. [**Harrison** v. **Welch** (2004) 116 CA4th 1084]

Consider an owner of real estate who erects a new fence on the property line after discovering a 20-year old fence dividing the property was not located on the legally described boundary.

The owner's neighbor requests the old fence to be reconstructed at its original location, removed from the legally described boundary line. The neighbor claims he holds a prescriptive easement across the property between the point where the old fence used to be and the new fence.

In response, the owner seeks to quiet title to the disputed portion of his property, claiming a prescriptive easement with the right to maintain the old fence is equivalent to taking his title by adverse possession since he would be excluded from any use of or access to the disputed portion of his property blocked by the old fence.

In this instance, the neighbor is not entitled to a prescriptive easement which would return the fence to its original location. A prescriptive easement is barred since an **easement coupled with a fence** would create an *exclusive right to possession* of the owner's property by the neighbor which is the equivalent of a fee interest. [**Mehdizadeh** v. **Mincer** (1996) 46 CA4th 1296]

Additionally, consider a property owner who purchases land within a common-interest-development (CID). A contiguous parcel is owned by the CID for a roadway. The property owner constructs a fence around his house. More than five years later, a survey reveals the owner's fence encroaches upon the roadway.

The owner claims he has a prescriptive easement over the roadway parcel since his use of the parcel was open and continuous for more than the statutory five-year period. However, the owner's use of the roadway constitutes adverse possession, not an easement, since the fence completely bars the CID's use of the land. [**Kapner** v. **Meadowlark Ranch Association** (2004) 116 CA4th 1182]

Easement limited to use

Like all easements, a **prescriptive easement** is limited in its use to the *parameters of the use* which created the easement.

For example, a neighboring rancher acquires a prescriptive easement for a right of way over an owner's property — an easement benefitting the neighboring ranch.

The rancher only uses his easement for two months each year as the easiest means for accessing his ranch.

Later, the rancher subdivides his property into residential lots. The rancher claims his prescriptive easement allows him to construct a road on the easement for public access to the new development.

The owner claims the rancher cannot use the easement for daily residential purposes since his prescriptive use was occasional and agricultural.

Can the owner limit the frequency and purpose of the neighbor's use of the easement to the pre-subdivision usage?

Yes! The use of a prescriptive easement is **limited to the adverse use** which created the easement. [**Cushman** v. **Davis** (1978) 80 CA3d 731]

Bona fide purchasers

After a neighbor continuously uses an owner's property for over five years without the owner's permission, an easement is established — even if the neighbor later ceases to use the easement.

However, whether an unrecorded easement by prescription will be enforced against a bona fide purchaser (BFP) who becomes the new owner of the burdened property is open to different interpretations.

On one hand, the courts have applied *public policy* to allow the BFP to take title free and clear of unknown, unobserveable and unrecorded easements. [**Mesmer** v. **Uharriet** (1916) 174 C 110]

Conversely, courts have also allowed the user to enforce the easement against a new owner who is a BFP since prescriptive easements are *created by use* and are not controlled by recording requirements. [**Jones** v. **Harmon** (1959) 175 CA2d 869]

A buyer is not considered a BFP if **physical conditions** on the property are present, such as a road or visible pipeline extending to the neighbor's property, since the improvements constitute *constructive notice* of the use. [**Rubio Cañon Land & Water Ass'n** v. **Everett** (1908) 154 C 29]

Chapter 22 Interference and termination of easements

This chapter reviews the ways in which an easement may be eliminated by an owner of property burdened by the easement.

Burdens and benefits exceeded

An owner of property benefitting from an easement allowing him to use a neighbor's property can enjoin any activity which interferes with his proper use of the easement. [Calif. Civil Code §809]

However, the *interfering activity* occurring within the parameters of the easement must actually interfere **with the intended use** granted by the easement.

For example, a neighbor who owns adjacent real estate has the right to use an easement across an owner's property for ingress and egress to the neighbor's property from a public road.

The owner places improvements in the form of water tanks and grapevines on his property within the legal description of the easement, but not on the actual roadway used for ingress and egress. The improvements do not interfere with the neighbor's ability to access his property by use of the easement.

The neighbor claims the easement granted him the exclusive use of the entire area within the description of the easement and demands the removal of the tanks and grapevines.

In this situation, the improvements do not unreasonably interfere with the neighbor's ability to use the easement since the neighbor is able to continue using the existing roadway within the easement to access his property. Thus, the owner can continue to maintain water tanks and grow grapevines in the easement area, but not on the portion of the easement used by the neighbor for ingress and egress. [**Scruby** v. **Vintage Grapevine, Inc.** (1995) 37 CA4th 697]

Consider an easement across an owner's property which provides a neighbor with access to his property by a roadway within the easement. The neighbor entitled to use the easement constantly harasses the owner and his guests when they park cars within the legally described boundaries of the easement. The parked cars do not interfere with the neighbor's use of the roadway located within the easement.

The owner is unable to sell his property since the easement holder (neighbor) intimidates potential buyers.

The owner seeks to **extinguish the easement** and clear his title of this encumbrance, claiming he is unable to use the portion of his property which is subject to the easement because of the unreasonable conduct of the neighbor.

The neighbor claims his easement cannot be extinguished since his use of the easement does not permanently interfere with or exclude the owner from the easement or additionally burden the owner's property.

In this example, the easement cannot be extinguished. The harassment of the property owner by the neighbor is not a use of the easement. Thus, the **neighbor's harassment** does not increase the burden of the *intended use* of the easement for ingress or egress. [**Reichardt** v. **Hoffman** (1997) 52 CA4th 754]

Termination of easements

An existing easement can be *extinguished*, and thus no longer affect the burdened property as an encumbrance on its title. Methods used to **extinguish** an easement include:

- *release* of the easement by a deed from the owner of the property holding the appurtenant right;
- *merger* by the acquisition of fee title to both the benefitting and burdened properties by the same owner;
- *destruction* of the burdened property which permanently prevents any further use of the easement;
- *forfeiture* due to the easement holder's abuse of his easement rights;
- *prescription* due to the burdened property owner's continuing interference with the easement; and
- *abandonment* by the conduct of the easement holder showing he does not intend to use his easement rights.

Release by deed to burdened property

An owner of property benefitting from the use of an easement may voluntarily terminate the easement by **releasing the easement** to the owner of the property burdened by the easement.

The release can be accomplished by the use of a quitclaim or grant deed in favor of the owner of the property burdened by the easement and signed by the owner of the property with the appurtenant right to use the easement.

Merger as an extinguisher

A **merger of legal interests** by common ownership of both the servient and dominant properties extinguishes an easement. A merger occurs when the same owner acquires fee title to both the benefitting and burdened properties.

Due to the fact that an owner cannot have an easement over his own property, the easement is automatically extinguished on the **common ownership** of both the properties. [CC §805]

However, no merger occurs when the sole owner of burdened property acquires title to the benefitting property as a co-owner since the owner is not the sole owner of both properties. [**Cheda** v. **Bodkin** (1916) 173 C 7]

Additionally, acquiring a lien which encumbers either the benefitting or burdened property by the owner of the other property is not a merger of interests.

Extinguished by destruction of property

An easement is terminated by the **destruction** of the burdened property since nonexistence of the burdened property renders the use of the easement impossible.

Consider an easement to use a stairway in an adjoining building. When the building burns down, the easement is extinguished since the owner is not required to rebuild the stairway. [**Cohen** v. **Adolph Kutner Co.** (1918) 177 C 592]

Forfeiture for exceeding authority

An easement is terminated by **forfeiture** when the easement holder exceeds his authorized use of the easement by placing an *excessive burden* on the property encumbered by the easement.

Consider a subdivider who owns land which entitles him to use a right-of-way easement over a neighbor's property.

Later, the subdivider divides his property into several residential lots. For access, he constructs a road on the neighbor's property within the legally described easement to a public road which opens the easement to use by purchasers of his lots and the public.

The neighbor claims the easement has been extinguished since the increased use of the easement by the buyers of the residential lots and the public creates an excessive burden on the property.

Is the right-of-way easement terminated by the increased use?

Yes! The increased use of the easement constitutes an excessive burden on the property it encumbers, and thus the easement is *extinguished by forfeiture*. [**Crimmins** v. **Gould** (1957) 149 CA2d 383]

The standards for forfeiture are vague and often left to the discretion of the courts to determine, on a case-by-case basis, whether the easement holder's actions create an undue hardship on the owner of the property burdened by the easement.

Prescription creates and destroys

Just as an easement can be established by adverse use of another's property, an **easement** can be *extinguished* by the burdened property owner's use of the area within the easement which *permanently interferes* with his neighbor's ability to use the easement.

For example, a subdivider sells a parcel, granting the buyer a right-of-way easement for ingress and egress over an adjoining parcel he owns in the subdivision. Later, the subdivider constructs a concrete block wall on the adjoining parcel which blocks the buyer's use of the easement.

More than five years after the block wall was constructed, the buyer of the parcel benefitting from the easement seeks to quiet title to the right of way.

Is the easement terminated by the subdivider's unauthorized improvement which entirely blocked the use of the easement for more than five years?

Yes! The obstruction of the easement is an adverse use by the subdivider of the property burdened by the easement. Thus, the easement is extinguished since the subdivider interfered with the use of the easement for a period of five years. [**Glatts** v. **Henson** (1948) 31 C2d 368]

An adverse use for purposes of terminating an easement is any act by the burdened property owner which **permanently obstructs** the beneficial use enjoyed by the holder of the easement.

Abandonment as never to use again

An easement can also be terminated through **abandonment** by the easement holder. However, the easement holder must clearly indicate his intent to **permanently abandon** the easement.

Consider a subdivider who grants a buyer of a parcel a right-of-way easement over an adjoining parcel owned by the subdivider. The buyer plants trees on his property blocking his access to his own easement over the adjoining parcel.

The subdivider later builds a fence between the parcels which further bars the buyer's access to the easement. The buyer makes a timely demand on the subdivider to remove the fence. The subdivider claims the easement has been extinguished by the buyer's abandonment of the easement, evidenced by the trees blocking access to the easement.

Has the buyer abandoned his easement by planting trees blocking his access to the right of way?

No! Mere **nonuse of an easement** is not sufficient conduct to demonstrate an easement holder's *intent to terminate* an easement by abandonment. The buyer's planting of trees which block access to the easement does not indicate he has decided to never use the easement in the future. [**Tract Development Service, Inc.** v. **Kepler** (1988) 199 CA3d 1374]

The termination of an easement by abandonment is not easily established. The easement holder's actions must demonstrate a **clear intent** to abandon all future use of the easement.

Chapter 23 Covenants, conditions and restrictions

This chapter discusses enforceable CC&R provisions, and reservations and restrictions in grant deeds.

Right-to-use limitations

The trees on a neighbor's lot have grown so tall that they obstruct a homeowner's ocean view from another lot in the subdivision. The homeowner, concerned about the loss of his view, checks the title restrictions recorded on the neighbor's lot for any height restrictions.

From the title restrictions, the homeowner determines:

- both his lot and the neighbor's lot are part of the **same subdivision**; and
- the original subdivision documents contain a restrictive provision limiting the **height of structures** located within the subdivision.

The homeowner requests his neighbor comply with the title restrictions by trimming his trees to conform to the height restriction on structures within the subdivision. The homeowner feels a reasonable interpretation of the subdivision height-of-structures restriction also extends to improvements in the form of trees.

The neighbor refuses to trim the trees, claiming the wording of the restrictive provision applies only to structural improvements and not to the trees growing on his lot.

Can the owner force the neighbor to trim his trees under the title restriction?

Yes! The neighbor must maintain his trees at a height equal to the height limitations imposed on all structures in the subdivision. One purpose of the structural height restriction is to protect the views of all owners in the subdivision. Title restrictions are enforced according to their intent. [**Ezer** v. **Fuchsloch** (1979) 99 CA3d 849]

The subdivision provision protecting the view of lot owners is classified as a *restrictive covenant.*

Recording restrictive covenants

When developers subdivide land or airspace, they cut a plot of land into two or more horizontal or vertical sections, called *lots*, *parcels* or *units*. Having created a subdivision, developers place **restrictive covenants** on how the **lots** may be used by later owners, called *successors*.

Use restrictions are usually contained in a document called a *Declaration of Covenants, Conditions and Restrictions* (CC&Rs). **CC&Rs** are typically recorded with the original subdivision map.

Recorded documents in the chain of title to a parcel of real estate place a buyer on *constructive notice* of their contents. A prospective buyer of a home in a subdivision protects himself from unknowingly buying property burdened with unwanted restrictions by reviewing and approving (or disapproving) the preliminary title report (prelim). A prelim discloses the results of the title company's search of the property's title history.

The title company conducts the document search and prepares the prelim which functions as an offer to issue a title policy. As a customer service, they will supply copies of any CC&Rs of record on request.

Consider CC&Rs which are recorded on a subdivision during the subdivider's ownership of the property, before any of the newly created lots are sold. The grant deeds initially conveying lots to buyers and the later grant deeds transferring title of lots in the subdivision do not reference the recorded CC&Rs.

An owner who buys one of the lots violates the CC&Rs. The owner's neighbors in the subdivision seek to enforce the CC&Rs against the owner.

The owner claims the CC&Rs are unenforceable since they were not referenced in any grant deeds which transferred title to the property.

In this example, the CC&Rs are enforceable. The CC&Rs were recorded on the subdivision before any of the lots were sold. Thus, all purchasers of the lots are on **constructive notice** of the CC&Rs and must abide by them. [**Citizens for Covenant Compliance** v. **Anderson** (1995) 12 C4th 345]

A recording of the CC&Rs on the subdivision prior to any conveyance of any parcel fulfills the intent of the subdivider, and the expectations of future buyers, regarding the use of the parcels, lots and units within the subdivision.

Covenants limiting use are affirmative

A recorded restriction can **limit the use** of a property to a specific purpose (e.g., a school, railroad, highway, dwelling, irrigation system, etc.). This type of restriction is classified as an *affirmative covenant*.

Another type of recorded restriction prohibits identified uses of the property, classified as a *negative covenant*. For instance, a typical **negative covenant** prohibits the sale of alcoholic beverages or other activities otherwise allowed to take place on the property.

For example, a neighbor in a subdivision seeks to restrain another owner in the subdivision from violating a restrictive covenant, similar to the previous example of a neighbor's trees exceeding the height restriction on improvements.

Can an owner of one lot enforce a restrictive covenant against an owner of another lot when the only relationship existing between them is ownership of a parcel, lot or unit within the same subdivision?

Yes! The right to enforce recorded subdivision restrictions transfers to the owners of each lot as part of the title to the property.

Further, the covenants, conditions and restrictions (CC&Rs) may provide for the property to revert to the original seller if the property is used in violation of a restriction. [**Romero** v. **Department of Public Works** (1941) 17 C2d 189]

CC&Rs and future owners

Recorded covenants, conditions and restrictions (CC&Rs) bind future owners of the subdivided lots, a scheme referred to as covenants *running with the land*. For a covenant to **run with the land** and affect future owners, the restriction must **directly benefit** the property. Thus, all lots within the subdivision are burdened by the restriction. [Calif. Civil Code §1462]

Consider a restriction limiting the use of all subdivision lots to single family residences. The use restriction equally *benefits* and *burdens* each lot in the subdivision, assuring consistent and compatible use throughout the subdivision — a **benefit** with an advantageous effect on each property. Since it benefits every lot, the restriction **runs with the title** to each lot and affects all future owners. [**Miles** v. **Hollingsworth** (1919) 44 CA 539]

However, consider a subdivider who sells a beachfront lot while retaining ownership of the surrounding lots in the subdivision. The grant deed conveying the beachfront lot to the buyer contains a use restriction, stating the buyer can only conduct a hotel or yachting clubhouse business on the lot.

The buyer, unable to develop the property for the purposes set out in the use restriction, sells the lot to a developer who plans to use the property for a ferry landing service, not a hotel or clubhouse. The subdivider seeks to prohibit the developer from conducting a business which violates the restrictive use covenant in the recorded grant deed to the original buyer.

Can the subdivider enforce the covenant entered into by the original buyer and stop the developer from using the lot for a ferry service?

No! The use restriction provides **no benefit** to the beachfront lot since it merely imposes a burden on the original buyer who agreed to limit his use of the property. Also, enforcement of the restriction is further limited due to its lack of wording binding the buyer's **successors in interest** to the restrictive covenant.

The restriction is only enforceable as long as the buyer holds title. Thus, it is classified as a *personal covenant*. Since the restriction against use is a personal promise, it does not run with the land and cannot be imposed on the developer who reacquired title.

However, the subdivider is entitled to enjoin the developer if the developer's use of the property would *materially injure* the subdivider's remaining lots in the subdivision, such as depreciating their value. In this instance, the developer's intended use of the property as a ferry service would in no way **injure** the subdivider's remaining property, thus depriving the subdivider of entitlement to relief. [**Los Angeles Terminal Land Co.** v. **Muir** (1902) 136 C 36]

A restriction which does not run with the land and affect future owners is considered the grant of a **personal benefit** to the original owner or seller of the benefitted property, usually the seller who owns adjacent property. The owner of the property agreeing to the restriction on its use does not benefit from the restriction. It is a **personal burden** on the owner of the restricted property, not the property itself. A personal restrictive covenant is enforceable only against the persons agreeing to it, not future owners of the property, called *remote grantees*.

Editor's note — Prior to 1968, for a covenant to run with the land, a common owner of two or more parcels had to reference the use restrictions in the grant deeds conveying title to the buyers. The relationship between the parcels descending from a common owner is called "privity of estate."

*Restrictive covenants between owners whose property did not descend from a common owner could not run with the land until 1968. However, those restrictions were enforced against future owners as **negative easements**. [CC §1468]*

*Similar to a restrictive covenant, a **negative easement** permits a person, usually the original owner or seller of a parcel, to limit a new owner's use of that parcel. Although it was unenforceable as a restrictive covenant, a negative easement was enforceable — the new owner being subject to the same burden as the prior owner of the property. [**Bryan** v. **Grosse** (1909) 155 C 132]*

Unenforceable or unreasonable CC&Rs

A subdivider sells "exclusive" residential lots with a deed restriction prohibiting the sale of lots to persons of a certain race or religion. Later, a member of the excluded race purchases and occupies a lot within the subdivision.

A neighbor attempts to invalidate the sale. The neighbor claims his rights under the subdivision plan have been violated since he purchased the lot subject to the restriction granting him the right not to live next to a person of the excluded race.

Can the neighbor enforce the race restriction?

No! Race restrictions violate federal civil rights laws and are unenforceable. Restrictions may not be imposed for unlawful purposes. [**Shelley** v. **Kraemer** (1948) 334 US 1]

Editor's note — California prohibits any restriction on the basis of race, national or ethnic origin, ancestry, sex, marital status, sexual orientation, religion or disability in a conveyance of any interest in real estate. [CC §§53, 782]

Additionally, restrictions on selling, leasing or encumbrancing real estate may not unreasonably restrict the marketability of the property, even if the restriction is contained in a trust deed or lease agreement. [CC §711]

However, due-on-sale clauses contained in a trust deed are no longer controlled by California law and, under federal mortgage law, are enforceable on the transfer of any interest in the real estate, except:

- short-term leases up to three years not coupled with a purchase option; and
- intra-family transfers of one-to-four unit, owner-occupied residential property on the death of an owner or for equity financing. [12 Code of Federal Regulations §591.5(b)]

Additionally, the assignment of a nonresidential lease may be restricted by a clause in the lease allowing the landlord to terminate the lease upon mere notice of the tenant's intent to assign the lease as provided under a separate **consent to assignment** clause. [**Carma Developers (California), Inc.** v. **Marathon Development California, Inc.** (1992) 2 C4th 342]

Covenants, conditions and restrictions (CC&Rs) on the installation or use of a solar energy system are unenforceable if the restrictions significantly increase the cost of the system or decrease its efficiency by:

- resulting in more than a 20% increase in the installation cost of the system; or
- decreasing the operating efficiency of the solar system by more than 20%. [CC §714]

Covenants restricting transferability

Government agencies are given a broader standard of reasonableness for enforcing restrictions on resales, if implemented to promote a public policy.

For example, an owner of coastal real estate obtains a coastal development permit by recombining 77 lots into two parcels and recording restrictions which prohibit the later division of the two recombined parcels.

To protect the public interest in costal areas, a deed is recorded giving notice that a resale of an individual lot within the two recombined parcels will subject the owner to penalties under the Coastal Act, a

restraint on alienation. No official map is recorded which reverts the lots into acreage consisting of two parcels.

An investor purchases 54 of the deed-restricted lots and sells them individually to buyers in defiance of the resale restriction.

In this example, the investor is required to pay the maximum in fines allowed under the Coastal Act since the sale of individual lots is a violation of the deed restrictions imposed by the coastal development permit. Also, the investor is ordered to rescind the sale of the individual deed-restricted lots to the buyers to protect the public from further violations of the Costal Act. [**Ojavan Investors, Inc.** v. **California Coastal Commission** (1997) 54 CA4th 373]

Amending CC&Rs

When circumstances affecting the use of lots in a subdivision have changed and the covenants, conditions and restrictions (CC&Rs) need to be altered, a provision for adding or removing covenants, called an *amendment clause*, usually exists in the originally recorded CC&Rs which establishes a procedure for making the change.

For example, a condominium association's CC&Rs usually can be amended by a majority or other percentage vote of the association members as set forth in the amendment clause in the association's CC&Rs. [**Diamond Bar Development Corporation** v. **Superior Court of County of Los Angeles** (1976) 60 CA3d 330]

Unlawful restrictive covenants in the CC&Rs for common interest developments (CIDs) can be removed from title under a program available through the California Department of Fair Employment and Housing (DFEH).

The DFEH's **Restrictive Covenant Identification Service** (RCIS) reviews deeds, declarations and CC&Rs sent to them by associations for CIDs to determine if they contain unlawful restrictive covenants, such as those based on race, color, religion, sex, familial or martial status, sexual orientation, disability, national origin or ancestry.

Upon receiving an application and the document containing the restrictive covenant in question, the DFEH reviews the language in the document. The DFEH then issues a written determination as to whether the identified language violates fair housing laws.

If the DFEH determines the language constitutes an unlawful restrictive covenant, the property owner may strike out the unenforceable language by recording a modification of the CC&Rs with the county recorder.

However, the RCIS procedure is not available to owners of individual units in a CID since the CID association must act on its own. The board of directors of a CID association is required to delete any unlawful restrictive covenants from its CC&Rs and governing documents without the need to first obtain either the approval of their owners or the DFEH. [CC §1352.5]

Changed circumstances avoid CC&Rs

A seller of property restricts its future use to residential purposes when it is conveyed to a buyer. Five years later, the road in front of the property is enlarged to a four lane thoroughfare and the property is rezoned for commercial use.

The buyer wants to develop the property for commercial use compatible with the surrounding area.

Can the buyer develop the property for commercial use regardless of the covenants, conditions and restrictions (CC&Rs) limiting the property to residential use?

Yes! Due to *changed conditions* in the area surrounding the restricted property, the restrictive covenant is no longer enforceable. If conditions in the area near the property have changed so drastically that a covenant can no longer serve its *intended purpose*, it is unenforceable under the doctrine of **changed conditions**. [**Key** v. **McCabe** (1960) 54 C2d 736]

Consider an owner of a parcel subdivided into lots which are sold subject to CC&Rs restricting the use of each lot to one single family dwelling. Also, structures are required to be set back a minimum distance from the adjoining lots. However, a number of lots in the subdivision have been improved with more than one residential unit in compliance with local zoning and use ordinances but in violation of the set-back requirement of the CC&Rs.

The owner obtains a building permit and begins construction of a rental unit on his lot, in violation of the CC&Rs.

A neighbor in the subdivision seeks to halt construction, claiming the second dwelling unit on the property violates the one-house and set-back restriction in the subdivision's CC&Rs.

The owner claims the CC&Rs are unenforceable since a number of lots in the subdivision already violate the one-house and set-back restriction, and thus the conduct of the neighbors indicate an abandonment of the CC&R restrictions.

Can the neighbor stop the owner from constructing the second unit in violation of the CC&Rs?

No! Lack of uniform observance and enforcement against prior violations of the CC&Rs by other owners in the subdivision render the CC&Rs unenforceable. [**Bryant** v. **Whitney** (1918) 178 C 640]

Environmental restrictions for personal benefit

A recorded covenant limiting the use and maintenance of hazardous materials is entered into by the owners of a property for the benefit of neighboring property owners, but not for the benefit of the property encumbered by the covenant. The covenant will **run with the land** and be enforceable against the present and future owners of the property by the other property owner's named as beneficiaries in the covenant, provided:

- the property burdened by the covenant is described in the document containing the covenant;
- the covenant is necessary to protect human health and safety due to hazardous materials; and
- the documents containing the covenant are recorded with the county recorder and entitled "Environmental Restriction." [CC §1471]

Chapter 24 Private road maintenance costs

This chapter reviews an owner's obligation to share in the maintenance and repair of private roads.

Repairs: who pays and how much?

Several homeowners share a private road located on an easement for ingress and egress to their residences. The private road is in need of repair.

Who is responsible for the cost to repair and maintain the private road?

All the easement owners share the responsibility to repair and maintain the road. [Calif. Civil Code §845(b)]

However, the following issues arise when considering the repair and maintenance of a private road used by others:

- who has the responsibility of maintenance;
- allocation of costs, by agreement or arbitration;
- secondary easements for maintenance on adjoining properties; and
- responsibilities of the owner of property burdened by a road easement.

Maintenance responsibility

A large development, such as a condominium project or other common interest development (CID), includes maintenance provisions in their covenants, conditions and restrictions (CC&Rs) to authorize centralized management to perform necessary repairs and maintenance of commonly used roads and driveways and assess the co-owners for their share of the costs.

Owners of property having appurtenant easements and persons holding easements in gross are allowed to use another's property. Consequently, they have the **duty to maintain** the easement they hold on that property. An owner of property with a private right-of-way easement across an adjacent property is responsible for maintenance of the right of way, not the owner of the adjacent property burdened by the easement. [CC §845(a)]

Owners of separate parcels who are entitled to use the same appurtenant easement may enter into an easement maintenance agreement. No standard maintenance agreement form exists.

If any owner fails to contribute under the maintenance agreement, the other owners must make a written demand on the easement user who defaults before taking legal action for reimbursement. [CC §845(b)]

When a written maintenance agreement does not exist between the holders of the easement and the owner of the burdened land, **maintenance costs are shared** in proportion to each users' use of the easement. [CC §845(c)]

Any one of the easement owners may apply for a court arbitrator to apportion the maintenance costs if the easement holders cannot reach an agreement. [CC §845(c)]

The maintenance and repair of an easement which is appurtenant to parcels owned by different owners includes the cost of **snow removal**, if snow removal:

- is not excluded from the maintenance and repair agreement;
- is necessary to provide access to the properties by way of the easement; and
- is approved by a vote of the property owners as called for in their maintenance agreement. [CC §845]

Sharing maintenance and repair costs

The maintenance and repair of a road requires keeping it useable and in its historic condition. This is different from improving a road, which entails upgrading it from its historic condition.

Although all owners of property who use an easement must share in the costs of maintaining the easement, no owner who **further improves** the easement can force nonconsenting owners to contribute to the costs of the further improvements. [**Holland** v. **Braun** (1956) 139 CA2d 626]

Determining the mathematical formula to set each neighbor's percentage of their beneficial use of an easement is difficult. Each neighbor travels a different distance on the road depending on where along the easement his property is located.

Additionally, some will travel the road more frequently than others. Some may ride motorcycles or drive compact cars which create less wear and tear on the road than large trucks, SUVs or vans.

Some owners of parcels entitled to use the appurtenant easement may not even use it. However, the existence and condition of the easement are factors that affect the value of the parcel.

Due to the variable circumstances surrounding each users' actual use of an easement, an approximation of each easement holder's percentage of use is the best mathematical allocation method available.

For instance, two brothers buy separate portions of their parents' farm. One brother's property is granted an easement across the other brother's property for use as a private road leading to the public highway.

For many years the brothers peacefully share the use of the right of way. Eventually, the brothers come to a disagreement about who should maintain the right of way and how to split the maintenance costs.

Nothing in the easement grant specifies how the repair and maintenance expenses should be divided.

The brother using the road to access his farm at the rear travels a greater distance from the public highway than the other brother. Thus, he should pay a larger percentage of the costs.

An exact distribution of costs and labor is impossible to achieve among users of a private right of way. The approximation reached is 60% for the brother located off the highway and 40% for the brother on the highway. The allocation of costs is determined by the distance each brother travels on the road as a percentage of the total distance traveled by all uses. [CC §845(c)]

Allocation by arbitration

If co-owners of an easement cannot agree on the allocation of costs for repair and maintenance of a private road, an arbitrator will be appointed by the courts. The repairs can be performed before or after the arbitrator is requested. [CC §845(c)]

An arbitrator's decision can be contested by any of the co-owners of an easement. However, the court then enters the arbitrator's award as a money judgment. If the award is contested by any of the co-owners, the court can enter a judgment which sets the liability of each owner in an amount proportionate to their use of the easement. The money judgment may be enforced by any co-owner against a defaulting co-owner. [CC §845(c)]

A court-appointed arbitrator can divide maintenance and repair costs equally, by the **distance** between an owner's driveway and the public road, or by **frequency** of use. [**Healy** v. **Onstott** (1987) 192 CA3d 612]

In calculating the apportionment of maintenance costs, an arbitrator should take into account which residences are and which residences are not occupied year-round. [Healy, *supra*]

Co-owners of a right-of-way easement may not be compelled to help pay for the cost of improving a road beyond its historical condition without their consent.

For example, a dirt road covered by an easement has fallen into disrepair. Some of the easement owners widen the road, grade it, install culverts and cut trees along its borders. They then demand contributions from other owners who did not consent to the improvement. The other owners refuse to contribute more than the cost of repair and maintenance of the existing dirt road, claiming the easement was upgraded from its historic condition.

The improvements did not merely repair the old road, but built it up to the extent that it was a new and different road located at the site of the historic road. The nonconsenting neighbors are not responsible for the **costs of upgrading** the road improvements. [Holland, *supra*]

Secondary easements for maintenance

In order to keep an easement in repair, a user of the easement or his contractors may need to enter a neighbor's property to maintain the easement. *Secondary easements* on the property abutting the easement allow an easement user to enter a property for maintenance purposes so the easement may be used.

For example, an easement user places posts and reflectors along the edge of a narrow steep right of way to prevent cars from going over the embankment.

The owner of the property subject to the easement removes the posts. The property owner finds them inconvenient even though they do not interfere with his use or enjoyment of his property or road.

However, an easement gives users of the easement the right to do what is necessary to maintain the safe use of the easement.

Due to the fact that the road abuts a steep embankment, the posts and reflectors are reasonably necessary and not a needless burden on the property owner. Thus, the property owner has to replace the posts created on his property by the user of the easement. [**Herzog** v. **Grosso** (1953) 41 C2d 219]

Consider a group of landowners who grant an easement over a road to the county for use as a public highway. Without permission from the landowner, county officials bore a well on the highway to obtain subterranean water for watering the landscaping.

Although the well does not interfere with road usage, it is not necessary to maintain the road by watering the landscaping.

The easement is for a right of way only. The county does not have the right to drill wells on the landowners' property since watering the landscaping is not necessary in keeping the road easement in repair. [**Wright** v. **Austin** (1904) 143 C 236]

Taking title subject to an easement

An *easement in gross* is a personal right to use another's property, such as a hunting easement. It is held by an individual and is not a right appurtenant to the title to any property he may own. The easement in gross, being a personal right only, will not remain with any property the holder of the easement may own and will not run with that property when the owner sells it.

An *appurtenant easement* is a right to use another's property which *runs with the land*, not the owner. Even though an appurtenant easement is located on neighboring property, it is transferred with the sale of the property it benefits since an appurtenant easement remains with the property. [CC §1104]

A right-of-way easement is transferred along with the conveyance of the property it benefits unless it is excepted under the terms of the conveyance. [**Lemos** v. **Farmin** (1932) 128 CA 195]

Lenders sometimes have special requirements when lending funds on property which holds a right-of-way easement for ingress and egress.

Loan appraisers and underwriters want a written maintenance agreement for the easement. In the absence of a written agreement, the buyer may be asked by the appraisers or underwriters to acknowledge he is aware of no written agreement.

If the right of way is to be repaired as a condition to closing a sale on a parcel benefiting from the easement, payment of the repairs needs to be worked out between the seller and the other users of the easement.

Lenders often require private rights of way be useable in all types of weather. Also, many lenders want the right of way to be consistent with other roads in the area. If the easement road is dirt and most of the roads in the area are paved, the lender may consider the property less valuable than a comparable property with a paved road.

Chapter 25 A deed as a transfer

This chapter covers the creation, delivery and voidablility of a deed.

Elements of a valid conveyance

An owner signs a grant deed and acknowledges his signature as a *grantor* before a notary public. The notary public notarizes the deed so it will be accepted for recording by the county.

The deed conveys the owner's real estate holdings to one of his children, identified in the grant deed as the *grantee*. The real estate described in the deed includes the owner's personal residence and income-producing properties. The deed is **absolute** on its face, since it does not contain *conditions* or *reservations* to the grant.

The deed is then **handed** to the **grantee**, one of the owner's children. At the owner's oral request, the grantee agrees to hold the deed unrecorded until the owner's death, at which time the deed may be recorded.

The owner and the grantee both occupy the personal residence and the owner continues to collect rents, pay taxes and manage his income-producing properties.

Later, the owner advises his other child that the grantee is only entitled to the rents from the income properties after his death and only for as long as the grantee's need for the income exists.

The owner dies and the deed conveying the real estate is recorded by the grantee.

The grantee sells one of the income-producing properties. The owner's other child seeks to recover the proceeds from the sale of the property on behalf of the owner's estate, claiming the sales proceeds are part of the estate since the owner's oral statements limited the grantee's ownership interest to the rents only. The other child and the grantee share equally in the deceased owner's estate under the will.

The grantee claims he became the fee owner of the property when the owner handed him the deed, which constituted *delivery*.

Did the grantee become the owner of the property on delivery of the deed conditioned on his oral promise not to record it?

Yes! When the owner hands the deed to the sole named grantee, **delivery** occurs and absolute ownership of the property **immediately passes** to the grantee. The deed contained no written reservation of a life estate on the owner nor placed any condition on the grantee's ownership of the fee interest conveyed.

The **oral conditions** placed on the recording of the grant deed are not enforceable since delivery of a deed to the grantee cannot be subjected to an oral condition. Only written conditions expressed in the deed itself are enforceable when the deed is handed to the grantee. Thus, oral conditions cannot alter, add or subtract from the contents of the deed. [**Blackledge** v. **McIntosh** (1927) 85 CA 475]

Further, an owner delivering a grant deed to the grantee named in the deed cannot orally reserve for himself a life estate in the property unless the condition is written in the deed as a *reservation* to limit

the interest conveyed. Also, the owner's continued possession and management of the property is insufficient to show an intent to reserve a life estate. [**Lewis** v. **Brown** (1913) 22 CA 38]

If an owner does not intend for his deed to take effect immediately, he must state so in writing in the deed he hands to the grantee, keep the deed to himself or deposit it with a third party, such as an escrow, along with instructions when to use it.

A deed by any name is a grant

Real estate is *conveyed* when title is transferred from one individual to another. [Calif. Civil Code §1039]

The transfer of title to real estate contained in a writing is called a *grant* or *conveyance*, no matter the form of writing. [CC §1053]

A *deed* is itself the **grant** which transfers title to property. [**Hamilton** v. **Hubbard** (1901) 134 C 603]

Title by deed passes either:

- *voluntarily* by agreement with the owner, as in a sale in the open market, or under a power of sale provision in a trust deed or the covenants, conditions and restrictions (CC&Rs) of a common interest development (CID); or
- *involuntarily* without agreement, as in the enforcement of a creditor's judgment or tax lien.

No matter the form of writing, the individual conveying real estate is called the *grantor*, and the individual acquiring title is called the *grantee*.

Fee simple ownership is presumed to pass by a grant of real estate, unless a lesser possessory interest is stated, such as an easement, life estate or leasehold interest, or a quitclaim deed is used. [CC §1105]

Ownership of *possessory interests* in real estate include:

- a fee simple;
- a life estate;
- a leasehold estate; and
- an estate at will. [See Chapter 7]

A **fee simple** interest in real estate is the absolute ownership of the possessory rights in the real estate for an indefinite duration.

Consider an owner who executes a grant deed which states the grantee is to hold ownership of the property until the grantee's death. On his death, the property is to revert back to the owner or the owner's heirs or successors.

Does the grantee receive a fee simple estate since a grant deed was used as the form of writing?

No! The grantee was conveyed only a *life estate* in the property since he was not given absolute ownership of the real estate for an indefinite period. Instead, the deed restricted the grantee's ownership to the right of possession for the duration of the grantee's lifetime only. [**Whitcomb** v. **Worthing** (1916) 30 CA 629]

Creating a valid deed for conveyancing

To be *valid*, a deed must:

- be in writing;
- identify the grantor and the grantee;
- contain a granting clause stating the grantor's intention to convey;
- adequately describe the real estate involved;
- be signed by the grantor; and
- be handed to and accepted by the grantee.

Form deeds used in real estate transactions conform to these validity requirements by containing words of conveyance, and contain provisions for the identification of the parties and a description of the real estate. They are also of suitable size and format to permit the deed to be notarized and recorded. [See **first tuesday** Forms 404 and 405]

A deed in writing, with exceptions

To be **valid**, the *transfer* of an ownership interest in real estate must be in writing, except for:

- an estate at will or a lease not exceeding one year [CC §1091];
- an *executed* (partially or fully performed) oral agreement under which the buyer takes possession of the property and makes payments toward the purchase price or makes valuable improvements on the property; or
- adverse possession.

An **executed oral agreement** for the transfer of real estate ownership will be enforced either under the doctrines of *specific performance* or *estoppel*. The application of both doctrines is unaffected by whether the property is being sold under an oral agreement to a buyer for consideration, or given to a **donee** by gift.

Enforcing an oral promise to convey

A buyer and seller who enter into an oral **land sales contract**. The buyer agrees to pay the purchase price by taking over payments on the first trust deed of record and making monthly payments to the seller.

The seller agrees to convey title to the buyer when the buyer has fully paid the purchase price, resulting in the satisfaction of the first trust deed and the complete payoff of the seller's equity in the land sales agreement.

The buyer takes possession of the property. The buyer eventually completes payment of all amounts due to the first trust deed lender and the seller under the land sales contract. Having fully performed the oral agreement, the buyer makes a demand on the seller to convey title to the property.

The seller refuses, claiming the oral land sales contract is unenforceable since the statute of frauds requires an agreement for the sale of real estate to be in writing to be enforceable.

Is the buyer entitled to the specific performance of the oral land sales contract and conveyance of title to the property?

Yes! The buyer's **possession** of the property and **full or partial performance** of the oral land sales contract collectively acts as a substitute for the prerequisite signed writing required by the statute of frauds for enforcement of a sale of real estate.

However, **partial payment** of the purchase price under an oral agreement when the buyer is not given possession is insufficient to overcome the statute of frauds writing requirement for an agreement transferring real estate.

The buyer must be given possession of the property for the oral purchase agreement to be enforceable on a partial payment. The buyer's **open and notorious** possession indicates a claim of ownership in the property which is inconsistent with the seller's claim of ownership when a verbal agreement for payment of the agreed-to price has been acted upon. [**Francis** v. **Colendich** (1961) 193 CA2d 128]

Additionally, the buyer's possession of the property is inconsistent with record title. Any purchaser obtaining title from the seller (or lender receiving a trust deed lien) after the buyer takes possession is on *constructive notice* to further inquire into the interest of the buyer-in-possession of the property.

The subsequent purchaser (or lender) will not be an innocent buyer who is without notice of the buyer-in-possession's interest, called a *bona fide purchaser* (BFP), since the purchaser (or lender) must inquire about the buyer-on-possession's interest when it appears inconsistent with the his recorded interest, if a recording exists. [**Gates Rubber Company** v. **Ulman** (1989) 214 CA3d 356]

Unjustly enriched unless estopped

Consider an owner of real estate who **orally conveys** all his interest in a vacant parcel of real estate to his son as a gift. The son takes possession of the property and makes substantial improvements on it, including the construction of a building. The value of the property added by the construction exceeds the fair rental value of the son's possession before completion of the construction.

Later, the owner dies. Other heirs under his will make a claim to an ownership interest in the improved property. The son seeks to quiet title to the property in his name, claiming he took possession and made substantial improvements to the property in reliance on the owner's gift of the real estate to him.

The heirs claim ownership to the property was not conveyed since the owner did not transfer title to the property by a signed writing.

Do the heirs have an ownership interest in the property orally conveyed to the son as a gift?

No! The heirs are barred, called *estopped*, from denying the son's claim of ownership by asserting a written conveyance must be signed by the owner as required by the statute of frauds. To now require a writing to evidence the gift will *unjustly enrich* the heirs, due to the value added by the improvements, and place an *unfair burden* on the son.

The son **took possession** of the property in reliance on the owner's oral conveyance as a gift, and later placed **substantial** and **permanent improvements** on the property. To deny the son title to the property after he built the substantial improvements would be *inequitable* and unfair. Thus, the equitable *doctrine of estoppel* will not allow the writing requirement in the statute of frauds to be used by challengers to defeat the gift made by an oral conveyance of the real estate. [**Green** v. **Brown** (1951) 37 C2d 391]

However, the expenditures and improvements on the property must provide **lasting benefits** and enhance the property's value beyond its mere rental value. Slight or temporary improvements by occupants who

claim ownership under an oral conveyance are not sufficient to quiet title in the occupant and defeat a challenge based on the need for a writing under the statute of frauds.

The value of the improvements made by the occupant-in-possession of a property in reliance on an owner's oral conveyance must exceed the **fair rental value** for the possession and use of the property, such as to constitute a capital investment by the occupant. Without an investment exceeding the rental value, no basis exists to support enforcement of the oral conveyance and **estop** others who wish to deny the occupant's ownership for the lack of a written conveyance. [**Burris** v. **Landers** (1896) 114 C 310]

Title by claims of adverse possession

To establish title by *adverse possession*, an occupant must show:

- his possession is based on a *claim of right* or *color of title*;
- he has occupied the property in an open and notorious way which constitutes *reasonable notice* to the record owner;
- his occupancy is *hostile and inconsistent* with the owner's title;
- he has been in possession for a *continuous and uninterrupted period* of at least five years; and
- he has *paid all taxes* assessed against the property during his occupancy. [Calif. Code of Civil Procedure §§318 et seq.; see Chapter 21]

An occupant's ownership by **adverse possession** based on a **claim of right** avoids the statute of frauds requirement that agreements to transfer real estate must be in writing.

To obtain title by adverse possession based on a claim of right, the occupant has, by the nature of adverse possession, no written documentation or evidence of title. Essentially, the adverse possessor is a trespasser in possession of the owner's property without any bona fide (good faith) belief he holds title to the property. [**Brown** v. **Berman** (1962) 203 CA2d 327]

Thus, in the case of adverse possession by a claim of right, the owner of the property has not orally conveyed title to the real estate to the occupant. The occupant is a trespasser until his **conduct** and **time in possession** meet the requirements for him to obtain a court ordered transfer of title by adverse possession.

On the other hand, title by adverse possession based on a **color of title** usually occurs when the occupant's title is based on a defective deed.

For example, a son forges his father's signature on a power of attorney form naming the son as his father's agent, called an *attorney in fact*. Using his authority under the power of attorney, the son sells the father's property, signing the grant deed conveying title to the buyer as his father's **attorney in fact**.

The buyer of the property, unaware of the son's forged authority, accepts the deed. The buyer takes possession of the property and conducts himself as the owner of the property, including paying the property taxes.

More than five years after title and possession of the property is delivered to the buyer, the father learns of the forged grant deed and seeks to eject the buyer from the property and clear (quiet) title of the cloud created by the forged deed (which is void).

Does the buyer hold title to the property by adverse possession — even though the deed of record is forged and void?

Yes! Although the buyer's deed was void due to the forged power of attorney, the buyer's possession was sufficient to put the true owner, the father, on notice of the buyer's claim. Since the buyer's conduct meets the requirements of adverse possession, including the payment of property taxes, the buyer is entitled to title by adverse possession based on his *color of title* as a defense against the father's attempt to recover the property. [CCP §§322, 323]

Grantor qualifications as capable

A **grantor** of property must be *capable* of conveying an interest in real estate at the time the deed is signed for the deed to be enforceable as an actual conveyance of real estate. [CC §38; Calif. Family Code §6701]

To be **capable**, the grantor at the time the deed is signed must:

- be of *sound mind*;
- possess his *civil rights*; and
- be *an adult* at least 18 years of age. [CC §1556]

However, an exception exists to the "18 or over" age qualification. An individual under the age of 18 is considered an adult as an *emancipated minor* if the individual:

- has entered into a valid marriage, even if the marriage is now dissolved;
- is on active duty with the United States armed forces; or
- has received a declaration of emancipation from the court. [Fam C §7002]

An **emancipated minor** is considered an adult capable of transferring an interest in real estate. [Fam C §7050(e)(3)]

Consider a **temporary conservator** who is appointed by the court to manage the affairs of a property owner when the owner is found to be of *unsound mind* and unable to care for himself. Later, the owner, without court approval, deeds his property to a friend.

The conservator seeks to set aside the owner's deed to the friend.

The conservator claims the deed is **voidable** since the temporary appointment of the conservator establishes that the owner lacks the legal capacity to deed property. The friend claims the appointment of the temporary conservator did not affect the owner's legal capacity to convey his real estate.

Is the owner legally capable of conveying his property to his friend when he is subject to a temporary appointment of a conservator?

No! The appointment of a temporary conservator is a determination by a court that the owner lacks the legal capacity to convey real estate. Thus, the deed is voidable and can be set aside as void since the owner is *legally incapable* of conveying property from the moment a temporary conservator has been appointed until the conservator is discharged. [**O'Brien** v. **Dudenhoeffer** (1993) 16 CA4th 327]

To put the public on notice of a conservatorship, a *notice of conservatorship* is recorded in the county where the property is located. Unless the notice is recorded, the owner's conveyance to an individual who does not have **actual knowledge** of the conservatorship is valid. [Calif. Probate Code §1875]

However, while the deed may be valid, the failure to record a **notice of conservatorship** does not eliminate the *rules of equity* when the incapable owner has conveyed property. A conveyance to a buyer who does not have actual or constructive knowledge of the conservatorship may be *rescinded* (set aside) as

voidable by the owner if he did not understand the nature and consequences of the sales transaction when he entered into it. [Prob C §§1875, 1876]

Further, if a court not only decrees an owner to be **incompetent** but appoints a *guardian* as well, any later conveyance of real estate by the owner is void as having transferred nothing, not merely voidable. When the owner has been adjudicated as entirely incompetent and is appointed a **guardian**, a later conveyance by the owner can be set aside as never having been effective, even if the grantee is a bona fide purchaser (BFP) for lack of actual or recorded notice of the guardianship.

The appointment of a guardian and decree of incompetency, even unrecorded, is considered notice to all individuals of the owner's legal incapacity to convey real estate under any circumstances.

Unlike the appointment of a conservator, a **guardian** does not need to record a notice of the appointment to put buyers and lenders on notice. A court's determination of the owner's incompetence and appointment of a guardian constitutes *notice to the world* that the deed is void since the owner lacks all legal capacity to convey property. [**Hellman Commercial Trust & Savings Bank** v. **Alden** (1929) 206 C 592]

Incompetency before court ruling

Consider an owner who conveys real estate before a court rules him incompetent. For the conveyance **to be void** and thus entirely unenforceable by the grantee, the owner must be incompetent as entirely without understanding on all matters when the deed was signed. [CC §38]

However, if the owner simply lacks an understanding of the nature and the consequences of the transaction but is not completely without understanding and has not been appointed a guardian, the conveyance may be merely **voidable**. Thus, the deed must be later rescinded by the owner to void its continued validity. [CC §39]

In the instance of an incompetent owner not entirely without understanding, if the grantee can show he was unaware of the owner's incompetency at the time of the conveyance and provided valuable consideration, the conveyance is enforceable. [Calif. Prob C §1875]

Grantor identification in deed

The *grant provision* in a deed must identify each person who is conveying an interest in the property. If a conveyance such as a deed is signed by a person who is **not named as the grantor** in the grant provision in the deed, the deed does not convey that person's interest in the property. The identity of the grantor in the provision containing words of conveyance (grant) must be certain by an examination of the entire deed, not just the signatures. [**Childs** v. **Newfield** (1934) 136 CA 217]

For example, a deed identifies several individuals as grantors in a grant provision and the document contains their signatures. However, the list of grantors named in the deed's grant provision is incomplete and does not convey all the fee ownership of the property since several unnamed individuals also have an ownership interest in the property.

Further, the signatures on the grant deed include all the individuals who are co-owners of the property — even though some are not named as grantors in the grant provision.

In this instance, the deed transfers only the ownership and title held by those owners named as grantors in the grant provision in the deed. The deed by its wording does not show the necessary intent to convey title by the unnamed owners who were not listed as grantors and also signed the deed. [**Roberts** v. **Abbott** (1920) 48 CA 779]

On recording, the county recorder will only index as grantors those persons listed in the grant provisions since only they conveyed their interests in the real estate.

Grantor's vesting in the chain of title

The name of the grantor on a deed must match up with the name of the grantee named in the previous deed which conveyed title to him.

For example, an unmarried woman takes title in her maiden name "as an unmarried woman."

Later, the woman marries and takes her husband's last name as her own.

If the woman then conveys the property using her newly acquired married name to identify herself as the grantor, a **break in the chain of title** occurs. When a different name is used as the grantor from the name used to receive title under a prior deed, the new name cannot be located in the county recorder's grantor-grantee index as the grantee who previously received and holds title to the property being conveyed. Further, the title would remain in her maiden name as no one is on notice (by the record) of her conveyance.

With a break in title between deeds due to the grantor's name change after taking title as a grantee, a buyer will receive an unmarketable title. In this example, the grantor received title in her maiden name as an unmarried woman and conveyed the property in her married name, causing a break in the chain of title. [**Benson** v. **Shotwell** (1890) 87 C 49]

Any person conveying property whose name has changed after becoming vested in title must also as the grantor on the conveyance enter the name in which they previously received title to the real estate as a grantee. [CC §1096]

For example, for the woman who later marries, the deed can identify the grantor as *Mary Smith, who took title as Mary Jones, an unmarried woman, does convey...*

The identification of the woman's prior name links her in the recorder's indexes as both a grantee of record and the grantor under the present deed which conveys her "out of title."

Thus, the conveyance refers to both the name in which the grantor originally received title, and the name by which the same grantor is conveying the title.

When a deed does not identify the grantor by the precise name and spelling under which the grantor previously took title, the deed does not give constructive notice to later buyers or encumbrancers of the property that the grantor has already conveyed his interest. However, the deed with the reference to the incorrect name of the grantor is valid and enforceable between the parties to the deed and those who have notice of the true identity of the grantor. [CC §1096]

Further, **possession** of real estate by the grantee is *constructive notice* to others that the defective deed exists since possession places future buyers, lenders and tenants on notice to ask the grantee-in-possession what interest he has in the property.

The grantee as any person

While the grantor must *have the capacity* to convey title, any existing person (individual or entity) may take and hold title to real estate as the *grantee.* [CC §671]

A child or an incompetent person has the *capacity to receive* and hold title as a grantee even though that person does not have the legal capacity to then convey the same property. [**Turner** v. **Turner** (1916) 173 C 782]

A deed must **identify** the grantee. For example, a seller accepts a buyer's purchase agreement offer. The seller concurrently signs a deed and hands it to the broker since the seller is leaving the country. However, the space for the name of the grantee is left blank. The broker is not instructed to enter the buyer's name as the grantee. The broker, as instructed, delivers the deed to the buyer without entering the buyer's name as the grantee.

Is the deed which does not name the grantee a valid transfer of title?

No! A deed which does not identify a grantee is void. The identity of the grantee must be sufficient to **identify with certainty** the individual to whom the seller intends title to be passed, such as by identifying the grantee as "the husband of the grantor." [**Tumansky** v. **Woodruff** (1936) 14 CA2d 279]

Consider a seller who places his grant deed in escrow (a third party) without naming a grantee or instructing escrow to enter a grantee's name.

Later, the escrow agent inserts the name of the buyer in the deed as the grantee on the assumption the deed was to be used to convey title to the buyer. The buyer's name is inserted without the seller being present or the seller's written authority.

Is the deed enforceable after escrow inserted the buyer's name in the deed without receiving the seller's authority?

No! If a seller/grantor is not present when a buyer's/grantee's name is inserted in the grant deed, or if the name of the grantee is inserted by a person without the grantor's written authority to do so, the deed is *void.* [**Tannahill** v. **Greening** (1927) 85 CA 714]

Additionally, a deed is considered valid if the individual identified as the grantee takes title under a *fictitious name* by which he is also known or has assumed for the purpose of receiving title.

However, if the fictitious name is established for the purpose of committing a fraud against the grantor, the grantor may set aside the deed as **voidable**.

A deed to a person who does not exist, referred to as a *fictitious person*, or to a person who is dead at the time of conveyance, or to a corporation, limited liability company (LLC) or partnership which does not legally exist, will not convey title since no one exists to accept delivery. [**McWhorter** v. **McWhorter** (1929) 99 CA 293]

Sometimes an unintentional error **misnames the grantee** in a recorded deed, such as by misspelling the grantee's name. A deed with a misnamed grantee is still a valid conveyance of the real estate.

Another deed from the same grantor to the grantee named with the correct spelling of the grantee's name will not correct the error, nor will re-recording the original deed with an amendment containing the grantee's correct name. The recording of a corrective deed falls outside the chain of title in the grantor-grantee index since the grantor no longer has any interest to convey. The grantor has already conveyed his title, albeit to a grantee with an erroneously spelled name. [**Walters** v. **Mitchell** (1907) 6 CA 410]

A grantor who has conveyed title cannot do so again even as an attempt to convey title to the same grantee.

Editor's note — Title companies are only concerned the grantor on a deed is the same person who took title under the incorrect name. Title companies will generally accept a deed conveying title which identifies the grantor by both his correct name and the incorrect (misspelled) name under which he originally took title as a grantee.

Conversely, consider a buyer who acquires title from a seller. The seller previously took title to the property as a grantee under a name different from the name the seller used to convey title to the buyer.

In this instance, the buyer may petition the court for an order stating the individual who conveyed title to the buyer is the same individual who previously acquired title to the property, even though the names used by the individual to take title as grantee and later convey title as grantor in the separate documents are different. The petition is for a *determination of the identity* of a person in the chain of title. [CCP §§770.010 et seq.]

Corporations, partnerships and LLCs

A partnership, limited liability company (LLC), corporation and real estate investment trust (REIT) are *persons* who may acquire title to California real estate since they are entities established or qualified under California law to conduct business in the state. [Calif. Corporations Code §§207, 16203, 17003(f)]

Consider a seller who sells property to a corporation which at the time does not yet legally exist. Further, a deed is signed and handed to escrow by the seller, naming the corporation as the grantee.

The corporation files its articles of incorporation with the Secretary of State of California prior to the close of escrow. Later, escrow is closed and the deed is delivered (recorded) and accepted by the corporation.

Is the deed enforceable?

Yes! A corporation has the capacity to receive title to real estate even though the deed was signed before the corporation legally existed. A deed **becomes effective** on its delivery to the grantee, not on the date it was signed.

However, a deed will not be considered delivered if the corporation does not exist at the time of the deed's delivery to the corporation since acceptance by the grantee is required for a delivery. The deed is not considered accepted if the corporation, as the grantee, does not legally exist at the time the deed is recorded. Thus, the deed will only be effective if it is delivered after the corporation files its articles of incorporation, legally bringing it into existence. [**Wall** v. **Mines Girls' Directory Orphan Asylum** (1900) 130 C 27]

A corporation filing its articles of incorporation is evidence of the formation and existence of the corporation. [Corp C §209]

Words of conveyance for a fee or less

The actual words of conveyance in a deed depend on whether the deed used is a *grant deed* or a *quitclaim deed*. [See Chapter 27]

A **grant deed** is used to pass a *fee simple interest* in real estate from the grantor to another individual, unless a lesser interest is stated in the deed. While no precise words of conveyance are necessary, use of the word "grant" in the granting clause, without noting a lesser interest in the description of the property, indicates the conveyance of a fee simple interest in the described property. [See **first tuesday** Form 404]

Alternatively, a **quitclaim deed** is intended to convey whatever interest, if any, the grantor may hold in the real estate. The words of conveyance historically used in a quitclaim deed are "remise, release and otherwise quitclaim."

However, only the word "quitclaim" is required as the word of conveyance. The word "grant" is not used in a quitclaim deed since no implied warranties are included with a conveyance under a quitclaim deed. However, the parties to a quitclaim deed are referred to as the "grantor" and the "grantee." [See **first tuesday** Form 405]

The property description imperative

Two parcels of real estate owned by the same individual are situated on opposite sides of a public street. The city abandons the street by recording an **abandonment order** while the individual still owns both parcels of real estate.

Later, the owner conveys, by an **easement deed**, a 100-foot wide railroad right of way across the southern parcel. The deed conveying the easement states the 100-foot wide right of way is located south of and adjacent to the northern line of the southern parcel. No reference to the abandoned street is made in the easement deed.

The railroad places survey stakes along the northern line of the southern parcel to mark the northerly boundary of the right of way. The stakes for the northern boundary of the right of way are located on the south side of the abandoned street.

The owner of the northern parcel plants an orange grove on the entire abandoned street, north of the survey stakes for the northern side of the 100-foot railroad right of way.

The owner sells the northern parcel. The deed conveying the northern parcel describes the parcel by referencing the subdivision map and the city's abandonment order. Due to the orange grove being located on the entire abandoned street, the buyer of the northern parcel believes the property conveyed includes all of the abandoned street.

Later, the owner sells the southern parcel subject to the railroad's right of way and the city's abandonment order.

The buyer of the southern parcel then purchases the right of way easement from the railroad and eliminates the easement (by merger) from his record title.

The buyer of the southern parcel and the buyer of the northern parcel dispute the location of the common boundary between their properties. The buyer of the northern parcel claims his parcel includes the entire abandoned street since the orange grove is located on the abandoned street.

The buyer of the southern parcel claims title to the southern half of the abandoned street since the southern half of the abandoned street attached to the southern parcel on the abandonment by the city.

Figure 1

Example of the reference in a deed to the description of property located in other documents:

Lot 30 of the Sherman Tract #3 as per map recorded in Book 34, pages 72 of maps, records of Riverside County, California.

Is the southern portion of the street included as part of the conveyance of the southern parcel to the buyer?

Yes! The deed given to the buyer of the southern parcel includes the southern portion of the street since the southern half of the street became part of the southern parcel by *operation of law* when the street was abandoned by the city.

The title of property which is bordered by a street extends to the center of the street on the abandonment of the street. Title to the abandoned street is conveyed by a deed describing the parcel unless the grantor does not intend to convey the portion of the street and reserves it for himself in the deed. [CC §1112]

Since the deed to the buyer of the southern parcel included reference to the city's abandonment order of the street, the owner did not intend to reserve for himself the southern half of the street.

Thus, *extrinsic evidence* cannot be used, such as the existence of the orange grove, to show the deed conveyed the entire street with the northern parcel. The deeds conveying the parcels to the buyers are not ambiguous. Each **deed on its face** conveys the entire parcel as described in the subdivision map and the city's abandonment order with one half of the abandoned street to each the northern and southern owner. [**Baker** v. **Ramirez** (1987) 190 CA3d 1123]

Describing the property conveyed

A deed conveying property must sufficiently describe the property being conveyed so it can be reasonably located from the description in the deed. If the property cannot be located from the description in the deed, the conveyance is void. [**Scott** v. **Woodworth** (1917) 34 CA 400]

Extrinsic evidence, facts not stated in the deed, may only be used when an **ambiguity** arises as to the description of the property conveyed.

However, extrinsic evidence may not be used to supply the deed with a missing description or correct a defective description.

The description of a parcel in a deed must be sufficient to allow the real estate conveyed to be identified and located with reasonable certainty by a surveyor. [**Best** v. **Wohlford** (1904) 144 C 733]

For example, real estate is conveyed by a deed describing the property as the "Occidental Mill Site, containing 4.95 acres, being a fraction of lot 2..." The use of the real estate's common name in the deed is sufficient to locate the boundaries and identify the real estate being conveyed. [CC §1092]

Editor's note — Any dispute regarding the location of the 4.95 acres on lot 2 must be resolved as a ***boundary dispute.***

Additionally, a deed which describes real estate by its street address, such as "879 Riverside Avenue, Riverside, CA 92507," will be considered sufficient to identify the real estate located at the street address, sometimes called a *common description* or *common address*. [**Brudvig** v. **Renner** (1959) 172 CA2d 522]

However, the deed should include the property's legal description (metes and bounds) or a map designation, such as a parcel or lot number, which contains the **metes and bounds** description needed to locate with certainty the parcel being conveyed.

Thus, the real estate can be described by reference to other documents, such as a subdivision map which contains the metes and bounds description of the parcel. The document referenced in a deed is incorporated into the deed as the source of the metes and bounds description of the property conveyed. [**Edwards** v. **Lewis** (1938) 25 CA2d 168; see Figure 1]

The grantor's signature

To transfer real estate by a deed, the deed must be signed by the grantor named in the deed. [CC §1091]

A deed can also be signed on behalf of the grantor by the **grantor's agent** if the agent is authorized in writing to convey the property on the grantor's behalf. The agent is called an *attorney in fact* and is operating under a *power of attorney.* [CC §1091; see Chapter 15]

Additionally, a deed can be signed in the name of the grantor by an *amanuensis* as orally instructed by the grantor. An **amanuensis** is an individual who has the oral authority of the grantor to sign a grant deed by his own hand on behalf of the grantor.

Unlike an **attorney in fact** who is an agent with **discretionary authority** to determine whether he is to enter into a deed without prior approval from the grantor, an amanuensis has a purely ministerial duty and signs a document as instructed without exercising his personal discretion or judgment.

Consider an owner who prior to becoming blind executes a **power of attorney** naming his daughter as his attorney in fact. Under the power of attorney, the daughter has the power to sell, convey and transfer the owner's property as though she were the owner. However, an attorney in fact does not have authority to convey the property to herself or anyone else as a gift.

A grant deed is prepared for the owner's signature, conveying the property to his daughter as a gift. On the verbal instruction of the now-blind owner, the daughter signs the owner's name on the grant deed by her own hand. The deed is recorded and returned by the recorder to the owner.

The owner dies and his son seeks to set the grant deed aside. The son claims the grant deed is invalid since as an attorney in fact, the daughter does not have the authority to convey the property to herself as a gift.

The daughter claims the grant deed is valid since she signed the deed as an amanuensis on the instruction from the owner to sign his name on the deed and did not act in her capacity of an attorney in fact.

Is the grant deed signed by the daughter on behalf of the owner valid?

Yes! The deed is valid. When the daughter signed the deed, she was not acting as an agent but as an instrument of the owner. Thus, the daughter did not exercise her discretion as an agent of the owner acting under a power of attorney when the property was conveyed to her since she acted as an amanuensis. She followed the owner's oral instructions when she signed the owner's name to the grant deed. [**Estate of Stephens** (2002) 28 C4th 665]

Editor's note — For a discussion on the differences between grant deeds and quitclaim deeds, see Chapter 27.

Chapter 26 Delivery, acceptance and validity of deeds

This chapter discusses the intent necessary for a deed to be considered an enforceable conveyance which will withstand claims it is void or voidable.

Need for delivery, not a recording

A deed conveying real estate **transfers ownership** to the named grantee when the deed is *delivered*. The mere signing of a deed by the owner as the grantor, naming another person as the grantee to become the owner, is not enough to divest the owner of his title to the interest he holds in the real estate. Delivery of the signed deed is required to transfer ownership.

Delivery refers to two separate acts:

- the grantor's present **intent to convey title**, not just the act of physically handing the deed to the grantee; and
- the grantee's **acceptance** of the grant deed as an immediately effective conveyance.

While the grantor may intend to convey title when he hands over the deed, if the grantee **does not accept** the deed, the deed will not be considered delivered and a conveyance does not occur.

However, the grant deed does not need to be recorded to deliver title to a new owner or to revest title in two or more persons. Recording only *perfects* the ownership against third-parties, such as unknown off-record interests or later buyers, tenants and encumbrancers of the property.

For example, a mother, son and daughter hold title to real estate as joint tenants.

The mother and daughter sign a grant deed to their undivided two-thirds interest in the property and deliver it to themselves as joint tenants. The deed is not recorded but the daughter has possession of the deed.

The mother passes away and the son seeks ownership of a one-half interest in the property. The son claims the grant deed did not sever the joint tenancy which existed between the mother, daughter and himself since it was not recorded.

The daughter claims the son only holds a one-third interest in the property since joint tenants who execute a deed to one another do not have to record the deed to sever the joint tenancy they hold with another co-owner.

Is the son entitled to a one-half interest in the property as one of the surviving joint tenants?

No! The grant deed between the mother and the daughter severed their joint tenancy with the son since the deed only needed to be **delivered, not recorded**, to terminate the son's right of survivorship. Thus, the son owns no more than his original one-third interest in the property since he no longer is a joint tenant. The son became a tenant in common on delivery of the deed. [**Re** v. **Re** (1995) 39 CA4th 91]

Constructive delivery inferred

The delivery of a deed is *inferred* when the grantee receives or has **possession** of the deed. The deed may also be considered delivered without the grantee having or holding actual possession of the deed.

Even if the grantee does not have possession of the deed, the deed is not necessarily considered void as never having been delivered. When a grantee is not physically handed the deed, a *constructive delivery* of the deed may still have taken place.

Constructive delivery of a deed to the grantee is deemed to have occurred if:

- the deed is understood by the grantor and the grantee to be delivered by an agreement between them when the grantor signs the deed; or
- the deed is delivered to a third party for the benefit of the grantee, and the grantee or an agent of the grantee demonstrates the grantee's acceptance of the deed, or acceptance may be presumed. [Calif. Civil Code §1059]

For example, a property owner intends to deed property to a family member (the grantee). The owner prepares and signs a deed as the grantor and **delivers it to his agent** with instructions to record the deed on the death of the owner. The agent accepts the deed and, as instructed, does not record it.

The grantee knows the deed exists and lives on the property with the owner under the presumption the grantee now owns the property. After the death of the owner, the deed is recorded and delivered to the grantee by the agent as instructed.

Was the deed constructively delivered to the grantee when it was handed to the agent?

Yes! *Constructive delivery* of the deed occurred when the deed was delivered to the agent since he was acting for the benefit of the grantee and the grantee's acceptance of the deed could be presumed from the grantee's conduct. [**Kelly** v. **Woolsey** (1918) 177 C 325]

Grantor's intent to convey

Without an owner's present *intent to convey* title as a grantor, a deed will not be considered delivered, even if the grantee is handed the grant deed and accepts physical possession of the deed.

Consider an owner who hands a grantee a deed as a gift. However, the owner orally advises the grantee that the deed is not to be effective until the owner dies, and if the grantee dies first, the deed must be returned to the owner. The owner of the real estate does not intend for the deed to be a present transfer of the ownership of the real estate to the grantee.

The owner dies and the grantee records the deed. Heirs of the owner assert they own the real estate, claiming the deed was not delivered and is invalid since the owner did not intend for the deed to convey ownership at the time the deed was handed to the grantee.

The grantee claims the deed is a valid conveyance of the real estate since delivery took place when the owner personally handed him the deed and he accepted it, subject to the condition of a delayed transfer.

Was the deed a valid conveyance of the real estate?

No! To be a *valid delivery*, both the owner and the grantee must **intend** for title to the real estate to be **conveyed concurrent** with the handing of the deed to the grantee. The owner of the real estate must

intend for the document used to convey the real estate to operate as a deed which **immediately divests** the owner of title.

Since the owner intended the deed to become operative only on his death, as evidenced by the his actions and statements when the deed was handed to the grantee, the deed is considered an improper probate avoidance device, and is void, conveying nothing.

A deed handed to the grantee cannot act as a will or revocable inter vivos (living) trust agreement to transfer property on the death of the owner.

A will and an inter vivos trust agreement are *testamentary documents* which take effect after they are signed, on the owner's death. Upon entering into a will or trust agreement, the owner does not give up control or ownership until his death.

Conversely, a deed is a document used to **immediately pass** fee simple title (or other estate) on recording or the grantee taking possession of the deed. If the grantor does not intend to pass fee simple (or other estate) on handing the deed to the grantee, no actual delivery takes place and the deed is void. [**In re Estate of Pieper** (1964) 224 CA2d 670]

Consider a property owner who conveys real estate to a grantee by a grant deed. The grant deed states the owner **reserves a life estate** for himself. The grant deed is delivered to the grantee, who takes possession of the grant deed but not the real estate, possession being retained by the owner.

In this example, the grantee under the deed reserving a life estate for the grantor is not entitled to possession of the property until the grantor dies. However, the deed is valid and title to the property has been conveyed to the grantee in spite of the deed's reservation of a life estate since the owner intended to immediately convey title, subject to the life estate he reserved for himself. [**White** v. **Hendley** (1921) 185 C 614]

Grant deed as a mortgage-in-fact

Usually a grant deed is used with the intent to pass full legal title to the described property when it is handed to the grantee or recorded by the grantor.

However, when a grant deed is intended to convey title to a lender as *security* for the repayment of a debt he owes, in spite of its wording of conveyance, the grant deed does not transfer the right of ownership.

A grant deed given to provide a creditor with the property as **security** (collateral) is a *mortgage-in-fact*. Thus, a *lien* is imposed on the property in favor of the lender, similar to a trust deed lien.

For example, an owner wants a loan but has poor credit and can not qualify for an institutional loan. A private lender agrees to lend the owner the needed funds. The private lender receives a grant deed to the property as security in the event of a default on the loan. The real estate is to be *reconveyed* to the owner when the loan is fully repaid.

The owner retains possession of the property and remains responsible for the payment of taxes, a trust deed lien of record, and maintenance of the property. The grant deed to the lender is coupled with a lease and option to repurchase the property on an installment program (rent) with a final/balloon payment (when the option is exercised).

Before the loan is repaid, the owner seeks to sell the property by listing it with a broker.

To investigate the condition of title, the broker's agent orders out a property profile from the title company. It shows the recorded title to the property is vested in the name of the private lender, not the owner. The agent now questions whether his client is the true owner of the property and will be able to convey title if a buyer is located to acquire the property.

However, the owner is the legal owner of the property and the lender simply holds a lien on title, evidenced by the grant deed and all the unrecorded loan and lease-option documents.

In this instance, the owner and the lender entered into a loan arrangement in which the **grant deed was intended** to be used as a *security device* for the lender to hold the property as collateral until the loan is repaid in full, not to convey any right of ownership of the real estate to the lender. [**Orlando v. Berns** (1957) 154 CA2d 753]

Brokers and their agents who arrange loans should always use a trust deed as the device which attaches the debt as a lien on real estate. Using a grant deed as a security device is improper practice. A grant deed is generally equated to the grantor's intent to convey all rights and title in the property to the named grantee.

A trust deed does not convey any ownership rights in the property to the lender. Rather, a trust deed imposes a lien on the property in favor of the lender to secure the owner's performance of a money obligation owed the lender. On executing a trust deed, the owner retains all ownership rights to the secured property, which is the intent when using a trust deed.

Conditional delivery of deed

A deed cannot be delivered conditionally to the grantee himself with instructions placing conditions on its use, called a *conditional delivery*.

An *absolute conveyance* occurs when a deed is handed to the grantee or received by constructive delivery. Any conditions imposed by the grantor which are not stated in the deed are unenforceable. Once a deed is delivered, it operates free from conditions not written in the deed. [CC §1056]

The **conditional delivery rule** only applies to deeds handed to the grantee. On the contrary, a deed may be conditionally delivered to a *third party*, such as an escrow agent, broker or attorney when the seller is preparing to convey the property under contract. A deed delivered to a **third party** with instructions to hand the deed to the grantee on the occurrence or performance of a condition is valid. [CC §1057]

For example, a seller opens escrow and hands escrow his grant deed with written instructions authorizing escrow to deliver the deed when the buyer has fully performed and escrow is in a position to close.

Escrow delivers the deed to the buyer on the close of escrow. Escrow records the deed with the county recorder who then mails it to the buyer under the return-of-document instructions set forth on the deed.

Once placed in escrow, the grant deed can only be returned to the grantor if the grantee fails to perform as agreed, or by the written instructions of the grantor and grantee to escrow.

Deed erroneously released to buyer

Consider a seller whose broker locates a buyer who agrees to purchase the seller's real estate. Escrow is opened. The seller signs and delivers instructions to escrow together with his signed grant deed. Escrow is authorized to use the grant deed to transfer ownership of the property to the buyer on the close of escrow.

The escrow instructions state the deed is to be recorded and forwarded to the buyer when the buyer performs as agreed. The instructions further state that the deed is to be returned to the seller if the buyer fails to perform by the date specified in the instructions.

The buyer does not perform as agreed. However, escrow mistakenly records the grant deed. The deed is mailed to the buyer by the county recorder.

Did the buyer receive title to the real estate?

No! Escrow did not follow the seller's instructions regarding recording and delivery of the deed on closing. The escrow's **unauthorized recording** and the buyer's possession of the deed is improper since *delivery was not intended* by either the seller or buyer. Thus, title was not conveyed, the deed is void, and no interest was ever conveyed. [**Hildebrand** v. **Beck** (1925) 196 C 141]

Irrevocable escrow creates life estate

Consider an owner who hands a deed to his broker or attorney with written instructions to hold the deed until his death. On his death, the deed is to be delivered to the grantee.

Under the instructions, the owner does not retain the right to withdraw or revoke the deed as he would have been able to do had he conveyed the property to an inter vivos (living) trust vesting.

Has the owner delivered an enforceable deed to the third party?

Yes! The owner's act of depositing the deed and instructions for its use with a third party and **relinquishing further control** over the deed constitutes delivery of the deed and concurrently transfers title to the individual named as the grantee. The third party holding the deed becomes the *agent* of the grantee. The owner's interest in the real estate is reduced to a life estate on delivery since the owner intends to retain possession, not ownership, and use of the property until his death. [**Husheon** v. **Kelley** (1912) 162 C 656]

Further, once the owner deposits his deed with the third party and relinquishes all control over the deed, the owner's later destruction of the grant deed, such as ripping it up or the agent's redelivery of the grant deed back to the owner, does not reconvey title. [CC §1058]

Additionally, an owner's instructions to escrow to record a deed when escrow is in a position to close creates a presumption of delivery, even if the owner dies before escrow closes. [**Osterberg** v. **Osterberg** (1945) 68 CA2d 254]

Acceptance by the grantee

A grantee is *presumed* to have accepted a deed if the grant is beneficial to the grantee.

For example, an owner of real estate deposits in an escrow, or with a broker or other agent of the owner, a deed conveying real estate to the named grantee. The owner's written instructions accompanying the deed state the deed is to be delivered to the grantee on the owner's death. The owner will continue to occupy the property.

The instructions contain no provisions for the owner's withdrawal of the deed from escrow. Thus, the owner retains no power to revoke the deed. However, the grantee is not aware of the existence of the grant conveying title to the real estate.

On the owner's death, escrow delivers the deed to the grantee as instructed.

Is the deed considered valid even though the grantee, being unaware of the deed, did not formally accept it?

Yes! The delivery of the deed to a third party, such as an escrow or someone else acting as the owner's agent, with instructions to deliver the deed to the grantee on the owner's (grantor's) death is considered *constructive acceptance* by the grantee — even though the deed's existence was unknown to the grantee.

The conveyance of the property was for the grantee's benefit and thus the deed was **presumed** to have been accepted by the grantee when the deed was **conditionally delivered** to a third party. [**Windiate** v. **Moore** (1962) 201 CA2d 509]

Additionally, a deed is **presumed to be accepted** and the conveyance complete if the deed is:

- physically handed to the grantee [**California Trust Co.** v. **Hughes** (1952) 111 CA2d 717];
- recorded by the grantee [**Drummond** v. **Drummond** (1940) 39 CA2d 418]; or
- in the grantee's possession. [California Trust Co., *supra*]

Conditional acceptance by grantee

The conditional acceptance of a deed by a grantee does not constitute delivery. A deed is not effective until the grantee or his agent *unconditionally accepts* the deed. [**Green** v. **Skinner** (1921) 185 C 435]

For example, a secured lender initiates foreclosure proceedings on an owner's property. The owner does not want a foreclosure in his name since it would adversely affect his credit. Thus, the owner offers to deed the property to the lender in exchange for cancellation (satisfaction) of the debt secured by the property, called a *deed-in-lieu of foreclosure*.

However, the lender states the deed will not be accepted until:

- the property is free of any encumbrances junior to his trust deed; and
- the title is insured under a policy issued by an insurance company.

The owner hands the lender the **deed-in-lieu of foreclosure**. However, a title search in anticipation of obtaining title insurance discloses a junior trust deed lien exists on the property. The lender proceeds with the foreclosure and does not record or rely on the deed-in-lieu of foreclosure since the condition of title is unacceptable to the lender.

The junior lienholder discovers the existence of the unrecorded deed-in-lieu of foreclosure and claims the lender cannot foreclose since the lender accepted the deed-in-lieu of foreclosure subject to the junior trust deed (which would then become a first trust deed).

However, the lender agreed to accept the deed only on confirmation that title is clear of junior liens. The grantee's receipt of a deed, with acceptance of the deed **conditioned on confirmation** of the title condition, is not a delivery of the conveyance when received.

A deed is effective when handed to the grantee only if the grantee **unconditionally accepts** the deed. In this example, the lender did not receive the deed with the **intention of accepting delivery** of the deed as an immediate conveyance of title. [**Brereton** v. **Burton** (1938) 27 CA2d 464]

Now consider a borrower who, aware of the lender's conditions for accepting a deed-in-lieu of foreclosure, records the deed with instructions to the recorder to mail the deed to the lender. The borrower's intent is to force the acceptance on the lender since the lender's conditions regarding junior liens cannot be met.

If the lender is unwilling to accept the deed when it is received from the recorder, the lender must act (in a writing or with litigation) to state that the deed is not accepted. The borrower cannot force the lender to accept a deed to property by simply recording it. The conveyance, while clouding the enforceability of the lender's trust deed, is ineffective until the lender's conditions for acceptance are met.

Consideration given for deed's sake?

A grantor's receipt of consideration is not necessary for a voluntary conveyance of real estate by deed. A deed is not void for **lack of consideration** received by the grantor for conveying property. [CC §1040]

Further, without fraud or misrepresentation on the part of a buyer of real estate, a deed cannot be voided or rescinded by a seller for a buyer's **failure to pay** the balance due on the purchase price. A delivered deed is not void or voidable and the title remains with the buyer when the buyer fails to tender the balance of the purchase price he agreed to pay to the seller after taking title.

The seller, having conveyed the property, can only recover his money losses in a judgment or by foreclosure of a carryback trust deed. [**Lavely** v. **Nonemaker** (1931) 212 C 380]

However, if the buyer promises to pay a portion of the purchase price after taking title and performance of the deferred payment on the price is unsecured, the seller is entitled to a *vendor's lien* on the property sold for the portion of the price that remains unpaid. [See Chapter 38]

Additionally, when a grantor conveys real estate to a grantee for the purpose of avoiding creditors by stripping the grantor/debtor of his assets, the conveyance can be set aside by the creditors as a *fraudulent conveyance*. [CC §§3439 et seq.; see Chapter 38]

A conveyance will be considered **fraudulent** if:

- the grantor intends to defraud creditors by avoiding payment;
- a reasonably equivalent value is not received by the grantor in exchange for the property transferred; and
- the grantor is or will become insolvent on the conveyance, or he intended or should have known he would incur debts beyond his ability to pay. [CC §3439.04]

Recording the grant deed

To convey real estate, the deed does not need to be recorded. A deed that is delivered conveys an interest in real estate even when the deed is **incapable of being recorded**.

For example, title to an owner's undivided one-half interest in real estate is vested in the owner and a co-owner as joint tenants.

The owner signs and delivers a deed conveying the property to a grantee, an act which severs the joint tenancy with the co-owner. The owner's signature on the deed is not acknowledged by a notary public, which is a requisite to its being recorded. [Calif. Government Code §27287]

The co-owner claims the deed signed by the owner was not delivered since the grantor's signature on the deed was not acknowledged by a notary.

In this instance, delivery of the deed is not affected by the fact that the deed was not acknowledged or recorded. The owner's delivery of the signed deed to the grantee was sufficient to convey the co-owner's interest and sever the joint tenancy. [**Gonzales** v. **Gonzales** (1968) 267 CA2d 428]

A deed only needs to be recorded to put future buyers or encumbrancers on notice of the transfer. Recording the deed *perfects ownership* of the interest conveyed against others who might later claim an ownership, security or leasehold interest in the property.

A deed **capable of being recorded** with the county recorder must include:

- **identification** of the person requesting the recording, and the person to whom the document will be returned by the county recorder as indicated at the top left hand corner of the deed [Gov C §27361.6]; and
- the **address** where and to whom tax statements are to be sent by the county tax collector, indicated at the bottom of the first page. [Gov C §27321.5]

Failure to identify the person requesting the recording of the deed, where the deed is to be sent after recording, or where the local real estate tax statements are to be sent does not affect the validity of the deed or the *constructive notice* to others implied by recording the deed. [Gov C §§27321.5, 27361.6]

The deed submitted for recording must also include the amount of the *documentary transfer tax* to be paid. The deed will not be recorded by the recorder unless the **documentary transfer tax** is paid at the time of the recording. An additional transfer tax may be charged by the city, county or both the city and the county. [Calif. Revenue and Taxation Code §§11901 et seq.]

Once recorded, a deed constitutes a change of ownership which subjects the property to reassessment. Thus, the deed should be accompanied by a **change of ownership statement** which the recorder hands to the county assessor. [Gov C §27280; Rev & T C §480]

If the deed submitted to the county recorder does not include a change of ownership statement, the recorder will record the document and either:

- include a change of ownership form with the return of the recorded deed; or
- provide the assessor with the identification of the recorded document which was not accompanied by the change of ownership statement. [Gov C §27321]

Additionally, a **notary public acknowledging** an individual's signature on a deed affecting the title to real estate, such as a grant deed, quitclaim deed or trust deed, will require the individual to place his thumbprint in the notary's journal. The **thumbprint requirement** does not apply to the recording of a trustee's deed or a reconveyance of a trust deed. [Gov C §8206(a)(2)(G)]

Void vs. voidable deeds

Void and *voidable* are terms which seem similar but are distinguishable by the date they affect the validity of a deed, and thus, the rights of those who relied on the deed.

Void deeds are unenforceable and never convey an interest in real estate at any time, a concept called *void ab initio* — without legal effect from the beginning.

If title is claimed under a void deed, any claim of ownership under the deed must fail, even if a further grantee purchases the property in good faith without any notice of a defect in title or in the deed held by the grantor.

For example, an owner of real estate has been adjudicated as insane and unable to manage his affairs (incompetent). The court appoints a guardian to manage the owner's affairs.

A buyer, unaware of the owner's condition or guardianship, purchases real estate from the owner. The buyer obtains a grant deed to the property from the owner.

Is the deed on the sale of the real estate a valid conveyance since the buyer was unaware of the owner's condition and paid a fair value for the property?

No! Prior to the conveyance, a court found the owner to be incompetent and appointed a guardian to manage his affairs. The **appointment of a guardian** by the court is considered notice to all of the owner's condition — whether or not a notice of appointment is recorded — since adjudication of the owner's incompetence is considered notice.

Thus, the buyer's status as a bona fide purchaser (BFP) of title from an adjudicated incompetent does not shield the deed from being set aside. The deed was void at its inception and had no legal effect at any time. [CC §40]

Other examples of **void deeds** include:

- a deed signed and delivered by a seller under the age of 18 — due to legal *incapacity* [Calif. Family Code §6701];
- a deed handed directly to the grantee with the intent it is not to be effective until the owner's death — conditional delivery to the grantee, not to a third party [Estate of Pieper, *supra*];
- a deed materially altered without the grantor's consent [**Tannahill** v. **Greening** (1927) 85 CA 714]; or
- a forged deed. [**Meley** v. **Collins** (1871) 41 C 663]

Voidable deeds

A **voidable deed**, unlike a void deed, is a deed which is *valid and enforceable* after delivery until it is challenged due to a defect and a court order declares the deed to be invalid.

Examples of **voidable deeds** include:

- a deed obtained through **false representations**, such as a grantee who acquires title at a trustee's sale by advising the owner he has superior knowledge concerning the property's title condition and then misrepresents the condition of title, inducing the owner to allow the property to be sold by foreclosure [**Seeger** v. **Odell** (1941) 18 C2d 409];
- a deed obtained through **undue influence** or threat, such as imprisoning or restraining the owner until he signs a grant deed [**Campbell** v. **Genshlea** (1919) 180 C 213]; or
- a deed from a grantor of **unsound mind**, but not entirely without understanding, made before the grantor's incompetency to convey has been adjudicated. [CC §39]

Unlike void deeds, a voidable deed is enforceable by a bona fide purchaser (BFP) or encumbrancer who relies on the title held by the grantee under a voidable deed which has not yet been challenged as invalid.

For example, a loan secured by real estate is in default. The owner is concerned the property might be sold through foreclosure, negatively affecting his credit. The owner is approached by a foreclosure consultant who, through fraudulent threats and harassment, is able to obtain a grant deed from the owner.

The consultant, as the grantee under the deed, takes possession of the property and refinances it by obtaining a new loan to pay off the old loan. The new lender, unaware the grantee obtained the grant deed by fraud, is secured by a trust deed on the property now vested in the name of the foreclosure consultant.

Later, the original owner sues the foreclosure consultant to set aside the deed as voidable. The owner records a notice of **pendency of action**, referred to as a *lis pendens*. The grant deed is later declared invalid since the foreclosure consultant, as the grantee, used threats and undue influence to fraudulently obtain the deed.

Meanwhile, the new lender whose security interest rests on the voidable deed begins foreclosure under his trust deed.

The owner, having set aside his deed as voidable, claims the lender cannot foreclose since the deed for the ownership on which the lender's trust deed was acquired has been declared invalid.

Can the lender enforce the trust deed created by the grantee under the fraudulent (and voidable) deed which has been declared invalid?

Yes! The deed was voidable, not void, when it was signed and delivered to the grantee who executed the trust deed now in foreclosure. The lender became an encumbrancer before the grantor (prior owner) challenged the validity of the deed to the grantee (foreclosure consultant).

Thus, the lender is considered a **bona fide encumbrancer** for value and without notice of the defect, entitled to enforce the note and trust deed since the trust deed was recorded before the lender had actual or constructive notice (by the **lis pendens**) of the owner's challenge which ultimately declared the grant deed invalid. [**Fallon** v. **Triangle Management** (1985) 169 CA3d 1103]

Chapter 27 Grant deed vs. quitclaim deed

This chapter presents the two most common types of deeds used to convey property interests and their characteristics.

The deeds of conveyance

Real estate solely owned as separate property by a married individual is sold.

Before issuing a title insurance policy to insure the conveyance of marketable title to the property against any potential community property claim of the seller's spouse, the title insurance company requests that the spouse join in the grant deed by signing it as the spouse of the grantor.

The spouse signs the grant deed for the sole purpose of releasing any community property interest possibly acquired as a result of the marriage — even though the spouse acquired no interest in the real estate, as reflected by the record title.

After closing, the buyer of the property discovers a tenant who holds a lease which was not agreed to in the purchase agreement as a condition to title nor referenced in the grant deed. As a result, the buyer incurs money losses to relocate the tenant. Meanwhile, the seller dies but is survived by the spouse who joined in the conveyance.

The buyer now seeks to collect his tenant relocation expenses from the seller's spouse for breach of the *implied covenant* in the grant deed signed by the spouse. The **implied covenant** warrants the grantor has not *encumbered* title to the property in any manner, such as creating a lease which was not included as a condition of title in the purchase agreement.

The seller's spouse who joined in the conveyance claims a spouse cannot be held liable for the breach of the **covenant against further encumbrances** when the spouse never had an interest in the property to convey, and that the buyer's only remedy is against the deceased seller.

Is the spouse liable for the breach of the implied covenant against further encumbrances since the grant deed was signed by the spouse as a grantor?

Yes! The covenants implied in a grant deed impose a *personal obligation* on each grantor, whether or not the grantor has an interest in the real estate described in the grant deed delivered to the buyer.

Since the spouse voluntarily participated as a grantor in the conveyance and did not enter into the conveyance through mistake or fraud, the spouse as a grantor **breached the implied covenant** against **further encumbrances** by failing to state the property was subject to the lease. [**Evans** v. **Faught** (1965) 231 CA2d 698]

To avoid the exposure to liability imposed by the implied covenants in the grant deed, the spouse should have signed a quitclaim deed to either the seller or the buyer. A **quitclaim deed** does not contain or carry with it the implied covenants of warranty of title and warranty against encumbrances created during the grantor's period of ownership.

The granting clause

The two types of deeds commonly used to convey a real estate interest are:

- *grant deeds*; and
- *quitclaim deeds*.

To pass a fee simple interest in real estate, only the word "grant" needs to be used in the conveyance. No other precise words of conveyance are necessary in a deed to convey a fee simple ownership. [Calif. Civil Code §1092]

The word "grant" contained in the conveyance provision in a grant deed indicates the conveyance of a fee simple interest to another individual, unless the deed states a lesser interest is conveyed. [See Form 404 accompanying this chapter]

A **quitclaim deed** customarily uses the words "remise," "release" or "quitclaim," but does not contain the word "grant." However, only the word "quitclaim" needs to be used to convey all interest held in the property by the grantor. [See Form 405 accompanying this chapter]

A quitclaim deed conveys only the grantor's interest in a property, if any exists. A quitclaim deed can also be used in lieu of a grant deed to pass fee simple in the described real estate.

The words used to convey property are evidence of the **future role** the individual conveying title undertakes after the deed has been signed and delivered. Thus, to convey real estate with **covenants** relating to the interest conveyed, a grant deed is used. To simply convey any interest in real estate without an assurance the individual holds that interest conveyed, a quitclaim deed is used.

Grant deed covenants are implied

The covenants, sometimes called *warranties*, implied in a grant deed include:

- the interest conveyed in the real estate has not been *previously conveyed* to another, except as disclosed in the grant deed; and
- the real estate has not been *further encumbered* by the grantor, except as disclosed in the grant deed. [CC §1113]

Grant deed covenants are **implied**. Thus, they are not separately bargained for as provisions to be included in the grant deed conveyance.

Figure 1 *Excerpt from* **first tuesday** *Form 552 – Nonresidential Lease Agreement*

19. ASSIGNMENT, SUBLETTING AND ENCUMBRANCE: [Check only one]

19.1 ☐ Tenant may not assign this lease or sublet any part of the premises, or further encumber the leasehold.

19.2 ☐ Tenant may not transfer any interest in the premises without the prior consent of Landlord.

a. ☐ Consent may not be unreasonably withheld.

b. ☐ Consent is subject to the attached conditions. [**ft** Form 250]

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

MAIL TAX STATEMENTS TO:

Name

Street Address

City & State

DOCUMENTARY TRANSFER TAX $_____

☐ Computed on the consideration or value of property conveyed; or

☐ Computed on the consideration or value less liens or encumbrances remaining at time of sale.

☐ Unincorporated area: _____

☐ City of _____,

_____

Signature of Agent determining tax

GRANT DEED

I/We, _____

grant to _____

the real property in the City of _____,

County of _____, State of California, described as:

_____

_____

_____

_____

_____

_____

APN # _____

Date:_____, 20_____ _____ (Print Name) _____ (Signature)

Date:_____, 20_____ _____ (Print Name) _____ (Signature)

STATE OF CALIFORNIA)

COUNTY OF_____)

On _____ before me,

_____ *(name of notary public)*

personally appeared _____

_____, *(name of principal)*

personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS my hand and official seal.

Signature: _____

(Signature of notary public)

(This area for official notarial seal)

TAX STATEMENTS TO BE MAILED AS DIRECTED ABOVE

If a grant deed covenant is breached by a seller (grantor), the buyer (grantee) may recover his money losses from the seller for the breach of the implied covenant, as though the covenant had been written into the grant deed. [CC §1113]

The covenant against prior conveyances

Consider a seller who owns a parcel of real estate with *appurtenant water rights* in other real estate. The seller enters into a purchase agreement with a buyer, agreeing to convey the real estate to the buyer.

The seller signs a grant deed and hands it to escrow to convey the real estate to the buyer on closing. However, before the grant deed is delivered to the buyer, the seller conveys the appurtenant water rights to another individual.

After closing, the buyer learns of the seller's conveyance of the water rights and seeks damages for the seller's breach of the implied covenant against previous conveyances in the grant deed.

In this example, the seller is liable to the buyer for the value of the water rights conveyed to another. The water rights were appurtenant to the property sold. The seller breached the implied covenant in the grant deed by conveying the water rights without noting the conveyance as an *exception in the grant deed* he delivered to the buyer. [**Lyles** v. **Perrin** (1901) 134 C 417]

The covenant against other conveyances by the seller does not also imply the grantor has title to the property, called the *covenant of seisin*. A grantor who conveys property he does not hold title to is not liable for breach of the implied covenant against prior conveyance, or any other implied covenant.

The covenant against prior conveyances only represents that the grantor has not previously conveyed any interest in the property.

Instead, the grantor may be liable to the grantee for money losses caused by his misrepresentation of title, failure of consideration or breach of his promise in the purchase agreement to convey real estate. Further, the grantee may *rescind* the transaction and obtain a return of his funds, called *restoration*. [CC §1689]

The **covenant of seisin** — that the grantor holds title to the real estate being conveyed — is now entirely unused. This covenant has been completely replaced by title insurance.

The covenant against encumbrances

Real estate **encumbrances** include taxes, assessments, conditions, covenants and restrictions (CC&Rs) and all liens, voluntary or involuntary, attached to the real estate. [CC §§1113, 1114]

Encumbrances are the subject of the implied warranty against encumbrances in the grant deed, since they burden title and depreciate its value. **Encumbrances** include:

- CC&Rs, such as covenants and use restrictions running with the land;
- building restrictions;
- a reservation of a right of way;
- an easement;
- an encroachment;
- a lease; and
- a pendency of a condemnation action. [Evans, *supra*]

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

MAIL TAX STATEMENTS TO:

Name

Street Address

City & State

DOCUMENTARY TRANSFER TAX $_____

☐ Computed on the consideration or value of property conveyed; or

☐ Computed on the consideration or value less liens or encumbrances remaining at time of sale.

☐ Unincorporated area:

☐ City of _____, and

_____
Signature of Agent determining tax

QUITCLAIM DEED

I/We, _____

quitclaim to _____

the real property in the City of _____,

County of _____, State of California, described as:

_____

_____

_____

_____

_____

_____

Date:_____, 20_____ _____
(Print Name) (Signature)

Date:_____, 20_____ _____
(Print Name) (Signature)

STATE OF CALIFORNIA)
COUNTY OF_____)
On _____ before me,
_____
(name of notary public)
personally appeared _____
_____,
(name of principal)
personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS my hand and official seal.

Signature: _____
(Signature of notary public)

(This area for official notarial seal)

TAX STATEMENTS TO BE MAILED AS DIRECTED ABOVE

Consider a buyer who is aware of an existing lease on the property which the seller entered into as the landlord. The lease is not referenced in the purchase agreement or the escrow instructions as a condition of the title to be conveyed to the buyer. The buyer never agrees in writing to take title subject to the existing lease.

Further, the grant deed to the buyer does not state he is receiving title to the legally described real estate *subject to* the existing lease created by the seller.

The transaction closes and the tenant refuses to vacate the property based on agreements entered into between the tenant and the seller. The buyer then incurs expenses relocating the tenant. The buyer makes a demand on the seller to reimburse him for the tenant relocation expenses. The buyer claims the seller breached the implied covenant against encumbrances in the grant deed delivered to the buyer.

The seller claims the buyer cannot recover his expenses for the tenant's relocation since the buyer had constructive knowledge (the tenant was in possession) and actual knowledge the lease existed at the time he accepted delivery of the seller's grant deed.

In this example, the **buyer's knowledge** that the lease existed does not bar recovery of his costs to relocate the tenant based on the seller's breach of the implied covenant against further encumbrances. The buyer is entitled to **rely on the grant deed** (and the purchase agreement). Thus, the seller was obligated under the implied covenant in his grant deed to deliver title clear of the lease he created. [Evans, *supra*]

Improvements are real estate, not encumbrances

Physical changes in a property, generally resulting from *improvements*, are not considered encumbrances even through they affect the property's value. Since improvements are readily seen on the property, their existence places the buyer on notice.

For example, a water district constructs a large levee across an owner's property after the owner grants the district an easement. The water district owns and is in possession of the levee which is within the easement.

The owner conveys the real estate to a buyer with a grant deed. The grant deed does not reference the water district's easement created during the grantor's ownership. The buyer believes he purchased the property free and clear of any encumbrances and is unaware the water district has an easement over the property or owns the levee.

Due to the interference of the water district's levee, the buyer is unable to use the property as planned and is prevented from using the property located within the easement.

The buyer seeks damages from the seller for breach of the implied covenant against encumbrances.

However, *encumbrances* do not include visible physical or permanent burdens on real estate. Improvements affecting the physical condition of a property and its value are open and notorious. A buyer accepts the property subject to the **physical improvements** since he is charged with notice of them as part of the real estate purchased.

Physical improvements are not considered an encumbrance since the improvements only affect the physical condition of the property, not its title like an easement. [Evans, *supra*]

In another example, a seller fails to disclose to a buyer that the soil used for a fill on the property is not compacted. The buyer builds a single family residence on the property and his residence sinks due to the uncompacted soil.

The buyer seeks to recover his money losses from the seller for the damage to his residence caused by the poor soil condition. The buyer claims the seller breached his covenants in the grant deed since the seller failed to disclose he altered the property by adding uncompacted soil.

However, a grant deed (or purchase agreement) includes no implied covenant regarding the **physical condition** of a property. Implied covenants only apply to the **condition of title** conveyed by the seller. Thus, the buyer should have based his recovery claim on the seller's misrepresentation of the physical condition of the property improvements — the fill.

A seller's misrepresentations or omissions about the physical conditions existing on the real estate are separate from a breach of title covenants; misrepresentations being a fraud, failure of a grant deed covenant being a breach of contract. [**Gustafson** v. **Dunham, Inc.** (1962) 204 CA2d 10]

If the grantee seeks to make the condition of the property a **contract warranty** and not just a representation, the grant deed or purchase agreement must state the seller is providing a warranty that the property's condition contains no known or unknown defects.

For example, only a representation exists, not a warranty against all known and unknown defects, when the seller discloses the property's physical condition in the Condition of Property Statement (TDS) delivered to the buyer of a one-to-four unit residential property. [See **first tuesday** Form 304]

Covenants restricted or limited

To avoid liability arising out of the implied covenants in a grant deed, the deed should state the title conditions (encumbrances) created by the seller during his ownership when these conditions are agreed to by the buyer in the purchase agreement.

The implied covenants in a grant deed are *waived* by the buyer and do not apply when the seller (grantor) and the buyer (grantee) agree to the contrary in the purchase agreement and list the title changes made by the seller in the grant deed — as long as all changes made by the seller are listed.

For example, if the grantee is taking title subject to encumbrances placed on the property by the seller, the grant deed should state the property is "subject to" encumbrances of record, and list each of these encumbrances.

The implied covenants in the grant deed only insure the property has not been previously conveyed or encumbered by the grantor. No other promises regarding the title or condition of the property are implied in the grant deed.

Covenants personal to grantor/grantee

Implied covenants are only for the **personal benefit** of a buyer, not future owners, called *remote grantees*. The implied covenants in a seller's grant deed to a buyer do not impose a condition on title and do not *run with the land*.

Thus, being personal to the seller (grantor) and the buyer (grantee), the implied covenants in a grant deed can only be enforced by the buyer (grantee) named in the deed. Implied covenants cannot be enforced by **remote grantees** who acquire the buyer's interest at a later date.

Conversely, covenants **running with the land**, such as conditions, covenants and restrictions (CC&Rs) or easements, bind all future owners (remote grantees) of the property, whether they take title by deed or court order. Covenants running with the land affect title.

For a **covenant to run with the land** and affect all remote grantees, the seller creating the covenant must state in his conveyance that *successors* (remote grantees) are bound by the covenants and restrictions imposed on the property as contained in the deed. [CC §1468]

Consider an owner who encumbers his real estate with a first trust deed lien. The owner then sells the property to a buyer who agrees in the purchase agreement and escrow instructions to take title subject to the first trust deed.

Title is conveyed by grant deed to the buyer. However, the grant deed does not note the title is subject to the first trust deed created by the owner.

Later, the property is resold by the buyer. The purchase agreement and the escrow instructions for the resale disclose the existence of the first trust deed — specifically, the remaining balance on the first trust deed note to be assumed as part of the terms for payment of the purchase price on the resale to the new buyer.

The grant deed for the resale states the new buyer will take title subject to all encumbrances of record.

Later, on a search of the record title, the new buyer discovers the first trust deed lien he took over was not referenced in the grant deed conveyance to his seller from the prior owner of the property who created the trust deed lien.

The new buyer seeks to recover money from the prior owner for the amount of the debt secured by the trust deed based on the prior owner's breach of the implied covenant against encumbrances. The new buyer claims he has suffered losses since the trust deed created by the prior owner was not referenced in the prior owner's grant deed when he sold the property.

Is the new buyer entitled to recover money losses from the prior owner for the breach of the implied covenant against encumbrances contained in the grant deed?

No! The covenant implying the real estate is free from further encumbrances created by the prior owner is a **personal covenant**, held by and for the benefit of the original buyer only. An implied covenant does not run with the land for the benefit of a subsequent buyer. Thus, the new buyer cannot recover money losses for the breach of an implied covenant under a grant deed which did not name him as the grantee.

Further, the new buyer agreed to the first trust deed since it was referenced in his purchase agreement and escrow instructions. Usually, a buyer's knowledge of an encumbrance does not bar an action by the buyer against the seller for the breach of implied covenants.

In this instance, the new buyer is not entitled to be *unjustly enriched* for the prior owner's breach of the covenant against encumbrances when the new buyer agrees in the purchase agreement to take title subject to the encumbrance. [**Babb** v.**Weemer** (1964) 225 CA2d 546]

Title insurer's right to pursue the seller

Title insurance companies issue policies of title insurance covering the conveyance of real estate interests based on the condition of title.

Occasionally, a title company fails to properly search or accurately document the record title of real estate, and issues a policy which fails to reference the seller's activity which affected title, such as a lien or conveyance entered into by the seller.

A policy of title insurance insures the buyer (grantee) against changes in the recorded title made by the seller (grantor) when the changes are not excluded from coverage by the terms of the purchase agreement.

For example, a seller of real estate encumbers his property with a trust deed during his ownership. To sell the property, a purchase agreement is entered into calling for the buyer to take title clear of all encumbrances except those listed. The trust deed encumbrance is not mentioned in the purchase agreement. Also, the seller's grant deed to the buyer does not state the title is subject to the encumbrance.

Further, the title insurance company insuring the grant deed fails to discover and disclose the encumbrance as an exception to coverage. Thus, the title insurance company indemnifies the buyer against the existence of the trust deed encumbrance on the property.

The buyer claims both the title insurance company and the seller are liable under their agreements with the buyer; the title insurance company under its policy, the seller under the implied covenant against further encumbrances in the grant deed.

If the title insurer pays this claim, the insurer will be *subrogated* by the terms of the policy to the buyer's claim against the seller and the seller's liability will shift to the title company.

Consider a property owner who grants a neighbor a view easement which imposes limits on the height of improvements on the owner's property. The neighbor records the document conveying the easement, called an *easement deed*.

The owner then sells the real estate, which is now subject to the view easement he created. Neither the purchase agreement nor the escrow instructions disclose the existence of the easement created by the owner.

Before closing, the owner **orally informs** his buyer of the view easement.

The owner further informs the buyer and the company providing title insurance he does not know whether the easement deed is recorded. A preliminary title report issued by the title company does not disclose the existence of the recorded easement deed. Neither the purchase agreement nor the escrow instructions are altered to reflect the existence of the easement.

Further, the owner's grant deed conveys the property to the buyer and makes no reference that the legally described real estate is subject to the easement created by the owner.

The title insurance policy issued to the buyer does not list the view easement as an exception to the insured condition of title.

After closing, the buyer discovers the easement was recorded while the owner held title. The buyer makes a claim against the title insurance company for the amount of the decrease in the value of the property caused by the easement.

The title insurance company pays the buyer's claim since title was insured against the recorded existence of the view easement. In exchange, the **buyer assigns** to the title company any rights held by the buyer against the owner for breach of the implied covenants in the owner's grant deed.

Recovery by subrogation to buyer's loss

The title insurance company then seeks to recover its payment of the claim from the owner based on his breach of the implied covenant to the buyer under the grant deed.

The owner claims the title insurance company cannot enforce a claim held by the buyer and assigned to the title company regarding the buyer's rights against the owner under the grant deed, called *subrogation*, since the buyer and the title insurance company were both aware of the easement before closing.

Is the title insurance company entitled to be **subrogated** to the rights of the buyer under the grant deed and recover the amount it paid for the buyer's lost value caused by the easement?

Yes! The buyer's and title insurance company's knowledge of the easement does not prevent recovery from the owner. The buyer is entitled to rely on the implied covenant against further encumbrances, which automatically accompanies the grant deed, unless the covenant is:

- *restricted* by listing the easement in the grant deed; or
- *waived* by agreeing to take title subject to the encumbrances in the purchase agreement, escrow instructions or other writing.

Further, the owner would be **unjustly enriched** if he were allowed to keep the entire amount of the purchase price received from the buyer since the price paid by the buyer did not reflect the reduced value caused by the easement.

Thus, the title insurance company, by the assignment, is entitled to step into the shoes of the buyer for the claim against the owner (by subrogation/equitable assignment) on payment to the buyer of the buyer's claim against the owner under the title insurance policy. The title insurer then pursues enforcement of the buyer's claim under the grant deed covenant against encumbrances. [**Fidelity National Title Insurance Company** v. **Miller** (1989) 215 CA3d 1163]

*Editor's note — An erroneous **preliminary title report** cannot be relied on as a warranty by the title insurance company of the condition of recorded title. A preliminary title report is merely an offer to issue a policy on the same terms and conditions, unless amended before closing. However, a seller is entitled to offset the title insurance company's recovery of its losses if the seller can show he justifiably relied on the title insurance company's representation concerning the non-existence of a recorded easement.*

*For the seller to justifiably rely on the title company, the title insurance company must issue an **abstract of title** policy to the seller. If an abstract of title policy discloses no easement of record when one exists, the title company is liable to the seller for the negligent preparation of the abstract of title, unless the seller knew the easement existed. [**Barthels** v. **Santa Barbara Title Company** (1994) 28 CA4th 674]*

Purchase agreement merges into deed

Title conditions bargained for and agreed to in the buyer's purchase agreement are *merged* into the grant deed accepted by the buyer on closing. [See **first tuesday** Form 150 §11.3]

Thus, when a title condition, such as a reservation of an easement by a seller, is agreed to in the purchase agreement, it must be restated in the grant deed if the condition is to become enforceable by the seller. The title condition agreed to in the purchase agreement is extinguished on closing by the **merger** of the bargained for title condition into the grant deed.

The *grant deed*, by merger, becomes the sole remaining **basis for enforcement** of either the buyer's or seller's rights to title. Thus, after closing, a purchase agreement provision affecting title is only enforceable if it is implied or stated in the grant deed. Recovery under the title insurance policy is an entirely separate source of recovery.

However, if a title condition, covenant or restriction (CC&R) is agreed to in the purchase agreement, but is **erroneously omitted** when escrow prepares the grant deed, the grant deed can be ordered corrected (by a court) to include the covenant, a legal process called *reformation*. Once the grant deed is corrected to include the omitted title condition, the condition is then enforceable since it is present in the grant deed. [CC §3399]

Grant deeds and after-acquired title

Consider an individual (grantor) who conveys title by grant deed to real estate he purports to own, but does not actually own in part or at all. Should the grantor later acquire title to the real estate interest he previously conveyed by grant deed, the *after-acquired title* to the real estate legally passes to the grantee under the grant deed. [CC §1106]

For example, an owner decides to sell property which is subject to an oil and gas lease calling for royalties (rent) to be paid to the owner by the tenant. The owner conveys his oil and gas rights by grant deed and transfers the oil and gas lease by assignment to an investor. Thus, the owner no longer owns the oil and gas rights in the real estate and no longer is entitled to receive royalties (rents) from the tenant under the lease.

Later, the owner locates a buyer of his remaining fee interest in the real estate. Neither the purchase agreement with the buyer nor the escrow instructions disclose the owner's prior conveyance of the oil and gas rights or the lease he entered into regarding those rights.

When a preliminary title report discloses the existence of the oil and gas lease, but not the recorded grant deed conveying the oil and gas rights or the lease assignment, the transaction is renegotiated and escrow instructions are amended by the owner's broker to provide for the owner to assign the oil and gas lease to the buyer. Further, the grant deed to the buyer does not limit the implied covenant against prior conveyance by referencing the prior transfer of the oil and gas rights held by the owner.

Later, after escrow closes, the owner reacquires the oil and gas rights by deed and the oil and gas lease by assignment.

However, on conveyance and assignment of the oil and gas rights back to the owner, these later acquired rights automatically pass *by operation of law* under the prior grant deed from the owner to the buyer who bought the real estate. The owner had previously conveyed the entire fee simple to the buyer, which included the oil and gas rights, subject only to the tenant's rights which still exist under the oil and gas lease. [**Schwenn** v. **Kaye** (1984) 155 CA3d 949]

Conveying lesser estates than the fee

If a buyer of real estate is receiving an ownership interest which is less than fee simple, the grant deed must explicitly state the lesser interest being conveyed to the buyer.

For example, to convey a **life estate**, the grant deed would state the grantee is to hold the property until the grantee's (or some other individual's) death, at which point the title will revert back to the grantor or the grantor's successors.

Covenants in a trustee's sale

The implied covenants of a grant deed apply to all *nonjudicial sales* of property which transfer a fee simple interest by grant deed. Conversely, transfers of real estate by *judicial order*, as well as by quitclaim deeds, carry no covenants (warranties) at all.

For example, a sale in a probate proceeding and the conveyance of real estate by a grant deed signed and delivered by an executor is a private, **nonjudicial sale**, not a **judicial sale**. The conveyance transferring title is not directed by an order of the court, though the court may have approved the sale. As a nonjudicial sale, the implied warranties of title in the executor's grant deed apply, unless the grant deed states otherwise. [**Mains** v. **City Title Ins. Co.** (1949) 34 C2d 580]

Now consider a trustee's foreclosure sale under a trust deed. The trustee acts on the authority given by the property owner (trustor) to sell and convey title to the real estate at a trustee's sale under the power-of-sale provision in the trust deed should the lender (beneficiary) declare a default and elect to foreclose.

Since the trustee's foreclosure process is a nonjudicial procedure, the implied covenants exist in the trustee's deed issued by the trustee on a foreclosure sale, unless the Notice of Trustee's Sale (NOTS) and the trustee's deed provisions eliminate the covenants. Standard NOTS and trustee's deeds avoid the implied covenants by stating the trustee transfers title with *no warranty.* [See **first tuesday** Form 474 and Form 475]

Additionally, a trustee's deed passes title to the real estate sold at the trustee's sale in the same condition as the title existed on the date the trust deed was recorded, called the *relation back theory*.

A trustee's deed conveys title to a buyer subject to all senior rights and encumbrances of record. The title received by the buyer at the trustee's sale is free and clear of any interest claimed by the prior owner or successors to the owner, and any liens, encumbrances or interests in the property junior in time of recording or subordinated to the trust deed which was foreclosed. [**Hohn** v. **Riverside County Flood Control and Water Conservation District** (1964) 228 CA2d 605]

Quitclaim deeds: you have what I had

A *quitclaim deed* terminates any interest in the real estate described in the deed which may be held by the person (grantor) signing and delivering the quitclaim deed.

Unlike a grant deed, a **quitclaim deed** does not carry with it the implied covenants contained in a grant deed. A quitclaim deed operates to **release to the grantee all interest** the grantor may hold in the property. [**Platner** v. **Vincent** (1924) 194 C 436]

A quitclaim deed passes whatever title, legal or equitable, the grantor possessed on execution (signing and delivering) of the quitclaim deed.

While a quitclaim deed is not intended to assure the conveyance transfers full fee simple ownership, the individual who **holds fee title** and signs and delivers a quitclaim deed does convey fee simple ownership of the property, and all the benefits of holding fee simple title. [**Spaulding** v. **Bradley** (1889) 79 C 449]

After-acquired title and quitclaims

Unlike a grant deed, a quitclaim deed does not also pass the grantor's after-acquired title to the real estate described in the quitclaim deed. The quitclaim deed is a *release* of the grantor's interest in the real estate at the time it is signed and delivered.

The individual signing and delivering a quitclaim deed does not promise to convey an interest in the real estate, much less agree he has received it (seisin) and not previously conveyed or encumbered it (implied covenants).

However, after-acquired title will pass to a buyer named in a previous quitclaim deed if:

- the seller sold by use of a quitclaim deed an *unperfected right* in the property which will later ripen into ownership, called an *inchoate right*, such as the interest held by a beneficiary under a will or inter vivos (living) trust prior to the death of the property owner [**Soares** v. **Steidtmann** (1955) 130 CA2d 401]; or
- the seller is *estopped* (barred) by his sales agreement or his conduct from claiming the after-acquired title does not pass to the buyer.

The seller is **estopped** from claiming the after-acquired title does not pass if:

- the quitclaim deed contains recitals or covenants, such as an *assignment clause*, showing the seller's intention was not to limit the interest conveyed to only the interest the seller had at the time the quitclaim deed was executed; or
- the seller has affirmed, or his conduct has implied, he actually had an interest in the property which was to be conveyed. [**In re Wilson's Estate** (1940) 40 CA2d 229]

Judicial sales and sheriff's deed

Deeds executed by agents of the court, such as a receiver or sheriff, to transfer title under a judicial foreclosure sale, an execution sale or other court-ordered sale are similar to quitclaim deeds in that none of these carry with them the *implied covenants* of a grant deed. Only an owner's interest in a property, if any exists, which was subject to the judicially ordered sale is conveyed. Likewise, any after-acquired title later acquired by the owner in the property sold by judicial order does not later pass to the buyer.

A sale is considered judicial if the property is conveyed by an order of the court to carry out a judgment, such as a sale on the execution of a money judgment or a judicial foreclosure sale. [**In re Backesto's Estate** (1923) 63 CA 265]

Additionally, a buyer and broker at a judicial foreclosure sale have the responsibility to investigate and determine the condition of the property, and the ownership interest and condition of the owner's title being conveyed by order of the court, since *no warranties exist*. [Mains, *supra*]

Chapter 28 Preliminary title reports

This chapter examines the use of a preliminary title report by a buyer to review the condition of title before allowing contingency provisions in purchase agreements to expire, and by escrow to prepare closing documents.

An offer to issue title insurance

An investor enters into an agreement to purchase real estate from a financially distressed seller.

Closing of the transaction is contingent on the investor's receipt and review of a preliminary title report (prelim) to confirm the property is subject only to the loans and other liens disclosed by the seller. Any taxes or monetary liens of record which are not disclosed in the purchase agreement are to remain of record. However, the amount of any undisclosed lien will be deducted from the cash down payment.

Escrow is opened with instructions to order a prelim from a title insurance company for approval of the condition of title by the investor. To keep acquisition costs to a minimum, escrow is instructed to close without obtaining a policy of title insurance.

The prelim received by escrow indicates the title is clear of all encumbrances, except those disclosed by the seller. Believing the title condition is as represented by the seller, the investor waives the further-approval contingency regarding approval of the prelim. Escrow closes on receiving a "date-down" on the prelim from the title company — without the issuance of a policy of title insurance.

However, the preliminary title report **failed to disclose** a recorded abstract of judgment against the seller which had attached to his title as a judgment lien. Later, the judgment creditor enforces the judgment lien by commencing a foreclosure on the property.

The investor clears title of the lien and makes a demand on the title company for the amount of the payoff since they prepared an **erroneous prelim**. The investor claims the title company is liable for his losses since it failed to disclose the judgment lien on the preliminary title report, a misrepresentation of title.

Can a buyer, escrow officer, broker or agent rely on a prelim as assurance the title condition is "as represented" in the preliminary title report?

No! A preliminary title report is not a representation of the condition of title or a policy of title insurance. Unlike an *abstract of title*, a prelim cannot be relied on by anyone. A title insurer has no duty to accurately report title defects and encumbrances on the preliminary title report (shown as exceptions in the proposed policy). [**Siegel** v. **Fidelity National Title Insurance Company** (1996) 46 CA4th 1181]

A preliminary title report is no more than an **offer to issue** a title insurance policy based on the contents of the prelim and any modifications made by the title company before the policy is issued. [Calif. Insurance Code §12340.11]

The limited use of the prelim

A preliminary title report typically discloses the current vesting, as well as the general and special taxes, assessments and bonds, covenants, conditions and restrictions (CC&Rs), easements, rights of way, en-

cumbrances, liens and any interests of others which may be reflected on the public record as affecting title, collectively called *encumbrances*.

The closing of many purchase escrows is conditioned on the buyer's approval of the prelim. The buyer, his agent and escrow review the report on its receipt for defects and encumbrances on title inconsistent with the terms for the seller's delivery of title in the purchase agreement and escrow instructions.

Buyer's agents in a sales transaction check the prelim prior to closing for title conditions. Buyers' agents are looking for title conditions which might interfere with any **intended use or change in the use** of the property contemplated by the buyer. Interferences could be in the form of unusual easements or use restrictions which obstruct the buyer's announced plans to make improvements.

Finally, escrow relies on the preliminary report to carry out its instructions to record grant deeds, trust deeds, leaseholds or options which will be insured.

Typically, escrow instructions call for closing when the deed can be recorded and insured, subject only to taxes, CC&Rs and other encumbrances specified in the instructions.

Ultimately, it is the escrow officer who, on review of the prelim, must advise the seller of any need to eliminate defects or encumbrances on title which interfere with closing as instructed.

The prelim and a last-minute *date-down* of title conditions are used by escrow to reveal any title problems to be eliminated before closing and, as instructed, obtain title insurance for the documents being recorded (deeds, trust deeds, etc.).

Should the date-down of the prelim reveal defects or liens not previously reported in the prelim, either by error or by later recording, the title company can **withdraw its offer** under the prelim and issue a new prelim — a different offer to issue a policy on different terms.

The prelim vs. an abstract of title

Title companies have long been aware of the public's reliance on the prelim. This reliance was consistently reinforced by the California courts which held title companies liable for their erroneous reports. However, legislation drafted by the title insurance industry was introduced and enacted in 1981 to eliminate liability for their preparation of faulty preliminary title reports.

Prelims were once compared to abstracts of title. An **abstract of title** is a written statement which may be relied on by those who order them as an accurate, factual representation of title to the property being acquired, encumbered or leased. [Ins C §12340.10]

An abstract of title is a **statement of facts** collected from the public records. An abstract is not an insurance policy with a dollar limit on liability set by the policy. Since the content of an abstract is intended by the insurance company to be relied upon **as fact**, the insurer is liable for all money losses of the policy holder flowing from a failure to properly prepare the abstract. [**1119 Delaware** v. **Continental Land Title Company** (1993) 16 CA4th 992]

In an effort to shield title companies from an *abstractor's liability* on the issuance of a defectively prepared prelim, the prelim has been legislatively redefined as being neither an abstract of title nor a representation of the condition of title. The prelim is now defined as a report furnished in connection with **an application** for title insurance. [Ins C §12340.11]

The prelim has become and is simply an offer by a title company to issue title insurance. The prelim is merely a statement of terms and conditions on which the title company is willing to issue a policy — subject to last minute changes prior to issuing the policy of title insurance.

Chapter 29 Title insurance

This chapter reviews title insurance and presents the distinguishing features of the different types of policies available.

Identifying an actual loss

A policy of title insurance is the means by which a title insurance company *indemnifies* — reimburses or holds harmless — a person who acquires an interest in real estate against a monetary loss caused by an **encumbrance on title** that:

- is not listed in the policy, which if listed is called an *exception*; and
- the insured was unaware of when the policy was issued. [Calif. Insurance Code §12340.1]

A policy of title insurance is issued on one of several prototypical forms which are used by the entire title insurance industry in California. The policies are typically issued to **buyers** of real estate, **tenants** acquiring long-term leases and **lenders** whose loans are secured by real estate.

As an **indemnity agreement**, a title insurance policy is a contract. The terms of coverage in the policy set forth the extent of the title insurance company's obligation, if any, to indemnify the named insured for a *money loss* caused by an **encumbrance on title** which is not listed in the policy's *exceptions*. [Ins C §12340.2]

For example, a lender acquires a note secured by a trust deed on real estate. The encumbrances listed as **exceptions** in the lender's policy of title insurance do not include a tax lien which encumbers the property and has priority over the lender's trust deed lien. The lender later discovers the existence of the tax lien.

The lender satisfies the tax lien, forecloses and obtains title by a **full credit bid**. The amount bid includes advances for the tax lien. The lender sells the property at a price in excess of the credit bid and resale costs. The lender makes a demand on the title company under its title insurance policy for the amount of the tax lien claiming the lien reduced the lender's profits on the sale. The title company denies the claim.

In this example, the insured lender cannot recover the **reduction in profits** due to an unlisted defect in title since lost profits are not covered by title insurance. The title insurance policy only indemnifies the insured against a **reduction in the value** of the property below the policy limits, not a reduction in future profits on either a foreclosure or resale of the property. [**Karl** v. **Commonwealth Land Title Insurance Company** (1993) 20 CA4th 972]

Encumbrances, unknown, undisclosed

Almost all losses due to the reduction in the value of real estate below the policy limits arise out of an *encumbrance*. An **encumbrance** is any condition which affects the ownership interest of the insured, whether the interest insured is a fee, leasehold, life estate or the security interest of a lender.

The word "encumbrance" is all encompassing. Any right or interest in real estate held by someone other than the owner which diminishes the value of the real estate is considered an encumbrance.

Encumbrances on title include:

- covenants restricting use;
- restrictions on use;
- reservations of a right of way;
- easements;
- encroachments;
- trust deeds or other security devices;
- pendency of condemnation; and
- leases. [**Evans** v. **Faught** (1965) 231 CA2d 698]

Property improvement and use not covered

Physical conditions on the property itself are not encumbrances which affect title since they are uses which exist and are visible (open and notorious) on the property, such as:

- canals;
- highways;
- irrigation ditches; and
- levees.

Accordingly, title insurance policies do not insure against open and notorious physical conditions which exist on the property, since these observable physical conditions are not encumbrances. A buyer is always presumed to have contracted to acquire property subject to physical conditions on the property which impede its use or impair its value. In the case of encumbrances, recorded or not, no such presumption exists.

A buyer under a purchase agreement contracts to acquire title from a seller free of all encumbrances except those agreed to in the purchase agreement. Even if the buyer has notice of an encumbrance affecting title and he has not agreed in the purchase agreement to take title subject to the encumbrance, the seller is liable to the buyer for its removal, extinguishment or compensation.

However, for title insurance purposes only, the buyer's knowledge of an encumbrance affecting title at the time of closing **removes the known encumbrance** from coverage. Thus, the insured buyer assumes the risk of loss due to the known encumbrance.

Underwriting only indemnifies a loss

A title insurance policy is not an *abstract of title*. Thus, a policy of title insurance does not *warrant* or *guarantee* the nonexistence of title encumbrances, as does an **abstract of title**. Instead, the insured is *indemnified* up to the **policy's dollar limits** against a money loss caused by a title condition (encumbrance) not listed as an exception or exclusion in the policy.

Under a title insurance policy, the title company only assumes (covers) the risks of a **monetary loss** caused by an encumbrance which is not listed as an exception to coverage, and was unknown to the insured buyer or lender at the time of closing. The title company has no obligation to clear title of the encumbrance.

Consider an owner who discovers the size of an easement was understated in the title insurance policy. Due to the actual dimensions of the easement, the owner cannot develop the property as planned.

The owner makes a claim on the title company for the **lost value** of the property based on its potential for development as allowed by the understated easement, not for his loss of value on the price he paid for the property (which is the dollar amount of the title policy limits).

Instead, the title insurance company only pays the owner an *inflation adjusted price* based on the price the owner paid for the property, an amount set by the policy limits and the inflation endorsement.

The owner claims the title company's *negligence* in the disclosure of the easement caused a loss in property value equal to the difference between the purchase price paid and the potential value of the property for development.

However, the title company is not liable under a policy for **lost profits** in the unrealized potential value of the property. It was the easement that caused the loss of profits, not the issuance of a title insurance policy. [**Barthels** v. **Santa Barbara Title Company** (1994) 28 CA4th 674]

A title insurance company issuing a preliminary title report or a policy of title insurance has two underwriting options when its title search reveals an encumbrance affecting title:

- list the encumbrance in a preliminary title report, requiring the parties to the transaction to either eliminate it or accept it as an *exception* to coverage in the policy of title insurance to be issued; or
- insure against the encumbrance by *writing over* the encumbrance — i.e., not listing it as an exception — and assuming any risk of loss connected to it.

When title companies **write over** a known encumbrance, they usually demand an indemnity agreement from the person responsible for eliminating the encumbrance — typically a money lien, such as a mechanic's lien, money judgment or blanket encumbrance. Thus, the title company can recover if a claim by the insured is later paid due to the encumbrance.

Additionally, a title policy is not a representation of the nonexistence of encumbrances that are not excluded or listed in the policy. If an encumbrance (unknown to the buyer or lender prior to closing) does exist and is not listed as an exception in the policy, a claim against the insurer in excess of the policy limits cannot be based on the insurer's *negligent preparation* of the list of encumbrances excluded from coverage in the title insurance policy. Also, a claim on an erroneous preliminary title report (prelim) cannot be based on the negligent preparation of the report. [See Chapter 28]

However, a title insurer might *intentionally write over* encumbrances at the request of a seller. If the buyer is not notified the encumbrance exists, the insurer is liable for actual losses in excess of the policy coverage for breach of the implied covenant of good faith and fair dealing imposed on title companies as a duty owed to their insured, the buyer. [**Jarchow** v. **Transamerica Title Insurance Company** (1975) 48 CA3d 917]

Introduction to title policy forms

Title insurance is purchased to assure real estate buyers, tenants and lenders the **interest in title** they acquire is what they bargained for from the seller, landlord or borrower. While title insurance is not a guarantee of the condition of the interest acquired in title, it does provide a **monetary recovery** up to the policy's dollar limits for the conveyance of any lesser interest than the interest insured due to unlisted exceptions.

On closing a real estate transaction, a policy of title insurance is issued on one of several prototypical forms used throughout the entire title insurance industry in California. The policies are typically issued

to **buyers** of real estate, **tenants** acquiring long-term leases and **lenders** whose loans are secured by the real estate.

Two basic forms exist which are the industry standard for:

- insuring the condition of record title only, accomplished by the issuance of a *California Land Title Association (CLTA) policy*; and
- insuring both the record title and observable on-site activities which affect title, accomplished by the issuance of an *American Land Title Association (ALTA) policy*.

A **policy of title insurance** is broken down into six operative sections, including:

- the **risks of loss covered**, called *insuring clauses*, which are based on a completely unencumbered title at the time of the insured transfer;
- the **risks of loss not covered**, comprised of encumbrances arising after the transfer or known to or brought about by the insured, called *exclusions*, which are a boilerplate set of title conditions;
- **identification** of the insured, the property, the vesting, the estate in the property, the dollar amount of the coverage, the premium paid and the policy (recording) date for the conveyance insured, called *Schedule A*;
- the **recorded interests**, i.e., any encumbrances affecting title and any observable on-site activities which are **listed as risks** agreed to and assumed by the insured and not covered by the policy, called *exceptions*, which are pre-printed for CLTA coverage and itemized for all types of coverage in *Schedule B*;
- the **procedures**, called *conditions*, for **claims made** by the named insured and for *settlement* by the insurance company on the occurrence of a loss due to any encumbrance on title which is not an exclusion or exception to the coverage initially granted by the insuring clauses; and
- any **endorsements** for additional coverage or removal of exclusions or pre-printed exceptions from the policy.

Insuring clauses

Coverage under the broadly worded **insuring clauses** of a policy of title insurance indemnifies the named insured for risks of loss **related to the title** due to:

- anyone making a claim against title to the real estate interest;
- the title being unmarketable for sale or as security for financing;
- any encumbrance on the title; and
- lack of recorded access to and from the described property.

Exclusions from coverage

All title insurance policies, in their **exclusions section**, eliminate from coverage those losses incurred by the insured buyer, tenant or lender due to:

- **use ordinances** or (zoning) laws;
- **unrecorded claims known** to the insured, but not to the title company;
- encumbrances or adverse **claims created** or attaching **after** the date of the policy;
- claims arising out of **bankruptcy** laws or due to a **fraudulent conveyance** to the insured;
- police power and **eminent domain**; and
- **post-closing events** caused by the insured.

Schedule A data

All policies of title insurance on **Schedule A** set forth:

- the property interest the insured acquired (fee simple, leasehold, life estate, security, etc.);
- the legal description of the insured property;
- the date and time the insured conveyance or lien recorded and coverage began;
- the premium paid for the policy; and
- the maximum total dollar amount to be paid for all claims settled.

Exceptions to coverage

In addition to the policy exclusions, a policy's coverage under its "no-encumbrance" insuring clause is further limited by **Schedule B** exceptions in the policy. The **exceptions section** contains an itemized list of recorded and unrecorded encumbrances which are known to the title company and affect the insured title. While the existence of these known encumbrances are insured against in the insuring clauses, they are removed by Schedule B as a basis for recovery under the policy.

In addition to the itemized **list of exclusions**, an American Land Title Association (ALTA) policy includes a set of pre-printed exceptions setting forth risks assumed by the insured buyer, tenant or lender, which include:

- taxes, assessments, liens, covenants, conditions and restrictions (CC&Rs), or any other interests, claims or encumbrances which have not been recorded with the county recorder or tax collector on the date of closing;
- any unrecorded and observable on-site activity which includes conflicts regarding boundary lines, encroachments or any other facts which a correct survey would disclose;
- unpatented mining claims; and
- all water rights.

Claims and settlements

Lastly, a policy of title insurance includes a **conditions section** which outlines the procedures the named insured must follow when making a claim for recovery under the policy. Also set forth are the settlement negotiations or legal actions available to the title company before they must pay a claim.

Figure 1 *Excerpt from **first tuesday** Form 150*

12.4 Title to be vested in Buyer or Assignee free of encumbrances other than those set forth herein. Buyer's interest in title to be insured under an ALTA form policy issued by _____ as a(n) ☐ Homeowner(s) policy (one-to-four units), ☐ Residential ALTA-R policy (vacant or improved residential parcel), ☐ Owner's policy (other than one-to-four units), ☐ CLTA Joint Protection policy (also naming Carryback Seller or purchase-assist lender), or ☐ Binder (to insure resale or refinance within two years).

a. Endorsements:_____

b. ☐ Seller, or ☐ Buyer, to pay the title insurance premium.

Owner's policies for buyers

Several types of title coverage are available for a buyer to choose from when entering into a purchase agreement with the seller, including:

- a California Land Title Association (CLTA) standard policy;
- an American Land Title Association (ALTA) owner's extended coverage policy;
- an ALTA residential (ALTA-R) policy; and
- an ALTA homeowner's policy.

When making an offer, a prospective buyer is informed by his agent about the coverage each type of policy provides. The buyer's need for title coverage must be reviewed when the buyer enters into a purchase agreement since the agreement's title insurance provision calls for the buyer to designate the type of title insurance policy on closing and states who will pay its premium. [See Figure 1]

The buyer's choice of a title policy as selected in the purchase agreement may depend on who is paying the title insurance premium — the buyer or the seller. Customarily, the seller pays the premium, except in some northern California counties.

Whoever will pay the policy premium is disclosed and accounted for in the brokers' disclosures to sellers and buyers of the net proceeds and costs to be expected on closing. [See **first tuesday** Forms 310 and 311]

Unless requested by the escrow holder when ordering a policy under escrow instructions, the tendency of title insurance companies is to issue the more expensive ALTA coverage policies. This condition is permitted by real estate brokers when using purchase agreement forms designed in collaboration with the title insurance industry. Here, the ALTA policy is the **default policy**.

The CLTA standard policy

The California Land Title Association (CLTA) standard policy is purchased solely by buyers, carryback sellers and private lenders, not institutional lenders or builders who generally need extended coverage.

The CLTA standard policy insures against all encumbrances affecting title to the property which can be discovered by a search of **public records** prior to issuance of the policy. Any encumbrance not recorded, whether or not observable by an **inspection or survey** of the property, is not covered due to the CLTA policy exclusions and standard exceptions.

Public records include those records which impart *constructive notice* of encumbrances affecting title to the property.

For example, a deed conveying a parcel of real estate which is actually **recorded and indexed** by the county recorder's office imparts constructive notice to buyers and lenders who later acquire an interest in the property. [Calif. Civil Code §1213]

Additionally, the CLTA standard policy (as well as the American Land Title Association (ALTA) policy) protects the insured against:

- the unmarketability of title or the inability to use it as security for financing;
- lack of ingress and egress rights to the property; and
- losses due to the ownership being vested in someone other than the buyer.

Excerpt from ALTA Short Form Residential Loan Policy Adopted 6/16/07

SCHEDULE B

EXCEPTIONS FROM COVERAGE AND AFFIRMATIVE INSURANCES

Except to the extent of the affirmative insurance set forth below, this policy does not insure against loss or damage (and the Company will not pay costs, attorneys' fees, or expenses) which arise by reason of:

1. Covenants, conditions, or restrictions, if any, appearing in the Public Records; however, this policy insures against loss or damage arising from:

   (a) the violation of those covenants, conditions, or restrictions on or prior to Date of Policy;

   (b) a forfeiture or reversion of Title from a future violation of those covenants, conditions, or restrictions, including those relating to environmental protection; and

   (c) provisions in those covenants, conditions, or restrictions, including those relating to environmental protection, under which the lien of the Insured Mortgage can be extinguished, subordinated, or impaired.

   As used in paragraph 1(a), the words "covenants, conditions, or restrictions" do not refer to or include any covenant, condition, or restriction (a) relating to obligations of any type to perform maintenance, repair or remediation on the Land, or (b) pertaining to environmental protection of any kind or nature, including hazardous or toxic matters, conditions, or substances, except to the extent that a notice of a violation or alleged violation affecting the Land has been recorded or filed in the Public Records at Date of Policy and is not referenced in an addendum attached to this policy.

2. Any easements or servitudes appearing in the Public Records; however, this policy insures against loss or damage arising from (a) the encroachment, at Date of Policy, of the improvements on any easement, and (b) any interference with or damage to existing improvements, including lawns, shrubbery, and trees, resulting from the use of the easements for the purposes granted or reserved.

3. Any lease, grant, exception, or reservation of minerals or mineral rights appearing in the Public Records; however, this policy insures against loss or damage arising from (a) any affect on or impairment of the use of the Land for residential one-to-four family dwelling purposes by reason of such lease, grant, exception or reservation of minerals or mineral rights, and (b) any damage to existing improvements, including lawns, shrubbery, and trees, resulting from the future exercise of any right to use the surface of the Land for the extraction or development of the minerals or mineral rights so leased, granted, excepted, or reserved. Nothing herein shall insure against loss or damage resulting from subsidence.

All title insurance policies provide coverage forever after the date and time the policy is issued, limited in recovery to the dollar amount of the policy, which is generally adjusted for inflation. Coverage is further limited by the **exclusions, exceptions and conditions on claims**.

The CLTA standard policy (as well as the ALTA policy) contains Schedule A *exclusions to coverage* which bar recovery by the buyer or joint protection carryback seller for losses due to:

- zoning laws, ordinances or regulations restricting or regulating the **occupancy, use or enjoyment** of the land;
- the character, dimensions or location of any **improvement erected** on the property;
- a **change in ownership** or a parceling or combining of the described property by the insured buyer;
- **police power**, eminent domain or violations of environmental protection laws, unless a notice or encumbrance resulting from the violation was recorded with the county recorder before closing;
- encumbrances **known** to the insured buyer or lender which are not recorded or disclosed to the title company;
- encumbrances which do not result in a **monetary loss**;
- encumbrances which are created or become encumbrances **after issuance** of the policy;
- encumbrances resulting from the buyer's payment of **insufficient consideration** for the property or delivery of improper security to the lender also insured under the policy; and
- the unenforceability of the insured trust deed lien due to the lender's **failure to comply** with laws regarding usury, consumer credit protection, truth-in-lending, bankruptcy and insolvency.

The CLTA standard policy contains **pre-printed exceptions** listed in the policy as Schedule B, also called *standard exceptions* or *regional exceptions*. It is the inclusion of these pre-printed boilerplate exceptions which makes the CLTA policy a standard policy. An ALTA owner's policy does not contain pre-printed exceptions, only the typewritten exceptions listing the encumbrances which are known to the title company and affect title to the property.

The **pre-printed standard exceptions** in Schedule B of the CLTA standard policy eliminate coverage for losses incurred by the buyer due to:

- taxes or assessments not shown as existing liens in the records of the county recorder, the county tax collector or any other agency which levies taxes on real property;
- unrecorded rights held by others which the buyer could have discovered by an inspection of the property or inquiry of persons in possession;
- easements or encumbrances which are not recorded and indexed by the county recorder;
- unrecorded encroachments or boundary line disputes which would have been disclosed by a survey; and
- recorded or unrecorded, unpatented mining claims or water rights.

A lower premium is charged to issue a CLTA policy since the title company undertakes a lower level of risk for indemnified losses due to the CLTA pre-printed exceptions as compared to the extended risks covered by the more expensive ALTA owner's policy.

The ALTA owner's policy and survey

Most policies issued today are of the American Land Title Association (ALTA) variety since the California Land Title Association (CLTA) policy format with pre-printed standard exceptions does not provide protection for **unrecorded encumbrances or claims** to title.

The ALTA owner's policy provides greater coverage (and requires greater premiums) than the CLTA policy since the exceptions in Schedule B do not include the pre-printed standard exceptions. If the pre-printed exceptions are included in Schedule B and attached to the ALTA policy, the policy becomes an ALTA standard policy, comparable in cost and coverage to the CLTA standard policy since unrecorded encumbrances will not be covered.

The ALTA owner's policy covers **off-record matters** not covered under the CLTA standard policy. As a result, the title company may require the parcel to be surveyed, and those in possession of the property to be interviewed or estopped, before the title company will issue an ALTA policy. Unrecorded interests in title are most often observable by an on-site inspection of the property.

Typewritten exceptions for existing encroachments or boundary conflicts are occasionally added to the ALTA policy (Schedule B) based on the survey.

The exclusions section of an ALTA owner's policy are identical to exclusions in the CLTA policy, except for additional exclusions relating to an insured lender or carryback seller. The ALTA owner's policy is not issued to secured creditors. More precisely, a joint protection ALTA policy is never issued.

Thus, separate policies and duplicate premiums are required for a lender's ALTA coverage when a buyer of property records a new loan.

The premium for an ALTA owner's policy is larger than the premium for a CLTA standard policy. The ALTA owner's policy provides additional coverages and may, as a requisite to issuance, require costs to be incurred for a survey.

Further, the premium is nearly doubled to pay for both a lender's policy and the buyer's policy when a new loan is recorded to fund the purchase of real estate acquired by the buyer. This is not the case for a CLTA joint protection policy covering both the lender and the buyer.

The ALTA residential policy

For buyers of parcels of real estate containing one-to-four residential units, an American Land Title Association Residential (ALTA-R) policy is available in lieu of the ALTA owner's or homeowner's policies. Parcels insured include lots and units in common interest developments (CIDs), such as condominiums.

The ALTA-R is referred to by the title companies as the *"plain language"* policy. The ALTA-R is written using wording which avoids legalese. The policy is structured and written to be easily read and understood by the average buyer. Also, the ALTA-R policy contains a **table of contents** and an **owner's information sheet** which outlines the policy's features.

The coverage, exclusions and exceptions in the ALTA-R policy are similar to the ALTA owner's policy. In addition, the ALTA-R policy covers losses due to:

- mechanic's liens incurred by someone other than the buyer; and
- the inability of the buyer to occupy the property should the single family residence violate the conditions, covenants and restrictions (CC&Rs) listed in the Schedule B exceptions in the policy or existing zoning.

The premium for an ALTA-R policy is priced lower than the premium for an ALTA owner's policy since the ALTA-R policy is usually issued only on parcels in an existing subdivision or CID which has no known problems with easements, encroachments or legal access.

The ALTA homeowner's policy

A **homeowner's policy** now exists to provide **more coverage** than the American Land Title Association (ALTA) owner's or the American Land Title Association Residential (ALTA-R) policies. In addition to the risks covered by the ALTA owner's and ALTA-R policies, the homeowner's policy covers several risks to ownership which could arise **after closing**, including:

- the **forging** of the buyer's signature on a deed in an attempt to sell or encumber the buyer's property;
- the construction on an adjoining parcel of a structure which **encroaches** onto the buyer's property, excluding a boundary wall or fence;
- the recording of a document which prevents the buyer from obtaining a secured loan or selling the property;
- claims of **adverse possession** or **easement by prescription** against the buyer's property; and
- claims by others of a right in the buyer's property arising out of a lease, contract or option **unrecorded and unknown** to the buyer at the time of closing.

The ALTA homeowner's policy also covers losses arising out of a lack of **vehicular and pedestrian access** to and from the property. Other owner's policies only cover losses resulting from the lack of a legal right to access, not a practical means of access which is covered by the ALTA homeowner's policy.

Also covered by the ALTA homeowner's policy are losses incurred due to many other risks which may exist at the time of closing, including:

- the correction of any pre-existing violation of a condition, covenant and restriction (CC&R);
- the inability to obtain a building permit or to sell, lease or use the property as security for a loan due to a pre-existing violation of a subdivision law or regulation;
- the removal or remedy of any existing structure on the property if it was built without obtaining a building permit, excluding a boundary wall or fence;
- damage to existing structures due to the exercise of a right to maintain or use an easement;
- damage to improvements due to mineral or water extraction;
- the enforcement of a discriminatory CC&R;
- the assessment of a supplemental real estate tax due to construction or a change of ownership or use occurring before closing;
- an incorrect property address stated in the policy; and
- the map attached to the policy showing the incorrect location of the property.

Encumbrances relating to the insured title and known to the title company will be itemized in the policy as additional exceptions which limit coverage. The exceptions should be reviewed by the buyer and the buyer's broker in a preliminary title report before closing and issuance of a policy.

The ALTA homeowner's policy contains the same exclusions from coverage stated in the ALTA-R policy, plus an exclusion for any **building code violations**, unless notice of the violation has been recorded with the county recorder (in which case it would be known to the title company and listed as an exception).

Before a ALTA homeowner's policy will be issued by a title insurer, two requirements must be met:

- the property must be *improved* with a one-to-four unit family residence; and
- the buyer must be a natural person, not an entity such as a corporation, limited liability company (LLC) or partnership.

Many title insurance companies use the ALTA homeowner's policy as their "default policy," which they will issue if a specific title policy is not requested by escrow. The premium for the policy is approximately 10% more than the California Land Title Association (CLTA) owner's policy.

Unless the buyer (or seller) calls for a CLTA standard policy, ALTA owner's or ALTA-R policy in the purchase agreement and escrow instructions, the title company will, by the default of the escrow, automatically issue the more expensive policy.

Binders for resale on a flip

An investor who buys property and plans on reselling it within two years after his purchase should be advised by the buyer's agent to consider a binder, also called a *commitment to issue.*

A binder entitles the buyer to title insurance coverage until the buyer requests a policy be issued to a new buyer on resale of the property or to a new lender on a refinance. An example is a relocation agent (broker) who temporarily takes title to a residence before it is resold to the ultimate buyer or an investor who intends to flip the property.

With a binder, the resale policy will be at no further charge, except for additional liability coverage requested for any increase in the resale price or loan amount.

Lender policy options

The California Land Title Association (CLTA) and American Land Title Association (ALTA) title policies available to insure the priority of the lien a lender holds to secure their loan, include:

- a CLTA standard joint protection (JP) policy; and
- an ALTA loan policy.

The CLTA standard JP policy

A lender or seller who carries back a note and trust deed for part of the sales price has options when calling for title insurance.

The lender or carryback seller can either:

- be named as an additional insured on a California Land Title Association (CLTA) standard joint protection (JP) title insurance policy with the buyer; or
- request a separate American Land Title Association (ALTA) loan policy as a only named insured.

The JP policy enables one or more individuals or entities to be named as insured.

In addition to the owner's standard CLTA title coverage, the JP policy provides coverage for a trust deed held by a lender or carryback seller. Thus, the JP policy indemnifies the lender or carryback seller against losses arising from risks such as:

- the invalidity or unenforceability of the insured creditor's trust deed lien;
- the priority of a lien or other encumbrance which was not listed in the policy exceptions; and
- the invalidity or unenforceability of an assignment of the insured trust deed when the assignment is listed in the exceptions as affecting the trust deed.

If a loss covered by a JP policy occurs, the named insureds suffering from the loss will share in any recovery up to the dollar limit of the policy, subject to disbursements based on their priority or pro rata

interest between themselves in title. Thus, recovery by both the owner and the secured creditor under the JP is not cumulative, nor should it be.

Accordingly, no windfall occurs since title policies only indemnify an insured against the insured's actual monetary loss. If there is no loss of value, there is no basis for recovery.

Most **policy limits** are established based on the value of the property, and as part of that value, the loan amount. Thus, the owner and the lender are fully protected under a JP policy since the aggregate value of their interests (debt and equity) do not exceed the policy limits on closing.

Accordingly, once a policy loss has been paid to an insured owner, lender or carryback seller, the amount of coverage under the policy is reduced.

However, the JP policy is only available under a CLTA standard policy. If either the buyer or lender in a cash-to-new-loan transaction requests ALTA coverage, a separate ALTA loan policy will be issued to each at approximately double the cost.

The ALTA loan policy increases costs

An institutional lender will usually require its trust deed lien on a parcel of real estate to be insured under an American Land Title Association (ALTA) loan policy as a condition for making a loan secured by real estate.

The ALTA loan policy insures against money losses incurred by lenders and carryback sellers due to the loss of priority of the insured trust deed lien, unless listed in the exceptions, to encumbrances such as:

- a mechanic's lien, if the work was commenced prior to recording the trust deed (which is the same date and time as the date of the policy) and the trust deed did not secure a loan to pay for the construction;
- a mechanic's lien arising out of work financed by proceeds from the construction loan secured by the insured trust deed, if no part of the construction work was commenced before the trust deed was recorded; and
- assessments (Mello-Roos) for street improvements under construction or completed prior to recording the trust deed.

However, the ALTA policy does not cover losses resulting from lack of priority of the insured trust deed to a mechanic's lien if:

- the secured loan was not a construction loan designed to finance construction; and
- no part of the construction work which led to the mechanic's lien commenced before the trust deed was recorded.

ALTA **exclusions** in lender policies eliminate coverage for claims arising out of a loan transaction due to the operation of federal bankruptcy law, state insolvency or similar creditors' rights laws, if the claims are based on:

- a *fraudulent conveyance* to the vested owner to conceal assets;
- the *equitable subordination* (a court ordered assignment) of the insured lender's lien; or
- the insured lender's trust deed being deemed a *preferential transfer* by a bankruptcy court due to the recording of the trust deed within 90 days before a bankruptcy filing.

The ALTA loan policy comes at a higher (and separate) premium than the California Land Title Association (CLTA) standard joint protection (JP) policy due to the extended mechanic's lien and assessment

coverage, the need to pay premiums on two title policies and the cost of any survey required before issuing a title insurance policy. A buyer who borrows funds to finance his purchase usually pays the premium for the lender's policy.

Endorsements for special occasions

Endorsements of great variety can be added to title insurance policies to provide coverage for title conditions and use or economic conditions not covered by the prototypical policies. **Endorsements** are usually issued only to lenders, though modified endorsements can be used in owner's policies as well, particularly for developers and builders.

Endorsements cover losses incurred due to violations of conditions, covenants and restrictions (CC&Rs), damage from extraction of water or minerals, mechanic's liens, encroachments (conditions covered in an American Land Title Association Residential (ALTA-R) policy) and the effects of inflation. Endorsements are also issued to remove an exclusion or exception which is an unwanted boilerplate provision in a policy.

Who is insured?

Those insured under the California Land Title Association (CLTA) standard policy, American Land Title Association (ALTA) owner's policy or American Land Title Association Residential (ALTA-R) policy, include the name of the insured in **Schedule A** and those **who succeed** to the interest of the named insured by *operation of law*, not by purchase, including:

- heirs;
- distributees;
- devisees;
- joint tenancy or community property survivors;
- personal representatives;
- next of kin by intestate succession; and
- corporate or fiduciary successors.

If title is to be transferred to another vesting, concurrently or within a few months, request should be made the title company to include that vesting as a named insured by endorsement.

However, the ALTA homeowner's policy requires the insured and any covered successor to be **an individual** or the trustee of an inter vivos (living) trust, not an entity such as a Limited Liability Company (LLC). A transfer of title by an insured to their revocable inter vivos trust is covered by the ALTA homeowner's policy without endorsement. This is not the case for other policies.

A policy covering an owner does not cover a buyer who purchases the insured property from the owner. A new policy must be obtained, unless the seller holds a **binder** and uses it to issue a policy in the name of the buyer.

Those insured under a lender's policy of title insurance include:

- the lenders described in the policy;
- future purchasers of the insured trust deed, except assignees who acquire the trust deed as a result of an indemnity, guaranty, other policy of insurance or bond held by the insured lender; and
- any government agency — such as Housing and Urban Development (HUD) and the Veterans Administration (VA) — which insures or guarantees the loan secured by the insured trust deed.

A lender's policy also insures:

- the lender's ownership of the described real estate due to a foreclosure or a deed-in-lieu of foreclosure;
- a parent or wholly owned subsidiary of an insured corporation who acquires the insured corporation's lien by operation of law (merger or spinoff), but not by purchase; and
- a government agency which acquires any interest in the insured lien as a result of mortgage insurance or guarantee.

Settling a claim

To begin the claims process, the insured, on becoming aware of an encumbrance covered as a loss by the policy of title insurance, must promptly give the title insurance company written **notice of claim**.

Upon being notified of the claim, the title company has 15 days to:

- acknowledge receipt of the claim or pay the claim;
- provide the insured with all forms, instructions, assistance and information necessary to prove up the claim; and
- begin any investigation of the claim. [10 Calif. Code of Regulations §2695.5(e)(1-3)]

Further, the insured must provide the title company with a *proof-of-loss statement* within 90 days after incurring the loss. The statement must set forth the encumbrance discovered, the amount of the loss, and the basis for calculating the loss. The title company may also require the insured party to make available records, checks, letters, contracts, insurance policies and other papers related to the claim.

After receipt of the 90-day **proof-of-claim statement**, the title insurance company has 40 days to **accept or reject** the claim, in whole or in part. [10 CCR §2695.7(b)]

On accepting a claim as one covered by the policy, the title company may handle the claim in one of several ways, including:

- **pay policy limits**, plus any authorized costs, attorney fees and expenses incurred by the insured;
- **pay the loss** incurred by the insured, plus costs, attorney fees and expenses;
- negotiate a **settlement**;
- bring or defend a **legal action** on the claim; and
- for an insured lender, **purchase the loan** from the lender for the amount owed by the borrower, plus any authorized costs, attorney fees and expenses incurred by the insured lender.

No payment will be made under a policy without **producing the policy** for payment. If the policy has been lost or destroyed, proof a policy existed must be furnished to the satisfaction of the title company. The documents insured, such as a grant deed or trust deed, contain on their face the title insurer's name and policy number.

Finally, the loss must be paid within 30 days after the loss has been established. [10 CCR §2695.7(h)]

Extent and limitation of liability

The **conditions section** of a title insurance policy limits the amount the title company is required to pay to settle a claim made by an insured owner, tenant or lender.

For owners, the title company can settle a claim by paying the lesser of:

- the full dollar amount of the policy; or
- the reduction in value of the insured's ownership interest caused by the title defect or encumbrance not listed in the policy exceptions which were missed by the title company.

For lenders, the title company can settle a claim by paying the lesser of:

- the full dollar amount of the policy;
- the impairment or reduction in value of the security interest due to the title defect or encumbrance not listed in the policy exceptions; or
- the amounts due on the unpaid loan at the time of the loss caused by a defect or encumbrance not listed in the policy exceptions.

The title company will not pay a claim:

- if the title company is able to remove the encumbrance from title;
- until any litigation over the encumbrance has become final; or
- if the owner or lender settles the claim without written permission of the title company.

Additionally, if the lender is the insured, the title company will not cover additional loan amounts which become secured by the trust deed after the insured trust deed is recorded, called *future advances*.

Future advances made by lenders are covered if the advances are:

- on an insured construction loan;
- to foreclose on a loan;
- to protect title to their lien rights; or
- to preserve the real estate from impairment.

All payments made by the title insurance company to pay claims, except payments made for costs, attorney fees and expenses, reduce the dollar amount of coverage remaining under the title policy.

Underinsured and apportioned losses

In addition to all the limitations on the title company's obligation to pay under a policy, the American Land Title Association (ALTA) owner's policy contains *underinsurance* and *apportionment* provisions. These provisions further limit payout by the title company by shifting a percentage of the loss to the insured. **Underinsurance** and **apportionment** provisions are not contained in policies other than ALTA owner's policies since other policies are not issued on large projects.

The **underinsurance provision** of the ALTA owner's policy is triggered when a claim is made, if:

- the amount of the policy limits is less than 80% of the value of the insured real estate or security interest on the date the policy was issued, which arises if the policy is for less than the price paid for the property; or
- an improvement has been erected on the real estate after issuance of the policy which increases the value of the property by at least 20% over the policy limits.

Thus, the underinsurance provision subjects the recovery on any partial loss to the following:

- the title company pays a pro rata amount based on the percentage that the policy limit is of the property value at the time the policy was issued, when improvements have not been made; or
- if improvements have been made, the title company pays a pro rata amount based on the percentage that 120% of the policy limits represents of the total of the policy limits (usually the price paid for the property) and the cost of the improvement.

The underinsurance provision does not apply to costs, attorney fees or expenses which the title company pays under the ALTA owner's policy. Further, the underinsurance provision only applies to that portion of any loss which exceeds 10% of the policy limits.

For example, an owner of a property valued at $2,000,000 on the date of the policy receives an ALTA owner's title policy with a policy limit of $1,400,000. The owner erects no improvements on his property. An undisclosed encumbrance on title results in a loss of $600,000. The owner of the property seeks recovery from the title company.

According to the underinsurance provision in the ALTA owner's policy, the owner would not be indemnified for the entire loss. Only $462,000 will be paid, being 10% of the policy limit, plus a percentage of the remaining loss based on a policy-limits to property-value ratio.

The amount of the loss which exceeds 10% of the policy limit is $460,000 ($600,000-$140,000 = $460,000). The percentage the policy limit represents of the property value on the date of the policy is 70% ($1,400,000/$2,000,000 = 70%).

Accordingly, the title company pays $140,000 (10% of the policy limit) and $322,200 (70% of the $460,000 remaining loss) for a total settlement of $462,000 on the $600,000 loss.

The ALTA owner's policy **apportionment provision** further limits the title company's pay out. The apportionment provision is triggered when the insured property consists of two or more parcels which have not been combined for use as a single site. If a loss affects less than all of the parcels, the loss will be settled based on each lot's value when the policy was issued as a pro rata share of the policy limit. Improvements made after the date of the policy are excluded.

Transfer of rights on settlement

On payment of a claim or elimination of the defect or encumbrance, called *settlement*, all the rights the owner may have against any person or property causing the paid loss are assigned to the title company under a *subrogation provision* in the policy.

Further, the title company has the right on settlement to sue, compromise or settle in the name of the insured to enforce the rights assigned to the title company.

Should the title company recover any money by enforcing the rights assigned to them by the owner, the title company will pay any loss sustained by the owner which was not covered or already paid under the policy. The title company retains any recovery remaining after paying the owner's loss.

Chapter 30 Real estate can be stolen

This chapter reviews the scheme for acquiring ownership of property by adverse possession.

Adverse possession becomes ownership

While real estate is not an item a thief can pick up and carry off, the ownership or rights in ownership to real estate is capable of being stolen — if you are not first caught **trespassing** and **ejected**. The means by which the law justifies a private taking of another's ownership is known as *adverse possession*.

Adverse possession is the only means by which the law will take 100% of an individual's legal or equitable ownership interest in a parcel of real estate and give it to another individual without **compensation**.

The doctrine of adverse possession is based on a social and economic rationale suggesting real estate should not lie idle. An individual who puts another's land to use without interference and pays taxes imposed on the property — *ad valorem* — is allowed to enjoy the benefits of continued long-term possession, namely **ownership**.

The use-it-or-lose-it rationale has remained unchanged since its inception when the doctrine of adverse possession was established to dispossess medieval lords of their stranglehold on fertile farmland in England.

Adverse possession is often confused with and must be **distinguished** from other legal principles establishing control over another's land, such as:

- boundary disputes;
- encroachments;
- easements by necessity; and
- prescriptive easements.

Possession under a rental agreement or lease is the antithesis of adverse possession since they require consent by conveyance of the right to possession. An individual claiming adverse possession will have his claim barred if he occupies the property as a tenant under a rental agreement or lease at any time during his five year claim.

Boundary disputes distinguished

Adverse possession is not connected with an individual's possession of another's property under the doctrine of *title by agreed boundaries*. [See Chapter 13]

The **agreed-boundary** doctrine applies when uncertainty exists between neighbors concerning the exact location of the legally described boundary between the properties. For example, an individual occupies land, by agreement with his neighbor, which the individual believes to be his own, but is located beyond his legally described lot line onto his neighbor's adjacent property.

Conversely, adverse possession is the **private taking** of another's land and the payment of taxes, knowing it is not yours and without permission from the true owner.

Encroachments distinguished

Encroachments are similar to boundary disputes. The distinguishing factor between the two is that an **encroachment** is a dispute between owners of adjoining property which results not from a simple misplaced fence or boundary line, but from the location of *improvements* by one property owner which improperly cross over the common boundary line and intrude into his neighbor's property. [See Chapter 15]

The owner of the encroaching improvements will be able to retain the improvements if the encroachment is relatively minor and resulted from the honest mistake of the owner or builder. [See Chapter 15]

Easement by necessity and prescription

An *easement by necessity* also differs from adverse possession. Easements are based on the *concurrent use* by a non-owner of another's property. By contrast, adverse possession is based on the **exclusive use** of another's property.

Typically, an **easement by necessity** is granted across a property when a neighboring property is unintentionally landlocked from access to a public right of way. [See Chapter 21]

The distinguishing feature of an easement by necessity is that it is granted by court order when no prior use of the easement might have existed. Conversely, adverse possession results from an individual's exclusive use of a property maintained by continuous and uninterrupted possession.

Most easily confused with adverse possession is a *prescriptive easement*. Like adverse possession, a **prescriptive easement** over another's property is an uncompensated *private taking* without the owner's consent.

However, a prescriptive easement only involves the non-exclusive (concurrent) and limited *right to use* another's real estate without any obligation to pay property taxes. On the contrary, **adverse possession** is concerned with acquiring the ownership of real estate with its right to **exclusive possession** and obligation to **pay taxes**. [**Silacci** v. **Abramson** (1996) 45 CA4th 558; see Chapter 21]

Adverse possession criteria

Any person claiming title to property through **adverse possession** must satisfy specific criteria to *perfect his claim* of ownership. If any portion of the criteria is not met, the adverse possessor's claim to ownership has not been perfected.

The criteria for **perfecting ownership** by an adverse possession claim are:

- a color of title or claim of right to title;
- actual, notorious and open possession;
- hostile, adverse and exclusive use;
- continuous and uninterrupted possession for five years; and
- payment of current and delinquent real estate taxes and assessments. [**Gilardi** v. **Hallam** (1981) 30 C3d 317]

Color of title or claim of right

Two distinct types of adverse possession claims exist:

- a claim of ownership based on a written instrument, called a *color of title* claim [Calif. Code of Civil Procedure §322]; or
- a claim of ownership made without any documentation, except possession and payment of taxes, called a *claim of right*. [CCP §324]

The **color of title** claim is used to defend the claim of ownership held by the individual in possession of the property. This defense is used against the person who holds recorded title and seeks to:

- wrest possession of the property from the occupant, called an *adverse possessor*; and
- clear title of the cloud created by the document which supports the adverse possessor's color of title claim.

To perfect a color of title claim, the **adverse possessor** presents written documentation demonstrating he is the owner of the property. This documentation need not be valid to support a color of title claim, and typically is defective and unenforceable. The adverse possessor only needs to show he has a good faith belief he is the true owner of the property.

For example, real estate is conveyed by a recorded grant deed to an individual on the distribution of a deceased relative's estate. The individual takes possession of the property and exercises the rights and responsibilities of ownership.

Later, it is discovered the deceased relative in fact was only a lessee, not the record owner of the property, and had no legal title to convey. However, the individual has an adverse possession claim to the property based on the **color of title** since he had a good faith belief the deed he received was valid. [**Helvey** v. **Lillis** (1934) 136 CA 644]

Conversely, adverse possession by **claim of right** attacks the title held by the recorded owner and takes possession of the property with the intent to interfere with that title.

A person whose adverse possession is based on a claim of right is merely a *trespasser* or *intruder* who has taken possession of a property without any belief he is the true owner.

Consider an adverse possessor who takes possession of an unoccupied residential property under a claim of right, then rents the property to a tenant.

The absentee owner of the property seeks to terminate the adverse possessor's occupancy within five years of the adverse possessor taking possession. The owner claims the adverse possessor is a criminal trespasser since he entered the property with the intent of interfering with the owner's property rights. The adverse possessor claims he is not a trespasser since his renting out of the property conferred on him a title by occupancy.

In this example, the adverse possessor is acting as a trespasser. The adverse possessor did not adversely occupy the property (and pay property taxes and any liens arising out of unpaid property taxes) for the five-year period required for his (or his tenant's) possession to ripen into ownership with the right to marketable title. [**People** v. **Lapcheske** (1999) 73 CA4th 571]

Additionally, an individual who has a mistaken but good faith belief he has an ownership interest in a property, but no documents to validate his ownership, establishes his adverse possession claim against the true owner under a claim of right. [**California Maryland Funding, Inc.** v. **Lowe** (1995) 37 CA4th 1798]

An adverse possessor's claim to ownership is based upon his willingness and ability to defend his possession of the property against others who may claim title, including the actual legal owner of record. [**Brown** v. **Berman** (1962) 203 CA2d 327]

Proving ownership by adverse possession based on a claim of right is more difficult than by color of title which relies on title documentation. Evidence of five years of continuous adverse and hostile possession and use by the adverse possessor and the payment of property taxes is required to prove ownership under a claim of right. [**Thomson** v. **Dypvik** (1985) 174 CA3d 329]

Actual, notorious and open possession

An adverse possessor must show he has been in *actual possession* of the property to which he is claiming ownership. [**Howell** v. **Slauson** (1890) 83 C 539]

Actual possession may be by the adverse possessor himself or by a tenant who rents the property from the adverse possessor. [**Palin** v. **Sweitzer** (1937) 8 C2d 329]

If the adverse possession claim is made under a **claim of right**, the adverse possessor must demonstrate his actual possession of the property by one of the following:

- surrounding the property with a substantial, protective enclosure;
- cultivating the property; or
- improving the property. [CCP §325]

A **substantial enclosure** must completely surround the claimed property and restrict access to the property by others, including the legal owner of record. [**Jones** v. **Hodges** (1905) 146 C 160]

The enclosure may be a fence, a natural barrier (such as a body of water), or a combination of each if the enclosure restricts access to the property. [Palin, *supra*]

Further, the enclosure must be **properly maintained** during the period the adverse possessor occupies the property. A fence which has deteriorated over time and is not in repair is an insufficient enclosure to put the legal owner of record on notice that another person is occupying the property. [**Ross** v. **Burkhard Inv. Co.** (1928) 90 CA 201]

An adverse possessor occupying property under *color of title* may show possession through one of the claim of right methods, or he may show that he used the land similar to the usage of like properties in the area. [CCP §323]

For example, an occupant of a property under **color of title** believes he is the true owner of the property based on a conveyance he received. However, the occupant has only cultivated a portion of the property described in the conveyance, leaving the remainder untouched.

Since the document of conveyance, which the occupier believes in good faith gave him title, describes the entire property, he will be deemed to have actual possession of the entire property, even though he only uses a portion of it. [CCP §322]

Conversely, a claim of right possessor cultivating land in a situation similar to the preceding color of title example is only able to claim that portion of the entire parcel he cultivated, not the portion of the parcel he left untouched. [CCP §324]

Additionally, the owner of the property against which an adverse possession claim is made must be **on notice** of the possessor's adverse activity regarding the property. This notice may be either *actual* or *constructive*.

Actual notice means the owner is personally aware of the occupancy or the adverse possessor's claim against his land.

However, the owner has **constructive notice** if, upon viewing the property, a reasonable person would know the adverse possessor appears to hold some interest in the property due to his occupancy. [**Myran** v. **Smith** (1931) 117 CA 355]

Hostile and adverse use

When an individual claims ownership under **color of title**, the existence of a document which purports to vest title in the individual, in conflict with the true title, satisfies the *hostile and adverse* possession requirements.

For possession to qualify as *hostile and adverse* under a **claim of right**, the possession must be without any permission or consent from the legal owner of record, and without regard to any rights of the true owner, which is the case under a lease or tenancy at will.

Consider a wife who holds title and occupies a single family residence, paying all mortgage installments, taxes and maintenance costs. The couple divorces and the husband is awarded the residence.

Title is never vested in the husband, nor does he ask his wife to move out or pay rent. The wife continues to make mortgage payments, pays property taxes and remodels the residence.

More than five years after the divorce is final, the wife lists the property for sale. The husband files an action to have title conveyed to him.

The wife claims she is the owner of the property by adverse possession.

However, the wife is not an adverse possessor since her possession of the property was not hostile and adverse. The husband allowed the wife to use the property as long as she paid all the obligations of ownership. [**Buic** v. **Buic** (1992) 5 CA4th 1600]

Now consider a husband who owns his residence as separate property. Unknown to his wife, he deeds the property to himself and his son from a previous marriage as joint tenants.

Later, the husband dies and the son asks the wife to vacate the residence.

The wife refuses to vacate the residence, claiming the residence is community property and she is now the owner due to her husband's death. The wife makes mortgage payments, pays property taxes and remodels the house. When the son lists the property for sale, she interferes with the "For Sale" signs.

More than five years after the husband's death, a buyer purchases the residence and seeks to eject the wife as a trespasser.

The wife claims she is entitled to ownership of the property under adverse possession. The buyer claims the wife's possession was permitted by the surviving son and is thus not hostile or adverse.

Is the wife's possession hostile and adverse?

Yes! The wife's possession is hostile and adverse since her actions are consistent with her belief that she is the owner of the property and not the son. [California Maryland Funding, Inc., *supra*]

Consider another buyer who constructs a home on a newly subdivided lot and pays all the property taxes. More than five years later, the buyer discovers his home is actually located on land legally described as his neighbor's property.

The buyer's use and improvement of the property are sufficiently hostile and adverse to establish his claim of ownership of the property he occupies, regardless of the true legal ownership. [**Kunza** v. **Gaskell** (1979) 91 CA3d 201]

Exclusive use

A possessor's *exclusive use* of a property is required to perfect any adverse possession claim, whether based on color of title or claim of right. If another person concurrently or intermittently uses the property without consent from the adverse possessor, the possessor's claim will be defeated.

For example, an adverse possessor who has occupied and used a parcel of real estate seeks to perfect his ownership interest by adverse possession. However, without permission from the adverse possessor, a neighboring property owner used the same property for storage and grazing during the period of the adverse possessor's occupancy. Accordingly, the adverse possessor's claim to ownership is denied for lack of **exclusive use**. [Myran, *supra*]

However, the occasional use of the property by the public (i.e., for recreational activities, as a right of way, etc.) will not affect an adverse possession claim. [**Webber** v. **Clarke** (1887) 74 C 11]

Continuous and uninterrupted use

An adverse possessor must have occupied a property for at least **five years** before he will be able to acquire title through adverse possession. [CCP §325]

Any interruption in the adverse possessor's possession of the property, such as use by another not authorized by the possessor, will negate the continuity of the five-year period, barring an adverse possession claim. [**Laubisch** v. **Roberdo** (1954) 43 C2d 702]

However, the adverse possessor need not be in continuous possession of the property to satisfy the **continuous possession** requirement. Exceptions to the continuous possession requirement include:

- vacancies between tenants of rental property [Montgomery & Mullen Lumber Co. v. Quimby (1912) 164 C 250];
- vacancies of homes built on subdivided property and not immediately sold [**Blume** v. **MacGregor** (1944) 64 CA2d 244]; and
- off-season vacancies of property used for agriculture or grazing. [**Park** v. **Powers** (1935) 2 C2d 590]

Continuous possession by an adverse possessor acting under a **claim of right** must encompass a constant, definable portion of the property. The claim-of-right possessor's use of different portions of a property at different times for a total of five years will not satisfy the continuity requirement.

For example, an adverse possessor, relying upon a claim of right, who uses part of a property for two years, then uses a different part of the property for three years, has not satisfied the five-year requirement. [**Zimmer** v. **Dykstra** (1974) 39 CA3d 422]

Payment of taxes

An adverse possessor must demonstrate he has **paid all taxes** due on the property during each year of his five year qualifying occupation. [CCP §325]

Additionally, the adverse possessor must pay any **back taxes** owed on the property when he took possession. [**City of Los Angeles** v. **Coffey** (1966) 243 CA2d 121]

In a situation where the taxes are assessed to both the true owner and the adverse possessor, the requirement will be satisfied if the adverse possessor pays the taxes which are assessed to him, without regard to their payment by the true owner. [**Cummings** v. **Laughlin** (1916) 173 C 561]

If the taxes are assessed only to the owner, the adverse possessor must pay the taxes before the **owner pays** them. Paying taxes after the owner will not satisfy the payment of taxes requirement and the possessor will not be able to obtain legal title through adverse possession. [**Carpenter** v. **Lewis** (1897) 119 C 18]

Chapter 31 Community property rights

This chapter explains the effect a marriage has on a spouse's ability to sell or encumber real estate.

Brokers have a role to play

A broker who represents a married individual in a sale, purchase, lease or financing of community real estate must know whether the performance of the married individual under a listing (paying the fee) or purchase agreement (closing escrow) can be negated by community property defenses held by the other spouse. If so, they can inflict a loss on the broker.

For example, a broker obtains an *exclusive right-to-sell listing* signed only by the wife. The real estate listed is community property, vested in the name of the husband and wife as joint tenants.

During the listing period, the husband and wife sell the property themselves without providing for payment of a fee to the listing broker. The **exclusive listing** agreement entitles the broker to a fee if the property is sold by anyone, including the husband and wife, during the listing period. [See **first tuesday** Form 102 §4.1(a)]

The broker claims both the husband and wife are liable for the brokerage fee since the property is a community asset and was sold during the listing period.

The wife claims the listing is unenforceable without the husband's signature since the property listed cannot be sold and conveyed without her husband's written consent.

Is the broker entitled to his fee?

Yes! While the husband, who did not sign the listing agreement, is not personally liable for the brokerage fee, the wife is liable for the fee. The wife signed the exclusive listing agreement employing the broker to render professional services to market the property and locate a buyer. The broker's enforcement of his fee agreement under the listing is an action for money due on an employment agreement, not an action for specific performance to deliver title under a real estate purchase agreement — which would require both spouses' signatures. [**Tamimi** v. **Bettencourt** (1966) 243 CA2d 377]

Judgment against a spouse

Continuing with our previous example, on recording an *abstract of judgment* against the wife for the brokerage fee, the judgment becomes a lien on **any community real estate** owned by the couple. However, the husband's separate property is not liened and is unaffected by the abstract.

Consider a husband who encumbers community property with a trust deed, executed by the husband alone and without the consent of his wife, to secure a note which evidences a loan.

Later, the trust deed held by the lender is set aside in an action by the wife to clear title of the trust deed since the wife did not consent to the encumbrance (financing) of the community property.

The husband defaults on the now unsecured loan. The lender obtains a money judgment against the husband and records an abstract of judgment.

The abstract now attaches as a lien to all community real estate, including the same community property which had been previously encumbered by the voided trust deed.

Later, the couple's marriage is dissolved and the wife is awarded sole ownership of the community property which had been cleared of the trust deed lien.

The wife claims the money judgment lien cannot attach to the property since the debt which became the money judgment had been secured by the same property under a trust deed the court declared void.

However, when the abstract of judgment against the husband was recorded, the abstract created a valid lien on all of their community property, including the property now solely owned by the wife. The judgment attached to the property while it was still community property, before the dissolution of the marriage. [**Lezine** v. **Security Pacific Financial Services, Inc.** (1996) 14 C4th 56]

Transfer by transmutation

A husband and wife divide their community assets between themselves so they can conveniently pass the assets on to their children from previous marriages.

The husband and wife do not provide for the division of the funds received by the husband from his pension fund. However, the money from the pension fund is community property, even though the pension is vested only in the husband's name.

The husband places the **pension funds** into an individual retirement account (IRA) vested in the name of the husband's revocable inter vivos (living) trust. The husband obtains the wife's consent to the deposits, acknowledging she is not to be named as a beneficiary on the IRA account.

Years later, the wife asserts an interest in the IRA, claiming the funds are community property.

The husband claims the wife *transmuted* her community property interest into his separate property when she signed the consent form for the change in vesting.

Does the wife have a community property interest in the husband's IRA?

Yes! For a written declaration to express an intent to **transmute property** from a community asset to a separate asset of one spouse, the declaration signed must contain an **explicit statement** confirming the spouse *conveys and terminates* the community property interest held in the property.

The use of the word "transmutation" is not required in a **transfer document** to transmute property. A transmutation would have taken place had the consent agreement contained the provision, "I give to the account holder any interest I have in the funds deposited in this account." [**In re Estate of MacDonald** (1990) 51 C3d 262]

Consider a husband and wife who buy property with money each earned during their marriage. Escrow is instructed to vest title to the property in the wife as her sole and separate property.

Concurrent with the recording of the grant deed to the wife, the husband signs a quitclaim deed (or joins in the grant deed as the husband of the grantee) clearing title of any interest he may have in the property.

Later, the property is sold and the wife's conveyance is insured by a title company as a transfer of the entire fee ownership of the property. The husband does not sign and record another quitclaim deed, or join in the wife's conveyance.

The title insurance company considers the husband's deed on his wife's acquisition of title to the property to be the only conveyance required since the quitclaim deed was recorded.

Within one year after recording the wife's conveyance, the husband seeks to set aside the sale as voidable. The husband claims the original quitclaim deed was not a transmutation of their community property into the separate property of his wife since they only intended to vest the property so his name did not appear of record.

Is the quitclaim deed a written declaration which changed the characteristics of the property from community to separate ownership by the other spouse?

Yes! The husband's *execution* (signature and delivery) of the **quitclaim deed** transferred his interest in the community property to his wife as her separate property since the deed released all interest he held in the property. Thus, the spouse's quitclaim deed transmuted the community property into the separate property of the other spouse. [**In re Marriage of Broderick** (1989) 209 CA3d 489]

A **transmutation occurs** when a married individual or couple transfers personal or real property from:

- community property to a separate property interest of one spouse;
- a separate property interest of one spouse to community property; or
- a separate property interest of one spouse to the separate property interest of the other. [Calif. Family Code §850]

Unrecorded transmutations

A transmutation must be *written and recorded* to be effective against persons relying on the record title. The recording requirement gives **notice to others** who rely on the recorded title (such as title insurance companies, buyers, tenants or lenders) and whose rights may be affected by a transmutation (such as family members). [Fam C §852]

For example, an individual acquires property as his sole and separate property.

Later, the individual marries. The individual, now a spouse, transmutes his separate property to community property by handing his wife a signed deed from himself granting the property to himself and his spouse, as husband and wife. However, the deed which transmuted the property is never recorded.

Later, the husband sells and conveys the property. Within one year after the sales transaction closes, the wife seeks to set aside the sale, claiming she did not consent to the sale of the community real estate as evidenced by the unrecorded deed.

The buyer claims he (and his title insurer) can rely on the record title which showed the property to be vested only in the husband as his sole and separate property.

Can the sale of the community property be set aside by the wife?

No! The transmutation of the husband's separate property to community property was never recorded. Thus, the buyer (and the title insurer) can rely upon the record title. [Fam C §852(b)]

Editor's note — This situation is unlikely to occur unless the broker representing the buyer knows the transmutation rules and presses the title company to issue a policy. Title insurance companies do not readily insure the conveyance by a spouse who is the sole vested owner until the off-record spouse delivers a quitclaim deed or joins in the conveyance.

However, no reported case or statute suggests a community interest accrues which can be adjudicated and enforced against a buyer or a lender. Title companies insuring conveyances on property acquired post-1984 or acquired prior to a post-1984 marriage can and should rely on the record title.

Community status imputed to buyer

Both spouses must consent to a *sale, lease* for more than one year or *encumbrance* of community real estate. [Fam C §1102]

If one spouse, without the consent of the other, sells, leases for more than one year or encumbers community real estate, the nonconsenting spouse may either *ratify* the transaction or have it *set aside*. The nonconsenting spouse has **one year** from the recording of the nonconsented-to transaction to file an action to set it aside. If a third party to the transaction — a buyer, tenant or lender — has no notice of the marriage, the transaction cannot be set aside. [Fam C §1102]

Consider a **buyer's broker** who has knowledge the seller of real estate is married and was married when, in his own name, he acquired the property being sold. The broker does not inform his buyer (or the title company) of the seller's marital status. The property is vested of record in the name of the seller only, with no recorded reference to his married status.

Later, and within one year, the nonconsenting spouse learns of the sale and files suit to void the transaction claiming a community property interest in the real estate. The buyer claims he is a bona fide purchaser, unaware of the marital relationship at the time of the sale.

However, the **knowledge** of the buyer's broker is *imputed* to the buyer since the broker is the buyer's agent. Thus, the nonconsenting spouse is able to set aside the sale of the property, even though the buyer himself was actually unaware of the marriage. [**Waldeck** v. **Hedden** (1928) 89 CA 485]

LLC as a vesting

To circumvent the need to obtain quitclaim deeds or determine whether a transmutation has occurred, real estate can be vested in a limited liability company (LLC) solely owned by one spouse, or owned by both spouses with only one spouse as the manager of the LLC. [See Chapter 39]

For example, a wife can transfer her separate property to an LLC, and manage and control the property as the manager of the LLC. While the LLC owns the real estate, the wife owns the LLC as its sole member.

As manager, the wife is able to sell, encumber or lease the property in the name of the LLC — without her spouse's consent. [Calif. Corporations Code §§17052(f), 17157]

Other instruments and entities which can be used to authorize one spouse to manage and control community property include:

- a power of attorney;
- a revocable trust in which one spouse is the named trustee [Fam C §761(c)]; or
- a limited partnership. [Corp C §15621]

Chapter 32 The revocable title holding trust

This chapter reviews the use of a living trust vesting to avoid probate supervision of a deceased owner's estate, and distinguishes the living trust from other trust arrangements.

A review of vestings

A broker, on behalf of a prospective buyer, locates real estate on which the buyer decides to make an offer to purchase.

Before preparing a purchase agreement for the buyer to sign, the broker asks the buyer:

- How are you going to *take title* to the property?; and
- How are you going to fund the good faith deposit?

The buyer informs the broker he will take title in the name of his **family trust**, legally titled a *revocable inter vivos trust agreement* and commonly called a *living trust vesting*. The deposit for the down payment of the purchase price will be made with a check drawn on a bank account in the buyer's name **as trustee** for the living trust.

Due to the buyer's trust vesting requirement, the buyer is told he will need to provide a copy of the trust agreement (or at least the first page) on the opening of escrow. Escrow will need a copy of the trust agreement to confirm the correct name and spelling of both the trustee and the family trust for use when preparing escrow instructions and the grant deed transferring title in the living trust.

The broker, aware the buyer will fund a portion of the purchase price from the net proceeds of a **new loan**, is concerned about the vesting the lender will demand to fund and record the loan.

Since the broker knows the lender will require the buyer to take title in his own name, the broker inquires into the buyer's legal status, asking:

- Are you single, married, unmarried or widowed?; and
- On acquisition, will the property be separate property, community property or a property jointly owned with others?

The buyer informs the broker he is married and the property acquired will be community property.

To avoid vesting complications on closing, the broker informs the buyer that the lender (and the title company) will require **both spouses** to enter into the loan agreements, including the trust deed. Lenders will not accept a living trust as a borrower since a living trust is not a person or legal entity.

Thus, the buyer and his spouse will be required to take title to the property in both their names — husband and wife — as joint tenants, as community property or as community property with the right of survivorship. [See Chapter 34]

Accordingly, the broker enters the names of both the buyer and his spouse as the buyers on the purchase agreement, not naming the family trust as the buyer.

The buyer is advised that after the spouses take title and the lender's trust deed is recorded, a grant deed further conveying the property from the spouses into the family trust vesting can be recorded.

The escrow officer will be instructed to prepare two grant deeds:

- one from the seller to the buyer; and
- one from the buyer to his family trust, to be recorded after the lender's trust deed is recorded.

This "double deeding" instruction is to be part of the mutual escrow instructions signed by the seller and buyer. The lender, on receiving a copy of the escrow instructions, will have notice (as required by federal mortgage law) of the additional transfer into the family trust vesting. [12 Code of Federal Regulations §591.5(b)(1)(vi)]

Additionally, escrow will be advised the policy of **title insurance** is to be issued in the name of the buyer and his spouse as the vested owners. However, only the American Land Title Association (ALTA) homeowner's policy of title insurance automatically provides coverage for a later transfer into the revocable inter vivos trust vesting, even though only the husband and his spouse are named as the insureds. All other title insurance policies require an endorsement to insure a later transfer to the inter vivos (living) trust vesting. [See Chapter 29]

Reasons for a trust vesting

An individual owner of property, real or personal, creates a **revocable living trust** to hold title to his property for multiple reasons, primarily:

- to accommodate the **distribution** of the owner's estate which remains at the time of the owner's death, without resorting to probate proceedings under a will; and
- to retain the **interim ability** to sell, encumber, lease or remove the property from the trust vesting without the debilities imposed by other estate planning vestings, such as joint tenancy or community property vestings.

Alternatively, spouses who want to best accomplish the passing of their community property to the surviving spouse should use a right of survivorship vesting such as a joint tenancy or community property with right of survivorship vesting. These survivorship vestings eliminate the need for a conveyance from the successor trustee under the living trust on the death of a spouse. Additionally, under these vestings, the **right of survivorship** can be individually *severed* — eliminated — by either spouse. To sever the right of survivorship, either spouse may deed their interest to themselves with a declaration stating they are terminating the joint tenancy or community property with right of survivorship vesting. [See Chapter 34]

The deed to oneself of a fractional ownership interest alters the vesting but does not alter the underlying nature of the ownership, whether it is a community asset or a separate asset. What remains after a spouse **severs** a right of survivorship vesting is a simple community property vesting.

Judgments attach to trust vestings

A popular misconception maintains that owners can use revocable living trust vestings to avoid their creditors. This is completely unfounded — the trust vesting is not a debt shield or an *asset preservation vesting*. Creditors can reach property vested in the owner's revocable living trust, both during the owner's lifetime and after his death.

A revocable living trust is not a vesting or legal entity separate or different from the owner, such as a partnership, limited liability company (LLC) or corporate form of ownership. [Calif. Probate Code §18200]

LIVING TRUST CONSIDERATIONS:

PROPERTY TAX REASSESSMENT: Transfers of title to real estate by individuals into their revocable living trusts are exempt from reassessment. [Calif. Revenue and Taxation Code §62(d)]

Editor's note — In an environment of financially strapped counties and trigger-happy assessors, the owner should get prior written approval from the assessor before conveying the property into an intervivos trust vesting.

DUE-ON-SALE: A conveyance of real estate into any trust vesting triggers the due-on clause, requiring written pre-conveyance consent by lenders with due-on clauses in their trust deeds. [12 Code of Federal Regulations §591.5 (b)(1)(vi)]

Editor's note — Federal regulations requiring lender approval on owner-occupied, one-to-four residential units ***contradict*** *federal codes, which exempt transfers to revocable living trusts from due-on-sale enforcement. However, in the 1990s, the discrepancy was a moot issue with Brokers since due-on-sale interference by lenders is primarily an economic issue, not the legal issue it once was. When pressure on interest rates subsides, old loans will typically have a higher rate of interest than new loans, creating no incentive for lenders to call loans due or recast them on transfer of title to a living trust. [12 United States Code §1701j-3(d)(8)]*

PROBATE AVOIDANCE: Trust provisions limiting the right of a successor trustee or beneficiary to petition the probate court to resolve disputes are unenforceable. [**In re Estate of Parrette** (1985) 165 CA3d 157]

TAX ASPECTS: All tax consequences remain with the beneficial owner of the property, unaltered by the trust vesting — including income and expenses, interest, depreciation, profit and loss, §1031 and §1040 reporting, the $250,000 per person residential §121 profit exclusion, rental operating losses, etc. However, the appointment of a trustee other than the owner to operate the property establishes the trust as a separate taxable activity (but not a separate entity), and the owner will lose the personal tax benefits from the real estate. A property manager is not a trustee.

FAMILY PARTNERSHIP: Community assets vested in the name of a limited partnership or limited liability company (LLC), with the husband and wife solely owning the partnership as partners or the LLC as members, allow their capital ownership interests in the company to be vested in the living trust. The same vesting holds for stock in a corporation, trust certificates, bonds, and notes and trust deeds owned by the husband and wife.

SURVIVING SPOUSE: A qualified terminable interest in property (QTIP) conveys to the surviving spouse a *life estate* in the deceased spouse's property, without the ability by the surviving spouse to amend or revoke the deceased's distribution of the fee simple to, for example, their children. The surviving spouse must file a declaration with the Internal Revenue Service (IRS) stating the life estate is a QTIP to exempt the property from the deceased spouse's estate taxes under the marital deduction. However, the property will be included in the surviving spouse's taxable estate on death. [Internal Revenue Code §2056(b)]

The **singular advantage** of a revocable living trust is its ability to perform the same functions as a will while avoiding probate procedures. Given the onerous nature of California probate proceedings, the advantage of the alternative trust vesting is substantial, both in conveyance time and handling costs.

A trust agreement is nothing more than escrow instructions to the successor trustee to deed properties to named beneficiaries on the death of the owner. Probate is **litigation**, service of process on heirs and courtroom actions which span over a long period of time, not just a few weeks.

Consider a creditor who records an **abstract of judgment** which attaches as a lien to all real estate owned in the county by a judgment debtor. A parcel of real estate owned by the debtor is vested in his revocable inter vivos (living) trust. The parcel is subject to a first trust deed.

A second trust deed to secure a loan is later recorded on the real estate vested in the revocable living trust.

Ultimately, the first trust deed holder forecloses. The property is sold at a trustee's sale for a price in excess of the amount due on the first trust deed. The judgment creditor demands the excess sales proceeds, claiming his judgment lien naming the debtor attached to the real estate vested in the debtor's revocable living trust and is second in priority to the first trust deed, ahead of the claims of the second trust deed holder.

The second trust deed holder claims he is entitled to the excess funds since he was a good faith encumbrancer of the "trust asset," unaware of the judgment recorded against the debtor who was the true owner of the property held in trust.

Is the second trust deed holder entitled to the excess proceeds?

No! The judgment creditor is entitled to the excess proceeds. The second trust deed holder has **constructive notice** of the recorded judgment against the debtor who is the owner (beneficiary) of the real estate vested in the revocable living trust. A review of the trust agreement controlling the trustee who holds title reveals the true owner's identity. [**Bank One Texas, N.A.** v. **Pollack** (1994) 24 CA4th 973]

Establishing the trust

Any trust created for the purpose of holding title to real estate for another person is only valid if the trust relationship with the trustee is declared in writing. [Prob C §15206]

Fortunately, only a minimal writing, called a *Declaration of Trust* or *trust agreement*, is required to establish a viable **living trust**.

The elements necessary to enter into a statutory living trust agreement include:

- the owner's declaration to establish a trust as the *trustor* (sometimes called the *settlor*) [Prob C §15201];
- identification of a *trustee* (usually the owner) to manage title to properties vested in the trustee as instructed by the trust agreement [Prob C §15200];
- actual conveyance of property (called the *corpus* or *trust property*) to the trustee [Prob C §15202]; and
- successor(s), called *beneficiaries*, to receive the trust property on the death of the owner. [Prob C §15205]

Community property, separate trusts

A husband and wife should each establish separate trusts for their half of the community property. The other spouse should be named as successor trustee.

Although spouses can jointly deed their community property into one trust, the joint trust is substantially more complex and replete with distribution and trust management complications after the first death.

The complexities involved with spouses deeding into the same trust are comparable to the folly of attempting to use one set of escrow instructions to handle the sale/exchange of properties owned by two separate parties. Two escrows should be created.

Placing each spouse's community property interest into separate trusts incurs no financial, legal or tax disadvantages, and in no way alters the character of community property. The trust vesting is just another way to vest community property. [Calif. Family Code §761]

Thus, the trust agreement becomes a **title holding arrangement** which is not operative and has no legal, financial or tax consequences until death. [See Form 390 accompanying this chapter]

The only activity remaining to complete after entering into the trust agreement is to convey title to the property into the trust vesting, called *funding the trust*.

The owner must sign and record grant deeds conveying his real estate into the trust vesting. Otherwise, the property will remain vested in the owner on his death, and the trust will be useless since it was not funded and has nothing to further convey.

The property vested in the trust estate is listed in a property distribution schedule attached to the trust declaration, usually called *Schedule A*. [See Form 390 Schedule A accompanying this chapter]

In addition to identifying the trust real estate, **Schedule A** specifies the **successors** of the owner as beneficiaries to whom property will be distributed by grant deed.

Trust agreements should not be recorded. However, it is prudent to have the trust agreement notarized to verify the owner signed the document when the title company asks for it before issuing an insurance policy or any further conveyances.

Amending Schedule A

An owner is able to add properties to Schedule A attached to the trust agreement at any time. To do so, the owner conveys properties to the trust and then adds a description of the properties to the list in Schedule A, naming the successors who are to receive the properties on his death.

Conversely, an owner removing properties from the trust and deleting them from Schedule A, or changing successors to a property, should redraft Schedule A in its entirety and attach the new draft to the original trust agreement after removing and destroying the old Schedule A.

Underage successors

An owner might consider including a clause in his trust document to prohibit the distribution of trust property directly to successors under a certain age.

For instance, individuals under the age of 18 can receive title to real estate, but cannot execute a valid contract or conveyance relating to disposition or encumbering the real estate. [Fam C §§6500, 6701(b)]

Thus, if real estate in a trust is conveyed to an underage successor on the owner's death, a **guardian** will have to be appointed by the court to manage the property. [Prob C §1514]

To prevent the underage *successor* from being subjected to a court-appointed guardian to administer the property received, the owner can simply require the trustee (or someone else) to retain title and manage the property until the successor reaches the age of 18.

Of course, an owner may not want the property to wind up in the possession of an 18-year-old either. Some owners prefer to prevent distribution of property to their children until the children reach a more mature age, for fear a younger, less experienced successor will waste or misuse the property.

Successor trustees to carry on

Critical to the distribution of properties on the death of an owner is:

- the naming of *successor trustees* in the declaration of trust agreement; and
- the preparation of an exhibit (attached to the trust agreement) listing the properties that are vested in the name of the trustee, followed by the name(s) of the individual(s) who are to receive the properties on the owner's death.

Variations on the distribution of the owner's property exist, such as having a list of beneficiaries who will "share and share alike" all the properties vested in the name of the trustee; or selling all the assets vested in the trustee and distributing the net proceeds of the sale to the named beneficiaries based on the percentage given each of them in the trust agreement, etc.

The variations are limited only by the simplicity or complexity sought by the owner, including the establishment by a provision in the living trust agreement for a management trust to own and operate the properties and distribute the income for a period of time after the owner's death.

A transfer of community assets, such as the disbursement of cash savings and borrowing funds to purchase a property or vest the property in the "[name of the trustee] for The [_____] Family Trust," does not alter the **community asset nature** of the property.

The trust vesting, like a joint tenancy vesting, has no effect on the nature of the property, whether the property is transferred into the trust or transferred out of the trust. It remains community property at all times since it was acquired or transmuted to community property during the marriage. [Fam C §761]

Additionally, the vesting of community property in a revocable inter vivos (living) trust avoids any conflicting attempts at distribution under a will or by intestate succession should a will not exist. The trust agreement provisions control the distribution of properties **vested in the name** of the trustee on the death of the owner. [Prob C §13504]

Taxwise, a living trust offers no ability to obtain greater or lesser **tax results** than can be attained under a will. Thus, the revocable inter vivos trust is a complete substitute for a will for those assets vested in

DECLARATION OF REVOCABLE LIVING TRUST

DATE:_____, 20_____, at_____, California.

_____ (TRUSTOR and TRUSTEE)

holds in trust the property listed in Schedule A, which constitutes the Trust Estate to be administered and distributed to the Beneficiaries listed in Schedule A.

This Trust is entitled The _____ Family Trust.

1. Until the Trust Estate is distributed to the Beneficiaries on the Trustor's death, all income and profits from the Trust Estate shall be received by the Trustor.

1.1 Trustor retains the right to the use and occupancy of property vested in this Trust.

2. Trustee shall receive no compensation for distributing property out of the Trust Estate.

2.1 No bond shall be required of any Trustee.

3. Upon the Trustor's death, _____ shall become Trustee of this Trust.

3.1 Should the Trustee no longer be able or willing to act as Trustee, then _____ shall become Trustee of this Trust.

3.2 Any Trustee is empowered to appoint one or more successor Trustees.

4. Upon Trustor's death, the Trustee shall distribute all property in the Trust Estate to the Beneficiaries as set forth in Schedule A.

4.1 If any Beneficiary is under the age of _____ on Trustor's death, the Trustee shall continue to hold the underage Beneficiary's portion of the Trust estate in trust, and administer the property in the best interest of the Beneficiary until the Beneficiary reaches such age, when the Trustee shall distribute to the Beneficiary.

4.2 Trustee shall receive as compensation _____% of the gross operating income while administering the Trust Estate for an underage Beneficiary.

5. Any property in the Trust estate not designated for distribution in Schedule A shall be distributed to _____.

6. Should any Beneficiary(ies) of the Trust predecease the Trustor, the deceased Beneficiary's share shall be distributed to _____.

7. The Trust shall be governed by the laws of the State of California.

Executed on _____, 20_____, at _____, California.

_____
Trustor/Trustee's signature

STATE OF CALIFORNIA)
COUNTY OF_____)
On _____ before me,
_____
(name of notary public)
personally appeared _____
_____,
(name of principal)
personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS my hand and official seal.

Signature: _____
(Signature of notary public)

_____
(This area for official notarial seal)

"Schedule A"

for the

_____ Family Trust

Property	Name of Beneficiary(ies)	Percentage of interest to each beneficiary
1. _____	a) _____	_____
	b) _____	_____
2. _____	a) _____	_____
	b) _____	_____
3. _____	a) _____	_____
	b) _____	_____
4. _____	a) _____	_____
	b) _____	_____
5. _____	a) _____	_____
	b) _____	_____
6. _____	a) _____	_____
	b) _____	_____
7. _____	a) _____	_____
	b) _____	_____
8. _____	a) _____	_____
	b) _____	_____
9. _____	a) _____	_____
	b) _____	_____
10. _____	a) _____	_____
	b) _____	_____

Initials:_____ Date:_____/_____/_____

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the trust at the time of the owner's death. A will controls the distribution of assets vested in the name of the owner at the time of his death.

Additionally, if the spouse of the deceased is the successor, and the property is a community property asset, the surviving spouse receives the entire property with a fully stepped up *cost basis* to the property's market value on the death of the spouse.

The surviving spouse receives a fully stepped up **cost basis** whether the property is vested in a living trust, as husband and wife as joint tenants, or as husband and wife under either community property vesting. [Internal Revenue Code §1014(b)(6); Revenue Ruling 87-98]

Trust entities and trust relationships

Relationships in real estate transactions frequently include an agency relationship which rises to the level of a *trust relationship*. A **trust relationship** imposes a **duty** on the agent who holds title, or who is to deliver the property *held in trust* to others, and requires the agent to follow instructions given to him by the principal who owns the property. Real estate brokers, escrow companies, title companies, banks operating a trust business and attorneys are commonly employed by principals to act as their agents, subject to the duties of a trust relationship which is imposed while the agent holds title to or manages property owned by the principal.

A *trust company* is any corporation or bank which is authorized to engage in the activities of a trust business. A *trust business* exists when a person acts as an executor, administrator, guardian or conservator of estates, or as assignee, receiver, depositary or trustee by the appointment of the court or for any purpose permitted by law. [Calif. Financial Code §106]

A **trust business** in California has a distinctly different relationship with the public than the relationship established by the activities of a *business trust.*

Business trusts, frequently called a *Massachusetts trust*, are engaged in general business, not in the trust business. The relationships created under a business trust arrangement do not include the trust relationship between a principal (beneficiary) and his agent (trustee).

A business trust is an entity which cannot be established under California law. A scheme does not exist for the creation of a business trust in California. Thus, a **business trust** can only be established in states with a scheme for creating a business trust entity.

When a business trust is created in another state, it can neither operate in California nor buy, sell, lease or operate real estate located in California on behalf of the entity or anyone else without first qualifying as a corporation under the California Corporate Securities Act. Business trusts are considered *foreign corporations*. [Calif. Corporations Code §§170, 171]

As **foreign corporations**, business trusts must register with the Department of Corporations and file corporate income tax returns with the Franchise Tax Board (FTB), since they will be conducting business within the state of California by owning and operating real estate assets. [Corp C §191; Calif. Revenue and Taxation Code §23038(b)(2)(B)]

Thus, a business trust, as a foreign corporation once it enters into activities in California, must **qualify** with a state agency before:

- conducting any business [Fin C §107];
- accepting money from investors in exchange for share ownership in the trust entity; or

- conducting any other lawful business in California.

The trustee of a business trust holds title to real estate in his name (as trustee for the named business trust), and **controls the operation** of the property. The trustee is also a principal himself, and is personally liable for all debts/obligations incurred by the business trust, as though he were a general partner in a limited partnership. [**Goldwater** v. **Oltman** (1930) 210 C 408]

Further, the business trust itself is liable for obligations incurred on its behalf in the management of the real estate vested in the trustee. Also, the assets of the business trust are directly liable for any *torts* of the trustee, such as failure to properly maintain the security of tenants or the condition of the property which causes injury to others. [**Alphonzo E. Bell Corporation** v. **Bell View Oil Syndicate** (1941) 46 CA2d 684]

If the beneficiaries are authorized to exercise ultimate control over the trustee's ability to buy, sell, refinance, own or operate the property, including the trustee's selection of successor trustees, the beneficiaries will be personally liable for the debts incurred by the trustee.

Accordingly, the trustee is then **not personally liable** since he has been reduced in his powers to a mere **agent** acting on behalf of the beneficiaries. Thus, the association between the trustee and the beneficiaries is not that of a business trust at all. It is a principal-agent relationship under a management contract. [**Bernesen** v. **Fish** (1933) 135 CA 588]

Real estate investment trusts

One trust entity, called a real estate investment trust (REIT), is authorized to be created under California law, but only if it has been:

- formed as a REIT under the Internal Revenue Code and does business under the code; and
- qualified by the Department of Corporations. [Corp C §23000]

The beneficiaries who invest in this real estate ownership entity are called *shareowners*. The **shareowners** hold transferable shares which are sold publicly. As individuals, the shareowners are not liable for the debts/obligations of the REIT. The REIT is managed by officers called *trustees* who also are not liable for the debts and obligations of the REIT.

Chapter 33 Tenants in common as a vesting

This chapter illustrates why a limited liability company form of vesting should be used by co-owners instead of holding title as tenants in common.

We cooperate in California

A group of investors acquire income-producing property located in California. Title is taken as **tenants in common**, naming each investor and stating his percentage or fractional share of *undivided ownership* in the property.

The property is occupied by tenants under short-term leases and periodic rental agreements that provide for the landlord to care for and maintain the premises.

The co-owners orally agree:

- to divide annual operating income (or losses) and resale profits pro rata based on their percentage of ownership;
- to hire the broker who organized the group to manage the property with authority to locate tenants, enter into short-term lease and rental agreements, collect rents, contract for the repair, maintenance, utilities and security to be provided by the landlord under the lease agreements, pay operating expenses and mortgage payments and distribute spendable income to the co-owners quarterly;
- to grant each other a right of first refusal on a resale of their fractional TIC interest; and
- to grant the syndicator the option to purchase the property at its fair market value.

Are the co-owners conducting themselves as partners under California partnership law despite the tenancy-in-common vesting placing each co-owner on title?

Yes! Co-owners of California real estate vested as tenants in common, when engaged in the business of **jointly operating** the property on terms calling for them to **share income and profits**, are conducting themselves as partners. Thus, they are considered *agents of one another*, charged as a fiduciary with the duty **to cooperate in the ownership** of the property. [Calif. Corporations Code §§16202(a), 16202(c)(3)]

A tenancy-in-common vesting does not control the **possessory rights** of the co-owners when the co-ownership in fact constitutes a state law partnership. For example, a partner may use or possess partnership property only on behalf of the partnership, while a tenant-in-common co-owner (at common law) may use, possess or lease the property himself, without regard to any other co-owner. [Corp C §16401(g)]

Further, tenant-in-common co-owners who conduct themselves as *joint operators* of a property, such as occurs with a rental property, are not co-owners of the real estate. They are partners who co-own their partnership. Thus, the partnership owns the property without concern for the type of vesting the group of investors has chosen.

As a *partner*, the vested co-owner does not hold a right to an interest in the property that he can independently possess or separately transfer by leasing the property to a tenant without concern for the other co-owners.

The only *transferable interest* the tenant-in-common owns is his **fractional interest in the partnership**. The partnership interest entitles him to share profits and receive distributions. Thus, the co-owner's fractional interest, vested as a tenant-in-common interest, is no more than a **personal property** share of ownership in a California partnership. [Corp C §16502]

Trustees for one another, by law

Although title to an income-producing property held by co-owners for profit is vested in the names of all the co-owners, each co-owner actually **holds title as a trustee** on behalf of all the tenant-in-common co-owners, collectively called a *partnership*. [Calif. Civil Code §682; Corp C §16404(b)(1)]

As co-owners and operators of a rental property, they have formed a partnership, holding title in the most troublesome of all California co-ownership vestings: tenants in common, a TIC.

Thus, the conveyance of a co-owner's TIC interest to another person conveys nothing more than the co-owner's interest in the partnership's *equitable ownership* of the property. The partnership's title to the property is **held in trust**, in the name of each co-owner for the benefit of all co-owners.

The defining acts of partners

Prior to California's 1949 enactment creating *tenancies in partnership*, TICs that owned rental property requiring centralized management did not constitute a partnership. No *agency relationship* existed between tenant-in-common co-owners before 1949 to protect the common interests of the co-owners to share profits. [**Johnston** v. **Kitchin** (1928) 203 C 766]

Since 1949, a California partnership exists when two or more investors join together to carry on a business for income and profit in California. A California business includes every trade, occupation or profession. [Corp C §16101(1)]

While landlording is not a trade or business category activity for federal income tax purposes (since the property is a passive rental operation or a portfolio asset), landlording by a syndicated group is an occupation under California partnership law. A co-ownership is a California partnership if the co-owners are involved in **sharing earnings and profits** from rental operations, refinancing and resale of the property they own. [Corp C §§16202(a), 16202(c)(3)]

Also, the receipt of income (from operations) and profits (from a sale) by co-owners from their joint investment is considered evidence of a California partnership, unless the earnings are received by a co-owner in payment:

- of an installment note, including one given in consideration for the sale of goodwill or property;
- for wages or rent due the co-owner;
- on an annuity to a surviving spouse, representative or a deceased co-owner; or
- as interest on a loan. [Corp C §16202(c)(3)]

The tenancy-in-common partnership

With a tenancy-in-common vesting, the sharing of income and profits earned by each co-owner's **separate use** of the property — such as occurs with the extraction of minerals from the property by each co-owner for their own separate use — does not in itself create a California partnership. It takes more than the sharing of use and possession by co-owners to constitute conduct on the level of a partnership. [Corp C §16202(c)(1)]

It is the **interaction** and **coordinated conduct** of the co-owners while directly or indirectly managing or operating the investment that determines whether a state law partnership relationship exists between them. Once the conduct of co-owners in a coordinated ongoing operation of the property constitutes a **joint and mutually beneficial activity**, an agency relationship exists between the co-owners.

With the agency relationship comes *fiduciary duties* owed to partners, which obligates each prospective or actual co-owner to **act in the best interest** of the group, not to act independently on the investment opportunity before them. [Corp C §16404; **Leff** v. **Gunter** (1983) 33 C3d 508]

Thus, co-owners of rental property who are vested as tenants in common and who **act collectively** to manage the property or authorize a property manager to operate the property on their behalf, hold ownership to the real estate under what has been best entitled a *tenancy in partnership*. Each co-owner is a tenant in partnership with all other co-owners.

By the sharing of income among co-owners who are vested as tenants in common, a **tenancy-in-common partnership** is established. Each co-owner is subjected to the rights and obligations of a partner, such as:

- the duty to hold title to the real estate as a trustee for the benefit of the partnership [Corp C §16404(a)(1)];
- the right of each co-owner to use and possess the real estate — but only for group purposes [Corp C §16401(g)];
- the right to use and possess the real estate is nontransferable unless all co-owners **collectively transfer** the partnership's right to possession of the property [Corp C §§16203, 16501]; and
- the property co-owned by the group is not subject to **attachment** or **execution** on a judgment against an individual co-owner, only on claims against the partnership. [Corp C §§16201, 16501]

Under state law, tenant-in-common co-owners hold no interest in the real estate they co-own that they can legally transfer, voluntarily or involuntarily, independent of the rights of the resulting California partnership. [Corp C §16502]

However, federal tax law for determining the tax partner status of TICs disregards state laws to the contrary. [Revenue Procedure 2002-22]

Vesting choices

When a group of investors purchases real estate, the vestings available to properly structure their common ownership interests include taking title in the name of:

- each of the investors;
- an LLC owned by the group; or
- a partnership (general or limited) comprised of the group.

A corporate ownership and vesting of real estate is infrequently used by investors in real estate held for rental income or profits on speculation due to adverse tax consequences, whether reporting as a C or S corporation.

While the steps for forming an LLC or a partnership are clearly defined and most easily memorialized, many groups still take title to the investment property in the name of all the investors — each investor to an undivided percentage of title as a tenant in common.

The annual franchise fee to the state of California is an inhibition interfering with the selection and use of an LLC or limited partnership entity.

Although vested as tenants in common, the group will be governed by partnership law. No individual will have the rights of a tenant in common since the property requires management to oversee:

- the collection of any income;
- payment of expense and debt obligations; and
- maintenance of insurance and the condition of the property.

Regarding the co-ownership of unimproved land, management responsibilities exist even if the land is unused.

However, some investors do not feel secure in their investment unless they see their names on the grant deed. Others vest (or revest) as tenants in common with the mistaken belief they will receive tax benefits otherwise disallowed, except for §1031 tenant-in-common (TIC) arrangements.

Hazards of investors on title

Consider an investment group of five people, including the syndicator/broker. The group invests in (residential or nonresidential) rental property. The management responsibilities are undertaken by the syndicator/broker.

The syndicator will share in the income and profits from a one-fifth co-ownership interest he receives for packaging the acquisition of property.

The group erroneously takes title to the property as tenants in common, as opposed to vesting it in the name of an LLC or a partnership formally created by the group. Each individual "holds title" to an undivided one-fifth interest in the property.

Even though vested as **tenants in common**, the rights of the individual partners are not those of tenants in common. The group is presumed to be governed by partnership law. [Corp C §§16202(a), 16204(c)]

However, due to the vesting, any number of disastrous situations can occur which will cloud title to the property and put the investment at risk.

For example, one of the co-owners files a **bankruptcy petition**. The bankrupt co-owner's one-fifth interest in the title to the property is then placed in the hands of a trustee before the bankruptcy court. Title to the whole property is clouded by the bankruptcy filing of a vested co-owner since the court can sell the entire property.

Yet, if the group entered into a co-owner "buyout" agreement, the bankruptcy filing allows the other co-owners to purchase the bankrupt co-owner's interest and eliminate the adverse effect on title. The bankrupt partner is typically reimbursed for his capital contribution, less any sums received. However, the uncertainties and complications associated with court proceedings would still exist.

A formal LLC operating agreement or partnership agreement and an LLC or a partnership vesting avoids interference with title by a co-owner and his creditors. The property is owned and operated by an entity, independent of the co-owner's problems.

Consider the co-owner who finds himself in debt for reasons having nothing to do with the investment property. The co-owner's creditor attaches or liens his vested tenant-in-common interest in the property, clouding the title.

Due to the tenants-in-common vesting, a creditor's only concern is that the co-owner owns a recorded interest in the property which is attached by the creditor's recorded **abstract of judgment**.

Had title to the real estate been vested in the name of an LLC or partnership, the creditor of the indebted co-owner could not have liened the real estate itself, but only attached the co-owner's interest in the LLC or partnership by way of a court issued *charging order*. [**North Coast Business Park** v. **Superior Court** (1984) 158 CA3d 858]

Suppose one of the co-owners vested as a tenant in common dies. The right of survivorship does not exist among the tenants in common. Thus, the remaining co-owners must look to the will of the **deceased co-owner** (or inter vivos trust, if vested) for a determination as to who will be taking title to the co-owner's interest. The transfer will be accomplished by court approval in probate naming a successor to the co-tenancy interest, or by a trustee under a living trust if the deceased's interest was vested in the trustee.

Any successor to the interest of the **deceased co-owner** will be a *non-voting partner* until he is accepted by the group as a member. The successor will not possess any rights as a partner other than the right to a pro rata share of any income/profit distributed on the investment — even though the successor holds title as a tenant in common. [Corp C §16503]

Consider the co-owner vested as a tenant in common who refuses to convey his one-fifth interest when the other co-owners decide to sell, encumber or lease the property. Under the tenants-in-common vesting, *all* the co-owners must sign the grant deed or trust deed in order to convey or encumber the entire property. [Corp C §16302(a)(3)]

One co-owner's **refusal to convey** gives him the potential for establishing anarchy within the group and blackmailing the co-owners — the co-owner may demand more than his fair share of the proceeds for his voluntary cooperation. The tenants-in-common vesting has given each co-owner veto power over the majority, resulting in the loss of control over the investment — even if a tenants-in-common agreement for voting and buy out exists.

Situations like these are eliminated by keeping investors off title and organized in an LLC or a partnership form of business entity.

As an LLC or formal partnership, the co-owners are not vested with any ownership interest in the real estate. Their ownership interest is a percentage interest as a co-owner of the LLC or partnership. Each co-owner's interest in the LLC or partnership is personal property under state law, comparable to a stockholder's interest in a corporation. [Corp C §16502]

A creditor can only attach a co-owner's ownership interest in the LLC or partnership, not the real estate owned by the LLC or partnership. [Corp C §16504**; Wardley Development Inc.** v. **Superior Court** (1989) 213 CA3d 391]

A tax partnership vs. a California partnership

The **coordinated conduct** of co-owners in the exercise of *ownership rights* to operate the investment real estate they co-own, is viewed differently under federal income tax law than under California partnership law.

Basically, if co-owners **share** the income, profit and losses generated by a joint investment in real estate and operate under an unincorporated ownership arrangement, California partnership law, which broadly defines a partnership, classifies the profit-sharing group as a partnership.

Thus, California imposes *agency obligations* on each co-owner to act in concert for the mutual benefit of the group from the first moment of discussions about a syndicated investment. As a result, anarchy within the group of co-owners is legally avoided as public policy in California.

Conversely, federal tax law places emphasis on tenant-in-common (TIC) law to establish co-owner rights. TIC ownership does not rise to tax partner status unless the co-owners are operating as either:

- a declared partnership;
- an LLC; or
- a cooperating TIC.

To avoid federal tax partnership status, each co-owner vested as a tenant-in-common must have the unrestricted common law right to independently *alienate* his fractional interest without the prior consent of other co-owners. Further, each co-owner must also have the unrestricted right to independently block any *alienation* of the entire property co-owned by the group.

Alienation of the entire property refers to its sale, further encumbrance or lease for a period exceeding one year.

Taxwise, the ownership of a TIC interest that retains its common law right of alienation in real estate is viewed as being the ownership of a fractional interest in the real estate itself. Thus, the tenant-in-common is not the owner of an interest in a partnership, but actually owns the property.

Further, TIC co-ownership arrangements may provide for **cooperation among the co-owners** in the ongoing management and operation of the property. **Operating the property** by *centralized management* does not violate the requirement of unanimous approval for the alienation of property. Thus, the alienation rights inherent in ownership are distinguished from the day-to-day operations of the property.

An understanding of the distinctions between federal tax law, which defines §1031 property investments as excluding fractional interests held by *tax partners*, and California's partnership law, which controls joint ventures and profit sharing ownerships, is helpful to all individuals involved in investment groups, such as:

- **syndicators** structuring the ownership for acquisition of property by an investment group they are forming;
- **investors** acquiring or withdrawing a fractional interest from a syndicated real estate investment; and
- **brokers** (or other advisors) representing a person who is buying into or withdrawing from a real estate syndicated investment.

Knowing the parameters for activities that establish a partner under California partnership law versus activities that establish a tax partnership for federal income tax reporting avoids unintended and unexpected results under either set of laws, or worse, the loss of a transaction because of insufficient knowledge.

A tax partner's profits disqualified

The penalty for a tenant-in-common co-owner who is federally classified as a *tax partner* in the ownership of either the property sold or the property acquired in a §1031 reinvestment plan, is the loss of the entire *§1031 tax exemption* for profit taken on the property sold.

Thus, the arrangements or activities a co-owner, other co-owners, a property manager, syndicator or lender agree to between themselves, which would make a co-owner a tax partner, are or may become of great concern to investors in syndicated real estate investments programs.

When a co-owner of investment real estate is classified by the Internal Revenue Service (IRS) as a **partner**, the real estate is considered to be owned by a *tax partnership*. Classified as a partner, the co-owner's ownership interest is that of a share in a partnership and the share **does not qualify** as **§1031 property.**

Thus, an investor with after-tax cash he has accumulated or §1031 money to reinvest, who makes a *capital contribution* to a group being formed to jointly own and operate an income-producing parcel of real estate, must be assured no co-owner is sharing in any income from tenants other than rent. Co-owners who occasionally provide tenants with business or professional services, such as linen service, maid service, meals, etc., for a fee separate from rent, or share in the income received by others providing services to tenants that go beyond the **customary services** required under a lease, establish tax partner status.

Chapter 34 The right of survivorship among co-owners

This chapter distinguishes the joint tenancy and community property with right of survivorship vestings for the co-ownership of real estate, and explains their creation and use as well as severance of the vesting and termination of the right of survivorship.

Vesting reflects estate planning

A husband and wife, with the assistance of their broker, locate real estate they intend to purchase. They will use monies accumulated during their marriage and the net proceeds from a new purchase-assist loan to pay the purchase price.

The broker, as part of his due diligence on any property acquisition, asks the couple how they want to take title to the property on the close of escrow. The broker determines the couple would like the property to be vested in both of their names, as husband and wife, with the right of survivorship. On the death of a spouse, the couple wants the surviving spouse to automatically become the sole owner of the property and entirely avoid probate procedures.

The couple is not interested in vesting title under a *revocable inter vivos (living) trust* agreement which would also avoid probate.

The broker recognizes the community property aspect of their funds and recommends they take title in their names, such as "husband and wife as community property with right of survivorship," rather than "husband and wife as joint tenants." However, the broker explains the two vestings are identical for conveyancing since:

- both vestings can be *severed* before death to provide for an alternative distribution of each spouse's ownership interest to others by will or a trust agreement; and
- on death the title is cleared of the deceased spouse's interest by the surviving spouse recording an *affidavit* declaring the death of the decedent and attaching a certificate of death. [Calif. Civil Code §682.1(a); Calif. Probate Code §210; see Form 460 accompanying this chapter; see **first tuesday** Form 461]

Mindful of the **tax consequences** for the surviving spouse, the broker recommends the couple vest title to the property as "community property with right of survivorship." Like the tax consequences of a joint tenancy vesting, the surviving spouse would be assured a fully **stepped-up cost basis** for the community property. [See Chapter 33]

In this example, the broker's advice to vest the community property as "community property with right of survivorship" satisfies the couple's estate planning needs for holding title. The property acquisition is made during the marriage, and thus is considered **community property** even if the couple vested the property in their names as joint tenants.

Additionally, the couple simply intends to avoid probate procedures and administration costs on the death of a spouse. Either right of survivorship vesting avoids enforcement of any contrary provisions in the will of the deceased since no interest remains to be transferred after death.

Thus, for the surviving spouse, a "community property vesting with right of survivorship" is superior to a simple community property vesting — even though a community property vesting (without the right of survivorship) also transfers the property to the surviving spouse if the deceased dies *intestate* (with no will) or *testate* (with a will) stating the surviving spouse takes the property.

On a simple community property vesting, if no one contests the surviving spouse's right to become the sole owner of the deceased spouse's interest in the property, the surviving spouse must wait 40 days following the death before the property can be sold, leased or encumbered. After 40 days, an affidavit by the surviving spouse is recorded to clear title by declaring the death and attaching a death certificate. [Prob C §13540; see **first tuesday** Form 461]

A joint tenancy recommendation by the broker would produce the same results during ownership (transferability) and on death (taxes) as would the community property vesting with right of survivorship. Additionally, joint tenancy allows for avoidance of some **community debts** during the marriage and on death. This avoidance of debts incurred solely by one spouse is not available under either community property vesting. [CC §682.1]

Creating a joint tenancy

Although most *joint tenancies* are created between a husband and wife, a joint tenancy can exist between non-married persons. Conversely, community property vestings are only available to a husband and wife.

Additionally, the number of joint tenants is not limited to two, as is a married couple's ownership of community property interests. Any number of co-owners can, under one deed, take title to real estate as joint tenants as long as they possess **equal ownership interests**.

Traditionally, the creation of a joint tenancy requires the conveyance of *four unities*:

1. *unity of title*, meaning the joint tenants take title to the real estate through the **same instrument**, such as a grant deed;
2. *unity of time*, meaning the joint tenants receive their interest in title at the **same time**;

Married couple: wording the grant deed vesting

Joint tenancy: *John Doe and Jane Doe, husband and wife as joint tenants.*

Community property: *John Doe and Jane Doe, husband and wife as community property with right of survivorship.*

Community property: *John Doe and Jane Doe, husband and wife as community property.*

Tenants in common: *John Doe, a married man as to an undivided one-half interest, and Jane Doe, a married woman as to an undivided one-half interest, as tenants in common.*

Separate property of one spouse: *John Doe, a married man as his separate property.*

3. *unity of interest*, meaning the joint tenants own **equal shares** in the ownership of the property; and
4. *unity of possession*, meaning each joint tenant has the **right to possess** the entire property. [**Swartzbaugh** v. **Sampson** (1936) 11 CA2d 451]

Today, a joint tenancy vesting is only loosely based on these four ancient unities. For example, a joint tenancy is currently defined as ownership by two or more persons **in equal shares**. Thus, the joint tenancy co-ownership incorporates the **unity of interest** into its statutory definition. [CC §683]

Similarly, a joint tenancy must be created by a **single transfer** to all the co-owners who are to become joint tenants. Thus, the historic **unity of title** (same deed) and **unity of time** (simultaneous transfers) required under common law have been retained in one event, typically being the recording of the conveyance transferring title to the joint tenants.

A joint tenancy ownership in real estate may be created by any of the following transfers, each being a single conveyance to all joint tenants, if the conveyance states the co-owners take title "as joint tenants":

- a transfer by grant deed, quitclaim deed or assignment, from an owner of the fee, leasehold or life estate, to himself and others;
- a transfer from co-owners vested as tenants in common to themselves; or
- a transfer from a husband and wife holding title as community property, tenants in common or separately, to themselves. [CC §683]

For the small percentage of joint tenants who are not husband and wife, typically family members or life-long friends, a valid joint tenancy is created when all co-owners take title under the same deed as joint tenants, without stating their **fractional ownership interest** in the property. Their actual fraction of ownership, if severed or transferred to others, is a function of the number of individuals who took title as joint tenants. Five co-owners as joint tenants indicate each holds a one-fifth or 20% fractional ownership interest.

A vesting of "community property with right of survivorship" is created on the *acceptance* by a husband and wife of the deed vesting their acquisition of property. For a husband and wife to convert a vesting to community property with the right of survivorship, they merely deed out of their present vesting (as grantors) and deed the property back to themselves in their names as "husband and wife as community property with right of survivorship" (as grantees).

No requirement exists calling for consent to the vesting beyond mere *delivery* of the deed. [CC §682.1(a)]

A joint tenant's right of survivorship

A joint tenancy vesting adds nothing to the legal aspects of the ownership interest held in real estate by each co-owner. Whether the interests held by the co-owners are separate property or community property, a joint tenancy vesting neither enlarges nor reduces the nature of the ownership interest.

However, the **necessary incident** of a joint tenancy vesting is the *right of survivorship*, legally referred to as *jus accrescendi*. The right of survivorship is a case law doctrine which is triggered by the death of one joint tenant. Thus, the joint tenancy vesting, by the incident of its right of survivorship, becomes operative only on the death of a joint tenant, at which point the right of survivorship **extinguishes the deceased's interest** and leaves the remaining joint tenant(s) with the entire ownership interest they held

as joint tenants. The right of survivorship is a mere **expectancy** held by each co-owner, and is not a property right.

Ultimately, and on the death of all other joint tenants, the last survivor becomes the sole owner of the interest in the property originally owned by all the joint tenants.

Vesting alone does not transmute community property

All property acquired jointly by a married couple during the marriage, no matter how vested, is **presumed** to be community property for purposes of division between them on a **dissolution** of the marriage. [Calif. Family Code §2581]

Should a couple having vested their co-ownership of property as joint tenants seek a divorce, the property is treated as community property.

Further, the community property presumption for married couples does not only come into play when a couple divorces. All property acquired by a couple or by either spouse during marriage is considered community property, unless the husband and wife clearly state their contrary intention to own their individual interests in the real estate as separate property. [Fam C §760]

Thus, real estate acquired by a married couple, or by a married individual (unless received as a gift), regardless of joint tenancy, community property, or inter vivos trust vesting, is always presumed to be community property under California law. [Fam C §761]

The overlay of community property

Joint tenancy rights and community property rights held by married couples **overlap** in California law when community property is placed in a joint tenancy vesting. This overlap is a by-product of California legal history.

Joint tenancy, with its inherent right of survivorship, arises out of the English common law, and is called a *common law estate*.

Community property, with its implicit partnership aspect, is a creation of Spanish civil law, dating from the time when California was a Spanish colony operating under the Law of the Indies.

Older cases treated community property and joint tenancy as **mutually exclusive**, i.e., holding real estate as community property meant it could not be held in a joint tenancy vesting and retain its community property status. Thus, a *transmutation* from community property to the separate property of each the husband and wife occurred by a transfer into a joint tenancy, comparable to vesting community property in a tenancy in common vesting today. [**Tomaier** v. **Tomaier** (1944) 23 C2d 754]

However, this mutually exclusive rule, which controlled legal results by the type of vesting and not by the community nature of the ownership by a husband and wife, was eliminated in 1975.

Today, a joint tenancy vesting is used by co-owners solely to avoid probate. The joint tenancy vesting provides no other advantage to co-owners. The underlying community or separate property character of the real estate is not affected when a husband and wife vest their co-ownership as joint tenants.

For example, a husband and wife who take title as joint tenants do not by the vesting **transmute** their community property into separate property owned 50:50 by the husband and wife.

However, a joint tenancy vesting allows a husband and wife, one of whom has a problem with a creditor, to **renounce the community property presumption** and claim they intended the joint tenancy vesting to establish separate property interests for each spouse in the real estate. Thus, the community property presumption can be rebutted by either spouse, and is occasionally exercised by a husband and wife to deter creditors. [**Abbett Electric Corporation** v. **Storek** (1994) 22 CA4th 1460]

A similar result altering community property rights occurs in federal **bankruptcy** proceedings when a husband and wife hold title as joint tenants. The interest of each spouse vested as a joint tenant is treated in bankruptcy proceedings as separate property in order to attain the objective of federal bankruptcy law to free individuals of onerous debt. Thus, a spouse's one-half interest in community property vested as joint tenants is not liable under bankruptcy for debts which were incurred solely by the other spouse and not on behalf of the community. [**In re Pavich** (1996) 191 BR 838]

If the couple does not intend by the joint tenancy vesting to transmute their community property into separate property, but to take title to their community assets as joint tenants for the sole purpose of avoiding probate (which is the case in most joint tenancy vestings), the property is **presumed** to be a community asset without concern for the joint tenancy vesting.

Thus, the nature of the underlying ownership of property held by a husband and wife as joint tenants — separate or community — may be challenged by a third party, such as a creditor of one of the spouses seeking to reach community assets.

However, title companies will always apply the community property presumption when real estate is vested in a husband and wife. A title company will not insure the conveyance of an interest in the couple's property, such as a trust deed encumbrance executed by only one spouse, since the signatures of both spouses are required to convey interests or impose liens on community property. [Fam C §1102]

Conveying community property

Both spouses must consent to the sale, lease for more than one year, or encumbrance of community real estate regardless of how it is vested. [Fam C §1102]

If one spouse, without the consent of the other, sells, leases for more than one year or encumbers community real estate, the nonconsenting spouse may either *ratify* the transaction or have it *set aside*. The nonconsenting spouse has **one year** from the recording of the nonconsented-to transaction to file an action to **set aside** the transaction.

However, if the other party to the transaction — the buyer, tenant or lender — has no notice of the marriage, actual or constructive, the transaction cannot be set aside by the nonconsenting spouse who has failed to make the community interest known. This includes any knowledge of the agent representing the buyer, tenant or lender, about the owner's marital status. [Fam C §1102(c)]

Conveying community property as joint tenants

The ability of a married joint tenant to sell, lease or encumber his interest in the real estate depends on whether the real estate interest vested in the individual is his *separate property* or the *community property* of the individual's marriage.

When community real estate is vested in joint tenancy, both spouses' signatures are required to execute an enforceable purchase agreement or trust deed lien, or to enter into a lease agreement with a term exceeding one year. [Fam C §1102]

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AFFIDAVIT OF DEATH OF JOINT TENANT

DATE:_____, 20_____, at_____, California.

_____,

is the deceased named in the attached certified copy of Certificate of Death and the same person named as one of the joint tenants vested as owner of the following property situated in the County of _____, California, described as:

APN# _____

I have personal knowledge of the facts in this affidavit.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date:_____, 20_____ _____
(Print Name) (Signature)

Date:_____, 20_____ _____
(Print Name) (Signature)

STATE OF CALIFORNIA _____)
COUNTY OF _____)
SUBSCRIBED and SWORN to (or affirmed) before me on this _____ day of _____, 20_____.
personally known to me or proved to me on the basis of satisfactory evidence to be the person(s) who appeared before me.

_____
Notary Name

_____
Notary Signature

(This area for official notarial seal)

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Thus, a sale, long-term lease or encumbrance of the community property executed by only one spouse is *voidable* since the transaction may be set aside by the nonconsenting spouse.

Further, a purchase agreement for the sale of community property entered into by only one spouse may not be enforced in any part by the buyer through an action for specific performance. Thus, a purchase agreement entered into by one spouse to sell only his one-half interest in the community property is unenforceable unless consented to by the other spouse since **no interest** in community property may be conveyed, leased or encumbered without the consent of both spouses. [**Andrade Development Company** v. **Martin** (1982) 138 CA3d 330]

Encumbering and leasing joint tenancy property

When real estate held in a joint tenancy vesting is **separate property** — as when the joint tenants are not husband and wife or when a husband and wife in writing agree their interests are separate property — each joint tenant can sell or encumber his interest in the real estate without the consent of the other joint tenants.

Additionally, when the joint tenancy in real estate represents **separate property**, a joint tenant may lease out the entire property since a lease is a transfer of possession, and each joint tenant has the right to possession of the entire property. [Swartzbaugh, *supra*]

However, consider a husband and wife who own real estate which is **community property**, holding title as joint tenants. The husband enters into an agreement to lease the property for a term over one year, which the wife does not sign.

Under the joint tenancy rule, either joint tenant alone may lease the property. However, under the community property rule (which applies to property acquired during marriage), **both spouses** must execute a long-term lease agreement with a term greater than one year.

This one-spouse leasing scenario is an example of the misunderstanding created by the overlay of community property rights when community property is placed in a joint tenancy vesting.

Although no case or statute addresses this set of leasing facts, existing case law suggests the joint tenancy vesting should be viewed as controlling, thus allowing the joint-tenant husband to lease the property without the wife's consent. Also, the doctrine of *ratification* would influence the result (in favor of the tenant) if the nonconsenting spouse knowingly enjoyed the benefits of the lease. [CC §2310]

Severing right-of-survivorship vestings

A husband and wife are the owners of a parcel of real estate, as community property. The vesting provides for the right of survivorship under either a community property with right of survivorship vesting or a joint tenancy vesting.

However, every co-owner vested as a joint tenant or as community property with the right of survivorship has the right to *unilaterally sever* the right of survivorship. The severance by a co-owner **terminates** the right of survivorship in that co-owner's interest, whether his interest in the real estate is separate or community property.

The separate or community property nature of the co-owner's interest in the property remains the same after severing the right of survivorship from the co-owner's interest.

A co-owner **unilaterally severing** the right of survivorship in his interest is not required to first give notice or seek consent from the other co-owner(s). [**Riddle** v. **Harmon** (1980) 102 CA3d 524]

To sever the vesting, the co-owner prepares and signs a deed from himself "as a joint tenant" or "as community property with right of survivorship" back to himself. On recording the deed, the right of survivorship is severed by having merely *revested* the co-owner's interest. The deed revesting title should include a statement noting that the transfer is intended to sever the prior vesting. [CC §683.2(a)]

Alternatively, the co-owner could transfer title to himself as trustee under the co-owner's revocable inter vivos (living) trust agreement. The conveyance into the trust vesting would also sever the right of survivorship. By the conveyance, the trust vesting would also avoid the probate process while gaining control over succession of the co-owner's interest on death. As before, community property remains community property even though it is vested in the living trust of the individual husband or wife.

Further, any transfer of a joint tenant's interest in the joint tenancy property to a third party, such as from a joint tenant parent to a child, **automatically severs** the joint tenancy.

However, a deed to oneself has only recently been recognized as a valid method for severing a joint tenancy. Historically, a joint tenant intending to unilaterally sever the joint tenancy was first required to deed the property to a third-party "straw man." The transfer to a third party having severed the joint tenancy, the straw man would concurrently deed the property back to the former joint tenant, who would hold title as a tenant in common or as community property without the right of survivorship. [**Burke** v. **Stevens** (1968) 264 CA2d 30]

The need for a straw man was based on joint tenancy's origins in feudal law, and the ancient theory that a person cannot deed property to himself. The *Riddle* court discarded this archaic and cumbersome double-deeding rule. Now, a joint tenant is able to sever the joint tenancy directly rather than through an elaborate legal fiction.

Riddle has since been codified, giving joint tenants the statutory right to sever joint tenancies through a unilateral deed or other written declaration. [CC §683.2]

Recording requirement for severance

Recording is necessary to terminate another joint tenant's right of survivorship. The **unilateral severance** (deed) of a joint tenant's interest must either be:

- recorded in the county where the property is located before the death of the severing joint tenant; or
- recorded within seven days after the joint tenant's death if executed and notarized within three days before the joint tenant's death. [CC §683.2(c)]

Additionally, the joint tenancy may be severed by agreement of the joint tenants. If a written agreement to sever the joint tenancy is signed by all the joint tenants, recording or notarization is not required. [CC §683.2(d)]

All the preceding rules for recording a severance deed apply fully to the severance deed of a spouse seeking to terminate the right of survivorship held under the community property vesting. [CC §682.1]

The unilateral severance of a joint tenancy terminates the right of survivorship. Without the existence of the right of survivorship, each co-owner disposes of his interest in the property on death as he wishes, such as by will or inter vivos trust, or by the severance itself.

Although the sale of a joint tenant's separate property interest in real estate severs the joint tenancy, a lease or encumbrance of the property by a joint tenant does not.

All the procedures for severing a joint tenancy are fully available for a husband or wife to sever the community property vesting which includes the right of survivorship. [CC §682.1]

Clear title on death by affidavit

When co-ownership of property is vested as a joint tenancy, the death of a joint tenant **automatically extinguishes** the deceased joint tenant's interest in the real estate, leaving the surviving joint tenant(s) as the sole owner(s). However, the deceased joint tenant's interest in the property must be cleared from the title before the surviving joint tenant(s) will be able to sell, lease or encumber the property as the sole owner.

The new ownership interest of the surviving joint tenant(s) is documented by simply recording an *affidavit*, signed by anyone, declaring the death of a joint tenant who was a co-owner of the described real estate. [Prob C §210(a)]

The interest in the property held by the deceased spouse "as community property with right of survivorship" is extinguished by the same **affidavit** procedure used to eliminate the interest of a joint tenant, except the surviving spouse (or his representative) is the only one authorized to make the declaration. [See **first tuesday** Form 461]

The **joint tenancy affidavit**, which is a statement made under the penalty of perjury, includes:

- the name of the deceased joint tenant, sometimes called the *decedent*;
- a copy of the deceased joint tenant's death certificate;
- a description of the real estate affected by the joint tenant's death; and
- a statement the deceased is the person vested in title to the described property as a joint tenant. [See Form 460]

Once the affidavit is **notarized, recorded and indexed**, anyone conducting a title search on the property will have notice of the joint tenant's death since the deceased joint tenant is indexed as a grantor. Thus, the surviving joint tenant becomes the **sole owner** of the property due to the right of survivorship.

Lien or lease extinguished on death

A trust deed lien or a creditor's judgment lien secured solely by a joint tenant's interest in real estate is extinguished on the death of the joint tenant. By the right of survivorship held by the surviving joint tenant(s), the ownership interest of the deceased joint tenant is **extinguished**, leaving nothing for the lien to encumber.

These rules of nonliability for surviving joint tenant(s) do not apply to the debts of a deceased spouse under the community property vestings, with or without the right of survivorship. [CC §682.1]

Consider an **unmarried couple** who hold title to a parcel of real estate as joint tenants.

A judgment creditor of one of the joint tenants seeks to execute on the judgment by foreclosing on the joint tenant's interest in the real estate.

A notice of levy is recorded and a date is set for the execution sale. However, before the date of the sale, the joint tenant who is the judgment debtor dies.

The surviving joint tenant seeks to bar (or set aside) the judgment creditor's execution sale, claiming the judgment lien only attached to the deceased joint tenant's **separate property interest** in the real estate which was extinguished on the joint tenant's death due to the right of survivorship.

The judgment creditor claims the joint tenancy was *severed* by the recording of the levy on the deceased joint tenant's interest, terminating the right of survivorship and preserving the judgment lien.

However, until the execution sale takes place, the judgment creditor only has a lien on the debtor joint tenant's interest in the property. Since a lien does not sever a joint tenancy and the joint tenant's interest **ceases to exist** on his death, the judgment creditor's lien disappears on the death of the joint tenant as well. [**Grothe** v. **Cortlandt Corporation** (1992) 11 CA4th 1313]

Similarly, a lease entered into by only one joint tenant is extinguished on the death of the joint tenant who executed the lease. [**Tenhet** v. **Boswell** (1976) 18 C3d 150]

Death during divorce

The coexistence of joint tenancy and community property can lead to unintended results. The following unintended result will occur whether a joint tenancy vesting or a community property with right of survivorship vesting is used.

Consider a husband and wife who own a residence as joint tenants. The wife seeks a divorce, but takes no action to **sever** the joint tenancy. Before the marriage is ordered dissolved by the court, the wife dies. The husband claims the property is now his under the joint tenancy right of survivorship and sells it to a bona fide (BFP) purchaser.

The executor of the wife's estate seeks to obtain one-half of the proceeds of the sale. He claims the joint tenancy was severed when the wife filed the action to dissolve the marriage, and all property acquired by a husband and wife during the marriage is to be divided under community property principles on dissolution of the marriage, without consideration for the joint tenancy vesting. [Fam C §2581]

However, the marriage was never dissolved (severed). Without a dissolution, the joint tenancy was never severed by the court. Until the **marriage is dissolved** and the joint tenancy is **severed**, the residence remains vested in the husband and wife as joint tenants. Thus, the husband's right of survivorship to the property was not terminated and he will retain all the proceeds from the property's sale.

The wife, who was seeking a divorce, clearly did not intend for her interest in the property to pass to her husband on her death. However, the wife did not effect her intentions — as her attorney should have advised her — by immediately severing the joint tenancy. Thus, the husband's right of survivorship was not terminated by conveyance of the deed or dissolution of the marriage, and could be enforced whether the deceased's interest in the real estate was separate or community property. [**Estate of Blair** (1988) 199 CA3d 161]

The best remedy for a spouse involved in a divorce is to promptly and unilaterally sever the joint tenancy and community property with right of survivorship vestings.

Controlling the vesting of one-half

A spouse can unilaterally sever the joint tenancy and community property with right of survivorship vestings by:

- executing and delivering a deed that conveys legal title to a third party;

- executing a deed to him or herself;
- executing a written severance of joint tenancy; or
- executing a written instrument that evidences an intent to sever. [CC §683.2(a)]

Consider a husband and wife who own a residence as joint tenants. A dissolution proceeding is filed, creating a court-ordered preliminary injunction which prohibits both spouses from transferring or disposing of any property. The husband executes and records a *declaration of severance* of joint tenancy, deeding the property to himself. The husband dies while the dissolution proceeding is pending.

The wife claims the severance is ineffective since it violates the court-ordered preliminary injunction. The administrator of the husband's estate claims the severance is effective since it did not constitute a transfer or disposition of the property.

Was the declaration of severance of joint tenancy executed by the husband prior to his death valid?

Yes! Revesting the property by deeding it to himself did not violate the preliminary injunction against transferring or disposing of the property. [**Estate of Mitchell** (1999) 76 CA4th 1378; Fam C §2040(b)(3)]

Additionally, the community property interest of a spouse who executes a deed to him or herself to sever the title and eliminate the right of survivorship remains community property. Community property cannot be transmuted to separate property without the consent of both spouses or a court order.

A **severance deed** to oneself terminating the right of survivorship is not sufficient by itself to avoid passing the property to the surviving spouse on death for community property vested as either community property with right of survivorship or in joint tenancy.

A will must also be prepared or a living trust established (and vested with title to the property) naming the person intended to receive the spouse's community property interest on death. Otherwise, since it is community property, the property will pass by *intestate succession* (without a will) to the surviving spouse as though the severance of the vesting had never occurred. [Calif. Probate Code §13500]

Consider a similar case which is identical to *Blair* in all respects, except the wife dies **after** the marriage is dissolved but **before** the property is taken out of the joint tenancy vesting. The husband claims he is entitled to the couple's residence due to the joint tenancy right of survivorship.

However, community real estate vested in the name of the husband and wife as joint tenants becomes separate property of each on the **dissolution of the marriage**, and the community ownership of the property no longer exists. Thus, the order dissolving the marriage **severs** the joint tenancy vesting and terminates the husband's right of survivorship to the wife's interest in the property. [**In re Marriage of Hilke** (1992) 4 C4th 215]

Accordingly, the (now) ex-wife's separate property interest will be distributed under the terms of her will (**testate**), or by **intestate succession** to her heirs in the absence of a will.

Joint tenancy tax aspects

Taxwise, the main question raised for a husband and wife when the surviving spouse becomes the sole owner of what was community property, no matter how it was vested by them, is: What is the surviving spouse's **cost basis** in the property as the sole owner after the death of the other spouse?

The surviving spouse who becomes the sole owner of community real estate on the death of the other spouse receives a fully stepped-up cost basis to the property's **fair market value** (FMV) on the date of the death which terminated the community property vesting.

Thus, the surviving spouse is entitled to a fully **stepped-up cost basis** in the real estate previously owned by the community without concern for whether the property was vested as community property (with or without the right of survivorship), as joint tenants or in a revocable inter vivos (living) trust.

State law controls how marital property will be characterized for federal tax purposes. Federal law is unconcerned with the form in which title is taken to community property. [IRS Revenue Ruling 87-98]

Under California law, all property acquired by a husband and wife during marriage is community property, regardless of the vesting, if it is acquired, managed and operated as a community asset by the couple. [Fam C §760]

Thus, the real estate owned by a husband and wife (unless vested as tenants in common) is considered community property for federal income tax purposes. Accordingly, a surviving spouse entitled to the property receives a fully stepped-up cost basis to the property's FMV on the date of the other spouse's death.

However, consider a wife who becomes the sole owner of a trust deed note on the death of her husband since they held the note and trust deed as joint tenants, in an inter vivos trust or in one of the community property vestings. The trust deed note is a carryback from a sale years earlier. The note amount contains profit the couple is reporting on the installment method for tax purposes.

At the time of the husband's death, profit on the unpaid principal in the note had not yet been taxed since calculation and payment of the **tax was deferred** until principal was received on the note.

For income tax purposes, the wife seeks a fully stepped-up cost basis on the entire note to its FMV on the date of her husband's death since she became the sole owner of the note which was community property.

The Internal Revenue Service (IRS) claims the note does not qualify for a fully stepped-up cost basis. The note contains profit from a **nonexempt sale** which is being taxed as principal is received, but has not been entirely taxed prior to the husband's death.

The wife claims the note qualifies for a stepped-up cost basis since the note is a community property asset she received on her husband's death.

Does the note qualify for a fully stepped-up cost basis?

No! The carryback note held by the community and received by the wife on her husband's death does not qualify for a fully stepped-up cost basis. The note at the time of death contained profit from a sale which was reportable (recognized) and had not yet been taxed, and the tax could not be avoided by a stepped-up cost basis on death. [**Holt** v. **United States** (1997) 39 Fed. Cl. 525]

Chapter 35 Overview of the LLC

This chapter examines the formation and taxation of a limited liability company (LLC), and the conversion of an existing limited partnership to an LLC.

A limited partnership vs. the LLC

A limited liability company (LLC) is a hybrid **business entity**. It combines state law, *limited liability* advantages of a corporation with the federal income *partnership tax treatment*. [Calif. Corporations Code §§17000 et seq.; Calif. Revenue and Taxation Code §§17941 et seq.]

Like a limited partnership, the LLC itself does not pay federal **income taxes**. Instead, all reportable income, profits and losses of the LLC are **passed through** to the members for individual tax reporting. The members, as individuals, pay federal and state income tax on their share of any LLC income and profits.

The LLC is an entity comparable to a limited partnership, but without a general (liability) partner. Limited liability in an LLC extends to all members, including the manager. Conversely, the managing general partner in a limited partnership is personally liable for the partnership's debts.

The syndicator in a limited partnership sometimes seeks to limit his liability by forming a one-man corporation to act as general partner for the partnership, rather than naming himself as the general partner. A sole, corporate general partner in a limited partnership creates a liability limitation situation for the syndicator similar to the LLC, with its limited liability extended to all individual members and the manager.

Taxwise, however, a limited partnership with a sole, corporate general partner is a co-ownership structure that is more restrictive than an LLC. For instance, all partnerships with the same corporation as the sole general partner for each are taxed as corporations unless the corporate general partner owns assets with a net worth of at least 15% of the partners' contributions to all the partnerships, limited to $250,000 for total contributions up to $2,500,000. When contributions exceed $2,500,000, the net worth of the corporate general partner must be at least 10% of total contributions by partners. [Revenue Procedure 72-13]

Also, a partnership with a corporate general partner is unable to take advantage of the exemption from tax reporting for small partnerships. Partnerships with 10 or fewer partners are exempt from filing the Internal Revenue Service (IRS) 1065 return, but only if all the partners are individuals. [Internal Revenue Code §6231(a)(1)(B)]

Taxwise, the LLC also resembles an S corporation. An LLC is essentially a small corporation (because of its state law corporate liability structure) that is treated as a partnership for income tax purposes. However, an LLC has fewer restrictions imposed on the participants and their investments than in an S corporation.

For example, the shareholders in an S corporation must be individuals (or estates, organizations or trusts in limited circumstances), and an S corporation may have no more than 100 shareholders. [IRC §1361(b)]

The members of an LLC, on the other hand, can be any kind of legal entity, including individuals, corporations, partnerships and other LLCs. Also, no limit is imposed on the **number of members**. [Corp C §17001(ae)]

For real estate syndication purposes, the LLC also resembles a real estate investment trust. Real estate investment trusts (REITs) are unincorporated organizations formed for the purpose of group investment primarily in real estate. They provide limited liability for investors and pass-through of income for state and federal tax reporting. [Corp C §23000; IRC §856]

However, the REIT is not an appropriate syndication vehicle for group investments in local real estate. The LLC offers more management flexibility and the same tax results for the participants.

For example, to qualify for federal tax reporting as a real estate investment trust, the REIT must have at least 100 shareholders and 75% of the REIT's business activities must be restricted to investments in real estate, trust deed notes, cash or government securities. [IRC §856(c)(4)]

No such restrictions apply to the LLC.

Further, a REIT must always qualify its investment program with the California Department of Corporations (DOC). Conversely, an LLC only needs to qualify its investment program if a securities risk exists for its members and no exemption applies. [Corp C §23000(b)]

Formation by filing by one

The form for filing the *articles of organization* is the LLC-1 issued by the Secretary of State, the equivalent of the LP-1 for limited partnerships. The filing fee is $70. [Calif. Government Code §12190(b); see LLC-1 accompanying this chapter]

The $70 LLC-1 fee is for documents filed by mail. The Secretary of State charges an additional $15 counter fee for any LLC documents delivered in person.

The person signing the LLC-1 does not need to be a shareholding member of the LLC. In a typical real estate investment program, the LLC-1 will be signed by the syndicator acting alone. The syndicator then typically designates himself or an entity he controls as the managing member.

The LLC-1, when filed with the Secretary of State along with the $70 fee, establishes the LLC as a legal entity in the state of California. The filing provides limited liability for its members and manager. No further recording with the county is necessary. However, a certified copy of an LLC-1 and any other addenda or documents is typically recorded with the county recorder in the county where the LLC will hold to title to real estate. [Corp C §17052(f)]

When recorded, those dealing with the LLC, such as title companies, lenders, sellers, buyers, escrows, brokers and others, do not need to look any further than the LLC-1 in the county records to determine who to deal with — the manager, a group of managers or a majority in interest of members.

The LLC-1 form can be obtained from the Secretary of State's Limited Liability Company Unit, from the branch offices of the Secretary of State or downloaded from the Secretary of State's website at www.ca.ss.gov/business. [See Figure 1]

Editor's note — Although LLC forms can be obtained from any branch office or downloaded from the Secretary of State's website, only the Limited Liability Company Unit in the Secretary of State's Sacramento office will accept LLC forms for filing.

State of California
Secretary of State

LIMITED LIABILITY COMPANY ARTICLES OF ORGANIZATION

File #: _____

A $70.00 filing fee must accompany this form

IMPORTANT – Read instructions before completing this form.

This Space For Filing Use Only

ENTITY NAME (End the name with the words "Limited Liability Company," "Ltd. Liability Co.," or the abbreviations "LLC" or "L.L.C.")

1. NAME OF LIMITED LIABILITY COMPANY

PURPOSE (The following statement is required by statute and may not be altered.)

2. THE PURPOSE OF THE LIMITED LIABILITY COMPANY IS TO ENGAGE IN ANY LAWFUL ACT OR ACTIVITY FOR WHICH A LIMITED LIABILITY COMPANY MAY BE ORGANIZED UNDER THE BEVERLY-KILLEA LIMITED LIABILITY COMPANY ACT

INITIAL AGENT FOR SERVICE OF PROCESS (If the agent is an individual, the agent must reside in California and both items 3 and 4 must be completed. If the agent is a corporation, the agent must have on file with the California Secretary of State a certificate pursuant to Corporations Code section 1505 and item 3 must be completed (leave item 4 blank).

3. NAME OF INITIAL AGENT FOR SERVICE OF PROCESS

4. IF AN INDIVIDUAL, ADDRESS OF INITIAL AGENT FOR SERVICE OF PROCESS IN CALIFORNIA | CITY | STATE | ZIP CODE

CA

MANAGEMENT (Check only one)

5. THE LIMITED LIABILITY COMPANY WILL BE MANAGED BY:

- ☐ ONE MANAGER
- ☐ MORE THAN ONE MANAGER
- ☐ ALL LIMITED LIABILITY COMPANY MEMBER(S)

ADDITIONAL INFORMATION

6. ADDITIONAL INFORMATION SET FORTH ON THE ATTACHED PAGES, IF ANY, IS INCORPORATED HEREIN BY THIS REFERENCE AND MADE A PART OF THIS CERTIFICATE

EXECUTION

7. I DECLARE I AM THE PERSON WHO EXECUTED THIS INSTRUMENT, WHICH EXECUTION IS MY ACT AND DEED

SIGNATURE OF ORGANIZER | DATE

TYPE OR PRINT NAME OF ORGANIZER

RETURN TO (Enter the name and the address of the person or firm to whom a copy of the filed document should be returned.)

8. NAME [ ]

FIRM

ADDRESS

CITY/STATE/ZIP [ ]

LLC-1 (REV 03/2005) | APPROVED BY SECRETARY OF STATE

The LLC-1 is a very limited and fairly simple document, intended mainly to:

- register the LLC with the state;
- establish it as a legal entity in order to provide limited liability to all managers and members (and a minimum tax of $800 annually to the state); and
- notify the public of the individual with the authority to bind the LLC by entering into agreements on its behalf.

In an addendum to the LLC-1, the syndicator might include an *alienation-restriction provision* to assure the members that the real estate vested in the name of the LLC cannot be sold, encumbered or subjected to a long-term lease without the consent of a majority in interest of the members. The addendum serves to limit the manager's activities to the designated purpose of the LLC — to **own and operate** the real estate for the benefit of the members.

An LLC is commonly thought of as having two or more members. However, a single person can form an LLC by filing **articles of organization** with the California Secretary of State. [Corp C §17050]

Limited liability for all

The liability limitation for members of an LLC is slightly less extensive in its protection from debts than it is for limited partners in a limited partnership. The **limited liability protection** for the members of an LLC is the same as for the shareholders in a corporation. [Corp C §17101(b)]

Figure 1

Offices of the Secretary of State

Office of The Secretary of State
Limited Liability Companies Unit . . . . . .
P.O Box 9442281350 Front Street, Suite 2060
Sacramento, Ca 94244-2280 . . . . . .
(916) 657-5448

Office of the Secretary of State
San Diego Office
San Diego, Ca 92101-3609
(619) 525-4113

Office of the Secretary of State
Los Angeles Office . . . . . .
300 South Spring Street . . . . . .
Rm. 12513
Los Angeles, Ca 90013-1233
(213) 897-3062

Office of Secretary of State
San Francisco Office
455 Golden Gate Ave. Suite 14500
San Francisco, Ca 94102-7007
(415) 557-8000

Office of Secretary of State
Fresno Office
1315 Van Ness Ave, Ste 203
Fresno, Ca 93721-1729
(559) 445-6900

For example, the liability of a partner in a limited partnership is absolutely limited to the amount of their capital contribution. However, corporate shareholders — as well as members in an LLC — can be held generally liable for the debts of the corporation or LLC if it can be proven that the corporation or LLC exists solely to shield the shareholders from liability for their debts or actions.

In a limited partnership, the limited partners escape liability beyond the amount of their contributions. However, the general partner of the limited partnership is then personally liable for all partnership debts.

In a corporation or LLC, no member, officer or shareholder is generally liable for any of the entity's debts. Without personal liability for debts incurred by the LLC, an individual can use a corporate or LLC business entity to shield themselves from liability in the conduct of the investment. Such individuals carry on their personal activities behind a corporation or LLC that is merely a facade, called an *alter ego*.

A corporation, and thus an LLC, is considered an alter ego of a controlling shareholder if:

- the corporation or LLC is entirely dominated by a single individual or by a small group of shareholders or members;
- the economic interests of the corporation or LLC are indistinguishable from the interests of the shareholders or members; and
- an injustice would result from treating the shareholders' or members' acts as the acts of the corporation or LLC and not as their own. [**Stark** v. **Coker** (1942) 20 C2d 839]

Also, a corporation that is **undercapitalized** to meet its reasonably anticipated demands for cash is often considered an alter ego of the shareholders. If a corporation is not funded with a sufficient amount of capital, it will not have sufficient assets to pay off the debts it incurs in the **ordinary course** of business.

LLC gross receipts tax declared invalid

In March, 2006, a California superior court held the gross receipts tax imposed on an LLC by the Franchise Tax Board (FTB) under Revenue and Taxation Code §17942 is unenforceable, as it is unconstitutional. The decision is on appeal and most likely will be upheld due to the failure of the code to provide for apportionment. The decision is not binding as precedent since a trial court issued the ruling.

Despite this, an LLC that paid more than $800 to the FTB with a timely filing of returns within the past four years should consider filing a claim as soon as possible for a refund of any gross receipts tax paid. The filing of the claim stops the running of the statute of limitations which would otherwise bar a tax refund. [See **first tuesday** Form 378 accompanying this chapter]

To file a claim, fax or mail the completed **first tuesday** Form 378 to the following:

Fax: (916) 845-9796

Franchise Tax Board, P.O. Box 942867, Sacramento, CA 94267-8888

More information is available at the FTB's website at www.ftb.ca.gov.

PROTECTIVE REFUND CLAIM
For LLC Gross Receipts Tax

DATE:_____, 20_____, at _____, California.

1. LLC Name:_____
   LLC Identification number issued by the Secretary of State on filing the LLC-1:_____
2. This LLC hereby makes a protective claim for a refund of taxes paid pursuant to Business & Professions Code §10238, which has been declared unconstitutional by a San Francisco Superior Court, case # CGC-05-437721.
3. The tax years involved in this claim include: _____
4. The amount of the claim for a refund of the tax based on the LLC's gross receipts and paid with timely filings during the preceding four years (not including the annual $800 franchise tax), is as follows:

20_____	$_____
20_____	$_____
20_____	$_____
20_____	$_____
for a total claim of:	$_____

The undersigned hereby makes this claim as the LLC's managing member or the representative under the attached power of attorney and is the person to be contacted by the FTB.

Date:_____, 20_____

Name of Manager:_____

Signature: _____

Phone number:_____

Fax number: _____

Fax: (916) 845-9796

Mail: FRANCHISE TAX BOARD
P.O. Box 942867
Sacramento, CA 94267-8888

FORM 378 06-06 ©2006 **first tuesday**, P.O. BOX 20069, RIVERSIDE, CA 92516 (800) 794-0494

Sufficient capitalization is rarely an issue in real estate transactions since all funds needed to own the property, in the form of cash and mortgage money, must be raised before the property can be acquired.

To be undercapitalized, a corporation or LLC is then regarded as existing in name only, created to shield the shareholders or members from liability for personal debts incurred in the entity's name. [**Automotriz del Golfo de California S. A. de C. V.** v. **Resnick** (1957) 47 C2d 792]

Taxation by the FTB, a problem

To maintain the limited liability of its members as permitted by state law, the LLC must report and pay annual taxes and fees to the state.

Every LLC must pay an annual $800 **minimum franchise tax**, a tax also imposed on corporations and limited partnerships. [Rev & T C §§17941, 23153(d)(1)]

In addition to the minimum franchise tax, an LLC with over $250,000 in annual gross income (rents) is assessed an *annual gross income fee* by the Franchise Tax Board (FTB). The fees are:

- $900 for a total gross income of $250,000 to $499,999;
- $2,500 for gross income of $500,000 to $999,999;
- $6,000 for gross income of $1,000,000 to $4,999,999; and
- $11,790 for gross income over $5 million. [Rev & T C §17942(a)]

An LLC formed solely for real estate syndication purposes that acquires income-producing property with a scheduled gross income of less than $250,000, will not be concerned with the additional tax. Thus, ownership of income property valued at roughly $1,500,000 and $2,000,000, based on the cost of operations and the gross income, would not be subject to the annual "rental tax."

The LLC name

A syndicator selects a name for an LLC, which must end with the words "Limited Liability Company," or the initials "LLC" or "L.L.C." The words "Limited" and "Company" may be abbreviated to "Ltd." and "Co." [Corp C §17052(a)]

As a practical matter, the **name selected** for the LLC should reference the property purchased and operated by the LLC, such as the property's name or street address. The name of the LLC should **not** include the name of the manager or any of the members, in order to avoid making their ownership interests in the LLC easily traceable.

Also, the name may not include the words "bank," "insurance company," "insurer," "trust," "trustee," "incorporated," "Inc.," "corporation" or "Corp." [Corp C §17052(d)]

For example, a typical LLC name, created from the property's address, might be "Main Street Properties, a California Limited Liability Company."

An LLC name may be reserved by applying to the Secretary of State with a Name Reservation Request Form. For a fee of $10, the name is **reserved** for 60 days. An additional $10 counter fee will be charged if the form is given in person to the Secretary of State's public counter. [Corp C §17053; Gov C §12190(a); see Name Reservation Request Form]

Alternatively, a syndicator can use a private filing service to reserve the LLC name or file the LLC forms. These companies charge a fee for these services. One such company is:

Corporation Service Company 2730 Gateway Oaks Dr. Ste. 100 Sacramento, CA 95833 (800) 927-9800 http://www.incspot.com

Preparing the LLC-1 articles

The LLC-1 articles of organization includes a space for stating whether the LLC will be managed by all members or by one or more *appointed managers*. For real estate syndication purposes, the syndicator will, in most cases, check the box stating the LLC has one manager — the syndicator himself. Thus, he alone will be able to bind the LLC to buy, sell, encumber or lease real estate.

Also, the LLC syndicator must designate an agent for the service of process on the LLC with an address in California, as is required of any statutory entity. The agent may be an individual or an entity. [Corp C §17057(b)]

For real estate syndication, the agent for service of process is usually the syndicator or his attorney.

State of California
Secretary of State

STATEMENT OF INFORMATION
(Limited Liability Company)

Filing Fee $20.00. If amendment, see instructions.

IMPORTANT — READ INSTRUCTIONS BEFORE COMPLETING THIS FORM

1. **LIMITED LIABILITY COMPANY NAME** (Please do not alter if name is preprinted.)

This Space For Filing Use Only

DUE DATE:

FILE NUMBER AND STATE OR PLACE OF ORGANIZATION

2. SECRETARY OF STATE FILE NUMBER
3. STATE OR PLACE OF ORGANIZATION

COMPLETE ADDRESSES FOR THE FOLLOWING (Do not abbreviate the name of the city. Items 4 and 5 cannot be P.O. Boxes.)

4. STREET ADDRESS OF PRINCIPAL EXECUTIVE OFFICE — CITY AND STATE — ZIP CODE
5. CALIFORNIA OFFICE WHERE RECORDS ARE MAINTAINED (DOMESTIC ONLY) — CITY — STATE: CA — ZIP CODE

NAME AND COMPLETE ADDRESS OF THE CHIEF EXECUTIVE OFFICER, IF ANY

6. NAME — ADDRESS — CITY AND STATE — ZIP CODE

NAME AND COMPLETE ADDRESS OF ANY MANAGER OR MANAGERS, OR IF NONE HAVE BEEN APPOINTED OR ELECTED, PROVIDE THE NAME AND ADDRESS OF EACH MEMBER (Attach additional pages, if necessary.)

7. NAME — ADDRESS — CITY AND STATE — ZIP CODE
8. NAME — ADDRESS — CITY AND STATE — ZIP CODE
9. NAME — ADDRESS — CITY AND STATE — ZIP CODE

AGENT FOR SERVICE OF PROCESS (If the agent is an individual, the agent must reside in California and Item 11 must be completed with a California address. If the agent is a corporation, the agent must have on file with the California Secretary of State a certificate pursuant to Corporations Code section 1505 and Item 11 must be left blank.)

10. NAME OF AGENT FOR SERVICE OF PROCESS
11. ADDRESS OF AGENT FOR SERVICE OF PROCESS IN CALIFORNIA, IF AN INDIVIDUAL — CITY — STATE: CA — ZIP CODE

TYPE OF BUSINESS

12. DESCRIBE THE TYPE OF BUSINESS OF THE LIMITED LIABILITY COMPANY

13. THE INFORMATION CONTAINED HEREIN IS TRUE AND CORRECT

TYPE OR PRINT NAME OF PERSON COMPLETING THE FORM — SIGNATURE — TITLE — DATE

LLC-12 (REV 05/2009) — APPROVED BY SECRETARY OF STATE

In addition to the appointed manager, the LLC's operating agreement may provide for the appointment of officers such as president, secretary, treasurer, chief executive officer (CEO), chief financial officer (CFO), chief operating officer (COO) and so on. [Corp C §17154]

The officers do not need to be members or managers of the LLC. For example, an accountant or bookkeeper who is not a member of the LLC can be hired as treasurer or the CFO.

The LLC must have an office in the state of California where it maintains its records. LLC records include the names and addresses of all members and managers, copies of the articles of organization (LLC-1) and the operating agreement, copies of state and federal tax returns, financial statements and the books and records of the current and past four fiscal years.

A true copy of business records relevant to the amount, cost and value of all property owned, claimed, possessed or controlled within the county must be made available upon the request of the county assessor. [Corp C §§17057, 17058]

The LLC-12 *Statement of Information* must first be filed **within 90 days** after filing the articles of organization for the LLC. It must state the name and address of the LLC, its manager, agent for service of process and the type of business it conducts. The statement is then filed every two years thereafter during the calendar month in which the articles of organization were first filed. A $20 filing fee is required each time the LLC-12 is filed. [Corp C §17060; Gov C §12190(k); see LLC-12, accompanying this chapter]

If the information required in the filing has not changed since the previous year, the LLC may simply file the form, stating no changes have been made. [Corp C §17060(b)]

LLCs are not currently permitted to be licensed as real estate brokers. The Limited Liability Company Act prohibits LLCs from offering professional services to others in the name of the LLC for a fee, which includes the services of accountants, attorneys, physicians and real estate brokers. Some professions may conduct business and provide services under a parallel entity called a limited liability partnership (LLP), but not real estate brokers.

However, an LLC manager who is licensed as a real estate broker may act as the real estate agent representing the LLC as its broker, and collect a brokerage fee on transactions handled on behalf of the LLC. Also, an LLC can act as a principal in any real estate-related transaction, with the same powers as a corporation, partnership or individual, to conduct any business, buy, sell, finance and lease property, sue or be sued, enter into agreements, etc. [Corp C §17003]

FTB annual tax reporting

Limited liability companies are considered partnerships for tax reporting purposes, except for the annual California franchise tax and tax on rental income. [Rev & T C §28.5]

An LLC is required, like a partnership, to submit a state **information return** annually to the FTB. The form for filing an LLC information return is FTB Form 568. [Rev & T C §18633.5]

An LLC reporting as a partnership for federal income tax purposes is required to file a 1065 return annually with the IRS, unless the LLC qualifies for the 10-or-fewer small partnership exemption.

Federal small partnership exemption

Although it does not pay income taxes, a partnership — including LLCs since they automatically qualify as partnerships — is required, unless exempt, to file an information return with the IRS, reporting the income and losses passed through to the partners. [IRC §6031]

The tax form for filing the LLC information return is the IRS Form 1065. The IRS 1065 return informs the IRS of the LLC's income and losses and identifies each member along with his share of the income and losses.

An LLC automatically qualifies as a partnership for federal income tax purposes. Thus, an LLC can avoid filing an IRS 1065 return if it qualifies under the *small partnership exemption*. [IRC §7701, IRS Letter Ruling 9543017]

An LLC or partnership with 10 or fewer participants, all of whom are natural persons or estates (husband and wife are treated as one), is not required to file an IRS 1065 Form. [IRC §6231(a)(1)(B)]

The IRS has imposed further restrictions beyond the number of participants for the exemption. Even if the LLC has 10 or fewer members, the IRS has ruled it is not exempt from filing a 1065 return if:

- it has significant holdings;
- it is a "tier" entity, in which a parent entity holds interests in one or more sub-entities;
- each member's interest in the capital and profits is not owned in the same proportion; or
- all items of income, deductions and credit are not allocated in proportion to the owner's percentage of membership. [Revenue Procedure 81-11]

Generally, most small investment groups do not have significant holdings and do report income and losses based on their percentage of ownership. Despite the additional restrictions imposed by the IRS, an LLC formed for real estate syndication with 10 or fewer members can avoid filing the IRS 1065 return. Each member reports his share of income, expenses, interest and depreciation in a schedule attached to his 1040 return, such as a Schedule E for rental ownership reporting.

Converting a partnership to an LLC

Many general partners who manage existing limited partnerships will convert their limited partnerships to LLCs. A syndicator, as manager in an LLC, has a limited liability that stands in dramatic contrast to his general liability for property operations and loans as the general partner in a limited partnership.

However, the process of conversion comes at a price. Filing the necessary forms requires fees of over $200.

Despite its cost, the advantage of limited liability gained for the syndicator ultimately outweighs the fees for converting to an LLC.

Conversion by merger

The simplest way to convert a limited partnership to an LLC is through a process called a *merger*. The LLC scheme allows a limited partnership to be merged into an LLC, which extinguishes the limited partnership. [Corp C §17550]

To complete a merger, the LLC is first created by filing an LLC-1 with the Secretary of State. Then the limited partnership is merged into the LLC by filing a **certificate of merger** form, the LLC-9. [Corp C §17552]

A merger agreement is also required, and must be approved by the limited partners. The agreement states the terms of the merger, the names of the surviving LLC and the merging partnership and the method for converting interests in the limited partnership into membership interests in the LLC. [Corp C §15678.2]

The merger agreement can simply be the operating agreement for the LLC. The syndicator can draw up an LLC operating agreement containing the same provisions as contained in the agreement for the merging limited partnership, and state in the purposes provision: "The LLC is the successor in interest to a limited partnership of the same name."

When the merger is completed by filing the LLC-9, the limited partnership ceases to exist as a separate entity, and the LLC succeeds to all the property, debts and liabilities of the "disappearing" limited partnership. No further act or documentation is required to transfer the partnership's real or personal property to the LLC. [Corp C §17554(a)]

However, if required by a title insurer, the change of ownership to the real estate can be documented by recording a copy of the LLC-9 and the LLC-1 with the county recorder of the county where the property is located.

A copy of the LLC-9, certified by the Secretary of State and recorded in the county recorder's office, serves as a notice of the transfer of property ownership to the LLC. [Corp C §1109]

Also, the limited partnership is dissolved automatically on filing the LLC-9, without having to file a certificate of dissolution (LP-3) or certificate of cancellation (LP-4). [Corp C §15678.4(c)]

The syndication program itself remains identical after the merger. The investors retain the same proportional interests, rights and obligations in the LLC as in the limited partnership as long as the LLC operating agreement is a mirror image of the limited partnership agreement.

The conversion is little more than a change in the entity's surname and the titles of co-owners of the entity. The limited partnership becomes an LLC, the limited partners become members and the general partner becomes the manager. Property operations and federal tax reporting remain the same.

The significant difference is the limited liability the former general partner gains as the syndicator of the newly-formed LLC. However, the syndicator's liability limitation does not extend to his liability for debts existing before the limited partnership was merged into the LLC. [Corp C §17554(d)]

The drawbacks of conversion

The conversion from a limited partnership to an LLC does not qualify as a change of ownership that triggers **reassessment** of the partnership's property, as long as all the members retain the same proportional interests in the LLC as in the extinguished partnership. [Rev & T C §62(a)(2)]

However, the conversion from a limited partnership to an LLC is a transfer of the limited partnership's property that triggers the due-on-sale clause in any security device, such as a trust deed, encumbering the property. [12 United States Code §1701j-3(a)]

Although the due-on-sale clause is triggered by this technical, statutory transfer of the partnership's property to the LLC, notice to the lender is avoided if the merger documents (LLC-1 and LLC-9) are not recorded with the county recorder.

No county recording is necessary to transfer the property to the LLC, since the LLC automatically succeeds to all rights and obligations of the partnership on filing the LLC-9 with the Secretary of State. Title to the real estate, tax billings and insurance policies can remain in the partnership's name since the LLC, even though the LLC-1 is not recorded, is still the successor-in-interest to the partnership.

If the LLC-9 is not recorded, and since no grant deed to the LLC exists, nothing on record will indicate a transfer of the property has taken place.

Of course, in order to obtain title insurance for a refinance or sale of the property, the LLC-9 will have to be recorded with the county recorder. However, delaying the recording interferes with the lender's ability to discover the transfer and call the loan due until the property is actually sold.

The Secretary of State will not file the LLC-9 until a *tax clearance certificate* is obtained from the FTB, stating the limited partnership has paid all taxes for which it is liable. [Corp C §17552(e); Rev & T C §23334]

Also, an LLC is not liable for the franchise tax if its tax year is 15 days or less and it does not do business during that tax year. Thus, the creation of an LLC and the merger should occur during the last 15 days of December. [Rev & T C §17946]

LLC-12 information statements

Within 90 days after recording an LLC-1 form with the state of California, called a *filing*, the LLC syndicator, as manager, must fill out an LLC-12 form **Statement of Information** and send it, along with a check for $20 payable to the Secretary of State, to:

Secretary of State, Statement of information Unit P.O. Box 944230 Sacramento, CA 94244-2300

Failure to file the LLC-12 within the 90-day period following the filing date of the LLC-1 results in a $250.00 penalty. The LLC-12 form is available online at www.ss.ca.gov/business. There, it can be viewed, filled out and printed from your computer for preparation prior to mailing to the state.

In addition, every two years after filing the LLC-1, an LLC-12R statement of information form must be mailed to the Secretary of State for filing, along with a payment for the $20.00 processing fee. The period for filing the LLC-12R is every two years during the month in which the LLC-1 was filed or the preceding five months. Filing the LLC-12R continues until the LLC files an LLC-4/8 form for cancellation of the LLC entity.

Preparing the statement of information

The following **instructions** are for the preparation and use of the LLC-12 statement of information. Each instruction corresponds to the provision in the form bearing the same number.

1. **Enter** the name of the limited liability company exactly as it is recorded with the Secretary of State.
2. **Enter** the file number issued by the Secretary of State.
3. **Enter** the state under whose laws the LLC was organized.

4. **Enter** the complete street address, city and zip code of the principal executive offices of the LLC. Do not enter a P.O. Box or abbreviate the name of the city.
5. **Enter** the complete street address, city and zip code of the office in California where the LLC's physical records are maintained.
6. **Enter** the name and complete business or residential address of the chief executive officer, if one exists.
7. **Enter** the name and complete business or residential address of the manager identified in the LLC-1 articles or operating agreement.
8. **Provides** for identification of an additional, named manager.
9. **Provides** for identification of an additional, named manager.
10. **Enter** the name of the agent for service of process located in California. Typically, the manager is the agent for service of process. However, a member or an attorney who represents the LLC could be named as the agent for service.
11. **Enter** the business or residential address of the agent for service if he is an individual.
12. **Enter** a brief description of the business conducted by the LLC.
13. **Enter** the name and title of the person completing the LLC-12 form. **Enter** the date this form was prepared and **obtain** the signature of the person named.

Cancellation of the LLC-1

Within 12 months after creating an LLC by filing the LLC-1 with the Secretary of State, a syndicator may need to or want to cancel the LLC. **Cancellation** eliminates the LLC entirely and terminates any further assessment of the annual $800 franchise tax on the entity.

Frequently, an LLC entity is formed solely to hold title to real estate for an individual who is the true owner of the property. For federal tax reporting purposes, the LLC is considered a *disregarded entity*, which does not affect the individual's personal tax handling of real estate vested in his "one-man" LLC.

The individual creates his one-man LLC by preparing, signing and filing the LLC-1. He takes on no co-owner, acts as the sole owner of the LLC, which does not report to the IRS, but does report to the California FTB and pay the annual California LLC franchise tax.

While the individual vests his property in the name of the LLC, he may want to retain the LLC vesting but cancel the entity to eliminate the annual franchise tax (and of course end the right of the LLC to sue or be sued and his right to limited liability for obligations of the LLC). Since the LLC was formed only for the purpose of vesting title to the property in the name of the LLC in lieu of vesting title in the name of the individual, the limited liability shield serves no legal consequence.

A checking account is established in the name of the LLC and will be retained. Following the cancellation of the entity, title will remain in the LLC vesting.

If the individual needs to encumber or convey the property on a refinance or sale, the LLC-1 remains of record with the county recorder, authorizing the individual to encumber or convey real estate vested in the name of the LLC, even though it, as an entity, has been formally canceled with the state of California. Conveying is different from suing someone in the name of the LLC since maintaining a lawsuit is not permitted after cancellation of the LLC-1, but the individual is unaffected by the cancellation and is able to sue in his own name.

State of California
Secretary of State

LIMITED LIABILITY COMPANY
SHORT FORM CERTIFICATE OF CANCELLATION

There is no fee for filing a Short Form Certificate of Cancellation.

IMPORTANT – Read instructions before completing this form.

This Space For Filing Use Only

FILE NUMBER

1. Secretary of State File Number

ENTITY NAME (Enter the exact name of the domestic limited liability company.)

2 Name of Limited Liability Company

REQUIRED STATEMENTS (The following statements are required by statute and may not be altered.)

3 a) This Short Form Certificate of Cancellation is being filed **within twelve (12) months** from the date the Articles of Organization were filed with the Secretary of State.

b) The limited liability company does not have any debts or other liabilities, except as provided in Item 3(c);

c) The tax liability of the limited liability company will be satisfied on a taxes-paid basis or a person, limited liability company, or other business entity assumes the tax liability, if any, of the dissolving limited liability company as security for the issuance of a tax clearance certificate from the Franchise Tax Board and is responsible for additional taxes or fees if any, that are assessed under the Revenue and Taxation Code and become due after the date of the assumption of tax liability;

d) The final tax return has been filed with the Franchise Tax Board, as required under Part 10.2 (commencing with Section 18401) of Division 2 of the Revenue and Taxation Code.

e) The limited liability company has not conducted any business from the time of the filing of the Articles of Organization; and

f) Payments received by the limited liability company for interests from investors, if any, have been returned to those investors

ASSETS (Check the applicable statement. Note. Only one box may be checked.)

4 ☐ The known assets of the limited liability company remaining after payment of, or adequately providing for, known debts and liabilities have been distributed to the persons entitled thereto

☐ The limited liability company has acquired no known assets.

DISSOLUTION (Check the applicable statement. Note. Only one box may be checked.)

5. ☐ A majority of the members or managers of the limited liability company named in Item 2, have voted to dissolve the limited liability company The undersigned constitutes a majority of the members or a majority of the managers

☐ There are no members or managers The sole person or a majority of the persons who signed the Articles of Organization of the limited liability company named in Item 2 has voted to dissolve the limited liability company The undersigned constitutes the sole person or a majority of the persons who signed the Articles of Organization.

EXECUTION

6. I declare I am the person who executed this instrument, which execution is my act and deed.

Signature of Member, Manager or Organizer	Date	Type or Print Name of Member, Manager or Organizer
Signature of Member, Manager or Organizer	Date	Type or Print Name of Member, Manager or Organizer
Signature of Member, Manager or Organizer	Date	Type or Print Name of Member, Manager or Organizer

RETURN TO (Enter the name and the address of the person or firm to whom a copy of the filed document should be returned.)

7. NAME

FIRM

ADDRESS

CITY/STATE/ZIP

LLC-4/8 (EST 03/2005) APPROVED BY SECRETARY OF STATE

Occasionally, a syndicator files an LLC-1 in anticipation of acquiring a property by forming an investment group, but is unable to close escrow and take title in the name of the LLC. The syndicator may have encountered difficulty clearing contingencies and, as a result, canceled the purchase agreement and escrow instructions. It is more likely that he failed to solicit and obtain sufficient commitments from investors to fund the closing.

Either way, the LLC now exists as an entity and the LLC-12 must be filed within 90 days after filing the LLC-1 or a $250 penalty is incurred. The syndicator must pay ongoing annual $800 franchise tax as long as the LLC-1 remains uncancelled. Thus, within 12 months after filing the LLC-1, the syndicator who created an LLC and no longer needs it, can prepare and file an LLC-4/8 form to rid himself of further liability and the continued existence of the LLC as an entity. There is no charge for filing an LLC-4/8. Any filing by mail should be sent Certified Mail Return Receipt Requested.

Before filing the LLC-4/8 cancellation, a final tax return must be filed with the Franchise Tax Board. However, a return does not need to be filed with the IRS if a return has not previously been filed.

The following instructions are for the preparation and use of Form LLC-4/8 Certificate of Cancellation. Each instruction corresponds to the provision in the form bearing the same number. [See Form LLC-4/8 accompanying this chapter]

1. **Enter** the file number assigned to the LLC by the Secretary of State.
2. **Enter** the name of the LLC exactly as it is recorded with the Secretary of State.
3. **Provide** statements required by the person canceling the LLC-1 and which cannot be altered. The form cannot be used if any of the statements do not apply.
4. **Check** the appropriate box to indicate whether property or cash has been acquired by the LLC or if neither has been acquired.
5. **Check** the appropriate box to indicate whether a group of members organized under an operating agreement has voted to dissolve the LLC, or the organizer who signed the LLC-1 has decided to dissolve the LLC.
6. If an operating agreement has not been entered into and no members have been admitted into the LLC, the individual who signed the LLC-1 must sign the LLC-4/8 as the organizer. If there are members, then a majority of the members must sign.
7. **Enter** the name and address of the person to whom a copy of the filed LLC-12 is to be returned.

Chapter 36 LLC membership buyouts

This chapter reviews the provisions in an operating agreement for a limited liability company (LLC) which allow for the buy out of one member by others.

Assigning or terminating a member's interest

Consider an investor who acquires a fractional ownership interest in a limited partnership which owns real estate. Later, the partnership is *converted* to a limited liability company (LLC) to eliminate the general partner's exposure to future liabilities.

An LLC *operating agreement*, nearly identical to the prior partnership agreement, is entered into by all parties involved. Each investor's ownership interest in the limited partnership is **converted** to a *member's interest* in the LLC, and the general partner is given the title *manager*.

The investor now wants to sell his fractional **membership interest** in the LLC.

However, the LLC **operating agreement** restricts the **assignability** of a member's interest, as did the limited partnership agreement. This *restraint* on assignability exists to prevent the admission of outsiders who might later interfere with the LLC's investment objectives and operations.

The LLC's operating agreement permits a member to **sell and assign** his membership interest in the LLC if:

- the manager or another member of the LLC exercises his *right of first refusal* to buy and acquire the investor's interest;
- the other members **waive** their *right to terminate* a member's interest should it be sold without their approval; or
- a voting majority of the members in interest **consent** to the sale and assignment of the member's interest. [See Figure 1 accompanying this chapter]

The investor first offers to sell his membership interest to the manager under the **right of first refusal** given to the manager in the LLC operating agreement.

The manager declines the offer since he is forming new investment groups to amass his own future wealth and has no interest in repurchasing or marketing fractional interests held by investors in existing investment groups. The manager would rather put investors into fresh deals which add fees and participation in ownership to the manager's portfolio.

Next, the investor offers to sell his fractional interest to other members of the LLC, who also decline.

The investor locates an outside buyer who is interested in buying his membership interest.

The other members pose no objection to the investor selling and assigning his interest and agree to *waive their right* to terminate the investor's membership interest on a sale to a buyer.

However, the other members are unwilling to also approve an assignment of the investor's membership interest and accept the buyer as a *substitute member*.

Buy-out provisions restrict assignments

By the terms of the operating agreement, a member's interest may be terminated by the remaining members if the existing member transfers his interest without the prior approval of the remaining members, unless they have *waived* their right to do so. On termination, the remaining members have the **right to buy out** the selling member's interest at what is usually an advantageous, predetermined price. [See Figure 1]

To continue with our previous example, while a waiver of termination rights allows the investor to freely dispose of his interest, the refusal of the other members to accept the investor's buyer as a member reduces the value of the investor's fractional interest.

The investor claims the limited liability company (LLC) cannot impair his right to sell and assign his fractional membership interest in the LLC to a buyer.

However, the **assignability**, and thus marketability, of a member's interest can be controlled by the LLC operating agreement. [Calif. Corporations Code §§17301, 17303]

Thus, while the investor may assign his interest to the buyer, the assignment cannot be freely made due to the restraint on a transfer agreed to in the LLC operating agreement. Even if a waiver is obtained from the other members, an assignment does not substitute the buyer as a new member.

The remaining members must **approve** of the buyer as a *substitute member* and **release** the investor from the LLC before the **right of membership** can be transferred to the buyer. [Corp C §17303]

Consent to the assignment of a membership interest by the remaining members is accomplished by a vote of a majority in interest of the members in the LLC, unless the operating agreement calls for a different voting percentage. [Corp C §17303]

Until approved as a **substitute member**, the buyer by an assignment of the investor's interest is a *non-voting member* of the LLC. [Corp C §17301]

Assignable interests in an LLC

No member of a limited liability company (LLC) has an ownership interest in the LLC's real estate. [Corp C §17300]

Rather, a member owns a **personal property** interest as a shareholder in the LLC which owns the real estate. [Corp C §17300]

Two **assignable interests** exist in an LLC:

- the ownership interests held by members; and
- the manager's administrative interest.

All of the fractional **ownership interests** in the LLC are held by its members only. The shares of ownership are based on the value of each member's contributions to capital, be they contributions in the form of cash (by investors) or assignment of purchase rights (by syndicators).

Unlike a standard member, the **manager's position** carries with it the administrative responsibility to operate the LLC and manage the real estate acquired with the capital contributed by the members. The manager is the **administrator** who oversees the day-to-day operations.

Figure 1 *Excerpt from **first tuesday's** LLC Operating Agreement*

5. **ASSIGNMENT OF INTEREST, SUBSTITUTED MEMBER:**

5.1 Assignment of Interest: A member may assign his membership interest to any other member at any time after he has given the manager ten (10) days notice to buy his interest on the same terms agreed upon with another member.

5.2 Invalid Assignment of Interest: All other assignment or transfer of members' interests are terminated according to the method under Section 6.

6. **TERMINATION OF MEMBERSHIP INTERESTS:**

6.2 Events Causing Termination of a Member: A member may be terminated if any of the following events occur:

a. He dies, unless survived in interest by a joint tenant;

b. He is adjudges insane or incompetent, or is committed to a mental institution;

c. He transfers his interest to a non-member under against his interest;

d. He fails to immediately remove a charging order against his interest;

e. He files for bankruptcy;

f. He voluntarily retires, withdraws or resigns as a member;

g. He is expelled by court order or by all of the remaining members; or

h. He fails to contribute capital to the limited liability company as agreed to in Section 2.1.

6.3 Notice of Termination: Service upon the member to be terminated of a written notice stating the cause for termination and the effective date of termination terminates all of his powers and his right to share in limited liability company profits as of the effective date. The effective date is 30 days after service of the notice. Each remaining member shall be served under Section 13.2 both a copy of the notice of termination and a notice of the option rights held by the remaining members under Section 7.

7. **OPTION TO PURCHASE:**

7.1 Option to Purchase Upon Termination: Upon termination of a member's interest under Section 6, the remaining members may:

a. Dissolve and liquidate the limited liability company under Section 10.1; or

b. Buy the terminated member's entire interest. Where more than one member exercises his option, those exercising shall purchase their pro rata shares as among their cumulative ownership interest.

7.2 Notice of Exercise of Option:

a. When a member dies, notice of the option shall be given to the deceased's representative within 120 days after the representative's appointment.

Additionally, the manager, like the president of a corporation, can be terminated and a new manager appointed at the will of the members. The **members govern** the LLC, like shareholders and directors of a corporation, since the members hold the voting rights over the *alienation* of the LLC's ownership interest in the real estate it owns.

Any capital interest also held by the manager of the LLC is vested in his name as a participating member with a percentage of ownership in the LLC. Thus, the contributing manager would be both the manager and a member.

The manager's individual membership share as a co-owner of the LLC typically arises out of his *assignment* to the LLC of his right to purchase the property which the LLC acquired, although he may have also contributed cash.

Assignee's rights to participate

An **assignment** of a member's ownership interest, with or without the approval of the other members of the limited liability company (LLC), does not *dissolve* the LLC. The LLC continues to operate without concern for the assignment. [Corp C §17301(a)(2)]

While the member's economic interest in the LLC is assignable, the sale and assignment of the member's interest does not automatically entitle the buyer of the fractional interest to governing rights held by a **voting member**. [Corp C §17301(a)(2)]

Without the remaining members' waiver of their **right to terminate** the selling member's interest, the selling member's assignment may result in his interest being terminated and bought out by the manager and remaining members.

If the remaining members neither buy out the interest assigned nor consent to the assignment, the buyer of the fractional interest is only entitled to an **accounting** of the distributions of income, profit or loss the selling member would have regularly received. [Corp C §17301(a)(3)]

Additionally, without acceptance as a member by a majority vote of the remaining members in interest, the buyer acquiring a member's fractional interest is not entitled to vote or participate in the governing of the LLC or exercise the rights of a member, unless the operating agreement states otherwise. [Corp C §17301(a)(2)]

Likewise, a judgment creditor of a member can *involuntarily acquire* that member's ownership interest in the LLC through a charging order and sheriff's sale of the member's fractional interest to satisfy a debt owed by the individual member.

However, on acquiring the fractional interest of a member at a judicially ordered sale of that interest, the foreclosing judgment creditor only receives the rights of an **assignee** as a nonvoting member of the LLC. The distributions of income, profit or loss the original member would have received are all the creditor is entitled to. [Corp C §17302]

A buyer or creditor who is assigned or forecloses on a member's interest and is not approved as a member receives only the member's **economic interest** in the LLC and assumes no duty or liability to the LLC or its other members. [Corp C §17301(b)]

Substitute member's obligations

The buyer of a member's fractional interest may be admitted as a *substitute member* by a majority vote of the remaining members as controlled by the operating agreement. When substituted, the new member takes on all the **rights and responsibilities** of the selling member, including all capital contributions assessed against that member's fractional interest. [Corp C §17303(b)]

Additionally, on approving an assignment to a **substitute member**, the remaining members must vote to amend the LLC to substitute and release the selling member from future liability to the LLC, called a *novation*. Without a release of liability, or **novation**, the selling member remains obligated to the LLC under the operating agreement he originally entered into. [Corp C §17303(c); see Form 374 accompanying this chapter]

*Editor's note — After he has left, the selling member cannot later interfere with the LLC's objectives. The selling member's withdrawal does not release him from all obligations owed to the remaining members. A **fiduciary** duty among members still remains in regard to investment opportunities and operations which are known to the released member and are of value to the LLC. [**Leff** v. **Gunter** (1983) 33 C3d 508]*

The same fiduciary duty is owed to the LLC by the substitute member who becomes a voting member.

Documenting the transfer

An *assignment* of a withdrawing member's interest and *substitution* of the buyer as a new member are completed by:

- a written **assignment** from the withdrawing member to the buyer; and
- an **amendment** to the operating agreement by a vote of the remaining members.

With an **assignment**, the withdrawing member transfers all his right, title and interest in the limited liability company (LLC) to the buyer who is acquiring his fractional interest. [See Form 374]

If the remaining members elect to accept the buyer as a substitute member, the operating agreement is **amended** to *substitute* the new member (buyer) for the withdrawing member. [See Form 375 accompanying this chapter]

For the amendment to be effective on the substitution of a member, it must be signed by the remaining members holding the percentage of ownership interest called for in the operating agreement, usually a super-majority (e.g., 75%).

Should the operating agreement not state the percentage of ownership interest required to consent to a substitute member, then a majority in interest of the members must sign the amendment. [Corp C §17303(a)]

The LLC does not need to prepare and file an amended Certificate of Limited Liability Company (LLC-2) on the assignment of a member's interest. [See LLC-2 accompanying this chapter]

However, when admitted to the LLC as a substitute member, the substitute member's name must be added to the list of current members which is required to be kept at the LLC office maintained by the manager. [Corp C §17100(b)]

AMENDMENT TO OPERATING AGREEMENT

of Limited Liability Company

DATE:_____, 20_____, at_____, California.

Items left blank or unchecked are not applicable.

FACTS:

This amends the operating agreement of _____, a California Limited Liability Company, dated_____, 20_____, at _____, California, formed under a Certificate of Limited Liability Company (LLC-1) filed with the California Secretary of State on _____, _____ as document number _____, and recorded on _____, _____ as document number _____, with the county recorder of _____ County, California.

AGREEMENT:

The Operating Agreement of Limited Liability Company is amended as follows:

1. _____ is substituted as the new manager in the place of _____, who is released of all rights and obligations under the operating agreement. The new manager shall immediately file an LLC-2 Amendment to Certificate of Limited Liability Company with the Secretary of State and record the same with the office of the county recorder where the limited liability company's real estate is located.

2. _____ is substituted as a new member in the place of _____, who is released of all rights and obligations under the operating agreement. An assignment of the member's interest is attached. [**first tuesday** Form 375]

3. The limited liability company has acquired the ownership interest in the limited liability company held by _____, who is released of all rights and obligations under the operating agreement. An assignment of the member's interest is attached. [**ft** Form 375]

4. _____ is added to the limited liability company as an additional member for the agreed capital contribution of $_____ payable in cash or _____, for a percentage ownership in the limited liability company of _____%.

5. The members agree to contribute additional capital to the limited liability company in the amount of $_____ as set forth in Exhibit "A" attached to this amendment.

6. Other _____

_____

_____

I agree to the terms of this amendment.

Member	Member	Member
Member	Member	Member

 © 2007 **first tuesday**, P.O. BOX 20069, RIVERSIDE, CA 92516 (800) 794-0494

Manager's assignments

The assignment of a limited liability company (LLC) manager's interest is more complex than the **assignment of a member's interest**. It is accomplished by:

- a written assignment by the manager or notice of termination by the members;
- a vote amending the operating agreement to identify the new (substituted) manger; and
- a filing with the Secretary of State and recording with the county recorder of an **amended Certificate** of Limited Liability Company (LLC-2) naming the substitute manager. [Corp C §17054(c)(2)]

The withdrawing manager's interest is assigned to a substitute manager and the operating agreement is amended by preparing the same documents used to substitute members. [See Forms 374 and 375]

Whenever a manager is substituted or removed, the LLC must notify the Secretary of State of the change by filing the LLC-2. [Corp C §17054(c)(2)]

An LLC-2 is a standardized form issued by the Secretary of State's office to amend or correct the Certificate of Limited Liability Company (LLC-1) which is on file with the Secretary of State. [See LLC-2 accompanying this chapter]

After the LLC-2 is filed with the Secretary of State, to terminate the prior manager's authority to act on behalf of the LLC the LLC-2 must be recorded in the county where the LLC's real estate is located. [Corp C §17052(f)]

Due-on and reassessment

Two further consequences must be considered when assigning a selling member's fractional interest in a limited liability company (LLC).

First, the manager and remaining members must review each provision in the trust deeds encumbering the real estate owned by the LLC for the existence of a *due-on clause* since the buy out of a co-owner's fractional interest may trigger the lender's **right to call or recast** the terms of the loan.

If a **due-on clause** exists which contains wording relating to the transfer of fractional ownership interests in the entity vested in title, the clause would be triggered by the assignment. The remaining members must then decide whether to notify the lender of the "off-record" buy out.

Second, the remaining members must ascertain whether the assignment of the selling member's interest is classified as a **change in ownership** which would trigger *reassessment* by the county assessor and result in higher property taxes.

The transfer of 50% or less of the ownership interests held by members during the life of the LLC does not constitute a change in ownership and does not trigger reassessment of real estate vested in the name of the LLC. Thus, the transfer by members of more than 50% of the member's ownership of the LLC does trigger reassessment of the LLC's property. [Calif. Revenue and Taxation Code §64(a)]

Additionally, when a member with a minority interest in an LLC acquires enough ownership interests to hold a majority interest (more than 50%), a *change of ownership* occurs, triggering reassessment of the entire parcel of real estate owned by the LLC. [Rev & T C §64(c)(1)]

ASSIGNMENT OF INTEREST

of Limited Liability Company

DATE:_____, 20_____, at_____, California.

Items left blank or un checked are not ap pli ca ble.

FACTS:

1. This assignment is of a member's interest in _____, a California Limited Liability Company, organized under an operating agreement dated _____, _____, at _____, California, and formed under a Certificate of Limited Liability Company (LLC-1)

1.1 filed with the California Secretary of State on _____ as document number _____, and

1.2 recorded on _____ as document number _____ with the county recorder of _____ County, California.

FOR VALUE RECEIVED

2. I hereby sell, assign and transfer to _____, all my rights, title and interest as a member in _____, a California Limited Liability Company,

2.1 which interest is identified as Class "_____" and represents _____% of the voting ownership of the limited liability company, and is represented by the attached Certificate of Interest in Limited Liability Company (if one exists).

3. Assignor hearby authorizes _____, as the manager of the limited liability company, to reflect this assignment on the books of the limited liability company.

4. This assignment is subject to any restrictions on the transfer of an ownership interest provided in the Operating Agreement of limited liability company for the limited liability company.

4.1 Any necessary notices and approval of this assignment by the limited liability company or members and any right of first refusal or option to purchase the interest assigned held by the remaining members ☐ have, or ☐ have not, been consented to or waived by them.

5. Assignee hereby assumes and agrees to timely perform all the assignor's obligations under the operating agreement of limited liability company.

Date:_____, 20_____	Date:_____, 20_____
_____ Assignor	_____ Assignee
_____ Assignor	_____ Assignee

FORM 375 10-01 © 2007 **first tuesday**, P.O. BOX 20069, RI VERSIDE, CA 92516 (800) 794-0494

Vesting of member is estate planning

Vesting co-owned real estate in a limited liability company (LLC) instead of as tenants in common eliminates any interference with title to the real estate on the death of an LLC member.

By filing the Certificate of Limited Liability Company (LLC-1), entering into an operating agreement to create an LLC and vesting real estate in the name of the LLC, the death of a member (co-owner) does not create chaos for the management of the real estate. This is in contrast to what occurs on the death of a co-owner when he is vested on title as a tenant in common.

The membership interest held in the LLC by a deceased member is transferred on or after death according to how he vested his ownership interest.

State of California
Secretary of State

LIMITED LIABILITY COMPANY CERTIFICATE OF AMENDMENT

A $30.00 filing fee must accompany this form.

IMPORTANT – Read instructions before completing this form.

This Space For Filing Use Only

1. SECRETARY OF STATE FILE NUMBER

2. NAME OF LIMITED LIABILITY COMPANY

3. COMPLETE ONLY THE SECTIONS WHERE INFORMATION IS BEING CHANGED. ADDITIONAL PAGES MAY BE ATTACHED IF NECESSARY.

A. LIMITED LIABILITY COMPANY NAME (END THE NAME WITH THE WORDS "LIMITED LIABILITY COMPANY," "LTD. LIABILITY CO." OR THE ABBREVIATIONS "LLC" OR "L.L.C.")

B. THE LIMITED LIABILITY COMPANY WILL BE MANAGED BY (CHECK ONE):

[ ] ONE MANAGER
[ ] MORE THAN ONE MANAGER
[ ] ALL LIMITED LIABILITY COMPANY MEMBER(S)

C. AMENDMENT TO TEXT OF THE ARTICLES OF ORGANIZATION:

D. OTHER MATTERS TO BE INCLUDED IN THIS CERTIFICATE MAY BE SET FORTH ON SEPARATE ATTACHED PAGES AND ARE MADE A PART OF THIS CERTIFICATE. OTHER MATTERS MAY INCLUDE A CHANGE IN THE LATEST DATE ON WHICH THE LIMITED LIABILITY COMPANY IS TO DISSOLVE OR ANY CHANGE IN THE EVENTS THAT WILL CAUSE THE DISSOLUTION.

4. FUTURE EFFECTIVE DATE, IF ANY:

MONTH DAY YEAR

5. NUMBER OF PAGES ATTACHED, IF ANY:

6. IT IS HEREBY DECLARED THAT I AM THE PERSON WHO EXECUTED THIS INSTRUMENT, WHICH EXECUTION IS MY ACT AND DEED.

SIGNATURE OF AUTHORIZED PERSON

DATE

TYPE OR PRINT NAME AND TITLE OF AUTHORIZED PERSON

7. RETURN TO:

NAME
FIRM
ADDRESS
CITY/STATE
ZIP CODE

SEC/STATE FORM LLC-2 (Rev. 03/2005) – FILING FEE $30.00

APPROVED BY SECRETARY OF STATE

Six **types of vestings** are available for ownership interests held by individuals in real estate or personal property (shares in the LLC) located in California:

- joint tenancy;
- community property;
- community property with right of survivorship;
- tenancy in common;
- sole and separate ownership (single, unmarried, spouse); and
- revocable living (inter vivos) trusts or other title holding arrangements.

Vesting is not only evidence of who owns an interest in property, vesting is a method of estate planning for stating the nature of the ownership (community or separate) and distribution of the interest on the owner's death (by the right of survivorship, will or trust).

Two or more individuals may vest the percentage of LLC membership interest they jointly own in "joint tenancy," such as "husband and wife as to a 20% interest, as joint tenants."

On the death of one of the joint tenant members, the surviving joint tenant who co-owned the interest with the deceased automatically succeeds as owner to the entire membership interest they had jointly held in the LLC. [See Chapter 34]

The **sole advantage** of a joint tenancy vesting for a co-owned interest is the avoidance of probate. The same results occur when the husband and wife vest their co-ownership as community property with the right of survivorship.

Managing a deceased member's interest

When a limited liability company (LLC) member dies, the member's legal representative, such as an executor, administrator or trustee, may exercise all of the member's rights in the LLC for the purpose of administering and securing the **deceased member's estate**. [Corp C §17304(a)]

LLC operating agreements typically include provisions allowing the remaining members to **terminate a member's interest** upon his death, unless the deceased member's interest is held by a surviving joint tenant who co-owned the interest with the deceased. [See Figure 1]

Thus, the remaining members can purchase the deceased member's terminated interest under the buy/sell provisions in the LLC operating agreement. [See Figure 1]

If the option to buy out the deceased member's interest is not exercised, the remaining members are under no obligation to approve the deceased's legal representative as a new member of the LLC. If they do not, the representative or any other successor of the deceased's interest may not vote or become involved in the governing of the LLC and the manager's administration of the LLC or its property.

Chapter 37 Securities aspects of LLC syndication

This chapter discusses the securities risk that exist in real estate development, financing and business operations co-owned as a group investment.

Excludes the economic risks of real estate

Bringing together a group of investors for real estate syndication as a limited liability company (LLC) or other form of co-ownership, requires an understanding of the social purpose underlying state and federal securities laws if the syndicator is to avoid **ownership activities** that become securities violations.

The classic definition of a *security* under federal law is comprised of:

- an **investment** of money;
- a **common enterprise** based on the mutual success or failure of the group in its investment goals; and
- an **expectation of profits** produced by the **efforts of others**. [**Securities and Exchange Commission** v. **W. J. Howey Co.** (1946) 328 US 293]

In application, the purchase and ownership of real estate by any group of investors involves both the elements of an **investment** and a **common enterprise**. Thus, the syndicator's formation of a group for an investment in real estate has the potential for creating a *securities risk*.

However, to create a security, the investment program must contain the third element of profit produced by others through an activity that creates property value. A **securities risk** arises when the investor releases control of his cash contribution, and it remains under the syndicator's control until the promised, value-creating activity is completed.

The risk created by including an activity that **creates value** distinguishes the group investment that contains the securities risk from a group investment that does not present a securities risk and is not controlled by the securities law.

To be a security, the investment program sold to the group of investors must provide for a **return of the original investment** based on a promise, by the syndicator or someone else, of future physical development or other change of use for the real estate acquired, that must be completed before the investment goal can be attained.

However, the mere formation of a group of investors by a syndicator to purchase and operate an existing income-producing real estate project for annual income or hold land for profit on resale, does not involve a securities risk. Here, the expectation of a return is based on the performance of the property in the marketplace, economic conditions that affect all properties. The investors are not counting on the efforts of the syndicator or any other person to produce improvements or to develop a use for the property after the invested money has been released from the investor's further control.

Also, an LLC is merely a **business structure** used as a form of group ownership in a real estate investment program. Thus, offering cash investors fractional membership interests in an LLC (or as tenants in common) formed to fund the acquisition of an existing income-producing property is not, without analyzing the syndicator's activities in the investment program, the offering of a security.

Conversely, an investment group formed to develop real estate or undertake an ongoing resale marketing program, farming operation or business opportunity contains securities risks, regardless of the entity or form of vesting chosen for the group.

A corporate securities risk is created by placing the investors' capital at a **risk of loss** before the property can be placed on the market for rent or for sale due to the need to:

- complete significant value-adding activities after the acquisition of the property; or
- select a property to be acquired after investors have relinquished control of their cash (a blind pool).

An investment program that involves an activity that constitutes a securities risk imposes a duty on the syndicator creating the program and soliciting investors' capital to comply with the securities law. Exemptions exist that remove some investment programs containing securities risks from control under the securities law.

Unless exempt, the syndicator first reports to the appropriate government agency:

- the California Department of Corporations (DOC) to comply with state securities rules (for qualification under a permit); or
- a registration with the Securities Exchange Commission (SEC) to comply with federal law.

Failure to qualify or register the sale of non-exempt corporate securities exposes the syndicator who creates the securities risk to civil and criminal liability.

A properly selected and structured investment program avoids ownership activities that place the investors' capital at a risk of loss after acquiring the property, such as after-closing development, asset selection or collective coordination with others (rental pooling). These ownership activities create a relationship between the investors and the syndicator that is classified as a *corporate security*.

Existing asset vs. securities risks

A group of investors formed as an LLC purchases a newly constructed, but unoccupied apartment building. The syndicator who solicited the investors' funds serves as manager for the LLC and the property. The LLC members have the right to cancel the property management agreement with the syndicator by removing him as the manager on 30 days' notice.

The investment program eventually fails to be a financial success. The local economy does not produce enough tenants to occupy the property and provide sufficient rental income to pay operating expenses and installments on the purchase-assist loan.

The LLC co-owners make a demand on the syndicator for a return of their investment, plus interest. They claim the purchase of the complex, when coupled with the property management agreement, created a corporate security that was neither exempt from the securities law nor qualified by the DOC. The co-owners claim they relied on the syndicator's **management expertise** to rent out units of the newly constructed building and create a *return on the capital* they invested in the LLC.

Does the syndicator who merely manages property in competition with other like properties impose a liability on himself for the return of the co-owner's capital?

No! A corporate security is not created solely by the existence of a property management related activity or the promise or expectation on an annual return on their investment. The members **retained control** over the management of the property, based on their right to terminate the property management agree-

ment and the manager by a vote of the members. Further, they could replace management with readily available management as a service offered in the brokerage community.

Here, the investors did not place their capital at risk in reliance on the skill and effort of another to **create value** in the property. Instead, they acquired a fully improved, existing asset in exchange for the funds invested, on the chance the market place will allow their investment to prosper. Also, they retained ultimate control over management since they could change management at any time. The investors bought the property as the investment, not the syndicator's management expertise (which was, instead, the subject of the property management agreement). [**Fargo Partners** v. **Dain Corp.** (8th Cir. 1976) 540 F2d 912]

Now consider a syndicator who sells small parcels of agricultural land planted with citrus trees to individual investors. Under a **service agreement** attached to each purchase agreement, the syndicator will care for the trees and harvest and market the fruit produced by the trees under his management. The term of the service agreement is 10 years.

The syndicator manages the groves on all the separate parcels by coordinating the ownership and operations of all the parcels as a single, large-scale farming operation. The syndicator has the knowledge and equipment required to conduct a successful farming operation and to **produce and sell** the crop. Each investor is to receive a share of the syndicator's net operating income from the crop production based on their pro rata ownership of all parcels farmed under the service agreement, called a *pooling arrangement*.

In contrast to the co-ownership of an apartment building by several investors who employ the syndicator as the manager to locate tenants and rent existing units, an investment in a parcel of agricultural land, operated as a farming business that is coordinated and managed by the syndicator, contains a corporate securities risk. The investors rely solely on the expertise of the syndicator to create a return of their invested funds by **producing a crop**, then harvesting and selling it. Further, he agreed to do so in cooperation with owners of other properties in a *pooling arrangement*.

Here, an investor who might cancel the service agreement with the syndicator will not be able to independently operate his parcel of land and its grove with any economy if it is separated from the others, or readily hire another operator to coordinate with the other owners to farm the parcels as a *collective* to produce and market crops. The **financial success** of the operation requires all the parcels in an economy of scale to be operated as one, using special equipment and skills possessed by the syndicator.

Thus, even though the transaction was structured as a sale of a parcel of real estate to an individual purchaser combined with a service agreement, the related series of transactions display the critical elements of a corporate security — a group investment with an expectation of profits and success inextricably interwoven with the efforts of others to produce a crop to generate an income and, ultimately, a return of the investment. [Securities and Exchange Commission., *supra*]

Protecting the investor

The state and federal corporate securities laws exist to protect investors who risk their capital in **asset-creating investment schemes** offered by others. The purpose is to give the investors a reasonable opportunity to realize profits on the investment.

A securities risk is created under California securities law whenever:

- an investor places his funds at risk of loss; and

- assumes a passive role, giving control of essential asset selection, development, pooling or resale decisions exclusively to the syndicator or others.

A security is created when the syndicator or others promise to perform an activity that **creates value** after the close of the purchase, an activity that must be completed successfully before value is added to the property and a return on or of capital can be expected.

In essence, the investor did not invest in an existing asset, but in the skill of someone else to create that valuable asset in the future. The invested funds are no longer controlled by the investor, but by the syndicator or others. Activities that occur after closing and create a **securities risk** include:

- locating and selecting a property for acquisition, called a *blind pool*;
- obtaining government approval or permits for zoning or use of the property;
- further improvement or significant alteration of the property; or
- operating a business or farming operation that requires expenditures for inventory, production or sales.

Thus, for a security to exist, the syndicator must undertake an ongoing investment activity that continuously places the investor's capital at risk of loss until the promised activity is completed. The securities risk is contained in the management of money, whether obtained from the investors or borrowed funds, to improve the property, create the crop or obtain agency approvals for a new use to fulfill the purpose of the investment.

Examples of activities that include a securities risk for investors in syndicated real estate transactions include:

- subdividing, improving or reselling the real estate (dealer activities);
- operating a business on the premises acquired rather than merely managing the rental of the real estate or the ownership of vacant land; and
- buying and selling to maintain a portfolio of trust deeds.

The California securities law is designed to give investors a fair chance of realizing investment objectives promised to be completed by others. The syndicator is responsible for returning the investor's capital if promises are not fulfilled to complete after-closing activities that create the significant value necessary to provide for a return of the investors' contributions. [**Silver Hills Country Club** v. **Sobieski** (1961) 55 C2d 811]

Controlled investments

The securities issue for the syndicate manager is to determine which investment activities do and which do not include risk situations that trigger the application of the securities law.

The existence of a security is a matter of the *substance* of the transaction, not the *form* it has been given. The economic function of the transaction, rather than the title the transaction bears or the type of business form used, determines whether a securities risk exists.

Editor's note — An exception to the substance-over-form rule is the issuance of ***stock****. Any transaction that involves the issuance or transfer of investment certificates, which are formally called stock, is a controlled security, regardless of the economic substance of the investment in the "stock." [****Landreth Timber Company*** *v.* ***Landreth*** *(1985) 471 US 681]*

For example, the citrus grove investment program in *W.J. Howey Co.* was structured as a sale of a parcel of improved agricultural property. Each investor became the sole owner of an individual parcel of land — a real estate sales situation that, without further involvement after the acquisition, does not contain a securities risk.

However, each owner has no reasonable ability to **independently control** or operate the property and farming business they bought into. Success was entirely in the hands of the syndicator to create a return of their invested funds through the husbandry, production, marketing and sale of the crop, and the coordination by *pooling* with other owners.

Next, consider an investor who purchases a condominium unit through a real estate broker. Normally, the purchase of a residential unit does not constitute a corporate security. However, the broker also arranges for the buyer to enter into a *rental pooling agreement* (RPA) with a vacation rental management company for the ongoing operation of the property. The broker has no connection to the management company employed in the RPA and receives no kickback or fee for the referral.

Under the RPA, the management company oversees rental operations for the entire project in which the investor's unit is located. As managers, they distribute spendable rental income (rent minus expenses) to the investors of individual units based on each of their pro rata share of ownership participation in the RPA, not based on the actual performance of each separate unit, an activity called *rental pooling*.

The RPA is a major inducement for the investor to purchase the condominium unit. The pooling arrangements will enable him to locate tenants, rent the unit and collect rental income without being personally responsible for the day-to-day management of his unit. Critical to the investment is the sharing of investment risks; he will share the income and expenses with everyone else within the "pool." More strategically, the investor plans to cover his monthly payments on the condominium out of the rental income.

Ultimately, due to market forces, not management, the unit fails to produce the level of rental income the investor expected. The investor seeks to recover his investment from the broker, claiming the purchase of the condominium coupled with the RPA was a corporate security, since the investor relied on the management efforts of others in the **joint operation** of several units to produce a return of his investment.

The broker claims he did not create a corporate security since the investor was not required to enter into the RPA as part of the agreement to purchase the condominium, and the broker was not in control of the management of the property. Did the broker create a corporate security by arranging an RPA for the investor?

Yes! The purchase of the condominium unit coupled with the RPA was presented to the investor as a single investment scheme. The investor was induced to invest his funds in the common enterprise based on an **expectation of profits** produced by the efforts of others in a "pool and split" program — even though the broker himself was not the person responsible for coordinating the rental pooling effort.

Since the broker induced the investor to place his funds at risk on the close of escrow in anticipation of a future return generated by the efforts of others — the pooling and management of several separately owned properties under the RPA — a securities risk was created. [**Hocking** v. **Dubois** (9th Cir. 1989) 885 F2d 1449]

Subdivided parcels sold to groups

Now consider a developer who acquires a large parcel of real estate for the development of a planned community. The developer sells parcels within the planned development to groups formed as LLCs. The parcels are advertised as being suitable for development as part of the planned community.

The developer does not promise to develop the parcels sold to the LLCs or to produce profits for the LLCs based on the development of the entire project, adjacent parcels, off-site infrastructure or a pooling arrangement.

One group of investors who acquired a parcel in an LLC makes a demand on the developer and his broker for a return of their investment, claiming a security was created since they relied on the developer to complete the development of the planned community, which did not occur.

However, the group of investors had complete control over the parcel it acquired from the developer — nothing remained to be done after acquisition, except for the investors to wait for the market to deliver a profit or loss. Thus, no securities risk was created. The transaction was merely a sale of real estate to the LLC, to hold for a profit on resale or later development as the group saw fit. [**De Luz Ranchos Investment, Ltd.** v. **Coldwell Banker & Company** (9th Cir. 1979) 608 F2d 1297]

Risk capital tests

State and federal courts apply slightly different tests to determine whether a securities risk exists in an investment program. In California, courts apply the *risk capital test* to determine whether a real estate transaction requires securities law protection.

The California risk capital test requires the investors' capital to simply be placed at risk in an activity controlled by the securities laws, **whether or not a profit** is expected or intended. Compared to federal securities law, the California securities law is further-reaching and covers more investment conduct.

The federal risk capital test, on the other hand, revolves around the element of the expectation of a profit on the investment. For a security to exist under the federal **risk capital test**, the investors must be induced to join the program by, among other activities, a promise that they will profit from their capital investment.

Personal use coupled with development

Under the California rule, a syndicator's mere promise of future profits does not create a securities risk unless it is accompanied by the promise to perform an activity that creates value, such as development.

For example, a developer sells investors memberships in a yet-to-be-built country club. Later, when the developer fails to complete construction of the country club, the investors make a demand on the developer for a return of their investment. They claim the developer violated California securities law since the club memberships sold were unqualified and non-exempt securities in a construction project.

The developer claims the country club memberships are not controlled by California securities laws since the memberships merely provide for personal recreation and involve no expectation of a profit.

However, unlike federal securities law with its profit-driven test, an expectation of profit is not of concern to the California securities law. Here, the sale of memberships was coupled with a securities risk. The investors risked their capital on a "yet-to-be-built" project, relying on the developer to **complete**

the construction of the country club after the members released their investment funds to acquire their group ownership of the property. [Silver Hills Country Club, *supra*]

Promised returns without development

To avoid creating a security under California's risk-capital test, the selection of a specifically identified parcel of real estate for acquisition must exist **before** the release of invested funds. Even then, the only business that may be conducted after acquiring the property is either the location of tenants and rental of the property or the ultimate resale of the unaltered property at a profit.

If, on closing a purchase escrow, the investor receives **full value** for his investment in the form of a fixed asset, such as a share ownership in an existing parcel of real estate, no security is created. The investor's invested capital is no more at risk than had he purchased the asset outright, with or without a promise of profits. [**Hamilton Jewelers** v. **Department of Corporations** (1974) 37 CA3d 330]

In another example, a syndicator locates real estate he decides to syndicate. On completing his due diligence investigation and analysis, a detailed **investment circular** is prepared. The circular states the real estate will not be developed or improved, but simply owned and operated for what it is — a rental income property.

The investors solicited by the syndicator know they will receive an existing fixed asset for their money. The property will not be altered, further improved or converted to another use after acquisition. Thus, their capital is not subjected to a securities risk — only the **economic risks** of locating tenants and incurring expenses in the rental marketplace as experienced by all property owners.

All money invested in real estate is, to some extent, at risk of loss due to fluctuating property values brought about by economic conditions, hazards, etc., called *marketplace risks*. However, marketplace risks merely affect the level of income, profit or loss. Income and profits (or loss) from ongoing rental operations in the local economy are not the concern of securities laws.

Exemptions when securities risks exist

A large number of investments that contain a securities risk are *exempted* by statute from control under the securities law.

Investment programs offered by banks and savings and loans (S & Ls) are exempt from securities law, as are nonpublic offerings.

The **non-public offering exemption** is the most useful exemption available to syndicators who put together an investment program which includes an activity containing a securities risk. The non-public offering exemption, called the *35-or-less interrelationship rule*, applies if:

- the investors do not number more than 35 (husband and wife counting as one);
- all investors have a meaningful, pre-existing business or personal relationship with the syndicator;
- the investors will not resell or distribute the interests they acquire; and
- the solicitation of investors does not involve public advertising. [Calif. Corporations Code §25102(f)]

Thus, even if an investment program does contain securities risks, such as exists in a construction or development project, the syndicator does not need to be further concerned with the securities law if his program meets the requirements of the 35-or-less interrelationship rule for the nonpublic offering of a

security. If a securities risk does not exist in the investment program, the **solicitation of investors** from the public is not an activity which itself places the investors' funds at risk.

Disclosure of securities and the statute of limitations

Consider a syndicator whose investment program contains a securities risk activity. To solicit investors, he posts his offering in the recreational rooms of condominium projects and mobilehome parks he has an interest in. He does not obtain a permit nor does he register the sale of the investment program with the DOC or SEC.

Here, the syndicator publicly offered his investment opportunity containing a securities risk to anyone visiting the recreational rooms. Thus, his investment program was a **non-exempt offering** of a security. As a result, if the investment fails, any investor in the program can recover the full amount of his investment from the syndicator, plus 10% interest from the date of investment and less any distributions the investor has received. [Corp C §25503]

However, the investor's recovery of his investment under California securities laws is subject to a *statute of limitations*. The limitation places a time deadline beyond which an investor is barred from filing a claim for the recovery of money. An action to recover the investor's funds must be filed within the earlier of:

- two years after the date the investor funds the investment; or
- one year after the investor's discovery of the violation of securities law. [Corp C §25507]

If the syndicator, as part of his investment memorandum, discloses securities permits have not been obtained, the investor will be aware of the potential violation from the beginning. Thus, the investor's recovery under the California securities law will be subject to the one-year statute of limitations for filing his complaint.

Until the one-year limitations period expires, the investor in an investment program that contains a securities risk and does not qualify for an exemption or was not qualified for investors by the DOC, may unilaterally withdraw his investment funds at any time (plus interest and less any distribution of earnings). However, when the year period has expired following disclosure and the close of escrow, the syndicator is no longer liable for any claims for securities violations and civil money damages.

Realistically, if an investor is willing to contribute his funds to a real estate syndication in the first place, he is unlikely to withdraw and file an action within one year. Real estate investments are unlikely to go sour within one year.

Thus, even if the syndicator is certain his investment program contains no activities that are securities risks and would place the investors' funds at risk of loss after acquisition of the property, a disclosure that no permit exists limits the syndicator's exposure to liability by commencing the one year statute of limitations.

Chapter 38 The statutory purchaser's lien

This chapter presents a purchaser's lien as a means for a buyer to enforce a return of monies paid toward the purchase price when the seller breaches their purchase agreement.

Foreclosing on the seller's property

A real estate broker employed by a seller as his listing agent misrepresents to a prospective buyer the construction costs incurred by the seller for a building located on a parcel of real estate. The misrepresentations result in the buyer and seller entering into a purchase agreement. The buyer makes the agreed down payment on the purchase price and escrow closes.

After the close of escrow, the buyer constructs further improvements on the property and pays property taxes and insurance premiums. Later, the buyer learns the broker misrepresented the costs incurred by the seller to construct the improvements.

The buyer demands that the seller return all monies paid on the purchase price, the cost of the additional improvements and the property taxes and insurance premiums, an action called *rescission*. The buyer reconveys the real estate to the seller, a transaction called *restoration*.

Does the buyer have a remedy against the seller to recover the payments made toward the purchase price and the expenses related to the property?

Yes! The buyer is entitled to a *purchaser's lien* which he can foreclose on the property he reconveys to the seller as part of the recovery process called **rescission and restoration**. The **purchaser's lien** is for the amount of payments made on the purchase price, plus expenditures made to improve the property and pay property taxes and insurance premiums. [**Montgomery** v. **Meyerstein** (1921) 186 C 459]

From the moment a buyer enters into a purchase agreement with a seller to acquire property, he has an interest in the seller's property, called an *equitable ownership*. This property interest entitles the buyer to a statutory lien against the property for **amounts paid** on the purchase price if the seller fails to deliver as agreed. [Calif. Civil Code §3050]

The amount of the purchaser's lien will be *offset* by any rent the buyer receives or the implicit rental value of the buyer's use of the property while he is in possession. [Montgomery, *supra*]

The buyer's right to a lien

The right to a **purchaser's lien** for monies paid includes situations where the seller:

- fails to deliver the property as agreed;
- interferes with the buyer's right to possession;
- fails to sign and deliver agreements or documents;
- induces the buyer to enter into the purchase agreement by misrepresentation; or
- attempts to avoid his performance on the purchase agreement.

Additionally, a buyer is not entitled to a purchaser's lien if a seller's nonperformance is excused due to a breach by the buyer. [Montgomery, *supra*]

Foreclosing the purchaser's lien

The right to a purchaser's lien permits a buyer to record a **lis pendens** on the property purchased while seeking a court ordered foreclosure of the property to satisfy the purchaser's lien. The seller's property under contract with the buyer is considered security for repayment of the money the seller owes the buyer. Any deficiency in the property's value after the foreclosure sale becomes a money judgment against the seller.

For example, a buyer and seller enter into a purchase agreement. The purchase agreement calls for the buyer to make a down payment on the purchase price. The seller agrees to carry back a note and trust deed for the dollar amount remaining to be paid on the purchase price.

The buyer tenders the down payment and signs and delivers the note and trust deed to the seller. The buyer is given possession of the property. The seller's grant deed and the trust deed are not recorded.

The seller later refuses to record the grant deed and convey title to the buyer as agreed. Due to the seller's breach of their purchase agreement, the buyer decides not to complete his purchase and restore the property to the seller. He then commences an action to establish and foreclose on a purchaser's lien for the amount paid towards the purchase price.

The seller claims the buyer is not entitled to a purchaser's lien since the buyer failed to first give the seller a notice of rescission or demand a return of the money paid.

However, by seeking a purchaser's lien on the property, service of the complaint in the action is notice of the **buyer's rescission** of the purchase agreement. Since the seller breached the purchase agreement by failing to convey the property, called a *material breach*, the buyer is entitled to treat the purchase agreement as terminated and seek recovery of the money previously paid on the purchase price without prior notice.

In addition to being entitled to the purchaser's lien by statute, the buyer is also allowed to **judicially foreclose** and sell the real estate under the purchaser's lien. [**Lockie** v. **Co-Operative Land Co.** (1929) 207 C 624]

The seller is entitled to receive an offset from the amount he owes the buyer for the rental value of the property for the period the buyer occupied the property.

Purchaser's lien priority

The **priority** of a purchaser's lien on title is set as of the date the buyer is *given possession* under the purchase agreement, called the *relation back theory*.

A purchaser's lien gives a buyer who takes possession of a property priority over all later buyers or lenders who acquire an interest in the property without the buyer's consent. Due to the buyer's possession of the property, future buyers and lenders have constructive knowledge of the original buyer's interest in the property, which includes the implicit right to a purchaser's lien.

Later buyers or lenders are considered to be aware of an original buyer's interest in a property if:

- the record title to the property, such as a recorded land sales contract, lis pendens or other document, gives notice of the original buyer's interest;
- the later buyer or lender has knowledge of the purchase agreement; or
- the original buyer's possession of the property is inconsistent with the record title.

Consider a buyer and seller who enter into an oral land sales contract. The property is encumbered by an existing first trust deed.

Before the buyer is given possession of the property, the trust deed lender advances additional funds to the seller under the *future advances clause* in the trust deed.

The buyer later takes possession of the property and makes all payments on the land sales contract directly to the trust deed lender. The trust deed lender accepts the buyer's payments with full knowledge of the land sales contract between the buyer and the seller.

Later, the trust deed lender advances additional funds to the seller, again under the **future advances** clause in the trust deed.

Meanwhile, the buyer pays the lender all amounts owed on the first trust deed note at the time the buyer took possession of the property. However, he does not also pay the amount advanced to the seller by the lender after he took possession. The buyer makes a demand on the lender to release the trust deed lien on the property, called a *reconveyance*.

The lender refuses to reconvey the trust deed unless all advances are repaid, an amount greater than the amount due to the seller on the land sales contract.

Due to the fact that the seller is unable to clear title to the property as agreed to under the oral land sales contract, the buyer seeks to enforce a purchaser's lien on the property for all his payments advanced toward the purchase price. Further, the buyer claims his purchaser's lien has priority over the lender's unpaid advances since his purchaser's lien relates back in time to the date the buyer took possession of the property under the unrecorded land sales contract.

In this example, the purchaser's lien has priority over all advances made by the trust deed lender after the date the buyer took possession of the property under the land sales contract. Advances made to the seller by the lender prior to the buyer's possession are senior to the purchaser's lien.

Alternatively, the buyer may *quiet title* to the property and extinguish the trust deed of record since the trust deed lender has been paid all amounts owed under the first trust deed on the date the buyer took possession of the property under the land sales contract. [**Garcia** v. **Atmajian** (1980) 113 CA3d 516]

Buyer in default

A purchaser's lien only arises if a buyer's failure to perform as agreed in the purchase agreement is *excused* due to wrongful actions by the seller.

For example, a buyer makes a good faith deposit with his offer to purchase a property. The good faith deposit is placed in escrow to be applied to the purchase price on the close of escrow. The seller hands his grant deed to escrow for delivery to the buyer on closing.

The buyer fails to place the entire amount of the down payment in escrow when escrow calls for funds, and thus escrow does not close. The seller refuses to release the buyer's good faith deposit from escrow by returning it to the buyer.

The buyer seeks to establish a purchaser's lien on the seller's property for the amount of the good faith deposit in escrow, claiming the seller can not forfeit the buyer's deposit.

Is the buyer entitled to a purchaser's lien when it is the buyer who is in default under the purchase agreement?

No! A purchaser's lien will not exist in favor of the buyer who defaults. Thus, the buyer who breached the purchase agreement by refusing to perform according to its terms is not entitled to a purchaser's lien to secure any amount. [**Merrill** v. **Merrill** (1894) 103 C 287]

However, the seller is not automatically entitled to retain the buyer's deposit in escrow on the buyer's default. A forfeiture of the funds is not allowed even if the buyer's breach is deliberate. [CC §1057.3]

Instead, the seller is entitled to an offset against the buyer's deposit for any recoverable money losses incurred by the seller due to the buyer's breach. [**Allen** v. **Enomoto** (1964) 228 CA2d 798]

Recovering the value of improvements

A purchaser's lien covers all monies paid out by a buyer for expenses and improvements on a property. [Montgomery, *supra*]

However, for a buyer to recover his expenditures on a property, the breach cannot be caused by the buyer.

For example, a buyer agrees in a purchase agreement to buy a parcel of real estate on which a water pumping plant is located. For consideration, the buyer agrees to lay water mains on adjacent property retained by the seller of the parcel. The buyer will also provide irrigation service to the adjacent property. These promises to perform are not secured by a performance trust deed on the property purchased. [See **first tuesday** Form 451]

The seller performs as agreed under the purchase agreement by conveying the parcel with the water pumping plant to the buyer. The buyer takes possession of the parcel on which the water pumping plant is located and completes some of the promised improvements on the seller's adjacent property.

However, the buyer fails to complete all of the improvements as agreed, **reconveys** the property to the seller and makes a demand on the seller for the cost of the improvements the buyer made.

The buyer claims he is entitled to a purchaser's lien on the property reconveyed to the seller for the value of the completed improvements on the adjacent property, with priority to any interest of the seller.

However, the default in the purchase agreement was due to the buyer's failure to complete the agreed upon improvements. Thus, the buyer is not entitled to a purchaser's lien on the property for the cost of the improvements he completed. [**Wilson** v. **Smith** (1924) 69 CA 211]

Quiet title action by breaching seller

Consider a buyer and seller who enter into a purchase agreement.

The buyer makes a good faith deposit which is deposited into escrow. Before closing, the buyer discovers a defect in the title to the property being purchased and makes a demand on the seller to clear title and close escrow.

The seller cannot convey a marketable title since a title company will not insure his conveyance as agreed to in the purchase agreement.

The buyer refuses to complete the transaction and demands a return of his deposit since the seller failed to deliver marketable title as agreed. However, the seller refuses to release the buyer's deposit from escrow.

The buyer files an action to impose and foreclose a purchaser's lien on the property to recover the deposit which the seller will not release. The seller counters with a quiet title action to clear title of the buyer's purchaser's lien.

Is the seller entitled to prevail on his quiet title action?

No! The seller may not quiet title and extinguish the purchaser's lien held by the buyer until the seller returns to the buyer all monies paid toward the purchase price by the buyer. [**Benson** v. **Shotwell** (1890) 87 C 49]

Chapter 39 Unsecured carryback sellers

This chapter examines a seller's use of a vendor's lien when the buyer owes unsecured amounts remaining to be paid on the purchase price after the close of escrow.

Vendor's lien allows foreclosure

Consider a seller whose equity in his income-producing real estate is less than 20% of the value of the property. Also, the rental income produced by the property is insufficient to pay its operating costs and the loan payments. Thus, a negative cash flow exists on the property.

The seller wants to sell the property to rid himself of the carrying costs and avoid what he anticipates will be a further decline in its value.

A creditworthy buyer is located who sees potential in the property and has substantial net worth according to his financial statements.

The buyer offers to buy the property at a price based on:

- a 5% down payment;
- the assumption of the existing first trust deed loan equal to 80% of the price; and
- the seller carrying back a trust deed note for 15% of the purchase price.

The seller and his broker know a carryback note secured by the property sold is *nonrecourse paper*. Thus, the carryback seller must look exclusively to the equity in the property he sold to recover on the note should the buyer default. A money judgment for any deficiency in property value is barred by **anti-deficiency** laws. [Calif. Code of Civil Procedure §580b]

Further, if the buyer defaults on the first trust deed loan, the seller will face the loss of his second trust deed on a foreclosure by the first trust deed holder. A default on the first trust deed would force the seller to either bring the first trust deed current and keep it current, or pay it off, to avoid seeing his trust deed wiped out at a foreclosure sale by the first trust deed holder.

However, the property lacks sufficient equity to allow the seller to foreclose and recover on a carryback note which would be junior to a first trust deed loan with an 80% loan-to-value (LTV) ratio. The ability to foreclosure under such conditions poses little financial incentive for carrying back a trust deed to secure the carryback note.

As disclosed by his broker, the costs to foreclose, carry and resell the property would equal about 20% of the property value by the time of the resale. Much of these costs will be paid in cash before reacquiring and reselling the property. [See **first tuesday** Form 303]

The financial position of the carryback trust deed would not justify foreclosing and taking back the property unless the property's value increases in excess of 10%, which is an unlikely development in the flat or declining real estate market the seller is experiencing.

Little equity: go unsecured

Continuing with our previous example, the seller agrees to carry back a note, but it will not be secured by a trust deed on the property sold. Thus, the carryback seller will avoid the nonrecourse risk of not being able to recover for failure of the property's value to cover the trust deed loan and his carryback note. The risk of loss inherent in a nonrecourse note would have existed had the carryback note been secured by a trust deed on the property sold, called the *value-deficiency risk*.

Now consider another seller whose equity is about 40% of the value of the property he wishes to sell.

A buyer makes a no-cash offer to buy the property, agreeing to take over the existing first trust deed and execute two notes in favor of the seller. One note is for 20% of the purchase price and will be secured by the property. The other note is for the remaining 20% of the price and will be unsecured.

The buyer has substantial net worth, including equities in other real estate he owns. However, the buyer does not want to use the other real estate he owns as primary, additional or substitute security for either of the two carryback notes. [See **first tuesday** Form 154]

The buyer wants the real estate he presently owns to remain unencumbered so he has easy access to cash to manage his real estate acquisition programs.

Do the sellers in both of these unsecured carryback examples have any remedy if the buyers default on the unsecured carryback notes, besides obtaining a judgment for monies due on the notes?

Yes! The carryback sellers also have a *vendor's lien* on the property they sold. The lien will allow the sellers to foreclose on the property for the amount of the purchase price which remains unpaid. The lien was not waived since the debt owed to them by the buyers was always unsecured. [Calif. Civil Code §3046]

On a default in payment, the seller can choose to exercise his **vendor's lien** and f**oreclose** on the property sold. However, unlike a money judgment lien which attaches to all properties owned by the debtor, the vendor's lien only attaches to the property sold, and only if the **buyer still owns it**.

If the value in the property is insufficient to recover the unsecured balance remaining due on the purchase price, the seller can obtain a money judgment for the deficiency. The seller can also obtain a money judgment if the vendor's lien is wiped out by a foreclosure sale on the first trust deed or no longer available due to the buyer's resale or further encumbrancing of the property to a third party who does not have knowledge of the fact the buyer still owes the seller payments on the purchase price.

On obtaining a money judgment for a deficiency in value, an **abstract of judgment** is recorded. Unlike the vendor's lien, a judgment lien attaches on title to all of the properties in the county vested in the buyer's name.

Now consider a seller who carries back both a secured note and an unsecured note to evidence **separate amounts** owed on the purchase price, as occurred in our last example.

The buyer defaults on both debts and the seller forecloses on the debt secured by the property sold. On completion of his foreclosure, the seller's right to a vendor's lien for the separate amount owned on the unsecured debt is wiped out. However, the seller is still entitled to a general money judgment for the amount of the unpaid balance remaining on the unsecured note.

Further, if a buyer misrepresents his net worth to the seller to induce him to carry back the unsecured note and then later files a bankruptcy petition, the carryback note is a nondischargeable debt since the seller financing was obtained through the misrepresentation of the buyer. [11 United States Code §523(a)(2)(A)]

Vendor's lien for error in closing funds

A **vendor's lien** is available to the seller to recover a shortage in the buyer's funds should an escrow officer miscalculate the demand on the buyer for funds to close escrow, leaving escrow with insufficient closing funds from the buyer.

For example, a buyer purchases a parcel of real estate on terms which include his taking title subject to a first trust deed lien of record.

Escrow is opened and a demand is made on the lender to furnish a beneficiary statement needed to determine prorates and adjustments in the loan balance, accrued interest, impounds and insurance, and the amount of cash proceeds to be paid to the seller on the close of escrow.

The first trust deed is an **add-on loan** which computes interest due over the life of the loan and adds it to the principal to set the face amount of the note.

The outstanding balance remaining on the note as stated in the **beneficiary statement** is not the actual principal balance, but is the principal and unaccrued interest over the remaining term of the loan. Thus, the outstanding balance of the debt is stated as an amount which includes the precomputed, unaccrued interest.

Escrow fails to note the loan is an add-on loan or that the payoff amount stated in the beneficiary statement is greater than the amount of principal actually owed by the seller.

The amount due the seller for his equity as calculated by escrow is less than the amount actually due the seller on the close of escrow. The demand on the buyer for **closing funds** is short by the amount of the unaccrued interest included in the loan balance submitted by the add-on lender in the beneficiary statement. The closing is not contingent on the seller receiving and approving an estimated closing statement from escrow.

After closing, escrow realizes its mistake and makes a demand on the buyer for the shortage in cash remaining due on the purchase price. The buyer refuses to pay escrow's demand for the shortage.

The escrow company, acknowledging its mistake, advances the seller the balance still owed on the purchase price. In exchange for full reimbursement, the seller agrees to cooperate with the escrow company's efforts to collect the outstanding balance the buyer owes the seller on the purchase price.

The escrow company will handle all litigation. Accordingly, the escrow company's attorney files, among other claims, the vendor's lien action in the name of the seller. The vendor's lien is an *unassignable equitable interest* which must be pursued in the name of the seller.

In return, the seller agrees to assign any **final judgment** he might receive to the escrow company. Thus, escrow will ultimately recover their cash advances and costs.

A vendor's lien cannot be assigned to anyone, such as the escrow company, since it is an equitable interest in the property sold. It is held personally and solely by the seller. Thus, only the seller can enforce a vendor's lien. [**Avery** v. **Clark** (1891) 87 C 619]

Establishing a vendor's lien

Vendor's lien rights are not available to sellers for amounts remaining due on the purchase price when legal title to the real estate has not been transferred to the buyer. A vendor's lien is an unrecorded interest held by the seller in the property he sold.

For example, a buyer and seller enter into a land sales contract (or lease-option sale agreement). In it, the seller agrees to convey title to the buyer on the buyer's completion of payments on the purchase price.

The buyer later defaults on payments due under the land sales contract. The seller attempts to obtain a **vendor's lien** against the buyer's interest in the property since the value in the property has fallen below the amount remaining due on the **land sales contract**. If the seller can enforce a vendor's lien, he will be entitled to a money judgment for the deficiency in the property's value to cover the principal balance remaining due on the land sales contract.

The buyer claims the seller, due to his retaining title to the property under a land sales contract, is a secured creditor and is barred from using the vendor's lien to recover the money due on the purchase price.

Is the seller entitled to a vendor's lien?

No! The vendor's lien is *waived* and does not exist when the seller sells real estate and by agreement retains the title (as security) until the amount remaining due is paid. The seller is entitled to a vendor's lien only when he conveys legal title and has not waived his vendor's claim to a lien for the unpaid portion of the purchase price by receiving security for its payment. [**Allen** v. **Wilson** (1918) 178 C 674]

A **land sales contract** is a *security device* evidencing the buyer's debt owed to the seller for the unpaid amount of the purchase price and stating the terms under which the seller retains title to the property. The contract must be foreclosed by sale of the property, even though the property is vested in the seller's name, to terminate the buyer's *right of redemption* which allows the buyer to pay off the land sales contract and obtain clear title.

Thus, a vendor's lien is not a **security device**, as is a trust deed, mortgage, land sales contract or lease-option sales agreement. A vendor's lien is an equitable interest in property, retained by the seller for monies due. The lien does not exist until it is *judicially imposed* in an action brought by the seller and then judicially foreclosed.

No formal notice for lien

Consider a seller who carries back an unsecured note signed by the buyer. Even though the buyer is not in default, the seller records a document entitled a *notice of vendor's lien*. The recording is an attempt to put future buyers and lenders on notice of the seller's lien rights.

The **notice of vendor's lien** references the property's legal description, the buyer's name, the amount remaining due and unpaid, and states a claim under the vendor's lien statutes. The notice is signed by the seller and his signature is notarized.

Later, the buyer conveys the property to a new buyer who executes a note and trust deed for the remaining amount of the price he owes on his purchase of the property.

The policy of title insurance does not disclose the existence of the prior seller's **notice of vendor's lien**, and the new buyer has no actual or imputed (via his broker) knowledge of the facts giving rise to the seller's lien rights.

After escrow for the resale of the property has closed, the unsecured note held by the original seller becomes delinquent. The seller files an action to foreclose his vendor's lien. The seller claims his lien rights have priority over the buyer's conveyance and trust deed lien entered into after the seller's notice of vendor's lien was recorded.

However, recording the notice of vendor's lien does not create such a lien or affect title. The statute creating the lien does not provide for notice of vendor's lien since only a court can establish the lien. A recorded notice of vendor's lien does not create any rights against future buyers and lenders since it is outside the chain of title as the seller previously conveyed his entire ownership interest in the property.

A **self-serving statement**, by an individual who is no longer on title and has nothing to convey, is not an instrument which transfers or reserves an interest in title to property now owned by someone else. Thus, its recording does not give notice of the lien to later buyers or lenders. A vendor's lien is established as an interest in property only by court order. Except for the cloud of the **lis pendens** in the vender's lien action, the vendor's lien has no effect on title until the court finds that the vendor's lien exists as an *equitable interest* held by the seller in the property and orders the lien to be foreclosed. [**Brown** v. **Johnson** (1979) 98 CA3d 844]

However, a seller will record a lis pendens when he files his action to foreclose on his vendor's lien since the action is a claim for an interest in title. From the time of recording, the lis pendens puts any subsequent buyer or lender on constructive notice of the seller's claim to an interest as a lienholder in the title to the real estate. [CCP §405.24]

Priority of the vendor's lien

A vendor's lien has *priority* against all later acquired interests in the property sold, except a buyer who purchases the property, or a lender who further encumbers the property, for value and without notice of the seller's rights to a lien. [CC §3048]

Consider a sales transaction on terms involving a new 90% first trust deed loan to be obtained by the buyer to fund his purchase of property. The seller is to carry back an unsecured note for the 10% balance of the purchase price. The lender has received copies of the purchase agreement and escrow instructions stating the seller will not be fully paid in cash and will hold an unsecured note for the balance due on the price when the lender's trust deed is recorded.

The buyer defaults on both the unsecured carryback note and the lender's loan. The lender forecloses on the property under its first trust deed.

The seller claims he has a vendor's lien which is senior to the lender's trust deed since the lender was aware when its trust deed was recorded that the seller had not been paid in full and thus did not receive its interest in the property in good faith.

In this example, the lender has a priority position over the carryback seller's unsecured vendor's lien even though the lender did not have a good faith defense against the seller's vendor's lien and the lender knew the seller had not been paid in full when the lender recorded his loan.

Knowledge of the carryback seller's equitable interest in the property under the vendor's lien law does not destroy the lender's priority position as recorded on title when the secured loan and the unsecured carryback note are concurrently created by conditions stated in the purchase agreement agreed to by the seller. [**Brock** v. **First South Savings Association in Receivership** (1992) 8 CA4th 661]

Now consider a lender who originates a loan secured by property the buyer had previously acquired by executing an unsecured note in favor of the seller as part of the price paid for the property. The lender is aware the unsecured carryback note held by the seller has not been paid.

The loan is not a purchase-assist loan since it was not provided for in the purchase agreement entered into by the buyer and seller, and the proceeds from the new loan do not fund any part of the sales price received by the seller.

Further, the seller does not waive his vendor's lien interest in the property or agree to subordinate it to the lender's trust deed. Thus, should the buyer default on the lender's trust deed and the lender foreclose by a trustee's sale, the seller will retain his vendor's lien rights. Here, the seller's interest has priority over the lender's trust deed. The lender knew the seller had not been paid in full and the loan originated by the lender was unrelated to the sales transaction which produced the seller's right to a vendor's lien. [**McGreevy** v. **Constitutional Life Insurance Company** (1965) 238 CA2d 364]

Additionally, a vendor's lien is given priority over a **judgment lien** against a buyer. A judgment creditor is not a *bona fide encumbrancer* since the abstract of judgment lien is not an encumbrance for value, whether or not the judgment creditor has knowledge of the seller's lien rights in the property. [**Schut** v. **Doyle** (1959) 168 CA2d 698]

Waiver of vendor's lien

A seller can *waive* his right to a vendor's lien by his conduct. For instance, a seller holds an unsecured carryback note which he sells and **assigns** to an investor.

Here, by the assignment of his unsecured carryback note, the seller waives his vendor's lien right since he no longer is owed money by the buyer. The right to a vendor's lien is **personal** to the seller and cannot be transferred to another person. [CC §3047]

Additionally, a seller waives his vendor's lien rights by taking any security, such as stock, to assure payment of the balance due on the purchase price. [McGreevy, *supra*]

Consider a seller who seeks a money judgment for the unsecured balance outstanding on the sale of his property, since no equity remains in the property sold to justify his pursuing foreclosure of his vendor's lien interest in the property.

If the seller obtains a money judgment on his unsecured note without first foreclosing on his vendor's lien, he waives his right to later enforce his lien since he is no longer owed money on his note, but on a money judgment. Thus, the seller would lose his right to priority over abstracts of judgment previously recorded by other creditors.

Also, when the seller does foreclose on his vendor's lien and is awarded a money judgment for a deficiency in the property's value, his recording of an abstract of judgment for the amount of the deficiency attaches as a lien on all other real estate owned by the buyer. However, the judgment lien on those properties will be junior to all liens of record, whether they are voluntary trust deed liens or involuntary judgment liens.

Finally, the recording by the buyer of a **declaration of homestead** exemption does not interfere with or have priority over a vendor's lien. The buyer knows of the seller's outstanding unsecured debt he owes the seller on the purchase price and is not allowed to avoid the vendor's lien by a claim of homestead. [CC §3048]

Chapter 40 Mechanic's liens and foreclosures

This chapter lays out a subcontractor's right to record a lien on title to a construction job site and the notices required to perfect and foreclose on that lien.

Obligation to pay for work performed

A landlord enters into a master lease with a tenant who will sublet space to occupants, called *subtenants*. The master lease contains a provision authorizing the **subtenants** to make improvements to their premises without the landlord's prior consent.

A general contractor is hired by a subtenant to make improvements to his property. In turn, the contractor hires a subcontractor who commences work to improve the space. The landlord is not aware of the construction and the subcontractor does not serve the landlord with a **20-day preliminary notice** of the subcontractor's lien rights.

Upon completion of the improvements, the subcontractor is not paid. The subcontractor records a *mechanic's lien* against the landlord's fee interest in the property within 30 days after completion of the work. A lawsuit is filed to foreclose the **mechanic's lien** on the landlord's interest within 90 days after recording the mechanic's lien.

The landlord claims the mechanic's lien is unenforceable since the subcontractor failed to serve the landlord with a 20-day preliminary notice identifying the subcontractor as a supplier of labor and materials to the job site.

The subcontractor claims the mechanic's lien is enforceable without the 20-day preliminary notice based on the landlord's *constructive knowledge* of the construction since the master lease authorized subtenants to make improvements, an authorization which imposes a duty on the landlord to conduct periodic inquiries to discover any construction.

Is the subcontractor's mechanic's lien enforceable?

No! Without service of the 20-day preliminary notice on the landlord, the subcontractor's mechanic's lien is unenforceable. The landlord, while authorizing future improvements without the need for his prior consent, did not have *actual knowledge* of the construction. [**Kim** v. **JF Enterprises** (1996) 42 CA4th 849]

Perfecting a mechanic's lien

Contractors and subcontractors have a **constitutionally protected** right to file a mechanic's lien against property they have improved should they not be paid for labor and materials. [California Constitution, Article XIV §3]

A **mechanic's lien** entitles the contractor or subcontractor to foreclose on the job site property to recover the amount due to him and unpaid under his contract for the labor and materials he supplied. [CC §3140]

However, the mechanic's lien remedy is only available to contractors and subcontractors whose right to be paid has been *perfected*.

A general contractor's right to a mechanic's lien is **perfected** when he and the property owner enter into an agreement calling for the contractor to deliver labor or furnish material to the job site, directly himself or through subcontractors. [Calif. Civil Code §3140]

Subcontractors **perfect** their right to payment differently from general contractors since subcontractors do not enter into contracts directly with a property owner. For a subcontractor to perfect his right to enforce a mechanic's lien against the ownership of the job site by foreclosure, a *20-day preliminary notice* must be served on the appropriate parties. [CC §3097]

Before a subcontractor employed by the general contractor can record a mechanic's lien against the property and enforce it by foreclosure, he must serve a **20-day preliminary notice** on:

- the owner;
- the general contractor; and
- the construction lender. [CC §§3097(a), 3098(a)]

The **20-day preliminary notice** informs the owner of the property and the lender that the subcontractor has the right to record and foreclose a mechanic's lien against the owner's interest in the property if the subcontractor is not paid for his labor and materials. The 20-day preliminary notice is not a notice of nonpayment. Rather, it is a notice which informs the relevant parties (the owner, the general contractor and the construction lender) that the subcontractor has been or is supplying labor and materials to the property. [CC §3097(c)(1)]

In contrast to subcontractors, a general contractor who enters into an agreement with the owner does not need to provide the owner or the construction lender with a 20-day preliminary notice. [CC §3097(a), (b)]

Preliminary notices by subcontractor

The **20-day preliminary notice** requirement applies to subcontractors in both private and public works. However, for public works, the subcontractor must serve the 20-day preliminary notice on the public agency responsible for the work. [CC §3098(a)]

The 20-day preliminary notice for private work must include:

- a description of the equipment, materials, services or work performed and an estimate of the price;
- the subcontractor's name and address;
- the name and address of the person with whom the subcontractor has contracted;
- a description of the job site location; and
- a statement of the subcontractor's lien rights. [CC §3097(c)]

The preliminary notice must be served within **20 days** after the subcontractor first furnishes labor, service, equipment or materials to the job site, commonly called *labor and materials*. [CC §§3097(d), 3098(a)]

The subcontractor who serves the preliminary notice more than 20 days after first providing labor, service, equipment or materials is barred from using the mechanic's lien for amounts of money owned for labor or supplies delivered prior to the 20 day period.

The subcontractor may only assert a claim under a mechanic's lien for nonpayment of labor and materials furnished beginning 20 days prior to service of the preliminary notice. [CC §§3097, 3098]

Further, if the subcontractor fails to serve the 20-day preliminary notice prior to recording his mechanic's lien, the mechanic's lien is invalid. Also, the subcontractor is subject to disciplinary action by the **Registrar of Contractors** for filing a mechanic's lien without first giving the 20-day preliminary notice if the subcontract exceeds $400. [CC §3097(h)]

Locating the construction lender

A subcontractor must check the *public record* to identify the **construction lenders** he must serve with a 20-day preliminary notice before his right to be paid and later record and enforce a mechanic's lien for nonpayment is established.

Identification of the construction lender in the **public record** is accomplished by checking the county recorder's office for any construction trust deeds recorded on the job site, and the county zoning office, the City Department of Building and Safety or any other agency which makes building permit information available for public inspection.

Agencies authorized to issue building permits provide space on their building permit application forms for entry of the construction lender's name and address. [CC §3097(i)]

It must be noted in the space provided in the building permit application if the construction lender is unknown at the time the contractor applies for the permit. [CC §3097(i)]

Consider a subcontractor who checks the public record on the day he begins on-site work to identify and serve the construction lender with a **20-day preliminary notice**. A construction loan has not been recorded with the county recorder's office and a lender is not noted on the building department records.

The subcontractor serves a 20-day preliminary notice on the owner and the contractor within 20 days of commencing on-site work. The project owner then records a trust deed for a construction loan before 20 days has run since the subcontractor began work. The subcontractor is unaware of the construction loan and does not serve a notice on the construction lender.

The subcontractor is not paid when the work is completed. The subcontractor records a **mechanic's lien** for the amount unpaid and makes a demand on the construction lender to be paid.

The construction lender seeks to invalidate the mechanic's lien, claiming the subcontractor has a duty to continue checking the public records for a recorded construction trust deed until the 20-day limitation for service of a preliminary notice expires, and if he discovers the existence of a construction loan, serve the notice on the lender.

Does the subcontractor have a duty to check the public records again on the 20th day after commencing work to locate the existence of a construction lender?

No! A subcontractor does not have a duty to **recheck the public records** to establish a construction lender's identity. A subcontractor only needs to check the public records once, whether on the first day of work or at any other time during the 20-day preliminary notice period.

Since no record of the construction loan existed at the time the subcontractor checked the public record, the subcontractor does not have *constructive notice* of the construction lender's identity. Thus, he is not required to send the lender a 20-day preliminary notice before exercising his mechanic's lien rights.

Constructive notice of the construction lender's identity exists when the lender's name appears on the public record, either by way of a recorded construction loan trust deed or on a building permit, on the day the subcontractor checks the records after he begins onsite work. [**Kodiak Industries, Inc.** v. **Ellis** (1986) 185 CA3d 75]

However, the failure of the public record to list a construction lender's name does not relieve a subcontractor from the obligation to serve the lender with a 20-day preliminary notice if the subcontractor has *actual knowledge* of the lender's identity due to information supplied by the owner or the general contractor. [CC §3097(i)]

Construction trust deeds

A trust deed securing a loan arranged to fund the construction of improvements on real estate must:

- be entitled *"Construction Trust Deed"*
- state the name and address of the owner (trustor) and the lender (beneficiary); and
- include a legal description of the property. [CC §3097(j)]

However, the failure of the person recording the construction trust deed to provide all of the aforementioned required information does not relieve the subcontractor of the obligation to serve the lender with the preliminary notice if the construction trust deed is on file on the first day the subcontractor begins work. [CC §3097(j)]

Contractor's and owner's duty to inform

Contractors are also responsible for providing subcontractors with the name and address of the owner and construction lender.

If known, the construction lender's name and address must be disclosed in the original written agreement entered into by the owner and the general contractor. [CC §3097(m)]

In turn, the general contractor entering into contracts with subcontractors must include the names and addresses of the owner and the construction lender in the subcontract. [CC §3097(m)]

When a construction loan is obtained after construction has commenced, the owner, on receipt of a 20-day preliminary notice from the subcontractor, must provide the subcontractor with the name(s) and address(es) of any construction lender(s). [CC §3097(n)]

The 20-day preliminary notice statutes do not dictate what is required of a subcontractor when an owner or general contractor provides a construction lender's name and address after construction has begun and the 20-day preliminary notice has been served.

However, a prudent subcontractor should serve the construction lender with a copy of the 20-day preliminary notice when he receives the name and address of the lender after construction has begun, even if the 20-day period has lapsed. Thus, the construction lender is notified at the earliest possible moment that the subcontractor has provided labor and materials to the job site.

This lender identification process does not apply to home improvement or swimming pool contracts. [CC §3097(m)]

Mechanic's lien recording period

A mechanic's lien, also called a *claim of lien*, is an unnotarized statement signed by the contractor or subcontractor and recorded. The lien statement in the mechanic's lien form sets out the dollar amount of the contractor's unpaid demand for labor and materials. The recording also identifies the parties and describes the property, labor and materials involved. [CC §3084]

A mechanic's lien may be recorded after the contractor/subcontractor has made a demand for payment and payment has not been tendered and received.

Time limitations exist for recording a mechanic's lien after *completion or cessation* of construction on the job site. Notices of completion or cessation are recorded by the owner of the property being improved to reduce the period during which the mechanic's lien must be recorded in order to be enforceable by foreclosure.

Thus, **recording a notice** of completion or cessation of labor is financially important to the owner since recording commences the time period which cuts off any further claims. A *notice of completion* may be recorded by the owner in the county where the property is located within 10 days after completion of construction. [CC §3093]

A *notice of cessation* may be recorded by the owner in the county where the property is located 30 days after cessation of all onsite labor when the project is not completed. [CC §3092]

However, if a **notice of cessation** is not recorded, a 60-day cessation of labor is **considered completion** of the construction project and commences the limitation period for recording a mechanic's lien.

Mechanic's liens must be recorded within one of two periods of time:

- when a notice of completion or cessation of labor is recorded, the mechanic's lien of a general contractor must be **recorded** within 60 days (30 days for a subcontractor) of the date the notice of completion or cessation is recorded; or
- if a notice of completion or cessation of labor is **not recorded**, all mechanic's liens must be recorded within 90 days of the date the project is completed or considered completed. [CC §§3115, 3116]

Consider a subcontractor who delivers materials to a site to be used in the construction of a building. The subcontractor is not paid for the materials.

More than 90 days after the project is completed, the subcontractor records a mechanic's lien.

After the mechanic's lien is recorded, a notice of completion is recorded which states an incorrect completion date. The completion date is erroneously stated as being within 30 days prior to the date the mechanic's lien was recorded.

To avoid the subcontractor's mechanic's lien, the owner and general contractor claim the mechanic's lien is unenforceable since it was not recorded within 90 days after the actual completion date of the building.

The subcontractor claims the mechanic's lien is enforceable since it was recorded within 30 days of the completion date stated in the notice of completion.

Is the mechanic's lien enforceable?

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

NOTICE OF NONRESPONSIBILITY

Civil Code §3094

DATE:_____, 20_____, at _____, California.

NOTICE IS HEREBY GIVEN:

1. _____ is the vested and legal owner of real property located in the County of _____, State of California, identified as:

1.1 Common address:_____

1.2 Legal description:

2. _____ is:

2.1 ☐ The Buyer of the property under a purchase agreement, option or land sales contract, or

2.2 ☐ The Tenant under a lease of the property.

3. Within 10 days before the posting and recording of this notice, the undersigned Owner or Agent of the owner obtained knowledge that a work of improvement has commenced on the site of the property involving ☐ construction, ☐ alteration, or ☐ repair.

4. The Owner will not be responsible for any claim arising out of this work of improvement.

5. I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct.

Date:_____, 20_____

Signature:_____

☐ Owner, or ☐ Agent of the owner.

STATE OF CALIFORNIA
COUNTY OF_____
On _____ before me,
_____
(name of notary public)
personally appeared _____
_____,
(name of principal)
personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.
WITNESS my hand and official seal.

Signature: _____
(Signature of notary public)

(This area for official notarial seal)

No! When a notice of completion is not recorded within 10 days after the actual completion date, a mechanic's lien must be recorded within 90 days after the actual completion date of construction to be enforceable.

While no statute requires the owner to record a notice of completion, the notice benefits the owner by shortening the period in which a mechanic's lien may be recorded and foreclosed upon. [**Fontana Paving, Inc.** v. **Hedley Brothers, Inc.** (1995) 38 CA4th 146]

Foreclosing the mechanic's lien

A general contractor or subcontractor who has entered into a construction contract with the owner or tenant of a job site has timely served a 20-day preliminary notice on the owner and the construction lender. The general contractor or subcontractor may record a mechanic's lien against the property if he has not been paid as agreed.

If the mechanic's lien is timely recorded, it is enforced by filing an action to *judicially foreclose* the lien on the property. The action must be filed within 90 days after the mechanic's lien is recorded. [CC §3144(a)]

On failure to file the **foreclosure action** within the 90-day period, the mechanic's lien becomes *void*, no longer binding or encumbering the property. [CC §3144(b)]

Notice of nonresponsibility

Consider a tenant who is authorized by the landlord to make improvements on the leased premises.

If the tenant contracts for improvements and fails to pay, a mechanic's lien recorded by the unpaid contractor will attach to the tenant's leasehold interest in the property. [CC §3128]

Further, if the landlord or his property manager has *actual knowledge* of the construction, the mechanic's lien will also attach to the landlord's fee interest in the property unless the landlord records and posts a *Notice of Nonresponsibility* within 10 days after he becomes aware of the improvements. [Kim, *supra*]

A landlord who has actual knowledge a tenant is making improvements must record and post a **Notice of Nonresponsibility** to avoid the attachment of the mechanic's lien to the fee interest held by the landlord. [See Form 597 accompanying this chapter]

The Notice of Nonresponsibility is a written notice which must be **posted** in a conspicuous place on the property and **recorded** with the recorder's office in the county where the property is located within 10 days after the landlord becomes aware of the improvements. [CC §3094]

Enforcement of rights

Consider a subcontractor who is employed by a general contractor to supply labor and materials for the improvement of a property.

The subcontractor is hired under a subcontract agreement with the general contractor which contains a *pay-when-paid provision*. The **pay-when-paid provision** states the general contractor must receive payment from the owner of the property before the general contractor is obligated to pay the subcontractor, called a *condition precedent* (to payment), or *contingency*.

The general contractor obtains a *payment bond* from a corporate surety to protect the owner from mechanic's lien claims arising due to the general contractor's failure to pay for labor and materials.

Later, the owner stops making payments to the general contractor. In turn, the general contractor stops making payments to the subcontractor since he owes the subcontractor nothing under the subcontract until he is paid by the owner.

The subcontractor records a mechanic's lien against the property and seeks recovery from the surety under the general contractor's payment bond.

The surety claims the subcontractor is not entitled to payment under the bond since the pay-when-paid provision ended the general contractor's obligation to pay when the owner ceased making payments.

Is the subcontractor entitled to payment under the surety bond issued to cover mechanic's lien claims?

Yes! The surety is liable to the subcontractor for amounts remaining unpaid since the pay-when-paid provision in the subcontract is *void*. The provision constitutes an unenforceable attempt by the general contractor to cause the subcontractor to waive his (constitutionally protected) mechanic's lien rights against the property since the subcontractor, by his agreement with the general contractor, is not entitled to compensation for unpaid work when the owner does not pay.

The *waiver* of a subcontractor's mechanic's lien rights is **unenforceable** since it is against public policy, except in limited situations authorized by statutes. [**Wm. R. Clarke Corporation** v. **Safeco Insurance Company of America** (1997) 15 C4th 882]

Chapter 41 Clearing a lien-clouded title

This chapter instructs a listing agent on how to negotiate the release of any judgments or state/federal income tax liens encumbering a homeowner's residence which is in foreclosure.

Negotiate a release to create equity

An **equity purchase** (EP) investor enters into an EP agreement to buy a seller's residence which is in foreclosure. [See **first tuesday** Form 156]

After expiration of the seller-in-foreclosure's five-day cancellation period, escrow is opened and a preliminary title report is ordered. The title report discloses an *abstract* has been recorded referencing a **money judgment** against the seller which has attached to the residence, called a *judgment lien*.

The **judgment lien** was not referenced in the purchase agreement. By the terms of the purchase agreement, the down payment may be reduced by the amount of any unmentioned lien and the responsibility for payment of the lien shifted to the EP investor. The purchase agreement makes it optional for the EP investor to take title subject to the recorded judgment lien rather than having the debt satisfied and the lien released prior to closing. [See **first tuesday** Form 156 §12.3]

Further, the title insurance company demands either a *partial* or *full release* be recorded before they will issue a policy of title insurance and eliminate any reference to the judgment lien as excluded from coverage. The EP investor chooses to have the lien released before closing, rather than opting to offset the down payment and leave the lien on the record for later negotiations for its release.

However, the seller-in-foreclosure is uninformed about **lien avoidance**. Accordingly, the seller's listing agent takes control by contacting the judgment lienholder, directly or through escrow, to negotiate a partial or full release of the lien so the purchase transaction can be closed. These negotiations are allied to those for a short payoff of a trust deed loan.

The lienholder initially demands full payment of the debt, which is the very reason he recorded his lien.

However, economic leverage exists when negotiating a lien release with the creditor since the first trust deed on the property is in foreclosure and the seller-in-foreclosure qualifies for an automatic homestead exemption. Both are senior to the judgment lienholder's rights to recover from the value in the property.

The trustee's foreclosure sale, should it take place, will wipe out the judgment lien. Also, the homestead exemption available to the head of a household protects up to $75,000 of the homeowner's equity, protecting that amount of equity from collection on the judgment.

The lien about to be wiped out

Generally, a good bargaining tactic for obtaining a **release of a lien** from a seller's residence is a combination of:

- a "gentle reminder" that the lien is on the verge of being *wiped out by foreclosure* of the first trust deed;

- a review of the homeowner's *homestead exemption* rights as having priority to the creditor's lien;
- an *offer to pay* a lesser amount in full satisfaction of the debt owed to the lienholder; and
- a partial (or full) satisfaction and the execution of a partial (or full) release, allowing the abstract of judgment to remain of record (unless fully released) while *releasing the residence* from its lien.

The objective of the agent's negotiations is to give the lienholder sufficient incentive to cooperate and release the property from the lien. The seller's agent is in a better position to deal with the lienholder in an aggressive manner than the seller-in-foreclosure who has exhausted his goodwill with the judgment creditor.

A financially advantageous situation is created for all parties when:

- the **lienholder** collects a portion of the money owed, which is not enforceable against the residence if a foreclosure wipes out the judgment lien, or a recorded or automatic homestead exemption exists;
- the **seller-in-foreclosure** continues with the sale of the residence, avoiding the elimination of his equity by the lender's foreclosure, and receives any proceeds protected by his homestead exemption for later reinvestment in a replacement residence; and
- the **equity purchase (EP) investor** keeps his purchase agreement alive by negotiating a release of the lien from the property's title in exchange for a less-than-full payoff to the lienholder, which is paid out of the seller-in-foreclosure's proceeds from the sale.

Release of recorded instrument

When a judgment lienholder agrees to release a residence, a signed and notarized **release of recorded instrument** must be obtained from the lienholder and recorded. All aspects of the paperwork can be handled through escrow after negotiations have been completed. [See Form 409 accompanying this chapter]

The release contains all the information necessary to clear the judgment lien from the residence's record title.

When the release is notarized and recorded, the judgment lien against the residence is removed, and a policy of title insurance is issued free of the lien.

The abstract of judgment lien

A judgment creditor creates a valid lien on his debtor's real estate by recording an *abstract of judgment* issued by a state court. [Calif. Code of Civil Procedure §697.310(a)]

A judgment lien continues in effect for 10 years from the date it was recorded, unless the money judgment is either satisfied or released. [CCP §697.310(b)]

However, the recording of a certified copy of a judgment awarded by a federal court attaches without the recording of an abstract of judgment.

For example, a judgment creditor obtains a federal district court money judgment against an individual. A **certified copy** of the judgment is recorded in the county where the individual is the vested owner of real estate.

The owner obtains a loan secured by a trust deed on the property. A dispute between the lender and the judgment creditor arises over who has priority and is entitled to funds remaining after a payoff of the first trust deed.

The lender claims the recorded federal judgment is not a valid lien since it is not documented by a recorded abstract of judgment to give the lien priority to the lender's trust deed.

Does the judgment creditor hold a valid lien senior to the lender's trust deed?

Yes! The judgment creditor holds a valid lien senior to the lender's trust deed since a federal judgment creditor creates a lien on real estate owned by the judgment debtor on recording a **certified copy** of the federal judgment. [**In re McDonell** (9th Cir. BAP 1996) 204 BR 976]

A money judgment from a court of the United States becomes a valid lien on real estate on the recording of:

- an abstract of judgment; or
- a certified copy of the money judgment. [CCP §697.060]

The FTB as a judgment creditor

A personal income tax lien on a residence recorded by the Franchise Tax Board (FTB) is enforced with the same procedure as any creditor's judgment lien. The FTB issues and records a *warrant* which has the same force and effect as an abstract of judgment issued by a court. [CCP §688.020]

The FTB lien created by recording the **warrant** attaches to real estate owed by the debtor in the same priority as would a judgment lien. More importantly for the debtor who is a homeowner and head of the household, the FTB lien is junior and subject to the seller-in-foreclosure's homestead exemption which shields $75,000 of his equity from seizure. [CCP §688.030; Government Code §§7170 et seq.]

Unfortunately for the seller-in-foreclosure and the equity purchase (EP) investor, no statutory or regulatory authority exists for the FTB to negotiate a partial payment of the tax bill in exchange for releasing the residence from the tax lien.

However, California's **Taxpayer Bill of Rights** provides some relief since the FTB must release its lien from the residence if the proceeds from the sale would not result in a reasonable reduction of the seller-in-foreclosure's debt to the FTB. [Calif. Revenue and Taxation Code §21016(a)(3)]

However, no case law exists testing whether the statute may be used as an offensive weapon to quiet title to real estate and eliminate the cloud of a state income tax lien.

Releasing an IRS lien

Consider an equity purchase (EP) investor whose preliminary title report reveals the existence of a **federal tax lien** junior to a trust deed loan which is in foreclosure.

If the residence is sold at a trustee's sale, the Internal Revenue Service (IRS) may later *redeem* (purchase) the property from the successful bidder at the trustee's sale by paying the amount of his bid within 120 days, plus interest and foreclosure costs. Thus, the equity can be acquired by the IRS after the trustee's foreclosure sale to satisfy the delinquent payment of income tax. The IRS will later hold its own auction and resell the residence.

If a second trust deed exists on the residence, the IRS will typically wait until the first trust deed lender completes its foreclosure, wiping out the second and creating an equity. The IRS then steps in within 120 days after the trustee's sale and acquires the residence from the buyer at the trustee's sale.

On a regular sale of property, the IRS has the *authority to negotiate* with the seller/taxpayer (or the EP investor after closing the EP transaction) to accept partial payment in exchange for releasing the income tax lien when the IRS' recovery under its lien and redemption and resale rights would be economically unfeasible. [Internal Revenue Code §6325(b)(2)]

Thus, the release of the IRS tax lien from the property's title can be negotiated by the agent (or other authorized person) on behalf of the taxpayer by using some of the same persuasive techniques used to negotiate a release of a judgment lien with a creditor.

To release the tax lien, the **seller-in-foreclosure applies** for a discharge of the residence from the federal tax lien by submitting a written request to the district director of the IRS. Instructions and format for the request are available in IRS Publication 783 at *www.irs.gov*. [Revenue Regulations §301.6325-1(b)]

Current IRS policy dictates the IRS, not the seller-in-foreclosure, must receive all or most of any equity remaining in the residence.

Additionally, the EP investor should consider whether it is more advantageous to take the residence subject to the IRS tax lien, especially if the property is a "fixer-upper." If little or no equity exists beyond the encumbrances senior to the IRS lien, the EP investor, as the new owner, can negotiate with the IRS for the release of the lien in exchange for a small cash payment — frequently an amount less than the IRS would have been willing to accept from the seller-in-foreclosure prior to the EP investor becoming the owner.

However, taking the residence subject to the IRS lien entails a risk of loss which must be analyzed. The IRS may decide to leave its lien intact on the property, and thus participate in the future property value added by inflation, appreciation or the efforts of the EP investor. [**Han** v. **United States of America** (9th Cir. 1991) 944 F2d 526]

The homestead exemption coup

A homeowner's equity of up to $75,000 for a head of household is protected by California homestead exemption laws. [CCP §§704.710 et seq.]

The homestead protection is **automatic** when the judgment lienholder, a creditor or the Franchise Tax Board (FTB), attempts to enforce its money judgment by a sheriff's sale of the homeowner's residence. The residence cannot be sold by the lienholder when the net proceeds of the sale will be less than the homestead exemption amount.

However, the statutory homestead exemption only applies to execution sales ordered by a court to satisfy money judgments against the homeowner and to the sale of the home in a bankruptcy proceeding.

Though merely a defensive tool for the homeowner, the **automatic homestead** exemption becomes a powerful offensive tool in a bankruptcy proceeding. Through bankruptcy proceedings, the homeowner can clear his title of judgment and state tax liens which impair the value of his homestead. [**In re Herman** (9th Cir. BAP 1990) 120 BR 127; 11 United States Code §522(f)].

However, the automatic homestead exemption is not enforceable against an Internal Revenue Service (IRS) tax lien in bankruptcy. [**U.S.** v. **Heffron** (9th Cir. 1947) 158 F2d 657; 11 USC §545]

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

RELEASE OF RECORDED INSTRUMENT

DATE:_____, 20_____, at _____, California.

Items left blank or unchecked are not applicable.

1. From the Document entitled _____,

2. Dated _____, and recorded on _____, as Instrument No._____ in the Official Records of _____County, California.

3. Pursuant to the judgment entered in the _____ branch of the _____County _____ Court, dated _____, renewed _____, in a legal action entitled _____, docket number _____,

4. Held by_____ and against _____,

5. Is hereby released:

5.1 ☐ all interests in real property situated in the County of record, owned or hereafter acquired by _____

5.2 ☐ the real property situated in the County of record described as:

_____

_____

THIS FORM IS NOT A RECONVEYANCE OF A TRUST DEED. DO NOT USE THIS FORM TO RECONVEY A TRUST DEED FROM RECORDED TITLE.

Date:_____, 20_____ _____ (Print Name) _____ (Signature)

Date:_____, 20_____ _____ (Print Name) _____ (Signature)

STATE OF CALIFORNIA)
COUNTY OF _____)
On _____ before me,

_____
(name of notary public)

personally appeared _____

_____,
(name of principal)

personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS my hand and official seal.

Signature: _____
(Signature of notary public)

(This area for official notarial seal)

Alternatively, the homeowner may have recorded his **declaration of homestead** prior to the date a judgment or FTB lien was recorded. If the recorded homestead is senior to the judgment creditor's or FTB's lien and the net proceeds of a voluntary sale of the residence will be less than the homestead amount, the owner can quiet title to the property and eliminate the effect of the judgment or FTB tax lien on that property.

However, like the automatic homestead exemption, the recorded homestead has no priority over an IRS tax lien. Thus, the IRS can still force the sale of the residence under its tax lien. [**U.S.** v. **Rodgers** (1983) 461 US 677]

In practice, the release of an IRS lien is always negotiated based on whether or not it has recorded priority over voluntary encumbrances and judgment liens on the residence. The homestead has no effect on the **lien rights of the IRS**.

Whether it is by an automatic exemption or recorded declaration, the homestead is leverage to be used to induce judgment lienholders and the FTB to voluntarily release their lien from the title to the residence. The effects of foreclosure, a bankruptcy or quiet title action to enforce the homestead exemption and clear title gives lienholders an incentive to negotiate the release.

Preparing the Release of Recorded Instrument

The numbers on the instructions correspond to the numbers given provisions in Form 409.

Check and **enter** only the items to be included as provisions in the release.

§1. Enter the name of the document which created the lien on the property, e.g., *abstract of money judgment.*

§2. Enter the date the document creating the lien was prepared, and the date and identification of its recording.

§3. If the document is a release of an abstract of money judgment:

- **enter** the identification of the court which entered the judgment;
- **enter** the date of the judgment and the date of any renewal;
- **enter** the title of the cause of action in the case, e.g., *breach of contract, negligent misrepresentation, unlawful detainer,* etc.; and
- **enter** the docket number the court assigned to the case. [CCP §697.370]

§4**. Enter** the names of the lienholder and seller. [Gov C §27288.1(b)]

§5. Check the box indicating whether the release is:

5.1 a blanket release of all recorded interests in real estate in the county. If all property is released, **enter** the name of the seller-in-foreclosure again, thus identifying him as the owner whose property interests are being released from the judgment lien; or

5.2 a partial release only for a specific property. If only a specific property is released, **enter** the legal description of the property released.

The lienholder unilaterally executes the release by **signing** it and **dating** his signature.

Notarize the release for recording. **Record** the release to clear the seller-in-foreclosure's title of the lien. [Gov C §27287]

Chapter 42 The lis pendens

This chapter explains the use of a lis pendens and the requisite of a probably-valid claim to record a lis pendens.

Clouding the title with a notice

Several days into a sales escrow, a seller discovers the sales price set by the purchase agreement he entered into with the buyer is 20% below the property's current market value.

Prior to closing, the seller receives a backup offer substantially above the sales price he is under contract to receive from the existing buyer. The seller enters into a purchase agreement with his back-up buyer, contingent on the cancellation of the purchase agreement and sales escrow with the existing buyer.

To frustrate the closing of the existing escrow and induce cancellation, the seller refuses to cooperate or perform any of the conditions required to close. However, the existing buyer performs all the obligations necessary for him to close as scheduled.

The seller has no contingency provision or other justifiable excuse to cancel the purchase agreement and escrow instructions he entered into with the existing buyer. Nevertheless, the seller sends a Notice of Cancellation to escrow. Further, mutual cancellation instructions are prepared by escrow and forwarded to the buyer for signatures.

The buyer refuses to sign the cancellation instructions and makes a demand on the seller to convey the real estate under the terms of their purchase agreement and escrow instructions, which is refused by the seller.

The buyer is concerned the seller will convey the real estate to the back-up buyer who may acquire an interest in the property superior to his rights to buy the property under the new purchase agreement.

Does a legal mechanism exist for the buyer to notify all future buyers, lenders and tenants of the buyer's claim to ownership of the real estate before the seller conveys an interest in the property to them?

Yes! A *lis pendens* or Notice of Pending Action, when recorded, is notice from the buyer, called a *claimant*, warning all prospective buyers, leasees or encumbrancers who might acquire an interest in the property that **title or possession** of the real estate described in the lis pendens is in dispute. [Calif. Code of Civil Procedure §405.2]

Lis pendens is the latin phrase for *pending litigation*. More commonly, a lis pendens is referred to as a **Notice of Pending Action**. In this example, the pending action noticed by the recorded lis pendens is the buyer's filing of a lawsuit for the specific performance of the original purchase agreement entered into with the seller.

Persons who acquire an ownership interest, a lien or take possession to real estate after a lis pendens describing the property has been recorded, take their interest in the property subject to the claimant's right, if any, to the real estate.

Preservation of title

The purpose of recording a **lis pendens** is to preserve a person's rights to the real estate until the dispute with the owner is resolved.

Without a recorded lis pendens or physical possession of the real estate, the person who claims an interest in title or the right to possession of the real estate, such as the buyer in our prior example, runs the risk the owner will encumber or convey the property to another buyer, lender or tenant who is unaware someone else already holds an interest in the property.

Occasionally another buyer or a lender acquires possession or a lien on the real estate before they become aware or are on notice of a dispute between the property owner and someone else (claimant) over title or possession. Then, the claimant in the dispute loses his rights to recover that interest, to the extent the interest he was to receive was conveyed to that someone else.

Title or possession to real estate

A lawsuit must affect title or the right to possession of real estate to support the recording of a lis pendens. [CCP §405.20]

Lawsuits affecting title or possession of real estate include:

- specific performance of unclosed transactions or rescission of closed transactions [**Wilkins** v. **Oken** (1958) 157 CA2d 603];
- judicial foreclosure of a trust deed lien by a lender [**Bolton** v. **Logan** (1938) 30 CA2d 30];
- foreclosure of a mechanic's lien by a construction contractor [Calif. Civil Code §3146];
- cancellation of a grant deed or other conveyance by a prior owner;
- fraudulent conveyance to be set aside as voidable by creditors [**Hunting World, Incorporated** v. **Superior Court** (1994) 22 CA4th 67];
- evictions and suits concerning unexpired leaseholds brought by tenants or leasehold lenders;
- termination or establishment of an easement between neighboring property owners [**Kendall-Brief Company** v. **Superior Court of Orange County** (1976) 60 CA3d 462];
- government declaration that a building is uninhabitable;
- ejectment of an unlawful occupant (other than a tenant) from real estate by an owner;
- partition or sale of the real estate by a co-owner;
- quiet title;
- eminent domain actions [CCP §1250.150]; and
- divorce proceedings involving real estate.

The recording of a lis pendens is also **permitted** in the following lawsuits over real estate:

- actions by adverse possessors to determine claims to title [CC §1007];
- actions to re-establish lost land records [CCP §751.13];
- actions to determine adverse interests in any liens or clouds on real estate arising out of public improvement assessments [CCP §801.5];
- actions by purchasers or the state to quiet title to tax-deeded property [Calif. Revenue and Taxation Code §3956];
- actions by innocent improvers of real estate against owners or lenders of record [CC §1013.5(b)];

- actions on an improvement bond [Calif. Streets and Highways Code §6619]; and
- actions terminating or establishing an easement, except for a public utility easement. [CCP §405.4(b)]

Improper use of a lis pendens

Actions in which it is **improper** to record a lis pendens include:

- suits affecting title to *personal property* located on real estate;
- foreclosure on real estate by a trustee's sale;
- actions to impress a trust on personal property being recovered;
- actions to recover attorney fees;
- actions for breach of a real estate contract when only money losses are sought;
- actions for recovery of a brokerage fee on the sale or lease of property; and
- actions against a partner, member or stockholder co-owning real estate as a partnership, limited liability company (LLC) or a corporation.

For example, a creditor of an individual who is a member of an LLC formed with others to operate a real estate venture sues the member and places a lis pendens on the real estate vested in the name of the LLC. The creditor has a specific claim against the member only and no claim against the LLC itself. However, the funds lent and sought to be recovered from the member were used to fund his contribution to the LLC.

Is the lis pendens properly recorded on the LLC's property?

No! The member's only interest in the venture is his membership in the LLC, not the real estate which is owned and vested in the name of the LLC. Further, the membership interest held by the member is personal property. [**North Coast Business Park** v. **Superior Court** (1984) 158 CA3d 858]

Additionally, a creditor's suit against a shareholder does not entitle the creditor to place a lis pendens on the corporation's real estate. A claim against the corporation does not exist even if the funds obtained by the shareholder's wrongful conduct can be traced to his contribution to the corporation.

The shareholder's interest is the stock he holds in the corporation. The real estate is owned exclusively by the corporation, an entity separate from its individual stockholders. Like the ownership interest of a member in an LLC or partnership, the interest of the shareholder in the corporation is personal property. [**Wardley Development, Inc.** v. **Superior Court** (1989) 213 CA3d 391]

Consider a county which repeals an ordinance designed to control the resale and possession of real estate for low-income buyers, affecting a large number of parcels. An individual files an action to invalidate the repeal and re-impose the county controls on these low-income designated parcels.

The individual also records a lis pendens describing all the properties in the county which could be affected by the possible outcome of the action even though none of the owners are named in the lawsuit.

Is the lis pendens proper notice to owners and buyers of a suit seeking to re-enact the county ordinance affecting an owner's right to sell his property?

No! The fact the action would affect title to the properties described in the lis pendens sometime in the future if the individual prevailed on his invalidation claim is an insufficient basis for a lis pendens when

none of the owners of the properties are named as parties to the suit. [**Moseley** v. **Superior Court** (1986) 177 CA3d 672]

Constructive trust on improper vestee

A lis pendens may be recorded in an action to impose a *constructive trust* on real estate if funds fraudulently acquired by an individual from the claimant can be directly traced to the acquisition of the real estate by that individual.

A **constructive trust** is an involuntary, court-created trust imposed on the ownership of property presently held by an owner who acquired it through:

- fraud (force, duress, undue influence, deceit or mistake);
- accident;
- the violation of a trust or agency relationship; or
- some other wrongful act. [CC §2224]

A constructive trust is imposed on title as a remedy used to establish that a wrongdoer, who holds title to property he did not properly acquire and is not entitled to own, is an *involuntary trustee* holding title to the property for the benefit of the person entitled to the property. [CC §2224]

However, a constructive trust is not created when real estate is **improved** rather than **purchased** with fraudulently acquired money. The transfer of property by a court imposed constructive trust on the vested owner in favor of an injured party is not appropriate when the fraudulently acquired funds are used to make improvements to the real estate which are less than the overall value of the property.

Thus, recording a lis pendens on property improved by the use of fraudulently acquired funds is improper. An action seeking to impose a constructive trust on property improved by wrongfully acquired funds is essentially an action for the recovery of money, not the ownership of real estate (title) acquired by those funds. [**Burger** v. **Superior Court of Santa Clara County** (1984) 151 CA3d 1013]

A loan unsecured is not a trust

Consider an unsecured lender who seeks to impose a **constructive trust** on real estate the owner acquired with funds advanced by the lender.

The lender files a lawsuit and records a **lis pendens** against the property to recover the money owed, claiming the owner purchased the real estate by using the lender's funds.

The owner claims the lis pendens is invalid since the underlying dispute does not concern the lender's enforcement of an unrecorded interest he presently holds in the real estate, but only the recovery of properly acquired funds used to purchase the real estate.

The lender claims the lis pendens is valid since the funds are directly traceable to the real estate and it seeks to impose a constructive trust on the property to avoid loss of the source of repayment.

Is the unsecured lender's lis pendens valid?

No! None of the claims the lender made against the owner of the real estate concern claims to possession or an interest in title to the real estate. The constructive trust was sought on the property to have it sold and provide a source of funds to repay the lender. [**Lewis** v. **Superior Court** (1994) 30 CA4th 1850]

In this example, the unsecured lender should have sought and obtained a court ordered *attachment* of the property to properly enforce the collection of his claim. Better yet, the lender should have initially obtained the owner's promise to secure the debt owed the lender by the real estate he was buying, and then perfect the promise to secure the loan by receiving and recording a trust deed as a voluntary lien on the property.

The lis pendens process

To record a lis pendens, a lawsuit must first be filed involving *title or possession* of the real estate. [CCP §405.20]

The lis pendens must:

- identify the parties to the lawsuit; and
- give an adequate description of the real estate. [CCP §405.20]

While the object of the lawsuit and its affect on title or possession of real estate does not need to be stated in the lis pendens, the **objective** of the lawsuit must be stated in the lis pendens for it to be considered an *absolutely privileged publication*. [CC §47(b)(4)]

*Editor's note — An **absolute privilege** covers any publication during a judicial proceeding which is authorized by law, including a lis pendens. A publication made under absolute privilege bars a **slander of title** action against the person wrongfully claiming an interest in the property. [See Chapter 45]*

A technical legal description of the property subject to litigation is not required as long as the property can be sufficiently identified.

For example, a property owner files a lis pendens which describes his property as being bounded by a specific road, river, fence and surveyed line. Additionally, the description erroneously states the property is located within a specific tract of land, which it is not.

Another property owner contesting the dispute claims the lis pendens is fatally defective and must be removed from the record since the description contains an error. In this instance, the lis pendens is valid even though it contains an error since the location of the property can be ascertained by the boundary description alone. [**McLean** v. **Baldwin** (1902) 136 C 565]

However, the property's legal description which is based on metes and bounds, such as exists for a numbered lot in a recorded subdivision map, should be used to clarify the location of the property.

Now consider a lis pendens **recorded** with a county recorder by a prior owner of the property to recover money owed him by the current owner from the sale of the real estate. The lis pendens identifies real estate which the current owner is under contract to convey to a buyer, but has yet to close escrow. However, the lis pendens, while recorded, is not also **indexed** by the county recorder until after the sales escrow closes.

Later, the buyer discovers the lis pendens and seeks to expunge it from his record title. The prior owner claims the lis pendens cannot be expunged since the recording alone places the buyer on *constructive notice* of the prior owner's claim against the real estate.

The buyer claims he did not have constructive notice since the lis pendens was not indexed by the recorder until after escrow closed.

Can the lis pendens be expunged by the buyer and his title cleared of its cloud?

Yes! The buyer took title to the property free of the prior owner's previously recorded lis pendens since only a **properly indexed** lis pendens gives **constructive notice**. [Lewis, *supra*]

The reason for the indexing requirements is basic. Until a recorded document is indexed, it cannot be found by a **title search**. Thus, it would be unfair to impose constructive notice on a buyer who cannot be expected to locate the document.

Notice by recording and indexing

A lis pendens is properly of record when it is *filed and indexed* in the county recorder's office of the county where the property is located. The lawsuit it references must involve a claim to a *right to title or possession* of the real estate described in the lis pendens. [CCP §405.20]

Recording and **indexing** a lis pendens is constructive notice to all persons about the existence of a dispute over title or possession of a property. Any buyer, lender or tenant who is later conveyed an interest in the property will be bound by the final resolution of the dispute.

Consider a buyer who enters into a purchase agreement and escrow instructions to acquire real estate from a seller. The seller then enters into a backup purchase agreement to sell the property to another buyer, contingent on the cancellation of the pre-existing purchase agreement and escrow instructions.

The seller then unilaterally cancels the pre-existing purchase agreement and escrow instructions. The buyer files a lawsuit to enforce the purchase agreement and records a lis pendens describing the property. The lis pendens, while recorded, is not immediately indexed by the recorder. Prior to indexing the lis pendens, the seller conveys the property to his new buyer.

The original buyer then seeks to enforce his purchase agreement with the seller against the new buyer, claiming the new buyer had constructive notice of the lis pendens when the new buyer acquired title since it was previously recorded with the county recorder.

Does recording a document, such as a lis pendens, provide constructive notice to the new buyer of the lis pendens prior to it being indexed by the recorder?

No! The original buyer cannot enforce the seller's purchase agreement against the new buyer of the property (who is a bona fide purchaser (BPF)) since a lis pendens which has been recorded but has not yet been indexed does not constitute constructive notice to the new buyer. [**Dyer** v. **Martinez** (February 23, 2007) __ CA4th __]

Title insurers and specific performance actions

Title companies usually refuse to insure title when a lis pendens is recorded against title which involves a specific performance action. Without title insurance, buyers will not buy, lenders will not lend and tenants will not occupy the property.

However, a lis pendens in a buyer's specific performance action does not interfere with a title company insuring a lender's trust deed which secures a debt in an amount less than the price the buyer will be paying for the property. [**Behniwal** v. **Mix** (2007) 147 CA4th 621]

As a result, property subject to specific performance actions by buyers is often rendered unmarketable while the lis pendens remains in effect.

The tremendous value of the lis pendens to litigating buyers is its ability to preserve the buyer's right to purchase the property. The recording of a lis pendens often persuades a hedging seller to perform.

Accordingly, the **potential for abuse** of the lis pendens procedure to cloud title of an owner's property is readily apparent.

Further aggravating to hostile owners is the rule that a recorded lis pendens identifying a court action which actually concerns title or right of possession to real estate is an absolutely privileged communication. [CC §47(b)(4)]

A publication made under an absolute privilege bars the owner from initiating a *slander of title* action against the person who claims to hold an unrecorded interest in the property. [See Chapter 45]

Expungement of a lis pendens

A lis pendens is sometimes improperly used to tie up real estate when the claim made is against the individual, not against an interest in his real estate.

Procedurally, a wrongfully recorded lis pendens can be removed quite quickly. [CCP §§405.30 et seq.]

Any time after a lis pendens has been recorded, anyone with an interest in the property affected may file a motion asking the court to remove the lis pendens from the record, called *expungement*.

An order **expunging** a lis pendens removes from title any restrictions sought to be imposed by the lawsuit on the transfer of the property described in the lis pendens. [CCP §405.61]

Once a lis pendens has been successfully expunged, another lis pendens may not be recorded against the property by the same person without the permission of the court. [CCP §405.36]

If the owner, or any other person with an interest in the property, contests a lis pendens which clouds title to his property, the person filing the lis pendens has to prove:

- the action affects title or the right of possession to the property described in the notice; and
- a valid claim exists on which he will **probably prevail** at trial. [Hunting World, Incorporated, *supra*]

If these two requirements are not established, the lis pendens will be ordered expunged and will no longer affect title.

Bonds in lieu of the real estate

Banks and insurance companies frequently issue a *bond* which acts as a source of payment for a liability which may arise in the future. A **bond** is a security device to insure repayment of a debt another person may become responsible to pay.

An owner seeking the expungement of a lis pendens does not have to *post a bond* with the court as a requirement for the removal of a lis pendens if a valid claim to the real estate probably does not exist. [CCP §405.32]

Conversely, the party who recorded the lis pendens may be required to **post a bond** for the amount of money he claims he is due as a condition of maintaining the lis pendens. [CCP §405.34]

Attorney fees with expungement

An owner who successfully defends his title by prevailing on a motion to expunge a claimant's lis pendens from the record is entitled to recover his attorney fees from the claimant, unless the claimant acted with justification. [CCP §405.38]

When a lis pendens is ordered expunged on a motion by the owner, the owner is considered the prevailing party for the purpose of recovering his attorney fees.

Chapter 43 Liens against individuals

This chapter explores an owner's use of a partnership or limited liability company (LLC) to avoid use of the owner's name in the vesting of title to a property.

Vesting to shield assets from others

A broker/owner of a high volume real estate office with several sales agents has continuous access to real estate entering the market for sale, some of which the broker occasionally acquires to own as a principal.

Due to the business activities of the sales agents employed by the broker, the broker is aware he has liability exposure for their professional errors and misconduct. Even though he has incorporated his real estate office and has errors and omissions coverage, he is the licensed broker who qualifies the corporation for its broker's license and is exposed to the most liability.

As the **designated officer** of the corporation, the broker bears the sole responsibility for the constant supervision of his sales agents. The broker manages the office and sales agents and occasionally meets with clients represented by agents under his employ.

The broker, cognizant of personally maintaining a low profile to avoid the appearance of a "deep pocket" which might trigger litigation, vests all the real estate he acquires personally in a limited liability company (LLC) he has created.

The broker's conflicting ownership interest in his brokerage office and any acquisitions handled in the office on behalf of his LLC vestings is fully disclosed to any seller or buyer with whom he or his corporate brokerage office or its sales agents have any relationship.

Later, an error occurs. The broker is faced with a potentially dangerous lawsuit arising out of a previous sales agent's misconduct while acting on behalf of the broker, unrelated to any of the broker's personal real estate acquisitions.

The broker needs assurance the pending litigation, which seeks a money judgment against him personally, will not interfere with his ability to manage, sell or lease his real estate vested in the LLC.

Will a money judgment or lien against an individual member who is an owner of an LLC interfere with the real estate vested in the LLC?

No! Only the broker's ownership interest in the LLC can ultimately be affected. Further, his interest as owner of the LLC is personal property. Thus, any liens or judgments against the broker will not affect the real estate vested in the LLC, only his ownership interest in the LLC. [Calif. Corporations Code §15671]

A lien or money judgment against an individual who is a general partner, limited partner, manager or member is unrelated to the real estate vested in either a partnership or LLC.

Only after a judicial procedure called a *charging order* is processed, can a money judgment against an individual attach to the individual's ownership interest as a member in an LLC.

Editor's note — The remainder of this chapter discusses a partner's interest in a partnership. However, the same results apply to a member's interest in an LLC. [Corp C §§17000 et seq.]

Interest in the partnership property

An individual who is a partner in a partnership has no interest in the real estate owned by the partnership. A partner's ownership interest in the partnership is *personal property*. [Corp C §15671]

While a partner has no interest in any partnership property, he is entitled to his share of the partnership's operating income, sales proceeds, and assets should the partnership be dissolved. [Corp C §15653]

A partner is usually a co-owner of the partnership with other partners, whom often are family members.

Creditors, judgments and liens

A partner in a partnership, whether general or limited, may have an outstanding debt he owes due to:

- a money judgment (i.e., lawsuit liability); or
- a local, state or federal tax lien.

Once recorded, these money judgments or liens automatically attach to any real estate **interests vested** in the individual's name or the name of his trust.

However, a money judgment against a partner which does not name the partner's partnership entity as a judgment debtor can only be satisfied by foreclosing on the partner's **ownership interest** in the partnership, not the real estate owned by the partnership.

Thus, a partnership entity remains unaffected by a lawsuit against a partner. The entity carries on its normal business activities without interference from a partner's creditor seeking to enforce its collection rights under a judgment. [Calif. Code of Civil Procedure §§708.310, 708.320]

Even if a judgment debtor is a general partner, a creditor cannot reach the assets owned by the partnership. [**Evans** v. **Galardi** (1976) 16 C3d 300]

Charging orders to attach a share

Through a money judgment against a partner in a partnership, the partner's *ownership interest* in the partnership may be attached to satisfy the judgment. This judicial procedure involves the use of an **attachment device** called a *charging order*. [CCP §708.310]

A creditor must first locate the partnership interests held by a judgment debtor. Once discovered, the creditor must apply to the court for an order to charge the ownership interest in the partnership held by the individual partner for payment of the judgment. [Corp C §15673]

Notice of the hearing on the charging order must be given to the debtor partner and all other partners in the partnership. [CCP §708.320]

A creditor of an individual partner has two options to enforce a money judgment:

- take over the partner's interest in the limited partnership, thus becoming an assignee by judicial order of the partner's ownership interest [Corp C §15673]; or
- appoint a receiver to receive the debtor's share of the income and profits; or
- foreclose on the partner's interest in the partnership. [Corp C §16504]

If a creditor chooses to take over a partner's interest, the partnership interest can be assigned to him. However, the creditor does not become a limited partner unless all partners in the partnership consent to his inclusion as provided for in the partnership agreement. [Corp C §15674(a)]

Under a charging order, the **appointment of a receiver** is also restricted to accepting the benefit of the individual partner's interest in the partnership. The creditor acquires no greater rights than the debtor partner had under the partnership law and partnership agreement. [**Ribero** v. **Callaway** (1948) 87 CA2d 135]

A creditor with a judgment has the judicial means to go after a partner's interest only. However, the reality of obtaining an individual partner's interest may be more of a hassle than it is worth. The interest the creditor obtains from the debtor partner is a nonvoting interest which prohibits interference with the partnership activities which require a vote.

Further, if a debtor partner is the general partner, the charging order's assignment of his ownership interest in the partnership to the creditor allows a majority of the other limited partners to remove the debtor partner. [Corp C §15674(d)]

If a creditor chooses to have a receiver appointed to manage a debtor partner's interest, the receiver is empowered with court supervision to sell the partner's interest in the partnership to pay off the partner's creditor.

Additionally, a receiver may judicially foreclose on a debtor partner's interest.

Buy-out provisions triggered

One or all of the partners in a partnership may terminate a debtor partner's interest in the partnership on the notice of a charging order without causing the partnership to be dissolved by:

- purchasing the debtor partner's interest using assets of one or more of the other partners;
- offering a buy out exchange of partnership property assets (such as a specific piece of real estate) for the debtor's interest with the consent of all partners [Corp C §16504(c)(3)]; or
- prior agreement under the terms of the *buy-out provisions* of the partnership agreement.

The **buy-out provisions** in a partnership agreement between partners is the most common method used for the elimination of a partner and his creditor. Additionally, the terms of buy-out provisions are usually advantageous to the remaining partners.

Most buy-out provisions in partnership agreements call for the termination of the attached interest held by the debtor partner.

Fraudulent conveyances by debtors

The transfer of property by an owner of real estate to **evade a creditor** is considered fraudulent when:

- the owner actually **intends to defraud** his creditors [Calif. Civil Code §3439.04(a)]; or
- a reasonably **equivalent value** is not received by the owner in exchange for the property transferred and the owner is or will be insolvent (i.e., debts exceed assets) on the transfer. [CC §3439.05]

Any property transfer made for the purpose of avoiding creditors can be set aside or invalidated as a *fraudulent conveyance*. [CC §§3439 et seq.]

However, if the full value or a reasonably equivalent value is received by an owner for a transfer, the transaction cannot be invalidated. The creditor is then left to chase down and attach the proceeds received by the owner (debtor).

A fraudulent conveyance is indicated when an individual knows of pending litigation or claims then transfers his real estate without receiving fair value.

For example, a partnership of three partners is formed. Later, a judgment is obtained against two of the partners in their individual capacities.

A creditor obtains a charging order against the partners' individual interests in the partnership. All three partners receive notice of the proceedings.

Prior to the enforcement of the charging order, the partners act to dissolve the partnership. The two debtor partners each transfer their ownership interest to the third partner, who is unnamed in the judgment, for a minimal sum. The transfer is fraudulent since the third partner was aware of the charging order and did not pay a fair value for the transfer.

If a transfer is made by an owner without a fair exchange of value to a "buyer" who knew the transfer would diminish the creditor's claim, the "buyer" becomes liable for the creditor's losses. [**Taylor** v. **S & M Lamp Co.** (1961) 190 CA2d 700]

Thus, the fraudulent conveyance of a debtor's "wealth" beyond the reach of a creditor will be subject to disciplinary action from the court.

Fraudulent conveyance and lis pendens

Consider a creditor who receives a money judgment against an owner of real estate vested in his name. The owner conveys his interest in the real estate by a quitclaim deed to a relative before title is liened by the creditor's abstract of judgment.

The creditor seeks to set aside the transfer as a fraudulent conveyance and records a lis pendens, which clouds the title to the property conveyed.

The relative holding title claims the lis pendens is improper and must be expunged since the fraudulent transfer claim by the creditor is an attempt to recover a money judgment, not an action affecting title to real estate.

However, the lis pendens is proper since the fraudulent transfer action concerned title to the real estate and is separate from any action to enforce the money judgment. [**Hunting World, Incorporated** v. **Superior Court** (1994) 22 CA4th 67]

The partnership asset shield

The use of a partnership to hold real estate assets was neither designed nor intended to be employed as a place to hide an individual's personal wealth. Rather, it is a means to allow real estate vested in the partnership to remain undisturbed in the face of an individual partner's adversity.

Consider an owner who places his ownership of real estate into a partnership and receives a percentage or all of the ownership interests in the partnership for the conveyance.

In this instance, the conveyance is not fraudulent. The owner has merely exchanged his interest in the real estate for an interest in the partnership. Full value is received and no tax liability is incurred on the exchange. [Internal Revenue Code §721]

In essence, the owner has substituted his real estate vesting for a position in the partnership. The owner still owns a value equal to the equity in the real estate he transferred, only in a different form. Thus, the value of the owner's interest was not diminished since he received an equivalent value for the property. The nature of his ownership interest merely changes from one of real property to one of personal property.

However, this simple change in vesting inherently makes it more difficult to locate and attach the debtor's assets. The individual owner (debtor) on a recorded abstract of judgment is not the vested owner of any real estate.

Further, the change in vesting makes the real estate, now the asset of a partnership, much more difficult for the creditor to reach due to the charging order process. As the creditor is attempting to locate and attach the debtor's assets, the partnership can continue its business of renting, selling or encumbering the property and distributing proceeds to the judgment debtor who is now a partner in the partnership.

Chapter 44 Automatic and declared homesteads

This chapter distinguishes the home-equity protection available to a homeowner against creditors under a recorded declaration of homestead and an automatic homestead.

Home-equity shield against judgments

A homeowner is sued by a creditor for money owed on a debt. The debt is not secured by the homeowner's residence. A **money judgment** is awarded to the creditor who becomes a *judgment creditor*. The homeowner becomes a *judgment debtor*.

An **abstract of judgment** is recorded by the **judgment creditor** in the county where the homeowner's residence is located.

Can the homeowner prevent the recorded abstract from attaching as a lien against the title to his home?

No! However, the type of homestead the homeowner claims — there are two — and the amount of the homestead exemption he qualifies for — there are three — determines the homeowner's ability to:

- **voluntarily sell** the home and buy another home with the homestead amount he has in his equity; or
- bar the judgment creditor from **forcing a sale** of the home to satisfy the judgment.

The homestead interest in title

A *homestead* is the dollar amount of the equity in a homeowner's dwelling which the homeowner qualifies to hold. The amount of the homestead held by the homeowner has priority on title over most judgment liens and some government liens.

Two types of **homestead** procedures are available to California homeowners to establish the priority of the homestead equity in their home which is exempt from execution by most involuntary lienholders:

- the *declaration of homestead*, which is recorded [Calif. Code of Civil Procedure §704.920]; and
- the *automatic homestead*, also called a *statutory homestead exemption*, which is not recorded. [CCP §704.720]

Both homestead arrangements provide the same dollar amount of home-equity protection given to all homeowners in California. However, a homeowner must record a **declaration of homestead** to receive the additional benefits available under the homestead laws allowing the homeowner the right to sell and to reinvest the dollar amount of the homestead in another home.

Neither the declared nor the automatic homestead interfere with:

- *voluntary liens* later placed on the property by the homeowner, such as trust deeds; and
- *involuntary liens* given priority to the homestead exemption under public policy legislation.

Involuntary liens and encumbrances which are given priority by statute and can be enforced as senior to the amount of the homestead exemption include mechanic's (contractor's) and vendor's (seller's) liens, homeowners' association (HOA) assessments, judgments for alimony or child support, real estate taxes and Internal Revenue Service (IRS) liens.

Involuntary liens which are subordinate and junior to the homestead amount include:

- Franchise Tax Board (FTB) personal income tax liens;
- Medi-Cal liens; and
- judgment creditor's liens.

Declaring a homestead

The **recorded homestead declaration** includes:

- the name of the homeowner declaring the homestead;
- a description of the property homesteaded; and
- a statement that the declared homestead is the principal dwelling of the homeowner in which he resides on the date the homestead is recorded. [CCP §704.930(a); see Form 448 accompanying this chapter]

The declaration must be signed, notarized and recorded to take effect. [CCP §704.930]

The homestead declaration may be **signed and recorded** by any one of several individuals, including:

- the owner of the homestead;
- the owner's spouse; or
- the guardian, conservator, attorney in fact, or a person otherwise authorized to act for the owner or the owner's spouse. [CCP §704.930(b)]

An individual's personal residence which is vested in a revocable inter vivos (living) trust, or other type of title holding arrangement established for the benefit of the homeowner, can also be declared a homestead by anyone who has an interest in the property and resides there. [**Fisch, Spiegler, Ginsburg & Ladner** v. **Appel** (1992) 10 CA4th 1810]

Additionally, a declaration of homestead in no way restricts the homeowner's ability to voluntarily sell, convey or encumber his homesteaded property. [CCP §704.940]

A recorded homestead declaration does not appear in credit reports or impact the homeowner's credit reputation or ability to borrow funds. Title companies disregard recorded homestead declarations, except in litigation guarantee policies.

Automatic and declared homesteads

An **automatic homestead** is always available on the principal dwelling occupied by the homeowner or his spouse when:

- a judgment creditor's abstract is recorded against the homeowner and attaches as a lien on the property; and
- the occupancy by the homeowner continues until a court determines the dwelling is a homestead. [CCP §704.710(c)]

The **automatic homestead exemption** applies to the equity in a real estate dwelling (and its outbuildings), a mobilehome, a condominium, a planned development, a stock cooperative or a community apartment project together with the land they rest on, as well as a houseboat or other waterborne vessel used as a dwelling. [CCP §704.710(a)]

On the other hand, a **recorded declaration of homestead** applies only to real estate dwellings. Thus, mobilehomes not established as real estate and houseboats are not protected by a recorded homestead, only the automatic homestead. Also, a leasehold interest in real estate with an unexpired term of less than two years is not protected by a recorded homestead declaration. [CCP §704.910(c)]

Homesteaded real estate

As long as the homeowner claiming the exemption actually uses the homesteaded property as the principal residence for himself and his family, the type of real estate qualifying for a homestead includes:

- two five-room flats [**Viotti** v. **Giomi** (1964) 230 CA2d 730];
- an 18-unit apartment building where the owner occupies only one unit [**Phelps** v. **Loop** (1944) 64 CA2d 332]; and
- 523 acres of rural land with a house and water rights for the land. [**Payne** v. **Cummings** (1905) 146 C 426]

Homeowners qualify for one of three dollar amounts of **net equity** homestead protection:

- a $50,000 equity for a homeowner with no dependents;
- a $75,000 equity for a head of household; or
- a $150,000 equity for the aged or disabled. [CCP §704.730]

Amount of equity protected

The dollar amount of whichever home equity protection a homeowner qualifies for is protected whether the homeowner relies on the automatic homestead or records a declaration of homestead.

An individual homeowner with **no dependents** other than himself qualifies for the $50,000 homestead exemption. [CCP §704.730(a)(1)]

A homeowner qualifies for the $75,000 homestead exemption as the **head of a household** by providing support for a spouse, dependent children, grandchildren, parents, grandparents or in-laws. [CCP §704.730(a)(2)]

An **aged or disabled** homeowner qualifies for the $150,000 homestead exemption if the homeowner or his spouse is:

- 65 or older;
- physically or mentally disabled; or
- 55 or older with an annual income of less than $15,000 or, if married, a combined gross annual income of no more than $20,000. [CCP §704.730(a)(3)]

Both a husband and a wife may be the declared homestead owners in the same homestead declaration when both husband and wife own an interest in the property. [CCP §704.930(a)(1)]

However, a couple's combined homestead exemption cannot exceed the exemption limit for a head of household ($75,000), unless one or both qualify as an aged or disabled person ($150,000). [CCP §704.730(b)]

Further, if both spouses are entitled to a homestead exemption, the homestead proceeds will be apportioned to each spouse according to their proportionate ownership interest in the homesteaded real estate. [CCP §704.730(b)]

Abstract avoids homestead increases

As the legislature increases the amount of the homestead exemptions, a homeowner does not need to record a new declaration since the increased amount applies to the old declaration.

However, if an involuntary lien is recorded prior to the increase in the amount of the exemption, the amount of equity protected from the attachment is the homestead amount which was available when the lien was recorded, whether the homeowner is claiming an automatic or declared homestead. Thus, inflation or appreciation in the value of the residence may eventually create a home-equity large enough to exceed the homestead amount and provide some recovery for a judgment creditor. [**Berhanu** v. **Metzger** (1992) 12 CA4th 445]

Combating a creditor's sale

A judgment creditor with a recorded abstract of judgment cannot force the sale of an owner's home to collect on a money judgment until a **court confirms** the owner's net equity in his home is a dollar amount greater than the amount of the owner's homestead exemption — whether the homestead is automatic or by recorded declaration. [CCP §704.740(a)]

For example, the head of a household owes $325,000 on trust deed loans encumbering his home. An unsecured creditor is awarded a money judgment against the homeowner and an abstract is recorded, attaching as a lien on title to the property.

Before the creditor can begin judicial proceedings against the equity in the home to collect on the judgment for the net proceeds of its sale, the home needs a **net value** in excess of $400,000 — the $325,000 owed on the existing trust deeds plus the $75,000 homestead exemption.

A home with a **net equity** (after transactional costs) of less than the homestead amount leaves nothing for the creditor to sell in order to collect on the judgment.

Forced sale by court order only

The sale of a homesteaded dwelling can be forced by a creditor if a net equity exists beyond the amount of the homestead. To force the sale of a homesteaded dwelling, the creditor must first **file an application** for a judicially ordered sale, called an *execution sale*, stating under oath:

- a description of the property;
- whether a declared homestead has been recorded on the property;
- the names of the person or persons who claim the homestead;
- the amount of the homestead; and
- the dollar amounts of all liens and encumbrances recorded on the property and the names and addresses of the lienholders. [CCP §704.760]

If the homestead is declared and the creditor challenges the **validity of the declaration**, the creditor must prove the property does not qualify for a homestead.

However, if the homeowner has not recorded a declaration of homestead on the property, the homeowner must prove his residency in the dwelling qualifying the property for the automatic homestead exemption. [CCP §704.780(a)(1)]

If the execution sale of the property is ordered by the court and the bids received at the sale are insufficient to satisfy the senior liens and encumbrances, plus the homestead amount and the sales costs, the dwelling will not be ordered sold. [CCP §704.800(a)]

Additionally, a winning bid must exceed **90%** of the fair market value (FMV) of the property as set by the court. [CCP §704.800(b)]

A real estate appraiser is often appointed by the court to assist in determining the FMV of the dwelling. Compensation for the appraiser may not exceed comparable fees for similar services in the community. [CCP §704.780(d)]

If the dwelling is jointly owned by the judgment debtor/homeowner and another person as joint tenants or tenants in common, only the judgment debtor's interest in the property will be sold. [CCP §704.820(a)]

The proceeds from an execution sale of the dwelling are disbursed in the following order:

- pay all senior liens and encumbrances on the property;
- disburse the amount of the homestead equity to the homeowner;
- cover the costs of the sale;
- pay the judgment creditor's court costs; and
- pay the amount due to the creditor from the judgment. [CCP §704.850]

Any remaining proceeds from an execution sale go to the homeowner.

"Drawing down" the homestead amount

Consider a homeowner who records a **declaration of homestead** on his principal residence which is encumbered by a trust deed. A creditor is awarded a money judgment against the homeowner and records an abstract of judgment.

Later, the homeowner records a second trust deed on the residence to secure another loan for an amount less than the dollar amount of the homestead exemption.

The homeowner defaults on the first trust deed loan and the first trust deed holder forecloses on the residence. The residence is sold at a trustee's sale on a bid in excess of the amount owed to the first trust deed holder.

The judgment lien creditor claims he is entitled to the excess funds since the judgment lien is prior in time to the later recorded second trust deed.

The second trust deed holder claims he is entitled to the remaining funds since the second trust deed lien is a voluntary encumbrance on the homeowner's equity protected by the homestead exemption, which entitles him to first recover against funds due to the homeowner under the recorded declaration of homestead exemption.

Is the second trust deed holder entitled to the excess funds?

Yes! The second trust deed holder is entitled to payment from the funds remaining after satisfaction of the first trust deed debt since the judgment creditor's **lien is subordinate** to the recorded declaration of homestead exemption. Further, the dollar amount of equity subject to the homestead exemption held by the homeowner was voluntarily encumbered by the second trust deed lien. [**Smith** v. **James A. Merrill, Inc.** (1998) 64 CA4th 94]

RECORDING REQUESTED BY

AND WHEN RECORDED MAIL TO

Name

Street Address

City & State

SPACE ABOVE THIS LINE FOR RECORDER'S USE

DECLARATION OF HOMESTEAD

DATE:_____, 20_____, at_____, California.

Items left blank or unchecked are not applicable.

1. The name of the owner or owners of the real estate subject to this declared homestead:

_____

enter the name of the individual entitled to the Homestead exemption

2. The declared homestead regards real estate situated in the City of _____, County of _____, California, described as:

2.1 The property is more commonly referred to as:

_____

enter the street address and the city

3. The declared homestead is the principal dwelling and now resided in as the residence of:

☐ A declared owner of the homestead;

☐ The declared owners of the homestead; or

☐ The spouse of the declared owner of the homestead.

4. I execute this declaration of homestead as:

☐ a declared homestead owner.

☐ the spouse of the declared homestead owner.

☐ the guardian or conservator of the person or estate of the:

☐ declared homestead owner; or

☐ spouse of the declared homestead owner.

☐ an attorney in fact for the:

☐ declared homestead owner; or

☐ spouse of the declared homestead owner.

4.1 As a guardian, conservator or attorney in fact, acting on behalf of the declared homestead owner or the spouse of the declared homestead owner, I am authorized to execute this declaration under the authority vested in me by _____
enter identification of the source of your authority

5. The facts stated above are known to me to be true as of my own personal knowledge.

Date:_____, 20_____ _____
(Print Name) (Signature)

Date:_____, 20_____ _____
(Print Name) (Signature)

STATE OF CALIFORNIA)
COUNTY OF_____)
On _____ before me,
_____
(name of notary public)
personally appeared _____
_____,
(name of principal)
personally known to me (or proved to me on the basis of satisfactory evidence) to be the person(s) whose name(s) is/are subscribed to the within instrument and acknowledged to me that he/she/they executed the same in his/her/their authorized capacity(ies), and that by his/her/their signature(s) on the instrument the person(s), or the entity upon behalf of which the person(s) acted, executed the instrument.

WITNESS my hand and official seal.

Signature: _____
(Signature of notary public)

(This area for official notarial seal)

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Automatic homestead as a shield

Although an **automatic homestead** exempts some or all of the equity in a homeowner's dwelling from money judgments obtained by the homeowner's creditors, use of the automatic homestead is limited to providing a **shield**, raised by the homeowner, to defend the equity in his house against a forced sale by an involuntary creditor.

For example, a homeowner claims his automatic exemption and receives funds in the amount of the homestead equity from a creditor's forced sale of the home. The homestead funds are protected from the creditor's attachment during a six-month reinvestment period. Further, an automatic homestead exemption is provided on the replacement residence to protect the reinvested funds. [CCP §704.720(b)]

Editor's note — Although the proceeds are protected from attachment by the creditor's lien for the six-month reinvestment period, if the property purchased is in the same county where the lien is recorded, it

will not prevent the lien from attaching to new property (subject to the homestead exemption) the instant title is transferred into the buyer's name.

Thus, a homeowner/debtor intending to purchase a replacement home in the same county with his protected funds will probably not be able to obtain title insurance for a new loan. Title companies will not make a determination as to whether an exemption on the new residence is valid. Also, the abstract lien will attach to the property as a lien senior in time to the new lender's trust deed, unless it is a trust deed carried back by a seller.

The best way to deal with the intervening (judgment) lien is to purchase property either subject to an existing trust deed or by creating a carryback trust deed. Carryback trust deeds have priority over any lien attaching to the title when the buyer takes title, unless the carryback note is specifically subordinated to the previously recorded abstract of judgment. [Calif. Civil Code §2898]

With the automatic homestead exemption, a homeowner who **voluntarily sells** his residence while title is clouded by a creditor's lien leaves the sales proceeds unprotected by the automatic exemption. This is not the case for a sale subject to a recorded declaration of homestead, which allows the homeowner to withdraw his homestead amount.

The exemption in bankruptcy sales

For an individual who files a bankruptcy petition, any sale of the individual's home during the bankruptcy, whether voluntary or court ordered, is considered a **forced sale** entitled to the automatic homestead exemption. Thus, a bankruptcy petitioner who voluntarily sells his home (even if the sale is against the bankruptcy court's order) is still entitled to an automatic homestead exemption on the proceeds of the sale. [**In re Reed** (9th Cir. 1991) 940 F2d 1317]

Consider a homeowner whose home is being foreclosed on by the first trust deed lender. The homeowner did not file a declaration of homestead prior to the recording of the judgment lien against the property.

At the trustee's sale, a bid in excess of the loan leaves funds to be disbursed to the junior lienholder (the judgment creditor), since a recorded abstract of judgment against the homeowner exists.

Since **foreclosure** under a power-of-sale provision is a **voluntary sale** by private agreement entered into by the homeowner, not a forced sale which triggers the automatic homestead exemption, the automatic homestead exemption does not protect the homeowner's equity on a foreclosure sale of the residence. Thus, the homeowner whose home is lost to foreclosure exposes any excess proceeds from the trustee's sale to the creditor's lien, unless a declaration of homestead was previously recorded. [**Spencer** v. **Lowery** (1991) 235 CA3d 1636]

*Editor's note — A homeowner foreclosing on his home will receive his automatic homestead exemption if he files a bankruptcy petition before the foreclosure is completed. In a bankruptcy proceeding, all sales are considered forced sales and thus protect the dollar amount of the equity covered by the automatic exemption from the claims of involuntary creditors. [In re Reed, **supra**]*

Additionally, the creditor holding a judgment lien (a recorded abstract of judgment) can simply wait until the equity in the home increases, due to inflation, appreciation or loan reduction, and exceeds the amount of the homestead exemption, and then begin a forced sale. Thus, the homeowner who relies solely on the automatic homestead exemption to protect his equity is imprisoned in his own home since he cannot voluntarily sell and avoid the judgment lien unless he files a bankruptcy petition.

Although a sufficient net equity may not exist to allow the judgment creditor to force a sale of the home, the homeowner may not use a *quiet title action* based on an automatic homestead exemption to remove the lien, unlike a declared homestead.

Declared homestead allows resale

A recorded declaration of homestead, in contrast to an automatic homestead exemption, allows a California homeowner to take the offensive against his creditors. The declaration of homestead allows the homeowner to use a quiet title action to **sever the liens** attached to his title.

Unlike the automatic homestead exemption, judgment liens do not attach to the exempt homestead amount under a declared homestead if the homestead declaration is recorded prior to the recording of the creditor's abstract of judgment. [CCP §704.950(a)]

Judgment liens attach to any equity exceeding the amount of the declared homestead exemption and all liens and encumbrances on the declared homestead at the time the abstract of judgment is recorded. [CCP §704.950(c)]

With prior planning, priority of the declaration can be accomplished by the homeowner. While it takes the creditor several months to obtain and record an abstract of judgment, a declaration of homestead can be prepared and recorded on readily available forms in a matter of minutes. [See Form 448 accompanying this chapter]

Once recorded, a declaration of homestead lasts until:

- the homestead owner records a declaration of **abandonment of the homestead**; or
- the homestead owner records a **new declaration** of homestead on another residence. [CCP §§704.980, 704.990]

If a homeowner whose title is clouded with a creditor's lien wishes to **sell his declared homestead**, the homeowner may either:

- negotiate a release of the lien with the creditor [See Chapter 41]; or
- clear title to the home through a quiet title action. [See Chapter 47]

Clearing title of a lien

A *quiet title* action determines the priority of the creditor's lien and the recorded homestead on title. If the homeowner demonstrates the homestead declaration is valid and was recorded prior to the creditor's lien, the title will be cleared of the lien, provided no equity remains after the homestead amount. [Viotti, *supra*]

Creditors junior to a declared homestead where no excess equity exists realize their futility in litigation and are generally receptive to a negotiated release. Consequently, the homeowner can usually "buy" a partial (or full) release from the creditor — typically for less than the costs of a **quiet title** action. [See **first tuesday** Form 409]

After title is cleared and the homeowner sells his property, he has six months to reinvest the homestead proceeds in another home. If the proceeds are reinvested in a new residence within six months, the new residence may then be declared a homestead by recording a homestead declaration within six months after the purchase.

When the homeowner records a new homestead declaration on his replacement residence, the recording *relates back* to the time the prior homestead was recorded. This leaves no gap for the creditor's lien to gain priority over the homestead declaration on the new residence. [CCP §704.960]

If the homestead equity exemption has increased after the creditor recorded his abstract of judgment, the amount of exemption the property owner is entitled to in his **new residence** is the amount that was in effect when the abstract of judgment was recorded, not the current increased amount.

However, if the homeowner has not invested the proceeds of the sale in a new homestead after six months, and the proceeds are still in the State of California, the proceeds of the homestead sale can be attached by the judgment creditor.

An alternative to vesting title in the judgment debtor's name is to use a title holding arrangement, such as a corporate trustee or a limited liability company (LLC) created by the homeowner to hold title. Thus, the abstract of judgment against the homeowner will not automatically attach to the title.

Chapter 45 Slander of title

This chapter reviews the conditions which allow a property owner to recover for slander of his title.

False statements, oral or written

Slander of title refers to both slander and libel. Any interest in real estate can be harmed or damaged by false **oral statements**, called *slander*, or false **written statements**, called *libel*. [Restatement of the Law Second, Torts §624]

For a person to be liable for **slander of title** based on his comments about another person's interest in a parcel of real estate, the oral or written statement must:

- be published;
- be untrue and disparaging to the owner's property interest;
- be made without privilege; and
- cause money losses. [Rest.2d Torts §624]

A real estate interest is **slandered** when a person makes an *unprivileged false statement* about a real estate interest which brings into question the right or title to the interest, called *disparagement*, and causes the owner of the real estate interest to lose money.

A **false statement** consists of writings, words or conduct communicated to another, called *published*, which adversely affects the desirability of a **marketable interest** in real estate.

For example, a business owner places his business on the market for sale. The lease on the premises occupied by the business owner is assignable without prohibition or restriction.

The lease contains an option to renew or extend the lease. The option needs to be exercised to assure potential buyers the business can remain in possession of the premises since the location contributes to the goodwill value of the business.

However, the landlord informs the business owner he expects him to vacate the property when the original term of the lease expires. Regardless, the business owner timely exercises the option to renew/extend the lease.

A buyer for the business is located and escrow is opened. The landlord contacts the buyer and orally advises him that the business owner's attempt to exercise the renewal option was ineffective and the landlord will sue and physically retake possession of the premises if the buyer accepts an assignment of the lease and occupies the premises.

The landlord's oral statements cause the buyer to cancel the purchase agreement and escrow. The business owner has lost his buyer and the monies he would receive from the sale. Further, the landlord continues to interfere with the business owner's marketing of the business, making the sale virtually impossible by causing the value of the leasehold interest to be uncertain.

Has the landlord slandered title to the business owner's leasehold interest in the real estate occupied by the business?

Yes! The landlord's *oral misrepresentations* about the validity of the exercise of the renewal option was a publication made to a buyer who acted on the information to the financial detriment of the business owner — by **placing a reduced value** on the leasehold interest to be assigned to the buyer as a business asset. Thus, the **landlord is liable** to the business owner for the loss in the value of the leasehold caused by the disparaging remarks made to the prospective buyer. [**Baker** v. **Kale** (1947) 83 CA2d 89]

Examples of written **publications** constituting slander of title include:

- forging a trust deed which is recorded as a lien on real estate [**Forte** v. **Nolfi** (1972) 25 CA3d 656]; and
- conveying real estate by a deed without possessing a claim to title. [**Cavin Memorial Corporation** v. **Requa** (1970) 5 CA3d 345]

Real estate interests open to slander

Slander of title applies to any marketable interest in real estate which is assignable, transferable or capable of being sold. A real estate interest includes the fee simple, a leasehold, an easement and covenants, conditions and restrictions (CC&Rs) — not just the vested title. [Rest.2d Torts §624]

For example, an owner and his neighbor have owned adjacent parcels of real estate for over 20 years.

The previous owner of the two adjacent parcels reserved the rear 43 feet of both parcels for road and utility purposes when he sold and conveyed the separate properties to the current owner and his neighbor. The portion reserved as a roadway was never used by the previous owner for the purposes stated in the reservation.

Both the current owner and his neighbor have always believed their actual boundaries included the reserved roadway parcels.

The owner builds his personal residence on his parcel, encroaching on the reserved parcel to the rear of his parcel. The neighbor openly uses his and the reserved parcel to the rear of his parcel and pays the property taxes on the parcel reserved from his title.

However, the neighbor does not file a judicial action to establish record title to the reserved parcel to the rear of his parcel.

The owner whose residence encroaches on the reserved parcel lists his parcel for sale.

The owner's broker obtains a property profile report from a title company and discovers the reserved parcels are not vested in the name of the owner or the neighbor. An argument about the ownership of both reserved parcels ensues between the owner's broker and the neighbor regarding the neighbor's claim of ownership by adverse possession to the reserved parcel at the rear of his parcel.

The broker arranges for the owner to purchase both reserved roadway parcels located to the rear of both properties. The owner's parcel and both roadway parcels are then acquired by a buyer. The buyer is not advised of the neighbor's claims of title by adverse possession to one of the reserved parcels.

After closing, the neighbor seeks money losses from the broker for **slander of title** regarding ownership of the reserved parcel he has been occupying. Further, the neighbor files an adverse possession action against the buyer to quiet title to that parcel.

The broker claims he did not slander the neighbor's title since a claim of adverse possession is not a property interest which can be slandered.

Can the broker slander title which is to be perfected by adverse possession?

No! The broker cannot be held liable for slander of title since he arranged the sale of the property as reflected by its recorded title. The neighbor did not hold legal title to the reservation at the rear of his parcel at the time of the broker's actions. The neighbor must first complete a judicial proceeding to **establish record title by adverse possession** before his interest can be slandered.

The intent of the policy which permits an owner to bring a slander of title action is to **protect the marketability** of his title for a potential sale of property. Title acquired by adverse possession is not marketable until the title is established by judicial proceedings against the record owner, which in this example was the buyer.

The broker did not interfere with the neighbor's ability to sell the reserved parcel he claims to own since the neighbor did not have marketable title to the property when the broker sold it. [**Howard** v. **Schaniel** (1980) 113 CA3d 256]

Editor's note — The broker is required to indemnify the buyer for the costs of quieting title since the broker failed to disclose to the buyer a condition of title known to him — the neighbor's unrecorded claim to the property by adverse possession.

Privileged statements are not slander

A statement made about a real estate interest as part of a *privileged publication* does not subject the person making the statements to liability for slander of title.

Two types of **privileges** exist:

- *conditional privilege*; and
- *absolute privilege*.

A **conditional privilege** is a defense, used by the person who made a statement, to defeat an owner's claim his title was slandered by the statement. A statement made to another person about an owner's interest is a communication legally called a *publication*. To be a **privileged publication** and thus avoid liability, the statement about the owner's interest in the real estate must be made **without malice** towards the owner of the interest. [Calif. Civil Code §47(c)]

A conditionally privileged communication includes the content of a lawsuit filed in good faith, or a dispute over a right or interest in real estate, such as a claim of ownership by way of a prescriptive easement.

Malice, as required to impose liability as a breach of good faith, can be:

- *actual*; or
- *implied*.

Actual malice, also called *malice in fact*, may be shown by the lack of justification for a person's communication when the person acts with ill will and the desire to do harm to the owner of the slandered interest. Actual malice exists when a statement adverse to an owner's interest is made solely for the purpose of causing harm to the owner.

While the existence of malice is essential for the owner to overcome the defense of a conditional privilege asserted by the individual making the injurious statement, actual malice is not required for the owner to prove his title has been slandered. **Implied** malice will suffice.

Malice may be **implied** from the conduct of the person making a disparaging statement if he is not acting in *good faith*, also called *malice in law*. Malice is inferred from the actions of an individual who is attempting to establish an invalid claim against an owner's title.

Thus, if the individual who slanders title can show his statement was made in **good faith** by showing he honestly believed his **claim of title** to be valid, then the individual cannot be held liable for slander of title when he fails to prove his claim.

For example, an owner executes a note in favor of a private lender secured by a trust deed on the owner's real estate. Later, a bank makes the owner a loan secured by a trust deed on the same property. The title insurance company erroneously insures the priority of the bank's trust deed as senior to the private lender's trust deed.

Later, the private lender attempts to foreclose as the senior lienholder. A dispute in priority between the private lender and the bank ensues. The private lender's trust deed is declared to be senior to the bank's trust deed.

The private lender initiates a slander of title action against the title company. The private lender seeks to collect his out-of-pocket money losses caused by the delay in foreclosure and a decline in the value of the security caused by the uncertainty of his trust deed's priority resulting from the erroneous priorities stated in the title insurance policy issued to the bank.

The private lender is unable to show the title company acted maliciously towards him when they issued the title policy.

Is the title insurance company liable to the private lender for slander of title?

No! The title insurance company's policy issued to the bank is *conditionally privileged*. The private lender cannot prove malice toward him exists on the part of the title company based on the erroneous priority of trust deeds in the policy of title insurance.

Additionally, a title insurance policy does not constitute a publication. A title insurance policy is not an abstract of title and does not warrant that conditions or defects in title do not exist. Under a title insurance policy, the title company only assumes the risk of the insured's money losses due to an undisclosed defect in title or error. [**Smith** v. **Commonwealth Land Title Insurance Company** (1986) 177 CA3d 625]

Absolute privilege

A publication which falls under an *absolute privilege* bars a slander of title action, even if the publication is made with actual malice.

A communication protected as an **absolute privilege** is any statement made as part of a legislative, judicial or other *official proceeding* authorized by law. [CC §47(b)]

For example, a creditor brings an action seeking to recover money from an owner and the imposition of a lien on the owner's property. The creditor records a **lis pendens** which clouds title to the owner's property.

The creditor does not prevail in the action and the owner's title is cleared of the lis pendens. The owner then files a slander of title action seeking to recover money losses he incurred due to the creditor's recording of the lis pendens.

The creditor claims the recordation of the lis pendens is absolutely privileged, barring the owner from any recovery in a slander of title action.

The owner claims the lis pendens is not absolutely privileged since it was not **made in a judicial proceeding**, such as pleadings and communications of the judge, parties, witnesses, etc.

Is the recording of the lis pendens absolutely privileged?

Yes! A recorded lis pendens which identifies a court action concerning adverse claims against title or right of possession to the owner's real estate is an **absolutely privileged publication**. [CC §47(b)(4)]

To be a properly recorded **lis pendens**, the recorded statement must identify all parties to the lawsuit and give an adequate description of the real estate. The object of the lawsuit, whether it is title or possession, does not need to be stated in the lis pendens. [Calif. Code of Civil Procedure §405.20]

Absolute privilege applies to any publication required by law **in the course of a judicial proceeding** to achieve the objectives of a final judgment in the litigation, even if the publication is made outside the courtroom, as is a lis pendens. [CC §47(b)]

Additionally, papers filed during court proceedings are absolutely privileged from a slander of title action. Absolute privilege applies to the recording of a lis pendens since its use is authorized to give constructive notice of a **claim against property** asserted in pending litigation. [**Albertson** v. **Raboff** (1956) 46 C2d 375]

Loss of privilege for lis pendens

However, a lis pendens losses its status as absolutely privileged if the litigation referenced does not state a claim to title or possession of the real estate described in the lis pendens.

For example, a buyer purchases property at a sheriff's sale which is in foreclosure on a money judgment an unsecured creditor was awarded in a debt collection action. The buyer intends to renovate and sell the property at a profit.

The prior owner who was wiped out by the sheriff's sale records a lis pendens against the property, referencing the debt collection lawsuit which resulted in a money judgment and the sheriff's sale and is now on appeal. The lis pendens remains of record and prevents the buyer from selling the property for three years, during which time it drops in value.

The buyer seeks to recover his loss of value from the prior owner, claiming he was prevented from selling the property since the lis pendens slandered title to his property. The prior owner claims a slander of title did not occur since the recordings of the lis pendens were absolutely privileged.

Are the recordings of the lis pendens absolutely privileged?

No! The buyer is able to recover his money losses caused by the recorded lis pendens. Here, the lis pendens were improper and lost their status as absolutely privileged. The lis pendens referenced and related to the creditor's collection effort on an unsecured debt, a lawsuit which contained no claim against the **title or possession** of the property, only to the creditor's entitlement to a **money judgment** for a debt owed. [**Palmer** v. **Zaklama** (2003) 109 CA4th 1367]

Editor's note — The remedy for an improperly recorded lis pendens is to have the lis pendens expunged as lacking a real estate claim or evidence to support a real estate claim, and collect damages caused by

the recording of the lis pendens or proceed with a malicious prosecution action. [CCP §405.30; Calif. Penal Code §1447]

Wrongful levy issued by a court

Consider a creditor who is awarded a judgment against an individual, called a *judgment debtor*. Later, the **judgment debtor** marries an individual who is the vested owner of real estate.

After the marriage, the creditor records a **writ of execution** issued by the court as a levy on all real estate vested in the owner's name, even though it is not vested in the debtor's name. The levy **attaches as a lien** on the owner's separate property.

The owner locates a ready, willing and able buyer who enters into an agreement to purchase the property. However, the buyer refuses to complete the transaction when he (and his title insurer) learn of the creditor's levy. The property's marketability and value drops as a result of the creditor's levy.

The property owner demands the creditor's levy under the writ of execution be removed, informing the creditor:

- the judgment debtor, who is the owner's spouse, does not have an interest in the property; and
- the property owner is not a party to the action creating the judgment.

The creditor refuses to remove the lien claiming married individuals are responsible for each other's debts.

The property owner sues the creditor for slander of title to collect his money losses caused by the creditor's levy, claiming the lien was improperly placed on his real estate.

The creditor claims the recording of the writ of execution (which is the levy) is an absolutely privileged publication, performed as part of a **judicial proceeding**.

Is the court ordered levy a privileged publication?

No! The levy on the property under the writ of execution was not obtained in good faith by the creditor. The creditor held **no honest belief** the judgment debtor had an interest in the property of the owner. Thus, the creditor is liable for the owner's out-of-pocket money losses caused by his slander of the owner's title resulting from the recording of a levy in the name of the owner, a person against whom the creditor had no judgment. [**Gudger** v. **Manton** (1943) 21 C2d 537]

Money losses due to slander of title

To impose liability, an individual's slanderous statements about title or possession do not need to be made for the purpose of directly influencing another person's conduct.

The individual making a disparaging statement is liable for an owner's losses if it is *reasonably foreseeable* his statement will be relied upon by another person, whose *reliance* will cause the owner to suffer out-of-pocket **money losses**. [Rest.2d Torts §623A, Comment b]

Thus, if the owner does not suffer out-of-pocket money losses due to the disparaging remarks, no basis exists for a claim of slander of title since nothing is to be recovered.

For example, a buyer and seller enter into a purchase agreement and open escrow. A neighboring owner makes statements to the buyer concerning a possible defect in the property's soil condition.

The seller assures the buyer the neighbor's statements are untrue, and the buyer closes escrow. The seller incurs no money damages as a result of the neighbor's statements, only minor aggravation and lost time.

Later, the seller claims the neighbor's statements slandered his title.

However, the seller has no claim against the neighbor for slander of title. The neighbor's statements, while erroneous, did not prevent the sale of the property at its full market value and the seller did not suffer any out-of-pocket money losses. [**Burkett** v. **Griffith** (1891) 90 C 532]

However, it is possible for an individual's statements to cause an owner to lose money, even if a sale is not involved.

For example, the money losses recoverable by an owner or tenant for slander of title include:

- money losses which are a direct result of another person's statement, including any decrease in the market value of the real estate caused by the slanderous statement [Rest.2d Torts §633(1)(a)]; and
- expenses incurred by the owner to remove any doubt caused by the slanderous statement, including the costs of litigation. [Rest.2d Torts §633(1)(b)]

Punitive damages for known falsehoods

If an owner can show the slanderous statement of an individual was made with **actual malice**, *punitive damages* can be recovered from the individual slandering the owner's title. [CC §3294]

For example, to improve his residence, an owner intends to remove an existing privacy fence constructed by the prior owner and relocate it on the boundary line, which is located six feet into what the neighbor now uses as part of his backyard. Both the owner and the neighbor are aware the fence is for privacy purposes and was not built to establish an agreed-to boundary.

Further, an existing utility pole must be relocated to the boundary line which is also the center of an easement held by the utility company. The owner takes out his building permits to relocate the fence and the utility company is requested to move the pole.

The neighbor is notified of the owner's construction plans to relocate:

- the privacy fence to the boundary line; and
- the utility pole to the center of the utility easement.

The neighbor does not want the fence or the utility pole to be moved and intends to prevent the construction by asserting a boundary line dispute. The neighbor notifies the owner and the utility company in writing that he considers the privacy fence to be the property's agreed-to boundary line — a statement the neighbor knows is false.

The utility company refuses to proceed with the relocation of the utility pole until the dispute with the neighbor over the boundary line is resolved. As a result of the neighbor's actions, construction is delayed and the owner's construction costs to improve his residence are increased.

The owner sues the neighbor to establish the fence as a privacy fence and not an agreed-to boundary fence. The owner also makes a demand on the neighbor for payment of increased construction costs, claiming they are the result of the neighbor **slandering his title** and delaying the construction of the improvements.

Has the neighbor slandered the owner's real estate title?

Yes! The neighbor made statements about the owner's real estate which he **knew to be false**, causing the owner to lose money and incur expenses. The neighbor knew the privacy fence was not the agreed-to boundary yet tried to enforce it as the boundary line by interfering with the construction. Thus, the neighbor is liable for:

- the owner's increased construction costs; and
- punitive damages for slandering the owner's title. [**Appel** v. **Burman** (1984) 159 CA3d 1209]

Editor's note — If the neighbor filed an action to dispute the boundary line instead of making the comments to the owner and the utility company, the neighbor would still have slandered the title. Any lawsuit the neighbor initiated would not be absolutely privileged since it would not be brought in good faith to protect his interest in another's property since he lacks evidence of a merit-worthy claim.

Chapter 46 Forcing co-owners out

This chapter applies the involuntary partition or sale of real estate to resolve disputes between vested co-owners.

Divide, sell or buy out

On the death of both parents, the surviving children receive real estate vested in their names as co-owners. One child is selected to manage the property on behalf of all the children.

Soon, the children disagree on the ownership and management of the inherited property. One child, concerned about his personal liability exposure from ownership, wants the property to be sold and the proceeds distributed based on each child's percentage of co-ownership.

Another child wants to subdivide the real estate and eliminate the co-ownership by conveying the separate parcels to one another. Each child would then be the sole owner and manager of his separately divided ownership of their parcel.

Yet another child is willing to cash out the other family members and acquire ownership of the entire property himself.

Thus, no arrangement will meet the individual goals of each child vested as a co-owner.

Can any one of the co-owners force a termination of the co-ownership since they no longer agree on the ownership and management of their real estate?

Yes! A *partition action* severs co-ownership of real estate by either:

- dividing the property into parcels and **distributing it in kind** among the co-owners, if feasible [Calif. Code of Civil Procedure §§873.210 et seq.]; or
- **selling and distributing** the net sales proceeds to the co-owners according to their percentage of ownership. [CCP §§873.510 et seq.]

With a **partition action**, the co-owner wanting to be cashed out would achieve his goal, directly by a sale of the whole or later by a sale on his receipt of his divided interest. Also, the co-owner wanting to buy out the other co-owners could achieve his goal by **bidding on the property** at the court ordered sale, unless the property is partitioned, in which case the third co-owner directly obtains his goal.

The quieting of quarreling co-owners

A **partition action** is a lawsuit to **sever** or **sell** real estate which is co-owned. [CCP §872.020]

The need for a partition action arises when co-owners cannot agree on the management, division or sale of the real estate they jointly own. Co-owners can mutually agree to divide the real estate in a **voluntary partition** or sell it as provided in most written co-ownership agreements.

Conversely, a partition action will force a division or sale of the real estate in an **involuntary division or sale** of the property.

Who can partition

A partition action is an *equitable* remedy which has its roots in English common law, called *chancery*. The court of equity — **chancery** — has great discretion in deciding what is the best resolution for feuding co-owners.

While partition and distribution of the property is the preferred equitable result, not all forms of co-ownership or types of property allow for a partition to terminate a co-ownership.

Nonmarried co-owners vested as joint tenants or tenants in common have an absolute right to partition (or sell) the real estate owned. [**Lazzarevich** v. **Lazzarevich** (1952) 39 C2d 48]

A partition action is available to nonmarried joint tenants or tenants in common who take title in their individual names, acquiring title either under an agreement between themselves or by *operation of law*, such as by a will or trust.

For example, a lender makes a loan secured by the fractional interest of a co-owner in real estate. The co-owner defaults on the loan. The lender forecloses and becomes a tenant in common with the other co-owner of the property. Here, the lender acquires a fractional ownership interest in the real estate, not the entire ownership.

Can the lender, as a fractional owner, sue the co-owner for partition or sale of the real estate simply to liquidate and recover his original investment in the loan?

Yes! The lender, now owning an **undivided fractional interest** in the real estate, can sue for partition or sale to complete the liquidation of his initial security interest in the property. [**Kane** v. **Huntley Financial** (1983) 146 CA3d 1092]

Husband/wife co-ownerships

Husbands and wives who vest title as community property are not entitled to sue for partition of the real estate owned by the community. [CCP §872.210(b)]

Further, real estate acquired after marriage and vested as joint tenants is presumed to be community property. If the property belongs to the community, a partition action is not permitted to divide and sever the ownership. [Calif. Family Code §2581]

However, real estate vested in a joint tenancy by a husband and wife can be separate property, thus rebutting the community property presumption, if either:

- a statement in the deed notes the real estate is not community property; or
- a separate written agreement states the real estate is not community property. [Fam C §2581]

Lawsuits between spouses to sever community property interests in real estate may not be brought by partition. Rather, they must be brought as part of divorce proceedings, called a *dissolution*. Consequently, the termination of a co-ownership of community real estate is subject to offsets and payment of monies to equal out the distribution of all assets of the community on **dissolution**.

Editor's note — Under a joint tenancy vesting, a deceased spouse's entire interest in the real estate passes to the surviving co-owner without the necessity of a probate order conveying title. [Calif. Civil Code §683]

Consider a couple who acquires real estate in a joint tenancy vesting as single or unmarried individuals before they are married.

The couple marry but do not alter the joint tenancy vesting nor enter into a written agreement transmuting the ownership into community property. Later, the couple divorce and cannot agree on the division or sale of the real estate.

Is the real estate community property?

No! Their ownership of the property is vested as joint tenants without a reference to their status as husband and wife. They were not married when they acquired title, and the vesting was not later altered by a writing (deed) to transmute their separate interests to community property. [**In re Marriage of Leversee** (1984) 156 CA3d 891]

Are the joint tenancy interests acquired before marriage severed by a partition action rather than by divorce proceedings?

Yes! Husbands and wives who vest title as joint tenants are entitled to a partition action if their co-ownership is held in a joint tenancy (or tenancy in common) vesting and the presumption of community property is rebutted by showing their interests are separate property. [CCP §872.210(b)]

Co-owners as partners

Consider co-owners who acquire real estate and vest title in the name of a limited liability company (LLC), each owning a fractional interest in the LLC as members. The LLC, not the individual members, owns the real estate.

When the members agree to dissolve their co-ownership, the relationship is mutually terminated by a dissolution of the LLC and an accounting of the LLC's assets.

Generally, **LLC's assets** are sold as part of the accounting, *not partitioned* and distributed. The sale proceeds are then distributed to the members. However, members can agree in the LLC operating agreement to a distribution of the LLC property to the individual members as a manner of returning their capital contributions. The distribution is called a *distribution in kind*.

In another example, several members in an LLC sign an operating agreement to own several parcels of land as a farm. Under the agreement, a member can resign and call for a conveyance of separate parcels to each individual member, which one member does.

Another member claims an LLC cannot distribute property it owns to the members *in kind*, but must sell the properties and distribute the proceeds pro rata, based on the percentage of ownership each member has in the LLC.

Can a dissolution of an LLC be completed by the division of the LLC real estate between the members as opposed to only a cash distribution?

Yes! While the general rule requires the sale of LLC assets and the net sales proceeds to be distributed, the members can enforce an agreement to divide or **partition the real estate**. [**Logoluso** v. **Logoluso** (1965) 233 CA2d 523]

Additionally, a court can dissolve an LLC and distribute its assets in kind whenever the distribution would be fair and would not impair the payment of LLC debts. [CCP §872.730]

For example, four investors enter into an LLC operating agreement to buy and operate a hotel. Title to the hotel is vested in the name of the LLC. The LLC agreement does not reference the division of the property on a dissolution of the LLC.

One of the members resigns and the LLC is dissolved. The remaining members demand the LLC's real estate be partitioned and distributed in kind.

Is a partition of the LLC assets proper in this case?

No! In this instance, there is only one LLC asset (the hotel) which would normally be impractical to subdivide, unless a condominium conversion would be practical. [**Jacoby** v. **Feldman** (1978) 81 CA3d 432]

Distribution of an LLC's assets

The ability of a member in a limited liability company (LLC) to demand a partition of LLC property is controlled by the buy out and dissolution provisions in the operating agreement.

Ordinarily, a member cannot be forced to receive part of the real estate owned by the LLC as a return of his contribution for his membership interest on dissolution of the LLC. [Calif. Corporations Code §15636(e)]

Additionally, without an agreement, no member has the right during the life of the LLC to receive any LLC asset other than money. [Corp C §15636(d)]

On *dissolution and winding up* of the LLC's affairs, the distribution to members will generally be made from the net **proceeds of a sale** of the assets.

What real estate is partitionable?

The real estate interests which are subject to a partition suit include:

- *fee estates*;
- *life estates*; and
- *leasehold estates*. [CCP §872.210(a)(2)]

Other real estate interests, such as *easements* or *profits a prendre*, cannot be partitioned. [**Porto** v. **Vosti** (1955) 136 CA2d 395]

Physical division preferred

A brother and sister own two adjacent parcels of unimproved land which they use for personal and recreational hunting and fishing. Title to the real estate is vested as tenants in common, each co-owner holding an undivided one-half interest. Both parcels are of equal value.

One parcel contains the actual hunting and fishing areas while the other provides access. Both co-owners use the property frequently.

The sister dies and passes her interest in the real estate to a hunting and fishing group who wish to open the real estate to the public. The hunting and fishing group offers to buy out the surviving co-owner's interest, but he refuses and files a partition action seeking to divide the property and become the sole owner of one of the parcels.

The group wants to buy out the co-owner on a sale of the property to permit members of the group to have exclusive access to the recreational areas claiming the real estate cannot be severed due to topographical problems.

The brother, as co-owner, claims he has a right to retain physical possession of a portion of the land since the land can be divided into separate parcels and the division would not reduce the economic value of the separate parcels.

Is a co-owner entitled to retain possession of a portion of the real estate if the property can be as a practical matter divided among the co-owners?

Yes! A division of the real estate is required of **tenants in common** unless it is impractical to divide and distribute or a sale of the entire real estate is fairer to all involved. [**Butte Creek Island Ranch** v. **Crim** (1982) 136 CA3d 360]

Impractical division

Consider two co-owners who inherit an inside lot in the middle of a densely populated area of a major city.

The lot is small (one-eighth of an acre) and is improved with residential structures — one facing the street, the other facing a back alley. The positions of the buildings on the lot do not permit a division (parceling) of the real estate or the construction of a partition wall.

Additionally, local **zoning restrictions** do not permit the further subdivision of the lot.

Is a sale of the real estate the best solution?

Yes! The further division of the lot is highly impractical and legally impossible without great loss of value to the co-owners. [**Priddel** v. **Shankie** (1945) 69 CA2d 319]

Similarly, consider the co-owners of real estate who operate a large, diverse enterprise on the property (e.g., a movie studio). The co-owners by agreement coordinate the use of the buildings, sets and lots for their own separate ventures.

Eventually, the co-owners can no longer agree on how to use the property. Due to the **location of the buildings**, a division of the property by partition is highly impractical. In this scenario, a sale of the property is the most practical remedy. [**Formosa Corp** v. **Rogers** (1951) 108 CA2d 397]

The partition action and lis pendens

To initiate a **partition action**, a co-owner must file a lawsuit stating his interest in the real estate and the facts which establish his right to maintain a partition suit.

Specifically, a partition action must include:

- a description of the real estate;
- the interest of the co-owner;
- all other recorded real estate interests or unrecorded interests actually known or reasonably discoverable;
- the real estate interest sought to be partitioned (fee, leasehold, minerals, etc.); and
- any facts justifying the sale of the real estate. [CCP §872.230]

Once the partition action is filed, the co-owner seeking partition must record a *lis pendens* (notice of pending legal action) with the county recorder identifying the parties and the real estate involved. [CCP §872.250(a)]

The **lis pendens** is notice to all future buyers, lenders or tenants that a dispute exists regarding *title* or *possession* to the real estate. Through the recorded lis pendens, any person later acquiring an interest in or encumbering the real estate takes the real estate interest subject to the pending partition action.

Determining real estate interests

The first procedure in a partition action is to establish each co-owner's interest in a parcel of real estate. [CCP §872.610]

The condition of the real estate's title is determined next, primarily by use of a title company's **litigation guarantee**, an insurance policy issued based on their search of the record title. [CCP §872.620]

The priority of all liens on the property is then set. Provisions will be made for the liens to be paid or assumed before the partition action can be completed or the sale proceeds distributed. [CCP §872.630(a)]

Typically, a real estate broker or attorney experienced in real estate matters is appointed as a *referee* to wade through the facts presented by the co-owners. The **referee** is an advisor to the court on the feasibility of the partition or sale. [CCP §872.630(b)]

Cutting up the real estate

An appointed referee's activities are subject to judicial review and approval. The referee's job is to balance the competing interests and arrive at a *reasonable division* of the property between the co-owners. [CCP §873.210]

The referee must consider:

- improvements made to the property [CCP §873.220];
- the size and number of lots owned [CCP §873.240]; and
- any liens on the real estate. [CCP §873.260]

The referee determines how the property is to be divided and prepares a report for the court's review and approval. [CCP §873.280]

The report can be contested by the owners. [CCP §873.290]

Division of the real estate

The objective in a partition action is to **physically divide ownership** and possession of the real estate between the co-owners in a practical way. The real estate can be divided in a number of ways:

- by separate lots or parcels [CCP §873.230]; or
- by allocating any improved real estate to the co-owner who constructed the improvements. [CCP §873.220]

When the real estate cannot be **divided equally**, one co-owner can be ordered to pay money to the other to even up the division. The money paid to even the distribution is legally called *owelty*. [CCP §873.250]

Any division of the real estate must comply with all environmental, zoning and other ordinances affecting the use of the real estate.

Sale of the real estate

The sale of real estate can be held at a public auction or by a privately negotiated sale, depending on:

- which is likely to bring more money for the co-owners [CCP §873.520]; or
- a prior agreement between the co-owners. [CCP §873.600]

A court-appointed referee, such as a listing broker, is given great latitude to conduct sales. For example, real estate consisting of more than one parcel can be sold collectively or individually. [CCP §873.620]

Notice of sale

The public or private sale of real estate must be conducted under the same rules for an execution sale on a money judgment. [CCP §873.640(a)]

For example, the *notice of sale* must be given to all parties named in the partition action at least 20 days before the sale date. [CCP §701.540(b)]

Additionally, the **notice of sale** must be published in a local newspaper of general circulation once a week for three weeks before the sale, similar to a trustee's sale under a power-of-sale provision. [CCP §701.540(g)]

Bidding at the sale

At a public or private sale, the real estate is sold to the highest bidder. [CCP §§873.670, 873.680]

The only persons prohibited from bidding at the sale are:

- the referee;
- an attorney for the parties in the partition suit; and
- a guardian of a party to the suit, unless it is for the benefit of his ward. [CCP §873.690(a)]

These prohibitions are not in place at a trustee's sale where anyone can bid, including the trustee holding the private sale. In a partition action, if one of the co-owners wants to own the entire property, they can acquire it by making the highest bid.

Confirmation and distribution

After the highest bid is accepted, the sale is confirmed in a hearing which permits an overbid to be accepted at the hearing. [CCP §§873.720, 873.730]

The proceeds of the sale are distributed as follows:

- to the expenses of the sale;
- to the costs of the partition action;
- to the payment of the liens; and
- to the co-owners. [CCP §873.820]

Judgment is entered and is binding on all persons with claims known or unknown in the real estate. [CCP §874.210]

Avoiding a partition action

What can be done by a co-owner to avoid the unnecessary costs of a partition action at the outset of a dispute between co-owners?

The keys to avoiding a partition action include:

- selecting the correct form of ownership; and
- including in the co-ownership agreement a provision for disposition of the property on termination of the co-ownership.

The best form of co-ownership of real estate is generally a limited liability company (LLC). In the LLC operating agreement, the co-owners agree in advance what will happen should one of the members want to withdraw or is expelled from the group.

A member himself has no interest in the LLC real estate, only a vote and entitlement to an accounting of the LLC's activities. [Corp C 17300]

On **dissolution of the LLC**, the member is only entitled to his percentage share in interest of the net *proceeds of a sale*, unless an agreement exists calling for a distribution of the real estate **in kind**. [Corp C §17250]

When a member's ownership interest in an LLC is assigned, whether voluntarily (to a buyer) or involuntarily (to a creditor), the assignee becomes a nonvoting member of the group. He has no voice in the LLC's business affairs, unless accepted as a member by a majority in interest of the existing members. [Corp C §§17301, 17303]

The operating agreement can also indicate events which terminate a member's interest, allowing others to buy out that member's interest (e.g., bankruptcy, failure to remove a charging order, death, assignment, etc.) at a prearranged price or valuation arrangement.

Chapter 47 Quiet title to clear title

This chapter explains the use of the quiet title action by owners of real estate to clear title of unenforceable claims, and distinguishes claims from liens.

The cloud of adverse claims removed

On receiving a preliminary title report after opening escrow, brokers are occasionally confronted with unexpected **title conditions** which will interfere with the closing of the sale if they are not removed from title to a property. Also, **off-record claims** occasionally arise before or after closing when the broker or buyer is advised of unrecorded documents which affect title, such as trust deeds, easements or license agreements.

These claims or conditions are collectively called *clouds on title*. Since **clouds on title** interfere with a transaction, brokers must consider effective ways to eliminate the clouds and close the transaction — the original goal of the buyer and the seller.

Presented here, in numerous scenarios, is a common involuntary resolution called a *quiet title action*. While the filing of a **quiet title action** necessarily involves the services of an attorney, the availability of quiet title relief to owners of property should first be raised by the broker in an effort to negotiate a resolution for owners confronted with a **cloud on title**.

Quiet title: an overview

A **quiet title action** is a judicial procedure employed to determine claims to **nonpossessory rights** in disputes over title to real estate. [Calif. Code of Civil Procedure §760.020]

Title disputes over real estate interests which are resolved by a quiet title action include:

- a buyer against the holder of an easement which was unrecorded and unknown on the date of the buyer's acquisition of ownership;
- an owner or a buyer against the holder of an expired lien;
- one owner against another who claims to be the owner;
- a buyer in possession of property under a land sales contract, lease-option sale or a similar security device against a lienholder who is not the seller; or
- an adverse possessor against the owner of title.

Other title-clearing remedies, such as cancellation of instruments, removal of a cloud on title, declaratory relief and a partition action, are also awarded as part of a quiet title action. Nonjudicial voluntary resolutions (which are privately negotiated) include a release of the recorded instrument. [See **first tuesday** Form 409]

Conversely, an owner's **possessory remedies**, such as *ejectment* or *removal of improvements*, are separate causes of action which may be filed with a quiet title action when possession of the property is also in question. Ejectment and encroachment actions address possession, not title, and are unrelated to quiet title actions.

Besides possession, other disputed rights to real estate interests which are not resolved by a quiet title action include:

- a lienholder against the owner; or
- a buyer against the carryback seller to enforce a security device such as an unexecuted purchase agreement, a land sales contract or a lease-option sale.

Record owner clears title

The record owner of a parcel of real estate eliminates unenforceable claims or other clouds on title, recorded or unrecorded, which are adverse to his ownership of the fee title by *quieting title* of the claim by a court order.

Unenforceable claims adverse to a fee owner's real estate interest which may be cleared from title by a quiet title action include:

- easements, right of ways and covenants, conditions and restrictions (CC&Rs);
- adverse possession;
- options; and
- trust deeds and other liens held by creditors.

An owner who is, or is a successor to, a *bona fide purchaser* (BFP) can eliminate claims against his interest in the property arising out of an unrecorded interest — such as a conveyance, lease, lien or use restriction — by commencing a quiet title action against the holder of the unrecorded interest.

A **bona fide purchaser** is a buyer of property for value and in good faith who acquired his ownership in a property while *unaware* of the existence of clouds on title which were:

- unrecorded;
- unobservable by a reasonable inspection of the property; and
- unknown to the buyer.

A buyer who purchases property from a BFP is called a *successor-in-interest*. The **successor-in-interest** is also considered a BFP, even though the successor may be fully informed about the cloud on title at the time of his acquisition.

Consider a real estate buyer whose seller does not inform him of an unrecorded easement to a utility company for the maintenance of underground utility lines on the property. The buried utility lines prevent the building of any structures within the easement.

The easement is not recorded and the lines are not apparent on a visual inspection of the property.

After acquiring the property, the buyer discovers the existence of the buried utility lines and demands their removal. The buyer seeks to quiet title against the utility company's claim to an easement on the property.

The utility company claims the buyer cannot quiet title since public interest requires the company to maintain the lines through the property.

Can the buyer demand the removal of the utility lines and clear the cloud of the easement from the title to his property?

Yes! The buyer is a BFP who was unaware of the unrecorded and unobservable easement when he purchased the property. As a BFP, the buyer has the right to remove the utility lines and quiet title of the easement.

However, if the utility company can show public interest necessitates the continued maintenance of the utility lines on the property, the buyer as a BFP is entitled to compensation in a separate action for his lost use of the land, called *inverse condemnation*. [**Pettis** v. **General Telephone Company of California** (1967) 66 C2d 503]

Further, had the buyer (or his broker) known of the unrecorded and unobservable utility easement, his title to the property would be subject to the easement. The buyer would not be entitled to the removal of the lines or compensation for **inverse condemnation** since his prior knowledge of their existence would not qualify him as a BFP.

Buyer in escrow quiets title

A buyer, through his agent, locates a parcel of real estate he would like to acquire. During his agent's due diligence search into property and title conditions, a **cloud on title** is discovered. A prior owner of the property entered into a restriction agreement **prohibiting construction** on the property without a neighbor's prior approval.

The prior-approval agreement was not recorded or brought to the seller's attention until after the seller acquired title to the property.

The buyer and seller enter into a purchase agreement contingent on the neighbor's approval of the buyer's construction plans. However, the neighbor does not approve the buyer's construction plans.

The buyer then seeks to clear title of the cloud by a court ordered cancellation of the prior-approval agreement in a quiet title action. When the restriction is canceled and cannot be enforced, the buyer intends to close escrow on the property and proceed with construction.

The neighbor claims the buyer cannot cancel the agreement since the buyer is not the owner of record on title to the property.

However, the buyer has acquired an interest in the ownership of the property by having merely entered into a binding purchase agreement with the seller. Thus, the buyer can obtain a cancellation of the prior-approval agreement in a quiet title action since it is a cloud on title.

The buyer is an *equitable owner* of the property since he holds the contract right to purchase the property. As an **equitable owner** of the property, the buyer can quiet title against unenforceable claims which are adverse to his ownership interest in the property.

A pivotal factor in this case is the fact the seller was unaware of the unrecorded agreement entered into by the prior owner and the neighbor when he agreed to purchase the property.

Thus, the seller qualifies as a **bona fide purchaser (BFP)** since the agreement was neither recorded nor brought to his or his agent's attention before he agreed to buy. The seller's BFP status shields both the seller and the buyer, as the *successor-in-interest* to the seller, from the neighbor's enforcement of the restriction agreement. [**Reiner** v. **Danial** (1989) 211 CA3d 682]

An all-inclusive remedy

A quiet title action may be joined with other causes of action related to the property. [CCP §760.030]

For example, a **quiet title** action to eliminate an adverse possessor's claim will be joined by an **ejectment** action to oust the adverse possessor from the property. [**Tobin** v. **Stevens** (1988) 204 CA3d 945]

Other claims used to clear title, which need not be stated as additional causes of action in a quiet title action, include:

- cancellation of instruments (removal of a cloud on title);
- declaratory relief (declaration of rights under an agreement or law); and
- partition (acknowledgement of co-ownership). [CCP §760.030]

In a quiet title action, a court may grant any equitable relief it deems necessary to quiet an owner's title. Thus, the lack of an additional **title-clearing** cause of action in the quiet title complaint does not deny the owner the relief necessary to resolve the title dispute. [CCP §760.040]

Editor's note — Rarely are additional title-clearing causes of action excluded from a quiet title complaint. Typically, attorneys use a scattershot approach to drafting complaints, stating the

Non-BFP buyers clear title

Consider real estate which is encumbered with a recorded *security device*, a lien on the property entered into by the owner. The **security device** does not contain a **power-of-sale provision** authorizing a nonjudicial foreclosure on the property by trustee's sale. The security device may be a mortgage-in-fact grant deed given to a private lender, a two-party mortgage, a land sales contract, or a lease-option sales agreement entered into to acquire the property.

The owner defaults on the debt owed under the security device and the creditor (lender or seller) does not enforce collection.

More than four years after default on all scheduled and balloon payments, the owner conveys his interest in the property to a buyer without satisfying or clearing title of the creditor's lien. The buyer acquires ownership, legal or equitable, subject to the recorded security device.

As owner of the property, the buyer files a **quiet title action** seeking to eliminate the security device, claiming:

- the debt secured by the security device is uncollectible due to the four-year statute of limitations barring judicial enforcement of obligations arising from written debt instruments, sometimes called an *outlawed debt*; and

- the security device is an encumbrance which is now *extinguished* since no debt enforceable in a court of law remains to be secured by the property.

The creditor claims the buyer is barred from eliminating the security device as a lien on the property since the buyer purchased the property with full knowledge of the lien and thus is not a bona fide purchaser (BFP). In essence, the creditor claims the lien remains valid even though the debt is uncollectible in a court of law due to the passage of time.

Can the buyer quiet title in his name and eliminate the lien from title to the property?

Yes! Status as a BFP is not required to clear title of an **extinguishable lien** which has not been paid in full. The only out-dated lien which cannot be extinguished by a non-BFP buyer in a quiet title action is a **public improvement lien**. [**Mix** v. **Sodd** (1981) 126 CA3d 386]

A money obligation evidenced by a written agreement, a security device — usually a note and trust deed or installment sales contract — becomes **judicially unenforceable** after a period of time due to the *statute of limitations*.

Scheduled principal and interest payments in default for more than four years cannot be enforced against the owner through a court action, such as a judicial foreclosure, even when title is vested in the name of the creditor as security for payment of the debt, which occurs with a land sales contract, a lease-option sale or a mortgage-in-fact grant deed. [CCP §337]

Conversely, a trust deed **power-of-sale provision** allows nonjudicial private enforcement of a note by a trustee's sale for 10 years after the note's final due date. [Calif. Civil Code §882.020]

A **trust deed expires** and is automatically *extinguished* from the record:

- 10 years after the entire debt becomes due; or
- 60 years after the trust deed is recorded if the due date cannot be ascertained by the written records of the transaction. [CC §882.020]

Editor's note — Under prior law, an owner could not quiet title of a lender's trust deed which was the owner's personal obligation. It was reasoned that to allow the owner to clear title of the lender's trust deed while the debt remained unpaid was tantamount to the court aiding him in avoiding his debt. [Mix, supra]

Now, all trust deeds automatically expire, clearing title without the need for a quiet title action after the 10-year or 60-year period. [CC §882.030]

Foreclose, do not quiet title, it's a loan

When a lender experiences a default on a loan secured by real estate, it should not attempt to *quiet title* to the secured real estate in its name. When a lender repossess real estate by a secured lender/creditor **quiet title** action as a method to foreclose, called *strict foreclosure*, the owner of the real estate is deprived of his *right to redemption* to pay off the debt and clear title of the lien.

A lender's quiet title action in lieu of foreclosure results in a *forfeiture* of the property to the lender since the property is not sold by an auction and followed by a **redemption** period for final payoff. Due to the **forfeiture** of the property, a valuation of each party's position on title and an accounting of the debt as of the **date of cancellation** is required since a quiet title action does not provide for the right of redemption.

Accordingly, a lender should always first foreclose by way of a judicial or nonjudicial (trustee's) foreclosure procedure. These foreclosure procedures provide a notice and opportunity for the borrower to redeem (keep) the property by paying off the debt — no forfeiture of the property on a default occurs as with a quiet title action.

Editor's note — CalVet loans permit the forfeiture of a residence on a default — leaving no right of redemption — and are an exception to the mortgage law right-of-redemption policy.

For example, when a buyer defaults on a **land sales contract**, the seller has three *remedies*:

- *rescind* the contract as though it never existed and *restore* the buyer to his pre-contractual position;
- *enforce* the seller's lien by a judicial foreclosure, or a nonjudicial foreclosure if the contract contains a power-of-sale provision; or
- terminate all rights under the contract by a quiet title action, sometimes referred to as a *strict foreclosure*.

When **rescinding** a land sales contract (or lease-option sale), the seller on recovering the property (voluntarily or by eviction) is required to **account for and restore** to the buyer all the money he received under the rescinded contract. Thus, everyone will be returned to their original position as though the transaction had never occurred, called *restoration*.

Offsets are given to the seller for the rental value of the property during the entire period of the buyer's occupancy. In turn, the buyer receives credit for all payments made toward the principal and interest under the contract.

Conversely, when the seller sues to **quiet title**, the seller is not restoring the parties to their pre-contractual positions. By quieting title, the seller is affirming and enforcing the contract — from *inception to default* — since he acts to remedy the default by terminating the contract and *forfeiting the buyer's equity* in the property.

When the seller carries back an installment sales contract and **quiets title** to terminate all the buyer's contract rights to acquire the property due to the breach, the buyer is entitled to *restitution*, not just **restoration**, as though the deed had never occurred.

Quiet title for the wrong reason

Restitution is an accounting between the buyer and seller which results in a refund to the buyer in exchange for the return of the property to the seller. However, if the property value has dropped and no credits are owed to the buyer to offset the drop in the value, no money judgment for the deficiency is available to the seller. [CCP §580b]

For example, a buyer purchases real estate under a land sales contract for the price of $400,000. A down payment is made. To pay the balance of the purchase price, the buyer agrees to takeover payments on an existing trust deed note, paying the installment directly to the lender or indirectly through the seller. Installments are also due the seller for the balance of his equity in the property.

The buyer takes possession of the property and makes principal and interest installments to the seller, as well as payments on the trust deed note.

Later, the buyer defaults on his payments, resulting in a *material breach* of the land sales contract. The seller terminates the contract by a notice of cancellation. The fair market value (FMV) of the property on the date of the breach is $300,000.

The buyer refuses to surrender possession of the property and continues to make principal and interest payments on the underlying trust deed.

The seller sues to quiet title of the buyer's land sales contract. A receiver is appointed to operate and maintain the property until the trial.

At trial, the seller regains possession of the property and the court calls for an accounting.

The seller's accounting for his losses

The seller's **losses** include:

- the *benefit of his bargain* under the land sales contract;
- *out-of-pocket expenses* caused by the breach; and
- other expenditures which naturally flow from the breach, called *consequential damages*.

During the buyer's equitable ownership of the property prior to his breach, the seller's **benefit of the bargain** under the land sales contract is calculated as the purchase price, less the current value of the property as of the date of breach (if it is lower).

In this example, the seller's lost benefit of the bargain is $100,000 — the sales price of $400,000 less the property's lower current value of $300,000.

However, the seller is also entitled to **out-of-pocket expenses** for the buyer's wrongful retention of the property after the date of the breach. After the date of the breach, the buyer's continued possession of the property is treated as though he were renting it, not buying it and owing interest, since his purchase contract and his ownership has been terminated by the notice of cancellation.

Thus, the seller is owed the fair rental value of the property from the date of the cancellation to the eviction of the buyer. Rent compensates the seller for the seller's loss of use of the property during the buyer's wrongful (holdover) possession of the property. [CC §3307]

The repossessing seller also receives credit for any expenses that are the **natural consequence** of the buyer's breach, including:

- payment of delinquent real estate taxes prior to termination of the contract;
- payment of any assessment bonds or association fees until termination of the contract;
- payment of penalties or fees for reinstating the trust deed;
- receivership costs;
- resale costs if the property is resold; and
- the cost to repair/replace any damage to the physical property over normal wear and tear.

The buyer's accounting for his forfeiture

On the other hand, the buyer having forfeited all rights to the property due to the breach gets credit for:

- the down payment;
- installments of principal paid to the seller on the land sales contract, excluding interest;

- principal payments on the trust deed note paid by the buyer prior to termination of the land sales contract, excluding interest;
- principal and interest payments paid by the buyer after termination of the land sales contract (during the buyer's wrongful holdover possession of the property); and
- any expenses paid by the buyer after the breach which the seller should have paid, such as care, maintenance and further improvements to the property since the buyer's ownership interest has been terminated.

The buyer's payments of interest to the seller during his equitable ownership are not an offset and are retained by the seller since the interest payments are the seller's earnings for the buyer's use of the principal remaining unpaid on the purchase price. The interest paid to the holder of the trust deed note **prior to termination** of the land sales contract is also not an offset since interest is part of the buyer's burden of ownership under the land sales contract.

Owners, equitable or legal, **do not owe rent** for their possession since they own the right to occupy (or to let) the property.

However, interest paid on the trust deed by the buyer **after termination** of the land sales contract is a credit due to the buyer. On the seller's termination of the land sales contract and commencement of the buyer's wrongful possession, the buyer only owes rent to the seller (which replaces any obligation to pay interest on the unpaid purchase price under the terminated land sales contract).

After the accounting is complete, if the amount the buyer is entitled to is greater than the credit the seller received for his losses, the buyer is entitled to a refund of the difference, called *restitution*. **Restitution** is the excess of the buyer's payments over the money losses incurred by the seller due to the buyer's breach of the contract and holdover possession of the property. The buyer is entitled to a money judgment for the amount of restitution. [**Kudokas** v. **Balkus** (1972) 26 CA3d 744]

Conversely, the seller is unable to obtain a money judgment against the buyer due to anti-deficiency laws controlling recovery of purchase-money debts.

The negotiation and execution of a deed-in-lieu of foreclosure on the land sales contract or lease-option sale would avoid the litigation and accomplish a mutually acceptable result — recovery of the property and a settlement. [See **first tuesday** Form 406]

Equitable ownership versus the trust

An *equitable owner* of real estate is a person who purchased the property and has not yet received a grant deed conveying **legal ownership** into his name. A buyer who is an **equitable owner** may quiet title of adverse claims which threaten his ownership interest in the property.

Equitable owners include:

- beneficiaries of an irrevocable trust, but not of a revocable inter vivos (living) trust;
- buyers in possession of property under a contract for deed, land sales contract or lease-option sale;
- buyers in escrow under purchase agreements; and
- owners in possession of property who have been defrauded of their legal title.

For example, four individuals buy a parcel of real estate as co-owners. An **irrevocable trust agreement** is entered into by the co-owners as beneficiaries.

One of the beneficiaries holds legal title to the property in his individual name, as trustee under the trust agreement. As trustee, he annually pays the real estate taxes from funds contributed by all beneficiaries.

The beneficiaries further agree that each is to possess a separate portion of the real estate which they are to exclusively occupy, called *divided interests*.

One of the beneficiaries conveys his divided interest in the real estate to his daughter by an assignment of his beneficial rights under the trust. The daughter takes and remains in possession of the real estate for more than five years.

The daughter then seeks to quiet title in her name to the portion of the property she exclusively possesses as against the other beneficiaries and the trustee, claiming she acquired title to her portion through *adverse possession*.

Can the daughter quiet title against the other beneficiaries and the trustee through **adverse possession**?

Yes and no! Yes, the daughter can quiet title against any claims the other beneficiaries may have in the portion of the real estate she exclusively occupies. However, she cannot quiet title in her name as against the trustee since he holds legal title and pays the taxes. Thus, title remains in the name of the trustee.

Unlike a limited partnership or limited liability company (LLC) vesting which creates a separate entity to own the property, a trustee merely holds title for the benefit of all occupants who are beneficiaries of the trust agreement.

As a successor-in-interest to one of the beneficiaries, the daughter is a **beneficiary of the trust**. Thus, she holds an *equitable ownership* interest to the portion of the real estate exclusively occupied by her and her predecessor. No entity intervenes as the owner of her portion by holding title, such as an LLC.

To take title from the trustee to the portion exclusively possessed by the beneficiary in this example, the daughter as a beneficiary is limited to **enforcement of the trust agreement**, a contract law remedy, not a real estate law remedy (such as a quiet title action). [**Tuffree** v. **Polhemus** (1895) 108 C 670]

Equitable owners by purchase agreement

Similarly, a buyer under a **purchase agreement** which is yet to be performed by closing escrow, or an optionee holding a purchase option, is an **equitable owner**. However, these buyers under contract may not use a quiet title action to resolve their claims to fee title against the owner of record who has yet to fully perform under a purchase agreement or option to sell the property.

The buyer's or optionee's remedy against the owner is *specific performance* of the purchase agreement or the option. Yet-to-be-performed real estate agreements which are enforced by specific performance include purchase agreements and escrow instructions, trust deed notes, leases and options.

Editor's note — Quieting title and partitioning real estate against the other co-owners gives rise to ***subdivision issues.***

*A partnership agreement giving a partner exclusive occupancy to a portion of the real estate, unless recorded in a grant deed or lease, does not violate subdivision law as long as the partnership pays all expenses on the property from capital contributions made by the partners, not from rent paid by the partners. [**Bakanauskas** v. **Urdan** (1988) 206 CA3d 621]*

Further, the purchase of rental or investment property by five or more co-owners vested as tenants in common creates a subdivision requiring clearance from the Department of Real Estate (DRE) except in cases where the undivided interests are:

- *held by people related by blood or marriage;*
- *created as a result of a foreclosure sale;*
- *created by a valid court order;*
- *offered and sold by permission of the Commissioner of Corporations according to the Corporate Securities Law of 1968; or*
- *in real estate offered for sale as an authorized time share project. [Calif. Business and Professions Code §11000.1]*

Additionally, a subdivision is not created when the undivided interests are purchased by less than 10 people who each give a signed statement to the Real Estate Commissioner acknowledging that they are:

- *fully informed about the ownership risks;*
- *purchasing the interest for themselves without present intention to resell the interest; and*
- *waiving any protections afforded under a subdivision. [Bus & P C §11000.1(b)(2)]*

Unrecorded owner in possession

Consider a buyer of real estate under a land sales contract. The seller **retains legal title** to the property as security for the buyer's payment of the remaining unpaid balance of the purchase price.

The buyer then enters into a construction and co-ownership agreement with a contractor to improve the property. The contractor is to build four houses on the property and pay the balance remaining due on the purchase price under the land sales contract.

In exchange, the contractor is to receive a 75% ownership interest in the property, as a co-owner with the buyer. The buyer is given the rights to exclusively occupy one of the units.

As agreed, the contractor pays off the balance due on the land sales contract to the seller. However, the seller conveys title to the contractor, not the buyer named in the land sales contract. The buyer occupies one of the residences on the property.

The contractor then encumbers the property with a trust deed loan without the consent of the buyer whose 25% co-ownership interest is not recorded.

Neither the lender holding the trust deed nor the title company insuring the trust deed inspect the property for occupants, much less inquire into interest held in the property by those in possession. Thus, the lender is actually unaware the co-owner of a 25% undivided interest exists or occupies the property.

Later, the buyer learns of the lender's trust deed encumbrance and seeks to quiet title against the lender's lien on the buyer's unrecorded 25% ownership interest in the entire property.

The lender claims the buyer cannot quiet title of its security interest since the contractor holds title and thus the buyer is not the owner of record.

However, when originating a loan, the lender has a duty to inspect the property, as well as the record title, for any off-record claims to title before making a loan secured by the real estate. The buyer's **actual possession** of the property places the lender on *constructive notice* of the buyer's ownership interest.

Thus, the contractor's trust deed lien never attached to the buyer's unrecorded ownership interest and the quiet title action *extinguishes* the trust deed lien from the buyer's 25% undivided ownership interest in the property. [**Dement** v. **Pierce** (1932) 122 CA 254]

Protecting non-fee title interests

The holder of an interest in real estate other than the fee title, such as an easement, right of way, lien, lease, option or by adverse possession, may also use a quiet title action to **eliminate claims** which challenge the interest he holds in the real estate.

Non-fee interests, such as possession held by tenants under the leasehold interest they own, may be protected by the use of a quiet title action — although the tenant's interest is not based on ownership of the fee interest in the real estate and title cannot be quieted in the name of the tenant. [Tuffree, *supra*]

Only an occupant who can establish a **claim of title** to property, such as by adverse possession, equitable ownership or strict foreclosure and forfeiture by a lender, can *quiet title* to the property in his name and become the owner of record. [See Chapter 30]

For example, a husband and wife dissolve their marriage. The wife is awarded the community residence and the husband is ordered to transfer possession of the residence to the wife.

Accordingly, the wife asks the husband to vacate the property. However, the husband refuses to vacate and remains in possession of the property for more than five years after the ownership and possession of the property are awarded to the wife. During the entire five-year period, the husband pays the taxes and other costs for maintaining and carrying the property and the wife takes no legal action to evict him.

Claiming title by **adverse possession**, the husband files a quiet title action to eliminate the wife's recorded ownership interest in the property. The wife claims the husband cannot quiet title since his possession is in violation of the court order awarding her the property.

Can the husband quiet title even though his possession is wrongful?

Lis pendens

When an action to quiet title is brought, a lis pendens describing the real estate must be recorded with the county recorder's office where the property is located. The recorded lis pendens puts potential lenders and buyers of the property on notice of the pending quiet title action. [CCP §§405.24; 761.010]

Title to the property may still be conveyed subject to the recorded lis pendens and the risks of the litigation's outcome.

If a buyer purchases the property from a seller whose ownership interest is later eliminated by a quiet title action when a lis pendens was of record prior to closing, the seller's conveyance to the buyer will be voided as part of the quiet title action. [CCP §405.24; see Chapter 42]

Yes! The husband has acquired title by adverse possession. The husband's possession is hostile since he did not vacate when asked, and he paid the taxes for a period of five years or more

An individual claiming ownership by adverse possession must have hostile possession of a property without the legal owner's stated or implied permission. He must also pay taxes and all encumbrances on the property and wait out the required five-year period in possession of the property (without being evicted) to obtain legal title. [**Buic** v. **Buic** (1992) 5 CA4th 1600]

Squatter's rights and nonresident owner

Consider an owner of record to real estate who has not occupied his property for over five years.

A **trespasser** has possession of the property and claims to be the true owner, but has not paid **property taxes**. The owner seeks to *quiet title* of the trespasser's claim to ownership and remove him from the property by ejectment.

The trespasser claims the owner is barred from recovering the property and **ejecting** him since the owner has not himself been in **physical possession** of the property within the last five years.

Can the owner quiet title of the trespasser's claim and remove him from possession of the property?

Yes! The trespasser is unable to establish a right to title by adverse possession since he has not paid the taxes on the property. Also, the owner of record at all times has the right to **immediate possession** of the property by **ejectment** of anyone not legally in possession or cannot prove an adverse possession claim. Thus, the owner is able to quiet title against the trespasser's claims. [**Tobin** v. **Stevens** (1988) 204 CA3d 945]

Five years to perfect title

A creditor records an *abstract of judgment*. The **abstract of judgment** attaches as a lien on title to a parcel of real estate which is vested of record in the name of the judgment debtor.

The judgment debtor later sells and conveys the property to a buyer.

The creditor obtains a **writ of execution** to foreclose the judgment lien and is the highest bidder at the sheriff's sale. The creditor receives a **certificate of sale** entitling it to a sheriff's deed and immediate possession of the property. However, the interest acquired in the property has no present value to the creditor due to the amount of the encumbrances with priority.

The buyer remains in possession and pays all taxes and encumbrances on the property.

The creditor waits more than five years after the sheriff's sale, when the value of the property has increased, to obtain and record the sheriff's deed. The creditor files a quiet title action against the buyer, claiming the sheriff's deed gives the creditor legal title and the right to possession.

The buyer claims the creditor has no right to quiet title to the property in the creditor's name since the creditor did not **possess or hold title** to the property within the five year period after the date of the sheriff's sale.

Is the creditor entitled to the property?

No! The creditor is barred from asserting a claim to the property. The creditor's right to record the sheriff's deed and to take possession of the property and eject the occupant first arose on the date it purchased

the property at the sheriff's sale. The five-year *statute of limitations* begins to run on the creditor's right to recover the property from the date it is first possible for the creditor to bring a suit to eject the buyer, which is the date of the sheriff's sale.

By the five-year delay in recording the sheriff's deed, the creditor lost its right to recover the property from the buyer. An injunction against the creditor's claim to ownership clears the buyer's title of the creditor's unenforceable sheriff's deed. [**Lawrence** v. **Maloof** (1967) 256 CA2d 600]

Had the creditor recorded the sheriff's deed and filed his quiet title action within five years after the sheriff's sale, the creditor would have been entitled to possession. The buyer would then be unable to prove his claim to title as an *adverse possessor* by his payment of taxes and possession for five years.

Chapter 48 Specific performance, loan commitments and attorney fees

This chapter covers the liability of a breaching seller on the buyer's enforcement of a purchase agreement for any increase in the interest rate on a buyer's purchase-assist loan and the buyer's attorney fees.

Future shock in a recovery

A buyer and his agent have been working for over a year to locate and buy a home at the lowest possible price. They have observed sales volume, loan originations, property prices and construction starts decline without an increase for the past three or four years.

However, interest rates are now falling from their highs during the past two or three years, as are foreclosure rates and the level of unsold inventory of listed and newly constructed homes.

The buyer senses the lull forming the bottom of this real estate recession is about to end. A comparable market analysis for properties the buyer is interested in indicates prices are no longer dropping, but are firming. Construction starts are even beginning to turn up and lenders are reported as being more lenient on credit scoring, qualifying buyers who a year ago could not qualify for financing.

Realizing that the dynamics of the local real estate market are changing and the prices will soon start to rise due to a reduction in available properties from which to select a home, the buyer decides now is the best time to make an offer. The buyer and his agent review the properties they have determined would be a suitable residence for the buyer. Offers will be made at the best (lowest) price possible for a purchase at the end of this recessionary phase in the real estate sales cycle.

Soon after making a few offers, the buyer enters into a purchase agreement with a seller to acquire a property. The purchase agreement contains a provision which conditions the close of escrow on the buyer arranging and recording a purchase-assist loan to fund his acquisition of the property.

Prior to the date for the close of escrow, the seller discovers real estate values have surged upward, driving up the value of his property beyond the price the buyer has agreed to pay. Seeing he can get a much greater price from a flood of prospective buyers in the suddenly competitive market, the **seller cancels** his sale escrow instructions days before the scheduled closing.

The buyer makes a demand on the seller to close escrow as agreed in the purchase agreement and escrow instructions, which the seller rejects. The buyer files a *specific performance* action to enforce the purchase agreement and require the seller to close escrow. At trial, the buyer prevails and the seller is **ordered to close escrow**.

An offset for increased interest

To continue with the prior example, **interest rates** offered by lenders on the purchase-assist loan called for in the purchase agreement have increased during the **time lapse** between:

- the date scheduled for performance (close of escrow) in the purchase agreement breached by the seller; and
- the date of the specific performance judgment ordering the seller to convey title and close escrow.

Can the buyer recover as part of his **specific performance judgment** the amount of the increased interest the buyer will pay on the purchase-assist loan he must now arrange to pay the purchase price and close escrow?

Yes, the cost of increased interest is recovered as a **direct offset** on the purchase price. When a seller breaches, it is foreseeable interest rates on purchase-assist financing called for as a condition for payment of the purchase price will rise by the time the seller is ordered to convey the property to the buyer.

Thus, it would be unreasonable for the buyer to pay both the original purchase price and the **increase in the interest rate** on a fixed rate loan when the increase is brought on by the seller's delay in conveying title until the time of a court ordered specific performance. [**Hutton** v. **Gliksberg** (1982) 128 CA3d 240]

If the interest differential in the increased rate on the purchase-assist financing available at the time the purchase agreement is enforced by specific performance was not borne by the breaching seller, the buyer would be deprived of the **economic benefit** of the lower interest he arranged at the time escrow was originally scheduled to close.

Conversely, if interest rates were to **drop** by the time the buyer is awarded ownership of the property in a specific performance action, none of the buyer's economic windfall due to the financial benefits of lower interest rates becomes a credit to the seller since:

- the seller cannot benefit from his misconduct which prevented the timely closing [Calif. Civil Code §3517]; and
- the buyer has incurred no loss.

The price paid and attorney fees due

Consider a buyer who enters into a purchase agreement with a seller to buy real estate. Prior to closing, the seller cancels the transaction. The buyer files a **specific performance** action to enforce the purchase agreement and acquire the property. The buyer prevails and the seller is ordered to deed the property to the buyer.

Having prevailed at trial on his specific performance action, the buyer now takes steps to enforce the **attorney fees provision** in the purchase agreement. The buyer seeks to directly offset the amount due on the price he will pay for the property by deducting the amount of the attorney fees he is awarded.

Can the buyer deduct the attorney fees award directly from the purchase price of the property?

No! An attorney fee award must be collected from the seller after recording the **abstract of judgment** for the attorney fees. The judgment for attorney fees is separate from the terms for payment of the purchase price.

If the amount of the attorney fees were to reduce the purchase price of the property as an offset to the amount due the seller, that enforcement of a money judgment for attorney fees would function retroactively as a *super lien* on the seller's property. **As an offset** to the price to be paid, an award of a money

judgment for attorney fees would have *priority over any liens* recorded on the property prior to receiving the judgment for attorney fees, as well as priority over the amount of the seller's homestead exemption.

Additionally, the amount due the seller for his price as called for in the terms for payment of the purchase agreement would be improperly altered by an offset. The buyer must pay the total amount due the seller on the purchase price and then, on close of escrow, collect the money due to him for his attorney fees by recording and executing on an abstract of the money judgment based on the priority status of the abstract to other liens on title. [**Behniwal** v. **Mix** (2007) 147 CA4th 621]

Unlike the *interest rate differential* on the purchase-assist loan which was part of the **terms for payment** of the purchase price in our prior example, the recovery of attorney fees for enforcing a purchase agreement is separate from the price paid for the property. A judgment for attorney fees cannot take priority over liens and homestead claims arising before entry of the money judgment for those attorney fees. Hence, the issue of priority of claims on the price paid to the seller.

Calculating interest losses

Two accounting formulas exist for calculating future money losses a buyer will incur due to the interest differential in the increase in interest rates on his purchase-assist **fixed-rate loan**:

- the *loan-term formula*, based on the dollar amount of increased interest the buyer will pay over the full term of the loan, discounted to its present value based on current capitalization rates [Hutton, *supra*]; or
- the *ownership-term formula*, based on the dollar amount of increased interest the buyer will pay over the buyer's anticipated holding period before a refinance or resale, discounted to its present value. [**Stratton** v. **Tejani** (1982) 139 CA3d 204]

A buyer financing his purchase with a variable or adjustable rate loan (ARM) is not likely to incur unexpected interest rate loss when interest rates increase. The buyer's bargain for ARM financing is to pay the prevailing short-term rate, adjusted monthly, quarterly or semi-annual, for the duration of the loan.

Loan-term formula for long-term buyer

For example, monthly payments on a loan origination at a fixed interest rate of 14% with a 30-year maturity on a principal of $400,000 would be $4,739.49. The same loan amount and amortization period at 9.25% carries a monthly payment of $3,290.70.

The difference in the monthly payment resulting from the increase in the interest rate is $1,448.79 per month. Over 30 years, this difference will cost an additional $521,564.40 in actual out-of-pocket dollars.

Discounting the dollar amount of the increase in payments at the then current rate of 14% over a 30-year period results in a *present cash value* of $122,274. Thus, under these loan conditions, awarding the buyer $122,274 now indemnifies the buyer for the increase in monthly payments he will later pay due to the seller's breach.

The **loan-term formula** indemnifies the buyer for future losses over the entire life of the loan. The likelihood the buyer will refinance or resell before the loan term expires calls into consideration the **ownership-term formula**.

Ownership-term formula

The alternative ownership-term formula of accounting requires a determination of how long the buyer intends to retain ownership of the property subject to the high interest rate loan. Does the buyer intend to retain the property or the fixed-rate financing for a short-, medium-or long-term period?

The ownership period during which the seller will pay an increased interest rate under the ownership-term formula runs until the date it is anticipated the buyer will **resell or refinance** the property. Thus, the buyer is not awarded a **windfall** if the interest rate in the mortgage market drops and the buyer refinances or he resells the property, putting an end to his payment of the higher interest rate. In this instance, the ownership-term formula is more equitable and economically prudent than the loan-term formula.

To establish the buyer's probable **ownership period** before a refinance or resale would likely occur, consider:

- whether the property is the buyer's principal residence, business or investment property;
- the cyclical nature of the rise and fall of interest rates on ten-year treasury notes;
- the buyer's prior ownership history;
- the ratio of the monthly payments to the buyer's income; and
- the buyer's employment history.

A persistent high level of interest on fixed-rate mortgages eventually translates economically into lower property values. This reciprocal movement between rates and values is due to the sympathetic and concurrent rise in capitalization rates used by real estate investors to set values when interest rates rise. Thus, a court award of the present worth of the increase in interest payments during a buyer's ownership functions in all respects as a **discount** on the price the buyer and seller agreed to in the purchase agreement.

These same financial and economic arguments apply to lower pricing when a buyer makes a decision about financing a property acquisition during a period of high interest rates on long-term mortgage financing.

Chapter 49 Declaratory relief prevents more costly litigation

This chapter explores the use of a declaratory relief action to resolve a real estate dispute before performing the contract or employing other remedies which would be expensive to reverse.

Disputes resolved before closing

A buyer is interested in purchasing an unimproved parcel of real estate on which to build a residence as allowed by zoning.

Before the buyer and seller enter into a purchase agreement, a neighbor informs the seller's listing agent a written agreement between the prior owners of the neighbor's property and the seller's property prohibits the construction of any improvements on the seller's property.

However, the agreement is not recorded and the seller was previously unaware of the existence of the use restriction. The agent believes the agreement is not binding since it was not recorded and the seller acquired the property without knowledge of the use restriction.

Before closing, the buyer is advised of the agreement and requests the neighbor's permission to build improvements on the property.

The neighbor refuses to grant the buyer permission, claiming the agreement is a covenant running with the land which is binding on all subsequent owners, including the buyer. No one wants escrow to close due to the uncertainty that the property can be used as expected.

To resolve the dispute over the use restriction agreement, the buyer and seller join together and file an action against the neighbor for *declaratory relief*.

The buyer and seller do not seek to recover any money losses or property from the neighbor. They only seek a **declaration of their rights and obligations** under the use restriction agreement entered into between the prior owners of the contiguous properties. Also, the buyer and seller agree with the agent to an extension of their escrow period with closing contingent on a favorable result in the **declaratory relief** action they filed.

The neighbor claims the buyer is barred from pursuing declaratory relief since he is merely a prospective buyer with no ownership interest in the property.

However, an **actual controversy** exists since the use restriction could force the buyer into further litigation after acquiring the property. If the buyer were to purchase the real estate and begin constructing improvements as allowed by zoning, but in violation of the unrecorded agreement, he would expose himself to an expensive and time-consuming lawsuit with the neighbor and possibly need to remove the improvements.

Thus, the buyer is entitled to a declaration of his rights to resolve the uncertainty before buying the property and constructing improvements since the buyer holds an *equitable ownership interest* in the property under his purchase agreement with the seller.

Likewise, the seller is entitled to a declaratory judgment since he will also be directly affected by the outcome — the closing of the sale is contingent on the buyer's ability to make improvements. [**Reiner** v. **Danial** (1989) 211 CA3d 682]

With a declaratory judgment, the agent is able to keep alive an otherwise dead transaction.

Preventative justice for a certain future

When one person sues another, he is typically seeking to recover something tangible — money, property or a right such as an easement.

However, controversies over the *nature of rights* or the *interpretation of agreements* frequently arise long before they produce any claims for the recovery of money or property. A prudent individual often wants to know what his rights and duties are before he undertakes irreversible actions which may result in costly litigation.

The declaratory relief statutes allow a person to obtain a **declaration of his rights** and obligations before an actual claim arises for the recovery of money or property, or a breach of an obligation. [Calif. Code of Civil Procedure §1060]

Resolve your disputes, then act

The real estate activities which give rise to a declaratory relief action include:

- trust deed **foreclosures** in which borrowers may have claims which cast doubt on the lender's or carryback seller's ability to foreclose, such as claims of misrepresentation or demands for offsets;
- **rental** or **lease** agreements involving such issues as the renewability of a lease or the landlord's demands for rent;
- **lease-option sales** with their frequently misunderstood legal status as security devices which raise questions as to the ownership rights of the seller/landlord and buyer/tenant;
- **right of first refusal** agreements which raise questions about whether a particular activity or event has triggered the first refusal right to acquire the property;
- **cancellation** of purchase agreements or **rescission** of closed transactions;
- claims of **usury** on private lender loans;
- **priority** of liens and **validity** of subordination agreements;
- **prepayment penalty** enforcement [**Sacramento Savings and Loan Association** v. **Superior Court County of Sacramento** (1982) 137 CA3d 142];
- enforceability of **trust deed provisions** [**Wellenkamp** v. **Bank of America** (1978) 21 C3d 943]; and
- **due dates** for the final payoff of a loan or performance dates for any other obligation.

To expedite the resolution of controversies which could result in a future loss and litigation, actions for declaratory relief are given **priority** over the court scheduling of other kinds of actions. [CCP §1062.3]

When a claim for declaratory relief arises due to a performance which is already in process, such as construction or foreclosure, the contested activity is typically postponed, or *stayed* by the court, until the declaratory relief action is resolved.

The differing parties in a declaratory relief action often enter into a *Reservation of Rights Agreement* allowing them to preserve their respective claims so they can later pursue them after a court declares their rights. The purpose of the **stay** with **reservation of rights** is to maintain the status quo, such as the acceptance of loan payments on a loan in dispute, until the uncertainty is resolved by a declaratory judgment. [**Wellenkamp** v. **Bank of America** (1978) 21 C3d 943]

Thus, declaratory relief functions as a kind of **preventive justice**, settling controversies before they result in litigation to recover money, convey property, rescind a transaction, reconvey property lost to foreclosure or reoccupy a premise after an eviction.

No breach required for clarification

Declaratory relief is based on an individual's *right to know* where he stands in relation to the adverse claims made by another person which might affect his position. If an individual is contemplating activity which he or others feel may be prohibited by law or contract, he is entitled to know whether the activity is permitted before undertaking it.

For instance, consider an owner who believes his property is no longer subject to **deed restrictions** against construction which were recorded many years earlier.

To know for certain whether the deed restrictions apply to him, the owner can either:

- **undertake construction activities** in violation of the restrictions (but not zoning ordinances) and run the risk of a potentially expensive lawsuit; or
- **obtain a declaration** from the court stating whether the restrictions are still binding before he proceeds with construction.

The owner is not required to breach his obligations before he can seek a judicial determination of his rights. Thus, the owner is entitled to a declaratory judgment clarifying his rights which will either allow him to proceed safely with his desired construction activities, or notify him the restrictions are still in effect. [**Ross** v. **Harootunian** (1967) 257 CA2d 292]

Predetermining legal results

Proceeding with activities under dubious authority without first obtaining a declaratory judgment can produce disastrous financial results.

For example, a buyer of real estate seeks to **rescind** his recently closed acquisition of property after grading it.

Without first seeking a court declaration of his rights, the buyer deeds the property back to the seller, called *rescission*. He then makes a demand on the seller to recover the purchase price and the costs of carrying the property during his ownership, called *restoration*.

The seller accepts the deed to the property but refuses to return any money to the buyer, claiming he physically damaged the property when he graded it in preparation for construction.

Ultimately, the buyer is unable to recover any money through **restoration** since he inflicted damage on the property by grading it. Thus, the buyer now has neither the property nor the money. [**Grill** v. **Hunt** (1992) 6 CA4th 73]

A declaratory judgment would have clarified whether the buyer was entitled to recover the purchase price by rescinding the transaction, and if so, the basis for valuation of the property on its return. Thus, the buyer would be able to decide whether to proceed with the rescission, which would have "restored" the property to the seller and the money to the buyer, or keep the property.

Anticipating a breach before closing?

Declaratory relief can also take the place of a buyer's or seller's claim that the conduct of the other party is an *anticipatory breach* of their purchase agreement, lease agreement or note and trust deed.

An **anticipatory breach** occurs when a buyer or seller in some way acts to repudiate the purchase agreement before the time for closing arrives — manifesting through words or conduct his intent not to further perform on his agreements. [Calif. Commercial Code §2610]

However, proving an anticipatory breach can be difficult since it is a claim for nonperformance before the time of performance by closing escrow has even arrived.

Thus, rather than attempting to prove a buyer or seller does not intend to perform on his agreement or close a transaction, a better remedy might be a declaratory relief action to determine if the other party's activities constitute a breach of the agreement. With a declaration of his rights in hand, the injured party can then pursue a specific performance action or recover his money losses for a breach should escrow not close.

Interpreting government agency rights

Declaratory relief can be sought to interpret nearly any kind of right or obligation.

For instance, a property owner may seek a declaratory judgment testing the validity of a city **zoning ordinance**. [**Viso** v. **State** (1979) 92 CA3d 15]

Additionally, an owner may seek declaratory relief before entering into a transaction which may result in a **tax liability** to determine what his liability would be if he undertook the activity. Since tax liability does not accrue before the transaction is completed, a declaratory judgment does not illegally prevent the collection of a tax. [**Honeywell, Inc.** v. **State Board of Equalization** (1975) 48 CA3d 907]

However, owners involved in tax disputes with state government agencies have no recourse to declaratory relief once the taxes are levied. Courts may not prevent the collection of taxes which are now due to state agencies. The owner's remedy is to pay the taxes and pursue an action for a **refund of excess taxes paid**. [Calif. Revenue and Taxation Code §§6931, 6932]

Interference with future events

Consider a tenant operating a barber shop who subleases a portion of the premises to a subtenant who sets up a smoke shop. The sublease grants the subtenant an **option to renew** the sublease contingent on the tenant renewing his lease.

The tenant arranges for his son to lease the property from the landlord at the end of the current lease term rather than renew or extend it himself. The tenant then informs the subtenant he will not be renewing the lease, and thus the sublease will be terminated at the end of the current term.

The subtenant claims the leasing of the property by the tenant's son is merely a ploy to terminate the sublease.

No cause of action yet exists for money losses or breach of the option to renew since the sublease is still in effect and no one is seeking to evict the subtenant.

However, due to the words and conduct of the tenant, a **controversy exists** as to whether the subtenant is entitled to renew his sublease. The subtenant seeks a declaration of his **right to renew his sublease**.

A declaratory judgment is handed down by the court stating the leasing of the property by a member of the tenant's family constitutes a renewal of the lease. With his rights established by a court order, the subtenant will be able to exercise his option to renew the sublease when the time to exercise the option arrives. [**Jones** v. **Feichtmeir** (1949) 95 CA2d 341]

Useful purpose of ending litigation

The requirements for obtaining a declaratory judgment are:

- an **actual controversy** exists as to a person's rights or duties; and
- the controversy will likely result in **future litigation** if not resolved.

Thus, a declaratory judgment is only granted if the judgment will serve a **useful purpose**. The court may deny declaratory relief if no declaration is necessary or proper. [CCP §1061]

For example, a buyer and seller sign a purchase agreement. Later, a third party records an option to purchase the property.

The seller informs the buyer he will be unable to deliver title to the property due to the option. The buyer's deposit is refunded and the property is sold to the optionee.

Cumulative remedy

Declaratory relief is a **cumulative remedy**. A person who is granted declaratory relief in a dispute may recover for other sorts of relief available to him arising out of the same dispute. [CCP §1062]

For instance, a lease agreement allows the landlord to terminate the lease if the tenant assigns the lease without the prior landlord's consent. However, the tenant assigns an interest in the lease to a partner without obtaining consent.

The landlord claims the unauthorized assignment allows him to terminate the lease. The tenant claims the landlord cannot terminate the lease based on the assignment since he only assigned a partial interest in the lease, and still retains an interest himself.

Rather than file an unlawful detainer (UD) action, the landlord obtains a declaratory judgment ruling that he can terminate the lease. Thus, if the dispute with the tenant is resolved in the land-

The buyer now claims the seller breached the purchase agreement and seeks a declaration of his rights. However, the buyer does not seek any other form of relief, such as the recovery of money losses or specific performance of the purchase agreement.

Thus, the buyer's claim for declaratory relief amounts to asking the court to declare the seller breached the purchase agreement when he conveyed the property to the optionee.

This is a **useless declaration** since it has no effect on the future rights or claims between the parties. The relationship between the buyer and seller was already terminated and the seller no longer owns the property.

Thus, any claims of the buyer against the seller can only be for money losses incurred by the termination of the agreement, for which a declaration is unnecessary. [**Travers** v. **Louden** (1967) 254 CA2d 926]

*Editor's note: An important distinction must be made between a court's refusal to award declaratory relief and a declaratory judgment which is **negative** or **adverse** to the individual seeking it.*

When an actual controversy exists, a person is entitled to declaratory relief even if the judgment is against him since he is entitled to have his uncertainty resolved.

Chapter 50 Rent skimming by buyers

This chapter examines the rent skimming remedies available to sellers, lenders and tenants affected by a buyer's rent skimming activities.

Five or more is a crime

Rent skimming occurs when a buyer receives rents from a *parcel* of residential rental property during his **first year of ownership** and does not apply the rents (or an equivalent amount) to the payments due on all notes secured by the property. [Calif. Civil Code §890(a)]

A **parcel** is real estate with a single legal description containing one-or-more residential units within the boundaries of the parcel.

A buyer who rent skims from five-or-more parcels of real estate he took title to during any two year period exposes himself to penalties for *multiple acts* of rent skimming.

The **multiple act** of rent skimming from five-or-more parcels of residential rental property must occur during the buyer's first year of ownership of each parcel. The parcels subject to one count of multiple acts of rent skimming are only those acquired during **any two-year period**. [CC §890(b)]

Skimming the rents for profit

A buyer seeks to purchase residential rental property in an effort to build an estate, but has insufficient cash savings to make a regular down payment. The buyer locates a residential property valued at $300,000, encumbered with a $260,000 first trust deed.

The seller is motivated to accept a "no-down" offer from the buyer if he can:

- sell the property at his asking price;
- earn interest income on a carryback installment sale; and
- defer profit tax reporting on the sale until the principal is paid in full or qualify for a $250,000 profit exclusion as his principal residence.

The buyer offers to enter into either a land sales contract, all-inclusive note and trust deed (AITD) or a lease-option sale with the seller, called *wrap-around financing*.

The buyer will not make a down payment on the property. However, a deferred down payment will be paid to the carryback seller through additional periodic principal payments over a three-year period.

The arrangement will defer payoff of the seller's equity in the property as part of the carryback arrangement. The seller will continue to make payments to the underlying lender with funds received from the buyer on the wraparound financing.

The purchase agreement calls for the seller to convey (or reconvey) the real estate to the buyer once all payments towards the principal have been paid.

This financing arrangement appears to match the seller's goals. The seller can convert his real estate equity into interest income and principal payments with:

- what he perceives to be a high degree of safety;
- a higher interest rate than offered on insured savings accounts; and
- apparent out-of-pocket relief from loan payments and property management.

The seller accepts the buyer's offer and the buyer takes possession of the property.

The buyer then rents the property to a tenant. However, within one year of purchasing the property, the buyer stops making payments to the seller. In turn, the seller defaults on his payments to the underlying lender since he is unable to fund the loan payments without payments from the buyer.

Due to the seller's default in payments, the underlying lender forecloses on the property and acquires it at the foreclosure sale, wiping out the seller's, buyer's and tenant's interests in the property. The buyer is not engaged in multiple (five) acts of rent skimming.

The lender, having acquired title, serves the tenant with a 30-day Notice to Quit Due to Foreclosure, and the tenant vacates the property. [See **first tuesday** Form 573]

The tenant sues the buyer, seeking to recover his security deposit and moving expenses.

Additionally, the seller sues the buyer for his money losses caused by the buyer's purchase of the property, its rental to a tenant by the buyer and the buyer's failure to pay on the carryback note during the buyer's first year of ownership, called **rent skimming activities**. The seller seeks to recover the amount of his equity still owed to him on the purchase price.

Can the tenant and the seller collect their money losses caused by the buyer's rent skimming activities which were limited to this property?

Yes! Both the tenant and the seller have separate and enforceable claims against the buyer. Each can collect their money losses caused by the buyer's rent skimming activities. [CC § 891(a), (d)]

Tenant recovery of money

A tenant of residential property may recover actual out-of-pocket money losses from a buyer who engages in **rent skimming** which causes:

- the property to be sold at a foreclosure sale; and
- the tenant to be forced to move.

The **tenant's recovery** includes any security deposit lost, moving expenses, attorney fees and court costs.

Additionally, the tenant may collect *punitive damages* from the rent skimming buyer at three times the amount of the tenant's out-of-pocket losses if:

- payments on the underlying trust deed were at least two months delinquent at the time the tenant rented the property; or
- the buyer participated in **multiple acts** of rent skimming (five properties within two years) which involved the property. [CC §891(d)]

The tenant's recovery for rent skimming is awarded in addition to his remedies for the buyer's breach of the rental agreement. For example, under a landlord's breach of a lease, the tenant can collect lost rental value for the remaining lease period should the rent he pays on a comparable replacement residence be higher.

Seller recovery of money

A carryback seller is entitled to his actual money losses caused by a buyer's rent skimming whether or not the buyer was involved in multiple acts of rent skimming. The **seller's recovery** includes the amount owed under a carryback note, land sales contract or lease-option — despite anti-deficiency, nonrecourse law barring recovery of money.

Additionally, the carryback seller is entitled to collect other money losses caused by the rent skimming buyer's activities, such as waste. [CC §891(a), (g)]

The carryback seller is further entitled to **punitive damages** of no less than three times his out-of-pocket losses if the buyer participated in **multiple acts** of rent skimming which involved the seller's property. [CC §891(a)]

Should the seller foreclose and bid on the property and recover ownership, he will have to underbid in the amount of his out-of-pocket losses if he is to sustain an actual loss on foreclosure.

Deed-in-lieu protection

A **carryback seller** who reacquires the property by a *deed-in-lieu of foreclosure* from a rent skimming buyer is entitled to a court order clearing title of any judgment liens brought about by the buyer.

The alternative to a **deed-in-lieu** is to foreclose on the carryback trust deed and eliminate the junior liens by a trustee's sale.

A carryback seller who reacquires clouded title under a deed-in-lieu must give the lienholders at least 30 days advance written notice of the seller's intention to remove the liens by court order. [CC §891(b)]

Lender recovery from buyer is limited

A lender whose loan is secured by property acquired by a buyer who is guilty of **multiple acts** of rent skimming involving the lender's secured property and other properties may recover its actual *money losses* from the buyer. However, recovery is **limited to the rents** collected on the property, whether or not the buyer assumed the loan. [CC §891(c)]

Rent recovery is separate from any recovery on the note through foreclosure. If the lender **underbids** at the trustee's sale by the amount of rents collected in order to sustain a loss on his loan, anti-deficiency law will not prevent the lender from recovering the rents up to the amount of the *loss on the underbid*.

Rent skimming prosecution

Not only will a buyer engaged in **multiple acts** of rent skimming be liable for money losses he inflicts on the tenant, seller and lender, but the buyer exposes himself to **criminal prosecution** as well.

The crime of multiple acts of rent skimming comprises rental units acquired during a two year period. Further, prosecution for the **multiple acts** of rent skimming must be filed within three years after the last parcel involved in the multiple acts of rent skimming was acquired. [CC §892(c)]

For example, a landlord skims the rents off more than five parcels. All the properties were encumbered and acquired by the landlord within a two-year period.

The state files criminal charges on:

- the **initial act** of multiple rent skimming (rent skimming on five parcels acquired in a two-year period); and
- **additional acts** of rent skimming for each parcel not included in the five parcels establishing the initial act of multiple rent skimming.

The state files the charges within three years of the landlord's acquisition of the last of the five parcels included in the initial charge of multiple acts of rent skimming. However, while the parcels involved in the additional charges were acquired during the same two-year period covered by the initial multiple act of rent skimming, the additional parcels were not acquired within the three-year statute of limitations period for rent skimming.

The landlord claims the criminal charges cannot be brought for the additional acts of rent skimming since these were not included in the charges of multiple acts of rent skimming and he acquired those additional parcels more than three years before the state brought the action, and thus he is protected by the statute of limitations.

The state claims the prosecution of each additional violation is proper since all the charges were brought within three years after the last acquisition of a parcel subject to rent skimming, and the additional acquisitions occurred within the two-year period ending on acquisition of the last parcel.

Is the landlord subject to criminal charges for the additional acts of rent skimming for properties acquired more than three years before charges were filed?

No! The state's action for each additional rent skimming violation after the first violation (comprised of five separate acts of rent skimming within a two year period) is time-barred by the three year *statute of limitations*. The acquisition of each additional parcel which is the subject of each **additional violation** did not occur within three years prior to filing the action. [**People** v. **Bell** (1996) 45 CA4th 1030]

A buyer found guilty of five acts of rent skimming is subject to imprisonment for one year, a fine of no more than $10,000, or both imprisonment and the fine.

For each additional act of rent skimming beyond five, the buyer is subject to an additional one-year imprisonment, or $10,000 fine, or both imprisonment and the fine. [CC §892(a)]

If the buyer was previously convicted of multiple acts of rent skimming, further rent skimming will subject the buyer to one-year imprisonment, a fine of no more than $10,000, or both imprisonment and the fine for **each additional act** of rent skimming. [CC §892(b)]

The crime of multiple acts of rent skimming is considered a misdemeanor unless the court in its discretion sentences the rent skimmer to state prison. [Calif. Penal Code §17]

Consider an individual who, within a two year period, takes possession of five or more parcels of unoccupied residential property, called an *adverse possessor*. Each parcel is encumbered by a trust deed lien. The **adverse possessor** then rents the properties to tenants who take possession.

The adverse possessor collects rents during the first year of possession. No part of the rents (or other funds) are applied toward payments due on the trust deed notes.

The state claims the adverse possessor engaged in the criminal act of rent skimming since no part of the rents collected were applied toward the payments due on the trust deed note.

The adverse possessor claims he did not engage in rent skimming since he rented the unoccupied parcels as his initial step toward acquiring title.

Is the adverse possessor guilty of the crime of rent skimming?

Yes! The adverse possessor is *criminally liable* for multiple acts of rent skimming. He **took possession** of five or more parcels of real estate within a two year period which were encumbered with a loan, rented them to tenants and failed to apply the rents toward payments due on the loan. [**People** v. **Lapcheske** (1999) 73 CA4th 571]

Buyer's defense

A rent skimming buyer may avoid rent skimming charges, both criminal and civil, if the rents were used to pay his medical expenses, or licensed contractors or material suppliers to correct violations relating to the habitability of the property, if:

- the payments are made within 30 days of receiving the rental revenue; and
- no other source of funds existed from which to make the payments. [CC §893]

Thus, to avoid rent skimming charges, buyers who become delinquent must submit to the lender the entire monthly rent they receive from tenants, limited to the delinquent and current monthly payment amounts. Typically, the lender will imprudently return the funds to the buyer, refusing to accept the rents since the amount is insufficient to fully reinstate the loan.

Consider an adverse possessor who is charged with the felony of grand theft for taking rents as a trespasser. However, the adverse possessor, like any buyer of property, is entitled to take the rents since he was in physical possession of the parcels.

Thus, an **adverse possessor** does not commit the felony of *grand theft* since his taking of the rents is not a crime. However, if he acquires five or more properties in a two year period and fails to pay the trust deed loans encumbering the properties from the rents he collects, he has committed a crime. [Lapcheske, *supra*]

The federal scheme

Many buyers seek out desperate sellers who are in default on loans insured by the Federal Housing Administration (FHA) or Veterans Administration (VA). In these situations, the buyer acquires the property with little or no money down, then converts it to a rental unit.

For example, an investor purchases homes in default which are encumbered by FHA and VA loans. The investor rents the properties to tenants but applies none of the rents received to the underlying loans.

The investor is prosecuted for equity skimming by the federal government.

The investor claims the government cannot prosecute him unless it can show he had an intent to defraud the government.

In this federal law case, the investor need not even be aware the properties are FHA-or VA-insured in order to be convicted of rent skimming when the investor who acquires a residential property:

- rents the property;
- collects rents; and
- fails to make payments on the loans. [**United States** v. **Laykin** (9th Cir. 1989) 886 F2d 1534]

An investor will be guilty of **rent skimming** under federal law if the investor:

- purchases a one-to-four unit residential property subject to an FHA-or VA-insured loan which is in default at the time of purchase, or defaults on the loan within one year after purchase;
- intentionally fails to make payments on the loan as they become due; and
- uses the rental income for his own purposes. [12 United States Code §1709-2]

The investor may be guilty of rent skimming regardless of whether he is personally obligated on the FHA/VA loan.

However, the federal rent skimming statute does not apply to an investor who only owns one property subject to a FHA/VA loan. The investor must be guilty of **two or more acts** of rent skimming on properties subject to FHA/VA loans to be prosecuted by the federal government.

An investor found guilty of rent skimming will be subject to a fine no greater than $250,000, imprisonment for no more than five years, or both imprisonment and the fine. [12 USC §1709-2]

Chapter 51 Getting out of litigation gracefully

This chapter illustrates a broker's use of good faith settlement negotiations to end his liability exposure in a dispute between others.

Good faith settlement ends broker liability

A buyer of a condominium unit discovers the actual size of the unit is considerably less than stated by the seller's broker. The buyer accuses the seller and the seller's broker of **misrepresenting the size** of the unit. The buyer makes a demand on both the seller and the broker to recover the money paid for the nonexistent square footage.

The seller and the broker each claim the other is responsible for bringing about any misrepresentation of the square footage which lead to the buyer's loss. Thus, they seek *indemnity* from each other for any recovery against them by the buyer.

Prior to trial on the buyer's dispute, the broker **negotiates a settlement** with the buyer. The settlement is approved by the court as being entered into *in good faith*. The seller is not released by the settlement.

Later, the seller claims the broker breached his fiduciary duty owed to the seller by misrepresenting the size of the property to the buyer. The seller seeks to recover the brokerage fee paid to the broker on the sale and the attorney fees he incurred to defend against the buyer's claim.

The broker claims the seller's action for breach of fiduciary duty is merely an *indemnity claim* which is barred since his liability to the seller for further liability due to the buyer's claim was terminated by his *good faith settlement* with the buyer.

Can the seller recover anything from the broker?

No! The seller's claim against the broker for breach of the agent's fiduciary duty owed the seller to accurately disclose the property's physical condition to the buyer was barred by the broker's **good faith settlement** with the buyer, which was approved by the court. [**Cal-Jones Properties** v. **Evans Pacific Corporation** (1989) 216 CA3d 324]

Indemnity is an obligation imposed on one individual, such as a broker, and owed to another individual, such as a seller, to pay a loss incurred by a third person, such as a buyer. The obligation is commonly referred to as a *hold harmless arrangement*.

An **indemnity** provision can be written into a contract, as is the case with a title insurance policy, or arises as part of a *special relationship*, such as exists between an agent and his client under a listing agreement.

A claim for indemnity arises between two individuals when one of the individuals is sued by someone else to recover losses caused by the other individual — such as the previous example where a buyer sues a seller and the seller claims the broker caused the buyer's loss. This results in a demand for *equitable indemnity* since the claim for indemnity is not covered by a contract provision.

For instance, claims for **equitable indemnity** frequently arise between builders and subcontractors in litigation over construction defects where their subcontract does not contain an indemnity provision. If the owner of the defectively constructed property makes a demand on the builder for the costs incurred to correct the defects, and the builder in turn makes a demand on the subcontractor to pay the loss, claiming it was actually caused by the faulty work of the subcontractor, the builder is seeking indemnity from the subcontractor for the claims made on the builder by the property owner.

Buyer and seller held harmless by broker

In real estate sales, disputes between buyers and sellers typically expose the brokers who negotiated the sales transaction to claims for **equitable indemnity** based on their involvement as agents in the transaction. However, no agreements entered into by brokers contain an indemnity provision, called a *hold harmless agreement*.

A broker's **good faith settlement** of his involvement in a lawsuit between a buyer and a seller allows the broker to escape further liability to either the buyer or seller on the dispute. The settlement ends all liability of the broker to others in the litigation who may still be held liable to the individual who settled with the broker. [Calif. Code of Civil Procedure §877.6]

The broker's client in the previous square footage dispute pursued an agency law claim against his broker for a breach of his fiduciary duty, rather than an indemnity claim which was terminated by the good faith settlement.

However, an indemnity claim against a broker who acts as an agent in a transaction for the person seeking indemnity is based on an agency claim — the failure of the broker to correctly advise or represent his client — which caused someone in the transaction to sustain a loss recoverable from the broker's client. Specifically, the broker's advice or representations **exposed his client to liability** under agency law.

The claim of the seller in the square footage case to recover his costs of further litigation from his broker is fundamentally an action for indemnity against the broker, no matter how the claim is worded. The seller's claim against the broker is triggered by the buyer's claim, since the seller would not have suffered a loss were it not for the buyer's lawsuit.

Thus, the seller was trying to **reestablish the broker's liability** for the same losses incurred by the buyer which were the subject of the court-approved good faith settlement between the broker and the buyer which terminated the broker's further liability.

To determine whether a settlement is made in good faith, the settlement amount must be within the reasonable range of the settling party's *proportional liability* based on the facts known at the time of the settlement. [**Far West Financial Corporation** v. **D & S Company, Inc.** (1988) 46 C3d 796]

The **apportionment of liability** — a percentage of fault imposed on the broker for the loss — is the same for the broker whether he first settles (for less money), or later reimburses the loser under an indemnity claim (for more money).

A court hearing that determines the broker's settlement with the buyer was in good faith was the **seller's last opportunity** to pursue his indemnity claim against the broker. Only a separate dispute between the broker and the seller, in which no one other than the **seller suffered a loss** as a result of the broker's actions, survives a court-approved good faith settlement between the broker and the buyer.

Any claim of the seller against the broker which is independent of the loss suffered by the buyer and uninvolved with the broker's good faith settlement with the buyer exposes the broker to continued liability since no aspect of the seller's claim relates to any losses suffered by the buyer.

Thus, a good faith settlement allows the broker to prudently get out of litigation early and for a reasonable price, and proceed with his life and business — except for direct losses incurred only by the client at the fault of the broker.

Chapter 52 Attorney fees reimbursed

This chapter discusses the recovery of attorney fees incurred to prevail in real estate disputes.

By agreement, by statute or by both

Consider an owner who signs a promissory note in favor of a private lender to evidence a debt. The debt is secured by a trust deed on real estate.

The note provides for the owner to pay attorney fees incurred by the lender on an *action to enforce the note. Thus, the* ***attorney fees provision***:

- limits recovery to actions on the contract, not negligence of other tort actions; and
- is one-sided in its application — enforceable by the lender only. [See Figure 1]

The lender **making** the loan is not licensed as a real estate broker. Also, a real estate broker is not consulted to **arrange** the loan. Thus, the loan is controlled by the *usury ceiling* on the annual yield received by the lender over the life of the loan, such as interest, discounts and bonuses. [Calif. Constitution, Article XV §1]

However, the interest yield agreed to by the owner exceeds the **usury ceiling** (the Federal Reserve Board of San Francisco discount rate, plus 5% with a 10% floor). Thus, the loan is usurious and only the principal amount advanced can be collected by the lender.

The owner discovers the loan is usurious and tenders only the amount the lender would be legally able to collect — the remaining principal, less all interest and discounts paid.

The lender rejects tender of the adjusted principal and statutory reconveyance costs and initiates foreclosure to enforce the note. To protect himself against the loss of his property, the owner files a lawsuit claiming usury as a defense to the lender's attempts to foreclose on his property.

The loan is held to be usurious. The owner, having prevailed, demands payment of his attorney fees from the defeated lender under the attorney fees provision in the note.

The lender claims he owes no attorney fees since he never agreed in the attorney fees provision to pay the owner's attorney fees; under the provision, only the owner agreed to pay the lender's attorney fees.

Is the lender liable for the owner's attorney fees?

Yes! The **existence** in the note of an attorney fees provision for enforcement of the note entitles the *prevailing party* to be awarded his attorney fees from the loser, even if the provision is written to protect only the lender. [Calif. Civil Code §1717; **Winnett** v. **Roberts** (1986) 179 CA3d 909]

Conversely, had the private lender successfully enforced his note against the owner's usury defense, the lender would have been entitled to reimbursement of his attorney fees from the owner.

Paying the attorney

Each party to a lawsuit must bear the burden of his own attorney fees unless a **statute**, or the **agreement** out of which the dispute arose, calls for an award of attorney fees to the prevailing party. [Calif. Code of Civil Procedure §1021]

Additionally, a claim by an individual, such as a broker, for *indemnity* to require another person, such as a seller, to hold the individual harmless in litigation initiated by a third person, such as a buyer, and involving the individual is another basis for collecting attorney fees.

Paying your own attorney fees is a tradition in American law. Conversely, the English common law entitles the winning party to be paid his attorney fees by the loser. [**Reynolds Metals Company** v. **Alperson** (1979) 25 C3d 124]

With attorney rates per hour far exceeding the average daily pay received by the typical household, and contingency fee arrangements exceeding one-third of the money/value recovered, the cost of litigation is an **economic factor** which weighs on the resolution of any dispute.

Accordingly, it is financially essential that a broker confronted with a claim understand when and how attorney fees can be collected (or paid), either by themselves or by others.

Real estate practices for attorney fees

Real estate agreements which typically contain an **attorney fees provision** include:

- listings;
- purchase and exchange agreements;
- escrow instructions;
- leases and rental agreements; and
- promissory notes and trust deeds.

Those who have the most to benefit from an attorney fees provision include landlords in lease agreements, lenders in promissory notes and brokers in listing agreements. These are the entities most likely to **sue and prevail** on these agreements.

Figure 1

"If an action is instituted to enforce this note, I promise to pay such sum as the court may fix as attorney fees."

Figure 2

"In any action to enforce this agreement, the prevailing party is to receive reasonable attorney fees."

Figure 3

"In any action arising out of this agreement, the prevailing party is to receive attorney fees."

Additionally, these classes of litigants are likely to want the attorney fees provisions to be worded to limit recovery of attorney fees to actions for **enforcement** of the lease, note or listing. Thus, they get attorney fees if they win, or the person sued gets attorney fees for defending.

However, the persons sued on a contract with an attorney fee provision limiting recovery of enforcement cannot collect their attorney fees on any action they pursue on a tort theory which **arises out of the contract**, such as misrepresentation or breach of agency duties, which are claims often raised by those defending against a lawsuit. [See Figure 2]

To use or not to use

Purchase agreements entered into by buyers and sellers exist in a litigation-prone environment. As a result, brokers should consider excluding attorney fees provisions from some agreements as a **risk reduction strategy** to avoid inducing litigation between others in which they become entangled.

For example, the California Association of Realtors' purchase agreement form contains an attorney fees provision (as well as the publicly unacceptable compulsory arbitration agreement).

Conversely, neither an attorney fees provision nor an arbitration agreement is included in any of the purchase agreement forms published by **first tuesday**.

The difference is significant.

For buyers and sellers, attorney fees provisions tend to encourage and promote litigation rather than inhibit it. Unfortunately, when buyers and sellers sue one another over a transaction, brokers are uniformly named as defendants who are at least claimed to owe a duty to indemnify.

The absence of an attorney fees provision in purchase agreements appropriately focuses the dispute on the **monetary recovery** available, an amount limited to actual money losses on a transaction. Thus, any money award recovered would be reduced by the attorney fees paid to pursue the recovery.

As a result, a dispute between a buyer and a seller will not proceed to litigation if the recovery of the money losses will be **economically infeasible** to pursue except for the additional recovery of attorney fees, an unintended but real consequence of the provision. Thus, the risk of a broker's entanglement in litigation between buyers and sellers is reduced by eliminating the attorney fees provisions from purchase agreement forms.

Without an attorney fees provision, the buyer or seller must be fully convinced they will prevail against the other, and are willing to pay and bear the ultimate cost of their own attorney fees from any recovery.

Who benefits by ability to recover fees

At first glance, attorney fees provisions inserted in purchase agreements appear to only benefit the fortuitous attorneys who will represent the parties.

However, real estate attorneys generally do not take cases involving real estate disputes on contingency fee arrangements. Rather, they are paid based on an hourly rate. On retaining an attorney, the client is required to sign an attorney fee agreement, which itself contains an attorney fees provision.

The deposit of an upfront retainer, against which the attorney will bill his time, is almost always demanded by the attorney.

Clients who do not pay their attorney by either depositing a minimum balance with them, or paying billings on time, will find their attorney successfully requesting the court for a withdrawal from the case. [**People** v. **Prince** (1968) 268 CA2d 398]

Accordingly, experienced attorneys retained on real estate matters assure themselves from the outset of a transaction that they will be paid for their services by their client.

Thus, attorney fees provisions can hardly be said to benefit attorneys, other than to induce them to incite their client to litigate based on their expectation of winning.

On the contrary, attorney fees provisions are designed to **reimburse the winner** — as the beneficiary of the provision — on successful completion of the litigation by trial. If the litigation is terminated by a voluntary dismissal or settlement, no one collects attorney fees.

The presence (or absence) of an attorney fees provision in a contract plays a significant role in the eagerness with which individuals pursue, defend or avoid legal disputes.

Agreed-to attorney fees

Any agreement containing an attorney fees provision entitles the prevailing party to reimbursement of attorney fees they incurred *enforcing* the contract, regardless of how the provision is worded. [CC §1717(a)]

This **reciprocal fee statute** applies to actions on the contract only, not tort actions such as misrepresentation, deceit or breach of agency duties.

An attorney fees provision in an agreement is read to apply reciprocally for all parties to the agreement to collect attorney fees on any action based on the contract. Simply, if an attorney fees provision exists, the prevailing party at trial receives his attorney fees in contract disputes, limited only by reasonableness, the wording of the fee provision and the application of the reciprocal fee statute. [**Smith** v. **Krueger** (1983) 150 CA3d 752]

Only reasonable fees

The losing party does not necessarily **pay all** of the prevailing party's attorney fees under an attorney fees provision — only the fees which the court deems **reasonable**.

Courts have a great deal of discretion in deciding what is reasonable and may consider:

- the complexity of the litigation;
- attorney rates for similar cases in the area;
- the prevailing attorney's experience, knowledge and skill;
- the time properly consumed by the case; and
- the amount of the final judgment. [**Clejan** v. **Reisman** (1970) 5 CA3d 224]

Many agreements include the word "reasonable" in the language of the attorney fees provision. [See Figure 2]

Even if the attorney fees provision does not state "reasonable attorney fees," **reasonable fees are implied**. [See Figure 1 and Figure 3]

Attorney fees are assessed and collectable only after a judgment becomes final and ends the litigation. The prevailing party must ask the court for the fees or submit the attorney fees as part of the court costs to be recovered. [CCP §1021]

Either way, a copy of all billings for legal services is submitted to the court as evidence of the prevailing party's attorney fees. The losing party will likely object to the costs as "unreasonable."

If the prevailing party's actual attorney fees exceed what the court deems reasonable, he is not reimbursed for the excessive fees paid or demanded by his attorney. Fees in excess of a reasonable amount are borne by the prevailing party.

Who is the prevailing party?

The **prevailing party**, determined when the court enters its final judgment in the case, is the individual who:

- receives the greater money damages award [CC §1717(b)(1)];
- receives the requested equitable relief (a non-money remedy, such as specific performance); or
- successfully defends against the plaintiff's claim and the plaintiff obtains no relief. [CCP §1032(a)(4)]

For example, a group of tenants sue their landlord for a breach of their leases. The leases contain an attorney fees provision.

When the tenants withhold rent payments, the landlord files an unlawful detainer (UD) action to evict the tenants. The tenants' action and the landlord's UD action are consolidated into one lawsuit.

The tenants prevail on their claim that the landlord breached their lease agreements and they are awarded a money judgment. However, the landlord is also awarded a money judgment against the same tenants for the delinquent rent. A setoff then occurs between the greater and the lesser amounts of the two opposing money awards.

The money judgment awarded to the tenants is greater than the amount of the landlord's judgment. Both the landlord and the tenants claim their attorney fees are owed since each prevailed on their respective claims.

Who is the prevailing party: the landlord, the tenants or both?

In this instance, the tenants prevail for purposes of recovering attorney fees under the lease since the tenants received a higher dollar amount of recovery then the landlord. [**Haire** v. **Stevenson** (1987) 196 CA3d 1249]

However, a court has the discretion to decide neither party prevailed. For example, when the money recovery by both parties is comparable or so small that neither party is the winner, the court can deny the payment of attorney fees. [CC §1717(b)(1)]

Additionally, when a case is **voluntarily dismissed** or **dismissed pursuant to a settlement**, neither party prevails for attorney fees purposes. [CC §1717(b)(2)]

On the contract or arising from it

A client's attorney pursues recovery based on numerous theories and causes of action, some in *contract* to enforce an agreement, some in *tort* to recover for bad conduct.

For example, a buyer sues his seller alleging intentional misrepresentation, negligence, **breach of contract** and agency duties, indemnity and even emotional distress in an effort to recover his loss of money on the purchase.

Each legal theory for recovery is a separately stated claim for recovery, some to enforce the **contract**, some based on the seller's conduct, called **torts**. The buyer's attorney spends billable time researching, investigating and establishing proof for each claim the buyer is making.

The purchase agreement used by the buyer to document the transaction contains an attorney fees provision covering all litigation **arising out of the subject** of the agreement, not limited to litigation enforcing the contract. [See Figure 3]

In this instance, the prevailing party can recover attorney fees for the billable time spent on every claim he prevails on which arises out of the **subject matter** of the agreement which contains the attorney fees provision — not just for the fees incurred on claims seeking to *enforce* the purchase agreement, such as specific performance.

Claims other than for enforcement or the recovery of money losses under a breached purchase agreement (specific performance or lost value) arise due to a person's improper conduct and are personal under *tort theories*, including breach of fiduciary duties, breach of covenants for good faith and fair dealing and fraudulent representation, deceit or concealment. [**3250 Wilshire Boulevard Building** v. **W.R. Grace & Company** (9th Cir. 1993) 990 F2d 487]

The listing and attorney fees provisions

Consider the recovery of attorney fees incurred by a client who pursues a *fraud or negligence* action against a broker arising out of his employment under a listing agreement. The recovery of the attorney fees by either party will depend on the type of attorney fees provision contained in the listing agreement.

For example, a broker employed by a buyer under a listing agreement fails to include key terms from a purchase agreement in the escrow instructions. The attorney fees provision is all-inclusive since it calls for reimbursement of attorney fees in **any action arising** out of the listing contract. [See Figure 3]

The buyer sues the broker for both neglect and breach of the listing agreement.

The buyer wins a money judgment against the broker for his negligent conduct as an agent of the buyer and demands his attorney fees under the attorney fees provision in the listing agreement.

The broker claims he owes no attorney fees since his negligence while acting as an agent was the basis for the client's recovery, not a dispute regarding a breach or performance of the listing agreement.

Is the buyer entitled to receive attorney fees?

Yes! The attorney fees provision in the agreement was not limited to recovery based solely on enforcement of the listing agreement. The broker's negligence as an agent **arose out** of his employment agreed to in the listing agreement, which is an action covered by the "all-inclusive" attorney fees provision.

The broker's negligent acts as an agent while handling the sale of the listed property is not a separate and distinctly different activity from the employment undertaken in the listing agreement to locate a buyer for the property. The neglect occurred as a result of the employment. [**Perry** v. **Robertson** (1988) 201 CA3d 333]

However, the broker would not have been liable for attorney fees for his negligent conduct had the attorney fees provision limited recovery to enforcement of the listing agreement. [See Figure 2]

Buyer's broker and no attorney fee provision

Now consider a buyer and seller who enter into a purchase agreement on a form which separates the seller's agreement to pay a brokerage fee from the purchase agreement signed by the buyer. The **separate brokerage fee agreement** is signed by the seller, but not the buyer. Thus, the brokerage fee is not provided for within the terms of the purchase agreement.

However, the buyer's purchase agreement includes an attorney fees provision covering any dispute between the parties to the purchase agreement.

Later, the buyer sues the broker for misrepresentation. The broker retains an attorney and prevails against the buyer.

The broker claims he is entitled to recover his attorney fees from the buyer since he received a fee on the sales transaction which was documented by a purchase agreement "containing" an attorney fees provision.

In this example, the broker is not entitled to recover his attorney fees. The broker's only right to a brokerage fee is derived from the separate brokerage fee agreement entered into by the seller to which the buyer was never a party.

Thus, the broker cannot benefit from the attorney fees provision in the purchase agreement since the provision for payment of a brokerage fee was not agreed to by the buyer. The attorney fees provision was part of the seller's separate brokerage fee agreement, not the buyer's purchase agreement entered into by the buyer. [**Super 7 Motel Associates** v. **Wang** (1993) 16 CA4th 541]

Unenforceable agreements

A buyer and seller enter into a real estate purchase agreement containing an attorney fees provision. The buyer and seller become embroiled in a dispute over a contingency and the seller cancels the transaction.

The buyer sues the seller for specific performance of the purchase agreement. However, the buyer loses since the terms of the purchase agreement are too ambiguous for the court to determine what the parties agreed to or how to enforce the agreement.

As the prevailing party, the seller makes a demand on the buyer for payment of his attorney fees. The buyer claims attorney fees are not owed since the **agreement is unenforceable**.

Is the seller entitled to recover his attorney fees from the buyer?

Yes! The judgment in favor of the seller is **on an agreement**, although unenforceable, which contains an attorney fees provision. [**Manier** v. **Anaheim Business Center Company** (1984) 161 CA3d 503]

Now consider a buyer and seller who enter into a purchase agreement.

Before closing, the seller's broker obtains a **backup offer** from another buyer to purchase the same property if the first transaction with the original buyer is terminated.

Both purchase agreements for both buyers contain attorney fees provisions.

The first transaction with the original buyer is *renegotiated* and totally restructured by the seller and the buyer. As a result, the renegotiated agreement has an entirely different set of terms and conditions than the original agreement. The first transaction with the original buyer, as renegotiated, closes.

The backup buyer claims the renegotiated transaction the seller actually closed on with the original buyer is a new and later agreement, not the prior agreement on which his backup transaction was contingent. Thus, the backup buyer claims the contingency no longer exists and the backup agreement now has priority and is enforceable.

The backup buyer sues the seller and the original buyer to enforce his backup purchase agreement and acquire ownership of the property.

However, the original buyer prevails. Additionally, the original buyer claims the backup buyer owes him the attorney fees he incurred defending against an attempt to enforce the backup buyer's purchase agreement.

The backup buyer claims he does not owe attorney fees to the original buyer since the original buyer was not a party to the backup purchase agreement which was litigated.

Does the original buyer, who was not a party to the unenforceable backup purchase agreement, receive his attorney fees?

Yes! The backup buyer sued the original buyer **to enforce an agreement** containing an attorney fees provision. The original buyer, now the owner, successfully defended his ownership of the property against the claim to ownership made under the backup contract. Conversely, had the backup buyer prevailed, he would have received his attorney fees since the original buyer had become the successor to the seller with knowledge of the backup sales agreement. [**Meadows** v. **Lee** (1985) 175 CA3d 475]

Attorney fees on an assumed loan

A buyer takes title to real estate subject to an existing first trust deed. The lender, aware of the transfer, **calls** the loan. Much later and after accepting installments without first entering into a loan assumption agreement with the buyer, the lender initiates foreclosure due to the tandem effect of the due-on-sale and acceleration clause in the trust deed.

Both the note and the trust deed contain an attorney fees provision. The buyer sues the lender to stop enforcement of the call under the due-on-sale and acceleration clause and **prevails** — the lender waived its right to foreclose by accepting payments after the call.

The buyer then makes a demand on the lender for attorney fees incurred to enforce his rights under the lender's note and trust deed.

The lender claims the buyer cannot collect attorney fees since he did not sign or formally assume the note and trust deed. Thus, the buyer is **not a party** to the trust deed contract being litigated.

Can the buyer collect his attorney fees even though he never signed or formally assumed the existing loan?

Yes! Attorney fees are payable to the prevailing party, in this example the buyer, in a dispute enforcing an agreement containing an attorney fees provision. An agreement containing an attorney fees provision *does not need to be signed* by either party for the prevailing party to collect attorney fees. [**Saucedo** v. **Mercury Savings and Loan Association** (1980) 111 CA3d 309]

By statute or by court order

In addition to collecting attorney fees under an attorney fees provision in a contract, the prevailing party in some real estate disputes is entitled to recover his attorney fees under a statute or by a court-created right.

For example, a water district maintains a canal system to collect excess water from one basin and divert it into a neighboring water basin.

The diverted water floods an owner's property. The property owner sues the water district to recover the fair market value (FMV) of his property under his federal constitutional right to just compensation for a *taking* by a government agency, legally called *inverse condemnation*.

The owner claims the water district has **taken** his property by physically occupying it with flood water, as though the water district has formally condemned the property through **inverse condemnation** for its own use to store excess water.

The water district claims the physical occupation of the owner's property by its flood waters is not a taking and only inflicts flood damage to the property. The owner wins his inverse condemnation action forcing the water district to pay him the full cash value of his flooded property.

The owner demands reimbursement of his attorney fees spent pursuing his claim against the water district.

The water district claims the owner has no right to reimbursement of attorney fees since the United States Constitution makes no mention of attorney fees as a part of recovery under the **just compensation** clause.

However, the owner claims the attorney fees are collectable under California **statutory** recovery of attorney fees in condemnation actions. [CCP §1036]

Is the owner of the flooded property entitled to reimbursement of his attorney fees spent on his condemnation action?

Yes! The California Legislature created the right to collect attorney fees in **taking actions**, even though the federal constitutional right to recover the property's value contains no mention of the payment of attorney fees. [**Salton Bay Marina, Inc.** v. **Imperial Irrigation District** (1985) 172 CA3d 914]

However, had the flooding only damaged the property and not been a taking of the real estate, no attorney fees would be owed since no statute exists for the reimbursement of attorney fees in real estate damage cases.

Eminent domain actions are often initiated by government agencies to take property from an owner and then compensate him for his property's value. If a property owner challenges the **eminent domain** action based on its legitimacy or the price the government agency offers to pay, the property owner is entitled to reimbursement of his attorney fees if he prevails. [CCP §1250.410]

However, consider a government agency which seeks a pre-trial settlement conference to negotiate the amount of compensation owed to a property owner in an eminent domain action.

The owner refuses to negotiate the compensation amount and demands a trial despite the government agency's willingness to compromise.

The owner prevails at trial but is not entitled to attorney fees since the trial was *frivolous and unnecessary*. The owner could have negotiated and settled the issue with the government agency in a pre-trial conference. [**Glendale Redevelopment Agency** v. **Parks** (1993) 18 CA4th 1409]

Mobilehome park rent increases and termination of lease/rental agreements are controlled by the **Mobilehome Residency Law**. This landlord/tenant law controlling mobilehomes entitles the prevailing party to attorney fees, whether the prevailing party is the landlord or the tenant. [CC §798.85]

Civil rights violations

Similarly, real estate owners who have had their civil rights violated can collect their attorney fees by statute.

For example, an owner of an adult theater is forced to shut down his business due to the city's excessively restrictive zoning ordinances.

The owner sues the city and wins since the ordinances violate federal First Amendment rights to free speech under the United States Constitution.

The owner is entitled to collect his attorney fees from the city, even though the First Amendment does not contain any mention of attorney fees.

Additionally, a federal code permits the collection of attorney fees for violation of civil rights. [42 United States Code §1983]

Partition actions

Consider attorney fees expended in disputes between vested co-owners of real estate to partition or sell the real estate. The co-owners cannot mutually agree on its management or disposal and have no partnership or limited liability company (LLC) agreement providing for resolution by a vote among the co-owners.

One of the co-owners incurs attorney fees for the benefit of all co-owners involved. Thus, in the judicial sale or parceling of the property, those **attorney fees** are recoverable pro rata from the other co-owners. [CCP §874.010]

Since they all benefitted from the litigation, the **contributions by all co-owners** for attorney fees is proportional to each owner's percentage of ownership interest in the real estate. [**Stutz** v. **Davis** (1981) 122 CA3d 1]

Another's wrong — indemnity for fees

Even without a statute or contract provision addressing attorney fees, an individual prevailing in real estate litigation may have a **court-created right** to recover his attorney fees.

Consider a buyer who makes an offer to purchase an improved lot on which he will build a home. The seller's broker erroneously advises the buyer his offer has been accepted by the seller and the transaction will close within 30 days.

As a result, the buyer spends money in reliance on the broker's erroneous representation regarding the existence of a binding purchase agreement.

After the buyer is advised he has no enforceable deal, he sues the seller for specific performance and the broker for negligent misrepresentation.

The buyer loses his specific performance action against the seller, but prevails against the broker for misrepresenting that the seller had accepted the purchase offer.

The buyer makes a demand on the broker for his attorney fees incurred in the action against the seller, claiming he would not have sued the seller had the broker properly advised him on whether a binding agreement existed.

Is the broker liable for the buyer's attorney fees for the action against the seller?

Yes! Attorney fees can be recovered from an individual, called *indemnity*, when the individual's wrongful conduct (in this example the broker's) forces someone (in this example the buyer) to bring or defend a lawsuit against another person (in this example the seller). [**Gray** v. **Don Miller & Associates, Inc.** (1984) 35 C3d 498]

Further, the seller also can collect attorney fees from the broker under either the attorney fees provision in the seller's listing agreement he entered into with the broker or the indemnity theory.

Benefits offset an award of fees

A broker negotiates the sale of an apartment building he has managed for a long time. The broker is aware of property defects, but fails to disclose these defects to the buyer.

As a result, the buyer pays the seller more for the apartment building than its present value. Thus, the seller who employed the broker receives a **higher sales price** than he should have received considering the property's condition.

The buyer, on discovering the property defects, sues the seller and the broker to recover the excess price paid for the property. The buyer obtains a money judgment against the broker, not the seller, for the amount he paid in excess of the property's fair market value (FMV).

Further, the seller also demands the broker reimburse him for his attorney fees incurred in his successful defense of the buyer's lawsuit, claiming the broker's failure to disclose the property's condition caused the litigation and therefore entitles him to *indemnity* from the broker due to their client/broker relationship.

The broker admits he owes attorney fees to the seller but claims he is entitled to an *offset* against the seller's attorney fees for benefits conferred on the seller by the broker's actions. The dollar **offset** would be the portion of the sales price received by the seller that exceeds the property's FMV.

Since the excess in the sales price is greater than the amount of the seller's attorney fees, the broker claims no reimbursement is due to the seller.

Does the broker owe the seller his attorney fees in spite of the benefits received and retained by the seller due to the broker's wrongful conduct?

Yes and no! The broker is liable for the seller's attorney fees since the broker caused the seller to have to defend against a lawsuit filed by the buyer.

However, the amount owed in attorney fees is reduced — offset — by the excess financial benefit the seller received and retained due to the broker's wrongful conduct. The right to reimbursement for attorney fees incurred due to the wrongful conduct of a broker is subject to a full offset for any **excess benefit derived** by the client from the client/broker relationship. Thus, due to the offset, the broker is left owing nothing to the seller. [**Heckert** v. **MacDonald** (1989) 208 CA3d 832]

Other court-created rights to attorney fees

Attorney fees can also be recovered as part of an action or actions against an individual or entity involving all similarly situated persons, called a *class action*, by such individuals as tenants, borrowers, insureds, buyers, clients, etc.

Legal theories to collect attorney fees in **class action** cases include:

- *common fund* recovery for numerous injured parties;
- *substantial benefit* conferred on a group; and
- benefits conferred on a broad class of people involving a matter of strong *public policy*.

Under the **common fund** theory, the person initiating an action must obtain a judgment which benefits a group of persons, such as multiple tenants of a landlord.

In the interest of fairness, the tenant suing and obtaining a money judgment on behalf of himself and all other tenants is entitled to have his attorney fees paid out of the "fund" of monies received from the landlord. [**Quinn** v. **State** (1975) 15 C3d 162]

Consider a city which establishes an assessment district to improve streets. A citizen's group sues the city to prepare an environmental impact report (EIR) before the work can be started.

The citizen's group prevails since an EIR is required as the project substantially affects the environment.

Is the citizen's group entitled to attorney fees from the city?

Yes! The EIR **substantially benefitted** a large group of people and is an important interpretation of environmental law. [**Friends of "B" Street** v. **City of Hayward** (1980) 106 CA3d 988]

Finally, when a party sues and obtains a judgment which affects a large group of people involving a matter of strong **public policy**, the party suing recovers his attorney fees.

For example, a citizen's group enters a shopping center to obtain signatures on a statewide political issue. The owner of the shopping center prohibits the citizen's group from entering the premises.

The citizen's group sues the owner, claiming there was a violation of their First Amendment rights to free speech under the California Constitution. The citizen's group prevails and demands their attorney fees.

The shopping center owner claims no contract or statute entitles the citizen's group to be paid their attorney fees.

The citizen's group claims the case is of such importance to the whole of society that it is a matter of public policy and their attorney fees must be paid. [CCP §1021.5]

Is the citizen's group entitled to have their attorney fees paid by the shopping center owner?

Yes! The citizen's group's case sets strong public policy since it **benefitted the public** as a whole, as if the Attorney General for the State of California had brought the suit on behalf of the people. Thus, the citizen's group is entitled to recover their attorney fees. [**Press** v. **Lucky Stores, Inc.** (1983) 34 C3d 311]

A private citizen who is awarded attorney fees in a public policy case is called a *private attorney general*. [**Serrano** v. **Priest** (1977) 20 C3d 25]

Chapter 53 Retaining a real estate attorney

This chapter reviews the process for locating, interviewing and retaining an attorney to advise and render services in real estate disputes confronting brokers.

Choosing the right one

A broker is faced with a dispute arising out of a real estate transaction and requiring advice from an attorney with legal expertise in the analysis and resolution of real estate conflicts.

The broker has never sought out the professional advice of an attorney and does not know how to go about locating or selecting a qualified one.

What steps should the broker take to select a competent attorney? What law office procedure should he look for when first meeting with an attorney? What can he expect to encounter when retaining an attorney?

These questions are reviewed with suggestions and activities to be considered when seeking out and comparing the services of an attorney who specializes in real estate related disputes.

Selecting an attorney

To initiate the attorney **selection process**, the broker should talk to several active real estate brokers in the location of the real estate which would be involved in any litigation. The brokers should be asked for the names of three or four real estate attorneys they are familiar with and feel confident referring someone to for advice on real estate and agency matters, especially of the type confronting the broker.

The broker should further inquire into the different areas of real estate law each attorney appears to be engaged in, the types of cases they handle and the competence demonstrated by the attorney as observed by the brokers he contacts. The recurrence of the name of one attorney who is consistently recommended by the brokers contacted is generally a helpful indication of the most qualified attorney.

While attorney referral services and media advertising may be helpful in the initial selection stage, it is difficult to obtain objective recommendations or criticism from these typically biased sources.

It may even be necessary to locate an out-of-area attorney who specializes in the particular type of legal situation confronting the broker due to the sensitivity of local attorneys.

Regardless of locale, at least two or more attorneys should be selected and a phone or office conference should be arranged.

Before (and after) selecting an attorney, it is both proper and prudent for the broker to contact yet another attorney and hold a telephone conference as a "brainstorming session." This would provide a second opinion — and an additional or alternative advisor. The cost of conferencing with another attorney should be considered the premium paid for assurance the broker and his selected attorney are on the right track, called *risk reduction*.

A client's expectations

When meeting with an attorney, the broker should consider many aspects of the attorney's law office, including:

- the compatibility of the attorney's personality with his own;
- the attorney's conversational skills;
- the efficiency and professionalism of the attorney's work habits;
- the law office's appearance (for example, does it appear organized and well equipped?);
- the courtesy, productivity and helpfulness of the secretarial staff; and
- the competency of the attorney's law clerks or legal assistants to follow up on fact investigation, legal research, calendaring of events and related details.

The initial conference

During the initial conference with the selected attorney, the broker will discuss his real estate dispute as well as interview the attorney. This contact is the initial step to determine whether or not the broker feels this attorney is the best one for him to retain.

Relevant topics which should be discussed during the initial interview include:

- the attorney's professional background and the types of legal disputes which make up his practice;
- the attorney's previous experience with cases similar to the broker's;
- whether his practice regularly calls for his appearance in the court which will hear the broker's case;
- the attorney's initial grasp and assessment of the facts and laws controlling the case;
- the outlook or probability of prevailing in the case;
- the different procedural stages, including negotiations, filing, discovery, trial and possible appeal;
- whether the dispute is covered by any insurance policies held by the broker;
- the potential liability exposure on an adverse result of the litigation;
- whether the prevailing party can collect his attorney fees from the other party;
- the attorney's hourly fee and required **retainer deposit**;
- the estimated cost of handling the various stages in the resolution of the dispute; and
- the tax reporting permitted for the payment of the attorney fees.

At the same time, the attorney will also be deciding whether or not he wants to represent the broker.

Additionally, bearing on the broker's decision to retain the attorney are factors including:

- the attorney's own knowledge and experience with this particular type of case, and his rapport with the broker;
- whether or not, and why, the attorney believes he can obtain a favorable result for the broker; and
- whether the attorney has a conflict based on his other cases and clients.

The broker will typically be billed for this initial consultation on a per hour basis.

Attorneys' hourly rates generally range from $150 to $400 per hour, depending on their location and expertise. Any time spent counseling with the attorney will cost the broker money.

The broker must also determine whether the attorney will handle the case himself or delegate the analysis and decision-making process to a subordinate or partner.

If delegated, to whom and how closely will the attorney supervise the handling of the case?

The broker also needs to interview any associate attorney who will work on or actually handle his case. A prudent broker will include any associate attorney in the conference to avoid double billing.

The broker must be certain the attorney or associate he is going to employ has the broker's best interests in mind.

An attorney has the basic duty to respond promptly to any status inquiries by the broker and keep the broker reasonably well informed, monthly if possible, on matters relating to the case. [Calif. Business and Professions Code §6068(m)]

If the attorney interviewed is not retained to represent the broker, the attorney still has the duty to maintain confidentiality of the information exchanged between him and the broker. [Bus & P C §6068(e)]

Retainer agreements

Once an attorney has been chosen, the broker will be asked by the attorney to enter into a *retainer agreement* employing the attorney. The attorney has a statutory right to collect a fee for his legal services. [Calif. Code of Civil Procedure §1021]

The attorney should fully explain the amount of fees or basis for their computation before the fee agreement is signed by the broker. To be enforceable, fee agreements for attorney services must be in writing when it is known the attorney fees will exceed $1,000. [Bus & P C §6148(a)]

Thus, written **retainer agreements** must contain:

- the hourly rate and other rates, fees and applicable charges;
- the nature of the services to be provided; and
- the respective responsibilities of the attorney and broker in performance of the retainer agreement. [Bus & P C §6148(a)(1-3)]

All billings for services must be itemized by naming the activity performed, clearly state the amount due and contain the hourly rate or basis of calculation used to determine the fees. [Bus & P C §6148(b)]

If a *contingency fee* agreement is negotiated, the agreement must be in writing and contain:

- a statement of the **contingency fee** rate;
- a statement addressing how disbursements and costs incurred in connection with prosecuting or settling the case will affect the amount of the contingency fee and the broker's recovery;
- a statement addressing what extent, if any, the broker could be required to pay attorney fees for related matters not covered in the fee agreement; and
- a statement the fee is negotiable and not set by law. [Bus & P C §6147(a)(1-4)]

A duplicate copy of the contingency fee agreement signed by the attorney and broker must be given to the broker. Failure to provide this information will render the retainer agreement voidable at the option of the broker. [Bus & P C §6147(b)]

Later, if the broker has grounds and chooses to void the contingency fee agreement, the attorney will be entitled to collect a reasonable fee from the broker based on the time spent on the case. [Bus & P C §§6147(b), 6148(c)]

The retainer agreement can also be signed by and given to a representative of the broker, such as his office manager. [Bus & P C §6147(a)]

Written fee agreements are confidential contracts between the attorney and his client, in this example the broker. [Bus & P C §6149]

Deductibility of legal fees

Deductibility of legal fees for tax reporting is determined by the activity causing the expense. If not deductible, the legal fees are either **personal losses** or a **capital investment** added to the cost basis of the property involved.

Legal fees fall into four federal tax reporting categories:

- personal expenses;
- business expenses;
- real estate rental (passive) expenses; or
- investment portfolio expenses.

Legal fees incurred for consultation on a broker's business-related matter are fully deductible as an expense of earning brokerage fees, his trade for which he holds a broker's license.

Legal fees incurred in the management, conservation or maintenance of income-producing real estate — rentals — or for the production or collection of rents, are **deductible** from rental income, a passive income category activity, as an expense. [Internal Revenue Code §212]

However, legal fees incurred in connection with zoning battles, title defenses, condemnation or acquisition must be *capitalized*, not expended. These expenditures are added to the property's basis as they are considered **capital expenditures**, not operating costs. [**Soelling** v. **Commissioner** 70 TC 1052]

Legal expenses incurred to preserve ownership or defend title to an owner's personal residence are **nondeductible** personal expenses.

When employing an attorney, it is prudent for the broker to ask for his advice on the tax deductibility of his fees and, in contingency cases, the reporting of the attorney's share of any recovery.

Itemized billings

The broker should ask for and review a typical or prototypical billing statement used by the attorney.

The billing statement should be itemized, describing each legal activity or service provided by the attorney or his staff, the date the service was performed, the time spent rendering the service and the fee charged or the cost of each item.

The statement should also state the amount due and the hourly rate or other basis for calculating the fees. [Bus & P C §6148(b)]

Should the broker request a billing at any time, the attorney must provide one within ten days following the request. [Bus & P C §6148(b)]

The broker is entitled to receive invoices at intervals of no less than 30 days following his initial request for a billing statement. [Bus & P C §6148(b)]

The attorney's failure to meet these requirements will render the fee agreement voidable at the option of the broker. However, if the broker elects to void the retainer agreement, the attorney will be entitled to collect a reasonable fee. [Bus & P C §6148(c)]

Other factors influencing selection

Additional factors the broker should consider before selecting an attorney to represent him include:

- the attorney's familiarity with real estate law and how up to date he is on any statutory, case law and regulatory changes;
- if the attorney will review the file on a monthly or other periodic basis;
- if the attorney will automatically provide the broker with copies of all correspondence, documents and papers related to the case, and at what cost;
- if the attorney will consult with the broker on any substantial issues which may arise before he makes a decision or takes action; and
- if the attorney will review insurance policies (i.e., homeowner's policies, business insurance, errors and omissions insurance) to determine if legal fees are covered.

If the dispute is covered by insurance, the insurance carrier may reserve its right to choose the broker's attorney. However, in some circumstances involving the insurance company's issuance of a reservation of rights, the broker is allowed to select his own attorney in addition to the attorney selected by the insurance carrier.

Appendix A

The following represents sections of the Commissioner's Ethics and Professional Conduct Code and the Fair Employment and Housing Acts prohibiting discrimination in housing and real estate brokerage.

DRE — Anti-discrimination statutes

DRE Regulation 2780
Discriminatory Conduct as the Basis for Disciplinary Action

Prohibited discriminatory conduct by a real estate licensee based upon race, color, sex, religion, ancestry, physical handicap, marital status or national origin includes, but is not limited to, the following:

(a) Refusing to neotiate for the sale, rental or financing of the purchase of real property or otherwise making unavailable or denying real property to any person because of such person's race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

(b) Refusing or failing to show, rent, sell or finance the purchase of real property to any person or refusing or failing to provide or volunteer information to any person about real property, or channeling or steering any person away from real property, because of that person's race, color, sex, religion, ancestry, physical handicap, marital status or national origin or because of the racial, religious, or ethnic composition of any occupants of the area in which the real property is located.

(c) Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin against any person in the sale or purchase or negotiation or solicitation of the sale or purchase or the collection of payment or the performance of services in connection with contracts for the sale of real property or in connection with loans secured directly or collaterally by liens on real property or on a business opportunity.

(d) Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin against any person in the terms, conditions or privileges of sale, rental or financing of the purchase of real property.

(e) Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin against any person in providing services or facilities in connection with the sale, rental or financing of the purchase of real property, including but not limited to: processing applications differently, referring prospects to other licensees because of the prospects' race, color, sex, religion, ancestry, physical handicap, marital status or national origin, using with discriminatory intent or effect, codes or other means of identifying minority prospects, or assigning real estate licensees on the basis of a prospective client's race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

(f) Representing to any person because of his or her race, color, sex, religion, ancestry, physical handicap, marital status or national origin that real property is not available for inspection, sale or rental when such real property is in fact available.

(g) Processing an application more slowly or otherwise acting to delay, hinder or avoid the sale, rental or financing of the purchase of real property on account of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of a potential owner or occupant.

(h) Making any effort to encourage discrimination against persons because of their race, color, sex, religion, ancestry, physical handicap, marital status or national origin in the showing, sale, lease or financing of the purchase of real property.

(i) Refusing or failing to cooperate with or refusing or failing to assist another real estate licensee in negotiating the sale, rental or financing of the purchase of real property because of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of any prospective purchaser or tenant.

(j) Making any effort to obstruct, retard or discourage the purchase, lease or financing of the purchase of real property by persons whose race, color, sex, religion, ancestry, physical handicap, marital status or national origin differs from that of the majority of persons presently residing in a structural improvement to real property or in an area in which the real property is located.

(k) Performing any acts, making any notation, asking any questions or making or circulating any written or oral statement which when taken in context, expresses or implies a limitation, preference or discrimination based upon race, color, sex, religion, ancestry, physical handicap, marital status or national origin; provided, however, that nothing herein shall limit the administering of forms or the making of a notation required by a federal, state or local agency for data collection or civil rights enforcement purposes; or in the case of a physically handicapped person, making notation, asking questions or circulating any written or oral statement in order to serve the needs of such a person.

(l) Making any effort to coerce, intimidate, threaten or interfere with any person in the exercise or enjoyment of, or on account of, such person's having exercised or enjoyed, or on account of such person's having aided or encouraged any other person in the exercise or enjoyment of any right granted or protected by a federal or state law, including but not limited to: assisting in any effort to coerce any person because of his or her race, color, sex, religion, ancestry, physical handicap, marital status or national origin to move from, or to not move into, a particular area; punishing or penalizing real estate licensees for their refusal to discriminate in the sale or rental of housing because of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of a prospective purchaser or lessee; or evicting or taking other retaliatory action against any person for having filed a fair housing complaint or for having undertaken other lawful efforts to promote fair housing.

(m) Soliciting of sales, rentals or listings of real estate from any person, but not from another person within the same area because of differences in the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of such persons.

(n) Discriminating because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin in informing persons of the existence of waiting lists or other procedures with respect to the future availability of real property for purchase or lease.

(o) Making any effort to discourage or prevent the rental, sale or financing of the purchase of real property because of the presence or absence of occupants of a particular race, color, sex, religion, ancestry, physical handicap, marital status or national origin, or on the basis of the future presence

or absence of a particular race, color, sex, religion, ancestry, physical handicap, marital status or national origin, whether actual, alleged or implied.

(p) Making any effort to discourage or prevent any person from renting, purchasing or financing the purchase of real property through any representations of actual or alleged community opposition based upon race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

(q) Providing information or advice to any person concerning the desirability of particular real property or a particular residential area(s) which is different from information or advice given to any other person with respect to the same property or area because of differences in the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of such persons.

(r) Refusing to accept a rental or sales listing or application for financing of the purchase of real property because of the owner's race, color, sex, religion, ancestry, physical handicap, marital status or national origin or because of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of any of the occupants in the area in which the real property is located.

(s) Entering into an agreement, or carrying out any instructions of another, explicit or understood, not to show, lease, sell or finance the purchase of real property because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

(t) Making, printing or publishing, or causing to be made, printed or published, any notice, statement or advertisement concerning the sale, rental or financing of the purchase of real property that indicates any preference, limitation or discrimination because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin, or any intention to make such preference, limitation or discrimination.

(u) Using any word, phrases, sentences, descriptions or visual aids in any notice, statement or advertisement describing real property or the area in which real property is located which indicates any preference, limitation or discrimination because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

(v) Selectively using, placing or designing any notice, statement or advertisement having to do with the sale, rental or financing of the purchase of real property in such a manner as to cause or increase discrimination by restricting or enhancing the exposure or appeal to persons of a particular race, color, sex, ancestry, physical handicap, marital status or national origin. This subdivision does not limit in any way the use of an affirmative marketing program designed to attract persons of a particular race, color, sex, religion, ancestry, physical handicap, marital status or national origin who would not otherwise be attracted to the real property or to the area.

(w) Quoting or charging a price, rent or cleaning or security deposit for a particular real property to any person which is different from the price, rent or security deposit quoted or charged to any other person because of differences in the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of such persons.

(x) Discriminating against any person because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin in performing any acts in connection with the making of any determination of financial ability or in the processing of any application for the financing or refinancing of real property.

(y) Advising a person of the price or value of real property on the basis of factors related to the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of residents of an area or of residents or potential residents of the area in which the property is located.

(z) Discriminating in the treatment of, or services provided to, occupants of any real property in the course of providing management services for the real property because of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of said occupants.

(aa) Discriminating against the owners or occupants of real property because of the race, color, sex, religion, ancestry, physical handicap, marital status or national origin of their guests, visitors or invitees.

(bb) Making any effort to instruct or encourage, expressly or impliedly, by either words or acts, licensees or their employees or other agents to engage in any discriminatory act in violation of a federal or state fair housing law.

(cc) Establishing or implementing rules that have the effect of limiting the opportunity for any person because of his or her race, color, sex, religion, ancestry, physical handicap, marital status or national origin to secure real property through a multiple listing or other real estate service.

(aa) Assisting or aiding in any way, any person in the sale, rental or financing of the purchase of real property where there are reasonable grounds to believe that such person intends to discriminate because of race, color, sex, religion, ancestry, physical handicap, marital status or national origin.

Calif. Business and Professions Code §125.6
Refusal to perform licensed activity

Every person who holds a license under the provisions of this code is subject to disciplinary action under the disciplinary provisions of this code applicable to such person if, because of the applicant's race, color, sex, religion, ancestry, disability, marital status, or national origin, he or she refuses to perform the licensed activity or aids or incites the refusal to perform such licensed activity by another licensee, or if, because of the applicant's race, color, sex, religion, ancestry, disability, marital status, or national origin, he or she makes any discrimination, or restriction in the performance of the licensed activity.

Nothing in this section requires a person licensed pursuant to Division 2 (commencing with Section 500) to permit an individual to participate in, or benefit from, the licensed activity of the licensee where that individual poses a direct threat to the health or safety of others. For this purpose, the term "direct threat" means a significant risk to the health or safety of others that cannot be eliminated by a modification of policies, practices, or procedures or by the provision of auxiliary aids and services.

"Disability" means any of the following with respect to an individual:

(a) A physical or mental impairment that substantially limits one or more of the major life activities of the individual.

(b) A record of such an impairment.

(c) Being regarded as having such an impairment.

Calif. Business and Professions Code §10177
Grounds for suspension or revocation of a real estate license

The commissioner may suspend or revoke the license of any real estate licensee, or may deny the issuance of a license to an applicant, who has done any of the following:

(1) Solicited or induced the sale, lease or the listing for sale or lease, of residential property on the ground, wholly or in part, of loss of value, increase in crime, or decline of the quality of the schools, due to the present or prospective entry into the neighborhood of a person or persons of another race, color, religion, ancestry or national origin.

Calif. Civil Code §51
Unruh Civil Rights Act

All persons within the jurisdiction of this state are free and equal, and no matter what their sex, race, color, religion, ancestry, national origin, or disability are entitled to the full and equal accommodations, advantages, facilities, privileges, or services in all business establishments of every kind whatsoever.

A violation of the right of any individual under the Americans with Disabilities Act of 1990 (Public Law 101-336) shall also constitute a violation of this section.

Calif. Civil Code §54.1
Unlawful discrimination due to physical disability

(b)(1) Individuals with disabilities shall be entitled to full and equal access, as other members of the general public, to all housing accommodations offer for rent, lease, or compensation in this state subject to the conditions and limitations established by law, or state or federal regulation, and applicable alike to all persons.

(6)(A) It shall be deemed a denial of equal access to housing accommodations within the meaning of this subdivision for any person, firm, or corporation to refuse to lease or rent housing accommodations to an individual who is blind or visually impaired on the basis that the individual uses the services of a guide dog, an individual who is deaf or hearing impaired on the basis that the individual uses the services of a signal dog, or to an individual with any other disability on the basis that the individual uses the services of a service dog, or to refuse to permit such an individual who is blind or visually impaired to keep a guide dog, an individual who is deaf or hearing impaired to keep a signal dog, or an individual with any other disability to keep a service dog on the premises.

Calif. Government Code §12940
Unlawful employment practices

It shall be an unlawful employment practice, unless based upon a bona fide occupational qualification, or, except where based upon applicable security regulations established by the United States or the State of California:

(g) For an employer, because of the race, religious creed, color, national origin, ancestry, physical handicap, medical condition, marital status, or sex of any person, to refuse to hire or employ the person or to refuse to select the person for a training program leading to employment, or to bar or to discharge the person from employment or from a training program leading to employment,

or to discriminate against the person in compensation or in terms, conditions or privileges of employment.

(c) For any person to discriminate against any person in the selection or training of that person in any apprenticeship training program or any other training program leading to employment because of the race, religious creed, color, national origin, ancestry, physical handicap, medical condition, marital status, or sex of the person discriminated against.

(d) For any employer or employment agency, unless specifically acting in accordance with federal equal employment opportunity guidelines and regulations approved by the commission, to print or circulate or cause to be printed or circulated any publication, or to make any non-job-related inquiry, either verbal or through use of an application form, which expresses, directly or indirectly, any limitation, specification, or discrimination as to race, religious creed, color, national origin, ancestry, physical handicap, medical condition, marital status, or sex, or any intent to make that limitation, specification or discrimination.

(f) For any employer, labor organization, employment agency, or person to discharge, expel, or otherwise discriminate against any person because the person has opposed any practices forbidden under this part or because the person has filed a complaint, testified, or assisted in any proceeding under this part.

(h) For an employer, labor organization, employment agency, apprenticeship training program or any training program leading to employment, or any other person, because of race, religious creed, color, national origin, ancestry, physical handicap, medical condition, marital status, sex, or age, to harass an employee or applicant.

Calif. Government Code §12941

(i) It is an unlawful employment practice for an employer to refuse to hire or employ, or to discharge, dismiss, reduce, suspend, or demote, any individual over the age of 40 on the ground of age, except in cases where the law compels or provides for such action.

Calif. Government Code §12955
Housing discrimination

It shall be unlawful:

(j) For the owner of any housing accommodation to discriminate against any person because of the race, color, religion, sex, marital status, national origin, or ancestry of such person.

(k) For the owner of any housing accommodation to make or to cause to be made any written or oral inquiry concerning the race, color, religion, sex, marital status, national origin, or ancestry of any person seeking to purchase, rent or lease any housing accommodation.

(f) For any owner of housing accommodations to harass, evict, or otherwise discriminate against any person in the sale or rental of housing accommodations when the owner's dominant purpose is retaliation against a person who has opposed practices unlawful under this section, informed law enforcement agencies of practices believed unlawful under this section, or has testified or assisted in any proceeding under this part.

(l) To discriminate through public or private land use practices, decisions, and authorizations because of race, color, religion, sex, familial status, marital status, disability, national origin, or ancestry.

Discrimination includes, but is not limited to, restrictive covenants, zoning laws, denials of use permits, and other actions authorized under the Planning and Zoning Law (Title 7 (commencing with Section 65000)), that make housing opportunities unavailable.

Calif. Health and Safety Code §35810
Unlawful discrimination by lenders

(m) No financial institution shall discriminate in the availability of, or in the provision of, financial assistance for the purpose of purchasing, constructing, rehabilitating, improving, or refinancing housing accommodations due, in whole or in part, to the consideration of conditions, characteristics, or trends in the neighborhood or geographic area surrounding the housing accommodation, unless the financial institution can demonstrate that consideration of these conditions in the particular case is required to avoid an unsafe and unsound business practice.

(n) Nothing in this section shall be construed to prohibit any financial institution from establishing a special loan program designed to engender equality in housing in accordance with the federal Fair Housing Act (42 U.S.C. Secs. 3601 et seq.) or similar state and federal laws, so long as the program promotes housing opportunities in ethnic minority or low-income neighborhoods.

Calif. Health and Safety Code §35811

No financial institution shall discriminate in the availability of, or in the provision of, financial assistance for the purpose of purchasing, constructing, rehabilitating, improving or refinancing housing accommodations due, in whole or in part, to the consideration of race, color, religion, sex, marital status, national origin, or ancestry.

Calif. Health and Safety Code §35812

No financial institution shall consider the racial, ethnic, religious, or national origin composition of a neighborhood or geographic area surrounding a housing accommodation or whether or not such composition is undergoing change, or is expected to undergo change, in appraising a housing accommodation or in determining whether or not, and under what terms and conditions, to provide financial assistance for the purpose of purchasing, constructing, rehabilitating, improving, or refinancing a housing accommodation. No financial institution shall utilize appraisal practices that are inconsistent with the provisions of this part.

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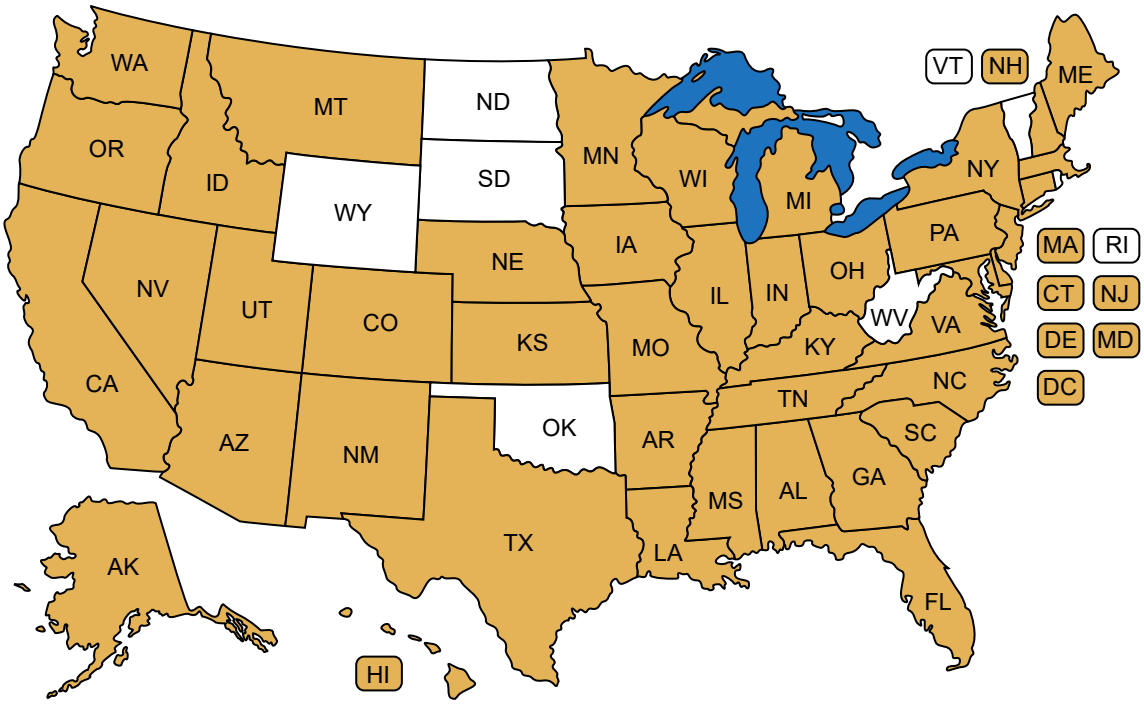

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Title America

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Title Clearinghouse of Jacksonville

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HOME AND FIELD POCKET GUIDE

Shirley A. Jones, EMT-P, RN

- Basic Safety
- CPR and Choking Guidelines
- Medical Emergencies
- Natural Disasters
- Outdoor Survival Skills
- Poisons, Bites, and Stings
- First Aid, Survival, and Disaster Kit
- Pet CPR & First Aid

EMERGENCY INFORMATION CONTACTS

American Red Cross (United States)
Phone: 800-733-2767
Website: www.redcross.org

International Committee of the Red Cross
Website: www.icrc.org

Centers for Disease Control and Prevention (United States)
Phone: 800-232-4636
Website: www.cdc.gov

Centers for Disease Control and Prevention (International) Travelers' Health Topics (safety, vaccinations, children, pets)
Phone: 800-232-4636
Website: www.cdc.gov/travel

Department of Homeland Security (United States)
Phone: 202-282-8000
Website: www.dhs.gov

Department of Health and Human Services (United States)
Phone: 877-696-6775
Website: www.hhs.gov

Divers Alert Network (International)
Phone: 800-446-2671
Website: www.diversalertnetwork.org

Federal Emergency Management Agency (United States)
Phone: 800-621-3362
Website: www.fema.gov

Food and Drug Administration (United States)
Phone: 888-463-6332
Website: www.fda.gov

Geological Survey (United States)
Phone: 888-275-8747
Website: www.usgs.gov

Humane Society of the United States
Phone: 202-452-1100
Website: www.hsus.org

National Weather Service (United States)
Website: www.weather.gov

Poison Control Center (United States)
Phone: 800-222-1222
Website: www.aapcc.org

Animal Poison Control Center (United States)
Phone: 888-426-4435
Website: www.aspca.org/pet-care/poison-control/

World Health Organization (International)
Website: www.who.int

United States Department of Agriculture
Website: www.usda.gov

2182_FM_i-v.qxd 8/17/11 3:12 PM Page i

First Aid, Survival, and CPR

HOME AND FIELD POCKET GUIDE

Shirley A. Jones, MS Ed, MHA, EMT-P, RN

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2182_FM_i-v.qxd 8/17/11 3:12 PM Page iv

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2182_Tab01_001-015.qxd 8/18/11 11:50 AM Page 1

Tab 1: Basic Safety

Your *First Aid, Survival, and CPR: Home and Field Pocket Guide* is designed to help you respond effectively in an emergency. Keep a copy with you at all times–in your first aid, survival, or disaster kit; in your home, school, and office; in your car, boat, recreational vehicle, hiking pack, and travel gear. Be proactive and take a first aid and cardiopulmonary resuscitation (CPR) course. Be sure to keep your training up to date.

In this tab on basic safety, you'll learn how to recognize and act in an emergency, how to avoid disease and injury, and how to assemble first aid, survival, and disaster kits.

HOW TO RECOGNIZE EMERGENCIES

Emergencies are unexpected events that require urgent action. They can affect anyone, anywhere, at any time. Here's how to recognize an emergency:

Unusual Personal Appearances or Behaviors

- Sudden collapse or unconsciousness
- Slurred speech, confusion, or drowsiness
- Trouble breathing, wheezing, and coughing
- Clutching the chest or throat
- Excessive sweating or inability to sweat in a hot environment
- Inability to move a body part
- Uncharacteristic skin color
- Nausea and vomiting

Noises

- Screaming, yelling, moaning, or calling for help
- Breaking glass, crashing metal, or screeching tires
- Sudden loud or unidentifiable sounds
- Sound of structural collapse or falling ladders
- An infant or child crying for unexplained reasons

Odors

- Unusually strong odors
- Unrecognizable odors
- Inappropriate odors
- The smell of smoke

Unusual Sights

- Broken glass, fallen boxes, or overturned chair
- Vehicle run off the road or twisted bicycle
- Burning pot in the kitchen or smoke from the oven
- Spilled medicine container
- Fallen electrical lines or trees
- Sparks, smoke, or fire

HOW TO ACT IN AN EMERGENCY

In any emergency, it's essential to stay calm if you are to help the individuals involved. Here are the actions to take:

- **Ensure that the scene is safe.** Make sure there are no immediate dangers such as fallen power lines, floodwaters, high tides, hazardous materials, or traffic.
- **Check victims for life-threatening conditions.** Common ones are unconsciousness, difficulty breathing, or severe bleeding.
- **Activate the Emergency Medical Services system.** Call 911 or another designated emergency phone number in your country or region and begin CPR if necessary. If you are not trained in CPR, see Tab 2: CPR, or ask for instructions from the emergency dispatcher.
- Stop any bleeding and treat for shock (see Tab 4: Injuries and Wounds).
- Check for head, neck, or spinal injuries. Don't move the person unless it's necessary (see Tab 4: Injuries and Wounds).
- Look for medical identification tags or prescription medications that may indicate special health problems.

2182_Tab01_001-015.qxd 8/18/11 11:50 AM Page 3

- Don't give fluids unless the person is conscious and alert. An unconscious person may not be able to swallow and could aspirate (breathe in) the fluids.
- Stay calm. Continue to aid the person until medical help arrives.

HOW TO AVOID DISEASE

Prevent Disease Transmission

- Avoid contact with blood and other body fluids. Protect yourself with barriers such as disposable gloves. These should be carried in your first aid kit.
- Use protective breathing barriers, such as a CPR face mask or face shield, if you need to give rescue breaths during CPR (see Tab 2: CPR).
- If you have any cuts, sores, scrapes, or scratches, cover them with a bandage before giving first aid.
- Use proper hand washing before and after giving first aid.

Wash Your Hands

Good hand hygiene is the single most important action you can take to prevent the spread of infection. Hand washing doesn't take much time or effort and is a proven way to kill harmful bacteria and wash off dirt and grime. Adopting this simple habit can play a major role in protecting your health.

Effective Hand Washing With Soap and Water

1. Wet your hands with warm running water.
2. Use liquid soap or clean bar soap. Lather well.
3. Rub your hands vigorously together for at least 20 seconds. Scrub all surfaces, including the backs of your hands, your wrists, between your fingers, and under your fingernails.
4. Rinse well.
5. Dry your hands with a clean or disposable towel.
6. Use a towel to turn off the faucet. This prevents germs from getting on your clean hands.

2182_Tab01_001-015.qxd 8/18/11 11:50 AM Page 4

SAFETY TIP—To get children into the habit, teach by example. Wash your hands with your children and supervise their hand washing. Tell them to wash their hands for as long as it takes them to sing their ABCs or to sing the "Happy Birthday" song twice. This works especially well with younger children, who may rush when washing their hands.

PROPER HAND WASHING TECHNIQUE

Step 1. Wet hands.

Step 2. Soap up.

Step 3. Scrub and rub for 20 seconds.

Step 4. Rinse.

5

Step 5. Dry.

Step 6. Turn off water.

SAFETY TIP—Antibacterial hand gels and wipes can be effective germ fighters when you don't have access to hand washing facilities. You can keep these gels and wipes in your car, handbag, gym bag, office drawer, or first aid kit. Under normal conditions a hand sanitizer complements, but doesn't substitute for, proper hand washing with soap and water.

HOW TO AVOID INJURY

Prevent Injuries Away From Home

- **Wear your seat belt** every time you get in a car. Teach your children to do the same. Children under 13 should ride in the backseat. Use car seats for babies and small children.
- **Never drink and drive** and don't ride in a car with a drunken driver. Don't drive if you are tired or taking a medication that makes you drowsy.
- **Wear a helmet** and other protective gear whenever you're bicycling, motorcycling, kayaking, horseback riding, skiing, snowboarding, or rock climbing.

- **Do not let children play near water** without a responsible adult watching them.
- **Wear safety goggles** whenever you use power tools or work with chemicals.
- **Be prepared** by keeping a first aid, survival, and disaster supply kit in your car and workplace.

Keep a Safer Home

- Maintain a **fall-proof home.** Keep stairs and walkways clear of clutter. Use bright lighting inside and outside. Make sure carpets are secured firmly to the floor; use a nonskid pad under a throw rug. Remove snow and ice from sidewalks and porches.
- Use a **step stool** to reach highly placed objects. Don't stand on chairs or countertops. Take care when you're high on a ladder or on the roof. Don't take chances.
- If you have young children or pets, plug **bare electrical sockets** with plastic inserts.
- Keep **electrical cords** out of reach of children and pets. Replace frayed electrical cords. Don't overload extension cords or outlets; this may lead to fire.
- Install **smoke and carbon monoxide detectors.** Check the batteries once a month and replace them once a year. Keep a working **fire extinguisher** in your home.
- Have an **emergency plan in case of fire.** Practice the plan with your family or group. Don't forget your pets.
- Keep **appliances** away from water. Turn off or unplug appliances when you're done with them. Read and follow the safety instructions that came with your appliances.
- Have your **heating and cooling system** checked once a year. Keep fireplaces and stoves in working order.
- Use a mask and gloves and follow the instructions on the label when you work with **harsh chemicals** such as pesticides, fertilizers, and strong cleaning products.

2182_Tab01_001-015.qxd 8/18/11 11:50 AM Page 7

- Follow the manufacturer's precautions when using **flammable liquids** such as gasoline or kerosene.
- Keep **toxic substances**, such as medications, vitamins, food, cleaning products, and bug killer, out of reach of children and pets. Keep products in their original containers. Never store poisons in food containers. Use childproof latches on your cabinets.
- **Be prepared** by keeping first aid, survival, and disaster supply kits in your home.

SAFETY TIP—Never douse an object with gasoline to start a fire. Once you light the match to toss at the gasoline-soaked object–whether a pile of leaves, wood, charcoal, or a hornet's nest–the fumes from the gasoline will burst into flames and cause life-threatening burns. Once a campfire or charcoal fire is lit, never pour gasoline on it. The fire will travel back up to the portable container and cause a potentially fatal explosion.

SAFETY TIP—Never smoke near flammable liquids, including gasoline and kerosene. The vapor from flammable liquids will burst into flames. This is a common but preventable cause of accidental burns.

HOW TO DESIGN FIRST AID, SURVIVAL, AND DISASTER SUPPLY KITS

In an emergency, the right equipment will give you the edge you need to treat any injuries and, in some cases, to survive. When designing your kit, consider the following:

- Environmental extremes
- Duration of travel (or how long you'll use the kit)
- Distance from medical care and availability of rescue
- Number of persons the kit will need to support–include enough items for all the members of your family and/or group
- Weight and space limitations

2182_Tab01_001-015.qxd 8/18/11 11:50 AM Page 8

SAFETY TIP—Write in emergency phone numbers here:

Police: _____

Fire: _____

Hospital: _____

Doctor: _____

Dentist: _____

Veterinarian: _____

Power company: _____

Gas company: _____

Water company: _____

Telephone company: _____

Home: _____

Office: _____

School: _____

First Aid Kit

A **first aid kit** contains the items necessary to provide urgent care. A well-stocked first aid kit should be kept in your home, office, school, and vehicle or boat. It should be packed with your survival kit (pages 11–13) when you camp, hike, or are in a remote location.

Bandages and Wound Care

- ☐ Alcohol wipes
- ☐ Antibacterial hand gel or wipes
- ☐ Antibiotic ointment packets
- ☐ Antiseptic cream or wipes
- ☐ Antiseptic solution (e.g., hydrogen peroxide)
- ☐ Bandages, adhesive (assorted sizes)
- ☐ Bandages, triangular (36 × 36 × 51 inches [100 × 100 × 143 cm])
- ☐ Cold packs (instant cold compresses)
- ☐ Cotton balls
- ☐ Elastic roller bandage, 3 inches (7.6 cm) wide
- ☐ Elastic roller bandage, 6 inches (15.2 cm) wide

2182_Tab01_001-015.qxd 8/18/11 11:50 AM Page 9

- ☐ Eye pads
- ☐ Gauze roller bandage, 3 inches (7.6 cm) wide
- ☐ Gauze pads, 4 × 4 inches (10 cm × 10 cm) (sterile)
- ☐ Gauze pads, 5 × 9 inches (13 × 23 cm) (sterile)
- ☐ Gloves (latex or nonlatex)
- ☐ Iodine wipes
- ☐ Insect sting relief
- ☐ Moleskin: An adhesive pad used to prevent and treat blisters
- ☐ SAM (structural aluminum malleable) splint (built from a thin core of aluminum alloy and sandwiched between two layers of closed-cell foam and available in a roll or as a flat strip): A compact, light-weight splint designed for immobilizing bone and soft tissue injuries
- ☐ Steri-Strips: Adhesive strips that keep the edges of a wound together
- ☐ Sterile water to cleanse wound (unopened bottled water can substitute)
- ☐ Tape (adhesive)
- ☐ Vaseline petroleum jelly

Medical Equipment

- ☐ CPR face mask or face shield (breathing barrier with one-way valve)
- ☐ Eyewash
- ☐ Knife (pocket knife)
- ☐ Safety pins
- ☐ Scissors
- ☐ Shears (heavy-duty serrated scissors with a blunt end)
- ☐ Suction bulb (used in emergency childbirth to remove secretions from the newborn's nose and mouth)
- ☐ Syringe (30 mL): To flush eye, ear, or wound with water
- ☐ Thermometer (nonmercury/nonglass)
- ☐ Tweezers: For taking out splinters or ticks

Medications

- ☐ Acetaminophen (Tylenol): Relieves pain and reduces fever
- ☐ Antacid tablets (Rolaids, Tums): Relieve stomach indigestion
- ☐ Antihistamine (diphenhydramine [Benadryl]): Relieves sneezing, itchy and watery eyes from an allergy; also relieves itchiness from insect bites and stings and from poison ivy, oak, and sumac
- ☐ Antifungal cream or ointment
- ☐ Aspirin: Relieves pain and reduces fever and inflammation (redness and swelling)
- ☐ Calamine lotion: Anti-itching lotion treats mild sunburn, insect bites and stings, and rashes from poison ivy, oak, and sumac
- ☐ Cough suppressant
- ☐ Decongestant tablets
- ☐ EpiPen: Prescription medication (epinephrine) in an injectable form counteracts life-threatening allergic reactions
- ☐ Hydrocortisone (1%) cream or packet: Relieves minor skin irritations, itches, and rashes
- ☐ Ibuprofen (Motrin, Advil): Relieves pain and reduces fever and inflammation (redness and swelling)
- ☐ Laxative: Relieves constipation
- ☐ Loperamide (Imodium): Relieves diarrhea
- ☐ Motion sickness tablets (dimenhydrinate [Dramamine]): Relieve nausea, vomiting, or dizziness associated with motion sickness
- ☐ Nasal spray: Relieves symptoms of colds, stuffy nose, or blocked sinuses
- ☐ Prescription medications: Especially for asthma, heart disease, diabetes, or high blood pressure

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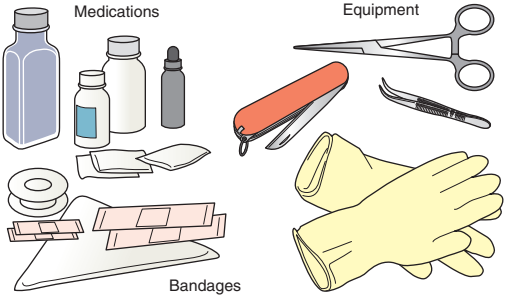


A well-stocked first aid kit.

SAFETY TIP—First aid, survival, and disaster supply kits should be checked regularly. Make sure flashlight and radio batteries work. Check expiration dates and replace any out-of-date contents. Include a copy of *First Aid, Survival, and CPR: Home and Field Pocket Guide* in every kit.

Survival Kit

A **survival kit** contains the items necessary to survive an unplanned night in the woods, in the desert, or at sea. If you're trapped by a natural disaster or if your car slides off the road in a snowstorm, it may be all that keeps you alive. It won't keep you safe, however, unless you've remembered to take it with you! Also, a survival kit doesn't substitute for a first aid kit; for your safety, bring them both along.

- ☐ Aluminum foil (heavy duty): A 24 × 24 inch (61 x 61 cm) piece can fold to 3 × 3 inches (7.6 × 7.6 cm) and is ideal for boiling water, cooking food, making a reflector for fire, and using as a signal mirror.

- Blanket (emergency space blanket): Strong and lightweight, about the size of your shirt pocket. It is coated on both sides with a heat-reflective metallic surface and offers basic protection from wind, cold, and rain.
- Bottled water: Enough to keep you hydrated during a hike or survival situation.
- Butane lighter: Be sure it is filled with lighter fluid.
- Compass: The arrow of the compass will always point north. It can help guide you north, south, east, and west.
- Flint: A durable form of quartz. When struck against steel (the back of a locked knife blade), flint generates sparks. Use it to ignite a survival fire.
- Flashlight and extra batteries.
- Fire starter (magnesium): A small, flat bar made of soft magnesium with a hard flint running along the edge. It is proven effective to start a fire even in wet conditions. The magnesium is scraped off the bar with a knife onto dry kindling. A scrape on the flint side sends a shower of sparks that ignite the magnesium.
- Food: Power Bar or other nonperishable energy food.
- Global positioning system (GPS): An electronic mapping system that shows your exact position on the Earth no matter where you are. Make sure you have spare batteries.
- Insect repellent: Protection from biting insects such as mosquitoes, ticks, and chiggers.
- Knife: A survival knife (with a 3–5 inch [7.6–12.7 cm] blade) is a good cutting tool for preparing food, spearing wild game, and using with a flint to spark a flame for a fire.
- Multifunction tool: This pocket-sized item contains a straight-edged knife, a serrated knife, and needle-nose pliers (good for fixing survival gear or removing a hook from a fish or your finger). Also included are screwdriver bits, a bottle opener, a scissors, a small saw, and two files. One file is for wood and softer metals; the other is diamond coated and can be used on harder metals.

2182_Tab01_001-015.qxd 8/18/11 11:50 AM Page 13

- ☐ Map: Kept in a plastic bag or laminate it to protect it from water.
- ☐ Matches (waterproof): Kept in a weather-tight plastic match safe. Replace them every 6 months or so because matches have a short shelf life.
- ☐ Plastic bag that seals shut (gallon or liter size): Holds water while you treat it with purification tablets.
- ☐ Radio: National Oceanic and Atmospheric Administration (NOAA) weather-band radio (United States).
- ☐ Signal mirror: Highly accurate mirror that reflects sunlight to help rescuers pinpoint your position.
- ☐ Sunscreen.
- ☐ Tube tent: Lightweight emergency shelter that sleeps two and is small enough to roll up in your pocket.
- ☐ Water purification tablets: Kills microbes to produce safe drinking water.
- ☐ Whistle: Can be used to signal for help over long distances.

Disaster Supply Kit

A **disaster supply kit** is a collection of essential items that members of a household need in the event of a disaster. You may be cut off from basic services such as electricity, gas, water, sewage treatment, or phones for days.

Keep enough supplies in your home or workplace kit to meet your needs for at least 3 days. Your disaster supply kit should also contain items you may need in an evacuation. Store all items in sturdy containers such as waterproof backpacks, duffle bags, or plastic bins. Adjust your kit to meet your own family or group needs and check it every 6 months to update supplies. A disaster supply kit is an adjunct to, not a substitute for, your first aid and survival kits. For more on preparing for natural disasters, see Tab 7: Natural Disasters.

- ☐ Three days' supply of clean water: Each person needs 1 gallon (or 4 liters) of water per day, half to drink and half to use for cooking and sanitation. The average person needs 2 quarts (2 liters) of

water daily, just for drinking. Reminder: 4 quarts equal 1 gallon, 1 quart equals 32 ounces, and 1 liter equals 1000 mL.

- ☐ Three-day supply, per person, of food that won't spoil.
- ☐ One change of clothing and footwear per person and one blanket or sleeping bag per person.
- ☐ Credit cards, cash or traveler's checks, and extra vehicle keys.
- ☐ Sanitation and hygiene items (moist towelettes and toilet paper).
- ☐ Important family or group documents: Keep these in a waterproof container. Make photocopies of health insurance cards, birth certificates, wills, driver's licenses, homeowner's insurance policy, bank account numbers, inventory of valuable household goods, Social Security cards, passports, immunization records, pet vaccination records, credit card information, and account numbers.
- ☐ Special-needs items: Prescription medications, contact lens solutions, and hearing aid batteries.
- ☐ Items for infants: Formula, diapers, bottles, and pacifiers.

HOW TO DESIGN A PET SAFETY KIT

After you've stocked yourself with supplies, it's time to take care of the pets who depend on you for their daily survival. Many of the supplies in your own first aid kit (pages 8–10) can be used to treat an injured pet. Your survival kit (pages 11–13) will also sustain your pet if you are lost or stranded at home together.

A pet safety kit includes a variety of pet-specific supplies to help keep your pet safe during an emergency. Store your pet safety kit in an easily transportable container. Supplies should include the following:

- ☐ Recent pictures of your pet (in the kit, in addition to carrying copies on your person)
- ☐ A spare collar, halter, and leash or lead rope
- ☐ Health records, including vaccination records showing that all of your pet's shots are current
- ☐ Medications
- ☐ Carrier or cage

2182_Tab01_001-015.qxd 8/18/11 11:50 AM Page 15

- ☐ Water and food bowls
- ☐ Three-day pet food supply
- ☐ Several gallons or liters of clean drinking water per pet, depending on size
- ☐ Manual can opener (not electric) to open canned pet food
- ☐ Waste disposal system: Newspapers, cat litter, scooper, bleach, and plastic garbage bags
- ☐ List of detailed, individualized pet care instructions
- ☐ Grooming supplies and toys
- ☐ Clean bedding
- ☐ Styptic powder or styptic pencil (to stop minor bleeding)
- ☐ Mild grease-cutting dishwashing liquid (to bathe animal after skin contamination)
- ☐ Emergency phone numbers (your veterinarian, nearby veterinary emergency clinic, Animal Poison Control)

Tab 2: CPR

CPR OVERVIEW

Every day around the world, CPR (also called cardiopulmonary resuscitation) is used to save lives. CPR has been used to save the lives of children who have swallowed something accidentally or gotten into a pool when they don't know how to swim, and even the lives of adults suffering from a heart attack.

What Is CPR?

Cardiopulmonary resuscitation is a lifesaving technique that is performed when a person's breathing or heart has stopped. The purpose of CPR is to move blood and therefore oxygen (which your body needs to survive) to the brain and heart. CPR involves three steps:

- Compressing the person's chest to keep the blood circulating.
- Opening the person's airway (the passageway between the nose/mouth and the lungs).
- Giving rescue breaths that fill the lungs with air.

Why Perform CPR?

- CPR is performed when a person's heart stops beating (a condition called cardiac arrest), to prevent brain damage and death. The heart may stop because of heart disease, a motor vehicle accident, drowning, or choking.
- Anyone who has lost consciousness may need CPR. Also, confusion, weakness, and chest pain may signal that cardiac arrest is about to occur and CPR may be needed.
- After the heart stops, even a few minutes' delay in starting CPR can mean the difference between life and death.
- Performing CPR supports the heart and brain with oxygen until medical help arrives.

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 17

How Can I Tell Whether CPR Is Needed?

If the person is conscious but cannot talk and appears to be choking, CPR is not appropriate. Instead, follow the instructions for choking on pages 29–36.

If the person appears to have lost consciousness:

- Ask, "Are you OK?" Call out loudly. The person may be asleep or hard of hearing.
- If the person answers, ask how you can help.
- If there is no answer, gently tap the person's shoulder.
- If there is still no response, begin the three steps of CPR. The general technique for each step is described next. See the step-by-step instructions for CPR for adults (page 21), young children (page 24), and infants (page 27).

How Do I Perform Chest Compression?

Chest compression substitutes for the lost pumping action of the heart and so keeps the blood moving through the body. The following is the general technique, which varies slightly for young children and for infants.

To compress the chest:

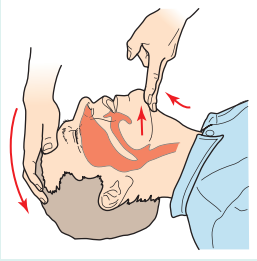
- Place the heel of one hand over the center of the person's chest between the nipples (lower half of breastbone); place the heel of your other hand over the first. Keep your arms straight and locked at the elbows.
- Firmly compress the person's chest.
- Push hard and fast, at a rate of at least 100 compressions/minute.

How Do I Open the Person's Airway?

Ensure an open airway. This does not require looking in the mouth, but straightening the angle of the head and neck so that the path of air flow is unobstructed (e.g., by the person's tongue).

To open the airway:

- Place the person face up on a hard, flat surface.
- Lift the person's chin with one hand while pushing down on the forehead with the other hand. This aligns the airway structures.



How Do I Perform Rescue Breathing?

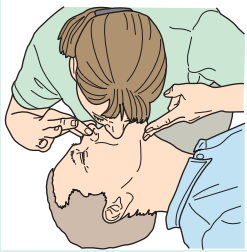
Rescue breathing delivers oxygen to the victim's lungs. The most common technique is mouth-to-mouth breathing. You probably won't catch a disease using this method, but you may want to buy a face mask or face shield at your local drug store and keep it in your first aid kit. See three following examples:

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 19

THREE RESCUE BREATHING METHODS

Method 1, Mouth-to-mouth:

- Open the person's airway by tilting the head and lifting the chin as shown.
- Pinch the person's nose shut with your fingers.
- Inhale normally and cover the person's mouth with your mouth to create an airtight seal.
- Exhale.
- Watch for the person's chest to rise as you give each breath.



Method 2, CPR face mask:

- Put the mask over the person's nose and mouth as shown.
- Make sure the airway is open and press the mask against the person's face to create an airtight seal.
- Give rescue breaths through the one-way valve.

Continued

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 20

THREE RESCUE BREATHING METHODS—cont'd

Method 3, CPR face shield:

- Place the shield over the person's mouth with the airway tube between the person's lips.
- Hold the airway open and pinch the person's nose shut with your fingers.
- Give rescue breaths through the breathing tube.

Do I Need an Automated External Defibrillator?

An **automated external defibrillator (AED)** can be used to "kick-start" a heart that has stopped beating. If CPR does not revive the person and an AED is available, you should use it. We explain how to use an AED at the end of this tab.

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 21

21
HOW TO PERFORM CPR: UNCONSCIOUS ADULT (8 YEARS OLD OR OLDER)

EMERGENCY ACTIONS

Step 1. First, check to make sure the scene is safe.

Step 2. Check the person for alertness. Gently tap the person's shoulder. Ask, "Are you OK?" See if the person moves or makes a noise.

Step 3. Check for breathing (no more than 10 seconds). If the person is not breathing or only gasping for breath go immediately to step 4.

Step 4. If there is no reaction and others are present, tell someone to phone 911 and get an AED, if available. If you are alone and have a cell phone, dial 911, put your cell phone on speaker, and begin CPR. If you are alone and do not have a cell phone, begin CPR immediately.

Step 5. Place the person face up on a hard, flat surface. Kneel on the floor at the person's side.

Continued

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 22

EMERGENCY ACTIONS—cont'd

Step 6. Begin chest compressions.

- Place the heel of one hand over the center of the person's chest between the nipples (lower half of breastbone); place the heel of your other hand over the first. Keep your arms straight and locked at the elbows.
- Firmly compress the person's chest at least 2.0 inches (5 cm).
- Give 30 compressions at a rate of at least 100/min.
- Push hard and fast.
- Allow complete recoil after each compression.
- Count 1, 2, 3, 4 . . . up to 30.

Step 7. After 30 chest compressions open the airway by lifting the person's chin with one hand while pushing down on the forehead with the other hand.

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 23

Step 8. If the person is not breathing, begin rescue breaths.

- Pinch the person's nose shut with your fingers.
- Give two breaths (1 sec each) strong enough to make the person's chest rise.

Step 9. Continue to give 2 breaths followed by 30 compressions for 2 min. Stop and look for signs of breathing, coughing, or movement. IF these signs are not present, continue CPR until help arrives. IF a second rescuer arrives to help with adult CPR, continue the same ratio of 2 breaths followed by 30 compressions.

WHAT TO DO NEXT

- If breathing begins, monitor the person until help arrives.
- If the person moves but is still not breathing, continue rescue breathing at 10–12 breaths/min until help arrives.
- If neither movement nor breathing occurs, continue CPR until help arrives. If an AED is available, set up and use it. See instructions on pages 36–39.

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 24

HOW TO PERFORM CPR: UNCONSCIOUS CHILD (1 TO 8 YEARS OLD)

EMERGENCY ACTIONS

Step 1. First, check to make sure the scene is safe.

Step 2. Check for alertness. Gently tap the child's shoulder. Ask, "Are you OK?" See whether the child moves or makes a noise.

Step 3. Check for breathing (no more than 10 seconds). If the child is not breathing or only gasping for breath go immediately to step 4.

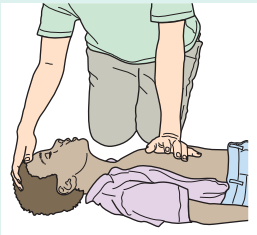
Step 4. If there is no reaction and others are present, tell someone to phone 911 and get an AED, if available. If you are alone and have a cell phone, dial 911, put your cell phone on speaker, and begin CPR. If you are alone and do not have a cell phone, begin CPR immediately.

Step 5. Place the child face up on a hard, flat surface. Kneel on the floor at the child's side.

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 25

Step 6. Begin chest compressions.

- Place the heel of one or both hands over the center of the child's chest between the nipples (lower half of breastbone). Keep your arm(s) straight and locked at the elbows.
- Firmly compress the child's chest at least one third the depth of the chest, about 2 inches (5 cm).
- Give 30 compressions at a rate of at least 100/min.
- Push hard and fast.
- Allow complete recoil after each compression.
- Count 1, 2, 3, 4 . . . up to 30



Step 7. Open the airway by lifting the child's chin with one hand while pushing down on the forehead with the other hand.

Continued

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 26

EMERGENCY ACTIONS—cont'd

Step 8. If the child is not breathing, begin rescue breaths.

- Pinch the child's nose shut with your fingers.
- Give two breaths (1 sec each) strong enough to make the child's chest rise.

Step 9. Continue to give 2 breaths followed by 30 compressions for 2 min. Stop and look for signs of breathing, coughing, or movement. IF these signs are not present, continue CPR until help arrives. IF a second rescuer arrives to help with child CPR, change the ratio to 2 breaths followed by 15 compressions.

WHAT TO DO NEXT

- If breathing begins, monitor the child until help arrives.
- If the child moves but is still not breathing, continue rescue breathing at 12–20 breaths/min until help arrives.
- If neither movement nor breathing occurs, continue CPR until help arrives. If an AED is available, set up and use it. See instructions on pages 36–39.

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 27

HOW TO PERFORM CPR: UNCONSCIOUS INFANT (YOUNGER THAN 1 YEAR)

EMERGENCY ACTIONS

Step 1. First, check to make sure the scene is safe.

Step 2. Check for alertness.
- Gently rub the infant's back or tap the feet.
- Never shake an infant.
- See whether the infant moves or makes a noise.

Step 3. Check for breathing (no more than 10 seconds). If the infant is not breathing or only gasping for breath go immediately to step 4.

Step 4. If there is no reaction and others are present, tell someone to phone 911 and get an AED, if available. If you are alone and have a cell phone, dial 911, put your cell phone on speaker, and begin CPR. If you are alone and do not have a cell phone, begin CPR immediately.

Step 5. Place the infant face up on a hard, flat surface, against your thigh or on the floor.

Continued

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 28

EMERGENCY ACTIONS—cont'd

Step 6. Begin chest compressions.

- Place two fingers just below the infant's nipple line on the breastbone (center of the chest).
- Firmly compress the infant's chest at least one third the depth of the chest, about 1½ inches (4 cm).
- Give 30 compressions at a rate of at least 100/min.
- Push hard and fast.
- Count 1, 2, 3, 4 . . . up to 30.

Step 7. Open the airway by lifting the infant's chin with one hand while pushing down on the forehead with the other hand.

- The infant's head should not be tilted as far back as an adult's.
- If the infant's head is tilted too far back, it may close off the airway.

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 29

Step 8. If the infant is not breathing, begin rescue breaths.

- Cover the infant's nose and mouth with your mouth.
- Give two breaths (1 sec each).
- Use small puffs of air so you don't over inflate the lungs.

Step 9. Continue to give 2 breaths followed by 30 compressions for 2 min. Stop and look for signs of breathing, coughing, or movement. IF these signs are not present, continue CPR until help arrives. IF a second rescuer arrives to help with infant CPR, change the ratio to 2 breaths followed by 15 compressions.

WHAT TO DO NEXT

- If breathing begins, monitor the infant until help arrives.
- If the infant moves but is still not breathing, continue rescue breathing at 12–20 breaths/min.
- If neither movement nor breathing occurs and you are still alone, shout for help. Continue CPR until help arrives. If an AED is available, set up and use it. See instructions on pages 36–39.

CHOKING: ALERT ADULT OR CHILD (1 YEAR OLD OR OLDER)

What Signs Indicate Choking?

- Grabbing at the throat with one or both hands
- Noisy breathing, gagging, coughing
- Inability to talk or make a sound

EMERGENCY ACTIONS

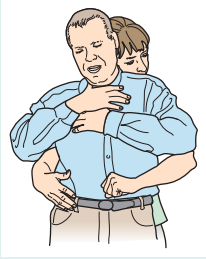
Step 1. Determine whether the airway is blocked. Ask, "Are you choking? Can you speak? Can I help you?"

Step 2. If you determine the airway is blocked:

- Stand behind the person and wrap your arms around the person's waist. Locate the navel (bellybutton).
- If the person is obese or pregnant, wrap your arms around the chest.

Step 3. Make a fist.

- Place thumb side just above the person's navel.
- Locate the middle of the person's chest if the person is obese or pregnant.



2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 31

Step 4. Grasp your fist with your other hand.

- Press your fist abruptly into the person's abdomen and use an upward, inward thrust.
- Use a straight thrust back if the person is obese or pregnant.
- Your action will push air from the lungs like a cough. This can help dislodge an object.

WHAT TO DO NEXT

- Continue thrusts until the object is coughed out and the person can breathe or talk.
- If the object cannot be removed, the person will pass out.
- If the person passes out, follow the steps for Adult or Child Who Becomes Unconscious From Choking (page 31).

ADULT OR CHILD WHO BECOMES UNCONSCIOUS FROM CHOKING

What Signs to Look For?

- No movement
- No breathing
- Bluish lips or skin (from lack of oxygen)
- Inability to move air into the lungs with rescue breaths

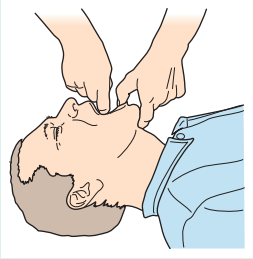
2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 32

EMERGENCY ACTIONS

Step 1. Check for alertness. Gently tap the person's shoulder. Ask, "Are you OK?" See whether the person moves or makes a noise.

Step 2. If others are present, tell someone to phone 911. If you are alone and have a cell phone, dial 911, put your cell phone on speaker, and begin adult or child CPR (pages 21–26). If you are alone and do not have a cell phone, begin CPR immediately.

Step 3. Each time you open the person's mouth to give rescue breaths:



- Look in the person's mouth for an object such as a piece of food that may have become stuck in the throat.
- If seen, do not push the object further into the throat. Instead, use your finger to sweep the object out.
- If not seen, never perform a blind finger sweep.
- Chest compressions from CPR can help force air from the lungs to dislodge the object.

Step 4. Continue to give 2 breaths followed by 30 compressions for 2 min. Stop and look for signs of breathing, coughing, or movement. If these signs are not present, continue CPR until help arrives. IF a second rescuer arrives to help with adult CPR, continue the ratio of 2 breaths to 30 compressions. IF a second rescuer arrives to help with child CPR, change the ratio to 2 breaths followed by 15 compressions.

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 33

WHAT TO DO NEXT

- If the person moves but is still not breathing, continue rescue breathing at 10–12 breaths/min for an adult and 12–20 breaths/min for a child.
- If breathing begins, monitor the person until help arrives.

CHOKING: ALERT INFANT (YOUNGER THAN 1 YEAR OLD)

What Signs Indicate an Infant Is Choking?

- Noisy breathing
- High-pitched crowing sounds
- Inability to breathe or cry

EMERGENCY ACTIONS

Step 1. Determine whether the airway is blocked. Listen for noisy or high-pitched breathing.

Step 2. If you determine the airway is blocked, support the infant's head and neck and lay the infant face down on your forearm. Using your leg or lap for support, keep the infant's head lower than the body.

Continued

EMERGENCY ACTIONS—cont'd

Step 3. Give back slaps: With the heel of your free hand, strike five quick, forceful slaps between the infant's shoulder blades.

Step 4. Turn the infant face up on your other arm. Using your leg or lap for support, keep the infant's head lower than the body.

Step 5. Give chest thrusts:

- Place two fingers on the breastbone just below nipple line.
- Give five quick thrusts downward, depressing the chest by 1/3 to 1/2 its depth each time.

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 35

WHAT TO DO NEXT

- Continue five back slaps and five chest thrusts until the object is coughed out or the infant cries.
- If the object cannot be removed, the infant will pass out.
- If the infant passes out, follow the steps for choking infant who becomes unconscious (page 35).

INFANT WHO BECOMES UNCONSCIOUS FROM CHOKING

What Signs to Look For?

- No movement
- No breathing
- Bluish lips or skin (from lack of oxygen)
- Inability to move air into the lungs with rescue breaths

EMERGENCY ACTIONS

Step 1. Check for alertness. Gently rub the infant's back or tap the feet. Never shake an infant. See whether the infant moves or makes a noise.

Step 2. If others are present, tell someone to phone 911. If you are alone and have a cell phone, dial 911, put your cell phone on speaker, and begin infant CPR (page 27). If you are alone and do not have a cell phone, begin CPR immediately.

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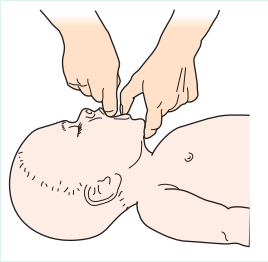
EMERGENCY ACTIONS—cont'd

Step 3. Each time you open the infant's mouth to give rescue breaths:



- Look in the infant's mouth for an object such as a piece of food or toy that may have become stuck in the throat.
- If seen, do not push the object further into the throat. Instead, use your finger to sweep the object out.
- If not seen, never perform a blind finger sweep.
- Chest compressions from CPR can help force air from the lungs to dislodge the object.

Step 4. Continue to give 2 breaths followed by 30 compressions for 2 min. Stop and look for signs of breathing, coughing, or movement. If these signs are not present, continue CPR until help arrives. IF a second rescuer arrives to help with infant CPR, change the ratio to 2 breaths followed by 15 compressions.

WHAT TO DO NEXT

- If the infant moves but is still not breathing, continue rescue breathing at 12–20 breaths/min.
- If breathing begins, monitor the infant until help arrives.

AED

An automated external defibrillator (AED) is a small, lightweight, portable device used to give an electric shock to restore a stopped heartbeat. An electric shock is the most important factor in kick-starting the heart.

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 37

How Does an AED Work?

- After you turn it on, an AED uses voice and visual prompts to tell you what to do.
- Pads are applied to the person's chest.
- An electric cord attaches the pads to the AED.
- The AED determines that a shock is needed.
- The AED delivers an electric shock.

Where Can You Find an AED?

- Schools, airports, office buildings, and sometimes a person's home
- Your local pharmacy

What Do I Need to Know About AEDs?

- Never use a child pad on an adult. The energy is too low.
- You can use adult pads on a child, but the pads must not touch each other.

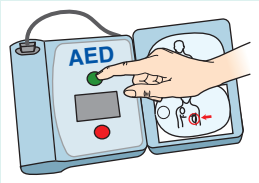
What Signs Indicate the Need for AED?

- No response to voice or touch
- No breathing
- No movement

EMERGENCY ACTIONS

Step 1. Perform CPR until an AED arrives and is set up.

Step 2. Turn on the AED. Follow the voice prompts and visual messages.



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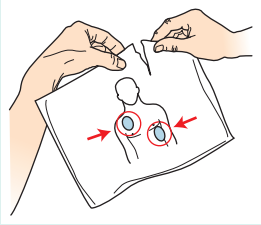
EMERGENCY ACTIONS—cont'd

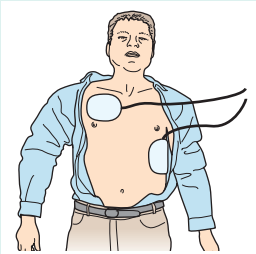
Step 3. Open the package of chest pads.

- Bare the chest.
- Check for medication patches on chest (use gloves).
- Shave chest (with included razor in AED pack) if person has chest hair where pads are placed.
- Do not place pads over an implanted pacemaker or defibrillator.
- Dry chest if moist or wet so electricity will not arc when shock is given.



Step 4. Attach the sticky side of the pads directly to the person's bare chest:

- Place one pad to the upper right side of the chest.
- Place the second pad under the left breast.
- The pads will have pictures on them that show where to put them.



2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 39

Step 5. Clear the area around the person.

Step 6. Wait until the AED tells you what to do.

Step 7. If a shock is indicated and other people are present, warn them to keep clear. Also make sure your body is not touching the person.

- Say, "I'm going to shock on three. One, I'm clear. Two, you're clear. Three, everybody's clear."
- Check to make sure no one is touching the person or the AED.

Step 8. Press the "Shock" button.

WHAT TO DO NEXT

- Once the shock is given, follow the voice prompts from the AED.
- If CPR is advised, continue CPR, beginning with chest compression.
- After 2 min of CPR, the AED will prompt you with further verbal and visual cues.

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 40

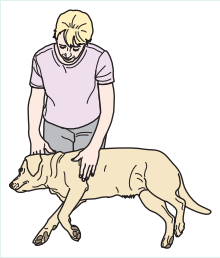
HOW TO PERFORM CPR ON A DOG OR CAT

If your pet collapses, there are steps you can take to save the animal's life. Performing CPR on a dog or cat is similar to the technique used on people.

EMERGENCY ACTIONS

Step 1. Check for alertness.

- Gently pat the animal on its back and call its name.
- See whether the animal moves or makes a noise.
- Take care not to be bitten if the animal is sleeping heavily and is startled awake.



Step 2. If the animal does not respond, lay the animal down, on either side, on a hard, flat surface. Kneel on the floor at the animal's head.

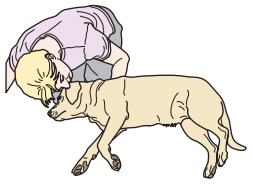
2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 41

Step 3. Open the airway.

- Straighten the animals' neck with the head in a natural, neutral position.
- Pull the animals' tongue forward between the front teeth, or to the side of the mouth. The tongue may be blocking the airway.
- Continue to Step 4 to check for breathing.

Step 4. Look, listen, and feel for breathing (no more than 10 sec).

- Look for the animals' chest to rise and fall.
- Listen for air.
- Feel for the animals' breath on your cheek or back of your hand.



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2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 42

EMERGENCY ACTIONS—cont'd

Step 5. If the animal is not breathing, begin rescue breaths. Remember to keep the airway open by straightening the neck with the head in a natural, neutral position.

For medium-sized and large dogs, place your mouth completely over the animal's nose to create an airtight seal.

- Grasp the animal's muzzle and hold the mouth closed with both hands.
- Make sure your hands tightly cover the corners of the animal's mouth so air does not leak out when you give a breath.

Mouth over the animal's nose.

For puppies/kittens and small dogs or cats, your mouth will seal over both the nose and mouth.

For any size animal, give **2 breaths** (1 sec each) strong enough to make the animal's chest rise. Larger animals need more air to fill their lungs; small animals need less.

Mouth seals the animal's nose/mouth.

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 43

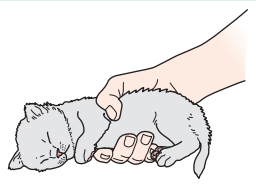
Step 6. After giving two breaths, locate the landmark for chest compressions.

- Take the animal's front leg and bend it at the elbow, flexing at the shoulder.
- The point where the elbow of the animal touches the body is where you place your hands for compressions.
- This should be the widest part of the chest.

Step 7. Begin chest compressions.

Puppies or kittens:

- Place your thumb on one side of the animal's chest and the rest of your fingers on the other side.
- Firmly compress the chest, with your thumb, 1/3–1/2 its depth.
- Give 15 compressions at a rate of at least 100–150 times/min.
- Push hard and fast.
- Count 1, 2, 3, 4 ... up to 15.



Chest compression: puppies or kittens.

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2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 44

EMERGENCY ACTIONS—cont'd

Small dogs and cats (less than 30 lb [13.6 kg]):

- Place the heel of one hand on the side of the animal's chest at its widest point (where the elbow is when the shoulder is bent). Keep your arm straight and locked at your elbow.
- Firmly compress the animal's chest to 1/3–1/2 its depth.
- Give 15 compressions at a rate of at least 100–150 times/min.
- Push hard and fast.
- Count 1, 2, 3, 4 ... up to 15.

Chest compression: small dogs and cats.

Medium-sized and large dogs (30 lb [13.6 kg] or more):

- Place the heel of one or both hands on the side of the animal's chest at its widest point (where the elbow is when the shoulder is bent). Keep your arms straight and locked at your elbows.
- Firmly compress the animal's chest to 1/3–1/2 its depth.
- Give 15 compressions at a rate of 80–100 times/min.
- Push hard and fast.
- Count 1, 2, 3, 4 . . . up to 15.

Chest compression: medium-sized and large dogs.

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 45

Step 8. Give 2 breaths followed by 15 compressions for 2 min. Stop and look for signs of breathing, coughing, or movement. If these signs are not present, continue CPR until help arrives.

WHAT TO DO NEXT

- If breathing begins, monitor the animal until help arrives.
- If the animal moves but is still not breathing, continue rescue breathing at 12–20 breaths/min for puppies/kittens and small dogs/cats or 10–12 breaths/min for medium-sized or large dogs until help arrives.
- If neither movement nor breathing occurs, continue CPR until help arrives.

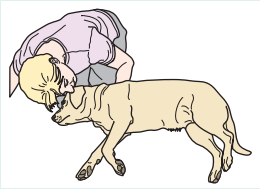
CHOKING: ALERT DOG OR CAT

What Signs Indicate a Dog or Cat Is Choking?

- Pawing at the mouth
- Change in sound of vocalizations/barking/meowing
- Change in breathing pattern
- Noisy breathing
- Gagging or coughing

EMERGENCY ACTIONS

Step 1. Determine whether the airway is blocked. Listen for noisy or high-pitched breathing.



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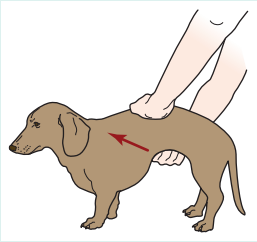
2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 46

EMERGENCY ACTIONS—cont'd

Step 2. Place the animal on a hard, flat surface with all four feet on the ground.

- Puppies/kittens and cats/small dogs (less than 30 lb [13.6 kg]): Kneel on the floor behind the animal. Place two knuckles (for puppies/kittens) or a fist of one hand in the center of the animal's abdomen just below the ribs and the other hand on the back for support.
- Press your knuckles or fist abruptly into the animal's abdomen and use an upward, inward thrust. If nothing comes out, do it again. You must apply just enough force to move the animal's body. Do this three to four times, and check each time to see whether the foreign object has been expelled.

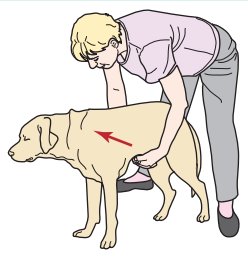


Abdominal thrust: puppies/kittens and cats/small dogs.

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 47

For a larger dog (more than 30 lb [13.6 kg]):

- Bend at the waist behind the animal and wrap your arms tightly around the center of the animal's abdomen just under the rib cage. Feel for the animal's ribs and make a fist with one hand just below the ribs.
- Place your other hand over your fist.
- Press your fist abruptly into the animal's abdomen and use an upward, inward thrust. Give one quick push upward. If nothing comes out, do it again. You must apply just enough force to move the animal's body. Do this three to four times, and check each time to see whether the foreign object has been expelled.



Abdominal thrust: larger dog.

WHAT TO DO NEXT

- Continue thrusts until the object is coughed out and the animal can breathe.
- If the object cannot be removed, the animal will pass out.
- If the animal passes out, follow the steps for Dog or Cat That Becomes Unconscious From Choking (page 48).

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 48

DOG OR CAT THAT BECOMES UNCONSCIOUS FROM CHOKING

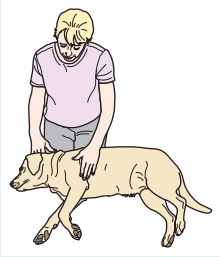
What Signs to Look For?

- No movement
- No breathing
- Inability to move air into lungs with rescue breaths

EMERGENCY ACTIONS

Step 1. Check for alertness.

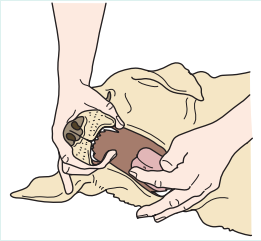
- Gently pat the animal on its back and call its name.
- See whether the animal moves or makes a noise.
- Take care not to be bitten if the animal is sleeping heavily and is startled awake.



Step 2. If the animal does not respond, immediately begin the steps for CPR (see page 40).

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 49

Step 3. Each time you open the animal's mouth to give rescue breaths:



- Look in the mouth for an object such as a piece of food, stick, or toy that may have become stuck in the throat.
- If seen, do not push the object further into the throat. Instead, use your finger to sweep the object out.
- If not seen, never perform a blind finger sweep.
- Do not place your fingers in the mouth of an alert animal, or you may get bitten.
- Chest compressions from CPR can help force air from the lungs to dislodge the object.

Caution: Do not attempt to remove the hard, bone-like structure deep in the throat at the base of the tongue called the hyoid apparatus (Adam's apple).

Step 4. Continue to give 2 breaths followed by 15 compressions for 2 min. Stop and look for signs of breathing, coughing, or movement. If these signs are not present, continue CPR until help arrives.

Continued

2182_Tab02_016-050.qxd 8/18/11 12:15 PM Page 50

EMERGENCY ACTIONS—cont'd

WHAT TO DO NEXT

- If breathing begins, monitor the animal until help arrives.
- If the animal moves but is still not breathing, continue rescue breathing at 12–20 breaths/min for puppies/kittens and small dogs/cats or 8–10 breaths/min for medium-sized or large dogs until help arrives.
- If neither movement nor breathing occurs, continue CPR until help arrives.

2182_Tab03_051-074.qxd 8/18/11 12:16 PM Page 51

Tab 3: Medical Emergencies

Medical emergencies are characterized by the sudden appearance of a serious–sometimes life-threatening–problem such as an allergic reaction, a heart attack, or a seizure. Medical emergencies related to injuries, environmental factors, and poisoning are covered in later tabs. Here, we focus on emergencies resulting from underlying medical conditions such as heart disease or diabetes. We also discuss acute medical conditions such as vomiting and dehydration that can develop suddenly in a previously healthy person.

Other medical problems include:

- Appendicitis
- Allergies
- Emergency childbirth
- Dehydration
- Ear problems
- Fever
- Respiratory conditions
- Seizures
- Stroke

The information in this tab should help you to

- Recognize that an emergency exists.
- Look for the cause of the illness.
- Treat the problem immediately to the extent possible.

PERFORM AN INITIAL ASSESSMENT

An initial assessment is a quick check for life-threatening problems in the body's respiratory, circulatory, and nervous systems. Follow the Personal Safety–Disease Transmission guidelines on page 3 to maintain proper safety precautions. To remember the steps, think ABCDE:

A: Airway Management

- A blocked airway can lead quickly to respiratory arrest and death.
- Check for responsiveness. If the person is agitated, confused, lethargic, or unconscious, the airway could be blocked.
- If necessary, open the airway. Follow guidelines for cardiopulmonary resuscitation (CPR) and Choking in Tab 2: CPR.

B: Breathing

- Respiratory arrest can quickly lead to cardiac arrest.
- Look, listen, and feel for air moving in and out of the person's chest. If the person is not breathing, follow the guidelines for CPR in Tab 2: CPR.

C: Circulation

- Check for signs of circulation (coughing, movement, normal breathing). If there are none, follow the guidelines for CPR in Tab 2: CPR.
- Assess for bleeding: If present, is it well controlled? If not, control the bleeding (page 80) and treat for shock (page 96).

D: Disability

- Determine whether the person is conscious or unconscious.
- Assess the level of consciousness. Is the person awake, verbal, reactive to pain?
- Check whether the person can move his or her arms and legs.
- Check for head, neck, or back injuries. If you suspect any, make sure the person is not moved. Once emergency personnel arrive on the scene, they should properly immobilize the person with a cervical collar and backboard.

E : Environment and Exposure

- Protect the person from the elements (heat, cold, rain).
- Keep the person warm and dry.

WHAT TO DO NEXT

Once you've identified and treated any life-threatening problems, you can perform a brief secondary assessment to help you determine

2182_Tab03_051-074.qxd 8/18/11 12:16 PM Page 53

what's wrong and whether or not immediate medical attention is needed.

- Reassess the level of consciousness.
- Examine the person from head to toe to identify any medical issues such as a headache; itchy, watery eyes; runny, stuffy, or itchy nose; difficulty with speech or vision; skin rash; chest pain; abdominal pain; or back pain.
- Ask whether the person is allergic to certain foods (i.e., peanuts, seafood), medications (i.e., penicillin), or insect stings.
- Ask what events led up to the current problem. Was the onset sudden, or did it occur over several hours or days?

If the person is experiencing pain, ask the following questions:

- When did it begin?
- What brought it on?
- What does it feel like?
- Where is it located?
- Does it go anywhere (e.g., into the jaw or shoulder)?
- Has this happened before?
- Does anything make it feel better?
- How bad is it on a scale of 0 (no pain) to 10 (pain as bad as it can be)?

A report of chest pain or pain extending into the jaw or shoulder suggests that the person may be experiencing a heart attack and needs immediate medical attention. Also, any report of severe pain warrants immediate medical attention.

The rest of this tab provides information on initial care for specific medical conditions and emergencies.

ABDOMINAL CONDITIONS

The location of abdominal pain, or bellyache, is useful in narrowing down the underlying cause. Pain in just one part of the abdomen may

point to a specific condition, such as appendicitis or gallstones. This interpretation is especially likely if the pain is bad, starts suddenly and doesn't go away, or gets worse when the person moves or coughs. Conditions such as diarrhea, dysentery, and vomiting may cause more generalized abdominal pain.

Appendicitis

The appendix is a small sac attached to the large intestine. If the appendix is blocked, it can swell and become infected. This infection is called appendicitis.

- **Signs and symptoms:** Pain in the right lower abdomen; nausea, vomiting, low fever, and constipation.
- **Treatment:** Don't give anything to eat or drink. Don't use laxatives or pain medication. Seek immediate medical care. The appendix may need to be surgically removed; if not, it could burst and spread infection throughout the abdomen.

Diarrhea

Diarrhea can be caused by a simple stomach flu virus, consumption of unusual kinds or amounts of food, or more serious intestinal problems such as bacterial or parasitic infection (from consumption of contaminated food or water), irritable bowel syndrome, celiac disease, inflammatory bowel disease (Crohn's disease or ulcerative colitis), or ischemic colitis.

- **Signs and symptoms:** *Mild:* Loose, runny stool. *Serious:* Loose, runny stool, signs of dehydration (see page 62), stomach or belly pain, and fever. Stool that is bloody, dark red, or black is a sign of internal bleeding.
- **Treatment:** *Mild:* Don't give any food for several hours until the person feels better. Have the person take small sips of water or a rehydration drink or sports drink. Try to match fluid intake to estimated fluid loss. *Serious:* Seek immediate medical care. For either mild or serious diarrhea, consider antidiarrheal agents such as Imodium

2182_Tab03_051-074.qxd 8/18/11 12:16 PM Page 55

(loperamide). If the diarrhea persists more than 72 hours, the person may need antibiotics.

SAFETY TIP—Rehydration drinks (Pedialyte, Rehydrate) and sports drinks (Gatorade, Powerade) replace fluids and electrolytes in amounts your body can use. Rehydration drinks are preferred for infants and young children.

Dysentery

Dysentery is a painful infection of the digestive system that results in severe diarrhea containing mucus and blood. The typical cause is consumption of unsanitary water or food containing microorganisms that damage the intestinal lining. There are two major types of dysentery: amebic and bacillary. Amebic dysentery is caused by a single-celled, microscopic parasite living in the large intestine. Bacillary dysentery is caused by a variety of bacteria, including *Salmonella, Shigella,* and *Escherichia coli* (*E. coli*). Poor hygiene and sanitation increase the risk of dysentery by allowing these organisms access to food or water via contaminated feces.

- **Signs and symptoms:** Frequent near-liquid diarrhea with mucus and blood. Sudden onset of high fever and chills, abdominal pain, cramps and bloating, fatigue, and vomiting. Vomiting may cause rapid and severe dehydration, which can lead to shock and death if it is not treated.
- **Treatment:** Maintain fluid intake using rehydration or sports drinks. If continued diarrhea or nausea and vomiting make adequate hydration impossible, seek immediate medical care. Imodium (loperamide) should not be used to treat acute dysentery because it can further damage the lining of the intestine. Most people will need antibiotic therapy and should see a doctor as soon as possible.

Gallstones

The gallbladder is a small, saclike organ located in the abdomen just under the liver. It holds bile, which is made in the liver and helps to break down fat. The gallbladder moves bile into the small intestine through the common bile ducts. Gallstones are solid particles that form within bile and can easily obstruct the bile duct. They can be as small as a grain of rice or as large as a golf ball.

- **Signs and symptoms:** Severe pain in the right upper portion of the abdomen; may be referred to the right shoulder and increase with deep inspiration. Nausea and vomiting can occur, as can fever.
- **Treatment:** Most measures to relieve symptoms are just temporary. The person should avoid drinking or eating anything and seek immediate medical care.

Vomiting

Vomiting can be caused by a stomach flu, unusual kinds or amounts of food, or bacterial infection (e.g., food poisoning). It can also point to serious problems such as head injury, meningitis, or a heart attack.

- **Signs and symptoms:** Inability to keep food or water down.
- **Treatment:** Avoid eating and drinking for several hours until the person feels better. If the person has not vomited for 1 hour, he or she can take small sips of water or a rehydration or sports drink. If vomiting continues, or if it contains blood or what looks like coffee grounds, seek immediate medical care.

ALLERGIES

Most allergies are caused by pollen, dust, molds and mildew, animal dander, and other irritants in the air. A few people have severe allergies to insect stings, nuts and shellfish or other foods, or drugs such as penicillin.

Allergic Reaction

Allergies are very common and can have many causes. Simple allergic reactions cause mild to moderate symptoms, such as a rash or sneezing, but are not life-threatening.

2182_Tab03_051-074.qxd 8/18/11 12:16 PM Page 57

- **Signs and symptoms:** Itchy, watery eyes; runny, stuffy, or itchy nose; sneezing, fatigue, rash, and hives.
- **Treatment:** The person should consult a physician, because over-the-counter and prescription decongestants and antihistamines may help with some allergies. If the person knows what he or she is allergic to, the best treatment is to avoid it whenever possible. The person should also keep a record of reactions to plants, animals, foods, medicines, or chemicals that seem to trigger symptoms.

Anaphylaxis

Anaphylaxis is a potentially fatal allergic reaction with a rapid onset. Anyone with severe allergies should learn to recognize warning signs early, have medication available for self-treatment, and seek immediate medical care if warning signs occur.

- **Signs and symptoms:** Rash, itching, hives, or swelling around the site of exposure. Trouble breathing, swelling of the tongue or throat, hoarse voice, chest tightness, and a drop in blood pressure causing lightheadedness and dizziness. The reaction is sudden, severe, and potentially fatal.
- **Treatment:** People who have a history of anaphylaxis should carry an autoinjector of epinephrine (e.g., EpiPen). Epinephrine is most effective if given before symptoms become severe. Epinephrine treats anaphylaxis more effectively than either antihistamines or asthma inhalers. If the person has been stung by an insect, dislodge the stinger (see page 138). If epinephrine isn't available, keep the person's airway open and seek immediate medical care. Immediate medical care is required even after an epinephrine injection. If the person becomes unconscious and stops breathing, follow guidelines for CPR in Tab 2: CPR.

SAFETY TIP—If you are at risk for anaphylaxis, your doctor may suggest that you carry an allergy kit. These kits contain antihistamine pills, an injection of epinephrine (e.g., EpiPen) that you can give yourself in an emergency, and alcohol wipes for cleaning the site before and after the injection. Seek immediate medical care even after using an allergy kit.

EMERGENCY CHILDBIRTH

Childbirth is a natural event, even when it happens unexpectedly at home or on the way to the hospital. Labor is the process of passing the baby and placenta from the uterus through the vagina. The powerful contractions of labor result from coordinated activity of the uterine muscle.

- First stage of labor: Mild contractions occurring 10 to 15 minutes apart. The mother may experience discomfort in the back and abdomen.
- Second stage of labor: Rupture of the amniotic sac, or "water breaking," usually early in the second stage. Toward the end of this stage, the urge to push or bear down becomes strong. Contractions last 50 to 70 seconds and occur at intervals of 2 to 3 minutes. A discharge of blood and mucus is a sign of impending birth.
- Third stage of labor: Delivery of the baby followed by delivery of the placenta.

2182_Tab03_051-074.qxd 8/18/11 12:16 PM Page 59

GUIDELINES FOR CHILDBIRTH

Step 1. If birth is imminent, stay calm, call 911 for immediate medical care, and reassure the mother.

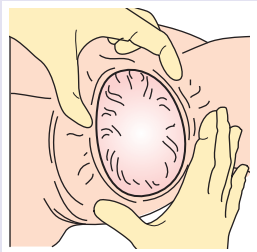
Step 2. Have the mother lie down on a flat, comfortable surface. Position her on her back with her knees bent, feet flat, and legs spread wide apart. Place layers of linens, towels, or blankets under her.

Step 3. Encourage the mother not to push. Your job is to support her until medical care arrives.

Step 4. Never let the mother hold her knees together; it won't slow the process and may complicate the birth or harm the baby.

Step 5. Use a watch to time contractions. If the baby is on the way, contractions will occur less than 2 minutes apart.

Step 6. Once you see crowning—the top of the baby's head appearing in the vaginal opening—wash your hands with soap and water, put on the gloves from your first aid kit, and prepare for delivery.



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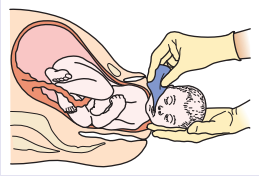
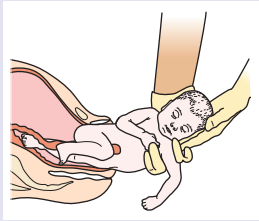
GUIDELINES FOR CHILDBIRTH—cont'd

Step 7. Never pull on the baby during delivery.

Step 8. Once the baby's head has cleared the birth canal, make sure the umbilical cord isn't wrapped around the baby's neck. If it is, gently ease it over the baby's head. Also use a suction bulb to remove secretions from the nose and mouth.



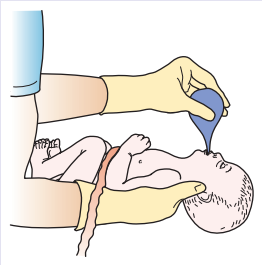
Step 9. After the head is clear, the next contraction should deliver the baby's shoulders, and then the rest of the body will slip out.



Step 10. Wipe the baby's face with a clean towel.

2182_Tab03_051-074.qxd 8/18/11 12:16 PM Page 61

Step 11. Hold the baby with the head slightly lower than the body to drain fluid from the nose and mouth. Once again, use a suction bulb to remove secretions from the nose and mouth.



Step 12. Use a clean towel to grasp the baby firmly; newborn babies are very slippery.

Step 13. Warm the baby with a clean blanket or large towel and place the baby in the mother's arms.

WHAT TO DO NEXT

- Don't cut the umbilical cord. If the placenta is delivered before help arrives, handle it gently and place it in a plastic bag.
- Massage the mother's belly firmly to help the uterus contract and stop further bleeding once the placenta is out.

SAFETY TIP—If the baby does not start breathing within 30 seconds, rub his or her back or stroke the bottom of the feet. If the baby is still not breathing, begin infant CPR (see Tab 2: CPR).

DEHYDRATION

Dehydration is a loss of too much fluid from the body. The person loses not only water, but also important minerals called electrolytes. When a viral stomach flu or an intestinal "bug" causes vomiting and/or diarrhea, the person may be too sick to hold down even sips of fluid, and dehydration can develop rapidly. Dehydration can also be caused by intense exercise and excessive sweating without adequate fluid replacement. Severe dehydration can be life-threatening, especially for infants, children, and the elderly.

- **Signs and symptoms:** *Mild:* Vomiting and diarrhea, dry mouth and tongue, and dark or not much urine. *Severe:* Sunken eyes, no tears, fast breathing and heartbeat, little or no urine for 8 hours, confusion, and skin that sags when you pinch it.
- **Treatment:** *Mild:* To stop vomiting or diarrhea, the person should avoid eating solid foods. During the first 24 hours, the person should sip water or a rehydration or sports drink. The person should keep the sips small until the stomach can handle larger amounts. Drinking too much fluid can make the person vomit again. *Severe:* Seek immediate medical care if vomiting and diarrhea last more than 24 hours, or the person is very young or elderly with severe symptoms. Intravenous fluids may be required.

SAFETY TIP—If you exercise or work in the heat, avoid caffeine. It makes you urinate more often, which dehydrates you faster. Drink water or a sports drink before, during, and after exercise and work. If you start feeling dehydrated, stop what you're doing, rest, and drink plenty of fluids.

2182_Tab03_051-074.qxd 8/18/11 12:16 PM Page 63

DIABETES

A person with diabetes either doesn't make enough insulin or can't use it effectively. Insulin is a hormone that helps your body use sugar (glucose) from food as energy or store it for later use. With diabetes, too much sugar accumulates in your blood and does not reach the body's cells. This excess sugar can cause both acute and chronic complications. Insulin and sugar must be balanced in the body or the cells will starve. Imbalances of blood sugar are called hyperglycemia and hypoglycemia.

Hyperglycemia

Hyperglycemia is an excess of sugar in the blood. The amount of sugar and the rate at which it accumulates will determine associated symptoms. When both the amount and the rate are high, diabetic ketoacidosis (DKA) or a diabetic coma may develop.

- **Signs and symptoms:** Confusion, weakness, rapid breathing and pulse, excessive thirst, frequent urination, nausea, loss of consciousness, coma, and blood glucose greater than 180 mg/dL.
- **Treatment:** Severe hyperglycemia needs immediate medical attention. It may be treated with insulin or oral medication, but only under medical supervision.

Hypoglycemia

In hypoglycemia, the blood is too low in sugar. If a person takes too much insulin or doesn't eat after injecting it, blood sugar will fall rapidly. Hypoglycemia may also be caused by taking too large a dose of an oral medication. These medications are long lasting, and hypoglycemia caused by them generally requires hospital admission.

- **Signs and symptoms:** Headache, shakiness, dizziness, anxiety, loss of consciousness, and blood glucose less than 70 mg/dL. The person probably has a history of diabetes and takes insulin or some oral medication (metformin, glyburide, and glipizide are common ones).
- **Treatment:** If the person can swallow, give fruit juice, a nondiet soft drink, or table sugar dissolved in water. If the problem is low

blood sugar, the added sugar will help quickly. If the problem is too much sugar, the sugar will not cause further harm. Seek immediate medical care.

SAFETY TIP—Your blood sugar level changes throughout the day and varies with diet and exercise. If it's normal, a "random" blood sugar test taken at any time will show a range of 70–130 mg/dL before meals and less than 180 mg/dL 2 hours after starting a meal. A fasting blood sugar level (no food or liquids for 8 hours) is normal if less than 100 mg/dL. A fasting level between 100 and 125 mg/dL signals prediabetes; a level of 126 mg/dL or higher signals diabetes.

EAR PROBLEMS

Earache

Earaches are particularly common in children and are usually caused by infection of the middle ear. Unlike swimmer's ear and other ear canal infections, these infections develop deeper in the ear and can cause more serious problems. They often begin during a cold. Colds can swell and close the eustachian tube (which connects the middle ear to the throat), with a resulting buildup of fluid. Bacteria or viruses can grow in the fluid and cause the infection.

- Signs and symptoms: Pain, swelling, or redness around or behind the ear, fever, hearing loss, and crying and/or ear-pulling in a baby or toddler. Pus or blood may be draining from the ear. Headache, stiff neck, or fever may indicate a more serious illness.
- Treatment: Put a warm washcloth on the ear to relieve pain. Seek immediate medical care and report fever or discharge. Use any prescribed medication as directed. Keep the ear dry during bathing.

Swimmer's Ear

Swimmer's ear is an irritation or infection of the ear canal. It often happens after water, sand, or dirt gets inside the ear.

2182_Tab03_051-074.qxd 8/18/11 12:16 PM Page 65

- **Signs and symptoms:** Pain, itching, and full feeling; redness and swelling in both the outer ear and the ear canal. Pus or blood may be draining from the ear.
- **Treatment:** Gently rinse the ear using a bulb syringe and a mixture of equal parts white vinegar and rubbing alcohol. Make sure the mixture is at body temperature. If the ear itches, try nonprescription swimmer's eardrops before and after the ears get wet. If symptoms persist, seek medical care.

FAINTING

Fainting is a brief loss of consciousness followed by reawakening. It occurs when the brain receives an insufficient supply of blood for a short time. Fainting is generally not harmful, and someone who has fainted usually recovers quickly with no lasting effects. However, fainting may be life-threatening if there is a serious underlying health condition such as an abnormal heart rhythm. Any episode of fainting warrants medical evaluation unless the person has a recurrent condition and has been instructed in managing it.

- **Signs and symptoms:** Sudden, temporary loss of consciousness and collapse. Someone about to faint becomes pale and weak or dizzy, begins to sweat, and then loses consciousness.
- **Treatment:** Lower the person to the ground or any flat surface in a face-up position, if possible. Loosen any tight clothing, and try to raise the person's legs to increase blood flow to the head. Don't give anything to eat or drink. Because fainting can signal a more serious condition, seek immediate medical care.

FEVER

A fever is a rise in body temperature above the normal 98.6°F (37°C). Fevers have a variety of causes, the most common of which are bacterial and viral infections. Fevers can be a sign of serious illness, especially in an infant less than 1 year old or an adult more than 65 years old.

- **Signs and symptoms:** Flushing, sweating, and skin hot to the touch. Body temperature is at least 100°F (37.8°C) measured orally or at least 101°F (38.3°C) measured rectally. Confusion signals a more serious problem.
- **Treatment:** Increase fluid intake by giving small sips of water or a rehydration or sports drink, sponge with warm water, and give acetaminophen or ibuprofen. Seek immediate medical care if the oral temperature is more than 102° F (38.9°C), if the fever persists, or if the person is confused.

SAFETY TIP—A fever in a child is always cause for parental concern. Most fevers are caused by viral illness, but occasionally they indicate a significant underlying problem. Be especially careful if fever develops in an infant less than 3 months old; infants this young are at risk for hidden infection. Seek immediate medical care if your child is less than 3 months old or shows signs of confusion or restlessness.

SAFETY TIP—Never give aspirin to a child less than 18 years old. Aspirin use during childhood has been linked with a rare but life-threatening condition known as Reye's syndrome. This condition occurs suddenly and affects the brain and liver. Instead of aspirin, use acetaminophen (Tylenol) or ibuprofen (Motrin) for children who have or are recovering from chickenpox or flu-like symptoms.

HEART EMERGENCIES

Chest Pain (Angina)

Angina, a form of chest pain, is a symptom of heart disease. The pain originates in the heart muscle when the heart has too little blood to work with. Blood flows to the heart through the coronary arteries. Sometimes these arteries become narrowed by inflammation and fatty deposits. If an artery becomes too narrow, it may not be able to carry enough blood to the muscle. When a person with angina is excited,

2182_Tab03_051-074.qxd 8/18/11 12:16 PM Page 67

exercising, or emotionally upset, the heart beats harder, but the narrowed blood vessels don't allow enough oxygen to reach the heart cells. As a result, cells die, causing chest pain, pressure, or discomfort.

- **Signs and symptoms:** Chest pain or discomfort that comes and goes, with onset usually related to exertion. The person may be taking a medication such as nitroglycerin to stop the pain.
- **Treatment:** Even if rest or medication has relieved the pain, call for immediate medical attention. Prompt action is the key to saving a life. After calling for help, give one adult aspirin if the person is still conscious and is more than 18 years old. If the person collapses, begin CPR (see Tab 2: CPR).

Heart Attack

Unlike in angina, symptoms of a heart attack usually last longer than 10 minutes and do not go away. At least one coronary artery is partially or completely blocked, and without rapid intervention, part of the heart muscle previously supplied by that artery may die. Health factors that put a person at higher risk for having a heart attack include diabetes, high blood pressure, obesity, smoking, and lack of physical activity.

- **Signs and symptoms:** Chest pain or heaviness, often radiating to the left arm or jaw, difficulty breathing, and sweating. Women are likely to experience warning signals such as nausea or vomiting, back pain, and fatigue.
- **Treatment:** Call for immediate medical attention. After calling for help, give one adult aspirin if the person is still conscious and is more than 18 years old. If the person collapses, begin CPR (see Tab 2: CPR).

SAFETY TIP—Reducing the risk for a heart attack usually means making healthy lifestyle changes by following a low-fat diet rich in fruits and vegetables, lowering salt intake, losing weight, quitting smoking, and getting regular exercise.

Congestive Heart Failure

Congestive heart failure is caused by a decrease in the pumping action of the heart. Blood "backs up" in the body and causes circulatory congestion that leads to fluid retention. Fluid can accumulate in the lungs and body tissues.

- **Signs and symptoms:** Shortness of breath, coughing or wheezing, swelling in the legs, ankles, or feet; and fatigue, nausea, and confusion. The person may appear restless and anxious.
- **Treatment:** The person may be more comfortable sitting up or leaning forward. Immediate medical care is required.

RESPIRATORY CONDITIONS

Asthma

Asthma is a chronic inflammatory disease of the airways. In acute episodes (asthma attacks), the small air passages become blocked. Common triggers are respiratory infections, exercise, and exposure to dust, pollens, smoke, certain foods, climatic changes, and pet dander. A person having an asthma attack may not be able to breathe because the chest, air passages, and throat are too constricted.

- **Signs and symptoms:** Sudden onset of labored breathing, progressive shortness of breath, chest tightness, wheezing, and coughing.
- **Treatment:** Medication can work in the short term. Any asthma attack should be treated aggressively, and the person should seek immediate medical care. For a severe attack, inhaled medication is preferred over liquid or tablets. A person with chronic asthma may already be using an inhaled medication such as albuterol. If so, administer the medication and seek immediate medical care.

Carbon Monoxide Poisoning

Carbon monoxide is a poisonous gas produced by fires and furnaces and present in large quantity in motor vehicle exhaust. It has no color, no odor, and no taste. Carbon monoxide bonds with red blood cells to form a stable compound, carboxyhemoglobin, which reduces the

2182_Tab03_051-074.qxd 8/18/11 12:16 PM Page 69

ability of red blood cells to carry oxygen. The result can be loss of consciousness and death.

- **Signs and symptoms:** Headache, nausea, fatigue, confusion, vomiting, and dizziness. High-risk groups include infants, elderly people, pregnant women, and anyone with a previous history of cardiac insufficiency or chronic obstructive lung disease.
- **Treatment:** First, move all victims into fresh air. Then seek immediate medical care for anyone affected, including pets. There is no home therapy for carbon monoxide poisoning.

SAFETY TIP—Carbon monoxide poisoning is sometimes called the "silent killer" because the toxic gas can't be seen, tasted, or smelled. Be careful around malfunctioning furnaces, when using kerosene or propane heaters or stoves, and around gas-powered engines and tools. Have your furnace checked annually, avoid using open stoves for heat, and make sure there is plenty of ventilation. Consider placing a carbon monoxide sensor in your home.

Emphysema

Emphysema results from damage to the elastic properties of the lungs, almost always by smoking. It decreases the ability of small air sacs (alveoli) to contract and expand. The alveoli are essential in exchanging oxygen and the waste product of breathing, carbon dioxide. When "old" air becomes trapped in the alveoli, it takes up space and prevents the influx of "fresh" air.

- **Signs and symptoms:** Shortness of breath, coughing, and wheezing. Bluish lips and skin indicate a dangerously low oxygen supply to the body.
- **Treatment:** The person may be more comfortable sitting up or leaning forward. Restlessness and anxiety are common. Many people with emphysema use a home oxygen supply and carry portable

oxygen with them. Administer oxygen, if available, and seek immediate medical care.

Flu (Influenza)

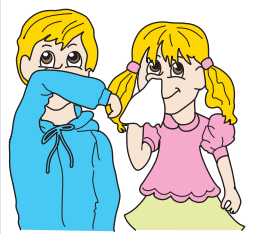
Flu (influenza) is a highly contagious disease caused by viruses that infect the respiratory tract. It lasts from 3 to 5 days and can be followed by fatigue for 2 or 3 weeks. It can cause mild to severe illness and at times can lead to death. At increased risk of complications from the flu are people 65 years old or older, pregnant women, and those with a chronic health problem (e.g., asthma, diabetes, or heart disease) or a weakened immune system.

Flu viruses spread easily from one person to another through droplets expelled when the infected person coughs or sneezes or by direct contact with the infected person. You can also be infected by touching an object that an infected person has touched, such as a door handle or child's toy. To prevent these contaminations, anyone with symptoms should wash his or her hands often and cover the nose and mouth when sneezing or coughing.

- **Signs and symptoms:** Cough, sore throat, headache, fever, aching muscles and joints, and extreme tiredness. Stomach upsets such as nausea, vomiting, and diarrhea can occur but are more common in children than in adults.
- **Treatment:** Some over-the-counter medications can help with the symptoms but don't cure the flu or shorten its duration. The best advice is to get plenty of rest, drink fluids, and take aspirin (if more than 18 years old) or acetaminophen to relieve a fever. Seek immediate medical care if symptoms become more severe. Antiviral medications are available but must be started within 72 hours after symptoms appear.

2182_Tab03_051-074.qxd 8/18/11 12:16 PM Page 71

COVERING YOUR COUGH



Use your upper sleeve. Use a tissue.

SAFETY TIP—The best way to prevent the flu is by getting a flu vaccination each year. The strains of flu virus change each year, so vaccines are updated to keep them effective. Check with your doctor about getting a yearly flu vaccine.

Hyperventilation

Hyperventilation is an excessively rapid respiratory rate. Breathing too fast causes the carbon dioxide level in your blood to drop too low. Hyperventilation may be caused by a panic attack or anxiety.

- **Signs and symptoms:** Numbness or tingling around the nose and mouth or in the hands and feet; a feeling of panic or anxiety along with a rapid heart rate; and lightheadedness or fainting.
- **Treatment:** Try a relaxation technique. Instruct the person to sit down and focus on slowing breathing by taking one breath every 5 seconds. Breathing through a paper bag on and off for a few minutes may also help slow breathing. Never use a plastic bag for this technique. If the person has chest pain or an underlying illness, or if breathing doesn't return to normal within a few minutes, seek immediate medical care.

Smoke Inhalation

A fire that produces smoke will rob the air of available oxygen and lead to asphyxia (lack of oxygen). Also, smoke is highly irritating to the airway and may cause the vocal cords to swell shut and cut off the airway. Some types of smoke are very poisonous.

- **Signs and symptoms:** Coughing, shortness of breath, headache, and change in mental status. Smoke can irritate the eyes and cause redness and tearing. In serious cases, the skin may turn white or blue from lack of oxygen. Changes in skin color can best be seen in mucous membranes such as the mouth.
- **Treatment:** The first thing to do is help the person to get fresh air. Then seek immediate medical care–oxygen is often required. Further evaluation for more serious respiratory issues will be needed.

SEIZURE

The brain is the control center for the body's electrical signals. A seizure, sometimes called a convulsion, occurs when the normal signals from the brain change. Although it may be frightening to watch, a single seizure usually lasts only a few minutes. Seizures can be brought on by acute or chronic conditions such as fever or infection, epilepsy, brain injury, extreme heat, or disease.

- **Signs and symptoms:** Body stiffness followed by uncontrolled jerking movements; loss of consciousness. Some seizures cause only slight shaking of a hand or other body part. In some cases, the person may stare blankly and not be aware of the surroundings.
- **Treatment:** Protect the person from injury. Clear a space; move furniture or other objects out of the way. Don't force your fingers or anything else into the person's mouth or try to stop the jerking motion. Loosen tight clothing. Try to stay calm. After the seizure, check for injuries. Turn the person's head to the side so any vomit or saliva will not block the airway. Provide a safe area where the person can rest until medical help arrives.

2182_Tab03_051-074.qxd 8/18/11 12:16 PM Page 73

SAFETY TIP—Infants and young children may develop seizures in response to a high fever. These are called febrile (fever-induced) seizures. Such children are at increased risk of recurrent febrile seizures, but few go on to develop a chronic seizure disorder.

STROKE

A stroke occurs when a blood vessel ruptures and bleeds into the brain or when the vessel is blocked by a blood clot or an injury. Within minutes, nerve cells in that part of the brain die. As a result, the part of the body controlled by those cells can't work properly. A stroke can affect vision, speech, behavior, thought processes, and the ability to move. Sometimes it can cause a coma or death. The risk factors for stroke include high blood pressure, smoking, a diet high in saturated fats and cholesterol, diabetes, heart disease, family history of stroke, and older age.

- Signs and symptoms: Sudden weakness; numbness; and loss of movement in the arm, leg, or face, usually on only one side. Headache, paralysis, difficulty with speech or vision, confusion, and loss of consciousness.
- Treatment: If possible, note the time that the symptoms began. Have the person rest comfortably and offer reassurance. Don't let the person eat or drink. If the person collapses, check for breathing and circulation and begin CPR (see Tab 2: CPR) if necessary. Seek immediate medical care. Medical treatment can limit or reduce the damage but must be given quickly to be effective.

SAFETY TIP—You can help prevent a stroke if you control your blood pressure, don't smoke, eat a healthy diet, exercise regularly, and control diabetes.

TOOTH PAIN

Tooth pain is either continuous or throbbing and may be felt in either the jaws or the teeth. Causes include tooth decay or infection, a tooth fracture, or another injury to the jaw.

- **Signs and symptoms:** Pain and facial swelling; and sensitivity to heat, cold, and sweets.
- **Treatment:** Give aspirin (for a person more than 18 years old), ibuprofen, or acetaminophen for pain. Consult a dentist immediately.

2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 75

Tab 4: Injuries and Wounds

Injuries and wounds result from some form of trauma: a blunt or penetrating force, intense heat, electricity, or exposure to a harmful chemical. They can be mild, requiring only home care, or serious, sometimes even life-threatening.

The information in this tab should help you to

- Recognize when an emergency exists.
- Survey the scene for potential hazards.
- Look for the cause of the injury or wound.
- Treat the problem immediately to the extent possible.

PERFORM AN INITIAL ASSESSMENT

An initial assessment is a quick check for life-threatening damage to the respiratory, circulatory, and nervous systems. Follow the Personal Safety––Disease Transmission guidelines on page 3 to maintain proper safety precautions. To remember the steps, think ABCDE:

A: Airway Management

- A blocked airway can quickly lead to respiratory arrest and death.
- Check for responsiveness. If the person is agitated, confused, lethargic, or unconscious, the airway could be blocked.
- If necessary, open the airway. Follow the guidelines for cardiopulmonary resuscitation (CPR) and Choking in Tab 2: CPR.

B: Breathing

- Respiratory arrest can quickly lead to cardiac arrest.
- Look, listen, and feel for air moving in and out of the person's chest. If the person is not breathing, follow the guidelines for CPR in Tab 2: CPR.

C: Circulation

- Check for signs of circulation (coughing, movement, normal breathing). If there are none, follow the guidelines for CPR in Tab 2: CPR.

- Assess for bleeding: If present, is it well controlled? If not, control the bleeding (page 80) and treat for shock (page 96).

D: Disability

- Determine whether the person is conscious or unconscious.
- Assess the level of consciousness. Is the person awake, verbal, reactive to pain?
- Check whether the person can move his or her arms and legs.
- Check for head, neck, or back injuries. If you suspect any, make sure the person is not moved. Once emergency personnel arrive on the scene, they should properly immobilize the person with a cervical collar and backboard.

E: Environment and Exposure

- Protect the person from the elements (heat, cold, rain).
- Keep the person warm and dry.

WHAT TO DO NEXT

Once you've identified and treated the life-threatening injuries, you can perform a brief secondary assessment to help you determine what's wrong and whether or not immediate medical attention is needed.

- Reassess the level of consciousness.
- Examine the person from head to toe to locate injuries and wounds.
- Ask whether the person is allergic to certain foods (i.e., peanuts, seafood), medications (i.e., penicillin), or insect stings.
- Ask what events lead up to the current problem. Was the onset sudden, or did it occur over several hours or days?

2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 77

If the person is experiencing pain, ask the following questions:

- When did it begin?
- What brought this on?
- What does it feel like?
- Where is it located?
- Does it go anywhere (e.g., into the jaw or shoulder)?
- Has this happened before?
- Does anything make it feel better?
- How bad is it on a scale of 0 (no pain) to 10 (pain as bad as it can be)?

A report of chest pain or pain extending into the jaw or shoulder suggests that the person may be experiencing a heart attack and needs immediate medical attention. Also, any report of severe pain warrants immediate medical attention.

The rest of this tab provides information on initial care for specific injuries and wounds.

ABDOMINAL INJURIES

Blow to the Abdomen

A blow to the abdomen can cause severe bruising and bleeding inside the body. Organs and tissues near the point of impact are most likely to be damaged. Abdominal injuries often occur during athletic events or in car or motorcycle accidents in which the person is thrown into an object or onto the ground.

- **Signs and symptoms:** Mild or severe abdominal pain that increases when an area is palpated (pressed lightly); and pain that gets worse or does not improve. Swollen, firm abdomen, nausea and vomiting (blood or coffee-ground type of material), restlessness, bloody stools, or blood in the urine. Look for signs of bruising or abrasion on the skin. Significant internal bleeding may lead to signs and

symptoms of shock (lightheadedness, confusion, pale appearance, and cool extremities).

- **Treatment:** Have the person lie down. Loosen the person's clothing, and cover the person with a blanket for warmth. If shock is present (see page 96), elevate the legs (unless you suspect neck, back, or lower extremity injury). Do not give anything by mouth, and seek immediate medical care.

Deep Open Wounds

Knives, bullets, sharp tools, and other sharp objects can cause penetrating trauma to the abdomen. The result is typically a deep open wound. Whereas the chest is largely protected by the rib cage, a large portion of the abdomen is protected only by soft tissue and muscle, thus leaving it vulnerable to penetrating trauma. Solid organs such as the liver, spleen, kidneys, and pancreas can bleed extensively when injured. A person can bleed to death if major abdominal blood vessels are cut.

- **Signs and symptoms:** Obvious open injuries, external bleeding, protruding object, mild or severe abdominal pain, and cool, moist skin.
- **Treatment:** Have the person lie down, loosen clothing, and cover with a blanket. Make sure the person is breathing and control external bleeding. Do not remove a knife or any other protruding object still embedded in the abdomen. Removal could cause severe internal bleeding. Secure the object in place with a bandage and tape. Give nothing by mouth, and seek immediate medical care.

BACK INJURIES

Back Pain

"Back" is a general term for the spinal column, which extends from your neck to your tailbone. It includes the bones and joints of the spine, the disks that separate the bones and absorb shock as you move, and the muscles and ligaments that hold them all together. People can stress or injure any of these structures. Direct trauma, repetitive motion,

2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 79

sudden twists, and sustained positions that strain the back can all cause significant injury and pain.

- **Signs and symptoms:** Severe pain in a specific area. Particularly severe pain may be caused by damage to a disk–the gel inside the disk may push out and press against a nerve.
- **Treatment:** Give aspirin (for a person more than 18 years old), ibuprofen, or acetaminophen for pain. Put heat on the sore spot for 20 minutes at a time. Moist heat (hot pack, bath, shower) works better than dry heat. Try switching between heat and ice or cold packs to see which works best. Seek immediate medical care for severe back pain, especially with weakness, tingling, and numbness in the arms or legs.

Spinal Cord Injury

The bones of the spine provide structure and support to the body. They also surround and protect the delicate nerves of the spinal cord that send motor and sensory information. Any injury that interrupts these signals may cause permanent loss of feeling and movement (paralysis).

- **Signs and symptoms:** Severe pain in any area from the neck to the tailbone following traumatic injury. Weakness, tingling, or numbness in the arms or legs. Loss of bowel or bladder control.
- **Treatment:** Do not move the person unless there is an immediate threat to life, such as a fire. If the injury occurred in a diving accident, float the person face up until help arrives. The water will act as a splint to keep the spine from moving. In any spinal injury, do not allow the person to move. Keep the person still until emergency medical care arrives.

BITES (ANIMAL AND HUMAN)

Bites from both animals and humans are dangerous. Simple bacterial infections are the most common complications. However, more severe consequences such as rabies and tetanus are always a concern.

2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 80

Check with the person's health-care provider about the need for a tetanus shot or booster. If an animal bites hard enough to break the skin, the person may need a rabies shot. Rabies, although rare, is deadly if not treated soon after a bite from an infected animal. The main carriers of rabies in North America are bats, raccoons, skunks, foxes, and coyotes. Vaccinated pets such as dogs and cats rarely have rabies. However, stray animals may not have been vaccinated. If someone is bitten, notify animal control, which may be able to capture and quarantine the animal safely.

- **Signs and symptoms:** A superficial wound or a deep, bleeding one. Infection, pain, swelling, warmth or redness at the injury site, and fever.
- **Treatment:** Stop bleeding by direct pressure. Wash the wound with soap and water, and cover with a clean dressing. Seek immediate medical care. Nearly all bites require an antibiotic to control potential infection. X-rays may be taken to rule out a fracture or retained tooth fragments.

SAFETY TIP—If someone is bitten by a pet dog or cat, find out whether the animal has a current rabies vaccine. A healthy pet that doesn't have a current vaccination should be confined and watched for up to 10 days by a veterinarian.

BLEEDING

External bleeding can be minimal or severe, depending on the seriousness of the wound. Any external bleeding must be controlled immediately.

Types of Bleeding

Bleeding can occur from an artery, vein, or capillary.

- **Arterial bleeding:** Arteries carry blood away from the heart. Blood from a cut artery is bright red and spurts out under high pressure, reflecting the pumping action of the heart. A large volume of blood

2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 81

can be lost in a short time. Arterial bleeding must be controlled immediately or the person may die.

- **Venous bleeding:** Veins carry blood back to the heart under low pressure. Blood from a cut vein is dark red. Venous bleeding is more easily controlled than arterial bleeding but is still considered serious.
- **Capillary bleeding:** Capillaries are small vessels that connect arteries and veins. Capillary bleeding is easily controlled and usually results from small cuts and abrasions.

Bleeding Management

Check for severe bleeding by looking over the person's body from head to toe.

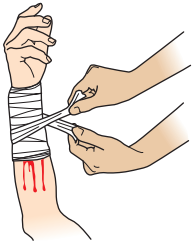
- **Signs and symptoms:** External bleeding from an exposed wound; and blood-soaked clothing.
- **Treatment:** Control the bleeding by direct pressure, elevation, or use of a pressure dressing:
  - **Direct pressure:** Press directly on the wound through a clean dressing to stop the blood flow. The pressure must be firm and should be maintained long enough to close the damaged surface.
  - **Elevation:** Whenever possible, the bleeding area should be elevated above the level of the heart (e.g., by raising an arm or leg) to slow the blood flow.
  - **Pressure dressing:** If bleeding continues after direct pressure and elevation, consider a pressure dressing. Apply a thick pad of gauze or other material and hold it in place with a bandage that's tightly wrapped but not overly constricting. Keep it loose enough to permit circulation.

In most situations, it's best to cleanse the wound with soap and water but not close it. Leaving the wound open will allow drainage from any infection that may occur. Once bleeding is controlled, cover the

2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 82

wound with a clean dressing and bandage, and seek immediate medical care. The dressing should be changed daily if possible.

Direct pressure and elevation.



Pressure dressing.

SAFETY TIP—Tourniquets are an extremely dangerous way to control bleeding. They should be used only for massive wounds with severe bleeding when all other methods have failed. Loss of a limb can result if the tourniquet is improperly placed.

BLISTERS AND "HOT SPOTS"

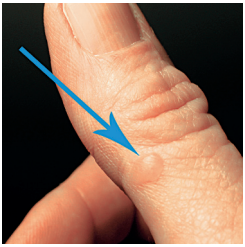
Blisters and "hot spots" develop most commonly on the feet, following constant friction or rubbing from poorly fitting shoes.

BLISTERS

A blister is a fluid-filled area that forms under the skin. Blisters commonly arise when constant friction or rubbing of footwear over the skin's surface causes microscopic tears under the skin. Most blisters can be avoided with proper footwear and some preventive measures. For prevention, apply a special material such as moleskin or an adhesive knit on blister-prone areas.

2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 83

- **Signs and symptoms:** Red, irritated skin with trapped fluid forming a small lump filled with clear fluid and sometimes blood.
- **Treatment:** It's best to never drain a blister. Instead, make a doughnut-shaped cover to keep pressure off the blister by cutting a hole in a piece of moleskin. If you do find it necessary to drain a blister, be sure you have adequate first aid supplies. First, clean the area around the blister. Then, using a clean needle, make a small hole in the top of the skin and press out the fluid. Next, apply an antibiotic ointment. Finally, cover the area using the technique for hot spots (see the following discussion of hot spots).



Blister on side of thumb.

Doughnut-shaped cover.

Hot Spots

A hot spot is a red, painful area, caused by irritation and friction, that hasn't become a true blister yet.

- **Signs and symptoms:** Redness, pain, oozing, and itchiness of the skin.
- **Treatment:** Treat with a bandage-type covering made from tape or Moleskin. Cut a piece of clean cotton dressing a bit larger than the hot spot. Put the dressing over the hot spot and cover with

2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 84

moleskin or tape. This dressing works like an adhesive bandage but holds better and lasts longer.

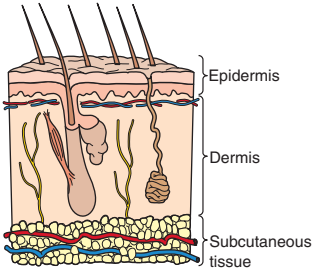
SAFETY TIP—Prevention is the key to avoiding blisters and hot spots. Boots and shoes should be broken in before being used for sports and backcountry travel. Blister prevention pads and patches provide protection, and over-the-counter products such as petrolatum (Vasoline petroleum jelly) give feet some lubrication and reduce friction.

BURNS

The severity of a burn injury is related to the cause of the burn (heat, chemical, electrical), its depth and size, and the part of the body injured. Recovery from a burn can be more difficult in people who are older, are in poor general health, or have associated injuries. Inhalation injuries, which are common, are caused by carbon monoxide, smoke, and toxic products.

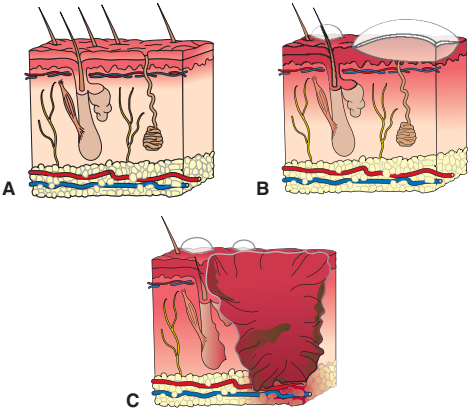
Depth of the Burn

Classification of burn injuries depends on the depth, or tissue layers, of damaged skin.



Cross section showing layers of the skin.

2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 85



Classification of burn injury: (A) first-degree, (B) second-degree, and (C) third-degree.

First-Degree Burn (Superficial Burn)

A first-degree burn involves only the outer layer of skin (the epidermis). A common example is a sunburn, which occurs after exposure to the ultraviolet rays of the sun.

- **Signs and symptoms:** Red, painful, swollen skin; and possible chills and fever.
- **Treatment:** Treat smaller burns by applying cold cloths or flushing with cool water. Give acetaminophen or ibuprofen for pain. After cooling apply an aloe vera gel or skin moisturizer lotion to keep the skin moist and reduce itching and peeling. If a large area is burned and the person has a fever and chills, a trip to the doctor would be in order.

Second-Degree Burn (Partial-Thickness Burn)

A second-degree burn involves the outer layer of skin (the epidermis) and the second layer (the dermis). The burn does not pass through to the underlying tissues.

- **Signs and symptoms:** Deep, intense pain, red and swollen skin; and moist, oozing, blistered skin appearing within hours.
- **Treatment:** Treat burns by applying cold cloths or flushing with cool water. If blisters form, don't break them. Give acetaminophen or ibuprofen for pain. Give fluids by mouth if the person's airway is not impaired. Use an antibiotic ointment. Do not use butter (it increases the risk of infection and doesn't help heal the burn). Cover the burn with sterile, dry bandages. Seek immediate medical care.

Third-Degree Burn (Full-Thickness Burn)

A third-degree burn involves all three layers of the skin: the epidermis, dermis, and fatty layer (subcutaneous tissue). If the burn is severe, even the muscle and bone may be involved.

- **Signs and symptoms:** Dry and white, or black and swollen, skin. Intense pain or absence of pain, depending on the number of nerve cells damaged.
- **Treatment:** Check the airway and administer oxygen if smoke inhalation is suspected. Remove all burned clothing and jewelry (especially rings) if not stuck to the skin. Swelling may make these items hard to remove later. Cover the burn with a dry, nonstick, sterile dressing or a clean cloth. Treat for shock (see page 96), and seek immediate medical care. Critical burn areas involve the face, hands, feet, and genital region.

SAFETY TIP—Be careful around campfires! Contact burns often result from handling hot rocks or stepping on hot embers around a campfire. Never attempt to start or refresh a campfire with gasoline or other liquid fuels: these are explosive, and fatal injury can result.

2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 87

Scald Burn

A scald burn is caused by a hot liquid at 140ºF (60ºC) that creates a first- or second-degree burn within 3 seconds. At 156ºF (68.9ºC), the same burn occurs in 1 second.

- **Signs and symptoms:** Redness of the outer layer of skin (epidermis) and second layer (dermis), blisters, and extreme pain.
- **Treatment:** Apply cold cloths or flush with cool water. If blisters form, don't break them. Give acetaminophen or ibuprofen for pain. Use an antibiotic ointment. Cover the burn with sterile, dry bandages. Seek immediate medical care. Critical burn areas involve the face, hands, feet, and genital region.

Chemical Burn

- **Signs and symptoms:** Severe pain, redness, and irritation at the site of the burn. Cough or shortness of breath if the chemical has been inhaled.
- **Treatment:** A chemical burn caused by an acid or lye spill should be flushed with large amounts of water. If the chemical has splashed into an eye, the eye may be red or blistered. Keep rinsing the eye with water, and seek immediate medical care. Chemical fumes can also burn the eyes, skin, and respiratory system (nose, mouth, and lungs). Caustic agents in some chemicals may continue to eat away at the skin even after being rinsed off with water. Brush dry powder chemicals from the skin before flushing with water unless large quantities of water are immediately available. Cover the burn with a dry, nonstick, sterile dressing or a clean cloth. Seek immediate medical care.

★ **SAFETY TIP—Be careful with chemicals. Store them where children and pets can't reach them. Wear safety glasses, goggles, or gloves when working with chemicals. Follow the product's warning label.**

Electrical Burn

An electrical burn from even a mild electric shock can cause external and internal damage. A current of 1000 volts or more is considered high voltage, but even the ordinary household current of 110 volts can be deadly. Children and pets may chew through an electrical cord, or an electric shock may be caused by a downed power line.

- **Signs and symptoms:** Electrical burns can cause severe pain and can penetrate deep into body tissues. In a serious electrical shock, the person may lose consciousness and need CPR (see Tab 2: CPR).
- **Treatment:** Call for help. Unplug or turn off the power source. Then remove the person from the electrical source. If the person is not breathing, begin CPR (see Tab 2: CPR) if you are trained or being guided by an emergency dispatcher. Treat for shock (see page 96) and burns if necessary. If the power source cannot be turned off, do not touch the person or you will become a victim yourself. Wait until the fire department or power company service arrives to shut off the live current of electricity.

CHEST INJURIES

Chest injuries include injuries to the lungs, heart, and large blood vessels such as the aorta and vena cava. Injuries to the ribs and diaphragm may also be involved. Because so many life-sustaining functions are performed by the organs of the chest, any injury in this region may be critical.

Blow to the Chest

A blow to the chest from a steering wheel, baseball bat, or other blunt object can damage the bones surrounding the chest and injure the heart, lungs, and large blood vessels.

- **Signs and symptoms:** Bruising, mild or severe chest pain, and trouble breathing. Signs of shock such as cool, moist skin may indicate internal bleeding.

2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 89

- **Treatment:** Have the person lie down or sit up if breathing is impaired. Loosen the person's clothing, and cover with a blanket. Make sure the person is breathing, and seek immediate medical care.

Deep Open Wounds

Pieces of glass or metal, bullets, knives, steel rods, and other sharp objects can penetrate the chest wall, impair breathing, and damage internal organs.

- **Signs and symptoms:** Bruising, external bleeding, mild or severe chest pain, trouble breathing, and cool, moist skin.
- **Treatment:** Have the person lie down or sit up if breathing is impaired. Loosen the person's clothing, and cover with a blanket. Make sure the person is breathing. Control external bleeding. Do not remove any knife or other protruding object still embedded in the chest; removal could cause severe internal bleeding. Secure the object in place with a bandage and tape. Seek immediate medical care.

Rib Fractures

Rib fractures–or broken ribs–are often caused by a blow to the chest. Even the fracture of a single rib can affect a person's ability to breathe. A rib fracture may cause substantial pain when the chest wall moves in with the process of normal breathing.

- **Signs and symptoms:** Bruising, external bleeding, mild or severe chest pain, and trouble breathing.
- **Treatment:** Place the person in a comfortable position. Rib injuries are painful, and the person may feel better seated or lying down with the injured side up. Because a fractured rib can penetrate internal organs, keep the person still, and seek immediate medical care.

EAR INJURIES

Children sometimes place small objects in their ears. Adults often injure their eardrums while cleaning the ear canal with cotton swabs. Earwax may block the ear canal, or an insect may crawl into the ear.

- **Signs and symptoms:** Pain (especially if the eardrum is ruptured) or strange noises in the ear. If an object stays in the ear too long, redness, swelling, pus drainage, or other signs of infection may develop.
- **Treatment:** Never try to kill an insect in the ear. In an adult or child, pull the earlobe up and back (in an infant pull the earlobe down and back) near a bright light to encourage the insect to crawl out. If you fill the ear canal with warm mineral oil or baby oil, the insect may float out. To remove an object other than an insect, gently tilt the head to the side to see if the object will fall out. If you can see the object, you can try removing it with blunt-nosed tweezers. Use care not to push the object farther in. If the object is too deep in the ear canal, don't attempt to remove it, but seek immediate medical care. If a ruptured eardrum is suspected (hearing change or loss, ringing, intense pain), do not put anything else in the ear, and seek medical care.

ELECTRIC SHOCK

An electric shock can occur when someone is using an electric appliance with wet hands or standing on a wet bathroom floor or otherwise around water. Someone can also receive an electric shock from exposed or faulty wiring, or, in rare circumstances, from being struck by lightning (see page 119).

- **Signs and symptoms:** Unconsciousness, breathing difficulty or no breathing, and no pulse. Burns at contact points; muscle spasms; and possible blunt trauma, especially if the person has been thrown in the air.
- **Treatment:** Call for help. Unplug or turn off the power source. Then remove the person from the electrical source. If the person is not breathing, begin CPR (see Tab 2: CPR) if you are trained or being guided by an emergency dispatcher. Treat for shock (see page 96) and burns (see page 84) if necessary. If the power source cannot be turned off, do not touch the person or you will become a victim

2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 91

yourself. Wait until the fire department or power company service arrives to shut off the live current of electricity.

EYE EMERGENCIES

Foreign Bodies

- **Signs and symptoms:** Watery, irritated, painful eye; reluctance to open the eye; and visible foreign object.
- **Treatment:** Let the eye tear; don't rub it. Wash your hands before you touch the eye. If the object is loose, it may dislodge itself; otherwise, do not try to dislodge it yourself. Never use tweezers or any other sharp, hard instrument to remove an object. If the object is embedded, cover the person's two eyes (to restrict eye movement), and seek immediate medical care.

Corneal Abrasion

A speck of dirt or another small object can become embedded in the eye and scratch the surface (the cornea).

- **Signs and Symptoms:** A speck or a small object washing out with tears.
- **Treatment:** Although most corneal scratches heal on their own, they can become infected and put you at risk for tetanus. If you suspect a corneal abrasion, flush the eye with water, and seek immediate medical care.

Black Eye

A black eye is a bruise caused by a blow to the eye. The soft tissue around the eye, the facial bones, or the eye itself may be injured.

- **Signs and symptoms:** Bruising over the bony area that protects the eye. Blood in the colored part of the eye (iris) or in the white part (sclera). Vision changes and severe pain. If the bone is injured, it may be difficult to move the eye in all directions.
- **Treatment:** Make sure the person has the affected eye closed, and cover it with a clean cloth. Then put an ice or cold pack over the

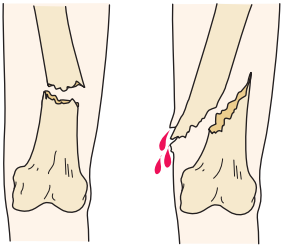
2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 92

eye for 10 minutes. Do not attempt to remove any debris from the injured eye. All eye injuries should be seen by a doctor. Seek immediate medical care.

FRACTURES AND DISLOCATIONS

Fractures

A broken bone is called a fracture**.** A fracture may occur from direct trauma or from any motion that bends or twists the bone suddenly. If the force shatters the bone, its fragments can cause extensive damage to adjacent blood vessels, peripheral nerves, muscles, and ligaments. **Fractures may be closed or open.** In a closed fracture, the skin is not broken. Open fractures involve broken or torn skin and possible protruding bone fragments. An open injury increases the likelihood of infection.



Closed fracture. **Open fracture.**

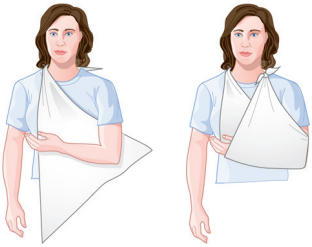
- **Signs and symptoms:** Severe pain, swelling or bruising, loss of motion, and protruding bone or deformity.
- **Treatment:** Don't move the person if neck or back injuries are suspected. Treat breathing, bleeding, and shock first. For an open fracture (bone protruding from the skin), control the bleeding and cover the open wound with a clean dressing or cloth. Immobilize the injury before moving the person. Seek immediate medical care.

2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 93

Immobilization Techniques

Fractures should be immobilized to prevent injury to blood vessels and nerves. Splinting is the primary immobilization technique. It helps prevent further damage and protects the injury until you can seek medical help. An improvised splint will immobilize an injured limb, reduce pain, and prevent further injury. A simple splint can be used on an arm, finger, leg, or toe.

- Remove all rings, watches, and bracelets. Swelling may make these items hard to remove later.
- Tie or tape the injured limb to a stiff object, such as rolled-up newspapers or magazines or a large stick. Ties can be made out of items such as a torn sheet, rope, or belt. Don't tie too tightly. Try to splint the joint above and below a suspected fracture to keep the injury from bending. For example, splint a fractured leg from above the knee to below the ankle.
- Tape a fractured finger or toe to the next uninjured finger or toe with padding between them.
- For joint injuries, immobilize the bone above and below the joint.
- Use a triangular arm sling to secure arm and shoulder injuries.



Applying a triangular arm sling.

Dislocations

Dislocation occurs at a joint, when one end of a bone is pulled or pushed out of its normal position. Ligaments (bands of tissue that hold bone to bone) can tear during a dislocation.

- **Signs and symptoms**: Swelling, intense pain, and immobility of the affected joint.
- **Treatment**: These injuries should be treated as fractures and splinted in place. Never try to reduce (put back in place) a dislocated joint. Seek medical care.

HEAD INJURIES

Head injuries can range from a minor bump to a major cut or a blow severe enough to cause brain injury. Minor cuts on the face or scalp often look worse than they are because the blood vessels are close to the skin surface and bleeding occurs easily. However, a head injury of any kind should be taken seriously. Blunt injuries often cause bleeding inside the skull. The more force is involved, the more serious the injury usually is. A head injury may also involve a neck injury that requires spinal precautions and immobilization.

Bleeding in the Brain

- **Signs and symptoms:** Sleepiness, dazed manner, or unconsciousness. Vomiting, pale skin, headache, and uneven pupils (one pupil may be smaller or larger than the other).
- **Treatment:** Treat the injury as an emergency. Keep the person still while immobilizing the neck. Call for immediate medical attention. Stay with the person, and monitor closely for unconsciousness.

Concussion

- **Signs and symptoms:** Headache; and loss of consciousness for a few seconds.
- **Treatment:** Treat any head injury as an emergency. Call for immediate medical attention. Stay with the person and monitor closely for

2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 95

unconsciousness. Anyone who has a head injury, no matter how minor, should be watched for 24 hours for signs of a serious problem.

Skull Fracture

A forceful blow to the head may cause a skull fracture (a broken bone). The fracture may or may not cause a depression with bone fragments showing. In either case, the injury can cause bleeding into the brain and must be taken seriously.

- **Signs and symptoms:** A dent or deformity in the skull; and sleepiness, dazed manner, or unconsciousness. Vomiting, pale skin, headache, and uneven pupils. Blood or clear fluid, not caused by a cut or direct hit, draining from the ears or nose.
- **Treatment:** Treat the injury as an emergency and use spinal precautions. Keep the person still while immobilizing the neck. Call for immediate medical attention. Stay with the person, and monitor closely for unconsciousness.

SAFETY TIP—Children and adults should always wear a properly fitted helmet when participating in activities such as bicycling, snowboarding, skiing, and riding a scooter or motorcycle. Seat belts and child seats should be used for traveling in a car. Never dive into shallow or unfamiliar water.

NOSE INJURIES

Nosebleed

Nosebleeds are not usually serious. They commonly occur because of dry air or high altitude, an injury to the nose, or a medication (especially a blood thinner such as warfarin [Coumadin]). Blowing or picking the nose can also cause a nosebleed.

- **Signs and symptoms:** Blood coming from the nostrils after nose blowing, sneezing, picking, illness, or injury.

- **Treatment:** Tilt the head forward. Squeeze the nose shut by pinching the nostrils and breathe through the mouth. If bleeding does not stop, apply a cold compress and reapply pressure. If bleeding continues after 30 minutes, seek immediate medical attention.

Object in the Nose

Children sometimes put small objects such as beads, marbles, or candy up their noses.

- **Signs and symptoms:** A tender, swollen nose with a yellow discharge draining from it.
- **Treatment:** Have the child pinch the other nostril closed and try to blow the object out. If you can see the object, try to remove it with blunt-nosed tweezers. Hold the child's head still, and use care not to push the object farther in. If the child resists and the object is still not dislodged, seek immediate medical attention.

SHOCK

Shock is caused by inadequate delivery of blood to the vital organs, especially the brain, heart, and kidneys. It may develop after sudden illness, infection, injury, burns, heart failure, bleeding, anaphylaxis, or fluid loss (vomiting or diarrhea). Sometimes even mild injury will lead to shock. Prompt treatment can save a person's life.

- **Signs and symptoms:** Cool, pale, moist skin; fast breathing; and rapid, weak pulse. Weakness, dizziness, excessive thirst; confusion or anxiety; and nausea or vomiting.
- **Treatment:** Check for breathing problems and any bleeding. Lay the person face up with feet raised unless you suspect head, neck, or back injuries. Try to control bleeding with direct pressure. Keep the person warm; use a blanket or sheet, depending on the weather. Don't give anything to eat or drink. Seek immediate medical attention. Continue to monitor airway, breathing, and circulation until help arrives.

2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 97

SPRAIN AND STRAIN

Ligaments connect one bone to another; tendons connect muscle and bone. A sprain is the stretching or tearing of ligaments when a joint is twisted beyond its normal range of motion. A strain is caused by overstretching or tearing a muscle or tendon.

- **Signs and symptoms:** Swelling, severe pain, and inability to move the limb normally because of both weakness and pain.
- **Treatment:** During the first 48 to 72 hours, apply an icepack or cold pack for 10 to 15 minutes at a time each hour. This treatment reduces swelling. Keep a damp cloth between the skin and the pack so the cold doesn't damage the skin. Heat should not be used because it encourages internal capillary bleeding and increases swelling. Use a compression wrap such as an elastic bandage to prevent swelling and support the joint. Don't wrap it too tightly. If possible, elevate the injury above the level of the heart to reduce swelling.

SAFETY TIP—Create a homemade flexible cold pack with rubbing alcohol. Mix one part rubbing alcohol with three parts water in a heavy-duty self-closing plastic freezer bag. Mark it "Cold pack: Do not eat," and set in your freezer. Soon you'll have a slushy, comfortable cold pack.

TOOTH INJURIES

A tooth can be knocked out by blunt trauma or another injury. It can also be chipped by a blow to the mouth or by inadvertently chewing on a hard object.

- **Signs and symptoms:** Sensitivity to heat, cold, and sweets. Pain and facial swelling. Bleeding will occur if a tooth is partially or fully knocked out.
- **Treatment:** Call a dentist if the injury is localized to the tooth. Otherwise, seek emergency care. Give aspirin (for a person more than

18 years old), ibuprofen, or acetaminophen for pain. If a permanent tooth is knocked out, the dentist may be able to reimplant it. This works best within about 30 minutes of the injury. Touch the tooth only by the top (crown), not the root. On the way to the dentist's office, keep the tooth moist or it will die within minutes. Transport it in milk or saliva; water is not recommended. To control bleeding around the injury site, have the person bite down gently on a gauze pad.

WOUNDS

Closed Wounds

Closed wounds can occur when a person is punched in the face or abdomen, falls down a flight of stairs, or suffers other mishaps. The skin will remain intact, with bleeding occurring just under the skin or deeper in the body. On the body surface, closed wounds are called bruises. Internal bleeding is caused by wounds deeper in the body.

Bruise

A bruise (contusion) is caused when small blood vessels under the skin bleed after a hit or fall. People who take aspirin or blood thinners may bruise more easily because the medication increases the length of time it takes for their blood to clot.

- **Signs and symptoms:** Redness on impact, with the area turning deep blue later. Pain, especially if a large area is affected.
- **Treatment:** Apply ice or cold packs to the affected area for 10 minutes. If an arm or leg is affected, elevate the limb. Give acetaminophen or ibuprofen for pain and swelling. If the bruising is severe, there may be underlying tissue, organ, or bone damage; seek immediate medical attention.

Internal Bleeding

Internal bleeding is often hard to detect but should be suspected when injuries are severe, as in a motor vehicle accident or a serious fall.

- **Signs and symptoms:** Bleeding from the nose, mouth, ears, or rectum. Growing swelling and tension in the chest, abdomen,

2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 99

or another region. Extensive bruising, restlessness, and signs of shock (page 96).

- **Treatment:** Treat for shock (page 96), and seek immediate medical care.

Open Wounds

In open wounds, the protective barrier of the skin has been breached. Bleeding is visible, and the potential for infection is significant.

Abrasion or Scrape

Abrasions are small tears to the skin caused, for example, by rubbing your arm against a brick or stone surface or "skinning" your knee when falling off a bike. Abrasions may have dirt and grime embedded in them. A scrape is a series of tiny cuts that may occur if you brush up against a bush or plant that has thorns. Abrasions and scrapes are usually minor. The first step is to control the bleeding.

- **Treatment:** Bleeding from a minor wound will usually stop on its own after you apply pressure with a clean cloth or bandage. Once the bleeding is under control, wash the wound with soap and water. Bandage the wound to keep it clean. Use an antibiotic ointment to prevent infection.

Amputation

A traumatic amputation is the partial or full severing of a body part, most commonly a finger, toe, ear, or limb (arm or leg).

- **Treatment:** A complete amputation may not bleed because the blood vessels tend to constrict. In some cases, however, superficial or deep bleeding may be severe. Follow page 80 on bleeding control. Wrap the amputated part in clean, slightly moist gauze, and place it in a plastic bag. Keep the part cool but **do not put it directly on ice.** Seek immediate medical attention.

Bullet Wounds

A bullet wound will cause extensive tissue damage beyond the path of the bullet. Damage from a bullet is affected by several factors: the

2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 100

distance from origin, the size and speed of the bullet, its tumble (rotation), and its degree of fragmentation. In .22-caliber rifles and M-16 firearms, the bullet sizes are similar, yet the resulting damage differs considerably. The wound caused by the M-16 is much more extensive. In this case, the speed of the firearm makes a difference. A bullet that fragments when it leaves the gun, such as a shotgun shell filled with small pellets, will move more slowly but cause damage over a wider area of the body.

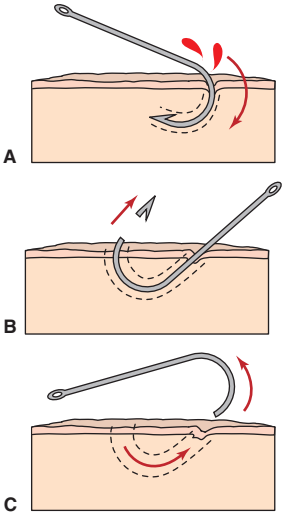
- **Treatment:** Apply direct pressure with a clean cloth or bandage to control bleeding. The bullet may stay lodged in the body or pass right through. If possible, check for entry and exit wounds. Check airway, breathing, and circulation. Seek immediate medical care.

Fishhook Injury

Fishhook injuries generally occur on the face, ears, back, or hands. These injuries can be serious if the barb of the hook is close to the eye. Because fishhooks are dirty and contaminated with bacteria, the wound is at risk for a skin infection.

- **Treatment:** Cut the fishing line, stop the bleeding, and clean the wound with soap and water. In some cases, the hook can be backed out of the injury site with little pain. Avoid removing hooks near joints, tendons, bones, ligaments, or arteries. If the injury is to the face or in or near the eye, shield the hook from further movement and seek immediate medical care. If the hook is removed, clean the wound with soap and water, use antibiotic ointment, and bandage the area. Even if the wound is minor, check with the health-care provider about the need for a tetanus shot or booster.

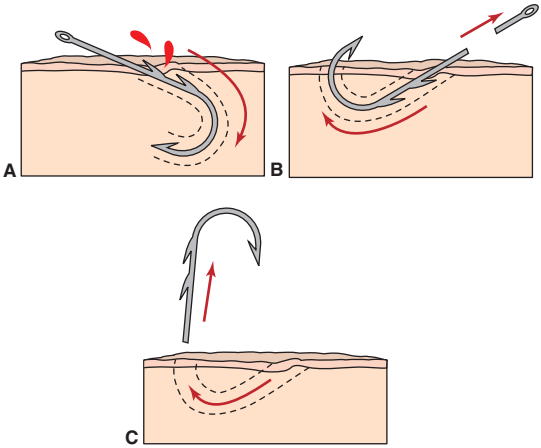
2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 101



Simple fishhook removal: (A) push barb through skin, (B) cut barb off, and (C) back hook out of skin.

- If the hook is in a finger and has only one barb, **a simple removal technique** is to force the barb through the skin and cutting the barb off with wire cutters. Back the remainder of the hook out of the wound the way it went in.

2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 102



Multiple-barb fishhook removal: (A) push hook through skin, (B) cut eye off hook, and (C) remove hook.

- If the **hook has multiple barbs,** force the point through the skin, cut off the eye of the hook, and push the shank forward until you can remove it.

Impaled Objects

An impaled object is a sharp object that has become imbedded in the skin or body.

- **Treatment:** Do not remove an impaled object if removal would result in more bleeding or pain. For example, do not remove a large impaled object (e.g., a stick) or an object lodged in the eye.

2182_Tab04_075-104.qxd 8/18/11 12:18 PM Page 103

For minor wounds, dirt and other loose foreign material should be carefully washed out with soap and water. Seek immediate medical attention.

Laceration (or Cut)

A laceration, or cut, may have a clean edge or may be irregular and torn. The injury can be minor or severe. The first step is to control the bleeding.

- **Treatment:** Bleeding from a minor wound will usually stop on its own after you apply pressure with a clean cloth or bandage. If the wound is bleeding heavily or spurting blood, follow the steps for bleeding management on page 80. Once the bleeding is under control, wash the wound with soap and water. Bandage the wound to keep it clean. Apply an antibiotic ointment. Check with the health-care provider about the need for a tetanus shot or booster. If you think the person may need stitches or if the bleeding is severe, seek immediate medical attention.

SAFETY TIP—Does the wound need stitches? For best results, cuts that need stitches should get them within 6 to 8 hours. Stitches can help cuts heal with less scarring. After you've washed the cut with soap and water and the bleeding has stopped, pinch the sides of the cut together. If it looks better that way, the wound may heal faster and better with stitches.

Puncture Wound

Sharp, pointed objects (nails, needles, teeth, and knives) cause puncture wounds that go through the skin. This type of wound can easily get infected because it's deep: this makes it hard to clean and creates a warm, moist place for bacteria to grow. Puncture wounds can lead to tetanus if left untreated.

- **Treatment:** Control the bleeding, and then clean the wound with soap and water. If the wound is minor, place some antibiotic ointment (or cream) over the wound to prevent infection and cover

with a bandage to keep it clean and protected. If it's major, seek medical attention and check with the health-care provider about the need for a tetanus shot or booster.

Splinter

A splinter is a small, sharp object, usually a thorn or a tiny piece of wood or metal, embedded in the skin.

- **Treatment:** Put a piece of tape over the splinter and pull it up. If that doesn't work, grip the end of the splinter with tweezers and gently try to pull it out. If the splinter isn't sticking out where you can reach it, clean a needle with alcohol and make a small hole in the skin over the end of the splinter. Then lift the splinter with the tip of the needle until you can grab it with the tweezers. After the splinter is removed, wash the area with soap and water. Watch for signs of infection. If the splinter is large, deep in the skin, or in the eye, do not try to remove it and seek immediate medical attention.

Stab Wound

Stab wounds produced by a knife or ice pick, for example, may go deep enough to penetrate tissues and organs, including bones.

- **Treatment:** Stop the bleeding with direct pressure; clean with soap and water and cover with a sterile bandage. Seek immediate medical care.

SAFETY TIP—Any injury involving an open wound can lead to tetanus. This disease is caused by soil bacteria introduced into open wounds. As the bacteria grow, they produce a toxin that provokes severe muscle spasms and interferes with breathing. Puncture wounds are fertile ground for tetanus. If you haven't had a tetanus shot in the last 5 years or don't know when your last shot was, see your health-care provider within 2 days of the injury and get a shot.

2182_Tab05_105-128.qxd 8/18/11 12:20 PM Page 105

Tab 5: Environmental Emergencies

The human body has evolved over thousands of years to thrive in an environment providing just the right range of temperature, pressure, and humidity, as well as shelter from storms. That's why exposure to environmental extremes such as altitude, cold or heat, lightning, and water can have a disastrous effect on your body.

ALTITUDE SICKNESS

Altitude is measured by feet (or meters) above sea level. The pressure that the air around you (the atmosphere) exerts on your body decreases with an increase in altitude. This means that the higher you go, the less oxygen is available for breathing.

The amount of oxygen your body needs to function doesn't change. So initially, as you move to higher altitudes, your breathing rate increases spontaneously, even while you're at rest. Over time, your oxygen-deprived body develops mechanisms to adapt. Your heart's output increases, your blood becomes more acidic, more red blood cells are produced, and your oxygen use changes. This process is called ***acclimatization*.**

Altitude sickness, or acute mountain sickness, occurs when people go to a higher altitude faster than their bodies can acclimatize. Most problems at high altitude are preventable, but climbing higher without proper acclimatization can lead to potentially serious, even life-threatening, situations.

HIGH ALTITUDE: 4950–11,500 ft (1509–3505 m). Exercise performance decreases and resting respiration increases. Altitude sickness is common with rapid ascent above 8200 ft (2500 m).
VERY HIGH ALTITUDE: 11,500–18,050 ft (3505–5502 m). Extreme shortness of breath may occur during exercise or sleep and with altitude sickness.
EXTREME ALTITUDE: Above 18,050 ft (5502 m). Severe shortness of breath occurs and acclimatization is impossible. Sudden ascent to this altitude without supplemental oxygen is dangerous.

Guidelines for Acclimatization

- Train for both endurance and strength before going to high elevations.
- Make day trips to a higher altitude and return to a lower altitude for sleep.
- Drink plenty of water to prevent dehydration. In high altitudes, people have a tendency to breathe deep and fast. This will cause the body to lose moisture and result in dehydration.
- Avoid alcohol, caffeine, and salty foods because these will increase the likelihood of dehydration.
- Ascend gradually to allow for acclimatization. Above 10,000 ft (3048 m), ascend no more than 2000 to 3000 ft (610 to 915 m) in a 24-hour period.
- Follow the **"golden rule":** climb high, sleep low. Above 10,000 ft (3048 m), no matter how high you climb always make sure you come back to a base camp that's no more than 1000 ft (310 m) higher than your previous night's sleeping elevation.
- Take a rest day every 2 to 3 days.
- Until acclimatized, avoid excessive exercise and fatigue.
- Consider taking Diamox (acetazolamide, a prescription drug) or ginkgo biloba (an herbal medication) when you arrive at high altitude to reduce the chances of mountain sickness.

2182_Tab05_105-128.qxd 8/18/11 12:20 PM Page 107

SAFETY TIP—Do not ascend to a higher altitude if you are feeling sick; take a rest day or descend. Descend if you do not feel better within 24 hours.

Acute Mountain Sickness

Mild

- **Signs and symptoms:** Headache, nausea, insomnia, fatigue, and loss of appetite. Usually develops at elevations over 8200 ft (2500 m).
- **Treatment:** Stop ascent and rest for a day. Maintain adequate hydration and nutrition. Use medications for pain, nausea, and acclimatization.

Moderate

- **Signs and symptoms:** More significant than mild acute mountain sickness. Headache not relieved by rest or medication, nausea and vomiting, shortness of breath at rest, fatigue and weakness at rest, loss of appetite, and insomnia.
- **Treatment:** Treat as for mild acute mountain sickness, but if the person is short of breath at rest, supplemental oxygen is a necessity. Descent is mandatory and immediate.

Severe

- **Signs and symptoms:** All the signs and symptoms of moderate acute mountain sickness, along with difficulty walking, extreme shortness of breath at rest, increased heart rate, persistent dry cough, and confusion or delirium.
- **Treatment:** Descent is mandatory and immediate, with evacuation to a medical facility. Administer oxygen and maintain proper hydration in the process. If the person is vomiting, an antiemetic (a drug to counteract vomiting and nausea) may be helpful.

High-Altitude Cerebral Edema

- **Signs and symptoms:** Mental status changes (confusion, lethargy), decreased consciousness or coma, severe headache, and nausea

and vomiting. High altitude and lower air pressure have caused fluid to leak from the capillaries and build up in the brain.

- **Treatment:** Descent is mandatory and immediate. Follow general respiratory protocols: administer oxygen, open the airway, and give rescue breathing if necessary. Request an emergency response team and begin emergency medications. Administer Decadron (dexamethazone, a drug to decrease brain swelling) if available.

High-Altitude Pulmonary Edema

- **Signs and symptoms:** Shortness of breath, cough, cyanosis (blue tinge) around the lips and mouth, crackles (fluid in lungs), gurgling, blood-tinged sputum, and increased respiratory and heart rates. High altitude and lower air pressure have caused fluid to leak from the capillaries and build up in the lungs.
- **Treatment:** Descent is mandatory and immediate. Follow general respiratory protocols: administer oxygen, open the airway, and give rescue breathing if necessary. Request an emergency response team, and begin emergency medications.

COLD-RELATED PROBLEMS

Cold-related problems include frostnip, frostbite, and hypothermia. In some settings, snow blindness and trench foot may also occur. Appropriate clothing is the most important protection from cold-related injury. Layers provide insulation by trapping body heat; the best cold-weather clothing includes several lightweight layers made of materials that conserve body heat and prevent moisture from building up. **A warm head covering, gloves or mittens, and warm socks inside boots or heavy shoes prevent heat loss from the head, hands, and feet.**

2182_Tab05_105-128.qxd 8/18/11 12:20 PM Page 109

MYTH BUSTER

"Drinking alcohol will help you stay warm."
False: Alcohol causes blood vessels to dilate. This increases blood flow to the surface of the skin and away from your body's core (brain and vital organs). Heat is then quickly radiated away from the body.

What Is Wind Chill?

Wind chill is a measure of how quickly the combination of wind speed and temperature remove warmth from exposed skin. As wind speed increases and air strikes your body, convective heat transfer draws away heat more quickly, and the air feels much colder than the temperature the thermometer displays.

SAFETY TIP—Conversion formulas for Celsius(°C) and Fahrenheit (°F).

$$°C = (°F - 32) \times 5/9$$

$$°F = °C \times 9/5 + 32$$

2182_Tab05_105-128.qxd 8/18/11 12:20 PM Page 110

Wind Chill Chart

Wind (mph)	Temperature (°F)																	
Calm	40	35	30	25	20	15	10	5	0	-5	-10	-15	-20	-25	-30	-35	-40	-45
5	36	31	25	19	13	7	1	-5	-11	-16	-22	-28	-34	-40	-46	-52	-57	-63
10	34	27	21	15	9	3	-4	-10	-16	-22	-28	-35	-41	-47	-53	-59	-66	-72
15	32	25	19	13	6	0	-7	-13	-19	-26	-32	-39	-45	-51	-58	-64	-71	-77
20	30	24	17	11	4	-2	-9	-15	-22	-29	-35	-42	-48	-55	-61	-68	-74	-81
25	29	23	16	9	3	-4	-11	-17	-24	-31	-37	-44	-51	-58	-64	-71	-78	-84
30	28	22	15	8	1	-5	-12	-19	-26	-33	-39	-46	-53	-60	-67	-73	-80	-87
35	28	21	14	7	0	-7	-14	-21	-27	-34	-41	-48	-55	-62	-69	-76	-82	-89
40	27	20	13	6	-1	-8	-15	-22	-29	-36	-43	-50	-57	-64	-71	-78	-84	-91
45	26	19	12	5	-2	-9	-16	-23	-30	-37	-44	-51	-58	-65	-72	-79	-86	-93
50	26	19	12	4	-3	-10	-17	-24	-31	-38	-45	-52	-60	-67	-74	-81	-88	-95
55	25	18	11	4	-3	-11	-18	-25	-32	-39	-46	-54	-61	-68	-75	-82	-89	-97
60	25	17	10	3	-4	-11	-19	-26	-33	-40	-48	-55	-62	-69	-76	-84	-91	-98

Frostbite Times: 30 minutes, 10 minutes, 5 minutes

$$\text{Wind Chill (°F)} = 35.74 + 0.6215T - 35.75(V^{0.16}) + 0.4275T(V^{0.16})$$

Where, T= Air Temperature (°F) V= Wind Speed (mph)

Effective 11/01/01

2182_Tab05_105-128.qxd 8/18/11 12:20 PM Page 111

Frostnip

In **frostnip,** vulnerable areas such as the ear lobes, nose, fingers, and toes become cold. **Frostnip is the precursor to frostbite,** so it must be taken care of immediately.

- **Signs and symptoms:** A sense of cold in vulnerable or unprotected areas of the body. Pale skin that feels numb or tingles until warming begins.
- **Treatment:** Frostnip is easily reversible with rewarming techniques, extra clothing, and shelter from the elements. If frostnip is not treated immediately, it may lead to frostbite.

Frostbite

Frostbite is the actual freezing of water in the cells. Vulnerable areas are the same as in frostnip: ear lobes, nose, fingers, and toes. You are more likely to suffer frostbite if you are already experiencing frostnip or hypothermia, or if areas of your body are exposed to cold and wind. In addition, if you are dehydrated, exhausted, or wearing constricting clothing such as tight boots or straps, or if you use substances that cause vasoconstriction, such as caffeine and nicotine, you're more vulnerable to frostbite.

- **Signs and symptoms:** Redness in the affected body area changing to gray, then white; numbness from affected nerves and blood vessels. In **partial-thickness frostbite,** the skin is pale and soft. In **full-thickness frostbite,** the skin is pale and hard (freezing has produced ice crystals).
- **Treatment:** Loosen constrictive clothing and straps. Don't rub affected areas. Slowly warm by immersing the body part in warm (not hot) water. Give warm drinks, and wrap the person in blankets. Seek immediate medical care.

SAFETY TIP—In the initial stages of frostbite, the skin is red, gray, or white. Only after frostbite has caused severe damage will the affected area turn black. The black coloration usually occurs within a few days after the initial injury as the skin and surrounding tissue begin to die.

Hypothermia

Hypothermia, a lowering of the body's core temperature, can strike in any season and in almost any climate. Just combine the following factors: an air temperature of 30º to 50ºF (–1º to 10ºC); rain, sweat, or other wetness; slight wind; and a tired person. This combination overwhelms the body's ability to produce and retain heat.

Hypothermia occurs when your body begins to lose heat faster than it produces it. At this point, you are aware of feeling cold. Structures in your brain stimulate your muscles to contract repeatedly, and you begin to shiver. This action produces heat, but not enough to maintain your functioning. When the cold reaches the brain and deprives you of good judgment, confusion will override your decision-making abilities. Without medical help, your core body temperature will decrease, and you will go into a coma, collapse, and die.

Guidelines to Preventing Hypothermia

- **Stay dry.** When clothing is wet, it may lose 90% of its insulating value. Even sweating can bring on hypothermia.
- **Stay out of the wind.** A slight breeze carries heat away from bare skin faster than still air does. Evaporation can turn wet clothing into a refrigerator.
- **Understand the effects of cool temperatures.** Most hypothermia cases develop in air temperatures that are considered mild, with wind chills in the range of 40° to 50°F (5° to 10°C). Most people don't believe such temperatures can be dangerous.

2182_Tab05_105-128.qxd 8/18/11 12:20 PM Page 113

- **Avoid exposure to cold.** When you can't stay warm and dry, get out of the wind and dampness and get warm as fast as possible.
- **Never ignore shivering.** Persistent or violent shivering is a clear warning that you are in the early stages of hypothermia.

Mild Hypothermia (body temperature 98.6° to 91°F [37° to 32.7°C])

- **Signs and symptoms:** Poor judgment, uncontrolled shivering, difficulty in speaking, apathy or moodiness, loss of fine motor coordination, ataxia (trouble walking), and amnesia.

Moderate Hypothermia (body temperature 90° to 78°F [32.2° to 25.5°C])

- **Signs and symptoms:** Mental status changes progressing to unconsciousness, loss of shivering reflex, irregular heartbeat, low blood pressure, decreased respiration, and diminished reflexes and voluntary movement.

Severe Hypothermia (body temperature less than 77°F [25°C])

- **Signs and symptoms:** Unconsciousness, no shivering, absent neurological reflexes, no response to pain, pulmonary edema, and significant decreases in pulse, respiration, and blood pressure. The person is at high risk for an erratic heartbeat, heart failure, and death.

BODY TEMPERATURE AND HYPOTHERMIA	
Body Temperature	**Body Response**
98.6°–96°F (37°–35.5° C)	Shivering becomes uncontrollable, and ability to perform complex tasks is impaired.
95°–91° F (35°–32.7°C)	Shivering becomes violent, and speaking is difficult.
90°–86° F (32.2°–30°C)	Shivering decreases, and muscles begin to stiffen. Mind becomes dull; in some cases, amnesia occurs.
85°–81° F (29.4°–27.2°C)	Person becomes irrational and drifts into a coma. Pulse and respiration become slow. Muscular rigidity continues.
80°–78° F (26.7°–25.5°C)	Person loses consciousness. Reflexes cease to function, and heartbeat becomes erratic.
Less than 77° F (25°C)	Cardiac and respiratory systems fail completely. Death occurs unless cardiopulmonary resuscitation (CPR) is successful.

Treating Hypothermia

- Get the person out of the cold, and remove wet clothing.
- If impairment is mild, give warm drinks if aspiration is not a risk. Provide dry clothing.
- Keep a semiconscious person awake. Initiate external warming using blankets, sleeping bags, or shelter.
- Apply hot water bottles or chemical heat packs to areas of high circulation, such as the neck, armpits, and groin.
- Avoid burns to the skin by insulating heated objects adequately.
- When no immediate signs of life are present, begin CPR (see Tab 2: CPR). Evacuate the person to advanced medical support.

2182_Tab05_105-128.qxd 8/18/11 12:20 PM Page 115

SAFETY TIP—Handle all victims of moderate to severe hypothermia gently, and immobilize them to reduce the risk for heart rhythm irregularities. Unnecessary movement may cause an already irritable heart to go into cardiac arrest.

Snow Blindness

Snow blindness is a sunburn of the cornea and conjunctiva of the eye. This painful condition is caused by exposure of unprotected eyes to bright sunlight reflected from ice or snow. It occurs in polar regions and at high altitudes. The intensity of ultraviolet rays increases by 5% with every 1000 ft (305 m) in elevation and can have serious consequences if the eyes are not protected by special sun-shielding goggles or glasses.

- **Signs and symptoms:** Bloodshot and teary eyes, eye pain, sensitivity to light, eyelid swelling, and sensation of grittiness in the eyes. Permanent vision loss in very severe cases.
- **Treatment:** Avoid rubbing the eyes, remove contact lenses, administer an oral pain medication such as aspirin (if more than 18 years old) or ibuprofen, use external cool compresses to ease burning and swelling, patch the affected eye(s) with soft dressings to prevent irritation from eyelid movement and light, and rest in a dark room if possible.

Trench Foot

Trench foot (immersion foot) follows exposure to nonfreezing cold and wet conditions over several days and causes nerve and blood vessel damage to the legs and feet without ice crystal formation.

- **Signs and symptoms:** Swelling, redness, and pain in the affected feet and legs during the first few hours to days, then pallor (whitish skin) with eventual numbness.
- **Treatment:** Loosen constrictive clothing, boots, and straps. Don't rub affected areas. Slowly warm by immersing the feet in warm (not hot) water. Give warm drinks, and wrap the person in blankets. When the feet are warmed, keep them dry and avoid re-exposure to moisture. Seek immediate medical care.

HEAT-RELATED PROBLEMS

Heat-related problems range from sunburn to life-threatening emergencies such as heatstroke. You are at greater risk for these problems when the environmental temperature exceeds 95ºF (35ºC) with humidity levels greater than 80%. Children and the elderly are also at increased risk, as are people who have underlying health problems, are dehydrated, or have a burn (including sunburn). Muscular exertion (hard labor or strenuous exercise) also greatly increases the risk.

During even moderate exercise in hot environments, sweat loss can exceed 2 quarts (2 liters) per hour. Drink 1 quart (1 liter) of water an hour to help offset the losses. You can also drink a rehydration drink or sports drink to maintain electrolyte balance. Humans can absorb only about 1 quart (1 liter) of fluid an hour, so frequent rest and rehydration breaks are critical.

★ **SAFETY TIP—Certain substances may predispose you to heat-related problems. These include psychotropic drugs, alcohol, stimulants, and decongestants, among others. Check with your doctor before being exposed to a hot environment.**

Sunburn

- **Signs and symptoms:** Minor skin redness and irritation in mild and uncomplicated cases. Possibly severe pain after sufficient exposure. Initially skin turns red about 2 to 6 hours after exposure and feels irritated. The peak effects appear at 12 to 24 hours.
- **Treatment:** Medications such as aspirin (if more than 18 years old) and ibuprofen are useful to relieve discomfort, especially when started early. For mild sunburn, cool compresses may suffice. Aloe-based lotions help soothe and moisturize the skin. Obviously, stay out of the sun while you're sunburned. Seek medical care if you experience a fever, chills, dehydration, or blistering.

2182_Tab05_105-128.qxd 8/18/11 12:20 PM Page 117

Heat Syncope

- **Signs and symptoms:** Syncope (fainting) after prolonged standing in a hot environment.
- **Treatment:** Check airway, breathing, and respiration. Assess for any trauma caused by a fall. When the person is alert and awake, give cool fluids.

Heat Cramps

- **Signs and symptoms:** Painful cramps usually occurring in heavily exercised muscles, with onset during or after the exercise.
- **Treatment:** Administer cool fluids, and allow the person to rest in a cool environment.

Heat Exhaustion

Heat exhaustion occurs when fluid loss (sweating) exceeds fluid intake. It often happens during manual labor or exercise in hot, humid environments and is common in people who are not used to a hot, humid climate. Electrolyte losses are frequent. Heat-exhausted people are dehydrated–if they continue their activity, heatstroke may follow.

- **Signs and symptoms:** Normal or increased pulse, respiration, and blood pressure. Normal or slightly elevated body temperature. Dizziness, nausea and vomiting, headache, chills, and lightheadedness may occur.
- **Treatment:** Stop exercise, drink fluids, and replace electrolytes with a sports or rehydration drink that contains potassium, sodium, phosphorus, and chloride. Rest in a cool environment. Seek medical care.

★ **SAFETY TIP—Unacclimatized people working in heat for 8 hours a day can prevent salt deficit and electrolyte imbalance by adding a small amount of salt to their drinking water. The ideal concentration is a 0.1% salt solution, which can be prepared by dissolving 1/4 tsp of table salt in 1 quart (1 liter) of water. Salt should never be eaten by itself. It irritates the stomach, causes vomiting, and does not treat the dehydration.**

Heatstroke

Heatstroke is a life-threatening emergency. It results when the body produces more heat than it can release with its normal cooling processes (sweat and respiration). Manual labor and exercise in a hot environment can bring on heatstroke very quickly even in a person who is not dehydrated. In addition to muscular exertion, risk factors include obesity, heart problems, and older age. Athletes training or competing in hot, especially hot and humid, environments are at significant risk.

- **Signs and symptoms:** Severe, life-threatening rise in body temperature to more than 105ºF (40.5ºC), with or without preceding heat exhaustion. Decreased or absent sweating, altered mental status (confusion, disorientation, bizarre behavior), seizures, elevated pulse and respiration, and decrease in blood pressure.
- **Treatment:** Provide rapid cooling. Place ice or cold packs on areas of high circulation: the neck, armpits, and groin. Immerse the person in cool water if possible (keeping the head out of water), or use evaporative cooling (wet the person with cool water and fan aggressively). Seek immediate medical care.

★ **SAFETY TIP—To avoid heatstroke, athletes should train and acclimatize to the heat (this may take several weeks), stay well hydrated, and curtail training when it's very hot.**

Hot Weather and Pets

Hot, humid weather can be dangerous to pets, particularly dogs left in cars or chained outside. Pets can suffer brain damage or even death.

Signs of Heat Illness in Pets

Dogs cool themselves by panting. If panting doesn't reduce the body temperature sufficiently, the dog will develop heat exhaustion or heatstroke. Signs of heat exhaustion include rapid breathing, heavy panting, and profuse salivation. As with a human, heat exhaustion can lead to

2182_Tab05_105-128.qxd 8/18/11 12:20 PM Page 119

heatstroke. Signs of heatstroke include heavy panting, glazed eyes, fatigue, vomiting, staggering or unsteady gait, rapid pulse, and deep red or purple tongue and gums. **If your dog exhibits any of these signs, lower its body temperature immediately!** Get the dog in the shade, apply cool, wet towels, put the dog in a shower, or use a hose and spray with cool water. Never cool the dog enough to cause shivering. Give small amounts of cool water and call a veterinarian for immediate medical help.

Safety Precautions

Use common sense, and remember these tips to keep your pet safe in hot weather:

- Always have plenty of fresh water available.
- Make sure your pet has access to shelter and shade.
- Dogs can get sunburned, especially those with light-colored noses or little hair on some parts of their bodies. Ask your veterinarian for advice on pet-safe sunscreens.
- Do not leave older pets, pets with health problems, or short-nosed dogs such as pugs outside in the heat.
- **Never** leave your dog unattended in a parked car with the windows up. Temperatures inside can reach more than 120° F (49°C) within minutes even when the outside temperature is just 70°F (21°C). Opening a window an inch or two or leaving a bowl of water will make little difference. Your dog will quickly overheat and could die.
- **Never** allow your dog to exercise excessively in hot weather. Walk the dog early in the morning or later in the evening.

LIGHTNING INJURIES

All thunderstorms produce lightning, and all are dangerous. Although most lightning victims survive, they often report a variety of long-term, debilitating problems.

Lightning bolts.

Lightning delivers a massive, very hot electrical pulse over a fraction of a millisecond. Ninety percent of lightning strikes are from cloud to cloud; only about 10% of lightning strikes are from cloud to ground. Two factors can predispose you to a lightning strike: height and isolation. Lightning tends to strike tall objects, including trees, gazebos, television or cell towers, shelters, flagpoles, bleachers, and fences. A person who is the tallest object in an open field is at risk.

MYTH BUSTER

"Lightning only occurs with thunderstorms."
False: Lightning can occur without rain or visible clouds in the sky. Most people know enough to seek shelter after the storm clouds roll overhead. Few realize that one of the most dangerous times for a fatal strike is before the storm.

2182_Tab05_105-128.qxd 8/18/11 12:20 PM Page 121

SEVERE THUNDERSTORM WATCH: Notice of when and where severe thunderstorms are likely to occur. Watch the sky, and stay tuned to a radio or television for information.
SEVERE THUNDERSTORM WARNING: Issued when severe weather has been reported by spotters or indicated by radar. Warnings indicate imminent danger to life and property for anyone in the path of the storm.

Prevention

- During the thunderstorm season, listen to weather reports. High winds, rain, and clouds may mean that a thunderstorm is imminent.
- Remove dead or rotting trees and branches that could fall and cause injury or damage.
- If you see a lightning bolt or hear a sharp, loud crack or long, low rumble from thunder (the sound of lightning), seek shelter. You can estimate the distance of the storm by seeing the flash of light in the distance and then listening for thunder. You see lightning the instant it flashes, whereas the sound waves of thunder travel a mile in about 5 seconds. **If the interval between lightning and thunder becomes less than 30 seconds, seek shelter immediately.** Storms travel quickly, and the next lightning strike could be dangerously close to you.
- Shelter in small, open structures is not safe. Try to get inside a large, enclosed building or an enclosed vehicle with the windows shut.
- Don't resume outdoor activities until 30 minutes after you hear the last thunder or see the last lightning.
- Before and during a thunderstorm, if you are caught outdoors, avoid high ground, metal objects, water, and open spaces such as fields. Stay at least 15 feet away from other people, and seek shelter in the middle of a grove of trees (but not under a solitary tree). **If you can't get to shelter, squat to make yourself as low as possible, but don't lie on the ground. Put your weight on the balls of your**

feet, feet together, head lowered, eyes closed, and ears covered (see lightning position). This position lowers your height and minimizes the area in contact with the surface of the ground.

- To prevent lightning injuries when indoors, avoid contact with water such as taking a shower or bath, because lightning can travel through the plumbing, and water conducts electricity. Also avoid talking on a landline corded telephone (lightning will travel through the phone line), working on a computer, or using headsets cabled to a sound system (lightening will travel through electrical sources). Stay away from windows and doors, and turn off and unplug electrical equipment before the thunderstorm arrives.
- Use your battery-operated radio for updates from local officials.

Lightning position.

SAFETY TIP—Seek shelter when you hear thunder or see lightning. During potential storms, avoid exposed areas such as open fields, water, tall objects, and openings of caves or buildings.

2182_Tab05_105-128.qxd 8/18/11 12:20 PM Page 123

MYTH BUSTER

"Wearing metal on your body attracts lightning."
False: Height, a pointed shape, and isolation are the dominant factors controlling where a lightning bolt will strike. The presence of metal makes virtually no difference. While metal doesn't attract lightning, touching or being near long metal objects (fences, railings, bleachers, vehicles) is still unsafe when thunderstorms are nearby. If lightning does happen to hit it, the metal can conduct the electricity a long distance and still electrocute you.

Lightning Injuries

Lightning is much less likely to cause internal burns than is generated electricity. The brief exposure often limits damage to the outer layer of skin. In most instances, the contact is too brief to burn the skin substantially. Lightning energy flows through the body for an incredibly brief period; most of it usually flashes around the body's surface. However, it can kill a person by instantly short-circuiting the heart or brain.

- **Signs and symptoms:** In mild injuries, possible ruptured eardrum or superficial burns in a fernlike pattern. In major injuries, cardiopulmonary arrest, chaotic heart rhythm, severe skin burns, fractures, and concussion. Look for entry and exit wounds.
- **Treatment:** Treat immediate life-threatening injuries, treat other injuries as needed, call for help, and evacuate the person to the nearest medical facility.

MYTH BUSTER

"Lightning victims are electrified. If you touch them, you'll be electrocuted." **False:** The human body doesn't store electricity. It's perfectly safe to touch a lightning victim to give first aid.

WATER EMERGENCIES

Prevent Injuries by Following These Water Safety Tips

- **Learn to swim.** Check out your local community center for swim classes.
- Adult supervision will minimize risks and injuries to children.
- Pool and hot tub safety is essential.
- Always wear a properly fitted and approved lifejacket, and use helmets when appropriate (for white-water rafting and kayaking).
- Never swim when intoxicated.
- Always swim with a buddy; never swim alone.
- **Obey pool rules:** Don't run on or near a pool deck; don't play on or near diving boards; don't jump on or near people in the water; never enter pool areas that are closed or locked; never fake an accident or drowning; don't engage in horseplay.

MYTH BUSTER

"Flotation devices serve the same purpose as lifejackets." **False:** Lifejackets are designed to hold a person on top of the water. Flotation devices (floats, surfboards, rafts) usually require you to hold on to, sit on, or lie on them and are not dependable. Weak swimmers can fall off in deeper water than they would swim in without the float.

2182_Tab05_105-128.qxd 8/18/11 12:20 PM Page 125

SAFETY TIP—Most cases of drowning are easily preventable. Preventive strategies include installing fencing around swimming pools to keep out children and pets, maintaining adult supervision, wearing lifejackets in boats, and above all, avoiding drugs and alcoholic beverages while swimming or boating.

How to Rescue a Drowning Person

Should you attempt to rescue someone who is drowning? Here are some things to consider before you do:

- Never attempt a rescue unless you're trained in water safety.
- Training in water safety, water rescue, CPR, and first aid provides the skills needed to save lives and the knowledge to take some panic out of the situation.

The first step in rescuing a drowning person is to ensure your own safety. A conscious person may panic and cling to you, thus submerging you in the process. Avoid being the second victim. The safest form of rescue is known as **"reach, throw, row, and go":**

- **Reach to grab a long object and extend it to let the drowning person reach for the other end.** A fishing rod, an oar, a branch, even a shirt or towel can help you pull someone to safety. If the person is close and you can't find anything to reach with, lie down, hold on to something solid with your arms, and reach with your leg.
- **Throw anything that floats to the drowning person.** Small plastic beverage coolers (soft or hard) and lifejackets are good floaters. People who perform rescues at sea say that many survivors are found clinging to their ice chests. If you are in a boat, it may be equipped with a flat cushion or round ring buoy; both are designed to be held on to, not worn. Tying a rope to the cushion or ring buoy before you have an emergency can save time and lives.

- **Row a boat, raft, log, or anything that can float safely to get the person back to shore.** Dragging someone into a boat over the stern (back) might require great strength. The person may be able to hold on to the boat as you either head for shore or stay put until more help arrives.
- **Go for help.** Time is critical but, unless you've been trained as a lifeguard, it's better to go for help than try to swim to someone's rescue. Dial 911 or your local emergency response number if you have a cell phone.

MYTH BUSTER

"*Good swimmers don't drown.*" **False:** People drown for many reasons besides a lack of swimming skills. Contributing factors include a medical emergency, injury, drug or alcohol intoxication, overexertion, hypothermia, and cramps. Some gifted swimmers have lost their lives in this manner. Good swimming skills are never a replacement for proper water safety.

First Aid for Victims of Drowning and Near-Drowning

Drowning is death caused by suffocation when a liquid interrupts the body's absorption of oxygen from the air. The primary causes of death are lack of oxygen and acidosis leading to cardiac arrest. **Near-drowning** is the survival of a drowning event involving unconsciousness or water inhalation. It can lead to serious secondary complications, including death, after the event.

- **Signs and symptoms:** Unconsciousness, no breathing, possibly no heartbeat; cold exposure and shock.
- **Treatment:** Remove the person from the water. If breathing is absent, begin CPR (see Tab 2: CPR) immediately if you are trained or being guided by an emergency dispatcher. Call for immediate

2182_Tab05_105-128.qxd 8/18/11 12:20 PM Page 127

medical assistance, and evacuate to a medical facility. Use blankets, and keep the person warm.

SAFETY TIP—Victims have recovered fully after immersion in cold water for more than 30 minutes. Cooling slows the body's metabolic processes and allows the brain to survive the lack of oxygen for longer than normal.

MYTH BUSTER

"Victims always drown in deep water." **False:** Shallow water in pools or along coastlines may seem harmless enough to let a child splash around in, but you may be surprised to learn that most drownings occur in less than 4 ft (1.22 m) of water. Small children can drown in as little as 1 inch (2.54 cm) of water and in just 30 seconds.

SCUBA DIVING EMERGENCIES

Trained and certified scuba divers know how to avoid common problems that can come up during a dive. The two most serious causes of injury are decompression sickness and arterial gas embolus.

Decompression Sickness

Decompression sickness (often called "the bends") is caused by the formation of nitrogen gas bubbles inside blood vessels and tissues. Excess nitrogen accumulates in the body when a diver breathes at a depth greater than 33 feet (10 m). Decompression sickness occurs when ascent is too rapid to allow the release of this excess nitrogen. Divers notice symptoms within minutes or hours after surfacing.

- Signs and symptoms: Fatigue and musculoskeletal pain, particularly around joints such as the shoulders or elbows. Pain may be a dull

ache but may also be sharp or throbbing. More severe cases may lead to unconsciousness, low blood pressure, and a fast heart rate.

- **Treatment:** Transport the patient for recompression treatment in a hyperbaric (oxygen) chamber. If an aircraft is used, ideally the cabin should be pressurized to sea level. If the patient is flown out by helicopter (unpressurized), the pilot should try to stay below 1000 ft (330 m) above sea level. Keep the patient facing up, and have a medical team administer oxygen and other necessary interventions.
  - Help with dive-related incidents is available 24 hours a day. Call the Divers Alert Network (in the United States) at 800-446-2671.

Arterial Gas Embolism

The pressure of water on a submerged diver's body is far greater than atmospheric pressure. When a diver ascends to the surface too quickly, this pressure can decrease so rapidly that gas expands in the lungs and air cannot escape in adequate amounts. Alveoli (small air sacs) rupture in the lungs and release air bubbles that enter the bloodstream and are circulated to the heart. This is called an ***arterial gas embolism*** and usually develops immediately after a diver surfaces. The result can be fatal.

- **Signs and symptoms:** Sudden loss of consciousness on surfacing from a dive, chest pain related to lack of oxygen to the heart, confusion, convulsions, difficulty speaking, shortness of breath, blindness or visual impairment, dizziness, and headache.
- **Treatment:** Transport the person for recompression treatment in a hyperbaric (oxygen) chamber. If an aircraft is used, ideally the cabin should be pressurized to sea level. If the person is flown out by helicopter (unpressurized), the pilot should try to stay below 1000 ft (330 m) above sea level. Keep the person facing up, and have a medical team administer oxygen and other necessary interventions.
  - Help with treatment of dive-related incidents is available 24 hours a day. Call the Divers Alert Network (in the United States) at 800-446-2671.

2182_Tab06_129-153.qxd 8/18/11 12:21 PM Page 129

Tab 6: Poisons, Bites, and Stings

Poisons are substances that can harm us if we come into contact with them. The most common sources of poisons are contaminated foods, certain household and industrial chemicals, the secretions of biting and stinging insects and other creatures, and the sap, berries, and other parts of poisonous plants. Bites from mammals such as humans, dogs, and cats are covered in Tab 4: Injuries and Wounds.

POISONING

Although poisonings are common in the workplace, most poisonings occur in the home. Household chemicals, especially those designed to have a pleasant odor and color, are a common cause, as are industrial chemicals used in the garage, workshop, or garden. Over-the-counter and prescription medications can easily cause an accidental overdose if a child or pet gets hold of them, as can vitamins and other dietary supplements.

As shown in the box immediately following, poisonous substances can be ingested–taken into the body by mouth–or inhaled or injected. They can also be absorbed by skin contact. From any of these routes, poisoning can produce local or generalized (body-wide) effects ranging from minor to critical. Identifying specific poisons may be easy or impossible because poisons may be mixed or even unknown.

POISON: ROUTES OF EXPOSURE AND ABSORPTION

Ingestion

- The most common exposure route is ingestion, and the most common substances are drugs, household products, plants, and contaminated food.

Continued

POISON: ROUTES OF EXPOSURE AND ABSORPTION—cont'd

- Absorption generally occurs in the gastrointestinal tract. The mouth and upper airway may also be affected.
- Take the person to a hospital emergency department without delay.

Inhalation

- Toxic fumes from gases such as smoke or carbon monoxide cause most cases of inhalation poisoning.
- The upper and lower airway may both be affected.
- Lack of oxygen may occur when air is displaced by gases, vapors, aerosols, or dusts.
- Move the person into fresh air, give supplemental oxygen if possible, and seek immediate medical care.

Injection

- Injection causes immediate (intravenous) or rapid (intramuscular, subcutaneous) absorption.
- This route includes bites, stings, and intravenous drug overdose.
- Generalized symptoms or intense local tissue destruction will occur soon after poisoning.
- Immobilize the extremity, and provide basic life support (airway, breathing, circulation). Seek immediate medical care.

Skin

- This is the route of slowest absorption; however, absorption will occur more quickly if the skin is broken.
- Contact with corrosives (e.g., acids and alkalis in plants and household or industrial cleaners) causes most skin absorption poisonings.
- Local effects include burns to the skin and blisters.
- Remove clothing, dust any dry material off the skin, and flush the skin with water. Seek immediate medical care.

2182_Tab06_129-153.qxd 8/18/11 12:21 PM Page 131

SAFETY TIP—If you have a question about a poison or poisoning, you can call the National Poison Control Center (800-222-1222) from anywhere in the United States. The medical staff are experts and will tell you what to do. Try to have the container or label handy so you can describe it. You can also call if you have any questions about poisoning prevention. The center will take your call for any reason, 24 hours a day, 7 days a week.

If poisoning has occurred, follow these steps:

- Identify the poison if you can.
- Call your local or national poison control center (see phone number under safety tip).
- Alternatively, go to a hospital emergency department immediately.

The signs, symptoms, and treatment of specific types of poisonings are discussed next.

Food Poisoning

Food poisoning can occur when certain microorganisms contaminate food. Food can become contaminated during processing or from improper preparation and storage. Any type of food, whether of plant or animal origin, can become infected. Undercooked beef and pork, raw seafood and produce, and foods that have been left out at warm temperatures, as during a picnic, are common sources of food poisoning.

- **Signs and symptoms:** Weakness, nausea, vomiting, abdominal pain or cramping, and diarrhea. Typically, symptoms begin within 1 to 48 hours after the contaminated food has been consumed.
- **Treatment:** Vomiting and diarrhea are normal methods the body uses to rid itself of the harmful substance. If short periods of vomiting and diarrhea have lasted less than 24 hours, the person can usually stay hydrated by taking frequent sips of a clear liquid. Avoid caffeinated or sugary drinks. After the vomiting and diarrhea have stopped, the person should eat plain foods (e.g., rice, wheat, and potatoes) that the

stomach can easily tolerate. If vomiting and diarrhea last more than 24 hours or abdominal pain is severe, seek medical care.

Chemical Poisoning

Chemical poisoning is often caused by the ingestion of household products, gardening chemicals, industrial chemicals, or plants. Children and pets will swallow just about anything, so make sure you keep the following common household poisons out of their reach:

- Antifreeze and windshield washer fluid
- Arts and crafts products such as glue and paint
- Bleach, drain cleaners, and toilet bowl cleaners
- Medications and vitamins and other supplements
- Mothballs, makeup, nail polish, and perfumes
- Plant food and bug and weed killers
- Some house plants (read about the plant before you buy it)
- Paint chips flaking off a wall, especially lead-based paint found in older homes

SAFETY TIP—Antifreeze can be fatal to humans and pets. Children and pets are drawn to it because of its sweet smell and taste. The most commonly used antifreeze compounds contain ethylene glycol, which is toxic. Poisoning of pets commonly occurs when pets lick antifreeze leaking from a vehicle's cooling system. If you change antifreeze in the driveway, collect all the waste coolant and dispose of it properly. Never leave a container of ethylene glycol coolant within reach of a child or pet. If you see a puddle of greenish liquid in your driveway, clean it up immediately. Flush the area with plenty of water and locate and fix the leak in your vehicle without delay. A quick clean-up technique is to spread cat litter on the spill, wipe it up with rags (bag them immediately), and rinse the area.

2182_Tab06_129-153.qxd 8/18/11 12:21 PM Page 133

When in doubt, assume the worst. Try to identify the product, and contact your local or national poison control center. Look for empty medicine bottles or scattered pills; look for skin burns and burns around the person's mouth and stains and/or odors on the person's clothing or on the furniture or floor nearby.

- **Signs and symptoms:** Burns on the skin or around the lips or mouth, severe sore throat, difficulty breathing, stomach cramps without fever, and unexplained nausea and vomiting. In a child, sudden behavioral changes such as sleepiness or anxiety, drooling, or odd breath odor.

★ **SAFETY TIP—Children experience greater toxicity from poisons because of the increased dose of toxin per pound (or kilogram) of weight.**

- **Treatment:** If there are no symptoms but you suspect poisoning, call the poison control center. Try to identify the possible poison, the amount ingested, and the time of occurrence. If the person has symptoms, call for immediate medical care. While waiting for help, keep the person calm, and make sure the airway is clear. Collect any bottles or containers of the suspected poison.

★ **SAFETY TIP—If someone is poisoned, don't administer ipecac syrup or do anything to induce vomiting. The American Association of Poison Control Centers and the American Academy of Pediatrics have recommended that ipecac not be used or even be kept at home. According to these sources, there's no solid evidence of effectiveness, and it can do more harm than good.**

Pet Safety: Foods Poisonous to Dogs and Cats

Avoid feeding your dog or cat any of the following:

- Alcoholic beverages
- Avocado
- Chocolate (all forms)
- Coffee (all forms)
- Fatty foods
- Garlic
- Macadamia nuts
- Moldy or spoiled foods
- Onions or onion powder
- Raisins and grapes
- Salt
- Products sweetened with xylitol (an artificial sweetener)
- Yeast dough

MYTH BUSTER

"I can give my dog or cat chocolate as a treat."
False: Chocolate contains theobromine, a stimulant found in the cocoa bean that's harmful to both dogs and cats. Chocolate can cause vomiting and diarrhea, excessive thirst and urination, hyperactivity, abnormal heart rhythm, tremors, seizures, and even death in severe cases. If your pet has gotten into chocolate, note the type, estimate the amount eaten, and call your veterinarian for advice. If your veterinarian is not available, seek immediate care at an emergency veterinary clinic.

2182_Tab06_129-153.qxd 8/18/11 12:21 PM Page 135

SAFETY TIP—If you have a question about a possible pet poison, call the Animal Poison Control Center at 888-426-4435. They are the best resource for any animal poison–related emergency, 24 hours a day, 365 days a year. If your pet needs immediate medical care, contact your veterinarian or an emergency veterinary clinic.

BITES AND STINGS

Many animals can bite or sting you. Injuries from the bites of mammals such as dogs, cats, and humans are discussed on page 79. Here, we discuss the bites and stings of flying insects, chiggers, ticks, spiders and scorpions, marine animals such as jellyfish and stingrays, and finally snakes. Whereas most such bites and stings are painful, only a few types can cause sickness, allergic reactions, or death. For instance, all spider bites can deliver toxic substances, but very few can penetrate deeply enough through human skin to cause sickness or death.

This section cannot cover all scenarios involving every biting or stinging creature on the planet. It does give you suggestions for dealing with the bites and stings of the most common such animals.

Flying Insects

If you are hiking, camping, or just sitting in your back yard, you may be exposed to bites and stings from flying insects. Although annoying, most bites and stings are preventable if you take the proper precautions (see the next Safety Tip).

SAFETY TIP—In bug-infested areas, wear protective clothing such as a long-sleeved shirt and trousers. Apply an insect repellent to your clothing as well as to exposed skin. A head net may be necessary to protect your face and neck.

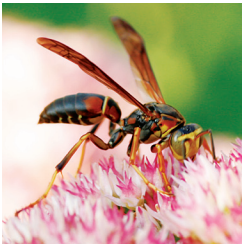
Bees and Wasps

Even a single sting from one of these winged insects can cause a great deal of pain.

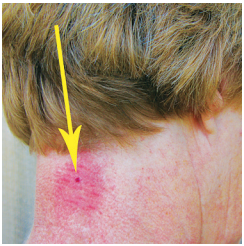
- Wasps, which include yellow jackets, paper wasps, and hornets, can deliver multiple stings and may attack as a group.
- The honeybee has a barbed stinger, attached to a venom sac, that remains in the victim's skin and prevents the bee from stinging more than once. After losing its stinger, the honeybee flies away to die.

Honeybee.

Yellow jacket wasp.



Paper wasp.



Sting from yellow jacket wasp.

2182_Tab06_129-153.qxd 8/18/11 12:21 PM Page 137

Black Flies, Fire Ants, and Mosquitoes

The bite of these flying insects causes pain and itching.

- **Black flies** are small, dark flies with a humped back and a painful bite. They breed around rapidly flowing streams rather than stagnant water. Black fly saliva is toxic. It can cause pain, itching, and even nervous and intestinal disorders.
- The **fire ant** both bites and stings. Its bite is used as a means to hold on so it can use its stinger. After latching on to your skin with its teeth, the fire ant delivers its painful sting. The ant swivels around the bite, stinging multiple times in a circular pattern. Although fire ants have two pairs of wings, they usually attack from the ground.
- **Mosquitoes** are found all over the world. Many are known to transmit diseases such as malaria, West Nile virus, encephalitis, and dengue fever. The mosquito penetrates the skin of a human or animal with a flexible snout that draws out the blood. The itching and local swelling around the bite characterize the allergic reaction to the mosquito's saliva.

Mosquito drawing blood.

SAFETY TIP—Mosquitoes mature in stagnant water, their usual breeding ground. Be sure to empty open containers filled with water and drain or fill in areas where water collects.

SAFETY TIP—Protect your dog and cat from heartworm disease. If there are mosquitoes in your area, your pet should be given preventive medication. Heartworm, a parasite, is transferred from one mammal (dog, cat, fox, wolf) to another by certain types of mosquito. If the mosquito bites an infected animal and then bites your pet, the worm's larvae will be deposited into your pet's bloodstream. As the larvae mature, they migrate to the animal's heart. Heartworm disease is fatal but preventable. Talk to your veterinarian, and keep your pet safe.

First Aid for Bites and Stings from Flying Insects

- Signs and symptoms: Local pain, redness, swelling, and itching; in moderate allergic reactions, possible rash or hives. In severe allergic reactions, wheezing or trouble breathing, severe swelling around the bite or sting, or swelling around the lips, tongue, or face. If you are allergic, particularly to bee or wasp venom, a single sting can cause a serious reaction or even death. Some reactions are local and affect only the skin; others are systemic and affect the whole body.
- Treatment: If a stinger is embedded in your skin, scrape or pick it off with your fingernail. Avoid squeezing, which can release more venom into the skin. Some insects may not have stingers; if you can't see one, assume it's not there. A cold compress may reduce the swelling and ease the pain. For moderate reactions, a mild painkiller such as acetaminophen or ibuprofen can make you feel more comfortable.
  - To prevent infection, wash the area with soap and water. Apply an antiseptic or an antibacterial ointment. Calamine lotion may

2182_Tab06_129-153.qxd 8/18/11 12:21 PM Page 139

relieve the discomfort. Avoid scratching—this is a major cause of infections. For a systemic reaction, use an over-the-counter antihistamine to control swelling, itching, and redness. If you have a sudden and severe allergic reaction, seek immediate medical attention. (See the discussion of anaphylaxis on page 57.) People prone to severe allergic reactions should carry epinephrine injections in case they get stung.

SAFETY TIP—If you are at risk for a sudden and severe allergic reaction, your doctor may suggest that you carry an allergy kit. These kits contain antihistamine pills (e.g., diphenhydramine [Benadryl]), alcohol wipes for cleansing the injection site, and an injection of epinephrine (e.g., EpiPen) that you can give yourself in case of an emergency. Seek immediate medical care even after the use of an allergy kit.

Chiggers

Chiggers are the larval stage of the harvest mite. Mites are not insects, but rather belong to a diverse group of creatures called *arachnids* that includes ticks, spiders, and scorpions. Chiggers crawl onto your skin and chew up tiny parts of the inner skin so they can survive into their final adult stage as harvest mites. Contrary to popular belief, they don't remain in the skin after feeding.

- Chiggers tend to congregate on your ankles or wrists because your skin is thinner there, thus making it easier for this tiny animal to penetrate your skin for its meal.
- Chiggers secrete a substance that desensitizes the area, so you don't react to their presence immediately. In fact, you won't feel the effects for up to 48 hours after the chiggers feed on you.
- To determine where you were when you encountered chiggers, count back 24 to 48 hours from when you began exhibiting irritating signs of their "bite."

MYTH BUSTER

"Applying fingernail polish will suffocate the chiggers." **False:** Chiggers don't bore into or live inside your skin. By the time a severe itching problem sets in, the chiggers are nowhere in sight. Trying to smother skin damaged by chiggers may actually cause more problems.

Ticks

Ticks are small arachnids that bite into the skin and feed on blood. They can transmit Lyme disease, Rocky Mountain spotted fever, tick paralysis, and other serious diseases. Wear long sleeves and pants tucked into closed-toed shoes or boots during your travels in "tick country."

Lone star tick.

Lone star tick (filled with blood).

Lyme Disease

Lyme disease is a progressive and debilitating bacterial disease spread by the bite of deer ticks, which are very small. Ticks must be attached to the skin for at least 24 hours to transmit the bacteria to humans.

2182_Tab06_129-153.qxd 8/18/11 12:21 PM Page 141

- **Stage 1: Days to weeks**—expanding red rash around the site; possible flu-like signs and symptoms such as fever, headache, fatigue, and joint pain.
- **Stage 2: Week to months**—Neurological problems (meningitis, Bell's palsy), cardiac abnormalities, infection, and rash.
- **Stage 3: Months to years**—circulatory, respiratory, and neurological problems; signs and symptoms of severe arthritis.

Rocky Mountain Spotted Fever

Rocky Mountain spotted fever is a severe bacterial disease spread by the bite of dog ticks and other types of ticks.

- **Stage 1:** Fever, headache, and sensitivity to light occur.
- **Stage 2:** This stage lasts 3 to 4 days and is characterized by high fever and rash.
- Deaths are rare but have been reported.

Tick Paralysis

Tick paralysis is a rare but potentially fatal disease caused when a paralyzing nerve toxin is released from the bite of a female tick.

- Leg weakness progresses to paralysis as long as the tick is still attached.
- Respiratory arrest is possible.
- Deaths are rare but have been reported.

Tick Removal and First Aid

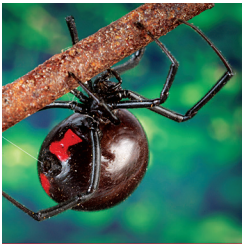
- You can use your fingers to remove an unattached tick from your skin. Dispose of the tick immediately.
- Remove an embedded tick with tweezers. Pull the tick straight out gently but firmly. Avoid jerking or twisting the tick or the head may remain embedded.
- After removing the tick, wash the bite area with soap and water, and apply an antiseptic if you can.
- The same removal procedures will work if your dog or cat has brought in ticks from outdoors. You may have to search beneath heavy fur if the tick has attached itself to the animal. Even in

short-haired pets, ticks can be found in obscure areas, such as between the toes, or under the chin, tail, or ear flap. Be sure to look closely.

SAFETY TIP—Ticks can give dogs and cats the same diseases they give humans. If left undiagnosed, Lyme disease, Rocky Mountain spotted fever, or tick paralysis can be fatal. Be sure your pet is protected against the most common carrier, fleas, in addition to ticks. Check with your veterinarian for the best flea and tick repellent.

Spiders

Many people fear spiders, but these fears are largely unfounded. Like scorpions, spiders are predators that help keep insect populations in check, and few species of spiders bite humans. The **black widow** and **brown recluse** spiders are exceptions: their bites can cause uncomfortable and even serious reactions.



Black widow spider.

Brown recluse spider.

2182_Tab06_129-153.qxd 8/18/11 12:21 PM Page 143

Black Widow Spiders

The adult black widow spider is medium sized, about 1/2 inch (1.3 cm) long. The female black widow is normally shiny black, with a red hourglass marking on the underside of the abdomen. Only the female's bite is toxic; the male is brown and is not poisonous to humans. Black widow spiders are active at night. They prefer dark corners or crevices, woodpiles, hollow stumps, sheds, outhouses, and garages. Indoors, they prefer cluttered areas in basements and crawl spaces.

- **Signs and symptoms:** A mild pinprick followed by severe muscle cramping and pain progressing to the chest, back, abdomen, arms, and legs. Difficulty breathing in severe cases. Although rare, fatalities do occur, particularly in children less than 3 years old or adults more than 55 years old.
- **Treatment:** Wash the bite area with soap and water. Apply ice or cold packs to relieve pain. Seek immediate medical care. Antivenin, a product that lessens the effect of the venom, should be administered only by a doctor. Most people recover within 36 to 72 hours.

Brown Recluse Spiders

The brown recluse spider is about ½ to 1 inch (1.3 to 2.5 cm) long. Its characteristic dark violin-shaped marking is on the back of the body (where the legs are attached), with the base of the violin at the spider's head and the neck of the violin pointing to the rear. These spiders seek out dark, warm, dry environments, such as attics, closets, porches, barns, basements, woodpiles, and old tires.

- **Signs and symptoms:** Usually a painless bite. Possible localized swelling and inflammation occur within 1 to 2 hours. After about 6 to 12 hours, a bull's-eye lesion with blistering or redness resembling a cigarette burn appears. If the area enlarges, the skin and tissue around it can die. If left untreated, the bite may cause widespread infection and, rarely, death.
- **Treatment:** Wash the bite area with soap and water. Apply ice or cold packs to relieve pain. Seek immediate medical care.

Scorpions

Scorpions are predatory arachnids, like spiders, but they have a true stinger located at the end of their tail. This stinger is used primarily to paralyze insect prey, but when threatened by a human, the scorpion will defend itself. A scorpion can sting multiple times. Most species cause significant local pain and swelling with little to no widespread effects. Scorpion stings are most dangerous to young children and elderly people. Pets are also at risk. Scorpion stings are not a major health concern for the United States except for stings of the bark scorpion in the Southwest. However, a more poisonous variety that lives in certain tropical countries can deliver a fatal sting.

Scorpion.

- **Signs and symptoms:** Immediate pain, burning, and swelling and redness at the sting site. The venom affects the nervous system and causes muscle twitching, which can progress to convulsions (seizures).
- **Treatment:** Wash the sting area with soap and water. Ice or cold packs can be applied to relieve pain. Seek medical care without delay.

2182_Tab06_129-153.qxd 8/18/11 12:21 PM Page 145

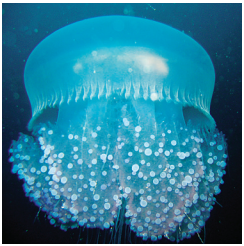
Marine Animals

Marine animals can inflict pain with their teeth, stingers, or even prickly body parts. Most such encounters occur in salt water and begin when the animal tries to defend itself. It's best to swim near a beach with a lifeguard and observe posted signs, which may alert you to danger from hazardous animals. **Do not touch unfamiliar marine life. Even dead animals and severed tentacles may contain venom.**

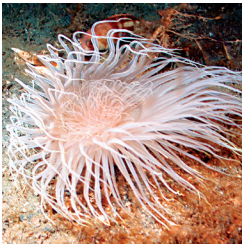
Types of Stinging Marine Animals

Three marine animals commonly involved in stinging incidents are jellyfish, sea anemones, and stingrays:

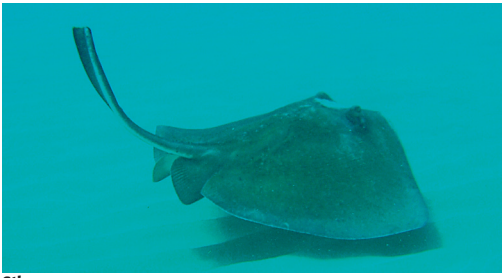
- **Jellyfish** have a nearly transparent body with long, fingerlike structures called tentacles. Stinging cells inside the tentacles can hurt you if you come in contact with them. Some stings can cause serious harm.
- **Sea anemones** have small, soft bodies that resemble flowers. They use their tentacles to catch prey. Their sting, like that of many bees, causes local pain, tenderness, and swelling.
- **Stingrays** have a long, whiplike tail with sharp spines that contain venom. A large stingray may cause serious injury or even death if the barb penetrates internal organs.



Jellyfish.



Sea anemone.



Stingray.

First Aid for Marine Animal Bites and Stings

- **Signs and symptoms:** Pain, burning, swelling, redness, and bleeding around the bite or sting. Muscle cramps, diarrhea, difficulty breathing, nausea or vomiting, and abdominal pain. Variable generalized signs and symptoms.
- **Treatment:** Wear gloves if possible, and wipe off stingers or tentacles with a towel. Be careful to avoid contact. Wash the area with salt water. In some cases, soaking the wound in very warm (not hot) water for 30 to 90 minutes is recommended to help inactivate the toxin. The area can also be soaked in alcohol or vinegar. If the sting or bite has caused bleeding, dress the wound. An over-the-counter antihistamine helps with localized swelling, tenderness, or itching. Hydrocortisone cream reduces swelling. Give acetaminophen, aspirin (if more than 18 years old), or ibuprofen for pain. Seek immediate medical care if the person has difficulty breathing, uncontrolled bleeding, or other generalized symptoms.

2182_Tab06_129-153.qxd 8/18/11 12:21 PM Page 147

SAFETY TIP—Don't rinse the injury with fresh water. Fresh water will activate any stinging cells that haven't already ruptured and will cause more painful stings. Rubbing the area will have the same effect.

Snakes

Poisonous snakes inject a toxic venom when they strike their victim. Most poisonous snakes belong to a group known as pit vipers. These snakes have two large fangs, located in the upper front portion of the mouth. The two fangs are hollow and work like a hypodermic needle to inject the venom. The coral snake is also poisonous, but it is not a pit viper. It has small teeth instead of fangs and has to chew to inflict its poison. It's important to identify the snake, if at all possible, because the type of venom makes a difference in the treatment given by the emergency medical team.

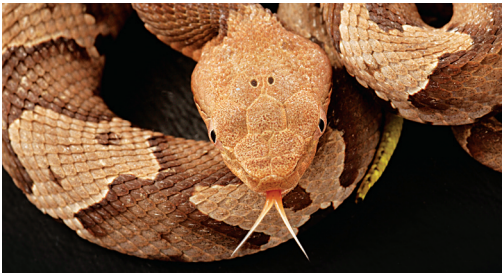
SAFETY TIP—Pit vipers have a triangular head, pupils that resemble vertical slits, and a telltale pit on each side of the head between the eye and the mouth. These pits, heat-sensing organs, make it possible for the snake to strike a warm-blooded victim, even one it can't see.

Common Pit Vipers

In the United States, common pit vipers include the rattlesnake, copperhead, and water moccasin (also called the cottonmouth).

2182_Tab06_129-153.qxd 8/18/11 12:21 PM Page 148

Timber rattlesnake.



Copperhead.

2182_Tab06_129-153.qxd 8/18/11 12:21 PM Page 149

Water moccasin (cottonmouth).

First Aid for a Bite from a Pit Viper

- **Signs and symptoms:** One to two punctures made by the hollow fangs of the snake. Severe pain within 5 to 10 minutes, accompanied by swelling and discoloration around the bite area, progressing up the bitten extremity. If treatment is delayed, possible kidney and liver damage may result from toxins.
- **Treatment:** Remove constricting clothing or jewelry, clean the bite with soap and water, immobilize the bite area, and keep it lower than the heart. Bandage the wound, and get the person to a hospital or clinic as soon as possible. The chances for recovery are good if the person receives care within 2 hours. Severe bites can be treated with antivenin, antibiotics, and antihistamines to reduce swelling, but time and identification of the snake are of the utmost importance.

Coral Snake

A coral snake is small and ringed with red, yellow, and black. It has a black head and red bands touching yellow bands. **The classic rhyme is "Red touching yellow, kill a fellow. Nose is black, head is yellow."** The nonpoisonous scarlet snake and scarlet kingsnake have a similar pattern

2182_Tab06_129-153.qxd 8/18/11 12:21 PM Page 150

but they have red noses and no red bands touching yellow bands. Unlike pit vipers, coral snakes lack fangs, and because their mouths are small and their teeth are short, most coral snakes bite by chewing on toes and fingers. Their bite is usually painless, with little or no swelling or discoloration. However, it is highly poisonous. Symptoms may be delayed for several hours, but when they do occur, they progress rapidly.

Coral snake.

First Aid for a Bite from a Coral Snake

- Signs and symptoms: Nausea, drowsiness, vomiting, marked salivation, and difficulty breathing. Delayed signs and symptoms may include numbness at the bite area, headache, and eventual muscular paralysis.
- Treatment: Remove constricting clothing or jewelry, clean the area and dress the wound, mark swelling with a pen to determine the rate and amount, and get the person to a hospital or clinic as soon as possible.

POISONOUS PLANTS

Plant poisonings can occur by ingestion or skin contact.

2182_Tab06_129-153.qxd 8/18/11 12:21 PM Page 151

Ingestion of Poisonous Plants

Frequently, curious children and pets ingest plants that weren't meant to be eaten. The poisonous quality of a plant depends on several factors:

- **The type and amount of poison ingested.** For example, oleander is one of the most toxic plants known. Ingestion of a single leaf can be fatal to a young child.
- **The part of the plant.** For example, rhubarb stalks are edible but the leaves are poisonous. In contrast, all parts of jimson weed (also called datura, or angel's trumpet) are highly toxic.

Most plant ingestions involve only a small amount and produce only nausea and vomiting. Clean the mouth, and contact the poison control center for plant protocols. If in doubt, seek immediate medical care.

Contact Poisoning by Poison Ivy, Poison Oak, and Poison Sumac

Poison ivy, poison oak, and poison sumac have a toxic oily sap called *urushiol* in their roots, stems, leaves, and fruit. The sap is released when the plant is bruised. It may be deposited on the skin by direct contact with the plant or by contact with contaminants, including shoes, clothing, tools, or animals. Urushiol is still present after the plant has died. Severe poisoning also has occurred from sap-coated soot in the smoke of burning plants. Inhaling smoke laced with urushiol can cause severe allergic reactions.

Poison Ivy

The leaves of poison ivy consist of three pointed leaflets. The edges can be smooth or toothed and vary in length from 2 to 4 inches (5 to 10 cm). Poison ivy can grow as a ground cover, shrub, or climbing vine. The leaves are reddish in spring and turn green during the summer.

Poison Oak

Poison oak grows as a shrub or a climbing vine. Its leaves are shaped like oak leaves. As with poison ivy, poison oak leaves are divided into three leaflets. The underside of the leaves, a lighter green than the surface, is covered in hairy filaments.

Poison Sumac

Poison sumac grows as a dense shrub or small tree. Its leaves grow in pairs, anywhere from 7 to 13. Unlike poison ivy leaves, poison sumac leaves never have a toothed outline. Small white or gray berries hang in clusters from the stalk.

Poison oak.

Poison ivy.

Poison sumac.

2182_Tab06_129-153.qxd 8/18/11 12:21 PM Page 153

First Aid for Contact Poisoning from a Poisonous Plant

- **Signs and symptoms:** Severe itching followed by red inflammation and blistering; and oozing sores in serious cases. Once the sap has been cleaned from all contact points, the contamination stops spreading.
- **Treatment:** Immediately wash exposed skin and clothing thoroughly with plenty of soap and water. If your pet has been exposed, bathe your pet thoroughly. Symptoms usually develop within 24 to 48 hours after contact with the oil. If poisoning develops, treat the blisters and inflammation with dressings of calamine lotion, Epsom salts, or bicarbonate of soda. Medical attention is required for severe rashes, especially those covering large areas, involving the eyes, nose, and mouth, or accompanied by fever. A prescription medication such as prednisone may help to contain the rash.

MYTH BUSTER

"Breaking the blisters releases urushiol that can spread." **False:** The rash spreads from the poisonous sap, not by contamination from sores. Urushiol is not present in the blister fluid.

Tab 7: Natural Disasters

Natural disasters can take many forms:

- Flood
- Hurricane
- Tornado
- House fire
- Wildfire
- Earthquake
- Tsunami
- Volcanic eruption
- Landslide or mudslide
- Avalanche
- Winter storm and extreme cold

BE PREPARED FOR A NATURAL DISASTER

A natural disaster can strike quickly and without warning. Although you can't foresee everything, a little advance planning can give you the edge you need to survive. To be prepared, take three steps:

- Develop a disaster action plan.
- Assemble survival supplies.
- Learn in advance how to help others in need.

At the close of this section, we'll also identify special steps you should take to safeguard livestock and pets.

★ **SAFETY TIP—Don't wait until an actual disaster occurs to develop an action plan. Planning at this late stage is planning to fail. The end result could be catastrophic–your survival is at stake.**

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 155

Develop a Disaster Action Plan

What would you do if utilities such as water, gas, and electricity were cut off? Or if you had only minutes to flee your home from approaching wildfires? Knowing the answer in advance is your best protection. Your disaster action plan will be unique to your family or group. The age, health, abilities, and special requirements of group members, your location, community resources, and even pets will all figure into your strategy. **Here are the steps to take in developing your natural disaster action plan:**

- Discuss with your family/group the types of disaster(s) most likely to occur in your area, what the consequences may be, and what you would do in each case. For example, should you prepare for a long-term power outage, or to flee your home because of rising flood waters?
- Decide the conditions for activating your plan. For example, will you activate it when a tornado has been spotted in your area, or a smoke alarm has gone off in your home or workplace?
- Determine where members should go and what they should do when action needs to be taken.
- Always have a backup plan. For example, select alternative sites in advance in case the main site is no longer viable or accessible.
- Plan how to take care of any pets and livestock. (See the tips at the end of this section.)
- Identify a place where your family/group can reunite after the disaster. It's a good idea to meet at a central point where most of your preparedness supplies are stored. (See the next section.)
- Identify the locations of your nearest fire and police stations and your local medical facility. Enter their contact numbers in your cell phone directory and/or post a list beside your home phone.
- Identify the people you will need to contact outside the area, and find their phone numbers. Enter these in your cell phone directory and/or post a list beside your home phone.

- Know where your gas, electric, and water main shutoffs are. Know how to turn off each utility. If in doubt, ask your utility company. Keep necessary tools near these areas.
- Store all valuables and critical documents in waterproof containers. Keep them in one accessible place so you can gather them quickly if you need to flee your home.
- Make sure all members know how to access local radio or television stations for emergency broadcast information.
- Make sure your vehicle is fueled with more than half a tank of gas at all times.
- Maintain your plan. Make sure all family/group members are up to date on the current plans.

STEPS TO SAFETY

1. **Find out what kinds of natural disaster are most likely to happen in your area.**
2. **Learn your community's warning signals–know what they sound like and what you should do when you hear them.**
3. **Find out about animal care after a disaster.**
4. **If necessary, know how to provide ongoing care to elderly or disabled family members or neighbors needing assistance in a disaster.**
5. **Learn the disaster plans at your workplace, your children's school or daycare center, and other places where your family/group spends time.**

Assemble Survival Supplies

If you've assembled your survival supplies in advance, you'll be able to act at a moment's notice with the confidence that you can get through the disaster. Make sure your first aid, survival, and disaster supply kits have everything you need to survive for at least 72 hours. (See Tab 1, Basic Safety for detailed instructions.) You'll also need the

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 157

following emergency items to keep you and your family/group safe during a natural disaster:

- Flashlight and portable radio with batteries (long-life alkaline batteries; store them in a cool dry place)
- Enough clean water for each person for at least 3 days (Allow 1 gallon [4 liters] per person per day, half to drink and half to use for cooking and sanitation. The average person needs 2 quarts [2 liters] of water daily just for drinking. Reminder: 4 quarts equal 1 gallon, 1 quart equals 32 ounces, and 1 liter equals 1000 mL.)
- Emergency food for at least 3 days (allow three meals per person per day)
- Required medications
- Blankets, warm clothes, gloves, and sturdy shoes
- Mosquito netting if you are in a damp, warm environment
- Pipe or crescent wrenches to turn off gas and water supplies

SAFETY TIP—Stock emergency supplies for your pets. Each pet should have a carrier and enough fresh food and water, medications, and other essentials to ride out the disaster with you.

Be Prepared to Help Others in Need

In special need during a disaster are the injured, trapped, disabled, children, and frail elderly. Follow the steps outlined here:

If someone is injured:

- Check the scene to ensure you can give assistance without endangering yourself.
- Give first aid if anyone needs it. See Tab 2: CPR, Tab 3: Medical Emergencies, Tab 4: Injuries and Wounds, Tab 5: Environmental Emergencies, and Tab 6: Poisons, Bites, and Stings.
- Do not move seriously injured persons unless they are in immediate danger of further injury.

- Cover injured persons with blankets to keep them warm.
- Ask bystanders for help, and phone 911.
- Seriously injured or burned persons should be treated and transported by medical professionals immediately.

If someone is trapped:

- Check the scene to ensure you can give assistance without endangering yourself.
- If it's safe to do so, try to free the person by removing debris and transporting the person to safety.

Others in need:

- Include in your disaster plan actions to assist your neighbors in need such as frail elders, people with disabilities, and families with infants and/or young children.
- Don't forget about helping guide and assistance dogs for people with special needs (e.g., the visually or hearing impaired). A dog may become disorientated and need safety during a disaster.

Preparing Your Pets and Livestock for Natural Disasters

Remember pets and livestock. If you are like millions of animal owners, your pet is an important member of your household. You'll increase the likelihood that your animals will survive a disaster by taking the following simple steps:

- Assemble an animal emergency supply kit (see Tab 1: Basic Safety). Include a pet first aid book.
- Have needed medications, your pet's medical history, and your veterinarian's contact numbers.
- Store at least 3 days' worth of pet food and water in airtight containers.
- Include identification. Small animals need a collar with ID tag, a microchip (see safety tip immediately following), or a tattoo. Livestock need a microchip, tattoo, ear tag, or halter tag.

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 159

- Prepare a pet carrier, harness, or leash.
- Make sure your pets' vaccinations are current. Animal shelters may require proof of immunization.
- Have current photographs of all your animals (see photos of Darby and Dude).
- Include litter, litter boxes, paper towels, and trash bags in emergency supplies.
- Don't forget familiar items such as toys, treats, and bedding. These can help reduce stress.
- Locate and prearrange an evacuation site outside your immediate area that will accept animals. Research pet-friendly hotels, veterinary hospitals, boarding stables, kennels, and animal shelters. Develop a buddy care system.

Current photo: Darby.

Current photo: Dude.

SAFETY TIP—Microchip your animal (dog, cat, horse, or any other). A microchip implant, no larger than a grain of rice, is placed under the skin, usually on the animal's back. Each chip has a unique number that shows up on an electronic scanner. After you register this number with a central data bank, it will trace you when your pet is scanned at an animal shelter or veterinary office. Ask your veterinarian about getting a chip implanted; it can save the life of a pet that's gotten lost and slipped out of its collar, halter, or harness.

Bear in mind that you may not be home with your animals when disaster strikes. Take the following steps to prepare in advance for such a situation:

- Preplace stickers on your front and back house doors, barn doors, and pasture entrances to notify rescue personnel that animals are on your property.
- List the number, species, and location of your animals and their favorite hiding spots.
- Post your contact information and the location of your evacuation supplies.
- Designate an off-site person, such as a willing neighbor, to tend to your animals. This person should be familiar with your animals and have access to your home, kennel, or barn.

FLOOD

Floods are one of the most common hazards in many countries.

- Flood effects can be local, affecting a neighborhood or community, or widespread, affecting entire river basins.
- Not all floods are alike. Some can take days to develop. However, flash floods can occur quickly, sometimes in just a few minutes.
- Flooding can also occur when a dam breaks or a levee is breached, producing effects similar to a flash flood.

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 161

Extensive flooding.

FLOOD WATCH: **This indicates the possibility of flooding in your area.**
FLOOD WARNING: **Ongoing or expected flooding. If advised to evacuate, do so immediately.**
FLASH FLOOD WATCH: **Possibility of flooding within hours or minutes. Be prepared to move to higher ground.**
FLASH FLOOD WARNING: **Occurrence of a flash flood. Seek higher ground immediately.**

Plan Ahead

- Know your area's flood risk. If unsure, call your local planning and zoning department.
- Know whether or not your house was built in a floodplain, and if so, whether appropriate preventive measures were incorporated (i.e., elevated pilings and a reinforced foundation).
- Elevate the furnace, water heater, and electrical panel if your home is susceptible to flooding.

- Install “check valves” in sewer traps to prevent floodwater from backing up into the drains of your house.
- Construct barriers (levees, beams, floodwalls) to stop floodwater from entering the building.
- Seal walls in basements with waterproofing compounds to avoid seepage.
- If it has been raining hard for many hours or steadily for many days, be alert for a flood warning.
- Listen to your local radio or television station for flood information.

During a Flood

- Listen to the radio or television for information.
- Be aware that flash flooding can occur. If a flash flood warning has been issued, move immediately to higher ground.
- Be aware of streams, drainage channels, canyons, and other areas known to flood suddenly. Flash floods can occur in these areas with or without rain clouds or heavy rain.

Preparing to Evacuate

- Secure your house. If you have time, bring in outdoor furniture. Move essential items to an upper floor.
- Turn off utilities at the main switches or valves if instructed to do so.
- Disconnect electrical appliances. Do not touch electrical equipment if you’re wet or standing in water.
- Once outside, don’t walk through moving water. Six inches (15 cm) of moving water can make you fall. If you have no choice, walk where the water is still. Use a stick to check the firmness of the ground in front of you.

When Driving in Flood Conditions

- Six inches (15 cm) of water will reach the bottom of most passenger cars and cause loss of control and possible stalling.
- One foot (30.5 cm) of water will float many vehicles.
- Two feet (61 cm) of rushing water can carry away most vehicles, including sport utility vehicles and pick-up trucks.

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 163

- Never drive into flooded areas.
- Heed barricades. Don't drive around them.
- If your vehicle stalls in rapidly rising waters, abandon it immediately and climb to higher ground.
- If floodwaters rise around your vehicle, abandon it and move to higher ground if you can do so safely. You and the vehicle can be quickly swept away.

SAFETY TIP—Don't expect flooding to occur only when it's raining. A broken dam or levee can also cause unexpected flooding.

After a Flood

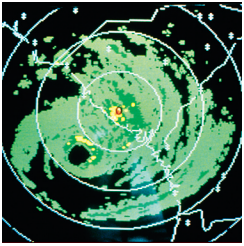
- Help injured or trapped persons if you can do so without endangering yourself.
- Listen for news reports to learn whether the community's water supply is safe to drink.
- Avoid contact with floodwaters; they may be contaminated by oil, gasoline, or raw sewage. Water may also be electrically charged from underground or fallen power lines.
- Be careful in areas where floodwaters have receded. Roads may have weakened and could collapse under the weight of a car.
- Stay away from fallen power lines, and report them to the power company.
- Return home only when authorities indicate it's safe.
- Use extreme caution when entering buildings; there may be hidden damage, particularly in foundations.
- Service damaged septic tanks, cesspools, pits, and leaching systems as soon as possible. Damaged sewage systems are serious health hazards.
- Clean and disinfect everything that got wet. Mud left from floodwater can contain sewage and toxic chemicals.

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 164

SAFETY TIP—Floodwaters can pose a variety of health risks. Avoid direct contact, and clean and disinfect everything that got wet. Discard food and water supplies that could have come into contact with floodwaters.

HURRICANE

A **hurricane** is an intense tropical storm system. Powered by heat from the sea, it is steered erratically by the easterly trade winds and the temperate westerly winds, as well as by its own energy. As it moves ashore, a hurricane brings with it a storm surge of ocean water along the coastline, high winds, tornadoes, torrential rains, and flooding. It can cause damage several hundred miles (or kilometers) inland. Winds can exceed 155 miles (249 km) per hour.



Hurricane: radar image.

Hurricane damage.

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 165

HURRICANE: This is an intense tropical weather system of strong thunderstorms and maximum sustained winds of 74 mph (64 knots or 119 km/hr) or higher.
HURRICANE/TROPICAL STORM WATCH: This watch indicates the possibility of hurricane or tropical storm conditions in the specified area, usually within 36 hours. Tune in to a radio or television for information.
HURRICANE/TROPICAL STORM WARNING: This warning indicates the likelihood of winds 74 mph (64 knots or 119 km/hr) or higher, or dangerously high water and rough seas, in 24 hours or less.
STORM SURGE: A dome of water pushed onshore by hurricane and tropical storm winds, storm surges can reach 25 ft (8 m) in height and 50–1000 miles (80–1609 km) in width.
STORM TIDE: This is a combination of storm surge and the normal tide. A 15-ft (5-m) storm surge combined with a 2-ft (0.6-m) normal high tide would create a 17-ft (5.5-m) storm tide.
TROPICAL DEPRESSION: This is an organized system of clouds and thunderstorms with a defined surface circulation and maximum sustained winds of 38 mph (33 knots or 61 km/hr) or less. Sustained winds are defined as 1-minute average wind measured at about 33 ft (10 m) above the surface.
TROPICAL STORM: This is an organized system of strong thunderstorms and maximum sustained winds of 39–73 mph (34–63 knots or 62–118 km/hr).

Hurricane Categories

Hurricanes are classified in five categories according to wind speed, central pressure, and damage potential. Category 3 and higher hurricanes are considered major, although category 1 and 2 storms are still extremely dangerous.

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 166

SAFFIR–SIMPSON HURRICANE SCALE

Scale Number (Category)	Sustained Winds	Damage	Storm Surge
1	74–95 mph (119–153 km/hr)	Minimal: Unanchored mobile homes, vegetation	4–5 ft (1.2–1.5 m)
2	96–110 mph (154–177 km/hr)	Moderate: All mobile homes, roofs, small crafts, flooding	6–8 ft (1.8–2.4 m)
3	111–130 mph (178–209 km/hr)	Extensive: Small buildings; low-lying roads cut off	9–12 ft (2.7–3.6 m)
4	131–155 mph (210–249 km/hr)	Extreme: Roofs destroyed, trees down, roads cut off, mobile homes destroyed, beach homes flooded	13–18 ft (3.9–5.4 m)
5	More than 155 mph (249 km/hr)	Catastrophic: Most buildings and vegetation destroyed, major roads cut off, homes flooded	Greater than18 ft (5.4 m)

Plan Ahead

- Be ready to drive up to 50 miles (80 km) inland.
- Make plans to secure your property.
- Know how to turn off gas, electricity, and water.

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 167

- Permanent storm shutters offer the best protection for windows. You can also board up windows with 1/2-inch (1.3-cm) plywood, cut to fit and ready to install. Be sure to mark which board fits which window. Tape doesn't prevent windows from breaking.
- Secure outdoor objects or bring them indoors.
- Determine how and where to secure your boat.
- Be sure trees and shrubs around your house are well trimmed.
- Clear loose and clogged rain gutters and downspouts.

MYTH BUSTER

"Most people are killed by hurricane winds and the damage they cause." **False: Nine out of 10 hurricane deaths are from inland flooding. Your biggest threat is water, including the surge after-effects. With the ground saturated, water won't drain off as quickly.**

During a Hurricane

- Listen to a battery-operated radio or television for progress reports.
- Stay inside and away from all windows and glass doors.
- Close all interior doors; secure and brace outside doors.
- Keep curtains and blinds closed. Don't be fooled if there's a lull; it could be the eye of the storm, and winds will pick up again.
- Take refuge in a small interior room, closet, or hallway on the lowest level, or in the basement.
- Lie on the floor under a table or other sturdy object.

When to Evacuate

- If local authorities direct you to do so. Be sure to follow their instructions.
- If you live in a mobile home or temporary structure. Such shelters are particularly hazardous during hurricanes no matter how well they're fastened to the ground.

- If you live in a high-rise building. Hurricane winds are stronger at higher elevations.
- If you live on the coast, on a floodplain, near a river, or on an inland waterway. Such areas are vulnerable to flooding.
- If you feel you are in danger. Trust your instincts.

After a Hurricane

- Help injured or trapped persons if you can do so without endangering yourself.
- Be informed: Listen to radio or television for official information.
- Return home only after officials advise that it's safe.
- Avoid fallen power lines.
- Check for potential risks such as gas leaks (shut off the main gas valve if you suspect a leak or smell natural gas) and damaged electrical wiring (shut off power at the control box if your house wiring is damaged).
- Check for sewage and water line damage.

TORNADO

A **tornado** is spawned from violent thunderstorms. It can cause fatalities and devastate an area in seconds.

- A tornado appears as a rotating, funnel-shaped cloud that extends from a thunderstorm to the ground.
- Its whirling winds can reach 300 mph (483 km/hr).
- Damage paths can be more than 1 mile (1.6 km) wide and 50 miles (80 km) long.
- Before a tornado hits, the wind may die down and the air may become very still.

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 169

Funnel cloud.

Tornado damage.

TORNADO WATCH: The weather conditions in your area are favorable for a tornado. Remain alert for approaching storms. Watch the sky and stay tuned to your local radio or television for nformation.
TORNADO WARNING: This indicates a sighting or other indication of a tornado on weather radar. Follow your tornado plan and seek shelter immediately!

Plan Ahead

- Learn the warning signals (siren sounds) in your area.
- Conduct safety drills at home with your family/group.
- Make sure all members of your family/group know the procedures to follow if they are at work or school when a tornado hits.

SAFETY TIP—Be alert to changing weather conditions. Listen to local radio or television newscasts for the latest information. Look for approaching storms; dark, often greenish sky; large hail; a large, dark, low-lying cloud (particularly if rotating); or a loud roar like that of a freight train. If you see approaching storms, be prepared to take shelter immediately.

MYTH BUSTER

"A car can outrun a tornado." **False:** A tornado's speed and direction change suddenly and quickly. Seek shelter in a building or on a low area of ground.

During a Tornado

If a tornado warning has been issued in your area, seek shelter immediately.

If you are indoors:

- Whether in your own home or a school, workplace, hospital, shopping center, or high-rise building, the safest place is underground (a storm cellar or basement) or on the lowest building level. Go there and stay there until the tornado warning has ended.
- If you can't get to these, go to the center of the smallest interior room (closet, interior hallway) on the lowest level.
- Stay away from corners, windows, exterior doors, and outside walls. Put as many walls as possible between you and the outside.
- Get under a sturdy table and use your arms to protect your head and neck. Do not open windows.

If you are in a vehicle, trailer, or mobile home:

- At the first sign of severe weather, get out immediately. Seek shelter elsewhere, such as at a community center or designated

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 171

storm shelter, or go to the lowest floor of a sturdy nearby building. Mobile homes, even if fastened down, offer little protection from tornadoes.

- Never try to outrun a tornado in a car or truck.

If you are outside with no shelter:

- Lie flat on the ground or in a ditch or depression with your hands over your head and neck. Do not get under an overpass or bridge; you're safer in a low, flat location.
- Watch out for flying debris; this causes most fatalities and injuries during a tornado.
- Be aware of the potential for flooding.

After a Tornado

- Stay in your shelter until it's safe to leave.
- Help injured or trapped persons if you can do so without endangering yourself.
- Check for risks such as fire hazard or gas leaks. Shut off the main gas valve if you suspect a gas leak or smell natural gas. Shut off power at the control box if there is any damage to your house wiring.
- Watch out for fallen power lines and stay out of damaged areas.

HOUSE FIRE

Fire is the combustion of flammable materials producing heat, light, and often smoke. House fires can be highly destructive and even lethal.

Plan Ahead

- Review escape routes with your family/group. Practice escaping from each room. Draw a floor plan with at least two ways of escaping every room.
- Learn to STOP, DROP to the ground, and ROLL if clothes catch on fire (see page 175).

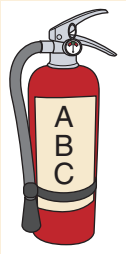
- Install smoke alarms on every level of your house. Attach them to the ceiling or 4 to 12 inches (10 to 30 cm) below it on the wall. Place alarms at the top of open stairways, or at the bottom of enclosed stairs and near (but not in) the kitchen. Test and clean smoke alarms once a month, and replace batteries at least once a year. Replace the alarm itself every 10 years.
- Install a fire extinguisher. Place the ABC type (see the box immediately following) in your home or office.
- Replace electrical wiring if it's frayed or cracked (call an electrician if you aren't sure). Wiring should not run under rugs or over nails.
- Don't overload outlets or extensions. Outlets should have cover plates and no exposed wiring.
- Have an escape ladder available. These are easily purchased and will help you escape if you're above the ground floor and cannot get out through a door.
- Make sure windows are not nailed or painted shut. Security gratings and burglar bars should have a fire safety feature that lets them be easily opened from the inside.

ABC FIRE EXTINGUISHERS

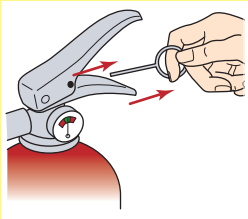
The most typical hand-held fire extinguisher is an ABC or "dry chemical" type and is suitable for class A, B, and C fires. The extinguishing agent is a powder. The extinguisher is light and very effective for its size and weight.

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 173

Class A: Fires in ordinary combustible materials such as wood, cloth, paper, rubber, and plastic
Class B: Fires in flammable liquids, combustible liquids, petroleum greases, tars, oils, oil-based paints, solvents, lacquers, alcohols, and flammable gases
Class C: Fires that involve energized electrical equipment
Caution: Do not use water or water-type extinguishers on electrical fires. Water conducts electricity.



★ **SAFETY TIP—When using an ABC fire extinguisher, know the PASS system.**



Step 1. Pull the pin.

Step 2. Aim the nozzle.

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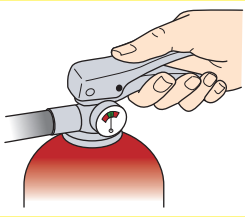
2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 174



Step 3. Squeeze the handle.

Step 4. Sweep the fire at its base.

SAFETY TIP—If you discover a fire in a public building (e.g., school, workplace, hospital, child care center), remember RACE:
R: Rescue anyone in danger.
A: Activate the fire alarm.
C: Contain the fire.
E: Extinguish the fire.

During a Fire

Escape the fire if possible:

- If on the ground floor, leave through a door or open a window and climb through.
- Do not use elevators to escape from an upper floor; use stairs.
- Stay low to the ground; smoke and heat rise. The air is clearer and cooler near the floor.
- Close doors behind you as you escape to delay the spread of the fire.

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 175

- Cover your mouth with a cloth to avoid inhaling smoke and gases.

If you are in an upper room with a closed door:

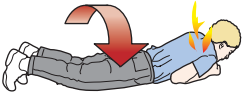
- If smoke is pouring in around the bottom of the door or it feels hot, keep the door closed.
- If there is no smoke at the bottom or top of the door and it does not feel hot, open it slowly. If you see smoke or fire in the hall, close the door.
- Open a window for fresh air while awaiting rescue.

If your clothes catch fire:

- **Stop, drop, and roll** until the fire is extinguished. Running only makes the fire burn faster.

Step 1. Stop.

Step 2. Drop.

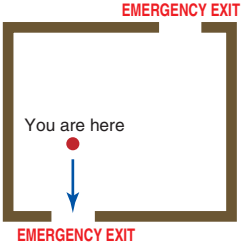


Step 3. Roll.

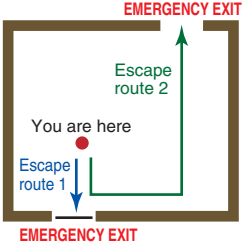
Step 4. Fire extinguished.

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 176

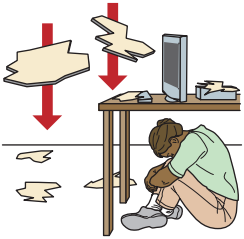
To escape from a high-rise building:



1. Use the closest exit.



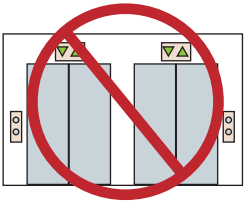
2. Use another route if your first route is blocked.



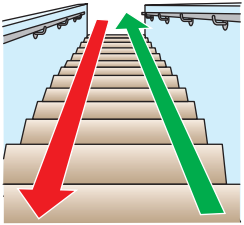
3. As you go, if things start to fall, take cover under a table or desk.

4. As you exit, face away from windows and glass.

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 177



5. Do not use elevators.



6. Keep to the right while going down stairwells. Emergency workers will walk up the left (their right).

MYTH BUSTER

"The smoke from fire isn't the real danger."
False: Smoke kills more people than burns do. In a matter of minutes, fire robs the air of oxygen and fills it with carbon monoxide and other deadly gases.

MYTH BUSTER

"You can leave home while food is in the oven."
False: Most house fires start in the kitchen. Turn your oven and burners off if you must leave the kitchen while cooking. Keep your oven and stovetop clean—grease and spilled food can start a fire.

Fire Hazards and Fire Safety Tips

Handle flammable items with care:

- Never use gasoline, benzine, or any other flammable liquid indoors.
- Store flammable liquids in approved containers in well-ventilated storage areas.
- Never smoke near flammable liquids.
- Discard all rags or materials that have been soaked in flammable liquids. Leave them outdoors in a metal container.
- Insulate chimneys and place spark arresters on top. The chimney should be at least 3 ft (91.5 cm) higher than the roof. Remove branches hanging above and around the chimney.

Take appropriate precautions with alternative heating sources:

- Be careful when using space heaters and other alternative heating sources.
- Place space heaters at least 3 ft (91.5 cm) away from flammable materials. Make sure the floor and nearby walls are properly insulated.
- Use only the type of fuel designated for your unit, and follow the manufacturer's instructions.
- Have heating units inspected and cleaned annually by a certified specialist.
- Keep a screen in front of your fireplace.
- Keep matches and lighters up high, away from children, and in a locked cabinet if possible.
- Store ashes in a metal container outside and away from your house.
- Keep open flames away from walls, furniture, drapery, and flammable items.

If you smoke:

- Never smoke in bed.
- Never smoke if you are feeling drowsy or are taking medications with a sedative effect.

- Use deep, sturdy ashtrays.
- Douse cigarette and cigar butts with water before disposal.

Avoid electrical fires:

- Have the wiring in your home checked by an electrician.
- Inspect extension cords for frayed or exposed wires or loose plugs.
- Make sure outlets have cover plates and no exposed wiring.
- Make sure wiring doesn't run under rugs, over nails, or across high-traffic areas.
- Don't overload extension cords or outlets.
- Make sure insulation doesn't touch bare electrical wiring.

Other fire safety tips:

- Sleep with your door closed.
- Install ABC fire extinguishers in your home, and teach family members how to use them.
- Consider installing an automatic fire sprinkler system.
- Ask your local fire department to inspect your house for fire safety and prevention.

After a Fire

- Help injured or trapped persons if you can do so without endangering yourself.
- If you detect heat or smoke when entering a damaged building, leave immediately.
- If you are a tenant, contact the landlord.
- If you have a safe or strongbox, don't try to open it. It can hold intense heat for several hours. If the safe door or box lid is opened before the safe or box has cooled, the contents could burst into flames.
- If you must leave your home because a building inspector says the building is unsafe, ask someone you trust to watch the property during your absence.

WILDFIRE

Wildfire is a real threat for people living near wilderness areas or using recreational facilities there. Dry conditions greatly increase the potential for wildfires. These occur regularly at various times of the year and in different parts of the world.

Extensive wildfire.

Plan Ahead

Find out your fire risk:

- Learn the history of wildfire in your area.
- Be aware of recent weather—a long period without rain increases the risk of wildfire.
- Consider having a professional inspect your property and give you recommendations for reducing your risk.
- Determine your community's ability to respond to wildfire. Are roads leading to your property clearly marked? Are they wide enough to allow firefighting equipment to get through? Is your house number visible from the roadside?

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 181

- Always be ready to evacuate–it may be the only way to protect your family/group in a wildfire. Know where to go and what to bring with you. Plan several escape routes in case the road you usually use is blocked by the fire.

Learn and teach safe fire practices:

- Build fires away from nearby trees, bushes, awnings, or tents.
- Always have a way to extinguish the fire quickly and completely.
- Install smoke detectors on every level of your home and near sleeping areas.
- Never leave a fire, even a cigarette, burning unattended.
- Avoid open burning completely; this is especially important during dry season.

Create a 30-ft (9-m) safety zone around your house:

- All vegetation is fuel for a wildfire. The greater the distance between it and your home, the better you are protected. Keep the volume of vegetation in this zone to a minimum.
- If you live on a hill, extend the zone on the downhill side–fire spreads rapidly uphill. The steeper the slope is, the more open space you'll need for protection.
- Consider installing a swimming pool and/or patios as part of your safety zone. Stone walls can act as heat shields and deflect flames.
- Clear all combustibles within your safety zone.
- Install electrical lines underground, if possible.
- Ask the power company to clear branches from power lines.
- Avoid using bark and wood chip mulch.
- Store combustible or flammable materials in approved safety containers, and keep them away from the house.
- Keep the gas grill and propane tank at least 15 ft (5 m) from any structure. Clear an area 15 ft (5 m) around the grill.

Create a second zone at least 100 ft (30 m) around your house:

- This zone should begin about 30 ft (9 m) from the house and extend to at least 100 ft (30 m). In this zone, reduce or replace as much of the most flammable vegetation as possible.
- Stack firewood 100 ft (30 m) away and uphill from any structure.

During a Wildfire

Escape the fire if possible:

- Immediately evacuate all members of your family/group, and don't forget your pets.
- Roll up vehicle windows and close air vents. Drive slowly with headlights on. Watch for other vehicles and pedestrians. Do not drive through heavy smoke.

If the approaching fire forces you to stop:

- Park away from the heaviest trees and brush. Turn the headlights on so rescuers can see you through the smoke. Turn the ignition off.
- Instruct all vehicle occupants to get on the floor and cover themselves with a blanket or coat.
- Stay in the vehicle until the main fire passes. Air currents may rock the car. Some smoke and sparks may enter. The temperature inside the car will increase. Metal gas tanks and containers can explode but rarely do so.

If you are trapped at home:

- Stay calm. As the fire front approaches, go inside the house.
- Once inside, close windows and outside doors. Stay in the center of the house away from outer walls.

If you are caught in the open:

- The best temporary shelter is in a sparse fuel area; that is, an area clear of brush. On a steep mountain, the side of the mountain away from the fire is safer.

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 183

- If a road is nearby, lie facedown along it or in the ditch on the uphill side. Cover yourself with anything that will shield you from the fire's heat.
- If hiking in the backcountry, seek a depression with sparse fuel. Clear fuel away from the area while the fire is approaching and then lie face down in the depression and cover yourself. Stay down until after the fire passes.

After a Wildfire

- Check the roof of your home immediately. Put out any roof fires, sparks, or embers. Check the attic for hidden sparks.
- Water in your pool or hot tub will come in handy now. For several hours after the fire, maintain a fire watch. Recheck for smoke and sparks throughout the house.

EARTHQUAKE

The earth's crust is divided into several major plates, some 50 miles (80 km) thick, which move slowly and continuously over the earth's interior. Most **earthquakes** occur at a point of contact along a fault line between two geological plates. When the slowly accumulating pressure reaches a peak, the two plates suddenly grind over, under, or past each other and cause the ground at the earth's surface to slip abruptly. The resulting waves of vibration within the earth also create complex waves of motion for many miles (many kilometers) at the surface.

Earthquakes strike suddenly, violently, and without warning. If an earthquake occurs in a populated area, it may cause many deaths and injuries and extensive property damage. Identifying potential hazards and planning in advance can reduce the dangers of serious injury or loss of life.

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 184

Earthquake damage.

EARTHQUAKE: This is a sudden slipping or movement of a portion of the earth's crust, accompanied and followed by a series of vibrations.
AFTERSHOCK: This is an earthquake of similar or lesser intensity that follows the main earthquake.
FAULT: This is the fracture across which displacement has occurred during an earthquake.
EPICENTER: The point on the surface directly above the point on the fault where the earthquake rupture began. Once fault slippage begins, it expands along the fault during the quake and can extend hundreds of miles before stopping.
SEISMIC WAVES: Vibrations that travel outward from the earthquake fault at speeds of several miles (several kilometers) per second. Although fault slippage directly under a structure can cause considerable damage, seismic wave vibrations cause most earthquake destruction.

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 185

MAGNITUDE: The amount of energy released during an earthquake, computed from the amplitude of the seismic waves. A magnitude of 7.0 on the Richter Scale indicates an extremely strong quake. Each whole number on the scale represents about a 30-fold energy increase from the previous whole number. Therefore, an earthquake measuring 6.0 is about 30 times more powerful than one measuring 5.0.

Plan Ahead

- Repair deep plaster cracks in ceilings and foundations.
- Locate children's play areas away from hazards such as brick walls.
- Anchor overhead lighting fixtures to the ceiling. Anchor bookcases to the wall. Securely attach heavy pictures and mirrors to the wall.
- In earthquake-prone areas, avoid placing heavy objects on open shelves, and install locking devices on kitchen cabinets.
- Store household chemicals so containers can't easily tip over or spill.
- Anchor mobile homes securely to the ground.
- Follow local seismic building standards; these help to reduce impact.

★ **SAFETY TIP—Ground movement during an earthquake is seldom the direct cause of death or injury. Most earthquake-related casualties result from collapsing walls, flying glass, and falling objects.**

During an Earthquake

If you are indoors:

- Drop down to the floor. Take cover under a sturdy desk, table, or other piece of furniture. Hold on to it and be prepared to move with it.

- Stay clear of glass, windows, outside doors and walls, and anything that could fall, such as lighting fixtures or furniture.
- Don't rush outside. You may be injured by falling debris.
- Don't use elevators.

If you are outdoors:

- Get into the open and stay there.
- Move away from buildings, streetlights, and utility wires.

If you are driving:

- Stop only if it's safe to do so.
- Stay inside the vehicle.
- Don't stop on or under a bridge or overpass or in a tunnel.
- Don't stop under trees, electrical power lines, light posts, or signs.

If trapped under debris:

- Don't light a match.
- Don't move about or kick up dust.
- Cover your mouth with a handkerchief or clothing.
- Tap on a pipe or wall so rescuers can locate you. Use a whistle if one is available. Shout only as a last resort; you could inhale dangerous amounts of dust.

★ **SAFETY TIP—Some earthquakes are actually foreshocks. Don't take it for granted that an earthquake is over; a larger one could still occur.**

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 187

MYTH BUSTER

"The safest place to be in an earthquake is under a doorway." **False:** In modern structures, the doorway is no stronger than the rest of the building. Actually, you're more likely to be hurt by the door swinging wildly. In a public building, you could be in danger from people trying to hurry outside. If you're inside, get under a table or desk and hang on to it.

After an Earthquake

- Expect aftershocks. Listen to a battery-operated radio or television for the latest emergency information.
- Use the telephone—including cell phones—only for emergency calls.
- Open cabinets cautiously. Beware of objects that could fall off shelves.
- Stay away from damaged areas.
- Help injured or trapped persons if you can do so without endangering yourself.
- Clean up spilled medicines, bleach, gasoline, or other flammable liquids immediately.
- Inspect the entire length of chimneys for damage. Unnoticed damage could lead to a fire.
- Inspect utilities. Check for gas leaks. Look for electrical system damage. Check for sewage and water line damage.
- If you live in a coastal area, be aware of possible tsunamis. See the next section.

TSUNAMI

A **tsunami** (pronounced soo-ná-mee), also called a "seismic sea wave" (or, mistakenly, "tidal wave"), is a series of enormous waves created by an underwater disturbance such as an earthquake. These waves can

also be generated by coastal or underwater landslides, volcanic eruptions, or meteor impacts in the water. Tsunamis threaten coastal populations of the Pacific and other oceans and seas.

A tsunami can move hundreds of miles (or kilometers) per hour in the open ocean and smash into land with waves as high as 100 ft (30 m) or more. Areas are at greater risk if they are less than 25 ft (8 m) above sea level and within a mile of the shoreline. Drowning is the most common cause of death associated with a tsunami. Hazards include flooding, contaminated drinking water, and fires from gas lines or ruptured tanks.

TSUNAMI ADVISORY: This indicates the recent occurrence of an earthquake, which could generate a tsunami.
TSUNAMI WATCH: This indicates the possibility that a tsunami has been generated but is at least 2 hours' travel time to the area under watch.
TSUNAMI WARNING: This indicates the possibility that a tsunami has been generated. People in the warned area are strongly advised to evacuate.

Plan Ahead

- Find out whether your home is in a danger area. Know the height of your street above sea level and its distance from the coast. Evacuation orders may be based on these numbers.
- Be familiar with the warning signs. Because tsunamis can be caused by an underwater disturbance or an earthquake, people living along the coast should consider an earthquake or a significant ground rumbling as a warning signal. A noticeably rapid rise or fall in coastal waters is also a sign that a tsunami is approaching.

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 189

- Make evacuation plans. Pick a safely elevated inland location. If an earthquake or other disaster has occurred, roads in and out of the vicinity may be blocked, so plan more than one evacuation route.

During a Tsunami

- If an earthquake occurs and you are in a coastal area, turn on your radio for a possible tsunami warning.
- If you hear an official tsunami warning or detect signs of a tsunami, evacuate at once. Climb to higher ground.
- Stay away from the beach. Never go down to the beach to watch a tsunami come in. If you can see the wave, you're too close to escape it.
- A tsunami is a series of waves. Don't assume that the danger is over because one wave has come and gone. The next wave may be larger than the first one. Stay out of the area.

SAFETY TIP—In any disaster, save yourself, not your possessions.

After a Tsunami

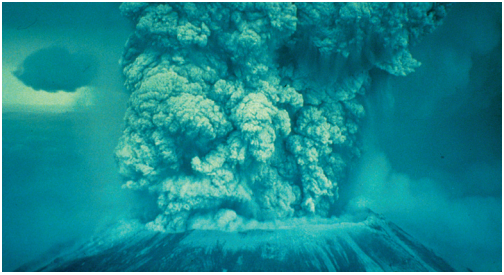
- Help injured or trapped persons if you can do so without endangering yourself.
- Stay away from flooded and damaged areas until officials say it's safe to return.
- Open windows and doors to help dry the building.
- Shovel mud while it's still moist to give walls and floors an opportunity to dry.
- Check food supplies, and test drinking water.

VOLCANIC ERUPTION

A **volcano** is a mountain that opens downward to a reservoir of molten rock below the surface of the earth. Unlike most mountains, which are pushed up from below, volcanoes build up from an accumulation of

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 190

their own eruptive products. When pressure from gases within the molten rock becomes too great, an eruption occurs. Eruptions can be quiet or explosive. There may be lava flows, flattened landscapes, poisonous gases, and flying rock and ash. Because of their intense heat, lava flows are great fire hazards. They destroy everything in their path, but most move slowly enough to let people get out of the way.



Volcanic eruption.

Plan Ahead

- Add a pair of goggles and a disposable breathing mask for each person to your disaster supply kit.
- Stay away from active volcano sites.
- If you live near a known volcano, active or dormant, be ready to evacuate at a moment's notice.

During a Volcanic Eruption

- Follow the evacuation order issued by authorities. Evacuate immediately from the volcano area to avoid flying debris, hot gases, and flowing lava.
- Wear a long-sleeved shirt and long pants.

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 191

- Use goggles and wear eyeglasses instead of contact lenses.
- Use a dust mask or hold a damp cloth over your face to help with breathing.
- If your home is outside the evacuation area, unless the roof is in danger of collapsing, stay indoors until the ash has settled.
- Close doors, windows, and all ventilation systems (chimney vents, furnaces, air conditioners, fans, and other vents) in the house.

After a Volcanic Eruption

- Help injured or trapped persons if you can do so without endangering yourself.

LANDSLIDE AND MUDSLIDE

In a **landslide** or **mudslide,** masses of rock, earth, or debris move down a slope. These slides may be small or large, slow or rapid. They are activated by storms, earthquakes, volcanic eruptions, fires, alternate freezing and thawing, and steepening of slopes by erosion or human modification. **Debris flows** and **mud flows** are rivers of rock, earth, and other debris saturated with water. They can travel several miles (or kilometers) from their source and grow in size as they pick up trees, boulders, cars, and other materials.

Landslide and mudslide damage.

Plan Ahead

- Don't build near steep slopes, close to cliff edges, near drainage ways, or in natural erosion valleys.
- Get a ground assessment of your property.
- Plant ground cover on slopes, and build retaining walls.
- In mudflow areas, build channels or deflection walls to direct the flow around buildings.

During a Landslide or Mudslide

- Listen to a portable, battery-powered radio or television for warnings of intense rainfall. Short bursts of rain may be particularly dangerous, especially after longer periods of heavy rainfall and damp weather.
- If your area is susceptible to landslides and debris flows, evacuate if it's safe to do so. If you remain at home, move to a second story if possible.
- Listen for any unusual sounds that could indicate moving debris, such as trees cracking or boulders knocking together. Debris can flow quickly and sometimes without warning.
- If you are near a stream or channel, watch for any sudden increase or decrease in water flow and for a change from clear to muddy water. Such changes may indicate landslide activity upstream, so be prepared to move quickly.
- Be especially alert when driving. Watch the road for collapsed pavement, mud, fallen rocks, and other indications of possible debris flows.

After a Landslide or Mudslide

- Listen to local radio or television stations for the latest emergency information.
- Stay away from the slide area. There may be danger of additional slides.
- Watch for flooding, which may occur after a slide. Floods sometimes follow the slide because both have been started by the same event.

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 193

- Help injured or trapped persons if you can do so without endangering yourself.
- Look for broken utility lines and damaged roadways and railways, and report them to appropriate authorities.
- Check the building foundation, chimney, and surrounding land for damage.
- Replant damaged ground as soon as possible. Erosion caused by loss of ground cover can lead to flash flooding and additional slides.
- Ask a geotechnical expert to evaluate landslide hazards or design corrective techniques to reduce risk.

AVALANCHE

An **avalanche** is a huge mass of ice and snow that breaks away from the side of a mountain and surges downward at great speed. Travel through avalanche terrain always involves risks. Be aware of avalanche hazards and select a safe route to avoid injury. Never ski or venture into dangerous conditions.

Safety Equipment for Backcountry Travel

- **Snow shovel:** Your shovel should be made of aluminum or high-impact plastic, collapse to fit into a pack, and be strong enough to dig in avalanche debris. You can also use it to dig snow caves for overnight shelter.
- **Probe pole or ski pole:** Probes help to pinpoint the location of avalanche victims. Organized rescue teams use 10- to 12-ft (3- to 3.6-m) poles. You can buy shorter poles that fit together to make a full-length one. Some ski poles come with removable grips and baskets that can be screwed together to make an avalanche probe.
- **Avalanche rescue transceiver (rescue beacon):** The transceiver emits a signal that tells the rescuer's unit where a buried person is located. It's essential to confirm that all members of the party are on the same frequency and have their transceivers set to "Transmit" before setting out.

MYTH BUSTER

"Noise triggers avalanches." **False:** Most noise does not exert enough force. To start an avalanche, a sound would have to be tremendously loud, like that of an explosive at close range. In almost all avalanche fatalities, the avalanche is triggered by the weight of one or more persons walking over the snow.

Avalanche Survival

- The moment snow begins to move, try to escape by moving quickly to the side of the avalanche. Don't try to outrun it by moving downhill–it will certainly overtake you.
- Shouting alerts companions that you need help. To prevent snow inhalation, close your mouth after you yell for help.
- If knocked off your feet, try to remain on the surface of the snow by staying facedown and "swimming" with the avalanche.
- As the avalanche slows down, use all possible strength to get your head, an arm, or a hand above the surface. Use your hand to create a breathing space around your face.
- If you are caught under the snow it is easy to become disoriented as to which direction is up (toward the surface) or down. An easy safety tip to remember is to spit. Due to general principles of physics you will see or feel your saliva (spit) run toward the direction of the ground. This will orientate you to the direction of the surface. Dig in the opposite direction that your spit falls, toward the surface.

Avalanche Rescue

- If the person is not alone, have a companion remain in a stable position and mark the last known location with a piece of equipment or clothing, or anything that can be seen from a distance. If enough people are available, send someone to notify the local ski patrol or emergency squad.

2182_Tab07_154-198.qxd 8/18/11 12:34 PM Page 195

- Visually check for any equipment or body parts sticking out of the snow.
- **With a rescue transceiver:** Switch your transceiver to "Receive," and use a methodical approach to narrow the search and pinpoint the signal. A skilled rescuer can find a buried person within a few minutes.
- **Once you locate the signal:** Use your probe to identify the victim. When probing the snow, look for changes in consistency: people and backpacks feel "soft," whereas rocks and trees feel "hard."
- **Once you locate the victim:** Use your shovel to dig the person out as quickly as possible. The average person cannot survive much beyond 15 minutes under the snow.
- **Without a rescue transceiver:** Search the fall line below the location where the person was last seen. Use your probe to search in likely spots, then use your shovel to dig the person out.

SAFETY TIP—If you own a rescue transceiver, practice using it before traveling in avalanche-prone terrain. Avalanche courses often include transceiver training. If you're planning on winter backcountry travel, take the course.

Treatment of Avalanche Injury

- Manage the person's airway, breathing, and circulation.
- Stabilize any fractures or bleeding.
- Treat for shock, and provide warmth in anticipation of hypothermia.
- Evacuate to a medical center immediately.

WINTER STORM AND EXTREME COLD

Heavy snowfall and extreme cold can immobilize an entire region. Even areas that normally experience mild winters can be hit with a major **winter storm** or **extreme cold.** Winter storms can result in flooding, storm surge, closed highways, blocked roads, fallen power lines, and hypothermia.

WIND CHILL: This calculation gauges how cold it feels outside when the effects of temperature and wind speed are combined.
WINTER STORM WATCH: This indicates the possibility of severe winter weather in your area.
WINTER STORM WARNING: This indicates the occurrence or prediction of a winter storm in your area.
BLIZZARD WARNING: This is a prediction that large amounts of falling or blowing snow will occur in several hours. In a blizzard, visibility is reduced to less than 1/4 mile (0.4 km), and sustained winds reach at least 35 mph (56 km/hr).
FREEZING RAIN: Rain that freezes when it hits the ground. Freezing rain creates a coating of ice on roads, walkways, trees, and power lines.
SLEET: Rain that turns to ice pellets before reaching the ground. Sleet also causes moisture on roads to freeze and become slippery.
FROST/FREEZE WARNING: This is a prediction that temperatures will fall below freezing.

Plan Ahead

- Be familiar with winter storm warning messages.
- Stock enough heating fuel.
- Service snow removal equipment.
- Keep snow shovels and other snow removal equipment in working order.
- Purchase rock salt to melt ice on walkways and sand to improve traction.
- If you have a fireplace, keep a good supply of wood.
- Winterize your house, barn, shed, or any other structure that can shelter your family, neighbors, livestock, or equipment.

- Keep fire extinguishers on hand. Extreme cold increases the risk of house fires: more people turn to alternate heating sources without taking the necessary safety precautions.
- Prepare your vehicle in advance. Check fuel and antifreeze levels, the battery and ignition systems, the brakes, and the heater and defroster. Stock each car with a winter emergency kit that includes the following: a shovel; a windshield scraper; blankets, extra hats, socks, and mittens; a first aid kit; a tow chain or rope; road salt and sand; booster cables; emergency flares; and a fluorescent distress flag.

During a Winter Storm or Extreme Cold

If you are indoors:

- Stay indoors and dress warmly.
- Listen to radio or television to get the latest information.

If you are outdoors:

- Wear loose-fitting, layered, and lightweight clothing. The outer garments should be tightly woven and water repellent.
- Wear mittens, which are warmer than gloves. Wear a hat.
- Cover your mouth with a scarf to protect your lungs.
- Avoid overexertion when shoveling snow. Overexertion can bring on a heart attack, a major cause of death in winter.
- Watch for any signs of frostbite or hypothermia.
- If you suspect frostbite or hypothermia, begin slow warming (see Tab 5: Environmental Emergencies), and seek immediate medical assistance.

If you are in your vehicle:

- Drive only if it's absolutely necessary.
- Don't travel alone, and make sure others know where you're going.
- Stay on main roads; avoid back road shortcuts.

If a blizzard traps you in the car:

- Pull off the highway. Turn on hazard lights, and hang a distress flag from the radio antenna or window.
- Remain in your vehicle, where rescuers are most likely to find you. Don't set out on foot unless you can see a nearby building where you know you can take shelter.
- Run the engine and heater about 10 minutes each hour to keep warm. When the engine is running, open a downwind window slightly for ventilation, and periodically clear snow from the exhaust pipe. This will protect you from possible carbon monoxide poisoning.
- Exercise to maintain body heat, but avoid overexertion. In extreme cold, use road maps, seat covers, and floor mats for insulation. Huddle with passengers, and use your coat for a blanket.
- Take turns sleeping. One person should be awake at all times to look for rescue crews.
- Drink fluids to avoid dehydration.
- Be careful not to waste battery power. Balance electrical energy needs with your supply–use the lights, heat, and radio sparingly.
- Turn on the inside light at night so work crews or rescuers can see you.
- If stranded in a remote area, use your feet to stamp **"HELP"** or **"SOS"** in an open area. Outline the letters with rocks or tree limbs. Rescue personnel may be surveying the area by airplane.

2182_Tab08_199-221.qxd 8/18/11 12:36 PM Page 199

Tab 8: Outdoor Survival Skills

Whether you're spending a weekend in the wilderness, taking a long car trip, or even hiking for an afternoon on your favorite trail, you may suddenly find yourself in danger, especially if you become lost, stranded, or injured. This tab will teach you the six basic survival skills you need to get home safely: fire, shelter, signaling, water, food, and first aid. Also included here are discussions of navigational systems, search and rescue, and encounters with wild animals. Let's begin by reviewing the safety measures you should take before setting out.

PLAN AHEAD

A quick rescue actually begins before you get lost, stranded, or injured. The first step is the precautions you take before you leave home, camp, or your vehicle.

- **Dress for the weather and expect the unexpected.** Pack a lightweight rain suit. It may even come in handy on a dry day as a windbreaker.
- **Don't forget a hat.** In cold weather, you can lose as much as 75% of your body heat through your uncovered head. On a hot day, a hat protects you against the sun's rays.
- **Dress in layers.** You can remove clothing as the temperature warms up and put on a jacket or hat as you slow your pace or the temperature drops.
- **Study maps and know the territory.** Pack your map in a waterproof plastic bag.
- Pack a compass or global positioning system (GPS) in your gear. Know how to use the equipment.
- Listen to the local weather report before every outing.
- **File a trip plan with a responsible person.**
- Pack a survival knife, a first aid kit, and a survival kit.
- Include supplies for any pets you may have with you. Pets will need fresh food and drinking water.

2182_Tab08_199-221.qxd 8/18/11 12:36 PM Page 200

- You may be required to keep your dog on a leash in many recreational areas.
- Carry a cell phone or two-way radio with freshly charged batteries.
- Remember that children are more susceptible to environmental factors such as cold, heat, and the sun's rays.
- Small children tend to explore their environments with hands and feet. Make sure they are safe from potential hazards.

SAMPLE TRIP PLAN

Name: _____
Address: _____
Emergency Contact and Phone Number: _____
Description and location of destination: _____
_____
Reason for trip: _____
Mode of transportation: _____
Departure time and date: _____
Return time and date: _____
Name of others with you (include any pets): _____
_____
_____

SAFETY TIP—If you're departing from a vehicle, be sure to park the vehicle where it can be easily found. Leave your trip plan in a plastic bag under the windshield wiper, regardless of how short the trip is. This will give authorities a starting point for the search if you don't return on schedule.

BASIC SURVIVAL SKILLS

One of the most important survival skills is also one of the simplest: DO NOT PANIC. If you find yourself lost or stranded, stop what you're

2182_Tab08_199-221.qxd 8/18/11 12:36 PM Page 201

doing and find a place to sit. Breathe slowly and deeply to help you stay calm and think more clearly. Plan to stay put until help arrives, and begin to focus on the six basic survival skills (fire, shelter, signaling, water, food, first aid).

SAFETY TIP—Most people are found within 72 hours after they are reported missing. However, even within this time frame, a basic knowledge of survival skills is essential. Otherwise, an emergency can end in tragedy.

FIRE

Knowing how to build a fire is the best survival skill you can have. Fire provides warmth, light, and comfort. It can purify water, cook food, signal rescuers, dry clothing, drive away pests, and keep predators at a distance. Even if you don't have adequate clothing, a good fire can help you survive the coldest of environments. When venturing into the outdoors, you should always bring at least two, and preferably three, ways of making a fire. Carry one on your person and the other with your gear.

How to Start a Fire

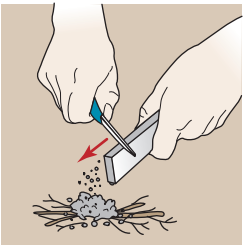
Several types of fire-making gear can maximize your ability to build and maintain a fire should the need arise:

- **Waterproof matches:** Keep these in a weather-tight plastic match safe. Matches have a short shelf life, so replace them about every 6 months.
- **Butane lighter**
- **Prepackaged fire starters**
- **Survival knife and flint**
- **Survival knife and magnesium fire starter**

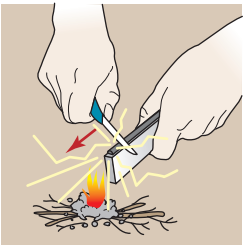
A **magnesium fire starter** consists of a small block of lightweight magnesium with a full-length flint attached to one side. To start a fire,

2182_Tab08_199-221.qxd 8/18/11 12:36 PM Page 202

scrape some of the soft magnesium into a small pile of tinder. Then strike your survival knife (the back of a locked knife blade) along the flint to create a shower of sparks; these will ignite the pile into a white-hot flame of 5400°F (2982°C). The advantage of a magnesium fire starter is the high temperature of the flame, which burns so hot that it can ignite damp wood.



Scrape magnesium on the tinder.



Ignite the fire.

SAFETY TIP—Know how to start a fire even in wet conditions. Building a fire in a survival situation is more difficult than most people think. Master the skill of fire making before you actually need it.

Steps to Building a Fire

A roaring fire requires five things:

1. **Oxygen source:** Burning is nothing more than rapid oxidation.
2. **Heat source:** Examples include matches, lighter, flint, a prepackaged fire starter, and a magnesium fire starter.
3. **Tinder to catch the flame and start the fire:** An abandoned bird's nest, bark from a birch or cedar tree, thistledown, or dry grass can be used.

2182_Tab08_199-221.qxd 8/18/11 12:36 PM Page 203

4. **Small sticks and twigs:** These catch the fire from the tinder.
5. **Dry, dead fuel wood:** In wet weather, look on the lower limbs of evergreen trees, or split wet logs down to their dry interiors. Collect the amount of firewood you think you'll need for the night. Then collect the same amount again: experience has shown most people underestimate by half the amount of firewood they need.

SAFETY TIP—When starting a fire, avoid adding large pieces of wood too quickly. Don't pile on so much wood that the flame gets too little oxygen to burn. Make sure you have enough tinder and wood gathered in advance before starting the fire.

Star fire.

Pyramid, or log-cabin, fire.

Once you have a roaring fire, conserve fuel by making a **star fire.** Using large logs if you can, place only their ends in the fire, and arrange the ends of the logs to meet so they form a star (see figure for star fire). Push the logs inward as more fuel is needed. You can also build a **pyramid fire, or log-cabin fire,** which will burn downward and require less attention at night.

An emergency space blanket placed against the back wall of a shelter makes a good reflector. To keep warm, sit between the fire and the reflecting wall.

SHELTER

Anything that reduces or increases your overall body temperature can be your enemy. Shelter protects your body from the elements: heat, cold, rain, snow, sun, and wind. Shelter also protects you from swarms of insects and other creatures that can irritate or harm you.

SAFETY TIP—Practice building a survival shelter. Experiment with different materials and survival scenarios. Should the need arise, you'll be glad you did.

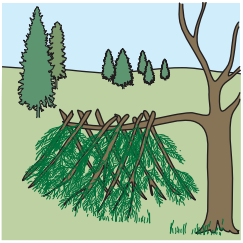
Basic Shelter Guidelines

- Clothing is your body's most fundamental shelter. Choose your clothing wisely, and consider the environment you're planning to enter. Dressing in layers will maximize your ability to adapt to changing conditions. Layers trap air and are warmer than one thick garment. Try to keep the layer closest to your body dry.
- Don't expend energy by making a shelter if nature provides one. Look for a cave, rocky crevice, large tree with low-hanging limbs, or a clump of bushes.
- Build a lean-to shelter. Gather fallen tree limbs. Lean them against a rock, top edge of an overhang, or fallen tree. Cover the leaning limbs with leaves, pine needles, or small tree branches and grass.
- Pack a lightweight tube tent for easy transportation and assembly. Insulate it with an emergency space blanket or tarpaulin to prevent dampness and hypothermia, or with dry leaves, dry grasses, or pine needles. You can also wrap yourself in a blanket or tarpaulin in a sitting or squatting position to concentrate your body's core heat.

2182_Tab08_199-221.qxd 8/18/11 12:36 PM Page 205

- If you are sheltering with a friend or your dog, stay in close contact to keep each other warm.
- If you are stranded with a vehicle, plane, boat, snowmobile, or canoe, try to use the craft as a shelter.
- Adequate sleep is important to help you make sound decisions. The need for rest becomes more critical as time passes and rescue is delayed. Rest contributes to mental and physical health, and adequate shelter contributes to sound rest.
- When sleeping with your clothes on, keep everything loose, including boots. The better circulation you have, the more warmly you will sleep. Loose clothing also permits moisture to evaporate.

Tube tent.



Lean-to shelter.

SAFETY TIP—The secret to shelter construction is simple. Use whatever is available to protect yourself from the elements. Construct a shelter that uses the least amount of energy to build and, if possible, set it up where it can be seen.

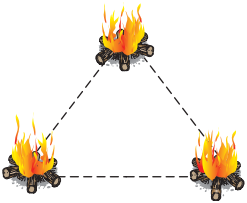
SIGNALING

Signaling is the use of any means available to alert all potential rescuers that you are in need of help. Fire and smoke, flashing light, brightly

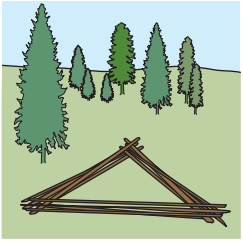
colored markers or clothing, flags, reflective mirrors, and whistles can all help a rescuer spot you. Your ingenuity in devising a signal could very well save your life. Most search and rescue parties use aircraft as a primary method of sighting.

SAFETY TIP—Three of anything is considered a universal signal for help: three gunshots, three blows on a whistle, three sticks in the shape of a triangle.

- **Three fires in a triangle are a recognized distress signal.** At night a bright fire in an open area can be seen for miles from the air and a fair distance from the ground, especially in mountains.
- Lay out a ground-to-air signal in an open field. **For example, a triangle means distress and is the universal signal for help.** It can be formed from rocks, logs, or colored clothing—whatever will show up against the background. Its lines should be 3 ft (1 m) wide and 18 ft (5.5 m) long to be seen by search aircraft. Dark tree limbs on snow or light-colored rocks on dark soil are proven examples of a ground-to-air signal.



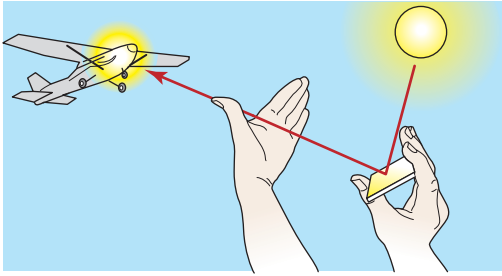
Three fires in triangular form.



Universal signal for help.

2182_Tab08_199-221.qxd 8/18/11 12:36 PM Page 207

- **Make a smoky fire** by piling wet leaves or green vegetation over the fire during the day. Smoke is an excellent signal to use during the day.
- Use an **emergency strobe light** to signal at night.
- **Blow on a whistle.** A loud whistle requires little energy, can be heard much further than the human voice, and is easily heard by tracking dogs.
- **Use a signal mirror when you can see a plane or people in the distance.** A commercially made emergency signal mirror is small and easy to carry. If you forgot to pack one in your survival kit, you can improvise and use the rear-view mirror of your vehicle, a shiny CD or DVD, a pocket/purse mirror, or even metal from cans or aluminum foil. Using the hand method, stretch out your hand and center the object you want to signal, such as an airplane, between the "V" made by your thumb and fingers. Position the mirror with your other hand so that the sunlight is directed off your mirror going through the "V." When you aim it correctly, the brilliant flash of light can't be ignored. It can attract the attention of rangers in a forest tower or searchers miles away in the air, on a mountainside, or in a desert.



Signal mirror: hand method using pocket mirror.

SAFETY TIP—Carry two methods of signaling besides a cell phone or two-way radio. Electronic devices don't always function even in ideal conditions. In rugged rural and mountainous areas, reception may be spotty or nonexistent. Other threats to outdoor electronic devices include damage and dead batteries.

WATER

When you're lost or stranded, clean, drinkable water is often the most important consideration in your survival. People have survived without food for weeks or even months, but you can live only up to 3 days without water. Depending on your health, going without water for even 1 day could mean desperate trouble. Remember the following:

- Always carry a canteen or other vessel filled with water.
- When planning your trip, always assume that you'll need extra water.
- Carry some plastic zip-lock bags to collect and store water.
- Include in your survival kit a metal pot or aluminum foil, which you can mold into a vessel, for boiling water.
- Never wait until you are out of water to collect it.

SAFETY TIP—Because safe drinking water has become scarce even in the most remote wilderness areas, it's a good idea to treat all water before drinking.

How Much Water Do You Need?

Water is by far the most important nutrient for the human body. Approximately 75% of the body consists of water, and the intake and output of liquids are necessary to keep our vital organs functioning normally. If you're having trouble finding potable water in a survival situation, you'll soon start wondering how long you can survive without it.

2182_Tab08_199-221.qxd 8/18/11 12:36 PM Page 209

- To maintain a high level of health in ideal environments, a minimum of 2 quarts (2 liters) of clean water per day per person is the generally accepted guideline.
- In general, your water consumption needs will increase with the temperature, in cold or very dry environments, or if you are physically active. In such situations, you may need more than a gallon (4 liters) of water per day to stay healthy.
- You need to replace water lost through perspiration and respiration, so if you are engaged in hiking or another vigorous activity and are sweating and breathing hard, you need to drink more water to stay healthy.
- You need water to process your food. Foods that are salty or high in protein increase your need for water.

SAFETY TIP—Very cold environments can be as dry as the desert. This is because cold air cannot hold much moisture. Cold, dry air not only dehydrates your body with every breath you take, but also robs your body of moisture via exposed skin. This is one reason your lips may be prone to chapping in cold weather. Because you won't sweat nearly as much in cold, dry air as you would in hot, dry air, you can become severely dehydrated without even realizing the danger you're in.

SAFETY TIP—Wind can also affect the amount of water you need to take in. A dry wind on exposed flesh can virtually suck the water right out of your skin.

What Water Is Safe to Drink?

In a survival situation, the water from a pond, lake, river, or stream may be the only water available. Never drink untreated water from such a source because it may contain harmful microorganisms such as bacteria,

viruses, and parasites like *Giardia*. Ingesting these microorganisms can make you very sick. Symptoms from drinking contaminated water may include nausea, diarrhea, fatigue, and stomach cramps and can begin within 2 to 7 days from the time of ingestion. People with significantly weakened immune systems are likely to have more severe and persistent symptoms than are healthy individuals.

The best way to ensure safe drinking water is to carry enough with you. However, in a survival situation lasting several days, when your bottled water runs out, you can collect, filter, and treat water from natural sources to make it safe to drink.

Step 1: Collect the Water

It's easiest to collect water from ponds, lakes, rivers, or streams. However, in a survival situation, if you are not near such sources, you can collect water by the following means:

- **Snow:** Snow is 17 parts air and 1 part water. If you melt snow by heating, put in a little at a time and compress it, or the pot will burn.
- **Ice:** If available, melt ice rather than snow. You get more water for the volume with less heat and time.
- **Rain:** If it rains, you can funnel runoff into your plastic zip bag. Use a rain suit or emergency space blanket to catch rain by digging a hole in the ground and lining it with the suit or blanket. Before using this method, make sure you'll stay dry in your shelter.
- **Dew:** Dew can be collected off plant leaves, vehicles, tube tents, and other surfaces with a cloth and squeezed into a container. Some dew will collect on the underside of a piece of plastic spread on the ground during the night.

SAFETY TIP—Do not try to eat snow or ice. Not only does it lower your body temperature, but it causes the mucous membranes of your mouth to become swollen and raw. The inflammation may become painful enough to prevent eating or drinking until it subsides. Dogs eat snow and get away with it; humans cannot.

2182_Tab08_199-221.qxd 8/18/11 12:36 PM Page 211

Step 2: Filter the Water

If the water you collect isn't clear, the first step is to get the sediment out. You can filter water through a clean handkerchief or similar fabric. Let the filtered water stand until any remaining sediment has settled to the bottom. Then pour the water into the container in which you plan to treat it.

Step 3: Treat the Water

Different methods are available to make water safer to drink. These include boiling, chemical treatment, filtration, and ultraviolet (UV) light–emitting systems.

Boiling

Boiling water thoroughly will kill all disease-causing microorganisms. Boiling does not remove chemicals, however. A full boil for at least 1 minute is recommended. If the water is heavily polluted, boil it for 10 minutes. Boiling leaves water with a flat taste, so after the water cools, aerate it by pouring it back and forth several times between two clean containers. This will give it back its natural taste. If you don't have a metal pot, you can make a container for boiling water from the aluminum foil in your survival kit.

SAFETY TIP—Water boils at 212°F (100°C). Temperatures above 160°F (70°C) kill all harmful microorganisms within 30 minutes; above 185°F (85°C), within a few minutes. In the time it takes water to reach the boiling point, all microbes will be killed. At high altitudes, it takes longer for water to boil, but once the water reaches a rolling boil and then cools, you can safely drink it.

Chemical Treatment

If boiling is not practical, chemical treatment will kill most harmful microbes. For effective chemical disinfection, the water must be filtered first. Commercial tablets, chlorine, and iodine are most commonly used to treat water. These chemicals are quite effective in protecting

against *Giardia*, but they may be less effective against certain other microorganisms:

- **Purification tablets**. Drug and supply stores carry halazone and other commercial water treatment tablets you can keep in your survival kit. These tablets do an excellent job. Be sure to follow the directions on the bottle. It's important to use the correct dose and waiting period to make sure the water is safe to drink.
- **Chlorine.** Chlorine is another excellent water treatment. To each quart (or liter) of questionable water, add 2 drops of chlorine (5% strength). If the water is cloudy or dirty, add 4 drops. Next, shake the water vigorously and let it sit for 30 minutes. A slight chlorine odor and taste will let you know the water has been properly treated. If not, repeat the dose, and let the water stand for an additional 15 minutes. If you don't know the strength of the chlorine, add 10 drops per quart (or liter) of filtered and settled water. Double the amount of chlorine for cloudy or dirty water.
- **Iodine.** Add 5 drops of 2% iodine tincture to 1 quart (or liter) of clear water and 10 drops to cloudy water. Let the water stand for 30 minutes before drinking it. With iodine tablets, follow the manufacturer's directions. The addition of vitamin C to iodine-purified water can neutralize some of the associated bad taste. Note: Pregnant women should not use iodine drops to purify water because it could affect the fetus. Prolonged use of iodine can cause thyroid problems, so you should not use it to disinfect water over long periods of time.

★ **SAFETY TIP—The effectiveness of chemical disinfectants such as water purification tablets, chlorine, or iodine depends on the concentration of the chemical, how contaminated the water is, the water temperature, the amount of suspended particles, and the duration of the treatment.**

2182_Tab08_199-221.qxd 8/18/11 12:36 PM Page 213

Filtration

The best water filters for individual use are often designed for hikers, kayakers, and other outdoor enthusiasts. Small, lightweight, and easy to operate, they filter out *Giardia* and other harmful microorganisms and fit into a survival kit easily. Because filters work by physically trapping infectious agents, the smaller creatures may slip through the pores of the filtering mechanism. Viruses are a special problem because they're exceedingly small: many portable water filters are unable to trap them.

Ultraviolet (UV) Light–Emitting Devices

These handheld, portable devices can effectively purify water against parasites, bacteria, and viruses. They use ultraviolet light to purify water so there is no chemical taste, odor, or risky side-effects. They work rapidly, requiring about 1 minute to purify 1 quart or liter of water. They are small, lightweight, and convenient for trips where weight and space are important considerations. Universal, portable, ultraviolet water purifying products made by SteriPEN (www.steripen.com) are the perfect tools to ensure your family has safe drinking water anywhere.

SteriPEN, a type of UV device.

SteriPEN purifies river water.

2182_Tab08_199-221.qxd 8/18/11 12:36 PM Page 214

Outdoor use of SteriPEN.

SAFETY TIP—Anytime you treat water in a canteen, jug, or other type of container, be sure to rinse the cap, spout, screw threads, and lid with some of the treated water. You shouldn't overlook any surface that may come in contact with either your mouth or the drinking water.

MYTH BUSTER

"I need to disinfect water only for drinking."
False: It's important to use disinfected water for anything that will enter your body. Don't wash your food or your cooking and eating utensils with contaminated water. Don't brush your teeth with it either—you will certainly introduce disease-causing organisms into your body. Avoid getting untreated water on any wounds or areas of open skin.

2182_Tab08_199-221.qxd 8/18/11 12:36 PM Page 215

FOOD

Although food is not as immediately critical as water, missing even just a few meals can cause

- Irritability
- Low morale
- Lethargy (physical weakness)
- Confusion, disorientation, and poor judgment
- Weakened immune system
- Inability to maintain body temperature that can lead to hypothermia, heat exhaustion, or even heatstroke

These symptoms can shorten your odds of survival as weakness, sickness, accidents, and mistakes take their toll. When you are well fed, you are better able to take on the challenges that may arise in your situation.

What to Include in Your Survival Food Supply

Several considerations go into creating your survival food supply:

- **Storability:** Food may be stored for long periods and must still be edible when you need it.
- **Nutrition:** Food must supply enough vitamins, minerals, fats, carbohydrates, and protein to sustain life.
- **Expense:** Buying freeze-dried meals can get expensive and exceed what you and your family can afford.
- **Food rotation:** Food items must be rotated in your survival kit to keep them from going out of date.
- **Edibility:** You're far better off if your survival food kit contains foods you eat normally. During a survival situation, it's a bad idea to stress your body further by consuming foods you aren't used to or don't like.
- **Ease of preparation:** In an emergency, you may need to prepare your food outdoors over an open fire. Some of the following are among the best survival foods for your kits:

- White or brown rice
- Protein or energy bars
- Dry cereal
- Trail mix (nuts, dried fruit, seeds)
- Dried beans—get the multiple-bean mix if possible
- Powdered milk
- All-purpose flour
- Canned fish—tuna, salmon, or other fish
- Canned vegetables including spinach, pumpkin, and carrots
- Olive oil or vegetable shortening
- Honey or sugar
- Iodized salt
- Multivitamins
- Spices according to your taste

Beans and brown rice together form a complete protein. That makes them as good as meat, yet they are much easier to store for long periods without spoilage. Canned fish and powdered milk are also good protein sources.

How to Store Your Food Supply Safely

Store food safely, especially if bears are in the area. Bears are always looking for something to eat. In bear country, follow these tips:

- Cook away from your tent.
- Store all food away from your campsite. Hang it from tree branches out of the bears' reach if possible.
- If no trees are available, store your food in airtight, locked, or specially designed bear-proof containers (in some locations, these "barrels" may be required by the National Park Service for backcountry travel).
- Remember, pets and their food may also attract bears.

2182_Tab08_199-221.qxd 8/18/11 12:36 PM Page 217

SAFETY TIP—People can live for weeks without eating. Avoid the temptation to eat wild foods such as insects, plants, and especially mushrooms unless you are well trained in identification of wild foods.

FIRST AID AND SURVIVAL KIT

First aid and survival kits are discussed on pages 8–13. Re-analyze your needs before every trip, create a medical checklist, and carry a small personal first aid kit with you at all times. Most survival situations require only bandaging for small cuts, care for bruises, and personal medication needs. Include added protection against biting insects such as mosquitoes, ticks, and chiggers. Make sure you know what you have with you and how to use it. Also, include a portable survival kit with the necessary equipment, water, and food to help you survive in an emergency.

NAVIGATIONAL SYSTEMS

- **Map:** Maps are essential for hiking, biking, and driving routes. Topographical maps come in handy in unfamiliar terrain.
- **Compass:** A compass will help orient you to the direction and route you are traveling. It does take some knowledge to use one, so plan ahead and make sure you understand how it works.
- **Global positioning system (GPS):** A GPS gives you the exact longitude and latitude of your position. It's also battery dependent and can be dropped or broken, so you should take a compass along as well.

SEARCH AND RESCUE

Modern search and rescue efforts begin as soon as you are reported missing to local authorities. Survival situations vary: you may be stranded during a day hike or extended outing, have your vehicle run off the side of a road, be caught in an avalanche, or be surrounded by floodwaters, to mention only a few. Most search teams estimate how

long the missing person can survive under present conditions and then search three times that long, if necessary. Search efforts go far beyond reasonable expectations, so don't give up hope.

Your preparation will determine how fast the search begins. Good preparation gets you rescued more quickly. Take the proper precautions in filing a trip plan with a responsible person (see page 200). Make sure you have the proper equipment and clothing for your planned trip. See pages 8–13 to make sure you have proper first aid and survival kits.

Rescuers need detailed information on the missing person. Name and address, physical description, clothing, boot or shoe type (important to trackers), age, equipment, medical conditions including medications, experience in the outdoors, physical condition, and personality traits—all this information helps experienced searchers locate someone who is lost or stranded.

ENCOUNTERS WITH WILD ANIMALS

Whether you hike, mountain bike, float down rivers, or ride horses, you must take precautions to make the journey safer for you, your companions, and wildlife. Before your outing, get to know about the wildlife you could encounter. **Remember, all wildlife can be dangerous. Do not approach or feed wild animals, especially bears.** Look for warning signs in parks that indicate sightings of a certain animal, such as a bear or mountain lion.

Many people mistakenly believe that wild animals make specific gestures and warning signals that give people time to retreat to safety. Wild animals are individualistic and unpredictable. Animals that ignore you, look calm, or appear friendly may charge or strike out suddenly and without warning. Human injury often occurs when any animal responds to a perceived threat with instinctive "fight-or-flight" behavior. People are injured simply because they're too close and get in the animal's way. A car horn, barking dog, or excited child can trigger an animal into fight-or-flight behavior.

2182_Tab08_199-221.qxd 8/18/11 12:36 PM Page 219

Bears

Follow Park Guidelines

- Don't camp along bear trails. Signs such as tracks, droppings, or a prey carcass are reliable indicators that a bear is in the vicinity.
- Use proper food storage to keep human or pet food unavailable to bears. Don't store food in vehicles or tents. Use park-provided, bear-proof storage lockers, or hang food from high tree branches.
- Handle food wastes properly. Never leave litter around your campsite, and don't bury garbage or food or pour it into the ground at a campsite.
- Avoid sloppy camping. A sloppy campsite attracts bears to your own and other people's camps. After you're gone, the bear may return to look for food in other campsites.

Personal Safety

- Never hike alone in bear country**.** This quiet activity makes it easy to surprise bears.
- Hike a trail with a group. Make sure your group is making noise and is watchful. Bears hear you coming and get out of your way. A bear is more likely to make contact with one person than with a group.
- Do not approach a bear if you see one. Be calm and move slowly away from the bear. Do not run away as this often triggers the bear's instinct to chase. Tell a park official where and when you saw the bear.
- Never approach a cub. A sow (mother bear) will overcome all fear of you to protect her cub. You may not see her, but chances are she isn't far away.

Mountain Lions

Follow Park Guidelines

- Be aware of park warnings. Signs may be posted stating that you're entering a mountain lion habitat.
- Stay on trails, stay aware of your surroundings, and make noise.
- Keep children close to you at all times, and keep pets on a leash.
- Hike only during daylight hours.

Personal Safety

- Never hike alone in a mountain lion habitat. This quiet activity makes it easy to surprise a mountain lion.
- Hike a trail with a group. Make sure your group is making noise and is watchful. Mountain lions hear you coming and get out of your way. A mountain lion is more likely to make contact with one person than with a group.
- If you encounter a mountain lion: Face the lion, back away slowly, do not run or crouch, and try to appear larger (stand tall with your hands above your head). Talk calmly but firmly to the animal. Keep children close to you and pick them up without bending. Try not to look the animal in the eye; this gesture is seen as a challenge.
- If the mountain lion becomes aggressive: Yell and throw anything you can without having to crouch. Fight back if attacked and stay on your feet.

Other Animals

It's possible to encounter just about any type of animal native to the region where you are hiking or camping. Most animals are not aggressive and will retreat quickly. For information about encounters with snakes and scorpions, see Tab 6: Poisons, Bites, and Stings. The following boxes describe some common myths and misperceptions about animal encounters.

MYTH BUSTER

"If you see a raccoon during the day, it must be rabid." **False:** Raccoons are opportunistic and will appear whenever food is around. Although they are normally nocturnal, it's not uncommon to see them during the day when pet food is outside. However, if the animal is circling or staggering, or otherwise acting disoriented or sick, contact a local animal control officer.

2182_Tab08_199-221.qxd 8/18/11 12:36 PM Page 221

MYTH BUSTER

"If you get close to a skunk you'll get sprayed." **False:** It's actually pretty unusual for a person to get sprayed by a skunk. These animals only spray to defend themselves, as when a dog runs up and grabs them. Unless threatened, they will stamp their front feet as a warning to get you to back off.

MYTH BUSTER

"*Bats get tangled up in your hair if they fly near you.*" **False:** The last place a bat wants to be is in your hair. Bats navigate using a complex sonar-like system called echolocation, which allows them to "see" their world with precision. The misconception about bats flying into hair is based on their swooping flight patterns when they are trapped in a confined space such as a house. The reason they swoop is not to fly into your hair, but to stay airborne.

MYTH BUSTER

"*Opossums are vicious and rabid.*" **False:** Opossums are highly resistant to rabies, most likely because of their low body temperature. Opossums are also relatively benign creatures that defend themselves by hissing, teeth-baring, and drooling. These are not signs of rabies, but rather a bluff to scare off potential predators. When their act doesn't work, they play dead.

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2182_Index_224-237.qxd 8/18/11 12:37 PM Page 224

Index

Note: Page numbers followed by f refer to figures/illustrations.

ABC fire extinguisher, 172–173, 173f
Abdomen, disorders of, 53–56
  blow (blunt trauma) to, 77–78
  deep open wounds to, 78
  injuries to, 77–78
  pain in, 53–54
  thrusts to, and management of
    choking, 31, 31f
    in alert child or adult, 31, 31f
    in alert dog or cat (puppies and kittens), 46, 46f, 47, 47f
Abrasions, 99
Acclimatization, 105, 106
Action plan (disaster action plan), 155–156
Acute mountain sickness, 107
AED (automated external defibrillator), 20, 36–39, 37f–39f
Aftershocks, earthquakes and, 188
Airway, assessment of, in injured person, 75
  obstruction of. *See* Choking.
  in injuries and wounds, 75
  in medical emergencies, 52
  opening of, in CPR, 18, 18f
    for child or infant, 25, 25f, 28, 28f
    for dog or cat, 41, 41f
    for unconscious person, 22, 22f, 25, 25f, 28, 28f
Alcohol, myths regarding warming effects of, 109
Allergies, 56–58
  allergic reactions, 56–57
  anaphylaxis, 57–58
Allergy kit, 58, 139
Alternative heating sources, precautions applicable to, 178
Altitude sickness, 105–108
  acute mountain sickness, 107
  high altitude cerebral edema, 107–108
Amebic dysentery, 55
Amputation, traumatic, 99
Anaphylaxis, 57–58
Anemones, 145, 145f
  stings by, 145
Angina (chest pain), 66–67
Animal(s), bites by, 79–80
  care of, disaster preparedness and, 158–160
  choking in, management of, 45–50
  CPR for, 40–45
  encounters with, 218–221
  foods and substances toxic to, 133, 134
  heartworm transmission in, 138
  heat illness in, 118–119
  marine, 145, 145f, 146f
    stings by, 145–146
  microchip implantation in, 160
  safety/supply kit for, 14–15, 157

2182_Index_224-237.qxd 8/18/11 12:37 PM Page 225

tick bites in, 141–142
wild, encounters with, 218–221
Animal Poison Control Center, 135
Antibacterial wipes/gels, 5
Antifreeze, toxicity of, 132
Ants (fire ants), 137
bites and stings by, 137
Appendicitis, 54
Arachnids, 139–144
bites or stings by, 139–144
Arterial bleeding, 81–82
Arterial gas embolism, 128
Assessment, 51–53
of injuries and wounds, 75–77
of medical emergencies, 51–53
of pain, 53, 77
Aspirin, administration of, in heart attack victim, 67
problems with use of, in children, 66
Asthma, 68
Automated external defibrillator (AED), 20, 36–39, 37f–39f
Avalanches, 193–195

Bacillary dysentery, 55
Back, injuries to, 78–79
pain in, 78–79
slaps on, in management of choking, 34, 34f, 35
Backcountry travel, equipment for, 193
Bandages, in first aid kit, 8–9
Barbs, fishhook, injuries from, 100–102, 101f, 102f
Bats, myths regarding, 221
Beacon transceiver, in avalanche setting, 193
Bears, encounters with, 219
Bees, 136, 136f
first aid for, 138–139
stings by, 136
"Bends," 127–128
Birth, emergency, 58–62, 59f–61f
Bite(s), animal, 79–80
arachnid, 139–144
human, 79–80
insect, 135–139
snake, 147, 149–150
Black eye, 91–92
Black flies, 137
bites by, 137
first aid for, 138–139
Black widow spiders, 142, 142f, 143
bites by, 142, 143
Bleeding, 80–82
brain as site of, 73, 94
direct pressure controlling, 81, 82f
dressings for, 81–82, 82f
elevation for, 81
external, 80–82
internal, 98–99
nosebleed, 95–96
management of, 81–82
pressure dressing controlling, 81, 82f
tooth, 97
Blindness, snow, 115
Blisters, 82–83, 83f
prevention of, 84
Blood sugar testing, 64
Body temperature, hypothermia and responses indicating, 114
Boiling, of water, 211

Bone(s), dislocations of, 94
fractures of, 89, 92–94, 92f, 95
Brain, bleeding in, 73, 94
edema of, altitude sickness and, 107–108
Breathing, in assessment of injured person, 75
in injuries and wounds, 75
in medical emergencies, 52
in CPR, 18–20, 19f, 20f
for child or infant, 26, 26f, 29, 29f
for dog or cat, 42, 42f
for unconscious person, 23, 23f, 26, 26f, 29, 29f
in management of choking, 32, 33, 36
in dog or cat, 49, 50
Brown recluse spiders, 142, 142f, 143
bites by, 142, 143
Bruises (contusions), 98
Building fires, 171–179
Bullet wounds, 99–100
Burns, 84–88, 84f, 85f
chemical, 87
depth of, 84–86
first-degree, 85, 85f
second-degree, 86, 85f
third-degree, 86, 85f
electrical, 88
lightening and, 116
nosebleed, 95–96
scald, 87
sun exposure and, 116

Caffeine consumption, and dehydration, 62
Campfires, dangers of, 86
Capillary bleeding, 81
Carbon monoxide poisoning, 68–69
carbon monoxide sensor, 69
Cardiopulmonary resuscitation (CPR), 16–29, 40–45
AED in, 20, 36–39, 37f–39f
airway opening in, 18, 18f
for unconscious adult, 22, 22f
for unconscious child, 25, 25f
for unconscious infant, 28, 28f
for unconscious dog or cat, 41, 41f
for unconscious person, 22, 22f, 25, 25f, 28, 28f
breathing in, 18–20, 19f, 20f
CPR face mask, 19, 19f
CPR face shield, 20, 20f
mouth to mouth, 19, 19f
for unconscious adult, 23, 23f
for unconscious child, 26, 26f
for unconscious infant, 29, 29f
for unconscious dog or cat, 41, 41f, 42, 42f
for unconscious person, 23, 23f, 26, 26f, 29, 29f
chest compressions in, 17, 17f
for unconscious adult, 23, 23f
for unconscious child, 25, 25f
for unconscious infant, 28, 28f
for unconscious dog or cat, 44, 44f
for unconscious puppies or kittens, 43, 43f
for unconscious person, 23, 23f, 25, 25f, 28, 28f

2182_Index_224-237.qxd 8/18/11 12:37 PM Page 227

unconscious adult receiving, 21–23, 21f– 23f
unconscious child receiving, 24–26, 24f–26f
unconscious infant receiving, 27–29, 27f– 29f
unconscious dog or cat receiving, 40–45, 40f–44f
unconscious person receiving, 21–29, 21f–29f
Cat(s), choking in, 45–50, 45f–49f
management of, 45–50, 45f–49f
CPR for, 40–45, 40f–44f
heartworm transmission in, 138
tick bites in, 141–142
toxicity of antifreeze, 132
toxicity of chocolate in, 134
animal poison control, 135
Cerebral bleeding, 73, 94
Cerebral edema, altitude sickness and, 107–108
Cerebral vascular accident (see stroke), 73
Chemical burn, 87
safety, 87
Chemical poisoning, 132–133
Chemical treatment, of water, 211–212
Chest injuries, 88–89
blow (blunt trauma) to, 88–89
deep open wounds, 89
rib fractures, 89
Chest pain, 66–67
Chest thrusts, in management of choking, 34, 34f, 35
Chiggers, 139
bites by, 139–140
Child(ren), avoidance of aspirin use in, 66
birth of, emergency, 58–62, 59f–61f
choking in, 29–36
management of, 30–36, 34f, 36f
CPR for, 24–29, 24f–29f
fever in, 66
hand washing by, 4
poisoning in, 132, 133
Childbirth, emergency, 58–62, 59f–61f
Chimney maintenance, 178
Chip implantation, in pets, 160
Chlorine, in purification of water, 212
Chocolate, toxicity of, in animals, 134
Choking, 29–36, 45–50
management of, 29–36, 30f–36f, 45–50, 45f–49f
in alert adult or child, 29–31, 30f–31f
in alert infant, 33–35, 34f
in alert dog or cat, 45–47, 45f–47f
in unconscious adult or child, 31–33, 32f
in unconscious infant, 35–36, 36f
in unconscious dog or cat, 48–50, 48f–49f
in unconscious person, 31–33, 32f, 35–36, 36f
Circulation, assessment of, in injured person, 75–76
in injuries and wounds, 75–76
in medical emergencies, 52

Closed fracture, 92, 92f
Closed wounds, 98–99
Clothing, protection provided by, 108, 204
Clothing fire, 175, 175f
Cold exposure, effects of, 108–115, 204
    extreme, 195–198, 204
Cold pack (handmade), 97
Collection, of water, 210
Compass, 217
Concussion, 94–95
Congestive heart failure, 68
Contaminated water, 210, 214
Contusions (bruise), 98
Copperhead snakes, 147–149, 148f
    bites by, 149
Coral snakes, 147, 149–150, 150f
    bites by, 147, 150
Corneal abrasion, 91
Cottonmouth snakes, 147–149, 149f
    bites by, 149
Cough, covering your, 71f
CPR. *See* Cardiopulmonary resuscitation (CPR).
Cramps, heat exposure and, 117
Cuts (lacerations), 103

Dam breaks, and flooding, 163
Debris flows, 191
Decompression sickness, 127–128
Deep open wounds, of chest, 89
Defibrillator, automated external, 20, 36–39, 37f–39f
Dehydration, 62
    cold exposure and, 209
Delivery, 60f
    labor and, 58
Dew, collection of, 210
Diabetes, 63–64
Diarrhea, 54–55
    and dehydration, 62
    due to dysentery, 55
    due to food poisoning, 131–132
Diet, and reduction of heart attack risk, 67
Direct pressure, to control bleeding, 81, 82f
Disability, assessment for, 52,76
    in injuries and wounds, 76
    in medical emergencies, 52
Disasters, 154–198
    preparedness for, 154–160
        action plan in, 155–156
        supply kit in, 13–14, 156–157
    providing assistance to victims of, 157–158
    providing assistance for pets and livestock, 158–159
Disease transmission, prevention of, 3–5
Dislocations (joint), 94
Diving emergencies, 127–128
Dog(s), choking in, 45–50, 45f–49f
        management of, 45–50, 45f–49f
    CPR for, 40–45, 40f–44f
    heartworm transmission in, 138
    heat illness in, 118–119
    tick bites in, 141–142
    toxicity of antifreeze, 132
    toxicity of chocolate in, 134
    animal poison control, 135
Doorway, myths regarding shelter provided by, 187

Dressings, for bleeding, 81–82, 82f
Drinkable water, 208–214
Driving, in earthquake setting, 186
in flood setting, 162–163
speed of, vs. progress of tornado, 170
Drowning, 125–126
Dysentery, 55

Ear(s), pain in, 64, 90
earache, 64
injury in, 89
swimmer's, 64–65
Earthquakes, 183–187, 184f
Edema, of brain and lungs, in altitude sickness, 107–108
Electrical burn, 88
Electrical fire, prevention of, 179
Electrical injury, from lightning, 119–124
Electric shock, 90–91
Embolism, gas, 128
Emergencies, 1–3
airway obstruction and, 29–36. *See also* Choking.
disasters and, 154–198
environmental, 105–128
how to act in, 2
how to recognize, 1–2
injuries and, 75–104
medical, 51–74
outdoor survival techniques of coping with, 199–221
poisoning and related problems causing, 129–153
resuscitation indicated in, 16–29. *See also* Cardiopulmonary resuscitation (CPR).
Emphysema, 69–70
Environment, in assessment of injured person, 52, 76
in injuries and wounds, 76
in medical emergencies, 52
Environmental emergencies, 105–128
Epicenter, of earthquakes, 184
EpiPen, 57, 58, 139
Eruptions, volcanic, 189–191, 190f
Evacuation, from flood site, 162
from hurricane site, 167–168
Exhaustion, heat exposure and, 117
Exits, from building fires, 176f
Exposure, in assessment of injured person, 76
External defibrillator, automated, 20, 36–39, 37f–39f
Extinguishers, fire, 172–173, 173f, 174f
Extreme cold exposure, 195–198, 204
Eye(s), foreign body in, 91
black eye in, 91–92
corneal abrasion in, 91
injuries to, 91–92
light sensitivity of, in snowy or icy environment, 115

Face mask, in CPR, 19, 19f
Face shield, in CPR, 20, 20f
Fainting (syncope), 65
heat exposure and, 117
Faults, earthquake, 184
Feet, blisters or "hot spots" on, 82
effects of immersion on, 115
Fever, 65–66
in children, 66, 73
risk of seizures with, 72–73
Rocky Mountain spotted, 141

Filtering, of water, 211, 213
Fingernail polish, ineffectiveness of, against chiggers, 140
Fire, 171
building of, 201–203, 203f
camp, dangers of, 86
electrical, prevention of, 179
hazarads, 178–179
high-rise building, 176, 177, 176f, 177f
house or building, 171–179
pyramid (log-cabin), 203, 203f
safety, 178–179
signaling with, 206, 206f, 207
star, 203, 203f
stop, drop, and roll, 175
wildfire, 180–183, 180f
wood for, 203, 203f
Fire ants, 137
bites and stings by, 137
Firearms, injuries from, 99–100
Fire extinguishers, 172–173, 173f, 174f
Fire-starter, magnesium, 201–202, 202f
First aid kit, 8–10, 11f, 14–15, 217
First-degree burns, 85, 85f
Fishhooks, injuries from, 100–102, 101f, 102f
Flammable liquids, 7, 86, 178
Flash floods, 161
Floods, 160–164, 161f
hurricanes and, 167
Floodwaters, problems of contact with, 164
Flotation devices, 124
Flu, 70–71
covering your cough, 71f
Flying insects, 135–139
bites or stings by, 135–139
Food, and outdoor survival, 215–217
Food poisoning, 131–132
Foot, blisters or "hot spots" on, 82
effects of immersion on, 115
Foreign body, in eye, 91
in nose, 96
Foreshocks, and earthquakes, 186
Fracture(s), 92–93, 92f
immobilation of, 93
rib, 89
skull, 95
Frostbite, 111–112
Frostnip, 111
Full-thickness burns, 85f, 86
Full-thickness frostbite, 111

Gallstones, 56
Gas embolism, 128
Gasoline, handling of, 7
Gels, antibacterial, 5
Global positioning system (GPS), 217
Gunshot wounds, 99–100

Halazone, in purification of water, 212
Hand method, of signaling with mirror, 207, 207f
Hand washing, 3, 4, 4f–5f, 5
Head injuries, 94–95
bleeding in the brain, 94–95
concussion, 94
skull fracture, 95
Heart, emergencies involving, 66–68

Heart attack, 67
reducing risk for, 67
resuscitation indicated in, 16–29. *See also* Cardiopulmonary resuscitation (CPR).
Heart failure, 68
Heartworm disease, 138
Heating sources, precautions applicable to, 178
Heat-related problems, 116–119
Help, signaling for, 205–208, 206f, 207f
Helmet safety, 5, 95
Hemorrhage. *See* Bleeding.
High-altitude cerebral edema, 107–108
High-altitude pulmonary edema, 108
High-rise building, fire exits from, 176f, 177f
Honeybees, 136, 136f
stings by, 136
Hooks (fishhooks), injuries from, 100–102, 101f, 102f
"Hot spots," 83–84
prevention of, 84
House fires, 171–179
Human bites, 79–80
Hurricanes, 164–168, 164f
categories, 165–166
Hyperglycemia, 64
Hyperventilation, 71
Hypoglycemia, 63–64
Hypothermia, 112–115

Ice, avalanches of, 193–196
melting of, to collect water, 210
problems with eating, 210
Immersion foot (trench foot), 115
Immobilization, in fracture management, 93
Impaled objects, 102–103
Implanted microchips, for pets, 160
Infant(s). *See also* Child(ren).
choking in, 33–36
management of, 33–36, 34f, 36f
CPR for, 27–29, 27f–29f
Influenza, 70–71
covering your cough, 71f
Ingestion, of poison, 130
Inhalation, of poison, 130
of smoke, 72
Injection, of poison, 129–130
Injuries, 75–104
assessment for, 75–77
prevention of, 5–7
Insects, 135–139
bites or stings by, 135–139
Internal bleeding, 98–99
Iodine, in purification of water, 212
Ipecac, recommendations against use of, 133

Jellyfish, 145, 145f
stings by, 145–147

Kittens/cats, CPR for, 40–45, 42f, 43f
heartworm transmission in, 138
management of choking in, 45–50
in alert kittens/cats, 45–47
in unconscious kittens/cats, 48–50
tick bites in, 141–142
toxicity of chocolate in, 134

Labor, 58
and delivery, 60f
Lacerations (cuts), 103
Landslides, 191–193, 191f
Lava flows, 190
Lean-to shelter, 204, 205f
Levee failures, and flooding, 163
Lifejackets, 124
Ligament injuries, 97
Lightning, 120, 120f
injuries from, 119–124
myths regarding, 120, 123, 124
prevention of, 121–123
Log-cabin (pyramid) fire, 203, 203f
Lungs, edema of, altitude sickness and, 108
Lyme disease, 140–141

Magnesium fire-starter, 201–202, 202f
Magnitude, of earthquakes, 185
Maps, 217
Marine animals, 145, 145f, 146f
stings by, 145–147
Mask (face mask), in CPR, 19, 19f
Medical emergencies, 51–74
Medical equipment, in first aid kit, 9
Medications, in first aid kit, 10
Melting, of snow or ice, to collect water, 210
Metal, conductivity of, 123
Microchip implantation, in pets, 160
Mirror, signaling with, 206, 206f, 207
Mosquitoes, 137, 137f
bites by, 137–138
first aid for, 138–139
Mountain lions, encounters with, 219–220
Mountain sickness, 105–108
Mouth seal, in CPR for dog or cat, 42, 42f
Mouth-to-mouth breathing, in CPR, 19, 19f
Mudslides, 191–193, 191f
Muscle injuries, 97

National Poison Control Center, 131
Natural disasters, 154–198
preparedness for, 154–160
action plan in, 155–156
supply kit in, 13–14
providing assistance to victims of, 157–158
Navigational systems, 217
Near-drowning, 125–126
Noise, myths regarding avalanche-triggering effects of, 194
Nose, foreign body in, 96
injuries to, 95–96
nosebleed, 95

Obstructed airway. *See* Choking.
Open fracture, 92, 92f
Opening of airway, in CPR, 18, 18f
for child or infant, 25, 25f, 28, 28f
for dog or cat, 41, 41f
for unconscious person, 22, 22f, 25, 25f, 28, 28f
Open wounds, 99–104
of chest, 89
Opossums, myths regarding, 221
Outdoor survival skills, 199–221
Oven, as source of house fire, 177

2182_Index_224-237.qxd 8/18/11 12:37 PM Page 233

Pain, abdominal, 53–54
assessment of, 53, 77
back, 78–79
chest, 66–67
ear, 64
tooth, 74
Paper wasps, 136, 136f
first aid for, 138–139
stings by, 136
Paralysis, tick bite and, 141
Partial-thickness burns, 85f, 86
Partial-thickness frostbite, 111
PASS mnemonic, in use of fire extinguisher, 173f–174f
Penetrating wounds, 78
abdomen, 78
Pet(s), care of, disaster preparedness and, 158–160
animal poison control, 135
choking in, management of, 45–50
CPR for, 40–45
foods and substances toxic to, 132, 133, 134
heartworm transmission in, 138
heat illness in, 118–119
safety precautions, 119
microchip implantation in, 160
safety/supply kit for, 14–15, 157
tick bites in, 141–142
Phone numbers, emergency, 8
Pit viper snakes, 147, 148f, 149, 149f
bites by, 147, 149
Poisoning, 129–135
animal poison control center, 135
antifreeze, 132
carbon monoxide, 68–69
chemical, 132–133
food-borne, 131–132
national poison control center, 131
plants causing, 150–153, 152f
routes of exposure and absorption in, 129–130
susceptibility of pets to, 134–135
Poison ivy, 151, 152f
first aid for, 153
Poison oak, 151, 152f
first aid for, 153
Poison sumac, 152, 152f
first aid for, 153
Polish (fingernail polish), ineffectiveness of, against chiggers, 140
Positioning, to lower exposure to lightning, 122–123, 123f
Positioning systems, 217
Potable water, 208–214
Pressure dressings, for bleeding, 81, 82f
Probe pole, in locating avalanche victim, 193
Pulmonary edema, altitude sickness and, 108
Puncture wounds, 103–104
Puppies/dogs, CPR for, 40–45, 40f–44f
heartworm transmission in, 138
heat illness in, 118–119
management of choking in, 45f–49f, 45–50
tick bites in, 141–142
toxicity of chocolate in, 134
Purification, of water, 211–214
Pyramid (log-cabin) fire, 203, 203f

Rabies, 80
Raccoons, myths regarding, 220
RACE mnemonic, in fire rescue, 174
Rain, collection of, 210
Rainstorms, 164, 165, 168
lightning injuries from, 119–124
Rattlesnakes, 147–149, 148f
bites by, 149
Recompression treatment, 128
Rehydration drinks, 55
Rescue breathing, in CPR, 18–20, 19f, 20f
for child or infant, 26, 26f, 29, 29f
for dog or cat, 42, 42f
for unconscious person, 23, 23f, 26, 26f, 29, 29f
in management of choking, 32, 33, 36
in dog or cat, 49, 50
Rescue transceiver, in avalanche setting, 193
Respiratory disorders, 68–72
Rest, and sleep, in outdoor survival, 205
Resuscitation, cardiopulmonary, 16–29
components of. *See specifics under* Cardiopulmonary resuscitation (CPR).
Reye's syndrome, 66
Rib fractures, 89
Richter scale, 185
Rocky Mountain spotted fever, 141

Safety, 1–15
keep a safe home, 6–7
threats to. *See specific risks and* Emergencies.
Safety kit, for pets, 14–15
Saffir-Simpson hurricane scale, 166
Scald burn, 87
Scorpions, 144, 144f
stings by, 144
Scrapes, 99
Scuba diving emergencies, 127–128
Sea anemones, 145, 145f
stings by, 145
Search and rescue, 217–218
Seatbelts, 5, 95
Second-degree burns, 85f, 86
Seismic waves, 184
Seizures, 72–73
febrile seizures in children, 73
Shallow water, drowning in, 127
Shelter, and outdoor survival, 204–205, 205f
Shield (face shield), in CPR, 20, 20f
Shock (electric shock), 90–91
Shock (hypovolemic shock), 96
Shovel, need for, in backcountry setting, 193
Signaling, for help, 205–208, 206f, 207f
Skin, 84f
burns of, 84–86, 85f, 116
effects of wind on, 209
poison absorption through, 130
wounds of, 98–104
Ski pole, as probe for locating avalanche victim, 193
Skull fracture, 95
Skunks, myths regarding, 221
Slaps, on back, in management of choking, 34, 34f, 35

2182_Index_224-237.qxd 8/18/11 12:37 PM Page 235

Sleep, and rest, in outdoor survival, 205
Slings, in fracture management, 93, 93f
Smoke, house or building fires and, 177
    inhalation of, 72
Smoke alarms, 172
Smoking, 7, 69, 178–179
Snakes, 147, 148f–150f, 149–150
    bites by, 147, 149–150
Snow, avalanches of, 193–196
    melting of, to collect water, 210
    problems with consuming, 210
Snow blindness, 115
Snow shovel, need for, in backcountry setting, 193
Soap and water, hand washing with, 3, 4, 4f–5f, 5
Spiders, 142, 142f, 143
    bites by, 142, 143
Spinal cord injuries, 79
Splint(s), in fracture management, 93
Splinters, injuries from, 104
Sport's drinks, 55
Spotted fever, Rocky Mountain, 141
Sprains, 97
Stab wounds, 104
Star fire, 203, 203f
SteriPEN purifiers, 213f, 214f
Sting(s), insect, 135–139
    marine animal, 145–147
    scorpion, 144
Stingrays, 145, 146f
    effects of contact with, 145–147
Stitches, 103
Stop-drop-`roll sequence, in extinguishing clothing fire, 175, 175f
Storm(s), 164, 165, 168
    lightning injuries from, 119–124
    winter, 195–198
Storm surge, 165
Storm tide, 165
Strains, 97
Stroke, 73
    reducing risk for, 73
    heat, 118
Sunburn, 116
Superficial burns, 85, 85f
Survival kit, 11–13, 217
Survival skills, outdoor, 199–221
Survival supplies, disaster preparedness and, 13–14, 156–157
Swimmer's ear, 64–65
Swimming, 124, 126
Syncope (fainting), 65
    heat exposure and, 117

Teeth, injuries to, 97–98
    pain in, 74
Temperature, hypothermia and responses indicating, 114
Tendon injuries, 97
Tent, tube, 204, 205f
Tetanus, 104
    prevention of, 104
Third-degree burns, 85f, 86
Threes, signaling in, to indicate distress, 206, 206f
Thrusts, abdominal, in management of choking, 31, 31f
        in dog or cat, 46, 46f, 47, 47f
    chest, in management of choking, 34, 34f, 35

2182_Index_224-237.qxd 8/18/11 12:37 PM Page 236

Thunderstorms, 168
lightning injuries from, 119–124
Ticks, 140, 140f
bites by, 140–142
removal of, 141–142
Tick paralysis, 141
Tooth injuries, 97–98
Tooth pain, 74
Tornadoes, 168–171, 169f
Tourniquets, dangers of, 82
Transceiver beacon, in avalanche setting, 193
Trauma, 75–104
assessment for, 75–77
prevention of, 5–7
Travel, backcountry, equipment for, 193
Trench foot (immersion foot), 115
Triangle signal, 206, 206f
Trip plan, 208
Tropical depression, 165
Tropical storms, 164, 165
Tsunamis, 187–189
Tube tent, 204, 205f

Ultraviolet light-emitting systems, of purifying water, 213, 213f
Unconscious animal, management of choking in, 48–50, 48f, 49f
Unconscious person, CPR in, 21–29, 21f–29f
management of choking in, 31–33, 32f, 35–36, 36f
Underwater hazards, 127–128
Universal signal, for help, 206, 206f
Urushiol, myths regarding, 153
toxicity of, 151

Vaccine, influenza, 71
Vegetation, as fuel for fire, 181
Venous bleeding, 81
Volcanic eruptions, 189–191, 190f
Vomiting, 56
and dehydration, 62
due to food poisoning, 131–132

Washing, of hands, 3, 4, 4f–5f, 5
Wasps, 136, 136f
first aid for, 138–139
stings by, 136, 136f
Watch vs. warning, in flood prediction, 161
in hurricane prediction, 165
in tornado prediction, 169
in tsunami prediction, 188
in winter storm prediction, 196
Water, collection of, 210
contaminated, 210, 214
drinkable, 208–214
drowning, 126–127
emergencies involving, 124–128
filtering of, 211
flood, problems of contact with, 164
hand washing with soap and, 3, 4, 4f–5f, 5
near-drowning, 126–127
problems of rinsing with, at sites of stings, 143
rescue, 125–126
safety, 14
treatment of, to render safe for drinking, 211–214
Water moccasin snakes, 147, 149, 149f
bites by, 149

2182_Index_224-237.qxd 8/18/11 12:37 PM Page 237

Weight, as avalanche trigger, 194
Wild animals, encounters with, 218–221
Wildfires, 180–183, 180f
Wind chill, 109, 110f, 196
Wind effects, on skin, 209
Wind speeds, of hurricanes, 166
of tornadoes, 168
Winter storms, 195–198
Wipes, antibacterial, 5
Wood, for fire, 203, 203f
Wounds, 75–104
care of, first aid kit for, 8–9
chest, 88–89

Yellow-jacket wasps, 136, 136f
first aid for, 138–139
stings by, 136, 136f